Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Birlasoft Ltd

Weak Q1; moving ahead on right growth path

IT & ITeS	Sharekhan code: BSOFT

Reco/View: Buy	↔	CMP: **Rs. 344**	Price Target: **Rs. 410**	↓

↑ 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 20.05

Updated July 08, 2022

Medium Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 9,593 cr
52-week high/low:	Rs. 585/306
NSE volume: (No of shares)	25.8 lakh
BSE code:	532400
NSE code:	BSOFT
Free float: (No of shares)	16.7 cr

Shareholding (%) as on June 30, 2022

Promoters	40
DII	23
FII	17
Others	20

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-0.6	-15.4	-27.4	-13.1
Relative to Sensex	-10.2	-20.3	-26.5	-21.5

Sharekhan Research, Bloomberg

Summary

- Birlasoft Limited (Birlasoft) reported below-than-expected revenue growth as a couple of client engagements were deferred. EBITDA margin declined due to higher costs to backfill attrition and lower utilization.
- Net new deal TCVs for Q1FY2023 were up 19% y-o-y, while the deal pipeline stood at $1.7 billion (up 40% q-o-q) in Q1FY2023. Management remains confident in achieving $100 million in revenues from its Microsoft relationship in next couple of years.
- With the ramp-up of the delayed engagements, healthy deal intake and broad-based growth across top accounts, we expect growth to accelerate in the remaining quarters of FY2023. EBITDA margin to remain stable with an upward bias in Q2FY23E despite wage revisions.
- We maintain Buy with a revised PT of Rs. 410, given a healthy deal intake, strong deal pipeline and robust partnership with Hyperscalers (including Google and Microsoft).

Birlasoft Limited (Birlasoft) reported below-than-expected revenue growth owing to deferral of its couple of engagements (potential revenue loss of $2 million), normalisation of revenues in lifesciences vertical and supply-side pressures. Q1 saw healthy new deal TCVs (19% y-o-y), strong net hiring, and broad-based growth across top accounts. Reported USD revenue grew by 1.5% q-o-q to $148.6 million, which lagged our estimate, led by strong growth in the BFSI (up 5% q-o-q) and manufacturing (up 2.8% q-o-q) verticals. EBITDA margin declined by 110 bps q-o-q to 14.7%, in line with our estimates, led by higher costs to backfill attrition, junior level promotions and lower utilisation, partially offset by rupee depreciation. The management cited that the demand outlook remains healthy despite adverse macro headwinds. Net new deal TCVs for Q1FY2023 were up 19% y-o-y, while the deal pipeline stood at $1.7 billion (up 40% q-o-q) in Q1FY2023. With the ramp-up of the delayed engagements in Q2FY23, we expect growth to accelerate in the remaining quarters of FY2023. EBITDA margin is expected to remain stable with an upward bias in Q2FY2023 despite in wage revision. Further, margin would improve sequentially in Q3FY23 and Q4FY23 as the management remains confident of achieving a 15%+ EBITDA margin in FY2023 despite 14.7% EBITDA margin in Q1FY23.

Key positives

- BFSI and manufacturing vertical's revenues grew by 5% and 2.8% q-o-q, higher than the company's overall growth rate.
- Top 5/10/20 accounts grew 4.2% /4.4%/4.5% q-o-q
- Deal pipeline grew by 42% q-o-q to $1.7 billion

Key negatives

- Delay in ramp-up of couple of engagements impacted its revenue growth in Q1
- OCF was down 79% q-o-q; OCF/EBITDA declined to 12% in Q1FY2023 versus 56% in Q4FY2022

Management Commentary

- Management indicated that revenue growth would pick-up in the remaining quarters of FY2023E, led by ramp-up of delayed projects, deal wins and strong traction in Cloud transformation.
- Both the deals that got delayed are in the range of $15-$20 million in terms of deal size.
- EBITDA margin is expected to remain stable with an upward bias in Q2FY2023 due to wage revision. Management expects margin would improve sequentially in Q3FY23 and Q4FY23 as management remains confident of achieving a 15%+ EBITDA margin in FY2023.
- The company plans to hire 500 freshers in Q2FY2023E, which will optimise resource expenses

Revision in estimates – We have lowered our earnings estimates for FY23E/FY24E by 6-10%, factoring revenue miss in Q1FY2023, delay in ramp-up of deals won earlier and anticipation of lower tech spends across the industries due to potential recessionary environment.

