Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Birlasoft Ltd

Weak Q2; Guidance reiterated despite macro challenges

IT & ITeS	Sharekhan code: BSOFT		
Reco/View: Buy ↔	CMP: Rs. 280	Price Target: Rs. 335 ↓	

↑ 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 Oct 08, 2022

Medium Risk

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

Source: Morningstar

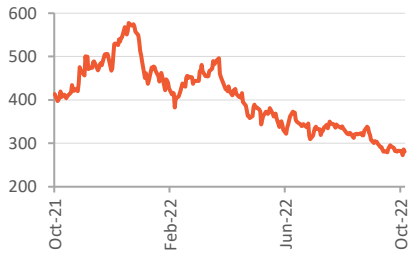
Company details

Market cap:	Rs. 7,633 cr
52-week high/low:	Rs. 586 / 269
NSE volume: (No of shares)	22.8 lakh
BSE code:	532400
NSE code:	BSOFT
Free float: (No of shares)	15.9 cr

Shareholding (%)

Promoters	41
FII	13
DII	20
Others	26

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.7	-15.9	-33.2	-32.2
Relative to Sensex	-8.0	-21.6	-36.9	-29.7

Sharekhan Research, Bloomberg

Summary

- Birlasoft posted below-than-expected reported USD revenue growth, while EBITDA margins remained in line with our estimates. Q2 saw healthy new deal TCVs of $138 million (up 23% q-o-q), but weak addition of active clients and employees.
- The company reiterated its double-digit revenue growth guidance and EBITDA of ~15% for FY2023.
- Company gave a positive outlook on BFSI but had a negative outlook on Lifesciences and Energy & Utilities. The overall situation is uncertain given the current macros, but the company is confident of achieving its guidance due to deals wins in H1FY23 and an expected decline in attrition rates for H2FY23.
- We maintain a Buy rating on Birlasoft with a revised price target (PT) of Rs. 335. At CMP, the stock trades at reasonable valuation of 15.7x/14.3x/12.8x FY23E/FY24E/FY25E EPS.

Birlasoft's Reported USD revenue at $149 million stayed flat sequentially and was 1.1% below our estimate of $151 million as service offerings posted weak sequential growth. The high sequential growth in BFSI vertical was offset by the continual sequential decline in Lifesciences and Energy & utilities vertical. EBITDA margins at 14.8% stayed flat sequentially as margin tailwinds of low travel costs and better productivity were offset by increased hiring and retention costs. Net profit at Rs. 115 crores declined by 4.7% q-o-q and was 7.9% below our estimate of Rs 125 crore due to lower than expected other income (owing to FX loss of -6.28 crores), which got partially offset due to lower tax rate on account of tax refund in USA. Company reiterated its double-digit revenue growth guidance and EBITDA of about 15% for FY2023.

Key positives

- Reported TCV of new deal wins at $138 million which was the highest in the last six quarters.
- Strong sequential growth of 7.4% in BFSI vertical.

Key negatives

- Sharp 6.1% sequential decline in Enterprise solutions and continual q-o-q decline in Lifesciences and Energy & Utilities vertical by 7.4% and 1.3% respectively.
- Number of active client increased only by 1 q-o-q to 301.
- High attrition rate at 27.4% and weak headcount addition.

Management Commentary

- Management maintained its double-digit revenue growth guidance of 10%-15% for FY23.
- EBITDA margin guidance of about 15%-17% in the long term.
- Management had a positive outlook for BFSI vertical but weak outlook for Lifesciences and Energy & Utilities.
- No material progress in its plan to acquire companies.

Revision in estimates – We have fine-tuned our earnings estimates for FY23/24 owing to macro overhang and INR-USD reset and have introduced our FY25 earnings estimates.

Our Call

Valuation – Maintain Buy: We remain positive on the stock considering 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. 335. At CMP, stock trades at reasonable valuation of 15.7x/14.3x/12.8x FY23E/FY24E/FY25E EPS.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US would affect earnings. Further, macro headwinds and possible recession in the US are likely to moderate the pace of technology spends.

