“Laurus Labs Q2 FY2020 Earnings Conference Call”
November 01, 2019

Moderator: Good day ladies and gentlemen and a very warm welcome to the Laurus Labs Q2 FY2020 Earnings Conference Call hosted by Kotak Securities Limited. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Kumar Gaurav from Kotak Securities. Thank you and over to you Sir!

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

Dr. Satyanarayana Chava: Thank you everyone and a very warm welcome to our results conference call. On the business highlights for Q2 and H1 of FY2020, Our Q2 revenues are Rs.712 Crores showcasing a robust growth of 21% year-on-year. I am happy to report that our FDF and Synthesis businesses along with ingredients business showcased a very healthy growth while revenues from API division were lower than expected. To begin with I would like to share the key updates on our formulation business. We are very happy to share that in Q2 FY2020 we reported formulation revenues of Rs.160 Crores that totals to ~Rs.260 Crores in the first half of the financial year. The major growth has come from our ARV tender driven business with Global Fund and from various in-country tenders. Increased FDF sales demonstrating our ability to execute large volume orders and also becoming a reliable supplier for future orders. We continued to have good visibility of orders from these markets. Apart from our LMIC business, we also witnessed a very healthy growth in North America and Europe. The sales growth in US was mainly driven by sales of Pregabalin, which was launched by our partner and we believe we have a double-digit lower teen market share in Pregabalin. We witnessed significant growth also in European supplies where we do contract manufacturing with our partner in Europe. Interestingly we also have seen a good traction in Canada where we have 2 products launched of 4 approved. As of today, in US we have 5 final approvals and 3 tentative approvals and we expect to have 2 more approvals in this financial year and hope to launch both as well.

As far as EU is concerned, we are happy to share that the contract manufacturing opportunity for certain non-ARV formulations are shaping up very well and we have a very robust order book for the next six to nine months. Besides we are also in the process of launching new products in various European markets on our own label, we got approvals for 3 products right now of which one product is already in the market and second product in Europe we will be launching in the next few months.

During the quarter, we also received ERP approval for TLE400. We expect to get final approval within next three to six months from FDA as well. On R&D front, we continued to invest in our FDF business aiming to file about 8 to 10 ANDAs every year. So far we have filed 21 ANDAs in US, 6 dossiers in Europe, 7 in Canada and 8 product with WHO as well as 2 dossiers in South Africa and 2 India as well. Of the 21 ANDAs we filed in US we believe there are 2 Para-IV and 7 FTF opportunities with several billions of dollars of market size. From the beginning, we always clear about our approach, which remains product specific and not market specific. When it comes to generic API, we are very pleased to share that all our large volume API facilities were inspected by FDA and we have EIR in place for unit I, III and IV. When it comes to ARV API business it continues to slow down, it has degrown by 23% year-on-year whereas H1 it has degrown by 25%, but fall in this growth is mainly led by change in treatment regimen from Efavirenz to Dolutegravir and some uncertainty in the regimen change in South Africa and also delay in announcement of results for the supplementary tenders in South Africa. Once these two are in place, we will have a very good visibility of our ARV sales in South Africa. Most of the Dolutegravir and Lamivudine what we are producing are being used captively for our formulation business. We are also executing some orders with third parties depending on their approvals.

In Second line ARVs we saw a lot of traction, we have two customers agreed for approving most of our second line ARVs for their PEPFAR market, which will have a good pickup for second half of FY2021. During the quarter, Hep C has witnessed ~Rs.18 Crores sales for the quarter and about Rs.30 Crores sales for the first half of the financial year. We believe this is the new norm for Hep C business and the way forward we would like to add Hep C into Other API segment for reporting because this segment became not very significant for us.

When it comes to Oncology API, we continued to do very well. We did Rs.60 Crores in this quarter and more than Rs.100 Crores in the first half of the financial year. Revenue growth in Q2 is about 28% whereas 16% for the H1. We expect it to do very well in the second half as well although we have some challenges in one of the starting material supply and we were able to mitigate this by backward integration and current production of one of our key API is being in-house which is one of the big factors that we have done in the backward integration. It is also very interesting to mention that we have one of the largest high potent API capacities in the country right now. We have also seen from traction of higher volumes of old oncology APIs so oncology segment continues to be a key growth driver for us and we will continue to see growth.

In the other API segment where we included contract manufacturing and generic APIs, has grown very well, for H1 we have grown almost 70% when compared to the H1 FY2019. This was primarily because of execution of contract manufacturing orders for

generic API and we also have good visibility for this segment for the coming few quarters. On the back of the sizeable order book and also new product introductions and also we have created some dedicated capacity with contract manufacturing, we are very hopeful with our other API dealers that is other than ARV and oncology we continued to see a positive momentum.

Synthesis business continues to see robust growth ~Rs.60 Crores in this quarter and almost Rs.120 Crores in the H1. This growth was led by healthy offtake from Aspen for steroids and intermediates and also it was well supported by other CDMO opportunities. The revenues from CDMO business will be significant in Q4 because we expect to deliver one large contract in Q4 so the outlook looks very good for Synthesis business. Ingredients business also improved significantly ~Rs.30 Crores in Q2 and almost Rs.46 Crores in first half of the year. We became a preferred ingredient manufacturer for some key products so we are very happy that our continued focus on this division is also bearing fruits. With that I would like to hand over to Ravi to share financial highlights.

