

Investors/Analysts Conference Call (July 28, 2006)

Moderator

Good afternoon ladies and gentlemen. I am Gaurav, the moderator for this conference. Welcome to the Zydus Cadila Healthcare Limited 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 Patel of Zydus Cadila. Thank you and over to Mr. Patel.

Pankaj Patel

Good evening and welcome to our post results teleconference. At the outset let me remind you of my last quarter's analysis in which I had mentioned that we were expecting our investment in US and other regulated markets and in research and development to bear fruits shortly. This year's first quarter, the effect of these fruits is very clearly seen. Our US business has generated a sale of Rs. 271 million and profit of Rs. 34 million against losses of Rs. 24 million last year. The French business generated a sale of Rs. 225 million, up by 68%.

With this background let me take you through the broad numbers.

In the quarter one on the consolidated basis,

- The total operating income has risen by 19.5% to Rs. 446 crores from Rs. 373 crores last year. Income growth was mainly driven by 131% growth in formulation exports on the back of sale of Rs. 271 million in US and 68% growth in the business of French subsidiary. Our own API exports also have grown by 24%.
- The PBIDT is up by 40% to Rs. 947 million from Rs. 674 million. The PBIDT margin as a percentage to total income also has improved by 2.9% from 18.1% to 21%.
- The PAT is up by 70.8% to Rs. 584 million from Rs. 342 million. PAT as % to total income has increased from 9.2% last year to 13% now.

Coming to standalone numbers,

- The operating income is up by 8.7% year on year from Rs. 335 crores to Rs. 364 crores. The top line growth was relatively lower in spite of 85% growth in formulation exports, 24% growth in API exports, and 32% growth in the consumer business, mainly because lower growth of 4% in domestic formation over the quarter one last year. This lower growth was mainly because of two factors, one is the impact of VAT due to which we had benefit of higher sales last year and secondly we had done a major restructuring of our domestic marketing operations, as a result of which we have consciously taken a lower target for the first quarter. Though the growth is 4% we are on budget as far as the domestic formation business is concerned.
- The margin is up by 1.2% to 783 million. The PAT was up by 2.7% to 492 million.

As far as our US operations are concerned, we received three more ANDA approvals during the quarter, taking total approval to 15. We have also launched Warfarin in the US market with good initial orders, and we have recently got approval from FDA for ANDA of Meloxicam Tablets, which was launched on the very first day in the US market. We have also filed three more ANDAs during the quarter taking total filing to 39, out of which 23 are now pending approval. We have filed two additional site transfer applications with French regulatory authority and received one more site transfer approval during the quarter.

Our API export business is back on track with sales of Rs. 326 million, up by 24%. During the quarter we signed three more contracts taking the cumulative number of contracts signed to 14 with peak revenue potential of \$24.24 million.

In the most recent development, we have received permission from DCGI to conduct phase one clinical studies for ZYH2. We will commence the phase 1 trial for ZYH2 very soon. With this, we will have three products in clinic as of beginning of next quarter.

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

Moderator

Thank you very much sir. We will now begin the Q&A interactive session. Participants who wish to ask questions may please press *1 on the telephone keypad. On pressing *1 participants will get a chance to present their questions on a first-in-line basis. Participants are requested to use only handsets while asking a question. To ask a question please press *1 now. First in line we have Nikunj Doshi from Kotak Assets Management.

Nikunj Doshi

Good evening Mr. Patel. Just wanted to know what would be the growth drivers over the next two to three quarters of the company, I mean geography-wise if you can give some insight into it?

Pankaj Patel

We believe that for the next two quarters the domestic market would have a growth in the range of 12-15%. The international business will continue growing at a similar pace. We expect to launch additional products during the next quarters into the US market and also the French subsidiary will continue growing at the fast pace. We expect also that the exports to non-regulated markets would grow further. Our API business as you are aware that was not growing, actually de-growing over the last four-five quarters, has shown a growth and we clearly see a trend that that upward trend will continue, it is not one off kind of a thing. So the overall growth would continue at the similar number even for the coming quarter.

Nikunj Doshi

What would be the margin outlook coming forward and will it remain at current level or will you see improvement possible there?

