Neogen Chemicals Limited
Q1 FY21 Earnings Conference Call Transcript
August 10, 2020

Moderator: Ladies and gentlemen, good day and welcome to the Neogen Chemicals Q1 FY21 Earnings Conference Call. As a reminder, all participants' 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 telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Shiv Muttoo from CDR India. Thank you and over to you, sir.

Shiv Muttoo: Good evening everyone and welcome to Neogen Chemicals Q1 FY21 Earnings Conference Call for investors and analysts. The call has been hosted to discuss the first quarter financial performance and share operating highlights of the Company. Joining us on the call today are, senior members of our management team, including Dr. Harin Kanani –Managing Director and Mr. Anurag Surana – Director of the Company.

We will commence the call with opening thoughts from the management team post which we shall open the session for Q&A where the management will be glad to respond to any queries that you may have.

At this point, I would like to state that some of the statements made in today's discussions may be forward looking in nature. Facts may vary from these forward-looking statement. A detailed disclaimer in this regard is available in Neogen Chemicals' Q1 FY21 Earnings Presentation which has been shared with everyone earlier.

I would now like to invite Dr. Harin Kanani to commence by sharing his thoughts on the Q1 FY21 financial performance as well as the strategic progress made by the Company.

Dr. Harin Kanani: Thank you so much, Shiv. Good evening everyone and a warm welcome to you on Neogen Chemicals Q1 FY21 earnings conference call. I hope everyone is keeping safe amidst the COVID-19 pandemic situation.

Before I get into the financials and operating discussions, let me start by thanking all our Neogen family members, especially the manufacturing and engineering teams, who have tirelessly worked in this unprecedented times to ensure that we serve our valuable customers in pharma and agro industries and supply key raw materials and intermediates for essential medicines and agrochemicals during the lockdown period, doing our duty to society. I appreciate all their efforts sincerely.

Moving on to the operating discussions:

I am sure all of you would have gone through the Q1 FY21 results document shared earlier and also updated on the stock exchanges.

We commenced FY21 on a positive note with healthy performance momentum which came in spite of the COVID-19 related prolonged lockdown situation across the country that resulted in loss of working days and capacity. Q1 FY21 performance was supported by prompt actions taken by the management to maintain business continuity through a host of initiatives largely targeted at the safety and welfare of our people. Some of these initiatives included alteration in the employee transport framework, additional incentives for both employees and contract workers and insurance benefits, among others. Also, systems were put in place to ensure proper sanitization measures and social distancing norms, all of which are imperative in the current operating circumstances and also fully aligned with Government guidelines.

All our manufacturing units are now running at close to optimal capacity utilization based on higher demand from key end-user industries. Our expansion project at Dahej is also progressing well and we remain on track to commission the organic chemicals plant by the end of FY21 in Q4, despite the disruption caused by the pandemic which is in line with our previously stated expectation.

Let me now move to the financial discussion:

In Q1 FY21, we registered a strong revenue growth of 19% to Rs. 76.6 crore. This was driven by high demand for key products in the market and also supported by revenue spillover from the previous quarter. Our performance would have been better, had we not lost several days of production in the month of April to COVID-19 and subsequent lockdown and some challenges we faced in the Mahape unit with manpower. Largely, both these events added up to an almost neutral impact on our turnover for the first quarter. Revenue growth in organic was robust at 36% to Rs. 66 crore while revenue from inorganic came in at Rs. 11 crore. EBITDA increased by 18% to 13.6 crore translating to EBITDA margin of 17.7%. Margins were maintained despite plant shutdown in the initial days of the lockdown. This was possible due to better fixed cost utilization and favorable product mix as well as being able to convert inventory and carry out sales from the hangover of the previous quarter.

Our targetted initiatives undertaken for COVID-19 related compliance resulted in total direct impact of Rs. 63 lakhs in employee benefit expenses and Rs. 31 lakhs in other expense. Our operating profitability would have been higher to the extent of Rs. 94 lakhs, but for these additional costs. Profit after tax was higher by 12% to Rs. 6.1 crore based on improving operating performance and higher depreciation in line with new inorganic capacity added in the fourth quarter last year and some Ind-AS adjustments. For Q1 FY21, our domestic and export mix stood at 62% and 38%, respectively.

Before I close, I would like to say that our growth journey thus far has been encouraging and we have a promising phase ahead of us where we will tend to benefit from the gains arising out of the plant expansion in organic chemicals and the newly commissioned facility of inorganic chemicals. The demand scenario appears positive as a large number of global customers continue to look to India for their intermediate requirements. Companies, such as, Neogen Chemicals are well positioned to enable them to de-risk their supply chain with a diversified product offering and strong forte in complex and specialized chemistry.

This concludes my opening remarks. I would now request the moderator to open the forum for questions from participants.

Moderator: The first question is from the line of Swarnabh Mukherjee from Edelweiss Broking.

