"Cyient Limited Q4 FY20 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day. And welcome to the Cyient Q4 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 from Cyient for opening comments. Thank you and over to you, sir.

Ajay Aggarwal: Good evening, ladies and gentlemen. Thank you so much for taking the call, despite late evening today. But just because of the COVID scenario, we just finished our Board meeting and we will be talking about these results for the quarter ended 31st March, and we will also be talking about the full year. I am Ajay Aggarwal. Present with me on this call is our Executive Chairman, Mr. Mohan Reddy; Managing Director and CEO, Krishna Bodanapu; and also our President and COO, Karthik Natarajan.

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 on our investor update, which has been emailed to you and is also posted on our corporate website. This call will be accompanied with an earnings call presentation. And with this may I invite Mr. Mohan Reddy to provide a brief overview of the company's performance for the quarter, and the year ended March 31, 2020.

B.V.R. Mohan Reddy: Thank you, Ajay. Good evening, ladies and gentlemen. Thank you again now for joining us this late on the conference call. As Ajay said, given the COVID situation and the restrictions on travel, none of our Directors could travel to India. We have three foreign Directors, one lives in Washington DC, the other two in Europe, so we had to accommodate their time constraints. We just finished the Board meeting and we thought we will probably take the opportunity of updating all of you on the results.

Let me briefly go. What I have in front of me is that we posted a quarterly revenue of Rs. 1,073.6 crores, this is de-growth to about 2.9% quarter-on-quarter basis. In U.S. dollar terms, it's about $149.2 million, that is a de-growth of 3.8% on a quarter-on- quarter basis, or it's about 3.7% on a constant currency terms. The services revenue were at $132.3 million, which again signifies a degrowth of 5.6% quarter-on-quarter basis, or 5.4% on a constant currency basis. The normalized EBIT margin stood at 8.4% for the quarter, lower by 118 basis points on a quarter-to-quarter basis. The services EBIT excluding one-off stood at 9.6% for the quarter, lower by 100 basis points on a quarter-to-quarter basis. The DLM EBIT stood at -0.5% for the quarter, normalized net profit for the quarter stood at Rs. 754 million or Rs. 75.4 crores, which is a de-growth of about 30.4% on a quarter-on-quarter basis.

Let me then take you through the highlights for the full year. For the full year, the total revenue stood at Rs. 4,427.4 crores, Rs. 44,274 million, signifying a de-growth of 4.1% for a full year basis. In dollar terms, the revenue was $625.2 million, a de-growth of about 5.3% or on constant currency terms it's at 4%. The services revenue stood at $550.7 million, signifying a de-growth of 5.1% in USD terms and 3.7% in constant currency terms. The DLM revenue for the year stood at $74.6 million, a de-growth of 6.6%. Normalized group EBIT stood at Rs. 4,084 million or Rs. 408.4 crores, down by 23.4%. The normalized group EBIT margin stood at 9.2% for the year, down by 232 bps. Services margins, excluding one-offs, stood at 10.5% for the year, and the DLM margins stood at -0.2% for the year. Normalized profit for the year stood at Rs. 372.7 crores, it's down by about 23.9%. Continued focus on cash flow has yielded good results with cash conversion of 56.9% for the full year, the cash flow was at Rs. 410.2 crores. The total dividend payout for the financial year 2020 was at Rs. 15 per share.

Let me come to a few business highlights for the quarter. Cyient remains focused on maximizing the remote working, work from home across all geographies to aid social distancing, and ensuring a safe working environment for business critical employees who needed to be on site. In India, 92% of the employees are enabled work from home, 96% of the employees are either work from home or from customer locations in other geographies. We managed to secure work from home approvals from 94% of our clients across top 65 accounts. All these metrics are as of 30th April, 2020. We signed an agreement with Hitachi Rail to deliver a series of project engineering services to support and accelerate the evolution of its signaling technology, and enhance its project execution capacity in April 2020. Our Mysore facility will support manufacturing of COVID-19 diagnostic kit, an X-ray system assembly. We are providing the Telangana State Police with drone-based surveillance technology to help implement the COVID-19 related lockdown in Hyderabad.

On the CSR front, Cyient contributed of Rs. 2 crores to Telangana Chief Minister Relief Fund to support government's effort for fighting COVID-19 pandemic in April 2020. I am extremely delighted to report Cyient received the 2019 Harithaharam award from CII Telangana State annual meeting. We continue to support the 28 government schools, provide education to about 18,500 underprivileged children. We continue to support 70 Cyient DLM Centers which are called CDC around Telangana and Andhra Pradesh. On the award front, Cyient won the Supplier Innovation award for the seventh consecutive year, and Suppliers Highest Productivity award for the fourth consecutive year at the annual Pratt & Whitney Supplier Summit 2019.

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

Ajay Aggarwal: Thank you, Mohan. Before I go to the financial update, two more updates I will add. First is, as you had seen, we had notified the stock exchange that in the Board meeting of 6th April, the Board of Directors had approved the appointment of Mr. Mohan Reddy as Executive Chairman of the company. He has volunteered not to draw any salary from the company. In today's concluded meeting, the Board has approved the removal of the cap of 49% on the foreign holding, subject to the shareholders' approval and the regulator's approval.

With this, I move over to the financial performance. If you see in terms of our revenue, we have de-growth of 5.6% quarter-on-quarter. This is not in line with the anticipation that we had. And I will explain to you in detail what happened, what were we expecting, and why we could not get to that number. Standalone, DLM growth is 12.7% and this was anticipated to be higher. In terms of overall DLM, 12.4%, this is including the manufacturing facility at U.S. If you look at the vertical view of the quarter-on-quarter performance, you would see that A&D and communication I think more or less have been in line with our anticipation, both have shown about little growth in aerospace and defense. And I would say, if you take the currency into account, communication is almost flat. Where we had more challenges was one in the semiconductor business and in E&U business as far as quarter-on-quarter decline is concerned.

