"HEG Limited Q3 FY-16 Earnings Conference Call"

February 02, 2016

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Moderator: Ladies and gentlemen good day and welcome to the Q3 FY16 Earnings Conference Call for HEG Limited. As a reminder all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ravi Jhunjhunwala-Chairman and Managing Director, HEG Limited. Thank you and over to you sir.

Ravi Jhunjhunwala: Thank you. Good afternoon and thank you for joining us my friends for HEG's Q3 2016 conference call.

Firstly I would like to share some recent developments in the global steel industry and its resulted impact on the Graphite Electrode industry. As per the WSA, the World Steel Association, world crude steel production for calendar year 2015 declined by about 2.8% to 1623 million tons as compared to 1670 million tons in '14. All the regions of the world registered a negative growth with America toping with -8.6%, South America by 2.5%, EU by 1.8%, Asia by 2.3% and so on. China continues to decelerate and dropped by 2.3%, probably the first time ever that the Steel production has come down in China. The production of top 10 steel producing countries was about 1350 million tons showing a decrease of about 3% versus 2014. Out of these top 10 steel producing countries India was the only exception to have registered a positive growth of about 2.6% in 2015.

Now turning to Graphite Electrodes and the Steel industry; this is obviously had a serious impact on Graphite Electrode industry. 2015 was a year when virtually all commodities, Oil, Iron Ore, Coke, scrap, Steel, Copper, Aluminum etc. took a freeway of beating and the production declined by anywhere between 20% to 45%, mainly driven by the slowdown in China. The Electric Arc Furnace segment of Steel which is our main customer base continues to be severely impacted due to disproportionate fall in the raw material prices of Iron Ore and Coke which are the two main raw materials for the Blast Furnace industry as compared to the Steel scrap which is the main raw material for the Electric Arc Furnace industry.

The rapid growth in the Chinese export of Steel is impacting production in the rest of the Steel producing nations and is putting tremendous pressure on the Steel companies. Chinese exports of steel are expected to have touched a record figure of 110 million tons in 2015 versus about 94 million tons in 2014 destroying the Steel prices globally. Many Steel plants all around the globe are either reducing or stopping their Steel melting and in turn are procuring Chinese Billet to process resulting in reduced Electrode demand. The impact of this is being felt drastically in South East Asia and Middle East besides India.

Due to steep fall in Oil prices budgets of all Oil-producing nations in the Middle East have been drastically reduced thereby reducing expenditure on projects resulting in reduced transaction of Steel slowing down steel production and Electrode demand in the region. These factors are resulting in the production drop in the Electric Arc Furnace segment leading to a decline in Electrode demand. Capacity utilization of the Graphite Electrode industry around the globe has fallen to around 55% to 60%. This obviously continues to exert pressure on the Electrode prices. One of the largest Graphite companies was acquired by a large fund last year. The next largest company in Europe is hiving off their Electrode business so as to be ready for any consolidation opportunity. We saw a total of four plants with a combined capacity of about 120,000 tons in Europe South America and South Africa permanently closing down early last year. We believe two more plants with a combined capacity of about 60,000 tons are also in the process of closing down very soon. In fact, SGL, the German company has only this morning the announced closing down of their German facility with the capacity of about 30,000-35,000 tons. We expect this trend to continue for the rest of the year with some more closures in the Western world. All this is a positive sign for this industry and gradually we will see a balancing of demand supply in our business.

In the backdrop of these negatives, friends, there are also some positive signs going forward which I would now like to place before you. Number one, Needle Coke prices have dropped substantially last year and with Oil prices consistently dropping, we expect Needle Coke prices to soften further in 2016. Two, other input cost like Indian Coke, binder and impregnation pitch, all types of fuels also declined in India resulting in reduced cost of production of Electrodes. Three, the plant operating parameters have registered the marked improvement with our ongoing emphasis on reducing operating cost. Four, consistent depreciation of rupee coupled with impositions of antidumping duties on Chinese Electrode imports into India have made imports costlier thereby helping domestic sales.

