Kwality Limited
Q2 & H1 FY18 Earnings Conference Call
November 16, 2017

Moderator Ladies and gentlemen, good day and welcome to the Kwality Limited's Q2 and H1 FY18 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 telephone. I would now like to hand the conference over to Mr. Gavin Desa from CDR India. Thank you and over to you sir.

Gavin Desa Thank you. Good day everyone and a warm welcome to all of you participating in Kwality Limited's Q2 and H1 FY18 earnings call. We have with us today on the call, Mr. Sidhant Gupta, Director, Mr. Nawal Sharma, President and Head, Business Transformation; Mr. S.K. Gupta, CFO; Mr. Pradeep Srivastava, Chief Compliance Officer; Mr. R. Raghunathan, Corporate Strategy and Investor Relations and other members of senior management team. Before we begin I would like to mention that some statements made in today's discussion maybe forward looking in nature and a statement to this effect has been included in the invite sent to you earlier. We will commence this call with opening remarks from the management following which we will have an interactive Q&A session. I now invite Mr. Nawal Sharma to share some perspective with regards to the company's operation strategy and his outlook on the business

Nawal Sharma Thank you, Gavin. Good afternoon everyone and a very warm welcome to all of you. So first of all, it gives me a great pleasure in sharing the successful execution of a well-defined B2C strategy, on the ground continues to give very good results.

So before getting into numbers, let us analyze the numbers from two perspectives, topline and bottom-line. As we talk about topline, the overall growth in the topline has been around 8.5% which is exactly in-line with our guidance where we said, over the next few years we will be growing at a rate of around 8% to 10% as the key focus is on bottom-line and not on the topline. Within the topline, let us talk about the area of strategic focus which is the B2C part of the business. If you see B2C part of the business, while the overall segment has grown by around 5%, but if you eliminate Ghee and the rest part of the B2C segment has grown by around 19%. Now you will ask we are talking about elimination of Ghee, what is the reason behind that. Now, as all of us are aware, there has been a GST introduction. So GST on Ghee has been 12% against 5% tax per year. So what happened as this was introduced from 01st July onwards, trade and channel partners displayed a wait and watch approach**.** While they have been catering to the consumer demand by drying out the stock pipeline but the overall primaries to the distributors was reduced in anticipation, that there will be some kind of rationalization of GST as there were lot of request going around and there was huge anticipation that the rationalization of GST on Ghee will happen, which did not finally happen. So due to this anticipation, there was a dip in the primaries of Ghee, thereby leading to the overall dip in this particular segment. Otherwise B2C segment has been growing pretty well at around 19%. So that was briefly on the topline.

Now let us get into the bottom-line analysis. Bottom-line can be divided into two sub buckets, i.e above and below EBITDA. Gross margin again as anticipated has improved by around 22%, moving from 9.7% to 10.9%. And EBITDA margin has also improved by around 14% moving from 6.8% to 7.2%. Now as we talk about the PAT level, there has been a decline from 2.7% to 1.3%. Now I would call it a positive decline and let us get into a little bit insight as to why there has been a decline at PAT level. Fundamentally there were two levers, first is depreciation, where depreciation has gone up from Rs. 3 crore to around Rs. 34 crore post our unit III, getting operational with effect from February 2017. Before getting operational the entire amount was getting added to CWIP. The moment it got operational, now it is being charged to P&L. So that is the reason this hit was there and depreciation increased from Rs. 3 to Rs. 34 crore. Second key lever was interest cost. Now, interest cost also went up from Rs. 38 crore to around Rs. 51 crore and again for the same reason, the interest costs which was earlier getting capitalized is now being charged to P&L. Now due to these two prime reasons, the overall PAT has reduced. So that is fundamentally as to how various dimensions of bottom-line have worked in last quarter.

Now let us also understand as to what are the key strategic developments which happen during this quarter, 4-5 areas, let us go one by one. First is, again it gives me a great pleasure to share that there has been a successful rollout of five value-added products which is the core of our entire B2C strategy. So we have successfully rolled out flavored milk, in 5 flavors, then Lassi in tetra pack, Chaach in tetra pack. And with two products already rolled out in the last couple of quarters which is UHT milk and UHT cream, now we have around 5 products in our VAP portfolio. So again the overall plan of let us say rolling out of around 8% to 10%, 5 products have already been rolled out and balance 4 to 6 will be rolled out over the next 12 to 15 months' time. So that is going to give a huge boost to our overall profitability over the next 2 to 3 years' time.

Now let us also try to touch up on few numbers as to how this strategy is getting translated into profitability and good numbers on the ground. If I just take you two years back, when the mix of topline was around 70:30 in favor of B2B and the EBITDA was hovering around 6% in FY17, it went up to 60:40 and EBITDA went up to 6.7%. So which in this quarter Q2, has gone up to 7.2%. So that is how rationalization of let us say margin profile is happening as the mix is changing. So this is one part of the story and this will continue because we have a very good past track record as to how these various strategic maneuvers are getting translated into enhanced profitability. Now couple of things I would like to touch upon, as to what do we think, as to how these products will do in future and what is the confidence that we have in terms of these value-added products being successful in the market and they will definitely translate into the numbers that we have always been talking about.

Let me touch up on two prime drivers for this which are the key source for our confidence. First of all, along with Ernst and Young(EY), we worked out a well-defined product strategy as part of the overall business growth strategy. So we defined two buckets, first is what is a differentiated framework in the market, how we will differentiate in the market? So we defined a proprietary framework what we call as HPC which stands for Health, Pleasure and Convenience. Any product that we will roll out, at least two of these dimensions will be covered. So that is one part of the story which is at a design principle level. Now second bucket is the execution which is key to success for any product roll out. On execution standpoint also we have defined a well-structured process which starts with the marketing function capturing consumer insights through a well-structured research framework where they analyze as to what competition is offering. What are the key opportunity of gap areas available and once they capture this insight, then it moves to the next level wherein an independent nutritionist brings in the medical standpoint as to what will be good for the consumer. So once we get these inputs from the nutritionist, it moves to the next level which is our internal R&D function, where seasoned professionals evaluate the technical feasibility of the inputs given by the nutritionist as well as the marketing function and once this is proved to be a physical proposition, a product prototype is developed which passes through ICT and ECT, which is internal customer testing as well as external customer testing. And once it passes through that successfully, we go for a pilot launch and it is only when we get encouraging response from the pilot that we go for a steady state commercial launch. Now due to this structured process, framework is what is going to ensure that we will get success in the market which is well proven by the response that we have got from the consumers, as well as from the trade and channel partners with respect to the 5 products that we have just rolled out in the market and the same processes will be adhered to in the coming times also. So that is primarily how value-added products are being introduced in the market and how we will ensure their success.