V.V. Ravikumar: Thank you Dr. Satya and a very warm welcome to everyone for our Q2 and H1 FY2020 earnings call. Total income for operations for the quarter Rs.712 Crores against Rs.588 Crores with 21% growth and H1 we have 12% growth with revenue of Rs.1,263 Crores. Our gross margins have continued to show an improvement. Improvement in gross margin is mainly because of the product mix and of course the additional formulation sales. Our EBITDA margins improved to 20% in quarter and for H1 around 18%. Growth in EBITDA is mainly because of the higher revenues and softening of raw material prices from China. Our diluted EPS at Rs.5.3 and Rs.at 6.7 for the H1 and on the capex front we have spent about Rs.89 Crores for H1. The capex for the full year will be in the range of Rs. 200 crores. With the improved contribution from the businesses of FDF and other APIs we remain confident of improving our return ratios. Our debt is at around Rs.1,050 Crores and well within the limit of Rs.1,100 Crores which we have been targeting. We are optimistic on the improvement of our return ratio in FY20 and I look forward for a positive free cash flow in FY2021. With this I would request the moderator to open the lines for Q&A.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the question and answer session. The first question is from the line of Sudarshan Padmanabhan from Sundaram Mutual Fund. Please go ahead.

Sudarshan Padmanabhan: Thank you for taking my question. Sir my question is on the inventory buildup that we are seeing in the balance sheet for the first half so if I am actually looking at the cash flows we are seeing an inventory jump of about Rs.200 odd Crores and if I look at the first half versus first half of the previous year broadly we are seeing a jump of about Rs.150 Crores in terms of sales so if you can split the inventory and tell us with respect to

how much of it has been build on account of the raw materials and we are seeing a jump in the formulations side whether this kind of inventory buildup is for similar growth that we are seeing in the second half on the formulations and on the API side as well?

V.V. Ravikumar: You are right the inventory buildup happen for Rs.200 Crores from March to September but even June quarter also we have an inventory buildup. Formulation is taking an additional inventory of around Rs.100 Crores and the other contract manufacturing opportunities also caused this buildup, but this will be regularized or normalized by March 2020.

Sudarshan Padmanabhan: What is the kind of growth that are we expecting in the second half on the formulation side if you are building Rs.100 Crores of inventory, which means that we are also looking at a sizeable growth coming in the second half is that a right assumption?

V.V. Ravikumar: No if you look at Rs.160 Crores revenue we made in the second quarter on the formulation side and Rs.100 Crores inventory that is reasonable, I think Rs.80 to 100 Crores inventory we are going to continue to have on formulation side. For the growth actually we are cautious to give guidance quantitatively, but qualitatively there will be a growth.

Sudarshan Padmanabhan: But I mean any full-year guidance that we have in terms of what can be the formulations that we might end up with?

V.V. Ravikumar: We are not giving quantitative guidance I am sorry for that.

Sudarshan Padmanabhan: Sure Sir. My second question is on the capex as well. I look at it we have done close to about Rs.100 Crores of capex in the first half, we have been talking about this key starting material and the need probably to build capacities over there. When we are talking about Rs.200 Crores this year where is it exactly going and post this buildup and specifically when one is looking at formulations we are under utilizing what would be the kind of capex as we move to FY2021-FY2022 from that side?

Dr. Satyanarayana Chava: In FY2020 we are also planning to do another Rs.100 Crores capex half of that will go into debottlenecking and optimizing our formulation capacity and half of that will go into backward integration and capacity expansion of some intermediates in anti-retroviral. So probably 50:50 will go into formulations and APIs in the next six months probably same percentage will continue to be there in the next financial year as well.

Sudarshan Padmanabhan: But why do we need capacities and formulations when already our utilization is less if I am correct we have close to about Rs.800 Crores of gross block in the formulation side

and even if you are assuming that and that will continue our utilization would be much lesser right?

Dr. Satyanarayana Chava: We are anticipating from additional contract manufacturing opportunities from European partner and also we are expecting some new approvals especially in Europe for Metformin and Canada for Metformin so we are hoping to sell significant volume of these production in FY2021 so we are debottlenecking for our next year growth. See this is nothing to do for our current year growth, this is primarily for the next year growth.

V.V. Ravikumar: Our capex investment into the formulation is not Rs.800 Crores it is around Rs.400 Crores.

Sudarshan Padmanabhan: Okay and Sir as we move towards the end of this year what could be the kind of working capital that would be from a normalized side because I think when you are looking at the first half of numbers given that we have demand in the second half optically it looks like there has been some kind of an inventory built so I am just trying to understand what can be the cash is when you report or the balance sheet in the fourth quarter?

V.V. Ravikumar: We are expecting to have a similar number or less than this for inventory but our receivable will be also in the similar range, we are not anticipating very significant increase in NWC.

Sudarshan Padmanabhan: Sure Sir. Thanks a lot. I will join back in the queue.

Moderator: Thank you. The next question is from the line of Anik Mitra from Stewart and Mackertich. Please go ahead.

Anik Mitra: Congratulations for a good set of numbers. My question is in the ARV part like we know that there is a transition from Efavirenz towards Dolutegravir so are you ramping up the DTG production are you going to cut your Efavirenz production, this is my first question and another question is how do you foresee the China condition, do you foresee any improvement over there?

