“Solara Active Pharma Sciences Limited
Q2 FY2020 Earnings Conference Call”

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Moderator: Ladies and gentlemen good day and welcome to the Solara Active Pharma Sciences Limited Q2 FY2020 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I will now hand the conference over to Mr. Abhishek Singhal. Thank you and over to you.

Abhishek Singhal: Thanks Steven. A very good afternoon to all of you and thank you for joining us today for Solara Active Pharma Sciences earnings conference call for the Q2 and half year ended FY2020. Today we have with us Mr. Jitesh Devendra, Solara's Managing Director and Mr. Hariharan, the CFO to share the highlights of the business and financials for the quarter. I hope you have gone through our results release and the quarterly investor presentation, which have been uploaded on our website as well as the stock exchange website. The transcript of this call will be available in a week's time on the company's website. Please note that today's discussion maybe forward-looking in nature and must be viewed in relation to the risks pertaining to our business. After the end of this call, in case you have any further questions please feel free to reach out to the Investor Relations team. I now hand over the call to Jitesh to open the floor.

Jitesh Devendra: Thanks Abhishek. Good afternoon everyone. We welcome you all to Solara's Q2 FY2020 investor call. I am happy to share that Q2 FY2020 was yet another quarter of consistent performance which resulted in a profitable growth and a steady base for the future. While we had a 4% growth in the revenues year-on-year, our EBITDA grew by over 43% resulting in a fourth successive quarter of greater than 20% operating margins. This performance also led to a two times growth in the PAT, which is now at 289 million. From a business standpoint, a combined growth of base business and new products continue to perform on the expected lines and received traction from the new customers and existing partners alike. We sustained the focus on R&D and filed one additional drug master file for the US market and did market extensions for three of our existing products to four new markets. As we progress, the R&D will remain intensively engaged with the development of APIs on newer technologies and re-engineering the current products with unique process for cost improvement programs which are already contributing well to our operating margins. This collective approach of new product development along with leadership orientation for the existing products places us reasonably well in the growing API opportunity.

Coming to the new lever of our business, the CRAMS domain, while the segment will remain in the incubation stage for a reasonable time, we are happy to have taken new steps towards creating a market place with digital initiatives and leveraging our business relationship with other partners. These strategies have resulted in success as we have had a series of positive customer interactions and progression in the funnel build out thereby indicating of a promising future. Clearly with our relentless efforts, we are hopeful of achieving a commercial breakthrough in the near-term. Now I would like to share a few updates on Ranitidine Hydrochloride NDMA issue which you may already be aware of. Towards the end of the quarter, one of our top 10 products which is a Ranitidine API experienced regulatory headwinds due to US FDA's notification around the NDMA impurity in the product.

While there was no indication on the ban or recall of this specific product by the agency, the company decided to voluntarily suspend our sales and productions for Ranitidine. The US FDA had issued an information request to all the Ranitidine drug substance including to Solara, to conduct some tests to assess the levels of the said impurity. At Solara, we have already conducted these tests and submitted our data to the agency. We are now collaborating with the agency and our customers to understand the next steps as to take our decision around the product supplies to the US as well as to the other regulated markets.

Meanwhile, what we could gather from the publicly available data is that the regulatory agencies outside of US have already started giving indications on the NDMA impurity limits and the initial data about impurity limits seem favorable for our API. Though it may be too early for us to give you a conclusive way forward, but these data points clearly suggest that the Ranitidine disruption is temporary, and we should soon have the global supplies initiated for the product. We would like to update you on the same as we progress and get an official notification. That said, the Ranitidine supply disruption in any case will not impact the prospects of our performance this fiscal. We continue to remain optimistic about meeting our growth outlook and we shall ensure that the strategic execution of our plan is achieved with efficiency. So, thank you all and we are now open for question and answers.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Vaibhav Gogate from Ashmore. Please go ahead.

Ashwini: This is Ashwini. Congratulations pretty good set of numbers given the difficult situation that you faced in Ranitidine for the quarter under review. So straight up first what is the impact of Ranitidine suspension of sales for the quarter that we have declared the numbers for?

Jitesh Devendra: Thanks Ashwini. We suspended the sales of the product in the month of September and overall Ranitidine as a year contributes to 5% of our revenues.

Ashwini: Alright, so this would be a small impact on the revenues and profits for the quarter under review not a significant number?

Jitesh Devendra: Not a significant number Ashwini.

