



“Strides Arcolab Q2 FY16 Earnings Conference Call”

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Moderator: Ladies and Gentlemen, Good Day and welcome to Strides Arcolab Q2 FY16 Earnings Conference Call hosted by Macquarie Capital Securities. As a remainder, for the duration of the conference all participant lines are in listen-only mode. There will be an opportunity for you to ask questions at the end of this presentation. Should you need assistance during the conference call, please indicate the operator by pressing ‘*’ and then ‘0’ on your touchtone phone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Abhishek Singhal from Macquarie Capital Securities. Thank you and over to you, sir.

Abhishek Singhal: Good afternoon all, thanks a lot for joining Stride’s Quarter 2 Earnings Call today. We have the senior management with us, I will hand over the call to Mr. Arun Kumar to make opening comments and post that we will open the session for question-and-answers. Over to you, sir.

Arun Kumar: Thank you Abhishek for hosting us again. Joining me on the call today is Badree – Group CFO, Vikesh and Sandeep. I will take the opportunity to give you a brief commentary, actually this will be slightly longer than our standard brief commentary simply because we believe there are significant corporate actions that have happened in the recent past plus we have for after long given a guidance, so I will take you through all of these step by step.

Starting off with the results, we had a strong Q2 with significant growth over the previous quarter and on a year-on-year basis. Revenues at 374 crores, a 28% growth over Q2 2015 and H1 number of 650 crores which is an 18% growth year on year. EBITDA was at 80 crores, in line with our typical EBITDA margins which we missed in Q1. So we are glad that we caught back on margins in Q2. So it has been a strong comeback quarter in all aspects both in terms of revenues and margins.

We also were very successful in closing and integrating the Arrow transaction in Australia. So our numbers include 30 days of trading in Arrow. In terms of the individual business performances, global pharma business had revenues like I said of 374 crores with 80 crores of EBITDA. Revenue composition by various businesses -regulated markets grew significantly from 97 crores to 144 crores year on year, that again includes one month of sales of Arrow. Institutional business grew from 81 crores to 119 crores, a 47% growth year on year mainly led by a significant off take in our anti-malarial business. In the emerging market business while the growth has been flat compared to the second quarter of the last year, there has been a significant growth compared to Q1 FY 2016. For those of you who remember, Q1 we had serious challenges in terms of oversupply in our pipeline which we of course corrected and I am glad to report a very strong pull back in our emerging markets business, especially in our branded strategy in Africa.

North America has been a strong performer, Benzonatate Softgel Capsule was launched during the quarter. We have achieved significant market share for the product and are currently tracking between 15% and 20% of the market. We think this will significantly go up as we are able to convert other contracts. Institutional business was mainly ramped up, by the anti-malarial portfolio. I am also delighted to state that Virso, the Sofosbuvir drug which was in-licensed from

Gilead has now commenced international sales in various small markets where we have started getting registration. In Emerging markets, our brands business has been strong. We have had a little over 40% secondary sale growth in our African market, so that is a very healthy trend. As all of you know that our R&D was hived off with the Agila transaction, a new R&D center has just about commenced commercial activities and somewhere later when we guide we can now confirm that we have now achieved a 25 product filing run rate with most of our filings happening in H2. So we have had a poor filing track record in the first half and that was mainly because of infrastructural challenges, that have been resolved and I am glad to report that we have now got to a standard momentum of high velocity of filings.

The biotech business is incurring significantly higher cost as we move one product into phase I in Australia, this is a global study which is being conducted out of Australia, and we have also commenced construction of the manufacturing facility in Bangalore. Many of you would remember that we brought back this facility from Malaysia to Bangalore simply because we believe that the operational challenges in Malaysia were hard to manage. There have been a lot of corporate actions, small transactions but all accretive. We announced three important transactions for the domestic market, one is a CNS division from Sun Pharma, the erstwhile Solus division of Ranbaxy. We acquired seven niche brands of Johnson & Johnson with significant gross margins and household brands like Stugil and Otogesic. And of course Medispan which is part of the Shriram Group, their pharmaceutical business where we took a 51% stake as they are emerging to become an important probiotics player.

