"Mphasis Limited Q2 FY-'17 Earning Conference Call"

November 4, 2016

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MODERATOR: **MR. SHIV MUTTOO – CDR INDIA**

Moderator: Good Day Ladies and Gentlemen. Welcome to the Mphasis Limited Q2 FY-'17 Earning 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 would now like to hand the conference over to Mr. Shiv Muttoo. Thank you and over to you sir.

Shiv Muttoo: Thanks, Karuna. Good Afternoon, everyone and thank you for joining us on Mphasis' Q2 FY-'17 Results Conference Call. We have with us today, Mr. Ganesh Ayyar -- CEO and Mr. V Suryanarayanan -- the CFO of the company.

Before we begin I would like to state that some of the statements in today's discussion may be forward-looking in nature and may involve certain risks and uncertainties. A detail statement in this regard is available in the Q2 FY-'17 result announcement release that has been sent out to you earlier. This conference will be archived and the transcript will be made available on Mphasis' corporate website www.mphasis.com.

I now invite Mr. Ganesh Ayyar to begin the proceedings of this call.

Ganesh Ayyar: Thank you, Shiv. Good Afternoon, everyone. Thanks for joining the call. I hope all of you have had the opportunity to go through our MD&A which provides details of our operational and financial performance for the quarter-ended 30th September, 2016.

Let me start with Direct International. Deal win momentum continues to be robust; we recorded TCV wins of $83 million during this quarter. 44% of these deals are focused in the area of Digital, Next Gen and Governance Risk and Compliance. Some of the key wins during the quarter included Next Gen deal for a global bank where we will help them build a consumer banking platform using Agile Methodologies and DevOps Tools. We also won a deal where we will be delivering a Digital Transformation platform using Agile Methodologies providing a seamless customer experience and faster time to market.

We continue to look at innovative new generation ways of adding value and becoming increasingly relevant to our customers. This will ensure that we future proof, we continue to win, and we continue to sustain the growth rates that we aspire to have. Overall Direct International business declined 0.2% sequentially adjusted for rupee appreciation. The Direct core business which constitutes about 75% of Direct International grew 1.2% quarter-on-quarter and 12.8% year-on-year adjusted for the rupee movement, driven by growth across key strategic account. While this was good, I would have expected Direct Core to grow better. We could ring fence this issue to a single account in our strategic account base which has embarked on an across the board IT cost optimization. This has impacted everybody who is providing service to that account. The good news is that we gain wallet share in this account despite the decline that we saw in this quarter, and going forward I expect this particular account to stabilize and the growth to come back. It was a one quarter phenomena and not necessarily impacting the mid-to-long term perspective that we hold of Direct Core. I strongly feel based on the TCV wins and the pipeline that our Direct Core business will beat market growth for the year.

Now let me move on to talk about other businesses. Digital Risk which constitutes about 21% of Direct International has performed within our guided range. It continues to perform as we had planned, I also see a strong pipeline for Digital Risk and I am hoping that we will have some good wins in the coming two quarters in Digital Risk arena as well.

Let me move on to HP Business: All the time that we have interacted the question which got asked of me was "When would the decline stop?" I am very happy to report that in Q2 we see the decline stopping and moderate growth of 1.5% quarter-on-quarter appearing in HP business. The good news is this is not a one-time phenomena. We believe this is the beginning of stability of HP business and we will see some moderate growth as well. After almost 5-years of decline we are beginning to see stability and moderate growth in HP business.

Let me now share some details of our "Financial and Operational Performance for the Quarter." Our consolidated revenue grew 0.8% sequentially in Q2 adjusted for rupee appreciation, driven by growth in Direct Core and HP business. Our gross margin remains flat quarter-on-quarter while it improved 150 basis points year-on-year. Operating margins expanded 10 basis points quarter-on-quarter and 150 basis points year-on-year to 15.3% in Q2 FY17. Based on the greater value that we are delivering to our customers, we are seeing a trend of margin improvement, and as communicated earlier we are confident of operating in the band of 14% to 16% for the remainder of the year. Net profit margin adjusted for one-time accelerated cost provision made on account of HP stake sale to Blackstone improved 80 basis points quarter-on-quarter and 170 basis points year-on-year to 14.3%. DSO saw robust improvement of 7 days this quarter to 67 days, leading to a very strong cash generation of Rs.3,417 million, almost a shade above $50 million, taking the total cash on our balance sheet to over $500 million or INR 33,615 million.

