"Aarti Drugs Q4 FY 20 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the Aarti Drugs Limited Conference Call hosted by Centrum Broking 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 the operator by pressing '*' and then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Ms. Cyndrella Carvalho from Centrum Broking. Thank you and over to you ma'am.

Cyndrella Carvalho: Good afternoon everyone. On behalf of Centrum Broking, I welcome you all on today's Aarti Drugs' Earnings Concall for the fourth quarter. I take a moment to thank the management for giving us this opportunity and their time. From the management today, we have with us, Mr. Harshit Savla, Joint Managing Director; Mr. Harit Shah, Whole-time Director; Mr. Adhish Patil, our CFO; Mr. Vishwa Savla, Director, Pinnacle Life science Private Limited. Over to Adhish, CFO, please.

Adhish Patil: Thank you for introducing us. We welcome you all for the conference call of Aarti Drugs Limited. Again, the main purpose of the call, as you all know is to brief you about the quarterly performance of the company and the current market conditions for the business. In March quarter, company recorded the consolidated quarterly revenue of 449.64 crores with a year-on-year decrease of around 2%. Domestic sales of the API segment grew by approximately 1.31% and exports down by 14.93% due to unavailability of cargo. Formulation segment revenues grew by around 26.52% on year-on-year basis.

For the March 2020 quarter, API segment contributed approximately 89% of the total consolidated revenues and Formulation segment contributed approximately 11%. Within the API segment, 63.57% of the revenues came from domestic market and 36.43% from the export market. In the Formulation division, 49% of the sales came from exports. For the period ended March 20, revenues from the API segment can be broadly classified into following therapeutic categories; the Antibiotic therapeutic category contributed to around 44%, Anti-protozoal around 16%, Anti-inflammatory around 10%, Anti-diabetic around 10%, Anti-fungal around 7% and the rest can be classified as other's category.

As compared to last financial year of 2018-19, the antibiotic segment has increased from 41% to 44%, mainly on the account of higher sales of Ciprofloxacin, Ofloxacin and Norfloxacin. In March 2020 quarter, consolidated EBITDA is Rs. 80.68 crores up by 32.47% and consolidated profit after tax for the quarter ended March 2020 is Rs. 58.86 crores up by 114.48%. Consolidated EBITDA margin improved to 16.08% even after removing exceptional item of land sale in this quarter.

Company has improved on its gross margins on the account of better operational efficiency and better realizations in selling prices. Due to continuous improvement in the working capital, the company was able to further reduce its debt to equity ratio to 0.58 as of March 2020 on consolidated basis. Company has already scaled up its anti-diabetic, anti-inflammatory capacity and it will give impetus to revenue growth in financial year 2021. Further CAPEX is planned for introducing new products in anti-diabetic category. Due to lockdown, lot of services are scarce and hence, it is affecting productivity to some extent. However, due to essential nature of our business, we are running our factories after practicing appropriate social distancing measures, regular health checkups enhance insurance, etc.

Now, we would like to open up question and answer session and take questions from the participants. Thank you.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Aditya Khemka from DSP Mutual Fund. Please go ahead.

Aditya Khemka: Adhish, on the gross margins for the quarter, earlier if you look at your FY18 numbers, you were at this 37-38% gross margin, from there, we came down to 32%-33%, we cited the increase in cost from China in raw material as the main reason and this quarter now we are now back to 37%, so one question is what drove the gross margin in the fourth quarter of FY20? What changed from the third quarter to fourth quarter in terms of the gross margins and number two, how sustainable do you think it is?

Adhish Patil: So, one thing is the fall in the crude prices definitely reduce the RM rates for us. Apart from that we had been continuously improving on the efficiency part of our business, which is the ongoing process and we have improved a lot as compared to previous quarter. Product mix also plays a role but most importantly, I would like to point out that in this particular quarter, we got much higher selling prices, the realization was much better because of lot of disruptions which was there in the market during last quarter. So, on the going forward basis, as of today the margins are stable, but then once this vaccination of Corona comes out, then may be but still we can eye EBITDA margins of around 15 to 16% on an ongoing basis.

Aditya Khemka: The pricing realization improvement in the fourth quarter was the biggest driver of gross margin improvement or was it crude?

Adhish Patil: It was mix of both actually.

Aditya Khemka: Understood and how does the lower crude price help us, it decreases the cost of our raw material, how does it help us?

Adhish Patil: Yes, so lot of crude based raw materials are basic materials, so the pricing goes down for those.

Aditya Khemka: And the vendors for those basically pass on the fall in their cost through us?

Adhish Patil: Most rightly, yes.

Aditya Khemka: And just in terms of your other expenses and employee expenses right, so both of them are up, employee cost is up 25% year over year and other expenses, although it has been high for the past 2 quarters is again high for 76-77 crores, 45% growth year over year, so one, what drove this high cost on employee as well as other expenses this quarter and next year what is the outlook on both these costs?

Adhish Patil: Actually, we had some dues, means labour contracts negotiations were going on, so approximately 1 Cr of extra payment was done in this quarter for the areas of the labour contracts, so that is where there was some exceptional bump of 1 Cr in this quarter and apart from that we have also growth on the number of facilities as compared to last year, so the workforce has also increased along with the increase in the salaries of the people.

Aditya Khemka: So your other expenses, growth of 45% is largely driven by capacity expansion?

Adhish Patil: Yes, means it is also processing cost and also I will also like to point out in other expenses, manufacturing expense will also be the part of that so in that we are focusing more towards treating the effluent and moving towards 0 discharge in most of our factories, so because of which a bit of operational expenses also goes up in evaporating all these liquid effluents so that is also one of the reason, why the manufacturing cost has gone up.

Aditya Khemka: Understood, just a couple of questions on the follow up, so let us say, so your improvement in manufacturing infrastructure to make it 0 discharge etc., all that is already done or is it work in progress and therefore, the cost would continue to grow?