Ashwini: Second question I wanted to ask was that we were just looking at the standalone numbers and the consolidated numbers and looking at the gap between the two, we saw the revenues from the subsidiaries fall significantly from roughly Rs.16 Crores in Q1 to less than a Crore in Q2 and consequently the EBITDA contribution also went down from a positive Rs.3 Crores contribution in Q1 to a negative Rs.5.5 Crores contribution in Q2, what is happening there, can you help us to understand the numbers a little bit?

Jitesh Devendra: Ashwini, when you talk about the subsidiary, it is Ambernath and the US operations, clearly, we were expecting the approvals to come in the early part of Q2. We had already started to do initial commercial supplies, in Q1 and we were hoping to make regular commercial supplies in Q2. Having said that what approval did not come in the early part of Q2 came in the later part of Q2 and now we have the approvals in place. The commercial supplies will be ongoing from this quarter onwards.

Ashwini: Okay perfect, so this is essentially Ambernath where you made some supplies in Q1, which is why you had a positive EBITDA contribution in Q1, but Q2 you had to suspend them because you probably had stocks available with you in the US, but from Q3 and Q4, it will be more normal numbers?

Jitesh Devendra: Absolutely. We have also received those approvals, so we have no concerns around that now.

Ashwini: And given that the Ambernath number should be kicking in, it would be fair for me to assume that outside of Ranitidine because Ranitidine we do not know what happens, H2 would be better than H1 in terms of revenue run rate, would that be a fair assumption?

Jitesh Devendra: That is what we are working on Ashwini. We have opportunities ahead of us and from an EBITDA perspective that is the focus assuming that the Ranitidine also comes back in line and with Ambernath making its commercial supplies that is what even we are targeting.

Ashwini: And in your opening comments, you spoke about your CRAMS effort and you hope that you will see commercial opportunities soon enough. Based on your conversations with

potential clients how far away do you think we are from realizing commercial revenues, six months, a year or would it be shorter I know it is difficult, but some color would really be helpful?

Jitesh Devendra: From H2 of the next financial year FY2021 we should start initiating the work on the R&D as well as on the commercial side. From now to say the next nine months to probably maximum 12 months, there will be audits of the facility. so Why it is positive is because the proposals what we have made out at least we have got feedback for those proposals and it is moving along well. So, from H2 of FY2021 but the bigger impact will come from an annualized basis on FY2022.

Ashwini: Okay alright and my last question is that obviously, you had a very solid Q1 in terms of your gross margins and probably that was a very, very strong number which was not sustainable but a gross margin of around 51% to 52% which you reported in Q2, is this a sustainable number or even this looks a little high from a sustainability perspective for you and what is really driving this movement, is it just raw material, product mix or what is it?

Jitesh Devendra: The raw material as well as on the product mix and as I said we also do a rationalization of the product where if it does not meet the minimum criteria of 50% GM, then we look at either exiting that API or increase the prices, but yes nothing less than 50% Ashwini and we are only looking at growing that number as CRAMS business come in with higher gross margin.

Ashwini: Okay and bulk of the capex has happened in H1 roughly Rs.100-odd Crores that has all gone to is Vizag investment, am I right?

Jitesh Devendra: Rs.70 Crores has gone to Vizag investment and balance Rs.30 Crores has gone to the other units.

Ashwini: Okay and when does the Vizag unit commence production?

Jitesh Devendra: By end of this year.

Ashwini: End of this financial year.

Jitesh Devendra: I mean not commercial production we had to take trials, then the validation will go on and then we must supply those validation quantities to the customer, then file for the US market and European approval. So, the revenues from the Vizag we can expect to generate in the next financial year, probably H2 of the next financial year.

Ashwini: Alright okay perfect. Thank you so much for your comments. I will be on the call and if there are any followup questions, I will come back and all the best.

Moderator: Thank you. The next question is from the line of Aditya Khemka from DSP Mutual Fund. Please go ahead.

Aditya Khemka: Sir if I look at your consolidated cash flow statement, there was a Rs.55 Crore investment in subsidiary under investment activities, could you tell us what is this about for Rs.55 Crore worth of investment in subsidiaries?

Hariharan Subramanian: We acquired Ambernath site from Strides and part payment has been made during the current financial year as per the Share Purchase Agreement and that is the amount which is reflecting in the cash flow statement as payment towards investment in subsidiary Rs. 551 Mn.

Aditya Khemka: So, is this the entire payment for acquiring that or is there more left which would be coming…?

Hariharan Subramanian: Rs.131 Crores is the total consideration and Rs.55.1 Crores paid during this current year, balance has already been paid in the previous financial year.

