RP-Sanjiv Goenka Group

Growing Legacies

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Q4 FY2018 Earnings Call Transcript – May 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: Ladies and gentlemen good day and welcome to the Firstsource Solutions Limited Q4 and Full Year 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. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankur Maheshwari-Head of IR and Corporate Planning, Firstsource. Thank you and over to you sir.

Ankur Maheshwari: Thank you Aman and welcome everyone for joining us for the quarter and the fiscal year ended March 31st 2018 Earnings Call for Firstsource. Please note that the results, the fact sheet and the presentation have been e-mailed to you and you can also view this on our website www.firstsource.com.

To take us through the results and to answer your queries we have with us today Mr. Rajesh Subramaniam – our MD and CEO and Mr. Dinesh Jain – our CFO. We will be starting this call with the 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 that 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 report that are available on our website.

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

Rajesh Subramaniam: Thank you Ankur. Good morning, afternoon and evening to everybody on the call today. Let me take you through the summary of Q4 and FY18 and some color on the outlook that we have getting into FY19.

Operating revenues in Q4 FY18 came in at Rs 897.3 crores compared to Rs 887.2 crores in Q3 FY18 and Rs 892.3 crores in Q4 FY17. Quarter-on-quarter growth is 1.1% in rupee terms and flat in constant currency terms, year-on-year growth of 0.6% in rupee terms and growth of 0.5% in constant currency terms. Pro forma that in the domestic business now which we sold in August last fiscal then the year-on-year growth is 6.9% in rupee terms and 6.7% in constant currency terms. Q4FY18 Operating EBITDA at Rs 132.5 crores compared to Rs 116.1 crores in Q3 FY18 and Rs 99 crores in Q4 FY17, quarter-on-quarter growth of 14.1%, margin expansion at 168 basis points from 13.09% to 14.77%, year-on-year growth of 33.8%, margin expansion by 367 basis points from 11.1% to 14.77%. Pro forma in the domestic business out, the 33.8% growth would be 40.6% year-on-year. Operating EBIT came in at Rs 115.3 crores in Q4 FY18 compared to Rs 99 crores in Q3 FY18 and Rs 88 crores in Q4 FY17. Quarter-on-quarter growth of 16.5%, margin expansion of 170 basis points from 11.15% to 12.85%, year-on-year growth of 31%, margin expansion of almost 300 basis points from 9.86% to 12.85%. The growth would have been 36.5% excluding the domestic business in both of the periods. Profit after tax came in at Rs 92.8 crores compared to the operating profit after tax for Rs 75.5 crores in Q3 FY18, the reported profit after tax is Rs 99.5 crores because of the defer tax benefit we got because of tax change in North America which came as a one-time benefit Rs 24 crores odd in Q3 of FY18. In Q4 FY17, the profit after tax was Rs 65.4 crores, so quarter-on-quarter growth of 23% on operating PAT, margin expansion of 184 basis points from 8.51% to 10.35%. On reported PAT there has been a degrowth of 6.7% and the reduction in margin of 87 basis points, year-on-year the growth is 42% and margin expansion of 302 basis points from 7.33% to 10.35%. Excluding the domestic business, the year on year growth would be 50.1%. We are really happy to note and mention that the board declared maiden dividend, in the history of this company this would be the first dividend of 15% which would be approximately 38% of the profit after tax including DBT.

