Sharekhan by BNP PARIBAS

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Stock Update

Birlasoft Ltd

Spotting right growth opportunities

IT & ITeS		Sharekhan code: BSOFT		
Reco/View: Buy	↔	CMP: **Rs. 474**	Price Target: **Rs. 580**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 20.60

Updated Oct 08, 2021

Medium Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

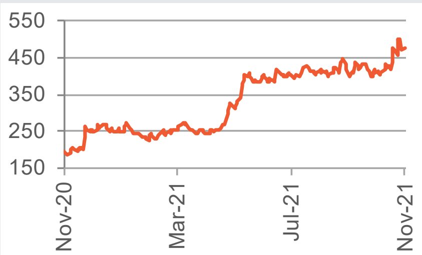
Company details

Market cap:	Rs. 13,182 cr
52-week high/low:	Rs. 513 / 185
NSE volume: (No of shares)	28.5 lakh
BSE code:	532400
NSE code:	BSOFT
Free float: (No of shares)	16.5 cr

Shareholding (%)

Promoters	41
DII	25
FII	19
Others	15

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	15.0	15.9	52.4	145.3
Relative to Sensex	20.1	16.4	42.5	117.5

Sharekhan Research, Bloomberg

Summary

- Birlasoft has transformed its business significantly from enterprise business to enterprise digital solutions in the last few years and is well-placed to capitalise opportunities by leveraging its product and platform-based solutions.
- Management remains confident of delivering decent revenue growth in Q3FY22 despite fewer billable days, led by strong broad-based demand, recovery in enterprise solutions and ramp-up of a new deal. Non-enterprise business to maintain growth momentum.
- The management aspires to clock $1 billion in annual revenues by FY2025 against current annual revenue run-rate of $548 million, of which $800-850 million would come from organic, while the rest would arise from inorganic activity. It also eyes EBITDA margins of 18% by FY2025.
- We maintain a Buy on Birlasoft with a PT of Rs. 580, given its strong earnings growth potential, healthy traction in deal ACVs, sharp focus on micro-verticals approach and robust demand.

We recently interacted with Birlasoft's management to understand demand outlook, growth prospects in enterprise and non-enterprise segments, supply-side constraints, traction for ACVs and the margin trajectory. Birlasoft has transformed its business from enterprise business to enterprise digital solutions in the past few years and is now well placed to capitalise opportunities by leveraging its product and platform-based solutions. The company's higher ERP exposure, strong digital capabilities and alliances with hyperscalers position it to close multiple transformative deals given its strong end-to-end enterprise digital capabilities across its targeted verticals.

- **Well-placed to capitalise opportunities in enterprise digital space:** Birlasoft has built unique and strong capabilities by combining enterprise applications with the most modern platforms, software and digitilasation processes. The company aims to scale its current Microsoft channel business to $100 million over next 2-3 years from current level of $23-25 million. The management indicated that the enterprise solutions business growth (down 3% y-o-y in H1FY2022) is expected to remain stable in the near-term given recovery in SAP business, while the growth would accelerate in FY2023E as SAP and other ERPs pipeline in terms of both transformation and implementation side increased.
- **Expect a decent growth in Q3:** The management remains confident of delivering decent revenue growth in Q3FY2022 despite lower billable days, led by strong broad-based demand, recovery in enterprise solutions segment and ramp-up of its new deal (a $20-million large deal) in the energy and utilities space. Deal TCVs would continue to remain low as the company is signing many digital transformation deals, which are by nature small in size. We expect H2FY2022 would be better compared to H1FY2022, driven by strong growth in non-enterprise business and stabilisation in enterprise segment.
- **Margins to remain stable in near term:** EBITDA margin is expected to remain stable in Q3FY2022 despite supply-side concerns, lower billing cycles, higher subcontractor expenses, unsustainable utilisation and one-month wage impact in Q3FY2022, led by strong revenue growth, higher offshoring and cost optimization. Management believes that the attrition is expected to soften in next 2-3 as the economy normalises and fresher hiring increases across the industry.

