"HEG Limited Q1FY15 Earnings Conference Call"

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Moderator: Ladies and Gentlemen, Good Day and Welcome to the Q1FY15 Earnings Conference Call of India's Leading Electrode Manufacturer HEG Limited. As a reminder, all participants' lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during this conference, please signal an operator by pressing '*' and then '0' on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Mr. Santosh K. Joy from Teamwork. Thank you. And over to you.

Santosh K Joy: Good Afternoon, everyone, and a Very Warm Welcome to the HEG Limited's Analyst and Investor Conference Call. We shall discuss the Performance and Financial Highlights of the First Quarter of 2014-15 Financial Year. We have with us today, Mr. Ravi Jhunjhunwala – Chairman and Managing Director of the company, and CFO – Mr. Raju Rustogi. We will begin this conference call with opening remarks from the management team following which we will open the floor for an interactive question-and-answer session. Before we begin I would like to brief you all that certain information during the concall will be forward-looking in nature and a disclaimer to this effect which was included in the 'Investor Presentation' which was sent to you earlier. Now I would hand over the floor to Mr. Ravi Jhunjhunwala. Over to you, sir.

Ravi Jhunjhunwala: Thank you, and Good Afternoon to all of you, and thank you for joining us for HEG's Q1 Conference Call.

Firstly, I would like to share with you some details about the global steel industry and its resultant impact on graphite electrode industry. The international analysts and global players in the graphite business are gradually turning positive that the worst is over and we are expecting some improvement in 2015 though internationally steel industry is still plagued with fairly large excess capacities especially in China. The Steel sector is expected to gradually gain momentum as the decade unfolds with optimism about what lies ahead. World Steel Association has forecast that global steel consumption or steel demand for 2014 would reach about 1527 million tons, which is about 3.15% higher than the previous year. According to the World Steel Association, the world crude steel production in the first six months of 2014 was approximately 821 million tons, an increase of 2.5% compared to the first 6 months of 2013. We expect production growth for 2014 also in the range of about 3% to 3.5%. However, what is promising here is the trend. The Steel growth for last many years especially post-2008 financial crisis was primarily due to growth in China. Now, we are seeing the growth in production as well as consumption in the 27 EU countries and the north of America, which is gradually coming back to the pre crisis days.

What is also heartening from our point of view is that Electric Arc Furnace sector of steel which is where Graphite Electrodes are primarily used is showing a larger growth than the total steel. In the first half of 2014, Electric Arc Furnace production has gone up by more than 8% while total steel has gone up by only 2.5%. It was also projected that with huge steel scrap reservoir in China now being packed for use in the electric arc furnace sector. China which is the largest importer of scrap today will soon turn into the largest exporter of scrap. In the next 10 to 15 years China is expected to have an additional 160 million tons of scrap which will not only help installations of more and more electric arc furnaces around the world leading to a growth and demand of graphite electrodes. As you all know new blast furnaces have only been established in the last few years in countries like India, China, and Brazil, while the rest of the world it is mostly the Electric Arc Furnaces which have contributed to the growth of steel. With increased availability in scrap from China it is expected that even China and India could also add substantial steel capacities in the future through the Electric Arc Furnace also leading to a growth in demand for Electrodes. Electric Arc Furnace share of total steel currently stands at about 29%. With increased availability of scrap and focus on environment issues around the world, if you remember the blast furnaces are the single largest pollutant in the world. Some of the international analysts are going as far as to project that Electric Arc Furnace share could rise to as much as 50% of total steel or even more than 50% over the next 10 to 15 years. This obviously augurs well for our industry.

Now, friends, coming to our "Operations." As envisaged earlier we achieved a capacity utilization of around 70% in the quarter under review and our margins are stable. As a result of our continuous efforts on operating parameters, better cost structure, product mix and customer mix besides soft Needle Coke prices and optimum utilization of our power plant has added strength to our bottom line.

With regards to raw material, as you all know Needle Coke is the single largest component of our cost. We are adequately placed with all our sourcing contracts in place for the current year. Reduced Needle Coke prices have helped maintain margins in these challenging times. The next largest cost component for us is electrical power, whereas you know we are fully self sufficient with two coal-based and one hydroelectric plant totaling about 77 MW. Though availability and transportation of linkage coal has been an issue in the recent past your company had adequate inventories which has enabled smooth operations of the power plant. However, with reduced allocation of linkage coal from the government expected in the future, we are sourcing material from the open market, which will affect our cost going forward.

Friends, HEG has demonstrated its strength of withstanding challenging times and is well positioned now to reap the benefits as the tide turns in the future.

