

Operator

Ladies and gentlemen, good day and welcome to HEG Limited Q2 FY 2014 Earnings Conference Call. 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. . Please note that this conference is being recorded. I now hand the conference over to Mr. Parin Narichania from ProActiv Teamwork. Thank you and over to you sir.

Parin Narichania, Investor Relations

Thank you. Good afternoon everyone. We welcome all of you to HEG Limited's analyst and investor conference call. We shall discuss the performance and financial highlights of Q2 FY14. We have with us today, Mr. Ravi Jhunjhunwala, Chairman and Managing Director and Mr. Raju Rustogi, the Chief Financial Officer. We will begin this 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 mention that certain statements in this con call may be forward-looking in nature and a disclaimer to this effect is included in the investor presentation which was sent to you earlier. I would now like to hand over the floor to Mr. Ravi Jhunjhunwala. Over to you sir.

Ravi Jhunjhunwala, Chairman and Managing Director

Thank you and good afternoon friends. Thank you for joining us on this call. Let me start with giving you a gist of the world steel industry, resultant impact on the graphite electrode industry. According to the World Steel Association data available for the first 10 months of this year, the world steel production without China is likely to see a drop of approximately 4% from 831 million tons last year to about 800 million tons this year and a marginal increase of about 2.8% including China from about 1,548 million tons last year to about 1,580 million tons this year.

India's year-to-date steel production of about 58 million tons was up by about 3% compared to last year. However from various reports, it now seems that the worst is behind us. The key risks of Eurozone crisis and hard lining of the Chinese economy has now somehow started stabilizing.

Recovery in global scale demand is expected in 2014 on account of steel demand returning to positive growth in developed economies. The prices of steel have also bottomed out and are likely to move in an upward trajectory. Graphite electrodes find their biggest industrial use in electric arc furnaces used in steel plants to melt steel scrap.

The demand for electrodes is therefore sensitive to steel production using electric arc furnaces. The share of electric arc furnaces in the global steel production currently stands at around 30% of total steel. EAF's share of global crude steel making has been steadily rising in recent years. There are two factors which are likely to have a positive effect on new capacity additions in this sector in the future.

One, growing steel scrap reservoirs and specially collection of scrap in China and two, the shale gas revolution in the US. China which is currently the largest importer of scrap is likely to be not just self sufficient, it will also become a net exporter of scrap by about 2020 which will boost not only their own eclectic arc steel production but increase the overall availability of scrap for rest of the world.

Secondly, the shale gas revolution in the US is helping create substantial new capacities of DRI, the direct reduced iron, more popularly known in India as sponge iron which provides additional raw material alternate of EAF steel, in addition to scrap. Moreover electric arc furnace is a much more cost effective and environment friendly process compared to the traditional blast furnaces. We see electric arc furnace share of steel all over the world to continue to rise substantially in the next five to 10 years and some substantial new deals coming in all over the world, especially in the US and the Middle East.

Now coming to our company's operations. Our capacity utilization in both first and second quarters remained at around 60%, which was somewhat intentionally reduced by us in the second quarter, in order to produce a portion of the product mix which takes more than two times the time than the conventional electrodes. This was intentionally done in order to use our production facilities efficiently at a time when the order book position was not good and in anticipation of certain large orders expected from different

countries for the second half of the year.

Our order book position now is fairly healthy for the rest of the year and with these long lead time products already produced in the last quarter for remaining part of the year and also partly for the next year 2014, '15, we expect to see a substantial jump in the plant capacity utilization in the third and the fourth quarters. We are currently operating at more than 85% of our capacity and expect to ramp it up to more than 100% in the last quarter.

Friends, two major industry players from the western world have recently announced a permanent closure of three plants, three graphite electrode plants totaling about 90,000 tons of their current capacities from the first half of calendar year 2014. This is a very major development for this industry, large part of capacity imbalance would be taken care of due to these closures. We expect some more such closing announcements in not too distant a future. Closing existing capacities in the electrode sector and additional capacities coming on stream, our raw material sector that is needle coke, over the next 12 to 15 months (inaudible) well for us, for our cost structure in the future.

As you all know, needle coke is the single largest component of our cost. We see needle coke prices softening in 2014 and 2015. The next largest cost component for us is power, where as you know we are fully self-sufficient with two coal-based and one hydro electric plant, which provide us with a very cost effective and stable power.

In summary, exhaustion of all high cost needle inventory, which we were carrying in the first half, our high capacity utilization in the next two quarters, a strong order book position for the next two quarters, softening of raw material prices, a stable and cost effective power, all these factors should see us post substantially better operations and financials for the third and fourth quarters of the current year. With this short overview, I would now ask Mr. Rustogi, our CFO, to take you through the financials. Thank you. Yeah, good afternoon. Just a quick overview of Q2 FY '14 numbers, and then we'll be happy to take questions. For the quarter ended September '13, HEG recorded net operating income of 301 crores as against 439 crores in the corresponding quarter of last year, registering a 31.4% decline in the top line and a corresponding decline of 25.14% in the EBITDA margin. The EBITDA margin which was 71 crores in Q2 FY '13, has come down to 53.27 crores in Q2 of FY '14. The encouraging part is to note that EBITDA margin has grown marginally from 17.4% in Q1 of FY '14 to 17.7% in the Q2 of FY '14 and specially understanding that for the low turnover period that we witnessed.