To conclude, while we remain alert to volatile market condition, we are excited about HP business stabilizing and showing growth. Our focus will be generating high quality revenue growth. We remain confident of our trajectory of faster than market growth in Direct Core business. As far as margin is concerned, we will continue to deliver on our communicated range of EBIT.

On that note, once again I thank you for your continued interest and would now request the moderator to open up the line for Questions.

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 Madhubabu from Centrum Broking. Please go ahead.

Madhubabu: HP usually has seasonality in 3Q because of furloughs. Would that continue this year and would we see sequential weakness in HP for third quarter?

Ganesh Ayyar: As we look ahead, we believe that we may not experience any decline in the coming quarters, you will see a stable business on HP and we may even see some moderate growth over the next two quarters.

Madhubabu: On Digital Risk, I think last four quarters it has been declining quarter-on-quarter. You said that from 3Q we should see some improvement. Can we build that improvement from next quarter onwards?

Ganesh Ayyar: Digital Risk has been operating in the range where the base business is in and around $28 million to $30 million and the rest of it is Project business. The good news is our pipeline is strong. The challenge ahead is to convert the pipeline and win those deals. I would not be able to commit that you will see growth in the coming quarter but I certainly believe that in coming quarters we will start seeing an upward trajectory of revenue in Digital Risk.

Madhubabu: How would the wage hikes pan out next quarter? Our head count has been on the downside, now that we are seeing some growth at least in HP, would we require headcount addition and how would that imply on the margins for 2H?

Ganesh Ayyar: Our policy is not necessarily to focus on building a bigger workforce because one of the things which you will see in time to come is greater injection of automation in service delivery, which we are extremely focused on. Right way to judge the future prospect is not based on hiring plans, but based on the pipeline and win probability and number of deals that we have won which have not yet made to revenue… combination thereof. To that extent in the Direct Core space, we feel very-very confident. Maybe I can ask Surya to take that question on wage hike.

V. Suryanarayanan: The wage hike impact would come in Q3: it will be about 160 basis points. Based on various optimization levers, we expect to recover some of it in Q3.

Moderator: Thank you. The next question is from the line of Ashish Chopra from Motilal Oswal Securities. Please go ahead.

Ashish Chopra: Ganesh, would it be possible for you to share the growth in the Direct Core business if you were to segregate out the impact from this one account?

Ganesh Ayyar: If I segregate this one account, on annualized basis we are growing at the rate of almost 15% to 16% and if I look at just this quarter sequential basis, our Direct Core would have grown closer to 2.5% and there about if this account had not happened.

Ashish Chopra: Just wanted to know the progress and the status of the offshoring initiative that you had set on in Digital Risk and when can we actually expect the revenues to go from offshore as well, you have a team now as I understand?

Ganesh Ayyar: Yes, we already have a team and we are servicing a couple of clients. The good news is we have received license from 23 states so far for offshoring, which is clearly a differentiator because nobody else has license approval from so many states and it is very important to do licensed services. Going forward, we are building the pipeline. It is too rash of me to say that in Q3 we will see growth, but I do see prospects starting from Q4 when we will start seeing good upward trajectory in offshoring services in Digital Risk space.

Ashish Chopra: Would this all be in the incremental business or do you also see some of the existing work which has been carried out in the U.S. also potentially coming here and hence maybe impacting profitability positively but revenues for the worse?

Ganesh Ayyar: Let me give you the lay of the land before I directly answer that question. When most of the customers outsource this kind of origination processing to Digital Risk, they do not typically give 100% of that work, they will give you certain percentage of work, and depending on our track record they give you increase in the transaction volume or "Number Of Files Per Day." Now, what we are planning to do is to see whether the customer will accept a proposal where increased number of files load can be spread between onsite and offshore. To that extent it would be a positive move for all the employees both in the US and here, that is on existing clients. In new clients depending on what service it is and the propensity of the client, we are introducing offshore as an added feature or as an alternative into a proposal. We will see offshore being taken up by not just new clients, but also by existing clients and more so based on the expansion of our business with existing clients.