Valuation Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	4,130	4,931	5,392	5,880
OPM (%)	15.5	14.9	15.0	15.2
Adjusted PAT	456	500	541	595
% YoY growth	*42*	*10*	*8*	*10*
Adjusted EPS (Rs.)	16.4	17.9	19.6	21.9
P/E (x)	17.1	15.7	14.3	12.8
P/B (x)	4.0	3.6	3.1	2.8
EV/EBIDTA (x)	14.6	12.5	11.1	9.8
RoNW (%)	19.1	18.1	17.3	16.8
RoCE (%)	21.7	22.3	21.7	21.3

Source: Company; Sharekhan estimates

Key result highlights from earnings call

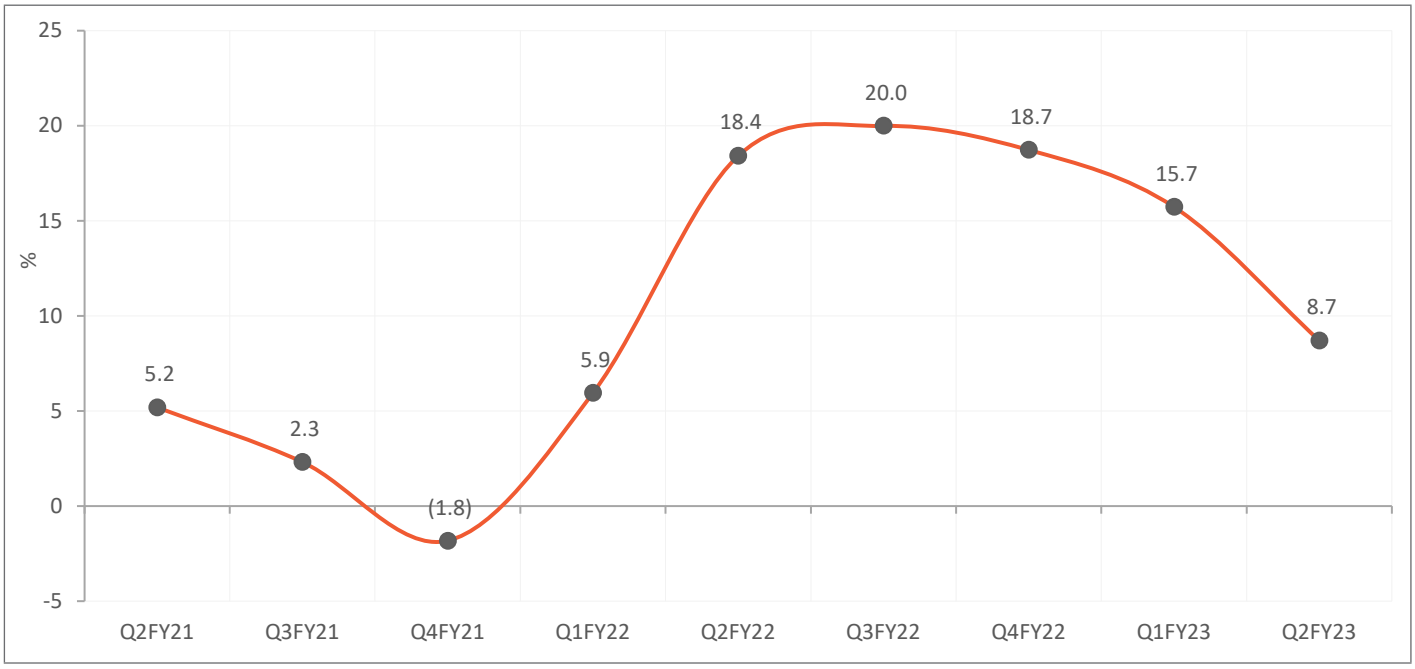
- **Weak growth of service offerings:** Reported USD revenue at $149 million stayed flat sequentially as growth declined by 6.1% q-o-q in Enterprise solutions and moderated to 3.5% q-o-q in Business & Technology Transformation. Continual weak growth rates in Enterprise solutions have now led its revenue contribution (37.7%) to be lower than Business technology and transformation (39.9%) for the first time in Q2. Management said the growth in enterprise solutions won't decline in the coming quarters. The cloud and base services increased by 6.3% on a q-o-q basis but on a low base.
- **Management commentary on key verticals:** The BFSI vertical grew strongly by 7.4% q-o-q in Q2 but the growth in manufacturing moderated to 1.2% q-o-q. Other verticals such as Lifesciences and Energy & Utilities declined by 7.4% q-o-q and 1.3% q-o-q respectively. Birlasoft had a positive outlook for the BFSI vertical led by good deal wins, strong relationship with large customers and clients finding their feet in digitization activities as their legacy modernization activities have been completed in the last 3-4 quarters. The company does not see any major concerns in the Lifesciences vertical despite it posting negative q-o-q growth rates in the last 4 quarters but said they will really need to push hard to post growth in the coming quarters. The impact of furloughs in Lifesciences led to a decline in growth for the vertical in Q2.
- **Maintained double digit growth guidance for FY23:** Despite uncertainty in macros and deal deferrals by cautious clients, the management maintained a double-digit growth guidance for FY23 to be in the range of 10%-15% and said they will be nearer to the 10% mark. Management was confident of achieving double digit growth as deal wins in H1FY23 will help increase the revenues in H2FY23. The decline in attrition rates will also help in faster execution of deals. The management certainly does not expect negative growth rates due to recessionary environment.
