S H Kelkar & Company Limited

Q4 & FY2017 Earnings Conference Call Transcript
May 12, 2017

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

Anoop Poojari: Thank you. Good evening, everyone and thank you for joining us on SH Kelkar & Company Limited's Q4 & FY 2017 Earnings Conference Call. We have with us Mr. Kedar Vaze – Whole-time Director and CEO; Mr. B. Ramkrishnan – Head-Strategy; Mr. Tapas Majumdar – CFO and Mr. Shrikant Mate – VP (Strategy) of the Company.

We will begin the call with opening remarks from the management following which we will have the forum opened for a question-and-answer session. Before we begin I would like to point out that some statements made in today's call may be 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 evening, everyone and thank you for joining us to discuss the operating and financial results for the quarter and the full year ended March 31st 2017. I will begin by taking you through the operational and financial highlights of the quarter and we will then look forward to taking your questions and suggestions.

Overall, we have reported stable financial and operating performance during the year, despite facing a challenging environment. The total income in FY17 grew by 6% to Rs. 992 crore, EBITDA improved by 11% to Rs. 177 crore translating into margins of 17.9%. The PAT grew by 44% to Rs. 105 crore. I would like to highlight here, that the consolidated financials give you a complete picture of the Company's performance. This quarter the standalone results are further distorted as we have started restructuring the organization into IP asset ownership (which we will consolidate in the holding company in SH Kelkar and Company) and operating companies where under the merger of KV Arochem and Keva Fragrances which was completed in the previous year. Consequently, the standalone business does not accurately represent our performance and we urge you to track the consolidated figures of the company.

Coming to our performance, demonetization and subsequent lower consumer demand adversely affected our entire FMCG industry in the second half of the fiscal. The subdued FMCG demand in turn affected the domestic fragrance business which grew at 7% during the year, while declining 12% in the last quarter. Further our overseas fragrance business was impacted by depreciating foreign currency and sluggish global environment which led to price pressures. As a result, our overseas revenue came in lower by 15% and 21% during the year and quarter respectively. However, the fragrance business reported healthy operating profit at Rs. 124 crore and margin improved to 14.5% as compared to 13.2% in FY16. We are constantly working on several cost benefit measures which should help lower our costs going forward. In addition we have finalized strategic investments in the fragrance division to improve overall operating efficiency along with enhancing our capacity in India. This will allow us greater flexibility in our operations and execute our plan to rationalize our backend manufacturing operations and leverage our existing presence in a low cost center as we expand our R&D and Creation & Development Centres in the international markets.

The Flavors division posted a strong growth in revenues of 113% to Rs. 124 crore with both domestic and export business growing by 155% and 80% respectively. The growth is a result of acquisition of HTT and integration of Gujarat Flavors during the last quarter. We have also registered a healthy 58% organic growth during the year by growing our market share in both the domestic as well as the overseas markets. The business saw strong growth in profitability with operating profits at Rs. 34 crore translating into margins of 28% as against 19% in FY16.

Moving on to some key developments, we have always maintained, we are a research driven company. Here, I am happy to share that we have been able to successfully commercialize one of our patented molecules and have recently commenced sale of products using these compounds. Although the current contribution is small, we remain excited and confident about the potential of this molecule. This is the first US patent office granted molecule of the company and with this commercialization it bears fruit to our R&D efforts on discovery over the last 5 to 6 years. Over the years our team of scientists has developed over 12 molecules and we remain one of the handful companies worldwide to file patents in the field of fragrance and novel aromatic molecules.

We have also executed the technology transfer agreement with the Tanishka products for acquisition of the Fragrance Encapsulation Technology and licensing agreement is in place. We expect this upcoming technology to provide the company unique opportunities in the future to offer differentiated fragrance products and solutions especially in the fabric and detergent applications. We have constantly invested in our R&D operations and established a wonderful team of perfumers, flavorists, evaluators, application executives spread across our five creation and development centers.

Continuing our focus on research, we plan to significantly increase our spending investments in the coming fiscal. These investments will concentrate on strengthening our creation and research team, improve operational and supply chain efficiency and most importantly drive product innovation and differentiation. We are confident that our plan to increase R&D investments in FY18 will create tremendous value for our stakeholders in the years to come and prepare us in advance for the expected growth in the FMCG consumption.

To conclude, our business closely tracks the performance of the FMCG industry, which is expected to rebound in the second half of fiscal 2018. In our business segments, we are already seeing an uptick in activity with more projects being approved by clients and new products being launched by FMCG companies. These positive developments will translate into higher growth for us over the next period of time. Overall, we are well positioned as the leading player in the unique Fragrance and Flavor industry and we believe we can sustainably outperform the industry growth rates, owing to our comprehensive product portfolio, strong balance sheet, diverse customer base and most importantly focus on differentiated products.

