



*Theme Address*

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Folks it is good to talk to you again. We will start this presentation and we do not have much time, so pardon me if I go slightly fast, however, the figures are with you so we could debate that later.

I will talk about the guidance that we gave, particularly the famous guidance on April 10th and the guidance subsequently, how we built the cost structure to meet the challenges that we face, how we mitigate the impact of rupee appreciation, meeting the challenges today in the global market place, and small things like the small amount of cash we have and stock option accounting.

Guidance - The environment as we stood before you on the 10th of April was challenging because there was SARS at the background, our customers were looking at enhanced focus and cost savings, because the budgets for IT worldwide were not rising, they were stagnant or coming down. The customers also prefer end-to-end players. Customers become ROI conscious but not exactly in the manner that some of you think it is, they look at the internal ROI rather than the vendors ROI. I do not think they care whether their vendors earn 20% or 40%. All they care is - what is it that I have to pay. The GDM is becoming mainstream today. All over the world people are talking of offshoring, the Chairman of companies are talking, the CEOs are talking. The visa issues are becoming real in some places. People are certainly finding that yes, offshoring is vital, globalization is becoming real, globalization is real for that class which is part of the SG&A of global corporations. India in software and BPO is attacking the inefficiencies in the SG&A sector of the global economy and if you take the top 1000-2000 companies from the globe, they could have revenues of about \$10 trillion, because the GDP of Europe and US is ,about I think \$16 trillion, assuming \$10 trillion comes from companies who sell services and goods. If we assume 15%, that is \$1.5 trillion of SG&A which you can theoretically attack in both the sectors. Though our guidance was given in the back drop of an uncertain US economy, the US economy is flat, not many people were positive about their economic growth, the Iraq war and subsequent pressure on IT spending because whenever there is talk of war people try to become extremely defensive, and of course we had this famous SARS impact, people wrote about it, but clients stopped coming from around the end of February and from then on, till the time we gave the guidance it did impact us.

Impact of rate pressure was anticipated because around the middle of March, CFO of a very major competitor made a famous statement, how they are going to come to India, take our employees and coach at a cost plus model and try to disrupt our market value so that we do not become a competitive threat. So we had to put in a model, a defensive mechanism. We moved our employees to a role-based organization, we upped the salaries, made the salaries variable, and we put in a pricing decline into the model to say that we are ready for the challenge, we are prepared and we will compete, and we also made sure that all this is disclosed to everybody else openly in a transparent manner and we are able to display to you the steps that we will take to meet competition.

What has changed since then? We upped the guidance in July. Well, the uncertainties relating to Iraq and SARS moved away, the dark clouds in the horizon became lighter, the monsoon became stronger, competitive pressure were lesser than anticipated because we are selling value, like Nandan said, yes in application development, maintenance, the values could be less, but the greatest growth areas are in enterprise solutions and other new areas where the rates are very good and we are competing against incumbents who charge \$100-125. Where they come to India and do application development maintenance what are they going to charge, the rates are average of \$20-22, and what are they going to charge, bring it down to 18, that is \$2 an hour, and if we grow our enterprise solutions to 15 to 16% of business and start charging \$75-80 incumbents lose \$25-30 an hour, if you look at the mathematics, it is very clear and for the entire Indian offshore segment the enterprise



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solutions seems to be growing the fastest, and that is where the pressure is. So we are not going to disappear in a hurry, we are here for the long haul and we are going to be here.

**Business gains** - We had stronger volume gains than anticipated because we were looking at the impact but it turned out that the impact was not as much as anticipated. We had the benefits of higher offshore revenues. We were planning for a long time to move offshore and it paid off.

**Internal cost-optimization initiatives, expenditure optimization** - Whenever we spoke about cost, people thought are you cutting the muscle on your body, we are not, we are optimizing expenditure, expenditure means something that is discretionary that you can do without, and we can optimize it to make sure that we get the biggest bang for the buck, and that is what GE has been doing for so many years and GE has been extremely successful. So I think, it finally got a message across that it is expenditure optimization, so that we are not cutting on any investment, we are investing heavily for growth.