Our Call

Valuation – Attractive valuation, maintain Buy: Though revenue growth in enterprise solutions business is expected to remain flat in FY2022, it is expected to pick-up in FY2023E led by higher spends on legacy modernisation by clients, strong partnerships with hyperscalers and closure of multiple transformative deals. We forecast that the company would register a 16% and 20% CAGR, respectively, in revenue and earnings over FY2022-FY2024.At CMP, the stock trades at 25x/21x its FY2023E/FY2024E earnings. We stay positive on the stock considering strong net cash position, robust partnership with hyperscalers, increasing net new deal wins, robust demand from enterprise customers and improving return ratios. Hence, we maintain a Buy rating on Birlasoft with a revised price target (PT) of Rs. 580.

Key Risks

(1) Deterioration of demand for IT services in the wake of second wave of COVID-19; (2)Loss of any large clients; and (3) stiff competition in the market.

Valuation Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	3,555.7	4,159.7	4,961.1	5,831.9
OPM (%)	14.9	15.7	16.2	16.3
Adjusted PAT	320.8	456.0	549.3	656.2
% y-o-y growth	43.0	42.1	20.5	19.5
Adjusted EPS (Rs.)	11.3	16.0	19.3	23.1
P/E (x)	42.0	29.6	24.5	20.5
P/B (x)	6.0	5.3	4.7	4.0
EV/EBITDA (x)	23.1	18.5	14.8	12.3
RoNW (%)	15.8	19.6	20.7	21.5
RoCE (%)	20.0	22.6	25.1	26.3

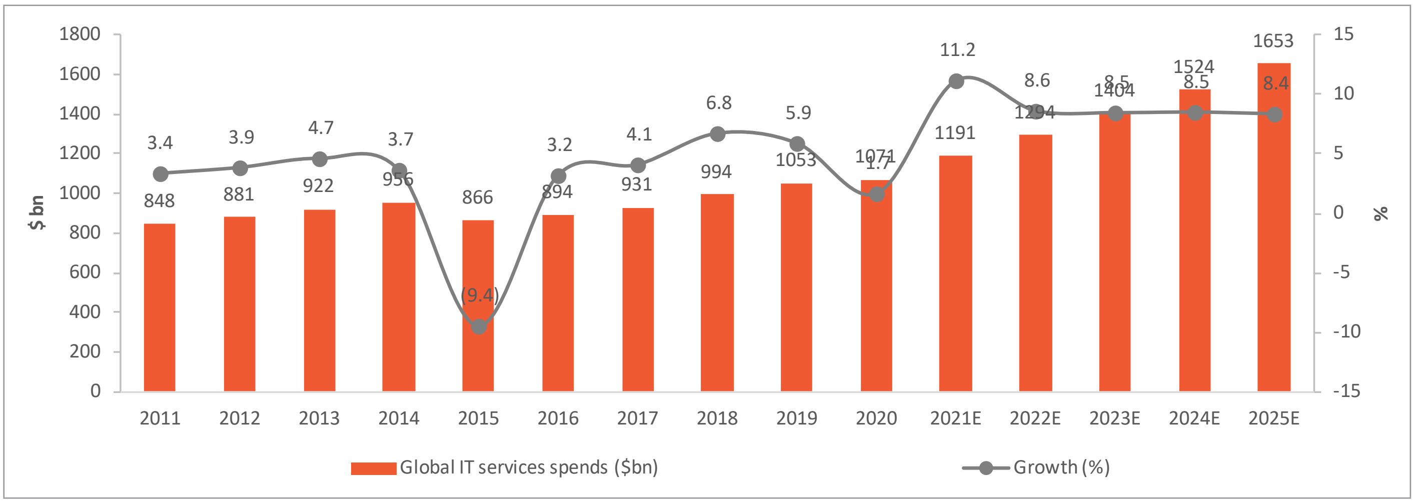
Source: Company; Sharekhan estimates

Tech spending to remain strong going ahead

An accelerated shift to cloud and increased spending on digital technologies such as cloud, artificial intelligence (AI), machine learning, data and analytics, cybersecurity, collaboration tools, and engineering post COVID are expected to drive demand for IT services going ahead. Enterprises across the globe are now using these new-age technologies to enhance digital experience, reduce costs, increase efficiencies, and create greater operating resilience and agility within the organisation. Most large global companies are shifting technology investments from capital expenditure to operating expenses as it would provide scalability. Technology spend is expected to increase to 5%of enterprise revenues over the next 5-10 years from 2-3% currently, as per McKinsey.

