

Q2 FY06 Earnings/Investors Conference call (October 22, 2005)

Moderator

Good afternoon ladies and gentlemen. I am Prathiba, the moderator for this conference. Welcome to the Zydus Cadila Healthcare conference call. For the duration of the presentation, all participants' lines will be in the listen-only mode. I will be standing by for the question and answer session. I would now like to hand over to Mr. Pankaj R. Patel of Zydus Cadila Healthcare. Thank you and over to Mr. Patel.

Pankaj R. Patel

Thank you Prathiba and good afternoon all of you, and welcome to our post result conference call for the second quarter of 2005-2006.

At the outset, let me highlight the key numbers. During the Q2 on a standalone basis, our total income grew by about 10% year-on-year to Rs. 3497 million. The revenue growth was mainly driven by formulation exports, which was up by about 70%, and the domestic formulation grew by about 10%. The PBIDT is up by 11% to Rs. 809 million, and after a 91% year-on-year increase of R&D expenses this number has been achieved. The profit after tax is up by 20% to Rs. 518 million.

Coming to the consolidated numbers for Q2, the consolidated total income went up by 13.7% to Rs. 3875 million. The PBIDT went up by 20.4% to Rs. 81.4 crores. In line with that, the net profit also is up by 37.5% to Rs. 480 million. The rise in the top line and in the bottom line was due to startup of regular supply by Zydus Altana and also commencement of income from GCM activities.

As far as our US operation is concerned, we now have seven ANDAs approved. We supplied two products namely atenolol and metformin, both of which are now on American pharmacy shelves. We received four additional approvals from Brazil during the quarter taking our total product approval to 11 and the initial response from the Brazilian market is encouraging. We also received approval from Taiwan and became the first Indian company to get an approval from Taiwanese market. We commenced our business in South Africa with launch of two products.

To update you on the progress made on the contract manufacturing activity, you must be aware that at the beginning of the year I had mentioned that during the year we intend to sign eight contracts for contract manufacturing and I also mentioned at the end of the first quarter results that we have signed four contracts amounting to something like \$13 million revenue potential. I am happy to inform you that during the quarter, we signed additional three contract with a peak revenue potential of \$8 million. So as of now on cumulative number, the contract signed up to the end of the quarter is eight, excluding the joint ventures with Mayne Pharmaceuticals, and the total peak revenue of all the eight contracts is \$21 million.

You would appreciate that as I have committed in the beginning of the year, we have already completed our target number in half of the year and we are very confident to continue signing more contracts in the next quarters to come. On the research and development front, we will complete the phase 1 clinical trial of ZYH1 and submit by December 2005. We also expect to commence phase 2 trials of this compound in the next financial year. We also expect to file one more IND in the current financial year.

Thank you and we will now start the Q&A session. You may address questions on domestic, non-regulated market, and regulated market to me, and on results and finance to Mr. M. K. Patel. Over to the coordinator for Q&A. Thank you.

Moderator

Thank you very much sir. We will now begin the Q&A interactive session. Participants who wish to ask questions please press *1 on your touchtone-enabled telephone keypad. On pressing *1, participants will get a chance to present their questions on a first-in-line basis. Participants are requested to kindly use handsets while asking a question. To ask a question please press *1 now. First in line, we have Mr. Rajesh from ICICI Securities.

Rajesh

Good evening gentlemen and congrats for good set of numbers. I just wanted to hear from Mr. Pankaj Patel on the US

business, which is sort of getting some amount of traction now, as to where do we see the new product launch flow as we move into the second half of this year and one year beyond that, and also in terms of his thoughts on pricing pressure and experience in the first two products that you have launched into the market?

