“Laurus Labs Q3 FY2020 Earnings Conference Call”
January 31, 2020

Moderator: Ladies and gentlemen, good day and welcome to the Laurus Labs Q3 FY2020 Earnings Conference Call hosted by Kotak Securities Limited. 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 "*" and then "0" on your touchtone phone. I now hand the conference over to Mr. Chirag Talati from Kotak Securities Limited. Thank you and over to you Sir!

Chirag Talati: Good morning everyone on behalf of Kotak I thank the Laurus Management for giving us the opportunity to host this call. From Laurus, we have with us today Dr. Satyanarayana Chava, CEO; Mr. V.V. Ravi kumar, CFO and Mr. Monish Shah from the Investor Relations Team. I now hand over the call to the management for their opening remarks. Over to you Sir!

Dr. Satyanarayana Chava: Thank you everyone and a very warm welcome to our results conference call on the Q3 and 9 months FY2020. Our Q3 revenues stood at Rs.730 Crores showcasing a robust growth of over 38% year-on-year. To begin with, I would like to share the key updates on our formulation business. We are happy to share that our Unit II which underwent successful US FDA inspection in November 2019 has received EIR. Moving to the performance of formulation business, the division reported its highest ever quarterly revenue of over Rs. 292 Crores and in the cumulative 9 months, we did Rs. 558 Crores. The overall contributions from FDF segment have improved to about 40% in the quarter and about 30% for the 9 months in the financial year. From low single digits in the corresponding period, this was a significant shift. This shift in our business model also underscores our philosophy of investing in manufacturing and research ahead of time. During the quarter, we have reached maximum utilization levels of our formulation unit and with healthy outlook and order book, we continue to invest further in our FDF infrastructure and also in the development. The growth diver for the formulation business remains tender driven LMIC antiretroviral market, funded by Global Fund, PEPFAR and other In Country tenders. We continue to have good visibility for FY2021 as well. We also expect two new major approvals in the next couple of months for TLE 400 and TLE 600.

We have had good sales growth in US as well as in EU. In US our sales were primarily driven by Pregabalin sales by our partner Rising and we have more than 10% market share right now. As of today, we have received total 8 approvals, 5 final approvals and 3 tentative approvals from US FDA. Going forward we expect 2 more approvals and launch a few more products in this financial year and few more in the FY2021. In Canada we also have 5 product approvals of which we have launched 2 and we are preparing to launch two more

shortly. As far as EU market is concerned, we are happy to share that our contract manufacturing partner for Non ARV formulations have done exceedingly well and we have a very good order book for FY2021 as well. Besides this, we are also launching two products in European market under our own label. So far, we have 5 products approval from Euro and we have already launched one and we are planning to launch two more.

As I always say our FDF R&D is geared up to do develop and validate between 8 and 10 product per year and we continue to believe we will meet that number. So far, we have filed 24 ANDAs in US, 6 dossiers in Europe, 9 in Canada and 8 with WHO Geneva and 2 with South Africa and also 2 dossiers in India. Also we have filed several dossiers in various African Countries for our products. Of the 24 ANDAs filed we believe that there are 2 P4s and 7 FTF for opportunities with addressable market of a share of billion dollars. As we always speak our approach remains product specific and not market specific, which is the reason we are filing our dossiers in various geographies across the globe.

Going into the business segment, although we have great success in formulations which fueled our growth, we had a set back in our ARV APIs where there was significant degrowth. Rest of the divisions performed as per our expectations. Synthesis grew ~14% compared to corresponding quarter and Ingredients did exceedingly well about 70% more than the corresponding quarter. Whereas generic API as a total, we de-grew in that segment by almost 20% on corresponding quarter. When it comes to ARV, our degrowth mainly came from lack of clarity on the awards of supplementary tender in South Africa where our key customers are not building up inventory. Once the tender results are clear, we will able to improve our ARV sales in the coming quarters. We have completed filing of our second line ARV APIs of Lopinavir and Ritonavir and we expect to do some formulation development of second line API as well.

When it comes to ONCO, our revenues were as expected. We did about Rs. 47 Crores in Q3 and about more than Rs. 150 Crores in 9 months. In the first year, we were unable to ramp up production of one of our key ONCO API because of backward integration which did not get complete on-time. But now since last quarter, we were able to ramp up intermediate manufacturing for our ONCO API and expect Q4 will be very good for us. In the other API segment, we did exceedingly well, the growth was primarily driven by contract manufacturing of APIs to other generic companies. We also have a very good visibility for Q4 and FY2021 for the contract manufacturing from our partners.

When it comes to Synthesis business, we are doing exceedingly good. In Q4, we did Rs. 62 Crores and in 9 months, we did Rs. 180 Crores and we have a very good sales plan for Q4. When it comes to Ingredients we did Rs. 18 Crores in Q3 and Rs. 64 Crores so far from 9 months. We also launched one key product to a customer in US and we expect that will do

very well in the near future as well. With that I would like to hand over to Ravi to share financial highlights.