Swarnabh Mukherjee: Two, three questions from my side. Regarding the inorganic business, I just wanted to understand that if you could give some quantification of the revenue shortfall that might have happened this quarter because of the lockdown scenario in that business and if you expect some amount of that to also continue in Q2. Any thoughts on that? That is the first question. The second question is, related to the custom synthesis business that you have earlier described in previous calls. So I think if I remember correctly, you had given a longer-term balance of around 20-50-30 between lithium derivatives, bromine derivatives and advanced intermediates. So just wanted to understand where this custom synthesis business would lie among this split and your longer-term vision on that?

Dr. Harin Kanani: First question about inorganic. I think as you know, engineering companies were not considered as an essential supply and they took some more time to start operations. It was only after unlock 1.0 or 2.0, they were able to start their operations. Usually they have a very large activity in Q4, some of which got transferred also to this year. So this was the mix. But I think the biggest challenge for them or for us was that the engineering customers started production a bit late. So their demand was muted specially in April and May. But post June I think they have been giving us regular POs and regular business is currently seen – what is their usual demand. In fact, in the month of June, what they bought was also slightly higher because they also had some overhang of their POs. So what we expect is more or less to be at par with last year and some improvement as our new customers kick in. One more challenge has been that lithium has continued its downward trend in terms of price reduction. So there will be about 5-7% impact because lithium prices are going down, while volume remains the same. So the turnover that we achieve can be 5-10% lower for the same volume. Overall we expect more or less similar performance as last year for the whole year. And as new customers come in, specially in the second half, you will see good performance. You will see improvement in performance in lithium. Q4, which is anyways a very strong quarter for lithium business usually, will again see a much stronger performance in Q3, Q4. So may be my guess is, Q2 will be more or less similar and Q3, Q4, you may see a significant increase for inorganic.

Swarnabh Mukherjee: That is very clear, sir, on the custom synthesis, if you could?

Dr. Harin Kanani: So again, if you look at our Q1 performance, we had around 25% which came from advanced intermediate and custom synthesis. What we have said is that for us, we will always keep this together, because whether we make advanced intermediates or contract manufacturing, in both basically we are making advanced intermediates. So when it comes to custom synthesis, yes, there are a number of customers with whom we are working even during COVID period. We have discussed and we have even signed a few more additional – initiation of work where we sign a NDA so we can exchange information. So the existing customer projects are also continuing and with new customers for new projects also, initiation of R&D work, etc., has started. Basically it remains on track with whatever has been our earlier guidance and we expect, especially as Dahej capacity comes in, more improvement as a percentage within advanced intermediate from contract manufacturing.

Swarnabh Mukherjee: So, are the molecules that you are working on in advanced intermediates and contract manufacturing more on the patented side and are they also agro and pharma focused?

Dr. Harin Kanani: Yes, they are more on the patented side and yes, they are more pharma and agro focused, though we do have some non-pharma, non-agro molecules also from other industries, but largely they have been pharma and agro focused.

Swarnabh Mukherjee: And any color on share of this business coming from overseas?

Dr. Harin Kanani: Most of the contract manufacturing, except in one or two cases, are international. We have, however, done within India also for a key customer. But then we are making an intermediate which is then going to our customer within India, which is ultimately going to go internationally. I mean the final AI or API is being sold internationally, so we do have some projects which are in that framework.

Swarnabh Mukherjee: Just the final question on custom synthesis. The kind of reactions that you are undertaking in this - are this primarily bromination heavy or do you use other chemistries also? And is it possible that other overseas players who focus on the CDMO side significantly, you are directly competing with them or not in this business?

Dr. Harin Kanani: Yes, whenever we do advanced chemistries, there is bromination and there is something else. We have a few projects where, once the customer has already started working with us on 2-3 projects, they also give us a project where there is other chemistries, but no bromination. But majority of them have bromination as an anchor. So major chemistry focus remains bromination, Grignard chemistries and other chemistries. So even in our DRHP, we had given a list of other chemistries which we have done and we continue to expand that portfolio for every new project we do because the other chemistries involved is always something new. Then over a period of time, sometimes we have done that other chemistry significant number of times and the customer may give us a project just to do that other chemistry, but more or less I think the color remains similar to what has been the case before. There is no specific chemistry which we had zeroed in and on which we have developed any expertise, as an anchor area or something like that.

Moderator: The next question is from the line of Kaushal Shah from Dhanki Securities.

Kaushal Shah: Can you can add some more color on the inorganic facility which has started – the expansion which has got commissioned? So how is the work over there and how is it progressing?

Dr. Harin Kanani: The inorganic plant as we informed earlier is already commissioned and we already made some shipments to international customers even before the lockdown and subsequently, after April, we re-started production there. As we had mentioned, some of the new customers were likely to approve this site but because of COVID they could not visit since February. So some of them have taken a decision to take some trial consignments and these trial consignments were already being shipped to the customer. Some of them are doing video audit or something like that, so those things are in progress and as I mentioned in my earlier answer, we expect in Q3 and Q4 some uptake from that.

