"HCL Technologies Limited Q2 FY'19 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the HCL Technologies Limited Q2 FY'19 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 telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. C. Vijayakumar -- President and CEO, HCL Technologies Limited. Thank you and over to you, sir.

C. Vijayakumar: Good evening and good morning to all of you. Welcome to our commentary on our second quarter performance of fiscal FY'19.

Today, I am joined by several members of our leadership team, including Anil Chanana and Prateek Aggarwal; Prateek has taken over as the CFO beginning this quarter from Anil.

We continue to deliver strong and consistent revenue and margin performance. Our robust financial performance is a result of two key focus areas: One, our pursuit to rapidly evolve into both next-generation services firm as well as building a highly profitable product revenue stream in line with our Mode-1-2-3 strategy. This unique business model differentiates us distinctly in the marketplace and the results are on the board. In the quarter, we witnessed strong constant currency growth of 3% sequentially and YoY growth of 10.5%. Our EBIT margin came within our expected range of 19.9% which is 20 basis points increase over the previous quarter.

We continue to bring home a number of transformational deals. This quarter again following a very good quarter in Q1, we signed about 17 transformational deals in Q2, reflecting a pretty healthy mix of our service lines, Mode-1-2-3 offering, different verticals and geographies. Our bookings and funnel remains quite strong. While we do not call out a specific booking number, we are happy to report that our bookings in Q2 was above the average of the last four quarters. Our Mode-2 and 3 combined revenues now constitute 28% of our total revenues and most significantly our Mode-3 business achieved the milestone of $1 billion annual run rate this quarter. I will provide a little more color on this a little later in my comments. But before that, let me quickly give a few messages from our geography and vertical performance.

US continues to deliver consistently good performance for many quarters now. In Q2, we posted 4.4% QoQ growth in constant currency. In US, we also completed 30-years of our operations, it is celebration of 30-years of our presence and contribution to the overall ecosystem and I m really proud that 65% of our workforce in the geography today are locals. Europe on the other hand was a little bit impacted by weakness in two customer engagements in Financial Services this quarter; however, our overall outlook in Europe continues to remain strong and I hope to see better growth in the coming two quarters. Rest of the World witnessed again a strong QoQ growth in constant currency terms. This is in spite of a small decline in our India SI business.

From a vertical perspective, four out of our seven verticals have shown pretty strong momentum, led by Technology & Services vertical, Life Sciences & Healthcare, Retail, CPG and our Public Services vertical. All of them had some handsome growth in the last quarter.

We continue to see an all-round acceleration in the Financial Services segment. We see good momentum, not just in Mode-1 and even Mode-2 services had lot of discretionary spend, we see a good momentum. The demand is pretty good in the Financial Services except for weakness in a couple of clients which we had pointed out earlier as well.

In terms of our Mode-1 services, the Global Infra business grew 3.2% QoQ. We expect the momentum to continue in H2. This is primarily driven by our next-gen IT Infra services like Digital Workplace, Software Defined Datacenters, all of this is finding good traction, almost all the deals that we signed in the last two quarters had Digital Workplace as a key component, all of them have private cloud as well as some amount of public cloud into the overall solution that we are executing for our clients. Our Digital Workplace service is particularly finding a lot of interest among the Fortune 500 enterprises. As they transform from the traditional device and enablement centric approach or device and enable centric organization into employee experience centric workplaces of the future. So that is one good macro trend, which is driving adoption of Digital Workplace, which is revolving around cognitive services, building collaboration and social kind of environments within the enterprise, all of that is driving the success and winability and demand for Digital Workplace Services.

Our Engineering Services, the services business witnessed one of the best quarters; we grew 6.3% QoQ in constant currency. This was of course helped by Actian revenues which closed during the last quarter. There was also seasonality in the IP business too which was a little bit offset by revenues from the new IP partnership that we find in June. Overall, the headline message is our Engineering Services business witnessed one of the best quarters. Lot of this is fueled by technology investments which is around productizing or SaaS-ification of some of the traditional products where we have a big role to play, lot of platform engineering kind of opportunities, where our Engineering Services team continues to have a market leading proposition and that is driving the growth there. Internet of Things is another area which has driven a little bit of growth in Engineering Services in the past quarter. In Mode-2, we continue to do well. As you can see, we grew 5.3% QoQ in constant currency terms.

