

Weak near term outlook...

About the stock: Firstsource Solutions (FSL) provides business process services to BFSI, communication, media, tech and healthcare.

- The company generates 70% revenues from the US and 29% from the UK
- FSL is a domain driven BPM company, which has 150+ clients, including 17 Fortune 500 companies and nine FTSE 100 companies. The company has 27,398 employees across the US, UK, India and Philippines

Q3FY22 Results: FSL reported weak numbers in Q3FY22.

- US\$ revenues increased 1% QoQ to US\$195 million (mn); organic revenue declined 2.3% QoQ
- EBIT declined 50 bps QoQ to 12.0%
- The company declared an interim dividend of ₹ 3.5 per share. The record date is February 18, 2022

What should investors do? FSL's share price has grown by ~3.8x over the past five years (from ~₹ 40 in February 2017 to ~₹ 153 levels in February 2022).

- We continue to maintain **HOLD** rating

Target Price and Valuation: We value FSL at ₹ 162 i.e. 16x P/E on FY24E.

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
- Revenue guidance revised downward to 14-14.5% (including acquisitions, organic growth guidance of 10-11% growth) from 15-18% given in Q1. We expect dollar revenues to increase at a CAGR of 13.8% in FY21-24E
- We expect margins to decline in FY23E due to lower revenue growth and recover in FY24E i.e. when growth comes back

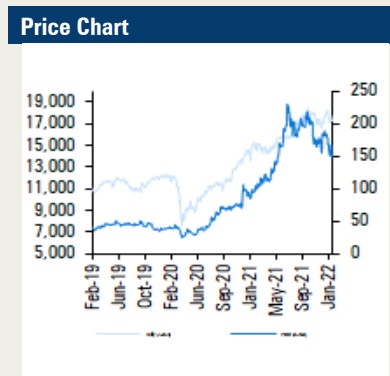
Alternate Stock Idea: Apart from FSL, in our IT coverage we also like Mastek.

- Growth in new logo acquisition, increasing deal size, expansion of sales, marketing and market share gains to drive revenues



Particulars	
Particular	Amount
Market Cap (₹ Crore)	10,506.2
Total Debt (₹ Crore)	604.5
Cash and Invests (₹ Crore)	219.9
EV (₹ Crore)	10,890.8
52 week H/L	242/ 93
Equity capital	696.1
Face value	10.0

Shareholding pattern				
	Mar-21	Jun-21	Sep-21	Dec-21
Promoters	54	54	54	54
FII	10	12	11	10
DII	14	15	14	15
Public	22	19	22	22



- Recent event & key risks**
- Revenue and EBIT margin guidance revised downward
 - Key Risk:** (i) Quicker than expected recovery in BFSI (ii) Lower than expected margins

