Syngene International's Q3 and 9M FY 2017 Conference Call

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Key Participants from Syngene International

- Mr. Jonathan Hunt: Chief Executive Officer
- Dr. Manoj Nerurkar: Chief Operating Officer
- Mr. M.B. Chinappa: Chief Financial Officer
- Ms. Chanderlekha Nayar: Investor Relations Team

Presentation Session

Moderator: Good Day, Ladies and Gentlemen and Welcome to the Q3 FY17 Earnings Conference Call of Syngene International. 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. In case 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 would now like to hand the conference over to Ms. Chanderlekha Nayar. Thank you and over to you, ma'am.

Chanderlekha Nayar: Thank you, Margaret. Good Afternoon, Ladies and Gentlemen. This is Chanderlekha Nayar from Syngene Investor Relations Team and I welcome you to Syngene International Earnings Call for Third Quarter and Nine Months of Fiscal 2017. We have with us today, Mr. Jonathan Hunt – Syngene's Chief Executive Officer and the Senior Management Team to discuss the Company's Performance. Before we proceed with this call, I would like to remind everybody that this call is being recorded and a replay will be available for the next few days immediately after the call. The transcript of this call will be made available in a week's time on the company's website. I would also like to add that today's discussion maybe forward-looking in nature and must be viewed in relation to the risks pertaining to our business. Our Safe Harbor clause indicated in our 'Investor Presentation' also applies to this conference call. After the end of this call, in case you have any further questions, please feel free to reach out to me.

Now, I would like to hand over the call to Mr. Jonathan Hunt. Over to you, sir.

Jonathan Hunt: Thanks, Chandra. Good Afternoon, Ladies and Gentlemen. Thank you for joining us on this Earnings Call for the Third Quarter FY17. Let me take this opportunity to extend a Warm New Year Greetings to all of you.

The third quarter has been overall a solid quarter for Syngene with good traction in all our business segments. At a high level, our revenue for the quarter grew by 23% to Rs.347 crores; EBITDA also registered 23% growth to Rs.127 crores while profit after tax was up by 12% to Rs.74 crores. We continue to maintain strong EBITDA and PAT margins at 37% and 21% respectively during the quarter. Looking on a year-to-date basis for the nine months, total revenue also grew by 23% to Rs.956 crores, while EBITDA and PAT grew at 33% and 29% respectively. I will let Mr. Chinappa, Syngene' s CFO give you more details on the financials in his comments.

Let me turn now and maybe make a few comments about business operations during the quarter. As you know we had a fire incident at one of our research buildings during the quarter, that caused some extensive damage to that facility. Thankfully, there were no injuries or loss of life and our evacuation and emergency response procedures worked as expected. This facility known as S2 is spread over five floors and the ground floor housed biologics pilot plant, the mezzanine had some office space and the top three floors of the building were largely chemistry and analytical labs. The fire broke out in one of the chemistry labs in the first floor and that spread quickly to other parts of the building despite the best efforts of the onsite emergency response team. At Syngene, we follow robust safety systems and procedures in all our operations with regular safety training conducted for all employees and each facility has a trained emergency response team to respond to such situations. In this instance it was the prompt action of the emergency response team who really played a critical role in making sure that it was a timely evacuation of the building in preventing the fire from spreading to other buildings.

Structural engineers have been engaged to assess the stability of the building and while we await their final report, initial indications are that the buildings external structures intact, but it is likely to require around 12-months to remediate and reconstruct that facility. Clearly, this removes some capacity for near-term future growth particularly from our organization and of course we will update you on the expected impact of that in the next quarter and beyond as and when we see anything. So as part of our business continuity plan, all of the ongoing projects in S2 have been relocated to other facilities across the campus. As many of you might recall we had commissioned the first phase of the Syngene research center a few months ago and this of course has provided us with additional lab hood capacity to accommodate these projects as we move them from the damaged facility into new homes.

