CHINA CERAMICS CO., LTD.
3Q 2014 Earnings Call
November 13, 2014
8:00 a.m. ET

Speakers:
Mr. Jaidong Huang, CEO
Mr. Edmund Hen, CFO

Operator: Good morning. My name is Melissa and I will be your conference operator today. At this time, I would like to welcome everyone to the China Ceramics' Third Quarter 2014 Earnings Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Mr. Rudnick, you may now begin your conference.

David Rudnick: Thank you, Melissa. Good morning, ladies and gentlemen, and good evening to those of you who are joining us from China. Welcome to China Ceramics' third quarter 2014 earnings conference call. With us today are China Ceramics' Chairman and Chief Executive Officer, Mr. Jia Dong Huang, and its Chief Financial Officer, Mr. Edmund Hen.

Before I turn the call over to Mr. Huang I remind our listeners that during this call, management's prepared remarks contain forward-looking statements which are subject to risks and uncertainties and management may make additional forward-looking statements in response to your questions. Therefore the company claims protection of the Safe Harbor for forward-looking statements as contained in the Private Securities Litigation Reform Act of 1995. Actual results may differ from those discussed today.

I refer you to more detailed discussion of the risks and uncertainties in the company's filings with the Securities and Exchange Commission. In addition, any projections as the company's future performance represent management's estimates as of today November 13, 2014. China Ceramics assumes no obligation to update these projections in the future as market conditions change.

And now, it's my pleasure to turn the call over to China Ceramic's Chairman and CEO, Mr. Jia Dong Huang, and China Ceramic's CFO, Mr. Edmund Hen. Precept Investor Relations' Sophie Wang will be translating for Mr. Huang. Mr. Huang, you may proceed.

Huang Jia Dong: (Interpreted) Thank you, David. On behalf of the company, I would like to welcome everyone to our third quarter 2014 earnings conference call.

We achieved solid revenue and profitability in the third quarter due to our strong marketing efforts and success in securing new business among China's real estate developers. The quarter's improved profitability with gross profit up 26 percent from year-ago quarter was driven by higher average selling price as we have substantially regained our pricing power from the business retraction that occurred in our sector approximately two years ago. However, the increase in our average selling price negatively impacted our sales volume causing a moderate decline in our top line results.

During the third quarter, we utilized production facilities capable of producing 49 million square meters of ceramic tiles per year out of a total annual production capacity of 72 million square meters. This was a 16 percent increase of our planned utilization in the third quarter. We hope to bring additional capacity online going forward as our business improves.

For the fourth quarter, we look for our customers to continue to adjust to our product prices and also anticipate a seasonal slowdown in the period ahead consistent with the construction building cycle. We believe that our superior brand name recognition, customer-centric focus, and market positioning should enable us to sustain our average selling price increases and continue to build sales volume in the quarters ahead.

Although there may be occasional volatility associated with China's real estate sector in the few years ahead, urbanization and demographic trends offer positive long-term fundamentals as we look to gain market share and further our geographic reach. Government policies promoting urbanization and real estate is vital to continue domestic and economic growth, should help sustain the macroeconomic conditions under which we operate. We continue to be strategically positioned as producer of high end ceramic sales and we will continue to offer superior product mix to our customers to try to sustain our competitive advantage.

With that, I would like to turn over the call to the company's Chief Financial Officer, Mr. Edmund Hen, who will discuss the company's earnings results in more detail. Thank you.

Edmund Hen: Thank you, Mr. Huang. I will now move on to a more detailed discussion of our financial results for the third quarter end September 30, 2014.

Our revenue for the third quarter ended September 30, 2014, was RMB320.1 million or US$52.2 million, a decrease of 6 percent from RMB340.7 million or US$55.3 million in the third quarter of 2013. The year-over-year decrease in revenue was primarily due to a 14.4 percent decrease in sales volume to 10.7 million square meters from the year-ago quarter, which was offset by a 9.9 percent increase in average selling price or ASP. Our ASP as of the third quarter is RMB29.9 or US$4.87 as compared to RMB 27.2 or US$4.41 as of the third quarter 2013.

