Q2 FY2021 Earnings Call Transcript - October 29, 2020

CORPORATE PARTICIPANTS

Mr. Vipul Khanna - Managing Director & Chief Executive Officer

Mr. Dinesh Jain - President and Chief Financial Officer

Mr. Ankur Maheshwari - Head Investor Relations

Moderator: Ladies and gentlemen, good day and welcome to the Firstsource Solutions Limited Q2 FY21 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 '*' and then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankur Maheshwari from Firstsource Solutions Limited. Thank you. And over to you, sir.

Ankur Maheshwari: Thank you, Inba. Welcome everyone and thank you for joining us for the quarter ended September 30, 2020 earnings call for Firstsource.

To take us through the results and to answer your queries, we have with us today, Vipul Khanna, our M.D. and CEO and 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. Do note that the results, the factsheet and the presentation have been e-mailed to you and they are also available on our website, www.firstsource.com

Before we begin the call, please note 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 risk. These uncertainties and the 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 Vipul Khanna to begin the proceedings

Vipul Khanna: Thank you Ankur. Good morning and good evening everyone. Thank you for joining us today. I hope you and your families are safe now and getting in the festivity mode as Diwali approaches.

I am excited to share the update on our performance. We had a good quarter; revenues grew at 13.1% YoY in constant currency and the EPS for this quarter came in at Rs 1.5 per share compared to Rs. 0.97 per share last year for the same period. We are experiencing a solid recovery in the business from last quarter following an uptick in the economic activity. The demand environment particularly in BFS and in Communication, Media & Tech is getting stronger resulting in the buildup of a robust pipeline. While Healthcare was steady with the last quarter, this business remains under pressure given the impact from the COVID on hospital visits. In Q2 for the fiscal year'21, we secured 15 new clients, 11 of those were in BFS including a fast growing fintech and 4 were in healthcare.

Last quarter when I had spoken to you, we had articulated 3 key elements of our growth focus:

1. First one, that we focus on core processes for the industries we serve; Banking and Financial Services, Healthcare, Comms, Media & Tech and the diverse industries to encompass the emerging verticals
2. Second element was modernizing our offerings and underpinning them with our Digital First, Digital Now approach. Accordingly, we have retooled our offerings as Digitally Empowered Contact Centers (DECC), smart back office and platforms automation and analytics
3. And third, build out a scalable and agile organization with the right leadership and skills to drive our growth ambition.

So, we are investing behind these 3 elements to build out and sustain and consistently growing business.

During this quarter, we rebranded our Healthcare business to 'Health plans and Healthcare Services' to better reflect the scope of the broader healthcare segment they serve. Healthcare services including telehealth, remote patient monitoring and medical devices are a rapidly growing segment and a focus area for us.

We continue to build our platforms roadmap and drive their adoption in the market. I am encouraged by the pipeline for our platform-based services and the increasing share of transformative and digital conversations with clients in prospects.

Building the digital muscle in the organization is a key focus for me. During this quarter we launched the first of its kind citizenship development program in partnership with UiPath for our employee base to create their personal bots. Now, in my experience automation is fundamentally a ground-up movement and a broader skill base accelerates the digitalization of our solutions. We also signed a strategic partnership with Uniphore, a global leader in conversational AI to add more horsepower to our DECC solution for more personalized and enriching customer experience.

We are pleased that this quarter's results are a validation that this growth focus is beginning to pay off.

Let me spend a few minutes reviewing our key industry performance. Our Banking and Financial Services segment grew 55.9% year-on-year and 45.8% in constant currency on the back of strong growth in our US BFS segment.

Let me take a minute to talk about the two components of Mortgage. There is origination and the servicing. Within origination there are pretty much two types of transactions: One is a refinance of an existing mortgage because interest rates are lower and you refinance the loan, house remaining the same, borrower remaining the same, lender may or may not be the same. That is kind of refinance of an existing mortgage and then there is mortgage for a new purchase whether I buy an existing property or I buy a new house, but I am doing a transaction and I am financing that. So that is like a purchase mortgage. We saw good demand from both these segments, Refinance as well as Purchase Mortgages. In fact, for the last several months, we are seeing a good surge in purchase mortgages. September, for example, saw a 21% surge in existing home sales versus September year ago, and the 32% increase in new home sales versus a year ago. Now, as you will appreciate, new purchase mortgages are less sensitive to interest rate movements relative to refinancing and the expectations as we talk to industry experts and to the Mortgage Bankers Association and others, the new purchase mortgage growth is expected to continue well into the medium term which we believe provides a reasonable hedge against the eventual tapering off of the current high refinance volumes.

