"Varroc Engineering Limited Q4 & FY19 Earnings Conference Call"

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Moderator: Ladies and gentlemen, Good day and welcome to the Varroc Engineering Limited's Q4 and FY19 earnings conference call. Varroc Engineering Limited's management is being represented by Mr. Tarang Jain – Managing Director along with Mr. Stephane Vedie – President & CEO, VLS Business; Mr. Ashwani Maheshwari – Whole-time Director & CEO, India Business; Mr. T. R. Srinivasan – Group CFO; and Mr. Nitin Kalani – AVP Finance and Head of Investor Relations. I now hand the conference over to Mr Tarang Jain – Managing Director. Thank you and over to you sir.

Tarang Jain: Good evening everyone. I would like to thank you for joining the quarterly earnings call of Varroc Engineering Limited. Before I speak about quarter 4, I would like to highlight the full year performance. The financial year gone by had a lot of uncertainties and challenges. Enough has been said about the challenges and I will not repeat those again. However, I strongly believe that in spite of these challenges, our business performed reasonably well, especially in the last quarter. During the year, we saw consolidated revenue growing past the Rs. 120 billion mark, a like-for-like growth of 18.8%. Our profit after tax for the full year is Rs. 4.5 billion, almost the same as the last year in spite of the significant reduction in the contribution of profit from the China JV from Rs. 690 million to about Rs. 300 million in the current year.

In our VLS business, we won the highest ever new orders of €462 million. In India business, we won our first business from TVS, expanded our presence with Hero, and secured first orders for new BS-VI related products like the electronic fuel injection and the catalytic converter. We also developed a prototype for the traction motor and controller for the two-wheeler electric vehicle which is currently under test by potential customers. We are also developing other products related to the electric vehicles.

During the year, we have started commercial production at 3 new manufacturing facilities which are Brazil, Morocco, and Halol in Gujarat, India, and started construction of new plants for the VLS business in Poland and in Chennai, India. We also completed the expansion and technological upgradation of the VLS Czech plant. The full benefit of these investments will be visible in the next 2 to 3 years. We also started our Poland R&D center recently.

During the fourth quarter, apart from the global macro challenges, the Indian two-wheeler industry also saw a 10% decline year-on-year. However, we were able to grow albeit at a slower pace in a declining market. However, this had an adverse impact on our India margins. At VLS, we were able to increase our revenue 6% in a declining industry including North America in the last quarter. This revenue growth along with improvement in operating efficiencies and better cost control helped in improving VLS margins by 90 basis points. The like-for-like EBITDA for the quarter is at Rs. 2625 million. The reported EBITDA for the quarter has been adjusted down to reflect the lower launch cost in this quarter of Rs. 308

million, the Ind-AS 115 impact of about 398 million, and upward for the impact of launch cost of about 174 million.

Our other businesses continue to perform well and grew by 15.6% year-on-year. EBITDA margin for other businesses which are VLS Italy and IMES was at 7.8% during the quarter. Our depreciation on year-on-year basis has gone up mainly due to the capacity expansion at the VLS Czech facilities and the adoption of the Ind-AS 115. Profit after tax for the quarter stands at 1500 million as against Rs. 1428 million in the corresponding quarter last year. I am happy to inform you that we are proposing a dividend per share of Rs. 4, i.e., 400% to the face value. Thank you. We are happy to take your questions now.

Moderator: Thank you very much, sir. Ladies and gentleman, we will now begin the question & answer session. We have the first question from the line of Hitesh Goel from Kotak Securities. Please go ahead.

Hitesh Goel: My first question is pertaining to this new revenue potential that you have talked about. It is a very detailed slide, so it is very helpful. But this 620 million revenue which we are talking about, can you just break it down and how much will come in FY20 and 21 so that we have some sense on the near-term trajectory?

My second question is on this EBITDA margin walk that you have given on slide #8. I understand the Ind-AS impact in terms of adjustment in EBITDA, but the startup cost and launch-related cost are part of business, right? So, ideally this should be included in your like-for-like EBITDA calculation, isn't it?

Stephane Vedie: About the slide #10 you are referring to, we are talking about the VLS business and all the growth projects that we are having on the development. This incremental revenue of more than €600 million is mainly driven by the new footprint on the new plant that we have launched or we have in the process of launching. The peak on the full benefit of 600 million will be reached by fiscal year 24. We will see the biggest portion already in fiscal year 22, and between now and fiscal year 22, this will be a gradual increase of roughly 10% per year but in '22, we should be able to see already half of these opportunities which are almost 300 million already incremental by 2022.

T. R. Srinivasan: Coming to the accounting of the launch cost, the reason we removed that to make comparable because the timing of the launch varies from year to year and quarter to quarter. We generally have a situation where sometimes a number of launches get all come together in 1 quarter or in some quarter the launches are very less. And because those costs are fairly significant and they are not directly in relation to let us say the revenue, that is why we remove that impact to show a comparable margin which is from the underlying operations, which is the revenue that the business generates. That is the logic for treating it like that and which we do consistently every quarter. Regardless of whether the direction is positive or negative, we still show it in a consistent way.

Hitesh Goel: Sir, just clarification on this startup cost. This startup cost will go away fully in FY20? How will this move? Because this should be related to the initial programs that you have run. Now that plant will stabilize, how should this startup cost move?

