"Mastek Limited Q1-FY14 Earnings Conference Call"

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MODERATORS: **MR. YASH GADODIA – ANALYST, CHRISTENSEN INDIA**

Moderator Ladies and gentlemen, good day and welcome to the Q1-FY14 Earnings Conference Call of Mastek Limited. As a reminder for the duration of this conference, all participants' lines will be in the listen only mode and there will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during this conference call, please signal an operator by pressing "*" and then "0" on your touchtone telephone. Please note that this conference is being recorded. At this time, I would like to hand the conference over to Mr. Yash Gadodia from Christensen Investor Relations. Thank you and over to you sir.

Yash Gadodia Welcome everyone to the Q1 FY14 Earnings call of Mastek. Joining us from the management are Mr. Sudhakar Ram – Managing Director & Group CEO and Mr. Farid Kazani – Group CFO & Finance Director. At this point, I will hand over the call to Mr. Ram for opening remarks. Thank you and over to you sir.

Sudhakar Ram Good evening to all analysts and fund managers. The results of Q1, our financial year has changed from April to March, have been mixed in some ways. We have had very good performance in the U.S where we continue to succeed on the Insurance front. We have won new deals in Insurance and apart from our leadership in Billing, we have added customers in the P&C Policy Admin space which is a larger market and we are well on our way to developing our products in the P&C space and delivering it in this fiscal year to these customers. In the U.K, the situation has not been as good. Like we said, some of the large services deals would see a ramp down as our strategy becomes pro solution, so, we did see a ramp down on large account both in services and projects which got over where on both of those accounts, we did see a drop in terms of revenue and that is something that was anticipated. We need to make up for it. We are building up a pipeline. We have also got improvements in our order back log and we expect to make up this difference within the next couple of quarters. The performance in India/Asia again was good. We did win large deals in the Government as well as in Insurance and that part of the business has got a good healthy backlog. It started growing well and also improving in terms of margins and profitability. Like we shared last time, the entire strategy of the company is moving away from commoditized services to high-end solutions which are industry-based and vertical focus as well as vertical products. So, this is a transition which will take time. We do expect that some of the services businesses that we had to book during the down turn, we slowly start exiting out of and more and more of our portfolio will be in the high margin solutions as well as product business. Pretty much, this is along the lines of what we expected in our 3 year strategy and plan and so to that extent, we do see that the pipeline as well as the order backlog are supporting what we expected as growth ambitions and we will continue to grow our business in the U.S, we will continue the whole idea of me moving to the U.K is going to turn around the U.K operations and I do expect to see that producing results in the next couple of quarters. So, with that let me hand it over to Farid to take you through the numbers.

Farid Kazani I will just share the headlines nos. and I am sure all of you must have got the financial statements and the press release.

The operating revenue for this quarter, which is the Q1 ended June was 222.3 crores as against 229.5 crores. In rupee terms there was a drop of 3.2% and in constant currency, the drop is around 6.6%. Total Income was 227.3 crores as compared to 232.9. That is roughly around 2.5% lower. At an EBITDA level, we have done 18.6 crores in this quarter as compared to 26.6 crores. As a percentage to total income, it is 8.2% as compared to 11.4% and I will come back to giving you the bridge of how the EBITDA drop has happened. So, let me just complete the other numbers.

At a PBT stage, we did 10.9 crores as compared to 18.9 and at a PAT of 7.1 crores as compared to 20.3. In the previous quarter, we had a negative tax and that was related to certain U.S tax provisions that were written back post the completion of assessment. To that extent, there was a 1.4 crore negative tax in the previous quarter as compared to a 3.8 crore in terms of a tax pay out in this quarter. The positives that we would like to highlight is the backlog which has actually gone up by 17.2% in rupee terms to 560 crores as compared to 478 crores and in constant currency, it is 511 crores which is a 6.9% growth as compared to the previous quarter. The other highlight has been significant improvement in our cash and, cash equivalent position to around 281 crores as compared to 159 crores. The increase has happened primarily on account of 3 reasons. One is the cash flows generated from operations. Second is in terms of the improvement in the working capital with receivables going down to 129 crores as compared to 139 crores and third, we have been able to structure a deal with the customer where we got advance money against projects of around 79 crores. So, that has helped the cash position to improve to 281 crores.

We added 4 clients during the quarter and 2 clients came in from the U.K, one in the U.S and one in India. Note the client additions are based on recognizing revenue in the quarter.

