Q2 FY2018 Earnings Call Transcript – November 01, 2017

CORPORATE PARTICIPANTS:

- Mr. Rajesh Subramaniam – Managing Director and Chief Executive Officer
- Mr. Dinesh Jain – CFO
- Mr. Ankur Maheshwari – Head Corporate Planning & Investor Relations

Moderator: Ladies and gentlemen good day and welcome to the Firstsource Solution Limited Q2 FY18 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. In case 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. Ankur Maheshwari. Thank you and over to you sir.

Ankur Maheshwari: Welcome everyone and thank you for joining us for the Q2 FY18, the quarter ended September 30th, 2017 earnings call for Firstsource. Please note that the results, the fact sheet and the presentation have been mailed to you and you can view this on our website www.firstsource.com.

To take us through the results and to answer your questions we have with us today Mr. Rajesh Subramaniam--our MD and CEO and Mr. Dinesh Jain--our CFO. We will be starting the call with a brief presentation providing an overview of the company's performance followed by a Q&A session.

Before we begin the call let me remind you that some of the matters we will discuss on this call, including our business outlook are forward-looking and as such, are subject to known and unknown risks. These uncertainties and risks are included, but not limited to what we have mentioned in our prospectus filed with SEBI and subsequent annual reports that are available on our website.

With that said, I now turn over the call over to Mr. Rajesh Subramaniam--our MD and CEO.

Rajesh Subramaniam: Thanks Ankur and hello everybody, good afternoon to the folks in India, good morning to the folks in the UK and US if anybody is joining in. At the outset I would like to mention that it has been a very good quarter for us while the headline numbers on the year-on-year basis suggest de-growth on all facets, all I want to say the core health of the business is very good. You will also recollect that we sold our domestic business in Q1 of this year, so the rupee number here reflects the post divestment of the business.

In this call I will have a presentation which will articulate what the true state of the businesses went pro-forma for the domestic business and while evaluating it on a constant currency year-on-year. So, let me start with the reported numbers; Q2 FY18 revenues came in at Rs 873 crores compared to Rs 877.7 crores in Q1 FY18 and Rs 884.4 crores in Q2 FY17. Quarter-on-quarter de-growth of 0.5% in rupee terms and de-growth of 0.9% in constant currency terms, year-on-year de-growth of 1.3% in rupee terms and growth of 3.7% in constant currency terms. In terms of operating EBITDA, Q2 FY18 operating EBITDA came in at Rs 109.7 crores compared to Rs 100.6 crores in the sequential prior quarter and Rs 112.6 crores in Q2 of last year. Quarter-on-quarter EBITDA has grown by 9% and margin has expanded by 110 basis points from 11.46% to 12.56%. Year-on-Year EBITDA degrowth by 2.6% and margin contraction of 17 basis points from 12.73% to 12.56%. Operating EBIT in Q2 FY18 at Rs 93.4 crores compared to Rs 85.3 crores in Q1 FY18 and Rs 96.5 in the year prior. Quarter-on-Quarter growth of 9.5%, margin expansion of 98 basis points from 9.72% to 10.7%, Year-on-Year de-growth of 3.2%, margin contraction by 22 basis points from 10.92% to 10.70%. Profit after tax in the Q2 FY18 stood at Rs 68.8 crores compared to Rs 65.4 crores in Q1 FY18 and Rs 71.3 crores in Q2 FY17. Quarter-on-Quarter growth of 5.1%, margin expansion of 43 basis points from 7.45% to 7.88%; Year-on-Year de-growth of 3.5%, margin contraction by 18 basis points from 8.06% to 7.88%.

I want to spend some time on the next slide which is if we take a look at the performance of the business assuming the domestic business which we sold in which the transaction culminated in June and there was some residual impact in the month of July'17, both from the divestment perspective and closure of some centers which saw taking some exceptional charges. Q2 FY18 without the domestic business would have been Rs 850.8 crores and if the domestic business was taken out in Q1 FY18 the revenues would have been Rs 825.2 crores, this represents 3.1% quarter-on-quarter growth. Translating that into profitability metrices, EBITDA would have been at Rs 112.2 crores compared to Rs 95.4 sequentially which comes to 13.2% EBITDA margin compared to 11.6% in Q1 FY18, the EBIT would have been Rs 97.2 crores compared to Rs 81.4 crores, EBIT% would have been 150 basis points increase in margins to 11.4% from 9.9% in Q1 FY18. Profit after tax which is Rs 68.8 crores would have been Rs 72.5 crores compared to Rs 61.5 crore, the delta between Rs 68.8 crores and Rs 72.5 crores being the shut-down cost that we had to undertake for three centers in Siliguri, Bhubaneswar and Trichy which was linked to the divestment that we undertook. PAT % was at 8.5% compared to 7.4% in Q1 FY18, again PAT growth would have been 18% and PAT margin expansion would have been about 110 basis points.

