# "MphasiS' Q2 FY 2012 Earnings Conference Call"

## June 04, 2012

**<u>MphasiS Participants</u>**

**Mr. Ganesh Ayyar – CEO, MphasiS Limited**

**Mr. Ganesh Murthy – CFO, MphasiS Limited**

**Moderator** Ladies and gentlemen, good day and welcome to the MphasiS Q2 FY 2012 Earnings Conference Call. As a reminder, for the duration of the conference, 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 touchtone telephone. Please note that this conference is being recorded. I would like to hand the conference over to Mr. Varun Divadkar from CDR India. Thank you, and over to you, Sir.

**Varun Divadkar** Thanks Marina. Good morning everyone and thank you for joining us on the Q2 FY 2012 Results Conference Call of MphasiS Limited. We have with us today Mr. Ganesh Ayyar, the CEO and Mr. Ganesh Murthy, the CFO. Before I 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 Q2 FY12 results announcement release that has been emailed to you earlier. This conference call will be archived and the transcripts will 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** Good morning everybody. Thanks for joining the call. We will discuss our operating and financial performance for the second quarter which ended on April 30th, 2012. I hope that you have had the time to go through the financial results and overview release that we sent to you.

If you recall, two quarters ago we informed our investors that our strategy going forward was of profitable growth. The results during the last two quarters have been very promising in this regard. We have seen a significant improvement in profitability in each quarter and in Q2 we ended the quarter with an EBIT margin of 16.2% which is 120 basis points higher than the previous quarter. What is even more heartening is that this improvement in margins is a permanent improvement and not arising out of any upside on account of rupee depreciation.

Our net revenue saw a sequential decline of 2.8% to Rs. 13,289 million. Direct channel revenue declined 3.2% quarter on quarter to Rs. 5,625 million. After removing the rupee appreciation that we experienced during the quarter, the decline in revenue is 2.6% which is primarily due to lower license revenue during this quarter. License revenue tends to be lumpy in nature and in this quarter the license sales were lower by Rs. 116 million. The Direct business now has an annual run rate of about $ 440 million and comprises 42% of our total revenue. The quarter witnessed a healthy addition of 14 new logos in the Direct business.

As far as HP Enterprise Services business is concerned we continue to see ramp downs on this account, contributing to 4% QoQ decline to Rs. 7,311 million. We expect these challenges to persist in the short to medium term and that will be our prognosis as far as HP Enterprise Services is concerned.

Now let me move onto talk about business with HP outside Enterprise Services. We gained traction this quarter as we accelerated growth in many new areas within HP. Revenues from this segment were higher by 17.5% QoQ at Rs. 592 million. HP non-ES contribution to our HP revenue has increased to 7.5% in Q2 from 6.2% in Q1. Our HP pipeline outside Enterprise Services has seen some delay in expansion due to some of HP's own plans. However, the pipeline remains encouraging and visible and is expected to contribute to our growth in the near to mid term.

Now let me talk a little bit about our operational metrics this quarter. If I can summarize this quarter with two words, it is "Operational Excellence". We delivered improvements in all operational metrics. Our DSO dropped from 88 days to 80 days. Our blended utilization improved by 200 basis points in Application Services, 300 basis points in ITO services and 100 basis points in BPO services. Our manpower cost declined from 58.6% of revenue in the previous quarter to 57.2% in the current quarter. Our cash balance increased by Rs. 1,566 million after accounting for the dividend outflow of Rs. 1,586 million, which means that our gross addition to cash during the quarter was Rs. 3,152 million or around $ 60 million.

With a view to enhance long term value that we deliver to our customers, we are re-investing some of these productivity gains into the business. The next few quarters will see investments by us in expanding the base of solution architects and increased focus on marketing spend and customer connect events. At the same time when the global market is in the midst of an economic downturn, or shall I say uncertainty, and clients are looking at vendor consolidation, we continue our transformation initiatives remaining focused on enhancing our level of hyper-specialization and customer centricity. In order to enhance our Global Delivery Model, we have set up a near-shore center at Prince Edward Island, Canada. Its proximity to North America and our focus on the Banking Capital Market and of course Insurance makes it a very attractive location.

Our aim is to always provide the best services and solutions to our clients. The CRM platform designed by MphasiS at Tata AIG won the Celent Asia Insurance Award.

