



“Varroc Engineering Limited Q1 FY 2021 Results Conference Call”

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Moderator:

Ladies and gentlemen, good day. And welcome to the Varroc Engineering Limited Q1 FY '21 Results Conference Call. As a reminder, all participant lines will be in a listen-only mode. And there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the call, please signal an operator by pressing “*” then “0” on your touchtone phone. Please note that this conference is being recorded.

Varroc Engineering Limited's management is being represented by Mr. Tarang Jain – Managing Director, along with Stephane Védie – President and CEO, VLS business; T.R. Srinivasan – Group CFO; and Nitin Kalani – Associate VP Finance and Head Investor Relations.

I now hand the conference over to Mr. Tarang Jain. Thank you and over to you, sir.

Tarang Jain:

Thank you. Good evening, everyone. I am Tarang Jain here, and I would like to thank you for joining the Q1 FY '21 earnings call of Varroc Engineering Limited.

As you are well aware, the last quarter Q1 was a challenging one due to the rapid spread of the coronavirus and the consequent decision by the governments in various countries to impose strict lockdown measures which severely disrupted economic activity. Our plants across India and in various countries across the world were closed for the entire April and most of May 2020. Production resumed in a small way towards the later part of May, and we have been gradually ramping up volumes over the last three months though there have been challenges relating to availability of raw material, labour, etc., along with localized lockdown measures.

As is required of any prudent business, we initiated a number of steps to mitigate the impact of the COVID-19 on the business. We have also taken steps to reduce the fixed cost base through various measures, resulting in savings of about 20% overall. At the time of the Q4 call, we announced that we will be reducing our recurring SG&A cost savings by almost 25% and product development spend reduction of more than 15%. I would like to update you that we have implemented these savings in Q1 FY '21. The full benefits of these changes are likely to be seen in the second half of FY '21. We also prioritized securing and preserving liquidity till the operations are fully stabilized and the visibility on business prospects has improved. These measures helped us weather the storm and navigate our way through the crisis and emerge stronger with a lower cost base and more efficient operations.

I am glad to inform you that we are now operating at almost 80% of the pre-COVID volume levels. The demand indications we have been receiving from the OEMs for the near future also had been encouraging. Though the sustainability of the demand remains to be seen, our profitability as well as cash flow have turned positive in the month of July 2020. And we hope to build on this over the rest of the year to deliver a strong performance and lay a strong foundation for the next year.

Apart from cost optimization, we have reduced our CAPEX spend for the financial year to about half of our average annual CAPEX spend in the last three years, during which time we have built four new plants, acquired a company in Turkey and invested in upgrading our Czech facilities. We are now coming to the end of our investment cycle. Once we are able to fully utilize the capacities created in the last three years, we should be able to see a significant improvement in our profitability and the cash flow matrix.

I would also like to highlight that during FY '21, after taking into consideration the COVID-19 related disruptions, we expect our new facilities to start contributing meaningfully to both top-line and the bottom-line and stop being a drag on profitability, as we ramp up volumes in the second half.

Our net debt increased during the quarter due to disruptions in working capital cycle, continuing fixed costs, CAPEX payments and adverse currency movement. The cash drawn down in March 2020 helped us in meeting the liquidity requirements during the quarter. As operations stabilized and the working capital cycle resumes, we have started seeing a reduction in debt levels. Our target is to bring down the net debt by the end of the year to the same level as was in March 2020.

With this, we are happy to take your questions now. Thank you.

Moderator: We will now begin the question and answer session. First question is from the line of Basudeb Banerjee from Ambit Capital. Please go ahead.

Basudeb Banerjee: Your note schedule 5 had some Rs. 94 crores of contingent liabilities and provisions related matters returned supposedly for VLS, if you can clarify on that.

T.R. Srinivasan: Yes, I think this about anything qualification the auditors' opinion, this was related to warranty claim received from one of our customers for the VLS business. And as explained in the note, we think this claim is very highly exaggerated and our liability under the contract is very limited. And in fact, we have actually settled claims for a fairly good amount in the last couple of years. So I think the incremental liability we feel is quite limited and we have made a provision for that towards that in Q1. But since the amount of claim is fairly large, and outcome of the issue is uncertain at the moment, so auditors have given a qualified opinion in that regard. Right now, we are in active negotiations with the customer to reach to a settlement and we expect that to happen fairly soon. And the initial indication is that we should be able to settle for a much lower amount. So that's where it's at the moment.

Basudeb Banerjee: Does that rotate through P&L this quarter?