Adhish Patil: It is the work in progress, so it is both, the CAPEX nature and also the OpEx nature. Even the CAPEX, we have taken up, keeping the budget of around 10 Cr or a little bit around that figure for coming year also, so that we can get better technologies in evaporating the effluent, so that our OpEx part will reduce and as we did in past also trying to get more and more by-products out of the effluents so that there would be some addition to the revenue also which we take care of the increase in OpEx but this is the ongoing process.

Aditya Khemka: So for next year also, we should expect that 20-30% growth in other expenses?

Adhish Patil: That will depend on the volume, means if the volume grows then it will coincide along.

Aditya Khemka: And along the same line, how much was the volume growth in fourth quarter and how much was the price growth in your revenue?

Adhish Patil: In volume growth, we were able to reduce but then the problem was in the last week, starting almost March 22nd because of the lockdown the dispatches were halted, so our inventory went up a little finished goods because of that and that is why there was no volume growth as such. In local, we were able to match the volumes, but in export whatever we had produced that got stuck at the planned level itself. So, in fact you can see a 14% reduction in exports because of the lockdown.

Aditya Khemka: And your tax rate going forward will be this 22-23% or your tax rate will?

Adhish Patil: Correct, so including all the surcharge is around 25%.

Aditya Khemka: Tax rate?

Adhish Patil: Yes.

Aditya Khemka: And lastly on your CAPEX, so you said you have 10 crores budget of CAPEX for improvement and how much would be your total CAPEX budget?

Adhish Patil: So total CAPEX budget, we have 2 years plan, so that is more but in the coming financial year, possibly anywhere between 70 to 100 Cr because already we have passed 2-3 months in the lockdown, so because of that may be major of little bit of the CAPEX should be shifted to the next financial year but still we are keeping a budget of 70 to 100 Cr in this year.

Moderator: Thank you very much. The next question is from the line of Sajal Kapoor**,** Individual Investor. Please go ahead.

Sajal Kapoor: I have a couple of questions, so first one being over the last 10-20 years, the API industry has seen some serious headwinds in terms of the competitive intensity, mainly from the Chinese players as they have had some unfair advantages like, much low power cost and reduced financing cost and other state funded incentives which our Indian players obviously don't get, but when I look at your 10-year performance, the cash generated from operations has grown at a very healthy CAGR of 28% and the market value of the business as a whole has compounded at a similar CAGR of 28-29%, so the question is what according to you have been the critical success factors and as the external environment has been very hostile and very challenging if not completely hostile but you have still delivered a very healthy CAGR on both on the cash side as well as on the market cap side, so what are you doing differently or better than the competition, please?

Adhish Patil: Thank you for such a detailed analysis of our company since last 10 years. I would just like to point out that in last 10 years…

Sajal Kapoor: I have been a shareholder.

Adhish Patil: So out of last 10 years, I think first 5 years were really good in terms of the growth, we had a very exponential growth. Last 5 years, there were lot of challenges frankly speaking as you correctly pointed out, the collapse of crude two times, heavy collapse of crude that is, right from 140 levels till 90 and then from 90 to 30-40, so that time the pricing went down for lot of raw materials and so the selling price also went down, so that was one sector, pollution was another key challenge which we are facing since last 5 years because the Indian government has also become strict on that part which is rightly so. Chinese competition has always been there, in fact what I would like to point out, the China competition is relatively easing out since last 3-4 years since that November 2017 when the Chinese government took that thrive of making all the position norms stringent and closing down lot of China factories. That had been a structural change and lot of global competition is also moving more towards India as compared to China. So as an API player which we were always strong from the technological front, in technology and in technical front. Our main focus area has always been to consolidate on our strengths, so whatever our top 10 products, earlier the contribution of top 10 products was only 55, then it became 60, 65, 75, it has now come to around 75 to 78 range. The main reason has been we improved, we enhanced our capacity in the top 10 products and we consolidated the market position in those products, so that had given us another benefits in becoming more competitive in those products and because of which fortunately our company had a very healthy profit growth and also as you correctly pointed out the operating cash flow has improved drastically that is mainly because of the few market dynamic changes in the API industry since last 2-3 years. Our credit period with the receivables have become better and the credit terms have also increased in terms of China, so that is one of the reasons why the operating cash flow has also improved drastically.

Sajal Kapoor: And the second question I have is, if I look at your annual reports over the last few years, our company has had difficulty in sourcing raw materials for antibiotics as well as the other therapeutic areas and to mitigate that risk, we went for backward integration and A, to reduce the cost and dependency on a somewhat easy supply chain and we have been incurring an annual CAPEX of approximately 100 crores. I think last fiscal was little less than that but on an average basis 100 crores over the last 4-5 years, so my question is, are we relatively immune now in terms of the future supply chain related disruptions across all our key therapeutic areas and how confident are you now?

Adhish Patil: In terms of disruptions in the raw material supply?

Sajal Kapoor: Yes exactly because we have done lot of backward integration right to mitigate that risk and we should be in a better position now?

Adhish Patil: Correct, we are in a better position definitely as compared to past few years, but we still foresee quite a few risks in terms of sourcing few of the key raw materials, in fact we are working in that direction. You must be aware that in fact even the government has identified many of a few key API intermediates and bulk drugs which they want to give subsidy to the private players and some of the large capacities in India. This is our dependence on the China. In fact, many of our products are highlighted in that so in fact.

Sajal Kapoor: No, I was just adding to that question, I think of the top of my head, they are about 53 APIs if I am not mistaken, somewhere in that ballpark, so how many of RP drugs APIs are in that list?

Adhish Patil: As far as I remember not accurately but 4-5 are there, our products.

Sajal Kapoor: So 10%.

Adhish Patil: Yes, in fact most of them are from our top 10 list, so they are big for us.

Sajal Kapoor: That boards well, then right. Then and is that there is still looming threat in terms of the supply chain disruptions, as a percentage if I remember I think it is about 20-30% of your raw materials you still getting from China or some of these ECM jurisdiction, is that number reasonably correct, this 30%?