Our Call

Valuation: Maintain Buy: We believe the company's growth would accelerate in the remaining quarters of FY2023 on the back of ramp-up of deals that got delayed due to client-specific issues, continued net new deal wins and healthy deal pipeline. Margins are expected to remain flat sequentially in Q2FY23 despite 250-300bps impact due to wage revision and to improve sequentially in Q3 and Q4 of FY2023 because of pyramid rationalization and operating efficiencies. At CMP, the stock trades at 19x/17x its FY2023E/FY2024E earnings. We continue to remain positive on the stock considering strong net cash position, robust partnership with hyperscalers, healthy deal intake, robust demand from enterprise customers and inorganic opportunities. Hence, we maintain a Buy rating on Birlasoft with a revised price target (PT) of Rs. 410.

Key Risks

(1) Currency fluctuation; (2) loss of any large clients; and (3) stiff competition in the market.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	3,555.7	4,130.4	4,819.5	5,475.3
OPM (%)	14.9	15.5	15.0	15.2
Adjusted PAT	320.8	455.6	499.5	571.7
% y-o-y growth	*43.0*	*42.0*	*9.6*	*14.5*
Adjusted EPS (Rs.)	11.3	16.4	17.9	20.7
P/E (x)	30.3	20.9	19.1	16.5
P/B (x)	4.8	4.0	3.6	3.1
EV/EBITDA (x)	17.9	14.6	12.7	10.8
RoNW (%)	15.8	19.1	18.1	18.2
RoCE (%)	20.0	21.7	21.9	22.3

Source: Company; Sharekhan estimates

Margins in-line, but revenue missed the mark

Constant currency (CC) revenue grew by 2.3% q-o-q (up 17.7% y-o-y). Revenue growth lagged our expectations owing to deferral of two large deals because of external factors. Reported revenue grew by 1.5% q-o-q to $148.6 million, which lagged our estimate of $150.5 million. Overall growth was affected by normalisation of growth in a healthcare account and loss of potential revenue with the deferral of deals. Revenue growth in the BFSI and manufacturing verticals grew by 5% and 2.8%, respectively, q-o-q. EBITDA margin declined by 110 bps q-o-q to 14.7%, in-line with our estimates, led by higher costs to backfill attrition, junior level promotions and lower utilisation, partially offset by rupee depreciation. Net profit came at Rs. 120.7 crore (down 7.7% q-o-q, but up 8.1% y-o-y) and was 3% below our estimates, owing to lower other income (down 32% q-o-q) and higher tax provision.

Enterprise solution growth to accelerate in FY2023E

Given strong partnerships with hyperscalers and platform companies, the company is well placed to capture opportunities across upgradations, implementation, and transformation. We believe growth in enterprise solutions in FY2023 would be better as compared to H2FY2022 on account of anticipated healthy growth momentum in integrated enterprise solutions business and strong deal pipeline in transformation and implementation areas. We forecast growth in the enterprise solutions business to accelerate to 8% in FY2023E from 2.5% y-o-y in FY2022.