Moderator: Thank you. The next question is from the line of Raunak Onkar from PPFAS Mutual Fund. Please go ahead.

Raunak Onkar: I had a question regarding the operating metrics. Are we seeing a trend in reducing time and material and increasing fixed price? Could you give a context to this trend in context to the pricing in the market that you are seeing right now?

Ganesh Ayyar: The objective is to have a good mix of fixed price and time and material because it depends on what kind of benefit it brings to the customer, there is obviously some benefits for the service provider when you move to fixed price over time and material but it is also a double edged sword. So I cannot conclude with saying that one is clearly better than the other. When I look ahead it depends on where you are winning, what service line and which customer because there are cultural nuances with customers, some of the customers prefer it to be completely time and material and they do not like fixed price, some customers prefer fixed price. By answering it on a generic basis I may not do justice to your question and complexity of the question, but our desire is to shift more and more towards fixed price and less and less towards time and material. At the same time I do believe that there is a market move in new generation which may not lend itself completely to fixed price.

Raunak Onkar: With the new promoters coming in, is there a change in the company incentive structure for how you look at sales and profitability going ahead?

Ganesh Ayyar: No, we have not changed any of our sales incentives scheme.

Moderator: Thank you. The next question is from the line of Gaurav Rateria from Morgan Stanley. Please go ahead.

Gaurav Rateria: One question around the HP channel. Do you think the incremental growth in HP will require you to make certain investments? Will there be formal sales process which you probably were not following earlier in pursuing HP business?

Ganesh Ayyar: I will answer it in two parts -- first part is that for moderate growth I think we are completely prepared and you would not see any cost structure shift. If we see that the moderate growth can be accelerated to market growth or significantly above market growth, and as a result to realize it, if we have to make an investment into go-to-market side, we will not hesitate to do it because the business with HP as our largest client is a very desirable business and we want to earn that business. At this stage I would not reach a conclusion that I have to invest in sales and marketing or go-to-market, at this stage both from process and dollar perspective what we are investing I think it is sufficient for moderate growth.

Gaurav Rateria: Second Question on Digital Risk. Where do you think the current margins are and can they come closer to the company average over a period of time as offshoring initiatives scale up?

Ganesh Ayyar: I do not see that happening in the next two quarters for sure, over a period of time if you take 4 to 6 quarter view it will start coming closer, but I do not see that rushing very close to the company average. That would be far from reality, I certainly believe that we are already on an upward trajectory of margins and offshoring would definitely help but I would not say that it is going to dramatically improve over the next two quarters.

Gaurav Rateria: Would it be possible to share where the margins currently are for Digital Risk in a range?

V Suryanarayanan: It is now at about high single digit on EBIT.

Gaurav Rateria: Do you think your target range of margins of 14% to 16% can move up or it has scope to go up as all the initiatives around better growth in Direct Core and new-gen work, which is coming possibly at higher margins and Digital Risk higher offshoring, all those initiatives kind of play out?

Ganesh Ayyar: That is our objective: to push it higher than the range which I have disclosed. One of the things Surya and I have been doing is we are guiding the band on a 6-month basis rather than every quarter because that gives us greater time and also it gives you greater time to choose your investments if I may. Let me divide your question into two parts; let me answer it for the second half and then beyond. Second half has the headwind of salary increases of 160 basis points which will have its full impact in Q3 results. We believe that we have a clear and executable plan which will help us to recoup a portion of the cost increase through productivity initiatives that we have. They are not one-off initiatives, they are sustained initiatives which we have in place. The fear that 160 basis points would be lost and we will fall below 14% to 16% is unnecessary because we do have plans where we will be able to recover portion of it through the activity which we have already started carrying out. Moving beyond second half, we do have plans and aspirations to take it further up. I would not claim victory and announce it today but that is our goal. At the same time we are extremely committed to grow our revenue which is of greater importance in our mind faster than the market especially in new generation area. In Direct Core business, we are supremely confident that we will grow faster than the market in revenue terms and the work is in progress in Digital Risk. The good news I have already shared on HP.

