"Cyient Q3 FY2020 Earnings Conference Call"

January 16, 2020

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Moderator: Ladies and gentlemen, good day and welcome to the Cyient Q3 FY20 Earnings Conference Call. As a reminder, all participant lines will be in the listen-only mode. And there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '*' then '0' on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Ajay Aggarwal. Thank you and over to you, sir.

Ajay Aggarwal: Thank you Good evening, ladies and gentlemen I wish you all a very Happy New Year Welcome to Cyient Limited Earnings Call for the Third Quarter of Financial Year 2020 ended 31st December 2019. I am Ajay Aggarwal – President and CFO. Present with me on this call are our Executive Chairman – Mr. B.V.R. Mohan Reddy; and Managing Director and CEO – Krishna Bodanapu.

Before we begin, I would like to mention that some of the statements made in today's discussion may be forward-looking in nature and may involve risks and uncertainties. A detailed statement in this regard is available in our investor update and has been e-mailed to you and is posted in our corporate website as well. The call is accompanied with the earnings presentation as usual.

Now, I would like to invite Mr Mohan Reddy, our Chairman, to provide a brief overview of the company's performance for the quarter ended December 31, 2019.

B.V.R. Mohan Reddy: Thank you, Ajay. Good evening to all of you. This is Mohan Reddy, Chairman of Cyient. I welcome you all to this conference call. Let me take you through the highlights of this quarter.

We posted a quarterly revenue of Rs. 1,106 crores. This signifies a de-growth of 4.6% quarter-on-quarter or a de-growth of 6.8% year-on-year. Largely, the de-growth was driven by our design-led manufacturing, which is of course a cyclical business. In U.S. dollar terms, we posted a revenue of $155.2 million, which translates to a de-growth of 5.5% on a quarter-on-quarter basis, or a de-growth of 6% year-on-year.

So more importantly, on the services business, which is our core, our revenues stood at $140.1 million, which signifies almost a very flattish quarter, or precisely in mathematical terms, it's about 20 basis points de-growth quarter-on-quarter or 50 basis points de-growth on constant currency terms.

The EBIT for the quarter stood at Rs. 106 crores. And the EBIT margin was flat at 9.6% for the quarter. Of course, excluding one-offs and adjustments, our normalized margin stood at 12.3% for the group. The net profit for the quarter stood at Rs. 108.3 crores, which translates to a quarter-on-quarter growth of 10%, year-on-year growth of 17.6%.

Let me briefly touch upon the business highlights now. Cyient is actively involved in accelerating the deployment of 5G networks for key clients in Australia. We signed an agreement with a transportation client, which extends the commercial framework until 2023 and reconfirms Cyient's position as preferred partner for a major program planned in 2020. We also partnered with Clear Horizon to capture and maintain quality mobile network asset data for utilities. AnSem has joined ARM as an Approved Design Partner program under their Approved Design Partner program. This will aid in reinforcing AnSem's expertise in delivering arm-based custom turnkey ASIC solutions and services, which would ensure faster time-to-market for customers. We will set up a new development center in Warangal to support telecom customers globally, with plan and design and engineering services for their mobile and fixed line networks.

Let me move on to the progress we are making on the CSR front. We continue to support 25 government schools, provide education to now 18,500 plus underprivileged children. We continue to support 70 Cyient Digital Centers in and around Hyderabad, which caters to more than 25,000 children and 15,000 community members.

We completed training the third pilot batch of 300 community unemployed women on tailoring, bakery and beautician courses through our Cyient Urban Micro Skilling Center for the urban poor. Cyient trained and certified 403 unemployed people under the Cyient IT/ITES Skilling Centre. Cyient Foundation received a Platinum Award from Apex India CSR Excellence Award 2019 in the Engineering and IT sector.

Very briefly on the awards, Cyient won the coveted Exemplar of Inclusion award as a part of the Most Inclusive Companies Index 2019 in India. Cyient was also recognized as one of the best companies for the women in India by Working Mother Media and AVTAR Group.

With this, I would like to hand over the call to Ajay, who will take you through the detailed financial performance for the quarter and the year. Thank you.

Ajay Aggarwal: Thank you, Mohan. In terms of the growth, I would say that we have quarter three which has two things. One is, we have a lower number of working days which impacted our businesses, which are more on-site. For example, we have the highest on-site deployment in case of aerospace & defense. And some of these businesses have definitely been impacted due to the number of working days being lower. But I would say that, overall basis, services revenue is flat. And at a group level, we have a decline of 5.5% in dollar terms and in constant currency 5.7%.

In case of design-led manufacturing, I think we have been making choices to do revenue with higher quality, so it is in line with the same. And we have a drop of 36% quarter-on-quarter. But only comment I would make, while Krishna is going to talk more about the business outlook, I think the two drivers where we have seen challenge is aerospace and communications. I think we are seeing a good traction and momentum as we look into the happenings of quarter three and as we look for the outlook going forward.

We have been talking about the cost optimization exercise which we initiated about a year back. And I am happy to state that we have been working on this program across the business units. And we had set ourselves a target, we are tracking to about 91% of that target in terms of the total savings. We are completing this exercise in quarter four and this has come to an end. We are also making sure that while we took the expert help, we are creating our own center for sustaining each of these activities so that whatever are the learnings from this program are also across BUs continued in the coming years by our internal teams.

In terms of the impact, if you see our year-on-year margin for quarter three, because that represents nine months of the year which had the impact of the program. So, our margin, if you see on like-for-like basis, is up by 400 basis points due to this program. When you see the final margin, of course, we have three things happening. One is, there is a one-time implementation cost, which is about 200-250 basis points. We also have the headwinds of wage hike, which is again between 150 to 200 basis points. And the third thing in terms of the lower volume and higher NBA investment, which is another 150 basis points.

So, when we are both working towards the next year, I think if we definitely do not have the headwinds, some of these headwinds, especially in terms of volume, while it is early days we are starting our budgeting exercise, we should definitely be looking at this headwind behind us. We are also looking at good amount of money spent on NBA investment and some of this will start fructifying and this amount may become lower in the coming year. And this one-off cost of implementation of this program of 200-250 basis points will not be there in the next year. So, it looks like we have created a cost base, which is very nice for the next year.