In doing this, one of our clients has informed us their decision to discontinue their ongoing research collaboration with Syngene and that is then exercising their own business continuity plan and that was triggered by the fire incident. It was the relationship where we worked together in discovery for number of years but was actually due to expire in December of 2017, so they have taken the opportunity to bring that forward.

So let me try and draw a net position of where we are as of today. We have lost one client contract with an annual value of around about Rs.40 crores. We have successfully restored all of the lab hood capacity impacted by the fire by relocating this work across the campus to the unoccupied facilities we had, and in doing this of course we consumed some of the reserve or growth capacity that we had in place for our Chemistry business, and our current view is that it will take about twelve-months to remediate and rebuild the damaged building.

As you also know, we have in place an Industrial All Risk Insurance Policy that covers losses related to equipment materials and business interruption; I think Chini is going to make a few comments around that later.

But given the magnitude and the complexity of the insurance claim, we would expect that to take something like 6 to 8-months process to complete that. S2 building makes up about 10% of our footprint lab and office infrastructure. While there was an extensive damage to that particular building, but the remaining 90% at all our infrastructure was not impacted and continues to operate normally.

So let me move on to some of the other developments in the quarter: We are happy to share that our ongoing agreement with Abbott Nutrition has been extended for another year. You may be aware that has been a multi-year relationship, actually, was Abbott's first R&D center in India and this has been a mutually rewarding partnership for both of us; we are delighted to see that extended for another year.

Turning now to CAPEX: Also happy to share that Phase-1 of Syngene' s new formulation facility will become operational next month. This is a state-of-the-art multiproduct facility and is part of the $200 million CAPEX program we are running. When it comes online next month, it will take manufacturing for Phase-1 through to Phase-3 clinical supplies as well as will be capable of supporting commercial supply, small volume, niche technology products, of course, this facility meets all of the expected regulatory requirements of the US FDA, EMEA and other regulatory authorities around the world.

So let me conclude here: Third quarter has been a solid quarter for Syngene despite the fire incident. We have seen solid performances across the business verticals.

Now let me turn to Mr. Chinappa to give you a little bit more detail on the Financials and the Financial Performance.

M.B. Chinappa: Thanks, Jonathan and Good Afternoon to all. I would like to take you through our Performance for the Third Quarter and the Nine Months of FY17.

Let me begin by giving the details of the overall performance and then cover the performance across each of our reporting verticals, the impact of the interest income, review of the expenses, the impact of the fire incident and end with the review of the investments in the balance sheet.

The total revenues for the quarter have grown 23% to Rs.347 crores. This includes the underlying business growth of 18% and 5% benefit on account interest income. EBITDA grew 23% to Rs.127 crores and the profit after tax has grown at 12% to Rs.74 crores. EBITDA and PAT margins were 37% and 21% respectively.

Looking at the results for the nine months' period, Syngene's revenues have also grown 23% to Rs.956 crores. The underlying operational growth for the nine months is 17% and benefit of interest income is 6%. EBITDA has grown at 33% to Rs.354 crores and profit after tax has grown 29% to Rs.209 crores as at December '17. EBITDA margin stand at 37% and PAT margins have improved 100 basis points to 22% year-on-year.

The Revenue Highlights by Business Segment: Our dedicated centers which represent about 35% of our total operations have grown with the addition of the Amgen research center that we announced last quarter. We are also happy to inform that Abbott Nutrition, one of our clients in the dedicated services space, has extended their contract for another year.

Our Discovery Services vertical, which comprises both Discovery Chemistry and Discovery Biology and represents a quarter of our total revenues was impacted by the fire incident which shaved off about 2% of the total company's revenue growth. Also, as Jonathan mentioned earlier, following the fire incident, a client has intimated us about their decision to discontinue their ongoing research collaboration with Syngene as part of their own business continuity plan. This client represents 3% of the total company's revenues for the nine months' period till December 2016. In the Development and Manufacturing vertical, we have seen good growth, this includes the impact of the resale of material that was returned to us in Q1 for reprocess.