Pankaj Patel

We expect the margin improvement to continue, but we cannot say that every quarter the margin will improve. We will be bringing in some improvement in the margin year-on-year for sure because lot of investment which we have been making during last couple of years on cost efficiency programmes, site variations for products of regulated markets etc. would yield results and that basically is going to really contribute to the bottom line

Nikunj Doshi

Can you just highlight what will be our research strategy or any kind of research output that we are looking forward in the next six months to twelve months period?

Pankaj Patel

Our goal is basically to create our own pipeline of a series of molecules. As a result we have internal target to file at least one IND per year. We would be filing one IND this year for sure, and we also expect to bring these INDs up to phase II trial to have a proof of concept for these molecules. Beyond that we are open to look at partners to work on it. We are not driven by R&D revenues at this moment, but we would see that R&D revenues would be a reality in the year FY08-09 or may be later.

Nikunj Doshi

You are doing some good work on the biotech side also. So, any kind of insight that you can give on that sir?

Pankaj Patel

We are doing work on biotech, but we would not like to give any further information. At appropriate time, we would disclose all the information.

Nikunj Doshi

Okay, thank you very much and all the best.

Moderator

Thank you very much sir. Next, we have Anshu Govil from CLSA.

Anshu Govil

Yeah, good evening. My question is regarding the gross margin. On a sequential basis the margins have improved by around 650 basis points. Now, what I want to understand is how much of it is because of translation gain you might have had on the inventory. So, what would be the normalized margin would be?

Pankaj Patel

Can you explain this what do you mean by translation to inventory?

Anshu Govil

Rupee has depreciated during the quarter and whatever inventory and account figure we have in foreign currency, we have some positive impact on that. So, how do we account for that ?. It can be accounted for in cost of goods sold and gross margins improved because of that. What is the extent of that?

M. K. Patel

I do not think there is a major increase because of the exchanges fluctuation in our case because most of the currencies were booked somewhere in the month of March.

Pankaj Patel

But anyhow we can provide you some specific numbers but as per our understanding there is no major impact of currency appreciation in our case.

Anshu Govil

So, gross margins of 65% this quarter would be sustainable going forward.

Pankaj Patel

That is what we believe.

Ansukh Govil

Okay, thanks.

Moderator

Thank you very much sir. Next, we have Mr. Shubham Mazumdar from McQuarrie Securities.

Subham Mazumdar

Hello everyone. I just had question one on the French generic business. If you could tell us what was the revenue and profit for the quarter and any sense in which quarter it will possibly may breakeven.

Pankaj Patel

The French business for the quarter, the sale was Rs. 225 million rupees and the profits were minus 8 million rupees. So there was a loss of Rs. 8 million.

Subham Mazumdar

Sorry, the profit was ?

Pankaj Patel

Minus 8 million rupees, that is the loss was 8 million rupees on a turnover of Rs. 225 million. As we have said before we expect to breakeven in the coming year but not in this year.

Subham Mazumdar

In fiscal 08.

Pankaj Patel

Sorry.

Subham Mazumdar

Breakeven at the PAT level in fiscal 08.

Pankaj Patel

Yeah.

Subham mazumdar

Okay any sense, first half or second half you would like to say anything on that.

Pankaj Patel

Second half.

Subham Mazumdar

Second half. Okay, on the Altana business if you could just give us the numbers for the quarter, your share of revenue and profit.

Pankaj Patel

For the quarter our share of revenue was Rs. 222 million and the profit was Rs. 182 million,

Subham Mazumdar

Any outlook in terms of how the volumes have been and you were possibly sourcing some kind of an increased quantity in the second half of this year. Are you seeing any kind of increased uptake from there?

Pankaj Patel

We have been telling that we would be expecting an overall bottom line contribution by Altana between Rs. 55 to 60 crores every year and we would maintain that guidance to you.

Subham Mazumdar

The third is on the new molecules on which you are taking the phase 2 and like-wise for other molecules in the IND pipeline. What is the time line in terms of their market launch?

Pankaj Patel

These are, NCEs and the time lines for an NCE varies between 8 to 10 years of development cycle which is why it is very difficult for us to give you timeline for their market launch. You should also be fully aware that these are in phase 1 or phase 2 and the product can fail even at phase 3 level, so for us to give you a specific year for market launch is extremely difficult, but if we get successful with the very first molecule we believe that it should be in the year 2011 that we see that molecule in market.

