"eClerx Services Limited Q3 FY 2017 Earnings Conference Call"

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Moderator: Ladies and Gentlemen, Good Day and Welcome to the eClerx Services Limited Q3 FY 2017 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 for an operator by pressing "*" followed by "0" on your touchtone phone. Please note that this conference is being recorded.

I now hand the conference over to Mr. Rohitash Gupta. Thank you and over to you, sir!

Rohitash Gupta: Good evening everyone. Thank you for joining eClerx earnings call for third fiscal quarter of FY17 and nine months ending 31st December 2016.

In Q3FY17 our operating revenue declined by 2.6% in constant currency terms, while our USD revenues declined by 3.5% totaling to about $47.2 million for the quarter. If you look at the first nine months of the year, our USD operating revenues declined by 1% and INR operating revenues grew by 3%. The continued revenue softness since start of this year has been mainly on account of in-sourcing, automation and M&A activity in our client base as we have described in the past especially among our some of the top 10 clients. We now anticipate that this revenue softness will continue into Q1 of next year. For margin trend, I would like to request you to focus more on YTD numbers, as quarterly numbers have been affected by the first-time adoption of Ind-AS at the start of the year. And the goal is that the full year numbers or even YTD numbers for the nine months now that we are reporting will be fairly representative of the numbers under the new accounting regime.

Coming to the positives, the YTD pricing for FTE based business has remained very stable on Y-o-Y YTD basis despite the revenue pressures. The operating margin percentage of first nine months has remained comfortably above 30% which was possible due to some excellent cost management by all our teams in a challenging revenue environment. Thirdly, the recent buyback of Rs. 234 crores at a price of INR 2,000 was very successful and well taken and has also contributed to the minor increase of 2.7% in the EPS. The new sales in Financial Services were strongest in this first nine months compared to the other two verticals which is a very-very positive sign. We have trained about 600 employees on robotics till date and plan to double that count by the end of next quarter. We have also deployed robotics for many of our top 10 clients which in few cases involves also eClerx's own proprietary ROBOWORX platform. Lastly, the digital pipeline has increased substantially compared to what we entered the year with and we have also seen good new large wins in APAC region.

The profit after-tax for this quarter is Rs. 86 crores; the other income for the quarter was about Rs. 11 crores which is more than double of the last quarter due to revaluation and realized gain impact in Q3 on account of favorable forex movement. Our forward hedge book is at $136 million and was maintained at 2.9 times the quarterly revenue. The average strike rate of these hedges is Rs 72.4 to a dollar which has improved by about Rs. 60 paisa to $1 since we last reported. Based on hedges booked till now we expect that about $29 million worth of inflows will convert into operating revenues at Rs. 71.5 to a dollar during Q4 of this year. The operating margin percentage dropped significantly this quarter compared to last year as employee cost for delivery grew disproportionately on a softer revenue base. We will continue to build our onshore delivery capabilities over next few quarters from a very small base currently and it may keep the employee cost number for the delivery at an elevated level. Most of the G&A items remained flat on sequential basis except for the catch-up expenditure that we did on CSR activity this quarter. The increase in S&D cost is primarily due to increase in senior hiring. We had about Rs. 553 crores worth of cash and cash equivalents at the end of the quarter and the decrease from last quarter is mainly on account of buyback. Our net operating cash flows for the YTD nine months is about Rs. 250 crores which has declined on Y-o-Y mainly due to working capital changes. The CAPEX continued to trend downwards compared to last year but is expected to go up significantly in next two quarters as we invest in our onshore delivery expansion. We have spent Rs. 5.4 crores on various CSR activities during YTD and we are on target to spend the full allocated amount for the year.

Our business concentration metrics like geographical and currency share of Americas and U.S. dollar remain largely unchanged but for minor fluctuations in digital EU business. The DSO was within our historically range of 70 days to 80 days at a level of 78 days this quarter. The staff utilization went down by 50 bps and is expected to decrease further a bit in the next few quarters as we adjust to the current revenue environment. The client counts under the top first two buckets have increased and decreased by one each due to downward movement of a top 10 clients. The top 10 clients have declined on Y-o-Y quarterly basis by 8.8% mainly due to the reasons previously discussed. Emerging clients also have shown a decline of about 2.6% Y-o-Y on constant currency basis. The Company employee strength has increased marginally to 8,648. Our sales and business development staff count has increased by a bit to 81. The India attrition which was at a very-very high level of 41% during Q2 has moderated down to 33% which is lower even on Y-o-Y basis and the trend has continued into January wherein January of this time attrition is lower than the last year January. Our effective tax rate for the YTD was at lower than usual level of around 19% mainly due to recognition of tax credit. The effective tax rate is likely to go in 23% to 25% range at console level during next year.

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

Moderator: Thank you, sir. Ladies and gentlemen, we will now begin with the Question-and-Answer Session. First question is from the line of Ankur Rudra from CLSA.

