"Vardhman Special Steel Limited Q2 FY21 Earnings Conference Call hosted by IIFL Capital Limited"

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MANAGEMENT:	**MR. SACHIT JAIN – VICE CHAIRMAN & MANAGING DIRECTOR** **MRS. SONAM TANEJA – COMPANY SECRETARY AND COMPLIANCE OFFICER.** **MR. MUKESH SRIVASTAV – COO** **MR. SUNIL – FINANCE TEAM** **MR. GAGAN – FINANCE TEAM**
MODERATORS:	**MR. URVIL SHAH – IIFL CAPITAL**

Moderator: Ladies and Gentlemen, Good day and welcome to Vardhman Special Steel Limited Q2 FY21 Earnings Conference Call hosted by IIFL Capital Limited. As a reminder, all participant 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 '*' and then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Urvil Shah from IIFL Capital. Thank you and over to you.

Urvil Shah: Thanks. Good evening everyone. On behalf of IIFL Securities I welcome you all to Vardhman Special Steel Limited Q2 FY21 and H1 FY21 Results Conference Call. From the management side we have Mr. Sachit Jain – Vice Chairman & Managing Director and Mrs. Sonam Taneja – Company Secretary and Chief Compliance Officer.

Without much ado, I would like to hand it over to you Sachit for your opening remarks.

Sachit Jain: Thank you Urvil. Good evening ladies and gentlemen and thank you for joining us on earnings call for second quarter and first half-ended 30th September. On this call with me is Sonam Taneja our Company Secretary, Mukesh Srivastav – our COO and unfortunately last night our CFO Sanjeev Singla mother passed away suddenly he is not there with us, but we have Sunil and Gagan from our finance team to support me. So please pardon me if we are not up to date on specific questions or numbers, but strategy of course we are all available. So basically, in this first half we have utilized this time to plan for the future of the company along with Aichi Steel Corporation and we have given a detail plan for the same in our presentation as well.

We worked on the plan which is higher EBITDA per ton by way of reducing operating cost and of course higher production and we are happy to share that finally EBITDA per ton is near the upper range of our earlier guidance to Rs. 4,500 to Rs. 6,000 a ton. Though in this quarter some of the items in other income are not sustainable, it is one-time roughly 2 crores is other income which has come in from the (PSPCL) the Punjab State Power Corporation part of our incentive pending from earlier which will not be coming in second half, but on operating basis second half is likely to better than the first and the second quarter. What we also feel is that the impact of COVID from our side in terms of demand for steel because auto demand seems to be going okay seems to be normalizing.

Partly towards 1. We believe pent up demand for autos and 2. because of demand for personal mobility coming in because of COVID leads to higher demand for entry level cars and motorcycles and in the first half we saw that commercial vehicle demand was lower, but that seems to be picking up now. So tractor have been very good because of the good crops both Rabi and Kharif crops as we expected Rabi crop again it is expected to be good. So overall demand for tractors and motorcycles also from the rural areas seems to be good. Capacity utilization are back to pre-COVID levels in fact we are much better than last year's capacity utilization levels and we have also done lot of training in this period for our employees.

We have got lot of cross-function of team is going on. Identified lots of projects for improvement both in terms of cost cutting as well as safety improvement and cleanliness improvement and so on.

So the benefits of our partners Aichi as shared earlier will come in over time, but the biggest benefit that we are seeing already are in terms of safety conscious in the company has gone up tremendously after they are coming in with reporting of even near misses and which was never and small accidents require first-aid require and so on all that it is this tremendous conscious improved, problem solving from the root cause is the second big area which has improved under Aichi guidance.

The third area which is improving under Aichi guidance is quality of Vardhman products has always been good, but quality variability lot to lot variability and within lot variability those are other areas which are improving with Aichi guidance. We are also finding that stability of production is improving at a higher level again these are all consciousness that are brought in because of regular follow up of Aichi team.

In terms of financial highlights for the quarter, volume for the quarter into the sales was almost 44,000 tons, year-on-year growth of 32.48% mainly as I said on account of very sharp recovery and pickup in demand.