Dr. Satyanarayana Chava: Sales from Efavirenz is coming down and interestingly sales from intermediates are more than what we anticipated. So far we have not used any of our Efavirenz for internal use for formulation sale so we were not diverting any of our Efavirenz to our formulations, most of the formulation sales in ARV is coming from Dolutegravir based combination. So we have increased our capacity of Dolutegravir significantly and we are able to meet our demand, we also did supply some from quantities to third party customers. When it comes to the improvement we do not see improvement in Q3 for ARV APIs unless clarity emerges from South Africa regarding the supplementary tender and also the

ambiguity around the switch from Efavirenz and Dolutegravir has to be cleared then only we will have clarity that is one and second for FY2021 definitely we expect improvement because we have seen good traction of alternate sourcing approvals of second line APIs so although Q3 ARV looks not very good, but Q4 should normalize and next year I think we will have a very good traction.

Anik Mitra: Okay in terms of raw material prices do you foresee any improvement in the China condition?

Dr. Satyanarayana Chava: China raw material prices I would say have softened somewhat and availability is fairly okay but sometimes there are some surprises like in one of the oncology intermediates we have challenges so we did backward integration then one of the raw material is not available so some other Indian companies making that for us, but situation is far better than what we experienced 18 months back.

Anik Mitra: Okay and Sir in terms of Gemcitabine backward integration what is the current status like to be commissioned around September and October?

Dr. Satyanarayana Chava: It has been done, it was successfully completed and currently whatever Gemcitabine we are producing we are using is by using our in-house intermediate only. We are not buying intermediates from China for the last two to three months.

Anik Mitra: Okay Sir. Thanks.

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

Nitin Agarwal: Sir in the formulation sales can you share a number for the LMIC sales in the first half of the year?

Dr. Satyanarayana Chava: Our two-third is coming from LMIC and then one-third is coming from North America and Europe. Broadly that will be the percentage we expect for Q3, Q4 as well.

Nitin Agarwal: And Sir typically what is the visibility do we have on this LMIC business, do we have like good two, three visibility on this business, is it going to be lumpy business, how do you see that?

Dr. Satyanarayana Chava: Our base is that not very big in LMIC, so we have visibility for that six months I would say.

Nitin Agarwal: Structurally how should we look at this business, should we look at the business on the base it is done, should it keep growing on this base or it should be a function of how the tenders playout?

Dr. Satyanarayana Chava: I think there will be some base and there will be ups and downs, it is not that entire business will be very bumpy, for example, people will get stability say one million or two million packs a month and then there could be a bump whether you supply three million in one month, two million in one month, three million one month, but we expect to have certain base and we are at a base right now, we are not changing our production plans based on the demand, we fairly have a stable production plan in place for the last three months and in the next six months also.

Nitin Agarwal: Okay Sir, just to confirm it this entire formulation sales which are there, it is largely on DTG combinations?

Dr. Satyanarayana Chava: Yes, We have been also selling triple combination of Dolutegravir, single Dolutegravir, we are selling Tenofovir singles, we are selling some Emtricitabine and Tenofovir combination also. There is fairly good diversification.

Nitin Agarwal: Okay Sir and secondly when you look at even the business now, we are doing some formulations, we are doing contract manufacturing of formulations as well as API when you look at the business, from a strategy perspective, do we intend to becoming more and more of a formulation play or where our focus would be, do we see ourselves evolving as a more of a formulation player or leveraging our API is more for captive consumption or we are going to keep deploying capital in both APIs and formulations as we go along?

Dr. Satyanarayana Chava: If we look at our journey, people used to consider us as a one product Company and then people use to consider us ARV-API Company then they started thinking of us as an API Company, now people are talking what will be the percentage of formulations sales, what is the percentage of synthesis business in our overall business?. If you look at our Q2 numbers, it is fairly visible, APIs contributed two-thirds of revenue and rest of the divisions contributed to one-third. By the end of the year, it could be 60%, 40%, so that means 40% of business coming from non-API by end of this year, so there is a significant diversification and going forward how people will perceive Laurus Labs as And we would like us to be known as a sustainable dependable partner whether we sell APIs, whether we sell custom synthesis business, we sell formulations, people should consider as a sustainable Company.

Nitin Agarwal: And Sir in terms of incremental capital allocation where do we see ourselves investing more capital, how you are visualizing capital allocation going forward more towards

APIs or more towards formulations, right now both in terms of capex as well as R&D Sir?

Dr. Satyanarayana Chava: R&D expenditure will remain the same because of the number of ANDAs we file and the associated filing costs, like bio-cost and all, R&D expenditure will be half between chemical and formulations. Capex, we have done Rs.400 Crores out of Rs.2800 Crores so far, but going forward our capital spend will be equally divided between formulations and chemical business, API and intermediary business.

Nitin Agarwal: Okay Sir. Thank you.

Moderator: Thank you. The next question is from the line of Jeevan Patwa from Candyfloss Advisors. Please go ahead.

Jeevan Patwa: I just have one question, you talk about few FTF opportunity, any timeline for those FTF opportunities to materialize? Will it be in FY2021 or FY2020?