Ankur Rudra: Could you perhaps help me understand, I mean not just may be for the next two quarters you have given an outlook there but may be for the next two years or three years. Do you see structural challenges in the business especially as automation goes up, possibility of your kind of services around manual intervention and making things more efficient, becoming less and less across your client base. What I am trying to understand is how tough is the sale the business from the current approximately $200 odd million annual size with limited service line and vertical diversification.

Anjan Malik: Actually we have a lot of discussion in this topic obviously in our internal strategy sessions over last six months and I think basic synopsis or hypothesis on this is that actually the book of work that we have run is always at risk of automation, most of everything that is done by people at risk of automation. But most of what we do in our focus in the area of exceptional handling and doing the bits that automation has not already taken care of. So, we do not think systematically there has been a change in the risk profile of our business. Is there sort of a disproportionate impact or focus on this like automation, robotics some of our customers, yes, there is. Do we feel it is significantly changed sort of the likelihood of some manual activities that we do today completely taken away, no. Do we think there will be a reduction in some of it, yes but we actually see increasing complexity in the remaining work that is left behind. In the short-term to medium-term we do not see that as a major driver of demand reduction but obviously, automation as a whole is by definition biggest enemy the manual labor. So, that team is continuing unabated.

Ankur Rudra: So, then structurally even beyond your current guidance that you are expecting revenue headwinds till 1Q one would expect this will be a headwind over the course of FY 2018 and future years also, right?

Anjan Malik: I think automation by definition is a headwind to the kind of businesses we run but that is true for every job that is how it is there. So, I do not think that is not a structural headwind that is new to our business I think that has always been there. I think, if you want to look at new things in the market place and you could look at for example sort of the anti-globalization themes that seem to be coming into government, you could look at potentially trade barriers being put in place or tax changes that are being put into places are some of our consumer markets. I mean those to me are things that could have a new change to our business and for example change in regulation, right. But I do not think for example, automation in its own is any new that was involved three years or four years ago.

Ankur Rudra: Fair enough. And could you perhaps help us understand how wide are your client issues in terms of in-sourcing automation at least for the next two quarters or three quarters you spoken about and also how much of this extends to emerging clients which also saw a decline this time?

PD Mundhra: I would say that we face challenges at two or three of our top 10 clients and it is sort of due to client specific reasons so, I would not draw a trend out of it. Those clients one came from banking ironically one came from digital and one even came from cable. Certainly, part of what has waved that conversation a little bit in recent months is also the changing environment in the U.S where there is increasing preference to have work done locally and some of it was accelerated by corporate actions that Rohitash alluded to in his remarks amongst our clients whereas sort of the previous management in that company had a stronger preference for off shoring and cost reduction. The management of the acquiring company has different philosophy and they prefer more local sourcing. I think we have all those things so, it is not linked to any one business. We have actually face this across all two or three of our businesses.

Ankur Rudra: And just lastly on margins, I think did you say 30% the YTD EBIT margins are sustainable perhaps thanks to your increase in pricing you have got this time?

PD Mundhra: Yes, I think so. But I will let Rohitash comment in more detail.

Rohitash Gupta: Yes, so Ankur what I mentioned was that Y-T-D for nine month operating margin percentage is 32% whereas for the quarter on its own it is only 28%. So, even if that trend continues we will be comfortably above 30% and the full year numbers are fairly representative of current state of business. So, to that extent I would say that 30% should be the target even for next year.

Moderator: Thank you. Next question is from Raj Kantawala from Equirus Securities.

Raj Kantawala: A couple of things is on this roboworx framework, if you could share some more flavor on which particular verticals and which particular geographies we have focus on? And the second question is on H1B visa changing regulation so, how does that impact us?

Rohitash Gupta: So, Raj thank you for the question. On ROBOWORX, it is our proprietary robotics platform which can do repetitive task that typically humans do and it is applicable generically across industry. So, for example we have now successful deployment across clients, across the three vertical. So, whether it is digital or whether it is banking clients or cable, we have deployed it. Now, in terms of acceptance of robotics as a principal or ROBOWORX as a tool; those are two separate questions. I would say that on robotics, banking sector has been a little more attracted towards RPA or BOT-like solutions in general and that is where we are also seeing traction. In most of the other cases it is also a tool of increasing your value proposition by giving productivity benefits to clients. So, to that extent it is beneficial for both us as well as clients to use as much automation as possible using roboworx or any other third-party tools, if they prefer to. On your second question about H1B, we do not have any dependence on H1B for our revenue generating work. So, I do not think that we are impacted by either a potential downsizing of grants of H1B or by even by the proposed wage hikes on that. We mostly hire locally and we will continue to do so even more so in future if need be.

Raj Kantawala: Okay. So, just a follow-up on the robotics platform. So, how is the pipeline have been shaping up overall on your overall level and what percentage of revenues if you could share would be presently coming in what are you targeting for the next 12 months to 15 months.