Unusual volatility in the ForEx market continues to affect the company adversely to the tune of about 9.2 crores, as rupee depreciated further during the quarter. As anticipated, the interest cost has been higher as the liquidity tightening measures by RBI continued. With enhanced focus on improving working capital investment, we are able to recycle our liquid assets more productively during the quarter under review.

To sum up, we are in a ramping up mode in the backdrop of a healthy order book position and look forward to post an improved results in both Q3 and Q4 of FY '14.

This is all from my side, if you have anything to ask we are here to revert on the same.

Questions And Answers

Operator

Thank you very much sir. Ladies and gentlemen, we'll now begin the question and answer session. . Our first question is from Goutam Chakraborty of Emkay Global. Please go ahead.

Goutam Chakraborty, Analyst

Yeah. Thank you and good evening sir.

Ravi Jhunjunwala, Chairman and Managing Director

Good evening.

Goutam Chakraborty, Analyst

Sir my question is related to your -- first on your topline front. As we understand and you had also mentioned that your utilization level --. Hello?

Ravi Jhunjunwala, Chairman and Managing Director

Can you be a bit louder please?

Goutam Chakraborty, Analyst

Yeah, yeah, sure. Is it okay now?

Ravi Jhunjunwala, Chairman and Managing Director Goutam Chakraborty, Analyst

Okay. Sir --.

Ravi Jhunjunwala, Chairman and Managing Director

There is a sound which is coming today. Can you please carry on?

Goutam Chakraborty, Analyst

Yeah. So, see my first question on the topline front, if you --. Hello?

Ravi Jhunjunwala, Chairman and Managing Director

Yeah. Go ahead, go ahead. We can hear you.

Goutam Chakraborty, Analyst

Yeah. Okay. So, as we understand and you had also mentioned that the utilization level remain almost same on a quarter-on-quarter basis, so the improvement which is almost 28% in the topline on a sequential basis, should we say is it -- it is because of the -- your product mix and the INR impact or is it because also of some improvement in your realizations, I mean graphite prices?

Ravi Jhunjunwala, Chairman and Managing Director

Yeah. Okay, let me answer this. This is -- what you said is rightly stated, some of it is due to INR dollar impact.

Goutam Chakraborty, Analyst

Yeah.

Ravi Jhunjunwala, Chairman and Managing Director

The second part is, we sold additional quantities out of our inventories which are reflected in the inventories which are reflected in the inventory reduction number in the results. Third is the product mix. So all three have contributed to the increased volume.

Goutam Chakraborty, Analyst

The topline --.

Ravi Jhunjunwala, Chairman and Managing Director Goutam Chakraborty, Analyst

And so there is no improvement as such on the graphite prices as such, right?

Ravi Jhunjunwala, Chairman and Managing Director

Graphite. No, there is no improvement on the prices at all.

Goutam Chakraborty, Analyst

Yeah. And so sir. Are we expecting any improvement in that as well because as you mentioned some development is going on in terms of closure of some of the facilities and overall there is a sense of bottoming out of the steel industry's utilization level globally. So, should we expect some improvement in that regard or do you think it will be stable more or less?

Ravi Jhunjhunwala, Chairman and Managing Director

See for the next two quarters, as I said, our order book position is fairly healthy. And on the back of that we are already working at between 85 and 90% in the current quarter.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

And in the last quarter, the next quarter we are fairly hopeful of reaching 100% or even more than 100%. That is on the back of a fairly healthy order position where the prices are slightly higher than what we have seen in the last two quarters.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

But all these orders are already on the book. So there is going to be an improvement because of the product mix and a slightly high priced orders for the next six months. But going forward from the new financial year we, it's still very early because the orders for the next year starting April --.

Goutam Chakraborty, Analyst

Right.

Have just started. I mean the negotiations in the world market for that period will just start now. I mean we are right now in the middle of already talking to the customers, filling up certain tenders and things like that.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

So we really don't have a feel of how the prices are going to look like from April onwards. But yes, to the extent that three plants have been announce to be closed totaling about 90,000 tons.

Goutam Chakraborty, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So that's a fairly substantial closure. It's almost like 10% of the total capacity of ultra high power electrodes in the world. So that should show some impact next year.