This reiterates our commitment to deliver customized solutions that add value to our clients' business. I would also like to highlight another development that took place recently and this is with regard to Javelina. Willamette Dental Group, the largest multi-specialty group dental practice in the Pacific Northwest recently purchased Eldorado's award winning payer platform, Javelina. They are deploying it in more than 50 locations throughout the US. Javelina will deliver insurance administration capabilities essential to managing multiple workflows and supporting Willamette Dental Group's numerous locations.

To sum up, our continued focus on hyper-specialized solutions that generate high quality revenue, cost optimization and high productivity is all focused on delivering profitable growth and that will be our journey. As far as the macro environment is concerned, we continue to see volatility in terms of buying patterns - how IT services are bought and sold; we also see increased volatility around the spends that customers have in a traditional sense on the discretionary spends. In our discussions with business leaders, we are seeing customers focus on identifying newer growth opportunities on innovation and solutions which can change the way they do business. Going into Q3 we expect to see improved traction with some more deals getting finalized. Thrust on implementing key strategic initiatives will continue. We remain confident of sustaining our margin profile while continuously adding new clients and creating innovative platforms and offerings, especially in the Direct business.

With that I would like to thank you for all your support and for your participation. I would now like to request the moderator to open this call for questions.

**Moderator** Sure Sir, thank you very much. Ladies and gentlemen, we will now begin the question and answer session. The first question is from Vihang Naik from MF Global. Please go ahead.

**Vihang Naik** On your BCM revenues, basically the gross margins have shown an impressive increase of about 490 basis points. What are the reasons for such a big increase and what is the sustainability of this?

**Ganesh Murthy** Our normalized gross margin is about 26-27% in the BCM area. There were certain cost declines and also a reduction in the bench that contributed to the jump in the gross margins to 31%.

**Vihang Naik** Okay, so I mean, do you see this as sustainable, particularly in BCM?

**Ganesh Murthy** Most of it is sustainable as none of it is because of any rupee, or forex, or one time.

**Vihang Naik** Touching on your utilizations, you know in most of the towers actually utilization is at or near the peak and since you know that has been also one of the drivers for your margin performance overall this quarter how do you see (a) utilizations and (b) margins going forward? Do you think these levels of utilizations are sustainable when growth returns?

**Ganesh Ayyar** Vihang, I will answer this question in two parts. First let me highlight to you some data points which you obviously would have noticed. I am just trying to highlight it. If you look at a YoY basis, our employee base has come down from 41,000 close to 37,000, whereas our revenues have gone up by 5.7%. Now this is also as a result of an increased focus on trying to have a profile of revenue which is high quality revenue. Obviously, it will start as a smaller stream which is non-linear in nature, and we are beginning to see some traction in that space. So as we look ahead, our profitability growth is going to be on multiple trends. One of the questions which you have asked is the utilization rate and I will get Ganesh Murthy to comment on it but as we look ahead our profitability focus is going to come through an increased share of revenue coming from high quality revenue. Secondly, we are ensuring that when we have got 37,000 employees, all the costs which are around an employee, real estate etc. gives us a tremendous opportunity to reduce that cost as well. So as we look ahead in terms of profit improvements, utilization is just one of the many levers available to us. As I mentioned during the opening remarks, some of the margin gains that we have seen or are going to see, we are re-investing a part of it into solutioning and go-to- market and marketing, so that we can continue to grow high quality revenue. Over to you, Ganesh Murthy, to share the utilization.

**Ganesh Murthy** For utilization, I think in onsite utilization we are pretty well reaching the top at 93% for Onsite Application Services. As far as offshore utilizations, I believe we still have about 100-200 basis points as further scope and headroom to go.

**Vihang Naik** And was some of the miss in this quarter both in HP-ES as well as Direct channel? I mean, was it somewhere also because of few client specific issues because looking at your client metric it seems that one of your clients has declined from probably $10 million account to $5 million account. So is there any client specific thing to discuss?

**Ganesh Murthy** That is not a HP client. That decline was primarily because of an Emerging Market client and essentially relating to the Aadhar project. If you recollect, because of the confusion between the Home Ministry and the UID ministry, we were asked to go slow in all the UID contracts in the month of March, but now that we have restarted it in the month of April we will see good traction there.

