"Cipla Limited Q1 FY19 Earnings Conference Call"

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Moderator: Good day, ladies and gentlemen and a very warm welcome to the Cipla Limited Q1 FY19 Earnings Conference Call hosted by Kotak Securities Limited. As a reminder, all participants' lines will be in the listen-only mode. 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 "*" and then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Chirag Talati from Kotak Securities Limited. Thank you and over to you, sir.

Chirag Talati: Hi, good evening, everyone. This is Chirag from Kotak Institutional Equities. I thank the Cipla management team for giving us the opportunity to host this call. From Cipla, we have with us today, Mr. Umang Vohra – Managing Director and Global CEO, Mr. Kedar Upadhye - Global CFO; Dr. R. Ananthanarayanan -- Global Chief Operating Officer and Mr. Naveen Bansal from the Investor Relations team. Over to you, sir.

Naveen Bansal: Thank you, Chirag. Good evening and a very warm welcome to Cipla's Q1 earnings call. I am Naveen from the Investor Relations team at Cipla.

Let me draw your attention to the fact that on this call our discussion will include certain forward-looking statements which are predictions, projections or other estimates about future events. These estimates reflect management's current expectation of the future performance of the company. Please note that these estimates involve several risks and uncertainties that could cause our actual results to differ materially from what is expressed or implied. Cipla does not undertake any obligation to publicly update any forward-looking statement whether as a result of new confirmation, future events or otherwise. I would like to request Umang to take over.

Umang Vohra: Thank you, Naveen and good evening to all of you.

Before we formally begin the commentary on the quarterly results, I would like to take a moment and extend a very warm welcome to Ananth, to the Cipla family as the Global Chief Operating Officer. Ananth, a Ph.D. in pharmaceutical technology has had an illustrious career in generic pharmaceutical spanning over three decades. Until recently, Ananth was the President and CEO of API, Biologics and Generics B2B business with Teva based in the US. Welcome, Ananth.

R. Ananthanarayanan: Thank you, Umang for the warm welcome and good evening everyone. I am extremely excited to be a part of this great organization. I look forward very much to drive various commercial, operational, and R&D initiatives with support from the entire team. I would now request Kedar to walk us through the financials for the quarter.

Kedar Upadhye: Thank you, Ananth and good evening to all of you. Welcome to our earnings call for the first quarter of fiscal 2019. I hope you have received the 'Investor Presentation' that we have posted on the website.

I will now take you through the financials for the quarter. Let me start with the core business margins. In terms of the quality of earnings, driven by the strong performance in our home markets of India and South Africa, combined with the contribution from API business, which operates at a very healthy EBITDA margin, the consolidated EBITDA for the quarter is expanded about 18.4% to sales, an increase of over 330 basis points over the sequential quarter of Q4 fiscal '18, this was planned and in line with our expectations. For the quarter, overall income from operations stands at Rs.3,939 crores which recorded year-on-year growth of 12% on GST impacted base of Q1 last year. As mentioned earlier, the growth was driven by India, South Africa and API, which was partly offset by challenges in other parts of the business, such as our Global Access business and Europe. Gross margin after material cost stood at 64% for the quarter. This reflects the number of factors: Positive one being currency, adverse being A) Chinese sourcing, commodities, and oil price linked material cost inflation; B) Overhead charge due to inventory reduction; and C) Certain one-off write-off which we have taken in this quarter.

We note that pricing pressures in our tender business is getting accentuated because of this cost inflation. During the quarter, we maintained tight control on expenses. Total expenses which include employee cost and other expenses stood at about Rs.1,789 crores, declined marginally on a sequential basis. Employee cost for this quarter stood at Rs.714 crores, an increase of about 2% on a sequential basis, largely due to annual increments. The other expenses for the quarter which include R&D, regulatory, quality, manufacturing and sales promotion expenses, stood at Rs.1,075 crores, decreasing 3% on a sequential basis. Total R&D investment for this quarter stands at 7% of revenues. We expect this to be ramped up in coming quarter in line with the progress on the generic Advair trials and other programs for the US market. EBITDA for the quarter stands at Rs.726 crores or 18.4% to sales. This is in line with our efforts to ensure year-on-year EBITDA margin improvement. Tax charge for the quarter stood at about Rs.174 crores. We are looking at full year effective tax rate of about 28%. Profit after tax stood at Rs.451 crores, impacted positively by the second tranche of the divestment proceeds of Rs.85 crores recorded in other income with respect to our stake in Chase Pharmaceuticals which is working on development of an Alzheimer drug.Although deals like this in specialty area part over routine business operations, they have booked in other income line below EBITDA due to the nature of the income being sale of equity stake. Till date we have received about Rs.245 crores from this particular divestment.