V.V. Ravikumar: Thank you Dr. Satya and very warm welcome to everyone for our Q3 and 9M FY2020. Total income for operations for the quarter Rs.730 Crores against Rs.530 Crores in the corresponding quarter showing a robust growth of 38% and for 9 months, Total Income from Operations came at Rs. 1,993 Crores against Rs. 1,657 Crores with a growth of 40% on corresponding basis. Our gross margins continue to show an improvement both sequentially and over the corresponding quarter at 51%. Improvement in our gross margin was mainly led by favorable product mix and higher contribution in the formulation business. Our EBITDA margin came at ~20% and the growth in EBITDA was mainly because of improved operating leverage from the formulations business and Other APIs. Our diluted EPS for the quarter is Rs.6.9 and Rs.13.6 on 9M basis with a growth of 306% and 183% respectively. On the capex front, we invested around Rs. 130 Crores for 9 months and we will have a normalized capex of around Rs. 250 Crores in the current year. For the next year, we are still working out based on higher demand and we expect it to be slightly higher than Rs. 250 Crores. We will share the guidance for FY2021 capex in our next call. With the improved contribution from our high margin businesses of Synthesis, FDF and Other APIs, we remained confident of improving our return ratios. We are very optimistic about the improvement of our return ratios in FY2020 and looking forward to positive FCF in FY2021 and beyond. With this I would request the moderator to open the lines for Q&A.

Moderator: Thank you very much Sir. Ladies and gentlemen, we will now begin the question and answer session. We have a first question from the line of Hari Belawat from Techfin Consultants. Please go ahead.

Hari Belawat: Good morning Sir. Congratulations for such nice results, which has come during this quarter, it is really very good. Sir this is regarding US FDA inspection, unit 2 have got EIR but for unit 1 and 3 in the month of June, inspection was done and EIR was given again in the month of November inspection was done, again some three observations were raised. How these inspections have come so quickly one? Second thing is why the observations have come in the second inspection?

Dr. Satyanarayana Chava: Unit 1 and 3 underwent FDI inspection in June 2019 which was a routine GMP inspection and for which we have received EIR and in the November we had another inspection which was a product specific preapproval inspection, (PAI) and we had three minor observations and we responded to those and we expect EIR soon.

Hari Belawat: Okay that means it will be cleared very soon whatever observations are there?

Dr. Satyanarayana Chava: Yes!

Hari Belawat: Another thing is that this is regarding investment in total usage, but till March some Rs. 250 Crores in FY2020-FY2021, also Rs. 250 Crores, how much will go in formulations and how much will go in API manufacturing?

Dr. Satyanarayana Chava: We are still finalizing the numbers, but next year probably the formulation and API will be equal.

Hari Belawat: Okay and because of the degrowth in API, are you looking for lower investment in API segment or any such view is being is taken?

Dr. Satyanarayana Chava: Actually, if you look at our formulation business is also driven by in house APIs so API production never came down.

Hari Belawat: Okay means both will continue to run that way?

Dr. Satyanarayana Chava: Yes!

Hari Belawat: Just one small query. Again China problems are there and so many APIs are being imported. Will it affect our company also in this regard?

Dr. Satyanarayana Chava: We are very well backward integrated to starting material so we do not import any API or advance intermediates from China, so we do not expect any disruption in supply chain because of this.

Hari Belawat: Okay good Sir, wish you all the best.

Dr. Satyanarayana Chava: Thank you.

Moderator: Thank you sir. We have next question from the line of Sudarshan Padmanabhan from Sundaram Mutual Fund. Please go ahead.

Sudarshan P: Good morning. Thanks for taking my question. Sir my question is on the formulation side, this quarter has been phenomenal where there is almost 300 Crores of sales and you did talk about capacities more or less reaching in a top of block over there. I mean given that we have invested in the nine months close to about 130-140 odd Crores, given that we are seeing fair amount of growth and some more products coming in the fourth quarter, should we be having capacities to kind of drive incremental growth as we move towards FY2021?

Dr. Satyanarayana Chava: We are getting some additional capacity between April and June FY2021, so after that we also have plan to construct a new building which we expect will come operational between April to June 2021, so we have some capacity augmentation coming in next quarter that is FY2021 and again significant capacity expansion will be available in the FY2022.

Sudarshan P: Sure and the ARVs segment, I mean one thing you have talked about in API is being used internally for formulation, this is a good thing. The second is if you give you a bit more color about the what we are seeing is that the older molecules specifically the Efavirenz specifically seeing some kind of slower growth whereas the expected is more towards Dolutegravir so if you can give some color about whether we are seeing that shift happening, is that getting delayed. When we can we see some kind of better margins, better mix as well as better growth in the segment?

Dr. Satyanarayana Chava: If you look at ARV APIs in Q3, contributed only 27% of our revenue whereas formulation contributed 40% of our revenue. If you look at 9 months number, 39% of revenue contributed by ARV APIs whereas formulation contributed 28% of our revenue. The decline in the sales of ARV API is a combination of many products, not only attributable to Efavirenz degrowth. If we get clarity on South African supplement tender, we supply Efavirenz, Tenofovir and Emtricitabine, so decline came from a bunch of APIs not alone Efavirenz and there is also shift in regimen, so other than South Africa majority of triple combination is Dolutegravir base rather than Efavirenz based. That also contributed some decline in our API sales, and we are not selling as much as Dolutegravir as we used to sell Efavirenz.

Sudarshan P: How about the oncology Sir, you did give some color about third party, dependence coming down with primarily some internal capacity is coming in and definitely I think compared to 1 Quarter we are expecting some kind of volume ramp up as well as value ramp up to happen, how do we see the trajectory over here in terms of growth, run rate, etc Sir?

Dr. Satyanarayana Chava: See the onco segment will give around Rs. 250 Crores per year from FY21, so that is a good number. We do not expect to significant growth coming from Onco APIs. In the Onco APIs as you are aware, the volume is low and Despite of having very large capacities the value growth translation is quite low, which is the nature of Onco business. Interestingly, our gross margin is going up in Onco business when compared to the previous year.