Going forward, the highlights for FY18 - Operating revenue was at Rs 3,535.2 crores compared to Rs 3,555.6 crores, while there is a degrowth year-on-year of 0.6%, the growth in constant currency is 2.8%. Excluding the domestic business, the rupee term growth would be 3.7% and the constant currency growth would be 7.1%. Operating EBITDA in FY18 was Rs 458.9 crores compared to Rs 438 crores in FY17. The growth year-on-year is just under 5%, margin expansion of 66 basis points from 12.32% to 12.98%. Pro forma of that in domestic business, the growth will be 8.9% year-on-year and on a constant currency basis the growth will be 15.2% year-on-year and the margin expansion would be closer to 1%. Operating EBIT at Rs 393 crores compared to Rs 379 crores in FY17, year-on-year growth of 3.7%, margin expansion of just under 50 basis points from 10.66% to 11.12%. Excluding the domestic business, it would be 7.5% year-on-year and the growth would be 14.3% year-on-year and the margin expansion of 80 basis points on the constant currency basis. Operating PAT at Rs 302.4 crores compared to Rs 280 crores, year-on-year growth of 8%, margin expansion by 68 basis points and 7.88% to 8.56%, the same number would be 13.4% year-on-year excluding the domestic business and the growth would be 22.6% year-on-year, margin expansion of 120 basis points on a constant currency basis. Reported PAT at Rs 326.5 crores compared to Rs 280 crores and that represents the growth of 22.2% year-on-year. We repaid $61.7 million of debt in FY18; there has been a complete closure of $135 billion term loan which was in our US books and the $20 million ECB. Last year we also successfully divested our domestic business which is been a big highlight in a sense it is revenue well for margin expansion next year.

Other highlights: Head account of 18,703 as on March 31st 2018, of this 8,809 employees in India, 9,894 based outside of India, we had a reduction of 523 employees. Some of them related to our largest client that we have, there was some portfolio rebalancing which happened between their sales and services states. Attrition details in onshore (US and Europe) 47.3% compared to 39.4% in Q3FY18, off-shore (India and Philippines) 46.6% compared to 39.8% in Q3FY18. Nothing exceptional here, it's a seasonal uptick, nothing that worries me at this point of time. Net long-term debt of $27.4 million as of 31st March 2018. This would become practically zero by the time we declare our Q2 Results in FY19. From our FX hedges, exchange hedges perspective outstanding FX hedges at $71 million for the dollar and £107 million for the pound. For the next 12 months - 58% coverage for USD at INR 70.7 levels, 62% coverage for the pound at INR 101.1 level, 38% coverage for the dollar at Philippine peso 51.7 levels and 73% coverage for the pound at Philippine peso 68.6 levels. Ensuing 12 to 24 months - 61% coverage for the dollar at INR 69.8 levels, 71% for the pound at INR 99.2 levels and 25% for the pound at Philippine peso 72 levels. Post 24 months - 83% coverage for the pound at INR 108 levels.

Slide #7, it's basically a tabular representation of what we have discussed right now. It just shows Q4 EBITDA Margin 14.8% probably one of the highest that we have seen in the recent past probably in the last 5-6 years. Operating EBITDA at 12.8% has done well; PAT margin at 10.3% has obviously Rs 92.8 crores on an operating PAT basis again it's one of the highest increase in recent times. In terms of sectors, all the numbers look largely flat but the key to note here is pro forma of that for the domestic business, constant currency growth has been 7.1% which is right away mid-point of over the industry growth have been and the margin expansion of (+) 60 basis points which we had committed to in Q1 of last year when we saw the outlook for the business in FY18.

Coming to our revenue snapshot: North America continues to be the principal market contributing 55.6% of our revenues, 43% from the UK and for India, ROW, because we have one customer in India which is in the banking field, it shows us at 1.2%. From the vertical perspective, largely we are equally distributed among all three – Healthcare being first time an equal 37.6%, T&M and BFSI largely at 31% each. By delivery perspective, 77% onshore, 23% off-shore. By segment perspective, Customer Interaction Management services 53.5%. This also includes Mortgages business which is consolidated under Customer Interaction Management services while the work is more platform-based origination and servicing work, Healthcare 35.2% and Collections 11.3%. From a client concentration perspective, top clients have reduced between Q3 and Q4 from 29.2% to 27% which also have the direct reflection on the top 5 clients at 41%. Nothing that I am worried for, there was a portfolio rebalancing which saw some elements of the sales state, headcount reduction and we expect once the EPL season starts, should be now due to some of these numbers start coming back again.

FY18 revenue snapshot; again I won't spend too much of time on this, only call out I have here is the fact of revenue by verticals - Healthcare and T&M are the two big ones, BFSI 29.2% in Q4 we saw the BFSI vertical typically is higher because of the Collection seasonality where most of the clients are banking clients and revenue by geography is 2.8%, reducing to 1% is the reflection of reduction in the domestic business which we divested in August so hasn't been with the company for the first 7 months of the fiscal year. Revenue by a client concentration, top client increased from 22% to 28.3%. Revenue by delivery - onshore 76% and offshore 24%.

