AARTI INDUSTRIES LIMITED

Aarti Industries Limited

Q2 FY20 Earning Conference Call Transcript

November 14, 2019

Moderator: Ladies and gentlemen, good day and welcome to the Aarti Industries Limited Q2 FY20 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 '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Shiv Muttoo from CDR India. Thank you and over to you, sir.

Shiv Muttoo: Thank you. Good afternoon everyone and thank you for joining us on Aarti Industries Q2 and FY20 earnings conference call. We have with us, Mr. Rajendra Gogri – Chairman and Managing Director of the company, Mr. Rashesh Gogri – Vice Chairman and Managing Director and Mr. Chetan Gandhi – CFO.

We will begin this call with opening remarks from the management, following which we will have the forum open for question and answer session. Before we begin this call, I would like to point out that some of the statements made in today's call may be forward looking in nature and a disclaimer to this effect has been included in the results presentation shared with you earlier.

We will begin the call with opening remarks from Mr. Rajendra Gogri who will take you through the performance of the company and the outlook on the business. We will then have the forum open for interactive question and answer session.

Now, I would like to invite Mr. Rajendra Gogri to share his views. Over to you sir.

Rajendra Gogri: Good afternoon and very warm welcome to all of you.

Our financial performance during Q2 is more representative of the plant transition that is happening in our core business. From the revenue standpoint, there are 3 key points that need to be highlighted. We have carved out revenues from the erstwhile homes and personal care segment that will be listed as Aarti Surfactants. There has been a sharp decline in the price of some key raw material which largely get passed onto the customer and 3 continuing increase in the contribution from downstream products which increased from 70% to 75% Y-o-Y. As a consequence of this, sectors reported revenues are optically lower compared to the same quarter last year. Export remained relatively stable, export contribution to revenue has expanded from 36% to 44% on Y-o-Y basis.

Overall, we see this as a positive performance from the perspective of our long-term business objectives. Our gross profit and operating profit are the more

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appropriate parameters to evaluate our business and both these remained almost flat on Y-o-Y basis. On the lower base of revenue, reported margins have expanded significantly, EBIT margin expanded by 400 bps Y-o-Y to 19.7% in Q2 FY20. We recorded our highest ever quarterly PAT of 142 crore on a standalone basis representing growth of 15% Y-o-Y. These numbers need to be looked at the backdrop of continuing macro challenges in the global agrochemical and automobile sectors. Aarti Industries with differentiated capability relationship and wide range of chemical products continue to be well recognized by most of the largest customers globally. At present, we have engagements more than 1100 global and domestic customers with a growing number of long-term partner size relationships. Our diversified portfolio over 200 products manufactured in stringent client specifications are sold in over 60 countries. We maintained low concentration on geography, client and product parameters, thereby significantly de-risking the business.

Our specialty chemical business revenue was lower by 19.5% Y-o-Y in Q2 including 7% impact from lower raw material prices and due to demand like factors. I explained earlier EBIT was lower by 4.8% and EBIT margin expanded by about 400 bps Y-o-Y during the quarter. We have been continuously leveraging our fungible capacity to optimize our product mix to maximize the margin resulting in the higher EBIT but the lower volume growth. Contribution from downstream products further increased from 70% to 75% which is a trend driving our business to the next level of customer engagement and into segment that see relatively less competitive intensity.

Selling more of higher value, lower volume products also brings about relative saving in shipping, handling and transportation cost especially for exports. We produce about 13,900 metric tonnes of Nitro Chloro Benzene during Q2 FY20 as against 17,000 metric tonnes for Q2 FY19. Production in the quarter was lower due to ongoing scale up and expansion activity at the said unit. The expansion of NCB capacity from 75,000 to 108,000 metric tonnes per annum expected to be implemented in FY21 will cater to the increasing external demand in India and also our requirement of manufacturing downstream products. Plant capacity addition in two phases would entail an investment of about 150 crore. We had also witnessed a temporary shortage in one of the key material Nitric Acid during Q2 FY20 which has impacted the volumes of some of our products.

Other major ongoing projects such as specialty chemical complex and chlorination plant in Jhagadia, project at Dahej SEZ in Gujarat are progressing as planned and are expected to be commission in second half of current fiscal. Likewise, our fourth R&D and scale-up centre which is coming up at New Mumbai is going to commence activity in the second half of current fiscal. This centre will facilitate further enhancement of product portfolio and also helped improve our manufacturing processes.

The pharma business showed some decline in revenue on Y-o-Y basis. This partly attributed to the continuing change in product mix towards higher value addition which is evident from the strong growth and profitability both on absolute basis and as a proportion of revenue. Segment margin expanded by more than 350 basis points to 18.7% with overall capacity utilization has been running at higher levels due to some lines being occupied by new products where we are undergoing a validation trial.

For our CAPEX fund, investment of Rs. 506 crore have been made in H1 and the planned full year CAPEX is expected to be in the range of 1000 to 1200 crore. The company continues to operate at a healthy gearing level and would utilize a surplus cash from the QIP projects for the ongoing CAPEX program.

