ExlService Holdings, Inc.
Form 10-Q
November 09, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009

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	**82-0572194**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
350 PARK AVENUE, NEW YORK, NEW YORK	**10022**
(Address of principal executive offices)	**(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 x 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	x
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 x

As of October 31, 2009, there were 28,957,823 shares of the registrant s common stock outstanding (excluding 247,030 shares held in treasury and 391,184 shares of restricted stock), par value $0.001 per share.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EXLSERVICE HOLDINGS, INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share and per share amounts)

	September 30, 2009	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 117,510	$ 112,174
Short-term investments	816	153
Restricted cash	1,311	203
Accounts receivable, net of allowance for doubtful accounts of $259 at September 30, 2009 and $128 at December 31, 2008	31,578	33,714
Deferred tax assets	4,490	3,401
Advance income-tax, net	101	2,033
Prepaid expenses and other current assets	3,546	6,199
Total current assets	159,352	157,877
Fixed assets, net of accumulated depreciation of $35,787 at September 30, 2009 and $27,727 at December 31, 2008	22,702	24,518
Goodwill	19,595	17,557
Intangible assets	710	
Restricted cash	3,744	281
Deferred tax assets, net	7,735	3,047
Other assets	10,500	8,689
Total assets	$ 224,338	$ 211,969
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,254	$ 3,371
Deferred revenue	3,379	2,961
Accrued employee cost	12,176	14,725
Accrued expenses and other current liabilities	12,157	18,011
Total current liabilities	29,966	39,068
Non-current liabilities	3,433	1,569
Total liabilities	33,399	40,637
Commitments and contingencies		
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, 29,179,013 shares issued and outstanding as of September 30, 2009 and 29,054,145 shares issued and outstanding as of December 31, 2008	29	29
Additional paid-in capital	122,308	116,676
Retained earnings	78,150	70,021
Accumulated other comprehensive loss	(8,572)	(14,491)
	191,915	172,235
Less: 247,030 shares as of September 30, 2009 and 237,080 shares as of December 31, 2008, held in treasury, at cost	(976)	(903)
Total stockholders equity	190,939	171,332
Total liabilities and stockholders equity	$ 224,338	$ 211,969

See accompanying notes

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EXLSERVICE HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except share and per share amounts)

	Three months ended September 30, 2009	Three months ended September 30, 2008	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Revenues	$ 48,186	$ 46,573	$ 131,557	$ 138,019
Cost of revenues (exclusive of depreciation and amortization)	28,803	28,046	78,986	86,902
Gross profit	19,383	18,527	52,571	51,117
Operating expenses:				
General and administrative expenses	7,770	7,349	22,137	24,193
Selling and marketing expenses	3,516	3,081	10,040	8,366
Depreciation and amortization	2,918	2,832	8,137	8,302
Total operating expenses	14,204	13,262	40,314	40,861
Income from continuing operations	5,179	5,265	12,257	10,256
Other income/(expense):				
Foreign exchange gain/(loss)	(1,995)	(6,637)	(5,014)	(5,847)
Interest and other income, net	269	1,157	856	2,294
Income/(loss) from continuing operations before income taxes	3,453	(215)	8,099	6,703
Income tax provision/(benefit)	(541)	(589)	(169)	(984)
Income from continuing operations	3,994	374	8,268	7,687
Income/(loss) from discontinued operations, net of taxes		(1,449)	(139)	3,302
Net income/(loss) to common stockholders	$ 3,994	$ (1,075)	$ 8,129	$ 10,989
Earnings/(loss) per share (a):				
Basic:				
Continuing operations	$ 0.14	$ 0.01	$ 0.29	$ 0.27
Discontinued operations		(0.05)		0.11
	$ 0.14	$ (0.04)	$ 0.28	$ 0.38
Diluted:				
Continuing operations	$ 0.14	$ 0.01	$ 0.28	$ 0.26
Discontinued operations		(0.05)		0.11
	$ 0.14	$ (0.04)	$ 0.28	$ 0.38
Weighted-average number of shares used in computing earnings per share:				
Basic	28,930,344	28,846,137	28,893,515	28,801,102
Diluted	29,368,390	29,127,304	29,202,856	29,257,254

(a) Per share amounts may not foot due to rounding.

See accompanying notes

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EXLSERVICE HOLDINGS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOW

(Unaudited)

(In thousands)

	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Cash flows from operating activities:		
Net income	$ 8,129	$ 10,989
(Income)/loss from discontinued operations, net of taxes	139	(3,302)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,137	8,302
Share-based compensation expense	5,389	4,426
Non employee stock options	110	193
Unrealized foreign exchange (gain)/loss	(981)	4,921
Deferred income taxes	(6,749)	242
Excess tax benefit from stock-based compensation		(28)
Change in operating assets and liabilities (net of effect of acquisitions):		
Restricted cash	(4,458)	(40)
Accounts receivable	3,040	(4,046)
Prepaid expenses and other current assets	1,754	(266)
Accounts payable	472	(1,726)
Deferred revenue	1,749	(2,272)
Accrued employee cost	(2,584)	158
Accrued expenses and other current liabilities	(321)	2,024
Income taxes payable	1,764	(2,160)
Other assets and liabilities	669	(3,061)
Net cash provided by operating activities - continuing operations	16,259	14,354
Net cash provided by operating activities - discontinued operations		4,064
Net cash provided by operating activities	16,259	18,418
Cash flows from investing activities:		
Purchase of fixed assets	(9,186)	(12,816)
Business acquisition	(3,505)	(1,949)
Purchase of short-term investments	(816)	
Proceeds from redemption of short-term investments	153	
Proceeds from sale of discontinued operations	1,448	911
Net cash used for investing activities - continuing operations	(11,906)	(13,854)
Net cash used for investing activities - discontinued operations		(40)
Net cash used for investing activities	(11,906)	(13,894)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(80)	(62)
Proceeds from exercise of stock options	193	385

Excess tax benefit from stock-based compensation		28
Acquisition of treasury stock	(73)	(238)
Net cash provided by financing activities	40	113
Effect of exchange rate changes on cash and cash equivalents	943	(5,094)
Net increase/(decrease) in cash and cash equivalents	5,336	(457)
Cash and cash equivalents, beginning of period (includes $804 at January 1, 2008 for discontinued operations)	112,174	102,210
Less cash and equivalents of discontinued operations, end of period		
Cash and equivalents of continuing operations, end of period	$ 117,510	$ 101,753

See accompanying notes

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2009

(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 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 and with 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, 2008.

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 these periods. The 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.

Certain prior period amounts have been reclassified in the unaudited consolidated financial statements to conform to the 2009 presentation. These reclassifications reflect the presentation of discontinued operations of Noida Customer Operations Private Limited (NCOP), previously included in the Outsourcing Services segment. On August 11, 2008, the Company completed the sale of all of its shares of NCOP to Aviva Global Services Singapore Pte Ltd (AGSS). See Note 17 on Discontinued Operations.

2. Summary of Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

The preparation of the 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 consolidated financial statements and the 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 accounts, future obligations under employee benefit plans, income tax valuation allowances and tax reserves, stock-based compensation expense, depreciation and amortization periods, recoverability of long-term assets including goodwill and intangibles, and estimates to complete fixed price contracts.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued FAS 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, which was principally codified into Accounting Standards Codification (ASC) 105 Generally Accepted Accounting Standards. This standard will become the single source of authoritative nongovernmental U.S. generally accepted accounting principles. All existing accounting standard documents will be superseded and all other accounting literature not included in the FASB Codification will be considered non-authoritative. This guidance is effective for interim and annual periods ending after September 15, 2009. As ASC 105 was not intended to change existing accounting guidance, its adoption did not have an impact on the Company s consolidated financial statements.

In December 2007, the FASB issued new accounting guidance for business combinations. The new accounting guidance changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition-related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. The Company acquired a 100% stake in Schneider Logistics Europe S.R.O. on July 3, 2009. The acquisition was accounted for in accordance with this new accounting guidance. See Note 5 on Business Combinations, Goodwill and Intangibles Assets.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(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 and diluted earnings per share is computed by using the weighted average number of common shares plus the potentially dilutive effect of stock options, restricted stock and restricted stock units issued and outstanding at the reporting date. Stock options, restricted stock and restricted stock units that are anti-dilutive are excluded from the computation of weighted average shares outstanding.

For the three months ended September 30, 2009 and 2008, the weighted average number of shares used in calculating the diluted earnings per share includes stock options, restricted stock and restricted stock units aggregating 438,046 shares and 281,167 shares, respectively. For the nine months ended September 30, 2009 and 2008, the weighted average number of shares used in calculating diluted earnings per share includes stock options, restricted stock and restricted stock units aggregating 309,341 shares and 456,152 shares, respectively.

The calculation of earnings per share for the three months ended September 30, 2009 and 2008 excludes stock options, restricted stock and restricted stock units aggregating 1,380,775 shares and 1,910,548 shares, respectively, as their effect would have been anti-dilutive.

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, 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 September 30, 2009 and 2008 for Outsourcing Services and Transformation Services segments, respectively, are as follows:

	Three months ended September 30, 2009			Three months ended September 30, 2008		
	Outsourcing Services	**Transformation Services**	**Total**	**Outsourcing Services**	**Transformation Services**	**Total**
Revenues	$ 37,673	$ 10,513	$ 48,186	$ 34,537	$ 12,036	$ 46,573
Cost of revenues (exclusive of depreciation and amortization)	22,230	6,573	28,803	20,633	7,413	28,046
Gross profit	$ 15,443	$ 3,940	$ 19,383	$ 13,904	$ 4,623	$ 18,527
Operating expenses			$ 14,204			$ 13,262
Other income/(expense)			(1,726)			(5,480)
Income tax provision/(benefit)			(541)			(589)
Income from continuing operations			$ 3,994			$ 374
Income/(loss) from discontinued operations, net of taxes of $0 and $1,993						(1,449)

Net income/(loss) to common stockholders	$ 3,994	$ (1,075)

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

(In thousands, except share and per share amounts)

Revenues and cost of revenues for each of the nine months ended September 30, 2009 and 2008 for Outsourcing Services and Transformation Services segments, respectively, are as follows:

	Nine months ended September 30, 2009			Nine months ended September 30, 2008		
	Outsourcing Services	Transformation Services	Total	Outsourcing Services	Transformation Services	Total
Revenues	$ 105,573	$ 25,984	$ 131,557	$ 105,598	$ 32,421	$ 138,019
Cost of revenues (exclusive of depreciation and amortization)	60,549	18,437	78,986	66,510	20,392	86,902
Gross profit	$ 45,024	$ 7,547	$ 52,571	$ 39,088	$ 12,029	$ 51,117
Operating expenses			$ 40,314			$ 40,861
Other income/(expense)			(4,158)			(3,553)
Income tax provision/(benefit)			(169)			(984)
Income from continuing operations			$ 8,268			$ 7,687
Income/(loss) from discontinued operations, net of taxes of ($41) and $3,449			(139)			3,302
Net income to common stockholders			$ 8,129			$ 10,989

5. Business Combinations, Goodwill and Intangible Assets

On July 3, 2009, the Company acquired a 100% stake in Schneider Logistics Europe S.R.O. (Schneider SRO), which is located in Olomouc, the Czech Republic, for a cash consideration of approximately $3,505 (net of cash acquired of $942), including post-closing adjustments. Schneider SRO provides complex transaction processing services to its clients in Europe and the U.S. The acquisition provides the Company with multi-lingual delivery capabilities and a cost effective delivery location in Eastern Europe.

The Company made an allocation of the purchase price to the tangible and intangible assets and liabilities acquired, based on their fair values, including approximately $2,038 to non-tax deductible goodwill and $794 to intangible assets (principally customer relationships). The intangible assets are being amortized over a life of 3 years. The Company recognized acquisition related costs of approximately $150 related to this transaction and are included in the general and administrative expenses in the unaudited consolidated statements of income.

Following are details of the Company s goodwill balance as of September 30, 2009:

Goodwill:

	Outsourcing Services	Transformation Services	Total

Balance at January 1, 2009	$ 772	$ 16,785	$ 17,557
Goodwill arising from acquisition	2,038		2,038
Balance at September 30, 2009	$ 2,810	$ 16,785	$ 19,595

Goodwill represents the cost of the acquired businesses in excess of the fair value of identifiable tangible and intangible net assets purchased. Goodwill is not amortized but is tested for impairment at least on an annual basis, relying on a number of factors including operating results, business plans and future cash flows. Recoverability of goodwill is evaluated using a two-step process. The first step involves a comparison of the fair value of a reporting unit with its carrying value. The fair value of the reporting unit is measured by discounting estimated future cash flows. If the carrying amount of the reporting unit exceeds its fair value, the second step of the process involves a comparison of the fair value and carrying value of the goodwill of that reporting unit. If the carrying value of the goodwill of a reporting unit exceeds the fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess. Goodwill of a reporting unit will be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

(In thousands, except share and per share amounts)

Intangible Assets

Information regarding the Company s intangible assets is as follows:

	As of September 30, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	$ 794	$ 84	$ 710
	$ 794	$ 84	$ 710

	As of December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trademarks	$ 330	$ (330)	$
Customer relationships	1,554	(1,554)	
Non-compete agreements	1,460	(1,460)	
	$ 3,344	$ (3,344)	$

Amortization expense for the three months ended September 30, 2009 and September 30, 2008 was $84 and $51, respectively. Amortization expense for the nine months ended September 30, 2009 and September 30, 2008 was $84 and $483, respectively. The estimated amortization of intangible assets for the years ending September 30, 2010, 2011 and 2012 is $332, $276 and $102, respectively.

6. Fair Value Measurements

ASC No. 820, *Fair Value Measurements and Disclosures* (ASC No. 820) defines fair value as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk, including the Company s own credit risk.

ASC No. 820 establishes a three-level hierarchy of fair value measurements based on whether the inputs to those measurements are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s market assumptions. The fair-value hierarchy requires the use of observable market data when available and consists of the following levels:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets; and

Level 3 Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

The following table sets forth the Company s assets and liabilities that were accounted for at fair value as of September 30, 2009. The table excludes short-term investments, accounts receivable, accounts payable and accrued expenses for which fair values approximate their carrying amounts.

Assets and Liabilities Measured at Fair Value

	Level 1	Level 2	Level 3	Total
Assets				
Money market and mutual funds	$ 103,873	$	$	$ 103,873
Derivative financial instruments		252		252
Total	$ 103,873	$ 252	$	$ 104,125
Liabilities				
Derivative financial instruments	$	$ 1,665	$	$ 1,665

Derivative Financial Instrument: 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 on Derivative Financial Instruments.

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(Unaudited)

(In thousands, except share and per share amounts)

7. Derivative Financial Instruments

In the normal course of business, the Company actively looks to mitigate the exposure of foreign currency market risk by entering into various hedging instruments, authorized under Company policies, with counterparties that are highly rated financial institutions. The Company s primary exchange rate exposure is to the U.K. pound sterling and the Indian rupee. 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.

The Company hedges anticipated transactions that are subject to foreign exchange exposure with foreign currency exchange contracts that are designated effective and that qualify as cash flow hedges under ASC No. 815, *Derivatives and Hedging* (ASC No. 815). Changes in the fair value of these cash flow hedges which are deemed effective, are recorded in accumulated other comprehensive income/(loss) (AOCI) until the hedged transactions occur and at that time are recognized in the unaudited consolidated statements of income. Changes in the fair value of cash flow hedges deemed ineffective are recognized in the unaudited consolidated statement of income and are included in foreign exchange gain/(loss).

The Company also uses derivatives consisting of foreign currency exchange contracts not designated as hedging instruments under ASC No. 815 to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the functional currency. Changes in the fair value of these derivatives are recognized in the unaudited consolidated statements of income and are included in foreign exchange gain/(loss).

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/(loss). 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 for the three and nine months ended September 30, 2009. For the three and nine months ended September 30, 2008, ($1,281) were reclassified from AOCI into earnings because it was not probable that the forecasted transaction would occur.

The Company had outstanding foreign exchange contracts totaling $96,939 and GBP 12,511 as of September 30, 2009 and totaling $110,182 and GBP 30,320 as of December 31, 2008. The Company estimates that approximately $1,667 of net derivative losses included in AOCI could be reclassified into earnings within the next 12 months based on exchange rates prevailing as of September 30, 2009. At September 30, 2009, the maximum outstanding term of derivative instruments that hedge forecasted transactions was 27 months.

The following tables set forth the fair value of derivative instruments included in the unaudited consolidated balance sheets as on September 30, 2009 and December 31, 2008:

Derivatives designated as hedging instruments:

	September 30, 2009	December 31, 2008
Accrued expense and other current liabilities:		
Foreign currency exchange contracts	$ 1,665	$ 5,411

Non-current liabilities:		
Foreign currency exchange contracts	$	$ 770
Other assets:		
Foreign currency exchange contracts	$ 210	$

Derivatives not designated as hedging instruments:

	September 30, 2009	December 31, 2008
Prepaid and other current assets:		
Foreign currency exchange contracts	$ 42	$
Accrued expense and other current liabilities:		
Foreign currency exchange contracts	$	$ 223

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EXLSERVICE HOLDINGS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2009

(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 September 30, 2009 and 2008:

Derivatives in Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in AOCI on Derivative (Effective Portion)		Location of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion)		Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	2009	2008		2009	2008		2009	2008
Foreign exchange contracts	$ 278	$ (351)	Foreign exchange gain/(loss)	$ (2,241)	$ (1,833)	Foreign exchange gain/(loss)	$	$ (2,358)

Derivatives not Designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain or (Loss) Recognized in Income on Derivatives	
		2009	2008
Foreign exchange contracts	Foreign exchange gain/(loss)	$ 513	$

The following tables set forth the effect of foreign currency exchange contracts on the unaudited consolidated statements of income for the nine months ended September 30, 2009 and 2008:

Derivatives in Cash Flow Hedging Relationships	Amount of Gain or (Loss) Recognized in AOCI on Derivative (Effective Portion)	Location of Gain or (Loss) Reclassified from AOCI into Income	Amount of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative	Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)

			(Effective Portion)			(Ineffective Portion and Amount Excluded from Effectiveness Testing)		
	2009	2008		2009	2008		2009	2008
Foreign exchange contracts	$ (649)	$ (16,447)	Foreign exchange gain/(loss)	$ (5,473)	$ 806	Foreign exchange gain/(loss)	$ (118)	$ (2,189)

Derivatives not Designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain or (Loss) Recognized in Income on Derivatives 2009	2008
Foreign exchange contracts	Foreign exchange gain/(loss)	$ (542)	$

8. Comprehensive Income/(Loss):

The following table sets forth the components of comprehensive income/(loss) for the three and nine months ended September 30, 2009 and 2008:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Net income/(loss) available to common stockholders	$ 3,994	$ (1,075)	$ 8,129	$ 10,989
Other comprehensive income/(loss):				
Unrealized gain/(loss) on effective cash flow hedges	2,519	1,482	4,824	(17,253)
Foreign currency translation adjustment	6	(4,339)	1,041	(8,389)
Retirement benefits	20	(33)	54	(83)
Total other comprehensive income/(loss)	2,545	(2,890)	5,919	(25,725)
Total comprehensive income/(loss)	$ 6,539	$ (3,965)	$ 14,048	$ (14,736)

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(In thousands, except share and per share amounts)

9. Capital Structure

The Company has one class of common stock.

During the three months ended September 30, 2009, 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 nine months ended September 30, 2009, the Company acquired 4,329 shares of common stock from employees in connection with withholding tax payments related to the vesting of restricted stock for a total consideration of $39. The purchase price of $9.08 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 September 30, 2009, the Company did not purchase any shares of its common stock as part of its previously announced share repurchase program. During the nine months ended September 30, 2009, the Company purchased 5,621 shares of its common stock for an aggregate purchase price of approximately $34, excluding commissions, representing an average purchase price per share of $6.11. These shares were purchased as part of the share repurchase program that authorized the purchase of up to $10,000 of the Company s outstanding common stock on or prior to November 2009. Repurchased shares have been recorded as treasury shares and will be held until the Company s board of directors designates that these shares be retired or used for other purposes.

10. Employee Benefit Plans

The Company s Gratuity Plan applicable to India-based employees provides 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 Plan are determined by actuarial valuation. Current service costs for the Gratuity Plan are accrued in the year to which they relate.

Net gratuity cost includes the following components:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Service cost	$ 67	$ 68	$ 199	$ 217
Interest cost	28	26	84	73
Actuarial loss	20		54	
Net gratuity cost	$ 115	$ 94	$ 337	$ 290

The Company maintains the Exl Service Inc. 401(k) Plan and the Inductis 401(k) Profit Sharing Plan, (the 401(k) Plans) under Section 401(k) of the Internal Revenue Code 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 s contribution to the 401(k) Plans amounted to $78 and $70 during the three months ended September 30, 2009 and 2008, respectively and $155 and $263 during the nine months ended September 30, 2009 and 2008, respectively.

The Company contributes to various defined contribution plans on behalf of its employees in India, Philippines and the Czech Republic. The assets held by the plans are not reported on the Company s balance sheet. The contributions made to the plans for each period are as follows:

Three months ended September 30, 2009	$ 715
Three months ended September 30, 2008	$ 465
Nine months ended September 30, 2009	$ 1,642
Nine months ended September 30, 2008	$ 1,470

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11. Leases

The Company leases motor vehicles for some of its employees. Such leases are recorded as capital leases. Future minimum lease payments under these capital leases at September 30, 2009 are as follows:

Year ending September 30,	
2010	$ 152
2011	86
2012	6
Total minimum lease payments	244
Less: amount representing interest	19
Present value of minimum lease payments	225
Less: current portion	137
Long term capital lease obligation	$ 88

The Company conducts its operations using facilities leased under operating lease agreements that expire through February 2014. Future minimum lease payments under non-cancelable operating lease agreements expiring after more than twelve months are as follows:

Year ending September 30,	
2010	$ 2,953
2011	2,741
2012	1,074
2013	645
2014	302
Total minimum lease payments	$ 7,715

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 cancelable and non-cancelable operating leases was $1,567 and $1,236 for the three months ended September 30, 2009 and 2008, respectively. Rent expense under both cancelable and non-cancelable operating leases was $4,249 and $3,874 for the nine months ended September 30, 2009 and 2008, respectively.

12. Income Taxes

The Company recorded income tax expense/(benefit) of ($541) and ($589) for the three months ended September 30, 2009 and 2008, respectively. The Company recorded income tax expense/(benefit) of ($169) and ($984) for the nine months ended September 30, 2009 and 2008, respectively. The effective rate of taxes attributable to continuing operations was a tax benefit of 15.7% and 274.1% for the three months ended September 30, 2009 and 2008, respectively. The effective rate of taxes attributable to continuing operations was a tax benefit of 2.7% and 14.7% for the nine months ended September 30, 2009 and 2008, respectively.

Certain units of the Company s Indian subsidiaries qualify for an exemption from taxable income under section 10A or 10B of the Indian Income Tax Act because their profits are attributable to work performed in Export Processing Zones. This exemption is available for a period of ten consecutive years beginning with the financial year in which the entity begins to manufacture or produce eliglible goods and services. During the three months ended September 30, 2009, the Indian parliament effected amendments to the Indian Income Tax Act and extended the tax holiday for eligible units. However, due to uncertainty relating to the availability of the tax holiday period for some of its units, the Company created a reserve of $2,710 during the three months ended September 30, 2009. After the expiration of the tax holiday period for some of the units of the Company on April 1, 2010, any profits from such units will be fully taxable.

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 September 30, 2009, the Company performed an analysis of the deferred tax asset valuation allowance for certain units of its Indian subsidiaries. Previously, the Company believed that there was uncertainty relating to the possible extension of the tax holiday for certain units and accordingly determined that it was more likely than not that the Company s deferred tax assets were not going to be utilized due to the tax holiday and possible extension of that tax holiday. Accordingly, a full valuation allowance offsetting these deferred tax assets was recorded. Due to the recent amendments of the Indian Income Tax Act mentioned above, the Company released the valuation allowance relating to those units and recognized an income tax benefit of $3,689 in the unaudited consolidated statement of income for the three months ended September 30, 2009. The Company continues to record a valuation allowance on deferred tax assets pertaining to those units of the Company s subsidiaries for which the tax holiday period is definitively extended. The valuation allowance as of September 30, 2009 and December 31, 2008 was approximately $1,398 and $4,010, respectively.

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During 2007, the Indian government passed tax legislation that, among other items, subjects Indian taxpayers to a Minimum Alternative Tax (MAT). As of September 30, 2009 and December 31, 2008, deferred income taxes related to the MAT were approximately $3,409 and $2,109, 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* (ASC No. 740) as well as the related net interest. Tax exposures can involve complex issues and may require extended periods 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.

The following summarizes the activity related to the gross unrecognized tax benefits from January 1, 2009 through September 30, 2009:

Balance as of January 1, 2009	$
Increases related to prior year tax positions	
Decreases related to prior year tax positions	
Increases related to current year tax positions	2,710
Balance as of September 30, 2009	$ 2,710

The unrecognized tax benefits as of September 30, 2009 of $2,710, if recognized, would impact the effective tax rate.

The Company did not recognize any interest and penalties during the three and nine months ended September 2009. The unrecognized tax benefits may increase or decrease in the next 12 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 statement of income:

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Cost of revenue	$ 341	$ 396	$ 1,096	$ 983
General and administrative expenses	894	778	2,564	2,341
Selling and marketing expenses	641	377	1,729	1,102
Total	$ 1,876	$ 1,551	$ 5,389	$ 4,426

Effective April 1, 2007 the Indian government enacted a Fringe Benefit Tax (FBT) on equity compensation. In July 2009, the Indian government abolished the FBT effective April 1, 2009. The FBT was calculated on the difference between the fair market value as of the vesting date and the exercise price of the equity compensation awards granted to India-based employees. For the three months ended September 30, 2009 and 2008, the Company recorded FBT expense of approximately $0 and $18, respectively. For the nine months ended September 30, 2009 and 2008, the Company recorded FBT expense of approximately $179 and $218, respectively. The Company recovered FBT from its India-based employees, and such recovery was treated as an additional exercise price and was recorded as additional paid-in capital in the unaudited consolidated balance sheet. Since abolition of FBT results in a change in exercise price for its India-based employees, the Company has to re-compute the fair value of the outstanding stock options and restricted stock on the date of the modification. For the three and nine months ended September 30, 2009, the Company has recognized expense of approximately $301 as a result of such modification.

The fair value of each stock option granted to employees not subject to the FBT is estimated on the date of grant using the Black-Scholes option-pricing model and the fair value of each stock option granted to employees subject to the FBT was estimated at the date of grant using the Monte Carlo simulation model with the following weighted average assumptions:

	Three months ended September 30,		**Nine months ended September 30,**	
	2009	**2008**	**2009**	**2008**
Dividend yield	0%	0%	0%	0%
Expected life (years)	3.5	5.10	4.56	5.68
Risk free interest rate	1.68%	2.52%	1.73%	2.43%
Volatility	50%	38%	50%	39%

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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 stocks 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.

