"Mastek Limited Q3 FY14 Earnings Conference Call"

January 23, 2014

MANAGEMENT: MR. SUDHAKAR RAM – MD & GROUP CEO, MASTEK LIMITED
MR. FARID KAZANI – FINANCE DIRECTOR & GROUP CFO, MASTEK LIMITED

Moderator Ladies and gentlemen, good evening and welcome to the Mastek Limited Q3 FY14 Earnings Conference Call. As a reminder all participants' lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. If you need assistance during the conference call, please signal an operator by pressing "*" and then "0" on your touchtone telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Diwakar Pingle from Christensen. Thank you and over to you sir.

Diwakar Pingle Good evening to all of you. Good morning to others who might have logged in from outside of India. Welcome to the Q3 FY14 Earnings Call of Mastek Limited. Today we have on the call, Mr. Sudhakar Ram – the Managing Director and group CEO and Mr. Farid Kazani – group CFO and Finance Director. Initially we will just have a brief overview of the quarter gone past by Mr. Sudhakar Ram, post which we will have the operation details of the quarter given by Mr. Farid. After that, we will throw open the floor to Q&A. At this point in time, I would like to hand over the floor to Mr. Sudhakar Ram. Over to you, sir.

Sudhakar Ram Thanks Diwakar and good afternoon/good evening to all of you on the call. The Q3 performance of the quarter ended in December, I think, has been pretty much in line with expectation. The trend towards improving our revenue base from strategic lines of business, which is our Insurance products, vertical product group as well as large complex solutions is steadily going up. So, as compared to, let us say, last year, where that portion of our business was about 70%, end of December for the nine month period, I think, it is closer to 80% or slightly above 80%. So, that directionally is right. So, Services business, which is a lower margin, has been going down and one would see that that shift is also improving our EBITDA margins and profitability quarter-on-quarter. So, that is as per expectations. In terms of deals in the pipeline, we have not done as well in terms of closing everything. There have been things which are slipping to January. But the pipeline itself remains strong both on Insurance and other lines of business. So, we feel pretty comfortable that the order book and the backlog will improve in the quarters ahead. We did have an impact on the North American account that we had given an indication of in November and today, the damage has been assessed in terms of what will be the revenue impact. It looks like somewhere in the 2.4 million a quarter based on what we build on that transformation program in the October-December quarter. So, that is a hole that we need to fill and given the fact that we do expect new deals to come, within a few quarters, we feel confident that we will be able to fill in and get back onto a growth momentum in the US. Broadly, if I look at geo by geo in US, I feel the Insurance story remains strong. This quarter we got rated by Celent, who is one of the leading Insurance Analysts as excellent in terms of our PAS technology.

So, the Policy Admin System, as you are aware, is a new product which we have just launched. Billing, we have anywhere been number one as far as all the analysts go, whether it is Celent or Novarica, in terms of both market position, functionality and technology. But it was pleasing to note that even in PAS, which is a relatively new offering, where we are competing with the likes of Guidewire and Duck Creek, we have been rated ahead of them in terms of technology. We obviously have a larger base of customers in US and we have to inch our way, getting there. In the P&C market, PAS we have seen to be much larger than Billing deals. So, this is a good move in the direction of expanding our footprint in P&C.

In L&A business, it has been a quiet quarter. We did not get too much new accounts but we have been focused on delivering because the key to L&A success is good delivery. Forester's one part is gone live. We have to move the other book's lines of business into that. Wawanesa will go live in 2014. So will Gerber. So, we have to get all these up and running and that is going to be critical for a Life & Annuity insurance business, going forward.

In Services, some of the large accounts which we have traditionally depended on where we were offering pure services, that has dropped. We see a potential in some Insurance accounts slowly creeping up. But it is still not large enough and we are focusing more attention in improving the Insurance services businesses in the US. If I come to UK, I think we have done well. We have grown the business and we continue to see a growth momentum and this growth has come out of large accounts, strategic accounts that we have. It is also come out of the win that we announced last quarter. Actually, the billing started this quarter which is the HSCIC which is the Health IT part of NHS, where we had a major victory on the G-Cloud platform and we are very well poised to win more deals around G-Cloud in the quarters ahead and even in this quarter we are pretty confident of opening up other departments within the Government. So, the Government business in UK seems to be doing well. The strategic partnerships are going along.

