Syngene International's Q3 FY 2023 Conference Call

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Key Participants from Syngene International

- Mr. Jonathan Hunt: Chief Executive Officer
- Mr. Sibaji Biswas: Chief Financial Officer
- Dr. Mahesh Bhalgat: Chief Operating Officer

Moderator: Ladies and gentlemen, good day and welcome to Syngene International Third Quarter ended December 2023 Financial Results Conference Call. As a reminder, all participant lines will be in 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 touch tone phone. Please note that this conference is being recorded.

I now hand the conference over to Ms. Avantika Mishra from EY. Thank you and over to you, ma'am.

Avantika Mishra: Thank you, Rujuta, and good afternoon, everyone. Thank you for joining us on this call to discuss Syngene's Q3 FY'23 financial and business performance. From the management's side, we have Mr. Jonathan Hunt, MD and Chief Executive Officer; Mr. Sibaji Biswas, Chief Financial Officer and Dr. Mahesh Bhalgat, Chief Operating Officer. Post opening remarks from the management, we will open the line for Q&A, and we will be happy to answer any questions you may have.

Before we begin, I would like to caution that comments made during this conference call today will contain certain forward-looking statements and must be viewed in relation to the risk pertaining to the business. The Safe Harbor clause indicated in the investor presentation also applies to this conference call. The replay of this call will be available for the next few days and the transcript will be subsequently made available.

With this, I now hand over the call to Mr. Jonathan Hunt. Thank you, and over to you, sir.

Jonathan Hunt: Thank you and good afternoon, everybody. Thanks for joining us on the call today to discuss Syngene's performance in the third quarter.

I'll start by commenting on the headline numbers, then move on to some key operational and strategic highlights for the quarter. Sibaji will provide a more detailed insight into the financials in his remarks. I am pleased to report that we continue to see good demand in our main client markets of the US and Europe, which combined with strong execution, and good forward planning, helped us deliver solid revenue growth in the third quarter.

In addition, I think we are building the quarter working with regulators. During the quarter, we received regulatory approval for our commercial biologics operations from the US FDA, from European Union, EMEA, and the UK's, MHRA. Pleased to have these audits behind us but more importantly, we are delighted to see that our commitment to high operating standards was endorsed. All four divisions performed well during the quarter. Revenue from operations grew by 23% to INR 786 crores over the corresponding quarter last year.

Operating EBITDA was up around 14% to INR 231 crores. Profit after tax was up 5% over the corresponding quarter last year to INR 110 crores. On the back of the robust first half of the year, the performance during the third quarter was steady and we continue to make progress on those strategic priorities. I think overall, we are well positioned to deliver our guidance for the full year.

Turning now to the operating divisions, I'll start with Discovery Services, which grew steadily through the quarter. Our second campus in Hyderabad continued to expand and now plays an increasingly important role in our Discovery Chemistry operations. In the last nine months, the number of scientists increased to around 800, and we expect the completion of additional 24,000 square foot of lab space and a new compound and management facility in the current quarter. It gives us further space to grow as well as enhance our capabilities.

Growth in Development Services was driven predominantly by repeat orders from existing clients as well as an increase in the number of collaborations with emerging biopharma companies. During the quarter, we continued to invest in new infrastructure and capability development. For example, we completed the construction of a state-of-the-art sterile fill-finish facility for small-scale clinical manufacturing. The facility successfully completed the Central Drugs Standard Control Organization (CDSCO) joint inspection, and we expect to start GMP production in this quarter.

This facility allows us ability to offer end-to-end solutions in drug product development and manufacturing for clinical supplies of both small and large molecules. Turning now to Manufacturing Services. Overall, we made good progress on our strategic milestones for the quarter. As I mentioned, we successfully completed the US FDA, EMEA, and MHRA regulatory audits for our commercial-scale biologics manufacturing facility. With cGMP certifications from the regulatory agencies in place, we are on track to manufacturing drug substance at a commercial scale and make progress on the Biologics growth strategy. So, to summarize, before I hand it over to Sibaji, overall, the demand environment remains broadly positive. To capture these opportunities, we continue to invest in digitization, capability-building and additional infrastructure development. All divisions have shown steady growth over the past nine months, and we expect a busy fourth quarter.

The positive outcomes for the quarter of the three major regulatory audits is a very positive step forward in enabling our commercial scale of Biologics strategy. So, overall, we are confident and we're on track to deliver our annual revenue growth guidance of high teens.