This is basically if you see, the gap between what we anticipated and the final growth is about 7%. That is about $12 million. I am looking at what we were anticipating a minimum growth for the group of 2% versus what we have ended up around 5% de-growth or $11.7 million. We did have the impact of the COVID. While we have been able to implement work from home and other contingent measures, it did take us some time to respond to that. And also the approval from the customer, that took time. Also, we had to put the IT controls and things like that. So, I think that is one factor that has impacted us. In terms of our DLM, Mysore, of course, it was again on lockdown, and we had some issues on raw materials, especially coming in from the part of Asia which got affected much earlier. Also, I think we had a lot of materials ready which could not be dispatched at the month end and that was not part of the revenue.

Also in semiconductor, again, the same thing, it has dependence on supplies from China and that part of the world. Because of that, we had impact of about $1.5 million. We were anticipating will be able to recognize the revenue towards license for E&U. But then later we realized, it's a combined offering with services. And the way we have to take it is, along with the implementation. So, revenue is there but it will be showing up in the coming quarter. And we had the most challenges on E&U site in this quarter, about $3 million. And mainly coming from North America utilities, especially relating to the field work kind of challenges. While we were looking at momentum on growth to continue, most of it is COVID, some of it is still our internal issues, last two items.

But I can assure you, and Krishna will also talk about in his presentation, that we have spent a lot of time in the last few quarters, including in the last few months, to make sure that whatever are the learnings we implement, this is for financial year 2020. So this year we are seeing a de-growth, if you see, for many years we have been giving a growth of double-digit, that's our CAGR for five years and 10 years. This year has been outlier and constant currency de-growth of about 3.7% in services. And there we had quite other than MTH which is positive, and E&U in constant currency which has grown by about 3%. I think we had challenges from most of the areas, we have been talking about our challenges in A&D and communication. And I think that's what it is. But the good thing is, in the last few quarters, I think we are getting better in terms of predictability and getting a complete handle of what is going on. Yes, those are some of my comments from this.

In terms of the hedge book, we have made one-time exception we had made in March when the rupee was depreciating by almost 5%, we had taken additional cover of 10% for financial year 2021. So, our hedge position is 80%. This is only one-time; policy change only applicable for financial year 2021. And based on this, our total forward cover position coverage is about $141 million. If you look at right hand chart, you will see while we have a difficulty at current spot rate of Rs. 75.6 in terms of the dollar, we are losing more than Rs. 1, we are getting about Rs. 4, Rs. 2, and Rs. 1 each in Australian dollar, British pound and euro. And overall, we are gaining about Rs. 2 or so. So, I think this is the correct position of exposures. We still should be positive at the current spot rate. But we have done an analysis internally, for the next year, based on how the other income moves based on the spot rate, and how we get the benefits of operating profit for roughly about 25 basis points for every Rs. 1 change of rupee, and assuming other currencies are not headwind, we have found that we should be neutral for the next year from the volatility of foreign exchange.

In terms of other income, I would say overall this has been a good year for us on other income. While in the quarter you will find there is a marginal drop, it is mostly led by the unrealized foreign exchange losses. I want to confirm these are notional in nature, this is just a restatement of some of the loans that are in our subsidiaries which are in euro and dollar. And they have natural hedge because of inflows, so it is just a notional loss that we have got in the quarter. Otherwise, I think we continue to be very prudent on our treasury. All our investments are based on the principle of preservation of capital, so that is going well. Overall for the year, the only thing is, while we were expecting the export benefits to come in quarter four, due to the lockdown they shifted in quarter one. Otherwise, this number of Rs.1,250 Mn and Rs. 206 Mn for the quarter and year would have been higher by about Rs. 50 crores. We have got those scrips as we speak now in this particular week, and they will be showing up in our profitability statement in quarter one when we convert those scripts into cash as we have been very prudent in terms of accounting any such benefit only on cash basis.

This is in terms of the profit and loss account. I would say that we had some one-off in this particular quarter as part of our event evaluation for the year. And we have been prudent to provide about Rs. 60 crores on the balance sheet in terms of the strengthening of the balance sheet. And we have also got some gains from reversal of some of the earn-outs which are not applicable. So net, net, the impact on the PAT is about Rs. 302 million or $4.1 million. And that also impacts on the respective categories, some of them show up in the EBIT, some of them show up on PBT and some of them are on tax. And thus what we have done, we have prepared a table. If you can just show the table. We have prepared a table for you to be able to clearly understand each of these one-offs.

So let me just take a minute to explain what are these one-offs. There are six one-offs in this particular period, and seven and eight item numbers pertains to previous year's one-off, just to make a comparison to be like-to-like. So, we have taken the impairment of intangible assets, one for our operations in Singapore, while operations continue, but we have assumed that the future revenue is going to be lower than our original projections. So we have taken the hit of about 109 million on that. Second one is the similar thing that has happened in case of the asset under development, which is the case of the BlueBird. While we have supplied the BlueBird to the government, we continue that business. But as prudent, whatever investment we have made, that is Rs. 222 million or $3 million, we have provided for that. Also, we had an acquisition in U.S.

called CERTON, and we had a IP platform for which an intangible asset was created, for that another provision of Rs. 73 million has been created. This is out of the prudence based on how we think things will be in future. I again continue, all of these operations continue. But we have taken and prepared our balance sheet for the worst case in each one of them.

Fourth item is, there is a trade write-off for the joint venture that we have. It is a small joint venture that we have, and we had some trade receivables. So serial number 1 to 4; 1, 2, 3 and 5 appears on EBIT adjustment. Serial number 4 is an item which we have taken as one-off other income, that's why you would see that our other income would have been higher by 333 million, that Rs. 120 crores would have been more like Rs. 153 crores had we not called out as one-off, so we are not taking them in our normalized PAT. These are some of the acquisitions were based on the share purchase agreement, the amounts payable are not due. But there have been some one-offs in these, especially Ansem for example, where we have seen because of COVID and some other considerations, there has been a little lower performance. The performance is growing, this is a good business. But just that we did not meet those milestones of earn-out, they were very aggressive, we have got the credit back of this. And there is a complete alignment with each of the sellers also, I just wanted to bring that to light.

