"Blue Star Limited Q4 FY12 Earnings Conference Call"

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MODERATORS: **MR. VIR ADVANI – EXECUTIVE DIRECTOR, BLUE STAR LIMITED**

MR. B. THIAGARAJAN – PRESIDENT, AIR CONDITIONING & REFRIGERATION PRODUCTS GROUP, BLUE STAR LIMITED

Moderator Ladies and gentlemen, good day and welcome to the Q4 FY12 earnings conference call of Blue Star India Limited. Joining us on the call today are Mr. Vir Advani, President Electro Mechanical Projects Group and Executive Director and Mr. B. Thiagarajan, President, Air-conditioning and Refrigeration Products Group. 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. If you should need any assistance during this conference call, please signal an operator by pressing "*" and then "0" on your touchtone telephones. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Vir Advani of Blue Star India Limited. Thank you and over to you sir.

Vir Advani Good morning ladies and gentlemen, this is Vir Advani. I have with me Mr B Thiagarajan and we will be giving you an overview of the results for Blue Star Limited for the quarter and year ended March 31, 2012.

The following are the financial highlights of the Company for the year on a standalone basis

- The Company reported a Total Operating Income of Rs 2700.28 crores for the year ended March 31, 2012, compared to Rs 2858.92 crores earned last year, representing a decline of 6%. Revenues in Segment 1, the Electromechanical Projects and Packaged Air-conditioning systems business declined sharply by about 16.5%. Within this segment, the revenue slow-down was most pronounced in the Projects business largely due to the impact of the overall economic climate, our cautious approach to execution and new business booking and mark to market updation of planned costs and its consequent impact on revenues. Cooling Products, Segment 2, revenue growth was quite robust at 18.2% driven by the Room Air-conditioner business which grew by almost 25% in a market which de-grew by 10%. Commercial Refrigeration grew at about 8%. Professional Electronics and Industrial Systems business, segment 3, grew marginally by about 2.6%.
- Gross margins declined to 22.76% from 28.53% in FY11, largely on account of significant cost over-runs in segment 1, inflation in input costs which impacted all segments and a marginal change in the business mix.

- Operating loss (PBIDT excluding Other Non-Operating Income) for the year was Rs 11.06 crores compared to the Operating Profit of Rs 248.58 crores in FY11. In addition to the gross margin reduction, the key factors contributing to the drop in operating margins are an increase in advertising, sales promotion and distribution expenses, tighter write-off and provisioning norms for bad and doubtful debts, increase in sub-contracting charges for the service business and inflationary increases in other administrative expenses

- Financial Expenses for the year increased from Rs 24.36 crores to Rs 70.25 crores due to higher interest and finance costs and foreign exchange losses on account of strengthening of the dollar

- Consequently, there was a Net Loss of Rs 89.15 crores as compared to a Net Profit of Rs 155 crores last year.

- The primary reasons for the significant reduction in PBT (from about Rs 227 crores in FY11 to a loss of about Rs 88 crores in FY12) and the indicative impact are as follows::

    - Margin erosion due to mark to market changes in planned costs and planned revenues primarily in segment 1 of about Rs 110 crores

    - Reduction in overall volumes in segment 1, reduction in other income and overall increases in costs of about Rs 102 crores

    - Increase in other operating expenses of about Rs 58 crores mainly:

        - Increase in advertising, sales promotion and distribution expenses of about Rs 22 crores

        - Tighter provisioning norms for bad and doubtful debts of about Rs 25 crores

        - Increase in sub-contracting charges and net impact of changes in other administrative costs of about Rs 11 crores

    - Increase in financial expenses of about Rs 46 crores comprising:

        - Foreign exchange losses of about Rs 37 crores

        - Increase in interest expenses and bank charges of about Rs 9 crores

- We will provide greater color on some of these items and the planned action going forward while discussing the quarterly performance later in the opening remarks

- We would also like to draw your attention to a reclassification of AMC sub-contracting costs which have now moved from cost of sales to other expenses to comply with revised

Schedule VI requirements. Consequently, gross margin numbers for the current year are not comparable with those published in earlier periods.

The total Capital Employed in the Segments reduced from Rs 866.4 crores (as at March 31, 2011) to Rs 628.4 crores (as at March 31, 2012). Receivables and inventories were reduced by about Rs 135 crores through tighter working capital management across all parts of the business. The total borrowings were contained at Rs 343 crores down from Rs 418 crores at the end of March 31, 2011. During the year, the company has reduced borrowings by about Rs 250 crores from the peak borrowing level.

Carry Forward Order Book as on March 31, 2012 declined marginally by 2% to Rs 1917

crores compared to the order book of Rs 1960 crores as at March 31, 2011.