Sudarshan P: One final question from my side. If we are looking at the run rate that we are seeing in the formulation side, almost from Rs. 100 Crores to Rs. 150 Crores to Rs. 300 Crores now. Would it be a right assumption that at the beginning of the year, we had probably looking at about Rs. 500 Crores this year and we are probably running at Rs. 750 Crores or Rs. 800 Crores this year going by the run rate and definitely next year we should be able to see even if you are looking at the similar kind of run rate over Rs. 1000 Crores to Rs. 1100 Crores of formulations happening, and probably with additional capacity coming in, it should also further improve from here on, so what is the kind of internal targets that you have for the formulation side and how do you see it in the next couple of years?

Dr. Satyanarayana Chava: See we are not giving any guidance but you are on the right track, so you can annualize our Rs. 290-300 Crores of our quarterly sales. We are geared up to deliver that kind of capacities to the market.

Sudarshan P: Sure thanks a lot. I will join back the queue.

Moderator: We have next question from the line of Prem Doshi from ACE Equities. Please go ahead.

Prem Doshi: Congratulations on a great set of result. I have a couple of question. One is that we have significant leadership in antiretroviral if I am correct globally, so have you seen a demand bump up related to the coronavirus outbreak in China?

Dr. Satyanarayana Chava: No.

Prem Doshi: There is no demand bump up yet?

Dr. Satyanarayana Chava: There is a small query but that is not going to be significant for us or anybody so the volume will be low.

Prem Doshi: Okay another question. Are you looking to bring down the promotor pledge that is on the shareholding as of now?

V.V. Ravikumar: Not right now, but we have plans to reduce the pledge over a period of time.

Prem Doshi: Okay alright. Thank you so much.

Moderator: Thank you. We have next question from the line of Kaustubh Bubna from Rare enterprises. Please go ahead.

Kaustubh Bubna: Our is 40% revenue is that coming from FDF in Q3 FY20 and 28% coming from FDF is 9 months FY20, how much would be the tender business and could you first answer that?

Dr. Satyanarayana Chava: About between 75% to 80% of the business is coming from tenders or ARV business and remaining is coming from North America and Europe.

Kaustubh Bubna: Okay that is helpful, on the 75%-80% coming from the tender business, could you explain exactly how sustainable this is, how does the tender process work, how much clarity do you have for the next few years in terms of where is this growth coming from, how much will its growth year-on-year, what is the clarity on ground like could you explain that situation?

Dr. Satyanarayana Chava: See there are three parts of this business. Global fund driven, PEPFAR fund driven, and In Country tenders, so in country tenders is winners takes all. There is no preference, you have

to quote based on that particular tender date, where as the PEPFAR and global fund, global fund especially there will be fixed allocation percentage wise, whatever they buy, we will get some fixed allocation, but that is more certain and they will place order over a period of several quarters. We have good visibility from global fund. We have reasonable visibility from PEPFAR and In Country tenders we cannot commit right now, because it is tender-to-tender quotes and then winner takes all. Whereas in the case, PEPFAR and Global Fund there is fixed allocation and they make sure the business is sustainable. Majority of our business came from Global Fund and PEPFAR but some business also came from In Country tenders.

Kaustubh Bubna: Okay and what is the margin profile of this tender business versus the rest of your business?

V.V. Ravikumar: See if you look at our gross margins it has improved when we are integrated. So FDF business is certainly helping us to increase our gross margins because we are getting more gross margins on APIs for sure in formulation business.

Kaustubh Bubna: Working capital cycle for this tender business versus API business?

V.V. Ravikumar: From an intermediate to formulation it is slightly higher than API.

Kaustubh Bubna: No I am specifically talking about the tender business of formulation not the US and Europe business?

Dr. Satyanarayana Chava: Tender business formulations, the payments cycles are very good and we never had any problem of receivables.

Kaustubh Bubna: How many months would it be the receivable days for the tender business?

V.V. Ravikumar: It is less than 90 days.

Kaustubh Bubna: Okay thank you.

Moderator: Thank you. We have next question from the line of Nitin Agarwal from IDFC Securities. Please go ahead.

Nitin Agarwal: Thanks for taking my question. On the Other API segment, which is there. Given the upsurge which is there in general API business momentum how do see the segment really playing out for us are there any specific new molecules where we see opportunities or how should we look at growth in the segment?

Dr. Satyanarayana Chava: The API segment our growth will be primarily driven by getting more clarity on the South African tenders that will fuel our growth in our API. In our API segment, we are doing

significant contract manufacturing and we have great visibility for Q4 as well as several quarters from now. The majority of the growth is coming from actually old molecules rather than from new API what we are working. So people are trying to move their business from regulatory uncertain manufacturing facilities to more sustainable regulatory companies. We are seeing good traction, but in this business if someone wants to move their APIs to a new manufacturer it takes anywhere between 12 to 14 months, so we are in that cycle. We expect good traction coming from non-ARV APIs in the coming 12-18 months.

Nitin Agarwal: So overall if you split the business in two formulations, API and synthesis, so API overall if you take a three year view what kind of growth overall API segment can deliver, given that challenges that are there in the oncology business. The hep C as well as the ARV API segment?

Dr. Satyanarayana Chava: I think based on our current estimate; we can expect around 10% growth in Generic API business. Formulation and Synthesis will drive our major growth drivers.

