"Mphasis Limited Q1 FY-'15 Earnings Conference Call"

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Moderator Ladies and gentlemen. Good day and welcome to the Mphasis Limited Q1 FY15 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 after the presentation concludes. Should you need assistance during the conference, please signal an operator by pressing '*' then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Varun Divadkar of CDR India. Thank you. And over to you sir.

Varun Divadkar: Good afternoon everyone and thank you for joining us on Mphasis Q1 FY15 results conference call. We have with us today, Mr. Ganesh Ayyar – the CEO and Mr. Suryanarayanan – the CFO.

Before we begin, I would like to state that some of the statements in today's discussion maybe forward-looking in nature and may involve certain risks and uncertainties. A detailed statement in this regard is available on the Q1 FY15 results announcement release that has been sent 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 Varun. Good afternoon everyone. I appreciate all of you taking time to join us today. We will be discussing the operating and financial performance for the first quarter ended 30th June 2014.

As you are aware the company has changed its financial year from 31st October to 31st March and consequently for computing growth percentages for the quarter ended 30th June 2014, results for the two month period ended 31st March 2014 have been normalized to three months for a meaningful comparison. I am sure that you had the opportunity to read our MD&A where we have provided most of the details on our performance. For today's call I would like to provide you additional color on our business.

Let me first talk about our Direct business and the progress that we have made thus far in our strategy. Let me begin by focusing on the organic side of our business. We are having tremendous traction in the Direct organic space. We have line of sight, we have wins and we can see us winning more. Whereas if you look at the other part of our direct business which is Digital Risk, that is experiencing the impact of volatility in the US mortgage industry. You may be aware that in the mortgage industry in US, transactions are down almost 40% and when the transactions are down they are directly impacting origination business and secondary business in this industry and this industry being transaction based, it immediately affects that line of service called the Origination and Secondary. On the other hand the settlements are impacting the Forensics line of business. So these two impacts are affecting Digital Risk performance. But we do have a plan and the leadership team of Digital Risk is working on it to get back to robustness on a mid-term basis.

Let me now go to certain specific numbers. Direct organic business grew sequentially on a normalized basis by 0.8% or 2% net of rupee appreciation. We won deals worth $45 million this quarter. In the coming quarter we expect to further accelerate the TCV and we will certainly talk about it during the question session. Our traction, our focus, our specialization that we have been discussing is now clearly bringing in results in terms of wins. We will discuss this during the question session.

Now let me move to the HP channel. HP channel revenues declined 4.3%, adjusted for the rupee appreciation. We continue to work on multiple initiatives to see how we can bring robustness in this business.

EBIT margin for Q1 FY15 stood at 14.8% as against 15.1% in the preceding quarter. The mortgage industries' impact on Digital Risk will bring some volatility in our numbers. We will continue to, as in previous quarters, roll out various initiatives to accelerate growth in our Direct business and that will continue to bring more wins in our books.

As far as cash is concerned, we continue to demonstrate strong cash position, We generated around $38 million of cash through operations during the quarter. A healthy cash balance of $443 million at the end of the quarter provides us the necessary leverage to pursue our growth strategy, whether it is organic or inorganic.

To conclude, our investment made in named account and specialization and our focus on ensuring high level of customer satisfaction, combined with the fact that we improve the process of large deals is beginning to bring in well qualified deals in our pipeline and we are also seeing translation of that pipeline into wins and that will generate high quality revenue.

So on that note I thank for your continued interest and let me ask the Moderator to open the line for questions. Over to you.

Moderator Thank you very much sir. Ladies and gentlemen, we will now begin the question-and-answer session. The first question is from Srivatsan Ramachandran of Spark Capital. Please go ahead.

Srivatsan Ramachandran Hi Ganesh, nice to hear about the good traction in Direct channel. Given the base you are in, do you think that both from an order signing and pipeline point of view, is the momentum adequate for us to be in line with the industry or mid-teens kind of a growth for the Direct channel at least?

Ganesh Ayyar Let me give you some color as to how we see the Direct organic business evolving. We won about $45 million TCV in Q1 and that included an AMS service in an insurance company which is a fairly substantial deal of about $20 million. Another deal that we won was with our Wyde platform which was in the European region to the tune of about $4 million.

