"Mphasis Limited Q1 FY17 Earnings Conference Call"

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MODERATOR: **MR. SHIV MUTTOO – CDR INDIA**

Moderator: Good morning, Ladies and Gentlemen. Welcome to the Mphasis Limited Q1 FY17 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 is being recorded. I would now like to hand the conference over to Mr. Shiv Muttoo. Thank you and over to you, sir.

Shiv Muttoo: Thank you. Good morning everyone and thank you for joining us on Mphasis' Q1 FY17 Results Conference Call. We have with us today Mr. Ganesh Ayyar – CEO and Mr. V. Suryanarayanan – CFO. Before we begin, I would like to state that some of the statements in today's discussion maybe forward-looking in nature and may involve certain risks and uncertainties. A detailed statement in this regard is available on the Q1 FY17 Results Announcement Release that has been sent to you earlier. The Conference Call would be archived and the transcript would be made available on Mphasis' corporate website www.mphasis.com. I now invite Mr. Ganesh Ayyar to begin the proceedings of the call.

Ganesh Ayyar: Thank you, Shiv. Good morning, everyone. Thanks for joining the call. I hope all of you have had the opportunity to go through our MD&A which provides details of our operational and financial performance for quarter ended 30th June, 2016.

Mphasis has adopted IndAS framework starting Q1 FY17. Comparable prior quarter numbers have been restated for a meaningful comparison.

Let me give you context of Q1 FY16 and our strategy: In the early part of FY 2016, we had outlined our overall strategy around growing Direct Core through hyper specialization and focused service offering around next-gen services. Second part of our strategy was to stabilize Digital risk. Third part of our strategy was to ensure that HP decline gets arrested. Last one was improving operating margins through growth and other initiatives.

I am happy to say that we are executing our strategy reasonably well which is reflected in our current quarter performance as well.

Let me start by giving some color to the Q1 performance by sharing that we won deals with total contract value of USD 96 million during the quarter. What is further encouraging is that 75% of those wins came from new generation services like Digital, GRC, and next-gen IT services. We clearly see demand and traction in new age services, especially around robotic process automation and Analytics on short-term basis. Cognitive computing is emerging as a growth area and that would have an impact on mid-term basis.

Let me pause and give some color to the wins in this $96 million, especially in the next-gen area. We are going to be doing some risk analytics business using big data and algorithms to look at the risk portfolio such as credit and market risk, etc. One of such wins helped us clock up $96 million.

For another bank we are doing end-user IT support through automation of service ticket workflows, deploying troubleshooting utility, enabling high degree of automated and self-service based resolution. So once again, it is next-gen services and here we have deployed analytics based solution to identify frequently occurring problems and provide automated solutions. In another bank we are implementing analytics solution to generate insights into bank's operations. Then we are partnering with broker-dealer firm to digitally transform and improve the client experience of their platform for doing broker-dealer solution with combination of usability engineering and redesigning their portal and data architecture.

These are just some samples of what has contributed to our next-gen wins in prior quarter. We see increased participation as we continue to add value to our customers and being relevant to them. This gives us greater confidence in delivering our growth, especially in Direct Core area.

Overall Direct International business grew 1.4% sequentially, adjusted for rupee appreciation. Direct Core which is part of Direct International, roughly about 73% of the Direct International grew 2.6% quarter-on-quarter net of rupee appreciation and 17.5% year-on-year net of rupee depreciation. Direct Core grew 23% year-on-year on a reported basis. That tells you that our Direct Core business is doing well.

Let me move on to Digital risk, which is one of the next big components of our Direct International. We had previously mentioned that we are working on achieving some stability in this business. Our efforts continue to ensure stability in this business and put it back on sustainable growth track. Digital risk revenue which is 22% of our Direct International this quarter has been stable during the quarter. Revenue grew 0.6% quarter-on-quarter, net of rupee appreciation.

Moving to HP business, we saw a decline of 4.4% quarter-on-quarter and 17.8% year-on-year. As mentioned in the previous quarter, we see stability coming to this business starting next quarter.