In terms of the geo splits, due to drop in revenues in the U.K. U.K proportion for this quarter was at 44% as against 49% the previous quarter. Correspondingly, the U.S revenues are reflected higher at 48% as against 44% in the previous quarter. In terms of vertical split, as Sudhakar mentioned, the Insurance business has shown very good signs of growth and the momentum is looking good in the U.S. The U.S itself grew by around 6% in rupee terms and 2.1% in dollar terms. That helped the insurance vertical to grow to 48% this quarter as compared to 42%. Correspondingly the Government business was at 26% in this quarter as compared to 30%.

Our utilization ratio was much lower in this quarter. As against 81.3 in the previous quarter, we ended up with close to 80% and that is linked to the drop in the business in the U.K and therefore correspondingly higher head count carried as bench. Total head count actually ended up with 3,271 as compared to 3,214 in the previous quarter.

Now let me just go back to giving you all an understanding of the EBITDA bridge., If you look at the EBITDA, as compared to 26.6 crores, we did 18.6 crores, that is a 8 crore drop in the EBITDA and if I have to gross it up for 2 items which is the FX Gain / Loss between the previous quarter and this quarter, and also the Additional Other Income which is as compared to previous quarter and this quarter, the actual operating drop in the EBITDA is 12 crores. This quarter there was an amount of 1.5 crores additional spends on product development expenditure plus there has been a mandatory provision for the collections which have not happened and which are over 180 days. That amount was 3.5 crores in this quarter and the last bit is the impact on margins due to the drop in the revenue in the U.K. So, while U.K revenues fell down by almost around 14 odd crores, the corresponding drop in the margin is close to 7 crores. So, the 12 crores actually accounted in these 3 buckets and if you add these 3, it is a 5.5% drop in the EBITDA margin. The product development expenditure 1.5 crores was a 0.7% impact. Provisions for overdue collections over 180 days of 3.5 crores impacted margins by 1.5% and 3+% is on account of the gross margin impact on drop in revenue primarily from the UK as mentioned.

Overall, I think the business is looking good as you look at the lead indicator, which is the backlog. 2 quarters back, we saw a drop in the backlog and the impact of the backlog gets followed through in a couple of quarters and have seen revenue going down. But when you look at this quarter end, the backlog has increased pretty well by – 7% in dollar terms and that should flow through in terms of buildup of revenues, going forward. Also, to give us a flavor on the backlog because I know this is something which most of you would have asked and have been asking on how does the backlog shape up? So, in the current backlog, at the end of June, we have the Insurance business which constitutes almost around 58% and Government business constitutes 26% and within geography, we have almost around 56% coming in from the U.S and 37% coming in from the U.K. The balance proportions are from India-Asia Pacific. This is the overall summary that I wanted to share with you all and I am happy to answer any questions. So, we can get back to the moderator. Thank you.

Moderator We will now begin the question and answer session. We have the first question from the line of from Dinesh Kumar from Aditya Birla Money. Please go ahead.

Dinesh Kumar I have this touch up on what you had said about cash position. So, there is an equal amount of increase in unearned income and other liabilities as well as in other income. Can you give us split up and what is the nature of this contract which you were saying in the introduction speech? Just want to understand what it is whether it is a license income which you got it in advance, so you will phase it out each and every quarter, once you get the revenue recognized. Just want to get a feel about what does it mean.

Farid Kazani Yes. The total unearned income is close to 84 crores. And around 80 crores is an additional advance cash that we have got upfront. There are actually 2 pieces of that. One is, yes you are right, there is license revenue that we get upfront for the year which gets amortized over the 12 months. So, this unearned revenue will get amortized over the next 12 months. But there is also an advance monies from another client for the work that we will be doing for a client in the U.K over the next 12 months.

Dinesh Kumar So, basically you are saying out of 126 crores, 80 crores is the advance which you got, the rest 46 crores is license fee, which you are saying?

Farid Kazani No. Out of the increase in the balance of around 120 odd crores, 80 crores is the total advance money which is split between these 2 items. One is the license fee advance and the second is the advance against a particular project that we got in the U.K.

Dinesh Kumar Okay and what about the rest 46 crores?

Farid Kazani That is the cash inflow through operations in this quarter and the reduction in the normal working capital level that we have been able to achieve with the receivables position going down dramatically to 129 crores.

Dinesh Kumar Okay, that means in the 80 crores, there is only an advance which you are saying.

Farid Kazani That is right. Yes.

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

Rahul Jain In general, as you shared more on the kind of backlog you have got across the board, if you could share more thoughts in terms of what the respective market look like and what is the kind of success ratio we are seeing now and what it was couple of months ago.