According to the latest forecast, Gartner expects worldwide IT spending to rise by 9.5% y-o-y to $4.2 trillion in 2021. Of this, Gartner forecasts IT services and enterprise software spend would grow by 11.2% and 13.6% respectively in FY2021. Further, IT services and enterprise software spending are likely to remain strong, clocking CAGRs of 9.1% and 12%, respectively over FY2020-FY2025, which will be significantly higher than the average growth during the last decade.

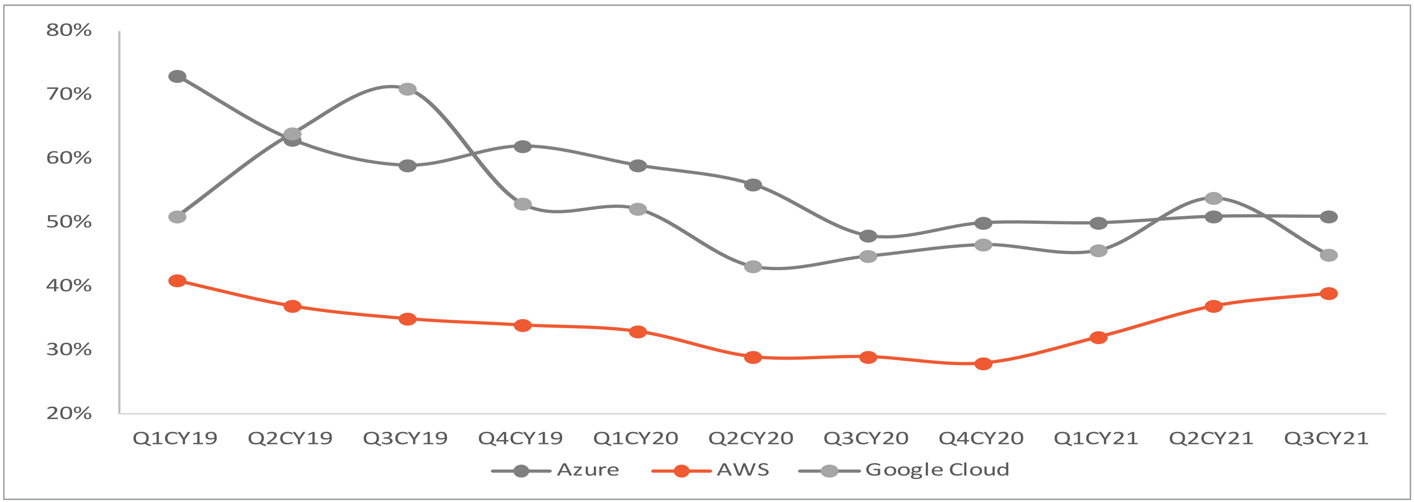
Global IT services spend growth (2021-2025) to remain higher than the levels seen during the last decade (2011)



Source: Gartner, Sharekhan Research

Cloud is expected to create a huge opportunity to Indian IT services companies beyond the initial migration phase. It is estimated that 20-30% of workloads have moved to Cloud and this share can increase to 70-80% over the next 3-5 years. When a client will migrate to cloud, we believe that IT services spend would increase substantially as clients will participate in Cloud-based ecosystems (including AI, data, and analytics spend) to derive benefits in terms of scalability, flexibility, resiliency, and agility. It is estimated that spending on public cloud services would grow at a 28.5% CAGR over 2020-2024. Stronger migration to cloud will provide healthy impetus to demand for migration and transformation services to Indian IT services companies.

Cloud hyperscalers continue to report strong growth even on a higher base



Source: Gartner, Sharekhan Research

Well-placed to capitalise opportunities in the Enterprise digital place

Birlasoft has built unique and strong capabilities by combining enterprise applications with the most modern platforms, software and digitization processes. Further, the company's alliances with key platform players and OEMs such as Microsoft, Google, SAP, Oracle, JD Edwards, Salesforce.com, ServiceNow help the company to provide services to its customers with a broader range of solutions and participate in enterprises' digital transformation journey. There are only 10-15% of total SAP installations (30,000-35,000) across the globe have moved to cloud. This indicates huge growth opportunity for IT service providers, though management believes that customers would evaluate their cost benefits before migrating to Cloud. As per IDC, 80% of the enterprises will put a mechanism in place to shift to cloud-centric infrastructure and applications, which is 2x faster than pre-pandemic.

