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Q2 2020 Taro Pharmaceutical Industries Ltd Earnings Call

EVENT DATE/TIME: NOVEMBER 05, 2019 / 1:00PM GMT



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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Taro Pharmaceutical's Second Quarter 2019/2020 Earnings Call.

(Operator Instructions)

As a reminder, this conference call is being recorded. I would now like to turn the conference over to your host, Mr. William Coote. Please go ahead, sir.

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 2019/2020 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 Mariano Balaguer, Vice President and CFO.

We hope you received a copy of the earnings press 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 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 than one question, please rejoin the queue. As a reminder, this call is being recorded, and a replay and call transcript will be 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 turn the call over to Mr. Dilip Shanghvi.

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 second quarter and 6-month 2019/'20 financial results.

As we have stated for some time, the challenging generic landscape continues as the results of the current quarter reflect. However, Taro is not managed quarter-by-quarter, but rather, we view the business over the long term. The sustained R&D investment is vital to Taro's long-term growth strategy and in conjunction with the announced Board-authorized share repurchase program demonstrates our



continuing commitment to creating shareholder value.

I will now hand over the call to Uday.

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

Thank you, Mr. Shanghvi. Welcome, everyone, and thank you for joining us.

As Mr. Shanghvi indicated, the current generic environment remains a very competitive and challenging industry. While some may see the market volatility as leveling off, we see the landscape as still influx with no dramatic change. There are a number of new entrants to the market, who continue to look for opportunities and to get approvals for topical and other products. The competition for market share continues.

A few of Taro highlights. Our 6-month net sales increased \$9 million or 3% over last year. Gross margins of 63%, while slightly lower than historical levels, remain healthy and among the best in the industry. Overall volumes increased by single digits on the year-to-year comparison.

Over 2/3 of our products ranked #1 and #2 by market share in the U.S. generic market. We have a pipeline of 25 ANDAs awaiting approval with the FDA, and we maintain an excellent record with the FDA and other regulatory agencies for quality and compliance.

Taro's strong balance sheet and operating cash flows continue to provide the company with the flexibility to consider a variety of future strategic growth opportunities and to further maximize the shareholder returns over the long term. We remain committed to maintaining a disciplined capital allocation strategy.

Regarding the Board-approved share purchase program. As I've just mentioned, we remain committed to providing value to shareholders. In this regard, we constantly evaluate various alternatives to obtain this result, which include acquisitions, special dividends or share buybacks, all of which have benefits and considerations. In regards to inorganic opportunities, Taro is keen and continues to evaluate such opportunities that have a strategic fit and are financially justifiable.

Based upon our strong balance sheet and operating cash flows as well as a cautiously optimistic view of our short- and long-term strategy, we believe the benefits of a share buyback provides the best benefits and most value to our shareholders, especially, by providing liquidity to the current shareholders.

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

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

Thank you, Uday. Hello, everyone and welcome, again.

Let me discuss some of the key financial highlights, which are in comparison with the comparable prior-year periods.

First, Q2 highlights, followed by 6 months comparison. Net sales were \$161 million, an increase of \$2 million, principally the result of increase in overall volumes. Gross profit of \$102 million, decreased \$7 million, and as a percentage of net sales was 63% compared to 68% for the same period last year.

Research and development expenses of \$16 million, increased slightly. Selling, marketing, general and administrative expenses of \$24 million, increased \$5 million, principally due to the timing of expenses. On a 6-month basis, we are in line with the prior year.

Operating income of \$63 million, decreased \$16 million, and as a percentage of net sales were 39% compared to 50% in the prior-year quarter. As a result of the above, second quarter EBITDA of \$68 million, decreased \$15 million, with EBITDA margin of 42% compared to 52% in quarter 2 last year.



Interest and other financial income remain in line with the prior year despite of a lower average balance in cash and marketable securities. The foreign exchange impact in the current quarter was immaterial as compared to the FX expense of \$6 million, principally the result of the commencement of hedging accounting in accordance with ASU No. 2017-12 and our Canadian subsidiary change to U.S. dollar as its functional currency. Israel, and obviously, USA, have historically been reported in U.S. dollars. The majority of the revenue of the company is generated in U.S. dollar. In addition, a substantial portion of the cost of the company is incurred in U.S. dollars.

