"Blue Star Q1 FY12 Earnings Conference Call"

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MODERATORS: **MR. VIR ADVANI, EXECUTIVE DIRECTOR, BLUE STAR**
MR. THIAGARAJAN – PRESIDENT, AIRCONDITIONING & REFRIGERATION PRODUCTS GROUP, BLUE STAR

Moderator Ladies and gentlemen, good day and welcome to the Blue Star Ltd. Q1FY12 Earnings conference call. As a reminder for the duration of this conference, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during the conference call, please signal an operator by pressing "*" and then "0" on your touchtone telephone. Please note that this conference is being recorded. At this time, I would like to hand the conference over to Mr. Vir Advani, Executive Director at Blue Star Limited. Thank you and over to you Sir

Vir Advani Thank you very much. Good morning ladies and gentlemen. I have with me Mr. Thiagarajan and we will be giving you an overview of the results of Blue Star Ltd. for the quarter ended June 30th, 2011.

The following are the financial highlights of the Company for the *quarter (Q1FY12)*

- We reported a Total Operating Income of Rs 704.68 crore for the quarter ended June 30, 2011, as compared to Rs 664.83 crore in Q1FY11, representing an increase of 6%.

- For the quarter, Gross Margin declined from 23.6% to 21.6%, due to higher costs pertaining to labor and raw materials and change in business mix.

- Operating profit (PBIDT excluding Other Income) for the quarter declined by 55% to Rs 27.59 crore. Operating Margin decreased to 3.7% compared to 8.5% in Q1FY11. In addition to the increase in direct costs, which I will explain in more detail shortly, this is on account of higher general operating expenses on account of a higher R&D expenditure, advertising spend and higher interest costs on account of acquisition funding and strategic stocking of inventory for the products business.

- Net Profit was lower by 74% at Rs 9.79 crore compared to Rs 37.15 crore in Q1FY11.

- Earnings per share for the quarter (Face value of Rs 2.00) stood at Rs 1.09 vis-à-vis Rs 4.13 in the corresponding quarter of the previous year.

- The Carry Forward Order Book as on June 30, 2011 increased to Rs 2099 crore compared to Rs 1976 crore as at June 30, 2010, representing a growth of 6%.

- Order Inflow during the quarter decreased from Rs 925 crore in Q1FY11 to Rs 851 crore in Q1FY12.

I will now spend some time on each of our lines of business and give you both financial as well as operating highlights for the *quarter*.

The Electro Mechanical Projects and Packaged Airconditioning business accounting for 49% of the total revenues in the quarter, declined 9% while segment results fell sharply to a loss of Rs 8.87 crore as compared to a profit of Rs 33.57 crore during Q1FY11. The Operating Margin of this business in Q1FY12 was -2.6% compared to 9% in Q1FY11.

To put this in context, after showing signs of revival in the middle of last year, the overall investment climate has significantly deteriorated in the last 6-9 months, something we have been indicating for the last 2 quarters. The market continues to be sluggish in terms of new orders and project execution time lines continue to be prolonged. Our focus in the last 6 months has been on managing the capital employed in this business and one of the outcomes is a lower revenue in the quarter. In addition, we have been focused on advancing projects that have been long delayed and prolonged beyond a reasonable period. A number of jobs, about 10-12, were either significantly advanced or short-closed in this quarter. Given the age of these projects, cost variation between the estimated costs and actuals on these projects were quite significant on account of the significant commodity price increases in the last two years. We have had to provide for these cost overruns in this quarter, thus pulling down the operating margins in this segment.

The major variations between estimates and actual are broadly in the following categories and segments:

- Building electrical projects which were part of the erstwhile Naseer Electricals which we acquired in 2008
- Infrastructure projects which are long duration and have a higher lumpsum portion
- Residential and Commercial projects where builders and general contractors are involved.

The current quarter was also impacted by lower margins on running jobs. The Projects business is expected to continue to face margin pressure for the coming 4-6 quarters. Given the fixed price nature of projects, there may be cost over-runs as well as some short-closures in builder promoted real estate projects as developers scale down the size and scope of projects already underway. Further, in our endeavor to diversify our project portfolio beyond commercial real estate, our overall order book has undergone a change in the last 24 months. This project portfolio change, the fixed price nature of contracts and the expected high levels of commodity prices (particularly copper and steel), will have an ongoing impact on our margins as we progressively execute this order book.

As a management team are taking a number of actions to control the impact of this potential margin erosion including:

- Maintaining our continued focus on managing the capital employed in this business by focusing on receivables and advancing and closing projects
- Being very selective and focused in terms of our order acceptance criteria, including improving the terms of payment and other commercial terms.
- Aggressively approaching clients for escalations and variations especially on long delayed projects
- Pursuing a number of options to optimize operating costs and improve productivity through modern work practices.

As stated earlier, we will be tempering revenue growth through this year as we work on reducing the capital employed in the business.