Adhish Patil: No, it is slightly higher, I would say 40 to 50% is sourcing from China but what we are trying to do, when the number of manufacturers are more and that particular raw material is going in lot of applications, then we don't go further back but if the application is narrow and since the application is only for our APIs, in that case we do go for backward integration because then we become overly dependent on the supply.

Sajal Kapoor: Correct, so 50% is that risks but I heard that in the previous calls as well that you were looking to sign in some Indian vendors to mitigate that risks?

Adhish Patil: Yes, we have done that.

Sajal Kapoor: So, 50% is what you get and so RM is at risk but of that 50% you have started qualifying some of the Indian vendors for the raw materials, so what is the net risk, I am just trying to get the net risk?

Adhish Patil: Correct, net risk would be anywhere between 15 to 20% possibly.

Sajal Kapoor: That is more like the number that I have thought.

Moderator: Thank you. The next question is from the line of Manish Poddar from Nippon Asset Management. Please go ahead.

Manish Poddar: Adhish, Manish here from Nippon AIF, so just wanted to get a sense, what is the outlook, let us say on volumes this year?

Adhish Patil: In terms of volume growth?

Manish Poddar: Yes.

Adhish Patil: Because of this COVID-19 situation, production of the first quarter is hampered little bit. Tentatively, we can say we would be able to achieve around 70% of our actual capacity, 70% production of our actual capacities on an average. This is in the first quarter, so that will hamper little bit of volumes but apart from that from demand point of view, we feel that there is significant growth available. We are expecting anywhere between 10 to 15% growth still, means in spite of this COVID situation on a yearly basis.

Manish Poddar: And this is just volumes, when you mention 10 to 15% growth?

Adhish Patil: Yes, correct, considering this, not entirely volume, it will be both, so the majorly means around 70% volume driven and 30% would be rate driven, something like that.

Manish Poddar: And can you provide an update on this chloro-sulphonation which you are planning to put? What is the status of that?

Adhish Patil: We already have the land, the CETP is already placed by the GIDC in that area. Now the only problem is because of this COVID-19, we had planned certain visits to outside India to meet with the technology partner and all, so because of this COVID-19 that plant is little bit delayed, so may be after the lockdown is listed we will again start with the process but that is still in the designing phase, designing as in the layout of the plant and all. We have the process but we still have to design the plant and finalize as it is.

Manish Poddar: So when you say this CAPEX somewhat of 70 to 100 crores that doesn't include this chloro-sulphonation?

Adhish Patil: So, the part of chloro, we have an option of putting in Tarapur itself, so that we might go ahead with, so around small part of 70 to 100 might go in that but otherwise in this 70 to 100 we haven't considered the main Specialty chemicals, but it will come in phase wise manner. So, suppose even if the project is of 150 Cr, we might end up spending only 20-30 Cr in this year, something like that. It will be in phases.

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

Aditya Khemka: So this year our operating cash flow has been 250 crores consolidated and our capital expenditure has been about 48 crores, so free cash flow that we have at disposal is 200 crores after CAPEX, FY20, so how have we?

Adhish Patil: So the thing is, most of it has gone into debt repayment, we did a total outflow to shareholders was around 30 to 33 Cr, something like that because it included two dividends. We had one unplanned dividend just before 31st of March, thus we had one planned dividend back in August, so two dividends and one buyback took place in last year, so it went there and plus it went in the reduction of working capital debt.

Aditya Khemka: So, our net debt today stands at how much, I mean because I can see borrowings on the balance sheet?

Adhish Patil: Yes, so on console basis around 380 Cr, on standalone basis it is around 360 Cr.

Aditya Khemka: 380 Cr on console which would mean, so I can see 330-340 on your balance sheet, rest 30-40 will be another financial liability?

Adhish Patil: Correct, means the long-term loans payable in 12 months.

Aditya Khemka: Right, that will be on the other financial liability?

Adhish Patil: Correct.

Aditya Khemka: Or other current liability?

Adhish Patil: Yes.

Aditya Khemka: Yes, got it, so 380 Cr, so next year assuming say CAPEX of 70 to 100 crores you said, so let us say next year you do 100 crores of CAPEX and your operating cash flow also grows by 50 crores, right because you have 250 crores base of operating cash flow, so 20% growth, so if you are looking at 300 crores of operating cash flow and 100 crores of CAPEX, how would you plan to use the 200 crores of free cash next year? How much of borrowing, so 80 crores of borrowing is coming due next year right, which is your other current liabilities, 80 crores of borrowing is coming up for repayment next year, right?

Adhish Patil: Repayment, yes, correct.

Aditya Khemka: So 80 crores will be repaid and you will be left to 120 crores of cash after repayment of borrowings and everything, so how would that be utilized?

Adhish Patil: Mainly, it will be utilized for all the CAPEX plans.. Working capital debt might go down a little, then obviously we will be doing a shareholder payout but typically we keep it around 30%, approximately around 30% of profit.

Aditya Khemka: Profit, right.

Adhish Patil: And the thing is, we do have lot of CAPEX planned may be in the year after that so we do not pay it out to shareholders completely, but then we will reduce the debt considerably and then I think when the new projects come in, our debt will slightly go up, so that will help us.

Aditya Khemka: And to a previous participant’s question you said that out of the list of products that the Indian government has released for increased self-reliance, you have 4-5 products which appear in that list, how significant are these 4-5 products as a percentage of revenue today?

Adhish Patil: I don’t have exact number, but then the thing is it will be quite significant, we can safely assume 15 to 20% of our revenue.

Aditya Khemka: 15 to 20%, so this will be mostly Floxacins?

Adhish Patil: Floxacins are there, yes, they are also there. Floxacins are there, Metronidazole is there, M&A based product projects.

Aditya Khemka: And how do you benefit from this because you still get the raw material for these from China?

