“Pennar Industries Limited Q1 FY13 Results Conference Call”

July 25, 2012

MANAGEMENT: MR. NRUPENDER RAO – CHAIRMAN, PENNAR INDUSTRIES LIMITED
MR. ADITYA RAO – DIRECTOR, PROJECTS, PENNAR INDUSTRIES LIMITED
MR. RAVI RAJGOPAL – CFO & COMPANY SECRETARY, PENNAR INDUSTRIES LIMITED

Moderator Ladies and gentlemen good day and welcome to the Pennar Industries Q1FY13 earnings conference call. As a reminder all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. If you should need assistance during the conference call, please signal an operator by pressing * followed by 0 on your touchtone phone. Please note that this conference is being recorded. I would now like to hand over the conference to Mr. Nrupender Rao – Chairman of Pennar Industries. Thank you and over to you Mr. Rao.

Nrupender Rao Good afternoon everybody and thank you for joining us today. We are meeting in a difficult Indian economic situation, but nevertheless, your Company is geared up to do what is required under the circumstances. The Indian economy continues to experience decline in GDP growth, relatively high interest rate environment, inflationary pressures, and also depreciation with rupee. Although, the industrial production and inflation have both shown some improvement recently and we need to wait for some more time till the Indian economy is fully on track. The overall environment remains tough as demand for railways and infrastructure sectors which are two of our major sectors and also the automobile sector continues to be under pressure. However, our selective portfolio diversification into specialized tubes, precision tubes, and also solar product divisions has done well. We also maintain strict financial discipline. We have a conservative debt profile and we are not increasing our long terms loan exposure. We are generating positive cash flows though not as much as last year.

During the quarter, the consolidated gross sales compared to Q1 last year decreased by 5.6%. This was primarily due to slow order inflow in the heavy engineering segment, which consists primarily of railways. For various reasons including budgetary constraints, the railways did not give any new orders for wagons and consequently we did not get our orders for wagon profiles or wagon sheets. This was one of the main reasons for our not being able to meet the target. If you were to exclude this segment, the net sales actually grew by 7.4% which was primarily driven by our new divisions, or the new subsidiary company pre engineered buildings which has really moved quite aggressively forward and PEBS as my colleague, Mr. Aditya, will tell you in course of time, has shown a strong growth and contributed to 23% of the total consolidated sales up from 19.7% in the last quarter.

In the Engineered products segment, tubes and solar structurals have performed well. This has resulted in increased sales and EBITDA improvement.

We are pleased to report that we have received an award for "Excellence in all round performance" by the Federation of Andhra Pradesh Chamber of Commerce . The award was presented yesterday night by the Honorable Chief Minister. My colleague Aditya will speak to you about our subsidiary PEBS. Over to you Aditya.

Aditya Rao I would like to begin by thanking everyone who is on the call with us today. The PEBS division has had a good quarter and we have been able to take advantage of our lower cost base and our scalability to grow this business. In a very tough economic environment, we have improved our price realization by 3.6% compared to last year's quarter. Segmental revenue increased from Rs. 55 crores to 67.7 crores. That is about a 22% year on year growth in terms of top-line.

Our profit after tax increased to 3.2 crores, which represents a 50.3% growth year on year and we have managed to grow our order book from the last quarter to 230 crores again in an environment which has been exceedingly tough. We have been able to retain our margin, retain our growth and improve our profitability. This quarter are also characterized by us receiving a lot of orders from a lot of blue chip customers, some of them repeat orders. Some of our customers this quarter are Tata Steel**,** Ramky, Volvo, Shimizu, Areva, Hindustan Unilever, and Schneider Electric. We are pretty confident in terms of meeting our internal targets for the year considering our capacities, customer base and the order book. With that I would like to hand it back to our Chairman Mr. Rao.

Nrupender Rao We expect continued volatility for this quarter also and therefore we are cautious in our approach while making decisions- both in terms of medium and long term. We are focusing on maintaining our balance sheet strength and generate positive cash flows. PEBS segment is doing well and we will do further improve our performance in the coming quarters. In fact, last year's revenue was 275 crores in PEBS. This year we are looking at a revenue of 350 crores which is about a 20% growth.

