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# Q2 FY2019 Earnings Call Transcript - November 01, 2018

## CORPORATE PARTICIPANTS

Mr. Rajesh Subramaniam - Managing Director & Chief Executive Officer

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Mr. Dinesh Jain - President and Chief Financial Officer

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Mr. Ankur Maheshwari - Head Corporate Planning & Investor Relations

**Moderator:** Ladies and gentlemen, good day and welcome to the Firstsource Solutions Limited Q2 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. Thank you and over to you sir.

**Ankur Maheshwari:** Welcome everyone and thank you for joining us for the quarter-ended September 30, 2018 earnings call for Firstsource. Please note that the 'Results', 'Fact Sheet' and 'Presentation' have been mailed to you and you can also view this on our website [www.firstsource.com](http://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 this call with a brief presentation providing an overview of the company's performance followed by 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 Subramaniam - our M.D. and CEO.

**Rajesh Subramaniam:** Hello, everybody. Very good morning and afternoon to all of you from wherever you dial in.

Q2 FY19 has been a very good quarter for us both from a financial performance standpoint and from a sales business development standpoint; I will talk about each of these elements in our presentation. Revenues in Q2 FY19 came in at Rs. 954.7 crores compared to Q1 which was at Rs.919.1 crores and Q2 of last year was at Rs.873 crores. Sequentially, we have grown at 3.9% in rupee terms and 1.8% in constant currency terms, year-on-year we have grown 9.4% in rupee terms and 3.2% in constant currency terms. If we proforma the ABU, the domestic business which was in our numbers last year until August, then the year-on-year growth is 12.2% in rupee terms and 4.9% on constant currency terms. The profitability margin expansion story continues from Q1, done reasonably well in maintaining our margin profile sequentially and showing the improvements year-on-year. EBITDA came in at Rs.132.8 crores or 13.9% of revenues, it is a 3.7% growth quarter-on-quarter and higher by Rs.4.7 crores, margin percentage being flat, year-on-year it is higher by Rs.23.2 crores or 21.1% growth and margin expansion of 1.3%. Operating EBIT came in at Rs.114.4 crores or 12% of our revenues, quarter-on-quarter demonstrating a almost 4% growth and higher by Rs.4.3 crores and margin percentage being flat, year-on-year higher by Rs.21 crores or 22.5% growth with margin expansion of 1.3%. All this translates into profit after tax at Rs.92.8 crores for Q2 FY19 or 9.7% of revenues, sequentially higher by Rs.4.2 crores or 4.7% growth and 10 basis points margin expansion, year-on-year it is higher by Rs.24.1 crores or 35% growth, margin expansion of 1.8%. So, overall it has been a reasonably good performance on year-on-year basis. Cash and cash equivalents shown a diminution to Rs.74.1 crores compared to Rs.133.3 crores largely on account of the maiden dividend we paid of Rs.124.8 crores in August 2018 which has depleted our cash reserves which we will get build up over the next few quarters.

Next slide is on H1FY19 Summary: Revenues came in at Rs.1,873.9 crores compared to Rs.1,750.7 crores last year; year-on-year growth of 7% in rupee terms and 1.7% in constant currency terms taking the domestic business out last year, the year-on-year growth was 11.7% in rupee terms and 5.3% on constant currency terms. EBITDA at Rs.260.9 crores or 13.9% of revenues, year-on-year higher by Rs.50.7 crores or 24.1% growth, margin expansion of 1.9%. Operating EBIT came in at Rs 224.6 crores, representing 12% of revenues, year-on-year higher by Rs.45.8 crores, representing 25.6% growth year-on-year and margin expansion very similar to EBITDA at 1.8%. Profit after tax at Rs.181.4 crores represented as 9.7% of revenues, year-on-year higher by Rs.47.3 crores or 35.2% growth and a margin expansion of 2%.

