"Eclerx Services Limited Q3 FY16 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to Eclerx Services Limited Q3 FY16 earnings conference call. As a reminder all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Rohitash Gupta – Chief Financial Officer, thank you and over to you sir.

Rohitash Gupta: Thank you. I welcome you all to the Eclerx earnings conference call for the third fiscal quarter of FY16. It has been a very good quarterly performance with satisfactory organic growth and continued strong margins. This is especially important given that Q3 is typically weak period for a lot of industries and that weakness was accentuated this time by Chennai floods.

Our Operating Revenue was $51.8 million in Q3 FY16 which is 3.2% up quarter-on-quarter and 31% up YoY for the first nine months. The organic YoY Dollar growth for first nine months was also satisfactory at 16.7%. In Constant Currency Terms, our Operating Revenue grew 4.2% quarter-on-quarter and 21.3% on organic YTD year-over-year basis. Our Total Revenues in INR was Rs 348 crores for Q3 and slightly above Rs 1000 crores for YTD which is up 41% YoY. Our growth this quarter continued to be supported with previously one short-term project some of which saw adhoc extensions during Q3. The short-term projects that were originally anticipated to end in various months of Q3 have come to an end as we speak. We also have several fixed duration projects which will come to an end over the next few quarters. In line with our Q2 commentary we maintain that Q4 revenues will largely remain flat versus Q2. Further, due to expected weaker average run rate in FY 16 we foresee that FY 17 may be a softer growth year for us. Our budgeting cycle will get over in March for the next year and hence we will provide more definitive qualitative outlook for FY 17 during our Q4 results. In terms of segmental performance, cable percentage growth on YTD year-over-year basis remained much higher than other two verticals.

Coming to profitability metrics, the Operating Margin percentage for the quarter is 32.2% compared to 33.3% last quarter in line with our previous commentary that H2 Operating Margins will be lower than H1. We expect it to further moderate in Q4 to give us FY 16 reported Operating Margins around 31%. CLX Operating Margins continues to be in mid-teens as we continue to invest in cross sell capabilities, improvement in Digital asset management platform and building more resilient, multi-country delivery framework for creative production services.

The Profit After Tax for this quarter is about Rs 89 crores which is about Rs 4 crores less than last quarter mainly due to drop in Other Income on account of lower FX effect. The Profit After Tax on YTD YoY basis has grown by 44% roughly in line with our 41% total Revenue growth in the same period. We have also completed issuance of 1 bonus share for every 3 shares held during the quarter. On the Other Income front the investment income has jumped back to Q1 levels of about Rs 2 crores due to additional Cash generation since the dividend payouts during Q2 FY16. The hedge Gain/Loss remained negligible as the Pre AS30 Hedge gains were largely offset by the MTM change. The revaluation and realized gains stood at Rs 2 crores which is roughly Rs 8 crores drop quarter-on-quarter due to relatively stable currency environment and contributed to drop in our Profit After Tax quarter-on-quarter.

Our Hedge book which is largely constituted of forwards has remained nearly flat at around $ 115 million with a strike rate of about Rs. 70.23 to a Dollar and that number has moved up by roughly 80 paisa to 90 paisa since Q2 level. We confirm that our Pre AS30 Hedge book will completely wind down during early part of Q4 and with that more than $77 million worth of inflows are expected to convert into Operating Revenues at about INR 70.1 to a Dollar during FY 17.

Moving to detailed P&L the Employee Cost increased by more than 7% quarter-on-quarter compared to the 5% sequential growth in Operating Revenue. This was the main reason for 150bps OPM decline quarter-on-quarter and this cost increase was mainly caused by increase in share of onshore delivery and consulting assignments both in US and Europe. Our SG&A cost remained roughly flat in percentage of OPR terms quarter-on-quarter at about 24%. We have Rs 426 crores of Cash and Cash Equivalent at the end of quarter which is a substantial increase from Rs 295 crore levels at the end of Q2 FY16. Our Net Operating cash flow generation during YTD was Rs 286 crores versus Rs 202 crores in the same period last year. As we mentioned in the last call most of FY 16 planned CAPEX spend was largely over in H1 and hence the Q3 CAPEX spend was a lesser number at about Rs 5 crores and we expect a similar lower number for Q4. We have spent about Rs 4 crores on various CSR initiatives related to Child Education and Health and we are closely monitoring the sustainable impact that this as spend creates on the lives of the effected.