T. R. Srinivasan: The startup cost obviously incurred till the commercial production starts. So, the existing sites of Brazil, Morocco, those things all will go away but you have to also keep in mind that we have started work on two new sites in VLS in the current year, Poland and Chennai, and those startup costs will be there for this year. The timing and amount will vary. That is the only thing. Otherwise, once all the Greenfield expansion programs are over, which will happen let us say by early next year or middle of next year, then you will see that this startup cost starts going down significantly.

Hitesh Goel: Can you give us some guidance on the revenue outlook for VLS in FY20 in terms of Euros?

Stephane Vedie: For FY20, we are still targeting an increase of 10% versus FY19 on Euro base. The main question mark right now is the China market situation. As you know, it is very volatile. In April, we had a pretty good month but we understand that in July, there will be a new emission norm put in place in China. So, we think that some of the customers are waiting for July to be able to take the decision and take the vehicles that will comply fully with the new emission that they will have no restriction to drive in certain cities that may put some restrictions. So, there is a lot of volatility. Obviously, the trade tensions between the US and China are contributing to this. The rest of our business except China, we have pretty good clarity, pretty good visibility, and we are confident about the volumes in Europe and confident about the volume in US right now. This is in line with what we had budgeted.

Moderator: We have the next question from the line of Aditya Jhawar from Investec Capital. Please go ahead.

Aditya Jhawar: Congrats on good set of numbers. In the new order wins slide, you have included an order win from Tesla of about €69 million, is this pertaining to the new model of Tesla, as we understand that we had 100% share in model S and X and we are not present in model 3. If you can throw some light on this?

Stephane Vedie: This in fact, is what we call a business career wherever he wins, we receive a commitment from Tesla to increase the lifetime of the model S and model X. This is good news for us because we did not invest into additional engineering, launch additional tooling, and additional capacity. Its lifetime extension that we have received as a contractual agreement from Tesla. About new model, the model Y, for your information, the lighting has not been sourced yet on this vehicle. And I have a lot of respect for what Tesla is doing but we want to limit our exposure on Tesla. On model 3, if you remember, we decided to pass. On model Y, we decided to attack what we call the small lighting. So, fascia lamp, CHMSL, reflex, the lights that don't really need big investment. That is why we think that is the right strategy. We expect some decision very soon in the next weeks but so far, no decision has been taken on sourcing in model Y.

Aditya Jhawar: Stephane, if you can highlight which are the OEMs in electric vehicles other than Tesla we supply to and which are the potential OEMs in pipeline that from the order of about €460 million, and what is the market share in electric vehicles as on last year?

Stephanie Vedie: As you know, we have done very good historically in electric vehicle lighting. Our market share I think it was around 20% and we think according to the last revision we are still maintaining around 20% to 21% even going this market share. The reason being that we have gone with other customers. I can give you some examples. With JLR which is an important customer for us, we have the E-Pace and the I-Pace, two vehicles that are doing pretty good for them. With Renault, we have a vehicle called Renault Zoe. It is a small city vehicle. That is also doing very well. We won replacement for Renault. This is a platform called BCB, the vehicle does not have yet a name. But according to the RFQ and the contractual information, the volume will be even higher than the Zoe. We won recently in North America Ford electric vehicle, will be on the Mustang platform. I have seen some sketches of this vehicle and it is pretty appealing and pretty nice. We have also the big platform that we commenced I think in previous investor calls Volkswagen they are #1 global platform of electric vehicles. The platform was initially called the Neo. Now, I think the first vehicle has a name. As of few weeks ago, they called the vehicle IG3. We have the volume for 100% of the headlamps production in Europe, we delivered the Zwickau plant in Germany, and then we won also this contract for their platform in China. That is a big contract for us. So, as you can see, we continue to have really a leadership position on electric vehicles.

Aditya Jhawar: The question would be if you can give us a breakup of revenue for VLS customers for 4Q FY18?

Tarang Jain: Customer A was 24.4%, customer B was 24.1%, customer C was 13%, customer D was 7%, customer E was 9.3%, and customer F was 11.9%.

Aditya Jhawar: Can you give us CAPEX guidance for VLS and India separately for FY20 and 21?

T. R. Srinivasan: FY20 we can talk about. FY21 is a bit early because we have to still see because we keep adapting the plans as we go along. The VLS probably will do about 454 CAPEX is what we expect in VLS and India would be around 300 crores.

Aditya Jhawar: We have given a revenue guidance for VLS. If you can give a revenue guidance even for India business?

Tarang Jain: India also I think that we are confident of achieving at least 10% growth. You know the current situation that the market is down in double digit at present, overall market. The only thing is that basically in India, 50% of our customer is Bajaj Auto which is in fact still growing and that is helping us. So, we are actually confident that we should at least do a double-digit growth in this year.

Moderator: We have the next question from the line of Ujjwal Shah from Quest Investment Advisors. Please go ahead.

Ujjwal Shah: My question pertains to the margins basically. Can you touch base upon the margins that we did in India. What really impacted that the margins got roughed up this time around? What are our margin expectations for FY20? On VLS, we seem to have overcome our challenges which we faced on the Czech Republic side. What are our expectations for VLS margins for next few years?

