Aarti Drugs Limited

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To,
Listing/ Compliance Department
BSE Limited
Phiroze Jeejeebhoy Towers,
Dalal Street,
Mumbai – 400 001

BSE CODE – 524348

To,
Listing/ Compliance Department
National Stock Exchange of India Limited,
"Exchange Plaza", Bandra - Kurla Complex, Bandra (E), Mumbai – 400051

NSE SYMBOL: AARTIDRUGS

Dear Sir/Madam,

Sub: Transcript of Q3 FY22 Earning Conference Call

Please find attached herewith transcript of Q3 FY22 Earning Conference call.

Kindly take the same on record.

Thanking you,

Yours faithfully,
FOR AARTI DRUGS LIMITED

AARTI DRUGS LTD. MUMBAI

RUSHIKESH DEOLE
COMPANY SECRETARY & COMPLIANCE OFFICER
ICSI M.No.: A54527

"Aarti Drugs Limited Q3 FY22 Earnings Conference Call"

February 02, 2022

Management: Mr. Harit Shah – Whole-Time Director, Aarti Drugs Limited
Mr. Adhish Patil - Chief Financial Officer, Aarti Drugs Limited
Mr. Vishwa Savla – Managing Director, Pinnacle Life Science Private Limited

Moderator: Ladies and gentlemen, good day and welcome to Aarti Drugs Limited Q3 FY22 Earnings Conference Call. This conference call may contain forward-looking statements about the company which are based on the beliefs, opinions and expectations of the company as on the date of this call. These statements are not the guarantees of future performance and involve risks and uncertainties that are difficult to predict. 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 an operator by pressing * then 0 on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Adhish Patil - Chief Financial Officer at Aarti Drugs Limited. Thank you and over to you, sir.

Adhish Patil: Thank you. Good morning, everyone and thank you for joining us today to discuss our financial results for the quarter ended December 31, 2021. At the onset, I hope everyone is healthy, safe and taking all the necessary precautions in the wake of the third wave of COVID-19.

Before I take you through the performance highlights, allow me to remind you that as communicated in the earlier earnings call, the financial performance on a year-on-year basis is exactly comparable, especially in the terms of realizations and margins because of elevated API crisis, driven by sudden supply disruptions due to COVID-19 related lockdowns during last year. The company posted robust growth in the revenue and profitability along with considerable improvement in the margins on a sequential basis. The robust performance was delivered in spite of the high freight cost, elevated coal prices, and sustained high raw material prices.

I will now take you through segment-wise performance. First, we will discuss standalone business performance. The standalone company has contributed around Rs. 579.9 crores to the total consolidated revenues in Q3 FY22. This contributed approximately 91% to the consolidated revenue. Around 59% of these revenues came from the domestic market and 41% from the export market. I would like to point out that we will be putting up some corrections in our press release as follows. There were some mistakes. So our domestic revenue for the standalone business grew by approximately 10% on a year-on-year basis for the current quarter and exports grew sharply by around 54.4% year-on-year basis. We expect the trend in export to sustain for a few quarters considering the current inquiry generation piece of export markets.

Similarly, domestic business is at the cusp of witnessing a recovery. API volumes grew by around 12% year-on-year led by secular growth across acute as well as chronic therapies. For Q3 FY22, within the API segment, the antibiotic therapeutic category contributed around 46%, antiprotozoal around 16%, anti-inflammatory around 10%, antidiabetic around 14%, antifungal around 10% and rest contributed around 5%.

Now we will discuss formulation segment performance. For the quarter, revenue for formulation stood at Rs. 54.9 crores, approximately 30% of the revenue came from exports during the quarter. The companies is well on track to increase exports for this segment, primarily driven by growing penetration in Latin America and selective African markets, new registrations in export markets and government tenders. The company is strategically utilizing foreign subsidiaries to tap these opportunities.

Now, we will discuss the specialty chemicals and intermediates segment performance. For the quarter, revenue for specialty chemicals and intermediates stood at Rs. 66.6 crores which grew 62% quarter-on-quarter basis and 74% year-on-year basis. We firmly believe that this segment is at the inflection point and a unique value proposition in which product profile and upcoming capacities in chlorosulfonation products are expected to bolster the growth momentum further. On a consolidated basis for Q3 FY22, the revenue stood at Rs. 641.5 crores. EBITDA stood at Rs. 96.7 crores and PAT at Rs. 58.3 crores. EBITDA margin percentage came in at about 15.1% on a consolidated basis. The company posted robust growth in revenue and profitability along with considerable improvement in the margins on a sequential basis as mentioned earlier. This robust performance has come amidst multiple headwinds in terms of high raw material prices, high freight costs and high coal prices. The margin expansion is primarily driven by proactive price hikes, API volume growth across therapies and strict cost control. The volume growth is expected to accelerate further on the back of recently commissioned anti-diabetic capacity, also upcoming antibiotic chlorosulfonation capacities in near future will give impetus to volume growth in the next financial year. This coupled with a growing share of niche products in chronic therapies and a strong API product launch pipeline is expected to augment the margin profile and profitability.

