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Q3 FY2022 Earnings Call Transcript – December 31, 2021

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 Firstsource Solutions Limited Q3 FY22 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ankur Maheshwari, Investor Relations. Thank you and over to you, Mr. Maheshwari.

Ankur Maheshwari: Welcome everyone and thank you for joining us for the quarter ended December 31st, 2021 earnings call for Firstsource.

To take us to the results and to answer your queries we have with us today Mr. Vipul Khanna our MD and CEO and Mr. Dinesh Jain our CFO will provide an Overview of Company's Performance followed by Q&A. Do note that these Results, the Fact Sheet and the Presentation have been e-mailed to you, and you can also view this on the website, www.firstsource.com.

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 risks. These uncertainties and risks are included but not limited to what we have mentioned in the 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. Vipul Khanna.

Vipul Khanna: Thanks, Ankur. Good afternoon everyone and thank you for joining us today. Welcome. I hope the new year has started on a good note and you and your families continue to be safe and healthy.

Here is a quick snapshot of the quarter gone by. Revenues grew 4.9% year-on-year in constant currency and came in at INR14,638 million or \$195.4 million. Of this approximately, 4% is the contribution from the recent acquisition of Stonehill and American Recovery Services, Inc. Operating margins were 12% and EPS grew by 11.6% year-on-year.

When we spoke in November, we mentioned that Q3 would be a muted quarter and that we anticipated revenue growth from Q4. Unfortunately, during the past couple of months, several factors have impacted Q3 revenues and delayed our growth trajectory.

The resurgence of COVID pandemic across geographies has spiked up, staff absenteeism especially in the onshore markets impacting fulfillment. This has also further delayed the anticipated growth in our provider business as hospitals again prioritize COVID treatments and consumers defer elective procedures further.

Additionally, a change in the timing and quantum of interest rate hike and the more aggressive tapering of mortgage-backed securities purchases by the Federal Reserve is leading to a sharper than anti-superior decline in the mortgage origination volumes.

Considering these macro factors and the supply side challenges, we are revising our FY22 revenue guidance to 14% to 14.5% including acquisitions. The acquisitions should contribute approximately 4% to the revenue growth for the year. Margins should be in the range of 11.8% to 12%, modestly impacted by the talent situation and the acquisitions.

While I'm disappointed that we are lowering our revenue guidance for FY22, I remain confident that we are strategically on the right track and that we have put in place the building blocks for strong sustained growth for the future.

Let's dive into the Industry Segment Performance. Our banking and financial services segment was flat year-on-year and shrunk by 2% in constant currency in Q3 FY22.

Let's talk Mortgages first. As you know, this business comprises of origination and servicing segments. The interest rate volatility, Fed's commentary on inflation and the likely interest rate increases in the calendar 2022 have all led to a sharper than anticipated decline in the origination market. 30-year mortgage rates are already near pre-COVID high in March '20 and have risen sharply from what we saw in November, December.

Our clients are actively rebalancing their capacities to align with the reduced refinance volumes. The impact is greater on our onshore portfolio versus offshore. We expect the recalibration of the refi market to carry into the next fiscal.

The Servicing segment remains solid and we continue to expand our servicing capabilities and offerings.

We have increased our focus on developing digital solutions to address the cost efficiency needs of our mortgage clients and we added three new clients in this quarter across both servicing and origination.

We also recently launched the next version of our post-closing platform in the market. This version reduces the backlog of closed files significantly by identifying the gaps much faster. We are pleased with the market traction of this offering thus far.

The integration of Stonehill is progressing as per plan. We are excited to take their capabilities to our existing clients and our capabilities to theirs.

Coming to Collections, last quarter we spoke about the record low delinquencies and charge off rates in the credit card industry. While delinquencies remain near those record lows, the credit card spending continues to rise and is beginning to trend towards pre-COVID levels. With the revival in spending and the impact of financial stimulus waning, the market expects delinquencies to rise over the next three to six months

So while our Q3 revenues remained muted, we are seeing green shoots of recovery. In some parts of our portfolio the debt placement volumes are beginning to rise.

In this quarter, we completed the acquisition of American Recovery Services Inc. or ARSI, a leading player in the legal network collections market. This company adds complementary capabilities, strengthens our digital portfolio, expands our client base including few fintechs and helps hedge against the near-term default cycle volatility. We believe that the acquisition of ARSI will significantly bolster our market positioning in collections. I'll talk a little bit more about this in a minute.

As we look ahead, we are very optimistic about the collections business. It hit an air pocket this year from the unique macro environment, but the fundamentals of this industry remain quite strong and we expect a revival of volumes in the next fiscal.

Our sales effort continues to generate results in this quarter. We added two new clients in the collections business including one fintech or a BNPL company.

For the UK BFS segment, last quarter we spoke about the unfulfilled demand due to talent shortage. We have managed to address the majority of those challenges by increasing our hiring reach and opening new satellite centers in the UK.

Clients continue to focus on scaling operations onshore but are now more receptive to near shore or offshore delivery markets. Some of these discussions are progressing well. However, as the COVID cases rose, we saw higher absenteeism even in the work from home teams impacting client fulfillment.

Let me switch to Healthcare. The Healthcare segment grew by 28.4% year-on-year and 26.6% in constant currency this quarter and was the fastest growing segment once again.

Our Health Plan and Health Services or HPHS business continues to make solid strides. We spoke of the large BPaaS deal with the leading health insurance company. The go live went as per a plan and the first batch of knowledge transition has started. The pipeline for HPHS remains strong especially in the digital intake business. The focus is now on strong execution. We are very pleased with the continued strong progress of the HPHS business.