Last item is, we have one-offs of tax of about Rs. 194 million or about $2.1 million, these are pertaining to practically previous year's, there are three items which are there. One is, we had to provide for the deferred tax for the future years in terms of the tax rates to 25%. While our tax rate continues to be 23% to 24%, we have delivered a little lower than 23% for the year as a whole. We are confident that for the next two years, we will be in this bracket of 23% to 24%. But once you go to 25% regime, three years from now, then we have to restate our deferred tax liability, that's the first item. Item number two is, we had very long outstanding items of dispute or litigation with the tax department. So under this scheme, one time scheme that has been made available to us, once we settle that we get our cash refund for that entire assessment period. So this Rs. 44 million gives us a cash flow of Rs. 55 million in H1 because of this. Other tax provisions, these are more of the settlements that arose from assessments and other provisions. So I just want to say that this is extremely conservative. We have absolute clean position on tax and our tax rate at normalized rates will continue to be 23% to 24%. So I would leave this table for all of you to read. We had circulated it about an hour back. So these items, and then two items for the last year will give you a very clear idea of how we have arrived at normalized EBIT, normalized PBT and normalized PAT.

In terms of the total performance, you would see that there are a few things I would like to highlight. Yes, I think we were definitely looking at something like 100 basis points improvement in this quarter. But there has been a decline on the other side. I can only assure you that from the efficiency measures, and whatever program we had launched for the quarter as well as for the year, we are absolutely on track. And whatever gap is there, it is because of the volume. You saw that $11 million plus of revenue that we lost and the corresponding loss of that in terms of the gross profit is what is reflected in our lower margin. For the services, our margin is 10.5% as against 9.2% for the group. And just to understand, for the whole year actually if you see, if you take off the impact of the volume, practically this number will be about 13% for the services, and this will be 12% for the group. Because if you take the absorption impact on the depreciation, the absorption impact on our SG&A and some of the utilization challenges that we got because of the unanticipated revenue being lower, especially in quarter four, I think we lost about 270 bps, otherwise our margin would have tracked with what we were internally expecting to be about 12%, which is about 200 plus points higher. The kind of comfort I am providing is in terms of our efficiency work and in terms of the R2020 program that we took, I think we feel we have got a annualized saving of about 3.5%, what is showing up in the P&L is about 2.2%, because this program has full impact in the coming years. But we are doing a lot to improve the margins. In terms of a normalized PAT, I already explained some of the items. Overall, the normalized number is Rs. 3,727 million, and this is a lower by 23.9% year-on-year.

I would like to read this bridge. We have provided you complete details of what has happened in terms of the movement of the margin, both for the quarter and for the year. And I have also tried to give you the guideline in terms of what happened from our anticipated margin to the actual margin. And anyone of you if you have further clarification, we can take in Q&A or we can talk offline.

In terms of cash generation, as Chairman mentioned, I think we had a good year and a good quarter. This has been the highest ever free cash flow that we have generated. Our cash and cash equivalents stand at Rs. 9,518 million. The cash flow conversion for quarter four has been at 74%. So that's another good thing. And we feel that going forward also we are anticipating that we should be able to at least maintain 50% plus conversion in H1 also, that's what we are targeting. In the current uncertainty, what we are able to plan right now is more for the two quarters ahead, and Krishna will talk about it more. But from our perspective, we are trying to make sure that we take care of this COVID opportunity to right size our cost. There is a lot of focus on cost optimization and cash. So that despite the challenges that would come from the demand side of the customer, and some supply side challenges because of the uncertainty that is there around working arrangements, we will be able to maximize the cash flow as well as optimize the profit in this particular situation.

With this, I will hand over to Krishna.

Krishna Bodanapu: Thank you, Ajay. Good evening, everyone. And like, Chairman and Ajay said, thank you for being on the call this late in the evening. But I will say the first thing is just some lessons learnt from our happened over the last year or so, and what we will do going forward. I would say there are three buckets of things to make sure we get to not just better predictability but also better execution.

The first is on the strategic lines, with Karthik's overview, we have created a team that is a lot more focused on our operational efficiency issues to make sure that we get to our revenue achievement, EBIT, achievement and sustenance. The structural changes in the delivery and sales team to get to more revenue accuracy and forecast accuracy. Also how we are doing contracts and restructuring them is what we are looking at. There are some process related changes that we have done, including the fact that we have the SAP system is finally up and running. This is the first quarter that the results came completely out of this system without any intervention. And we believe that now we just need to pull in the time, because even this quarter it took us a while to get the results, though it all came from the system. Lastly, we have a cost management program, which we are working on quite a bit in terms of making sure that we are planning our costs and we are tracking them.

If you go to the next slide, its the M&A slide, nothing's really changed. And it's probably not the right time to talk too much about M&A, so I will skip on that. Just to give you some colour on the industries that we work in, the first is aerospace and defense. Again, I think there is no secret here that this industry will be quite impacted with what is going on. If you read the commentary of Boeing and Airbus, they are saying that their planes will be 50% less or there will be 50% less deliverables, at least in the immediate future. So we just have to brace for that and the impact that it has on us. We will have a significant impact, it's not going to be 50% on us, hopefully, but we will have a significant impact and we just need to brace for that. At the same time, the silver lining there is that the defense part of aerospace and defense is actually holding up quite well. And we believe that that is going to be an area of focus. And we are working with our sales team to really bring focus to that part of the business.

The communications industry, we will see just a medium-term impact. We believe that this is one industry that for the year will still do quite well. Because all said and done, investments in 5G, investments in broadband, etc., will only have to increase considering what is going on in the world. But having said that, in the immediate term we do have some issues, because if you look, there's a lot of field related activities as we have to get our inputs from what exists in the field. And our outputs goes to the construction companies to actually build the network once we have designed it. Therefore, there is a field challenge and that's why though in the immediate term we do have a little bit of a challenge, we believe from a longer term basis this is one industry, and when I say longer, I take that back, from a midterm basis and especially in the second half of the year we believe that this industry will be a strong performer.