For 9 months FY22, the revenues from operations stood at Rs. 1,802.7 crores as against Rs. 1,656.6 crores last year, up by 8.8%, year-on-year basis. EBITDA stood at Rs. 251.8 crores, EBITDA margin came in at 14.0% and PAT stood at Rs. 149.7 crores. The investing cash flow for 9 months FY22 stood at Rs. 103 crores and is expected to be in the range of Rs. 150 to 200 crores for the entire FY22 which will be funded through a mix of internal accruals and debt. The pace of CAPEX was impacted to some extent due to the incessant rains in Maharashtra and Gujarat during the first half of FY22, however, the CAPEX of Maharashtra projects has picked up a good pace and Gujarat projects will follow the suit. The balance sheet continues to remain strong with the comfortable net debt to equity ratio of 0.51x as of December 31, 2021. We can now begin the Q&A session and we will welcome questions from the participants.

Moderator: Thank you very much. We will now begin the question-and-answer session. The first question is from the line of Abdulkader Puranwala from Elara Capital. Please go ahead.

Abdulkader Puranwala: Sir, my question was basically on the margin front, so this quarter we did see some improvement on an EBITDA front, I wanted to understand that are we still holding our long-term EBITDA margin guidance with close to 18% and by when should we see this starts getting reflected into our reported numbers?

Adhish Patil: Abdul, I got your question, the thing is the recent drop in gross margins was mainly because of rise in the raw material prices. Now we have taken the price hike at the output side, the selling prices have gone up and now we are seeing a trend of reversal which will take time though, but we are seeing the negotiated prices in the month of December for raw materials, they are coming off, they are tapering off, so we do feel that the gross margins will improve in future and also as far as the EBITDA margins are concerned, the coal has been the major factor, means we lost almost Rs. 5 to 6 crores of EBITDA per quarter just because of the rate variance in the coal which seems to be temporary in nature and should revert back. So, on the long-term basis, yes, we do aim for that 18% margin of EBITDA.

Abdulkader Puranwala: My next question is basically on this chlorosulfonation opportunity what you highlighted, going ahead, how should we look at specialty chemical as a division and what could be the contribution of this business say in the next 3 to 4 years?

Adhish Patil: Yes, the thing is we are adding up capacities in specialty chemicals, in fact, one of the chlorosulfonation line will be active in this current month itself in February 2022. So, we expect the specialty chemical, the potential is the capacity potential to almost double from what we are right now with this current capacity addition and we also plan for Greenfield CAPEX which is yet to start for specialty chemicals. That would be another leap forward in terms of increasing the pie of specialty chemicals segment to our overall segments, but right now in short term, in near future like in the next 2 years' time, we can see that we can double the revenues from specialty chemicals from where we are right now.

Abdulkader Puranwala: Just a followup on this, so the spec-chem revenue, when we are talking about doubling, does that include what we doing under the PLI as well?

Adhish Patil: No, these are the regular products, I am talking on an overall basis.

Abdulkader Puranwala: And on the opening remarks, you mentioned about some delays which had happened on Maharashtra because of the ongoing pandemic, sir how should we look at the overall CAPEX trend, has the timeline now been revised by almost 6 months, what you are going to complete, say by next year?

Adhish Patil: So, the thing is right now we are doing big Greenfield expansion at two locations, in Maharashtra and Gujarat. So, the Maharashtra capacity ideally should come up by December 2022, it should be commissioned and ready whereas the Gujarat facility should come up by February-March 2023. So approximately in 12 months' time, we still expect both these capacities to become operational.

Abdulkader Puranwala: So not much of a delay?

Adhish Patil: No.

Abdulkader Puranwala: And just one final question on the formulation business, though this being from the last couple of quarters, formulation business is not picking in the pace as kind of what we have expected, so going ahead, as you mentioned one would be the Africa segment, but what could be the other driver of this business within the existing geographies what you are currently catering to?

Adhish Patil: I think Vishwa can handle the question.

Vishwa Savla: From the existing geographies for the next couple of years, where we have established ourselves majorly in Latin America and Africa. We have now our distribution in place and we are adding more and more products. A lot of our products are under approvals and we are receiving the approvals and we are also participating in institutional tenders that will give us a higher growth push. So, for the next 2 years we will continue having growth from our exqisting territories and at the same time, we are working heavily onto the development of products for regulated markets in Europe and North America and those markets will start picking for us in about 2 to 3 years, so for long-term growth, we are anticipating from regulated markets, whereas short term for the next 2 years, we have good growth plans from our existing market.

Moderator: Thank you. The next question is from the line of Cyndrella Carvalho from Centrum Broking Limited. Please go ahead.