Summarizing on our performance; despite macro challenges, we have been able to achieve consolidated PAT of 286 crore for H1 FY20 as against full year consolidated PAT of Rs. 491 crore for FY19. Looking at this in the current situation, we expect to be able to close the year with a bottom-line growth of about 10 to 15% on an annualized basis.

To conclude, we believe that India is emerging as a more significant player in the global chemical supply chain with its scalable low cost manufacturing ecosystem, improving infrastructure and established VHS compliance framework. The country is well positioned to expand its market share globally and there are also opportunities to replace import with domestic production. Investment into operational excellence and new product development can create differentiation and strong long-term business visibility. We are making several initiatives and investment to participate in this growing potential.

On that note, I conclude my opening remarks. We would be very happy to give you our perspective on any questions that you may have. I request the operator on this call to open question and answer session.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the question and answer session. We take the first question from the line of Ritesh Gupta from Ambit Capital. Please go ahead.

Ritesh Gupta: I just wanted to check on the contract manufacturing capacities for the two of the large clients – when are they expected to get commissioned and when do you expect them to start running at full utilization? That was question number one. Secondly, the NCB capacities were impacted on two accounts – there was commissioning of the new capacities or expansion that is going on and Nitric Acid was also limited. Did this only impact the NCB and the downstream products or did it also impact other products? These are the two major questions that I have right now.

Rajendra Gogri: As mentioned in my opening remarks, those projects are going as per time and we will be commissioning them in Q4 of FY20; FY21 and FY22 is where we will see major volumes coming in from these two contracts. As far as Nitro Chloro Benzene is concerned, the Nitric Acid has impacted Nitrotoluene production also, in addition to Nitro Chloro Benzene.

Ritesh Gupta: Is there any top-line or EBITDA impact that you would like to quantify on that account?

Rajendra Gogri: That is the reason why, the top-line has been impacted; especially on the basic chemical front which are – Nitro Chloro Benzene and Nitrotoluene.

Ritesh Gupta: On Toluene capacity – how is the utilization for the Nitrotoluene capacities right now; as you had some disruption, is it likely that the Nitric Acid situation will neutralize or get resolved? Do you expect them to reach full utilization soon or will it still take some time for the Toluene capacities to get fully utilized?

Rajendra Gogri: In this quarter, it was substantially lower. We had about 1,400 tonnes of production but progressively, it will increase.

Ritesh Gupta: You said that the slowdown has been impacted. Is it that the realization has also been impacted badly or is it just the volume impact that is there? In terms of realization, on a like-to-like basis or EBITDA per tonne – in some of these products, has it seen a major decline or has it remained the same as the last year?

Rajendra Gogri: We make many different products for different end-use applications and geographies. The impact will depend from product to product; we have structural contracts where margins may not be impacted but only the volumes may be impacted. In a multi-product situation, the impact may be seen on both – volume and margins. Generally, in our case, the impact on margins is relatively less and is more of an impact on volumes.

Ritesh Gupta: An increase in the employee cost for the quarter, on a Y-o-Y basis, looks heavy. Is it line with the people addition that you had or was it a one-off?

Rajendra Gogri: The merger of Nascent Chemical factors into that; it is what increased the overall employees. Also, we recruited people for an upcoming project and they are on training.

Moderator: Thank you. Next question is from the line of Abhijit Akella from IIFL. Please go ahead.

Abhijit Akella: First, on the PDA segment – in the last quarter you had mentioned that there was about a Rs. 10 crore boost to EBITDA because of higher prices there. What was the impact this quarter?

Rajendra Gogri: In this quarter, it may be around Rs. 15 crore and will come as an additional impact because of PDA.

Abhijit Akella: How are you seeing the prices trending there in Q3?

Rajendra Gogri: It has peaked now. It will be tariff-correcting in Q3. Q2 was the peak.

Abhijit Akella: If it were not for the temporary issues such as – Nitric Acid shortage and plant shutdown for the purpose of de-bottlenecking, is it fair to assume that the NCB volumes would have been the full 17,000 tonnes or was it that the actual number was 13,000 tonnes, odd, this quarter?

Rajendra Gogri: Yes, 13,900 tonnes; otherwise we would have been at around 16,000-17,000 tonnes which is our normal run rate.

Abhijit Akella: Was Nitrotoluene about 1,400 tonnes this quarter?

Rajendra Gogri: Yes.

Abhijit Akella: On the Pharma side – we have seen some sequential decrease in revenues from Q1 to Q2. Is that because of any specific client issues or is it anything else? The guidance given is about 20 to 25% growth for the full year, for Pharma; how do you see that spanning out?

Rajendra Gogri: Yes, in this quarter we had some products' validations being taken up and certain high value products were not produced i.e., the higher value of sales products. That will be taken care of in next quarter.

Abhijit Akella: On tax rates – if you could give us some guidance on what to expect going forward?

Rajendra Gogri: We have been at a lower tax rate and used to be at somewhere between 17-18%. I believe that we will be in that range.

