“Arvind Limited Q1 FY20 Earnings Conference Call”

August 6, 2019

MANAGEMENT: MR. JAYESH K. SHAH – WHOLE-TIME DIRECTOR & CHIEF FINANCIAL OFFICER
MR. SAMIR AGRAWAL – CHIEF STRATEGY OFFICER

Moderator: Ladies and gentlemen, good day and welcome to the conference call for analysts and investors for post result discussions for quarter 1 financial year 2019-2020 Arvind Limited.

As a reminder, all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone.

I now hand the conference over to Mr. Samir Agrawal. Thank you and over to you sir.

Samir Agrawal: Good afternoon and thank you for participating in the Q1 FY2020 earnings call of Arvind Limited. I head the Strategy Department of Arvind Limited, and joining me is Mr. Jayesh Shah – Executive Director & our group CFO.

Our results this quarter were broadly in line with our plan of modest top line growth and reduced earnings compared to the Q1 of the previous financial year. As you all are aware, we have been operating in quite difficult market conditions over the past few months characterized by a relatively weak consumer sentiment and credit crunch which impacts our business through the trade channels adversely. In addition to this general market environment, apparel markets – and this is true for both our business in India as well as globally we are seeing – are impacted by two clear trends which are very specific to the industry. One is, clear shift towards the value retail offerings as well as larger and larger portion of consumer buying shifting online.

Now, getting to the specifics of our Q1 financial results, our top line overall grew by 5% to reach Rs. 1896 crores. The two key factors which contributed to this were the garment volumes which were higher and also the growth in our advanced materials business. Overall EBITDA for the quarter was Rs. 154 crores which translates into an EBITA margin of 8.1%. In comparison, the margin for the same period was 11.1% in FY2019 Q1. Textile revenues grew by 4% in this quarter. Fabric revenues were almost flat across all subcategories of denim, woven, knits, etc. Garmenting volumes continued to scale up as per our plan. Like we have shared a few times in the past that we are aggressively scaling up our garmenting capacities and many of the new factories have started to come online, the revenues from garmenting grew by 22%. Cumulatively, our garment volumes for this quarter stood at 9.9 million pieces excluding essentials and suites. And just as a comparison, for the Q1 of the previous year, this number was 8.3 million pieces. EBITDA margin for textiles business overall stood at 9.7% as compared to 10.5% in the previous quarter which is the Q4 of FY19. So, if you compare it with the previous quarter, we went from 10.5 to 9.7, and if you compare this with the previous year, i.e., Q1 of FY2019, the margin stood at 11.9% and it was a very strong 1st half of the last year. So, that gave a very high baseline as well.

Also, as we have described in the past, our garmenting manufacturing facilities are ramping up on efficiency. So, some of the newer factories are still subscale and those tend to erode margins in the initial 2 or 3 quarters which is happening as well. Now, talking about the advanced materials business, the top line grew by 30% for the quarter and reached Rs. 167 crores. As a recap for all of you, this business of advanced materials consists of human protection which is specialty clothing for different applications like fire retardant, etc., advanced composites, and a set of industrial products which include belts, filters, and so on. All these businesses clocked healthy growth and they continued to be on the momentum. EBITDA margin for the advanced materials improved from 7.8% to 11% as operating leverage improved in more mature parts of its portfolio. Overall, we are on course to hit the 800-crore revenue run rate for this business by the end of this financial year. So, we will do 800 crores offline.

The others category consists of a few businesses that are yet to mature. Among these, the more prominent one is our industrial effluent treatment business. By nature, this is a project type of a business and hence the revenue and the margins are driven when the contracted invoicing milestones kick in. So, as this business stabilizes in terms of the volume, we will start to share more specific details. Our net debt at the end of the quarter was Rs. 3024 crores as of 30th June 2019. The debt increased as compared to March and quarter as we front loaded capital expenditure and did some opportunistic buying of cotton.

