# "HEG Limited Q2 FY16 Earnings Conference Call"

**November 10, 2015**

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**Moderator:** Good day, ladies and gentlemen and welcome to the Q2 FY16 Earnings Call for HEG Limited. As a remainder, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions after the presentation concludes at the end of today's presentation. 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. Thank you and over to you, sir.

**Ravi Jhunjhunwala:** Good afternoon to all of you and thank you for joining us for HEGs Q2 Conference Call. Firstly, I would like to share some latest developments on the global Steel Industry and its resulted impact on the Graphite Electrode Industry. As per the World Steel Association, the total world crude steel production for the period January-September 2015 declined by about 2.4% to 1.21 billion tonnes as compared to 1.24 billion tonnes in the same period in 2014. All the major areas like North America witnessed a declined whereas North America witnessed the largest decline of 6.8% it was followed by CIS 5.8% Asia by 2, South America by 1.4%, and EU by 0.3%. Even China which had been till recently accelerating the steel production has dropped its production by about 2.1%. Only the Middle East registered a moderate growth of 2.9% and Africa by 0.5%. The total World Steel production excluding China also declined by 2.7% over the same period. The steel capacity utilization currently is at a historical low and can be compared to 2008-2009 financial crisis period.

Now turning to the Graphite Industry, subsequently the Electrode Industry is passing through a challenging environment. The electric arc furnace segment of steel which is our main customer base continues to be severely impacted due to disproportionate fall in the prices of iron ore and coke, the two main raw materials to the blast furnace industry as compared to the steel scrap which is the main raw material to the EAF Steel Industry. China continues to export steel aggressively. The total Chinese exports in the first nine months of this year have been over 83 million tonnes with an annualized number over 110 million tonnes which would be about 17% higher with the last year's exports of 94 million tonnes. The Chinese exports has spread to over 200 countries resulting into closure and decline of steel production in many western part of the world as well as other parts of the world. It is believed that the World Steel Industry is plagued by over capacity of anywhere between 400 million tonnes to 600 million tones, a very large part of that being in China. The above factors combined are resulting in production drop in electric arc furnace segment more than the blast furnace steel leading to a sharp decline in electrode demand. Capacity utilization in the Graphite Electrode Industry has fallen to around 60% to 65% of the new capacities after the closure of four plants earlier this year. This obviously continues to put prices under pressure.

Recently announced results of some of the large players in this industry continue to dismal and exposing them to expedite their restructuring calls. The industry is likely to see some more capacity closures and reduction of capacities which should help in balancing the current demand supply imbalance. However, with the backdrop of these negatives there are also some positive signs over the last quarter which I would like to place before you.

Number one, significantly lower priced needle coke contracts during the current year are now helping us in improving our margins as we start exhausting our high priced coke from previous year. Two, power generation cost is stable with the availability of higher linkage coal in the country, thereby improving cost structures. Three, our Hydro Electric Plant commenced production at the end of last month. Its captive usage has added strength to the bottom-line. Fourth and the most important one is the operating parameters at the plant have further improved considerably and are close to benchmark levels in the industry anywhere in the world.

Now coming to company operations. We achieved the capacity utilization of around 60% in the quarter. We are continuously working on building our order book position which is slower than the previous year more prominently in the export market. Anti-Dumping Duties on imports of Chinese Electrode into India which was effective February 2015 have now started showing signs in drop of Chinese imports of Electrodes in the country in the last few months. This has resulted in shoring up our domestic sales and we expect a significant growth in the next couple of quarters in the domestic market.

As on date, the company has repaid 54 crores of our long-term debt out of our total of 89 crores which is due in this financial year. Subsequent to an upgrade in the company ratings, the limit of commercial papers has been increased from about 100 crores to 150 crores during the quarter. This would further help us in cost leveraging our working capital finances.

Now the outlook for the balance 2015. The IMF has revised the global GDP growth further downward by 0.2% to 3.1%. Advance economies led by U.S. and Canada are expect to perform weaker at 2% down from the last estimates of 2.1%. EU growth is expected to remain unchanged at 1.5%. There is a continued slowdown in emerging economies as well. Pricing of Electrodes is expected to remain under pressure for both Graphite Electrode as well as Needle Coke. All though we have been able to significantly enhance our market share in the Indian market, export volumes continue to remain under pressure. While we continue to face considerable industry challenges we have made significant progress in the quality of our products, freed cash from working capital elements and there is a continuous focus on management of variable and fixed costs. Given the positives that I narrated earlier - Anti-Dumping Duties on Chinese Electrodes, weakening rupee making imports more expensive, reduced needle coke and other domestic input prices and better plant operating parameters should help us to in sailing through these very challenging times. With these comments friends, I would now turn over to our CFO, Mr. Rustogi and I look forward to your questions later on. Thank you.

**Raju Rustogi:** Good afternoon friends. For the quarter ended September 2016, please forgive me for my voice today I have a bad throat. For the quarter ended September 2016. I would request, please help me.

