"Mahindra EPC Irrigation Limited Q2 FY-22 Earnings Conference Call"

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MANAGEMENT: MR. ASHOK SHARMA – MANAGING DIRECTOR

Moderator: Ladies and gentlemen, good day and welcome to the Mahindra EPC Irrigation Limited Investor's 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. Ashok Sharma, Managing Director from Mahindra EPC Irrigation Limited. Thank you and over to you Mr. Sharma.

Ashok Sharma: Thank you very much Vivian. Good evening, ladies and gentlemen and a warm welcome to each one of you at the sixth investor call for Mahindra EPC Irrigation Limited. On behalf of Mahindra EPC, I would like to thank each one of for joining this call and I would also like to take this opportunity to wish you and your family a very Happy Diwali in advance. So, today I will be sharing with you the key developments in the Agri environment, micro irrigation industry, the specific performance of the company in Q2 and H1, and the outlook for the year briefly.

As some of you may be new, I'll just quickly recap on the situation of water, and how micro irrigation is so crucial for solving the water crisis in our country. As I've been mentioning on the previous call, we are moving from a water stressed economy to a water scarce economy. If no urgent actions are taken, it is forecasted that in few decades we'll be facing severe water shortages. Already few states are experiencing water shortage and are trying hard to drive micro irrigation so that they can overcome this problem. Hence, water conservation will be one of the most important priority for the future for our country & the planet at large. Now, agriculture actually consumes almost 80% of the freshwater withdrawals. Hence water needs to be conserved in agriculture and that's where micro irrigation comes in. It has been a very important priority for the government. Micro irrigation creates a win-win scenario for all stakeholders. The farmers benefit from using lesser water and increase in the crop production because of precision irrigation, optimum use of water at right time giving required nutrition and technologies like water soluble fertilizers and fertigation. Micro irrigation also helps to bring down the costs due to lesser need for labor for de-weeding, which is one of the costly operations. So, clearly, it's a win for the farmer and as I mentioned before, for the government it's a very important priority. As a result, over the last few decades, the government has been announcing various schemes & subsidies to promote this technology.

We are all aware of the plans of the government, they are working very hard towards the mission of doubling farmers income. The long-term plan is to add almost 2 Mn hectares under micro irrigation every year. The achievement is almost around 40%, - 50% but the intention is there, the central government has been allocating funds. This year, almost ₹ 4000 Crs. was allocated for micro irrigation subsidies. The industry meets the environment friendly and ESG criterions. Hence, it's a big priority for the government and the farmer community driving the long-term attractiveness of this industry. So, clearly with these fundamentals, we are very excited about the future of this industry.

Having said this, there are few states like Tamil Nadu, Andhra Pradesh, Gujarat, Maharashtra & Karnataka, who have taken the lead in micro irrigation. These states are contributing almost 70% of the entire industry. As you know, this is a state subject, the policies of the state actually impact the industry, either favorable or unfavorable.

Moving to Mahindra EPC, most of you are familiar that this company is all about working towards farmer prosperity, using precision technology for water management and focusing on customer satisfaction. The reason why EPC has been successful over the years is because of its consistent high-quality products, focus on customer service, high quality installation design and ensuring that our farmers are happy with our products and the advice we provide for using our product effectively.

Some of you who were there in the last call would remember that as part of our strategy we have decided to focus on few critical markets and increase our market share in those markets. High focus is given to cost reduction, more so in these difficult times, and moving our product mix towards higher margin drip sales to ensure that we are able to get better margins as we go forward. In this industry, one of the key success factor is managing working capital, because the working capital is largely controlled by the state governments. Their ability to pay decides how industry will perform in that market. As a result, we are very mindful about that and keep good checks and balances to ensure that we are managing this efficiently.

Another unique thing about Mahindra EPC is the advantage of leveraging the Mahindra agribusiness ecosystem. We have businesses in seeds, agrichemicals, seed potato and grape exports. We are also able to leverage those farmers to promote our products and services.

Now let me talk about the performance of the industry in this year, the positives, the challenges and then I will talk about our Q2 & H1 performance post which we'll open the floor for questions, and I'll be happy to answer them.

Now, F21 was a year which saw a drop over F20 largely due to the effect of COVID in the first quarter followed by limited funds by the state governments. Even at the start of this year, the phenomena almost replicated. Q1 was again affected, the government priorities remained focused towards healthcare and there was also election in certain key states, as a result, Q1 industry was dull. There are estimates that the drop in the industry would be between around 20% to 25%. Please bear with me that the industry data are our estimates based on market feedback as there are no official publications available for the data. Even in Q2 the industry degrowth continued at around 15% to 20%. There were some improvements in Q2. State like Tamil Nadu which was in election in Q1 started generating some business for the industry. Hence, there was some improvement in Q2 but overall, the industry would be down by almost 20% compared to H1 of last year. Industry currently is at quite low levels. F19 industry was around ₹ 5000 Crs. This year in H1, there was a 15% to 20% drop and expected drop for H2 would be another 8% to 10% drop. We are hopeful that this industry will go back to its original levels in a short time.

