"Sterling Tools Limited
Q3 FY23 Earnings Conference Call"
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Moderator: Ladies and gentlemen, good day, and welcome to the Sterling Tools Limited Q3 FY23 Earnings Conference Call. This conference call may contain forward-looking statements about the company, which are based on the beliefs, opinions and expectations of the company as on date of this call. These statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict.

As a reminder, all participant lines will be in the listen-only mode, and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' and then '0' your touchtone phone. Please note that this conference is being recorded.

We have with us today, Mr. Atul Aggarwal, Whole Time Director; Mr. Jaideep Wadhwa, Director; Mr. Pankaj Gupta, Chief Financial Officer. I now hand the conference over to Mr. Pankaj Gupta, CFO of Sterling Tools Limited. Thank you, and over to you, sir.

Pankaj Gupta: Good morning, everyone. On behalf of Sterling Tools Limited, I extend a warm welcome to our Q3 & 9M FY23 Earnings Call. I'm joined on this call by Mr. Atul Aggarwal, our Whole-time Director; Mr. Jaideep Wadhwa, Director; and SGA, our Investor Relations Advisors. We have uploaded our results presentation on the exchanges, and I hope everyone has had a chance to go through the same.

I will now request Mr. Atul Aggarwal for his opening remarks.

Atul Aggarwal: Good morning, everybody. Welcome to the call this morning. This is, I think, third in the series of the calls we've been doing with you. Once again, a very warm welcome to Sterling tools earnings call, and we hope to see you guys more in physical meetings as we go forward. Well, we've had a good quarter and a good nine months, and I broadly, what I can say is I think we have fourth quarter which is also looking quite optimistic. We have a good momentum in our business, and we believe we are on a path changing operation side and product lines going-forward.

Just to give you a sense, Sterling Tools have four facilities, three in NCR area, one in Bangalore. That business is doing very well. As the numbers say, Pankaj will run through the financials with you. We are up about 33% in revenue. So, despite the challenges and production levels with our customers I think we've been able to grow faster than the industry in that segment. But I want to spend more time on our electronics business on our motor control unit business, which has done extremely well.

We had closed last financial year, since we started operations in last quarter of last financial year, we did about INR 40-odd crores in that business. I think we're looking at a 4x growth in that business for this year. So, we are closing that business at about INR 120 crores for about nine months this year. And the most important fact would be that in the first full year of operations, we already have a positive bottom line. The business is already generating cash in the portfolio of the business.

We manufacture motor control units for electric vehicles and we believe we have a 50% market share in the two-wheeler high-speed scooter segment. We do get done a tremendous job in that. We have the first mover advantage in that business. Our businesses are reasonably localized. Our supply chain is localized. And most importantly, we have a large tech center abilities with two tech centers out of Faridabad and Bangalore.

So, the kind of customization and product optimization we are able to do, we believe we are reasonably ahead of our competition. So, the visibility for growth in this business is very good. I'm just going to give you broad statements out here, we'll also be adding more components in the electric vehicle supply chain, we are currently studying. Jaideep is there on the call. If you have any specific questions, we'll be more than happy to take them on for you.

But broadly, I just want to mention that we've had a good nine months, and we're looking at closing at a good financial year itself also. And hopefully, we will continue this momentum in the years going forward. I'm going to hand over the call to Pankaj to run through some financial numbers in detail with you, and then we'll open the room for questions where Jaideep, I and Pankaj will be happy to take on anything you want us to answer.

Pankaj Gupta: Thank you, sir. So once again, Welcome. The financial highlights for this quarter and for the nine months, we have seen an excellent nine months run for Sterling. And when I speak about financials, I will share both standalone as well as consolidated. Our Standalone revenue grew by 30%, we had INR 151 crores of revenue in this quarter. And the revenue has similarly increased by 33% to INR 445 crores in nine months in the current financial year. So that's 33% growth in the fastener business.

And the increase in volume and our capacity utilization and focus on right from beginning of the year to reach to INR 575 crores - INR 600 crores of turnover, we are aligned to that. So, a good revenue run for nine months and EBITDA margins in this period. We had INR 17 crores of EBITDA last year, Q3 FY23 we have INR 23 crores of EBITDA. In terms of percentages, EBITDA margin is 15.4%. The cumulative EBITDA for the nine months is INR 71 crores, which is again about 32% higher than the previous year. Profit after tax, we had a growth of 52%, INR 10 crores of PAT in Q3, and reported PAT of INR 36 crores in this current year nine months.

The consolidated financials, the revenue increase is about 70%. We have revenue of INR 208 crores in Q3 FY23 and total revenue of INR 560 crores in nine months. The revenue increase is a factor of increase in our MCU sales in this year and also sales in the fasteners business. So, INR 560 crores is the number.

EBITDA, again, has seen an upswing from INR 16.8 crores in Q3 FY22 to INR 28.7 crores in Q3 FY23 and cumulative EBITDA of nine months stood at INR 77 crores, increased from INR 52 crores over last year. Profit after tax has grown by almost 150% to INR 13 crores during Q3, and we reported a PAT of INR 40 crores for nine months.

The EV vertical, our revenue in nine months is INR 119 crores. If we go to the comparable period last year was only INR 7 crores because that was probably the first quarter where we started clocking the revenue. The full year revenue just to have a data point was INR 38 crores last year. So, INR 119 crores in nine months against INR 38 crores for full year of FY22. EV business, a very exciting part, what Atul ji also mentioned, in the very first full year of operations, we have a positive PBT in electric vehicle, MCU business. So, a very exciting time. Thank you very much, and we can open the floor for the question and answer now.

Moderator: We have the first question from the line of Nidhi Babaria from Envision Capital.

Nidhi Babaria: Sir, if you can help me understand what are the gross margins and operating margins in MCU division for nine months and Q3?