Our Digital and Analytics business primarily was driven by Financial Services, Retail, CPG and Life Sciences & Healthcare verticals, they contributed to the growth in the Digital and Analytics service. We are seeing increasing demand for digital transformation at scale, what we call as "Scale Agile" deal where customers are keen for HCL to drive an operating model change within the enterprise. This operating model change as we have mentioned earlier is not just a technology change, but it is also a significant change in culture and mindset and behaviors of the technology and the business teams collaborating to drive faster and quicker outcomes for our clients. There is significant traction for digital at scale in US as well as Europe. We did several strategic deals in the Digital and Analytics sector this quarter including one with the largest telecom service providers in the US to consolidate and modernize their middleware platform that supports B2B products.

In our Cloud Native business, we are witnessing good overlay of Cloud Native solutions in most of the large infrastructure and application deals. We continue to strengthen our capabilities in

Cloud Native services in areas like Cloud Native platforms like Pivotal Cloud Foundry, Kubernetes and Public Cloud. In fact, in this quarter, we invested in building an extension of our innovation lab in London to accommodate Cloud Foundry pivotal development team.

We also won two partner awards at Pivotal SpringOne platform this year. One of them was the System Integrator Rising Star, and the second one was ANZ Global SI of the Year. So these awards are a validation of our excellence in the full spectrum of Pivotal Cloud Foundry Services that we offer to our customers.

We are also seeing significant demand in Cloud Native SaaS space, especially around commerce cloud and CPQ. Both Internet of Things, IoT Works and Cybersecurity businesses, they continue to find good traction in the market, chipping in not just standalone deals, but also creating a differentiator for us in some of the largest strategic engagements.

Underlying all the Mode-2 opportunities and deals is our strong AI capability, when as you would know, HCL has been advocating the autonomic first model for last many years, which is integral to our Mode-1, 2, 3 strategy. We believe in human plus machine augmentation model and have embedded this model deeply in our core delivery framework.

In Mode-3, our revenues grew 10.4% QoQ in constant currency. Our Mode-3 business is such a real inflection point. As I said earlier, it is now on a billion run rate and it is one of the fastest acceleration of an offering in our industry segments.

Our products and platform helping us win new accounts across geographies and verticals. Specifically, I want to call out, we had a recent win with one of the largest US banks which was really contributed by a capability, which we have now modernized as iControl which is a part our Alpha Insights acquisition which we did a few quarters back.

We also won a deal with the leading US-based equipment manufacturer for a Product Lifecycle Management solution on the strength of the PLM product offerings that we acquired via Geometric.

In summary, our Mode-3 IP are aligning well with our Mode-1 and 2 offerings, and we are trying to create synergies to kind of enhance and win some of these opportunities.

We recently launched the third wave of product releases as a part of our IP partnership program. These releases are significant milestones as these new features improve stickiness with the existing client base and it also helps in retention. Some of these are catch up features, while many others are raising the bar for the entire market, which is what is helping some of these products to be improving their ratings in most analyst commentaries from what they had announced in the last year. We talked about some of this in our last quarter call in detail. We see similar trends continuing across the entire portfolio. This gives a strong validation of our partnership approach to IP that we took a couple of years back. Today, we enjoy confidence of our partners and customers as we deliver on the promise we made to them when we started on this whole IP partnership journey.

Our organic IPs are continuing to move in the right direction. We continue to incubate ideas across technology and vertical domains. We started investing in the go-to-market strategy a couple of years back. We are continuing to accelerate that to help leverage our existing relationship, but with the separate sales program to support the whole product sales lifecycle which is quite different from the services sales lifecycle.

So overall, it is a very satisfying performance. We feel very confident of the momentum in the subsequent quarters. As we progress forward in the fiscal, we expect to deliver revenues around the midpoint of our annual guidance.

With this broad commentary, I will request Prateek to provide you a little more detail on the financials for this quarter. Over to Prateek.

Prateek Aggarwal: Thank you, CVK. So just to recap quickly all the various numbers, so starting with revenue, good constant currency growth 3.0% QoQ, 10.5% YoY, especially gratifying to note that the Mode-3 business is now at a run rate of $1 billion annually. In terms of EBIT, we delivered again within the guided range of 19.5% to 20.5%, practically in the midpoint of that range at 19.9%. What makes me happier still is the net profit that we delivered this quarter which is in rupee terms Rs. 2,540 which takes us to a milestone of Rs. 10,000 crores annualized run rate net profit. It is in rupee terms 5.7% growth QoQ and 16.1% growth YoY. This quarter or rather at the beginning of this month, we also completed the buyback of Rs. 4,000 crores and happy to also report the return on equity is at 25.8%. Our revenue per employee stands at a very healthy number of US$66,000 p.a.

On the guidance, we continue to reaffirm our guidance of revenue. We expect to be around the midpoint of the guided range; 9.5%-11.5%. And as far as EBIT guidance is concerned, we are again reaffirming that we expect to be within the guided range of 19.5%-20.5%.