Our guidance for the year stands very much in line with what we had stated in May. As a quick recap, what we had said is we will grow on a full year basis at 7% to 8% on top line in FY2020 and most of this growth will come in the 2nd half of the year. We still stick to that expectation guidance. We expect many of our garmenting facilities to start scaling up and delivering significant volume by the 3rd quarter onwards. Despite market challenges, we expect denim volumes to improve slightly and advanced materials will grow 30% on a topline basis for the year. In terms of margins, we expect the EBITDA in H1 to be lower than the previous year and we have said this before as well because there was a strong base effect for H1 in between FY19 and 20. Secondly, our new garment facilities will kind of stop making the losses which they do typically in the initial part of the ramp up. For these two reasons, we expect that the 2nd half of FY20 will deliver higher EBITDA than H2 of the 2019 and hence we are looking at a pretty good overall year by the end of March. So, we are looking to reduce the overall debt from March 2019 base by about Rs. 300 crores during the year and this guidance does not take into account any impact from significant movements in currency exchange rates, cotton prices, and other input raw material costs. So, overall we expect the year to end up on a good note with a lot of good news coming in the 2nd half of the year.

I will wrap up my initial brief here and invite you to ask any questions which you may have.

Moderator: We will now begin the question & answer session. The first question is from the line of Maulik Patel from Equirus Securities. Please go ahead.

Maulik Patel: A couple of questions. One on the garment and the expansion what we have been doing since the last couple of years. If you can throw some light on the facility-wise how the ramp up has been, and particularly on the Ethiopia where we set up the facility 2-3 years back, what kind of revenue it has been generating, and the profitability which could be the benchmark in the upcoming Indian plants, particularly in both in Ahmedabad and Ranchi.

Jayesh K Shah: We have plants which we have been setting up since last few years and particularly last year, we have set up a plant near Bengaluru, a place called Arasikere, to manufacture about 3.5 to 5 million shirts in a year. That plant got commissioned and stabilized by the end of last year. We had a plant to manufacture 4 million shirts in Ethiopia. That plant is running now for about 6 months. We have set up a new plant to do about 4 million jeans in Ethiopia. That plant is starting now. It has started in quarter 1. There is a plant of about 4 million shirts in Ranchi. That plant is started in quarter 1 again. In fact, it started late March. It has gone into commercial production. There are two plants, one activewear plant of about again 6 million garments in Bavla. That plant has started in quarter 1 and 1 plant for denim in Bavla is yet to start. Overall, if I were to say all of these facilities getting fully utilized, we should be having close to 60 million garment capacity. We are hoping to do about between 40-42 million this year as opposed to 30 million that we did last year.

Maulik Patel: And once we reach this 60 million and the capacity utilization in 2 to 3 years, probably next year 2nd half or onwards….

Jayesh K Shah: In that, we should be exiting at 60 million next year. So, it could be more like 50-52 million plus next year and ending with 60 million next year. That is currently the way the plan looks.

Maulik Patel: So, that should bring the overall revenue of the garment business closer to around 2500 crores or something?

Jayesh K Shah: Yes, it should be around that.

Maulik Patel: The older plants which are probably in full ramp up utilization like what we had in Bengaluru, what kind of margin which we are making there? And is this the kind of margin which we will achieve eventually in the other plants also or it could be higher?

Jayesh K Shah: The way we are looking at it is to see end to end as to what kind of margins between fabrics and garments we make and the very matured plants are at about 12% to 13%. And we believe that similar margins should come from even the newer plants because they are no different than the old plants in terms of facility or the product mix that we are making there.

Maulik Patel: Having said that, you mentioned earlier that there is a substantial initial operative cost for each of the plant which has been happening since last 1 or 2 quarters and probably will be there a couple of more quarters, but any absolute amount to be suggested as to what is that quantum of initial running cost which impacts the EBITDA?