Gaurav Rateria: You talked about market share gains in one of the accounts where you face some issue with respect to spends. This market share gain is coming from the global vendors, the Indian vendors. Any color around that will be helpful and what makes you confident that the worst is behind in that client, any qualitative color on the pipeline or any work which is already in progress?

Ganesh Ayyar: We know the numbers in Q2, we have had many years of relationship with this client, we are a strategic partner in the service provisioning to this client, and we are committed to this client being successful thereby we becoming successful. How do we know that wallet share wise we have gained is because we are in the field we know what is happening in the account. It gives me confidence that going forward we will start seeing stability and growth because they have plans and the partners who provide high quality service and are in resonance with their initiative would have greater ability to win. We have a reasonable pipeline in this account. So to that extent I am confident. It is not something which will permanently damage our business prospects is what I would like to kind of conclude.

Moderator: Thank you. The next question is from the line of Rahul Jain from Systematix Shares. Please go ahead.

Rahul Jain: My question is regarding this TCV which we have been announcing. So we did growth of around 14% on this number for FY'16, but if I see the first half number and if I do a trailing 12-month kind of a math, it looks like around 5-6% growth. So just trying to understand how we see the progression moving from this average $75 million to $82 million on annual basis going beyond $100 million a quarter kind of a thing or you think the current level itself is enough to sustain the momentum which we are anticipating?

Ganesh Ayyar: $83 million is the total contract value wins that we announced in Q2, and if I split the business into three buckets within the Direct International space which is our Direct Core, roughly 75% of revenue and Digital Risk which is about 21% of it and the rest is PPG. Our commitment to grow Direct Core faster than the market can be sufficiently fueled by the TCV wins that we are having. Our Digital Risk prospects of winning some of the larger deals and taking the run rate up is what we have to do, the pipeline is good. Do not read too much into first half versus first half TCV comparison of 6% because seasonality and the type of deal, customers, very hard to judge year-on-year comparison because many variables creep in over a period of 1-year. All I would say is that we are very confident that our TCV addition this year in proportionate terms would be more than what it was last year.

Rahul Jain: What is the contribution of Digital Risk in this total TCV and any major concrete thoughts on why you see a better time for this business given the past volatility if you could share?

Ganesh Ayyar: I will get Surya to comment. This quarter out of $83 million roughly about say 19% is coming from Digital Risk.

V Suryanarayanan: In TCV wins for the last four quarters, it is around 15% to 17% contribution from Digital Risk towards the TCV wins.

Rahul Jain: This is towards the lower end of our quarterly business that we have done except for one quarter in Q2'15 when it was down pretty sharply. Otherwise also, this number has reached moreover towards the lower end of our quarterly run rate for Digital Risk, but still we are confident on this?

Ganesh Ayyar: No, if you look at last year, in total we did $303 million total contract value and if Digital Risk was in the range of 15% of that amount and this quarter also they are in the similar range, in fact they are higher at 18%. In Digital Risk I am seeing a good traction in the market, I see very good pipeline and that gives me confidence rather than just the current set of numbers. But we have work to do because we have to convert that pipeline into wins and that would lead us to greater growth in Digital Risk. At this point of time, I am seeing that we are keeping to our commitment of the base revenue in the range of $28 million to $30 million and project revenue to anything depending on how many projects we win.

Rahul Jain: Of the current business, you are saying $28 million to $30 million is on a regular business basis and 15%, 17% of the new TCV addition would be creating a base incremental on this $28 million to $30 million run rate?

Ganesh Ayyar: Disassociate the TCV with this. I would say $28 million to $30 million is almost like annuity predictable business on a quarterly basis in Digital Risk and then we have Project business which can have a very short sales cycle of as low as two weeks and that comes into the pipeline, you convert and you win and that happens on fairly regular basis. The only thing is you do not have a line of sight for that business far ahead of time. So what we have worked on is to continuously increase the share of annuity business in our overall stack of Digital Risk revenue and today it is in the range of $28 million to $30 million per quarter, which is the good news. TCV also comes towards annuity and some of it can come towards project.

Rahul Jain: Is it that we are better positioned in the space or even the Digital Risk space itself looks attractive to you?