Nitin Agarwal: And the synthesis our growth is going to be driven by existing products or contracts or envisage ramp up coming through some newer sort of contracts and pipeline?

Dr. Satyanarayana Chava: Majority of Synthesis growth will come from our existing customers and existing products going into the next clinical development phase and some commercial supplies as well. While we grow from existing clients and products, but there is also a possibility that we will add new clients and new products, which we are doing. We added two clients last year.

Nitin Agarwal: Last one on the formulation side on this ARV formulation side, what is the peak size that we can potentially do on this business, what is peak potential opportunity which is there in this market for us Sir?

Dr. Satyanarayana Chava: It is difficult to predict. See there are 25 million patients on treatment and about 22 on the first line, so whether we get 10% market share, 15% market share it all depends, but today are geared up around 10% market share. Our capacities are created to get 10% market share.

Nitin Agarwal: 10% of a Billion Dollar market?

Dr. Satyanarayana Chava: Yes.

Moderator: Thank you. We have next question from the line of Arun Subrahmanyam from Ampersand Capital. Please go ahead.

Arun Subrahmanyam: Just two questions. When you are saying that your API will grow at about 10% CAGR and formulations will grow lot faster, so can you give you sense what is the overall growth of

the company over the next 3 year and considering that you are doing at this Rs. 250 Crores kind of capex, which will continue, what will be the overall growth over 3 years?

Dr. Satyanarayana Chava: See if you look at our 9 months we did grow 20% despite significant drop in ARV and APIs, so we expect that trend will continue at least we will have 20% growth next year as well, so we cannot tell you beyond that. We do not have visibility.

Arun Subrahmanyam: Your lack of visibility which you are talking about considering that you are putting the capacity and you have just 10% market share, the lack of visibility is because of what? you cannot get substantial higher market share or considering your cost structure and your cost advantages I thought that you would be in a far better position?

Dr. Satyanarayana Chava: See it is not absolutely lack of visibility. We are not giving any guidance, generally we can say we are investing in capacities and we will grow but we are not giving any guidance how much we will grow, but I am giving the trend as per what happened in 9 months where we grew by 20%. So it is reasonable to estimate that we will also grow in Q4 by 20% and in FY2021 also by 20%. If you are asking FY2022 how much we will grow, we have not done our numbers right now.

Arun Subrahmanyam: Understood. Last thing that I wanted to understand from you is that when you are seeing this drop in API and the significant expansion in formulations, but formulation is far more tender business. It is tender business lot more like in the sense it is like not a smooth forecastable number or what I am saying is that it is the tender business like a normal production, manufacturing and sales business or not? The tender's orders are big quantity and you are not sure when the next tender will be opened I am just trying to get a sense of how smooth?

Dr. Satyanarayana Chava: This is a long-term tender. It is not that you will get tender for half a million pack, so you get tender and with committed delivery times, so for example we have visibility for Q4 and Q1 next year as well.

Arun Subrahmanyam: Okay and final question like earlier when we are interacting with you, you are saying that you are winning more and more tenders. Is that something which is a status now or you are like because you are fully already utilized so you will just continue at current level of operation?

Dr. Satyanarayana Chava: For Q4, we run at the current level of operations, but Q1 FY2021 we are adding more capacity so we have scope to grow our formulation business in Q1 FY2021.

Arun Subrahmanyam: Thanks a lot Sir.

Moderator: Thank you. We have next question from the line of C Shri Hari from PCS Securities. Please go ahead.

C Shri Hari: Yes. Thanks for the opportunity. Firstly Congratulation on good set of numbers. I have a few questions. Firstly if I look at the product mix, it has improved dramatically sequentially, but the gross margins have moved just 100 odd basis point so could you please explain that and secondly on the formulation front, if you could please give the US sales breakup for Q2 and Q3 that would be great and I would like to know that whether there is any exceptional out there in terms of let say profit share or a milestone receipt and finally on the ARV front, you have indicated that you are going file for Lopinavir and Ritonavir now was this as per schedule or your are trying to accelerate this process for development, thank you?

Dr. Satyanarayana Chava: Maybe I will answer question in reverse orders. So for Lopinavir and Ritonavir we have a goal dates and I do not expect that the FDA is going to fast track approval because of coronavirus. And second there is no one off in Q3. And on third is our formulation business as we explained little more than 3/4 is coming from ARV and rest is coming North America and Europe. We cannot give you how much we are selling in North America and Europe, but that trend will continue. Quarter of revenue will come from North America and Europe and 3/4 will come from LMIC.

C Shri Hari: Could you give at least give an indication directionally US sales has it increased sequentially?

Dr. Satyanarayana Chava: It is growing. When we have increased our revenue from Rs. 150 to Rs. 290 Crores in Q3, our US, Canada and Europe revenue has gone up.

C Shri Hari: Finally, basically based on the guidelines that you have given regarding asset turnover, if I go by that number, then Rs. 290 Crores seems way beyond what you had indicated as an optimal revenue for the formulation division, so can you please explain that?

Dr. Satyanarayana Chava: Can you repeat the question?

C Shri Hari: See for the formulation division, you had indicated earlier that the asset turnover should be around 1.7x for maybe at most I guess 2x, where we are right now I presume it would be close to 3x if you annualize the quarterly number?