Jayesh K Shah: Different plants have different levels of productivity, but it could be like a percentage or about of the overall textile margin that can, for a given quarter which is 1st quarter, get eaten away. I think it will start tapering off in Q2 that is our plan. But it should almost become as zero in quarter 3 onwards. I think the progress has been quite good and we believe that we are on course to achieve the earlier guidance, and my colleague just said that it may look a little lopsided top line growth or earnings growth for this year, but we believe that we are likely to be able to achieve our overall guidance that we have given.

I am sorry but I am adding to the guidance again. If you look at what are the things which are positive? Currency is a positive factor for this year compared to what it was last year. Cotton prices of late are soft and we believe with good monsoon and a low overall demand for cotton, we should not see a significant change in the cotton prices. The third of course is the export market that is reasonably good. It is not weak at all. And on our side, we are getting extra output. So, you have the ability to sell more and earn more.

There are challenges in the form of domestic market. It is quite soft as you know. In across, I think the retail is quite soft for most of the product groups in India and we are no exception, and we have an added challenge also that the trade channels still continue to be under cash flow strain.

We don't expect it to happen but there could be an uncertainty of 1 or 2 months of MEIS not being there while the new scheme may come or it may get delayed, something like that. These are some of the pluses and minuses as we see for the current year.

The way we see our garment ramp-up progress, we believe that we should be able to achieve what we have set out ourselves to do this year. We have purposely front loaded the CAPEX this year and also we have done quite a bit of opportunistic cotton buying in June and July months. So, the debt seems to be on a higher side for quarter 1 but it is tapering off as we speak. In July, it has come down sharply because we already have cotton which we don't need to pay for. And we believe that we should be below March number in September and we should be able to reduce the debt by 300 crores by end of this year. Overall, that's broadly the guidance for the year.

Maulik Patel: The CAPEX could be what for this year?

Jayesh K Shah: CAPEX, I think we will be spending about 250 crores in H1 and another 30 to 40 crores in H2.

Maulik Patel: That comes to around 280-300 crores and a large part of the CAPEX I think 150-200 crores is on the garment side, right?

Jayesh K Shah: It will be more on garment side. It will be like 200 crores roughly and the balance will be on our textile and advanced material.

Maulik Patel: So, next year the CAPEX should come down drastically given that we don't have too much of….

Jayesh K Shah: I think there would be a pause on CAPEX till we utilize these capacities. So, next year would be that year where I think we will go through that period where we have been through a good 18 months of heavy CAPEX. H2 of this year and most part of the next year would be a low CAPEX period. And again, we will see how we want to further add capacity.

Moderator: The next question is from the line of Sagar Parekh from Deep Finance. Please go ahead.

Sagar Parekh: A couple of clarifications. On the CAPEX, you said for this full year FY20, you mentioned 250 plus 40, right? So, 290 crores CAPEX for the year?

Jayesh K Shah: 280 to 300 crores, yes.

Sagar Parekh: How much have we spent in Q1?

Jayesh K Shah: It is close to 170-175 crores in Q1.

Sagar Parekh: Next year, how much are we looking to spend?

Jayesh K Shah: It is early to say but I would think that it will be more like 200-250 crores.

Sagar Parekh: So, our earlier plan of 500 crores CAPEX is now revised downwards to 200-250 for next year?

Jayesh K Shah: It is like yes and no in the sense that if you look at it year-to-year, it may look so, but if you look at last year and H1 of this year, it will be like a large CAPEX of 650 odd crores. That would be that 1 year of little bit of lower CAPEX that will absorb this capacity and again begin. The current CAPEX should give us 7%, 8%, or 9% growth even for the next year. We will have to figure out in the middle of next year or in the early part of next year how we plan to grow in the year following for which we will come out with a CAPEX plan, but broadly, as things stand today, around 250 odd crores.

Sagar Parekh: Then, by the end of next year, you said 60 million pieces of garmenting capacity will be the total capacity for us.

Jayesh K Shah: That's correct.