On the servicing side, mortgage defaults are increasing given the economic hardships many people are facing. By the end of September, the mortgage delinquency rate in residential properties had increased to 8.2%. This is an increase of almost four percentage points versus both June of this year and versus September a year ago. We expect growing demand for expert capacity and digital solutions as the mortgage industry prepares for higher default. Our clients are increasingly trusting us to have compassionate conversation with borrowers, helping them exit mortgage payment forbearance for temporary halts into longer-term solutions.

Collections, which is the second part of our BFS business and particularly our digital collection is witnessing strong traction among both existing and new clients. As with mortgage default servicing, high unemployment and underemployment levels in this current financial environment is driving higher loan credit losses and provisions across all lending categories. The collections business as you know is counter-cyclical and we expect a good demand scenario for the medium term. More importantly, we appreciate the privilege of helping individuals get their financial affairs in order gracefully while maintaining the health of the financial sector.

Our UK BFS business operated with solid volume. After last few month's scramble to keep operations running, the UK financial institutions are now preparing to tackle the new normal more structurally. The two primary themes we are hearing from our clients are lower and more sustainable cost base and an increased digital access to consumers. I expect an uptick in the buying activity in the UK financial services sector in the next few quarters.

Switching to Healthcare, Healthcare declined 4.8% year-on-year and 9.8% in constant currency.

The industry continues to experience volume challenges. Elective procedures are still not close to pre-COVID levels impacting both hospital business and health plan claim volume. As per industry reports, August was the sixth consecutive month in which patient volumes were below 2019 levels and below budget for hospitals and we believe September was no different. The second factor we are seeing now for a few months is that the cycle time to convert Medicaid payments to revenue is being impacted by slower billing from the hospitals as they deal with capacity constraints and multiple priorities on their leadership capacity and processing capacity.

We anticipated a recovery in this segment from Q2FY21; however, given the increase in COVID-19 cases we are witnessing, this could get delayed until later this fiscal year.

On a positive note, Mgagement, our digital screening and collection tool, is seeing increasing traction. Hospitals are witnessing a shifting payer mix as there has been an uptick in self intake customers and Medicaid patients, and a decrease in commercial reimbursement as unemployment levels are high. To counter this, hospitals are turning to remote customer engagement such as telehealth, financial counselling and online portals for price estimates and payment plans. We made good pipeline progress for this service and we continue to develop adjacent areas of growth in the Revenue Cycle Management value chain.

On the flip side, fewer medical procedures have resulted in fewer claims and more cash with the health plans of the health insurance companies. Consequently, we are seeing an increased appetite for disruptive and long-range impact solutions from this sector. Our health plans and healthcare services business is scaling well. We added 2 new clients and increased our engagement scope with the number of existing clients despite volume compression in a few clients from lower claim volume. The sales pipeline bill is very solid, and our digital intake solution – Sympraxis, is faring strongly in competitive situations.

Telehealth has witnessed significant acceleration and adoption by consumers, and this has been aided by regulatory action to memorialize remote care charges in CMS fee schedules to incentivize providers and health plans to do more of telehealth. And as you would have read, once in a generational change in telehealth adoption that we are seeing in the US in the last 6 months. As I mentioned earlier, we added a new client in this segment and scaled up relationship with an existing remote care provider.

Communications, Media and Tech (CMT) that grew 3.7% year-on-year and de-grew 5.9% in the constant currency. This segment is witnessing solid volume recovery and grew sequentially by 27.8% in constant currency.

We have also started moving some of the processes to a work from home model which we could not do earlier in the year from client constraints. As I mentioned in the last call, when the pandemic started in the UK our biggest client had prioritized service to a few customer segments only. As they have gradually normalized service and sales operations, volume recovery for us has been strong both on and offshore. Overall trajectory for CMT is encouraging, pipeline build is decent, and we should be at nearly pre-COVID levels by Q3 or start of Q4.

Let me take a quick sense and do a flyby for you on the outlook for Fiscal Year 2021. While market uncertainty and volume volatility continues to remain high, considering our trajectory and secured business, we are revising our guidance upwards. Our full year 2021 revenue is expected to grow between 9% to 12% in constant currency and our operating margin is expected to be in the range of 11% to 11.5%.

With that, let me turnover the call to Dinesh to cover the Financial details for this quarter.

Dinesh Jain: Thank you Vipul. Let me quickly take you through the financial highlight for the Q2 FY2021.