In the Provider business, the resurgence of COVID has further delayed our anticipated growth impacting volumes and our ability to staff capacity onsite at hospitals. The staffing issue is further exacerbated by the recent Fed rule requiring the staff at hospitals and health systems and their partners to be fully vaccinated.

If we step back and take in the macro view, the hospital financials have been significantly impacted by this successive COVID base. A recent study by the American Hospital Association and Kaufman Hall & Associates estimated that US hospitals lost more than \$50 billion of net income in 2021 despite the significant government support. Keep in mind, fewer medical procedures and disruption to a hospital's normal revenue cycle directly impacts the volume flow to us.

Assuming that Omicron is the last of the big disruptive COVID wave and that the public health emergency program is consequently wound down, we are cautiously optimistic on the return to normalcy and revival of volumes in the coming years.

Lastly, our efforts to extend the patient continuum into pharma and med devices market is yielding encouraging results. We've created a digital beach head and added two clients this year and as we speak we are working through a decent pipeline for the pharma and the med device segment.

On Communications, Media and Tech segment, this segment continues to perform well. In Q3 FY22 the segment grew by 2% year-on-year but degrew by 1.7% in constant currency.

Similar to the UK BFS, we have resolved most of the hiring challenges from our prior update by expanding the hiring reach and by moving some lines of work offshore. However, higher than anticipated absenteeism due to the COVID wave has hit this segment as well. Given the circumstances, we believe that the business has performed reasonably well and remains on a steady growth path. I'm currently in the UK and had a very good meeting with the largest client earlier in the week. The relationship remains very strong and we continue to explore new growth opportunities together.

Our sharp focus on scaling our footprint in the tech industry is playing out nicely. We added three new clients this quarter in the fintech space including our first crypto client and expanded to risk management services to these clients. The pipeline is building nicely and is currently at the high point for the year.

Let me give you a little bit more detail on the acquisition of American Recovery Services Inc. or ARSI. It's a leading player in the legal network collections market. ARSI was founded in 1986 providing legal collection services nationwide to the leading credit card issuers, insurance and fintech companies. The firm over the years has developed a strong partner network of attorney firms across the 50 states in the US to help provide legal action to resolve uncollected debt in their respective jurisdictions.

Let me just take a minute and explain the high-level debt collection value chain. Once a borrower defaults or charges off, creditors have largely three options: One, they could call and collect which is what we do today, is recover outstanding dues by call or digital strategies.

The second is debt sale where you sell the debt portfolio to a debt buyer for a percentage of the outstanding balance, cents to a dollar and then whatever the debt buyer does after that.

The third option is legal collections where you use a legal collection channel to file lawsuits to obtain a judgment against the charges off debt. The legal strategy can be deployed at all stages of the debt cycle from charge-off to late stage debt. It can be a standalone strategy or can be a follow-on strategy to the call and collect strategy. Typically, accounts with a higher outstanding balance and value are better suited for legal treatment. The legal collections market in the US alone is estimated to have a TAM of \$1 to \$1.5 billion and continues to grow.

This acquisition helps us build our capabilities and scale in the debt collection industry. It's firmly in line with our "Digital First, Digital Now" strategy and will enhance our platform-based services portfolio. ARSI has developed strong IP in the way prioritizes the lawsuit filing and has a proprietary platform that partner attorney firms use to manage case volumes.

The purchase consideration for this acquisition is expected to be US\$53 million, of which US\$46 million was paid at closing and the balance is payable on the first anniversary of the deal linked to performance-based earn outs. We are onboarding a very tenured and experienced team and I'm very excited as we integrate the entity within the wider Firstsource organization.

In another development, we are actively evaluating nearshore locations for the US and UK markets to address the structural demand/supply challenges in the onshore markets.

We're delighted to report that we opened our first delivery center in Mexico, creating a near shore option for a US client and we will go live with a large health plan in March next month.

This has been a challenging year. A couple of macro factors. One, the surprising strength of the household finances and then the continued impact of public health have dented our original growth expectation in the collections and provider business respectively. And then while we anticipated that the mortgage refi market would cool this year, the reduction in volumes has been sharper than what we had expected. However, we shouldn't lose sight of the progress that we have made building out a foundation that we anticipate will drive consistent top quartile growth in our industry over the longer-term.

We are focused on our growth framework to one, maintain a sharp focus on the three core industries of banking, healthcare and CMT. Second, modernize our offerings particularly investing in our "Digital First, Digital Now" approach and third building a purpose-led scalable and agile organization.

With rejoinder, we made solid progress on these over the last 12 to 18-months. We successfully turned around our HPHS business including the largest platform-based services deal in our history, further expanded our domain and digital capabilities with the acquisition of Stonehill and ARSI.

We engineered and introduced new platform-based services like the mortgage post closing and a few others, greatly strengthen our delivery and account management capabilities and we've recently gained inclusion in the Bloomberg Gender Equality Index, a testament of our efforts to build a holistic and inclusive growth-oriented company.

We look forward to speaking you again in three months and we'll highlight our full your results and provide our expectations and guidance for the next fiscal year.

I will now pass over to Dinesh to Cover the Financial Details for Q3.

Dinesh Jain:

Thank you, Vipul and hi, everyone. Here is a quick summary of Q3 FY22 financial performance. Revenue for Q3 came in at Rs.14,638 million or \$195.4 million in dollar terms. This implies a year-on-year 7.2% in rupee terms and 4.9% growth in constant currency terms.