Revenue has also been up because of this volume increases, but prices have been lower and therefore revenue growth is only 16.3%. EBITDA including other income is Rs. 26.67 crores against Rs. 7.97 crores and PBT is Rs. 15 crores with a PAT of Rs. 8.94 crores. So that is the kind of performance it has, and this seems to be our best quarter ever in terms of sales as well as in terms of profits. And despite the good performance in second quarter we still in loss for the first half because of the large loss in first quarter, but from what our original estimates were in terms of our performance the situation seems to be much better from that.

In terms of return on capital employed if I look at just second quarter performance and if we remove the fixed deposit of Rs. 50 crores which is really the amount put in by Aichi and we remove the income on that also so remove that from capital employed. The return on capital employed, EBITDA on capital employed for this quarter if we analyze it has reached a figure of 16% which was our first target so we hope to continue to work at this figure and eventually even improve this figure.

I would also like to believe that we are reaching a stage where we would like to revise our guidance for future. So from a range of Rs. 4,500 to Rs. 6,000 a ton I would like to believe that now that Rs. 5,000 a ton should be a minimum range of course for some time we like to increase the range. So, I would say EBITDA per ton range as what are called as normal profitability should be between Rs. 5,000 to Rs. 7,000 a ton. Anything less than that would be abnormal and anything more than Rs. 7,000 would also be abnormal. We expect these kind of numbers to remain for two to three years and beyond that once our capacity increases and the full benefits of Aichi come in including business for export to South East Asia towards Toyota Group Companies and other Japanese OEMs with the help of Aichi, we expect this range could improve further from this level also.

In terms of return on capital employed the 16% return on capital employed is something we will continue to strive to achieve, but three years later we expect to improve from the current levels.

Overall, if I look at our employees – the moral is excellet. In these good times now as I will call it the way we looked after employees in the tough times in the COVID times, in the lockdown period that seems to have gone deep into our employees because we did not cut any salaries, we did not have any layoffs, we paid full salaries to all officers, managers, workers we even paid full wages to our contractor workers, not only that we have now announced increments for the year for our officers and managers and we are working on the increments from January and as well as we are working on the increments for our workers and clerical staff which is due from 1st January which will also announced within November, but otherwise mid-December all that will be announced so we are on track in terms of our performance.

Working with Aichi is going well. Our OEM seem to be doing well at least in terms of car manufacturing the trend seems to be that this trend seems to continue till March because earlier our expectation would work that around Diwali time the demand would drop so we were expecting lower demand in October and significantly lower demand in November. October has also been strong and November continuous to be strong of course little weaker than August and September, but October and November continue to be stronger than what we had anticipated.

So, at this point I would like to close my opening remarks and we are open to questions.

Moderator: Thank you very much sir. Ladies and gentlemen, we will now begin the question and answer session. The first question is from the line of Anil Kumar Sharma an Individual Investor. Please go ahead.

Anil Kumar Sharma: Sir you have given the expansion plan in detail, but the amount of CAPEX is it possible to share number one, number two share of non-automotive parts and number three cost power cost is on very higher side, is it going to be same I have three questions?

Sachit Jain: First of all, the power cost is in control so I do not know how you are seeing it at a higher level so this will remain at this level only. Automotive business is almost 100% so we have very little I mean may be 0.5% or 1% is non-automotive business so that is very tiny percentage. So when we are saying auto of course this includes the biggest segment is cars the second biggest segment is two wheelers than after that we have going to commercial vehicles as well as come to the tractor segments and off-road segments like JCB, Caterpillar also. CAPEX plan, we had plan to announce at the end of our second quarter board meeting, but it is still being finalized and discussed with our partner Aichi and it will get finalized in the next month or two so we will definitely be able to announce it we are sorry we are little delayed in that area, but we will announce the CAPEX plan the next five year CAPEX plan we should be able to announce it by January end or February beginning when we represent our third quarter results.

Anil Kumar Sharma: One more question export, we are at 3% and we have written that we are reaching a 20 to 25 is it increasing on yearly basis or after two years we will start exporting to some extent?

Sachit Jain: So as you would understand that most of our exports most of the increase in exports will really be to the Japanese OEMs and with the help of our partners Aichi. So those kind of exports takes time whenever you are export steel for automobile it is a very critical part that the steel is going to be used for. So it takes time to validate the steel for Aichi to get full confidence on the quality levels and so on. So there are many steps to be taken between now and then. So we will start seeing may be small impact from third quarter to fourth quarter next year, but real impact of that will start only from 2022 and then it will be increasing every year.

