Sharekhan by BNP PARIBAS

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Birlasoft Limited

Riding wave of optimism

IT & ITeS	Sharekhan code: BSOFT	Company Update

Summary

- We recommend a Buy on Birlasoft Ltd with a price target (PT) of Rs. 222 as it trades at a significant discount to peers. Cash and cash equivalents account for 18% of market capitalization.
- Birlasoft eyes a bounceback in Q3FY2021 despite lower billable days, driven by ramp-up large deals, reversal of price discounts and revenue contribution from a transformational deal
- Manufacturing vertical would continue its growth momentum in Q3, while energy and utilities vertical (down 7.1% q-o-q in Q2) is expected to bounce back; lifesciences vertical likely to recover in Q4FY2021
- Management indicated that it aims to scale up Microsoft cloud business to $100 million in the next couple of years from current level of $20-25 million; expect to achieve 15% EBITDA margin in Q1FY2022.

We recently interacted with Birlasoft's management to understand opportunities around cloud and digital transformation, growth outlook, conversion of deal pipeline and margin trajectory. The management maintained that the company would return to growth trajectory on both y-o-y and q-o-q terms in Q3FY2021 despite lower billable days and a continued decline in tail accounts (though a large portion is completed). Growth would be driven by ramp-up large deals, reversal of price discounts, top account mining and revenue contribution from a transformational deal (that has spilled over to Q3FY2021). The manufacturing vertical is expected to continue growing led by the strong show of the hi-tech and discrete manufacturing sub-segments, while energy and utilities vertical (down 7.1% q-o-q in Q2FY2021) is expected to deliver growth in coming quarters, led by ramp-up of a long term contract. The management indicated that the lifescience vertical and aero sub-segment would also start growing again in Q4FY2021. Movement of SAP workloads to the cloud is expected to create a huge opportunity for the company given its strong partnership with SAP, Oracle, Salesforce and Microsoft. One must note that ~2,000 of SAP's 45,000 ERP customers have migrated to the cloud framework. Management indicated that it aims to scale up its Microsoft Cloud business to $100 million over next couple of years from $20-25 million currently. EBITDA margin is expected improve on a sequential basis in Q3FY2021. The management aspires to achieve a 15% EBITDA margin in Q1FY2022 from 13.9% currently. We believe that the company would deliver strong earnings CAGR of 26% over FY2020-FY2023E on the back of continued momentum in large deal wins, a healthy deal pipeline, strong execution, higher spends on transformation by clients and anticipated margin improvement.

Our Call

Valuation: Reasonably valued, maintain Buy: We assume company's revenue growth would bounce back in Q3FY2021 despite lower working days, while margins would be better than Q2FY2021 led by cost optimisation measures. The management eyes total deal signings of $100-$150 million per quarter in the coming months, which would accelerate growth. We estimate revenue to clock a 10% CAGR over FY2021-23E, while earnings would clock a 25% CAGR in the same period led by an improvement in profitability and lower tax provision. At CMP, the stock trades at 14x/12x of FY2022E/FY2023E earnings, which is at a significant discount to peers. Further, net cash on balance sheet stood at Rs. 917 crore (18% of market capitalisation). Hence, we maintain Buy on Birlasoft with a price target of Rs. 222.

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.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	3,305.2	3,291.0	3,594.2	4,022.2	4,408.4
OPM (%)	9.7	11.9	13.8	14.8	15.4
Adjusted PAT	231.0	224.3	287.3	368.1	447.6
% y-o-y growth		*(2.9)*	*28.1*	*28.1*	*21.6*
Adjusted EPS (Rs.)	8.3	8.1	10.2	13.0	15.9
P/E (x)	22.7	23.3	18.4	14.4	11.9
P/B (x)	3.0	2.8	2.5	2.2	2.0
EV/EBITDA (x)	14.6	12.0	9.2	7.5	6.3
RoNW (%)	13.5	12.4	14.5	16.7	18.2
RoCE (%)	28.1	15.7	18.7	20.7	21.4

Source: Company; Sharekhan estimates

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		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 188**	
Price Target: **Rs. 222**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