Pankaj R. Patel

Thank you very much Rajesh for your compliments. We take your lot of support and good wishes to continue doing well. This also encourages us all to do better. Thank you very much again. Let me address the questions one by one. First is, as far as US market is concerned, this year we expect to put between five to six products on the market. We have two products as I mention already in the market and we expect to launch balance products during the next few months. You must have seen one of our product approval, which is ribavirin tablet, which got approved. We had a tentative approval. The patent of this is expiring on December 3, 2005. We expect to put this product on the day one on the US market. You must be aware that there are two more approvals of this product also is there, but this is going to be an interesting market where in we would have a good opportunity to sell and achieve some good numbers. We expect some more approvals in the next month, which would basically allow us to get some significant opportunity there. As I have said before, we are very confident that we would achieve our number for the current year of \$9 to 10 million and we expect that next year, we should have several more approvals and we should have around 15 products on the market by the end of the next financial year. We expect that our sale in next year should basically multiply as we go forward. The last and very important question about the pricing pressure, I think generic market globally is facing lot of pricing pressure, and I think the product basket and the product differentiation would become a very significant thing into this. We have from the beginning much before this, our strategy has been to build a big pipeline at the same time to ensure that we do not want to over depend on one or two products to build up volume. We would be happy to build 10 products to get 20 millions than have one product with 20 million sale, and that is the way we achieve the number, so even if the pricing pressure are there, it is never uniform on each product and that would allow us to really continue growing as we move forward. The second point is you must have noticed, also now there are some public information available that within the Indian companies we have one of the top ranking product pipeline and that is going to ensure that we would be able to have continuous flow of products and again the selection of product has been done very carefully, which would ensure that we would have success as and when we launch products. The key to this pricing pressure is going to be the cost of goods and unless we improve our efficiency, unless we keep on working continuously to reduce costs across, be it development, be it cost of goods, be it overheads, it is going to be always difficult for generic companies, and if you see the top ranking companies who have done well in this market they have always improved on their margins through cost efficiencies. So I think efficiency is going to be key factor. Backward integration coupled with PRISM-like initiative should ensure that year-on-year our cost of goods keep on coming down so that we can neutralize some of the pricing pressure. I hope, I have answered your question.

Rajesh

Yeah. That is quite useful, and the last touching upon the cost part of the efficiency as you mentioned going to be the key differentiating factor as we move into the pricing pressure scenario more ahead into the future. Isn't it is, I mean, an M&A taking shape by larger companies, how does at Cadila you view M&A opportunities in light on one side, isn't it paradoxical on one side the business environment is worsening while on the other side the acquirer companies like Teva, Sandos, and Actaves in the recently have been paying expensive, so called expensive numbers to gobble up the companies, so it is quite paradoxical on one side business worsening on the other side you pay a greater price than you would otherwise. How do you view this and where does Cadila's thinking is placed in terms of going forward if any M&A activity.

Pankaj R. Patel

As a part of our overall growth strategy, and I am talking about long term, not short term, M&A would be a part of that basically because we cannot just organically grow and buildup a leading global company in the generic area, and going forward meeting some of our aspirational target. At the same time, I believe that the valuations currently which companies are paying are the valuations which basically do not justify from my point of view that we could do this. One thought about these third largest player or the fourth largest player, one thought about large size, all that looks very attractive from the number point of view, but I believe larger the size you lose flexibility, you have larger issues, and to continue growing the business and also to improve efficiency would be much a bigger challenge for these companies to really significantly show a number difference. From the customer point of view, they would always welcome competition and if you are efficient smart competitor who is able to offer customer a price advantage and service level advantage, they are not going to look at size alone to buy that and that we clearly see it when we launched our first product atenolol. We are the only small company in this field otherwise there are all large players selling atenolol in US market, but we still could get some major accounts and

that clearly indicates that the customer are looking for good companies, good suppliers, they want to encourage competition because that is the only way they can make money, so we see clearly there is opportunity of also an efficient player, so I think our goal would be how we can be always efficient. If we were to acquire, we would always keep this in mind and acquire. Currently, we have no activity in that area going on.

Rajesh

Okay. Thank you very much and all the best.

Pankaj R. Patel

Thank you.

Moderator

Thank you very much Sir. Participants who wish to ask question, please press *1 now. We have our next question from Ms. Visalakshi of DSP.

Visalakshi

Yeah Hi. I would like an update on you French subsidiary as to what is the extent of losses that you are likely to make this year, and how that is going to go down going forward? And secondly on your outsourcing deals, the contract manufacturing deals which you have announced, when do you see revenue pickup from that business?