We believe all of this will give us the critical size that is required to be an important player in the Indian market and we are very happy with all of these transactions as we believe that there would be a lot of Opex leverage given that we already have a sizable presence in the Indian market.

In terms of other updates on the merger with Shasun, we have received all the High Court approvals, we believe that the FIPB approval should be on its way in the next couple of days. We are not expecting any untoward incidence like last time where we had to go back to FIPB with clarifications. And therefore that is another reason why we believe that going forward from this quarter onwards we would have a consolidated number presentation.

The appointed date of the amalgamation is effective April 2015. It is true that this delay is impacting some of the synergies we would have loved to enjoy but we believe Shasun is tracking well towards the defined strategy of the merger and that is reflective in Shasun's numbers which have improved by almost 500 basis points since we have announced this transaction, that is an very important sign that strategically the businesses at both places are doing well.

We also announced during the quarter a fund raising plan of 1500 crores including a green show option. We believe we will be in the market sometime in the next quarter to raise this cash and this will be partly used to repay debt but will also have enough cash to continue our accretive

transactions that we think are important to become a fully integrated pharmaceutical company in version 2 of Strides.

The Board today also approved the company's plan to spin off the biotech division into a separated listed company, Strides will continue to retain 20% treasury ownership, until such time the biotech division is on its own footings, and we think this will take three to four years after which Strides will exit this ownership. We already have GMS as our partner here from Jordan They will continue to own the 25% ownership and the remaining shares will be distributed to shareholders of the combined entity that we expect to have in place in the next couple of weeks.

Given the significant corporate actions, the size and the scale we have now decided to report our businesses in four different and unique segments going forward. One is a regulated markets business with front end in Australia, US and UK. We would not report individual markets, and we believe this business would be our most profitable business in the near term. Continued spend in R&D will probably depress some of our margins but pre-R&D we expect margins to be significant and in line with most of the larger players in the industry. Emerging markets will be an in-market for market strategy which includes the branded generics and the generic strategy and this will be across Africa, India, Russia CIS, and Southeast Asia. We expect to increase our headcount in the next few years from 1,000 medical reps to about 2,300 medical reps in this region, again we will not report individual markets in this segment. The institutional business will continue to be reported as is today which is basically the anti-malarial, hepatitis C and the ARV business. We are combining the legacy business of Shasun comprising of API and Crams in a new division called pharmaceutical services and active ingredients and this will be the fourth divisions that we will be reporting going forward.

Considering the significant corporate actions the company has taken in the recent past, we have taken an exception to provide a one-off guidance for H2 FY 2016. I would like to repeat, it is going to be a one-off guidance for H2 2016, this is not something we plan to repeat. The guidance is being provided because we would like investors and analysts to understand that the scale and scope of the company has been achieved but you will see that emerging in the next half. We have given standard disclaimers. We expect revenues to be between 1,850 crores to 2,000 crores in H2, EBITDA to be between 350 to 380 crores. We are confident of filing between 10 and 12 filings in H2 with the US FDA and then continue our momentum of around 25 filings per year. This guidance does not include the recently announced acquisitions of the CNS division of Sun Pharma, J&J and also Medispan because most of these go through a CCI approval which can take a couple of months and this guidance can be adapted suitably when those events occur.

As requested by a few of our analysts and investors we have also provided an EBITDA bridge on how we report consolidated EBITDA and how we report to the stock exchanges. So with that, I am happy to answer questions and if there is anything that I have missed in the debrief I will be very happy to address that. Thank you.

