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TARO - Q2 2019 Taro Pharmaceutical Industries Ltd Earnings Call

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## CORPORATE PARTICIPANTS

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**Mariano Balaguer** *Taro Pharmaceutical Industries Ltd. - CFO, CAO & VP*

**Uday V. Baldota** *Taro Pharmaceutical Industries Ltd. - CEO & Director*

**William J. Coote** *Taro Pharmaceutical Industries Ltd. - Assistant VP of Business Finance & IR and Treasurer*

## CONFERENCE CALL PARTICIPANTS

**Anubhav Aggarwal** *Crédit Suisse AG, Research Division - Associate*

**Karthik Sagar Sunkesula** *H.C. Wainwright & Co, LLC, Research Division - Research Analyst*

**Sameer Baisiwala** *Morgan Stanley, Research Division - Executive Director*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Taro Earnings Call. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to turn the call over to Bill Coote. You may begin.

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**William J. Coote** - *Taro Pharmaceutical Industries Ltd. - Assistant VP of Business Finance & IR and Treasurer*

Thank you. Good morning, everyone, and welcome to our fiscal year 2018/'19 first half earnings call. Joining me today on the call are Mr. Dilip Shanghvi, Chairman of the Board of Directors; Mr. Uday Baldota, Taro's CEO; and Mr. Mariano Balaguer, Vice President and CFO.

We hope you received a copy of the earnings release, which can be found on our website at taro.com.

We anticipate that many of you may have questions concerning not only this quarter's and year-to-date financial performance, but also our markets, operations, strategies and other matters. While we will try to respond to most of your queries, we will not be able to share product-specific and commercially sensitive information, including pipeline details. We ask that you limit yourself to one question. And if you have more questions, please rejoin the queue. As a reminder, this call is being recorded and a replay and call transcript will be made available on our website.

Before we proceed, I must remind you that today's discussion may include certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Although the company believes the expectations reflected in such forward-looking statements to be based on reasonable assumptions, it can give no assurances that its expectations will be attained and should be viewed in conjunction with the risks that our business faces as detailed from time to time in the company's filings with the SEC.

With this, I would like to turn the call over to Mr. Dilip Shanghvi.

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**Dilip Shantilal Shanghvi** - *Taro Pharmaceutical Industries Ltd. - Chairman of the Board*

Thank you, Bill. Welcome all of you, and thank you for joining us today for Taro's earnings call after the announcement of the financial results for the 2018/'19 second quarter.

While we are encouraged with the positive directions that we realized in the quarter, especially for both gross profit and EBITDA over quarter 1 of this year, we expect the U.S. generic market to remain competitive in the short term.



Yesterday's announcement of a \$500 million special dividend, in conjunction with our ongoing share repurchase program, is our latest action in creating value for our shareholders.

Taro's strong balance sheet and operating cash flows continues to provide the company with the flexibility to consider a variety of operational and strategic growth opportunities going forward, including inorganic growth opportunities, to further maximize stockholder return over the longer term. We remain committed to maintaining a disciplined capital allocation strategy.

I will now hand over the call to Uday.

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

Thank you, Mr. Shanghvi. Welcome, everyone, and thank you for joining us today. As Mr. Shanghvi indicated, the generic climate remains very much the same. We are in a very dynamic and competitive industry. Our observations are that the overall pricing trend and environment, especially in the U.S., is not changing dramatically, and price deflation depending on the product is a reality.

A few highlights of our business. Our volumes have increased on the year-to-year comparison up 7% over last year. Our 2/3 of our products rank #1 or #2. We have a pipeline of 30 ANDAs awaiting approval with the FDA.

We have a strong balance sheet with \$1.8 billion in cash, \$1.3 billion after the special dividend payment and no debt. We consider -- we continue to consider and execute on creating long-term value for all the stakeholders.

With today's announcement of the \$500 million special dividend or approximately \$12.81 per share and in conjunction with our share repurchase program, we have created significant value for our shareholders.

In total, counting share repurchases and the special dividend, we will have returned more than \$1.1 billion in value, with \$55 million as of September 30 remaining under the current share repurchase authorization.

