

## Syngene International's Q3 and 9M FY 2018 Conference Call

January 24, 2017

### Key Participants from Syngene International

- Mr. Jonathan Hunt: Chief Executive Officer
- Dr. Manoj Nerurkar: Chief Operating Officer
- Mr. M.B. Chinappa: Chief Financial Officer
- Ms. Chanderlekha Nayar: Investor Relations

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**Moderator:** Ladies and gentlemen, good day, and welcome to Syngene International's Q3 FY 2018 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode, and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal the operator by pressing '\*' and then '0' on your touchtone phone. Please note that this conference is being recorded. I will now hand over the call to Ms. Chanderlekha Nayar from Syngene International. Thank you and over to you, ma'am.

**Chanderlekha Nayar:** Thank you Stanford and good afternoon to everyone. This is Chanderlekha Nayar from Syngene Investor Relations Team and I welcome you to Syngene International Earnings Call for the Third Quarter Fiscal Year 2018. To discuss our financial and business performance, outlook and address your queries, we have with us Mr. Jonathan Hunt – Syngene's Chief Executive Officer and the Senior Management Team. I hope you have gone through our result release and the quarterly investor presentation, which have been uploaded on our website as well as the Stock Exchange website. Before we proceed with this call, I would like to remind everybody that this call is being recorded and a replay will be available for the next few days immediately after the call. The transcript of this call will be made available in a week's time on the company's website. I would also like to add that today's

discussion maybe forward-looking in nature and must be viewed in relation to the risks pertaining to our business. The Safe Harbor clause indicated in our Investor Presentation also applies to this conference call. After the end of this call, in case you have any further questions, please feel free to reach out to me. Over to you Jonathan.

### **Jonathan Hunt:**

Thanks Chanderlekha and good afternoon ladies and gentlemen.

Thank you for joining us on this earnings call following the announcement of our third quarter results for FY18.

I will start with a high level overview of our financial performance during the quarter before getting in to the quarter's business performance. Mr. Chinappa, our CFO, will cover finer details of our financials in his address.

### **Financial Overview**

I am happy to report that the growth momentum of the last two quarters continued to pick up pace into the third quarter.

Revenue grew 15% during the quarter to Rs 399 Cr while on a year-to-year basis, our 9-month revenue is up 11% to Rs 1059 Cr. strong fundamentals and I think robust business model at Syngene. EBITDA for the quarter is up 8% to Rs.138 crores and the profit after tax line was up 10% to Rs.82 crores. So overall good growth across all the businesses.

Our Chemicals Development business within the Development and Manufacturing vertical continue to pick up pace and we also saw good traction in our Discovery Services vertical.

Good cost management together with some fiscal benefits in terms of higher tax incentives helped us deliver good profitability margins... Chini will give some more details and comments on that later.

## Business & Operational Highlights

Let me turn now to “Key Business and Operational Highlights” as we see them in the quarter. So, as you know, Syngene share a long association with Bristol-Myers Squibb starting all the way back in 1998. In 2007, we set up our first dedicated R&D Center to BMS and today that is the largest research facility for BMS outside of the USA. I am happy to update you that Syngene and BMS further consolidated this partnership during the quarter by expanding the scope as well as extending the duration of that collaboration. So under the changed agreement, Syngene will set up an additional new facility, will put dedicated team of Syngene scientists within that and support the future R&D requirements of BMS. The duration of the collaboration also was extended and now runs to 2026, gives us very good long-term visibility. The collaboration with BMS really is the “Flagship” relationship and this expansion I think gives good validation to the exceptional quality of science that Syngene delivers to BMS to meet their R&D requirements and this would enable the two companies to collaborate ever more closely and across a wider range of scientific and research and development really there with the aims to develop new drugs that will bring benefit and betterment of patient communities around the world.

## Agreement with Zoetis

Also during the quarter, we entered into a multi-year development and manufacturing relationship with Zoetis. Zoetis is I am sure you know is a global leader in animal health. They work on discovering, developing and manufacturing a diverse portfolio of animal health medicines and vaccines. The agreement includes Research and Development activities but also provides for development and commercial scale manufacturing.