Cyndrella Carvalho: Adhish, if you can help us understand if I look at, you mentioned in your commentary also that there is some supply-side pressure on the input cost is reducing or easing off, but in terms of earnings reflection, when do you see that will reflect meaningfully and if the pricing of past levels are coming off or easing off, would that mean that our final price also would get adjusted to it and by when do you see all these things, even there will be a gap, we understand in terms of seeing the current prices in our earnings, so can you help us understand the current scenario where we are and how should proceed over the coming 2-3 quarters?

Adhish Patil: I will answer this question, like few details, after we order local materials, typically within one month's time, it will be delivered to the factory. After we give our input purchase orders, then within 2 to 3 months' time, they get delivered to the factory. Now the trend what we have observed is that on the monthly basis, if I analyze the purchases which we received at the factory in the last quarter, till we saw that more than 60-70% of the raw material has the maximum rate in the month of December when that material came into our factory, so that will definitely affect the margins of the month of January and February, but because we have taken price hikes that will insulate us to some degree, no doubt about that and as far as the purchase orders are concerned with the negotiated purchase order rates, what we have observed is that only 17% of the raw material had maximum purchased negotiated rates in the month of December and more than 80% of the raw materials, the rates have fallen down in the month of

December, so that will definitely show up towards the end of this Q4 and the first quarter of next financial year.

Cyndrella Carvalho: So basically starting next year, we should see normalization, but would that mean that our end prices also will adjust accordingly if the raw material comes down, you see some impact on pricing?

Adhish Patil: To some extent, we will see, no doubt about that, but the main challenge what we had been facing in last year was the sudden variations in the price. Whenever the prices settled down for the three months or so and talking about the raw materials and then we can easily reach that 17-18% EBITDA margins based on the volumes which you are manufacturing, but then any movement in the prices, usually that kind of shocks, it is difficult to exactly correlate the selling prices with the input prices.

Cyndrella Carvalho: On the demand side, we are seeing some good traction which is the positive scenario, but I understand that most of it would be driven even by the price hikes that we are taking, so how is the outlook on the demand side and if you can help us understand on the specialty and the API side, both put together and if you can help us understand the formulation run rate that we should look at from an annual basis, that will be helpful?

Adhish Patil: As far as the specialty is concerned, right now, our capacities are very small as compared to the global demand, so it will be relatively easy to capture the market and it won't be difficult and our new processes or cost will also be much lower than our existing cost of production for the same product in chlorosulfonation, so definitely specialty chemicals, we should be able to sell quickly. As far as the APIs are concerned, can you repeat the question related to the API?

Cyndrella Carvalho: API also, I am asking you on the demand side, we are seeing some strong traction, but however, the cash accompanied by the license fees is also, so how should we see this?

Adhish Patil: As far as the exports are concerned, we have a lot of demand, because we already have a lot of pending orders in line and domestic API demand usually picks up in the fourth quarter of every financial year because that is the time when most of the formulation company increases their production policy, so now in Q4 ideally the demand should be more for APIs in domestic and for formulation from 2 to 3 years perspective, I will request Vishwa to answer your question.

Vishwa Savla: Yes, so in formulations as well, we are expecting good growth mainly due to some capacity enhancement in our existing facility as well as product line expansion in terms of getting new products and products with better margins and our new Greenfield project into oral oncology is also upcoming which we are expecting to commission by the end of quarter 2, so that will also over the next 3 to 4 years give us good revenue growth with improved EBITDA levels.

Cyndrella Carvalho: Sir, what should be our annual run rate and we have seen some decline in the H1, how should we see it over coming 2 to 3 years, any range that you can help us understand because if you are talking about oncology also, how big it is? What is the basket of the product? How much can it contribute? Would from a get **a** 20% share, can it become 14-16% or 18-20%? What range are we looking at if you can just help us with some numbers, some broad range would be helpful?

Vishwa Savla: Sure, so over the next 3 years, we are looking at a growth rate of about 25% annually and in oncology, we have about 10 to 12 products lined up in the oral oncology sector which we would be filing in the international globally regulated market, however, since we are targeting products with patent expiries, starting from 2024 to 2027, so oncology as a segments for us would start contributing post FY24, but even our general segment would give us growth of about 25% annually.

Moderator: Thank you. The next question is from the line of Ria Verma from Oracle. Please go ahead.

Ria Verma: My first question is formulation segment witnessed a decent amount of fall in revenue, so can you throw some light on that and when can we see a pickup in revenue again?

Vishwa Savla: I will answer that. So, the revenue fall in the formulation and Pinnacle was a temporary in this particular quarter due to lower demands actually in the domestic segment, however, we are seeing in the current quarter, in Q4, we will see good recovery and going forward in the next financial year, we will expect like further growth of about 25%, so I will say the drop in revenue was temporary and we are already seeing recovery in that.