With the above, our consolidated revenue for Q1 FY17 remained flat quarter-on-quarter and grew 5.1% year-on-year excluding the domestic business which was reflected in Q1. We need to view this performance in the context of the challenges that declining HP business posed to us.

Moving on to margins: Our gross margins improved 40 bps quarter-on-quarter and 240 bps year-on-year in Q1 to 27.3%. Operating margin expanded 70 bps quarter-on-quarter and 250 bps year-on-year to 15.2% this quarter.

Our cash generation continues to be healthy. During the quarter we generated operating cash of INR 1,915 million, roughly $30 million. We now have close to $448 million of cash in our balance sheet.

Coming to Blackstone transaction – we expect the deal closure to take place sometime in the month of September.

To conclude, our size provides us the flexibility and agility to adapt to disruption that is taking place in the industry. Our deal wins give us the confidence on the sustainability of growth. We look forward to closing the transaction with Blackstone which will provide a platform for us to do business with their portfolio companies in time to come. We are clearly focused to provide greater value, both in terms of growth and value to our shareholders.

On that note, once again I thank you for your continued interest. I would now request the moderator to open up the line for questions. Over to you.

Moderator: Thank you. Ladies and Gentlemen, we will now begin the question-and-answer session. We have the first question from the line of Rahul Jain from Systematix Shares. Please go ahead.

Rahul Jain: We have seen this strong shift towards the T&M efforts in last few quarters which is a bit contrary to the approach by many of our peers. Is this intentional or any specific reason you could highlight here?

Ganesh Ayyar: To say it is intentional is not an accurate statement. Our focus is to win in new generation areas, sometimes we have to deploy commercial models which are commensurate with our risk appetite and preference of our customers to do business in that model. We are clearly focused on looking at commercial models which are relevant. If you look at the variation, it is a 1% shift which is not significant, it is just as a reflection of the business that we did.

Rahul Jain: In some of these deals which you have highlighted on the analytics and big data side on the BFSI business, could you share more thoughts in terms of how big these deals are in the beginning and what are the eventual potential opportunity that we may be looking at going forward?

Ganesh Ayyar: It is these wins that give us the confidence that we will grow faster than the market. Some of these deals are themselves going to grow with the same customer in time to come upon successful execution. Customers are clearly investing more money in these areas and they are cutting down on traditional IT services. So it is extremely important to track where you are winning. 75% of $96 million are in these areas, so that is giving us the confidence that we will definitely grow faster than the market in Direct Core.

Rahul Jain: Are these deals right now on a potential full size basis or they are pilot right now and may scale up very substantially over a period of time?

Ganesh Ayyar: I will answer it differently. What happens is when you win certain contracts this quarter they start reflecting on steady state in revenue stream probably two quarters down the road depending on service line. So this $96 million is not definitely fully reflected in the current quarter revenue and it will start reflecting on a gradual basis and we will get to steady state in two quarters, which is Q3 and that gives us the confidence that we will grow faster than the market. If you look back and see what was our Q3 total contract value wins, we had won $60-odd million of total contract value and that is reflected in growth pattern for current quarter.

Rahul Jain: And last one, we have seen this absolute decline in the S&M and G&A headcount. Is it India related or this is an efficiency that we have brought into the system because we thought the sales headcount would increase substantially as the HP revenue share goes down?

V. Suryanarayanan: This is more of a rationalization and it is a question of getting the right people with the right skill sets to address the new developments in the market place.

Rahul Jain: But are we at optimum workforce or it would ramp up in next six, nine months disproportionately to revenue growth?

V. Suryanarayanan: I will talk more from a percentage basis: G&A we would be around the same percentage; sales expenses, there could be a slight increase of about 20 to 30 bps from where we are in terms of the percentage spend.

Rahul Jain: And just last one, this HP deal that we have in terms of revenue commitment would only kick in once we are through with the entire deal which is post September?

V. Suryanarayanan: Yes, you are right.

Rahul Jain: But still we have a confidence that 2Q should be a stable number for HP?

V. Suryanarayanan: Yes.

Moderator: Thank you. We have the next question from the line of Gaurav Rateria from Morgan Stanley. Please go ahead.