Almost one or one & a half years ago, I had mentioned on the call that we are seeing an increase in the raw material prices and it has been increasing for almost last six quarters. The raw material prices have gone up significantly. In Q2 of this year, the raw material prices have gone up by almost 30% over the previous year. This has been a big challenge for the industry. There have been many efforts by the industry seeking increase in the prices by the government because the prices are controlled by the state governments and overall guided by GoI. And there has been a positive development in this month, the central government has given a notification to increase the cost norms by around 11% which is a big positive for the industry. Now, based on central government's advice, it is expected that the state governments will increase the price starting from December onwards. Having said that, the risk of increase in raw material price still continues with no indication that raw material prices will drop in the near future, perhaps it might increase though marginally, but one cannot say for sure, given the impact of crude oil, overall freight costs and the increased demand for polyethylene globally. So, the raw material prices is one thing we see as a risk in the coming time.

Now let me give a quick update on our performance. You would have seen the published results, the revenue for Q2 has been almost the same as previous year. We have a marginal loss of ₹ 1 Crs. The material costs have increased to almost 60% compared to 46.6% in the previous year. Now, in this backdrop, there are few things I would like to bring to your notice. Despite 14% increase in the material cost, we have been able to save close to 2% because of our efficient way of working and finding solutions to reduce cost. Also, we approximately saved 6% in fixed expenses compared to last year Q2 and H1. We could achieve this despite the inflationary pressures, because of better utilization of resources, tighter cost control, savings on sales and distribution and efficient utilization of resources. Another thing which I mentioned in the last call is our focus on growing the non-subsidy business. We have almost grown by 60% in non-subsidy business in H1 which is also helping us to get better cash collection and reducing our dependence on subsidies business.

Going forward, we also have certain challenges on our receivable collection, as certain states have been a bit slow in making the payments. We expect those payments to come in H2, while already some payments have come in this month. So, that is more of a timing issue. The chronic issue on receivables has been our payments being stuck with one state, which is awaited for the whole industry which should ease the working capital situation.

So, ladies and gentlemen, this was a brief overview of the industry, Agri environment, little bit on the financials, which you must have read in detail, and the expectation that there will be some benefit in terms of price increase in the next few months. Raw material prices may still increase, though hopefully not so steep, because it already had a big run up. We also expect that the industry should improve given that states like Karnataka and Tamil Nadu will get more active. We expect the year to end at approximately 15% de-growth. So, with this, I would like to take a pause and then open floor for your questions, and we will try our best to give the possible answer for them. So, thank you very much, over to you Vivian, we can now move to the question and answers.

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. We have the first question from the line of Aditya Shah from Vikram Advisory. Please proceed.

Aditya Shah: I have three questions from my side as of now, one being that we would like to know what is the sustainable margin that you can guide for some years to come and if at all you have one, then how would you plan to achieve it, because I see obviously, there are raw material price changes that you already mentioned, but the volatility is too much for a company to have. So, how do you plan to sustain a particular margin for many years to come, that's my first question. The second question is that what is your vision for the company in the coming five years as in where do you see the company to have a turnover or a profit margin or the profit after tax to be like. And the third question is that, since you already mentioned a lot of times that there are so many synergies possible with Mahindra Group as the promoter and the agri businesses of it. Could you please quantify the synergies that you have been able to gather in these years and what are those. Thank you.

Ashok Sharma: Thank you, Mr. Shah. I will start with the first question in terms of what are the sustainable margins from a long-term point of view. The industry's structure is such that the prices are maintained by the government. So, we are largely influenced by the state government pricing. The inputs are largely dependent on the global PE cost which are quite volatile. If you look at the last 5-7 years, we have had situations where the material cost has ranged from 45% to 60%. This is something we have experienced even on a long-term average. Going forward, we are aware of this volatility and what are we doing to sustain our margin is most important. Firstly, we have a very tight control on our fixed costs. As I mentioned before that year-on-year we are trying to see how we can maintain our fixed costs and reduce wherever possible, and to increase operational efficiencies for reducing material consumption. Secondly, as a strategy, we are focusing on businesses where there is better pricing power, like the thin wall business. We are trying to build that business. To give you some numbers, last year in H1 we had almost 3% to 4% business contribution from thin wall segment while this year in H1 we had 8% to 9% business contribution from this segment. So, that is one shift where we have better controls on the pricing, and we can predict that these margins would be doable.

