“MphasiS Limited Q4 FY12 Earnings Conference Call”

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Moderator Ladies and gentlemen, good day and welcome to the MphasiS Q4 FY12 Earnings Conference Call. As a reminder, for the duration of this conference, all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during this conference, please signal an operator by pressing '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. At this time I would like to hand the conference over to Mr. Varun Diwadkar from CDR India. Thank you and over to you, Sir.

Varun Divadkar Good morning everyone, and thank you for joining us on the Q4 FY12 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 statements made 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 Q4 FY12 results announcement release that has been e-mailed to you earlier. This conference call will be archived and the transcript will be available on the MphasiS corporate website, www.mphasis.com . I now invite Mr. Ganesh Ayyar to begin the proceedings of the call.

Ganesh Ayyar Thank you, Varun. We will discuss our operating and financial performance for the fourth quarter ended 31st October 2012. I hope that you have had the time to go through the financial results and group overview documents that we sent all of you.

Let me divide today's discussion into 3 buckets, the first being - Operational Excellence; the second bucket being - how we are building our future; and the third one being - how we are generating wealth and sharing it with our shareholders.

Let me begin by talking a little bit about operational excellence. I am very happy to share that the team has really worked extremely hard to drive increased revenue and solid profitability even in a volatile environment. We see profit discipline resulting in augmented profit visibility. As you know, we have sustained four consecutive quarters of profit improvement. We will continue to play in the band of 15 – 18% EBIT in coming years as well. Our utilization has been consistently on the radar and we have improved that during the last six quarters consecutively. We demonstrated consistent cash accretion over the last two years and in Q4 2012, the cash generation from the operations stood at ₹ 2,723 million. We see an average cash accretion ranging from US$ 40-50 million every quarter. Our DSO also showed a marked improvement this quarter by four days to 81 days contributing to an incremental cash growth.

Let me now briefly discuss how we are building our future. We began our transformation journey two years ago and our efforts in expanding our Direct channel business has yielded significant results. The Direct channel this year saw a volume growth of 25%. This growth has been spread across both Mature as well as Emerging markets. The Direct versus HP business mix shifted from 30:70 in Q4 FY10 to 38: 62 in Q4 FY11 and at the end of Q4 FY12 it stands at

46:54. This is clearly helping us manage the client concentration risk that we had. We aim at growing our Direct channel business by at least 1.5x the market growth in the coming year.

We are executing our focused acquisition strategy and as you would know we have signed a definitive agreement to acquire 100% shareholding of Digital Risk LLC. This is a milestone for us and adds a critical dimension to our strong value proposition for the Financial Services industry. Having made this transformative acquisition, we will now look at smaller acquisitions adding capabilities in our chosen domain areas.

Now to discuss how we continue to share our prosperity or shall I say wealth. The Board has recommended a significant increase in the dividend payout from ₹ 6.50 in FY11 to ₹ 17.00 in FY12. This translates into 52% dividend payout of earnings, including dividend distribution tax. We are confident that the successful execution of our strategic plan will continue to generate strong cash flows enabling us to strike a balance between investing in the business and regularly returning a larger proportion of our cash flow to shareholders.

Now to discuss some of our other business updates. With regard to the demand scenario, the pipeline in our Direct business continues to be healthy but at the same time the deal velocity and demand pattern is erratic. The deal velocity is slow in the current market conditions due to which deal closures have become unpredictable. The delay in decision-making is happening more in the case of mid-size or large deals. Direct business pipeline is healthy and to add to that we just won a deal from one of the largest insurance segment players within the US for our Wynsure software license implementations services and maintenance. This deal has a total value of US$6.6 million and we expect this momentum to continue. To conclude, our focus on driving operational excellence has resulted in incremental margin expansion in each quarter this year, improving overall profitability. This was in line with what we had committed to our shareholders at the beginning of the year. Going forward, we will continue to execute on strategic imperatives and drive hyper specialized growth, both organically and through select acquisitions. We look to increase our focus in select horizontals and emerging technologies such as Mobility and Advanced Analytics which we believe will play a more strategic role in preparing our clients for the future and to drive growth. We will continue to invest in building best-in-class Go-to Market capabilities to drive higher sales returns.