Dr. Satyanarayana Chava: See here you have to consider the API capex, see this is a captive backward integrated project for us, so entire API is what we are using in formulation coming from our own facilities. Where we are not taking any revenue of API in API division, so when it comes to the asset of our ratio, we have to think at API capex as well as the FDF capex. So is not 3,

as you are saying. 300 x 1200/400 Crores capex is not 3 assets turn over ratio, it would be you have to allocate certain amount of capex we have done for API as well here.

C Shri Hari: Okay I am still not clear about that, but your existing capacity is at 5 billion tablets, right?

Dr. Satyanarayana Chava: You are right. Is a notional capacity but ARVs doing triple combination, so one tablet is equivalent to more or less equivalent to 3 dispensing, 3 granulations, where as compression and packing is one so significant capacity will be used for triple combination and we are doing capsules, we are doing tablets for the other markets. Per say, if you convert triple combination as three, we are running around maybe 300-400 million units per month.

C Shri Hari: So at optimal capacity for the quarter, you would be at around 1.25 billion tablets is that the…?

Dr. Satyanarayana Chava: You are right.

C Shri Hari: Production was around 1.25 billion tablets this in the quarter?

Dr. Satyanarayana Chava: Yes, but you have to consider triple as 3x. See at the ARV we are doing a combination of 3 drugs into one tablet.

V.V. Ravikumar: When we are talking on what is the possible revenue from formulation, we have been saying about 2 times plus. It was in the earlier case when you are talking about up to Rs. 800 Crores revenue on Rs. 400+ crores of capex and we have done more than that, so this is a peak that it is possible with the existing capacity, I hope that answers your question.

C Shri Hari: So what is the kind of capex you are planning on that dossier front?

V.V. Ravikumar: Another Rs. 50 Crores is what we are planning immediately and then the further expansion, we have not crystalized the capex amount.

C Shri Hari: I mean in terms of capacity vis-à-vis 5 billion tablets?

V.V. Ravikumar: I think let's not talk on the tablet because it confuses. It is a triple combination and all, but if you have any further questions we will take it offline.

C Shri Hari: Sure thank you.

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

Aditya Khemka: Sorry I also had similar question as the previous participant. So just to understand what you are saying, so currently running at a 5 billion tablet capacity counting triple combination as one right because that is how the industry deals with it, so 5 billion tablet capacity and you are doing 3-400 million as a Chava Sir has indicated in his comment per month, so you are doing 3.6 to 4.8 billion tablets already so pretty much 100% utilized, right, so going from by what you previously mentioned, that you have visibility that you will be able to sell this 300-400 million tablets a month for the next 3-6 months, right that is the order book you already have, correct?

Dr. Satyanarayana Chava: You are right Aditya and also, we mentioned, we are going to debottleneck and add little capacity which will come into operation between April and June this year.

Aditya Khemka: Between April and June this year, so perfect, I got your comments there. Now if you were to quantify the debottlenecking potential capacity to add to these 300-400 million tablets per month, how much debottlenecking can help. Can it add 50 million tablets, can it add 100 million, 20 million?

Dr. Satyanarayana Chava: About 20% capacity.

Aditya Khemka: Okay about 20% it can add and the cost of this bottlenecking is that Rs. 50 Crores?

Dr. Satyanarayana Chava: Actually close to Rs. 60 Crores.

Aditya Khemka: 60 Crores okay so the capex that he was alluding is this debottlenecking capex right. So now is the next question, so we have already incurred capex of Rs. 400 Crores on the formulation side alone. I understand you are using API capacity as well, but on the formulation side only you have done capex of 400, this 60 Crores is only formulation capex, correct?

Dr. Satyanarayana Chava: Only formulation capex.

Aditya Khemka: Right your total capex would be 460 Crores on the formulation side. Now my question is now that give that you have been able to sell so well on the formulation side, you have been able to get a very decent sized order book, why are we limiting our capex on the formulation to Rs. 60 Crores only. There can be few reasons for that. One can be that is the only the amount of market share that you are able to get in the end market, or it could be that you do not want to spend as much in that particular segment and you see better opportunity in another segments?

Dr. Satyanarayana Chava: Well we have one existing building where we did initial investment and we are doing debottlenecking and some new line addition that is in the existing building, so with this

additional Rs. 64 Crores we do not have any space in the existing building, we have to do it in a new building, which is under planning right now and probably we will do have a groundbreaking in the next few weeks. There we will need 12 months to finish the building and bring into operation, so that is the reason I mentioned some additional capacity will come between April and June 2020 and again in April and June next year. We are going to construct a new building and that building can take another 5 million capacity.

Aditya Khemka: Fair enough. I understood sir so that is good. Now on the gross margin side, I think one participant asked you this question, so in that second quarter of FY2020 you had a gross margin of 49.5%, this quarter you have reported 50.6% despite a significant jumping of formulation revenue, so the question I think everybody is trying to understand is from a margin profile perspective, how different as I understand your ARV API segment is probably the lowest gross margin segment which is where you have significantly declined this quarter and your formulation should be ideally your highest gross margin segment where you have significantly grown this quarter, so ideally the delta in the gross margin in the third quarter versus the second quarter should have been much higher than what has been reported, so this is what we are trying to understand as to whether this incremental volume in formulation segment from Rs. 150 to 300 Crores whether that came at a significantly lower margin versus what we were doing earlier in the Rs. 150 Crores?

V.V. Ravikumar: ARV APIs are not lower gross margin business. It may be slightly lower, not very low and secondly, it depends on the product mix.

Aditya Khemka: Understood, so is it fair to say that formulations are not like 20% point higher gross margin than API more like 5-10% higher margin than API, is that a fair statement?

