“Zydus Wellness Limited Q1 FY18 Post Results Conference Call”

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Moderator: Good day, ladies and gentlemen and welcome to the Zydus Wellness Limited Q1 FY18 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 * 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: Good evening and welcome to the post results teleconference of Zydus Wellness Limited for the quarter one financial year 2017-2018. We have with us Dr. Sharvil Patel, Chairman; Mr. Ganesh Nayak, Director; Mr. Amit Jain, CFO; Mr. Tushar Shroff, Senior Vice President, Corporate Finance and Mr. Vishal Gor, Vice President, Corporate Finance at Cadila Healthcare Limited.

It has been a challenging quarter as the business was impacted in the month of May and June in the run up to the GST implementation from 1st July 2017. Our April and May 2017 sales grew by 8.2%; however, in the month of June, the company witnessed destocking by the trade. As a result of which, sales were impacted. The company registered an overall consolidated decline of 1.1% in the total income from operations for the quarter. During the quarter gone by, our key brands namely Sugar Free, Everyuth scrub and Everyuth peel off have maintained leadership positions in the respective categories.

Coming to the consolidated financial performance of the quarter one financial year 2017-2018, our total income from operations have gone down by 1.1% year-on-year to Rs. 1,155 million. The gross margin of the quarter ended 30th June 2017 included Rs. 180 million related to additional excise duty credit received by Zydus Wellness Sikkim, our partnership firm for the financial year 2014-2015 and 2015-2016 pursuing to the order passed by the office of the commissioner of customs, central excise and service tax for the fixation of special rates of excise duty. Hence, the figures of previous periods are not comparable with those of the current quarter. Our gross margins as a percentage to total income from operations on a like-to-like basis decreased by 673 basis points as compared to last year and by 87 basis points on a sequential basis and stood at 61.3%. The reduction in the gross margins was mainly on account of increase in prices of key input materials and product mix due to destocking by the trade.

During the quarter gone by, we have continued our investments behind the new launches and category building. As a result, our earnings before interest depreciation and tax on a like-to-like basis was down by 71.5% year-on-year to Rs. 56.2 million. EBITDA margin as a percentage to total income from operations stood at 4.9%. Profit before tax on a like-to-like basis was down by 55.4% to Rs. 113.7 million. Net profit on a like-to-like basis was down by 57.4% to Rs. 94 million. The above performance is one-off and reflects the challenges which are more of a temporary by nature due to transition issues related to GST. We expect business to recover back to normalcy in the coming quarters.

With that, let me share some of the highlights of operations for the quarter gone by. On the Sugar Free front, our new launch Sugar Free Green launched in March 2017 was supported by 360 degree campaign to drive awareness and offtake. The initial feedback from the trade is encouraging. We extended our advertising platform of Smartness Wali Sweetness with our brand ambassador Parineeti Chopra and Sanjeev Kapoor to the new campaign on the Sugar Free Green as well. Going forward, our focus will be aggressively driving the culinary business through first of its kind digital initiation and further driving the awareness of Sugar Free Green.

On the EverYuth front to drive the growth of scrub, in May 2017 we launched new scrub for problem problem-prone skin with neem and papaya as the ingredients. We continue to support scrub and peel-off through various media campaigns to drive the category penetration. To further drive the growth of face wash segment, we launched new advertising campaign to support Tulsi Turmeric Face Wash that was launched in the earlier quarter.

On the Nutralite front, Nutralite had continued its strong volume growth during the quarter despite the GST. To widen the reach of our premium range and new flavors, we have launched new advertising campaign with celebrity chef Sanjeev Kapoor. This was complemented with on-ground activations to drive trials and further strengthen Nutralite credentials. On the digital front, we have used digital media like Facebook Live with chef Sanjeev Kapoor to drive consumer engagement. Going forward, we intend to increase our investments and efforts in digital space to complement conventional touch points.

As per MAT June 2017 report of Nielsen, the sugar substitute category has grown by 14.1%. Sugar Free has maintained its number one position with the market share of 94.6% which is an increase of 50 basis points over the same period last year. The scrub category has grown by 8.6%. EverYuth Scrub has maintained its number one position with the market share of 31.7% which is an increase of 30 basis points over the same period last year. The Peel Off Mask category has grown by 11.1%. The EverYuth Peel Off Mask has maintained its number one position with a market share of 88.9%.

While we have transitioned to GST regime from 1st of July, there could be some hiccups in the trade especially in the wholesale channel. We expect things to improve over the next few months. Going forward, we also see softening in the prices of our key input materials which will help us improve our gross margins and bag our brand investment plans going forward. We are committed to improve our growth rates and focus on executing our strategy.

Thank you and we will start the Q&A session. Over to the coordinator for the Q&A.

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. We have the first question from the line of Kaustubh Pawaskar from Sharekhan Limited. Please go ahead.

Kaustubh Pawaskar: Sir, just wanted to know Sugar Free, it has maintained its leadership position and on Y-on-Y basis, even the market share has improved. So going ahead with the new product, what kind of growth you are expecting in the category because since you have added variance into it and what is your expectation from this particular brand?