In terms of energy and utilities, energy is sort of two different things are going on. The mining sector is actually doing quite well. Whereas oil and gas has significant challenges with where the pricing is. So we think that overall it will be tepid in the energy segment. Utilities will do well, while we had a challenge, as Ajay explained, we had a fairly significant challenge at the end of the year because of some execution issues and field issues. Again, I would say, in hindsight a lot of the COVID stuff has been lingering around in the field towards end of February, early March in various customers, or in various geographies, which we didn’t necessarily think the impact would be quite significant. But the field stuff is a lingering and we need to work around a bit around that. But utilities, there is a lot of investments going on, utilities are being upgraded. There is a lot of technology that's being put in, therefore, we are quite confident of it.

Transport, like aerospace, we believe will have a little bit of a medium term impact also, because, as you can imagine, anything that brings a lot of people together in a closed confined space would not be very sort of palatable to people. So, we believe transport will have a slight issue in the medium-term. But we also think that transport is an infrastructure related sector, therefore, a lot of spend will go into the transport sector going forward. So we assume that there will be an uptick and we are also seeing our customers win some reasonable deals.

The portfolio business has two components, the industrial segment is going to be hit hard in the immediate term, because there are supply chain challenges, there are capex spends that are coming down. But also at the same time, a lot of the equipment that we design goes into infrastructure type of projects, be it construction, road works, etc. So we believe that that will recover also in the medium-term. But we will have some short-term issues.

Geospatial, we have challenges with fieldwork again there, because this is really the way I look at the geospatial business is capturing the realities on the ground into a virtual database, which is essentially what we do. And we don't have the access to the realities in terms of the raw data, and that's when we will have an immediate term challenge. So from a medium to long-term, I think this is actually one industry which will see some good growth, given that geography and tagging and proximity are going to become that much more important.

There are certain areas in the semiconductor industry that are doing quite well and there are certain areas where we will have a challenge. For example, there is a lot more being spent on network equipment, computing equipment, which consumes a lot of chips. Whereas we believe that there will be a challenge on some of the consumer type of applications.

Medical and healthcare is a little bit counterintuitive, because a lot of spend in medical and healthcare is going towards COVID related activities. And there is an absolute stoppage in the non-COVID related activities, which is a lot of the equipment that we provide, because elective surgeries have come down, people are waiting for things to smoothen out before a lot of those things are done. There was an interesting statistic that one out of five doctors in the U.S. apparently is in furlough because they don't want people coming into the hospital risking infection if they don't have to. So in that sense, I think there are some good opportunities, there because there is a lot more around technology, digital, telemedicine. But we will have to see how things work out in the medium-term over there.

So having said that, and before I stop, I want to say, we don't give guidance, as you know. And we typically at the beginning of the year give a broad framework in terms of how the year looks like. This time, I think it is not going to be prudent to do that, because while we have a fairly good handle on how the first half of the year is going to look like, I think, the second half of the year is still up in the air and therefore it's not very prudent to give a yearly outlook. Having said that, and in the spirit of transparency, I will say that the first quarter looks challenging. We will have de-growth in the first quarter. We believe that the de-growth, we are at least planning for a degrowth between 15% and 20% quarter-on-quarter, which is quite significant. But I think in the spirit of being transparent, we wanted to also convey that, because I think there is a lot of hypothesis on what the numbers will be. But in our case, we are bracing for this, I will say, what will happen we have to see, but I think in prudence and being cautious, we are bracing for an impact of 15% to 20%. There are, of course, a number of actions that we are taking in line to this in terms of what we can do with subcontracting facilities, sales, marketing, travel, there's a lot of things that we are doing at this point. We also won't do any salary increases, at least in the first half of the year we certainly won't do it. If we do something in the second half, it will be for a small set of people more at the early career stages. We also have initiatives to improve utilization etc.

So, what we are working towards is, we will see the drop in Q1, we will see growth back coming in Q2, and we have confidence in that based on the current backlog and order book. And we believe that while EBIT margins will be a fairly significant challenge in Q1, coming to Q2, they will improve quite significantly and they will be back to Q4 levels in Q2. And we hope we plan and we commit that we will only improve them further from there in the second half of the year.

With that, I will hand it back to the moderator to facilitate the Q&A.

Moderator: Thank you very much. We will now begin the question and answer session. The first question is from the line of Urmil Shah from IDBI Capital. Please go ahead.

Urmil Shah: Krishna, thanks for sharing the outlook for Q1. It would be very helpful if you could qualitatively call out which of the verticals would be more severely impacted. Basically I am trying to gauge, while the second half is uncertain, how the vertical spread would be for FY21?

Krishna Bodanapu: Urmil, I think the challenge through the year I would imagine is primarily in aerospace. I think that is a fairly significant challenge and that's something that we know for a fact. Now, if I look at some of the others, like, comms or utilities, we will have a challenge in Q1, and maybe in Q2, because the challenge there is not the lack of order book, we have a fairly significant order book in both these businesses and also in some elements of portfolio where the geospatial element is there. The challenge is really going to be because of the fact that the fieldwork is severely restricted because of all the restrictions that are in place in our various places. So, A&D will be a challenge through the year is what we anticipate. We anticipate that comms, utilities and some elements of portfolio will have a challenge in the first quarter or maybe into the second quarter, depending on how the opening up happens. But in the second half, they will actually do quite well. Transport also we believe has a challenge in the immediate term, due to some customer related challenges. But transport also will do quite well over a period of time into the second half of the year. So the real challenge is in aerospace and you know what's going on there. But also we are trying to mitigate, I would say, whatever I am telling you is sort of the downside scenario because we want to be prudent, that's what we know best. And I think the view that we are taking is that we prepare for the worst, but of course hope for the best. So that's the view that we have right now.

