



“HEG Limited Q1FY20 Results Conference Call”

August 16, 2019



**MANAGEMENT: MR. RAVI JHUNJHUNWALA – CHAIRMAN &
MANAGING DIRECTOR & CEO
MR. MANISH GULATI – COO & CMO
MR. GULSHAN SAKHUJA – CFO
MR. OM PRAKASH AJMERA – GROUP CFO**



*HEG Limited
August 16, 2019*

Moderator:

Ladies and gentlemen, good day and welcome to the HEG Limited conference call to discuss the company's Q1FY20 results. Joining us on the call today is Mr. Ravi Jhunjhunwala - Chairman & Managing Director & CEO, HEG Limited; Mr. Manish Gulati - COO & CMO, HEG Limited; Mr. Gulshan Sakhuja - CFO, HEG Limited; and Mr. Om Prakash Ajmera - Group CFO, HEG Limited.

As a reminder, for the duration of this conference, all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the end of today's presentation. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touch-tone telephone. Please note that this conference is being recorded.

At this time, I would now like to hand the floor over to Mr. Ravi Jhunjhunwala. Thank you and over to you, sir.

Ravi Jhunjhunwala:

Good afternoon friends and welcome to our Q1FY19-20 con-call. Our COO Manish, group CFO Mr. Ajmera, and CFO Gulshan also join me in these deliberations. Our results in this quarter, although lower than the previous quarters, still remain one of the strongest in the industry. Comparing the 1st half of this calendar year over last year, world crude steel production including China registered a growth of 4.6% on the back of a very strong, 9.9% growth coming from China alone but if you look at the steel production in the rest of the world without China after 2 years of positive growth, it was negative 0.4%.

Now, coming specifically to the electric arc furnace steel production which is the segment that we cater to, the steel production was down by 4% in the 1st half of calendar year 2019 in the rest of the world without China after having grown at a very healthy levels of 8% and 5% in the two preceding years 2017 and 2018. Some of the large steel producing regions like Europe, Japan, South America, and Turkey registered a decline mainly resulting from slowdown in demand due to an overall sluggishness of the global economy, trade tensions between the US and China and other geopolitical tensions prevailing in some parts of the world. However, the United States of America steel production grew by a healthy 5% where more than two-thirds of the total steel is produced through the electric arc furnace process. The trade sanctions on Iran and uncertain economic and political developments in Turkey and some other countries with a large EAF base also have had an impact on demand of electrodes.

Friends, past two years 2017 and 2018 and in the 1st quarter of 2019 saw an unprecedented tightness of supply of electrodes and that fear also created a surge in demand and many of the large steel companies overbought electrodes resulting into excess inventories in the pipeline. Amid steel market getting tough starting this year impacting production and resultant decrease in the demand of steel coupled with excess inventory of electrodes which the customers had built last year resulted into a drop in sales and stabilization of prices. However, from all



HEG Limited
August 16, 2019

available indications, we believe that the inventory correction should be completed in the next few quarters and then we see a normalcy restored in the market. Although China continues to register strong steel production growth but backed by an equally strong internal demand, China's export of steel to the rest of the world still remains at the same low level as the last 2-3 years, and to that extent, the electric arc furnace steel production in the rest of the world is still strong. China on the other hand continues to remain on the path of replacing their old blast furnaces with new electric arc furnace capacities to take its share to 20% through electric arc furnace production by about 2020. China also continues to add electrode capacities to meet their internal demand. However, as China mostly makes lower grade HP grade electrodes, we are impacted to the extent of about 20-25% of our product mix with declining margins. We believe that once more and more electric arc furnaces start production in China, the excess electrode production that we are currently seeing in China would get absorbed due to rising internal demand within China. The price of UHP electrodes which saw extraordinary levels of increase over the past 2 years is now stabilizing and going forward, we expect the current levels to sustain in the near future.