Pankaj Gupta: Yes. So MCU business, we are currently at EBITDA margin of about 6%. And that is what nine months average margin is. This is a new business, and we keep a lot of provisions for warranties, etc. And in this business we are adding a lot of customers, a lot of development is going on. So currently, this is the one and we shared our advisory will be about double-digit margin is the target what we have for MCU business.

Jaideep, you want to add to that?

Jaideep Wadhwa: I would just say that it's early stage of the business. We are investing tremendously in the engineering capabilities, etc. And like, Pankaj said, we should go from the mid-single digits that we have right now to the low-double digits in the coming period.

Nidhi Babaria: And what would be the gross margin for the same? Because if I see, the consolidated gross margins have impacted hugely on a Y-o-Y basis, even on Q-o-Q basis. I was trying to understand what all could be the reason for that.

Atul Aggarwal: Jaideep, let me take that. We've got to separate the two businesses. When we talk about margin structures, we've got to separate the two businesses to get a better understanding of consolidation. Sterling is currently operating at about 16% EBITDA margins, operating margins. And Sterling Gtake MCU business is currently at about 6% levels, which we think the 6% level should normalized this year to maybe 7%-8%, and maybe in the very near term, we are looking at anywhere in the range of 8% to 12% EBITDA margins.

Our fasteners business historically has been ranging between 16% and 19%. We are on the lower side, because there were a lot of commodity price increases, and we've been able to get compensation and inflationary pressures, which we have already done a lot of mitigation exercise through price increases and cost cutting internally.

So if you see our EBITDA margins last year, it was around 15% in our fasteners business, it's gone up to 16%. We believe, we have a lot of momentum on the positive side. This number will only improve as we go forward. And having said that, additionally, another factor which impacts the percentages are the mathematical equation. Our raw materials have gone up by almost 40%

in the last two years. Since our steel as a percentage of our selling prices is sub-40%. Our price increases have been in the range of 10%, 12%, 13% only.

So, when you do a numerator, denominator effect, it has an impact of additional 1.5%. So like-to-like comparison from a selling price basis, and a buying price basis, I think we are doing fine. You will see, if you do those numbers, we'll be fine. So if you look at the two businesses independently, both have a different DNA. One, we are doing a traditional automotive component for the last 30-40 years. And despite that, we still generate 16%-17% EBITDA levels on that, which I believe is very healthy, keeping in mind the peer group in the industry.

On the MCU side, it's, like Jaideep said, it's a new business. Supply chains are very new. Customer learning is also new, on top of that, we are investing a lot of money in our engineering capabilities. We have a lot of tech center competencies we have added to that in people, etc. Currently, we are at 6%. We'll probably go to 8% to 12% in times to come. But if you consolidate the two, obviously, the weighted average margins kick-in. But I think you've got to assess both independently. And when I say that what you also got to keep in mind, the return on capital employed in our MCU business is substantially high. We are looking at north of 30%, maybe at timed up to 40% levels, which in our fasteners business at about 20%-odd. So both are different DNAs, different animals altogether.

And I think they need to be assessed in separation. Yes, on a consolidated basis, I think we are at about 13%-14% level right now, 14% levels. That should only get better as we go forward, close to 15%. But yes, just to give you a sense of the numbers independently for both the businesses.

Nidhi Babaria: So sir, if you can give me some color or some very rough numbers on gross margin for MCU business, because I understand that is surely dragging our overall EBITDA margin. But like are these gross margins going to sustain or can we see more impact going ahead as in MCU business increases from here?

Pankaj Gupta: So normally, what we analyze across, as I said, 40% approximately is the material cost. We have about another 25%...

Atul Aggarwal: She wanted to know about MCU business…

Pankaj Gupta: MCU business, again, it's a very -- as we said, it's a working capital-intensive business with a very low capex and material cost…

Atul Aggarwal: I think Pankaj, the question is on the GM. So let me address this way.

Pankaj Gupta: Should I take that?

Atul Aggarwal: Jaideep take that please?

Jaideep Wadhwa: So, to answer your question, our gross margins will be in the 20s in the MCU business. As supply chain issues ease out, we hope to be able to increase that.

Atul Aggarwal: Probably go to more close to about 24% over time to come.

Jaideep Wadhwa: Yes. So I mean, I can't give you exact prediction, because right now, the supply chain, the electronic supply chain is so difficult to predict. But I mean, it could be better than that, but we are in the 20s. And as the situation eases out, as we stabilize on long-term contracts with some of our suppliers, we hope to be able to improve that further.

Nidhi Babaria: And sir, on other expenses side, as other expenses as percentage to sales has gone down significantly from 34% last quarter to 27%. And even on absolute basis, we have reduced our other expenses. If you can help me to understand, which line item has moved or what exactly the other expenses is hitting, right now?

Pankaj Gupta: You're talking of consol or standalone ma'am?

Nidhi Babaria: Consol. In last quarter, we had seen ~INR 61 crores of other expense. Right now, we are at ~INR 56 crores and as percentage to this surely our topline would have been significantly higher. But like, do we expect that this other expense is going to sustain or any changes in any of the line items?

Pankaj Gupta: So we took a note of this point. We'll come back to you on this, because other expenses is largely fixed cost. And as the turnover increases, this probably as a percentage will come down. So we'll come back to you on this later.

Moderator: We have the next question from the line of Tushar Sarda from Athena Investment.

Tushar Sarda: I wanted a little more color on the MCU business. How big is the opportunity size? What is your supply per vehicle? And what is your market share, because it's new, just from an understanding point of view, can you explain on this?

Jaideep Wadhwa: So first of all, I think the size of the opportunity is huge. I mean, I can't give you an exact number because every report that we read gives us a slightly different and usually higher output. I mean there was a higher number. I mean, there was a report recently that said that by 2030, we could have more than 30% penetration in the two-wheeler segment for electrification. 30% electric and if you assume that, that business is close to 30 million units. You're talking about 10 million units being electrified.