## CAPEX and S2 update

So let us turn and quickly look at “Future Investments, CAPEX Projects and also Update you on the S2 Facility.” So, our new Biologics manufacturing plant is now

operational and will significantly boost to our commercial scale biologics manufacturing capabilities and capacity. The plant comes with three state-of-the-art single use bio-reactors, each one has got the capacity of 2,000 liters and is designed to both manufacture clinical as well as commercial batches for the global markets.

The construction activities at our upcoming API manufacturing facility in Mangalore have commenced and we expect that facility to be operational in FY20, which will significantly ramp up our commercial scale manufacturing capacities.

The S2 refurbishment activities are in full swing and we are expecting that facility to be back in operation by the first quarter of the next financial year. We have also received Rs.61 crores towards the second tranche of the insurance claim and we will continue to work closer with the insurance provider towards the final settlement for the claim.

### **Management Update**

Switching on next to say the Management side:

We have strengthened our global commercial leadership as well as the EHSS function. Ashu Tandon joins us as Chief Commercial Officer and he is going to drive global commercial activities which include business development, marketing, brand building, customer relations and key account management. He will continue to be based out of the US but has global responsibilities.

In EHSS, Rajendra Patel joins us as the Head of EHSS and he is going to drive various initiatives across the company to continue to maintain strong safety systems, strong safety processes across the organization.

So with that let me make some “Summary Comments” before I hand over to Chini for some of the key highlights of the quarter:

- Very pleased with the growth momentum we saw that pick up throughout the quarter
- Our business development activities are paying dividends and we are engaging new customers, which signifies good future prospects, especially in the Biologics segment
- The commissioning of our new Biologics manufacturing facility brings capacity that we need on line and the S2 facility is nearing completion and that gives some more headroom for growth in our Discovery Services segment
- So overall I see it as a good performance in a particularly good quarter

I will now hand over to Mr. Chinappa our CFO to give more details on the financial performance during the quarter.

Thank you

**M.B. Chinappa:**

Thanks Jonathan and afternoon everyone.

Let me give you brief of the Financial Highlights for the Quarter and Nine Month Period. I will then cover the “Impact of the Interest Income”, will provide an “Update on the CAPEX Program” and the “Impact of the Currency Movement. I will finally reprise you all on the FY18 Directional Outlook.

Coming to the quarter result, we have registered a robust revenue growth of 15% in Q3 FY18 at Rs. 399 crores compared to Rs. 347 crores in the same quarter in the previous year.

In constant currency terms, our revenue growth is 4% higher at 19%. The average realization against the US dollar was at Rs.64.6 compared to an average of Rs.67.3 in the same quarter in the previous year.

The EBITDA at Rs.138 crores, is up by 8% as compared to Rs. 127 crores in Q3 FY17, while the profit after tax at Rs.82 crores, is up by 10% as compared to Rs.74 crores in

the same quarter in the previous year. EBITDA and PAT margins for the quarter are at 34% and 21% respectively, compared to 37% and 21% respectively in Q3 FY17.

During the quarter, we have recorded an interest income of Rs. 11 crores. Associated with the interest income are finance charges of Rs.5 crores and income tax of Rs.4 crores. If we exclude the benefit of interest income, the revenue growth for the quarter is at 17%. Adjusted EBITDA and PAT margins for Q3 FY18 is at 33% and 20% respectively.

Turning to the cost elements - our material and power costs, as a percentage of revenues, have marginally increased to 29% this quarter compared to 28% in Q3 FY17. This is largely owing to the sales mix and pick up in Chemical Development revenues as Jonathan highlighted earlier. Employee cost as a percentage of revenues is up marginally to 24% compared to 23% in Q3 FY17. The other expenses for the quarter are up by 25% reflecting a ramp-up in facilities and as well as on a/c of various initiatives in Business Development, Safety and Compliance. We also had one-off cost associated with the expiry of the Abbott contract and the hedging gain of Rs.15 crores in the quarter. As you may be aware, we had a contract with Abbott Nutrition that is about 20 FTEs and represented about 1% of our total revenue. Last year they extended the contract for a year and the same has expired as of December 2017.