Now, we will move to the underlying performance of the business excluding the impact of interest income. The revenue from operations as I mentioned earlier, grew 18%. The interest income is mainly from unutilized portion of the ECB loan, that was drawn to support the long-term investment plan and is currently parked in bank fixed deposit.

The reported revenue includes interest income of Rs.15 crores, associated with the interest income is finance charges of Rs.7 crores and income tax of Rs.5 crores. Adjusted for the EBITDA and PAT margins for the quarter would have been 34% and 21% respectively, marginally above the company's historical average. Looking into the same on YTD basis, our reported EBITDA includes interest income of Rs.46 crores. Associated interest cost of Rs.15 crores and income tax of Rs.13 crores. Adjusted for this, the EBITDA and PAT margins for the year would have been similar to the current quarter, that is 34% and 21% respectively, again above the company's historical average margin.

Moving to Expenses, during the quarter, our material and power cost as a percentage of revenues from operations has reduced from 32% to 30%, reflective of an improved sales mix. Similarly, for the nine months' period, our material and power cost as a percentage has declined from 31% to 29%. In continuation of our hire for growth strategy, our employee benefits expense for the quarter has increased by 33% year-on-year, reflecting an annual salary increment of 12% and increase in the employee count from 2900 to 3400 plus as of today. Other expenses are higher on account of increased repairs and maintenance cost associated with the new facilities and higher selling expenses associated with the increased business development activity.

The effective tax rate of business income excluding tax on interest income is 14% for the quarter and for the nine months' period. As indicated in the previous quarters, we have moved to the new accounting standard and shared with you the impact on account of the change.

Q3 FY16 PAT has increased by Rs.8 crores while full year FY16 PAT has increased by Rs.20 crores on account of the shift to IND AS. The adjustment is mainly due to the mark-to-market adjustments on FX contract.

Moving to the Fire Incident, as I said in my opening remarks, we had revenue loss of about 2% in this quarter on account of the fire incident in our S2 lab which represent about 20% of our total revenue and 12% of our net block. Most of the clients' related projects have been redeployed to other labs and enhanced shift working has been introduced to minimize the impact on revenue. However, as Jonathan mentioned, the redeployment of projects to other labs has used up some of our new labs, that were being commissioned to support future growth.

During the quarter, we recorded an exceptional loss of Rs.80 crores on account of the assets damaged by the fire incident and also recognized exceptional income of an equivalent amount being the minimum insurance claim under Industrial All Risk Policy.

As regards CAPEX, the USD100 million dedicated to our existing capacities and capabilities enhancement is progressing as per plan. The new CGMP formulations facility is on track to be commissioned in Q4 and is strategically positioned in providing integrated Discovery and Development Services. We are also happy to announce that we have received the environment clearance for our commercial API facility in Mangalore. We expect construction to begin in the next fiscal and the facility to be operational in FY2020. Overall, we have invested approximately $72 million against the planned 200 million CAPEX program and the net debt position as of December was Rs.30 crores.

With this, let me turn it back to the operator and open up the session for Q&A

Q & A Session

Moderator: Thank you very much. We will now begin with the Question-and-Answer Session. The first question is from the line of Nitin Gosar from Religare. Please go ahead

Nitin Gosar: Would like to understand the impact of the fire incident. You said that there is impact of 2% on revenue for the quarter. All the procedural actions that you have taken towards shifting out, working on to the alternate shift, using up the other reserve facility, does it mean that the incremental revenue loss will not be there and this 2% loss which we had on revenue will be patched up in the upcoming quarter?