Dr. Satyanarayana Chava: First-to-file opportunity is, the earliest one we have is 2025 and significant ones are in 2027.

Jeevan Patwa: Okay, thanks a lot.

Moderator: Thank you. The next question is from the line of Gagan Thareja from Kotak Investments. Please go ahead.

Gagan Thareja: Good morning Sir. Compliments on the good scale up in your formulation business. The first question is around your capacity utilization, if you could give an idea of the capacity utilization in your API side and in your formulation side separately, some idea or ballpark number?

Dr. Satyanarayana Chava: In the API side, our capacity utilization is about 75% right now, we cannot do 100% for sure, because of our multiproduct environment, 80%, 85% is considered very, very good, so we are at 75% level. The main capacity where we are not utilizing is Efavirenz where we have 70 tonne capacity we are utilizing half of it right now that is one and the rest of the production fairly we are utilizing very well. When it comes to formulations, our capacity utilization is at almost optimum level right now that is good for us for this year as we mentioned in the previous question and we are debottlenecking and adding some capacity by April next year for our FY2021 growth opportunities.

Gagan Thareja: If one were to sort of try and segregate the fixed cost, how much of that would be attributed to the formulation facility?

V.V. Ravikumar: Fixed cost for the formulation is lower than API, if you look at outcome of formulation is a combination of our in house API as well as formulation block, and the revenue will be reflected in the formulation, but the support is from the API too. Our fixed cost in the formulation is lower.

Gagan Thareja: But ballpark split could be of what order 60-40, 70-30?

V.V. Ravikumar: On an annual basis may be around Rs.80 Crores to Rs.100 Crores.

Gagan Thareja: Are you sweating that fully now on a quarterly basis, because you have scaled up fairly sharply or there is a lot of room still to sweat it fully?

V.V. Ravikumar: It is sweating fully, but like once we are moving every quarter we will get some efficiencies and learnings, so we are also finding some of the balancing equipments, we can sweat it out further too, as we said like we have made an investment around Rs.400 Crores into the fixed asset there.

Gagan Thareja: Coming onto the formulation space, as you said two-thirds of it is coming from ARV formulations and there has been a good scale up there and that scale up has come entirely from the DTG formulations or largely from the DTG formulations. You have also indicated in your opening remarks that TLE400, you think FDA approval will come in three to six months which means starting next year, you will be in a position to be there in the TLE400 market. Given your strength in superior process in your further and then your backward integration there, two things will happen. First, DTG you will be there for the tenders this year I think you might not have been there for the tendered quantities, you would have been there for the non-tendered quantities, so the scale of the DTG market available to you increases next year. Secondly TLE, if you manage to get your approval three months out, you will be there again for the tenders next year, so the scale of opportunity that you can address would increase I am just trying to understand what was the scale of opportunity in terms of the tenders or addressable market that you bid for this year and what could be the addressable market that you could bid for next year?

Dr. Satyanarayana Chava: Hoping that we will get approval for TLE400, TLE600 during this financial year and our ability to take market share in the next year will be good that is the reason we are debottlenecking our capacity to be ready to serve TLE market. It is difficult to predict how much we will able to sell like we were unable to predict Dolutegravir triple combination when we are fairly successful there. This year we are not in the fixed allocation, next year we will go into fixed allocation. Opportunity will be bigger than this, we cannot quantify right now, but it is bigger than what we are having right now.

Gagan Thareja: So let me then put in this way Sir, the market size you have been generally indicating is of the order one, USD $1.5 billion, LMIC first line ARVs, am I correct there?

Dr. Satyanarayana Chava: You are right.

Gagan Thareja: So, next year you will virtually be addressing that entire tender market, I am not saying that across the board, but by and large, the most significant geographies you will be in a position to address?

Dr. Satyanarayana Chava: Out of that $1.5 billion you have to remove 25% which is from South Africa that is $500- 600 million is gone out of that, so you have about $900 million to a billion dollar which is available for us, so if everybody's guess is how which market we will get, we will get equivalent of revenue, so 5%, 10%, 15%? you do not know right now. So it is not very easy to guess and how much of that South African business we will get depends on how much of the substitution happens from Efavirenz to Dolutegravir, what could be the results out of the supplementary tender and how much of that we will able to take, so that is not very clear for us whereas rest of the business i.e non-South Africa business, we are well placed to take Efavirenz combinations or Dolutegravir combinations by next year.

Gagan Thareja: What was the size of the supplementary tender in South Africa if you could give some idea there?

Dr. Satyanarayana Chava: Supplementary tender value is $200 million per year.

Gagan Thareja: You participated in that tender or you just supply to Aspen there?

Dr. Satyanarayana Chava: We did not participate, Aspen participated and as you are aware we are licensing the dossiers from Aspen for that market and eventually whatever Aspen gets will be our business in South Africa over a period of time, assuming we will close the transaction of subsidiary acquisition.

Gagan Thareja: If you could elaborate on the contours of that transaction, where you are saying eventually, you are in licensing the Aspen intellectual property and eventually you will be the front facing formulation supplier there if I have understood it correctly, but if you could correct me if I am wrong and also elaborate on the timeframe within which this happens. I presume the South African tender is the rolling three-year tender and also the supplementary tender is for Efavirenz, the main tender was largely I think a split towards DTG and less toward Efavirenz you had indicated last call although the bulk of the tender went in February I think it was went to DTG supplementary tenders were required for Efavirenz because the shift did not happen, so on these aspects if you could just clarify a little bit?