The following are the financial highlights of the Company for the year on a consolidated basis

- On a consolidated basis, Total Operating Income stood at Rs 2819.86 crores for the year ended March 31, 2012. The consolidated financial results include the results of the Company's wholly owned subsidiary Blue Star Electro Mechanical Limited (BSEML), joint ventures namely, Blue Star M& E Engineering SDN BHD, Malaysia, Blue Star Qatar (WLL) and Blue Star Design & Engineering Limited and the share of profit in the associate company Blue Star Infotech Limited.
- Operating loss (PBIDT excluding Other Non-Operating Income) for the year was Rs 22.72 crores.
- Net Loss was Rs 105.10 crores for the year as compared to the Net Profit of Rs 160.96 crores registered last year. The loss is higher at the consolidated level primarily due to the loss of about Rs 16 crore recorded by the Company’s wholly owned subsidiary ie, BSEML.

Here are the financial highlights for the *quarter on a standalone basis*

- Total Operating Income at Rs 813.60 crores declined by 11% over the same period last year
- Gross Margins for the quarter were significantly lower than the same quarter last year due to continuing changes in planned costs and revenues, overall increases in material costs and changes in the business mix
- Operating Margins for the quarter were (4.7 %). Decline in gross margins, lower business volumes and tighter norms for debtor write-off and provisioning for bad and doubtful were primarily responsible for this drop. During the quarter we wrote off/ provided for about Rs 24.86 crores towards bad and doubtful debts vis-à-vis Rs 4.95 crores in Q4FY11.
- Interest and finance costs were lower at Rs 9.43 crores (as compared to Rs 10.91 crores in Q4FY11 and Rs 22.09 crores in Q3FY12) due to tight control on capital employed in the business and lower foreign exchange losses
- Net Loss was for the quarter was Rs 45.37 crores as compared to Net Profit of Rs 56.85 crores registered during the same period last year.

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 segment revenues of the Electro Mechanical Projects and Packaged Airconditioning business declined by 20% during the quarter, while the segment results reduced significantly from a profit of Rs 69.80 crores in Q4FY11 to a loss of Rs 57.62 crores

As you are aware, through the year we have been closely reviewing our Projects order book and updating the planned costs and planned revenues to reflect the most current prices of materials and equipment. If you recollect, we started the year with a consolidated (including the order book of our plumbing subsidiary BSEML) order book of about Rs 1800 crores in this segment spread across 900 odd jobs. By the end of Q3FY12, we had reviewed about 600 jobs which accounted for about Rs 1200 crores of our order book and updated the planned revenues and costs and the resultant margin erosion of about Rs 70 crores was incorporated into our financials of Q3FY12, primarily in Blue Star Limited. In Q4FY12, we continued the process of review and we have now covered about

85% of our active order book and as has been the practice the resultant changes in planned costs and revenues have been incorporated into the financials. The net impact of the additional margin erosion in Q4FY12 is about Rs 50 crores of which Rs 40 crores was in BSL and the balance Rs 10 crores in our plumbing subsidiary BSEML. Thus the review till date has resulted in a margin erosion of about 7% on our opening order book of about Rs 1800 crores ie, about Rs 120 crores in total of which Rs 110 crores is accounted for in Blue Star Limited and the balance in our 100% subsidiary Blue Star Electro Mechanical Limited. This margin erosion is higher than our original estimate of 5% erosion on the overall order book, however, the process of marking to market for the old jobs is largely complete for Blue Star Limited. A few old projects in the plumbing business, forming part of BSEML will be reviewed in the coming quarters and we will update you on the progress and the impact, if any. The building electricals business, long gestation infrastructure projects and a few projects for builders and general contractors continue to account for a significant part of the margin erosion. In the plumbing business, the margin erosion has primarily been in Residential Projects. While we have initiated a number of actions to recover some of the margin erosion through re-negotiating dormant contracts, raising escalation claims with customers and short closing non-profitable contracts, we will recognize the positive impact of these claims as and when they are financially closed with our customers.

Through the year, we have worked on strengthening our order acceptance criteria and tightening our estimation methods which have now been rolled out to all our projects businesses and locations. Our primary focus has been to reduce the capital employed in this business and I am happy to note that we continue to make progress in this area. The Capital Employed in this segment is currently about 351 crores (as at March 31, 2012), down from almost Rs 498 crores at the end of Q3 and the peak of Rs 638 crores at the end of September 2011. This continues to be the number one priority in this business and team is working very hard to make sure we can optimally deploy all resources (materials and manpower) to projects and customers which are moving quickly and paying promptly.

On the market side, despite the overall sluggishness and our cautious approach to order booking, the company continues to witness demand from the Industrial, Hospitality, and IT/ITeS segments. During the Quarter, Blue Star won many prestigious orders in the above segments namely, Bhilai Steel Plant, JK Paper Ltd-Orissa, BHEL-Bokaro, Urban Square - Gurgaon, Corporate Greens -

Gurgaon, Crown Plaza - Jaipur, Infosys Technologies - Chennai, Ohio Cardiac Hospital - Kolkata and Wells Fargo - Bengaluru.