So, with that, let me hand over to Sibaji to provide more details on the financials.

Sibaji Biswas: Thank you, Jonathan, and a very good afternoon to you all. Let me we start with the revenue performance and take you through margins, profitability and capex investments for the company and end with the outlook for the full year FY '23, which is in line with our upgraded guidance given at the end of the first quarter.

I'll cover the third quarter performance at the beginning and then we'll briefly touch on the nine months performance. Like the previous two quarters, you will hear me referring to underlying performance in parts of my comments. Just to be clear, this is performance excluding the impact of remdesivir manufacturing. We recorded high sales of remdesivir during the last financial year, most of it in the first quarter. However, we did continue remdesivir sales last year till the end of the third quarter. As no remdesivir sales have been recorded in the first nine months of this financial year, we think it is helpful to exclude remdesivir from both periods to illustrate the underlying performance of the ongoing business. As you heard from Jonathan, the reported revenue from operations for the third quarter grew by 23% versus the same quarter last year. Underlying revenue growth, that is excluding remdesivir, was stronger at around 28%. This performance comes on back of a very strong first half, but we had an underlying growth of around 30%.

Growth was primarily driven by continued good performance from the Discovery Services division and strong performance from manufacturing division driven by Biologics. Development Services also grew well, but the growth was relatively modest due to spillover of execution to quarter Q4.

Overall, reported EBITDA for the quarter was up 15% year-on-year to INR 248 crores compared to INR 216 crores for the same period last year. The reported EBITDA margin for the quarter was at 30.9% versus 33.1% last year.

EBITDA from operations, that is excluding other income, came in at INR 231 crores compared to INR 203 crores in the same quarter last year, up by around 14%. The operating EBITDA margin, which is without other income was 29.4% for the quarter compared to 31.7% last year. To understand the operating leverage equation, it is important to look at the P&L restated at the hedge rate, which form the basis of our guidance at the beginning of the year.

Our reported hedge rate is based on average values of the forward and options contracts for the period and builds in the structural long-term rupee depreciation versus the US dollar. The forward rate which is generally higher than the spot rate provides partial cover for the Indian inflation which shows up in the expense lines. The hedged rate revenue growth was at high teens this quarter, while the EBITDA growth for the quarter was 15%. The EBITDA growth was lower than the revenue growth, primarily due to achieving the mix towards manufacturing, which currently has lower margins because of lower scale and capacity utilization. In addition, there are inflationary pressures on other operating expenses, which are explained further.

During the quarter, staff cost increased by 12% year-on-year. The increase is in line with the increase in headcount and reflects salary increases and change in mix of the employee base. Other opex has seen a 33% increase versus the third quarter last year. This is primarily due to cost inflation as well as a step-up in business travel, sales promotion, and other overheads. It is important to note that as we came out of the pandemic at the beginning of this year, we deliberately chose to invest in business and sales promotion activities including travel, which also drove up costs.

Maintenance expenses increased as a reflection of the new facilities built over the last few years. Other operating investments, including the expansion of the commercial team and acceleration of digitization and automation projects across the business also led to higher costs on a year-on-year basis. These are sound investments for the future, and we should see benefits from these investments over the long run.

Other direct costs, which primarily include power and equity costs, increased 7% year-on-year, and these now constitute 3.4% of the revenue from operations for the quarter compared to 3.8% for the corresponding period in the prior year. In the current environment, we are seeing benefit of our investments in renewable energy, which is not only de-risking the cost of energy supply, but also helping us make good progress on our environmental commitments by reducing carbon emissions. Despite an increase in total energy consumption due to the expansion of our facilities and increasing power and fuel tariffs, these investments provide us a mechanism to mitigate cost increases.

Revenue for the quarter was hedged at INR 79 per US dollar. Our margin guidance for the top line was driven at the hedged exchange rate, while the average realized rate was upward of INR 81 per US dollar. The depreciation of the rupee versus the US dollar tendered our top line without commensurate benefit of the bottom line because we booked hedge losses as a part of our operating expenses.

In summary, the operating margin adjusted for the revenue at the hedge rate was 30% compared to 30.8% last year. Hedge losses during the quarter were at INR 16 crores, reflecting the difference between average spot rate during the quarter to the hedge rate. This is compared to the hedge gain of INR 20 crores in the same quarter last year.

