

ExlService Holdings, Inc.
Form 10-Q
May 04, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 001-33089

EXLSERVICE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of

incorporation or organization)

280 PARK AVENUE, 38TH FLOOR, NEW YORK,

NEW YORK
(Address of principal executive offices)

(212) 277-7100

(Registrant's telephone number, including area code)

82-0572194
(I.R.S. Employer

Identification No.)

10017
(Zip code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of April 30, 2012, there were 31,905,746 shares of the registrant's common stock outstanding (excluding 336,262 shares held in treasury and 9,907 shares of restricted stock), par value \$0.001 per share.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****EXLSERVICE HOLDINGS, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share amounts)**

	March 31, 2012 (Unaudited)	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 82,272	\$ 82,393
Short-term investments	7,258	7,869
Restricted cash	834	934
Accounts receivable, net	58,837	55,672
Prepaid expenses	4,349	4,269
Deferred tax assets, net	5,774	6,228
Advance income tax, net	2,787	3,379
Other current assets	8,452	6,097
Total current assets	170,563	166,841
Fixed assets, net	44,840	42,320
Restricted cash	3,630	3,387
Deferred tax assets, net	14,334	16,495
Intangible assets, net	35,090	36,313
Goodwill	93,627	92,287
Other assets	21,353	19,768
Total assets	\$ 383,437	\$ 377,411
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 3,674	\$ 4,333
Deferred revenue	7,805	7,772
Accrued employee cost	16,016	27,700
Accrued expenses and other current liabilities	26,398	30,700
Current portion of capital lease obligations	1,832	1,729
Total current liabilities	55,725	72,234
Capital lease obligations, less current portion	4,027	4,244
Non-current liabilities	18,139	22,458
Total liabilities	77,891	98,936
Commitments and contingencies		
Preferred stock, \$0.001 par value; 15,000,000 shares authorized, none issued		

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Stockholders' equity:

Common stock, \$0.001 par value; 100,000,000 shares authorized, 31,880,218 shares issued and 31,549,366 shares outstanding as of March 31, 2012 and 31,496,461 shares issued and 31,173,064 shares outstanding as of December 31, 2011.	32	31
Additional paid-in-capital	179,604	173,926
Retained earnings	155,962	147,046
Accumulated other comprehensive loss	(27,200)	(39,858)
Total stockholders' equity including shares held in treasury	308,398	281,145
Less: 330,852 shares as of March 31, 2012 and 323,397 shares as of December 31, 2011, held in treasury, at cost	(2,875)	(2,693)
ExlService Holdings, Inc. stockholders' equity	305,523	278,452
Non-controlling interest	23	23
Total stockholders' equity	305,546	278,475
Total liabilities and stockholders' equity	\$ 383,437	\$ 377,411

See accompanying notes.

Table of Contents**EXLSERVICE HOLDINGS, INC.****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)****(In thousands, except share and per share amounts)**

	Three months ended March 31,	
	2012	2011
Revenues	\$ 104,608	\$ 72,907
Cost of revenues (exclusive of depreciation and amortization)	66,672	44,219
Gross profit	37,936	28,688
Operating expenses:		
General and administrative expenses	13,347	10,471
Selling and marketing expenses	7,799	5,857
Depreciation and amortization	6,359	4,852
Total operating expenses	27,505	21,180
Income from operations	10,431	7,508
Other income, net:		
Foreign exchange gain	1,058	1,648
Interest and other income, net	447	325
Income before income taxes	11,936	9,481
Income tax provision	3,020	1,120
Net income	\$ 8,916	\$ 8,361
Earnings per share:		
Basic	\$ 0.28	\$ 0.28
Diluted	\$ 0.27	\$ 0.27
Weighted-average number of shares used in computing earnings per share:		
Basic	31,445,592	29,620,218
Diluted	32,783,855	30,911,066

See accompanying notes.