Subham Mazumdar

For the first one.

Pankaj Patel

First one, yeah. But again I would like to basically draw your attention that these are very risky and we are not building any revenue models at this moment on this pipeline.

Subham Mazumdar

And, there has been some sense from the French business in terms of distribution. What has been the effect on the business and revenues on account of these changes.

Pankaj Patel

These changes would have real effect starting from the next quarter because they were just trying to begin launching of our products, so the real benefit we would see in the next two quarters of this partnership with Evolupharm, which is the company in France which represents the buying group of about 2250 retail pharmacies.

Subham Mazumdar

Are you facing any increased pricing pressure in the French generic market ?

Pankaj Patel

Currently, we are not seeing that.

Subham Mazumdar

So, you would roughly say realization as a whole in the market is stable on a year on year basis?

Pankaj Patel

Yes, that is true.

Subham Mazumdar

Thank you so much.

Moderator

Thank you very much sir. Next, we have Mr. Rana from Kotak Securities. Mr. Rana. I will take the next question. Next, we have Mr. Ravi Agarwal from JP Morgan.

Jaisal

Yeah hi, this is Jaisal. Just one or two issues, first in the domestic market, you had a growth of about I think 4%. You know you talked about in your opening remarks the fact that this is in line with your internal estimates because of some changes some field force. Can you just explain this a little bit more in terms of what changes you made and what was your full year expectation annually and how does it look now?

Pankaj Patel

Okay, let me explain you. We had 13 marketing divisions in the company. We consolidated these 13 marketing divisions into 10 marketing divisions, and while doing so obviously we made certain changes of product transfer, people transfer, etc. Since we have made these changes this quarter, we intentionally did not take a very high growth target, because if you take that then while implementing the changes, there could be some issues. So, we basically have consciously decided to do this. In this restructuring process, we have reduced some of the unwanted low productive field force and basically focused on high potential and high growth territory by adding some people there. All that is basically going to help us in terms of improving our overall field force productivity going forward. Hence, we are actually 100% on the budget but we had planned for low growth thinking that we should not take aggressive growth target during this transition period. However for the coming quarters our targets are high.

Jaisal

Fine. Have you seen any loss or gain in market share in the products which you have transferred?

Pankaj Patel

Actually we have been monitoring this on a very regular basis In some of the products, we are actually doing better than what we were doing earlier. And in some small products we have lost our market share, but that does not have any significant impact on the overall number.

Jaisal

Do you have a sense of how much you are having the price increase in this quarter in the domestic business?

Pankaj Patel

I do not think we have had any price increase this quarter.

Jaisal

Fine. Do you have any plans in the current year and the next year?

Pankaj Patel

For increasing the price?

Jaisal

Yeah.

Pankaj Patel

We are watching now. We do not want to be on the newspaper headlines.

Jaisal

What about the US business? You know, how do you see it kind of shaping up?

Pankaj Patel

I believe our strategies are going in the right direction. I can say that from the performance of the products, which we launched. I told you before that for all the products we have launched, we have got more than 10% market share. The last product we launched was Meloxicam, and you know on day one there were 11 companies whose products got approved. In that scenario also we have got more than 10% market share. That proves that our strategy is right and is moving in the right direction.

Jaisal

Fine. Just a last one from my side. Can you explain the reduction in the raw materials cost - which are the main reasons contributing to this?

Pankaj Patel

See, there are several reasons why it has happened. A is, there is an overall better product mix, B is that exports started earning more. The API, which was losing money, is now making money. And all of them have helped us to improve on the overall raw material cost, and of course there is also an impact of shifting products from external manufacturers to our own plant in Baddi, which also has helped improving some margins. And you will see that there is some increase in excise as a result of that.

Jaisal

Okay, thank you.

Moderator

Thank you very much sir. Next, we have Mr. Rana from Kotak Securities.

Rana

Good evening sir. You mentioned that last year as you have had 11 contracts signed. So what part of this revenue has been realized here and by when can we expect the realization of full revenue potential.

