"Neuland Laboratories Limited Q3 FY20 Earnings Conference Call"

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Moderator: Good day, ladies and gentlemen, and welcome to the Q3 FY20 Earnings Conference Call of Neuland Laboratories 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 "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Diwakar Pingle from Christensen IR. Thank you and over to you, sir.

Diwakar Pingle: Thank you, Margaret. Good afternoon friends. Welcome to the Q3 FY20 earnings call of Neuland Laboratories. To take you through the results and answer your questions today, we have the management team from Neuland Labs represented by Sucheth Davuluri - Vice Chairman and CEO, Saharsh Davuluri - Joint Managing Director and Amit Agarwal - CFO.

At the outset, we would like to apologize the delay in sending the results to you. Two reasons, the board meeting extended much more than we expected it to and number two, there were some technical issues on the exchange's website. So, we really had to confirm that the results had been uploaded before they actually send it out. It has been uploaded right now and we will also be sending the press release to you shortly. As the call goes on, you will see it hitting your mailbox. Again apologies for this, something that we could not totally forecast.

Before we start, I would like to say that everything that is said on this call which reflects any outlook for the future or which can be construed as a forward-looking statement must be viewed in conjunction with the risks and uncertainties that we face. These uncertainties and risks are included but not limited to what we have mentioned in the prospectus and subsequently in the annual reports which you can find on the website.

With that said, I will hand over the floor to Amit Agarwal to make the opening comments which will be followed by Saharsh and then we will go on to the Q&A. Amit, over to you.

Amit Agarwal: Thanks, Diwakar. Good evening friends, a very warm welcome to all of you joining this call.

I will first touch upon the financials followed by Saharsh taking you through the business highlights, after which we will open this call for the Q&A session. On the quarterly financials, the total revenue was Rs. 204.6 crores for Q3 FY20 as compared to Rs. 171.8 crores in the same period last year registering a growth of 19%. EBITDA stood at Rs. 29.1 crores versus 16.3 crores last year. This translates to an EBITDA margin improvement of about 407 bps Net profit stood at Rs. 11.0 crores as compared to Rs. 4.6 crores in the corresponding quarter and EPS stood at Rs. 8.61 as against Rs. 3.59.

The financials for 9 months ended 31st December 2019 also show a similar trend. The total revenue was up 572.9 crores as compared to 496.3 crores, an increase of 15.4%. EBITDA Margin also was up at about 4.4% points and net profit saw a growth of about 168% to finish at 25.2 crores as opposed to 9.4 crores in corresponding 9 months of last year.

Q3 FY20 was driven by strong growth in CMS segment which was about 25% of the total pie as opposed to 16% in the corresponding quarter of FY19. Along with this, the cost optimizing initiatives in the GDS prime category products has led to continuous improvement in the margins of the company. As mentioned in the last conference call, our debt levels continued to be comfortable and we will end the year with almost a similar debt level as we are seeing now. So currently we are at about 211 crores. We should end the year anywhere between 220 - 225 crores and our current cash balance is about 26 crores.

I will now hand over the call to Saharsh to give the highlights of the business.

Saharsh Davuluri: Thanks, Amit. Good evening everyone. We have done another quarter of reasonable revenue growth driven primarily by our CMS business which is showing good momentum now. The growth in the CMS revenue is primarily driven by projects in the pipeline which actually augurs well for our future growth. The GDS business is stable and it is in line with our plans for the year. We see our specialty business which is again part of our GDS business is growing and margins have improved with better product, segment mix and cost structure across the GDS business.

On the CMS side, while the overall pipeline of projects is increasing which you will see in the table that is provided in the press release, we are also now seeing a trend of getting more advanced projects with closer cycle times to commercialization. So over the past few quarters, we have added many projects of which 3 APIs are either in phase 3 or development stages which could contribute significantly to our revenue in the medium term. So overall, we are excited by the prospects of all our businesses as we see evolution of the product mix even within the segments.

On the China front as it stands, we do not have any issues for Q4 supplies. However, we will be monitoring the situation very closely for the next fiscal to make sure that our supplies are secure. The backward integration at Unit III is going on as planned and we will have two scaled up products this year. Unit III is slowly but steadily being readied for capacity planning for the future years. We do believe that our decision of investing in this facility which is the largest of our three units will definitely yield us good returns. We have also provided you as I mentioned earlier the pipeline data for the CMS projects, so you can monitor the progress and if you have any questions about any of this information, please let us know. I think now we can move to Q&A.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Shlok Dave from Seraphic Capital. Please go ahead.

Shlok Dave: I was just looking at the gross margin number that has come forward and also the split that you have given in terms of Prime, Niche and CMS. So there has been a degrowth in Niche, am I reading this right or am I mistaken, quarter-on-quarter and also Y-o-Y?