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EXLSERVICE HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three months ended March 31,	
	2012	2011
Net income	\$ 8,916	\$ 8,361
Other comprehensive income:		
Unrealized gain/(loss) on effective cash flow hedges, net of taxes	6,486	(314)
Foreign currency translation adjustment	6,223	902
Retirement benefits, net of taxes	(51)	20
Total other comprehensive income	12,658	608
Total comprehensive income	\$ 21,574	\$ 8,969

See accompanying notes.

Table of Contents**EXLSERVICE HOLDINGS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOW****(Unaudited)****(In thousands)**

	Three months ended March 31,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 8,916	\$ 8,361
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,359	4,852
Amortization of debt issuance costs	38	
Stock-based compensation expense	2,743	2,248
Non-employee stock options	32	
Unrealized foreign exchange loss	1,711	297
Deferred income taxes	954	(1,553)
Change in operating assets and liabilities :		
Restricted cash	108	(118)
Accounts receivable	(2,839)	(1,051)
Prepaid expenses and other current assets	(2,292)	(544)
Accounts payable	569	(1,059)
Deferred revenue	21	1,436
Accrued employee cost	(13,229)	(10,109)
Accrued expenses and other liabilities	883	3,972
Advance income tax, net	817	609
Other assets	(422)	411
Net cash provided by operating activities	4,369	7,752
Cash flows from investing activities:		
Purchase of fixed assets	(9,299)	(7,158)
Purchase of short-term investments	(1,369)	(72)
Proceeds from redemption of short-term investments	2,223	
Net cash used for investing activities	(8,445)	(7,230)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(446)	(51)
Acquisition of treasury stock	(182)	(34)
Proceeds from exercise of stock options	2,903	595
Net cash provided by financing activities	2,275	510
Effect of exchange rate changes on cash and cash equivalents	1,680	329
Net (decrease)/increase in cash and cash equivalents	(121)	1,361
Cash and cash equivalents, beginning of period	82,393	111,182

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Cash and cash equivalents, end of period

\$ 82,272 \$ 112,543

See accompanying notes.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

(In thousands, except share and per share amounts)

1. Organization and Basis of Presentation

Organization

ExlService Holdings, Inc. (ExlService Holdings) is organized as a corporation under the laws of the State of Delaware. ExlService Holdings, together with its subsidiaries (collectively, the Company), is a leading provider of outsourcing services and transformation services. The Company's clients are located principally in the United States and the United Kingdom.

Basis of Presentation

The unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements and therefore should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

The unaudited interim consolidated financial statements reflect all adjustments (of a normal and recurring nature) which management considers necessary for a fair presentation of such statements for the interim periods presented. The unaudited consolidated statements of income for the interim periods presented are not necessarily indicative of the results for the full year or for any subsequent period.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying unaudited consolidated financial statements include the financial statements of ExlService Holdings and all of its subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

The non-controlling interest represents the minority partner's interest in the operation of exl Service.com (India) Private Limited (Exl India) and the profits associated with the minority partner's interest in those operations, in the unaudited consolidated balance sheet and unaudited consolidated statement of income, respectively. The non-controlling interest in the operations for the three months ended March 31, 2012 and 2011 was insignificant and is included under general and administrative expenses in the unaudited consolidated statements of income.

Use of Estimates

The preparation of the unaudited consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the unaudited consolidated financial statements and the unaudited consolidated statements of income during the reporting period. Estimates are based upon management's best assessment of the current business environment. Actual results could differ from those estimates. The significant estimates and assumptions that affect the financial statements include, but are not limited to, allowance for doubtful receivables, service tax receivables, assets and obligations related to employee benefit plans, deferred tax valuation allowances, income-tax uncertainties and other contingencies, valuation of derivative financial instruments, stock-based compensation expense, depreciation and amortization periods, recoverability of long-term assets including goodwill and intangibles, and estimates to complete fixed price contracts.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)*****Recent Accounting Pronouncements***

In May 2011, the FASB issued update No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS* (ASU No. 2011-04). ASU No. 2011-04 was intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The amendments in this update result in common fair value measurement and disclosure requirements in GAAP and IFRS. The update explains how to measure fair value and does not require additional measurements. The adoption of this accounting pronouncement from January 1, 2012 did not have any impact on the Company's unaudited consolidated financial statements.

