Keva

August 17, 2022

To
The Manager
The Department of Corporate Services
BSE Limited
Floor 25, P. J. Towers,
Dalal Street, Mumbai – 400 001

Scrip Code: 539450

To
The Manager
The Listing Department
National Stock Exchange of India Limited
Exchange Plaza, Bandra Kurla Complex,
Bandra (East), Mumbai – 400 051

Scrip Symbol: SHK

Dear Sir/ Madam,

Sub : Submission of transcript of conference call under Regulation 30 of Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015

Pursuant to Regulation 30 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, we are enclosing the transcript of Q1 & FY 23 Earnings conference call for investors and analysts organized by the Company on Friday, August 12, 2022 at 02:00 P.M. IST. The audio recording and transcript is also available on the website of the Company.

You are requested to take the same on record.

Thanking you,

Yours faithfully,

For **S H Kelkar and Company Limited**

Rohit Saraogi
Company Secretary & Compliance Officer

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S H Kelkar & Company Limited

Q1 FY 2023 Earnings Conference Call

August 12, 2022

Moderator: Ladies and gentlemen, good day and welcome to the S H Kelkar and Company Limited Q1 FY '23 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 after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Mr. Anoop Poojari from CDR India. Thank you and over to you, sir.

Anoop Poojari: Thank you. Good afternoon, everyone, and thank you for joining us today on S H Kelkar and Company Limited Q1 FY '23 earnings conference call. We have with us, Mr. Kedar Vaze, Whole-time Director and Group CEO and Mr. Rohit Saraogi, EVP and Group CFO of the company.

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

I would now like to invite Mr. Kedar Vaze to make his opening remarks.

Kedar Vaze: Good afternoon, everyone, and thank you for joining us on our Q1 FY23 earnings call. We will discuss the operating and financial performance for the quarter and give some idea about how the business is doing. I hope you had all the opportunity to go through the results and we will get into the details of the operational and financial performance here in.

We have reported a resilient performance during the quarter, despite a challenging macroeconomic due to the inflation pressures. While we saw some operating constraints during the period, our client engagements and wins across the market remain stable.

I'm happy to share that we have successfully and efficiently integrated our recent acquisitions, namely Holland Aromatics and NuTaste Food into our business model during the quarter. Overall, on a consolidated basis, our total income stood at Rs. 415 crore, higher by 15.7% year-on-year and on a like-to-like basis, our revenues excluding the acquisitions at constant currency grew by 7.5% year-on-year.

Emerging market sales in the quarter stood at Rs. 319 crore registering an organic growth of 12% year-on-year. Acquired businesses delivery also remained robust led by improved demand and volume uptick in the European markets. On a like-to-like basis, our European core business grew by 8% year-on-year.

During the quarter, we continue to witness cost pressures on account of inflation in raw materials. Despite these challenges, we have maintained our gross margins at 39%. This was made possible through a combination of price increases, inventory management, and somewhat flattening and easing of inflationary pressures in the market.

Overall, our EBITDA stood in the quarter at Rs. 55.1 crore with margins at 13.4%. Cash profits in the quarter stood at Rs. 42.1 crore as against cash profit of Rs. 34.1 crore in Quarter 1 last year. The reported PAT figure includes exceptional gain of Rs. 1.22 crore on account of reprocessing of raw material damaged in the Mahad floods last year. This converted into finished goods and corresponding profits were taken in this quarter.

The Q1 FY22 reported PAT also included a reversal of additional tax provision, aggregating to Rs. 64.5 crore consequent to a ITAT order in the company's favor.

So, the adjusted for these one-offs, Q1 FY23 PAT stood at Rs. 22.3 crore against a PAT of Rs. 16.9 crore in Q1 FY'22.

On a consolidated balance sheet perspective, our current net debt position stood at Rs. 469 crore as on June 30, 2022 against Rs. 509 crore as on March 31, 2022. The decrease in debt was primarily on account of healthy cash flow generation during the quarter. In the next quarter, we would see some increase of debt on account of payment of the second tranche of Holland Aromatics, 19% stake, and the balance 30% acquisition of Nova Fragrances in Italy. From a medium-term perspective, we remained focused on reducing our total debt levels from next quarter onwards, post the acquisitions of these two stakes of roughly INR 50 crore.

On the business operations, I am pleased to share that our participation in the RFP by a large global MNC is going very well. In the quarter, we have signed the agreement with them making us one of the few global fragrance and flavor companies to be in their core list suppliers. This is a major milestone in our growth journey, and we remain optimistic on the significant multiyear business potential from this account.

Currently, our team is already working on several briefs, and we expect business to build on this from this calendar here itself.

To conclude as we look ahead from a demand standpoint, we are currently witnessing steady wins and inquiries across customers in our Emerging and European markets. There are concerns with regard to the macros, given the inflationary environment and accordingly we remain cautious. However, we have promising growth initiatives in place and from a longer-term perspective, we are confident that the industry growth levers, and our robust business model should enable us to grow and help report healthy performance.