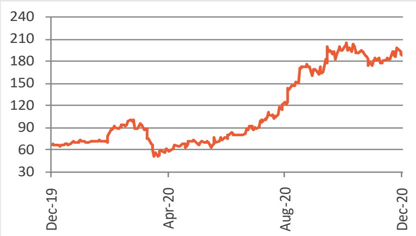
Company details

Market cap:	Rs. 5,214 cr
52-week high/low:	Rs. 210/48
NSE volume: (No of shares)	22.9 lakh
BSE code:	532400
NSE code:	BSOFT
Free float: (No of shares)	16.4 cr

Shareholding (%)

Promoters	41
DII	13
FII	23
Others	23

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.5	10.6	133.7	174.9
Relative to Sensex	-6.4	-3.8	102.4	165.6

Sharekhan Research, Bloomberg

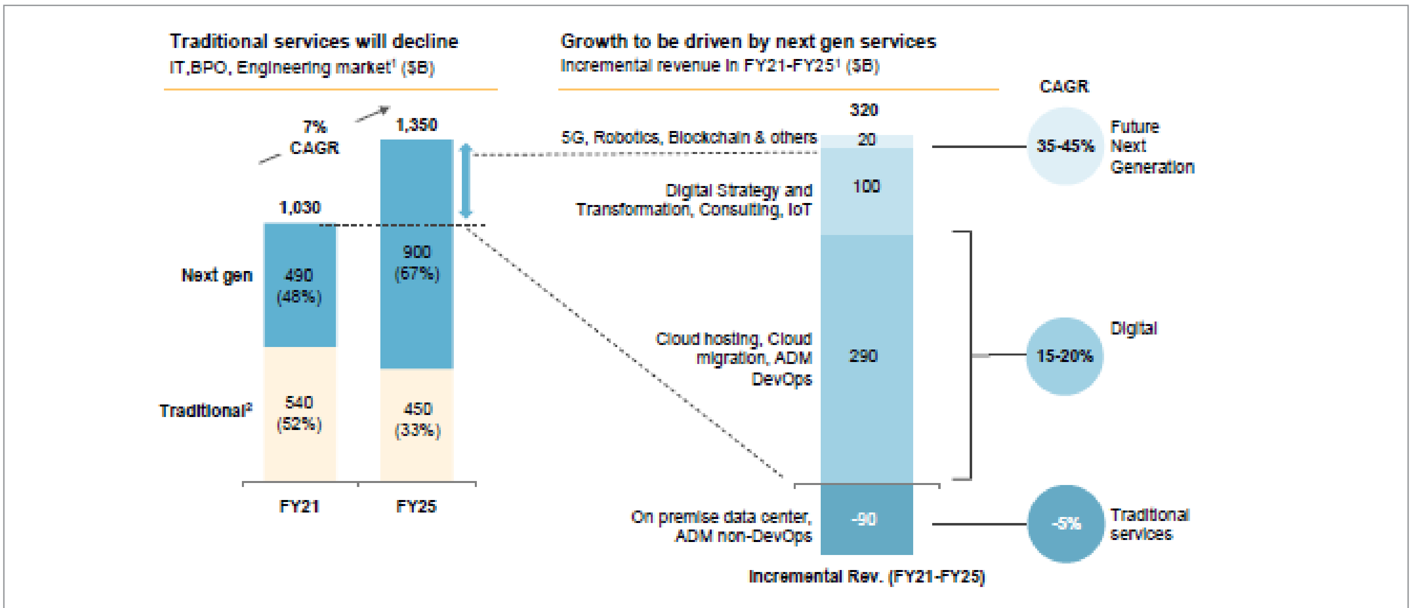
Growth to accelerate as more enterprises seek to ride the Cloud

We recently interacted with Birlasoft's management to understand the opportunities for the company from the accelerated cloud adoption by enterprises. The company has the strong partnership with SAP, Oracle, Salesforce and Microsoft. The management sees significant opportunities in cloud migration, implementation of new solutions on the cloud and application modernisation as only 15% of enterprises have moved to the cloud framework till date. Further, significant movement of SAP workloads to cloud would also support its growth as about 2,000 of SAP's 45,000 ERP customers have migrated to cloud. the management indicated that it aims to scale up its Microsoft cloud business to $100 million over next couple of years from $20-25 million currently.