Moderator: Thank you. The next question is from the line of Urvil Bhatt from IIFL Capital. Please go ahead.

Urvil Bhatt: So just want to get some update on the volumes front so we have done 44 KT in Q2 that was one of the best numbers that we have done in last many years, so what is the visibility now for FY21 and 22 I mean how are you seeing November and ordering in December, what kind of levels are we targeting in second half just want to get some color on that?

Sachit Jain: Again, we still have uncertainty for the fourth quarter because demand October is fine October is already behind us November also is doing okay. December onwards we should see some slowdown this is normal so there is nothing abnormal about it. So the way I would see it that last year we did 135,000 tons in sales and we could be somewhere near that, but clearly, I see us north of 125,000.

Urvil Bhatt: Anything on the mix part I mean how is the mix changed during COVID time and now I mean in Q2 are we getting some benefit of improved mix or how is the thing at present and outlook for that?

Sachit Jain: In the second quarter we did because tractors were booming in the North and the other sectors had not yet picked up. So in the second quarter clearly our sales in the tractor segment had increased. So once the other sectors have picked up which are our regular sectors tractors is not that important for us. So third quarter onwards we will see it coming back to our normal trends of four wheelers being the maximum and then two wheelers and tractors would drop in percentage from this third quarter.

Urvil Bhatt: And any update on the price negotiation that we have done with the auto clients?

Sachit Jain: Those are going in still not concluded, but I would say within the next few days we are at advanced level of conclusion. So some OEMs have already concluded, but the mains ones are Maruti and Hero because they are our biggest customers plus many other some of the customers that we are dealing with follow these. So the impact of Maruti and Hero price negotiation is the highest for our company. So those are last stages of finalization, but I would say the price negotiations are going well and the cost increase in raw material which happened towards the end or second quarter we would be able to cover that easily. So which is why I was confident in saying that operationally the third quarter is likely to be little better than the second quarter.

Moderator: Thank you. The next question is from the line of Jeetu Punjabi from EM Capital Advisors. Please go ahead.

Jeetu Punjabi: So couple of questions I heard you say to the previous questions that you think after December things slowdown a bit, can you contextualize that is that based on what the OEs are telling or is that based on your own estimates and is the risk the whole system is wrong things just melt up instead of melting down?

Sachit Jain: So this is normal the pace slowing down just before Diwali is normal as you would know that two wheeler and four wheeler sales the maximum of the sales happens just before Diwali so which means from our point of view we were expecting September to be the peak and October the slowdown should have started this is normal. So whereas this time what we found that the sales in October continue to be very strong and November has again continuous to be very strong so we are just saying the perhaps the slowdown which we were expecting from October as normal may happen from December, but as you said as we have been surprised for October as well as we are surprised for November may well the bigger surprise for December too, but as of now we have no information saying that the sales should slowdown and as I said in my opening remarks the car manufacturing continuous to remain strong, but since we also have two wheelers in our segment which share the retail levels there seems to be may be slight slowdown in sales which again is normal I mean what I am talking about is normal circumstances, but in this desire for personal mobility continuous to be strong and the other counter argument say that once colleges open then this time the number of youngster who will get personal mobility two wheeler and once offices open completely still lot of offices in the big cities are work from home and so on. So once those offices open may be there will be a second spurt for demand for two wheelers. So our ability to predict all those things is very low. So we are just saying in terms of guidance that we are ready for a slight slowdown which is a normal behavior.

Jeetu Punjabi: The second question your spread of margin, gross margins that you are making that next whatever three, six months looks okay if the price increases within the range of expectation?

Sachit Jain: We are reasonably confident of third and fourth quarter both being on track and better than our expectations and as I said in all probability is better than second quarter. Again, what we are saying is this is as of up to March. April onwards will again depend on the price negotiations changing because as I said there is possibility of the price increase and we are expecting to be little better than our cost increase. So whether the numbers that we get which is slight improvement from second quarter will those numbers be sustained next year in terms of pricing I do not know, but I will also say that our teams have worked very well on the cost initiative. So those initiatives which are on the cost side those initiatives remain with us which is why we are quite confident of saying that the range we are revising upwards.

