eClerx Services Limited
Q4 FY'20 Earnings Conference Call

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Moderator: Ladies and gentlemen, good day and welcome to eClerx Services Limited Q4 FY'20 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. Rohitash Gupta – Chief Financial Officer, eClerx Services Limited, thank you and over to you, sir.

Rohitash Gupta: Thank you. Good evening and thank you for joining eClerx Q4 & FY'20 Earnings Call for the year ending 31st March 2020. Firstly, I would like to thank our employees, customers, shareholders, regulators and vendor partners who have very thoughtfully helped us over last few months in reducing the economic, business and employee health threat caused by the pandemic.

The delivery paradigm for BPM industry and eClerx changed overnight. I want to specifically call out the monumental efforts of our IT teams to achieve an unimaginable feat of migrating from closed ODC environment to flexible work from home environment in a matter of weeks supported by our administration to deliver work from home assets during lockdown and our HR team for reaching out every single employee to check for their wellbeing. As a combined effort, we reached a work from home coverage by mid-April which exceeded similar metric of our much larger client captives and BPM peers in India. Our work from home switch was very swift in our global operations due to higher proportion of pre-existing work from home infrastructure. By May end, we were able to achieve work from home productivity similar to work from office.

Our focus in last few months has been on relentless execution of business continuity plan with single minded focus on employee safety. Last 10 days of March were severely impacted for India delivery due to sudden transition which required us to put multiple pieces together including client approvals, availability of computers and broadband at employee homes and enablement of data security on a very challenging and diverse IT environment. Almost all of our clients were extremely supportive for work from home enablement, including nearly all of the banking clients, thereby approving vast majority of our offshore delivery to work from home in very quick time. Further in some cases, where certain processes such as voices were not approved to do work from home, we were able to eventually migrate them to alternate workstreams such as chat. Onshore consulting and Fayetteville delivery were also impacted for part of March due to furloughs and shelter-in-place orders. However, CLX was hit the hardest in Q4 due to severe health crisis caused early on due to COVID-19 in Italy. We hope that demand situation for CLX will be alleviated in Q2 as Italy returns to an early normalcy now and we hope to see more brands ready to use our nimbler CGI capabilities thereby accelerating market shift from traditional photo shoot and post production processes to CGI.

'Overall peak supply constraints impact' and 'demand softness lead revenue decrease' due to COVID are likely to play out in Q1 and hence Q1 will see considerable decrease in top line and possibly more adverse impact on bottom line and we hope to return to our historical performance levels now by late FY'21. On demand side, we saw delays both in go-live of new projects and roll offs, although overall roll offs have exceeded new sales for last few months contributing to anticipated revenue decline in Q1. New client conversations also slowed down as clients were reassessing their priorities and reshuffling their budgets. Amongst our client industry sectors, Travel was hit the hardest, however that is about 2% of our total revenue, thereby not causing any major impact on us. Much of our revenue comes from Fortune 500 type clients in industries that did not come to a complete standstill during this crisis. That coupled with the fact that we were close to 90% delivery within a month of lockdown ensured that revenue impact due to supply constraints was limited only to late March and April. On pricing front, H2 FY’20 was relatively better period for us as we locked price hikes with several of our top 10 clients. Our near-term approach is to offer clients price competitive managed services solutions to their emerging challenges and changing priorities in tackling COVID impact on their businesses.

Moving on to Q4 Financials, eClerx completed Q4 with US$47.7 million in revenue with a constant currency decline of about 6.4% on YoY basis with vast majority of decline coming from offshore business. Half of the QoQ decline of about US$4 million was attributable to COVID impacted supply situation whereas rest of the decline was due to planned roll offs that happened earlier in the quarter that could not be replenished due to tough demand environment. Amongst our strategic areas, Analytics has maintained double-digit growth in Q4 YoY, but we saw a decline in Managed Services in Q4 due to lower volumes in early part of Q4, direct impact on travel clients who majorly are on Managed Services model and coupled with supply constraints in later part of Q4 as discussed earlier. Our other income during Q4 increased sharply by about INR 55 million due to forex movement related revaluations. Our EBIT in Q4 stood at INR 760 million declining sequentially, with almost all of the decline contributed by the revenue drop. Our hedges of about US$127 million will strike at INR/$ 75.2 giving us visibility of locking rates similar to current spot over next two years.