**Manish Gulati:** Yes, I will speak on Mr. Rustogi's behalf. For the quarter ended September 2015 HEG recorded net operating income of Rs.240 crores as against Rs.249 crores in the immediately preceding quarter. EBITDA witnessed an increase from Rs.25.15 crores in Q1 FY16 to Rs.53.93 crores in Q2 FY16. EBITDA margin increased to 22% as compared to 10% in Q1 FY16. PAT also increased from the level of loss of Rs.10.55 crores in Q1 FY16 to a profit of Rs.14.66 crores in Q2 FY16.

Significantly improved EBITDA vis-à-vis last quarter is largely contributed by reduction in needle coke prices, improved efficiency level in the plant operations and rupee depreciation. Net sales in power segment were much higher than previous quarter as the hydro facility began generation during the quarter. Also margins improved further with improved usage of low cost linkage coal in this period.

Borrowing cost during the quarter is higher in the foreign currency denominated borrowings due to steep fall in rupee during August 2015 as a result of Chinese devaluation. Progressive increase in the issuance of commercial paper has not only reduced rupee borrowing cost during the quarter but has also provided additional option to optimize on cost, in this fast changing financial market. Company is trying to add volumes which at current level of margins would add strength to the Company's financial position.

Depreciation is higher mainly on account of identification of significant components with shorter useful like than the main equipment. This is a line with the provisions of Schedule II of the Company's Act 2013. The Company's strong balance sheet with low long-term debt to equity ratio and stable cash flows, positions us in a relatively comfortable position in seeing through these challenging times. Thank you.

**Manish Gulati:** Friends, now we will open up for questions and answer.

**Moderator:** Thank you very much, sir. Ladies and gentlemen, we will now begin the question and answer session. We have the first question from the line of Gurvinder Wasanfrom Principal Mutual Fund. Please go ahead.

**Gurvinder Wasan:** See basically I was getting confused between the number shown in the presentation which show the net operating income for the quarter two is 322 crores and when I see it in the format which is filed which NSE on our website is showing 240 crores so, what am I missing can you help me with that.

**Raju Rustogi:** The Q2 FY16 is 240 crores only. I think what you are reading is Q2 FY15 the last column so, 2014-2015.

**Gurvinder Wasan:** Fair enough, yes 240, okay I read in that way. And the other clarification I needed was on your financial cost which has been booked at 18 crores for the quarter.

**Raju Rustogi** See our working capital finances includes almost like 50% in foreign currency and 50% in rupee denominated borrowings. In line with As AS 16, in terms of booking the foreign currency fluctuation equivalent of interest with interest. Since the fluctuation in Q2 has been very-very high this period which was about two & two quarter rupees on 15th August and which continued till the quarter end. On the base price of Rs 64 to a dollar, it was almost like 3%-3.5% which got added to the interest cost.

**Gurvinder Wasan:** Okay. It has been I mean there is no line item for it, it is clubbed during the financial cost only.

**Raju Rustogi:** Yes.

**Gurvinder Wasan:** So despite our rating upgrade while your domestic cost of borrowing would have gone down and this was mainly because of rupee movement?

**Raju Rustogi:** Absolutely.

**Moderator:** Thank you. Next question is from the line of Dewang Sanghavi from ICICI Direct. Please go ahead.

**Dewang Sanghavi:** My question is regarding this EBITDA margin which we have clocked at 22%. What could be because of the lower inventory of needle coke and how it is sustainable going forward?

**Raju Rustogi:** See our EBITDA has always been in north of 16% historically. So what you are saying as 22 is because of number one the foreign currency fluctuation, which is about 3% and rest 3% is on account of our operational efficiencies we have really done very well in our plant operations. So our operating cost the plant has been low. So how much operate is going to sustain besides raw material the plant operation is going to sustain, foreign currency is something that we are not sure of.

**Dewang Sanghavi:** Okay. And what kind of utilization level you are guiding for FY16 and FY17?

**Raju Rustogi:** Capacity utilization has been 60% and we hope to be around this percentage, this is the industry average as well for 2015-2016 as we see the Graphite Electrode industry worldwide.

**Dewang Sanghavi:** And more in the macro perspective are we seeing any kind of increment in EF route of steel production within Europe and U.S. or has this strength been?

**Ravi Jhunjhunwala:** No, on the contrarily it is actuallyelectric arc furnace production which is under pressure because iron ore has fallen much more than scrap and which has made the steel made through last one as route more competitive compared to electric arc furnace made with steel. So let us say if the world steel is fallen by 2.5% actually electric arc furnace steel production has fallen by more than 5% and China continues to export their steel everywhere which is causing pressure on the other electric arc furnace industry around the world.

**Dewang Sanghavi:** And needle coke prices we have booked for FY16 at 20%-25% lower prices or what could be the number could be more broad number this is, no exact number.

**Ravi Jhunjhunwala:** About 38% to 40% lower than last year.

**Dewang Sanghavi:** About 38% to 40% last year.

**Moderator:** Thank you. Next question is from the line of Pritesh Vora from Incedo. Please go ahead.

**Pritesh Vora:** I have just one question on this, how do you see the steel industry as a whole transforming in next one year or two years what is your call?