With continuing healthy operating cash flows and cash of \$1.3 billion after the \$500 million special dividend, we will continue to identify and evaluate opportunities that make strategic and financial sense and will remain disciplined in our evaluation.

Let me talk about Taro's R&D effort. As you have known, we have always undertaken -- we have always taken a long-term view of our R&D investments. We have a pipeline of products under development for supporting growth and portfolio strategy of our different business segments. Given the challenging external environment, we will continuously evaluate our pipeline and invest in products which are viable.

With this, I will now hand over the call to Mariano to discuss financials.

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**Mariano Balaguer** - *Taro Pharmaceutical Industries Ltd. - CFO, CAO & VP*

Thank you, Uday. Good morning, everyone, and welcome. Let me discuss some of the key financial highlights, which are in comparison to the comparable prior year period. First, second quarter followed by the 6-months comparisons.

Net sales were \$159 million, a decrease of \$11 million as a result of continuing increased competition and the challenging U.S. pricing environment. Overall, volumes for the quarter increased slightly. Gross profit of \$109 million, decreased \$17 million and as a percentage of net sales was 68% compared to 74%.

Research and development expenses of \$15 million decreased \$3 million. Selling, marketing, general and administrative expenses, SG&A, of \$19 million increased slightly. Operating income of \$79 million decreased \$10 million and as a percentage of net sales were 50% compared to 52% in the prior year quarter.

As a result of the above, quarter 2 EBITDA of \$83 million decreased \$10 million, with EBITDA margin of 52% compared to 55% in quarter 2 last year.

Interest and other financial income increased \$5 million to \$9 million. Foreign exchange expenses of \$6 million compared to FX expenses of \$33 million, a \$27 million favorable income to earnings. This impact is principally the result of a strengthening of Canadian dollar versus the U.S. dollar at a lower rate than the prior period.

Tax expenses increased \$12 million to \$19 million, resulting in an effective tax rate of 23.5% compared to 11.5% in Q2 last year.

Net income attributable to Taro was \$63 million as compared to \$52 million as the decrease in operating income was more than offset by the favorable impact from FX, resulting in diluted earnings per share of \$1.60 compared to \$1.30 for the same period last year.

Let me now discuss the 6-month performance and comparison to last year. Net sales of \$314 million decreased \$18 million, the result of continuing increase in competition and the challenging U.S. price environment mentioned before in a quarter, with a 7% increase in overall volumes.

Gross profit of \$209 million decreased \$33 million and as a percentage of net sales was 67% compared to 73%. R&D expenses of \$28 million decreased \$5 million, principally due to the timing of clinical studies. SG&A expenses remained flat at \$43 million.

Operating income of \$142 million decreased \$25 million and as a percentage of net sales was 45% compared to 50% in the prior year.

EBITDA was \$151 million, with a decrease in margin from 53% to 48%. Interest and other financial income increased \$8 million to \$17 million in the current period.

FX income of \$4 million compared to FX expenses of \$52 million, a favorable impact on the earning of \$56 million. This is principally the result of the Canadian dollar remaining relatively flat versus the U.S. dollar in the current year compared to a strengthening in the prior year period.

Tax expenses of \$33 million increased \$16 million, with an effective tax rate increased to 20% from 14%, which reflects some onetime benefit in prior year. The 20% rate is relatively in line with our historical tax rate.

Net income attributable to Taro increased \$23 million to \$130 million from \$107 million, resulting in diluted earnings per share of \$3.31 compared to \$2.65 in the prior period.

Our cash flow and balance sheet remained strong. Cash, including short-term and long-term bank deposits and marketable securities increased \$110 million to \$1.8 billion from March 31, 2018, including a \$32 million impact from the company's share repurchase in the fiscal year 2018/'19.

Cash provided by operations for the 6 months ended September 30, 2018 of \$158 million as compared to \$139 million for the 6 months ended September 30, 2017.

As Uday previously mentioned, we continue to return value to our shareholders through our share repurchase program.

During the current fiscal year, the company repurchased 286,000 shares at an average price of \$100.88. Throughout September 30 in total under the authorization, the company has repurchased 1,891,000 shares at an average price of \$102.83. As of September 30, 2018, approximately \$55 million remain under this authorization.