- T.R. Srinivasan:** Yes, we have made a provision of, let's say, about 20% of the claim amount, and that provision in the P&L. And the settlement we expect will be around that amount, maybe plus or minus, we don't expect a significant additional liability on top of the provision we already made.
- Basudeb Banerjee:** Because I remember, you are focusing on rejections and waste and quality improvement of VLS plants, so how to look at the warranty claims down the line why did it arrives at all at such a quantum?
- Tarang Jain:** I think that maybe Stephane, you can answer that question.
- Stephane Védie:** Yes. So I think if you speak about this specific warranty issue, this is a problem that dates back from 2016. So this is absolutely not in line with the kind of performance or the kind of level that we are experiencing right now with our customers. We see a good trend on our warranty, there is a reduction right now. And then we continue to receive recognition from our customers. So this last month we received two awards from GM, General Motors, one from our Mexico facility, one from our Pune, India facility. Few weeks ago, we received the Q1 Gold Award from Ford with one of our major customers for the performance of our facility in Mexico. So we continue to really show a good trend in terms of quality and good improvement in warranty.
- Basudeb Banerjee:** Sure. So these are regarding legacy productions of last 12, 18 months related as such?
- Stephane Védie:** Absolutely.
- Basudeb Banerjee:** Sure. That's good. Next thing, sir, as this is a very technology intensive segment where halogens to LEDs to numerous technologies coming up, so for the cash flow or margin management how to look at the 15% cut in R&D expenses as a sustainable tool? Don't you think it will hurt your product development as such?
- Tarang Jain:** Not really. I think, see, this is a technology product, it's a proprietary item, it's a jewellery of a car. And obviously very important for every customer. Having said that, yes, there is an R&D expenditure here and today it's somewhere between 5% and 6% is something where we are trending as an engineering cost. That's something which is quite normal in a business. This of course, covers all the new innovations, and also the regular developments we do on the programs which we win. But I don't think, I think the way the pricing is done, I think there are not so many players also in the market who are into the lighting business, I am talking about people who have this level of technology, there may not be more than seven or eight at the max. So the issue today, I mean, let's say, we are not probably achieving a level of profitability. It has nothing to do with the R&D, you know, in R&D as I mentioned, we have already reduced the cost by 15% further in this year. The issue today for us, where it has been the most challenging for us has been our investment which we have embarked on two years ago on a EUR 225 million investment, out of which we have already covered EUR 160 million

in the last financial year end. And the balance will probably happen in the next two to three years. This major investment and the under-utilization of this investment is what is causing issues at present. And also the market, as you know, has been a little bit subdued since October 2018, which we see now probably returning to certain levels going forward. Starting from September onwards we see a good level of recovery and sales and utilization of not only our old facilities, but also of the new facilities which we have set up. So, having said that, I think once that happens, you will see a clear kind of good level of profitability being generated in our VLS business.

Basudeb Banerjee:

So, sir, will it be right to look at, because Q1 results are inconsequential, so as you were saying you are already at 80% of pre-COVID level production. So, one can understand Q2 revenue, if one were to read what you are saying, will it be right to look at other expenses' absolute number, say, what was in Q3 or Q4, it should be flat 25%, lower than that level, irrespective of revenue increasing? Should that be the way to look at?

Tarang Jain:

Yes. So fixed also, the whole objective has been to lower our breakeven points, and there was a lot of possibilities and I think there is something not only because of COVID, but this is an exercise we started anyway in the last financial year. So this has been going from one year. So this 20% reduction not just happened, because this is like a sustained reduction which we will do. So you are absolutely right. Once we see the larger volumes come back, our fixed costs are not going to go up. So fixed cost, 70% of the manpower cost is the fixed cost, the others would be like travelling and that kind of stuff, which is also, as you know, at the moment not happening really. So, we see the lower fixed costs sustaining itself as we move forward. So, we will see that with the increased sales volume and lower cost base, we can achieve a better profitability and a better free cash flow as we move forward. And Q3 and Q4 clearly demonstrate that.

Basudeb Banerjee:

Sir, last question. if I remember, your peak revenue before this to EUR 25 million CAPEX for the addition of greenfields and bit of brownfield, I suppose was EUR 1.3 billion roughly?

Tarang Jain:

No, it was less. Actually we were actually at about EUR 1 billion in sales.

Basudeb Banerjee:

No, I am saying your peak revenue capacity, not actually execution.

Tarang Jain:

You are right, so peak revenue capacity you are right, was at a level of, I would say, probably more like capacity was there but what we achieved was maybe a production revenue at a level of probably about EUR 1.1 billion, plus we have about EUR 100 million of revenues coming from a tooling sales. So, that's about EUR 1.2 billion, EUR 100 million of this thing and EUR 1.1 million is what the piece we have actually gone up to in the production and tooling together, so far. But of course, capacity you can say can be for EUR 1.3 billion.