So let's spend some time on the business outlook now that we have done with historical facts: Growth momentum is looking very good for 2019. Constant currency revenue growth will be at the top end of the industry growth rate or my sense this could be higher than industry growth rate, the deal pipelines that we have the deals that we have signed, very encouraging. Evidence of this will be seen in Q1, I think Q1 seasonality follow-up usually ensures muted quarter compared to Q4 but you will see growth evident in Q1 and Q2 is where the deals that we saw last year start getting into BAU mode and you will see a step-up from Q2 onwards, so very-very bullish about where our growth rates will end next year in relation to where industry is expected to be. Healthcare and BFSI would lead the growth rates in FY19, a significant transformation led revenue acceleration will be evident across Healthcare specifically across both the providers and BU space. In BFSI clearly see some of the deals we've won in the customer interaction management space specifically in mortgages which are driven by significant RPA and machine learning with an RPA. Transformation led growth sales pipeline attrition also has been pretty positive across both BFSI and Healthcare. Margin expansion will continue in FY19 and ladies and gentlemen remember this was margin expansion from where we ended FY18 with…so 60 to 80 basis points improvement in margin expecting us to get to a 14% EBITDA level is not unrealistic in FY19 which takes us closer to some of our peer group EBITDA listed in the US who are in the 15% to 17% range. So again, the divestment of domestic business transformation led growth where transformation led gain share and operating leverages provide continuing tailwind for margin expansion; so overall feeling very good about FY19.

Q4 FY18 could have been better but for the portfolio rebalancing with our largest client but it's a temporary phenomenon. As I had mentioned in the last quarter that top client it would be flat, or it would be slightly with a downward bias that's the same outlook we have with our largest client what basis the guidance we have. But in our portfolio of other businesses which are growing especially in mortgages, Healthcare and banking business within the customer interaction management services business is very encouraging at this point in time which lead us to believe the guidance that we have given. That's all I had this point in time. I'm happy to hand it back to the moderator to open the floor for questions.

Moderator: Thank you very much. Ladies and gentleman, we will now begin the question and answer session. The first question is from the line of Amit Goela from Rare Enterprises. Please go ahead.

Amit Goela: Going forward while you gave a fairly bullish outlook, Rajesh, two questions. Would you like to put a number to the growth number where you said you might exceed or match the industry growth, would like to put a number on that? And the way the currencies have strengthened now, the pound and all that while you've given your hedges like what kind of impact it might have on the business?

Rajesh Subramaniam: To put a number down, I think 9% to 10% growth next year, this is basis the reported results. That is for the ABU because ABU business last year also where for 5 months the growth rate will be closer to about 12% year-on-year which is far exceeding anything that the industry today is looking at. Similarly, on the profitability the year-on-year profitable growth between Q1 of FY19 and Q1 of FY18 will be in excess of 25% which will give you a sense of how well we are set up as we look at FY19. On the hedges, ours is 0 to 12 months and 12 to 24 months, so on the offshore book whatever we have hedged its roughly between 60% to 80%. So any growth that comes in right now there will be benefits on the pound because when the pound was 85 the forwards were closer to about 90-91. But the pound being spot at about 90-90.5 right now, the rates are about 96-97 for the next 12 months. Our unhedged portion is probably about 20%-25% but obviously the big uplift is on the dollar. Similarly, on the consolidation side at this point in time if the pound and dollar hold where they are to the guidance we have given there could be some upside but those are translation related. So numbers are guided for are in a constant currency, there could be translation-led increases that we could see the rupee continues to remain weak through the year at the current level on both dollar and pound.

Moderator: The next question is from the line of Mohit Jain from Anand Rathi. Please go ahead.

Mohit Jain: Anything on dividend for FY19 like you guys will be having cash and I am assuming debt is already repaid, anything on capital allocation that you have thought through and would like to discuss.