Very quickly in terms of the hedge book, we have all seen the volatility in the exchange rates, but we remain very principled. No change in the hedging policy. We continue to be 12 months for 70% of the net cash flows. Typically, for most of the currencies, if you look at the right hand side of the chart, for most of the currencies our forward rates of each of the currencies are higher than the current spot rates. Our outstanding forward contracts are $134 million. And for the next four quarters, at the current spot rate, again, still will be positive at about $4 million.

So, I think if you look at the current year, and I will talk about the other income, we are sure between the combination of treasury income, the gains from the forward contracts what we have got as anticipated in quarter four, as well as some of the other benefits from export incentives and the other items. We should be at least equal to the last year or definitely higher than the last year in terms of other income. So again, I think from the other income perspective, I would say we are well positioned.

If you see this from this quarter, we had other income of Rs. 498 million compared to Rs. 264 million, so it's a combination. I think most of it is coming for the particular quarter from the unrealized gains, mainly because of the exchange rate between the closing of September and closing of December. But I think if you look at for the three quarters and for the full year projection, I would say, even in terms of the realized gains we are doing well. Last quarter we got about Rs. 174 million or Rs. 17 crores, and this quarter we got Rs. 15 crores. The same number last year was about minus Rs. 6 crores or minus Rs. 66 million. So, I would like to again reiterate, other income, we are positioned well.

So, I think you have to read this chart in conjunction to what is the progress that we are making in terms of resetting our cost structure. So, if you look at the reported margin, we are flat 9.6% last quarter and 9.6% this quarter. But as I said, when I look at year-on-year EBIT movement, at least 400-450 bps of cost optimization, offset by one-time cost of restructuring, wage hike and also the incremental investments in NBA. So, I would like to assure the investors, while you are looking at a lower margin year-on-year, I think some of these one-offs are not likely to be there in the next year. And we should definitely see the benefits of this exercise in the coming year.

In terms of tax, I would say nothing much. I think we are still tracking for the year between 22.5% and 23%, and that's the tax rate. And maybe in the next two, three years, we should get to that 25% rate after all the SEZs we have calculated three years from now. I think we will be getting to 25% with the SEZ, and that's the time for us to go over to selecting that 25% no benefit regime.

We have also provided the EBIT margin. I would allow you to please read it and go through it. We can go to the cash generation. I would say in terms of, you would see the cash has risen to about Rs. 1,023 crores. This is despite paying dividends and buyback of about Rs. 500 crores in the last two years. And the free cash flow has been strong in the quarter, we had about Rs. 194 crores or Rs. 1.944 million of free cash flow.

So, I must admit, in H1 our free cash flow conversions were lower. So, when you look at the full year, I think we are back to the normal and we are likely to be little better than the last year, despite the flat EBIT. And I am confident that we will exceed 50% conversion for the full year. And we have also made good progress on DSO quarter-on-quarter. Now we are at 94 days. And this traction will continue. We will continue to have very strong cash generation.

With this, I will hand over to Krishna for commentary on the business.

Krishna Bodanapu: Thank you, Ajay. Good evening, everyone. And may I also take this opportunity to wish you a very Happy New Year.

Before I start with the business update, going forward, one of the things we would like to do is, whenever there is a special resolution that will be sent for your consideration during the quarter, we also, on this call, will give you the context of that resolution upfront. So, in the next few weeks you will see a resolution on creating an RSU scheme for senior management. I will just take a minute to explain this so you have the context when you see the resolution.

The scheme is really designed to encourage the senior management, about 100 of the top leaders of the company to participate in the growth. And to also align the incentive structure of the senior management to the shareholders and, therefore, to align it to the share price. I want to say that this is in lieu of existing variable pay. So, what it means is, we are giving the opportunity to these 100 or so associates to convert a part of their variable pay, which is right now paid out in cash, into variable pay that is paid out as a restricted share. Therefore, the impact on the P&L will be minimal, because whatever we are paying out as cash variable will be paid out as RSU at market price. It's not at face value like the options are, but rather it's at the market price, whichever is the price that day.

Also, to encourage participation, we will have a 25% top-up for the associates in terms of the value. That is what it means is, if they're converting Rs. 1 or Rs. 100 of variable pay into RSUs, they can convert at Rs. 125. But I want to say, the RSUs have a three year holding cycle. Therefore, even at a nominal 8% interest rate, the net result is the same because the RSU only gets paid over a three-year period whereas cash would have gotten paid at the end of that period, which is typically the six months or a year depending on who it is.

Therefore, the impact will be minimal. And also, more importantly, it brings in a significant alignment between the compensation of some of the senior managers or most of the senior managers and how the share price has performed, which is really the compensation or the incentive for the investors. So hopefully, that sets it in context. If you have any questions, we can answer them, maybe not in this call, but please do reach out and we will be happy to answer them. But I look forward to your support when this resolution comes out later in the quarter.

In terms of a quick business update, so we will leave some time for Q&A also. The investment pipeline is what it is. We haven't made an announcement in the last few quarters, but we continue to focus on that and we continue to focus on various opportunities across the focus areas, be it industries or verticals and also the technology and capability.

In terms of the individual businesses, aerospace & defense, the business is growing. That is the A&D business globally is growing by about 4% every year. But the challenge that is there is most of the growth is driven by new product manufacturing and MRO. The engineering design spend has come down quite significantly. And as you can imagine, that is where a lot of our revenue comes from.

We have been able to mitigate a lot of the slowdown in engineering design through our capabilities in manufacturing support, MRO, etc. But as you can correlate it to the results, we believe it will take one more quarter before the aerospace business comes back into a growth path again. And this quarter we were anticipating that, that will happen this quarter. But we now believe that it will happen in Q4, we will see some good growth coming back to the aerospace business.

The communications business is expected to grow about 4-4.5%. There is a lot going on in that market, especially as it relates to technology, 5G, etc. As you can imagine, we went through a rough patch there. But this quarter, finally, we are out of the challenges that we had faced in that business.