On that note, I would now request the moderator to open the forum for any questions or suggestions that you may have.

Moderator: Thank you. We will now begin the question-and-answer session. The first question comes from the line of Faisal Hawa from H. G. Hawa & Co. Please go ahead.

Faisal Hawa: Development budget in one year and sir, what kind of efforts are we making to penetrate the, which are very amenable to our products and what is sales contributed by our top three products and our top three customers?

Kedar Vaze: Sir, we lost the question in between. You asked us about efforts to penetrate the market to product. I'm assuming this is in allied lines or similar to our product. So, we are obviously expanding our product portfolio to newer customers and newer opportunities.

The second part of the question was in relation to the top three customers and products. Our top three customers and products contribute roughly about 10% of the overall revenue of the Company. So, it's a very diversified portfolio of products and customers. On the fragrance side, we are catering to more than 4,000 large or medium FMCG companies across the regions. Similarly on the flavour, we have more than 200 plus customers in the flavor portfolio. So, our concentration of customers is not very high.

Faisal Hawa: What is your development budget and what kind of revenue do you expect new products to contribute to our sales in the next two to three financial years?

Kedar Vaze: I think, one important part of the business is the business momentum. As we are coming out of the two pandemic years, a lot of the R&D was focused on pandemic specific products and launches and now the FMCG companies, with the inflation, are relooking at their strategy going forward in terms of new product launches. With that, we see that the new wins in the pipeline however they're strong, there will be some sort of gap between the time they're launched in the market. We do not know whether that is one quarter or two quarters, but we expect that the companies who have approved and the products are in the pipeline, will look at the overall market growth and dynamics before the products are launched. So, quantify that on a yearly basis may not be a very accurate number, but we have roughly Rs. 50 crore worth of annual potential products in the pipeline, which are approved at various stages, which is a good number and in line with our expectations for growth in the future.

In addition, our targets on the global MNC account are in addition to this Rs. 50 crore. So, we are expecting good amount of conversion of projects in the next couple of quarters and then the growth momentum will resume.

Faisal Hawa: Sir, assumption that we would be able to grow 15% CAGR in the next two to three years looking at the kind of approvals that we have and the product that we are going to put into the market.

Kedar Vaze: No, we are talking about 12% CAGR on our existing business across the next two to three years. We are confident of that outlook.

Moderator: Next question comes from the line of Madhav Marda from Fidelity International. Please go ahead.

Madhav Marda: My question was that basically sir, if you could just talk us through this a global client RFP, which we've been speaking about, is it basically with one FMCG company or is it with like two to three companies with whom we are discussing for this RFP and basically what is the potential order size that we're looking to target? And when you're saying that the order book is going to build up, during CY ‘22, basically do the revenues also start this year, or it could be like next year? If you could give some sense that would be helpful.

Kedar Vaze: So, the RFP process has multiple parts. We have not even completed the entire tendering process. So, one part of the tendering process is still going on. On the other part of the tendering process is completed, we have been assigned certain projects. We anticipate these projects to start to actually see the sort of product testing in the consumer phase, starting in the second half calendar and then thereafter from first quarter calendar, last quarter this year, some revenues are expected from this RFP. We are very confident on the submissions and the work that we are undertaking for these projects. In addition, we have multiple other global MNC clients where our engagement levels have substantially increased in the last one year. So overall we remain confident to break into the global MNC accounts as we have been working with the regionals, in the same manner, we expect that the next phase of growth will come from the global accounts in the Asian region. And we continue to work with the small and medium accounts in the European and newer geographies.

Madhav Marda: And when you say that we have got engagement with these clients are scaling up in the last one year and also, I think we've been trying to break into these large MNC accounts for some years, but now we are seeing good traction. Is there something which is changing on the macro side, which is helping us get better sort of foot in the door with these customers?

Kedar Vaze: Yes, so, like you mentioned for the last past decade, we have always been knocking on the doors and it was at finalization stage or at various stages, but never converted into a final brief and product development engagement. I think a number of factors are contributing to this as we go forward. Asia is becoming important market of growth for the global FMCG market. The shift of the kind of epicenter of growth from China into Southeast Asia and MENA regions. So that is expected that the larger part of the FMCG growth will be in the markets where we are traditionally present and where we have good presence and understanding.

The second impact of the pandemic has been disruptions in supply chain. So, there is a heightened move by most global companies to have more regional or more local sourcing. To that extent, we offer a very good alternative regional supplier to the global MNCs. So, I think these are the two trends which are helping, which has enabled that now we finally are in the operating side of the product development.

Madhav Marda: And sir, this business that we are talking about, that supplies for Asia market only like you said MNC client, but supplies for their Asia business or the?

