“Solara Active Pharma Sciences Limited Q2 & H1 FY23 Conference Call”

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MANAGEMENT: **MR. JITESH DEVENDRA – MANAGING DIRECTOR, SOLARA ACTIVE PHARMA SCIENCES LIMITED**
MR. S HARIHARAN – EXECUTIVE DIRECTOR AND CHIEF FINANCIAL OFFICER, SOLARA ACTIVE PHARMA SCIENCES LIMITED
MR. ABHISHEK SINGHAL – INVESTOR RELATIONS, SOLARA ACTIVE PHARMA SCIENCES LIMITED

Moderator: Ladies and gentlemen, good day, and welcome to the Q2 FY2023 and H1 FY23 Solara Active Pharma Sciences Limited Conference Call. As a reminder, all participant lines will be in 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 star then zero on your touch-tone phone. Please note that this conference is being recorded.

I now hand the conference over to Abhishek. Thank you and over to you.

Abhishek Singhal: A very good afternoon to all of you and thank you for joining us today for Solara Active Pharma Sciences Earnings Conference Call for the second quarter and half year ended Financial Year 2023. Today we have with us Jitesh – Solara MD and Hari - ED and CFO to share the highlights of the business and financials for the quarter.

I hope you have gone through our results released and quarterly investor presentation which have been uploaded on our website. The transcript of this call will be available in a week's time on the company's website.

Please note that today's discussion may be forward looking in nature and must be viewed in relation to the risk pertaining to our business. After the end of this call, in case if you have any further questions, please feel free to reach out to the investor relation team.

I now hand over the call to the management to make the opening remarks. Jitesh over to you.

Jitesh Devendra: Good evening, everyone. Thank you for joining the call today.

I like to start off with sharing good news that we have received CEP approval for manufacture of ibuprofen from our Vizag site which is in addition to our Puducherry site. We also received approval for ibuprofen DMF from China, for our Puducherry site, making a total of two products approved by Chinese authorities. This is our first step towards Vizag being qualified for regulated markets. We have also amended our US DMF to include Vizag as an additional site for ibuprofen with one of our major customers filing PAS application. We expect a prior approval inspection (PAI) by US FDA in the next financial year. We have initiated validation of new products from Vizag site, which shall be filed in second half of this financial year.

Coming to the Q2 performance:

We have a steady performance during the quarter with Q2 revenues at Rs.342 crores, which is greater than 85% of our historical run rate. I would like to reiterate that our course correction strategy is in action now. We continue to focus and build on the actions that we have initiated in this fiscal year to get back to growth, both in terms of revenue and margins improving, our cash flows and strengthening our balance sheet.

The first one **reviving the base business growth and profits** by bringing back the momentum, we had on customer centricity by better networking and continuing our focus on operating cost reduction, continuous improvement program and efficient inventory management.

With improved base business margins in Q2 FY2023 and along with our actions taken in H1, the stage is set for a stronger bounce back in second half of this financial year.

The second one **rekindling the R&D focus** by adding 15 plus new programs for the year and we are on track to file six new products in this financial year and adding more high-volume products under the cost improvement basket. We have filed eight new market extensions for nine of our existing APIs for Q2 taking the total to nine new market extensions for 10 of our existing APIs for H1.

The third one **Enhanced capacity usage at Vizag** by supplying validation quantities to our customers. Although our greater focus will be on regulated markets, we are tapping opportunities in markets with no regulatory binding, and we are planning certain product supplies from Vizag to markets where there is no less regulatory binding from Q3 of this financial year and this will help to reduce the under recoveries at Vizag. Our Vizag strategy is playing to plan as stated at the opening of my speech as one of our customers has already filed the PAS for the US FDA, and we have received the CEP approval for manufacture of ibuprofen. We have invested on lyophilization capability at our Vizag site which is a unique capability added for one of our ongoing product validations.

Coming to the update on the Cuddalore site:

In the last quarter, I mentioned, we have 11 pending approvals from our Cuddalore site. Our customer has filed, one of our polymer products taking the total to 12 pending approvals from US FDA. Our focus market, Latin America, specifically, Brazil and China have also seen traction. We secured a major order for one of our key products from Brazil, for which the delivery will take place in Q3. With this our total number of filings in Brazil is two, and the target is to file, three to four products in this financial year.

On CRAMS front:

We have had good inroads in the US market with onboarding of our CRAMS head for North America. We will see traction of these efforts in FY2024. Meanwhile, the RFPs we have submitted in first half of this year, we are hoping to win some in the second half of this financial year.

