Transcription for KRKA

August 1st 2019

Operator
Ladies and gentlemen, welcome to Krka's January-June 2019 results conference call. Today's speakers are Mr David Bratož, Member of the Management Board, Mr Brane Kastelec, Finance Director, and Mr Peter Skubic, Deputy Finance Director.

I will now hand you over to Mr David Bratož. Sir, please go ahead.

David Bratož
Good afternoon ladies and gentlemen. It is my great pleasure to welcome you on the conference call. I am David Bratož, Member of the Management Board.

Today, I would like to share with you Krka's business performance for the first six months of 2019. The unaudited report for the Krka Group and the Krka Company for the first half of 2019 was discussed yesterday by the supervisory board at its regular meeting. I can say that results for the first half of 2019 are very good and they show continuation of improvement and steady growth. The Krka Group sales in the first two quarters of 2019 amounted to €761 million. Sales increased by €82 million and were 12% stronger than in the same period last year. The highest absolute sales growth by €33 million was recorded in the Region East Europe, while the highest relative sales growth by 17% was recorded in West Europe. Krka's most important group of products in terms of sales remain prescription pharmaceuticals. With prescription pharmaceuticals, we achieved the highest absolute sales growth and the highest relative sales growth. All products and service groups recorded an increase in sales. Sales volume went up by 4%. Krka realised net profit of nearly €140 million, this is up 38%.

Let me continue with some more details about sales. Our sales are divided into six regions. Here, I would like to point out that sales increased in all sales regions and majority of our markets. The largest region was Region East Europe, where we generated €252 million or 33% of total Krka Group sales. Year-on-year sales grew by 15%, this is the highest absolute growth among all sales regions. Sales in the Russian Federation totalled €167 million, up 9% corresponding to a 12% increase expressed in the Russian rouble. One of the key advantages of our operations in Russia is the production site located there. Over 70% of products intended for the Russian market are manufactured in the Russian plant, thus giving Krka the status of a domestic producer. We have been strengthening our position of the leading provider of medicines for the treatment of cardiovascular diseases in the Russian Federation.

During the first five months of this year, the retail market in Russia has grown with index 106 in roubles and 97 in volume. Our growth is much stronger than market growth. Successful work in marketing & sales, we have 1,500 medical reps in Russian Federation, enabled our good performance on key and newer products with increasing market share.

In Ukraine, which is the second biggest market in the Region East Europe, the sales added up to €36 million, this means 51% of growth in comparison to first half of 2018. The growth rate notably exceeded dynamics of the Ukrainian market and further strengthened our market share in the country. Prescription pharmaceuticals (our leading product group) contributed most importantly to this growth. We recorded double-digit growth rates in most other regional markets.

Region West Europe became second biggest region with regard to sales. It generated €170 million or 22.5% of total Krka Group sales. Sales grew by 17%, this is the highest relative growth among all regions. Sales were the strongest in Germany, the Scandinavian countries, followed by Spain. Sales of our own product brands through subsidiaries increased by 26% and accounted for 75% of total regional sales. The Scandinavian countries, Spain, Portugal, and the United Kingdom recorded highest sales increases. Medicines containing valsartan, esomeprazole and clopidogrel were at the forefront. Germany remains our largest regional market where we made almost €41 million sales. The 6% sales rise compared to the same period last year resulted, primarily, from new product launches. This placed us among the leading suppliers of fixed-dose combinations for the treatment of cardiovascular diseases in Germany. In the Scandinavian countries, sales saw 67% growth and totalled €31 million. Sweden remained our leading market and it was followed by Finland, Denmark, Norway, and Iceland.