Our Business Concentration metrics like geographical and currency share have remained largely flat quarter-on-quarter while the top 5 and top 10 shares in terms of revenue has shown minor increase of about 2%. The DSOs remained largely at the lower end of the historical range of 70-80 days. The staff utilization in Q3 was at 69% and it has been steadily increasing over the last few quarters due to increased scale in cable business and effect of short-term projects. However, it is likely to come down over the next few quarters as the fixed term project end.

One of the retail clients has moved from up from $0.5 million bucket to $1 million plus bucket while several other retail and luxury clients entered into $0.5 million plus bucket during this quarter. Many of these movements have been due to accumulation of trailing 12 months' revenue for CLX clients excluding which the client revenue bucket metrics have largely remained stable since last quarter.

Top 5 clients have shown a year-over-year Dollar growth of about 17.5% this quarter and 20.4% on Constant Currency terms. This is contributed both by continued attractiveness of value proposition of our cable services and various fixed term projects including Consulting among our Banking and Digital clients. Our reported emerging YoY growth continue to be very high primarily due to CLX addition, although we do see a moderation on organic emerging growth from previous high range of 30-40% as we increase penetration in many of those accounts. The significant reduction in organic emerging growth this time was aided by the fact that few of our

7 clients that are in $5 million plus range are of similar revenue size and have been displaying divergent growth rates and hence have changed positions between top 5 and emerging bucket. Henceforth we will start reporting Top 10 versus rest under the revenue mix trend.

The overall headcount has shown a decline quarter-on-quarter at about 8600 people which is in line with the utilization improvement that you saw previously. Our sales and BD staff count remained largely flat through this year-to-date in early 80s. The India attrition stood at 36.6% for the quarter which is 70 bps up compared to the Q2 number and is largely consistent with the Q2 to Q3 jump of 60 bps that we saw last year. However, overall attrition for this year is trending higher than last few years and we have been working on several people and structural initiatives both at industry as well as company level to improve the talent engagement and attrition metrics.

Lastly, as an administrative point in line with the new requirements we will be planning all investor, media and analyst interactions only on sufficient advance notice and inform stock exchanges about such interactions and hence I request your cooperation by contacting our investor relations agency for setting up any meetings or calls.

With this I will hand over the call back for Q&A.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Manik Taneja from Emkay Global. Please go ahead.

Manik Taneja: If you could give us some sense in terms of how is the demand panning out across the 3 business segments and how do you see this over the medium term? That question number one. The second question is that your investor presentation has talked about relatively softer revenue performance in FY 17, should that essentially be looked at versus what we have delivered in nine months FY 16 or you think one needs to possibly see a moderation in the 10-15% revenue growth range that you guys have talked about in the past?

Rohitash Gupta: Our commentary on FY 17 to be a softer growth year is in relation to the expected FY 16 outcome versus FY 15. As I mentioned earlier, we will give more definitive commentary in the Q4 results as we are undergoing budgeting cycle both on the margin as well as on the revenue growth trajectory front. But as of now you can assume that it will be definitely lower than what we will achieve this year let's say.

Manik Taneja: My question was with regards if you could help us understand the demand outlook within your three keys sub-segments and do you think cable will continue to outgrow the other 2 verticals even for the next 1 to 2 years?