Similarly, the metrices year-on-year would have been 2% growth in revenues; this is FY18 currency without the domestic business compared to FY17 where the pound and dollar were at 95 and 65 to the rupee and without the domestic business. The year-on-year growth would have been 2%, EBITDA would have been higher by 10 basis points and PAT would have been higher by 2 basis points representing the 5% growth. Now if you take the same numbers year-on-year on a constant currency that is if Q2 FY18 consolidation rates so far is on the pound and dollar were the same as

Q2 FY17. Our Q2 FY18 revenues without the domestic business would have been Rs 901.3 crores which would represent the year-on-year growth of 8.1%. Our EBITDA would have been Rs 124.2 crores representing 13.3% year-on-year growth and the margin expansion of 60 basis points to 13.8%. Our operating profit would have been Rs 108.4 crores representing 12% margin and a 14.4% growth year-on-year. Our profit after tax would have been Rs 83.7 crores representing a 21% growth year-on-year at 9.3% PAT margin. So, ladies and gentlemen limited points, I'm trying to explain is that the health of the business is in great shape. I think the divesting ABU while we had Rs 3.5 crores charge in Q2 obviously will not exist going forward, so whatever margin expansion we have seen in Q2 we expect that to have an upward bias in Q3 and obviously next year we will see the full benefit of the margin expansion story.

So, having said in that context, I will spend some time now on H1FY18 highlights. H1 operating revenues were at Rs 1750.7 crores compared to Rs 1,777.9 last year. Year-on-Year de-growth of 1.5% in rupee terms and growth of 4.7% in constant currency terms. If we have taken last year's currency at this year, the year-on-year growth number would have been 4.3% in rupee terms and 4.7% in constant currency terms. Similarly, operating EBITDA stood at Rs 210.3 crores compared to Rs 231.8 crores while the year-on-year de-growth is 9.3% and margin reduction of 103 basis points from 13.03% to 12.01%. On the constant currency, year-on-year growth would have been 1% and the margin reduction would have been largely flat at about 40 basis points. In terms of operating EBIT, H1 FY18 operating EBIT came in at Rs 178.8 crores compared to Rs 199.5 crores in H1 FY17. Year-on-year de-growth of 10.4%, margin reduction of 101 basis points from 11.22% to 10.21% and EBIT would have been Rs 201 crores representing a year-on-year growth of 0.7% while a margin reduction of 40 basis points. The H1 FY18 PAT stood at Rs 134.1 crores compared to Rs 144.6 crores, year-on-year de-growth of 7.2%, margin reduction by 47 basis points from 8.13% to 7.66%. At H1 FY17 base, current H1 FY18 PAT would have been Rs 156.4 crores, year-on-year growth of 8.1% and margin expansion at the net profit level of 30 basis points.

Similarly, the same analysis without the domestic business, the headline numbers would have been year-on-year de-growth of 0.1% in rupee terms for revenues and growth at 6.5% in constant currency terms. Operating EBITDA would have had a year-on-year de-growth of 7.7% instead of 9.3% and margin reduction of 100 basis points to 12.4%. Operating EBIT would have had a de-growth of 8.3% compared to 10.4%, margin reduction by 100 basis points to 10.7% and PAT would have had a de-growth of 4.2% and margin reduction by 30 basis points from 8.3% to 8.0%. And the same reported rupee numbers for H1 FY18 at constant currency, the revenue growth at 6.5% doesn't change, the EBITDA margin reduction would have been only 40 basis points but a growth of 3% year-on-year. EBIT would have seen a margin reduction of 30 basis points, a year-on-year growth of 3.1% and PAT would have been Rs 156.2 crores, a year-on-year growth of 12% and a margin expansion of 40 basis points. So that's the summary of the numbers. I know it's a little long winded, but it was important for me to explain to you about the health of the business in relation to post the divestment of the domestic business and the earnings profile and the margin profile of the company.