Our long-term debt remains at USD 550 million, which was mainly used to fund the InvaGen acquisition. We also have working capital loans of about USD 61 million which act as natural hedges towards our receivables. Total net debt-to-equity ratio is 0.13. Outstanding forward contract as a hedge for receivables as of 30th June are USD 126 million and ZAR 865 million. During the quarter we have also hedged a certain portion of our forecasted export revenues. The outstanding forward contract as cash flow is as of 30th June are USD 131 million.

I would now like to invite Umang to present the business and operational performance.

Umang Vohra: Thank you, Kedar. I am happy to report that our quarterly operational performance was in line with our expectations and we performed well against our key priorities. Our key priorities were around India business growth, US differentiated launches, respiratory franchise in the US, South Africa growth, emerging markets biosimilar, filing trajectory and quality focus, I will talk through each one of them shortly.

On our India business growth, our India business delivered healthy 22% year-on-year growth with both prescription and generic businesses growing strongly. As you are aware, the Q1 FY18 numbers were impacted due to GST led destocking in the channel and the impact of the field force transformation. We also strengthened our portfolio further with the partnership with Eli Lilly for launching BASAGLAR which is the insulin glargine injection in India.

US differentiated launches: We are happy to report that against the guidance of one limited competition product launch every quarter, we are already tracking ahead with seven overall approvals in Q1 including two limited competition approvals -- Isoproterenol and Testosterone. We are already noticing early signals of revenue build up on these products which has helped us improve our DTM business gross margins. We recently announced the approval of Diclofenac as well. We maintain our guidance of unlimited competition launch for quarter and are excited about our pipeline products coming up for approvals.

With respect to the respiratory franchise in the US, we are happy to announce that we have successfully completed the pivotal trials for generic Advair and are initiating clinical trial recruitments.

In South Africa, we continued a strong performance in the market with the business growing over double the market growth of 15%. In the emerging markets, biosimilar partnering franchise we had good momentum and we are happy to announce that we have signed a deal on Trastuzumab for Australia, Columbia and Malaysia. We are maintaining a strong filing rate with five new fillings in Q1 and are tracking healthy against a target of 20 plus filings for the full year and we continue to operate our facilities with highest level of compliance and control. As a closure for both Goa, Indore and InvaGen we received the EIR for all the plants.

I will now talk to you through the business performance starting with our India business. As alluded to earlier, India business recorded strong year-on-year growth of 22% on previous year GST impacted base. Key therapeutic areas delivered above market performance which includes cardiac, respiratory and urology. Most of these therapy areas, we have grown by almost 2% to 3% points above the market growth. Our top brands continue to outperform the market; 16 out of our top 23 brands grew higher than market. Our key respiratory brands Foracort, Seroflo and Duolin feature amongst the top 50 brands in the industry. We also entered into strategic partnership with Roche strengthening our oncology portfolio with the launch of three monoclonal antibodies. We also expanded our diabetes franchise by partnering with Eli Lilly to market and distribute insulin glargine.

As you know India Q2 growth is heavily dependent on the anti-infective seasonal push. We are continuing to monitor the situation as it unfolds, but the season seems to be a little delayed compared to the earlier years.

Our North America business delivered sales of 100 million, in line with the same quarter last year and lower by 5% versus the last quarter.

As I alluded in the last quarterly call, the supply disruptions continued to impact the quarter, but are resolved fully and completely behind us now. Also, we continue driving value play in the US market through rationalization of select low margin SKU categories, which also impacted the recorded sales in this quarter. Having said that the sales from new products including Budesonide, Decitabine, Palonosetron and Isoproterenol contribute 30% to our DTM revenues and help deliver 300 basis points in overall DTM gross margins. This is on expected lines as we move towards the healthier product mix in the US with the ramp up of new launches and rationalization of low margin SKUs. We continue to maintain our guidance of one limited competition launch for quarter.

The SAGA region which includes South Africa, Sub-Saharan Africa, and Cipla Global Access recorded a growth of 7% year-on-year basis when reported in USD. Our South Africa business delivered yet another strong quarter recording 14% growth when adjusted for animal health for Q1. As per the IMS MAT South Africa business grew at more than double the market growth at 15% in the private market. We will soon be launching the first biosimilar Filgrastim injection from our alliance with Teva. The South African business got a significant OTC boost with the acquisition which is pending competition commission approval, of Mirren, which is an OTC portfolio present in South Africa. The acquired business has been growing over 25% in an OTC segment and is growing 300 basis points higher than market. As part of this acquisition we will get access to four key OTC brands in the cough and cold and supplement segment. We see significant synergies with the acquired business and now have access to a local manufacturing facility as well.

Our Europe business declined during the quarter largely behind run offs in the same quarter of the previous year. Having said that the business continues to operate on healthy margins now. We have now taken various initiatives to improve traction on FPSM in the UK market and several other respiratory products.

In emerging markets outside Africa, quarterly sales declined marginally. We are happy to announce that we have received the pharma status for our plant in Morocco, expanding our presence in Columbia we launched five new products during the quarter. We also launched Dymista in New Zealand.