Just to provide you a quick walk on the EBIT movement on QoQ basis, we were at 19.7% last quarter and we are at 19.9%, we had a benefit tailwind of 90 basis points from the FOREX benefit which is largely in the USD/INR exchange rate. This quarter as we had announced previously we had a wage increment impact of about 70 basis points across direct and SG&A cost. And SG&A increased over and above that by another 50 basis points, so that is plus 90, minus 70 and minus 50.

We had a productivity coming in. You would have noticed that our utilization has significantly increased, and also the benefits from the automation and orchestration that we keep driving from DRYiCE™ and other IP. So productivity delivered additional 80 basis points and they were from other balancing factors of 30 basis points negative, which includes a little bit of PNP seasonality, etc., So that is how the 19.7% moved to 19.9% this quarter.

Quick update on the FOREX hedging status. So we had a gain from FOREX in this quarter of US $9.2 million. We continue to follow our layered hedging policy, which allows us through has a maximum of up to 40% for year one and lower thereafter. At September end, we had $1,764 million of outstanding FOREX hedges, most of it were options, about two-thirds/68% to be precise, and the balance 32% being forward largely in the cross-currency areas where options are not so readily available.

On the other income, we had a good increase on QoQ basis. We reported $25.8 million, which is $3.2 million higher compared to the previous quarter, driven by higher volumes, more investments basically, and little bit of gain from the interest rates improvement as well.

Our effective tax rate for the quarter is at about 21% and we expect to be in the guided range again of about 22% to 23% which we have previously talked about. So that is the quick update from a financial perspective. Back to you, CVK.

C Vijayakumar: So now we are ready to take any questions that you may have.

Moderator: Thank you very much, sir. Ladies and gentlemen, we will now begin the question-and-answer session. The first question is from the line of Surendra Goel from Citigroup. Please go ahead.

Surendra Goel: I had a couple of questions: Firstly, what is your experience with IMS contract renegotiations been so far, what is the kind of pressure that you have seen on deal values or TCVs, and has it been better, worse or in line with what you expected going into this year?

C Vijayakumar: Thank you, Surendra. In terms of IMS, all the renewals that we had this year so far is on track. I would say it is in line with what we had expected, I would not say it was any worse or any better, largely in line, it is very difficult to quantify it, because there are different dynamics, but generally in line with what we had expected.

Surendra Goel: I am just following up, are you seeing more customers move more workloads to you and that is kind of offsetting the unit pressure that would have been expected, is that something which has been playing out?

C Vijayakumar: Yes, obviously, when we are confronted with renewal and there is expectation that we should reduce and give them more productivity benefits, we also see how much we can pitch in for slightly broader set of services, not just infrastructure, even in infrastructure, more workloads, more geographies and much more fuller service offering that we can offer, and that has been one of the strategies which is also helping us little bit offset some of the loss in revenue that comes up during the renewals.

Surendra Goel: My second question was on Europe. I think you said on TV that you expect growth to kind of start going forward. What I wanted to understand here is, is this client-specific issue will continue to be a headwind and hence Europe will still be growing well below company average like we saw this quarter?

C Vijayakumar: I think the company-specific headwinds we expect it to continue for some more time; however, if you look at the overall book of business, the booking momentum in Europe, including the booking momentum in Financial Services looks pretty good. So, I expect Europe growth to pick up, it may still be a little below our company average, but definitely much better than what we are seeing now.

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

Pankaj Kapoor: CVK, the first question is on the Application Services business which has been sluggish for quite a while now. So, any thoughts in terms of how we should look at it going forward and any corrective steps that you have been taking in that area?

C Vijayakumar: Pankaj, Application Services business, of course, there is pressure on some of the traditional areas where we are focused on, including some of the business around SAP and things like that; however, our digital practice is generating a lot of enthusiasm across the board. So, we are very happy about how are we positioned in new opportunities in the digital space, as well as the renewal of a lot of our application engagements are getting morphed into the Scaled Agile engagements and we have been able to protect all of our clients in this renewal process and migrated them into Scaled Agile wherever customer also had an interest to move into this model. So in terms of our proposition and capability, we are pretty confident, and that is what we are seeing in the momentum; however, you would see softness in Financial Services largely because of the two client-specific issues. If you see what happened in the last year, we had one of the highest growth in Financial Services. So probably there are some softness after a good growth phase, similar trend is reflected in Application Services as well.

Pankaj Kapoor: My second question is on the ER&D services where you highlighted you had a good growth on the organic business also. Is it possible to give some color and more granular details there because I understand that is an area where we have done several acquisition and a lot of IPs also are parked under there, so is it possible to get a sense outside of the geometric and the other acquisitions that we have done and the IPs, how the organic ER&D services of HCL has been doing?

