

## Teamlease: Well-Managed Staffing Company with Long Growth Runway

Soumil Zaveri of DMZ Partners will present his in-depth investment thesis on Teamlease Services (NSE: TEAMLEASE) at Asian Investing Summit 2018.

### *Thesis summary:*

Teamlease Services (TL) is one of India's largest "people supply chain" companies with an estimated ~5% market share in India's flexible staffing industry. The company provides general staffing solutions which involves matching hiring requirements of customers (companies) with the right human resources (associates). TL currently manages ~177,000 associates for 2,500+ customers at 6,000+ locations across industries in India. The company is able to do this with ~1,600 core employees. TL also offers recruitment, regulatory compliance, payroll and skill enhancement services.

The company was founded in 2002 by two industry veterans, Manish Sabharwal and Ashok Reddy with 40 employees and one client. In Soumil's view, Teamlease could manage a much larger associate employee base while substantially leveraging technology to improve operational efficiencies over the next decade. Soumil does not find it implausible for the flexible staffing business to continue to take market share from informal market participants given the country's continued "formalization". To provide some context on the opportunity set, India's working age population consists of ~60% of its ~1.2 billion people, yet only 10% of the workforce forms a part of the formal economy (although a majority of the informal sector includes agricultural employment).

Additionally, complex labor laws have hampered a faster transition to more formal and permanent employment. In fact, more than 70% market share in the temporary staffing industry is estimated to be in the informal sector. As enforceability of regulations and progressive changes (e.g., GST) gain momentum we expect participants like Teamlease with proficient technology platforms, lean operating models and robust compliance and regulatory frameworks to be large beneficiaries.

Read two recent articles: [A "Big Macro Call" on India](#) and [A New Phase](#).

*The following transcript has been edited for space and clarity.*

My investment idea is an Indian company called Teamlease Services, which we see in many ways as an emerging domestic platform.

Before I get into the details, let me do a quick recap of our idea from 2017, non-banking financial company Capital First, and some of the lessons we learned from the experience. We were optimistic on its prospects for the long haul. However, in January 2018, the company decided to merge with IDFC Bank. In our view, this dramatically shifted the nature of the business model and led us to revisit our original thesis on the company. We subsequently decided to exit the position.

We estimate our personal returns to be upwards of 30% compounded since 2014. Please note these are not audited returns but estimates from personal records. However, we viewed this as a relatively suboptimal outcome. We would have much rather preferred to own the standalone entity for a substantially longer time given the highly positive characteristics the company had inherent in terms of its long-term prospects as a standalone entity. We felt many of these characteristics would find themselves harder to manifest in the larger and more complex business model that would be the merged entity.

This event also led to some introspection, reminding us of the powerful impact of what you may call “special situations.” They can dramatically alter the enthusiasm one may hold about the underlying business.

Although the price rallied briefly after the announcement of the deal, it has been somewhat lackluster. This made us appreciate another nuance, which is that our best idea at any point in time is often unlikely to be the best idea for the year itself. There are two reasons for this. The first is general noise and volatility, and the second is certain special situations where “buy, hold, and forget” may lead to suboptimal outcomes.

Let me elaborate a bit on why a best idea is not necessarily optimal for the year itself, as silly as it might sound. The two key sources of edge we have as long-term capital allocators are time and qualitative arbitrage. This essentially means: A) patience, being substantially more patient than other allocators; and B) qualitative assessments of companies and the people who run them. Both of these factors may take a significantly longer time to play out and manifest themselves than one year.

That said, our predominant focus is on finding what we like to call compounding machines given the ecosystem we operate in and the long runway many companies have ahead of them in this environment.

Although this is not done dogmatically, we are guided by six key criteria when we score underlying investment opportunities.

The first one is understandability. We want to be able to inherently understand the core prospects of a business and what makes it work. The second is competitive advantages, which may be one or two large advantages or sometimes a series of small but highly consequential advantages that add up. Thirdly, we need companies we entrust with our capital to be prudent allocators.