The needle coke availability has somewhat eased compared to last year due to which we are producing more UHP electrodes and have consequently reduced the production of non-UHP electrodes. The tightness of supply of needle coke due to rising demand for electrode segment and competing demand from lithium ion batteries should keep the availability somewhat tight for the near foreseeable future. As you are aware, early this year, we had started our expansion from current levels of 80,000 tons to 100,000 tons. The construction activities are in progress and full swing and we should be ready by the 3rd to 4th quarters of 2021 and after a stabilization period of 3 to 6 months which we have experienced in all our past expansions in this business, we should be in the market with these additional products from early 2022.

We do believe that this new capacity coming on-stream, the quality of our products will see a marked improvement due to state of the art equipment that we are currently installing. This will also enable us to do some cost savings and achieve better efficiencies. We are confident that with no other new electrode capacity coming in on the ground by then in the western world and with the return of a normal growth of the world economy by then, the demand of electrodes will increase sufficiently to absorb this entire expanded production of our company.

Our sales were less compared to last year as our customers worked through their inventory. We expect the volumes to pick up towards the end of this year by when we believe the inventory correction would have taken place.

Electric arc furnace production growth is expected to continue at a long-term CAGR of around 1.5-2% generating enough demand for good quality UHP electrodes and our small expansion should easily get absorbed when we are ready.



*HEG Limited
August 16, 2019*

With our four decades of experience in business, we expect to be a supplier of choice to all our global and Indian customers. With this, I would now hand over the floor to our CFO Gulshan to take you through all the financial numbers and then I along with my colleagues Manish and Ajmera, will be very happy to answer any queries that you have.

Gulshan Sakhuja:

Good afternoon friends. For the quarter ended June 2019, HEG recorded revenue from operations of 817 crore as against 1347 crore in the previous quarter and 1587 crore in the corresponding quarter of last financial year. EBITDA including other income stood at Rs. 387 crore in quarter 1 versus 830 crore of previous quarter and 1196 crore in the corresponding quarter of the last financial year. Our company reported a net profit of Rs. 234 crore in quarter 1 as against 524 crore in the previous quarter and 770 crore in the corresponding quarter of last financial year.

In power segment, after successful negotiation having mutually beneficial terms with a government utility company and we have been able to replace part of our high-cost self-generated power which is thermal with the power purchased from the state electricity board. While this step has reduced revenue and bottom line in the power segment, it has had a very favorable impact on the overall power cost of the graphite electrodes making.

The company is long-term debt-free, and I have been handling treasury operations to the tune of nearly 1400 crore as on date and average return has been around 7.7% per annum on the same. For the quarter ended 30th June 2019, the company has presented consolidated financial results along with the standalone financial results as a part of compliance.

Expansion project is going as per the plan and we expect it to be operational by early 2022. Our company aims to further strengthen its balance sheet through effective working capital management, thereby creating a value for its stakeholders. With this background, I would request questions which we can clarify more.

Moderator:

Ladies and gentlemen, we will now begin the question & answer session. The first question is from the line of Sonali Salgaonkar from Jefferies. Please go ahead.

Sonali Salgaonkar:

Sir, Thank you for the opportunity sir my first question is in your initial remarks, you mentioned that you are expecting the inventories to get corrected in the next few quarters and things should stabilize and you are expecting volumes to improve by the end of this year. Sir, I wanted to understand, what gives us this confidence that probably stabilization will kick in from the coming quarters considering that it is quite a volatile situation right now?

Ravi Jhunjunwala:

A couple of things. As I mentioned in my initial remarks, there was a fairly strong growth in the electric arc furnace industry in 2017 and 2018. Only in the last 6 months or so, we spoke about the reasons general pessimism in the world economy, the America-China problem, and



HEG Limited
August 16, 2019

geopolitical issues in Turkey and the Middle East. All of them combined are taking a toll on everything and obviously steel and electrodes cannot be left alone.

What gives us some sort of a confidence is that if you have gone through the results and public discussions that all other graphite companies have had, everybody seems to have cut back on their production by about 15-20%. These are the numbers we have read publicly from our other graphite friends from around the world. So obviously, if everybody has reduced their capacity utilization and their actual production for the next 6 or 9 months, to that extent the supply is not in the market anymore, and my guess is that again one of the main suppliers has also said publicly that they believe that a lot of customers had bought maybe one-third or maybe as much as 40-45% more electrodes than they actually needed. So, all this gives us confidence. Of course, we always are in contact with all our customers around the world. All that gives us an indication that with a cut back in production and the use of all the stocks which people have been carrying, it should come to a situation in the next couple of quarters that this imbalance will be removed.

