"Elgi Equipments Ltd. 2Q FY19 Results Conference Call"

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MANAGEMENT: **MR. JAIRAM VARADARAJ - MANAGING DIRECTOR, ELGI EQUIPMENTS LTD.**

MODERATOR: **MR. KAMLESH KOTAK – ASIAN MARKET SECURITIES**

Moderator: Ladies and gentlemen, good day and welcome to the Elgi Equipments Ltd. 2Q FY19 Results Conference Call hosted by Asian Market Securities Limited. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference, please signal an operator by pressing "*" then "0" on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Kamlesh Kotak from Asian Market Securities. Thank you and over to you, sir!

Kamlesh Kotak: Thanks Melissa. Good evening, everyone. On behalf of Asian Markets, we welcome you all to the 2Q FY20 Earnings Conference Call of Elgi Equipment's Ltd. We have with us today Mr. Jairam Varadaraj – Managing Director, representing the company. I request Mr. Jairam to take us through an overview of the quarterly results and then we shall begin the Q&A session. Over to you, sir! Thank you.

Jairam Varadaraj: Thank you Kamlesh. Good evening, ladies and gentlemen. Thank you for taking the time of to live with us.

I will take you through our consolidated numbers for the current quarter in comparison to the second quarter of the previous year. Our sales, we compared to the previous year's Q2 we are lower to the extent of about 1%-1.5% at the consolidated level. Our contribution margin has been slightly better at material cost level. Our EBITDA which should have been if we had hit the same revenue levels as last year we should have had contribution of EBITDA level of about 482. Our actual EBITDA is only 338. So, I am going to give you an explanation for close to 140 million drop in EBITDA. The biggest contributor has been increased in people cost, all other costs have been at or lower than the previous year. If I take the people cost increase there are 2 aspects to it. There is a regular growth for our business as usual, elements of people and then there is strategic thing like I explained to you in the last quarterly analyst meet call.

We are investing in Europe and we continue to increase our investment in talent in Europe and that is a big aspect of our investment and impact in this quarter's performance. I am not overly worried about it because this is something that we consciously said that we are going to do. And it is in line with what we planned to invest as far as talent is concerned. So, close to 53 million odd of our 140 million, a drop in EBITDA can be attributed to strategic elements both in Europe and in the US.

In our regular cost, we have got about close to 70 million and out of that 70 million the biggest element is the people cost in Pulford and that is not because people cost has gone up. Last year we had only 2 months of cost because of the acquisition and this year, I mean last year this year we have got the full 3 months of the impact coming in. So, this is just a matter of getting normalized over the years. We have invested, we have added people in Patton's as part of building our business and compared to last year Patton's is beginning to grow this year and we are quite happy with the traction it is gaining in the market. And I am very confident that things are going to look up for Patton's and the US business.

So, this is a summary of our performance in the current quarter. Sales have been a challenge and I will talk a little bit about that. At a consolidated level India has dropped by about 2% whereas the rest of the world has grown by about 6% to 7%. The markets have been very challenging in India across all verticals. They have been specific verticals where we have been running strategic initiatives and those have performed really well for us. So, while the business as usual performance in India has been not so good far from our budgeted plan of growth, strategic initiatives have far exceeded our targeted levels of growth. As far as the rest of the world is concerned, I will start again from Australia. As a consolidated level, Elgi Australia Pulford all the entities put together has been relatively flat compared to last year. But there was a slowdown in the Australian market for the last 2 to 3 months but things are beginning to look up. We believe that there will be a correction in the balance of the 6 months of the current financial year. South East Asia was very muted, we have had some growth in specific markets but it is not been to our budget. But we think the balance of the 6 months would be slightly better than the first 6 months of this year.

Jumping over India into the Middle East:

Our initiative to go direct in UAE has yielded good results. We have gained some significant share in the market and this is reflected in the fact that our sales have been far ahead of last year as well as far ahead of budget.