New product lines like precision tubes for automobiles and solar structures are expected to make some good contributions as we go along. If you really look at it, the drop in our production during the quarter was due to reduction in the demand for commercial vehicles. Orders from Tata, Ashok Leyland and Eicher were down by almost as much as 30 to 40%. And in the infrastructure, power, road and irrigation sectors, there was a definite slow down which also resulted in our losing some of the orders from this segment. More importantly then these two events was that in the last quarter of the earlier year, we are done a significant amount of railway products with a very high contribution, but now what has happened is that during the last quarter, because of railways budgetary constraints and also because of non finalization of the tenders, the railways wagon builders Texmaco, Titagarh, Modern Wagons, some of our main customers, did not get any meaningful orders from the railway and hence we did not get any meaningful orders from them. As a result our production in this segment has been very low and hence it has definitely affected us. We are addressing this by procuring new orders from other business segments. We have received orders from Larson and Turbo and Mahindra for solar structures which will start shipping from September onwards. And I am happy to tell you that the chief inspector of boilers Andhra-Pradesh has certified our plant for making boiler tubes. This segment of boiler tubes serviced mainly by TI, and Innoventive and we are going to concentrate on this segment. And similarly we will also be making precision tubes for the automobile sector including exhaust tubes and shock absorber tubes. We have now commissioned the line and we have started marketing these products.

In the engineering components division, we have developed two products for Bajaj in Aurangabad, namely brake disc and clutch plate. With these we expect to return to our last years performance level from the third quarter onwards. We are conscious of controlling costs.

We are taking a lot of steps to optimize fixed and variable costs . One of the problems in the plant has been the power cuts in Andhra-Pradesh, for two or three days in a week. We are using diesel generators which is twice as expensive as the grid power. Nevertheless, we are not allowing the operations to be impacted by the higher cost of power.

This is a broad overview of the first quarter and our expectations in the next few quarters. I now request the moderator to open the lines for Q&A session.

Moderator Thank you very much. We will now begin the question and answer session. We have the first question from the line of Giriraj Daga from the Nirmal Bang Equities, please go ahead.

Giriraj Daga My first question related to PEBS expansion, you are talking about 90000 ton from 60000 so what is the status there, have we reached the commissioning stage or what is the status?

Aditya Rao As far as PEBS expansion is concerned, it is a hybrid expansion. It is not a straight forward increase in capacity alone. We are also adding value added services like shot blasting and painting. The beam fabrication capacity expansion is ongoing and should be operational very soon. We think by the middle of next quarter, we should be able to commence production on that the third beam line. The reason for that essentially is that we wanted to take advantage of some falling prices. So we are currently looking at a capacity of about 60000 and we are not completely constrained by it yet so we have a little bit of buffer in terms of beam fabrication.

Giriraj Daga You would have already started marketing this third line also I guess?

Aditya Rao Yes, we have built up an order book and we intend to start using the beam line very soon.

Giriraj Daga What is the margin profile of the remaining 230 crores order, is it a same like 10.9% what you have able to achieve in the Q1, can you take that number forward or to be the lower or higher?

Aditya Rao I would prefer not to blame the economic environment for our margins, but we are in a very competitive environment and while we do have certain advantages when it comes to our customer base, technologies and certain tax benefits that we receive. We are looking to gain scale and retain margins rather than aggressively grow them this year.

Giriraj Daga My question related to margin is for the other segments also as well like a product. Everywhere on a QOQ basis, like Q4 to Q1 we are able to increase margin by almost 160 to 180 bps. So is this sustainable or we will raise prices in the coming quarter

Aditya Rao I think we were looking at sustaining, there is definitely difference between Q4 and Q1 in terms of improvement because we went for a lot of scale in the fourth quarter, but I think for this year certainly our goal is to ensure that our margins are sustained and the EBITDA margins do not decline. . We expect this year to be at around 10% for both companies.