One large Services opportunity in one of the strategic accounts, we know, has been coming down quarter-on-quarter but we are looking at other ways of replacing that. In the Retail part, which is a new vertical, there is traction to our story based on the successes we have had at Morrison that we have built good expertise in the data warehousing business intelligence around the Retail segment. So, we do expect some wins on that in this quarter. So, that is again picking up.

In Insurance, we need to get our IP ready for the UK. Right now, there is so much traction in the US that we have not been able to spend as much time and attention on the UK in terms of Insurance but in the next financial year, I think, we should start rolling out some concrete strategies in that marketplace. But all these put together, UK has started growing. There is a good order book. There is a better pipeline which is visible. As far as I/A goes, while the previous quarter was very strong, we did see a marginal drop this quarter and that is largely because of right shifting of some of the large Government deals. We remain pretty confident of closing it but the I/A performance this quarter should be in Q4. Q4 will be better than in Q3.

Q3 was not really up to expectations but I/A is a smaller part of our total portfolio. To that extent, we will make it up and it will not have too much of an impact overall in terms of business.

So, broadly if I see, we are moving in the right direction. We need to step-up momentum. We need further speed in terms of order book and growth but we will get there. So, overall we are confident and the buy-back announcement that we have made and sent out to shareholders is a reflection of that confidence that we will do well and we can afford to return some money to shareholders and improve return for the other shareholders.

So, with that, let me hand it over to Farid to take you through the details.

Farid Kazani Thank you, Sudhakar. Good afternoon/good evening to all the listeners. I will just give you the headlines on the financials for this quarter and on the YTD. Of the total income from Operations we ended up with Rs. 240.2 crores as compared to Rs. 236.7 crores. That is a 1.5% improvement in rupee terms. In constant currency, it is approximately 0.7% and on dollar basis, it is close to 3% improvement quarter-on-quarter. On a YTD basis, we ended up with Rs. 699.2 crores as compared to Rs. 667.5 crores. That is 4.75% increase. If you add the Other Income, the Total Income for the quarter is Rs. 242.3 crores as compared to Rs. 238.5 crores. That is 1.6% improvement. And on an YTD basis, it is Rs. 704.7 crores as compared to Rs. 682 crores. That is an increase of 3.3%.

I think the most encouraging part of the financial performance in this quarter has been the improvement in profitability In the last quarter, in September we did an EBITDA of Rs. 28.9 crores which was 12.1%. And it had certain one-time effects which gave us an increase or bump-up in profitability, largely in the area of employee cost due to lower gratuity provision and an incentive reversal. If you looked at the real profitability in the last quarter, the EBITDA would have been 10.8%. And if you compare with this quarter, we have done Rs. 35.8 crores EBITDA which is 14.8%.

There is no one-time impact in this quarter at all except that in the UK, the profitability has been higher because where we were able to release certain contingency on a couple of projects, which gave us an improved profitability in the quarter. That could knock off roughly 1.5% from the EBIDTA. So, against of 14.8%, we have done approx13.3% in terms of normal EBITDA in this quarter, and this is quite healthy as compared to the 10.8% in the previous quarter. In terms of the YTD figure, we have done a total EBITDA of Rs. 83.8 crores as compared to Rs. 70.3 crores. So, that is a substantial improvement. In percentage terms, it is 11.8% in this quarter as compared to 10.4%. On the net profit, it has been higher by 21% in this quarter with Rs. 18.3 crores as compared to 15.5 crores. And as a percentage to revenue, it is around 7.6% as compared to 6.3% in the previous quarter. On the YTD basis, we have done 40.5 crores as compared to 36.3 crores. So, that has also been a good improvement. It is 5.7%