Other highlights, employee and attrition details; our headcount is 19,194 employees as of September 30th 2017, 8,666 based out of India, 10,328 based outside of India, there is a net reduction of 5,819 employees in Q2 FY18. On attrition details - offshore (India and Philippines) has slightly improved to 38.8% from 40.5% in Q1 FY18. Onshore (US and Europe) has slightly increased to 53% compared to 48.2% in Q1 FY18 because largely there is a lot of activity of people going to college and that has a strong impact on our business. From a net debt position, our net long-term debt was $64.3 million, we paid tenth principal installment of $11.25 million on September 30, 2017. On Foreign exchange hedges – outstanding FX hedges was at $36 million for USD and £77 million for GBP. Next 12 months - 37% covered at Rs 73.2 to the dollar and 79% covered for pound at Rs 106.7; 62% coverage for the dollar at Philippine peso at 51.2 and 67% coverage for GBP at Philippine peso at 66.5 levels. For the forward 12 to 24 months - 13% coverage for USD rates at Rs 71.9 levels and 47% coverage for GBP at Rs 98.3 levels. Post 24 months - 58% coverage for the GBP at Rs 102.4 levels.

The next slide is on the revenue snapshot; if you clearly take the look, the India and Rest of the World revenue by geography has obviously reduced to 2.6% and UK has grown to 45.2% and North America is at 52.2%. From a revenue contribution by verticals, BFSI has increased from 27.1% to 29.2%, Healthcare has largely remained the same and Telecom & Media has fallen from 36.6% to 34.7%. From revenue by an operating delivery perspective, onshore is 76.1%, offshore is 21.3% and domestic is 2.6%. Obviously, we have seen growth both in the UK and US in our Healthcare and in Banking business in the UK and obviously the domestic business, reduction has also been distributed to both these geographies and hence the number representation. From revenue by segment perspective; Healthcare is about 34%, collections about 10%, domestic is 2.6% and Customer Management business is at 53.7%. Revenue by customer concentration our top client contribution is 29.1%, top 5 clients is 47.3%.

The next slide is the tabular representation of the financial performance, no specific callouts here. We have gone through the numbers, average tax rate is about 17.5%, 17.7% apart from that everything else here has been articulated in the prior slides.

Let me move to the last section which is the business outlook. The transition of the domestic business will be completed. Some shutdown cost which I mentioned about Rs 3.5 crores we incurred in Q2 FY18, margin accretion driven by divestment will be evident from Q3 FY18 onwards. As far as some of the other macroeconomic events which have been oscillating between headwinds and tailwinds in our business, so finally we have got some clarity on the potential repealing of Obamacare, this has been unsuccessful, however, there are changes in the Obamacare structure which by executive decision from the office of the President will have some impact on the end outcomes of Obamacare and this will have a mixed impact on our business. It's all about more uninsured work into the segment which is going to be good for a provider business but it's going to have restrictive impact on Healthcare exchanges which will have an impact on our payers' side of the business. So, it's a mixed bag but I think end of it all, if not neutral, it should have an upward bias given some of the growth we are seeing on the provider side and the payers' side business also continues to grow at this point in time. Pipeline of deals, transformative deals embedding RPA, analytics, significant momentum across all businesses - Healthcare, Customer Management and Mortgages - deals are getting delayed because the entire nuances of transformation net sales, the sales cycles are definitely longer than traditional sales cycles, but we are very excited about the outcomes that we potentially see converting into wins in the very near future.

ISGN – we mentioned, the turnaround was evident last quarter with a muted loss compared to the loss we have seen in Q4 FY17. The business has turned profitable at the same level of revenues for about $8 million in generating about $0.5 million of EBIT, about 10% EBITDA margins at this point in time and expected to pick up in the ensuing quarters. So that business has come back on track and as I said that transformative sales deals in the Mortgages business also are looking very attractive at this point in time.

From our guidance perspective pro-forma in ABU and normalizing for currency, we will be at the upfront of the revenue growth of what the expectations are. In rupee terms pro-forma for ABU will probably be at somewhere between 5% to 6%. Margin expansion of 30 to 40 basis points is on the table and could be slightly higher this year and the full impact on the divestment of ABU will have a clear uplift next year. That's all I had on this call from a presentation perspective, I am happy to open it back to the floor for questions.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin with the question and answer session. The first question is from the line of Deepesh Mehta from SBI CAP Securities. Please go ahead.

Deepesh Mehta: I just want to get some sense about couple of businesses. Healthcare, I think we sounded very positive last quarter about the growth outlook. Now broadly what I understand this quarter seems to be fairly muted from Healthcare perspective, can you help us understand how we see payer's side, provider's side? In your opening remark you touched upon briefly but if you can provide some greater detail?

