S H Kelkar and Company Limited

Q1 FY17 Earnings Conference Call Transcript
August 10, 2016

Moderator Ladies and Gentlemen, Good Day and Welcome to the SH Kelkar & Company Limited Earnings Conference Call. As a reminder, all participants' lines will be in listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing * and then 0 on your touchtone phone. Please note this conference is being recorded. I now hand the conference over to Mr. Anoop Poojari of CDR India. Thank you and over to you, sir.

Anoop Poojari: Thank you. Good Afternoon, everyone and thank you for joining us on S H Kelkar & Company's Q1 FY17 Earnings Conference Call. We have with us Mr. Kedar Vaze – Whole Time Director and CEO; Mr. B. Ramkrishnan – Director, Strategy; Mr. Tapas Majumdar – CFO and Mr. Shrikant Mate – V.P., Strategy of the Company.

We will begin the call with opening remarks from the management, following which we will have the forum open for a Question-and-Answer Session. Before we start, I would like to point out that some statements made in today's call maybe forward-looking in nature and a disclaimer to this effect has been included in the Earnings Presentation shared with you earlier.

I would now like to invite Mr. Kedar Vaze to make his opening remarks.

Kedar Vaze: Good afternoon everyone and thank you for joining us for our First Quarter Financial Year 2017 Earnings Conference Call.

I will begin by taking you through the Operational and Financial Highlights of the quarter and we then look forward to taking your Questions and Suggestions. We have begun the financial year on a strong note with healthy performance in both Fragrance and Flavor businesses. Total income increased by 16% to Rs.256 crore and growth on constant currency basis was 15%, EBITDA grew by 20% to Rs.51 crore, PBT was up by 59% to Rs.44 crore and PAT improved by 41% to Rs.28 crore.

I would like to highlight here that as per statutory guidelines the Company has implemented the new accounting standards and we have reported our financials under Ind AS. We have included the details in our earnings presentation, although there is no significant net impact on our financials in the accounting change.

We have reported positive growth on the back of solid demand witnessed in the domestic markets; revenue in India grew by 21%, assisted by better realizations and volumes while overseas revenue grew by 6%. One of the key developments for the quarter was the successful integration of Hi-Tech Technologies Company we acquired in the first quarter into the Flavours division of the company. This along with significant offtake in the domestic and overseas markets enabled us to report strong results in the Flavours segment, registered a robust 208% increase year-on-year with both Domestic and Export business growing by 174% and 257% respectively. While the Fragrance division forms a major part of our revenue, contribution from the

Flavours business increases to 14% during the quarter compared to 5% in the corresponding quarter last year in line with our long-term strategy of accessing both Fragrance and Flavours market. I would like to emphasize here that the Flavours industry is a high potential segment for the Company and we foresee a number of opportunities to augment our market share going forward in a relatively more fragmented industry.

Our Fragrance business grew by 5% during the quarter with Domestic revenue showcasing healthy growth of 13%; however, the Overseas business reported subdued performance owing to slower demand witnessed in some markets and lower rupee realizations.

Coming to our operating profit, EBITDA has improved by 20% to Rs.51 crore and margins expanded to 19.7% as compared to 19.1% in the corresponding quarter last year. Margin improvement was primarily due to better realizations, higher profitability in the Flavours business and contribution from the new business acquisitions. Profit before tax was up 59% to Rs.44 crore, net PAT increased by 41% to Rs.28 crore. Our profitability was significantly ahead of revenue and EBITDA growth owing to operating and financial leverage in our business. In addition, change in depreciation policy led to lower depreciation charge during the quarter.

S H Kelkar & Company is a research-driven company and we have invested significantly on R&D over the years. We have a strong and dedicated research team of 18 scientists operating in our facilities in Mumbai and Barneveld. In the last four years, the team has developed 12 molecules and we are the only company of Indian origin to file patents globally in the field of Fragrances and Novel Aromatic Molecules. We also have a team of Perfumers, Flavourists, Evaluators, Application Executives in our five Creation & development centers (CDC) in Mumbai, Bangalore, Netherlands and Indonesia for the development of our Fragrance and Flavours products. As you are aware, our products are a blend of large number of ingredients and are created exclusively by Perfumers and Flavourists to produce proprietary formulas. Fragrance and Flavours are considered to be one of the most important factors for consumers in deciding whether to repurchase the product, thereby making them one of the key components of FMCG goods.

Our creative and consumer-centric research through R&D and CDC work in collaboration with our customers to understand consumer preferences and offer innovative products and solutions. Innovation from our research and development and creation is a basic prerequisite for sustainable success of the company. Going forward we plan to increase our investments in research and development that will drive product innovation and ultimately lead to customer acquisition at a global scale. Keeping this in view, we have revisited our accounting policy for R&D expenses. We will be amortizing certain amount of development cost incurred on eligible products under development and prudently write-off the cost over the next three years. The amortized expense this quarter was Rs.3 crore.