At this time, I would also like to inform all of you that we have a change in our key management personnel, the Board considered the request from Mr. Tapas Majumdar – Executive Vice President and Group CFO, to pursue career opportunities outside KEVA Group, he would be relieved from his role on May 31st 2017. The Board placed on record the considerable contribution made by Mr. Tapas Majumdar during his 5 years' stint in the company and whilst accepting his request, wished him all the best for his future endeavors.

With this, I would now request the moderator to open the forum for any questions or suggestion that you may have.

Moderator: Ladies and gentlemen, we will now begin the question and answer session. First question is from the line of Chintan Modi from Motilal Oswal Securities. Please go ahead.

Chintan Modi: The overseas business showed a significant decline in growth, can you highlight how much was contributed because of the forex impact and how much would be due to the volume impact?

Kedar Vaze: In the overseas fragrance business, there has been impact both in terms of price erosion because of high competition in certain markets and about a 3% decline in terms of currency restatement.

Chintan Modi: Was this in Q4?

Kedar Vaze: Yes.

Chintan Modi: How is the performance for ingredients business?

Kedar Vaze: While we do not track ingredients business separately, the operations in the Netherlands subsidiary have been under pressure for some time now. As we have mentioned earlier, we have taken up with the Board for a strategic investment, various options have been considered in the Board meeting today and I am happy to announce that decision has been taken on an outlay plan for strategic investments which will allow us to manage the manufacturing capacities in the best manner. So, that outlay has been approved by the Board and we will execute that over the next 2 quarters.

Chintan Modi: So we had a plan of shifting the production from Netherlands to the Vapi facility in India. What does the strategic investment mean?

Kedar Vaze: Strategic investment means investment in additional capacities in India and based on how the market pans out over the next period of time. We have seen a rapid decline in the last 2 years in the global demand for some of the fragrance related products. These typically go through a cycle and if, for example, supply demand equation changes; we will be prepared for both growth as well as declining scenario with the new investment. One of the options could be a relocation, the other option could be expansion and looking at different markets being serviced from different factories or multiple brand or different products been sold in different markets based on the price and quality requirements of each market.

Chintan Modi: The agri-basket has been moving up. A lot of raw materials form part of the agri-basket, do you see that impact flowing down into our numbers?

Kedar Vaze: We have very limited exposure to the agri-basket in terms of the commodities. Our exposure to agriculture products is limited to few products like Orange or fruit processing and it constitutes a very small percentage of our overall raw material cost.

Chintan Modi: For the domestic business for FY17, could you throw some light on the market share movement, whether we would have gained or lost? How have the competitors been doing?

Kedar Vaze: We believe that we have continued to grow our market share both on Flavors and Fragrances in the domestic market. I do not have any validated number but we estimate around half percent market share gain.

Chintan Modi: In the balance sheet, trade payables have come down from Rs. 163 crore to almost Rs. 110 crore as on March 31, 2017, any specific reason for that?

Tapas Majumdar: It is actually repayments that have happened and what we are trying to do is we relook into our payment cycle time to time. So, going forward, we should be able to see some better payments strategy in terms of expansion of our working capital.

Chintan Modi: This would have brought some pressure on your working capital is what I understand. So, is this some pressure from the vendors or if you can just explain a little bit more on that? Should we consider this as a new normal in terms of payables, payment days?

Kedar Vaze: There have been several payments which were due at the end of last year, which has been paid and also this year has been a normal payment year but we are looking at various options at this point of the time in order to increase the payable position.

Management: We have made payments out to suppliers at this point to take advantage of better exchange rate than what was in the budget.

Chintan Modi: Can you give some guidance on FY18 on the topline and the bottom-line?

Kedar Vaze: We maintain our view to continue to look at a double digit 12% to 15% topline growth year-on-year on a longer term. This has been a very difficult second half of the year in various markets due to different geo-political and economic circumstances and this would result in an uptick in consumption particularly in the domestic market in the years to come. We have already outlaid the product development teams and are getting ready for this uptick in consumption. I am happy in terms of our key developments, number of the patented products have seen and completed their cycle. They are now in commercial use and being sold as part of fragrance and with that we have completed the cycle from research, from first principles, from new molecule discovery all the way through regulatory toxicology in use, consumer understanding in use and completion and launching and commercializing the final fragrance formulation. So, we are confident that now that the first one is through, this will augur well for the differentiation that we can offer our customers and thereby we have now outlaid a 3-year plan for our teams where the spending on development, we will wish to increase offset by an improvement in the operating cost to maintain our long term EBITDA and growth rates.