Adhish Patil: we were importing from couple of Chinese factories, one was our own JV in China and one was another player. We have another player in India who is an exclusive partner to us for that product, so we are increasing that because we will be getting capital subsidy also most probably. This is all not written but ideas. Most probably we might get capital subsidy, so we might expand those intermediates also in India, if not directly then through our partners.

Aditya Khemka: Right and your partner has enough capacity to substitute the Chinese volume?

Adhish Patil: No, we will be putting capacities.

Aditya Khemka: So Greenfield, you will do the capacity.

Adhish Patil: Greenfield or Brownfield, something like that.

Aditya Khemka: Sorry, I missed your response to my previous question on how much has the rupee dollar helped you in this margin expansion?

Adhish Patil: Rupee dollar did not help much because the thing is, our imports is also there, in fact we have booked around 9 Cr of product losses in the March quarter.

Aditya Khemka: Which is under which line item?

Adhish Patil: They will be in raw materials.

Aditya Khemka: So, if the rupee dollar continues at the current rate of 75-76, would you see upside to your margin guidance of 15-16% or would that be downside?

Adhish Patil: If it remains absolutely stable, then yes because the thing is the dollar rate went up gradually from 1st January to 31st March but all the imports which were opened were to be valued at 75 point sort or something, that exchange rate, so all the notional loss has been booked, so if it remains same, no further notional loss will come, however, all the exports will be done at the higher rates, all the pending orders what we have, will go at a higher rate, so we might benefit a little bit over there.

Aditya Khemka: So, what was the average currency realization for you on the export side for fourth quarter?

Adhish Patil: I don’t have that number. I will get back to you on that.

Aditya Khemka: Also Adhish on the gross block turnover, so we are doing CAPEX and our average gross block turnover in the past has been 1.16, 1.2 in that range, in your new CAPEX what kind of gross block turnover do you expect given the current scenario, I mean if the cost of putting the plant going up more than the potential revenue or if the revenue going up more than the cost of putting up the capacity?

Adhish Patil: Actually, more or less the numbers are same, means whatever CAPEX we had been doing in last couple of years, more or less the asset turn is same, it depends on product to product basis it is different but it hovers anywhere between 3 to 4.

Aditya Khemka: The reason I asked that question was because some of your CAPEX seems to be done on the vertical integration part right, so when you do more CAPEX on, so that will not necessarily reflect in your sales, it will actually reflect in your margins?

Adhish Patil: Correct, so now the CAPEX which we have planned mainly it is related to the one which will be sold out right.

Aditya Khemka: So in the past what we have done is more on vertical integration, but going forward, your CAPEX is going to be more on capacity expansion and not vertical integration?

Adhish Patil: At least for next couple of years, we can see that for revenues.

Aditya Khemka: And this China, sort of diversifying away from China globally becoming a theme and obviously you are also working towards adding domestic vendors to your arsenal, are you also getting more customer enquiries because of them looking at an alternate source other than China for your products?

Adhish Patil: Definitely, we have seen that trend that people, at least from the long-term contract point of view, in fact we are talking with, there are ongoing talks also for not exactly contract manufacturing, but kind of that especially for products which were coming from China, intermediates which are coming from China, so we might manufacture that also as import substitution, so which indicates that people are more and more moving towards Indian supplies.

Aditya Khemka: One last question, this government scheme that came out for API manufacturers, how far along is the government in implementing this because I saw that you hesitated in responding to if you get capital subsidy or not, so I just want to understand, although the government has announced the schemes, where is the implementation today and how long do you think it will take to implement, number one; number two, assuming it gets implemented perfectly, how much does it benefit you across these different line items of cost or capital expenditure or whatever? How does it impact you?

Adhish Patil: I haven’t worked on that actual numbers how exactly it will impact us financially but where it will help you, I will tell you, one, we feel that actually we are also in talk with few of the officials through PSC which are working in those government committee. They took out few circulars regarding the incremental sales we will get 10% incentive, something like that for few of the products but that is absolutely wrong strategy on the part of government because you cannot talk about incremental sales of 2019-20 because the existing supplier will have no benefit. Anyone who puts new capacity, they will be at benefit. So there are few lacunas in the way they are trying to implement but we are constantly giving them feedback, so we have given these feedback to the committee, so that they will come up with appropriate measures, so that is why I was little hesitant in saying that though they have the will to do it but now the way they do it is more important.

Aditya Khemka: But it defeats a purpose, right I think the idea of the incentive is to make India more competitive versus China?

Adhish Patil: Exactly, so the thing is industry needs to give them feedback because they may not have the real time experience of manufacturing and also in making the policies, they don't take the feedback from the existing phase, they might mess up a little bit.

Aditya Khemka: That I think therefore, it is not good for the industry, right?

Adhish Patil: Correct, but then I think they are very much open to listen to industries, so that is good because in fact one person contacted from their side to us which is a good sense as if they want to know how the industry should be helped from the industry itself rather than doing it on their own.

Aditya Khemka: One last question from me Adhish, on the formulation sales that we have booked this quarter and how we have been doing in the past, so we have seen a very good ramp up from what FY19 was to FY20, would you care to comment on what has driven the growth in Formulations, FY19 to FY20?

Adhish Patil: I think Vishwa will answer your queries.

Vishwa Savla: So, the major reason for the increase in sales and increase in margins has been the growth in the export formulation business. So since the last couple of years, we were in the process of filing a lot of products in many territories and kind of establishing our marketing presence, so that has started coming along and that is the reason since the last few quarters, there has been an increase in the export sales and where we direct better margin and that helped us grow the business.

Aditya Khemka: So, when you say you promote yourself, are these branded generics or are these like those unbranded generics that you sell in developed markets of US, Europe, etc.,?

Vishwa Savla: We are presently not. It depends on the country of operation, in some especially in the emerging markets of Africa and Asia we are more in the branded generics, those products are ethically promoted and also there are some countries in Latin America and other parts of the world where we are selling them as generic substitute similar to how it is sold in the US.