- Basudeb Banerjee:** But now with these EUR 225 million CAPEX, that figure's peak potential revenue will be moving up towards EUR 2 billion?
- Tarang Jain:** No. So this EUR 225 million, I mean, once it's fully done, like I said, it is about EUR 160 million we have achieved last year and this year also we will be around EUR 20 million, EUR 22 million more, as per the commitments given towards programs to customers. So, I think that this level of investment could take us to around probably EUR 1.6 billion, EUR 1.7 billion. Of course, there will be some incremental CAPEX also, because the EUR 225 million I am talking about is only towards the new plants and our acquisition in Turkey, it is not the expansion at our current plants. So, there will be a further CAPEX happening, but the CAPEXs which will happen now going forward, will be at probably 50% levels of what we have been doing in the past. So now it will not be that heavy CAPEX I think because of the new plants which we had kind of do to be a larger global supplier in this business.
- Basudeb Banerjee:** So, broadly as you said EUR 1.6 billion, EUR 1.7 billion will be the foreseeable peak capacity next 2-3 years?
- Tarang Jain:** Over the next, I would say, three years is something that is what we will be achieving.
- Basudeb Banerjee:** Sure. So now as you have mentioned the revenue, actual execution was close to EUR 1 billion, my guess is this fiscal it will be below EUR 800 million as such. So, as a promoter how do you envisage, where do you see, say, in fiscal 2023 this EUR 800 million moving towards as per your order book and demand scheduling as per your visibility? Not this year, not next year.
- Tarang Jain:** Yes. I would say, FY '22 I see is going to overall revenues of about EUR 1.2 billion in the next financial year. I expect that to be at a minimum, what we see as sales from this business. Then it will go to EUR 1.3 billion, EUR 1.4 billion, like that, that as we move along the sales will go up by EUR 100 million, EUR 150 million a year.
- Basudeb Banerjee:** Only for VLS you mean?
- Tarang Jain:** Only for VLS, I am only talking about VLS in euro terms.
- Basudeb Banerjee:** So sir, it will be great for everyone to understand on what drivers you are confident that EUR 800 million this year will move all the way to EUR 1.2 billion, if you can give those breakup of orders which you are confident?
- Tarang Jain:** Okay. I can explain to you now itself. See, the first quarter was like a washout, you saw the revenues we achieved. I mean, whatever major part of revenue came only in June, and in July and August also the revenues are going to be a little bit subdued because of the holidays in Europe. So I am just saying that we will see strong revenues coming in from September, after all the holiday season and everything is over, September to March we will see higher level of

revenues in the VLS business. And that's what will make us achieve a revenue of about EUR 800 million, the production revenue will go to about EUR 800 million and, of course, plus the tooling revenue whatever we have of about EUR 100 million. So probably we can see a revenue as we see today at about EUR 900 million in this financial year.

Moderator: Thank you. The next question is from the line of Ronak Sarda from Systematics. Please go ahead.

Ronak Sarda: First question on the China JV, I mean, a pretty sharp uptick in top-line and profitability at the JV. If you can just explain us how does the full year FY '21 looks like? Is this operation sustainable right now or this was more of a, I mean, a quick recovery in pent-up in China as well?

Tarang Jain: See, since April we see a very, very strong growth. Because see, when you achieve the volumes in China, you see the profitability, because the profitability is quite high in China once the volumes are there. It is not something we have seen in the last past one and a half years. Yes, we have seen low volumes because of the China - U.S. dispute from October 2018. But now we see the volumes coming back. And I think maybe I will let Stephane a little bit kind of expand on this. But I mean, the way I see it, I think this demand will continue for the rest of the year. Stephane, you would like to add? Because you would probably have a better idea of the China market.

Stephane Védie: Yes. If we look at the China market overall, this is the fourth month in the row that China is increasing year-over-year. We have seen that the COVID crisis has changed a little bit the behavior of some customers, the ones that used to take public corporations, they don't necessarily want to be among other people, and the ones that can afford they decided to buy new vehicles. So we have seen that there is a strong demand right now, every customer is pulling very nice volumes. And for the fourth month in a row, we see the China market increasing. For us, in a month from now, we are also starting to ramp up very important projects with Volkswagen, the joint venture with Volkswagen in China, the one that we are already producing in Europe. And this will add incremental revenue also to our Chinese JV. So we see a strong year for China. And we think that the performance that you have seen in the first quarter will be consistent we see already as the middle of August, and we will continue until the end of the fiscal year for sure.

Ronak Sarda: Okay. Second question is again on VLS, I mean, you mentioned July is almost 92% and August maybe because of holidays it would be slightly lower. But on these utilization levels, what could be now a breakeven level maybe in terms of the utilization level or in terms of revenues, where would we be on the breakeven levels right now, given we have seen really sharp recovery again?