Now to support the value-added product portfolio we have kick started a very structured brand campaign. So what we call as, Drinking is Good, and this campaign has been well accepted by the consumers as well as appreciated by the trade partners also because of the noticeability and innovation quotient. And the media that we used included ATL, where we leveraged print as well as the radio, then BTL was also leveraged by taking hoardings and bus shelters, at strategic locations and then customer engagement programs was also a key focus area for us where we did a huge sampling program to ensure that customers test the product before the switch. So that is how a well-structured program is supporting the value-added product strategy and that is how it is contributing to the overall success. So having said that we will move to the next part which is the procurement part, how procurement has happened and where exactly has been the development. On procurement front also, the overall direct sourcing channel has improved from 24% to 26%.

Now as we all appreciate and understand, procurement is the backbone of the complete strategy. And there has been a consistent improvement on this front also because we want to really make procurement as a key differentiator in the market. Now without getting into much details, as we discussed within the last call also as you are all aware that we are present in 3 states which is UP, Rajasthan and Haryana which contribute more than 34% of all India production, with 158 million liters of milk per day, whereas our capacity is just 4.3 million liters which is not even 3%, which means there is a huge potential available for us, on the other side we have already struck path breaking disruptive deals like Bank of Baroda which is a first of its kind in India and various farmers taking this program is helping us in terms of creating a very strong procurement engine in the market. So that is another key development.

Next is on quality front that we mentioned that we really want to make quality as an independent vertical and a very strong function within the organization because of the B2C focus. So the development is we hired Mr. K.T. Rao a very seasoned professional, who comes from GSK with more than 34 years of experience in building design systems, managing operations, doing product development, working in domestic as well as international scenarios. So through this framework we are driving quality very hard within the organization and from cattle till customer entire things are being studied as to where all quality can be compromised, so that proactive, systemic and process fixes can be implemented and this is supported through independent process audits which we do on a regular basis. So that is how this independent authority is given to a seasoned professional who will help us driving quality very hard within the organization and that is how we want to create a very strong B2C driven lines within the organization.

Another point, so it is again good news that rating of the organization has also improved from A positive stable outlook to positive outlook, And lastly I would like to touch upon the corporate governance framework which at this point of time is a huge focus area for us. That is the fundamental on which the entire organization design is being built and in line with this focus area, we engaged MZSK & Associate which is part of BDO International network, world's fifth largest in terms of geographic footprint with presence in more than 159 countries, 1,400 offices and more than 68,000 professionals. So this is definitely going to help us a lot. So this is the first audit that they have done. And we assure that on the corporate governance framework a lot of systems and processes are being worked out because we strongly believe that this is the fundamental on which a great organization can be built. And lastly on the organization design, in the last quarter we did an internal workshop within the organization to align all our employees which are currently around 1,100 in number, so that everyone talks the same language and are aligned with respect to the organization architecture, what is that our company stands for. So post this workshop, we created the DNA of the organization, and what is this DNA of this organization? It is a 3-layered architecture that we are talking about. So the core of the organization is a set of 5 values that have defined for ourselves what we call as VOOST, where V stands for value people. There is no differentiation whether you are working as a pantry boy or you could be the President in the organization, at the fundamental human level you are absolutely same. So this is how the intent to ensure that a respect is given to each and every individual. So value people is the first, then we are talking about ownership, where mandate to all the senior management and executives are, to try and delegate as much as possible through a well-structured framework so that people feel independent and they enjoy delivering targets on the ground.

Third part is open communication, where we encourage lot of debates, discussions within the organization so that the best comes out. And then we will talk about speed and finally is the trust. So these are set of 5 values that we have defined for ourselves as the core of the organizations. Around this core we have a well-defined business strategy. So we strongly believe if we have a razor sharp business strategy and a well-focused vision, nobody can stop you from becoming successful, so that is the second layer. And the outermost layer is the financial metrics layer, where the belief is if we have very strong value driven by a rock solid business strategy, financial delivery will automatically happen whether two quarters here or two quarters there. So that is the fundamental organization design.

Values are nonnegotiable, noncompromising, driven by a razor sharp strategy followed by a strong chasing of financial metrics. So that is how we ensure that we build a great organization and with this organization design, which is driven very hard by values, systems and processes we want to ensure that the delivery happens every quarter, every year in line with the target that we have set for ourselves. So that is the journey that we intend to travel and the good part is these strategies that you have defined for ourselves are giving us good results which are being demonstrated by hard core numbers over the last 4 to 6 quarters time, so this gives us a lot of confidence that in future also we will continue to deliver on the lines that we have just discussed. So that is briefly the overview as to how we have done in the last quarter from number stand point, the various strategic developments and what are the key long-term programs that we have executed.

So feel free to ask any questions, we will be more than happy to answer.

Moderator Thank you. We will now begin with the question and answer session. We will take the first question from the line of Jimit Shah, Individual Investor. Please go ahead.

Jimit Shah Sir my question is regarding taking the depreciation into line, sir, what would be your CAPEX guideline for FY18 and 19 and what is the CAPEX that we incurred in H1 FY18?

Nawal Sharma See, the overall CAPEX outlay plan is to the tune of Rs. 520 crore broken into two buckets which is the backend infrastructure procurement which is to the tune of Rs. 120 crore and then there is plant infrastructure upgrade which is to the tune of Rs. 400 crore and again this Rs. 520 crore around a Rs. 437 crore has already been executed, incurred and the balance Rs. 83 crore will be done over the next 15 months' time.

Jimit Shah And sir the amount that you have incurred in H1, any significant CAPEX we did in H1?

