Conference Call transcript

9 August 2017

ORIENTAL WEAVERS CARPETS

Operator
Good day ladies and gentlemen and welcome to the Oriental Weavers first half 2017 financial results conference. All participants will be in listen-only mode and there will be an opportunity to ask questions later during the conference. If you should need assistance during the call please signal an operator by pressing star and then zero. Please note that this call is being recorded. I would now like to turn the conference over to Mohamed Zein from RenCap. Please go ahead sir.

Mohamed Zein
Thank you Irene. Good morning, good afternoon and good evening everybody. My name is Mohamed Zein. On behalf of Renaissance Capital I would like to welcome you all to the Oriental Weavers first half 2017 results conference call. We are delighted to have with us today Farida Khamis, Vice President for Corporate Finance from the company who will introduce the rest of the team and go through the company's presentation. Farida, please go ahead.

Farida Khamis
Thank you. Hello everyone and thank you for your continued interest in Oriental Weavers and welcome to our quarterly investor conference call. Today we will be providing you with an update on the Q2 results 2017 and provide guidance for year end. On this call we have Ingy, our IR Director, and Jonathan, President of Oriental Weavers USA. We also have Amin who is the Deputy Export Director OW Egypt. We also have Yahir [?], IKEA account manager OW Egypt. We have Madani, our group CFO, Radwa, our group Treasurer, and Shehta, our group Financial Controller.

Oriental Weavers continued to record strong results in second quarter 2017 with revenues and EBITDA figures increasing by more than 50% compared to Q2 2016. This is a result of a gradual recovery in exports in value terms while our response to the EGP floatation and diverse product range helped maintain our strong position in the local market and overcome still market demand. With 15% local currency debt on hand Oriental Weavers plans to gradually settle its EGP debt facilities to avoid the high finance charges while maintaining a naturally hedged position on the balance sheet. OW has also signed forward contracts in March to send the excess Dollar proceeds and the resulting FX gains from these contracts to offset the high finance charges in the EGP debt facilities.

As for our outlook for 2017 it still remains positive. We continue to attract new clients, pursue new opportunities and expand traditional and online sales. As for our capex plans we have already added three looms during the first half of this year and we plan to add another four looms in the second half. This will bring our total capex figure for 2017 to €12 million. As for our year-end guidance we still maintain our top line guidance estimate for around EGP 10 billion to EGP 11 billion and earnings to reach close to EGP 800 million. We are open for Q&A if you would like to go ahead.

Operator

If anyone would like to ask a question please press star and then one on your touchphone phone. If you wish to withdraw the question please press star and then two to remove yourself from the queue. If anyone would like to ask a question please press star and then one. We have a question from Nadar Biman [?] of EFD.

Nadar Biman [?]
Good afternoon ladies. Thank you for taking the time to have this call. I just have a question regarding the exports really. It seems as though production was a little bit more delayed than usual during the quarter, so I was wondering if there was any issues on that front.

Farida Khamis
For the exports we have collected in the first half almost EGP 60 million and we expect to collect around the same figure in the second half. So we should end the year with almost 120 million. The backlog that we have is close to EGP 160 million for the delayed disbursement from the fund. So this didn't take into account the impact of the floatation. So it was based on an exchange rate of EGP 8.80. So I believe if we factor in the higher Dollar exchange rate this figure could double. But so far we haven't tackled how the export subsidy fund will deal with the export rebate post the [unclear].

Nadar Biman
Okay. I understand. Thank you very much.

Operator
If anyone would like to ask a question please press star and then one on your touchtone phone.

Mohamed Zein
I would like to ask a question please on your views on consumption in Egypt. What are you seeing specifically in the retail showrooms, in your showrooms? Is footfall declining, the ticket sizes are declining, stable year on year and quarter on quarter please?

Farida Khamis
Currently we have seen a slight uptick in demand from the third to the second quarter of this year. Still there is demand for grade A and B, but for grade C we have seen a shift from grade C products of Oriental Weavers to much lower price points. So we still maintain our guidance that this year will be a price growth for the local market whereas we expect volumes to remain within the range of 8% to 10% lower compared to last year. So far we opened five showrooms and we expect to open three in the second half of this year. [Overtalking]. We have seen more than 100% growth in our hospitality business in the local market and we expect this trend to continue. We have sold several products in the new administrative capital. And given that tourism has started to rebound again we expect to refurbish some of the hotels in Hurghada and Sharm el-Sheikh and [unclear].

