Q1 FY2019 Earnings Call Transcript - August 06, 2018

CORPORATE PARTICIPANTS

Mr. Rajesh Subramaniam - Managing Director & Chief Executive Officer

Mr. Dinesh Jain - President and Chief Financial Officer

Mr. Ankur Maheshwari - Head Corporate Planning & Investor Relations

Moderator: Ladies and gentlemen good day and welcome to the Firstsource Solution Limited Q1 FY19 Earnings Conference Call. As a reminder, all participants' 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, thank you and over to you sir.

Ankur Maheshwari: Welcome everyone and thank you for joining us for the quarter ended June 30, 2018, Earnings Call for Firstsource. Please note that the results, fact sheet and the presentation have been 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 questions, we have with us today, Mr. Rajesh Subramaniam – our Managing Director & 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 the call over to Mr. Rajesh Subramanian – our MD and CEO.

Rajesh Subramanian: Thank you Ankur. Good morning, afternoon, and evening to everybody on the call. Thanks for taking time to listen to our earnings story.

Q1 FY19 has been a good quarter for us. We have demonstrated some of the guidance principles that laid off in the last quarter both on the revenue side and on profitability. Revenues in Q1 FY19 came in at Rs 919.1 crores, the sequential quarter in Q4 of last fiscal was Rs 897.3 crores and year prior Q1 FY18 was at Rs 877.7 crores. Quarter-on-quarter, the growth has been 2.4% in rupee terms and 1.1% in constant currency terms. Year-on-year, the growth has been 4.7% in rupee terms and de-growth of 0.1% in constant currency terms that is largely because of the ABU business being present in Q1 of last year. If we proforma out the ABU business in FY18, the year-on-year growth metrics is 11.4% in rupee terms and 5.3% on constant currency terms setting this up well for the revenue guidance of 7% to 9% we had laid out early.

EBITDA for Q1 FY19 came in at Rs 128.1 crores or 13.9% of the revenues compared to Rs 132.5 crores in Q4 of FY18 and Rs 100.6 crores in Q1 of FY18. Quarter-on-quarter degrowth of 3.3%, margin reduction of 83 basis points from 14.77% to 13.94%. All of you know that Q4 is seasonally our strongest quarter so reduction in profitability is expected given the seasonality element in our Collections business and also we have seen some impact of wage increases beyond what we expected especially around minimum wages in some of the election states that we operate in and that we saw some increases but nonetheless, year-on-year which measures true health of the business, EBITDA grew 27.3%, margin expansion of 248 basis points to 11.46% to 13.94% and proformaing out the domestic business, the ABU business, the growth in EBITDA is 34.3% year-on-year, margin expansion of 238 basis points from 11.56% to 13.94%.

Q1 FY19 operating EBIT came in at Rs 110.1 crores, there is a typo error, sorry about that, it is Rs 110.1 crores, not Rs 110.1 million or 12% of revenues compared to Rs 115.3 crores in Q4 of FY18 and Rs 85.3 crores in Q1 of FY18. What is the reduction in EBITDA sequentially is again reflected in the EBIT and the PAT degrowth of the reasons I explained. Q-o-Q degrowth of 4.5%, margin reduction from 12.84% to 11.98% sequentially but year-on-year growth of 29.1%, margin expansion of 226 basis points from 9.72% to 11.98%. Taking out the domestic business, the EBIT growth is 35.4% and margin expansion of 212 basis point from 9.86% to 11.98%.

Translation of all this on to profit after tax, Q1 FY19 profit after tax stood at Rs 88.6 crores or 9.6% of revenues compared to Rs 92.8 crores in Q4 of FY18 and Rs 65.4 crores in Q1 of FY18. Quarter-on-quarter degrowth of 4.5%, reduction in margin of 70 basis points from 10.34% to 9.64%. Year-on-year growth of 35.5%, margin expansion of 219 basis points from 7.45% to 9.64%. Taking out the domestic business 44.1% year-on-year growth and 219 basis point margin expansion from 7.45% to 9.64%. So, overall it been a reasonably robust quarter for us.

Other highlights – employees and attrition details: 18,759 employees as on June 30th, 2018; 8,664 in India, 10,095 outside of India, net addition of 56 employees in Q1FY19.

Attrition details: Onshore (US and UK) 48.7% compared to 47.3% in Q4 of FY18. Offshore – (India and Philippines) 51.7% compared to 46.6% in Q4 of FY18. Again, nothing that worries me and very consistent with what we see in the April, May, June quarters compared to the Q4.