Aditya Khemka: What percentage would be branded of your current revenue in Formulations and what is unbranded?

Vishwa Savla: From the export sale, it would be about 60 to 70% would be branded and the remaining would be unbranded.

Aditya Khemka: And your domestic Formulation revenues are all unbranded, right?

Vishwa Savla: Domestic is all contract manufacturing revenue majorly, so it is more like a service project. We manufacture it for the domestic player and they brand it further.

Aditya Khemka: And your customers are branded players in the domestic formulation sales?

Vishwa Savla: Yes, mostly**.**

Aditya Khemka: Got it. And 40% of your Formulation revenue is exports?

Vishwa Savla: Yes.

Aditya Khemka: Is that the comment I heard from Adhish in the opening remarks, 40%?

Vishwa Savla: Yes, it was about 49% in this quarter and it is expected to be around 40% would be export done?

Aditya Khemka: Sorry come again, going forward?

Vishwa Savla: Between 40 to 50% would be export contribution.

Aditya Khemka: And how different is your gross margin in your export formulation versus your gross margin in your domestic formulation?

Vishwa Savla: As export margins are significantly higher in domestic.

Aditya Khemka: And going forward which of the two segments would you see growing faster, exports or domestic?

Vishwa Savla: We would say exports growing faster.

Aditya Khemka: But it is 49% as a percentage of sales already and you are guiding to 40 to 50%?

Vishwa Savla: Because last two quarters had been exceptionally high for exports, but from annual perspective there will be a growth but from the quarter to quarter we would expect it to be around 45 to 50% contribution because there will be some growth on the domestic part also which was lowest in the last quarter.

Aditya Khemka: Adhish, one final suggestion, I mean if that revenue breakup could be given between API, Formulation, Specialty Chemicals and Intermediates?

Adhish Patil: Actually the thing is, we are thinking on those lines. Right now, Intermediates is only 4% of the total API segment. The thing is it is not that significant right now, so it will be only hovering around 3 to 4% right now. May be in couple of years' time that might become significant, then we might have to actually report separate segments itself, but as of now, it is too less to report separately but to answer your query it is around 4% and last year it was around 3%, Specialty Chemicals.

Aditya Khemka: Understood but if you could give the breakup between API and Formulation at least because these two are now very?

Adhish Patil: Yes that we are giving. That practice we have started so in the press release we will be giving two separate.

Aditya Khemka: And that to divide Formulation and API to domestic and exports?

Adhish Patil: Yes.

Aditya Khemka: Two by two metric, API, Formulation and domestic and exports.

Adhish Patil: Understood.

Aditya Khemka: Because you understand the dynamics of these businesses are very different right?

Adhish Patil: Yes.

Moderator: Thank you. The next question is from the line of Saravanan Viswanathan from Unifi Capital. Please go ahead.

Saravanan Viswanathan: At this point, do we have any foreign currency debt?

Adhish Patil: Foreign currency debt we don't have right now, means whatever buyer's credit we have in foreign currency those are completely hedged.

Saravanan Viswanathan: Even the net, let us say we have net exports position, so that is fully hedged or partially hedged?

Adhish Patil: No, right now we may not have net export means it will be slight matching more or less but imports might be slightly higher than exports. What we do is, whenever dispatches takes place in exports, at that time we hedge the exports.

Saravanan Viswanathan: So, you are not expecting any significant volatility from foreign currency fluctuations?

Adhish Patil: No, more or less we are naturally hedged but little bit whenever the dollar goes up immediately, whenever there is a sharp increase in dollar means, rupee depreciate sharply towards the end of the reporting period that time we have to book notional losses on the inputs. That is the only thing but on an overall basis, the impact is very subdued because we have a natural hedge.

Saravanan Viswanathan: To earlier question, you had guided volume growth plus price growth all in all 10 to 15% revenue growth for FY21, although you also mentioned that Q1 you have been able to function only 70% of your capacity?

Adhish Patil: Correct.

Saravanan Viswanathan: What are the COVID related safety measures and related cost that you will have to undertake and how will it affect the EBITDA margins?

Adhish Patil: So, right now means what we saw that initially even though we got the permission from government to run the factory, the key issue was transportation of the labour workforce and morale of workforce. That has been the major challenge in running the factories in this lockdown period. So we have taken initiatives like having our own transport buses, means social distancing, means reduction of workforce in one area but by frankly speaking the workforce available itself is low, so we don't have to reduce it but we are taking few deviations in our existing processes so as to manage 70% to 80% production with this reduced workforce. We are documenting everything in the records as planned deviations, and I think that is okay from the regulatory standpoint. That is something which we are doing to be able to produce 75% to 80% even though the workforce is actually much lesser than that.

Saravanan Viswanathan: Does that mean that I mean is this the new normal, so you will nationalize with?

Adhish Patil: No, it is the new normal for say couple of months, then it will revert back to normal, I think. Once the lockdown is over, then at least to the 90% you can say it will revert back to normal. The current situation is very exceptional.

Saravanan Viswanathan: What would be the full year capacity utilization FY20, what would have been?

Adhish Patil: What we are expecting means, first quarter we are expecting 70% and that is also to do with the fact that many of the workforce are not from the same locality and when this COVID thing happened, many of them traveled to their native places but when they came to know that the companies have started but they are not able to travel from their hometown to the Tarapur or Sarigam, so that was one of the reason why many of the workforce is stuck at their native places. So once the lockdown is liftedthat problem will solve immediately. That is one of the key problems for us as of today. So for first quarter, we are giving on a consolidative basis 70% utilization but going forward we should come back to normal utilization.

Saravanan Viswanathan: No, I was asking FY20, last year what was the final capacity utilization?

Adhish Patil: It will be somewhere in mid 70s to late 70s.

