Eclerx Services Limited
Q2 FY21 Earnings Conference Call

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MODERATOR:
DIWAKAR PINGLE – CHRISTENSEN IR

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AKSHAY RAMNANI – AXIS CAPITAL LTD.
DEVANG BHATT - ICICI DIRECT SECURITIES
V P RAJESH - BANYAN CAPITAL ADVISORS LLP
BALDEO SINGH – ECLERX SERVICES LTD
PANKAJ GARG – INDIVIDUAL INVESTOR

Diwakar Pingle:

Good evening, good morning friends, based on the geography you are in. Welcome to the Q2 FY21 earnings call of eClerx Services Limited. Please note that this webinar is being recorded. The transcript of the webinar will be made available in a week's time from the call.

Joining you today to give you an update about the quarter and to answer your questions, we have with us the top management of eClerx. PD Mundhra, Co-Founder & Executive Director; Anjan Malik, Co-Founder & Director; and Rohitash Gupta, Chief Financial Officer. I now hand over the conference to Rohitash Gupta, Chief Financial Officer of eClerx Services. He will make his opening remarks and then we'll move to the Q&A. As far as the Q&A is concerned, I will let you know the rules as we start that particular session. Over to you, Rohitash.

Rohitash Gupta

Thank you, Diwakar. And good evening to all of you who have joined eClerx's Q2FY21 earnings call for the quarter and half year ended on 30th September 2020.

Our USD revenue in the quarter was $48.5 million, which is sequentially up by 8.1% in USD terms and 7.1% in CC terms. We saw Q2 YoY constant currency revenue decline of 1.0% in offshore business and decline of 13.2% in onshore business.

The total INR revenue in Q2 was at INR 3,604 million and was 3.5% up sequentially as we had lower other income this quarter due to adverse forex movement as well as cash outgo on account of various corporate actions. All the margin metrics were up in Q2 on QoQ basis as well as for H1 on YoY basis. Our net profit this quarter was INR 610 million which is 17.8% up sequentially. Q2 margin improvement was due to lower work from home costs and lower attrition. Wage increase for 95% of India staff were effective from 1st July, however, increments for others in upper management will be effective from 1st October.

We had cash balance of INR 7,582 million at the quarter end, which is about INR 1,300 million higher on YoY basis. EBITDA to net cash conversion was very satisfactory at 90% this quarter and was partly aided by an improved DSO of 74 days. We have been able to maintain payout ratio at historical levels as we paid dividend of INR 1 per share, amounting to INR 34 million, in addition to the buyback of INR 1,095 million during Q2.

The currency and geography concentration has tilted towards Euro this quarter due to sharp recovery in CLX revenue. QoQ increase in managed services share was again aided by CLX growth as well as new deals being increasingly sold as managed services. Staff utilization improved to 79% due to lower attrition and improving productivity in, now, stable WFH environment.

Lastly, based on the Q2 revenue uptick and current deal flow, we expect H2 USD revenue to be better than H1.

With this, I will hand over the call for Q&A.

Diwakar Pingle:

Thanks Rohitash. We will now begin the Q&A session. Participants having questions will have to click on 'Raise Hands' button for asking questions. The first question is from the line of Akshay Ramnani. Please go ahead.

Akshay Ramnani:

Congratulations on very good set of numbers. Can you give some commentary on what is driving the confidence on a better H2? Some color on the deal wins and pipeline over the past 2 quarters? And also how the pipeline has shaped up during Q2? Are we better than pre-COVID levels? So some color on the demand? And second one I have on utilization. You've seen sharp improvement in utilization levels, which have also driven margin expansion. So do you think these level of utilization and margins are sustainable going forward? Or do you expect them to moderate a bit?

PD Mundhra:

I think when we make the statement that we expect H2 to be stronger than H1, a couple of things to keep in mind. Obviously, H1 also includes the very muted Q1 that we had, which was most affected by COVID constraints, both on supply side and demand side. And we would expect that, that doesn't recur in H2. So hopefully, what the performance that we've had in Q2 becomes more representative of what the baseline is for H2. So that's one point to keep in mind.