In the meantime, what we are doing is, as you know Mumbai is affected significantly and in our Mahape unit also, we sometimes have manpower challenges, space challenges and other things. So, we are currently using it to support our Mahape unit's inorganic facility as and when needed, so every month there is a significant utilization of the Dahej capacity also and overall, we are basically keeping both the sites active.

Kaushal Shah: And sir, you mentioned about the lithium price drop, will we be able to maintain our per kilogram margins there?

Dr. Harin Kanani: Yes.

Moderator: The next question is from the line of Rohit Nagraj from Sunidhi Securities.

Rohit Nagraj: Sir, in terms of the RM supplies, last quarter you had mentioned that we had higher inventories due to COVID-19 issues so that it does not disrupt our operations. So have they normalized? And how have been these supplies of lithium in terms of imports and other imported intermediates currently?

Dr. Harin Kanani: Rohit, two parts of this question. One is the raw material side of it. So yes, the raw material inventory remains slightly higher because while some of our production in April and May was impacted – we had lower capacity – but imports had already been planned and while we took some corrective actions wherever needed, there was some inventory which was still available of the raw material. Also, because of all the uncertainty, specially for imported raw materials, we are purposefully also keeping slightly more inventory. If you see historically, in Q1, we always generally build inventory of WIP and FG because generally the demand is a bit softer. We build some inventory at that time, so if you look even in this quarter, this may be the first Q1 where there is a reduction in our WIP and FG inventory. So overall, there is reduction in inventory, but some inventory we have kept higher at the RM level. Some inventory we have, like generally as our regular practice also in Q1 some inventory gets built up. So, it is kind of combination, but overall there is reduction from March and because we are again targeting around 15% growth, so around Rs. 350 crore, so there will be some increase in our WIP, FG to support that.

Rohit Nagraj: Sir, and in terms of pass on of the raw material prices to customer, so what is the general lag and during this lag, is there any inventory gain or loss which is recognized? You pointed out that lithium prices have come down 7-10%, so eventually it will be passed on to the customer. How does it work in terms of the pricing structure?

Dr. Harin Kanani: Generally, what we tend to do is, we try to do back to back and we make sure that whatever we have booked, we commit to our customers accordingly. So when there is a price increase or decrease, accordingly we take that whenever we are discussing. For example, in lithium we were doing only quarter to quarter kind of contracts while historically we used to do annual contracts. So accordingly, whenever we see prices moving, when we are discussing with the customer, we also pass on because our competitors also do the same. So sometimes we always keep some raw materials which is a bit excess. We can have one container or two containers which we book at any point of time. There are some products where there is a decrease and in some products there is an increase. So more or less the range that we give for our EBITDA margins or the range that we give for our gross margins, basically most of the time it gets captured in that because we don't have significant inventory of a specific molecule that is distributed over many compounds.

Rohit Nagraj: On the R&D front, just want to get an understanding about how big is the team, how it has changed over the last 3-4 years? How much do we spend yearly in terms of percentage to expand the pipeline and what are the new technologies or new customer segments that we are targeting in terms of future products?

Dr. Harin Kanani: Let me see how best I can answer all the questions you asked. About R&D, maybe from a 3-4 year horizon, 4 years ago, when we were only in Mahape, we had only one PhD scientist supported by around 7-8 people. So when we were about 100 people, roughly we had around 8-10% of our staff which was dedicated for R&D. Again, when total employee strength has gone from 100 to almost 240, our R&D team has also more or less increased proportionately at around 24-25 people who are working in R&D and some who work in scale up of that. Now we have a dedicated team which is taking care of that, so between 25 to 30 people who worked in R&D and scaling of R&D to commercial team. There are may be more than 5-6 PhD scientists, who are already working and because the number of projects that we are doing at any given point of time also has increased. So at any given time, each team basically is having 2-3 projects, so around 15 to 18 projects are on. The duration of the project can vary, so that has increased significantly. As I mentioned earlier, we keep learning new chemistries. Each project requires, especially in advanced intermediates and custom synthesis, us to do some different chemistry and that is almost like an ongoing effort for us. So I think these are the updates I would like to give you on R&D. Industry wise, we are not targeting specific industries that we have to have, let us say in dyes or anything like that. So you don't have a target industry, but we do have customers who are basically fine chemicals and specialty. Sometimes they are making some intermediate which has dual usage or the same customer has applications going into pharma and another one can be specialty polymer or electronic materials. So in our previous slides also, we have always given other industries, specialty polymer, electronic, perfumery, dye intermediates, so whatever we have been doing so far is in the same space and there is no new specific industry which we have added subsequent to that.

Moderator: The next question is from the line of Bobby Jayaram from Falcon Investment.

Bobby Jayaram: Couple of questions. First, bromine is heavily used as a flame retardant, correct?

