



“HEG Limited Q3 FY17 Earnings Conference Call”

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Moderator: Ladies and gentlemen good day and welcome to The HEG Limited Q3 FY17 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 now hand the conference over to Mr. Ravi Jhunjhunwala - Chairman & Managing Director, HEG Limited. Thank you and over to you Sir.

Ravi Jhunjhunwala: Thank you. Good afternoon and thank you for joining us for HEG's quarter 3 conference call. I will start with sharing with you the latest developments in the steel industry worldwide and in India and its resultant impact on the graphite electrode industry. The World Steel Association reported a growth of a mere 0.8% in the world crude steel production to 1628 million tons for the calendar year 2016. Steel producing regions registering a positive growth where Asia 1.4%, CIS 0.8% and Middle East 7.6% whereas North America stood at almost 0 growth. The negative growth areas were EU with -2.3%, South America was -10.6% and Africa by -4.7%. China produced 808 million tons registering a growth of just 1.2%. As against this, India produced to a healthy 95.6 million tons steel posting an impressive growth of about 7.4%. Coming to the Indian steel scenario, crude steel production grew by about 8.5% to 72 million tons in the first nine months of current year. Steel imports stood at 5.5 million tons in April - December 2016, declining by overall 37% over the same period of last year as a result of various duties imposed by the government of India like minimum import price, safeguard duty and anti-dumping duties from time to time. Considering an upward trend in domestic steel production and surge in consumption with declining imports, government of India has recently withdrawn the minimum import price but still continues with its safeguard duty and anti-dumping duty to support the Indian steel industry. However, as you all know that Indian steel industry continues to be heavily stressed due to heavy debt burdens especially some of the large ones.

Now turning over to the graphite industry; as shared during the last con call, the graphite-electrode business of SGL, Germany, one of the industry leaders is in the process of being acquired by SDK, Japan. This is a major consolidation in the graphite industry and a big positive factor for future. So once this acquisition is completed, SDK will become clearly the industry leader with a capacity of approximately 290, 000 tons followed by Brookfield 160, 000 tons and then the two Indian producers followed by a few small Japanese players or suppliers. This consolidation is expected to help the industry in the near future. The current capacity utilization industry has been inching up and it is currently in the range of 70%, 75% as compared to about 60%, 65% in the first six months of the calendar year 2016 after substantial closures of capacities early last year and end of 2015. Electrode prices seem to have bottomed down by now and we are clearly seeing an uptrend not only in the prices but also in the demand. Turning over to the company's operation, I am happy to inform you that our order book for 2017 – 2018 is looking much healthier than what we experienced at this time last year. We operated at a much healthier utilization rate of over 75% in the third quarter and we

expect this to continue at the same levels in the current quarter ending with an overall utilization rate of around 65% for the whole year as compared to about 55% last year. The plant parameters have continuously registered a marked improvement with our ongoing emphasis on cost control, rejections and focus on quality, which is amongst the best in the industry today. Good and evenly dispersed monsoon in Madhya Pradesh this year has enabled us to attain one of the highest generation at our Hydro-electric plants in the first nine months of the financial year and we expect to end the year also with one of the highest generations ever. The future outlook as I mentioned, the global steel demand is going to remain subdued in the current year as well, however with some of the duty measures taken by the government of India on steel imports, the domestic production of steel will continue to increase and we see a continued increase in domestic demand for electrodes in India. The consolidation of electrode industry should help in price recovery and margin improvements. Acquisition of SGL electrodes capacity by SDK is a major development in recent times and should help reducing some more excess capacities in the world, thus helping the demand from existing large electrode players. Our efforts on gaining new territories and new customers in exports in 2016 have paid off and will benefit us in the next year as well. We have added some large customers in our fold in the last 12 months. We expect that increase in domestic sales volumes in the current year as well as the next year. The graphite electrode inventory correction across the globe has taken place leading to a substantial improvement in demand. Our order book position for 2017 – 2018 is fairly healthy and we expect to run the plant at much higher utilizations next year. Initial indications on next year's prices of Needle Coke are indicating an increase due to an uptake in the oil prices. The negotiations for Needle Coke are currently going on and we should be able to conclude this fairly soon. Friends with these comments I would now turnover to our CFO, Mr. Rustogi to take you over the financial numbers, thank you.