Moving on to Europe, our industrial performance through Rotair in Italy has grown and it is continuing to move from strength to strength. I will come back and talk about the portable business in the context of what we did in the US.

Moving on to the US:

Like I said the Patton's business has grown and I believe that we are back on a growth trajectory and we are expecting to see good results from Patton's in the future. USA direct which is non-Patton's sales through other distributors has been flat. But there are some we lost some big accounts by virtue of acquisition of some of our distributors by competitors. But we have some initiatives plan for the balance of the 6 months. We expect that we will be back on a growth path for the balance 6 months.

In this financial year, like I explained in the last call we have taken over the distribution business of Rotair's master distributor for portable compressors in the US. So, our numbers today reflect the sales directly done by the US subsidiary of portables made by Rotair. The sales performance of those portables has been relatively flat. It is not grown. We are going through some the transition phase between the distributor and our own direct operation. We have built the team and place and we still continuing to add to the team that is going to eventually run the business. At the moment, our earlier distributor is helping us through a management contract to run the business but eventually we will take over and run the business ourselves and towards that end we are preparing. So, as a consequence of muted portable sale in the US Rotair's portable sales correspondingly has been also muted. And there have been some other impacts which I will talk about in the cash flow.

So, if I step back and look at the future through the size of the current performance, all indications that we are getting about the Indian market is we do not see any big change happening in the next at least couple of years. It does not mean that we are going to drop but I do not think the kind of expectation of growth is going to happen. We have gone back to the drawing board we are looking at different strategic initiatives. It may take us a few months but I am confident that we will come back with very strong initiatives in the market to compensate for the overall dullness in the market in India.

As far as our expectation the rest of the strategic markets we are not changing our opinion or expectation we continue to remain. The quarter-to-quarter variations that we are seeing are nothing more than just variations in as a blurb rather than any indication of trends. So, we remain optimistic. The fact that we have been able to improve our contribution margin in spite of the markets being so competitive is a fact that we are beginning to gain traction, we are not giving things away in the marketplace.

So, I still remain confident about continuing to perform well, we need to adjust ourselves to the circumstances of the market in India. We did not expect compare to the call in the first quarter when I said things seem to be slowing down, I did not expect things to drop as significantly and as sharply as they have. But this is the reality and we will respond to this reality in the appropriate manner and we are quite confident that we will. We have already initiated multiple avenues for bringing cost down reigning in cost appropriately without compromising on our long-term commitment to our aspiration. This has already started and we are hoping in the next couple of months we will start seeing the results of these initiatives showing up in our financial statements.

During this quarter by virtue of one are taking over of the portable's distributor in the US we also acquired a lot of inventory and that has put a dent on our working capital which we had to fund. And then significant drop in the sales in India has also saddled us with a little bit of raw material that we will consume over the next when we readjust, we recalibrate our production to the market reality. So, as a consequence of all the working capital increases that has happened in the last 3 months, our net debt has gone up by about 100 crores. So, in this, but we are very confident in the next 3 to 4 months we will be able to bring that inventory back to reasonable levels. So, this is just an aberration.

So, the debt in Q1, I do not remember the exact number but compared to March 2019 the debt position has gone up by 100 crores but compared to Q1 of this year I will give you the number the debt positioned has gone up by about in the 50 crores, right. So, it is even increased between the first quarter and the second quarter.

So, this is a summary of our performance, I will be happy to answer any questions that you may have.

Moderator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. We have the first question from the line of Manish Goyal from Enam Holdings. Please go ahead.

Manish Goyal: Just if you can elaborate little bit more on like in last 6 months, how like things have changed quite badly in terms of your outlook for India market. If you can elaborate a little bit more like what are the change on the ground as per what your perception was on at the beginning of the year, sir?