In Packaged/Ducted Air-conditioning and small chillers, there was good demand from segments such as educational institutions, Industrial sector, showrooms, Offices, hotels & restaurants, and marriage halls. Some of the important projects executed by Blue Star in Q4 FY12 were Sreyas Gurukul - Hyderabad, D S Group - Delhi, Ocwen Financial - Mumbai, Gotri Medical College - Vadodara, Benaras Hindu University - Varnasi, Adani Power - Gondia, Jagathi Publications - Hyderabad, BILT - Chadrapur, Filmstan Studio - Mumbai, Hotel Seven Star - Delhi, HTMT - Bengaluru, Norfolk Mechanical - Mumbai, Mumbai University - Mumbai, Alstom T&D India - Vadodara etc.

Going into FY13, due to the presence of low margin orders in the carried forward order book, the first half of the year will continue to be challenging. However, we are focused on returning this segment to profitability which we expect we will achieve by the end of the year.

In the Cooling Products segment, Segment 2, revenue growth for the quarter vis-à-vis Q4FY11 was about 6.5%. Despite a delayed and intermittent summer and significant levels of trade inventories due to changes in energy labeling our Room Air Conditioner business grew quite well. We are continuing with our strategy of increasing the distribution reach in tier -3, 4 and 5 markets and selectively increasing our presence in reputed retail counters. The demand for commercial refrigeration products was quite robust, however, we faced a few supply chain challenges which have now been resolved. In cold storage products, we have reoriented our strategy to focus on higher margin products and modular cold room projects, and reduced our focus on low margin large cold storage projects which provide a revenue growth opportunity but are typically higher risk due to long execution cycles and with greater exposure to material price volatility. As we complete this transition during the next few quarters, we expect the growth momentum to revive and this should come in at higher margins.

Operating Margins of 9.8% in this quarter, though marginally lower than the 10.8% in Q4FY11, are a significant improvement from the margins of 5.4% % and 4.4% % in Q2 and Q3 of FY12, respectively. We will continue to aggressively pursue all options of margin improvement including price increases

and cost control. However, we believe volumes and margins will be under pressure largely on account of the delayed summer, high levels of trade inventories, continuing depreciation of the Rupee, and higher fuel and freight costs. We are focused on managing the margins in this business and are continuously monitoring the market situation and shaping our responses accordingly.

The Capital Employed in this segment was reduced from Rs 276.28 crores as at March 31, 2011 to Rs 206.83 crores as at March 31, 2012. This has been achieved in a quarter where stocks are typically higher to meet seasonal requirements and volumes in this segment have grown by 18% vis-à-vis the previous year.

In the Professional Electronics and Industrial Systems business, Segment 3, revenues grew 8% in this quarter. We continue to show modest growth in this segment across all our business lines. The Operating Margins in this segment are stable, however, we will continue to show quarter to quarter variations largely on account of the change in the business mix. Growth in this segment is geared to the Industrial Capex cycle particularly Steel, Chemicals and Petrochemicals, Automotive and Defense industries where investment sentiment is poor. Our focus will be to maintain moderate levels of growth and maintain Operating Margins at long term trend levels.

Outlook

FY12 has been a challenging year for the company and we believe this is an aberration in our seven decade long history of consistent growth, profits and returns. The Company has taken vigorous steps to correct the decline in profitability. Strict controls have been implemented to improve the quality of new orders. There is a multi-pronged drive to improve profit margins through price increases, value engineering and cost control. Moreover, a focus on working capital management and cash flow will keep borrowings and interest cost under control.

Though the economic environment remains uncertain, the Company is confident of returning to modest profitability in 2012-13. The results should become increasingly evident as the year progresses. And if economic growth revives, it can only be of additional help in getting the Company back to good health.

With that ladies and gentlemen, I am done with my opening remarks. 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 via e-mail. With that, we are open for questions.

Moderator Thank you very much, sir. Ladies and gentlemen we will now begin with the question and answer session. The first question is from the line of Mahesh Bendre from Quantum Securities. Please go ahead.

Mahesh Bendre Sir, just want to know your view on the industry. Over the last 12 months how has industry behaved, in terms of what has been the contraction in the size of overall industry and how the various sub-segments have grown? Also what kind of growth do you anticipate over the next 12 months?

