"eClerx Services Limited Q2 FY19 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the eClerx Services Limited Q2FY19 Earnings Conference Call. As a remainder, 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 telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Rohitash Gupta from eClerx Services Limited. Thank you and over to you, Mr. Gupta.

Rohitash Gupta: Thank you for joining eClerx's earnings call for the second fiscal quarter of FY19 ending 30th September.

In Q2, we saw sequential increase in $ revenue by about 1.6% to $50mm while our YoY $ revenue witnessed acceleration from 0.9% in Q1 to 3.5% in Q2. The sequential growth in Constant currency stood at 2.2%. We saw a modest increase in offshore $ revenues sequentially, but it decreased marginally on YoY basis. On the other hand, our efforts on building onshore revenues continued to result in healthy YoY growth of about 33% this quarter. This Q2 was our fourth consecutive quarter with YoY $ revenue increase after 5 prior quarters of continuous YoY declines.

INR Operating revenues increased by 8% YoY accelerating from 6% YoY in Q1. INR operating revenue increased by 1% QoQ to INR 3,559 million despite accommodating 77mm sequential decrease in SEIS income and INR 15mm decline due to lower hedge realization rates. The OPM for Q2 stood at INR 728 million, an increase of 6% sequentially but a decline of 13% on YoY basis. Profit after tax in Q2 was at INR 699 million witnessing a 16% increase since last quarter.

Other income for the quarter increased by about INR 8 million due to revaluation and realized gains because of INR depreciation against USD. Our forward hedge book of about $151 mm is at an avg rate of 70.5, a rate that has increased by about 120 paisa since last qtr primarily due to recently booked hedges at higher spot rates. We have hit our lowest hedge realization rate in Q2 and this rate will modestly increase in H2 and will show significant increase from next FY.

The Operating margin % increased by ~90bps this qtr as global delivery and support model optimisation efforts played out as expected supported by reduction in travel costs and one-time accounting benefit of Pune facility consolidation; all three of which helped more than offset the two headwinds of INR 92 mm in the quarter of lower SEIS accruals and lower hedge realisation rates. SG&A put together contributed to OPM increase by about 70 bps sequential basis while depreciation increase contributed to 20 bps of OPM decrease.

We had about 6,531 mm INR of cash and cash equivalent at the Q2 end, which increased by INR 464mm since Q1. The net Operating cash flow during the quarter jumped back to healthy level of INR 937 mm. We have spent around 64 mm INR on capex in Q2, which is higher than Q1 amount as we have recently started on previously announced Fayetteville expansion and Pune facility consolidation. The Capex will keep increasing over next few quarters, with total one time capex budget of INR 300 mm during FY19 and any project overrun will get into Q1. This capex has started showing minor impact on depreciation in Q2 and this impact is likely to peak around Q1FY20. On Balance sheet, the only significant change is in increase of deferred tax assets, which in turn is due to MTM loss on hedges given the current depreciation.

We have spent ~24 mm INR on various CSR activities during the quarter including catch up on unspent budget from Q1. eClerx and its employees have also supported Flood and hurricane rehabilitation efforts in Southern India and North Carolina respectively. ESOP Trust, which began operations in 2016, has accumulated about 705 thousand shares at an average price of 1268 INR. Shareholders have approved a further loan of INR 600mm to the Trust to continue the market purchase activity. In line with our stated approach, we have distributed 53% of our last 12 quarters cumulative PAT in form of dividends and Buybacks and we will continue to follow similar approach.

The DSO was at 89 days in Q2, which has improved significantly since the last quarter. Additionally, since our top 10 client's Account payable process have stabilized, we have started certain initiatives to bring further improvements in DSO by this year-end. Most of the Revenue concentration and utilization metrics have remained same as last quarter. In addition to the continued growth in Onshore revenue, Managed services growth has also panned out as per our longer term strategy and it now contributes to more than a quarter of our revenue. A very satisfactory achievement here is that all the three verticals have increased managed services book by similar % over last year.

Two of the clients, one each from Financial Markets and Retail have moved from half mm to 1mm revenue buckets. Revenue of Top 10 clients has entered into positive YoY growth after many quarters of continuous decline. Emerging client's growth, albeit still in comfortable double digits, has moderated temporarily. The emerging client revenues in both 0.5mm+ bucket and rest remains volatile due to higher mix of project business.

