RAK Ceramics Second Quarter 2016 Earnings Conference Call and Webcast

4 August 2016

Company participants:

Abdallah Massaad, CEO

PK Chand, CFO

Philippe Habeichi, Head of IR

Operator: Ladies and gentlemen, welcome to RAK Ceramics Second Quarter 2016 Results Conference Call. I'll now handover to your host, Mr. Mohammed Haidar. Sir, please go ahead.

Mohammed Haidar: Good afternoon ladies and gentlemen. This is Mohammed Haidar from Arqaam Capital. And I would like to welcome you all for RAK Ceramics Second Quarter 2016 Earnings Conference Call hosted by Arqaam Capital. I'm joined today by RAK Ceramics' management team, Abdallah Massaad, Chief Executive Officer, PK Chand, Chief Financial Officer, and Philippe Habeichi, Head of Investor Relations of RAK Ceramics. And without further delay, I will now turn the call to, Abdallah Massaad. Please go ahead.

Abdallah Massaad: Thank you, Mohammed. Good morning, everyone, and welcome to our Q2 2016 Results Conference Call and webcast. I'm Abdallah Massaad, CEO and I'll walk you through the operation highlights for the quarter and review for the segment performance. Economic conditions in the GCC were challenging in the last 3 months. There is slowdown in the pace of government-driven project hit the construction and building materials sector and general business confidence, particularly in Saudi Arabia. As a consequence, our export sector – our export from UAE were down for this quarter. Europe is growing Q-on-Q reflecting better sell through since we took over distribution in Germany and the UK at the beginning of the year. Offsetting the export weakness were sales in the UAE, our home market and largest market, which rose by 4.6% year-on-year. If we recall that, we mentioned last year we took as a part of our value creation plan, we appointed a new head of project team, a new head of retail and the fruit of this initiative is that we're growing sales in those two segments.

Looking at our international production centers, sales in Bangladesh grew by 3.1% year-on-year even as we remained capacity constrained there while India performance struggled ahead of transitioning to new leadership.

Now on the operational highlights, we reported revenues of 757 million dirham. It's a decline by 5.9% year-on-year, but up by 2.9% Q-on-Q. Core revenue were largely flat, while non-core revenue drove the sales decline. Our gross margin was 29.5%. It is up by 220 basis points year-on-year, but 60 basis points lower Q-on-Q. Our second quarter EBITDA came at 144 million dirham. It is 7.6% decline year-on-year, but up by 4.5% Q-on-Q. EBITDA margin of 19.1% is the 30 basis points lower year-on-year, but 30 basis points higher Q-on-Q. Our reported net profit was 65.3 million dirham, a decline from 86 million reported in second quarter of 2015, but flat quarter-on-quarter. We calculate normalized net profits of 83.5 million dirham in the quarter, vis-a-vis 94.4 million in Q2 2015. It's 11.6% decline year-on-year. We continued to look for ways to optimize cost, and during the quarter, we were able to squeeze more than 5.4 million dirham in raw material savings in top of whole initiative after 2 years back. Despite the tough liquidity environment in construction, our cash flow and liquidity position were strong, and we ended the quarter with lower gearing ratio with a net debt to EBITDA of 3 times from 3.1 at the end of Q1. Lastly, during the quarter we obtained a Sharia Compliance certification from Dar Al Sharia, an Islamic Finance Consultant. This step is part of our effort to improve liquidity in our stock and open up ownership to a wider potential audience.

Looking at the quarter against this quarter our valuation plan, which we introduced two years ago, we moved ahead towards the integration of UK and Germany and Q-on-Q results showed growth. We are also pleased to announce that we concluded the purchase of the stake of our distributor in Italy, and we will be consolidating that entity as of Q3. On the production front, we relaunched production in Iran started producing from the recent expansions in tiles in Bangladesh and sanitaryware in the UAE. Last year we pushed forward on the branding, brand building initiative, which will be launched towards end of September. As you can see, we have made a fair progress in the last two years, and we were working on the next set of initiatives to create value for the company, which we plan to share with you in the near future.