The next three points have a special India focus. First, we need to own businesses which can be substantially larger over a long period of time in terms of earnings power. Given the ecosystem we operate in, we also need our business to have high degrees of embedded resilience to alternative outcomes. Specifically, we examine whether companies and business models we invest in are highly sensitive to particular legislative or regulatory outcomes, and we try to be mindful of those factors. Lastly, but most importantly in this environment, is the quality of people. You can’t have a good deal with a bad person, and we’re mindful of that dynamic given the ecosystem we operate in.

Since we have six factors, we call this approach finding “hexagons.” Ultimately, we want to try buying these at relatively rational prices. We look for the common ground between things we understand and some things we might find appealing. This common ground is usually dominated by companies in the financial and banking space, consumption, and a whole host of other companies we’re slowly adding to our zone of competence.

One common question we hear about investing in India is the sensitivity of the underlying investment theses for our portfolio companies to the overall macro picture or political situations. In the last 20-odd years, we’ve had various types of governments led by different parties with different philosophies and approaches. Each time governments changed, markets reacted violently. We’ve also had some major scams emerge over that period. In the last decade, there was the accounting scandal at high-profile IT company Satyam. More recently, we have seen the issues with the public sector banks and the alleged cronyism in lending. Some single events, like the demonetization in 2017, also led to a disruption in the economy. On an ongoing basis, you have pundits trying to decipher what happens in both Houses of Parliament and how it impacts a whole host of listed entities.

Each time, astute observers of India or allocators in the country had reasons to curtail their optimism

and fine-tune expectations for their investments because of the so-called macro view.

Irrespective of all this noise, about 50-odd companies of the listed universe did consistently well, and we typically aspire to own companies that inherently possess such qualities of embedded resilience. Now, this is not to say our companies can thrive in total chaos. However, we believe the vast majority of our portfolio will do just fine in a variety of alternative outcomes, and these are the type of companies we want to own.

This is possible in India for a couple of reasons. One is the low base effect. marginal changes in the scale of consumption can still have huge effects on companies or industries and sectors. Secondly, all our portfolio companies - irrespective of whether they are classified as mid-caps or large-caps - are still nascent in terms of market share or adoption rates. The largest of them may have 5% or 6% market share in their respective industries, and they often compete with large, inefficient, and sometimes misaligned rivals. In other words, the playing field is simply not level. This gives us confidence our companies can do quite well, even in relatively lackluster environments, because of their ability to take share away from incumbents.

The topic of my presentation, Teamlease Services, is a company closely related to the employment sector in India. I'd certainly like to acknowledge upfront the irony of saying macro doesn't matter so much and then talk about employment generation, particularly with a flexi-staffing company in focus. That said, let me share the nature of employment in India.

People are well-aware of India's demographic dividend, so to speak, and what comes with this young population of more than a billion people. Over 60% of this population is of working age, with workforce itself estimated to be about 450 million to 500 million people. A critical nuance here is only a small fraction of this workforce participates in the so-called "formal" economy. Even if you exclude agriculture, which is an important sector in terms of employment, only about a third of the workforce benefits from some social security coverage. Even that is not completely "formal," perhaps you could call it "semi-formal." The vast majority of the workforce is either self-employed or employed informally with "unregistered" enterprises. In fact, out of the estimated 60 million or so enterprises in the country, only about 1.7 million are formally registered. If you look at recent labor statistics, industries like manufacturing and construction, where relatively small or medium enterprises are larger contributors to output, more than 70% of the employment tends to be informal in nature.

This low level of formalization is attributed to two key factors. One is a generally low level of tax compliance across the country although this is steadily changing because of improved enforceability. Secondly, perhaps less evident to indirect allocators of capital, is that, as a country, we are dealing with outdated and onerous labor laws. As industry veterans often joke, "A company in India can't comply with 100 labor laws without breaking 20." Some of these laws dictate extremely onerous conditions of employment. To appreciate this further, it's interesting to know nine out of 44 central laws related to employment date back to 1947. Besides these central laws, there are hundreds of state laws. You have laws dictating what you must do if you want to hire more than 100 or 300 people. Official enforceability of these laws is quite poor. I believe there is an interesting study on the inverse relationship between the number of laws and their enforceability.

This dynamic leads to an environment where the so-called assessment officers visiting factories and other premises tend to become rent-seekers. In the past, many entrepreneurs reacted to this dynamic by having multiple small factories as opposed to growing larger in one entity, which can cause immense inefficiencies.