Management believes that the dollar is primary currency in the economic environment in which the company and the subsidiaries operate, and we have previously disclosed in our 20-F.

Tax expenses decreased \$3 million to \$16 million, resulting in an effective tax rate of 22.4% compared to 23.5% in quarter 2 last year. Net income attributable to Taro was \$56 million as compared to \$63 million as the decrease in operating income was partially offset by favorable impact in FX and lower tax expenses, resulting in a diluted earnings per share of \$1.46 compared to \$1.60 for the same period last year.

Let me now discuss the 6-month performance and comparison to last year.

Net sales of \$322 million, increased \$9 million, principally the result of a single-digit increase in overall volumes. Gross profit of \$203 million, decreased \$5 million, and as a percentage of net sales was 63% compared to 67%.

R&D expenses of \$29 million, increased by \$1 million. And as I said before, SG&A expenses are \$43 million, increased slightly. Operating income of \$131 million, decreased \$11 million, and as a percentage of net sales was 41% as compared to 45% in the prior year.

EBITDA was \$142 million with a decrease in margin from 48% to 44%. Interest and other financial income increased \$2 million to \$19 million, driven by our treasury strategy of focusing on higher rate long-term instruments, which more than offset the impact of lower average balances in the -- than in the prior year.

FX income of \$8 million compared to \$4 million in the prior-year period. And tax expenses of \$33 million (sic) [\$36.7 million], increased \$3 million, with an effective tax rate increased to 23% from 20%. Net income attributable to Taro was \$122 million compared to \$130 million, resulting in a diluted earnings per share of \$3.17 compared to \$3.31.

As Uday said, our cash flow and balance sheet remain strong. Cash and cash equivalents together with short-term and long-term marketable securities, increased \$122 million to \$1.5 billion from March 31, 2019. Cash provided by operations for the 6 months ending September 30, 2019, of \$123 million as compared to \$158 million for the 6 months ended in September 30, 2018.

I will conclude this. Thank you. And now, I would like to hand back the floor to Uday.

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

Thank you, Mariano.

Before we open the floor to questions, regarding the Department of Justice investigation and state -- and related State Attorney General's investigation.

We have nothing new to report on these matters, and we continue to work with our counsel to cooperate with the Department of Justice and the investigating states. We continue to believe these related civil suits are without merit and continue to defend against them vigorously. Furthermore, 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 announcement today regarding the Board approval of \$300 million share purchase demonstrates. It is important to note that this action does not preclude us from implementing our strategy. Given our strong balance sheet and cash flow, we will continue to pursue further business development opportunities.

As part of our strategy, we continue to look for various ways to strengthen our generic and OTC revenue streams in the U.S., grow our market position in Canada, Israel and other markets around the world that we currently serve in a much smaller scale.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Raghuram Selvaraju with H.C. Wainwright.

Edward D. Marks *H.C. Wainwright & Co, LLC, Research Division - Research Analyst*

This is Edward Marks on for Ram. Just 3 quick ones from me. Just wondering what the effective tax rate is likely to trend towards going forward? Is it going to be more like 23%? Or closer to what it was historically, about 20%?

Of the ANDAs, how many submitted abbreviated new drug applications are either first-to-file or aimed at products for which there are currently fewer than 5 generic entrants?

And finally, have there been any signs of stabilization in price erosion within the core business lines? Or has the extent of erosion remained the same in the most recent period, as it has been historically?

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

So let me respond to your questions. I think from a guidance perspective, generally, we've not given any specific indication of the tax rate, and I think we will sort of continue to maintain the same status that we won't give any specific indication on what the tax rate will be going forward.

As far as, let's say, the ANDAs are concerned, we mentioned that there are 25 ANDAs pending approval with the FDA. We don't break out the first-to-file, and we also don't give any specific details as to how many competitors do we sort of expect for these. And you understand that it's also often difficult for us to estimate precisely both of these things. And to that extent, I think we hesitate giving any specific details and sort of creating a certain expectation in our [investor base].