The company employee strength has increased YoY to 9,583 with an increase of 161 coming from offshore delivery teams, partly to offset increased attrition. Our onshore staff, mainly in Fayetteville and consulting has increased by 87 in line with the onshore revenue growth. Our sales and Business Development staff count has increased since last quarter from 78 to 86. The India attrition has increased sequentially to 42% with most of the increase at the execution level, while our high performer manager and SME attrition is now near multi-year low. Our effective tax rate for H1 has moderated to 27.5% and we expect our FY19 ETR to be between 28-30%.

The demand environment for our services has remained very strong, as our H1 new sales have been highest ever in any 6 months period with our pipeline conversion rates across all verticals increasing YoY. Our Revenue per employee has been rising continuously across last 6 quarters, most notably in Digital as we become integral part of our client's digital initiatives through our consulting practice. An interesting emerging trend is that deal sizes of our new logo wins have increased substantially, demonstrating the recognition of our niche positioning in a more competitive new client landscape. As we see lot of positives in our demand environment, we also feel that pace of roll offs and expectations of higher productivity on legacy work remains high resulting in relatively tepid revenue growth. Count of deployed Roboworx bots has increased by more than 50% and Machine-learning projects have grown 4 times YoY. Overall, we are confident that with broad based demand, tailwind on currency, strong execution on new deals, increasing mix of managed services, onshore consulting, Analytics, Robotics and Machine learning, we are strongly positioned to capture increasing mind and revenue share from our clients while maintaining or improving profitability.

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

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. We will take the first question from the line of Ruchi Burde from Bank of Baroda Capital Markets. Please go ahead.

Ruchi Burde: Could you update us regarding your new onsite facility due to come up?

Rohitash Gupta: Sure, as I mentioned, Ruchi, we have had our Fayetteville facility more than 12-months. What we did now is that we increased space by hiring a nearby space to the existing facility and that work has almost come to completion so which means that we have started hiring new people to fill up and train the people who will fit in this new leased space, so that is I think work-in progress, but as we speak, this is nearly done.

Ruchi Burde: Onsite headcount increase that we see is happening for this newly extended facility or it was on the…?

Rohitash Gupta: Mostly on this plus there is also little bit increase in digital consulting practice onshore.

Ruchi Burde: Secondly, you had mentioned that substantial increase in profitability would largely hinge on how we can derive offshore revenue even as our onsite revenue continue to increase. In your prepared comment, you mentioned that we look for improving profitability going ahead. So, do we have a visibility for higher offshore revenue growth from here onwards?

PD Mundhra: Hi, this is P.D. I think as Rohitash mentioned, at the moment we are seeing more demand for onshore work for a variety of reasons than offshore, so the offshore book is roughly flat year-over-year, most of the growth has come in onshore and other new services. I think as we go forward, we do see some growth offshore as well but I think we see stronger demand growth for onshore services; however, I think sort of given the trajectory of the currency we do expect profitability to improve as a result especially come next year when our realization rate should improve substantially from what we have seen in FY19 so far. So, I think the currency will be one driver of slightly improving offshore profitability over the next 18-24-months.

Ruchi Burde: In the recent quarter we have seen onsite revenue mix for you guys increasing but in tandem your managed services proportion of book has also increased. Now given it has been quite a while, is it reasonable to assume that maturity of those managed services would be a significant margin lever going ahead?

Rohitash Gupta: It depends on the area, but generally speaking, you are right that in the chosen areas for example KYC or any other such nearly productized areas, the managed services work have started to reach maturity where we are working on managed services projects across multiple clients for the same area and we have the toolset, whether it is automation or robots or machine learning type initiative which are deployed for that and we expect that as business grows further in those chosen areas, that will be a margin lever.

Moderator: Thank you. We will take the next question from the line of Vishal Desai from Axis Capital. Please go ahead.

Vishal Desai: Just to recap in terms of our outlook which we had laid out in Q1, we had mentioned that in H2 we are likely to see probably a growth revival but I guess from Rohitash prepared comments we still see the risk of roll-offs as well as automation-led threats on our legacy business. Could you spell out in terms of how are we seeing H2 shape up in the coming quarters?