On the market side, in spite of the sluggish commercial real estate environment, we continue to witness demand from the healthcare, education, hospitality & power segments. During the quarter, Blue Star won prestigious HVAC orders across the above segments namely Reliance Samalkot Project, BHEL-Shree Singaji Thermal Power Project -Khandwa, New Integrated Terminal Building at Goa Airport, CISCO & HCL Technologies - Bangalore, MRF Ltd- Chennai, Galaxy Mall- Bangalore, Shristi Hotel, Kolkata etc.

The Electrical Projects business caters to the commercial building market, residential and the power sector. During the quarter, we received impressive stand-alone electrical orders in the residential and Offices segments. These included prestigious projects like IOCL-Paradip, Citizen Hospital-Secunderabad, Prestige towers - Bangalore etc.

In Packaged/Ducted airconditioning and small chillers, there was a good inflow of orders from the Industrial, Offices, and Education segments. The Company launched a new range of eco-friendly and energy efficient Variable Refrigerant Flow (VRF) airconditioning systems using inverter technology in Feb'11 and started getting orders across segments like Offices, IT/ITeS and Industrial. Some of the major orders in VRF for both Digital Scroll and Inverter technologies are Goa State IDC, Embassy Projects -Pune, SRP Oils Pvt Ltd – Kolkata and Persistent Software - Nagpur.

Moving on to Segment 2, the Cooling Products business comprises room airconditioners and refrigeration products and systems. Segment revenue registered a healthy increase of 30% in the quarter, driven by room airconditioner sales. Segment results increased by 24%. The Operating Margin declined marginally from 14.1% in Q1FY11 to 13.5% in Q1FY12.

Despite a decline of around 6% in the room airconditioner market due to subdued consumer buying in this category, our Room Airconditioner business registered a good growth in Q1FY12. This growth was mainly driven by the Company's foray into the retail channel & widening the range of models. The Company also had an enhanced visibility in mass media & extended its coverage through its dealer network.

The Refrigeration Products business continued to perform well with healthy growth in the water cooler business, mainly from the Educational institutions, Manufacturing, and Offices. Some of the prestigious orders were that of BITS Pilani - Hyderabad, IIIT - Cuddapah, Vizag Steel plant, Infosys etc. The Company also witnessed considerable growth in the chest cooler and freezer business driven by the ice cream and dairy segments. A few noteable orders are Vijaykant Dairy - Karnataka, Lazza Ice-creams - Kerala. Further, bottled water dispensers continued to do well due to enhanced demand from the residential segment, small offices and commercial establishments. For the cold chain, the Company has witnessed good inflow of orders in the Pharma segment and the food processing sector. During the quarter, major orders were booked from Monsanto - Bangalore; Haldiram-Noida; Khyber Group - Gulmarg and Indian Food Tech - Rudrapur.

The revenues of the Professional Electronics and Industrial Systems business (Segment 3) grew marginally by 3%, but segment results registered a substantial increase of 46%. All the Departments of the Division have done well. The Company has specifically done well in the Industrial Projects segment with a major order booked from Rourkela Steel plant.

In conclusion, the Q1 financial results show a mixed bag of business opportunities. One the one hand, the overall market sentiment with respect to the Electro Mechanical Projects business is down as the investment climate has significantly deteriorated over last one year. The company expects the coming quarters to continue to be challenging for the EMPG business. As market leaders, we are committed to the business and are confident about its long-term prospects. We see the current situation as a natural extension of a delayed investment cycle and we are hopeful that the situation will correct and momentum will return in the business over the next 6 to 8 quarters.

On the other hand, the Cooling Products and Professional Electronics & Industrial Systems businesses have performed well during the quarter and this trend is likely to continue. In the coming quarters, our prime focus continues to be to manage capital efficiency and improve the quality of the incoming business while we navigate through our current order book.

With that ladies and gentlemen, I am done with my opening remark. I would like to now pass it back to the moderator, who will open up floor to questions. Between Thyag and me, we will try and answer as many questions as we can. To the extent we are unable to, we will get back to you all as well. With that, we are open for questions.

Moderator Thank you. Ladies and gentlemen we will now begin with question and answer session. The first question is from the line of Ruchi Vora from UBS, please go ahead.

Ruchi Vora My question is related to Segment-I, I was wondering, how do we see the cost panning out through the rest of the year and will this segment be profitable, that is my first question? Second is, just wanted some more details on the order book in terms of, is it only related to Segment-I and what is the exposure to different sectors like commercial, real estate, IT, infrastructure? And the third question is, on the working capital. Would highly appreciate if you could share the working capital details?