**Manish Gulati:** See steel industry being a core sector industry is so closely linked with the general economic environment and you can look at the IMF forecast which have been coming down by every time they adjusted by 0.2% they started with 3.7 today they said that 2015 would probably go by 3.1% and China since it makes 50% of all the steel made in the world is a big sector in this steel industry. So the Chinese consumption of steel has started to slow down, they have been growing rapidly and now they have started to slow down in their consumption so, their industry which they had has started exporting outside China which is affecting the rest of the world. So going forward at least for either more sales or economic situation improves in Europe, in Russia, in Middle East and you are aware whether oil prices have gone. So till the construction activity resumes the steel industry would be in pressure for another year because we have seen short range outlook publish by World Steel Association and it says that steel demand would be up by only 0.7% in 2016. So it seems that 2016 would also be just like this not better.

**Pritesh Vora:** Right. And as you mentioned the blast furnace route and EF route so, do you see what kind of dynamics you see in that is that the blast furnace steel is much cheaper than EF route or…

**Manish Gulati:** Yes, it depends upon the input prices, you see the way either know which was $135 in January 2014 a year and half back is $45 today. And the scrap prices which was at then that point in time $285 and just $210 or $220. So see the fall in the price of iron ore has actually made blast furnace route more competitive so electric arc furnace industry is finding it tough to corporate it. Till scrap adjust and come below $180electric arc furnace industry will be under pressure.

**Pritesh Vora:** Right. And sir, as far as your business is concern do you have some kind of visibility for or is it just on spot basis how do you sell your Graphite Electrodes?

**Manish Gulati:** See normally it use to be contractual business till about two years - three years back. But now since the visibility for our customer is also low so people avoid taking big positions because they themselves do not know what their production is going to be. So now the trend is more towards spilling let us say half year or maybe three months. Most of the companies are now finding it difficult to take calls and get into contracts on annual basis. So the percentage is more dented to more towards spot buying.

**Pritesh Vora:** Right. And spot buying means the three month contract basically?

**Manish Gulati:** Yes, three months to six months is more...

**Pritesh Vora:** The do they tell you that how much quantity they have? How does the price determined, how do you determine your price of the product?

**Manish Gulati:** See prices are determined by the market and of course at the same time you have to look at the cost. Till the wholeindustry works at 60% everybody is going to try to increase their volumes as long as it covers their variable cost. So which is what actually it is a demand supply question and unfortunately right now we are in a situation where there is excess supply and less demand despite that there have been closures in the industry.

**Pritesh Vora:** Right. No my question was particularly when they enter a contract with you for three months or six months or one year. So suppose they have enter a contract will be one year is the price fixed to one year it has some variability?

**Manish Gulati:** No, when they enter into a contract they would honor that price otherwise they have lack of visibility then they would just float a six month enquiry and just try to work with if they think that prices will drop in six months then they take a six months positions.

**Moderator:** Thank you. Next quarter is from the line of Pritesh Vora from Incedo. Please go ahead.

**Pritesh Vora:** Yes, I have one more question how does raw material prices decided in your case?

**Ravi Jhunjhunwala:** Normally the major cost of producing Electrode something in the region of 40%-45% is determined and an annual basis but again as Manish explained because of the current market situation things are changing pretty fast. So depending upon what is happening in the steel industry consequently having an effect on the Electrode industry obviously down the line it also as an impact on what happens to the needle coke industry. Because the needle coke industry is totally dependent on Electrode industry and Electrode industry is directly linked to the electric arc furnace industry. So although the decision has taken at the beginning of the year for the whole year but obviously the supplier in the supplying industry which is needle coke they are also very much aware of what is happening to the steel industry and the Electrode industry and they also react from time to time. So the price adjustments do take place in between also.

**Pritesh Vora:** And sir I have a question on this your turnover has decreased but your EBITDA has increased as compared to last quarter so, what is the reason for that

**Raju Rustogi:** See the turnover has reduced by an amount of Rs.9 crores. In Graphite Electrode industry if I say it not even 150 tonnes. See our product is something like $(+3,000) per tonne of material. So if you calculate tonnage it is hardly 150 tonnes to 200 tonnes. So in terms of turnover the reduction is not substantial. Why EBITDA is improved is as we said in the previous conference call we were carrying an inventory pertaining to the raw material contracted in 2014-2015 which was a much higher priced raw material and our industry the manufacturing cycle is minimum two months and maximum six months. So if we have inserted material in January to March it gets cleaned-up from the system by August only. So that is the way the change happen.

**Pritesh Vora:** So you have basically raw material as the costly inventory has gone as compared to first quarter result basically?

**Raju Rustogi:** Yes.

**Moderator:** Thank you.

**Raju Rustogi:** I it is festival time and people want to leave early so may not be having many questions. I think I would like to thank the participants and for bearing with us at least with me in terms of my bad voice. Thanks in any case for being always with us, working with us, analyzing us, and supporting us. Thank you so much.

**Moderator:** Thank you very much members of the management. Ladies and gentlemen, on behalf of HEG, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.