Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Coforge Ltd

Mixed bag quarter; forging new growth paths

IT & ITeS	Sharekhan code: COFORGE
Reco/View: Buy ⇔	CMP: Rs. 3,732
	Price Target: Rs. 4,680 ⇔

↑ 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 19.29

Updated July 08, 2022

Low Risk

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

Source: Morningstar

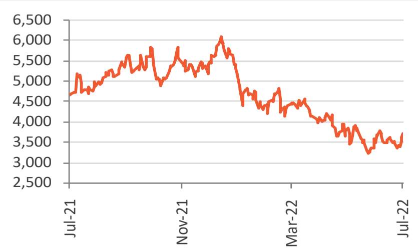
Company details

Market cap:	Rs. 22,734 cr
52-week high/low:	Rs. 6133/3224
NSE volume: (No of shares)	4.3 lakh
BSE code:	532541
NSE code:	COFORGE
Free float: (No of shares)	3.6 cr

Shareholding (%)

Promoters	40
DII	28
FII	22
Others	10

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6.6	-9.5	-29.7	-20.1
Relative to Sensex	-1.6	-7.6	-24.0	-26.2

Sharekhan Research, Bloomberg

Summary

- Q1FY23 revenue growth was a tad below estimates and margins too were off the mark owing to investments in talent & wage revisions. Q1FY23 saw healthy fresh order bookings, sustained large deal wins (greater than $50 million), stable attrition and logo addition.
- Management reiterated revenue growth outlook of at-least 20% on CC terms after factoring in all possible macro events and adjusted EBITDA margin band of 18.5-19% for FY2023. It remains confident of clocking a 100-250 bps q-o-q rise in margin in Q2FY23.
- Medium-term growth to be led by sustained large order intake, investment in talent, recovery in travel industry, robust growth momentum in BFS and solid execution. EBITDA margin to improve in FY2023E, primarily aided by increasing offshore revenue and pyramid rationalisation.
- We maintain a Buy on Coforge with an unchanged PT of Rs. 4,680, given strong earnings visibility, robust order bookings and stable margin outlook.

Coforge delivered slightly below-than-expected revenue growth in Q1FY2023 owing to a sharp revenue decline in its insurance vertical, while margins missed our estimates at a wide range of 110 bps, which dragged down net profit by 28% q-o-q. However, Q1 saw strong fresh order bookings (close to record-high order intake of Q1FY22), sustained large deal wins (greater than $50 million), stable attrition (among the lowest in the industry), strong client mining, decent growth in top accounts and new logo addition. Constant currency (CC) revenue growth was at 4.7% q-o-q led by strong growth in BFS (up 11.1% q-o-q on CC) and other verticals (up 11.4% q-o-q on CC), while the USD revenue grew by 2.7% q-o-q to $238.7 million owing to a higher exposure to EMEA region (contributed 36.9% to total revenue). EBIT margin contracted 300 bps q-o-q to 12.5%, lagged our estimates by 110bps, owing to higher-than usual wage revision and investments leaderships and building capabilities. The company signed its fifth large deal of greater than $50 million+ TCVs. Fresh order intake of $315 million remained healthy, grew 4.7% q-o-q. The company reiterated its revenue growth outlook of at least 20% on CC terms after factoring in all possible macro events and adjusted EBITDA margin band of 18.5-19% for FY2023. Medium-term growth is expected to be led by strong order intake, investment in talents, recovery in travel industry, robust growth momentum in BFS and solid execution. EBITDA margin is likely to improve marginally in FY2023E, aided by rising offshore revenue, pyramid rationalization and operating leverage.

Key positives

- Fresh order intake increased by 26% y-o-y to $1.15 billion on LTM basis. Signed two large deals, including one $50 million+ deal in BFS space
- BFS vertical continued growth momentum, rising 11.1% q-o-q on CC terms
- Added one and five clients on q-o-q in $10mn+ and $5mn+ revenue category

Key negatives

- Insurance vertical declined 6.3% q-o-q on CC
- Weak cash generation – Cash balance declined to $42 million in Q1FY23 from $62.2 million in Q4FY22

Management Commentary

- Company reiterated its revenue growth outlook of at-least 20% on CC terms after factoring in all possible macro events and adjusted EBITDA margin band of 18.5-19% for FY2023.
- Management remains confident of delivering a sequential improvement in margin of 100-250 bps q-o-q in Q2FY23.
- Management believes transformation program in the travel vertical is in the first half/middle of cycle.
- The company expects strong rebound in insurance vertical in Q2FY23.
- Management expects the cash flows to improve in the next three quarters.