However on FY’20 the annual basis, we return to a modest constant currency growth of 0.6% closing the year at US$200.5 million. We have not accrued a SEIS income for FY’20 and we will review that during H1 of FY’21 when SEIS policy implementation is clearer and foreign trade normalizes. Our FY’20 EBIT stood at INR 2,993 million which was lower by about INR 121 million YoY, however it remain flat if we were to adjust it for SEIS and impact of AS116. Our cash balance at year end stood comfortably above US$100 million and we had an exceptional operating cash flow generation in FY’20 at about INR 3,328 million which is more than 150% conversion of PAT.

Excluding the possible catch up of SEIS income, we expect further sequential decline in revenue and in absolute EBIT in Q1 versus Q4 due to increased work from home costs. We expect capex and thereby depreciation to increase during FY’21 due to provisioning of work from home infrastructure. However, we have taken several measures to minimize this margin impact due to new unplanned costs through one to two quarters deferral of increment and promotion cycle, natural reduction in travel cost and reduction in administrative services and office rental costs. We are also seeing sharp reduction in attrition in Q1, which may help bring productivity improvements in the near term. We expect our FY’21 effective tax rate to be around 26%.

We are seeing increased deal flow for our continuing target search for inorganic growth and also seeing moderation in target valuations. Cash has been the most valuable asset for us during the current global crisis and we expect to distribute it to shareholders as per our stated policy, but only after giving careful consideration for higher cash needs for the organic business during the current uncertainty and for increased probability of inorganic growth event.

Except for unforeseen circumstances during March, we are satisfied with the overall outcome of this year and will continue to focus on execution in FY'21 to overcome challenges posed by the economic environment.

With this I will open up for the Q&A.

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

Manik Taneja: This is a question both for PD and Anjan. If you could detail out your thoughts across the three streams of our business in terms of how you are seeing business getting impacted because of COVID and how do you see things evolving going forward?

PD Mundhra: Let me attempt to answer and Anjan can supplement with his thoughts. I think as Rohitash alluded to in his opening remarks, we have seen softness in a couple of specific areas; one, definitely was CLX because of the situation that was prevailing in Northern Italy which affected not just us, but also our clients who were unable to send work to us because they were also in lockdown. We have also seen impact on our retail and travel clients who are clients of the digital business. We saw some impact initially on the voice processes like Rohitash mentioned because those are not very amenable to being delivered from home. But on the whole, I would say, our telecom business and the banking business has been more resilient because I guess to a degree, the nature of work done is more business as usual support and less discretionary in that in that sense. With all that said, I think if I net it out, you saw that we had a drop in Q4 over Q3. Q1 we expect will be the trough because we will have some supply side effect that still lingered on through most of April and you certainly have demand side effects that will continue to play in Q1. I think as we go forward, the hope is that we should slowly start seeing recovery from the trough of Q1. The pace of that recovery is still uncertain because I think it is linked also with the pace of opening up in the West. But I think broadly speaking; we would expect sequentially some improvement in the remaining quarters. If all goes well, hopefully by the time we get to Q4 this year we will be at a similar trajectory as where we were in Q4 last year. But I mean that is just shooting in the dark. I have no concrete way to say and it is certainly not a guidance, but I think directionally we are quite clear that Q1 should be the trough and hopefully from Q2 we should see a modest recovery from there.

Manik Taneja: The other question that I had was for Rohitash. So you talked about some. Cost related to work from home enablement hitting us in Q1. Is there some hit of that cost even in Q4 FY'20?

Rohitash Gupta: Manik, Q4 was very minimal. Q1 is the substantial cost which will run into multiple of crores, but I think Q4 was very negligible on that count.

Moderator: Thank. The next question is from the line of Sandip Agarwal from Edelweiss. Please go ahead.