Tarang Jain:

See, presently, I think the level of sales in July and August, I think, by 92%, we meant compared to the previous year, sales. Because July and August, like I mentioned and like what you said also, I mean, there are holidays, there are about three weeks at least of holidays between July and August, when there is a total shutdown. So, obviously, the sales are 90%, but they are still at a lower level in July or August. Not to say otherwise, because I mean, if these OEMs are open then of course the sale would have been at a much higher level. Of course, at the level of sales we have now at about probably EUR 60 million there, I am talking only production revenue, not the tooling revenue, EUR 60 million. I think that, of course, EBITDA is of course very much positive, but I think we would probably be a little bit off on the PAT side, only for VLS I am talking about. We were a little bit off on the PAT side. But I think that when we reach a level of about between about EUR 67 million to EUR 70 million is when we are going to see a PAT positive kind of a result.

Nitin Kalani:

I just wanted to add one point. Basically, July and August, if you see, are seasonally very small months, given the holidays. So this is not the benchmark month anyways. What we believe is, basically in a normal month we usually sort of, that's I think EUR 75 million of revenue, and that's where we make a decent amount of profit after taxes.

Ronak Sarda:

No, I understood that. I just wanted to understand breakeven.

Nitin Kalani:

Breakeven will come around, after EUR 65 million I think we can have a breakeven. But when I say breakeven, it is on the PAT side. Because we have a high level of depreciation and, of course, some increased interest in this period. That's the reason I am saying on the PAT side, once things normalize in a certain way, with the higher volumes, we will see. But that's the level I am talking about roughly.

Ronak Sarda:

And two clarifications on the VLS. Have we received any support from government in terms of fixed cost recovery or loans? One is that. And second, earlier when we spoke around in March, there was a thought process that the holiday season would be shorter given OEMs would be looking to recover production. So, is that the case? Or the holiday season is as similar to the last year?

Tarang Jain:

I think, see, in the U.S. they canceled all the holidays, so we have seen a strong rebound in the U.S. market. And there we are doing pretty well even in this period of time, July, August. But in Europe, I mean, for whatever reasons, I think they have continued I think with the holidays. And the larger play for us is in Europe, almost 60% of our revenues, a little bit more, come from the European region. So that's the reason that overall our sales are going to be probably at a very low level, because in spite of the COVID and all, I mean, they have still kind of continued to go on their holidays. So that's where we are. What was the other question you were asking, Ronak?

Ronak Sarda:

Any government support in terms of fixed cost recovery or loans?

- Tarang Jain:** No, nothing on the fixed cost. I mean, in the Czech and Poland especially, I mean, they did kind of give us some kind of a reimbursement on the salaries of the people across the board, and that was I think in Czech, I think it was extended up to probably August. And it was for three months in Poland. That's when we got a major amount of a fiscal incentive. And then of course, the Czech banks also had given us a moratorium up to September on the repayment side for the loans and everything. So, that was the other benefit which we received, that would be the extent of at least about maybe EUR 15 million to EUR 20 million of rollover up to September. I mean, this was some of the incentive and the incentive must have been around probably between EUR 2 million and EUR 3 million, as what we got towards the salaries.
- Moderator:** Thank you. The next question is from the line of Aditya Jhawar from Investec Capital. Please go ahead.
- Aditya Jhawar:** You gave a good sense on overall your ramp-up plans. But if you can split by geography, China we are clearly seeing that it's already doing reasonably strong numbers. But in terms of ramp up in production by geography, how you see the next one quarter or two, it would be quite helpful.
- Tarang Jain:** Okay. Stephane, I think maybe you would be a better person to maybe answer this question.
- Aditya Jhawar:** Just one small thing. Sir, the Y-o-Y numbers, when you talk about the production ramp-up, it will be great if you do a comparison on a Y-o-Y numbers. And VW and Renault orders would already be in base, so Y-o-Y numbers would give a good sense.
- Tarang Jain:** So, I think, probably Stephane, would you like to this thing, then I can probably add to that.
- Stephane Védie:** Yes. Okay. So I think we spoke about China, I think China is a very good surprise for everyone. And Y-o-Y in China we will be over last year, so we see strong volume right now, we see strong volume in July. And with the ramp-up of the the main Volkswagen project that I mentioned, will be over last year in terms of revenue. In terms of North America, the volumes have been pretty strong, Tarang has already commented, the summer shutdown has been concerned with most of the customers. Tesla has been pretty strong in terms of demand for the Model S, the Model X, Ford has been strong, FCA has been strong. So we see revenue getting pretty close to last year for the full year. In terms of Europe, we are taking a little more time to ramp-up the production, customers like Renault, like JLR really needed to reduce their stock before starting full speed the factories. The very good drive force and boost for our revenue was Volkswagen Group. Volkswagen is our number one customer globally right now. They are launching two models, they are called ID.3 and ID.4, these are electric vehicles. They absolutely need these vehicles to be successful in order to reduce their carbon footprint overall. And they are boosting the marketing and boosting the launch on these vehicles, and we keep having requests for volume increase on these two platforms and these two vehicles. One of the headlamps we produce in Czech Republic, one of the headlamps we produce in Poland. So

these are the significant impact on our European business. So year-over-year, despite the COVID impact, still the European business, especially if you include Morocco as part of Europe, that will be slightly, let's say, at the same level of slightly overall last year. So in terms of year-over-year, this is all I would describe it.