Vir Advani So to answer your first question, our carry forward order book in our projects/contracting business as of April 1st 2011, was approximately Rs 1800 crore including our subsidiaries. We believe that there may be cost over runs, that may impact our carry forward margins by as much as 3 to 5%, part of which has been taken in the current quarter. However, we will only know the position as we advance jobs in the order book over the next 12 to 18 months, because of the average life of the order book we are carrying. So as stated earlier, this will be countered by a number of measures within the company as well as an aggressive escalation and variation claims, which will only get determined as we advance the projects. But as it stands today, there may be as much as 3 to 5% margin erosion on the carry forward order book. This carry forward book erosion is only related to Electro-Mechanical projects business and therefore Segment-I.

To answer you the current year is difficult for us, because as I mentioned earlier this carry forward order book takes anywhere between 14 and 18 months to be executed. On one hand, we are trying to close and advance all jobs as quickly as we can, either with new terms or on old terms if they are unable to change, and on the other hand we are also slowing down delivery and execution on ongoing jobs, because we want to manage the capital employed. So it is difficult at this stage to see what the revenue will look like in the current quarter. But as we bill out the Rs1800 crore, there will be a margin impact.

Ruchi Vora Actually I was more looking for as if we look at the last 8 quarters, your average margins been about 11%. I just wanted your sense on, what is the kind of sustainable margin that you see over the long-term and in the over the medium term what if the kind of margin that you envisage because if you are doing a lot of provisioning also in the next few quarters, it will obviously impact your margins. So a specific numbers in terms of what would be your internal target, would really help us?

Vir Advani We don't have specific targets but in the medium term, which is the life of this order book, if you correct margins by 3 to 5% that will be probably accurate and beyond that on a sustainable basis we intend to take the business back to its 11% margins level.

Ruchi Vora Okay and also my question on the order book, could you help us with the details on the order book? What is the exposure of commercial real estate?

Vir Advani It couldn't have changed much over the last few quarters. We have been indicating that the commercial real estate would be about 70% to 75% of the order book and that continues to be the case.

Ruchi Vora So, out of Rs 2100 crore, what you have reported, 70% to 75% is related to commercial real estate and this also includes the IT Park, right?

Vir Advani Yeah. We include in commercial, just to remind everyone, IT, ITES, retail, healthcare, hotels, office, multiplex etc.

Ruchi Vora How much would be the office segment?

Vir Advani Office will be about 40% to 45%.

Ruchi Vora My last question on the unitary cooling products segment, what is the kind of margins that we see on a sustainable basis and what is the mix in our revenue between the ACs consumer durable business and the commercial refrigeration?

B. Thiagarajan The current level of margin should be sustainable. Actually there is a lot of import content as well, and with the rupee strengthening, there is some advantage out there.

Ruchi Vora Sir, my second question is on the revenue breakup between the consumer durable business on the AC side and commercial refrigeration?

B. Thiagarajan You can say, they are around 60:40, 60 is air conditioners, 40 is commercial refrigeration.

Ruchi Vora What has made us grow much faster than the market. Could you please elaborate on what have we done in terms of the distribution channel?

B. Thiagarajan One is that, we got into the residential segment, by entering the retail channel. Number two is the enhancement of distribution reach, basically Tier 4-Tier 5 cities which are all graphically growing in this particular product category. These are the two reasons.

Moderator Thank you. The next question is from the line of Ankit Babel from Pinc Research, please go ahead.

Ankit Babel Sir, you are talking about pressure on margins. Now what about the new orders which you would be bagging in say next couple of quarters. The same 6 to 7% kind of margins we should assume or we should assume 10 to 11% kind of margins?

Vir Advani We have been talking for the last two quarters about improving the quality of order inflow. I will say that while we have been facing pressure on the carry forward, I'm happy to note that even though the order inflow has slowed as we mentioned even in Q1, the quality of the orders that are flowing in now, are definitely superior to last year and even over the last few quarters. This is primarily because, we have seen for the last two or three quarters that atleast both copper and steel are being range bound and therefore we can estimate far more clearly, that is one, but more importantly we have been pushing on far better terms of payment as well as other commercial terms, which is one of the main reasons for the adverse capital employed position in the company right now. So the combination of the two; better margins as well as better terms of payment, is why we are optimistic that as we clear out this carry forward, we are replacing it with a higher quality business and will take us back to where we have been for the last two or three years.

Moderator The next question is from the line of E A Sundaram from M3 Investments, please go ahead.

E A Sundaram This is in response to the comment that you had made about the margins being inferior for this quarter and indeed for the next couple of quarters and you also said that the quality of customers have gone down, that is the reason why the capital employed increased etc. Now I want to know, what clearly happened, was it because of higher fixed price contract, did you not anticipate the rise in commodity prices, was it not built into your pricing mechanism? What exactly went wrong? And when you say quality of customers have now improved, that it means that Blue Star went for high revenue growth compromising on the quality of the customer? What exactly happened, can you please explain that to us?