- Moderator:** Thank you. Ladies and Gentlemen, we will now begin the question-and-answer session. Our first question is from the line of Prakash Agarwal from Axis Capital. Please go ahead.
- Prakash Agarwal:** Sir first question on the comment you made on moving for version 2 and the fund raising plans you have first to repay part of the debt and the second for the accretive transactions, could you just give some broad highlight apart from India which you have already seen in the last couple of months, which are the gaps you think are there and would like to plug them?
- Arun Kumar:** We have a few more gaps as far as our India strategy goes Prakash and we also have important step-ups that we are planning to achieve in the regulated markets. You know we are number three in Australia, we are looking at climbing up that value chain a little bit, as soon as we can. So we are looking at a few more transactions which will kind of meet our requirements to get to a stated objective in version 2. And the fund raiser, see currently we have a very comfortable debt-equity ratio, we are very comfortable what it is but we think it will be prudent for us to reduce debt to some extent and then also keep enough cash to grow the business.
- Prakash Agarwal:** And sir secondly on Australia which we just talked about, we have seen one month of consolidation, would you say that what numbers we shared is pretty much in line or given that it is initial there could be some teething issues and the margins would have been lower?
- Arun Kumar:** First month is in line with our investor meet in terms of margin expectations and revenues, so we would not get too excited with that because the first month actually will not reflect the complete cost that are required for setup. So we think that this first month has been very good, it has actually been slightly higher than what we guided when we announced this transaction but we think it will settle down at around 29% after a setup cost, but currently it is a little more than that.
- Prakash Agarwal:** And this 29% would be starting next quarter onwards?
- Arun Kumar:** Yes.
- Prakash Agarwal:** And how much time sir, I mean we also had a plan to bring some products back to India for cost optimization, so it would be a 12 month to 18 month window or could be lesser?
- Arun Kumar:** Well, Australia is got the most efficient regulatory agency system, however we have a lot of inventory so it takes about close to a year for us to get the full benefit of synergies that we estimated and that is in line with our estimate. So there is nothing that we have discovered since operating the business in the first month that impacts our number in any which way.
- Prakash Agarwal:** So we are set for a margin expansion year two post the inventory is cleared?
- Arun Kumar:** It is not margin expansion, it takes care of the PBS impact on price cuts.

- Prakash Agarwal:** And lastly sir, we talked about spinning of R&D as a separate company, I understand it is a mirror image like what Sun and Spark happened?
- Arun Kumar:** Not R&D, we are spinning up the biotech division.
- Prakash Agarwal:** Yes, biotech sorry, but it is like a mirror image?
- Arun Kumar:** Exactly, so mirror image on shareholding except for the fact that 25% of the company is owned by GMS, so 75% of the company will mirror image but Stride is going to retain 20% ownership, so the 55% will be distributed to existing shareholders.
- Prakash Agarwal:** And this one more clarification, this GMS holding which was due, the money was due because of FIPB approval, what is the status there sir?
- Arun Kumar:** Well, the FIPB approval has still not come, so we are expecting this approval to come through during this quarter.
- Prakash Agarwal:** This is in line with this Shasun also you expect this quarter sir?
- Arun Kumar:** Shasun we are expecting it in the next few days.
- Moderator:** Thank you. Our next question is from the line of Nitin Agarwal from IDFC Securities. Please go ahead.
- Nitin Agarwal:** Arun quickly on the guidance, when we talk about second half guidance so just want to clarify does it include six months of Shasun or how does it...?
- Arun Kumar:** Shasun is effective 1st April 2015 Nitin, so it is technically all of the six months.
- Nitin Agarwal:** So for example for our full year numbers it will be what you reported in the first half plus whatever Shasun would have done in the first half and then...?
- Nitin Agarwal:** Correct.
- Nitin Agarwal:** And secondly, when you talked about adding people in the emerging markets, the numbers 1,000 to 2,300 reps, is this for Africa as a business I mean as a geography or for entire emerging market business?
- Arun Kumar:** It is for the entire emerging markets business.
- Nitin Agarwal:** So where would these larger pieces of additions really come through?
- Arun Kumar:** Well, Africa will get the bulk of the additions. In India because the CNS and Medispan acquisition includes people, we are going to add 400 additional foot soldiers in India, so that will

take our India strength close to 1,000 and we have close to about 300 new reps in Southeast Asia and Africa.

Nitin Agarwal: So we have about 600 reps in Africa right now?

Arun Kumar: No, we have 225 reps.

Nitin Agarwal: And this 225, you will add another 300-odd more?

Arun Kumar: We will add 300-odd new reps both in Southeast Asia and in Africa.