Tarang Jain: Yes. Just to add to that, you were asking about Q2, you were talking about Q2, we safely see a 10% increase over the previous year in euro terms. So, July, August, September will be 10% more than the previous year in euro terms.

Aditya Jhawar: That's quite interesting to hear. Stephane, you mentioned that in China, the new model of VW should come in, in the second half. And what about/ is there any delay in the order execution from JV?

Stephane Védie: No, the main impact for us is coming from, once again, joint venture. So, that's the platform I was describing, this ID.3, ID.4 vehicles. We have won the platform in Europe, we have won the platform in China, and we have won the platform in North America. So we are already ramp-up in Europe, and the volumes keep increasing. And now we will start production in China, North America will come only next year.

Aditya Jhawar: But I was asking more about, so we had two big orders kicking in from second half of FY '21, that is from VW and Geely. So you mentioned about VW, the second OEM that we are planning to start in second half, is there a postponement of that order?

Stephane Védie: No, it's not postponed, it's moved towards the end of the calendar year.

Aditya Jhawar: Okay. And just one clarification, the incentive that he received in EU for the salaries, is it by way of kind of a lower interest loan or we do have to repay that money received?

Tarang Jain: No, we don't have to repay, that's like a grant. It is reimbursement of the part of the salary cost, up to a certain limit.

Stephane Védie: When we are keeping the people at home, our operators at home, a portion of the salary is paid by us and a portion is paid by the local governments. It's different from Czech Republic, Poland, but that's basically what it is.

Aditya Jhawar: Okay. Now coming to India, as we are in middle of August, are you seeing some order backlog from customers? So, are we still facing certain meaningful bottlenecks in meeting customer requirements in India?

Tarang Jain: See, overall, Aditya, you know that, of course, there is a huge issues with getting skilled manpower, and also there are issues on getting components from your suppliers, even imports to some extent are an issue. So, a lot of suppliers are having issues with this, not that we are

not having issues. But in our case, we are not losing a single order. So, we have been able to manage quite well in this period of time since I think the production started in a small way in May from various customers. Yes, the demand is ramping up because it is like a V-curve when it comes to definitely the Indian market, especially the two wheeler market where we have a larger play. But what we are seeing is, where there is a share of business is there, we are able to supply more, which is good for us because we are able to manage our resources in a better manner across all of our plants in India. So we are able to kind of increase the share of business in this period of time, so it has been a positive for us, I would say.

Aditya Jhawar: Okay. That's helpful. And final question, if you can give us the CAPEX number for FY '21 and FY '22?

Nitin Kalani: FY '21 I can give you an indication, FY '22, obviously, we have to go back to the drawing board and rework the plans, etc.

Tarang Jain: But I think I can step in here. See, this year the overall CAPEX in India will be not more than, I mean, new orders I am saying, will not be more than probably Rs. 140 crores, Rs. 150 crores. Normally we do Rs. 250 crores to Rs. 300 crores every year. And in the VLS business it will not cross EUR 45 million. I mean, last couple of years we have done EUR 85 million to EUR 90 million. But this year onwards I don't think I think this year it will be EUR 45 million, and going forward also we will be limiting CAPEX, because the larger part of the CAPEX cycle has already ended, which was related more to the new plants which we set up. So now I think we are going to be extremely conscious on how do we do our CAPEX in the coming years? So even FY '22, probably we will see what is the demand. But I don't think it will be probably more than this number. So we have enough capacities also which are, I mean, unutilized at present in both these businesses, which we need to fill up.

Moderator: Thank you. The next question is from the line of Hitesh Goel from Kotak Securities. Please go ahead.

Hitesh Goel: I have three questions. First question is on China JV, this quarter's performance in terms of EBITDA margin has been quite significant. What I wanted to understand is that even if you grow 30% this year in China JV, you will get a revenue of Rs. 8 billion, right? And you have reported EBITDA margin of 15%, 16% at Rs. 12 billion of revenue. So is this margin sustainable? Or what can be the sustainable margin levels at these kinds of revenues?

Tarang Jain: I think, I mean, I can say very clearly, I mean, seeing the past experience in China, that if you make the sales numbers like they are today, you are definitely going to be achieving this level of profitability. So, that's the level of popularity which exists in the Chinese market. So, going forward, I think that if we have a higher level of sales, probably even these numbers could probably go up a little bit. So, I am pretty confident of the sustained performance in China because things are very stable there when it comes to all resources, and there is no issue at all.

And I am very confident of the sustained performance month on month in the Chinese market. What do you feel, Stephane?