Revision in estimates – We revised downward our earnings estimates for FY2023E/FY2024E by 3-4% factoring margin miss in Q1FY2023 and continued investments in building capabilities and talents, and possible tech spend moderation owing micro factors.

Our Call

Valuation – Growth outlook intact: Coforge is well poised to achieve its strong revenue growth guidance in FY2023E on the back strong order intake, recovery in travel industry, continued growth momentum in BFS vertical, new logo addition, investments in leadership team and strong execution. Further, its executable order bookings for next 12 months remain 73% of our FY2023E revenue estimates. Coforge is expected to clock a revenue/earnings CAGR of 16%/22%, respectively over FY2022-24E, implies a market leading growth among the top mid-tier peers. At CMP, the stock is trading at a valuation of 28x/23x of its FY2023E/FY2024E earnings, which is at a 20% discount to its 3-year average valuation. Hence, we maintain a Buy rating on Coforge with an unchanged price target of Rs. 4,680.

Key Risks

Any integration issues in ongoing M&A activities, especially IP-related transactions, could affect earnings. Further, high dependence on IMS could create challenges to its revenue growth trajectory.

Valuation (consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	4,662.8	6,432.0	7,936.9	9,126.8
OPM (%)	16.9	17.3	17.6	17.9
Adjusted PAT	473.5	661.7	801.7	989.6
% YoY growth	5.0	39.7	21.2	23.4
Adjusted EPS (Rs.)	74.7	109.0	132.0	162.7
P/E (x)	50.0	34.2	28.3	22.9
P/B (x)	9.2	8.3	6.8	5.8
EV/EBITDA (x)	27.8	20.4	16.0	13.3
RoNW (%)	19.5	25.5	26.4	27.3
RoCE (%)	22.7	27.3	26.9	27.6

Source: Company; Sharekhan estimates

Weak margins dragged down net profit

Coforge delivered slightly below-than-expected revenue growth in Q1FY2023, while margins missed our estimates at wide range of 110 bps, which led to 28% q-o-q decline in net profit. Constant currency revenue grew by 4.7% q-o-q, a tad below our estimates, owing to continued weakness in the insurance vertical. On reported basis, the USD revenue grew by 2.7% q-o-q to $238.7 million. USD revenue growth was impacted due to its higher exposure to EMEA region (contributed 36.9% to total revenues). The revenue growth was led by strong growth in BFS (up 9.4% q-o-q) and other verticals (up 8.5% q-o-q), while its TTH vertical revenue growth remained muted on q-o-q in Q1FY23 due to higher base effect. Revenue growth of insurance vertical declined 7.7% q-o-q in Q1FY23. EBIT margin contracted 300 bps q-o-q to 12.5%, lagged our estimates by 110bps, owing to higher wage revision (versus FY2022), and continued investments in talents and building capabilities (reflected in 100 bps q-o-q increase in SG&A to revenue). Net profit came at Rs. 149.7 crore (down 27.9% q-o-q, but up 22.9% y-o-y) and was 16% below our estimates owing to miss in operating margin, lower other income (down 40% q-o-q) and higher tax provisions (22.3% versus 13.2% in Q4FY22).

Expect strong growth to continue in FY2023E; reiterated guidance

Management cited that demand outlook remains strong given its discussion with its customers, healthy deal pipeline despite strong conversion rate and higher spending around cloud migration, digital transformation and technology modernization. Strong order intake, robust executable order book for next 12 months, differentiated capabilities, cross-sell opportunities and investments in talents and building capabilities would help the company to deliver strong revenue growth yet again in FY2023E. Aggressive investments in talents and building capabilities indicate that the company's commitment to double down its growth engines to rapidly achieve its $2 billion revenue milestone. Further, the company focuses on strengthening its capability via partner ecosystem, differentiated portfolio offerings, and cross selling opportunity to drive the growth momentum in the next few years. The company's fresh order intakes ($315 million) and executable order booking ($745 million) over next 12 months remained healthy, grew 4.7% q-o-q and 3.5% q-o-q, respectively. The company reiterated its revenue growth outlook of at least 20% in CC terms after factoring in all possible macro events and adjusted EBITDA margin band of 18.5-19% for FY2023. We believe the company is well positioned to deliver another year of strong organic revenue growth in FY2023 on the back of strong order intake, recovery in travel vertical, continued strong growth momentum in BFS vertical, new logo addition, investments in leadership team and strong execution.