Saravanan Viswanathan: And you had mentioned that last year you had several efficiencies and that is why EBITDA margins are also went up, so considering that and considering the COVID related cost in first quarter sort of subdued production numbers, what would be the overall margin guidance?

Adhish Patil: We do feel that overheads per kg will go up as you rightly estimated for the first quarter, but as of now, the selling prices are also higher because of the shortage of supply, so that is one of the reason the increase in cost will be taken care by the increase in selling prices. So margin front, frankly speaking we are giving the same guidance, we delivered margins, we should be able to achieve between 15 to 16% but let us see means we are also not sure exactly how it will pan out but we are hopeful that we will be able to maintain the margin in the first quarter also.

Saravanan Viswanathan: And one question on US FDA inspection, so what is the status, do they have any Indian inspectors who can review the facility?

Adhish Patil: They do have Indian inspectors but we don't know how many, but they do have. That much we know, so we are trying to contact them. Now, let us see means that has been on the back seat in this COVID situation. Even one of the Chinese clients who had for DMS in their ANDA their inspection was also postponed because of this COVID thing. It was supposed to happen in the end of February in 2020. That has also been postponed. We are trying hard but right now the situation is not clear even to us means how it will pan out.

Anand: Adhish, just wanted to understand we had anti-dumping duty, protection in our Ofloxacin series of products, so do you anticipate similar anti-dumping duty productions might come and other products given government is trying to incentivize?

Adhish Patil: There is a good chance that it might happen.

Anand: So any of our products which are currently being studied for anti-dumping duty production?

Adhish Patil: There are few Floxacins which are under study.

Anand: And anti-dumping production that we already have on the Ciprofloxacin, ester and the intermediates?

Adhish Patil: Ofloxacin.

Anand: Ofloxacin, so this is until December of 2020, correct?

Adhish Patil: I don't have the exact date. I will have to come back to you on that. It was given for 3 years. That much I remember right now, around 3 years.

Anand: If you can check that right and whether we are, there must be some process that we will have to undertake in order to get that continuation of the ADD, you can just check the date and let us know if it is started.

Adhish Patil: Yes.

Moderator: Thank you. The next question is from the line of Dhwanil Desai from Turtle Capital. Please go ahead.

Dhwanil Desai: Two questions from my side. I think you alluded to this potential or possibility of long-term contract coming your way, but, I mean in the product that you manufacture, the nature of the market is where you started on a spot basis, right? So, is the nature of the market for the existing product changing or are you referring to some new products which may come or people are talking about contract manufacturing. If you can throw some light on that?

Adhish Patil: Right. So, this particular product which I was referring to is a new product. That is a new product.

Dhwanil Desai: For that you would need a separate facility and investment and all those things, right?

Adhish Patil: Correct. So we have factored in that CAPEX in that plan for this year.

Dhwanil Desai: Okay. And second question, I think you have been saying that our current capacity is good enough. It will take us through 2000 crores kind of revenue given the pricing that we currently have barring the current bump up in the pricing. So, we are already at 1700-1800 crores mark now. So, 10%-15% growth from here and is it be running out of capacity and this year our CAPEX maybe also curtailed because of the COVID crisis. So, do you see capacity becoming a constraint for us going forward during the capacity in FY22 when it comes up?

Adhish Patil: The thing is last year we did say that, we can easily reach 2000. Now our anti diabetic facility has scaled up. Then, we also expanded anti-inflammatory products in the March quarter. So that will be additional capacity. Plus, there are couple of antidiabetic products, production lines will be implementing this year also. So incremental CAPEX is continuously on which should ideally take care of further revenue growth. So that is on. Brown field projects are definitely on. The bigger CAPEX, the specialty chemical CAPEX is yet to happen but there are still lot of other CAPEX which are happening and what we feel is, right now the prices are up, but with the current scenario even 2200 is possible from the existing products. I am talking about the standalone company.

Dhwanil Desai: That is based on the current pricing, right, which may or may not sustain at the time of supply?

Adhish Patil: Which may or may not sustain, correct. And right now we made a standalone sales of 1636, around**.**

Dhwanil Desai: So, you on a standalone basis saying that can reach up to 2100-2200 crores, on for around 25% growth from here on?

Adhish Patil: Yes, and the Pinnacle will be additional.

Dhwanil Desai: Okay. And my last question is on specialty chemicals. So, if I heard you correct, that product implementation and the work will be taken up only after the lockdown end. So essentially these are targeting somewhere in the FY22 and the commercialization of some production starting from that possibility. So now, will it be pushed back by 6 months or you think it will be more than that?

Adhish Patil: I think, in general or specific to specialty chemicals?

Dhwanil Desai: I am saying the green field capacity that you are planning.

Adhish Patil: The specialty chemicals, okay. That is around 6 months it will be delayed. But we have other few projects which were not there earlier that were taking up speedily in the particular financial year. So that will start from Q2 itself.

Dhwanil Desai: Okay, that will start kicking from FY22?

Adhish Patil True. Some of the facilities will come, towards the end of this year itself.

Moderator: Thank you. The next question is from the line of Chintan Sheth from Sameeksha Capital. Please go ahead.

Chintan Sheth: I just wanted to check, on the CAPEX flow, you are guiding recently, on few of the product category we are planning then there are process improvement, CAPEX, then specialty. So, all and all if you can lay down next 3 year to 5-year plan which looks like you have internally been discussed. Can you just lay out or what kind of CAPEX we are planning over the next 3 to 5 years across our three categories of businesses, that is formulation, API and specialty? That will be really helpful to understand the scale and opportunity of the business.

Adhish Patil: So, right now, from 3 to 4 years perspective, we can have a CAPEX plan of around 300-400 crores but again that is very dynamic, and it might change, you know as the situation changes. So but for next two years we do have visibility of around 200 crores CAPEX plan which is excluding your specialty chemicals, excluding specialty chemicals there is another CAPEX plan of 220 crores also which we have in front of us, but obviously as you said that we may not take it in this year itself, so some of the projects might get differed like that. So, the priorities of the project might keep changing based on the market dynamics.

