"Cyient Limited Q2 FY21 Earnings Conference Call"

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MANAGEMENT:

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Moderator: Ladies and gentlemen, good day. And welcome to the Cyient Limited Q2 FY '21 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. Krishna Bodanapu. Thank you and over to you, sir.

Krishna Bodanapu: Thank you. Good evening, ladies and gentlemen, and welcome to Cyient's Earnings Call for the Second Quarter of FY21. I am Krishna Bodanapu – the Managing Director and Chief Executive Officer of Cyient. Present with me on this call are our Executive Chairman – Dr. B.V.R. Mohan Reddy; President and Chief Financial Officer – Mr. Ajay Aggarwal; and President and Chief Operating Officer – Mr. Karthik Natarajan.

Before we begin, I would like to mention that some of the statements made in today's discussions 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 e-mailed to you and also is posted on our corporate website. This call will be accompanied by an earnings presentation, details of the same have been shared with you.

With this, let me first take you through the highlights for the quarter:

We posted revenue of Rs. 10,033 million or Rs. 1,003.3 crores. This signifies a growth of 1.2% on a QoQ basis. In U.S. dollar terms, we posted revenue of $135 million, which is a growth of 3.4% on a quarter-on-quarter basis and 1.3% on a constant currency basis. Services revenue stood at $114.1 million, which signifies a growth of 1.7% on a QoQ basis and a slight degrowth on a constant currency.

EBIT margin stood at 11% for the quarter, higher by 586 bps on a quarter-on-quarter basis. Services EBIT is at 12.2% for the quarter, higher quarter-on-quarter by 542 bps, primarily from improvements in operational efficiency.

DLM revenue, the design-led manufacturing revenue for the quarter stood at $20.9 million, which is up by 13.3% on a sequential basis. The EBIT margin of DLM also stood at 4.7% for the quarter, which is higher by 926 bps quarter-on-quarter, primarily because of the mix and the quality of revenue.

Net profit for the quarter stood at Rs. 839 million or Rs. 83.9 crores, which is a growth of 3% on a quarter-on-quarter basis. FCF is over Rs. 200 crores for the quarter and for the second consecutive quarter, mainly driven by better collections, reduction in DSO by 10 days, tax and capex optimization. And I would say, this is a very significant achievement because this is in spite of the fact that in Q1 we had a government benefit with SEIS, which is not there in Q2, and that was a significant amount of, I think, about Rs. 52 crores which means that in spite of that we still have done quite well on our cash collection. Free cash flow to EBITDA conversion now stands at 131.4% for the quarter.

Coming to the business highlights for the quarter:

You may have seen an announcement where we announced the intent to acquire IG Partners to strengthen our digital capabilities in the energy and mining industry. We believe mining is an interesting new avenue for us, where a fair amount of digital technologies are being used. IG Partners' consulting, advisory and technology capability, along with our digital capability, gives us a unique value proposition for our clients, which we will be able to deliver to the mining industry.

We have entered into a manufacturing collaboration with Agappe to bring world-class diagnostic capabilities to rural India. We will manufacture some key components of their Mispa Count X product. And as you know, digital healthcare is becoming more prevalent, especially in a place like India where there is a fair amount of need for digital healthcare and low-cost devices. We now have a very strong proposition for this market, along with the work that we do for some of the others like Molbio, etc. With this transformation in healthcare and with the prevalence of digital health care, we believe we are very well placed to accelerate our growth in that particular market, both with design and also with manufacturing.

We also are certified as a gold status partner in the Esri network. It's an important asset for our geospatial business, and this will significantly improve the pipeline of deals that come through because of this. For the eighth or ninth year Boeing has acknowledged us as a Silver Performance Partner, which is an important testament to the work that we do with them.

Lastly, we are bringing all our sustainability and CSR initiatives together under one umbrella, and the aim is to build synergies, optimize resources and maximize the impact that the Cyient Foundation will have through the outreach programs. We are doing this through a brand umbrella called 'Empowering Tomorrow Together'. This is a play on our brand promise of designing tomorrow together. So, the Empowering Tomorrow Together initiative will cover our activities in the four focus areas of education, digital literacy, social innovation and community development.

Lastly, we have strengthened the Board. Mr. Ramesh Abhishek, a retired Indian Administrative Services officer of the 1982 batch has joined our Board. Mr. Abhishek has more than 37 years of experience as one of the senior bureaucrats. Many of you may have also heard about him in the context of Make in India, which was something that he spearheaded in launching. It has been incredibly helpful to us in understanding the intent and also helping us derive opportunities as more and more companies look at India as a viable manufacturing location.

With this, I would like to hand this call over to Mr. Ajay Aggarwal, who will take you through the detailed financial performance. Ajay, over to you.

Ajay Aggarwal: Thank you, Krishna. As usual, I will take you through the revenues and the profitability and cash flow. In terms of revenue, as Krishna already talked about, we delivered $135 million of revenue. The interesting part is, we have got good revenue in DLM, about 13.3% quarter-on-quarter growth. And we believe that both in terms of the volume, the quality of revenue and thus, the margin, we have done very good performance in DLM. And that is something which is sustainable over Q3 and Q4 as well. And in terms of where the growth is coming from, Karthik will give more color. But primarily transport, communication, medical, these are the verticals in services side, which have given us growth quarter-on-quarter.

In terms of the margin, as you would have seen, we had an expansion of about 586 bps quarter-on-quarter. And our margin is at about 11%. In terms of the services, our margin is 12.2%. Our DLM is at about 5%. And you will see that one of the headwinds we used to have on our overall group margin used to be the impact of DLM, that's coming down. That's only about 1% now. And as I said, it is sustainable. Most of the improvement in the efficiency has come because of the improvement in the operation metrics.