Vir Advani Yes, there are two parts of your question; one is the historical question and one is in the quarter. So when you say quality of customers, I don't mean the names of the customers, I mean it's a type of projects that we have taken on. I think in the last three years one has seen a dramatic change from fast-moving private sector jobs to slower moving both builder promoted jobs as well as infra general contractor jobs. That is the nature of the projects and have finalized over the last two years whether it is hotels, hospitals, its airports, metros all of that. All of these projects have come with a longer gestation time. They all are fixed price, as you may know, the bulk of our order book is a fixed-price order book.

So you are asking what happened in Q1 specifically: as I mentioned for the last six months we have been focused on reduction of capital employed . One of the ways you attack capital employed is that you try and either short close or close old jobs that are stalled and not moving. These are jobs that have been with us over three years. So you will imagine that they were costed at the time when copper was at $3000 and $4000 which moved to date to $9000-$10,000. Similarly with Steel from 35 to 40 to now much higher. So when you have fixed-price projects of long gestation like this, that have not been moving because of either customers doesn't want to progress them or there are various other issues, unless you force closure, you have to leave them open, which is what we were doing. However, now it has taken us probably four or five months to push some of these, which is what we're able to do. Obviously we have to take the losses in the quarter; we have also managed to cleanup some of the older jobs. Having said that, in the quarter, I also made a point to note, that even on running jobs, (so by running jobs, I am referring to jobs that we have booked in the last 12 to 18 months, not necessarily three and four years ago) we have had pressure on margins because, what we had anticipated to be the input cost on steel, copper other finished goods this sector we are finding it difficult to get that pricing in the market and yet we need to progress these jobs and so the combination of the two; one is 10 to 12 jobs specifically which are old, as well as some running jobs has led to the lower margins in the current quarter. And looking forward, it is very difficult to estimate, this is not guidance to anything, but strongly what we feel, as we execute this order book, there is the possibility of 3 to 5% erosion. Of course, we are doing everything internally to counter that as one; secondly we are going back to the customers very aggressively to see how we can restructure these fixed price contracts and also if there is a chance that commodity prices ease,(we need them easing more than stabilizing as of now,) then obviously we don't face this pressure. Our approach to this is our commitment to continue to advance projects at the correct pace so that customers are willing to take delivery, and are willing to pay. We will continue to advance, but if the customers are holding our capital, then we will obviously have to hold these projects and the order book, which is quite difficult at this stage to give everyone an idea on quarter-to-quarter, what the impact may be.

E A Sundaram Is a fixed-price contract in projects the norm for the industry. It has been unusual that in a volatile price environment Blue Star opts for fixed-price contracts with customers?

Vir Advani This has been a very old tradition, I think, probably, 60 years. All services contracts tend to be fixed-price. There are obviously exceptions, there were certain government contracts like NTPC contracts and some other CPWD every now and then, which does give you price variation clause. Some electrical contracts again with the public sector , utilities will give you price variation clause. But again, these are all price variations based on a fixed-price, whereas, the bulk of almost all private sectors jobs will be fixed-price.

Moderator Thank you. The next question is from the lineup Ashi Anand from Kotak, please go ahead.

Ashi Anand Just wanted to understand in terms of competitive intensity on the Electro Mechanical business. We spoke to certain players, so there are certain civil contractors who have expressed their desire to become a full fledged EPC contractor and therefore also take on HVAC jobs. I think, there are some talks like either Carrier or Lloyd trying to get little more aggressive in this particular market. How are you seeing competition in the space? Can you elaborate on the entry barriers which could actually help us maintain our market shares?

Vir Advani I'll take the first one, which is the most serious consideration. I don't think we are too concerned with the equipment manufacturers because that is a very different business. From whatever we know of them, they will do it if they have to, for the sake of equipment sales but they do not kind of buildup business around that. So leaving those guys aside, on the civil side there are a few examples of players who are trying. The only successful company as far as we know, is L&T. L&T has a full-fledged air-conditioning contracting business. However, having said that, as you may know that we are executing the air-conditioning plumbing fire fighting work for L&T at MIAL and in about 3 to 4 other large projects around the country. I am not sure what is their internal policy, but I think they execute small projects in-house. When it comes to larger more complex projects, they come to MEP specialized contractors like us. Other than L&T, I have heard about three or four civil contractors trying to build this business. They have had not much success, in what I know. One of the major difference, is that, there is a lot of equipment that we buy as part of our contract, whereas in civil contracts, it tends to be bricks and sand and then a lot of labour. Also the terms of payment are very different in civil and MEP because of the material content on the MEP side. So whilst it is not impossible for anyone to build, I'll be quite frank, that it is not rocket science.Our own understanding by looking around the world whether it is Middle East, the Far East or Europe, is that, very few if any, civil contractors will have an in-house MEP operations. At most, what will happen is that, at a group level, a large civil company will also own a MEP standalone operation and they will have a special arrangement between them. But it will be very much on a standalone operation as the nature of the business is very different. So if one looks outside the country, then I am not sure whether the Indian civil contractors will be able to build this up.though I know some of them are trying. But for the time being, we continue to see the same competition, which is Voltas, ETA and Sterling Wilson, as our prime competitors. There are smaller competitors coming into the market, but they tend to be restricted to very small projects.