- **Stable EBITDA margins; improvement likely in the near term:** EBITDA margins stayed flat sequentially at 14.8%. Margin tailwinds of low cost of service delivery, low travel costs, higher offshoring mix and improvement in productivity were offset by margin headwinds of high cost of hiring, increase in retention cost and increments given in July 2022. The management said decreasing attrition rates, fresher hiring, pyramid restructuring, higher offshoring mix and lower subcontractor cost will help support the margins going forward but higher than expected furloughs in Q3 could put pressure on margins. Management guided for EBITDA margins to be in the range of 15-17% in the long-term.
- **Robust TCV of new deal wins, but Aggregate TCV deal wins decline:** The company recorded TCV of new deal wins at $138 million which was the highest in the last six quarters. It grew by 23% q-o-q and 33% y-o-y. Aggregate TCV deal wins stood only at $166 million (down 10% q-o-q) as TCV of renewal deal wins declined by 62% q-o-q to $28 million.
- **Weak client additions:** The number of active client additions moderated to one on a q-o-q basis vs four in Q1FY23. The number of $10 million+ clients increased by one on a q-o-q basis taking the total to 14 clients. The number of $5 million+ clients increased by two on a on a q-o-q basis taking the total to 27 clients.
- **Healthy growth in top accounts:** Client concentration of Top 5, Top 10 and Top 20 increased to 31.1%, 47.2% and 63.7% respectively from 30.7%, 47% and 63.1% in Q1FY23.
- **Weak staff additions:** Staff addition growth moderated to only 1.54% q-o-q to 12,758 employees. Company hired 253 freshers in Q2FY23 and guided for hiring approximately 500 freshers for H2FY22.
- **Attrition rate slows, but still high:** Attrition rate moderated by 50 bps q-o-q but is still high at 27.4%. Management said that attrition rate will decline by 4% q-o-q in Q3. The fall in attrition rates will help Birlasoft to realise revenue faster in H2FY23 than H1FY23. Management's target is to take attrition rates to 20% in the long term.
- **No material progress in acquisition plans:** The company said it is still searching to acquire the right company and there hasn't been any material progress on this front.
- **Low effective tax rate (ETR):** ETR declined to 21.8% versus 25.7% in Q1FY23, Management said this was due to tax refund in the US. They guided for ETR to be in the range of 25-26% going forward.
- **Cash balance declines on buyback:** Cash & cash equivalents came at Rs. 795 crores versus Rs. 1,204 crores in Q1FY2023 as company made a net payment of Rs 470 crores for buyback in Q2.