Gaurav Rateria: So Ganesh, firstly on the Direct Core business, it has grown slower than the last quarter on a sequential basis. Is it in line with your expectation or you saw some hiccups during the quarter?

Ganesh Ayyar: It is in line with our expectations and one of the things which I would like you to focus on is that on an ongoing basis we look at year-on-year rather than just sequential. I have nothing which surprised me to answer your question differently. Growth at the rate of 23% and 17%-odd net of rupee depreciation is a source of confidence. The fact that we are adding greater amount of TCV, last quarter we did $76 million of TCV, this quarter we are doing $96 million of TCV, Q3 we had done about $61 million of TCV is a reflection of new wins turning up in our revenue.

Gaurav Rateria: What percentage of your business in the Direct International is coming from Digital and next-generation services?

Ganesh Ayyar: See, revenue is a lag indicator because the new wins will gradually get translated. When we looked at it 12 months ago, roughly one-third of our Direct International was coming from areas where customers were investing more money. I have not looked at it now because our focus is more on new wins, revenue will happen automatically after that.

Gaurav Rateria: Sure. I am asking this question because I am trying to understand what is the overlap between Digital GRC next-generation services and discretionary spend. If there is a slowdown in macro, we hear that discretionary spend gets hurt first. So can the current Digital spend be bucketed as discretionary and which can get hurt in event of a slowdown?

Ganesh Ayyar: We are not seeing slowdown whether it is discretionary or non-discretionary in new generation areas. In fact, what we are seeing is they are cutting on traditional areas to fund newer areas. I will go one more step, our addressable market size as a result of Digital has expanded exponentially but it requires ability to participate and win which is different from traditional IT services.

Gaurav Rateria: Last question from my side, is it fair to say that the current margin improvement in the quarter is led by FOREX and cost rationalization rather than by improving mix of high quality revenues as lower rent and depreciation cost has helped the margin improvement? And if you can highlight some of the levers for the second half.

Ganesh Ayyar: Let me answer this question from a different angle. Do we see this margin sustainable? Answer is absolutely yes. In fact, we see greater positive trajectory for second quarter and now we are confident to say that our guidance of 14% to 16% will hold true for the entire year and not just for the first half. Despite the fact that in Q3 we will see some headwinds due to the salary increment cycle which is typically about 160 bps, we will continue to operate between 14% to 16% range, and most of the time we hope to operate north of midpoint of 14% to 16%.

Moderator: Thank you. Our next question is from the line of Karan Torani from Dolat Capital. Please go ahead.

Karan Torani: Wanted to ask about the pricing decline on QoQ basis in the apps segment by 5% odd. Anything to look into this?

V. Suryanarayanan: Karan we always have puts and takes in the quarter, so that is no indication in respect of either the pricing of deals we have or what we are seeing in the larger market space.

Karan Torani: And when do you see growth from Digital risk actually picking up going ahead?

Ganesh Ayyar: At this point of time, I am just going to give you a quick historical context: at one stage Digital risk had dropped to $22 million per quarter. We worked very hard to have clear line of stable sight at $28 million. At this point of time the stable sight that we see for Digital risk is 33 to 35 million dollars. That is not the total revenue because beyond stability they have business. I expect some form of growth to come probably one to two quarters from now.

Karan Torani: And what would be the quantum of this quarter we expect from Digital risk, I mean two quarters down the line?

Ganesh Ayyar: Very hard right now for me to predict, if I had the numbers I would have shared it with you, hard to predict at this stage.

Moderator: Thank you. We have the next question from the line of Madhu Babu from Centrum. Please go ahead.

Madhu Babu: Sir, about the initiatives in tapping Blackstone's group companies' portfolio?

Ganesh Ayyar: It is early for us to talk about it, we are waiting for transaction to close in September and depending on our rate of success, I do not see that significantly changing our numbers in FY17. I expect that to start having a trickle and impact in FY18 onwards.

Madhu Babu: Have we put in any sales guys to look into that opportunity?

Ganesh Ayyar: Not yet, we have a model in place and we are in discussion with Blackstone, we have not started approaching Blackstone portfolio companies yet.

Madhu Babu: And in terms of headcount, I think it has just started to increase from this quarter. So can we see headcount addition going forward, because now we are on the growth path?

