Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Coforge Ltd

In-line Q2, operating metrics strong

IT & ITeS	Sharekhan code: COFORGE
Reco/View: Buy ↔	CMP: **Rs. 3,850**

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. 23,472 cr
52-week high/low:	Rs. 4,235/3,465
NSE volume: (No of shares)	3.6 lakh
BSE code:	532541
NSE code:	COFORGE
Free float: (No of shares)	3.7 cr

Shareholding (%) as on Sep 30, 2022

Promoters	40
DII	21
FII	26
Others	12

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	15.8	6.3	(6.0)	(29.3)
Relative to Sensex	16.2	0.0	(8.2)	(26.5)

Sharekhan Research, Bloomberg

Summary

- Q2FY23 was in line with estimates on all fronts for Coforge. Q2 saw large deal wins, robust order pipeline, new logo additions, improvement in offshoring mix and utilization rates and drop-in attrition levels.
- Management reiterated revenue growth outlook of at-least 20% on CC terms and adjusted EBITDA margin band of 18.5-19% for FY2023.
- Company gave a positive outlook on all the key verticals - BFS, Insurance and Travel with continuous growth in automation and digital transformation activities of clients. The company is cautious given the current weak macros but is strongly optimistic on its highest ever locked in order book of $802 million for the next 12 months.
- We maintain a Buy on Coforge with an unchanged PT of Rs. 4,680, given strong earnings visibility, robust order bookings, stable margin outlook and improving operating metrics.

Coforge's reported numbers were in line with our estimates on all fronts. Reported Revenues at $246.9 million were 3.4% up q-o-q and in-line with our estimate of $247.5 million. Strong 6.2% q-o-q cc revenue growth was led by 14% q-o-q cc revenue growth in BFS vertical and strong performance in EMEA and Americas. Reported EBITDA at Rs 344 crores was 18% up q-o-q and in line with our estimate of Rs. 347 crore. Reported EBITDA margins improved by 160 bps q-o-q to 17.6% led by control over employee and SG&A expenses. Net profit at Rs 201 crores was 34.3% up q-o-q and and in-line with our estimate of Rs 200 crore. Net profit margins improved by 208 bps q-o-q to 10.3% led by lower effective tax rate of 17.7% due to net operating loss in a subsidiary. Company reiterated its revenue growth outlook of at least 20% in CC terms and adjusted EBITDA margin band of 18.5-19% for FY2023. Q2 saw strong order intakes, two large deal wins (greater than $30 million), healthy growth in top accounts and new logo additions, improvement in offshoring mix and utilization rates and drop-in attrition levels (one of the lowest in the industry).

Key positives

- The company reported an order intake of $304 million making it the third consecutive quarter of order intakes above $300 million.
- Executable order book for next 12 months grew by 7.7% q-o-q to a robust $802 million.
- Attrition rate in the past 12 months declined by 160 bps q-o-q to 16.4% which is one the lowest in the industry.
- Adjusted EBITDA margin improved by 190 bps q-o-q to 18.4% due to increase in offshoring mix, higher utilization levels, improvement in fresher hiring and operational improvements.

Key negatives

- ADR listing delayed as current market conditions are not favourable.
- RoW declined by 7.3% q-o-q in cc due to contraction in business in India.
- Net headcount addition increased only by 1.1% q-o-q to 22,991 employees.

Management Commentary

- Coforge reiterated its revenue growth outlook of at-least 20% on CC terms, adjusted EBITDA margin band of 18.5-19% for FY2023 and has a positive outlook across all key verticals.
- The high 6.2% q-o-q cc revenue growth was led by 14% q-o-q cc revenue growth in BFS vertical and strong performance in EMEA and Americas.
- The company had healthy q-o-q growth of top accounts and strong client metrics on y-oy basis. The company added 11 new logos in Q2 with 5 in America, 4 in EMEA and 2 in ROW.
- Offshoring mix increased by 180 bps q-o-q to 49.8% and has improved by 1,380 bps in the last 8 quarters.
- Utilization rate including trained employees increased by 110 bps q-o-q to 77.3% and company expects it to remain at about 77.5% going forward.

