



“HEG Limited Q3 FY20 Results Conference Call”

February 14, 2020



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Moderator:

Ladies and gentlemen, good afternoon. And welcome to the HEG Limited Conference Call to discuss the company's Q3 FY20 Results. Joining us on the call today is Mr. Manish Gulati – COO and CMO, HEG Limited; Mr. Gulshan Sakhuja – CFO, HEG Limited; and Mr. Om Prakash Ajmera – Group CFO, 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. At this time, I would like to hand over the floor to Mr. Manish Gulati. Thank you and over to you, sir.

Manish Gulati:

Good afternoon, friends. And welcome to our Q3 FY2019-2020 con-call. This is Manish Gulati and I just wanted to share with you that I have been appointed as Executive Director of the company with effect from 1st of March 2020.

In the year 2019, total world crude steel production registered a growth of 3.4%, which came mainly on the back of a high 8.3% growth coming from China. But if you look at the steel production in the rest of the world without China, after two years of positive growth, it was minus 1.7% last year. Now, China, which produces 50% of the total world's steel in 2016 has been continuously growing in production, and now they are producing 53% of all the steel made in the world.

The electric arc furnace steel production was down in some of the large steel producing regions like Europe, Japan, Turkey, mainly resulting from slowdown in demand, the trade tensions between US and China and other geopolitical tension in some parts of the world. Iran's steel production, which is mainly EAF based, grew in 2019 by 30%. But due to sanctions, we could not participate in this growth.

Due to reduction in the amount of electrodes and large inventory overhang, which was caused due to customers' buying much higher volumes of electrodes in 2018, and in the first few months of 2019 on account of an unprecedented increase in electrode prices witnessed month after month, we have seen much less buying in the last couple of quarters. As you all are aware, graphite electrodes has a long production cycle anywhere between six to eight weeks to 20 to 24 weeks for different category of electrodes and nipples that we produce.

Moreover, as our primary raw material, needle coke is totally imported by us from Europe, US and Japan. At any particular time, we have large inventory of needle coke in stock on seaborne transit, and work in process given by above stated production cycle. And finally, in the form of finished electrodes. While the electrode prices have corrected in the past few quarters, we still keep consuming high priced coke.



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Since the past year, the electrode prices have been sequentially dropping quarter after quarter to reflect the market conditions. As the customer has overbought in 2018 and first half of 2019, the new purchases have come down to more normal operating levels. This has led to a drop in our revenue and EBIT margins, etc. However, one of the largest industries there from Japan have recently announced a shutdown of one of its plant impacting a reduction of 40,000 tonnes of electrode capacity, and it's further considering temporary idling of another 25,000 tonnes to 27,000 tonnes capacity in Europe. This should help in stabilizing the market.

On our side, we are vigorously pursuing our expansion which is going as per original schedule, and as planned, it should be operational by first quarter of 2022. Our plant with an installed capacity of 80,000 tonnes is currently the single largest plant in the world. And by addition of another 20,000 tonnes, it would become even larger, giving us significant advantage in cost. We are happy with the timing of our expansion and we believe that by then the world market for electrodes would have grown larger to absorb this 20,000 additional electrodes, easily adding to our international market share.

The needle coke availability has substantially eased compared to the recent past due to reduced demand from GE producers, and more importantly, an overhang of inventory, both with all the electrode producers as well as needle coke producers as explained above. And accordingly, the prices of needle coke are significantly coming down.

Our sales in Q3 were at low 50% utilization level and we expect it to become better from this quarter onwards as the demand picks up gradually. We do believe that with this new capacity coming on stream, the quality of our products will see a marked improvement due to state of art equipments and the latest available technology that we are currently in process of installing. This would have a positive impact on the quality of our products.

In addition, this will also enable us to do cost savings due to economies of scale and also achieve better efficiencies. With our four decades of experience in business, we expect to be a supplier of choice to all our global and Indian customers. With this, I would now hand over the floor to our CFO, Gulshan, to take you through the financial numbers. And then, along with our group CFO, Mr. Ajmera, we will be very happy to answer any queries that you may have. Over to you Mr. Gulshan.