Pankaj R. Patel

Before I come to France, I will answer the contract manufacturing because the data is in front of me. First point is that the revenues have started coming in, even in this quarter itself there is a revenue of about Rs. 7 crores coming from the contract manufacturing initiative. So, going forward, this number would be seen every quarter. Coming to the French subsidiary, as we mentioned we are in investment phase. We are launching products and there are related cost for that, and we expect as we have given guidance from the beginning that we expect that we would have a loss of about €4 million this year from the French subsidiary and going forward this will keep on reducing and we expect that we will breakeven in the year three, which is FY 2008. So that is what it is. The good thing to tell you is that from French market we have received good response for our generic launch though we have been the late entrant and started Greenfield. Last month, for example our overall sale was about a million euro and also we have doubled our market share from 0.2% to 0.4%. We hope to continue this now and gradually we will build up from here step by step. One of the important part of success in generic business is to be on the market on the very first day and there I would like to tell you that both for simvastatin and omeprazole, we were on the first day on the market and now the Sertraline is also going off patent in the French market and we are going to be on that. However, please understand that all the generic markets are facing severe pricing pressure as it is happening to US, France also is facing severe pricing pressure. We have seen clearly, when we acquired the company and today, the stock discounts are higher by more than 10%, that basically has deferred the breakeven by a year. Just to give you a specific number, the first quarter our losses from the French subsidiary was Rs. 57 million, for the second quarter it is Rs. 53 million. I hope, I have given you all answer Visalakshi.

Visalakshi

Yeah, and coming back on the contract manufacturing deals, when do you expect the peak revenues of \$20 odd million which you were talking of?

Pankaj R. Patel

I think peaks will be happening at different times, so it is difficult for me to give you exact number. Some of the contracts started paying immediately. For example, this quarter we had Rs. 7.3 crore revenue. Some contract may start giving us revenue in six months and some may take one year, so all have different time zones, so I do not have number to give you. I think we would basically start working on it and maybe also give you some guidance in course of time how we can say that.

Visalakshi

But cumulatively all put together do you see anything that being achieved in about one year, two years, or three years how is that?

Pankaj R. Patel

See, cumulatively, I think we could see that all these should be peaking around between two and two and half years.

Visalakshi

Okay.

Pankaj Patel

Yeah, that is the peak we can expect, but Visalakshi, the point is that they are all signed in different times, like we signed 4 in first quarter, now 3 in second quarter, and I am pretty confident we will sign in third and fourth quarter as well. So every quarter there will be additional contract and all of them will start, the clock will start once we sign. So if you understand that this is going to go ahead as well. I would also like to inform you here that we have just begun the construction of the joint venture plant, which is the Zydus-Mayne Oncology facility in Ahmedabad.

Visalakshi

Okay, and finally can you give us an update on Altana JV?

Pankaj R. Patel

Altana JV we have resumed our normal working, and for the quarter which has gone by, our profits, our share of the profit was Rs. 95 million, against a profit share of Rs. 66 million in the first quarter.

Visalakshi

Okay, and recently you know there was a news flow that Altana could possibly sell off its pharma business venture, in such an event would you be impacted?

Pankaj R. Patel

First of all we are not aware of any of these move from Altana, so it is all speculative things in the newspaper, so we do not know. We have proper agreements in place, so we do not expect any change or anything happening because of any signing of agreements.

Visalakshi

And how do you see growth in this JV say in next year?

Pankaj R. Patel

As I mention always that I would like to continue telling you that we do not expect profits to grow from this JV.

Visalakshi

Okay, thank you.

Moderator

Thank you very much mam. Next question comes from Mr. Rahul Sharma of Karvy Stock Broking.

Rahul Sharma

Good set of numbers. I just wanted to ask you how much US revenues have we clocked in this quarter Sir?

Pankaj R. Patel

This quarter, revenue from the US subsidiary is Rs.62 million.

Rahul Sharma

Okay. Sir another thing was despite Altana doing well, our export of APIs is down by 12%, 425 million to 375 million could you just throw some light on it Sir?