Chintan Modi: On the margin front, do you see expansion happening?

Kedar Vaze: We are structurally in 20% EBITDA margin business, we have had some negative quarters in this year on certain parts of the business and we will continue to maintain that kind of margin profile and incremental operating leverage, we will continue to increase our R&D spend to prepare ourselves for faster growth rates in the future.

Moderator: Next question is from the line of Anand Shah from Kotak Securities. Please go ahead.

Anand Shah: On the domestic fragrance performance in Q4FY17, we have seen a decline of about 12%, is this largely through impact of demonetization or is there anything other to read into it?

Kedar Vaze: 4^{th} quarter of the last year was a very strong quarter and that continued in the first half of the year and as a result of demonetization and post Diwali, there was a pause in the launch of new products and pause in the market on account of uncertainty and the net effect of liquidity being difficult in the markets. So, we have seen that a lot of the wins that we had in the beginning of the year and the lot of the products in the pipeline were not launched as per schedule. The second half of the year saw depressed / slower growth in the market. While that is true, there has been good traction on new wins that we have and continue to win, while the products were not launched, they are all now in the pipeline in the initial trial. Orders have gone in the 4^{th} quarter, so we see that the growth pipeline is intact and this was a transient phenomenon through the last 2 quarters, last 2 months of December and January particularly.

Anand Shah: What is the other service income component in the fragrance business this quarter versus Q4 FY16?

Kedar Vaze: The service income in Q4 FY17 was also subdued. There was a lot of uncertainty and from GST and the effect of demonetization. So, I believe it will rebound and it will be again strong or normal quarter going from the first quarter this year.

Anand Shah: Growth of 12-15% should be re-doable in the next year from domestic side?

Kedar Vaze: Yes.

Anand Shah: Why would there be an impact on service income because of GST?

Kedar Vaze: There was sort of de-stocking by certain customers as in they did not want anything at the end of March and they wanted to buy up everything in first week of April. It was just uncertain and they had already planned accordingly and sent us the schedules accordingly.

Anand Shah: Once GST comes in, would you see an impact on service income?

Kedar Vaze: Once the GST dates are announced and it is very clear on what it would be, people would want to move to a low inventory position on the cutoff date and then schedule everything to come out in new regime.

Anand Shah: There wouldn't be any major impact from GST on your business?

Kedar Vaze: The exact rate of GST which will be applicable to our product range is not yet communicated to us. The industry association and we have made various representations to the government to make it minimum disruptive and keep it very close to consolidated taxation as today. I believe that we will end up in the 18% GST bracket and in case the industry and the notifications in later part of this month are in line of 18%, the net impact of GST will be almost nil for us. At the moment, our consolidated tax is around 17.5% and with some cess and some areas it is slightly higher. So, the net effect between 17.5% and 18% will be almost negligible for us in the new GST if it is indeed 18%. With a caveat that our customers and some of their smaller customers and some sectors are not in a position to avail of excise and they will be able to avail their GST credit and credit into their inputs and therefore we would see an uptick in the demand from these customers.

Anand Shah: On the overseas fragrance business, can you give us guidance as to how F18 may pan out both on PFW side and the overseas export business?

Kedar Vaze: As I mentioned on the PFW side, there is an additional investment which has been approved today in the Board, which we will play out in the next 2 quarters and have built up additional capacities in India and subsequently depending on the global supply-demand situation and price structure, we can take correct position in the second half of the year. As regards the formulation growth in international fragrances, we have been focusing in the last year on the premium product and differentiated products and we have seen decline in revenue in the low margin or low cost, low value products that we have decided not to compete below a certain margin or gross margin expectation. So, we have dedicated ourselves to a fewer markets with in-depth presence and are working on the premium and large domestic brands. That strategy will play out with strong growth in the next 2 to 3 years.

Anand Shah: Are you seeing any major challenges, any of your core geographies in international markets, macro-level challenges?

Kedar Vaze: We have seen a lot of challenges in this year particularly in Africa and some of the re-export markets from Middle East and Africa, where devaluation of currencies has created market disruptions and that has stabilized in the last quarter and there would be a new pricing, new cost structures as a result of the devaluation and new set of products and new set of solutions will now come into the market place. We will start to see the growth for us on that business once it stabilizes.