Goutam Chakraborty, Analyst

Okay. And sir, when you were talking about the order book position, what I understand I think last quarter, this Q1 you had mentioned it was a bit lower compared to the normal run rate and it was probably at around 30 odd percent. So and you were saying that --

Ravi Jhunjunwala, Chairman and Managing Director

(Technical difficulty)

Goutam Chakraborty, Analyst

Yeah, so currently as a percentage how much it would be I mean, you were saying that it is covered full -- the next two quarters are covered and in fact probably in Q1 of the FY '15 also to some extent it covered, so is it the -- more than the normal run rate you see normally during this time?

Ravi Jhunjunwala, Chairman and Managing Director

It's not, this product has not much of a cyclical nature. All the four quarters are normally more or less equal, but as I said, currently our order book position is fairly good for the next quarters, at least for the next two quarters.

And there are certain orders which are in hand for longer term.
Okay.

Ravi Jhunjunwala, Chairman and Managing Director

So which gives us some hope and on the back of improved steel market, as we spoke about and the impact of these closures, so at least for the first two quarters of the next year, which is April-September quarter. We would still see a fairly healthy position as far as the order book is concerned.

Goutam Chakraborty, Analyst

Okay. And on the raw material side, sir needle coke, you see some improvement, I mean, some softening of prices in the next year, or -- I mean what is the sense on that?

Ravi Jhunjunwala, Chairman and Managing Director

You see the needle coke prices have already softened compared to the beginning of this year.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjunwala, Chairman and Managing Director

Our current prices of needle coke has already softened in any case.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

And given this announcement of capacity closures on the electrode side, we do expect some more softening for the 2014 prices.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

There again, the discussions will start in the next couple of weeks, because, normally by January end, February beginning, we normally would have closed all our purchases for the next 12 months.

Okay, okay. And lastly on the balance sheet side, the borrowing, if I look at, it has actually come down compared to your March position. So did we repay something?

Ravi Jhunjhunwala, Chairman and Managing Director

Yeah, in fact the borrowing comprises of these terms loans as well as the working capital finances.

Goutam Chakraborty, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

On the term loan side, we have repaid about 80 crores in the first half of 2013-2014.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

But not in same reduction in term loan number because of reinstatement due to currency.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

Yes, the overall -- there is a overall reduction but (technical difficulty) we've done. On the working capital side also, we are closely monitoring all the elements of working capital and I'm happy to inform you that we have collected some dues from the government, which was blocked for some time and they are being productively used into our business now. So, on both the fronts, we are able to, one is repay the term loans as well as the throughput of the working capital investments.

Goutam Chakraborty, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

So, all in all, we're lower by about 130 crores from what we started with in March.

Okay. So this kind of run rate, should we expect even for -- till March in this fiscal and probably the next fiscal as well? I mean, there is no as such CapEx lined out, right?

Ravi Jhunjhunwala, Chairman and Managing Director

No, CapEx is whatever are there in the pipeline we'll be closing all of them.

Goutam Chakraborty, Analyst

Yeah.

Ravi Jhunjhunwala, Chairman and Managing Director

And other than that, we are not coming up with anything other than replacement CapEx.

Goutam Chakraborty, Analyst

Okay. And that would be sir, how much run rate 50 odd crores per year or something?

Ravi Jhunjhunwala, Chairman and Managing Director

I think, the rest of the year we are expecting not more than 20 crores.

Goutam Chakraborty, Analyst

Yeah.

Ravi Jhunjhunwala, Chairman and Managing Director

Next year, we still have to plan out.

Goutam Chakraborty, Analyst

Okay, okay, okay. Okay thank you very much for taking my questions. Thanks.

Operator

Thank you. Our next question is from Neeraj Mansingka of Edelweiss Capital. Please go ahead.

Neeraj Mansingka, Analyst

Hi, sir, hi. I had one question related to the industry, you had said that the players in the US has closed. Can you give some color on how their cost has stacked against yours and or other players and what was the basic reason that they

Ravi Jhunjhunwala, Chairman and Managing Director

Basically this industry is controlled by three large players, one each in US, Europe and Japan. If you look at the total production capacities of these three companies.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

It is more or less in the region of anywhere between 200,000 tons to 250,000 tons each. And apart from these three, there are only two of us, us and Graphite India in India and some producers in China, which are not really in the same quality league as the rest of us. So the American company has announced the closure of two plants of about 30,000 tons each, in Brazil and in South Africa and the German company has announced closure of their Canadian plant which is also 30,000 tons.

Now, as per this statement, these three have been the highest cost plants.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

Some of them has about five to six plants, each of these groups out of which these three have been closed down.

Neeraj Mansingka, Analyst

Okay, so do you expect, so what part are. Okay let me put the other way, where does HEG's competitiveness lie in a long-term over other players as far as cost is concerned?

Ravi Jhunjhunwala, Chairman and Managing Director

See, just to give you answers in a very simple manner, about 40% to 50% of our direct cost is our raw material which is needle coke.

Neeraj Mansingka, Analyst

Right sir.