Amit Agarwal: Yeah. So, quarter-on-quarter, you are right. There is about 1-1.5% degrowth in the gross margin. That will always happen because we prefer looking at on either a full year basis how it is moving because there are lot of factors in terms of how much of inventory we sold during the quarter, what has been the specific product mix. So yes, what you are saying on a gross margin basis quarter-on-quarter there has been a marginal decline.

Shlok Dave: But in the individual segments there has been no decline, right? It is just that the mix has changed a bit?

Amit Agarwal: Yes.

Shlok Dave: And any commentary you can give on the niche segment? How do we expect Q4 and then first half of next year to pan out?

Saharsh Davuluri: I think the one thing that we are observing in the niche segment is that, it is getting more and more diversified. I think there are lot of products like Deferasirox, Dorzolamide many other products which are actually now ramping up in terms of volume. So, we are seeing even molecules like Ezetimibe which are kind of contributing in the last couple of quarters. So, we see the diversification will continue to happen. So, growth will continue to be there. But as Amit said, the caveat is quarter-to-quarter there could be some volatility. But in general, it would be hard for us to give a guidance per se, but I think if you look at the kind of performance we have had over the last year, I think it is a good base for us going forward.

Moderator: Thank you. The next question is from the line of Jyotivardhan Jaipuria from Valentis Advisors. Please go ahead.

Jyotivardhan Jaipuria: I had a couple of questions on this China issue. So one is, are you still getting supplies from China or have they all stopped totally?

Saharsh Davuluri: So Jyoti, I think as I had mentioned for now the China situation seems to be unclear for us. For Q4, we have our supply secured. There is also Chinese New Year that happens towards the end of Jan. So typically, most organizations including Neuland stock up for inventories for the month of Feb and March, in anticipation of Chinese New Year. The only thing that we know for sure is that the Chinese government had extended the Chinese New Year holidays by about a week to deal with the virus outbreak and so China has really come back from holidays yesterday only. So, it is still very early for us to figure out what is the situation and the short answer to your question is that we have not planned to receive many shipments from China in the last couple of weeks. So, it is hard for us to know if there has been a real impact or not.

Jyotivardhan Jaipuria: How much of our raw material comes from China today? How dependent are we?

Sucheth Davuluri: So, our direct imports are about 30%, Jyoti, rest of it is brought from India and Europe as well, but indirectly obviously the number could be much larger, but we don't have a handle on that number. But based on our initial assessment of the situation, we only have about 2 suppliers or 2 approved vendors from the provinces that have been mostly hit because of this coronavirus situation. Most of the other vendors belong to other areas which have not been severely hit. But we still continue to monitor the situation. As of now, for Q4 we don't see a significant impact, but will have to continue monitoring and see how the situation develops.

Jyotivardhan Jaipuria: Okay. And our Unit III, I guess is not equipped to take care of some of the supply in case we don't get it let us say for Q1 of next year?

Sucheth Davuluri: Not immediately, Jyoti, obviously since all of our sales are to the organized markets so it will take 3 to 6 months leans time to get Unit III up and running and get it qualified at an alternate site. So, Unit III will not help us for any immediate impact mostly for long term. Notwithstanding that as we mentioned on previous calls, that we have already qualified Unit III for couple of our very key regulatory starting materials and continues to supply for our commercial API and that is continuing to work for us.

Jyotivardhan Jaipuria: So at least for Q4, we are comfortable with the earlier guidance and then we will have to figure in the next few weeks what happens to the China again, would that be a fair assessment?

Saharsh Davuluri: Yes, for Q4 most of our raw materials are already in our possession. So, we feel secured for Q4, but I think Q1 we will have to monitor closely and as and when we have any updates, we will let you know.

Jyotivardhan Jaipuria: Just another question. I believe Amit is leaving, right? So, have you found a replacement, or we are going to start looking?

Sucheth Davuluri: We will start the process immediately, Jyoti. Amit has been solid member of the team. He has contributed significantly to the organization and has got a lot of value through his position and the organization as well. I think all of us recognized that. It sad to see him go and we will immediately start the process to find a suitable replacement while wishing him all the luck.

Moderator: Thank you. The next question is from the line of Diwakar Pingle from Christensen IR. Please go ahead.

Diwakar Pingle: Sir, to just slip in a question. How do you kind of see growth in CMS panning out for maybe the next financial year and going forward? Is that what is going to drive growth for the company in the next 2 years?