Stephane Védie: I feel that the numbers we are seeing in terms of profitability, they are the direct results of the actions we have taken last year. Last year, we had a difficult situation, the markets fell significantly. So we have adapted our breakeven point and have adapted our fixed cost. Exactly what we are doing now and in the rest of the world, we have done last year in China and this is really the consequences of the results of the work that we have done last year.

Hitesh Goel: Okay. A least Rs. 9 billion of revenue in China we expect the same EBITDA margin to continue. That's what I wanted to ask. So I think you are quite confident in that.

Stephane Védie: Yes.

Hitesh Goel: And sir, my second question is on depreciation. I have actually not seen such a high depreciation rate in any company. So your depreciation rate on gross comes to 15%, 16%. I know you did an accounting change in terms of amortization, but how should we forecast that number now? Because in six years we are depreciating a gross block. So can you just talk about how should we look at this depreciation number?

T R Srinivasan: See, there are three components to this depreciation, okay. The first component is the regular depreciation on the property, plant and equipment, typical assets depreciation. It has gone up over the last two, three years because of all the investments we have made in the new greenfield facilities at Brazil, Morocco etc CAPEX utilization is still quite low. So the revenue is not there at the level to justify the full depreciation charge. That's number one.

Second part is, what is called be capitalized engineering cost incurred in development of products which are subsequently recovered through the pricing to customers. This capitalized engineering costs are then amortized over the life of the program, which is between three and half to four years. And that amortization of this engineering cost also comes under this line, under depreciation amortization. This is the change which came when Accounting Standard 115 was implemented effective FY '18. The third component of the depreciation is the capitalization, which is as per Accounting Standard 116 which came into effect in FY '20. Earlier all operating leases, the rentals were charged to the P&L under operating expenses, whenever the base rentals were paid off. And under AS 116, they are treated more like a finance lease. The entire future lease rental payments over the life of the lease are capitalized and then amortized over the life of the asset. Part of the cost goes into amortization and part of the cost; the discounted part of the future rental goes under finance cost. So, which is where you will also see the finance cost compared to last year, etc.

And as a part of our strategy, in most of the new facilities, we are not interested in land and building. We have taken this thing on long-term leases; we are only invested in plant and

machinery. So, the capitalized value of those leased plant building leases which are typically for periods ranging from 10 to 15 years, this will capitalize in the balance sheet and amortized, which is the third component I was talking about. So, combination of three factors is what you see over the last two years, two and a half years, depreciation and amortization cost going up, apart from a little bit of amortized intangibles due to the acquisitions we had in Turkey and the CarIQ and cost of acquisition and so on. So this is basically the thing. Going forward, the depreciation and amortization cost in absolute amount should not go up that much, but once we start utilizing the capacities to a large extent, the revenue growth will be faster, so as a percentage it should start coming down over the next couple of years.

Hitesh Goel:

And in the annual report, the other income actually, there is an element called net foreign exchange of Rs. 48 crores. So what is this? And also, I think you raised money at the end of that year, right, in March 2020, that is why you see a cash balance of Rs. 1,000-odd crores in balance sheet but the interest income is very low of around only Rs. 22 million in FY '20. Am I right in my understand?

TR Srinivasan:

Yes, you are right. Taking the FOREX part first, it is basically impact of translating the closing balance of balance sheet currency in difference between functional and reporting currency restate and take it to the balance sheet, so that we had gained last year, which we have put it in that. And coming to the borrowings part, actually in the last two weeks of March, we drew down all the unutilized facilities limits we had at various places, Czech, U.S., Morocco, Netherlands and even in India, and kept the cash, that's why you will see a lot of cash flow in the balance sheet as of 31st March. And since we drew down only in the last two weeks, the impact on the interest cost itself in Q4 last year was very small. So, most of the impact actually was in Q1 this year, so that's basically the story.

Moderator:

Thank you. The next question is from the line of Ronak Sarda from Systematix. Please go ahead.

Ronak Sarda:

Just a follow-up. If I look at the annual report, in terms of contingent liabilities there has been a sharp increase for corporate guarantees and guarantee for loans by I think VLS. Can you explain, I mean, is this something more of a temporary nature or given our debt leverage position, has this been asked by the bankers as such?

TR Srinivasan:

Yes. So basically this guarantee is given by the group holding company, Varroc Engineering Limited to third parties mainly in VLS on account of two things, one is certain new borrowing facilities we had during last year, like we had set up a EUR 60 million facility at the Netherlands level to fund our share of the CAPEX in Morocco, Poland, Brazil, etc., the rest is funded through local borrowings. So, that amount is guaranteed by the parent company. And like I said, we have also entered into some long-term leases for facilities in Morocco and Poland, and so on and Brazil and those leases are also guaranteed my VEL. The reason we do that is to give a higher amount of securities to lenders or the third parties which brings down

the interest cost and rental cost. So that is the comfort they have, so it is the part of the overall thing. And as per whatever RBI limits we have, we are well within the RBI norms of four times the network kind of a thing for profit guarantee.