Anand Shah: On the PFW, if the revenue. Say, will be Rs. 100 in FY17 then would you see a sharp decline for the H1 until you sort out your strategy and then start correcting in H2?

Kedar Vaze: I do not think that there would be a very much decline on the topline. If you look at the global numbers on the industry basis, the typical industry has been planning for a 4% to 5% global growth year-on-year on a CAGR basis and in the last 2 years, it has been subdued and therefore we are seeing oversupply not only in the product that we are selling but a lot of the products in the industry. The oversupply will result in correction in the supply demand with uncompetitive or marginal market players exiting the business and if that correction happens you will see the stabilization of the ingredient business globally and we expect that to play out over the next 1 or 2 quarters and we will be ready for any eventuality thereafter to be able to compete. We clearly have a lowest cost producer advantage and we will make sure that we maintain our market shares.

Anand Shah: On this flavors business, you had a very strong year, both on domestic and overseas, what would your guidance be on your flavors business again on domestic and overseas here organically?

Kedar Vaze: Long-term guidance for the flavors continues to be the same at (+25%) CAGR topline growth for the domestic and around 20% growth for the international business.

Anand Shah: You are doing strategic investments to enhance capacities and should we see capex going up materially from the Rs. 25 crore-30 crore level we have seen over the last few years?

Kedar Vaze: Yes, for the year we will outlay capex in excess of Rs.25 crore-30 crore, which we have been doing in the previous year. Each of these capex would be marginal improvement in operating margin and/or reduction in operating costs because of the additional efficiencies. While we will outlay a large investment, each investment will be Rs.25 crore-30 crore investments in various projects which will enable us to have better operating margin or reduction in cost. We have also undertaken sustainability in solar power as one of our plans in all the facilities that we are operating and we have already invested roughly Rs. 6.5 crore in this year, some of it will play into the current year as the capex is ongoing so this capex is to result in reduction in our electricity cost almost by 35% in all the operations.

Anand Shah: What would be the total outlay for FY18 and may be 2019?

Kedar Vaze: Roughly, Rs. 15 crore-18 crore will be the maintenance capex and we would take up 2 or 3 projects of Rs.25 crore each. Each will have its own cycle of ROCE and ROI and proposal for the investment. So, we do not foresee one large big ticket investment, we will look at 2 or 3 phase investments to ensure that we have the flexibility built in our operations and we can react quickly to any changes or any further adverse changes to the market or improvements in the market, however, the situation may be.

Moderator: Next question is from the line of Jasdeep Walia from Infina Finance. Please go ahead.

Jasdeep Walia: You have mentioned that you are going to increase R&D investments significantly over the next 3 years, could you quantify it?

Kedar Vaze: Our objective is to double the number of people that we have in terms of our R&D right from the discovery all the way to the consumer insight and product development. So that is our objective in the next 12 to 18 months to deploy, put the infrastructure, train the people, and have a pipeline then we will be able to double the number of projects and number of product development that we are doing today.

Jasdeep Walia: On the acquisition of Gujarat Flavors, what kind of product segments does this company cater to?

Kedar Vaze: The Company operates in the space of Flavors and we are looking to integrate that with Keva Flavors portfolio and hence combine the operations like we have done for HTT.

Jasdeep Walia: What kind of flavor products or is it generic?

Kedar Vaze: It has some savory flavors and some of the regular sweet goods flavors and confectionery flavors, which we already have in our portfolio.

Jasdeep Walia: This company primarily deals with organized segment?

Kedar Vaze: So, it deals with both organized segment as well as distribution market where they have a strong brand which we can piggyback our products into the smaller customers. More than the fragrance market, the flavor consumption even for larger organized companies tends to be small volume and there is a lot of distribution through the branded distributor trader market in which they are very strong with their brand. So, we will capitalize on that distributions' strength and people on the market place and also cross-sell the existing Keva range.

Jasdeep Walia: What percentage of the sales would be from organized segment?

Kedar Vaze: Half of their sales would be from organized segment.

Jasdeep Walia: Any Tier-1 client that you have got out of this acquisition?

Kedar Vaze: Various large companies in dairy and savory and snack food.

Jasdeep Walia: On the service income aspect of your sale, say the value of the concentrated fragrance that you sell is Rs. 100. So, what will the value increase to if you sell it as a diluted product and it comes under your service income?

Kedar Vaze: For example, the product costing is Rs. 1,000 and you add 3x or 4x of the volume or solvent at Rs. 100, so we met our margin on the Rs. 1000 as we would in typical fragrance business and then we charge per kilo fixed fee for the solvent plus mixing and sending the goods to various locations, so that margin is roughly 7%-8% on top of the fragrance business. So, the net margin of this service income business when you look at the final revenue is around 18% there above and it translates to roughly 40% to 45% on the fragrance and 3% to 5% on the service income.