While hiring can be quite difficult, firing is extremely difficult because of the regulatory environment. You have legal cases dating back to the 1980s and 1990s still making the rounds in courts, involving,

for example, a factory worker who was fired for sleeping on the job. In general, compliance with labor laws, the ability to hire and fire, is considered a major headache.

In populist moves, many past governments intended to empower low-wage workers by adding more laws. However, this has translated into more laws but less justice.

Teamlease Services is an important participant in India's flexi-staffing industry. People usually think of flexi-staffing globally as perhaps one of the sectors most vulnerable to macro-economic factors and noise. But in India, this dynamic is quite different for a variety of reasons. This is substantially a more sticky business than is typical in developed economies, where these businesses tend to be traditionally more cyclical.

Globally, the flexi-staffing industry usually caters to seasonal variations in demand. However, many non-core requirements in India are almost permanently outsourced rather than building headcount in-house. Search and recruitment costs are high and, spatially, things are quite dispersed. You may have a talent pool of engineers in a state down south, but a client may require 100 engineers of a specific type on the east coast, where finding and recruiting such talent may be more difficult. Additionally, regulatory compliance is quite cumbersome with regard to headcount. This is best handled by someone else, or a company could waste many man-hours for the 100 or 200 employees it seeks to add to headcount.

From the point of view of first-time jobseekers, the flexi-staffing industry has quite a compelling value proposition. One, wages and benefits are provided in line with all statutory requirements. Two, there's always the potential for conversion to permanent headcount.

India is the second largest labor market, yet the penetration of formal flexi-staffing in the country is low. The reason it appears so low is because the majority of this industry, which comprises 0.3% of the workforce, also operates in the shadows. According to some estimates, about 75% of this industry is informal in nature. However, industry executives and different statistics suggest the number may be as high as 90% or 95%. The formal section of this industry comprises 5 or 6 large players, one of them being Teamlease Services.

Another key reason the unorganized sector in this industry did well is because of the traditional regulatory arbitrage it offered. On the one hand, first-time jobseekers have been desperate for work. India needs to find as many as one million jobs per month, and these unorganized players have gotten away with depriving new labor market entrants from statutory benefits that would otherwise accrue to them. On the other hand, these participants pay no service taxes to the government, so they can offer clients their services at lower prices than the organized sector could. This dynamic has allowed the informal sector to proliferate in terms of flexi-staffing.

However, one critical aspect is these entities find it difficult to scale beyond their particular regional footprint and especially beyond a particular scale because they are forced to continually fly below the radar.

There are several structural tectonic shifts in the way the economy is evolving today, and they meaningfully reduce the viability of such informal participants, especially beyond a certain relatively small scale. Anecdotally, this has already started to benefit organized players in the industry. The economy has been continually nudged to increasingly formalize, one example being GST - a single value-added tax which replaced a whole slew of levies and surcharges that were difficult to administer and even more difficult to enforce. In fact, those played a crucial role in bolstering the growth of the erstwhile "informal" economy. However, since the introduction of GST, the number of entities registered to pay these taxes has grown almost 50% in one year. Given the tax liabilities they now

have, companies expect service providers to give them the input tax credits to set off against the services they use or products they buy. Unorganized flexi-staffing agencies are unregistered and are typically unable to pass on these benefits to customers.

In addition, you had one-time shocks like demonetization, which more or less crippled the ability of flexi-staffing informal participants to keep their operations running because they were heavily dependent on cash payments to associates, among other things.

If you go across sectors, in real estate you see things such as the Real Estate Regulatory Authority, which has been brought in to ensure more transparency and accountability in this sector. All in all, what you can see is an improved focus not just on changes or reforms for the sake of it but on better enforceability of newer and more progressive changes.

All put together, we expect the flexi-staffing industry to be one of the major beneficiaries of these transitions.

Teamlease Services is what you could call a people supply chain company. The bulk of its revenues come from general staffing – as high as 95%. This largely involves matching the hiring requirements of the 2,500 companies it has as customers with the right human resources. This means Teamlease maintains and grows a large headcount of associates, about 170,000 or 180,000, and places them at 6,000 locations on behalf of its customers. One way to think of this is as a human resources bank – you pay your associate headcount salaries and earn a markup when you place them at client locations. In many ways, this resembles a platform business.