Sandip Agarwal: I have just two questions basically. One, where do you think that the impact of COVID will start flattening out? I understand you are saying Q1 is where you will see probably same level of activity which was there earlier. But, the question is more relevant from the perspective that, we have seen quite a bit of pain before that also. So, how will you put this pain that put our recovery more behind than we were earlier anticipating to the extent of the impact of this pandemic or it has a rippling effect of exaggerating that pain for us, in the sense that if we were earlier expecting three, four quarters recovery time and this pandemic let us say impacts us two quarters, so is it a six quarter pain versus your earlier expectation or it could be eight, nine quarters, that is the way output? I am not saying exactly the quarters going forward. I am just trying to understand whether there is impact of this pandemic also on our recovery path?

PD Mundhra: Sandip, I will confess I am not sure I fully understood your question but let me try and attempt to answer it in a different way. So if you go back to the statement I made to Manik, which again I will caveat by saying conjecture at this point that we hope that Q4 of FY'21 gets us back to levels of where we were in Q4 FY'20. If that scenario plays out, then effectively we have lost a year, right because it has taken us a year to get down to the trough and then get back to the place where we were pre-pandemic. So that is one way of thinking about it that I guess Q4 was a US$48 to US$50 million, so the next time we reach that milestone is when I would say that we have reversed the effect of the pandemic.

Sandip Agarwal: And also to some extent I wanted to understand that why we are talking about only the cost hike because if we see there are many areas where cost cutting could be significant and this is probably the time where we can re-innovate or rethink on our costs structure. I understand that in our business model, work from home cannot be as well implemented or I would say as easily doable like probably the software services part, but still I think there are a lot of areas where we can contain cost in a significant way? Second, why we are not allowing our natural attrition to not fill up for some time till the time we are seeing not having clarity of growth coming back or till the time in a revenue declining scenario. So is it a very optimistic outlook for future so that we are ready to take a hit right now or is there something else which I am missing?

PD Mundhra: Sandip, let me answer that in reverse order. Your first question was about natural attrition. And if you look at the investor pack, we have a slide on headcount and you will see that we were at 9,500 total headcount in FY'19 Q4 and we are at 8,500 total headcount in FY'20 Q4. So we have dropped a 1,000 FTE give or take over that one year period. Exactly for the reasons you described that obviously as we saw some challenges on the revenue front, we let natural attrition take its course and right size the staff strength. Obviously, post the pandemic, I would say to the comments Rohitash made, attrition has really, really reduced because obviously if you put yourself in the shoes of the employee, it is hard also for them to find alternative position at this time. So April and May I think we have seen our lowest attrition ever. But before that, to the point that you were making, exactly that is a strategy that we have allowed natural attrition to rebalance total team size. On your first question of cost saving opportunities, absolutely, I think we have tried to utilize all those opportunities as Rohitash mentioned that we have deferred pay raises for some between three to six months after a certain seniority in the organization, senior management has elected to keep the pay flat this year. Obviously, we have had savings on travel. We have had some savings on services like local transport, the cab services and buses that we run, housekeeping, etc., So there will be substantial elements of savings as well that will offset the BCP imposed costs and therefore I think to your point probably the biggest net driver of reduction in margin in Q1 is a drop in revenue. So, we do expect a drop in revenue in Q1 over Q4 and the margin that was coming from that revenue will also go consequently. So, I think from a BCP perspective not all the costs are incremental, I think we have the ability to offset a lot of it. But the drop in revenue will definitely be painful.

Sandip Agarwal: A follow up on that. I agree the point you mentioned of 9500 becoming 8500. But our attrition rate is such that we could have brought down probably this number to 7500 unless it was very-very critical, or we have built in some bench for some sharp turnaround in growth which probably got impacted due to COVID-19. So I was just trying to understand that limited point that was there a sharp turnaround in site which got impacted because of these things?

PD Mundhra: Sandip, if I can just respond to that, if you look at revenues, FY'19 was give or take US$200 million, FY'20 was also give or take US$200 million and we dropped 1,000 heads over that period for delivering essentially the same revenue. So I think we were quite happy with our exit in FY'20 Q4, we feel that 8,500 headcount was right size to service the base of revenue that we had at that point. From a utilization perspective, we thought that all those metrics were in the right zone.