Anjan Malik: From whatever you guys can see there is obviously a lot of revenue pressure in our client industry and you have seen that across from all the people, all the vendors that you cover in India and outside. We see consolidation of demand from our customers at that again is across all the Fortune 2000 type of customers that we today support. So there is definitely immense pressure out there. So within that if I may say that things look different in different places. If you look at our digital business we continue to see a large amount of demand in obviously e-commerce, analytics, content and commerce type of activity and that continues to be the case. In cable we still continue to see demand from the data services that we are providing. It's hard to say whether or not it's going to continue but certainly in short to medium term we see very healthy demand. In the Banking space clearly there is a lot of focus on reducing costs, there are pressure from Utilities and Automation, etc., but we continue to see demand in new areas and also changing areas of what we already support. For example, in Banking a lot of focus on Documentation, Digitization, Know Your Customer and whoever is going from over the counter to clearing, etc. So we have seen lots of changes taking place but because we see such changes which we hadn’t seen in the past is why we have been saying look we expect growth to be slightly slower. We expect short-term projects to continue to sort of be headlining over the next 12 months.

Manik Taneja: If I can prod you further with regards to your outlook, you guys have done reasonably well in your top customers in this financial year with growth accelerating through each of the few quarters, is there anything within some of your top customers that is making you cautious on near term revenue performance? And secondly, with regards to our emerging clients I suppose there is a significant cable business within that segment, so how is the growth within emerging clients across these three buckets?

P.D. Mundhra: Manik, this is PD let me take that. As you know we don't comment on any client specific question but more generally if I talk about our top 5 clients as a whole I would say that one of the reasons we have seen good growth with the top 5 and also good growth in Q3 is because of some of the short-term projects that we have been able to sign on within that cluster and as these projects have expired this quarter we expect that top 5 growth rates will moderate, that's one reason. The other reason is that the threat from captives also tends to come more to us in accounts where we have larger footprints which are typically our top let's say 5 to 8 accounts. And typically a strong Dollar and a weak Rupee in the short-term makes the captive proposition more attractive. So I think concern on those two factors is what leads us to believe that we will be off to a slower start in the next couple of quarters. Against that we still have growth opportunities both with the top 5 and non-top 5. So that’s kind of what the thinking is and why we are talking about growth rates being slightly soft in the next six months or so.

Manik Taneja: If you could give us some sense with regards to the progress on the CLX integration as well as some cross sell opportunities on that side?

P.D. Mundhra: I think that’s an area that’s proceeding pretty well so the native business at CLX is continuing to perform along expected lines and along our internal budgets and targets. From an integration standpoint our go-to-market teams in Europe are fully integrated and now they are under the common leadership of the erstwhile CLX, CEO, so he’s running the combined business. From a cross sell perspective I think we made good progress within the Retail segment in the UK in particular where we have shared clients and we have been able to benefit from each other's footprints. We have also now won a couple of sample digital engagements with their legacy clients in Italy as well. So I would say that there are green shoots in terms of cross sell in that business and we remain quite hopeful that in FY 17 it should perform well for us.

Moderator: Our next question is from the line of Madhu Babu from Centrum Broking. Please go ahead.

Madhu Babu: We have mentioned that onsite has increased and consulting engagements have increased which led to this margin drop. Could you talk more about how much is the onsite mix now? Because headcount has fallen and still margins have dropped.

Anjan Malik: Head count hasn't really dropped actually headcount has increased but I think all of it is a re-classification so what we showed you on our deck was pure biz dev because what we have been doing over the last couple of months is segregating delivery and considering those guys who are providing onshore consulting and analytics work as a part of the delivery organization. So we are reporting that separately today in terms of P&L and Revenue but its affect this quarter will be the highest that it's been in a long time.

Madhu Babu: So we are not disclosing that, onsite mix?

Anjan Malik: No, because at the moment we are still working from the metrics that we want to follow because it's still a quite a nascent business.

Madhu Babu: Could you talk about any number in the cable what is that year-on-year growth in the last nine months versus last year and how the consolidation is playing out and when we expect any impact of this consolidation in the cable industry?