And as we all know, we don't see except HEG, nobody has as yet announced any expansion, and as we all have spoken in the past, any expansion of a existing graphite unit will take anywhere between 3 and 3-1/2 years and this is exactly what we are talking about, we are going to be ready with this expansion by let's say 3rd or 4th quarter of 2021 and then it takes anywhere between 3 to 6 months before you can use that facility to the extent of 70-80%. This is something which we have seen in all our past de-bottlenecking and expansions. So, we are still talking of another close to 3 years before this additional capacity is available in the market and until then if there is no new capacity coming in and as soon as this inventory adjustment takes place, and going by the past record, an annual increase of around 1.5-2% is all that we are aiming for.

If the electric arc furnace industry grows by even 1.5-2% per annum, there should be enough demand not only for everybody to operate at 85-90%, but the additional 20,000 tons which we are going to be putting into the market by early 2022. That is all. We cannot say anything more than what I just explained to you.

Sonali Salgaonkar:

Sure Sir, this has been helpful sir my second question is what is the update on exports? Especially an update on Iran.

Ravi Jhunjhunwala:

Nothing changes in Iran. We are not alone in this boat as far as the sanctions are concerned. Whatever products were being exported from India, they are all in the same boat and that used to be one of the large markets for the Indian graphite industries because the other two larger companies in the world had stopped exporting to Iran for last 4-5 years.

Sonali Salgaonkar:

Sir, this capacity expansion that you have just mentioned, over the next 3 years, what would be the CAPEX per annum that we should expect for this?



*HEG Limited
August 16, 2019*

- Ravi Jhunjunwala:** The total amount is 1200 crore, and I can't tell you in very exact numbers but it is around 400 crore this year and more or less similar amounts in 2020 and 2021.
- Sonali Salgaonkar:** Sir, ending this quarter, this June ending quarter, what was our utilization and cash position?
- Gulshan Sakhuja:** Cash position as on 30th June was approximately 1650 crore and the capacity utilization was 85%.
- Sonali Salgaonkar:** Even if I factor that your annual CAPEX would be about 400 crore, this still leaves a lot of cash on your balance sheet. So, any plans for that sir? How do you want to utilize that? That's it from my side.
- Ravi Jhunjunwala:** For the time being, there is nothing very specific on the table. We keep looking at some opportunities here and there, but I can only assure you that we are not going to be irresponsible and use a large chunk of this cash in a rush. Unless we are very convinced about something which is not connected to our business, we will be extremely careful in jumping into this.
- Moderator:** The next question is from the line of Aashish Agarwal, an individual investor. Please go ahead.
- Aashish Agarwal:** Hello Sir, my question is similar to what the previous person asked about the cash. Like we have 1650 crore cash available with us. So, what is the plan? And you mentioned that you are into something. In the past, I think we discussed about some anode or some other field. Can you give some more idea about that? Are you still pursuing that?
- Manish Gulati:** We did mention that last time. We are still looking into it. It is still at a very nascent stage and that field is completely different and it has to be very well understood. China has this lithium deposits and has already taken leadership in this electric vehicle segment. We are also watching how soon the Indian government and, in our country, these electric vehicles develop. That, if you ask us, is still at a research stage but we continue to keep looking at it.
- Aashish Agarwal:** One more question about the needle coke supply. Are we still facing the shortness there and still we are paying the high charges or we are seeing the softening of the prices in needle coke?
- Ravi Jhunjunwala:** See on the availability as I said, the availability has somewhat eased and as I also said that since we are competing with China in the low-end market which is about 20-25% of our production, we have intentionally reduced production of non-UHP electrodes because of the pricing situation which means we do need more needle coke to shift our production to the UHP. So, for that additional shift of UHP electrodes, we have been able to get enough coke. So, as far as the needle coke is concerned, the availability has eased. It is helping us to produce more UHP where the prices are still much more remunerative than the non-UHP. On the pricing, we always have a half-yearly contract. So, that price got frozen say in May-June. That is what the situation is.