Dr. Satyanarayana Chava: You are right, the primary tender went towards more Dolutegravir whereas supplementary tender were more towards Efavirenz. And as far as the transaction with Aspen is concerned will license the dossiers for public market and they will continue to manufacture and they will continue to distribute our product and take a fees for manufacturing, take a certain fee for distribution, so whereas we will sell APIs to the subsidiary, subsidiary will do contract manufacturing with Aspen and they will distribute until we have created our own distribution network, they will continue to do that. That is the arrangement.

Gagan Thareja: How does that arrangement sort of help you I am presuming the ultimate aim is to transition away from API into formulation supply in South Africa, have I got it correctly?

Dr. Satyanarayana Chava: Once the transaction is closed and if any successful tender awarded to Aspen, so our entity will hold the marketing of these certain ARVs in the public market, ultimately we will supply API to South African market and Aspen will convert into finished those forms and supply to the government.

Gagan Thareja: And you will be giving Aspen a conversion fees, is it?

Dr. Satyanarayana Chava: Yes.

Gagan Thareja: And the final sales will be booked in your name?

Dr. Satyanarayana Chava: Yes.

Gagan Thareja: Any numbers you could roughly give around the fees that you might have to pay off to Aspen for this?

Dr. Satyanarayana Chava: We cannot tell you, all depends on the successful outcomes of supplement tender, once it is there then it is also a public document.

Gagan Thareja: So this arrangement that you have done will become effective for this supplementary tender right?

Dr. Satyanarayana Chava: That includes supplementary tender, effective when the transaction is closed which we expect will be closed in next six to eight weeks.

Gagan Thareja: Alright but the next tender in South Africa only happens three years or is there going to be something in between also which you can address?

Dr. Satyanarayana Chava: No, nothing in between.

Gagan Thareja: Is it fair to presume that since your strength has been Efavirenz, in the TLE 400 market you would be in a better position to take larger market share, I understand the number of suppliers in the TLE market or more than DTG last call you indicated 10, 12 suppliers in the TLE market vis-à-vis four in the DTG, but given your cost competitiveness, it would be fair to presume that you could at least take as much market share in TLE as you could in DTG or even more logically speaking?

Dr. Satyanarayana Chava: It is difficult to predict, but one correction I would like to mention. There are good numbers of approvals in TLE600, but fewer approvals in TLE400.

Moderator: Thank you. We will take the next question from the line of C. Srihari from PCS Securities.

C. Srihari: Thanks for the opportunity. Firstly on the formulation side, has the share of the LMIC tender business been similar during Q1 and Q2 and secondly, is there a profit share for Pregabalin in the Q2 numbers and on the API side, for onco, you have mentioned that depending on some patent expiry, can you please give some kind of a timeframe and increased potential there and finally on the payable side there has been significant increase, can you please throw some light there? Thank you.

Dr. Satyanarayana Chava: On the Pregabalin, because as per agreement once the quarter is ended, they have to give numbers within 60 days, so profitability of Pregabalin sales is not recognized in this quarter. And on oncology, we are doing very well in oncology and backward integration is done for our key API, we expect to get couple of approvals more during this financial year, so that segment looks good for us and when it comes payables, I will ask Ravi to say why our payables went up.

V.V. Ravikumar: This reflects in through the inventory also, where we have build up to inventory further we made more purchases and that's why the payables have gone up.

C. Srihari: Okay basically on the onco side, you have mentioned about some patent expiry, those are some opportunities you are looking out for, so I wanted a little more clarity on that?

Dr. Satyanarayana Chava: One European supplies we started which expired this year and we also expect some approvals will come in US as well.

C. Srihari: And the other question was pertaining to LMIC split Q1, Q2 is it similar?

Dr. Satyanarayana Chava: Q1 and Q2 are very similar and we expect same trend for further two quarters as well.

C. Srihari: Okay, fine. That is helpful. Thank you.

Moderator: Thank you. The next question is from the line of Harith Ahmed from Spark Capital. Please go ahead.

Harith Ahmed: Good morning everyone. On the ARV, API front, we have seen decline this year, given the transition to DTG, do we expect stabilization at current levels for the remainder of the year or should we be looking at more decline on the ARV-API sales?

Dr. Satyanarayana Chava: We do not expect it to decline further, if you do on the annualized basis may be Rs.570 in the first half may be another Rs.500 in the second half that is what we expect. Initially we used to sell more, if you look at our FY2019 ARV numbers it was Rs.1390 Crores, this will come down to little over Rs.1000 Crores in this year. As I mentioned earlier, we will be in a position to recoup some of this lost sales in the next financial year because of estimated approvals of second line APIs with customers.

Harith Ahmed: Okay and on the formulations front, we had commented that the transition to TLD has been quite slow in South Africa, has this situation changed or do we still see some resistance the transition to TLD?

Dr. Satyanarayana Chava: In South Africa still the transition is very slow and we do not expect that situation change dramatically, so in this current tender period we expect majority of the regimen will be toward Efavirenz triple combination rather than Dolutegravir triple combination.