Urmil Shah: Sure. And just to understand, as regard to A&D, comms and utilities, would the impact be higher than the company level impact we are talking for Q1?

Krishna Bodanapu: A&D will be, I think the rest will be a little bit more muted. The problem with A&D is, and I am sure you read enough about it is that the deliverables are down quite a bit, which has a fairly significant impact across the supply chain. And also, one of the things we had done well in A&D business is, we were doing a lot of the sustenance work that is, as planes were coming back for repair, overhaul, etc. We were doing the work around the engineering for MRO. Now, with the planes itself not flying, even the sustenance, keep the lights on business has got dramatically hit. Whereas if you look at a lot of the other business, like comms, for example, we help networks run and keep them running, it's just a matter of time because once the COVID impact goes we will actually see very good growth there. But the challenge is in aerospace, it looks like structurally itself air traffic will be down for a while.

Urmil Shah: Ajay, if you could run us through what are the kinds of factors, you know, while Krishna did mention about it, but to what extent they can help containing the impact of lower revenue on EBIT margin? And we had spoken about improvement in EBIT margin for this year, even the current scenario by what period you think that improvement is likely to get delayed?

Ajay Aggarwal: See, I would say there are two parts from the perspective of the levers to improve the margin. Definitely, this is sort of quite a drastic situation in terms of what has happened already in Q4 and then what we are seeing happening in the world in quarter one and quarter two. So, as Krishna said, from the cost structure perspective, we have made a plan, so that if the worst comes through, then what are the actions that we can take. And we need some kind of calibration depending on which zone of de-growth that we hit. So, we are looking at some kind of a red zone of de-growth, a yellow kind of a zone and a green kind of a zone. And then accordingly we are saying what actions will be taken. So Krishna already said in terms of no salary increases and maybe, obviously, since some of the variable pays are linked to the performance in the company, they definitely will get impacted. So that's one action. And that definitely helps on the margin side. But also on the utilization and efficiency, I think it's important that our cost base has to be resized. But that will mean that we have to do a lot of hard work in quarter one and continue to do what we did in the last year in terms of improving the efficiency and utilization. And that will require some investments upfront. But I think with all those efforts, with these range of the scenarios coming on revenue, while I will prefer to look at a scenario where our worst case preparation goes wrong, and we don't have to take all these cost actions, but we are very confident that with this kind of a scenario we will have two bad quarters in terms of time to get back to the quarter four level of margins. But then we can quickly, at least from quarter three we would have taken the actions to make sure that we can at least sustain or slightly improve the margin from quarter four level.

Krishna Bodanapu: So I will just say that based on how things look like today, quarter three, we believe we can get back to quarter three margins. I won't comment on the revenue yet because it's too uncertain at this point. But from a profitability perspective, in quarter three we will get back to quarter three. That's the plan that we are working towards. I mean, again, if the world collapses, that's a different story. But based on a pessimistic view of things that we currently have, that's still work we believe we can achieve.

Moderator: Thank you. The next question is from the line of Madhu Babu from Centrum Capital. Please go ahead.

Madhu Babu: My question is regarding aerospace. So, how much is in the commercial airline, supporting the commercial airline, or we do a couple of projects in the defense side as well, so how much is related to that. And secondly, some of the smaller verticals, this question is to Mr. Karthikeyan, considering that we have a sizable experience, how easily we can scale up some of the smaller verticals like industrial equipment and all those things?

Krishna Bodanapu: So, on the first one, I would say, it's about 80:20, 80% or so of the work that we do is for commercial aerospace, and 20% of the work is for defense right now, give or take, I mean, it might vary at certain points. Like I said, the idea is really to focus on that defense piece, because there is still a lot of engineering going on. It's easier said than done, but I think there are some actions that we are putting in place. And also the advantage that we have in that is the U.S. based workforce, because a lot of the defense spend will also happen in the U.S. Therefore, the advantage I will say is the U.S. based or U.S. citizens in the capability that we have for aerospace is going to be a big differentiator or a good differentiator I would say. On the second piece, we have a plan on how we will focus on the smaller verticals. We weren't as aggressive on the smaller verticals because we thought that there was still a lot of opportunity in some of the bigger verticals, which still holds, I think even aerospace will take you know probably 12 to 18 to 24 months to recover back. But we are looking at how we can accelerate that, not that the market will recover, but just how we can grow our share within some customers. But the idea is also that we will focus on some of the smaller verticals that we have, because I think there is a good value proposition. And also, there are opportunities which we earlier wouldn't have addressed because of various reasons, but I think now it becomes quite interesting for us also to look at. So we are looking at the various smaller verticals, be it medical, semiconductor, I think there is a fairly robust plan on semiconductor how we could grow that business, especially given that chips will go into a lot more things with the whole remote working and the remote world, there will be a lot more semiconductor consumption. So we will share the details as they work, but that's a part of our plan as to how to focus as much as some of the other sort of verticals that we did not in the past.

Madhu Babu: And my second question is to Ajay, so in the debt we include, so how much is the actual debt and how much is lease liabilities? And though we have paid a good dividend last year, around Rs. 15, considering the outlook for first half is so low, can we plan an open market buy back in the medium-term, because we have a decent net cash in there?

Ajay Aggarwal: Madhu, I am not sure I understood your question. Are you saying we have so much of cash…

Ajay Aggarwal: Actually, the net debt in the company if you look at, if I can talk in the dollar terms, we have about $130 million of cash. And in terms of debt we have about net debt of $50 million. So 130 minus 50, that is about $80 million of net cash that we have.

Madhu Babu: So that's almost Rs. 580 crores, so considering that the first half is going to be very weak and as per regulation we can ideally even go ahead and do a buyback. Would we like to look at open market buyback for the next six months to at least protect the stock?