Mohamed Zein
Thanks. Can you remind us how much wholesale and direct retail represent of domestic sales, wholesale versus direct sales?

Farida Khamis
It is almost 50/50.

Mohamed Zein
Okay. 50/50. In light of the interest rates do you foresee any further price increases?

Farida Khamis
All the estimates that the Egyptian Pound will appreciate, I believe as the Egyptian Pound increases to around EGP 16.25 to the Dollar then I expect that we are going to revisit our pricing in the local market.

Mohamed Zein
As in reduce pricing?

Farida Khamis
Yes.

Mohamed Zein
Okay, thanks. Sorry, just a follow-up question here. Now that liquidity is back in the banking system do you see imports increasing again, imports of carpets, competition from China and Asia in general?

Farida Khamis
We have seen slight penetration from Jordan and from Saudi Arabia, but overall I believe competition from Turkey is declining in the local market given that it is mostly produced at workshops. So it is difficult for them to comply with the procedures that the central bank asks for. Like they have to hand in their commercial register i.e. they have to comply with the ISO quality controls. That is why I believe this is something difficult for them to comply with at least for the time being.

Mohamed Zein
Okay thanks. I see no further questions in the queue, so can I ask a couple more questions? I saw that the blended price in Dollars in the second quarter was almost unchanged from Q1. Do you expect it to be pressured in the second half if you're expecting higher volume? So should we expect a fall in the blended price in Dollars?

Farida Khamis
No, we do not expect any pressure in pricing in the second half. I think maybe Jonathan can comment about the US market in general and then we can have Amin and Yehia discussing exports from Egypt just to give you a better idea in relation to your question. Jonathan, would you like to go ahead with the outlook on how the markets are in the US?

Jonathan Witt
Sure. Sure. The market in the US there's a lot of excellent macroeconomic data out there. I think if anybody has been watching some of the local stories at the retail level it has been a bit of a struggle here in the United States. Normally if the stock market is up, unemployment is down, housing stocks are up etc. any combination of two of those factors should lead to a real gain in retail sales. It seems like the footfall store traffic is down substantially for most retailers. And that's across a lot of channels, whether it is national mass merchants and home centres all the way down to your independent shops. So as we've been through the market in trade shows over the last quarter it has been interesting to speak with our customers because no one can exactly put their thumb on exactly what is going on.

I think there are a lot of unknowns in the consumer mind right now. There is really a lack of action taking place in the political side of things which leaves a lot of unknowns for people. As loud and boisterous as things are really when it comes down to policy and finalising decisions there hasn't been a lot accomplished. So between that and also people that have had a little extra money have been able to go out this summer and spend a lot more time vacationing with their family. I see the economy has seen gains there comparatively compared to previous years. And now we are coming back into that fall season where kids go back to school and we traditionally see a nice pick-up in sales. And regardless of those challenges in foot traffic in the stores two things that we have heard repeatedly. Number one, that Oriental Weavers here in the States, our business with those key retailers has continued to grow and outpace their growth in the category. So we are taking market share. And then we also have some nice commitments for some of the seasonal promotions at year end which will be going out really in Q4. So we still expect to see growth going into the back side of the year over 2016.

Farida Khamis
Thank you.

Mohamed Zein
Thanks. Irene, I think we have a question in the queue.

Operator
We do, we have a question from Seki Mutukwa of Ashmore.

Seki Mutukwa
Hi there. Thank you very much. I just wanted to ask about your total cost expectations in your budget for 2017 when you give guidance and how that is tracking relative to your expectations and maybe where you're seeing a little bit more pressure or where things are tracking better than you anticipated on the cost side. Thanks.

Ingy El Diwany
We expect from the cost side slight pressure resulting from the higher energy costs and resulting from the new fees which are implemented starting July this year according to the new investment law. Any sales from the free zone entities to the local market are going to be subject to an additional 1% rate. So this should create a slight pressure on our cost side. But overall this year we expect margins to be within the range of 16% to 17%. This is the EBITDA margin estimate for 2017. For polypropylene prices they have been up by almost 10% compared to last year and we expect by year end prices to reach $1,100. But still nevertheless currently we are adding new looms and these looms are more cost efficient. They should reduce our energy consumption somehow, so this should offset the higher energy cost. But the impact of course will be clear next year.