Region Central Europe that comprises of Poland, Hungary, Slovakia, Czech Republic, and the Baltic States was the third largest region in terms of sales value accounting for €169 million or 22.3% of Krka Group sales. Year-on-year, the growth was 5%. Poland, which is the leading market, generated sales total of almost €80 million and recorded strong 6% growth. We're ranked third amongst foreign providers of generic medicines in Poland. Sales growth dynamics in most therapeutic areas was above the average, also due to strong sales of our new products introduced to the market in the previous couple of years. Medicines from the reimbursement list contributed the most to sales value. We retained the leading position among all producers of prescription pharmaceuticals from the reimbursement list that are free for patients aged 75+ years. Slovakia is also our key market in the Region Central Europe, where our product sales grew 11%, generating about €20 million of sales. All three product groups presented above average sales growth dynamics in the market, ranking us third among the providers of generic medicines in the country. Sales went up also in Hungary, Lithuania and Estonia.

Sales in Region South-East Europe amounted to €99 million, this is 12% more than in the same period of last year. This accounts for 13% of total Krka Group sales. Romania and Croatia were our two key markets in this region. However, we recorded the highest growth rate in Bulgaria and Serbia. Romania, which is our leading market in this region, generated sales of nearly €30 million, up 13%. We ranked first among foreign providers of generic prescription pharmaceuticals, exceeding 7% market share in volumes. In Bulgaria, where we recorded a highest sales growth in the region of 46%, we're ranked second among all pharmaceutical companies. This results in prescription pharmaceuticals market share exceeding 5.6% in terms of volume. In Croatia, we have production site where oncology products are produced.

In Slovenia, domestic market, sales were €45 million, accounting for nearly 6% of total sales. The growth rate was 4%. Product sales generated 26.6 million, the largest portion of total sales. Health resorts and tourist services sales were €18.4 million with 6% growth. Slovenia is a mature pharmaceutical market and we remained the leading provider of medicines in Slovenia, with a market share just shy of 9%. Our volume market share is far above 20%.

Product sales in Region Overseas Markets totalled almost €25 million, achieving 13% growth and represents 3.2% of total Krka Group sales. Iran, Iraq, Saudi Arabia, Vietnam, followed by the Republic of South Africa and China are our key markets in the region. Last year, we established a joint venture in China, Ningbo Krka Menovo, with a local partner Menovo. We'd like to underline that we already obtained an EU GMP certificate for the leased production facilities in China. Commercial manufacture of the first product intended for the markets outside China started at the end of 2018, when we also filed all marketing authorisation documentation required for marketing of that product in China. In 2019, we have started filing registration documentation for additional five products for Chinese market. First sales results in China are expected in two years.

With regard to structure of sales, prescription pharmaceuticals remain by far the most important group. For Krka, this is a core business which represents almost 85% of group sales. We recorded 13% growth in sales of Rx, generating a total of €643 million of sales. At the same time, all products and service groups recorded an increase in sales. With prescription pharmaceuticals, we achieved the highest absolute sales growth of €75 million and the highest relative sales growth. Looking at our major markets, the sales went up in Russia by 11%, Poland by 8% and Germany by 5%, followed by other markets. Sales also increased in the Scandinavian countries by 70%, in Ukraine by 56%, in Spain by 34%, in Portugal by 29% and in the United Kingdom by 26%. As far as sales of prescription pharmaceuticals are concerned, medicines for the treatment of cardiovascular diseases remained the key and the biggest therapeutic group, followed by pharmaceuticals for diseases of the central nervous system and medicines for alimentary tract and metabolic diseases.

Top products in terms of sales are products containing valsartan and combinations, perindopril, losartan, atorvastatin and esomeprazole.

I continue with OTC and animal health business segments. The sales of non-prescription products totalled €62 million; this is 7% more than in the first half of 2018. Sales generated in the Region East Europe accounted for more than 50% of the total non-prescription product sales. In our biggest market, Russian Federation, we generated 30% of total OTC sales. This is similar to the results for the first six months of the previous year. Most of other markets also grew. OTC sales increased in the following regions: in Slovenia by 12%, in South-East Europe by 2%, in East Europe by 8% and in Overseas Markets by 53%. Sales in Region Central Europe matched to those generated in the first two quarters of 2018. Sales of our animal health products accounted to €36 million and were by 2% higher than in the same period of last year.