Raju Rustogi:

Thank you Sir, good afternoon friends. I would share with you a quick overview of Q3 FY17 numbers and then we would be happy to take questions. For the quarter ended December 2016, HEG recorded net operating income of Rs. 246 crore as against Rs. 200 crore in the previous quarter, an increase of about 23%. EBITDA including other income which stood at Rs. 22 crore in the previous quarter improved to around Rs. 31 crore in the current quarter thereby reducing the net loss to Rs. 3 crore as compared to Rs. 13 crore reported in the immediately preceding quarter. With increases level of operations progressively over last three quarters reflected by diminishing losses, the lowest in the industry seems to be over for us. Margins in graphite electrodes segment continue to be under pressure as the sale prices remain flat during the quarter. Net sales in power segment is higher than previous quarter as our Hydro-electric generating facility in Tawanagar reached its peak generation during the quarter. The profitability of the segment has also improved with the availability of cheapest power from our captive facility coupled with higher realizations in the bilateral power sale arrangements over IEX. The total debt as on date stands at Rs. 660 crore vis-à-vis about Rs. 736 crore as on 31st March 2016. This comprises of Rs. 243 crore of term debt and the balance on account of working capital loans. The Mantra today as I said in the past; managing tight controls over

controllable costs and I can only assure the friends here that the company is doing everything possible which has indicated by the numbers on controlling the controllable costs.

With that I would request questions to be asked, in case any clarification is required from our side.

Moderator: Thank you. Ladies and gentlemen, we will now begin with the question and answer session. We take the first question from the line of Devang Sangvi from ICICI Direct. Please go ahead.

Devang Sangvi: My question is regarding the capacity utilization guidance the next year. We have seen a good second half this particular year, so do we expect that improvement to carry forward for next year also?

Ravi Jhunjunwala: As I said our current utilization is above 70%, in the region of let us say 70%, 75% and we surely expect to run at these levels.

Devang Sangvi: And going around Needle Coke prices; would it be fair to assume that this particular year you have some amount interest due to hike seen in the crude oil prices and secondly just wanted to ask do you have any low-cost inventory going forward for the quarter 4?

Ravi Jhunjunwala: See as you know, we more or less stick the prices of Needle Coke and fairly substantial quantities of Electrode orders for almost like twelve months. It changes every year depending on what the market looks like, but for Needle Coke, yes it is mostly purchased on a twelve months' basis and typically it is in a market which is going down, we do end up having more inventories at lower prices which impacts the results of the latter part. So the third quarter and fourth quarter of current year would certainly show lower cost inventory because obviously being a process where it takes anywhere between ten weeks and let us say five to six months to produce electrodes. So there is always a lag between the Coke purchases that to sales.

Devang Sangvi: And my third question is, in the larger the sector as a whole since we are seeing consolidation endlessly happening this time around, so maybe over a medium to longer term you can see some amount of firming of on prices also?

Ravi Jhunjunwala: Yes, that is what we indicated. I mean a lot of capacities have been taken off the ground in the last two, three years as you know and we believe that this consolidation also will lead to some more closures because obviously between the plants of SGL and the SDK the acquirer, there is still a lot more capacity in Europe specially. The European capacities of electrodes which are probably amongst the highest cost capacities much larger than the demand of electrodes in Europe, so we think that there will be some more reductions, some more closures of plants.

Devang Sangvi: I was more coming onto the aspect of supply demand balance only; that this incremental supplies what you see, when that could see some amount of say the balance with the demand - supply will be maintained in either your balance will slacking.

- Ravi Jhunjunwala:** Yes, balance will improve. I mean that is exactly what I am meaning that once this consolidation happens, some more capacities are likely to go off the ground.
- Devang Sangvi:** Are we seeing any uptake in the EAF route of first steel production from say 28%, 29%, what that was say last couple of years or so?
- Ravi Jhunjunwala:** Not last couple of years, getting the exact data of Electric Arc Furnace is not very easy, we can only talk about what is happening in the Electric Arc Furnace in that stream based on a feel by meeting the customers, talking to them the world over but there is no exact data which is collected and circulated by anybody but it does seem that ...
- Devang Sangvi:** Generally, your sense that maybe some amount of production you are picking up from say European countries which are broadly EAF based?
- Ravi Jhunjunwala:** See America continues to produce more than 60% of steel through EAF; that is always been the case. Overall Europe, Western Europe will be in the region of 40% and overall worldwide it is more or less in the region of 25%, 26% with China dragging this number because China does about 10%, 12%, no more than that.
- Devang Sangvi:** Few years back there was a kind of news that China may increase this EAF route but nothing has seemed to materialize, maybe any specific reason or?
- Ravi Jhunjunwala:** See Chinese' total steel production is so large; it is more than 100 million ton, so 5 million or a 10 million increase in Electric Arc Furnace this way or that way in terms of percentage makes no difference.
- Devang Sangvi:** Just last question regarding the repayment of loans what we have for the current year and next year?
- Raju Rustogi:** The repayment during 2016 – 2017 financial year comprise Rs. 108 crore, out of which we have already repaid Rs. 91 crore as we stand today, about next year it is Rs. 156 crore of repayment that is due and thereafter in fact, you can work it out; Rs. 220 crore of term loan and Rs. 160 crore for next year.
- Moderator:** Thank you. Next question is from the line of Abhishar Jain from Centrum Broking. Please go ahead.
- Abhishar Jain:** My question is on the realization; so because of the consolidation which is being taking place and plus some of the capacities that have gone off stream, so have we already started seeing sequential increase in realization sir because PAT calculation is showing some increase on a sequential basis in this quarter?
- Manish Gulati:** I am Marketing Head, Manish Gulati. I will answer this question. Yes definitely the prices are inching up, not to the levels we expect but certainly they are going up. Last year all across the