You would see that our offshoring has improved by about 3%, our utilization is also up by about 3%. So, I think those two things together itself gives us about 3-3.5% of improvement. And you know we have been taking some initiatives over the period on cost reduction. So, all of them are showing very nicely. And still, we have some investments that we have made in quarter one. And of course, the impact between the quarters keep changing. And also, in terms of the volume and absorption, we are also getting benefit. So, I would say that the way we have managed the costs, both on variable side as well as on the fixed side, we have been able to get to a flat EBIT despite, especially year-on-year, if you see, despite a lot of challenges on the volume side.

I will just take a minute to explain the margin bridge. As I said, the margin improvement you will find from this table 327 bps, mostly from the operational metrics. There will be some headwinds in quarter three. We have decided to give the hike to the employees at the bottom of the pyramid, about 8,000-odd people, which will be effective 1st October, that will have an impact of about 1%. Also, quarter three typically has the mismatch between the billing days and the paydays that also impacts by about 1%. But then, of course, we also have some improvements that are possible. But marginally, there may be a degrowth in quarter three. But again, I think there is still room for improving the operational efficiencies and other levers. And you will see that our exit margin will be a little shade higher than the margin that we have delivered here. So that's what we feel that whatever we have performed is something which is sustainable, and we will deliver a robust margin at the exit of FY21, which will become the basis for financial year 2022.

You would have observed, we have a good cash generation during the quarter, the conversion is 132%. This is mainly coming from the reduction, if you see, the DSO movement itself has generated about Rs. 122 crores, that's a 10-day reduction. And also, in terms of the cash position, we have a good position of Rs. 1,350.9 crores, which gives us a good headroom to be able to take care of the investments that we are working on for fueling the growth. I would also say that apart from this, there are initiatives on capex and tax optimization that we are working on. Capex we are confident would be considerably lower, and we can really peg capex at 2.5% to 3% of the revenue.

I also want to also reiterate that there is no change in our payout policy. While you would have seen we have not declared any interim dividend, but for the year, we will maintain our payout policy of 40-50% of the PAT. This can be either in form of dividend or buyback, and we will let you know as we finalize those details during the year.

With this, I pass on to Karthik to give more insights around the operations.

Karthikeyan Natarajan: Thanks, Ajay. Thanks, Krishna. And as all of us realized three months ago, when we started looking at the market, we realized that many of our customers' demand is getting contracted. They were facing liquidity crunch issues and supply chain disruptions and their costs were not in line, so they needed to rationalize on that. We also saw that the impact was heavy on asset-heavy industries, whether it is oil and gas, aviation, industrial and transport as compared to asset-light industries like technology and consumer.

And with that backdrop, when we really look at it, our business performance for Q2 FY21, I am referring to the group column, against each of the business units and quarter-on-quarter performance. So, Aerospace and Defense has shown about 10% degrowth, and Communication has grown about 7.9%. And the Energy & Utilities has been flat. Transportation, which is the rail transport part, has grown about 21.3% QoQ. Portfolio has been about 5.4% and Semiconductor has done (-2.3%), Medical technologies and Healthcare has done about 49.4%.

The key highlights that I would like to bring out is 3.4% quarter-on-quarter growth, constant currency of 1.3%. Services grew about 1.7%, the DLM business grew about 13.3%. I also want to highlight about the order intake, which is about $127.3 million has grown by 9% quarter-on-quarter. This is more of a leading indicator for what we are expected to do in the remainder of the year. In terms of improvement in margins, which is led by various operational metrics, whether it is about offshoring improvement up about 3.2%, and utilization has improved by about 4.5%, and also the subcontracting, down by 8% quarter-on-quarter. All this contributed to our operational performance.

I would also like to deep dive by each of the verticals that we operate in, just to give a color in terms of what we have seen so far and how are we looking at for the remainder of the year. So, we talked about Aerospace and Defense, which continues to face headwinds. And we hope Q3 or Q4 would be a bottoming quarter, and we are still keeping a close tab on what is happening. The good news in the last six, seven weeks has been better than what we expected. We hope the same trend continues as we close 2020 and head into 2021. We are still not getting clarity on how the budgets would pan out for 2021. In a normal course of year, we would have understood by this time how the budgets would come up for the year to come. But in these extraordinary times, they are still going through final updates on the budgets. We will probably get to know around end of this calendar year.

Communication, which has seen a growth, which is essentially driven by what we call them as the rollout of broadband networks globally as well as the 5G network. And with virtual collaboration, working from home, probably increasing the bandwidth demand across both consumer as well as on the enterprises. And that has essentially helped us to grow by 7.9% quarter-on-quarter. And also, interesting to note is communication is our largest vertical as of Q2 FY21. We are continuing to be positive on this vertical as we start seeing significant investment around the network transformation and accelerated deployment of broadband and wireless infrastructure globally.

Rail transportation, which has been the star of the performance in Q2, which has grown by 21%, and what is driving this growth is essentially most of the customers did not want to move their project closures to the right because the end users were governments. And they wanted to make sure that most of the projects are completed on time. And we needed to ensure that we are able to meet the schedule and the timeline that is already agreed with them. So, we were almost in line with what is expected by our customers, and we have seen a significant ramp up. We continue to remain positive for the next couple of quarters as we see a steady recovery on the rail and transport industry.

And in terms of Energy & Utilities, we have seen a flattish growth between last quarter to this quarter. And I also want to highlight that we are expecting to see an upside with IG Partners as the deal gets approved during this quarter, and we expect to see a momentum on our digital transformation journey as well as growth in the mining industry as well.