Ajay Aggarwal: We have evaluated various options, but right now I think we want to be in this particular position, H1 we may not take any of these corporate actions looking at the situation right now, and would like to look at conservation. And also why Krishna said that at this time we don't talk about M&A, I think there is a team within the company which is dedicated to looking at some kind of opportunities. And we are also seeing that over and above this cash, we can definitely do some kind of good investment activity. So our focus is on that side. But nothing is ruled out but it is unlikely.

Moderator: Thank you. The next question is from the line of Sudheer Guntupalli from Motilal Oswal Securities Limited. Please go ahead.

Sudheer Guntupalli: You have a list of exceptional items, I have questions on a couple of them. First is in terms of the impairment of intangible assets under development. This is a little surprising given the fact it's an impairment of something which is still under development and not an actual asset. So to begin with, why was a sizeable cost incurred when the orders were not even materialized and we were not even sure we could monetize them?

Ajay Aggarwal: Let me explain to you that this is more of a technical term. Normally when you acquire, this is about the acquisition of what you have all heard as Certon, our avionics company in Melbourne U.S. And as part of the acquisition, there is a software platform. So, I think in this particular case we had started a joint venture with a Israeli technology partner for supply of niche technology into India. And based on our experience of three years, we have definitely supplied the commercial products, so definitely that has happened. But how we look at the outlook and the uncertainties in that particular market, we have been prudent to provide for it. So I think it is a change in outlook in terms of the defense work.

Krishna Bodanapu: Sorry, I will just add to that. Two things happened there, one is, we did sell Rs. 10 crores worth of equipment to the Indian defense, Indian Army. So it was something that was progressing. But looking at the current situation and where the spend of the Indian Armed Forces is going to be, etc., and what our take on that was, that's why we thought it was prudent. So, I think like Ajay said it's a technical term, ultimately we actually commercialize it and sold it. That's why we invested a little bit more also last year or I think, yes, something early last year. So that was one.

The second is, what also happened is, given that Ajay said, we are going to remove or the Board has approved removing the foreign investment cap, we will not be qualified as an Indian company, given that our foreign holdings is already close to 49%. And once the cap comes off, it will likely go beyond 51%. There is a good chance that we won't qualify as an Indian company, which will also make our chances of success much lower. And obviously we weighed in a lot of these options and then came up with the final solution. We will still continue to sell that product and if we are able to then well and good. But the prudent thing was to provide for it, considering both the market where the government is and where the spend is, has changed quite significantly. And two is, our situation with being a non-Indian potentially being classified as a non-Indian company could disqualify us from some of the tenders.

Sudheer Guntupalli: Sure. Second thing is on the reversal of earn-outs. So, our understanding is that whenever there is a case of contingent consideration payable, first of all, the earn-out entry is booked only when the payout is reasonably certain. Just want to check, did we pre-book this payout earlier which we are reversing right now?

Ajay Aggarwal: No, so if you look at the capitalization of goodwill, it is based on the upfront payment and the deferred payment. So typically in these cases, you have 70% which is upfront and about 30% which is linked to the future milestones. So, what we capitalize is, whatever is the most likely configuration that we negotiate, and some of that terms on how it gets dispersed are more of execution issues. And if you see our overall experience, you will find these as exceptional, in 8 out of 10 or 9 out of 10 cases we have paid the earn-outs.

Sudheer Guntupalli: Sure. One last question if I can squeeze in. So, we have been talking about recovery in growth and cost optimization for some time. However, quarter after quarter our performance has been disappointing, not just in standalone terms, but even versus a broader set of peers. So, if we do a root cause analysis and introspect about it, when do you think we will be able to go beyond these issues and perform in line with the industry, if not outperform it?

Krishna Bodanapu: So, I think that's a difficult question to answer just because of the uncertainty that we face. So, the way I would look at it, I would look at it quarter-by-quarter at least for the next quarter or two. So, we were quite transparent in terms of what we think the quarter will turn out to be. We will focus on efficiency and optimization. And I think I would err on the side of caution to say this is when we will outperform anybody else. I mean, the intuitive answer is next quarter, but obviously that's a very dangerous thing to say. So I would say, let's take it a quarter at a time. Right now there's just way too much uncertainty to that. Having said that, I will say our commitment is absolutely that. I mean, we take a lot of pride that four out of the last five years we did outperform most of the competition, and we were always in the top quartile, in four out of the last five or six years. So that is the ambition, we hit a roadblock obviously last year. You are absolutely right, we had some misses. And that's why we have introspected a lot in terms of what we can do better. So, the commitment is absolutely there. I will also say that we will target on making that happen sometime this year, probably in Q3 or Q4, but it will take some time before I can commit to it. I mean, especially, given that we are coming off of a weak foot that I don't want to make a commitment that we can't keep at this point.

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

Sandeep Shah: Just the question about this 15% to 20% decline which we speak about in the first quarter, can you give us a colour how it will look like in services and how it will look like in DLM? And also some colour in terms of a volume versus pricing pressure within the same.

Krishna Bodanapu: See, I think, right now I won't get too much more into the details on DLM versus services, I think both will be within that range. And again, there's way too many paths, but plus or minus, both will be within that range. Now, in terms of the volume versus price, price is still quite marginal. And I think given the drops in volumes we have taken into account the fact that there won't be significant price drops, because volume and price have to be looked in conjunction. Where there are price drops, we have already factored them in, again, they are fairly minimal but wherever there are price drops, we have already factored them in. And we have also put a little bit of buffer on what the potential price drops could be. So I would say that most of the drop is really coming because of volume rather than price.

Sandeep Shah: Krishna, it looks like that the business looks really sensitive to this kind of a slowdown, because at one end engineering R&D is a core work where such kind of a sudden drop to a volume looks like that most of our business looks like is a non-core to the client and that is why it is happening. How do you explain this kind of volume? Because it looks like in aerospace and defense it could be a decline of more than 15% to 20%. So are there project cancellations? Is it a systematic risk on the clients? What are you factoring while predicting this kind of a big decline in the volumes?