C Vijayakumar: Yes, I will request GH to…

GH Rao: Hi, this is GH Rao handling the Engineering and R&D Services. When we take the baseline of Engineering and R&D Services and especially if you are talking about in terms of organic growth, Geometric is already baseline because the acquisition is fairly two years old. So we have a broad based growth in core Engineering Services today, not necessarily driven by the acquisitions. The growth has been predominantly because of several reengineering opportunities for products that are coming up, driven by several technologies, what we call as Consumerization or Softwarization or Cloudification, these are the three technologies which are driving. We have won several projects in the area of reengineering. So the growth this quarter has not been driven by either acquisition of the organic growth or by a large deal, it is more of organic growth driven around technology driven engineering opportunities.

Moderator: Thank you. The next question is from the line of Srini Rao from Deutsche Bank. Please go ahead.

Srini Rao: Two questions; As someone has asked, are you seeing any change in the trajectory for BFSI, your peers reflect a slightly different picture than yours, so, a), is that a client-specific issue or it is more the kind of mix of clients you have right now? Second, on your margins on the various mode service which you highlight, do you expect the margins from Mode-3 to improve further with scale or that is not what we should expect going forward?

C Vijayakumar: Rahul, would you want to take the question on Financial Services?

Rahul Singh: Yes, thanks, CVK. So, as CVK mentioned, we had a little bit of a headwind on two of our clients. We grew by between 10-11% all of last year, all our growth was organic growth, right, so there were very high growth we had last year and offset by a couple of client situations this time. Now, you spoke about whether it has anything to do with our mix of business, which is not at all true. We have very strong banking business in Financial Services and we have seen some very high digital growth, Digital & Analytics Services growth in our banking businesses across Europe, US and Rest of the World. Especially the banking customers and the insurance customers are aggressively adopting digital in a big way, and our proposition around digital at scale is doing pretty good in these client bases. We are also seeing new customers, in fact, all of last year we had acquired at least three or four large customers which are now ramping up this year and plus we continue to see good traction in terms of both renewals and new customers being acquired even this year, right. So, I think the base of the Financial Services business continues to grow. Of course, it is being offset as you mentioned earlier by two client situations which should kind of even out over the next couple of quarters and things should be okay after that.

Prateek Aggarwal: On the Mode-3 EBIT percentage, I think while we do not want to give any specific guidance for any individual mode, but you have seen 25% last quarter, this quarter is about 24.5%, I would expect that to remain in that kind of a range broadly, of course, the product business has its own seasonality, and October to December tends to be the best and Q4 which is Jan to March and July to September tend to be a little weaker. But that is the seasonality there, but otherwise on an annualized basis, I would expect it to be in that range of around 24%, 25%.

Srini Rao: I think previous analyst also asked, on your Infrastructure Services, we have been hearing kind of mixed views in terms of how much of workloads are moving to the large hyper scale cloud and how much are still kind of pretty with or transitioning to players like you, what is your sense when enterprises are looking at migrating their workloads to Cloud, are you still able to capture a reasonable proportion of those deals or you are seeing kind of an acceleration into Cloud in terms of workload migration, acceleration to hyper scale clouds?

C Vijayakumar: In the market segment that we operate, I think the most prevalent solution is the Hybrid Cloud solution. There is obviously some percentage of Cloud Services solution to move into some of the public cloud providers, but very large part of the workload in large enterprises are either private cloud or software defined datacenters and some of the new workloads which are getting built as a part of digital applications, some of that that is slightly more shift towards using public cloud in some of the areas, but there is also significant adoption of Cloud Foundry platforms, there were some Cloud Foundry platform is a pretty strong adoption in some of the large enterprises. That is really helping customers to build applications which are Cloud-agnostic and that is where we see a lot of workloads are moving up.

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

Sandeep Shah: In terms of looking at your guidance in reported dollar terms at a midpoint, it shows that you may have to do 3.3% compounded QoQ growth for the next two quarters. My sense is I think a lot of deal wins have been announced in the last three to four quarters in terms of number of deals including some mega deals. So, is it fair to say that coming December quarter could be one of the best in this year as well as the Q4 growth would also be better because of the deal ramp ups if we even strip out some of the acquisitions which will play out in the coming quarters?

C Vijayakumar: Q3 has a couple of dynamics, of course, it is going to be a good quarter from a product seasonality perspective; however, in some of our traditional businesses, there is a little bit of headwind around that, furloughs and time-offs and things like that, and a lot of new deals also will transition into steady state and projects. So I expect Q3 to be a solid quarter and that is what is giving us confidence to say that it will be at a midpoint. Also one of our acquisitions, which is the company in Germany, there is no revenue in the previous quarter. We will have full quarter impact of that in Q3. So overall we are looking at a pretty strong quarter in Q3 and that is what is giving us a little more confidence of H2 and getting you a midpoint kind of guidance for the full year.