Ria Verma: Secondly, you mentioned about the strong pipeline for product launches, can you give us some guidance in what are the products we are planning to launch in API's, formulation as well as specialty chemical segment?

Vishwa Savla: I will answer for formulation and probably Adhish can answer for this API and Specialty chemicals. So in formulations, we are currently having our pipeline of 8 products, majority of which are backward integration of the API and we majorly are into cardiac and diabetic new age products, so products which would be going off-patent from the next financial year, so we will be targeting day 1 launches in the majority of our markets and apart from that in oncology segment, we have a pipeline of about 10 products which are majorly tablets and capsules, new age oncology products especially in **these** category of products.

Adhish Patil: And regarding the API, if I tell you the main therapeutic areas where we are expanding in a big way, so antidiabetic, obviously is one of our favorite segments there where already launched couple of Gliptins in the current year, so there will in next couple of years, their the contribution should become meaningful. Then we are launching a derma product in the next financial year, then we are expanding, we already expanded one and one we are further expanding in the antibiotic segment. In antifungal, we are launching a new product very soon and also expanding the current one which we already have. Then, we are Brownfield expansion of one of our cardiovascular products which is very popular and then specialty chemicals as we discussed earlier in earlier concalls that we are coming in a big way in chlorosulfonation, then we are also doing backward integration for a few of the intermediates which we would also sell outside, means the derivatives of the intermediates, we will sell outside. And we also have contract manufacturing with MNC for one of the specialty or intermediate products which we have expanded recently because they have increased the business volume with us looking at our performance in the last couple of years. So the growth is seen across a lot of products actually in coming future.

Ria Verma: And my last question is, what is the current status of our US FDA inspection for our facility ?

Adhish Patil: We already got in contact in the December quarter for US FDA and the thing is we were in very close contact with ex-US FDA inspector, so they have already started doing our all the responses and everything. We already had done all the work, all the background work is done, so the last step is this month, ex-US FDA inspector reviews everything, they will come with the focussed approach to audit our plant in person at the site and then they will represent the case, they will represent the findings to the US FDA directly. Actually speaking, it was supposed to happen byDecember, it was supposed to happen that visit, but because of this third wave, their travel plans got delayed, so that is why they took another approach of first doing the remote audit or a remote review kind of a thing and then come in and do the onsite thing quickly.

Moderator: Thank you. The next question is from the line of Ranvir Singh from Sunidhi Securities. Please go ahead.

Ranvir Singh: Sir, just I wanted clarity on your earlier comment, so 17% you said the raw material cost was negotiated for your price that is what you have said?

Adhish Patil: Yes, I will explain again. The thing is, we took different analysis, one was the material which came into the factory every month and that material price was negotiated a couple of months before in the purchase order and the one analysis what we did was regarding the new purchase orders which we have raised and that material will come in after one month or two months or three months. So what I was saying that out of the total raw materials, for 17% of the raw material, the negotiated prices in the month of December was still the highest amongst October, November and December, but for more than 80% of the raw material, the prices have tapered, the negotiated prices have tapered off in the month of December.

Ranvir Singh: And this is the tapering off the price, it is triggered due to softening of prices there or?

Adhish Patil: May be yes because the sudden splurge was more of opportunistic kind of a price hike by our vendors because of demand-supply situation and there was frantic buying also in the market because the surety of the supplies was not there in those months, so lot of people have, in fact we have ramped up our inventory quite a lot in the quarter of December and that is another reason why our RM inventory had gone up, so that will also be one of the focus area in the coming quarter to reduce our operating working capital cycle, but then that was the reason, mainly it was frantic buying because of which the prices had gone up, so now with the clearer picture coming out in the market, the prices are softening a little bit.

Ranvir Singh: So, I wanted to understand this dynamics, so in case, after witnessing a hike in price and then again price has softened, in case again the price is hiked or normal industry runs in a way it was running last year, so again the raw material prices goes up, then negotiation of only that portion of raw material we will be able to do or it is nothing to do with this again the new negotiation will happen?

Adhish Patil: No new negotiations will happen, so this is done, meanswe have placed the orders.

Ranvir Singh: Another thing on the oncology side, what kind of API we are planning to produce, whether we will have a high potential facility there or what kind of API setting you are doing?

Adhish Patil: Oncology, we are doing at the formulation side, not on the API side.

Ranvir Singh: And sir, the last one, in the budget, some solvent customs duty has been reduced, so anyway are we benefiting from it?

Adhish Patil: Little bit we will be, means the quantum, very roughly speaking around 30 to 50 crores, somewhere in that range of the raw materials where the duty has reduced, the per annum I am talking about.

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

Tushar Manudhane: Sir, while you have explained nicely in terms of pricing factor, but just would like to understand this disruption in China, is this fundamentally or structurally driving more volumes to Indian companies like yours?