Now looking at the performance of our segment, Q2 tile sales were 487 million dirham. It's 5.3% lower year-on-year, and 1.8% lower Q-on-Q. UAE and Europe showed growth while the rest of the GCC and MENA where we in the light of difficult climate for government-driven construction project in particular as I previously mentioned. Some things we don't expect will change in the near term. Indian sales fell as a result of lower volume and average selling price, down 27.5% year-on-year, and 10.2% Q-on-Q respectively. Bangladesh revenue was fairly bad as sales from our new capacity contributed less in the quarter. Our tile gross margin was 24.7%, down 100 basis points year-on-year, and 70 basis points Q-on-Q. The decline is due to unfavorable product mix and higher cost, especially in Bangladesh as a result of the time of revenue from the new line and the higher power and the electricity cost, which we intend to push on to the customers in the quarter ahead.

On sanitaryware sales came in at 122.4 million dirham. It's a 5.3% higher year-on-year, and 9.8% higher Q-on-Q. Higher sales to Europe and Bangladesh offset weakness in other markets. Q2 2016 sanitaryware margins fell 230 basis points from the last year to 40.8%, but rose 30 basis points Q-on-Q. In terms of production location, UAE margins fell 110 basis points to 42.2%, mostly as a result of product mix. Bangladesh margins fell to 43.5% from 46.1% as we absorb higher utility cost as mentioned. India margins fell to 4.4% from 32.6%. As we mentioned earlier, we had some technical issue in production last year, and we have piled up stock from the same, so we decided to liquidate, and this will continue in the second half of the year to rid off from the old inventory we have.

Out tableware business did very well in the quarter with the revenue up by 41.8% year-on-year, partially reflecting consolidation of RAK Porcelain Europe, but even Q-on-Q revenues rose by 37.6%. Gross margin was 62.1% versus 55.1% in Q2 2016, and 62.8% in Q1 2016. On a like for like basis, gross margin rose 90 basis points year-on-year. Recent product introductions at RAK Porcelain continue to be very well. This year we launched as mentioned earlier several finishes and colors, and it is showing a good feedback from the market, and this supported our growth and profitability in during the first 6 months.

Non-core revenue was 96.1 million dirham versus 137.6 million in Q2 2016, down 32.2% year-on-year, but up 5.5 from the first quarter. The decline largely reflects the sales of RAK Logistics, which had contributed 17.9 million dirham in the Q2 2015, as well as lower revenues from our construction related business, Electro RAK and the Al Hamra construction. Non-core gross margins surged, however, to 27.6%, a 1,500 basis points increase from 12.6% in Q2 2015. The turnaround in our non-core portfolio has been successful. The challenge, however, is executing the sales to good volume. We continue to be optimistic about finding buyers for the non-core operation and the current economic context for the timing is uncertain whereas we initially had [inaudible 00:11:21] to conclude the sales of the non-core assets like sell the land of Al Jazeera Al Hamra by end 2016/beginning 2017. We no longer believe that the timeline to be realistic given current business condition.

Now I turn it over to our CFO, PK Chand for an overview for the financial. PK?

PK Chand: Yeah. Thank you, Abdallah. The first slide is the financial highlights on a quarterly basis for the last 9 quarters. We can see from this slide that the EBITDA margin of 19.1% in this quarter tracks within the historical range. It is in the net profit margin that looks a bit weaker, and that is a result of higher interest cost due to increase in net debt YoY and provision for receivables, which we exclude to calculate EBITDA. And therefore to understand our profitability better, we are introducing normalized net profit, which can be seen at the bottom of the table where provision and one-off items have been added back. For example, in Q2 ’15, we incurred a one-time loss of 4.4 million dirham on the sale of assets, which has been added back to get normalized net profit and growth. From this perspective, and as Abdallah said in his overview, Q2 decline was 12.6% YoY compared to the reported decline of 24%. And for 6-months period, the normalized net profit is 158 million versus 154 million that is growth of 2.7%.

On the next slide, we highlight our EBITDA calculation methodology, and as we have done in previous quarters. As a result of Sudan fail and Iran economy going out of hyper inflation, impact of hyper inflation is not there. On slide 18, we can see the main cost categories. Material cost, which represents our largest cost component, fell close to 15% year-on-year as a result of cost savings and material substitution.

Energy is another cost component for us at 20% of COGS, and that actually declined 4.3% YoY. However, the price we pay for natural gas was up 2.5% YoY, but down 6.3% quarter-on-quarter. Our labor cost rose 8.8% YoY, mainly on account of recruiting workers for expansion of tiles in Bangladesh and sanitaryware in UAE. Depreciation is lower by 4.8% year-on-year, mainly due to change of useful life of assets in Iran since the last quarter of 2015. Repairs and maintenance have been stable.