Nitin Agarwal: But Arun this still does not add to 2,300, this is what I was thinking?

Arun Kumar: I said 2,300 over three years.

Nitin Agarwal: So this is what you talk about near term delta that is going to come through?

Arun Kumar: Correct.

Nitin Agarwal: But in general when you look at emerging markets now so we already had, the India piece is what we are bulking up, we already had our pieces in place in Africa, I mean overall what is your own thought, I mean when you look at this business how are you looking at the business from a five year perspective?

Arun Kumar: It is going to be diverse in terms of a model. So in India being a late entrant we will be a niche player in specific domains that we have identified or we will try and build brands like Raricap that we already have and that is why brands like Otogesic or Stugil that we brought from Johnson & Johnson adds great value to that overall strategy that you become more a branded player rather than a large portfolio of products in India. In Africa it is very different, we focus on chronic so it is all about long-term relationship between a patient and the company. It is more to do with being a very aggressive front line player with a large range of products. We are not in acute care so we are going to be focused on chronic care and that is a differentiation. It is a similar strategy in Southeast Asia. It is a slightly hybrid model in Russia, we have already had some great success in Russia in the full year, our brands are doing fairly including Rx-OTC kind of products that we sell over there. So it is all very diverse Nitin, it is not one standard model for the emerging markets.

Nitin Agarwal: And excluding India, would emerging markets continue to be a segment where we will be pursuing many options?

Arun Kumar: Yes, we will.

Moderator: Thank you. Our next question is from the line of Avinash Jain from 130 Capital. Please go ahead.

- Avinash Jain:** On the 1,500 crores capital raised, I was trying to understand if we are talking about a 1,500 crores capital raise plus maybe some debt, so we are looking at maybe 3,000 crores worth of acquisitions, 2,500 crores to 3,000 crores worth of acquisitions, is that broadly the ballpark math?
- Arun Kumar:** No, we are not, the idea of raising capital is to reduce debt and not to add debt. So your numbers are wrong, we think that we will use a large part of this money to reduce the debt, not that we have any challenges with our current debt structure. We will probably keep half the money for acquisition, so that will be the ticket size.
- Nitin Agarwal:** So about 750 for acquisition?
- Arun Kumar:** That is right.
- Moderator:** Thank you. Our next question is from the line of Karthik Mehta from Deutsche Securities. Please go ahead.
- Karthik Mehta:** Just trying to understand from Badree on the hedging and the currency movement in the emerging markets, because there has been fair amount of volatility and also if you can share the local currency growth on a year-over-year basis it would be helpful.
- Badree Komandur:** On the hedging, the company is having an outstanding, we do only forward covers and we have got an outstanding mark to market gain of about Rs.85 million which is there in the balance sheet. This is on the overall position from a financial perspective. From Africa perspective we did not see much of variations in performance during the current quarter, so it was a very stable performance and from a euro perspective we are okay. But overall hedging group strategy will take care of the specific issues we have in Africa. And as far as the constant currency growth, we will share it with you offline.
- Karthik Mehta:** And just trying to understand the overall EBITDA margin for this quarter, so you mentioned that there is one month consolidation of the Australian business here so on a consolidated basis the EBITDA margin has not improved, so is there any existing business or is it just quarterly trend?
- Arun Kumar:** No, I think Kartik what is important for you to note is that our R&D spends have started increasing, so it is to be adjusted for the R&D spend, so R&Ds are written off, we do not capitalize it as you know.
- Karthik Mehta:** So will you maintain this level of R&D, is it a number that will be there as of...
- Arun Kumar:** Our guidance expects an increase in our R&D spend from our current levels.