Krishna Bodanapu: See, if you look at the volume that both Boeing and Airbus are predicting, the drop in volume for them is 50%. So when there is a 50% drop in volume, and a lot of this is public information, when there is a 50% drop in volume, they don't have a choice but to also significantly reduce the core programs. I mean, yes, it is important for the long-term sustenance of the organization to invest in your programs. But they just don't at this point have the cash flow to invest in a lot of even the very core programs. So I think it's not fair to say that it's not because, you must have seen Caterpillar's results for example, Caterpillar's revenue dropped by 20% year-on-year in their Q1. Again, when that happens, they don't have a choice but to cut down on a number of things, including the new product developments. So I think it's not fair to say that what we do is not core, because I am sure we have talked about what we do in great detail in the past. It's just that the nature of which businesses that we work in and the challenges that they are facing in the immediate term is leading to this drop.

Sandeep Shah: Okay, fair enough. Just if we do the calculation based on what you have said, it looks like the whole year we will have a revenue decline of mid-teens to high teens. And in this scenario also we are talking about the margin improvement.

Krishna Bodanapu: One is, I don't think that is the case, I don't think we should extrapolate it yet. See, at this point, there's just way too much uncertainty in terms of how each industry and each business will evolve. So again, I would err on the side of caution, we have to take it a little bit slower because there is potentially good recovery that is happening starting Q2. So I would say, before jumping to that conclusion I would wait for a little bit.

Sandeep Shah: So just further to that, when you say 2Q increase, because you also said that aerospace may see 12 to 24 months of recovery, communication portfolio, transportation will all see a 1Q and 2Q also kind of a headwind. So, what makes you confident about the 2Q recovery? And question to Ajay, what should we take the commentary? So, as per the reported margins of this quarter on which we should build the model or what we have reported in the presentation also has some one-offs in terms of the margin? Because what you said in terms of the non-extraordinary charges, it looks like you are thinking above the EBIT only in the BSE filing not in the presentation.

Ajay Aggarwal: So, what we have explained in terms of our EBIT, we said for the quarter we are 8.4% normalized EBIT. So, that is the normal number after excluding the one-off. And then we also said that for the services it is higher by about 1%, 1.5% because that is the gap because of DLM.

Sandeep Shah: Okay, got it. And the question in terms of 2Q, why we are so confident about the recovery in the volume or in the revenue growth?

Krishna Bodanapu: That's a good question. Because what we see is, aerospace will be flat, people are talking about various shapes, probably the best case a U shaped recovery or an L shaped recovery. So aerospace, we are not anticipating great growth for the rest of the year after the drop. But some of the other industries like comms, utilities, etc., where there is a clear order book, and the challenge that we have really is more on the supply side, where we are not able to do field work or we are not able to get inputs from the field or construction has slowed down, therefore our outputs have slowed down. We see that those things that easing in Q1 going into Q2. And therefore, a fair amount of growth will come in utilities, in communications and also in transport. We also see that there has been some production challenges, there have been some slowdown in production, all those we see that some of those things are coming off and that's what gives me confidence. I mean, aerospace, let's face it, the situation that air travel is in and therefore aircraft sales is in etc., is something we have to manage with.

Sandeep Shah: Okay. And last question if I can squeeze. Ajay, last time on a cost optimization program, you have given us a colour that close to 400 bps worth of cost which was unlikely to recur in FY2021, of which you have given a breakup of 150 bps, 200 bps would be a benefit out of the cost optimization, and close to another 150 bps to 200 bps of some severance cost, some early expiry of the facilities and some consultant cost which will not repeat. Now, out of which you were deducting 150 bps to 200 bps of wage hikes. So now wage hikes is unlikely to be there, you still hang on to that 350 bps, 400 bps worth of tailwinds which can come in the FY2021?

Krishna Bodanapu: See, now with this revised scenario, in terms of the one-time cost versus what gains we had, as I explained earlier, we had about one-time cost of about, if I can round it off, about 1.5%, we got a gain for in-year saving of 2.5%, that on a annualized basis if the volumes were continuing would have been 3.5% to 4%. That is pre-COVID scenario and that's what my original budget also had. Now with this post-COVID scenario, now dealing with this uncertainty, I think one is, some of those processes and some of the tools and some of the rigor that we did in each of those areas, whether it was about efficiency in utilization, whether it was about efficiency, which was about G&A optimization, I think all of them are there and they will stay in dollar terms. The problem is, the moment the base and the scale goes down, these percentages don't work. So we will be able to provide you the guidance in terms of the fact that we will again start cost optimization this year, with this revised cost structure for the volume that we are expecting for H1. Based on that we are working to make sure that by the Q2 end we should be like-to-like where we are in quarter four, which means with 15%, 20% drop we have to make sure that we also get those utilization efficiency and all other things also in line. So, that's what we are saying, we will get back to quarter four level in Q2, and then we will sustain it or marginally improve. So some of these percentages are clearly a function of the case.

Sandeep Shah: Okay. So, for the full year we are saying from 9.2% which we reported as an EBIT margin in FY20, we will see an improvement in that 9.2% in FY21 despite the headwind on the revenue?

Krishna Bodanapu: No, I am saying H1 there will be a decline because in quarter one with this degrowth, quarter one will be the quarter of preparation and work that has to be done. So, a lot of that will go in not getting some kind of breakeven margin is what we are expecting in quarter one. But in quarter two, with those investments and effort, we will restore back to those levels. That means that you are looking at three quarters at quarter four level and one quarter where the investment will go to get back to at least the quarter four levels.

Sandeep Shah: Because your presentation is saying we expect our margin to strengthen in FY21, that's why I am seeing about this.

Krishna Bodanapu: Nope, what we are saying is, I stand corrected. What we are saying is, by quarter two we will try to get back to the levels and in H2 either we will sustain or improve. So I stand corrected.

Ajay Aggarwal: I would say, in Q1 we will have to put in a lot of work. Q2 we will see better margins, we will probably get back to Q4 margins. And in H2, we will get back to Q3 margins. But that's the current prognosis.

