"MphasiS Q1-FY13 Earnings Conference Call"

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Moderator Ladies and gentlemen, good day and welcome to the MphasiS Q1 FY13 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode. There will be an opportunity for you to ask questions at the end of today's presentation. If you should need assistance during this conference call please signal an operator by pressing * and then 0 on your touch-tone telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Varun Divadkar from CDR India. Thank you and over to you, Sir.

Varun Divadkar Good morning everyone, and thank you for joining us on the Q1 FY13 results conference call of MphasiS Limited. We have with us today Mr. Ganesh Ayyar, the CEO and Mr. Ganesh Murthy, the CFO. Before we begin, I would like to state that some of the statements in today's discussion may be forward-looking in nature and may involve certain risks and uncertainties. A detailed statement in this regard is available on the Q1 FY13 results announcement release that has been emailed to you earlier. This conference call will be archived and the transcript would be made available on MphasiS' corporate website, www.mphasis.com. I now invite Mr. Ganesh Ayyar to begin the proceedings of the call.

Ganesh Ayyar Thank you. Good morning everyone and thank you for attending the call. Today we will discuss our operating and financial performance for the first quarter ended 31st January, 2013. I hope that you have had time to go through the financial results and group overview documents that we have sent to all of you.

To begin with, I would say that our result in Q1 is modest. What I would like to do now in the next few minutes is to provide some color beyond the numbers so that you are able to contextualize these numbers. I will categorize my comments in the following areas - first one is inorganic activity, second one is client concentration, third is a little bit on revenue. I will then move on to profit followed by market assessment.

Let me begin by sharing with you the inorganic activity. As you may recall, we had acquired Wyde in September 2011 and have put in a huge amount of focus in building effective go-to-market for Wyde. We are seeing pretty good results especially in the US and significant traction for Wyde. In the last four quarters we have won four contracts in the US totaling more than $20 million. This has been a consistent performance where every quarter we are winning a deal. This clearly helps us with our IP based hyper-specialization journey. Now the second acquisition which I would like to touch upon is Digital Risk. As you are aware, we have closed the transaction on February 11, 2013 and I am happy to share with you that we have secured approval for 100% of the licenses covering 46 States in the USA. This was important because of the 'Change of Control' clause which was there with regard to the licenses. Now this sets the stage for us to leverage Digital Risk for Direct business growth in the future.

Now let me move on to talk a little bit about client concentration because this has been our journey for the last two-and-a-half years where we were focused on client concentration which was HP's business and comparing it with the Direct business that we have. You would see in the Q1 FY13 results which we just announced, the ratio of HP and Direct Business stood at 52:48. During the same quarter last year this stood at 58:42 and two years ago it was 69:31. So, we have been consistently growing our Direct business and addressing the issue of client concentration. We are clearly on our path to have Direct business becoming the greater portion of our revenue and crossing the 50% limit in the second quarter. The Digital Risk transaction alone will result in a 6% to 7% shift in favor of Direct business, starting second quarter.

Let me move on to talk a little bit about revenue. Our revenue declined on a quarter-on-quarter basis by 3.8%. When you peel the data, you will notice that we had a growth of 1.1% in our Direct business, whereas the HP business declined by 9.1% on a quarter-on-quarter basis. One of the important things to note is that Q1 is traditionally impacted by the annual shutdown which takes place around the Christmas to New Year period. Overall impact of this is in and around 1.5% on sequential basis. In this quarter we had 22 wins; 14 of those wins were in the Direct space.

A quick comment on profit and profitability this quarter. On a year-on-year basis, our profitability improved but we saw a decline of 210 basis points on a quarter-on-quarter basis. Impact of annual shutdown, however, on our profitability was about 100 basis points out of these 210 basis points.

Let me move on to share with you a little bit about our market assessment. As we look ahead, we have seen good traction in the US and India market for our Direct business. We will continue to stay invested in our go-to-market activity and are ensuring that our go-to-market remains relevant with the changing demand pattern of the market.

