"HEG Limited Q4 FY-16 Earnings Conference Call"

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Moderator: Good day Ladies and gentlemen, welcome to HEG Limited Q4 FY16 Earnings Conference Call. As a reminder all participant 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 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 all friends and thank you for joining us on HEG quarter 4 and full '15/'16 conference call. I would like to begin with the latest developments in the steel industry worldwide and how it has impacted our industry. As per the World Steel Association, world crude steel production for January, April '16 has declined by about 2.8% to 521 million tons. World Steel Association forecasts global steel demand to decrease by 0.8% to about 1490 million tons in 2016 after a contraction of about 3% in 2015.

All the regions registered a negative growth with North America being -1.3%, South America (-14.2%), EU (-6.5%), Asia (-2.1%) and so on. Chinese production continues to slow down and dropped by 2.3% probably for the first time. While almost all major steel producing countries registered a decline in steel production, India stood out with an increase of 2.3%, however Electric Arc Furnace share where electrodes are used has fallen in last decade from about 32% to 33% to about 25%, 26% in 2015. Steel Industry continues to be plagued by extreme over capacity to the tune of anywhere between 400 to 500 million tons predominantly in China. Huge Blast Furnace capacity additions in China over the past decade have resulted in fall of global Electric Arc Furnace production. Iron ore and Coking Coal prices have fallen much more over the past few years in comparison to scrap thereby impacting the Electric Arc Furnace segment further. Besides China exported about 112 million tons, a record number accounting for about 14% of their total steel production in 2015 to more than 210 countries of the worlds at dumping prices which further resulted in depressed markets where Electric Arc Furnace is a large part of their total steel production. Chinese government has recently announced its plans to shut down 100 to 150 million tons of steel capacities by 2020. We will have to wait and watch how much and when does it materialize. However, in the medium to long term Electric Arc Furnace will continue to be more competitive than Blast Furnace as iron Ore and Coking Coal prices rebound to normal levels and availability of scrap especially from China increases substantially as very large volumes of scraps are likely to be generated from all the steels that China has used in the last couple of decades. In the middle of all these negatives, there are some positive signs. The two largest graphite companies in the world closed down 6 plants of graphite permanently in North America, Europe, South America and South Africa in the last about 12, 15 months.

The total of this is about 170,000 tons which accounts for approximately 18% of the total graphite capacities in the world. The second largest graphite producer SGL Carbon, Germany has announced their plans for selling their entire Graphite assets and this process is moving fairly rapidly. And this also might need some more closures of capacities in the immediate future.

Now coming to the Indian Steel scenario, 2015/16 has been a tough period as the prices of steel went down month after month. Indian steel faced over supply below cost prices due to imports, tough market conditions for a drop of capacity utilization from about 82% in '14/15' to about 77% in '15/16', steel imports mainly from China increased by close to 26% to 12 million tons in '15/16'.

As you are all aware the steel industry is burdened with large bank debts of maybe over Rs. 3 lakh crores and heavy losses as they have been unable to raise prices despite government support. The above factors have resulted in continuous pressure on volumes as well as prices of Electrodes.

In the backdrop of these negatives, there are some positive signs going forward which I would now like to place before you:

1) The Needle Coke prices which is one of our major cost has dropped substantially since last year off setting a part of decline in the Electrode prices. 2) Other input cost like binder and integration pitch, all types of fuels have also decline resulting in reduced cost of production. 3) The plant operating parameters have registered a significant improvement with our ongoing emphasis on reducing operating cost and increasing margins. 4) Lastly, consistent depreciation of rupee coupled with imposition of anti-dumping duties on imports of Electrodes from China are making imports of these Electrodes costlier thereby helping domestic sales.