### **Moving to the Nine Months Performance**

During 9M FY18 period, we have achieved a 11% revenue growth to Rs. 1,059 crores compared to Rs. 956 crores in the same period last year. I would like to point out that this includes the benefit of Rs.65 crores from export incentive scheme. These benefits pertain to the period of FY'16, FY'17 and nine month of FY'18, all of which have been accounted in the current year based on the certainty of realization. This has helped neutralize the 4% impact of currency depreciation.

EBITDA at Rs. 381 crores, reflects 36% margin compared to Rs.354 crores and 37% margin in the same period last year. Profit after tax is at Rs. 221 crores compared to Rs.209 crores as at 9M FY17. PAT margins stand at 21% against 22% in 9M FY17.

The effective tax rate for nine months ended December 31, 2017 was at 18%. We will continue to benefit from the tax incentives applicable to Special Economic Zones; however, we expect to see an increase in tax rates from FY19 onwards as some of the units come out of the tax holiday period.

### **CAPEX and Balance Sheet Items:**

As regards to the CAPEX, we have so far committed a total spend of \$103 million against our ongoing \$200 CAPEX program. This includes \$72 million for expansion of facilities in Bangalore and another \$31 million towards the upcoming commercial API manufacturing facility in Mangalore. I am happy to share that the construction at Mangalore site has commenced and we remain committed to commissioning the facility in FY20.

The net cash position as at December 31, 2017 is Rs. 95 crores compared to Rs. 280 crores as at March 31, 2017. As you are aware, we receive advance from some of our customers which should come in the month of January and increase the cash balance as of March 2018.

### **Insurance:**

As regards the insurance claim related to the S2 facility –we have now received the second interim payment of Rs. 61 crores, taking the total insurance receipts to Rs 81 crores. The balance insurance proceeds are expected to be realized along with refurbishing of the facility, which is scheduled to be completed in Q1 FY19.

### **Forex:**

About 93% of our CRAMS revenues are priced in US dollars and 3% in Euros. While we have seen a strong appreciation of the Rupee against the US Dollar, our hedging policy has helped reverse the negative impact of the rupee appreciation and is further expected to protect margins in the near-term.

### **FY18 Remarks:**

Lastly, as mentioned earlier, we expect to close FY18 with strong growth momentum, driven primarily by Biologics.

With this, I would like to hand over back to the operator and would be happy to take any questions.

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin with the Question-and-Answer Session. We will take the first question from the line of Nitin Gosar from Invesco Mutual Fund. Please go ahead.

Nitin Gosar: Hi, I have two questions: One is on the current quarter's number, the revenue seems to be around \$60 million. Should this be the base going forward on quarterly basis? #2 question is with regard to other operating income all the export incentives, if I heard it right, it is accumulation of FY'16-17 and nine months of '18 which got reported in this quarter number?

Jonathan Hunt: Chini, if you want to take the second question, but I will give a comment on the first one. I am almost tempted to say no, I hope our past three quarters results have fairly indicated good acceleration in our revenues throughout the year, to take sequentially the growth rate in first quarter at 6%, second quarter was 10%, third quarter is 15%. So even my expectation is we will continue to grow as we go into the past quarters. At the same time, we do not give forward looking earnings guidance or revenue guidance. Just the general commentary on what we see as the drivers within the business. With the Biologics capacity coming on line this quarter, we expect to see opportunity starting from the fourth quarter and of course going into the next full fiscal, which will then become revenue generating asset rather than CAPEX project. So that is another string to our boat. I am highlighting only on the broad performances across the business, we indicated that we have seen good pick up with Chem Dev during the year particularly in the third quarter, Discovery Services are doing well, Biology within the Discovery Biology group is one of those areas I think is a structural change going in globally amongst our clients business who have more demand for expertise in services within Biology. So, looks good, good



position, happy with the progress we made this quarter and I think it indicates good direction for future quarters. As I said we do not give particular earnings guidance. Chini, if you want to talk a little bit about moving parts on the export tax.

M.B. Chinappa: Nitin, these tax incentives are the incentives that come through the foreign trade policy. Till 2015 these benefits were not applicable to Special Economic Zone, these were only available for units operating in the domestic tariff area. However, to compensate exporters for the poor infrastructure, higher cost of credit, and high incidence of taxes, these benefits have been rolled forward also for Special Economic Zone w.e.f. 2016; however, the procedure for claiming this money and funding of it all, all of that was kind of uncertain. This year we have been able to claim for FY16 and then later also filed and realized claims for FY17. Following the certainty of the benefits under this scheme, we have started to record the income this year, Rs.65 crores is the total revenue recorded in the nine-month period, during the quarter it is Rs.20 crores.