Moderator: Thank you. The next question is from the line of Manish Sehgal an Individual Investor. Please go ahead.

Manish Sehgal: I just want to check you mentioned that the range will grow from 5,000 to 7,000 and there is a scenario where our price hike is higher than the raw material increase, so are the in the next two quarters where we go beyond 7,000 as well in an abnormal situation?

Sachit Jain: Very difficult to say, but we will clearly be on the upper we seem to be on the upper end of this range, but how much higher we go we cannot say at this point in time till the prices are finalized and I would not like to speculate unnecessarily and then be proven wrong, but as of now the reading is it will be towards the higher end of the new range.

Manish Sehgal: One more question 2 crores is the numbers that you said was one time because of the incentives apart from that in which quarter what is the incentive number which may not have been there in the previous year's numbers?

Sachit Jain: There are two other figures that occur in the other income which were not there in earlier times. So one is there is this fixed deposit of 50 crores which is the proceeds from the rights issue of Aichi steel so that the interest on that fixed deposit comes in the other income as well as we have this time in COVID times the Punjab State Electricity Board was running short of cash and they put in an appeal to industry that you pay your power bills in advance and you get reasonably high I think 12% interest so we deposited our estimated power bill for the full year well in advance. So we are getting an interest arbitrage because of the interest rate on this advanced electricity consumption deposited is around 12% whereas the cost of our borrowing has been coming down constantly as the rates in the market has gone down. Our latest CP raising was at 4.75%. We are getting a healthy spread which is also coming in other income, which was not part of earlier years income, but this incentive part has occurred in the past also. So the interest income which is on Aichi fixed deposit as well as the Punjab State Power Corporation Limited deposits these are items that have not occurred earlier and since now every month the remaining months are lower so the income on this account will keep dropping. So third quarter will be lower than second quarter and fourth quarter will be lower than third quarter because the deposit is still 31st of March.

Manish Sehgal: One final question Sachit do you think that the growth numbers that you are putting out in terms of volumes going to 250,000 and 300,000 over the next 8 to 10 years is conservative given where we are from a country perspective a 50% growth in 10 years is slightly conservative in volume terms?

Sachit Jain: This is the sales that we will be expecting from this plant. So this is the maximum that we can get out of this plant and 300,000 tons would be billed production which means from that you have to take out the wastages so the sales maximum sales that we expect from this plant would be of the order of 260,000, 270,000 tons.

Manish Sehgal: Are you planning for another plant?

Sachit Jain: So clearly this part is up to 2025. So around 2024, 2025 depending on how the Indian business is progressing depending on how Aichi and Vardhman teams together see the confidence in the way our people have invibe the culture and the quality levels of Aichi and our ability to satisfy Japanese OEMs in South East Asia especially Toyota for critical parts and so on. So once that happens then very clearly on the angle is plans to put up to look at expansion. We have already said that our long-term vision by 2030 is to if all goes well to reach between 800,000 tons to million tons of steel capacity. So that remains on track, but that is the vision. We have not talked about it in detail just now because the decision on that will be taken only in 2024.

Manish Sehgal: And anything on the annual in the near future in terms of say an acquisition or something?

Sachit Jain: So those are things that there is no firm plan that the way things are going if all goes well and Indian market continuous to be strong and the way our customers are responding to us we feel that our growth internally could become a little higher and then and if Aichi develops confidence in us earlier than the schedule so far so if volumes start coming little bit earlier then we might run into capacity constraint, but before that the important thing is to get the environment approval which allows us to expand as you would know. As of now our capacity is cap at 200,000 tons of melting. We have got the terms of reference which seems to be the first set of approval from the Ministry of Environment which means there is we are reasonably confident that by March or so we should get the approval from the ministry of environment for expansion. Once that happens then that clears the way for expansion in this plant. However, if that does not happen then we will be in trouble in terms of not having enough capacity and in that stage then alternate strategy of an acquisition or some such thing could become imperative. Let me say out here that we are our team is reasonably confident that we should get the approval by March we would have got it earlier it is COVID has delayed things by I would say by six months. So what should have happened by now is really may happen by March.

Moderator: Thank you very much. The next question is from the line of Shivani Mehta an Individual Investor. Please go ahead.