Dr. Harin Kanani: Yes.

Bobby Jayaraman: But you don't seem to be in that area, why is that?

Dr. Harin Kanani: So what we have seen is that to be successful in flame retardants, majority of the significant players are the ones which have their own bromine and they are backward integrated into bromine. The biggest cost in any flame retardant product is bromine, so we feel that except for maybe some very specialty flame retardant used for a specific end-use, this is best served by the bromine manufacturers themselves and they tend to forward integrate into that. So this has been one of the reasons. Generally, some of these flame retardants have 10,000 or 20,000 tonnes of worldwide demand, so your minimum plant size has to be 2,000 tonnes or 5,000 tonnes to make commercial sense. So, our scale of reactors and everything is designed a bit differently, not basically focused on that. I think these are the primary reasons and then there are some smaller, finer reasons.

Bobby Jayaraman: Sir, the other question is, would you say bromine is more often used in pharmaceuticals or fluorine?

Dr. Harin Kanani: I have answered this earlier that bromine and fluorine have a very different usage in pharma. So fluorine majority of the times is part of the molecule and it stays in the molecule even in the API which is consumed by any sick patient and it has some biological activity for which it is present. Whereas majority of the role of a bromine derivative is to bring two molecules together and you will not see it in the end-molecule. So it is kind of a bromine derivative that reacts with something else and the bromine comes off and the two things together like we will then go ahead and do the biological activity. So that is why they both have a very different role and fluorine rarely gets used for that.

Bobby Jayaraman: Final question, you think your strategy seems to be more, one of breadth because you are in a lot of compounds. But you are mostly sub-scale on them. So why not get deeper into a few of the most profitable ones?

Dr. Harin Kanani: So, historically, what we wanted to do is generally, we don't want a single molecule to contribute more than 15% of our turnover. This is a broad range, I mean for a short while it can be 20% also if it is very profitable and the customer needs it – but we generally tend to do that as a selection criteria. Like historically there was a molecule in 2016, my entire unit capacity could be utilized by just one molecule. But if something were to happen to that molecule, it is a big risk. So, it is kind of de-risking, not depending too much and not trying to be greedy and get majority of market share in a very big molecule. We do have some smaller molecules where we may sometimes have 85-90% market share of that molecule in the world, sometimes even 100%. But then those molecules have only that much demand, so that is the best we can do. I hope that answers your question.

Bobby Jayaraman: Understand what you are saying, but wouldn't that constantly involve carrying a lot of inventory, your whole working capital will be stretched if you need a lot of different molecules?

Dr. Harin Kanani: Yes, it does, but at the same time, it also gives us the freedom that when we want to grow capacity we have those many molecules and those many customers. So it is a trade-off between what you are today and your de-risking in terms of what if the molecule were to become bad. And for future growth, being in those many molecules where you can quickly capture growth. So, we have historically chosen this in the trade-off because fortunately our capex to asset turn is relatively better and so even with a higher working capital cycle, what we feel is our debt and our interest costs are quite manageable. It is basically a trade-off and we tend to choose the de-risking and future growth versus the immediate benefit.

Bobby Jayaraman: So, growth is going to come from new molecules, right? Because you have pretty much saturated the potential for existing ones. Is that what you are saying? You are already 80% to 90% of those.

Dr. Harin Kanani: In some of them. But yes, in some of them we are not. And basically, in our previous discussions also I have shared that. For example, when we have capacity, we have two scenarios. In one scenario, the entire capacity will be sold off for new molecules and because they are new molecules, we are still not sure of customer demand or winning that till the time the final PO or the contract is signed. So, we also have kept the option ready that even in my existing capacity or for my existing molecules, I can sell the capacity.

So, even in the last three years' growth that we have seen, it has come from a mix of both, new molecules as well as more volume of my existing molecules, winning more market share, especially in the larger molecules where we generally limit ourselves. Even if the customer demands, I do not want to commit beyond certain capacity for that molecule. So then when I have capacity available, this becomes like a low hanging fruit and I can capture that business relatively faster.

Moderator: The next question is from the line of Jason Soans from Monarch Networth.

Jason Soans: Just wanted to know, where are we on the guidance? In the Q4 call you had guided for Rs. 350 crore for FY 2021 and for FY 2022 a top-line of around Rs. 450 crore to Rs. 500 crore. So just wanted to get your sense on where exactly, especially with COVID going around, where are we on that guidance?

Dr. Harin Kanani: So, I think, we still maintain guidance for this year as Rs. 350 crore and for the second guidance, you can go back and also check, I have always said that we will have capacity of Rs. 500 crore of which we will try to do close to around Rs. 450 crore. So, the next year guidance is to try to reach Rs. 450 crore, so somewhere close to Rs. 450 crore. And yes, so we still maintain both.

Jason Soans: Your business in the second half of FY2021, is typically or seasonally stronger? How do you see 2HFY21 performing this year, especially with COVID going around?