If you look at the Y-on-Y growth for Q3, there is a slight growth, and we believe that growth will continue. And I will be happy to explain in more detail if you wish, but we believe that the worst is way behind us there. And what we have done to bring that business back to growth has paid off and it will continue to grow at least for the foreseeable future into the next year.

Energy and utilities has been a bright spot for us. The business itself is growing. The utilities industry is expected to grow 4%; mining, oil and gas is expected to grow 7%. There is a lot of investment in distributed and renewable power. There is a lot of investment in technology such as smart meters, smart cities, etc. We are playing well into that market, and therefore, we will see in excess of double-digit growth for that BU this year. And I think Q3 was good. We have started seeing a big growth there and Q4 will continue to be good.

Rail transportation, the industry itself is growing and we are well positioned there. Q3 was an anomaly there, because as the Chairman said, there was a one-off event in terms of transport where we extended a contract and are committed to making certain investments for the future, which will lead to some very good growth. But also, just basis this how the contract was structured, etc., we also had an event in Q3 where some of the revenue had to be recognized.

So, some of the one-off investments that we made upfront had to be recognized as a hit on the P&L. And actually, that was fairly significant. And therefore, even from a company perspective, while net-net from a business perspective, we had a slight growth, which is what we had actually anticipated and commented at the beginning of the quarter, we did have a slight growth. But once we took this investment into account, it became a slight de-growth that we saw for the quarter.

We'll explain that if you are interested. But I want to assure you that, while it has created a small blip in Q3, both for the BU and for the company, this is actually a great thing for us because it significantly solidifies this relationship that we have. It will put it into a further growth path, and that's actually a great spot to be. So, we are actually quite excited, though by the time we concluded the contract, etc., it is a little bit of a blip that we had to manage through in Q3.

The portfolio of business units that is two segments, industrial and geospatial. The industrial segment has been a little bit muted because of the conditions around the world, but we have been doing well there. It is a small business for us, but we have been doing well.

Geospatial will continue to grow. Geographical coordinates have become quite ubiquitous in many, many applications, and therefore the GIS business as a market will grow. We do have some challenges there based on where we are positioned in the industry, we do have some challenges in growth. And therefore, it is a de-growth year for the geospatial business and we are working on various options on how to bring back growth there, but it will probably be another quarter or two before we see a solid turnaround there.

The semiconductor industry this year looks good, last year was a little bit of a tepid year for the overall industry. And we believe that while we will have a flat year there, overall, we are very well positioned. And that's actually showing up in some of the order intake and the wins that we have, which will go into next quarter.

So, net-net, I will summarize this by saying the quarter from just a revenue perspective ended up where we thought it would, which was a slight growth or a little bit of a growth. There was this investment that we made, which I am very confident and that's something that we absolutely had to do. Or not just had to do, I think it's something that gives us a very unique growth opportunity, and therefore, we did it. But of course, how the investment got treated gave us a little bit of a blip in Q3. But what you will see is from Q4 onwards there is a strong growth coming back into the business.

I also want to give you two quick updates. One is the fact that over the last four years we are quite cognizant of what we do in terms of shareholder returns and that we listen to our shareholders. There is a lot of feedback that's come, both from our shareholders, potential shareholders and the analyst community. And therefore, if you look at it over the last four years, we have back more than Rs. 700 crores through dividends and buybacks.

And therefore, I want to assure you that we pay a lot of cognizance to it, and we also want to make sure that we consider the returns expectation. If not as much as possible, obviously through growth and I am committed that we will be back into that mode into Q4 and into the next year, but also through the capital structuring, be it dividends or buybacks. And we will continue to focus on this. Our dividend policy is well articulated, and we are on it.

I also want to highlight that over the last nine months, to demonstrate our confidence between the three types of people; the promoters, the independent directors and senior management, we have bought in excess of 300,000 shares over the last nine months. If you look at that, that itself from our side is a commitment of about $2 million to $3 million, given that we have also bought over a period of time. So not just the company, but even as individuals, the promoters, the management and the Board is very committed to the future of the company. And obviously, we see a great path ahead and that's why we have done what we have done.

So, with that, I will stop here. And I will pass it on back to Ajay and see if there are any questions.

Moderator: Sure, sir. Thank you. Ladies and gentlemen, we will now begin the questions-and-answer session. The first question is from the line of Madhu Babu from Centrum Broking. Please go ahead.

Madhu Babu: Congrats on the revival in the communication vertical. So, this has been a good swing vertical for us. So, do we expect significant opportunities from the 5G in the Asia Pac client? And so, what is the momentum in this vertical from here on?

Krishna Bodanapu: Madhu Babu, I think the momentum will continue. This was a good swing quarter, like you said, because we did a lot of things to bring back growth into that business. A lot of effort has gone in. Obviously, this quarter is a break in our growth, but we will continue to see growth. I think structurally, we have fixed issues. So, this is not a sort of a one-off thing, structurally we were able to fix some issues. And fixing those issues has meant that the base is now back to where we need it to be, and therefore, growth will happen on top of this base. So, I think this quarter we had a very strong double-digit growth even quarter-on-quarter. It won't be at double-digit growth going forward, at least in the next few quarters, but we are back on a growth path.

Madhu Babu: And the second question is on the Boeing issue, which is going on, which has disrupted the supplier ecosystem as well. So, do we see that for us the worst is behind, we don't get much impacted because we are not directly engaged in that program? But how are the suppliers who are also big clients for us, how that is impacted? And could you throw some outlook on that?

Krishna Bodanapu: So, we believe we have seen the worst in terms of what is happening, because, like you said, we are not involved in the 737 MAX program, so directly there is no impact. So, what has happened is there has been a lot of slowdown in the new work coming from Boeing and the supply chain. And that work has not picked up yet. So, I would say we are at the bottom, but I still don't see that the growth, at least with Boeing and related projects will happen very, very quickly. That will still take some time. Aerospace will grow starting Q4, but that's because of other things that are happening. But Boeing won't drag us down any further. Or Boeing and the related issues won't drag us down any further.

Madhu Babu: Sir, and last one from my side. So, this year has been a washout year, obviously, because of some issues in our top accounts. But next year, how do we see the overall outlook? I mean, what should we model it for?