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Key Financial Summary

Key Financials	FY19	FY20	FY21	5 year CAGR (FY16-21)	FY22E	FY23E	FY24E	3 year CAGR (FY21-24E)
Net Sales	3,826	4,099	5,078	9.6%	5,825	6,576	7,621	14.5%
EBITDA	535	629	804	15.5%	955	1,026	1,227	15.1%
Margins (%)	14.0	15.3	15.8		16.4	15.6	16.1	
Net Profit	378	340	362	6.7%	531	575	702	24.7%
EPS (₹)	5.4	4.9	5.2		7.7	8.3	10.1	
P/E	28.1	31.2	29.3		20.0	18.4	15.1	
RoNW (%)	13.9	12.3	12.9		17.3	17.5	19.7	
RoCE (%)	14.0	11.1	15.5		17.6	17.9	20.3	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported revenue of US\$195 mn for the quarter, up 1% QoQ. The revenue growth for the quarter was aided by its two acquisitions i.e. Stonehill (two-month consolidation) and ARSI (one month consolidation), which contributed US\$7.5 mn revenue together. The organic revenue came in at US\$187.5 mn, down 2.3% QoQ
- Geography wise, US (70% mix) grew 3.1% QoQ while UK (30% mix) declined 4.3% QoQ. Vertical wise BFSI (48% mix) declined 0.9% QoQ while healthcare (30% mix)/telecom & media (20% mix), grew 3.4% QoQ, 1.6% QoQ, respectively
- The company has revised downward revenue guidance of FY22 to 14-14.5% (including acquisitions i.e. Stonehill and ARSI put together, organic revenue growth guidance of 10-11%) vs. organic revenue growth guidance of 15-18% given in Q1 and 14-14.5% revenue growth guidance (Including Stonehill) given in Q2
- In the BFS segment, the company indicated that FY22 is a unique year in which its collections as well as mortgage refinancing business are weak, which used to mitigate each other historically. The management indicated that collections business was impacted due to continued low delinquency in credit card, which is impacting volumes. It also mentioned that refinancing volumes are being impacted due to Fed rate hike. The management indicated that they expect credit card spending in US and subsequently delinquency to pick up from Q2FY23 onward, which is expected to support its overall business
- In the healthcare business, the company indicated that its Health Plans and Health Services (HPHS) is doing well but provide business (hospitals), where it caters to US hospitals, has been under pressure on account of new Covid related rule of full vaccination. The company indicated that Q4 will be weak for this business due to resurgence of Covid third wave. This business is likely to see a recovery from Q1FY23 onwards. The company indicated that US hospitals lost around US\$50 billion of business in Covid wave despite government support
- The company indicated that UK business was impacted for the quarter due to higher employee absence even in work from home due to Covid infections. The company expects a recovery in Q4
- The company acquired two companies during the quarter. i) it acquired 'Stonehill', US based mortgage firm with focus on loan quality control and due diligence for consideration of US\$27 mn (1.17x price to sales) including earnouts payable at the first anniversary from closing. ii) it acquired ARSI, which provides legal collection services to leading BFS and fintech clients, in the US. The company paid US\$53 mn (0.7x price to sales) including earnouts payable at the first anniversary from closing
- The company revised downward EBIT margin upper end of the band from 12.3% to 12% for FY22. The company also indicated that ARSI has lower margin profile vs. FSL and The company expects margin profile of ARSI to improve, going forward, and will come at par with the company EBIT margins in three to four quarters. The company indicated that the legal collections market in the US is estimated at US\$1-1.5 bn, where it will benefit from its acquisition of ARSI

Exhibit 1: P&L

	Q3FY22	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	Comments
Revenue	1,463.8	1,365.2	7.2	1,428.6		Organic revenue in USD term, declined 2.3% QoQ, reported growth 2.5 includes USD7.5mn from Stonehill (2 months) and ARSI (1 month consolidation)
Employee expenses	967.6	950.3	2.0	972.8	-0.6	
Gross Margin	496.2	415.0	19.6	455.8	8.9	
Gross margin (%)	33.9	30.4	350 bps	31.9	199 bps	
SG&A expenses	258.3	204.6	26.2	217.1	19.0	
EBITDA	237.9	210.3	13.1	238.7	-0.3	
EBITDA Margin (%)	16.3	15.4	84 bps	16.7	-46 bps	EBITDA margin declined on muted operating performance
Depreciation & amortisation	61.7	51.3	20.3	59.7	3.4	
EBIT	176.2	159.0	10.8	179.0	-1.6	
EBIT Margin (%)	12.0	11.6	39 bps	12.5	-49 bps	
Other income (less interest)	-14.8	-12.7	16.4	-14.8	0.0	
PBT	161.4	146.3	10.3	164.2	-1.7	
Tax paid	25.9	26.5	-2.4	29.3	-11.6	
PAT	135.5	121.0	11.9	134.9	0.4	

Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

	FY22E			FY23E			FY24E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	5,863	5,825	-0.6	6,898	6,576	-4.7	7,621	We tweak revenues downwards as per revenue guidance cut due to continued pressure on BFSI and provider business
EBITDA	962	955	-0.6	1,145	1,026	-10.4	1,227	
EBITDA Margin (%)	16.4	16.4	0 bps	16.6	15.6	-100 bps	16.1	EBITDA margins trim due to ARSI acquisition which has lower than company margins
PAT	535	531	-0.7	660	575	-12.8	702	
EPS (₹)	7.7	7.7	-0.7	9.5	8.3	-12.8	10.1	