Management expects margin improvement in Q2FY23; reiterated margin guidance for FY23E

Coforge saw a significant decline in EBIT margin in Q1FY23 owing to higher-than usual wage revision and higher SG&A expenses to revenues, which was partially offset by higher offshore revenues. However, the company's EBIT margin improved 169 bps on y-o-y. Management remain confident of delivering a sequential improvement in EBIT margin of 100-250 bps q-o-q in Q2FY23 on the back of rising utilization, higher offshoring, absence of wage revision and pyramid balancing as freshers would come on billings. The management believes the offshore revenue mix would be sustainable in FY2023 given a higher portion of offshoring in large deals won in the pa st twelve months. Further, the higher investments in talents and leaderships will help the company to drive its strong revenue growth going ahead. Levers for margin improvement in FY2023 are (1) strong revenue growth, (2) higher offshoring, (3) greater revenue contribution from the AdvantageGO, (4) utilisation improvement, (5) pyramid rationalisation, (6) absence of acquisition related expenses and (7) currency tailwinds. Management reiterated its adjusted EBITDA margin guidance of 18.5-19% for FY2023. We forecast EBITDA margins would be at 18.1% and 18.4% for FY2023E and FY2024E respectively.

Q1FY2023 Key earnings call highlights

- **Strong growth in BFS and other verticals, while insurance continued to decline:** Both BFS (up 11.1% q-o-q CC) and other vertical (up 11.4% q-o-q on CC) reported significantly higher-than the company's overall sequential revenue growth of 4.7% on CC, while insurance vertical continued to decline at 6.3% q-o-q on CC in Q1FY23. Travel, tourism & hospitality (TTH) vertical reported muted revenue growth (up 1.1% q-o-q on CC) on a sequential basis owing to higher base effect, while it grew 23% y-o-y in Q1FY23. Strong revenue growth of other vertical was driven by the strong performance of its sub-verticals such as public sector outside India, retail and healthcare and ramp-up of multi-year multi-million deal.
- **Strong growth outlook for its key verticals, while insurance to recover strongly in Q2:** BFS continued to outperform other verticals in Q1FY23 and management expects the strong growth momentum in this vertical to continue in coming quarters given ramp-up of large deals won earlier quarters (including $50 million deal during Q1FY23). After a sharp decline in revenue in insurance vertical, the company expects strong rebound in growth in Q2FY23. Though growth in TTH vertical moderated in Q1FY23, management cited that its revenue surpassed the pre-pandemic level. The TTH vertical continues to see strong growth momentum ahead on the back strong tech spends on cloud transformation to strengthen business resilience

and contactless travel, deep domain expertise and large deal intake during Q1FY23. Management believes the transformation program in the travel vertical is in the first half/middle of the cycle. Further, the emerging vertical is also poised for strong growth in the coming quarters.