Adhish Patil: Definitely, right since 2018, a lot of events have happened in past that suddenly which basically is giving us an indication that China is moving more towards greener technology and they are focusing less and less on the manufacturing of specialty chemicals or intermediates and so on. Definitely, they will continue to focus in the areas where they have natural resources, so that they will continue to, but more or less the trend what we have seen is they are focusing more towards the greener technology. So definitely, all these events give an indication to global buyers that they should be derisking their supplies if they are depending only on China and that has started to happen. In fact, in this COVID only, for one of the very big top 3 molecules, one of the biggest MNC customers for that molecule were able to crack, the business of which earlier was going to China. So, we are seeing that trend, no doubt, so means it will be helpful in longer term.

Tushar Manudhane: And particularly for this Gliptins, while you are saying good orders for the Gliptin's front, but what is happening on, let us say the existing or let us say the other molecules in your diabetic portfolio?

Adhish Patil: So the other molecules are going really well, December was good and those are showing a promising signs lately.

Tushar Manudhane: And additionally, Gliptins is further over and above, that is the way to understand?

Adhish Patil: Yes.

Moderator: Thank you. The next question is from the line of Cyndrella Carvalho from Centrum Broking. Please go ahead.

Cyndrella Carvalho: So Adhish, coming to the API side, if I try and understand you have mentioned about Gliptins, how about our Metformin planned CAPEX, where are we on that? And in terms of Gliptin, what kind of market share do we expect to acquire over 2 to 3 years, what is the plan there? And in terms of Metformin CAPEX, if you can update us, that will be helpful?

Adhish Patil: Regarding Gliptins, it is more like a stage-wise expansion for us. We already have set up Gliptin multipurpose facility for both the products, but we have four production lines in that particular location, so our next stage was once the Gliptins grow for us, then we will shift one of the Gliptins under the line, so we will have two dedicated lines one for each for the Gliptin and then from there, may be after 2-3 years, if it grows even further then we have space to put up another block itself, so that will be like very major capacity. So, when that happens, then definitely we will aim for more than 50% of the market shares, that kind of capacity which we do for typically top 10 of our products what we have done, so that ground of expansion for Gliptins will come may be in the third year or so, but right now also we are very much, our capacity is good enough to get a substantial share of this, but Gliptins is a very growing market, but it is very difficult to put a number that how much share we will capture, it is a growing market. One of them is domestic-focused and other is export focused. As far as Metformin is concerned, we are going very strongly with our current capacity of 1,100 metric tons per month**.** The utilisation is going up rapidly. We also have European approval for that facility, we plan to do US FDA soon and we already have all the plans are ready. The civil work is yet to start, but it will be completed. Once the project starts, it will be completed within a year's time that 3,000 tons per month capacity. Obviously, if you are doing it in a phase wise manner, first it will be 2,000 tons and then it will be 3,000 tons per month. For other Brownfield expansions are concerned, this antibiotic expansion within the next 4 months it will be done, then derma capacity will come online may be by December 22, then another intermediate capacities will come online, may be around February to March 23, that is the end of next financial year and antifungal products also, there are few new launches of antifungal products also, which we will be taken up in one of the existing facilities and once it grows again, then we will have dedicated block for that. Then, our cardiovascular product also, we are looking almost to double the capacity from where we are right now, so there also, we are seeing good demand. So, a lot of expansions are happening, small ones also and also the big ones.

Cyndrella Carvalho: Any update on the PLI side, where we are you think, there is some delay there?

Adhish Patil: In the PLI there was a condition of spending around Rs. 78-80 crores of CAPEX to hit that PLI, but then we had a change of process and because of which we are able to put up the same facility in about Rs. 25-30 crores, so there was upfront saving of more than Rs. 50 crores. So, we thought that rather than taking, applying and getting PLI every year, about Rs. 8 to 12 crores per annum, it was better to save upfront, so we have already gone and set up the plant in whatever we had planned around three-fourth of that capacity is already commissioned and the rest one-fourth will also be commissioned very soon. So basically, what I am trying to say, instead of going for PLI, we have expanded in the same product, but with much lesser CAPEX which more or less equals to the PLI which we will be receiving in the next 6 years.

Moderator: Thank you. The next question is from the line of Bob from Falcon Investments. Please go ahead.

Bob: Could you explain why you formulation given that your sub scale. There is a lot of scope for APIs coming forward, so why do you, what is the need to go in?

Adhish Patil: More from a strategic point of view you are asking, right?

Bob: Yes.