Kedar Vaze: So the business tender and what work we are doing is on the global basis. Obviously, there are different brands which have different sales in different countries. So, within the entire 1 billion, we are seeing little bit more focus on the Asia brands, so brands which are larger in the Asian countries are where our engagement has begun, but the brief is open for global. So, we will engage as things progress to other regions as well.

Moderator: Next question comes from the line of Chirag Maroo from Keynote Capital. Please go ahead.

Chirag Maroo: Sir, earlier we used to give a geographical bifurcation of revenue from Fragrances and Flavours separately. Could you please help me out with that number?

Kedar Vaze: Just to update, we used to give domestic and export Fragrance and Flavours as our geographies. With the acquisitions in Europe, we are now moving into because there is some business cross production. We are looking at the sort of three geographies, Emerging Markets, Europe, and Rest of the World in term of the revenue and we have the similar bifurcation for the Flavour as well. So the revenue, there is, you want the exact number. For Q1 FY23, the revenue for fragrances in India is Rs. 196 crore, Europe is Rs. 103 crore and rest of the world is Rs. 59 crore. And on the Flavour, the revenue is Rs. 34 crore for India and rest of the world is Rs. 19 crore.

Chirag Maroo: Sir, my next question is what kind of stable margins can we expect in Fragrance and Flavour business?

Kedar Vaze: I think we are today at EBITDA level of 13.5% ballpark. We anticipate that we will keep this and going forward, there may be slight improvement as growth kicks in. I am sort of optimistic that we have moved beyond the worst phase in the inflation of raw material. So, the raw material prices should start to stabilize that will help us somewhat reduce our inventory and further improve the PAT levels.

In addition, just one sort of black Swan event in scenario, if there is raw material price crash, it might have impact on few of our ingredient sales in terms of the realized revenue, but in terms of the profit margin that will remain intact.

Chirag Maroo: My last question is that the kind of the growth that you had said that around 12% that you would be able to grow for next couple of years. Is it based on constant currency or is it based on something else?

Kedar Vaze: Yes, it's based on constant currency.

Moderator: Next question comes from the line of Ganesh Shetty, an individual investor. Please go ahead.

Ganesh Shetty: Sir, I just want to have some clarity on our debt that last quarter to last quarter, we had increased the number of debt and now this quarter, we had reasonably paid off some amount of debt and going forward, are we going to show accretion and try to deleverage your balance sheet, any thought on this? Can you please share it with us sir?

Kedar Vaze: Yes, so, as I mentioned in my opening remarks, we have ballpark after currency conversion the exact number, but about Rs. 50 crore of payments towards the balance acquisition of Holland Aromatics and Nova, which is scheduled for this quarter which is the second tranche of the acquisition. So that Rs. 50 crore outlay is our outlay for this quarter. Apart from that, we have no major large capex or any other large ticket expenses. So, we are anticipating that we will progressively bring down the debt from current levels by end of the year to ballpark number Rs. 400 crore. So, this is the target and the next three quarters, we will look to reduce the debt, use the operating cash flows to continually reduce the debt.

Ganesh Shetty: As far as the macroeconomic challenges are concerned, last two quarters have been very tough for us. There was logistics pressure and there was raw material pressure and are you facing any type of attrition related problems in our industry or is there some normalcy as far as logistics is concerned? Can you please throw some light on this?

Kedar Vaze: I think the question was not very clear. I will answer. If I have missed the point, please re-question. In terms of supply chain, I think we have had a pretty standard situation after the first lockdown in 2019, we were able to make all our factories COVID ready and continue our operations uninterrupted throughout this period. Many of our products go to essential commodities like soap, detergent and others. So, we were requested to be continuing production throughout this period. As far as supply chain, there is no specific disruption on the horizon at the moment. We see that the supplies from China last quarter were a bit affected, but now as we speak, things are coming on stream, and we are seeing material availability starting to come in.

Ganesh Shetty: Related to that, I had asked one more question regarding attrition and employee cost. Is there any pressure from that end as everywhere this problem is present.

Kedar Vaze: We are managing to control our employee cost within a band of acceptable levels. Two years ago, or three years ago, we did reduce our R&D expenditure and now correspondingly employee cost came down to some extent. At this point, we are in control of the overall scenario and there is no specific program or specific plan except to continue steady state putting down the debt. As our engagement with the global MNCs increases, there may be some one-off costs on development and engagement with them, which we are confident will result in business revenue over the next three, four years and offset the additional cost.

Moderator: Next question comes from the line of Anurag Patil from Roha Asset Managers. Please go ahead.

Anurag Patil: Sir, from this global FRP, what sort of revenues we can expect in FY '24 and FY'25? Any ballpark idea, you can give?

Kedar Vaze: So, as we've talked to earlier, the entire RFP is about $1 billion to be issued out within sort of two to three years. Realistically, we expect that roughly 10% of that is something where we will be participating in the entirety and out of that $100 million odd is the total potential. There will be two, three other companies and existing suppliers. So, that's the sort of maximum potential is $100 million over three years. And we expect to get our share through that $100 million anywhere between 20% to 30% of that share is good ballpark target if we do reasonably well. If we are taking more than 30% share, it's possible, but we are participating for the first time. I want to be cautious, and I think 20% of the share is something, which we will target in our first RFP.