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, 2008	1,788,751	$ 14.67	$ 364	7.92
Granted	1,642,389	8.84		
Exercised	(2,064)	6.67		
Forfeited	(181,550)	18.61		
Outstanding at September 30, 2009	3,247,526	$ 11.50	$ 13,345	8.26
Vested and exercisable at September 30, 2009	853,847	$ 12.39	$ 2,636	6.52
Available for grant at September 30, 2009	4,245,327			

The unrecognized compensation cost for unvested options as of September 30, 2009 is $9,571 which is expected to be expensed over a weighted average period of 2.68 years. The weighted-average fair value of options granted during the three months ended September 30, 2009 and 2008 was $5.26 and $3.30, respectively. The weighted-average fair value of options granted during the nine months ended September 30, 2009 and 2008 was $3.48 and $6.54, respectively. The total fair value of shares vested during the three months ended September 30, 2009 is $574. The total fair value of shares vested during the nine months ended September 30, 2009 is $2,273.

Restricted Stock and Restricted Stock Units

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

	Restricted Stock		Restricted Stock Units	
	Number	Weighted-Average	Number	Weighted-Average

		Intrinsic Value		Intrinsic Value
Outstanding at December 31, 2008	578,246	$ 20.13	24,000	$ 10.26
Granted			8,000	10.17
Vested	(122,804)	16.80	(8,000)	17.34
Forfeited	(50,056)	18.98		
Outstanding at September 30, 2009	405,386	$ 21.28	24,000	$ 7.87

As of September 30, 2009, unrecognized compensation cost of $6,294 is expected to be expensed over a weighted average period of 1.98 years.

Client and Advisory Board Options

In connection with the execution of a five-year services agreement, the Company issued options to purchase 230,200 shares of common stock at an exercise price of $6.25 per share in July 2004 to one of its clients. The options are fully exercisable and expire ten years from the date of grant. The value of the options on the date of issuance, using the Black-Scholes option-pricing model, was approximately $1,792. Such amount is being amortized as a reduction in revenue over the five-year term of the services agreement which expired in March 2009. Amortization for the three months ended September 30, 2009 and 2008 was $0 and $90, respectively. Amortization for the nine months ended September 30, 2009 and 2008 was $60 and $269, respectively.

During the three months ended September 30, 2009 and 2008, the Company recorded compensation expense/(income) of $24 and ($26), respectively related to stock options granted to members of the Company s advisory board. For the nine months ended September 30, 2009 and 2008, the Company recorded compensation expense/(income) of $50 and ($75), respectively. The fair value and related compensation expense will be calculated for the unvested portion of these options at the end of each reporting period until such options are fully vested.

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14. Related Party Transactions

On January 15, 2008, the Company purchased net assets for a consideration of $1,508 from a company controlled by entities related to the Oak Hill Partnerships, one of the Company s significant stockholders. The Company recorded expenses of $0 and $394 for the nine months ended September 30, 2009 and 2008, respectively, for transition services performed by the seller prior to the acquisition. As of September 30, 2009 and December 31, 2008, the Company had no amounts payable related to these transactions.

The Company provides services to Duane Reade Holdings, Inc., a New York City drugstore chain. Duane Reade Holdings, Inc. is indirectly owned by entities related to the Oak Hill Partnerships, one of the Company s significant stockholders. The Company recognized revenue of approximately $167 and $219 during the three months ended September 30, 2009 and 2008, respectively, and $387 and $234 during the nine months ended September 30, 2009 and 2008, respectively, for fees and expense reimbursements from Duane Reade Holdings, Inc. At September 30, 2009 and December 31, 2008, the Company had an account receivable of $61 and $89, respectively, related to these services.

The Company provides services to Oak Hill Capital Partners, one of the Company s significant stockholders. The Company recognized revenue of approximately $12 and $0 during the three months ended September 30, 2009 and 2008, respectively, and $19 and $0 during the nine months ended September 30, 2009 and 2008, respectively, for fees and expense reimbursements from Oak Hill Capital Partners. At September 30, 2009 and December 31, 2008, the Company had an account receivable of $4 and $0, respectively, related to these services.

15. Geographical Information

	Three months ended September 30,