Sandeep Shah: Just on the IMS, CVK, just wanted to understand, we maybe in the fourth or the fifth year of renewal cycle, where some cloud element has been asked by the client and you might have provided by cannibalizing the revenue. Is it fair to say that after one year or maybe by the mid of next year which is FY2020, the impact of renewal through cloud cannibalization will reduce on YoY and which may give you a confidence to say that the organic growth prospects in the IMS next year would be better?

C Vijayakumar: Just leaving cloud apart, our general outlook is the infrastructure growth will continue to get better. Some of the headwinds that we saw were all planned and factored into what we gave as a guidance this year. So I think just purely looking at global Infrastructure Services, I think it will get better as we move forward.

Sandeep Shah: Just last two housekeeping questions: The cash flow generation at OCF level for the first quarter was weak, even second quarter was weak. I wanted to understand in a cash flow statement, there is $85 million payout for other asset. What is this exactly and how are we looking at cash flow generation in second half? Second is the Mode-2 margin which is a pure digital service has further declined to almost like 10% at EBIT level. So what is causing this because most of the other peers are saying that Mode-2 services are high margin businesses?

Prateek Aggarwal: Sandeep, if you look at even the Q2 of last year, the cash flow from operating activities as a percentage of net income and above that 78%, it happens to be exactly at that same 78% this year also. That is basically due to some seasonality factors in terms of annual flows. First of all, the annual bonus get paid out during this quarter; Secondly, in most geographies higher tax outflow going out in this quarter, and then there are some smaller things like annual insurance premiums and things like that. So that is just a seasonality I would say. On an annual basis, I think we continue to be generating good cash as always, and one would expect it to be in the same annual ranges that we have been in before.

C Vijayakumar: Specifically talking about Mode-2 profitability, even in the last quarter when we for the first time provided visibility of EBIT level on Mode-1, 2, 3, we have just pointed out that there is a caution especially in Mode-2 and Mode-3 since the scale is low compared to the overall business, there will be some level of fluctuations. At this point, we continue to do well in Mode-2, our gross margins are definitely better than Mode-1 gross margins; however, our investment at SG&A continues to be a focus area, because we believe at this point we are really not focused on optimizing margins in Mode-2 business, we are focused on how can we continue to build capabilities and make them across the geographies and markets that we operate in under the verticals. So you will continue to see some kind of fluctuations in Mode-2 margins, but as the business scales up, you will see kind of increasing margins here.

Sandeep Shah: What is the organic growth of this quarter apart from Actian, you also call out, CVK, there was some revenue coming from the acquired IP business, so if you can just get a total inorganic portion for this quarter?

C Vijayakumar: I would say largely organic barring Actian, Actian probably contributed to about 1%, and there was a significant seasonality in the product business, this was one of the softer quarters in the product business, but a little bit of that was offset by some revenues from the new IP. So I think a little less than 2% would be the organic growth, and a lot of that is visible in our Engineering Services and Infrastructure business, and a little bit in the BPO business as well.

Moderator: Thank you. We will take the next question from the line of Ankur Rudra from CLSA. Please go ahead.

Ankur Rudra: Just a question on the breakup of where organic versus inorganic is trending for the year, we are at the half year mark, at the beginning of the year you highlighted a certain break up. How has it trended so far for the first half? Do you think the mix between organic, inorganic will be different for the second? I am looking at YoY basis?

C Vijayakumar: We started with half organic and half inorganic. As we stand now, it looks like we will do a little bit more organic and a little bit less inorganic for the full year.

Ankur Rudra: Your organic business has done a bit better than you expected, is that what you are trying to say?

C Vijayakumar: Yes.

Ankur Rudra: A quick follow-up on the margin side. You had a margin tailwind this quarter, you broke out the margin breakup. I think even at the spot level there is a margin tailwind in 3Q. I notice that you have not revised your margin guidance for the full year which was I think previously set at a probably lower average currency level. So what is the thought process behind that… where are the puts and takes on the margin side for the rest of the year?

Prateek Aggarwal: So Ankur, the margin guidance we continue to sort of retain at 19.5%-20.5% in the first half of the year, if you take the average of Q1 and Q2 we had at about 19.8%. You are absolutely right, there is a tailwind going into Q3, but at the same time we do intend to and plan to invest back in the business both on the Mode-3 and Mode-2 side on an organic basis which is what we have done partly this quarter, there are plans to do more of that, which is the reason we are sort of sticking to the guidance we expect second half to be incrementally better, but within the range.