Giriraj Daga Okay for railway orders, what is the status right now. We are in one month after this quarter and what we can assume for next two quarters, can we assume that substitute environment or it can continue problem. What do you expect?

Nrupender Rao No. Texmaco and Titagarh are the main suppliers for Railways and it is a very important segment for them. I do not expect them to get orders from the tenders and pass it on to us in the next two months so I think from September onwards, we should see some movement and I am sure the second, third and fourth quarter will definitely be good,

Giriraj Daga But September quarter order flow should help in Q4 and Q1 right?

Nrupender Rao Q3, Q4 we will get definitely, in Q2 I am a little doubtfull. In September we will get some orders then it can catch up.

Giriraj Daga Okay expansion of the like existing parent companies by 12000, what is the status there and if we have completed the first phase of commissioning right.

Nrupender Rao Yes we have already completed it both at Tarapur and Isnapur plants. We have received the certification for boiler tubes from the chief inspector of boilers and started getting orders for ERW tubes. We have set up new capacities for solar.

Giriraj Daga Would you be able to share the solar panel sales that number during this quarter Q1, what was the sales number of solar panel and what was the margin for that?

Nrupender Rao There were no sales for Solar in Q1 as the demand is seasonal.. Third and fourth quarter, we are expecting that they will be maintained orders that we brought from Larson and Turbo and Mahindra for solar is all from supplies from September onwards.

Giriraj Daga About the finance, have we capitalized any interest cost during the quarter?

Aditya Rao No. We have not capitalized anything.

Giriraj Daga So whatever loan cost is there for 45 crores is 100%.

Aditya Rao Its 100%. We do not capitalize interest.

Giriraj Daga All our projects are commissioned that base we are having right?

Aditya Rao Yes and even in projects which are under implementation we only capitalize the cost of equipment and not the interest

Giriraj Daga Okay and one more thing from this quarter you are not giving full year guidance which earlier you used to give, so any intentional decision not give guidance because of the economic environment being so tardy. Is that the reason?

Aditya Rao Yes. you are right actually because we are not 100% sure of the market. We are not cutting the guidance because of the environment. We are essentially not providing the guidance.

Griraj Daga Not cutting guidance, we are not providing the guidance I will put it this way.

Aditya Rao Yes. That is correct.

Giriraj Daga All the best, I will say particularly that we will be doing still well because of the order book, we were estimating some cut in that you were able to add some order book to that. That is fairly good job.

Moderator Thank you. We have the next question from the line of Akhil Jain from Aditya Birla Money, please go ahead.

Akhil Jain I wanted to know who are our main competitors in the PEBS space?

Aditya Rao Our main competitor in this business is Kirby Building Systems, which is the market leader at about 1000 crore of revenue. There are not any public listed companies which I can give you as examples, but Kirby and Tata Bluescope are the primary competitors. There some other such as Zamil, but we currently believe that we are number three in India.

Akhil Jain Okay this Kirby Building System- is it an overseas company.

Nrupender Rao Yes. It is owned by the Alghanim Group based in Kuwait. It is a multinational.

Akhil Jain Then in the railway products business who are your main competitors?

Nrupender Rao Yes railway product in terms of wagon profiles are made by TI and ourselves. For a few years we were the only two people. Now one more company has got the approvals namely. DTLA in Pune.

Akhil Jain Okay, what is the reason that there has been a delay in the orders for wagons because I believe that railway is actually facing a huge shortage supplying wagons to coal India.

Nrupender Rao That is very true. Railway is having a shortage of wagons. Coal is suffering, cement is suffering. Number of people are suffering so by all common sense and logic, the railway should order more wagons, build more wagons, but either there will be budgetary constraint or systemic problems and they have not placed orders and every time the minister goes and says that this year the budget will be 18000 wagons**.** I think the minister said this time also and for the last year they did not go beyond 10500 wagons and the way things are going now we do not expect that we will really cross 10000 wagon this year also.

Akhil Jain Okay what are the typical operating margins in this business?