A small percentage of the revenue comes from what the company calls specialized staffing. This business has a significantly higher-margin profile since the employees hired and placed are more skilled in niche domain applications, for example, telecom or IT. They usually command higher salaries than general staff, which also allows Teamlease to earn a higher spread.

The final piece comes from a host of different HR services the company offers, examples including regulatory compliance and payroll. This is more of a cross-sell opportunity flowing directly to the bottom line, so it is accretive.

Interestingly, it is a price-taker business, with cost and realization largely market-determined. There are only two ways to earn meaningful returns. One is improving the spread between what you pay associates and what you charge clientele. This can be done by continually improving the skill sets of your associate pool, which allows them to have high realization in the marketplace. The second is using technology and processes to have highly streamlined operations because this allows operating leverage to kick in meaningfully as the business scales in terms of headcount.

All put together, the company earns about 2% net margins and just short of 20% ROE. As for sectoral exposure, it's quite well-balanced, with retail and manufacturing being relatively larger contributors. One of the interesting statistics about the company is it has placed more than 1.8 million people in formal jobs since its inception. This hints at the scalability prospect when you consider India's potential jobs problem given the need to put a million people to work each month over the next decade.

The two founders, Manish Sabharwal and Ashok Reddy, are industry veterans and true specialists with regard to labor market dynamics in the country. They play complementary roles at Teamlease. Manish is more focused on advocacy and represents the company at various official forums, playing a key role in pushing for progressive changes and reforms in the labor market. Ashok is more reticent and focused on the operational side of the business, continually looking for ways to leverage technology

better, improve efficiencies, and standardize processes. This has played a critical role in Teamlease being able to go from 10,000 to 50,000 to 100,000 associates and potentially multiply the number over the next decade. Anecdotally, the company sees itself as potentially becoming one of the largest employers in the country. I like what they were quoted as saying in one Fortune article, and I'd like to use it to highlight the interplay between the two founders: "With just Ashok there, Teamlease would have been one-hundredth its current size; and had only Manish been there, there would be no company." This process of pull-and-push between two rational-minded partners is critical for the evolution of the business over time and can help build an exceptional platform.

When it comes to the margin profile, I must point out this is truly a razor-thin margin business. Gross margins at this company have escalated from about 2.5% to about 4% more recently. When we say gross profit here, we mean total revenues less employee costs because the latter are the key expense, the raw materials, so to speak. Core profitability (net of all operational expenses) is about 45% of gross profit. This is a tough business, so technology, operational streamlining, and standardizing processes are much more than catchphrases. They mean something different from what a 40% or 50% gross margin business means when it says it's streamlining operations. Here, the dynamic it can create is far more emphasized.

Associate headcount growth at Teamlease has been roughly 20% compounded over the last 5 years, while revenues have grown roughly 27% compounded.

The general staffing business, which includes 130,000-odd associates and 40,000 trainees, is typically low margin.

There are two interesting things to point out here. One, Teamlease set up a skills university in partnership with the state government a few years ago, and this has been a powerful way to source trainee headcount. The company also lobbied strongly to renew the apprenticeship programs in the country. Despite being the world's second largest labor market, India has a woefully low number of apprentices, a couple of hundred thousand. If you compare this to Germany or Australia, you'll appreciate how humongous the difference is. Teamlease has been successful in renewing some of these programs, and trainee numbers have grown almost 2.5-fold in the last few quarters.

In the specialized staffing segment, the spread earned can be potentially higher because these are employees with solid domain-specific expertise. Headcount here has grown from 1,000-odd to almost 6,000 in the last 5 or 6 quarters. This is a small contribution to the top line but extremely accretive at the profitability level.

Finally, the aim is to continue expanding the associate bank, if I may call it so, without commensurate expansion in operational expenses. One way to measure this is by the productivity of this associate headcount, where you take the headcount and divide it by the number of core employees required to manage this operation. The productivity here has been continually improving from about 170-odd associates per core employee to almost 220 now. The company thinks this could become substantially higher over time, largely driven by tech. One of the things Teamlease always underscores is that the technology and operational platforms which worked when there were 10,000 people didn't work when those became 50,000, and the ones that worked at 50,000 won't work at 180,000, etc. This is the continued focus to push the envelope. In so many ways, more informal or less tech-oriented people will just stumble here.

