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Q4 2020 Taro Pharmaceutical Industries Ltd Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Taro Pharmaceuticals Year-End 2019 and 2020 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Mr. William Coote. Thank you. Please go ahead.

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

Good morning, everyone, and welcome to our Q4 and full year 2019-'20 earnings conference call. We hope everyone is healthy and safe during these trying times, and since safety is our top priority, we are conducting this call virtually.

Joining me today -- on the call are Mr. Dilip Shanghvi, Chairman of the Board of Directors; Mr. Uday Baldota, Taro's CEO; and Ms. Daphne Huang, Taro's new 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 full year 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. As a reminder, this call is being recorded, and a replay of the transcript will be made [available] (added by company after the call) on our website.

Before I proceed, I must remind you that today's discussion may include certain forward-looking statements within the meeting 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 businesses face, as detailed from time to time in the company's SEC reports.

With this, I will now 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 earning call after the announcement of the fourth quarter and full year '19/'20 financial results. I hope that all of you, including your family, friends and colleagues, remain safe and healthy.

The fourth quarter results reflect the challenging times that we are all facing, not only due to the COVID-19 pandemic, but also the continuing headwinds in the generic industry environment that Taro has been operating in for some time. While we did witness a higher than normal sales trend in March 2020 owing to the stocking up by customers at the outbreak of COVID-19 was spreading, we've witnessed a little softness in demand for our products since then. While the long-term impact from COVID-19 is difficult to measure at this time, we believe that the U.S. generic market will continue to be competitive in foreseeable future.

If we specifically look at opportunities available for Taro, on the positive side, last year, we have obtained 9 new product approvals, and some of these approvals have come recently, and they are interesting products, products with relatively small competition and should

help us make up for some of those losses.

On behalf of the entire Board of Directors, I would like to thank all Taro employees for their continuing dedication and commitment to the customers and patients we serve during these trying times.

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 today. I hope you are all in good health.

I want to start off by thanking the 1,500 strong team of Taro-dedicated employees, who are making sacrifices every day throughout this crisis to keep our products flowing to customers and ultimately to patients who need them.

During this crisis, we focused on 3 key areas: safety of our employees, business continuity and sourcing and production.

For our employees, safety has been our first priority while they work hard to deliver these essential products to market. We implemented both local and global precautions in order to stay operational and keep a safe and healthy working environment, including a prescreening process before anyone can enter into the facilities, enhanced sanitization procedures, staggered shifts to ensure workplace social distancing and eliminate any nonessential travel even before the federal travel bans went into effect with steady communication with our workforce.

It has been important for us to secure business continuity, not just because of the need of the business, but also because of the needs of people who depend on our medicines every day, or as we say, reaching people, touching lives. In addition, we also wanted to minimize the impact on our quality and R&D programs to ensure that we could progress towards new product launches. However, we anticipate that some of the clinical trials that are underway or have been planned may be delayed, and the dealers will then depend on how long the effect of the lockdown will last in individual countries.

A third and the vital part of our operation is sourcing and production. Our production and distribution facilities have remained open to meet demand. As you may be aware, we produce our own API, especially for several critical products. We have adequate inventories of most of the raw materials and the majority of finished products to meet customer demand. We have maintained a safe operating supply chain.

Before I hand over the floor to Daphne Huang, our new CFO, just a word on her background. Daphne has been -- has had over 20 years of senior executive experience in finance, most recently serving as Chief Financial Officer at Humanwell Healthcare USA and Puracap International, having financial oversight over their genetic pharmaceutical and OTC portfolios. Prior to Humanwell, Daphne had progressively responsible positions in the financial service sector and debt capital markets working for companies such as PricewaterhouseCoopers, FleetBoston, GE Capital and HSBC. Her extensive diversified financial background and experience will strengthen our management team and contribute to the continuing growth and expansion of our business.

Welcome, Daphne.

Daphne Yan Huang ***Taro Pharmaceutical Industries Ltd. - VP, CFO & CAO***

Thank you, Uday. Hello, everyone, and welcome. I'm very happy and excited to join Taro. And I look forward to working with the entire Taro team and making a meaningful contribution to the company and its growth. My goal is to provide strong financial and strategic leadership alongside the executive management team and the Board, keeping in mind also that providing quality products to the market and creating shareholder value is paramount to what we do.

