"Zydus Wellness Limited Q3 FY '19 Post Results Conference Call"

February 6, 2019

MANAGEMENT: DR. SHARVIL PATEL – CHAIRMAN, ZYDUS WELLNESS LIMITED
MR. GANESH NAYAK – DIRECTOR, ZYDUS WELLNESS LIMITED
MR. TARUN ARORA – COO AND WHOLE-TIME DIRECTOR, ZYDUS WELLNESS LIMITED
MR. UMESH PARIKH – CFO, ZYDUS WELLNESS LIMITED
MR. VISHAL GOR – VICE PRESIDENT (CORPORATE FINANCE), CADILA HEALTHCARE LIMITED

Moderator: Ladies and Gentlemen, Good Day and Welcome to the Zydus Wellness Limited Q3 FY '19 Post Results 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 an operator by pressing '*' and then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Tarun Arora, COO and Whole-Time Director, Zydus Wellness Limited. Thank you and over to you, Sir.

Tarun Arora: Thank you. Good Evening and Welcome to the post result teleconference of Zydus Wellness Limited for Quarter-3 Financial Year 2018-19. We have with us Dr. Sharvil Patel – Chairman; Mr. Ganesh Nayak – Director; Mr. Umesh Parikh – CFO; and Mr. Vishal Gor – Vice President (Corporate Finance) with Cadila Healthcare Limited.

The company is pleased to announce the appointment of Mr. Ashish Bhargava as Nominee Director of Threpsi Care LLP representing private equity fund, True North. Mr. Ashish Bhargava is a partner with a leading homegrown private equity fund, True North. Prior to joining True North, he was a part of Marico where he helped build some of the most admired and innovative brand equity in India. We warmly Welcome Mr. Ashish Bhargava on the Board.

As you are all aware, the company has successfully completed the acquisition of Heinz India Private Limited, the subsidiary of Kraft Heinz on January 30, 2019. The closing of this transaction represents a new and exciting chapter for Zydus Wellness as we continue our journey of transformation into a leading player in the Wellness domain. We are delighted to Welcome Heinz India team into our fold and are ready to script a bright future ahead.

Let me share with you the highlights for the quarter gone by:

The quarter gone by has seen good growth while the company recorded net sales of growth of 10.5%, the reduction in net operating income of year-on-year basis has brought down the growth of consolidated income from operations to 9.8% which stands at Rs. 145.41 crores. The reported profit after tax stood at Rs. 39.69 crores. During the quarter gone by, our key brands namely Sugar Free, Everyuth scrub, and Everyuth Peel Off have maintained leadership positions in their respective categories. Coming to consolidated financial performance of Quarter-3 Financial Year 2018-19, the terms adjusted income from operations, EBITDA, PBT, and PAT exclude central capital subsidy income of Rs. 1.7 million recognized during Quarter-3. The adjusted total income from operations has increased by 9.7% year-on-year to Rs. 145.24 crores. Our reported EBITDA were up at 13.7%, however, our adjusted EBITDA were up by 13.1% year-on-year to Rs. 37.55 crores.

Profit before tax was up by 15.7% to Rs. 45.41 crores, adjusted net profit was up by 9.3% to Rs. 39.53 crores. With this, Quarter-3 performance our YTD growth of total income from operations at 15.5% on a GST comparable basis and excluding one-offs. Adjusted net profit was up by 18% excluding one-offs. With that, let me share some of the highlights of the operations for the quarter gone by. We continued our thrust on marketing initiatives to grow the categories and market share of our brands during the year.

To narrate a few, on Sugar Free front during the last quarter we continued investing on sustained media support for Sugar Free TVC campaign to **dial** up safety credentials around the brand. We also continue to support Sugar Free GreenVeda through media support for the TVC as well as new digital campaign on how to use infomercial to drive consumer education. Our new product, Sugarlite has been launched successfully both in online trade as well as off-line. We believe the product has huge potential to become a major business driver going forward and we plan to support it through various media initiatives ahead.

On the Everyuth front, Everyuth has witnessed yet another strong quarter with double-digit growth across all segments. We have continued to support all the segments through aggressive ATL campaigns to drive the category penetration. E-commerce business continued to post exponential growth for the brand.