- Revenue came in at Rs.1,187.7 crores and in dollar term $159.8 million. This implies a year-on-year growth of 13.1% in constant currency and 20.6% in rupee terms.
- On margin front, operating margin or earnings before interest and tax came in at Rs.135.8 crores or 11.4% of the revenue.
- Profit after tax came in at Rs.105.3 crores or 8.9% of the revenue. This is the first time we achieved Rs.100 crores PAT. It is an immensely proud feeling for all of us. This has been my dream too, to achieve this target ever since I joined the company at inception in 2002
- Our cash flow from operations and free cash flow generation has been quite strong; we generated Rs.235 crores cash from operation and our free cash flow after adjusting for CAPEX came in at Rs.209 crores or in dollar term $28.3 million
- Our DSO declined sequentially from 63-days to 54-days including unbilled. Our team and we have ensured that we bill on time and also do the follow-up to ensure that the collections are done on the right time. And I think cash generation is a pure reflection to be able to bill on time and collect on time. And the same way I think this has resulted into higher cash balance as of September 30th, we have Rs.215.9 crores cash after repaying of almost Rs.150.6 crores of working capital borrowing, and also as you are aware we utilized around Rs.10 crores on a stock purchase for ESOP trust
- Net debt stands at Rs.391 crores versus Rs.553 crores in Q1FY21 or $53 million versus the $73 million in Q1FY21.
- Tax rate for Q2FY21 was around 16.1%, but I think we are keeping the expected range for the year between 13% to 15% for the tax.
- Hedging side, as you are aware, I think we always keep the pound hedges for 2 to 3 years and as of today we are carrying around £59.5 million of hedges for next three years with the rates ranging between Rs. 102 to Rs. 119 per pound. On a dollar term, the hedges are for $57 million with the rate around Rs. 76.4 per USD.

Overall I am very pleased with our strong collective effort to deliver this performance despite multiple challenges which we are facing in last 6-7 months.

With this we can open the call for questions.

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. Our first question is from the line of Manik Taneja from JM Financial. Please go ahead.

Manik Taneja: Just wanted to understand the trend that we have seen in terms of increased offshore delivery in the current quarter. How should we be reading that? The second question is a bookkeeping question in terms of trying to understand what was the contribution of mortgage business in the current quarter?

Vipul Khanna: Manik, from an offshore sustainability as I mentioned in the last quarter as well, where we are today, we are building services without necessarily keeping a focus one way or the other and on versus off, right, we are in the process of building the right capabilities, chasing the right opportunities and delivering them. It just happens that given mortgage demand has been strong and that is something which we have been working very hard over the last several quarters to make sure we had the right training, the right academy and capacity both on, onshore and offshore to deliver to that demand as it is coming through. So because that demand has come to offshore delivery has kind of increased from the last quarter given the development, but structurally we are driving one versus the other at this stage, right. That is the answer for on and off. As I look to the future, for instance, as we see more demand for servicing for mortgage, a chunk of that will be served onshore and then we will see some components that come offshore as well, but we could see this ratio moving about a little bit here and there between on and off depending on the business portfolio.

Your second question was how much is the mortgage growth? So obviously, mortgage, majority of the growth that we saw in BFS both in origination as well as servicing and collections business had decent increase given Q2 for them it is kind of like in the middle, it starts to build up towards Q4. So, despite we were in the part of the year, etc., I think they grew reasonably well. Europe was marginally up sequentially, but largely flat which is a good thing given where the volumes have been for the UK BFS segment.

Manik Taneja: Are you not calling out the absolute numbers because last quarter the mortgage business was listed to be about $35.5 million in revenue?

Vipul Khanna: Happy to share. So I think this quarter we were closer to more like $44 to $46 million, that is the range for mortgage.

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

Mohit Jain: First was you mentioned about this offshore versus onsite thing. But if you look at last four, five quarters, our offshore has gone up quite considerably, but at the same time margins are more or less at the same level including your guidance. So where is this incremental margin benefit going into in the form of investment? And second was related even if you increase mortgage, the rate at which it is growing and your outlook remains okay, why the margin guidance is more or less similar where we were earlier?