In June 2011, the FASB issued update No. 2011-05, *Presentation of Comprehensive Income* (ASU No. 2011-05). ASU No. 2011-05 effective retrospectively for the interim and annual periods beginning on or after December 15, 2011 (early adoption is permitted), requires presentation of total comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In December 2011, FASB issued update No. 2011-12, an amendment to defer the presentation on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for annual and interim financial statements. The adoption of this accounting pronouncement from January 1, 2012 did not have any impact on the Company's unaudited consolidated financial statements. Refer to the Company's unaudited consolidated statements of comprehensive income for further details.

In September 2011, the FASB issued update No. 2011-08, *Testing Goodwill for Impairment* (ASU No. 2011-08), which allows entities to use a qualitative approach to test goodwill for impairment. ASU No. 2011-08 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this accounting pronouncement did not have a material impact on the Company's unaudited consolidated financial statements and the Company does not expect this to have a material impact on its annual goodwill impairment assessment in the fourth quarter of fiscal 2012.

Accrued expenses and other current liabilities

	March 31, 2012	December 31, 2011
Accrued expenses	\$ 14,014	\$ 12,134
Derivative instruments	4,657	9,170
Other current liabilities	7,727	9,396
Accrued expenses and other current liabilities	\$ 26,398	\$ 30,700

Non-current liabilities

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	March 31, 2012	December 31, 2011
Derivative instruments	\$ 5,037	\$ 8,559
Unrecognized tax benefits	5,517	4,981
Deferred rent	3,754	3,319
Retirement benefits	2,172	3,068
Other non-current liabilities	1,659	2,531
 Non-current liabilities	 \$ 18,139	 \$ 22,458

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)****3. Earnings Per Share**

Basic earnings per share is computed by dividing net income to common stockholders by the weighted average number of common shares outstanding during each period. Diluted earnings per share is computed using the weighted average number of common shares plus the potentially dilutive effect of common stock equivalents issued and outstanding at the reporting date, using the treasury stock method. Stock options, restricted stock and restricted stock units that are anti-dilutive are excluded from the computation of weighted average shares outstanding.

The following table sets forth the computation of basic and diluted earnings per share:

	Three months ended March 31,	
	2012	2011
Numerators:		
Net income	\$ 8,916	\$ 8,361
Denominators:		
Basic weighted average common shares outstanding	31,445,592	29,620,218
Dilutive effect of share based awards	1,338,263	1,290,848
Diluted weighted average common shares outstanding	32,783,855	30,911,066
Weighted average common shares considered anti-dilutive in computing diluted earnings per share	338,237	611,069

4. Segment Information

The Company is organized around its outsourcing services and transformation services segments.

The chief operating decision maker generally reviews financial information at the consolidated statement of income level but does not review any information except for revenues and cost of revenues of the individual segments. Therefore, the Company does not allocate or evaluate depreciation, amortization, other income, capital expenditures and income taxes to its operating segments. Consequently, it is not practical to show assets, capital expenditures, depreciation or amortization by segment.

Revenues and cost of revenues for each of the three months ended March 31, 2012 and 2011 for the Company's outsourcing services and transformation services segments, respectively, are as follows:

	Three months ended March 31, 2012			Three months ended March 31, 2011		
	Outsourcing Services	Transformation Services	Total	Outsourcing Services	Transformation Services	Total
Revenues	\$ 89,734	\$ 14,874	\$ 104,608	\$ 56,841	\$ 16,066	\$ 72,907

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Cost of revenues (exclusive of depreciation and amortization)	56,478	10,194	66,672	34,235	9,984	44,219
Gross profit	\$ 33,256	\$ 4,680	\$ 37,936	\$ 22,606	\$ 6,082	\$ 28,688
Operating expenses			27,505			21,180
Other income, net			1,505			1,973
Income tax provision			3,020			1,120
Net income			\$ 8,916			\$ 8,361

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)****5. Business Combinations, Goodwill and Intangible Assets**

On May 31, 2011, the Company completed its acquisition of Business Process Outsourcing Inc., a Delaware corporation formerly organized as a Cayman Islands exempted company (OPI), pursuant to a Merger Agreement, dated as of April 30, 2011 (the OPI Acquisition).