Let me discuss some of the key financial highlights, which are in comparison with the comparable prior year periods. First, Q4 highlights, then followed by the full year comparisons.

Net sales were $175 million in Q4 and decreased $5 million. Gross profit of $102 million in Q4 decreased $17 million. And as a percentage of net sales was 59% compared to 66%. Cost of goods sold increased $12 million over last year's comparable quarter, reflecting higher product costs, principally due to a 13% increase in overall volume as compared to high product costs, and that's due to a double-digit increase in volume. Royalties and other costs, some of these costs have been recurring in nature and not a structural change in general in our operations.

R&D expenses of $16 million decreased $5 million. Our R&D expenses are not evenly distributed across quarters and primarily vary due to the timing of our R&D activities, including clinical studies and certain other expenses.

Selling, marketing, general and administrative expenses of $29 million increased $6 million, mainly due to higher legal and professional fees, higher sales and marketing expenses as a result of scheduled activities early in the quarter, depreciation and some items that are nonrecurring in nature.

As a result of the above, our Q4 EBITDA of $62 million decreased $18 million, with EBITDA margin of 36% compared to 45% in the prior year quarter. Owing to the above, operating income of $57 million decreased $18 million, and as a percentage of net sales, was 33% compared to 42% in the prior year quarter.

Interest and other financial income decreased $2 million to $7 million as a result of the low rate environment. And our Q4 foreign exchange income was $4 million compared to FX expense of $9 million in last year's same period. It's a $13 million favorable impact on our earnings. This impact is principally the result of the commencement of hedging accounting in accordance with ASU 2017-12 and our Canadian subsidiary change to the U.S. dollar as its functional currency. Israel and obviously, USA has historically been reported in U.S. dollar, and majority of the revenue and a substantial portion of the costs of the company is U.S. dollar. Management believes that the U.S. dollar is the primary currency of the economic environment in which the company and our subsidiaries operate.

Our tax expense of $14 million decreased $2 million, resulting in an effective tax rate of 20% compared to 21% in Q4 of last year.

Net income attributable to Taro was $54 million as compared to $58 million, as the decrease in operating income and interest revenue were partially offset by the favorable FX impact and decrease in tax expense, resulting in diluted earnings per share of $1.42 compared to $1.52 for the fourth quarter last year.

Let me now discuss the full year performance in comparison to last year.

Net sales of $645 million decreased $25 million. Gross profit of $400 million decreased $46 million, and as a percentage of net sales, was 62% compared to 67% in the prior year. Primarily, that's the result of product mix throughout the year. Margins were also impacted in part by the aforementioned onetime items.

R&D expenses of $60 million decreased $3 million, That's mainly due to the timing and types of clinical studies as well as continuous evaluation and rationalization of our portfolio. SG&A expenses of $93 million increased $3 million, principally due to higher legal fees.

Our EBITDA for the full year was $268 million, with a decrease in margin from 47% to 42%. Operating income of $247 million decreased $49 million, and as a percentage of net sales, was 38% as compared to 44% in the prior year. Interest and other financial income remained in line with the prior year at $34 million. Our FX income in the fiscal year 2019 to '20 of $15 million compared to $25 million in the prior fiscal year. That's a $10 million unfavorable impact on our earnings.

Tax expense decreased $21 million to $53 million, resulting in an effective tax rate of 18% compared to 21%. That's principally the result of nonrecurring items in the current year.

Net income attributable to Taro was $244 million compared to $282 million, resulting in diluted EPS of $6.35 compared to $7.23.

Now our cash flow and balance sheet remain very strong. Cash and cash equivalents, including short and long-term marketable

securities, increased $215 million to $1.6 billion from March 31, 2019. This reflects the impact from the $27 million tender offer, which was paid in December 2019. Cash provided by operations for the year ended March 31, 2020, was $272 million. Our $300 million share repurchase program, with $273 million remaining, which was approved last November, will remain in place.

I will now hand the floor back to Uday.

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

Thanks, Daphne.

Concerning the industry-wide governmental antitrust investigations and the multi-district civil litigation, we continue to work with our counsel to cooperate with the Department of Justice and the state, and we believe the allegations are without merit and are defending against them vigorously. Furthermore, we remain committed to strong corporate governance and fostering the culture of compliance at Taro.