Ashi Anand We were looking as company of moving from the pure HVAC company towards being fuller fledged MEP kind of a player. Where exactly are we in terms of the transformation?

Vir Advani We are halfway there. We have integrated our electrical business fairly well into our operation, across India. Our plumbing, fire fighting business, which we acquired last year, is still very much work-in-progress. It will be probably at the end of this year, that we would be able to integrate it more extensively, more than internally. We are seeing even today, only about 25% of contracts are getting bundled as MEP in the country. We would have expected that by now, it will be about 40 to 50% of all the projects. But I think, that the downturn in the market has set back some of its progress. You will see a lot more integration both internally as well as in the market. We're internally about halfway there.

Moderator Thank you. The next question is from the line of Aman Batra from Goldman Sachs, please go ahead.

Aman Batra Just a couple of questions, one on the unitary cooling product side, the capital employed has gone up significantly, would that be a function of scaling up this business or there is some inventory buildup which is also there, which we need to reduce over a period of time?

Vir Advani It is due to the inventory buildup. The whole industry was expecting that the market will grow by around 30%. In the process, our ambition also was to grow above 40%. However, the summer was short and the market actually de-grew. That is the main reason. But over the next 3 to 4 months, the inventory should get liquidated.

Aman Batra The other question was on the projects side, you had indicated some sort of stalled projects as well which you are trying to close out now, can you highlight is there any kind of a city concentration or a segment concentration retail malls, etc., which has been highlighted. Any colour on that?

Vir Advani I talked about three distinct types there, one is that we have a small number of inherited electrical jobs from our acquisition of 2008. These are commercial electrical projects in Bangalore and Hyderabad. The second one is that there are large infrastructures projects which have been running for over two years now. And the third one that I referred to, is that we have also have a small number of residential projects, (these are residential towers where we are doing electrical, plumbing fire fighting). There again, we had some cost overruns and need to book some of those losses.

Moderator Thank you. The next question is from the line of Kirti Dalvi from Enam Asset Management, please go ahead.

Kirti Dalvi Would you throw some light on your consolidated numbers, I think these are standalone numbers?

Vir Advani I am sorry, we do not consolidate on a quarterly basis. We will be giving our consolidate at the end of the year as the practice we are following right now.

Kirti Dalvi Second question, though you gave fair bit of light on your Segment-I results and the outlook going forward, could you just elaborate these coming orders probably say next couple of quarters, will be at a similar margin of 6 to 8% or upwards of that because we are seeing 3 to 5% correction in the 11% trend what we have seen in the past?

Vir Advani The new orders have definitely come in at higher margins. I would like to say, they are not yet coming at the levels we witnessed three years ago, but it is definitely better than the last 12 months.

Kirti Dalvi And you said 6 to 8 quarters of pain, that means probably FY12 and probably first half of FY13 we can see this kind of pain in the Segment-I?

Vir Advani I agree with you.

Kirti Dalvi The interest cost and the average interest cost would also have moved up because of tax?

Vir Advani Yes, you are seeing for the quarter we had about Rs 7.5 crore interest cost. Just to clarify Rs 2.5 crore of that is on account of our acquisition funding. The other Rs 5 crore is on the account of operations.

Kirti Dalvi In our annual report, we mentioned a couple of things, if you could throw some light on that. Entering into the highway lighting which segment are we talking about in this?

B. Thiagarajan It is an electrical lighting contract. We have done rural electrification; it is in the eastern region actually.

Kirti Dalvi In the current order book there is nothing like that?

B. Thiagarajan We will continue to do such kind of jobs, though our focus as of now as Vir mentioned, as long as the job is giving us the required margin, it is upwards of 11% .It is a fully funded project which will get close between 12 to 18 months' time and the customer profile is not three he mentioned, we will go ahead and do.

Kirti Dalvi You also mentioned in your annual report that this Himachal Pradesh plant getting commissioned by FY12, for what segment this plant would be and what kind of capacity it has currently?

B. Thiagarajan It is mainly for the segment 2 This factory is supposed to be catering to refrigeration products as well. Our intention in FY12, is to more or less reach the full capacity.

Kirti Dalvi Any particular Capex we are incurring this year?

B. Thiagarajan We had mentioned, that we will incur around Rs 50 crore of Capex.

Kirti Dalvi And there is no cut on the ad spends on our room AC and other products?

B. Thiagarajan Q1 is the biggest advertising season, of course again in February-March we will be there. Q1 is a clear indicator that we have enhanced the advertising spends.

Kirti Dalvi So there is no cut we are seeing probably going forward?