So these deals resulted because we were focused, specialized and we had IP. Now going forward if I look at the deals, I clearly believe that in coming quarters the TCV size that we will win will increase. We have tremendous traction in GRC area, we have tremendous traction in digital transformation area, AMS is tracking, we have a fairly large deal in pipeline on the infrastructure services and if I look at the averages of these deals, we have $15 million average deals size in the coming quarter and multiple deals which we can close. I certainly believe and I feel good about the fact that we will far exceed the $45 million benchmark that we have set in Q1. Once you win you have to take it from wins to revenue and revenue to profits, while ensuring customer satisfaction is high. So that will be the traction. The leading indicator for this is wins, as I have articulated $45 million in the direct organic space in Q1 and we hope to be bigger in Q2. When I look at the pipeline we have a line of sight well beyond Q2 and Q3.

Srivatsan Ramachandran On Digital Risk, in terms of mitigation strategy, we had proactively moved a team of people on a contract basis. Is that move enough to keep margins as they are or do you think the existing employees that you have in Digital Risk onsite itself, capacity utilization can be surplus and it could cause more margin pressures on ongoing basis?

Ganesh Ayyar Let me explain the Digital Risk business in a summarized way. This business depends on the number of mortgage transactions. We provide multiple services around these mortgage transactions. Since we are providing transaction based services, when the mortgage transactions come down, it starts hurting your top line and your bottom line. In US the number of transactions are down by around 40%, which is hurting the transaction based business of all the service providers including Digital Risk. When the revenues come down it does have an impact on margins. I will talk specifically about margins in a bit but let me talk about the plan that we have ahead and how long will it take for us to get back to the business.

When the transactions are down, one strategy which we have adopted is, in the services that you provide per transaction, can you expand that services portfolio around per transaction. The value proposition of doing that is the players who are in the mortgage industry have to variabilize their cost. So what was being done in-house, they are more open to outsource. What we have done is we have enhanced our portfolio to increase the services that wrap around per transaction. So that is the first strategy to mitigate the downward trend that we are seeing and we will continue to see on mid-term basis.

Second is to increase market penetration. We were focused on certain set of players. We have expanded that market place to go after the medium-sized players as well in addition to our focus on larger players. We hope to increase the market penetration and this is fundamentally simple, executable, well thought through strategy and we are already seeing traction. Converting the traction into revenue and profit takes time because these services need to mature in order to generate margins.

This business was generating margin in and around low double digits, if I may. I expect this to go to low single digits for the midterm basis which is in and around nine month period.

Srivatsan Ramachandran Sure. On Digital Risk, are numbers exposed more to the residential mortgage or commercial mortgage segment?

Ganesh Ayyar Focus is on residential mortgage

Moderator Thank you. Our next question is from Madhu Babu of HDFC Securities. Please go ahead.

Madhu Babu When are you giving wage hikes and what would be the impact on margins?

Ganesh Ayyar I am delighted to announce that Suryanarayanan has accepted our offer to take up the role of Chief Finance Officer. I will ask him to do the honor of answering this question. Over to you Surya

Suryanarayanan Good afternoon to all of you. We are planning to give the wage hike from next quarter, that is Q3 and this would have an impact of close to 150 to 175 basis points on the margins.

Madhu Babu Is the delayed wage hike showing up on the attrition.

Ganesh Ayyar Delayed wage hike will obviously have an impact and to some extent that may have added to your attrition but I believe that we are in control because the best way to judge it is, is it affecting our ability to hire and most importantly is customer satisfaction hurting. In fact our customer satisfaction is at all-time high as we speak.

Madhu Babu Now that we are having a good TCV in the Direct channel, can we see a sustainable 2% to 3% of CQGR in Direct channel organic business excluding Digital Risk?

Ganesh Ayyar Yes, two aspects. That is clearly the expectation because these TCVs will result in revenue and depending on the service line the revenue time frame ranges between three to nine months. The good news is that the deals that I described in the pipeline and the deals that we have won range from BPO which is highly profitable, infrastructure services and AMS. All three service line are seeing good traction. So coming back to you question, yes that is my expectation as well.

Madhu Babu Lastly on the direction of emerging markets. We mostly exited the Indian government business, so what is the outlook there and where are we trying to drive growth?

Ganesh Ayyar In the emerging geo we have a focus strategy and that focus strategy is helping us to win deals and our focus is on profitable growth. We are very selective on the type of deals that we focus on because ultimately it is about having good return on investment.

