India I Equities

Technology
Company Update

Change in Estimates ☑ Target ☑ Reco☐

29 October 2020

Firstsource Solutions

Strong quarter supported by its mortgage business; Buy

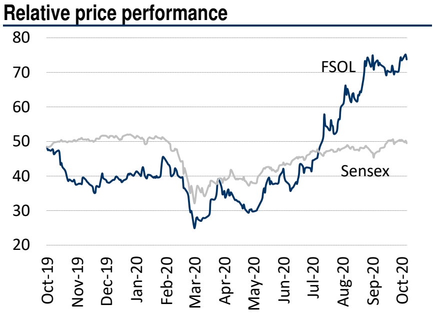
Rating: **Buy**
Target Price: Rs90
Share Price: Rs71

Key data	FSOL IN / FISO.BO
52-week high / low	Rs78 / 20
Sensex / Nifty	39922 / 11730
3-m average volume	$3.9m
Market cap	Rs51bn / $694m
Shares outstanding	695m

Shareholding pattern (%)	Sep'20	Jun'20	Mar'20
Promoters	53.8	53.9	53.7
- of which, Pledged			
Free float	46.2	46.1	46.3
- Foreign institutions	6.6	7.6	9.0
- Domestic institutions	14.5	13.2	12.8
- Public	25.1	25.4	24.5

Estimates revision (%)	FY21e	FY22e
Sales ($)	5.0	3.8
EBIT	5.1	2.5
PAT	5.7	2.6

Relative price performance



Source: Bloomberg

With revenue of $160m, up 14% q/q, 15% y/y, FSL had another good quarter. In this, the top client grew 35% q/q (though y/y, it declined 6%) and contributed 16% to revenue. FSL's strong execution in its mortgage business (28% of revenue) absorbed the softness in health-care. Ahead, healthcare may accelerate in FY22 as mortgage stabilises. For FY21, guidance was raised to 9-12% CC (from 6-10%). The 10.7% EBIT margin (up 43bps q/q, 141bps y/y) is likely to be maintained in a narrow band. We raise our FY21e/FY22e revenue ~5%/4%, earnings 6%/3%, leading to a higher target of Rs90 (13x FY22 EPS) earlier Rs85.

FSoL sees strong growth in its mortgage business. With the new management's focus on sales and account mining, FSoL seems better placed to sustain growth. Strong momentum in its mortgage and collections businesses (with scope for higher offshoring and more platform-based delivery) is helping cushion the impact of the healthcare-business decline in FY21. We expect investments in healthcare and new service lines to largely offset the normalisation in the mortgage business in FY22.

EBIT to be maintained between 11% and 11.5%. Net hiring (up 2,129 people in Q2), normalisation in the top client in Q2, and resumption of pay for some employees furloughed in Jul suggest greater assurance in the business. SG&A (up 10% q/q, 23% y/y) reflects higher investments in the workforce for growth and lower benefits from work-from-home (as FSoL is large on-site). With steady gross margins and SG&A, we expect stable margins for the rest of FY21. Net profit was Rs1053m, up 19% q/q, 56% y/y.

Raising estimates; new target of Rs90. Considering steady growth ahead (7% FY20-22 revenue CAGR), the greater focus on a more profitable back-office and platform-based growth, and expectations of a high pay-out (dividend yield: 3.3%), we raise our estimates and target. We retain a Buy with a higher target of Rs90 (13x FY22 EPS). **Risk**: Protracted recovery in healthcare.