Results (Consolidated) **Rs cr**

Particulars	Q2FY23	Q2FY22	Q1FY23	Y-o-Y %	Q-o-Q %
Revenues ($ mn)	**148.8**	**136.9**	**148.6**	**8.7**	**0.1**
Net sales	**1,192.1**	**1,011.7**	**1,154.4**	**17.8**	**3.3**
Employee benefit expenses	693.8	576.4	657.9	20.4	5.5
Gross Profit	**498.3**	**435.2**	**496.6**	**14.5**	**0.3**
Operating expenses	321.9	283.5	326.8	13.6	-1.5
EBITDA	**176.4**	**151.8**	**169.8**	**16.2**	**3.9**
Depreciation	20.7	19.4	19.6	6.8	5.2
EBIT	**155.7**	**132.4**	**150.2**	**17.6**	**3.7**
Other income	(2.7)	9.4	15.5	-129.1	-117.6
Finance cost	5.8	3.4	3.3	69.0	78.6
PBT	**147.2**	**138.3**	**162.4**	**6.4**	**-9.4**
Tax provision	32.1	35.1	41.7	-8.5	-22.9
Net profit	**115.1**	**103.3**	**120.7**	**11.4**	**-4.7**
EPS (Rs)	**4.1**	**3.6**	**4.3**	**12.4**	**-4.0**
Margin (%)					
EBITDA	14.8	15.0	14.7	-21	9
EBIT	13.1	13.1	13.0	-3	5
NPM	9.7	10.2	10.5	-56	-81

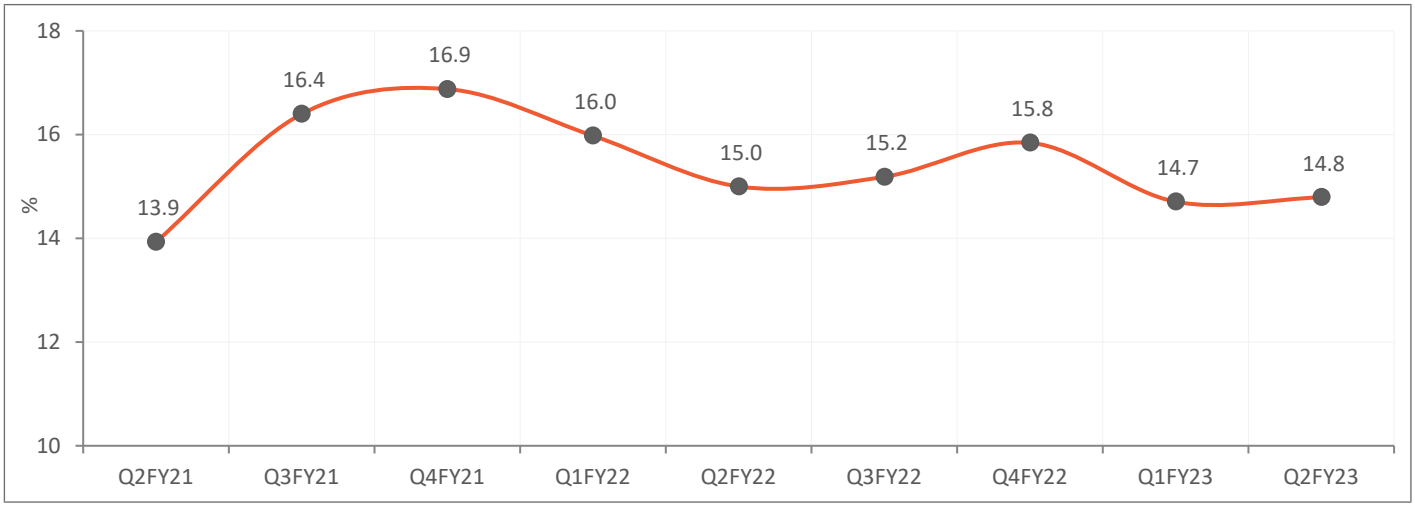
Source: Company; Sharekhan Research

USD revenue growth trend (y-o-y)