Gulshan Sakhuja:

Thank you. For the quarter ended December 2019, HEG recorded revenue from operations of Rs. 394 crores as against Rs. 564 crores in the previous quarter and Rs. 1,865 crores in the corresponding quarter of the last financial year. EBITDA, including other income stood at Rs. 32 crores in quarter three verses Rs. 174 crores of previous year quarter, and Rs. 1,351 crores in the corresponding quarter of the last financial year.

The company reported a net profit of Rs. 6 crores in quarter three as against profit of Rs. 179 crores in the previous quarter and Rs. 867 crores in the corresponding quarter of last financial



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year. The company is debt free and have been handling treasury operations to the tune of nearly Rs. 1,200 crores as on 31st December 2019, and the average return has been around 8% per annum on the same.

The company is having a history of maintaining a payout ratio of around 30% to 35% and we do expect to maintain the same in the current financial year. In line with that, the Board has already approved the payment of interim dividend of 250% that is Rs. 25 per equity share. For the quarter ended December 2019, the company has presented consolidated financial results along with a standalone results as a part of the compliance with the SEBI circular. The company aims to further strengthen its balance sheet through effective working capital management, thereby creating value for its stakeholders.

And now we would now like to address any questions or queries you may have in your mind. Thank you.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Sonali Salgaonkar from Jefferies. Please go ahead.

Sonali Salgaonkar: Sir my first question is, I just wanted to understand what has changed substantially in Q3 versus Q2, which is why we are seeing the results sharply down sequentially as well? And you know, where do you really see the realizations bottoming out?

Manish Gulati: Right, okay. So, if you are asking what has happened between the two quarters, there have been less sales. And we said the Q3 was in low 50s and Q2 was in 60s. So, that is one reason and the next reason is a drop in prices or rather, adjustment of prices. Coupled with that we have the needle coke and our WIPs and finished goods which were made from the highest price of coke it could get. So when the electrodes prices are falling and we are holding inventory which is at the earlier raw material prices, so that is what has hit us for Q3.

Sonali Salgaonkar: Got it. And there do you see this as probably the bottom of realizations or do you still think that there is still some more pain left?

Manish Gulati: No, I think this should be the bottom. I think so I hope so, because there is not much room left to go below this. But these levels which you are having, and once we have this high cost inventory out of our system, the margin should return.

Sonali Salgaonkar: Sir, by when do you foresee the high cost needle coke inventory to be out of your system?

Manish Gulati: Let's say, safely take six months.

Sonali Salgaonkar: That's two quarters from now?

Manish Gulati: Yes.



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Sonali Salgaonkar: Sir, my second question is, probably you could choose to answer this from industry level. What is the current level of inventory of graphite electrodes that you see the industry sitting on? And probably what timeline do you expect to liquidate this?

Manish Gulati: See, people globally, including us, we have adjusted our production levels to reflect the market demand and we should time to customers to adjust their inventories which they have. But I believe that once people are working on lesser capacity utilizations, not only us, but everybody else, they should now again take six months to either liquid excess inventory with overhang or excess inventories which customers are holding. So, probably we have to give everybody six month timeframe. Because, of course, people have realized that yes, there's not enough demand in the market. So all the companies have adjusted their capacities to whatever level they could. And again, for the same reason that we have to adjust to the new level and excess inventories.

Sonali Salgaonkar: Sure. My next question is from the perspective of needle coke. Sir, just wanted to understand probably what is the current cost of needle coke? And typically, what is the temptation of the contracts and when is the next renewal up?

Manish Gulati: See, right now we have excess inventory, then we will probably know about the new levels sometime in March, what kind of... right now we are not buying any needle coke but we, of course, have a sense that prices are coming down. So probably in the month of March when we will talk about April and beyond, we will have a sense of where the pricing is. So far, the pricing has been six monthly at a time. But in these new conditions we will see, it all depends on the market. In good old days we used to get into a year-long contract with customers because we used to have year-long back to back contracts for needle coke. And then the market went hot, it became six monthly, then began three monthly. Now we will see in March. I mean, we will see both ways, whether we are willing to get into a six month contract if we don't have enough visibility, likewise they can also take a call.