We reduced the cost of onsite subcontractors, we had to take on business because customers told us take out some of these subcontractors, give us new business, business is ramping up, they did not have the right call to have resource at that point of time, took subcontractors, now they have been replaced.

**Rationalise onsite non-billable resources** - We had hired non-billable resources to make sure that we could respond to the client in a faster time, we GDMized this aspect too and brought them offshore and started just-in-time inventory process. And we did many small rationalization of policies to make our expenditure optimization much more exciting, and of course there was a change in tax liability.

So offshore was becoming mainstream, the US economy continues to be uncertain but there are some glimmers of hope, and competition from global majors, these three things have not changed since the last two guidance calls. Look at this chart, the increase of guidance to 23.2-25.4 in Indian rupee terms, in terms of revenues and EPS growth rates slightly higher. We calculated that the rupee appreciation in the first quarter would lead to loss of revenue to the whole year of about Rs. 100 crores to the top line and bottom line could be something like Rs. 45-50 crores. Now look at this irony, US GAAP numbers are going up at a faster rate, growth is much faster, EPS is much faster, our investors also are very happy when they see the dollar terms, and here we have rupees and the rupee is appreciating. The world is becoming much more dynamic and India is opening up and this is something that we have to learn how to handle. So we revised the guidance, the guidance was revised, but look at the components of the guidance revision, Rs. 3.4 a share was because of the rupee appreciation, there was an adverse impact. The tax reduction gave us Rs. 3, set off one against the other. And the scaled benefit on enhanced revenue because of certain expenditure optimization processes gave us 8.6. So when we gave our guidance, we factored in the challenges we faced, and we found that the pricing decline in the first quarter was lower than anticipated but the pricing challenge continues, the battle continues, the war continues, and we are getting stronger and stronger.

We changed the salary structure for entire people and whatever was saved was ploughed back to our people. On the 10th of July, Kris made an announcement to everybody that with retrospective effect from 1st of April, we got to give a grant to our own employees for the three months, which is because they saved some money. We gave the money back because we said that whatever we save, should be shared with the people because these are the people who create this company, these are the people who make sure that we are able to deliver superior services to our clients, and we had of course some increase in our revenues. The benefits of a reduced percentage spent on SG&A, not the absolute amount, reduced percentage spend on SG&A, came to us.

We build the cost structure to meet what we are going to face. Look at this income statement, our software development expense has gone up from 45.8 to 52.9, partly because the onsite offshore ratio became more onsite-oriented, partly because the H1B compliance really hit us, it cost us 2.2% of revenues. On H1B, there is a clause which says you are exempt from notification and certification



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process in case you are able to pay more than \$60,000 per head annually. We do not want to go the client and say 35 some matters are needed to be done, so we said we will pay \$60,000 plus to everybody, the average cost of software engineer is about \$73,000 per head. Why I say is that some of the Indian companies that shift people there and do not pay enough, should look at facts. That situation in terms of software development cost, the pricing declines also hit us because in 2003 we had a 5% pricing decline, fiscal 2002, a 2.5% pricing decline. So gross margin got hit, our SG&A remained constant with G&A coming down. G&A is what, Bala and I poor folks like us get, so we said we will tighten up belts, eat one meal less, but we will earn that margin for you. But this year we should spend more on Basab because Basab is a person who sells and gets the bacon home, so Basab should be empowered, Basab should be strengthened. So we gave him a troop, an increased no. of people and we enhanced budget to go and spend, at the same time we put in a financial controller to make sure that his focus is more on meeting clients rather than writing cheques.

So our operating profits came down, yes, it came down, it came down. Hello, this is competition and this is the result of a stagnant economy. The significant factor is economic conditions are stagnant in the west and the spending on IT is not going up. Operating income has come down to 28.1% and net income is about 25.7%, I think in Q4 we did 24.8% and in Q1 25.7%. But the profit before tax levels has come down by 1.5% as compared to the whole year, but Q4 to Q1 the decline is not so much.