V.V. Ravikumar: It all depends it could be from 5-20% that kind of a range.

Aditya Khemka: Depending on the product that you are selling.

Dr. Satyanarayana Chava: Depending on the product.

Aditya Khemka: So LMIC would be a lower gross margin within formulations and US and Europe will have a higher gross margin.

Dr. Satyanarayana Chava: When compared to US and Europe is lower, North American and Europe for sure.

Aditya Khemka: Volume is higher, absolutely. No Sir that explains a lot to me. Thank you and on the cost side now, so on our other expenses the growth in the cost has been phenomenal now as I understand it the capacity that we already had in the formulation and API so in this quarter or in the last 2-3 quarters we have not added any material capacity we already had this

capacity from a very long time, right and the sales actually went up this quarter because you got the tenders and we were able to supply, so let say I am comparing second quarter to the third quarter so in second quarter our other expenses were 88 Crores which was a growth of 11% year-on-year but in this quarter we have other expenses of 92 Crores which is actually a growth of something like 70% year-on-year so one is the base effect, because the second quarter FY2019 other expenses was 80 Crores and then third quarter FY2019, other expenses only 54 Crores and this is excluding your R&D spend, so if you add your R&D spend the numbers become slightly different, but I am just taking out the entire R&D spend from other expenses and then stating the numbers, so what I am trying to understand is that ideally again with such a huge amount of jump in your formulation sales, I would have expected that your other expenses would not have gone up they have gone up this quarter so anything that you point us out to whether this run rate of other expenses is what you should sustain or can that further growth in this other expenses?

V.V. Ravikumar: I can take a sense from the question that you are asking why the other expenses are higher in the third quarter? The answer is there is one off expenditure for a CPHI conference expenditure that has booked on cash expenses basis till this year, so probably from next year onwards we are going to move it on an accrual basis, and secondly because of the increase in formulations revenue its selling cost will also increase. These are two reasons for the higher other expenses in the third quarter.

Aditya Khemka: Fair enough Sir. Can you quantify the CPHI expenses this quarter?

V.V. Ravikumar: Around Rs. 5 Crores.

Aditya Khemka: About 5 Crores. Yes that explains a lot on that front and in your formulation business you are incurring more selling expenses because in the LMIC, but LMIC is tender business so right what is the reason for incurring more selling expenses in LMIC kind of business?

V.V. Ravikumar: Carriage outward and fright commission will be there.

Aditya Khemka: Basically carriage. Okay I got you. Thank you so much and all the best.

Moderator: Thank you. We have next question from the line of Aditya Agrawal from Indgrowth Capital Advisors. Please go ahead.

Aditya Agrawal: I had a couple of questions. You had mentioned that we do not buy any APIs or intermediates from China. Would we also be buying any KSM from China?

Dr. Satyanarayana Chava: We buy significant quantities of KSM from China.

Aditya Agrawal: Okay in case there is a disruption there, how would that affect us?

Dr. Satyanarayana Chava: It is difficult to predict. If There is a disruption, then there is no ship coming out of China, and it's a challenge for everybody and it is a sectorial challenge, not only pharma, many other sectors, but looking at some feedback which we are getting from vendors, they are starting their operations from next week.

Aditya Agrawal: Okay so our KSM dependency on China is going to hopefully reduce over a period of time?

Dr. Satyanarayana Chava: No it is not going to reduce. You look at one is coronavirus, other one is spring festival, and most of the China is on vacation, they were supposed to come back on 3rd of February, now they are starting their operations on 10th of February so there is a week's delay, but a week's delay in supplies of KSM is not going to disrupt for sure.

Aditya Agrawal: Okay thank you. My next question roughly what would be your market share in Dolutegravir till now. Roughly what would that number be?

Dr. Satyanarayana Chava: About 10%.

Aditya Agrawal: Okay. Are we expecting our market share in that to increase over a period time?

Dr. Satyanarayana Chava: We are creating capacities to get additional market share, but we cannot say right now what percentage we will get, but we are adding capacities to garner more market share.

Aditya Agrawal: Thank you and my third question is the tender business which is for Global fund etc, is that increasing over the last few quarters and are we projecting it to continue increasing?

Dr. Satyanarayana Chava: Increased from Q2-Q3, but we expect to it should go up in Q1 FY2021.

Aditya Agrawal: Okay fine. That is all that I have. Thank you.

Moderator: Thank you. We have a next question from the line of Dipan Mehta from Elixir Equities. Please go ahead.

Dipan Mehta: Sir my question of these Rs. 700 Crores odd sales which are there, how much would be completely tender driven, what percent?

Dr. Satyanarayana Chava: 25%.

Dipan Mehta: Only 25% is tender driven, whether it is ARV, generic, FDF or whatever?

Dr. Satyanarayana Chava: Generic, FDF yes.

Dipan Mehta: Because I understand that there is tender business in ARV and generic FDF so…

Dr. Satyanarayana Chava: The ARV APIs, we do not participate in any tenders. Our customers patriciate and we supply API to them, whereas generic FDF we directly participate in tenders.

Dipan Mehta: Next question how have you seen the prices in the tenders over the past few months, quarter. If you can give us some idea of the direction of pricing, has it been stable or decline and if so by what percent?

Dr. Satyanarayana Chava: I would say it is fairly stable.

Dipan Mehta: Okay second question is generic FDF what would be the percentage of sales to US?

Dr. Satyanarayana Chava: As we mentioned in the 9 months timeframe, 3/4 is coming from ARVs and 1/4 coming from North America and Europe and within that North America and Europe is purely non-ARV driven business.