to revenue in this quarter as compared to 5.3% in the previous year similar period. These were the top financial headlines. Let me share with you some other details on how we performed this quarter. The order backlog has seen a little drop from 558 crores to 513 crores. In dollar terms, from $89 million to $83 million. It is a drop of around 7.5-8%. As Sudhakar did mention, that it is primarily due to right shifting and we are hoping that the order backlog gets made up from the next quarter onwards. In this quarter, the adjustment has also been done for the ramp down in the North America in the business rampdown that we had mentioned. So the order book actually stands adjusted to that extent. Otherwise, we would have been almost close to similar number that we had in the last quarter. In terms of the cash and cash equivalent, we had Rs. 250 crores as the total number in the last quarter as of September. In this quarter, we have ended up with Rs. 249 crores. So, it is almost at a similar level. As of September, the advance money that we had got from a couple of clients, was Rs. 60 crores. The advance now stands at Rs. 30 crores. So, if I net that off, we have actually improved the cash reserve by almost close to Rs. 29 crores in this quarter. That is primarily because of the improvement in the operating profit and a better working capital management.

On the head count, there has been a minor drop from 3,185 to 3,128 employees as of December end. Utilization has remained at more or less the same level. As compared to 81.5, we had 81.2. There could be an impact in the next quarter because of the ramp down that we are having in the North American clientbut we are hoping to see that pull back once the new business starts building up.

Keeping in mind the strategic intent, the product development expenditure has been higher in this quarter. It has been at Rs. 15.5 crores as compared to Rs. 14.4 crores. And on an YTD basis, it has been at Rs. 41.6 crores as compared to Rs. 30 crores. This is primarily incurred for the product development in North America Insurance business, both in the P&C and some part of it in the Life & Annuity segment. We had two clients' wins in this quarter, primarily from the UK and we are looking at some critical wins to happen from the US in the next quarter. The total client as of December stands at 123 number. This quarter we had a much lower FX loss. If you look at last quarter, we had a Rs. 4.6 crores FX loss which was reflected as part of Other Expenses. As against the Rs. 4.6 crores, we had a much lesser loss of around 76 lakhs in this quarter. In terms of our working capital, the DSOs have been at a very healthy level at around close to 50 days and in terms of our FX hedges, we have done almost on 60% coverage on net exposure over the next 12 months which is roughly around 17.6 million dollars at an average of around Rs. 60. And also done some bit of additional coverage beyond 12 months which is roughly around nine million dollars . That is booked at Rs. 67.7. So, we are hoping to benefit from the higher rates. On the pound, we have done in the first 12 months, £7.7 million, which is covered at around Rs. 95.8 and beyond 12 months, we have done at £3.5 million, which is at Rs. 106. In terms of the split of business between the geographies, UK has done better in this quarter. We have seen UK at 47.8% in December quarter as compared to 45.7 in the previous quarter. North America has been more or less at the same level, at around 46.5% odd. India/Asia Pacific has been lower in this quarter.

Sudhakar did mentioned that there was an impact in the India/Asia Pacific business. That was at 5.6% as compared to 7.4%. We shared some data on the quadrant analysis also. So, that shaped up pretty well. The Verticals and Solution business was almost close to 81% and the Services business has gone down to 19%. And compared to March '13 period, it was close to around 71.6% and the Services business was 28.4%. At the industry segment, the Insurance business is a little higher in this quarter primarily because we had good revenues in North America in the Insurance and also good revenue from a marine Insurance client in the UK. So, the Insurance business was around 52.6% as compared to 49.2%. Government was at 23.4 as against 24.8 and in the Other Financial Services and IT Services, we have been seeing a down-trend over the past few quarters. That has gone down to almost around 24% as compared to 26% in the previous quarter. So, overall it has been a pretty satisfactory quarter in line with our expectations The current cash flow position also helps us to kind of return some amount to the shareholders. We have announced a share buyback of 54.5 crores which is pending approval from the shareholders, which we would expect to get by 21st of February. And once we have the approvals in place, we can look at commencing the buyback. Thebuyback is at a maximum buyback price of Rs. 250. So, that was the overall highlights from the financials and I am happy to answer any questions. I would now return this call back to the operator to open the floor for questions. Thank you.

Moderator Thank you very much sir. We will now begin the question and answer session. The first question is from the line of S Ramachandran from Spark Capital. Please go ahead.