Jairam Varadaraj: If you wind back to what we said in the end of the first quarter we were beginning to see enquiries continuing to be very healthy and they were continuing to grow at a pace that was consistent with our budgeted growth**.** But I had said that there was a little stickiness in terms of finalizing people who are delaying things. That was the status as of the end of the first quarter. But as the second quarter rolled in not only did the conversion was sticky but also the general levels of enquiries have also dropped quite significantly. So, it is a combination of both I think people there was a certain tentativeness I would think in the first quarter which made them kind of wait but I think that tentativeness converted into getting to the other side of the fence and postponing many of their investment decision. So, this phenomenon we have seen across all verticals of our business and even our after-market where is also another indicator of general industrial activity. We see a significant slowdown because many of our customers are not have reduced their shift which means maintenance requirements have come down and therefore the after-market requirements have come down as well. Though from, if you look at the first quarter we did well compared to our aspiration and to our budget in previous year we did well in after-market and then the slide has been pretty significant in the second quarter. So, all this is kind of indicative of the fact, general capacity building activity has substantially slowdown, right. Now having said that we have been running certain initiatives in specific products like our oil free, where we have seen a solid growth compared to even the previous year. I do not want to get into specific numbers but we are very pleased with the way that we have grown that business. It is also indicative of the fact that we can possibly create those kind of niche initiatives in the other current markets that we are operating in as well. So, there is some possibility that we can work out for the balance of the year.

Manish Goyal: And on the rest of the world if you can like you did mention about specific markets. So, ideally for the rest of the world you expect the single-digit growth or double-digit growth? How do you see that?

Jairam Varadaraj: We started of this year expecting double-digit growth in the rest of the year, rest of the markets. I would say Australia will be close to double-digit maybe not a big double-digit but it is possible that they will have at least a high single-digit growth. South East Asia would again be a single-digit growth maybe a high single-digit growth. Our Middle East will be a significant double-digit growth. Europe, our business in Italy for industrials is got double-digit growth as of now and I expect that will continue. As we build our initiative, as we build the team and roll out our initiative in the rest of the year in Europe it has to be double-digit growth because the starting point is zero, right. So, there will be a significant growth. As far as the US is concerned, I expect

Patton's to have a high single or a double-digit, low double-digit growth for this year. As far as Elgi direct through other distributors, I would say other than an initiative that we are working on, I would say that we would have a high single-digit growth. So, that will be the summary across markets.

Manish Goyal: And also, a bit confusion on what you mentioned about the distributorship what we have taken over Rotair**.** So, basically there was a separate distributor of Rotair in US which now we have taken over, is that right?

Jairam Varadaraj: No, Manish, I explained this in the last call. There was a master distributor for Rotair who was selling exclusively the products, Rotair's portable products in the US. We have taken over that business we did not buy the distributor. We have just taken over the distribution business in our subsidiary in the US. And the distributor the management team of the erstwhile distributor is helping us run the business till for during a transit period till we build our own capability to run the business, right. So, right from May of this year the revenue and profit from the business is accruing to Elgi. Of course, we are paying them a fee, a management fee for helping us run the business for a limited period of time.

Manish Goyal: And on the cost rationalization, what kind of improvement or cost cutting can we see as you said it will be visible in couple of quarters. So, would you like to put some number or …

Jairam Varadaraj: I could not like to put a number yet, Manish but in another month, we should be able to have a reasonably good idea what will be those numbers.

Manish Goyal: And last question in standalone the other income has gone up. So, is it that this quarter we have received dividend from the subsidiary?

Jairam Varadaraj: Right, it is dividend from ATS.

Manish Goyal: How much would it be?

Jairam Varadaraj: It is 7 crores.

Moderator: Thank you. We have the next question is from the line of Renjith Sivaram from ICICI Securities. Please go ahead.

Renjith Sivaram: Just wanted to know like, we are hearing lot of slowdown in terms of private sector and the liquidity prices. So, what is your view? How do you see this and is there any impact to our growth because of this and when do you, what are the signs we should look at for the uptick or what and Elgi has this tax rationalization or reduction improved in at least people converting enquiries into orders things like that?