And that even taking a weighted average between high-speed scooters, low-speed scooters, you're talking about INR 8,000 in MCU. So you're talking about a very significant market. And I'm just talking about (Inaudible) then, of course, there's a three-wheeler market where you could see 70%-80% penetration and the LCV market, again has a similar projection.

About 30% penetration, would mean 10 million vehicles and even with a weighted average of, say, INR 8,000 per MCU. That's a very significant market. In the LCV and three-wheeler spaces, you could see upward of 70%-80% penetration because these are very appropriate for electrification. So the market itself is very large.

The second question was what is our pack price for MCUs. It ranges from at the bottom end of about INR 3,000-INR 3,500 from the absolute low-cost scooter where we don't do very much, but we do have a product to about INR 12,000 for three-wheelers. The weighted average sits somewhere around INR 10,000. So it's a significant amount of the total vehicle price.

In terms of our market share, we have close to 50% market share in the high-speed scooter market. And we have about 30% market share in the overall electric scooter market. So very healthy market shares there. The three-wheeler market, I'm not able to give you an exact number, but because there are a lot of moving pieces there in terms of the way the e-rickshaws numbers are reported. But again, I would estimate that we would be in the 20s or 20% to 30% kind of number.

Atul Aggarwal: If I can add on top of that, just to give you a flavor of the potential size, depending on the penetration, assuming the current size of the two-wheeler market is at 15 million and currently, that's the biggest segment for electrification right now, plus public transport buses and then you've got passenger vehicles coming in, commercial vehicles kicking in. But let's just talk about the two-wheeler market at a 15 million level currently. Let's look at a very wide scenario where all 15 million become electric and an INR 8,000-unit price on an average, you're looking at roughly, I think about INR 12,000 crores market sizes for this product line itself. I'm not saying we'll maintain 50% market share.

Obviously, the market shares will fall for us eventually. But one can do back of the envelope calculations, even at a 10%, 20% market share what that means for our business going forward. So looking at the revenue, each of us can do our own homework on it, but we have some very optimistic numbers for our business going forward, keeping in mind the total addressable market. Idea was to just give you a flavor as to where we are.

Moderator: We have the next question from the line of Deepan Shankar from Trustline PMS.

Deepan Shankar: Congratulations for a good set of numbers. So firstly, on the two-wheeler MCU side, so have we started supplying MCUs for our second and third customer? And how has been the ramp-up there?

Jaideep Wadhwa: We are now currently at 14 customers who are in production with us at different stages. The ramp-up is being slightly slower than we would have liked because of the change in battery regulations that the government push forward. So a lot of the companies had to rework their BMS and battery strategies and technologies, which has caused delays. And as you're probably aware the waiting period to get certification done for a battery pack today's months right now.

So because everyone who is not in production has to get recertified on this or get certified as per the new standards. So the ramp-up has not been as we would expect, but we have been engineered into the design of several vehicles and supplies have started. They're in the thousands right now. They're not in the tens of thousands, but we hope to get to the tens of thousands in some of them within the next few months.

Deepan Shankar: And any updates on the production supply for our electric three-wheeler, motorcycle and LCV customers? And when do we expect the full ramp-up happening there?

Jaideep Wadhwa: So three-wheelers, like I mentioned, sorry, I'm just wanted to do a couple of counts as we speak one. So on three-wheelers, we are at least three or four different platforms which are selling in numbers. Some of the exact three-wheeler data, like I said, it's difficult, the three-wheeler data in exact market share is a little difficult for us to estimate because of the fact that we get confused with or we get confusing numbers along with the e-rickshaw market. We are also in production with a couple of LCVs and even with farm equipment. So across the board, we've got representation in across all the categories, two-wheelers, motorcycles, three-wheelers, LCVs and farm equipment.

Deepan Shankar: And lastly, from my side, so at the current EV run rate, so we'll be almost fully utilizing this 3-lakh capacity. So when will be our next expansion of this 5-lakh capacity getting commissioned. And any plan for further expansion?

Jaideep Wadhwa: So the construction is getting kicked off within the month of February. Equipment has already been ordered and some of it has been shipped. And we are actively evaluating if we need a second facility or not, I can't give you an answer on that right now, but we are actually having those internal discussions at this stage.

Deepan Shankar: So the 5-lakh capacity, when it will get commissioned sir, fully?

Jaideep Wadhwa: I think by in the first quarter of the next fiscal or the second quarter of this calendar year.

Atul Aggarwal: So we'll be ready by June, July this year.

Jaideep Wadhwa: Yes. June, July this year will be fully ramped-up, but we will have some increases coming up even before that because we are de-bottlenecking certain operations to maximize the output from the current facility.

Atul Aggarwal: Yes. So I think in net-net June, July, we'll be ready with the 5-lakh capacity.

Moderator: We have the next question from the line of Nikhil from SIMPL.

Nikhil: I have just two questions. One is on the fasteners business. Sir, you mentioned during the discussion that the gross margin was impacted because of the RM costs being higher. Now if you look at it, that is true on a Y-o-Y basis, but if you look at it on a Q-o-Q basis, last quarter our gross margin was around 60% and this quarter, it came to 57%. So is there a product mix difference which also impacts or what has happened that on a Q-o-Q basis, the margins have dropped?

Atul Aggarwal: I will not worry about quarter-to-quarter numbers, primarily being that we carry a large amount of inventory. So it's just an accounting issue, if you bought, if you had a lot of steel you're carrying in your system or work in progress, we just bought at the higher peak levels of steel, then you carry that for a quarter till it's liquidated. So it's more of an accounting issue. When I would assess this, I would look at it on a minimum half yearly or on an annual year annual basis. Quarter-to-quarter will not give you the right picture. And that's what we like to do in our business when we run this analysis. So we're not really worried on that.

Nikhil: Because the steel prices has corrected. So we were expecting that in this quarter, our gross margin should sustain.

Atul Aggarwal: That's what I'm saying. So you will find it's all balancing not by 31st of March, these all numbers will be annualized, and we get a sense of what the annual numbers look like, which are healthier than what we had last year.