B. Thiagarajan Not as of now.

Vir Advani Just what Thiag was clarifying, is that we spend most in Q1 and Q4. Q1 spend would not continue in Q2 and Q3 obviously but in Q4, we will be relooking at our ad spend based on the market and what we need to do so it is still a while away.

Kirti Dalvi And the average tax rate for the current year, because I think you must be getting some benefits of our R&D spends and probably of the Himachal Pradesh plant benefit?

Vir Advani Yeah we are getting benefits from both. We expect the tax rate to drop around 25%.

Moderator Thank you. The next question is from the line of Shefali Doshi from KJMC Capitals. Please go ahead.

Shefali Doshi As far as your order book is concerned, whether it is a stand-alone order book or consolidated order book?

Vir Advani The one I told you Rs 2099 crore is standalone, I mentioned earlier that the subsidiary has carry forward of Rs 225-250 crore.

Shefali Doshi This Rs 225 crore pertains to Naseer Electricals as well as DS Gupta, both?

Vir Advani Naseer is a division of the company. It is actually now in our electricals projects division, so that is part of the standalone. Blue Star Electromechanical has the part of our plumbing firefighting business

Shefali Doshi Coming to the fixed order book proportion, what will be the percentage of the order book containing fixed orders?

Vir Advani Pretty much I can say 85 to 90%.

Shefali Doshi I am just talking that historically, in the past say two years before, was this the same ratio, or it used to be in the range of 60 to 40 and it has increased substantially to 85% recently?

Vir Advani No. 15% is where we had price variation clauses. So the share price variation clauses as a percentage, I do not think that would change too much. In fact for anything, it would have gone up a little bit because in the last 2 -2.5 years we have been taking a little more government projects as well as our electrical business has been quoting to a lot more public-sector, which is typically the way to get the price variation.

Moderator Thank you. The next question is from the line of Nitin Bhasin from Ambit Capital, please go ahead.

Nitin Bhasin I was looking at the quarterly numbers, your project business has actually dropped to less than half of your entire revenues for this quarter. So do you think this could be the shape of the revenue profile of, the company for the next couple of years wherein you would have given thrust to your product business?

Vir Advani No, let us put it this way. There are two reasons for that, one is that our product business grew quite well. Coupled with, we took some decisions on our projects business which we have in last two or three quarters, where now we are seeing slow down in revenues, which basically means slow down in execution on running jobs because of the capital employed. So my sense is, this carry forward needs to be executed. So to that extent, once we get the capital employed under control, we will again see revenue growing at the rate it has been for the last few years. So I would still expect that Segment-I would continue to be around 65% of the overall pie.

Nitin Bhasin That is materially even lower than 2011, now prior to that you were possibly at 70 to 74% something like that?

Vir Advani Around 70 maybe. But room air conditioner business is growing very fast and so to that extent, that is one business that will grow a little bit faster than Segment-I and therefore it will eat into that mix, but it will not become 50/50, as far as we can see as of now.

Nitin Bhasin So would it be fair to assume that next year FY13, let us not talk about 12 because it is time where you are not consolidating your businesses, it will be like a 65, or lower than 65 as per your capital employed, what FY13 for next year where do you see?

Vir Advani I suppose 65/35.

Nitin Bhasin I was going through your annual report last year. Looking at your central air-conditioning plant, there is revenue that gave under sales contract. that was just growing at 6% after growing only 4% the year before that. Can you just shed some light on the central air-conditioning plants sales contract, why is that business growing so slow at about 4 to 6% only? And where do you think you can grow to, that is one? And similar related to this is, the other part of the business again is the others' works contract? Which grew at about 11%, but your central air-conditioning plant grew only at 6%, so this dichotomy?

B. Thiagarajan So the Segment-I basically comprises air-conditioning projects, number one which is what you call as central air-conditioning projects. There is a packaged air-conditioning business there, which is basically an equipment business. And it caters to medium-sized space in air-conditioning. There is VRF system, which also is part of packaged air-conditioning, which contains medium-size projects as well as equipment business, where the packaged is equipment dominant business. There is a fourth category which is electrical projects, fifth category is plumbing projects. Okay, as of now plumbing you take it as it is in the books of the subsidiary, it is not consolidated here. For your understanding what you need to know, which are the markets that are growing. That is basically your question.

Definitely central air-conditioning projects market has shrunk and it may continue to shrink in FY13 also. It is basically IT, ITES, shop, showrooms, boutiques, as well as infrastructure projects. The problem is the large space air conditioning, I do not think that there are many projects that are in the pipeline. There are no big new projects that are on the anvil. The hotel orders were getting finalized. I am not seeing in the coming years, any big boom further happening there. Retail, unless and until FDI in retail comes and people start investing, it is going to be a while. So if you're talking specifically about FY13, air-conditioning projects overall market size may be stagnant.