With these opening remarks I will pass you on to Mr. Rustogi who will take you through the financial figures. Thank you.

Raju Rustogi: Good Afternoon, friends. I would just give a quick overview of Q1 FY15 numbers and then will be able to take questions. For the quarter-ended 30th June 2014 HEG recorded a net operating income of Rs.347 crores as against Rs.235 crores in the corresponding quarter of last year, registering 47% increase in the top line. EBITDA including other income and excluding exceptional items witnessed an increase of 52% from Rs.40 crores in Q1 FY14. EBITDA margin stood at 17.8% as compared to 17.2% of the corresponding quarter last year. The company recorded PAT of Rs.18.94 crores as against loss of Rs.9 crores in the corresponding quarter of last year. The company has been impacted adversely during the quarter by an unprecedented surge in the input cost of certain domestic items which made the pressure on EBITDA going forward. We have been updating the investor community on our efforts towards improving working capital investment from time-to-time. Those improvements is a continuous process. Our challenge now is to sustain these **(Inaudible) 9:02-9:05** in almost all its components during the previous year. With this I conclude my remarks and open the floor for questions.

Moderator: Thank you very much, sir. We will now begin the question-and-answer session. We have the first question is from the line of Arijit Malakar from Ashika Stock. Please go ahead.

Arijit Malakar: My first question is that your operating expenses declined year-on-year by 700 bps, but at the same time raw material cost as a percentage of sales has increased by 300 bps. So was there any pressure on the Needle Coke prices during the quarter?

Management: As had been communicated in chairman's speech the raw material prices are softening over a period of time, but in our manufacturing process there is a lead and lag effect. We have a large inventory period. Our processing time inside manufacturing is more than 3 months. So what we are selling in the quarter ending June was inventory which entered the process during March quarter. So the real effect of the price reduction follows a lag effect and it takes about 3 to 6 months to actually feel the full impact of the price reduction.

Arijit Malakar: So coming in 3 to 6 months that effect will come to play?

Management: Yes.

Arijit Malakar My second question is as you say the Needle Coke prices has been subdued, so how do you look this Needle Coke prices throughout the year?

Ravi Jhunjhunwala: It is too early to talk about that. We generally start getting the first feel by November-December and normally by about January-February we are in a position to start negotiations and conclude the prices and the quantities. It is actually rather early to talk about what we think would be the prices but going by the demand/supply situation where Needle Coke seems to be in much more easy supply situation compared to the Electrodes and with 2 new Greenfield plants of pitch coke which is similar to needle coke as we speak about, there are 2 new plants coming up – one in Korea, one in China – and both of them are going to be in operation – one by end of this year and one by early next year – and you need one ton of Coke for one ton of Electrodes. So obviously, we are not expecting the production or the demand for Electrodes to rise by as much as 120,000 tons, a new capacity for Coke is coming on the screen in the next 6 to 9 months. Logically, one should expect pressure on the Needle Coke price going forward also but it is just a hypothetical, as I said we will only get to know after 3-4 months.

Arijit Malakar: You were saying that new plant in Korea and China would ease some pressure on the Needle Coke price going ahead?

Ravi Jhunjhunwala: That is what I am saying.

Arijit Malakar: Is there any improvement in your net working capital days?

Management: Net working capital we are maintaining the levels of March 2014 as on 30th June.

Arijit Malakar: What is the figure of net working capital in the last quarter?

Management: This is about Rs.900 crores of net working capital we have at the balance sheet.

Arijit Malakar: What is the net working capital days?

Management: It is about 220 days.

Arijit Malakar: How is the outlook for the industry in the coming two years? And are you planning to expand your current capacity?

Ravi Jhunjhunwala: As I said in my opening remarks, we believe that in the Steel industry probably we are the bottom now, things are slowly looking up though very slowly, Steel production the world over has increased especially the Electric Arc Furnace is showing a stronger sign of improvement in blast furnace which is good for us. However, in spite of about 120,000 tons of capacity shutdown which have now actually happened in US and Europe there is still enough capacity. The demand/supply balance is still not in balance and as you have heard we are still operating at no more than 70-75% utilization. Until we come close to 100%, obviously there is no need to expand any capacity. For the time being we are not planning any capacity expansion.

Arijit Malakar: What percentage of the power requirement that company's need is met by your captive power?

Ravi Jhunjhunwala: 100%.

Arijit Malakar: Do you hedge any foreign exposure or is your natural hedge as the 75% coming from the export revenue as well 74% also import of your raw material?