To sum up, we foresee notable traction in domestic demand led by healthy expansion in the FMCG sector. We are confident of our business model's ability to leverage on this growth and deliver above industry growth rates and expect to record a CAGR of 15% over the next five years. Our leadership position in a niche industry with increased investments in R&D to drive product innovation which will ultimately lead to better margins and a unique business model should enable us to create sustainable value for all stakeholders.

This brings me to the end of my discussion. Thank you for your time. I would request the moderator to open the forum for any Questions and Suggestions that you may have.

Moderator: Thank you very much, sir. Ladies and Gentlemen, we will now begin the Question-and-Answer Session. We have a first question from the line of Kunal Jagda from Keynote Capital. Please go ahead.

Kunal Jagda: Sir, I have a couple of questions: My first question is what was the major reason for high growth in Flavours business? What were the measures taken to reduce the operating expenses which lead to higher operating profits in Flavours business?

Kedar Vaze: We have two sections for growth in Flavours business. As we talked about last year, towards the second half of last year, we have seen a lot of degrowth in our Flavours Exports business. This quarter the Flavour Exports business has resumed to normal business and therefore we see increase in the sales volume and the revenues. We have been continuously investing in new product development for the Export Flavours and this has also resulted in a large number of adoptions of Flavours in the Export market. So combining resumption of normal business and new wins, the Export market has grown by almost 250% over the same quarter last year. As regards Domestic Flavours, we have almost 25% growth of business year-on-year in line with our strategy and discussion. In addition, we have Rs.9.8 crore revenue in terms of the HTT acquisition which is added to our Domestic Flavours. So the Domestic Flavours like-for-like existing business has grown by 25% and additional revenue has come in by way of the revenue from the acquisition. As regards operating margins, due to the synergies coming in from the acquired company, we have been able to improve our operating margins on the Flavours business.

Kunal Jagda: Do you expect the demand will maintain for the Exports market going further?

Kedar Vaze: There is no unusual demand in the first quarter; this is a normal demand which was unusually low last year due to various geopolitical scenarios.. In Flavours there is some level of seasonality because of the Flavours for summer and winter products and we would see the same seasonality play out in the Flavours sales. So I expect although this quarter has not been an exceptional sales quarter, there will be some slowdown in the second quarter and will pick up in the last quarters of the year which is in line with normal trend in Flavours.

Kunal Jagda: My next question is about capacity. Sir, can you just tell me what is the installed capacity and how much is your utilization?

Kedar Vaze: Across all our plants in total we have a utilization of around 45% of the installed capacity. In the Fragrance Vashivali plant, it is around 40%, we have invested in our Mulund plant further last year and that capacity also is now on-stream. So all the plants in India we are running between 40 and 45% capacity. As regards our operations in Europe, the capacity utilization is around 75% and we do not have any additional investments in that plant over the previous year.

Kunal Jagda: Sir, in your earlier con-call, you mentioned that for every 15% increase in capacity utilization, your revenue will be doubled. So when can we expect the next leap or what would be the phase or how much would be the next leap in the utilization of capacity?

Kedar Vaze: In our industry, we are suppliers to multiple customers across different brand categories both in Foods as well as FMCG Fragrance products. There is no single driver that one product kicks in and the capacity gets utilized. So there is a consistent increase in revenue and consistent increase in capacity utilization year-on-year.

Kunal Jagda: In terms of number, can you just give me the installed capacity?

Kedar Vaze: So on the Fragrances we have a capacity of making 25,000 tonnes and on the Flavours I would think it is around 2,500 tonnes. Although it is difficult to estimate on Flavors because it maybe concentrated flavors or diluted flavors, it is a batch process. So net utilization is difficult to judge. But we will be in a position to make 2500 tonnes of Flavours which is at the moment almost twice of our capacity.

Kunal Jagda: Fragrance market share and Flavours market share, can you share that sir?

Kedar Vaze: We have no immediate data on the market share, but last year our market share on Fragrances was 20.5% and on Flavors was 2%. We have consistently grown above market growth in both Fragrances and Flavors. So our market share should be in excess of 21% in Fragrances and 4.5% on the Flavors on the back of the HTT acquisition, although this is a guesstimate from the management we do not have a third-party report to that effect.

Moderator: Thank you. The next question is from the line of Abneesh Roy from Edelweiss. Please go ahead.

AbneeshRoy: Sir, my question is on your Flavors division, you have done quite well. Ex of the acquisition you have grown 25%. So how much is pricing growth here and volume growth? Currently, you have 400 consumers here. So from 2-3-years perspective, how much is the ramp up you expect in terms of this?

Kedar Vaze: I would just correct part information there; we have grown our Domestic Flavours by 25%. Our Exports Flavours has grown by 257% which is completely organic. So Rs.9.8 crore of the revenue in domestic market is what we have acquired through HTT. This is all volume growth, 0% pricing.