Ganesh Ayyar: Digital Risk is in a space which currently is focused on US residential mortgage market, it has direct correlation to number of mortgage transactions, we are beginning to see stability and marginal growth in mortgage transactions, which are given to us… I am not speaking for the market, we are seeing some good pipeline, some marquee clients in our pipeline that is giving me confidence. Also the execution track record that we have built over the last 6-weeks is helping me to generate that confidence.

Moderator: Thank you. The next question is from the line of Deepesh Mehta of SBI CAP Securities. Please go ahead.

Deepesh Mehta: I have 2-3-questions. First is: earlier we used to have a billing rate card in rupee for HP business. With the new MSA is there any change in terms of how we bill for HP business? Second question is about Digital Risk. Earlier, we suggested we intend to expand our offering in terms of what Digital Risk earlier used to offer. If you can provide some color in the last few quarters how we expanded offering and what kind of traction we have witnessed in Digital Risk business? Third question is can you help us understand how we look CAPEX for us in medium term kind of thing?

V Suryanarayanan: CAPEX will be a normal spend of around US $10-15 million p.a., there will be nothing substantial over the year.

Deepesh Mehta: So Surya can we expect the depreciation run rate is likely to continue or we expect any kind of change?

V Suryanarayanan: It could be slightly higher because some of the assets are already fully depreciated, but it will not be substantially higher from the current trend. The point on the HP rate card, as per the new MSA, it has been converted to dollars. Now we have the billing in dollars with respect to whatever was in rupee earlier.

Deepesh Mehta: Full HP business would be on dollar rate card?

V Suryanarayanan: Yes, dollar or in the respective currencies if the services are rendered in the respective countries onsite, but the offshore rate card is in dollars.

Deepesh Mehta: Any implied differences or it would be largely same as rupee card?

V Suryanarayanan: The conversion is done on the same rate card.

Ganesh Ayyar: Let me move to Digital Risk; it is very hard to communicate this in an answer as to what have we done in offerings. Earlier there was a question which was raised about offshoring. Even the offshoring in some ways brings tremendous value proposition to our client. I would not go into details because lot more has been done. I will kind of take a rain check on that question and do it at a different time, but I must tell you that the work that has been done is resulting in a very good pipeline for Digital Risk.

Deepesh Mehta: So in simple words, you expect the base business, what is the current run rate -- may expand once all the offering take shape. So we get more and more stability with higher run rate?

Ganesh Ayyar: Spot on.

Deepesh Mehta: We have seen significant improvement in our DSO. Can you provide some color whether it is sustainable or there is some kind of one-off?

V Suryanarayanan: I think the DSO of around 70-days would be sustainable. Yes, there were additional efforts and we got better collections in this quarter, but around 70-days would be the DSO based on the credit period that we have with various clients.

Moderator: Thank you. The next question is from the line of Avinash Sharma from Dalal & Broacha. Please go ahead.

Avinash Sharma: Just wanted some color on our Direct Core business where our margins are obviously above the company average, but is there scope for further improvement in margins in the medium term? If yes, then where do we see that coming from?

Ganesh Ayyar: In Direct Core we are making a conscious effort to double down around margin accretive businesses that we have, be it the region, the account or service line. It is a conscious effort and we are committed to looking at margins and continuing to improve margins in Direct Core. What is even more important is we are focused on growing faster than the market but profitably… let me put it that way.

Avinash Sharma: So actually just look at it on a consolidated view for the next few years, if we are looking at the margin improvement, more of the effort would be based on the margins in the Digital Risk and HP business. Would that be correct to assess it that way?

V Suryanarayanan: Only with respect to Digital Risk. HP is in line or better than the company average. As you know our sales spend in HP channel is much lower than the direct channel

Ganesh Ayyar: Yes, thanks for clarifying that Surya that is an important point. HP business is not margin-dilutive to Mphasis. Digital Risk and couple of product businesses is where we have margin dilutive business, we have clear focus and we are committed to improving margin in those areas.

Avinash Sharma: In Digital Risk, in geographical spread, where is the business concentrated in terms of onsite-offshore, you mentioned offshore had just begun, and so where our business is currently -- is it predominantly in USA?