As far as your third question is concerned, which is about, let's say, the price erosion. As mentioned right in the beginning of the call, I think price erosion is something that we've witnessed in the past and we sort of continue to witness pressure on pricing. And that's something that we are not seeing a dramatic change and that situation may actually continue for some time.

Operator

Your next question comes from Anubhav Aggarwal with Crédit Suisse.

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

One question, Uday. If we just look at quarterly trend of Taro past reported numbers, just wanted to understand, is there any seasonality in Taro numbers, like any quarter which is higher in general on a like-to-like comparison basis or second half higher than the first half? I'm asking because in 2019, second half was significantly higher than the first half. So some help here will be useful.

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

So generally speaking, there is no seasonality if I look at the overall business. I think there are 2 or 3 things that you need to keep in mind. And you've tracked the industry for a long time, so you know. When you launch a product, which can become meaningful, I think it does impact the overall sales numbers that they report. So to that extent, I think there may be some impact in one quarter versus the other quarter.



I think the other thing, which is sort of a very small component, but I think it's important. Some of the products are related to, let's say, the allergy season that is witnessed in the U.S. And to that extent, there may be some amount of seasonality. But these are very small components of the overall revenue. So at an overall level, there is no material seasonality that is something that impacts our revenue.

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

That's useful. Just one clarity on SG&A as well. You mentioned that you're no longer promoting the branded products. And therefore, the reduction in SG&A in quarter 1 was understandable. And certainly, the SG&A shot up now. Mariano mentioned that it's more useful to look at SG&A as a first half number, but second quarter does seem much higher. It's same base what we used to do in 2019 when we are promoting branded products. So what's driving this surge in second quarter?

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

So I think -- I would say that the impact that you see in the second quarter partly is probably also flowing off from, I think, certain underlying, let's say, litigations and things like that, that may have picked up in the second quarter. So it's partly on account of that, but I don't see a dramatic change in terms of the trend.

Mariano, you want to add something?

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

Yes. Remember, we have some IP litigations that we -- going into developing our products. We have components in different level of insurance and other activities that could fall into one quarter versus the other. But overall, I think, [as such pricing] you can take in a better view there.

Operator

Your next question comes from the line of Shyam Srinivasan with Goldman Sachs.

Shyam Srinivasan *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Question, just one on the volume development. If I recollect the commentary in Q1, we had a decline in volume, single digit. And now first half number says single-digit increase. So has there been a change in our strategy in terms of going for volume share during the quarter or during the year? Just if you can help us understand the strategy on volume.

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

Actually, there has been no change in strategy. I think the strategy remains constant. I think the key for us to understand is that there is some shift in the product mix or the business mix. And to that extent, we see, let's say, some changes in the volume growth numbers. But overall, there is no underlying change in the overall strategy that we are pursuing in the market.

Shyam Srinivasan *Goldman Sachs Group Inc., Research Division - Equity Analyst*

So then in the opening remarks, there was a mention that several players are looking at market share. So that doesn't seem to include you. Would that be fair?

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

No. No, I think what we said is that the competition continues to look at gaining market share. And to that extent, it does impact us.

Shyam Srinivasan *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay, got it. Second question is on the cash. I know you've announced like a buyback, \$300 million, but still, that leaves us with significant amount of cash, even if I assume that the buyback completes. So I'm just curious, is there any transformational M&A, any of the other things that you know that one can envisage that what Taro could do with that cash?

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

So as I said, I think we continue to look for inorganic growth opportunities in all our businesses, and that sort of includes -- we would look at in-licensing products, we could look at alliances, we could look at M&A. So I think we continue to evaluate opportunities. It would be difficult for me to give you any specific guidance, either in terms of size or timing.

Shyam Srinivasan Goldman Sachs Group Inc., Research Division - Equity Analyst

Got it. But any specific areas that are adjacent to you? Or any specific therapy areas that you think you are starting to see more interest in? Any color on the M&A would be helpful, yes.

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

No. I think we are looking at all of our existing businesses, how do we sort of add to what we have and probably also a few adjacent areas, but we are looking at all of these.