Krishna Bodanapu: I think it's a little bit early for that. Give us till the Q4 earnings call because, obviously, we want to be a lot more cautious and realistic on how we budget for the next year and, therefore, how we commit to you for the next year. I would say, we don't see any extraordinary events as things stand, so we will take all that into account and come back at the end of Q4.

Moderator: Thank you. The next question is from the line of Mohit Jain from Anand Rathi. Please go ahead.

Mohit Jain: One is on the margins. You have given this outlook in the presentation that your margin may go up by approximately 200-250 basis points. So, this will be starting 1Q FY21? And should we build other headwinds into this or this is the gross level extension that you may see at the company level?

Ajay Aggarwal: Net level, yes. So, as I said, 400 to 450 is the benefit of the cost optimization program, which is gross. And if you take for the wage inflation and other things, that will be a clear headwind, that will be 200-250 bps. And, as I said, year-on-year, I think both the investment as well as the scale of the volume absorption should also be opportunities in the next year.

Mohit Jain: So, this 250 basis point is from 12.3% normalized EBIT that you have shown for Q3 2020? Or this is from 9.6%?

Ajay Aggarwal: No. But you have to take it year-on-year rather than just quarter-on-quarter.

Mohit Jain: So last quarter also 12.3% normalized, I am assuming broadly we will be in that range for the current quarter as well?

Ajay Aggarwal: Yes.

Mohit Jain: Okay. And second thing is on this NBA investments. So, you have mentioned this 150 basis point investment there. So now that thing will continue in 2021? Or do we see some benefits offsetting investment next year?

Ajay Aggarwal: So, some of the investments will continue, it won't continue at the same scale. In that, there are projects that we are going to end over there. But there are also projects that are progressing well. We have had order intake from at least 3 NBA projects that we had. There is an additive manufacturing project that has an order intake, there is a TRM module that had an order intake. And there is an iDMS project that had an order intake. But we will rationalize down the investment. So, I say as an absolute number, it won't go up. So hopefully, as a percentage, it will actually come down because with revenue growth there should be absorption.

Mohit Jain: Okay. And that number is shown in long-term investments in the same table, right? That is the number you are referring to?

Ajay Aggarwal: That is right.

Mohit Jain: Rs. 12 crores quarterly run rate. And sir, lastly, on the free cash flow. So, free cash flow on a reported basis. So, what you have shown is prior to one-off. How much is the free cash flow to EBITDA conversion including one-off?

Ajay Aggarwal: So, I would say that you should look at YTD, because there were quarters where we had higher working capital and it also depends on receipt of some of the other income in cash basis. So, it's very clear, excluding any one-off, I think 52% is the YTD free cash flow, that's what you should look.

Mohit Jain: 52% is what we are targeting, what you have mentioned in the PPT. So, we should focus on that number, right?

Ajay Aggarwal: 52% is already there for the first nine months of the financial year 2020. And that will be similar level for the year end also, plus/minus.

Mohit Jain: So, going forward we are targeting broadly in that range is what I am asking, sir?

Ajay Aggarwal: Yes, that's right.

Moderator: Thank you. The next question is from the line of Pankaj Kapoor from JM Financial. Please go ahead.

Pankaj Kapoor: Krishna, will it be possible for you to quantify the impact of the pricing discount that we gave to the client in this quarter? How much of that really affected the revenues?

Krishna Bodanapu: We can't quantify it, Pankaj. I think I would say that from a situation where we had a growth, we went to a de-growth because of that, because the discount was also for, not discount, but it's actually an investment. But the way it's all structured, we have to take it both in the top-line and therefore, obviously, it came out of the bottom-line. But it put us from growth to a small de-growth.

Pankaj Kapoor: Okay. And does it give you any kind of a firm commitment from the client in terms of spend that they will be doing with you over the next four years?

Krishna Bodanapu: Yes, it does, both with the exiting business, but there is also some new business that we have won as a part of it. So, both existing businesses will continue, and we will see a little bit of a growth there.

Pankaj Kapoor: So, I am just curious, because our order book that we have reported in the results, that doesn't seem to have grown significantly. So, is it more of an anticipated revenue? Or you are taking it on an annualized basis in the order book that we report?

Krishna Bodanapu: No, in the order book we will take it as things come. There is nothing in the order book of this. Because it's just the way that the contract is structured there. Typically, we have not taken a bit, it's not a TCV kind of contract.

Pankaj Kapoor: Okay. Sir, just on the order book then, there seems to be a pickup versus the previous couple of quarters where it had gone down significantly. But if I look it on a Y-o-Y basis, the order book is still not picked up to the same extent. So, you attribute that more to what the current operating environment is? Or you think that there have been other companies have been able to gain market share? Or this is more a factor of your own operating clientele, which is having an impact on your order book?

Krishna Bodanapu: I think we haven't lost share in any of our clients that I can assure you. I think it's a bit of how our sort of business is structured and how orders come. Because if I look at Q3 FY19, there were about $70 million of multiyear contracts that had come in, which have not been there this year. Because we are still executing some of those contracts even now and we still have some more time, including more than a year, for example, in one of the contracts, or actually two years in one of the contracts. So, these are multiyear contracts.

The second thing is, there was about $25 million of order intake that also should have happened in Q3 that got right-shifted and it all happens. I mean, this was attributable to Q3. So, in that context, I mean, though it is a little bit lower, I am not very worried about that because I think we are back to a reasonable number, $180 million would be a good number for us. And what we are focused on is to continue to build that book for Q4 so we can go into FY '21 in a strong wicket.

Pankaj Kapoor: And on the DLM side, you mentioned in the standalone business there has been a decline of about $8.9 million, which I guess is basically some attrition of the legacy business that we have been doing. So, is that the base now or you think that there could be some further decline on that?

Krishna Bodanapu: No, this has actually hit the base. I think the decline has been a little bit more than what the base would be. So, this is at least the base. And actually, one of the things that if you see is, while the revenue has come down quite a bit, I think the reported margin in DLM is 7.9% at an operating level, though there are some one-offs there. But it's about a 6% margin, which means that the quality of revenue if -- though the business has come down, the quality of revenue has gone up significantly. And really, the idea is to start scaling on this because then with scale we can get to the 10% number, which is what we have been targeting.