Dr. Harin Kanani: So, if you are looking at today's situation, what we feel is, it will be similar that 2HFY 21 will be stronger as compared to the first half. That has historically been, 40:60 or 35:65 or 45:55, if I look at 6-7 years' performance. The same we are expecting this year also – unless there is a very dramatic change in demand or supply, which currently I cannot foresee. So, what we have seen of COVID, this has been around since February to August. So now it is almost close to six months and whatever we have seen so far, if it remains on the same lines or improves, then that is what we see in the second half.

Jason Soans: Okay. So, you see growth coming in, I mean you expect the trend to continue basically?

Dr. Harin Kanani: Yes.

Jason Soans: Okay. And obviously, currently in the market, you see a lot of interest towards API manufacturers and our products, also intermediates, feed into those APIs and a lot of focus is also on self-dependence for APIs in India and taking the initiative back from China, however we can. So, in light of all that, do you see increased interest, increased inquiries for your products in terms of organic compounds as well as CRAMS. In terms of on ground you see increased activities or increased enquiries?

Dr. Harin Kanani: Yes. So again, I think this is a question which has come to me in the last 2-3 quarters' calls and I think my stand has been that especially when we are thinking of CRAMS or international customer interest, that has been an ongoing activity, specially in case of bromine derivatives and bromine related chemistries for the last 3-4 years because of challenges which China faced with bromine production and subsequently some quality challenges which were faced where some major API producers' plants were closed by USFDA. All these basically created opportunities for companies in India and the interest in India continues. So, that remains, and I think, yes, we are still watching the Government initiative and how Indian local consumption of API can be increased or made more in India and several of my customers are also working on their strategies for that. To the best of my knowledge, we have had discussions around that. Customers also have logistic challenges, which were faced in clearance, etc., wanting to have more supplies from domestic vendors and that trend is continuing.

Jason Soans: Right. And just one final one. This inorganic plant, which you mentioned has been commissioned. It is at Mahape, right?

Dr. Harin Kanani: No, the inorganic plant got commissioned in Dahej. Mahape has an organic plant since 1991.

Jason Soans: Okay. And this has been commissioned at Dahej. And the status currently, how do you see the demand there? I mean, you said some video trials or something.

Dr. Harin Kanani: Yes. What happens is that these engineering customers typically like to come and see the plant and then approve. Some of these have been deferred, so what they have said is you anyway send us trial supply. So we have sent these trial supplies and once it reaches the customers and once they try it then they will start placing more commercial PO. In Q3 and Q4 we expect some of these approvals to come. So, we can see a higher increase in lithium. I think, if you go back, we always said that this will take a bit of a time. So, this additional capacity worth around Rs. 40 odd crore will be split over two years, because capturing it in the first year in inorganic is going to be a bit of a challenge. So, we will see some of the increase come in from there in the second-half. And what we are currently doing is for some of the molecules are supporting the Mahape unit and making it in Dahej for some of the customers of Mahape. So that, in Mahape, we can fully utilize our manpower for organic production where we see a very heavy demand and we can optimize it that way.

Jason Soans: Okay. And sir, this lithium price when you mentioned the 5% to 10%, the turnover can be lower, you meant it on a yearly basis, right?

Dr. Harin Kanani: Yes, overall, on a yearly basis.

Moderator: The next question is from the line of Aashish Upganlawar from InvesQ Investment.

Aashish Upganlawar: Just wanted to understand. Since the IPO probably we have heard you that work is going on the CSM front. Yes, basically to make this space a bit bigger over a period of time. So where are we in the overall process and maybe three years or five years view anything that is coming to you in terms of the progress or is it still in a smaller phase actually?

Dr. Harin Kanani: So I think, what we have basically said – to summarize, so far, in the last one year, we said that as of now, we are at 50% of bromine derivatives; about 30% of advanced intermediates; and about 20% of lithium derivatives. This has been the status for the last one year, plus or minus 5% to 7% like from a quarter-to-quarter basis. Now, within that 30% piece, about 8% to 10% has been the CSM business and the remaining 20% is our own products of advanced intermediates. Again, plus or minus 5%. So, of the advanced intermediates, 25% to 30% is coming from CSM. And I think the target, which we had set for us is that since we are going from Rs. 160 crore to Rs. 240 crore then Rs. 300 crore and then, next year especially when we are looking at Rs. 450 crore kind of revenue, we were trying to see at least if we can maintain that. So, of course, advanced intermediates add 30%. So, in terms of absolute, there will be a very significant increase even for that and then, we may shift may be 5% or more towards advanced intermediates. As I told you, you know we had five scenarios. One scenario, everything coming in from new projects and the other scenario from existing. So, depending on where we are able to balance that, we will see whether we are able to make a shift more towards the advance and then within advance more toward CSM. But as of now, our first target is to at least make sure that even when we are growing to Rs. 450 crore that 30% is maintained, which itself will increase both CSM and advanced intermediates to that extent.