The second thing I would say is that your question on pipeline and demand, I think it's fair to say that we've been surprised positively by the speed at which demand has recovered. Because if you recall our remarks from the Q4 earnings call, we were originally anticipating and hoping that we recover to pre-COVID levels by Q4 of this year, the Jan to March quarter. Whereas, actually, if you look at performance now, we are pretty close to those levels in Q2, Q3 itself. So from that perspective, yes, certainly, the recovery in demand has been faster than what we would have anticipated. Pipeline also continues to, I would say, be as strong as it's been in the past. So it's at the same levels as it's been historically. A lot of the work is also sort of project work and tied with change because many of our clients, for example, given the COVID experience, are wanting to adopt more digital presence, in a more accelerated fashion than they might have done otherwise. So there is some fair amount of COVID-related disruption that I think has created opportunity for us across our businesses in digital, in CO and in the markets business. So I think that's the foundation for the statement that we expect H2 to be better than H1.

On utilization, I can take a quick response, and then maybe Rohitash, you can supplement. So I think one thing that we've seen is obviously much lower attrition in the COVID period. And also because of the sharp recovery in demand, we ended up using some of our bench resources to provide services against those projects. So, I would say the utilization level at 79% that we had in Q2 is probably, is not going to be something that's sustained over the longer term. So you may see some reversion to the mean there. But I would say that we get more efficiency opportunities as we go forward. But 79% probably is quite high even by historic levels. So there might be some onward pressure on that number, but I'll let Rohitash talk to it.

Rohitash Gupta:

Thanks, PD. Yes. So as PD mentioned, this is very, very low attrition environment that we are facing which is very unusual. As you know, last year same time, our attrition was more than 40% at firm level. And today, we are sub-20%. So in the current circumstances, we are able to run with relatively lower benches. But as soon as the normalcy returns in two senses, both in economy as well as lockdowns, I think attrition may go up, and hence, some bit of utilization may taper off just on that count alone.

Akshay Ramnani:

Thanks. So, if I can chip in just another one. I wanted to know the outlook for both set of clients that are top 10 and the emerging set of client. So in this quarter, top 10 has been flattish and growth has been driven by the emerging clients, I assume CLX business impact there. So going forward, how would you break outlook for these 2 buckets of our business?

PD Mundhra:

So Akshay, I think if you just take a step back and look at longer-term trends over the past 3, 4 years, I think the trend is quite clear that growth has been fostered in our non-top 10 clients and partly by design, than in the top 10. And I would extrapolate that in the future as well, barring some bumps quarter-on-quarter given the volatility. But otherwise, generally speaking, I would say expectation is that the non-top 10 will grow faster than the top 10. And that, I think, helps us also diversify revenues and become more resilient as a business.

Diwakar Pingle:

The next question comes from the line of V.P. Rajesh of Banyan Capital.

V.P. Rajesh:

My first question is regarding CLX. As we are hearing about the second wave in Europe, how do you feel about that business continuing or getting disrupted again? Just trying to understand what impact do you foresee with the second wave coming in back in Europe?

PD Mundhra:

That's a great question. I think up until now, as of even as late as yesterday, it seems that the new restrictions in Europe and in Italy, in particular, are aimed more at curtailing social activity and more discretionary activities. And the big effort is being made by governments to keep businesses open and to keep the economy open as much as possible. So for all the rules that have currently been announced, we do not anticipate material effect on the CLX business. Having said that, of course, if the health situation takes a substantial turn for the worse, and new restrictions come in, which are more like what was there in February, March, then possibly, we could definitely see an impact. But at least as of now, that's not the case based on everything announced by the government so far.

V.P. Rajesh:

My other question was just on the EBITDA margin. Do you think this almost 30% EBITDA margin we have posted this quarter is sustainable? Or do you foresee it dipping again? If you can just comment on that?