Abhijit Akella: 17-18% is where it will remain?

Rajendra Gogri: Yes.

Moderator: Thank you. We take the next question from the line of Naushad Chaudhary from Systematix Shares. Please go ahead.

Naushad Chaudhary: I have two-three quick questions. The first, is on the finance cost – if the half-year interest cost is calculated with the debt which is on the balance sheet, it comes to around 3% to 4% of the interest cost; if you can help me understand why?

Rajendra Gogri: There is a certain interest income which gets netted-off in the interest expense. Also, there were QIP proceeds in last quarter and that interest income got netted off. Thus, the actual cost would have been higher by around Rs. 4 crore to Rs. 5 crore to that extent.

Naushad Chaudhary: Do we include the FOREX gain or loss in this line item or is that under other expenses?

Rajendra Gogri: FOREX gain or loss, in respect of long-term loans, is part of the finance cost. The gain or loss, in respect of the trade transactions like – exports, imports and others is part of the operating income.

Naushad Chaudhary: That is not the part of this line item, right?

Rajendra Gogri: No, that is not part of this line item.

Naushad Chaudhary: Second question – from the consolidated figures, if I subtract the standalone amount, I get the numbers for subsidiaries. If I look at the EBITDA margin of these numbers, I get around 32% to 33% of EBITDA margin versus the consolidated margin of around 24%. I would like to understand what these products are that have these kinds of margins.

Rajendra Gogri: There were cancellations of intra-group sales and thus, there are broader numbers. Actually, the EBITDA margin is similar; we have two subsidiaries, for expansion of marketing in US and Europe. Sales have been knocked off at an overall basis. There is another entity, a subsidiary – Ganesh Polychem, which is the only larger manufacturing entity; they have an annual profit of about Rs. 25 crore, odd, after tax. So that is the major addition to the bottom-line for the company.

Naushad Chaudhary: Are these two the only marketing entities for us?

Rajendra Gogri: Yes.

Naushad Chaudhary: Lastly, could you share the NCB volume and also share the Hydrogenation and PDA production volume of this quarter?

Rajendra Gogri: Nitro Chloro Benzene was 13,900 metric tonnes, Hydrogenation was at the level of 2,340 metric tonnes (per month) in this quarter and PDA was 433 metric tonnes.

Naushad Chaudhary: How much was it in Hydrogenation?

Rajendra Gogri: 2,340 metric tonnes.

Naushad Chaudhary: In Jaghadia, did you say that is was 1,400 tonnes for the Nitrotoluene volume?

Rajendra Gogri: Yes.

Naushad Chaudhary: Do you also share the Ethylation volume at the Dahej plant?

Rajendra Gogri: No. That, we have not given.

Moderator: Thank you. The next question is from the line of Surya Patra from Phillip Capital. Please go ahead.

Surya Patra: Since the last few quarters, there has been mention about increasing sales of value-added products which are supporting the margin performance of the company. Can you add some colour to the kind/ nature of the new product in which you have seen progress, in the recent few quarters? Also, what is the kind of value-added product that you are looking at and what is the scenario that one should really see in terms of the product mix going ahead?

Rajendra Gogri: The products are similar; but, we are trying to push for more of the downstream products. That is why the impact on EBIT is relatively less because a large part of the decrease in production is in the base products. For all of our downstream products, we are trying to expand the volumes and utilize maximum capacities.

Surya Patra: If not the products' names, what are the key additional chemistries that have been added to the processes which are resulting in value-added products? Since the last 4 to 5 quarters, there have been sequential price corrections. From that specific point, there has also been sequential margin expansion or EBIT margin expansion for the Specialty Chemical business; which is a very interesting trend. Are there any new chemistries that you have added for the downstream products?

Rajendra Gogri: The downstream products like – Chloroaniline, some other Chloro products and the like have been the same. We are trying to achieve more volumes. The margin in general has improved and we had mentioned this in the past as well. In the last few years, the overall downstream margins have expanded. There are no new products as such; except that now, there is Hydrogenation on ONT and PNT that has been started and it is getting consumed internally and not being sold outside.

Surya Patra: The quarterly EBIT margin for Specialty Chemical, over the first quarter of FY19 was 17%. It has gone up to 24% this quarter and is already witnessing an increase. Would a portion of this be attributed to lower prices, as the expansion cannot be possible because of lower raw material costs alone? Subsequently, there is expectation for the commissioning of the agro compound supply which has been guided for at about a 40% margin profile. Where do you see your margin trajectory reaching, over a period of 1 to 2 years?

Rajendra Gogri: Yes, it will increase and the new contract is at a 40% margin. For any base chemical and in fact, even for Nitro Chloro Benzene, after reaching capacities at

1,08,000 tonnes, is not likely to expand further in the next 5 to 7 years. The idea is to move towards more value-added downstream products. In Chloro Benzene as well – after the expansion has been achieved on the base chemical, the focus will shift to value-added products. There is an appetite for the product supply chain to be independent of China and we already have demand for the products to be created from our value chain with levels of $30, $40 and $50 per kg. These are the final phases of base chemical expansion and in the future we will be moving towards value-added products.