Finally, regarding the payment of the special dividend, let me explain that dividends payment will be subject to withholding of Israel taxes.

Shareholders, who are resident in the U.S. or any country that is party to a tax treaty with Israel may be entitled to a refund of a portion or all of the Israeli tax withheld. Shareholders will be notified of the procedures to obtain refund of withheld tax, if applicable, shortly after the record date. Such procedures will also be available on our company website at taro.com.



I would like to thank you everybody. And now I will hand back the floor to Uday.

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

Thanks, Mariano. Before we open the floor up to your questions, regarding the Department of Justice investigation, we have nothing new to report on this matter, and we continue to work with our counsel to cooperate with the Department of Justice.

We remain committed to strong corporate governance and fostering a culture of compliance at Taro.

In conclusion, we are committed to enhancing shareholder value, as our recent action indicated, growing our business with the execution of our strategy and the evaluation of business opportunities that meet our criteria.

With this, I would like to open the floor up for your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from Ram Selvaraju of H.C. Wainwright.

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**Karthik Sagar Sunkesula** - *H.C. Wainwright & Co, LLC, Research Division - Research Analyst*

This is Karthik on for Ram. So the payment of a special dividend mean that substantial acquisitions are now off the table?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think that's what we attempted to indicate in our communication that despite making this payment of \$500 million, I think we'll still continue to have a reasonably strong cash position of \$1.3 billion. And the business thus continue to generate strong cash flows. And we're committed to using this opportunity -- using this funds to look for opportunities that meet our criteria.

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**Karthik Sagar Sunkesula** - *H.C. Wainwright & Co, LLC, Research Division - Research Analyst*

Okay. Great. And can you tell me more about the drivers underlying the continued gross margin pressure being observed? And at what gross margin level might these cease to be a factor?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think the continued competition in the industry on account of new entrants, on account of accelerated accruals, on account of customer consolidation and expectations of customers for lower prices, I think all of that continues to pressure the prices that we get for our product and hence the gross margins. I think in terms of expectations of gross margins, very difficult to sort of state anything because it also depends on the specific product mix that we have and how does the competition impact the products that we are presenting.

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**Karthik Sagar Sunkesula** - *H.C. Wainwright & Co, LLC, Research Division - Research Analyst*

Okay. That was very helpful. And lastly, when might the firm in-license or acquire a branded drug opportunity of the same ilk as Novexatin could have been considered to be?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

Again, I think it's very difficult to talk of specific time lines. I think we continue to look for opportunities that could sort of aid in the execution of our strategy. But given the uncertainties of these processes, I think it's difficult for us to talk of any specific time lines.

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**Operator**

(Operator Instructions) Our next question comes from Anubhav Aggarwal.

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**Anubhav Aggarwal** - *Crédit Suisse AG, Research Division - Associate*

Uday, how does the company decide between a special dividend versus share buyback, which one to go for? And why are the last share buyback, which is on for last 2 years, why it's still been so slow to complete?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

So I'll ask Mariano to specifically respond here. I think there is a specific structure put together for the share buyback that is currently ongoing. And depending on, I think, the price in the market, the purchases can be affected during the day, but Mariano, you can give some more color to that.

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**Mariano Balaguer** - *Taro Pharmaceutical Industries Ltd. - CFO, CAO & VP*

Yes, thank you, Uday. To answer your question, first, our capital allocation, we discussed the strategy on our board, we watched different proposal and options. So the difference between a share buy back or a special dividend it comes from our strategy of capital allocations that we have. All that considering how is the best way to return value to our shareholders. In term of the length of the share buyback, we do not have a specific time purposely because we consider that to be also a way to return value to shareholders. So we do not have an agenda of completing that in a certain time. And as we put it together as a team (inaudible), the program is working well, and we're very pleased with the result that we have seen and I hope that our shareholders have seen that same.

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**Operator**

(Operator Instructions) We have a follow-up question from Anubhav Aggarwal of Crédit Suisse.

