

CMP: ₹ 173

Target: ₹ 180 (4%)

Target Period: 12 months

HOLD

November 25, 2021

Weak collections business performance to impact near term revenues

About the stock: Firstsource Solutions (FSL) provides business process services to BFSI, Communication, Media, Tech and Healthcare

- The company generates 49% revenues from BFSI while healthcare and communication form 30% and 20%, respectively
- FSL has witnessed healthy revenue improvement (up 19% YoY in FY21)

Analyst day highlights:

- The company reiterated its revenue guidance of 14.5-15.5% in FY22, cut downwards from its earlier guidance range of 15-18%
- EBIT margin guidance maintained at 11.8-12.3%
- Weakness in collections business in the US is one of the drivers of a cut in revenue guidance for FY22
- The company acquired US based firm 'StoneHill', which focuses on loan quality control, due diligence and loan origination services for US\$27 mn

What should investors do? FSL's share price has grown by ~5.7x over the past five years (from ~₹ 30 in November 2016 to ~₹ 173 levels in November 2021).

- We maintain HOLD rating

Target Price and Valuation: We value FSL at ₹ 180 i.e. 19x P/E on FY23E EPS

Key triggers for future price performance:

- Improvement in provider, collection segment, diversification in CMT segment, new logo wins, focus on client mining cross selling of platforms business and hiring of leaders bodes well for long term revenue growth
- The company closed one large deal recently with a health insurance company, under which the company will replace with modern integrated software and services solutions
- The company faces high attrition, especially on the onshore side. Controlling the same can boost its financials

Alternate Stock Idea: Apart from FSL, in our IT coverage we also like Infosys.

- Key beneficiary of improved digital demand, industry leading revenue growth and healthy capital allocation prompts us to be positive
- BUY with a target price of ₹ 2,060



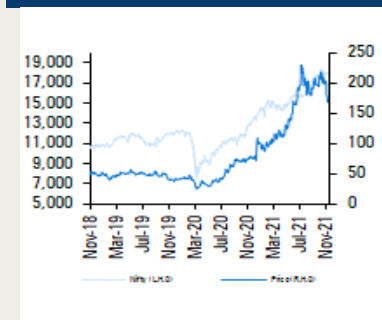
Particulars

| Particular | Amount |
|----------------------------|----------|
| Market Cap (₹ Crore) | 11,879.6 |
| Total Debt (₹ Crore) | 604.5 |
| Cash and Invests (₹ Crore) | 219.9 |
| EV (₹ Crore) | 12,264.2 |
| 52 week H/L | 242/66 |
| Equity capital | 696.1 |
| Face value | 10.0 |

Shareholding pattern

| | Dec-20 | Mar-21 | Jun-21 | Sep-21 |
|-----------|--------|--------|--------|--------|
| Promoters | 54 | 54 | 54 | 54 |
| FII | 7 | 10 | 12 | 11 |
| DII | 17 | 14 | 15 | 14 |
| Public | 22 | 22 | 19 | 22 |

Price Chart



Recent event & key risks

- Revenue guidance revised downward to 14.5-15.5% for FY22
- Key Risk:** (i) Deceleration in BFSI & health segment (ii) Higher than expected margin expansion

Research Analyst

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Key Financial Summary

| Key Financials | FY19 | FY20 | FY21 | 5 year CAGR (FY16-21) | FY22E | FY23E | 2 year CAGR (FY21-23E) |
|----------------|-------|-------|-------|-----------------------|-------|-------|------------------------|
| Net Sales | 3,826 | 4,099 | 5,078 | 9.6% | 5,863 | 6,898 | 16.5% |
| EBITDA | 535 | 629 | 804 | 15.5% | 962 | 1,145 | 19.3% |
| Margins (%) | 14.0 | 15.3 | 15.8 | | 16.4 | 16.6 | |
| Net Profit | 378 | 340 | 362 | 6.7% | 535 | 660 | 35.0% |
| EPS (₹) | 5.4 | 4.9 | 5.2 | | 7.7 | 9.5 | |
| P/E | 31.8 | 35.3 | 33.2 | | 22.4 | 18.2 | |
| RoNW (%) | 13.9 | 12.3 | 12.9 | | 17.4 | 19.8 | |
| RoCE (%) | 14.0 | 11.1 | 15.5 | | 17.7 | 20.2 | |