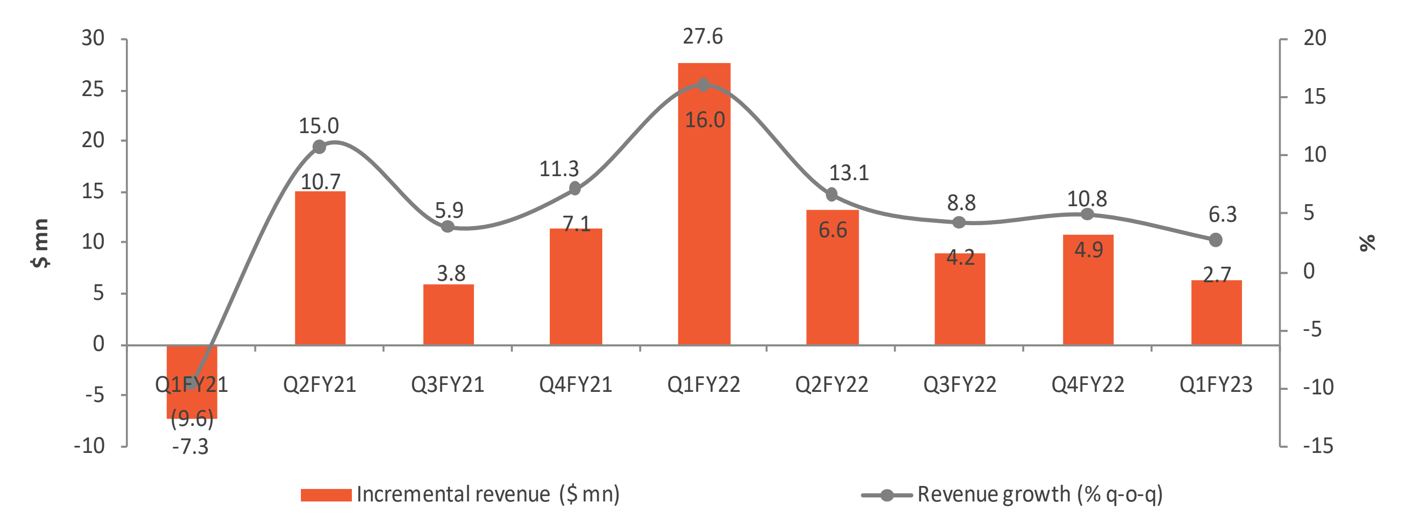
- **Expect strong growth digital process automation:** Management expects strong growth in digital process automation (DPA) given its recent partnerships during the quarter.
- **Large deal win momentum continues:** The company reported 4.7% q-o-q growth in fresh deal intake in Q1FY23. The company signed its fifth large deal of greater than $50 million+ TCVs during the quarters, taking total large deal TCVs (higher than $50 million) of $550 million in last five quarters. The company was able to win large deals in each quarter over last five quarters. The company won two large deals (including a $50 mn+ deal from the BFS vertical and another one from travel vertical) during the quarter given its continued focus on driving the velocity of large deals. The size and velocity of large deal will further enhance the company's offshore revenue, which will help in improving margin performance going ahead.
- **Guidance reiterated:** Management guided for at least 20% revenue growth even after taking in all possible impact from the macro events and margins to be around 18.5-19%. The growth would be supported by strong executable order book for next 12 months, new logo addition, and healthy deal pipeline.
- **Strong growth in top 6-10 accounts:** Post decline in revenue in its top-5 clients, revenue in top-5 account grew by 1.8% q-o-q in Q1FY23, while revenue from the top-10 clients accelerated to 4.2% q-o-q. Revenue from top 6-10 clients grew by 8.8% q-o-q during the quarter.
- **Strong client mining:** The management indicated that the company focuses on the mining activities among top accounts. Coforge added four clients on y-o-y (and one on q-o-q) in the $10 mn+ revenue bucket. Similarly, the company added 4 and 3clients on y-o-y basis in $5 mn+ and $1 mn+ revenue bucket in Q1FY2022. On q-o-q, the company added five clients in its $5 mn+ revenue bucket.
- **Net headcount addition moderated, attrition stable:** Net headcount addition remained at 242 in Q1FY23, significantly down from average net headcount addition of last four quarters, owing to decline in headcounts of its BPS business. However, the company LTM attrition remained stable at 18%, which is amongst the lowest in the industry. Over the last few quarters, the company expanded its leadership team meaningfully across verticals, geographies and capabilities to match the growth agenda of the company.
- **Cash & cash equivalents:** The cash and cash equivalents stood at $42 million in Q1FY23 versus $62.2 million in Q4FY2022. The company's capex was $7 million compared to $3.4 million in Q4FY2022. DSO increased by 9 days to 72 days in Q1FY2023. Bank borrowings have increased due to weak cash flows amid significant higher compensation payments, interest payments and capex. However, management expects the cash flows to improve in the next three quarters.

Results Rs cr

Particulars	Q1FY23	Q1FY22	Q4FY22	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	232.4	172.1	221.6	35.0	4.9
Net sales	**1,742.9**	**1,261.5**	**1,658.1**	**38.2**	**5.1**
Direct costs	1,162.0	858.0	1,121.0	35.4	3.7
Gross profit	**580.9**	**403.5**	**537.1**	**44.0**	**8.2**
SG&A	226.0	176.7	214.5	27.9	5.4
Acquisition related expenses & costs of ESOPs	25.6	14.6	20.6	75.3	24.3
EBITDA	**329.3**	**212.2**	**302.0**	**55.2**	**9.0**
Depreciation andamortisation	58.4	44.9	56.6	30.1	3.2
EBIT	**270.9**	**167.3**	**245.4**	**61.9**	**10.4**
Other income	(11.9)	10.9	(12.2)	-209.2	-2.5
PBT	**259.0**	**178.2**	**233.2**	**45.3**	**11.1**
Tax provision	34.2	40.8	36.0	-16.2	-5.0
Minority interest	17.1	4.4	13.5	288.6	26.7
Adjusted net profit	**207.7**	**133.0**	**183.7**	**56.2**	**13.1**
EPS (Rs.)	34.1	21.9	30.3	55.7	12.5
Margin (%)				**BPS**	**BPS**
EBITDA	18.9	16.8	18.2	207	68
EBIT	15.5	13.3	14.8	228	74
NPM	11.9	10.5	11.1	137	84
Tax rate	13.2	22.9	15.4	-969	-223