I will take you over to the next slide. No specific call outs on this slide, it is just a representation. Our tax rates are about 16%. You clearly see our interest reduction on the back deleveraging which is evident. The other call out you will see is that the other operating income has clearly reduced from Rs.26.6 crores in Q2 of last year to Rs.10.5 crores which reflects the pricing on the hedge book compared to what we got last year, but despite that fall off our margin expansion has been clearly evident. So, the core operating performance of the business is in a very good shape.

If I go to other highlights, employee and attrition details: Our head count is 19,615 employees, 9,040 employees in India and 10,575 employees based outside India, net addition of 856 employees in Q2. Attrition onshore US and UK 54.9% compared to 48.7% in Q1, there has been a slight increase in attrition, we are seeing some pressure in markets such as London, Paris and Cardiff, but we expect to normalize going forward. Offshore (India and Philippines) 44.8% compared to 51.7% in Q1 FY19. Net debt of \$19.8 million as on September 30, 2018. We repaid £6 million in Q2 of FY19. Our net debt would have been zero. Our dividend payout of \$17.2 million which we did in August had ensured that the net debt has remained at \$19.8 million, otherwise net debt would have been sub \$2 million bracketing zero. We expect to be at that level at the end of Q3 for sure.

From our FX hedges provision, our outstanding FX hedges at \$84 million for the dollar and £115 million for the GBP, next 12 months, 88% coverage of the dollar at INR 70.3 level and 85% coverage for the pound at INR 98.4 levels and 51% coverage for the pound at Philippine Peso 71.6 levels. For the subsequent 13 to 24-months period, 65% coverage for the dollar at INR 72.6 levels, 90% coverage for the pound at INR 101.2 levels and post that period we have 89% coverage for the pound at INR 109.7 levels.

Just to give you a snapshot from how we derive our revenues and some other nuances of our verticals and delivery locations. The United States of America continues to be alpha geography; Q2 was 55.1%, UK 43.8% and India we have a single contract in the banking space which contributes 1.1%. It has been pretty similar to what we saw in Q1 last year.

From a vertical contribution, Banking has clearly stepped up compared to the same period last year from 29.2% to 36%, Telecoms and Media at 28%, and Healthcare at 34.8% have largely remained around the same range compared to the numbers in the last quarter. In terms of revenue by delivery, 80% of our revenues delivered onshore, 20% delivered offshore. From a revenue by segment perspective, Customer Management accounted to 55.7%, Healthcare 32.6% and Collections 11.7%, very similar to our Q1FY19 numbers.

From a client concentration perspective, our top client is at 23.8%, top-5 at 41.6%, between Q2 of last year and Q2 of this year, our top client has dropped by about \$5 million and there is some growth which we expect which will ensure that this gap gets reduced further going forward.

From a business outlook perspective, as I said, there has been a strong operational performance across all business units, some headwinds in the Healthcare payer segment we definitely see. We see some of the deal pipeline that we have had not converting to revenues in the speed that we expected, but the sales momentum in the BFSI segment across US and UK and Healthcare provider in Collections continue to remain extremely strong. The heartening thing is the sales momentum whatever we have sold in H1, 40% of those revenues are transformation-led sales. They have component of digital and Omni-channel framework aided around RPA coupled with Machine Learning or there is an element of Analytics in it. So, very heartened with the quality of revenues which is aiding in our margin expansion which is clearly evident. The revenue acceleration, while we are at about 5.3% growth rate in H1 year-on-year on constant currency, proforma on the ABU business, we clearly expect to achieve growth guidance between 7% to 8.5% for end of the year. We have several deals which have been signed up, which are in various stages of execution and the growth will be clearly evident from Q3 and Q4 would be the quarter of deliverance which sets us up very well going into FY20. So, very, very positive about the pipeline that we have, quality of a pipeline which is in terms of composition of digital Tier-1, Tier-2 deals and the industry segmentation of what we are seeing in provider and banking, just clearly sets us up well for a very good FY20.

From margin profile perspective, we hold our guidance, you have seen the numbers, second half, we will have some tail-off in other operating income, so you will see the margin expansion not at the same level that we have witnessed in the first half, but nonetheless whatever we have committed to on the profitability side, we will definitely beat it comfortably and earlier our revenue projections which could have been higher in the low double digits is now we have taken that down to in the range of 7% to 8.5% largely on account of some of the delays and what we have seen in the Healthcare Payer segment which will correct itself next year.