And now turning our focus to the operations; we achieved a capacity utilization of a little over 50% in the quarter, we are continuously working on building our order book position which is lower than previous year, both prominently in the export market. Electrodes import in India have fallen by more than 55% last year, mainly due to rupee depreciation and anti-dumping duties imposed in China. This resulted in increasing in our domestic sales volumes by 53% compared to last year. Minimum import price of steel has been introduced now on 173 varieties of flat steel products in India recently. Similarly, safeguard duties of 20% on flat steel products levied in September '15 has been extended in March '16 which is going to be valid till March 2018. Full impact of these governmental measures against cheaper imports will come into effect over the next 6 months. The recovery is projected to strengthen in 2017 when Indian Steel production is likely to increase by 3.5% and beyond driven mainly by emerging or developing economies. This cumulative effect of big demand supply imbalance tumbling Iron Ore and Coal prices, ever increasing Chinese Steel exports cut down in budgets of all producing economies decelerating Chinese economy will continue to put pressure on electrodes sales, volumes and prices, however as I said before the industry is seeing a major restructuring and churning and consolidation between the major players. Given the above positive that I narrated it earlier, efficient plant operations, softening Needle Coke prices, softening other input costs related to oil and energy, anti-dumping duty on Chinese Electrodes, weakening rupee making imports more expensive and still a growing Indian Steel production should help us in sailing would be a very challenging times. With these comments, I would now turn over to our CFO, Rustogi who will take you through the financial numbers. Thank you.

Raju Rustogi: Good afternoon, a quick overview of Q4 FY16 numbers and then we will be able to take your questions. For the quarter ended March '16, HEG recorded net operating income of Rs. 163 crores as against Rs. 179 crores in the immediately preceding quarter, a reduction of about 9%. EBITDA including other income decrease from a level of Rs. 40 crores in Q3 FY16 to present of Rs. 9 crores in Q4 FY16. The company has suffered a net loss of Rs. 25 crores vis-à-vis a net profit of Rs. 6.5 crores in Q3 FY16. Loss during the quarter under review could largely be attributed to drop in sale prices and its consequent effect on configuration and marking down of high cost inventory. Reduction in turnover vis-à-vis previous quarter is mainly on account of sharp drop in prices as the market continues to witness pressure on demand from the EAF segment.

Net sales in power segment is lower than previous quarter as the generation from Hydro facility tapered down and stopped towards the end of February 2016. Also the Thermal generation was adjusted to the reduced demand of Graphite Electrodes business. We actually have a captive facility for Thermal and we have to adjust the generation of thermal power according to what is required in the Graphite making. There has been significant reduction in working capital during the year which has helped the company in reducing its short term debt position to below Rs. 500 crores on a sustainable basis. Our managing tide controls over controllable cost is key to sustaining in today's time when competition is buying to capture additional buy of market and in turn slashing prices.

With these I would request questions from friends and would like to clarify as to the extent we know about the market.

Moderator: Thank you. We will now begin the question and answer session. The first question is from the line of Shailesh Nayak from SCODE. Please go ahead.

Shailesh Nayak: Recently I was looking at the numbers of Q4 versus last year Q4; drop in sales is almost 45% in Graphite Electrodes, how does it compare with Indian competition which is there because you are saying you have increased the market share and because when at the fact Indian competition this drop is not as much as what you have at 45%. At the same time, EBITDA margin also has collapsed dramatically, I mean from 8.34 last year to a (-9.35) this time, so why has such a huge change that has happened vis-à-vis, I mean when I look at vis-à-vis your Indian competition because we were one of the lowest cost producers so has something change in this entire scenario?

Raju Rustogi: See about the competition though we are not fully familiar with the breakup of the numbers that comprises of total turnover of the Indian competition that you are referring to, what we know is about Rs. 300+ crores of their turnover is from segments where we do not operate. So we are not very sure in terms of whether the Indian competition performs better than previous year in those segments or not. Now related to the Graphite Electrode as a segment we believe they are also down from the last year's levels. If we are down by 30% is our number, I do not know from where are you referring to as 40%, our number is 33% precisely and our just rough guess is maybe they are also down by 20%+. So we do not have the exact breakup and hence our understanding is the world market of Graphite Electrodes is affected by slow demand and everybody is affected, yes it could be one-off quarter wherein the other company may have fared well than the other but if you see the annual performance it is majorly in line. In terms of the bottom line again it is a factor of; 1) performance of each of the four sectors that we know, we know one of the sectors which is Graphite Specialty where the margins of that sector are better than Graphite Electrodes, now if the competition has performed well, their bottom line is not as badly affected as we are but I am more than confident that the performance in Graphite electrode segment for both the Indian competition as well as the world market is in line. That is all I can say.