Vipul Khanna: Look, I think the growth has been fairly strong in the quarter. Take mortgage as an example. It has grown pretty strongly this quarter. The demand environment for talent is also hot, right, talent for mortgage across the industry is in short supply. So, there has been an uptick in the cost of talent for mortgage, one. And two, given majority of the operations are still work from home, the supply chain of getting somebody onboard, getting the equipment to them and the training happening, everything happening, the time to bill has somewhat increased given this distributed supply chain. We continue to invest for growth. We see demand. We are continuing to invest both in operating capacity as well as leadership and account management capacity to make sure that we harvest the growth opportunities out there. So, that has taken some points from the mortgage margins. But other businesses have performed well on margins. Overall I think we improve margins quarter-on-quarter about 40 basis points and we think given the strong demand environment for the next two quarters, at this point our expectation is we will stay in the range of 11% to 11.5% for the full year.

Mohit Jain: The investment for growth, does this also mean some pricing discounts, etc., or this is more into new capabilities that may get pushed next year maybe?

Vipul Khanna: Absolutely, the latter. There are no discounts, but as I said, in some cases there is some mismatch in terms of the cost of talent versus price recovery and we are trying to get that calibrated, but there will be some timing lag in sort of signed contracts, but that is normal execution calibration that we need to do. There is the operating cost for growth and then there is the new business cost of growth that we have been talking for the past few quarters in terms of the focus in leadership and the new sales and account management capacity not just in BFS but across businesses that we have been adding.

Mohit Jain: And your thoughts on top two to five clients also? Like top-one we have seen some normalization. In two to five, is it primarily mortgage clients or do you think some recovery in some other accounts as well from top client perspective?

Vipul Khanna: It is a good mix of CMT, BFS and healthcare clients in the top-five. Clearly, the mortgage component there has been driving. We saw a good recovery as you would see from the top client given the volumes came back to top client. So that and mortgage helped. Other BFS customers have held steady, but we see a decent pipeline as we go into the next few quarters that we should see a broad-based BFS growth in addition to what we have seen in mortgage.

Mohit Jain: Last one for Dinesh sir. Sir, these other expenses piece was little on a higher side. Is there a one-time expense or something which is not going to happen from next quarter onwards? And connected to that industry has moved up significantly because of work from home. Is there a way our company can also sort of benefit from this initiative in terms of your cost reduction progress?

Dinesh Jain: So there is no one-off in any of the line item, whether the revenue or expenses, everything is normal, and I think when you take the growth, operating cost always going to come higher, I think Vipul already talked about the mortgage side of thing. So that also some of the cost component part is there. As far as the expenses are higher in term of the percentage maybe and a value term also is on account of being, as we already talked about, in mortgages and other businesses, as you have work from home, you need to have extra cost coming into it, it is not that you are going to save it, the saving is only on the facility side which you already have the center. But I think going forward if we are able to have some capacities which will not go back to the offices, the likely chance that margin profile which we are showing has been built in there. So, I see as of today that I think margin profile guidance is what we have indicated, and as far as there is no one-offs in any of the line.

Vipul Khanna: Mohit, just to add to the point about work from home margin leverage, I think there are some obviously cost line items where you see the hit, but keep in mind our relative portfolio between on and off, onshore operations have been kind of continuing with the decent mix of work from home and at site. And regardless of the location in the onshore, the weightage of labor cost or human cost is higher relative to infrastructure versus say offshore, right, so some of the advantage that you will see from offshore work from home that does not as much pass through in the onshore operation because the cost mix between talent and others is different there relative to offshore.

Mohit Jain: So you mean this benefit will flow to players who are more offshore-driven than onsite-driven?

Vipul Khanna: It is a relative thing, yes, I mean, we get advantages of being onshore showing in better growth and better intimacy with clients but yes, that is one of the corollaries of that.

Moderator: Thank you. Our next question is from the line of Dipesh Mehta from Emkay Global. Please go ahead.

Dipesh Mehta: A couple of questions: First, just to understand your thought process on the guidance. Now we have revised guidance to 9% to 12% and only two quarters left. So why such wide range when we are already one month in the third quarter, just want to get your thought process what are the pros and cons or puts and take you consider when you guided this wider range? Second question on the healthcare side. Healthcare remains low. So what is the payer and provider mix now and whether any incremental optimism on payer side because I think some of your peers indicated payer is recovering very strongly, so if you can provide your perspective on this?

