



“Tata Elxsi Q3 FY13 Results Conference Call”

January 23, 2013



MANAGEMENT: MR. MADHUKAR DEV – CEO & MD, TATA ELXSI
MODERATORS: MR. ASHISH AGGARWAL – ANALYST, TATA SECURITIES

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Moderator Ladies and gentleman, good day and welcome to the Q3 FY13 results conference call of Tata Elxsi hosted by Tata Securities Limited. As a reminder for the duration of the conference, all participant 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 the conference call, you may signal for an operator by pressing * and then 0 on your touchtone telephone. Please note this conference is being recorded. I would now like to hand the conference over to Mr. Ashish Aggarwal of Tata Securities. Thank you and over to you sir.

Ashish Aggarwal Thanks Lavina. On behalf of Tata Securities I welcome all the participants for Tata Elxsi 3Q FY13 conference call. From Tata Elxsi, we have Mr. Madhukar Dev, MD and CEO of the company. Now I would like to transfer the call to Mr. Dev.?

Madhukar Dev Thank you. Good morning everybody and welcome to this session. As you would have seen from our results which have been published since our board meeting. We have had a quarter which is sort of mixed in terms of outcome but in terms of the progress that we have made on the decisions that we had taken, it has been reasonably satisfactory quarter. I would go into each of our divisions. The main profit generators of the company are the electronic or embedded product design and the industrial design businesses. Both showed reasonably good performance. We had a growth of about 20% year on year in the embedded product design and a growth of about 33% in the industrial design. And normally this quarter has bit of a revenue drop due to the holidays and time and material contracts but that was partly compensated by the favorable exchange trend and the third segment in our services software development and services that we report is the animation business VCL where we have been facing considerable amount of challenges and substantial amount of losses in the period running up to the quarter and we took a decision to wind down the non profitable parts of the business. And while the quarter's results do not really reflect that outcome because we had to close down the existing contracts, bring them to a logical end, otherwise we would be open to liabilities etc, if we just drop the deal but we logically concluded most of the work and has eliminated the most of the non profitable parts of the business. Nevertheless VCL did have a fairly substantial loss in the quarter in excess of 7 crores for the quarter and if you see VCL performance in 3 quarters ending December, the losses about 21 crores. But going forward we expect this loss in March to be in the vicinity of about 3 crores and by the June quarter there should be no further losses. So in that sense we have progressed well and now I will go a bit deeper into the individual market verticals of the embedded product design which is 70% of our revenue. As you know we operate in 3 primary markets, the broadcast and home entertainment market, the transportation electronics market and the communication and wireless broadband market. In the broadcast market relationships with our key customers have moved to a stronger level than they were before with being selected as priority partners, for some of the initiatives of largest customers and which is leading us to more engagements in the entire eco system of the broadcast space. Equally our relationship with the key set top box makers that we work with has expanded. To expand territories, ranging from

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Brazil to Greece and more recently the United States of America. So the broadcast business all in all is doing well. Our customers are happy and we see a lot of traction for growth in that business. In the transportation electronics business, the bulk of the business is automotive electronics. And we have had a significant achievement in the quarter, not in financial terms but in strategic terms and getting into an engagement with the leading Japanese OEM. It's a direct engagement with the OEM. The initial values of revenue that will come out of it may not be much but over a 6 – 7 month period, it could become one of our largest engagements. So that's been a significant achievement in the quarter. Some of the disappointments in the quarter is lack of progress on 2 – 3 fronts. In the transportation electronics space itself, if we were to have got started with a leading tier 1 supplier of infotainment systems. We are hoping to start that in the next 15 days. It should have happened a quarter ago. And in broadcast business, we were to have started an engagement with the second largest cable TV operator with the US. We have been selected in October and it's just the paperwork is taking a bit longer and we expected it to. But in another couple of weeks, we should be starting with that engagement also. In terms of our joint venture, we have already provided for the loss of equity as well as the financing that we had made available to the animation joint venture which was called A2E2 Entertainment. We are looking at taking legal action to see if we can recover some of the money that we had provided them or something else in return. We have engaged a law firm which is in dialogue with the law firm of our JV partners and we hope to see some progress in the next few weeks or may be couple of months. In terms of manpower we have in this quarter added by our standards a fairly high number of laterals locally hired in the US for deployment with some of our key customers. This was done on a request on the customer because they were existing service providers and they wanted to get out of the engineers that were deployed were good quality. So this is not a particularly profitable engagement but nevertheless it's strengthened our association with the customer and there is an expectation that this will be more than compensated by the growth that we will see in off shore business. So that in summary is what the performance was like in Q3 for Tata Elxsi. I will be happy to attempt to answer any questions.