Nawal Sharma Around Rs. 100 crore has been done in H1, so far as CAPEX.

Jimit Shah And again, the remainder of the year and FY19, same amount we expect, how much now?

Nawal Sharma So as we said balance Rs. 83 crore will be executed over the next 12 to 15 months.

Jimit Shah Understood. And sir one more question, last question. Sir, can you throw some light on the update on the ad-for-equity deal with HT and TOI, what is the progress of that in your exchange?

Nawal Sharma See, let us understand the design principle as per equity deal. So first of all it is very rare that two competitors and the leading company which is Hindustan Times and Times of India come onboard in the same organization. So it is very good development for us. And the prime drivers are, one, while on one side we will be able to leverage their electronic platform at very cost-effective prices, on the other side it will also help us in optimizing the cash outflows, right? So that is why we struck this deal. So this is for the period of 5 years and overall to the tune of Rs. 60 crore is what has been the agreement on the equity side. So this is basically divided into warrants and upfront equity and with one partner, it is CCDs.

Moderator Thank you. We will take the next question from the line of Sunil Kothari from Unique Investments. Please go ahead.

Sunil Kothari Sir, my question is our asset as on September 30, total assets Rs. 463 crore as per our annual report property plant is Rs. 430 crore. So what is this rate of depreciation we are utilizing and debiting in the P&L? Just to understand.

S.K. Gupta So the methodology is written down value as provided in the company act that is being provided on the various assets that is prescribed and few assets basically having a higher rate of depreciation and some of them like plant and machinery are having a low rate of depreciation.

Sunil Kothari On the plant machinery of Rs. 300 crore, how much is the depreciation?

Nawal Sharma Yes, let me touch upon two buckets First is the procurement which is AMCUs, where there is a depreciation of 60% in the first year, right? 60% gets depreciated first year, this is the framework for AMCUs which is the procurement infrastructure and on the plant infrastructure depending on the line item, it is done on a written down value basis. So that is how the depreciation is executed across these two buckets.

Sunil Kothari So sir for whole year, how much we will be depreciating, what will be the figure of depreciation because first quarter it was 24, now it is 34. So just to understand annual how much?

Nawal Sharma What we are expecting is, it could touch a peak of around Rs. 125 crore. Around Rs. 125 crore for the full year is what we are expecting.

Sunil Kothari And sir next question is our debt is roughly Rs. 1,500 crore?

Nawal Sharma Around Rs. 605 crore.

Sunil Kothari Okay and interest cost is Rs. 51 crore, so that comes to roughly 12%-13% rate of interest, so are we trying to do any debt restructuring or swap with some low cost debt, is there any possibility of getting lower rate debt or we will be paying this type of rate of interest?

Nawal Sharma So let us understand the fundamental framework how we intend to manage the interest part. So there is a capital structure optimization that we are pursuing, so that by having the right capital structure while you can leverage the benefit of debt, because debt also there is certain benefit with respect to the overall average cost of capital. But on the other side it has got certain cons also, right? So while we intend to leverage the benefit of debt on the other side through capital structure optimization we intend to bring the right amount by way of capital raising so that the overall cost of capital is optimized. And on the other side, we are also in a process of evaluating how we can get a better rate of interest and we intend to retire some of the high cost debt. So that is another key channel and third part as we mentioned that we have just recently got an enhanced rating, which will also give us room and leverage to better negotiate the rates. So through these three channels is what we think we will be able to manage and optimize as far as the interest numbers are concerned.

S.K. Gupta Including the bankers**.** So we are enjoying the working capital from them also. So with a better rating we will be able to get better rates from the banks also**.**

Sunil Kothari What is the current rate, rate of interest?

S.K. Gupta 11%.

Sunil Kothari Okay because now on a run rate of Rs. 200 crore annual interest cost we are going on and we will be spending little bit more during the current year for CAPEX, so I think by year end the debt will be more or it will remain of this size?

Nawal Sharma See, it will be almost same because if you see the way the business is evolving already we have hit the peak, maybe 10% here and there depending on how our capital optimization strategy is executed on the ground but overall on a fundamental basis we can say, almost we are there. So now we will start getting the leverage in terms of the downward term, so far as the debt part is concerned. Because as we are talking about the overall cash conversion cycle which is again a key focus area for us. So here again we have reduced from 97 days to around 92 days which is a positive development, where we intend to hit between 50 to 60 days by 2020. So as the mix is changing, as the cash conversion cycle is changing, we are confident that with the same amount of working capital we will be able to service very high level of revenues. So that is what the plan is and we will get lot of relief because you can see the overall growth path into three buckets. First one is, as we are entering into the market with value-added product that is the first. FY18 will be the entry focus, FY19 will be the build focus and FY20 will be the leverage focus, where we will leverage the benefit, where things will get optimized, stabilized and will get all the benefits of enhanced cash flows, whether enhanced margins are concerned, whether it is optimization of cash conversion cycle, coming back to let us say 50 to 60 days, so that is how we will develop a capability to pay off all our debts. So while we will develop the capability of becoming debt free over the next 4 to 5 years' time, but still we intend to retain debt because of its obvious benefit of ensuring a optimal cost of capital and to ensure that we leverage the benefit of debt because ultimately the cost, net of debt is around 8.5% only, whereas the cost of capital is higher. So that is how we intend to get best of both the worlds by optimizing the capital structure.

Sunil Kothari So by optimization of capital structure you mean to say you will be raising more equity?

Nawal Sharma Yes. See now, as we are seeing, so far as the capital raising part is concerned, yes, there is a plan, but it will depend as to when is the right time. So when we say when is the right time, this means you need to get the right and fair valuation, that is one. And second is basically the timing has to be right and to ensure that much dilution doesn't happen. So, based on lot of these external factors that we will take a strategic call. However, we can put it on record while for the regular business growth is concerned we are sorted, but yes, if there has to be an accelerated growth, capital raising will definitely be of great help. So we are having our ears and eyes open to encash any opportunity which comes in front of us to see as to whether we can go for an accelerated growth but we are all sorted as far as the regular business growth is concerned.

Sunil Kothari So sir if investor comes at around this price, do you feel this is a fair price to dilute or you will not be ready at this time?