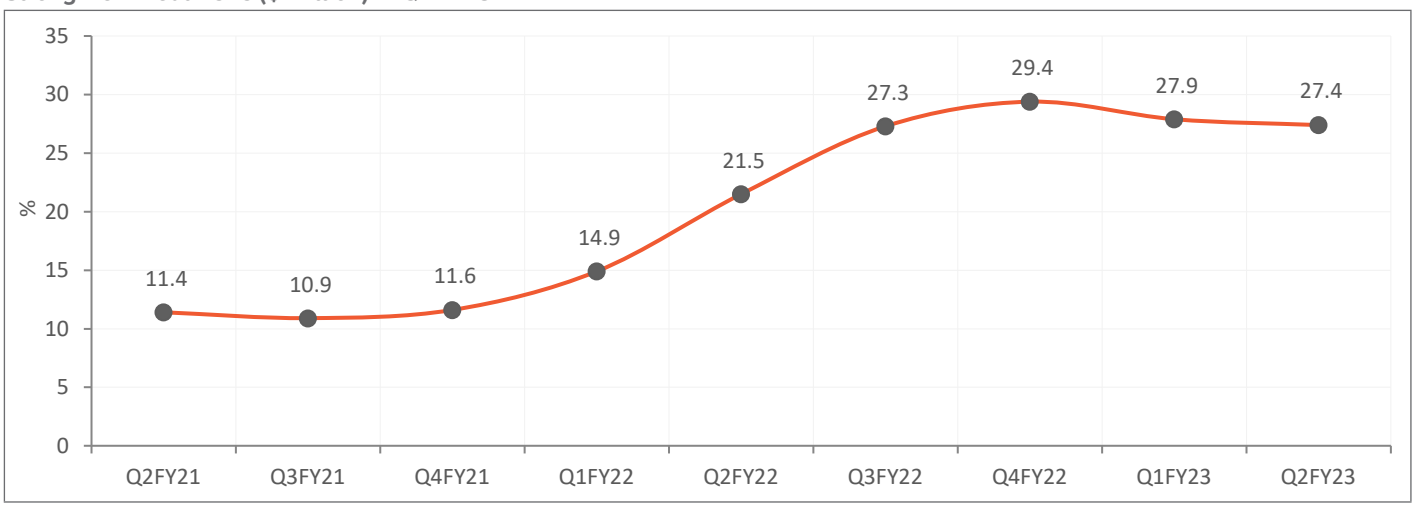
Source: Company, Sharekhan Research

EBITDA margin trend



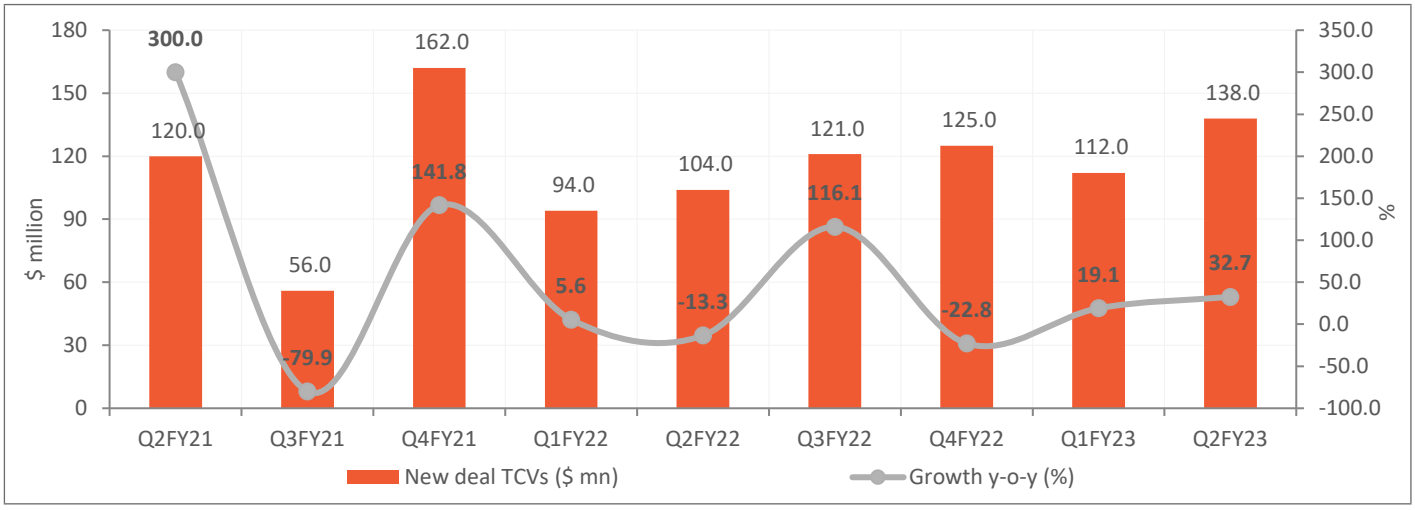
Source: Company, Sharekhan Research

Strong New Deal TCVs ($ million) in Q2FY23



Source: Company, Sharekhan Research

Strong New Deal TCVs ($ million) in Q2FY23



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 a size of $350 billion by 2025 from the current estimated revenue of $191 billion.