- Moderator** Thank you very much sir. Participants we will begin the question and answer session. Our first question from the line of Apoorva Shah from Dalal and Broacha, please go ahead.
- Apoorva Shah** Sir my question is can you give me revenue break up for EPD and industrialization in VCL.
- Madhukar Dev** In the quarter we did about 120 crores of EPD, 17 crores of industrial design and about little over 4 crores of VCL.
- Apoorva Shah** In the current quarter salary hike and other expenditure has moved up significantly.
- Madhukar Dev** There has been no salary hike. It is the hiring of local onsite in the US which has increased the cost quite significantly.
- Apoorva Shah** So sir can you put a number how many people were employed in US?

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Madhukar Dev There are about 50 people that got added in the quarter in the US.

Apoorva Shah And what was the reason for the increase in other expenditure? That is, in the reported number it is reported 37.

Madhukar Dev Okay, that's mainly admin cost etc, rentals, travel, the key components of, if you just hold on for a moment I will give you the break up. Travel was almost a 3 crores increase which was largely due to air fares being much higher. Some rentals in India became due for revision and rent and there was about a crore of provision for bad debts.

Apoorva Shah So going forward, we will be in the more or less same range, right?

Madhukar Dev Yes.

Apoorva Shah And sir can you give me exchange impact in top line and the margin?

Madhukar Dev Exchange impact would be somewhere about 12 crores in the top line and about 40% of our total expenditure is in foreign exchange. So it would take away something like 4 crores of the top line. So about 8 crores was favorable impact.

Apoorva Shah Sir my last question is on system integration business. Because in last 3 quarters it has been declining continuously and in fact we are impacting in margins as well. So what's happening with that business?

Madhukar Dev You are right, that's a business that is beginning to cause us worry because the traditional business of selling systems whether servers or desktops, reselling them sort of disappeared over the last few years and we had focused more and more on specialized equipment like projectors and storage systems and things which you cant really sell through a re-seller but you sell through an integrator. Even that seems to be now becoming commoditized and therefore a scope for a company like us seems to be shrinking constantly. We will over the course of the next month or month and a half evolve our strategy for that business going forward and I wont be surprised if it is largely devoid of a hardware component and focuses only on software and services in that segment.

Apoorva Shah Okay so going forward there may not be top line growth but there might be increase in the margin level, right?

Madhukar Dev That's right.

Moderator Our next question from the line of Mr. HR. Gala from Quest investments, please go ahead.