I also want to add that on Monday next week we are hosting our "Investors and Analysts Meet" at Mumbai. At this meet we plan to share with you our detailed business strategy for the next three years. We look forward to your participation in this meeting. I would now like to request the moderator to open the call for questions.

Moderator Thank you very much, Sir. Ladies and gentlemen, we will now begin the questions-and-answer session. We have the first question from Nitin Mohta of Macquarie; please go ahead.

Nitin Mohta Firstly, if I can get your thoughts on CY13 IT budgets, what are the positive surprises or negative surprises that you have seen so far in your discussions?

Ganesh Ayyar We are seeing two trends in the market. The traditional IT Services business model that all of us have been benefiting from in the entire industry is going through kind of a lean patch. We are clearly seeing that demand is slowing down and growth may be very muted. My expectation is that it would be in single digits. Now there is another type of demand which is emerging which requires business innovation where you are talking about anything ranging from transaction as a service, to risk-and-reward model. And of course, newer technologies are driving this model. I believe that there is clearly a demand and we are seeing that if you are highly specialized and if you can Go-to-Market with a new business model you could grow. So these two patterns are emerging and which is forcing us to undergo the transformation.

Nitin Mohta The revenue decline has been helped by very aggressive cost management, especially utilization rates of 85- 87% or even higher compared to some of the larger peers. Just wanted to understand how sustainable that utilization number is and obviously there is some worry in the market about your headcount, it seems to be declining every quarter. So how does that kind of tie-in with the growth strategy?

Ganesh Ayyar First, if I look ahead our focus is to drive revenue and growth, especially in the Direct channel for which we have been investing and we will continue to invest in Go-to-Market because that is primary. When I say Go-to Market it is not just quantity, it is also what type of Go-to Market you are augmenting because you need to have specialized people - domain experts, practitioners - who are able to take your solutions to the market. Two areas where we are investing, one is vertical, and two, we have also chosen certain horizontal solution sets ranging from ERP, Supply Chain Management, Testing to Mobility and Advanced Analytics. So that is one part of the answer because we would like to see that our Direct revenue grows at least at the rate of 1.5 x the industry growth rate.

Ganesh Murthy I think we have demonstrated a very good equation between our headcount and our cost, in line with revenue. So the way we look at it, the reduction in headcount is in line with revenue and it is imperative for us to maintain that kind of utilization as well as match the headcount with the revenue, so as to ensure that we increase our profitability and deliver a fair return to our shareholders.

Nitin Mohta If I can understand it better, would it be fair to say that the reduction that we have been seeing in Application Services and ITO side in the last one year, that has kind of bottomed out and now the employee headcount is going to mirror where the revenue profile is? Or do you still think there is some leeway to extract more efficiency from the employee headcount?

Ganesh Ayyar If you put the entire year in perspective, Nitin, our Direct business has grown roughly at 38% and if you look at it in volume terms, it has grown somewhere around 24-25%. So that is the feature, less to do with the Service line and more to do with which channel is growing. We have experienced a decline in the HP ES channel and that’s what you are seeing in the Application Services and ITO services. So it is more channel-specific rather than service-line specific. Now coming back to your question on head count, do we believe that it has bottomed out and will we see an increase in the head count? We are working on multiple fronts, first is, how do we enhance the value of the existing employee base by investing in training and combining it with an innovative business model so that we are able to generate higher returns on each employee. So that's one part of the equation. Second part of the equation is traditional services that we have and continue to grow in some shape and form would clearly drive the headcount growth. Whether the headcount grows or not depends on how the HP channel comes through. We are fairly confident about our Direct business growth; as I mentioned earlier, it should grow at the rate of 1.5x the industry.