As Mr. Shanghvi indicated, the generic landscape remains a very competitive industry. While we are not completely satisfied with the year's results, we have some accomplishments and trends we are encouraged by. Our volumes for the year increased in low single digits over last year — low teens in the fourth quarter. These volumes have present all-time highs. This is our fourth consecutive year of volume growth. Our products rank #1 and #2 by market share in the U.S. generic market in over 70% of our portfolio. From a quality and compliance standpoint, we continue to maintain an excellent track record with the FDA and other regulatory agencies.

We continue to invest in our business. In R&D, we have reported 5 filings and 9 approvals this year. We maintain a healthy pipeline of 21 ANDAs awaiting FDA approval, with 5 tentative approvals. Regarding our investment, the full year spend is lower than the prior year, principally due to the continuous evaluation of our portfolio and adjusting for viable development of products. We invest only in those products which are feasible and have a strong business case. We have also made significant technology investments in manufacturing, operations, quality and financial systems and will continue to invest in the future.

Turning to discussions on strategy. We are always looking at opportunities to strengthen our generic and OTC revenue streams in the U.S., either through organic growth, strategic acquisition or alliances. We will continue to be disciplined in our evaluation of all opportunities in order to ensure that they meet both our business and financial criteria. We also continue to look for various opportunities to strengthen our positions in the Canadian and the Israel market.

Finally, I would like to thank the entire Taro team and all our employees for their continuing outstanding effort and total commitment to our primary objective, which is delivering quality products to those who need them.

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

QUESTIONS AND ANSWERS

Operator

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

Raghuram Selvaraju ***H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Healthcare Analyst***

Firstly, I wanted to ask whether you have seen any slowdown in FDA ANDA processing time due to COVID-19 or if there appears to be no change on that front with respect to the agency.

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

I think I can probably talk of Taro's experience here and not necessarily a generally industry comment. As Mr. Shanghvi mentioned at the beginning of the call, and I in a way repeated that, that we've seen a good flow of approvals from the FDA during the year, including in

recent months. And I have to say, at least one of these approvals came ahead of our internally anticipated time line. I think that we as a company and I think the industry continues to work very cooperative with the FDA to ensure that all the products that are filed and are waiting approval, we continue to get approvals as anticipated.

Raghuram Selvaraju ***H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Healthcare Analyst***

Okay. And then you mentioned previously that you are evaluating nonorganic strategic alternatives. Can you comment at this time whether you have reevaluated at any point recently the possibility of reentering the U.S. branded pharmaceutical business? Or is that still something that you don't intend to do at this point?

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

I think as part of our long-term strategy, entering into the U.S. branded pharmaceutical space is something that is important for us. And we do look at opportunities in that space as well. Difficult for me to comment on anything specific that we may have looked at.

Raghuram Selvaraju ***H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Healthcare Analyst***

Okay. And then just two very quick financial things. Firstly, do you have an updated or changed stance with respect to the overall attitude towards share buybacks at this time? And then secondly, can you comment on the outlook for the effective tax rate? It's mentioned in the press release that the reduction in the effective tax rate on a year-over-year basis was due to nonrecurring items. So should we expect the tax rate going forward, say, for example, looking ahead to next year, to revert back to what we have seen historically? Or if the tax rate, as you have reported it currently for the most recently reported year is what we should expect to persist going forward?

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

Let me take the first attempt, and then maybe Daphne can join me. I think on the buyback, as Daphne mentioned earlier, that the Board approval for the buyback remains in place, and that's something that is not changing. So I think the intent is reflected in that approval, that stays in place. As far as the tax is concerned, typically, we don't give any specific guidance. I think Daphne in a readout did mention that the current tax rate that we see, both in the year and the quarter, is something that has been in part impacted by at least 1 or 2 nonrecurring items that we witnessed during the year. And typically, we would hesitate giving any next year or longer-term guidance on the tax rate.

Daphne Yan Huang ***Taro Pharmaceutical Industries Ltd. - VP, CFO & CAO***

I would agree with Uday.

Raghuram Selvaraju ***H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Healthcare Analyst***

Can you just clarify what the nonrecurring items were?

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

I think these are specific tax benefits or tax provisions that have been enacted by governments, and we've sort of been able to apply for those benefits and get those. I think some of these are related to, let's say, the COVID-19 situation and some of the others are longer term programs. It's a mix of both.