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- HR Gala** Sir we do appreciate that as you have shared with us in the earlier conference and analyst meets that operationally I think we need to do a lot to bring our businesses at a satisfactory level and we can see the attempts being made by you. I just wanted to know that what would be the trajectory of EBITDA margin going ahead. See right now we are getting around say 10 – 11% type if we exclude the entire component of other income. So what kind of margin do you think in the near term we are aiming at?
- Madhukar Dev** About 15% is where we need to get to. We need to do that very quickly. And once we get to 15, we set aside on taking it back to 17 – 18% where it used to be.
- HR Gala** So do you think with the initiatives we are undertaking you will be able to achieve 15% in the next year FY14?
- Madhukar Dev** I am quite confident we should be able to.
- HR Gala** And 17 – 18% may be next year or so?
- Madhukar Dev** That's right.
- HR Gala** On some of the macro things we have been reading which has got relevance on our company. Recently a news item appeared that India to western tech firms sell it here build it here like government wants to make India as an electronic hub. Do you see any big opportunities for the product design and engineering services as a result of this policy shift?
- Madhukar Dev** Indeed and in fact over the last 3 – 4 quarters I have been mentioning the draft electronic policy which is no longer draft and which is seeing a lot of thrust from the government, is even half of what the government is setting out to do becomes reality. This will be a huge boost for a company like ours because you cannot have an electronic manufacturing industry without commensurate growth in design. And if you see some of the government statements their expectation is that by 2020 the size of the industry will be \$500 billion. So going forward I think even if we are half as successful as what the government is setting it out be, it is huge leap forward.
- HR Gala** But my only question was do you think the western economies will allow that you should gradually stop importing the electronic items and make everything here, then a counter question probably might come in our mind is why would they take a software outsourcing from India?
- Madhukar Dev** A bit hard to answer for sure, but what I see happening is the foreign companies will be the ones who will set up manufacturing of electronics in India for us. And therefore as long as their own P&L are protected they would not block or oppose the government initiatives here. And to make their P&L even healthier they would look at doing designs also here. That's the way I think they will play out.

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- HR Gala** Sir my other question pertains to that we have recently entered into a partnership with Brash Brands. So can you throw some more light on that?
- Madhukar Dev** Yes. In our industrial design services, we have been working with customers in helping them re-position their products or their services and part of the work that we do, has got to do with the user experience the esthetic appeal, the form and shape etc of visuals that come into play. Now very often we do this in collaboration with a brand strategy consultant that our customer engages. So the customer strategy is based on the inputs from the strategy consultants and part of that is re-designed of product services that we do. We thought it is a more efficient way for the customer to engage partners if there was a single point responsibility of somebody providing brand strategy consulting as well as design. Now we ourselves don't have the capability of brand strategy consulting for all kind of things. Whereas Brash brands is a very successful business. So we partner with them. We will sell their service along with our design service.
- HR Gala** It is US based company sir?
- Madhukar Dev** It's originally from UK but the center of gravity is now in the Middle-East. It's Dubai, Qatar, Oman all those places and they will cross sell our design services to their customers.
- HR Gala** So have we entered in to any sort of joint venture?
- Madhukar Dev** No, it is an alliance. It is not a financial joint venture but there is a contract and we have agreed on what kind of cost will be shared and what revenues will be shared?
- HR Gala** Last question from my side, like in current year so far we have grown at 16% top line. Do you think by end of the year the growth will be more or less similar?
- Madhukar Dev** Yes I think so.
- HR Gala** Next year what is your aim?
- Madhukar Dev** Next year, once the demons of the animation business are contained, we would be targeting a growth of at least double of what we have done this year.
- HR Gala** That would be great, so around 30% plus.
- Madhukar Dev** That's right.
- HR Gala** And as you are going to stop bleeding the VLC, the 21 crores type of loss also would not be there?
- Madhukar Dev** 21 plus 22 for the joint venture, all that would not be there.

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HR Gala Anyway it was one time. We have provided 16 crores so far?

Madhukar Dev No we have provided 22 odd crores.

HR Gala In this quarter we have provided another 6 crores?

Madhukar Dev No, in Q4 last year. Once that burden is not there, you can take a little more risk in growing business, entering new countries expanding sales force, hiring exceptional talent.

HR Gala So next year as you said that you are looking forward to around 15% type of EBITDA margin with all these initiatives?

Madhukar Dev Yes.

Moderator Our next question is from the line of Kavita Vempalli from Nirmal Bang Securities, please go ahead.

Kavita Vempalli Could you give me the employee size?

Madhukar Dev We ended the quarter with about 4300 employees.

Kavita Vempalli And what was that number in the previous quarter sir if you have it?

Madhukar Dev I think it's about 300 less.

Kavita Vempalli Any order book position, those kind of details if you can share with us or how does it work?

Madhukar Dev We normally don't share order book details but I can tell you that we never entered a quarter with as much of the planned revenue in hand as we have in January. So it's a healthy situation.