AbneeshRoy: Why Exports have risen so much – is it sustainable? You mentioned Q1 is high and Q4 is high. So if you could explain the reasons behind that?

Kedar Vaze: If you look at say two years ago, our Exports Flavours was around Rs.36-37 crore in the full year. We have done Rs.16 crore in the first quarter this year. If you take 20-25% CAGR growth year-on-year we are on track with that number. Last year sales was much subdued because of various geopolitical situations in the region, particularly in the Middle East and therefore our sales were affected in the second half of last year.

AbneeshRoy: This 25% growth in domestic, so what is driving this? This is a good number, but clearly seems you are adding new consumer. So any insights you can give how sustainable is this, how many new consumers you plan to add from 2-years perspective?

Kedar Vaze: Just on the Flavours strategy, we continue to grow at 25% CAGR, we have ambitions to continue to grow at a fast pace. Towards that we have almost doubled our strength in the development and sales and marketing teams required to sustain this growth.

AbneeshRoy: Margins sir in Exports and Domestic, could you give us some color for both the segments of your business?

Kedar Vaze: As far as Domestic is concerned, we have 4% improvement in the Domestic Fragrances on the gross margin side. In terms of the Flavours, it reported the same margin profile as previous years. On the export Fragrances, we have a 1% increase in the cost of products vis-à-vis last year same quarter.

Moderator: Thank you. The next question is from the line of Jasdeep Walia from Infina Finance. Please go ahead.

Jasdeep Walia: What was the rationale for acquiring PFW and why has this entity been making losses or negligible profit in the last two years?

Kedar Vaze: I think the PFW entity is very incorrect way to look at the business. PFW forms part of our integral operations of Fragrances and Fragrances supply chain. To that effect, we have built the plant in Vapi to better utilize capacities and produce product at the right locations with the best cost structures, Fragrance Ingredients is an integral part of our Fragrance segment, so we do not look at it independently. Our operations in India and Overseas are also fungible in nature. So we can produce as per demand. What I want to focus is that the customer engagement is intact and it does not matter to us whether the orders are received and serviced from India or from Europe as the decision is based on consolidated level profitability and maximizing the operating efficiency and not at the subsidiary level. Overall, we evaluate the strategic nature of this business periodically, based on which our board will decide if this business requires any considered action, investments to rejuvenate itself. Having said that any investment decision would be based on how attractive the payback is or if it is strategic in nature. So the PFW business, in isolation is a very different thing to look at because we are using it as one of the production sites to optimize our production capabilities.

Jasdeep Walia: Sir, did PFW give you access to some kind of network in Europe which has allowed you to make inroads into that market?

Kedar Vaze: Yes, PFW has access to customers like P&G and markets like US. In addition, PFW has a proven track record of bringing new molecules to the market and have the systems of regulatory, toxicology and other analysis required to bring new products to the global market. So we are leveraging on these two platforms that PFW offers the group.

Jasdeep Walia: Sir, does PFW make an ingredient which goes into Fragrances or it makes the final Fragrance also?

Kedar Vaze: It makes largely ingredients which go into Fragrances.

Jasdeep Walia: So then how is it dealing with P&G because I guess P&G would be buying finished Fragrances rather than ingredient?

Kedar Vaze: So P&G buys both ingredients and finished products.

Jasdeep Walia: Sir, in your Annual Report, you mentioned that in FY'16 there was a headwind on account of the PFW business, you said that the research-led Aroma Ingredients business did not perform well on account of technology transfer issues from PFW to the new Vapi plant. So could you elaborate on this point?

Kedar Vaze: If you look at the entire business we invested in additional capacity at our Vapi plant, if you go back to the IPO RHP, we had almost 100% utilization in our PFW plant at the time prior to the investments at Vapi. So these two or three years are period where we are transferring products which have a higher demand but the production capability at Barneveld is at maximum and hence moving them to Vapi location. So while the revenue remains the same, we have now moved the products to facility where we are ready for growth.

Jasdeep Walia: So there were issues in the technology transfer in this …?

Kedar Vaze: There were delays in the technology transfer in what we had originally planned, but there were no technical issues, the products have been transferred, we are now poised to maximize our gains on the product transfer.

Jasdeep Walia: So what kind of gains are you talking about?

Kedar Vaze: For many of these products we are only covering 20% or 15% of the market because of the previous capacity constraints. So we have now opened up additional capacities which will enable us to access larger markets.

Jasdeep Walia: Sir, the margins in this business, when the capacity scaled up, would ultimately converge to the base margins of the company or they are lower?

Kedar Vaze: It will be close to the base margin of the company.

Jasdeep Walia: As of now the margins in this business are zero or let us say single digit levels?

Kedar Vaze: If you look at the margin, only in the PFW subsidiary then you will see a zero margin scenario, but if you look at the business as a total you will end up with margin. Last quarter and previous quarters where we were transferring products, at the moment we are running cost on both the sides for the products because we have to manufacture in both the locations. Once the product transfers are completed, I think we have ability to adjust the cost according to the product mix.