Harith Ahmed: Okay, and then lastly as you ramp up of formulation business, does it affect the API business in terms of our relationships with customers as we start competing with them on the formulation side, is there impact on their uptake of our APIs as we compete with them?

Dr. Satyanarayana Chava: We have not seen any of that, because we would not have backlog orders to be delivered a customer gets upset when we are not delivering on time to them, we do not have that kind of situation. We have enough capacities to meet their demand and our demand as well. Interestingly, if you look at we have not used single KG of Efavirenz which is our lead product into our formulations, so we have not seen any of those.

Harith Ahmed: Alright. That is all from my side. Thank you.

Moderator: Thank you. The next question is from the line of Dheeresh Pathak from Goldman Sachs. Please go ahead.

Dheeresh Pathak: Thank you for the opportunity. Sir the formulation gross block is Rs. 400 Crores, right? and you said if you annualize this year half year sale you are doing about Rs.500 Crores

annual and you said you will be fully optimally utilized by the end of the year so on Rs.400 Crores of gross block we are generating Rs.500 Crores of revenue?

Dr. Satyanarayana Chava: That is our guess. We are also putting some new capital expenditure to optimize for us to have bigger opportunities next financial year.

Dheeresh Pathak: No. Just I meant if this fixed asset turnover on 1.25 looked on the lower side because when you said that by the end of the year FDF capacity would be optimally utilized and that is why we are debottlenecking, so I just wanted to make sure that if I am missing something.

V.V. Ravikumar: I think you need to annualize the Q2 number.

Dheeresh Pathak: So Rs.600 crs?.

Dr. Satyanarayana Chava: That could be the potential revenue generation possible form the asset.

Dheeresh Pathak: Current asset?

V.V. Ravikumar: Current asset.

Dheeresh Pathak: Okay this 1.58 asset turn is still on the lower side is it because of the ARV part that is the realizations are lower.

V.V. Ravikumar: I think what we want to do is we have to create in larger building. The combination of products what we make, where we can make, we can expand the capacity by just simply investing into the equipment, when Dr Satya said Rs.50 Crores investment which we are planning to do is for the equipment and then you will really see the good revenue multiples out of that asset after the expansion.

Dheeresh Pathak: Okay Sir in the LMIC if you go by the numbers you reported so about Rs.180 Crores for 1H roughly to about Rs.360, 400 for the full years so this Rs.400 Crores for the full year in FY2020 in LMIC this is mainly coming from you mentioned a few products but mainly it will be from TLD and non-South Africa market?

Dr. Satyanarayana Chava: Yes, you are right.

Dheeresh Pathak: And that tender is annual tender or is it multiyear tender.

Dr. Satyanarayana Chava: In the non-South Africa it is not a multiyear tender. See this year we got non-allocated volumes and some in-country tenders but next year we are moving into fixed volume allocations so things will be better next year.

Dheeresh Pathak: So fixed volume allocation is an annual process by the various countries or there is some central agency involved here.

Dr. Satyanarayana Chava: There are two central agencies which will do annual volume. We will go to that next year.

Dheeresh Pathak: Okay and when does it happen like which month typically with the tender outcomes happen?

Dr. Satyanarayana Chava: It is in the Q1 of calendar year that is Q4 of the financial year.

Dheeresh Pathak: Okay so probably by March 2020, we will know whether we have how much we have won and what we have won we will have clarity right at that in the Q4 quarter you can give us clarity right?

Dr. Satyanarayana Chava: Yes.

Dheeresh Pathak: Okay Sir last quarter, you mentioned that there were some Rs.75 Crores of sales which did not happen in ARV would have been pushed to Q2 but based on that guidance last quarter, there seems to be still shortfall in the ARV API numbers?

Dr. Satyanarayana Chava: That is true and it will be the same because we expect the supplementary tender results in the Q2 it did not happen. We are expecting supplementary tender results in Q3. So we are already in the first of November, there is no clarity on when the supplementary results will be done so that ambiguity is there right now and we cannot predict how much API we will be able to sell into South African Market.

Dheeresh Pathak: This supplementary tender in Africa. This has already happened or is it yet to happen or it has happened but results are yet to be announced?

Dr. Satyanarayana Chava: Results are yet to be announced.

Moderator: Thank you. The next question is from the line of Tushar Bohra from Emkay Ventures. Please go ahead.

Tushar Bohra: Thank you so much for the opportunity and congratulations on good set of numbers. Couple of points, so the margins have improved meaningfully for us, but as you guided that we are still expecting formulations revenue to move up or other non-API revenue as it percentage to move up, so should we take Q2 EBITDA margins as a baseline going forward do we expect more improvement in EBITDA margins let us say it is to FY2020 and may be even FY2021. We are not giving quantitative guidance so we cannot.

Dr. Satyanarayana Chava: You are in the right direction that much we can tell you.

Tushar Bohra: Second in terms of the formulations I think but Rs.156 Crores in Q2 if I am not mistaken right so we mentioned that this can be annualized and I am assuming there would be some growth on this number in H2, qualitatively can we assume that there would be growth over the Q2 baseline in H2.

Dr. Satyanarayana Chava: Probably yes.

Tushar Bohra: What would be good range to consider for the capacity utilization for the formulations block, I mean let us say for 1.8X to 2X to 1.6X to 1.8X but would be the range that you think depending on the product mix and depending on the circumstances situation what kind of range should be build in for formulations?