The company has transformed its business meaningfully from enterprise business and turned into an enterprise digital solutions provider and now moving towards integrated solutions provider by combining ERP business with digital platforms and solutions. Birlasoft generated 41% of revenues from enterprise solutions business during Q2FY2022, which showed signs of improvement compared to earlier quarter. SAP, which is the largest revenue contributor to its enterprise solutions, was dragging its enterprise solutions revenue for last two years, while the remaining integrated enterprise solutions (Oracle, JD Edwards, Infor and digital work) business has been growing steadily. During H1FY2022, the enterprise solutions business declined 3% y-o-y, while non-enterprise solutions grew strongly at 26.2% y-o-y during the same period.

The company's strong relationships with SAP and Oracle would help Birlasoft to participate in enterprises' cloud migration journey as both SAP and Oracle are focusing aggressively on Cloud. Further, the company partnered withMicrosoftto scale its current Microsoft channel business to $100 million in the next 2-3 years from current level of $23-$25 million. Note that the company has doubled its revenue from Microsoft channel business over last one year. The company has recently improved its partnership with Amazon Web Services (AWS) and intends for similar partnerships with Google cloud to provide end-to-end solutions to enterprises in Cloud transformation areas.

Birlasoft's higher exposure to the ERP segment gives it an edge in terms of strong understanding of its clients' core business. This together with its digital capabilities and alliances with hyperscalers and platform companies position the company to close multiple transformative deals given its strong end-to-end enterprise digital capabilities across its targeted verticals.

The enterprise solutions business would recover in coming quarters as the company won deals in this segment across upgradations, implementation and transformation. Clients have been investing on legacy modernisation which would help to drive the growth of its enterprise solutions. The management indicated that the enterprise solutions business growth is expected to remain stable in the near term led by a recovery in SAP business, while the growth in the enterprise solutions business would accelerate to 5-10% in FY2023E as SAP and other ERP pipeline widen both in terms of transformation and implementation.

Management expects a decent growth in Q3; 2HFY22 likely to better than 1HFY22

With a significant improvement in growth momentum over last four quarters, the company delivered revenue growth at a CQGR of 4.3% over Q2FY2021-Q2FY2022. The management remains confident of delivering decent revenue growth in Q3FY2022 despite lower billable days, led by strong broad-based demand, recovery in enterprise solutions segment and ramp-up of its new deal (a $20-million large deal) in the energy and utilities space. Deal TCVs would remain low as the company is signing many digital transformation deals, which are by nature small in size or short-cycled deals. Hence, the management expects strong growth in deal ACVs. The management also cited that the demand environment (traction for specifically in the areas of cloud, digital and cybersecurity) across verticals remains robust.The company's new logos, deal ACVs and net new business improved on q-o-q basis, which provide confidence for strong growth momentum in the mediumterm. The management does not see any material impact on deal inflows from the surging infections in some key developed markets due to new COVID-19 Omicron variant. We expect H2FY2022 would be better compared to H1FY2022, driven by strong growth in non-enterprise business and stabilization in enterprise segment.

Aspires to reach $1 billion revenue by 2025

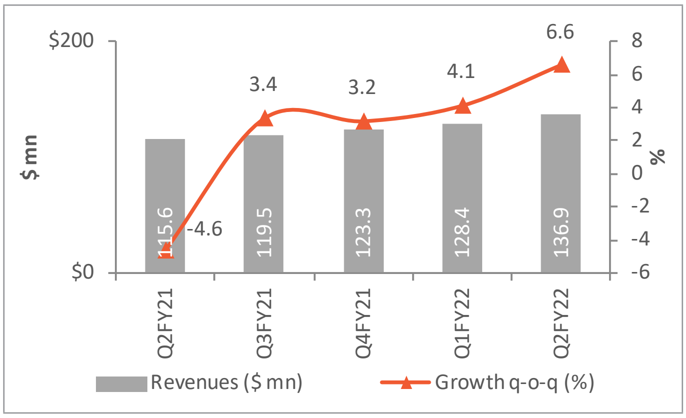
The management aspires to reach $1billion annual revenues by FY2025 against current annual revenue run-rate of $548 million, of which $800-850 million would come from organic and the rest from inorganic activity. This also indicates that organic/overall revenue growth would remain strong, clocking a 16%/22% CAGR over next four years. Management believes that the strong revenue growth would be driven by strong deal intake, addition of new clients, acceleration of cross selling, higher annuity revenue, strong strategic partnership and alliances and building capabilities around macro services in its targeted verticals.