On the Nutralite front, good volume growth largely led by Institutional segment has resulted into one more strong quarter with a view of investing in future drivers of growth, brand continued to support Nutralite through endorsement of Chota Bheem to appeal to kids and to increase penetration. On the international business front, we continue to building our business in international markets during the quarter with export of Everyuth products in new markets like UAE, Bahrain, Qatar, and Oman. As per MAT December '18 report of Nielsen, sugar substitute category growth rate is at 0.6%, Sugar Free has maintained its number one position with the market share of 93.9%. The scrub category has grown by 17.7%, Everyuth scrub has maintained its number one position with a market share of 32.5% which is an increase of 30 basis points over the same period last year. The Peel-Off Mask category has grown by 19.7%. Everyuth Peel-Off Mask has maintained its number one position with the market share of 84.9%.

To conclude, at an overall level we continue our journey to drive market share growth profitably while investing in our brands. Going ahead, with the new iconic brands like Complan, Nycil, and Glucon-D added to the portfolio, Zydus Wellness will have a larger play in the consumer health space. We now hand it back for the question and answers session.

Moderator: Thank you very much, Sir. Ladies and Gentlemen, we will now begin the question and answer session. The first question is from the line of Kaustubh Pawaskar from Sharekhan. Please go ahead.

Kaustubh Pawaskar: Sir, for Sugar Free category you just mentioned that the growth was 0.6%, I guess it is year-to-date growth, can you just give us some thoughts on how the growth was in Quarter-3 whether you have seen some improvement because of the new launches you have done in the market?

Tarun Arora: Sugar Free, this is a MAT growth for the full year and this does not include some pricing changes which we had done post GST. We have seen improvement and the category growths in the last quarter and we hope to continue this momentum.

Kaustubh Pawaskar: Sir, my second question is on the operating margins, we have seen that your operating margin trajectory was somewhere between 25 to 26 years in some of your previous year, now it has reduced to 22% to 23% maybe largely because of the fact that you are spending heavily behind the advertisement spends, so can we consider it as going to be in the similar range excluding the Heinz portfolio because including Heinz it will be something else, but excluding Heinz should we expect your core portfolio should have operating margins from 22% to 23%?

Umesh Parikh: As and when there will be new product launches, we continue to invest in the media and all media expenses, so whenever the new products get commercialized and stabilize at a particular level, the EBITDA margin operating margins are expected to improve but in the next one or two years, we see the operating margins around the same range.

Kaustubh Pawaskar: Can you throw some light on your international business, because you have increased your exports to many countries, so now how much international business contributes to overall revenues and whether you are seeing it as one of your key growth driver going ahead?

Tarun Arora: It adds to the portfolio, it started becoming valuable to us but it is still low single digits and if we continue to grow, we will see it playing a larger role in our growth story ahead.

Moderator: Thank you. The next question is from the line of Jignesh Makwana from Asian Market Securities. Please go ahead.

Jignesh Makwana: What is the underlying volume growth for this particular quarter?

Umesh Parikh: Underlying volume growth is almost the same as the growth which is reported in the operations number, which is 10%.

Jignesh Makwana: What is the reason behind higher tax provisioning for this particular quarter?

Umesh Parikh: Actually, it is not a higher tax provision; in the quarter last year, we had an income tax refund which brought down the tax expense, so this year that unusual item is not there and therefore the tax expense looks higher.

Jignesh Makwana: Can you please quantify the income tax refund which we got last quarter?

Umesh Parikh: Overall, reduction in deferred tax liability and income tax refund all put together, it is 2.2 crores.

Jignesh Makwana: Sir, can you just give some color on initial inception on the customer side, particularly the retail front if you can give some highlights?

Tarun Arora: For Mayonnaise it is early stage, but we are seeing good traction, we are focused on the main cities and it is tracking well, therefore, we have launched some of these initiatives to take it to the next level, but the initial response on the product is fairly good and we are seeing some repeats as well.

Jignesh Makwana: Are we managed to create some differentiation as compared to other available products in the Mayonnaise category?

Tarun Arora: Two key differentiators for us, the flavors we have added which are differentiated and the fortification which is new to this category with the vitamins that we have added.

Jignesh Makwana: How about the institutional segment of Mayonnaise?

Tarun Arora: We have made small progress there, put together I think Mayonnaise will be important going forward, but we are far more focused on fat spread. We are seeing some traction at Mayonnaise level as well because of our distribution capabilities.

Jignesh Makwana: Lastly, from when we will start consolidating Heinz numbers with our core numbers?

Umesh Parikh: That will be starting with the Q4 of 2018-19, so in the May result you will see the consolidated number for one quarter.

Moderator: Thank you. The next question is from the line of Tejas Shah from Spark Capital. Please go ahead.

Tejas Shah: Sir, the question is an extension of the previous participant's question only, but if you can give us some sense on the initial response to all the launches that we would have done in last 2 to three quarters, Sugar, Stevia based sweetener and all the products that we have launched in last one year?