Sonali Salgaonkar: Sure. And would it be able to you to share what is the current cost of needle coke?

Manish Gulati: I wouldn't like to say, ma'am, for competitive reasons. But yes, you have enough data in the market, you can figure it out. But I would not like to mention or put a figure to that, ma'am.

Sonali Salgaonkar: Understand. Sir, my next question is related to Coronavirus and the probable supply chain disruption in China. Do you see all the imports of Chinese graphite electrodes getting affected because of this? Or have you seen or come across any data that they have come down from the start of January to the mid of Feb?

Manish Gulati: See, I think to be able to properly answer this question, another few days may be required. Because you see, before the Chinese went for the holiday, everything was planned and everything was done, organized accordingly. Now it's about a week or 10 days that they are



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back. And I don't know whether they are back but maybe another few days. Like you everybody is watching the situation very closely, but I can only share which is common sense that if it lasts for a little longer, not only electrodes but several other industries would be impacted. So I mean, we should see some decline in exports, not only in India, because China was exporting a lot of the lower grade, high power electrodes to several countries in the world. So another few days and it will become clearer actually. Today I cannot hazard a guess.

Sonali Salgaonkar: Got it. Sir, could you provide us your current breakup of UHP versus non-UHP and exports versus domestic?

Manish Gulati: Export versus domestic is about 70:30 portion. And UHP versus non-UHP keeps varying a little bit, but if you take an average, it is about 20%, 25%.

Sonali Salgaonkar: Sorry, what is 22%?

Manish Gulati: 20% to 25% is the portion of our non-UHP products.

Sonali Salgaonkar: Understand, sir. And how are the exports doing and any particular geographies where you are finding constraints or probably a lot of competition because China's exporting in them?

Manish Gulati: No, the competition which we have with China is only for the 20%, 25% of our non-UHP grade which we make. We do not have straight competition with the ultra-high power grade which is our mainstay. So, I mean, this has always been, not only now it has been for last so many years we have been competing with this 20%, 25% of our business segment. So it's not restricted to any geography, they were exporting this lower way to so many countries so we compete with them everywhere.

Sonali Salgaonkar: Sure. And any particular geographies which are doing well or not so well export wise?

Manish Gulati: If you see, Europe has lot of slowdown in steel. If you look at the world steel production figures, I can share with you, let's say, the electric arcs furnace is down in Japan, Turkey, South Korea, Russia, Italy, Mexico, Germany, most of these major steel making countries are down in production. The only place where they seem to be growing is Iran, which is out of our purview and United States is growing in steel and India is growing in steel. So other than that, the European part is significantly down in production.

Sonali Salgaonkar: Got it. And sir, and are the realizations of export and domestic comparable?

Manish Gulati: Domestic realizations have become much less, the pricing in India has become much too aggressive because it's a home market and everybody tries to sell. But the export is better I would say, better than domestic.

Sonali Salgaonkar: Would it be able for you to quantify the differential?