Sagar Parekh: Last year what I recall is you mentioned about 34 million pieces of garmenting volumes we did last year in FY19 and we were talking about 30% growth for this year. But you mentioned 42 million pieces, so that is lower than that. It is about 20% growth for this year.

Jayesh K Shah: 34 x 30%, it will be like 41-42, right?

Sagar Parekh: So, it will be about 42 for this year then?

Jayesh K Shah: That's correct.

Sagar Parekh: Once all the plants are stabilized, where do you see the textile margins stabilizing? Obviously, this has been a quarter where the garmenting facilities are getting ramped up, but once after that is done, where do you see the margins?

Jayesh K Shah: Overall, I think the margins in fabric should be closer to 14% to 17% based on what the dollar, cotton price, everything is, and on our garment should be between 11% and 12% to 13%. So, blended margin of 12% to 13% is achievable. It could as well be 14% but in that range, 12% to 14%, based on what the dollar is or what the cotton prices are.

Sagar Parekh: So, 12% to 14% is achievable. This possibly would be like the trough in terms of margins that we have reported in Q1?

Jayesh K Shah: In Q1, the fabric margins are good except that the denim has been still subdued in this quarter. It is the garments where the margins are softened and there are quite a few plants which are currently absorbing the losses. As we said that we should be able to do a 10% margin for the year for whole of the company and that would mean that 10% or higher margin for our textile business as well. But for the fact that the denim is still under a bit of a supply overhang situation and that garments are taking away some part of the margins, I think across all other products groups, the margins have been very comfortable.

Sagar Parekh: In spite of this oversupply in denim on the domestic side and on the global side also we are seeing the capacity is shifting to Bangladesh, especially on the garmenting and fabric both. Garmenting was anyways there, but the fabric capacity demand also is shifting to Bangladesh. So, you think 14% to 17% margins on the fabric is still possible in spite of all these challenges?

Jayesh K Shah: Two facts. One is that of course there is regionalization of supply chain which is now very evident that brands globally are looking at – If you can supply me from the same city, both fabric and garment, that is the best. If you can supply me from the same country, that is also fine. If you are supplying from a neighboring country, that is also fine. But anything more than that is not an acceptable situation is currently the way supply chains are changing and they are changing very rapidly because they want to reduce the time cycle and they want to also offload more and more responsibility to manufacturers and focus on their retailing business. That is the way the business is moving, and incidentally, we are also moving in the same direction as a company. So, we believe that if we do this and if we do so much hard work and investment, we should continue to earn that margin because we shouldn't be losing out on that, especially because we are looking at gaining or increasing our verticalization ratio over the next year.

Sagar Parekh: On the Others division, there was a 15 crores EBIT loss for this quarter. How should we look at this and what should be read into this loss?

Jayesh K Shah: It will fluctuate by quarter. As a large portion of this business is our Envisol business, in the quarter 1, there were I think very insignificant amount of sales and the project completion. So, you would have very less contribution and overheads being there, you will have negative. We don't see that being negative for the whole of this year, although the last year, as far as Envisol is concerned, was a very, I would say, extraordinary year, especially because they implemented very large projects overseas. This year, the traction is good. We would refrain from giving details on a quarterly basis in that business right now because it is still a small business and we would wait for a year or so before we talk about it, but as the quarters pass, we believe that, based on the order book, this should be able to do a reasonable job this year as well.

Sagar Parekh: How much margin should be built into it for this year?

Jayesh K Shah: I would think that others would be like 3% to 4% margin with a 300 to 400 crores business.

Sagar Parekh: 300 to 400 for the full year then. So, Envisol would possibly be lower than last year because Envisol itself was about 300-350 crores last year.

Jayesh K Shah: I would like to refrain from giving numbers for this segment for now.

Sagar Parekh: Because last year, we did about 620 crores of top line. Now, we are guiding for 300-400 crores. So, that is like a steep decline in terms of….

Jayesh K Shah: I just explained that last year was an extraordinary year.

Moderator: The next question is from the line of Prerna Jhunjhunwala from B&K Securities. Please go ahead.