We certainly don't want to sugarcoat the reality and claim this is a business with practically no barrier to entry. There's no pricing power, and clients have practically no switching cost. What then makes this business appealing?

While barriers to entry here are low, the barriers to success are incredibly high, especially at scale.

This is typically a business easy to understand or conceptualize but difficult to execute. That's why moats need to be built in this space. It may not be one big moat but a dozen or so mini-moats, which can help build a successful business model allowing you to have 20% ROEs that can be juiced out and re-deployed at scale. This is where the real moat in a business like this comes from.

There are two mental models I'd like to share with regard to the nature of this entity. The first is a platform. On the one hand, you have a continual flow of jobseekers entering the market and looking for decent pay and employment conditions, an alternative to the so-called informal employment where there is little job security, let alone things like social security coverage. On the other hand, you have companies incurring high search costs in looking for people with the right skill sets, especially at scale. This is not a company looking to build a team of 5 or 10 people; it's looking for particular skill sets and getting 100 or 200 of that type of headcount.

It's a win-win for both sides, and Teamlease is the platform in the middle helping companies deal with the sky-high search cost and the regulatory burdens of hiring and firing. On the other hand, associates are looking to gain suitable employment and fair wages as mandated by the law of the land, and Teamlease offers these with the additional benefit of potential full-time placement.

Alternatively, the company can be thought of as a human resources bank. Just like you would conceptualize the balance sheet of a bank, with liabilities on one side and deposits on the other, you have associates you've hired and they come with a cost, your liabilities, as it were. On the asset side, when you place these associates with companies, you earn a markup, which you can think of as the yield on your assets. In the case of Teamlease, this is about 800 rupees a month per associate. This is razor-thin but gets higher in the specialized categories.

Your ability to leverage this balance sheet is defined by how large a headcount you can manage by capitalizing on technology and your core employees without commensurately increasing your operating expenses.

Since I've drawn this analogy to banks, I'd like to say just as private sector banks have taken market share away from their larger, inefficient public sector peers, in many ways, Teamlease benefits from a similar dynamic where you can take away share from informal market participants, which, in the aggregate, represent the industry behemoth. This is a mighty powerful dynamic.

Let's look at the corporate structure of the company. One tricky point here is although it looks like it's been quite acquisitive over the past 2 or 3 years, it is much more measured than you typically see in this industry. The criteria for what makes acquisitions compelling are quite explicit. They had a suboptimal experience in 2009 with their acquisition of an education centers business called IIJT Education. They realized this was a difficult business to scale with regard to capital and not optimal in terms of the return profile. It has played an imprinting role in helping the management team as a case study of how to do things differently.

Second, one of the powerful dynamics in this industry is small participants often want to sell their businesses because they find they lack the management depth and width to scale beyond a particular associate headcount. They may have regional strengths but not the bandwidth to build a national footprint. These are ideal situations for Teamlease to go in and acquire.

This brings me to its explicit mindset to create what it calls "opening balances" in particular niches. We can use as an example the case with one of its subsidiaries, Evolve Technologies. The company was keen on building a presence in telecom staffing but realized that building these so-called "opening balances" in terms of headcount is difficult with new clients. It can take time. It had the opportunity to acquire a business which may have built these balances but had difficulty scaling beyond a particular

headcount. Given Teamlease's experience in the general staffing segment, that's not a problem it faces. This becomes an ideal situation where the acquirer can leverage these "opening balances," build a larger headcount because of its deep experience in general staffing, and leverage existing client relationships. The company calls this the farming strategy because, typically, you have your clients giving you maybe 10% or 15% of the business they usually give out, and now you have this opportunity because of your scale and ability to build larger associate headcount, go in, and farm for higher wallet-share of clients. That's a compelling dynamic. You can think of this as a "roll-up" strategy where you use free cash flows and can do something value accretive.

