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Q3 FY2018 Earnings Call Transcript – February 07, 2018

CORPORATE PARTICIPANTS:

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

Moderator: Good day ladies and gentlemen and welcome to the Firstsource Solution Limited Q3 FY18 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 this 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 – Head Strategy and Investor Relations. Thank you, and over to you, sir.

Ankur Maheshwari: Thanks, Mallika. Welcome everyone and thank you for joining us for the Q3 FY18 the quarter ended December 31st, 2017 Earnings Call of Firstsource. Please note that the results, 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 & 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 this 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 the call over to Mr. Rajesh Subramaniam – our MD and CEO.

Rajesh Subramaniam: Good evening, ladies and gentlemen. Thanks for your time today. A sincere apologies for the delay in the uploading the results, some technical issues where we couldn't upload it on time. Hopefully you have it in front of you as we speak and I'm happy to take you through the numbers for Q3 FY18.

Operating revenues for Q3 FY18 came in at Rs 887.2 crores compared to Rs 873.0 crores in Q2 FY18 and Rs 885.4 crores in Q3 FY17. You will all realize that Q3 of last year, all the last year numbers had the domestic business for the full year and Q3 FY18 is the first quarter where we don't have the domestic business reported in the numbers given the scale of divestment, which happened in the previous quarter. Quarter-on-quarter, the growth rate is 1.6% in rupee terms and 0.6% in constant currency terms. Year-on-year growth is 0.2% in rupee terms and growth of 2.4% in constant currency terms. Pro forma for the domestic business divestment, year-on-year growth is 6% in rupee terms and 7.3% in constant currency terms. Operating EBITDA for Q3 FY18 came in at Rs 116.1 crores compared to Rs 109.7 crores previous quarter and Rs 107.2 crores in Q3 of last year. The quarter-on-quarter growth is 5.9%, margin expansion by 53 basis points from 12.56% to 13.09%. Year-on-year, we have grown 8.4%, margin expansion by 99 basis points from 12.10% to 13.09%. Operating EBIT came in at Rs 99 crores for Q3 of FY18 compared to Rs 93.4 crores in previous quarter and Rs 91.6 crores in the corresponding quarter last year. Quarter-on-quarter growth of 5.9%, margin expansion by 45 basis point, from 10.70% to 11.15%. Year-on-year, 8% growth and a margin expansion of 80 basis points from 10.35% to 11.15%. Profit after tax for Q3 FY18 came in at Rs 99.5 crores compared to Rs 68.8 crores in Q2 of FY18 and Rs 70 crores in Q3 of FY17. Thanks to the reduction in federal tax from 34% to 21%, one time deferred tax credit of Rs 24 crores has accrued to us, which has resulted in a quarter-on-quarter growth of 44.8% and a margin expansion of 334 basis points from 7.88% to 11.22%. Year-on-year growth of 42.2% from 7.91% to 11.22% is the net margin year-on-year. The normalized PAT excluding this one-time gain would be Rs 75.5 crores, which is 8.5% of revenues, represents the quarter-on-quarter growth of 10% and an expansion of margins of 60 basis points from 7.9% to 8.5%. Year-on-year the growth is 8%, margin expansion of 60 basis points from 7.9% to 8.5%.

The tabular representation of the financial performance, the key call-outs here has been that Q3 FY18 despite being seasonally our weakest quarter, we have fewer working days and more salary days, we still have demonstrated a clear margin expansion. We have done well on our personnel and operating expenses, the percentage of revenues is coming much better because of better control in operating leverages. And of course our profit after tax on a normalized basis has clearly shown a sequential expansion and Q4 being our seasonally a strongest quarter, we expect the momentum to be much more significant in Q4 FY18. You will also realize that in Q3 last year, the mortgages businesses was still doing well and the scale of numbers in the mortgages business in Q3 last year was far higher than what we're seeing this quarter. So despite a reduction in revenues and lower profitability in comparable quarters year-on-year, our metrics have done well. And as we go to the business outlook, I'll give you some color on how robust Q4 FY18 numbers likely to pan out.