Saharsh Davuluri: I think obviously the current year has given us a lot of satisfaction in terms of results. There is a lot of traction on the CMS new projects as well as good growth in the baseline of the CMS business which is the traditional whole CMS we had for several years. I think our outlook remains positive especially because the two markets that we are focusing on Japan and North America and their pipeline of opportunity looks quite strong. The level of confidence that our current customers are exhibiting on Neuland's capabilities are also very encouraging to us. The biotech funding which is a very important factor that drives our businesses also is looking quite optimistic, thanks to the US economy and the investment cycles that are happening over there. So I think all in all, just putting this together, we feel that the outlook for new business going forward also should be positive. As I had also mentioned in my opening remarks, the pipeline of projects that have entered the system in the last 3 to 6 months are quite advanced in nature, like say 3 molecules are about to get into commercial. These are opportunities which have a shorter cycle for commercialization. So, unlike say 4-5 years ago, where we were mostly engaged in phase I, phase II projects and they would go through a natural attrition and a long cycle. These molecules have very little attrition because from phase III to commercialization, the rate of failure is very low and also, the chances of commercialization are high. The cycle time for commercialization is high. We see that the opportunities entering the system recently help us look at a strong growth, but having said all these, we would refrain from giving any specific guidance in terms of any kind of growth moving forward.

Sucheth Davuluri: Just to add to that, Diwakar, just to reinforce what have been said, we are seeing a lot of momentum from projects of molecules which are in a late stage of development either at the verge of application being filed or where the application is already filed and that customers looking for reliable long-term source. So, I think Neuland has definitely been recognized as one of those organizations that is able to help our company commercialize that molecule and manage the lifecycles. We are seeing a lot of traction there. So, when we look at some of our lag indicators such as RFPs, the RFPs conversion, the number of customers in the pipeline and number of projects that we are executing compared to the previous quarters, all of those lag indicators have shown improvement which is reflective of the overall market dynamics and the growth in business.

Moderator: Thank you. The next question is from the line of Vikrant Kashyap from Kedia Securities. Please go ahead.

Vikrant Kashyap: You just mentioned in the opening commentary that CMS is contributing 25% of the total pie, am I correct?

Amit Agarwal: Yes.

Vikrant Kashyap: And what was it in the last year?

Amit Agarwal: It was 16%.

Vikrant Kashyap: So where do you see it in next 2-3 years? How is it shaping up?

Saharsh Davuluri: See, now since the base is higher, so I do not see it growing at a similar level by about 9% points or something of that kind, but we will see a gradual growth and our target is we should see this business from 25% to anywhere between 30%-35% over next 2-3 years because the overall size, the pie also is going to grow.

Vikrant Kashyap: So, it is a fair assumption that most of the pie will be coming from CMS and the specialty part of the GDS?

Saharsh Davuluri: Largely, the growth will be driven by these two segments, Vikrant; however, the caveat is that there will be certain products from prime category which be added from time to time and there will be these exceptions that could also determine the overall growth rate. So, two specific examples I can give you, Levetiracetam and Labetalol. These are two products from a prime category, but both these products have not only grown in the current year, but we expect them to grow in the next year as well. These are high volume and mid value products, so if their growth goes above than our expectations, then what we said earlier may not necessarily hold water. So all segments will grow in that case, but then our overall growth projections also will be better than what we anticipate.

Vikrant Kashyap: Got your point. And do you think that the current margins that we have reported are sustainable?

Amit Agarwal: Yes, they will be sustainable. The only caveat is that the raw material prices remain the way they are because these margins have been achieved as we mentioned because of both our focus on the product mix as well as the cost measures. Along with that, we are doing the improvement in the product mix and the segment mix. So, I do feel basis this it is sustainable, and it should improve from here.

Vikrant Kashyap: And you mentioned that our debt would be like Rs.20-25 crores for the year and if we see that, there is an improvement in the cash flow of the company. So over next 2-3 years, do we see this numbers coming down or your focus will be more on deploying money for R&D of the new molecules or creating new product pipelines?

Amit Agarwal: Vikrant, the way I track it or the company tracks it is to see that where is my debt to EBITDA, where is my return on capital employed. So, our decisions on increasing or decreasing debt or investing, it will all depend on ensuring that we have healthy numbers on that front, and we have enough cushion to take care of any business volatility. In next 1 to 2 years, I do not see any significant increase in debt, but yes, we will ensure that our current ratio is stable, this time it is more than 1.3. We will ensure that debt to EBITDA is somewhere around 2. So, I think those kinds of measures we would like to maintain.

Moderator: Thank you. The next question is from the line of Abdul Puranwala from Anand Rathi Securities. Please go ahead.

Abdul Puranwala: The first question is regarding the CMS pipeline, so in commercial side we have seen that there were 7 molecules till Q2 and that has now reduced to 4 in Q3. So, the first question is what would be the reason for this decline and what would be the outlook for the other 4 molecules which we have?

Saharsh Davuluri: I think Abdul, the numbers are also changing because the commercial pipeline for the Q3 indicates that for those 3 molecules, we did not have orders in Q3. And these 3 specific molecules, however, we cannot disclose the names. We had made deliveries, I believe, in Q1 or Q2 and we expect that orders will again be coming maybe from Q4 or Q1. So, I think it is a very recognizable pattern and we think it is a part of our business.