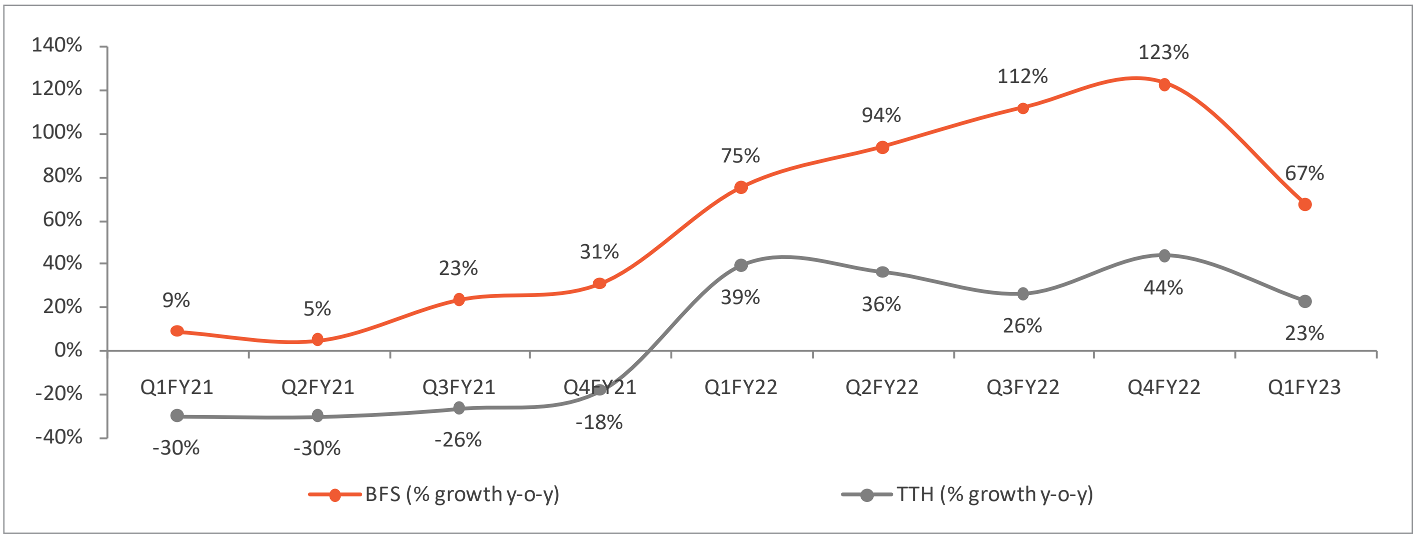
Source: Company, Sharekhan Research

Q2 usually the strongest quarter in a year; FY2023 likely to be a normal year



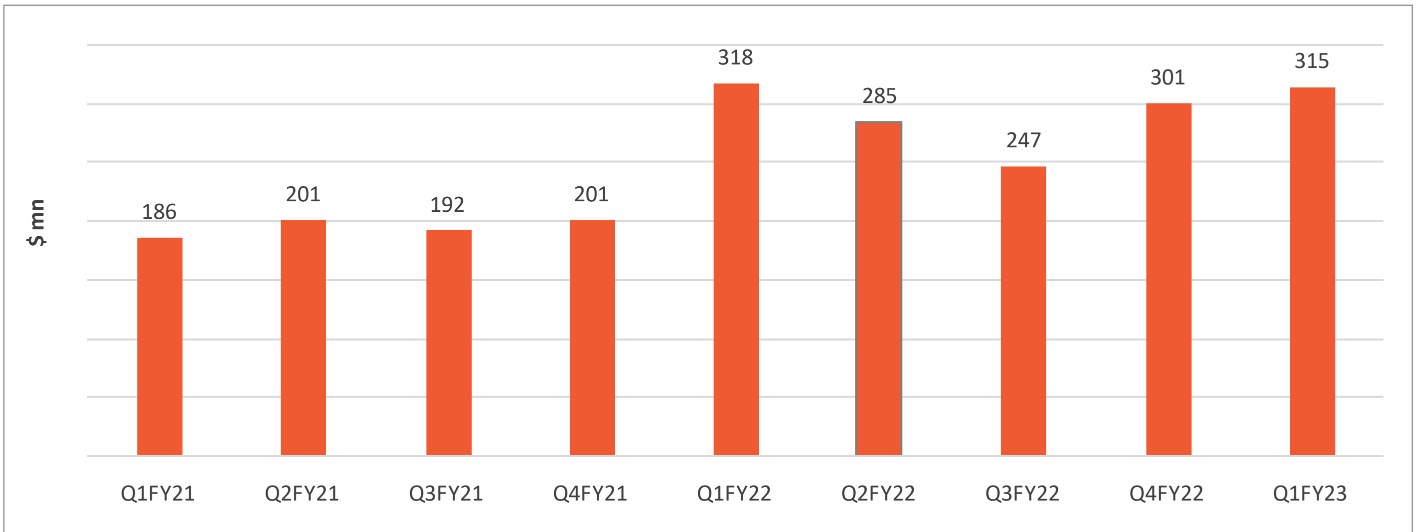
Source: Company; Sharekhan Research

BFS growth (y-o-y) outpaced TTH growth; BFS is set to outgrow other verticals in FY2023