Rajesh Subramaniam: Q3 we will see a significant uptick in the payer business. We have had some delays between Q1-Q2 and Q2 and Q3 but Q3 you will see significant uptick in the Healthcare business especially in the payer's side. Provider side - the Denial Analytics, Patient Care Analytics and what we are selling in, there are not big ticket items but highly transformative deals that are hugely profit accretive, so the margin profile that we have seen despite if you recollect in Q1 and Q2 last year the Mortgages business gave a superlative almost 20% EBITDA margins and at this point 10% EBITDA margins on a revenue profile which is lower but all that has been absorbed and margin expansion also has been sequentially evident in year-on-year on constant currency evident largely because of the Healthcare business and some of the new wins and the new logos we have had in the Customer Management business. So, Yes, Healthcare continue to remain positive, will have a very good end to a current fiscal.

Deepesh Mehta: Broadly, because I think we also indicated about delay in decision-making as well as Obamacare has made impact on us, so whether it has some implication on what we expected let's say at the beginning of year and now?

Rajesh Subramaniam: I think at this point in time the Obamacare impact on the payer will directly have an impact on Healthcare exchanges. So this year the enrollment cycles have started will start in November and we don't expect a big impact this year. But next year absolutely yes, the same period between November and February we will see an impact if some of the executive orders play themselves out. And whatever happens clearly the impact of enrollments going down means they are going to be more uninsured work and that plays corollary to some of the strengths we have in the provider side of the business on the hospital side. So, as I said it's a mixed bag, the negative impact from the payer will be evident next year, so would the positive elements but currently we are seeing significant traction in the current businesses on RP and analytics driven solutions across all our businesses definitely evident in the Healthcare business also and we will start seeing the impact in Q3 which will be linked to the enrollment side where we see a significant uptick in our payer business.

Deepesh Mehta: Just to understand about collection business. I think if I look last few quarters collection remained muted and profitability has substantially declined over last year, so can you help us understand what is happening in collection side and what is the revenue and profitability outlook there?

Rajesh Subramaniam: In the collections business last year we were working for an agency that is contracted with the Department of Education. That is very profitable business and that's our entry into the Department of Education also. But since early part of this year there has been a statutory ruling that has frozen all the placements from the Department of Education on something linked to jurisprudence investigation which is being undertaken at the Federal level because of that that business is completely ramped down. Last year that was almost $4 million in revenues contributing to almost $1.5 million in profitability and impact of those ramp downs are evident in Q2 and will be evident in Q3 also. Q4 seasonality element kicks in but on a like to like basis Q4 also will have an impact because of the shutdown of the work we were doing for Department of Education.

Deepesh Mehta: I missed what work we used to do for that and why it stopped I was not clear about it?

Rajesh Subramaniam: Basically, student loan collections.

Deepesh Mehta: And what regulation change happened?

Rajesh Subramaniam: That is not regulation change. There was something around the method of placements of how these student loans were placed by the 4 or 5 big contracted agencies with the Department of Education. So, we are subcontractor to one of them, so there are certain investigative requirements which has happened which is necessitated for the Department of Education to shut down placements across all agencies until they get to a resolution on the method and the process as how the placements used to happen.

Deepesh Mehta: In near term you expect that weakness to persist?

Rajesh Subramaniam: That's right. We don't see that being lifting and I mean there is crystal ball gazing, we don't know how that will play itself out.

Deepesh Mehta: Last is about the top client, now whether we reach to steady-state in top client considering the deal which ramp up we expected?

Rajesh Subramaniam: Steady state is the function of assuming the client doesn't grow. The client is doing well so being a single partner; we have the beneficiary of business. Q3 traditionally is the holiday season, Christmas quarter, Thanksgiving quarter there is a whole bunch of stuff across with US and UK which will make it seasonally little weak. But as I said we are in a good place with our top client.

Deepesh Mehta: Last is about the outlook but you gave pro-forma kind of thing but now on the reported basis how you look H2 to be?

Rajesh Subramaniam: I think H2 obviously the delta between Q1 and Q2 itself is about Rs 30 crores on revenues in a domestic business. Now taking the domestic business out as I said we should end the year on a reported basis at about close to 5% to 6% and on a pro-forma basis on a constant currency basis would be closer to about 8%.

Deepesh Mehta: When you say Rs 30 crores and 5% to 6%, you are roughly adding Rs 90 crores to what reported basis now, is my understanding right?

Rajesh Subramaniam: I am saying Rs 30 crores was the revenue contribution, a delta between Q1 and Q2.