Kavita Vempalli Okay and sir one more bookkeeping question, could you give me the details of your other income for the current quarter, 3.6 crores?

Madhukar Dev That is just restatement of foreign currency assets.

Kavita Vempalli And sir you said by June there will not be any loss in the VCL segment. So could you give some details exactly what is happening in that business?

Madhukar Dev There are certain sub-segments in that business, one is visual effects and the other is 3D animation. In visual effects we had opened a studio in Los Angeles to do work for their Hollywood movies and in the first year of its operation we saw lot of 2D to 3D conversion work and so the entire skill base in that studio was oriented to enable that 2D to 3D conversion. That work flow dried up. So therefore we downsized that LA studio which is very expensive to run if

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there are no revenues. And the other hand the 3D animation which was long formed for television, we had a handful of projects and they were long duration projects and all of them ended up costing us much more than their revenue that had been agreed because of the changes in the quality of animation. The number of characters the kind of background etc. We went back to most of the customer seeking revision and the price and were not very successful. We just gave a token increase. So we are winding those terms because that's hurting us a lot. And once we are out of those 3D animation engagements we should be more focused on the VFX for films Indian or international. And long form animation will not be there. So we will be doing short form animations like for TV commercials, 7 minute - 10 minute visualization films, etc., which are not loss making.

- Kavita Vempalli** What kind of margin would that kind of business?
- Madhukar Dev** Our endeavor right now is to make sure it's breakeven, that's it. We are not looking for higher margin. See over the years we have built very strong technical capability. We want to hold on to that capability, deploy it in profitable endeavors and then revisit the future of that division after a year or so.
- Kavita Vempalli** And sir your outlook, what kind of growth would you see in embedded business for say FY14?
- Madhukar Dev** I would as I was mentioning to Mr. Gala I would see a growth of about 30% year-on-year.
- Kavita Vempalli** For FY14 you are saying?
- Madhukar Dev** Yes.
- Kavita Vempalli** And what are your hiring plans for FY14 sir?
- Madhukar Dev** We will hire a small number of fresh graduated less than what we did in the current year and we will be hiring more specialized laterals from within the country and may be even outside who will help us push up the capability of our engineering team.
- Kavita Vempalli** And one last question, what is our onsite - offshore ratio as of now?
- Madhukar Dev** It's about 27% onsite and the rest is offshore.
- Moderator** Our next question is from the line of Nishit Shah from Ambika Fincap, please go ahead.
- Nishit Shah** Actually I go back to last several years that we have been tracking and invested in your company and we see that you have been actually struggling on the visual computing side and these business have given a lot of pain now. If I look at the third quarter revenue of 4 crores in VCL and your losses of 7 crores, it puzzles me that why so much of energy is being put on that,

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whereas on the other side you have electronic designs and industrial designs and those businesses, which can be the individually substantially higher business. So a) the management band width, management time has been going into all of this and in this entire discussion we spent whole lot of time discussing on our business which is so insignificant and if you look at the amount of losses that we have incurred in the 3 quarters this year and the amount that you have invested over the last several years into this business and the amount of losses that has been incurred I mean I actually, I don't know whether it is appropriate for me to raise this question but what is the wisdom of doing this activity?

Madhukar Dev

If you go back a few years, we used to believe that there are 2 key drivers that can take this company to significant size when we were talking of 4000 – 5000 crores size and one was the electronic product design. And the other was the visual computing because the potential there is enormous. And that is the reason we have tried many different approaches in that business, even engaged very expensive consultants to give us advice on what may work and what may not. And essentially it was on the belief that there is a bright future in that business. Over the last one year we have concluded that with the approach that we have, the engagement model that we have, there isn't such a bright future in that business. At the same time exceptional skills that we have built we don't want them to be frittered away. So we are in the process of eliminating the non-profitable part of that business. So that what we keep alive is our core strength and which is no longer a burden on the company. Just to put things in perspective, when we did our first animated movie called Roadside Romeo, it was nominated by the visual effect society of Hollywood among the best animated movies of the year. We were one of the 5 and logically if you see we made that movie at a budget which was less than 1/25th of the budget of the other movies. So you think an achievement like that would have lot of people using us for making movies but for whatever reasons that didn't happen. Our second, movie which was called Arjun - The Warrior Prince which UTV did not release till May last year, but when it was released it was in the final 16 for the shortlist for Oscars this year. It didn't make it into the final 5 but it was in the final 16 from all over the world. So technically, our work is recognized as very good. But it does not seem to generate money that you would expect that kind of work to generate. And therefore we are going to focus on may be not so much on the entertainment market, more on the non-entertainment market. And therefore the whole approach is to hang on to the key capabilities that we have built without being a burden on the rest of the company.