Chintan Sheth: Correct. So, within the 200 crores CAPEX, what will be the split between your formulation and API?

Adhish Patil: Sorry, this is just API I am talking about, the formulation will be different.

Chintan Sheth: So, will you provide CAPEX towards the formulation over next two years?

Vishwa Savla: So, in a formulation business, this year and most probably even next year, we are not planning for a heavy CAPEX. Most of our investments will be going into R&D projects, since we are moving towards more regulated markets. So, most of our investments will go into product development and couple of your years our aim would be to invest a major chunk of our internal accruals into the product development and market establishment. So, we don't expect any major capacity enhancement or new facility for the new two years.

Chintan Sheth: Sure. And earlier, on the earlier participants question on the front, so as we mentioned 53 APIs has been identified by government of which 4-5 products are part of your current product range. Apart from the capital subsidy, what we government can help to boost local manufacturing. What kind of discussions you had with the government, if you can throw some light on?

Adhish Patil: So, there were quite a few areas which government suggested. One was capital subsidy, other was 10% incentive on the incremental sales with respect to 2019-2020. Then other was establishing per drug and intermediate park where they will give you common power and state utility at a much lower rate, subsidized rate. Then also give the CTP and power and fuel. So this way they were 3 areas which we discussed with them as of today. But I think the incremental subsidy is the one which I don't think is the right way to go. The third option of having parks where they can establish a bigger utility and then if they can supply that utility at a cheaper rate to all the units within that vicinity, that is a very good way of building the core competency and efficiency among Indian manufacturers, that is one good thing and other can be general subsidies like interest subsidies or something like that.

Chintan Sheth: So, this establishment of industrial park, obviously take little bit time before companies taking interest into it. The initial point which earlier participant also asked that if they are looking at securing through imposing ADDs to benefit or incentivize the local manufacturers and then obviously the longer-term solution is the investment parks as you rightly say. So, any discussions on that front that actually considering ADD, some sort of duties to block imports of Chinese products in India and we can have a larger share as a domestic manufacturer?

Adhish Patil: Yes, so that thing is, they are also in discussion phase right now. We have also held various of meetings and discussing what is the best way to help industry. It is not a very easy thing to do, frankly speaking. Capital subsidy is one of the easiest form, and if you don't have that capacities at all in India and you want to build those products in India then capital subsidy is one of the simplest form for them to execute. Any other method might take a lot of time. Even the anti-dumping duties right now the process is very long Right now their process is like, the manufacturers should make loses one year and then with these loses they should go to government and apply for the anti-dumping duty. So, it is very dicey frankly speaking. But the good part is at least you know wherever there were lot of blockage in terms of expansion permission and all, at least that will be very unique for us. So that is going to help us.

Chintan Sheth: So, indirectly you are saying that ADD as such is not that useful compared to….

Adhish Patil: You are talking about, what is the full form of that?

Chintan Sheth: Anti-dumping duty.

Adhish Patil: That is useful for temporary. Maybe it is like whenever a new manufacturer comes in the business, initially they have teething problems, so they don't have the most efficient process. So anti-dumping duty gives them some time benefit in terms of say 2-3 years to become more efficient. So that is the main purpose of anti-dumping duty, so that you get some breather.

Chintan Sheth: ADD we are currently benefiting from right now, how much is currently…

Adhish Patil: We are benefiting. So earlier there were some material where we had ADD, but then that anti-dumping duty was removed because we started making profits in that product, so we do not require that. So, the situation keeps on changing. So, as you manufacture the product over a number of years, then you become more and more efficient and ultimately you don't require those duties.

Moderator: Thank you. The next question is from Umang shah from AMSEC Research. Please go ahead.

Umang Shah: I had two questions. The first question was that once you have the USFDA approval in place, do you envisage certain amount of revenues that you are looking at by exporting to regulated market or to elevate the company?

Adhish Patil: US, the plant would might be capable of manufacturing anywhere between 6200 Cr. But then the profit margins are much higher in the US market. We do have one empty space where another plants can come in once, we get the approval in a very short-term, and in fact we have one building also ready. So, there is a potential once, we get the approval. But even before getting USFDA approval, we do have lot of potential in getting European approvals, we already have EU GMP for that Plan. So, we already have some form of, though it is very less as of today, but we have some regulated business for Europe also from that point. But then FDA will definitely be a very big kicker in terms of marketing that one.

Umang Shah: Correct. And sir you mentioned the revenues as 6200 Cr. right?

Adhish Patil: Correct, as of the current capacities.

Umang Shah: And sir, one more question was, sir, there is as significant difference in realization of Ciprofloxacin and Metformin. I think it is 2000 per Kg and 200 per Kg. So, on unit economics front want is the margin that you look at while you are taking up new projects and what is the IRR that is required when you are expanding?

Adhish Patil: So, we basically go with IRR. So, the flow of IRR Is 18% that we take, so it should be higher than that. But what we assume is, we assume 75% debt and 25% cost of equities and we take equity cost around 20%.

Moderator: Thank you. The next question is from the line of Ankit Gupta from Bamboo Capital. Please go ahead.

Ankit Gupta: I just wanted to understand more about this contract manufacturing opportunity, like how can this scale up over the next 2-3 years and apart from this molecule, do we have any other small molecules which are in discussion with the clients?

Adhish Patil: So, these are couple of molecules which you are discussing with direct client. In fact we were able to success, means it wasn't exactly contract manufacturing kind of contract but then we did similar kind of arrangement with one of the Japanese player also in the past, just a year back and we are successfully able to supply them earlier that they were procuring from some other clients, from China in fact and now they have shifted to our client.

Ankit Gupta: How much is it contributing to and offline currently?

Adhish Patil: I don't have the exact cover, which has a potential of going in the 9200 crores.

Ankit Gupta: This is in addition to one more molecule that we will be supplying in this year?