Prerna Jhunjhunwala: Sir, I would like to understand the garment cycle. How many months lead time would be there and what kind of order book do you have this year, to understand the 30% volume growth?

Jayesh K Shah: Currently, we are relatively small. The volume growth is coming primarily through capacity utilization as we expand capacity. As far as orders are concerned, as we have said, our initial hypothesis or our argument for this business has been that we are supplying fabrics to some of the large retailers and brands globally and India for a very long period of time. And those customers are getting the garments made in other parts of the world. If we are willing to take that responsibility and supply them a full package, we should be able to get the orders. That is the reason why we are confident that we should be able to sell this because it is not a new customer or new market, we are going in. So, as we expand, we are able to get the orders and we are able to sell. It is not a very long-term contract because fabric and garments are both fashion. Though there are indications that customer A and customer B and C will buy like this, they change and they change every month because the fashion cycle, demand, stock inventory levels of our customers, all of them change. So, it is not a robust healthy order book for a long period of time that any textile company or a garment company would have.

Prerna Jhunjhunwala: Sir, our capacity at the end of FY16 stood at 56 million pieces. Is that the right number?

Jayesh K Shah: Around 60 odd million. Depending upon the project, style, and the complexity of the product, 55-60 million is what we should be ending this year at the capacity level but that is an exit capacity. It is not that we would be able to achieve the efficiencies of that level by the end of this year.

Prerna Jhunjhunwala: Sir, US-China trade war, do you have any higher enquiries coming also because of that phenomenon happening?

Jayesh K Shah: US-China trade war is a very big subject of course, but as far as our product and we as a company are concerned, we are not seeing too much of a challenge because we are not too large in the overall context of the global market and we have our customers who have grown and we have been not growing so much. So, we have a steady customer base to whom we supply and we have been having more orders from exports market, especially for garments for quite a long period of time and that is the reason why we decided to export or set up these plants.

Prerna Jhunjhunwala: So, even if you get orders after September also, still you will be able to maintain your guidance of 42 to 45 million pieces for the year, is what I was trying to understand.

Jayesh K Shah: Production cycle is only 30 days. It doesn't take time. Even if we get the orders for 15th September delivery today, we should be able to deliver which will not be a problem.

Prerna Jhunjhunwala: Sir, this quarter, the tax rate was higher for us. What would be the guidance for the full year for tax rate?

Jayesh K Shah: Around 31%.

Prerna Jhunjhunwala: Sir, then why this quarter, it was higher?

Jayesh K Shah: Some of the companies which are our subsidiaries where there may be a loss where we may not make deferred tax asset provision, those kind of changes, but if you look at for the whole year, it should be around 31% to 32%.

Prerna Jhunjhunwala: Sir, my last question would be on cotton. You have mentioned that you have done some opportunistic buying. When should the benefit of that buying be visible in your numbers? Secondly, Indian cotton prices have not declined so much. So, would you be resorting to importing of cotton going forward to reduce your cost and will it be possible?

Jayesh K Shah: Even when I talked about buying, we did import quite a bit of it in June and July and we keep doing it. Depending upon quality and price parameter, wherever we get a most optimum combination thereof, it doesn't really matter if it is Indian versus imported, we do that.

As far as your first question is concerned, I think July-August-September is where we will be using that cotton so that the small benefit that we should get out of it.

Prerna Jhunjhunwala: At least 100 BPS improvement in gross margin can be seen because of that, minimum? Because the decline on the imports side is very high.

Jayesh K Shah: No comment ma'am.

Moderator: The next question is from the line of Arjun Singar from Reliance Mutual Fund. Please go ahead.

Arjun Singar: Sir, my question is on the denim segment. Can you throw some light on the export market as to how is it faring?