Anurag Patil: Sir in our European businesses, what percentage of revenue should be from essential product category? Very rough idea will be fine.

Kedar Vaze: So, in the European business, I do not have that specific number. It would be in excess of 65%. I don't have exact number. More than two third of our business is going in home care, detergent and functional product. The balance, I mean, it's in various products. So, it's difficult to quantify essential or unessential, but in terms of cleaning, home care, detergent, fabric, these categories are two third of our business in Europe.

Anurag Patil: So, demand wise sir, we are expecting stable scenario in the next couple of quarters?

Kedar Vaze: Yes. So, our business in Europe is not very much dependent on it. So, it's not very dependent on Fine Fragrances or discretionary spend. We have various trends. So, within the business, we have certain large brand business and certain private label, or local brand business and we see that during the time of fast work, the large brand business grows faster and during the time of recession, the mid or private label business goes faster.

Having said that, we have the additional impact of inflation in Europe, particularly in Italy because there is a very big sentiment on the Russian gas cost and whether it'll be available and this uncertainty is reducing the consumer spending to some extent, while Northern Europe, Netherlands side, we see less impact of this phenomenon. In Italy, whereas clearly, it's an important factor. We don't really have too much past experience to judge how much it'll affect us, but principally, we don't see any of our businesses being kind of stopping completely or starting with a big boom because of external. They're all essential commodities and the growth rates maybe little less or more based on the macroeconomic and inflation and uncertainty of consumer spending.

Anurag Patil: And one last question, on the raw material basket, are we already witnessing reduction in the prices or it is still at the elevated level?

Kedar Vaze: So, they are not, I would say at the full basket level, we are not seeing reduction as of now. We are seeing some stabilization. So, there was additional expectation of further inflation due to the Ukraine situation that is not happening at the moment. We see the same elevated prices, but no further aggravation of that. Small impact of the currency, which may come in in the later parts. Right now, we are hedged, and we have the raw material stocks, but if there is a very big movement on the currencies, like in U.S. Dollar-Rupee, Euro-U.S. Dollar, there may be a small impact on the costs. But as of now, we see that the overall impact of inflation in our basket this quarter versus last quarter and the expected second quarter, it is flat. The first quarter, we are not seeing additional inflation.

Moderator: Next question comes from the line of Payal Lad from Progressive Shares. Please go ahead.

Payal Lad: I need a few clarifications from the annual report, if you could just highlight on the same. Firstly, there has been a mention in the AR that you are trying to focus more on the QSR space via the NuTaste acquisition. So how is the demand and how big is the opportunity size that the company is eyeing at?

Kedar Vaze: The QSR business is basically the opportunity size is very large. It's about Rs. 2,000 crore of Flavour and the Savory products going to QSR. With this NuTaste Food acquisition, we are now starting to target part of that, especially the syrup, sausage, seasoning kind of product. We have doubled almost the revenue in this vis-a-vis the last couple of years of this acquisition. Although last year was a pandemic affected year or the last two years are not exactly the underlying base. There is a very large future demand. So, the expected market size for this QSR product ranges, ballpark estimate, to be Rs. 2,000 crore across the country. We are taking a certain small niche size of that. So, we are looking at Rs. 200 crore growth potential market right away for us to grow from the base of Rs. 12 crore and we continue to grow that part.

Payal Lad: And how is the traction seen in the Ayush business? Like how is it favoring SHK?

Kedar Vaze: So, as I mentioned, I think the Ayush business has two parts. One is combination sales with Fragrances. So ayurvedic extracts going together with our Fragrance offering. So that has seen good traction. We have some very nice products launched in the last six months, which have both Fragrance as well as Active Ingredients from the company. So, this is a good synergy, but the ayurvedic extract part of the business itself in term of value remains small because they're added in very small quantity. They're not the major product. So, the volume of that is very small, but it is helping us to crack and develop new innovative solutions for our client.

Payal Lad: There was a mention like two quarters as well, like Q1 '21 PAT had seen a reversal of additional tax provision pertaining to previous assessment years and also reversal and disposal of assets. So, are these provision and reversals a thing of the past or anything is left to be undertaken yet?

Kedar Vaze: No, these are actually the reversals, and these all were one-offs. There is nothing left to be taken. We had the capital work in progress, particularly on the research and unfortunately in the two pandemic years, a lot of the projects got delayed. So as a result, we have written it off and we are now expensing all our development costs rather than taking to the CWIP. So, it doesn't really change anything going forward.

Payal Lad: One last question, you have been mentioning about undertaking calibrated price hikes. So just like to understand, like what exactly is the structure or the policy at the company level? Like how does it happen? The frequency of the same?