On October 1, 2011, the Company also acquired Trumbull Services, LLC. (Trumbull), a market leader in subrogation services for property and casualty insurance companies, from The Hartford Financial Services Group, Inc. (the Trumbull Acquisition).

Goodwill

The following table sets forth details of the Company's goodwill balance as of March 31, 2012:

	Outsourcing Services	Transformation Services	Total
Balance at January 1, 2011	\$ 26,585	\$ 16,785	\$ 43,370
Goodwill arising from OPI Acquisition	54,604		54,604
Currency translation adjustments	(5,687)		(5,687)
Balance at December 31, 2011	75,502	16,785	92,287
Currency translation adjustments	1,340		1,340
Balance at March 31, 2012	\$ 76,842	\$ 16,785	\$ 93,627

Intangible Assets

Information regarding the Company's intangible assets is as follows:

	As of March 31, 2012		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	\$ 33,146	\$ (5,284)	\$ 27,862
Leasehold benefits	3,626	(850)	2,776
Developed technology	2,133	(405)	1,728
Non-compete agreements	1,317	(813)	504
Trade names and trademarks	2,722	(502)	2,220
	\$ 42,944	\$ (7,854)	\$ 35,090

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	As of December 31, 2011		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	\$ 33,100	\$ (4,456)	\$ 28,644
Leasehold benefits	3,474	(668)	2,806
Developed technology	2,133	(351)	1,782
Non-compete agreements	1,316	(606)	710
Trade names and trademarks	2,722	(351)	2,371
	\$ 42,745	\$ (6,432)	\$ 36,313

Amortization expense for the three months ended March 31, 2012 and 2011 was \$1,394 and \$636, respectively. The weighted average life of intangible assets was 10.1 years for customer relationships, 6.8 years for leasehold benefits, 10.0 years for developed technology, 1.5 years for non-compete agreements and 3.0 years for trade names and trademarks excluding indefinite life trade names and trademarks. The Company had \$900 of indefinite life trade names and trademarks as of March 31, 2012 and December 31, 2011.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

Estimated amortization of intangible assets during the year ending March 31,	
2013	\$ 5,136
2014	\$ 4,373
2015	\$ 3,828
2016	\$ 3,728
2017	\$ 3,723

6. Fair Value Measurements

The following table sets forth the Company's assets and liabilities that were accounted for at fair value on a recurring basis as of March 31, 2012 and December 31, 2011. The table excludes short-term investments, accounts receivable, short-term borrowings, accounts payable and accrued expenses for which fair values approximate their carrying amounts.

Assets and Liabilities Measured at Fair Value

As of March 31, 2012	Level 1	Level 2	Level 3	Total
Assets				
Money market and mutual funds	\$ 42,685	\$	\$	\$ 42,685
Derivative financial instruments		960		960
Total	\$ 42,685	\$ 960	\$	\$ 43,645
Liabilities				
Derivative financial instruments	\$	\$ 9,694	\$	\$ 9,694
Total	\$	\$ 9,694	\$	\$ 9,694
As of December 31, 2011				
Assets				
Money market and mutual funds	\$ 42,067	\$	\$	\$ 42,067
Derivative financial instruments		32		32
Total	\$ 42,067	\$ 32	\$	\$ 42,099
Liabilities				
Derivative financial instruments	\$	\$ 17,729	\$	\$ 17,729
Total	\$	\$ 17,729	\$	\$ 17,729

Derivative Financial Instruments: The Company's derivative financial instruments consist of foreign currency forward exchange contracts. Fair values for derivative financial instruments are based on broker quotations and are classified as Level 2. See Note 7 for further details.