Vipul Khanna: I think the first question on – 'how we came to the range of 9% to 12%?' So look, when we spoke to you in July or August, we had said 6% to 10% at the start of the second quarter. We are sort of six months into the year, coming to the end of October. Looking at the deal pipeline, looking at sort of what we have signed business and the expected start date, our prudent guidance at this stage is 9% to 12%. The reason we have it a little bit broad is to keep in mind and kind of ground ourselves to the fact that it still is an absolutely unique year, this FY2021 for the industry, for the world. The volatility in terms of demand recovery in healthcare is something that we are watching. The second element is we want to make sure that there are no supply side shocks as well, right, if there is a lockdown or if there is a shelter in place order somewhere else as well. So we are keeping an eye for supply side constraints as well. So given sort of some of the volatility still there in demand and the supply side environment we think this is best to give a guidance of 9% to 12% range at this time of the year. Your second question on Healthcare. The payer-provider mix is kind of changing a tad as you would expect. It is now 43% - 57% between payer and provider, right. It is up a few points in the favor of payer. So your sentiment is right, the payer business as I mentioned is seeing an uptick, health plans are having sort of some of the best financial periods even there are less claims coming on to them, so medical costs are lower and there is breathing room where we see sort of increasing appetite from healthcare executives to consider and take on transformational projects which have multi-year impacts, not just looking for immediate term impact and it is showing in our pipeline, it is showing in our conversion. And as I mentioned, we had two new client wins in healthcare payer. We see a very healthy pipeline built with some high quality conversation and for a reasonable chunk of our existing portfolio despite claim volumes being lower we saw increased spend as we kind of went into other areas for them. So, I am sort of bullish about healthcare payer segment over the next several quarters kind of playing out both at the sector level and how we are executing with the added investments we have done to the leadership team and solutioning capacity there.

Dipesh Mehta: One question on the mortgage side. Now because of very strong growth, obviously, some of the operating parameters, I do not know whether utilization or seat fill factor whichever way but which in a way gives you operating efficiency kind of thing might have implication because you plan for strong growth. So once stability return, so what margin compression would be explained by those parameters and how much would be because of talent cost increases, if you can give some color because talent cost increase might sustain for some time but this operating once you reach to some capacity stability then I think your margin should reflect, so if you can provide some perspective, how this margin is divided between these two aspects? And second question is about effective tax rate. Now what one should expect your medium term tax rate? This year I think Dinesh indicated around 13% to 15%, but for next 2 years if one try to get some sense, what would be that number? And the third is about capital allocation. Now, we have generated very strong cash in H1FY21. If you can provide your thought process about capital return?

Vipul Khanna: Dipesh, on the mortgage, you mentioned talent cost. What was the other thing you said, the other component of the margin?

Dipesh Mehta: Because revenue growth is very strong, your utilization of resources might have implication, it might not be optimally utilized kind of thing because you, let us say, recruit 100 people in anticipation of growth and that recruitment engine would be ahead of that kind of planning and that is why your utilization would be lower from optimal level. So, so how you can explain this margin compression between these 2 aspects – talent cost increase and there is some of the margin levers not optimally utilized in mortgage?

Vipul Khanna: Okay, understand. So I think the second component which is time to bill, hiring ahead of need because you cannot really time it to perfection in terms of demand and supply, getting through training or kind of investing in talent in some cases with longer lead time for training because it is kind of frankly in the long term kind of get more profitable, we are working on all levers, right, our academy that we established offshore as well as now onshore, that is starting to kick in. Obviously, that is an investment for us, but it kind of pays out in the medium-term. So, bulk of our operating sort of, if I could use the term operating investment, is going towards this aspect. I do not know. Maybe my guess is about one-fourth of the margin impact we talked about would come from talent cost kind of picking up. Again, as I said, we think over time we will manage it, we will calibrate with our clients, right, as we get into sort of some price calibrations with them, not something which we are worried about, it is still a growth environment, it is good, healthy relationship. So I would say bulk of our sort of margin investments so to say in mortgage is going towards funding and fuelling the growth.

Dinesh Jain: I think tax rate is I believe in the next 2 to 3 year it will not exceed more than 18%, so I think it will range between 13% to 18%, and as you know as we have a lot more onshore it is automatically reflection of that, their effective tax rates are around 20% - 21%. So automatically the effective tax is lower. We do not know what is going to happen into this US election, there are a lot of talks happening around the tax rate increase for corporate. If anything of that change happens, then we need to revise the guidance. Otherwise I do not see as of today any change in these rates. Maximum can be 18%.

Vipul Khanna: Dipesh, on your question of capital allocation, I think as you rightly noticed, we had good cash flow generation, we took the opportunity to kind of moderate down our working capital debt with that. We had a good dividend payout last year. We are still in the middle of the year as we progress more in the year, we will take a look at it on the capital allocation side. But for now, I think we continue to generate work and debt and look for both opportunity for organic and inorganic investments.