Nawal Sharma See, we don't think we are ready at this point of time.

Sunil Kothari Right. And sir last question is trade receivables almost Rs. 1,500 crore, I mean how you will be improving this thing, because this is a very sizeable number?

Nawal Sharma Yes. So now let us understand this numbers based on the design. So while the overall debtors have come down from let us say 79 days to 75 days, so this depends on your business mix. Now as an organization since it is still tilted towards B2B which is 60%, so where we have let us say a much longer cycle but as you will move towards B2C, the overall cash conversion cycle will reduce which means your debtor days will go down drastically because on one side you are talking about 60 to 90 days, going up to 120 days, on the other side you are talking about 35 to 40 days. So that is how and why we are going for a business model change and so this business model change is how we are going to bring down debtor drastically. And in B2B part as we mentioned it will either be flat or it will de-grow. So that is the reason when we mentioned that there is no focus on enhancing and driving topline big time, this is the prime reason. That topline will be fair, which is 8% to 10% with lesser focus on B2B and B2C will be a prime driver to ensure that all these dimensions whether it is debtor days or whether it is basically overall cash conversion cycles are optimized over a bit of time, that is part of the strategy, you have rightly identified that.

Moderator Thank you. We take the next question from the line of Ashi Anand from Allegro Capital Advisors. Please go ahead.

Ashi Anand The first question is a just a follow-up question on a previous question. If I am looking at depreciation for the year, you mentioned Rs. 125 crore is what we are looking at. Now the fixed block is something like Rs. 463 crore right now. So it is a depreciation rate for almost 23%-24%. Just trying to understand why exactly is the depreciation rate so high?

Nawal Sharma So, as you mentioned, see there are two buckets, on one side the depreciation happens at 60% on the procurement part, on the plant side the rates are differential which is based on written down value. It is the weighted average that you will see that you are getting this result.

Ashi Anand So sir if I look at say the post Rs. 63 crore

Nawal Sharma Let me tell you the gross block is Rs. 624 crore and the Rs. 465 crore is the net block.

Ashi Anand So on a Rs.600 crore net gross block.

Nawal Sharma Yes, you are right.

Ashi Anand How much of the Rs. 600 crore gross block would be say procurement infra?

Nawal Sharma Procurement infra would be around Rs. 150 crore, or maybe we can check and come back to you on that because right now the operation team is not there. So we don't have these numbers handy with us. So maybe we can have an offline call and we can share this number with you, what the exact spend on this.

Ashi Anand And just wanted to understand as in, is it that the life of procurement infra is low or is it just a higher first year rate?

Nawal Sharma Can you please come again?

Ashi Anand Is the life of the procurement infrastructure actually just higher every year?

Nawal Sharma You are right it is because of that.

Ashi Anand Okay, perfect. Secondly just wanted to understand we have done a couple of strategic deals, one was the KKR fund raise from the structured debt, the other is the Ad-for-Equity deals. Now firstly on the KKR Fund raise, is this pure debt or can this convert into equity?

Nawal Sharma It is pure debt.

Ashi Anand It is just that we got it at a preferential rate?

Nawal Sharma See, let us understand. Okay, let me share with you, why KKR first of all. So while options were always there to raise money through our banking partner, that is one, there was a reason for going for a deal with KKR. As we mentioned some time back that on an overall basis there is a huge focus on building very strong corporate governance frameworks, right? So that is the reason that we intend to work with one of the best partners and deal with KKR is going to help us in multiple ways. First of all this puts a huge focus on corporate governance within the organization. So that is one, and how we intend to let us say utilize these funds, primarily into CAPEX, brand building, IT infrastructure and all that stuff. On the other side, the cost of debt is not on a very higher side. At that point of time, it was just 0.5% delta. So if we took a deliberate business call because some decisions when you see from a financial standpoint that's why are you paying 0.5% extra is one way of looking at it. But then there is the business way of looking at it. Yes, I am willing to pay 0.5% extra, but in return I am getting huge benefit because the way I am driving the organization on corporate governance frameworks and all that stuff. So that is how and why we got into a deal with KKR, so where the delta is not much with respect to the interest outlook.

Ashi Anand Okay. And in terms of the Ad-for-Equity deal, you mentioned Rs. 60 crore is the agreement on the equity side, split between warrants and upfront equity, what would the fully diluted equity be once all of this is diluted?

Nawal Sharma It will be around 1%.

Ashi Anand Okay. The dilution impact is only 1%?

Nawal Sharma Yes. Around 1%.

Ashi Anand And if I am just looking at it strategically, if we are looking at kind of building out a B2C business and value-added products, we obviously will need to up our marketing spends. Does the Ad-for-Equity deal kind of takes care of these marketing spends over the next few years so that we won't really see an impact of this on margins or increase marketing spends, or could this be an impact on margins?

Nawal Sharma It will not affect margins much in a major way because we actually don't need to spend much, so far as the marketing part is concerned. But since we are in a brand building process, I think Rs. 35-40 crore per annum basis should be more than enough. So that is how it is not going to be of major consequence when it comes to impact on the margin is concerned, because see any case of the revenues that you have, I think in terms of percentages it will still be very small. So to some extent yes, the treaty will help and the rest I think it will be a very small number, which can take care of the advertising.

Ashi Anand Okay. Sir just a last couple of questions. On the B2C business what would the share of value-added products be in the B2C segment specifically?

Nawal Sharma See value-added products we have just started rolling out these products. So it will be less than 5%. But yes, over a period of time by 2020 it should be contributing at least 20% of the overall revenues.

Ashi Anand Okay. And would UHT milk and UHT cream be part of value-added or that is not, that is part of normal B2C business?

Nawal Sharma Yes, that is part of the value-added products.

Ashi Anand Okay, great. There is a significant amount of promoter, shareholding pledging which is pledged and I think sometime back, there was some kind of market rumors about some of this getting sold etc. if you could just give any kind of update on the pledging of shares, what this is for and is there any kind of growth to any sales that happened from these shelves?

Nawal Sharma No, I think they have some amount of pledging which was done to KKR and that was for the CAPEX that we have done and we had to pledge them because of slight drop in the share price. So you had to keep the same cover. I don't think so that there has been anything else other than that.

