"Strides Arcolab – Analyst Call"

On

Sale of Generic Pharmaceuticals Operations in
Australia and Southeast Asia to Watson Pharmaceuticals

Tuesday, January 24, 2012 at 1700 hrs IST

STRIDES MANAGEMENT

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Operator: Ladies and gentlemen, thank you for standing by and welcome to the analyst call of Strides Arcolab.

At this time all participants are in a listen-only mode. We will begin with introductory remarks by Mr. Arun Kumar, the CEO of Strides Arcolab, followed by a question and answer session at which time if you wish to ask a question you will need to press *1 on your telephone keypad.

I would now like to hand the conference over to Mr. Arun Kumar. Thank you sir, please go ahead now.

Mr. Arun Kumar: Good evening to everybody and thank you for taking time out today to join the Strides conference call for analysts. We do understand today is a busy results day and we appreciate the time all of you have taken to join in or listen into our call.

This morning we announced the sale of a part of our pharmaceutical generics business which we operate out of Australia and Asia, that we call the Australasian region, which is our branded generics business, headquartered in Australia with manufacturing facilities in Singapore which we sold to Watson Pharmaceuticals on a transaction value of AU$375 million, which is approximately US$390 million based on today's exchange rate.

The transaction, highlights of which we will go through in a while, also was concluded today, so it was a simultaneous signing and closing, and the cash offerred values the company at AU$ 375 million. We had a process by which we mandated Jefferies recently and we had a very efficient process which they managed for us and we received a competitive bid from Watson and we engaged into discussions and concluded this transaction in a relatively efficient and short period of time.

We believe that this transaction is significantly accretive to our strategy, completely gets our focus into high growth Agila business translated, and obviously it represents a very high return on our original investment for our share holders. Most importantly it does strengthen our balance sheet and takes care of not only our commitments of bonds and other repayment schedules at the close of the year but will also leave enough cash to accelerate the growth of our Agila Specialties' business.

We have taken the opportunity today to send an analyst presentation which we hope most of you have; if not, it should be on the website very shortly or just after the call.

Joining me on this call today are my colleagues Manish Gupta who is our CEO of our Pharmaceutical division and who also led the transaction. I am also joined by Dr. Rangan, who is our Group CFO; Venkat Iyer, who is our CEO of our Agila business; Ajay Singh, Badree and Kannan form part of our financial and analyst relationships group.

So, in terms of coming to the transaction overview, we concluded this transaction this morning, like we said it was an all-cash transaction, and it included the sale of 100% equity including the 94% ownership belonging to Strides and the 6% ownership belonging to Mr. Dennis Bastas who was the founder of Ascent Pharma prior to our acquisition of majority control.

For those of you who remember this transaction, we entered the Singapore market in 2008 with the acquisition of a company called Drug Houses of Australia and subsequently we sold this entity to Ascent Pharma, Australia - Genepharm as it was called then. It was a listed company for a long period of time and in early 2011 we completed privatization of this company and we have completed the transaction fully today.

What we have done in the last 4 years in this business is that we have created significant value, we have integrated this business to be a leading cutting edge generics company which has resulted in discovery of a value in a scarcity market, because Australia is a $12 billion pharmaceutical market and it is extremely difficult for new entrants, being a significantly important players in that market with a large portfolio of products and the second largest pharmacy field force we created what we think is an important strategy going forward for an acquirer.

Also we are a leading player in the Singapore in generics business. We were, until this transaction, the number one pharmaceutical company in Singapore and we had expanded markets in other regions.

According to our guidance and as we cannot during this call get into fine granularity as most of you know that we have just completed our financial year, we are going through an audit of our accounts, and in line with our targeted last week February results this is not a time for us to get into fine granularity, but to give you a guidance Ascent has contributed about 32% of our turn over and an EBIDTA range of between 18 and 20% of our guided EBIDTA range.

So what was the rationale is in the next page. We were executing the strategy predominantly to discover the announced focus on our high growth Agila business. Since the last one year we have been magnifying our business in Agila, which is our specialties business where we believe we have a very differentiated business, a strong R&D, strong infrastructure, and high levels of FDA compliance in a very difficult environment. Also it monitized significant value creation and for those of you who would have studied this transaction you will appreciate that this is, if not the top. amongst the top value transaction that have been delivered in the last many years in the pharma space in this region, and of course the primary objective of strengthening the balance sheet is achieved.