Deepesh Mehta: So, you have Rs 30 crores less in Q2 and this would be reflected even in H2, right so total Rs 30 crores kind of impact?

Rajesh Subramaniam: Correct, H2 will be bigger because in Q2 we still had one-month revenue, so impact would be closer to about Rs 70 crores to Rs 80 crores in H2.

Deepesh Mehta: Put together roughly around Rs 100 crores is what you are adding to get 5% to 6% number?

Rajesh Subramaniam: That's right.

Moderator: The next question from the line of Nagraj Chandrasekar from Laburnum Capital. Please go ahead.

Nagraj Chandrasekar: Just two questions, first of all on the Obamacare impact, any way of dimension how does the business breakup right now between payers and providers and any sort of estimate like what the downside could be upside on the provider side? And secondly when you talked about the ISGN and the turnaround, it will be helpful to know what exactly caused the turnaround this quarter was is just the declining portion of the business bottoming out, was it us being able to take down cost and proportion of bottoming out, so if we get little more color on that that will be helpful.

Rajesh Subramaniam: I think from a revenue contribution between the payer and provider, its roughly $180 million state at this point in time, it will probably be 53:47 payer- provider from a revenue contribution perspective. In terms of what happened in the impact I mean what was the end impact of replacement of Obamacare would be more uninsured work, people basically the whole Healthcare exchange network would have been disbanded at an Ethiopian state, now with that not happening but some parts of that happening with cutting down the subsidies to the states and other executive actions which are being done, it's basically going to be prohibitively expensive the people to go on to the exchanges to go and buy policies which means you are going to have more uninsured work, which is more eligibility work more charge of debt work which we will see in a provider segment. So, I don't have an ability to quantify what that impact is because it's still right now at a policy level. So, the corollary to that is the Healthcare exchanges I mean we work for lot of these Medicare payers like Molina, Kaiser and there is a lot of enrollment which happens on some of these clients and if those enrollments shrink it has a direct impact on our business, its seasonal, it happened between November and February, it's the seasonal but nonetheless it is an impact. It roughly contributes about $3 million revenues every year. So that as I quantify will impact at this point in time if those Healthcare exchanges get dismantled. Apart from that it has no material impact on the other payers that we work for.

As far as ISGN is concerned actually everything that you mentioned, it is little bit of everything in their which helped in the turnaround, one was little more leverage with customers on negotiating some of the contracts in terms of minimum volume commitments and earlier they used to completely variablize their cost structure that make it our cost structure entirely fixed. So, there has been a little bit of give and take to ensure that there are fair principles in the way we engage with our clients. So that enabled us to ramp up when the requirement is real and ramp down much sooner than expecting the business to flow through which has been one of the reason why we fell off significantly between Q3 and Q4 of last year. Just in perspective in Q4 on an $8 million revenue we lost $2 million and Q2 on $8 million revenue we have made $0.5 million in EBIT. That will give you a perspective of what we have done in various constituents. Obviously, we had to separate a lot of people, we have to make certain changes, restructure some of the elements of the business, so it's basically a combination of everything which is ensured then ISGN has reported the numbers that have articulated.

Moderator: The next question is from the line of Ruchi Burde from Emkay Global. Please go ahead.

Ruchi Burde: I wanted to check not for a near term for that you have been guiding us pretty well. But over last two calls we have been hearing slow sale cycle for large deal so in that context how do we see our revenue traction or in medium term how do you see business and growth shaping up in general?

Rajesh Subramaniam: I think as I said everything that you have asked was very relevant and whatever guidance we have given is incorporating with some of the realities that we are facing. I should tell you that some of these large deals they suddenly get unclogged, we could clearly see a spike next year but it's too early for me to comment on that. But at this point in time whatever we have stated what we have been saying in the last couple of calls and this one I think we are confident we will be able to achieve numbers in that range.

Moderator: Thank you. Ladies and gentlemen that was the last question. I now hand the conference over to the management for their closing comments. Thank you and over to you.

Rajesh Subramaniam: Thanks everybody, thanks for your time. It's been a good quarter. We expect the margin expansion to continue in the Q3. Q3 is traditionally seasonally a weakest quarter, so well there are some headwinds, we are still confident with the continuing uptake in Healthcare, customers management and better performance from ISGN, set up by weaker than expected performance in collections still on the balance we should be in reasonably good shape. I really appreciate your time. Thank you.

Moderator: Thank you very much. Ladies and gentlemen on behalf of Firstsource Solution Limited that concludes this conference. Thank you for joining us and you may now disconnect your lines.