Rajesh Subramaniam: I think 35% to 40% payout of PAT is something which the board debated on which we are comfortable with. For IT company its obviously the lower number but we stepped it up and if you honestly take a look at it we have been paying about $47-$48 million between principal repayments and interest repayments every year. We will become net long-term debt zero in October, so if you take a look at $47-$48 million and roughly I allocate 50% towards dividend and 50% towards M&A, 50% will translate into about $25 million which roughly works out to be dividend levels that we have currently announced. So that's the thinking right now but going forward with the accretion in profits, the policy would be somewhere between 35% to 40% payout of PAT.

Mohit Jain: 35% to 40% from FY19?

Rajesh Subramaniam: Yes.

Mohit Jain: On the acquisition side your guidance includes anything on that front because you are already allocating 50% to be used for acquisition?

Rajesh Subramaniam: We have nothing on the table right now. We're looking at several targets across several businesses, nothing which is even close to on long-binding LOI at this point.

Mohit Jain: On the currency, in the PPT we have seen you have almost 80% on-site proportion, so with 80% your ability to benefit from rupee depreciation would be little less compared to other companies. Is that the fair assumption?

Rajesh Subramaniam: Earlier as long as our loan book was there and principle and interest repayments were happening, the cash flows were a natural hedge towards the foreign currency payments. At this point in time, for example, the Healthcare generates a 15% debit margin. So, 15% on $213 million, the only thing that if we try to downstream the cash into India that's where we will look at hedging gain. But apart from that the benefit we have is on the delivery book in India which is roughly about 22%-23% on our $500 million revenues.

Mohit Jain: So it basically doesn't impact your earnings guidance so to say?

Rajesh Subramaniam: No it doesn't impact my earnings guidance. Only where it will impact is if the rupee depreciates further on consolidation there could be some gain in rupee terms.

Mohit Jain: On taxes front, your US taxes have naturally come down, so any planning on that front, what should we expect for FY19?

Dinesh Jain: I think as we guided in the last quarter also the US tax rate dropped down to 21% we expect I think this should be in the range of 17%-18%.

Mohit Jain: 17%-18% for this year?

Dinesh Jain: Yes.

Mohit Jain: And similar rate for 2020 as well, right?

Dinesh Jain: Next two years probably we should range between that only.

Mohit Jain: There is no question of you going up beyond that, right like 21%?

Dinesh Jain: As of today unlikely because if you really see UK tax rates at 19%, US at 21%, India has got SEZ, so we do have tax benefits on that I probably don't see much change happening in that space.

Mohit Jain: So 17%-18% should be the steady state for us?

Dinesh Jain: Yes.

Mohit Jain: Lastly on the CAPEX side, anything to be added or CAPEX will continue to be low for us?

Rajesh Subramaniam: CAPEX will be in the $10-$12 million range.

Mohit Jain: Same?

Rajesh Subramaniam: Yes.

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

Rahul Jain: Though you have shared some bit of color in terms of where are you expecting this growth but if you could share in terms of what is driving this thought process and how this growth compared to the real peer-set for us. I mean we have benchmark it to this industry of NASCOM growth or something but what is the deal benchmark for us and what is the growth for that industry on a like-to-like basis?

Rajesh Subramaniam: We don't benchmark each industry. NASCCOM comes with the overall industry growth for the BPM industry that saddles verticals, horizontals, it saddles the entire industry which is at-large. So, the growth rate we are saying, the alpha drivers for us, the alpha and beta are going to be BFSI and Healthcare. Within BFSI is going to be Mortgages, within Healthcare it's going to be the Healthcare Provider business. So these are the two big principal drivers of our growth going forward. In the Customer Management business as I said last time, the growth rates it is going to be again being driven by banking because we have only two T&M customers and there as I said it's going to be more of a little downward bias than an upward bias and the growth is going to be driven by the BFSI segment. Similarly, the Financial Services Collections, the Department of Education which had shut down in FY17 has come back again towards the latter part of FY18 and that will drive growth going forward. The Financial Services portfolio will largely remain stable with some upward bias from some of our clients who are consolidating existing vendors and we will be a gainer from a market share perspective. So as I said over all these growth rates that we have projected are superior because of the deals that we have signed and when we benchmark ourselves to our peers in the industry.

Rahul Jain: When you say improvement of margins possibility and in light of the billing rates and pricing that we might be seeing in the market, so how much volume growth and how much would be pricing growth when you build this guidance for the next year and if that is the case what is the real operating leverage for us from a margin uptick perspective?