Our flagship program in specialty Tizanidine patch for the management of spasticity is progressing well. We are also exploring injectable formulations for several products for epilepsy indications that are in discussions with FDA for the development strategy. The company is evaluating several opportunities in the CNS space and other areas linked to movement disorders as well as in respiratory with the focus to service unmet patient needs.

To close, we had a good quarter with significant progress on our key priorities. In the coming quarters our focus will remain on development of generic Advair, driving profitable growth in the US through continued focus on the limited competition launches, maintaining India performance strategy and working towards the closure of the Mirren acquisition to drive the OTC expansion in South Africa and establishing our in-license biosimilar franchise in emerging markets. We are also seeing some challenges in various parts of the businesses due to cost escalations linked to China sourced materials, the commodity cycle and the oil price hike. We are working towards mitigating these challenges through various efficiency and strategic initiatives. The Global Access business has been under pressure for some time largely behind the challenges in the funding environment and continued pricing pressure on key molecules. Despite the rebasing of the CGA business, we have been able to drive growth at an overall corporate level.

I would like to thank you for your attention and will request the moderator to open the session 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 Prakash Agarwal from Axis Capital. Please go ahead.

Prakash Agarwal: Just trying to understand the India business, very good growth. How do we look at full year growth number because I understand Q2 last year was a bump up, so how do we see at six month and at yearly basis? The second one is on gross margin. Since India has done very good growth in absolute terms, despite that we have not seen much movement on gross margin, is it largely impacted by the China disruption and the high prices of raw materials?

Kedar Upadhye: Prakash, maybe I will take the second question, I will request Umang to answer the first question. So, in terms of the margin movement, the impact of inflation because of China sourcing and commodities and oil, etc., is about 30 to 40 basis points of sales. In addition to that we also seen certain overhead charge because of the inventory reduction and there have been certain one-off write-offs. So, this partly impacted but going forward in the long-term I would like to believe our margins will stay in this range unless we get really high margin product opportunities for the US. So, in the near-term, I would like to believe margins would stay in the current range.

Prakash Agarwal: So, would it not improve sir with the improvement in the US and limited competition and the US depreciating currency?

Kedar Upadhye: Which is what I said. The benefit of currency this quarter got offset by a couple of these items that I just alluded to. Once the contribution from limited opportunities in the US goes up, it will reflect in the margins.

Umang Vohra: So, currency for us from a profitability perspective, Prakash, does not impact as much as it does for other players because we have almost naturally hedged with the dollar and ZAR and every other currency in the world and we do not have very large business in the US. So, therefore it has an impact on the top line but not so much on the bottom line. Coming to India business growth, I think your first question, normalized growth for a full year will not be more than 12-14% which is going to be higher than industry but that is where the overall growth for the year will be and you are right, Q2 will show subdued growth because of the base of the previous year, because of the opening up of GST. So, our business fundamentals will be on track but I think because the base effect of this quarter will bring growth down a bit.

Prakash Agarwal: Kedar, you said overhead charges, can you just give some more color there?

Kedar Upadhye: Inventory, as you would have noticed, has gone down sequentially from the March quarter which is what we are focusing on and the overheads get booked in the material cost line, that offsets currency.

Moderator: Thank you. We will take the next question from the line of Neha Manpuria from JP Morgan. Please go ahead.

Neha Manpuria: My first question is on the US business. Sir, how much of the rationalization is still remaining or should I assume that most of the impact from rationalization is behind us and we should see an improvement in the US revenue particularly given the new launches that we have seen?

Umang Vohra: I think you can take two things, Neha: First is we had some supply challenges, right, they are behind us now completely. The second is rationalization. The impact of rationalization will go on for the next three quarters in the year but I think what we will be losing because of rationalization will be about 4 million to a base per quarter. So, versus last year, every quarter we will see a 4 million impact on account of rationalization for the next three quarters; however, this quarter we have also had the same supply challenges that we had guided even in the previous quarter call saying that we will have this issue for two quarters. All of those are behind us. But I would like to believe that the impact of that for the quarter, amount of rationalization as well as the supply challenges was close to almost $10 million for this quarter.

Neha Manpuria: Both of them included together?

Umang Vohra: Yes.

Neha Manpuria: Because we have seen two good launches plus the ramp up of the existing differentiated launches, it is fair to assume that this quarter is probably the floor in terms of the US revenue?

Umang Vohra: Well said and yes, it is the floor.

Neha Manpuria: If that is the case sir, why are we still indicating gross margins remaining in this range because India even if the 12% to 14% growth rate, and the improvement that we have seen from the new launches, should not our gross margin probably start showing that improvement in the US business which remains key?

Kedar Upadhye: Neha, it will go up, like what I said the improvement in the margins henceforth will be linked to the trajectory for the limited competition launches in US. We would not be able to quantify that now, but yes, it will go up and which is linked to the launches in US.