Jasdeep Walia: Sir what could be the potential turnover of your Vapi plant on full utilization?

Kedar Vaze: About Rs.200 crore.

Moderator: Thank you. The next question is from the line of Jignesh Makwana from AMSEC. Please go ahead.

Jignesh Makwana: Can you just tell me what is the volume growth for Fragrances division?

Kedar Vaze: While we do not track a specific volume growth because there are new products. It is in line with our long-term average which is about 10% volume and 3% average price rise and 2% new products added for the year.

Jignesh Makwana: But we have mentioned some realization gain in your presentation. So can you quantify that realization gain?

Kedar Vaze: The realization gain is in terms of our strategy where we have also optimized our supply chain. There are some benefits coming out of the cost optimization. We have better margins of the products that we are selling.

Jignesh Makwana: Last quarter we have started new service ready-to-use Fragrances. So can you give some details for this quarter?

Kedar Vaze: We mentioned last quarter that this is a new business model which we are adopting with certain customers and in line with that even this quarter we would have revenues of around Rs.12 crore in the service product. That is the kind of trajectory we see going forward.

Jignesh Makwana: So in FY16 we have some inventory days of about 132-days. So what kind of improvement we are expecting on that front?

Kedar Vaze: I think again inventory we need to relook in terms of longer-term. We will be bringing this down, so if you look at a 5-year trajectory, we have brought it down from 180 days working capital to 140 days; it is stabilizing around that figure now. We have taken a number of supply chain initiatives post SAP which will now start to play out. At our unit at Vashivali we had additional line installed and operationalized at the end of June. If you see the stock levels are higher than normal and we see that will come down through the next quarter.

Jignesh Makwana: Did the compulsory shutdown of our Netherlands plant in April impact our overseas performance in this quarter?

Kedar Vaze: Yes, we have unabsorbed fixed cost for the first quarter because of the shutdown. That is quite normal and it will average out over the full year.

Jignesh Makwana: In terms of the revenue and some business performance?

Kedar Vaze: We have had to defer some revenues to the future quarters due to the stock position on account of the shutdown. I do not see any loss of business. The demand continues to be strong, the customers continue to be with us, there is a timing effect of the shutdown that we have requested customers to either prepone or postpone their orders on the supply situation. So everything has been managed as was expected and budgeted.

Jignesh Makwana: So can you just quantify the deferment of revenue to the next quarter?

Kedar Vaze: It is not substantial but I would typically say about 30 tons of Tonalid should translate to around Rs.3 crore of revenue.

Moderator: Thank you. The next question is from the line of Pulkit Singhal from Motilal Oswal AMC. Please go ahead.

Pulkit Singhal: This is from the asset management division. Can you just give an outlook for the Fragrances Exports because it was down 10% year-on-year; we have lesser understanding of the Exports market?

Kedar Vaze: On the Fragrances Export as you are aware the global scenario is not a very high growth environment. So we have adopted a strategy from last year to focus on the right product mix, a profitable sector of the business. And we have been focusing on margin protection and growth rather than on looking at the large volume top line growth. So the strategy has been focused on the bottom-line growth and therefore the top line revenue actually has shrunk in this quarter vis-à-vis same period last quarter. Some of the products where the margin was very low or almost negative, in some cases, we have eliminated from our product mix. On the other side, we now have our new investment in place, as we call it Keva Group plant which is fully operational. The additional line is focused on Fine Fragrance and Beauty Care sector for the Export market where we have already started to develop new products and sample them through to our customers. We will see that the revenue will pick up in the second half of the year.

Pulkit Singhal: But from a 2 to 3-year perspective, should we expect this division to grow revenues and profits?

Kedar Vaze: Yes, so from a profit point of view even this quarter we have a 5% improvement in operating profit vis-à-vis last year and I think we continue to see both top line and profit growth. The product rationalization that we have undertaken is almost completed, so we have no revenue loss expected going forward and then we expect to grow at 8 to 10% year-on-year on both top line and corresponding benefit of operating leverage will follow on the bottom line.

Pulkit Singhal: Secondly, on the raw material cost, I think you mentioned you had 4 percentage points gross margin expansion in domestic Fragrances. Is that right?

Kedar Vaze: Yes.

Pulkit Singhal: What are the trends we are seeing in the raw material cost?

Kedar Vaze: I think it is a mixed bag, there are some raw materials where the prices have shot up quite high like Orange Oil, Citrus Oil where the climatic conditions have not been conducive and some other products particularly the bulk commodities in Turpentine chemistry, there prices have come down. So overall we had a saving of about 2% on the cost base and additionally we have been able to implement some supply chain rationalization and in-house production where we have been able to save cost on the raw materials.