Moderator: Thank you. The next question is from the line of Madhu Babu from Centrum Broking. Please go ahead.

Madhu Babu: What is the quantum of revenue decline we can look in because large caps itself was like 5%, 6% drop will be there in 1Q, considering that we had a soft 4Q, so what is the kind of drop we can look at for 1Q?

PD Mundhra: Madhu, I would not want to put a number on it because we do not really offer guidance as a policy, but I think direction of travel is very clear given that we are sort of almost mid-June by now, so we thought it is fair especially in light of the recent SEBI guidance to share the COVID impact to at least show you the direction that we expect Q1 to go. I would not want to share a precise number at this stage.

Madhu Babu: Second, on the capital allocation. Now the cash is around Rs.770 crores. Last time we did around Rs.265 crores kind of the buyback. So, I mean, even if you conserve cash, I think a similar quantum of payout can be expected this year because the balance sheet is sizable in terms of the net cash position?

PD Mundhra: We have not taken a call on that, but I would add two points of caution -- One is that to the point we made, we do expect to see more inorganic opportunities in the wake of the COVID pandemic because especially for smaller companies, I think this has imposed stress on their business models. Rohitash probably receives about 20 to 25 teasers any given year. We expect this year we will see a significant increment to that. So we want to retain some cash to take advantage of those opportunities if they should present themselves, point one. Point two also, I think from our own internal perspective, obviously there is a little bit more uncertainty than usual. Given the impact of this pandemic, is there a second wave, not a second wave, so we would want to conserve cash also to hedge against that uncertainty. Having said that our stated policy is to pay out at least 50% of net income. And I think from that perspective we remain committed to doing that over periods of time.

Madhu Babu: So just on that CLX part, I think predominantly they are based in Italy, which has been one of the most hit and we have a couple of other centers in Thailand as well apart from US. So just on the global delivery centers, how is the momentum and acquisition what is the target we are looking this time because it has been a good amount of time since we have done a sizeable acquisition?

PD Mundhra: On the CLX front, I think as we shared, we saw some effect in March because Italy went into shutdown basically end of February, April was the trough, May was slightly better, June is I would say getting close to normal, and hopefully July will be semi-normal in terms of production volumes levels. So that has been the trajectory that we have seen in CLX. And Thailand is basically a back office to Italy, so the volumes they see are a function of incoming demand into Italy. In terms of your second question on areas of interest, I think that has not really changed. We continue to like businesses that serve large corporate clients, typically, a performing work that has a continuing demand and therefore they tend to have long tenure relationships with their customers. I think those are pretty broad filters, the nature of the customer base and the type of work are important filters for us besides of course financial filters around valuations, etc., So we continue to look within that target segment.

Madhu Babu: Last one is work from home team, I mean, it is going to continue even post-COVID or is it just over hyped for the medium term and how are we because we are not a typical IT services company, we are process-driven and at least large banking accounts approvals might be difficult, so next three, four year perspective how do you see this work from home, whether it be a part of your existing delivery model or it will just fade away?

PD Mundhra: So I think it is not totally clear at this stage. I will share with you where we are and near-term what we see. So it did take us time to convert a large part of our workforce into work from home because all the IT infrastructure we had was desktops in the office besides laptops that were given to relatively senior employees. So first of all, the challenge for us was to procure laptops in that quantity along with things like data cards and then distribute them to all the employees in the middle of the lockdown and the curfew. So that was a herculean challenge. But we got over that and I think today of our 8,500 staff, probably I would say barring maybe 300 to 500 people, everybody else is equipped to work productively from home. So I think we have managed to make the transition to the point that Rohitash was sharing in his opening remarks. As we go through this model, I think it has both pros and cons. We definitely see people able to put in more time if required because they no longer have to spend time on the commute. On the other hand, there is a latency penalty because obviously the connectivity at home may not be as good as that in the office. There is also information security risk enhancement when people work from home as compared to what we are able to manage in the office. And from a client perspective, I would say some clients do not have a strong opinion on where the work is done, but some others do, and they tend to prefer people working from the office. Primarily, I would think from an information security perspective. So I would guess that once the health situation stabilizes, we will end up going back to the offices although a small percentage of staff may continue to work from home especially in functions like shared services. But I think people engage in doing work that handle sensitive data, I would think that most clients would be more comfortable having them back within the confines of the office in a more controlled environment.