If we stick to our high growth Agila business, what this does is that, we are currently better placed to fund future capital expenditures in Agila. As everybody knows it is a high capex, long gestation, high entry barrier market. It obviously allows management to have sharper focus on Agila, and we believe that this transaction takes away some of the older hands of debt and will we be able to pay our bonds. We believe the analyst and financial community will focus more on the quality of the company's business strategy than other over hangs, and we believe that this will certainly take us to accelerate our leadership position in the sterile injectable sector whereby delivering what we think would be a very differentiated specialties business in the next few years.

What we did in the last 5 years is that Ascent, as it is called today, was predominantly a trading company, lot of the IPs belonged to various companies and it was only a beach head or front ending marketing strategy. What we did was we brought in all the R&D in-house at Strides, we almost created a full basket of IP, we completed 14 projects where IP ownerships were transferred from third parties to Ascent owned product, and we today have a deep product pipeline with almost for every single product going off generic Australia with a day 1 launch, and of course we have managed significant price arbitrage by shifting manufacturing from Europe and other parts of the world to India, where we have got cost savings between and 15 and 75%, which has reflected in an increased EBIDTA in the last few years, but also more importantly going forward for Watson and new owners obviously, it gets a significant new opportunity to grow on that base.

The Asian business we already had a very strong position in Asia, but combining significant operational excellence we have managed to extract new profits and new gross margins from that business and therefore we have maintained and accelerated our leadership position in the Singaporean pharmaceutical market.

In terms of the monitization at AU$375 million and assuming an 18-20% EBIDTA contribution to our guidance, we believe that this transaction gives one of the highest or the top end of the very best transactions in the industry. And the last best known transaction has been at 16 times, obviously this has exceeded that significantly, and we believe that this would be a benchmark transaction in the industry.

What this does for Strides is that out of the AU$375 million consideration, after some exit events and management options and employee options, we would have an ability to reduce debt to a minimum of $250 million and out of which a $120 million will be used to redeem foreign currency convertible bonds during June 2012. It will have growth capital for Agila, and this can be achieved without new borrowings, and we will also be able to directly improve our leveraged position reducing our net debt. The profit obviously are that substantial reduction in debt will be achieved immediately or by June latest when the bonds are paid, and an increase in networth and profits in the transaction. Obviously this gives us a stronger balance sheet and hopefully going forward our cost of money will reduce significantly.

So, this is a three-pronged strategy which has been achieved, it monitizes what we think an important assets, it also delivers a very important financial result for Strides and its share holders but more importantly it generates new avenues for accelerating the growth of Agila.

So, this is background and back drop. I am more than happy to take questions,
Operator: Right sir, so we can begin the question and answer session now.

Participants if you wish to ask a question, please press * followed by 1 on your telephone keypad and wait for your name to be announced. If you wish to cancel your request, please press the pound or the hash key.

Sir, your first question comes from Manoj Garg from Edelweiss. Please go ahead sir.

Mr. Manoj Garg: Congratulations for great set of deal. I would just like to understand that what could be the net cash realization to your company net of tax?

Mr. Arun Kumar: At the moment the tax elements are being calculated and so also the exit events. So, for all your calculation purposes you should assume the net debt amount plus what we believe is a 30 to 40 million spend range in Agila as the possible end cash for the end of the transaction.

Mr. Manoj Garg: Second thing, I think the last quarter you have done some strategic deal where you got some upfront licensing payment also. Now in this renewed transaction will that licensing deal will remain with Strides or it will go along with Watson?

Mr. Arun Kumar: It will stay with Strides.

Mr. Manoj Garg: So, we will continue to supply those products from India now?

Mr. Arun Kumar: That is right.

Mr. Manoj Garg: Okay. I just want to take a little overview in terms of the specialty business in the US with the backdrop because you know there is an acute shortage in terms of injectable products and all we start gaining lot of approvals of there. How do you see in terms of approval going forward?