- Karthik Mehta:** So just trying to dig a little deep, because our revenue base will be high so I am asking as an absolute number I can understand it would increase because you will be filing more, you will have more businesses but as a percentage of sales what is the good number to run with?
- Arun Kumar:** You see for a business which is as diverse as ours you cannot take it on a percentage of a total sales, so good point for you to understand is we are currently spending close to about 8% of our sales on a regulated market business because bulk of our R&D spend is for regular markets. So you can take that as your guidance.
- Karthik Mehta:** This would be even after we merge Australia, right?
- Arun Kumar:** Yes.
- Moderator:** Thank you. Our next question is from the line of Brijesh Kasear from Edelweiss. Please go ahead.
- Brijesh Kasear:** My first question is on Sofosbuvir, could you highlight which markets we have got approval for and what is the outlook for this product going forward?
- Arun Kumar:** We do not disclose specific markets Brijesh, but we have access to about 95 countries. We are registering this product across these countries. It is a slow start but a good start is all I can say.
- Brijesh Kasear:** Are you the only player in these markets at this point of time?
- Arun Kumar:** In most of the markets that we are currently selling, yes because we have a WHO approved file that is going into these markets where registration process is a lot quicker. But wherever we have gone, we seem to be the only player or we have significant market share.
- Brijesh Kasear:** Sir my second question is on Medispan, sorry for my ignorance but if you could help me understand what the business is and what kind of stake that we have and how does it stand in the Indian market?
- Arun Kumar:** Well, Medispan is a very small operating division belonging to the Shriram Group in Chennai and it is a non-core business for them obviously. Medispan has a very important product portfolio in probiotics which is a very targeted probiotic range of products that they have developed for specific disease profiles. Growth has been good, although this company is a very small company the probiotic sale alone this year is going to be about 15 crores to 16 crores which is very important from our perspective. So it is a small transaction at a great multiple that has been acquired and then it just adds to the overall strategy of picking what we call this String of Pearls, that we pick up small assets and then build them like we have done with Raricap from Johnson & Johnson, previously. Just to give you an example Raricap when it was acquired first from Johnson & Johnson was a 5 crores brand, it is 4 years and it is now a 25 crores brand, a little more than 25 crores. So we believe that there is a lot of opportunity when you market these

products with focus and that is what we are targeting in the Indian market. We are not looking at scale, we are looking at creating a special niche of products.

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

Nitin Agarwal: On the question of domestic market again, what do you think is an optimal size that you are probably aiming for the domestic business to get to over the next few years?

Arun Kumar: I think with some of the transactions we have already done and which we hope to close, we will move our business from about 100 crores to a little over 300 crores next financial year and I think from there we can grow very aggressively organically. I do not think we will look at any additional inorganic strategies except one or two that we are currently looking at. There would not be very significant transactions. I think that should be a good size for us from an India perspective and I think if we get to 500 crores, 600 crores of sales in the next three to four years we think that we would have achieved great success considering that we are very young player in this business.

Nitin Agarwal: So say 300 crores by FY17 on a run rate basis?

Arun Kumar: Correct.

Nitin Agarwal: And secondly on the US, have we filed any products in the first half of the year?

Arun Kumar: No, like I said in my opening statements we filed none because our R&D center has just gone commercial. We have guided that we will file 12 products in H2 and we can also confirm that our minimum run rate will be over 20 files from next year.

Nitin Agarwal: And these filings would be largely in line with the broad structure that you have outlined, segments you have outlined during our interaction that we had post the Shasun...?

Arun Kumar: Exactly, nothing changes.

Nitin Agarwal: And in terms of the approvals, in the second half of the year are there any specific visibility that you have on the approval that can come through?

Arun Kumar: Yes, so we have fairly good visibility, our first set of approvals following GDUFA guidelines start actually coming in the first quarter of next year based on the timelines that have been announced, but we expect two important product approvals in H2.

Nitin Agarwal: We were looking at three approved products if I remember as per the last call is concerned?

Arun Kumar: At this time I am looking at two products at the minimum.

Moderator: Thank you. As there are no further questions I would now like to hand the floor over to the management for closing comments.

Arun Kumar: Thank you Abhishek and thank you all for joining in today, I know it is a busy day and you have lots of other calls to attend. Appreciate your time. And as always, please feel free to write to the company or connect with any one of us if you have any additional questions. Thank you and have a good day.

Moderator: Ladies and Gentlemen, on behalf of Macquarie Capital Securities that concludes this conference. Thank you for joining us and you may now disconnect your line.