The COVID-19 pandemic has acted as a catalyst in accelerating demand for cloud transformation among enterprises. Top Cloud solutions providers have reported strong revenue growth during quarter ending September, registering a robust 29%/48%/45% y-o-y growth by AWS, Azure and Google Cloud, respectively. Cloud is one of the transformational pillars in the digital journeys of enterprises as half of their total transformational spends comes from cloud-related technologies. Amazon Web Services (AWS) continues to be the largest cloud service provider with 32% market share, followed by Azure (19%) and Google Cloud (7%) which is growing rapidly. It is estimated that around $500 billion would be spent on cloud over next three years.

IT services vendors are placed well considering size of opportunities from the long-term contracts to operate IT infrastructure on the cloud. Indian IT service providers generate revenue by helping enterprises migrate to the Cloud roadmap including services such as data management, processes and applications transformation, digital transformation, creating multi-cloud environment and offering products and platforms.

Next-gen technologies will drive incremental growth

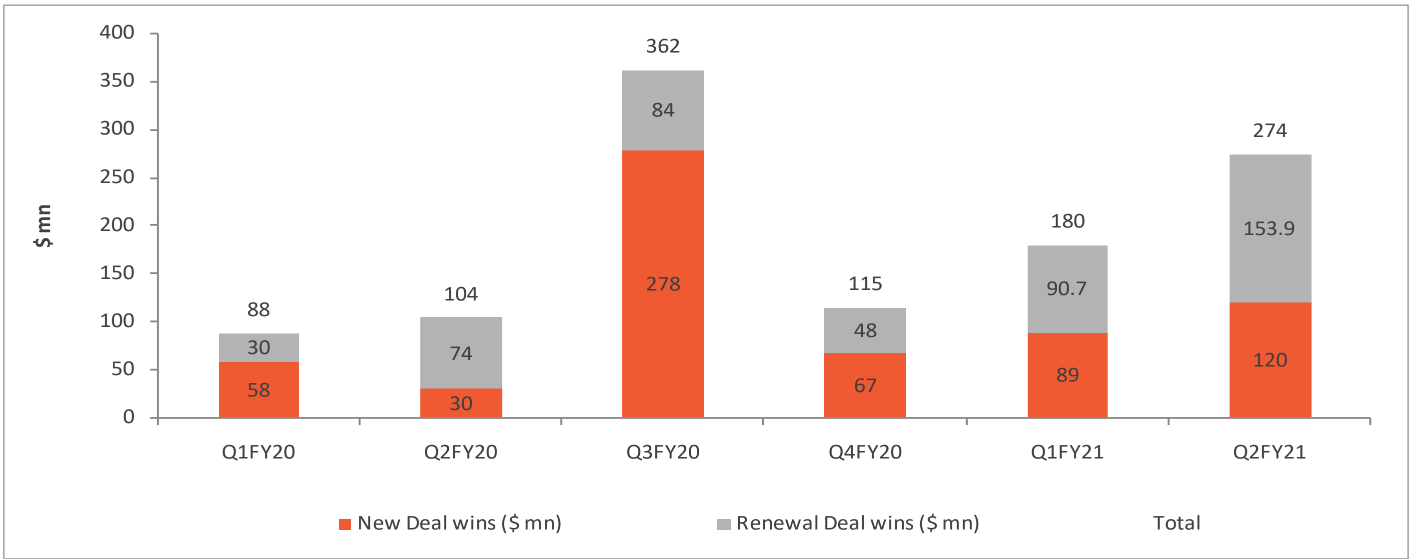


Source: Gartner; Sharekhan Research

Growth outlook reiterated; expects strong deal signings to continue

After three consecutive quarters of beating the industry average, revenue growth disappointed in Q2FY2021 owing to moderation in Invacare's revenue, full quarter impact of pricing discounts offered to customers and project deferrals. However, the management remains confident that it would report positive revenue growth in Q3FY2021 on both y-o-y and q-o-q terms despite lower billable days and continued reduction of tail accounts. The growth would be driven by ramp-up of two large deals, reversal of discounts to customers, new logo additions and improving traction in certain pockets. The management highlighted that the execution of a transformational project which spilled over to Q3FY2021 has started contributing to revenues from the first week of October 2020. Though the manufacturing vertical would continue its growth momentum given strong demand for its offering from its hi-tech and discrete manufacturing clients, revenue growth of energy and utilities vertical (down 7.1% q-o-q in Q2FY2021) would recover on the back of a ramp-up of a large deal. The management indicated that growth in lifesciences vertical and aero sub-segment are expected to come back in Q4FY2021 with the return of discretionary spends. TCVs of overall deals (including renewals) and net new deals were up 136% y-o-y and 138% y-o-y respectively during H1FY2021. Management targets to maintain total deal signings of $100-$150 million per quarter in coming quarters, which would help acceleration growth. We believe the company is well-placed to clock 10% CAGR growth in its USD revenue over FY2021-2023E on the back of strong deal wins, healthy deal pipeline, strong execution and higher adoption of digital transformation.