Mr. Arun Kumar: How do you see expansion of capacity?

Mr. Manoj Garg: Approval and may be utilization of capacity?

Mr. Arun Kumar: We received 24 product approvals in 2011, which again is the highest number of product approvals in the space, and we believe that the approval momentum will continue. We do have significant capacities now that they are FDA approved and we believe 2012 would be another important big year for Agila, but at this moment in time we cant put any specific numbers.

Mr. Manoj Garg: Okay. In the last call you have guided about some fair visibility of the dossier income or the licensing income at least for the next 2-3 years, would you like to put some numbers on that?

Mr. Arun Kumar: No, not at this time.

Mr. Manoj Garg: Okay, wish you all the best.

Mr. Arun Kumar: Thank you.

Operator: Sir, your next question comes from Prashant Sawant from KNG Securities. Please go ahead sir.

Mr. Prashant Sawant: Good evening sir. Hearty congratulations on your deal. Could you just update me on the entire debt profile of the company. I know that you have to repay FCCB, also how much is the exact outstanding of the FCCB which is to be redeemed in June and the other debt profile.

Mr. Arun Kumar: I would request Rangan to answer this question.

Mr. Rangan: We had two FCCBs, but if you recollect in the year 2010 we repaid the one which was raised in the year 2005 of $40 million, and Reserve Bank of India announced the buy back, the second FCCB which was a book value of $100 million we bought 20, so currently the book value of FCCB is $80 million with the YTM it is US$117 million, and this is payable on June 25, 2012.

Mr. Prashant Sawant: And what is the other debt you have to repay?

Mr. Rangan: Other debts are the term debts wherein that we generally borrow against the asset, so they have a fixed time, quarterly dues, which has been accounted as part of this $250 million.

Mr. Prashant Sawant: $250 million.

Mr. Rangan: I said that including FCCB.

Mr. Prashant Sawant: Including FCCB is $250 million, so with this cash which is generated out of this deal you will be able to repay entire debt or there will be still some debt outstanding?

Mr. Arun Kumar: I think Prashant you are not understanding. Our total debt is $525 million as has been guided from time to time. So, you have to work from that number. So including working capital after this event, will be close to about $250 million.

Mr. Rangan: And as part of the 2011 guidance we said that we will achieve the debt equity of 1.5.

With this transaction we feel that by end of June the debt equity could go down at 0.75.

Mr. Prashant Sawant: Okay great. Last time you mentioned you had a cash of about $30 million USD, and the net cash which will be remain after repaying the debt from this deal is about 30-40 million. Am I right?

Mr. Rangan: Like Arun said in the beginning, as part of the financial year end, actually we are going through the audit process, so just allow us to give clarity post results.

Mr. Prashant Sawant: Okay. Do you have plans to increase your capex on your existing plants, what is the funding option for that?

Mr. Arun Kumar: Currently our injectables business has capacities enough for 2012, but with all the problems in the US we probably need to accelerate that, and we will guide that a little later, but at the moment we don't intent any new borrowing for capex.

Mr. Prashant Sawant: Oh! you don't intend any new borrowings. Okay, right. Thank you. Just briefly, if you could explain or brush upon the challenges, I mean we know what is happening in the US, what is happening in the European market, and your most of the revenue is coming from outside India, and are you doing any particular measures to increase your margins apart from the cost cutting?

Mr. Arun Kumar: I think to be in a generics business you need to be cost cutting everyday, that is something which we always focus on. So, unless you do that you cant be in business. So that is something every company focuses on, so does Strides, so that is all I can tell you now.

Mr. Prashant Sawant: Okay, thank you so much.

Operator: Sir, your next question comes from Hitesh Mahida from PUG Securities.

Mr. Hitesh Mahida: Congratulations for the deal. I just wanted to know what would this particular business was one of the better margin business as far as the overall pharma business is concerned. So, now what would be the margins of the remaining pharma business?

Mr. Arun Kumar: If you recall our guidance of pharmaceutical business is 15%, and it may not be right in saying that this is the highest margin, it is in that range.

Mr. Hitesh Mahida: Okay, so the remaining business would be in that range itself. Sir, what are the segments in the sterile space which we would be looking to invest going forward?