Surya Patra: With the numbers shared, whether it is NCB, Hydrogenation or PDA, I believe that they are the lowest quarterly numbers over last 3 to 4 years. Was it a concern that that the availability of Nitric Acid was in short supply at the time when you were procuring it from Deepak Nitrite?

Rajendra Gogri: No, the numbers for Hydrogenation have increased. Nitration, is the where the numbers were impacted and hence, some of the base chemicals of Nitro Chloro Benzene and Nitrotoluene were impacted.

Surya Patra: How are you to sustain it and how long would it take to correct? Is it likely to be a continuous problem, in the near term; what is the situation likely to be?

Rajendra Gogri: There is a water-related issue .

Chetan Gandhi: With reference to what Mr. Gogri said, there were issues which resulted into curtailing the water supply to Deepak Fertilizer and other players in the region. Also, due to other reasons, they faced issues related to production in their alternate plant at Dahej. It is because of these factors that we had to buy a Nitrated product and further process it. Hence, we sold more of the downstream products; but had to purchase a one-step plus in the base products.

Surya Patra: Is there a strategy in place to ensure the steady availability of Nitric Acid as there was a similar situation previously as well?

Rajendra Gogri: Deepak Fertilizer has set up a plant in Dahej. They now have one 3 CNA stream in Taloja and two in Dahej. We did not opt for expansion because Deepak Nitrite announced theirs. As mentioned earlier, the overall capacity is not a major issue as of now; although, if a problem does occur at both of the locations then there will be an impact.

Surya Patra: Would the correction in revenues, at 7%, be because of lower input prices? Has there been any impact from the global slowdown on the business?

Rajendra Gogri: Yes, we mentioned that. Regarding the volumes, they have been impacted in the agro chemicals sector – especially in the US; and also – the automobiles sector, for some of the products that are sent there.

Surya Patra: Would the decline (in revenue) by 7% be on account of lower prices? What percentages would be attributed to the slowdown and to lower volumes?

Rajendra Gogri: That is difficult to bifurcate. Due to the switch in base products, the volume reduction is more.

Chetan Gandhi: In the scenario where the volumes for certain products have been lower, because of the slowdown, there the product profile was changed to a different product with higher margins and higher product volumes. Thus, it is difficult to differentiate and compare.

Surya Patra: Would the agro unit expect be commissioned by fourth quarter?

Rajendra Gogri: Yes.

Moderator: Thank you. The next question is from the line of Dipesh Mehta from SBICAP Securities. Please go ahead.

Dipesh Mehta: I would like to ask two to three questions. First – can you help us understand the net of raw material changes and what would be the revenue growth, this quarter, in Specialty Chemicals? Second – about the long-term contract which is for the 10 year period, and likely to commence in Q4; regarding the second contract, for the 20 year period – are we on track to achieve the commercialization of that plant by Q1 FY21? The third question is about the margins in Specialty Chemicals – previously, the Company would use integration when there was a correction in raw material prices and there is some benefit in terms of percentage calculation on the margins. How much of margin expansion would be attributed to raw material price softness versus how much would be attributed to a change in the mix?

Rajendra Gogri: There was a raw material impact. Speciality Chemicals saw an overall reduction in the top-line by about 19% of which 7% was because of the raw material and 12% was due to volume reduction. Within that, volume reduction was more on the base chemicals as compared to the value-added chemicals. That is how the overall volume spanned out. Regarding the second contract - it is on track and is expected to commence supply in next year's first quarter.

Dipesh Mehta: If you could address the third question regarding the raw material prices.

Rajendra Gogri: 7% is basically because of the raw material prices.

Dipesh Mehta: The question was about the margins, i.e., the EBITDA margin or EBIT margin which is reported for the segment.

Rajendra Gogri: The absolute margin is tracked; at constant raw material prices, with an addition of value-added products, the margin to sales will increase. To look at the top-line solely may not be the correct way to decipher. Correspondingly, margins as a percentage may also not be the correct way to judge. The absolute EBIT number would have to be looked at.

Dipesh Mehta: I was trying to gauge that; and a percentage alone it is not adequate to discern the changes in the product mix.

Rajendra Gogri: Yes. Last time, the base chemical was 30% and the value-added component was 70%. In this quarter, on a YoY basis, the base chemical was 25% and the value-added component was 75%. Even though there was a reduction in the top-line; not considering the raw material impact, it is about 12% in the top-line reduction. The EBIT reduction was only around 4%.

Moderator: Thank you. The next question is from the line of Rohan Gupta from Edelweiss. Please go ahead.

Rohan Gupta: The first question is on the NCB volume which was affected by almost 20%. Even though it was the base chemical that was impacted, did it impact your value-added product portfolio as well; especially as fuel products are used? There was a 12% impact due to volumes and a 7% impact due to prices; is this trend likely to continue? Since the expansion is being carried out, what would be expected impact in terms of volume for the second half?