Jayesh K Shah: As my colleague mentioned in his opening statement, more than the volume, there is a significant change that we are seeing both in India as well as in export market and that super premium products are getting sold more and value products are getting sold more. The in-between category of $40 to $70 a pair of jeans segment is getting squeezed, which was the market where we used to be supplying. That required us to make changes in our product development to manufacturing setup to cost base to everything which we have done.

As I said sometime back, we would see a rise in our denim volumes in Q2. It is because we have tweaked the product and the cost structure. As you know, we were always supplying at a very high differentiated prices where the market has been a little soft, but at the value and at the premium, the markets have been fairly strong globally as well as in India. So, we have tweaked it and we should be able to supply now. As far as Indian market is concerned, especially for denim – I am not saying generally for textiles but for denim – more than the demand, it had been a supply overhang challenge which is there but we believe that it should reduce as some capacities go out of the market and as the demand also increases. So, I think it is a period of 1 more year of a bit of a supply-demand mismatch that will continue but it should stabilize.

Arjun Singar: Also sir, can you give a similar commentary for wovens? Downtrending must be common to wovens also.

Jayesh K Shah: The trend broadly is not different for wovens. There has been a bit of a change in the product mix there also, not so significant like denim. If I talk about market – the wovens – at least for us also it is true that we are more India centric on sales than as compared to denim. And Indian brands and retail have been soft as you know in the last 6 months and I think most of the retailers and brands have had a tough quarter 1 and particularly July month is what we hear, and as a result, there is that challenge in the local market. Export markets are fairly good for wovens and the positive side for wovens is that there aren't too many strong players and some of the players in the wovens business have recently in fact reduced capacities or have shut. So, the demand-supply situation is not as bad as it is in the case of denim.

Arjun Singar: A couple of quarters back, you had mentioned of some destocking happening with some of your key customers in Europe.

Jayesh K Shah: That is all over, it is all done. That was for denim, not for wovens. Now, it has become business as usual for denim.

Arjun Singar: Coming to the garment side, typically when you commission a plant, do you already have planned orders?

Jayesh K Shah: In garments, what happens is that there are always orders because we have orders for the whole system. We are making the same product in one plant versus another plant but then, like in pharmaceutical, there are factory approvals that you need from your major customers. They go for compliance test and everything. After you set it up, it takes about 3 more months. Sometimes, from day #0, it is 6 to 7 months before you actually load the factory with the right type of an order. So, during that period, you always have orders, but they are less contributing in terms of margins.

Arjun Singar: Since this trade war between China and the USA, Vietnam and Bangladesh have benefited significantly over the course of the last year.

Jayesh K Shah: Even the Indian garment manufacturers who are capable of delivering are running at full capacity. I think in India, the bigger challenge is that no large capacities have come of late.

Arjun Singar: Since we are expanding significantly, do you think this can be a structural tailwind for us?

Jayesh K Shah: We think so. As I said earlier, apart from China-US trade tussle, it is a very clear trend that we are seeing that our customers are wanting as shortest time cycle as possible and they want as hassle-free a supply chain as it can be which is why a company which can supply a garment instead of fabric is always a preferred supplier No.1. So, even in India, some of the unlisted companies but large garment manufacturers have decided to go backward and put up the fabric capacities. If you see Bangladesh which is a strong garment exporter, many of those people have started putting fabric manufacturing capacities.

We are a manufacturer of fabrics and we are trying to go 1 step above. So, it is becoming clear that players who are large and significant in the global market, either fabric makers or garment makers, are becoming vertical and that is the preferred supplier for major brands in the world.

Arjun Singar: Just one suggestion if you can take that into consideration. In the presentation, in one of the slides, you give the breakup of revenue for our different segments and then on the right-hand side, you have the total EBITDA. If you can give the breakup of the EBITDA, that would be quite useful.

Jayesh K Shah: We will consider that. We will think about it.

Moderator: Ladies and gentlemen, due to time constraint, that was the last question. I now hand the conference over to Mr. Samir Agrawal for his closing comments.

Samir Agrawal: Thank you everybody. We will again meet in another quarter.

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