Rohitash Gupta:

Thank you for your question. So as I mentioned in the previous answer, so there are 2 or 3 main factors why EBITDA or any profit metric for that matter has jumped substantially in Q2 versus the historical levels. First reason, as we already discussed, is the utilization, which is currently at a high because of lower attrition environment. Second is basically our travel cost, which used to be substantial in the normal times, but in entire of H1, travel, international travel for either business development or even for project ramp-up, training, et cetera, has more or less come to a standstill. So that's a significant saving. And the third one is that although most of the office cost, office-related costs are somewhat fixed in nature, but there are some savings that happen when your office is not functioning to 100%. It's hardly functioning to, let's say, 10% or less capacity. So these 3 are unusual factors, which are aiding to, I would say, somewhat exceptional margin performance, especially given the backdrop of the environment. So some of it, we think, will not be sustainable. But hopefully, as the economy turns for the better, revenue growth trajectory will hopefully make up for it.

V.P. Rajesh:

That's helpful. And if I may, just 1 more quick question? Any update on the M&A pipeline? What are you seeing out there?

PD Mundhra:

We continue to look at all available opportunities. And I would say the pipeline is as strong as it's been. So Rohitash probably reviews 30 to 40 potential targets any given year. And then, of course, there's a set of filters that you go through in terms of attractiveness of the business, fit with our business, evaluation metrics, strength of management and so on and so forth. So pipeline continues to be good. But as of now, we have nothing specific to report. When we do, you guys will be the first to know.

Diwakar Pingle:

We have the next question from the line of Baldeo Singh.

Baldeo Singh:

Congratulations for good results. I've just joined the company as PD also probably have got some discussion with Jagjeet. My question is, digital is very, very exciting, as you know, post COVID situation. Everybody is looking for digital, even the small companies like barber shop and all, so what's our strategy to get into this aggressive market? I mean what's the best way if I may ask, is to get in there?

PD Mundhra:

Baldeo, I would say probably this is a longer discussion, and this may not be the best forum to do that. So probably, we can set up some other time and have a more detailed discussion on this topic because I guess this forum is more for investor questions.

Diwakar Pingle:

Do you have questions V.P. Rajesh?

V.P. Rajesh:

Yes. One more question on the pricing. If you can just comment what kind of pricing you are seeing in some of your top 10 customers? Is it still benign or there is pressure there?

Anjan Malik:

Yes. I think there is pressure on pricing. So all of our clients continue be very focused on the bottom line. Obviously, everybody has been revenue challenged over the last 6 months. So our focus continues to be on reducing costs, both through automation and, I guess, digital first, which is reducing intermediate steps and getting the customer directly, and, of course, through location strategy. And as a part of the location strategy and as part of that automation initiative, there continues to be pressure on vendors like us to look for more innovative ways to reduce costs. Some of it is through pricing, some of it is through volume, some of it is through automation. So yes, I mean, cost pressure remains.

V.P. Rajesh:

And are there any major contracts that are coming up for renewal in that context, which can potentially, again, have a reset on the revenue growth?

Anjan Malik:

No, it's not really of that nature. I mean I think the way the nature of our business is that you have a massive renewal in 3 years and then all of a sudden, there's a reset. I mean when there's pricing pressure, it tends to be built in quarter-by-quarter because a lot of it is reflected in volume and the projects that you run as opposed to sort of one large price change. And as a larger percentage of our business moves towards managed service, managed outcomes, the concept of sort of price reset starts going away anyway.

Diwakar Pingle:

We have a follow-on from the line of Akshay Ramnani.

Akshay Ramnani:

So follow-up is on managed services. We have been seeing gradual inch up in managed services as a percentage of our revenue. Does that give you more visibility on a blended basis in the business? Like we have been historically having lower visibility in terms of upcoming revenues. So do you also expect this trend to continue? Like when do we expect to settle this managed services by?