Ravi Jhunjhunwala, Chairman and Managing Director

This needle coke is again produced by only about three to four players in the world.
Right.

Ravi Jhunjhunwala, Chairman and Managing Director

Basically two American companies and two large American companies and two small Japanese companies. So, the needle coke prices are virtually similar for all the graphite players, because these prices are fairly stable and known to all of us.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

And this needle coke is a product which is only used by the six, seven of us, six, seven of the graphite producers all over the world.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So, except an additional element of cost due to distance due to freight, the basic cost of the needle coke is virtually similar for all of us. The second largest component is electrical power. Power constitutes in our case about 20% to 25% of the cost.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

There, we believe we have certain advantage because way back about 20, 22 years ago, we have started, we had put up a 18 megawatt of hydro electric plant which has been in operation since '92, '93. And as you know in hydro, virtually the entire cost of operation is interest cost. So, having repaid all the loan, the operating cost of the hydro plant today is very, very small.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So, of course, the coal cost will keep going up in our country, but still our self generated power which comes to us from 70 megawatts of coal and about 18 megawatts [ph] of hydro, it's still much lower than the cost that one -- that normally one would pay to buy power today in Madhya Pradesh or any other state.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So, there we do have certain advantages compared to international players where the cost of power could be higher than ours. These two elements virtually control about 70%, 75% of our direct cost.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

On the fix cost, in spite of the fact that it's not a very labor intensive industry, but still if you look at the international P&L and the balance sheet of the international (technical difficulty) major companies in this business, their cost of labor or cost of manpower does account for 15% to 20% of their cost versus about 7% to 8% in our case. So as I said, in spite of being a fairly technologically oriented industry, not a very labor intensive, but still there is a substantial difference of almost like 10% to 13%.

Neeraj Mansingka, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

Between us and three of our major competitors in the world.

Neeraj Mansingka, Analyst

Right. Sir is that the reason that you are getting your order book full or your capacity utilization is reaching -- going to -- expect it to reach much higher?

Ravi Jhunjhunwala, Chairman and Managing Director

I mean, yes, of course, that could be one of the reason, I mean, there are so many reasons for order book becoming good at sometimes and bad at sometimes.

Okay, okay sir. That's all. Thank you very much.

Ravi Jhunjhunwala, Chairman and Managing Director

Thank you.

Neeraj Mansingka, Analyst

Yeah.

Operator

Thank you. Our next question is from Kumar Chandan of State Bank of India. Please go ahead.

Kumar Chandan, Analyst

Sir good evening. I just want to ask, your profitability is now -- mainly contributor of your profitability is now your hydro power division. Is it that the profitability of graphite division is impacting adversely due to any specific reason or what?

Ravi Jhunjhunwala, Chairman and Managing Director

Just can you repeat and can you be a bit louder Chandan.

Kumar Chandan, Analyst

Sir, I am observing, we are observing it that your -- main contributor for your profitability is now shifted to hydro power division, the main contributor is now hydro power division for last year and now for this half year also. So that means the profitability of graphite division is impacting adversely, any specific reason sir?

Ravi Jhunjhunwala, Chairman and Managing Director

No, I'll explain, it's not the, it should not be looked at this manner. I mean first of all, out of the total power, hydro is a fairly small component. Our total capacity of hydro power is only 16, 17 megawatt, versus about 60 to 65 megawatt of thermal.

Kumar Chandan, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

Number one. Number two, since both the divisions are part of the same company, as a policy we are buying power from our own power division at the price at which we would normally have purchased from the Electricity Board.

Kumar Chandan, Analyst

Right sir.

Ravi Jhunjhunwala, Chairman and Managing Director

So, basically you should look at the profitability as one and it's quite confusing to see division wise between graphite and power.

Raju Rustogi, Chief Financial Officer

See I would like to add here, this is more to suit the accounting standards prevailing in India than the business profitability. So the accounting standards in India requires us to do a transfer pricing of power at the same price at which it is available in the market and hence this mechanism and this is followed by all companies not only HEG in India. So if you see a consolidated picture you will -- for HEG as a company the power remains, the power cost remains the cost of generation itself which gets allocated between graphite and power divisions.

Kumar Chandan, Analyst

Okay. Sir so, do we expect that you will able to achieve the level of sales or profitability whatever is for FY '12, '13, at least at that extent in '13, '14 also?

Ravi Jhunjhunwala, Chairman and Managing Director

Okay. Looking at the first half and our estimate of this half, we are expecting our cash generation to be same as last year. But this is a forward-looking statement, let me also caution the team that it is a forward-looking statement because the order book is there, it all depends on our efficiencies of producing and delivering. So to -- considering that we are hopeful that the last year numbers -- or we will reach close to last year numbers in terms of cash generation.

Kumar Chandan, Analyst

Thank you. Thank you sir.

Operator

Thank you. . Our next question is from Ashutosh Tiwari of Equirus. Please go ahead.