Ashi Anand Okay. Sir because the share price sale we have to top up the cover which is why the pledging is done?

Nawal Sharma Yes, because of the coverage. So we had to top up those, but otherwise there is no fresh thing and whatever has been pledged that has also been pledged and the money has come into the company only. So there is no personal pledges that have happened ever.

Ashi Anand So this is pledged for company kind of, for corporate loan?

Nawal Sharma Yes.

S.K. Gupta To provide the margin.

Moderator Thank you. We take the next question from the line of Chris Loving from Taiyo Pacific Partners. Please go ahead.

Chris Loving I had a question related to the capital structure earlier and I was glad to hear the mention that a good amount of debt to lower cost of capital. Regarding equity side, there is I think a Rs. 1,500 crore allotments that is sort of out there, could you talk a little about why this amount and whether or not an indication of using a little of this or why have you allotted Rs. 1,500 crore at this point?

Nawal Sharma Yes. If you see now, let us see the number for example is x. It is very critical to see that what is the design principles behind this number. So first of all I would like to say that this is up to the amount that you have mentioning. It is not that we are going for this kind of amount, couple of reasons for that. One is basically on a regular business this is, we are all sorted. It is only in case we want to go for an accelerated business growth that we may go for capital raising. But on the basis of certain well-defined design principle. Now what are these design principles? One, dilution cannot be more than 15% or it will be hovering somewhere around 15% to ensure that shareholders interest are fully protected. So that is one. Second is, we will only get into execution or raise capital when the market conditions are conducive and the business environment is absolutely fine to go for this kind of capital raising, that is two. Point number three is, we will also see that our other track, which is EBITDA enhancement track is running absolutely smooth so that the returns to shareholders are fully protected. So that is third part of design principle. And fourth design principle that we are talking about is that cost of capital is optimized. It should not unnecessarily put burden on the overall cost of capital. So based on these four design principles that we will be going for capital raising, so that there should be no confusion and nobody should consider that this is the amount for which we are going for capital raising. So just to put it on record, these are the few things that we want to highlight. So we will decide at the appropriate time what is the right amount that the company needs and accordingly, we will take this call.

Chris Loving I just wanted to confirm that for the normal course of business, you do not need to raise any equity and if you do raise the equity it is because you see a solid growth opportunity that is going to generate your returns sufficient for recovering the cost of equity.

Nawal Sharma Absolutely, right. We are focusing on it.

Moderator Thank you. We take the next question from the line of Nishit Shah from Ambika FinCap. Please go ahead.

Nishit Shah Most of my questions have been answered, but I just wanted to know when some of these value-added products are going to be launched like butter, cheese, if you could elaborate on that and paneer also?

Nawal Sharma So as we said out of the overall portfolio identified which is 8-10 in numbers, around 5 have already been rolled out and balance 4 to 6 will be rolled out over the next 12 to 15 months' time and this include the key products like ghee, value-added ghee, paneer, milk shake, butter and cheese. So this is the 5 key product portfolio that will be rolled out.

Moderator Thank you. We take the next question from the line of Jigar Shah from Maybank. Please go ahead.

Jigar Shah My question is why the growth in the B2C business is so low in the second quarter and how do you see the outlook for the full year?

Nawal Sharma As we mentioned, let us break B2C into two buckets. One is ghee and one is rest of the B2C bucket. So as we mentioned, that there has been an increase of tax on ghee moving from 5% to around 12%. So as this happened, what trade partners did in anticipation that there will be rationalization of GST, so while they cater to the existing demand through their existing pipeline of stock, but they did not buy additional stocks from the organization in anticipation there could be a dip in GST which led to decline of ghee sales which ultimately impacted the B2C sales. So if you eliminate ghee, the rest of the portfolio has grown by around 19%. So ghee will also get stabilize over the next 2 quarters' time because now more or less people are aligned that this is the final GST which will exist.

Sidhant Gupta And also after the GST rates have been kind of corrected by the government, now I think people are coming back to normalcy and we feel that in the coming time we should look quite good.

Jigar Shah Is the GST on ghee back to 5%?

Sidhant Gupta No, it is still at 12% but at least there were talks of GST being removed on certain items, then bringing it back to 5% on ghee, but at least on ghee that has not happened, it has stabilized. So, all the products have stabilized now. So now people know that they will have to live with this structure. So I think it should look normal now.

Jigar Shah My second question is how is the milk sourcing progressing and how is the general trend in the milk prices etc.?

Sidhant Gupta So as far as the milk sourcing is concerned, this is absolutely going as per the defined plans. As we mentioned, the direct sourcing component has gone up from 24% to 26%. So this perfectly is working in sync with the overall product rollout strategy and so far as the milk prices are concerned, luckily in this case what happened is, it does not impact your bottom-line because in case there is an increase, it is passed on to the customer as it happened in the case of Q4, then there has been a price rise by around Rs. 1 per liter and around 15% in the other products. But as of now, the prices of milk are down but that is more to do with the contracts of milk. So as far as the farmer milk is concerned, still we are paying them a better pricing as compared to the contractor milk. But the contractor milk, the prices have come down, but similarly on the same side, the prices of skimmed milk powder and ghee have also kind of softened a bit and also because of the GST, we noticed that in terms of ghee sales that has come down. So overall, in terms of the procurement we are doing fine and it is in line with the vision that we have, but in terms of pricing, I think that is very dynamic and they keep on changing, but we foresee that the prices as of now have already hit the bottom and that is also because of the fact that it is peak season in North India and going forward, I think that should go up a bit, but then that will take a few months' time.

Moderator Thank you. We take the next question from the line of Kaustav Bubana from SKS Capital. Please go ahead.

Kaustav Bubana Just on the depreciation front, so you said the first year of depreciation and procurement infra is about 60%. So going into FY19, out of this Rs. 83 crore of CAPEX that is left, how much will be on procurement and how much will be on plant infra?

Nawal Sharma Actually these transaction details if you want we can have an offline discussion because right now these numbers are not handy.

Kaustav Bubana What I am trying to understand is what will be your FY19 depreciation figures offlate?

Nawal Sharma It will be hovering around same Rs. 100 crore or so, but exact number one has to calculate based on the transaction details. From here onwards, we expect it to decline only.