Rajendra Gogri: No, when down-streaming, either that the sales of our base chemicals will reduce or that we would procure from suppliers.

Rohan Gupta: What was it that you said about the base chemicals?

Rajendra Gogri: Even if the volume is lower, we would either reduce our sales or buy the base chemicals from the suppliers, for our captive consumption. Doing this prevents our downstream processes from getting impacted.

Rohan Gupta: In the case where more raw materials i.e., base chemicals would need to be sourced, would that affect the margins?

Rajendra Gogri: It actually improves the margins on switching. We ensure that our downstream requirements are fulfilled even in a situation where the production of the base chemicals is down.

Rohan Gupta: There were two reasons that impacted the NCB volumes this quarter; one was the on-going expansion and the second was the availability of raw material – Nitric Acid. What would be expected for the second half?

Rajendra Gogri: The second half might also see an impact on NCB.

Rohan Gupta: Would the impact be seen on both the fronts; the availability of Nitric Acid still remains under pressure. There was also a mention about Deepak Fertilizer and their plant in Dahej?

Chetan Gandhi: There was an impact for 15 days in the last month.

Rajendra Gogri: Overall, it is not a significant one. The third quarter might see an impact. Come November, the issue on Nitric Acid has stabilized.

Rohan Gupta: Is the expansion still going on; and also the operations for the current plant?

Rajendra Gogri: Yes, as we are debottlenecking and it takes a certain number of days to do a portion of the work. It is not a greenfield project but is more of a brownfield one. The equipment for debottlenecking is now being installed.

Rohan Gupta: The second question is on your guidance. The management seems confident of 10% to 15% PAT growth this quarter; while in Q1 they were hesitant to state their guidance due to the volatile scenario globally, in agro chemicals and auto markets. About the growth this quarter – is it growth in the EBITDA or the growth in the PBT, since the growth in the EBITDA is quite significant than the PBT, in the first half.

Rajendra Gogri: This number is going to impact bottom-line. The guidance is also on the bottom-line as we have the figures for the first 6-month period and the month of October has also passed. Hence, we have more visibility on this and are able to provide the revised numbers.

Rohan Gupta: Would it mean that, working backward on the PAT growth of 10%; Aarti Industries Ltd. is required to reach a growth of 10% for the second half?

Rajendra Gogri: Yes.

Moderator: Thank you. We take the next question from the line of Nav Bhardwaj from Anand Rathi. Please go ahead.

Nav Bhardwaj: With reference to the long term contracts – is there any postponement or pressure coming from the plant in terms of a possible delay in deliveries for products that are expected in the next year or at end of the last quarter, this year?

Rajendra Gogri: As of now, there is no such indication. Albeit, we are trying to assess that whether there has been an impact on that front.

Nav Bhardwaj: What are the utilization levels to be expected in the initial year, specifically for the long-term contracts?

Rajendra Gogri: It depends on how the commissioning at Dahej goes; as it is said to be a Greenfield plant for them. Based on that, the first year will be difficult to guide on. The next year is to be a stabilization phase and subsequent to that, the utilization should be much better.

Nav Bhardwaj: A 50% for the first year and going ahead around 60%; would that be a fair assumption?

Rajendra Gogri: Yes. From the second year onwards, it should be stabilized – their products, the corresponding qualifications and everything else. In the first year, it might see an impact because of being a Greenfield project.

Nav Bhardwaj: For FY21, would 50% utilization be a good number to be worked with?

Rajendra Gogri: Yes; although, we are still to get clarity from them about the extent of the impact. Since it is in the stabilization phase this year, there will be an impact.

Moderator: Thank you. The next question is from the line of Dipen Seth from HDFC Securities. Please go ahead.

Dipen Seth: I have two questions. The first is on the Pharma side of the business – there seems to be a gradual but steady expansion in EBIT margins. Intuitively, I would have expected the Pharma product line to have been more profitable than the Specialty one; but it is not so in this case. Would this trend continue going forward i.e., would it lack the profitability like that of Speciality for a while or are the numbers catching up to the same?

Chetan Gandhi: The EBIT numbers in Pharma have been lower and are catching up with the numbers of Speciality Chemicals. It will take some time.

Dipen Seth: Inherently, the product range affords better profitability. Is that the right way to look at it or is it much varied that it cannot be compared to the profitability as seen in Specialty Chemicals?

Chetan Gandhi: There have been a few brownfield expansions and more expansions are on the way. These will result in capacity creation at the location due to which, we will gain an operating advantage and higher margins as the fixed cost component will be taken care of. This is expected for the next year.

Dipen Seth: Is there confidence that the margins should expand in the Pharma segment over a period of time?

Chetan Gandhi: Yes.

Dipen Seth: With the array of products that you manufacture, if I just look at the gross numbers in terms of profitability, Aarti Industries Ltd. is sitting on about Rs. 2,000 crore, net block; and Rs. 1,151 crore of capital work in progress which has increased by more than Rs. 300 crore over the half year. Are there new manufacturing facilities likely to get commissioned? I would like to understand the Rs. 2,000 crore of net block, having generated around Rs. 400 crore of EBIT in the half year – it seems to be the written down value and Rs. 1,151 of capital work in progress, a fresh value. Could we understand the revenue and profitability that is embedded in the capital work in progress; when it is likely to play out? In the situation where there is global easing of demand, would this be a wrong time or is there confidence on commissioning of facilities and delivering profitably?