Shyam Srinivasan Goldman Sachs Group Inc., Research Division - Equity Analyst

Got it. And my last question, I'm just going to try my luck, product specific, Dapsone Gel. We have a Para IV -- we have an approval. Any idea on when the launch could be?

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

Well, I think, Bill mentioned right in the beginning, we generally don't give product-specific information, but sort of -- now that you've asked the question, I think it would be appropriate for me to say that we are sort of prevented from giving any specific date publicly. So as and, I think, when we would be allowed, I think we would talk about it.

Operator

And your next question comes from Anubhav Agarwal with Crédit Suisse.

Anubhav Aggarwal Crédit Suisse AG, Research Division - Associate

Yes. So one question was on the receivable days sequentially. Sales are almost flattish and receivable days have shot up from almost like 121 days to 140 days. Is this geography-related impact? Or what could be driving this?

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

I would say part geography, part timing.

Anubhav Aggarwal Crédit Suisse AG, Research Division - Associate

But when sales are flattish, would the mix change so dramatically in a quarter?

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

When we're talking about geographical mix, we're also talking about where is the sourcing of our product. So that's what is happening in that respect. So that's where you have a big influence, depending on where we building the stock in the U.S., depending on where the product coming, either from Canada or Israel.

Anubhav Aggarwal Crédit Suisse AG, Research Division - Associate

Sorry. Mariano, I did not understand.

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

Anubhav -- Anubhav, if it helps, there is no deterioration in the debtor quality. I think, if that helps. Yes.

Anubhav Aggarwal Crédit Suisse AG, Research Division - Associate

No. For sure, I'm not even doubting that, but just the working capital -- overall working capital for us has increased so dramatically. I know the environment, it's increased for everybody operating in the U.S. But for Taro, in particular, the receivable days have increased so sharply over the last 3 years and it continues to increase. That's why I was asking about it.

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

Yes, specifically on your question on AR. We have also AR that could change at anytime during the quarter depending on our charge-backs and some customer getting into credit balances or not. So that could potentially delay some of the payments. However, as Uday rightfully pointed out, there is no quality issues in our credit at all. There will be no difficulties for collection at all. And as I said



before, there is also a geographical mix in 2 components, also depending on some markets where they have longer term -- payment terms than others. So overall, you can rest assure that quality is being collected pretty well, and this is mainly because of the timing of the quarter end.

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

So just to put it in, this is not -- this quarter receivable is not the right representation, would that be a right statement?

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

As we said before, we don't provide a specific guidance, but I always suggest to all of you to take a look at the company in a longer run and compare more on the annual basis or year-to-year basis.

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

I think, Anubhav -- let me address your question differently. I think there would be an effort internally to ensure that we -- receivables. Clearly, I think, today, where we see ourselves, probably, we also feel that there is a need for us to improve.

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

Sure. And just secondly, on R&D, now we -- I'm just talking about numbers right now. So 25 pending ANDAs, our annual sales is about \$640 million, \$650 million. Do you think that pipeline is good enough for us to enable us to grow, let's say, whatever the internal management aim is, single digit or double digit? So with the resources that you have, do you think you could be spending more or increasing the pipeline? I know we guys got good approvals, but 25, do you think you could -- do you want to spend more money or you're happy with the kind of 25, 30 kind of pending ANDAs?

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

I think, Anubhav, we need to look at it from the perspective as to what is that we can justify in terms of investment. I think what we have in our portfolio today, which is filed with the FDA, but not approved, and what we have, let's say, in development within the company, we are confident that all of these have a positive contribution when they sort of come to market. I think that's the basis on which we build the pipeline.

It would be very difficult for us to say whether it is adequate for us to grow or not because you know there's -- a lot of things depends on when we come to market, what is the competition when we come to market and what is the pricing that we will get. So I think it's difficult for me to characterize it that way. I would only say that all the products that we have, both filed and under development, are sort of constantly reviewed, and we ensure that we have a good return on investment that we are making.

Operator

Your next question comes from Sameer Baisiwala with Morgan Stanley.