Kaustav Bubana Will your gross block be the same in FY19 compared to FY18?

Nawal Sharma That is what it looks like because only Rs. 83 crore is what additional we will be signing.

Sidhant Gupta And maybe some interim CAPEX that may require other than that, it should not go up.

Kaustav Bubana On the procurement front, as of this quarter, how much is directly sourced?

Nawal Sharma So it is at 26%.

Kaustav Bubana And why is this our company has such less direct sourcing compared to our competitors who have all above 50% like the main competitors?

Sidhant Gupta So I think one will have to understand that India is a very diverse country. So in North India, if you look at there was no direct procurement system in place. So because it has been going on for ages, whereas if you compare that to the western part of India or to the southern part of India that is relatively new. So there it was never the contractor, it was almost everything was being given by the farmers and people were collecting it directly and that is a very important thing which I think, good you raised it, because North India has been traditionally very different and also if you look at it that the three states of UP, Rajasthan and Haryana together constitutes almost 35% of the milk in the country and there the procurement system was always through the aggregators or the contractors and that is why it look a lot more time for anybody to go directly to the farmers because that was not there whereas in the other places because of the cooperatives being there or relatively new system, people could go directly to the farmers and it took much longer and fortunately if you look at it, Kwality has the biggest network in North India. If you compare it even to most of the smaller cooperatives, we have much better sourcing and in terms of certain areas, I think we are sourcing the highest amount of milk. Because of the fact that it is quite wide spread, if you look at the states, UP which is a very big state and also because the milk is highly perishable, so it takes a lot more time, effort and energy to set up the system through which you can start procuring directly from the farmers, but we are going as per the plan and we are very hopeful because of the fact that we created such a large infrastructure on ground by almost connecting 5,000 villages and collecting it from 3,50,000 farmers. Going forward, it should only accelerate the way it has gone up.

Kaustav Bubana So what is your target FY20, direct sourcing?

Sidhant Gupta So we are looking at anywhere around 50% to 55% or 60% rather direct procurement.

Kaustav Bubana We are ending the first half of FY18 with around 7% EBITDA margins. So we have FY20 target of 9%, so the time is getting shorter and shorter, but this is also highly dependent on new product launches, right, the margins…?

Sidhant Gupta I would not say the time is shorter. I think it was meant to be the same. See when you setup a plant, obviously initially you need some time to have the plant fully operational and also to have the capacity utilization to reach at 85%, but in the third year once the plant is fully operational and your capacity is fully utilized, then I think all these things of depreciation, all the other things, they will not be of any concern because the incremental EBITDA should take care of all the things which are kind of bothering people now, but then that is the way it is. Once you have a CAPEX, then initial few quarters are like this but then once everything stabilizes, I think we will be in a much more comfortable position.

Kaustav Bubana And your interest cost should stay around these levels?

Sidhant Gupta It should stay around at these levels or maybe come down because that is what restructuring they are doing and I think the way interest rates are looking, we are quite hopeful that it should come down.

Kaustav Bubana So I understand raising equity is just a resolution, it is just like it is out there, I understand that, but I trying to understand if you got enough money from KKR, this question was in some form answered, it was asked already but since you have already got enough money to even fund your existing Rs. 83 crore from KKR, you got enough money in your pool, what is the opportunity was seeing because I mean Rs. 1,500 crore putting it out that to the investors**,** this is more than 50% dilution?

Sidhant Gupta You are right, but I think two parts. One is, from KKR though they had sanctioned or given Rs. 520 crore, we have only withdrawn Rs. 300 crore. So it is not that we have taken completely from them and also to answer that Rs. 1,500 crore, you are right. It was more of a mechanical thing that happened and we just kind of passed that. Obviously, there are no plans of raising Rs. 1,500 crore and that is what Nawalji also answered and at an appropriate time, at an appropriate valuation.

Kaustav Bubana Even Rs. 500 crore would be 25% dilution depending on market cap, let us say even if it increases, it will be 25% dilution, **Sidhant Gupta** We are not going in for 25% dilution in any case. We will be in the range of around 15% dilution if at all that happens and I think it is too early to say when it will happen.

Kaustav Bubana What is this for, like what is your plan, I mean 5 year?

Sidhant Gupta As the way things are going in, so if you look at once we launch the flavored milk, so we got a fantastic response of the flavored milk even from the Delhi market. So we have not gone to the other markets and last month, we were at 44% minus. So whatever was the intent, 44% we could not supply. So I think the way things are looking for these products, we may need some more CAPEX and that will be a very healthy sign because in that case, if you have to capture the whole market as of now we are focusing only on Delhi and then North India, but then products which have a longer shelf life, I think this is the right time that we can look at the other markets also because there is definitely a large demand for all these products.

Nawal Sharma And also you see, we talked about accelerated business growth. Now let us take a deep dive into world of accelerated business growth. Now the kind of 6-7 categories that we are entering into, there is a huge potential in this. Now what we are planning with this idea is for example, one option is already we have mother brand architecture with us, but there is a huge potential that each product category can be focused separately. For example maybe in the next quarter we will be starting a brand campaign on CPD products, flavored milk. Similarly we are toying with this idea, can there be a dedicated focus for each of these categories and we can create a huge jump in the overall sales, let us say preponing the targets of 2020 into 2019 and potentially we are and it is all doable. Now on one side since we are getting very good response from the market, that is the reason we are talking about these things, let us explore the possibilities. But when you talk about this Rs. 1,500 crore, please ensure that you go through the designed principles, then arrive on the plan.

Sidhant Gupta And also it is up to Rs. 1,500 crore.

Nawal Sharma As we said even you do it right now, it will be 25%. So as we said, it cannot be more than 15% or around 15%, you have to do the reverse calculation. So design principle is what is going to drive our capital raising if at all it has to happen.

Moderator Thank you. We take the next question from the line of Milind Muchhala from Julius Baer. Please go ahead.

Milind Muchhala First question again related to some extent on depreciation. So sir typically what is the life of the procurement infra?

Nawal Sharma It is around 3 years.

Milind Muchhala So what we are employing is right now we have spent around Rs. 150 crore on that, so are you employing that this will be a kind of recurring expenditure every 3 years?