Pankaj Kapoor: And Ajay, I had just a clarification on the margin commentary that you mentioned. So, if I understood right, basically this 200 to 250 bps of investment impact that is there in this year and which you expect not to be repeated in the next year, I have to look at the reported EBIT for that, right?

Ajay Aggarwal: Yes.

Pankaj Kapoor: So, on a 9.5%, 9.6% base, we can theoretically have a 200-250 bps expansion next year. That would be the comparison, and not the 12.3% number?

Ajay Aggarwal: From the efficiency perspective, yes. And as I explained, other two levers that would be there is, if we can get some opportunity out of the investment being lower. And another opportunity would be from the scale which was not there this year or the volume benefit in the next year.

Pankaj Kapoor: Right. But that will also get dropped possibly if we see some headwind because of the wage hikes and all.

Ajay Aggarwal: No, I think 2%, 2.5% is net.

Pankaj Kapoor: Okay. So, 2%-2.5% is basically coming in primarily because the investment that we have made in these cost efficiency consulting charges, etc., that is what is not going to be there, right?

Ajay Aggarwal: That's right.

Pankaj Kapoor: Okay. And just last question on my side. Krishna, you mentioned about the capital allocation and giving share was part of the cash back. So, are you hinting at rethink or a review of your dividend policy?

Krishna Bodanapu: No, no Pankaj. I am just saying that we have been prudent about it and as things evolve we are looking at that aspect also. At this point, the dividend policy will continue as it is, and we will stick to it. But if things change we will relook at it.

Ajay Aggarwal: And you know, Pankaj, we are all very direct as a management team, we never drop hints. We are very direct.

Moderator: Thank you. The next question is from the line of Sandeep Shah from CGS-CIMB. Please go ahead.

Sandeep Shah: Just, Krishna, in your comments, you have mentioned that in the 4Q we expect a strong growth led by E&U, transportation, semiconductor IoT, and analytics BU. So, are we talking of consol level or you believe the growth could be also through revival in DLM? Or you also believe the services growth will also be to maybe a mid-single-digit kind of a growth rates in the fourth quarter? Any color will help us?

Krishna Bodanapu: So, the growth will be both at a services level and at a consol level. So, it's not just that we will do more DLM work. I think, DLM also will have growth, but I mean, the growth is going to be at a services level and also at a consolidated level. Now I would say, I don't want to talk about the absolute numbers, but I would say we will be back to the path, our quarterly growth path that we were three-four quarters ago. That's approximately where we will come back to in Q4.

Sandeep Shah: Okay. And within services, is it fair to say that outside aerospace & defense and geospatial, most of the verticals we have a good growth outlook? And even in aerospace & defense, you believe that the worst is getting behind or still we can say that, no the growth would be muted?

Krishna Bodanapu: I think the growth will be muted, but there will be growth in aerospace & defense. Again, I think it will still take some time, but we will definitely grow. I think the de-growth days are behind us. Now, it won't be back to significant growth in A&D yet, but we will see growth in Q4 in A&D.

Sandeep Shah: Okay. And your commentary about the rail account where you actually took an accumulated impact in this quarter itself, which has impacted both the revenue and the margins. Do you believe that could act as a margin tailwind in the 4Q? Or you believe that the business in 4Q will also come at a lower billing rate level?

Krishna Bodanapu: No, there will be a margin tailwind because of that, because it was a one-off investment that we made that had to be accumulated. So that would be a tailwind.

Sandeep Shah: Okay. And Ajay, just one question in terms of the cost optimization what we have explained. Is it fair to say that fourth quarter itself would be a first full quarter of benefit? Or you believe the April, May, June would be the first quarter of benefit?

Ajay Aggarwal: I think April, May, June will be the first quarter. As explained, the program continues till 31st March. Of course, there is lot of focus on sustenance. But in terms of the cost, those program costs, they will also be there in quarter four.

Sandeep Shah: Okay. So, one can say, there could be a handsome jump can be expected in the fourth quarter margin on Q-on-Q?

Ajay Aggarwal: I think we will see a margin growth in quarter four and the full impact of it will come in the next year.

Sandeep Shah: Okay. And just one thing, out of 400, 450 bps of gross impact of cost optimization, roughly 200, 250 bps is coming because of the absence of onetime cost. So, one can say, structurally, the cost optimization exercise has been leading company to save 150 to 200 bps. Is this the right way of looking at it?

Ajay Aggarwal: See, I would say that actually, structurally, if you see, it's all 400 bps that is going to continue. But right now, we are saying it depends how we look at it. Onetime this year, we have the 200 to 250 bps as a cost. Going forward, if you also take it against the wage hike, then you get to 200 basis points.

Sandeep Shah: Okay. And just last question on DSO. I agree there is an improvement in this quarter, but if you look at this year, it has been a decline both in DLM and services. So now Y-o-Y the DSO still looks higher despite the business has been de-growing. So, what is the reason for collection not upto the mark despite the growth has not been there in the business?

Ajay Aggarwal: So, I would say, from the collection perspective we are doing well. I think our account receivable year-on-year is lower. I think where we have some more work to do is on the unbilled revenue, which is up year-on-year by about 12 days or so. That's what we are working on and we will assure you that in the coming quarters we will focus on that. So, there is a room for improvement there.

Sandeep Shah: Okay. So, one can expect that it can go to normal days of 80-85 days, including billed and unbilled?

Ajay Aggarwal: So, I would say that first step is for us to sustain it between 90 and 95. But if you ask me in the next two years, if we can set some of these things right, definitely we aim to go to 80 to 85 days.

Moderator: Thank you. The next question is from the line of Rishi Jhunjhunwala from India Infoline. Please go ahead.

Rishi Jhunjhunwala: Just wanted to understand a bit on the DLM side. So, you have basically come down to $15 million annual run rate. And if we exclude the acquisition that we made last year, we are probably at $50 million kind of an annual run rate. So, this was one of the strategic pieces of the overall business that we had looked out for in the past three years, but it's been really volatile. Just wanted to understand, I mean, what are we thinking about DLM considering the amount of bandwidth and capital it takes? And up until now we haven't necessarily seen too much benefit of that coming into the core business.