Tarun Arora: Overall, the products launched in last three years contribute to almost 5% of our turnover in last quarter, some of the launches have done better, some are lower, so we have seen decent traction on Sugar Free Green, Sugarlite is too early, tan removal has also started off on a right note and last three quarters we seem to be on a right track, we will have to see as the season comes back. Mayonnaise has started off on a slower note, we are still working on it, so overall I think we have a mixed bag, some of course leading well.

Tejas Shah: Sir, looking at both the P&Ls of Zydus and Heinz, do you think that there will be any cross subsidy which will be required to support each other's portfolio or both portfolio can actually fund its own growth path without looking at or dipping into each other's pool of cash?

Tarun Arora: Both are I think profitable businesses, there will not be any required to do any.

Tarun Arora: I think you will find more synergies than cross subsidy.

Moderator: Thank you. The next question is from the line of Sanjeev Panda from Tamohara Investment Managers. Please go ahead.

Sanjeev Panda: Sir, just wanted to check the employee cost has gone up 32% on YOY basis, is it something that we have added strength or it is revision or is there any one-time that has gone into it?

Umesh Parikh: It is expansion plus beauty advisors cost, so that is part of the employee cost, and therefore, you see the increase in the employee cost.

Sanjeev Panda: Sir, the beauty advisors it is a recurring thing every quarter or it is?

Tarun Arora: It depends every year it is incurred, but it is not a permanent nature depending on the initiatives that we run and we hire and reduce beauty advisors.

Sanjeev Panda: On a normalized quarterly basis, this number is how much higher than the normalized quarterly employee cost?

Umesh Parikh: This employee cost increase should be in the range of 15% to 16%, this time it is higher.

Sanjeev Panda: Sir, ad spends similar thing, ad and sales promotion number has jumped up, so is there any single one-time activity that we have done which has gone up or any effort you can throw some light on that or what could be the normalized?

Tarun Arora: Specific is Sugarlite is added to the portfolio and that is a fairly large initiative and that is single-handedly would have added to the percentage growth.

Moderator: Thank you. The next question is from the line of Ankit Kanodia from Smart Sync Services. Please go ahead.

Ankit Kanodia: Can you throw some color on the funding aspect as to how we have funded this acquisition, if you can explain it?

Umesh Parikh: We have paid out 4667 crores including cash balance of 125 crores, which is sitting in the Heinz India book, so broadly if I were to say on the funding structure, 2575 crores is by way of equity, 1500 crores is by way of NCD issuance and rest is from the internal accruals and for top up cash we did little bit of borrowing that will be adjusted within few days and set off.

Ankit Kanodia: Can you come again, what is the NCD figure?

Umesh Parikh: NCD of 1500 crores.

Moderator: Thank you. The next question is from the line of Nilesh Shah from Envision Capital. Please go ahead.

Nilesh Shah: What are the terms of this NCD, I mean what is the kind of coupon rate and for what tenure are these NCDs, is it one bullet repayment at the end of three years and five years, just kind of?

Umesh Parikh: It is an average maturity of four years and the payment is in equal installment of 500 crores each, in the third year, fourth year, and fifth year respectively. By then we will have finished of the repayment and the interest payable is 9.14% on semi-annual basis.

Nilesh Shah: Next question is on Sugarlite, can you just throw some light on what is basically the rational you are seeing for launching Sugarlite, is it a product which will cannibalize on Sugar Free or it is a very independent category, what is the kind of potential that we see in Sugarlite, if you could just kind of throw some light on the business aspect of it?

Tarun Arora: It is a different product than Sugar Free, it just has a endorsement of Sugar Free, it is basically for the sugar users where you do not change the habit of regular sugar, but you need because it is more intensive due to blending of Stevia, so instead of one spoon of sugar you can do with half a spoon sugar and thereby reducing your calories by half, and therefore, it is a strong proposition for better calorie management without changing your regular habit of sugar, and therefore, the whole family can use it.

Nilesh Shah: Just to understand, in terms of the availability, where all would this kind of a product be available, there is of course the online availability as well as may be in modern trade, but Sugar Free has a much larger penetration and availability, so how would basically the distribution of Sugarlite, would it be any different from Sugar Free or how would it work, I am asking this because sugar would be sold at a lot of the general stores or that kind of stuff, provision stores?

Tarun Arora: I get your question, our focus is on three channels. Of course, you got the first two right, which is the e-commerce and Modern trade, but anywhere where there is a branded sugar available, so it is largely focused on grocers. The chemists, the pharmacy outlets which represent a large portion of Sugar Free is not a priority, but the grocers are, so this will be placed next to sugar, so our target is to place it next to the sugar.