We achieved the capacity utilization of just around 55% in this quarter. We are continuously working on building our order book position for 2016 which is much slower than the previous year, more prominently in the export market. As I said at Electrode imports have fallen substantially and they have actually fallen by more than 50% mainly due to rupee depreciation and antidumping duties imposed on China. This has obviously resulted in shoring up our domestic sales and in the first nine months this year domestic sales have reached an all-time high.

Outlook for 2016; as all of you must have seen IMF has revised the global GDP growth downward by 0.2% to 3.4% in 2016. In the advanced economies a modest and uneven recovery is expected to continue. The slowdown and rebalancing of Chinese economy lower commodity prices and strains in some large emerging markets economies with all means will continue to weigh on growth prospects in 2016-17 as well. Growth in China is expected to slow down further to 6.3% in ‘16 and 6% in 2017. The cumulative effect of big demand supply imbalance, stumbling Iron Ore prices, ever increasing Chinese Steel exports, cut down in budgets of oil-producing economies, decelerating Chinese economy, the Electrode sales volume and prices are expected to remain under pressure.

As I said before, the industry is seeing a major restructuring and consolidation by the major graphite players. While we continue to face considerable industry challenges, we have made significant progress in quality of our products, free substantial cash from working capital arrangement and there is a continuous focus on management of variable and fixed costs.

Given some of the positives that I narrated earlier, efficient plant operations, softening of Needle Coke prices, softening of all other domestic inputs related to oil and energy, antidumping duty on Chinese Electrodes, weakening rupee and still a growing Indian Steel production should help us in sailing through these very challenging times.

Friends with these comments I would now turn over to our CFO, Mr. Rustogi.

Raju Rustogi: Good afternoon. For the quarter ended December '16 HEG recorded net operating income of 179 crores as against 240 crores in the immediately preceding quarter, a reduction of about 25%. EBITDA including other income decreased from 54 crores in Q2 FY16 to 40 crores in Q3 FY16. EBITDA margin was maintained at 22% in spite of reduction in turnover. PAT also reduced from the level of 15 crores in Q2 FY16 to Rs.6.5 crores in Q3 FY16. Maintenance of EBITDA margin in a reduced turnover scenario and a constant fixed cost vis-à-vis last year it is largely contributed by reduction in input prices, improved efficiency in the plant operations and rupee depreciation.

Net sales in power segment were higher than previous quarter as the hydro facility reached its peak of generation during the quarter. Hydro being the lowest cost of power generation source has added strength to this segment results. Borrowing cost during the quarter is lower than the immediately preceding quarter as the impact of cost due to adverse movement in foreign currency rates were relatively small in this quarter besides company has also been able to reduce its overall debt position with the repayment of term loan as well as working capital loans. Depreciation is higher mainly on account of identification of significant component with shorter useful life than the main equipment. This is in line with the provisions of schedule 2 to companies act 2013. Friends, need of the hour therefore is to remain in the cost leadership position to sustain these times when companies are vying to capture additional pie of market and in turn slashing prices. We expect that some of the high cost facilities in the world would soon give way which will reinstate the demand supply balance in the Graphite Electrode industry. With these comments I would like to open the floor for questions.

Moderator: Thank you very much. We will now begin with the question and answer session. The first question is from the line of Devang Sanghvi from ICICI Direct. Please go ahead.

Devang Sanghvi: Just wanted to know that are we kind of giving any guidance for next year in terms of capacity utilization?

Ravi Jhunjhunwala: In terms of what?

Devang Sanghvi: Capacity utilization for next year, FY17 I'm talking about.

Ravi Jhunjhunwala: It will be anywhere in that region, 55%-60% as we just said.

Devang Sanghvi: We have seen a decline in the interest cost is there anything because of repayment what we have done or it is something else one-off in the interest cost?

Raju Rustogi: There is something called accounting standard in India wherein the foreign currency fluctuation related to borrowing in foreign currency is to be added to the interest cost. If you see fluctuation during Q2 it was significantly higher, it was in the range of Rs.2 per dollar whereas in this quarter fluctuation is to the tune of 50 paisa a dollar. So if you compare the interest cost between Q2 of this year and Q3 of this year the difference is primarily on account of foreign currency fluctuation which becomes part of interest cost.