**Ganesh Ayyar** Let me share with you some pointers. In many ways, the new world is fascinatingly different. So with one customer where we have a significant footprint around testing, the customer saw a huge decline in their testing budgets. As a result, the testing budgets came under pressure and that is one of the factors which played out in Q2. At the same time, they are looking at doing things differently to acquire and retain their profitable customers so hence there are projects which we are entering into because we do a fantastic job in the testing side. So this is the dichotomy that we are dealing with in the market or I do not know whether you should call it a 'new normal' of the marketplace. When we looked at our pipeline for Q3, we went very granular to see whether the pipeline is robust for Q3 in terms of Direct business, and this is the detailed analysis which we had to go through before we felt that the so called absence of growth in the Direct business was specific to second quarter only.

**Vihang Naik** So your expectation of Direct business that kind of growing in line with the industry average stays, right apart from the miss in this quarter?

**Ganesh Ayyar** That is right.

**Ganesh Murthy** In fact our aim is to grow the above industry in the Direct channel.

**Vihang Moderator:** Thank you. The next question is from Vibha Salvi from Anvil Shares & Stock Broking. Please go ahead.

**Vibha Shah** Yeah, actually my question was on billing rates. If you see in ITO, the billing rate onsite and offshore has gone down this quarter, so could you throw some light on that?

**Ganesh Murthy** It is a very marginal reduction of around 40 cents in the billing rate on offshore. I really would not put too much on the onsite reduction because our onsite ITO presence is very limited. Our offshore Applications as well as ITO billing rates have declined very marginally by about 40 cents, primarily because during the quarter we had about 1,300 campus hires who were hired in the previous quarters and all of them have now got into billable positions, and since 86% of our revenue is Time and Material, obviously these 1,300 freshers command a lower rate than the lateral hires. So that brought down the overall rate slightly by about 40 cents.

**Vibha Shah** But was that on account of some specific projects that the rates were down?

**Ganesh Murthy** It was not project specific, it was across the board. Whichever projects where we put in freshers, you would see there would be a decline because we have to bill these freshers at a lower rate. Let me also categorically emphasize that we have not reduced our rates both for HP or any Direct channel customer.

**Vibha Shah** Okay, again if you could throw some more light on utilization. This quarter ITO utilization has gone up from 79% to 82%, so just wanted to know what were the deals like that came for execution for this quarter and how do we see the utilization moving in coming quarters?

**Ganesh Murthy** I think in ITO we have only about 70 people onsite if you are talking about onsite utilization. So again you are talking about a very low base, even if a few people go on vacation, your utilization will drop and vice-versa; if they all come back from vacation it will increase.

**Moderator** Thank you. The next question is from Sandeep Shah from RBS Equities. Please go ahead.

**Sandeep Shah** In terms of the Direct channel apart from the UID projects that you said, last quarter we have disclosed that we have won some very large number of good sized deals and despite that excluding Javelina, the revenues were flat. So can you exactly let us know that within the developed markets for the Direct channel are there any project cancellations because we also do discretionary projects within those set of clients**?**

**Ganesh Murthy** There have been no project cancellations. The pipeline is very robust but it is taking more time for us to convert the pipeline into actual orders. The decision cycles are elongated in the Mature markets. If you see the overall industry, we are focused on BFSI side, and there is a bit of discretionary spending cut in the BFSI area with some of our customers. So it is a combination of these two factors that have led to a flattish kind of revenue in the Direct channel.

**Sandeep Shah** We also work with some of the leading Wall Street banks in the Direct channel. What is the discussion in terms of their spend with a company like MphasiS? Is there any risk to vendor consolidation for MphasiS or can you give us a color on how the budgets would be spent with MphasiS from these kind of banks?

**Ganesh Ayyar** We went through a similar cycle if you recall in 2008 and 2009 when the economy was volatile and the customers across the industry were looking at alternative methods to optimize their cost, and their discretionary spend got cut to anywhere between 17% to 25%, and that continues to be the case even now. So vendor consolidation happened in 2008 and to be honest as a result of vendor consolidation we gained share with some of the customers on an overall basis. At this point of time, vendor consolidation activity is taking place in multiple customers. We do not see any material risk of a loss of a customer at this point of time.