Tarang Jain: When it comes to India, if you were to take the first three quarters of the year, we have kind of done close to 12% EBITDA but as you know, there has been from November 2018, we have started seeing a slow down for the reasons you know. There has been a lot of cost added to the vehicle pricing and we have seen a lot of inventory buildup across, i.e., two-wheeler and four-wheeler segments, there has been really a stock buildup which has led to actually obviously a slowdown in sales. Fortunately, for us, like I had mentioned earlier that in India, 50% of our customer is Bajaj Auto which has still grown in the last quarter which has helped us at least maintain an overall EBITDA for the year in India a little bit over 11%. We were expecting it to be higher, but the last quarter, definitely we have not met our budgeted sales numbers which were okay till the first three quarters. Going forward, I feel that we should at least try to maintain this 11% EBITDA which we have set for ourselves because of the uncertain market. If the volumes improve all-round, not just Bajaj auto, then obviously we will see an increase in profit margins because ultimately we have to utilize our capacities we have set for ourselves in the existing and the new plants. Where Bajaj plants are largely utilized, but the others, the story is not the same. Obviously, the margins will go up with sales growth. That is where India is concerned.

Regarding VLS, we are expecting a double-digit growth in this coming year. And yes, you are right. We have definitely turned around our Czech operations. We are doing much better there operationally and therefore; we are definitely targeting a double-digit EBITDA in the coming year where VLS is concerned.

Ujjwal Shah: Secondly, you did mention that you have won some orders on the BS-VI side as well and some orders with TVS as well. Can you just throw some light into how big the orders are and which specific areas are we really catering to?

Tarang Jain: For the BS-VI for India, there is going to be definitely a kind of value add when it comes to products like the magneto, the AC generator. Across we are moving the products of BS-VI where there is a certain value add. So, I think the pricing probably will go up by about 5% when it comes to the magnetos. Other than that, where we expect to see a growth is in the BS-VI catalytic converters which will start in the last quarter of FY20. This is actually very different from the BS-IV catalytic converter. The BS-VI catalytic converter, there is a huge value add where the value of the product is about 3 to 4 times. There we expect a very good business volume. Going forward, I think for Bajaj and another one customer from the year, I would say 20-21, we could see a revenue of almost 300 to 350 crores coming in from the catalytic converters and of course, magneto is already a product line, so there we will see a 5% increase in pricing on top of the growth what we will experience with our customers for magnetos.

The other product where we are in the BS-VI is on the electronic fuel injection for Royal Enfield. That is the product where we have a share of at least about 250,000 to 300,000 bikes a year. We will be supplying the fuel injection system mainly. Of course, there are two products which are the main products – the ECO and the throttle body. This is through our joint venture with Dell'Orto which is out of Chakan and there also, the revenues are expected for these two products in the next year to the tune of about 60 to 70 crores. Plus there are also some other allied products which also overall I think that we can in the not only in this year, but in the coming year, we can see a revenue increase of almost about 50 to 100 crores.

Ujjwal Shah: Also wanted to know we were looking at e-carburetor opportunity as well. Has any of the two-wheeler players really looking for e-carburetors for BS-VI?

Tarang Jain: Presently, we are not allowed to comment on this product. We are working on it but we cannot disclose the name or names of the customers we are actually going to be supplying this product to because it is confidential.

Ujjwal Shah: Just a query to Srini sir. We are being reporting this adjusted revenue and adjusted EBITDA and it also includes the impact for the interior business. If I am not mistaken, that got closed last year sir?

T. R. Srinivasan: Yeah, so that will not appear from the next quarters onwards.

Tarang Jain: So, in the first quarter of FY20, it will be a very minimal kind of amount and obviously it goes away from the second quarter of this year.

Moderator: We have the next question from the line of Chirag Shah from Edelweiss. Please go ahead.

Chirag Shah: Sir, two questions. First on the extension on this BS-VI opportunity. Would it be right to assume that your profitability in the initial phase would be reasonably lower during the initial phase of BS-VI transition on those new products?

Tarang Jain: Initially when you say if you talk about this year, yes, because this year obviously BS-VI is mandatory only from April 1st 2020. So, obviously I think probably there will be some smaller volumes, people will start putting in BS-VI components probably from somewhere around September-October of FY20 and there will be a slow ramp up. I think from the last quarter of FY20, we will see probably a much larger volume but in the last quarter of this FY20, we will see major volumes would have already come in. I feel when the major volumes are already there and it is mandatory anyway from April 1st, 2020, we will see decent margins because the volumes have to come in. It is not a question mark. It is mandatory, so the volumes are guaranteed, I mean subject to the market conditions. So, we do see good margins in the BS-VI products, of course, based on whatever volumes are there in the current market situation.

Chirag Shah: Because some of the other auto ancillary suppliers all are cautioning that the profitability in the initial 1 or 2 years would be on the lower side. While the value content will go up and your revenues will go up, your margins could see a slight trend down.

Taranga Jain: I think the margins would be I would say kind of similar to the kind of margins as a percentage but I don't think it is going to be lower than what one enjoys today on the current products. It is going to be probably similar. And here, it is not a question of option for people to go to BS-VI. BS-VI is mandatory. It is like 100% of volumes from April 1st 2020 transitioning to into BS-VI. Let us say BS-IV is going to be BS-VI those concerned components, the content goes up but the percentages may not go up because obviously the OEMs are also driving the prices down because it is adding cost to the vehicle. So, obviously they are interested in driving the cost down as much as possible, but I would say that there are still decent margins in BS-VI products even from April 1st 2020 onwards.