Dipan Mehta: Generic FDF also sell you US market, right?

Dr. Satyanarayana Chava: That is what I am saying. US and Europe formulation business is 25% of our Formulations revenue and while we say North America we are also selling in Canada apart from US, so that segment is about 25% of our FDF revenue.

Dipan Mehta: Thank you and all the best.

Moderator: Thank you. We have next question from the line of Anuj Momaya from Value Quest Investment Advisors. Please go ahead.

Anuj Momaya: Congratulation on the good set of numbers. On the ARV business have you seen any prices correction in Efavirenz API or the price have remained stable?

Dr. Satyanarayana Chava: Efavirenz is fairly matured product, so prices were stable.

Anuj Momaya: So whatever the loss of business is volume loss is what you are saying?

Dr. Satyanarayana Chava: Volume losses. There is no value loss.

Anuj Momaya: And do you think this will be coming back in the next couple of quarters or now this is Rs. 200 Crores or 250 Crores for the quarterly is the new run rate for the ARV business?

Dr. Satyanarayana Chava: I think we expect this should go up.

Anuj Momaya: Go up and this become coming back to a 1000 Crores close kind of annual?

Dr. Satyanarayana Chava: Yes, we expect that.

Anuj Momaya: And what is the current gross date on our books, gross and net?

Dr. Satyanarayana Chava: 1100 Crores.

Anuj Momaya: Okay.

Moderator: Thank you. We have next question from the line of Prakash Agarwal from Axis Capital. Please go ahead.

Prakash Agarwal: Thanks for the opportunity and congrats for good set of numbers. Sir just one clarification of what you mentioned that we are vertically integrated, so I understand from a formulation side, you have strong API, but from the API side, I think one of the participant also asked that most of the industries dependent on KSM from China so you mentioned that it is a week postponement I heard that but what I am trying to understand here is what is the kind of inventory levels we normally keep so that even if there is a delay we are able to keep the supply momentum on?

V.V. Ravikumar: Normally 1-2 months there would not be any issues, but if you are aware that China was shut for last 15 days, because of the holiday, but now they are extending, they were supposed to start their operation, but they have extended by a week. We have to wait and watch, and probably if this continues beyond March for another month, probably the trouble may come. So let's wait and watch for the next one week and then probably we can decide.

Prakash Agarwal: I am just trying to understand actually the worst case like when you say trouble and suppose it opens by March and there is a month delay, what really can go for pharma companies what I am trying to understand like if we do not get KSM you would not able to supply so what really happens from a business point of view?

Dr. Satyanarayana Chava: See you will exhaust most of the inventory, you have inventory in raw materials, you have inventory in warehouse, you have inventory in port, inventory of intermediates, inventories of API then there will not be an issue for a quarter, so then maybe when one has to import instead of importing by sea you will import by air, you will cut down your logistics time by 3-4 weeks. If everything has to be imported by air in that situation we have to plan as things go by. It is difficult to plan right now.

Prakash Agarwal: So for the temporary purpose the worst case could be some cost could increase, but what I was trying to understand, if the supply be restricted and not only cost but could there be

damages in terms of not able to supply or the industry world understands that okay there is a severe problem and the penalties are not levied?

V.V. Ravikumar: Right now it is very hypothetical. We need to wait and watch how it is going to move, the pipeline will be dried up, so you have to fill in the pipeline through air imports and some other measures, so I think we have to wait and watch.

Prakash Agarwal: Okay I understand. Thank you, Sir and all the best.

Moderator: Thank you. We have next question from the line of Tarang Agrawal from Old Bridge Capital Management. Please go ahead.

Tarang Agrawal: Good afternoon. So as I see the trend in your ARV business and whatever commentary that I have gathered on your generics FDF, my sense is going forward we should see a decline in your ARV API which essentially would be because you would be utilizing those APIs to manufacture your FDF correct and consequently getting better margins?

Dr. Satyanarayana Chava: Is not true, we have earmarked capacities for inhouse FDF consumption which are separate from our 3rd party sales orders.

Tarang Agrawal: Okay and so other than FDA capacities will be used to cater to your generics FDF business, is not it?

Dr. Satyanarayana Chava: If there is more demand in generic API, we are geared up to service so we are not diverting third party API sales to our formulation.

Tarang Agrawal: Okay thank you.

Moderator: Thank you. We have next question from the line of Tushar Bohra from MK Ventures. Please go ahead.

Tushar Bohra: Good morning. Thanks for the opportunity and congratulations on an excellent set of numbers. Just to understand there has been a discussion on gross margin earlier on in the conversation, would it be fair to assume that over the next two years, as formulation revenue from US picks up and I would assume North America today would probably more Canada than US, please correct me if I am wrong?

Dr. Satyanarayana Chava: You are right.

Tushar Bohra: Okay so as US picks up over the next two years maybe European formulations business picks up, within formulations your mix is changing, so again your gross margins overall are

there is a scope for this to move up say be 300 to 350 bps say next three years or that would be an overestimate or is it a possibility?

V.V. Ravikumar: No we do want to give a quantitative guidance here on the percentage, but there are chances of improvement. In the worst case scenario, probably it is going to be maintained.

Tushar Bohra: Okay so we should be at or above the current level?

Dr. Satyanarayana Chava: That is a good estimate.