If we continue with the slide number four, we would like to underline that vertical integration is our competitive advantage, because every phase, starting with development of API, then production of API, development and production of finished goods and marketing, is under our direct control. This also ensures that our products are of top quality, as all production phases undergo strict quality controls. Thanks to vertically integrated business model, we minimise risks with regard to quality. Quality assurance has been becoming extremely important in the recent years. This also minimises risk with regard to timely production and delivery of goods, and at the same time, we are significantly more flexible to adapt to special market needs, opportunities or changes. Our lead-time is comparatively significantly shorter.

In the first two quarters of 2019, we obtained marketing authorisations for six new products in 12 dosage forms and strengths. They are all described on slide number five. We extended our range of products with many new products including new fixed-dose combinations, in addition to this, we also launched several existing medicines in new markets. For example, we launched product for treatment of HIV in Germany, Scandinavian countries, Italy and Portugal. You can get more details about new launches on the page 23 of the half-year report.

We are committed to product development and we invest, approximately, 10% of sales for research and development. Approximately one-third of sales are generated by new products. We are an innovative generic manufacturer, because we were the first to offer unique strengths on the global market, then we were the first generic in Europe which was introducing many fixed-dose combinations and our medicines are available in unconventional dosage forms.

We have a strong new product pipeline. I would like to point out that 700 scientists in research and development work on 170 products in our pipeline. Our target is to launch at least 20 new products every year.

Let's have now a closer look into figures. On the next two slides, slide number seven and eight, you can see our operating results and income statement. Krka Group realised €761 million of sales revenues in the reported period. This is up €82 million or by 12% compared to first half 2018. The Krka Group had €613 million of operating expenses, among which the cost of goods sold is the largest cost item, amounting to €328 million. Selling and distribution expenses were €170 million and up 2%. R&D expenses were €74.5 million, up 19%. General and administrative expenses were €40.6 million, up 7%. Selling and distribution expenses or marketing (promotional) costs account for 22.4% of total sales and R&D expenses represent nearly 10% of total sales. It is important to know that in the case of Krka, R&D expenses are fully recognised as expenses in P&L, because the group does not capitalise them. The increase in R&D expenses in first half of 2019 was due to increased number of R&D projects this year, especially the number of bioequivalence studies was significantly higher this year. The increase is also due to increase of registration variations caused by increased regulatory requirements and more studies needed for our business development, including for marketing authorisations in China. This is nothing extraordinary. The dynamics of R&D activity may differ year-over-year, and we expect R&D costs to be around 9-10% of sales on yearly level as well. This is also one of our strategic objectives.

Operating profit of the Krka Group totalled €154.5 million, a 14% rise or €19 million up compared to the first half of 2018. With regard to foreign exchange risk, our activities in the second quarter of 2019 remained unchanged. It means that we reduced foreign currency exposure primarily by natural hedging, and just partially with hedging using derivatives, financial instruments against the rouble-related risk, where the exposure is higher and the exchange rate is more volatile. The value of the Russian rouble against euro increased by 11% over the first half of this year, while the average euro-rouble exchange rate decreased by 2.4%.

Taking into account net foreign exchange gains, gains and losses from derivatives and interest rate expenses as well as other financial incomes and expenses, the net financial result was positive and totalled €9.4 million. Profit before tax of the Krka Group grew by 36% and totalled €164 million. The effective tax rate was 14.6%.

Finally, the net profit was almost €140 million, up 38% or €38 million compared to the first half of 2018.

In the consolidated balance sheet, there is nothing especially different from the end of the first quarter. Trade receivables in the amount of €475 million went up by 8%, less than sales, and inventories went up by 2% to €318 million. All performance ratios such as EBIT margin, profit margin, return on equity, return on assets improved in the first half of 2019 over the same period of last year. They also improved in comparison to performance indicators for the whole year 2018. The Krka Group net profit margin for the first half 2019 was 18.4%, EBIT margin 20.3% and EBITDA margin 27.5%. Return on equity at the level of Krka Group was 17.3%, with return on assets at 13.4%.