Looking at the current situation, we had seen a similar situation in F18 where the material cost went up because of the global supply demand scenario and it took four to six quarters for it to kind of come back to the original levels. When I look at our operations, given our drive on efficiencies and cost management, it is helping us to create a good base for our fixed & variable expenses. Though for me to forecast the exact margins will be difficult because of the two factors, which are the global raw material input cos, and the end price, which are not in our control. But what is in control is our costs & business model in terms of focusing on products and services, which are less capped by government prices.

So, on a long-term basis, I would definitely expect the margins to improve. Also, one more thing we have seen is that when the raw material prices go up, with a lag of approximately 6 to 12 months, prices fall in place, there's a lag because government takes some time to adjust to the new price. And hence from a long-term perspective of three to five years, we expect that the gross contribution could range from 40% to 50%. Perhaps we are at the lower end now and as things improve, margins should get better and better.

Coming to the next question, in the last 3-4 years, we have been increasing our market share year on year with an approximately 0.5% growth in market share each year. Our aspiration is to reach double digit market share in the next 3 - 4 years and to be amongst the top three companies in the micro irrigation industry. We are also looking at margins, given our way of working and focus on quality and cost, we expect to be in line or slightly better than the industry. Beyond that it's difficult to project the numbers because it's a function of how the industry grows. As an example, if in next year things are conducive, which is a highly probable, like Andhra which has not been very active in last 2.5 years, the moment Andhra becomes active we can witness a jump of approximately 20% - 25% revenue for the industry and for us.

Coming to synergies, we have synergies in terms of leveraging common database of our farmers. We run joint campaigns where we are able to reach out to our seed and agrichemicals customers. We also have a good base of grape growers around Nasik who are approached by our sales team. In terms of exact contribution, it's not very big number as it varies from year to year and season to season. It's a single digit contribution we have on percentage points to our business which we are able to leverage. The brand Mahindra also helps us to reach out to new customers and new markets. Overall, there is a farmer trust that Mahindra is a holistic Agri company, as a result even if they are using our micro irrigation products, they know about the high-quality seeds and agrichemicals products we sell in the market. So, I hope that answers your question, Mr. Shah.

Aditya Shah: Yes. Can I squeeze in one more question, it's just regarding the coming five years that you've spoken about. My question to that was, how do we plan to sort of safeguard ourselves from the sort of volatility or dependence on the government, because I completely agree with you on this that a lot of things is dependent on the state and the central government, the policies and the payment deadlines etc., but as a company or as a shareholder we would like to know that are there any ways the company is thinking of diversifying into something else which can have steady profitability, revenues & cash flows?

Ashok Sharma: I fully agree with you as a key requirement for an investor. Firstly, as I mentioned that we are focusing on non-subsidy business which is not much government dependent, in terms of payments and pricing. From current 8%, we would like to move the business contribution in the 15% - 20% range. This will be a very specific step in the next two to three years. Additionally, we keep various options open keeping in mind that there should be consistent value creation for our shareholders. So, as and when there is something concrete to inform you, we will update you.

Moderator: Thank you. The next question is from the line of Rajendra Shah, an Individual Investor. Can we proceed?

Rajendra Shah: Thank you. First of all, I would like to congratulate you on the performance because, yes the company has gone into loss, that's fine. But considering the challenging situation, and the circumstances in which the company operated, the results are reasonably fine. So, congratulations for this. I had a few questions. Is this 11% hike in the end product price enough to take care of this raw material cost increase, which we have seen over the last six months. My point is that assuming that this price hike comes from let's say November, so in the December quarter, considering that the raw material prices are at the same level as they are now, would you be comfortable with this 11% hike and will the company get back into profit, if at all raw material prices stay at this level. And there's a 11% hike in the end product price. So, that was my first question. Second question sir, you mentioned about the thin wall business, which is about 9%, approximately 8% to 9%. And my question was, how much would this thin wall business be in the next two, three years are we planning to scale it up to let's say, 15% - 25% and if the margins in that business are much better than the existing business. And sir your employee cost has gone up by 20% so is it because of additional manpower or is it because of pay hike. If at all employees have been added, what are the plans, are we expanding in any new region? And something on the greenhouse business, did we see any growth over there? So, these are my four questions sir. Thank you so much.

Ashok Sharma: Rajendra, thank you very much for congratulating our team and our performance. It indeed was a tough quarter & H1 when I look at the bottom line, but given the industry de-growth and raw material costs increase, the team has tried to see how best we can save cost and maximize our business. However, there's a lot to be done in terms of future growth. Now, coming to your question on the central government price increase, if you look at the central government's 11% increase, this is lesser than the raw material costs increase. Moreover, this is what the central government has notified, though it is not binding on the state governments subsequently it is possible that the state government might not pass the full 11%. So, this is something we also need to keep in mind. Assuming they pass on the full amount, which could be the best-case scenario, it will help significantly in terms of the financial performance. Moreover, we have seen that H2 historically is a much better season for the micro irrigation business where the volumes and revenue are much higher. So, with the passing of this price increase, industry & Mahindra EPC will benefit and improve its financial performance.