Margins likely to remain stable in near-term; management aspires for 18% by FY2025

The management expects to maintain EBITDA margins with an upward bias in Q3FY2022despite supply-side concerns (including higher recruitment expenses), lower billing cycles, higher subcontractor expenses, unsustainable utilisation and one-month wage impact in Q3FY2022, led strong revenue growth, higher offshoring and cost optimization. Management believes that the attrition is expected to soften in next 2-3 quarters given normalization of economy and higher fresher hiring across the industry. The management expects EBITDA margin to be at 18% by FY2025, led by moderation in subcontractor expenses, pyramid management, strong growth in enterprise business and higher offshoring.

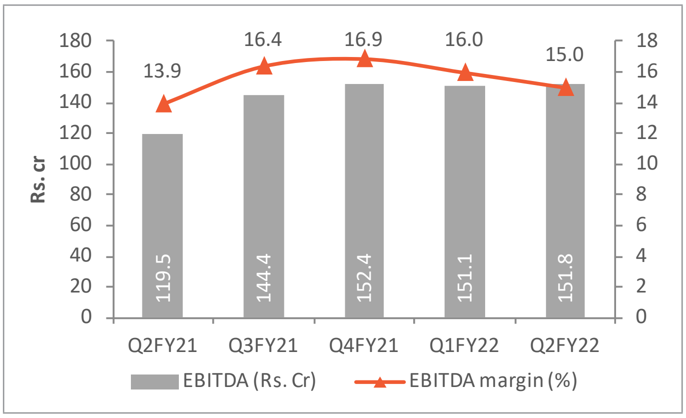
Financials in charts

Revenue ($ mn) and growth (%)



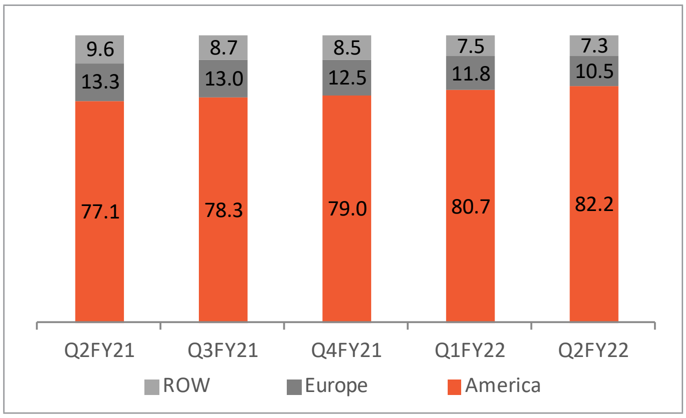
Source: Company, Sharekhan Research

EBITDA (Rs. cr) & margin (%)



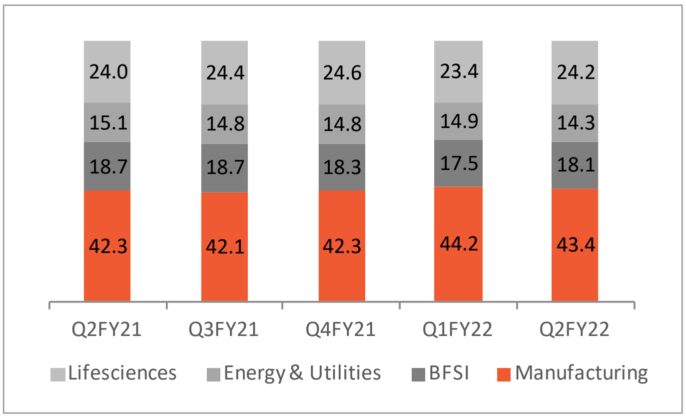
Source: Company, Sharekhan Research

Revenue mix by Geography (%)