Ganesh Ayyar: You are talking about total headcount?

Madhu Babu: Yes, total headcount has shown a marginal increase.

Ganesh Ayyar: While we are looking at some ratios in time to come, I would suggest that we stop using headcount as a proxy for future revenue growth because what is happening is we will see more and more automation in our delivery and when we do that, number of headcount linkage to revenue growth will break and rightfully so. Hence my request would be to move away from that metric. At this point of time I am not in a position to predict headcount growth.

Madhu Babu: Sir, and lastly, apart from BFSI any other verticals we have seen success, in the direct channel?

Ganesh Ayyar: We have. We are in horizontal services like infrastructure services and some areas of BPO and even Digital. You can use it in other industries as well. We do have clients, we have growth possibilities and we have a strong pipeline in those areas with those clients.

Moderator: Thank you. We have the next question from the line of Sandeep Shah from CIMB. Please go ahead.

Sandeep Shah: Just a question in terms of the direct core, as we are largely focused on BFSI and more peers of yours are showing some concerns because of the macro, so what is our experience here? I do agree that the deal wins in this quarter are good, so coming quarters may be good, but do you now witness that the deal closures are taking longer time or the start of the new deals are taking longer than expected?

Ganesh Ayyar: No, we are not seeing it.

Sandeep Shah: And sir second, in the Direct Core you said maybe one-third of the revenue is from new areas, so the two-third of the revenues are still from traditional areas but if you are seeing pressure on that side of the spend you still believe that the new business win would be sufficient in terms of a pressure or cannibalization on traditional areas?

Ganesh Ayyar: Absolutely, we are very confident for FY17 to grow faster than the market in Direct Core area, no ifs and buts.

Sandeep Shah: Just on the HP side, as you said the deal of the Blackstone may be getting over by September, but you expect the stability in this side of the business. So what gives that confidence? Is there any new deal win or any incremental development here?

Ganesh Ayyar: All of the above. We know where they are exiting with us, we know what deals we have won or are winning. When we look at our forecast for Q2 and beyond, we see a pattern where we believe that the revenue will be stable.

Sandeep Shah: So is it fair to say that worst of the revenue decline or leakage from HP channel is behind?

Ganesh Ayyar: Yes.

Sandeep Shah: Before it recovers in terms of growth?

Ganesh Ayyar: Yes, absolutely yes.

Sandeep Shah: Sir, just book keeping, on the employee cost both in the G&A and S&M has gone down, so what is the reason on a QoQ basis?

V. Suryanarayanan: There are certain rationalizations which we have done on the headcount and you will see a marginal increase in sales expenses going forward. On G&A, it is more or less around the same. I think we have to view it from a percentage basis, we will be between 5.4% to 5.5% going forward.

Sandeep Shah: And the depreciation has gone down materially, so what has led to this?

V. Suryanarayanan: I think there are always puts and takes. There are certain assets which completed their life in terms of depreciation; new assets are coming so you will see a slight increase in the depreciation in the coming quarters but not a substantial increase.

Sandeep Shah: Would you like to call out the impact of IndAS or this is not material for us?

V. Suryanarayanan: Yes, it is already explained in our Regulation 33 notice to the stock exchange. If you see in Q4, our EBIT improved from 14.3% to 14.5% and even in Q1 we have a small impact. As you said rightly we do not have a material impact, it is more due to the accounting treatment with respect to investments and forward cover.

Sandeep Shah: And just last question, on the Digital risk we are seeing that the revenue run rate in the near term could be 33 - 35 before we foresee growth after one or two quarters?

V. Suryanarayanan: Yes, that would be a right assumption.

Moderator: Thank you. Our next question is from the line of Abhishek Bhandari from Macquarie Securities. Please go ahead.

Abhishek Bhandari: Sir I just wanted to know by when we expect to hit the milestone of a billion dollar revenues again, given that we are seeing lot of traction in Digital and some stability in HP.

Ganesh Ayyar: Have not quite computed that number yet, but hopefully when we connect next quarter we can discuss potential timelines for billion dollars.

