

SIS Limited

Q2 FY23 Earnings Conference Call Transcript November 3, 2022

Moderator:

Good day, ladies, and gentlemen, and welcome to the SIS Limited Q2 FY '23 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 zero '0' your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Bharat Bakhshi, President M&A, Investor Relations and Ventures from SIS Limited. Thank you and over to you, Mr. Bharat Bakhshi.

Bharat Bakhshi:

Thank you very much. Good afternoon, everyone, and welcome to our Q2 FY23 earnings call. Along with me, I have our Group Managing Director, Rituraj Sinha and our Group CFO, Devesh Desai. I hope everyone has had a chance to look at our results and the earnings note, which has been updated on the stock exchanges and also on the company's website.

So, for this quarter, we are happy to report that the India business is showing extremely strong growth in revenue and improving margins. This quarter, we recorded our highest ever revenue of Rs. 2,678 crore. The India security business grew 8.8% quarter-on-quarter and 21.7% year-on-year.

The Facility Management business grew 10.1% quarter-on-quarter and 40.1% year-on-year. In fact, this is the second quarter in a row that the Facility Management business has grown at almost 40% year-on-year and is now run rating Rs. 500 crore a quarter.

On the margin front, as we had indicated earlier, India margins are on an upwards trajectory. In India Securities, margins, which had moved from around 3.8% to 4% in the previous quarter, have now moved to 4.4% this quarter, which we find very encouraging.

On the International side, as we had indicated earlier, margins will now be returning to pre-COVID levels with higher-margin COVID contracts coming to an end. And this quarter, margins were further

depressed due to an unusually high minimum wage increase of 4.6% in Australia, which is quite unprecedented. However, this impact is a temporary phenomenon. The wage increase gets passed on to clients for our contracts, but there is a timing lag. So, we expect this to be compensated in the next two quarters. In fact, this large wage hike is actually better for us as it will help boost absolute revenues and earnings as it gets passed out to the client. So, on an overall basis, we are very happy with the business momentum.

We will now turn it back over for questions and answers.

Moderator: Thank you, very much. We will now begin the question-and-answer session. The first question is from the line of Aditya Khandelwal from SILTS. Please go ahead.

Aditya Khandelwal: Sir, we have seen good growth in Facility Management business, and it is back to more than a pre-COVID level, but the margins still seem to be lower. So, any particular reason why these margins are lower?

Rituraj Sinha: I think the most notable fact that I want to bring to your attention is that our Facility Management business, we had called it in the midst of COVID that this business will be the greatest beneficiary from the fact that COVID has brought greater impetus on hygiene and sanitation. And that clearly seems to be playing out, for the last two quarters the business has maintained almost 40% growth over same quarter last year. And now the business is run rating Rs. 500 crore per quarter. Mind you, this business was barely Rs. 300 crore in the pre-COVID time. So it's almost doubled, close to doubled in this period.

Your concerns around margins are very well understood. Margins (inaudible) seem to hover around 4.5%. A large part of that is because of onboarding of a large number of contracts, new contracts. And there are start-up costs of those contracts, but rest assured, the Facility Management business' gross margin is very much intact. We are operating at ballpark 12% range gross margin. And we believe that we will be back towards the pre-COVID level of 6% EBITDA within one or two quarters.

Aditya Khandelwal: And sir, I read an article regarding Government has allowed private security operators to man the airports as well. So we are doing this business in Australia. So do you think there is an opportunity for us in India as well?

Rituraj Sinha: Yes. The aviation sector opening up for private security is a mega opportunity for the entire sector. I think this opportunity will evolve over the coming years. As of right now, the standards are yet to be defined and most of the airports have gone for the lowest cost agencies to undertake some basic work like boarding pass

checking, etc. But as the sector opens-up more like in Australia, like in US and other parts of the world, there will be more stringent qualifying criteria for who can be the private security provider at an airport facility. I think in the long term, this augers very well for us. We have the necessary expertise and the credentials to run aviation security, complex staff, including people and baggage frisking. We are waiting for two things: No. 1, the regulations to be clarified and additional roles beyond just boarding pass checking to be handed over to private securities. At which point in time, we will enter the aviation security market at the right price points.