Ashutosh Tiwari, Analyst

Yeah, hello sir. On this demand scenario, are you seeing any improvement in Europe particularly, I think that's one market is suffering a lot for a long time, so is there any green shoot coming out of Europe?

Yeah we do, we are seeing some improvement in Europe also, the capacity utilization of the steel plants are increasing somewhat.

Ashutosh Tiwari, Analyst

But is it, the EA furnaces you are talking about or overall industry as such, steel industry?

Ravi Jhunjhunwala, Chairman and Managing Director

No, I'm talking more of the overall, I mean EAF is part of the overall steel, and as I said EAF constitutes about 30%, 31% (technical difficulty) both side by side.

Ashutosh Tiwari, Analyst

But in terms of your order booking or your interaction with the customers, are you seeing some pick up happening or --?

Operator

Sorry to interrupt. Mr. Tiwari if you are connected on a speaker phone, could you please switch to a handset? We can't hear you clearly.

Ashutosh Tiwari, Analyst

Yeah, yeah. So in terms of your interaction with the companies in Europe, I mean are you seeing any improvement happening in terms of their order booking is increasing or anything like that?

Ravi Jhunjunwala, Chairman and Managing Director

Yeah absolutely, absolutely we are.

Ashutosh Tiwari, Analyst

Okay. And the second thing, you talked about this plant closure by some of the global players like GrafTech is closing 60,000 [ph] in terms of capacity.

Ravi Jhunjunwala, Chairman and Managing Director

Yeah.

Ashutosh Tiwari, Analyst

So the high cost capacity in Mexico and Brazil. But the surprising part is that I saw was that when they are talking about that if they want to actually increase this amount of capacity at their existing plant basically, the total amount that will be incurred on a per ton basis would hardly be \$2,500 and actually if you take up the CapEx required initially, for the whole capacity that you are talking about, would be similar to what I mean you are say, Graphite would have incurred for similar amount of capacity. So that capital cost is coming out to be quite lower, if they want to incrementally increase the capacity by that amount.

Ravi Jhunjunwala, Chairman and Managing Director

Yeah, that is true. I mean that 2,500 or \$3,000 per ton, was more or less similar to what we would have spent or what we would be required to spend, if we wanted to incrementally increase. But the fact is that whenever you see an uptrend in the market condition and you want to add that capacity, it's a time consuming process.

It takes anywhere between, I would say 18 to 24 months to add capacity on an existing plant. So that time lag will always be there. Similarly, in our case also, I mean if we wanted to increase our capacity from let's say, 80,000 tons, which is what it is today to about 100,000 tons, probably we will spend less than 2,500.

Ashutosh Tiwari, Analyst

Okay.

Ravi Jhunjunwala, Chairman and Managing Director

I mean, given the difference between the European and the American cost and Indian cost in any sector, our incremental cost will be lower than 2,500 and that option is in any case available to any company.

Ashutosh Tiwari, Analyst

Okay. And sir, if I compare electrode prices from one year back to current levels, I mean your recent bookings, what's the quantum of decline that you've seen so far and now you talked about that it's improving. So, I mean going ahead will you be booking at higher

levels or these levels whatever you're doing right now will sustain?

Ravi Jhunjhunwala, Chairman and Managing Director

You are talking in terms of prices?

Ashutosh Tiwari, Analyst

Yeah, prices, yeah.

Ravi Jhunjhunwala, Chairman and Managing Director

See the prices have dropped by, I would say anywhere between 15% to 20% in the last 12 months.

Ashutosh Tiwari, Analyst

Okay.

So what we're seeing, the results that we are seeing right now are based on these kinds of drop that we've seen in the last let's say 12 months or so.

Ashutosh Tiwari, Analyst

Okay. But now is it improving I mean --?

Ravi Jhunjhunwala, Chairman and Managing Director

See, as I said, more or less we -- you see the trend of this industry is such that you almost book about 60% to 70% of your order book for the next 12 months by January, February or March, a calendar year basis. Once you have booked your 60%, 70% of order book at the firm price, what is open for sales on a spot basis is normally anywhere between 30% to 40%. So any drop or any increase in the price subsequent to January, February of every year is only on that 30, 40%. Similarly, on the raw material, needle coke which is almost like 45, 50% of our cost, it's the same thing there. We more or less buy everything for the calendar year in January, February at a firm price.

Ashutosh Tiwari, Analyst

Yeah. So, and what kind of drop you have seen in the needle coke prices over last one year?

Ravi Jhunjhunwala, Chairman and Managing Director

No, as I said if you compare our calendar year 2012 versus calendar year 2013, my guess is we would have a drop of about 15% to 20% in the spending prices, but there is a drop -- there is a similar drop in the raw material cost also. Although, it doesn't take care of the entire drop on the electrode prices, but the needle coke prices have also dropped.