Shailesh Nayak: Basically where I have got this figure is your own presentation; Quarter 4 last year was Rs. 282 crores and this year Quarter 4 is Rs. 157 crores and that is how the drop is 45% which I mentioned.

Raju Rustogi: This 45% you are comparing quarter to quarter.

Shailesh Nayak: Yes but suddenly the differences are now considerably falling down, I thought after Quarter 3 your performance would improve now but somewhere I was not able to understand why it is still going down?

Raju Rustogi: Yes. See the performance is a factor of both quantity and prices. This year and as I said the demand has been sourced so our volume in terms of quantity is lower than previous year. That is one of the reasons and secondly the price fall which is very evident in the market for Graphite Electrodes is also significant which can be seen from the major players talking about it. I think these are two reasons where the prices for Graphite Electrode and the quantity of Graphite Electrode have fallen which is a fact. For other segments where we do not operate is where I am not able to comment upon.

Shailesh Nayak: One more thing, on a futuristic if I look at the International Companies that there is SGL as well as GrafTech basically what I seeing is they are moving towards a higher value add segments in Synthetic Carbon, so is there an opportunity for HEG also in that because if you look at future, let us say Electrical Car etc, are there is a huge potential people are talking about Synthetic Carbon as such, so leave that, that will be also looking into that spear?

Manish Gulati: This Carbon Fiber segment is a completely different product altogether and have absolutely no relation to Graphite Electrodes business and I think Carbon has had this division for quite many years and this is kind of linked to their development of fibers for the BMW cars which are futuristic cars, so this is not the segment in which HEG operates, it is completely different from the Graphite Electrode segment. So we do not have plans to go into Carbon Fiber as of now.

Moderator: Thank you. The next question is from the line of Abhisar Jain from Centrum Broking. Please go ahead.

Abhisar Jain: My question is on the gross margin front, if we see in this quarter on a sequential basis there has been a large fall. You mentioned that there is some inventory right down that we have factored in but Sir my calculations are showing that the electrode realizations from the segmental revenue that you report is around $2300 to $2350 per ton, is that a number near to what we are currently realizing?

Raju Rustogi: This dollar per ton that you seems to have estimated. I will not be able to understand how you have worked it out, yes I would say the present prevailing prices are close to those numbers or even below them. That is all I can say but I am not able to understand the way you have worked out this dollar per ton. About the gross margin falling in Q4, there are three primary reasons which I have also narrated in my initial commentary; one is of course the price fall which was very harsh in the specific quarter or fourth quarter. Now there was a steep fall in prices, it was in excess of 15% as we have noticed in one quarter, now the consequent of this price fall is in Indian Accounting Parlance you have to adjust your inventories according to your cost or sale price whichever is lower. Now if your price fall is so significant you have to mark down your inventory which is one of the reason of this one-time loss that we have incurred. And finally we have a manufacturing cycle which is three months' from start point of raw material to end point of sale of material. Now if the sale prices fall in the month of say January '16, our raw material price fall impact happens after three months. So this one quarter result that you are seeing is comprising of one, the market sectors and the other one is a one-time sector presently which is dominated in Q4.

Abhisar Jain: So Sir basically the 15% fall in the prices which has led to this inventory ride down that is on both RM as well as finished goods side, is it?

Raju Rustogi: It is mainly the WIP and FG, not RM.

Abhisar Jain: But Sir in the Needle Coke as you mentioned that the prices have come down substantially, so what we were picking up maybe from the market is, the prices are now below $500, will that be a correct estimate?

Raju Rustogi: It is much below this $500 level. I would say it is below $350.

Abhisar Jain: So the FY17 sourcing majorly is going to be at around those levels, right?