Medical Technologies and Healthcare has seen the highest growth as compared to our other verticals, though it's small in terms of services. But if you also look at from DLM, I think this has really picked up significant momentum in the last three months. We continue to be bullish on the Medical Technologies. We also have added a new customer in this segment, which is amongst the top three medical device manufacturers. And we continue to be positive about the Medical Technologies and Healthcare business.

Semiconductors have seen a mixed bag, and we won some deals. We also did not see the ramp-up. We are seeing some delays in terms of customer decisions. And we continue to see softness in the vertical for the next couple of quarters.

Portfolio business has witnessed a growth of 5.4% quarter-on-quarter. And along with Esri Gold Partner status that Krishna talked about, we continue to see momentum with opportunities around energy and utilities and mining, defense and public sector areas on the geospatial side.

DLM, which has seen the significant growth of 13.3%, one thing I want to add to this, we are very cautious in terms of ensuring that we are only driving the profitable growth in this segment and has been an issue that we are aware of. We are very conscious of that and ensuring that we are able to improve significantly in terms of inventory, and we are also able to increase the cash flow for the business. We believe this is sustainable, and we want to continue to be profitable in this segment and ensure that the cash flows are intact.

So, with that, we will probably leave it for Q&A.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the questions-and-answer session. The first question is from the line of Sandeep Shah from Equitas Securities. Please go ahead.

Sandeep Shah: Congrats on a very strong margin execution. Just the first question, wanted to understand how easy to now predict the growth in the Aerospace & Defense? Because as we are saying, Q3, Q4 may bottom out, but do we believe the time has come where predictability has improved in this segment, especially on the services side?

Karthikeyan Natarajan: Sure. Thanks, Sandeep. This is still a big challenge for the whole industry. If you look, still we have seen that only 25% of the travel has resumed as compared to what was seen same time last year. So, unless the travel resumes, it's a difficult one to predict how the industry would turn around. There are various analysts who predict that by 2023, or late 2022 is when the industry is likely to recover. So, we are keeping a close tab both on the commercial aviation as well as on the defense side. And as we have shared in the last call, we are continuing to look at how we grow our DLM business, defense business and the digital business within Aerospace & Defense. And when we said we are bottoming out in Q3 and Q4, we hope the growth would be compensated by some of the actions that we are taking on the DLM and digital. And that's the kind of expectation that we have for the next two or three quarters.

Krishna Bodanapu: I think just to add to that, I would say, I think what the line of sight that we have is, from a volume perspective Q3 seems to be holding up. It's just that we have a problem with a number of bill days and the capacity that's available. So, in that sense, we believe that we still have to address that problem in Q3. Therefore, if we can maintain the volume, which is what we have a line of sight to, then we think at least Q4 onwards some growth will start to return. But I think to Karthik's point, any appreciable growth, is still a while away. I don't think any of the aerospace companies have a line of sight to any appreciable growth at the moment.

Sandeep Shah: Okay. Fair enough. So, in this scenario, looking at Aerospace & Defense still close to 30% of services segment, how do you see the growth outlook in the services segment going forward in constant currency, because even in this quarter in CC term it has declined as a whole?

Karthikeyan Natarajan: Sandeep, what I would really look at is, as we have talked about, communication has become our largest vertical. So, we are very confident on the growth that is going to come through the communication vertical. And we are also looking at the segments like Transportation which will continue to do well. And we are also bullish on the medical devices and healthcare. So, these are the three segments we see that the growth is likely to be sustained in the near-term. And we hope the energy and utilities and the portfolio catch up soon. And aerospace would be, as we said, we have to really wait and watch how this industry will pan out. So, this is the kind of view that we have.

And what is driving that? We have seen that momentum on the 5G rollout globally. And the network transformation is definitely on the cards as the network demand has expanded by at least 15% to 18% in major markets that we operate in. And this requires many customers to accelerate on the rollout, both on the broadband as well as on 5G. So, we are hopeful on that segment as compared to what we have seen in the past. And rail transport, we have seen secular growth across all our customers. And that's the reason why we have seen a 20%-plus growth from Q1 to Q2. And we still believe this will have some more steam left for the next few quarters, and that's essentially what we are planning for. And Medical, some part of Medical has seen a growth and some part has not seen the growth, depending on whether they are part of the pandemic-related issues that we are addressing on diagnostics or any kind of hospitalization, ventilators etc. And I think that part of the business that's seen the growth in the last six or seven months, while the growth would probably be a lot more secular on the medical businesses moving forward. So that's the kind of color I can provide there, Sandeep.

Sandeep Shah: Yes. So, looking at the tailwinds versus the headwinds, do you believe services segment can actually now start posting a positive growth in a constant currency terms in second half? So, on the services side, looking at the tailwinds versus the headwinds segment wise, do you believe services segment can start posting a positive constant currency growth in the second half? And Krishna, your comment about the full year growth, you expect a double-digit decline versus last quarter you said 10% to 15% decline. So, is it fair to say 10% to 15% range is now at close to low double-digit kind of a decline?

Krishna Bodanapu: Yes. I think that's fair to say. I think its low double-digit kind of a decline is what we are looking at. And I think looking at your point about headwinds and tailwinds, I think net-net, we are quite positive on what's happening in the second quarter in most parts of our business. I think there are positives, negatives. But overall, net-net, we come out with being confident about growth. Also taking into account what is happening in aerospace, I think we still need to be cautious about that particular sector. But taking everything into account, I am quite confident that we will have a much better H2 compared to H1 from the revenue perspective.