Management: We still have some gap between the net foreign exchange earned and net foreign exchange payable, that differential part we hedge.

Arijit Malakar: What is the percentage of that? 100% you have hedged your foreign exposure.

Management: It is based on view taken by us in terms of where the dollar is moving in the next 6 months, so we do not hedge on a mechanical basis; we take a view and hedge accordingly.

Moderator: We have the next question from the line of Ashutosh Tiwari from Equirus. Please go ahead.

Ashutosh Tiwari: Regarding the market as such post the capacity closure by both Graftech and SGL, at least Graftech is talking about utilization level for them going up to 90% by the end of the year, and what is your sense on that – can they reach that kind of level when you guys operating around 70-75%?

Ravi Jhunjhunwala: When you speak about Graftech and SGL talking about close to 100% utilization you have to keep in mind that this is after they have closed about 20%, their capacities have gone down from 100% to 80% and at that level they are saying that they expect to run fairly close to that capacity now. So it is more or less similar to what we are saying; when we say we are likely to operate at 70-75% it is arithmetically more or less the same thing.

Ashutosh Tiwari: I agree completely on that part. My point is that in that scenario when you go for next year price negotiation, will there be a high possibility of a price increase because what we have seen say over the last 3-4 years definitely market was in a tough condition but leaders basically had announced price increase and that never came through, but now under this scenario, and also combined with the fact that I believe the leader of both the companies have actually changed. So do you think that the direction could change essentially in terms of the pricing outlook whatever they give, that we can assume that there is some improvement happening over there in that sense?

Ravi Jhunjhunwala: Obviously we hope you are right and we are all hoping that the situation is probably looking better. As we just saw if you look at the first 6 months data of steel production, Electric Arc Furnace Steel has gone up by something like 8% Vs about 2.5% for the total steel. So obviously Electric Arc capacities and productions have gone up more than the blast furnaces, at the same time there has been a shut down of 120,000 tons of Electrode capacity. So to that extent there is some semblance of demand/supply position on the Electrode side, and we just heard a conference call two days ago from one of the major suppliers that they probably decided to increase prices, and as you rightly said, everybody has been trying to increase prices over the last three-four years which has not materialized, because of the market situation. So, hopefully, this time we should be able to do something but again it is too early because as you also probably heard in the same conference call, everybody is more or less fully committed for this year at whatever prices they are for today. So whatever prices have been newly announced and whatever prices may increase or may not increase three months later, four months later, we will only know in October-November, that is the time you really start talking seriously to the customers for next year. As far as this year is concerned there will be very little impact of the price increase if at all it happens.

Ashutosh Tiwari: That I agree, definitely you do not have in this year, but throughout last year the prices were declining and quarterly negotiations that used to happen, but now do you find the stability in the pricing that no longer prices are going down and negotiations for whatever three months?

Ravi Jhunjhunwala: To that extent what you are saying is exactly correct, now we are surely seeing a stabilization of prices; the prices are not going down any further.

Ashutosh Tiwari: I was looking at the margin profile of both SGL and Graftech over last say 22 years, and if you look at that roughly in '96-97 was a peak when the board delivered almost like 30% odd kind of margin, then that went down to 12% only in 2012 calendar year, again, it went up to 30% odd in CY07-08 and then fell to roughly 12% in last year. This could also be a bottom year. Do you think again this is just a bottom and then again from here things will start improving? Other thing we are supporting probably is that as you mentioned Needle Coke ___ **22:14** is going to increase. So one thing which probably was a concern for the industry, in say 2007-08 is kind of easing out, and now probably we are at the bottom from where we will start seeing uptick.

Ravi Jhunjhunwala: I only wish whatever you said that comes out correctly, we can only hope and wish for what you just said. We have all seen those kinds of EBITDAs only 6-7 years ago in 2008-09. You have to also remember that 2008-09 where those years there was a shortage of electrodes. We have seen steel plants shutting down for week together because there was a shortage; they were not able to get electrodes. So that scenario does not exist today until the electric arc furnace capacities keep going up and electrode capacities lag behind. So it is just a guess, we can hope for margin increase next year or maybe 2016, you never know, it is very difficult to hazard that guess, whether we are at that cycle that suddenly from 12%-13% we will go to 20-25%. But yes, directionally, it looks that the worst is over.

Ashutosh Tiwari: I am not even talking about that kind of margin because that happened over from bottom to top it took around 6-7 years, 30% kind of margin if industry peaks out that would happen only after 6-7 years from here, but the point is that directionally it will start increasing from here, that is what I am inferring essentially.