So, that is our summary. Good quarter and the performance will continue into Q3 and Q4 would be the significant quarter which clearly takes the Firstsource into a completely different orbit from a revenue growth perspective year-on-year and from a profitability margin perspective. So, with that summary I am happy to hand it back to the moderator to open it up for questions.

**Moderator:**

Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. We will take the first question from the line of Nagraj Chandrasekar from Laburnum Capital. Please go ahead.

**Nagraj Chandrasekar:** Just a couple of questions: In terms of the growth, it has come off nicely this quarter and you are maintaining guidance. Is it fair to assume that what you are saying is whatever ramped down had to happen from Sky has happened and going forward this should be at a relatively steady level and the acceleration from the other contracts that are ramping up will compensate, is that basically what you are guiding to? The second question would be obviously lots of businesses in Britain are doing contingency planning for Brexit. In the event the Brexit were to happen, how does it impact our ability to serve Britain from European locations or Europe from Britain, do we have a plan in place where we would be able to realign where we are servicing from, and what would be the cost involved? Finally, is mortgage is in a steady pace, is it ramping up, is it ramping down, is it at the 40, 45 million a year type run rate and what is the outlook there?

**Rajesh Subramaniam:** For the first question, absolutely yes, there is no softness that we see from our top client. I think whatever had to happen for this year has happened. Q3 seasonally is a soft quarter but it is not a big magnitude but change that you will see between Q2 and Q3 and every other deal that we have won will start ramping up and showing up in our ability to go from that 5.5% to 8% and some will have 8.5% and we end the year. So, that is one. #2 from Brexit perspective, today we have no service delivery outside of the UK, we do not service UK clients from anywhere in Europe, we are all UK-centric or it is offshore-centric. So, the impact of Brexit from a service delivery perspective does not exist. More importantly, what is the impact on clients? So, right now is it a hard Brexit, soft Brexit, irrespective of whatever the situation, whatever contingency planning we have done with our client, whatever is the outlook that they believe will play themselves out, whatever guidance we have given you on growth factors in any such impact especially around banking customers, we do not see any impact with our largest client and what happens to the UK business if there is a hard Brexit at this point in time. But yes, the banks interlinkages a lot closer but we do not see any impact laying out from a Brexit perspective at this point in time. On question #3, the mortgage business is doing well. We are signing a lot more logos, you can see that the interest rates went to right now 3.1%, 3.15%, but the pivot to mortgage servicing which is in excess of 50% today has clearly derisked the business from the vagaries of interest yield curves and to that extent that business is doing outstandingly well, will be the fastest growing asset within the Firstsource family and from last year to this year the growth rates would be north of 30%, so the numbers that you articulated is well on track to achieve those numbers and probably exceed them too.

**Moderator:** Thank you. We will take the next question from the line of Devanshu Bansal from Emkay Global. Please go ahead.