Dr. Satyanarayana Chava: We have invested Rs.400 where debottlenecking is putting another Rs.50. Then it will be Rs.450 Crores assets . Probably you can get closer to 2x.

Tushar Bohra: In fact, you mentioned Rs.80 to 100 Crores on formulations side, capex?

Dr. Satyanarayana Chava: Rs.30 crores is already done and Rs.50crores we are doing right now.

Tushar Bohra: So that Rs.30crores is not part of Rs.400crores? That is what I am trying to get?

Dr. Satyanarayana Chava: In the Unit II where we have API and formulations, so if you segregate API and including what we are planning to do as Rs.50 crores, that will take us to total around Rs.450 Crores capex for formulations specific, you can multiply that by 2 broadly.

Tushar Bohra: So, roughly given that we are doing this debottlenecking for FY2021 we have visibility for let us say closer to Rs.1000 Crores formulations sales by FY2021. Is that a fair assumption to make?

Dr. Satyanarayana Chava: If you put three more questions we have to tell you the number, so we will resist answering.

Tushar Bohra: Not a problem. I get that. I would like to understand your outlook on the North America formulations. I believe there is still a Pregabalin was a successful launch but I could not think we are still anyway close to out optimum guidance on US formulations, right?

Dr. Satyanarayana Chava: North America which is US and Canada. Whether we sell or our partners sells we have a good product mix right now and we hope to launch another product. We have launched Metformin on our own label, we are launching Hydroxychloroquine, we will launch one more product in this financial year, whereas in Canada we have already launched two

products. We will be launching five more products and we will launch maybe two more in this financial year so that is North America. When it comes to Europe, we have launched one product, although not significant revenues are coming from there but we are going to have two more products launched in this financial year. We are also doing two commercialized contract manufacturing products for our partner so if you take going forward may be 60% in LMIC and may be 20% in North America and 20% in Europe that could be the broad revenue mix in formulations.

Tushar Bohra: That is for H2 or FY2021?

Dr. Satyanarayana Chava: FY2021.

Tushar Bohra: We mentioned that Pregabalin has not taken any profits in Q2, but there is a profit share arrangement and assuming so we should expect some delta in Q3, Q4 may be on the basis of that?

Dr. Satyanarayana Chava: Hopefully. We have not taken anything in Q2.

Tushar Bohra: Sir finally very quickly just to understand we had a large gross block sitting which was at least and the last year has not been fully utilized, what we understand is that in Q2 we are closer to optimally utilizing the operating leverage that we are saying, are we already is it the start of the operating leverage benefits taking or should be assume in Q2 has more or less all the benefits have come in?

Dr. Satyanarayana Chava: I would say this is the beginning rather than the optimum.

Tushar Bohra: I know you do not give qualitative guidance but just from a baseline perspective Q2 FY2020 PAT would be closer to a baseline number that we should budget for going forward and then whatever we want to build in growth on that in our model?

Dr. Satyanarayana Chava: We will tell you maybe in our Q3 results call how the Q4 looks like. Sales from Q1 to Q2 have done significantlywell..

Tushar Bohra: I am not asking from quarterly perspective Sir I am saying so we had a difficult couple of years over the last couple of years?

Dr. Satyanarayana Chava: We can tell you very clearly. We are out of the woods. So things are in a different situation right now.

Tushar Bohra: Exactly Sir Q2 could be closer to baseline number for us to look forward right and then whatever growth we may want to budget at least we should not be below Q2 kind of number on a sustainable basis right annualized?

Dr. Satyanarayana Chava: Hopefully.

Tushar Bohra: Perfectly. Thank you so much Sir. I will come back in the queue.

Moderator: Thank you. The next question is from the line of Tushar Manudhane from Motilal Oswal. Please go ahead.

Tushar Manudhane: Congrats on a good set of numbers. Sir just wanted to check on the gross margins where in the share of formulation has increased sequentially but there is a dip in the gross margin, minor dip so any color on that?

V.V. Ravikumar: It is based on the product mix.

Tushar Manudhane: With the formulation share rising like what can be gross margin level?

Dr. Satyanarayana Chava: We expect gross margins will remain the same in Q2 and Q3, Q4 as well.

V.V. Ravikumar: Do you have any other questions?

Tushar Manudhane: No. That's it.

Moderator: Thank you. The next question is from the line of Srihari from PCS Securities. Please go ahead.

C. Srihari: Thanks for a followup. You have mentioned debottlenecking project formulation so that could take up capacity for dosages from 5 million tablets so how much?

Dr. Satyanarayana Chava: I think 5 million is a notional capacity depending on what we produce. We produce more of triple combinations, actually real capacity goes down whereas we are debottlenecking by putting these Rs.50-odd Crores to put more inspection lines, more packaging lines, few granulations so capacity will not go up significantly, but our ability to utilize the current capacity will be very, very good.

C. Srihari: What could be the incremental? I mean I understand that okay you are processing efficiency will improve so what would be? Can you please quantify that?

Dr. Satyanarayana Chava: May be around 10%.

C. Srihari: Okay fine. Thank you.

Moderator: Thank you. The next question is from the line of Gagan Thareja from Kotak Investments. Please go ahead.