Mr. Arun Kumar: If you look at our investor presentation, our domain expansion is in ophthalmics, which is what we are doing now in 2012, and then we make investments in other technologies which are not in the public domain, but what is in the public domain is that we will become a significant ophthalmics players in 2012.

Mr. Hitesh Mahida: Okay sir, thank you.

Operator: Sir, your next question comes from Surya Patra from Systematix Shares.

Mr. Surya Patra: Congrats, great deal sir. Just a couple of specific questions, in fact possibly with the deal we are transferring just one Singapore based facility, so what is the value of that or what is the kind of fixed asset that would be transferred to Watson with the deal?

Mr. Arun Kumar: We don't have specifics, but it is very insignificant, I mean it is an important asset but it is insignificant asset value, but I don't have specifics at this time.

Mr. Surya Patra: Okay, can you please tell us what is the total value of the asset that we are transferring with the deal?

Mr. Rangan: As per the books is concerned actually we have an investment of about US$113 million, that is the value of investment which reflects the entire Australasia business. So, we are adjusting as part of this calculation, but then we need to really look at other impacts before we really talk about the net impact of this deal.

Mr. Surya Patra: Okay, so what would be the ultimate profit out of the transaction sir?

Mr. Arun Kumar: You cant expect us to give you these details today, you need to wait for our final financial fact and closing, and then happy to answer your specific on this.

Mr. Surya Patra: Okay, and any likely adjustment on the goodwill, why because at the time of acquisition also we have added a good amount of goodwill to the book, so …..

Mr. Arun Kumar: You need to have patience, wait for our results and it will reflect in that. So, it is something which we will be addressing.

Mr. Surya Patra: Okay, in fact ……

Mr. Arun Kumar: Rangan has some color to add here.

Mr. Rangan: It is not a significant value like you said, we did not over value the business, but certainly we will be adjusting and Ascent carries a goodwill ranging between $50-60 million, that will be adjusted before we compute the profit on sale of this transaction.

Mr. Surya Patra: Okay, $50-60 million.

Mr. Rangan: Yes.

Mr. Surya Patra: Okay sir, and in the presentation you have mentioned that the debts and obligations relating to the Ascent have also been transferred to Watson, so that means that it is included in that $50 million kind of a debt reduction plan what you said.

Mr. Arun Kumar: Correct.

Mr. Surya Patra: Okay, and possibly we have been doing some sort of marketing for Pfizer in Australia, so does that business would be out with the deal happening with Watson?

Mr. Arun Kumar: As communicated to one of your colleagues earlier, the business will stay with Strides.

Mr. Surya Patra: Okay, that is all from my side, thank you sir. Once again congrats for the good deal.

Operator: Sir, your next question comes from the line of Amit Shah from Motilal Oswal. Please go ahead sir.

Mr. Amit Shah: Hi congrats everyone for a good deal. Actually most of the questions have been answered, just one thing, I mean again going back to the same question which the previous participant asked that it is said that with this deal all the obligations will be transferred or repaid. So, just want to understand how much of that would be transferred to Watson?

Mr. Arun Kumar: Nothing has been transferred, everything has been paid, except certain tax liabilities and others you know like which are in the normal course of business which cannot be discovered. So, there is some provisions for that, but there is no debt transferred to Watson, it is part of our $525 million bucket and that is reduced to that extent.

Mr. Amit Shah: Okay understood. And sir one more question on the interest side, now with the repayment of this $250 million of debt in some time, where do you expect your interest cost vis-à-vis 2011 number?

Mr. Rangan: We anticipate reduction in interest cost somewhere between $15 million to 20 million, which is equivalent to EBIDTA of Ascent Pharma after divesting this.

Mr. Amit Shah: So $15 to 20 million reduction one can expect for the year.

Mr. Rangan: Yes, 2012.

Mr. Amit Shah: Okay understood. Thank you so much.

Operator: Sir, your next question comes from the line of Krishna Kiran from ICICI Bank. Please go ahead sir.

Mr. Krishna Kiran: Thanks. Sir, congrats for great deal. Sir, one, sparing your pharma selling of this business, this will be accounted from Jan 1st right?