Jasdeep Walia: Rs. 1000 is the value of the concentrated fragrance in this example, right?

Kedar Vaze: Yes. So, a solvent cost Rs. 100, we will add 4 kilos of solvent per concentrate that is Rs. 400 and Rs. 10-Rs. 12 on top of that. The effectively revenue is Rs. 1,500 and the actual margin is only on the Rs. 1,000 which we sell as fragrance.

Jasdeep Walia: With increasing service income, your percentage margin should go down. Instead they have broadly remained flat

Kedar Vaze: Yes, the percentage margins which you see is a composite, so we have been selling more premium products as well with which the margins have increased and with service income the gross margin percentage has decreased. So, the net composite result is better margin.

Moderator: Next question is from the line and of Vignesh Makwana from AMSEC. Please go ahead.

Vignesh Makwana: What is the current contribution from the branded small packs in the domestic market in the fragrance?

Kedar Vaze: It is around 7% of the total consolidated revnues.

Vignesh Makwana: Can you give organic growth in flavor, both in domestic and international markets separately?

Kedar Vaze: We have a total composite organic growth of 58% in the flavor business, comprising 30% in the domestic and 80% in the international market.

Vignesh Makwana: What is our current inventory deals and how do we see it in the coming years?

Kedar Vaze: Our current inventory days is 146 days as on March 31st, 2017 and we have brought it down from 160 odd days in the end of December as we had promised and we see this will continue to improve at roughly 10 to 15 days as we grow our topline. So in other words, we will maintain the same net working capital quantity in absolute terms and continue to grow our topline by 12% to 15%.

Vignesh Makwana: How are we going to reduce our inventory days? By way of reducing the product numbers or product library?

Kedar Vaze: Large part of the inventories is in the form of raw material. So, it is based on the size of your operations, so as we have invested in a large capacity of the base storage tanks, the minimum holding volume that we need to maintain to run it efficiently is high and as we grow our topline we do not need to grow our raw material holdings. So, that remains the same at around Rs. 300 crore in all the plants put together.

Vignesh Makwana: When we say you have guided about 25% growth in the domestic flavor market, is it including the organic plus inorganic growth or it is a pure organic growth that we are targeting?

Kedar Vaze: We are looking at a 25% CAGR growth, purely organic basis and we will continue to have a bolt-on strategy wherever there is a good strategic fit.

Moderator: Next question is from the line and of Chintan Modi from Motilal Oswal Securities Ltd. Please go ahead.

Chintan Modi: On the domestic fragrance business, the 12% de-growth that we have seen in fourth quarter, can you highlight what was the like-to-like de-growth in that?

Kedar Vaze: If you look at the service income it has been around 4% like-to-like decline from last quarter. If you remember it is a first quarter where the service income as a business model work was started. So, we had a high level of service income in the last quarter FY2016 and to that extent it is less by Rs. 4 crore or thereabouts in Q4 FY17. So, leaving or apart from this service income, the overall fourth quarter is down by around 8%, vis-à-vis Q4 FY16. The decline has been broad based with almost all customers and all the products having a slightly lower volume than what was forecasted, which was the trend in the first half of the year and we had significant new wins and good momentum in the first half of the year which did not take off to the same expected growth rates. So, our pipeline for growth is still intact our wins have been there. The growth of those wins have not come in. As a typical year, we would see second half of the year about at 10% or 12% extra growth coming from new products.

Chintan Modi: Have we seen any loss of customer or loss of some segment, product specific?

Kedar Vaze: I will not want to comment on small products here and there where we do not have a very clear picture because people can buy and stop for a while and then restart after a while but none of the large brands, none of the larger products, we have seen any switch off or decline in consumption. We continued to get orders, only the volume of the order has been subdued or lower than what was the trend in the first half of the year. I just wanted to add that again December and January was even lower than the average months. So, February and March months were better than January, so it was a normal good momentum before demonetization. So, we have seen a pass through one month in the third quarter and one month in the fourth quarter which has been subdued in relation with the first half of the year.

Moderator: Thank you. I would now like to hand over the floor to the management for their closing comments. Over to you, sir.

Kedar Vaze: Thank you. I hope we have been able to answer all your questions satisfactorily. Should you need any further clarifications or would like to know more 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 Call. Thank you for joining us and you may now disconnect your lines.

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