Rajendra Gogri: Yes, this additional asset is to result into sizeable absolute EBITDA and EBIT as more, high value products are added. It may not as a percentage and the top-line may not grow as much. The projects which will get commissioned in this second half should start contributing significantly to the EBIT from the next year and the year after.

Dipen Seth: Do you expect to derive a similar kind of profitability from this gross block which will be commissioned, over a period of time?

Chetan Gandhi: Yes, we have long-term contracts which are backing these three projects.

Rajendra Gogri: A corresponding increase in EBIT will take place once these assets are get commissioned.

Dipen Seth: Have new products been added to the portfolio? Will you add segments, in terms of the disclosures; or does it get incorporated into Specialty?

Rajendra Gogri: No, it will get incorporated into Specialty as there are a lot of fungible capacities in that.

Dipen Seth: Would the key task hereon be – to monitor the commissioning and output from these new capacities?

Rajendra Gogri: Yes.

Moderator: Thank you. The next question is from the line of Miloni from IDFC Securities. Please go ahead.

Miloni: A couple of the large contracts were signed a few quarters ago; where are we in terms of signing on more new contracts? In the past, the management mentioned of opportunities beginning to come through because of downstream production shifting to India; has there been a dramatic change in that trend over the last 6 months?

Rajendra Gogri: In Q1, we had mentioned that the entire manufacturing has shifted and a lot of our products which were exported to China had tariffs getting consumed in India. In general, manufacturing in India is increasing and we are also seeing a lot of opportunities in our downstream for – multi-product customers as well as on one-on-one basis; the trade war between the US and China would help India in a big way. In such a situation, India would become an excellent destination to be able to export to the US and China. That should pan out well for the entire industry over the next few years.

Miloni: Is there any visible impact of the trade war; in the sense of potential importers in the US looking to diversify, de-risk and source opportunities in India or is it the other way around?

Rajendra Gogri: Yes, a lot of customers have started coming up. One of them expects products in the next 2 to 3 years for which we have put up the plant. It is a long term structural issue because of which they want to de-risk. The trade war is accelerating things specifically for the US market and in the case where they want to export to the US they will try to get it done faster.

Miloni: Does it imply more dedicated long-term contracts or being regulators of the usual supplies to multiple customers? How would this be worked out?

Rajendra Gogri: When it comes to a long-term contract, the customer's timeline and everything related to that contract becomes a priority. During that time if multiple customers come up for other products; and where there is no customer timeline or are fresher customers, then that takes a bit of a backstage. This is how it works. We are now getting a lot of demand from the customer side, and a lot of work happens on that front on a higher priority basis.

Miloni: Over the next year, could we expect to close more of the contracts like in the past?

Rajendra Gogri: Yes, we are looking at that. The three contracts that were signed are very big in the sense that two are for 10 years and one for 20 years. It is likely that contracts for a fewer number of years will not come to the market. Although, we used to have these type of contracts earlier; we have had a 3-year contract which has been rolled over 5 times for 15 years and likewise, we have another contract which is for 4 years and might get extended. Our strategy would be to negotiate, to get a maximum period locked in which would be more towards 10 years. The public will be informed of any new, future long-term contracts. The signing of contracts for lesser number of years will also continue.

Miloni: On the Pharmaceutical side, what proportion of our business right now is towards regulated markets in the US and Europe?

Chetan Gandhi: Out of the total API that we sell, more than 50% is in the US and Europe.

Miloni: In terms of incremental growth – are you looking at growing the existing portfolio of products; or is the focus on adding more products to the portfolio? Where do you see an opportunity in the current context?

Chetan Gandhi: For generic APIs, we develop 8 to 10 newer APIs every year and that is what we are doing this year. Every quarter will see 2 to 3 validations happening and that will continue. Even in our intermediate manufacturing activities that are done for global generic as well as the innovators, there also we have newer products which are lined up in our portfolio.

Miloni: When you said 2 validations, is that US DMFs per quarter?

Chetan Gandhi: Yes, for any DMF, so be it US or EDQM, EDMF; for any market supply we have to validate the product because we are operating our plants as GMP plants.

Moderator: Thank you. We will take the next question from the line of Deepan Mehta from Elixir Equities. Please go ahead.

Deepan Mehta: The last 3 to 4 years have seen exceptional growth coming through from the company; and after many quarters we have seen a flattish kind of quarter. We are all aware of the reasons for the growth; it was because of increase in prices and volumes and also due to other measures that were taken. If there is more business in the current environment can we expect a slightly tepid growth rate of 10% to 12% in the core business? Would the growth drivers come as and when new plants get commissioned; especially for contract manufacturing or on the Pharmaceutical side? Is that a correct assessment of the company at this stage?