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (Rs m)	34,315	37,867	40,502	46,307	48,590
Net profit (Rs m)	3,265	3,778	3,397	4,186	4,627
EPS (Rs)	4.7	5.5	4.9	6.0	6.6
PE (x)	15.4	13.4	15.0	12.2	11.0
EV / EBITDA (x)	15.8	11.3	9.4	7.9	7.2
PBV (x)	2.2	1.9	1.8	1.7	1.6
RoE (%)	14.9	14.9	12.4	14.5	14.7
RoCE (%)	8.7	11.4	9.5	10.2	11.1
Dividend yield (%)	2.1	2.7	3.4	3.4	3.8
Net debt / equity (x)	0.2	0.1	0.2	0.1	0.1

Source: Company, Anand Rathi Research

Mohit Jain
Research Analyst

Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rs m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Revenues ($ m)	**532.0**	**541.3**	**572.2**	**623.8**	**656.6**
Growth (%)	***3***	***2***	***6***	***9***	***5***
Net revenues	34,315	37,867	40,502	46,307	48,590
Employee & direct costs	23,955	25,573	27,735	31,496	33,102
Gross profit	10,360	12,294	12,767	14,811	15,488
Gross margins (%)	*30.2*	*32.5*	*31.5*	*32.0*	*31.9*
SG&A	6,809	7,336	6,792	7,731	7,719
EBITDA	**3,552**	**4,959**	**5,975**	**7,080**	**7,769**
EBITDA margins (%)	***10.3***	***13.1***	***14.8***	***15.3***	***16.0***
- Depreciation	659	744	1,852	2,054	2,074
Other income	1,092	435	403	450	454
Interest expenses	404	290	583	507	448
PBT	3,580	4,359	3,942	4,970	5,701
Effective tax rate (%)	*8.8*	*13.3*	*13.8*	*15.8*	*18.8*
+ Associates / (Minorities)	-1	-0	-0	-	-
Net income	**3,265**	**3,778**	**3,397**	**4,186**	**4,627**
WANS	688	692	699	698	698
FDEPS (Rs / sh)	**4.7**	**5.5**	**4.9**	**6.0**	**6.6**

Fig 2 – Balance sheet (Rs m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Share capital	6,865	6,911	6,938	6,938	6,938
Net worth	23,518	27,207	27,654	30,094	32,801
Debt	6,723	5,459	8,369	6,284	5,033
Minority interest	13	6	6	6	6
DTL / (Assets)	-2,590	-2,630	-1,776	-1,776	-1,776
Capital employed	**27,663**	**30,042**	**34,253**	**34,607**	**36,063**
Net tangible assets	882	1,143	5,885	4,826	3,697
Net intangible assets	624	632	500	500	500
Goodwill	19,308	20,452	22,324	22,324	22,324
CWIP (tang. & intang.)	4	20	-	-	-
Investments (strategic)	-	-	-	-	-
Investments (financial)	220	1,218	122	86	60
Current assets (ex cash)	8,853	9,728	12,621	13,239	13,894
Cash	1,230	474	1,907	2,189	2,529
Current liabilities	3,458	3,624	9,107	8,556	6,941
Working capital	5,394	6,103	3,514	4,683	6,953
Capital deployed	**27,663**	**30,042**	**34,253**	**34,607**	**36,063**
Contingent liabilities	1,119	535	875	-	-

Fig 3 – Cash-flow statement (Rs m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
PBT	3,580	4,359	3,942	4,970	5,701
+ Non-cash items	1,060	768	2,051	2,486	2,378
Oper. prof. before WC	4,641	5,127	5,993	7,456	8,079
- Incr. / (decr.) in WC	1,753	647	1,354	-6	1,087
Others incl. taxes	263	-630	-535	-1,959	-2,257
Operating cash-flow	**3,151**	**3,851**	**4,104**	**5,503**	**4,735**
- Capex (tang. + intang.)	625	1,081	948	995	945
Free cash-flow	**2,526**	**2,770**	**3,156**	**4,508**	**3,790**
Acquisitions	-	-	-	-	-
- Div. +(incl. buyback, taxes)	**-**	**1,242**	**3,762**	**1,746**	**1,920**
+ Equity raised	101	142	77	-	-
+ Debt raised	-2,946	-1,190	2,527	-2,085	-1,251
- Fin investments	-1,354	954	-1,277	-37	-26
- Misc. (CFI + CFF)	192	287	1,857	432	304
Net cash-flow	843	-762	1,418	282	340

Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis

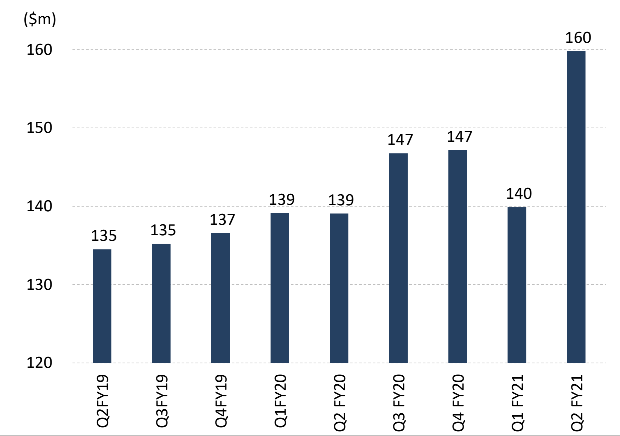
Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
P/E (x)	**15.4**	**13.4**	**15.0**	**12.2**	**11.0**
EV / EBITDA (x)	**15.8**	**11.3**	**9.4**	**7.9**	**7.2**
EV / Sales (x)	1.6	1.4	1.4	1.2	1.1
P/B (x)	2.2	1.9	1.8	1.7	1.6
RoE (%)	14.9	14.9	12.4	14.5	14.7
RoCE (%) - after tax	8.7	11.4	9.5	10.2	11.1
RoIC (%) - after tax	9.2	12.0	9.9	10.7	11.8
DPS (Rs / sh)	**1.5**	**2.0**	**2.5**	**2.5**	**2.8**
Dividend yield (%)	**2.1**	**2.7**	**3.4**	**3.4**	**3.8**
Dividend payout (%) - incl. DDT	36.8	42.7	59.9	48.6	48.3
Net debt / equity (x)	0.2	0.1	0.2	0.1	0.1
Receivables (days)	56	52	68	63	63
Inventory (days)					
Payables (days)	11	10	10	11	9
CFO : PAT %	**96.5**	**101.9**	**120.8**	**131.5**	**102.3**

Source: Company, Anand Rathi Research

Fig 5 – Price movement

Source: Bloomberg

Fig 6 – Revenue trend



Source: Company

Result Highlights

Q2 FY21 Results at a Glance

Fig 7 – Segment-wise results

(Rs m)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	Q/Q %	Y/Y %
Revenues ($ m)	**139**	**147**	**147**	**140**	**160**	***14***	***15***
Growth Y/Y %	***3.4***	***8.5***	***7.8***	***0.5***	***14.9***	***1437 bps***	***1150 bps***
Volume growth %	*3.5*	*5.0*	*-0.1*	*3.2*	*6.4*	*317 bps*	*295 bps*
Revenues	9,715	10,446	10,673	10,537	11,783	*12*	*21*
Eff. exchange rate	69.9	71.2	72.5	75.3	73.7	*-2*	*6*
Employees (EoP)	20,001	20,482	21,203	21,831	23,960	*10*	*20*
Revenue productivity ($'000 / employee)	**7.0**	**7.2**	**6.9**	**6.4**	**6.7**	***4***	***-4***
No. of seats	16,594	17,261	17,559	17,537	17,500	*0*	*5*
Seat-fill factor (%)	*75.0*	*87.0*	*79.0*	*78.0*	*78.0*	*0 bps*	*300 bps*
CoR (excl. D&A)	(6,722)	(7,053)	(7,350)	(7,128)	(7,985)	*12*	*19*
as % of revenues	-69.2	-67.5	-68.9	-67.6	-67.8	*-12 bps*	*143 bps*
SG&A	(1,633)	(1,816)	(1,813)	(1,826)	(2,016)	*10*	*23*
as % of revenues	*-17*	*-17*	*-17*	*-17*	*-17*	*22 bps*	*-30 bps*
EBITDA	**1,360**	**1,577**	**1,509**	**1,583**	**1,783**	***13***	***31***
EBITDA margins %	***14.0***	***15.1***	***14.1***	***15.0***	***15.1***	***10 bps***	***113 bps***
EBIT	905	1,093	1,036	1,085	1,264	*17*	*40*
EBIT margins %	*9.3*	*10.5*	*9.7*	*10.3*	*10.7*	*43 bps*	*141 bps*
Other income	49	101	138	83	115	*37*	*134*
Forex gain / loss	134	89	132	85	94	*11*	*-30*
PBT	806	1,036	1,031	1,035	1,254	*21*	*56*
PBT margins %	*8*	*10*	*10*	*10*	*11*	*82 bps*	*234 bps*
Taxes	(132)	(140)	(115)	(148)	(202)	*36*	*52*
ETR %	*-16*	*-14*	*-11*	*-14*	*-16*	*-176 bps*	*36 bps*
PAT	**674**	**895**	**916**	**887**	**1,053**	***19***	***56***
PAT margins %	***7***	***9***	***9***	***8***	***9***	***52 bps***	***200 bps***