Sandeep Shah: Okay. And last question, if I can squeeze. In terms of margins, I think what the CFO is talking about in Q3, there could be some decline, but in Q4, it can be similar to 2Q margin and the full year margin would be similar to last year margin of 9%. Is it the right way?

Krishna Bodanapu: Yes, that is correct.

Moderator: Thank you. The next question is from the line of Urmil Shah from IDBI Capital Markets. Please go ahead.

Urmil Shah: Krishna, first, wanted to understand, as regards to growth in Transportation in this quarter, how much of it would have been driven by the new deal with Hitachi? Because we have called out Transportation as one of the growth verticals. So, ex of the new deal, how the performance has panned out?

Krishna Bodanapu: The new deal would have been relatively small because we are still in a ramp-up mode. So, a lot of the ramp-up is really happening because of the existing customers. We have Hitachi, we also have one more new deal in transport which is ramping up now. So, what we think there is decent growth that's coming back in the existing base. And then on top of this, these two new customers will add to it for the coming quarters. So right now, it seems most of the growth would have been driven by existing customers.

Urmil Shah: Yes. So, you are talking about two new customers in the coming quarters in this segment?

Krishna Bodanapu: No, no. They have been already added, we are already working with them. They will drive the growth in the coming quarters.

Urmil Shah: The outlook for FY 21. Last quarter, we had indicated that as regards to 15% decline, given more positives from DLM, now are seeing outlook of a low double-digit decline in outlook as DLM improved much better than what it was last quarter? Or this is driven by some growth in revenue?

Krishna Bodanapu: So DLM will grow faster than services. I think that is quite clear now. And also, having said that, the good news is the DLM margins will also continue to improve. We did 4.7% EBIT this quarter, and we will continue to do better going forward. There will be more growth in DLM and at a better margin. But it will be a mix of services and DLM growth. It's not that there will be a significant change to the overall mix of how services in DLM will work.

Moderator: The next question is from the line of Mayank Babla from Dalal & Broacha Stock Broking. Please go ahead.

Mayank: Sir, my question was regarding the operation metrics improvement. So, we can see that the head count has reduced in the quarter versus the previous quarter also and the same quarter last year also. I wanted to understand how much of the direct salary and related cost reduction was due to offshoring? And how much was because of reduction in head count, if you could help explain that?

Ajay Aggarwal: I would say that between offshoring and utilization, it's about 3% improvement, 3-3.5%. Roughly, you can say half-half. Half is because of offshoring and half is because of utilization and also the optimization of cost in payment line.

Moderator: Thank you. The next question is from the line of Zakin Aser who is an individual investor. Please go ahead.

Zakin Aser: Congratulations on a steady set of numbers, I would say, for this quarter. I have two questions. Number one, how is the work from home situation panning out? And does that entail a higher expenditure then when people come to office? I mean, how do you see this will pan out and how this panning out for clients? Point number two is about the degrowth, what Mr. Krishna was mentioning. So, what I can gather is, on the consol basis, we could see on a top-line degrowth of mainly around 10% to 11%. Would it be right, sir? Thank you.

Krishna Bodanapu: On the second one, roughly, maybe I would say 10% might still be optimistic, but roughly we are closer to 10% rather than 15% at this point. On work from home, I will ask Karthik to answer it, because he's done most of the work.

Karthikeyan Natarajan: Sure. Yes. No, I think it's been eventful quarter. And as we started learning to operationalize the work from home, I think we did see a lot of teething issues in the late part of Q1 and early part of Q2. And we are also able to stabilize in terms of productivity, and we are also seeing in some cities, we started slowly moving to a work from office by 10-15%, but then we have to reverse it due to the changes that have happened due to the pandemic. So, we have been able to manage productivity as well as on the health of our associates. And we started focusing more on the mental health in the last three months. We have been able to do many programs and ensuring that they are able to get their energy back, since most of them are working remotely and we wanted to make sure that they see a common engagement across their own fellow associates.

So, a lot of emphasis on morale of our workforce and helping them with training, and the training content and quality of training that we started providing to our associate has expanded significantly in Q2. And we continue to see that gaining momentum in Q3 and Q4 as well. So, we are probably saying that we have learnt how to manage work from home in the last six months. And we are also fairly confident that we can continue this till the pandemic situation improves. We are not rushing to get our associates back to work from office. And just to share some of the challenges we have seen due to the floods in the last two days, we have been able to recover our operations within two to four hours of SLA. So, this is not possible unless we have gone through the last six months of learning. And that has been really putting to use when we see any cities that is likely to have an issue or any particular state will have issues, we know how to really manage such challenges we will see moving forward.

Moderator: Thank you. The next question is from the line of Neerav Dalal from Maybank Kim Eng Securities. Please go ahead.

Neerav Dalal: I just had this one question regarding the employee head count. What would be the outlook going ahead? How should one look at that number? Utilization has also improved. So, your comments on that.

Krishna Bodanapu: I think we would be cautious about head count; I think we still have a little bit of room for utilization. So, we are looking at all the levers. I think the challenge that we have created for ourselves was the utilization number, and we had a challenge with utilization that we are still trying to fix. So, I would say that we are definitely recruiting for the quarter also, though the net head count is negative, we have recruited a bit of people this quarter, I think 270 people or so at a gross level, at least. So, we will continue to do that, but I wouldn't expect to see a significant shift on head count as yet because I think there are still some levers that we need to work on. And we also need to optimize the fact that while the overall average number seems to be palatable, there are still some significant areas where we need to improve. So, we will focus on that. So at least for the next couple of quarters, I would say, the growth wouldn't necessarily be driven by head count because there is still enough slack in the system.

Neerav Dalal: Got that. No, because the other thing is that our utilizations are sort of the highest that we have done. The last we had done a similar number was in FY12. So yes, so just wanted to your take on that. So how much more room is there on the utilization side?