Nishit Shah

But actually I understand what you are trying to say but in the process, if we look at even the last 10 years of Elxsi, actually company has not progressed much. Looking at the potential, looking at where the other Tata companies have grown, even in the software side, company has had one or the other problems. Initially you had a problem with one of the large accounts in Japan which ramped down suddenly.

Madhukar Dev

That was in 2009 January, not so long ago.

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Nishit Shah And then you had to revisit the whole thing and relook at the entire strategy. Then came now this visual computing side, I mean I am not sure you also had a transition period where your CFO left abruptly, you had another CFO who also left.

Madhukar Dev Why are you raising that?

Nishit Shah What I am trying to say is there has been a series of problems.

Madhukar Dev Let me assure you there have been no problems with CFO leaving or CFO being there. The CFO is an executive of the company. I have so many other Vice Presidents who left in the last 10 years.

Nishit Shah Mr. Madhukar in Tata companies normally you don't see 2 guys changing in one year or less than one year period.

Madhukar Dev It's unfortunate that you are raising it. Let me just tell you the second person was diagnosed with cancer and he opted out of a full time job. I don't want to make this public. But unnecessarily if you are going to raise it, I am forced to say it.

Nishit Shah We have been very hopeful that things will work out and we have been patiently waiting. So when these kinds of issues normally doesn't happen in a Tata Group Company.

Madhukar Dev What kind of issues doesn't happen, a CFO getting cancer, cannot happen in a Tata company?

Nishit Shah I didn't know this.

Madhukar Dev So without knowing anything why are you imagining there to be ghosts where there aren't any?

Moderator Our next question from the line of Mr. Akshay Shah from Quest investments, please go ahead.

Akshay Shah Sir just a clarification, you said FY14 revenue growth is 30%. So it is in a particular embedded product designed business or is it overall 30% growth?

Madhukar Dev It will be in the services segment which is embedded product and industrial design.

Akshay Shah So without any animation it will be out totally?

Madhukar Dev There will be a very small revenue in animation, so it's materially not going to make too much of difference.

Akshay Shah Separately give 30% business.

Madhukar Dev Yes.

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Moderator Mr. Shah you may go ahead with your question.

Nishit Shah We talked last year about 35 – 40% growth in the electronic product design. If you look at the growth that you have had this year, it's about 21 – 22%, could you explain me why there has been a slowdown in the main core business?

Madhukar Dev The growth in the electronic product design business is about 29% year-on-year.

Nishit Shah On a 9 month basis?

Madhukar Dev Yes 29%.

Nishit Shah And in industrial design?

Madhukar Dev Industrial design is 33%.

Nishit Shah So these trends you expect to continue?

Madhukar Dev Yes.

Nishit Shah So what is the road going forward? Now if I have to look at it for a 3 year basis, Tata Elxsi how do you see the company shipping up?