Ashutosh Tiwari, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

But the next six months order book that we have; fortunately, we have certain orders which are -- which don't have a 15% to 20% drop. So to that extent, the overall average could be a little better than what we have seen in the first two quarters.

Ashutosh Tiwari, Analyst

Okay so in USG [ph] pricing essentially you are saying the second half selling prices would be slightly higher than the first half?

Ravi Jhunjhunwala, Chairman and Managing Director

Correct, correct.

Okay. And, sir needle coke, (inaudible) must have started by now, so what's your sense over there, because actually retail prices kept on falling throughout the year while needle coke are normally one year contracts, so what's the sense on needle coke pricing for next year?

Ravi Jhunjhunwala, Chairman and Managing Director

You see as I said, the prices have softened even in the last two, three months, but it's too early for us to conclude the order for the 2014. We have just started getting some feel and we were just waiting for these announcements to be absorbed in the market. Obviously, this will have a impact on the needle coke pricing also, this 90,000 ton capacity is going out of business, but it is too early to talk about 2014 needle coke prices.

Ashutosh Tiwari, Analyst

Okay. So, but everybody, I mean, Conoco or Sumitomo everybody has yearly contracts only or in between also there are some companies who are negotiating?

Ravi Jhunjhunwala, Chairman and Managing Director

No, more or less everybody has a 12-month contract.

Ashutosh Tiwari, Analyst

Okay, okay. So, I think, picture will be more clear only in Jan., Feb., basically --?

Ravi Jhunjhunwala, Chairman and Managing Director

Yeah. By the time we speak next, we will surely be in a position to talk.

Ashutosh Tiwari, Analyst

Okay. And, definitely I mean again this has now become like a norm only that the bigger players announced price increase, but it doesn't come through like GrafTech also announced the price increase effective [ph] \$400 I think for electrodes. So, I mean is -- do you think that industry can absorb a very big price increase next year or it's just that every year they announce and then negotiation happen at about slower level.

Ravi Jhunjhunwala, Chairman and Managing Director

I can't comment on that right now but given that psychologically, it definitely has a psychological impact with almost 10% percent of the world capacity going out of business. So instead of operating at 60, 70% which they have been operating for the last two years, now they will be operating at 90, 95%.

So to that extend, there won't be so much of pressure on them to sell. So -- and as I said, it has coincided with a time when steel industry seems to be bottoming out already. So we do, we are quite hopeful of at least some recovery in the next year's price. It's too early for us to say that the entire price increase which they have announced gets absorbed or not but our belief is that certainly there should be some uptrend in the next year.

Okay. And sir, what's your sense on the inventory in the system I mean because last year inventory levels were quite high in Q1, CY '13. So what about inventory throughout in the system right now, is it at comfortable levels or what's the sense?

Ravi Jhunjhunwala, Chairman and Managing Director

See the inventory level as I said, we are really focused on monitoring our working capital level. The inventory are at comfortable level. We are not overstocking neither under stocking.

Ashutosh Tiwari, Analyst

No, no, no I am not talking from the company's perspective, I am talking more so on the industry perspective because last year what happened that in Q4 FY '12 onwards actually there was large inventory built-up with the consumers basically of electrode, has that impacted the utilization levels in the subsequent quarters in the first half of this calendar year. So my question is how is the inventory levels in a challenge right now?

Ravi Jhunjhunwala, Chairman and Managing Director

No, it was corrected itself, there is not much of an inventory. I mean that's why we are seeing that the bottom seems to have reached and that's why we are hopeful that some price increase should take place and the customers have started coming back and talking about next year.

Ashutosh Tiwari, Analyst

Okay. And needle coke contract prices will still be yearly contract phenomena or you think that it could change this year?

Ravi Jhunjhunwala, Chairman and Managing Director

See it will mainly depend upon us. I mean today we are in a buyer's market as far as needle coke is concerned. So, really we will have to take a view whether we should go for a 12 month contract, or we should rather talk about the six month contract.

If we get a feeling that the prices could drop in the middle of next year, then we might as well just take it as a six month contract.

Ashutosh Tiwari, Analyst

Okay. And sir incrementally over last one year, is there new capacity of needle coke that has come up into the supply side?

Ravi Jhunjhunwala, Chairman and Managing Director

On the needle coke you mean?
Yes sir.

Ravi Jhunjhunwala, Chairman and Managing Director

No, there has been no new capacity which is coming to operation in the last year, but there are two small plants of needle coke which use pitch. You see needle coke is produced out of -- majority of the petroleum, I mean majority of the needle coke is produced out of oil and probably about 10% to 15% of the needle coke uses pitch, which comes out of steel plant. So there are two plants, there are two new greenfield plants, one each in Korea and in China, which are under construction.

So at least one of them is going to be on stream in the second half of next year and the other one should be on stream sometime end of 2015. So, that is also a good sign as far as we are concerned because obviously, the needle coke market is already under pressure, two plants will add more capacity to the extent of about 120,000 tons.