7. Derivatives and Hedge Accounting

The Company actively looks to mitigate the exposure of foreign currency market risk by entering into various hedging transactions, authorized under Company policies, with counterparties that are highly rated financial institutions. The Company's primary exchange rate exposure is with the U.K. pound sterling and the Indian rupee. The Company also has exposure in Philippine pesos, Czech koruna and other local currencies in which it operates. The Company uses derivative instruments for the purpose of mitigating the underlying exposure from foreign currency fluctuation risks associated with forecasted transactions denominated in certain foreign currencies and to minimize earnings and cash flow volatility associated with changes in foreign currency exchange rates, and not for speculative trading purposes. These derivative financial instruments are largely forward foreign exchange contracts that are designated effective and that qualify as cash flow hedges under ASC topic 815, *Derivatives and Hedging* (ASC 815). The Company also uses derivatives consisting of foreign currency exchange contracts not designated as hedging instruments under ASC 815 to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the functional currency.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

The Company had outstanding foreign exchange contracts totaling \$227,104 and GBP 11,919 as of March 31, 2012 and totaling \$235,866 and GBP 10,368 as of December 31, 2011. The Company estimates that approximately \$4,113 of net derivative losses included in accumulated other comprehensive income (AOCI) could be reclassified into earnings within the next twelve months based on exchange rates prevailing as of March 31, 2012. As of March 31, 2012, the maximum outstanding term of derivative instruments that hedge forecasted transactions was thirty three months.

The Company evaluates hedge effectiveness at the time a contract is entered into as well as on an ongoing basis. If during this time a contract is deemed ineffective, the change in the fair value is recorded in the unaudited consolidated statements of income and is included in foreign exchange gain. For hedge relationships that are discontinued because the forecasted transaction is not expected to occur by the end of the originally specified period, any related derivative amounts recorded in equity are reclassified to earnings. No significant amounts of gains or losses were reclassified from AOCI into earnings as a result of forecasted transactions that failed to occur during the three months ended March 31, 2012 and 2011.

The following tables set forth the fair value of the foreign currency exchange contracts and their location on the unaudited consolidated financial statements:

Derivatives designated as hedging instruments:

	March 31, 2012	December 31, 2011
Other current assets:		
Foreign currency exchange contracts	\$ 544	\$
Other assets:		
Foreign currency exchange contracts	\$ 112	\$
Accrued expenses and other current liabilities:		
Foreign currency exchange contracts	\$ 4,657	\$ 9,170
Other non-current liabilities:		
Foreign currency exchange contracts	\$ 5,037	\$ 8,559

Derivatives not designated as hedging instruments:

	March 31, 2012	December 31, 2011
Other current assets:		
Foreign currency exchange contracts	\$ 304	\$ 32

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

The following tables set forth the effect of foreign currency exchange contracts on the unaudited consolidated statements of income for the three months ended March 31, 2012 and 2011:

Derivatives in

Cash Flow	Amount of Gain Recognized in AOCI on Derivative (Effective Portion)		Location of Gain/ (Loss) Reclassified from AOCI into Income (Effective Portion)	Amount of Gain/ (Loss) Reclassified from AOCI into Income (Effective Portion)		Location of Gain/(Loss) Recognized in Income on Derivative and Amount Excluded from Effectiveness Testing	Amount of Gain/ (Loss) Recognized in Income on Derivative and Amount Excluded from Effectiveness Testing	
	2012	2011		2012	2011		2012	2011
Foreign exchange contracts	\$ 8,309	\$ 889	Foreign exchange gain	\$ (381)	\$ 1,203	Foreign exchange gain	\$	\$

Derivatives not designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain Recognized in Income on Derivatives	
		2012	2011
Foreign exchange contracts	Foreign exchange gain	\$ 2,898	\$ 371

8. Fixed Assets

The components of fixed assets, net of accumulated depreciation, consisted of the following:

	March 31, 2012	December 31, 2011
Owned Assets:		
Network equipment, computers and software	\$ 60,302	\$ 55,499
Buildings	1,563	1,498
Land	1,023	980
Leasehold improvements	23,852	21,733
Office furniture and equipment	10,078	9,011
Motor vehicles	772	828
Capital work in progress	2,660	2,737
	100,250	92,286
Less: Accumulated depreciation and amortization	(60,010)	(54,736)
	\$ 40,240	\$ 37,550