Devang Sanghvi: Just wanted to know the debt repayment for next year, FY17 and FY18.

Raju Rustogi: I would start with current year, we plan to repay about 94 crores during the current year which is '15-16 and next year would be another 100 crores as per the commitment.

Devang Sanghvi: By nine months how much will be repaid for the current year?

Raju Rustogi: As we stand today we have repaid 70 crores out of 94.

Devang Sanghvi: Just a bookkeeping question what would be the gross debt and net debt as on 31st of December 2015?

Raju Rustogi: Our cash equivalent is small so you can take it as same in terms of the total debt. Whatever is our gross debt is equivalent of the net debt as well.

Moderator: The next question is from the line of Saket Kapoor from Kapoor and Company. Please go ahead.

Saket Kapoor: What are the volume numbers in terms of tons for the quarter and the comparison quarter-on-quarter also, how has Quarter 2 played versus Quarter 3 played up?

Raju Rustogi: We talk in terms of capacity utilization and as we said it is 55% this quarter and 66% previous quarter.

Saket Kapoor: 66% for the last year as compared to this quarter you are talking, Quarter 2 versus Quarter 3?

Raju Rustogi: Quarter 2 is between 60 to 65 and this quarter it is around 55%.

Saket Kapoor: Since the antidumping duty has been allowed have the demand which you have told earlier has started creeping up or the fall in the Steel prices and all have dented that chance of ours also?

Ravi Jhunjhunwala: The imports in the first nine months are less than half of what it was in the corresponding year, last year. That is the reason our domestic sales have substantially gone up this year and as I mentioned in the first nine months it has been the highest ever.

Moderator: The next question is from the line of Rajat Jain from Principal Mutual Fund. Please go ahead.

Rajat Jain: In terms of our cost of production to the variable cost of production, how do we compare with global players in terms of quartile where do we lye? You referred to SGL shutting down its facility in Germany and other shut down that you referred to, are they likely to come back and what is your sense on that?

Ravi Jhunjhunwala: Four facilities were closed early last year, two each by this American company and the European company. Our guess is that it is permanently closed and the first place they were closed because obviously there was not enough demand and then obviously they closed the most expensive facilities. Similarly as I said SGL has put it on their website only this morning about this German facility. That is going to be a permanent closure as well.

Raju Rustogi: I will take the second question of yours about the where do we stand in terms of the variable cost. Our understanding of the competition and the data that we have, we are equivalent to everybody in the industry in terms of the vehicle cost where we are better off is in terms of the fixed cost and primarily into the employee related cost.

Ravi Jhunjhunwala: If you look at the percentages whether it is EBITDA or EBIT or PBT or PAT, we are definitely better than all the other international players.

Rajat Jain: How do we compare the Chinese data, I guess it's not very transparent.

Ravi Jhunjhunwala: Chinese are not really in the same area of competition. The product line in the product mix and the quality of product that they produce and sell, they are not really competing with us. They are more or less domestic player in the Chinese market. In the high grade Electrode that all of us produce minus China we don't see them much.

Moderator: The next question is from the line of Saket Kapoor from Kapoor and Company. Please go ahead.

Saket Kapoor: I referred to the sales mixture in terms of domestic and export and that time, line got disconnected.

Raju Rustogi: It is 65-35 this year, export is 65%.

Saket Kapoor: Are you hoping that for current year the skewed would be more towards the domestic and we can see incremental demand on the domestic front?

Raju Rustogi: You are already seeing in the data. Till last year we were 80-20 towards export and this year we are already 65-35 towards export so that clearly explains the incremental sale in the domestic market.