Revision in estimates – We revised upwards our FY23 estimate by 5% and revised downwards our FY24 earning estimate by 2%. We have introduced new FY25 estimate.

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 the BFS vertical, new logo addition, investments in leadership team and strong execution. Further, its executable order bookings for the next 12 months remain 80% of our FY2023E revenue estimates. Coforge is expected to clock a revenue/earnings CAGR of 14%/19.5%, respectively over FY2022-25E, implies a high growth among top mid-tier peers. At CMP, the stock is trading at a valuation of 28x/24x/21x of its FY2023E/FY2024E/FY2025E earnings. We maintain a Buy rating on Coforge with an unchanged price target of Rs. 4,680.

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 (consolidated) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	6,432	8,046	8,959	10,002
OPM (%)	17.3	18.0	17.9	18.1
Adjusted PAT	662	844	972	1,130
% YoY growth	40	27	15	16
Adjusted EPS (Rs.)	109.0	138.9	159.8	185.4
P/E (x)	35.3	27.7	24.1	20.8
P/B (x)	8.6	7.0	5.9	5.0
EV/EBIDTA (x)	21.0	15.9	14.0	12.0
RoNW (%)	25.5	27.7	26.6	26.2
RoCE (%)	27.3	28.0	26.9	27.6

Source: Company; Sharekhan estimates

Q2FY2023 Key earnings call highlights

- **High 6.2% q-o-q cc revenue growth led by BFS vertical:** The company grew by 6.2% q-o-q in cc which was primarily led by high 14% q-o-q cc growth in BFS vertical. Insurance vertical grew by 5.5% q-o-q in cc but on a low base. The Travel, Transportation and Hospitality (TTH) grew by 4.9% q-o-q in cc. Other verticals declined by 0.9% q-o-q cc but on a high base.

- **Strong performance across geographies barring Rest of the World (RoW):** EMEA grew by 12.9% q-o-q in cc and Americas grew by 4.5% q-o-q in cc. ROW declined by 7.3% q-o-q in cc terms due to a contraction in business in India.

- **Positive outlook across verticals:** Company is witnessing continuous growth in automation and digital transformation activities for their clients in the BFS vertical. The mortgage segment in the BFS vertical is experiencing some slowdown but the revenue contribution from this segment is only about 2.5% of the firm's revenues. The company also had a positive outlook for the next 18 months in the TTH vertical. Demand traction is improving in the airline, airports, railroads and logistic segments but clients in the hospitality, hotels and cruise lines are cautious over their discretionary spends. The insurance vertical is seeing transformation from basic digitisation activities to more of end-to-end digitization activities with clients wanting to launch more products faster.

- **Adjusted EBITDA margins improved by 190 bps q-o-q to 18.4%:** Adjusted EBITDA margin for the quarter increased by almost 190 bps to 18.4%. Only 10 bps was contributed from the positive currency impact as the company has significant exposure to Europe. A 20 bps gain from SGA cost control and 160 bps gain from continued offshoring expansion, utilisation uptick, higher contribution from higher margin businesses and operational improvements. The offshoring mix increased by 180 bps q-o-q to 49.8% and has improved by 1,380 bps since the last 8 quarters.

- **Large deal wins and robust deal pipeline:** The company reported order intake of $304 million making it the third consecutive quarter of order intakes above $300 million. Coforge won two $30 million+ TCV deals in Q2. One was $32 million TCV deal to transform and manage technology infrastructure of a wealth management platform provider and the other was for a large global bank wanting multiple large scale transformation programs over the next 3 years. The company added 11 new logos in Q2 with five in America, four in EMEA and two in ROW. The executable order book for next 12 months grew by 7.7% q-o-q to a robust $802 million. Regarding client budgets for calendar year 2023, company said they will get finalised only by mid November 2022.