Ronak Sarda: Sir, the letter of guarantees for loans by third parties, that is for the leases which is a higher amount given the new CAPEX of 790 odd crores?

TR Srinivasan: Yes, the one increases during the last year would be what combination of borrowing as well as the leases, both.

Moderator: Thank you. The next question is from the line of Pankaj Bobade from Axis Securities. Please go ahead.

Pankaj Bobade: Can you please throw more light on the Turkey acquisition which you have done? And secondly, I would like to know, would we focusing only on lighting as a segment or we will be adding new products to our product basket?

Tarang Jain: On the Turkey side, of course, Stephane will explain to you about the future of the Turkish market. But I can tell you one thing, is that, we are going to be focusing largely in the lighting business only. This business when we had acquired was doing small lamps, and now we are going to be adding headlamps and rear lamps here. Going forward, there could be also some more of electronics, which we are also probably planning to kind of pursue as a business unit. But having said that, I think probably Stephane you could add on the reasons why we have gotten to Turkish market and its potential for us.

Stephane Védie: Yes. So we made the acquisition of the Turkish company Sa-ba back in July 2018. This was the second generation owned by two brothers. The revenue at the time was about EUR 30 million, EUR 35 million. This company was focusing on what we call small lightings, so everything exterior, except the headlamp and rear lamp. With our technology, we are bringing the possibility now to this footprint in Turkey to produce also headlamp and rear lamp in Turkey. This is a market producing about 1.5 million vehicles a year, we had only two competitors locally and there was not much competition. So the customers were really encouraging us to make this acquisition. We have been very successful in growing this business; we have an order book now that's showing above EUR 110 million, EUR 120 million of revenue. One of the marquee projects that we won, one of the highlights is the Ford, we won the headlamp, the rear lamp, the stop lamp, this is a commercial vehicle and long-term project, very stable volume in the range of 250,000 vehicles a year. In addition to this, you may have seen that Ford and Volkswagen have made a partnership in the field of commercial vehicles, so there will be in addition Volkswagen version of this commercial vehicle coming, and the lamp should be pretty similar or maybe common. So this should be worse to lose, this should be our really additional volume that we could take. So, so far we have been very successful in growing this business. We are happy about the team we are putting the way things are ramping

up. And one of the targets that we had also was to get really more sticky with the customer in person. So we thought it's really panning out. With FCA, we have a good momentum; with Renault there will be the Renault project that is coming for a request for quotation at the very end of our fiscal year, that's an interesting platform. And then thanks to Turkey, we opened the doors of Hyundai. So we won our first business with Hyundai roughly a year ago. Two months ago won a second business with Hyundai in Turkey. Thanks to this, now Hyundai is considering us as a global partner, also including India. So, this so far is the strategy that we have put in place, is executing and is panning out well.

Pankaj Bobade: So, as you mentioned that we would be specializing only in lightning segment, so what all new additions could be brought to bring growth going forward? Means, would there be any technological segue or anything like that?

Stephane Védie: Maybe I wasn't clear enough. So this company was producing what we call...

Pankaj Bobade: No, I am talking about at the group level, not Turkish company only.

Stephane Védie: Okay. So, at group level lighting remains our number one focus, exterior lighting, mainly headlamp on rear lamp. We continue to play an important part in the increase of technology content of the product. I think Varroc is really one of the main players trying to convert right not the halogen technology into LED. We have some very good products, low cost LED systems that are really able to replace today halogen in most of the developed markets. So that's really a trend where we don't see yet the upside, there continue to be opportunities there. Then I think in the previous calls we have also mentioned the fact that in our headlamps and rear lamps we are integrating more and more of the new components for radar, so we see a trend where we are able to integrate in our headlamp and rear lamp a radar or lidar or camera sensor, so this is becoming more and more real. And this will generate also some additional revenue for us. So electronic as a component is becoming more and more important. We are already developing all our electronics ourselves. We have already a strong partnership with Ford to develop their ECU, LDM, HCM. We see ourselves growing in the field of electronic, growing in the field of control modules where we have this engineering expertise where we have good manufacturing footprint in India on our joint venture in Romania for Europe. So, this is the other additional revenue stream that we see developing. But clearly, lighting will remain and is remaining our number one focus.

Pankaj Bobade: What is the share of LED and halogen on global level?

Stephane Védie: On global level, I think we need to make the distinction between head lamp and rear lamp. But basically on the headlamp side, LED penetration is in the range of, I would say, 65%, and on the rear lamp side we should be in the range of 75% going forward.

Moderator: Thank you. The next question is from the line of Nagraj Chandrasekar from Laburnum Capital. Please go ahead.