Neha Manpuria: My last question on the US Last quarter, we had indicated about ten odd launches for the full year. We are tracking ahead of that. So, is it fair to assume that the number of launches in this year would be probably closer to 15?

Umang Vohra: Yes, you could assume that.

Moderator: Thank you. We will take the next question from the line of Anubhav Agarwal from Credit Suisse. Please go ahead.

Anubhav Agarwal: Umang, you just mentioned about supply constraint impact of roughly about $5 million in this quarter. Would that imply that all of that will you get in the September quarter now?

Umang Vohra: Yes, we will.

Anubhav Agarwal: We had such good products, Dacogen and Budesonide and we lost almost two quarter sales. That period seems very high, among my experience of tracking the sector, I have never seen a company losing six months of sales because of supply issue on two key products. In hindsight, was there an issue you guys could not have taken care of it, what was the reason and how you are making sure that it does not appear again?

Umang Vohra: Dacogen had a different issue and I am not sure that Dacogen is the issue for the supply. The supply issues are largely linked to our facility in the US. Dacogen has been launched but Dacogen has to open up because when contracts open up in the market. As and when the GPOs begin to tender, then that is the time we will build for Dacogen. So, I do not think that has linked so much to supply. Last quarter we had some issue of supply but that is not the major constitute of Dacogen thing. Dacogen is a gradual progression to when the contracts open up. The supply disruptions are largely from the InvaGen side, not from India. The other thing that is happening since you raised this on the US, Cipla's earlier business model was completely B2B in the US, we used to partner with companies and they used to sell now. Of late we have done our own filings and our B2B trajectory is coming down slowly. As a result of that, I think you will find that the overall income will start going up now. If you look at our recent launches show that 30% of our revenues are coming from DTM from the new launches that we have launched in the last 12-months. So, the traction for new product launches is there, we have had supply challenges and I believe we have reached the floor in terms of the US earnings or the US potential for sales.

Anubhav Agarwal: So, basically that implies that on Budesonide at least we are at contracted market share, that is a steady state now largely for us. On Dacogen when do we see the upside because you mentioned last time that you already have more than 15% contracted share on that. So, should we start seeing that upside from September quarter or should we have to wait for little longer?

Umang Vohra: Dacogen, I think we will stay at the share that we have right now. It will be linked to the contracts opening up which I am hoping that in the next six months the contract begin to open up and we see share expansion there. So, Dacogen will be that story. I think Diclofenac we are about to launch, we have got an approval. So, there will be a fair number of launches which will be coming which will improve the trajectory of the business. Isoproterenol also we will see a good upsurge, it has been a good launch for us.

Anubhav Agarwal: On Toprol XL is that approval that you expect this year or next year for Cipla?

Umang Vohra: Hopefully this year.

Anubhav Agarwal: Kedar, one question, in the segmental disclosure, new ventures have suddenly become very profitable this quarter from a big loss which was continuing till last quarter. What’s change suddenly?

Kedar Upadhye: Anubhav, there is a note that we have made in the financial about the income that we have got. We have got a second tranche for divestment proceeds of our stake in Chase Pharmaceuticals, that is about Rs.85 crores. If you remember we had got more than Rs.120 crores a few quarters back. So, this is the second tranche and that is booked in the new venture. So, that is why it is showing a profit. So, you should exclude that and then compute the run rate for the quarter.

Moderator: Thank you. We will take the next question from the line of Nitin Agarwal from IDFC. Please go ahead.

Nitin Agarwal: Umang, you made a few references to the biosimilar launches in the emerging markets. How do you see this biosimilar opportunity in emerging markets, I mean, how easy is it to get access to some of these products, and what kind of competition do you see in these markets?

Umang Vohra: I would like to say it is not easy to get access to the products. So, every deal therefore is special to us. A lot of people who offer it, but by the time we finish our diligence and satisfy ourselves, it is only a few who we can go ahead with it. I think we have signed, we are completing the metric for some of our key markets like Australia, New Zealand, Colombia and Malaysia. We have relatively deep presence here and we are going to impact with the launch of biosimilars here as well as in Algeria and Morocco. I think each product if I was to look at depending on the type of product, we are the first and alone has the potential in each country to add almost $3 to $5 million worth of annual sales and in some markets it could be a lot higher than that, so some markets we could be adding almost up to 10 million of incremental sales depending on the products. So, it is related to the timing of entry and everything else but look at our emerging markets base today, we do about $70 million of emerging market sales. So, even if we get two biosimilar products in some markets, we are almost talking about 10-12% uplift but I think that will come only after a little bit period of time, it is not immediate and imminent, but we will start getting this into our portfolio next year onwards.

Nitin Agarwal: How competitive do you see these markets to be apart from the first mover advantage that you will get in some cases, do you see this to be fairly competitive marketplaces, how do you see them playing out?

Umang Vohra: Some markets we do not think will be very competitive but some markets would be competitive. I think some markets like Algeria, Morocco, we are not sure that we will see the same intensity of competition as we will possibly see in Australia, New Zealand or Colombia, there the intensity will be a lot higher.