Moderator: Thank you. Our next question is from the line of Dipesh Mehta from SBI Cap Securities. Please go ahead.

Dipesh Mehta: Want to get your perspective on vertical and service lines, so can you provide some color about how insurance is doing for us? Because it remains relatively muted in terms of growth rate, so what is happening there if you can provide some color? And second, in service line infrastructure if you can provide some colors.

Ganesh Ayyar: Insurance is following similar pattern as banking and capital markets where traditional IT is being compressed and new generation services are being sought after. Our pipeline is strong with regards to insurance new generation services, in fact we have couple of large deals in our pipeline. Going to infrastructure services, in our Direct space our infrastructure services is exclusively focused on new generation services and we have created an automated tool fabric which is going to be utilized or we are open to using customer's automated tool fabric as well. But the focus is not doing the same old way of infrastructure management services. We see opportunity, we see pipeline and we see probability that we will do well in this area.

Dipesh Mehta: Sir, recent weakness what we have seen is largely on account of HP and not because of Direct side?

Ganesh Ayyar: Weakness in?

Dipesh Mehta: Infra.

Ganesh Ayyar: Yes, absolutely.

Dipesh Mehta: And sir, last question is about bucket size, if I look our Direct channel 1, 5, 10, 20 what we report in terms of bucket size, 5 million if I look at in Direct side it is down YoY, QoQ, whichever way we look at it. So client wise if I look the clients are not shifting to the extent. So if you can provide some color what is happening there in bucket moment?

V. Suryanarayanan: This is because we talk about trailing 12 months revenue here. They had some domestic BPO clients which were there earlier and they moved out. Hence the reduction.

Dipesh Mehta: So it is because of the exit from that business, nothing else?

V. Suryanarayanan: Yes. Whereas if you see over 10 million there is an increase.

Moderator: Thank you. Our next question is from the line of Sagar Lele from Motilal Oswal Securities. Please go ahead.

Sagar Lele: We had been seeing significant improvement in the performance of Wyde and Eldorado sometime back, would it be possible for you to throw some light on these products in terms of revenue or profitability or the kind of investments you are making into them?

Ganesh Ayyar: Eldorado has become a very good business from profitability perspective, it is accretive to our profit and it is giving predictable revenue patterns. Wyde: pipeline is strong but has been having some volatility due to the revenue of license because license tends to be lumpy revenue. However, we are seeing good traction in our pipeline and we believe that we will see some steady growth in Wyde starting Q4 of this year.

Moderator: Thank you. Our next question is from the line of Rahul Jain from Systematix Shares. Please go ahead.

Rahul Jain: Just a follow-up on the Center of Excellence for Blockchain Technology, what we are doing here and what kind of opportunity we are chasing through this?

Ganesh Ayyar: Block-chain has become and will be even more important in time to come and has implications beyond BFSI, but certainly more so in BFSI. Other than Block-chain we will also have other COEs because what we are trying to do is increase our value through equal specialization in select areas. Block-chain is one of the many to come, in fact we will announce another one on 3rd of August if I am right, a COE being formed which is very relevant, so stay tuned. In terms of pipeline for Block-chain and COEs, we will start adding some color probably next quarter onwards, too early to talk about it.

Rahul Jain: But just to understand from a potential in terms of the kind of technology or any other meaningful insight that you could share here?

Ganesh Ayyar: For example, $96 million TCV, out of that 75% coming from new generation would not be possible if not for the kind of specialization and investment we are making. Otherwise if we had remained in traditional areas alone our quarter would have shown only $24 million of TCV. So these are absolutely essential for us not just to stay in the game but to also succeed in time to come. And by the way, none of these are margin dilutive investments that we are making.

Rahul Jain: So broadly these are our efforts to strengthen our portfolio for the next-generation opportunity?

Ganesh Ayyar: Absolutely.

Rahul Jain: And is there anything more you could share on the strategy or any perspective that we are trying to boost our business in the Digital Risk portfolio going forward?