Gross profit for the third quarter of 2014 was RMB41.8 million or US$6.8 million, an increase of 25.5 percent from RMB33.3 million or US$5.74 million in the third quarter 2013. The year-over-year increase in gross profit was driven by a 9.9 percent increase in the ASP as we raised our selling price on all of our products beginning on July 1, 2014.

Profits before taxes for the third quarter of 2014 was RMB44.1 million or US$7.2 million as compared to RMB6 million or US$1 million in the third quarter of 2013. The year-over-year increase was primarily the result of the increase in ASP as well as the decrease in other expenses of RMB19 million relative to the third quarter of 2013 when there was a loss on the disposal of equipment of RMB18.9 million attributable to the replacement and upgrading of plant production equipment at the company's Hengda facility.

Net profit for the third quarter of 2014 was RMB35.7 million or US$5.8 million as compared to RMB4.4 million or US$0.7 million for the same period of 2013. Earnings per fully diluted share were RMB 1.75 or US$0.28 for the third quarter of 2014 as compared to RMB0.21 or US$0.03 in the third quarter of 2013.

For the nine months ended September 30, 2014, revenue was RMB797.5 million or US$129.9 million, an increase of 11.9 percent as compared to the nine months ended September 30, 2013. Gross profit was RMB75.3 million or US$12.3 million, up 24.3 percent from the same period of 2013. Gross margin for the nine months ended September 30, 2014, was 9.4 percent compared to 8.5 percent for the same period of 2013. The realized and unrealized fair value loss on derivative financial instruments was RMB59.5 million or US$9.7 compared to a realized and unrealized fair value gain of RMB0.2 million for the same period of 2013. Our net loss for the nine months ended September 30, 2014 was RMB35.1 million or US$5.7 million, compared to a net profit of RMB8.6 million or US$1.4 million for the same period of 2013. The loss per fully diluted share for the nine months ended September 30, 2014 was RMB1.72 or US$0.28 as compared to earnings per fully diluted share of RMB0.42 or US$0.07 for the first nine months of 2013.

Turning to our balance sheet, as of September 30, 2014, we had cash and bank balances of RMB63.4 million or US$10.3 million compared to RMB28.8 million or US$4.7 million as of September 31, 2013. The increase in cash and bank balances was the result of cash generated of RMB46.1 million or US$7.5 million. As of the end of the third quarter our debt was RMB84.3 million or US$13.7 million as compared to debt of RMB99.7 million or US$16.3 million as of the year end fiscal 2013.

As of September 30, 2014, we had an inventory turn of 127 days compared to 124 days as of December 31, 2013. Trade receivables turnover was 186 days as of September 30, 2014, compared to 185 days as of September 31, 2013. The company typically offers a credit period of 90 days to our customers and have extended the credit period to 150 days to address the funding pressure among some distributors attributable to the challenging market conditions in China's real estate industry in the second quarter of 2012.

Moving on to our business outlook, as our CEO Mr. Huang has said, although we are likely to experience occasional volatility in the period ahead, we believe that the macroeconomic environment will continue to be relatively stable for the remainder of 2014, even as business typically slows due to the seasonality of the building cycle. In terms of the next quarter, our backlog was RMB171.7 million or US$28 million which represents approximately the next two months of revenue as of the end of the third quarter. This compares to a backlog of approximately RMB155 million or US$25.3 million as of September 30, 2013, a year-over-year increase of 10.8 percent.

Despite favorable year-to-year comparisons to-date, we note that residential real estate prices have flattened out in recent months, reflecting a decrease in housing demand and units of housing properties being sold. This could lead to a contraction of the construction industry which could adversely impact our sales volume in the period ahead. To boost demand, the Chinese government has eased property market controls, accelerated infrastructure construction and relaxed reserve requirements for small banks in order to increase lending. Local governments have also eased access to capital, curbed restrictions on home purchases and introduced tax incentives. In the company’s view, these measures tend to support China’s property development and construction markets.

We believe that the real estate sector continues to be important in China’s economy and that the Chinese government will continue to promote policies to meet urbanization and boost domestic economic growth. The Chinese government has recently reiterated its position that the greatest potential for expanding domestic demand and sustaining economic growth lies in urbanization. This urbanization leads to new property development and housing construction. Government policies and current urbanization trends augur positive long-term fundamentals which could beneficially impact company's business.