Direct costs, look at this, this is the chart I want you folks to see. Personnel cost went up from 36.3% to 43.3%, onsite went up from 26% to 32.4% because the ratio, it is a ratio. Remember, when Clinton went on the road for his first election, he coined a slogan against George Bush Sr. "It is the economy stupid....". I am not saying the latter part of it, I will not make the remark, pardon me, but it is the ratio of onsite to offshore because as you go up the value chain, when you do out consulting, enterprise solutions, the ratios change, and this had an impact, plus we had an impact of the H1B regulations impacting us from fiscal 2002 onwards. So there has been a jump of 3.6% and after that a jump of something like 2.7%. But look at the other expense they remained more or less constant. Our offshore salaries are variable by about 17% after this hike, 15% based in the first quarter, 35% at senior level, the poor blokes like Bala and me offshore, you do not get paid unless you perform, unless the monkey performs and dances to satisfaction of everybody else. We have the same wages for H1 and L1. When we send people on L1 there is no deduction in the wages, the same wages are paid to everybody, so in case they bring in legislation on economic grounds to say that L1 people should have the same economic condition, comparative wages, we are not going to be hurt. We have already done it long back.

Other direct costs come down over the years, is 3.6% because we have a software product which is sold along with our banking products and that is 0.5%. If you remove that the trend is clearly downwards. So we are optimizing to the maximum extent possible.

Sales and marketing expenses, salaries and bonus up from 2.3% to 4.6%, so we have empowered our sales and marketing team to go and fight the battle and take us faster and Basab is doing exactly that, after this meeting he is going to go back recharged. So we increase our SG&A to 7.4% and now we are optimizing, while we took a jump now we are telling Basab to view the performance. We gave you the money, we gave you all the people, now go well and get us more business, and he is doing exactly that as you have seen in the first quarter.

G&A 9.1% to 7.5%, salaries and bonus stagnated. Some of it is investment, some of it is stopped that we take for other people, but we will do that like insurance charges for instance, insurance charges has gone up for many, many reasons, depreciation is coming down because we have made huge investment in the past but the quantum of depreciation has not come down, it has come down as a percentage.

Tax expense - we fully comply with tax, we pay tax and all dues where we have to pay tax. We fully provide, our tax charges for a country depends on the proportion of onsite to offshore because we have taken this stand, if there is any income arising from a country we will have a permanent establishment and pay tax. Income occurs there, pay tax, that is the thing. No tax structuring, no tax



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planning to reduce tax. We will plan tax legitimately without any risk for future, we do want to have a good meal today so that we starve tomorrow. No, we want to do well tomorrow. According to our policy we use the tax effect accounting, you people know all this stuff. So effective tax rate has come down, it has not come down because we did not factor in the 10% tax benefit that the finance minister gave us this year. It came down because overseas taxes came down from 3.9% to 3.4%, I want to make this point, and it happened because we have made tax returns, making tax returns for many countries is a complicated exercise. We did that, and we found that it benefited us this year too, and the pricing decline that we have built in said the tax liability is going to be less.