Krishna Bodanapu: I think it is about 2% is what I think.

Karthikeyan Natarajan: I would say it's a combination of utilization plus the productivity and our ability to bring automation to the fore. I think all combination of things that we are trying to drive, it is just not about the headcount and the utilization, and it is also the productivity and how we think we can maximize leveraging the automation. I think that's a lever that we are trying to push forward, Neerav.

Moderator: Thank you. The next question is from the line of Sandeep Shah from Equirus Securities. Please go ahead.

Sandeep Shah: Karthik, just a question in terms of, post you joined you were indicating that you will do some restructuring efforts, both on the delivery as well as on the sales organization as a whole. So where are you in that journey? And is there any performance measurement which you would like to share that, where are you in terms of the progress on those performance measurement KPIs? That will help us.

Karthikeyan Natarajan: Sure, Sandeep. And we are going through the process, as we speak, in this quarter. Probably, we will share more details by the time we do the next call. And as I started saying, we are definitely looking at key levers from the revenue or growth standpoint with leading indicators, like order intake, which is essentially part of the BBC, booking, billing and collections, how do we think we really start matching the complete order to cash. And from the operations standpoint, I think it's a typical metric, which includes the key levers on utilization and how the automation and how do we think our G&A costs are across space, software, and travel, and how do we think we manage all the other costs. So, we are looking at all the possible levers and how do we really look at a better optimization plan for the H2. And most of the levers are close to getting optimized. And we have a couple of them which have been worked upon during H2 as such.

Sandeep Shah: Okay. And just a related question on the strategy side. Do you believe we have to have some rebalancing on the portfolio to actually have a better growth outlook in FY22? Because Aerospace & Defense may continue to remain weak beyond FY21. So, in that scenario, are you confident in saying that the rest of the segments will have a lot of growth visibility which will help you to compensate any kind of a softer growth or the headwinds from the Aerospace & Defense?

Karthikeyan Natarajan: Yes. I think we are definitely looking at it as part of our structuring for H2 and fiscal 2022 ahead. We are definitely planning for looking at some sectors which can accelerate our growth and also bring focus on digital. And I think that's definitely been in the plan. We have just announced an acquisition of IG Partners. Once that gets consummated, we hope that can drive the growth in the mining sector. So, we are seeing some green shoots on subvertical level, not necessarily at the broad vertical level. And focused on sub-verticals, which can give us growth probably in the next 18 months, and how do we think we are really able to focus on those sub-verticals for growth.

Krishna Bodanapu: And if I can just add to that, I will say that the focus also is to bring some new sectors and skills into play. For example, if you look at it, there were certain areas of the engineering spectrum that we weren't focused on, process engineering, automotive and so on and so forth. In the new structure, we also have a play to focus on those areas. Again, I would say that it's not the traditional automotive, mechanical engineering kind of work, because that is something that is quite commoditized. But we believe that with things like electrification and autonomous driving and those kinds of things happening, we have a horizontal play into some of the new markets. And actually, we are seeing the first wins in those areas also. So, we have to compensate for aerospace. I think that's just the reality we face.

But I think we have also put in work in the last 9 to 12 months, and especially in the last six months we have really put in a lot more focus on some of the new areas. So, I think there are three elements. One is, we have to make sure that the existing businesses like aerospace continue to be stable. We will start to look at growth opportunities in other segments, but also focus on new sectors. So, I think the combination of these three things. We are starting to see some good outcomes out of it. And therefore, I think a combination of all these gives us that confidence.

Sandeep Shah: Okay. And just a question to Ajay, this direct salary and related cost has gone down by more than 8% Q-on-Q. So, is it more to do from on-site to offshore as well as decline in the employee as a whole?

Ajay Aggarwal: I would say there are two or three things. One is, I think the mix of subcontracting. The subcontract cost, so it's a combination between that direct cost and this cost. And second one is, yes, whatever you are seeing that 150 basis points, I said half of that 300 to 350 basis points, that reduction is coming mostly from this direct cost. And also, some of it is also a function of some of the grants that we get in terms of the compensation in the various geographies. That's almost about 1%. That's also accounted and netted off in the people cost. So, these are the three things.

Sandeep Shah: Okay. And just the last thing, in terms of engineering R&D, whenever the slowdown hits, it is first to get impacted. And we perceive that it's last to recover. So, any thoughts and negotiations if the client indicates that the decision-making has started improving and clients have started spending on the engineering R&D? Or it will come with a lag post the enterprise IT decision-making or digital adoption decision-making actually going up?

Karthikeyan Natarajan: Yes. It is driven by essentially their ability to stem their cost. I think that's one of the key priorities for them. Second, they are looking for new revenue streams, and that is where we are seeing opportunities for ourselves. We have talked about whether it is on 5G, we have talked about something on medical devices or on the rail transportation. And most of the rail transportation customers, they also prioritize what would give them cash in the short-term, so that their projects are also prioritized in line with that. So, we have started seeing some momentum because a lot of projects got prioritized, which they will get cash in the near-term. So, it is essentially driven by that. But the broader demand expansion is going to be driven by stimulus, how the infrastructure and other areas would pick up based on the stimulus growth and the economic recovery that is going to happen across automotive and the consumer areas. We hope some of them would start showing up in early fiscal 2022. And that's something we are prepared for riding on the growth.

Moderator: The next question is from the line of Amit Chandra from HDFC Securities. Please go ahead.