Expect growth to pick up in the remaining quarter of FY2023

Higher spending on digital and Cloud transformation initiatives, aggressive automation, and increasing cost-saving initiatives by global enterprises are expected to keep the demand environment robust in the medium term. Management cited that the demand outlook remains healthy despite adverse macro headwinds. The company's net new deal TCVs for Q1FY2023 were up 19% y-o-y, while the deal pipeline stood at $1.7 billion (up 40% q-o-q) in Q1FY2023. Management expects growth to pick up in the remaining quarter of FY2023. The management also aims to reach $1 billion revenue by FY2025 with $800-850 million achieved by organic contribution and remaining $100-150 million achieved by inorganic route, implying a revenue CAGR of 22%. With healthy new deal TCVs, strong deal pipeline, and strong growth momentum in top accounts, we forecast the company's overall USD revenue growth to accelerate in the remaining quarters of FY2023.

Key result highlights from earnings call

- **Growth affected by deferral of deals and supply-side challenges:** Management indicated that the growth was lower than expectations was due to (1) Deferment of couple of engagements won last quarter. One engagement which was expected to contribute to revenues in Q1FY23 that got delayed by a quarter due to the merger related issues at the client's end. Similarly, the second deal got delayed and closed in Q2FY23 instead of its earlier expectation in Q1FY23. Management expects revenue from this deal to flow in Q2FY23, (2) revenue normalisation in lifescience and healthcare vertical and (3) supply-side pressures.

- **Net new deal wins and deal pipeline remained healthy:** The company signed $185 million of TCVs of deals (including renewals), up 21% y-o-y. Net new deal TCVs stood at $112 million, up 19% q-o-q. TCVs of renewal deals remained at $73 million, up 24% y-o-y. As clients are pushing for restructuring of deals, which are modular in nature and short cycled deals as well, the company's deal ACVs remained strong compared to deal TCVs. The deal pipeline increased 42% on a q-o-q basis to $1.7 billion.

- **Net staff addition, drop in LTM attrition and higher fresher intake in Q2FY2023:** The total number of employees stood at 12,565, with sequential net employee addition of 361 employees. Attrition rate (on LTM basis) declined by 150bps q-o-q to 27.9% in Q1FY2023 as compared to 29.4% in Q4FY2022. Management expects a further decline in attrition rate going ahead, which would support its margins improvement. The company hired 250 freshers in Q1FY23 and it plans to hire around 500 freshers in Q2FY2023, which will optimise resource expenses and meet demand.

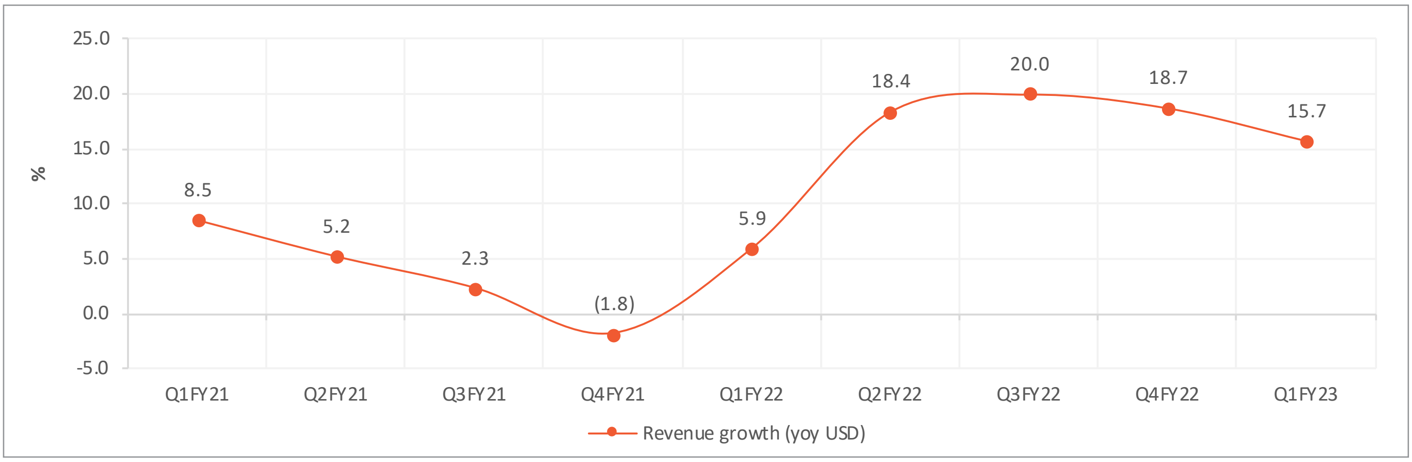
- **Wage hike:** The company is expected to take wage hike in Q2FY2023. Wage revision is expected to impact 250-300 bps on margins, which would be mitigated by margin levers.
- **DSO days rise; cash balance stays healthy:** DSO days remained flat on a q-o-q basis to 58 days and increased by four days on a y-o-y basis. Cash & cash equivalents remained at Rs. 1,204 crore versus Rs. 1,225 crore in Q4FY2022.
- **Client additions moderated:** The number of client additions moderated to 4 on a q-o-q basis (vs 11 in Q4FY22) during the quarter. The number of $10-million+ clients increased by three on a y-o-y basis (flat on a q-o-q basis), taking the total count of such clients to 13. The number of $5 million+ clients increased by three on a y-o-y basis (flat on a q-o-q basis), taking the total count of such clients to 25.
- **Strong growth in top accounts:** Revenue from the top 5 and top 10 accounts grew by 4.2% and 4.4% on a q-o-q basis, respectively. Top 20 accounts grew by 4.5% q-o-q. It indicates higher focus on client mining activities.
- **Operating cash flows declined q-o-q:** Operating cash flow declined by 79% q-o-q to Rs. 20 crore in Q1FY2023 compared to Rs. 97 crore in Q4FY2022. OCF to EBITDA stood at 12% as compared to 56% in Q4FY2022.