Chirag Shah: Second question was on the Europe side. While you indicated very strong order wins, how should we look at the traditional or the older portfolio, be it US, be it Europe or even China, there are pressure on volumes and generally the volume pressure is seen on models that have not been upgraded which are middle age of cycle. How that part of our revenue looks like because you will be cushioned by new business cycle? How will the older models will play out? Any view on that side?

Stephane Vedie: I think we have been very cautious the way we have built our budget for FY20. We are not forecasting a market growth in Europe or in North America. We have been building our assumption based on the market small de-growth. The reason why we are going is because we have increased our market share and also because the level of technology of our product continues to increase. We continue to penetrate more with the LED. The key, as I think Tarang has already touched on in previous comments has been for us to work on efficiencies. We have reduced considerably the head count globally. We have reduced by almost 10% the head count in every category; direct labor, indirect labor, salaried. We want to keep high level of flexibility in a volatile environment. What we have done also is focusing our purchasing, professionalizing purchasing. Now, most of the business awards are done via online auctions. We are centralizing our purchasing department in Poland in our new office there, modifying the competencies and bringing some new competencies.

On the top of this, we are also working on insourcing some of the external services like logistics. This has been survivable on the previous quarter in terms of profitability and will continue to be profitable in the first quarter of FY20. In addition to this, we have also worked on insourcing some of the production that we are at suppliers by improving our efficiencies in our factories, improving the OE. We have freed space on our machine and we want to maximize the utilization of the machines. In order to maximize this utilization, we moved some molds that we had at suppliers in-house. We see that some opportunities in first quarter of FY20 and also second quarter to continue this insourcing and continue to generate more profitability. We are working on being very flexible. I am not optimistic on the market conditions. Our motto I think is plan for the worse and hope for the best and keep the flexibility. This is what we are doing.

Chirag Shah: If I can just take one more question, a clarification on this start-up cost and launch cost. I missed the explanation actually. The like to like adjustment that you indicated in the presentation.

T. R. Srinivasan: Start-up costs are basically the costs which are incurred on setting up the Greenfield sites till they start commercial production which in the normal course we are not allowed to capitalize under Ind-AS. We have to charge it to P&L. Those costs are not contributing to the revenue. That is why we show that separately.

The launch costs are the costs related to launch of specific programs whenever we launch a new product or relaunch an existing program by the customer, and at that time, there are a number of one-off costs related to that launch. Because the timing of the launch can vary from quarter to quarter with the number of launches we have, sometimes it tends to get concentrated or bunched up in one quarter and the costs become higher. Since they are also not contributing to the revenue in that quarter immediately and those are one-time costs in nature, that also we show it separately to arrive at a like-to-like comparisons.

Chirag Shah: But on an annualized basis, it should not really matter at least.

T. R. Srinivasan: Over the year, the impact will be less, let me put it that way.

Stephane Vedie: I wanted to highlight the fact that in the case of Brazil and in the case of Morocco, we launched plants either on time of before our targeted schedule. For these two plants, we had met every customer milestone, every internal milestone, and so far in Morocco, we started introduction in February. We have zero customer concern, zero return. In Brazil, we started small production end of December and started really more in January and we have just 1 lamp lightened so far. So, customers are happy, satisfied. This is the key for us to continue to go with these customers by executing, by delivering good quality good program management. If you meet the milestone and if you deliver on time, then you can minimize your launch cost. That is also the key.

Moderator: We have the next question from the line of Rakesh Jain from Asit C. Mehta. Please go ahead.

Rakesh Jain: I have a question on the VLS for two of your clients – customer C and customer F. If I look at sequentially, their contribution for customer C has gone down from 14.6 to 6.3% and for customer F from 12.8 to 19.4%. Can you just provide some color on what has happened in these two quarters between these two clients?

Stephane Vedie: It is difficult to make an answer without mentioning the name of the customers. Customer C I think in the footnote you see this is a US electric car manufacturer. So, you have an idea who it is. The name is starting with T. This customer had difficulties in volume, especially on the previous models. So, we have seen a reduction when we compare year-over-year with this customer. The good news is that what we are delivering right now, we are not supposed to continue to deliver. This is the project that was supposed already to phase out. So, everything we have right now and even the contract extension that I mentioned earlier in a previous question is a bonus for us and I think this is a very good news because you can benefit from better depreciation of your assets, better depreciation of your investment in engineering.

About the customer F, this is the customer that is driving the growth today of VLS globally. This is the #1 car manufacturer in the world. They are already becoming the #2 customer of VLS in fiscal year 20, and by 24, they will become our #1 customer. The good news with this customer is that we are able to serve them globally. We serve them in Europe, we serve them in North America, we serve them in Brazil, we serve them in China, and we serve also every brand of this customer. I cannot mention the brands but we serve all of them, which gives us a good penetration. We are also equally important for them in terms of headlamps and in terms of taillamps. We have a good balance of business with this customer. So, this is the customer that you will see more and more growing in our customer pie chart if you want.

Rakesh Jain: Can you explain with respect to customer C, the electric car manufacturer, what could be the trend next year?