Kedar Vaze: So normally, frequency of our price hikes would've been sort of 12 months annually discussion with the client. The extreme inflation scenario we have seen in the last 12 months, we've had to do two times engagement with the client on the price increase. And we expect as a normal practice and annual discussion on setting, resetting the prices, but this time around, we've done two times in the last 12 months. And with the prices stabilizing, I think hopefully we get a good 12 to 18 months of stable pricing.

Moderator: Next question comes from the line of Rajesh Jain from NB Investments. Please go ahead.

Rajesh Jain: I had two questions. The first is regarding the RFP of the global MNC and you had mentioned around $100 million over a period of three years. So, it is not annual. It is over a period of three years. Is that understanding is correct?

Kedar Vaze: No, it is the annual potential of the business, but it'll not be all issued out at one go. So the potential annual business is $100 million. So, $300 million worth of business will be tender.

Rajesh Jain: So now you also mentioned that you are expecting minimum 20% of that business. Based on the way, the speed at which they're processing and all that, can we expect some sales in the current year or will it go to the next financial year?

Kedar Vaze: I think it's a question of timing. It's difficult to ascertain exact time, but we are confident of some additional business coming by quarter four this financial, at least second half of this year. And next couple of years that business will continue to ramp up as projects get completed.

Rajesh Jain: So you mean to say maybe by FY '24, we may get around whatever the share of business we get, we will be able to do that in the fully financial year?

Kedar Vaze: Yes. So, this $100 million odd business will be split into projects. Wherever we win, we will start to supply for three to four years horizon on that product. So, it'll keep adding and as this first cycle completes, the next cycle of product development and tenders will start. So it's a continuous, it's not that one happens and it stops at some point. Now we are on this, the next three years, there will be product development happening and parallelly sales will follow with a lag of say 6 to 9 months to 12 months.

Rajesh Jain: Sir, once you get an opportunity to develop a product, does it mean that you will also get an opportunity to supply also?

Kedar Vaze: Yes. So, the steps are the selection, I would say white listed or approved vendors. So, we are now qualified vendor. Now between the qualified vendors, would say tender or bidding, competition or design competition for the various brands at the sub level within the tender. So that work has now started, and we expect roughly potential annual $100 million is the kitty of projects that we will undertake and 20% of that is our good starting point. We are in this for the first time. So, we are hopeful to look at 20% win ratio or win rate as a good target. And, yes, then this process will continue. I mean, it's not that there is an end to this process in one year or two years. We have entered this process will run for next two to three years. Ideally, by the time this first wave and these tenders start to complete, we will have three years of supply time. And by that time, the next wave will start. So, there will be an overlap and it should not be like, it'll not end at some point. We expect to be in this on a continuous basis.

Rajesh Jain: So you mean to say after two years, let us say you win 20% of this $100 million and if any new products or new tender also you win, that would be in addition to this 20% of what we have won now, that's what you are saying. Correct?

Kedar Vaze: So let's assume we have won Rs. 50 crore business. This Rs. 50 crore business will remain for the next three years. That's the project cycle. And other projects we will keep working. So this Rs. 50 crore is in the supply and there will be another Rs. 50 crore, which happens in the new development. So not everything will start on the same day and end on the same day. So, there will be an overlap. In the two years period, we will have our maximum on this RFP. By the end of the third year, the RFP of the first year would've completed and the new tender will start to come in. So, I don't expect this to be ending like a sharp end. It'll progressively go up and then there will be a steady state where we are working on new projects and then the win ratios will determine if our business continues to grow and what pace it grows? So, on a starting base of very small, we expect it to grow to a steady state and expected to be around $20 million.

Rajesh Jain: Okay. But I think you had mentioned this would be very low margin business. Is that understanding is correct?

Kedar Vaze: So typically, in terms of the volume and gross margin, so even in our current business, we have the larger clients that are at a lower gross margin level, but the operating cost per kilo for the manufacturing are also proportionately lower. So, the net margin level is not very different between the small clients and the big clients. And in this case, depending on the product, we expect that the gross margin will be on the lower side, but our net operating cost per kilo also will be much lower than our current size and scale of operation, which will enable us to maintain the net margin.

Rajesh Jain: Okay. But this winning of any orders from this MNC will open a gate for the opportunity with other big MNCs. Is that understanding is correct?

Kedar Vaze: Absolutely. Right.

Rajesh Jain: But tell me, we have been acquiring lot of European F&F companies. Is that not sufficient to go and approach the other global MNCs for us?

Kedar Vaze: So yes, it is part of the strategy. Now there are so many factors. It's not just one factor that you have European presence or not present. So, there are so many factors in their decision making, but certainly the acquisitions in Europe and having the presence and development centers on different parts of the globe has helped us take this additional global MMC contract.