Nrupender Rao Margins were very good actually, about one-two years we were running at 25% EBITDA and it has come down to 15% now because of competition and because of pressures from Texmaco, Titagarh who are themselves taking orders at lower prices from their Railways.

Akhil Jain Okay, most of it I believe would be cargo based orders right?

Nrupender Rao Yes. Actually if you look at our turnover, 2/3rd of our turnover comes from wagons and 1/3rd from coaches. Our Madras factory specifically caters to the Integral Coach Factory in Madras where we make coach sections and the roof and the floor and the sidewalls forBombay Suburban Electric coaches. For the metro coaches which require more precision, they are sourcing from Alstom or Bombardier. Bombardier has established some facility in Gujarat and Alstom has setup facilities in North of Madras.

Akhil Jain Okay, so 1/3rd is passenger coaches and 2/3rd is fleet.

Nrupender Rao Yes.

Akhil Jain Okay what is your capacity for precision tube?

Aditya Rao We have two types of tube products, ERW and CDW. For ERW, we have a total installed capacity of about 3000 MT. For CDW tubes, the total capacity is currently at 500 MT, but we intend to expand that.

Akhil Jain 500 ton per annum.

Aditya Rao No per month.

Nrupender Rao 40,000 tons per year.

Akhil Jain It is the ERW.

Nrupender Rao Yes.

Akhil Jain Okay 36 roughly in ERW and CDW is 6000.

Nrupender Rao Yes**.**

Akhil Jain Okay what is the growth to that you are seeing the automobile sector is slowing down so what is the current production? What is the current capacity at which we are operating at?

Aditya Rao In the tubes business?

Akhil Jain Yes tubes business production what is the capacity utilization?

Aditya Rao In the tube business we have just setup a capacity at Isnapur to manufacture ERW and CDW tubes and yes the market is definitely not very favorable, but like PEBS, we are actually scaling up from the bottom. So this year even though the market is tough, we will be stealing market share right now as there is no new demand being created. Mr. Rao mentioned we got boiler certifications. We have had a lot of success with our APH tube products and we believe that we should be able to break in into the auto sector as well. There are several trial orders going on right now. We are confident of achieving 150 crores this year in this business.

Akhil Jain This boiler tubes are CDW in nature or ERW tubes?

Aditya Rao APH tubes themselves are ERW plus some furnace and surface treatment, but boiler tubes are ERW.

Akhil Jain Boiler tubes are ERW okay.

Aditya Rao CDW are used in the automobile sector. CDW is essentially a downstream product from ERW. We would take an ERW tube and expose it to certain surface treatment, suaging and push pointing and reduction thickness in diameter.

Akhil Jain Okay, right now it is basically business is more geared toward ERW tubes?

Aditya Rao Correct in terms of capacity, but APH is actually high margin business and a good scalable business. So I would say ERW and CDW both are actually a combined capacity and we are not exclusively focusing on either.

Akhil Jain Okay this plant that you have, where is it located?

Aditya Rao This is located in Hyderabad in Insnapur and we inviteyou to come visit us if you can.

Moderator Thank you. We have the next question from the line of Subhankar Ojha from SKS Capital & Research, please go ahead.

Subhankar Ojha I know that you are not giving guidance for the FY13 financial year. Just to get a sense of your internal projections, are you assuming a growth in your top-line numbers FY13 over FY12?

Nrupender Rao As from a consolidated business, we definitely want growth and achieve what we did last time. So yes the answer is yes.

Subhankar Ojha Okay and secondly this power situation that you have just mentioned in AP, because last quarter also there was these problems which is why our margin was hit badly. When is it going to be resolved, is there a possibility that quarter improvement….

Nrupender Rao Yesterday we had an opportunity to listen to the Chief Minister and what they are saying is the reduction in gas supply is one of the reasons for this issue. They are accessing power from the grid from North and secondly the inflows that are coming in because there have been heavy rain lately so the hydroelectric power started to go up from one project now to two to three projects and that should reduce the problem at least half of it. So we expect that from now onwards, the rains are there and the power situation should slightly ease compared to what it was earlier and that is what we hope and we are looking at somethings like buying from the grid and then we are also looking at some other aspects of taking a stake in a gas based power plant so something of that so that we can reduce the cost.