Moderator Thank you very much. Our next question is from Manik Taneja of Emkay Global, please go ahead.

Manik Taneja Could you give us a sense on the outlook on business from HP outside the ES segment as well as then talk about what would be the margin tailwinds for us going forward? We have done extremely well in terms of improving margins every single quarter in the last 5 – 6 quarters. Just trying to get a sense on what are our operation levers that you can still squeeze in?

Ganesh Murthy Let me talk about the non-ES business. As you know, that was one of our focus areas and over the last one year we have grown our HP non-ES business by 50%. In FY11 we did about $35 million and in FY12 we have closed the year with about $48 million of non-ES revenue. We continue to see a growth in non-ES revenue. We won't be able to give you an exact indication of how much we will end up with in FY13 but it is definitely a growth and focus area for us.

Manik Taneja On the margin front?

Ganesh Murthy On the margin front, at the beginning of the year we mentioned that our aim was to maintain the EBIT margin between a band of 15-18% and if you notice our financials every quarter, we started at 15% and ended the year with 17.6% EBIT margins. As Mr. Ayyar mentioned, our aim remains the same. We will continue to operate in the next year and future years at a margin band between 15 – 18%. One of the levers that we still have is on account of our hedging policy; we follow a monthly rolling hedge. As you can see because of the rupee depreciation over the last one year; the hedges that we have taken for FY13 are at a significantly higher rate than the average rate at which we took our hedges in FY12 and that is going to give a significant boost to our margins. At the same time, we remain conscious to continuously re-invest our profits into selling so that we can grow organically, and as Mr. Ayyar mentioned, at least 1.5x the industry growth and the market growth. So you will continue to see EBIT margins between the band of 15 – 18%.

Manik Taneja Just trying to understand the non-salary cost element within our cost of revenue line. This cost used to be close to ~ ₹ 200 crore on a quarterly basis in the first quarter of FY12, it's now down to below ₹ 140 crore. I am just trying to understand how much juice is there in cutting these non-manpower based cost?

Ganesh Murthy If you are referring to the 'others' in our Cost of Revenues, it has gone down in the last quarter from ₹ 117 crore to ₹ 102 crore primarily because we had certain amount of re-billable and traded goods in the earlier quarters that was not there in this quarter. So this quarter represents the actual run rate.

Manik Taneja So one should look at similar number going forward or further reduction is possible over there?

Ganesh Murthy I think we should look at similar numbers going forward. Again, this will have a direct relation to revenue. So if revenue grows this would grow correspondingly.

Manik Taneja And Mr. Ayyar mentioned about us targeting 1.5x multiple to industry growth for the Direct business. Just trying to understand which pockets are you seeing growth and does that also build in the benefit from Digital Risk consolidation?

Ganesh Murthy This is an organic growth. We are talking about organically growing at 1.5x the market growth.

Ganesh Ayyar The demand pattern that we are seeing is across all the areas that we are focused on, from traditional areas like Testing to newer business models where we are looking at Transaction as a Service - basically the entire spectrum. We are not seeing any issues whatsoever in Banking and Capital Market and Insurance which is our primary areas of focus. There were a lot of concerns due to economic uncertainties that this sector would be hit and that there won't be any demand but we are not seeing those kind of trends.

Manik Taneja And you intend to maintain the dividend payout ratios at current levels going forward as well?

Ganesh Ayyar As I articulated right in the beginning, our plan is to first of all generate cash and share that wealth with our shareholders and that is why the current announcement has been made at ₹ 17.00. So our plan is to look at similar models going forward as well.

Moderator Our next question is from Sandeep Shah of CIMB, please go ahead.