Rohitash Gupta:

So maybe I can start and then Anjan can chip in. So Akshay, see, there are two facets to it. One, if you look historically until now, objectively, I think FTE deals in the industry have been very, very long duration and renewing year-over-year, right? When we talk about managed services, it's basically a peek into the future. And it's hard to say in future whether FTE deals will be longer lasting than managed. But our bet is that managed services will provide us more visibility of controlling the input and also provide stability in pricing, both for clients and ourselves. Having said that, managed services have a couple of ingredients that we define. First, it has to have some kind of IP, internal IP, which will provides us productivity benefits or automation benefits, some of which will be visible to clients as we can process more transactions, et cetera. Second is multi-tenancy. So in the things that we sell in managed services mode, we are doing it for many, many clients in the similar industries. And that provides domain benefits, knowledge benefits, and things that we have coded in the IP or in the platform that sits below the services. And third is that it provides transaction level pricing visibility to clients, and it becomes much more easier for them to see what it will cost them in their process because they are running something bigger, and we are only doing a piece of it, right? So it provides them that visibility to bake those costs into their own internal cost. So we think it is a better thing to do for future from all perspectives, but it will be hard to say whether they will be longer than FTE in future.

Diwakar Pingle:

We have the next question from Devang Bhatt.

Devang Bhatt:

I just wanted to know like what we have experienced in most of the IT companies is that there has been increased offshoring. What's your view on that, can we do the same thing? And secondly, can we see there's a regime change and you would generate more from some amount of revenue from North America, so if there is a higher tax, would there be an implication on you?

Anjan Malik:

It's hard, I mean that's a very geopolitically challenged question to be able to answer honestly and fairly for somebody like us. Ultimately, we were regulation takers. So our focus continues to be on servicing clients and the feedback that we get from them and from what we see talking to our peers is that cost pressure is paramount, so that’s one. And two, that India has become the destination of choice for offshore work over the last 6 months, much, much more so than other locations. For example, India's response during the pandemic, customers broadly see as much better than, for example, places like the Philippines, Mexico and other parts of Central America. And three, automation capability in markets like India are much deeper. So if you take those 3 things together, we continue to see much stronger demand coming into India. The question is, are we as vendors able to capture that versus it going to captive organizations, which we see our clients building, were continuing to build up.

PD Mundhra:

And I would add one more thought to Anjan's comments, which is I think one thing COVID has done is it's made people question the importance of location, right? Because everything is being done virtually. So for example, in certain situations in the past, clients may have chosen local delivery or even on-premise delivery. And now because that's no longer an option and if somebody has to be remote, then you don't really care if they're remote in the building across the street or remote in India for that matter. And given that this is likely to persist for a few months or perhaps even a year, at the margin to your question, I think, yes, there's probably more offshoring happening because of COVID than there would have been otherwise simply because that USP of being in the same market, being in the same office is no longer available.

Devang Bhatt:

Do you see your off-shore percentage increasing in the next 2, 3 quarters?

PD Mundhra:

So I think that's a much harder question to answer because for a small business like ours, we get disproportionately affected by individual deals, right? But I think are there more opportunities available offshore, perhaps in a post COVID scenario than there were pre COVID? Frankly speaking, the answer is yes. And for all the reasons that Anjan mentioned, I think India continues to be a favored geography for many clients just because of the maturity and depth of talent available.

Anjan Malik:

So I think I'll add one point to that, which is that I think onshore services tend to be much more location specific to the point that PD is making they tend to be at client offices and/or in facility. Whereas, by definition, most of off-shore services than our facilities. And I think the bright line that the industry crossed at the end of March when work from home was allowed, basically meaning that off-shore work has gone virtual and cloud-based, but onshore work has not and has, in fact, reduced. So you can see broadly that the majority of the reductions that the industry would have taken in the first half of this year was really onshore driven versus offshore driven. So if we were betting, we bet that there's broadly more demand offshore than onshore over the next medium term, but that's just a guess.

Devang Bhatt:

Great. So another is on the margin front, so what kind of margins do you think is sustainable, Q1 levels or the Q2 levels?

Rohitash Gupta:

I think both the quarters are exceptional in some sense, Q1 for a lot of disturbance and Q2 for stabilizing in the current situation we find ourselves in or even the industry finds themselves in. So shorter answer is that none of these two quarters are probably representative. I think FY '20 was much more stable year from our perspective. And that should be the baseline for if the things were to become totally normal without any positive or negative after effects. Definitely, if there is a resurgence in offshoring to your earlier point and things like that, then we may be beneficiary of that trend post this COVID crisis. But as of now, I would not say that either Q1 or Q2 are representative.