Krishna Bodanapu: Okay. That's a good question and I think that's something that we have worked on quite a bit. But from a strategic perspective, it still remains a core piece of what we want to do, I think that honestly has not changed. Because when we look at what our customers are wanting and where the opportunities lie, this is a key part of where the growth for the future will come from. I think what we have done is we have really made sure that we have brought it down to a situation where it is sustainable and from an economics perspective it at least starts to make sense. Because even when we were at $75 million to $80 million business, economically it wasn't makes sense because a lot of this delta business was low margin, it took a lot of capital, took a lot of inventory, etc.

So, we believe we now have the right set of customers in place. We will focus over the next 12 to 24 months in really scaling those up. I think the premise still holds very strongly and we are seeing traction. And give us another 12 months or so and you will see that the strategic intent is also fulfilled, along with of course the economic returns, which has not yet happened. So, give us another 12 months there, and I think you will see some good changes over there.

For example, we will bill one new customer this quarter, which is already an engineering customer, already a significant engineering customer. There is a lot of things that are going on with them, and we are going to have a big opportunity with them going forward. So, it's turning out. Strategically, I am still quite convinced that it's the right thing for us to do. Unfortunately, it has taken longer than what we anticipated and we'll stick to that.

Rishi Jhunjhunwala: Okay. And the other thing is in A&D vertical, right, so of course there are issues related to Boeing and the supply chain. But just wanted to understand a bit more on our top client as well. There have been issues in the company either because of merger or some of the other things that has been going on because of which it hasn't grown. How are we placed there? Have we retained our wallet share or market share within that client? And do we expect any kind of growth coming back to high single digit in that client in the near to medium term?

Krishna Bodanapu: Absolutely, I think in the near term we will see growth coming back. Basically, what's happened there is, they ran into some serious budget issues considering how much they spent in the first half of the year. So, the second half of the year, not just with suppliers, but even internally they have to do a lot of resizing and stop of projects and so on so forth. But also considering that they are going through the financial structuring, they wanted to make sure that they have the right sort of capital, etc. So, I will leave that.

But I want to assure you couple of things. One is, we have not lost market share. If anything, we have gained market share. And one of the good things this quarter is, we added $12 million order intake from an automation solution that we built there. Now the platform is an automation platform, the work that goes in the platform is engineering, so it actually works well. We have taken away a lot of work from some of our competitors because of the platform. So actually, the feedback that we have is the impact on other suppliers there is actually much more significant, so we feel good about that. But because we also see that the work is coming back in Q4 or our Q4, which is their Q1, so I am not too worried there. We will see growth there in our largest customer this year.

Rishi Jhunjhunwala: And one lastly, just in the beginning of the year we had talked about Rs. 30 crores to Rs. 35 crores of export incentives coming through, but we haven't seen that materializing in the first nine months. Do we expect that to come through in Q4?

Ajay Aggarwal: So, if you see in the current quarter, we have got about Rs. 1.8 crores of export incentive. We have been very conservative in how we recognize the income out of these benefits. We are taking them on the cash received basis. So, we have filed a claim which we expect to come with high probability in quarter four, otherwise in quarter one, and that amount is higher than the number that you have mentioned. So, unless the department gives and we get it, we are not recognizing. But I think whatever we had said, it's most likely to happen.

Rishi Jhunjhunwala: Okay. Because I could see only 18 million number in the PPT. So, I was just wondering whether I am missing anything.

Ajay Aggarwal: Okay, I stand corrected. On the P&L, what we used to do, when that came we were taking it on the filing basis, so I stand corrected. Now we are taking it on cash collection basis. So, there are no claims that are pending. They are doing very well. All claims have been recognized. We have got all the money. Whatever we filed for 2018, 2019, that we have filed. And we expect, as I said, to come in quarter four or quarter one. And it will hit both cash flow as well as P&L. I would say 90% probability is it will hit in quarter four, 10% probability it may come in quarter one, just that it comes from government department, so I can't tell with 100% certainty.

Moderator: Thank you. The next question is from the line of Prashant Kothari from Pictet. Please go ahead.

Prashant Kothari: My first question is about this one-off investment that you have made with your clients. Can you just explain how it works? And is it the usual in the industry to do it? And what kind of benefits are you looking forward to closely?

Krishna Bodanapu: So, the idea is that there is a significant opportunity in front of us, and to avail the opportunity there are some investments that need to be made. And therefore, we make the investment. It is quite normal in some of these industries. Because as you become a larger supplier, you also participate in a risk-reward sharing kind of a model, which is what this contract will help us do.

Now what happened is, because the contract started from October 2018, there was an extension and there were other things that got added to it. Therefore, the way that it was accounted, for the previous period we had to take the investment, because some of the wording was at the start of the project, etc. So therefore, we had to make it. Now it's quite normal because in a number of our customers as you move up the value chain there is more investment that they expect, and then we have actually been doing it in a number of other places also. Therefore, we made the investment. It gives us an opportunity to take a disproportionate amount of return when the outcome happens. And it also puts us with the customer for a much longer time.

Prashant Kothari: You are calling it an investment, but in the presentation, it says it is a onetime discount?

Krishna Bodanapu: Well, it was an investment but the way it was recognized was a discount. That's why we have had to take it in one bullet rather than do any amortization.

Prashant Kothari: So, when you say investment, is it like investing physically in something or what is it?

Krishna Bodanapu: So, it's investment in people, it's investment in the project. For example, some parts of the project have been done, now they are converted into a risk-reward and therefore we give back some of the money that was invested into the project.

Prashant Kothari: You have returned some money which was...?

Krishna Bodanapu: Returned meaning we build them for some work which was a time and material work. As it gets converted into a risk-reward project, the time and material are given back in the sense that we provide a discount, however you look at it as an investment. And now we amortize that because the way we get paid is based on the outcome of the project, we get a share.

Prashant Kothari: Okay. Then can you quantify the benefit of this investment?

Krishna Bodanapu: See, I can't give you the number, but I will say that there will be growth. And we will also make better profitability because it's based on the outcome and we are quite confident that the outcomes will be much better than a simple T&M project.