On the margin front, operating margin on EBIT came in at Rs.1,762 million or 12% of the revenue for the quarter which is 10.8% growth year-on-year and the margin expansion of 39 bps.

Profit after tax came in at Rs.1,355 million or 9.3% of the revenue for Q3. This is 11.9% growth year-on-year with a margin expansion of 39 bps. In Q3 FY22 we generated Rs.3,243 million cash from operation. Our free cash flow was Rs.3,059 million after existing for CAPEX of \$184 million. Our closing cash balance as of December 31st was approximately Rs.1,898 million.

DSO is slightly higher this quarter which is at 58 days as compared to 54 days last quarter.

We completed two acquisitions during the quarter as Vipul talked about in detail about the ARSI and Stonehill. The purchase consideration paid were around Rs.5,067 million. Both these acquisitions have earnout payable on first anniversary linked to the performance.

Net debt as of December 31st stand at Rs.5,882 million or \$79.1 million versus the Rs.3,380 million or \$45.5 million as of September 30,2021.

Tax rate for the quarter is slightly lower around 16% but we expect it to be within the range of 16%-19% for the year.

I am pleased to announce also that board has recommended an interim dividend of Rs.3.5 per share or 35% for the financial year. Total payable expected on account of this going to be Rs.2,439 million.

On our FOREX hedging, we have coverage of GBP 43.3 million for the next two year with rates ranging from Rs.108 to Rs.113 per pound. We also have a coverage of \$68 million with average rate between Rs.77 to Rs.80 to a dollar.

With this we can open up for the questions.

Moderator:

Thank you very much. We now begin the question-and-answer session. The first question is from the line of Nagraj Chandrasekar from Laburnum Capital Advisors. Please go ahead.

N Chandrasekar:

I can understand on the current quarter but even by the second quarter provider business was still 15% to 20% roughly below the pre-COVID run rate of \$120 million a year. Why was this even in the second quarter despite electives being back to normal in the US and how does the public health emergency specifically hit us and our eligibility business? I'm asking this because some of the larger RCM players like R1 were talking about procedures being back to normal by the second quarter two, three months ago. So just wanted to understand how we were specifically hit more than the larger RCM players by what has happened.

- Vipul Khanna:** So couple of comments, right. One, relative to public health emergency I think that's one of the nuance which impacts us. We play on a part of the revenue cycle or a big part of our business is just the eligibility services where we get coverage for uncompensated care for our clients, primarily through either medicaid enrollment or other avenues which might be available. Now, because of the public health emergency, government is providing a lot of support to hospitals for COVID treatments and others and there has been almost a large chunk of population which is automatically enrolled in medicaid because of the public health emergency through proclamation. So that has disrupted the normal revenue cycle flows, the normal sort of portfolio of what type of clients will come in and what sort of support they would need for our hospital clients. That disruption of the flow has impacted our flow which is the eligibility services. And our hope was that in Q3, we'll see that support will wane down and normalcy will return to people coming back to hospitals. But with the resurgence of Omicron, again, we saw that a lot of hospitals prioritize COVID care, consumers also were hesitant sort of coming back and that ran through most of December and January, hopefully that kind of starts to die down. But we were expecting growth to come back in Q3 and Q4 and that's what we've seen deferred back because public health emergency for now targeted to go sometime in mid-April. That's the difference between us versus some of the full scope RCM players which might be doing different scope deals.
- N Chandrasekar:** Does that mean the growth we've seen QoQ on the healthcare side has all been driven by HPHS?
- Vipul Khanna:** Majority is absolutely coming from HPHS and provider has had a relatively muted year.
- N Chandrasekar:** On the BFSI side, we've seen a moderation in margins which were at sort of all-time highs. Is this now a more normalized number and what really were the drivers of this spiking up over the last few quarters, was it driven by sort of mortgages numbers and is the current margin a more normalized margin?
- Vipul Khanna:** So as volumes in the refinance portion of the business side, as they have started to tone down, more than what we expected, we are balancing our costs. So there is a little bit of a time lag between revenue dropping off and full cost action taking and there'll always be some fixed costs as well. So I think some of it is baked into our Q3 numbers and some moderation in the margin will kind of come through in Q4 as well. But, when we were enjoying the higher volatile revenues of mortgage, we had a little more SGA leverage on that business as well. So that was partly driving some of the reasons. Collections, again, as we said, we started well in Q1 and then it started dropping. That has an impact on the margins. I think next year when collection volumes come back, that will be a positive sort of tailwind to the margins for BFS while mortgage will kind of pull it down a little bit.