HEG Limited
August 16, 2019

Moderator: The next question is from the line of Dewang Sanghvi from ICICI Securities. Please go ahead.

Dewang Sanghvi: My question is regarding utilization levels what we are targeting for the current year. And I missed the number for Q1 utilization levels.

Manish Gulati: Dewang, we think that it should be around 75% for the whole of the year which was 80% last year.

Dewang Sanghvi: And the Q1 number would be?

Manish Gulati: The capacity utilization is on the basis of production. So, it was 85%. However, we have sold lesser than that and you can notice that in the increase in inventory levels.

Dewang Sanghvi: This needle coke what we have frozen in May-June, when will it come in our financials in terms of cost?

Ravi Jhunjhunwala: It has already started reflecting. The current year profits and the current year costs are already taking care of that at the higher price.

Dewang Sanghvi: With supply increasing, is there any chance of the needle coke may be softening from current levels?

Ravi Jhunjhunwala: I hope so. I am sure the coke suppliers are looking at the graphite market and they are as much aware about the conditions that we are.

Dewang Sanghvi: For the quarter, what was the export in domestic mix?

Manish Gulati: It is again two-thirds/one-third.

Dewang Sanghvi: Normal as we do. We have I think increased our UHP from current quarter as you have indicated. What is the UHP and non-UHP breakup?

Manish Gulati: We wouldn't provide the exact breakup as such but yes, we have increased the portion compared to last year by at least 5-7% more.

Dewang Sanghvi: YOY increase of 5-7%?

Manish Gulati: But going forward, it will further go up.

Moderator: The next question is from the line of Saumil Mehta from BNP Paribas. Please go ahead.

Saumil Mehta: I missed out on the approx decline in needle coke prices we are looking at. A very rough number would be?



*HEG Limited
August 16, 2019*

Ravi Jhunjunwala: No we didn't say we are looking at decline in needle coke prices. I think you got it wrong. What we are saying is that the needle coke as soon as this year's contracts that kicked in, the 1st quarter results already factored the increased prices and those prices are likely to remain the same through till the end of the year.

And somebody asked about the softening thing, and to that, we replied that we are sure the suppliers must be looking at graphite industry.

Saumil Mehta: So, is it fair to assume that for the balance year of FY19, we will continue to have high-cost needle coke, i.e., for our \$4500 what has been reported in the news reports?

Ravi Jhunjunwala: For the time being, you can assume that.

Saumil Mehta: Sir, from the channel checks and from some of the customers, it is believed that certain imports have gone up and also in the export market, there is some down-trading wherein some players are shifting from UHP to non-UHP. Are you seeing any such signs given that you have a very strong export base?

Ravi Jhunjunwala: Just wanted to clarify. The switching between UHP and HP doesn't happen actually. Otherwise, why would anybody use UHP when everybody would take the cheapest electrodes because the whole design of the plant is like that? There is a furnace that is expected to operate at a certain current level. With that, there is a transformer behind it, and we are supposed to churn out so many tonnes of steel in 40 minutes. That is the quality requirement. It is not easily replaceable. It is a myth that some people have switched from UHP and HP. If that were to be true, then all the world can do that. That's not possible.

Your earlier question was about the Chinese exports. Yes, you are right. The Chinese exports to India have increased, especially after renewal of those anti-dumping duties and there it seems there was a time lag between the new electric arc furnace plants coming up and the electrode production came up faster than China which has resulted in China increasing their exports to the rest of the world and the dropping of prices.

Saumil Mehta: While you mentioned that it is not easy to switch but can you switch from a higher dia UHP to a lower dia UHP? Is there a change in realization because of that?

Ravi Jhunjunwala: No, actually you can't do that. That is what I said. That is how the plant is made. When the plant is made, the furnace, the diameter, everything is all decided. There is no room to play in that. Otherwise, it is not an optimal solution. You can always change the wheels of a car and take a narrow wheel but that is not how the car is supposed to run.