For the next couple of years, needle coke should be fairly soft.

Ashutosh Tiwari, Analyst

So, it seems like after a long time I think things are turning around that electrode capacities are going of at least by some amount while needle coke --?

Ravi Jhunjhunwala, Chairman and Managing Director

Correct. And needle coke capacities are increasing.

Ashutosh Tiwari, Analyst

Yeah, okay, okay.

Ravi Jhunjhunwala, Chairman and Managing Director

Correct.

Ashutosh Tiwari, Analyst

Sir, thank you so much and all the best.

Ravi Jhunjhunwala, Chairman and Managing Director

Thank you.

Operator

Thank you. Our next question is from Rahul Bhangadia of Lucky Investments Managers. Please go ahead.

Thank you for taking my question sir. So you have given us a color of the global scenario, if you could just help me with some few numbers in the sense that your presentation mentions that the market is about 1.1 million tons. What would be the global capacity be of the order of? Roughly -- rough numbers would do sir, nothing --.

Ravi Jhunjhunwala, Chairman and Managing Director

See the global capacity today is going to be 800,000 tons for (technical difficulty) and when we say actually 1.1 million, we do take around 250,000 tons to 300,000 tons, which is actually not a UHP grade and it is mainly produced by Chinese manufacturers.

Rahul Bhangadia, Analyst

Okay, so the UHP grade is about 800,000 tons, what you're saying?

Ravi Jhunjhunwala, Chairman and Managing Director

Yes, we should take it as 800,000 tons.

Rahul Bhangadia, Analyst

That -- now this 800,000 tons is after this 90,000 tons of closure?

Ravi Jhunjhunwala, Chairman and Managing Director

Yeah, yeah, actually that's right.

Rahul Bhangadia, Analyst

Okay so 9 lakh tons has gone to 8 lakh tons is what you are saying basically rough?

Ravi Jhunjhunwala, Chairman and Managing Director

That's right, absolutely right.

Rahul Bhangadia, Analyst

Sir as you mentioned that you are going to get into the process of negotiations for the next year and the picture is going to be much clearer when you talk to us next. But that is for the next year. Over the next three, four years or over the next five years as the market moves towards EAF as is expected, then in the phase of an oligopolistic production or supply side, do you see significant pricing power emerging or that is unlikely to happen?

Ravi Jhunjhunwala, Chairman and Managing Director

See, I will clarify your first point first on the UHP, non-UHP. See it's a very generic kind of a definition so when we speak about a capacity of 800,000 tons in UHP, it's not really very (inaudible) I mean what I call as UHP, somebody may call not UHP or a semi UHP. And especially in China these terms are very loosely used.

Rahul Bhangadia, Analyst

Sure.

Ravi Jhunjhunwala, Chairman and Managing Director

So don't be surprised if somebody tells you the UHP capacity is 900 or somebody says it's close to a million because there is no strict definition as far as these terms are concerned.

Rahul Bhangadia, Analyst

So these are capacities or these are market sizes?

Ravi Jhunjhunwala, Chairman and Managing Director

We are talking of the electrode market, electrode capacities.

Rahul Bhangadia, Analyst

And the size would be -- the existing?

Ravi Jhunjhunwala, Chairman and Managing Director

The market will be more or less similar, if you include all the Chinese consumption of regular grade, very low quality grade and everything, it will be more or less, after this closure of 100,000 tons, 90,000 tons we are more or less in line with the market now.

Rahul Bhangadia, Analyst

So the demand supply is more or less balanced on all fronts?

Ravi Jhunjhunwala, Chairman and Managing Director

Yes, more or less, yeah, I would say more or less.

Rahul Bhangadia, Analyst

Okay, okay.

Ravi Jhunjhunwala, Chairman and Managing Director Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

But to the extent that there are two new plants, two new greenfield plants which are coming up in China and Korea, adding 120,000 tons and this 12,000 tons is going to be added in the next 12 to 15 months.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

60,000 tons is going to be added in Korea in the second half of next year and the next 60,000 tons sometimes in the second half of 2015.

Rahul Bhangadia, Analyst

That would take the global needle coke capacity to what level, sir?

Ravi Jhunjhunwala, Chairman and Managing Director

See, again if you talk about the needle coke capacity, currently it is about 850 to 900.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

So that will add another 100,000, 120,000 tons.

Rahul Bhangadia, Analyst

Another 15% maybe?

Ravi Jhunjhunwala, Chairman and Managing Director

Another 15%.

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

So, to the extent that electrode capacity doesn't increase by 120,000 tons.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjunwala, Chairman and Managing Director

So this will put some softness, this will put some pressure.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjunwala, Chairman and Managing Director

Of the needle coke pricing.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjunwala, Chairman and Managing Director

Because needle coke is only used by people like us, there is no second market for needle coke.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjunwala, Chairman and Managing Director

So at least in the next two, three years we don't see any problem in getting needle coke to the desired level.