Vir Advani Our view on the industry is that, there has been about 20% reduction in the size of the industry in terms of order booking i.e. fresh order inflow. For the year FY12, we estimate that it will be 20% lower, largely on account of further drop in IT, ITES, commercial buildings, office complexes. We continue to see some demand in two segments namely hotels i.e. 5 star and 7 star hotels, and in super specialty hospitals. We have recently (in the beginning of FY13), started to see some increase in industrial air conditioning demand i.e. in the steel, auto, heavy industrial segments. Although CAPEX cycle tends to be much longer and therefore even though some order inflow may come in FY13, very little revenue will be coming in. The other segment that dropped off in FY12 vis-à-vis FY11 would have been the infrastructure segment. For us, we account airports, metros, power plants as infra. Within that, airports and metro were particularly quiet in FY12. Power plants continued to get finalized, but these were now NTPC, BHEL power plants and not private power. Private power stopped spending about mid-year of FY12 because of the uncertainty of input. Going into FY13, we see the market being flat to maybe plus 5%. So it will continue at FY12 levels of volumes of order inflow, largely on the back of similar segments. So there will be hotels, hospitals, industrial and I think after two-and-a-half year break we are going to see some movement in the metro segment as well. So metros like Delhi, Calcutta and Bangalore should see

movement, but towards the end of the year. So we will only see that in Q4 of FY13 and so you will see revenue benefits coming in FY14. So at an aggregate market level, about flat to plus 5% demand for FY13.

Mahesh Bendre And sir, what was the contribution from the product business in FY12 revenues for us?

B. Thiagarajan For the Segment-2, the revenue contribution for the whole company is Rs932.64 Crore and it is 35% of the total.

Mahesh Bendre And sir for this segment also we expect single-digit growth?

B. Thiagarajan Not exactly. Here the drivers are completely different. Number one, shops, showrooms, boutiques, that kind of commercial spaces continue to attract investment. Two, residential is of course, the other part of it. As of now residential is somewhat not a very major portion of our revenue. Even the cold storages, refrigeration systems, which form very small segment, they continue to grow. So I would say the growth can be at least 10% to 12%.

Mahesh Bendre And sir on an aggregate level the room air-conditioner market in terms of volume will be somewhere 4 million pieces?

B. Thiagarajan No, it was around 3.2 million for the year ended March 2012. As of now the industry is saying that it will de-grow by around 15% or so, but my own personal expectation is in value terms it will be same as last year.

Moderator Thank you. The next question is from the line of Chhavi Aggarwal from Ambit Capital. Please go ahead.

Chhavi Aggarwal In this quarter the FOREX loss was very low. Was it because of the hedging activities that you have undertaken or was it because of Rupee appreciating against the other currency?

Vir Advani We had changed our policy on hedging in the middle of the year because we had a very bad experience with FOREX .We increased our hedged component from under 50% to over 80% and we continue to do that even now. So it is hedged to about 80-82% as of now. That has helped us manage the FOREX loss in Q4.

Chhavi Aggarwal Sir, in Q4 you have shown healthy margins in the RAC business, is that sustainable for FY13 or we can expect the margins to decline?

B. Thiagarajan I have a feeling the margin will be under pressure if the Rupee is going to behave like it has recently. In Q1, we may scrape through for the simple reason that these inventories came in much before Dollar began to move up. But if it is going to be like this, of course, the price revisions will take place in the market. But I think there will be a potential possibility of operating margin level dropping by 1%. Also you should keep in mind the price increase pushes up the value for the same volume. By sheer arithmetic, as a percentage the margin will drop. But between the market share, growth and the profitability, our strategy is very clear. We want to go for profitability rather than growth. But still I have a feeling that the margin will be under pressure.

Chhavi Aggarwal Can you please again mention as to other than room AC, on the commercial storage side what would be the growth drivers which would drive these commercial cooling products business for you?

B. Thiagarajan Shops, showrooms, boutiques, and restaurants would be the growth drivers. Actually the biggest contributor in the past one year is the restaurant chains and the QSR, the fast food chains and these are medium spaces. Basically where we do not have a land acquisition kind of issues, other regulatory issues, the investments are not very huge. Still it is an attractive investment. The next one is Tier-3, 4, 5 cities. They behave completely different; they are not worried about Euro zone or global economic conditions at all. They continue to grow.

Chhavi Aggarwal So sir after the growth of 25% in the RAC segment, now room air conditioning segment forms what percentage of your cooling products segment business?

B. Thiagarajan You can say roughly 50% of cooling products segment.

Moderator Thank you. The next question is from the line of Gaurav Jalan from Avant Garde Wealth Management. Please go ahead.

Gaurav Jalan Just want to understand your cost to overrun maths again. So if I understand it correctly you have booked Rs120 Crore of total cost overruns for the year, is that on a consolidated basis or on a standalone basis?

Vir Advani Rs120 Crore is on consolidated basis. Of that a Rs110 Crore is in the standalone Blue Star Limited and Rs10 Crore is in our subsidiary Blue Star Electromechanical.

Gaurav Jalan In the Q4 you said you have booked Rs50 Crore. Just on a standalone basis you have an EBIT loss of around Rs58 Crore in this segment. So aside from the cost overruns, this business made a loss in Q4. Please just explain that?