To conclude, I can say that there are predominantly two positive impacts of business environment on our business performance. First, an appreciation of Russian rouble against Euro in the first half of this year created substantial foreign exchange gains. Secondly, which is even more important, it also turned out that due to systematic investment into the development of the vertically integrated business model and into quality assurance, Krka is one of rare pharmaceutical suppliers that is able to sell higher value-added products such as already mentioned valsartan products and many others, whereas the competition has been having quality assurance issues with API and, therefore, also with final products.

With regard to investments, we allocated €52.6 million, out of that, €42 million in the controlling company. Our investments were aimed to increase and technologically upgrade production and quality assurance capacities. We also invested in our production and distribution centres around the world. The key investments of Krka in the upcoming years are the €54 million development and quality control facility at the production site in Slovenia. At the end of 2017 we also started to build a multipurpose warehouse at the same location to ensure additional storage rooms for incoming material and finished products, because this will increase the speed and flexibility of production and even improve product availability and market supply. In order to meet the increasing demand we have been purchasing additional technological equipment for Notol 2, so when the plant is fully equipped, it will be able to operate at its planned volume, which is approximately 5 billion tablets p.a. Our total production capacity is around 16 billion tablets, capsules, injections...

I would like also to mention that in February 2019, the EU introduced new rules for protection of public health by preventing the entry of falsified medicinal products into the pharmaceutical supply chain. In accordance with this directive, we introduced obligatory safety features. We allocated approximately €20 million in the last two years for the new equipment. Krka has managed to leverage the significant challenges posed by EU FMD implementation in the first quarter without negative effects. Our attention is now focused to achieve the similar success with pending Russian Federation serialisation and aggregation requirements, which is even somehow more comprehensive and new track and trace system than this one in Europe.

One of the most important investments in Krka subsidiaries abroad is investment in Krka Russia. The investment is estimated at €33 million. As a result we will increase manufacturing capacities in Russia to 3 billion tablets on a yearly level.

To recap this first part of the conference call, I can say once again that the results for the first half of 2019 are very good and we are satisfied, as we maintained our main strategic guidelines, such as vertical integration, predominant organic growth combined with new joint venture and maintaining high share of sales from new products. We are completing our product portfolio in our key therapeutic groups, such as medicines for cardiovascular system, gastrointestinal, and central nervous system. We have some competitive advantages, especially with medicines for cardiovascular diseases and in the form of fixed-dose combinations. Products with two or even three substances in one tablet, represent, in our view, an attractive market niche. We've already launched some of these products in markets. We continue to supplement the product portfolio also with analgesics, oncology medicines, HIV products, and many others. At the same time, we consider diabetes as one of the most important therapeutic areas for our future.

The projected EBITDA margin in the five-year strategic period will range between 21 and 22, and the projected return on equity between 9 and 12. We will focus on the European market, the Chinese market, and the markets of Central Asia, striving to better utilise the sales potential of all sales regions. Right now we sell our products in 70 markets, so we will strengthen the cost synergies within the group. A particular focus is placed on the Chinese market in the coming five-year period where major opportunities are arising in lieu of the increasing use of modern generic medicines. The management board also remains committed to the stable dividend policy and intends to allocate at least 50% of net profits to dividends with due consideration given to the financial needs of the Krka Group related to capital expenditures and acquisitions. The management board is also optimistic about the whole 2019 business year. If the conditions in our main markets remain roughly the same until the end of the year, we estimate that sales, and especially profit, will exceed our plans approved on 21 November 2018.

Thank you so far. Now we are open for the questions.

Question and Answer Session

Operator
Our first question comes from Đivo Pulitika, Intercapital. Please go ahead.

Đivo Pulitika
I have three of them. I actually had to miss the first part when you mentioned Western Europe, so I apologise if you already talked about this, but by my calculations show that your sales in Germany grew by 24% in the second quarter, that's compared to Q2 last year. Were there any one-offs there or can we expect Q3 and Q4 to be as least as good as Q2 in Germany?

Next, Ukraine is very good if we look at the entire first quarter, the first half of the year, but sales in Q2 are 10% below the Q1 number. Should we expect growth there to normalise at these Q2 or Q1 levels, or do you think there is more room to make a stronger push and to grow even further in the future?