Results — Rs cr

Particulars	Q1FY23	Q1FY22	Q4FY22	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**148.6**	**128.4**	**146.4**	**15.7**	**1.5**
Net sales	**1,154.4**	**945.3**	**1,101.4**	**22.1**	**4.8**
Employee benefit expenses	657.9	556.0	629.7	18.3	4.5
Gross Profit	**496.6**	**389.3**	**471.7**	**27.6**	**5.3**
Operating expenses	326.8	238.3	297.2	37.2	9.9
EBITDA	**169.8**	**151.1**	**174.5**	**12.4**	**-2.7**
Depreciation	19.6	18.4	20.0	6.5	-1.8
EBIT	**150.2**	**132.6**	**154.5**	**13.2**	**-2.8**
Other income	15.5	21.5	22.6	-27.9	-31.5
Finance cost	3.3	2.8	3.6	14.3	-9.7
PBT	**162.4**	**151.2**	**173.5**	**7.4**	**-6.4**
Tax provision	41.7	37.6	40.7	10.8	2.3
Net profit	**120.7**	**113.6**	**132.8**	**6.2**	**-9.1**
EPS (Rs.)	**4.3**	**4.0**	**4.7**	**7.3**	**-9.2**
Margin (%)				**bps**	**Bps**
EBITDA	14.7	16.0	15.8	-127	-114
EBIT	13.0	14.0	14.0	-102	-102
NPM	10.5	12.0	12.1	-156	-160