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Assets under capital leases:		
Network equipment, computers and software	\$ 485	\$ 474
Leasehold improvements	2,653	2,541
Office furniture and equipment	1,692	1,645
Motor vehicles	1,011	882
	5,841	5,542
Less: Accumulated depreciation and amortization	(1,241)	(772)
	\$ 4,600	\$ 4,770
Fixed assets, net	\$ 44,840	\$ 42,320

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

Depreciation and amortization expense excluding amortization of acquisition-related intangibles for the three months ended March 31, 2012 and 2011 was \$4,965 and \$4,216, respectively.

Capital work in progress represents advances paid towards acquisition of fixed assets and the cost of fixed assets not yet ready to be placed in service.

9. Capital Structure

The Company has one class of common stock.

During the three months ended March 31, 2012, the Company acquired 7,455 shares of common stock from employees in connection with withholding tax payments related to the vesting of restricted stock for a total consideration of \$182. The purchase price of \$24.45 per share was the average of the high and low price of the Company's shares of common stock on the Nasdaq Global Select Market on the trading day prior to the vesting date of the shares of restricted stock. These shares are held as treasury stock.

During the three months ended March 31, 2011, the Company acquired 1,714 shares of common stock from employees in connection with withholding tax payments related to the vesting of restricted stock for a total consideration of \$34. The purchase price of \$19.76 per share was the average of the high and low price of the Company's shares of common stock on the Nasdaq Global Select Market on the trading day prior to the vesting date of the shares of restricted stock. These shares are held as treasury stock.

10. Employee Benefit Plans

The Company's Gratuity Plans in India and the Philippines provide a lump-sum payment to vested employees on retirement or on termination of employment in an amount based on the respective employee's salary and years of employment with the Company. Liabilities with regard to the Gratuity Plans are determined by actuarial valuation using the projected unit credit method. Current service costs for the Gratuity Plans are accrued in the year to which they relate. Actuarial gains or losses or prior service costs, if any, resulting from amendments to the plans are recognized and amortized over the remaining period of service of the employees.

Net gratuity cost includes the following components:

	Three months ended March 31,	
	2012	2011
Service cost	\$271	\$171
Interest cost	111	64
Expected return on plan assets	(19)	
Actuarial loss	33	26
Net gratuity cost	\$396	\$261

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The Gratuity Plans are funded plans that are managed and administered by Life Insurance Corporation (LIC) of India and HDFC Standard Life Insurance Company. They calculate the annual contribution required to be made by the Company and manage the investment as well as payouts under the plans. The Company expects a return on the fund assets to be approximately 9% per annum for the year ended March 31, 2012. Fund managers manage these funds on a cash accumulation basis and declare interest retrospectively on March 31 of each year.

Change in Plan Assets

Plan assets at January 1, 2012	\$ 1,015
Employer contribution	1,143
Expected return	19
Effect of exchange rate changes	44
Plan assets at March 31, 2012	\$ 2,221

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

The Company maintains the Exl Service Inc. 401(k) Plan under Section 401(k) of the Internal Revenue Code of 1986, covering all eligible employees, as defined. The Company may make discretionary contributions of up to a maximum of 3% of employee compensation within certain limits. The Company has made a provision for contributions to the 401(k) Plans amounting to \$377 and \$146 during the three month periods ended March 31, 2012 and March 31, 2011, respectively under the plans as applicable for these years.