Stephane Vedie: The trend next year I think we continue to see a decrease in their revenue and in their share inside the VLS customer portfolio. This is what we are budgeted for.

Rakesh Jain: One question on the depreciation. For the next year, what should be the run rate for the consolidated?

T. R. Srinivasan: Run rate it is a bit difficult to say offhand. It will be in line with Q4 or a little higher than the Q4 run rate I would say.

Moderator: We have the next question from the line of Jatin Kalani from Enam Holdings. Please go ahead.

Jatin Kalani: A couple of questions. First one on the catalytic converter side. When you move from BS-IV to BS-VI, what is the kind of price increase that happens here?

Tarang Jain: We are looking at a price increase because firstly instead of 1, there could be 2 catalysts, in some cases even 3 catalysts. So numbers go up when it comes to BS-VI. Then, because to meet those increased emission norms, the noble metal content is much higher which drives up the cost of the product. Let us say if you are able to maintain the same margin, obviously you can make a 3 to 4 times more quantum profits like supplying probably if it is only catalyst, we were supplying almost like 3 to 4 BS-IV catalysts as such. So, the price would be 3 to 4 times, the BS-VI catalyst price.

Jatin Kalani: BS-IV the price of a catalytic converter was about Rs. 1000 roughly if I am right.

Tarang Jain: Not for a two-wheeler. We are only in the two and three-wheeler segment. Our focus is only in the two and three -wheeler segment where we are playing.

Jatin Kalani: You have the price in the BS-IV CC would be roughly?

Tarang Jain: This would be across. Whether it is 100 cc going up to even 300-400 cc whatever. So, it would be similar kind of an increase between 3 to 4 times of existing price to BS-IV.

Jatin Kalani: If you could just help me with your CAPEX for FY19 in both VLS and India. In your presentation, VLS you have given a number of 76 for those projects but I am assuming there will be something in addition to that as well. Just if you could share the full-year number?

T. R. Srinivasan: In VLS last year, we had a CAPEX of close to €90 million overall – the combination of Greenfield site, Brownfield expansion, and the routine maintenance CAPEX all put together. And in India, we had about 300 odd crores, i.e., roughly you can say about 1050-1075 crores roughly overall.

Jatin Kalani: Would it be fair to say that your cost structure in Morocco is far better than your cost structure in you Czech plant and hence has the contribution of Morocco rises. We should see some benefit of that on EBITDA margins?

Stephane Vedie: Morocco is definitely a competitive setup. Not only rate in the country is competitive but also the core business attracts lower taxes, we have zero taxes for the first seven years of operation for example. The fact that we are receiving something that are helping us to reduce our CAPEX that are giving us some cash reimbursement of a certain level of CAPEX. This is definitely creating a competitive setup but don't forget that we have also products that cannot travelling so easily. It is complicated to deliver for Morocco customer that would be located in Czech Republic like Skoda for example or Volkswagen. So, we use Morocco really to attack the south European market that we could difficulty serve from our footprint in Czech Republic. So, the proximity to the customer is important to us.

When you compare ourselves to the other competitors that are located in the south European market, you see that they still have an important presence in France and in Spain. So, even if we have a competitor that has already a plant in Morocco, they cannot really make Moroccan price because they cannot close affairs, some serious issues with the unions in France or in Spain. So, they have to make some kind of average price for the region. For us, we don't have this constraint. So, we have really Moroccan costs. So, we can be more competitive but also we can be more profitable. That fully answers your question.

Jatin Kalani: Just a follow-up on this to Srini. We have seen the tax rate go up this year from 15% to 19%. For next year, given that Morocco is 0% tax. I don't know whether you have some tax benefits in Brazil as well but broadly what kind of tax rates should we be working with?

T. R. Srinivasan: Actually, in FY18, the tax rates are especially lower because we had significant tax credits in Czech Republic. So, this year that has come down to some extent plus the mix of profits from VLS in India also changed. There are more profits in India where we have a higher tax rate. So, that 21% whatever you are saying, broadly it will be in the same levels going forward, we don't see a major deviation to that. And of course, next year Morocco full year basis next level may not still be profitable because we still will be ramping up the operations during the year. So, the benefit of Morocco will come in the subsequent year. And Brazil there are no specific tax incentives as such at the moment.

Moderator: We have the next question from the line of Prayesh Jain from Yes Securities. Please go ahead.

Prayesh Jain: A few questions. First one, on the India operations, you mentioned that there is a lag impact of raw material price you have not been able to pass through. Basically, the two months have passed now in this quarter and do you think that you have been able to pass it on to customers or how has that been? Because in a couple of smaller we have seen that there have been some credit notes that have been issued or the pricing environment has not been very good from the OEM side. Is that kind of an environment that even you are witnessing or this would be passed through going ahead?

Tarang Jain: There can be an increasing trend in raw material prices and there could also be a decreasing trend. In the FY19, we saw an increasing trend. There is a minimum three months to a six months lag. Some customers are also they corrected to me after six months which means that you have to observe it for the six months and then they make it effective on the average of the past three months or six months. So, that it has obviously hurt us like it has hurt also our competitors but now we do see a softening in certain raw material prices. We see a little bit more stability at the moment coming in. I think post April 1st 2019, we do see things stabilizing. We have still to get a correction from April 1st. We also have to get a correction on January 1st in some cases but we basically know what we are going to get, but April 1st onwards, we do feel that the raw material prices will be more stable going forward. That is the sense we have at least for this particular first quarter of FY20.