Aashish Upganlawar: Okay. So, out of the Rs. 450 crore, how does this calculation work out? I mean, in absolute numbers if you can give. The calculation is pretty long for me actually.

Dr. Harin Kanani: So, I think let us say at 50%, around Rs. 225 crore of bromine derivatives. At 30%, it will be around Rs. 125 crore to Rs. 150 crore of advance intermediates and within that some portion coming in from CSM.

Aashish Upganlawar: Okay. So how is this growing? Is it still in the trial phase from a customer perspective, we are trying to gain their confidence or some break-throughs that might be countable in terms of giving a larger proportion. May be five years?

Dr. Harin Kanani: I think if you look at our DRHP, we had mentioned a number. We had at that time eight or nine customers with whom we were working under this contract manufacturing mode. Now, the number of customers has increased significantly, the number of projects has increased significantly and many of these are already at a commercial scale. So, when we went from let us say Rs. 240 crore to Rs. 300 crore, or now as we are targeting Rs. 350 crore, this absolute number is also increasing and that is coming from some of the molecules which are now maturing or going from pilot to commercial level. So, they are contributing to the additional absolute increase. And as we go into Rs. 450 crore, a lot of projects which are current this year, where we will be in pilot or commercial initial trials, they will contribute towards that absolute increase to Rs. 450 crore.

Aashish Upganlawar: So, just to summarize everything, we are constrained by capacity more than demand. Will this be true and is this probably going to be the case for the next say 3-4 years? Do you see that happening?

Dr. Harin Kanani: Yes. So, as of now, we are for sure capacity constrained. The way we are looking at our business yes, I mean, if what we have thought pans out, like I said, the five scenarios of which, if we have a scenario that everything comes in just from new customer demand then very soon we will be capacity constrained. But again, what we will have is, we will have the Dahej site which is active, we will have Baroda site, which is now already active. So, we will then have an opportunity to further increase our capacity if needed, because at both the sites, we have land available and especially in Dahej, at least for 2x - 3x additional increase also we have permissions already in place. So, there we can quickly add more capacity.

And I think in earlier calls also what we have said is that we have been contemplating what will be the next nature of our capex to ensure that this capacity limitation does not stop our business. Somewhere between September and December, we will take a final call on that and plan our next capacity increase, because if we are Rs. 450 crore out of Rs. 500 crore in FY 2022, then FY 2023 we are already seeing a capacity constraint. But I think, if we decide by December then that gives us sufficient time to invest, so that we have capacity available for FY 2023.

Moderator: The next question is from the line of Puneet Kabra, Individual Investor.

Puneet Kabra: Just two questions. One is, can you throw some color on the gross margin erosion that we have seen this quarter? Y-o-Y, there has been significant erosion. And related to that, you just mentioned on lithium that turnover may go down because of lithium commodity pricing while volumes will remain the same. How does that impact our margin? When we look at our margins, do we look at margin per kg? So, whenever revenue goes down, not only volumes, our margins are protected. Or do we tend to lose margins when prices go down? That is the first question.

Dr. Harin Kanani: So, Mr. Kabra, basically, what happens is we always try to make sure we get the better of the two, right? I mean, if there is a per kg margin and there is a percentage margin, like in case of a decrease, we try to protect our per kg margin. And when the prices are increasing, we try to protect our percentage margin. Now, when you have relationships with customers over many years, sometimes you have to give sometimes they give you. So, it is something which is not a standard rule that yes, we will always be able to protect this versus the other. For example, when it is increasing, we at least make sure that our per kg is protected or when it is decreasing, we at least make sure our percentage is protected. But it changes, there have been times when it has decreased and we have been able to protect or improve upon margins also as a percentage. Per kg is almost given so we always get that part right, percentage we have to try and win when it is possible. It depends also on customer situation and overall market dynamics, because sometimes when it is increasing, the supply is very tight. So just the fact that you are able to get the material itself is a very big thing and then, in such cases, you are able to also protect your percentage margins.

Puneet Kabra: Any specific reason for the gross margin erosion that we have seen in this quarter last year?

Dr. Harin Kanani: Okay. So, I think the gross margin erosion, what basically happened is that a lot of inventory that we have sold was already almost done. It is valued that way and the production cost. We have done less of production, I mean, let us say there is a case where I start from scratch and there is a case where I already have 75% work done and I am just doing the last 25%. So, as I mentioned in the opening remarks, we had some sales in March, which did not happen, in which we had either ready or almost ready material. So then that inventory is valued at cost. So as opposed to raw material, when I am using that, for my sales, my percentage RM cost will go a bit higher and if you will see my manufacturing cost as a percentage has gone a bit lower. Because in the first month, when we did not have the capacity, there was no power or electricity or fuel costs. So, because of the mix that we sold this time, that is what has happened. But again, more or less, it is almost bordering even in such a dramatic year where we had so much downtime because of capacity etc. You will see that we give a range between 58% and 62% of RM costs, gross margin between 42% and 38%. So, in this case also we were closer to the 38% in that dramatic period.