Gagan Thareja: Thank you for the opportunity. Last question that I was discussing with TLE400 you indicated that the number of suppliers would be lower, could you give us some idea of what we have approved number of suppliers there?

Dr. Satyanarayana Chava: There are two approvals right now.

Gagan Thareja: Including yours?

Dr. Satyanarayana Chava: No we did not get final approval.

Gagan Thareja: So there is two plus, but you think that this $900 million market like you have ex of South Africa first of all could you split between unallocated and tender quantities how much would be unallocated. I presume it will be very small amount, but if you could give us some idea?

Dr. Satyanarayana Chava: It is difficult but you can take it is equal split allocated and unallocated.

Gagan Thareja: Also if we were to again try and split it in terms of the first line treatment so $900 million this year how would have split up between DTG combinations and EFV combinations?

Dr. Satyanarayana Chava: What we have estimated to be $900 million is entirely first line treatment. Based on trend two-thirds will be DTG base and one-third could be EFV based. That is for next year but this year it is 50:50, next year it could be two-third, one-third.

Gagan Thareja: $600 million would be DTG in your understanding and $300 million would be next year and TLE if you split down again between 600mg and 400mg I presume people will shift to 400mg because it is the lower dosage with same efficacy, would it be correct to presume $300 million would by and large be TLE400 itself?

Dr. Satyanarayana Chava: I will say maybe again two-third, one-third split probably.

Gagan Thareja: Two-thirds in favor of 400mg?

Dr. Satyanarayana Chava: Yes.

Gagan Thareja: So $200 million would be in your assessment TLE400 market and $100 millin would be TLE600 and you do not see, market number of approvals in this TLE400 market going

beyond three or you think it will be by the time the tender comes in will be much bigger number?

Dr. Satyanarayana Chava: It is difficult to guess, we have filed. All these are dynamics. We do not know.

Gagan Thareja: Okay fine so DTG this year was how much we are saying next year could be $600 million, this year will how much if you could give us some idea?

Dr. Satyanarayana Chava: It is difficult, see this will be guess work, agencies do publish this data in the early next year, here we are doing too much of guess work.

Gagan Thareja: The other question is DTG there is lot of 10 players, around 12 what you indicated arithmetically without bias that we means 8% to 9% market share, but TLE400 arithmetically if three even goes to five without bias it should be mean around 20% market share for each player at least and given the way backward integration works to the advantage of a company like yours, it could ideally be the north of that so even in one word to presume 20% market share there on 200 that is a fifth of 200 market that itself is fairly significant number and you will close the year with what? 50 million, 60 million this year on formulations and all of it only for unallocated market, next year you get the allocated market, you get to my understanding larger market share in TLE400 mathematically speaking and around 10% odd, 8%, 9% even at parity with BTG.

Dr. Satyanarayana Chava: This is going into granularity, so maybe you can have offline call which will be better for you to more data, otherwise you are doing too much of guess work and which we will give some clarity and more of ambiguity so maybe we can it offline.

Gagan Thareja: Fine Sir. Last question from my side, CRAMS business you saying you are going to invest there and presuming there will be a good scale up, how should we look at the first of all where it does not sit in your revenue streams, where does it sit and what order of magnitude of growth are we looking there it is coming up additional customers and additional formulations how should we think about?

Dr. Satyanarayana Chava: Custom synthesis used to be 2%, 3% of all our revenues three to four years back. As you have seen this is almost close to 10% right now so as our base has become bigger, but we still expect this CDMO business will continue to be 10%, 12% business for us and it is coming from mostly existing customers and some revenue obviously will come from you customers as well

Gagan Thareja: Finally from the tax rate point of view after the recent changes any impact for you or none whatsoever?

V.V. Ravikumar: There is no impact except for the MAT reduction and the profits from formulation being in SEZ our effective tax rate has come down in the second quarter.

Gagan Thareja: So effective tax rate now should be of what order sustainably?

V.V. Ravikumar: This YTD rate may be sustainable, but we have to see how things move from the Government of India side and extension of weighted deduction etc., I think it we will have to wait till March and the next union budget to understand.

Gagan Thareja: All the best.

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

Charulata Gaidhani: Congrats on the good set of numbers. My question pertains to Efavirenz in the first quarter, there was some unsold inventory as it has been sold?

Dr. Satyanarayana Chava: It is not for Efavirenz, it is for an ARV API and formulation. This partly moved actually we are also building for formulation revenues so there is a reason the inventory is higher as of September 30, 2019.

Charulata Gaidhani: Again in case of the oncology API, can we treat it as new base going forward every quarter or will there be fluctuation?

Dr. Satyanarayana Chava: Probably that will be the runrate we expect.

Charulata Gaidhani: Okay around Rs.60 Crores?

Dr. Satyanarayana Chava: Rs.60 Crores.

Charulata Gaidhani: Okay and what is others, API comprising?

Dr. Satyanarayana Chava: Majority of other APIs is because of our contract manufacturing APIs to third parties and we have our own APIs for example Montelukast comes in that so majority is coming from contract manufacturing to third parties.

Charulata Gaidhani: Okay fine. Thank you.

Moderator: Thank you. That was the last question. I now hand the conference over to the management for their closing comments.

Dr. Satyanarayana Chava: Thanks everyone for active participation and very insightful questions. We hope we will continue to do well in the coming quarters and thanks for your participation. Thank you.

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