Seki Mutukwa
And it's too soon to see whether you think even with these additional fees that you mentioned 2018 could be lower than where we are today in terms of profitability? I think you mentioned that the new equipment means that might completely offset those costs.

Ingy El Diwany
Yes, and of course this all depends on polypropylene prices next year. But in general next year we expect earnings to grow by almost 10% compared to 2017. And on the top line side we expect almost 10% of top line growth. So as we are moving towards more efficient looms and more cost rationalisation from the [unclear] and more cost controls that should all offset the impact of the new fees.

Seki Mutukwa
Thank you.

Farida Khamis
[Inaudible segment] in the export market and pick up with IKEA generally. Again that should attribute to the earnings growth that Ingy had referred to. And Amin and Yehia will give us an overview.

Amin
For the markets Jonathan mentioned for the US market. We already made some growth in Asia, Africa and southern Europe. And this reflects on the numbers for Q3. And we are expecting more orders that will be reflected on Q4. Also we are working on a lot of developments because this is where we start for the second half of the year market with the development and market visits. Also Africa we have a good increase during the first half of this year and expecting more as we have during this month a lot of visits for orders for the fourth quarter of 2017 and first quarter of 2018. And for IKEA Yehia could add.

Yehia
The first two quarters [unclear] compared to the previous year by about 20%. By the end of June, by the second half of June, we succeeded to fulfil our export shipping. It is a new development that has been prepared in the first two quarters. And to reduce this deficit from 23% to 11%. And we do expect that the second half will be much more. So we can reach the end of this year by the second half with 20% more than the first half. And expecting in 2018 about 45% then [unclear]. So it is totally promising with IKEA. We started already to come back again with them. And especially we are now classified as a prioritised supplier for IKEA.

Operator
Our next question is from Aatman Ajmera of East Capital.

Aatman Ajmera
Hi. Thanks for taking my question. I just wanted to clarify the export rebate again. The rebates that we see on the P&L right now are they from the exports in previous years or is it for exports of last quarter? What is the time lag is what I want to understand.

Farida Khamis
The lag is almost a year now. So the EGP 60 million that you saw on the income statement is related to the first and second quarters of 2016.

Aatman Ajmera
Understood. And are you matching the criteria for additional incentives? I mean you exported to new markets now, so do you see any additional rebate in excess of the primary incentive?

Farida Khamis
This programme will be implemented as of July 2016 which we haven't still collected yet. I believe once they start to pay the rebates starting July the incentives will be factored in.

Aatman Ajmera
Understood. Are you matching the criteria? I'm not too clear on what the exact criteria are. Are you matching the criteria for additional rebates?

Farida Khamis
We are matching all the criteria. We have raised our exports to Africa, and exports to Africa are going to be subject to an additional 50% export rebate rate. And we are going to pay 50% of the freight costs. We are increasing our exports to Russia and Eastern Europe and this should be subject to an additional 2% rebate rate.

Aatman Ajmera
Understood. And do you have some sort of budget on what you expect in cash terms for this year's exports for next year? What sort of cash do you expect in rebate terms?

Farida Khamis
This year we expect to collect EGP 120 million.

Aatman Ajmera
But that is for last year's exports, right? I mean for this year's exports what cash will you be collecting next year?

Farida Khamis
Ah, for this year's exports. It is still subject to the exchange rate that the fund will use to calculate the export rebates. So if they are going to use the same exchange rate, which I doubt, of around EGP 8 then in this case we will collect around EGP 160 million. If they are going to factor in the impact of the flotation this figure should double.

Aatman Ajmera
Understood. And my last question actually is not related to the earnings specifically. I want to understand fundamentally is carpet manufacturing a very capital intensive business? We have seen that even with growth your ROEs at 11% or 12%. Is this because of underutilisation of the assets or is it primarily that this business itself is capital intensive and this is just how it is?

Farida Khamis
Part of the answer is yes, it's because of the capital intensity or the high fixed assets that we have on the balance sheet. And the other part is related to competition in the industry because there is a slight oversupply in the market and it's a competitive industry. So I believe there is so much pressure on pricing. But we manage by introducing new products to sell more high-profit-margin products. So we are trying to work around this to raise our ROEs and return on investment.

Aatman Ajmera
Understood. Thanks, that's all from my side actually.

Operator
Just a reminder, if anyone would like to ask a question please press star and then one.