Rajendra Gogri: Yes. As the capacity gets filled up you need newer plants which would give more volume and EBITDA growth. That is why we are expanding in our Nitro Chloro Benzene also – from the current 75,000 to 108,000 metric tonnes; that is a generally a multi-customer product and also step-related; this will always cater to both kinds of contracts – long-term as well as multi-customer. We are also looking at putting up an entire multi-customer Chlorotoluene line of products which has been there for long time but because of this contract, has been left out. We expect to start activity in next year on the project front on the Chlorotoluene chain; this will again be a multi-customer product. We will be looking at both the scenarios; but will prioritise the customer related contracts.

Deepan Mehta: The one time benefit we saw was because of price increases and surge in volumes as our capacities got utilized and in the last 3 to 4 years, because of the global situation; especially in China where they have had to curb their chemical output and their exports for environmental reasons or otherwise. Do you see a tailwind now from that particular phase?

Rajendra Gogri: We have been able to sell our volume as they are. The only thing about it is that they have been shifted; we used to export to China previously and now they are consumed in India. These disruptions have not increased much for us on the volume front, as there were margins there. A lot of other Indian companies may have been impacted on both the fronts.

Deepan Mehta: The EBIT figure is not adding up. If I look at what you have filed with the stock exchanges, the EBIT should come to Rs. 201.57 crore. Then in your presentation on page 8, you have mentioned EBIT on standalone at Rs. 196 crore. When you go down the line for slide 9 and slide 10 and if you aggregate the EBIT over there, that comes to Rs. 234 crore for Q2 FY20.

Chetan Gandhi: You are comparing Standalone and Consolidated numbers plus the difference between Rs. 196 crore and Rs. 201 crore is the 'other income' because the EBIT from the results posted on the stock exchange includes the 'other income' whereas the reported numbers do not include it.

Deepan Mehta: What about slide 8, 9 and 10; if you see slide 8 and 9, so on slide 10, the EBIT for Pharma in Q2 is Rs. 34 crore, on slide 9 EBIT for Specialty is Rs. 200 crore and on slide 8 it is Rs. 196 crore.

Chetan Gandhi: Let me just help you on that. The numbers that you are referring to of Rs. 201 crore and Rs. 196 crore are the EBIT figures for the company as a whole. When you look at the segmental performances and you look at the segment report, there are certain expenses which are directly allocated to that segment and the EBIT number of that segment; there are certain 'unallocated expenses' which cannot be allocated to both the segments and those are separate numbers.

Moderator: Thank you. We take the next question from the line of Rishab Bothra from Sharekhan. Please go ahead.

Rishab Bothra: Just wanted to understand the revenue mix better, i.e, how much of the revenue is on contractual basis and how much is on spot basis?

Rajendra Gogri: We have not done that bifurcation in this.

Rishab Bothra: In respect of products specific to a client and multiple clients, is that revenue split available? I wanted to understand this.

Rajendra Gogri: No, we are not doing that kind of a bifurcation.

Rishab Bothra: Are there other players who are entering into multi-year contracts with large MNCs; is there any contractual obligation such that our partners for multi-year contracts will not be able to enter into multi-year contracts with other parties in India?

Rajendra Gogri: There are thousands of chemicals and hundreds of manufacturers. There are various contracts between suppliers and customers for different products and different companies. Even for the same product, there is no restriction for somebody to enter into any contract with somebody else.

Rishab Bothra: On the other parties entering into multiyear contracts, are we aware of any other Indian manufacturers, listed or unlisted?

Rajendra Gogri: For our products?

Rishab Bothra: Our products and other products as well.

Rajendra Gogri: Nothing has come in public domain as such although different companies must be having such contracts. There are so many companies in India that have been doing business with multinational companies for many years; and must be having contracts, but possibly for a lower period. We were able to get these long-term contracts because the amount of investment and other factors were much more. These types of long-term contracts are difficult to get; it was a much aggressive and complex negotiation to get.

Rishab Bothra: By when will the demerged entity's shares be allotted to the investors and what is the growth outlook there?

Rajendra Gogri: It is mostly November or at the most, December; is what I was informed of from the secretarial department.

Rishab Bothra: We are already in November.

Rajendra Gogri: So originally, they were saying that; although, these are all SEBI and stock exchange related.

Rishab Bothra: What would be the growth outlook in that particular area?

Rajendra Gogri: We have invested there as well. The volumes and the like should expand. Other than that, I do not have much detail.

Chetan Gandhi: We have also got certain new products within the range of chemicals where the margin profile is better; they are under validation and approval with a lot of FMCG companies. Going forward, that should attract the margins and the growth of our business over a long-term basis.

Rishab Bothra: The management mentioned that the business potential is there and post the demerger; the company will have a different path altogether in terms of revenue, growth and profitability. Can we expect that momentum in the Company in one year?

Chetan Gandhi: Yes.

Moderator: Thank you. The next question is from the line of Arun Prasad from Spark Capital. Please go ahead.