Sandeep Shah Just on the Direct Channel you commented that on organic basis we want to grow 1.5x higher than the market rate. But if you look at the last four quarters, quarterly run rate on a Direct business in dollar terms it has been stagnated at ~$113 million. So this time the growth could be because of some of the exit rates have been better in the last financial year in the Q4 FY11. So what is exactly happening? Is it a client-specific issue or you believe that the competition to some extent is keeping us deprived in terms of some of the growth?

Ganesh Murthy To give you a perspective, if you look at the whole FY12, our Direct channel grew by 38% year-on-year and if you take out the impact of the rupee depreciation, our Direct channel actually grew in volume terms by 25% year-on-year. So I think that is significantly above the industry and market growth rate.

Ganesh Ayyar As I said during the opening remarks, one of the issues which we have been confronted with is, earlier there was a greater predictability of a deal, i.e. if you were predicting it will close by June of this year or July of this year then it will happen but that predictability has gone away. We are not seeing any inherent weaknesses in the demand especially for newer business models but this unpredictability about the sales cycle is what is causing a bit of havoc in quarterly numbers. Other than that we are not seeing anything which tells us that we are losing against the competition or that our customers are not buying or that the pipeline is not strong. Our pipeline is strong, we are winning deals, we have a good mix of small and mid-size and large deals and at the same time we are also seeing that there is pretty good demand for newer business models.

Sandeep Shah So what is giving us that confidence to say that we will be able to grow at 1.5 times on an organic basis, is it more to do with the new business model or you believe that things may improve entering CY13?

Ganesh Ayyar If things don't improve in CY13 then the average market rate will drop and still, we want to grow at 1.5x. So it does not have dependence when I say 1.5x on market improving. But it is clear that the investment that we have made in the Go-to Market and the portfolio refresh that we have done, the kind of solutions that we are bringing to the market, our quality of existing service where the customers are happy, that all these are contributing to my confidence and I am confident based on our current pipeline.

Sandeep Shah Any outlook in terms of the HP Enterprise side, do you believe that revenue run rate to some extent may now stabilize or you still expect the revenue run rate may continue to have challenges going forward?

Ganesh Ayyar Broadly speaking if I look at the trend, it has been declining every quarter in the last four quarters. I expect the decline to continue for at least the coming two quarters, and I have been saying this every quarter and unfortunately I am not able to demonstrate numbers along with it. We are trying different business models with HP Enterprise services and I am hoping that once we crack the code, I would be able to report back to you that we have cracked the code and now the decline either has slowed down or the growth days are back. As of now I am still looking at a decline from HP.

Sandeep Shah And Sir, given some more balance sheet write-offs in the books of the parent, is it more cost pressure to the subsidiaries and the associates because of the same?

Ganesh Ayyar As of now I have not seen any change whatsoever in my interaction with HP on our business and that's the only thing I can share with you. And our discussions continue in the same way or similar way that they were continuing six months ago.

Sandeep Shah Just a last question on the dividend payout which you said is likely to continue. But if you look at this year the free cash flow was closer to around $150 million and when you entered FY13 you are liable to pay $175 million for the acquisition. So in that scenario still you believe that this dividend payout would be sustainable?

Ganesh Murthy Definitely it is sustainable because what you are talking about is dividend payout from our existing cash flow. If you look at the last three years we have been adding $15 million a month. And this dividend outflow will take away about $75 million which we will actually recoup in a few months time. And we are sitting right now with slightly over $0.5 billion of cash. So even after spending $175 million, we still have a significant cash balance in our balance sheet and at the same time there is a balance 50% cash accretion that is also adding to our cash balance.

Ganesh Ayyar Let me add one more point to what Ganesh Murthy has said. It is important to understand the strategy which we are adopting and not just look at the outcome. The strategy is to have operational excellence in place, generate cash and to share it with the shareholders based on a plan. I want to be very clear that we haven't said that this is the payout ratio that we are going to give every year. That's not what we have said. We have just said we have a strategy in place which is what the Board wants to pursue and we will continue to pursue that. And this confidence is stemming from the fact that in multiple quarters we have been adding good cash and this is not just one quarter or two quarters or three quarters. That's what gives us the confidence.