Source: Company Reports, Anand Rathi Research

Fig 8 – Quarterly result (Rs m)

Year-end: Mar	Q2 FY21	% Q/Q	% Y/Y	FY20	FY21	% Y/Y
Sales ($ m)	160	*14.2*	*14.9*	572	624	*9.0*
Sales	11,783	*11.8*	*21.3*	40,502	46,307	*14.3*
EBITDA	1,783	*12.6*	*31.1*	5,975	7,080	*18.5*
EBITDA margins (%)	*15*	*10 bps*	*113 bps*	*14.8*	*15.3*	*54 bps*
EBIT	1,264	*16.5*	*39.6*	4,123	5,026	*21.9*
EBIT margins (%)	*11*	*43 bps*	*141 bps*	*10.2*	*10.9*	*68 bps*
PBT	1,254	*21.2*	*55.6*	3,942	4,970	*26.1*
Tax	(202)	*36.1*	*52.2*	(545)	(784)	*43.8*
Tax rate (%)	*(16)*	*-176 bps*	*36 bps*	*(13.8)*	*(15.8)*	*-195 bps*
Net income	1,053	*18.7*	*56.2*	3,397	4,186	*23.2*

Source: Company, Anand Rathi Research

Conference-call takeaways

Q2 FY21

- Healthcare was better than the previous quarter, but recovery in this business is under pressure due to Covid-induced delays in elective procedures and, thereby, hospital earnings. However, investments are being made here and results are anticipated in the next few quarters. 57% of healthcare is payer, the balance 43% is provider.
- The company added 15 clients in Q2 (11 in BFS, four in healthcare)
- In the CMT vertical, the top client has returned with volumes as the business normalises at its end. There are also opportunities of increasing offshore and work-from-home and, thereby, eventually margins.
- Q2 PAT was Rs1.05bn, a milestone as the company crosses Rs1bn PAT for the first time.
- DSO declined sequentially from 63 days to 54 (including unbilled)
- Net debt was Rs3.91bn ($53m) vs. Rs5.53bn ($73m) the quarter prior.
- The mortgage business revenue was $44m-46m.
- Cost for talent in mortgage rose as supply was short. Therefore, margins could not be improved in the quarter.
- The CMT EBIT margin would normalise in the next few quarters, at 10-13%. The work-from-home option increases margins for companies which are more India-oriented in terms of delivery. For onsite-heavy firms, the difference is not much.
- Prioritizing acquisition in areas of provider and collections.

FY21 outlook

- Guidance has been raised with FY21 revenue expected to grow 9-12% in constant currency and operating margin at 11-11.5%.
- ETR of 13-15% for FY21 and 15-18% for FY22 and FY23, based in existing US tax rates.

Notes from the last quarters' conference calls

Q1 FY21

- Top client volumes are coming back gradually and are likely to reach last year Q4 levels by Q4 of this year.
- There is a strong tailwind in the mortgage business due to low interest rates in the US. In addition, the company has been able to get business on the servicing side (40% of the mortgage business). This is more recurring in nature vs. the origination which is more driven by interest-rate cycles. With the servicing side ramping up faster than the origination, the company is trying to make it a recurring business.
- Some UK employees have been sent on furlough while they are still being counted in the overall headcount. They are likely to come back by Q3 as the UK business ramps up.
- Excluding this, there was no wage revision or headcount revision for the year.
- Within the new service-line classification, back-office operations are

likely to grow fastest, followed by platform and analytics. The contact centre business will be normal but may grow slow from there.

- The tax rate for FY21 is likely to be in the 13-15% range.
- CC revenues are likely to grow 6-10% in FY21.

Operating margins are likely to be maintained at 11-11.5%.

Q4 FY20

- Firstsource's Q4 revenues were hit to the tune of $6m (demand and supply impact) by Covid-19. This included the impact on the collections business from Feb.
- From home, the company is operating at 95% capacity (on demand that can be serviced from there).
- Q4 mortgage revenue was affectedby the holiday season but the low interest-rate environment to be a micro-tailwind ahead in the mortgage business.
- In Healthcare, revenues were struck by lower volumes in the provider segment(60% of Healthcare) and fewer claims in the payer segment (40%). Provider was troubled as the government slowed down payments, starting Feb'20.
- Step-up in DSO days by 10 q/q will be corrected as collections have been made in April and the company doesn't expect significant deterioration in collections in FY21.

Q3 FY20

- The company believes the top client has bottomed out and has now stabilised. Therefore, the drag on growth from the top account is likely to be less.
- It is seeing client addition in the mortgage business on the originations side, with three this quarter;this would spur growth till H1 FY21.
- It added employees mainly on the offshore front to support growth.
- It has outstanding hedges of $36m.
- It has on-boarded a head for the digital business and is likely to appoint other people in leadership roles in the next two quarters.
- FY21capex expected at $12m-15m.
- FY20 and FY21 ETR expected at 13-15%.
- The company has revised its revenue growth outlook to 7.5–8.5% in CC terms (earlier 7–9%) and margin guidance to 11–11.2% (from 10.8–11.2%). Q4 is expected to be strong.

Q2 FY20

- The environment in the UK is more supportive of growth as BPM is considered more of operational expense than discretionary.
- The Collections and Provider businesses continue to grow. The set-back is in the top client or the telecoms business, but the company believes this has bottomed out there as well. Hence, it has guided to a strong recovery in H2.
- Rising wages are a risk to margins, but the company is exploring alternative hiring and retention methods to create capacity. Part of the exercise is to deliver more services from India and the Philippines where

attrition has come down in Q2FY20 to 40% (from 45% in Q1). Onshore attrition is running at an all-time 55%high.

- The CM business dipped in Q2 as one centre was transferred to the client. However, the company is exploring ways to run a new centre in India for that client. This is likely to materialise in the next six months.
- Firstsource is looking to enter new service lines to generate growth, content moderation being one such. It will explore ways and invest 60bps of EBIT margins in this business. It is also looking to digitise existing offerings to rejuvenate growth.
- Ithas maintained its 7-9% revenue growth guidance in CC, but cut its margin guidance to 10.8–11.2%.

Q1 FY20

- Good traction is being seen in the collections business, likely to be its highest growth area in FY20.
- The UK business is under pressure however, on the input side. While the company has not lost any business, wages are rising, with the consequent squeeze on margins. The hiring situation in the US is similar.
- The company has started off-shoring more business (evident in the Q1 figures) to expand margins and manage the tight labour situation in the key regions of the US and the UK.
- The CRM business may dip in Q2 as the top client has moved some business in-house (400 FTEs).
- The company maintains its 7–9% guidance in CC growth, with a margin expansion of 50–75bps.