To summarize, Q1 was a modest quarter. The actions that we have taken are yielding results in the Direct space. We remain focused on delivering 1.5x the market growth in the Direct space. On that note, I thank you for your continued interest in MphasiS. Now let me ask the moderator the open the line for questions.

Moderator Thank you very much, Sir. Ladies and gentlemen we will now begin the question and answer session. The first question is from Priya Rohira from Axis Capital. Please go ahead.

Priya Rohira Could you give us some color on the deal pipeline and the pricing as you are seeing in the market. The second question relates to the direction on the employee deployment in Software Services. And lastly, on your outlook on S&M spend because there seems to be some rationalization in the current quarter but would be useful if you could give us the trend which you envisage to invest in future.

Ganesh Ayyar As I mentioned earlier, the pipeline continues to be robust. Though I would like to mention that even though traditional services are there in the pipeline, customers wants to look at options which are more kind of emerging and then they decide. So if I may, your beachhead has to be new generation services in order for you to even win traditional services. This is a concept which is emerging in the market. I see clearly that demand is beginning to come back in the US or North America; Europe continues to be soft; India is still strong. These are the three big countries or three regions that we are focused on and this is the update with regards to pipeline. With regards to pricing, we haven't seen any unusual pressure. In fact, I am happy to share that the MSA with HP has been extended without any change in any aspect of the MSA. On the pricing front, nothing unusual, the market continues to be in a normal state, if I may say so. The emerging services model defies the traditional rate card driven model, so to that extent it is a variation that all of us have to cope with. The good news is that MphasiS started on this journey 2.5 years ago, so in many ways we are better prepared for that aspect.

Priya Rohira Mr. Ayyar, can I just take a follow up question on your answer to my question. You mentioned the pipeline is robust. Is it possible for you to qualify how what the trend has been? I mean from what was it last year and what is it now, has it increased by 25% - 30% for non-HP business?

Ganesh Ayyar I would say that in the US, while I don't have exact amounts, if I compare our pipeline right now versus pipeline the same time last year, I would say that we are clearly seeing anywhere between 10% to 20% improvement in pipeline.

Ganesh Murthy On the employee hiring, because of the declines that we have had in the last few quarters in our HP channel, we basically hire based on demand. We will be continuing with that strategy. We don't really have any clear hiring plans as such and as far as our fresher or college hires are concerned it would be pretty modest this year but again it will be based purely on how we see the demand progressing. Regarding sales and marketing spend, you are right; you will notice that our selling headcount has come down by 41 people quarter-on-quarter. What we did is cut back and changed the model in so far as the sales effort in the HP channel was concerned. Given the decline in the HP channel, we decided that we will shift the selling targets for the HP channel to the delivery folks because they are nearer to the customer and they have access to the account managers with HP. So we adopted the shift in the entire sales strategy for HP and as a result there were people in the HP sales force that we had to let go of in the organization. We are now going to be ramping up the Direct channel sales effort.

Priya Rohira Sure and just a follow up, your tax rate for CY13 and CY14, how would you see it?

Ganesh Murthy We had provided a guidance of 23% effective tax rate for the Company this year. Now because of the proposals and the surcharge increase in the Union Budget that will go up by 0.5%, it will be around 23.5% and because of the acquisition of Digital Risk we would see a further increase of about 1.5% which would take the effective tax rate to the region of 25% for 2013 – 2014.

Priya Rohira And for CY14 obviously we need to adjust for the surcharge because that's relevant for one year.

Ganesh Murthy It affects us for most of the year because it would be effective from April.

Priya Rohira Yes, but for CY14?

Ganesh Murthy CY14 also I would say that it would be around 0.5% to 0.6% impact.

Priya Rohira Okay and on the capex front, could you just give us some color for CY13?

Ganesh Murthy Capex will continue to remain modest, Priya because if you see, our overall growth is modest. We are ramping down in our HP channel but we are growing in the Direct channel, net- net it still remains a reduction. So while we are looking at specific optimization and shifting from high cost facilities to lower cost facilities we are not really spending too much on the capital front.

Moderator Thank you. The next question is from Atul Soni from Macquarie Capital. Please go ahead.