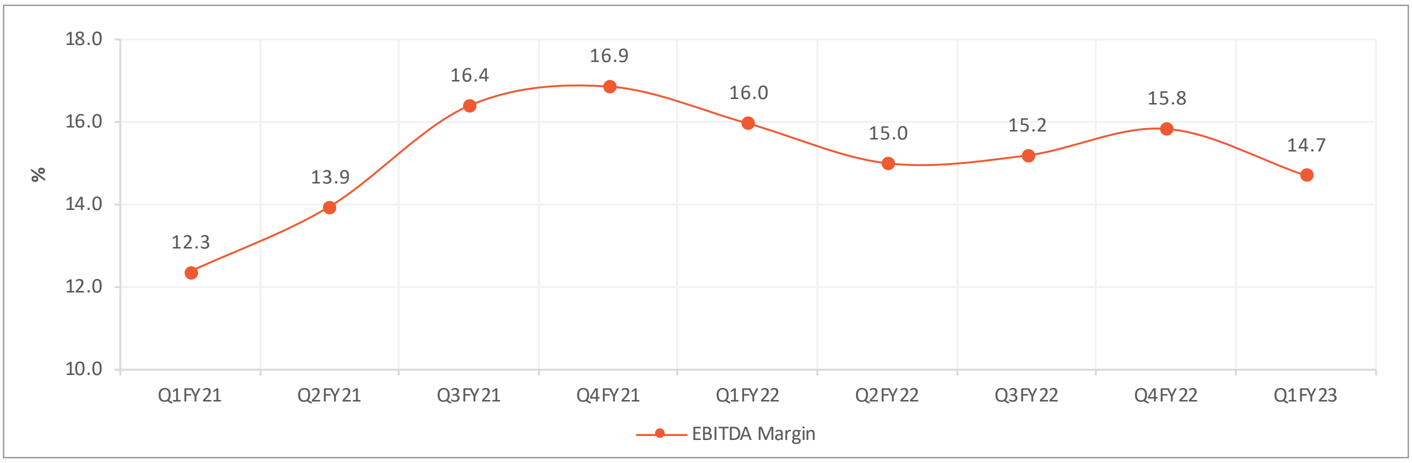
Source: Company, Sharekhan Research

USD revenue growth trend (y-o-y)