Rohitash Gupta: Vishal, what I have told is the factual things that we have seen in H1 which includes the roll-offs that we have seen of legacy offshore business and as PD was also alluding on offshore dollar revenue basis it has remained almost flat year-over-year. So, as of now we are seeing higher roll-off to continue, but in future we think that this base will come down as our mix of legacy projects comes down; and legacy we define typically by SOWs which are more than five years old; has been decreasing. So, that threat for roll-off is basically continuously decreasing as we speak.

Vishal Desai: Could you help me with the ballpark figure in terms of how much portion of our revenue would be on the legacy side of the business?

Rohitash Gupta: As I said, we are defining legacy in a convenient age fashion and it does not necessarily works always in that manner because the underlying work and toolsets keeps on changing. But if we were to take a very hard cut definition of five years plus, the mix is roughly 50% of the total revenue.

Vishal Desai: In terms of the positives going into H2, could we have an update in terms of how is the outlook shaping up in terms of the three verticals?

PD Mundhra: I think we continue to see good demand across all the three businesses which is what helped us sort of replace all the revenue loss because of either roll-off or automation. I think as we have shared last financial year we saw a lot of roll-offs on the cable side, this year that slowed down, so we see good net growth on the cable business. I think also on financial and digital we will see some growth. If I had to pick one, I would say strongest momentum is probably on the customer operations, our cable business and the other two still positive momentum but maybe not as strong in terms of net growth.

Vishal Desai: Given that pretty much all our revenue growth which we are expecting from the commentary that you guys are stating out is likely to be driven from onsite location going forward, is it fair to assume that margin growth would be largely led by operating efficiencies in terms of SG&A rationalization rather than any kind of an offshore shift or do we see any scope for further levers or any kind of margin improvement from here on?

PD Mundhra: I do not think that the proportion of onshore revenue is going to come down. If it is anything in fact it might go up a little bit because we see more traction in the near term for onshore work. Having said that, as I shared in response to a previous question, I think one tailwind that we do expect to get some benefits from is the recent INR depreciation which after a gap of maybe three or four years will help us offset some of the accumulated impact of wage inflation that we have seen over that period. So, in terms of factors that might improve profitability let us say 12-months from now has better hedges start factoring into our P&L, I think currency would be one big one.

Moderator: Thank you. We will take the next question from the line of Abhishek S from Equirus Securities. Please go ahead.

Abhishek S: The year-on-year growth in the top-10 was reassuring after almost five, six quarters. So, if you can elaborate on the visibility going ahead for the next three, four quarters?

PD Mundhra: It is hard for me to give you a firm number but I will say qualitatively I think that the broader trend of the emerging accounts growing faster than the top-5, top-10 will not change. So, the numbers may move up and down a little bit but I think we continue to expect a larger part of our growth to come from our non-top-10 accounts which in a way side to a sort of long running strategic goal of ours in terms of derisking the business. So, the top-10 growth number might be low single digit positive one quarter may even be flat or negative another quarter but it is not going to be very super strong, I think that is pretty much clear. I think we do expect to see more growth continue on the emerging accounts.

Abhishek S: Secondly, in the prepared remarks, there was a mention about shift of clients to 1 million bucket. Could you elaborate as to what led to this, what was the kind of services that we sold or cross-sold, any color on that would be interesting?

Rohitash Gupta: Abhishek, specifics I would not have off-hand now, but in general, in the clients that move up the buckets, they are generally in form of selling new concentric services in addition to what we have been serving them already. So, typically, in a digital retail clients, we may end up selling analytics or AB testing kind of service, in addition to current let us say campaign management service. In Financial Services, it could be additional work in the areas of reference data or any regulatory risk reporting kind of processes. So, it is typically something related to what we are doing in the higher growth areas in both cases, analytics in digital for example and maybe KYC or reference data kind of services in financial markets.

Abhishek S: Lastly, the staff utilization in the 10-quarter period, I think we only had one or two quarters above 75. Based on your commentary do you think this can go back to those levels or do you think it is still more time to go there?