Sudhakar Ram Backlog is a good indicator of what kind of revenues and growth we are going to get in the future. We did have a problem in U.K in terms of new business that we shared last quarter and so bulk of the growth has happened out of existing accounts. Our new business engine is working much better in North America. So, our immediate focus is to turn around the new business engine in U.K and start winning new things. What we are banking on is our strong ability in doing large complex Government projects. So, in the analyst meet we had last quarter, we shared a new thing which the U.K Government is doing in terms of G-Cloud. There they are encouraging smaller companies to bid for deals directly rather than going through large system integrators. So, that is something we expect to win deals on and as we go through the next 2-3 quarters, you will see us bidding aggressively on those and attempting to win deals. We are also re-launching ourselves in the Insurance market which is a longer lead time because we are trying to take our P&C experience in U.S and bring it to U.K. I do not expect any results this financial year there but we will build a pipeline this year and of course, actual order books next year. On our existing account, we have to continue to work to build them up and that we need to continue doing. So, that is the attempt to get back onto a growth track in U.K. In U.S, I think the growth momentum is well established. In fact, the biggest change in mix which is happening, which I explained last time was that the services portfolio, which is a low-margin portfolio, across the company is going down and that is getting replaced by more profitable products as well as vertical solutions which is why we expect a margin expansion also to happen quarter-on-quarter, year-on-year on this basis.

Rahul Jain Okay, so just an extension to the same. As you said in U.K market, there are 2 aspects. One is that the Government is allowing smaller player to get into this. So, what is the kind of competition that you would be having and what would be the typical expected deal size, considering that these newer initiatives are starting as a small offing rather than big deals.

Sudhakar Jain Yes, that is correct. Obviously, the NHS deal for us was the 150 million pounds. We are not going to do 150 million pounds type deals in G-Cloud. But typically G-Cloud deals tend to be in the 1-10 million range. So, there is lot of competition. I would say that there are many small companies because moment you put the size barrier, the competition in numbers is very large but in terms of the people who have a track record in executing large complex Government programs, I would say they are in a select few and we are well positioned.

Rahul Jain So, you think our past experience of doing complex Government projects would be a crucial factor considering the expertise which is required is more towards the next generation technology which I think everybody is at par in a way.

Sudhakar Ram Everybody is in par with technology but very few people actually execute fixed price programs successfully. So, I would say we are on par in technology but we are slightly ahead in terms of our ability to take on programs and deliver it successfully.

Rahul Jain Okay and the P&C part which you are saying that you would now more aggressively look UK market for that. So, what is the current landscape. Like if there is a Rs. 100 business, 100 pounds business, then what is the current sort of share or what is the market presence of say large Indian vendors, midsize Indian vendors and global players?

Sudhakar Ram In P&C business, we do not compete with Indian vendors, we compete mainly with Guidewire and Accenture and so on. So, Guidewire has been extremely successful in U.K and Europe. In fact, if you see overall Guidewire revenues, about half their business comes outside the U.S and U.K is their number one market outside the U.S. So, that is what we are looking at in terms of if Guidewire is successful, can we also take our all the expertise we have in the software we have and apply it to the U.K market. So, it is early stages. Still we do not know how large the market opportunity could be for us but we think it can be significant.

Rahul Jain And one question for Farid. If you could give some clue on what could be the likely running tax rate or is there any possibility of any deferred treatment in the coming figures, considering the past losses or something?

Farid Kazani There is some bit of it FIN 48 credits in the U.S,. But they are not too huge. I would assume around 28 – 30 percent effective tax rate for the next year. Primarily because significant portion of our profit comes from the business in P&C in the U.S and there the tax rate is much higher. We are exploring possible structures to reduce that overall tax rate. But I would not want the bank it or take that as a target to be delivered in this year but it is something there on our minds.

Rahul Jain Yes, right and just a small thing that this travelling and conveyance expenses which we have been reporting is significantly lower than what we used to do on absolute basis couple of quarter ago, is it a conscious effort or some re-shuffle in the way of reporting that?

Farid Kazani No, there is no change in the way of reporting. In fact, there has been a conscious attempt to bring down the cost through various means. We have done multiple things to help reduce the cost. One is video conferencing we have implemented across the 3 geos and that has helped in terms of reducing some bit of travel expenditure. Then there are corporate and team meetings that happen, we combine some of that, plus at the commercial level, we have been able to negotiate better rates on hotels and we have also streamlined policies across geos such that the spends are managed and controlled and lastly there is a monitoring process on the expenditure that happens at each geo and by each unit and by each person. So, I think these are normal steps and measures that we would or anybody would look at to control the cost. It is quite possible that there could be certain spikes in travel when we have a foreign travel and teams come in from U.S and U.K to India. But that happens on a particular month. Otherwise, I think we are pretty much well in control of the travel cost.