Finally, Teamlease has also been proactive in its approach to technology, for example, building small stakes in online learning courseware companies. These can be all laid on the complete associate headcount to improve skill sets and employability across client requirements or sectors. This thinking is evident in the investment in online courses provider School Guru, which can be leveraged across the whole Teamlease University platform.

The other progressive move was taking a 30% stake in Freshersworld, an online jobs portal. It is thus widening the sourcing funnel on the supply side of the platform and being able to add headcount with first-time jobseekers.

We believe in the power of past experiences and typically have a strong preference for companies which have gone through trial by fire or some traumatic experiences, allowing them to create a memory bank that helps them behave more rationally going forward. The first one for Teamlease was the acquisition of IIJT. The second one to point out is that going into the financial crisis of 2008-2009, the company had almost 70% or 75% exposure to the banking and financial services sector. When the crisis hit, its revenue shrank by a half and headcount by almost 45%. This imprinted on the management team, who thought, "Hey, we need to build balances across industry." It led to the company now being much more spread out in terms of sectoral contribution. Even in sectors like manufacturing and retail, where concentration is relatively high, it tends to be more granular with regard to underlying clients.

The second big point to make is that, unlike most smaller and mid-sized staffing agencies, this is a purpose-driven organization. The team is eager to help solve the jobs challenge India is likely to face over the next decade. This is done two-fold. One, because of a strong focus on advocacy, the intellectual leadership of the company is well-respected in the entire sector. The senior management is strongly tuned into the way government is thinking and tries to play a progressive role in advocacy and shaping reform measures. The second is a big push toward employability. The company is not simply focused on the staffing agency business – a big motivational factor is improving the employability prospects of the whole headcount base. Teamlease does this through some of the acquisitions it has made, leveraging the courseware and the learning across this headcount. The second way in which it does it is by being involved directly in the Teamlease Skills University and improving the prospects of its headcount in the job market, both in terms of being placed and having potential for permanent employment and in terms of improving the realization its associates have as the labor industry dynamics keep evolving.

The company went public in 2016, and the stock has done relatively well since then. The key rationale behind going public was to allow the partial exit of a few private equity entities. The new issue of shares was roughly INR 1.4 billion, which is a relatively small amount of capital when you consider it is about 1.5 years' worth of free operating cash flow, not that much in terms of scale.

We identified Teamlease while looking for companies which went public but didn't raise much capital. That was one of mental models we were running at the time. They've used these proceeds predominantly for acquisitions.

A few private equity investors trimmed their holdings, and a bunch of institutional investors came in. Liquidity is a bit tight, and only a small percentage of shareholding is in retail hands.

If you look at global peers, the largest among them, Adecco and Randstad, have a headcount of close to 700,000 each versus 180,000 for Teamlease. Those peers operate in 40 to 60 countries whereas Teamlease operates in one country and has a continued domestic focus. In considering the scalability prospects, it helps you appreciate how things can play out over the long run because organic growth at the global peers ranges from 6% to 8% while long-term associate headcount growth in India can be in the range of 15% to 20% because of enough on both the supply and demand sides. This is why we find this company to be well-positioned in terms of the broader picture.

Let me go quickly over some of our expectations over the long run and the impact of the narrative on fundamentals.

Number one, large and inefficient incumbents controlling more than 75% of the market are getting disrupted, with the informal side of the industry becoming less and less viable. What this implies in terms of fundamentals is we can have a fair degree of conviction in seeing 15% to 20% headcount growth over the next decade in a business like this as more and more of the economy formalizes.

Second, this is a business difficult to operate but even much more difficult to scale, so you have small and medium-sized inefficient practitioners getting capped out at perhaps a couple of thousand in headcount. This means market share gains can be quite high at the expense of not just informal but relatively limited bandwidth participants.

Third, this is a space where customers are paranoid about compliance. few flexi-staffing agencies have the intellectual bandwidth to keep updating their clients with regard to regulatory developments and be sure clients have been compliant in all ways. On the fundamental side, this means the company is able to launch the so-called hunting and farming campaigns and have continual focus on customer "wallet-share." One thing astute participants may have observed is the client count is almost 2,500 and the top 10 concentration is about 18% or 19%. In other words, you have 2,500 clients but 10 companies contribute a large percent of revenues. This is a great depiction of what the farming opportunity can be in terms of getting more and more "wallet-share" from relatively few clients.