With a focus on all the actions above, we are confident that in outgoing Q4, we will return to our historical revenue, run rate of minimum Rs.400 crores per quarter with mid-teens EBITDA margin and turning PAT positive.

I, now hand over to Hari to take us to the financials for Q2 FY2023. Thank you.

S. Hariharan: We are pleased to announce our Q2 FY2023 Results. Key highlights for the quarter are the following.:

Our revenue is Rs.342 crores which is about 85% of our historical quarterly ran rate, and as Jitesh indicated in Q3 and Q4 will be at a historical run rate. Our gross margin stands at 44.2% improved by 270 basis points over Q1 and operating EBITDA at 52.6 Crores with 15% margins. We recognize the fact that we are working on the various actions to improve the EBITDA and mainly, due to the under recovery of Vizag and now with the CEP approval received and other new product validations and the generic product being made for the less regulated market, and we will be out from the under recovery of Vizag in quarter 4 of this current financial year, so that we become normalized.

As indicated by Jitesh, we have identified key focus areas and we are working on these areas which will result in an improved second half of this financial year. Our immediate priority is to offset the under recovery in Vizag and achieve a break-even profitable growth in near term. And during the current quarter, we have initiated action particularly regulatory inspection which was delayed due to the COVID for a long time. In H1, we have reduced the debt by Rs.12 crores and we are working to achieve the comfortable net debt EBITDA ratio for the end of this financial year.

Our net current assets were reduced by Rs.63.8 crores mainly due to the inventory reduction and the government refund of GST funds. Our focus is on improving our cash flows by prudent application of capital with a clear focus on the actions to improve profitability. We remain confident above our growth prospects of Solara. Thank you so much.

Moderator: We will now begin the question-and-answer session. We have our first question from the line of Rohan John from ICICI Securities. Please go ahead.

Rohan John: I have a few questions. So, first of all sequential improvement which we have seen in the regulated and other markets. I see it is quite low for this quarter. So, what will drive as growth going forward in the coming quarters?

Jitesh Devendra: Yes, so the growth, what we are seeing in the coming Q3 and Q4 will be due to the demands for our base business that is coming back and what we have seen in the H1 is not what we are used to as from a historical point of view. So. in the second half we are definitely seeing the demand for our key products coming back that is one of the key drivers for the revenue growth.

Rohan John: Yes, so now the second question I had was especially on the gross margins, so if I see currently the gross margin for the half year is around 42% and you had initially guided to around 50% for the year. So, do you still maintain this guidance? Or are you going to revise it?

Jitesh Devendra: Yes, so we did mention that, you know, with the actions, what we have taken in H1 and the demands coming back for our key products. The second half of this financial year, especially the outgoing Q4 we will be at closer to the 50% gross margin.

Rohan Johan: Yes, and then another question was related to ibuprofen approval, which you have got in China. So, when will we start shipping and what is the potential revenue from this opportunity?

Jitesh Devendra: We will not give specific revenue for a product, but the commercial supplies will only happen in 2024 because customers have to take the validation batches. They have to do their own, regulatory submissions.

Rohan John: Okay and also ibuprofen that was set to be manufactured in Vizag, right? So, could you give me some timelines as to when will you reach EBIT, when the plant will be EBITDA neutral. I think you have told near term, could you give some timelines.

Jitesh Devendra: Yes, so we are aiming for Vizag under recoveries to be met from the outgoing Q4.

Rohan Johan: And the last question which I had was related with the CRAMS revenue. So, if I see currently, it stands at around 5%, if I am not wrong. So, do you see that getting giving more contribution in the revenues? Or do you see it at the current levels only?

Jitesh Devendra: No, we want CRAMS to be definitely a bigger piece than being a single digit, with the head of CRAMS for North America come into the picture. We have seen a lot of traction in the last one month. So, we are quite upbeat about the CRAMS business. But yes, we want to grow this business and not just maintain it at 5%.

Moderator: We have our next question from the line of Palak Deka an individual investor. Please go ahead.

Palak Deka: Yes, so just one question on the revenue side sir when do we expect to head back to quarterly run rate Rs.400 crores?

Jitesh Devendra: So, while we are confident that from Q4 but internally with the green shoots we are seeing in some of our base business maybe it could even advance from Q4 to Q3 itself.

Moderator: Thank you. We have our next question from the line of Sumit Gupta from Motilal Oswal Financial Services. Please go ahead.

Sumit Gupta: Just need to have clarification if there is any schedule of the US FDA inspection at Vizag facility. So, if you can give any color on the market size of the product which has triggered the Vizag inspection.