S Ramachandran Just wanted to get management's thought in terms of the Sales and Marketing initiatives or the focus areas within the various verticals and geographies. It will be helpful if you could just highlight where the money is being spent at this point of time. Where do you see the growth happening from a next 12-24 months' perspective?

Sudhakar Ram If I take the US, bulk of our investment is happening in the Property & Casualty Insurance, next is in the Life & Annuity and then small amount is spent on Services right now. We are increasing the sales footprint in Services to see if we can reach a momentum there. In the UK, it is predominantly Government and Health and then it is Retail and the balance is Insurance. Then we have Account Management who cover our large accounts like Capita, BT and so on. India is again between Government and Insurance.

S Ramachandran Would you look at expanding the Insurance into other geographies at this point of time?

Sudhakar Ram We have all three geographies in Insurance.

S Ramachandran Something beyond Europe, into continental Europe?

Sudhakar Ram Not right now because we have to first establish a good presence in UK and get the product successful there before we get into continental Europe. So, in this 12 month period, I do not think we will move beyond UK, US and the Asia Pac countries that we operate.

S Ramachandran And in terms of the US Property & Casualty market, how would you look at the opportunity? Some time back we had a large deal. How is that implementation shaping up and have you seen any large deals or meaningful deals in the pipeline?

Sudhakar Ram Yeah. In fact, we were quite surprised that moment we moved into a policy admin market, the deal size has become larger even if we are dealing with a mid-tier insurer. So, we are looking at 5-10 million, 15 million kind of deals. There are quite a few in the pipeline and we should be able to close our fair share of them in the next 12 months.

S Ramachandran And any update on the large deal which you had won maybe about 8-9 months back? How is the implementation going on?

Sudhakar Ram Nothing specific in terms of it. The entire program is something that is managed by the client. We do not have any specific update on that.

S Ramachandran And it will be helpful if you can give us some broad thumb rules on if you have a $5-10 million deal, how much would be Life and its implementation vis-à-vis what will be the broad break-up like?

Sudhakar Ram Typically, the ratio in our business is about 1:4, 1:5. For a dollar of License, we should do $4-5 of Services.

Moderator Thank you. The next question is from the line of Mr. Amar Maurya from India Nivesh Securities. Please go ahead.

Amar Maurya Farid, a few book keeping questions. First is, if I see the SG&A expenditure as part of the revenue and other expenditures have come down to 9.1% of the revenue, so is it likely to continue at this level or do we expect this to increase, going ahead?

Farid Kazani The other expenses that you see in the financial statement also includes a line item which is the FX loss Last quarter it was Rs. 4.6 crores. This quarter it is just Rs. 76 lakhs. There is a Rs. 3.8 crores reduction on account of that. Then there is another item which has seen a little drop that is the purchase of software which was Rs. 1.5 crores last quarter, it is at Rs. 75 lakhs this quarter. And lastlt, the Miscellaneous Expenses which was higher at Rs. 3.9 crores last quarter. included xpenses that got incurred for the client. This quarter, it is much lower at 1.24 crore, which is sustainable. So, that is the major reason why there is a drop in the Miscellaneous Expenses.

Amar Maurya And secondly, Selling and Marketing?

Farid Kazani Selling and Marketing has been at almost the same level. There has been a marginal increase in the UK. But that has got offset by a user conference expenses that we had last quarter in September which is not there in December quarter. So, to that extent, Net net we are at the same level.

Amar Maurya Meaning what you are saying is that in other expenditure part, excluding FOREX, and a few of the software purchases, it looks sustainable?

Farid Kazani Yes. It does looks sustainable.

Amar Maurya So, can we expect at least going ahead, it should continue something around 10% levels, even though there are minor changes in FOREX?

Farid Kazani There are some specific activities that are lined up on the Sales and Marketing side in this quarter also, so there will be some increase. But if very specific activity is not there, then this is sustainable level.

Amar Maurya And second question is on the US. We did mention that there are few critical large deals which we are targeting in US. So is it into the Insurance space or primarily into the bagging some large clients or what is it?

Sudhakar Ram Correct. Almost all our activities in the US new sales is focused on Insurance.