Rahul Bhangadia, Analyst

Okay.

And we certainly feel that needle coke will be very soft, as far as the pricing is concerned.

Rahul Bhangadia, Analyst

Sir, that was on your supply side, I was actually -- my question was more related to the electrode supply market itself, the electrode production market itself is on the reasonable quality side with three players in the developed markets and two here, so we only have five player on the supply side of electrodes.

Ravi Jhunjunwala, Chairman and Managing Director

Yeah.

Rahul Bhangadia, Analyst

So, do you see some pricing, a reasonable pricing power coming into the electrode market? At the needle coke market may fluctuate a little but electrode market (Foreign Language) is the question?

Ravi Jhunjunwala, Chairman and Managing Director

See again, I mean, this scenario has existed for more than 25, 30 years.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

In fact, HEG was the last entrant of graphite electrode in the world way back in '76, '77.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

The number of players have not changed in the last 30, 35 years.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

So that situation or that power of pricing has always existed between these five, six players for last 30, 35 years. But basically pricing power only comes from the market, I mean it really depends upon how the steel business performs next year, what is the impact of this 90,000 tons of electrode capacity going out of the business.

Rahul Bhangadia, Analyst

Sir but I get your point sir. My question is, have we ever reached the situation as you just said where the demand supply seems to be in reasonable balance and most players are now expected to run at 90%, 95% rather than at 65%, 70%, or 75%?

Ravi Jhunjhunwala, Chairman and Managing Director

You see that, that's what I responded in response to one of the questions. I mean if you look at GrafTech, their capacity before this closure was about 250,000 tons.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

And I don't think in the last five, seven years, they ever operated more than 180,000, 185,000 tons.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So which is like 70%.

Rahul Bhangadia, Analyst

Correct.

Ravi Jhunjhunwala, Chairman and Managing Director

So with 60,000 tons going out of business or closure, their capacity itself is now down to 190.

Rahul Bhangadia, Analyst

Right, so they are almost at 95 now?

Ravi Jhunjhunwala, Chairman and Managing Director Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

And similarly SGL, the other large player, their capacity is about -- has been about 210 and they have again been in the range of about 180,000 tons.

Rahul Bhangadia, Analyst

Okay.

Ravi Jhunjhunwala, Chairman and Managing Director

They have closed another 30,000 tons in Canada.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So with this, their capacity of 180 and their last five year's production of about 175, 185 will virtually mean 100%.

Rahul Bhangadia, Analyst

Right.

Ravi Jhunjhunwala, Chairman and Managing Director

So to that extent, there should be some relief because once you are operating at 90%, 95%, then you tend to focus more on the prices than on volumes.

Rahul Bhangadia, Analyst

Sir have you in your experience of being in the industry ever seen such a situation where the big -- the developed guys are at 90%, 95%.

Ravi Jhunjhunwala, Chairman and Managing Director Rahul Bhangadia, Analyst

Against the current price of?

Ravi Jhunjhunwala, Chairman and Managing Director

Against the current price of at least 20%, 25% lower than that.

Rahul Bhangadia, Analyst

Okay. So would it be fair to say that if the scenario persists as it is looking right now, maybe two years down the line or three years down the line or over a period of two, three years we may likely go back to \$5,000 or \$5,500?

Ravi Jhunjhunwala, Chairman and Managing Director

See (inaudible) I can't venture two, three years ahead I mean, but it is not, it cannot be ruled out.

Rahul Bhangadia, Analyst

So some kind of pricing power cannot be ruled out is what I can take from this?

Ravi Jhunjhunwala, Chairman and Managing Director

\$5,000 was there about two years ago also. Even last year a part of the production was sold at 5,000 so 5,000 is a very justifiable number that you are asking, so \$5,000, yes, I mean at least next year, probably in the next two years or three years reaching \$5,000 should not be a big problem.

But I am talking about the fact that we have even sold at more than \$6,000 only four, five years ago.

Rahul Bhangadia, Analyst

Yeah, yeah sir, that I take. So basically we can expect \$5,000 and there could also be a pressure on the needle coke side as you mentioned on the incremental capacities.

Ravi Jhunjhunwala, Chairman and Managing Director

Yeah, needle coke pricing to our favor not to --

Rahul Bhangadia, Analyst

Yeah, yeah, yeah to your favor, yeah, yeah, to your favor.

To our favor, yeah.

Rahul Bhangadia, Analyst

Great sir, thank you for those clarifications, thank you so much.

Ravi Jhunjhunwala, Chairman and Managing Director

Thank you, thank you.

Operator

Thank you very much. That was the last question sir, would you like to add a few closing comments

Ravi Jhunjhunwala, Chairman and Managing Director

No nothing much, thank you friends for listening to our conference call and asking some very probing questions. I look forward to speaking to you in three months time and expect to speak to you with much better numbers and much better operations. Thank you.

Operator

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