Jonathan Hunt: I think part of my comments and I think some of Chini's as well, which is directly pointed to expect some sort of headwind effect in the fourth quarter, however, we will reevaluate when we report in April. But certainly I would expect it to be some sort of headwind in our Discovery business, S2 lab is about 10% of our entire lab footprint, and about 20% of our total revenues. Most of those projects are up and running now, but of course there will be some disruption and we also flagged up for you that there was one client loss that will be absent from the fourth quarter revenue. The net of those is what you can see as the headwind in the coming quarter, however, the rest of the business, which is 90% was unaffected by the fire. In the three months' time when we report we will know where we are and we will be happy to discuss that. Hopefully that gives you enough of a sense of the direction without actually giving you a specific forecast of growth.

Nitin Gosar: Are we in a position to revisit the guidance that you had provided earlier or it will be taken care in the next coming quarter?

Jonathan Hunt: The only guidance we gave you is I think four or five years ago was a long-term plan, specifically as a matter of policy, we have not given annual or quarterly guidance on revenue or the cost line. Very happy to talk about our strategy, and I think you can see that from our continuation of the CAPEX investment plan, the new capabilities that we are building, one off of the incident like a fire does not cause us to reappraise our long-term strategy. So I think at an industry level, we continue to see a vibrant outsourcing market in science both in biotechnology and in pharmaceuticals and in CRO model and then expanding into the CRAMS model, which is the one that is very-very relevant to the industry to construct today and we continue to see good long-term demand trend. This specific impact of one-off event like a fire will only impact part of our business largely the chemistry one for a short period of time, but it does not really the change the strategic direction of the company.

Nitin Gosar: The client that you lost, is it not part of the FTE program?

M.B. Chinappa: It is part of the FTE program, but it is not part of the dedicated center.

Moderator: Thank you. The next question is from the line of Prakash Agarwal from Axis Capital. Please go ahead?

Prakash Agarwal: Sir, a question on understanding the restoration of the R&D center which you said that you are already building up a facility for growth and now it would utilize the growth capacity. So the 10% of the area has been fully now shifted and up and running, could you just update on the same?

Jonathan Hunt: Approximate and fairly accurate way to think about it is S2 which was the building that was in the fire incident was a large multi-storey building, five floors, the top three floors of those have chemistry labs, which are no longer operational, they were very severely damaged in that fire. Of course, the lowest floors of that building we could probably remediate and get back up and running more quickly. The only issue being is we secure the whole building that we would not want to repopulate that and put people back in that working environment. So I think that will take about 12-months from now to renovate that building and get it back up on operation. The other point we were making is that very quickly, as a matter of days into one or two weeks, we managed to shift nearly all of the work which was going in S2 to a new home within our campus. As you know it is a large facility with a large number of buildings. One of the things inherent in our CRO business model is that if it were to grow in many of our service lines, we have to put capacity in place before we see demand coming through and we have done that last year by opening what is a very modern state of the art facility, SRC, some of that was occupied already with clients but a large proportion of it has been fitted out in anticipation of future demand and we may switch that use and we move the existing employees from the S2 building which was damaged and put it into some of the floor spaces in SRC and one or two other places actually around the campus. Of course, that means those projects very quickly from a client point of view go back up and running, but it also means that the spare capacity that we had in the organization that has been used, not all of it but a large portion.

M.B. Chinappa: Yes, the Discovery Chemistry business has been shifted to the new capacities and will be available sometime this quarter, but it would not be available for the full quarter. Also as Jonathan mentioned what is housed in the ground floor was the Biologics business. The Biologics business will take a slightly longer time to be repositioned as the new facilities come up in the second half of this calendar year.

Prakash Agarwal: So when you say would impact some growth capacity, I can see nine months we have grown at 17-18% ex of other income, so would that mean that growth could taper from here on?

M.B. Chinappa: As I mentioned already, the Discovery Services growth capacity has been utilized by relocating the business to S2 and Biologics there will be a temporary impact of about six to nine months' as we shift the business to a new facility. The rest of the business we have capacities for growth and we need to look at it on a total basis, to give you a full picture.

Jonathan Hunt: So we will update you as we go through each quarter, very are happy to discuss that the trends that we have seen during the fourth quarter when we report. As you know, we do not give business unit level or year-on-year guidance. So it is not something that for us to update. But I think if you go back and listen to both my transcript comments and Chini's as well, all the moving parts are in there and it is a general sense of what is likely to happen, I think it is there for you to think about the model.