Rahul Jain Okay and lastly on my side, I know you gave the reason why the profitability was down in this particular quarter but if one has to assume what is the kind of contract based margin input which we would be putting on our portfolio basis so that there could be little ups and downs but what is the current achievable and aspiring margins on the deals which we are structuring?

Farid Kazani If you were part of the analyst meet that happened last quarter, we shared the margins that we would build up over a 3 year period going from a 8-9 percent EBITDA to a 15-16 percent EBITDA level and that will happen gradually. Secondly, in the splits of businesses, the business that comes from Insurance and from the U.S is at a much higher margin almost 50 – 55 percent gross margin. The normal services business that we have is at around 35 – 40 percent and the Solutions business is around 45% gross margin. So, it depends upon really how the mix of this business starts shaping up from now till the next 3 years. Our intention is to get to growth in the verticals business and the solutions business and therefore as an average, we should get much better margins and get to that 16% EBITDA level that we are targeting.

Rahul Jain And we do not see any near term headwind situation from the next couple of quarters, specific on which could be distracting for margin?

Farid Kazani There is no untoward or abnormal items that will impact profitability except FX gain loss . In this quarter, there has been an exchange gain as compared to an exchange loss in previous quarter. That is a translational gain,. And the provisioning that has happened in this quarter of , 3½ crores is clearly mandated as per our policy and the money will get collected in this period and they will reverse.. It is a quarter impact that will get reversed in the following quarter. We have been successful in actually receiving good amount of money in this quarter from some of the Government projects where the money is long outstanding. So, the delay happens but we have to make the mandated provision

Moderator Thank you. The next question is from the line of Dhawal Mehta from Ventura Securities. Please go ahead.

Dhawal Mehta You added 4 customers and out of that 2 are from U.K. So, can you just throw some light on which particular vertical these 2 customers were added and how you see the U.K market panning out in the next few years?

Sudhakar Ram Clearly we see a lot of opportunities in the U.K market because the best track record we have across Mastek, we have always been very strong in U.K. The kind of programs we have executed has been excellent. But we have not spent as much time reaching out directly to customers. Most of our success has come out of working through partners. So, the transformation we intend to make happen in the U.K is to move from partner led business to a direct business by and large, and focus on key verticals. The strengths that we have are in Insurance, we have in Financial Services, we have in Health because we did a major program in Health. We have a lot of Government experience now. We have opened Retail. So, these are the segments that we are focusing on in building strong expertise and market presence in each one of them. So, the strategy going forward is to bring value propositions specifically to market in each one of them. Some things based on IP but certain things just based on our expertise. So, the things that we have won last quarter were in Insurance and in Government actually. So, one was in Insurance, one was in Government. So, it's in the chosen verticals.

Dhawal Mehta Okay. As you discussed in the earlier questions that you are planning to basically launch STG in U.K market in next few years. So, what will be the development cost for that product because it will require some changes because the laws in U.S and U.K market are different. So, what will be the tentative development cost for the STG product and when it is likely to be launched in the U.K market?

Sudhakar Ram Right now, it is still in the survey phase. So, it is early to estimate what are the costs because we have not even established what the differences are and which modules from STG to be actually launched in the U.K. But I think, in the next couple of quarters, we will have clarity there and we can share that.

Moderator Thank you. We have a question from the line of Anshul Dosi from Primus Investments. Please go ahead.

Anshul Dosi Can you give me break up of order backlog once again in terms of verticals as well as geographically?

Farid Kazani At a geography level, the backlog stands at 56% from North America, 37% from U.K and 7% from India-Asia Pacific. At a vertical level, the Insurance is at 58%, Government is at 26% and the rest of the vertical is 16%.

Anshul Dosi When you said about dropping EBITDA margins, if I strip out Other Income and FX Gains, the drop in EBITDA comes at around 15 crores.

Farid Kazani It comes to 12 crores we have EBITDA at 18.6 and 26.6, and the difference between exchange is 5.8. Difference between Additional Other Income is 1.8. Therefore 12 crores is the EBITDA drop which is 5.5%.

Moderator Thank you. As there are no further questions, I would now like to hand the floor over to Mr. Ram for closing comments.

Sudhakar Ram Thanks everyone for making it to this call. As I had mentioned in the address last quarter that we are on a transformation path. We think we can be unique in terms of being a high-end solutions and products company from India. This journey will go through ups and downs. There will be quarter-on-quarter variations but I think the investment that we have made over the last 3-4 years in building the IP, building the market presence, I can clearly see it paying off over the next couple of years. So, you would definitely see better results from Mastek, going forward. So, thanks everyone and we will connect back next quarter.

Moderator Thank you sir. On behalf of Mastek Limited, that concludes this conference. Thank you for joining us.