Puneet Kabra: So, this could not be more of an aberration?

Dr. Harin Kanani: That is right. I mean we will stay within that 38% - 42% range, 40 being closer to where we generally are till this 50:30:20 metric changes or some very different product comes or something like that.

Puneet Kabra: Second question was on capex. Partly you have answered it – that we will get clarity in September or December. But the question I had is that the Mahape facility has exhausted and earlier we had operationalized the facility at Baroda and subsequently now we have done it at Dahej. So, most of it was Greenfield. Now, I believe that whatever expansion that we will do, be it Dahej or Baroda, will end up being brownfield expansion, is that understanding correct? In the same piece of land, meaning the common infrastructure facility will get utilized?

Dr. Harin Kanani: In the same piece of land, we are not planning. Yes, there will be some common infrastructure. Though in Baroda we may have to ramp up, whenever we do in Baroda, we may require some more additional ramp-ups. Because what will happen is as of now majority of facilities require zero liquid discharge. So we will have to set that facility from scratch whenever we do expansion in Baroda. But yes, they will both in some sense be a brownfield kind of expansion. You are right.

Puneet Kabra: So what I am trying to understand is: is it fair to assume that the next set of capacity expansion you had mentioned in the past will help you release working capital? And it should also help to improve return ratios or margin because of operating leverage be it because of brownfield expansions. Is that a fair understanding that should likely happen?

Dr. Harin Kanani: Yes, so for the margins, I have always said that because we are also trying to expand, we are trying to get new people, infrastructure, and getting capacity people, etc., together, there can be some variations in margin. Even for my FY2022, I had given a margin range that we still maintain 18.5% plus-minus 1%. And we discussed, I think, in the last call that because of COVID, may be you can give me 0.5% leverage or something like that.

But basically, that range still continues, because even for Dahej, we will start employing people, let us say from September, October. Because we will have to start employing people, we will have to start training them and some of the things needed to support this new business. So, we always look at a very long-term view rather than every single quarter performance kind of view.

Puneet Kabra: Whatever margins were, when we did our IPO, to whatever margins will be in 2022 being a milestone year and then say, whatever margins will be in 2025. Just because of the incremental capex, fair to assume that on all financial ratios, whether it is working capital, whether it is asset turn, whether it is return on capital employed, we have to be directionally inching upwards?

Dr. Harin Kanani: Yes, you are right and that is our effort and that is our target. And though I am not able to give a guidance or a number because we said let first FY2022 happen or at least when we are a little bit in between and once we know exactly how the cost structure looks like, the product mix looks like because this is going to be a very big step for us, the first organic greenfield, which we will be doing and it will double our organic capacity. And may be for the first time, we feel we will not have a capacity constraint. Plus, we discussed also, I will be able to do more of the larger molecules as the size increases, things like that. So how many of these pan out, we need to see that and then we can give you beyond that.

Moderator: The next question is from the line of Nav Bhardwaj from Anand Rathi.

Nav Bhardwaj: Sir, what I would want to know is that, the buzz that is going around with the new APIs and the new names that have come across that has been released in the gazette, is that an increased business opportunity? Will that lead to a faster utilization of the capacities that are coming by?

Dr. Harin Kanani: Yes, we do have APIs in that list for which we make raw materials, some of our advanced intermediates or the planned advanced intermediates also fall in those broad range of APIs. But as you know, this is something which was announced one month ago, people are still going to apply and whether for the pharma companies, the attraction which is given by the Government is significant enough, whether they really put the capacities and when those capacities come online. So, we are also reviewing what is happening there, discussing with our customers and taking it into our plans, but nothing concrete yet has happened in that direction.

Moderator: The next question is from the line of Puneet Jain from Fair Value Capital.

Puneet Jain: I want to know what is the supply situation on our domestic RM, specifically bromine? And what has been the price movement in the RM component?

Dr. Harin Kanani: **T**he domestic supply specifically with bromine. The answer to that is, yes, the bromine plants started a bit later than our plants started, but we had some inventory and we had some small strategic quantity, which we import, which was available. So, with that we were not affected and by the time that inventory would have gotten over, the Indian bromine plants also started, and they have been supplying bromine regularly after that. So yes, and all other raw material also from international suppliers also continues to be available.

However, as I mentioned earlier, for some of the imported raw materials, we are keeping a bit more inventory just in case because you do not know, which region may get affected when. And also, sometimes there are logistical challenges at the port, etc. So, we are keeping a slightly more inventory.

Puneet Jain: Any significant movement in time?