- Devanshu Bansal:** Sir, I have one question regarding the revenue growth. Sir, we have guided for 7-8.5% revenue. So, this requires healthy ticket you are going ahead for the second half of FY19. So, Q3 being a seasonally weak quarter, do you expect this growth to be divided equally between Q3 and Q4 or is it going to be more Q4 oriented growth?
- Rajesh Subramaniam:** It will be Q4 oriented growth, Q3 seasonally is weak for existing business but the new businesses that we have signed up will contribute to Q3, so Q3 also growth will be evident, Q4 the growth will be significant because that is when the seasonally strongest quarter for our base business plus the ramps that we have been undertaking in Q2 which will start showing up in Q3 will be full blown in Q4.
- Devanshu Bansal:** For the outlook as of now, are we expecting like achieving the lower end of the growth rate or we are confident of achieving the higher end of the growth rate as well?
- Rajesh Subramaniam:** At this point in time, we clearly have the visibility of the lower end and can we achieve something in the midpoint of the lower end, higher end at this point, it is definitely tenable, but we need to close a few deals if I have to get into the higher end of the spectrum which I will get clarity before the start of the holiday season... before December 10<sup>th</sup>, before everything shuts down in the markets, that is when we will have clarity on whether we get to the higher end of the spectrum.
- Moderator:** Thank you. We will take the next question from the line of Ashish Kumar from Infinity Alternatives. Please go ahead.
- Ashish Kumar:** Just wanted to understand as to what is your capital allocation policy going forward to be? Cost of debt is lower than the cost of equity. So, wanted to understand your thoughts? I heard initial comments about being debt-free. Given the fact that we have a stable business, would we be following 100% payout policy or would we be looking, what is your thoughts around that?
- Rajesh Subramaniam:** I think our payout policies at this stage we are thinking more closer to 35-40% and reviving our M&A engine for acquisitions, Rs.500 plus crores EBITDA, the free cash flows available after the payout we clearly have ideas around what we need to acquire going forward. It is not going to be 100% payout, our stated policy would be somewhere between 35-40% of our profits as payout and use the rest for inorganic means.
- Ashish Kumar:** But we do have the leveraging capacity, right?
- Rajesh Subramaniam:** Absolutely, zero debt is basically the hangover which the company started out with because now it is immaterial.
- Ashish Kumar:** It started being immaterial a few quarters back I guess?

- Rajesh Subramaniam:** Yes, absolutely, it is just the confidence of the company's ability three, four years back to deleverage, obviously, it is no merchant on issue right now and probably going forward certain amount of debt is probably good exactly, the cost of debt is cheaper than cost of equity.
- Ashish Kumar:** I guess we would hear about your inorganic strategy in the coming couple of quarters?
- Rajesh Subramaniam:** As and when the plan fructify we definitely will come back to you with more insights.
- Moderator:** Thank you. We will take the next question from the line of Ashish Agarwal from Principal Mutual Fund. Please go ahead.
- Ashish Agarwal:** The headwinds are lower on the Payer side of the business; the Provider side of the business is doing well and it is clearly leading from a revenue growth and from a profit margin expansion perspective. The payer side of the business I definitely see at least probably till Q1 of next year of pain before we start seeing some of the deal conversions reflecting in our results.
- Ashish Agarwal:** Just wanted to understand the margins front. We are guiding for a flattish margin in second half. But generally our second half margins are better than first half because of seasonality in our collections business especially in Q4. Is there any specific headwind which we are factoring?
- Rajesh Subramaniam:** There is no headwind; it is essentially our other operating income that line will be a lot muted in Q3 and Q4 compared to Q3 and Q4 of last year.
- Ashish Agarwal:** So, excluding that margins will follow normal seasonality?
- Rajesh Subramaniam:** Yes-yes, it will be substantially higher.
- Moderator:** Thank you. We will take the next question from the line of Devanshu Bansal from Emkay Global. Please go ahead.
- Devanshu Bansal:** Just you talked about good deals in the pipeline. Can you allude to which verticals are these deals wins either with Healthcare provider or BFSI?
- Rajesh Subramaniam:** This will be in BFSI in the UK, will be BFSI in the US portfolio allocated both to mortgages and to collections and would be in healthcare provider.
- Moderator:** Thank you. We will take the next question from the line of Nagraj Chandrasekar from Laburnum Capital. Please go ahead.



**Nagraj Chandrasekar:** Just had a question on the seat fill factor being down and also what you said on attrition. Any sort of further commentary on that, is there a tight labor market in the UK, in the US, what is driving this, what is the impact likely to be?