Nitin Agarwal: On the US business, in the light of the way the market has played out over the last few quarters, we have been around this $100 million number for some time now, how do you see scale up in this business, where we stand up, meaningful growth over the next two to three years, 40%, 50% growth on our current base, is that a realistic possibility or it is going to be very, very dependent on the approvals that we get?

Kedar Upadhye: Yes, to be referred from Q4 and Q1, we refer to the serviceability issues which are over now and I think we internally do keep tracking this statistics. So, while the B2B part of the US business is getting realigned more in favor of DTM how much percentage of the current quarter's revenue is contributed by new launches in the last 12 months. So, that indicator is growing for us, Nitin. These are all high margin launches. We also in Slide #7 in the investor deck you can see that the margin improvement because of this percentage contribution improving is quite healthy. So, to answer your question, it is very clear headroom for us, given where we are today, I think headroom to improve our US footprint is very high. So, we are not going to give any guidance in terms of percentage growth but trajectory is improving, you will see it every quarter henceforth.

Moderator: Thank you. We will take the next question from the line of Sameer Baisiwala from Morgan Stanley. Please go ahead.

Sameer Baisiwala: Just on biosimilar, what is the commercial arrangement over here in a partnership for the emerging markets?

Umang Vohra: It will be roughly at market. I am not sure that we would give individual specifics but usually it will be at deals that are seen in market right now.

Sameer Baisiwala: Which is roughly 50:50 profit share?

Umang Vohra: No, I think it is going to be transfer price, some places, the transfer price might include an element of profit share and again transfer prices today are based on certain projections of market price. So, we have a correction possibility if the market prices do not act the way we think they will.

Sameer Baisiwala: So, transfer pricing would be based on cost plus basis, is it?

Kedar Upadhye: Yes, Sameer. Many of these deals in fact the gross margin is as good as company level gross margin today, some not. So, you should take that way. Our preference is to sign pure play in-licensing deals without too much of a profit sharing.

Sameer Baisiwala: Is there reverse volume commitment or market share commitment on your side?

Kedar Upadhye: Yes, many of these deals at times there is minimum purchase commitment we do have, but those are achievable.

Sameer Baisiwala: When you enter these emerging markets, is this going to be the market creation or is it going to be the market share from the branded?

Umang Vohra: On branded, it will be conversion, Sameer, because a large section of the world on biosimilar at least in the markets we operate in is still tender-based. So, we are hoping that it will be tender-based conversion, some places where limited detailing is involved, we will also try and carve out. A lot of these markets and if you keep Australia and New Zealand out of the overall mix, these are still self-funded. What we saw in India was huge amounts of elasticity to how people react when prices are lower. We do not know how this will play out in these markets where again insurance is self-funded.

Sameer Baisiwala: Second is on the domestic business. For all the in-license products, again what exactly is the commercial arrangement?

Umang Vohra: Sameer, for this domestic in-license product you should assume that gross margin is relatively lower than company level gross margin.

Sameer Baisiwala: At EBITDA level, I guess it flows through because …?

Kedar Upadhye: EBITDA level also it will be relatively lower but we do see that as avenues to create market, many of these are monoclonal antibodies and innovator products. It is important for us to get into this kind of arrangements with innovators.

Sameer Baisiwala: Just thinking a bit long-term say five to ten years out, it is not only limited to biosim, it is also to chemical entity, how do you see the domestic pipeline and do you think you will be constrained given the inability to get some of these products in-house because of patent restriction?

Umang Vohra: I think our whole strategy has been around that because of the patent regime if we cannot do, we have to in-license these products, talk to innovators early on so that they have belief in our ability to create therapies and once we have shown them the ability to create therapies, we become the preferred partner of choice and that is the strategy that we have used. We are unique a little bit in India because we do not pay incentives to our field and as a result of this some of our partners and MNC partners actually like this arrangement because it does not induce any kind of practices in the field. So, I think it is a mix of a couple of items, it is building the trust with the partners and showing that we can help them shape therapies, providing access to their medicines as well as the governance model of Cipla.

Sameer Baisiwala: Just a final part on this, so five to ten years down the road, Umang, do you think this would be a sizeable part of your domestic business?

Umang Vohra: I would like to believe that, Sameer, we are about a billion dollars now in India, five years down I do not think that this will be an extremely large proportion of where we are but at the same time in terms of incremental growth, this will be a large share of our incremental growth.

Sameer Baisiwala: On the FX side, Kedar, how much would be the translation impact in the P&L this quarter given your dollar current assets?

Kedar Upadhye: Actually, on the South African side, we had a loss, so the ZAR as on June is adverse as compared to ZAR as on March, and that got offset by dollars. This is booked below EBITDA in other income line, that is about Rs.35- 40 crores gain on dollar, offset by loss on ZAR.

Sameer Baisiwala: Given your large dollar loan, you would also be carrying a lot of negative dollar translation value no?