Nikhil: And secondly, you mentioned that on the motor control unit business, we are carrying some warranty provisions and all, is it a large number in terms of these warranty provisions? What kind of warranties or what kind of a product issues can come up?

Atul Aggarwal: So let me address the financial part for you first, which is yes, we have warranties out and what the numbers what we are showing you 6% are post those provisions, we are providing certain percentages for potential warranty costs proactively on a M-o-M and a Q-o-Q and Y-o-Y basis. So what numbers, what you see of operating margins are post those provisions. So we are following a conservative accounting policy and conservative operating posture on this whole thing.

I think, we have given three-year warranties to our customers for our product lines. And from the data, what we have till now for about 12 months operations, those warranty numbers do not seem to concern us at all. They are minimal against the provisions we have already taken in our P&L. So we are on top of that. And the provisions are more conservative, keeping our philosophy of giving conservative outlook to our customers and our investors.

Moderator: We have the next question from the line of Sandeep Dixit from Arjav Partners.

Sandeep Dixit: Just wanted to understand a little bit on the MCU business. What's the total capital we have deployed in it so far? And what is the break-even for it? And also, what is the asset turn likely?

Atul Aggarwal: We have invested INR 28 crores in that business. Sterling has invested INR 28 crores in that business. On a breakeven level, like you see at INR 120 crores, we are already making money. So I think we don't look at breakeven level, we are still in the growth phase, customer acquisition phase. A lot of investment going into tech, into people, into systems, etc. Its early days to talk about breakeven. We are more interested to grow the business, acquire customers and strengthen our technology base. That's our vision for now. In terms of cost optimization, we always have an eye on that, but that's not our primary focus. Primary focus is we want to do customer acquisition and customer servicing and tech building.

Sandeep Dixit: And the asset turn, what are your stable, steady-state asset turn like in this?

Atul Aggarwal: I don't have the exact number with me right now. We'll come back to you on that.

Sandeep Dixit: On the four-wheeler side, the government seems to be pushing the hydrogen technology rather than the conventional lithium ion or whatever battery technology. How does that impact us in the MCU business, especially whether CVs and four-wheelers are concerned, it can give me a broad understanding of how I should look at it?

Atul Aggarwal: So the government is pushing, if you see the in major application of hydrogen business is going to be in commercial vehicles, public transport, the hydrogen and fuel for two-wheelers, is not going to be very dramatic. The applicability is very low in that. There's a lot of issues of engineering and supply chain and safety in that. So firstly, its for commercial vehicles, etc. So currently, with the MCU business we are doing is substantially in the two-wheeler, three-wheeler space, just to answer that.

But yes, if we talk about commercial vehicles, etc., if the industry follows the hydrogen route, then products like motor control units and all definitely get impacted, including motors itself because the powertrain changes substantially by using hydrogen as the fuel. So for our MCU business, in the segment we are in, we don't see that as a threat at all right now. And having said that, speaking about hydrogen, we are currently exploring opportunities in the hydrogen space also. As and when we have done some homework and analysis on that, we'll come back to you as to what our strategy on that is.

Jaideep Wadhwa: I mean, I think Atul alluded to this a little bit that if you look at the strategy for Sterling, we are very clear. We want to stick to our core. Our core is the auto components business. The future of the Auto Components business is green fuels and that's where we are heading. So whatever the source of energy is, whether its lithium ion or maybe it's a metal-air or whether it's hydrogen, we are looking at all of those opportunities and trying to understand how we can provide value to our customers. So that's at a strategy level is what I would just like to reinforce what Atul has said.

If you talk specifically about hydrogen, there are two aspects of hydrogen. One is when there's a play to use hydrogen in internal combustion engine. Now this is similar to using CNG that you see today. Now obviously, when you do that, then there are no motor control units or electric motors or anything else. And therefore, that is a different segment.

The second is when there is a fuel cell. And the fuel cell provides electric power, which is then used by an MCU and in electric motor. So we need to kind of be very clear about what segments you're talking about. If it is a fuel cell-based electric vehicle, but it's an electric vehicle, then obviously, MCUs and electric motors and such things will be there and will apply. If it's an internal combustion engine that is running on hydrogen, then that's actually a replacement for, I won't call it a replacement because they may coexist, but that's in the same domain as CNG is today. And there, you won't have the electrification.

So, if you look at the overall growth of electrification, hydrogen does not change that dramatically because that's the segment that I was trying to explain to you the conversion of or the use of hydrogen gas to power and internal combustion engine, that's a very small piece of that and electrification as a whole, the numbers that we talked about in the beginning of the call that INR 70,000 crores is the potential market just for two-wheelers by 2030 at 30% penetration. Those kind of numbers don't change. And then you add to that three-wheelers and the LCVs and the HCVs and so on. So I hope that answer provides more detail to our response there.

Moderator: We have the next question from the line of Vinayak Mohta from Stallion Asset.

Vinayak Mohta: Congrats on a great set of numbers. I wanted to start by asking what is the kind of growth that we can look at going forward, because I can see given the expansion and the kind of scale that we are having on the EV segment, at 25%-30% kind of growth is something that we can expect for the next two year to three years?

Atul Aggarwal: Yes I think that's the number we are also looking and beyond. That's our expectation from the kind of trajectory we have built for ourselves in terms of customer acquisition, products and capacity. So yes, you can look at that.

Vinayak Mohta: And what would be our utilization as of now for the EV capacity on the 3-lakh capacity basis?

Atul Aggarwal: I think we currently are about my sense on a 3-lakh capacity basis, we are at about 65%-70% levels. We have an expansion plan, ways to take it up to 5 lakhs, we should be ready by June-July. Let me just add to that. I think you've got to look at the EV business from a different lens. Capacity expansions are not that dramatic in terms of financial needs or timelines. They are more tech-oriented, they're more about securing supply chains. Those are as critical parameters and just as laying fixed assets on the ground.