Nitin Bhasin Okay, alongside there are two small segments called spare and components and income from services. You see income from services is very much related to your central air-conditioning plants sales, where you see plants sales rising in your AMC revenues growing alongside?

B. Thiagarajan There is a small correction; the service revenue comes from air-conditioning projects as well as packaged air-conditioning. As of now the packaged air-conditioning service revenue is growing significantly; it is growing at the rate of 30% or so. In central air-conditioning, there is a time lag basically between the order execution and the service revenues start kicking in. So therefore if the service revenue should grow in that particular business, though the conversion may have limitations because in large infrastructure projects, they get either unbundled or tendered out. It is not necessary as a captive customer they should come to us. Whereas IT, ITES, healthcare, these AMCs will come. In case of segments like hotels or industrial or power they maintain themselves so it is not AMC friendly. So between central and packaged, our service revenue growth will be from packaged air-conditioning.

Nitin Bhasin In the beginning there was the question by one of the participants, he was asking about the comparative intensity increasing with couple of people coming in to the business, one is the civil guy and one is the product guys. We have been noticing certain tenders of HVAC, whether it is AIIMS or others, is the civil companies like Simplex and the others, they are all bidding for these kind of jobs, hoping to get these turnkey solutions. So do you think from here on increasingly even if you are not participating as the primary bidder, your clientele would be moving away from a direct client to a general contractor as a client?

Vir Advani That trend has been on for a couple of years now. I've talked about this in a couple of calls, AIIMS is an example where they went for a bundled thing and then if you want to participate you have to work with the general contractor, which is obviously having a preference, from capital employed point of view. But having said that, Airports Authority has reversed that and now it has gone back to issuing air-conditioning outside the civil scope, Metros have gone back and changed from the general contract to direct. Power at NTPC, BHEL all of them continued to keep it outside. So in fact, AIIMS is turning out to be an exception here. But we do not know which way the market will move. What we can see from these large government spenders is that they still prefer to keep it outside the scope of civil.

Moderator Thank you. The next question is from the line of Sanjeev Zarbade from Kotak Securities please go ahead.

Sanjeev Zarbade It was regarding the electronics business; typically of course the industrial slowdown would have slowed down the business, but how is the outlook from this segment because the margins in this segment are typically much better than the other businesses?

Vir Advani Yes, I'll answer the outlook in two ways. We have two parts of the business. One is an electronics business and the other is an industrial systems business. The electronics business as you know, caters to institutional sales including whether it is healthcare or it is labs, etc., while there is not any major slowdown in demand, we are not seeing a huge growth in that business, it is a fairly mature business for us. It is growing in single digits. The industrial system side of the business, which is pumps, valves, industrial projects, disruptive and non-disruptive testing machines, etc., which cater to automotive, steel, power, and cement all of that. We are still seeing a fair amount of opportunity and growth there. We are watching it because obviously, that whole part of the business will be linked to industrial Capex, and industrial Capex, as we all know, is under pressure. I have a feeling that because we are in very niche and very specialized areas in these large buying segments, we are still able to drive growth but as this business grows and it becomes more mainstream, which is part of what we're trying to do, we will fall into the regular industrial Capex cycle and then things may get impacted. For the time being, for the next 2 to 3 quarters, we are seeing a fairly robust growth in the current portfolio what we sell, but I don't know going to FY13, how the outlook is going to be. If the trend in industrial Capex continues at the current rate.

Sanjeev Zarbade Because in the previous year our actually run rate in the 2nd, 3rd, 4th Quarter in this segment was around Rs 65-60 crore. So before that till FY10, we in this segment around Rs 35-40 crore order levels on a quarterly basis. So from here on, can we revert back to the Rs 60 crore odd kind of run rate or?

Vir Advani Yes, like we mentioned, looking at this business really on a quarterly basis, is very difficult but on an annualized basis, we are still expecting some growth in FY12 which you can assume. Again like I said, going into FY13, we will have a carry forward order book there, but I am not sure about new order inflow as we move towards the end of this year and into the new year, because clearly Cement, Steel, and Power are getting effected by the overall economic situation.

Moderator Thank you. The next question is from the line of Ankit Babel from Pinc Research, please go ahead.

Ankit Babel Sir, since most of your contracts are on fixed-price nature, we would also be subcontracting a part of our contract to subcontractors. So when we subcontract, do we do it on a fixed-price nature or it's on a variable price nature, when we subcontract a part of our contract to a subcontractor?

Vir Advani Unlike a civil contract, where a large percentage of contract value is labour, which is variable in nature, in our contract, an MEP contract, the bulk of the cost is in equipment and material. And an equipment and material is obviously negotiated purchase from multinational and as well as domestic suppliers. There is a smaller percentage of labour that we do subcontract .