Vir Advani Yes, so I explained it on two counts. One is of course, the margin market-to-market; the other is the volume of business dropped vis-à-vis about 20% drop in revenue in the quarter. So that leads to operating cost which obviously are fixed to a certain nature, you can cut a certain amount but the operating cost tend to be largely fixed. And so the revenue that flows down is about 20% lower and therefore you see a loss. So we are now operating at a breakeven level in Q4FY12

Gaurav Jalan Okay, so then is it fair to assume that as you mentioned you expect to return to profitability towards the end of fiscal 2013? In your last conference call you had mentioned that the margins in fiscal 2013 maybe somewhere between zero and 10%, which is kind of the stable margins you hope to get back to. So given what you are saying now, is it likely that the margins for the fiscal 2013 as a whole in this segment are likely to be much lower?

Vir Advani In our last call I had mentioned that we would be at about 4 to 5%. We have said that in FY14 we would return to the 9 to 10% level. Because we had said that the first half would be challenging, the second half would begin to return to normal. So what has changed since the last call is that we had anticipated about Rs30 Crore of margin adjustment in Q4, that has become Rs50 Crore. There is a Rs20 Crore addition that we have now taken and that we had not seen in Q3. Other than that the business continues to be largely the same as Q3 and, therefore, what we are saying is that we would see profit returning in H2FY13. So in H1FY13, because of the volumes still being low, we will continue to see loss at an operating level. But by the Q3, we will begin to show a profit and by Q4 we should see a profit margin of between 3 to 5% for Segment-1.

Gaurav Jalan On cooling products business, you mentioned that you are going to start focusing on higher margin products which could lead to lower revenue growth. But on an EBIT level, do you expect to see growth in this Segment in FY13 or do you expect that to be a challenge?

B. Thiagarajan I think it will be a challenge. But still we will manage to marginally exceed the last year level. As of now, that is my assessment.

Moderator Thank you. The next question is from the line of Neha Majithia from Microsec Capital. Please go ahead.

Neha Majithia Keeping in mind the company's seasonal performance in Q4 FY12 and on the other side, the company's expectation of seeing modest profitability as mentioned in the press release in say, 2012-13, I had two questions. First one is how does the company foresee the level of EBITDA and PAT margins in the coming quarters; I am talking of the overall margins. And the second question is, what strategy is the company opting to yield such results in FY13?

Vir Advani We do not give guidance. But let me try and address at a broader level. We are looking to be profitable at a company level from Q1 onwards. That is our aim. So for the rest of the year we intend to be profitable on a quarterly basis. We said modest performance only because like I just mentioned, Segment-I will continue to show a loss for the first couple of quarters, the Segments-II and III will show a profit and therefore at a company level we would be profitable. The profit margins will be fractional or much lower than our historical levels. For Segment-1, we will look to end the year at about 3-5% as against our historical 9 to 10% and you also heard in Segment-II that there will be margin pressure at an operating level if rupee does not come back to reasonable levels. Therefore at a company level we will see a modest profit in FY13. What we have done is really, one is of course, like I mentioned in Segment-I, we have changed our order booking guidelines in the middle of last year, so business has come in although at a lower level. You can see the order book has not grown much in FY12 and that had been consciously done. We have taken business at a same volume as FY11. But whatever business that has come in FY12 and getting executed in FY13 is at historical margins in Segment-1. You do make a reasonable

profit there. So, the endeavour is to execute a new order book at the pace required by the customers keeping the capital employed of the segment at the forefront and therefore we expect to follow that through. That is how we take care of Segment I. In Segment II as you know, we have a Room Airconditioners business as well as Refrigeration business. The Refrigeration business continues to grow reasonably. We had some supply chain challenges in Q4 that impacted our revenue but those have been sorted out and therefore we see FY13 being positive for our Refrigeration business. In Room Airconditioners business, as you know, we have entered into residential market last year. We continue to operate in that market even though it is very competitive. Thiagarajan mentioned that profit focus is the priority over volume in that business. So, while our commercial Room Airconditioners business continues to do well, the residential business we will be careful about the volumes that we do. So you may see some volume reduction obviously versus FY12, the growth rate will not be the 25%. But we hope to keep our margins at an operating level flat in spite of reduction in the operating margin percentage. In Segment III, even though industrial CAPEX continues to be challenged from an investment point of view, we have niche products and services that we sell there. Therefore we expect moderate growth both for profit as well as the operating margins. So if you are looking at the quality of business coming in, it is managing our cash flow and our capital employed much more tightly than we have done earlier. Obviously, watching our operating expenses, we have an employee headcount reduction as well as employee cost reduction program that is already underway. We have a procurement excellence program that is underway to reduce our cost of procurement material and of course, we have already demonstrated that we are able to manage our interest cost much better in FY12 as against FY11, especially in Q3 and Q4 between covering our exposure as well as reducing our capital employed. So, it is like staying focused on market that is going to stay flat or grow marginally, but doing a lot better from an operating and execution point of view.

B. Thiagarajan To add to that, steady inflow of service income will help us to go through this tough phase.

Neha Majithia I am talking about Segment-1, when does the company expect to close all the old projects? Say by the Q2FY13? I hope it will not put an impact on the second half of FY13 then?