Q4 FY19

- One-time training and up-skilling cost of ₹87.5m, incurred in Q4, has trimmed 90bps off the EBITDA margin. This included identification of resources, who can or cannot be trained for digital projects, and associated training costs.
- 117 employees (net) were added in Q4. Although, in the UK attrition was lower, it was a high 70.3% (83.4% the quarter prior). This somewhat impacted growth in the region.
- FY20 revenues would likely grow 7–9% (in CC). Given the seasonality factor, Q1 FY20 would be soft.
- The EBITDA margin would expand 50–70bps.
- Expected ETR: ~16-18%. Capex next year could be $10m-12m.

Factsheet

Fig 9 – Revenue

	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
Revenues ($ m)	139	147	147	140	160

Source: Company, Anand Rathi Research

Fig 10 – Revenue by area

(%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
North America	62	63	63	69	68
The UK	37	35	35	30	31
India	2	1	2	1	1
APAC(RotW)	0	0	0	0	0

Source: Company, Anand Rathi Research

Fig 11 – Revenue by vertical

(%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
BFSI	40	43	43	51	52
Telecoms	22	22	23	16	19
Life Sciences	35	32	31	30	27
Others	3	3	3	3	2

Source: Company, Anand Rathi Research

Fig 12 – Client concentration

(%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
Top-client	20	20	20	14	16
Top-5 clients	40	42	42	40	40

Source: Company, Anand Rathi Research

Fig 13 – Revenue by delivery location

(%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
Offshore	22.8	25.2	25.6	24.8	27.0
On-shore	77.2	74.8	74.4	75.2	73.0

Source: Company, Anand Rathi Research

Fig 14 – Workforce spread

(%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
India	*52*	*54*	*54*	*54*	*56*
Abroad	*48*	*46*	*46*	*46*	*44*
Total	20,001	20,482	21,203	21,831	23,960

Source: Company, Anand Rathi Research

Fig 15 – Seats

	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21
Number of seats	16,594	17,261	17,559	17,537	17,500
Seat-fill factor (%)	*75*	*87*	*79*	*78*	*78*

Source: Company, Anand Rathi Research

Valuations

The stock trades at 10.9x FY22e EPS of Rs6.6. This, we reckon, is attractive, given that the business is now accelerating, supported by an upswing in the mortgage (28% of revenue) and collections businesses. The pipeline seems strong and, given the current momentum, the FY20-22 revenue CAGR should be nearly 7%, a many-year high for FSoL.

The softness in the healthcare business is a negative, but as the US and UK are opening up, their volumes are likely to climb. Also, on the flip side, client-concentration ratios may come down as healthcare gains momentum in the next 12 months. As growth widens with new service lines, risks will fade. The EBIT margin is likely to be steady at 11-11.5%, given the revenue trajectory and strong focus on growth over margins.

We are giving Firstsource (a BPO company) a 13x FY22e PE (as before), a ~20% discount to similar-sized generic IT-services companies. This reflects its relatively weaker balance sheet (still running on gross and net debt) and slower organic growth in the last few years. Also, we believe that valuations at 13x would find support, given expectations of a higher dividend payout and growth acceleration.

IT-services companies, being higher up the value chain than BPO companies, command a higher billing rate and enjoy higher margins than BPO companies. However, in the present milieu, BPO companies, being transaction-volume driven, are more a reflection of the current economic milieu than IT-services companies are. Therefore, recovery in BPO is likely to be faster than in IT services as general transaction volumes in the economy pick up.

Considering all these factors, at the current trading multiple the risk-reward seems to us favourable. Our target price is based on a PE of 13x FY22e EPS, which reflects a target EV/EBITDA FY22 of 9x. FY22 FCF yield is 7%.