Net debt of $21.3 million as of June 30, 2018, and from a net debt perspective practically will be down to 0 by the end of Q2 or early part of Q3.

Outstanding FX hedges at $75 million for the US dollar and £107 million for the British Pound. Next 12 months, 58% of the dollar has been covered at INR 70.7 levels and about 58% for the pound at INR 101.1 levels and 38% for US dollar at Philippine peso 51.7 levels and 73% coverage for the pound at Philippine peso 68.6 levels. For the next 13 to 24 months, 68% coverage for the US dollar at INR 70 levels, 68% coverage for the pound at INR 99.2 levels and 25% for the pound at peso 72 levels. Post 2 years, 80% coverage for the pound at INR 108 levels at this point.

If you take the next slide which depicts the financial performance in a different format, the only call out here is the improvement in margins and in revenue performance despite other operating income reducing from Rs 27 crores in Q1 of last year and Rs 26 crores in Q4 of FY18 to Rs 13.1 crores in Q1 of FY19. Its largely a reflection of a hedging policy. We hedge 12 months, 24 months forward and where the pound on a 24-month basis, this is just after Brexit where the pound was with the reflection of where our Q1 or other operating income levels reduction shows. But despite that reduction you can see the performance on revenues and the operating EBITDA. From our tabular representation, revenue from operations has grown 4.7% year-on-year in rupee terms, higher in constant currency terms and PAT is around 35.5%.

The next slide, there is the composition of revenues:

From revenue by geography, USA remains the alpha 54.1%, largely in consistent with Q4 and slightly higher than Q1 of last year. UK at 44.7% and India one client in the banking industry contributing 1.2% from the 6.2% which was there same period last year. From revenue by location: Onshore 77%, offshore 23%. From Revenue by verticals, as I have mentioned in the past, see the banking/BFSI vertical which is going to be driving growth going forward. That has clearly stepped up from 27% in Q1 of last year to 35% in Q1 of this year. Telecoms and Media 28.7%, Healthcare – largely stable at about 35.4% as compared to 36% same period last year and 37.6% in Q4 of FY18. Q4 to Q1 there will be a drop because the enrollment in the Healthcare Payer industry ends in February and that typically will see a significant fall off in revenues during Q4 and Q1.

From a revenue composition, from a business unit perspective, Customer management 55.8%, Healthcare 33% and Collections 11.3%. From a concentration perspective, top client 24.7%, top 5 was at 42.7%. As I said in top client, there is realignment within the top client portfolio. We expect these numbers to stay stable for the next two quarters and then we will see one more step-off given some of the realignment strategies that are being undertaken by the top client in Firstsource where certain elements of work will be taken back and certain elements of work will be outsourced to reflect what we believe would be the appropriate leverage of skills in both our organizations.

Business outlook perspective, our operational performance continues to remain robust as demonstrated by the margin expansion that we have shown. We are seeing a good traction in the Services business of our mortgages business unit. The very focused pivot from being reliant on the origination business to the servicing business over the last year given the vagaries of the interest rate cycles which have frequently affected our businesses has clearly paid-off. We have been clearly identified as the strategic partner with our top client and that business, that account will grow on the back of internal consolidation of opportunities. We have signed up several other strategic deals with large mortgage outsourcers especially on the servicing side which will bear results and growth. We had given you a guidance of 25% to 30% growth for this business unit year-on-year, I think those numbers are likely to be demonstrating a slightly upward trajectory to that guidance but in a way very comfortable with the guidance we had given you. Similarly, the Healthcare Provider business continues to do very well. Our transformation efforts in selling differentiated solutions into a hospital network is yielding us in a very-very attractive levels of profitability which is holding us in good stead and is giving us deal wins our margin expansion.

Going forward, BFSI and Healthcare will be the two businesses that will drive growth. BFSI, the mortgages business is included in the BFSI segment, so BFSI US and in the UK, where we are kind of the top three banks and we have signed up one more very large bank which has gone live in Q1, are going to be driving profitable growth for us going forward. Healthcare, we definitely see some headwinds in our payer business but lot of strategic conversations at this point of time driven by transformation-led sales, we expect will drive revenues in Q4 onwards but Healthcare on the provider side, we are very-very bullish on the outcomes that we are driving with our customers and how they reflect value to us.

So, that is all I had in this presentation and I am at this point in time happy to open it up with the floor for questions.