Ankur Rudra: Could you elaborate a bit more on the areas you are investing it?

C Vijayakumar: I think we had planned certain investments where an investment pipeline of co-innovation labs. As a strategy, co-innovation labs has been a big anchor for a lot of our wins. So we are accelerating some of those investments like we announced a lab for IoT recently in Seattle. Very recently we expanded our co-innovation lab in London to build the capability around rapid development using Cloud Foundry Pivotal platform and we continue to look at organic investments to build stronger capabilities across the globe around UI/UX. We had a good momentum in US, now we are continuing to hire and build little more presence across the world. It is largely in line with some of the key things that we are doing, but maybe we are just accelerating and we are little more flexible to invest, so that it will help us to kind of gain some more momentum as we move forward.

Ankur Rudra: This on that same front, I know you have a lot bigger proportion of local employees in the US, are there any pressure on the supply front there where you may have to step up your investments which may be another pressure point to the second half?

C Vijayakumar: Yes, to some extent, there is a lot of demand, so there is definitely good competition for talent, so that is where we increase some of our cost. But at this point at least in the Q2 number I did not see that, but I generally see a little bit of pressure and more subcontractor usage, that is what we are seeing.

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

Rishi Jhunjhunwala: Couple of quick questions. So one, your gross block on licensed IPR has declined by $66 million in this quarter versus last. Why would that actually decline?

Prateek Aggarwal: I think that is just exchange rate, because all of the IPs that we have taken through this partnership, when we buy its in dollars, but when we recorded in the book it is in rupee and when such volatility plays out, it is basically the exchange rate.

Rishi Jhunjhunwala: Because I was referring to your dollar GAAP account itself. So I thought rupee should not have mattered there?

Prateek Aggarwal: The dollar number is converted into rupees and then getting converted back into dollar at a different way. Rishi, we can connect offline, if you have further question on that, but that is really the reason, we can help you understand better.

Rishi Jhunjhunwala: The other thing is just on IMS. Apart from some of the trends that you have already talked about, are you seeing pressure from either vendor consolidation or anything of that sort, because one of your large European peers basically cut their guidance today in the morning on the back of pressure on the IMF especially in the US and the Germany area. So I just wanted to understand, is it something which is more prevalent across the sector or could it just be specific to one vendor?

C Vijayakumar: There is definitely a little bit more focus around consolidation in IMS space and we are definitely at the forefront of capitalizing on this opportunity. So I think we have a pretty strong advantage in some of the clients especially in the US, where we are consolidating some of their infrastructure landscape.

Rishi Jhunjhunwala: On margins, at what currency rates your margin guidance is pegged at?

C Vijayakumar: As I said last time, we do not believe the appreciation in dollar, it is all going to flow into margins, because we have given a guided range and we were open to invest and we see a lot of opportunities to invest and grow some of the areas especially in Mode-2, where the number of capabilities are 10 different areas across different offerings in Mode-2. So we are continuing with that irrespective of the currency movement we believe, we will deliver within our guided range; however, if the current state of currency continues, of course, it will create a little bit tailwind in the overall margins compared to what you saw in the H1.

Moderator: Thank you. The next question is from the line of Viju George from JP Morgan. Please go ahead.

Viju George: I think most of my questions have been answered, but if I may just press this point on acquisition, it seems to me that the last couple of years, CVK, you have been running at almost half of organic, inorganic growth. Assuming that good targets available, good IPs available for you to acquire at the right price point, do you think that having 50-50 or the near 50-50 contribution of inorganic to organic, it is a sustainable growth model, that is part one? Second is that what will be the cash flow and margin implications of that kind of a strategy?

C Vijayakumar: Viju, thank you for the question. First, we have two different teams, the whole services and Mode-2 and Mode-1 organization, and the leadership and management is dedicated to Mode-1 and Mode-2 services and Mode-3 is a separate team. So each one has an opportunity to look at what the growth opportunities that are available. We do see significant opportunities on the Mode-3 front. A lot of products are needing significant transformation to be relevant in the new world and not every company is focused on making those investments to make that shift. So I think that is where we are seeing opportunities. So as long as right opportunities at the right price point and our ability to make a difference to that product, and it create some synergies in our Mode-1 and 2, we will invest. I do not think investment will be a constraint, because we think it is a strategic choice that we have made to not only deliver grow into next-generation services firm, but we also want to build a strong product business, and of course, with the product business is $100 billion plus kind of an opportunity and we have hardly crashed the surface of this. This will mean some kind of, our cash flows and some of that will have to be planned to help us do this. As we had indicated, we would be open to borrow as well to drive this, because it is a very important element of our strategy, and it is working very well, it is creating the right synergy benefits, our IRR is significantly better than what we had planned. So with all these, I think it is only logical that we pursue the strategy even more.