Deal wins remained strong, expect deal TCVs likely to remain healthy going ahead

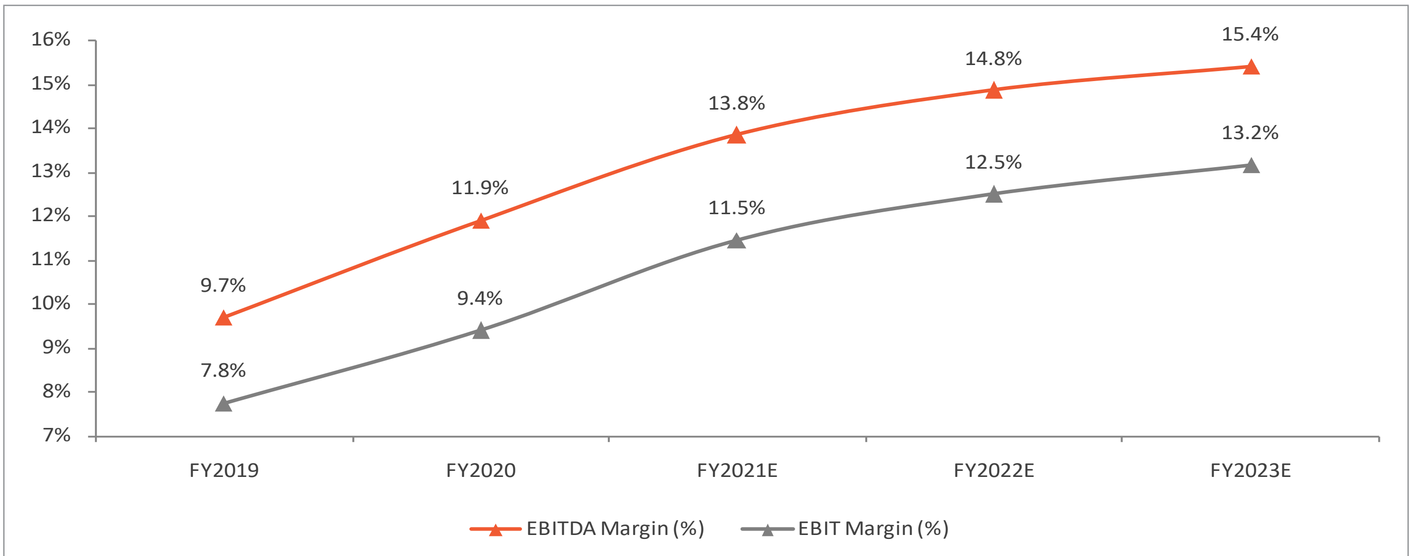


Source: Company; Sharekhan Research

Scope for margin improvement, management aspires for 15% in Q1FY2022

EBITDA margin of the company has improved from 7.9% in Q4FY2019 to 12.9% in Q4FY2020 and 13.9% in Q2FY2021, led by cost optimisation initiatives, divesting tail accounts, lower travel expenses and higher utilisations. The management guided that EBITDA margin in Q3FY2021 would be better than Q2, while it expects EBITDA margin to reach 15% in Q1FY2022 from 13.9% currently. Management may roll out annual wage hike in Q4FY2021. We believe there is a scope for margin improvement in FY2022E and FY2023E post the reduction of expenses in the overlapping areas.