Prashant Kothari: Okay. And second was just on margin issue. I know there have been many questions and there is some confusion about kind of the margins going forward. What would you do because this is kind of at normalized margin for us going forward?

Ajay Aggarwal: See, I would say that what we wanted to give the update was that as far as what we see from the business as of now based on what we have done this year, we are giving commentary. We are getting into the budgeting exercise, and at the end of the budgeting exercise based on what investments we have to make, how do we look at SG&A investments, how do we look at revenue growth, we will be able to give you a precise this thing. I think the point being made is that we have done a major program in this particular year, which will have its benefits at steady state from the next year. We just wanted to make that limited point that, that's baked in. It is not showing up in current year margin. But that will come in the next year margin. I think please give us time for one more quarter, where we can comprehensively look at all these aspects and come back to you how to build for your model, the margin for the next year.

Prashant Kothari: Because a couple of quarters back you were suggesting that the normalized margin should be around that 14% mark. I am not sure whether you are still confident of reaching there, just trying to gauge that.

Ajay Aggarwal: So, if you see that from the perspective of this program, I would say, just the question is from the services perspective, definitely within one year or two years we can get to 14% as margin definitely. Those precise things will all depend on the business plan of...

Krishna Bodanapu: Timing and investment.

Ajay Aggarwal: I just request you to be patient for one more quarter.

Prashant Kothari: Okay. And the last question is about the unbilled revenue. You said it has gone up by 12 days. What is the absolute number of unbilled days there?

Ajay Aggarwal: So, the unbilled days are 35 days.

Prashant Kothari: Okay. And any specific reason why it is up so much?

Ajay Aggarwal: So, if you look at from the quarter-on-quarter perspective, it's not much. I think it's about three days up. But year-on-year, it has gone up by 10 or 12 days. The reason is, I think the number of milestone projects have increased. And I think as I have said, I think we are very confident in the next one quarter, there should be a reduction. And over the next four quarters, we should be able to go back to quarter three financial year 2019 levels.

Prashant Kothari: So, the project mix is changing again in the next few quarters, is that what is driving this confidence?

Ajay Aggarwal: That is one idea. I think also what happens is, sometime there are documentation issues with the customers where purchase orders are delayed or some confirmations are delayed and they continue to be sitting in. So, we are running a campaign to make sure that we go to the customer, get all of them and bill them, so that it doesn't mount. So, it's the combination of some increase in the business mix, some informal dealings in terms of POs not being there in time and things like that getting more formal. And also, I think more internal discipline. So, I think all these three things when we do, we can get back to that.

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

Sandip Agarwal: So, Krishna, I have just couple of questions. One, if you see nine month revenue versus last year, we have lost few million dollars on a year-over-year basis. A small proportion we have lost in the DLM side and a larger portion we have lost on the services side. And with EL space is still not bottoming out or maybe we are not expecting much growth there, and also some challenges still continuing in communications, how do you see, let’s forget for the time being the current year, but how do you see the next year growth numbers? I am not asking for a precise guidance, but what I am trying to understand is that, will we have a much, much better year than the current year or any filler on that?

And secondly, my also worry is that this 5G thing which we are talking about, most of the other companies are still not saying that it is firing so much right now. So, any sense on that, whether it can impact us negatively if it doesn't play out?

And finally, on the profit side a lot. Ajay has already explained in very minute details, but I still would like to understand that, last year in the fourth quarter we have a massive PAT of Rs. 172 crores. So, are you looking at that kind of significant number in this year also in quarter four which will probably lead us to at least have a flat PAT for the full year basis? And if so, then where will the margins head next year? I understand the onetime kind of expense which you have done right now. But other than that, are you seeing any other recovery from the operational side?

Krishna Bodanapu: Okay. Sandip, so let me answer them in sequence. I think, yes, obviously, it's not been a great nine months, but it is what it is. I would say, like you said, it's a little bit early to comment on next year. The communications business is recovering. We were close to having the best quarter ever this quarter. We will definitely be there or a little bit better next quarter. So, I think the communications business has come up.

Aerospace, again, I don't see any further decline. Now, I am just saying that the growth won't be rapid back, we will see growth in Q4 in the aerospace business, we are quite confident of that. But then it will slowly come out. And how will it look next year, we will have to look at it. Having said that, I don't see any extraordinary events just because things have come down as much as they can just looking at our business to see that. So, therefore, next year will be better than this year. I can assure you that. At least, as things stand, next year will be better than this year.

How much better and what growth? Like Ajay had previously said, give us till the end of Q4 because we are also coming off an extraordinary year. Unfortunately, things happened which we did not anticipate. And obviously, thankfully, this is not an area of expertise managing from a situation like this, we have always managed through good growth year. So, anyways, all that is fine. We will come out of it.

Now, in the communications business, 5G, I will say 5G is just one element of it. Most of our growth still is coming from fiber rollout, it's not coming from 5G. We are just saying 5G is a good opportunity for the future. But even if you look at Q4, if you look at what happened up to Q3 and into next year, most of the growth assumption is built on fiber rollout and 4G rollout, not on 5G rollout. Therefore, I think the 5G is really out there, it's not still in the immediate term.

And I think previously also I said 5G rollouts won't be like 4G rollouts. There won't be massive pan-country rollouts. They will be more like around a certain area where you need that network, they will roll it out. So, therefore, the opportunity in 5G will actually be lower. So, our case is really built on continuing fiber rollout, continuing 4G rollout. 5G is an opportunity for the future.

Now coming to the question on profitability. Last time that Rs. 176 crores were also because there was an SEIS recognition last year and that's why it was big. This year, like Ajay said, we are anticipating like 90% probability we will recognize that also this year. If that happens, we will have again a very, very good Q4 from that perspective and that's what we are working towards. Hopefully, that answers the question, Sandeep.

Moderator: Thank you. The next question is from the line of Abhishek S from Elara. Please go ahead.

Abhishek S: Just a quick question on attrition. You know, I see that almost a quarter of the employees is the attrition both involuntary and voluntary put together. Any color to whom are we losing this attrition? Is it competition, captives or Tier-1 IT players or IT services business? Any color on that would be helpful.