Adhish Patil: Yes, this one we already started last year and now we are talking about some another player for another drug.

Ankit Gupta: And how much can this opportunity scale up?

Adhish Patil: This again, in a similar range, around 135 crores per annum kind of a business.

Ankit Gupta: Okay. And secondly on the specialty, as you were saying you know we will be doing one CAPEX at our existing plants. So out of this 70-80 crores. of CAPEX that you a have planned how much will be allocated to specialty chemical sin FY21?

Adhish Patil: So, that would be around, say anywhere between 30-40 crores, something like that.

Ankit Gupta: Okay, and how much revenue can it generate? The asset turns broadly…

Adhish Patil: In these two products asset turns is very high. It can be done anywhere between 4 to 5 times.

Ankit Gupta: Okay. And thirdly on the pricing side, if you can guide us how much have the prices increase during Q4, especially the time when Chinese supply had reduced during January-February and now how is the pricing behaving after March when the Chinese are back?

Adhish Patil: Frankly speaking, if we do a rate variance from March versus March, March 19 versus March 20, prices are almost flat in terms of the phase which already happened. But if the prices have gone up towards the end of March, so now that increase prices will actually come in this quarter. Last time also it is almost flat, means around 1.5% increase in domestic market, exports are actually negative.

Ankit Gupta: Sure. How much has it increased now, in let us say post March?

Adhish Patil: It is difficult for me to say but then in few of the products have seen 10%-15% increase.

Ankit Gupta: So, what were the key reason for the price increase especially when you know the Chinese supply is back into the market in April?

Adhish Patil: Actually, see, many of the factories are not running at full capacity. Even the Chinese factories, Chinese also facing a second outbreak of this virus even though China has stopped publishing the numbers. But if you see few other news sources, they are also having lockdown in few of the areas like Harbin City and all. So, the thing is, overall, the supply is not like in a regular scenario. So that is the reason why the prices are high. Even for example, even we are able to manufacture only 70% of our capacity. So similarly, everyone will be facing the same trouble. So that is why shortage**.**

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

Dhiraj Shah: Sir, my question is regarding the CAPEX. So, in FY20 our CAPEX was 50 crores, right?

Adhish Patil: Correct.

Dhiraj Shah: So, in that we have expanded the capacity in anti-inflammatory and anti-diabetic?

Adhish Patil: Yes. Anti-diabetic, the thing is part of the CAPEX was done in the previous done and part of it came in last financial year, whereas anti-inflammatory completely in last year.

Dhiraj Shah: Okay. And so, what could be our optimum utilization of overall plant or maybe in API, optimum?

Adhish Patil: Optimum, means till what capacity?

Dhiraj Shah: Yes.

Adhish Patil: Typically go 95% of the capacities, usually.

Dhiraj Shah: Because pre COVID we used to run at around 75% to 77%, so…

Adhish Patil: That is because we were continuously expanding in last 2-3 years, right? So the capacity which we expanded recently they were not completely filled, but few of the molecules which we are running since last 10-15 years, those are almost completely utilized. So, on an average I would say around late 70s.

Dhiraj Shah: Okay. So, we still have a room to go through up to (+90%) this expanded capacity. So FY21 would cover this too, right?

Adhish Patil: Right. From the potential point of view what you said is right.

Dhiraj Shah: Okay. And sir when we are going to launch Gliptin?

Adhish Patil: It might be this year itself; this year will be in April. We are putting up one new production line. It will be a Brownfield project because, we already have this civil structure in place. So that will be a quick thing. So, in this year itself we will be able to launch the Gliptins in the market.

Dhiraj Shah: So, this we are considering in our CAPEX of FY21, 70 crores?

Adhish Patil: Yes, 70 to 100 crores, yeah.

Dhiraj Shah: Okay. And sir about formulation, what is the capacity utilization in formulation?

Vishwa Savla: Capacity utilization at the moment is around 70%-75% and it has been around 75% in terms of previous financial year and this year we expected to, we had apart from the first quarter the rest of the quarter should be at between 80% to 85%.

Dhiraj Shah: So, do we require any CAPEX, maybe not this year but maybe in future FY20-FY23?

Vishwa Savla: Yes, definitely not in this year. Maybe in future some debottlenecking by just adding up few equipment in the next year to increase the capacity by another 10-15% that may go through, but also one of the main reasons for the increase in sales would come from a change in product mix and a change in market. So as we are developing newer products, we will be coming up with products that will give us better sales value and better profit margin. So, these majority of the growth has come from a change in product mix.

Dhiraj Shah: Okay. And Adhish sir, whatever CAPEX we are planning of 200 crores and maybe we have a long-term vision of 400-500 crores, so what would be our debt utilization in that or it will be purely internal approval?

Adhish Patil: So, the thing is, as we were speaking with Aditya also, that we might generate good amount of operating cash flows next year. So, in that case the debt proportion will go down. Last year we will not get any new term loan debt, all the proposals were done from internal accruals. So, a part of that will be done, typically what we do is, we take 75% term loan and 25% internal accruals. But because we might have surplus funds, so that percentage will reduce in future. And to answer your last question about capital utilization of Pinnacle and whether it will require new CAPEX to increase its revenue, so in Pinnacle we also hold IP. So, in that case we can get the manufacturing done from a different party also. So, in that case we don't require actually CAPEX to increase our revenues. So that is also one of the business models which we have in Pinnacle.

Moderator: Thank you. I would now like to hand the conference over to Mr. Adhish Patil for closing comments.

Adhish Patil: I thank all of our participants for actively participating and asking very intriguing questions to us which also keep management on toes to keep performing for the company and will continue to do so in future. Again, from the behalf of the management I will like to thank everyone for participating in this concall. Thank you.

Vishwa Savla: Thank you for participating and be safe.

Moderator: Thank you. On behalf of Centrum Broking that concludes this conference. Thank you for joining us and you may now disconnect your lines.