Viju George: So essentially you are comfortable with the current growth model where maybe 50% comes from inorganic activity, so you are saying that is a sustainable growth model?

C Vijayakumar: 50-50 was a little bit incidental when we kind of gave the guidance for FY19. I think it is going to be driven around opportunities, but we will continue to focus and grow our business organically which is primarily in Mode-1 and 2 and to some extent in Mode-3. I think there is zero dilution and focused on going to drive that. So we continue to be very competitive, our bookings looks good, our core business around Infrastructure, Engineering, our Digital offering, all of that continues to drive good momentum in organic. So we will leave no stone unturned to continue to drive our organic business. So whatever growth rates are delivered that is what it is. But inorganic maybe there are bigger opportunities, so the ratio may skew as well. But be sure that there is adequate focus and adequate interest to drive greater and greater organic growth.

Viju George: The last question was on margins, CVK. If you assume a very reasonable component of inorganic growth in your growth model for years to come, do you think that eventually longer term, it will take margins downwards or upwards, because on the one hand you can argue with IP revenues have better margins, but on the other hand one can also argue that the organic growth rate may not be as good as it was in the past so the margins might tend to dropdown. So what will this have for implications on margins you think at an overall level maybe a year or two out in terms of direction?

C Vijayakumar: At a macro level, the strategy will be a tailwind to the overall margin strategy in the mid- to-long-term, because when our product mix increases and becomes significant, it will definitely change the mix of our margins between the different businesses and as Mode-2 business scales up as well, that will deliver a little bit better margins. So I do not want to call out what will happen a couple of years from now, but generally as a strategy, it is designed to deliver a higher margin, that is fundamental to the underlying Mode-1, 2, 3 strategy.

Viju George: My last question on the renewal cycle. I think you mentioned that you are probably close to the end of the renewal cycle in terms of deals getting negotiated downwards in pricing due to Cloud, new technology, etc., Do you think therefore we could start to see this bottom out pretty quickly and therefore the new wins will translate substantially into revenue growth full enough in IMS, is that what you have indicated?

C Vijayakumar: When I talked about in the beginning of the year, I said, FY19 was probably the largest renewals that we were facing. FY20 will be slightly lower. While renewals may continue, lot of deals would have been reconfigured with the new set of solutions including a certain amount of public cloud adoption and things like that. So I think it is probably one more year where you will see some deals which were in the traditional solutions set to a new solutions set, so that will drive some kind of reduction in revenue. But I think as I see FY20 will be a little lesser than FY19 I would say.

Moderator: Thank you. The next question is from the line of Nitin Padmanabhan from Investec. Please go ahead.

Nitin Padmanabhan: Last quarter you spoke about how the deal pipeline was pretty solid and the last quarter was possibly the highest wins that you had. In the context, if you look at it this quarter, how would that compare versus last quarter in terms of the value of deals, is it comparable? Two, how do you see the pipeline out there? The final question is we have a lot of deals that are ramping up in Q3, a lot of those which we won in Q2. In that context, if you look at utilization it is all time high. When we look at a lot of peers who suggest that the supply is very tight, and they will need to create utilization buffer, just wanted your thoughts about how we go about executing in that context and whether do you perceive any execution related issues from a supply perspective?

C Vijayakumar: There are multiple questions, Nitin. Let me take one by one. First is one on booking. I do not want to call out a specific number, but if you recall last year Q3, we said it was the highest booking, then we also followed up in this year saying Q1 booking was even higher, so the Q2 booking is higher than the last four quarter average. So fairly good bookings may not be the highest, but more than the average of the last four quarters, which I consider it as a very fine. The pipeline from end of last quarter to end of this quarter, the qualified pipeline has increased over 10%, so which is again a good indication. Now in terms of headcount growth, even this quarter net addition was about 4,000. When you see utilization there are a lot of people who are doing transitions, so that would be considered as utilized, but that will kind of translate into revenues in the subsequent quarters. At this point while I do acknowledge that there is a little bit demand from a fulfillment perspective, I do not see it impacting our execution in Q3 and most likely in Q4 as well and we put a lot of measures to strengthen our fulfillment engines across the globe in line with the increased demand that we are seeing, we started doing that the beginning of first quarter, I think we are in good shape there.

Moderator: Thank you. The next question is from the line of Ravi Menon from Elara Securities. Please go ahead.