Sandeep Shah And Sir, just last thing in terms of the SG&A cost efficiency and some of the efficiency in the direct cost, you still believe there is a head room ?

Ganesh Murthy Let me split the question into Selling expenses and G&A. If you look at the selling expenses, we have actually increased our selling expenses in FY12 by over $10 million. So this represents an increase of 1% of our revenues in the selling expenses. We will continue to increase our selling expenses to around 6% of revenues because it is important for us to invest in ourselves and to sustain our organic growth in the Direct channel. Now about G&A, we have made tremendous strides in the G&A area to optimize our G&A and to ensure we have a very effective organization structure. I would say the run rate right now in Q4 was about ₹ 48 crore on G&A. We would say somewhere around ₹ 50 crore would be the normal run rate per quarter.

Sandeep Shah Any outlook on the tax rate and the capex?

Ganesh Murthy The capex will be every minimal, it is all based upon our normal operations and our revenue forecast. And regarding the tax rate, we would look at a tax rate between 22 – 23%.

Moderator Our next question is from Raunak Onkar of PPFAS, please go ahead.

Raunak Onkar I just wanted to ask a question about your strategy. Like HP has several verticals and we are working only in a couple of them. So do you in the future plan to go into these new verticals if possible?

Ganesh Ayyar We actually choose our verticals or anything that we do based on two vectors. One is attractiveness of the market and the other our ability to execute. So if HP is focused on certain verticals and MphasiS doesn't have any specific value proposition then we wouldn't go after those verticals. We will stay focused on what we are good at and market attractiveness. Whether we will have a third vertical or fourth vertical, time will tell. But our basis is very simple, is it attractive and can it be executed.

Raunak Onkar So you are not averse to the fact that you can add new verticals and acquire new skills?

Ganesh Ayyar Absolutely not. We are not averse. Ultimately we are in business. If it makes sense we will do it.

Moderator Our next question is from Dipesh Mehta of SBI Cap Securities, please go ahead.

Dipesh Mehta I just want to understand emerging market and Direct channel is growing for us. This quarter it appears to be relatively weak. So can you provide some colors how we expect the next year to pan out for that segment?

Ganesh Murthy We have grown tremendously in the India market in FY12. In this quarter the growth is muted because we cut back on certain projects, primarily to get our DSO under control. It was a conscious decision not to grow significantly till we get our DSO within reasonable measures.

Dipesh Mehta So because the nature of that business would be always challenging for managing DSO. Do you expect some kind of relatively slow down compared to what earlier we used to see?

Ganesh Murthy I think we are also looking at the quality of our customers and the quality of our revenues. So I think the focus will be to grow good quality, high margin and also with customers where we would not have to invest in a significant amount of working capital. We will see growth in our Emerging markets; it continues to be our focus area but we will be very selective in the future.

Dipesh Mehta So because our aspiration is growing at 1.5x. I think earlier emerging market used to provide some kind of momentum. So you expect because of the change in strategy or maybe now realigning strategy with DSO and other things you expect it to be similar kind of thing or Mature market to drive for more growth?

Ganesh Ayyar The DSO which Ganesh Murthy was referring to it doesn’t matter whether it is Emerging or Mature. Our focus is we want to do business in an area where the quality of revenue is in line with the operational excellence model that we have in place. There is no distinction between Mature or Emerging. The specific point which he was raising is relating to an area within Emerging and if it is not in line with what we want to operate obviously we will de-focus. Regardless, our line of sight and our confidence around 1.5x growth continues in the Direct space.

Dipesh Mehta And just to understand the dividend policy better. So can you tell us what the stated policy is? Now we have increased dividend significantly, this year. So as a policy matter what will be the payout within range we would like to maintain?