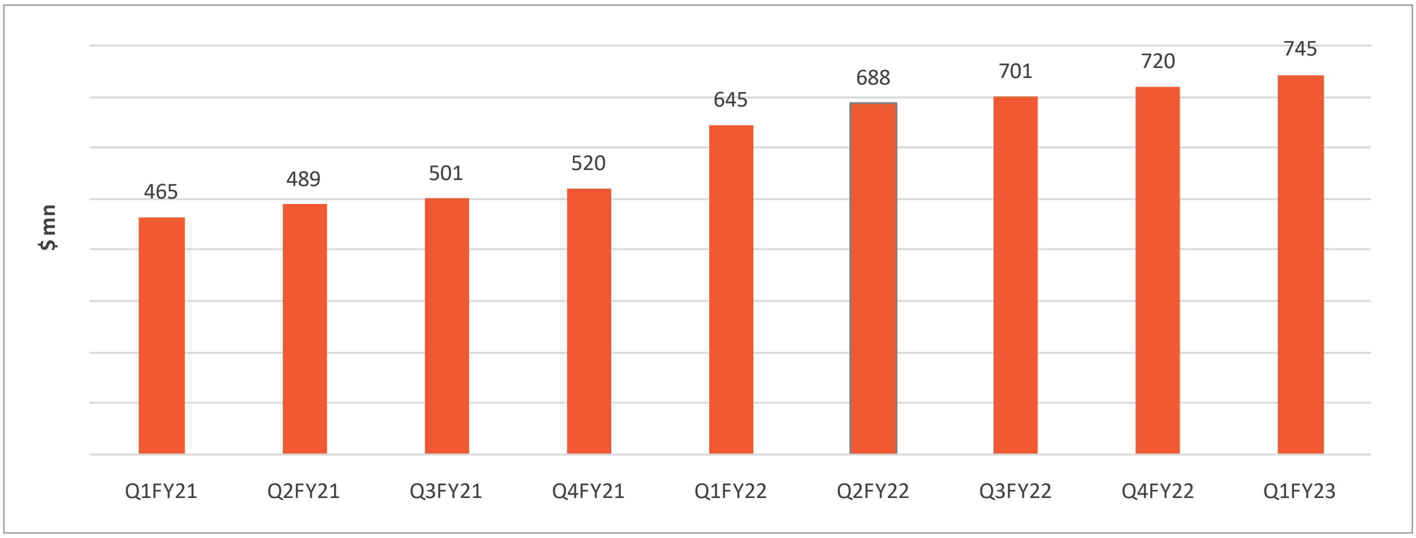
Source: Company; Sharekhan Research

Fresh order book trend



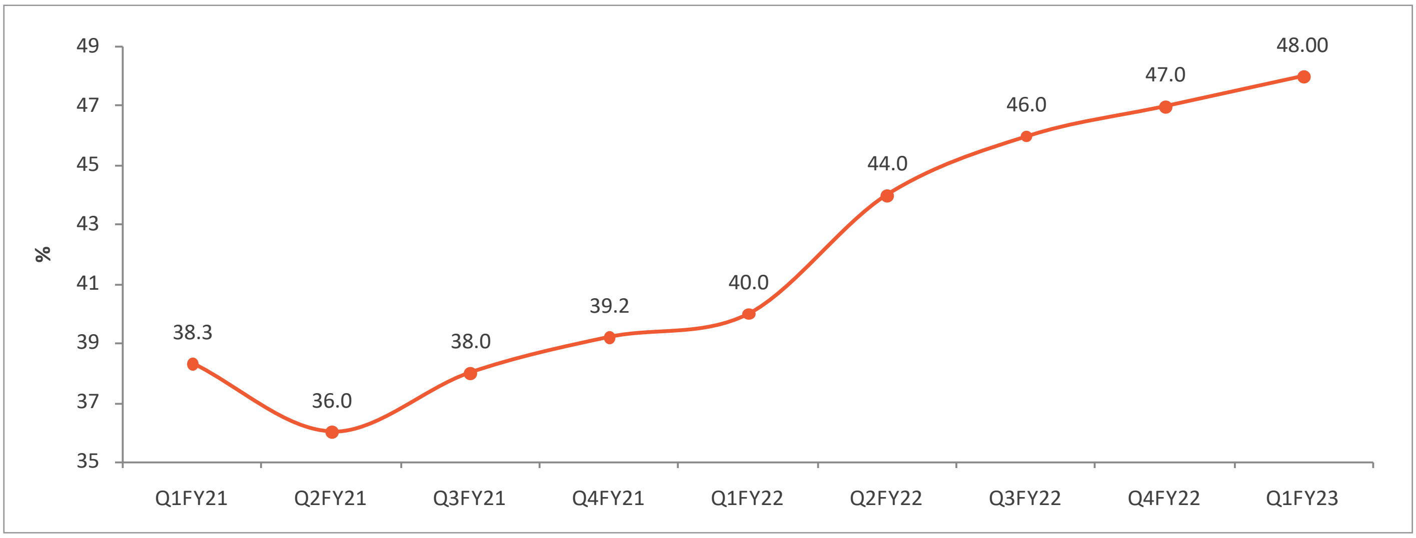
Source: Company; Sharekhan Research

Executable orders to be executed over next 12 months is 73% of FY23E revenue



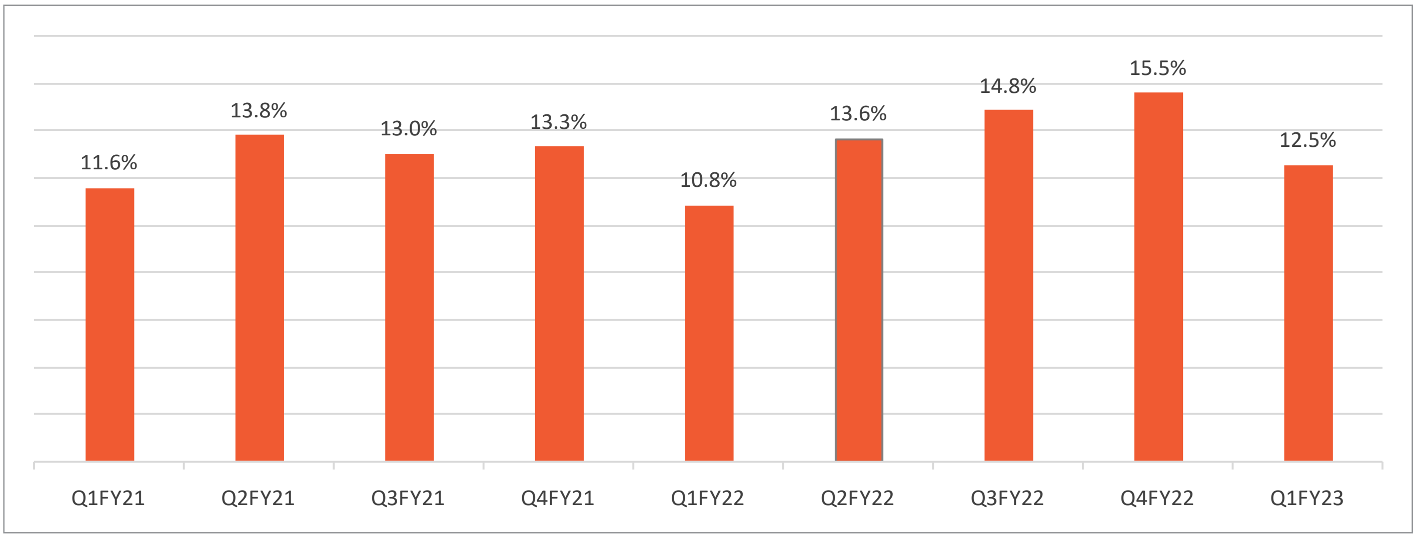
Source: Company; Sharekhan Research

Offshore revenue mix (%) trend



Source: Company; Sharekhan Research

EBIT margin is expected to improve in Q2FY23



Source: Company; Sharekhan Research

Outlook and Valuation

■ **Sector view - Strong demand environment here to stay**

Broad-based spending on digital transformation and cloud-related technologies across the industries and geographies is expected to maintain demand momentum in CY2022. Industry analysts such as Gartner estimate that IT services spending would grow by 8-8.5% in the next four years as compared to the average of 4.3% achieved over 2011-20. Consulting (+11%) and application implementation and managed services (+9%) are expected to grow faster than BPO (+7%) and infra implementation and managed services (+4%) in CY2022E. Forecasts indicate higher demand for Cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

■ **Company outlook - Well-prepared for next leg of growth**

Coforge has successfully transformed and re-organised itself into one of the fastest-growing mid-sized IT services provider under a revamped management in the past few years. A strong leadership, deep domain capability in select verticals, improved capability and marquee client base would help the company to sustain the growth momentum. Further, strategic focus on diversifying the business into emerging verticals, improvement in client metrics, strong executable orders and sharp recovery in travel segment would further aid growth. Strong growth, better digital mix and operating efficiencies should drive margin expansion in the next two years.

■ **Valuation - Maintain Buy with an unchanged PT of Rs. 4,680**

Coforge is well poised to achieve its strong revenue growth guidance in FY2023E on the back strong order intake, recovery in travel industry, continued growth momentum in BFS vertical, new logo addition, investments in leadership team and strong execution. Further, its executable order bookings for next 12 months remain 73% of our FY2023E revenue estimates. Coforge is expected to clock a revenue/earnings CAGR of 16%/22%, respectively over FY2022-24E, implies a market leading growth among the top mid-tier peers. At CMP, the stock is trading at a valuation of 28x/23x of its FY2023E/FY2024E earnings, which is at a 20% discount to its 3-year average valuation. Hence, we maintain a Buy rating on Coforge with an unchanged price target of Rs. 4,680.

One-year forward P/E (x) band

Source: Sharekhan Research

About company

Established in 1981, Coforge (earlier known as NIIT Technologies) is one of the leading mid-sized Indian IT services company, engaged in providing services in cloud, managed services, data & analytics, automation, application development & maintenance and Business Process Management. The company focuses on three key industries such as insurance, travel, transportation & hospitality and BFS. The company has started focusing on other industries such as manufacturing, healthcare, hi-tech, public sector to capture the opportunity. Digital technologies revenue, including product engineering, intelligent automation, data, integration and cloud, stood around 71% of total revenue. Coforge has over 22,000 professionals serving customers in North America, Europe, Asia and Australia.