- **Healthy growth of top accounts and strong client metrics:** Top 5 and top 10 clients grew by 4.3% each q-o-q to $57 million and $88.4 million, respectively. Coforge added 3, 4 and 5 clients on a y-o-y basis in the $10 million+ bucket, $5-10 million bucket and $1-5 million bucket respectively. On a q-o-q basis clients in the $ 10 million+ bucket stayed flat, 2 were added in the $5-10 million bucket and one declined in the $1-5 million bucket.

- **Revenue guidance reiterated:** Coforge reiterated its annual revenue guidance to grow at least 20% in constant currency terms. A strong order book, large deal wins, low attrition rates, close relationship with clients and absence of a disproportionate reliance on any single client gives the management confidence to achieve the revenue growth rate. The management said Coforge will be a $1 billion revenue enterprise in FY23 and they aspire to be a $2 billion revenue enterprise over the long term.

- **Reiterated Adjusted EBITDA margin:** Company reiterated adjusted EBITDA margin guidance between 18.5% and 19.0% for FY23. The margin pressure from wage hikes would be absent in H2FY23 as the management has already rolled it out in March 2022. Company said it does not see pricing to be a margin lever going forward.

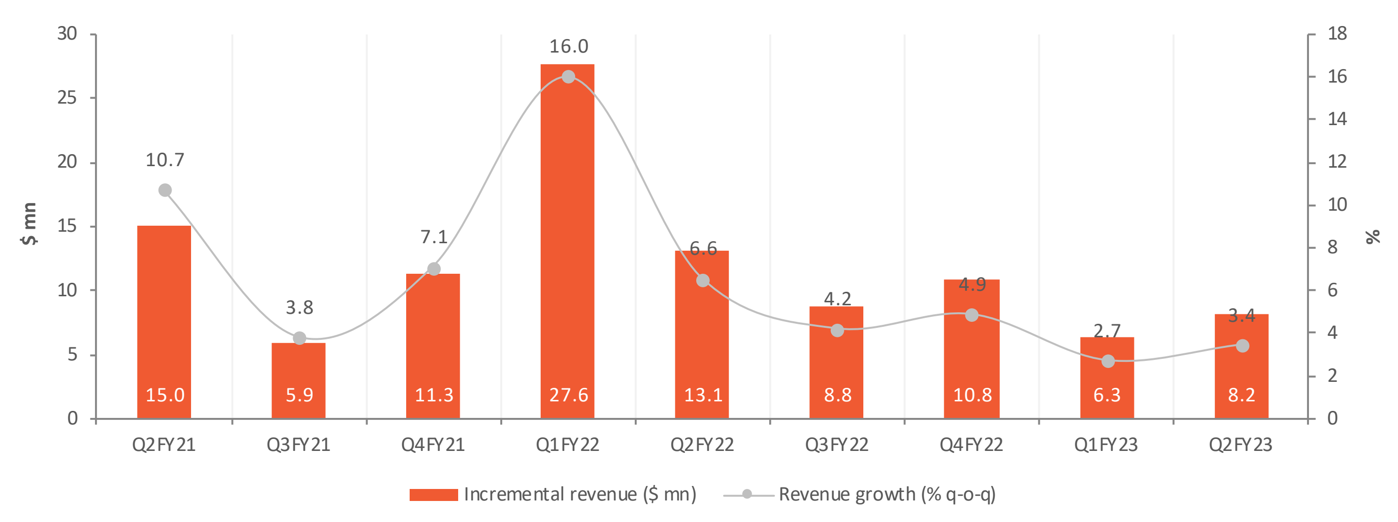
- **Net headcount addition moderated, but focus lies on training employees:** Net headcount addition increased only by 1.1% q-o-q to 22,991 employees. The increase in headcounts in the technology segment was offset by the decrease in the BPO segment. 2300 people were trained across the verticals in BFS, travel and insurance and 500 freshers were hired and trained in Q2.
- **Improvement in utilisation rates:** Utilisation rate including trained employees increased by 110 bps q-o-q to 77.3% and management guided for utilisation levels to remain at about 77.5% as the company will first prioritize the growth opportunities available to them. Company said furloughs in Q3FY23 won't be a major issue and would be in-line with Q3FY22.
- **Low attrition:** LTM attrition rate declined 160 bps q-o-q to 16.4% which is one the lowest in the industry. This is a testament of the strong bond between Coforge and its employees, good organizational work culture and high compensation benefits.
- **ADR listing delayed:** Current market conditions are not favourable for the ADR listing, which is why it has got delayed but the company said they are still committed on the listing in the future.
- **One-time benefit in Effective Tax rate (ETR):** The ETR declined by 460 bps q-o-q to 17.7% because there was a net operating loss in one of its subsidiaries. This was only a one-time benefit and company guided for ETR to be in the normal range of 21%-22% for the coming quarters
- **Healthy balance sheet metrics:** The cash and cash equivalents stood at $50.2 million in Q2FY23 versus $42.4 million in Q1FY2023. The company's capex stood at $5 million compared to $7.2 million in Q1FY2023. DSO decreased by 2 days to 70 days in Q2FY2023. Bank borrowings have decreased by 3.1% q-o-q to Rs 5,840 million.