Moderator: Thank you. The next question is from the line of VP Rajesh from Banyan Capital. Please go ahead.

VP Rajesh: My first question is what is the ramp up in Fayetteville -- has it started coming back to normal kind of a shift that you used to have before the COVID happened?

Anjan Malik: So actually, Fayetteville has been one of the first facilities to get back to normal. So, I think over this week and next week we are basically expecting to be back to normal over there. So we are obviously going to be taking into account things like social distancing and some of the new rules that may be put into place, but North Carolina is probably one of the states that was not that hard hit. So, it has been relatively fairly quick to return.

VP Rajesh: So from operating level, it would be profitable or breakeven or losing money?

Rohitash Gupta: I think we have spoken about it in previous calls as well. So in Q4, we were profitable at EBIT level excluding the COVID impact and for the full year we were EBITDA positive in FY'20 in Fayetteville.

VP Rajesh: In terms of Q1, would that be the case or meaning, what I am trying to understand is that once it normalizes it will back to be profitable, is that a fair assumption?

Rohitash Gupta: Yes, as Anjan was mentioning, now we are returning back to office in Fayetteville. The second caveat will be that the normal volume should also come through….when I say normal, I mean, let us say February kind of volumes, once that comes in, we will be back to EBIT positive straightaway.

VP Rajesh: My next question is regarding the capital allocation. So, we are sitting about US$100 million of cash and looking at the free cash flow we probably generate another let us say US$40 million of cash flow per year. So, in terms of the acquisition, yes, I agree that you will get a lot more opportunities these years, but given where the stock price is and I think last year the buyback at Rs 1500, so therefore it makes sense to go for a buyback because whatever cash is left after that, I am sure you will be able to find acquisition candidates that you have enough cash. I am just curious like how you guys are thinking about it because the stock is at 25% of your last buyback price?

PD Mundhra: I think definitely the buyback is an option for us and as you may know we have used buyback as a vehicle to return cash to shareholders pretty consistently over the last three or four years. So, it continues to be an option for us. Price, size etc. is all TBD, timing as well. But you are right; I think that is an option under active consideration.

Moderator: Thank you. The next question is from the line of Akshay Ramnani from Axis Capital. Please go ahead.

Akshay Ramnani: My question is on pricing. You mentioned that you expect to provide some price concessions to clients. So, what is the quantum of price concessions are you seeing right now and how much of these price discount would you call it as temporary or permanent in nature and how soon do you expect to recoup on the pricing front?

Rohitash Gupta: I think you may have misheard. I very clearly mentioned we have seen uptick in the pricing and H2 of FY'20 has been relatively better for us on the client pricing front. So, there was no discussion on the price reduction. Now, if your question was about forward looking, "Do we have to give price concession?", I do not think there is any such consideration or request on the table as of now.

Akshay Ramnani: Ok, and in this scenario where we could aggressively provide pricing discounts to clients, and we have been seeing some shift to onsite delivery for a few years now, so would you call this COVID as a point where we can think about offshoring more of your work providing some price concessions to clients?

Anjan Malik: If the question is broadly, "Do we see any change in the demand for onshore work or offshore work because of COVID?" not necessarily, I think in the early days or the middle of March or late March there was some discussion about whether there was too much concentration risk in India for many of our clients. But I think as time has passed, there has actually been more comfort around the way Indian vendors and the captives managed delivery during this period. So, I would say that there has actually been more confidence built to the extent that "Do we think that there is an opportunity to do more offshore work?" We think so, yes. "Do we continue to feel like customers who want work done in their local jurisdictions as a result of more localized demand because our customers are not able to travel as much?", that also possibly, yes. So, I think we see demand both for offshore and onshore over the medium term, but we do not think that there is a marked reduction or increase, one way or the other.