Saumil Mehta: So, once you start using 600 mm or maybe 750 or whatever 480, you will continue to use that. That's a fair assumption, right?



*HEG Limited
August 16, 2019*

- Ravi Jhunjunwala:** Yeah. It is not easy at all, I would say. Ask any steel company and they will tell you. And it needs a huge investment with those copper arms to be changed. Nobody will do it.
- Moderator:** The next question is from the line of Anubhav Sahu from MC Research. Please go ahead.
- Anubhav Sahu:** In your opening remarks, you mentioned UHP electrode price might stabilize at the current levels. The current levels should be around \$6000 to \$7000 for the UHP. Would that be a right assumption?
- Ravi Jhunjunwala:** We will not comment on specific pricing. What we can share with you that the major amount of correction in UHP pricing has already taken place which is reflected in this quarter results. I am talking about UHP. Major part of correction has already taken place. Going forward, there is not much room left for correction, but I will not comment on the price levels you have said.
- Anubhav Sahu:** Could you guide us what is the market prevailing price? Not for the company but in general, what should be the range which should be prevailing in the market right now for the UHP?
- Ravi Jhunjunwala:** The same question in a different manner. There is no difference.
- It is a competitive market and in the public space, we cannot divulge so many other things.
- Anubhav Sahu:** Sir, on the needle coke prices, I remember that for the January to June period you had contracted in the range of 4500 to 5000. So, when you are saying that it is getting priced in the Q1 results, are you seeing the same range?
- Ravi Jhunjunwala:** First of all, we never said it is 4500 to 5000 as I earlier said in response to your query about the sales prices, we would never have said this number 4500 to 5000. So again, let us refrain from specific numbers. The prices were different in January-June and the prices are different in the 2nd half. Now, what it was in the 1st half and what it is in the 2nd half, it is very confidential information and I am very sorry, we cannot share it.
- Anubhav Sahu:** When I referred to that time period, I am saying that you earlier guided that when the contracts happen, it seeps into the financial statement with a 6 months' lag because of the production cycle.
- Ravi Jhunjunwala:** Yes, that you are right. The contract for needle coke is done on a half yearly basis for the 1st half and 2nd half. And you are also right; there is a time lag because our production cycle is so long that it generally spills over for the next quarter. If the prices, let us say were to drop for shipment starting January 2010, its impact will not be seen in that 1st quarter, it will be seen in the 2nd quarter because it takes some time to get the needle coke from the US or Japan or from the UK, then the production cycle of electrode itself is very large.



*HEG Limited
August 16, 2019*

- Anubhav Sahu:** Any inkling on the price level for needle coke? You said that it should probably stabilize again at the level which we have seen recently but any guidance on that?
- Ravi Jhunjunwala:** No as I said, the prices for January-December shipment are already contracted. So, there is nothing new to talk about. The new prices will only be applicable for shipment starting from January and those prices will only be discussed in November.
- Moderator:** The next question is from the line of Saurabh Soni, an individual investor. Please go ahead.
- Saurabh Soni:** Thank you for your information so far. My question is as per your statement just before that the prices for needle coke you already know for the next half of the year till December, right? So let's assume that if the price of our final product on the sales side also remains stable what it is right now for the 1st quarter, then, are we expecting the same level of sales for the rest of two more quarters, the profitability which we have right now?
- Ravi Jhunjunwala:** As I said, the higher needle coke cost is already factored in. Our needle coke cost for the quarter that we are talking about April-June, and the quarter which we are currently sitting in, the second quarter, is more or less similar. So, on that side, yes, more or less, there is no change in that. Secondly, as we answered in the previous question, we are moving more towards the UHP electrodes than the non-UHP electrodes where the competition is much less because of China not being there. That will help us to increase our UHP sales with better margins. On the volumes, again, as I said, a lot of other graphite producers have announced a cut of 15-20%. So, we only hope that this cut of 15-20% is going to help to stabilize the market because the demand of electrode has come down. There is a lot of inventory in the pipeline. So, it is very difficult to tell you about the volumes. When there is a situation where there are more electrodes than the demand, then when it is going to change, we don't know.
- If you had followed this company or the graphite industry in general, you would have seen about 2 years ago, we had no idea that the prices of electrodes were going to go up by 5x or 6x or 7x. In some cases, the electrode prices were 7 times more than they were in, let us say, the 1st quarter of 2017. If anybody had that idea, we would not have sold anything for those 6 months and just kept waiting to sell all those products at 5, 6, 7 times the prices but in practice, it doesn't happen. You are in the market and you cannot withdraw from the market even if you think that the prices are going to be 2x or 3x or 6x six months down the road. So, it is a very difficult question to answer as to where do we see the prices or the volumes. We can only talk about a very near term, current quarter, or maybe at the most next quarter, but beyond that, anything that we will be talking about will be mere speculation.
- Saurabh Soni:** I agree fully that of course many things depend upon demand & supply and which we do not have control over, but as you said just now that for the next quarter at least, do we have some kind of conservative estimate at least for the volume for the current quarter we are in right now, maybe?