Results Rs cr

Particulars	Q2FY23	Q2FY22	Q1FY23	% YoY	% QoQ
Revenues ($ mn)	246.9	212.8	238.7	16.0	3.4
Net Sales	**1,959.4**	**1,569.4**	**1,829.4**	**24.9**	**7.1**
Direct costs	1,331.6	1,065.6	1,273.9	25.0	4.5
Gross Profit	**627.8**	**503.8**	**555.5**	**24.6**	**13.0**
SGA	268.2	211.5	254.3	26.8	5.5
Acquisition related expenses & costs of ESOPs	15.2	18.6	9.4	-18.3	61.7
EBITDA	**344.4**	**273.7**	**291.8**	**25.8**	**18.0**
Depreciation and amortization	61.4	59.8	63.0	2.7	-2.5
EBIT	**283.0**	**213.9**	**228.8**	**32.3**	**23.7**
Other income	(15.0)	(7.7)	(7.6)	94.8	97.4
PBT	**268.0**	**206.2**	**221.2**	**30.0**	**21.2**
Tax provision	47.4	44.6	49.3	6.3	-3.9
Minority Interest	19.5	14.9	22.2	30.9	-12.2
Net profit	**201.1**	**146.7**	**149.7**	**37.1**	**34.3**
EPS (Rs)	33.0	24.2	24.6	36.4	34.1
Margin (%)					
EBITDA	17.6	17.4	16.0	14	163
EBIT	14.4	13.6	12.5	81	194
NPM	10.3	9.3	8.2	92	208
Tax rate (%)	17.7	21.6	22.3	-394	-460