Adhish Patil: So, the thing is that, I will just say that the basic strength of our company does lie in manufacturing bulk products where the volumes are very high, so we are doing that. Wherever we are getting opportunities we are doing that and specialty chemicals and intermediates is something very similar to what we already do which much lesser regulatory framework you can say, but manufacturing skills which are required remains the same for specialty chemicals and intermediates, so there also we are expanding, however, the only piece which are remaining for us for vertical integration was formulation. They are integrated on the backward side, but at the forward side, we were never integrated. So, what we thought that there are very few products, which it is very difficult. The number of formulation players are concentrated, then it becomes very difficult, but the APIs the number of formulation players are fragmented, there are 8 to 10 formulation players, then it becomes a very good business case to manufacture, API only, but if it is concentrated in 2 to 3 buyers, then it might be little difficult to sell that particular API with good margin. So, for this and for value addition purpose, we had introduced formulation as a strategy. Ten years back, many of the formulation players, they used to purchase our API and give it to a third-party manufacturer, a formulation manufacturer in Baddi that is in Himachal Pradesh and get their tablet manufactured from them. So, what we thought that rather than doing that, we can offer their tablets on our own, means we can give them combined pricing of API plus the formulation and that was the main, you can say starting point of our formulation business and slowly we become experts, we had our own facility, then we started registering in the export market because we saw there are few niche opportunities available with very high margin and that is the reason why we started with the formulation division. Let us see where it takes us.

Bob: For how many APIs as percent of revenue is fully backward integrated?

Adhish Patil: So, the top 10 API is contributing around 75%, top 15 would be somewhere in the range of mid-80s and the thing is out of top 15, in 13 of those molecules, we are the largest manufacturer in India and in few of them globally also, so I would say that once in which we are the largest manufacturer, we have reached there because we are either same or more backward integrated than our competitors. So, you can roughly assume that more than 80% of our revenues are backward integrated.

Participant: Completely back, so didn't import anything from China or elsewhere for 80% of your revenue?

Adhish Patil: No, the thing is, it is a very tricky phrase, saying completely backward integrated because there are a lot of stages, means we can go N-2, we can go N-4, N-7, but even for N-7, there might be some raw material which we might need from China, so that is always there. We can never get rid of that, but what we try to do is that we see how many manufacturers of that particular raw materials are there globally, is there any risk of supplies for that particular raw material, if there is and if there is good margins in that product as well, then that is the time when we take a call to go for further backward integration and for many of the products, which we are buying from China or elsewhere, we already have developed technologies as well, means it is just that we are ready with the technology, but we don't want to put the plant yet because we don't want to over invest because if you go further and further backward integration, then your return on assets will go down because the sales turnover will also go down to assets.

Bob: Yes, Adhish, at least say your backward integration for 80% revenues, what you really mean, what is your turnout?

Adhish Patil: What I really mean is it is all relating to the competition. That will be the good way of looking at it. As compared to our competition, how much you are backward integrated.

Bob: So, what you are saying is even the top manufacturer of these API would only be as backward integrated as you are?

Adhish Patil: Yes, correct, either as backward integrated or they will be less backward integrated than us

Bob: So, in terms of pricing, you won't lose out because of the level of integration?

Adhish Patil: It gives more sustainability, yes, correct.

Moderator: Thank you. The next question is from the line of Surajit Pal from BOP Capital Markets. Please go ahead.

Surajit Pal: I have only one question is that about Gliptin, what percentage of the revenue is coming from Gliptin if you can quantify that?

Adhish Patil: As of now, it is just launched. It is like negligible to our revenues. In a couple of years, the contribution will become meaningful, so as of now it is just like a launch, so in API typically there is a local market there is a gestation period of almost a year and for our export markets, it can take anywhere between 18 months to 36 months depending upon what kind of markets we are supplying it to. In the ROW market, it will be less, but in the semi-regulated and regulated markets, it will be more.

Surajit Pal: My doubt is that because recently what we are hearing from the formulators in India, Gliptin is gradually and slowly losing the market share to the new generation of molecules, as where they say is that Metformin has always been a gold standard from Metformin the second line of treatment is basically Gliptin and those Gliptin is losing market share to the Dapaglifozin kind of new generation molecule and Gliptin is mainly used as one of those combination products in diabetic treatment, so in that case, if you go by the IBM data also, Gliptin is losing market share and losing the value, so I was just wondering is that how prudent it is to get into Gliptin and increase capacity in that?

Adhish Patil: Yes, so the thing is, right now, it is a good information for us, no doubt. So right now where we have put Gliptin into the multipurpose facility, so we always have the option to, if any problem happens for Gliptin when we always have the option to convert that facility to something else, but as of now, when we see Gliptin is still way ahead of the next-generation molecules in terms of API sales, I would say, not formulation, but the API sales. So still it will take a lot of time for other molecules to catch up to Gliptin.

Moderator: Thank you. The next question is from the line of Gagan Thareja from ASK Investment Managers. Please go ahead.

Gagan Thareja: A couple of questions, one is, what is your dependence on China for your KSMs and intermediates by value?

Adhish Patil: So that would be a little less than 20% of our raw material purchases.

Gagan Thareja: And going into the future, you expect this to stabilize at these levels or is there any intention to bring it down?