The next point is improving margin profile by targeting niches. Telecom and IT are great examples here. In these niches, gross margins could be substantially higher than in general staffing - 15% or higher as opposed to 2.5% or 3%. This gives us conviction profit margins will keep improving.

Then we have leveraging technology to continually handle larger associate headcounts. Global peers are at 700,000-800,000 people. There's potential for a company like this to set a new precedent of how many employees one entity is capable of managing, which largely translates into higher productivity. Productivity ratios can move materially higher from where they are today in terms of managing that associate headcount without large increases in the core employee base.

Finally, we continually expect the company to acquire intellectual depth in tangential areas. This could be various job portals to keep the sourcing funnel wide open for first-time jobseekers, or online course providers for enhancing employability prospects and improving realization for associates out in the marketplace. This allows us to have some degree of certainty about long-term realization growth.

I'd like to make a few more caveats here. In contrast to 2017, we have moved away from detailed 10-year models. If you think of value in businesses like this, one-year forward earnings of about 40x is certainly not a bargain. However, we'd like to highlight that a one-year forward multiple can be misleading in environments with such meaningful structural growth. Bottom-line growth can be in the range of 20% to 25% over the long term. We do build detailed ten-year models for our own mental

clarity, but we've become a little reticent in sharing them widely considering how circumstances can change with regard to special acquisitions or similar situations. Few businesses lend themselves to such a build-out in terms of the certainty factor over the next decade. This company is no exception to that mental process. However, we have to be mindful of not letting long-term projections be viewed as estimates or forecasts with regard to regulations.

When it comes to risk factors, there are a few company-specific points. One is its high exposure to a single business line, which is general staffing. Regarding more thematic concerns, we always need consistency in terms of regulatory and government support, in how the temporary staffing industry is viewed, incentives and so on. The other is the stuff we continually read about the impact of artificial intelligence and technology on relatively entry-level jobs. Those are two areas which one needs to be mindful of.

In many ways, we see Teamlease as a good candidate to be called a "hexagon." The company is understandable, the prospects are easy to identify over the long run, and there are no single competitive advantages but a group of many small, micro advantages that become quite impactful in the aggregate. Also, experience has taught the company to be quite prudent in terms of allocating capital and free cash flow. As regards scalability, the informal sector is the largest incumbent here even though it's not one entity, but there are many reasons to believe the weight it holds in the industry will keep reducing over time. As for resilience to alternative outcomes, a company like this gains resilience with scale. The crisis of 2008/2009 definitely exposed certain vulnerabilities and those have imprinted deep learning on the management. We are also confident about the quality of its people - this a passionate and focus-driven group of founders and a management team with meaningful alignment and skin in the game as well.

Finally, in terms of price, 40x next year's earnings is certainly not a bargain but, in our view, long-term allocators ought to take a closer look.

*The following are excerpts of the Q&A session with Soumil Zaveri:*

**Q:** Could you elaborate on the pricing model and how that works in light of the low gross margins? It seems like the pricing model would have to be somehow tied in with the costs of the company to ensure gross margins don't turn negative in bad times.

**A:** This is typically a cost plus markup model. With most of these contracts with clients, the employee costs are covered plus there's usually a fixed markup in rupees. What the company is doing is continually trying to transition to a variable markup model as opposed to a fixed markup. It is having some success with clients in this. Anecdotally, it seems to be improving as the intensity with which informal market participants were competing earlier is starting to abate. This is definitely not a business where you get to set or command prices, but it's certainly a business where the extent to which the company was a price-taker is improving towards more and more contracts done on a variable percentage model as opposed to fixed markups relative to employee cost.

**Q:** You spoke about viewing Teamlease as a platform and as a bank. With the bank view, it seemed like it takes on the liability of this labor. Perhaps you could elaborate on that because it sounds as if the company doesn't hire people full-time unless they are placed with a customer. Is that right?

**A:** The way this works is the company hires people full-time onto its payrolls and subsequently places them with clients or customers. Most of the time, this is driven by clear visibility on what the pipeline is in terms of opportunities for placement. The people are hired as employees who subsequently get placed but, in all ways, they gain all the statutory benefits of what would be considered full-time employees. They are full-time employees of the company.