So really, it doesn't come down to be here to pass on any fixed-price part of the contract down. It is purely a negotiated purchase of various equipment and materials. So, to that extent, our ability to push that risk down is limited. What we are able to do as a contractor in this field and given the nature of equipment and materials that we buy, is that we are able to push down in terms of payment pressure as well as linking the inflow and outflow. This is what you can do as an MEP contractor, you can't actually pass on the price risk.

Ankit Babel Because I was just wondering, since 90% of our contracts are on fixed-price in nature and this volatility will continue to infinity. So how are we going to de-risk or reduce the volatility into our business going forward? Just because of commodity prices, there is such a huge variation in a margins and profitability. So at the time of planning, at the time of bidding for the contract, what kind of contingencies you already built-in and to that extent we are safe as far as the rise in commodity prices is concerned. So how do we manage actually, the whole contract?

Vir Advani There is a very long answer to that question but the short answer is that, you have to do the estimation correctly and we have internal guidelines that we issue to give guidance to our teams on what kind of contingencies and what percentage and how large a contingency to take based on the nature of the contract, duration of the contract and the nature of the customer, where things have obviously gone wrong and in this carry forward is that we have underestimated the durations and the gestation period of these projects. We did not anticipate, that projects should have taken 12 months are now taking 24 months, due to the external environment. It's not an internal ability or execution capability problem, it's a market and when we decided six months ago, that capital employed is more important than pushing the progress on projects, there is obviously a natural impact on why the revenues slows and on your P&L basis you begin to see a shrinkage in margin. Really what's happening is that, the elapse time of that project is increasing, to that extent you're holding that risk on that project for a longer time. So it is a fine balance between pushing it out too far, as well as executing quickly and then getting stuck with the large capital employed. So I think, going forward what we're doing for the last six months and we continue to do is that we are getting cautious about our planning. We are estimating in delays based on the city, based on the particular project. We are actually starting to look at the market data to try and understand that if it is a hospital project in South Mumbai, then what is the demand for that project in South Mumbai and if so, what can one expect to be the lapse time for the project and then we cost accordingly. So that is the type of insight we are trying to drill down, to try and improve the quality of booking. But given the understanding that we have of the market, we are fairly confident that we should be able to do a better job of estimating all of this as we go forward. And of course, while we do all of that, there is always an ongoing effort to try and introduce price variation clauses into all our contracts. We are succeeding one by one on the electrical front, where the price variation tends to be a more accepted practice. We are struggling in the air-conditioning and plumbing firefighting space, where it is not historically been a norm, but we're hoping to move that along as the coming quarters pass.

Ankit Babel That is where I was coming in from, whether your execution cycles which were originally 12 months, that has now increased to 24 months and where you do not have any control, in that case, why can't we go to the client and ask for the variation because it is from their side that the project have been slowing down not because of your side. What are the chances that out of 100 say 80% of the claims would be accepted by the clients, or 70% would be accepted,, what is that range?

Vir Advani That is what we are on right now, is actually going after all of these based on the delayed projects, going back to customers and in many cases if a delayed project has been dormant for some time and it is restarting, we insist that we will not start unless we get price revisions, for example. So there are ways and means that we're employing. I think what I'm trying to do on this calls is give you a sense, if the market continues at its current rate of cost and we are unable to bring back some of this margin to our customers, through all of these efforts, then there is a potential and possible impact of 3% to 5%, but I continue to be hopeful, that we will be able recover at least a part of this.

Ankit Babel This is the worst case which you are anticipating.

Vir Advani Yes.

Ankit Babel My last question is you have always remained a low debt company but last year your debt level on a consolidated basis was around Rs 445 crore. Now considering pressure on your working capital which you were mentioning that you were facing problems on receivables and all, what would be your debt level at the end of the year approximately?

Vir Advani I do not think we have anticipated bringing down the debt levels too dramatically. One is, there is an inventory buildup in these numbers in Q1 which will obviously gets liquidated. Over and above that as we force close and we short close all projects and move them out of the order book, we are expecting to bring down the capital employed by, if we do a good job by, 25%. But that is an internal target, if we are able to pull down the capital employed by 25%, obviously debt levels will come down by that amount. But there is a lot of work to be done before we get there.

Ankit Babel You are expecting this Rs 445 crore to come down, as of now which is Rs 500 crore, they should come down to below Rs 400 crore or so, this is what is your targeting internally?

Vir Advani We are intimately targeting that, whether we will be successful is what we have to watch.

Ankit Babel What would be the average cost of the debt, what rate of interest are we paying?

Vir Advani Our average cost I think is about 6 to 7%.

Moderator Thank you. Ladies and gentlemen that is the last question. I would now like to hand the floor back to the management for closing comments. Please go ahead sir.

Vir Advani Thank you very much everyone to log in into a call. We will be available to answer any other questions on e-mail, if required please do send them.

Moderator Thank you gentlemen of the management. Ladies and gentlemen on behalf of the Blue Star Ltd. that concludes this conference call.