Tushar Bohra: Right. Second just again sticking into numbers, we did about Rs. 74 Crores profit in this quarter assuming that we maintain more or less these levels just for the sake assumption. You effectively saying about Rs. 300 Crores is the run rate we established at end of FY20. Will it be fair to assume that we are seeing 20% revenue growth in FY21 with some operating leverage the profitability should be higher and it could be on a Rs. 300 Crores base, would that be a fair assumption?

V.V. Ravikumar: We do not want to comment on the numbers.

Tushar Bohra: Okay just generally the base for profit calculation for next year should be the exact run rate for FY20, would that be fair to assume?

Dr. Satyanarayana Chava: We can say the gross margin and our EBITDA margins will be maintained at least the current level. We are not commenting how much we will grow, but it will be maintained at least the current level.

Tushar Bohra: Thanks that helps. On the overall China situation, again a lot has been asked earlier by earlier participants, but just to take the scenario where this scales up into a bigger issues and say worst case we do not supplies from China coming in, maybe a 20-25% 30% supply cut or even something more drastic, what are the alternatives we have from a sourcing perspective and how costly could those alternatives be and second is there any opportunity also from a supply perspective for us in turn for any API and intermediate could that be an opportunistic business for Indian companies?

Dr. Satyanarayana Chava: Yes there is an opportunity but see when API manufacturing unit uses 20 chemicals to make an API, and of which if you get 19 and do not get 1, that means you do not make any APIs as simple as that. So this is a difficult period. We are taking this risk to an extreme extent but we don't see that happening. The reality is supplies will resume very quickly.

Tushar Bohra: But just to understand intermediate and KSM is relatively easier to source in India, you can still setup supplies in India right if you plan ahead as compared to API?

Dr. Satyanarayana Chava: No actually it is relatively easy to be an intermediate supplier in India rather than starting materials supplier as the intermediate supplier in India also has to by starting materials from China.

Tushar Bohra: Okay, so there could be an issue overall with KSM supplies. Fair enough. Thank you so much for the opportunity.

Moderator: Thank you. We have next question from the line of Cyndrella Carvalho from Centrum Broking Limited. Please go ahead.

Cyndrella Carvalho: Congratulations on good set of numbers. Sir just wanted to understand more on synthesis side, so the Aspen contract whatever we have said earlier how do we see it going ahead and you have also mentioned that there are two commercialized products right now with us so how many are there with us in total in terms of number of products if you could help us understand and how many of them would be in the late stages if you could provide some color on that could be really helpful?

Dr. Satyanarayana Chava: Yes, our Aspen business will peak out next year because most of the products went commercial and when it comes to NCE part, we have two products commercial though they are APIs and one intermediate is commercial. I think there are the two more in phase 3 right now and several in earlier phases. Total we have maybe 30-40 active projects right now at various stages.

Cyndrella Carvalho: Just to get more clarity the margin profile of this business should be better than our average margin is a good understanding?

Dr. Satyanarayana Chava: Absolutely, this is the highest margin business right now.

Cyndrella Carvalho: Yes that is very helpful Sir. Thank you and all the best.

Moderator: Thank you. We have next question from the line of Charulata Gaidhani from Dalal & Broacha. Please go ahead.

Charulata Gaidhani: Hi congrats on the good set of numbers. Can you give some clarity on the EU partner? You said that non ARV business will grow by what percent?

Dr. Satyanarayana Chava: See in the current year, we expect to do about 600 million units for the partner and the FY2021 maybe we will do a billion units for that, so that is the level of increase we expect.

Charulata Gaidhani: Okay and this is entirely formulation?

Dr. Satyanarayana Chava: We do API as well and we convert that API into formulation and give it in bulk to our partner in Europe.

Charulata Gaidhani: So what proportion would be formulation from this?

Dr. Satyanarayana Chava: 1 billion units is formulation so that means we are using roughly 20% of our formulation capacity to contract manufacturing where we make API also for our formulations.

Charulata Gaidhani: Okay and my second question pertains to Efavirenz. The inventory has it been sold off?

Dr. Satyanarayana Chava: There is No Inventory.

Charulata Gaidhani: It was there in the last quarter right?

Dr. Satyanarayana Chava: We do not have any inventory challenges in Efavirenz.

Charulata Gaidhani: Okay and in terms of how our products doing in the US market, Pregabalin?

Dr. Satyanarayana Chava: Pregabalin is doing good. We have about 10%-12% market share right now.

Charulata Gaidhani: Okay and metformin?

Dr. Satyanarayana Chava: Metformin we have very small market share.

Charulata Gaidhani: Okay and my question was in terms of ARV treatment is the Indian market also seeing some scope for opening up?

Dr. Satyanarayana Chava: So far in the ARV India tenders we do not participated, but the opportunity is big, so far, we have not participated.

Charulata Gaidhani: Okay but do you think it can with more focus on health in the Indian market.

Dr. Satyanarayana Chava: Probably yes, but not in the near future. We are not intending to participate in the NACO Indian government tenders.

Charulata Gaidhani: Okay. Thank you, all the best.

Moderator: Thank you. Ladies and gentleman that was the last question. I now hand the conference over to the management for closing comments. Sir over to you!

Dr. Satyanarayana Chava: Thanks everyone for supporting us during the last several years and some of your questions were very encouraging and very thought provoking. Thanks for participation. Thank you Chirag and thank you Kotak Sec, for hosting. Thank you.

Moderator: Thank you. Ladies and gentlemen on behalf of Kotak Securities Limited that concludes this conference call. Thank you for joining with us. You may now disconnect your lines.