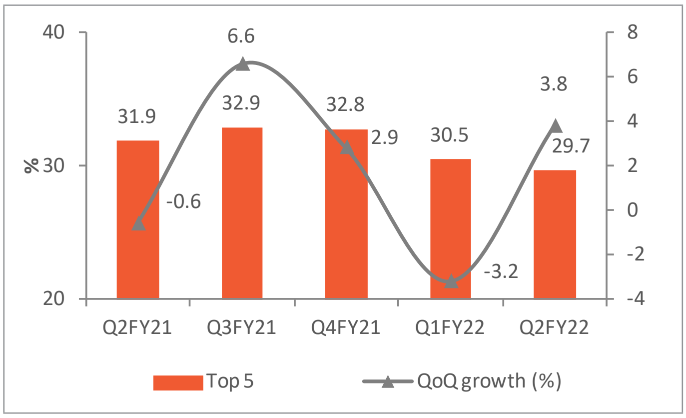
Source: Company, Sharekhan Research

Revenue mix by vertical (%)



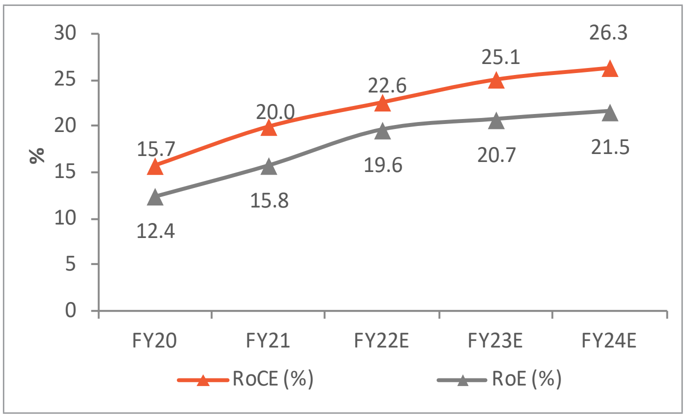
Source: Company, Sharekhan Research

Client revenue concentration



Source: Company, Sharekhan Research

RoCE (%) and RoE (%) trends



Source: Company, Sharekhan Research

Outlook and Valuation

Sector outlook – Expect acceleration in technology spending going forward

The COVID-19 outbreak has accelerated the need for business continuity, operational resilience and the switch to digital transactions, which has led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would clock an 8.5% CAGR over CY2021-CY2024E as compared to an average of 3.6% achieved in CY2010-CY2020. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. India's IT-BPM industry is estimated to reach $350 billion by 2025 from the current estimated revenue of $191 billion.

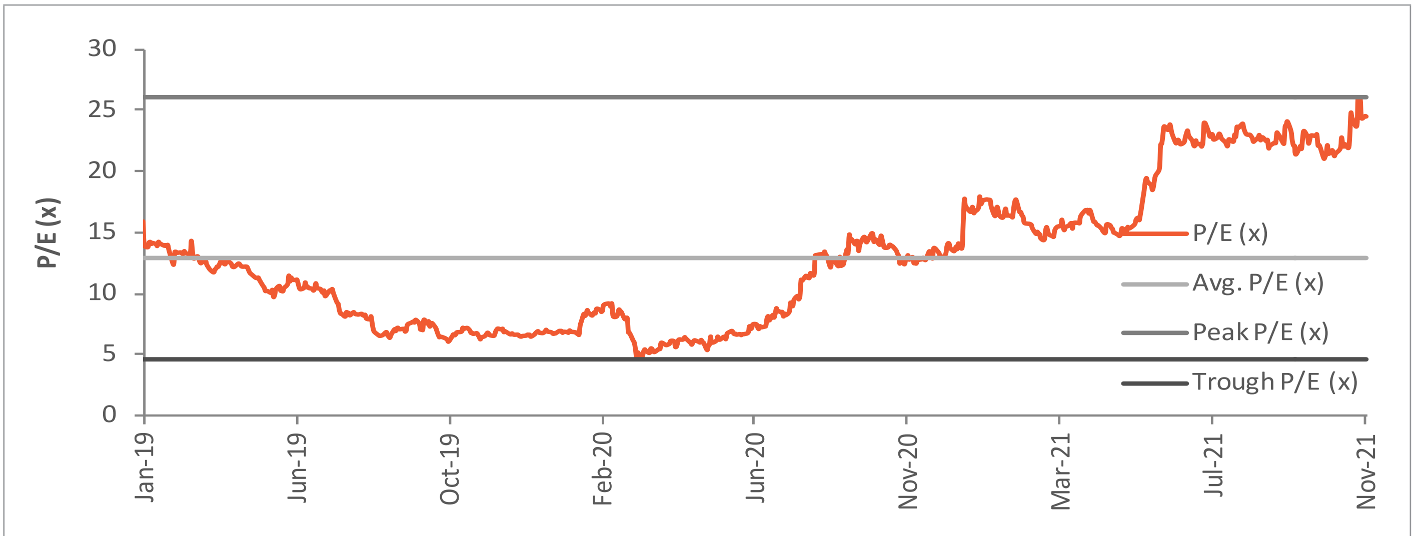
Company outlook – Moving in the right direction