Adhish Patil: Right now, there is no business case to do so, there is one product go, I wouldn't name the product, but there is one product where we are seeing business case and we are only working on that, but in the rest of that scenario means as of now, because the thing is, if the supplies are stable and there are more number of supplies in China, then it doesn't make sense to put up capacity right now, but wherever we see there is a problem, there are only two players, something like that, if you see any risk of supplies, then we decide to go further backward integration.

Gagan Thareja: But apart from China, where else do you source?

Adhish Patil: Europe and the Middle East.

Gagan Thareja: So, are they entirely outsourced or do you also have some in-house KSMs or intermediates?

Adhish Patil: No, we do a lot of in-house for a lot of products, we have like N-5, N-7 stages, so we manufacture a lot of products in-house. In fact, as I was talking earlier that in more than 80% of the cases, we will be either more or as much backward integrated as a competitor and that is the reason why our off-shore production is low. Apart from volume, means economies of scale, the second most important factor is backward integration in this business and that we have continuously done for our top 13 products.

Gagan Thareja: On the same topic, while I understand you have indicated that December on there is a softening in input prices, they are largely crude derivatives as I understand and given the current crude price scenario, do you see this softening sustaining or do you feel that it is small or temporary dip and thereafter the prices move back after that?

Adhish Patil: Is Harit bhai available on the call?

Harit Shah: Last year, whatever raw material prices went up was nothing to do with crude, so it was mainly demand-supply mismatch and some of the plants had closed in the US and China due to pollution and other things, so crude also definitely we will have some impact, but the price increase in last year, many of the commodity chemicals was not due to crude, but some other factor, demand-supply mismatch, so which is now tapering off basically.

Gagan Thareja: And this price increase, obviously you know is a consequence of the input price materials going up, right, I understand that one bit of it which you experienced is coming because of the disruptions in supply, but are these disruptions in supply especially from China of a temporary nature or do you think that because of the policy or regulatory changes in China, some bit of the input cost increases is sticky and would stay because the cost of production itself would have gone up on a permanent basis?

Harit Shah: Yes, the cost of producing chemicals, intermediate in China has definitely gone up because many of their plants they have to move to remote basis from the cities where they are earlier, so definitely they was supply, this price will be definitely the issue, whatever.

Gagan Thareja: My question is simply this, that is if let us say your selling price was 100 for a particular API and your input price was 60, input price went up from 60 to 70, there is a difference of 10 which you pass on, so 100 goes to 110 input, 60 goes to 70, so in absolute terms you have passed on the Rs. 10, but in percentage terms, margins will actually come down, right?

Adhish Patil: Yes, this is a very good question. The thing is, in the short run what you say is correct, in the short run like a month-to-month basis, but most of the companies, they are evaluated, even bankers also evaluate the company based on margin front typically, gross margin probably. So, in the short run, maybe people look at that, but on year to year basis, long run people try to revert back to margin, then what you say means, we will add one more rupee to return the margin as well, something like that, but in the short run, we may not be but in longer run, yes.

Gagan Thareja: And you got new capacities coming on stream throughout the next 12 months, what could be the OPEX related to that new capacity?

Adhish Patil: It is difficult for me to tell like that, difficult, I don't have exact numbers that exactly how much OPEX will go up, but typically what we have seen is that based on the historical numbers, historical trend, this thing has happened quite often in between last 10 years, it must have happened 3-4 times, when big capacities have come up. What happens is our earlier capacities, they also keep on getting more and more utilized, so more or less it averages out, so there is not big…..

Gagan Thareja: So what you are saying is that as you sweat your existing assets more, it absorbs the impact of the additional cost and the margin remains stable?

Adhish Patil: Yes.

Gagan Thareja: And what is your utilization on your existing capacity?

Adhish Patil: Right now, for the last quarter it was somewhere in the early 70s.

Gagan Thareja: So, you have some more room to sweat them?

Adhish Patil: Yes, we continuously as a part of what we call maintenance CAPEX, but it is actually maintenance plus debottlenecking CAPEX, so we continuously try to keep on increasing capacities with the existing plant as well and we had successfully done it in the last year for one of the antifungal products, one of our antibiotic products and coming year, we are planning to do in one of our cardiovascular products as well, so we continuously do that for Brownfield expansions as well, so that also helps us in having more margins in that plant which subsidizes the cost of additional OPEX because of the newer CAPEX, new branch.

Gagan Thareja: And your presentation mentions Rs. 600 crores CAPEX with sales potential of Rs. 1,200 of 5 to 6 years, what is the base or reference here or which were you are saying this 5, adding this 5 to 6?

Adhish Patil: So, the thing is typically we were assuming full capacity utilization in 4 to 5 years once the capacity is online and by next December 22 or you can safely assume by the end of next financial year, most of this capacity will be online, most of it, not all of it, but at least 70% of it will be online.

Gagan Thareja: By December 22?

Adhish Patil: December 22 or March 23, one by December 22, another by March 23.