Ravi Jhunjhunwala: But you are right this antidumping duty which is the major reason in addition to the rupee depreciation. This antidumping duty came in place only sometime in mid-February last year. As you can imagine lot of customers had some pending orders which trickled in March-April-May also obviously they could not stop the shipment so they must have paid antidumping duty but some Chinese products did come in April-May-June also. The Chinese imports are not coming anymore or are coming in very-very small trickles. So there could be some additional tilt towards domestic in addition to the 65%-35% ratio that we spoke about as the Chinese imports keeps coming down. Imports from other regions like the American companies or the Japanese or the European are also at a disadvantage with rupee being 68 and forward rupee being 70-71 so obviously the domestic players do get an advantage there.

Moderator: The next question is from the line of Sudhakar Prabhu from Span Capital. Please go ahead.

Sudhakar Prabhu: First of all, if you could give us some idea about the global capacity, what is the global capacity and what is the demand?

Ravi Jhunjhunwala: If we exclude China because of very unreliable data that we have about the Chinese producers and as I said, China is really not a force in the world market so if we keep aside China typically there is a large American company Graphtec which till about a year and a half ago had a capacity of about 250,000 tons so that 250,000 tons is down by about 90,000-95,000 tons. They closed two plants last year and they have closed one plant this year. So their capacity is around 160 from 250. Similarly, there is only one large European player SGL had a capacity of about 200,000-210,000 tons about a year ago and they also closed two plants totaling about 60,000 tons last year and they have announced closure of another 30,000 tons today so there capacity would be down to about 120,000 tons as of now. So in total six plants with the capacity 180,000 tons have been closed in the last 12 to 15 months. Then there is a Chinese company which was about 90,000 tons, they also closed about 25,000 tons last year. If you add all the three, there have been closures of about 200,000 tons which is fairly substantial.

Sudhakar Prabhu: When you think we will have certain equilibrium in the market in terms of demand and supply? I understand that demand for Electrodes have gone down because of Steel manufacturers moving from Electric Arc Furnace to the traditional type of manufacturing, so any sense on when we can see some equilibrium in the market, 6 months, 18 months?

Ravi Jhunjhunwala: In the normal course Electric Arc Furnace is much more efficient and it is much more adjustable kind of process of production. So in really these bad times Blast Furnace has become easier to operate because the cost of closure and restarting of Blast Furnace is huge. Even in spite of that somebody who has a Blast Furnace as well as the Electric Arc Furnace, he prefers to use Blast Furnace because of the cost that we spoke about. The cost of closure and the cost of restarting the Blast Furnace is much larger than Electric Arc Furnace which is unfortunate because in the bad times even if the cost is slightly higher in Blast Furnace one tends to produce on the Blast Furnace because she doesn't want to incur that large cost. All the Steel companies are losing big-time money in any case. The second reason is there is a ratio of the raw material cost between Electric Arc Furnace and blast furnace. Iron Ore and Coal are the major raw materials for the Blast Furnace and scrap is the major raw material for Electric Arc Furnace. If you see the last 2-3 years' graph of the drop in the prices of these three raw materials, the prices of Iron Ore and coal have dropped much more in terms of percentages as compared to scrap. Now the only hope towards Electric Arc furnace 3-4-5 years ago was that America was the only country which was exporting very huge quantities of scrap. The hope was that China is now in the market in China is going to generate scrap and instead of importing scrap they were to become the largest exporter of scrap. So country like China which was the largest importer over the next 2-3 years is supposed to be becoming the largest exporter. So that process is going on and the scrap import into China is declining year after year. As soon as China become self-sufficient in scrap and start exports of scrap then the scrap prices will drop substantially and that's where this relationship between cost of production of Blast Furnace and cost of production of Electric Arc Furnace comes into play. It can be 2018, it can be 2019, it can be 2017 that's anybody's guess how much will the scrap prices drop.

Sudhakar Prabhu: In terms of Graphite prices what has been the fall in prices in last 12 months?

Ravi Jhunjhunwala: We would not like to give specific number for obvious reasons.

Sudhakar Prabhu: I understand that you don't share the absolute number but just in terms of percentage.

Ravi Jhunjhunwala: I will give you some feel for that, let's say if you talk of the high-grade Electrodes which is where our company is, we do about 75% to 80% of the very high-grade production. The average for this year would be down by about 20% -22%.