Raju Rustogi: It has to be around those levels though the contracts are under breathing, we are still into the discussion stage and you can always observe when the prices are continuously falling it takes time to finally reach the last point of contracting.

Abhisar Jain: Sir one more thing here is that on the overall inventory number that we have, we have obviously reduced the inventory but still around Rs. 300 crores that we have on the inventory side, I would assume that the substantial portion will be on the finished goods and WIP and not on the RM side, is that understanding correct?

Raju Rustogi: Yes absolutely correct.

Abhisar Jain: And in terms of the capacity utilization versus Graphite India for full year FY16 we seems to have been significantly behind as the other participant was also indicating because when I see their capacity utilization which they report on quarterly basis in the last two quarters they have been above 70% and also on a full year basis they are closer to 70% whereas we have been closer to 55% on full year and 50% in Q4. So Sir any comment on that and your strategy on that going forward?

Raju Rustogi: See number one, we also have seen their quarterly presentation and what is disclosed by the management of Indian competition is 56% in Q3 and 58% in Q4. So we also have not seen any number called 70% during '15/'16 of the Indian competition. If it is 56% or 55% maybe the difference is between choice of customers, the market is same for both of us.

Abhisar Jain: And on FY17, what are your volume targets and how is the pricing scenario looking likely?

Manish Gulati: Pricing is expected to be another 15% down compared to that of '15/16' because we cannot say for sure because we are building the order book still but 15% price decline looks likely. That is point one and about capacity utilization, we think it should be around 58%, 60%.

Abhisar Jain: So of the Q4 run rate of the realization will already be closer to what you are indicating because the Q4 run rate itself is around 15%,16% lower than the full year run rate I believe, on the pricing?

Manish Gulati: If you compare '14/15' with '15/16' there has been a 15%,16% price decline and there is expected to be another decline of the similar quantum; 15% to 16%. Some of which will be recovered from the fall in Needle Coke prices. Yes, Q4 prices are reflective of next year.

Abhisar Jain: One more thing on the expense side, we have been able to cut on the Power and the other expenses significantly in Q4, so can you mention what has driven that and how sustainable this will be?

Raju Rustogi: In terms of Power, we have taken certain measures which are I would say optimum in the present circumstances. We have two Power plants, earlier we were running both of them a bit on lower capacity. So, now we have decided internally optimized the operation by closing down one and operating one of the two plants at 100% capacity that has brought cost effectiveness on the Power generation. The other part is on the mix of coal that we used has resulted in cost saving to us in terms of specific heat rate and the grams per unit of generation for Power. And third is on the fuel side, the prices of gas, the LNG gas and also the Furnace oil have reached the rock bottom which has actually made it more efficient to run.

Abhisar Jain: And on the other expense side, the other expense has also come down significantly both sequentially obviously year on year?

Raju Rustogi: See this company has a philosophy of managing the cost in the most appropriate way, so we try and manage all the controllable cost to bring the effect of falling prices has to basically be compensated by falling cost to the extent possible and I would say if you see administration, if you see maintenance, if you see the fixed cost element of the cost, all of them are today I would say optimized and are in line with what is expected out of the business for year '16/'17 and they are sustainable, this reduction is sustainable.

Abhisar Jain: Just one more question in terms of the overall compensation on the employee cost, so since in PBT basis, this year we have been on a loss level, so could you indicate that the overall promoter compensation would be coming down for FY16?

Raju Rustogi: Yes it has come down according to what is provided in the Company's Act, so the compensation to the Managing Director of the company is in line with what the law prescribes and it is lower than previous year.

Abhisar Jain: Sir one last thing I had actually checked on the Graphite presentation for Q4, actually sir you can maybe cross check once again but the numbers on the capacity utilization that they have given on slide 9 is 76% and 70% for the standalone business, so maybe we can reconcile that later but just that there was a very sharp difference that is why I pointed out.

Raju Rustogi: No issues friend, I think Abhisar Jain we will be able to come back to you specifically in this subject on a one to one basis.

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

Ravi Jhunjhunwala: Thank you friends for joining today and I look forward to speaking to you next quarter with probably some better results in the first quarter. Thank you.

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