Kedar Upadhye: The loan and the associated investment, the translation on that, Sameer, goes to OCI, the other comprehensive income line in balance sheet, it does not come to P&L because it is naturally hedged.

Moderator: Thank you. We will take the next question from the line of Abhishek Sharma from IIFL. Please go ahead.

Abhishek Sharma: Just one question which is basically around these recent sanctions that US has put on Iran which could prohibit companies from doing business with both the countries. Just wanted to understand in Iran, what is our exposure, what is our presence there and what could be a potential impact of such a sanction?

Kedar Upadhye: Abhishek, all our business is backed by letter of credit. So in that sense there is no current exposure, inventories will be minimal, revenue per quarter will not be more than $5 million or so. Our preference will be obviously to comply given that this is an inter-governmental matter.

We are watching the developments and we will see whichever best way we can handle it but whichever way it shapes up we will have to comply.

Moderator: Thank you. We will take the next question from the line of Charulata Gaidhani from Dalal & Broacha. Please go ahead.

Charulata Gaidhani: I wanted information on the Advair trial. How much of R&D spend would you guide for?

Kedar Upadhye: This quarter we have little less than Rs.10 crores I think which we have booked in terms of preparatory work for the trial. Charulata, balance spend on Advair trial would scale up in the balance quarters, how much, we are still in the mode to finalize a number of patients, protocol, etc., so at this stage probably it is early to comment on it, going forward, we will comment when the things become clearer.

Charulata Gaidhani: Would you commence this trial in FY'19 or would it go into FY'20?

Kedar Upadhye: The trial will be commenced now as we are speaking, it will go into FY'20 as well.

Moderator: Thank you. We will take the next question from the line of Purvi Shah from Sharekhan. Please go ahead.

Purvi Shah: Basically, my question relates to the tax rate guidance that we have given, that it would be 28% for the year. So, just wanted to know why the increase? The other is that the other income is quite high. So, we said that it includes certain other FOREX gain that is there. Apart from that, what else would be the other income component?

Kedar Upadhye: On the tax rate, as you are aware, at industry level, this weighted reduction has come down by half compared to the past. That is one factor. Secondly, one of our plants for domestic business, it completed backward area incentives as on March '18. So, that cover has gone away. I think two reasons are largely why tax rate is at 28% now. In terms of other income breakup, we spoke about the second tranche of that divestment, so that is one and the FOREX translation gain that we spoke about. Even these two are largely contributors to the other income line.

Purvi Shah: Just to reconfirm, the divestment income was around Rs.80 crores and FOREX was Rs.35-40 crores?

Kedar Upadhye: Yes.

Purvi Shah: On the tax rate, just wanted to reconfirm, will this be stable at this level for the next two, three years also or else we have some plans wherein we would like to get it down in terms of say some other plants where we will be putting up our investments?

Kedar Upadhye: We do have various plans for mitigating tax rate increase, but this is pretty much the range at which we see many of our peers also. So, while internally we will deploy several tools to mitigate the hike in tax rate, I do not want to commit anything at this stage now.

Moderator: Thank you. We will take the next question from the line of Vishal Manchanda from Nirmal Bang. Please go ahead.

Vishal Manchanda: One related to your Voltaren Gel launch in the generic version. So, would you be launching this as an OTC product or would that be generic substitute of Voltaren?

Umang Vohra: It is a prescription product generic.

Vishal Manchanda: So, it would not be promoted like a brand?

Umang Vohra: No.

Vishal Manchanda: Sir, $350 million sales that you mentioned in the press release is all related to the prescription product or it includes the OTC sales as well?

Umang Vohra: No, that is largely prescription.

Moderator: Thank you. We will take the next question from the line of Chirag Dagli from HDFC Asset Management. Please go ahead.

Chirag Dagli: Just correct me if I am wrong, it seems from your earlier commentary that Dacogen is not yet fully optimal contracted market share reflected in Q1. Is understanding right?

Umang Vohra: That is correct.

Chirag Dagli: This 110 million if I add back what you guided in terms of the quarterly impact, is in line with what you set out a few quarters back for the US business, are we tracking behind or ahead of it, some color because as investors we just see the reported numbers and 100 going to 110 does not seem like to have achieved a nonlinear kind of growth?

Umang Vohra: First, let me say yes, I think it is obviously behind because we did not plan for supply disruptions, right that we had from our InvaGen facility. You have to understand the overall US context is one of price deflation, every year we are losing about 10% of our revenues in the US. So, whatever we are launching is offsetting that and Cipla has never had this type of trajectory of products and base of products in the US. So, I think now as the trajectory is coming up, the growth will only start increasing further and further.

Chirag Dagli: So, adjusting for this $10 million, let us say $110 million for the quarter that was in line with what you initially started?

Umang Vohra: That is right.

Moderator: Thank you. The next question is from the line of Prashant Nair from Citi Group. Please go ahead.