Moderator: Thank you. We will take the next question from the line of Prakash Agarwal from Axis Capital. Please go ahead.

Prakash Agarwal: Trying understanding the run rate QoQ on revenue side and the cost side. So, if you see the other expenses seem to be running faster, you did mention that you have commissioned the Biologics plant. The understanding is correct that this is still to be revenue generating and if yes, what is the ballpark kind of revenue generation estimate that we can assume given its fully commissioned and operational?

Jonathan Hunt: Unlike sort of broader strategic comments, Chini, maybe you want to talk a little bit about the moving parts and the cost base during the quarter. I will have to disappoint you, I will go back to the comment I made in the last question. Just as a matter of policy, we do not give line item forward-looking guidance. But I think the most strategic benefits that if I have to look at where Syngene is, is the business that we are simultaneously growing while building and there is a lot of

investments, new capabilities and capacities going in. Some of it is about strengthening systems. So you have seen us talking during the year around our wish to continue to raise the standards under which we operate to make sure that we are definitively world-class when we talk about quality, safety and integrity of what we do. There is only one standard at Syngene and it is world-class and we have to operate to that. This state-of-the-art continues to evolve and pace with it and we have a willingness to do that. So this constant investment is making sure that we operate under very best standards. By the way this is visible in the marketplace and that is why our customers will often uniquely consider Syngene as a vector of choice if they are coming into India because while we are Indian in our heart and our soul, we operate with the world-class standards. I think the second question is just around expansion of what we do. We are not the same business we were five years ago on much broader base than predominantly say discovery chemistry and Chem Dev focused organization, we have now built debt for talent in biology, we have grown in other areas by the way that is not to say are not strategically important, but we have added biology to manage a whole number of other capabilities and you will see us continue to invest. At the same time, we have seen some pretty good revenue performance. So it is a little bit of building up a plane while flying in. You do not get to stop them and we are trying to keep that momentum going. Hopefully that gives you a sense of strategic framework I am putting on it. Chini, do you want to talk a little bit about the nuts and bolts of the moving parts?

M.B. Chinappa: If we look at the quarter, our total other expenses are about Rs.52 crores, this has a net of Rs.15 crores of hedging gain. So if we add back the hedging gains it is at Rs.67 crores other expenses as compared to Rs.42 crores last year, however last year we did not have any and would be at about Rs.40 lakhs of hedging gains. So the cost increase is really Rs.42 crores to Rs.67 crores, which is Rs.25 crores cost increase. I would split this into three parts roughly a third each -- One-third is associated with some one-time cost associated with the expiry of Abbott contract, one-third would be linked to expansion of our facility as we ramp up and another

third is that as Jonathan mentioned towards the initiative launched in business development, safety and compliance.

Prakash Agarwal: Just to reconfirm, this expansion of facility especially the Biologics, has it started to generate revenues or in future quarters we will start seeing that?

M.B. Chinappa: It started to generate revenue last quarter but most of the projects will be looking up for completion in this quarter. The higher impact of the new facilities will be reflected truly in Q4 FY18.

Jonathan Hunt: Little bit to clarify that, Chini, the revenue driver from that new Biologics capacity will start making some impact in the P&L from next quarter onwards. However, please note that it is a long way to go to fill this facility with the business, it is just operational now is the point we wanted to make.

Prakash Agarwal: Just a last question here, this is a follow-up on the previous question; I am trying to understand the consolidated EBITDA margins. Little pressure that we see is more of timing issue because few of the facilities are yet to be fully operational and revenue generating. So once that comes in, we will be back to our 33-34% EBITDA margin is what I am trying to understand?

Jonathan Hunt: The EBITDA margin for the quarter was 34%.

Prakash Agarwal: No-no, the street does excluding other income, so we are talking of the operational margins which is 32 is what I am trying to understand?

M.B. Chinappa: Roughly 33%...

Prakash Agarwal: There have been some operating leverage is what I am trying to understand, if a little more color could be given, that would be very helpful?