Aditya Khandelwal: And sir, we are providing Security, Facility Management and Cash Logistics services in India. So just wanted to understand, do you think there are cross-sell opportunities to clients where we are supplying only one service? So, do you have any data points regarding this, or we are tracking this?

Rituraj Sinha: Well, we've had this question in the past as well. If you reach out to the Investor Relations team, they will be happy to share the percentage of Security clients who use Facility Management services and the number of Facility Management clients who use security services from us. That data is available and please reach out directly to the IR team.

Moderator: Thank you. We have the next question from the line of Vidit Shah from IIFL Securities. Please go ahead.

Vidit Shah: My first question was on this acquisition of SDS. Could you just elaborate on the sort of market opportunity that is there in Australia and what sort of market share does SDS command? And just broadly what the EBITDA margins and profitability is for this Company?

Rituraj Sinha: SDS is operating on a 5% EBITDA margin line, as of right now. But as we integrate that with our strategic medical services and synergize the cost, I think the EBITDA margin line will move up further. And this is a strategic acquisition for us because apart from plain vanilla security services, this is a higher-end service with paramedics and other such health and safety-related services, which are in high demand now in evolved markets like Australia. And combined with our organically built strategic medical business, plus SDS, we are roughly \$65 million per annum in this segment. And post synergies, we think the margins will also move up. So, this is quite an attractive deal for us, especially because we've acquired this asset at marginally below 5x EV/EBITDA.

Vidit Shah: And it's profitable as well, right, SDS?

Rituraj Sinha: Yes, it is 5% EBITDA.

Vidit Shah: On the PAT level, I asked?

Rituraj Sinha: Yes.

Vidit Shah: And in the opening remarks, I think you have mentioned that the wage hike will help boost revenues and EBITDA. I understand how it'll help boost revenues, but could you elaborate on how would wage hike in Australia will help boost our profitability in the long run?

Rituraj Sinha: So what we said is that 4.6% is the highest minimum wage hike in Australia for the past 10 years. If this entire wage hike is passed through, it will translate to roughly 4% to 5% revenue increase on an annualized basis. As regards to EBITDA impact, this will obviously increase the absolute value of the EBITDA. Further in contracts, which were lower margins and operationally more complex, we are pushing an incremental 1% to 2% price increase on top of the 4.6%. And a reasonable chunk of clients so far seem to be supporting the idea. Therefore, we are very bullish that even as Australia has reported its worst quarterly numbers in a decade at least, this development of 4.6% wage hike and incremental price hike on select customers, which are relatively lower margins will more than adequately cover up for the revenue gap, which exit of COVID-related contracts have resulted.

I would like to also share with you that in this quarter, we had new order wins worth \$25 million annualized in Australia on top of the price hikes. So I guess, even as the Australian result or the International business results sort of clouds over the good performance in India in the quarter, this is a transitioning phase. So you will see better numbers hopefully.

Vidit Shah: And in Australia, are most contracts, annual contracts, where the revision happens at the expiry of the contracts? So what is the average duration of contracts?

Rituraj Sinha: So like I have said this in the past, in security industry globally in India, Australia, Singapore, New Zealand, contracts are generally signed for one year to three years, but most of these contracts roll over for longer periods. For example, in Australia, more than half our revenues, more than half our contracts have been continuing for 10 years or more. So these are all rollover contracts. It's a very sticky business. That is the reason why in this annuity business model, you have a very predictable revenue growth. I mean, for example, if you look at the last five years of the 20 quarters as SIS listed, we have maintained a 15.1% annual CAGR. Over the last 20 quarters of 15.1% annualized CAGR, despite COVID and all the things that have happened in this duration. So the stickiness of contracts is not the issue in this industry.

Vidit Shah: Understood. And do we still maintain our Cash OCF to EBITDA target of 50% going forward with this level of growth being achievable like I mean, if, let's say, India business grows at around

25%, 30%, would we be able to achieve the 50% target that we set up?