Pulkit Singhal: So of the 4% margin expansion, you are saying 2 or 3% is due to raw material cost and maybe 1%-odd from product mix, is that broadly right?

Kedar Vaze: About 2% is product cost declines on the full basket, 2% is our product rationalization and in-house development.

Pulkit Singhal: Should that continue for the rest of the year as well?

Kedar Vaze: I think we are at 55% more or less COGS which is in line with our expected margin profile.

Moderator: Thank you. The next question is from the line of Suvarna Joshi from SMC Global Securities. Please go ahead.

Suvarna Joshi: You mentioned in your presentation about numerous small firms being in the unorganized market and also you have said that we will be doing tuck-in acquisition. So, is this a strategy going to be focused only for the Flavours business or are we also looking to adopt this particular strategy in the Fragrances business as well?

Kedar Vaze: Our strategy is largely focused on the Flavours business, because the Fragrances market is already much more consolidated in the industry, we are not averse to looking at any strategic position or acquisition possibility whether it is Fragrances or Flavours, but as an active strategy we need to grow our Flavours business to critical mass in a very quick manner. So it is focused on tuck-in acquisitions on Flavours.

Suvarna Joshi: So in this context, I think we had taken over Rasiklal company which was one of our distributors in the northern region. So are we seeing any benefits of that also come in, in this particular quarter in terms of the supply chain rationalization that you have mentioned?

Kedar Vaze: Not really. I think the RHAPL does not fall part of the supply chain. As they are not distributors, they are actually a marketing and sales office. We have taken over the office and we will continue to deploy our own marketing and sales personnel in the market for further growth.

Suvarna Joshi: But if I remember correctly, RHAPL when we acquired we had mentioned that we will gain access to some new customers in the northern region where RHAPL has good relationships with. So it was in that context that I wanted to understand have we been able to get in any new….?

Kedar Vaze: Customer relations have been transferred to a company personnel and it is an ongoing process, it is not an overnight process as you can understand. So we are committed to that process, the transition is smooth; we have no hiccups of any customer loss or any relationship being lost within the group. RHAPL continues to be working with the company, they have been our agents in the north for 50-plus years and although not formal role in the organization, they continue to be part of the advisor and help us take over the customer relationship.

Suvarna Joshi: The second question was taking the point from the earlier participant on the raw material front, what is the trend that you are seeing going forward – do you expect this 2% decline that we have seen in the cost basket to continue or should it increase or decrease going forward?

Kedar Vaze: I think the 2% decline in the cost on the raw materials is a global phenomenon and we are not planning or anticipating any further decline. As relates to our R&D efforts in further cost optimizations and saving production cost, we continue to invest heavily on that and we would see some benefit of that as we go forward. I think the benefits would be quantifiable year-on-year but there is no specific target per annum.

Moderator: Thank you. The next question is from the line of Vicky Punjabi from JM Financial. Please go ahead.

Vicky Punjabi: Just on the balance sheet side, this quarter we are showing a net debt of Rs.24 crore vs Rs.31 crore net cash in the previous quarter. I understand that HTT acquisition was supposed to cost us Rs.25 crore. But what could be the balance attributable to?

Kedar Vaze: As I mentioned, we operationalized our second line in our Vashivali factory and that was targeted for end of June when we have the lowest demand. So, we had a higher stock level. So the end of June is not a correct picture of the inventory levels. In addition, we also had the RHAPL acquisition in this quarter.

Vicky Punjabi: RHAPL acquisition that costed us I think around Rs.5 crore, right, the balance being mostly cash?

Kedar Vaze: Yes.

Vicky Punjabi: How much did we spend on this Vashivali factory?

Kedar Vaze: We did not spend too much. I think it was part of our operating expense. What we needed to do is shut down the full line reorganize to have two lines operationalized. The bulk of the investment was already done, but we took the opportunity to update our software, computer systems and so on and so forth. So, I think the CAPEX was quite small, I think Rs 1.5-2 crore of CAPEX, but it was largely organizing the operations in the new manner which required us to shut down the operations for 7-days.

Vicky Punjabi: Going forward how are we seeing our cash flows then?

Kedar Vaze: The cash flow will continue to be strong, we had a large increase in inventory due to this Vashivali factory.

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

Anand Shah: A few questions: One on this Fragrances business domestic. Did you have any service income? Last quarter you had some Rs.10-13 crore of additional service income.

Kedar Vaze: Last quarter we had Rs.12 crore of service income, this quarter also we had Rs.12 crore of service income.

Anand Shah: So this was not in the base, right?

Kedar Vaze: This was not in the base.

Anand Shah: But then if I exclude that, then the organic Fragrances domestic business is not really growing very fast, why would that be?

Kedar Vaze: So it is a 5.4% growth over strong first quarter last year, if you look at the quarter-on-quarter progression first quarter last year was a better quarter because we had price increases for the second quarter and the seasonality of the festival. So particularly on the trade cobra brand products almost Rs.5-6 crore of additional sales in the first quarter last year

Anand Shah: But then this 5.4% should it grow at least in double-digits for the full year?