Investment theme

Coforge's deep-domain expertise in select industry verticals and sub-verticals with heavy investments on technology, proprietary products and resources position it to participate in customers' transformation journey. Further, the company has reinvested its excess profitability in enhancing the technical capabilities by adding management/sales bandwidth. The company has also started scaling up the sub-segments such as healthcare within other verticals to drive its growth. We believe the company's differentiated positioning in select verticals, strong leadership, robust executable orders and mining of strategic accounts would position the company to deliver strong revenue growth going ahead.

Key Risks

(1) Any hostile development against current visa regime and higher attrition would affect employee expenses; (2) rupee appreciation or/and adverse cross-currency movements might affect earnings; (3) Delay in travel segment recovery; (4) a churn in senior management.

Additional Data

Key management personnel

Sudhir Singh	Chief Executive Officer & ED
Ajay Kalra	Chief Financial Officer
Madan Mohan	EVP & Global Head - TTH
Gautam Samanta	EVP & Global Head - BFS
Rajeev Batra	EVP & Global Head - Insurance

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Axis Asset Management	6.08
2	Capital Group Cos Inc	4.00
3	UTI Asset Management	3.88
4	Life Insurance Corp of India	3.80
5	Nomura Holdings Inc	2.30
6	Vanguard Group Inc	2.06
7	Aditya Birla Sun Life Asset Management	1.67
8	Goldman Sachs Group Inc	1.58
9	DSP Investment Managers	1.22
10	Government Pension	1.18

Source: Bloomberg