Atul Soni First of all, can you give some color on the employee cost moving forward post the Digital Risk acquisition and then secondly would the cash payout happen in this quarter itself for Digital Risk or is this kind of a layered payout?

Ganesh Murthy Manpower cost will increase obviously because Digital Risk employees are all entirely onshore but we don't have those details to share with you. As for the second question on the payout, there will be two significant payouts in the second quarter - there will be a payout for the acquisition of Digital Risk plus there will be a payout of the dividend that we had proposed.

Atul Soni Okay so can you quantify how much cash would be going off the balance sheet?

Ganesh Murthy The dividend would be about $80 million, including the dividend tax and on Digital Risk it would be about $200 million.

Moderator Thank you. The next question is from Pinku Pappan from Nomura. Please go ahead.

Pinku Pappan I wanted to know what the outlook in HP was, how long do you see this ramp down continuing and when is the earliest you expect some stability to happen there?

Ganesh Ayyar As of now we believe that the decline will continue for at least one to two quarters. I am not saying that it will stop after that but at this juncture I don't believe that the decline will stop in the coming quarter at least.

Pinku Pappan Okay but what kind of declines are you expecting in the near term at least?

Ganesh Ayyar I don't have a specific percentage so I can only give you the broader directional statement that the decline will continue.

Ganesh Murthy It will be lower than the current quarter because about 1.5% of the decline in the current quarter as Mr. Ganesh Ayyar mentioned was because of the annual shutdown.

Pinku Pappan And can you give us an update on your efforts to directly engage with the clients that HP is losing out and try to win contracts?

Ganesh Ayyar I would categorize our relationship in two parts. Where we are partnering with HP in an existing contract and if they are going up for renewal and we are invited as a partner in the renewal process, then obviously we will not go Direct because it is important that we demonstrate professionalism in our partnership. We will work closely with HP and be a part of their strategy to get it renewed. In those contracts where we are not part of HP's partnership and we are not invited to be part of the renewal process then that is an option available to us. We can't specifically comment which customer and we will evaluate based on our ability to put in an effective value proposition on whether we are going to put in a bid in those contracts.

Pinku Pappan Okay on the non-ES side, what is the outlook, what kind of revenues are you looking at for the year?

Ganesh Murthy On the non-ES side there has been a slight reduction in this quarter entirely because of the furlough that we had. We did about $12.5 million in this quarter as compared to about $14 million in the previous quarter but going forward we will see higher revenues i.e. in quarter two and so on.

Pinku Pappan Okay but is the growth going to be a similar to what you saw last year or it's going to taper down.

Ganesh Murthy Last year we grew by about $13 million as compared to FY11 and I would say that in absolute terms that it would be more or less the same kind of growth.

Pinku Pappan You shared you won contracts in Wyde worth greater than $20 million in TCV, can you give us a sense of what is the similar number for your entire Direct channel business, the contracts you won?

Ganesh Murthy We don't provide that information.

Moderator Thank you. The next question is from Kunal Tayal from Bank of America. Please go ahead.

Kunal Tayal Sir, you did mentioned earlier that your pipeline would have indicatively gone up 10% - 20%. Just curious that you think if that should put you at par with industry level growth in the Direct channel this year because at least this last reported quarter growth in the Direct channel seems to have come off sharply to about mid single digits.

Ganesh Ayyar As I mentioned, our objective and focus is to grow not just at market growth rate but at 1.5x and we continue to pursue that as our focus and continue to build our pipeline and our offerings. That will continue to remain our focus, there is no change in our plan.

Kunal Tayal Sure, and Mr. Murthy any one-time reductions in G&A expenses this quarter or is all of it sustainable.

Ganesh Murthy I would say about Rs. 5 to 6 crore, it is not really a one-time, it is more of truing up of the variable pay that we have for management as well as for employees. That has to be trued up every six months and it would amount to about Rs.5 crore but apart from that there are no other significant one-time items.

Kunal Tayal Right, got it. Lastly, on the acquisition, anything that you have in terms of how much should be the component of amortization that we could expect from next quarter onwards so that would be helpful.