Jitesh Devendra: So, the product which has triggered the Vizag inspection is ibuprofen but there are couple of other products which we are doing validations which will also help in triggering. So, with this trigger, we are expecting the US FDA inspection for our Vizag site in the next financial year, probably sometime in the second half of next financial year.

Sumit Gupta: And another question is just to know if any shortage of the ibuprofen that has triggered the inspection if there is any shortage of it.

Jitesh Devendra: We do not see any shortage of ibuprofen but yes, our growth in ibuprofen is coming by, because we have added some new customers and new geographies and that will also help in terms of Vizag site where we are also talking to our customers to qualify Vizag also so we could have both the sites Puducherry and Vizag to meet the demand growth for ibuprofen.

Sumit Gupta: Okay and sir how big can the opportunity be from the approval of ibuprofen API by CDE China and over what period of time, like you said for FY2024 and is it right?

Jitesh Devendra: I think we are still working on that, give us some time. We will get back on the size of the opportunities, definitely China is a large market for ibuprofen. So, we are working out with our customers now because it took us nearly three years to get this approval. So, it is a tough regulated market. So now with this approval in place we are working with our customers, in terms of what is the business potential.

Sumit Gupta: And sir, one more question, can you explain the improvement in the gross margin given that the share of regulated market is almost similar sequentially, is at 66%. So, is it the same base case improvement this business?

Jitesh Devendra: So, we had a good product mix of our current base products and that has led to an improvement in the gross margins.

Sumit Gupta: And sir final question is like, are you seeing normalization of inventory with respect to ibuprofen and just to understand the pricing of products on consequential basis.

Jitesh Devendra: Pricing is pretty stable on ibuprofen and on other key APIs also what we manufacture and the inventory level of ibuprofen for us as I said, in the first half, also we had seen a decent demand. I would not say a great one. This is what we are expecting in the second half and the inventory levels are not a concern at all.

Moderator: Thank you. We have a question from the line of Mittal Jain an individual investor. Please go ahead.

Mittal Jain: Hi sir, my question pertains to the Vizag facility so as you reiterated that will be breaking even by Q4, so by when do we expect optimum utilization of Vizag facility and what is the peak asset turn that we can expect and what are the further capex number, which you are planning to incur for this facility. Those are my two questions.

S. Hariharan: We do not expect major capex in Vizag facility because most of the capex we have already incurred and because we just got CEP approval, it will take another one year for us to reach the full-fledged operation in Vizag in terms of capacity utilization. So that by end of FY2024, we are fully potential of the capacity which will be achieved.

Moderator: Thank you. We have our next question from the line of Nitin Agarwal from DAM Capital.

Nitin Agarwal: Just two questions, one is on the debt level, which are there, we still have a fairly high level of debt versus given our EBITDA levels. So how are we thinking about reduction in debt levels, over the next couple of years and what are levels do we feel reaching lowering down to as you go forward?

S. Hariharan: If you take a look, our debt level, the term debt is Rs.346 crores and we expect that every year we repay around Rs. 100 crores debt from our internal accruals. The term loan is especially for Vizag and once it is fully operational and it will be subsidized. The working capital debt is at Rs.600 crores and that is also pretty much in line with the current inventory debtor's level. We will be having slight reduction in the debt by end of the current financial year. But in terms of net debt to EBITDA, we will be reaching the normalized position by FY2024.

Nitin Agarwal: What would be the normalized position? Sir if you can repeat that?

S. Hariharan: 2.5 to 3 times.

Nitin Agarwal: Sorry sir I think the voice was breaking when you were saying.

S. Hariharan: Around 2.5 to 3 times.

Nitin Agarwal: 2.5 to 3 times net debt to EBITDA by the end of FY2024.

Jitesh Devendra: Yes.

Nitin Agarwal: And secondly, on the CRAMS business, you talked about RFPs, you are participating in RFPs but what is the nature of typically client call or business that we are chasing these are largely late-stage contract or these are basically the lifecycle management contracts and molecules are in late stages of the patent life or what is the nature of the contracts typically?

Jitesh Devendra: On the CRAMS businesses, it is a mix of both the early stage and also on the late stage then we also have business where we are also supplying the key intermediate, because the regulations around the intermediates also have significantly changed from US FDA. So, it is a combination of both.

Nitin Agarwal: But the bulk as an industry perspective, bulk of the RFP that you typically see getting floated by companies. What is the typical nature of these RFPs? What kind of products are companies really are putting out RFPs for?