During the three month periods ended March 31, 2012 and 2011, the Company contributed the following amounts to various defined contribution plans on behalf of its employees in India, the Philippines, Romania, Bulgaria, Malaysia and the Czech Republic:

Three months ended March 31, 2012	\$ 1,481
Three months ended March 31, 2011	\$ 1,022

11. Leases

The Company finances its use of certain facilities, computer hardware, leasehold improvements, furniture, fixtures, office equipment and motor vehicles under various lease arrangements provided by financial institutions. Future minimum lease payments under these capital leases as of March 31, 2012 are as follows:

Year ending March 31,	
2013	\$ 2,316
2014	1,934
2015	1,448
2016	1,062
2017	137
Total minimum lease payments	6,897
Less: amount representing interest	1,038
Present value of minimum lease payments	5,859
Less: current portion	1,832
Long term capital lease obligation	\$ 4,027

The Company conducts its operations using facilities leased under non-cancelable operating lease agreements that expire at various dates. Future minimum lease payments under non-cancelable operating lease agreements expiring after more than twelve months are as follows:

Year ending March 31,	
2013	\$ 10,128

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2014	7,334
2015	6,716
2016	5,105
2017	1,463
2018 and thereafter	1,141

\$ 31,887

The operating leases are subject to renewal periodically and have scheduled rent increases. The Company accounts for scheduled rent on a straight-line basis over the lease period. Rent expense under both cancellable and non-cancellable operating leases was \$4,682 and \$2,812 for the three months ended March 31, 2012 and 2011, respectively. Deferred rent as of March 31, 2012 and December 31, 2011 was \$4,298 and \$3,815, respectively, and are included in Accrued expenses and other current liabilities and Non-current liabilities in the unaudited consolidated balance sheets.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

March 31, 2012

(Unaudited)

(In thousands, except share and per share amounts)

12. Income Taxes

The Company recorded income tax expense of \$3,020 and \$1,120 for the three months ended March 31, 2012 and 2011, respectively. The effective rate of taxes increased from 11.8% during the three months ended March 31, 2011 to 25.3% during the three months ended March 31, 2012. The increase in the effective tax rate is primarily due to the expiry of a tax holiday period for most of the Company's operating units in India from April 1, 2011 and release of a valuation allowance on deferred tax assets of \$1,961 during the three months ended March 31, 2011 as a result of the Company's assessment that the deferred tax assets generated by certain of the Company's operating units in India that were under a tax holiday period were more likely than not to be realized upon the expiration of the tax holiday period.

The fiscal year under the Indian Income Tax Act ends on March 31. Certain of the Company's operations centers in India qualified for an exemption from corporate tax under Section 10A or 10B of the Indian Income Tax Act. This exemption was available for a period of ten consecutive years beginning with the financial year in which an operations center began to manufacture or produce eligible goods and services and expired on April 1, 2011. Therefore, profits generated from the services provided from such operations centers have become fully taxable and consequently, the Company's tax expense increased significantly during the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 and may continue to be higher in future.

The Company currently benefits from a four-year income tax holiday for one of its operations centers in the Philippines that will expire in the middle of 2012 but is extendable for an additional two years. The Company's new operations center in the Philippines, inaugurated in January 2012, will also benefit from a four-year income tax holiday that is extendable for an additional two years. While the Company intends to apply for extensions of these holidays when they expire, it is possible that such extensions could be denied, or these holidays could be removed entirely due to changes in applicable legislation by the government of the Philippines. Should either of these events occur, the Company's tax liability in the Philippines could increase.

The Company's operations centers in Jaipur and Noida, which were established in special economic zones (SEZs) in 2010, are eligible for tax incentives until 2020. As part of the OPI Acquisition, the Company also acquired operations centers in Bengaluru and Kochi, India that are also established in SEZs. The operations center in Bengaluru completed its first five years of operations on March 31, 2012. Under the tax regulations, the Bengaluru operations center will be entitled to a 50% tax exemption on profits from April 1, 2012, after which there will be an increase in the tax expense for such center. The Company anticipates establishing additional operations centers in SEZs in the future.

Deferred tax assets and liabilities are recognized for future tax consequences attributable to temporary differences between the financial statement carrying values of assets and liabilities and their respective tax bases and operating loss carry forwards. At March 31, 2012, the Company performed an analysis of the deferred tax asset valuation allowance for net operating loss carry forward for its domestic entities. Based on this analysis, the Company continues to carry a valuation allowance on the deferred tax assets on net operating loss carry forwards. The valuation allowance as of March 31, 2012 and December 31, 2011 was approximately \$665 and \$919, respectively.