prices continued to dip and the lowest was seen in the quarter 3 which we are talking about and going forward the prices have started to inch up and there is always a lag. When we started last year 2016 – 2017, there were carry over orders which were higher priced and same situation continues this year also. So it is going to take time, it seems that prices are definitely on a way up gradually.

Abhishar Jain: Is that increase from the bottom level, a decent increase of say a 15% to 20% or is it still much lower in some single digits?

Manish Gulati: No it is not to that extent although we would prefer that to happen but it is not happening to that level, so in percentage terms, I mean of just 5% or something, not more than that.

Abhishar Jain: And just one more related question to this; because the GrafTech or the Brookfield has given an indication of the pricing which is obviously much higher at somewhere around \$3000 but obviously they give discount to the customers, so right now even on the new contracts we are say nowhere close to even \$2500 per ton?

Manish Gulati: That is quite off, I would say. These price increase circulars were a norm many years back and they usually do not follow it. It is like indicating an MRP and then working out discounts over and above that price, so it does not actually really translate but yes it is a at best a statement of intent.

Abhishar Jain: And so Sir just your comment or your feedback on this pricing power for the industry, you know we used to have very good electrode prices back in the day four, five years back as high as above \$5000 and then the pricing power kept on going down because there was competition, there was over supply but lot of that has just got corrected, right? So on the way up, you know why is it becoming such a painful journey and is it that a small bunch of five, six players are not able to have any pricing power or oligopoly of source going in this case basically?

Ravi Jhunjhunwala: Yes a lot of capacities have come down in the last two, three years especially closed by The Americans and the German companies but lot of expansions had taken place, especially between the two Indian companies if you look at the last about eight, nine years. We have added a lot of capacities and we added this at a time just as the financial crisis happened in 2008. So those capacities where the decisions to implement those capacities were taken let us say 2007 – 2008 and obviously they could not have been in deferred. So they were there by when the financial crisis hit us and at that time the assumption and the hope was that the Electric Arc Furnace share which was at that time let us say as the region of 30% would keep inching up to 32%, 33%, 34%. The whole basis of those expansions in 2007 – 2008 by the Indian industry was based on that and based on exports, not based on the domestic market and in the background of the financial crisis that did not happen and on the contrary the 30% Electric Arc Furnace share gradually started coming down over the last five years, seven years especially because the iron ore and coke, the prices fell much more than the scrap prices in the last three, four years so which made the Blast Furnace process much more competitive for some time. Now this happens all the time, I mean sometimes we will see international scrap

prices falling down much more substantially compared to iron ore and coal and vice versa, so lots of these large steel companies in the world who have access to the Blast Furnace capacities as well as the electric Arc furnace capacities, they can opt to increase or decrease the production through one of these routes depending upon what the raw material costs are for the Blast Furnace and scrap. So that is still favoring overall in the last three, four years; the prices of iron ore plus coke and the prices of scrap has still favored the Blast Furnace industry. And that is the reason the Electric Arc Furnace while the total production of Electric Arc Furnace steel has been more or less stable, it has not come down, it has not gone up but in terms of percentage it has come down especially because until about let us say, a year or two ago, China was still growing by about 6%, 7% in steel and China is basically more than 90% based on Blast Furnace. So that percentage becomes very misleading because China dominates the steel industry with more than 50% of the world steel and of that China produces more than 90% of steel through the Blast Furnace route. So any percentage that we speak about gets so much colored with the Japanese figures which are so substantial, so if we speak of the total industry of steel and electrodes with China and without China, the whole picture changes.