Moderator: Thank you. We will take our next question from the line of Kaustav Bubna from Rare Enterprises. Please go ahead.

Kaustav Bubna: So on your margin front, in your Communications, Media business, I see that this quarter has a big jump in EBIT margin. So, could you explain what is the reason for this and also how sustainable this is and what has moved this margin?

Vipul Khanna: Hi, Kaustav. It is a fair observation. I think a part of the CMT if you recall is we had lower volumes in Q1FY21 because of the demand situation and most of our clients prioritizing to serve only the very vulnerable or priority customer base. We obviously paid down some of bearable expenses, we could not do it, or we did not want to do it and then there was obviously the fixed cost base. As volumes have come back, there has been an element of catch up on revenue and I think that is kind of showing in higher margin. Last quarter was kind of suboptimal because of the reason that I mentioned. So, there is a little bit of a catch up and there is a little bit of a normalization. From a sustainability standpoint, I think for that business we stay in the EBIT range, it can fluctuate between sort of 10% to 13%-odd this month, this quarter was a little bit higher because of a little bit of catch up. So, I think we will start to see normalization to our historical levels as we come to pre-COVID levels in the next two quarters.

Kaustav Bubna: So you said the sustainable range is between 10% to 13%? Okay, thank you. One more thing I couldn't hear you properly in the beginning of the call. So just wanted to understand if you said this right, you said the situation right now, new purchase mortgages are increasing, at the same time the delinquency rates are increasing, right, is that the correct statement you made? And so, how do you see a situation like this really ending and what are the different possible scenarios you see and how does this impact FSL and how are you preparing to deal with such a situation?

Vipul Khanna: I think your observation is right that the macro situation we are seeing in the housing market especially in the US is that there demand is picking up for purchase mortgages and obviously there is the refinance mortgage volumes are high because interest rates are record low, but at the same time delinquencies are rising. So, I think it reflects the fact that a chunk of the population is not impacted, and a chunk of the population is impacted. This is how the pandemic has impacted different sections of the society. And whether it is demand coming for second homes or people moving from big cities to suburban houses or people not wanting to live in rentals and want to own their own property now or there is more liquidity and they want to put it in property, all four of those factors are kind of driving new housing demand up, right, and we have seen this very strong trend coming through and builders have announced new projects and stuff like that. And this is expected to continue over the next medium term.

Delinquencies for now, as you know, in the US environment, there is a very structured process if people start to kind of miss mortgage payments, there is a very structured performance of they get abeyance or temporary sort of halt and then it moves more structured solutions, more permanent solutions of either redoing the mortgage payment or worst case repo and sell. So I think what we have seen thus far is that delinquencies are rising.

As I mentioned, they have grown about 4% year-on-year or even quarter-on-quarter. At this stage it is still in the early days of abeyance, right, but as this continues, waterfall into the next step, and the industry will need capacity for that. So I think we are preparing for that, we have won some business, we are building solutions, we are adding up on our capacity for that as well. Because that wave will come, whether it comes next quarter or quarter, who knows, but we are preparing for that as demand comes, we want to make sure we participate in that with more than a fair share on that.

Moderator: Thank you. The next question is from the line of Rahul Jain from Dolat Capital. Please go ahead.

Rahul Jain: I think you partly answered in the previous question as well. But I mean, how this mix signal eventually land up in terms of how you deliver in the BFS space, same element given that demand has new home sales as well as increased delinquency factor, so how we think beyond a couple of quarters? Of course, the current book and client addition may give us confidence for now, but what is the real thing beyond this a couple of quarters when this mix signal may normalize? Secondly how we plan to mitigate the challenges on the healthcare side given the situation and the provider element of it and will the superlative traction in payer should be good enough to drive us to the level of growth we are looking into this?

Vipul Khanna: Let me try to answer and if I do not please follow on. So, look, mortgage, as I said, between origination we see there is somewhat of a hedge between existing mortgage and purchase mortgage originations. Interest rate movements, our sense is the low interest rate regime that we are in today, unless unemployment comes back to sort of where it was pre-COVID, sort of the 4% to 5% levels, interest rates will continue to be low because there is that much slack in the economy, try to absorb it. So, to that extent, anywhere from three to six quarters is where I see the interest rates continuing the way they are in the US. That is one factor to consider. Second, as I mentioned, the purchase mortgage demand will continue for longer even if the refinance starts to taper off once interest rates kind of stabilize, they will start to move in the other direction. I have spoken to clients and to industry experts, the sense is that about 60% of the existing mortgages in the US are still in the money, which means that there is still incentive for 60% of the mortgage holders to go in for a refinance and still save money. So, there is that much work still needs to be done on the refinance side. Whether that is done in three quarters or six quarters, I guess we will see how that kind of plays out or even longer.