P.D. Mundhra: I think by way of perspective I will give you a longer term view. When we acquired the company it was about $15 million or so in Revenues and it's grown about 3 times since then so that sort of a growth that we have had over the last four years in that business which clearly has been very strong for us. From an industry consolidation standpoint those transactions are still pending in the US. The acquisition of Time Warner Cable has not closed yet, it's expected to take a few more months, so it's not fully clear at this point who the new management team will be and what their priorities will be. Our teams continue to remain close to our clients' stakeholders to make sure that we are able to properly position our services and convey the value of what we are doing for them.

Madhu Babu: On Automation, we are hearing that Banking is more aggressive in implementing that, so any directional impact on our segment of work?

P.D. Mundhra: I would say Automation is something that the large Wall Street Banks have always invested a lot of money in. There is a new focus on things like Robotics. And what we are trying to do is trying to be a part of the solution with clients so with a couple of our banking strategic customers we are partnering with them to implement their chosen robotic solutions in some of the processes that we are running for them. We are also engaged in doing some consulting work and trying to figure out what the value is of implementing robotic solutions in other areas where we are not present today. So I would say we are dipping the toes from a Robotics implementation standpoint but it's not yet mainstream in terms of what we are doing.

Moderator: We have a next question from the line of Abhishek Shindadkar from ICICI Direct. Please go ahead.

Abhishek Shindadkar: The first question is regarding the guidance that we are seeing, that's for the consolidated Revenues, right? That's includes everything, right?

Rohitash Gupta: That's right.

Abhishek Shindadkar: The second question is regarding acquisition what's our pipeline, anything that we are looking at for the next 3 to 6 months and if yes then what is the kind of service line that we are looking at?

P.D. Mundhra: I would say acquisition is something that we look for on a continuous basis even in the last four or five months we would have received potential teasers on anywhere from 20 to 25 companies. So there is a variety of assets out there and from our perspective we are open to looking both at companies that could function as an add-on or bolt-ons to our existing businesses as well as assets that might help us create a new business like Agilyst did in the Cable sector for us. So I would hesitate before narrowing down and saying that this is the segment or this is the product in which we are looking for an asset. I think it's more opportunistic than that. What's very important to us is our conviction around how that as it would fit with our existing business, our ability to integrate it and the revenue characteristics of that company whether we are comfortable with that or not. So those would be more important factors in our mind than necessarily in which industry of which function the company is engaged in.

Abhishek Shindadkar: Even from a service line perspective anything that we are looking at which could help us on the digital side?

P.D. Mundhra: I think for us on the digital side we have already added creative services with the acquisition of CLX this year, so the next couple of areas where we need to invest are around Analytics or Mobile and perhaps around Search. So those would be the three areas that we have are prioritizing and we are at different points in terms of evolving our service capability than those three areas. Analytics, we already have a fairly good starting position, we are doing work with a number of clients in that area and I think some of the other areas for example, Mobile we need to build a little bit more.

Moderator: Our next question is from the line of Ankur Rudra from CLSA. Please go ahead.

Ankur Rudra: I wanted to understand your comment about FY 17 growth rates. Did you make the comment mainly on the organic growth this year for the overall growth this year?

Rohitash Gupta: Overall growth.

Ankur Rudra: Secondly on the top 5 acceleration this time was that because of……I didn't understand the commentary on the deck very clearly. Is that because of emerging client breaking into the top 5?

Rohitash Gupta: That's right. So as I mentioned if you see the metrics there are 7 clients which are over $5 million plus and some of them have been very close to each other for a while but at a different point of growth trajectory, some have been flat, some have been slightly down or up and there has been a flip there. And that is more possibility in future as accounts move forward.

Ankur Rudra: I might have missed this as part of the call so far but can you give me a sense how the Cable part of your business is growing and independently what kind of growth rates you see there going forward. I understand the commentary around Digital and Banking but Cable would help. Thanks.

Rohitash Gupta: As PD mentioned for a longer term perspective on Cable business when we acquired it 3.5 years back it was roughly around $15 million run rate and it has almost tripled in Revenue terms now. So that is the kind of growth rate we have seen. Our value proposition remains to be very attractive amongst the cable clients especially in the US and we continue to see growth in Cable segment to be superior to other two verticals in the near term.