Jonathan Hunt: I have to give the premise of your question about why comments we have made in the past. Business like ours, with the mix that we got skills and capabilities of differentiation, EBITDA margins in the low-30s is a strong performance,

one should drift not beyond sort of 32-33-34 percent, because then you are start getting those strong performance, which we are capable of doing. We currently are in high-teens tax, 20s as the PAT margins look solid and sustainable during business cycle.

Moderator: Thank you. We will take the next question from the line of Nishant Chandra from Temasek. Please go ahead.

Nishant Chandra: Chini, on this accounting of this export incentive, is it all booked in Q3 or is it evenly spread out over the three quarters?

M.B. Chinappa: Rs.65 crores in the nine months period, Rs.20 crores in Q3 FY18.

Nishant Chandra: Given that it is an element of catch-up, why is it actually fails across the three quarters?

M.B. Chinappa: It is linked to each year's incentives, in Q1 we actually filed and received a benefit for FY'16, FY'17 as rates were not notified till that time. In Q2 we got the FY'17 rates notified, we filed the claim and accounted in Q2, and then FY'18 rates got notified in Q3, that got filed.

Nishant Chandra: The second one is on the hedging. So I understand that we do like portfolio hedging of sorts trying to match revenue profiles and the hedging profile. I have two questions in this one: Currently, what would be let us say percentage of notional hedge that we have outstanding to the extent, any color that you can give around percentage of revenue, run rate covered or anything to sort of quantify that? Second thing is from contract renegotiation principles perspective, our costs are primarily in rupee and hence on the incremental renegotiations, are we able to pass through this element of effectively INR appreciation to our customers, just directionally would be fine, just to get some color on what is happening on the business?

M.B. Chinappa: The hedging policy covers 100% of our net year-one exposure, 70% of our net year-two exposure and 100% of our long-term fixed price contracts. So that is how we go about the hedging, this have been consistent over the last 10-years. So that really gives us a near-term protection and gives us a window to start discussing with clients and looking at opportunity to deal with any appreciation of the rupee if we can either improve efficiencies, cut costs or increase billing rates. Typically, there is a lag between the currency movement and a point at which you can negotiate with the customers, you cannot keep going back to them quarter-on-quarter. If rupee appreciation persists, that will be another point of discussion as we negotiate with our clients.

Jonathan Hunt: Just maybe put a bit of flavor around that, Chini. Our history particularly with some of our larger long-term strategic clients is they take a very pragmatic view around the currency movement. We have seen a period of dollar appreciation, rupee depreciation, and they have understood the economic impact that has on us and then they have been pragmatic around it. I would expect to be similarly pragmatic if the same thing happens in reverse because ultimately what I am looking forward is value creation in their own businesses through excellent times of innovation and then are looking to do that purely through FX translation on effect, it is faith, innovation and science, but the real super returns in value creation is in dealing with an organization like Syngene and the work we can do for them. So this tends to be quite pragmatic and I think well-balanced discussions. None of us have to call the currency markets would be perfect in any given future period.

Nishant Chandra: Just to sort of put some context to my question, so the last year or so have seen reasonably large magnitude appreciation of the rupee and it sort of persisted for a while to the extent that I do not know if it has been brought up during the current round of negotiation especially in the non-long-term customers, because long-term in any case you cover, only those which are coming up for renewals or let us say newer contracts with the same existing bunch of customers where we would have this principle of FX movement coming into the negotiation table. So I was wondering if it has been discussed at this stage or we still feel that it is still too early

and hence we are just holding it back till it becomes far more structural adjustment that we see on FX?

Jonathan Hunt: I think it is elements of both which it is not a new issue to have, you need to agree if you are pricing in multiple currencies. Not quite all of our contracts are in dollars, however our operations are in rupees, so it is just the standard delivery discussion. It has not got to the point yet where it is either bone of contention with our clients or unmanageable pain point garner for us and ultimately those discussions grounded in, tell me that how you can innovate correct sciences that you are going to do and increasingly elastic what is the translation of dollar cost and a price point. We are an added value service provider in the main not necessarily just the cheapest scientific solution.