Source: Company, ICICI Direct Research

Financial summary

Exhibit 3: Profit and loss statement ₹ crore				
	FY21	FY22E	FY23E	FY24E
Total Revenues	5,078	5,825	6,576	7,621
Growth (%)	23.9	14.7	12.9	15.9
Employee expenses	3,467	3,961	4,538	5,221
Other Expenses	807	909	1,013	1,174
EBITDA	804	955	1,026	1,227
Growth (%)	27.9	18.8	7.4	19.6
Depreciation & Amortization	206	255	281	326
Other Income	1	4	4	4
Interest	52	49	29	27
PBT before Exceptional Items	432	655	719	878
Growth (%)	9.5	51.8	9.7	22.0
Tax	70	125	144	176
PAT before Excp Items	362	531	575	702
Exceptional items				
PAT before MI	362	531	575	702
Minority Int & Pft. from associates	0	0	0	0
PAT	362	531	575	702
Growth (%)	6.5	46.8	8.4	22.0
EPS	5.2	7.7	8.3	10.1
EPS (Growth %)	6.5	46.8	8.4	22.0

Source: Company, ICICI Direct Research

Exhibit 4: Cash flow statement ₹ crore				
	FY21	FY22E	FY23E	FY24E
Profit before Tax	432	655	719	878
Depreciation & Amortization	206	255	281	326
WC changes	290	(54)	(201)	(100)
Other non cash adju.	48	(79)	(118)	(152)
CF from operations	976	776	681	952
Capital expenditure	(173)	(274)	(163)	(189)
Δ in investments	(176)	-	-	-
Other investing cash flow	1	4	4	4
CF from investing Activities	(350)	(270)	(159)	(185)
Issue of equity	(57)	-	-	-
Δ in debt funds	(376)	(124)	(50)	-
Dividends paid	(204)	(265)	(351)	(428)
Other financing cash flow	(51)	(49)	(29)	(27)
CF from Financial Activities	(689)	(532)	(523)	(549)
Δ in cash and cash bank balance	(63)	(25)	(2)	218
Effect of exchange rate changes				
Opening cash	191	137	112	111
Closing cash	137	112	111	329

Source: Company, ICICI Direct Research

Exhibit 5: Balance sheet ₹ crore				
Particulars	FY21	FY22E	FY23E	FY24E
Equity	696	696	696	696
Reserves & Surplus	2,103	2,369	2,593	2,867
Networth	2,799	3,065	3,289	3,563
Minority Interest	1	1	1	1
LT liabilities & provisions	461	399	399	399
Total Debt	604	543	493	493
Source of funds	3,865	4,007	4,181	4,455
Net fixed assets	749	861	836	792
CWIP	-	-	-	-
Goodwill	2,195	2,195	2,195	2,195
Other non current assets	655	702	897	987
Loans and advances	-	-	-	-
Current Investments	83	83	83	83
Debtors	577	662	748	868
Cash & Cash equivalents	137	112	111	329
Other current assets	435	499	564	654
Trade payables	279	320	362	420
Current liabilities	604	693	783	909
Provisions	82	95	107	124
Application of funds	3,865	4,007	4,181	4,455

Source: Company, ICICI Direct Research

Exhibit 6: Key ratios ₹ crore				
(Year-end March)	FY21	FY22E	FY23E	FY24E
Per share data (₹)				
EPS-diluted	5.2	7.7	8.3	10.1
DPS	3.0	3.8	5.0	6.1
BV	40.8	44.6	47.9	51.9
Operating Ratios (%)				
EBITDA Margin	15.8	16.4	15.6	16.1
PBT Margin	8.5	11.3	10.9	11.5
PAT Margin	7.1	9.1	8.7	9.2
Return Ratios (%)				
RoNW	12.9	17.3	17.5	19.7
RoCE	15.5	17.6	17.9	20.3
Valuation Ratios (x)				
P/E	29.3	20.0	18.4	15.1
EV / EBITDA	13.5	11.4	10.5	8.6
Price to Book Value	3.8	3.4	3.2	2.9
EV / Net Sales	2.1	1.9	1.6	1.4
Mcap / Net Sales	2.1	1.8	1.6	1.4
Turnover Ratios				
Debtor days	41	42	42	42
Creditors days	20	20	20	20
Solvency Ratios				
Total Debt / Equity	0.2	0.2	0.1	0.1
Current Ratio	1.0	1.0	1.0	1.0
Quick Ratio	1.0	1.0	1.0	1.0
Net Debt / EBITDA	0.5	0.4	0.3	0.1

Source: Company, ICICI Direct Research

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Hold: -5% to 15%;

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