- N Chandrasekar:** Finally, what was the absolute mortgages dollar number this quarter? I see the total origination and REFI volume in the US is now settled at roughly \$600 billion ballpark in the last quarter if I'm not mistaken. Do you think that is a sort of normalized number or did you see it having the chances of going to a \$300, \$400 billion combined number like you had in the first half of 2019.
- Vipul Khanna:** In terms of our revenue, Q3 including for partial quarter for the acquisition, we're closer to about \$50 million revenue for Q3 on the mortgage side. The market in terms of the volumes is a very dynamic market by Fed zone and own admission. They've taken out the word transitional from their inflation commentary and they said that "We'll have to watch it carefully and keep the policy nimble." And we are seeing most of our clients also kind of watching it. The purchase market continues to be strong in the US and that we see that demand is strong, it's more limited by supply. Obviously, as interest rates have grown, there will be some dampening of demand because of higher interest rates as the 30-year mortgage has already moved up something like 50 basis points from November to now. I think there'll be some dampening, but the purchase market continues to be strong. The refi volume as to what is the equilibrium based on the interest rate I think that judgment has to come to say what will be the volume out there. But I also wanted to caution out that, look, there is a lag between the volumes that are coming there and what is forecasted versus how it plays out in our revenue and forecast. So what you saw in Q3, we expect Q4 will be lower as far as refi volume is concerned.
- Moderator:** The next question is from the line of Mohit Jain from Anand Rathi. Please go ahead.
- Mohit Jain:** One, I was not clear about the organic growth number. So how much contribution have you added for Q3FY22 in terms of absolute dollars?
- Vipul Khanna:** We said we've done about 5% year-on-year, of which approximately 4% came from inorganic, so modest 1% year-on-year came from organic.
- Mohit Jain:** So, when you say modest 1%, 3Q'21 you're closer to \$185, \$186 million and this time we have reported \$195 million. We are seeing almost \$7, \$8 million have come of an organic which seems to be on the higher side.
- Vipul Khanna:** About \$7 to \$7.5 million has come from inorganic.
- Mohit Jain:** That includes Stonehill and two days contribution of ARSI?
- Vipul Khanna:** No, we actually got more than that because we signed the contracts sort of earlier, so we got more than that revenue in ARSI.
- Mohit Jain:** So ARSI they integrate for one month or how should we read it?

- Vipul Khanna:** ARSI was slightly less than a month but closer to a month.
- Mohit Jain:** The other one, Stonehill group is integrated for almost two months, is that correct?
- Vipul Khanna:** Slightly less than two months but yeah.
- Mohit Jain:** From a 4Q perspective, what is our outlook because there is a sharp downward revision, there is a revision in the last two quarters as well. Any outlook on '23 would be helpful like you guys are bottoming out in 4Q or you think there will be some pressure in first half '23 as well and then you may see recovery towards second half of next year?
- Vipul Khanna:** Q4, if you look at it obviously we will see an impact, that's why we have brought the full year guidance down to the 14% to 14.5%. Taking the full quarter impact of the acquisition, I think the fourth quarter will be growth over what we saw in Q3 because of the impact of these acquisitions. But in terms of the outlook that you asked I think I mentioned earlier collections is starting to turn around, we're starting to see green shoots of higher volume. Obviously, they won't show up in the revenue for Q4 but I'm cautiously optimistic that volume recovery will start to climb up through Q1 and kind of continue to climb through Q2 FY22. Second, provider, again, little bit of a variable. Hopefully omicron dies away as it's for now tending to be and there's no reversal of this declining trend. With that we expect that provider should start to come back to normal especially if the public health emergency is finally closed down in April. HPHS is continuing strong. Mortgage servicing is continuing strong. Europe is strong. The only variable is definitely Q4 for mortgage refi will be lower. I expect that will continue, the refi will at least be lower in the first half of H1 right before it stabilizes. So when you add all it up we haven't done the full forecast but I would expect that next year most businesses will start to trend upwards barring sort of the refi portion of the market business.
- Mohit Jain:** From the total mortgage standpoint like you spoke about I think \$50 million as the revenue for 3Q. You are obviously expecting a sharp decline next quarter. Where do you sort of expect it to settle down?
- Vipul Khanna:** Without acquisitions mortgage is about \$50 million for the quarter (Q3). Now as we go to Q4 and then we have the full impact of the acquisition, we expect at this time we are modeling about \$45, \$46 million including acquisition.
- Mohit Jain:** And then steady from there till the time you see some recovery?
- Vipul Khanna:** We will see some softness from that level thereon as we go into next fiscal because of refi volumes.
- Moderator:** The next question is from the line of Dipesh Mehta from Emkay Global Financial Services. Please go ahead.

Dipesh Mehta:

Just want to get sense about the organic business. I think you partly answered \$7.5 million is acquisition. So in a way you are employing this quarter, we have a sizable sequential decline and probably even YoY we might be down or might be hardly any growth. So if you can help us understand now mortgage business if one look at it, mortgage business is not explaining full weakness and obviously we know some of the factors which are not doing well but surprisingly there are not sufficient factors which are negating that insights. If you can help us understand structurally what measures you are taking which can negate some of the headwind, right. In business in any given period, you have some headwind, you have some tailwind. But for us, negatives are outweighing positives. So if you can help us what steps you are taking which can give sustainable growth over medium term?

Vipul Khanna:

Great question, Dipesh. If I just step back and look at our portfolio of the five large operating businesses, this year HPHS had a strong year, CMT had a strong year. Europe which partly overlapped the CMT had a decent year. There were some staffing issues, etc., which kind of took away some of the revenue opportunities. But collection was impacted with very unique economic environment. Provider is because of continued COVID. And then mortgage we expected but it's gone a little bit worse than we anticipated because of how the markets moved and how inflations come up in the US economy. So effectively two of the businesses were buffeted or face macro headwind which I think will play out which should ease out next year both for collections and provider. Organically, in terms of our effort, the stuff we're doing is that we have invested and we've taken the time for a provider business to strengthen our offering, strengthen our teams on sales and account management and we've integrated patient matters into a better platform and I think as markets come back we have a broader offering which covers the entire patient payment experience as opposed to just we were doing chunks of collections and chunks of eligibility. Now, we'll do the patient experience. So I think provider, we have done a lot of work kind of make sure that we have a broader offering and a more strengthened team as the market comes back. As far as collections is concerned, I think the acquisition of ARSI gives us tremendous capabilities on the complementary side. Today, we just did one part which is the early stage. Now we can do the third leg of the value chain which is legal collection. And we do intend to take this broader capability to a broader customer set beyond the credit card segment into fintechs, into utilities as well and we are also actively deploying some investment into UK to take the collection capability out of US and take it to the UK market. Again, early days to kind of keep there. That's on the collection side of it. Keeping on with the CMT focus that I've been talking to you about I think it's been a complete organic build, coming cold into the market from a standing start. While revenue wise is taking time but I'm very encouraged by the kind of logos and the kind of work we're signing up and I think that will start to kind of gather momentum into next year. And that will be all net new growth given the new growth sector, the fast-growing sector has a very small revenue base into this year, whatever we get next year majority of it will be net new growth. And then lastly on mortgage, the Stonehill acquisition is almost two-thirds or more than that is towards servicing. So it kind of strengthens our servicing portfolio.

So while we'll deal with the volatility of the refinance market, I think we continue to focus on the service portfolio so that we kind of continue to have a more stable revenue mix as well as that share increases as far as overall mortgage is concerned. So those are some of the specifics in terms of actions across the businesses so that we can somewhat limit the better deal with the macro impact that we saw in '22.

Dipesh Mehta:

So let me ask it differently, Vipul. I think year back or a year and a half back over here, you always used to say business considering overall portfolio, we can deliver low to mid teen growth on sustainable basis, on organic basis. That is what you expect the business to deliver. FY22 seems to be weak year. But considering all these put-and-take, how far we are from delivering those kind of number on organic basis?

Vipul Khanna:

Dipesh, it's a fair question but now that I'm guiding to 14% to 14.5% we're still looking at between 10% to 10.5% organic growth to come this year despite the significant sort of headwinds that we've had. So to that extent, if you think about it, last year you guys had asked us and challenged us that FY21 a lot of the majority growth came from mortgage. This year if you look at it mortgage had pretty small growth, low single digit growth on a net year-on-year basis although run rate will be lower. So all the organic growth that you're seeing has come from the investments that we put in '21 into healthcare, CMT and stuff. I think that robustness will continue to show into next year as the volatile revenue plays itself out and it's a more stable and sustainable revenue which comes into play.

Dipesh Mehta:

But if I do adjustment for mortgage business from exit FY21 to now, you have significant headwind entering into FY23. In FY22 because we are saved because our exit rate was very high in mortgage. Once we exit FY22 we have significant headwind to get that double digit organic growth and that's why I ask this question.

Vipul Khanna:

Again, we are going through a robust budgeting process. I don't have the numbers yet to give you for the next year growth. I am giving you direction and qualitative answers from how the numbers are playing out. I think the foundation for the business is solid in sort of four of the five. It's the mortgage volatility which is kind of creating some noise but otherwise the businesses are all on a sound footing. Once you kind of pause and look at the math, you can see what the organic will come out to be.

Dipesh Mehta:

Can you give me a couple of data points? What would be the servicing mix or servicing revenue this quarter out of mortgage \$53 million which you said including acquisition?

Vipul Khanna:

This quarter the servicing is closer to 40%.

Dipesh Mehta:

The split between provider and payer?

Vipul Khanna:

It's half and half with maybe HPHS being slightly higher than 50%.

- Moderator:** The next question is from the line of Manoj Baheti from Carnelin Asset Advisors. Please go ahead.
- Manoj Baheti:** I have a couple of questions. First one is if I look at the headcount, the head count is going down and that is something like maybe due to attrition but if the headcount starts going down especially in your business, are you factoring in a lower growth momentum or it is because of higher efficiency or higher digital-enabled solutions or services which you are providing, how do we read this number?
- Vipul Khanna:** Clearly, as we talked about, right, as some of the volumes have declined this quarter on mortgage and last two quarters we've been seeing softness in collections business, we've kind of managed our headcount as attrition has happened we've not refreshed some of the positions right to make sure our headcount is in line in this. I think it reflects that majority but yes, ongoing basis there is a lot of effort at automation both in terms of what we contractually commit to our clients as well as for our internal efficiency. Also, keep in mind that the acquisitions that we've done, although they had a small impact in the third quarter, more in Q4, both have platform-based services at the core, so their revenue runs on a different trajectory than our business, both majority of the business and outcome basis and delivered through platforms. So they have a different revenue to headcount sort of dynamic compared to rest of our business and that will also have a positive impact on the revenue to headcount relation on overall as those are fully integrated in Q4 in our results.
- Manoj Baheti:** So this headcount number is inclusive of your acquisition the manpower which you acquire or ex of that?
- Vipul Khanna:** Inclusive.
- Manoj Baheti:** On organic basis, is it much bigger drop than this number?
- Vipul Khanna:** We've added slightly less than 400 people through these two acquisitions.
- Manoj Baheti:** My second question is like if I have to see mortgages reduced from a medium term perspective especially looking at the way the US macro will unfold, interest rate starts going up, I don't know whether delinquencies on credit card will again go up with the rising spend and also in terms of your refinancing business like which will have a structural headwind at least for the next one or two years, so how you are going to mitigate these kind of headwinds especially on mortgages business which is a large proportion of your revenues as well as I think on the base side also it is having a good growth, so if you can answer this question?