Ganesh Murthy I don't understand what you mean by amortization; we don't amortize the goodwill.

Kunal Tayal Okay, so all of it is going to be just a balance sheet impact and no pass through to P&L.

Ganesh Murthy We don't pass through goodwill to P&L. We have done various acquisitions in the past and it would all be in the balance sheet, capitalized as goodwill.

Moderator Thank you. The next question is from Ashwin Mehta from Nomura. Please go ahead.

Ashwin Mehta I had a question on margins, what is our outlook on margins for the full year and do you see the recoupment of the 100 bps decline due to shutdowns happen next quarter or the SG&A investments in the Direct channel will cause some adverse impact.

Ganesh Murthy Yes, we will see a recoupment but there will be two other headwinds that will kick in from quarter two. We will obviously have to step up our selling and marketing investments and that will take place over a period of time. We are interested in hiring the right kind of people who can help us in our chosen verticals. So there will be an investment over a period of time and an increase in the selling and marketing space. The other impact that we will be having on the margins will be the impact of Digital Risk because Digital Risk will have slightly lower EBIT margins than the Company average. But on an overall basis I would say our stated intent is to keep our EBIT margins between 15% - 18%. It will be at the lower end of the range for the next couple of quarters.

Ashwin Mehta Okay, and my second question is in terms of HP. HP has been indicating that four large clients of theirs would see ramp downs over the next few quarters. Does MphasiS have an exposure on these four large clients?

Ganesh Murthy This question has been asked earlier and we are not aware of the names of these clients so we really can't comment on who the four clients are. All I can say is that it is not necessary that we are involved with each and every client that HP has. There are many clients who are in the Government space for instance where we are not involved at all.

Moderator Thank you. The next question is from Manik Taneja from Emkay Global. Please go ahead.

Manik Taneja This pertains to our Direct channel business. Although you did indicate that the pipeline remains very healthy on that side and you are seeing greater traction both in US and India but I am looking at revenues for the recent quarters, the revenue growth is pretty muted both on a sequential basis as well as on a year-on-year basis. I am just trying to understand how you envisage going to your intention of growing at 1.5x industry growth rate.

Ganesh Murthy Let me point out that our aim is to grow at 1.5x the industry and we are working towards that. It may not necessarily translate in the next couple of quarters to 1.5x market growth because there will always be a time lag between the time we make investment in selling, beef up our go-to-market efforts and by the time we actually realize the revenue.

Ganesh Ayyar And there is always a gap between win and revenue also. So services business, depending on what service line, the gap from win to revenue could be anywhere between 3 to 9 months.

Manik Taneja So Sir, do you still hold that 1.5x industry growth outlook for financial October '13 or that might be tough for this particular financial year.

Ganesh Murthy Again, I just want to re-emphasize that it is not an outlook. It is our intent and aim to grow at 1.5x industry growth over the period of the next two to three years.

Moderator Thank you. The next question is from Srivathsan Ramachandaran from Spark Capital. Please go ahead.

Srivathsan R. Just wanted to get some sense on Digital Risk. You had mentioned that the revenues were around $127 million. So is there any seasonality that we need to factor in from quarterly revenues point of view or it would be pretty even all out.

Ganesh Murthy No there is no seasonality that we are aware of. But we need to factor in the growth. Digital Risk has being growing steadily and they have shown between 60% to 70% year-on-year growth for the last three years. The future growth will definitely not be 60% and 70% but there will be a growth in the revenues moving forward.

Srivathsan R. Okay my next question is from the ATM deal that we had won sometime back. When does it effectively start flowing into revenues and what kind of a ramp up typically you can see from that?

Ganesh Murthy It has already started flowing in this quarter but in a very small way. A very small amount of revenue i.e. about Rs. 0.2 crores has flown in from this quarter. It will reach steady state only in 2015.

Moderator Thank you. The next question is from Pratish Krishnan from Antique Stock Broking. Please go ahead.

Pratish Krishnan In terms of the sales and marketing spends that you would want to invest, is there a number that you would put in terms of what percentage of revenues should we factor in our number?