Jairam Varadaraj: I will try to answer as best as I have understood your question. Our business is capital goods which is closely link to capacity creation in the economy. A big part of our revenue is towards actually building the capacity of a customer's plant**.** Now, for us the main indicator for capacity build up is the utilization of the current facility of the customer. Now that will show up first in our after-market business. Now if our after-market business starts improving it means then all our customers production capacities are going up and then therefore, they will be soon coming in for additional capacities for compressors. So, that is a clear indicative internally for us. There are of course, external indicators of capital formation in the economy investments by government on major projects. But how they will trickle-down into compressor demand and when they will trickle-down to compressor demand is very difficult for us to predict. So, there are macro level stuff that we cannot use to predict precisely but micro within our own business for us is after-market.

Renjith Sivaram: So, what are the signals that you are seeing? Are things improving or is it still in the same status quo, what is your reading of the market?

Jairam Varadaraj: So, if I have to interpret the market through the lens of our after-market business it is pretty bad because our after-market business is not grown, and it is languishing below last year's levels. And the trend over the last 6 months, clearly indicate that customers are using our equipment less which really mean that their production is also come down. So, unless we start seeing an uptick in that we will not have an optimistic view of the market.

Renjith Sivaram: And again, taking to looking at Europe and Australia, so what is the outlook you are forming up and is Brexit anything to worry about for us? Or is it just a normal disruption?

Jairam Varadaraj: In markets like Europe where we are nothing, our share is so small. The headroom for growth is so high. Turbulences at the top of the ocean should not make any difference at the floor of the ocean.

Renjith Sivaram: So, you do not see any risk because of these overall challenges into our growth? Is that interpretation, right?

Jairam Varadaraj: Yes, because if you look at it the Italian economy has had the most challenging period in the last year and half where as we have grown in double-digit in that market.

Renjith Sivaram: Sir, lastly just water well, how has the water well market been worked at? Better than expectation or below expectation?

Jairam Varadaraj: It is far below expectation. I think, we can reasonably say it has been far below expectation across the board for all players.

Renjith Sivaram: So, what should be read like we should kind of one-year tough period or what do you, when can we see this reversing the overall market?

Jairam Varadaraj: Well, if I had a magic glass through which I can look and predict then it will be wonderful. I will be making money somewhere else. But at the moment when we look at all the indications, talking to customers they are not seeing any timeframe because it is you cannot say it is now post Diwali this is going to happen or post this, this is going to happen. There is no post anything. So, there is a newly elected government, so you cannot say post elections that something is going to happen. So, Diwali is come and go, so I do not think there is anything indicative of saying post this. I think fundamentally the economy I believe is growing through a cycle. It is taking a pause on consumption, income and ability to spend has to increase and then there will be back into a consumption cycle. So, this is my kind of interpretation of the whole thing. So, it is very difficult to say at by which time. So, we are saying maybe couple of years, couple of years of subdued maybe 4%-5% growth of the economy and then maybe it starts climbing again.

Moderator: Thank you. We have the next question from the line of Manish Goel from Enam Holdings. Please go ahead.

Manish Goyal: Just to understand you did allude on the improvement in the gross margins. So, do you see this, just wanted to know what is driving that improvement? And do you see this sustaining?

Jairam Varadaraj: I think, what is driving it is one is this, softening of commodity prices in the last year, year and a half. So, to the extent that expected price increases that we had, that we anticipated or projected did not happen. And our international sales as a percentage is higher in the current period, which is our price realizations are far better in those markets. So, that is the secondary factor. Though will we be able to sustain it? Yes, we should be able to. And Manish, you need to remember that we have achieved this contribution with a lower contribution of after-market which is a more profitable business.

Manish Goyal: Yes, in fact that is what …

Jairam Varadaraj: So, if when the after-market kicks in and the economy grows our margins should definitely improve.

Manish Goyal: But what kind of decline have you seen in after-market in terms of after-markets?

Jairam Varadaraj: I do not want to talk about specific percentages, Manish but it is lower than last year. It was very good in the first quarter but in the second quarter it is lower than last year. So, yes …

Manish Goyal: And on the CAPEX side, on the motor facility how is it progressing and any other CAPEX plans?