Our headcount is 19,226 employees at the end of the calendar year 2017, 8,850 employees in India; 10,376 based outside of India. Net addition of 32 employees in Q3 FY18. Attrition onshore significant improvement 53% in Q2 FY18 reduced to 39.4% in Q3 FY18. Offshore largely flat at 39.8% and 38.8% between the two quarters. On net debt, our net long-term debt is about $50.4 million as of December 31st, 2017, will reduce by another $12 million by March 31st, 2018 going forward and will repay our 11th installment; so our principal repayment of $11.25 million is completely on track. As far as our hedging strategy goes, for the next 12 months, 33% of our $29 million coverage is covered at Rs 73.3 levels and 65% for the count of total exposure of $88 million we've covered at Rs 103.9 levels. We have the small exposure between the dollar and Philippine peso that's a PHP 51.3 levels causing 3% of the exposure and between the pound and the peso 78% at PHP 67.5 levels. For the forward 13 to 24 months, we have covered 53% of the pound at Rs 98.5 levels and 8% for the dollar at Rs 70.3 levels, smaller numbers for the dollar peso and the pound peso. Post 24 months, we have covered 84% for the pound at Rs 105 levels to the pound. Given, we believe, given a long-term contract with Sky and given the certainty of the revenues, we wanted to ensure lock-in a certain P&L structure and given the attractive premiums we are getting beyond 2 years is the rational why we have taken hedges on the offshore book beyond 2 years.

Next slide on Revenue snapshot, in terms of elements of how we grew the verticals and revenue by delivery, by geography and by segment. North America continues to be the alpha 54% revenues in Q3 FY18, UK 45% and India, rest the world is 1%. In Q3, we still have some businesses with a couple of client in the domestic business not materially small, which going forward is being clubbed with offshore delivery because the margin profile of the businesses is very akin to the offshore delivery, it's in the banking vertical. And hence going forward, we would classify those revenues in Customer management and in offshore delivery, but those numbers are very small. From a revenue by delivery perspective, 77% delivered onshore, 23% delivered offshore. From a vertical perspective, healthcare continues to be the leading segment with 37.4%. Q3 is typically when on the payer business we see the enrollment business kicking in at its peak and that explains the momentum between Q2 and Q3. Telecoms and media at 33.3% and the banking business, BFSI business at 29.3%. From a segment perspective, the customer management 54.5%, healthcare, which is entirely our whole business is on outcome or a transaction processing basis is 35.5% and collections at 10%. Top client stable sequentially 29.2% and Top 5 clients also stable at 47.5%.

From a business outlook perspective, core business performance continues to do well. Q4 seasonally our strongest quarter. So performance is going to be very strong, both sequentially and year-on-year. Quality of sales pipeline is the number of transformation driven deals that we are adding to the pipeline and the seat at the table we are getting on deals and the deals that we are winning has been very encouraging. Decision-making cycles are longer because unlike traditional businesses, which customers agree to sign up very quickly, transformation led deals have a different level of governance and buying processes are lot more complex. But ultimately when we get there, the impact it makes is pretty significant. Last time, I made a mention that we have several deals under negotiations, two long-term engagements, one in healthcare and one in customer management. Again transformation led, one is led by completely ubiquitous digital application in the provider segment, hospital provider segment, which with one of our marquee clients, which is expected to scale rapidly. And in customer management, we have won a pretty large deal TCV of $75 million with very large clients still under on the contracting phase, so can't disclose more at this point in time. But that's looking good in setting us up well for next year. Reduction in US tax rate is a positive, 21% tax will be a positive, give us positive tailwind forward. Q4 last year, the mortgage businesses came out with a loss falling of the peak in Q3. And to recollect our profits after tax in Q4 last year was about Rs 64.8 crores. At this point in time, we clearly are seeing a guidance of year-on-year growth of anywhere between 25% to 30% profit growth between Q4 of last year and Q4 of this year. And this is on the back of revenue growth, which will be evident sequentially and year-on-year despite the fall-up of the domestic business and the profit metrics give us the overall improvement in our business at this point in time. So overall a very positive quarter and looking good for Q4 at this point in time.

And I am happy to open up the floor for any questions at this point in time.

Moderator: Thank you very much sir. Ladies and gentlemen, we will now begin the question-and-answer session. The first question is from the line of Mohit Jain from Anand Rathi. Please go ahead.

Mohit Jain: Three questions. One is, if you could help us understand with $75 million deal, what is the timeframe and when do you start ramping up on that? Second, was on the tax rate, if you could help us quantify the whole impact over the next two years, where our tax rate is likely to be about 19%, 20%, one would be higher taxes in India and second would be the impact of US. So on a net basis, how should we look at it. And third is on the margins. The full impact of India business not being there is there, so going forward what kind of margins you are looking at and what are the levers?