Prakash Agarwal: One clarification I had; so in 1Q you had made a comment that there has been some sales return. Would that sales return of 3-4% back in Q3 and if yes, so if we exclude from 18%, we practically get 15% kind of growth, so just trying to understand that in this quarter if we add back the 2% of fire impact, the growth is still lagging?

Jonathan Hunt: I think you make sense on those adjustments in terms of getting to an underlying sense of performance, I can follow the logic.

Prakash Agarwal: So apart from fire, has there been any particular reason for a slower growth sir?

Jonathan Hunt: Nothing that I would call out. If you actually look at the trends through the year, top line revenue growth has been very strong but clearly I think we flagged this to you all the year, boosted by the benefit we are getting from the ECB loans on deposit and the other income interest there. We have had some favorability from currency but that is a long-term trend that I think many businesses that operate functionally in US dollar reported rupees would have had this benefit. So I leave you to determine how you treat that for modeling purposes. But the underlying mid-teens to high-teens growth been I think evident throughout the last year or so.

Moderator: Thank you. The next question is from the line of Surya Patra from PhillipCapital. Please go ahead.

Surya Patra: Just wanted to know a bit more clarity about the Biologics business. We are in the early phase of business in that Biologics phase and recently we have done acquisition also in terms of capability on the Biologics side. So now the early stages the business getting impacted because of the restructuring, so what is the kind of outlook that one would be having on the Biologics front end, the capability that we are building around that?

Jonathan Hunt: Let me make a couple of introductory comments in response to your question and I look to Manoj maybe to fill in some of his perspective on it. I think from a strategic point of view, my reflection from the last 12-months or so is that the Biologics opportunity, that is both Biologics Discovery and Development, Biologics flowing into the small scale and then ultimately large scale manufacturing, that whole value chain in the marketplace has a stronger opportunity, however, we considered this opportunity previously for the long-term growth and are not necessarily indicating that it is a transformatory point in the next quarter or two's revenues. But for the long-term played over business cycle which a business like us would be a multi-year five-year plan. I think general sense is the Biologics is an exciting area and we are getting very good interactions and signals from clients when we discuss that. That pretty much catches why we are investing in capability and capacity building. We lost a little bit of capacity with the move and the damage in S2 building, but actually beyond that we are investing in other parts of the campus where we have Biologics manufacturing and development capabilities.

Manoj Nerurkar: Surya, apart from what Jonathan said, where we clearly see a momentum building not just for us as a service industry but if you look at the pharma industry in general and how Biologics are becoming more and more important types of therapies that are coming on market today, there is clearly a momentum, there is no doubt and there is a market demand that is coming up through Discovery into Development and eventually commercialization. As Jonathan said, we are setting up a new biologics plant. That will give us that capacity. We are close to having that plant now operational in a few months. The acquisition that you specifically refer to is in Bioinformatics and not really Biologics and that is really to do with the analysis of large data that all pharma companies and other related industrial sectors generate and how do you look at that information and how do you make sense of it, how do you analyze it. So, although the data is related to Biological data in a way, it is a completely different service vertical and therefore some overlap but it is a distinct vertical by itself.

Surya Patra: Is Bioinformatics a diagnostic kind of set up sir?

Manoj Nerurkar: No, it is a diagnostic set up, it is a set up that helps life sciences companies, for example, pharma companies generate huge amount of data through their discovery effort and then when molecules are tested into clinical trials and the huge amount of data that gets generated, someone needs to make sense out of that data and Bioinformatics really helps you look at that data in a systematic way and makes sense out of it in terms of what are the patterns you are seeing, what are the signals that are worth noticing, what are the signals that are worth following up so on and so forth. So that is the type of work that Bioinformatics does. Of course, there is a diagnostic element to it or diagnostic kind of industry but that is not what we are looking at when it comes to Pharma and Life Sciences and application of Bioinformatics to those kinds of industries.