Ravi Jhunjhunwala: Hopefully, you are right, the direction is right, the first six months electric arc furnace data that we have seen hold good for the next couple of years, and hopefully this needle coke capacity which is coming up in the next six to nine months, would also probably put more pressure on the Needle Coke prices. What has happened now is to the extent Electrode prices have dropped, the Needle Coke prices have dropped. So that is virtually helping us to maintain the margins. So now the Electrode prices have to go up and the Needle Coke prices do not go up. That is where the margin will come from.

Ashutosh Tiwari: Because you are there for this business for a long time, so say around 2003-04 when industry started reviving at that time the first kick actually came in for Electrode prices and then later on Needle Coke prices started going up or how it happened essentially at that time?

Ravi Jhunjhunwala: Yes, of course, Needle Coke prices were very high in 2007-08 compared to Electrode prices.

Ashutosh Tiwari: No, but 2003-04 essentially I am talking about when the industry started reviving from one bottom in 2002, that time actually what happened?

Ravi Jhunjhunwala: I will not be able to give you an off-the-cuff answer for 2003, we can have an offline discussion, give us some time, and we can go back to our data of 2003-04 and get back to you.

Ashutosh Tiwari: But Needle Coke do you think that the pricing increase possibility over say next two years is not that high as compared to Electrode prices as such?

Ravi Jhunjhunwala: I personally do not think that can happen, the market condition is not such that they can force that kind of an increase.

Ashutosh Tiwari: The other thing you talk about is 8% EAF Steel production in the first half of this calendar year. It has mainly come from which regions – Europe and US – or there are some regions which contributed to this?

Ravi Jhunjhunwala: The single increase is in china. As I touched upon, steel scrap is a major raw material for electric arc furnace and China has now come to a stage that they have started generating and collecting a lot of scrap, which America was doing up till now. So a lot of scrap is now available in China for reuse into electric arc furnace. So China which has been the single largest importer of steel scrap over the next four, five years is likely to become the largest exporter. So that will surely help more electric arc furnaces because the raw material is available.

Ashutosh Tiwari: But, if you are mentioning that a major part of this year production growth has come from China, in that case you guys would not benefit from this, outside China would not benefit from that or is there a possibility of that also happening?

Management: You are right to an extent, but what happens is when EAF goes up anywhere in the world, at least it helps the Chinese Electrode maker sell in their country instead of spreading their products to the other countries. So in effect, wherever it goes up, it does help us directly or indirectly.

Ashutosh Tiwari: On the regulations side in India, there are some duty drawback which was reduced from 4% to 3% in India in September basically in 2013. So, any change happening over there, you guys are fighting to basically increase it further which could benefit Electrode players in India?

Management: Yes, there was a cap actually and we have made a representation, so we are waiting to hear from them.

Ashutosh Tiwari: And also, both the Electrode players – you and other player – are probably demanding anti-dumping duty from Electrodes from China, is that correct? If that is correct, then what is happening over there?

Management: China is actually selling their products in India at such a low prices, which are actually hurting the industry. So, yes, we have made a representation, and yes, they are looking into it and we are quite hopeful that our plea would be heard and we should have some decision hopefully in our favor soon.

Ashutosh Tiwari: That would help basically in the UHP segment or that is a regular high power segment?

Management: We will get more benefit for the non-UHP segment, and a little less benefit in the UHP segment also because one or two of their companies are trying to make some UHP products, but selling at a deep discount to our prices, which is hurting us. So maybe you can say 75% benefit from the non-UHP side and 25% benefit from the UHP side.

Moderator: Thank you. The next question is from the line of Niraj Mansingka from Edelweiss Securities. Please go ahead.

Niraj Mansingka: Just taking continuation to this discussion on the competition, how do you see the competition of the Chinese players in the entire Graphite UHP market because if they are able to push some products in UHP, is it possible that in next 2-3 years they may evolve as a large UHP player in the entire Graphite market?

Ravi Jhunjhunwala: There is a big learning curve associated with making UHP products. The capacities are there in China, they are trying to learn it, but most of the players there in China are still not equipped neither technology wise nor equipment wise to make good quality UHP products. Competition is always going to be there, but we just have to keep ahead of them, but in the near future we do not see them as a significant threat to UHP business.

Niraj Mansingka: There would not have any impact in the anti-dumping duty, right?

Ravi Jhunjhunwala: That is what Manish was explaining. If the anti-dumping duty does come in India, it will primarily help us in the lower segment, and India has a fairly large lower segment. So we do sell quite a lot of electrodes in lower segment which we are currently losing to China because of the prices.