**Sandeep Shah** When do we expect the decision to be implemented?

**Ganesh Ayyar** Different customers have different timelines. They are not guided by our quarters and it may not be even vendor consolidation across the board. It could be for certain specific areas that customers may be looking at vendor consolidation. For example, a customer may decide in testing that from five vendors he wants to consolidate to two. So it may not be across the board vendor consolidation, it may be stream by stream. So we are seeing both these trends and as I said that at this point of time we do not see any negative possibility. At the same time I would not rush to say that there is a positive possibility but there is a probability that it can also be positive for us.

**Sandeep Shah** Okay, and Sir, in terms of HP when it announced reorganization of cutting the staff by 27,000 by 2014, can you give us some color in terms of how it will impact some of the India units of HP including MphasiS?

**Ganesh Ayyar** I cannot comment on how it will affect HP's India entity because we do not have that knowledge and it is not within our purview. As far as MphasiS is concerned, MphasiS is completely independent. The 27,000 figure that you are seeing has nothing to do with MphasiS. We make decisions on our employee base, growth of our business, quality of revenue and so on. So the 27,000 job cuts have nothing whatsoever to do with MphasiS.

**Sandeep Shah** Will it be an opportunity where they want to actually increase their revenue productivity by reducing manpower there and outsourcing more to India units? Do you read that as a possibility?

**Ganesh Ayyar** Like in any other customer base when they announce that they are going to do workforce reduction, we see that as an opportunity as an offshore player but today, I am not in a position to say that it is going to change the trend of HP-ES business to us.

**Sandeep Shah** There were some transactions in terms of the Employee Welfare Trust where we have received the money - can you give the actual nature of this, what has happened exactly?

**Ganesh Murthy** This Trust was created in the year 2000 - 2001, more than 10-12 years back and this Trust was created to pay for the options held by the ex-employees of MphasiS

Corporation. This Trust operated independently; there were a set of trustees, it was based in Mauritius and all the options which were there were either vested and exercised or had lapsed. This Trust was sitting on a certain amount of MphasiS shares as well as certain cash balance. We took legal opinion and decided that since all the options have lapsed, the best course of action would be to dissolve the Trust and to transfer the funds to MphasiS. So we have done that in the last quarter. About $ 3.4 million have been transferred to MphasiS. We have not credited this to the P&L. There is no profit and loss impact. This is more of a transfer of cash and we have credited this amount directly to the capital reserves.

**Sandeep Shah** Okay, and just in terms of the hedging, can you let us know the OCI losses outstanding in the balance sheet debt?

**Ganesh Murthy** The OCI losses are around Rs. 160 crores in the balance sheet.

**Sandeep Shah** And Ganesh, if you can give a color in terms of a strike rate of the hedges in the immediate next two quarters?

**Ganesh Murthy** That is little difficult. We do not have that data readily available.

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

**Atul Soni** My question to the management would be with regards to the wage hike cycle, so just your thoughts on what kind of wage hikes or what kind of wage hike expectations would be there from the company's employed this time around?

**Ganesh Murthy** Our wage hike cycle is in the month of May. We are implementing a wage hike of around 8% for our offshore employees and about 3% for our onsite employees. This will have an impact of around 1.8% on our margins but we have a lot of levers that we can exercise including our facility consolidation, our leave policy rationalization and reduction of the headcount which will have an impact on the leave encashment and gratuity provisions. So all in all we find that the wage hike will have a neutral impact on our margins because we would have mitigated it with several cost mitigation activities. This is without considering the significant rupee depreciation in the month of May.

**Atul Soni** My second question would be with regards to selling and marketing and G&A expenses. This quarter we saw a slight uptake in both of these numbers - so should we take this as a regular picture going forward? Just wanted some color on the broad trend for that.

**Ganesh Murthy** Okay, let me first talk about the selling expenses. The selling expenses have gone up and we intend to continue this trend because we are making significant investments from an organic perspective in selling, marketing, and in solutioning. In fact, a lot of cost optimization benefits that we have reaped and that we are going to reap further will be reinvested into sales and solutioning. So you can expect selling expenses to remain in the 5% plus range. On the general and administrative expenses, as we have mentioned in our MD&A this quarter, there was a one-time expense that we incurred on an acquisition that did not materialize. So there were certain expenses related to that which we charged off in the P&L.

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

**Dipesh Mehta** Can you tell us the YoY growth in the HP non-ES channel in the first half?

**Ganesh Murthy** Last year we did $ 35 million in non-ES and in the first two quarters of this year we have done around $ 23 million.