Rituraj Sinha:

So look from the day we have listed, we have indicated to the stock market that SIS benchmarks itself against three metrics: 20% growth, 20% return on equity and 50% OCF to EBITDA. This is not to say that this is how you should model our forecasted numbers. This is the metrics on which the compensation structures of my CXO's are set up and Profit Center Head is set up. So, what I want to explain to you is that we are hoping to go back to the high teens or 20% range growth this year. And mind you, that is not coming off a low base in FY '21 and FY '22, both COVID years, SIS has maintained 7% growth in the first year, 10% growth in the second year, despite zero acquisitions and with little to none minimum wage increase. So, basis absolute volume growth, we have delivered 7% to 10% growth in FY '21 and FY '22. Despite Australia and International business going to look slower this year in FY '23 because of the fact that the COVID, 45 million contracts are exiting the system despite that, in the Indian side, you will see close to 20% growth. Return ratio-wise, we have maintained 19% odd return on equity throughout the five years. I mean, again, a statistic I want to share with you. In the five years since SIS is listed, we have maintained an average return on equity of 19.7%. So, we see ourselves, despite good years of growth and COVID time years, the return ratios are pretty much stacked up, like we have indicated. As far as your exact question about OCF to EBITDA, during COVID years, what we witnessed was exponential OCF because growth was slow. Now as growth increases, working capital requirements in the business will increase, OCF to EBITDA will come down, but we still track ourselves against 50% OCF to EBITDA as a metric.

Vidit Shah:

Just one last question from me is on the annual report, there's like this Rs. 20 crore computer software and development asset that is being there. Could you just highlight on what sort of computer software is being developed and the capabilities that come with it?

Devesh Desai:

Yes. So this is basically largely centered around two core platforms. One is to redevelop and reorient our core business software of invoicing payroll contract management, make it scalable, cover all businesses in the group and create one uniform system across the India businesses at least. That's one part of the core platform. The second part of the core platform is to introduce and implement a common financial accounting platform across the group. We have just completed that deployment across the group in India, Australia, Singapore and New Zealand in the last quarter, that is Oracle Fusion. And the next step is to live the two platforms, integrate them and complete the deployment in India for the core business platform.

Apart from that, there are various enhancements going on to the different existing systems like the SalesMaxx, the iOPS, the mobile and antenna and different applications also, which have been put in to capture daily attendance, facial attendance of our guards, manpower through the MySIS App. So there's a whole host of technology and tech-enabled initiatives going on to streamline our operations, make ourselves more efficient and provide more granular detail into the business to enable us to take better decisions going forward.

Vidit Shah: So these are largely to aid decision-making? Or will there be any some substantial benefits to our fixed costs in the future?

Devesh Desai: So we will get more visibility into our cost structure, our contract structure, our site profit structure, we'll get more visibility into that. It has enabled us to take the right decisions and improve our margins and profitability going forward and also make up is more efficient in our operation.

Moderator: We have the next question from the line of Mukul Garg from Motilal Oswal Financial Services. Please go ahead.

Mukul Garg: First of all, good performance in the India business, both on Security as well as Facility Management and especially seeing that finally, the minimum wages are moving up to something which was pending for a while. Just two questions regarding that. First, while you guys are saying that you will take about two quarters for the impact of minimum wage increase in Australia to pass through the contracts. How should we think about the impact in India as this minimum wages kind of start getting into your costs as well as your contracts, will these duration be slightly longer as contracts for some of our renewal or how should we think about the timeline from a pass-through perspective? And second, again, this is something which puts a bit of an incremental pressure on the formal side of the cost for enterprises. So do you think in the near term, this can have some adverse impact of the utilization of formal versus informal services at your clients?

Rituraj Sinha: So on the India minimum wage issue, I think you must first understand that between 2010 and 2020 pre-COVID, the average minimum wage increase in this country was ballpark 10%, 11%. And this happens State level and Central level combined. During COVID years, this went down to sub 3%, with high inflation and pressure on the Governments, both State and Central, it is highly likely that the Governments will come up with significant minimum wage changes. I can sight some examples, large States like Karnataka had gone for 23% minimum wage increase in one shot. That's a 23% rise in minimum wage to compensate. States like Bihar, which are traditionally very low minimum wage area where they don't increase minimum wage generally, they have gone for 17% minimum wage hike one shot. Even smaller States like Sikkim,