Kedar Vaze: Very close to double-digits.

Anand Shah: This service income, it will continue at this run rate for the next quarter as well?

Kedar Vaze: Just to put in perspective, first quarter last year was Rs.220 crore and the second quarter was Rs.193 crore, so on an average…

Anand Shah: Domestic Fragrances this time was Rs.154 crore, right?

Kedar Vaze: My mistake, but most of the Rs.20 crore decline in the second quarter was on domestic Fragrances.

Anand Shah: But this service income will continue at this rate for this year Rs.10 to 12 crore each quarter?

Kedar Vaze: Yes.

Anand Shah: Any guidance for the full year for HTT revenues? This quarter you did Rs.9.8 crore. so is this the run rate we should continue?

Kedar Vaze: It would be premature for us to judge the HTT business since we have only one real operating quarter of the business. There is a part seasonality in the business where there is a higher sale during the first quarter. So more sale in summer, lower sale during the rain where they try to reduce the production volumes. First quarter last year was Rs.6.8 crore, this year it is Rs.9.8 crore, so there is a 50% increase, partly price rationalization and partly volume increase. But it is too early to predict a trend because only one quarter and we do not have the full data of the previous many years. So once we continue to run operate this on a longer-term, we can better judge. I would just like to add that we are at 50% higher than what was the same quarter last year with HTT as an independent company. So that is a great quarter. But whether it will be 50% higher, 25% higher or 12% higher for the full year? We will only know when the demand for next quarters come in.

Anand Shah: This change in depreciation policy, can you just explain what exactly have you changed, because there is about Rs.3 crore fall?

Kedar Vaze: Depreciation, actually we are looking at the various methods as part of Ind AS, we have reviewed our comprehensive accounting policies and we are aligned to the SLM method which is what our industry globally all peers have been following. So…

Anand Shah: Earlier, you were doing WDV, now you have gone to SLM?

Kedar Vaze: Yes, so we are now following the same basis as what the international peers are following in terms of SLM in depreciation and moving weighted average for inventory.

Anand Shah: Depreciation, so we will see a similar fall for the entire year…Rs.10 to 12 crore fall?

Kedar Vaze: Yes.

Anand Shah: Tax rate why it has gone up so much?

Kedar Vaze: I think partly we have been conservative on our assumptions as regards 35 (2AB), you know the government has made a very clear policy, there are sunset clause on this specific tax basis…

Anand Shah: That kicks in 2018, right?

Kedar Vaze: Yes, that is one, so we have not taken that benefit in the first quarter, we will know in the second quarter the assessment of the previous year we will have a clear picture. So that is a conservative policy we have not taken the benefit on the R&D in this quarter. In addition, we have no deferred tax asset created on our PFW operations, although there were losses, as the accounting in Netherlands is different from the accounting in India on the tax treatment and we have not taken any deferred tax asset. Overall in line with our earlier guidance, we think we should have 27-28% effective tax rate in the full year.

Anand Shah: So this should fall materially down in subsequent quarters?

Kedar Vaze: Yes.

Anand Shah: Back on the Flavours, HTT had much higher margin than your normal Flavours business?

Kedar Vaze: No, HTT the gross margins are slightly lower, we have no real additional operating cost since we integrated into our own company. So the operating costs have been synergized, we have much lesser per kilo operating cost as a result of the HTT acquisition, the volumes have almost doubled, therefore our operating costs have reduced significantly.

Anand Shah: So this is pure leverage playing out in terms of margin expansion that you witness in Flavours?

Kedar Vaze: Yes.

Moderator: Thank you. The next question is from the line of Yashas Bhat from LKP Securities. Please go ahead.

Yashas Bhat: In terms of top line, what is the breakup of India and Overseas? We have also cited in the past about geopolitical reasons in the Middle East. So I wanted to know which specific countries are you actually having Exports in? What are the geopolitical reasons in exact?

Kedar Vaze: We are exporting across Middle East to UAE, Jordan, Saudi Arabia and a number of countries in and around. While the specific country where we export may not have the problems on geopolitical various supply chains into their markets in Turkey, Russia, North Africa, they have had disruption in the way that they could not supply the product to the end markets. Many of the companies in the previous year have relocated their factories where they have moved their factories to UAE or other regions which are not affected by any geopolitical situation and they have restored their business through different supply lines via sea port, avoiding any kind of areas of trouble or where they would have supply chain disruptions.

Yashas Bhat: Because on a strategic standpoint, you would want to expand more of global operations going forward. So how are you exactly looking at this now?

Kedar Vaze: There is no problem at our end, it is actually the demand from the customers due to their supply chain through the region being affected.

Yashas Bhat: I meant in terms of your plans of expansion globally going forward, you had mentioned that in your annual report?