From slide 19, it can be seen that in second quarter 2015, the administrative cost fell 13.1% year-on-year as the second quarter of 2015 included impairment provision of 4.4 million dirham on sale of asset. However, selling and distribution cost increased by 14.8% year-on-year, on consolidation of European and Saudi subsidiaries.

On slide 20, we can see that gearing level in the quarter is at 3 times to EBITDA compared to 3.1 times at the end of first quarter. We have mentioned in the past that we are comfortable at around current levels of debt, but we expect our net gearing level to decline in the coming quarters with better working capital management. As we indicated previously, we have been taking steps in the last few quarters to reduce the ratio of conventional loans to Islamic loans. And as Abdallah mentioned, we recently received the certification from Dar Al Sharia, subsidiary of Dubai Islamic Bank that our shares meet the standards of accounting and auditing organization for Islamic financial institutions and are Sharia compliant for the purpose of investing and trading. We believe this action will increase the pool of potential investors in our stock.

Our interest cost for the quarter is better at 2.5% compared to 2.6% year-on-year even after increase in average 3 months Libor from 0.27 in the second quarter of '15 to 0.63 in this quarter. On the CAPEX side, we are revising our previous forecast included a potential investment of 60 million dirham to expand our sanitaryware capacity further in the UAE, which we are not going ahead with at this time. our capital expenditure needs are being weighed against the current market environment in the UAE and opportunities outside the country. During H1 2015, our core CAPEX had increased by 18.9% to 108 million dirham.

Lastly, on working capital, it continues to be a difficult environment for collection as liquidity, especially in the GCC is scarce. We were able to extend our payable days somewhat to mitigate that impact. And receivables from related parties during the quarter about 80 million from RAK Water Tech engaged in a project in Iraq has been received. This is about half of the outstanding amount, and we expect to receive major portion of the remainder in the second half of 2015 in line with the schedule of payment.

Now, I will turn over to Mr. Abdallah for his concluding remarks.

Abdallah Massaad: Thank you. The outlook for the third quarter looks challenging, especially in the GCC where demand at the distributor level is worsening, and prices are on the pressure. I'm sure most of you have seen the result of building material peers who predominantly supply the region and the impact on their profitability of lower volume and prices. While we are not immune to these challenges, as we derive just 50% of our sales in tiles and sanitaryware revenue comes from the GCC and MENA, we are a global company, and we are better equipped than our peers to deal with the current economic condition. As such as the management team will look beyond the current environment to lay the foundation for growth, and focus on long-term value creation for our shareholders as set out in our value creation plan.

We spoke earlier about our rebranding exercise to launch in late September to coincide with an international tile and Sanitaryware exhibition (CERSAIE), which normally is the largest international exhibition. Initially, we will roll out a new branding strategy around a new integrated product collection, new visual identity, a new marketing material, a new advertising campaign. The product development approach and the rebranding are the first steps in a three years plan to be seen in the mind of distributors, architects, certifiers and consumer as the world leading ceramic lifestyle solution provider. As we invest to improve our products and brand perception not just locally but globally, we are also building a new source of production outside of our traditional hub of Ras Al Khaimah. The Iran unit is operational, and the sales have begun. We are encouraged by early results and we are setting up to reserve the second line thereby the fourth quarter 2015.

In India the tile and sanitaryware market is growing strongly, and we believe we finally have the talent in place to lead our Indian operation. Over the next 6 months, our new CEO will be building a team around him to turnaround our performance in that market, and we expect the efforts to show starting 2017. With the completion of major capital expansion cycle late 2015 and in the first half of 2016, managing and financing future growth becomes somewhat easier. At the same time, we continue to focus on improving our cash balance and cash flow generation, reducing net working capital, pushing forward with the sale of non-core assets, and non-strategic assets like China plant, which we mentioned earlier. In the current environment, we believe liquidity and a strong balance sheet are very important competitive tools, and a number of acquisition opportunities that we are presented continue to grow. Finding the right click between organic growth and acquisitions is a challenge that we face this year, but one that we are privileged to be in a financial position to undertake given our strong balance sheet, and with the managerial depth and place after expanding our management team in the last 18 months.

And with that said, I would like to turn the call over to the operator and open the line to questions.