it's not a big market for us, but even smaller States, just to illustrate my point, Sikkim has gone for a 67% minimum wage hike one shot. Now these are just some States that have moved. We believe, large portion of the States will have to take similar action. When it will happen, cannot be forecasted, whether it will be 15% or 5% or 45%, again it's not for me to predict. What I can see clearly is that minimum wage revision is due, there will be catch-up minimum wage revision across the States. When that happens, in the immediate term, there will be catch-up impact on us, numbers will take a hit for one to two quarters, but the long-term implications will be extremely positive because higher minimum wages, means industry consolidation, when people have to pay higher prices, they tend to move towards larger and more compliant operators because they don't want to pay a higher minimum wage to the local agency, that makes no sense. So that is a trigger for formalization. It's a trigger for attracting better talent and retaining talent in the industry. So, more people join the industry, more people stay back in the industry. And number three, it has an immediate yield of higher margins on an absolute basis, and it also allows us to squeeze out incremental price changes from low-margin contracts. So macro level, it's great news, but whenever this happens, it will upset the numbers for that one quarter.

Mukul Garg:

And in terms of any past experience of shift for like maybe a near term move towards the informal economy from the formal sector because the people generally intend to push back on paying higher prices for availing services. Is that something which can be a slight near-term hit, or I think those things are unlikely to happen given the new compliance regulations?

Rituraj Sinha:

It's quite unlikely. It can happen in remote certain situations, but very few.

Moderator:

Thank you. We have the next question from the line of Shalabh Agarwal from Snowball Capital. Please go ahead.

Shalabh Agarwal:

Sir the first question is on the India side. Our annual report mentioned that we had won couple of contracts, both in VProtect as well as Tech SIS for certain PSUs. So wanted to understand whether these will be all tender-based businesses in which case would profitability be lower given these PSUs would have selected the lowest bid? That's the first question.

Rituraj Sinha:

So VProtect does a service called alarm monitoring and response. It is basically a service where you provide security with negligible manpower involvement. The contracts we've taken on are both tender-based contracts from the likes of State Bank of India, Canara Bank, etc. But a large share of contracts are also direct contracts, which are not particularly tender-based. They are negotiated contracts. Then add to that, there is also direct sales, which is into homes and small businesses that want to replace

guards with a more sophisticated electronic security solution. On a combined basis, if you look at even State Bank of India, which is a tender-based contract, it generates an EBITDA of double digits. And the contracts which are non-tender-based generally ballpark in mid-teens to high teens in terms of EBITDA.

Moderator: Sorry to interrupt, your voice broken. Can you please repeat your last line?

Rituraj Sinha: So I was saying that even State Bank of India type tender contracts are double-digit EBITDA contracts. And the negotiated contracts are ballpark in mid-teens to high teens in terms of EBITDA. So overall, because this is not a manpower-based service and there are great economies of scale because the same monitoring center actually services all the lines, and we've already made those initial investments. This is a higher-margin business. I must share with you that by the end of this year, this business will be run rating close to Rs. 75 crore, Rs. 80 crore on an annualized basis. And we believe that as the share of such type of services goes up in our overall mix of security solutions in India, this will also help with margin uptick just like ManTech Solutions that Tech SIS provides basically equipment rental business, where we provide electronic security as a service, that plus alarm-monitoring both are margin drivers for us in the long term. And it's great that both businesses are developing well.

Shalabh Agarwal: How do these businesses fare in Australia, given that's a developed nation and one would expect a higher demand in that part of the geography, the ManTech, which is what Tech SIS does and what VProtect does?

Devesh Desai: So in Australia, of course, they are, again, specialized service providers who provide this kind of business and service in our Southern Cross Protection business. We have a similar kind of alarm monitoring and response services. We have some level of electronic security business over there. And that is why the Southern Cross Protection business delivers a higher margin than the traditional guarding business.

Shalabh Agarwal: How much would they contribute to our International sales these ManTech kind of solutions that we are doing?

Devesh Desai: That would be approximately maybe around 8% to 10%.

Shalabh Agarwal: And the second question is on International. Are you also exploring having FM in International markets where you are already present and you know we have expertise in that area? Is that something that you are exploring or is that possible?

Devesh Desai: So in the International business, we will be focusing on the core Security business and Security-Related services. We do not intend to get into the FM kind of business in our International segment.

Shalabh Agarwal: Any reason why is that business different over there? Or is it done differently and doesn't make sense for us? Or any particular points that you would like to highlight?

Devesh Desai: So we want to focus on the Security business and the Security-Related services in International segment. That's the strategy we've adopted and we'll focus on this only over there.