Ganesh Ayyar: One of the developments that I would like to share with you all is that we received the necessary approvals from all concerned authorities to have an offshore branch in India for Digital risk and we have received approval from 15 different states for this offshore center. This augers well both for potential revenue growth and profitability growth of Digital risk, because this will enhance our value proposition. In fact, we have just concluded a small transaction leveraging offshore branch of Digital risk in the mortgage space for one of their clients.

Rahul Jain: So 15 states you mean to say of the 46 states that it had license with?

V. Suryanarayanan: Yes, 49.

Rahul Jain: And would this mean a better margin but maybe a strong cut in terms of the run rate of the equivalent work that goes offshore?

Ganesh Ayyar: No, we are not planning to shift work from onsite to offshore, we are planning to go and attack new business. This actually means growth for top-line and growth for bottom-line.

Rahul Jain: So only the incremental component?

Ganesh Ayyar: That is right.

Moderator: Thank you. Our next question is from the line of Dipesh Mehta from SBI Cap Securities. Please go ahead.

Dipesh Mehta: Sir, just want to get sense about salary hike cycle, it is from Q3 or Q2?

V. Suryanarayanan: Salary hike will be from Q3 of this year FY17.

Rahul Jain: So next quarter there would be no impact because of salary hike and Visa cost would not be there, so to that extent we have some positive margin lever?

V. Suryanarayanan: Yes, correct.

Moderator: Thank you. Our next question is from the line of Nirav Dalal from Maybank. Please go ahead.

Nirav Dalal: I just wanted to know, are there any gaps in terms of senior management that needs to be filled in any of the verticals or horizontals?

Ganesh Ayyar: We do not have a distinct gap in senior management, but what we are doing is we are going for experts in select areas where we are investing. So you will see us hiring true experts and most of these positions are billable positions because that is how you enhance the value, whether you look at Block-chain or otherwise. So that is what we have to hire rather than senior management in traditional terms.

Nirav Dalal: Neither in sales nor in the corporate level?

Ganesh Ayyar: No, we do not have any obvious gaps at this stage.

Moderator: Thank you. Our next question is from the line of Karan Torani from Dolat Capital. Please go ahead.

Karan Torani: Sir, just a question on the tailwind and headwind that lead to this margin improvement, if you can walk me through that.

Ganesh Ayyar: I will get Surya also to help me out with this question, but let me give you a perspective. First of all, what we have ensured is greater focus in those areas where we want to operate. We have exited businesses which we did not want to have in our portfolio. What it does is it enhances not only your win rate, it also enhances your bottom-line. So that has been one factor. Second is, we are continuously trying to shift our business towards new generation and newer commercial models which gives us the ability to improve our growth and margin performance both. Third, in select portfolio areas we are injecting greater ratio of off-shoring, I just gave an example of Digital risk, and similar work is underway with Wyde. So that helps us to improve margin for those businesses. Let me get Surya to add anything else.

V. Suryanarayanan: To that I will just add that hedge also helped us in this quarter, if you look at it quarter-on-quarter.

Moderator: Thank you. Our next question is from the line of Rahul Jain from Systematix shares. Please go ahead.

Rahul Jain: Just one thing, have you finalized the AGM date and possible dividend scenarios?

Ganesh Ayyar: Not yet, we are waiting for transaction to be completed and at that stage the Board will make a decision on date and cash utilization. If you look at the filings done by Blackstone they have specifically called it out, so it is not out of realm. It will happen but timing and specificity will emerge post close.

Moderator: Thank you. Ladies and Gentlemen, that was the last quarter. I would now like to hand the conference over to Mr. Ganesh Ayyar for his closing comments.

Ganesh Ayyar: Thank you so much. Once again, thank you for all your support through many years where we were transforming our business, we were dealing with the decline of HP business, we were ramping up our Direct business. What you see in Q1 is culmination of our intense strategy, we are excited about the future. I hope you share our excitement and I look forward to connecting again at end of next quarter and we hope to be in person to person touch post close because I am sure you would like to have more interaction at that point of time. As soon as the transaction closes we will fix some time to have face to face interaction with many of you. Thank you very much, good luck and best wishes.

Moderator: Thank you, members of the management team. Ladies and Gentlemen, on behalf of Mphasis that concludes this conference. Thank you for joining us and you may now disconnect your lines.