**Rajesh Subramaniam:** Excellent question. I think the labor markets are tight both in the UK and US. We are seeing literally unemployment rates in the UK are at historical lows which were earlier seen in the 1970s and that is ensuring that the market is tight. The cost of traction is increasing. So, the game now is improving, productivity and creating effective retention strategies both from employee engagement perspective and from a deferred incentive plan which then ensures that the requirement for us to go out and hire becomes a lot lesser, but again these are all the drawing boards, still some work that needs to be done. Nothing which has not happened in the last three years is going to happen overnight. So, it is going to take some time for the strategies to play out. Similarly, in the US, unemployment rates are at historical lows. While that is good for my collections business, that is good for my business, that coupled with some of the places where we have direct competition with players like Amazon who have increased their minimum wages to 15,000, we do not pay minimum wages, but when minimum wages increases to \$15, there is an expectation that it will have a cascading impact on the wage structure. So, that is also a reflection of the tight labor markets. So, tight labor market across the market is a concern but these are cycles and clients are also cognizant of what is happening. So, there are conversations which are happening to ensure that it does not result in a price increase, but results more in how we drive productivity and how we engage with both the employees and with customers to mitigate some of the negative impacts we are seeing from these tight markets.

**Nagraj Chandrasekar:** How much of an opportunity has Brexit for us potentially because what you often see happen is when the economic shock people become more proactive about picking the most cost competitive service provider or potentially about outsourcing, things that they had earlier been keeping in-house? Second, just in terms of the run rate on the top clients, it looks like the top clients is at about \$25 million on a sort of flattish run rate. So, is the issue more of there been delays and ramping up the two new UK clients or could you just give us a sense of between what is happening at the top clients and the ramp up on the other clients, what is actually going on there?

- Rajesh Subramaniam:** The top clients is about \$33 million, not \$25 million, so I think that is going to be largely flattish for at least Q3 and it should show some growth in Q4. As far as Brexit is concerned, I do not know at what point we broke off but as I said the planning for Brexit has been ongoing for the last two years and the biggest opportunity of Brexit for us is with our banking and financial services clients who have a clearly integrated businesses with Europe. We are going to be a beneficiary. We are going to see continued growth in the banking segment in the UK and cost has been a big focus because the growth rates have slowed down. What was growth rate at 2.3%, 2.4% pre-Brexit is down to 1.5%. The question is if it is a soft Brexit, then I think you are going to see growth coming back. If it is going to be a hard Brexit, then it will throw open more opportunities for us.
- Moderator:** Thank you. We will take the next question from the line of Vinay Saraogi from CRISIL. Please go ahead.
- Vinay Saraogi:** The question is when we are looking for M&A, can you just throw some light on what kind of M&As are we looking at? Given the Brexit is due, are we also looking at expanding internationally and if you could just throw some light also on amount, kind and size of Brexit?
- Rajesh Subramaniam:** Our M&As are going to be in our chosen businesses. So, we hope to require for deepening our domain capabilities and healthcare and in assets that can clearly drive a differential speed in creating omni-channel frameworks in the customer management business, specifically also looking for assets in analytics where we clearly believe that the pivot of some of the outcomes we can drive, we need a little bit of scale player at this point in time, very difficult to find the kind of profile of assets we want in India, it is likely to be in the markets, US and UK and we expect the acquisition sizes could be as small as \$10 million, we could stretch as high as \$50 million to \$75 million.
- Vinay Saraogi:** Are we also looking at opportunities outside UK as well?
- Rajesh Subramaniam:** Not in Mainland Europe at this point in time. If our customer takes us we will go, but today we do not have a clear strategy on creating a sales force to go salient to European customers. So, at this point in time, we have enough and more opportunities in the UK and US for us to go up to.
- Moderator:** Thank you. We will take the next question from the line of Deepesh Mehta from SBICAP Securities. Please go ahead.
- Deepesh Mehta:** Can you provide some more detail about what headwind specifically we are facing on healthcare payer side? And then if you can provide a color across the vertical, how demand has changed over let us say the beginning of the year and how the trends you are witnessing, so if you can give any take and put kind of incentive?