Operator

And our next question comes from Gregg Gilbert with SunTrust.

Gregory Gilbert

I realize you make some of your own APIs. But in light of the pandemic and what you've learned lately, are you considering any changes to how you source key starting materials or APIs or where you do finished dosage manufacturing? And secondly, on organic pipeline growth. Are you seeing enough targets to go after that fit your technology and your financial criteria? Or are you running into difficulty finding enough organic opportunities to go after with your R&D platform, and therefore, you need to become more reliant on alliances or external growth drivers going forward for the U.S. market?

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

Sure. So let me take the first question first. I think in terms of the overall sourcing and the production base that we have, I think at the moment -- or, let's say, as a strategy, there is no dramatic shift that we are looking at. I think we have very strong production base, one in Israel and one in Canada. And I think over the years, we've continued to invest and ensure that we have much stronger capabilities and capacities in both of these locations. And that's something that we will continue to invest towards.

I think from a sourcing perspective, we have a pretty diversified sourcing base, and we will continue to evaluate more in terms of the ability of the suppliers to sort of continue to supply to us rather than any overriding country criteria. And I think that's something that we've done over a period of time. As I said, we already have a diversified sourcing base. We will continue to work on that and make sure that we retain a pretty diversified sourcing base for our products.

On the -- sorry, I'm forgetting. What was your second question?

Gregory Gilbert

Organic pipeline opportunities. Are you running into a limitation in the number of targets that fit your criteria and your technology?

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

Yes. I think -- and as I said in my readout that I think as far as our opportunities are concerned, given the dynamic of the generic industry where I think prices have declined quite sharply over the last 4, 5 years and the investment has continued to go up per product. It is often difficult for us to necessarily justify investment in a large number of products and that does result in our, either not selecting a product for development or probably even discontinuing some of the existing products. And we are seeing some, I would say, shrinkage in the overall pipeline of products that we are working towards. But I would say that we have a pretty -- despite all of that, we have a healthy pipeline of products that are under development, which are sort of all -- are justified on the financial criteria that we use. So while the overall number of targets may have gone down, but at least from our pipeline perspective, I think we have a reasonably good pipeline.

Operator

(Operator Instructions) Our next question comes from Sahil Dhingra with JPMorgan.

Sahil Dhingra ***JP Morgan Chase & Co, Research Division - Research Analyst***

Two quick ones from my side. Firstly, on the gross margins. Is it entirely on the -- is it entirely based on the onetime nature of those? And secondly, on the derma product specifically, due to the ongoing COVID pandemic, are you seeing a huge decline in volume as compared to other generics?

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

I think on the gross margin, I think Daphne mentioned specifically that a part of it was on account of the product mix and part is on account of some nonrecurring items. I think it would be difficult for us to sort of quantify that beyond that. As far as derma products are concerned, and we did mention upfront that March was -- March '20 was a higher demand month for us, and we've seen some softness in demand post March '20.

Operator

(Operator Instructions) And we have a follow-up from Gregg Gilbert with SunTrust.

Gregory Gilbert

Yes. At the risk of putting the new CFO on the spot, I was hoping Daphne could just weigh in, generally speaking, on the flexibility that the company has to utilize the cash and cash flow in a way that could enhance shareholder value versus any limitations you see in being able to do so.

Daphne Yan Huang ***Taro Pharmaceutical Industries Ltd. - VP, CFO & CAO***

Thank you, Gregg, and thank you for putting me on the spot. I think I've been here for a little over a month, and I have reached -- and I'm in agreement with Taro management as well as the Board of Directors that, yes, we are constantly looking to enhance shareholder value.

But in the same time, given the competitive nature of the market that we're in, given the macroeconomic environment we're in, we need to be very cognizant about being very disciplined in other alternatives and methods, options to increase -- enhance shareholder value, including, but not limited to, methods of share buyback, when to execute as well as continuously looking at acquisition nonorganic opportunities, either by product portfolio to complement with Taro's business strategy or any potential other acquisition opportunities. So hopefully, that's a good answer for you.

Operator

And I'm showing no further questions in the queue at this time. Ladies and gentlemen, thank you for your participation on today's conference. This does conclude your program, and you may now disconnect.

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

Thank you.