Vipul Khanna:

Two parts of your question. When you talked about the impact on the credit card, right. So clearly as spend rises, right, as people step out and start to do discretionary spend on credit card and which is essentially an unsecured loan and with inflation starting to kind of impact household finances, delinquencies rate will rise, right. Right now they are way off the normal delinquency or historical delinquency rate, but they will rise and we're starting to see that. And in normal economic environment, there is a natural some part of a hedge between our collections and mortgage business, right. FY22 was a very unique year where both kind of went in one direction of sorts, right. Next year I think they'll return to some element of natural hedge between the mortgage and collection business, that's just one comment. The second comment on the mortgage side, yes, as interest rates rise, refinance economics change for average home buyers, right. They go for a refinance when it makes sense if interest low, they save some dollars. But when interest rates go high, there is no incentive for them to seek a refinance, right. Then you're down to sort of the normal purchase transactions or there'll always be a population of home buyers who've had historically higher rates or whose credits improve and then they're eligible for lower rates and they come in for refi. So there is that core refi, there is core purchase and then there is a volatile or the more opportunistic refi buyer who comes in because there is interest arbitrage opportunity for them. I think the third portion is what is dropping of now. And they all repeat the cycle three to five years as interest rate go above that. So we are starting the end of that cycle, whether it takes three months, six months, nine months to work its way through the system, we'll kind of see. But I think there is a core element to our mortgage business, the servicing as well as the core volumes of refi which is strong. With the acquisition of Stonehill, we are adding two new lines -- quality control and due diligence. Due diligence especially plays in the secondary market purchases which is unlinked to what's happening in the core market and especially with the MBS purchase lower by Federal Reserve, the secondary market activity increases, right, more investors buy pools of loans, and they need due diligence services on them and they need QC services on them. So I think that was the whole reason we also were keen on that acquisition to make sure we are building foils for additional growth lines there. And I think for servicing, more efficient refi or more efficient financing and then QC and due diligence are the building blocks for now for us. And second, clients still are doing a reasonable amount of financing and refinancing with them. As we kind of push more efficient solutions, after this initial shock of capacity wears off, clients have to look for lower cost options and I think that's where offshore and digital comes into play that you become an answer for your clients in a declining market mode. So I think those are the factors which we think will help us buffet some of the declines that we are seeing this quarter and potentially going into next year as well.

Manoj Baheti:

On ARSI, if you can give some more color in terms of some quality parameters of the target, where are you seeing the potential, where are they right now in terms of revenues, profitability and how do you see that it is going to unfold over next couple of years?

Vipul Khanna: Look, it was a founder-led company. They had a good portfolio. Two of their largest clients overlap with us. We also serve them. We serve the early collection needs, these guys serve the legal collection needs for two of the largest banks in the US. So that's a good synergy for us to kind of combine. They had a decent go-to market but I think it was from our standpoint the way we would run our business, we will increase the investment in the go-to market and extend the sales and the account teams, we want to take them to our clients and we want to push hard on the fintech side as fintechs to come more influential players in the lending side of the market. I think giving them holistic collection solutions both early stage or call and collect or legal collection option, that's one of our strategies. And then obviously when we marry our digital collections with their abilities, we need to play out but our thesis is that low balance debt which is typically let's say utilities or BNPL, if we can do legal collections with a very strong digital intent, it brings down the threshold of what debt you can chase, right. Then it makes a little bit more economic sense to do for lower debt as well because you're able to do digitally. So I think there is potential to grow that business, expand it into other parts of the banking chain and maybe take to other industries. Margin wise they are somewhat lower than our target margins. We kind of know that and we think as we get there as more scale comes in as we put in a little bit more technology and more leadership discipline on cost management, over the next four to six quarters we will kind of bring them on parity to our margins. All of that is kind of baked in how we evaluated this business. So I think that's how we're kind of looking at that business.

Moderator: The next question is from the line of Mihir Manohar from Carnelian Asset Advisors. Please go ahead.

Mihir Manohar: I wanted to understand a split between refinancing, origination and collections. So among the BFSI domain what is the split in these three categories?

Vipul Khanna: There are three parts to our banking and financial services business, right. There is the mortgage business which in turn is made up of origination and servicing, right, which we said is like a 60:40 split between them. Then there is collections which is largely a US business today as is the mortgage as we call it. And then there is a Europe banking and financial services business where we serve retail and commercial banks. Those three combines are a BFS business.

Mihir Manohar: Broadly among these three divisions, which division has higher margins?

Vipul Khanna: I think both mortgage and collections generally run at the same margin levels. In Europe, our margins are somewhat lower because of the higher onshore component of that business and it's pretty much majority DECC business or Digital Empowered Contact Center. Europe tends to be somewhat lower, but mortgage and collections are generally in parity.