**Rajesh Subramaniam:** On healthcare payer, we had one customer in the enrolment side which we separated with because of the economics of doing business. So, that is one specific headwind. There are a couple of big consolidation deals within our existing customers which need to come unstuck and convert, we are the alpha, and we are placed very well. So, the delay in closing those deals have had an impact in the ability to grow, the kind of growth we are seeing historically and the separation from the customer in which we are doing enrolment which typically plays out between October and Feb is going to see softness in the payer segment. Again, as I said, two quarters, it would take for us to correct remedial situation and you will see the growth coming back by Q1 of next year. Similarly, in terms of buying behavior, as I mentioned, banking, mortgage in US, the collections business focused on the banking business both are seeing significant momentum, healthcare provider, the four new solutions we have introduced leveraging our core proprietary of flow and analytics tools is giving us significant traction in the provider segment. Banking customers in the UK across a spectrum of retail banking, across commercial banking, across remediation which is more PPI-driven, there we are clearly seeing growth across all segments in the UK. So, very bullish about banking segment in the UK.

**Deepesh Mehta:** Any specific thing on communications side if you can help us considering the top client and rest of the opportunity?

**Rajesh Subramaniam:** Lot of overhang on the acquisition by the top client and the actions they would have taken while going through an acquisition process, that is all done, it is behind us, it has been a great outcome for us because Comcast has absolutely no presence in Europe and we clearly see significant growth coming back from the top client as the integration plays out from how content dissemination from Comcast starts taking shape through Sky's distribution channel plus Comcast is also an existing customer of ours, so overall it has been a great win-win for us and all the uncertainties around the impact of an asset going through an acquisition, all those seem to have completely been lifted given Comcast is lack of any presence in Europe and Sky being the channel for them.

**Moderator:** Thank you. We will take the next question from the line of Mohit Jain from Anand Rathi. Please go ahead.

**Mohit Jain:** First is on your onsite/offshore mix. This time it has gone up because there are people moving more towards offshore, we are going exactly opposite. So, is there a tactical move in a quarter or we should expect high onsite to continue?

- Rajesh Subramaniam:** The key point is the growth that we are going to see in Q3, Q4 is onshore-driven, it is in businesses where our existing footprint with clients are going to expand further, the new deals that we won in the recoveries, in the digital dissemination in the recovery space is again going to be delivered onshore. Again, for me onshore/offshore does not matter. With 80% onshore and 20% offshore, I am still at 14% EBITDA margin. I think the percentages do not matter, the absolute deals make a lot of money, the absolute deals generate significant ROI and at least for the next two quarters I do not see any ratios changing.
- Mohit Jain:** Second is on the collections business like typically the seasonality is in the fourth quarter, this time I think second quarter seems up on the collections side?
- Rajesh Subramaniam:** We have got new customers, we have one new business and the Department of Education is back, sometime it was shut down last year, so that has come back again. So, a combination of both is ensuring that there is an expansion in the business. So, it is well for seasonality because an expansion on the business coupled with seasonality is going to help us drive better growth than what we have seen last year.
- Mohit Jain:** Q4 will anyways be higher than Q2, right?
- Rajesh Subramaniam:** I am saying Q4 this year will be higher than Q4 of last year because Q2 this year is higher than Q2 last year.
- Mohit Jain:** With the same proportion because it is new business and not...?
- Rajesh Subramaniam:** That is right.
- Mohit Jain:** Sir, last is on goodwill, there is some increase in intangibles, is that all or is there some capitalization also?
- Rajesh Subramaniam:** Just FOREX.
- Moderator:** Thank you. Ladies and gentlemen, as there are no further questions from the participants, I would now like to hand the conference over to the management for closing comments.

**Rajesh Subramaniam:** Yes, thank you very much everybody. It has been a good quarter. We continue to drive profitable growth. We are committed to meeting our revenue guidance at this point in time and our margin expansion story has been good. Our end Q4, the set up for FY20 is going to be extremely robust, probably we are going to have some of the best tailwinds going into next fiscal. We are very excited about the fact that the sales proportion driven by digital solutions is clearly showing an upward trajectory which is aiding in our margin expansion. So, if you have any other specific questions that you might have missed out, please do reach out to Ankur, our IR Head and we will be more than happy to address them or if you need a conversation with me, I am happy to come on a call. Really appreciate your time today.

**Moderator:** Thank you very much, sir. 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.