Ganesh Ayyar On an overall basis we are looking at a steady state of 6% of our revenue in sales and marketing.

Pratish Krishnan This includes the investment that you would foresee for the 1.5x industry growth?

Ganesh Ayyar That's right.

Ganesh Murthy Yes, but Pratish, please also bear in mind that this 6% on our overall revenues includes Digital Risk.

Pratish Krishnan Okay fine. And second is in terms of infra business, we did see some 4% growth in the quarter. If you can just clarify whether there was any milestone payment here or any one-off and which segment did this come through? Was it from the HP business or is it largely Direct business oriented.

Ganesh Ayyar There was no one-off and it's predominantly in the Direct space.

Moderator Thank you. The next question is from Dipesh Mehta from SBI Cap Securities. Please go ahead.

Dipesh Mehta Sir, for last few quarters we continue to book hedge losses, now considering if rupee remains at 54 kind of level, what kind of gain or loss do you expect? Secondly, about growth prospects on Direct side, is double-digit growth feasible for the current year, 1.5x industry growth might be the few quarters away story, but is a double digit a reasonable expectation for the current year?

Ganesh Murthy Let me talk about the hedge position. You will notice that because we take a long-term position and we do a monthly rolling hedge, the losses or adjustments from hedging reserve quarter-on-quarter has been declining. If you see, in Q4 we did about Rs. 33 crore of losses from hedges. In Q1 it was about Rs. 23 crore. This will continue to decline and we will have a much more moderate loss in Q2 and Q3 onwards we anticipate that it will actually breakeven or turn into a profit from the hedging.

Dipesh Mehta Okay and about Direct business?

Ganesh Murthy Again it's very difficult to give a guidance like this. We don't provide any forward guidance but definitely our aim, from a long-term perspective is to grow 1.5x the industry growth.

Dipesh Mehta And with regards to Digital Risk, the $127 million what we suggested was historical revenue run-rate. When we acquired currently what kind of revenue monthly run-rate is it growing at.

Ganesh Murthy We won't be able to provide that information but all I can say is that it is a healthy growth.

Dipesh Mehta Okay and what kind of margin is it operating at right now?

Ganesh Murthy Last year it operated at 10% EBIT. Our aim over a period of three years is to bring the EBIT margins to around 15% which is the bottom of the range of our EBIT margins.

Moderator Thank you. The next question is from Vinay Rohit from ICICI Prudential Life Insurance. Please go ahead.

Vinay Rohit Just wanted to check, are we evaluating any more acquisition opportunities or are we going to focus on integrating and growing Wyde and Digital Risk?

Ganesh Ayyar At this of point of time we have done this large acquisition. We will focus on getting Digital Risk right. So our focus would be small to mid size acquisitions and that too in areas which accelerate our strategy journey. We are not looking at large acquisitions at this point of time.

Moderator The next question is from Hardik Shah from KR Choksey. Please go ahead.

Hardik Shah Sir, your aspiration to grow the Direct channel by 1.5x the industry, does it include the inorganic growth or it's just on organic growth?

Ganesh Ayyar It's purely organic. In inorganic anyway, we will do more 1.5x with the Digital Risk acquisition.

Hardik Shah And Sir, a bookkeeping clarification. In your Group Overview you have mentioned your cash flow from operation is Rs. 250 crore, whereas your consolidated financial statement shows it is Rs. 159 crore. So is the cash flow from operations Rs. 250 crore or is it Rs. 159 crore?

Ganesh Murthy The cash flow from operation that is shown in the Clause-41 advertisement is in a different format. It includes increase / decrease in working capital. So our cash flow from operations is at Rs. 250 crore this quarter.

Ganesh Ayyar Alright, so once again thank you everyone for joining the call. We will stay connected and reassemble again at the end of the next quarter or if there is any significant event. Look forward to continuing our relationship. Thank you so much.

Moderator Thank you very much. On behalf of MphasiS, that concludes this conference call. Thank you for joining us and you may now disconnect your lines. Thank you.