The second factor I want to say is that between our origination and mortgage, it is about a two-third, one-third mix at this point in time that we have seen over the last few quarters. And we are very conscious that we do not go too high on one or the other and then we keep sharply focused on building our servicing portfolio both regular servicing as well as default servicing. And I think that provides a natural hedge to sort of the origination side of the house as well.

So I think it is the portfolio and our job is to make sure that we manage the portfolio given the changes to the macro environment but I feel reasonably sort of comfortable that we have two or three set of irons in the mortgage fire that as things change, we will be able to kind of balance it out with the other.

On healthcare, this thing has obviously extended on, right, people are still not going to hospital for elective treatment unless it is a real emergency. And that is kind of showing up on hospital finances and the volumes that come through. Part of the thing to think about is that some of the volumes are lost, right, some of these procedures not going to happen, right, if somebody used to go for a quarterly, let us say diagnostic for a cancer or something, they miss two, they miss two, but if you have to go for a knee surgery or a knee replacement, if not now, you will go after 3 months or 6 months. So, some of the volumes is not lost forever, it will come back. And I feel reasonably in good shape that our eligibility services which is a big chunk of our provider business, we are amongst the market leaders, we continue to kind of hold strong relationship with our clients and as volumes pick up, there is nothing structurally missing in this business, it will come back and we are pushing hard on the self-pay which is the other component of our provider business. As volumes or payment responsibilities shifts to individuals, self-pay business will kind of pick up and we have been pushing hard on our digital tool, their engagement to come on strong. So I think it is a macro situation we are facing. It could last through sort of Q3FY21, maybe start of Q4FY21 as well, but it should normalize, and we are looking for additional pockets of growth in Provider to go further in the RCM value chain.

Rahul Jain: You have a good jump in new client addition over the last two quarters. If you could share more insight on the elements in terms of the size of the deal, scalability potential, any other flavor you could give this?

Vipul Khanna: As I mentioned, this quarter we had 15, of which 9 were banking and financial services, mortgage obviously was a big chunk of that, and there the obviously the traction is phased, right, demand is there, you sign up and you kind of get going on that. And to that extent the revenues that we kind of declared for Q2FY21 had a good mix of growth from existing clients as well as sort of revenue starting to come through from Q1FY21 and Q2FY21 wins as well. On Healthcare, on the payer side, we have seen good traction in terms of immediate convertibility, right, sign a deal and sort of get on with the revenue. On the provider side, while there have been wins, the build up to revenue is taking longer than what we have seen historically. So, a little bit of a mixed bag of the billability but I am beginning to see that the deal sizes in our pipeline in BFS, and in Healthcare, especially Payer, are starting to take up from what we have seen historically.

Moderator: Thank you. Our next question is from the Sarvesh Gupta from Maximal Capital. Please go ahead.

Sarvesh Gupta: Most of my questions related to the quarterly performance as it has been answered. One question which I had by the way was if I look at your relatively medium term trajectory, we have been sort of being able to move more towards the offshore in the last 2 years from 20% odd to 27% and at least if not for the top 5 clients, we have been able to reduce some concentration in the top client. So if one has to look at the next 3 years, what is the aspiration in terms of reaching a particular level of margins, do we have a number that we want to reach to? And, of course, I was thinking that the offshore-onsite mix will be a main driver of that. So do you have a number around that metric as well?

Vipul Khanna: As I have been kind of saying, I think the onshore-offshore mix at this stage is a function of the kind of business and the kind of capability we are building. We are not necessarily kind of driving towards a specific target. It is a valid lever, of course, offshore gives you sort of the lever on margins, but at this stage the focus is to build the right relationships and the right services which continue to kind of give us a differentiated position and momentum for the market. From a margin standpoint, we have guided for 11% to 11.5% versus 10.8% that we had in FY20. And also given we are in the early days of building our business in newer segments like the born digitals, our renewed push into the healthcare payer, etc., we expect that the operating margins to be in the same range in the short to medium term. Over time, with scale, we will see some advantages from operating leverage start to come through into the margins. We have not kind of sat down and modelled for the long term to see where we expect long-term margins to be. So I could not answer more specifically except thematically. We do want to continue to invest and I do expect that from scale we should start to see some benefit from operating leverage to come through into our margins.