Rajesh Subramaniam: As I said in our business, there is traditional volume and there is transformation volume. So margin expansion for us is happening because there'll be certain parts of our portfolio where there will be a revenue reduction but profit accretion. So that's a smaller part of our portfolio and going forward probably from Q2 onwards we will be disclosing what our transformation-led growth is and how that plays out into how you will clearly start seeing the margin accretion happening from Q1 and Q2. At that point in time it will be easier for me to tell you what is the volume declined but profit increase and what is the absolute volume increase which sets itself up for a transformation 12 months once the business is stable and then the transformation ensures that there is a productivity improvement which then drives a higher margin profile. So that's how the whole cycle of the engagement with clients is shaping up. And as I said we are looking at the 14% EBITDA margin, that's about all almost 100 basis points year-on-year while we have guided for 60 to 80 basis points, 14% number doesn't look unrealistic on the back of growth which drives operating leverages and transformation led which is more outcome basis where the gain share ensure the margin accretion for the same effort provided.

Moderator: The next question is from the line of Ashish Agarwal from Principle Mutual Fund. Please go ahead.

Ashish Agarwal: First of all, on the largest client, what is the prognosis on the client, will that grow now into FY19? And number two just a bookkeeping, was there any one-off in the margins in Q4?

Rajesh Subramaniam: No, there was one-off in the margins in Q4. Q4 is 93 crores as all operating PAT, so one-off was in Q3 when we showed 99.4 there was 24.1 crores in Q3. As far as the largest customer is concerned, as I said it will be flat to a decline. Flat if we win one of the deals in the pipeline and if one of those deals don't happen and they get delayed for any reason which is a way life in our industry, then we are likely to see a year-on-year decline which I am not too worried because it's a portfolio rebalancing. And despite that the growth rate which I articulated will be through.

Ashish Agarwal: But the largest client will be in the current quarterly run rate, right if you don't win that incremental order?

Rajesh Subramaniam: That's right.

Moderator: We have the next question from the line of Abhishek Agarwal from Finmart. Please go ahead.

Abhishek Agarwal: My question is regarding revenue growth like Quarter 4 is always the good quarter for us, so what is the reason for the flattish growth? And secondly if you look at EBITDA margin we have performed quite well because we are pushing very hard to achieve this level of margin, so do you think that this level of margin is sustainable or there is still possibility for expansion margins front?

Rajesh Subramaniam: So first thing is as I mentioned there was a drop in our top client revenues in Q4 which is why our revenues have come in flat quarter-on-quarter. So that answers one question. Second question, margins Q4, there is a seasonality element where there is a disproportionate share of profitability drop to the bottom line from revenues because there is a seasonality element in our Collection business because tax refunds happened in Q4 and peoples' ability to pay on charged-off debt is highest. So the EBITDA margins you see in Q4 is not representative of the EBITDA margins of the ensuing year. As I mentioned the EBITDA margins of Q4 are roughly 14.8% odd and we are guiding full year margins of EBITDA are at about closer to 13%. And as a management team we believe that in EBITDA margin of 14% there is something which is possible next year. Though we are guiding to 60 to 80 basis points improvement we believe a 100 basis points is possible.

Abhishek Agarwal: As company is virtually debt-free right now so company will start throwing lot of free cash flow, so what is our plan for future, where we will deploy this free cash flow?

Rajesh Subramaniam: That's what we have a dividend policy if you were in the call we discussed our dividend policy and our capital allocation towards M&A as and when we see relevant assets that fall into our sweet spot.

Abhishek Agarwal: So currently we don't have any expansion acquisition plan which can boost our growth and the revenue?

Rajesh Subramaniam: No, nothing. As of now we don't have any. We are looking at several targets across several industries and applications. Nothing which is even close to a closure at this point in time.

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: Thank everybody for your time, appreciate it. It's been a good quarter. It hasn't been a great quarter but it's been a good quarter. But I think next year the outlook looks very good and happy to take any questions that you might have missed on today's call, Ankur is available. He can respond or coordinate as you deem appropriate and I look forward to speaking to you in three months. Thank you.

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