V Suryanarayanan: It is addressing the US market, so the clients are all based out of US, and it is part of their work which we are starting offshore also.

Avinash Sharma: Offshore process began how many quarters back?

V Suryanarayanan: It is just a couple of quarters, we are in the buildup mode and we got a couple of clients. As Ganesh mentioned earlier, it is not necessarily the full work gets done offshore, it is a split between onsite and offshore.

Moderator: Thank you. The next question is from the line of Ruchi Burde from Emkay Global. Please go ahead.

Ruchi Burde: The notes to account mention regarding recognition of revenue to the tune of Rs.235 million pertaining to the previous quarter. Could you give more color regarding this item?

V. Suryanarayanan: The note is in relation to the revenue sharing between the company and its subsidiary. It has no impact on the overall profitability of the company.

Ruchi Burde: Would it be a fair understanding that this was a one-off and now that the agreement has been revised, such a thing may not occur?

V. Suryanarayanan: Yes, you are right, your assumption is right.

Ruchi Burde: Secondly, if you could clarify regarding the exceptional charge which we have provided during this quarter. Could you help us understand how change of the ownership led to accelerated vesting of ESOP?

V. Suryanarayanan: Yes, we had certain RSU agreements and as per the policy, in case there was a change in control, it would vest and that is the result of this one-time exception.

Moderator: Thank you. The next question is from the line of Raunak Onkar from PPFAS Mutual Fund.

Raunak Onkar: I just hope you could indulge me in a slightly broader question; you spoke about cost optimization. Could you just give your observations on how the pricing is moving in the industry and what is working and what is not working?

Ganesh Ayyar: The pricing pressure has always existed even during the times when Digital was not the word and other words were being used. Pricing pressure continues. The trend which we are seeing clearly is that certain traditional businesses are being forced to change because those businesses in themselves will start vanishing… I am using a strong word, it may not happen in that way, but there is tremendous focus where we are seeing tremendous move towards Cloud, we are seeing tremendous move towards Autonomics, DevOps is the big thing, Robotic Process Automation in the space of BPO. These are the trends which we are noticing. What is most important is to use these trends, but mix it with the domain knowledge one has and take a value proposition to your client which is what we have been doing which is why we are seeing traction in our new generation wins.

Moderator: Thank you. The next question is from the line of Rahul Jain of Systematix Shares. Please go ahead.

Rahul Jain: The client where you saw this current quarter impact, is this cost of optimization largely from some project they have been shelving or is it more from pricing perspective?

Ganesh Ayyar: First of all, it was across the board, so it was not project-specific. It also involved some impact on pricing for that client.

Rahul Jain: So when we have increased our scope or eventual wallet, basically we have gained more volume on lower new price on the total basis?

Ganesh Ayyar: Do not take pricing literally because if you derive pricing it is not as if it is a new rate card. When I say pricing, there are other mechanisms through which you help the client to reduce the cost, which does reduce the overall pricing. That is what has happened. This does not cripple our profitability in the account, to answer it differently.

Rahul Jain: On the earlier point where you said that all HP business is now converted into their respective geographic currency, does that mean it opens up the opportunity that in case of any INR depreciation it would lead to margin expansion?

Ganesh Ayyar: It would be the same as any other customer.

Rahul Jain: When we said that HP is not a dilutive business in general, is it not dilutive because the rate cards are at par historically or is it that it is more remunerative business in general?

Ganesh Ayyar: The comment is not on the rate card when I say it is not dilutive. It has never been dilutive to our margin profile ever. They are a good customer both from the professionalism perspective and from profitability perspective as far as we are concerned.

Moderator: Thank you. Next question is from the line of Deepesh Mehta from SBICAP Securities. Please go ahead.

Deepesh Mehta: Can you provide our currency exposure?

V Suryanarayanan: The dollar is around 74% and pound is around 5%, these are the major currencies where we have the exposure.

Moderator: Sir, this was the last question for today.

Ganesh Ayyar: Thank you so much for joining the call and always being engaged because this helps us to focus in the right areas. I look forward to continuing the journey and connecting with you sometime soon. Thank you so much. If we do not catch up earlier, want to Wish All Of You Merry Christmas and Happy New year ahead and look forward to staying connected. Bye for now.

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