Devang Bhatt:

Just wanted to know, since we have seen a very volatile growth in terms of revenue. So what could be a sustainable revenue growth in the medium term from your end?

PD Mundhra:

I think the last 3 or 4 years have been sort of challenging for us from an organic growth perspective because as you guys will know, we've sort of impact around that $200 million number. But I would say if you look internally of what's happened, there was a fair amount of churn because we had 2 or 3 sort of large streams of revenue that came to an end because of corporate actions by clients or other reasons. And there was a lot of other sales replacement that had to be done to fill that hole in revenues. As from where we sit today, at least as of now, we have no visibility of any adverse event of that order of magnitude in the future. So we remain optimistic that we should continue to see reasonable growth in the medium term, and I would define that as being at least whatever the industry average is. So if you look at what our performance is in Q2, I would say, it's probably similar to maybe slightly on the upper side of what our peers have reported. And I think if I look at our pipeline and I look at what the expectation is for the back half of the year, I would say, we're probably well positioned to at least report what the industry is expecting to do.

Diwakar Pingle:

We have next question from the line of Pankaj Garg.

Pankaj Garg:

Yes. I have a question regarding our strategy for Europe. We have recently set up a subsidiary in Amsterdam. So just color on what's the plan for Europe?

PD Mundhra:

Our primary European presence is via CLX, which although headquartered in Italy has been serving clients in France and Germany as well. Also, in our digital business, which is headquartered out of London, we've seen increasing traction in Europe. And actually, the subsidiary that we have set up in the Netherlands is mainly into be a hiring vehicle so that we can hire people in that country to serve clients based there. So the strategy continues to be the same, I think, in Europe, which is to push for services from our existing portfolio, especially our focused product areas into those clients where we think that there is good opportunity and a good chance of winning.

Diwakar Pingle:

We have a follow-on again from the line of V.P. Rajesh.

V.P. Rajesh:

Rohitash, a quick question on the EBITDA guidance, EBITDA margin that you spoke about. So for the first half, we are around 25.8%, 26%, call it. And last year, if I remember correctly, you were around 22%. So what can be the reasons that you would be thinking about such a lower number, 400 basis points lower, given that you guys are expecting more off-shoring, given that the business seems to be finally starting to get better? So just if you can help us understand that it will be helpful.

Rohitash Gupta

Yes. I think my comment was more pointing towards the unknown as opposed to guiding towards something. So basically, the current situation is totally new for everyone, including ourselves. And what will be lying on the other side when the dust settles, it's hard to predict. So I was just urging to look into the past and see that in those kind of revenue environment, we have performed to a certain level of EBITDA. And in current H1, because of various positives and negatives, more positives than negatives actually, on the margin front we have performed much better, at least in percentage terms. So I think the reality will lie somewhere in between and not necessarily any particular number.

V.P. Rajesh:

Okay. That's helpful. And on the sales and S&D cost, they were higher, but your BD headcount has come down. So if you can just comment as to what's going on? Are you seeing increase in bonus provisions, are folks meeting their sales quota, and that's why this particular accrual is going up?

Rohitash Gupta:

So that's a good observation V.P. and a couple of reasons. So first of all, when you see the count, it only includes full-time employee count and some people who may be working on other models may not be included there. That's point number one. But more substantially, the cost has increased because there has been a sharp uptick in the revenue in Q2, and this was higher than our earlier expectation as PD alluded to earlier. And that's why since we are doing a provisioning for bonus for the full year achievement, we had to reset the base, and that's why there was a little bit of catch-up. So I think your observation is fair, but there are many underlying pieces which make the numbers happen.

Diwakar Pingle:

Anyone else has a question, please go ahead. As there are no further questions, I am handing it back to Rohitash for your closing comments.

Rohitash Gupta:

Thank you, Diwakar. And thank you everyone for joining in this call. Look forward to speaking to you again next quarter. Thank you.

Diwakar Pingle:

Thank you, everyone, and have a good evening.