Ravi Menon: So just to extend the question that was previously asked about medium-term margins for Mode-3, what do you think we should expect, because as this scales up, any new products that you acquire, that should be a fairly small portion, because this is already $1 billion run rate business, and this includes your organic IP as well, so should we not see margins expand for this business over time or you think you need to make a lot more investments in creating a separate sales channel, so if you could just walk us through that?

C Vijayakumar: As Prateek mentioned, I think margins will remain in this range in the near future barring a little bit of seasonality which is pretty common in the product business. In terms of investments, of course, we are not looking at IP investments to drive margins, but we are continuing to build a sales channel, we continue to invest in modernizing and we are also incubating a lot of ideas and lot of product IPs in automation and some vertical segments. So at this point we are comfortable to kind of see the business at 25% EBIT level in the near future.

Moderator: Thank you. The next question is from the line of Dipesh Mehta from SBICAP Securities. Please go ahead.

Dipesh Mehta: Can you provide some colors on manufacturing and communication outlook because it seems to be sluggish for some time now? So, if you can help us what is leading to this weakness in the performance and how you expect that to play out?

C Vijayakumar: So in terms of verticals, communications will definitely pick up, I see the second half to be driving good momentum, manufacturing as well, there will be an improvement over what we are seeing so far in the next quarter.

Dipesh Mehta: Because we report of 5, 10 and 20, so if one do arithmetic on top 6 to 20, performance seems to be muted for I think a couple of quarters now. So is it because of the two clients which you referred in BFSI, which is leading to this reported number or there are weakness in other client as well?

C Vijayakumar: No, I think BFSI clients are in the significantly larger category, not in the $5 million to $20 million category. Some of these are like from $49 million something can go to $51 million or will reverse, so some minor changes, I do not see any specific issue there. In fact, our $20 million clients have gone up by three QoQ perspective and YoY perspective six and $50 million client is reduced by one QoQ, but that is some marginal changes, I think some of this is also some currency impact as well.

Moderator: Thank you. The next question is from the line of Mukul Garg from Haitong Securities. Please go ahead.

Mukul Garg: CVK, earlier in the call you mentioned about continued investment in IP acquisition. So can you shed a bit more light on this? In the medium term, where do you see Mode-1, Mode-2, Mode-3 as share in total revenues, is it possible that Mode-3 can move from current levels to somewhere in mid-20s couple of years down the line? Similarly, do you have any sort of target in terms of how much cash you are going to spend annually, is it something which will be a target-led meaningful amount which you will be spending on attractive IP acquisitions?

C Vijayakumar: In terms of acquisitions, as we had called out, our payout ratio is 50/50, so we have the remaining cash flow, potentially it could be used for acquisitions. So our acquisitions will be somewhat similar to what we have seen in the last couple of years; however, it is also going to depend a lot on the specific opportunity, we may hit on a big opportunity and there may be a slightly higher outflow or we may not get the right opportunity and you may see a little bit lower. So directionally, the plan is to see a similar amount of investments from an acquisition perspective.

Mukul Garg: So does that mean that we should expect Mode-3 to be much larger portion of your overall revenues in a few years?

C Vijayakumar: Yes, of course, I think there is a lot of focus. So Mode-3, definitely you should see a much higher percentage of our revenues, but I do not have a number, all that we were stating was at least we want to drive to a 40% mix of Mode-2 and 3, but the way strategy plays out, you may see a maybe higher proportion of Mode-3 business, but all of that will be visible to you as we grow our Mode-3 business. Like in this quarter, there is a significant organic traction as well in the product business, because lot of IPs that we acquired, we found good opportunities in our existing customers. So Mode-3 is also going to be driven by both organic and inorganic and we are continuing to build a strong sales channel to drive our products and platform revenue stream. So we will keep you updated as we invest more or as we find more opportunity.

Mukul Garg: Just one final point in this, given that your aspiration on Mode-3 are quite big, do you think you will sometime in future require a significant product focus sales team similar to what large software companies have in place, is there something which you foresee down the line?

C Vijayakumar: Yes, we are already building a sales channel as we said even two years back, we already have 100-plus people focused on product sales and solutions, and services around. So, it will continually evolve and that will mean that we will build a strong product sales organization as well.

Moderator: Thank you. Ladies and gentlemen, this was the last question for today. I now hand the conference over to Mr. C. Vijayakumar for his closing comments. Over to you, sir.

C Vijayakumar: Yes, thank you, everyone for joining us on this second quarter performance and the commentary. Overall, it has been a pretty satisfying performance. We continue to show incremental traction in our overall growth and the overall demand environment and the opportunity that is there, and the strong differentiation and a distinct strategy that we have adopted, we feel very confident of continuing to deliver industry-leading growth and look forward to interacting with you in subsequent interactions.

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