Nilesh Shah: Just one more in terms of the theoretical possibility that I am assuming that Sugarlite is more targeted towards the sugar segment and sugar per se is a much, much bigger opportunity or an industry or size of the market versus the size of the market of Sugar Free, so would it be in a way fair to assume that may be in the next five years or 10 years, Sugarlite per se could become a much, much bigger product for us versus Sugar Free?

Tarun Arora: Yes.

Nilesh Shah: Post the Heinz acquisition, how does the organization structure play out, because I am assuming that people who are running these three or four brands at Heinz have also come on-board, so if you could throw some light in terms of how is the new organization structure post this acquisition?

Dr. Sharvil Patel: I think more of this we can tell you in the next couple of quarters, we have just closed the transaction, so it will be too early for us to comment on the organizational structure right now.

Moderator: Thank you. The next question is from the line of Monica Joshi from Hornbill Capital. Please go ahead.

Monica Joshi: Two questions, one is on the financials, Tarun you mentioned that there was a cost element on Sugarlite on the advertising expenses, is it possible to quantify this?

Tarun Arora: We do not share brand wise numbers, so it will be not possible.

Tarun Arora: But it was a significant expenditure because of the buildup that we are doing.

Monica Joshi: Is this likely to sustain in the March quarter or this is a one-off in this December quarter?

Tarun Arora: It will sustain over the next couple of quarters.

Monica Joshi: Also, the other expenses side, we see a very sharp decline in absolute value and also as a percentage of sales, again is there any one-offs here?

Umesh Parikh: Yeah, there were certain project-related expenses last year same quarter and they are not there this quarter, so they are kind of one-off in nature.

Monica Joshi: So this should bounce back is it, is that what we are seeing?

Umesh Parikh: Yeah, the reduction is not permanent in nature.

Monica Joshi: Now, we have been with Heinz now for the last three, four to five months and we have now had an opportunity to be interactive with the team a lot more. We spoke a bit about synergies a few participants back, is it possible for us now to quantify what are the synergies that we could draw in terms of revenues in the next three, four or five years as we integrate this acquisition, any number that you guys have worked out?

Tarun Arora: That is work in progress, we definitely know that there will be an improvement in distribution which we see which will happen because of the acquisition. Also, there will be some opportunities on the cost of goods side improvement that we will look at and the whole supply chain that we manage, so those two are very clear and evident. Also, we see other important synergies also, but more details of this we can give you in the next couple of quarters.

Monica Joshi: But you clearly see cost synergies also is it, that is how we should read it?

Tarun Arora: Yes.

Monica Joshi: So you will see an opportunity both on revenues and on margin expansion from here?

Tarun Arora: Yes.

Moderator: Thank you. The next question is from the line of Sameer from Reliance Mutual Fund. Please go ahead.

Sameer: What I was trying to understand is that if one looks at the revenue growth numbers of last two quarters compared to revenue growth number of first quarter, it is slightly on lower side, so one, reasons for that, and secondly, overall on a medium-term basis what kind of growth we are targeting for the Zydus portfolio?

Tarun Arora: If you really look at it, I think it is very important to look at some of these numbers together rather than isolation, so we had a extraordinary growth in first quarter and a lower growth in the following two quarters because if you look at last year's base also that reflects the reason for some of those things where the numbers got dipped in the GST quarter and the next two quarters saw a lot of channel filling back, and therefore, the growth numbers get a little bit affected by that. In a YTD level, I think it is more consistent number of growths that we saw and similarly I think if you look at the other way is the trajectory across the three quarters has been fairly consistent with the earlier years, so we should not look at a decent teens kind of growth is the expectation from our business on an ongoing basis.

Sameer: So nine-month growth number is a more representative kind of growth number which you are looking forward and quarterly variations we should ignore that is what you are trying to say?

Tarun Arora: Specifically, because of the anomaly last year where sales got skewed.

Sameer: Sir, if I understood correctly on this merger and all since now we will be like control on both the entities, by the end of this financial you will be able to share more on what kind of synergies you are targeting and what is organized structure and all, so you will be able to share more details by the next quarter if I understood it correctly?

Tarun Arora: Not next quarter, in two quarter's time.

Moderator: Thank you. Ladies and Gentlemen, that was the last question. I now hand the conference over to Mr. Tarun Arora for closing comments.

Management: Thank you all for your support, we meet next quarter.

Moderator: Thank you very much, Sir. Ladies and Gentlemen, on behalf of Zydus Wellness Limited, that concludes this conference. Thank you for joining us and you may now disconnect your lines.