Lastly, have you considered changing the full year guidance numbers, so to really give a number and not just like an explanation saying we could go about the 172 profit target? Comparing how this year is going to your original guidance, is a higher net financial result the only significant reason behind the net profit beating the plan? That's it, thank you.

David Bratož
Let me start with the first one. You mentioned that you skipped the West Europe explanation and you had a question with regards to Germany. The Region West Europe became the second biggest region in the first half of 2019. This is a really great result. Normally it was in the third place. Also the growth was really high. It grew by 17%, so this is the highest relative growth among all regions. Most probably you also missed the explanation that the sales were the strongest in Germany then followed by Scandinavian countries and Spain.

With regards to Germany, you noted that Germany had a nice increase of sales in the second quarter. You are right. We are actually realising our strategy which goes towards promotion of products which are not tender dependent. In the past, in Germany, more than half of the sales were generated on tenders, nowadays this proportion is much, much lower, so this is something that helped us to increase the sales in Germany and to increase their profitability. Besides that, we also successfully launched quite a plump list of new products, which are from different therapeutic groups, from cardiovascular, from urology, from HIV, from oncology, and this also helped us to develop the sales on the German market. We can say that we expect good development of the sales in the German market with positive trends in the second part of the year as well.

Your second question was with regards to Ukraine and you noted that the sales in Ukraine in the second quarter went down by 10% in comparison to the results from the first quarter. You need to know that the growth in the first quarter in Ukraine was incredibly high. It was above70%, so after the first half of the year it’s still around 50%, so we are growing in Ukraine very nicely, and we see strong performance also in the following two quarters. So there will be high growth, most probably growth rates will be a little bit lower, but still there will be two digits growth until the end of this year in this market. We are optimistic. We are employing on this market and we believe that the yearly results will be with the two digits growth rate.

Your last question was about plans and about the reasons which are behind our optimistic forecast. I would like to correct you. It’s not just the rouble. Of course, the situation with the rouble helped us. But secondly, which I also mentioned, good results are also due to our vertically integrated business model and our quality assurance. We are one of the rare producers that are able to sell higher value-added products, for which some of the competitors have quite some big problems with regards to quality and deliveries. So far we cannot be more concrete providing you with numbers right now, but if you go, again, through this statement you can see that we estimate that sales and profits will exceed our plans, which were approved at the end of 2018.

Operator
Our next question comes from Bram Buring, Wood & Co. Please go ahead.

Bram Buring
Three questions, please. First of all, I noticed that labour costs for the group were up 11% year-on-year. I'd like to understand how much of this is driven by wage growth, how much of this is driven by headcount?
The second question would be you mentioned there were some tender sales in Spain. Just broadly speaking – and of course you had new launches in Germany – any more new launches that you think would be material expected in the second half, and for those Spanish tenders, were these longer-term or were these just for a few weeks or months?

The last question would be with regard to China. You say that you're going to have the first launches of drugs in China in a couple of years. I assume that those are going to be locally produced, but what kind of a salesforce do you have there currently and how do you plan to ramp this up ahead of launches in a couple of years? Are you going to be doing some promotions and hirings there to establish or raise the profile of the brand in the country? Any further discussion about what you would see coming from China over the next five years and, of course, if you're willing to offer a sales forecast target, that would be great, but any more colour on the Chinese business would be fabulous. Thank you very much.

David Bratož

The first question was with regards to labour costs. You're right, there is an increase by 11%. I can say that we actually increased also the number of employees. Generally we increased the number of employees in Slovenia, because we were also employing those who had started to work with us through agencies. After a certain period of time, if they meet all of our conditions then we employ them. So partially the growth of costs is due to new employees and, on average, we had more employees. I cannot be more precise. I would say that approximately one half of the growth is related to salary increases and one half roughly is related to higher headcount.

The second question was with regards to Spain. We won tenders in Andalusia, which continued the sales growth of our product brands. These tenders are normally valid for one to two years and, at the same time, we are quite successful when promoting those products at the retail market. So we see Spain as one of the important markets in the Region West Europe in the future as well.