Pankaj Patel

Mr. Rana, I do not have the data in front of me to give you the details, but we can give you off line and I would request Mr. M.K. Patel to provide you this information. Your question was not very clear, but what I understood is that your question was what will be the revenue expectation of the contract manufacturing this year and going forward. I can only say that our target for this year is about Rs. 20 crores.

Rana

Okay. Thank you.

Moderator

Thank you very much sir. Next we have Mr. Rajesh from ICICI Securities.

Rajesh

Good evening and congratulations for good set of numbers. Firstly, if Mr. Pankaj Patel can shed some light on contract manufacturing business with specific focus on the Mayne JV and when the production and all will go on, and from a medium-term perspective what sort of strategy is for this business in the overall objective and the goal of billion dollars revenue by 2010.

Pankaj Patel

Rajesh thanks for the complement. I was in fact looking forward from every one of you, but I at least got first one. Thank you very much and I believe every other colleague of yours would have the same feeling. Coming to your specific question, Zydus Mayne project is moving very much on schedule. We are moving towards completing the construction of the plant, and we would start installing the equipment. As we have originally envisaged there is no delays, so next year we should be seeing products being site transferred here. All of the products which we have selected, Mayne has independently done the filing of ANDA, so all the products will be done through a site transfer so it will take shorter period for us to get product approvals. We expect the revenues to start from 2008 onwards and in 2009 and 2010 we will see the peak of this revenues. The product list which contains about eight products, most of them are going off patent and we would be among the first ones launching these products in the global market. So, we expect this joint venture to be very successful in contributing high numbers. We know that there is a revenue gap we are going to get in 2010 from our JV with Altana, and this JV with

Mayne is going to be a bridge which we are creating which will allow us to cross this gap very easily. Going forward on our plan and our vision of creating a billion dollar company by 2010, we have our first milestone coming this year crossing the \$400 million mark which we are very confident of crossing, and going forward we have plans in place including organic and inorganic growth to ensure that we hit this billion dollar mark by 2010. I believe that about 80% of that will be achieved organically, about 20% will be done through inorganic way.

Rajesh

I think that is useful and wish you good luck.

Pankaj Patel

Thank you.

Moderator

Thank you very much sir. Next we have Mr. Rahul Sharma from Karvy. Mr. Sharma?

Rahul Sharma

First of all, I would like to congratulate the management on a very good set of numbers, and sir I just wanted to ask what was the US business that we clocked in for the first quarter and are we confident of doing close to \$ 30 million for the year?

Pankaj Patel

Yes, thank you for the compliments. We are confident of exceeding the numbers which we have committed, which is \$30 million by the end of this financial year. This quarter the sale was Rs. 271 million rupees.

Rajesh

Sir, how much of contract manufacturing revenues did we book in this quarter?

Pankaj Patel

This quarter the revenue was Rs. 6 million.

Rajesh

Okay sir. Thank you.

Moderator

Thank you very much sir. Participants, who wish to ask questions may please press *1 now. We have a follow up question from Mr. Pavan of Kotak.

Pavan

Yeah, good evening and congratulations to the team on a good set of numbers. In fact hopefully we are looking much more than this from you in the next few quarters and the next few years. Okay, Mr. Patel you said that 80% of your billion dollars in 2010 is organic. So that is about \$800 million. You are roughly doubling in the next three years.

Pankaj Patel

Yes.

Pavan

And, can I understand what will drive that, I mean like your key geographies, I mean let us say US how much will that come to be?

Pankaj Patel

I would not like to give you so much of details at this moment. We have a plan and I think whenever we have a meeting we will be happy to discuss this more in detail with you. However, as you know that we are talking about our global business to become about \$370 million by 2010 which gives you a clear idea where we are and where we are going; from current about \$ 83 million, we are trying to reach \$ 370 million by 2010. Our domestic business will continue to grow. Some of our joint ventures will start contributing much more. You know, we have very important joint venture with Bharat Serum and Vaccines Ltd., under which we are developing an NDDS-based oncology drug. We are already in clinic now with this drug and we plan to launch in some unregulated markets this product before end of this year and we expect that we would be filing in both US and Europe this product. We have a full patent protection because we have our own IPR in this. This itself can contribute significant numbers into this. So, all of these are going to help us reach this target or close to the \$ 800 million number. The balance would be done through inorganic way. However, you know, these are the questions which basically can be answered in extract form at this moment, but if you meet I would be happy to discuss this more and give you more clarity on this.