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- Manish Gulati:** No, not exactly. Please don't ask for that. But it is certainly better I would say.
- Sonali Salgaonkar:** Sure. Sir, and my last question, in the opening remarks you mentioned that there is a 40,000 metric tonne shut down of graphite electrode capacity in Japan. Which player are you referring to?
- Manish Gulati:** Sorry, which?
- Sonali Salgaonkar:** Which company are you referring to?
- Manish Gulati:** I said in my speech that it is the largest, it will not be nice on my part to name our competitors, but it is very easy for you to find out the largest competitor. I have clearly said in my speech, the largest industry player from Japan.
- Sonali Salgaonkar:** Sure. And when have they shut down?
- Manish Gulati:** This news which we have is about a week or 10 days old. So, I think they announced it on 5th of Feb.
- Moderator:** Thank you so much. The next question is from the line of Bhavesh Chauhan from IDBI Capital. Please go ahead.
- Bhavesh Chauhan:** Sir, just want to know, can you quantify the volume decline that is happening year-over-year in this quarter?
- Manish Gulati:** We gave the capacity utilization, I said low 50s for this quarter, 60s for Q2, and 70s for Q1, so that's the deadline.
- Bhavesh Chauhan:** Okay. And one, in the previous question you said that the margins are probably at bottom, did you mean that pricing of the end products, graphite electrodes are at bottom or do you mean the margins?
- Manish Gulati:** The pricing, the earlier participant asked about the pricing, and I said that this about the lowest it can get. And then I added that once the new price of raw material kicks in, our margins will improve. But right now we are still working with that high, very high cost of needle coke bought in 2019. And it is just a nature of our industry which has such a long production cycle of anywhere around two to five months, and we have since stopped. And it all comes from US, Europe and Japan, we always have two months' worth on seas, seaborne transit, which I mentioned in my speech. So it always hits us that way that when the electrode prices drop and if you have this kind of an inventory already logged and paid for, so that is what caused the hit in margins.
- Bhavesh Chauhan:** And what would be the price differential between UHP and non-UHP today?



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- Manish Gulati:** It's big actually, it's big. There was a time when electrodes were short, so the pricing distance had closed because people wanted electrodes, no matter which grade. But now the pricing is significantly different between the two.
- Moderator:** Thank you. The next question is from the line of Sonali Salgaonkar from Jeffries. Please go
- Sonali Salgaonkar:** Sir, just one clarification. The needle coke that you were using in Q2, that's the earlier quarter, and the price that you have in Q3, are they comparable or have you seen a sequential rise in needle coke prices well?
- Sonali Salgaonkar:** No, they are compatible, because this all is bought, these are 2019 contracts. So price of needle coke we consumed and Q2 and Q3 are almost the same. Because, of course, where will the new coke come from, this is the price of coke we had been buying since the start of the year. So whatever the price of coke was there with us in Q2, it is the same in Q3, and almost the same and going to be the same in Q4 as well.
- Moderator:** Thank you. The next question is from the line of Ujwal Agarwal from New Horizon. Please go ahead.
- Ujwal Agarwal:** And the question I have is, the EBITDA on EBIT margins that we were saying for the last two years were completely unsustainable, that I understand. But what would be the stable level of EBITDA and EBIT margins that we might be able to see that will be sustainable for the long term?
- Manish Gulati:** I mean, Gulshan, would you like to answer this?
- Gulshan Sakhuja:** Ujwal, you have to see the EBITDA margin is a factor of two things. One, coke consumption and other is selling price of Graphite Electrodes. Currently it is difficult to comment on how the electrode prices would turn around in next financial year or in future how EBITDA margin would remain. But if you see the past history, and when the prices were normal and at that time we were having EBITDA margin in the range of 20% to 25%. But right now, commenting for the future is quite difficult, as I said earlier because it is a factor of two things, one, the selling price; and the second one is coke.
- Ujwal Agarwal:** Okay. And I have one more question, it is about the needle coke price. Do you see any extra capacity that might be added to the needle coke so that the prices might come down? Because as you said before that it is also used for lithium ion batteries also. So is there any planned capacity additions all over the world or somewhere that would help us get needle coke for cheaper?
- Manish Gulati:** No, you see, the needle coke prices have already got heated a lot. In fact, they are already in the process of correction and needle coke supplies are not even able to use current capacity. So



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there is no need for the new capacity when they are still grappling with their existing capacity. So the prices are already on the way down, we will get a better feel of the needle coke prices sometime in March. Because right now we do not need any needle coke. So we will come to know where the prices settle sometime in March when we talk for coke beyond April.

Moderator: Thank you. The next question is from the line of Anubhav Saho from MC Research. Please go ahead.