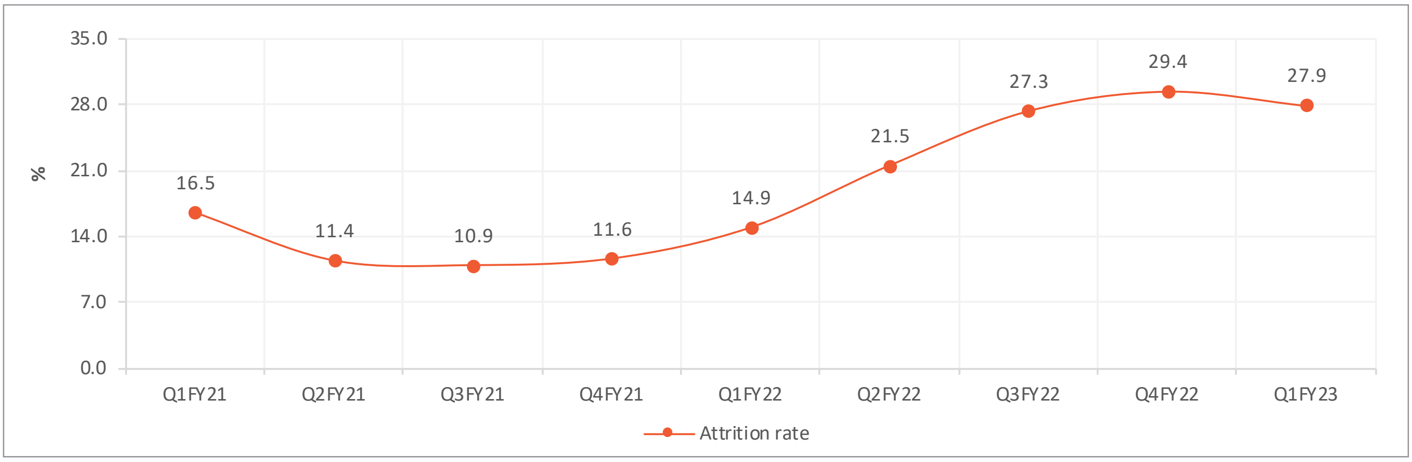
Source: Company; Sharekhan Research

EBITDA margin contracted due to supply-side pressure



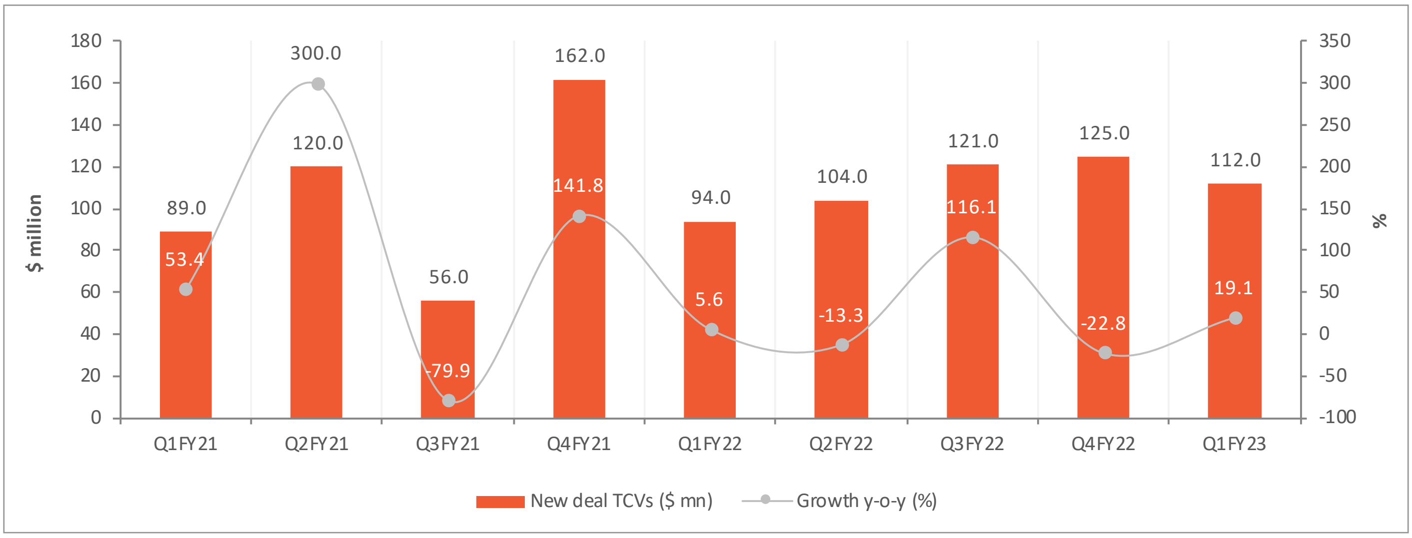
Source: Company; Sharekhan Research

Attrition dropped on q-o-q



Source: Company; Sharekhan Research

New deal TCVs ($ mn) and growth (yoy %)



Source: Company; Sharekhan Research

Outlook and Valuation

Sector View – 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 have led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would register 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, a 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.

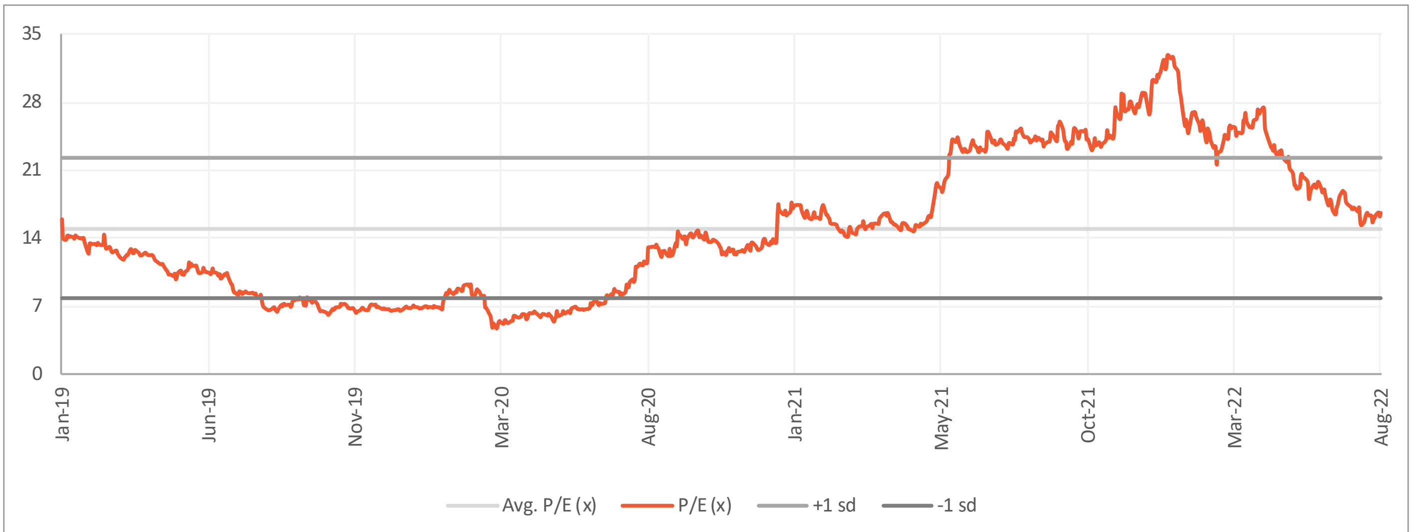
Company Outlook – Moving in the right direction

Management sees strong traction for virtual engagement, Cloud adoption, and digital transformation work. We believe 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. We believe revenue growth would accelerate in FY2023 because of strong growth in enterprise solutions, robust deal intake, healthy deal pipeline, and broad-based demand across verticals. Further, management aspires to maintain its EBITDA margin of above 15% in the subsequent quarters despite supply-side issues and investments for capability enhancements.

Valuation – Maintain Buy

We believe the company's growth would accelerate in the remaining quarters of FY2023 on the back of ramp-up of deals that got delayed due to client-specific issues, continued net new deal wins and healthy deal pipeline. Margins are expected to remain flat sequentially in Q2FY23 despite 250-300bps impact due to wage revision and to improve sequentially in Q3 and Q4 of FY2023 because of pyramid rationalization and operating efficiencies. At CMP, the stock trades at 19x/17x its FY2023E/FY2024E earnings. We continue to remain positive on the stock considering strong net cash position, robust partnership with hyperscalers, healthy deal intake, robust demand from enterprise customers and inorganic opportunities. Hence, we maintain a Buy rating on Birlasoft with a revised price target (PT) of Rs. 410.

One-year forward P/E (x) band



Source: Sharekhan Research

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 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 (an unlisted company) merged and amalgamated with KPIT Technologies Limited (merger) and the engineering business of KPIT Technologies Limited, which was on a going concern basis, demerged and transferred to an independent entity. Post restructuring, Birlasoft became a $450 million-475 million organisation with a mix of digital and ERP revenue. Birlasoft had strengths primarily on 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 indicate the company's position in the enterprise digital space. Management expects gradual improvement in operating profitability to continue, given its cost-optimisation 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 and non-executive Director
Dharmender Kapoor	CEO and MD
Shreeranganath Kulkarni	Chief Delivery Officer (CDO)
Roop Singh	Chief Business Officer (CBO)
Arun Dinakar Rao	Chief People Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Axis Asset Management Co	4.65
2	ICICI Prudential Asset Management Co	3.50
3	Aditya Birla Sun Life Asset Management	2.77
4	L&T Mutual Fund Trustee	2.26
5	Central India Industries Ltd	1.85
6	Vanguard Group Inc	1.84
7	Dimensional Fund Advisors	1.20
8	Emirate of Abu Dhabi United Arab Emirates	1.18
9	Nippon Life India Asset Management Ltd	1.14
10	TATA Asset Management	0.95

Source: Bloomberg

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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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