Mr. Arun Kumar: Sorry? Can you please repeat your question?

Mr. Krishna Kiran: I mean the transfer will be completed or the date of transfer will be from January 1st 2011, right?

Mr. Rangan: Obviously it is transferred from today, it is concluded today….

Mr. Krishna Kiran: Okay, it is from today, so 21 days of sales will be included in this quarter. Thanks.

Secondly, sir, if this Australasia business has around 18% of EBIDTA margins and overall if pharma has around 15-16%, so you know once this Australasian business go out of pharma what would be the EBIDTA margin, it would be around 12-13% or it would be lesser than that?

Mr. Arun Kumar: We need to get to that post our results.

Mr. Krishna Kiran: Okay fine. Sir, you were talking about ophthalmic business, sir how many ANDAs have been filed so far for the ophthalmic business?

Mr. Arun Kumar: Nothing, because we said we are entering that domain.

Mr. Krishna Kiran: Entering, I am sorry. Lastly, regarding FCCB, I think overall $80 million were there on the book and we are including YTM it is 117, so $37 million will be passed through P&L or it will be reduced from share premium account?

Mr. Rangan: What we have done is that, since 2008 when we implemented the AS13, we started routing the interest cost via P&L, to that extent the reversal will happen in P&L; whatever was accounted earlier in share premium will go to share premium account.

Mr. Krishna Kiran: Okay, how much would be that approximately hit to P&L.

Mr. Rangan: I will need to really look at that.

Mr. Krishna Kiran: Okay sir, fine. Thanks sir.

Operator: Sir, your next question comes from the line of Bhavin Shah from Dolat Capital. Please go ahead sir.

Mr. Bhavin Shah: Sir, congrats on the deal. I have no more questions, thanks so much.

Operator: Sir, the next question is from Purni Shah from Dalal & Broacha.

Ms. Purni Shah: Hello. Sir, I have two questions. One is that is the $375 AUD is net of tax?

Mr. Arun Kumar: It is enterprise value.

Ms. Purni Shah: Okay, how much will be the debt on the Ascent?

Mr. Arun Kumar: About $50 million.

Ms. Purni Shah: Okay. So you said this is the enterprise value, but I just wanted to say that is it net of tax?

Mr. Arun Kumar: Enterprise value is the value for the business and then you reduce everything including tax.

Mr. Rangan: If you are trying to arrive at the net cash, then we need to spend some time to understand the tax implication, because it involves various jurisdictions of Singapore, Australia and India.

Ms. Purni Shah: Okay sir, thank you.

Operator: Sir, your next question is from Kartik Mehta from Daiwa Capital Market.

Mr. Kartik Mehta: I just have one thing to ask, Arun, any thought on the other non-sterile part of the business? I know it would be too early to ask you, but we have been emphasizing also in this overall presentation that Agila or the specialty business as the key.

Mr. Arun Kumar: Emphasizing of Agila business Kartik is something which we have been doing for 2 years. We also emphasized at the same time that all our other businesses are performing well and doesn't take too much management time nor does it take too much working capital. When there is a willing buyer and the willing seller a transaction takes place, that is what we told you and that is what we say, that doesn't mean that we are in a hurry to do any other transactions but we are open to look at any transactions, but at this time there is no such activity because we are very focused on achieving this first goal and then focusing on the Agila business.

Mr. Kartik Mehta: Okay, just one last thing from my side was that can you tell us if there was any milestone income that we would have booked in Ascent, because we have not shared in terms of the break up.

Mr. Arun Kumar: EBIDTA that are reported are purely operational EBIDTA, it doesn't include any licensing income.

Mr. Kartik Mehta: Okay, that helps. Thanks.

Operator: Thank you sir. Sir, your next question comes from the line of Nitin Aggarwal from IDFC Securities. Please go ahead sir.

Mr. Nitin Aggarwal: Thanks, questions have been answered. Thanks very much.

Operator: Sir, the next question is from Kaushik Paul from Kotak Mutual Fund. Please go ahead sir.