*HEG Limited
August 16, 2019*

- Ravi Jhunjhunwala:** I am pretty sure it will not be less than this. It could only be higher than this, it will not be lower than that.
- Saurabh Soni:** On the margin and on the bottom line?
- Ravi Jhunjhunwala:** No, it is not about the margin. We are talking about volumes because there is a non-UHP segment of the 20% that is still under pressure, might be it will further be under pressure for this quarter. UHP pricing, that's more stable that way. So, we are not commenting absolutely on the profitability part. We are just talking about the volumes, are likely to remain the same for the 2nd quarter.
- Moderator:** The next question is from the line Lalit Aariwala from BS Securities. Please go ahead.
- Lalit Aariwala:** EBITDA from last quarter, 62% it has come down to 46% in this quarter, the last results which have been declared. What do you expect further down? Would you be able to maintain this or how much do you expect it can come down?
- Ravi Jhunjhunwala:** There might be a slightly downward pressure, and "slightly" I have said. And because the major part of correction, as you can see yourself, has already taken place.
- Lalit Aariwala:** So, can we assume that as guidance that it would be around 45% or it could be around 40%?
- Ravi Jhunjhunwala:** It will continue to be under pressure and the UHP is more stable compared to the non-UHP part. So, margins you might see some more softening.
- Lalit Aariwala:** Needle coke prices as compared to the 1st half and the contract for the 2nd half of this year, what has been the difference? Whether there has been any change, or it is continuing to remain the same?
- Ravi Jhunjhunwala:** They will remain the same actually because these are through till the end of the year and now the increased prices have already been factored in in the 1st quarter, the results which you are looking at and these prices are likely to remain the same through till the end of the year.
- Lalit Aariwala:** As you said that contract takes place twice a year for 6 months, the prices have been the same for even the 2nd half of this year, more or less the same as what you had contracted for the 1st half of this year?
- Ravi Jhunjhunwala:** Yeah.
- Lalit Aariwala:** What would be the approximate conversion cost from needle coke for you for UHP grade in dollar terms?
- Ravi Jhunjhunwala:** No, that of course we won't share. And, of course, you don't expect us to answer that question.



HEG Limited
August 16, 2019

- Moderator:** The next question is from the line of Rubin Paliwala, an individual investor. Please go ahead.
- Rubin Paliwala:** My question is that the appreciation in the dollar, will it benefit the bottom line of the company?
- Ravi Jhunjhunwala:** Yeah, certainly. But please also note that our purchases of coke are also in dollar terms. So, there is a natural hedge between the two but to some extent, it should benefit it if it stays that way.
- Rubin Paliwala:** My question was if the raw material prices are also in dollar terms and if the sales are also in dollar terms.
- Ravi Jhunjhunwala:** Yeah.
- Moderator:** Ladies and gentlemen, that was the last question. I now hand the conference over to the management for closing comments.
- Ravi Jhunjhunwala:** Thank you friends for understanding the current situation and asking some very relevant questions and I look forward to speaking to you in 3 months' time from now. Thank you very much.
- Moderator:** Ladies and gentlemen, on behalf of HEG Limited, that concludes this conference. Thank you for joining us, and you may now disconnect your lines.