Prashant Nair: I just had a couple of more clarifications actually. If I got it right, in this quarter you had $5 million impact on US sales on account of SKU rationalization plus an additional 5 million due to supply constraints. Is that understanding right?

Kedar Upadhye: That is right, Prashant, in total 10 million both from serviceability and our decisions to rationalize the portfolio.

Prashant Nair: The supply constraints are now behind you and should not impact from the next quarter?

Kedar Upadhye: Yes.

Prashant Nair: **C**urrent $100, $110 million run rate in the US, how much roughly would be the direct to market component and how much would be the B2B component which you had earlier?

Kedar Upadhye: Approximately 65% is direct to market, Prashant and that part is growing and B2B by design is coming down. But that issue which is holding now, may not hold true going forward. So, there will be a preference for the DTM proportion to go up.

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

Surya Patra: On the B2B business front whether it is the strategy now going forward is to eliminate that part from the US revenues?

Kedar Upadhye: Surya, we are not going to eliminate it, some of these relationships will over time get over and our focus is going to be on DTM, so most of the new files are going to be through DTM, that is why the growth in DTM is going to be much higher.

Surya Patra: But the net-net impact, the falling B2B business and rising DTM business and the price impact all put together, whether the growth movement would be continued or for some time there would be kind of stagnation in US business?

Kedar Upadhye: Initial part of the call we explained this. You will see growth, the decline in B2B is by design and growth in DTM is linked to scale up with the market shares of new launches.

Surya Patra: Anything to understand from the API numbers, this quarter is relatively much stronger compared to the trend, so whether this is a kind of one-off quarter from that point or something else here?

Umang Vohra: I think there is a base impact also, if you look at Q2 of the last year, the base was very high because we had supplies of Tenofovir to Teva. So, I think the issue is that API because of the delivery model you can never be sure of how it plays out. So, the base effect of last year was low, we have grown high. This quarter will be challenging to show growth at the same level of the previous quarter, but overall year wise we are looking at API business to grow between 5% to 10%.

Surya Patra: We always used to indicate that annually there is a likelihood of 1% kind of margin expansion and that should continue for few years. So, whether this is year of break from that guidance?

Kedar Upadhye: No, internally we will take targets for margin enhancements, Surya. While guiding externally obviously we will have to be cautious, but there are opportunities in terms of both revenue enhancement and cost leverage. Directionally yes, but satisfying that we have got into zone now, which is 18% to 20% zone, either at the lower end or the higher end based upon the specific quarters developments. Normally that margin enhancement will continue to remain our target.

Moderator: Thank you. The next question is from the line of Prakash Agarwal from Axis Capital. Please go ahead.

Prakash Agarwal: Just a clarification, the tax rate I missed, 28% you reported this quarter, but your guidance is 22%?

Kedar Upadhye: Prakash, we said 28%, so full year ETR is in the zone of 28%, and the couple of reasons we said -- one is the decline in the weighted reduction of R&D which is an industry level thing and secondly internally one of our plants had a sunset clause in terms of the backward area incentives.

Prakash Agarwal: That is how you look at the full year as well

Kedar Upadhye: Yes.

Prakash Agarwal: Secondly on depreciation, it has actually moved down. I did not understand what has really happened?

Kedar Upadhye: In Q4 there was some incremental charge, but subject to capitalization of additional equipments it will keep going up.

Prakash Agarwal: So, this is the base or it can go even further down because we have seen actually bell-shaped 2 billion, 3 billion, 5 billion, 2.8 billion, now 2.4 billion?

Kedar Upadhye: In Q4, in amortization we had one-time charge, so that has gone away. So, each launch in the first quarter there is an additional amortization.

Prakash Agarwal: So, more or less this would be the base and some incremental is what I understand?

Kedar Upadhye: Absolutely.

Prakash Agarwal: In R&D you already mentioned that this quarter is 7% but it would move up and I think you have earlier given guidance of 8 to 9% if I am not wrong?

Kedar Upadhye: Yes, Prakash.

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

Tushar Manudhane: Sir, have we launched generic Sensipar?

Umang Vohra: No, we have not launched generic Sensipar.

Tushar Manudhane: Is that due to settlement or is that due to the in-process manufacturing?

Umang Vohra: We do not comment on specifics of products, but I think most people have probably figured out that we may have settled this product.

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

Nitin Agarwal: Umang, on the overall business mix, is it fair to assume that US and India will be pretty much are primary drivers of profitability at least for the next few quarters?

Umang Vohra: Also, our South Africa business.

Nitin Agarwal: If you look at the quarterly sort of variation in these businesses, I think Q2 and Q3 would be relatively bigger quarter for the India business, is there a fair comment?

Umang Vohra: Yes, Q2, Q3 will be bigger quarters for the India business, but on the base of last year and Q2 it would look subdued because it was GST-led restocking in Q2 of the previous year, but absolute wise Q2, Q3 will larger.