Sudhakar Prabhu: How about Needle Coke prices?

Ravi Jhunjhunwala: The Needle Coke prices have dropped by again if you look at the comparative numbers for last year meaning '14-15 versus '15-16; we are talking more or less in the region of 40%-45%.

Sudhakar Prabhu: Probably the company has benefited more from the Needle Coke prices fall?

Ravi Jhunjhunwala: Yeah but these numbers are in terms of percentage. Obviously Needle Coke prices are much lower than the Electrode prices so if you look at the absolute number, 20% of 100 or 40% of 40 or 30 is very different.

Sudhakar Prabhu: Usually how much is Needle Coke as a percentage of sales?

Ravi Jhunjhunwala: Up till now we have been saying off-hand about 40%-45% has been the cost of Needle Coke in our total cost. But this number has changed drastically because the selling prices have dropped, the operating cost has dropped and the Needle Coke has dropped substantially. So you don't have one number until it's a year or two years ago, we had seen more or less in the region of 40%-45% as a Needle Coke cost.

Sudhakar Prabhu: My another question is on your power business. The numbers which you have quoted, this is sale to third-party, the net sales I believe 60 crores for the quarter this is actually the sale which you do the third party, right?

Raju Rustogi: No, in fact if you see the segment reporting numbers, the 60 crores is the gross generation number and there is a number which is reduced at the bottom which is 53 crores which is the internal consumption of our own plant. So the power sale is principally to the external parties between 5% to 10%, rest everything we consume ourselves.

Sudhakar Prabhu: So largely it's in-house?

Raju Rustogi: It's been in-house.

Sudhakar Prabhu: What is your gross debt on your books as on 31st December?

Raju Rustogi: This is about 800 crores as on 31st December.

Sudhakar Prabhu: This would be largely term loan?

Raju Rustogi: Largely working capital.

Sudhakar Prabhu: So there is no term loan in your books?

Raju Rustogi: Term loan is about 280 crores.

Sudhakar Prabhu: Just to clarify out of 800 crores, 280 is your term loan and balance is working capital, right?

Raju Rustogi: Yes.

Moderator: The next question is from the line of Devang Sanghvi from ICICI Direct. Please go ahead.

Devang Sanghvi: Just wanted to know that what could be the effective tax rate for this year and next year?

Raju Rustogi: It is 16%.

Devang Sanghvi: For both the years?

Raju Rustogi: Next year is also expected to be similar.

Moderator: The next question is from the line of Rajat Jain from Principal Mutual Fund. Please go ahead.

Rajat Jain: Actually I had a question on Electric Arc Furnace versus Blast Furnace, is it more structural in terms of issues with Electric Arc Furnaces because they are mostly literally smaller sized companies compared to the ones who are operating Blast Furnaces, so because the way interest rates are, the weakness in the economy overall, do you think that the people who operate EAFs will be out of the market for longer domestically?

Ravi Jhunjhunwala: Your presumption is not correct I guess. If you look at the percentage of Electric Arc Furnace production out of total Steel, you will invariably find that this percentage is much higher in developed world compared to underdeveloped or developing countries. To give you an example of America which is probably the largest Steel producer in the world, they produce about 60% of their total Steel through Electric Arc Furnace. If you look at Western Europe, this number is about 45% whereas the world average is about 26%-27%.

Rajat Jain: My question was more specific to India; in India do we find relatively smaller companies producing…

Ravi Jhunjhunwala: Not really, if you look at Essar, Essar has 100% electric arc furnace. They have about 10 million to 11 million tons of Steel capacity and 100% of that is Electric Arc Furnace. Similarly, if you look at JSPL and if you look at JSL, they are practically 100% Electric Arc Furnace.

Moderator: Thank you. As there are no further questions I would now like to hand the floor over to Mr. Ravi Jhunjhunwala for closing comments.

Ravi Jhunjhunwala: Thank you friends for joining today and I look forward to speaking to you in about three months' time with our annual set of numbers. I hope that will be a little more encouraging than what we spoke about today. Thank you.

Moderator: Thank you. On behalf of HEG Limited, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.