So, we're looking at binge by June-July being ready with 0.5 million. And if there's a market uptick, like Jaideep said, we are also currently considering studying the potential of doing another facility in our tech center. And the lead time for that is anywhere from 6-10 months to do that.

Vinayak Mohta: And how do you see your working capital being evolving going forward because they have increased substantially in the last two years. So do you think it will fall back to the 50 days-60 days range or you'll see it remain elevated given the new segment and the customers or they also playing this?

Atul Aggarwal: So, I think you got to again separate the fasteners business and the MCU business. Fasteners business, I think the current cycle time we have will probably get more efficient by about 10 days to 15 days going forward, because we were carrying higher inventory levels, keeping in mind the volatility in the steel industry, but I think that's become more stable. So, we probably rationalize those number of days down by 10%-15%.

In our motor control unit business, its heavily semiconductor based. There's a lot of shortage, so we have commitments out. We have understanding commitments going up to six months' time on certain products of semiconductors. But currently, despite all those commitments, our current supply chains are very tight. The number of days you see are very low right now. We feel that the way we are growing and we want to grow, we'll have to take a more aggressive or increase the number of days of working capital on inventory we carry to meet our targets going forward.

Vinayak Mohta: So is it fair to assume that post this quarter, you'll be basically given like your growth has continued. So, post this quarter, is it fair to assume that you will see margin expansion, your working capital is going lower, which eventually will aid to the RoCEs, and with an additional capacity is coming in, that would further aid to your growth level. So ultimately, it's an improving trajectory on all the fronts from this quarter onwards? Or do you think that there will be a certain amount of margin pressure, given at the new capacity coming in and it would take 0.5 year or so more for things to normalize and then move forward?

Atul Aggarwal: So, I think working capital will not put much pressure on our margin structures at all. Our current finance cost is very minimal anyways. But we don't see working capital putting much pressure on our margin structures at all. Yes, maybe the certain amount of capex going to the MCU business, but that capex is not very high, maybe within a quarter or two, we'll be able to normalize those numbers. So, I don't think we should worry about working capital, putting any pressure on the margin structures.

Vinayak Mohta: And one last question. Any idea on the competitive scenario and what kind of risk do you see on the business from a competitive scenario or any other front that you guys discussed within yourselves as a team?

Atul Aggarwal: So, you want to specify what business are we talking about?

Vinayak Mohta: Both the businesses, but a little more focus on the EV segment because I think that would ideally be the growth driver.

Atul Aggarwal: Yes. So, like we said in the beginning, our current market share is of 50% of high-speed scooter segment. Going forward, the penetration for these vehicles is going to go up dramatically. I don't think we'll be able to retain the 50% market share. Like I said, the potential size of market on 100% conversion to electric is about INR 12,000 crores roughly on a current level of 15 million two-wheeler units. Just an extra sensitivity you need to do. But I personally believe on an optimal basis, in the next three years, our market share may be in the range of 20%. So, keeping in mind all the customers getting active, all the customer acquisitions we have done and all the customers we have in the pipeline. So that's the number we have set for ourselves for market share.

Jaideep Wadhwa: I want to make an apology to the group. I just said a number of INR 70,000 crores, sorry, that should be INR 7,000 crores. So that was a number which we use for the two-wheeler market, which is based on 30% penetration and assuming an overall size of 30 million. So, Atul was talking about current size which is 15%. What I mentioned was 2030 with a projection of about 30 million and 30% penetration will give you MCU market size only for that segment of INR 7,000 crores. And then, of course, you add to that the three wheelers and LCVs and passenger vehicles and everything else.

The other question, Atul had addressed this, but I'd just like to just give you a little bit more operating details on this, that the numbers that we are talking about on capacity are not based on three-shift working. So even now, we are flexing constantly because customers in this segment have varying needs. We are able to add shifts, we are able to debottleneck, as I mentioned, and we are able to exceed, because just to give you a quick number, 3 lakh pieces means 25,000 a month. That's something we can exceed in the month of February if the customers wanted it because we have the ability to do so. So, I just want to give you a little bit of operating flavour on that because it's not three-shift 100% working. That's not how this number has been calculated.

Moderator: We have the next question from the line of Jayesh Gandhi from Harshad Gandhi Securities.

Jayesh Gandhi: So, a couple of questions from me. So, from the earlier caller, can you just help me out in more understanding about the competitive landscape? I mean who else are there other than us who are supplying MCU? And one question is regarding if MCU is like 10% of the cost of electric two-wheeler. Is there a possibility that OEMs go ahead and manufacture it on their own?

Jaideep Wadhwa: So, the ones of the major companies that are currently selling you really have, only Mahle, Hella and Bosch, who make up the balance 50% market share that we were talking about. Many other companies are talking about entering this space. What we have to keep in mind is that launching a product or introducing a product is very different from industrializing the product, having the supply chain in place, having securing electronic components, etc. So, there is a lot of talk and a lot of newspaper article that come out…

Atul Aggarwal: Jaideep, I think we need to give them a flavour of what does an MCU mean. MCU is a hardware design, hardware supply chain and there's a huge software layer on top, which is customized for each customer. I think it's important for the investors to realize that it's not purely a hardware product you put together electronics and put a box together and give. There is a huge software customization which happens, which is a differentiator in the product line itself.

So, it's not as simple as doing industrializing the hardware and shipping it out. There's a lot of tech work which has to be done on software on top. Even in the hardware, there's a lot of design capability, which goes into semiconductor design, etc. So, it's not as simple as doing a traditional auto comp. These are, for lack of a better word, there's a huge amount of technology which goes into it, which is dynamic on a daily basis depending on the feedback you get from the customer for user experience, customer experience, interfaces which keep on changing. Each vehicle has a different user experience. And the user experience is being upgraded by the OEMs for their customers on a regular basis.