Vir Advani Let me explain how it works. Closing projects is a priority because we want to close out the financial exposure there. However, we have taken all the costs overrun impact in FY12 regardless of whether the project is going to end in April of FY13 or in March of FY13 or in September FY14. What that means is that, if this job has a cost overrun the entire impact is taken in FY12. That means the balance revenue that remains in that project will be a zero margin. So you will not see a negative margin on that project however long it takes to execute. You will see some revenue there with zero margins. So that is what I had explained in the last conference call, that we now we have a mix of projects in the order book some of which is the first type i.e. An old job, cost overrun is incurred, and we are carrying forward some revenue with zero margins because we have taken away all the cost in FY12 overrun. The second type is that there are old jobs which are still profitable but which have been impacted by cost increases in the economy that are outside our control. So, that is still a profitable project but at lower profit margin levels. The third bucket is the newer jobs that are booked from Q2FY12 on wards, which are profitable and at a historical margin level, that we are now trying to execute. So, we have a mix of all these three projects types that are advancing in the order book. We are advancing all of them at a required pace and at a required level at which customers are paying us, which is managing the capital employed. So I hope that is clear.

Moderator Thank you. The next question is from the line of Nirav Vasa from SBI Cap Securities. Please go ahead.

Nirav Vasa Now, going forward when we are booking new orders, are we insisting on getting escalation clauses on those projects?

Vir Advani We have talked about this in a couple of conference calls. Just to be clear, very small percentage of the orders that we have booked have an escalation clause in-built. I will repeat for the sake of everyone. The bulk of our business is a fixed price, variable item contract. That means the prices are fixed but the quantities are variable. In those contracts, the majority of them

do not have a price escalation clause in-built. Projects that do have a price escalation clause would be in the power sector, government jobs, certain infrastructure jobs, especially the metro segment. But all of that only accounts for 20-25% of our order book, large percentage of it which is 70-75% would be from private and from our commercial spaces where escalation clauses are not in-built and so, we do carry that risk in the project. Having said that, we are now being far more diligent about the contractual period in which we have signed. That means that private customers are giving us a contract of Rs. 100 to be executed over 12 months period, which is a fixed price project. We are quite clear now that as we get to that in 10-11 months if a certain percentage of the cost has not already been incurred, that means that the fronts at the site are not available for us to deliver material, then we will go back to the customer at that time and renegotiate prices to the level that makes sense. We are already underway on many such exercises with our existing customers and we are seeing a fairly positive feedback from them wherever the overruns on time are as to their account or the project has been stalled or there are various changes. So, just as a practice now, we are incorporating all this into our standard operating procedure. And so, while we do not have an in-built escalation clause, we feel that by being proactive on the documentation and on progress on jobs, we should be able to manage this risk that exists in the business.

Nirav Vasa The other question would be now what would be the target EBIT margin that you would be going forward in the projects business. So, if in other words, if I were to ask this question, what is going to be the minimum threshold EBIT margin in each and every project business that you would be targeting below which you would not be ready to take a project?

Vir Advani I will just clarify. Given the size of our projects we do not look at an EBIT margin at a project level. As you know, we have hundreds of projects in a year. What we do, however, we look at a gross margin. To us the gross margin is all our material cost, all our labor cost, all our project management cost, including the site management and including all finance cost related to the project. So, all of that is our gross margin historically. And now from Q3

of FY12 we have various thresholds depending on the risks of the projects. So depending on whether it is a private or a government or a builder or a non-builder, direct customer, corporate type of segment which is hospital, hotel, IT, etc. we have a metrics there. But broadly the metrics ranges between 12% and 14% at a gross margin level and those thresholds are being maintained by us now.

Nirav Vasa Sir you also informed that the manpower reduction is underway. So, would it be a possible for you to help me in which level is the manpower reduction on and how much manpower in volume terms would be lower?

Vir Advani We have already reduced our manpower in FY12 and I do not have that number in front of me, maybe Thiag can pull it out while I am answering your second part of the question. In FY13, our intent is to reduce our manpower by another 100 people and this is across all levels, senior down to junior. This is a net all, an addition of freshers that we are bringing into the organization of about 150 trainees.

B. Thiagarajan Our reduction is to the tune of around 130 in real terms but actually we would have inducted graduating trainees as a matter of policy. So the intention is to reduce the headcount by around 5% last year which really got achieved. Maybe another 5% in this financial year.

Moderator Thank you. The next question is from the line of Mithun Soni from Gee Cee Invest. Please go ahead.

Mithun Soni I have 16 years of history of the company with me; 1996 onwards. We have consistently been performing very, very minor variations, given the industry. With all this experience, where did we go wrong or what is it that has led to this scenario what we are seeing, if you could just take us through that? And going forward are we seeing any structural change in the way, the business dynamics or it was a temporary phase which we missed out?