Rajesh Subramaniam: Okay, the first question is, the new contract will start generating revenues from April onwards, so that's first. Second, going forward, the tax rates we expect will stabilize for next two years around the 17%, 18% mark. We expected it to increase next year, but because of reduction in US taxes now it could come down to the 17% to 18% mark. And on the third question…

Mohit Jain: EBITDA margin.

Rajesh Subramaniam: Yes, on the domestic business, see the domestic business shutdown, we expect when the dust settles down on everything should contribute, should improve our margin by anywhere between 35 to 45 basis points is our expectation for next year.

Mohit Jain: 35 to 45 basis points on a Y-o-Y basis.

Rajesh Subramaniam: Yes, EBITDA flowing down right up to EBIT.

Mohit Jain: This is on a full year '19 versus full year '18 basis, is it?

Rajesh Subramaniam: This is for FY '19.

Mohit Jain: Versus third quarter '18.

Rajesh Subramaniam: Versus full year '18.

Mohit Jain: Okay. And lastly on TCV, how many years is this deal for?

Rajesh Subramaniam: Five years. $75 million is five years, $15 million a year.

Mohit Jain: And how is the deal pipeline looking like in terms of growth for next year, any outlook on FY19?

Rajesh Subramaniam: So 300 million plus deal pipeline right now and at this point in time, I don't want to put a number on, because there are couple of deals that we are negotiating that can change those numbers. But a zero risk number to give is, growth rates on constant currency, what we did 7.7% will definitely be achieved next year. And I think there could be an upward bias to those numbers.

Mohit Jain: Probably 8% is where we can start our base assumption?

Rajesh Subramaniam: That's right.

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

Ruchi Burde: First question I have regarding ISGN. Could you talk us through how was the performance of ISGN in Q3?

Rajesh Subramaniam: Yes, so ISGN, the revenue profile was very similar to what it was in Q1 and Q2, which is sub $7 million a quarter in revenues and it is profitable, at $7 million the EBIT profile is lower than the company average, but it is profitable. But there are a few deals in the ISGN pipeline when converted, the margin profile will significantly improve going forward.

Ruchi Burde: Did we see any improvement in the profitability of ISGN in last quarter compared to previous quarter?

Rajesh Subramaniam: Yes, we did. The business has done profitably. As I said, Q4 was loss making, Q1 the loss was muted. So we made profits using the profitability is far more significant, Q4 it will keep improving.

Ruchi Burde: Okay. Secondly, on healthcare segment, so this enrollment season was not as disappointing as might have been expected. So how do we see our healthcare business both on payer as well as providers are shaping up for you moving into next year?

Rajesh Subramaniam: I think next year the provider business is looking extremely positive. The growth and the margin accretion on the back of, you know, selling our transformation solutions around digital app-based customer experience and certain applications around analytics is driving growth. The core business is around receivables management also is driving growth. And on the back of whatever happens on various ways of how Obamacare is being looked to being scuttled, ultimately will have a positive impact on the hospital side. On the payers' side, any impact on Obamacare will have a negative impact on the all enrollment side, it's seasonal, as I said, it's there for three months between November and Jan and it contributes roughly about $3 million of revenues to our payer organization. As of now, no reason to believe that number will come under attack, but Yes, there could be some sensitivities with a slight downward bias on those numbers next year. But it won't have a material impact on our overall payer numbers given the pipeline of other deals that we are pursuing at this point.

Ruchi Burde: Okay. And lastly, now for our large part Sky deal, it's been more than a year we have taken up the large contract we signed up. How do you see the traction in that account or our milestones or goal post plan for this timeframe, are we on track, how the traction has been going?

Rajesh Subramaniam: Everything is going well. Sky continues to do well and we continue to do well, and it's a great question on milestones going forward. There are several transformative led deflection strategies and sales improvement strategies at play. There are also new pipeline of deals within Sky from other parts of Sky that we're negotiating on. So I would expect that the absolute growth in Sky will be muted or probably have a slight downward bias. But I think, from as far as the customer relationship and engagement is evident, the chances of winning new deals within the Sky universe and other parts of Sky is also looking real at this point in time.