Nawal Sharma Again it depends on the overall growth as to what kind of let us say growth we are having on the B2C side because as we said these are called as AMC, automated milk collection units. So this is what is needed to have a deeper penetration into the market for the direct sourcing business. So depending on the plan, the execution will happen. And also as of now, that is the useful life of the equipment that we considered because these are all important in the villages, but we are trying to upgrade the facilities at the villages by improving the power supply and also by better earthing and other things. We may be able to use those machines for slightly longer period, but as of now for considering the depreciation part of it, we kept it as 3 years of useful line.

Milind Muchhala And so this Rs. 150 crore figure, is the entire amount spent in the last 1 year or this is what we spent over the last few years?

Nawal Sharma I tell you it is Rs. 120 crore is the overall plan for procurement and out of which, we think around Rs. 90 crore has been spent.

Milind Muchhala Because the thing is again, is it by any chance to possible break down the depreciation figures for the Rs. 125 crore that you have spoken about. So how much would be related to procurement…?

Sidhant Gupta I think we can do that separately, or we will capture next time I think or separately we will capture that, differently.

Sidhant Gupta We will put it to the finance guys and we can have a concall.

Milind Muchhala Because that will give us a lot of clarity because even if you assume an accelerated depreciation on this infra of 60%, then again the figures look a bit on the higher side that is the reason.

Nawal Sharma Sure.

Milind Muchhala And also second question is on this B2C share, so I heard about this impact of ghee an all, but if I have to remove that so on a normalized basis, what would have been the share of B2C in overall sales, because I believe last quarter it was around 44%.

Nawal Sharma Currently, it is around 40%.

Milind Muchhala 40% I believe is for the first half and in this quarter was it 38% if I am not mistaken?

Nawal Sharma I tell you. On first quarter, it was 42%. Q2 was 38% and for H1, it is 43%.

Milind Muchhala Right. So if I have to remove this impact of ghee, then would the share of B2C would it have been higher than 42% or where would it have been?

Nawal Sharma It would have been much higher.

Milind Muchhala So basically the trend is on the positive side on a sequential basis.

Nawal Sharma You are absolutely right.

Milind Muchhala So for this year by the end of the year, do we have a target that we want to maybe reach 50% of the sales of B2C or something like that?

Nawal Sharma: Again, what the thing is, as a company policy, we refrain from commenting on short-term guidance. We have been following in the last couple of years. So while we set a reasonably good vision for ourselves which is 2020, but short term for the next 2 quarters, one quarter we refrain, because the organization is passing through a huge transformation. There are multiple variables which are in place simultaneously.

Milind Muchhala I understand that, but our 70% guidance remains in place?

Nawal Sharma: That is in line with plan.

Milind Muchhala And sir any color in terms of the traction in the new products or how has been the customer response in the initial couple of days or months?

Nawal Sharma: The customer response has been very good. Let me share few examples. If we take example of flavored milk, customer is really appreciating couple of things. One is the fortification what we have done, it is first time in India that flavored milk has come with a fortification with vitamin A and D and customer is really appreciating that. And secondly, the thickness that it has and the overall taste, so that is how customer is really going lot of preference towards these kind of products because they have gone through lot of customer research and all that stuff. Just to share few numbers, over them maybe last couple of months only, so we have already opened around 20,000 outlets from over 300 distributors have been appointed. So both interest at the trade level as well as the customer level is there. So response has been pretty good specifically for this innovation which is fortification that we are targeting.

Milind Muchhala And sir how this association with BOB shaping up in the sense how many farmers till now would have taken advantage of the loan?

Nawal Sharma: See, I tell you. Overall if you see where do we stand as of now, so around Rs. 55 crore has been sanctioned and around 8,000 application have been submitted with around 2,000 sanctions which has happened. So it is going absolutely in line with our requirement that we have because this BOB track is working in sync with our requirement on the product side because as you drive products based on the acceptance in the market, you drive the direct sourcing channel which in turn is driven by BOB because BOB is a very good asset light model. So as couple of questions back somebody was asking as to what will be the CAPEX and all the stuff. See now why sometimes it becomes very difficult because you are exploring two channels. One is you start having your own penetration and second is you used BOB as a good framework to enhance the current productivity of the villages as well as farmers. So this is a very asset light model and it will help us a lot.

Milind Muchhala And so what is the cost of fund that we raised on KKR?

Nawal Sharma: As we said, overall delta is not more than 0.5% with respect to the current interest cost that we have. So it is around 12.5%.

Milind Muchhala And sir one last question. Any comments in terms of the promoter pledge, any thoughts or any plans over there?

Sidhant Gupta: I think we have already discussed that it was purely because of the fact that the money that it was pledged to KKR and because of the downward trend and the slight correction in the share price, that we had to cover the margin, rest it is all, there is no further pledge.

Milind Muchhala So can we expect an improving trend over there in the senses…?

Sidhant Gupta: As the prices go up and then also with time, I think this should come down.

Milind Muchhala Yes, because with KKR money coming in, so I think that term should be kind of an available for reducing the pledge and that itself will give a huge comfort to the market once the pledges are coming off.

Sidhant Gupta: Yes. You will see the trend next quarter.

Moderator Thank you. We take the next question from the line of Devraj Rada from Param Value Advisors. Please go ahead.

Devraj Rada Sir, can you tell regarding the minimum support price, actually this has been implemented in Maharashtra, it is getting implemented in Northern India. What will be the impact on procurement prices?

Sidhant Gupta: There is no minimum support price in these states, North India, but that is only a phenomena that happens in Maharashtra. Other than that in North, there is no concept of minimum support price for milk.

Devraj Rada And sir regarding this cow slaughter bans, will it have any structural impact on the milk production down the line sir, next 2 to 3 years?

Sidhant Gupta: No, I do not think so that there is going to be anything like this. In fact we see a positive trend that the production has gone up. And with the Bank of Baroda MoU that we signed, we have seen that people are much more keen to have new animals so that they can support their families and you know because the land holdings are becoming smaller and families are becoming bigger. So probably diary is the only thing which helps them in meeting their everyday needs. So we see a positive trend in milk production going up and over a period of time if you look at the figures, I think last year we were at 165 million tonnes and I think in terms of the growth in the milk production, India as a country we have done phenomenally well as compared to the world. So we do not see any challenge on that going forward.