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

Uday, just carrying on from the previous question. When you say that you continuously review your pipeline for good returns, et cetera, I see the 2 new approvals that you've got, both Azelaic Acid and [Clinda-Benzo] combination, both of them look to me to be roughly about \$80 million branded net sale opportunity, and you are the fourth entrant. So is this the kind of standard sort of metrics for your pipeline? And do you think you can generate healthy returns with this kind of market dynamics?

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

So Sameer, I think, again, it will be difficult for me to characterize that all of the products that we file, we will be the fourth entrant or a certain number of entrant.

In response to another question, I did say that we do have, let's say, a few first-to-file, but we don't generally break out that number separately. I think the assessment that we do is when we invested this money or when we are investing this money in developing these products, we do look at the number of potential competitors that will come to market and what is the likely revenue that we will get, and hence, does that investment or will that justify the investment that we are making. So we look at all of that and then we decide to go ahead with a certain project. I'm not sure if I can characterize, let's say, these 2 products that you talked of, the generic for Azelaic and

Acanya, and say that all our products are of similar type or very different. But it's product on product that we look at the investment and the return.

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

So, fair enough, Uday. It's just -- sorry for persisting on this point, but when the branded size is 80, prices fall 60, 70 what is left now, whether it's 1 player, 3 player, 4 player, there is hardly anything to justify any return, I mean, I would have thought. So both of these products don't look exciting at all to me.

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

And I respect your view, Sameer. And it does happen that something that you've developed over the years and you have a certain business case, and by the time, let's say, you get an approval and you come to market, the business case does change. It's not as if -- and you've seen the kind of erosion that the market has seen over the years and -- and that's something that's our reality. So I wouldn't say that necessarily in all the cases, we are able to hit the business case that we've had, but we constantly keep on reviewing this and ensure that the money that we are spending today is worth the return that we are likely to get.

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

So fair enough, Uday. And so in the same breath, when your research team is working on future projects, are you able to see enough opportunities based on the current market dynamics that can be lucrative going forward?

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

I think what we've witnessed is that in the last few quarters, particularly given the sharp erosion that you've seen in -- on the pricing, justifying a large number of projects has been difficult. And to that extent, I think our development pipeline has shrunk. But whatever we have in development, we see a strong business case for that. And that's the only reason why it is still in development.

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

Okay, great. With your permission, one final, if I may. [And that's in a] pricing environment, Uday. So even if there is no new entrant in a given product, do you still see some sort of price erosion? Or it's only where there is a new entrant?

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

So I think we are seeing price erosions in a large number of situations, even if there is no new entrant.

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

Okay. If you don't mind, Uday, can you elaborate on that? I mean what drives, in those situations, prices down?

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

I think we talked about it. Someone wants to take a larger market share. We talked about that earlier in the call.

Operator

Your next question comes from the line of Neha Manpuria with JP Morgan.

Neha Manpuria *JP Morgan Chase & Co, Research Division - Analyst*

Uday, in your opening remarks, you mentioned the Gx and OTC revenue stream is what you're looking to strengthen. Could you talk a little bit more about your OTC business? Would this -- do we have a pipeline to grow this business? Or potentially, could we look at more business development to sort of build out that business?

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

So -- yes, I think we have a pipeline. It can be richer than what probably it is today and I think internally we are working to enrich that pipeline. But as I mentioned, when we are looking at inorganic opportunities, we are looking at the OTC business as well in addition to the U.S. generic business or the Canada or the Israel business. We're also looking at the U.S. OTC business to be strengthened with inorganic opportunities.



Neha Manpuria *JP Morgan Chase & Co, Research Division - Analyst*

And is it fair to assume that the OTC business is more resilient and probably growing as a part of our revenue stream?

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

I think it also depends on specific products. I think there are products on which we do face very high competition, but there are a few products on which we are able to grow the business. So it's -- I would say, it's a mix.

Operator

(Operator Instructions) At this time, I would like to turn the call back over to William Coote for any closing remarks or comments.

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

Thank you. Thank you for joining -- your questions today and for joining us on our call. We look forward to speaking to all of you after the announcement of our full year results. Thank you, and have a great day.

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

Thank you.

Operator

This does conclude today's conference call. You may now disconnect.

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