The company is currently utilizing plant facility capable of producing 49 million square meters of ceramic tiles annually out of a total annual production capacity of 72 million square meters that is available to the company. We will bring this unused production capacity online as customer demand dictates and when there are further signs of an improvement in China's real estate and construction sector.

The company views the 9.9 percent increase in the average selling price of its ceramic tiles in the third quarter as positive and indicative of a return to the better operating climate relative to the retrenchment that occurred in this sector in late 2012. The company has now regained almost all of its pricing power as the average selling price of RMB29.9 or US$4.87 per square meters of the company's ceramic tiles has helped the ceramic price of the current quarter is now 22.5 percent higher than the low of RMB24.4 experienced in the first quarter of 2013.

Although the company has been able to steadily increase its average selling price over the last six quarters, we believe that some of its customers are still adjusting to our price increases but enhanced marketing will help to produce wider customer acceptance of this new pricing point. This could result in better sales of its ceramic tiles in the periods ahead so as to better utilize the full extent of the company production capacity.

Before we move to Q&A, we would like to discuss an issue that we also addressed on our last earnings call as well as in the current quarter and the second quarter earnings press releases. This concerns the foreign currency agreement that the company entered into during the second quarter of 2013 and the first quarter of 2014 which were for the investment purposes.

During 2013 throughout 2014, the RMB had been on an upward trend when compared to the U.S. dollar. At the end of 2013, we actually have a net cash gain of US$0.5 million. However, the renminbi started to depreciate against the dollar on February 12, 2014 and the company eventually incurred realized and unrealized losses amounting to US$11.6 million in connection with these agreements through June 30, 2014. On July 31, 2014, our largest shareholder and an affiliate of our CEO entered into a three party agreement with the financial institution that originated the foreign currency transition agreement and the company.

Under this agreement, our largest shareholder assumed these agreements that all assets, mainly deposits placed with the financial institution, and all existing and future liabilities arising under these agreements, so that the company was relieved from the liabilities arising under these foreign currency transition agreements. As a result, the company will not be required to fund any losses related to these agreements and will neither suffer any future liabilities arising under these agreements nor enjoy any benefits arising under these agreements.

As a result, and affiliate of our CEO released us from liability of RMB87.8 million which were extinguished on our books in the third quarter of 2014. RMB15.1 million in deposits held at financial institutions was transferred by the company to an affiliate of our CEO and additional trading capital was increased about approximately RMB72.7 million. Our CEO has now taken on the risk of these agreements so as to protect the company from any future losses and we will not be required to fund any further losses related to this agreement. As of the current quarter the foreign currency transaction has been resolved. I would like to emphasize that the company has no intention of entering into similar foreign exchange agreement in the future.

Now we have addressed this important issue. I would like to mention that we have Mr. Liu Jianwei, our Audit Committee Chairman, on the call for further clarification should he need pertaining to this topic.

At this point, we would like to open up the call to any questions pertaining to the third quarter financials and operating performance.

Operator: At this time, I would like to remind everyone. In order to ask a question, press star then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Howard Flinker with Flinker & Company

Howard Flinker: (Foreign Language).

Male: (Foreign Language)

Howard Flinker: I have heard that a number of competitors are closing up. Is that true?

Edmund Hen: Yes, they have stopped their production lines, a number of them.

Howard Flinker: And I understand it's a rather large number. Is that correct, too?

Edmund Hen: Yes, in our area a large number of our competitors have closed their production lines.

Howard Flinker: OK. Now they have inventory they'll have to sell, but even comparing it to you, you have about four months of inventory, they are not as well financed. So let's say they have three months of inventory and let's make six to eight months of inventory or six to eight months to sell. So, sometime by the middle of next year, all their remaining inventory will be gone and so will they, is that probably a good guess?

Edmund Hen: You have a very good estimate. We also hope this is the truth.

Howard Flinker: OK, of course, just an estimate. Second, is your depreciation and amortization for the year going to about $11 million?

Edmund Hen: Yes, that is the approximate figure.

Howard Flinker: Yes. And your capital expenditures for next year will be how much? I noticed that …

Edmund Hen: We do not provide a forecast for the physical capital expenditure at this moment, but you will have some insights in the year-end reporting.