Amar Maurya And sir, one last question. If I see, we are in the phase of transformation and if I look, say, probably, nine months we have already covered. So, from the day one, when we started the year, what are the deviations from our initial estimates, favorable or unfavorable, which we are seeing in nine months?

Sudhakar Ram Except for this ramp down in the North American client, I think, pretty much the year has gone as per our expectation.

Amar Maurya And secondly, sir, the decline in revenue from these shortfalls, which we are talking about is already expected, right?

Sudhakar Ram No, it was not expected at the beginning of last quarter. Now it is expected.

Amar Maurya And sir, lastly, what is the update in terms of the outlook of the Government business? Last quarter, we did win a few deals in G-Cloud. In general, when do we expect the sequential growth in the Government business, because even this quarter it is de-growing?

Sudhakar Ram This quarter part of the Government business is old Services business while some of it is new Solutions business. So, when you just look at the vertical, you would not get that picture. It is a combination of both those factors in operation. So, we do expect to win more deals in G-Cloud and now we are also part of the GDF (Government Digital Framework). So, we do expect to win deals there and that is where the growth will come.

Amar Maurya So, if I look at the total Government business, what would be the part of Services? What would be the part of Solutions?

Sudhakar Ram Off-hand, I cannot give that.

Moderator Thank you. The next question is from the line of Mr. Ganesh Shetty. Please go ahead.

Ganesh Shetty I am an individual investor. Just one question regarding product development ex-business. Our product development ex-business have been more or less in line with our quarterly profits. So, when you are going to get the benefits of these ex-businesses or in future?

Sudhakar Ram I think, given that there is a huge potential in the policy admin market, till we finish all the lines of business there, which is at least another 18-24 months, we will not let our people continue the investment there.

Ganesh Shetty Sir, looking at UK's macro-economic conditions and improving the macroeconomic conditions in Europe, can we expect some large deals in Government or Insurance sector in this region?

Sudhakar Ram In the UK, now the tendency is for the Government not to do large deals. So, after all the austerity measures, they do not want to do large deals, they want to release smaller deals. So, we are planning to get more smaller deals where we are equipped to get on our own. If you see earlier, the large deals, we would always get through some partner, like a Capita or a BT or a TALIS and so on, while now we are better poised to win deals on our own, which is actually strategically better for us.

Ganesh Shetty Sir, apart from Insurance and Government sectors, are we looking for some other verticals so that we can have inorganic growth or wrapping it up in future? More or less, our revenues for the last 1-1.5 years is steady and can we have some uptick in our revenues?

Sudhakar Ram Sure. We are looking at opportunities. Like Retail is another vertical we are looking at and both organic and inorganic, we are always looking for.

Ganesh Shetty Sir, but are we into specific verticals like what we are having, like Insurance and Government or we may go for other new verticals?

Sudhakar Ram We already started in UK a new vertical, which is Retail. Organically, we will go after and we may also look at inorganic opportunities as they present themselves.

Moderator Thank you. Next question is from the line of Mr. S Ramachandran from Spark Capital. Please go ahead.

S Ramachandran Just wanted to get your sense in terms of the Asia-Pacific business. Would most of it at this point be predominantly Government and Insurance and not bunch of other offerings?

Sudhakar Ram Yeah. I think predominantly.

S Ramachandran Okay and in terms of the product development expenditure, you said you would want to expand into other offerings within the policy admin space. This would be more on the property side or policy admin in both P&C and Life side?

Sudhakar Ram Life, we have already covered all lines. Policy admin in P&C. We are refreshing the technology. So, as we had lines of business, we have a better market access. So, that is largely in the P&C PAS space.

S Ramachandran Okay. Given we have a pretty decent exposure in Insurance, any thoughts on looking at the Health Insurance market in US, given the amount of churn and the focus and spend that is going to happen in that market?

Sudhakar Ram Not immediately because we do not have the expertise in Health, as yet. But that is an adjacent area we can look at.

S Ramachandran Okay and in terms of the competition, if we look at the typical competitors we encounter and the deals that we have lost, what would be the key reasons on which we end up losing some of the deals?