Prayesh Jain: Secondly, on the China operations, what would be your assumptions for FY20 in terms of revenues and profitability?

Tarang Jain: I think we can comment on the revenues and maybe profitability generally but what I can see is that basically we have put in a small growth in our China operations when it comes to revenues and also in the profitability but not too much.

Stephane Vedie: We tried to be conservative about China like I mentioned earlier; we see a lot of volatility. So, I think when we look at 100% of revenue, I remind you that we own only 50% of the share of this JV. I think we budgeted for 900 million RMB in China. Still it is a profitable operation. We manage also to flex our costs. So, we are able to deliver similar level of profitability and even higher level of profitability in FY20. This is our target. The way we have budgeted is we think that the beginning of the year will be slow. April was kind of good news but we are very careful for May and June but like I mentioned, we think that after the new emission norms will be in place, we should see the market pick up. For sure, the market sentiments and the trade tensions between US and China are playing a big role. The people there are concerned. Some companies are downsizing there. So, we need to be very flexible, nimble, and agile. And this is the DNA of Varroc. This is what we are good at to adapt to these changing market conditions.

Prayesh Jain: Thirdly, on the EBITDA margins for VLS operations. When you say that you will hit a double-digit level in FY20, how much of that would come in from the benefits that you would possibly reap from the plant of electronics that starts operations in the second half?

Stephane Vedie: These electronic plants will start to ramp up at the very end of 2019 calendar year. So, the benefit in this fiscal year will be minimum. We are targeting to have an impact on fiscal year 21.

Prayesh Jain: So, around 60-70 basis points improvement can be expected in FY21 just from the electronics plant. That would be a right assumption?

Stephane Vedie: That's correct. The profitability in FY20 is really focused on the operations. The increased KPIs that we see in terms of OE in terms of cost projection, in terms of better utilization, and then purchasing continues to be an important driver force as well.

Prayesh Jain: Lastly, on the India operations again. The traction motor and the controller you have spoken about for the electric two-wheelers, what kind of potential it has?

Tarang Jain: There are two models to this traction motor and controller. One is that we have designed our own traction motor and controller for which we already have a customer for our own design. That is one model and once this is proven, we will take it forward to other customers also. Then, we are also getting enquiries for a build to print kind of a situation where the OEM had designed this motor and the controller and they want supplies from us. So, there are these two models. Depending on the customer, we will be supplying the motor and the controller. So, we have 1 customer today for our build to print and we have 1 customer where we are using our own design presently.

Moderator: We have the next question from the line of Basudeb Banerjee from Ambit Capital. Please go ahead.

Basudeb Banerjee: What would be the utilization of Czech Republic plant as of now?

Stephane Vedie: We have two plants in Czech Republic. The bigger plant is the plant that is located in Novy Jicin. The utilization is close to 85%. We have a smaller plant still in the same regions of Czech Republic. It is called Rychvald. This one is lower because this one depends a lot more from the customer JLR. So, this one I would say decreased a little bit to 65% but this is the plant where we are launching new projects for Renault and Volkswagen and we will be able to bring back the utilization in the next six months.

Basudeb Banerjee: Second thing as was asked by a previous caller, if I see in your standalone business, though 10% YOY revenue growth, bulk of the margin decline came from gross margin coming down. Is it purely because of raw material cost or some pressure from the OEM side where as you mentioned high inventory and lower wholesaling, so some kind of cost pressure is also trickling down to the ancillary supplier?

Tarang Jain: I presume you are talking about India, right?

Basudeb Banerjee: Yeah.

Tarang Jain: The first nine months, our capacity utilization was pretty good, but the main reason for our profits dropping has been the drop in sales of all our customers barring Bajaj Auto. Where we have seen a drop, this has led to the lower capacity utilization in those concert plants which would be more than half our plants. Utilization has been low. So, I would say at least 75% of the driver for profitability reduction has been lack of sales. And I would say about 15% to 20% probably would be more to do with the lag in the raw material pricing because this was the situation also in the first three quarters but some of us were still able to achieve at 12% EBITDA for the first three quarters. While in the last quarter, we kind of fell to just close to a double digit. It was mainly because I would say lack of capacity utilization. That was the major reason basically for our drop in profits because our investments are already in place and we could not utilize the capacities.

Basudev Banerjee: So, will it be right to assume that the lag effect of raw material pass on should get reflected soon and you are gross margins should revive back?

Tarang Jain: When it comes to raw material part, that 20% part will definitely I think we should be fine. But when it comes to the utilization part which is a larger part is something we have to wait and watch how things pan out now because at the moment, still there is pain. It is reduced but the pain is still there. Like I said, in our case, 50% we are fine when it comes to Bajaj but the other 50%, there is still some pain. We see some improvement in the month of May but we are still not there.

Basudev Banerjee: Sir, in the initial part, you said new business from Hero Moto and TVS coming down. If you can quantify the prospective business which will be delivering in FY20-21?

Tarang Jain: Some of the businesses which we have shown here actually largely probably may start in the last quarter of FY20, but these are the businesses more meant for 20-21 and 21-22 in some cases. Like the four-wheeler would be more I think towards 21-22 where we will see full impact of these sales what we have mentioned. When it comes to the two-wheeler parts when it comes to let us say TVS, Hero, and all that will be more in 20-21 that will realize full sales. But this year, we have not taken much of the sales in account for these businesses.