Pankaj R. Patel

I think API overall as you know that we are facing pricing pressure and as a result some of the European supplies the prices have gone down and that basically is impacting the growth of the API. This actually began last year during the third quarter. We believe that going forward, this may not be continued factor, but as of today, as of this quarter, we have, yes, a declining exports of API in terms of value, of course quantities have been the same or more.

Rahul Sharma

How much has been booked in books as of September 2004 from Altana JV Sir?

Pankaj R. Patel

The profits you are talking about?

Rahul Sharma

No Sir, revenue Sir.

Pankaj R. Patel

Okay let me just give you. The revenue number for the first half is Rs.269 million.

Rahul Sharma

Okay, and last year corresponding?

Pankaj R. Patel

Last year the corresponding number for the first half was Rs. 281 million and now it is Rs. 269 million for the first half.

Rahul Sharma

Okay. Sir how many products have we launched in US, two products, one is atenolol and the second one is which was the other product Sir?

Pankaj R. Patel

Metformin.

Rahul Sharma

Metformin okay, and Sir which are the products apart from Ribavirin are we planning to launch Sir?

Pankaj R. Patel

I think whatever is approved, I have just given one more product name, which we are planning to launch, which is ribavirin, for which we have tentative approval. Other products are under approval and we cannot give you the details at this moment as far as the name is concerned.

Rahul Sharma

Okay, and next year how many product launches you all are looking at?

Pankaj R. Patel

In the US market, we are looking at 10 more, which is basically going to make a total of 15.

Rahul Sharma

Okay. Sir one thing which I just, going through last year's quarterly numbers and this year's numbers, there has been quite a change in our exports compared to the corresponding quarter last year and also our profits were higher than what we had shown last year, now can you explain this.

Pankaj R. Patel

Okay if you look at our results, we have made a clear disclosure there. If you read the note #3, it states that to give a meaningful comparison, the comparable figures for and up to the previous quarter ended September 30, 2004, the reporting period for all the foreign subsidiaries and joint venture company have been restated to align with that of the reporting period of the holding company. So what happened is that last year, basically our numbers for foreign subsidiaries and a JV were one quarter behind and now we are exactly giving you quarter to quarter comparison not only for holding co., but also for the joint ventures and the subsidiaries and that is where the difference what you are seeing is being seen. More details you can always get from our finance department and we can provide you more information.

Rahul Sharma

Sir, but which subsidiaries were not included in last year's consolidated numbers?

Pankaj R. Patel

Subsidiaries were all included, but they were one quarter behind.

Rahul Sharma

Okay, so that is the loss that is there and hence the impact of profits coming down.

Pankaj R. Patel

Yeah. If you look at this every quarter we were merging the quarter of this subsidiaries one quarter late, which we corrected at the end of the last year and now it is relevant that we give you exact quarter-to-quarter comparison and this is exact quarter-to-quarter comparison. So first half comparison is exactly what happened last year and what happened this year in our company and as well as in our subsidiaries. So it is exactly apple-to-apple comparison.

Rahul Sharma

Okay Sir. Thank you sir.

Moderator

Thank you very much Sir. Participants are requested to kindly use handsets while asking a question. Next in line, we have Mr. Rakesh Naidu from Mehta Partners.

Rakesh Naidu

Good afternoon gentlemen and congrats on the good set of numbers that you have come up with. My question has already been answered, but building on it. I had a question on Altana, now let us assume that Altana goes out and sells its company, so in that scenario how do you see that impacting your joint venture?

Pankaj R. Patel

We do not see any impact because we are protected by proper agreements.

Rakesh Naidu

Okay, thank you.

Moderator

Thank you very much Sir. Our next question comes from Mr. Shubham of DSP Merrill Lynch.

Shubham

Good afternoon everybody. I had two-three questions on the financial numbers. One is the margins, you know, that you have been able to get on the EBITDA level as well as net profit level have been very very good and I can see a distinct up trend in the margins that one can see over the last three quarters. Obviously, the March quarter numbers were bad because of VAT, but the bounce back that you got in June quarter, the margins in this quarter are actually better than the June quarter as well, both at the EBITDA level as well as the net profit level and most of it seems to have come along on the staff cost line as well as on the SG&A line, so can you just tell us what were the key reasons for a decent margin expansion when no other company actually is showing margin expansion in the business and more importantly whether this trend is sustainable from here on or not?