The management sees strong traction for virtual engagement, Cloud adoption and digital transformation work. We believe the company's focus on deepening relationships with existing large clients, a vertical sales structure, leveraging of core and peripheral services, ramp-up of deal winsand defined incentives for cross-selling/up-selling would drive revenue growth.The management aspires to maintain its EBITDA margin of above 15% in the subsequent quarters despite supply-side issues and investments for capability enhancements.

Valuation – Attractive valuation, maintain Buy

Though revenue growth in enterprise solutions business is expected to remain flat in FY2022, it is expected to pick-up in FY2023E led by higher spends on legacy modernisation by clients, strong partnerships with hyperscalers and closure of multiple transformative deals. We forecast that the company would register a 16% and 20% CAGR, respectively, in revenue and earnings over FY2022-FY2024.At CMP, the stock trades at 25x/21x its FY2023E/FY2024E earnings. We stay positive on the stock considering strong net cash position, robust partnership with hyperscalers, increasing net new deal wins, robust demand from enterprise customers and improving return ratios. Hence, we maintain a Buy rating on Birlasoft with a revised price target (PT) of Rs. 580.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Mastek	2,700	3	7,927	28.0	24.2	13.6	11.1	7.3	6.4	28.9	29.3
Persistent	4,123	8	31,509	47.0	35.6	33.5	24.9	9.8	8.4	22.4	25.4
Birlasoft	474	28	13,182	29.6	24.5	18.5	14.8	5.3	4.7	19.6	20.7

Source: Company, Sharekhan estimates

About company

Promoted by CK Birla Group, Birlasoft was heavily dependent on GE for its business till FY2015.During this phase (FY2015-FY2018), the non-GE business reported a healthy 15%-16% CAGR and the company divested the GE business in a slump sale to GENPACT.On January 15, 2019, Birlasoft (India) Limited(an unlisted company) merged and amalgamated with KPIT Technologies Limited (merger) and the engineering business of KPIT Technologies Limited was on a going concern basis demerged and transferred to an independent entity.Post restructuring,Birlasoft became anorganisation with a mix of digital and ERP revenue.Birlasoft had strengths primarily on the non-ERP digital businesses, while KPIT IT services possessed core strengths on the enterprise software solutions and capabilities in digital transformation services.

Investment theme

Post the merger in January 2019, the new combined entity had very complementary skill sets from both the businesses. Focus on deepening relationship with existing large accounts, verticalised sales structure, leveraging core and peripheral services, and defined incentives of cross-sell/up-sell are expected to drive the company's revenue growth going ahead. Further, Birlasoft has been signing a steady mix of net-new deals and renewal of deals, which indicates the company's position in the enterprise digital space. Management expects gradual improvement in operating profitability to continue, given its cost-optimisationinitiatives and reduction in discretionary spends.

Key Risks

- (1) Deterioration of demand for IT services in the wake of second wave COVID-19; (2) loss of any large clients; and (3) stiff competition in the market.

Additional Data

Key management personnel

Amita Birla	Chairman & non-executive Director
Dharmender Kapoor	CEO & MD
Shreeranganath Kulkarni	Chief Delivery Officer (CDO)
Roop Singh	Chief Business Officer (CBO)
ArunDinakar Rao	Chief People Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Asset Management Co Ltd	3.9
2	L&T Mutual Fund Trustee	3.6
3	Vanguard Group Inc	2.5
4	Emirate of Abu Dhabi UAE	2.4
5	Aditya Birla Sun Life Asset Management Co Ltd	2.2
6	Axis Asset Management Co Ltd	1.9
7	Central India Industries	1.9
8	Ashish Dhawan	1.8
9	Nippon Life India Asset Management	1.3
10	Ellpsis Partners LLP	1.3

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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