Moderator: Thank you. Next question is from the line of Pranav Tendulkar from Rare Enterprises. Please go ahead.

Pranav Tendulkar: Can you just give me vertical wise demand outlook, I think, I missed little bit of that. So in terms of healthcare and other verticals?

Rajesh Subramaniam: Healthcare demand growth is robust, the healthcare will probably grow at 10% to 12% next year. Collections will be a lot more muted, collections probably would be sub 5%. The mortgages business, the growth could be anywhere conservatively 15% and could be as high as 30% to 40% given some of the deals that we are negotiating at this point in time. And it's coming off a small base of $33 million, $34 million. But, again, the art of the possible in mortgages is going to be significant this year. In the UK business, the whole customer management business, we expect the growth rates on the back of Sky stabilizing and some of the transformative solutions and the reason of why we consolidated and driving some of those deflection strategies, we expect the growth rates in that market and that horizontal to be closer to 6% to 7%. So at an aggregate level, at this point in time, we clearly have visibility of 7.5%, 7.7% plus what we have delivered, what we likely to deliver this year, including our Q4 forecast. But positive upsides could happen, if couple of other deals that are taking time to close, the customer management business will be accrued to us in Q1 then we could change some of those numbers.

Pranav Tendulkar: Right. Sir, can you just highlight our plan to repay debt? What is the plan, and what is the operational cash flow that you are expecting this year, next year and how is the repayment scheduled?

Rajesh Subramaniam: Our EBITDA are Rs 450 crores plus and it will keep increasing. And our net debt is about $50.5 million. So by March, we would be at about $37 million. So, next year we are practically, we will be net debt negative. So, Yes, the debt is no more an issue here. With $11.25 million it keeps happening there, working capital debt of about $25 million to $30 million, which are backed by the net current assets, which probably would be 3x of those numbers.

Pranav Tendulkar: Right. Sir can you just highlight what are the margin levers available overall on the Company level for next two to three years?

Rajesh Subramaniam: I think the margin levers at this point in time virtually linked to growth. I think, SG&A leverage, I think the Company is at an optimal level at this point in time. We will be on the investment curve on some of the licenses that we will start paying for driving some of the transformation, the tools that we need to acquire to drive the transformation agenda. I think, the margin levers is going to be the entire sales process, the deal that we are winning and selling are transformation driven and coming at the higher margin profile than the traditional businesses that we've seen in the past. So I think that is one. Apart from that, the interest cost reduction, which will happen will give us margin uplift, there will be a tax given the guidance on tax, which will help in the margin profile. So overall, Yes, there will be bits and pieces of margins, which will get added right from our gross margin right now to our PAT, which hopefully will give us a healthier margin profile next year than what we've seen in FY18.

Pranav Tendulkar: Right. So out of your cost basis of employees, how much is domestic and how much is onsite locations or outside India?

Rajesh Subramaniam: So if I take a look at 10,000 employees are outside of India. And I would expect that 60% to 70% of my employee cost would be on account of employees outside the country.

Pranav Tendulkar: Right. And on those employees, the general salary hike per year that you take is how much?

Rajesh Subramaniam: Well, it will be anywhere between 1.5% to 2.5%.

Pranav Tendulkar: Right. And in Indian?

Rajesh Subramaniam: The Indian salary increases will be anywhere between 7% to 10%.

Pranav Tendulkar: Okay. So it is broader in line with other IT services companies.

Rajesh Subramaniam: Yes.

Pranav Tendulkar: You mentioned that you are already at SG&A optimum level. And for the transformational deals that you are going to win or participate, there are various tools that you need to invest in.

Rajesh Subramaniam: No, it's basically license. For example, if I'm driving an RPA engagement with a client, you know I have Blue Prism, UiPath or Automation Anywhere. These are the three platforms that I aligned with, that can give me the best outcome and then I have to pay the license fee to get the licenses for the automation platform, it's as simple as that.

Pranav Tendulkar: Right. So actually, can you just tell me an example of how structurally these transformational deals are different from traditional ones?

Rajesh Subramaniam: Yes, so that is basically, I'm going into somebody and saying that I'm going to be reducing your cost to serve by 25%, by implementing 100 bots within the first six months to eliminate x number of employees, compared to saying, that, okay, let's work with your employees, I'll move to work offshore and reduce the cost for you by 25%, big difference between the two.