Shivani Mehta: I have two questions one what kind of EBITDA per ton do we expect in the tractor segment?

Sachit Jain: So we do not release EBITDA per ton segment wise but to say at the tractor segment the EBITDA per ton is extremely low.

Shivani Mehta: Our 6,000 per ton EBITDA in this quarter has been driven by which segment majorly?

Sachit Jain: We do not declare all that, but as I said in my response to the earlier question that the tractor business was higher than normal in the second quarter and it is for this reasons that we are saying that as the tractor segment has already gone down in third quarter so the average EBITDA per ton will automatically improve in the third quarter and which is why our confidence where we will be despite whatever happens in the price negotiation that we should reach the upper end of the range of 5,000 to 7,000 for the second half.

Shivani Mehta: Sir the EBITDA that has been mentioned does it consider price increase and what are the factors?

Sachit Jain: It does consider some aspect of the price increase, but till the final amount happened we are not able to take give any false indications we do not want a false buildup of expectations. We are suffered as you would recall some of you who have been long term investors with us 2018 was a similar situation where we were expecting price increases of Rs. 4,300 a ton and eventually got 2,000 to 2,2000 a ton and suddenly from what was going to be our best year ever turned out to be a disaster second half which is why we are taking a reasonable increase in the prices and we are speaking more on terms of our confidence in cost reduction as well as product mix change in the third quarter compared to second quarter which is giving us a confidence that we should be at the higher end of this range.

Moderator: Thank you very much. The next question is from the line of Karthikeyan VK from Suyash Advisors. Please go ahead.

Karthikeyan VK: Can you give us the sense of the capital intensity of the business 16% seems like relatively modest for the kind of ambitions you are talking about in order to scale up?

Sachit Jain: See this is a manufacturing intensive industry and lot of working capital is involved into the outstanding and when our cost of working capital is around 5% then EBITDA to capital in front of 16% in my opinion is a pretty good number because all our outstanding is all part of this capital employed and since we are primarily buying scrap so which is normally mostly cash paid in terms of meaning you do not take credit for scrap you are paying spot basis. So it is a working capital-intensive business also. So in that sense I think EBITDA to capital in front of about 16% is a reasonable number however it is very easy to discount these figures, it is very easy to give a cash discount and reduce this capital employed and which will increase our return on capital employed, but when your cost of money is 5% it does not make sense to aim for much higher figure than this. Sorry to disappoint you, but 16% EBITDA to capital employed is what we believe is a decent number and hopefully once this expansion happens in terms of approval from the environment as we increase our production out here. The fixed asset intensity is going to be not so high what our increase in sales and working capital also in terms of our current assets on raw material side will not increase dramatically only outstanding would increase. See there are some of our customers who the payment cycle is 90 days, 100 days, 120 days and 45 days there are all kinds of customers on an average our payment cycle is about 65 days. It is very easy to cut out those customers of 120 days and improve the return on capital employed that is not our objective. Our objective is that the cost of interest for us is 5% it does not make sense of cut out these good customers and the advantage of being a cash rich company which is strong in this region and has long term relationship, relationships over generation with some of these customers we have the ability to take the risk so to speak credit to some of these customers.

Moderator: Thank you. As there are no further questions, I now hand the conference over to the management for closing remarks. Over to you team.

Sachit Jain: Thank you so much ladies and gentlemen. We feel heartened that after disappointing first quarter we were able to recover some bit in the second quarter. I am also feeling reasonably satisfied that we have been talking about this range of Rs. 4,500 to 6,000 EBITDA per ton and we were expecting that to have happened from last year itself because basically we are waiting for the expansion which we did the upgradation of furnace last year after that we were expecting these kind of returns, but the dip in auto business which happened in last year put paid to all our plans. So we are disappointed in our performance so finally to reach those levels that we have suggested has taken a little longer than we anticipated, but we are glad it is there and thank you for showing patient for anyone of you who are the long term investors with us and I can only promise you that we are now on a better road and with us the strength of our partners Aichi steel we expect that we will be more consistent performer than the past. So look forward to seeing you in the third quarter call. Thank you so much.

Moderator: Thank you very much members of management. Ladies and gentlemen on behalf of IIFL Capital Limited that concludes today's conference call. Thank you all for joining us and you may now disconnect your lines.