Tarun Arora: First to put, simply I think we have already seen last quarter, the growth rates of the category going up. The offtake growth rates going up to double digit to 14.1% at a MAT level. We believe with Sugar Free Green coming in and I think this was a long-awaited project for us, several times this has been discussed in the investor calls as well. We believe Sugar Free Green could help us grow the category at a significant level and it could be a major driver of growth for the whole category as well. It comes from being a 100% natural source, it could address a lot of barriers which exist for the category and we are really putting sufficient resources to back this initiative.

Kaustubh Pawaskar: And sir my second question is on the GST impact. I think June was quite bad for you and we have seen the similar kind of trend for most of the FMCG companies, how was it July and is now trade back to normalcy or still you are seeing some kind of hiccups?

Tarun Arora: So June was bad, you are right and I think it was more affected by some sub channels if I were to give you a sense of pharma chemist who is most affected. That is why Sugar Free was most affected. Modern trade and some other substockists as well also affected. It is hard to discuss the specific details going for the next quarter, but I can tell you that we are facing some hiccups which are getting eased out and like I mentioned over the next few months, everything should come back to normalcy. The wholesale is being slow to start if I can give you a sense.

Kaustubh Pawaskar: Sir but just an understanding. For you, modern trade and pharma, this channel is quite important than the wholesale. So is it right to understand that recovery may be faster for you in comparison to other companies where wholesale mix is little bit on a higher side?

Tarun Arora: Wholesale is important to us as well. I cannot compare ourselves with others, but wholesale is important to us as well, but we expect smooth recovery over the next 3 months.

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

Manoj Thakur: What we understand globally is that the consumption of sucralose as well as aspartame. They have been consistently coming down whereas Stevia has been going up. So with the launch of Sugar Free Green, do you believe that similar trend would emerge in India or we are at a fairly low consumption phase so that all the three categories can grow? What do you think?

Tarun Arora: Manoj, I think so what is really happening is we are reasonably should I say molecule agnostic in our approach. To us, formats are important, how people are consuming and table top and culinary are the two spaces that we believe. Culinary could be much bigger than what it is today. There is still sufficient room for growth for sucralose as well. It is one of the most suitable culinary formats. So we expect all the three molecules to continue to grow. I have no reason to believe that we will see a decline in any of these. Obviously, Sugar Free Green Stevia is sitting on a negligible base. The potential of growth is humongous. Lot of people sitting on the side could expand it out of that category.

Manoj Thakur: In the table top category, do you believe that the Sugar Free Green could cannibalize the Sucralose (Natura) as well as Gold?

Tarun Arora: I do not think there is too much of worry of cannibalization. We have had two molecules for long enough time and we have seen very limited cannibalization. So, I do not envisage cannibalization, but if any happens, we are reasonably prepared and we will be able to deal with it, but I am seeing a good potential for growth for both Natura which is sucralose and Stevia to drive growth. Aspartame will remain because there are consumers who committed loyal to it and will stay there. So, I am seeing very limited cannibalization as of today.

Management: And I think it is also important to understand that taste plays a very critical role and there are long-term consumers of both Gold and Natura and they do not like to shift from one brand to the other because of taste and other reasons. So, the existing loyal base remains and the growth will come from the non-users and the sitting on the sense kind of users for the Green where that will fill that place.

Tarun Arora: new users and increasing consumption around culinary and other things. These are two fundamental reasons.

Manoj Thakur: Sir, what is your internal asset in terms of growth rate, we have been at the exit, almost double digit 13%-14% growth rate which is a fairly strong growth rate last quarter. This year, GST impact, the water is muddied, but going forward do you believe that we could with addition of Stevia, we could exceed that 14%-15% growth rate?

Tarun Arora: That is what we are building for and that is why we have kept our investments up, we are trying to keep the momentum up.

Management: As we strongly feel that next, the Sugar Free Green could be the significant value enhancer for the overall category for us because it is able to answer one of the difficult questions that are poised for the other brands.

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

Tejas Shah: Sir, if I look at your numbers for the quarter, drop in sales is not that severe, but when we go down, the gross contribution in EBITDA actually has dropped materially. I understand that there is negative operating leverage at play, but if you can help us understand which cost item actually drag the numbers to this proportion?

Tarun Arora: So fundamentally, the key driver of this struggle at the bottomline is gross margin which is affected largely by the very high input prices which have existed for last couple of quarters and this quarter when the sales is dropped, we have not been able to manage that impact on the overall bottomline at EBITDA level and we have not cut our advertising because there is a momentum on our brands. The consumers are buying the products. For one or two months, the operating reason I did not want to cut the consumer offtake and these investments are required for the brand. Personally, what we have discussed, we believe with the prices getting better, the softening of input prices, we believe over next 1-2 quarters, we could have quick recovery on the gross margins which will get our overall bottomline back to a regular level.

Management: So, I think it is important to say that two of our larger areas, we have forward booked at lower prices, so it is something that we are very clear that gross margins will come back from the low levels that are right now because we already have forward booked on lower rates.