Shalabh Agarwal: And sir, lastly, on the International side, I think last quarter also, Rituraj mentioned that Henderson acquisition hasn't really gone that well. Given Henderson was one of our biggest and most expensive acquisition in terms of the absolute amounts probably that we would have spent. Just wanted to understand what, where we went wrong and we always have this structured approach to our, whatever we pay to the seller, so where you went wrong and why, which needed to face this kind of a loss in Henderson?

Rituraj Sinha: So I don't think that I'd say that Henderson is money down the chute and it's a deal that's gone wrong. I won't say that as yet. Let me remind you of the facts. So we acquired a business in Singapore, just barely half a year before COVID struck. We were in the process of changing management and putting in place our systems and protocols when COVID started. Now that led to a contraction of demand. It also resulted in several things, which are just beyond our control. Physically, we had no access. Net summary, COVID sort of disrupted our post-acquisition integration plans in a very severe fashion. Net result was that we lost a bunch of contracts. We came down severely on the EBITDA line. But the business is under redevelopment or rebuilding phase.

What you must remember is that the upside of COVID was that we received close to SGD 30 million as grants from the Singapore Government under the Job Keepers Act in order to ensure that nobody loses his job. Out of that 30 million, we have rarely used 3 million, 27 million dollars remains parked in Singapore, which is basically more than adequate to rebuild this business back to where it was. It is just that rebuilding will take time.

So two things I want to call out today. Number one, that Henderson is not down the chute. It's just a business where we got caught in the midst of COVID. Number two, to rebuild Henderson, we have adequate funds parked, which is Henderson money, and Henderson would not be needing to lean on our International or Indian operations in the rebuilding phase. So what Henderson needs is some patience.

Having said that, SIS over the last many years has acquired more than 14 assets, 14 different acquisitions in India and overseas. We've done joint ventures. We don't have a failed case on our hands to date. And sometimes you take good decisions. Sometimes you take decisions that have gone wrong. But what we need to then do is to stand by your decision that is seemingly going wrong and fix it. So we are not abandoning Henderson in any way. We believe it's the right market. It's a good asset. We put in good leaders. Now it will take some time to turn this around.

Shalabh Agarwal: How is Henderson trending currently in terms of top line and EBITDA for this year or where you are targeting it for this year?

Devesh Desai: So at this point, Henderson is run rating at a revenue of almost 30 million. And we believe that on an EBITDA basis in Q3 or Q4, we should reach the EBITDA breakeven there. So we had all our SG&A costs over there. We have deliberately not reduced our SG&A costs. We haven't deliberately reduced our people because we are invested in them. And they will be required when we are doing the rebuilding phase. So at this point, there is a conscious decision we have taken to keep that investment in the business.

Moderator: Thank you. As there are no further questions from the participants, I would now like to hand the conference over to Mr. Rituraj Sinha for closing comments.

Rituraj Sinha: Thank you very much. I think it's been a pleasure to talk to all of you today. I know that the results for this quarter are clouded by the situation in International business. But I would encourage all of you to look at the business in India and the significant development on the Indian side. The Security business in India has reported a 9% quarter-on-quarter growth and our Facility Management business, has yet again reported 10% quarter-on-quarter growth.

And if you look at the margins on the Indian Security side, there were 3.8%, which went up to 4% last quarter, which has gone up to 4.5% this quarter. So we are tracking well on the Security margin recovery as well. If you look at our Cash Logistics business, even they have done fairly well reporting, not just group, but also a record 17% EBITDA in this quarter. Like I explained, the International business has more to win as the minimum wage catch up, etc., plays out by Q4. So I guess that's my summary take on the results.

And I also want to underline the fact, before I conclude, that apart from the organic development, our M&A engine is back in action. Post-COVID, we have acquired SDS, albeit a small deal, and we hope to get the second engine of our growth also up, even as SIS group will remain predominantly organic, strategic acquisitions that we have been making pre-COVID that trend will continue, and we hope that we bring it back on reins for FY '24 transactions

mainly. But we are in the process of developing some interesting discussions.

So thank you very much once again. I wish you all the best. Thank you.

Moderator:

Thank you. On behalf of SIS Limited, that concludes this conference. Thank you for joining us, and you may now disconnect your lines.

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