Ganesh Murthy There is no stated policy. The only policy that we have got is to share a significant portion of our profits and wealth with our investors and shareholders. We are not looking at a precise number at which we will continue to maintain dividends.

Moderator Our next question is from Ashwin Mehta of Nomura, please go ahead.

Ashwin Mehta Just wanted to check in terms of HP. What is our outlook there in light of what HP is talking about, especially for their Enterprise Services business going into the next year?

Ganesh Murthy We don't give out guidances like that. At the same time, there is a limited amount of visibility so far as our HP Enterprise Services volumes are concerned because it is directly dependent upon the new deals being won by HP Enterprise Services. As Mr. Ayyar mentioned, we will continue to see declines in the next couple of quarters in our Enterprise Services business but beyond that it is quite difficult to provide an estimate.

Ashwin Mehta Secondly, in terms of employee motivation, how do you keep your employee motivation high in a scenario where for the last 5 – 6 quarters we have seen declines in terms of headcount and especially in a scenario where you are looking at 1.5x the market growth both in the Direct channel where possibly we will have to start to attract talent?

Ganesh Ayyar Sure, it is a great question, and I wish there was one single bullet by which I can explain it to you. But the fact remains that the strategy of MphasiS is abundantly clear, not only to the external market but to the family as well. We are aware of the decline that we have seen on the HP ES front which puts pressure in terms of employees. But what keeps us going is the quality of wins that we are having, the business model that we have invested in and also the fact that we have invested significantly in learning and development last year. In fact, we won an award as one of the best companies in "Learning and Development" in India. So it goes beyond the norm for us to keep ourselves motivated and so far we are doing alright. Can we do better? Yes, we can do better in that space.

Ashwin Mehta But we do not envisage that when we start to hire from the market for the anticipated growth the people would possibly want some premium in terms of coming in which is something that we have seen in the past downturns where there have been some curtailments in terms of head count, the salary increases have actually been slightly higher?

Ganesh Ayyar We haven't seen that as a trend in our offers in acquiring talent. In fact, the more specialized we get, better growth becomes the attraction for employees to come and join us because they don't just see this as a job, they see it as a career and our work is to make them even more valuable to our customers. That is why we are investing in learning and development and the stated strategy that we want to be hyper specialized. So it's not just employees, when you look at an inorganic acquisition also it's the same challenge if you ask me. But so far our track record has been pretty good. If we decide that this is the Company and the fact that we are very clear about where we want to play and where we don't want to play does tend to be part of the family.

Moderator Our next question is from Madhu Babu of HDFC Securities, please go ahead.

Madhu Babu We are talking of hyper specialization. So apart from BFSI which are the other verticals we are trying to strengthen?

Ganesh Ayyar Actually right now our investments are going into two verticals and select horizontal solutions. The two verticals that we are focused on are Banking and Capital Markets and Insurance. We don't club it together because they have a different set of requirements. In horizontal areas we have selected certain solution sets. So what I would highly recommend is that you join us on

Monday so we can take you through the details of our business strategy and our plans for the coming three years.

Moderator Our next question is from Srivatsan Ramachandran of Spark Capital, please go ahead.

Srivatsan Ramachandran Just wanted to understand the large ATM deal that you had won, any update on it?

Ganesh Ayyar Right now it is in the initial stage, what I call the installation stage, then the run stage will start probably a quarter later. As and when we get to the run stage we will be able to share more details.

Srivatsan Ramachandran So as things stand now there are not much revenues from these projects?

Ganesh Ayyar Right now there is zero revenue from this project.

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

Ganesh Ayyar Thank you so much. Once again I appreciate all of you for taking time to join us today. We intend to continue the trend of having more discussions with you. Look forward to meeting all of you and thanks for all your support in 2012. Let’s work together to have a stellar 2013. Thank you.

Moderator Thank you very much members of the management. Ladies and gentlemen, on behalf of MphasiS that concludes this conference.