Moderator: Thank you. Next question is from the line of Rohit Balakrishnan who is an Individual Investor. Please go ahead sir.

Rohit Balakrishnan: Sir, you mentioned in your opening remarks about Q4 being strong. So can you just elaborate that I couldn't catch that part properly.

Rajesh Subramaniam: Yes, the Q4 traditionally is a strongest quarter, seasonally a strongest quarter, so at this point in time between Q3, Q4 of last year, the number was about probably Rs 61 crores to Rs 62 crores in profit after tax. So Q4 of this year, we clearly see a 25% to 30% uplift in net profit after tax.

Rohit Balakrishnan: And this would be driven largely because of the growth that you're seeing?

Rajesh Subramaniam: Yes, it's on the back of growth, it's on the back of seasonality, it's on the back of turnaround in the mortgages business, and on back of all the elements that I spoke through the call.

Rohit Balakrishnan: Got it. And you spoke about the deal that you won in the customer management side, that is about $75 million. Can you talk about the other deal that you also mentioned that is the healthcare deal, how big is that and has that also been signed and you expected to contribute to revenues?

Rajesh Subramaniam: That also has been signed and that's incrementally will add about, that is a two plus one year deal and contract incremental, today it's $2 million to $2.5 million client and the client will become a $7.5 million a year. So incrementally we add about another $15 million over three years.

Rohit Balakrishnan: Got it. And in terms of the other deals that you mentioned, when you had spoke about the deal pipeline. So is there any other deal worth mentioning, which could probably take the growth, any bigger deals, which could probably take the growth in double digits or that is difficult to achieve?

Rajesh Subramaniam: There are couple of deals in the mortgages base, there are couple of deals in the customer management space, there is one big deal in the healthcare space. So there are several deals out there in various stages of being cooked. So at this point in time, and if all of them come, then our guidance will look different. But in life, you win some, you lose some. So as I said, I will have a clearer picture when I come in for the Q4 earnings call.

Moderator: Thank you. Next question is from the line of Rajesh Agarwal from Moneyore. Please go ahead.

Rajesh Agarwal: Sir, various steps been taken for shareholder value creation like dividend, capital restructuring etc.

Rajesh Subramaniam: I think, there is a lot of effort, which is going out in the background on capital restructuring. Nothing concrete at this point in time. I think once something fructifies and is approved by the Board, we'll come and give you an update.

Rajesh Agarwal: It will be sooner or later, sir?

Rajesh Subramaniam: It depends on what you define as sooner and later.

Moderator: Thank you. The next question is from the line of Pranav Tendulkar from Rare Enterprises. Please go ahead.

Pranav Tendulkar: I just wanted to ask that, out of your whole revenue, how much percent is outcome based or volume based and how much percent is a constant run rate with a steady inflation built in?

Rajesh Subramaniam: If you take a look at on the entire healthcare business is on a per transaction or on outcome base, which is roughly about 35% of my revenues. My entire collections business is on an outcome basis, which is, I get money, I get revenues when I collect and keep a percentage. So, you add 10% to 35%, it's 45%. My entire mortgages business is on a per transaction basis. I get paid only when the loan gets funded and as the pivot happens towards the servicing side, then there would be an element of FTE-based pricing. So the mortgages business today probably, 60% to 70% would be on an output basis. So if I take a look at it, at this point in time and if I take a look at the sales estate within the customer management business, it's at some level, which are base rate plus an incentive driven model. So there is an outcome component to it. So at this point in time, and of course, the Lloyds Banking deal on commercial lending is all on an outcome basis. So it will be safe for me to say that 55% to 60% of our revenues will be on an outcome or an output and the balance would be on an input basis.

Pranav Tendulkar: So on the input business deals you generally built in a cost hike that you face in the cost side to the client billing right?

Rajesh Subramaniam: Yes, that's an indexation of cost on inflation.

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

Rajesh Subramaniam: Yes, thanks everybody. I know it's late in the day. Apologies for the delay in uploading the results because of some technical glitches, but overall very confident of our performance going forward. I look forward to talking to each one of you individually through the quarter if you have any other queries or I look forward to seeing all of you in the Q4 analyst call. Really appreciate your time. Cheers. Thank you.

Moderator: Thank you very much, members of the management. Ladies and gentlemen, on behalf of Firstsource Solutions Limited, that concludes this conference call. Thank you for joining us and you may now disconnect the lines.