Nishant Chandra: John, just to sort of get some perspective around points of engagement with your clients. Is the ultimate decision maker the R&D team and it goes to the CFOs office for just a practical sign of a house-keeping or do you face two negotiation teams; one for scope with the research team and second on the commercials with let us say the finance team or the CFOs office?

Jonathan Hunt: I think it is much more complex than that. You are going to have the operational science as you are going to have the R&D leadership, you are going to have the CFO and the finance team, you missed procurement, in many big organizations either heavy hand on the strategic partner depends on the line they take. So it can be more complex than that, but in the manner it works.

Moderator: Thank you. We will take the next question from the line of Paresh Dave from SBICAP Securities. Please go ahead.

Paresh Dave: First question, extending on the EBITDA margin question which was asked earlier, is there scope for margin expansion through the biologics facility, in the sense that is biologic actually a higher margin potential for us wherein it could lead to some kind of margin expansion, I am trying to get an indication as to is this better profitable business?

Jonathan Hunt: We will discuss in abstract terms and directions rather than particularly. In general, there are a couple of things I think we always do which is that in the Biologics it can be a good business, we have just put new capacity and so things like asset utilization curbs, getting the maximum return under the asset you go. We are nowhere near that yet because we are on day-one, we have only just brought that infrastructure on line. So that is going to take a period of time. Our management period of time is in physical terms that you need to think about it, it is not going to happen over night. Second thing is the manufacturing businesses compared to say FTE or even fee-for-service type work has scale efficiency. If you build a factory, you can drive up your utilization and your efficiency. So I think it is a good move. It is prospectively good margin business but let us go and win those relationships, bring the businesses and then you see it in the P&L. So lots more operational work and sales and business development to be done before you could really see that jumping ahead in the quarter's earnings and revenue.

Paresh Dave: Second question was with respect to the US. Is there any impact on the change on tax laws in the US, I mean, will the companies taking services from us will be taxed higher due to outsourcing their business, any such indication?

Jonathan Hunt: I am not aware of that is being an issue or even something from the agenda.

Paresh Dave: Sub-part-2 is we have opened a new office in US. Is it more from the perspective of business development or is there a scope for R&D as well?

Jonathan Hunt: I think the first situation is that it is about being close to customer and convenience, it is about having great quality communication you take the same time zone, it is about making sure that all of the science we do is easy for people to access because it just demonstrates around the corner, metaphorically. So you are primarily around the key relationship building and business development as well.

Thank you. Ladies and gentlemen, we will take the last question from the line of Ashish Thavkar from Motilal Oswal Asset Management. Please go ahead.

Ashish Thavkar: Jonathan, would like to have your views on ADC, since you are working on ADC, would it be safe to assume that you would also be working on the Oral and Injectable side of the cancer treatment?

Manoj Nerurkar: Yes, we are, I mean, ADC business, as you know is predominantly Injectable, it is intervention that is given as an injectable drug. Having said that the new formulation facility that we just inaugurated a couple of quarters back, does cater to oral solids business as well. So a lot of these novel drugs which require oral solid tablet capsules powder, all those are developed and the clinical supplies are manufactured and supplied to a client for conducting clinical trial. As far as the Injectable is concerned, currently, we are in a drug substance space but also looking at what other opportunities are available on the injectable drug product side.

Ashish Thavkar: So much of action happening in the Oncology space in the US, just wanted to know whether we would have gotten enquiry from our clients for doing directly in Phase-III clinical studies?

Manoj Nerurkar: No, most of these clinical studies are actually global studies and therefore they happen around the world in different countries. We being a clinical trial player only for India and India-specific studies, our business is limited to only this geography. Yes, we do some bit of Phase-III studies but that is not predominant part of our clinical business.

Ashish Thavkar: Last one for Chini, you are saying there was increase in tax rate. Any guidance on that?

M.B. Chinappa: It is a complex thing, but my sense is it could be up 1-2% over current tax.

Moderator: Thank you. Ladies and gentlemen, that was the last question. I would now like to hand the conference over to Ms. Chanderlekha Nayar for closing comments.



Chanderlekha Nayar: Thank you, everyone for joining today's call. In case you have any questions please feel free to reach out to me. Have a good evening.

Moderator: Thank you very much. Ladies and gentlemen, on behalf of Syngene International, that concludes this conference. Thank you for joining us and you may now disconnect your lines.