Moderator: Sure, thank you very much. We will now begin the question and answer session. We have the first question from the line of Mohit Jain from Anand Rathi. Please go ahead.

Mohit Jain: First is on the pricing, if you could help us understand quarter-on-quarter movement in pricing and the correlation with the seat-fill factor which sort of went down this quarter, despite that your revenue per employee was maintained.

Rajesh Subramanian: Okay, on the pricing, Mohit as you know we don't have pricing changes that happen quarterly. Ours are all long-term contracts, so we haven't had any contract renewals that have required differential pricing at this point in time, so it is not that our margin increases because certain contracts which have been priced higher. But what I can say is that the margin increase has happened because of better performance from outcomes we have driven in our Healthcare Provider business and in some of the go-lives in a customer-management business in the UK. We probably would have had one or two contracts that would have had indexation kick-in during the quarter but that definitely won't have had a material impact on the margin profile, so that is the question on the pricing environment. The second question was around seat-fill factor. I don't have the details right now, but I can get it for you but the operating leverage from seat-fill would not have played a significant impact on our margin expansion either. The seat-fill factor was 74% in Q1 of last year and 79% in Q4 of FY18. In June 30 2018, it was 75% gone down by almost 5% because we have invested in new facilities in the payer business especially in Chennai. We have new SEZ which has been created in Chennai for the growth of the payer business and also for the growth of our mortgages business, the growth which we see is happening in Chennai, the seat fill factor has come down but that will normalize itself over the next few quarters as the growth kicks up.

Mohit Jain: The total number of seats have also come down this quarter.

Rajesh Subramanian: Total number of seats also has come down because we have given up a larger center in Chennai and consolidated that into a smaller SEZ in Chennai and enrollment came in Colorado Springs which ends in Feb, those seats become empty and reduces the fill factor.

Mohit Jain: Okay because that is somehow getting affected in the pricing because seats going down, seat factor going down and revenues being stable.

Rajesh Subramanian: The fill factor reduction is also function of the enrollment and as I said you know the enrollment that we do for one of our payor clients which is in Colorado Spring that Center becomes empty in Q1.

Mohit Jain: Okay, second was on the tax rate for the quarter. I think you are looking at from 13% and 14% for this year, is there any change in the outcome there.

Dinesh Jain: No I think this year, Q1 is around 16% and we see that in between 16% and 18% it will remain, it depends on sometime also the way their revenues and the profitability come with geographically but I think the range will be 15% to 18%, which we highlighted last time.

Mohit Jain: 15% to 18%, but first quarter you typically pay higher as compared to the rest of the year, so that thing will not play out this time.

Dinesh Jain: No not like that, it is not always. Last year was different because the US tax rate Q3 of one-time PAT and Q4 also has some follow on which has reduced the tax rate, otherwise the normalized tax rate movement should not be more than 1% to 2% between the quarter-on-quarter because you have to forecast the annualized tax rate and you have to provide for it.

Mohit Jain: Okay, third is on the sky payment, is it done now or is there anything which is left.

Rajesh Subramanian: No, it is over, that is it. That is all over.

Mohit Jain: So, this quarter was the last year.

Rajesh Subramanian: Yes.

Mohit Jain: Lastly on BFSI if you could help us understand, this is driven by few clients like wide spread shed the light because other verticals are not growing. BFSI is probably growing right now, how reliable is the growth there.

Rajesh Subramanian: Yes, I think BFSI as I said you know the mortgages business is clearly doing well, between last year and this year the growth rate I guided in the last years call and the other big element is we won pretty large deal with one of bigger banks in the UK, it's a logo addition, which was in the news recently for all the wrong reasons and we have explained why we are growing strongly with them and that is driving growth plus our existing clients, the top three banks that we work for, there are incremental increases which are helping us and in the US, the collection seasonality tail off has happened but we have got new businesses in the collections vertical and the department of education also has comeback up which had been a shutdown last year, which have mitigated the follow-up in revenues between Q4 and Q1, while the impact on profitability is high because you know 1 dollar of revenue which generates 80 cents of profitability in Q4 that same dollar will not generate that level of profitability so while the impact of profitability is there, on the revenue side new businesses have ensured that the tail off Q1 has not been that material.

Mohit Jain: But nothing one off in terms of project going live.

Rajesh Subramanian: Nothing, no one-off revenues, nothing.

Mohit Jain: And your full year guidance of 10% constant currency is sort of maintained.