Tejas Shah: And sir, are we taking any pricing interventions to protect margins?

Tarun Arora: No, there is no need to do that. It is a very temporary phenomena and it is not required.

Tejas Shah: And even for GST, we are not required to take any pricing action?

Tarun Arora: Whatever were required for GST, we have actioned those out.

Tejas Shah: And sir you mentioned that retail offtake is very robust across our brands and some of our GST reason that was not visible in our primary numbers. So is channel running with very low inventory level as of now?

Tarun Arora: Not really, I think it could have come down substantially, but the full recovery may not have happened. Pharma was a worst hit. So that was the worst hit and that affected us most. We hope that some of this recovery will happen.

Management: See pharma overall after GST also destocks, so I think they will not go back to the earlier inventory, but there has been a significant destocking. So some improvement will happen. How the wholesale channel starts behaving, we have to still wait and see, but our modern format had come back faster and we are doing well. Pharma will come back and we have to watch for the wholesale to see how they roll in the next couple of months. I think for us it should be okay because we have a strong market share in all of the three categories. So for us, that should not be a concern and so far, Nutralite has no concerns related to GST. So that brand continues to perform irrespective of GST.

Tejas Shah: And what proportion of our revenue is exposed to CSD channel?

Tarun Arora: Very small. So therefore there is no channel. Less than 1%.

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

Kinjal Desai: I just wanted to understand one point. The tax refund that we have got this quarter, is it a one-time thing or would we be seeing it for the subsequent quarters also?

Management: No, it is a one-time thing. We got that 18 crores refund from the government.

Tarun Arora: It pertains to 2014-2015 and 2015-2016.

Kinjal Desai: So going ahead now we will get back to one normal rate of duties, right?

Tarun Arora: Yeah.

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

Monica Joshi: If you could give us a ballpark number, on a steady state basis, how much of your Sugar Free sales will be coming from the chemist channel, how much would be from the modern trade and how much would be from any other channels?

Tarun Arora: So broadly two-thirds of our sales is still from the chemist channel.

Monica Joshi: And as you said, if I heard you correctly, you said that April and most part of May, you were at about 8% revenue growth for the company and then the GST hit. Sir if you could just give us some color on how much of this decline that you saw in June particularly was because of the pharma channel and how much was in modern trade?

Tarun Arora: I cannot give you a breakup of these, but both came down significantly. Pharma was worst affected, but the modern trade cut down on purchases and that started right in May itself, partially in May.

Monica Joshi: So in pharma, we have started seeing inventory buildup. So would you say that, that is happening in Sugar Free too?

Tarun Arora: Not really. We will not see an inventory back to the same levels.

Management: It has started to come up because it is significantly fallen, but we all feel that the earlier inventory levels will not be, let us see. We have to wait and see what the pharma channel..

Tarun Arora: But there will be some resistance to go back to the inventory levels. So same levels may not reach at least in short to medium term.

Monica Joshi: And what about modern trade, how does that stand recover?

Tarun Arora: That will be back to normal, that should be back to normal. There is a reasonably well organized setup. So I do not see any challenges there. It is going to be far more transparent there.

Monica Joshi: One accounting number here. So the employee cost we see has gone up significantly. It has also gone up a bit on a quarter-on-quarter basis. So is this one-off element here or it should be this run rate as you go ahead?

Tarun Arora: So on a sequential basis, it is not that significant. It has grown up by 14% which is largely on account of the increments which we rolled out every year in the April.

Monica Joshi: Sir then this is a run rate we should consider as we go along?

Tarun Arora: Yeah, that should be fine.

Monica Joshi: And it is great to see that advertising is back and you are putting all your might behind the brand. Sir, we should expect advertising as a percentage of revenues now to revive from the FY17 levels. It should go up.

Tarun Arora: Could you just repeat the last part of the question?

Monica Joshi: Sir, advertising has a bit of seasonality as we see the quarters, right, but it is nice to see that in a market which was so tough for most players, you have maintained your absolute outgo in advertising. Now what I wanted to understand is that we closed FY17 at about 17% and to sales proportion. Sir you expect this number to go up and if yes, can you give us some indication will it be 17%, 18%, 19%. Where do you see to close the year?

Tarun Arora: We are trying to maintain a similar level. We may see a 2%-3% if at all going up based on initiatives as they will come along, but we are largely trying to maintain our annual numbers. They may have quarter to quarter some differences of course you will see. We have got some new launches more in the pipeline. So to bag the new launches, we will invest, but over a period of time that will even out as the new launches mature over a period of time. We are seeing very good traction on our Sugar Free Green. So, the campaign seems to be working well, so we will look at how do we enhance that campaign because the start has been very good for Sugar Free Green. But even EverYuth has responded well. So, we are quite bullish on our launches and we are hoping that as we keep getting a response to that, we will keep investing back and it will be useful.

Moderator: Thank you. Ladies and gentlemen, that was the last question. As no further questions, I would now like to hand the conference over to Mr. Tarun Arora for closing comments.

Tarun Arora: Thank you all for your questions. We will meet next quarter.

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