Niraj Mansingka: Another question is on the margin expansion when it happened in 2009-10. What would have been the affordable utilization of industry then?

Ravi Jhunjhunwala: We were close to 100% during 2007-08, 2008-09 till the financial crisis hit and the steel production went down substantially. Internationally, everybody was very close to 100%, and that is a time our expansions, Graphite India’s expansions and all the Chinese expansions came in.

Niraj Mansingka: Which means that again the industry growth at say 10% CAGR, you require at least two years hence forth when the margin can shoot up to very high return levels?.

Ravi Jhunjhunwala These margins will increase gradually, you do not expect 20%, 30% kind of an increase in prices immediately, it will happen gradually as the prices decline gradually over the last 2-3 years. So, this process is going to happen gradually, but, only thing is, I hope we are all correct when we say that we are seeing the bottom now. Growth will also come gradually, as the decline came over the last 3-4 years.

Niraj Mansingka How much is the lead times from you deciding to expand a plant till the final commercial production on the plant?

Ravi Jhunjhunwala In our case just to give you a background, Electrode consists of 5 to 6 different processes. So, out of this 5 or 6, there are at least 4 operations or 4 processes where we are even currently having a much larger capacity than the current 80,000 tonnes that we speak about. So, when we speak about 80,000 tonnes plant capacity of Electrode, we talk about 80,000 tonnes in all the 6 processes. Out of this 6, at least in 4, we are more than 80,000 tonnes even today. So, 80,000 tonnes when we say, we are talking about the capacity which is our limiting factor out of the 6. So, one or two places where we have to increase our capacity, it will take anywhere between 18 to 24 months once we take that decision. So, the only thing to know here is the capital expenditure from let us say, 80,000 to close to 100,000 that we are talking about for the next phase will not be very large because it will be restricted to only 2 of the 6 processes.

Niraj Mansingka What would be the ballpark number?

Ravi Jhunjhunwala We made that calculation 2 or 3 years ago, probably it will have to be relooked at, I do not want to give you that number which is 2 years' old. We have not even looked at these kinds of capital expenses at this time because we are still far away to taking that decision, but, it will be much less than what we did in the previous two expansions, let us say. Because in the previous two, we had to expand in all the 5 or 6 processes, and so those expansions, those CAPEX already took care of several capacities going close to 100,000 tonnes. So, now we have to increase only in two processes from 80 to 100.

Niraj Mansingka Sir, would you be having the drawing board plan right now on those expansions, because it will take 2 years and 7-8% growth on industry, means that you will have to do the drawing board at 75%-80% of capacity utilizations?

Ravi Jhunjhunwala As I said, this is the first quarter, the last 3 months that we are seeing some uptick in the Electric Arc Furnace, and there is still enough capacity in the world to take care of these kinds of growth that we are speaking about. So, obviously, we will keep a very close watch and we will take the decision at the right time and this will have to be done on one phase, this 80 to 100 should not be staggered into two phases of expansion. So, whatever that number is, it will be for about 20,000 tonnes. So, one will have to be very cautious in terms of timing because you do not want to spend that kind of money and then not utilize it.

Moderator We have the next question from the line of Dewang Sanghavi from ICICI Direct. Please go ahead.

Dewang Sanghavi Just wanted to know in the realization front, we have seen a decline on Q-o-Q basis. So do you expect some further upper movement in the same or it will be a decline only going forward on realization front?

Ravi Jhunjhunwala As Manish has explained in answer to the previous question, probably, we have seen the bottom, and the prices are now more or less stabilizing, we are not seeing any further drop in the spot prices that we are now booking our orders. Probably, this is a stabilized price one could say.

Dewang Sanghavi Secondly, just wanted to get an idea regarding this costing of Needle Coke. Do we see a drop there or stabilization there going forward?

Management I think the chairman answered that, but let us see from 2013 to 2014 there was let us say $400 and $500 drop, but as we go by, we will know what happens in 2015 by about October or November when we actually start the negotiations with all the suppliers. But, since there are two new capacities which are coming in – one coming in by end of 2014, and one by beginning of 2015 – we expect that Needle Coke prices will continue to be under pressure. And we do not feel threatened by any price increase from their site.

Moderator As there are no further questions, I hand the floor back to Mr. Santhosk K. Over to you.

Santhosh K. Joy Since we do not have any more questions on the floor, so with the permission of Mr. Jhunjhunwala, can we consider this question-and-answer session to be over?

Ravi Jhunjhunwala Yes, thank you friends for joining for this conference call and I look forward to speak to you in about 3 months' time with probably with some better set of numbers. Thank you.

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