Rajesh Subramanian: At this point in time, I think 7% to 9% is something which we would. 10% as I said we would if everything played out well, at this point in time there are some rebalancing which will happen with our largest client and because of that 10% is clearly not visible, very comfortable with the guidance of 7% to 9% at this point in time.

Moderator: Next question is from the line of Deepesh Mehta from SBI Cap Securities. Please go ahead.

Deepesh Mehta: Just on the guidance part, I think you indicated about 7% to 9% and Q1 seems to be lower than the lower end of the guidance, I think around 5% which we indicated adjusting for the business sale happened last year. So can you help me understand this. I think top client is where one of the weakness seems to be and if you can provide some more detail you I think initial remark indicated about recovery unlikely to happen in next few quarters and stability might be there rather than recovery. So that element if you can address and then if you can help us about mortgage and collection business, how you expect them to shape up?

Rajesh Subramanian: Yes, so as I said the mortgage business will likely grow anywhere between 7% to 10% quarter-on-quarter, every quarter for the next 3 quarters so that is one growth driver. The second is the utility client which we signed up, which went live in Q1 will be full on in Q2. The bank that we signed up in Q1 for some part of Q1 will be full on in Q2, so some of these growth elements will mitigate some of the softness that we have seen our top client plus the enrollments will start in October again in Q3 which will again step up our growth trajectory plus some of the wins that we have had in our collections business will scale up including the department of education to a higher level than what we have seen in Q1, so the provider business will again grow significantly year-on-year. Healthcare business at the portfolio level will probably grow at about 6% to 7% but the alpha being the hospital provider business, the payor business will see some softness given some of the transformation led shrinkages which is happening right now which sets up well for margin expansion and growth from Q4 onwards, more it will benefit us in FY20 rather than FY19, so on the balance as I said, if we hadn't seen some of the structure realignment that we expect to see in Q4 or later part of Q3 and Q4 with our largest client, I would have been more comfortable with the guidance of 10% but given that some of the changes are going to be happening and the timing of rebalancing the portfolio from what is taken away from us and what is given to us, there will be a timing mismatch which is why I am more comfortable with the 7% to 9% guidance and that is something, we have done 5.6% on a constant currency basis, that will step itself up slightly in Q2 and it will take the trajectory including the benefit of seasonality which will show up in Q4 to get us to the guidance mark which we have declared.

Deepesh Mehta: Is it possible to give deal win ACV signed during Q1.

Rajesh Subramanian: Why don't we park that question. We will give you the answer.

Deepesh Mehta: The reason for asking is you said you added UK BFSI new logo during the quarter, just to get sense about size of the engagement kind of thing and you indicated two things about department of education. I think for last few quarters, that business was because of some legal issues remained very soft kind of almost negligible for us.

Rajesh Subramanian: Correct that has come back up, so those legal issues have been resolved between the departmental head and the agency we were working with, I mean that industry issue has gone away now, so placements are back, so that will start things on scale and in terms of the contract value we won, I mean, see again, an ACV number of my, I can give you a number but that number will mean nothing because it does not include some of the shrinkages that we see in the volume reductions, we see in businesses basis of seasonality so standalone the ACV of contract that we won in Q1, I mean that went live in Q1 is about between $30 to $35 million which includes and roughly one-third of that would be the banking customer which will translate to the revenues in FY19.

Deepesh Mehta: Okay and that is new logo, so roughly around $10 to $12 million what you are indicating which is closer to double digit is new logo which we have signed this quarter.

Rajesh Subramanian: Yes which has gone live in Q1, which we won in Q4 which has gone live in Q1.

Deepesh Mehta: Deal signed happened in Q4 not Q1.

Rajesh Subramanian: No, deal signed in Q1 yes in the early part of Q1 yes.

Deepesh Mehta: In Q1 okay and sir just about this department of education, can you help us how much revenue we booked last year and what changes do you expect with the clarity immerging under that business.

Rajesh Subramanian: Yes last year, I don't think we had very miniscule, year prior departmental edge was about 2.5 to 3 million dollars in revenue, that was expected to be about 6 to 7 million dollars last year which did not fructify, I had to probably ended it about 300 to 500,000 dollars and Ankur can give you the exact numbers and this year as coming back up, we expect it to get back up to the 2 million dollar mark this year.

Deepesh Mehta: Understand and the last question from my side is about mortgage business or ISGN earlier what we used to call it. Now you indicated about business mix change kind of service is getting more and more, can you help us provide some data on the business mix change and how the margin trajectory change.