With regards to Germany, you asked about the new launches. The bulk of new products was launched in the first half, but there are still some left for the fourth quarter, so I can say that in the second half of the year there will be additional growth generated from the launches which were done during the first half of this year and some new products which will be launched in the fourth quarter of this year. But, at the same time, I would like to underline that we work also on the existing portfolio, so this is also important.

The last, but not the least, we are all the time decreasing our participation in the tenders, which is actually harmful on the sales and in spite of this we are still growing total sales. So we are improving our performance in Germany.

With regards to China, I would like to ask Mr Brane Kastelec to answer you, because he is directly involved.

Brane Kastelec
Regarding the China project, I have to underline that we still focus at the moment on transfers of products to our leased facilities in China, and especially on registration procedures. We believe that we will receive soon a deficiency letter for the first product for which we filed registration documentation in December last year. By saying that, I also somehow announced that we should not expect our first product on Chinese market before mid of next year, so that's why, Mr Buring, we don't have at the moment our own salesforce at all, and even in 2020 we have no intention to build a strong marketing and sales team in the Chinese company, because that would not be rational having on the market only one, two or three products. We will develop that later on, so in the beginning we intend to do it through our marketing partners with which we have already been in contact. We will have partners, independent companies and individuals that will work on promotion of our products. But, of course, management of these activities will be done by us and this team will be established a few months before the first product will be launched in the Chinese market. Thank you.

David Bratož
I would like to add some additional explanation with regards to your question connected to West Europe, so I would just like to say that the sales in the third quarter will be somehow lower than the average sales in the first two quarters, but they will be still better and higher than the sales in comparison to the third quarter of 2018. Generally you need to know that the third quarters are weaker in our industry and in our company.

Operator
Our next question comes from Vladimira Urbankova, Erste Bank. Please go ahead.

Vladimira Urbankova
I have two questions. The first one would be related to the gross margin which was decreasing in the first half of this year. If you can remind me what were the major factors behind the decreasing gross margin profitability?

The second question would be related to your plant in Russia. You said that you plan investment at the level of €33 million and increased manufacturing capacities to 3 billion tablets per year. By when do you want to achieve this target and what is the current capacity and its current utilisation?

David Bratož

I will start with the last one, with the plant in Russia. Currently, we are able to produce around 2 billion tablets in the Russian plant, and with the new investments we will be able to increase this by 50%, so with the investment of about €30 million we will have much higher output in Russian plant. This will be realised in the next two to three years.

Your first question was related to gross margins. You are right. It went down a little bit. The reason behind are increasing prices for some intermediates. This is also due to the rising price of the oil, because some of them are produced from oil, and basically we believe that on the long-term we can improve this-- we believe that the gross margin until the end of this year will become, again, better as it is now, if we measure this as a percentage of sales.

Operator

Our next question comes from Matej Simnic, BKS bank. Please go ahead.

Matej Simnic

Is it possible to explain to what extent are results affected by global valsartan issues and, in this way, is somewhat a one-time opportunity for Krka? So in short, can you maintain the current levels of sales from Western markets?

David Bratož

Unfortunately, we do not disclose precisely to what extent this result is due to valsartan case, but we can say that this is not just the valsartan. It actually shows us that Krka is flexible enough to react on different market situations, and not just this one; we are able to fulfil different needs and we are able to produce this in accordance with high quality standards. So this is just one part. If you go a little bit more into the products then you can see that the growth is coming also from other products containing perindopril, losartan, atorvastatin, esomeprazole, new products/combinations of simvastatin with ezetimibe, then with new products from urology and HIV. Partially the sales and there the growth is coming from newly launched products, partially thanks to a situation which we were able to use, and finally thanks to our vertically integrated model.

With regards to your second question, it was about West Europe, connected with valsartan. We also see the opportunity for our sales development in the quarters to come, so we are optimistic for the second part of the year and for the future. That means that at the same time we do not rely only on valsartan growth, because we have many new products which are launched, and which will be launched, or which are still on lifecycle level, which enables us further growth.

[No further questions and end of conference call]