Abhishar Jain:

I understand that point Sir completely but actually my point was that since supply has been addressed by the electrode industry in some way or the other and demand as you said that an absolute demand or an absolute EAF production is say flattish and percentage is falling just because of China but absolute EAF production is flattish, so the absolute electrode demand is flattish and supply has been addressed, so my question was that why is the pricing power or at least some flexibility in pricing is not happening or why are the producers not willing to work at a price which makes everyone a decent money, why work on single digit margins, particularly now the ownership of GrafTech change has also happened, it has been at least a year or so more, obviously more consolidation is happening, so it was more to do with that Sir.

Ravi Jhunjhunwala:

See I understand your question. Two things; the one is obviously despite lot of closures which happened in 2014 and 2015, there is an oversupply today also even with the flat production of steel. See the consumption of electrode because of the quality of the electrode and the handling of electrodes at the steel plants keeps improving. It is a continuous process, the raw material of electrode which is coke keeps improving, the production processes keep improving, the quality of electrodes keeps improving, the way electrodes are used in the steel plants keeps improving. So the consumption which used to be let us say, 4 kilos, 4.5 kilos, 5 kilos about 15, 20 years ago per ton of steel is currently probably sharply down to something like 2 kilos. So even with the same amount of steel produced, electrode consumption would have come down by half. Thanks to the Electric Arc Furnace industry producing more steel through Electric Arc Furnace compared to let us say ten, fifteen years ago. We still are able to sell electrodes even with a per ton consumption coming down by 40%, 50%. So obviously there is still a scope of further reduction of electrode capacity and probably this consolidation which is in the offing right now will bring some more closures because as I said SGL's major capacities are still in Europe and Europe is the one area where there is the largest excess capacity of electrodes. And secondly, SDK is amongst the biggest producers of electrodes in US, so GrafTech does not produce any electrodes out of US and SDK is the single largest producer of electrodes in US

and SGL also has a plant in US. So between the two and I mean obviously now the SGL plant would be soon owned by SDK, so even in US there could be some sort of a reduction, the closure because there is only one producer now, who is going to control 100% of the Europe's market and the capacity of the two US plants are much more than what the demand for US electrodes are. So we do see that some sort of a reduction of capacities will happen after this acquisition takes place and that should more or less bring the supply demand on balance. And India again happens to be in the right place at the right time as I gave you the figures of steel production, India is the only country which has grown by 6%, 7% in steel, Korea, Taiwan has been more or less flat whereas US is flat and Europe is -2.5%, south America is -10%, Middle East where Indian producers are very strong is up 7.5%. So this entire growth which is happening even today, we are very sluggish steel market, basically happening East of Middle East, India, Japan and the rest of Asia, let us say. And West of Middle East either it is flat, the whole of Europe is minus, America is flat and South America is a big minus. So we do have those geographical advantages and obviously we have certain cost advantages being in India and especially with us having a 100% captive power capacities, we hardly buy any power except the 5% or 10% we are obligated to buy from the Electricity board, most of our power is captive reproduced. So we do have those advantages being in India.

Abhishar Jain: And sir the other question is on the domestic industry; so what is the overall electrode demand in India right now because we have had an overall growth in steel production here and also clamped down on the imports because of anti-dumping, so right now what is the addressable market for electrodes in India?

Manish Gulati: I would say somewhere between 45-50,000 tons that is the Indian demand for electrodes.

Abhishar Jain: And sir what would be our market share in this as such approximate?

Manish Gulati: I would say, it would be inappropriate for us to comment our share in Indian market because it makes it very easy for you to calculate everything about everybody.

Ravi Jhunjhunwala: Some of these issues are highly competitive in nature and highly confidential; let us say we have our export probably 65-70%.

Abhishar Jain: And sir just lastly on the needle coke gas you indicated that for the next year's negotiation the prices are looking up, so I think the last negotiation for the previous contract was somewhere around \$375-400, so are we looking at a substantial increase in that or will it again be more of single digit token increase, or something like that?

Ravi Jhunjhunwala: I do not know from where you got those numbers at least you would not have got it from us but without commenting on the numbers that you mentioned I mean these discussions are going for last about 6-8 weeks and it is more or less around this time March or April that we come to a conclusion on that, so these things are going on right now and it will be very inappropriate at this time to talk about any numbers.

Moderator: Thank you. Sir there are no more questions I would just handover the call to you.

Ravi Jhunjhunwala: Thank you for bearing with us in these hard times and I look forward to speaking to you in sometime middle to end of May with our full year results. Thank you.

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