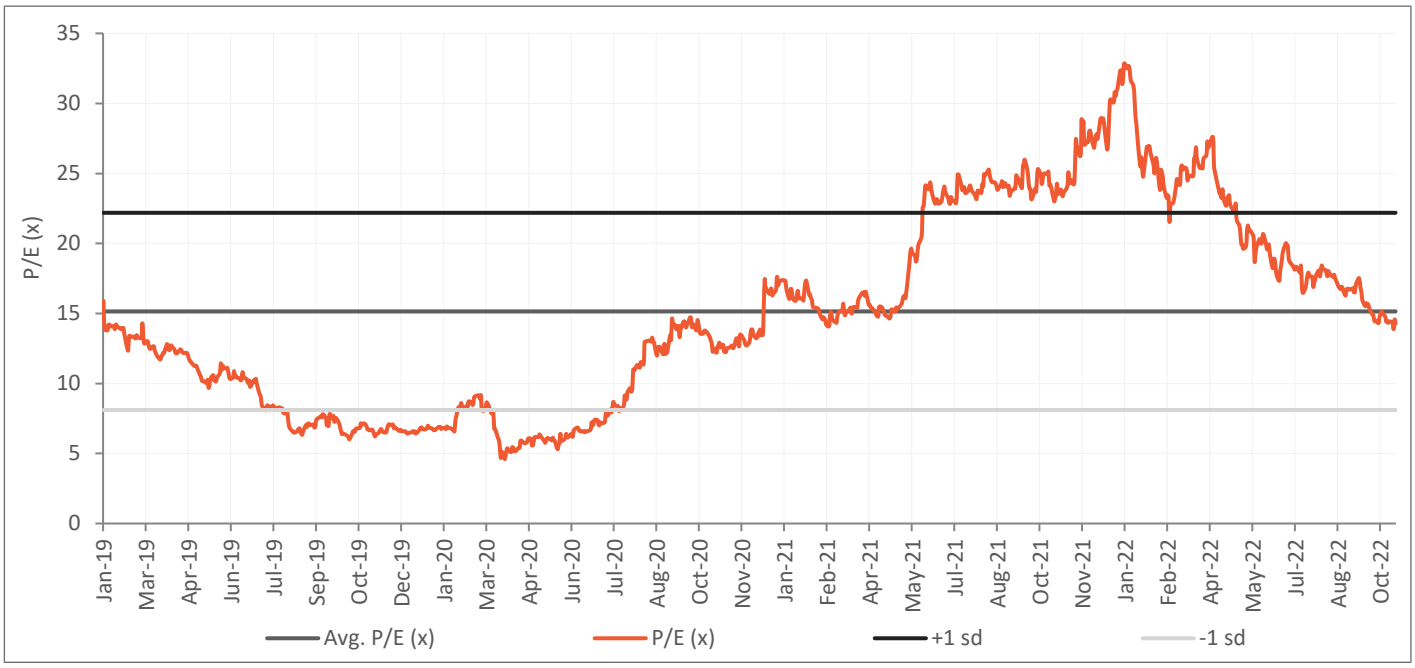
■ Company Outlook – Moving in the right direction

The management sees strong traction for virtual engagement, Cloud adoption, and digital transformation work. We believe the company's focus on deepening 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 led by strong growth in enterprise solutions, robust deal intake, healthy deal pipeline, and broad-based demand across verticals. Further, 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 – Maintain Buy

We remain positive on the stock considering 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. 335. At CMP, the stock trades at reasonable valuation of 15.7x/14.3x/12.8x FY23E/FY24E/FY25E EPS.

One-year forward P/E (x) band



Source: Company, 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) Rupee appreciation and/or adverse cross-currency movements, 2) Constraint in local talent supply in the US would have an adverse impact on its earnings and 3) Macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

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

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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