Basudev Banerjee: Any quantum you can say that in FY21, how much of new business from TVS and Hero?

Tarang Jain: TVS in fact like we have said, we should do at least 45 crores for one of the products, the magneto, which we have won. That is the sales revenue we will achieve in 20-21. Then, we have already put up a plant for Hero for lighting. So, lighting this year we see the revenue to be in the range of 35 to 40 crores in the new plant which is put up at Halol for lighting which will go towards 75 crores in the year 20-21. And then, we are also putting up for Honda towards the expansion. They are expanding the capacity from April 2020. We have won the business of seats and molding which is a business of almost 75 crores. This is something also we see happening in the year 20-21, but of course, this all also is dependent on how the market behaves in this full year FY20 because we do need some traction towards the positive side in volumes. Otherwise, some of these plants could get postponed because volumes would be important. Some increasing volume should be there going forward, at least from the second quarter onwards this year.

Basudev Banerjee: If I see your PAT of around full year 450 crores and depreciation around 550, so 1000 odd crores, more or less matching the CAPEX which Srini sir mentioned. Why this almost 700 crore rise in debt for the year and increase in dividend and also a major increase in debt. If you can explain that?

T. R. Srinivasan: The increase in a debt you see is basically because of the working capital movement from March ‘18 to March ‘19. In March ‘18, the working capital levels, especially in our VLS business was quite low because we managed to collect quite a lot of tooling receivables in the last quarter of last year and also because the payables were at a much higher level related to both CAPEX and routine raw material purchases. That got kind of normalized during the year and that is why you see the working capital level is now at a fairly stable level which will kind of continue. The current debt-equity level of about 0.7 is also what is a sustainable level which we have consistently done for the last three quarters or so. Going forward, this year, the CAPEX levels will come down because large part of the investments are done in the last couple of years. So, this year CAPEX plans are lower. That along with improved operational performance should see a positive free cash flow coming through for the year which is why we decided to propose the dividend what we have proposed you would have seen in the announcement which is about 65 crores payout total.

Basudev Banerjee: Any visibility on reversal in working capital cycle in the coming quarters or it will remain stable?

T. R. Srinivasan: It will remain stable now at this level.

Basudev Banerjee: Some media reports of you acquiring plastic business of Sintex, any comments on that?

T. R. Srinivasan: We have also seen the reports and obviously market rumors and speculations we don’t comment upon. Having said that, acquisition has been a part of our strategy in the past and will remain going forward. We keep evaluating various opportunities as they come by and when there is something concrete to announce, we will definitely let you also know.

Moderator: We have the next question from the line of Ronak Sarda from Systematix Shares. Please go ahead.

Ronak Sarda: A couple of questions. One on VLS CAPEX slide which you have put in the presentation. If I see the CAPEX amount and the revenue, the asset-turnovers are in a large range. Is there anything specific for these CAPEX amounts like for Brazil, Morocco, Poland, all have a very different asset-turnover ratio?

Stephane Vedie: If you want me to answer this question, I think it depends on the type of vertical integration we decide to put in different plants. Also, if we focus a plant on rear lamp or if we focus a plant on headlamp, headlamp requires different type of processes. You need off coating, you need base coating, you need BMC, you need multi-color injections. So, it is all depending from the mix of products we are defining on putting in the respective plants. Morocco, this is the plant where we decided to have a high level of vertical integration because there are not so many supplies around in Morocco and so that was our choice.

In Poland, there are lot of suppliers in the regions. Our polish plant is also not so far away from our Czech plant. So, we decided to use some of the processes in the Czech plant to ship up the Polish plant like BMC for example, this is the set production for your reflector. This is the reason why you see different scenarios based on different plants. I think important to see is the ratio between CAPEX and incremental revenue. This is where we are trying to follow a line of multiple. This is what we are trying to follow.

Ronak Sarda: Just a clarification on the launch cost. What kind of costs are these? This is just like a trial production run when a new product is being launched? And are these reimbursed by the customers given the quantum of these costs is so high?

Stephane Vedie: When you make a new facility, then you need to hire the people and you need to train the people. In order to train the people, you need to make parts that are not yet fully validated so that you are cutting. So, that is part of the training your people. The customers are not paying for this, but this is part of our economical scenarios when we are putting in place a business case for new plant. This is part of our quotation but formally the customers would not like to pay for this. In some cases, in some countries, we managed to have reimbursement of some specific training costs especially in Morocco for example, and I think in Poland, we will have a deal also to get back some training costs.

Ronak Sarda: So, these are related more at the new plants, not at the existing plants which have been running for some time.

Stephane Vedie: In the existing plants, we have existing labor and it is easier for us to ramp up because we have experience so that can teach the newer ones if we need newer ones.

Ronak Sarda: Second question is for Tarang on the India business. In your opening remarks, you mentioned fuel injection system for Hero. In the presentation, you highlighted BS-VI crankpin. Is it the same thing you are talking about or….?