Krishna Bodanapu: Okay. This is based on what we see today and what we think we can take the action further. So if revenue is a little bit better, then we have some good tailwinds.

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

Sandeep Agarwal: Just one questions, Krishna, I have, on the margin front for some reason for quite some time and I will not sideline COVID-19 because it is definitely something which no one has anticipated. But my question is that if you see last three years also, we are continuously losing on margin for one or other reason. So, have we lost margin structurally somewhere? That is question number one.

And question number two, again the commentary which you made, instances that we are now going to focus on smaller verticals versus the large. But even if you focus on the smaller vertical and we are able to grow them faster, the base effect or the current contribution itself will negate all the work done there. So have you done that math in that sense that how long it will take for us to stabilize? So I am not asking any specific number or outlook, I am just trying to understand how long it will take before we can go back to reasonable growth and reasonable margins.

Krishna Bodanapu: You know, the first one I would say, structurally I think there have been some changes over the last three years. And that's why even margin has come down. But I think we recognize that last year in the whole exercise around structuring we did was to address that. We would have seen good outcome of that this year, but now with the COVID situation that's just gone and we need to relook at it from scratch basically. And that is what we are doing, that's just the reality that we are faced with. So I think you are right, margin has changed structurally, and we just need to relook at our operations to make sure that it supports that kind of a margin structure. But having said that, I am quite confident we took a lot of the hard decisions over the last year or so. And we are committed to making sure we continue them, because I think structurally there is a change, we just have to make sure that we bring in certain discipline and certain actions in place to get back to the margin numbers.

On the second question, it's not the change in strategy, it's just that we will focus on the same buckets, and going forward some of the smaller businesses have good synergy with what we do, good fungibility of skills with what we have. And therefore, especially at times like this when there's a lot of disruption, the way we have to look at it is, in status quo it doesn't give us an opportunity to go disrupt somebody else's business. But when there is so much disruption in the market, it gives us an opportunity to get into new businesses and do something different in those businesses to become successful. So that's why I would say that it is a plan. And we will create a separate structure, and we will come back with you on how we do it. But the idea is, we don't get an opportunity like this to disrupt the business, because fundamentally on the ground there is a lot that is going on. And when that happens, it's a great opportunity for us to be successful in a business that we have not been successful previously. I would say, we chose not to focus on some verticals, because we didn't have a clever plan of how we could be successful. Now with all the disruption, we see a line of sight of how we could build a business in those verticals.

Moderator: Thank you. The next question is from the line of Shraddha Agarwal from Asian Market Securities. Please go ahead.

Shraddha Agarwal: Sir, one question. Last quarter, we had given a pricing discount to one of our transportation clients in anticipation of good volumes pick up from that account. So how do we stand in that particular case?

Krishna Bodanapu: We are tracking a little bit behind now. They also have some serious issues in their businesses. But what we think is, because of all the work that we did last quarter we are very well positioned. So we will remain a very key part of their whole engineering chain and their whole engineering spend. The volumes might not pick up immediately to the extent that we thought because their production has stopped, their deliverables have been pushed out, etc. But we are quite confident that in the medium-term we will be where we need to be. It's just that in the short-term we won't see the volumes that we had anticipated.

Shraddha Agarwal: All right. And secondly on the receivables side, do we foresee any chances of providing for doubtful debts on any of our receivables? And how do we look at, you know, demand for credit extension from some of our accounts?

Krishna Bodanapu: So, we have provided what we needed to wherever we saw a risk with any of the customers, we have already provided for. So that is one of the reasons why we had the hit in Q4 that we did. In terms of credit period extension, etc., we are taking it case by case. There are some customers where we would extend that because of relationship, because of bad financial strength, these might be very specific reason why they are asking for it. In other cases, we have refused because if we see that it is too much of a risk, then we have refused it. So we will deal with it on a case by case basis.

Moderator: Thank you. We take the next question from the line of Mayank Babla from Dalal & Broacha. Please go ahead.

Mayank Babla: Sir, I had question around the inventory, which is around 2267 million, I believe that's for the DLM business where the top line is around 5,500 million approximately, seems to be a bit high. Could you just throw some light on there?

Ajay Aggarwal: So it is primarily because we have some large orders that go on for a period of time. And we have built up the inventory because we get some fairly good benefit of buying in scale etc. The holding cost is covered for by the customer so we can buy in scale. The auditors also have done a fairly thorough check on the inventory. There was a little bit that we had to write-off, which we wrote-off. But otherwise we are quite confident that this inventory will be consumed during the course of the year. Also, I would say, at the same time there is a fair amount of opportunity there to do better inventory management. And that's a very important element of that business for cash flow and optimization. And in that spirit, we also hired a gentleman called Rick, who is now the VP of supply chain for this business. He comes with a lot of experience in some of the largest electronic manufacturing companies. So one of the objectives of bringing in Rick is also that we make absolutely optimal supply chain based decisions, because that's where the value really in that business is.

Mayank Babla: Right. And just the capex this quarter was around 242 million, which was a sudden jump from the previous few quarters. Could you just explain that?

Ajay Aggarwal: It is the purchases for laptops and work from home equipment.

Krishna Bodanapu: We did buy some of the equipment on leasing and some on capex, whatever was available. Can I check the details and come back to you.

B.V.R. Mohan Reddy: So, once again, thank you very much for staying up so late. We appreciate a fairly substantially large number of investors participating in the call. There were at some point of time close to 200 people on the call, I believe. Thank you very much for your interest in the company. Yes, these are very challenging times. And the way in which we are handling the situation is bracing realism on one side, but steadfastly work with a great amount of optimism that at the end of it we will come out very strong. So with that, I will conclude the call by thanking you again, and wishing all of you to stay safe and stay healthy. Thank you.

Moderator: Thank you. Ladies and gentlemen, with that we conclude today's conference. Thank you all for joining us. And you may now disconnect your lines.

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