Arun Prasad: Just one interesting thought – when you were saying that the trade war is beneficial to Indian manufacturers, recently we heard the commentary from other management saying that trade war is ensuring that Chinese Government is becoming soft on the Chinese producers thereby relaxing certain environmental norms. Just want to get a sense of how you see the situation evolving over the next 1 or 2 years?

Rajendra Gogri: The environment in China is affecting the masses; you do not see much of relaxation in that. They ask the manufacturers to shift, but it will still take a year or more to make that shift. This change in direction that China is adopting would apply to that front only. There is no visibility of much impact on that because in general, everybody will have to comply. The environmental cost in China is now going to be more or less at par with that of India and there would not be much of a difference in that because of a trade war.

Moderator: Thank you. The next question is from the line of Sanjaya Satapathy from Ampersand Capital. Please go ahead.

Sanjaya Satapathy: Is there any disruption on the supply side of the raw material which we procured from the market; if you can throw some light on that?

Rajendra Gogri: In Chemicals, it is all purchased from India.

Chetan Gandhi: To add to that, we did have some issue on the supply side on the supply of Nitric Acid.

Sanjaya Satapathy: Some plants that supply to you suffered from a fire; would be any disruptions from that?

Chetan Gandhi: No. We have no issues with the plants that caught fire.

Moderator: Thank you. Our next question is from the line of Abhishek Bhanushali from Internex Capital. Please go ahead.

Abhishek Bhanushali: One quick question – there is a pretty consistent reduction in promoter holding over the last one year. Can you throw some colour on that; and what is the plan for the future, in terms of the promoter holding?

Rajendra Gogri: We had a QIP; after which, the promoter percentage will go down.

Abhishek Bhanushali: No, not about the QIP; there has been sustained selling also on the open market, if I am not mistaken?

Rajendra Gogri: It is not very significant, maybe about 1% or 2%.

Abhishek Bhanushali: The promoter holding is down from 53% to 48% over the last one year.

Chetan Gandhi: The decline from 53% to 49% is purely due to a QIP issuance which was almost around 6.7%.

Moderator: Thank you. The next question is from the line of Abhijit Akella from IIFL. Please go ahead.

Abhijit Akella: Just wanted to clarify – regarding the long-term contracts, year one would be slightly subdued but by year two, would we expect to reach full utilization at the Agro Chemical facility?

Rajendra Gogri: The first year, with it being greenfield facility, we expect that there would be some stabilization issues which would be dealt with. Then, the second year onwards, it should be mostly normal.

Abhijit Akella: We have spoken about a Rs. 400 crore annual revenue potential from this project; is it fair to assume that in FY22 this is the number that we should be targeting at 40% EBIT margins?

Chetan Gandhi: Yes, that is what we are looking at.

Moderator: Thank you. We take the next question from the line of Naushad Chaudhary from Systematix Shares. Please go ahead.

Naushad Chaudhary: I have a question on the balance sheet. Looking at the working capital cycle, there are around 15 days of increase in our debtor days and inventory days. So if you can clarify that? The overall working capital has gone up around 25 to 30 days, if you can clarify that as well?

Chetan Gandhi: As you would have noted, the revenue from the exports has gone up; typically exports operate at a higher working capital cycle as compared to the domestic receivables. So that one aspect is linked with that. About the inventory being there, it is generally because of the higher scale of activity and integrated business chain that the inventory numbers have been going up. Plus, we had an issue with some of the feedstock availability, so we maintained some buffer stock for some of the key materials what was needed.

Naushad Chaudhary: Is this in context of the availability of Nitric Acid or some other raw materials for which we had to maintain an inventory?

Rajendra Gogri: There will be more on the Pharma side where we import materials from China, so there we have started keeping a higher inventory than earlier.

Naushad Chaudhary: Would this new level be normal for this inventory level or do you think that it would correct, going ahead?

Chetan Gandhi: We are keeping higher inventory because of the supply issue in Pharma which we want to avoid; we would want to maintain the higher inventories till the situation in China normalises.

Naushad Chaudhary: What margins do we make in export versus domestic?

Chetan Gandhi: Similar.

Naushad Chaudhary: In terms of profitability, is the export portion less profitable compared to the domestic one?

Chetan Gandhi: You have to compare it on a product to product basis. In some cases, the revenues from the export of high value products have gone up and along with that, the margin profile is higher.

Rajendra Gogri: It is all dependent on the products, the specific quality requirements, geography and all that. Generally, all these chemicals are sold on specifications and there is not much of branding involved. You do not see a big difference in the pricing.

Moderator: Thank you. Ladies and gentlemen, that was the last question for today. I would now like to hand the conference back to the management for closing comments. Over to you, all.

Rajendra Gogri: It has been a pleasure interacting with you over the call. We thank you for taking time out and engaging with us today. We value your continued interest and support. If you have any further questions or would like to know more about the company, kindly reach our Investor Relations desk. Thank you.

Moderator: Thank you very much. On behalf of Aarti Industries Limited, we conclude today's conference. Thank you for joining, you may disconnect your lines now.