Mohamed Zein
If there are no questions I would like to ask two more please, one a follow-up on the export rebate discussion. As you know we now are officially in the government's new fiscal year. So when do you exactly expect the discussion on the exchange rate embedded in the calculation of the export rebate to end? When do you expect a decision? That's my first question. My second question is on your market shares, direct and indirect in the US and in your key markets in Europe. How have they developed year on year now?

Farida Khamis
For the export rebate the current budget which was announced two days ago I think they are factoring in an export subsidy of around EGP 2.6 billion which is the same figure as last year. As for the discussion I don't know when they are going to discuss this issue. But I think very soon once they start paying on exports starting November. So it can give them like two more months and then the decision will be clear.

Amin [?]

By any means we record the revenue on collection. So we are very conservative in this topic. And once collected, last November and December have been collected we will see which rates they are using. But we will not recognise revenue unless it is collected.

Mohamed Zein
Very clear. Thank you. And on market shares please in Europe and the US?

Farida Khamis
Jonathan, would you like to answer the US? Jonathan?

Jonathan Witt
Hello. Sorry, can you hear me?

Farida Khamis
They were asking the market share in the US.

Jonathan Witt
Yes, I think the last three years we've had substantial growth year over year. Looking at 2017 versus 2016 as it stands we are slightly positive compared to last year. But again as I mentioned earlier the foot traffic in the stores especially has been soft through the second quarter and continuing into part of the summer. And everything that we're hearing is that our performance with our key partners is outpacing their other sales in the category, which means we are continuing to take share even though it's harder to comp the overall number at the higher percentage rate. So through an interesting time in the States we are doing well, and again looking forward to Q4 and the promotions and the new programmes we have coming out. We still feel that we will be able to show positive growth year over year again.

Mohamed Zein
Thanks. And on Europe please, in Europe?

Farida Khamis
Amin will respond.

Amin
For Europe on the other hand I want to add what Jonathan mentioned for the US market because we have a direct shipping from Egypt. We add like two or three online companies that increased their volume of business comparing with last year. And this will reflect by end of this year because we developed like two or three products that they sell online and this will reflect. And this will increase our market share definitely. And for Europe we don't have a great increase comparing with last year. It is between 3% and 5%. And by the beginning of this year we increased our sales in France for example which we were not existing in the past year. And we are working on a few developments that could be seen by the fourth quarter of this year. On the other hand we make a contact with another two marketing companies that can allow us to get more market share in some European countries like the Netherlands, like Switzerland. In these countries because it is a border country or it could be reached by road from the Belgian and Turkish manufacturers this will allow us to be more into the market. Plus we are planning for a [unclear] to be in Europe by next year.

Mohamed Zein
That's clear. Thank you very much. Irene, do we have more questions?

Operator
It seems we have no further questions on the line, sir.

Mohamed Zein
Okay. Farida, would you like to conclude?

Farida Khamis
We just wanted to add a fact about another market. Ingy, go ahead about the Japanese market.

Ingy El Diwany
We have seen strong development in Japan through Nitori. Nitori is a retail chain with almost 450 stores in Japan, China and Taiwan. But there are 360 stores in Japan. And our exports to Nitori almost tripled this year in 2017 compared to 2016. So we are expecting strong growth potential to come from Japan. They have a target to double the number of stores by 2020. So this should be a further growth postnatal with this customer. Radwa, our group Treasurer would also like to add something.

Radwa Kamel
Maybe it's a little bit too early to mention it, but there is a new programme offered by the EBID [?] that allows companies to redeem 10% of the value of their machines in case they replace old machinery that consumes more energy. The criteria has to be that the new machine consumes 20% less energy compared to the old machine. In this case we redeem 10% of the value of the machine. The borrowing costs will be slightly higher compared to our regulator borrowing cost for long-term debt. It would be around 5% compared to usually 4%.

Mohamed Zein
Thank you. Just a final question on the Japan partner. Do you expect this to become another IKEA, as in the size of IKEA within five years?

Ingy El Diwany
The size of the business is $3 million so it is still a very minor contribution to our total sales.

Mohamed Zein
Okay, thank you very much. Thank you for joining the call with us today.

Farida Khamis
Thank you, and thank you for your continued support.

Mohamed Zein
Thanks a lot.

Operator
Ladies and gentlemen, that concludes today's conference. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT