

ExlService Holdings, Inc.
Form 10-Q
July 29, 2014
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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 JUNE 30, 2014

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)

DELAWARE (State or other jurisdiction of incorporation or organization)	82-0572194 (I.R.S. Employer Identification No.)
280 PARK AVENUE, 38TH FLOOR NEW YORK, NEW YORK (Address of principal executive offices)	10017 (Zip code)
(212) 277-7100 (Registrant's telephone number, including area 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 <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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 July 25, 2014, there were 32,767,199 shares of the registrant's common stock outstanding (excluding 1,188,385 shares held in treasury stock), par value \$0.001 per share.

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

	June 30, 2014 (Unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 160,937	\$ 148,065
Short-term investments	7,556	5,987
Restricted cash	571	423
Accounts receivable, net	73,721	76,121
Prepaid expenses	5,564	5,168
Deferred tax assets, net	4,843	6,958
Advance income tax, net	8,447	2,024
Other current assets	11,223	7,881
Total current assets	272,862	252,627
Fixed assets, net	45,978	34,564
Restricted cash	3,800	3,568
Deferred tax assets, net	8,544	12,254
Intangible assets, net	31,147	34,115
Goodwill	108,120	107,407
Other assets	23,822	18,897
Total assets	\$ 494,273	\$ 463,432
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 4,294	\$ 4,714
Deferred revenue	9,659	8,618
Accrued employee cost	24,886	29,405
Accrued expenses and other current liabilities	29,722	32,219
Current portion of capital lease obligations	1,058	1,119
Total current liabilities	69,619	76,075

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Capital lease obligations, less current portion	977	1,371
Non-current liabilities	14,385	19,812
Total liabilities	84,981	97,258
Commitments and contingencies (See Note 15)		
Preferred stock, \$0.001 par value; 15,000,000 shares authorized, none issued		
Stockholders' equity:		
Common stock, \$0.001 par value; 100,000,000 shares authorized, 33,922,584 shares issued and 32,734,199 shares outstanding as of June 30, 2014 and 33,342,312 shares issued and 32,172,183 shares outstanding as of December 31, 2013	34	33
Additional paid-in-capital	223,477	214,522
Retained earnings	255,889	236,979
Accumulated other comprehensive loss	(45,007)	(60,718)
Total stockholders' equity including shares held in treasury	434,393	390,816
Less: 1,188,385 shares as of June 30, 2014 and 1,170,129 shares as of December 31, 2013, held in treasury, at cost	(25,101)	(24,642)
Total stockholders' equity	409,292	366,174
Total liabilities and stockholders' equity	\$ 494,273	\$ 463,432

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		Six months ended June 30,	
	June 30,		2014	2013
	2014	2013	2014	2013
Revenues	\$ 119,738	\$ 116,008	\$ 241,535	\$ 232,014
Cost of revenues (exclusive of depreciation and amortization)	81,259	73,930	156,181	146,843
Gross profit	38,479	42,078	85,354	85,171
Operating expenses:				
General and administrative expenses	16,240	13,753	31,040	28,474
Selling and marketing expenses	9,463	9,136	19,695	18,891
Depreciation and amortization	6,679	6,362	13,035	12,874
Total operating expenses	32,382	29,251	63,770	60,239
Income from operations	6,097	12,827	21,584	24,932
Other income/(expense) :				
Foreign exchange loss	(137)	(569)	(970)	(618)
Interest and other income, net	858	593	1,817	1,296
Income before income taxes	6,818	12,851	22,431	25,610
Income tax provision / (benefit)	(944)	3,615	3,521	6,612
Net income	\$ 7,762	\$ 9,236	\$ 18,910	\$ 18,998
Earnings per share:				
Basic	\$ 0.24	\$ 0.28	\$ 0.58	\$ 0.58
Diluted	\$ 0.23	\$ 0.27	\$ 0.56	\$ 0.56
Weighted-average number of shares used in computing earnings per share:				
Basic	32,812,155	32,778,800	32,668,620	32,650,852
Diluted	33,673,669	33,899,097	33,551,904	33,810,156

See accompanying notes.

Table of Contents**EXLSERVICE HOLDINGS, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)****(Unaudited)****(In thousands)**

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	\$ 7,762	\$ 9,236	\$ 18,910	\$ 18,998
Other comprehensive income/(loss):				
Unrealized income/(loss) on effective cash flow hedges, net of taxes \$578, (\$2,315), \$2,186 and (\$1,689), respectively	1,964	(8,734)	7,366	(7,287)
Foreign currency translation adjustment	24	(15,297)	4,812	(13,606)
Reclassification adjustments				
Realized loss on cash flow hedges, net of taxes \$485, \$361, \$980 and \$789 ⁽¹⁾	1,720	783	3,478	1,709
Retirement benefits, net of taxes \$7, \$9, \$15 and \$17, respectively ⁽²⁾	26	27	55	57
Total other comprehensive income/(loss):	3,734	(23,221)	15,711	(19,127)
Total comprehensive income/(loss):	\$ 11,496	\$ (13,985)	\$ 34,621	\$ (129)

- (1) *These are reclassified to net income and are included in the foreign exchange gain/(loss) in the unaudited consolidated statements of income. See Note 7 to the unaudited consolidated financial statements.*
- (2) *These are reclassified to net income and are included in the computation of net periodic pension costs in the unaudited consolidated statements of income. See Note 10 to the unaudited consolidated financial statements. See accompanying notes.*

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

	Six months ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$ 18,910	\$ 18,998
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	13,035	12,874
Stock-based compensation expense	6,142	6,505
Amortization of deferred financing costs	53	76
Unrealized foreign exchange gain/(loss)	2,206	(4,788)
Deferred income taxes	2,709	2,373
Gain on sale of fixed assets	(61)	
Non-controlling interest		2
Change in operating assets and liabilities:		
Restricted cash	(291)	44
Accounts receivable	2,472	(3,896)
Prepaid expenses and other current assets	(2,008)	(2,389)
Accounts payable	419	(1,283)
Deferred revenue	1,035	46
Accrued employee cost	(4,940)	(6,599)
Accrued expenses and other liabilities	(3,959)	2,882
Advance income tax, net	(6,263)	489
Other assets	(1,706)	67
Net cash provided by operating activities	27,753	25,401
Cash flows from investing activities:		
Purchase of fixed assets	(16,637)	(10,281)
Business acquisition (net of cash acquired)		(1,183)
Purchase of short-term investments	(1,408)	(166)
Proceeds from redemption of short-term investments		281
Net cash used for investing activities	(18,045)	(11,349)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(564)	(787)
Acquisition of treasury stock	(459)	(389)
Proceeds from exercise of stock options	2,813	2,456

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Net cash provided by financing activities	1,790	1,280
Effect of exchange rate changes on cash and cash equivalents	1,374	(3,800)
Net increase in cash and cash equivalents	12,872	11,532
Cash and cash equivalents, beginning of period	148,065	103,037
Cash and cash equivalents, end of period	\$ 160,937	\$ 114,569

See accompanying notes.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

(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 business process solutions, utilizing operations management, analytics and technology. The Company's clients are located principally in the U.S. and the U.K.

Basis of Presentation

The unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (US GAAP) 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 US GAAP 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, 2013.

The unaudited interim consolidated financial statements reflect all adjustments (of a normal and recurring nature) that 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.

Use of Estimates

The preparation of the unaudited consolidated financial statements in conformity with US GAAP 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. Although these estimates are based on management's best assessment of the current business environment, actual results may be different 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, purchase price allocation, recoverability of long-term assets including goodwill and intangibles, and estimates to complete the fixed price contracts.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

(In thousands, except share and per share amounts)

Recent Accounting Pronouncements

In March 2013, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) No. 2013-05, *Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05). ASU 2013-05 applies to the release of the currency translation adjustment into net income when a parent either sells a part of all of its investment in a foreign entity or no longer holds a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity. ASU 2013-05 became effective from January 1, 2014 and the new guidance did not have any material impact on the Company's unaudited consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11). The provisions of the rule require an unrecognized tax benefit to be presented as a reduction to a deferred tax asset in the financial statements for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward except in circumstances when the carryforward or tax loss is not available at the reporting date under the tax laws of the applicable jurisdiction to settle any additional income taxes or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purposes. When those circumstances exist, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. ASU No. 2013-11 became effective from January 1, 2014 and the new guidance did not have any material impact on the Company's unaudited consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The new standard is effective for reporting periods beginning after December 15, 2016 and early adoption is not permitted. The comprehensive new standard will supersede existing revenue recognition guidance and require revenue to be recognized when promised goods or services are transferred to customers in amounts that reflect the consideration to which the Company expects to be entitled in exchange for those goods or services. Adoption of the new rules could affect the timing of revenue recognition for certain transactions of the Company. ASU 2014-09 is effective for the Company in the first quarter of fiscal 2017 using either one of two methods: (i) retrospectively to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or (ii) retrospectively with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined per ASU 2014-09. The Company is currently evaluating the impacts of adoption and the implementation approach to be used.

In June 2014, the FASB issued ASU No. 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (ASU 2014-12).

The amendments in ASU 2014-12 require that a performance target in a share based payment that affects vesting and that could be achieved after the requisite service period should be accounted for as a performance condition. The amendments in ASU 2014-12 are effective for annual periods beginning after December 15, 2015 and interim periods within those annual periods with early adoption permitted. Entities may apply the amendments in ASU 2014-12 either: (a) prospectively to all awards granted or modified after the effective date; or (b) modified retrospectively to all awards with performance targets that are outstanding on or after the beginning of the first annual period presented as of the adoption date. ASU 2014-12 is not applicable to the Company's current stock based compensation plan and it does not expect this guidance to have any impact on the consolidated financial statements.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)***Accrued expenses and other current liabilities*

Accrued expenses and other current liabilities consist of the following:

	June 30, 2014	December 31, 2013
Accrued expenses	\$ 22,460	\$ 20,607
Derivative instruments	2,320	7,689
Other current liabilities	4,942	3,923
Accrued expenses and other current liabilities	\$ 29,722	\$ 32,219

Non-current liabilities

Non-current liabilities consist of the following:

	June 30, 2014	December 31, 2013
Derivative instruments	\$ 1,260	\$ 5,606
Unrecognized tax benefits	2,839	4,776
Deferred rent	5,905	4,973
Retirement benefits	1,570	3,543
Other non-current liabilities	2,811	914
Non-current liabilities	\$ 14,385	\$ 19,812

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		Six months ended June 30,	
	2014	2013	2014	2013
Numerators:				
Net income	\$ 7,762	\$ 9,236	\$ 18,910	\$ 18,998
Denominators:				
Basic weighted average common shares outstanding	32,812,155	32,778,800	32,668,620	32,650,852
Dilutive effect of share based awards	861,514	1,120,297	883,284	1,159,304
Diluted weighted average common shares outstanding	33,673,669	33,899,097	33,551,904	33,810,156
Earnings per share:				
Basic	\$ 0.24	\$ 0.28	\$ 0.58	\$ 0.58
Diluted	\$ 0.23	\$ 0.27	\$ 0.56	\$ 0.56
Weighted average common shares considered anti-dilutive in computing diluted earnings per share	179,450	150,902	192,669	253,810

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)****4. Segment Information**

The Company provides various types of business process solutions utilizing operations management, analytics and technology. These services are provided in an integrated manner to clients in various industries. The chief operating decision maker (the CODM) generally reviews financial information at the consolidated statement of income level disaggregated by our two segments: Outsourcing Services and Transformation Services, but does not review any information except for revenues and cost of revenues for these individual segments. Therefore, the Company does not allocate or evaluate operating expenses, interest expense or 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 June 30, 2014 and 2013 for the Company's outsourcing services and transformation services segments, respectively, are as follows:

	Three months ended June 30, 2014			Three months ended June 30, 2013		
	Outsourcing Services	Transformation Services	Total	Outsourcing Services	Transformation Services	Total
Revenues	\$ 94,314	\$ 25,424	\$ 119,738	\$ 97,328	\$ 18,680	\$ 116,008
Cost of revenues (exclusive of depreciation and amortization)	62,494	18,765	81,259	59,483	14,447	73,930
Gross profit	\$ 31,820	\$ 6,659	\$ 38,479	\$ 37,845	\$ 4,233	\$ 42,078
Operating expenses			32,382			29,251
Other income/(expense)			721			24
Income tax provision			(944)			3,615
Net income			\$ 7,762			\$ 9,236

Revenues and cost of revenues for each of the six months ended June 30, 2014 and 2013 for the Company's outsourcing services and transformation services segments, respectively, are as follows:

	Six months ended June 30, 2014			Six months ended June 30, 2013		
	Outsourcing Services	Transformation Services	Total	Outsourcing Services	Transformation Services	Total
Revenues	\$ 194,405	\$ 47,130	\$ 241,535	\$ 194,900	\$ 37,114	\$ 232,014
Cost of revenues (exclusive of depreciation and amortization)	121,393	34,788	156,181	118,959	27,884	146,843
Gross profit	\$ 73,012	\$ 12,342	\$ 85,354	\$ 75,941	\$ 9,230	\$ 85,171
Operating expenses			63,770			60,239
Other income/(expense)			847			678
Income tax provision			3,521			6,612
Net income			\$ 18,910			\$ 18,998

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)****5. Business Combinations, Goodwill and Intangible Assets*****Goodwill***

The following table sets forth details of the Company's goodwill balance as of June 30, 2014:

	Outsourcing Services	Transformation Services	Total
Balance at January 1, 2013	\$ 94,163	\$ 16,785	\$ 110,948
Currency translation adjustments	(3,291)		(3,291)
Allocation on sale of a business unit ⁽¹⁾	(250)		(250)
Balance at December 31, 2013	\$ 90,622	\$ 16,785	\$ 107,407
Currency translation adjustments	713		713
Balance at June 30, 2014	\$ 91,335	\$ 16,785	\$ 108,120

(1) Relates to the sale of a business unit (acquired with the acquisition of Business Process Outsourcing, Inc.) during the year ended December 31, 2013. The net loss recognized from the sale of this business unit is \$190 and is included under other income / (expense) in the consolidated statements of income for the year ended December 31, 2013 included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Intangible Assets

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

	As of June 30, 2014	
Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

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Customer relationships	\$ 38,639	\$ (14,393)	\$ 24,246
Leasehold benefits	3,067	(1,639)	1,428
Developed technology	6,013	(1,844)	4,169
Non-compete agreements	1,316	(1,316)	
Trade names and trademarks	3,322	(2,018)	1,304
	\$ 52,357	\$ (21,210)	\$ 31,147

As of December 31, 2013

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	\$ 38,614	\$ (12,201)	\$ 26,413
Leasehold benefits	2,986	(1,455)	1,531
Developed technology	6,013	(1,458)	4,555
Non-compete agreements	1,316	(1,316)	
Trade names and trademarks	3,322	(1,706)	1,616
	\$ 52,251	\$ (18,136)	\$ 34,115

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)**

Amortization expense for the three months ended June 30, 2014 and 2013 was \$1,489 and \$1,596, respectively. Amortization expense for the six months ended June 30, 2014 and 2013 was \$3,025 and \$3,230, respectively. The weighted average life of intangible assets was 8.8 years for customer relationships, 6.8 years for leasehold benefits, 8.0 years for developed technology, 1.5 years for non-compete agreements and 3.5 years for trade names and trademarks excluding indefinite life trade names and trademarks. The Company had \$900 of indefinite lived trade names and trademarks as of June 30, 2014 and December 31, 2013.

Estimated amortization of intangible assets during the year ending**June 30,**

2015	\$ 5,554
2016	\$ 5,554
2017	\$ 5,547
2018	\$ 5,459
2019	\$ 5,400

6. Fair Value Measurements*Assets and Liabilities Measured at Fair Value*

The following table sets forth the Company's assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2014 and December 31, 2013. The table excludes short-term investments, accounts receivable, accounts payable and accrued expenses for which fair values approximate their carrying amounts.

As of June 30, 2014	Level 1	Level 2	Level 3	Total
Assets				
Money market and mutual funds	\$ 111,478	\$	\$	\$ 111,478
Derivative financial instruments		5,195		5,195
Total	\$ 111,478	\$ 5,195	\$	\$ 116,673
Liabilities				
Derivative financial instruments	\$	\$ 3,580	\$	\$ 3,580

Total	\$	\$ 3,580	\$	\$ 3,580
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As of December 31, 2013	Level 1	Level 2	Level 3	Total
Assets				
Money market and mutual funds	\$ 116,662	\$	\$	\$ 116,662
Derivative financial instruments		957		957
Total	\$ 116,662	\$ 957	\$	\$ 117,619
Liabilities				
Derivative financial instruments		13,295		\$ 13,295
Total	\$	\$ 13,295	\$	\$ 13,295

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 independent sources including highly rated financial institutions and are classified as Level 2. See Note 7 for further details on derivatives and hedge accounting.

7. Derivatives and Hedge Accounting

The Company uses derivative instruments and hedging transactions to mitigate exposure to 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. The Company's derivative financial instruments are largely forward foreign exchange contracts that are designated effective and that qualify as cash flow hedges under FASB Accounting Standard Codification(ASC) 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

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)**

liabilities denominated in currencies other than the functional currencies of various subsidiaries of the Company (fair value hedges). The Company s primary exchange rate exposure is with the Indian Rupee, the U.K. pound sterling and the Philippine peso. The Company also has exposure to the Czech koruna and other local currencies in which it operates.

The Company had outstanding foreign exchange contracts totaling \$298,135 and GBP 10,350 as of June 30, 2014 and \$262,085 and GBP 10,973 as of December 31, 2013. The Company estimates that approximately \$318 of net derivative losses included in accumulated other comprehensive loss (AOCI) could be reclassified into earnings within the next twelve months based on exchange rates prevailing as of June 30, 2014. As of June 30, 2014, the maximum outstanding term of derivative instruments that hedge forecasted transactions was forty-five months.

The Company evaluates the 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 loss. For hedging positions 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 such significant amounts of gains or losses were reclassified from AOCI into earnings during the three and six months ended June 30, 2014 and 2013.

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

Derivatives designated as hedging instruments

	June 30, 2014	December 31, 2013
Other current assets:		
Foreign currency exchange contracts	\$ 2,002	\$ 437
Other assets:		
Foreign currency exchange contracts	\$ 3,153	\$ 423
Accrued expenses and other current liabilities:		
Foreign currency exchange contracts	\$ 2,320	\$ 7,689
Other non current liabilities:		
Foreign currency exchange contracts	\$ 1,260	\$ 5,606

Derivatives not designated as hedging instruments:

	June 30, 2014	December 31, 2013
Other current assets:		
Foreign currency exchange contracts	\$ 40	\$ 97

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(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 June 30, 2014 and 2013:

Derivatives in Cash Flow	Amount of Gain/(Loss) Recognized in AOCI on Derivative (Effective Portion)		Location of Gain/(Loss) Recognized 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 Derivatives (Ineffective Portion) and Amount Excluded from Effectiveness Testing	Amount of Gain/(Loss) Recognized in Income on Derivatives (Ineffective Portion) and Amount Excluded from Effectiveness Testing	
	2014	2013		2014	2013		2014	2013
Foreign exchange contracts	\$ 2,542	\$ (11,049)	Foreign exchange loss	\$ (2,205)	\$ (1,144)	Foreign exchange loss	\$	\$

Derivatives not designated as Hedging Instruments	Amount of Gain/(Loss) Recognized in Income on Derivatives	
	2014	2013
Foreign exchange contracts	\$ 732	\$ (4,837)

The following tables set forth the effect of foreign currency exchange contracts on the unaudited consolidated statements of income for the six months ended June 30, 2014 and 2013:

Derivatives in Cash Flow	Amount of Gain/(Loss) Recognized in AOCI on Derivative (Effective Portion)		Location of Gain/(Loss) Recognized 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 Derivatives (Ineffective Portion) and Amount Excluded from Effectiveness Testing	Amount of Gain/(Loss) Recognized in Income on Derivatives (Ineffective Portion) and Amount Excluded from Effectiveness Testing	
	2014	2013		2014	2013		2014	2013
Foreign exchange contracts	\$ 9,552	\$ (8,976)	Foreign exchange loss	\$ (4,458)	\$ (2,498)	Foreign exchange loss	\$	\$

Derivatives not designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain/(Loss) Recognized in Income on Derivatives	
		2014	2013
Foreign exchange contracts	Foreign exchange loss	\$ 3,451	\$ (2,539)

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)****8. Fixed Assets**

Fixed assets consist of the following:

	June 30, 2014	December 31, 2013
Owned Assets:		
Network equipment, computers and software	\$ 79,533	\$ 63,428
Buildings	1,322	1,287
Land	865	842
Leasehold improvements	26,195	24,382
Office furniture and equipment	12,730	11,111
Motor vehicles	603	507
Capital work in progress	4,174	715
	125,422	102,272
Less: Accumulated depreciation and amortization	(80,553)	(69,242)
	\$ 44,869	\$ 33,030
Assets under capital leases:		
Network equipment, computers and software	\$	\$ 184
Leasehold improvements	2,003	1,955
Office furniture and equipment	995	1,079
Motor vehicles	875	934
	3,873	4,152
Less: Accumulated depreciation and amortization	(2,764)	(2,618)
	\$ 1,109	\$ 1,534
Fixed assets, net	\$ 45,978	\$ 34,564

Depreciation and amortization expense excluding amortization of acquisition-related intangibles for the three months ended June 30, 2014 and 2013 was \$5,190 and \$4,766, respectively, and \$10,010 and \$9,644 for the six months ended June 30, 2014 and 2013, respectively.

Capital work in progress represents advances paid toward acquisitions 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 outstanding.

During the three months ended June 30, 2014 and June 30, 2013, the Company did not acquire any shares of common stock from employees in connection with withholding tax payments related to the vesting of restricted stock.

During the six months ended June 30, 2014 and June 30, 2013, the Company acquired 18,256 and 13,018 shares of common stock, respectively, from employees in connection with withholding tax payments related to the vesting of restricted stock for a total consideration of \$459 and \$389. The weighted average purchase price of \$25.14 and \$29.89, respectively, 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. The shares acquired are held as treasury stock.

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)****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 June 30, Six months ended June 30,			
	2014	2013	2014	2013
Service cost	\$ 350	\$ 293	\$ 728	\$ 601
Interest cost	121	115	260	236
Expected return on plan assets	(44)	(42)	(87)	(87)
Actuarial loss	33	36	70	74
Net gratuity cost	\$ 460	\$ 402	\$ 971	\$ 824

The gratuity plans in India are partially funded and are managed and administered by Life Insurance Corporation of India and HDFC Standard Life Insurance Company. These entities calculate the annual contribution required to be made by the Company and manage the gratuity plans, including any required payouts. Fund managers manage these funds on a cash accumulation basis and declare interest retrospectively on March 31st of each year. The Company earned a return of approximately 9.0% on these gratuity plans for the year ended March 31, 2014.

Change in Plan Assets

Plan assets at January 1, 2014	\$ 2,156
Actual return	99
Actuarial gain	
Effect of exchange rate changes	59

Plan assets at June 30, 2014	\$ 2,314
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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 provisions for contributions to the 401(k) Plan amounting to \$342 and \$354 during the three month periods ended June 30, 2014 and June 30, 2013, respectively, and \$845 and \$973 during the six month periods ended June 30, 2014 and June 30, 2013, respectively.

During the three and six month periods ended June 30, 2014 and 2013, 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 June 30, 2014	\$ 1,463
Three months ended June 30, 2013	\$ 1,413
Six months ended June 30, 2014	\$ 2,861
Six months ended June 30, 2013	\$ 2,860

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)****11. Leases**

The Company finances its use of certain 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 June 30, 2014 are as follows:

Year ending June 30,	
2015	\$ 1,207
2016	894
2017	137
2018	8
Total minimum lease payments	2,246
Less: amount representing interest	211
Present value of minimum lease payments	2,035
Less: current portion	1,058
Long term capital lease obligation	\$ 977

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 agreements expiring after June 30, 2014 are set forth below:

Year ending June 30,	
2015	\$ 9,959
2016	8,518
2017	2,771
2018	1,730
2019	1,517
2020 and thereafter	254

\$ 24,749

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 non-cancelable lease period determined under ASC 840. Rent expense under both cancelable and non-cancelable operating leases was \$4,775 and \$4,448 for the three months ended June 30, 2014 and 2013, respectively, and \$9,256 and \$8,785 for the six months ended June 30, 2014 and 2013, respectively. Deferred rent as of June 30, 2014 and December 31, 2013 was \$6,431 and \$5,394, respectively, and is included under Accrued expenses and other current liabilities and Non-current liabilities in the consolidated balance sheets.

12. Income Taxes

The Company determines the tax provision for interim periods using an estimate of annual effective tax rate adjusted for discrete items, if any, that are taken into account in the relevant period. Each quarter, the Company updates its estimate of the annual effective tax rate, and if its estimated tax rate changes, the Company makes a cumulative adjustment.

The Company recorded an income tax benefit of \$944 and an income tax expense of \$3,615 for the three months ended June 30, 2014 and 2013, respectively. Income tax expense for the six months ended June 30, 2014 and 2013 was \$3,521 and \$6,612, respectively. The effective rate of taxes decreased from 28.1% during the three months ended June 30, 2013 to a negative 13.8% during the three months ended June 30, 2014. The effective rate of taxes decreased from 25.8% during the six months ended June 30, 2013 to 15.7% during the six months ended June 30, 2014. The decrease in effective tax rate was primarily due to reversal of an unrecognized tax benefit of \$2,173 and lower income in the U.S. due to reimbursement of disentanglement costs to The Travelers Indemnity Company (refer to Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations for further details).

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The following table summarizes the activity related to the gross unrecognized tax benefits from January 1, 2014 through June 30, 2014:

Balance as of January 1, 2014	\$ 4,913
Increases related to prior year tax positions	
Decreases related to prior year tax positions	(2,173)
Increases related to current year tax positions	
Decreases related to current year tax positions	
Effect of exchange rate changes	105
Balance as of June 30, 2014	\$ 2,845

The unrecognized tax benefits as of June 30, 2014 of \$2,845, if recognized, would impact the effective tax rate.

During the three months ended June 30, 2014 and June 30, 2013, the Company has recognized interest of \$55 and \$56 respectively, which is included in the income tax provision in the unaudited consolidated statements of income. As of June 30, 2014 and December 31, 2013, the Company has accrued approximately \$994 and \$863, respectively, in interest relating to unrecognized tax benefits.

The unrecognized tax benefits may increase or decrease in the next twelve months depending on the Company's tax position.

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 June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Cost of revenue	\$ 447	\$ 529	\$ 1,460	\$ 1,398
General and administrative expenses	787	1,265	2,301	2,816
Selling and marketing expenses	733	1,066	2,381	2,291

Total \$ 1,967 \$ 2,860 \$ 6,142 \$ 6,505

Stock Options

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:

	Six months ended June 30,	
	2014	2013
Dividend yield	0%	0%
Expected life (years)	5.50	5.50
Risk free interest rate	1.84%	0.87%
Volatility	35%	40%

The estimated expected term of options granted has been based on historical experience, 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

Table of Contents**EXLSERVICE HOLDINGS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****June 30, 2014****(Unaudited)****(In thousands, except share and per share amounts)**

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.

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, 2013	1,956,515	\$ 16.25	\$ 22,255	5.55
Granted	9,794	27.62		
Exercised	(185,362)	15.18		
Forfeited/Expired	(77,750)	24.72		
Outstanding at June 30, 2014	1,703,197	\$ 16.04	\$ 23,136	5.05
Vested and exercisable at June 30, 2014	1,360,044	\$ 14.60	\$ 20,195	4.52
Available for grant at June 30, 2014	1,472,884			

The unrecognized compensation cost for unvested options as of June 30, 2014 was \$1,448, which is expected to be expensed over a weighted average period of 1.38 years. The Company did not issue any options during the three months ended June 30, 2014 and 2013. The weighted-average fair value of options granted during the six months ended June 30, 2014 and 2013 was \$9.77 and \$10.07, respectively. The total grant date fair value of options vested during the three months ended June 30, 2014 and 2013 was \$33 and \$205, respectively. The total grant date fair value of options vested during the six months ended June 30, 2014 and 2013 was \$1,224 and \$2,324 respectively.

Restricted Stock Units

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

	Restricted Stock Units	
	Number	Weighted-Avg Fair Value
Outstanding at December 31, 2013*	1,144,442	\$ 24.95
Granted	427,087	25.75
Vested	(406,910)	21.81
Forfeited	(103,316)	26.40
Outstanding at June 30, 2014*	1,061,303	\$ 26.36

* Excludes 124,000 and 112,000 vested restricted stock units as of June 30, 2014 and December 31, 2013, respectively, for which the underlying common stock is yet to be issued.

As of June 30, 2014, unrecognized compensation cost of \$22,831 is expected to be expensed over a weighted average period of 2.66 years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2014

(Unaudited)

(In thousands, except share and per share amounts)

Performance Based Stock Awards

On February 13, 2014, the Compensation Committee of the Board of Directors of the Company approved the program of performance based grant of restricted stock units (PRSUs) for executive officers and other specified employees under its existing 2006 Omnibus Award Plan.

Under this program, the PRSUs will cliff vest at the end of a three-year period based on satisfaction of dual performance criteria: 50% of the PRSUs shall be based on a total revenue performance condition (PUs) measured on a cumulative basis over a three-year performance period and the other 50% shall be based on a market condition (MUs) that is contingent on meeting or exceeding the total shareholder return relative to a group of peer companies specified under the program, measured over a three-year performance period. In addition, up to one-third of the PUs may be earned based on the Company's revenue performance in each of 2014 and 2015 against revenue targets in those years. The ultimate amount of PUs that the recipient earns, will be the greater of (x) the PUs earned in 2016 and (y) the sum of the earned PUs in 2014 and 2015. The award recipient may earn up to two hundred percent (200%) of the target based on the actual performance for both kinds of PRSUs.

The fair value of each PU was determined based on the market price of one common share of the Company on the date of grant, and assumes that performance targets will be achieved. The compensation expense for the PUs is recognized on a straight-line basis over the vesting terms. Over the performance period, the number of shares that will be issued will be adjusted upward or downward based upon the probability of achievement of the performance targets. The ultimate number of shares issued and the related compensation cost recognized as an expense will be based on a comparison of the final performance metrics to the specified targets.

The grant date fair value for the MUs was determined using a Monte Carlo simulation model and will be expensed on a straight-line basis over the vesting period. All compensation expense related to the MUs will be recognized if the requisite performance period is fulfilled, even if the market condition is not achieved.

The Monte-Carlo simulation model simulates a range of possible future stock prices and estimates the probabilities of the potential payouts. This model also incorporates the following ranges of assumptions:

The historical volatilities are used over the most recent three-year period for the components of the peer group.

The risk-free interest rate is based on the U.S. Treasury rate assumption commensurate with the three-year performance period.

Since the plan stipulates that the awards are based upon the TSR of the Company and the components of the peer group, it is assumed that the dividends get reinvested in the issuing entity on a continuous basis.

The correlation coefficients are used to model the way in which each entity tends to move in relation to each other are based upon the price data used to calculate the historical volatilities.

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

	Revenue Based PRSU s		Market Condition Based PRSU s	
	Number	Weighted Avg Fair Value	Number	Weighted Avg Fair Value
Outstanding at Dec 31, 2013		\$		\$
Granted	55,475	25.63	55,475	33.60
Vested				
Forfeited	(7,750)	25.63	(7,750)	33.60
Outstanding at June 30, 2014	47,725	\$ 25.63	47,725	\$ 33.60

As of June 30, 2014, unrecognized compensation cost of \$2,509 was expected to be expensed over a weighted average period of 2.51 years.

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	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Revenues				
United States	\$ 87,888	\$ 84,638	\$ 178,301	\$ 167,774
United Kingdom	24,734	23,088	48,155	47,186
Rest of World	7,116	8,282	15,079	17,054
	\$ 119,738	\$ 116,008	\$ 241,535	\$ 232,014

June 30, December 31,