Kedar Vaze: We are committed to our expansion plans on Flavours as well as Fragrances. So we now have our offices in Indonesia, which are fully staffed in development and sales and marketing. In Thailand, in Malaysia, we are also working with various distributors in Southeast Asia and Middle East and East Africa. So we will continue our geographic expansion into these regions both on Fragrances and Flavours.

Yashas Bhat: Also, in respect of the very strength of S H Kelkar has been going with the emerging regional players in the FMCG segment, but at the same time you would also be looking at the Procter & Gambles and the Unilevers of the world where Givaudan and other major global competitors have a major share in your domestic market as well as overseas. So what kind of inroads are you making in order to make sure that you enter into big FMCG basically?

Kedar Vaze: The answer to the big FMCG is we are continuously investing in our development capabilities to play the game in the larger accounts and larger brands. In addition, we are investing in basic research and we want to increase that investment in basic research for new molecules to allow our Perfumers and Flavours to differentiate the product and be able to better compete with the large global MNCs in these large projects.

Yashas Bhat: Would we be able to see any kind of traction in this anytime soon?

Kedar Vaze: It will be premature for me to comment on revenues. We are continuing our work through the approval of vendor, through supply chain of these companies, through their research and development teams to get our products in the testing phase. It is very premature for us to look at when this will materialize into revenue till we have a finalized product on the market.

Moderator: Thank you. The next question is from the line of Anuj Sehgal from Manas Capital. Please go ahead.

Anuj Sehgal: If I look at your presentation, the industry in India has grown at a 10% CAGR over the last four years, your revenue growth is closer to 13%. How much would you say is the organic growth and how much has been sort of delivered through acquisition? Secondly, you mentioned about 15% CAGR over the next five years. What will accelerate this growth rate over that period? Something related to what the previous caller asked, so how are you going to compete with the competition which looks mostly dominated by the global majors? Then maybe slightly on the same note, if I compare your EBITDA margins and your ROCEs with some of the global Fragrances players, your margins and ROCEs are much lower, the competitors margins and ROCEs are in the range of sort of mid-20s. So can you help us understand what will take your margins and ROCEs to that level or is there a fundamental difference in the way the business is done?

Kedar Vaze: I think the fundamental difference in the business model and in terms of the lifecycle of where the customers and their markets are. So most of these companies have almost 50% of their business in developed markets which are slow growing and they have done their capital expansion many years ago and their capacities in these markets are fully utilized or have been rationalized to a very small growth or almost zero growth environment. While our investments have gone in for a very large growth opportunity which lies ahead of us. So we have invested ahead of the curve and therefore our ROCEs which are much higher in long-term are depleted. So in the last 5 and half years as a total we have invested more than Rs.200 crore in capacity investments across different sectors at different locations. So it is a long investment cycle business. We have invested in capacities. As we start to reach 60 -65- 70% capacity utilization, our ROCE will start to improve. So that is a continuous trend.

Anuj Sehgal: What about on the growth -- so fiscal '12 to fiscal '16 12.9% is CAGR, how much is organic and how much is through acquisitions?

Kedar Vaze: Out of the total revenue of this quarter, we have about Rs.18 crore of revenue which has come by way of acquisition in last three years, not this quarter, annualized basis. I much rather answer this on end March 2016 because we have the full year revenue, we had only Rs.12 crore revenue which was acquired, the rest of the revenue of the CAGR was actually our own organic growth. This quarter everything is organic except the Rs.9.8 crore which is HTT.

Anuj Sehgal: Then what gives you the confidence that the next five years you would be able to sort of grow at 15% CAGR?

Kedar Vaze: So we have long years of being in this business… more than 90-years in this business, our own track record for long periods we have grown at (+15%) organic CAGR. So I think there is a lot of headroom both the Indian markets are growing fast and the market share in global markets where we are operating is quite small. There is a huge opportunity for us and that gives us the confidence that we will take this opportunity and be able to continue our growth trajectory.

Moderator: Thank you. The next question is from the line of Sandeep Baid from Quest Investments. Please go ahead.

Sandeep Baid: One, I wanted to understand in Fragrances or Flavours for a particular product, normally you are the only supplier or customer will have two-three suppliers for the same Fragrances for a particular product?

Kedar Vaze: Typically, there will be only one supplier.

Sandeep Baid: So you enter into a long-term contract with the customer?

Kedar Vaze: Actually, we do not enter into a long-term contract, we have an understanding both ways that the product is exclusively maintained for the customer, so we do not sell the product to other customers, the customer buys it from us. As the brand grows, the customer continues to grow, they continue to buy more of it from us. We do not have any binding contract in place, probably very few customers make contract, it is not kind of industry practice. Although we have one or two contracts of long-term nature with customers such as Godrej, where we have been supplier for well over 50-years, so there is enough knowledge and understanding and relationship to have long-term contracts. But industry practice is not to have any contracts in place, it is in-built in the way that the product is proprietary.