Jairam Varadaraj: Well, the motor plant CAPEX is mostly done. There is a few balancing equipment but it is still within the overall number of 18 crores that I had mentioned earlier.

Manish Goyal: 18 crores?

Jairam Varadaraj: 18. So, that we have already started trial production of motors, we have putting them into the field. They have couple of equipment that has been delayed by vendor. We have had issues of delays we are trying to get that result. Once that is in then we will should get into regular production very soon.

Manish Goyal: And overall CAPEX, sir, for current year?

Jairam Varadaraj: Overall CAPEX, I think bulk of it is going to be CAPEX that has committed last year that we need to complete. We will probably be spending about 20 crores, besides the motor plant. These are all machine tools that have been bought in advanced paid for last year. In terms of, we are really not doing anything that is we are not initiating any big CAPEX this year.

Manish Goyal: And on the debt side, by year end what is your expectation? Should we back to the previous year level? So, the increment 100 crores what we have seen in last 6 months should we be able to kind of reduce it?

Jairam Varadaraj: If I look at the biggest contributor for the increased debt is inventory. It is not some of working capital point of view it is inventory. Of that is the biggest, one of the biggest chunks is notable inventory that we have picked up from distributor. That is not going to be completely brought down to zero levels in the next 6 months. So, I expect maybe half of that inventory getting utilized over in next 6 months. India, India inventory we are quite confident that we will bring that under control it is just a one planning cycle that we need to exercise control over and we will start seeing the results. So, out of the 100 crores additional I would, my estimate is half of it can be recovered very conservatively half of it can be recovered in the balance period.

Manish Goyal: And the last question on water well you mentioned that market has been bad. But what probably we see is on the from the coming industrial numbers the compressor sales have been quiet, compressor sales to whatever has been quite good in Q1 and Q2 as well. So, just wondering that have we lost market share or?

Jairam Varadaraj: Well, Manish we have a lot of stock of engines. So, you should ask the competitors what is their stock of engine.

Moderator: Thank you.

Kamlesh Kotak: Kamlesh here. Sir, can you just share some more insights about how the BCG marketing initiative programs progressing? Sir, any need to be tweaking that as well and how has been the results thus far?

Jairam Varadaraj: As far as that project is concerned, it has been a resounding success for us, Kamlesh. We had originally planned that the ROI on that project was about 2 years and we have more than adequately recovered that investment. Now what we are doing is we are taking it to the next level through our own internal initiatives and those are the special kinds of initiatives that we are working internally.

Kamlesh Kotak: And how has been the expense in the global market we were supposed to launch Phase II of that?

Jairam Varadaraj: No, we have done it in the US. It is not in the global market.

Kamlesh Kotak: Yes, US.

Jairam Varadaraj: So, the fact that we are beginning to see traction at Patton's is a result of that initiative. And we waiting to see there has been a bit of a delay in seeing the results in Elgi Direct which means the other than Patton's territory, but we are quite confident it will come in. Like I said we lost a few big accounts because they got acquired by competitors.

Kamlesh Kotak: And any major cost of that still need to be amortized or it has been already being largely funded?

Jairam Varadaraj: We have still some cost to be incurred this up to March of about 5 crores.

Kamlesh Kotak: Secondly sir, coming to the Indian markets, you highlighted across the segments the market was dull. Any specific color you can put up to say infra, steel, cement, auto or maybe on the consumer industry like pharma, chemical, FMCG.

Jairam Varadaraj: I think cement has been strong, it has done well. The chemical process specifically in chemicals it has done well. Auto has been down, textiles have been down, general engineering has been down. Pharmaceuticals has done well for us because of our specific initiatives that we are earning for oil free machines. But overall, I would say this is the breakup of verticals.

Kamlesh Kotak: And sir, anything about steel and railways?