B Thiagarajan I hear it as 16 years actually. Over 7 decades, it was a sterling performance. As we have stated in the press release, it is one year of aberration. So, indeed it is regretful. There is nothing wrong with the fundamentals of the company and I think in the exponential growth phase that we have had and the customer profiles dramatically changing and with the external market

conditions being different, we would have faced this problem. And definitely, from FY13 it will be a different story altogether.

Mithun Soni Was there a scenario during this phase where a lot of real estate projects were coming up and we faced some issues with those builders where financial discipline would be less?

B. Thiagarajan No, actually for the past three-four years' time the builders, developers as a segment or as a customer segment have dramatically increased. Even an IT, ITES or retail mall, instead of setting up themselves, going and taking the space from the builder has increased. But then, our central Airconditioning business is related to construction. It has got a correlation that way and the main reason is the fixed price contracts, number one. Real estate collapse leading to project overruns. So, obviously, there is a cost that has to be incurred for this.

Mithun Soni With respect to our Segment-1, would you be able to share like? We have already shared the gross margins what we are targeting. What would be approximate fixed operating cost which will take sometime to get in? So, what would be for FY12 our current fixed operating cost for the segment?

Vir Advani We have a carry-forward now on April 1, which is significantly lower carry-forward margin as you would imagine because we have taken out this 110 Crore out of that carry-forward of last year. The carry-forward margin on an aggregate across those three buckets I mentioned; the first bucket is old jobs which were loss making, where we have taken out all the cost overrun, carrying a zero margin, old jobs where it was profitable, but at lower carry-forward margins, and the third is profitable newer jobs which are carrying at the current or historical levels of margin. The aggregate margin of all of these jobs together is about 7%. That cost needs to be covered in order for us to breakeven for Segment-1. Also, we have to figure out how to bill newer jobs faster than older, so we have to manage the entire order book so that the execution comes in at that certain level. You also remember Segment-1, we have related businesses, our equipment business that goes into the same projects our service business that supports that etc. So, while the pure projects business is about 7%, the other businesses are at historical levels. So, what I am saying is that if we are able to execute our current

order book at the same rate as what we have executed last year plus 10%, so there we have slightly faster levels of execution in FY13 of our project order book ramp up. So, Q1, Q2 will be slower than Q3, Q4. So, if we are able to ramp-up that project execution by about 10% over last year then we will end this year at an operating profit level of Segment-1 to about 3 to 5%. In FY14, once we have cleaned up that bucket I and bucket II of our order book and we have a cleaner order book that we are executing, then you will see historical levels of operating profit of 9 to 10% returning in Segment-1 and we are quite confident that we will be able to do that. What this does not take into account is any significant economic recovery or a further dramatic deterioration in the economic environment. So, presuming that the economy stays at this lacklustre level that it is currently, we should be able to do this 3 to 5% in the current year and about 9 to 10% in FY14 based on the cost structure that we have. Obviously, we are reducing the cost structure as we will primarily focus on manpower reduction as well as controlling the interest cost, because that is also a large cost in that business.

Mithun Soni My rough calculation says that approximately our quarterly or yearly fixed cost which is like 12 to 14% of our gross margins minus the EBIT what we were targeting would be in the range of about 15 Crore a quarter, somewhere in that range. Is that right?

Vir Advani Yeah, you would be plus/minus a little bit there.

Mithun Soni So now with the changes we have done or reduction in the manpower or the tranches that we are targeting, is that level likely to come down any further or it will be difficult to do beyond a certain level?

Vir Advani It is difficult. We have a very large carry-forward that we are obligated to execute. As you can see even today, in spite of everything that we have done in terms of taking care of the over run, we still have a fairly large order book that we are carrying and customers seem to want us to execute that. Obviously, a lot of that execution as and when it comes, we would be renegotiating the rates and the contract for that but the fact remains that the volume of business continues and we are contractually obligated to execute. So, beyond a point it will be difficult to reduce that fixed cost

which is why even in Q3 & Q4, even when the volume has been down by 15-18- 20%, you have not seen a consequent reduction in the operating cost. So, I will say that this is a long-term adjustment of the costs that we are trying to carry out to bring it down to manageable levels but we will not be able to cut beyond a point. This is because we are not looking to exit the business. We are looking to be judicious and sensible about the business we take in, we are looking to increase the size of projects that we take in, and we are looking to look at more MEP integrated projects which will automatically result in larger value but lower resource utilization. So, it is changing the mix of business, the focus of the business and the target customer profile that will allow us to reduce our sitting cost but will not result in a consequent huge reduction in revenue or anything.

Mithun Soni And in terms of the capital employed also, we should be able to maintain this new level what we have seen in this quarter?

Vir Advani Yes. Our target is to significantly improve the capital employed in Segment-I in FY13. I do not give any indication of that as against this. I think we had talked about it in my conference call. I had mentioned that in the end of the year we have brought down our projects, capital employed to about 350 Crore. We are looking to knock another 50 to 75 Crore of that in FY13 in spite of increase in the revenue in that segment.