Fig 18 – Change in estimates

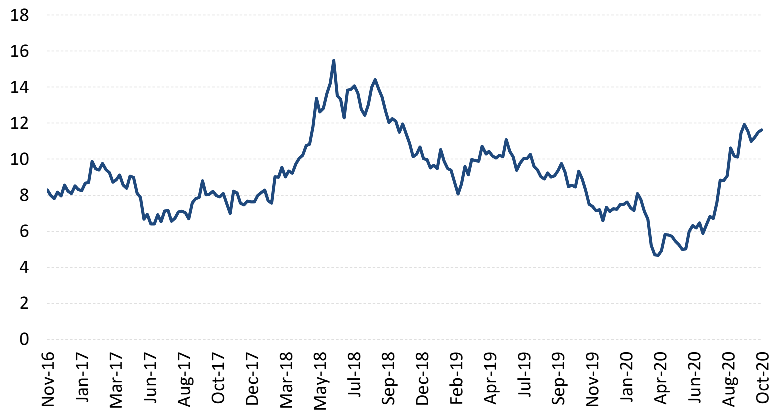
	FY21e			FY22e		
(Rs m)	New	Old	Chg %	New	Old	Chg %
Revenues ($ m)	624	594	*5.0*	657	633	*3.8*
Revenues	46,307	44,325	*4.5*	48,590	47,060	*3.3*
EBITDA	7,080	6,774	*4.5*	7,769	7,549	*2.9*
EBITDA margins %	*15.3*	*15.3*	*1 bps*	*16.0*	*16.0*	*-5 bps*
EBIT	5,026	4,781	*5.1*	5,695	5,556	*2.5*
EBIT margins %	*10.9*	*10.8*	*7 bps*	*11.7*	*11.8*	*-8 bps*
PAT	4,186	3,959	*5.7*	4,627	4,510	*2.6*

Source: Anand Rathi Research

Risk

- Protracted recovery of the healthcare business

Fig 19 – PE band



Source: Bloomberg, Anand Rathi Research

Appendix

Analyst Certification

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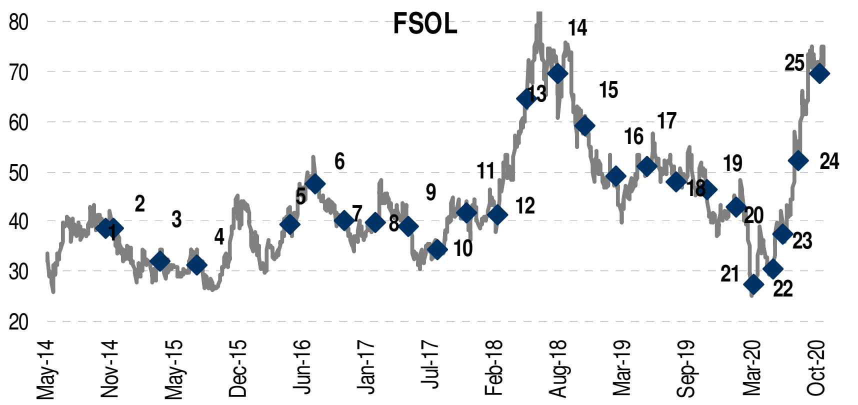
Rating and Target Price History (as of 30 October 2020)



	Date	Rating	TP (₹)	Share Price (₹)
1	28-Oct-14	Buy	59	39
2	17-Nov-14	Buy	57	40
3	09-Apr-15	Buy	47	31
4	04-Aug-15	Buy	40	32
5	13-May-16	Sell	40	40
6	28-Jul-16	Sell	44	47
7	28-Oct-16	Hold	44	39
8	31-Jan-17	Hold	42	39
9	08-May-17	Hold	40	39
10	08-Aug-17	Hold	38	35
11	02-Nov-17	Hold	41	41
12	08-Feb-18	Buy	55	40
13	08-May-18	Buy	75	63
14	06-Aug-18	Buy	80	69
15	02-Nov-18	Buy	75	60
16	04-Feb-19	Buy	70	49
17	07-May-19	Buy	65	51
18	05-Aug-19	Buy	60	49
19	07-Nov-19	Buy	58	49
20	05-Feb-20	Buy	55	43
21	31-Mar-20	Buy	45	28
22	27-May-20	Buy	42	29
23	29-Jun-20	Hold	42	38
24	14-Aug-20	Hold	60	54
25	15-Oct-20	Buy	85	71

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Ratings Guide (12 months)	Buy	Hold	Sell
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