Jairam Varadaraj: Railways has been business as usual. It is a function of what is the allocation of the budget by the government and that is kind of just steadily ploughed along, I would not say anything spectacular about railways. It is just there.

Kamlesh Kotak: And steel side?

Jairam Varadaraj: We do not see any much of activity in steel at least not from our side.

Kamlesh Kotak: And sir, anything in terms of the other markets. So, I think we are not touch on Brazilian and another markets. So, how the business has been there?

Jairam Varadaraj: Brazil has grown compared to previous year. But it is still very small. Our biggest challenge in Brazil is to collect our old outstanding. Our entire focus is on doing that. But it is grown and it has done better than last year.

Kamlesh Kotak: Melissa, any further questions?

Moderator: We have the next question from the line of Amit Anwani from ICICI Direct. Please go ahead.

Amit Anwani: Could you share the breakup of rest of the world and India for this quarter and Y-o-Y? And if you could elaborate more on the growth outlook for the whole year on a consolidated basis and any color on the margins for this year, FY20?

Jairam Varadaraj: So, for Q2, our rest of the world business was about 45% of the total India. I expected that the balance of the year will be the same with probably the rest of the world contributing more than India. As far as the margins at gross profit level we will, we are confident that we will continue to maintain it there is no problem. In terms of revenues for the rest of the 2 quarters I think it is going to be at the current level. I do not see it being significantly better than the current.

Amit Anwani: You mean to say at the level of Y-o-Y or the H1?

Jairam Varadaraj: Current level of Q2.

Moderator: Thank you. Mr. Kotak, do you have any more questions from your end?

Kamlesh Kotak: Jairam, just one thing, are we through with the manpower cost, you said new initiatives the strategic one and all that. So, should we go by this as a run rate or how it will be normalized the employee cost?

Jairam Varadaraj: No, I explained to you we are going to increase our cost in Europe. Rest of the world will be in a steady state basis. Now our estimate of Europe, so we have estimated over the next year and a half we will be investing close to about €10 million. So, that will be close to about 80 crores but we will also begin to see some revenues coming in as part of that. So, the manpower cost in Europe is going to continue to be increase still we reach that level.

Kamlesh Kotak: And sir, looking at the overall state of the things do you see our 3 years target what we had made. So, is there any need to revoke the same?

Jairam Varadaraj: No, we are going to stay focussed on this. We will, of course take a lot of short-term measures to strengthen our position wherever needs to be done. We cannot lose sight of the long-term focus. The fact that we have built this international business needs to be sustained. It needs to be nurtured. We have also learned how to engage and gets stronger in India. We will continue to use that learning to get deeper into Indian market. So, I would not change the formula in any significant way. I will stay the course while at the same time strengthen the company's short-term stamina to stay the course. That is really the recipe. I do not think we should pretend that things are so bad. They are not they are just we are going through some turbulent time. So, we just need to get stronger. Though even if you look at Europe today our current number already is people cost are already pegged into the tune of 240 almost to the extent of €3 million. So, when I am saying from €3 million, we are going to go to €6 million. It is not a big change from what it is in terms what it can bring in, right. And if we go by the experience or what we had in Italy which is still growing as we can replicate that in the chosen markets in Europe, it is exceedingly doable. India has grown and we would have all these adventures would be looking so bad, Kamlesh. Yes.

Kamlesh Kotak: Melissa, any further questions.

Moderator: Sir, no participants in queue as of now.

Kamlesh Kotak: So, sir with that we conclude the call. Special thanks to Mr. Jairam and his team for providing us the insights about company's business plan and financial performance. With that we conclude the call. Sir, any closing remarks you want to make?

Jairam Varadaraj: Nothing special, Kamlesh. I think the thing is I know it is disappointing for everyone but I would say that considering the numbers that I have seen of other companies going so badly, a big part of our cost today is because of initiatives that we are driving to grow our business internationally, I think we need to stay the course and make that happen.

Kamlesh Kotak: So, with that we conclude the call. Thank you everyone for joining by and have a great day. Thank you.

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