Other income for the period increased from INR 13 crores to INR 17 crores, an increase of 34% on back of increasing yields on investments and fixed deposits. Depreciation and amortization for the period was at INR 95 crores compared to INR 79 crores in the same period last year. This increase of 21% on a year-on-year basis is mainly due to the new investments that we made in the last 12 months.

Finance cost increased from INR 9.4 crores to INR 13.7 crores and are still recognized by interest component on new released assets following lease accounting, as per accounting standard IAS 116. This is in addition to rising interest rate on borrowings. Even though a large part of our loan is covered through interest rate swaps, the steep increase in the interest rate on the unhedged portion of the loan debt to higher interest costs.

Profit before tax increased by 9% year-on-year. Here the lower growth of PBT compared to the EBITDA is on account of high interest rates and increased depreciation. The effective tax rate for the quarter was around 21.5% compared to 19% during the same period last year. You will remember that we expect that there will be a gradual increase in the tax rate as some of our units move out of SEZ tax benefit period and an increasing share of business coming from locations not enjoying SEZ benefits.

While the effective tax rate is going up, we have a MAT credit of INR 160 crores, which will be utilized over the next few years, and this will enable us to maintain the cash outflow for income tax at the minimum pertained tax level. Profit after tax stood at INR 110 crores as compared to INR 104 crores last year, a growth of around 5%.

Moving to the nine months performance. Revenue from operations grew by 19% including the impact of remdesivir in the base. Underlying revenue growth for 9 months was at 30%. Material costs increased by 6% year-on-year. However, adjusted for the remdesivir impacting the last year material costs growth was around 26% year-on-year, reflecting the change in mix of revenues towards development and manufacturing divisions.

Staff costs increased by 13% YTD in line with the headcount growth. Other direct costs increased by 32% basically driven by inflationary pressures on utility and other costs and other expenses grew by 37%, primarily due to resumption of activities post-pandemic and other operating investments explained earlier.

The reported EBITDA margin for 9 months was at 29.7% against 31% last year. EBITDA margin from operations were at 28.2% against 29.6% last year for the same period. Capex for the 9 months of the year was around $50 million, and an almost equal amount has been committed and projects are under execution.

Now moving to the guidance for the year. Based on the 9-month results and the overall trajectory of the business, I am happy to reconfirm the guidance for the full year of high-teens revenue growth and an EBITDA margin of around 30%. Please note that this guidance was made and continues to be at the hedge rate of INR 79 per US dollar. Given the rupee versus US dollar depreciation we have seen, you need to address the top line growth and the margins accordingly.

PAT growth for the full year continues to be expected in the single digits. Looking forward, we expect operating leverage within the business to improve from next year onwards, and that should improve the overall PAT outlook in the coming year. But I'll say more about that once we have completed the year at the full year results.

With this, I complete my commentary and will hand back to the moderator for questions. Thank you.

Moderator: The first question is from the line of Tarang Agrawal from Old Bridge Capital.

Tarang Agrawal: Three questions from my side. One, Jonathan, are you witnessing any slowdown in preclinical or Phase I clinical projects, especially from your emerging biopharma customers? That's one. The second, if you could just give us some sense on what percentage of your molecule is currently under Phase II and Phase III would be with the emerging bio customers? And what percentage would be perhaps with the big pharma? The third question is, in the quarter gone by, did any of your customers receive any NCE approvals, which is likely to be commercialized in the near future?

Jonathan Hunt: Thank you for the questions. Albeit you sound a bit anxious by the nature of the question. So, the first question, the answer is no, which is probably about the most direct sort of insight I would give you. I am not really seeing a slowdown . I'm assuming your question, just do feel free to come back and comment, is born out of trying to interpret US fundraising and the environment for US biotech in terms of IPOs and fundraising.

To some extent, and I think I commented this on previous quarters, those that have already well-funded are very keen to try and stretch that money. If they've got a year's funding, they'd love to turn it into the two years funding pathway. One of the ways they can do that is making sure that they are spending it smartly and wisely and companies like Syngene offering very good value for money. So, I think that sort of offsets a bit, no I'm not seeing a discernible mix.

Of course, it all depends on your reference point. If you go back to, I don't know, 18 months to two years ago, we were at an all the time peak for fundraising in the US start-up biotech environment but driven to some extent by two factors that are unusual in tempo. One is 10 years of quantitative easing, an incredibly low cost of capital and cost of fundraising. And the other one is, a lot of work that is driven in related to the pandemic.