Q & A session

Operator: Thank you, sir. Ladies and gentlemen, we will now start Q&A session. If you wish to ask a question, please press 0 1 on your telephone keypad. Thank you for holding. And we have our first question. Ladies and gentlemen, as a reminder, if you wish to ask a question, please press 0 1 on your telephone keypad. Thank you for holding. Our first question comes from Christopher Cleave, Pioneer Investments. Sir, please go ahead.

Christopher Cleave: I was wondering whether you could share a little bit more light whether you could tell me anymore about what your new Indian CEO is planning to do with the Indian business?

Abdallah Massaad: Look, our new CEO joined us. He is an expert in the market. He has spent more than 25 years in this industry. He was the head of vitrified business, which we produce in Kajaria, which is a leading company in India. So first we appointed also a new technical manager to do the efficiency requirement, and the product development and innovation required in our existing plant. Now first the restraint coming to the marketing team, the relation and building around a distribution network, which we have, and so this is basically the marketing team in place and the relation with our distributor as well as the product.

Christopher Cleave: Okay. So could you maybe tell me a little bit more about what kind of acquisitions Ras Al Khaimah Ceramics is looking at, you mentioned in your summary at the end?

Abdallah Massaad: Just as mentioned several times like in India we have only a production unit in South, and for sure we need to have a different production location, especially in Gujarat and western area. So we decided to strengthen before going into acquisition strengthen our team and restrengthening our distribution network, and the second step will be having a different footprint in production in India in order to, you know, the logistics cost today was a competitive environment. It is very important and to optimizing our logistics cost will be essential in our turnaround in India.

Christopher Cleave: Okay. Thank you very much.

Abdallah Massaad: Okay.

Operator: Ladies and gentlemen, I would like to remind you, if you have any further questions, please press 0 1 on your telephone keypad. Thank you for holding. Our next question is from Mahmoud Elsafty, Ghobash Trading and Investment. Sir, please go ahead.

Mahmoud Elsafty: Good evening, gentlemen. This is actually Alok Nawani from Ghobash Trading and Investment. I just wanted to ask you, again, about your change in CAPEX guidance. I didn't quite catch that. And the other question would be, what would you guide for a good sustainable margin for your UAE business? And I am wondering if there, you know, have been any changes with regards to energy pricing, or if you expect some prices to come down as we have talked about in previous calls? Thank you.

PK Chand: As far as the CAPEX guidance is concerned, what was said is that we are revising our previous forecast for CAPEX spends of 300 million dirham in 2016, and this actually 300 dirhams included 60 million dirhams on account of expanding our sanitaryware capacity further in the UAE, which we are not going ahead with at this time. So actually the revised forecast is 240 million dirham. So that is as far as the CAPEX is concerned. Now the gas price and margins is lower.

Abdallah Massaad: Today we mentioned that in terms of gas, you know, we are paying I believe a price, which is more than the average today. So honestly, we don't have a visibility, pure visibility on the prices, but we mentioned that the prices for the second quarter is slightly lower than the first quarter price. In terms of margin in the UAE as mentioned that in the UAE business we have our 10 showrooms which we started renovating now and we would be finishing the first showroom in Sharjah. We started with our headquarter showroom, our now certification team is completed. We are winning a good project, so I don't foresee any change in our margin in the UAE business.

Mahmoud Elsafty: All right. Thank you very much.

Operator: Ladies and gentlemen, I would like to remind you, if you have any further questions, please press 0 1 on your telephone keypad. Thank you for holding. Mahmoud, please go ahead with your question.

Mahmoud Elsafty: Thank you. Abdallah, what percentage of your backlog is exports to government deals? And has this composition changed following this macro slowdown in GCC and especially in Saudi? And another question, please, you have a large land plot in UAE. I think it's part of your non-core assets. So what's your plan for this land? And are you in negotiations with any buyers or do you plan to develop this land? Thank you.

Abdallah Massaad: Mahmoud, we mentioned that there is for sure slowdown in project in the region, especially, there are delays in project in Saudi Arabia. Now the percentage is very minimal, you know, I don't have a percentage with me, but for sure we are facing some delays in projects, but what I mentioned that we are very diversified. Our UAE market is moving. Europe with the restructuring is moving, and we are in process of also having a product development. We are doing a great job by developing products to cater other markets. In terms of development of land, I mentioned that for sure we intend to sell, but also we don't have a timeline for this. It depends on the financial economic condition.