Abdul Puranwala: And the next question would be on margins. I understand you just explained that, but my question was really on this margin expansion what we see of nearly 470 bps. What portion of that would be attributable to the improvement in realization due to this China issue? And what portion would be towards cost optimization effort?

Amit Agarwal: I think I would not attribute anything to the China issue as far as improvement in margins is concerned. The margins are purely driven by the segment mix, partially the product mix, but it is more so the segment mix where CMS has gone up and the cost measures. I do not have the precise numbers right now in terms of what percentage between these two, but to answer your question nothing on account of China.

Abdul Puranwala: Sure. And just last question would be on what would be your working capital in terms of days for the 9 months?

Amit Agarwal: So, our working capital, if you look at the 3 elements, inventory, receivables and payables, it is close to about 120 days of sales.

Moderator: Thank you. The next question is from the line of VP Rajesh from Banyan Capital Advisors. Please go ahead.

VP Rajesh: Just a question about how this coronavirus in China is impacting our business even on the supply side or on the customer side?

Sucheth Davuluri: So far, Rajesh, we were mentioning earlier in the call that as far as Q4 is concerned, we are not seeing any significant impact. As you know, the Chinese year has just ended, and people are just returning. Few of the ports have been shut down and a lot of backup of vessels which are waiting to be shipped. In that sense, a lot of our materials is already in transit or in stock already. We do not expect a significant impact in Q4. However, based on early information from our suppliers, we do expect things to continue and shipments to happen, but how much it will impact is still not clear. Having said that, we do not have any major suppliers in the two provinces that have been most impacted by the coronavirus. And for the suppliers that have been impacted, we either have an alternate source in a different part of the China or an Indian or a European alternate source, but we are continuing to monitor the situation. It is difficult to say how good or bad it is going to be.

Moderator: Thank you. We will take the last question from the line of Anirudh Shetty from Solidarity Investment. Please go ahead.

Anirudh Shetty: Sir, earlier you had mentioned that you are very disciplined on the debt to EBITDA ratio and return on capital employed ratios. So just wanted to know every time you guys do a project, what is the minimum ROE requirement that you guys have, below which you guys want to pursue anything?

Amit Agarwal: So Anirudh, just to be clear on your question, what you are asking is that earlier you had mentioned that you guys intend to be fiscally frugal given the background you given us what is the return on investment that you look for when you are approving a capital project, is that correct?

Anirudh Shetty: Yes, sir, absolutely.

Amit Agarwal: The hurdle rate for that is about 25% should be return on capital employed.

Anirudh Shetty: So, this is pre-tax return on capital employed?

Amit Agarwal: This is pre-tax return on capital employed.

Sucheth Davuluri: This is pre-tax return, Anirudh, but also you have to take into consideration that not all the capital projects we do have a specific return attached to it, lot of them are also for upgradation and replacement capital expenditure as well.

Amit Agarwal: So, if I put it this way, one is the maintenance CAPEX which is about 20 to 30 crores approximately in a year, rest of the CAPEX would have a threshold of 25% return on capital employed and out of that, majority of would be higher. So generally, they are larger projects which obviously have to have their maturity period and therefore they would be judged at 25%. Otherwise, we generally prefer a project which has a payback of about 2 years, maximum for the smaller projects. So, if a smaller project of 5 crores comes to the organization and if it is like 4 years payback, probably it will not get approved.

Anirudh Shetty: Last question is so EBITDA margins stand at roughly around 13% for the 9 months FY20 standalone, so where do you guys see the margins settling at 3 to 5 years down the line when things are more normalized?

Amit Agarwal: Our target is that it should be in line with industry. Today, we understand it is a little lower for various reasons. But the way we are working and we have discussed as part of our strategy in our call and earlier as well, so over next 3 to 5 years we should be in line with industry.

Saharsh Davuluri: I think what we have said previously is 18 to 20% ideally is where we would like to get to, but it all depends on the kind of mix of projects, the kind of molecules we have and the product mix. So, I think that is what we are targeting. I think we want to be cautious in terms of giving it out as guidance.

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

Sucheth Davuluri: Good evening friends. Thanks again for your questions and your interest in the business. I hope that we have answered all your questions and as a result of that, provided more insights about Neuland's business strategy, current operations, where the improvement in margins is coming from, what are the initiatives that we are taking, what is the threshold return that we expect for our capital projects, we update on Unit III, the China situation as well as the product mix. Once again, we thank you for your interest and we look forward to future interactions. You can always reach out to Diwakar at Christensen or us with your questions and will be more than happy to answer them with respect to Neuland's future and business performance. Thank you.

Moderator: Thank you. On behalf of Neuland Laboratories Limited, that concludes this conference. Thank you for joining us and you may now disconnect your lines.