Ankur Rudra: Cable historically had slightly different processes required lower utilization and hence it was a bit drag on margins. Do you think that drag will restart given this growth rate changes because this year we probably had benefits of some of the other businesses doing well as well?

P.D. Mundhra: I think on the cable side now that we have had significant scale actually the margin profile is converging with our other businesses, so with the other businesses as we are adding more onshore delivery there is a slight drag on margins and on the cable side as we get economies of scale there is a slight lift in margins. So they seem to be converging a little bit so I think further growth in cable might not necessarily mean big reduction in margins.

Moderator: Our next question is from the line of Sagar Rastogi from Ambit Capital. Please go ahead.

Sagar Rastogi: One is when you implement a robotic solution for a customer is it for the same people who are performing that process earlier, who are then engaged in the implementation phase? Also if you could give a sense of how much is the cut and effort that happens with robotic process automation on a sustainable basis, is it as high as 80-90% or is it relatively lesser than that?

Anjan Malik: I think at this stage all these robotic discussions are I would say beta at best. So the cuts and work that you will see is 3% points in many instances but its nowhere in 80-90% because much of the activity that we do because it tends to be of the more complex end of the spectrum, there is a lot to be needed to be automated away. So that's part one. Part two is that it's typically on the same people that work on robotics as let's say the guys who would be processing functions. It would be the higher end in skills set of that spectrum of service provider. So for example in our group of let's say 20 or 30 people that are servicing a particular function we might have subject matter experts or specialists, they will be a part of the robotics team, then we have people that are working in our technology function that specialize in say that vertical or that function that will be part of that robotics team and additionally even somebody from our consulting group that will be involved in the robotics team. So it tends to be the more SME end of our team that end up working on those robotic projects because they are more sort of a consultative.

Sagar Rastogi: Because you are closest to the action there perhaps if you could take a shot at maybe trying to predict what the metrics would look like maybe three years from now? Do you think a large part of your BFSI business specifically would be under robotics then? I understand the projects are in beta phase now do you think in something like 2 or 3 years that could change?

Anjan Malik: I think 2 or 3 years is a very short time horizon for any substantial change to happen given the number of industries, number of banks, number of participants and the complexity of functions. Do we see a continued focus in investing in technology, we definitely do. Do we see more leadership in our buyer base coming for technology, we definitely do. How much of the investment and technology and the focus on Robotics of Automation is coming from, just change in leadership in the last year or 18 months versus a change in underlying technology that has become available in the last 18 months I'm not sure. But you have to a assume that it’s a bit of both. We don't believe any new fundamental technology has come about in the last 18 months all of a sudden it can change the world. I think it’s more of a shift of investment.

Sagar Rastogi: Rohitash, if I could squeeze in one clarification, did I hear you right when you said that your top 7 clients are roughly the same size?

Rohitash Gupta: Few of them.

Sagar Rastogi: Few of them are of the same size and their growth rates are diverging?

Rohitash Gupta: Yes.

Moderator: Our next question is from the line of Pankaj from JM Financial. Please go ahead.

Pankaj: This is Pankaj here. PD, I think this is the fourth quarter when the topline growth has actually come ahead of expectations. So obviously this is a good surprise to have. But I am just trying to understand essentially is that there is a shift in the nature of demand and our business mix that we analysts are unable to really understand and hence estimate or is it something which is a very near-term phenomenon which is driving this? And related to this, I believe most of the surprise is largely due to the short term projects that we are getting in the digital business. Given that by definition such projects are of short duration and hence difficult to extrapolate, should we read the commentary as being conservative because of this?