- Mihir Manohar:** One last clarification. Last time you had guided for 14.5% to 15.5% and that was including the acquisition of Stonehill. But this time the guidance that you have given also includes the acquisition of ARSI, right. So the clarification that I want is last time the guidance that you had given was without the acquisition of ARSI, is that understanding, correct?
- Vipul Khanna:** Correct. At that time we hadn't closed the deal. We were still in the due diligence phase of that.
- Mihir Manohar:** Size of that company is close to 10% of our revenue. So in that context, downward revision guidance is even more than what downward revision was in 2Q, right?
- Vipul Khanna:** Correct, at that time we had given including one but yes we have downward revision now, the organic guidance to about 10-10.5% and then about 4% will come from these two guys combined for the quarter baked into the full year guidance.
- Mihir Manohar:** The guidance that you had given at the start of the year was without any inorganic component, correct?
- Vipul Khanna:** Largely, yes.
- Moderator:** The next question is from the line of Shradha from Asian Markets Securities. Please go ahead.
- Shradha:** One clarification. This mortgage business has a run rate of \$50 million. Is it with or without acquisition this time?
- Vipul Khanna:** The \$50 million that I mentioned to you for this quarter is without the acquisition.
- Shradha:** Vipul, you mentioned that Stonehill was consolidated for less than two months. But when I see the BSE filings I see that the acquisition got completed only in the month of December and the ARSI acquisition got consolidated in the last week of December and there again you're saying that the numbers are consolidated for broadly a month. So just wanted to check how is that possible when the acquisition has got closed late, so how are we accruing for a higher duration for both these acquisitions?
- Dinesh Jain:** As per the accounting norms, you require to go through the agreement which we have signed with those guys. Stonehill, on 9th November we have closed the deal. There are some administrative thing needs to be closed which was pending. So from the control point of view we have started getting control from that point. And as per the agreement all the profitability and everything accrue to the Firstsource. And the same applies to ARSI also because we were in discussion, there are things which is what pending due to the Christmas holidays and all of those but I think from the promoter angle point of view, we did close. Accounting suggest that for a practical purpose you need to take when you have a control of those assets. And that's the reason we accounted for these months.

- Shradha:** Secondly, ARSI had revenues of close to \$72 million, that was the last year that got reported for them. We did indicate that we have some client commonality in the sense that two of their largest clients overlapped with us. So do you think we can expect this entire \$72 million get added to our top line or will there be some let off because of some client commonality?
- Vipul Khanna:** Not because of client commonality because we do completely different things for the same client. But the collection softness that we see in our business in FY22, because they come later in the default cycle, right, we will see the softness of collections in terms of lesser volumes which flew into the delinquent bucket in FY22, will reflect in some softness in the ARSI business in FY23 because that's how the cycle works. They're sitting on a large portfolio. So that kind of buffers it but there'll be some softness from FY22 flowing into FY23 and then it'll come back up again. From the \$72 million that you mentioned, we expect there'll be some downturn and obviously there'll be some element goes down when you do an acquisition for a founder-led company. There'll be some softness in a few relationships which we have baked in going into next year.
- Shradha:** So would it be possible for you to quantify what should be the reasonable revenue to be built in for ARSI for next year?
- Vipul Khanna:** We are working through the details. When we come and talk to you for the next quarter, when we give guidance, we'll try to kind of isolate that out.
- Shradha:** Vipul, just on the large HPHS deal that we signed last quarter, how is the ramp up going on, is it broadly on track and do we expect good revenue to flow from this deal in Q4?
- Vipul Khanna:** Yes, it's on track. All the milestones as we had agreed with the client and our IT services partner are on track. There was a small portion of re-batch that we had to do. That happened on the milestone and the first batch of knowledge transfer is on track. So, yes, we expect Q1 calendar, Q4 fiscal revenues to be on track from that deal.
- Shradha:** So \$15, \$16 million is the kind of annual run rate that we were talking of. So broadly that would be the run rate, right?
- Vipul Khanna:** \$15-odd million, yes.
- Moderator:** The next question is from the Line of Rahul Jain from Dolat Capital. Please go ahead.

Rahul Jain: Basically I have a question regarding some perspective if you could share for FY23 because if we factor in the guidance that you have suggested for this year, we may have the run rate of close to \$200, \$205 on Q4 basis, but based on various comments that you have shared for FY23, we may see some downtick on the numbers that we will have for ARSI going into FY23, also for the mortgage business in general. We expect collection and provider business to improve only ideally by Q1 which can also see some kind of delay because that's just an anticipation at this point. So with so many headwinds and no real kind of a trigger driver for the revenue stream in FY23, what kind of a growth band or range one should kind of put into FY23 with multiple headwinds coming into play?

Vipul Khanna: Rahul, I think you've captured some of the things that I've commented on. I think ARSI will not be any significant, but I was just giving a sense that it won't be an uptick right away, there will be some downtick before it comes back. And also I'm not sure I would agree to say there are multiple headwinds. I think mortgage refi is one headwind, that we have to grapple through as we get into next year. But both collections and provider which have been impacted this year, I think it should start to ease off, collections definitely starting to ease off already, provider still kind of on the fence depending on how Omicron kind of downplays, but I think in general the foundation for that business is strong and there were earlier comments of some of the other players who have broader offerings, they are starting to see normalcy back. I think we'll see that as well albeit with a little bit of a lag. I think HPHS in a strong wicket. We'll see some of the wins that they've done, the benefit will come through, as well as our UK business is working on a decent pipeline. I think that will have a good solid next year as well. In my head I don't characterize as multiple headwinds. I characterize as sort of one headwind and the rest we obviously face the brunt of it in Q4 and I think it will reverse and sort of ease off as we go into the next fiscal. In terms of actual growth guidance, I'm very conscious of that we need to come and give you credible guidance. So I don't want to sort of hazard a speculation yet until I've gone through a proper budget and kind of tested it a couple of ways before I come back and give you the growth guidance.

Rahul Jain: Maybe I need to put this in a different manner. So first thing is that first, the allocations on the inorganic side are coming in an area which we know that at least from a near-term perspective are not going to be an attractive asset, of course, the valuation are also very attractive at which we might have done this transaction which also suggests that the run rate is expected to go down. Of course, this is a definite positive from a very long term perspective but there is one thing which I found little not very ideal given that we are also dealing with the revenue deceleration so as to call it looking at the number what we delivered in FY21.