Nitin Agarwal: A typical seasonality for us is Q4 tends to be slightly lower quarter from India business perspective, which has implications on the overall business?

Umang Vohra: That is right. I think we might see a little bit of rephasing of Q2 and Q3, usually our season goes away by the end of Q2, but I think this year the season has started late, so we have not seen the seasonal trigger yet comprehensively in the first month of this quarter for the India business.

Nitin Agarwal: We have had a reasonably good quarter by way of new launches in the US, plus this is one of our slightly stronger India businesses, we have not spent much in R&D, but still we had about 18, 18.5% EBITDA margins which is necessary for us to improve or increase the R&D spends, how much leeway do we have to increase our reported EBITDA going forward?

Umang Vohra: We have some leeway… I think as other has asked on the call, once we start doing a lot of the limited competition launches, our margin profile will hopefully go up which will allow us to invest more in R&D. We have also said that we are not going to take R&D higher than 7.5-8% of sales, we are very clear about that.

Nitin Agarwal: Umang, but our revenue growth has been little muted right, per se that constraints if you know go by that framework, it has constraint in terms of increasing our R&D spends?

Umang Vohra: I would like to put it the other way -- this industry that we are in has muted or declining revenue growth. I am not sure that anyone is showing spectacular revenue growth because there is pricing pressure all across the world and we are not immune to that pressure. So, I think the subdued revenue growth you are right will be there and I think the margins will have to solve for that by trying to run cost programs, etc., We will have to fund this R&D from what we can do from an overall cost perspective in the business.

Nitin Agarwal: Are we exploring opportunities apart from organic spends in R&D to sort of accelerate some of these programs through partnering or probably getting still capital in, is that some option which is there on the table for us?

Umang Vohra: Yes, it is there.

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

Shyam Srinivasan: First one is on the US Umang and team. If you can tell us about the pricing environment, we seem to be getting confusing messages from different places; Sandoz is one, you talked about a 10% number. But are you seeing something incremental where things are improving, for example Rite Aid recently said they are cutting down their guidance as well, so mixed messages, anything you can tell on the overall industry that will be very helpful?

Umang Vohra: I am not sure that the pricing environment has improved, I think the declines have abated and probably that is the way to put it. We have to realize that at least for Rite Aid has disclosed. Every year they saw huge efficiency because of some buying group forming and something else happening and prices getting marked. So, a new buying group was formed, they mark the prices of wholesalers and retailers and that became suddenly a one up game, right. Once all of that has happened in the market, we will not see those spectacular gain which is probably why Rite Aid announced what they did. But I think the issue is we have seen its stable, but that does not mean that prices are not falling.

Shyam Srinivasan: When you said assume $100 million quarterly that erodes 10%, so that number is…?

Umang Vohra: That includes the 10%.

Shyam Srinivasan: My second question is on China and you had small 30, 40 bps impact from a sourcing perspective. In the long term, is there something that we can do to kind of mitigate against some of the cost pressures? And a related question on China, given the whole tariff wars that are happening, we have seen a lot of Chinese media reports that talk about them trying to invite more India participation in their generic market, are we getting into China, so any thoughts again on these two developments?

Kedar Upadhye: In terms of indigenization, if not the finished API, at least of intermediates would examine some of those plants, but those are capital-intensive plants, so in terms of short to medium term probably nothing much, in case of local sourcing some of the opportunities could emerge, but be it in terms of being able to mitigate cost increase or being able to pass on as price increases, I do not think we will be able to do much.

Umang Vohra: To your second question, we have plans to get into China and that is more for the respiratory franchise, but it is still early days for that. I think the Chinese authorities are accepting files which have clinical trials done in the US or Europe and we will capitalize on that.

Moderator: Thank you. We will take the last question from the line of Chirag Dagli from HDFC Asset Management. Please go ahead.

Chirag Dagli: Sir, for the past few quarters, we have seen good control on costs. As we get into the next two years, OPEX growth slower than sales growth. Will this sort of continue as we get into the next two years?

Kedar Upadhye: Yes, Chirag, performance comparisons or target setting, revenue and margin growth being higher than OPEX growth is going to be the principle.

Chirag Dagli: So, still there is opportunity to…?

Kedar Upadhye: We would like to believe, may be the low hanging fruits have been all exhausted, but structural solutions are possible, and we will maintain that as a management principle.

Chirag Dagli: Will this be more from fixed cost or will there be sourcing benefit is there?

Kedar Upadhye: Probably lower sourcing benefits.

Chirag Dagli: Can you quantify the size of China imports for the full year?

Kedar Upadhye: Not the imports per se, but like what I said up to 40 basis points to sales is the impact that we have seen in this quarter. Let us see how it pans out for the balance of the year.

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

Naveen Bansal: Thank you everyone for joining us for the call today. In case you have any follow-on questions, please reach out to the investor relations team. Thank you and a very good evening.

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 and you may now disconnect your lines.