Amit Chandra: Sir, my first question is related to the Aerospace & Defense vertical. So, we have seen that there is steep decline there over the last four, five quarters. So just want to understand because we have high client concentration there, so whether the decline is mostly due to ramp down in the large client or it has been broad-based? I am not asking for this quarter, but like over the last one year. And as we are saying that the next two quarters going to stabilize and the finalization of the list are going to happen by the end of this year, so are you expecting the growth in this vertical to come through the existing clients? Or you are trying to add some other clients in this vertical? So, this is my first question.

And sir, second question is on the DLM side. So now we are expecting higher growth in the DLM side. So, if you can throw some more light on what will be the ongoing strategy or strategy around DLM, which is driving growth here? So, it is more of, say, like higher contract manufacturing contracts or like solution-based contracts? Or it is like driven by this, like medical devices or short-term contracts? So, I just want the long-term vision here in terms of DLM, what can be the scale and the current capacity utilization in DLM and any investments that you have to make in the near future?

Krishna Bodanapu: So, I can answer the DLM part first. I think if you look at the growth in DLM and also, it's manifested in margins, is because a lot of the work that we are doing fits into the original strategy that we want to do, engineering-led, high-complexity, low-volume kind of work. And a lot of the business is really transforming into that. I mean, at the end of the day, we have a very unique DLM business. There is a lot of contract manufacturing, that's not what we do. And our customers don't come to us because we can make millions of parts for the cheap, that's not where our focus has been. Our focus has, again, been engineering-led, it's been where there is complexity, where there is low volume. And that's starting to pick up, and that's manifested in the margins. Like I said, EBIT this quarter was 4.7% and it will only go up in the next coming quarters. And if you look at other sort of contract manufacturing businesses, nobody would have margins like that, which means that the work that we are doing is quite unique and quite high end.

We will continue to focus on that. I think we have turned the corner in terms of how the whole business will play out over the next few years or even next many years. Having said that, at the same time, I want to reiterate that our core business is engineering business, services, and solutions. But if you look at where we will continue to focus, we will focus where there is engineering-led growth that will give us manufacturing rather than just contract manufacturing. So therefore, we are quite bullish about this sector. It's taken five years to turn the corner, but I think we have turned the corner or at least I will say we are turning the corner, and therefore, it gives me a lot of confidence that we have a very unique positioning, and that will reflect going forward.

The second part of your question in terms of capacity, we have capacity to at least double that business before we make any significant capex. There might be some ongoing capex in terms of some specialized equipment, testers, etc., but nothing significant. So, we feel quite confident that we still have a lot of capacity that we can utilize and leverage.

To the first part of your question on aerospace, it's been a decline across the sector. If you look, we did a count with some of our customers, their outsourcing spend has gone down by 60- 65% across the board whereas our revenue is down by 35%. So, the good news in all this is we have actually taken market share. But the bad news is, the decline has been across the sector because the impact has been across the sector, it's not a company-specific thing. I will only say that where there is more defense-related work or government spend-related work, there the decline has been less. If it's purely commercial, the decline has been a lot more.

Amit Chandra: Okay, sir. Thank you. And sir, my last question would be on the salary cost or the indirect cost. So, the fall in direct cost is also a function of the involuntary attrition that we had till last quarter. So how has been the involuntary component in this quarter? So, whether the fall is also due to involuntary attrition or we have seen that fall significantly in this quarter?

Ajay Aggarwal: See, as far as involuntary attrition is concerned, it also has associated costs. To that extent, I think this reduction is despite that sort of what we call a restructuring cost, and that set off. So, don't read too much into that. I think on one side we have one-offs of grants and settlement costs. On other side, we have the benefits of utilization. So, both of them set off, and this could be quite representative with further improvement in utilization.

Moderator: Thank you. The next question is from the line of Ritesh Rathod from Nippon India Mutual Fund.

Ritesh Rathod: Can you help me out on your acquisition strategy? What kind of targets we are seeing, what are kind of valuation expectations, have they come down? And have we become more aggressive in the targets?

Krishna Bodanapu: So, I think we absolutely have become more aggressive. I think it's a great opportunity for us to acquire good businesses at this point. We are aggressively looking for options where we won't shy out from acquiring, that's been a key element of how we have grown the business. I think we just need to be prudent. Obviously, we are seeing good targets. But I would say the valuations have not necessarily come down. And at the end of the day, I think my view always has been at low or high that you have to find a good value. But more importantly, you have to find something that makes strategic sense. And if it makes strategic sense, we are not trying to time the market, I think that's not the view that we are taking. We just want to make sure that we make the right prudent acquisitions at the right point in time. So, we are going to be aggressive about it. It's something that we believe we have done very well; we have the competence and the capability and the ability to integrate. It's just that we need to be a little bit prudent to see how things settle down in some of the markets. Like, if you look at IG Partners, we still did the deal, though we had agreed to the terms before the sort of the whole situation developed, and we did the deal more or less on the same terms after, because we feel quite confident of the business, where the business fits in and how we can actually integrate and grow the business. So, net-net, where I am coming from is, we will do it. And we also have the cash and the access to credit. I think, Ajay, you set the number of what the cash balance is, but also, I will add to that, that it's the highest it's ever been. And we are also keeping that because we believe that we do want to grow the business, accelerate the business out of this. But we just need to find the right targets.

Ritesh Rathod: Okay. And any particular vertical where you have this pre-LOI kind of thing?

Krishna Bodanapu: No. I think it's across the board. And I think it's where we are and in the spread that we have, it's a little bit difficult to pin it down to a vertical. Because all said and done, even in aerospace, there are some very interesting opportunities, for example, right now. So, we just have to take it as things come. But I would say, we have clearly laid out objective of where we want to accelerate the business, and we will focus on those areas, especially as they relate to digital electronics, embedded software, kind of areas.