Mahmoud Elsafty: All right. Thank you.

Operator: Ladies and gentlemen, I would like to remind you, if you have any further questions, please press 0 1 on your telephone keypad. Thank you for holding. Our next question is from Anoop Fernandes, SICO Bahrain. Sir, please go ahead.

Anoop Fernandes: Yeah, hi, gentlemen. Thanks for the opportunity. My first question is related to freight expenses. We've seen this freight to sales ratio jump to 4.1% from 2.2% last year. I just wanted to get a sense of what is the sustainable level that we are looking at going forward? What we should be building in going forward? Some guidance from you in this regard? And secondly, regarding the sanitaryware expansion in UAE, is this the 1800 pieces per day project that we were talking about earlier?

Abdallah Massaad: Regarding the freight, you know, it depends on where we export. When we sell to Saudi Arabia and the Gulf, we normally sell like ex-factory basis, while to Europe and other places, we other it like C&F. So as we sold more to Europe, so we had more freight to be paid, so this is the reason. The second expansion…

Anoop Fernandes: Yeah. Connected to that, there was some question.

Abdallah Massaad: But the 18000 piece I do not understand that the pieces you were mentioning.

Anoop Fernandes: No, this was we are planning to have an expansion in the sanitaryware segment in UAE. I mean, is the expansion shelved? I mean, is that what we are implying?

Philippe Habeichi: Anoop, the expansion we are not moving ahead with the designs. We never specified a production quantity or an amount, so I don't want you to confuse the production that we completed in the quarter in sanitaryware with the potential expansion that we had based into our 300 million CAPEX figure, which we never outlined how big that would be. So that is the one we are not moving ahead with. It's the 60 million which brings down our CAPEX estimate for the year to 240. Does that clarify your question?

Anoop Fernandes: Yeah. So basically, there is no change in the sanitaryware capacity in UAE going forward, right? That's what it is.

Abdallah Massaad: That's correct. That's correct. That's correct.

Anoop Fernandes: Okay. Yeah. All right. Thank you.

Operator: Our next question is from Taher Safieddine, Citi group. Sir, please go ahead.

Taher Safieddine: Hi, gentlemen. Thank you for the opportunity. I might have logged into the call a bit late, but just want to get an understanding on the operational developments during the quarter in the GCC and specifically in Saudi Arabia. I mean, how is the revenue growth in Saudi? This is my first question. And I mean, what's the outlook? We are hearing negative news in terms of cut down in spending. So this is my first question. My second question is on the UAE. I mean, are you seeing any major slowdown in UAE and specifically in Abu Dhabi given the low oil price environment and cuts we are hearing about within the government spending? Thank you.

Abdallah Massaad: Regarding Saudi, if you see on year-on-year we have a sale down by almost 17%. Yes, we see that during the last quarter, there was a slowdown in the market. We can see that there are projects also delayed. So we mentioned that we are trying to diversify. We are not only in projects in Saudi. We had also the whole failure to retail, to private projects, but yes, there is a delay. In the UAE market, we grew by 5.4%. We can see that as mentioned we already strengthened our team, and we believe we are taking more market share. We don't see any like major delays in projects in the UAE.

Taher Safieddine: Just a follow-up on the payments, I mean, are you seeing any delays in the payments in Saudi and in the UAE within your receivables?

Abdallah Massaad: Look, in the UAE we don't have issues. In Saudi we can see from the market sentiment as there are delays, but we don't have a lot of direct receivables from construction companies directly to us. This is through our distributors in the Kingdom. And further to add what Abdallah said,

PK Chand: And further to add what Abdallah said, so we are trying to convert our sales to the secured sales to the maximum possible extent, so that is another step which the company has taken.

Taher Safieddine: Okay. Thank you.

Abdallah Massaad: Welcome.

Operator: Ladies and gentlemen, as a reminder, if you wish to ask any question, please press 0 1 on your telephone keypad. Thank you for holding. We have no further questions. Dear speaker, back to you for the conclusion.

Mohammed Haidar: Thank you, operator. Thank you, Abdallah. That concludes today's conference. We do appreciate everybody's participation. Please have a great day.

Abdallah Massaad: Thank you. Thank you very much. Thank you.

Operator: This concludes today's conference call. Thank you for participation. You may now disconnect.