Pankaj R. Patel

I think first of all let me tell you that we as a company have always given a lot of emphasis on improving margins and if you look at our company's five, seven, ten year's numbers, you will see every year we have done a serious effort to improve the margins, and we have improved our margin by about 1 percentage point every year on an average, even little more. This is happening because we continuously work in improving the product mix, reducing the cost of goods, and in the process improve the overall gross margins. We also work continuously on, through various mechanisms to basically improve our overall sales and marketing and administrative cost and all of these are basically contributing positively, and coupled with that our sales growth helps us to overall margin improvement and our desire always has been that if we grow by 1% then we should be able to improve our margins by 2% in terms of growth, so that is the way we always try to work and plan our budget and try to achieve that. There is, you must be aware that we have done this program couple of years back called Prism, a key learning was there in the organization for that, which has then been institutionalized and the Prism has been continuously going forward. Subsequently, we had another program called Diamond, which has also contributed to that. For example, on the people front, we have reduced headcount by about 200 people in spite of growth being achieved across. We have reduced overall headcount by about 200 numbers through this exercise.

Shubham

In what amount of time Sir?

Pankaj R. Patel

Over the last few months. Over the last six months I would say.

Shubham

Okay.

Pankaj R. Patel

So, we have been basically continuously working on several ways to reduce our cost, so that we can improve our margins. So we clearly see this margins are sustainable and going forward we have very positive outlook for that..

Shubham

Currently, if were to ask you the EBITDA margins are roughly about 17.9-18%, so what in your assessment given the kind of Diamond program and other initiatives that you are undertaking, what would you put the kind of margin expansion potential from here on at?

Pankaj R. Patel

Actually, it is our desire, it is our aspiration that every year we should be able to improve our margins by 1% and that is what our aspiration and we all work towards that, and I am confident that these efforts which has been put in all around should help us to do this as we have done in past.

Shubham

Okay, and would you be able to quantify the amount of R&D expenses in this quarter?

Pankaj R. Patel

Yeah, we can. The R&D expenses for the quarter is Rs. 24.4 crores against Rs. 12.8 crores the same quarter last year.

Shubham

And what was the number sequentially in the June quarter?

Pankaj R. Patel

JUNE quarter, the number was Rs. 27.5 crore.

Shubham

Okay.

Pankaj R. Patel

So, for the first half we have spent Rs. 51.9 crore.

Shubham

And what in your view would be the likely number for the full year, any sense you would like to give us?

Pankaj R. Patel

I think we are going to be close to Rs.100 crore.

Shubham

Okay. I think those were the questions I had. Thanks a lot.

Pankaj R. Patel

Thank you.

Moderator

Thank you very much Sir. Our next question comes from Ms. Shaheena of IDBI Capital.

Shaheena

Yeah Hi, I just had one small question. The other income has shot up substantially in the quarter, could I have some sort of sense or breakup as to what are the components?

Pankaj R. Patel

I think other income has mainly gone up because of contract manufacturing income is booked under the other income and as I mentioned before there is about Rs. 7.3 crore income that is coming from contract manufacturing alone.

Shaheena

Okay. So basically, the profits are added to the other income and then, that means the sales do not include the top line?

Pankaj Patel

No, the sales does not include top line. This is a contract manufacturing income.

Shaheena

Okay. Thank you.

Moderator

Thank you very much mam. Participants who wish to ask questions, may please press *1 now. Next in line, we have Mr. Surjeet from KJMC.

Surjeet

Good evening everybody.

Pankaj R. Patel

Good evening.

Surjeet

Actually, somewhere I missed the numbers about your share in the Altana business. This quarter your revenue from Altana business, is your share of revenue?

Pankaj R. Patel

50% is our share of revenue and we will give you the numbers. For the quarter, the sales number is Rs. 127 million that is our share, and the profit number is Rs. 95 million.

Surjeet

I believe, last year the same number was around Rs. 206.4 million?

Pankaj R. Patel

No, it has to be restated because that was first quarter, so this Q2 last year, the Altana number was 75 million top line and 61 million bottom line.

Surjeet

61 million bottom line.