Now coming to the question of thin Wall business, as I already mentioned, around 8% of our total revenue is from thin wall business which we would like to move in the range of 12% to 15% in the next three years because that is a business where we can do the pricing based on our quality and brand. Moreover, we are able to collect the money on cash basis or on very limited credit, depending on our policy. The good thing about our experience in last one and half year is that the customers have appreciated the quality of our product and we are able to enjoy some price premium compared to other players in the market. However, the margins in thin wall segment are 20% - 25%, slightly lower than our other products. However, it benefits in the cash flow and as additional business. Moreover, as we see better raw material costs, we'll be able to get better margins. So, it's reasonably profitable for us to promote thin wall.

Moving to the employee cost, there has been no major addition of people. Last year we did not give salary increase because of COVID, however, this year there has been some increments. Additionally, we had some cost related to COVID expenses in order to take care of the COVID management for our employees. Also, the percentage seems higher because the revenue is lower in this H1.

Coming to the next question, in greenhouse we have developed some very interesting products which can be offered at a low cost to farmers which has been encouraging. In the early days so far, we are looking at approximately 2% - 3% contribution, however, we are hopeful that with a 3 - 5 years perspective, given the climate change and farmer's ability to absorb this technology, we will see some more growth in this segment. Having said that, the growth in thin wall segment is going to be much more because that's where there is an established market. So, I hope that answers your question Rajendra and thank you very much for your support.

Moderator: Thank you. We have the next question from the line of Gokul Tarapura an Individual Investor. Kindly proceed.

Gokul Tarapura: Good afternoon sir. Thanks for the opportunity. I have two questions. One is with respect to the product portfolio. Does there already exist a plan to expand in different types of irrigation systems namely to foggers, misters and automatic water controlling systems, as I couldn't see them in your website. And secondly, in order to overcome the dependence on government subsidies, are you planning to foray into household farming space or growing more on the commercial landscape irrigation space where the margin could be probably much higher?

Ashok Sharma: Thank you very much for joining us Gokul. Perhaps it's the first time you're asking a question to me. So, thanks for taking interest in this company. Gokul, our portfolio is pretty complete, and we have a very good range of different types of drip & sprinkler equipments across different segments like discharge per minute, drips spacing etc. which are very well appreciated by the farmers. We are also one of the early manufacturers who introduced automation in their products where farmers can set up the time for irrigation by using his mobile phone and automate the irrigation depending on the water availability in his farm. However, there's always scope for improvement. We already are in greenhouse business with access to good products for foggers and other such equipment to help the farmers. Hence, on the portfolio, we are reasonably well covered. We also have good partnership for bought out items so that we are able to give good quality at attractive price.

Coming on to the next question on diversifying into non-government subsidy business. In the first phase, we are looking at thin wall segment which I have talked at length. We are also evaluating some ideas but we have not concluded at this point. So, it will not be right for me to give a very firm answer on that, but definitely we're evaluating, and we would like to leverage our current strengths. However, at the same time, we are also mindful that we should not get into unrelated areas and de-focus from our core strategy of serving the farmer. We will take a balanced view depending on overall analysis of the situation. I hope that answers your question, Gokul.

Gokul Tarapura: Yes, just wanted to follow up because I see that there's more growth on the household farming space. And usually, as the farming system develops, you see a lot of retail selling on the drip irrigation systems. So, I just wanted to know if you were marketing to the retail segments more than farmers because the margin could be higher with fewer products so just wanted to know more on that side?

Ashok Sharma: We have got some do it yourself kits. However, we are still at the POC stage and looking at the segment carefully. The good thing with digital and online is that it's not so complicated to reach out to the consumers compared to the old days where you needed a very physical distribution setup. Our team is working these ideas, but yes, we are in the evolution phase for sure.

Gokul Tarapura: Thank you so much.

Ashok Sharma: Thank you Gokul. And have a nice Diwali and be safe, thank you very much for joining the call.

Moderator: Thank you. Ladies and gentlemen, that was the last question. I now hand the floor over to Mr. Ashok Sharma for closing comments.

Ashok Sharma: So, it's really wonderful for you guys to come over and have this conversation. I really want to thank each one of you. I've tried to answer all the questions to the best of my ability. We look forward to connecting with you again in April. Until then, please take care of yourself. Once again, best wishes for the festive season ahead, may all of you be safe and happy. Thank you very much and Vivian thank you very much for coordinating the session so well.

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