Madhukar Dev I will not bring VCL into the picture because I am not very clear on what it will be like in a 3 years' timeframe. But predominantly, we will be a design services company and a design capability will range from industrial design with a lot of focus on human machine interface to innovative technologies which will enable things but it is still somewhat futuristic targeted advertising which will, given that if there is a legal infrastructure to enable that, being able to generate a profile of a customer as you often to retail stores by using visual techniques and so that the customer experience becomes more fulfilling and more pleasant. In all such areas whether it is retail experience or an infotainment system and a car where the interface could be based on hybrid of voice and gestures and things of that nature, we will always be at the forefront of harnessing technology for making the human experience better. And today we worked except for 1 – 2 engagements where we are doing advance R&D for our customers. The rest of our engagements are really driven by customers giving us specifications and executing them. I see that change in over a 3 years' timeframe to our conceiving our products solutions and prototyping it and showing it to customer and licensing it for them to manufacture and market. That in summary is where we are heading.

Nishit Shah On the operating margins where would you aim to reach in 2- 3 years' period?

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Madhukar Dev My first objective is to get back to the margins that prevailed till 2008 where we were doing PBT of between 18 and 20%.

Nishit Shah PBT of 18 and 20% is doable in 3 years' timeframe?

Madhukar Dev I think so.

Nishit Shah And on tax front because you have been paying a substantially higher tax rate. So my question is what are you doing to save on tax? Are you moving to SEZ because in the past I think you were telling that you don't have SEZ and you do not intent to use SEZ facility, so is there a rethinking on that?

Madhukar Dev Let me tell you, our understanding of the SEZ and tax law, we cannot move into an SEZ. You can only create new capabilities with new people, new equipment and then SEZ. This is a conservative interpretation of tax law and we being a Tata company we think this is the way we ought to interpret it. We have hired SEZ from **(Inaudible) 37.22** where we would be hiring new people acquiring equipment and bringing in some new engagements of a different nature which will be serviced out of SEZ but because it has to be all new and it cannot be a shift the amount of revenue that it can generate will be only small. So you may not see too much of an impact in the tax liability of the company but we have already hired a SEZ from **(Inaudible)** and in the next month or two start operating some new engagements from there.

Nishit Shah So incrementally you expect tax rates to come down as you go from the new site?

Madhukar Dev Marginally but not substantially because the new sites will generate only a fraction of my revenue.

Nishit Shah How's the cash situation right now at this point in time?

Madhukar Dev Reasonably good. The collections were fantastic over the last 9 months. Our DSO is at a low time at 66 DSO outstanding bulk of it being less than 60 days old.

Nishit Shah So are you net cash positive or net cash negative?

Madhukar Dev We are not net cash positive primarily because of the borrowing that we had to do for the joint venture.

Nishit Shah So right now how much would be the debt?

Madhukar Dev 33 crores would be the borrowing?

Nishit Shah You expect it to be repaid next year?

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Madhukar Dev Yes.

Moderator Our next question from is the line of Mr. Gala from Quest Investments, please go ahead.

HR Gala Just wanted to understand this FOREX impact you said that 12 crores is in revenue and 8 crores in expenses.

Madhukar Dev Not 8 crores in expenses, about 4 crores in expenses.

HR Gala So net impact is 8 crores, is it reflected in different lines or it is all in other income or some such thing?

Madhukar Dev The other income is a restatement of the current assets. This is reflected in individual lines.

HR Gala So that means total positive impact of FOREX in this particular quarter is roughly around 11 – 12 crores?

Madhukar Dev Yes.

HR Gala And how much would be in 9 months' period if you can just let us know?

Madhukar Dev I don't have that number yet.

HR Gala In that case I will send you an email.

Madhukar Dev I can tell you that the last quarter it was about (-11) crores.

HR Gala 11 crores totally?

Madhukar Dev Negative.

HR Gala But total.

Madhukar Dev So between these 2 quarters it has squared off, only the Q1 was a favorable one so I will have to dig that out.

Moderator As there are no further questions, I would now like to hand the conference over to Mr. Ashish Aggarwal for closing comments.

Ashish Aggarwal Thanks Lavina. I would like to thank all the participants for taking out the time for the call. I would also like to thank Mr. Madhukar Dev for giving us the opportunity to host this call.

Madhukar Dev Thanks very much.

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Moderator

On behalf of Tata Securities Limited, that concludes this conference. Thank you for joining us.
You may now disconnect your lines. Thank you.