Krishna Bodanapu: See, it's an extraordinary time in terms of attrition just because we are also resizing, and the full effect of some of the resizing initiatives happened in Q3. If you look at our net addition for Q3, it was minus 400 people or so, which, I mean, it is unfortunate, but that is what it is. We need to make our business efficient. Now, therefore, a lot of the attrition was also forced attrition, as we call it, because we just have overcapacity. Having said that, where people go is all over the place. I mean, a lot of them go to our customers, some of them go to our competitors, a number of them go to product companies because we also recruit quite extensively from product companies, be it hardware product, places like the large OEMs or Tier-1's or even software product. So, it's all over the place. I mean, we have analyzed that information a lot. And we are not very concerned in terms of it's not that somebody is targeting us and taking our people. That's not the case. It's just a natural process. And also, Q3 was regrettable because a lot of the efficiency exercise came to happen.

Moderator: Thank you. The next question is from the line of Vibhor Singhal from PhillipCapital. Please go ahead.

Vibhor Singhal: Sorry to harp on this again on the margins front. I know the question has been asked multiple times. But I just wanted to understand that if we are looking at the mathematics of 9.6% plus 250 basis point, and we are looking at maybe margins of around 12% in next year, which was the same as the margins last year, what is the net benefit of this entire restructuring size that we are getting until unless we reach the margins, as one of the participants said to around 14%. And we have clear visibility of a time frame by which we reach that. How are we kind of looking at this whole restructuring exercise in terms of net benefits to the company?

Ajay Aggarwal: I think that's a good point that you raised. If you see from our perspective, in the current year we had three headwinds which were between 150 and 200 bps. One was from the volume impact, this year-on-year growth not being there. I think and of course we continue to invest in the company from long-term perspective, so I think that was one headwind. Second headwind is, year-on-year incremental investment, again, on the NBA of 150 to 200 basis points. And third has been the wage increase, again, between 150 and 200.

So, to your point, you are very right. But I think I would say that about 3%, 3.5% of this has been investment for future, both in terms of the NBA and onetime cost of implementation or about 3% to 4% of it. And rest of it, I think could be taken as got compensated by this program. So, your point is valid, but I think we have to see the position in overall perspective. And as we calibrate some of these things in the coming year, we see there is a good opportunity.

Vibhor Singhal: But sir, many of these things will be recurring, right? Salary hike, we will give every year. Even the investment that we are making might be smaller in quantum, but we would be making them for future growth. So, if we have to depend on these things lowering down and then only our margins will increase to that 14% kind of a level, then it defeats the purpose of the entire exercise.

I mean, I am sorry if I am getting it wrong, but I am just doing the math's that you mentioned and trying to figure it out.

Ajay Aggarwal: So, as I said, I think we definitely want to work as, you said, to get to that 14%. But I think the benefit of this exercise is definitely 400, 450 bps with onetime associated cost. And we feel that some of the calls we have to take, how do we invest for future, how do we see the volumes and then we have done. I think we definitely feel that apart from the benefit of the margin, it has been a good learning for ourselves, the kind of robustness it has brought and the rigor it has brought to how do we look at each of the levers. And that's what I mentioned, we are trying to create our own team, which we will take it forward. So, we think there are lot of learnings apart from the numbers on this. So that's what is my take on this.

Vibhor Singhal: Sure, that's really good to hear. Just last question if I could ask. So, what is the total cost of this exercise that we are kind of doing, as we are seeing dollar on rupee terms, instead of just on basis point what is the total cost exercise that the company will incur for this restructuring exercise?

Ajay Aggarwal: So, if you take on the percentage basis, we said 2% to 2.5%, so that tells you everything. So roughly I think the cost is between $9 million and $10 million for the full year. What we have incurred so far is about $6 million to $7 million, and the rest of it will come in quarter four.

Moderator: Thank you. The next question is from the line of Andrew Peretti from Macquarie. Please go ahead.

Andrew Peretti: Apologies for the two rather technical questions. Just one relating to your foreign ownership limit. I believe currently that's restricted at 44%. And foreign shareholding is very close to that limit. Is there any reason why you haven't decided to raise that foreign investment limit?

Krishna Bodanapu: So, Andrew, it's actually 49%, and it's almost there, it's just the buckets between foreign institutional investors, direct investors, foreign individuals, etc. It's at 49% right now, and the ownership is almost there. The reason why we did it is because there are some India projects that we believe we are very strongly placed, India defense projects. And for that, the defense will require that the company remains Indian. And the only way to guarantee it was to say that there is a 49% cap.

Having said that, both from the perspective of how long the defense projects are taking and also the impact on the overall sort of shareholders, etc., we are working towards removing that limit. And we believe that we will be able to do it sometime within the course of this quarter or latest by next quarter. And what happens to the India investments, we are coming up with a structure which we will transparently share with you, which will make that also work.

So, the short of the long story is that we did it because for India defense projects. But we are still bullish on India defense projects, but we are also understanding that it's having a big impact on the main company, which we can't let it at this point.

Andrew Peretti: So, if I am not mistaken as well, from April 2020 that foreign limit will actually be defaulted to the sector limit, so you don't have any plans to restrict? I assume that sector limit will obviously be higher than the foreign limit, so I assume you don't any have plans to restrict foreign investment when defaulting happens come April 2020?

Krishna Bodanapu: Yes, absolutely. I think the IT services, the category we fall into its 100%.

Andrew Peretti: Perfect. And you don't have any plans to restrict the foreign investment limit via a special resolution?

Krishna Bodanapu: No. Once we get to this 49%, the defense problem is solved, I think we have taken a call that we won't put anymore limits on foreign ownership, because there is a big implication from a share perspective.

Andrew Peretti: And so that issue will be resolved within the quarter?

Krishna Bodanapu: Within this quarter is what we are working towards. Worse case, it will be next quarter.

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

B.V.R. Mohan Reddy: Thank you very much for participating in our Q3 earnings call. Both Krishna and Ajay explained to you in detail that we are back on the growth path. We are hoping to see much stronger quarter in Q4, and we continue to look forward to your support. Thank you very much for your participation. Thank you.

Moderator: Thank you very much, sir. Ladies and gentlemen, on behalf of Cyient, that concludes this conference. Thank you for joining us. And you may now disconnect your lines.