Pavan

Sure, sure. My second question which I want to understand basically is on French business, I mean you will be going basically variable from 1st January 2007, right?

Pankaj Patel

Yeah.

Pavan

Okay. I mean why does a breakeven happen in H2 of FY 08? I mean I am just trying to understand how different will it be ?

Pankaj Patel

There are two things. One is that by getting variable, we will not become zero as far as our fixed costs are concerned. So, it will take sometime before we completely breakeven and that is why we said H2.

Pavan

Okay, thanks, that is part one.

Pankaj Patel

There will be profit from the first quarter itself since we will have small office setup there having some amount of fixed costs. Some of the site transfers going to kick in during that time will give some advantage as far as cost of goods are concerned.

Pavan

What kind of fixed costs would you have in that market?

Pankaj Patel

I do not have the data right now in front of me.

Pavan

Ballpark, I mean I am not going to use.

Pankaj Patel

I think the fixed cost should be approximately \$2 million to \$3 million I do not have the numbers in front of me; But since you told me I am trying to make a guess. So, pardon me if I am wrong, but as I remember it is \$2 million to \$3 million.

Pavan

Sir, basically in this business, I mean even in France the only way to make money is when you are shipping out of India and you are on a variable cost structure I mean some partnership agreement.

Pankaj Patel

I believe that we need to reach customers in much larger numbers and you can make money by doing that on your own but that would basically require a significantly large sales volume as also huge investment. So, I do not think that that is the only formula. But, you know, for a start up company or a small company, this could be a better strategy that is what we believe. .

Pavan

Okay. And on Brazil can you just give us some idea because you know that apparently seems to be a very promising market.

Pankaj Patel

Yeah, Brazil you know, we just started last year and this quarter our sale was Rs. 48 million.

Pavan

Okay, and what were the profits in US on sales of Rs. 271 million.

Pankaj Patel

The profits in US were Rs. 34 million.

Pavan

I mean, can I understand this a little more. When you mean profit, you mean consolidated.

Pankaj Patel

This is after US costs. These are not the profits, which are booked in India. This is the profit of the US subsidiary, but this is before allocation of any R&D cost.

Pavan

Sure, sure. Before R&D if I look at consolidated, it would be much higher than this.

Pankaj Patel

Correct. Whatever is the transfer price of goods transferred from India to US is not included in this. This is the profit of the US subsidiary after deducting minority interest.

Pavan

Okay, fine. Thank you so much.

Moderator

Thank you very much sir. Next we have Mr. Alok Dalal from India Infoline.

Alok Dalal

Good evening sir and congratulations on the good set of numbers. Sir, can you throw some light on the new three contracts,

which you signed?

Pankaj Patel

We are not giving any specific details, I am sorry I cannot provide you further details.

Alok Dalal

Okay, and sir you spoke about inorganic growth. So, can you share some details as to what kind of companies you are looking at?

Pankaj Patel

Sorry, we are not going to give you any further details. Since the question was how are you going to reach \$1 billion mark, I just gave you very broad numbers, but anything about M&A we are not disclosing anything except that we want to acquire something in Spain and Italy.

Alok Dalal

Okay sir. Thank you and all the best.

Pankaj Patel

Thank you.

Moderator

Thank you very much sir. Participants who wish to ask questions may please press *1 now. We have a follow up question from Mr. Rahul of Karvy.

Rahul

Sir, I just wanted to get a feel on your consumer business, now that you have acquired the artificial butter business, how much does it contribute to our revenues in the current quarter and how do you see it scale up?

Pankaj Patel

The current quarter the revenue contribution was Rs. 80 million, and going forward it is going to grow at about 30%.

Rahul

Okay, sir. Thank you.

Moderator

Thank you very much sir. Participants who wish to ask questions, may please press *1 now. 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 hand over the floor back to Mr. Patel for final remarks.

Pankaj Patel

Thank you very much for joining the conference call and I look forward to talking to you again next time. Thank you and have a nice weekend.