Surya Patra: Whether Strand added any client to our Biologics business or not or just the capability that we have added?

Manoj Nerurkar: We have definitely added a capability. We also had a few clients come through the acquisition that were legacy clients and now have become our clients and we definitely look at building that business. Of course, the clients that Syngene had pre-acquisitions, we are talking to them about this particular service line that we have now added and how can we integrate that service into some of the other things that we do for them to see how we can enhance the kind of value addition om what we do for those clients as well.

Surya Patra: So is it possible to say that what is the kind of revenue base that we have so far received on this front?

Jonathan Hunt: One of the key things operationally with this business is that you integrate it with all of the other aspects of discovery science that you do. So the best is driving the problem if you think about it from a client perspective. The discovery engine in chemistry, the discovery engine in biology, in toxicology, the use of high throughput screening, genomics, proteomics, all of those things are generating, in the past gigabytes of data and now it is terabytes. The challenge is to interpret that and that really has two dimensions to it. IT Informatics capability and deep understanding of science, whether it be chemistry or biology, when Bioinformatics group does, is not only do that as a standalone service line, but more importantly integrate that into all of the other work we do. So while we are seeing good client traction post the Strand acquisition, financially, it is most likely to materialize itself in the other verticals because it adds value to what they are doing.

Surya Patra: A query for Chinappa sir. You have indicated that around $20 million kind of CAPEX out of the total planned CAPEX of $200 million has been done. So that has been done in this financial year or so far that is the amount that we have done?

MB Chinappa: Surya, it is $72 million spent till date.

Surya Patra: On the Amgen alliance, what is the peak scientist's potential that we are factoring for that opportunity?

Jonathan Hunt: I do not think we put a ceiling on that. We are very happy with the starting point of the relationship and we are very happy with the rates of processing, but I have not reached a point where I have the limits on it.

Moderator: Thank you. We will take one last question from the line of Paresh Dave from Ambit Capital. Please go ahead.

Paresh Dave: We had a write-off of around Rs.80 crores and we are saying that we are providing for it as the receivable from the insurance company. So my question here is that are we being a bit too optimistic in expecting that the entire amount will be passed by the insurance company, are we following a theory of conservatism over there?

M.B. Chinappa: We are insured for replacement cost. So we expect the insurance claim to be more than the written down value of the assets damaged under the fire. We are conservative as we have only recognized income equivalent to the loss at this moment.

Jonathan Hunt: If I understand that, Chini, essentially said that we have written down the entire cost we have been to your point conservative in what we put into the balance sheet is the old cost but actually we believe our insurance coverage is better than.

Paresh Dave: Probing on to what Prakash asked earlier, past two-three years we were reporting sales growth of 25-30% and now this quarter if we do the adjustments we are at around 14-15%. Do we see ourselves returning back to the 25% kind of growth levels again…is there a visibility of that sort around?

Jonathan Hunt: The near-term trading position which is impacted by the fire, I do not think is a reason to not return back to looking at the long-term strategy and the confidence we got in there. We are seeing good growth in global investments in science and the biological sciences and the traditional pharmaceutical sciences. I think the CRO model and particularly if you are building reputation as we are globally to be a reliable sophisticated top end provider of Contract Research Services to both the pharma and the biotechnology industry and I would also say other adjacent industries as well, then I think the opportunities are great. So for the medium to long term absolute confidence in where we are going.

Moderator: Thank you. Ladies and gentlemen, that was the last question. I now hand the conference over to Ms. Chanderlekha Nayar for her closing comments.

Chanderlekha Nayar: Thank you, Margaret and thank you, everybody for joining today's conference call. I hope we have addressed all your queries. In case there are any follow up questions, please feel free to get in touch with me.

Moderator: Thank you. On behalf of Syngene International, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.

Note: This document has been edited to improve readability