Howard Flinker: But in the last nine months your capital expenditures have been zero, correct?

Edmund Hen: Yes, correct.

Howard Flinker: So they should be small next year because you have plenty of capacity, is that also correct?

Edmund Hen: Yes, we have plenty of our capacity, of course, in a logical way we would like to use our current capacity before tremendous expansion on the capital expenditures.

Howard Flinker: So almost of your depreciation and amortization will go into cash or in inventory or current assets but not fixed plant, it will be in nearly free cash, is that correct?

Edmund Hen: This is a very good estimation on that.

Howard Flinker: OK. And your current run rate it looks like your stock is going to be selling around 1.5 or 2 times earnings and about one times cash flow because next year you could easily earn between $7 million and $10 million after tax. Is that a decent range?

Edmund Hen: Well, it all depends on the economic climate.

Howard Flinker: Sure.

Edmund Hen: Yes. If the economic climate is still getting upward, so this may be the truth, but it is very difficult to say at this moment.

Howard Flinker: Of course, you are also going to gaining business from the competitors who are in the middle of closing up. You are going to have a pretty good year next year.

Edmund Hen: Yes, thank you. We hope we can do that.

Howard Flinker: One last question. How is your boy?

Edmund Hen: Yes, just born two months, very good health.

Howard Flinker: Two months or two weeks?

Edmund Hen: Yes, two weeks.

Howard Flinker: Yes, right.

Edmund Hen: Yes, very handsome.

Howard Flinker: Yes, is he all right. Is he on the conference call?

Edmund Hen: Yes.

Howard Flinker: Is he going to participate in the conference call in the fourth quarter or not?

Edmund Hen: He is sleeping, so …

Howard Flinker: You don't think so.

Edmund Hen: Yes, I don't think so.

Howard Flinker: Those are my only questions. Thank you.

Operator: Again, if you would like to ask a question, press star one.

There are no further questions as this time.

I am sorry, we do have a question from Duane Roberts with SH Fund.

Duane Roberts: Hi, good morning.

Edmund Hen: Hi, good morning.

Duane Roberts: I missed a little bit of the very beginning of the call and then the other participant just asked a question prompt or something. Could you give me a little bit of indication of the housing, what the housing climate is, what the housing climate is like there, number one? And then number two, with the closing down of your competitors, obviously, that gives you an advantage but you got to wade through this inventory. My second question is, is it because of the housing climate that these competitors of yours had to close down?

Edmund Hen: Yes, while we feel that the housing climate is still very challenging right now in China and a lot of positives from banks, and they are encouraging people to buy their second house. It seems the government is doing that. But the thing is the housing pricing is just keeping stable at this moment. And I think most of people are still under observation for the whole market. So I think we have little bit of a decline at this moment.

And for your second question, it is true that some of our competitor have closed down their production line and are selling their inventory at this moment. And one more thing is it also takes some time for us to observe the market, especially the construction rate for the buildings. And I think we will have a better picture after the Chinese New Year. So at the moment, it is very difficult to tell what is the climate in three or six months later.

Duane Robert: Do you have any indications of any type of – do you anticipate any government stimulus packages or some financing that would try to stimulate the housing market there?

Edmund Hen: Yes, the Central Bank is pushing up their lending to their second home buyers, so in some Tier 2 or Tier 3 cities. We do not see the government have any significant quality to pull out of the market for the housing. So I think we still need some time to observe on this matter.

Duane Robert: OK, so my last question is do you think that the first, maybe the first, according to the numbers of the previous person asked a question, do you think that the first six months of 2015 will probably be a little challenging and maybe the second half of 2015 probably should be a little bit better once you get through this inventory issues from your old competitors?

Edmund Hen: In the historical momentum from the companies, actually the first quarter is always the slowest season for us. So we do expect the second half will be better than the first half of 2015 in terms of the historical traction. Also, for the first half of next year we're seeing the whole housing climate is still under observing from the buyers.

Duane Roberts: OK, thank you very much.

Edmund Hen: Thank you.

Operator: Again, to ask a question, press star one.

There are no further questions. This does conclude today's conference call. You may now disconnect.

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