So, it's an ongoing work on technology, it's not a standalone onetime product. It's a very dynamic work you've got to keep on doing with existing product lines also with the customer. I think it's important to recognize that, that it's not a pure traditional hardware auto comp.

Jaideep Wadhwa: And I think to just add to what Atul just said, what that software component means because the MCU talks to the battery management system talks, to the vehicle control unit, talks to the instrument cluster, etc.

Atul Aggarwal: While Jaideep logs in again, let me just add to what he was being said. So, your second question was the OEMs themselves wanting to do it. Yes, that's always a threat for anything. Like OEMs could have been tire manufacturers also or could be battery manufacturers in traditional space. But I think whether the OEMs can add the nimbleness and the flexibility and the speed with the way the Tier 1 vendor would. This is a huge software play in that, whether their in-house tech teams can do that or not, or whether they have the nimbleness and the flexibility to do that.

If you look at from a more mature basis, as the industry matures over time, even if the OEMs bring some components in-house, there'll always be a dual sourcing philosophy going forward because, this is a customer use experience product and doing everything in-house is always difficult for this. And I think that if you look at experiences of other OEM companies in India and overseas, in India could be Mahindra Electric and overseas could be Tesla, etc. They all have vendor partners for tech products. Mahindra Electric started with the philosophy of making everything in-house, and they realized that it is not possible to do that because the kind of engineering capability, flexibility and nimbleness you need to do, is not available with the large corporates because of their own structures. So yes, that threat is always there, like competition.

But idea is to stay on top of the game through our technology, through your design, through your quality levels and supply chain robustness to counter that. As long as you were able to do that and offer a good product at a very competitive price, I think it will be very hard for OEMs to ignore that.

Atul Aggarwal: What I was saying was your second question was, is it -- what is the value of MCU? The value of the MCU can very, like I said, from INR 3,000 to couple of lakh of rupees and depending on the value of the -- and you also...

Jayesh Gandhi: Sorry to interrupt, that was not the question actually.

Atul Aggarwal: Okay. Jaideep, other question only addressed in terms of OEM competition coming in.

Jayesh Gandhi: Sir, second question is around the warranty that we have put into contingent liabilities. How do we calculate those contingent liabilities? I mean, is it on x percentage of sales that we put a contingent liability, how do we calculate it?

Atul Aggarwal: Currently, we are on percentage of sales. We have taken, like I said earlier, we are looking at a very conservative number. When I say conservative, it's not a small number. We are taking a number beyond our own estimations because we are still 12 months into the business.

And I think our view is we don't have enough data to say, what may be the relevant number right now. But based on our current estimations, the provisions we have done are higher than that. But as a business, as we age with this business, as and when we have more-and-more units out in the market and we get some data back from that, that will help us crystallize what the relevant numbers may be. But let me assure you, the current provisions we have are more than what our current estimates tell us.

Jayesh Gandhi: You talked about moving towards 14%-15% EBITDA margin even in our MCU business -- what kind of sales do we think should bring us to those levels?

Atul Aggarwal: Let me correct you. We never said that. We said it will be in the range of 8% to 12%.

Jayesh Gandhi: While we are thinking of moving towards 8% to 12% of EBITDA margin in our MCU business. What kind of sales do we think should bring us to those levels?

Atul Aggarwal: I think we'll probably get there in the next year or so. Anywhere from INR 400 crores to INR 600 crores will be at that level.

Moderator: We have the next question from the line of Arjun Gaddam an individual investor.

Arjun Gaddam: You have around 6% EBITDA margin is what you claim in this quarter for the MCU segment. Is this after any contribution we made to your Chinese partner Gtake, or is it without that?

Jaideep Wadhwa: This is net after all expenses, all fees, all payments, everything.

Arjun Gaddam: So do you pay a royalty to the Gtake? How do we need to see this, like you claim that you're going to have an 8%-12% EBITDA margin going forward, so will this consist of the royalty which you pay if you're paying any royalty or what kind?

Jaideep Wadhwa: Obviously, I mean, any royalties that are paid are a part of normal operating costs in our opinion and are not below the line. So what we believe is a sustainable EBITDA. There is a sustainable EBITDA after all payments to our partners for the technology as well as for the other support that you provide us.

Arjun Gaddam: So the EBITDA margin, what you have this quarter is after making the royalty payment to Gtake?

Jaideep Wadhwa: After all costs, yes.

Arjun Gaddam: It also includes the royalty, right? Because you don't have a joint venture with them. Just trying to get more clarity.

Atul Aggarwal: We don't have a joint venture, it's a technical amendment only. And yes, like Jaideep said, it's after all costs, including all fees and payments.

Moderator: We have the next question on the line of Sumit from Finacle Investment Advisors.

Sumit: Can you please share which part of the MCU is localized and which part do we need to import?

Jaideep Wadhwa: All electronic components, active and passive have to be imported because they're not available in India, but the actual assembly of the PCB is done in India. All mechanical components are localized.

Sumit: Sir, can you give the details of what included in mechanical or electronic components?

Jaideep Wadhwa: Very simply, electronic components is IC, MOSFET, etce. And mechanical is all housings, all heat sinks, rubber part, plastic parts, hardware, terminals, connectors, all of that.

Sumit: Can you please share, who are the major suppliers in India?

Jaideep Wadhwa: I don't think that's the appropriate question. That's a company confidential data. Our partners in these are the best Tier 1 companies in India, not only in North India, but we have suppliers across the country who support us in the manufacturing of our product.

Sumit: How much amount of capital expenditure is required for building 5 lakh units?

Jaideep Wadhwa: Right now, we got a capex plan of INR 12 crores for this fiscal year and next year, we're looking at about INR 20 crores.

Sumit: INR 12 crores, only for MCU business?

Jaideep Wadhwa: Yes.

Sumit: And just for confirmation, is the market size of MCU is INR 7,000 crores?

Atul Aggarwal: Jaideep, let me take that. The market size, Sumit, I'm giving the broad numbers and you can calculate the market size there on based on your own assumptions you want to carry. The current two-wheeler market is 15 million which is expected to grow at whatever clip you want to project that.