Rajesh Subramanian: The business mix change was very simple, when we acquired ISGN, origination was probably was about 70% to 80% of the revenues and within the originations business, probably 70% to 80% would have been refinanced. And servicing was a small portfolio title evaluation would be you know the other contributions of the balance 20% to 30%. This year, we see servicing business at about just under 50% of our revenues compared to 15% to 17% in the previous year and this brings in a lot more margins stability and predictability while in the origination business when interest rates are low and refinance is up, you know your margin profile can be very attractive, can be more than steady state servicing business but the servicing business gives a predictability in margins and also has amenability to large scale off shoring which is what we believe we will see you know going forward, so overall what the business which generated loss last year will generate healthy EBIT margins this year. We expect the EBIT margins to be anywhere between in a 10% to 12% this year with significant operating leverages for margin expansion as the business grows.

Deepesh Mehta: This quarter is also broadly within the range you indicated.

Rajesh Subramanian: This quarter profitability would be lower than the indication because the revenue is lower but as the revenue grows the margin expands.

Deepesh Mehta: Even in servicing that non-linearity is there, with revenue only you get those margins?

Rajesh Subramanian: Servicing business is very similar to what we do in customer management, the rhythm is very similar to what we do in customer management and nonlinearity comes only from utilization and once the process is matured comes from driving either automation where back office is heavy and omni channel where it is contact center heavy but given the early stage infancy of the servicing business, those operating leverages I don't see playing out at least for the next 12 months.

Deepesh Mehta: So broadly the factor which you eluded indicate Q1 should not be materially different than your full year expectation.

Rajesh Subramanian: No will be different. Q1 is lower than as I said as this business grows almost 10% quarter-on-quarter, the margin expansion will happen so today the margins, EBIT margins are high single digit and the migrations of high single digit to a midpoint of the low double-digit guidance which I had given you will happen over the next few quarters.

Deepesh Mehta: Last question, whether any change to margin expected or margin guidance.

Rajesh Subramanian: I think what we have articulated I mean, we are hoping to end the year at about 14% EBITDA margin. I don't think I want to change that guidance.

Deepesh Mehta: Thank you.

Moderator: Thank you. Next question is from Shekhar Singh from Excelsior Capital. Please go ahead.

Shekhar Singh: Sir, just in terms of guidance for the margin, see this quarter had a sharp improvement in margin but is that on account of some fixed price contracts which might not repeat in the coming quarter.

Rajesh Subramanian: No nothing like that.

Shekhar Singh: So, going forward what is the sort of margin which we can expect for FY19.

Rajesh Subramanian: Yes, we talked about an EBITDA profile of about 14%.

Shekhar Singh: 14%, okay.

Moderator: Thank you. Next question is from Abhishek S from Equirus Securities. Please go ahead.

Abhishek S: Sir, this might be repeat, but at the start of the call, you mentioned about the realignment of business within your top customer, could you elaborate as to what is the rationale behind it and add a color to it, thanks.

Rajesh Subramanian: Yes, I think there are certain lines of work which have sensitivity from regulatory oversight which is in an outsourced environment would be sought to be done inhouse and to rebalance what has to be done in-house, certain elements of customer lifecycle work which is done combination of inhouse and some other partners in other geographies that they currently are in play with will move to us but the timing of that might not coincide.

Abhishek S: Okay, that is helpful and in case that you know as it pans out then what could be the revenue contribution you could just be for the top customer, if you can just give a ball park number, that will.

Rajesh Subramanian: I think at this point of time I will say we will come back, this is something we expect to impact us in later part of Q3 and early Q4. By the time you come to the next call, I will give you a lot more clarity but in the spirit of full transparency, I just want to give you where this heads up that this is something which will happen, but it does not impair my ability to achieve the guidance of 7% to 9%.

Moderator: As there are no further questions, I would like to hand the conference back to the management for any closing comments.

Rajesh Subramanian: So, thanks everybody, thanks for the time appreciated, I know it is late. Today was our AGM that is why we can't do this call earlier, so we finished our shareholder meeting and we had to schedule it at 6 p.m. We have good quarter. Q2 will see similar growth year-on-year on a year-on-year basis feeling very good and then the growth momentum in BFSI, Healthcare continues to be robust. In our business, there will be some headwinds but you know we are confident of dealing with those headwinds and deliver to the guidance which we have given, so appreciate your time and look forward to speaking to anyone of you would have any specific queries, Ankur will take those questions and I am happy to meet or have a conversation if it needs my attention, so fairly appreciated, thank you everybody.

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