Akshay Ramnani: Last one on revenues. So, can you quantify what percentage of the revenue would come from impacted verticals of say travel, retail, manufacturing or other impacted verticals as per your sense and what is the proportion of revenue where you have been seeing challenges, any color on that front?

PD Mundhra: Rohitash can supplement. I will just kick off with a couple of thoughts. I think answer to that question is also a function of time horizon because obviously in the immediate aftermath of the lockdown, we saw some constraints almost across the board, but then as time progressed in certain areas we were almost able to get back to what I would call normal levels of demand and delivery. Continuing effect I think is most in travel and retail and to some degree also in the luxury business in Italy. So, I would say primarily concentrated around our digital business. Next would be some impact on our customer ops business and least affected would be the banking business, purely again as a function of the kind of work we do in each of those three verticals, but Rohitash, you can add some more color if you want.

Rohitash Gupta: Yeah, that covers it all, PD. I already mentioned that travel is barely 2% of our total revenue and retail if you include the luxury good brands in it is probably high single digit % And beyond that it is banking, telecom, hi tech, those kind of industries which make up vast majority of our revenue which were not majorly impacted, I would say.

Moderator: Thank you. The next follow up question is from the line of Manik Taneja from Emkay Global. Please go ahead.

Manik Taneja: PD, I wanted to pick your brains on a couple of things. Number one thing is that at least in some parts of this portfolio we typically compete with the captive of our customers and in the past when we have seen currency essentially depreciate sharply with some lag we have seen more competition emerging from the captive side or they are translating in terms of price discounts. So, your thoughts here? Second question is that one of our large customers on the telecom, media side essentially has also been building up his own captive in Chennai. How do you see the situation evolve with that customer over the medium to longer term?

Anjan Malik: Manik, captives have been a way of life for the last two and a half decades. So I am not really sure if it is a new phenomenon as such. If you look at actually IT wages indexed to US dollars over the last decade or so, I think you will find that most indices will show you a compounding increase of between 5% and 7% per annum, right. I think if you compare for example vendor prices like ours, you will see that they have been flat to declining because of productivity, rate changes, lower inflation rates or skill mix, etc., What I would say is that experienced buyers know the game very well that going from vendor to captive or picking the captive strategy is typically a pretty short-term one to two year viewpoint, whereas I think if you look at total cost of ownership of a three to seven years the vendor model typically is cheaper, caveat it for obviously functions that are very sensitive or functions that are rapidly changing or that need to be co-located with technology because there is a big technology roadmap may have a different consideration, right. So we do not really see that gap the vendor choice being driven so much by FX but much more by broader discussions about if you look what functions are so-called proprietary that they have to stay in or those that they feel that co-locate with strategic technology roadmaps giving it to vendors actually slows it down. So I think that is usually the first determination. We have not really seen that change and I think in COVID times we do not know what the next steps are given just the travel restrictions that many of our stakeholders will have around sending work to India or in fact setting up new captives. I mean, I guess it is somewhat reflective in recent times in reductions in roll offs, but it is very temporary for now as far as we can see. The second question around the large telco media, I mean, this particular company uses something in the region of 25,000 vendor personnel just in the call center space, for example, they are very sophisticated buyers of both, what I would call third-party services as well as in-house facilities both for customer care, for field operations and for technology services and in fact they buy a lot from most parts of the world. So, I would say for a sophisticated buyer like that, these additional facilities tend to be at best and there have been very really to be an all or none decision. Never is a big word but we do not really expect any change in the strategy with respect to also with what I would call high performing vendors in the short to medium term.

Moderator: Thank you. Ladies and gentlemen, that was the last question for today. I now hand the conference over to the management for their closing comments. Thank you and over to you.

Rohitash Gupta: Thank you everyone for joining with us today. Hope you guys will stay safe and look forward to talking to you next time.

Moderator: Thank you very much. Ladies and gentlemen, on behalf of eClerx Services Limited that concludes today’s call. Thank you all for joining us and you may now disconnect your lines.