Mitigating the impact of rupee - Rupee is going up, the rupee has appreciated 1.5% in Q1. 1.5% per quarter, well it is big for India. Other countries see the rate going up like this, we have not seen that yet. Now there are two things that happened, one is the rate going down, other is the translation difference. Translation difference is whenever they translate the Indian balance sheet, the dollars into the rupees at the end of the quarter or the vice versa, there is a gain or a loss, and that has to be written off. If you look at the chart, the translation factor was 1.16% of revenues. On 233 million, 1.16% comes to \$3 million, and overall gains and forward contracts are nearly \$4 million. Bala got very active. We had a policy for long, we did not activate policy. He sold forward, he hedged, he made sure that it was protected, and when you hedge, there is a problem between Indian GAAP and US GAAP. In US GAAP - mark to market, Indian GAAP - amortize it over the period. So there could be differing profits. We had to diverge, so we canceled some of the contracts and rebooked so that the gains are even across both the accounting. It is an accounting issue that I am sure all of you will appreciate. The impact is Rs. 100 crores for the full year and for this quarter we had an exchange rate at 46.4 and 46 for Q3 and Q4. We are already at 46.1. I mean the ADR money came in, the rupee appreciated even more, talk about double jeopardy. But we still have a hedge of \$250 million, large part of it marked to market in US GAAP. So you may not see an increase in net revenues like you saw in the first quarter and we lose out net revenues to provide for any investment impairment. We keep our eyes on the impairment. In fact, we have all the investment that we have made, we have provided more or less. Progeon has kept all the cash in the bank, so investment is quite safe.

So meeting continuing challenges, this is public information folks, this is what Narayana Murthy spoke about. Do not grudge at the money that we make and do not think that we will disappear. Look at this, where do we make money? We make money because SG&A is more efficient, because of the offshore model. We are efficient even in the gross profit area primarily because we work offshore. So what happens? After a certain point while per person we earn the same amount of operating profits than the larger competitors, we do it on the lesser revenue. If you earn \$17,000 on \$170,000 that is 10% right, you earn \$17,000 on \$80,000 that is about 20%. We earn the same amount of money per person, but we charge less. For the client, it is fantastic. He pays 50% and he does not care how much money we make, so that is where is ROI business. No client looks at balance sheet and says well you have this ROI, so I am going to cut you down because price is what market dictates, value is what customer pays. This is a very important point, I see many research reports saying ROI will gravitate towards long-term cost of capital, blah blah blah, great theory, I read that too when I did my finance, but in the real life there is a range. Some companies earn less ROI, some companies earn more because of efficient model. In the long-term, it theoretically it has to converge. But long term is long term, I mean, 15 to 20 years, that is fairly long. So in the meantime, you have efficient models which get you more. I think that is important, and so we make money on SG&A. So we are in a strong competitive situation, if somebody comes here, reduces the price. On what? Application development and maintenance, they are at \$ 20-21 average. Fine, great, but then we are expanding into enterprise solutions and you come here. Can you get this 25% SG&A and all that. Remember 25% SG&A on \$170,000 is about \$43,000 dollars or \$41,000 dollars right? Now our SG&A is about 15%. On \$80,000 it is \$12,000. So we have to earn per person \$12,000, somebody already earning \$41,000-42,000 SG&A and if they bring down the revenue they cannot earn that much, that is the disruptive model Nandan spoke about.

So we are planning to increase offshore to meet the pricing pressure, moving up the value chain, improve utilization rates. If you look at the utilizations, there is something called utilization including trainees. That is where we have enough people to put into production. We have 1720 trainees in



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training, the cost of all of them have been met, the revenues are not there. So a large number of people 1700 trainees, 1300 bench, 3000 people end of the quarter were not being billed. The expenses offshore are all being met.

Wage inflations - we have made it variable. We were asked on the road when are the Indian wages going to meet US wage levels? If that happens my friends this will be heaven itself, Kubera's heaven not other heaven. Just think, per capita GDP should go to \$25,000 or \$30,000. Then India's GDP will be \$30 trillion, wow! You will all be coming in jets to office, everybody in this country. So in sales and marketing, we have already made the investment, we are going to get the benefits. To increase offshore, I think the figures are there. Look at this non-ADM and reengineering revenues, 38.6% including products, on 25.3%, we have made investments. Here we have strong competitive situation. We have gone up the value chain. Look at this chart, it is all here. We have ramped up the utilization to make sure we protect margins, variable compensation is 15% for the entire company and is 35% for the senior people. It is tied to revenue targets. Till last year Basab's bonus for the entire staff was tied to revenue. Now we suddenly thought that these guys are going and selling. What about margins, margins is not just concern of to Nandan, Kris, me, and Bala. It got to be a concern to Basab too. So we said, Basab all the commission is waiting for all the sales staff, you earn these revenues plus the growth plus the margins, so he has to look at three or four parameters. We gave him a complex algorithm to work on, to make sure that timing is done right and he is not selling value, so thing have changed.