Mithun Soni That will be driven by getting more current liabilities in hand or it could be more improvements in inventory and the debtors' part?

Vir Advani Obviously we cannot push our liabilities any further. We do not want to, because the bulk of our liabilities are with small vendors. The real driver of this on one side is how you manage your contracts more tightly, but also just keep in mind that from Q3 FY12 onwards, we have changed our commercial terms on which we accept projects. So, our terms of payment have improved significantly of what we were accepting in the two years prior to that. So just the terms of payment that we are getting on delivery and on installation of our projects is good 5% to 10% higher than what we were getting a year ago. So that automatically translates into a better cash flow. Over and above that, managing our contracts more carefully, cautiously and being sensible about how you deliver material at the right

time rather than delivering it before funds are available, is the way we manage the business and the capital employed much more tightly and as a team we are very determined to do that and we are confident that we can even at these levels of 50 Crore to 75 Crore below current levels. With the volume of business we are looking at, it is still nowhere close to historical levels of capital turns that we want. So, we are taking a relatively sensible approach to this thing in FY13. We will take a certain capital turn target but in FY14 we want to return to historical 5 turns plus and that is when you see the business on a long-term basis being sustainable again. So, I understand all investors are questioning right now, the viability of this business as it is run right now, but with all the steps we have taken in the last six to eight months we will begin to demonstrate by Q3, Q4 this year that business is in fact profitable, can be grown and that we should be investing more in it because we believe on a long-term basis being a leading MEP contractor at the terms and conditions that we want to work with, it will be a very exciting viable business.

Mithun Soni So one question on the Airconditioning segment, particularly, Room Airconditioners. Competitive intensity is just increasing and the products are available at a price gap of Rs. 500 here and there with huge amount of discounts and it is not that the market is growing. So how are we positioning ourselves and even though we may say we are not targeting the market share we would like to protect some amount of margins. But we see that competition, particularly from the Japanese side is getting more aggressive in terms of the pricing. So if you can just give a color as to what is our long-term idea over there and how do we position ourselves versus this full gamut of competition?

B. Thiagarajan It is a good and valid question. Our Room Airconditioners strategy is not built on market share right from the beginning. That is, we will not mind being a No. 5 or a No. 6 player in the country. Two, it is not fully founded on a residential segment alone. A significant part of our business comes from light commercial and commercial segments as well. Three , indeed last year the market grew, this year it maybe flat or may degrow. But the long-term potential for this particular business is huge. To give you the comparison in

relation to the current market size of India at 3.2 million, China is around 45 million units. In how many years we will reach that figure is the question? Normally, in any category you take Refrigerators or you take Automobiles, you take Washing Machines, there is a ten-year gap. In other words, whatever the markets in China in 2002 would have been the market size now in India. Even by that standard, we are less than half the market size what it should have been. So, there is an exponential growth in the offing and the very reason, the competition appears to have over intensified at this point of time is in anticipation of that. All want to be here and that is the reason. Once the growth revives, I do not see the difference. There is enough room for 10 to 12 players. Our own results show that we are one of the preferred brands and there maybe 15 players in the market but we are compared just with three or four players. Even the recent research shows that we are compared only with the top three players. We believe as we demonstrated last year, we will either outgrow the market or we will be in line with the market growth. The April figure shows that the market degrew more than what we did. In May it should be a growth for most of the players that is what I see. So at least in the immediate short-term I see the prospects for this business to be good and we do not have to make at least for next three years of a time any significant investment in the manufacturing capacity. We have an adequate capacity, we have expanded our product development function, we have made substantial investments last year, we are making now and it will be easy for us to compete there. Lastly, this particular business is not about any fundamental research or something like that. It is manufacturing and is more of an assembly than an integrated manufacturing.

Mithun Soni It is an assembly line, the capital required for this business is very low and I think the production is like 100 Crore with some 10-15 Crore of CAPEX if I am not wrong. Everyone has set up the capacity. So, it is not the capacity which is a constraint, it is, as you said, Blue Star does have a brand recognition in the market but will the customers pay a little higher price or you will have to pay the same price at what the next best competitor is giving?

B. Thiagarajan No, we are priced higher than most of the players. The top three players and our price maybe the same. This is not a very new story in the Indian market at all. You take Automobiles or Refrigerators. So that is what it is. It is not only the brand recognition, it is also the distribution reach and the credentials you have built over long years to have many repeat customers. Even today, in the Room Airconditioners business around 25% of our business comes as repeat business.

Moderator Thank you. Ladies and gentlemen, that was the last question. I would now like to hand the floor back to Mr. Vir Advani for closing comments.

Vir Advani Thank you everyone for taking our call. If we have not been able to answer any questions or you were not able to ask questions in time, please do reach out to us on e-mail and we will be happy to answer. We are all available to meet in person as well, as required in the coming weeks. We look forward to our Q1 conference call and hope you all attend it.

Moderator Thank you. On behalf of Blue Star India Limited that concludes this conference call.