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**Anubhav Aggarwal** - *Crédit Suisse AG, Research Division - Associate*

So just one quick question on the quarter sales increase that we see sequentially from June quarter to September quarter. What you would say that -- how much was the contribution of new launches? I'm not looking for a number here, but I'm trying to say, is the majority of the delta which is coming here, did that come from new launches, or the volume ramp up in the existing products?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think there is no one single product that sort of has contributed to this change. So it's sort of broad-based and sort of mixed. It's not as if we just launched one product and hence, we've got this case.

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**Anubhav Aggarwal** - *Crédit Suisse AG, Research Division - Associate*

And that is why, Uday, I was just clubbing all of them as one new launches, which you would have launched in this quarter. The reason I'm asking that because the margins have expanded significantly gross margins. So certainly, since -- in this quarter, we shipped products where the margins were very favorable. And I was thinking -- that's why I was asking the new launches are a large contributor of this delta.

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I wouldn't say so, Anubhav. It's not as if the new launches are the dominant contributor of this margin change.

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**Operator**

Our next question comes from (inaudible) [Bilal] of CLSA.

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**Unidentified Analyst**

Just one question. So far in the earnings season, we have seen most of the generic pharma companies talk about stabilization or an improving trend or rather stability in the U.S. So what are you seeing differently that makes you believe that this kind of environment may remain for some time?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think what we're seeing is 2, 3 things. First is, the continued approvals for products which are sort of in our segment. We're seeing entry of new competitors. We're seeing continued pressures from our customers in terms of pricing. So when we look at the overall portfolio that we have and probably the larger industry has, we don't see a dramatic change.

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**Unidentified Analyst**

But are you seeing all those launches happening? I understand that the approval cycle has been very fast. But we have not seen companies launch at the same pace. Maybe because the dynamics are such that maybe the new launch is not as viable or profitable. So are you seeing those launches coming through?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think, incrementally, launches do hurt ultimately the incumbents. So to that extent, if we have, let's say, a reasonable share of products -- reasonable share of the market in products that we're marketing, any incremental competition certainly hurts. And that's something that we will see even if, let's say, the number of launches to the approvals even if it is low, but anything which is incremental hurts.

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**Unidentified Analyst**

So from June 2017 to September '18, if we look at your revenues, then you are in this \$160 million to \$170 million band. Don't you feel that the kind of damage that should have happened because of new entrants coming through possibly has, to some extent, played out for the base business?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think the partly compensating factor is the volume growth also that you're seeing here. No, I'm saying which is also on account of the way the industry is positioned today.

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**Unidentified Analyst**

And are you happy with the pace of approvals for you?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

Yes. I think the approvals that we're getting is in line with our expectations. So that I would say, yes.

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**Operator**

Our next question comes from Sameer Baisiwala of Morgan Stanley.

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**Sameer Baisiwala** - *Morgan Stanley, Research Division - Executive Director*

Uday, just on your M&A efforts, it's been quite a while, nothing has been done. So can you just help us with what's going on over there? What's stopping you from pulling the trigger?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think, Sameer, as we said that it has to make strategic sense and also be reasonable in terms of our financial evaluation. So we were looking at opportunities, but we haven't been able to find anything which sort of beats that.

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**Sameer Baisiwala** - *Morgan Stanley, Research Division - Executive Director*

So Uday, specifically, I mean is it the valuation issue? Or is it the strategic fit? And when you say that strategic fit, I mean, are you looking at specialty portfolio or more of a generic portfolio?

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**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I would say that, ultimately, the businesses that Taro has and we have several revenue segments, we are looking at supporting all the revenue segments through organic as well as inorganic opportunities. So we were looking at opportunities, but the way we see these opportunities, some of these don't fit the way we look at the future of our business. And if something fits, then probably it doesn't fit the financial criteria that we have in mind. So it's sort of ultimately the result is that we haven't been able to make any specific move on a target.



**Sameer Baisiwala** - *Morgan Stanley, Research Division - Executive Director*

Okay. And just on the special dividend, anything you suggest why you chose to give back \$500 million? Why not more? Why not less?

**Uday V. Baldota** - *Taro Pharmaceutical Industries Ltd. - CEO & Director*

I think the amount was determined keeping in mind the fact that we've also wanted to retain flexibility within Taro for any strategic move that we would like to make. So I think that's what, I think, the board's guidance was to us.

**Operator**

(Operator Instructions) There are no further questions. Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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