Rohitash Gupta: One of the reasons why it has remained at a lower level than what historically it has been is that the older legacy work which was slightly more efficient for us from pyramid perspective has rolled off of late and the new services especially in the initial days require more staff to ramp up. Secondly, due to the higher attrition levels that we are seeing in last couple of quarters compared to our history, the bench is a slightly elevated level. So, I think once these two factors go down, we will see some minor improvement, but structurally I do not see a massive improvement in this because we are delivering newer services which have that kind of bench requirement.

Moderator: Thank you. We will take the next follow up question from the line of Vishal Desai from Axis Capital. Please go ahead.

Vishal Desai: Just wanted to check in terms of Q3, do we face any kind of seasonality, are we expecting any momentum slowdown from the 1.6% or growth that we have seen in this quarter, is there any seasonality impact that we need to factor in going into Q3 and Q4 or we could expect momentum to accelerate or probably remain steady from here on?

PD Mundhra: In our business, there is no defined seasonality. So, I do not think there is a constant factor which should either push revenues up or down in the last calendar quarter. I think base case would be similar sort of performance, maybe a little bit up or down depending on how events play out.

Moderator: Thank you. We will take the next question from the line of Ruchi Burde from Bank of Baroda Capital Markets. Please go ahead.

Ruchi Burde: For our onsite delivery center that we are ramping up, could you talk us through the resource composition in terms of locals when is a dependency, also it would be great to hear your view regarding are you experiencing any challenges or tightening of administrative norms around visa?

Rohitash Gupta: On your first question, Fayetteville facility, we not only hire locals which means US citizens, but we also tend to hire from local community. That have been part of our strategy since day one. Barring handful or single digit senior management which may have come from other cities within US, everybody is from the local area. On your visa question, we did not have much footprint or strategy of sending people from India to do work in US for clients. I think we are continuing with that approach as well in the current environments when getting visas are tight. So, we are largely not affected.

Ruchi Burde: Secondly, Rohitash, could you explain on the one-time gain that you have mentioned in the press release due to the Pune facility consolidation, what led to that?

Rohitash Gupta: I have accounted into our existing landlords in signing up agreements for the newer deal. So, since that event has happened, we had certain lease equalization charge from the balance sheet which passed through P&L giving an advantage because now the total tenure of the lease is lesser than what we initially planned, right. So, that has led to the impact of about 5, 6 crores. To offset that, there were certain OPEX charges like stamp duty or other thing, which go along with that. So, that net benefit was only Rs.3-4 crores.

Moderator: Thank you. We will take the next question from the line of Apurva Prasad from HDFC Securities. Please go ahead.

Apurva Prasad: On the emerging accounts, what is the near-term growth visibility that you see?

Rohitash Gupta: On the emerging accounts, one of the comments that I already mentioned that landscape especially for the clients which are outside or lower than 0.5 million trajectory, that landscape remains volatile because some of those clients or logos come for a project and then go away. Having said that, last 12-months have been very good for us in terms of winning newer logos from Fortune 500 client league. So, we will see how emerging landscape plays. Having said that, the clients in emerging space which are already established typically 0.5 million plus bucket clients, we see as PD mentioned much stronger growth than what is currently being shown in that chart, of lower double-digits; we expect that trajectory should be much higher.

Apurva Prasad: The lower double digits what number you just referred to?

Rohitash Gupta: Our emerging client growth YoY basis this quarter has been about 12% on constant currency. We expect that number to be higher in near-term or medium-term.

Apurva Prasad: My other question was on margin, your near-term outlook on that?

Rohitash Gupta: I think I alluded earlier, the margin trajectory is predicated on currency which is pretty well known and disclosed in the deck. What is not known or clear at this point is the offshore revenue growth which is the other big driver. All we can hinge on is the history of last four quarters where the offshore revenue has not grown. So, unless that picks up substantially over next few quarters, major organic revenue driven improvements in margin will be slower.

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

Rohitash Gupta: Thank you, everyone for joining us this time. We look forward to talk to you next quarter.

Moderator: Thank you very much, sir. Ladies and gentlemen, on behalf of eClerx Services Limited, that concludes this conference call. Thank you for joining us and you may now disconnect your lines.