**Q:** What is the definition of associate headcount versus full-time employees? As we saw with Adecco and Randstad, the companies have a lot more associate headcount than what they call full-time employees.

**A:** One of the distinctions here is what you would think of as core employees. These are employees you need to manage this headcount. A lot of the HR responsibilities a client company would have with regard to payroll or managing the employee base remains with Teamlease. You have an associate headcount and then what should perhaps be referred to as core employees. The latter play an essential role in supporting this type of headcount and supporting the client companies with regard to all non-core aspects associated with managing this headcount.

**Q:** So they are all full-time, but associate headcount are the employees who get sent out for the staffing assignments, and the other group is the internal staff that runs and manages the business of the company.

**A:** Absolutely. It may have been clearer to call them core employees because they are core to the running of the business and manage the overall associate headcount, so to speak.

**Q:** Understood. Could you now elaborate on whether and to what extent the possible deregulation of India's labor laws could erode the moat of Teamlease?

**A:** This point comes up quite often. In our view, even in a scenario where labor laws keep getting more streamlined and less onerous, there's still the problem of hefty search and matching costs. India is an ecosystem where we may have many graduates with a particular skill set, but what many companies and HR departments lament is the title of the qualification is not necessarily indicative of the underlying skill sets required for the job. There are many moats beyond the mere fact labor laws are onerous. For one, even though labor laws become more streamlined over time, this dynamic of finding it difficult to find skilled people will remain. That's one huge contributor to a moat in a business like this. The ability to handle non-core staff is likely to be a great asset for a company.

Even when we talk about the labor market getting more formalized, this is likely to be a long, steady process, not something happening overnight. In fact, it could be a welcome move for companies like Teamlease, with more streamlined labor laws allowing them to operate at significantly larger scale and with higher productivity. It keeps us confident this is not solely an arbitrage business in the sense where onerous laws ensure the existence of companies like this. In our opinion, even in an environment where laws keep getting more rational, you will need a platform to be able to find 200, 300, or 500 people for the launch of a product or 1,000 people for your sales staff. This will not necessarily be full-time headcount you want on your balance sheet. A platform will ensure the HR department's man-hours are not spent on recruiting, then training and then firing and re-finding people. In short, those dynamics remain.

**Q:** Lastly, do you see potential threats from online models over the long term? I understand this is not an issue now and is even a channel for Teamlease. But given the fairly low gross margin of the business and the platform aspect, is it conceivable over the long-term there could be some viable competition doing it mainly online? If so, is Teamlease taking steps in that direction?

**A:** In many ways, online is an enabler for the company. Through some of the acquisitions it does, taking small equity stakes in online portals and suchlike, it's experimenting and considering how those can be overlaid on the entire headcount.

That said, the crux of the matter is that, in many ways, this is an industry where companies need to have clarity and conviction about the nature of staff they bring into their client locations. They want to

be sure of the quality, the long-term employability, the skill set, and the capabilities on the job. Many of these things become harder to quantify with an online platform and only become apparent after the decision is made to have someone at a client location. In this sense, it will be a business where you'll need to assess a lot of qualitative factors regarding your associate base and place people accordingly. I'm not sure how quickly or rapidly this will lend itself to becoming a completely online business.

*About the instructor:*

Soumil Zaveri moved to the US in 2005 to study Economics and Biology at Duke University. He had the good fortune of being taught by phenomenal professors including Dr. Emma Rasiel. In the summer of junior year, He interned with Goldman, Sachs & Co. in New York on the healthcare team within the Research division. He was extended a full time offer and joined the banking team there after graduation. Given the magnitude of changes affecting the western economies, the resilience of Asian ones and his desire to be back home, after a few years in New York, he moved back to Mumbai to start his own investment firm, and to work directly on allocating personal and family capital. He founded DMZ Partners in early 2011 with his father, Sanjay who has played a key role in shaping his investment philosophy. DMZ Partners has recently transitioned from allocating only family capital to a SEBI Registered Portfolio Manager. Soumil & Sanjay intend to cautiously curate their investor base to ensure that their investors' philosophies and expectations are well aligned over the long-term.