Subhankar Ojha We saw some 200 basis point improvements in our EBITDA margin on a sequential basis, what has help us to see this expansion on a sequential basis?

Aditya Rao I would counter in two ways. First let me speak of PEBS alone. PEBS has had a good improvement in terms of margins primarily because of scale improvements, but in terms of Pennar Industries considering the recession we have gone through a cost cutting exercise. We have been very careful. We have not increased our borrowings. We are making sure that all these cost are under control- of course EBITDA does not trigger into interest cost. But overall we feel that you can see the turnover also is lower so we are making a conscious choice to ensure that our margins are retained. And we are not going to create customers who are going to give us low margins or even might become questionable receivables. So this year is the year of cash flow for us. We are going to ensure that we continue to see strong cash flows. We are not going to borrow any money. There aren't any realistic levels of debt anyway in this company, but we are going to ensure that our margins stay constant and grow and we will focus on that rather than just turnover growth.

Subhankar Ojha If you can talk a bit about this latest ordering that you had I think which was there in, I think you have received some significant orders from overseas client.

Aditya Rao You mean in the last quarterly conference or what we have announced in the market?

Subhankar Ojha In the market actually during this quarter.

Aditya Rao Okay let me just tell you little bit about some of the orders we have got. We have received an order from Volvo for design, manufacture, supplying, and erection of five of their buildings to be used for their truck manufacturing factory near Bangalore. We received an order from Shimuzu Corporation again for the turnkey, design manufacture, supply and construction of buildings to be used as ancillary units, structural steels systems, conveyor belts, material handling, external pipeline systems and one from Unilever for a warehouse. This is to be built in Haldia. From Areva Industries, we received an order for an electric circuit breaker manufacturing unit. This is going to be in Chennai.

Subhankar Ojha Right and typically these orders you are confident of achieving similar level of margin that you currently doing?

Aditya Rao I think we will not book orders at levels less than what make sense to us. Quite frankly we do not do it on a per ton basis, but we have certain contribution margin levels to be met. If fixed cost are in control and as we increase our sales, we would obviously see the fixed cost being divided over a larger turnover so that gives us some flexibility if we just want to retain margins but overall as far as EBITDA and PAT is concerned we will not be compromising on margins.

Moderator Thank you. We have the next question from the line of Sonal Srivastav from MF Global please go ahead.

Sonal Srivastav I just wanted to understand when you mention that you are being cautious and not wanting to increase the debt level, so I assume that we are operating at same level of last year at around the 40-45 crore of debt?

Aditya Rao Yes we are but I will give it over to our CFO for more details.

Ravi Rajgopal Yes basically for the present volume which we are operating, we do not require any additional funding or anything.

Sonal Srivastav Right but what is the gross debt situation right now?

Ravi Rajgopal Total borrowings from bank for working capital part of it, we are having 110 crores limit, we are utilizing around 90-95.

Sonal Srivastav Does it mean that there has been some ramped down at the inventory levels also looking at the business condition because last year we were operating at around 52 days of working capital inventory?

Ravi Rajgopal Yes, actually volume has come down so the inventory level is maintained and I am also collecting receivables more and cutting costs .

Aditya Rao Just to clarify- in terms of our inventory I would look at in terms of RM and work-in-progress in FG. You do not really hold down to too much FG. here this is a much quicker model, but RM we really have about one month in terms of our holdings and of course WIP will be about 1 to 2 months. So that is more or less constant as compared to last year.

Sonal Srivastav Okay you are not saying any pressure happening on the working capital side at least.

Aditya Rao No we are not going to borrow anymore….

Ravi Rajgopal We are having control on this one also.

Aditya Rao That is the reason for the turnover to be where it is really because in this kind of environment we have heard a cases where people are getting orders, but they are not able to execute it. We are not going to get into a working capital trap. We do not want to get our receivable stuck for a long time and in PEBS specifically, we have absolutely no receivables which we have not provisioned for more than 360 days and our more than 180 days receivables is 2 crores which is about 10 days of sales. So effectively a lot of what we do is cash flow control and ensuring that our working capital stays in control and that will continue even if that comes at an expense of slightly lower turnover.