Pankaj R. Patel

Yeah.

Surjeet

Okay.

Pankaj R. Patel

This 61 has become 95.

Surjeet

Right okay, and your French business revenue this quarter?

Pankaj R. Patel

Rs. 141 million.

Surjeet

And loss?

Pankaj R. Patel

Loss is Rs. 53 million.

Surjeet

Thank you Sir.

Moderator

Thank you very much Sir. Next is a followup from Mr. Rahul Sharma of Karvy Stock Broking.

Rahul Sharma

My question has been answered. Thank you.

Moderator

Thank you very much Sir. Participants who wish to ask questions may please press *1 now. We have a followup question from Ms. Shaheena of IDBI Capital.

Shaheena

This is a very general question basically on the US market. While we have a plan to file say 15 ANDAs, take it up to 15 ANDAs by the year end. What is the sense in terms of what sort of revenues you can see from the US market let us say 2007 or 2008. Could you give us a sense of actual target and also if you could do the same for the French market?

Pankaj R. Patel

I think our aspiration is to grow the US business to something like close to \$70-80 million by that time and our aspiration to grow in France about €25-30 million business there.

Shaheena

You are talking of FY08.

Pankaj R. Patel

Yes.

Shaheena

Okay Sir. Thank you.

Pankaj R. Patel

But it is too early to give you guidance, this is like an aspiration.

Shaheena

Yeah. Sure, but the filings that you have let us say 15 for this year and maybe another 10 or 15 added next year would that be sufficient to give you these sort of revenues?

Pankaj R. Patel

Yes.

Shaheena

Okay. Thanks.

Moderator

Thank you very much mam. Next question comes from Ms. Monica of Quantum Securities.

Monica

Good evening gentlemen. My question was mainly on your, I mean, I did not understand how you were classifying the contract manufacturing revenue in other account and why was it not added in your gross sales?

Pankaj R. Patel

Basically, we are only charging the processing charges and that is why it has been classified as other income.

Monica

And this the norm you are going to follow for all your...?

Pankaj R. Patel

Yeah, unless and until we change the nature of billing.

M. K. Patel

If we make an invoice which is in terms of goods, we have to show it as sales. We will follow the accounting principals.

Monica

Sir, what is, let us say, ballpark number you see in terms of margins for your contract manufacturing activities?

Pankaj R. Patel

I think, anything between 30-40% should be fair to assume.

Monica

That is quite high compared to what other companies are earning. So could you give us some, you know, more color on...?

Pankaj R. Patel

That is our business secret, we cannot share it. We are making in Altana 82% you know that.

Monica

Okay. Thank you Sir.

Moderator

Thank you very much mam. Next is a followup question from Mr. Rahul Sharma of Karvy Stock Broking.

Rahul Sharma

Sir, just wanted to get a feel on the other income. Rs. 7 crores is from our contract manufacturing business, what about the other remaining part?

Pankaj R. Patel

We have some favorable exchange rate fluctuation of about Rs. 4 million, export incentive of about Rs. 10 million, and about Rs. 42 million processing income for processing goods for others.

Rahul Sharma

Sir, the first part I missed out. Which was the first part Sir.

Pankaj R. Patel

Export incentive 10 million.

Rahul Sharma

Prior to that Sir, export incentive and processing income.

Pankaj R. Patel

Yeah, and favorable exchange rate fluctuation of Rs. 4 million.

Rahul Sharma

Okay Sir. Thank you.

Moderator

Thank you very much Sir. Participants who wish to ask questions, may please press *1 now. At this moment, there are no further questions from participants. I would like to handover the floor back to Mr. Pankaj R. Patel for final remarks.

Pankaj R. Patel

Let me thank you all of you for being on the conference call on Saturday. There was a problem with timing of all our directors to attend meeting and that is why we had to keep the meeting on Saturday. We will ensure that in future you do not have to spend your Saturday evening on a conference call. Thank you very much once again for joining us and see you at the next conference call. Thank you.

Moderator

Ladies and gentlemen, thank you for choosing WebEx conferencing service. That concludes this conference call. Thank you for your participation. You may now disconnect your lines. Thank you and have a nice evening.