Ritesh Rathod: Second was on the large deals in the pipeline, are there any deals? How has been their behavior? Are they slow-moving or their decision making has picked up and you can see some large deals getting closed in the coming quarter?

Karthikeyan Natarajan: I think we are seeing what we are classifying them as large deal is $25 million of total contract value. And we have about seven of them in our pipeline currently. And we are continuing to see the action, but the decision is not getting made anytime soon. I think that's getting pushed to the right. And what we are also conscious of the fact is to start focusing on deals between $10 million to $25 million in Q3 and Q4 as we are trying to mature our processes towards the large deal. So, we are looking at it from both angles. How do we really look at deals of $10 million to $25 million, while we are trying to build the pipeline for $25 million plus too.

The second one is to also focus on conversion and how do we think we can really make it compelling for our customers to go for the conversion or go for the deal closure at the earliest. And we are trying to work with them to see how do we really make it interesting for them in terms of decision-making. We are confident that some of them would move between Q3 and Q4, and we definitely want to work towards increasing our large deal wins in H2 as well as fiscal 2022.

Ritesh Rathod: Okay. And last question from my side, Ajay, in terms of capex you mentioned 2-2.5% of revenue will be the capex on approximately sort of Rs. 4,000 crores kind of a base. So, it's kind of Rs. 90 crores kind of a number you are hinting at for the annual?

Ajay Aggarwal: That's right. I said 2.5-3%, depending on which quarter and which year. But earlier there was a concern that we were crossing that when we were investing in Hyderabad plant and all. That's why I just wanted to clarify, 2.5% to 3%. You are right.

Ritesh Rathod: So, first half, we have done Rs. 69 crores kind of thing, that's your cash flow statement in fact?

Ajay Aggarwal: Well, it also had one-offs, some of the continued capex on Hyderabad plant for DLM, which was about Rs. 20 crores. We had also acquired something in Germany in terms of people acquisition, some asset acquisition, that was also there which was another Rs. 15-20 crores. So that's why the number was high, which are one-offs.

Ritesh Rathod: Okay. So basically, you are hinting at Rs. 120 crores, and in first half you have done Rs. 70 crores is how one should read it? Or you should see first half is a lower number, and you will see a similar number in the second half?

Ajay Aggarwal: I would say, overall, I would look at a number of 2.5-3% for the full year. And specific details between H1, H2, maybe we can take it off-line.

Ritesh Rathod: And would it come down dramatically in FY22-23 after this DLM and everything being there in FY21?

Ajay Aggarwal: See, I am saying that when DLM and all came, it moved towards 4-4.5 to 5%. So, the norm is that we are growing, we are setting up CoEs, and things like that, spend on hardware, software that we need and some of the other things that we need. But I think we have to also see how these business models evolve and basically call for reduction once we finalize the go-forward strategy. So, I would still say 2.5-3% with some scope for further reductions based on new ways of working.

Ritesh Rathod: But work from home, if that thing stays or it becomes a structural thing, that will reduce the capex intensity, would it be a fair assumption?

Ajay Aggarwal: Yes. I think that is a fair assumption. Obviously, we have to also enable the associates, and we are working on some policy to make them comfortable. But why don't you give us some time. I think we are thinking about the long-term. Maybe in the next six months we will finalize. So, by the time we talk for maybe the quarter four or the next year, we will have more visibility on this. I am just saying from pure common sense whatever I am saying. I need to have it in terms of a road map.

Ritesh Rathod: And would this December quarter see some sort of extended furloughs? Are you seeing any such kind of signs or it's a normal kind of thing which you see every annual year?

Ajay Aggarwal: So, every year we see the normal situation, especially in North America where we have Aerospace & Defense, where we get the gap between the billing days and the pay days of about three days. We are still working on bridging the gap by overtime, other things. But I think that's, as usual, unless Karthik, you feel otherwise.

Karthikeyan Natarajan: No, I think we are still assessing would that be any different this year. We are not having any clear views on it until now. So, we will probably get to know in the next one month how this quarter will pan out. We are really prepared to see how do we minimize the impact for this quarter.

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

Mohit Jain: I have two small questions, sir. One is on DLM outlook. You guys alluded to the fact that DLM business, the composition of the business is changing a lot and that is getting reflected into margins as well. So, is there any benefit you got because of this medical thing during the quarter? And should we assume a Y-o-Y seasonality in line with the past on the DLM business? That is question number one.

And second was on headcount. Headcount has been coming off for quite some time and now margins have gone up to a reasonable level. Should we assume that going forward, headcount would remain stable, more or less? Or do you still think some corrections are on the way?

Krishna Bodanapu: So, I will answer the first one and then I will ask Karthik for the second one. But on DLM, I mean, we are seeing benefits both of the current situation because we have a fairly sizable capability to manufacture medical devices, and that's also driving some good growth. But having said that, we are also seeing good growth across other sectors. I mean, even if you look at the aerospace sector, for example, the DLM growth in aerospace has been quite significant because the work that we have done in terms of transitioning some of the products to manufacture over the last few quarters or even last few years in some cases is starting to pick up. So, I would say, overall, the DLM business is looking reasonably good from that perspective. There will always be seasonality in that business. I think, like I have been saying for the last couple of quarters, it's something that we just have to deal with. And we just have to make sure that we manage ourselves within that seasonality. So, there will be seasonality. Healthcare is helping us at the moment. But I will say it's not just driven by healthcare, it's also other sectors like aerospace and defense, for example, that have caught on quite a bit in DLM.