The current size in '23 is 15 million expected to go to maybe 20 million in the next three years. Whatever penetration you want to take as a percentage of that, the market is saying 50% penetration in the next 3-5 years. If that is true, you're looking at a 10-million-unit two-wheeler market size, and that's only two-wheelers, then you got three-wheelers on top, passenger vehicles, commercial vehicles, etc., on top of that.

So just to give you a flavor of the market size at 10-million-unit level at an average price of INR 8,000, the market size is INR 8,000 crores on a 50% market share for EVs. So INR 8,000 crores is the minimum market size is to go up to like I said INR 16,000 crores also, depending on the penetration we have. And that's only in the two-wheeler segment. And you've got another 0.5 million three-wheelers, which are at a higher ticket price, then you got commercial vehicles, you've got passenger vehicles. So the market size has a extrapolation on that. There's a lot of data out there in the field. There's a lot of report circulating, which I'm sure you have access to, which will give you a total size of the market.

Moderator: We have the next question from the line of Nidhi Babaria from Envision Capital.

Nidhi Babaria: Sir, if you can just help me understand, how do you pass on the steel prices? And what gives us the confidence that our EBITDA margin for fasteners division can go up as high as 17%-18% in near term?

Atul Aggarwal: So Nidhi, a couple of things. Historically, we have operated in the range of 16% to 19%. That gives us one benchmark we like to work with. Based on our quality costs, delivery service, our customer confidence, our product range, we do with different customers and the critical quality of components we do with them. We believe that's the second factor, which we believe we'll get to that again.

Finally, on the steel part of it, it's a negotiation exercise with customers. And based on the history of the last 30 years, we believe that whenever the steel has gone up, we've been able to negotiate compensation with our customers on that and we've been able to get full compensation to address those cost increases. So I think based on the history and what we have done, we believe we'll be able to get back to that again. And which we have shown, it's gone up 15% to 16% and the balance impact is, like I said, a numerator denominator effect. So as and when the time passes, all this will balance out. We are reasonably confident that we'll be able to hit those numbers again very soon.

Nidhi Babaria: So only if the steel prices are moving abruptly in the near term, that would be the only area where we won't be able to maintain the 17%-18% kind of EBITDA margin in FY24-FY25?

Atul Aggarwal: No, firstly, even if the steel prices go up on a worst-case scenario, my sense is it has probably peaked out. There'll be marginal movement of steel upward or downward. But even if the steel on a worst-case scenario goes up by 20%, we are reasonably confident that we'll still be able to move the needle positively on our EBITDA margins because we get full compensation from our customers.

Nidhi Babaria: And sir, on this Gtake JV side, currently, we have done some INR 120 crores of revenues in nine months. What types of revenue sharing are we planning to do with these JV partners for current year, till the time we are not getting the approval?

Atul Aggarwal: Firstly, they are not JV partners. The initial plan was to be a JV partner, but because of FDI regulation, which kicked in a couple of years ago, this enterprise could not be a joint venture. Currently, it is 100% owned by Sterling Tools and that's the way it's going to be. So the relationship has morphed into a technology agreement with them. So there's no revenue sharing happening with that.

Nidhi Babaria: So then what do they get from sharing the technology?

Atul Aggarwal: So I think they're a large part of our supply chain, a lot of the electronics, a lot of the software is coming from them. So we have a combination of that supply chain and also eventually, there's a certain amount of technology, fees/royalty fees they are working with them on.

Nidhi Babaria: Till the time we are finalizing the royalty payment and all those things, how are you going to share the things in this current year?

Atul Aggarwal: So like I said, there's a lot of supply chain activity, which is happening jointly with them. And this is being addressed through that.

Nidhi Babaria: And this one last thing, our total capex for FY23-FY24, which we said that INR 12 crores and INR 20 crores for MCU division. What would be the other is the divisions capex, like the consolidated capex for FY24?

Atul Aggarwal: So the capex for the fasteners business will be in the range of INR 25-odd crores.

Nidhi Babaria: So INR 25 crores for fasteners plus INR 20 crores for MCU, which is INR 45 crores.

Atul Aggarwal: Correct.

Moderator: We have the next question of the line of Tushar Sarda from Athena Investments.

Tushar Sarda: I have just one follow-up. You mentioned that you do this MCU product for three-wheelers also. But when I look at your chart on Page 23, the three-wheeler is only 1% of the segment. So what is the reason for this because I thought EV traction in three-wheelers is very high right now.

Jaideep Wadhwa: There are a couple of reasons for that. One is that some of the programs have been delayed because of the new battery regulations that came in. Secondly, we do sell some of our MCUs through partners. And when we get to a three-wheeler, people use a Motor Control Unit and an e-axle. Now we do sell, so which is on an axle which is together, this is called an e-axle. Now what happens is that some of our sales are to companies that integrate units into an e-axle.

We show that because we don't know they can use that for a two-wheeler product or they can use that for an e-axle, because we just sell it to an integrator who then supplies the electronic powertrain or the electric powertrain to an end customer. So we don't know what the end use is. And therefore, maybe some of the numbers are getting lost in there. I will work with Pankaj and try and get greater clarity on that for our next quarter results and try and ask our sales team to give us a little bit more clarity on the actual end use so that we can clean that data for you a little bit.

Tushar Sarda: And Pankaj, I have one suggestion. I don't know if you'll be able to do it. You report the standalone and consolidated. So if I want the EV business, I actually have to look at excel and the consolidated minus standalone. If you can report P&L separately for EV, it will just become easier for everybody because I think there is a lot of interest on the EV business.

Atul Aggarwal: We'll come back to you on that.

Moderator: We have the next question from the line of Nikhil from SIMPL.