Rajesh Jain: Okay. So, my second question is regarding the margins. If you see Q1 margins have been lower than the Q4 of the last financial year. So, my first question is you said there is no increase in the raw material prices. So then why is the EBITDA margins are down in Q1 of this financial year compared to last quarter of last financial year?

Kedar Vaze: So, I am referring to additional increase in this quarter versus last quarter because we have almost two and two and a half, three months of stock. Our price increase impact in the accounts happens in the quarter next quarter. So, price increases happened in the first quarter calendar and second half of last year. The full impact of that is seen in the first quarter of this year.

Rajesh Jain: Okay. But now that there is no more further increase in inflation and by the end of this Quarter 1, you would've exhausted the earlier high priced inventory. What I want to know is have we passed on all the increase in cost of raw materials or the freight cost or whatever increases were there, are we in a position to pass on all that to our customers?

Kedar Vaze: So I think we have passed on a reasonable amount. We are not in a position to pass on the entire amount. That's why our gross margins from 43%, 44% are now at 39%, 40%. We are not in a position to pass on entire cost increases to our clients in a short time. We anticipate as growth kicks in, I mean, at some point in the few years down the line mid-term basis, we will slowly be able to improve our margins. But, at the moment, I think the 39%-40% margin is the level at which we will continue to operate.

Rajesh Jain: Okay. Assuming that there will be no increase in the raw material prices, we had done in FY ‘21 around 45% of gross margin. To reach that level, how many more years we do require?

Kedar Vaze: It's a very difficult question given the uncertainties. I think the question really is question of what is the growth strategy and what is the margin strategy? So, we are focusing on growth at this kind of gross margin level. We could move the needle and say, okay, if we are looking at more global MNC business and the gross margin will be lower, the growth rate will be higher, net margin level, PAT percentage level, things will even out. And at some point, we may have to take the strategy to say, okay, we are kind of looking at slower growth, but we need to increase gross margin in the product mix. So, this is always kind of a balancing act. So, we are sort of looking at now 40% gross margin, 12% CAGR growth as our baseline. If there are challenges on growth because of macro or other things, then we will relook at this, but right now, we are talking about this trend line. If, for example, prices start to soften, maybe it can happen in one year that our margin instead. If you go back in force majeure scenario 2018, '19, and couple of years, we were able to jump back to 44%. So, it's all market dynamic, supply chain, supply demand and inflation rate and growth rate. But our objective will be to restore back to 44%, 45%. We see that as a long-term target for our gross margin expectation.

Rajesh Jain: Okay, sir, my last question is we have done a lot of acquisitions, both in India, as well as Europe, but in one of the AGM, you had mentioned, if we want to achieve our vision of reaching $1 billion of sales, we need to have presence in America, which has a bigger market for F&F. Keeping that in mind, just wanted to know do you have any companies or anything in mind to acquire it in USA?

Kedar Vaze: Like I mentioned, we are not actively looking at any specific acquisition. You mentioned America, yes, that's 30% plus of the global market is in one country and it's important. We will need to look at managing our debt level and the kind of stabilizing the current business before we do any larger or next step acquisition. So as a springboard to the American business, we need to stabilize our European business, to strengthen it further, and then we will go from Europe to America in stage two. So with this global MNC project, we may have some activity in America linked to their projects. So we are observing or looking at that, but there is no immediate plan of any big investment in America.

Rajesh Jain: Okay. But if we want to achieve our vision, is it necessary that we have to have our presence in America?

Kedar Vaze: I think the long and short answer of that is yes, because in relation to the global business, the America, North America particularly is almost 30% of the global business. So, it is important that we at least have a presence in two out of the three big markets, China, Europe, and America. Europe, we are already working, the growth in Southeast Asia, in South Asia and Africa, but on a short term in the next 10 years, to really take aggressive growth, we'll need to have a presence in the U.S as well.

Moderator: Next question comes from the line of Pavas Pethia from Enam AMC. Please go ahead.

Pavas Pethia: Just wanted to understand this 12% CAGR target, does that include this RFP wins or that is separate?

Kedar Vaze: So, in a way, there is an overlap. I don't think that 12% CAGR is based on the RFP. It is an organic target for us in total. However, with this RFP, we are also utilizing some of our development and sales resources in this target. So, we see that, but in a steady state scenario, our 12% ambition is without the global RFP. So, the global RFP should be in addition. For the first, I would say two, three quarters, four quarters, we will have to make double use of the development resource and yes. So, 12% CAGR is not with calculating the RFP into the account on a longer term.

Pavas Pethia: But how much sales will be overlapped initially in 2024 first year?

Kedar Vaze: It's not so much the sales, it's the opportunity. So, we may have to not do some projects in the current customer base. We may have to be a little bit selective on the projects and adjust our approach with the global RFP for a year, or I would next 18 months. So, I mean if I have to put a number maybe for one year, we will be 9% in our current business and 3% in RFP and the year after that, it will be 12% and additional top up one 1%-2% from the RFP. So, something like this, I mean, it's very difficult to quantify. Our objective is to make sure we put the full resources on this RFP opportunity, which is a big opportunity for us.