Aditya Khemka: Okay so now we have done with the payment of Ambernath facility consideration?

Hariharan Subramanian: You are right.

Aditya Khemka: Okay and could you just talk on a little bit about the API supply situation in China and how much is your raw material currently dependent on Chinese imports and what is the pricing situation there which China now, what is the latest update there?

Jitesh Devendra: 30% of our imports are from China and which is basically the case for these various products, but we are not seeing any more supply disruptions at least for the raw materials what we buy and so we are not seeing any of those supply disruptions or increase in the prices. Those are pretty much stable. Our dependence on China as Hari rightly said is 30% of our raw material consumption.

Aditya Khemka: And are we comfortable at that 30% as in do we intend to keep it at 30% or do we intend to take it up around different…?

Jitesh Devendra: We had plans of reducing that also as I mentioned in my previous calls, there are domestic suppliers for one of those key raw materials which we buy, and we will bring down by 30% number on the current base products.

Aditya Khemka: Right so just to understand that better, so if the pricing from China is not very fluctuating and the supply is consistent, what is the need for you to reduce that 30% further down, what is that we are trying to hedge ourselves against?

Jitesh Devendra: Because we have to de-risk from just banking on China, we do not want to have another situation in this year, where again the prices go up and we have not taken those actions. Now that the Indian suppliers are coming up, we would like to qualify them and of course they will achieve the efficiencies of scales, so we believe that even they will give us a pricing advantage to what we buy from China.

Aditya Khemka: Do you think the Indian suppliers can supply at a cheaper rate versus China for some of the raw materials?

Jitesh Devendra: Earlier we used to buy from India and then when the Chinese came in they went in with a very aggressive pricing, so we do believe, and it is not just one, there are three other suppliers which are coming up for these raw materials. So, we believe that…I mean the main thing is one is de-risking from China and second is we are also hoping that on the pricing we will have an advantage on that.

Aditya Khemka: Okay and just on your cash position lastly, so I see incrementally we have built up more cash while we have taken on more current debt, so we took about Rs.155 Crores of debt and we are holding Rs.117 Crores in cash, any reason for having high cash reserves and while paying interest on the debt?

Hariharan Subramanian: No, this cash is towards the receipt for the equity infusion by the promoters and Investor during the last financial year and we are holding this cash to be utilized for the future growth.

Aditya Khemka: So how much is the capital expenditure budget for FY2020?

Hariharan Subramanian: FY2020 for the normal capex, it is around Rs.80 Crores to Rs.100 Crores and for Vizag capital, it is Rs.170 Crores.

Aditya Khemka: So, for the full year of FY2019, you are saying it is about Rs.100 Crores for your capital expenditure budget and excluding Vizag?

Hariharan Subramanian: That is excluding Vizag.

Aditya Khemka: Excluding Vizag, so if you add Vizag to that, then it is Rs.270 Crores,

Hariharan Subramanian: Right.

Aditya Khemka: And just one final question from my side so when we look at fixed asset turnover in your industry. Generally, in the industry, we look at fixed asset turnover as accurate depicter of potential revenue from incremental capex. Given the current sort of cost of putting plant in the current pricing environment in the API segment, do you think the historical gross block turnover or fixed asset turnover, can still be maintained with your incremental capex or do you think your incremental capex cost is higher and therefore the gross block turnover ratio that we need to probably go ahead and forecast would be lower than what you have been able to maintain historically?

Hariharan Subramanian: The average we expect revenue to the asset turns is around 1.4 to 1.5 times.

Aditya Khemka: 1.4 to 1.5 times okay that has answered my questions. Thank you.

Moderator: Thank you. The next question is from the line of Vipul Shah from RW Equity. Please go ahead.

Vipul Shah: I had a question on the tax, so when do we expect the tax rate to normalize for us because whatever we provide as current tax, there is an equivalent deferred tax credit and this has been consistent so I just wanted to know because the PBT and the PAT are at the same level, which at some point when the deferred tax starts to reverse, it can have bigger impact on the PAT? Yes, that was it.

Hariharan Subramanian: Mr. Shah, we explained this to you last time also that Solara, has accumulated IT loss because of the business demerger of the Sequent. With the accumulated loss along with the statutory tax benefit available during the last financial year, there is no full-fledged tax liability and for the current financial year we will be paying the tax under the MAT and taking credit for the same.