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

Dipesh Mehta Can you provide the split between HP Enterprise Services and non-ES revenues? What would be your outlook about HP as an overall business over the next few quarters? Second question is about emerging market. Emerging market is showing traction and if you can throw some light on where we are seeing this traction, may be vertical or service line perspective? Thirdly, this quarter if we exclude Emerging market, our Mature market, even after adjusting for Digital Risk seems muted. If you can provide some color about Mature market excluding Digital Risk?

Ganesh Ayyar I will bucket your question into broad buckets. First you spoke about HP split between ES and rest of HP, I will get Surya to provide that. But before we get there, you had questions on Direct organic, you had questions on Emerging Geo. The TCV is a lead indicator for revenue growth and while we have the results of Q1 with us, what it does not reflect clearly are the wins that we have had in the Direct organic space. That is the space which is humming and with a very clear line of sight over the next nine months for us in terms of pipeline and wins.

In terms of the Emerging geos as well, we are focused in our chosen areas. We are focused on payments, insurance, we are very-very strong on BPO side and we are also focused on Banking, Capital Market. These focuses are generating selected positive growth in our numbers.

Suryanarayanan Net decrease in HP channel is around 4.9%, out of which there was reduction in the HP-ES about 5.8% and an increase of about 1% on the HP non-ES business side.

Dipesh Mehta I have one question which remained unanswered about mature market. if I adjust for Digital Risk, there is $4 million to $5 million kind of decline and then I look at the QoQ performance it appears that Mature market remained muted this quarter. If you can provide some color about Mature market business in Direct channel.

Ganesh Ayyar There was a question asking whether I feel confident of 2% to 3% quarterly growth rate over a midterm basis and I answered in affirmative. So yes that is what the mature market is looking like.

Suryanarayanan Just to elaborate that point, Mature organic revenues grew by around 1.7% in the current quarter, net of rupee appreciation.

Moderator Thank you. Our next question is from Hardik Shah of KR Choksey. Please go ahead.

Hardik Shah What is the outlook for Digital Risk in the coming quarter? Do we expect the pressure or do we expect it to be flat in Q2 FY15?

Ganesh Ayyar I expect the revenue and margin pressure at least for coming couple of quarters which puts pressure on our margins. If you look at our margin scenario, we have always maintained 15% to 18% range. I am not just commenting on the immediate quarter but if I look at the next couple of quarters, margin would clearly be under pressure because of Digital Risk. MSI would also put pressure on margins, while we always work on mitigating that risk, whether we would completely be able to eliminate it, time would tell. On top of it when you win large deals which is good news, during the initial phase of large deals you would have some transition cost which you will have to absorb and that also puts pressure on margins. So if you look at margin scenario, I expect some downward pressure on our margins in coming quarters. We may see a 200 basis points downward pressure at the lower end of the margin.

Hardik Shah So the band will become 13% to 16%

Ganesh Ayyar 13% to 15% range.

Hardik Shah And sir, on Digital Risk do you expect revenue pressure in Q2 or expect it to stabilize?

Ganesh Ayyar Digital Risk will experience some pressure on revenue and margins for next couple of quarters, and we are beginning to see traction based on the new strategy. So I can say that this pressure will get mitigated over a mid-term basis but we will see pressure for the next couple of quarters.

Moderator Thank you. Our next question is from Rahul Jain of Dolat Capital. Please go ahead.

Rahul Jain Just a follow up on the earlier question. You said that there are other new strategies which would sort of mitigate these problems in the Digital Risk area. Basically, there has not been any significant announcement for Digital Risk for over 10 months now. So is it that we are finding it difficult to get new deals and do we plan to take this offering beyond US so as to drive up the revenue?

Ganesh Ayyar Excellent question. As I said we have a two-pronged strategy to recover on the current situation. One strategy is to wrap more services per transaction. To illustrate it simply, if we were doing a dollar of service, can you make it dollar and thirty. I am using this figuratively and not literally. We were focused on larger players in the sector, so the second strategy is whether we can we take it to medium sized players. We have had some wins in the medium sized players market and we are also seeing that our strategy of wrapping more services per transaction is playing out well. That has not translated into immediate big revenue and margins. That takes time because it is a typical BPO type of business and from win to revenue it takes time and when you start wrapping new types of services for it to generate positive margins, that also takes time. So we have a strategy in place and we have tested the strategy and initial transactions are flowing in. Hence I am able to time box it that over a mid-term period we will recover in Digital Risk.