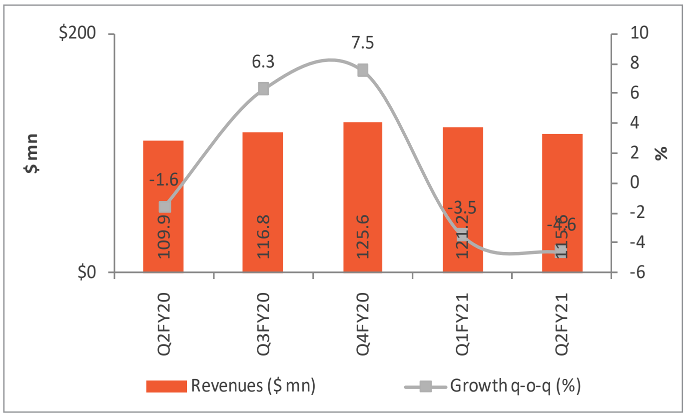
Scope for margin improvement going ahead



Source: Company; Sharekhan Research

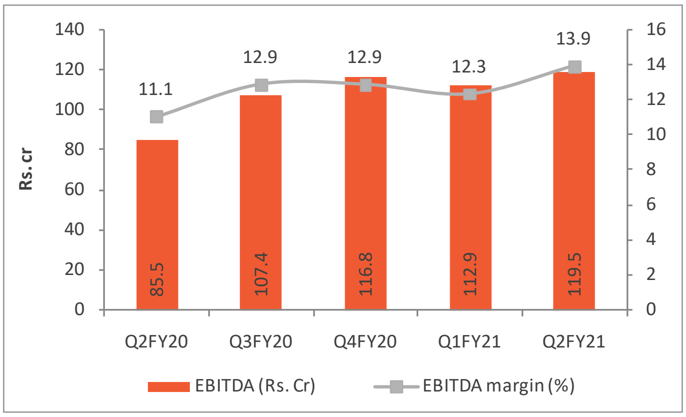
Financials in charts

Revenue (Rs. cr) and growth (%)



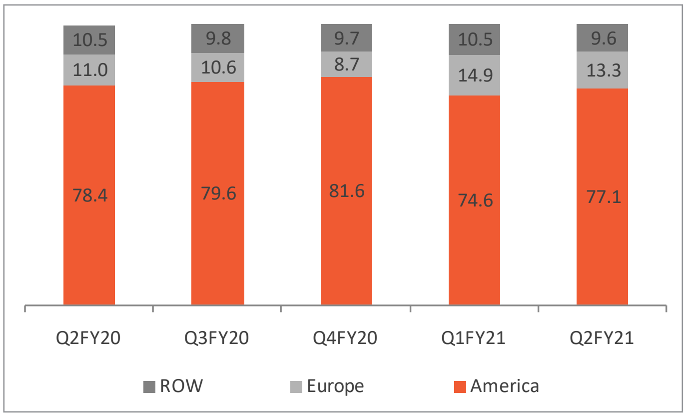
Source: Company, Sharekhan Research

EBITDA (Rs. cr) & margin (%)



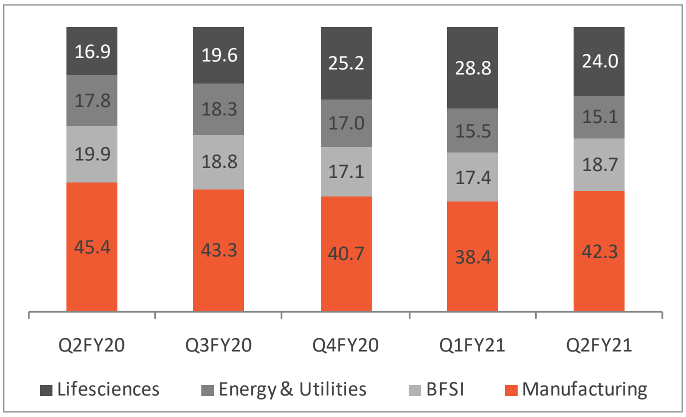
Source: Company, Sharekhan Research

Global presence



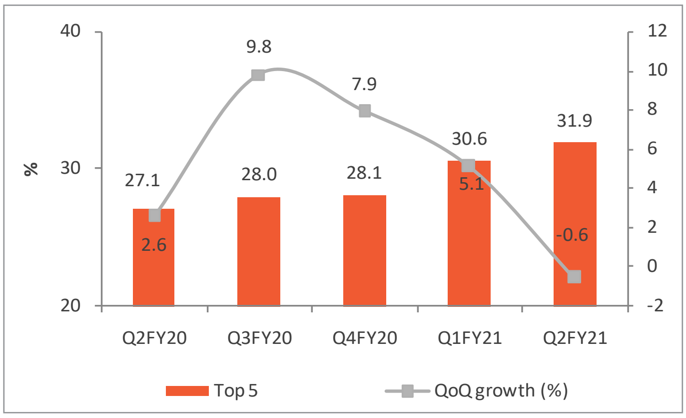
Source: Company, Sharekhan Research

Customer contribution (%)