As a result of the OPI Acquisition, the Company also acquired OPI's federal and state net operating losses in the United States. Thus, as of March 31, 2012, the Company has federal net operating loss carry forwards of approximately \$21,600, which expire in 2027. The Company's federal net operating loss carry forwards are subject to certain annual utilization limitations under Section 382 of the United States Internal Revenue Code. The Company also has state and local net operating loss carry forwards of varying amounts, which also are subject to limitations under the applicable rules and regulations of those taxing jurisdictions. The Company estimates that it will be able to utilize all of the losses before their expiry.

During 2007, the Indian government passed tax legislation that, among other items, subjects Indian taxpayers to a Minimum Alternative Tax (MAT). As of March 31, 2012 and December 31, 2011, deferred income taxes related to the MAT were approximately \$3,456 and \$2,793,

respectively.

The Company's provision for income taxes also includes the impact of provisions established for uncertain income tax positions determined in accordance with ASC No. 740, *Income Taxes*, as well as the related net interest. Tax exposures can involve complex issues and may require an extended period to resolve. Although the Company believes that it has adequately reserved for its uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. The Company adjusts these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters differs from the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

The following table summarizes the activity related to the gross unrecognized tax benefits from January 1, 2012 through March 31, 2012:

Balance as of January 1, 2012	\$ 5,324
Increases related to prior year tax positions	
Decreases related to prior year tax positions	
Increases related to current year tax positions	201
Decreases related to current year tax positions	
Effect of exchange rate changes	190
Balance as of March 31, 2012	\$ 5,715

The unrecognized tax benefits as of March 31, 2012 of \$5,715, if recognized, would impact the effective tax rate.

The Company has recognized interest and penalties of \$117 during the three months ended March 31, 2012. The unrecognized tax benefits may increase or decrease in the next twelve months depending on the Company's tax positions.

13. Stock-Based Compensation

The following costs related to the Company's stock-based compensation plan are included in the unaudited consolidated statements of income:

	Three months ended March 31,	
	2012	2011
Cost of revenue	\$ 655	\$ 395
General and administrative expenses	1,326	982
Selling and marketing expenses	762	871
Total	\$ 2,743	\$ 2,248

The fair value of each stock option granted to employees is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three months ended March 31,	
	2012	2011
Dividend yield	0%	0%
Expected life (years)	5.66	5.76
Risk free interest rate	0.99%	2.32%

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Volatility

40%

40%

The estimated expected term of options granted has been based on historical experience since October 2006, which is representative of the expected term of the options. Volatility has been calculated based on the volatility of the Company's common stock and the volatility of stock of comparative companies. The risk-free interest rate that the Company uses in the option valuation model is based on U.S. treasury zero-coupon bonds with a remaining term similar to the expected term of the options.

The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)****March 31, 2012****(Unaudited)****(In thousands, except share and per share amounts)**

Stock option activity under the Company's stock plans is shown below:

	Number of Options	Weighted- Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Remaining Contractual Life (Years)
Outstanding at December 31, 2011	3,030,128	\$ 13.22	\$ 28,318	6.79
Granted	316,129	24.64		
Exercised	(246,430)	12.14		
Forfeited	(53,590)	10.03		
Outstanding at March 31, 2012	3,046,237	\$ 14.54	\$ 39,595	6.96
Vested and exercisable at March 31, 2012	1,694,675	\$ 12.72	\$ 24,954	6.06
Available for grant at March 31, 2012	2,158,237			

The unrecognized compensation cost for unvested options as of March 31, 2012 was \$7,409, which is expected to be expensed over a weighted average period of 2.79 years. The weighted-average fair value of options granted during the three months ended March 31, 2012 and 2011 was \$9.42 and \$8.21, respectively. The total fair value of shares vested during the three months ended March 31, 2012 and 2011 was \$2,036 and \$1,508, respectively.

Restricted Stock and Restricted Stock Units

Restricted stock and restricted stock unit activity under the Company's stock plans is shown below:

	Restricted Stock Weighted- Average Intrinsic Value	Restricted Stock Units
Number	Value	Number