So, it depends on what you compare. And so, if you compare it to a sort of a once in a decade high, then I think funding levels have come down, but I am not seeing anything discernible. Onto the other two questions. I don't really have a comment. –We do not track our projects by Phase I, Phase II, Phase III, all are represented. So, it's not a number I can really report. I think you can an essence from our commentary and my answer for the question.

The demand in the market, I think, is reasonably healthy. We are seeing at our Discovery Services, development and manufacturing, a reasonable demand environment for us in the US and Europe to our main markets. It is much more around execution and being commercially competitive, and I think are the drivers of our growth. Does that help?

Tarang Agrawal: It does. And to my last question, I mean, on any of your clients getting an NCE approval in the quarter gone by?

Jonathan Hunt: But I am not sure what can you do with that information, I'll try to answer it. This is on our manufacturing business.

Tarang Agrawal: Okay. Sure. And if I can squeeze in one more. Sibaji, typically, I mean, if I look at FY '22 over '21, the rupee-dollar exchange rate was rather flat, and we saw that you are reaping in forex gains. And in '23 over '22, we're witnessing extreme depreciation of rupee against dollars, where we are essentially seeing some kind of forex losses. So, what it says is effectively, I mean, at an average rupee depreciates by about 5%. So that is typically what your forward hedge rate would be. And if in any given year, the depreciation is more acute then we will probably see a forex loss. And if the depreciation is perhaps a little lower, then that will translate into forex gain. Would that be the right way to look at it?

Sibaji Biswas: Yes. You're right, Tarang, that's how it is. The point to note over here is that in the way, EBITDA or the PAT does not get impacted. So, if we actually have a rupee depreciation and the spot rate is above the hedge rate, we do get a bit of point in the top line, but then we have hedge losses at the profit level, at EBITDA level in cost. It only optically impacts the margin because with an inflated top line and the same absolute EBITDA, the margins look a bit lower and that's what the guidance was given of margin at the hedge rate, getting at 81 at this point, you may have slightly better top line, but the margins could be lower. So those adjustments have to be in the model, but we continue to focus at our business.

Moderator: The next question is from the line of Surya Patra from Phillip Capital.

Surya Patra: Just first question on the fill-finish unit that you have indicated about. So, what is the scale and size of the fill-finish facility? And if you can also share the size of the investment in that? That is the first question. And maybe if you can clarify whether this is part of the Mangalore site, or it is part of the Bangalore site?

Jonathan Hunt: It's in the Bangalore site. And I don't think that we're going to dimension it. I think the advice that I give you is, it's the clinical scale, its small enough. It's not a line item in an analyst model. Does that sort of capture the essence of the question?

Surya Patra: Yes. So, I'm just here trying to understand the scale, size because, is it just a kind of this facility is capable of doing some kind of developmental support service or it is also capable of offering commercialized manufacturing service?

Jonathan Hunt: No, no. It is clinical scale. That is the reason for describing it as clinical scale. It's just clinical, Phase I, Phase II type clinical trials, and therefore the volumes are relatively small. So, I think that answers the essence of the question. It's not commercial scale fill-finish, it's clinical.

Surya Patra: Yes, Got it. So, my second question is, Sibaji sir, if you can just update about the cumulative capex for the Mangalore site as of now? And what is the cumulative capex in the Biologics assets so far? That would be helpful.

Sibaji Biswas: Yes. So, the capex in Mangalore site hasn not been really increased much from the last quarter, if you recall I mentioned it's around $85 million that we have invested over there. To be clear, they are depending on what exchange rate we take, so that remains broadly at the same level.

In case of Biologics, cumulatively in the beginning of the year, we invested $55 million, again to be clear, they are for the exchange rate, and we have started a program of another $30 million for the execution. That is still not in books because the program is under-way and you can expect to see that facility and the capex coming to the books for the next few quarters, whether we have approved execution as planned.

Moderator: Ladies and gentlemen, that was the last question for today. I now hand the conference over to Ms. Avantika Mishra from EY for closing comments.

Avantika Mishra: Thank you, everyone, for joining today's call. I hope we have answered your questions. If you have any further queries, please do get in touch with our team, and we will be happy to get back to you. Have a good day, and thank you once again.

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