Rohitash Gupta: Raj, it is a very-very difficult question because as I mentioned it is not necessarily only a standalone license sale; for some specialist's robotics platform provider, it may be so but as a large BPO or KPO provider for us that is not the main stream. So, what we are doing is that we are using this tool for our existing work, number one. And number two, to get into newer areas which were otherwise not possible for us using our older model. So, it is very hard to differentiate what is the standalone ROBOWORX potential because we will use it in every single opportunity actually.

Moderator: Thank you. Next question is from the line of Abhishek Kumar from JM Financial.

Abhishek Kumar: Rohitash, you mentioned that the new sales in BFS has been one of the highest this quarter. Just wanted to understand what are the kind of new projects that we are winning from the BFS and in terms of size of these engagements do they start small and therefore they are not able to offset the contraction that we are seeing in the automation.

Anjan Malik: So, if you look at our book which is broadly broken up into trade lifecycle and client lifecycle, a lot of the growth that we have had actually split across the two books both in trade and client lifecycle services. We continue to see a reducing dependent on something like derivatives and increasing our other product support. A lot of the growth has actually come in Tier-II clients as we have had a couple of large engagements and what we are finding is of course that these tend to be a longer-term investment cycles in terms of their on-boarding period. So, some of them are starting small but will grow to the large clients over a period of time. Well, at present in some places they are not big enough to offset some of the reduction in project work that we were doing some of the larger clients, so regulatory programs roll off the reduction that we have in those programs is not offsetting so these longer-term businesses as usual programs building these new clients.

Abhishek Kumar: Okay. Second question, I know it might be a little early but there are talks of some part of Dodd Frank being repeal. So, does that impact us in positive or negatives way because there are some part of regulatory work that we might be doing for Dodd Frank at the same time some of the derivative volumes kind of increase because of that. So, any initial thoughts that you have?

Anjan Malik: It is really hard to tell because it is very early in the process, today if you look at the services that we provide, yes, some of the programs that we run I think certainly a lot of the project work that we have run is driven by regulation in total, right Dodd Frank is one because we have got EMIR in Europe, you have a number of directives, etc. So, there are number of regulations that drive overall volume. But clearly, if you have a reduction in Dodd Frank and you reduce the cost of capital for these organizations and it is very obvious that some of our clients will be winners in terms of being able to trade more in those products that ultimately will drive more volume, right. But it is hard to tell how things end up. So, I think potential reduction in projects but you potentially have a growth in volume and more business confidence. And ultimately, we want to have customers that are increasing revenue and our customers have not seen that in the long-run.

Moderator: Thank you. The next question is from Apoorva Prasad from HDFC Securities.

Apoorva Prasad: I just want to check when we were talking about headwinds extending up to first quarter I mean are we really envisaging similar decline that we have been seeing for last few quarters?

PD Mundhra: Let me take that, I would say that we are sort of seeing an environment that is zero, plus minus, that is a 2% a quarter. So, within that tolerance whether we end up as a plus one or a minus two, we do not really have that visibility at this point but from what we can see in terms of likely roll off as well as new sales in the pipeline that is a sort of range that we see for the next couple of quarters. So, that is sort of what we can share with you.

Apoorva Prasad: Right. And just to follow-up on that, what is really giving us confidence of acceleration post that?

PD Mundhra: There is nothing that is giving us confidence of acceleration post that definitively, but what we can see is sort of at any given time is a four month to six months' horizon because that is the length of our sales cycle. So, whatever is there in our pipeline or whatever known events we have even from a reduction and revenue standalone point roll off all those will play out in the next three months, four months, five months, so that is really the only length of time for which we have even limited visibility. Having said that and now tying back to some comments that we made earlier in response to a question a lot of the softness in net revenue growth is on account of roll offs we have experienced a two clients or three clients and from whatever we can tell and looking at the root causes for those roll offs those are very specific to those clients. So, I do remain optimistic that one those things are behind us the momentum for new sales still continues to be strong. We still continue to sell, give or take $50 million worth of new deals every year. So, with that continuing once we get pass the role offs logic would dictate that net growth numbers become stronger but that is the basis for the outlook that we have given.

Apoorva Prasad: Sure, sir, that is helpful. Is it possible to really break out excluding the three clients how would the growth have been for the third quarter?

PD Mundhra: I think that is difficult for us to do. But what I can tell you is from a reduction and revenue perspective almost half of the reductions that we are seeing would be across two or three large client accounts. The rest is normal run rate of doing business in our kind of scenario, 10%, 15% of our book of revenue does roll off any given year because it is a variety of reasons and that is baked into our financial model. This year has been heavier. I mean the last two quarters, three quarters and the next couple of quarters is heavier because of the two or three clients that I spoke about.

Moderator: Thank you.

Rohitash Gupta: We can end the call if there are no further questions.

Moderator: Would you like to add any closing comments, members of management?

Rohitash Gupta: Thank you very much for all the people for participating in this earnings call and look forward to talking to you in next quarter.

Moderator: Thank you very much members of the management. Ladies and gentlemen, on behalf of eClerx Services Limited that concludes today's conference call. Thank you all for joining us and you may disconnect your lines now.