Rahul Jain So basically what you're trying to say is that when you say per transaction more services, mining more out of the same, and the mid-sized banks in the US are finding it little tricky to get into?

Ganesh Ayyar I do not compete with banks, I compete with service providers. What happens when the mortgage transactions are down is that many things which they were doing in-house creates a fixed cost structure and they are not able to reduce their fixed costs and that puts pressure on their own margins. Hence they start looking for outsourcing, some additional services to the market to variabilize the cost. And that is where we come in by wrapping more services per transaction. Hopefully I answered your question.

Rahul Jain So that means when mortgage origination is down that should create an opportunity or an inroad?

Ganesh Ayyar Correct. Penetration and wrapping more services per transaction, this is the two-pronged strategy.

Rahul Jain So from the current set of things which we are doing, not taking into account any further downside from the existing business, how many deal wins can we close from say six to nine month perspective?

Ganesh Ayyar So first of all, in the previous quarter I mentioned that we will see a downward pressure on revenue of about 15 percent and I maintain that will be the case for at least a quarter or two. And then we will see these wins turning into revenue and profits and the recovery will start. That's the kind of a horizon that we see for the Digital Risk.

Rahul Jain 15% from the current run rate further down or stability at the current run rate?

Ganesh Ayyar No, we will expect further pressure on revenues from Digital Risk to the tune about 15%.

Rahul Jain 15% a quarter?

Ganesh Ayyar That is right.

Rahul Jain So if we are doing around $40 million, it should be around $6 million cut ideally.

Ganesh Ayyar That's right.

Rahul Jain On the Forensics side, I know there have been certain project closures but how do you see the potential in terms of new business on Forensics side?

Ganesh Ayyar Forensics business hurts when big settlements take place and that is what has happened in the US market. We are working on a strategy where you start playing during the lifespan of a mortgage rather than during the origination of it. I cannot quantify it but that is another thing which we are working on, which will slowly fill the gap created by the settlements in Forensics line of business.

Moderator Thank you. Our next question is a follow up from Srivatsan Ramachandran of Spark Capital. Please go ahead.

Srivatsan Ramachandran Just wanted to get your comments on the HP business that we are losing. Would it be fair to say that a good part of this business, even HP as a vendor is losing or is it that we could be losing a part of it even to HP's captive? Just wanted to know how you would bi-furcate between the loss to a captive vis-à-vis HP itself losing a contract?

Ganesh Ayyar I want to respect HP as a customer and not comment on their business because it is important that even though they happen to be our largest shareholder, when it comes to customer relationship I must respect them as a customer. But what I can comment is that we are experiencing decline and as a service provider the onus is on me to figure out how to arrest it. We have attempted many things so far and not succeeded. This seems to be constantly the same line that I seem to be adopting, not proud of it but that is my line and the onus is on me and my team to crack the code. As of now I have nothing to report which tells me that we have cracked the code.

Moderator Thank you. As there are no further questions from the participants, I now hand the floor back to Mr. Ganesh Ayyar for closing comments

Ganesh Ayyar Thank you. First of all I appreciate your insightful questions. You have been a part of our journey and you have been with us throughout when we spoke about hyper-specialization, when we spoke about industry focus, when we spoke about our Direct business and you were patient with us. So today when we are talking about wins, we are talking about good pipeline, confidence in greater wins in the Direct organic space, I am thrilled that you are with us because your support has brought us where we are and we are clearly feeling good about our Direct organic business. Digital Risk is an important part of our business and will continue to be an important part. It has fantastic leadership, good talent and in the mortgage industry where the business is down 40%, they have been creative, their high value services has resulted in them opening up newer ways of doing business and next nine months would be metamorphosis of Digital Risk into a stronger part of Mphasis. Last but not the least, this journey has built a company which is able to work with our customers to deliver a high customer satisfaction, is able to get into emerging services areas like GRC and Digital, is able to build good pipeline and is able to win large deals. So thank you for your support and patience. Good luck and we will stay connected and hope to see you either in person or during our next call. Thank you so much.

Moderator: Thank you sir. On behalf of Mphasis Limited that concludes this conference call. Thank you for joining us. You may now disconnect your lines.