And secondly, from the perspective that provider also like I think right from the beginning of the year we were very hopeful about that this could be a driver for the business, but which has not played out and none of us have any control from a virus perspective. So keeping those things in mind, do you think the current year organic growth of 10%, 10.5% which you said is something what we can have into next year or higher or you can say this too early to even give any number related to that as well?

Vipul Khanna:

Again, as I said right, we need some more time as we come to Q4 we will kind of come and talk about the guidance for next year in terms of growth percentages. Just to kind of a little rejoinder on your point, I think you captured well. I think these are good, valued acquisitions. I think legal collections is a little bit of a fragmented market and I think there is an opportunity for us to come in and apply the scale of a well-run enterprise and kind of make inroads into that market. So I think notwithstanding the unique collections environment right of robust household finances causing low delinquencies, it will have some impact but overall I think not long term but sort of I would say short to medium term. It's a good business and likewise mortgage as I mentioned, Stonehill plays in a market segment which is not as directly correlated to refinance. QC somewhat is but due diligence is completely unrelated and QC has also done for more complex either purchase transactions or more what is called as non-conventional or jumbo transactions. So, it's not as correlated to the refinance or interest rate sensitivity. I think both these are good additions to our repertoire that we have added adjacent capabilities allow us to get growth. I just wanted to correct that perception that we bought in the segments which haven't done well. I think we baked that in and I think this kind of helps us kind of add new capabilities even in those segments. So that's how we look at it rather than just a pure value buy.

Rahul Jain:

Just to ensure my understanding, can we say that now because the kind of a portfolio that we have around in the mortgage, in a normalized scenario let's say beyond FY23, now the kind of portfolio we have irrespective of the cycle of the mortgage, we should be able to have some growth on a sustainable basis or you think will have volatility but lesser volatility given the portfolio that we have?

Vipul Khanna:

100% the latter part, Rahul. We enjoyed this volatile revenue for the last 18 odd months. It will play out but the core of the finance volumes and servicing and what we are adding I think this is a very solid portfolio and especially when you look at beyond FY23 we absolutely have to look at it as a growth portfolio.

Moderator:

The next question is from the line of Dipesh Mehta from Emkay Global. Please go ahead.

Dipesh Mehta:

Just one clarification. You indicated mortgage revenue to be around \$45, \$46 million next quarter. That is including acquisition or ex-acquisition?

Vipul Khanna:

Including acquisition.

- Dipesh Mehta:** So, in a way you are implying roughly 30% decline in origination business on sequential basis? Servicing business is a stable business.
- Ankur:** Yes, Dipesh. If you take from that perspective, servicing is stable, the original drop is about 30%.
- Dipesh Mehta:** So 30% is in origination business. And if I compare that with your historical, so we are back to Q4 FY20 kind of run rate from where we have seen significant uptick in our revenue. So from that context now we have signed some agreement with one of the anchor clients where Source point made some equity-related payment and other things. Now any conditionality change to that thing because I think in future performance also it was linked to some kind of equity-related payments, if you can provide some sense about how economics works for those relationships?
- Vipul Khanna:** So those relationships as we had said, there were two parts to it. Bulk of the payment was pertaining to sort of what was historical, right, going back to the 2018 agreement, so almost four years of kind of playing into that. As we go into the future, there is a variability to the payment that we had given which is linked to certain spend levels which are significantly lower than the historical levels. So as long as we get that base revenue, the variable portion of the payment will be paid, otherwise it won't be paid.
- Dipesh Mehta:** Any sense you can provide us because that number will be there in the...!m not sure FY22 number or it will come only in FY23 now?
- Vipul Khanna:** It will come in FY23 now.
- Dipesh Mehta:** Can you help us understand collection business organic revenue run rate because if I look your non-mortgage BFS revenue and if I adjust for the run rate of the acquisition, it seems to be very weak and that's why I just want to get sense, what explains that weakness?
- Vipul Khanna:** So, look, collections I had told you in Q2, that is going through a historically low volume period and it's been a very soft year compared to what our growth expectations were for that business. So Q3 December quarter if I look at collection business without acquisition, we would be on the run rate of somewhere between 15.5 and 16.
- Dipesh Mehta:** So Vipul, then the weakness appears to be in UK BFS. Can you help us understand why the weakness is in UK BFS because it is generally stable business?
- Vipul Khanna:** Very small weakness, wasn't anything material or any major factor there, Dipesh, primarily due to the talent situation that we had talked about plus the higher absenteeism which meant some revenue loss, there was just minor impact.

Dipesh Mehta: You say that thing for CMT as well as UK BFS. How is that situation, whether it is returning to normalcy or yet situation is still dicey?

Vipul Khanna: I think it's better now as we come into the second part of January as UK and US both have started declining numbers, we are starting to see the shrinkage factor as we call it, that has started to come down.

Dipesh Mehta: So Q4 should have been relatively better performance from those parameter perspective?

Vipul Khanna: Correct.

Moderator: As there are no further questions, I now hand the conference over to the management for closing comments.

Vipul Khanna: Again, thank you everyone for joining. Thank you for your continued engagement and great questions. Again, as I said, somewhat disappointing quarter and the guidance but I remain very confident that we have the right foundations, and we welcome your questions and engagement with us and we'll come back and talk to you in another three months.

Moderator: On behalf of Firstsource Solutions Limited, that concludes this conference. Thank you for joining us. You may now disconnect your lines.