Devraj Rada Because these products is really more from the buffalo, right, compared to cow?

Sidhant Gupta: Yes, North India is predominantly buffalo belt**,** but then now you are seeing the trend that people are also keeping cows and that is one of the reasons is also that the lean mean and flush period for both these are separate. So people can manage their kind of productivity much better if they have a combination of cows and buffalos.

Nawal Sharma And the area that we are present in which is UP, Rajasthan and Haryana, around 65% is buffalo.

Devraj Rada So sir, these won't give any impact on the procurement prices down the line?

Nawal Sharma: Yes, we do not see.

Moderator Thank you. We take the next question from the line of Rounak Jain from Vibrant Securities. Please go ahead.

Rounak Jain First question is on, what is the cost of debt from KKR? Is it somewhat higher compared to our current cost?

Sidhant Gupta Almost at a same level of around 12.5%.

Rounak Jain And sir what is the portion of the direct procurement in comparison to the overall procurement that we do?

Nawal Sharma Around 26% is the direct procurement.

Rounak Jain And what is the target we want to make?

Nawal Sharma We want to take it around 55%-60%**.**

Rounak Jain And sir like the direct procurement that we do, like one is that it provides us good quality and the other is does it also increase the margins like in the long-term will you also see the margin improvement because of it?

Sidhant Gupta The margin improvement will come because of the fact that you can use only this milk for value-added product. So it is not coming directly as in this price of the milk. The price of the milk or the cost of collecting this milk is slightly higher than the contractor milk, but the advantage will definitely come from the fact that with this kind of good quality milk, you can do all your value-added products. So it will be not direct, it will be indirect.

Rounak Jain And in value-added, we take ghee, paneer, milk shakes all of those things?

Sidhant Gupta Yes. So in value-added, we take all these milk shakes and sterilized flavored milk and tetra packs.

Rounak Jain What about curd? Do we also take it as value-added

Sidhant Gupta Curd is value-added.

Rounak Jain And like going forward I suppose our main focus area would be value-added products only apart from this?

Nawal Sharma Absolutely.

Rounak Jain And what is our current product mix, the portion of milk and value-added products to the total product mix?

Nawal Sharma If you see currently, out of the total sales, around 25% would be the contribution of pouch milk right and 24 to 25%, 6% would be curd, 7% would be ghee, 1% chaach and 2%. So this is how it makes 40%.

Rounak Jain Can you please repeat it, 25% is.

Nawal Sharma You can take 24% is pouch milk, curd is around 6%, 7% is ghee, 1% is chaach and 2% is others**.** So that is how it makes it 40%.

Moderator Thank you. We take the next question from the line of Venkat Subramaniam from Organic Capital. Please go ahead.

Venkat Subramaniam I just wanted to point out a curious coincidence. Around the time when all our numbers are playing out and all our strategies actually falling into place, there is a lot of wealth erosion and the reasons are not possible to see because our enabling resolution for fund raising really being made them to lot people, so we are following the company fairly closely. There have frankly been some confusing signals from the management. I am wondering whether we can actually put to raise and put some communication in the form of a presentation shedding all the doubts at bay it is very counterproductive frankly. You can see it right in front of your eyes.

Sidhant Gupta Absolutely, we noted that and I think that is what we wanted to make sure and clear in this concall even that it may have sent confusing signals but then as far as the management is concerned, we are absolutely clear as to what we want to do and we want to absolutely ensure the wealth creation for the shareholder and to protect the interest of all the stakeholders and there is no doubt about it.

Venkat Subramaniam Can we take it a little further sir frankly because back in 2016, we gave a guidance that we will be debt free based on internal generation and then within about 6 months, 9 months, we had this enabling resolution and only in this conference call that we are saying that this is probably only for new cases and that too its futuristic**.** So can we possibly put out the communication to this effect that internal generation will be sufficient to make it debt free and this is for some specifically identified opportunities and specifically identified CAPEX?

Nawal Sharma So definitely we can do that.

Venkat Subramaniam But where frankly it is hurting you more than hurting others?

Nawal Sharma Absolutely. So you are right, but just to put it on record, so last year in none of the conference calls we said that within in a year we will be debt free, we are saying about the next 3 to 4 years' time.

Venkat Subramaniam No, I am not talking about, you had a finite time, range you said by 2020 based on your 9.5%-10.5% kind of EBITDA guidance, you had cash flows coming and that you said was getting sufficient to repay debt. And then came thisBboard. So frankly, I just want to share with you the kind of confusion that exist in the market and this conference call sufficient testimony that is for that because this is the fourth or fifth question regarding that and there are lot of people who are not asking you, but they are not acting on the stock because the numbers don't add**.**

Nawal Sharma Sure, definitely. We will do it absolutely and plus I hope that we are clear as we define the design principles with respect to this question. Four design principles we have defined. That point is well taken and we will ensure that we are absolutely clear on certain things.

Moderator Thank you. Well, that was the last question. I now hand the floor back to the management for their closing comments.

Nawal Sharma I think it was really a pleasure talking to all the family members and we look forward to this kind of call where we receive very valuable inputs and we are very happy to share the development and we are very sure and we assure that we will continue to deliver in line with your expectations based on the framework that strategy has to be very clear, execution has to be very robust. So currently, the entire management is focusing on execution, execution and execution and we assure you the way we have done over the last 4-6 quarters, it will continue over the next 3-4 years' time and we will hit the business target that we have set in front of ourselves.

Sidhant Gupta We are always open to any questions and any discussions, we should not wait for the conference call to happen, but we are always there, we are always open. If anybody can call us directly for any clarification that they want to seek at any point in time and we really like the way people are engaging and this is what we want that people should come forward and they should ask questions if they have any doubts and we are always there. We are available 24/7 to answer any queries of anybody. So thank you very much everyone for taking out time and we really enjoyed the session and we are hopeful that we will continue to have a continuous dialogue on all the things that we are doing and we will be always open and happy about people coming and asking us questions. Thank you very much.

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