Gagan Thareja: And the presentation also indicates that there is room to improve margin, so what is the cost levers or is it simply a sales mix related margin expansion if you could sort of help us understand attribution on both the sides?

Adhish Patil: One is the backward integration program, the big Greenfield CAPEX which we are doing, one is the backward integration that will help us. Another is having more or more phase the semi-regulated and regulated markets, we are consistently trying to take over and get more market share in those kinds of markets where the selling prices are higher and the margins are higher and another is, what we are trying to do is something what we have already done in products like Metronidazole wherein now, more than 95% of India's production is our company's position and rest is on China. So, we want to achieve that level of market consolidation because once that happens, then the margins become much more stable, so something like that.

Gagan Thareja: In which molecules do you see yourself getting that sort of transition?

Adhish Patil: There are quite a few, antibiotic products are there, one antifungal product is there, then in fact one anti-inflammatory product is also there, so there are quite a few molecules, which we have been manufacturing since the last 15 years.

Gagan Thareja: And then when your Latin sales goes up as it will over a period of time, it comes with its own set of issues in terms of currency volatility and probably higher working capital, if I understand that geography in some way, so in terms of currency risk, in terms of working capital, in terms of debt to equity, how are you thinking over the next 3-to-5-year timeframe your thoughts there?

Adhish Patil: As far as currency risk is concerned, more than 95% of the business in exports we are doing in US dollar probably, so that takes care of that. As far as working capital is concerned, you correctly pointed out that Latin America being the opposite side of the globe, it takes maximum transit time, so definitely the working capital required is more for those kind of sales, but then we accordingly charge, we built that cost into our selling prices which is taken care in that and your last question was regarding the debt to equity ratio, so debt to equity means whatever CAPEX we are planning and whatever internal accruals we will be generating and also we plan to do a shareholder payout of say around 25% of profit after tax. So considering CAPEX and the shareholder's payout, both considered together, we still feel that our debt to equity ratio should not go at a peak level beyond 0.7. That is what as of now we are envisaging.

Gagan Thareja: So you will take on more debt as you go, if you could just give us an idea of what is the?

Adhish Patil: We will take term loan debt, no doubt for the Greenfield CAPEX to some extent because the cost of debt is much cheaper than the cost of equity for us and historically, if you take out the last 6-7 years, then before that almost 30 years we have run the company with the debt to equity of around 1.5 and there was absolutely no default in any of the years in working capital so we were quite comfortable, but then we realized that we had the option of reducing the risk, so we brought down risk, every year, incrementally the debt to equity ratio kept on going down and now it is at 0.51, hence I said at the peak level, we are envisaging around 0.7, but again with more quarters as it will go by and the internal accruals which will add up, again the debt to equity ratio should come down to 0.51.

Gagan Thareja: What is the gross debt and where could it be?

Adhish Patil: Around 500.

Gagan Thareja: And at what sort of levels could it peak out?

Adhish Patil: Absolute debt?

Gagan Thareja: Yes.

Adhish Patil: Absolute debt, see in this 500 also, around 330 or 336 crores is a short-term debt only, working capital and the long term is less than 170.

Gagan Thareja: Like you would be adding to that, right?

Adhish Patil: Yes, now we will be adding long-term debt more, but then there is a repayment schedule also, almost 40 to 50 crores of repayments also happen every year in the long term. So, let us say, we will have to calculate that, we take another 200 crores of long-term debt and whatever working capital required for that also we take around 40 to 50% of that we find through debt, the increase in the working capital. So typically, the way we will function is, both put together, term loan and working capital debt put together, we will make sure that the debt-to-equity ratios doesn't go beyond 0.7 and when I state 0.7, I am also considering shareholder's payout in spite of doing that 25% shareholder payout, still we will be at the debt to equity of 0.7.

Gagan Thareja: And finally if you could just give me what is the budgeted CAPEX for FY23-24, if you give some idea of that?

Adhish Patil: As of now, the plans whatever we have announced in the investor presentation also those are the Greenfield projects right now which we have announced and apart from that around 40 to 50 crores of CAPEX is spent every year for enhancing GMP requirements or maintenance or debottlenecking of Brownfield expansion in the existing plant. All that is covering 40 to 50 crores per annum, so that line we will continue and the bigger ones we will announce as and when we decide, means 550 crores of CAPEX we have already announced and may be in a year's time, we will announce further Greenfield CAPEX.

Moderator: Thank you. Ladies and gentlemen, that would be our last question for today. I now hand the conference over to Mr. Adhish Patil for closing comments. Thank you and over to you, sir.

Adhish Patil: Thank you everyone for joining us on this call and giving more than 1 hour of your precious time. Please reach out to our IR Consultants, Strategic Growth Advisors or us directly if you have any further queries. You can now close the call. Thank you and have a nice day.

Moderator: Thank you. Ladies and gentlemen, on behalf of Aarti Drugs Limited, that concludes this conference. Thank you all for joining us and you may now disconnect your lines.

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