Rohit Saraogi: And it is about the effort and return metrics, which we have to follow and at some point in time, we have to cut the tail to achieve a larger objective.

Pavas Pethia: And you also said that margins will be similar. So on a gross margin, it will be lower, but on an operating margin, it will be 14%-odd or 15%-odd of the RFP margins.

Kedar Vaze: Yes. There is no impacted operating level with the large business or large products or the small products. The gross margin level, it's a product mix scenario.

Pavas Pethia: Okay. And how this RFP works after three years though, initials sales kind of die down and you have to bid again, or is it that continues?

Rohit Saraogi: No, after three years typically, there is a second bidding process.

Pavas Pethia: But does that mean that your chances of winning the next bid is higher because you've already supplied or is it a fresh process, different product?

Kedar Vaze: Yes. I mean, obviously our chances, if we are doing well in this RFP, the chances are better. That's clear.

Rohit Saraogi: Because today we are acting as a challenger. If you work for three years, then we will be one of the key suppliers and we won't be a challenger anymore.

Moderator: Thank you. Next question comes from the line of Sachin Kasera from Svan Investments, please go ahead.

Sachin Kasera: Sir in gross margin, you mentioned that it is going up from 44% to 39% and you have also mentioned towards the previous queries that because of this sharp increase in raw material, you cannot go frequently to the customers and ask for a price hike. And now that the price has stabilized, so I'm a little confused, but you also mentioned that we may not be able to grow margin significantly in the short term. Si it's a little confusing because if you are seeing the raw material price stabilized and we should be able to get a price hike, and at the same point of time, you're saying in the short term, the margins will not improve, but the long term especially remains pertinent, so it’s a little confusing.

Kedar Vaze: The price hikes have happened in the past. We won't be able to get additional price hikes as the raw material prices remaining stable and our selling price is remaining stable, our margins will remain stable. There is no further impact of additional inflation or additional pricing. So, it'll be steady state. Going forward next quarter, we don't anticipate any price increase and we don't anticipate any raw material increase either. Now if the raw materials start to fall, at that time we will be able to negotiate with the clients accordingly.

Rohit Saraogi: And the way we have managed 39%-40% gross margin is through our prudent inventory policy. That has also helped us. Now in times, when we see that the prices are stabilizing or it is going to soften, we will play it accordingly and that will further help us.

Sachin Kasera: No, but sir, I’m not able to understand in the business model. Just want to understand the way it works is that in the short term, the price fluctuations are absorbed by the supplier and eventually over a few quarters, once the raw material price stabilize, the gross margin go back to the previous level. I'm still not able to reconcile, is it that our customers are asking us to take up 4% price hike on a structural basis to remain in the business with them.

Kedar Vaze: No. Just understand the dynamics of this, we have had a 25% ballpark cost increase. We are not in a position to pass on anything like 25% on our product mix within three to six months period. So, we have taken a hit of roughly 10% on the gross margin side at our end. Right now, the costs are where they are, selling prices are where they are, so effective gross margin of around 40% will be the paradigm for the next two quarters. We have the material stock and the sales contracts and prices accordingly. Now if the raw material prices were to further increase, we will obviously be forced to give additional price increases to our clients, which we will do, but if the prices were to soften, then we will again look at re-adjusting the prices if there is a big change. So, we are now in a stable state at 40%. Unless there is a huge sort of growth spot and big dynamic change in the market, we anticipate 40% to be the new norm for the next six to nine months. It's anybody's guess, but if let's say there was a big recession and big challenge on the growth and the raw material prices fell, maybe the margins are better, the growth challenges will be there. So right now, 40% margin, 12% growth is what we see. If the growth is remaining like this, we don't see how the cost prices will dramatically change.

Sachin Kasera: Sure. Well, understood, sir. But then can you then explain, how do we reach back because you said the long term goal remains 44%. So, while you're explaining very well that in the next six to nine months, why you should remain at 40%, but then how things will change, which take us to 44% over next three to four years, which is like a long term aspiration of the company?

Kedar Vaze: Yes, so I think there is obviously steps on the backward integration on our costs, which we will keep taking and improving. So, there is ballpark 0.5% to 1% of raw material price improvements, which we do with our research on the chemical or raw material side or vendor development side. All those things are not seen because of this major inflation at this point. And when the inflation stops, those initiatives will start to help us drive better margins.

Sachin Kasera: So fair to assume that we should see some improvements say in financial year ‘24 and major improvement in FY ’25 in this long-term journey?

Kedar Vaze: I think as we speak now, yes. There are some other new factors which happened during the next, I want to caution that the uncertainty in all the forecasts are now very high, but if there is no additional big disruption, global disruption, then in two years' time, things will stabilize, our margins will slightly get better and that will be, I think again, it's a product mix scenario. If our global MNC, if RFP becomes a bigger part of our business and our overall gross margin while they are lower, our operating margin will improve.

Sachin Kasera: Yes. So that was my next question. So with all these initiatives from a little long term, say FY'25-FY'26 perspective, as in, we also win this global tender, which we are very hopeful of, then how should we look at the EBITDA margin because see, our has been 18% to 20%, on the lower end, we are between 12%-13%, is it that in 3-4 years with all the initiatives you're talking on the gross margin, as well as new tender and the growth and operating leverage, can you to aspire to become a centering point margin or that was like a one-off and sustainable number in the, like even from a 5-year perspective, more like 15%. What is your take on that?

Rohit Saraogi: Yes. So you have basically answered the question in the question itself. I think on the lowest end, we are at the 14% EBITDA level, which is right now, and I think that's the lower end of the range. We aspire to be a 20% EBITDA business. We've done 18%, we've done 16, we had quarters we had done 13.5%. So the -- I think the average range now with the new inflation existed basis is more or less 16.5%. If inflation were to kind of convert into deflation, maybe that can go up, but we kind of, I would say 18% median is now 16.5% median in terms of the EBITDA percentage. And, as we go, our margin stabilizes, improves, our EBITDA percentage should reach that kind of level.

Sachin Kasera: Yes. I'm saying, in the call, you mentioned that you expect the net debt to be Rs. 400 crore by end of March FY '23, is that correct?

Kedar Vaze: So basically, net debt in this quarter will go up because of the Rs. 50 crore second tranche. So, it's not that in September end quarter, the debt will come down. I'm talking about Rs. 400 crore directionally. I think, we also need to be mindful of what is the raw material situation. So, I expect somewhat cooling off of the raw material and reaching the Rs. 400 crore target. Raw material prices remain where they are, maybe we reach Rs. 425 crore at the end of March.

Now, these are the operating level numbers. Depending on interim dividend or any other payouts. So I expect to be between Rs. 400 crore and Rs. 425 crore by end of March as of the cash flow from the business. There will be some interim dividend, or if we don't do any interim dividend, what are the cash outflow to the shareholders are not factored in this at this point.

Sachin Kasera: And so just one last question on capital allocation. So, we did one round of buyback and we are very confident of growth in margin coming back. So do you think that you aspire to do maybe another buyback at this time from the European market because since then, there's been further PAT correction, whereas our overall outlook at growth expressions have changed. So once in the next 2-3 quarters, the debt comes on further, we will seriously evaluate looking at our buyback, because current valuations are very, very low.

Kedar Vaze: So we are looking at buyback and dividend as two methods for cash distribution or profit distribution to the shareholders. We have a policy of 30%-40% of PAT to be distributed to the shareholders. We'll follow that consistently. The modality of whether we do buyback or dividend depends on the situation at that time. And we will consider various options. At the moment, there is no cash distribution or profit distribution to the shareholders in the plan for the next 2-3 quarters. We are focused on operations, getting the growth and reducing the debt. And once that happens, we will evaluate the best form of distribution of profit to the shareholders at that relevant time taking into account the conditions at that time.

Sachin Kasera: Sure. And just lastly again on this debt thing, so what level of absolute debt or debt to EBITDA or net debt to equity, is where we may again start to evaluate, or, if any good acquisition comes, we look very seriously. I think right now, the priority is to bring the debt down, but is it like some number, like say Rs. 400 crore or Rs. 300 crore or 3 times debt to EBITDA, what level even we may again start to look good acquisition opportunities?

Kedar Vaze: See the acquisition and strategic discussions are not timed, right? It happens. There can be a very big market dynamic, some merger, some fallout, some distress sale by somebody, lot of things can happen. So, I don't want to speculate on that in the future. As of now, we are not in any active proposal to acquire or invest additional money. Our focus this year is on running what we have and bringing the debt down. I mean, we don't have any specific level above which we will start again, active acquisition process in mind. We will continue to evaluate any opportunities if they come, but we are not actively seeking. So, if some opportunity were to come and it makes real sense. We could look at it, but as of now. I think the expectations in valuations and the debt level where we are, I don't see any deals happening.

Moderator: Thank you. As there are no further questions, we have reached the end of question-and-answer session. I would now like to hand the conference over to the management for closing comments.

Kedar Vaze: Thank you. I hope we have been able to answer all of your questions satisfactorily. Should you need any further clarifications or would like to know more about the company, please feel free to contact us or our team of CDR India. Thank you once again for joining us on this call.

Moderator: Thank you. On behalf of S H Kelkar and Company Limited, this concludes this conference. Thank you for joining us. You may now disconnect your lines.

-End-

This is a transcription and may contain transcription errors. The transcript has been edited for clarity. The Company takes no responsibility of such errors, although an effort has been made to ensure high level of accuracy. No unpublished price sensitive information was shared/discussed on the call.