Tarang Jain: I never said for Hero. For Hero, we are doing the crankpin which is one of the regular products which is an engine part. That is just an additional business which we have got. I don't think there is much of a change because of BS-VI in the crankpin area. That is an ongoing part. It will just one another product from Hero other than what we do already on lighting and some painting and molding for Hero. Regarding the fuel injection, I mentioned our first customer and the only customer at present is Royal Enfield. We have received a share of about between 250,000 to 300,000 kits per year for the full year starting April 2020. That is our share of business where we will be supplying the two major components of this fuel injection system which is the ECU and the throttle body. But there are lot of the other parts like injector and lambda sensor and these are all actually commodities. What happens is the OEMs directly negotiate sometimes with the suppliers, but of course, we do the integration of the whole EFI system. So, for us, the critical products of throttle body and ECU, we cannot give it to anybody else to supply. Other parts of the system are fine but we help the OEM do the integration of this system into their vehicle. That is about the fuel injection.

Ronak Sarda: This would be in the JV?

Taranga Jain: This is a part of the JV which we have Dell'Orto. It is a 50/50 JV. Having said that, there will be no production in the JV. The sale will be through the JV. The production of ECU will be done in our electronic facility and the throttle body will be manufactured in the current throttle body plant of Dell'Orto which is also in Pune.

Ronak Sarda: If I am not wrong, in the ECU, the main content is of the software. That is being done in-house. That is what you mean, right?

Taranga Jain: Yeah that of course will be done in-house. This is the software part of the ECU of course which is the heart of the system and also the integration of the whole system with all the parts into the vehicle. It is something which we have to work with the OEM on the integration part. That is something also which the JV is doing.

Moderator: We have the next question from the line of Niranjan Sakhalkar from Acuitas Capital. Please go ahead.

Niranjan Sakhalkar: I had a question on the VLS business, specifically the business win from Renault Nissan. Given that you are expecting to supply Renault both from the Brazil as well as the Morocco plant, is the €27 million business win in line with what you had expected?

Stephane Vedie: Yes, don't forget that we have won also some important business with Renault in the fiscal year '18. The order is the big project, the big platform of that share-branded vehicle of Renault, we won in the fiscal year '18.

Niranjan Sakhalkar: So, this €27 million win is in line with what you had expected? Because our understanding was that in the next few years, Renault is going to become a significantly important customer in terms of your order of customers. So, this €27 million win, is it in line with what you are expecting, then?

Stephane Vedie: Yes, we are expecting to do about €100-110 million of revenue in fiscal year '24 with Renault. We have won already around 70 million in fiscal year '18. This addition of 27 million in fiscal year '19 and then we have all the opportunities coming up in fiscal year '20. So, we are following our matching orders.

Moderator: We have the next question from the line of Joseph George from IIFL. Please go ahead.

Joseph George: Just one simple question. Throughout this call, you have highlighted how lack of scale or lack of volumes was the reason for the sharp drop in EBITDA margin but the simple thing I am noticing here is that if I look at your 1Q revenue, it is 1043 crores. If I look at your 3Q revenues, it is 1056, not materially different. And when I look at your 4Q revenues, it is 1024, maybe a difference of 2% or 3% at best. And we have seen EBITDA margin drop from 11.9 to 8.7. That is a drop of more than 300 basis points. So, I am not able to understand how revenue drop from 1056 to 1024 QOQ results in such a big drop in margins and you are highlighting lack of scale being the reason?

Taranga Jain: One is that you have seen the rising raw material prices from first quarter to Q4. So, we have to go on the volumes actually. One is that you have to see what has been the sale of every product in Q4 compared to Q1. Barring Bajaj Auto, the volumes have actually decreased for most customers. Plus, for the forthcoming revenues, there are some new plants and some expansions. You have been building some overheads – manpower or some other overheads – you have been actually building for the sales which have not materialized which is added to the cost. These are some of the reasons by which where our margins have been impacted. The point is that it is very difficult to be able to predict what is going to happen because there is no real volume warning given by any customer. They will only give you a volume warning for the coming month and sometimes, even that is not realized. So, we are in a situation today that it is very difficult for an OEM to predict what is next month's volumes are going to be really. Even those may not be materializing. But today the problem is that we have to be anyway building capability and capability building is not only from the plant angle, even on the engineering side. We are coming up with new products to do with BS-VI or even on the EV side. We are doing a lot of investments there. So, we have to also now start building the engineering side of things like we are building up competencies on software, on systems engineering, simulation, testing validation. Those investments cannot stop just because the markets have dropped temporarily. These things do happen, but having said that, yes we have seen a drop in quarter 4 but we continue to be very conscious. In VLS also, we have seen the turnaround what has happened in the major plant in Czech. Here also, whatever the concerned plants where the volumes have dropped or even otherwise, we do drive efficiencies. So, we will see improvements in margins. Irrespective of whatever the volumes are, we will see better margins going forward. That you keep flexing costs depending on the situation. But certain things you cannot avoid like engineering costs, you cannot avoid it.

Moderator: Ladies and gentlemen, that was the last question. I now hand the conference over to the management for closing comments. Sir, over to you.

T. R. Srinivasan: I think we have covered all the major topics quite exhaustively. We would like to thank everyone for your participation in the call and for the interest in the company and we look forward to staying in touch.

Moderator: Ladies and gentlemen, on behalf of Varroc Engineering Limited, that concludes this conference call. Thank you for joining with us and you may now disconnect your lines.