Source: Company, ICICI Direct Research

Other highlights

- The company operates in four segments namely i) BFSI (49% of revenue mix) ii) healthcare (30%), iii) Communication Media & Technology (20%) iv) Diversified (2%)
- In BFSI, it operates in three sub-segments i) Mortgage ii) Collections iii) Retail & Commercial banking. In healthcare it operates in two sub-segments of i) Healthcare provider ii) Healthcare services. In BFSI, it works with five out top 10 credit card issuers in the US, two out of top six retail banks in the UK, six out of top 15 lenders in the US and four out of top 15 mortgage servicers in the US
- The company guided for 14.5-15.5% revenue growth in FY22 (including revenues from StoneHill) from earlier range of 15-18%. The management indicated that the collection business is underperforming their expectations impacting the full year growth projection. Credit card delinquency rates in US are at record lows at 1.54%, which implies that customers are paying off their balances due on time or are increasingly using debit cards for their purchases. This is impacting the volume that it handles for its clients. The management maintained that this pain will remain for the short-term. It expects delinquencies to rise as in when the economic stimulus impact wanes
- FSL acquired 100% stake in US based company 'StoneHill' for total consideration of US\$27 mn out of which US\$21.6 mn to be paid at the closing of the transaction (i.e. December 2021) and rest to be paid after 12 months of the closing. As per FSL, Stonehill is expected to report US\$20 mn revenues in CY21. The acquisition expands and strengthens FSL's offerings in US mortgage market
- In the healthcare segment, FSL closed a large deal with a health insurance company recently. The deal scope includes entire re-architecture of the client's business operations and technologies. FSL will operate as a deal owner, which will take care of the process part while it will bring in few IT companies as sub-contractors to take care of technology part. Total deal size is of US\$210 mn spanning over a few years. The share of FSL would be in the ball park range of US\$100-110 mn. FSL expects annual revenues of US\$15-16 mn from the deal
- The company indicated that the US and UK markets are going through unprecedented talent shortages driven by a multitude of structural and pandemic related reasons. It further says that attracting and retaining talent both these markets have been challenging resulting in some revenue being left on the table. The company is executing a slew of tactical and structural actions to retain talent for longer term including higher compensation, revamping of training for upscaling. At the same time, FSL is adapting itself to the evolving hybrid work model

Exhibit 1: Change in estimates

| (₹ Crore) | FY22E | | | FY23E | | | Comments |
|-------------------|-------|-------|----------|-------|-------|----------|--|
| | Old | New | % Change | Old | New | % Change | |
| Revenue | 6,271 | 5,863 | -6.5 | 7,191 | 6,898 | -4.1 | We tweak revenues downwards as per revenue guidance cut |
| EBITDA | 1,028 | 962 | -6.5 | 1,208 | 1,145 | -5.2 | |
| EBITDA Margin (%) | 16.4 | 16.4 | 1 bps | 16.8 | 16.6 | -20 bps | EBITDA margins cut further to reflect talent crunch in its core US and UK market |
| PAT | 588 | 535 | -9.1 | 710 | 660 | -7.1 | |
| EPS (₹) | 8.5 | 7.7 | -9.1 | 10.2 | 9.5 | -7.1 | |

Source: Company, ICICI Direct Research

Financial summary

| Exhibit 2: Profit and loss statement | | | | | ₹ crore |
|--------------------------------------|--------------|--------------|--------------|--------------|---------|
| | FY20 | FY21 | FY22E | FY23E | |
| Total Revenues | 4,099 | 5,078 | 5,863 | 6,898 | |
| Growth (%) | 7.1 | 23.9 | 15.5 | 17.6 | |
| Employee expenses | 2,774 | 3,467 | 3,987 | 4,690 | |
| Other Expenses | 696 | 807 | 915 | 1,062 | |
| EBITDA | 629 | 804 | 962 | 1,145 | |
| Growth (%) | 17.4 | 27.9 | 19.6 | 19.1 | |
| Depreciation & Amortization | 185 | 206 | 256 | 295 | |
| Other Income | 9 | 1 | 4 | 4 | |
| Interest | 58 | 52 | 49 | 29 | |
| PBT before Exceptional Items | 394 | 432 | 660 | 824 | |
| Growth (%) | (9.6) | 9.5 | 52.8 | 24.9 | |
| Tax | 55 | 70 | 125 | 165 | |
| PAT before Excp Items | 340 | 362 | 535 | 660 | |
| Exceptional items | | | | | |
| PAT before MI | 340 | 362 | 535 | 660 | |
| Minority Int & Pft. from associates | (0) | 0 | 0 | 0 | |
| PAT | 340 | 362 | 535 | 660 | |
| Growth (%) | (10.1) | 6.5 | 47.8 | 23.4 | |
| EPS | 4.9 | 5.2 | 7.7 | 9.5 | |
| EPS (Growth %) | (10.1) | 6.5 | 47.8 | 23.4 | |

Source: Company, ICICI Direct Research

| Exhibit 3: Cash flow statement | | | | | ₹ crore |
|-------------------------------------|--------------|--------------|--------------|--------------|---------|
| | FY20 | FY21 | FY22E | FY23E | |
| Profit before Tax | 394 | 432 | 660 | 824 | |
| Depreciation & Amortization | 185 | 206 | 256 | 295 | |
| WC changes | (135) | 290 | (57) | (229) | |
| Other non cash adju. | (34) | 48 | (80) | (140) | |
| CF from operations | 410 | 976 | 779 | 751 | |
| Capital expenditure | (95) | (173) | (276) | (171) | |
| Δ in investments | 128 | (176) | - | - | |
| Other investing cash flow | (18) | 1 | 4 | 4 | |
| CF from investing Activities | 14 | (350) | (272) | (167) | |
| Issue of equity | 8 | (57) | - | - | |
| Δ in debt funds | 150 | (376) | (124) | (50) | |
| Dividends paid | (376) | (204) | (267) | (402) | |
| Other financing cash flow | (58) | (51) | (49) | (29) | |
| CF from Financial Activities | (277) | (689) | (533) | (575) | |
| Δ in cash and cash bank balance | 148 | (63) | (26) | 9 | |
| Effect of exchange rate changes | (5) | | | | |
| Opening cash | 47 | 191 | 137 | 111 | |
| Closing cash | 191 | 137 | 111 | 120 | |

Source: Company, ICICI Direct Research

| Exhibit 4: Balance sheet | | | | | ₹ crore |
|-----------------------------|--------------|--------------|--------------|--------------|---------|
| Particulars | FY20 | FY21 | FY22E | FY23E | |
| Equity | 694 | 696 | 696 | 696 | |
| Reserves & Surplus | 2,072 | 2,103 | 2,370 | 2,628 | |
| Networth | 2,765 | 2,799 | 3,067 | 3,324 | |
| Minority Interest | 1 | 1 | 1 | 1 | |
| LT liabilities & provisions | 487 | 461 | 399 | 399 | |
| Total Debt | 837 | 604 | 543 | 493 | |
| Source of funds | 4,090 | 3,865 | 4,008 | 4,216 | |
| Net fixed assets | 588 | 749 | 861 | 830 | |
| CWIP | - | - | - | - | |
| Goodwill | 2,232 | 2,195 | 2,195 | 2,195 | |
| Other non current assets | 662 | 655 | 705 | 924 | |
| Loans and advances | - | - | - | - | |
| Current Investments | - | 83 | 83 | 83 | |
| Debtors | 557 | 577 | 667 | 785 | |
| Cash & Cash equivalents | 191 | 137 | 111 | 120 | |
| Other current assets | 357 | 435 | 502 | 592 | |
| Trade payables | 95 | 279 | 322 | 380 | |
| Current liabilities | 355 | 604 | 698 | 822 | |
| Provisions | 46 | 82 | 95 | 112 | |
| Application of funds | 4,090 | 3,865 | 4,008 | 4,216 | |

Source: Company, ICICI Direct Research

| Exhibit 5: Key ratios | | | | |
|-----------------------------|------|------|-------|-------|
| (Year-end March) | FY20 | FY21 | FY22E | FY23E |
| Per share data (₹) | | | | |
| EPS-diluted | 4.9 | 5.2 | 7.7 | 9.5 |
| DPS | 2.5 | 3.0 | 3.8 | 5.7 |
| BV | 40.3 | 40.8 | 44.7 | 48.4 |
| Operating Ratios (%) | | | | |
| EBITDA Margin | 15.3 | 15.8 | 16.4 | 16.6 |
| PBT Margin | 9.6 | 8.5 | 11.3 | 12.0 |
| PAT Margin | 8.3 | 7.1 | 9.1 | 9.6 |
| Return Ratios (%) | | | | |
| RoNW | 12.3 | 12.9 | 17.4 | 19.8 |
| RoCE | 11.1 | 15.5 | 17.7 | 20.2 |
| Valuation Ratios (x) | | | | |
| P/E | 35.3 | 33.2 | 22.4 | 18.2 |
| EV / EBITDA | 19.9 | 15.3 | 12.7 | 10.6 |
| Price to Book Value | 4.3 | 4.2 | 3.9 | 3.6 |
| EV / Net Sales | 3.1 | 2.4 | 2.1 | 1.8 |
| Mcap / Net Sales | 2.9 | 2.3 | 2.0 | 1.7 |
| Turnover Ratios | | | | |
| Debtor days | 50 | 41 | 42 | 42 |
| Creditors days | 8 | 20 | 20 | 20 |
| Solvency Ratios | | | | |
| Total Debt / Equity | 0.3 | 0.2 | 0.2 | 0.1 |
| Current Ratio | 1.8 | 1.0 | 1.0 | 1.0 |
| Quick Ratio | 1.8 | 1.0 | 1.0 | 1.0 |
| Net Debt / EBITDA | 1.0 | 0.5 | 0.4 | 0.3 |

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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