P.D. Mundhra: I think we can solve that problem by underperforming versus expectations in the next couple of quarters. Honestly on a more serious note I think when we convey any guidance it is our best guess of what the future is going to look like based on the information we have at that time and our P&L is still small enough that individual events can create either an upside surprise or a downside shot. So that continues to be the case. You are absolutely right that we had some short-term projects that we were expecting will roll off at the end of Q2 or in early Q3 and a large part of those got extended out till December which is why our Q3 frankly came in higher than what we were thinking. But we are quite clear that we will not have that benefit in Q4 which is why we are saying that Q4 will probably be similar to Q2. So all I would say is we are not of the size of an Infosys or a Cognizant where you can apply a very probabilistic approach to your pipeline and come out with a very narrow guidance. At our small scale individual deals can make a substantial difference and that's what really happened. It's not any deliberate attempt to be conservative.

Pankaj: Sure PD. That comment was more on my sense than of course on you. But just to get this thing clearer, do you think that there is this whole short-term duration or projects in digital businesses which are driving this kind of a behavior?

P.D. Mundhra: Yes, I think to Anjan's point, certainly for the kind of business that we are in now we are seeing a greater propensity for clients to sign on short-term work. The onshore work also tends to be sort of shorter commitment unlike the offshore long-term BPO type work. So yes, if your question is that will we seeing more short-term work in the future, I would say probably yes.

Anjan Malik: I think you also have to look at the underlying demand environment because if you look at everything from politics to revenue growth in our client industry, if you look at M&A, you look at some of the underlying compression that's happening in the industry, our buyers are not willing to make long term bets certainly when it comes to service centers or any kind of long-term commitments on cost, so that's one, so that's one of the reasons why I think durations of the contracts in the as a whole have come down. Secondly because there is a lot of focus on what I will call change the business, those activities by definition need a different skill set and not necessarily a traditional BPO model. You have to be much more creative in how you bring value to the table in those kinds of circumstances, as we said some combination of technology, higher end consulting resources, more SME and more domain plus execution offshore. So those kinds of programs tend not to be your traditional sort of long lead, long end BPO businesses.

Pankaj: If I recall right, I think we used to mention that about 10-15% of our revenue is typically constituted by these short-term projects. So given the last nine months volatility any number you want to put that? I am sure this would have gone up significantly.

Rohitash Gupta: Yes Pankaj, this has gone up significantly but putting a number will be misleading simply because very nature of short-term projects is that the next quarter number will be very different in terms of percentage. But you're right that it has increased significantly.

Moderator: Our next question is from the line of Madhu Babu from Centrum Broking. Please go ahead.

Madhu Babu: On the attrition, last few quarters steadily it is increasing. Are we losing to captives and what are we trying to do to contain this attrition?

Rohitash Gupta: You are right that on an annual basis this year may be higher than what we have seen in the last 3 to 4 years and reasons are many fold especially in the BFSI space as I think PD was also alluding that in large clients especially BFSI there is lot of threat from captives also and those captives and insourcing decisions sometimes tend to increase the demand for people that they look for and that may cause more attrition for people like us where employees are much better trained in those kinds of processes. So that could be one factor. But I think in general what we are trying to do to bring back that attrition number to historical levels is several people initiatives on around comp restructuring or people layering, pyramid restructuring, roles and KRA clarifications, more communication, more fun and engagement type initiatives. So there are array of initiatives which are being planned for last 4 to 6 months which we hope will start yielding results possibly next year.

Madhu Babu: Second thing currency is falling again very sharply so earlier we used to have this pricing discount because of the steep fall in currency. Any threat for FY 17 on that aspect because now it's at $/INR 68 approximately.

P.D. Mundhra: I think at this point there is no such discussion that is happening and I would say the fall has not been all that sharp, ultimately it has gone from give or take $/INR 66 to 68 which is 3% more.

Madhu Babu: Ok…Year-on-year its higher. Anyway.

P.D. Mundhra: So I guess it's also a function of the trajectory the currency takes over the next few months.

Moderator: As there are no further questions I would now like to hand the conference over to Mr. Mundhra for his closing comments, over to you sir.

P.D. Mundhra: Thanks to everybody for joining the call. We look forward to talking to you next quarter. Thank you.

Moderator: Thank you very much members of the management. On behalf of Eclerx Services Limited that concludes this conference call. Thank you for joining us and you may now disconnect your lines.