Jitesh Devendra: It is more on the capability, what the company has right? The product could be anything because if these are products from the CRAMS side and you are working with the innovator companies. They are in the discovery phase. So, if it matches our capability both from an R&D as well as from a manufacturing point of view. Then, we will go ahead and evaluate and take it forward.

Nitin Agarwal Right. Jitesh, you talked about a 50% gross margin by the end of the year. How should we achieve it? Any thoughts on what is your sustainable level of margins for our business, given the way it is, the way you see it over the next few quarters beyond Q4.

Jitesh Devendra: So, beyond Q4 also, we will see the same levels of the gross margins. Of course, you know, we are working in terms of the product mix where we introduce new products and the sales of the new product validation that will help in terms of improving, the gross margin beyond 50 percent but for now, I think 50% is something which is quite comfortable.

Moderator: Thank you. We have our next question from the line of Avnish Khara from VT Capital. Please go ahead.

Avnish Khara: I just wanted to understand what our utilization levels are at for the first half and where do you think they will leap for the second half just for the Vizag site.

S. Hariharan: Yes, the overall capacity is about 75% currently.

Avnish Khara: So, it is at 75% and where do you see it going in the next half?

Jitesh Devendra: As we see, the demands for the key products coming back and Vizag also has to go through the full cycle of inspections from other regulatory body. Then of course this percentage will improve.

Avnish Khara: Okay and on the ibuprofen side, how much of the difference in the average selling price are you seeing in North America and Europe is compared to the less regulated markets.

Jitesh Devendra: We do not give any market specific pricing guidance.

Avnish Khara: Okay no worries, also from your tone it seems that you are not seeing as much demand on the ibuprofen side as we would want to. So, then what is the reason for qualifying an additional facility at Vizag, when we could also be supplying from our existing sites to regulated markets as well, right?

Jitesh Devendra: No, what I said was, we are seeing growth of ibuprofen coming from new geographies and new customers.

Avnish Khara: Also, how much traction are you seeing on the CRAMS side with respect to a China Plus One model, we are hearing about it for a long time. But, on the ground what is the reality according to you?

Jitesh Devendra: On the ground reality of course China, you have some reputed companies also who are there in the CDMO space. Now yes, this China Plus One policy has always been there, but overall, I think it all comes down to what efforts we make in terms of breaking through with the new customers and with the existing customers, right? And with that kind of traction and we are

developing a team around it on the business development side. So, with that approach, we are quite confident CRAMS there will be a sizable portion of our business. As we look in the next 3-to-4-year horizon.

Moderator: Thank you. Thank you. We have our next question from the line of Rohit Suresh from Samatva Investments, please go ahead.

Rohit Suresh: Sir, I just wanted to know, there was BASF Facility that was supposed to come up in Germany. Has it come up or just highlight something on that?

S. Hariharan: No idea sir.

Jitesh Devendra: We have no validated information around that.

Rohit Suresh: So, in Europe, there is no major manufacturer of Ibu. So how is our market share in the European regions and how do you see it going forward?

Jitesh Devendra: So again, I will not be able to quantify from a number perspective, but I can confidently say, from a regulated market perspective Solara has a good market share. A sizable market share in the regulated markets for ibuprofen.

Rohit Suresh: Sir, one last question on the non Ibu part. So, what are your plans for the next couple of years and in terms of your total revenues. How do you see that part moving forward?

Jitesh Devendra: See on the non-ibuprofen business on the base business we are pretty solid with what business we have with our existing customers and markets. What is important is that we also are doing market extensions for these and that is why I said the market extensions for our current products we are looking at newer geographies. So, we will see even growth coming from our non-ibuprofen-based products. So, our focus in terms of, newer geographies which really, we did not have in the past like Brazil or China, that will drive the traction for the non-ibuprofen APIs.

Moderator: Thank you. We have our next question from the line of Sumit Gupta Motilal Oswal Financial Services. Please go ahead.

Summit Gupta: Thanks again. Just want to note the target debt rate to EBITDA by FY2023 sir.

S. Hariharan: This financial year, it will be equal to 5 or to that range.

S. Hariharan: Net Debt EBITDA at five times, current financial year and working for 2.5 to 3 by end of the next financial year.

Moderator: Thank you for the questions over to the management team.

Jitesh Devendra: Thank you everyone again for joining the Solara Q2 FY2023 call, and we look forward to interacting with you for the next Q3 call. So, thank you, everyone.

Moderator: Thank you. On behalf of Solara Active Pharma Sciences Limited that concludes this conference. Thank you for joining us and you may now disconnect your lines.