Sudhakar Ram The main competitor in the US is Guidewire, which is a very successful Property & Casualty company. Normally, they would win ahead of us because they have a better brand. So, if somebody is just looking for size and brand, then they would buy Guidewire. If they are looking at the quality of the solution and our long term cost of ownership and so on, then we have a good chance.

S Ramachandran Okay and from a technology point of view, would most of our, at this point of time, be predominantly stack agnostic or you would be more comfortable with any specific stack if it works better?

Sudhakar Ram We have everything under Java stack but we are agnostic as far as database goes.

Moderator Thank you. Next question is from the line of Mr. Ashraf Sadan from Dalal Street Investments. Please go ahead.

Ashraf Sadan Thank you for taking my question and congratulations for the good set of numbers. The question I have is what is your outlook on the margins, going forward?

Farid Kazani If you look at the margins in this quarter, it is 14.8% and even if I have to remove the impact of the higher profitability that we got in the UK, we had almost around close to 13%. As revenue starts picking up, we should see improvement in margin but just keep in mind that there is a revemue impact of $2.4 million that is going to hit us from next quarter onwards. And that will have some impact on the EBITDA margins of approximately 1.3 million from that business. So, while we will come lower than the current level of EBITDA margins in the coming quarters, as business picks up, especially in the Insurance space, we should be in the 12-14% EBITDA margins over the next couple of quarters.

Ashraf Sadan And do you see a good momentum in Insurance business in North America to bridge up the gap revenue over the next few quarters?

Sudhakar Ram Yeah. We do.

Ashraf Sadan Okay. Are you looking for any potential acquisition?

Sudhakar Ram Yeah. We are.

Moderator Thank you. The next question is from the line of Shruti Ambavat from Financial Express. Please go ahead.

Shruti Ambavat I wanted to ask, you mentioned that you are looking at potential acquisitions. Could you clarify a bit on that? In what space and region? And how is it going to be like?

Sudhakar Ram We are essentially looking for acquisitions in the US, UK in the verticals that we are in – Insurance, Government, maybe Retail.

Shruti Ambavat Okay and what is kind of timeline that you have given for yourself on this? Have you shortlisted any potential targets?

Sudhakar Ram They work off a long list. It is completely unpredictable and I do not think anything is going to happen in the next six months or so. It is a process. Even if you identify someone and you start talking, it takes six months to close an acquisition. So, nothing in the immediate future.

Shruti Ambavat And the potential size?

Sudhakar Ram Digestible by us. Given the cash that we have, we may be open to a bit of debt but not very large.

Shruti Ambavat Okay. I must have missed it in the call, can you please tell me what is your cash reserve?

Farid Kazani Yeah. The total cash reserve as of December is Rs. 249 crores.

Moderator Thank you. Next question is from the line of Rishendra Goswami from Locus Investment Group. Please go ahead.

Rishendra Goswami Just a quick clarification. The hit that you mentioned in the EBITDA line in next quarter from the North America client, would be in the range of $1.3 million?

Farid Kazani Yeah. That is right.

Rishendra Goswami This would be on a quarterly basis, right?

Farid Kazani Yeah, quarterly. The revenue impact is $2.4 million and the approximate EBITDA impact will be close to 1.3 million.

Rishendra Goswami Which implies that the EBITDA margin on this contract was almost 50%?

Sudhakar Ram That is a wrong way of looking at it. In essence, none of the other costs change. So, the entire gross margin flows down to the EBITDA margin in a deal like this.

Moderator Thank you. As there are no further questions from the participants, I would now like to hand the conference over back to Mr. Sudhakar Ram for closing comments. Thank you and over to you, sir.

Sudhakar Ram Thanks everyone for making it to the call. Like I said in the beginning, it has been a good quarter for us, except for the setback on the large account. These are short term setbacks and as a company focused on Insurance and Government, we do see a momentum and we do expect to get back onto a growth in the next few quarters. So, stay tuned. We will connect back with you in a quarter. Thanks.

Farid Kazani Thank you.

Moderator Thank you. On behalf of Mastek Limited that concludes this conference call. Thank you for joining us and you may now disconnect your lines.