Sarvesh Gupta: Okay. The reason I was asking you is of course if you compare our return on capital employed to many of our peers, it is possibly on the much lower side and one of the reasons I see is lower margins as such. So, I was trying to figure out if there is a plan in the next 3 years to sort of scale it up to a more respectable number?

Vipul Khanna: Again, just your comment on the ROCE, it is important to point out that big part of where our ROCE is because of the goodwill on the balance sheet, right, and this has been flat for a long time from historical acquisitions and that kind of base has its weight on the way ROCE comes out to be. Incremental ROCE is more relevant metric and I think we have given some numbers. Ankur can share more details with you, sort of one-on-one. But our focus is growth, our focus is contemporary offering so that is why the push towards digital and digital in general should be higher margins, but there is the path and there is a plan to kind of get to a meaningful scale on digital as well. How those factors, the puts and take play out on the margin? That is something we can talk more in the subsequent quarters.

Sarvesh Gupta: With regard to our UK business, now given the recent rise in the COVID cases, are we seeing any new headwinds over there especially from the client side in the month of October because I think the lockdowns and the COVID situation has got sort of increased exponentially in the recent times?

Vipul Khanna: It has for sure, we are seeing the impact on the street and stuff like that. Now from a demand standpoint, we have not seen any impact yet. From a supply side standpoint we have had the opportunity now for the last several months to build up pretty strong work in office as well as work from home and some of our clients, who were sensitive early on to work from home, are now allowing work from home. We have seen movement on that, right, including our biggest clients, we have some reasonable capacity now for work from home. So, to that extent we feel good that if there is another strong or a multiple week sort of lockdown, we can continue operations between our on and off as in work from home and work from office options. But demand thus far, we have not seen any impact.

Sarvesh Gupta: Even on the deal win side?

Vipul Khanna: Deal win side obviously was low as the year started by, right, through summer as people came back from the holidays, we saw more conversation. I think it was building up. I hope the momentum continues into the end of the year and it does not impact. But we did see more conversation in the last 2 months than we saw in the first few months.

Moderator: Thank you. Our next question is from the line of Sachin Kasera from Svan Investment. Please go ahead.

Sachin Kasera: Most of the questions have been answered. Just one question on acquisitions. So now it has been more than a year since you have been here. So any thoughts that you have been able to crystallize, one, in terms of what is the size of acquisition we are looking, what are the areas and capabilities we are looking? And secondly, have you started to see some attractive deals now on the table?

Vipul Khanna: So, look, as I mentioned early on, to me, acquisition is a very viable and a valid part of growing a business and we want to do it systematically, right. In the last several quarters, we strengthened our relationships and are reaching to the market. We are building up our pipeline of interesting sort of targets and companies. We do want to prioritize at this stage acquisitions in the areas of provider, even collections given sort of what the demand environment will be. Those are our top priorities at this stage. Nothing specific to report, but we continue to work hard on building deal visibility and pipeline to add new capabilities, right, that is the primary focus. In the adjacent areas of growth, if we need capabilities, we kind of try to kind of do through the inorganic route. But I do not have anything specific to report at this stage.

Sachin Kasera: But in terms of the valuation expectations or the type of IRR that you are looking at, now you are looking at deals because of the way market has shaped up better than what it was say six months or a year back or it just remains very-very specific to deal?

Vipul Khanna: I think it is specific to deals given we are looking for specific capabilities rather than sort of scale or revenue only. And obviously, we want to be judicious even in those areas that we pay a reasonable amount not under, not over, pay fair value and bring right capabilities and right teams on. So, that is how I kind of tend to think about acquisition.

Moderator: Thank you. Our next question is from the line of Himesh Satra from Sequent Investments. Please go ahead.

Himesh Satra: My question is we have seen that there has been a considerable reduction in the net debt. But the finance cost has not come down to that extent. So can I know the reason?

Dinesh Jain: Finance cost did come down quarter-on-quarter and also you have to remember that cash collection normally happens at period-end, so probably you will see more in the coming quarters. But I think the finance cost has dropped in a real term also because the rates are cheaper now.

Moderator: Thank you. As there are no further questions from the participants, I now hand the conference back to the management for closing comments.

Vipul Khanna: Great. Well, first of all, thank you, everyone for bearing. Look like we had bad line quality. So thank you for straining hard and listening to us. If you have further questions, reach out, Ankur is there, if I need too, I will help along given the line quality. But thank you for great questions, thank you for your interest. We look forward to sort of keeping our heads down and executing and come back to you in the next quarter. 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.