Nagraj Chandrasekar: Congratulations on a great performance, especially the recovery in China. Just on slide eight, the situation update and the guide for FY '21. From the June end Rs. 3,410 crores number, how much of the decline you projected Rs. 2,600 crores is going to be from normalization of working capital? And how much of it will be from cash profitability? Number one. And number two, if it will stay at current utilization that we have for all our markets, not the 1Q or the June levels but the current August levels, what sort of EBITDA should we end up making for FY '21?

Nitin Kalani: In terms of the reduction we haven't made that kind of a split, but roughly let's say for the rest of the year, let's say, we will do about Rs. 4,000 crores revenue per quarter kind of thing roughly, this way. And around 10% EBITDA or some more, so about 12,000. So yes, I mean, that will be including China so we need to probably take out China. And probably about close to Rs. 1,000 crore in terms of EBITDA we should be able to do in the nine months is what we are expecting, so tax an interest would be the accretion to cash part of that. So, let's say, out of that, at least Rs. 500 crores to Rs. 600 crores should be the cash profits I would expect roughly speaking. Then the rest should broadly come through working capital, and of course there is also some CAPEX. So, will we have control as Mr. Jain was saying, CAPEX will be upwards half of the last year or more, and we are looking at probably Rs. 600 crores or thereabout for the full year. So, probably we will do about Rs. 400 crores, Rs. 450 crores for the rest of the year, let's say two, three quarters to go. So that will be the outflow on the CAPEX account. So fair to just add up these numbers, let's say, Rs. 700 crores thereabout improvement should come from working capital side roughly.

Nagraj Chandrasekar: Understood. And the Rs. 500 crores to Rs. 600 crores cash profit would exclude China?

Nitin Kalani: Yes, because China we consolidated fully at the PAT level, so we are not counting that cash. And that cash is also not immediately accessible, except through dividend.

Moderator: Thank you. The next question is from the line of Apoorva Mehta from AM Investment. Please go ahead.

Apoorva Mehta: Sir, just wanted to know, FY '21 we understood everything, now what about FY '22? Can you break up the 2022 sales what we are projecting like VLS, India and China to sum up where we can go in 2022, what is your rough estimate on this thing?

Tarang Jain: Yes. So I think when it comes to the VLS business, I have already said that we will be EUR 1.2 billion, including China market. Off which, EUR 1.1 billion will be the production revenue which will get out over customers, I mean, through our various plants and the capacities we have built, EUR 100 million of that is, of course, the tooling revenue which we do every year.

So EUR 1.2 billion is what we expect in FY '22. And in India, I think we expect a revenue of at least about Rs. 4,500 crores in the coming year. So, it will be EUR 1.2 billion which maybe if you have to multiply by roughly Rs. 85, how much it comes to, can somebody just tell me?

Apoorva Mehta:

Roughly Rs. 9,500 crores?

Tarang Jain:

Yes, so Rs. 9,500 crores and you can take another Rs. 4,500. So this is, I would say, Rs. 14,000 crores is what something we expect to do in the coming year, which obviously is clearly a double-digit profit.

Apoorva Mehta:

And EBITDA margin will be upwards of 12%?

Tarang Jain:

Let's see, but it will definitely be more than 10%, I don't want to give a number at this stage. It will closer to probably 11%.

Moderator:

Thank you. I now hand the conference to the management for closing comments. Thank you, and over to you.

Tarang Jain:

I feel that I would like to thank everyone for their questions. And also thank all the investors who have stayed invested in our organization, in spite of facing tough times, especially in the last probably 15 to 18 months. I just want to kind of just say that, see, India business, of course, we have grown, we are pretty stable and everything. But the lighting business was a business which we acquired in 2012. And of course, in 2016 and 2017 we kind of decided that we have to be a more relevant player in the lighting business, for which we had to make substantial investments to become a more relevant player in the lighting business, increase the market share with the top OEMs in the world to become more relevant. Yes, that's been the vision of the organization to be a bigger player. Yes, there have been some hiccups along the way in the last year and a half. But I just want to say that probably the people who stay, I just want to reiterate that please have the confidence, and let the confidence remain in the organization. We are fairly confident that with the volume cycle coming back I think we will deliver on the results also in VLS. And we will see that in the coming years that whatever investments we have made will bear fruit. So I am pretty confident of this business, we have a right business. Please do not think that there is a very high R&D cost here, or it is a unbelievable business, the lighting business, it's not true. I mean, lighting business is one of the most profitable businesses in the world and we are in the right business. And as we go along, we will we will produce the results. So with that, I just want to kind of thank you once again. And please stay safe and healthy in these special times. Thank you.

Moderator:

Thank you very much, sir. On behalf of Varroc Engineering, we conclude this conference. Thank you for joining us. And you may now disconnect your lines.