Dr. Harin Kanani: I think, I have shared earlier that in this year, bromine prices had increased as average. In fact, they had increased in Q3, Q4 of last year itself, but we do have annual contracts with our customers. So last year, the impact of that was relatively less, but in this year's contracts, we had a slight increase in bromine prices.

Moderator: The next question is from the line of Rohit Nagraj from Sunidhi Securities.

Rohit Nagraj: Sir, last quarter you had mentioned about the collections trend, which was affected during the early part of April. How is it now in Q1 and probably, for the 1.5 months, which have gone by for Q2?

Dr. Harin Kanani: So, in April and May the challenge continued. I think, post mid-May, it started improving, June was regular and we removed a significant backlog by July. So, our cash flows and working capital requirements, where the limits are available, have become even more comfortable than during the last 3-4 months. I have to check, but it is now slightly better than what it was end of March.

Rohit Nagraj: Sir, and one last clarification. We have mentioned that we will be going from Rs. 300 crore to nearly Rs. 350 crore. Would this growth be driven by volumes, because as I understand, probably we have capacity constraint at most of the facilities and as you mentioned on the lithium derivatives, half of the revenues will come this year and full potential will be recognized in the next year. Also, if prices correct, will that have an impact on the overall revenues?

Dr. Harin Kanani: Yes. So more accurate numbers are Rs. 306 crore to close to Rs. 350 crore. Now, in the first quarter, partly because of the overhang and good demand together we already have done Rs. 12 crore more. So, we still have about Rs. 25 odd crore to gain over the last three quarters. And last Q4 was an aberration, if you see. In last Q4 also, we would have done slightly more. So, what we feel is I cannot say it will be uniform throughout the year. As I mentioned earlier also, second-half we see better opportunities to capture that growth. One is that a lithium approval will come. Then in Q4, we are also expecting the Dahej facility to come and any which ways Q4 is generally quite heavy. So, we already got something in Q1 and then Q3, Q4. So second-half is also something where I expect more growth to come.

Moderator: The next question is from the line of Karthik Bhatt**,** Individual Investor.

Karthik Bhatt: During the last call, there was a mention that there is an export benefit given to players in China. So, is there any update on that? Are we seeing any change in competition landscape from China?

Dr. Harin Kanani: Yes, as one of the analysts in his question had asked me that, is China getting some incentives or incentives have come extra? As I was not aware at that time, I tried to find out a bit more and what I have learnt is that China has a policy of giving a VAT refund, like a GST refund. They were not doing full refund, they have done some 3-

4% change in that. But for me, just that alone has not changed any significant things in the landscape.

Moderator: The next question is from the line of Pallavi Deshpande from Sameeksha Capital.

Pallavi Deshpande: On the contract research part, you mentioned, the number of clients has increased dramatically from initially seven to eight. What percentage of revenue is it now and where do you see it going by the end of FY 2022?

Dr. Harin Kanani: So, as I answered previously, currently 30% is advanced intermediates and within that 30%, between 7% and 10% is contract manufacturing and 20-22% is pure advanced intermediates of our own. So as of now, because our absolute number is increasing significantly, from let us say Rs. 306 crore last year to Rs. 450 crore, what we are targeting in next year. For now, we have kept ourselves a target to at least maintain that because this is a focused area. So even when we grow in absolute terms in two years by about 50%, we at least try to maintain the same percentage. So, that is our first target. And then, we will try to see if we can further improve.

The increasing number of clients is the number of customers with whom we have started working. So, whether that will be sufficient. I mean, our target is to at least make sure it is sufficient that even when the absolute growth is upped by 50%, this is growing at least by 50%. And then, if we can do more, I mean, that is something that will be our effort.

Pallavi Deshpande: And my second question, if I may, would be, any guidance you can give us on the FY2022? I mean, post this complete expansion on the margin side?

Dr. Harin Kanani: As we said, when you are operating a facility in the first year, sometimes there are some operational challenges, there are efficiency issues, etc. So, while we will have the benefit of higher capacity, lower overheads as a percentage, there will also be some of the challenges of the new unit, things like that. So, as of now, our guidance remains at 18.5%, plus-minus 1%. If COVID remains, and is significant, plus-minus 1.5%, in that range. And we said, allow us to please reach up to FY2022 to get the unit started and then, we will have a better idea of what is the exact product mix we are able to achieve, because this is a significant increase in our capacities. So, once we will know what is the new product mix, what is the final cost structure that we are getting, we will give you a guidance on what will be the margins going forward.

Moderator: Thank you. Well, ladies and gentlemen, that was the last question for today. I would now like to have the conference back to the management for their closing comments.

Dr. Harin Kanani: Thank you once again for taking time out to join our call. I hope we have satisfactorily answered all your questions. Should you have any further question, please feel free to contact our Investor Relations team, CDR India. We look forward to connecting with all of you again in the next quarter.

The transcript has been edited for clarity. The transcript may contain transcription errors. The Company takes no responsibility of such errors, although an effort has been made to ensure high level of accuracy.