Nikhil: Just one question on the MCU side. As you said, there is a combination of electronic components and mechanical components. When we look at the electronic components, a lot of these chipsets and everything has seen a heavy price increase in last year and now things are coming back. So how does the pricing happen for the products? So because when we would have taken the orders, you would have taken the base pricing of last year. But now when we are giving the orders to the customer, the prices have gone down. So the price variation on the component side, is it borne by the customer?

Jaideep Wadhwa: So I don't know where you're seeing the pricing going down, we haven't seen that as much. When you talk of chipsets, let's talk about just controllers, you have different makes of controllers, you have different end users of controllers. And I'm just talking about controller to use DSP, rather it confuse you. So, the microprocessors have different makes and different end users. For the electric vehicles in these areas, there is absolutely no let-up in supply issues and therefore, pricing is still a concern. And I think one of your colleagues had asked earlier about margins and I had explained that, as things stabilize and ease out a little bit, we do hope to be able to get better margins by negotiating better with the end suppliers.

Now, in terms of what happens with the customers, we can work with customers on pricing. We can go back to them and say, listen here are the supplies that have happened. Here is what we use, and this is what's the price increase is, and we can request them for price increases, or they can come back to us for price reductions. We've not been focusing on that and all we've been focusing on is supply. Because it's been a desperate struggle to secure DSPs and to actually push out the volumes that we wanted to push out. So neither our customers nor we have tried to focus too much if there's been a variation. But in the future, as the industry stabilizes, definitely, there will be price adjustment basis movements on electronic component pricing.

Nikhil: Sir, would it be right to say that as of now, we are bearing that higher cost?

Jaideep Wadhwa: That's what I had said earlier. Please look at the ramp-up that we have done from a pretty much a standing start, we are doing more than 20,000 units a month. What I'm saying is not only have our suppliers increase prices on us. We also have situations where we've gone out and bought material in the spot market and paid double and triple just to be able to meet supplies. So it's not only about a TI or Infineon saying there's a 20% price increase. If they don't give materials, we still have to keep the customers' live and running.

Nikhil: No, I appreciate it and really appreciate the way the company has scaled up. So really, congrats on great achievements. Just one last question, sir, on Gtake. When you said that we are working with them on the royalty arrangement or what kind of an arrangement. So just one clarity, It won't be retrospective, right?

Jaideep Wadhwa: No, not at all. And that's I think another colleague of yours had asked that question, and we had clarified that all our numbers as we report them are after all expenses, because we've had to constantly adapt in our relationships. So it's difficult to give you a specific thing. But at any stage, whatever we report is after all expenses, we have no further liabilities or claims from Gtake on any account.

Nikhil: And last on this contingent liability on the export side, which we report in our balance sheet. So is it a large material number, which is left?

Atul Aggarwal: I'm glad you raise this. I was going to take it on the closing comments. So the contingent liability firstly see is the large number is for an export obligation number. That's the revenue we need to do from export proceeds in terms of selling prices. But in case there is a default on some values on that, the liabilities are a fraction of that amount in terms of a few crores of rupees itself. So it's not the numbers, when you read annual report, they seem very large, but the potential liabilities in terms of penalties and interest are much lower.

Now having said that, we are currently in the process of realigning all these numbers of EPCG obligations. We are working with our relevant government authorities, keeping in mind our momentum on exports, etc. And we hope to bring down this export obligations by a substantial amount within this financial year, working with the relevant government authorities and working out the potential liabilities we need to pay, keeping in mind also the future export potential we have.

So you'll see a lot of clarity coming in the full year call, but I just want to repeat, this is being addressed very closely, and the number is not for a lack of a better word, the potential penalty number is not very material. So I would not worry about it, but I just want to address the flags since you're raising one. I was going to take it up in my closing comments anyways.

Moderator: Thank you. Ladies and Gentlemen that was the last question. I would now like to hand it over to Mr. Atul Aggarwal for closing comments.

Atul Aggarwal: Thank you very much, everybody, for spending time with us this morning. I just want to repeat a couple of things, which I was hoping to do in my closing comments, but as the question came up on EPCG obligations, I want to reassure all the investors that this is being addressed. It's more of an optical issue, but we are still addressing it. The penalty numbers are not material, but having said that, we will address the numbers. We are currently in negotiation with the relevant government authorities to do that. We'll give you more clarity in our full year investor call. But just to reassure you, this is being addressed and the numbers are not very material either.

We have a lot of momentum in our legacy fasteners business. We are up 33% in revenue nine months, and we see last quarter is looking quite good as well. And when I see the next year, there's a lot of momentum in a lot of the segments and probably also because FY24 is going to be more like an election year with election coming up in May of '24, we see that there's going to be a lot of spending across segments coming through.

So there is a momentum of growth in our fasteners business as well also. Putting aside the fasteners business on one side, our vision, like we've been saying in the last three years has been to invest more-and-more into new technologies. We started working on electric vehicle components 3-4 years ago, and we were able to identify our Motor Control Unit business. We will have the first full year of operations this year and as you can see from the numbers, there's a lot of growth in that business this year and the year forward.

The visibility in terms of customer acquisition, product pricing, margin structure, supply chain enhancements, localization and most importantly, the tech capabilities we have built in our facilities, that's giving us a lot of first mover advantage vis-a-vis our competition. And we hope to continue investing to retain, to maintain that particular growth trajectory and also address the market going forward.

Also, we are currently assessing a few more product lines could be onboard chargers or other green technology systems. It's early to talk about on this call right now. There's a lot of homework going on that. But let me assure you that we are working on some exciting stuff going forward. And as in we have some more clarity on some of those products and product lines, we will keep you informed. But our vision going forward is going to be a lot more because of our success in our Motor Control Unit business, our vision going forward is going to be more on electronics, green tech and new technologies in the business lines. So net, we have a lot of momentum. Vision is very clear, and you'll find us coming up with promising results and a promising future. Thank you.

Moderator: Thank you. On behalf of Sterling Tools Limited, that concludes this conference. Thank you for joining us, and you may now disconnect your lines.