**Moderator** The next question is from Sandeep Shah from RBS Equities.

**Sandeep Shah** Yes Sir, just in terms of our treasury yield I believe it is largely in FMP and that is why it is net of tax, correct?

**Ganesh Murthy** It is net of tax, correct. About 50% is invested in FMP's as interest rates really went up. We took the opportunity and locked-in on those FMP's. We also have a bulk of our other investments in liquid mutual funds. So it is mix of both, but we have been averaging very good interest yields, especially since the RBI also reduced the rate a few weeks ago.

**Sandeep Shah** So of the investible funds you said 50% is in FMP.

**Ganesh Murthy** Around 50% is in FMP. That is right.

**Sandeep Shah** And seasonally this is a good quarter so is it true even for this year that Q2 has some spike in the treasury income?

**Ganesh Murthy** Q2 definitely has a spike. We have grown our treasury income quite significantly. If you look at the other income, net, it has grown now pretty significantly.

**Sandeep Shah** And Sir, in the HP non-Enterprise side the earlier target was $75 to $80 million so can you give color on whether this target remains or it has come down?

**Ganesh Murthy** As I mentioned, we have clocked $ 23 million so far. Last year we clocked around $ 35 million for the whole year, so we have already achieved a significant growth as compared to the last year. It is showing an increasing trend QoQ and should roughly be about $ 55 to $ 60 million for the whole year. I would say about $ 60 million is what is likely.

**Ganesh Ayyar** The next question is from Manik Taneja from Emkay Global.

**Manik Taneja** Could you talk about what you are seeing within HP Enterprise Services side which has been under pressure in the recent quarters? Also, you mentioned that you are now looking at $ 55 to $ 60 million in sales from the HP non-enterprise side, you talked about the ramp ups on a couple of large deals that we won in HP outside of Enterprise business?

**Ganesh Ayyar** As I mentioned earlier, our prognosis around Enterprise Services is that we will continue to see decline and non-Enterprise Services saw a growth of about 17.4% in Q2 sequentially and that has given us $ 23 million already this year. You just heard Ganesh Murthy mentioning that we are looking at a possibility of closer to $ 60 million for the full year. Then we have the Direct business in which if you take out the lumpy license revenue which we had in Q1, it was flattish and obviously we are more geared towards growth. So when we look at the pipeline we believe that our Direct business is clearly poised for growth rates which are in line with the industry in the second half.

**Manik Taneja** And Sir, any thoughts on the cash utilization?

**Ganesh Murthy** We have been very successful in cash accretion. This quarter, cash flow from operations alone was $ 57 million which means around $ 19 million addition every month. So that is a very healthy signal for us. We have around $ 450 million of cash and we want to use this cash essentially to act as a catalyst for furthering our strategy. So we remained focused on M&A in select sectors like the Banking and Capital Market sectors and the Analytics space, all of which we feel will help us in our strategy of growing in Banking and Capital Markets and Insurance.

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

**Dipesh Mehta** Yes Sir, just on currency mix, what would be the currency mix for non-HP? How much would be rupee billing in that segment?

**Ganesh Murthy** About 24% is rupee billing in HP and for HP non-ES it is entirely dollar billing or foreign currency billing. And about 11% of our revenues is domestic, which is again in rupee.

**Dipesh Mehta:** So roughly 35% is rupee billing?

**Ganesh Murthy** That is right.

**Dipesh Mehta** And in non HP-ES it's fully other currency, not in rupee billing.

**Ganesh Murthy** That is right.

**Moderator:** Thank you. As there are no further questions from the participants, I now hand the conference over to the management for closing comments.

**Ganesh Ayyar** Once again, I would like to thank all of you for having interest in MphasiS. As I mentioned earlier, as the market continues to be uncertain and volatile what is most important for companies to know is what they stand for. MphasiS has always maintained that we stand for profitable growth. We have seen it in the last three quarters where we moved our operating margin from 14.7% to 15% to 16.2%. We will continue to stay focused on generating profitable growth. That will be our focus. At the same time we are going into our second half with a robust pipeline for our Direct business and good growth momentum around non-ES. So with that we look forward to again connecting at the end of Q3.

**Moderator** Thank you very much. On behalf of MphasiS, that concludes this conference call.