Karthikeyan Natarajan: Sure. Thanks, Krishna. And I will also add on the DLM part, and we are also seeing growth coming essentially from A&D and medical, but we are also wanting to see how do we take it across the E&U and the transport vertical as well. On the headcount part, what I would say is, Mohit, it's a combination of two or three things. And as Krishna said, even in Q2 we have added about 270 people. So, we will continue to look for the right skill, and if that is available internally, how do we maximize it. And if you don't find it, still, how do we get it from outside. So, it's a combination of both internal as well as external that we will look for.

Second, we are also clear on certain operating metrics, because we still have some headroom to improve in terms of utilization, and we want to bring in automation as a key driver of productivity. And how do we think we are able to leverage that. And third, the nature of growth that we are likely to see and how do we think we are able to manage it. And if that requires us to hire people permanently versus managing some short burst. And we are also open in terms of contingent levers we need to bring on board. So, we are looking at all combination of levers that we have. And we will see some stability in terms of our headcount in Q3, and maybe by Q4 it starts picking up as the growth picks up.

Mohit Jain: Okay. And lastly, sir, in terms of margins, you said Q4 should be similar to last year's Q4 or Q2? I missed that point actually.

Ajay Aggarwal: We said that we have delivered 11% margin in this particular quarter. There are a few headwinds because of the wage correction and the capacity constraint, which was the gap between the paydays and the bill days in quarter three. But quarter four, at least, we should be able to get back to the Q2 margin of 11%.

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

Sandip Kumar Agarwal: Sir, I have only one question, Krishna, that if you see our segment, and I know one of the earlier questions, the gentleman also asked a question that we have good exposure to aerospace and defense, and that industry is going to take a lot of time probably to recover. And I don't know in energy what is happening, because of the oil situation it was also weak. And we, in fact, saw in this quarter also it was almost flattish and has not recovered strongly. So, will the growth which will be there in FY22 more of a base effect where A&Ds have declined? And from there we only recover, that is the key reason of recovery you would think? Or you believe inherently there will be strength in a lot of segments? That is number one.

And number two, you are also announcing wage hike in line with the industry from 1st October. So how do we read that, that you are expecting some kind of strong momentum from here or you are just doing it in line with the industry practice?

Krishna Bodanapu: No. I think one is, there is going to be a base effect. And therefore, the recovery will be based on the base effect. Like, I was saying, the way that we are looking at it is the aerospace business is a lower base business, and we need to now take that into cognizance and grow from there. The rest of the industries, we will actually recover. And if you look at places like communications and transportation, they will have their best quarters ever within the next couple of quarters. So, I think it's a bit of both in that sense. In most of the businesses, we are just I think well positioned. We will recover or it has to be the best levels. Whereas in A&D, we just have to take a new base impact.

Now in terms of the salary hikes also, I would say it's in line with the market. We would not do anything different or extraordinary. But I think there are some reasons why we need to do that. And therefore, we will do it with the broad market or in line with the broad market.

Sandip Kumar Agarwal: Also, one quick question to Ajay and I am not asking for any specific number, but how do you see margins to evolve over next year as a full year? Do you see this was the worst year for the margins or you would not be able to comment right now?

Ajay Aggarwal: We are very happy with where we are currently, despite the revenue challenges and we have demonstrated our ability to do the right cost structure. And some of the things that we have done are very sustainable. So, I think our exit quarter Q4 is something that should be definitely sustainable, structural changes in terms of some of the metrics. And then going forward, once the volume also picks up, then I think we will be in a good place. Now how much will be the margin for the next year, I think it's a little early. Nowadays, predicting beyond six months is really difficult.

Sandip Kumar Agarwal: One final question, if I can squeeze, is that we have a huge cash balance now and will it not be little prudent that we stabilize all our acquisitions which happened until now. And we had tough time with DLM in the past, so we stabilize everything for a year or two and probably a better use of this cash could be probably returning them to investors, or you think that the opportunity right now is much better to acquire assets which are available cheaper because of the disruption?

Krishna Bodanapu: We will be prudent about this, not just because it's cheaper because of the acquisition, also because we have had a rough couple of quarters. We have stabilized the business. There is a huge opportunity to grow the business. So, like I said, I am not necessarily looking just for value. I am looking for a good opportunity. We will always be prudent. If we don't think we can deliver the returns that justify putting the money, we won't do it. But I think at this point at least, there is an opportunity to do that in a good way.

Moderator: Thank you very much. We will take that as the last question. I would now like to hand the conference back to the management team for closing comments.

Krishna Bodanapu: Thank you very much. I know it's a little bit late these days with all the virtual board meetings, etc. But thank you very much for joining. As you saw, there is a fair degree of stability returning to the business. We are also trying to prudently manage through for the next couple of quarters, at least. I think the opportunities are in front of us, but we also have to be careful that we don't overexert ourselves or overcommit or set an irrational expectation of how we can avail those opportunities.

But I just want to assure you that the business is looking quite good, from where things started off on March 23rd. And I will say thank you very much for your support. I think many of you have interacted with us through the thick and thin. I want to assure you that we are now starting to enter a patch where we believe that the business will come back to the good quarters that we had a couple of years ago.

We also will have an Investor update call. We did not do the Investor Day this year, given that it was supposed to be done in May, and that's when the peak of the uncertainty was. So therefore, we will do an Investor Update call, which will be a few hours long. We are planning to do it in either late November or early December. We will send you the information on that, but please do look out for that. And once again, thank you very much for joining the call. But more importantly, thank you for your support. And look forward to speaking to you during the quarter, or if not, at the next call in January. Thank you very much, and have a good evening.

Moderator: Thank you very much. On behalf of Cyient, that concludes the conference. Thank you for joining us, ladies and gentlemen. You may now disconnect your lines.

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