Vipul Shah: That is what my question was Sir. When do we expect this to be normalized from whatever reading we read from the annual report, we are not able to estimate when is the normal tax comes,

Hariharan Subramanian: Sir currently we are in the process of filing the income tax return for the last financial year. So once that is completed and after assessment then only we will able to comment about this information.

Vipul Shah: Sir the assessment will happen in two years from now, it will not happen now.

Hariharan Subramanian: As soon we file the return we will be informing sir. As of now this information cannot be provided.

Moderator: Do you have any more questions Mr. Shah?

Vipul Shah: No.

Moderator: The next question is from the line of Ashwini from Ashmore. Please go ahead.

Ashwini: Hari from what I understand the consolidated cash flow, which shows incremental debt of roughly Rs.150 Crores that is really not incremental debt, but actually a reclassification of debt in a manner of speaking because you had cash parked in your working capital, sort of cash credit account because in your presentation your gross debt numbers are quite stable is that understanding correct?

Hariharan Subramanian: Yes, this gross debt number in the presentation in March 2019 we had Rs.686 Crores and in September also it is the same number, but cash what we have received for the equity as well as from the customer advance has been utilized for the capital project and acquisition and now we have Rs.119 Crores of cash in our hand.

Ashwini: And all this cash is accessible in the sense that it is utilizable, there is really nothing that is not…

Hariharan Subramanian: No, it is available in a fixed deposit with the bank.

Ashwini: Okay, Thank you so much.

Moderator: The next question is from the line of Arun Kumar from Atom Capital. Please go ahead.

Arun Kumar: I have one from an industry perspective so from an API industry perspective if we juxtapose India and China on the parameters of let us say technology, power cost and infrastructure in terms of effluent treatment park, zero discharge and environmental clearance and all that where do you think India has got a real sustainable advantage because

this China destruction could well be shortlived worldwide so I am just trying to understand, India as a country got a sustainable advantage now in China and in what parameters?

Jitesh Devendra: The key in the API what we have seen in the last two years where there has been supply disruption and prices going up. The focus of course apart from the compliance from a quality point of view the compliance on the environment standpoint is very important and we have clearly seen that the China is behind India and that is why there are so many shutdowns and that led to the supply disruptions. Of course, now even they must meet all those environmental standards so the factories, which are coming up into production they must invest in like zero liquid discharge, which we have done and the companies in India also are doing that because that is going to be key to sustainable or a continuity of the business.

Arun Kumar: Okay and what about the power cost and the technology because power cost is very cheap in China right and that is a significant proportion of the manufacturing expenses in API?

Jitesh Devendra: What we are seeing right now, and you also would have read, many companies are now focusing on the China market, this year huge opportunity where the companies in China, they probably want to focus more on the finished dosage, buying the API from India. Yes, you are right in terms of the power cost, I do not know what the current situation is but, in the past, there were concessions, which were given to the Chinese companies on the power as well as on the benefits related to export of the products.

Arun Kumar: Right and in terms of technology you believe that Indian companies are in no way inferior in terms of scientific talent and technologies relative to China?

Jitesh Devendra: I would say comparable.

Arun Kumar: Right so based on the infrastructure in terms of the effluent treatment, etc., the Chinese companies were not compliant or fulfilling previously now that the regulations are forcing them and the blue skies policies in the China the government also is forcing them, is it fair to say that the cost of compliance of the Chinese API manufacturers has permanently shifted upward, which means that the Indian companies will remain competitive or they foresee the future?

Jitesh Devendra: Yes, that is one from a pricing point of view the increased cost will drive up the price plus more from a supply continuity perspective we are seeing a lot of opportunities, which are being presented and I am sure the other Indian API companies also are seeing that kind of opportunities and the growth aspects. Companies who have relied on China they either are de-risking with Indian supplies or outsourcing in Europe itself.

Arun Kumar: Sure, sure and one last question on the CRAMS side of new ventures so I have been hearing the plan for that, you believe that the material revenues will only come in FY2022 on a full-year basis. I am just trying to understand that CRAMS is sort of a crowded market if I may say so, so what exactly are you trying to position as a niche within Solara, how do you aim to differentiate yourself because there are many CRAMS companies in Asia alone, Europe and elsewhere?

Jitesh Devendra: Yes this is some business, which is not new domain to us, we have had previous experiences of back in legacy Shasun days and yes, we are selling on reliability, compliance and also we are adding also new technologies in our R&D, which should be an added advantage for the clients so we have done business in the past with pharma companies as well as biotech companies and we are going back to them. The other key thing is when we had done this business this is a service-oriented business and there is lot of IP involved in it, so we never had a breach of confidentiality and we have been very transparent in terms of our communication, so confidentiality is also a big aspect when you talk in the CRAMS business.