Mr. Kaushik Paul: Hi, congrats to everyone in Strides for this great deal. Just one clarification Mr. Rangan, if I heard you correctly you said total investment for Strides in Ascent was $113 million, and apart from this being in the gross block and various sets of assets there is another $50 or 60 million of goodwill which is there in the balance sheet. Is my understanding correct?

Mr. Rangan: Yes.

Mr. Kaushik Paul: So, total balance sheet will be lighter on the asset side by about $160 – 170 million.

Mr. Rangan: Correct.

Mr. Kaushik Paul: Secondly, you know, just wanted to understand, I didn't understand clearly why you are unable to share the post tax number at this point of time, has it not been worked out, and that $250 million number that you are sharing as the minimum level of debt repayment is that the ballpark number that we should sort of work with as a post tax number as of now before the final number comes?

Mr. Arun Kumar: Yes.

Mr. Kaushik Paul: Okay, and this is simply because the liability is not clear at this point of time.

Mr. Arun Kumar: Sorry?

Mr. Kaushik Paul: I mean the tax liabilities are not clear and that is why that is the number we should go with.

Mr. Arun Kumar: So assuming a pessimistic view on tax we believe that a $250 million would be a reasonable amount for you to take back and do your work in terms of how the balance sheet looks.

Mr. Kaushik Paul: Sure, finally, on the deal itself, on other adjustments, just to understand the figures so that we are clear, US$393 million is at today's exchange rate is the valuation of the total business, out of which Strides' share is let us say $370 million based on 94% stake, and we should reduce the $50 million proportionate 94% from this to arrive at the equity value, and post that the tax will come and the rest will accrue to you. Is my understanding of the structure correct?

Mr. Arun Kumar: There are some exit events, because you know we do have a fairly significant employee and management option scheme, and this top value transaction which therefore there is a decent amount of upside share with our employees and with the management staff because you need to understand that the incentivization of the teams were based on the value we will get out of our business, so like Rangan rightly said the distribution and the planning distribution will take us a little time because this has got multiple jurisdictions in Australia and part of Asia and in Singapore, so we have taken certain math at this point in time, we are not in a position to disclose/discuss what exactly those amounts are, and the $250 million kind of reflects a safety margin where we feel comfortable to commit today.

Mr. Kaushik Paul: Sure. Finally, in our outlook which we have obviously shared in either concalls or may be in meetings on CY12 on the licensing side, should that change in any material fashion after the sale of Ascent?

Mr. Arun Kumar: No. Ascent is a predominantly orals business, the licensing streams are predominantly in our injectables space.

Mr. Kaushik Paul: Okay sure. That is all. Congrats again and that is it from me sir. Thank you.

Operator: Sir, your next question comes from the line of Divya Rajgopal from Economic Times. Please go ahead now.

Ms. Divya Rajgopal: Hello Arun, this is Divya here. I just wanted to check with you after this deal what will be the status with your Indian branded generics firm, Grandix if I am not wrong, so would you be investing something on that as well or would you also look at probably looking for a buyer?

Mr. Arun Kumar: We are moving our business to sort of pure play branded business or a specialties business. India for us is an important pure play branded business that we are invested and we will continue to make investments in that business as we grow that.

Ms. Divya Rajgopal: Okay, so that business you will be investing in future also?

Mr. Arun Kumar: That is right.

Ms. Divya Rajgopal: Also, just wanted to check with you how much did Agila contribute to your revenues last quarter?

Mr. Arun Kumar: I mean this is not the forum to discuss that. We gave you a guidance for $225 odd million of sales for the last year. At the moment you should work your numbers based on that guidance.

Ms. Divya Rajgopal: Okay, thank you very much.

Operator: Once again, if you wish to ask a question, please press *1 on your telephone and wait for your name to be announced.

Excuse me sir, there are no further questions at this point of time sir. You can go ahead.

Mr. Arun Kumar: Thank you all, thank you so much for your time today and for participating in our conference call. We do hope that it gives you better perspective of some of the businesses that we have been growing and developing at time, and appreciate your questions and if there are more please feel free to write to any of our colleagues we have introduced at the beginning of this call.

Thank you all and good evening.

Operator: Ladies and gentlemen, this does concludes the conference for today. Thank you for participating. You may all disconnect now.