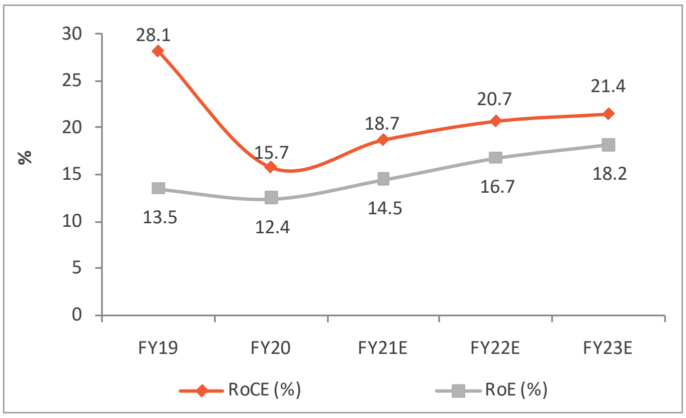
Source: Company, Sharekhan Research

RoE (%)



Source: Company, Sharekhan Research

RoCE (%)



Source: Company, Sharekhan Research

Outlook and Valuation

Sector view - Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate that IT services spending would grow by 5-8% over CY2021-24E as compared to the average of 4.2% achieved in CY2010-19. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients and an increase in online adoption across verticals. India's IT-BPM industry is estimated to reach $350 billion by 2025 from currently estimated revenue of $191 billion.

Company outlook - moving on right direction

The management sees strong traction for virtual engagement, cloud adoption and digital transformation work. We believe that the company's focus on deepening relationship with existing large accounts, vertical sales structure, leveraging of core and peripheral services, ramp-up of deal wins and defined incentives of cross-selling/up-selling would drive revenue growth. The management aspires to achieve EBITDA margins of 15% by Q1FY2022 from 13.9% currently.

Valuation - Reasonably valued, recommend Buy

We assume company's revenue growth would bounce back in Q3FY2021 despite lower working days, while margins would be better than Q2FY2021 led by cost optimisation measures. The management eyes total deal signings of $100-$150 million per quarter in the coming months, which would accelerate growth. We estimate revenue to clock a 10% CAGR over FY2021-23E, while earnings would clock a 25% CAGR in the same period led by an improvement in profitability and lower tax provision. At CMP, the stock trades at 14x/12x of FY2022E/FY2023E earnings, which is at a significant discount to peers. Further, net cash on balance sheet stood at Rs. 917 crore (18% of market capitalisation). Hence, we maintain Buy on Birlasoft with a price target of Rs. 222.

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 (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Persistent	1231	8	9409	22.4	18.2	13.7	11.2	3.6	3.3	16.8	18.8
Mastek	989	2	2450	15.3	13.2	7.0	6.0	3.1	2.6	22.1	21.7
Birlasoft	188	27	5145	18.4	14.4	9.2	7.5	2.5	2.2	14.5	16.7

Source: Company, Sharekhan Research

About company

Promoted by the CK Birla Group, Birlasoft was heavily dependent on GE for its business till FY2015. During this phase (FY2015-FY2018), the non-GE business was growing at a healthy 15-16% CAGR and the company divested the GE business in a slump sale to GENPACT. On January 15, 2019, Birlasoft (India) Ltd (an unlisted company) merged and amalgamated with KPIT Technologies Limited (merger) and the engineering business of the KPIT Technologies Limited was on a going concern basis demerged and transferred to an independent entity. Post restructuring Birlasoft became ~$450-475 million organisation 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 revenue growth for the company going ahead. Further, Birlasoft has been signing steady mix of net-new deals and renewal of deals, which indicates the company's positioning in the enterprise digital space. Management expects gradual improvement in operating profitability would continue given its cost optimization initiatives 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)
Arun Dinakar Rao	Chief People Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Ashish Dhawan	3.61
2	IDFC Mutual Fund	3.34
3	L&T Mutual Fund Trustee	2.60
4	Ellipsis Partners LLC	2.54
5	Ashish Kacholia	2.35
6	FMR LLC	2.11
7	Vanguard Group Inc	2.00
8	Dimensional Fund Advisor	1.98
9	Bengal Finance & Investment	1.80
10	New Horizon Opportunities	1.80

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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