Arun Kumar: Yes, sure and just one last on that R&D side, how much do you expect to invest this year and next year and how many scientists or manpower you have in between currently please?

Jitesh Devendra: So both our R&D centers put together both on the synthetic development and the analytical development we have about approximate about 200 people and right now the R&D is focused in terms of the CIP work as well as filing new products and giving the support to the regulatory for extending our current products to new markets, So our spent on the R&D is about Rs.45 Crores and of course on the CRAMS business it is a service business so if the business opportunity really grows then we only have to add people, the rest of it is all paid by the customer, which includes the cost of the people.

Arun Kumar: Sure, understood. Thank you I will call back in the queue. All the best.

Moderator: Thank you. We take the last question which is from the line of Aditya Khemka from DSP Mutual Fund. Please go ahead.

Aditya Khemka: Thanks for taking my followup, just the one on Ranitidine, so what are the next steps now so I mean you have stopped the product given the issue of potential impurity and I am sure you must have already sent your independent lab test data to the regulator then what happens next and what is the timeline?

Jitesh Devendra: Yes, we are waiting to hear back from the FDA in terms of what limits they are going to set, of course we are also following up with the FDA and it is also FDA's top priority because

there is no product in the market with all these suspended supplies of the finished product. I believe we should hear back from the FDA in the next 10 to 14 working days that is what we are hoping for being in touch with the US FDA as well as the other regulatory agencies.

Aditya Khemka: In the meanwhile, if Ranitidine as a molecule is losing share in the US market let us say to Famotidine or the proton pump inhibitors what would your expectation given that FDA gives a clean chit would volumes come back to Ranitidine or would you feel the switch will be more sticky as you have seen in the case of sartans?

Jitesh Devendra: Ranitidine has sold both in the prescription as well as on the OTC side and it is too early for us to comment whether the volumes will be impacted because of this NDMA issue, I mean if you look at the Valsartan I think the volumes are more or less what it was when it was selling out probably there was a marginal drop, but it is too early for us to comment on what the FDA comes back with and the limits and what will be the market share. Given that of course our sales of Ranitidine are to the regulated markets we see an opportunity for growth.

Aditya Khemka: Right but to begin with I thought the level of impurity that FDA was comfortable with was 96 nanograms and from whatever I have been reading in the media at least our products that have been tested under different conditions, LCMS or GCMS I have given variety of results, may be the same product tested in both liquid and gas have given you different output, so what is your take on the issue I mean if the liquid chromatography the right way of looking at it, is gas chromatography the right way of looking at it and why has this issue suddenly cropped up earlier nowadays spoke of Ranitidine is an unsafe for carcinogenic molecule?

Jitesh Devendra: So, the FDA has given us method in terms of how we must test for these impurities and they have also recommended the equipment which we need to use to test, it is the HRMS equipment which is different from the LCMS or the GCMS. Why this issue has cropped up to be honest I do not know what the background of this is, there is lot of theories around it and now that it is come we only focus in terms of how we must resolve and initiate the supplies again.

Aditya Khemka: Sorry last question on this side, any reason for you to believe that you could have an edge with your competitors when it comes to the impurity levels as and your guys have a different process versus the traditional process of manufacturing or it is probably the same for everybody else in the segment?

Jitesh Devendra: For that validation we will wait for the regulatory agency to come back on the samples what we have given and if that is true then at least whatever capacities of Ranitidine we have which we have always been fully utilized we see no issues in terms of going forward as that well, but we will wait for the regulatory agencies to come back on the samples what we have submitted to them.

Aditya Khemka: Yes, I understand but to the best of your knowledge is the manufacturing process that you use like your competitors, different from your competitors?

Jitesh Devendra: I would not want to comment on that.

Aditya Khemka: Okay fair enough. Thank you.

Moderator: Thank you. Ladies and gentlemen, I would now like to hand the conference over to Mr. Jitesh Devendra for closing comments.

Jitesh Devendra: Thank you everyone again for joining our investor call and we look forward to Q3 investor call, by then we should have more updates on Ranitidine as well as the business how it is progressing. So, I again appreciate your time and thanks for joining.

Moderator: Thank you. Ladies and gentlemen, on behalf of Solara Active Pharma Sciences Limited that concludes this conference. Thank you for joining us. You may now disconnect your lines.