SG&A – Folks, look at this chart. Okay, we have spent 266 crores. This year we are going to spend \$74 million or \$73 million on sales and marketing. That is hell of a lot of money. Show me comparable companies in this country who would spend that much, who put that much of stuff in the marketing, and that is the difference in the growth rates, Look at the Indian competition, who is growing the fastest in three years. Who has shown the same kind of growth? Because we are making investments, we will make investments today for two years down the line, and we make strong investments every quarter. We fight, we give money for sales and marketing, we give money for quality, we give money for HRD, we cut money for finance. Finance is the most destructive department, they hang on to cost, but we are tightening the belts. That is the message we want to give you.

Employees and client facing roles - Optimization taking place because we ramped up.

Cash policy - We have a small amount of cash, just about \$403 million, 55% of balance sheet. We want to keep the cash because we want to reduce the risk in the business for all of you, but we understand concerns about return on equity, return on capital employed, and it is so funny when in India, everybody asks what you do with the cash? You go to Europe - return on equity. You go to America - growth, growth, growth, so we are children of many cultures and we have to make sure that everybody is happy, and at the same time you keep up focus on important things. So we have a policy, return on capital employed 2 times the cost of capital. Cost of capital 17%. Somebody told me, the cost of capital should be 12%, but I said no. For a high growth company, in a high risk area, beta should be high, beta is 1.56. So we take beta of 1.56. 17% cost of capital. We are right now at 46% on capital employed, 76% on invested capital. Don't grudge at these returns, we have worked very, very hard for this, we have taken many steps to make sure returns happen. So we have put these parameters to make sure that we have superior returns. The day we earn less we certainly will say, may be, we are not earning more, may be there are better people who can earn more for you. But remember we are your trustees, we will ensure that we earn higher returns, put our best step forward, do everything possible, so that cash that we have is required for us for liquidity purposes. Last year we saw many software companies, the downturn not coming up. When the tide rises fewer ships rise with the tide. Remember the old saying? Murthy used to tell us eight years back. So we are going to rise with the tide. To make sure we need cash in the balance sheet, but we will keep our eyes on the numbers, we will always listen to you and we debate in the Board every quarter about this, we debate this, we understand your concerns.



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Major developments and stock option accounting, Microsoft said, they are going to look at Restricted stock. Being discussed internally, FASB is coming out with standards, IASB is coming out with standards. The key here is there is no point rushing and doing something because there has to be inter-firm comparability, there are deep technical issues which all of you know. I keep having running debate with my friend who keeps telling me about all these things. And, there are technical issues, there are some issues which have to be looked at and we need comparable standards for inter-firm comparisons. So, as soon as IASB and FASB come with standards, we will comply, in the meantime, information is there with all of you. But the grants have been coming down. We understand concerns, grants have been coming down. So, in the nutshell, today I read that if you want to have a long healthy life you got to eat lot of nuts. So, in the nutshell, we are focussed in enhancing offshore, increasing utilization to maximum extent possible, improving the margins by improving the mix, enhance variable compensation to make us much less risk prone, lesser escalation in the onsite compensation costs. All such salaries have become soft, so the hikes have been frozen. Our cost there should be coming down as a percentage because we have taken some steps, and what you save there, put it offshore. Look at the strategy, onsite salary cost are coming down, competition is paying lesser than us, so you cut it down by reducing the ranges, optimize, pay it offshore because the war for talent is offshore, in offshore we put the defenses up. Continuous expense optimization, vigorous control on G&A, enhanced sales and marketing, liquidity in the balance sheet and the debt-free status. So, we have got the financial model to be a company that all of you desire to see succeed in the global market place for the future. So, thank you very much.