Sandeep Baid: So the products are basically customized for a particular customer and if you are supplying a particular product for a customer, you will not supply the same product to some other customer?

Kedar Vaze: That is right.

Sandeep Baid: Just wanted to understand the nature of the Services business?

Kedar Vaze: What has happened in certain of our product categories the customer is subsequently supplying the product to multiple vendors to produce the final product. So job workers have their own production facilities which are spread over the region all over India. Previously they were looking to add certain additional solvents or additional products to our product and then supply to all their vendors across the country. We have now undertaken to do that activity in-house. So we do the additional kind of addition of solvents or addition of active to our products. That product is directly supplied to their job workers across the country.

Sandeep Baid: So instead of you giving your ingredient to the supply chain, they gave their ingredient to you, you mix it and then supply to the final…?

Kedar Vaze: The ingredients are common solvents or emulsifiers or products like that. So there are well-known producers. We buy that directly, add it and we sell it. So we only do that as a service, we have a service agreement where a certain fee is charged for doing that rather than anything to do with the gross margins. The gross margin of that combined business comes down substantially. But we get our gross margin as regards the Fragrances or Flavours and then we have a service income which is only adding this product and supplying across to enable the logistics.

Sandeep Baid: Finally, you mentioned that you have amortized Rs.3 crore of R&D expense this quarter. How much was capitalized?

Kedar Vaze: Rs.3 crore has been capitalized. It will be amortized over the next 3-year period.

Sandeep Baid: How much was the total R&D expense that you incurred in the quarter in terms of cash?

Kedar Vaze: Roughly about Rs.7 crore.

Sandeep Baid: So Rs.4 crore was expensed in the quarter and Rs.3 crore was capitalized?

Kedar Vaze: Exactly.

Moderator: Thank you. We have a last question from the line of Mr. Aakash Manghani from BOI AXA Investment Managers. Please go ahead.

Aakash Manghani: I had a question on your Flavours division. I think this quarter the operating margin that you are reporting is 30%-odd versus last year 21%. I understand lot of it is because of the HTT acquisition. But could you give some guidance on what would be the normalized margin in this business over the next 2-3-years? What sort of growth rate are you looking at Domestic and Overseas combined?

Kedar Vaze: I think on the Flavours, we would have 25% CAGR expectation from Domestic as well as Export business on organic basis and operating margin on a long-term basis should be around 25% range.

Aakash Manghani: So, was there any one-off this quarter that led to 30% margin or …?

Kedar Vaze: Because we have integrated the HTT operations into our operations, there has been an operating leverage. So the additional capacity got utilized without additional large cost on operations.

Aakash Manghani: 25% CAGR and 25% EBITDA margin?

Kedar Vaze: Yes.

Aakash Manghani: With regards to inorganic opportunities in this space, if at all you are planning any in the near future, could you give some idea on what sort of revenue size or what will be the thought process behind them access to clients, access to specific technology or certain expertise?

Kedar Vaze: As regards the board mandate on the acquisition strategy, we have been mandated to look at tuck-in strategy of the acquisition where we will not look at very large ticket or the very large outlay for the investments. I would typically say that the sweet spot is around Rs.50 to 75 crore revenue or below that. In terms of strategy from technology or any other synergies, then we would look at it at a case-to-case basis. So, generally we would look at companies which are Rs.50 to 75 crore or below revenue as a tuck-in strategy acquisition. Anything which is either bigger than this or which is more linked to a technological synergy or technology advancement and so on and so forth, we would look at as independent case-to-case.

Aakash Manghani: Also, then your implied guidance which is 15% sales growth over the next 5-years, in effect, you are saying that your core business which is the Fragrances business would probably grow at a slow pace than it has grown over the last 4-5-years, because 15% of the business grows at 25%...?

Kedar Vaze: I think I would want to make a rider there that on a particularly Fragrance international, the market is large and we would like to play in the quality and premium sector and not in the bulk sectors where the margins are lower. So we are targeting profitability as our measure for growth and not the revenue. So the composite 15% would have a better quality of growth on the international Fragrances.

Aakash Manghani: So what sort of margins can ballpark one expect over 2-3-years down the line on the consolidated business -- the trajectory would be going towards early 20s or remain in this late teens band for you, how does that?

Kedar Vaze: This quarter already we are exceeding 20% as a margin profile.

Moderator: Thank you, sir. Ladies and Gentlemen, that was the last question. I would now like to hand the conference over to the management for closing comments. Over to you, sir.

Kedar Vaze: I hope we have been able to answer all your questions satisfactorily. Should anyone need further clarifications or would like to know about the company, please feel free to contact our team or CDR India. Thank you once again for taking the time to join us on this call.

Moderator: Thank you very much, sir. Ladies and Gentlemen, on behalf of SH Kelkar & Company Limited, that concludes this conference. Thanks for joining us and you may now disconnect your lines.

- ENDS –