Moderator Thank you. We have the next follow up question from the line of Giriraj Daga from Nirmal Bang Equities, please go ahead.

Giriraj Daga Like what is the free cash flow is generated during the quarter?

Ravi Rajgopal 16.2 crores.

Giriraj Daga That is cash profit or free cash?

Ravi Rajgopal It is a free cash flow.

Giriraj Daga What is the CAPEX we are looking in FY13 and 14?

Aditya Rao We are actually going a little slow on CAPEX so we are going to have about 10 crores.

Giriraj Daga 10 crores in each of the year?

Aditya Rao No, only FY13. FY14 we are actually going to be looking at some kind of recovery coming. We think recovery is going to take about a year for larger industry or the market so at that point of time we will be looking for opportunities pretty aggressively. I guess we cannot comment right now on FY14 CAPEX.

Giriraj Daga What is the mode we are putting for this cash generation like would we utilizing first for the debt payment and then would we are making generous dividend payment or this point what sense management have because already we have some 20-25% of dividend payout.

Aditya Rao We have declared that policy at 20-25% in terms of dividend payout. As far as our remaining cash utilization is concerned I think as you mentioned we want to decrease our bank payables and hopefully become a completely debt free company. So that we should probably be able to achieve as well this year.

Giriraj Daga We are in 172 crores of total debt right?

Aditya Rao	That is correct including both companies yes.
Giriraj Daga	Yes so you are saying debt-free for the total debt 172 crores or only for the long term debt?
Aditya Rao	Total long term debt in the company including Pennar Industries and PEBS is about 50 crores, so we can wipe that out this year.
Giriraj Daga	No I just missed the number, 90 crore we have working capital debt. I thought the 82 crores would be the normal long term debt.
Ravi Rajgopal	No 90 is used for Pennar Industries. And our PEBS is also there. Together it is 180 to 172 minus 50, 122.
Giriraj Daga	122 is the total working capital debt of both the companies.
Ravi Rajgopal	Yes.
Giriraj Daga	And you can pay this 50 crores initially first and then you will be coming back on to working capital funding for the internal accruals.
Nrupender Rao	We are generating enough cash flows to first of all pay both the interest and then pay dividend
Giriraj Daga	That is a thought like our business ROEs are quite better compared to if I see the held which you would be making on the cash or cost you to paying on the debt so any thought of buyback also?
Nrupender Rao	No we have no intention of buying back the shares. We have to conserve money, because times are not very good and we have very difficult times. We do not want to use any of our money in buying some shares.
Giriraj Daga	If I put it from an investor prospective, you are looking at ROE, business is making 20% ROE if you are paying on a debt around 12-13%. So you should always go for the 20% business with ROE business.
Aditya Rao	There is definitely financial sense in doing it and also in terms of shareholders value too, there is some amount of sense, but I think we will have to take a long term view on this. We have done a buyback before actually but I think the cash flow that we generate, should be conserved for opportunities we see in the future rather than invested into share buyback right now. I think we would like to be a secure company first. Definitely stakeholder interest is an important aspect but right now we do not believe buyback is the best use of funds.
Moderator	Thank you. I would now like to hand the floor back to Mr. Nrupender Rao for closing comments. Over to you sir.

Nrupender Rao We just want to leave the thought with you that like you are all aware as you are tracking so many companies that times are tough. From the second quarter we definitely want to retain or improve the situation and we definitely see that the third and fourth quarter will be better. We do hope that dark clouds will vanish and the economy will improve because in a way we are tied up with the overall economy. When automobile, infrastructure and Railways improve we are definitely looking for a much better second half. Meanwhile we are controlling costs and conserving cash. We leave the thought with you that management is fully geared up to the current situation and we are doing our very best. Thank you.

Moderator On behalf of Pennar Industries that concludes this conference call. Thank you for joining us.