Anubhav Saho: Hi, sir. This is Anubhav Saho. I had a couple of question. One, given that we have a high cost inventory for needle coke, and it probably will take around two quarters to consume. So, do think that current margin range of around high single digits to low double digit EBITDA margin will sustain for next two quarters?

Manish Gulati: No, next two quarter should be similar, because with electrode prices stabilizing, it's just that how fast we can just consume our high cost inventory. So, I think for next two quarters situation should be more or less the same. We do not expect anything inordinate, whatever is there. I mean, because we know where we are, we know where electrode prices are today, although they have stabilized but we know where they are today, we know we have to live with this high cost needle coke inventory and finished goods inventory we have. So nothing much is expected to change for two quarters. However, then later we definitely are expecting things to get better, because then the needle coke prices are coming down again to adjust to the market conditions

Anubhav Saho: Sir, is there any way to check, do you have any estimate that if we didn't have the high cost inventory and if our input cost for needle coke in this quarter was at the current prices or needle coke which is prevailing in the market, then what could have been our EBITDA margins or operating margins.

Manish Gulati: Yes, it's a good wish. I keep wishing this all the time. Hope we did not have this inventory, because today the electrode prices are off today and the price of coke is of yesterday, so it is causing a mismatch. But I mean, I wouldn't be able to answer this question of what EBITDA could have been if we had needle coke prices.

Anubhav Saho: No, what I mean is that, I mean, the other question would have been like, post two quarters what would be the normalized margin you would be looking at? But since they have multiple factors, it should be running after two quarters, we don't know.

Manish Gulati: For that you don't even have to ask me. If look at the electrode industry margins over the last 10 years, that's where it should be, 10, 15 years, just have a look. I mean, if you have access, not only for us but for others. If you have, look at the industry's margins for the last 10, 15, 20 years, it's a very good indication because that is what is sustainable, that is what led the industry grow at a healthy pace and serve our customers. So I think that is where it should be.



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- Anubhav Saho:** And sir, last question on the industry, per se. I mean, any idea what is the utilization level for the graphite industry right now? Is it close to what we are putting up or it's something different?
- Manish Gulati:** Some of the players were close to where we are, and one player is probably having a better capacity utilization, because they had some long-term contracts. Of course, they are getting benefits for the first two years. Because there are some sales which is already locked up, but those legal kind of contracts. So barring those, I believe many of us are very similar range today.
- Moderator:** Thank you. Next question is from the line of Payal from Ratnamani Investment. Please go ahead.
- Payal:** Sir, my question is related to the inventory. So what is the inventory that we have taken for the quarter? Has the inventor hit been done, I mean to say, or we can see it going ahead to hit in some quarter?
- Manish Gulati:** Rather I have Gulshan answer this question.
- Gulshan Sakhuja:** Payal, please come again.
- Payal:** Yes. So, I just want to know what is the inventory loss that we have booked in this quarter?
- Gulshan Sakhuja:** Ma'am, if you see, there is no inventory loss, only the reduction of this margin is on account of that reduction in the selling prices, and that high cost inventory and the high cost consumption that we have booked in this quarter. So there is no inventory loss on amount of this. But that's why EBITDA margins and EBIT margin has come down on account of that reduction in selling price and high cost consumption.
- Payal:** Consumption that we have?
- Gulshan Sakhuja:** Yes.
- Payal:** So, on the remaining needle coke that we have as a raw material or WIP, we have not taken any hit on that.
- Gulshan Sakhuja:** And we don't foresee also, based on the selling prices which is currently prevailing, Further the same shall be evaluated as and when required.
- Moderator:** Thank you. Members of the management, sir would you like to wait for some time? We do not have any questions in the queue as of now.
- Manish Gulati:** No, you can proceed for that.



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Moderator: Sure. Mr. Gulati, any closing comments?

Manish Gulati: Thank you, friends. And we are optimistic about the medium to long-term growth of our industry, considering this as a temporary dip. And we look forward to speaking to you in the next quarter hopefully with more clear picture and a better set of numbers. All the best. Thank you very much.

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