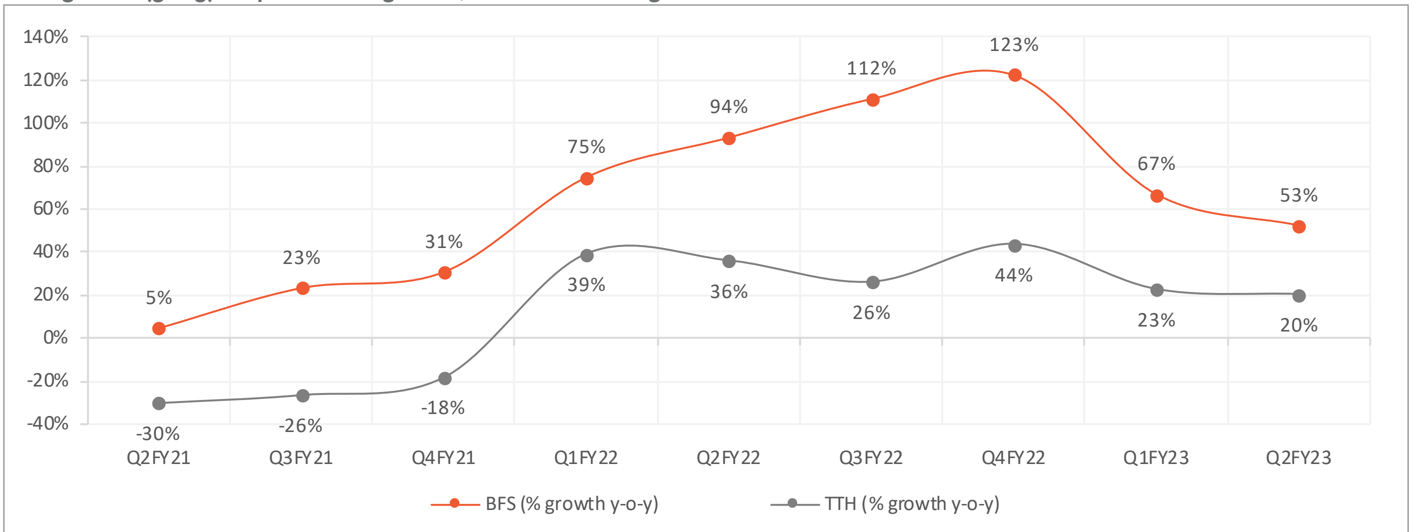
Source: Company, Sharekhan Research

Incremental revenue trend



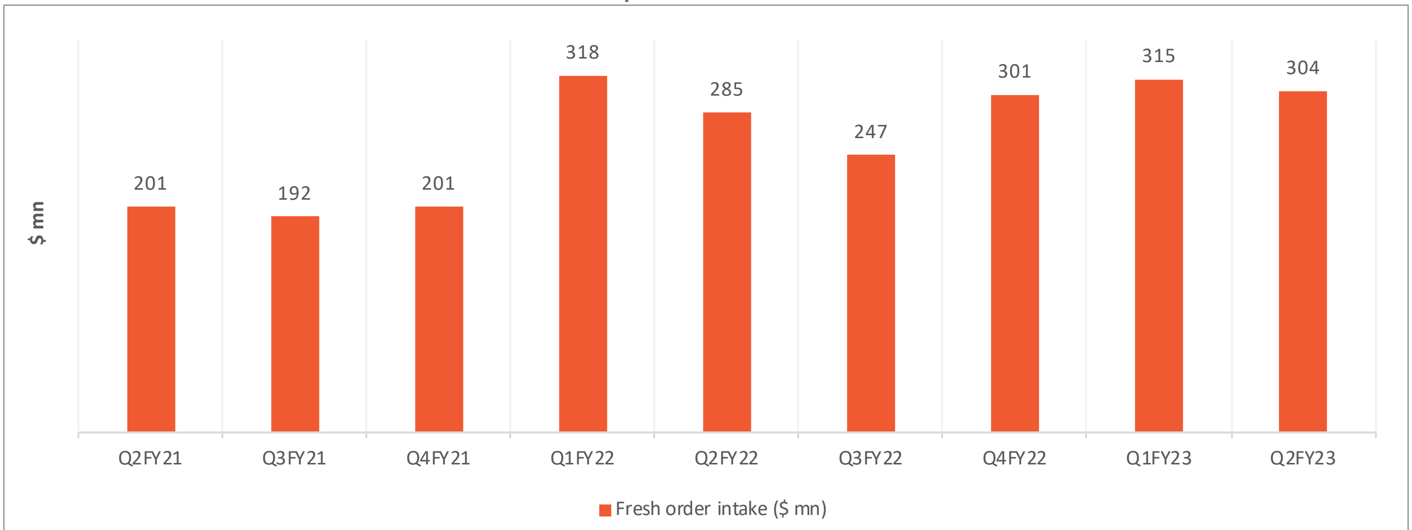
Source: Company; Sharekhan Research

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



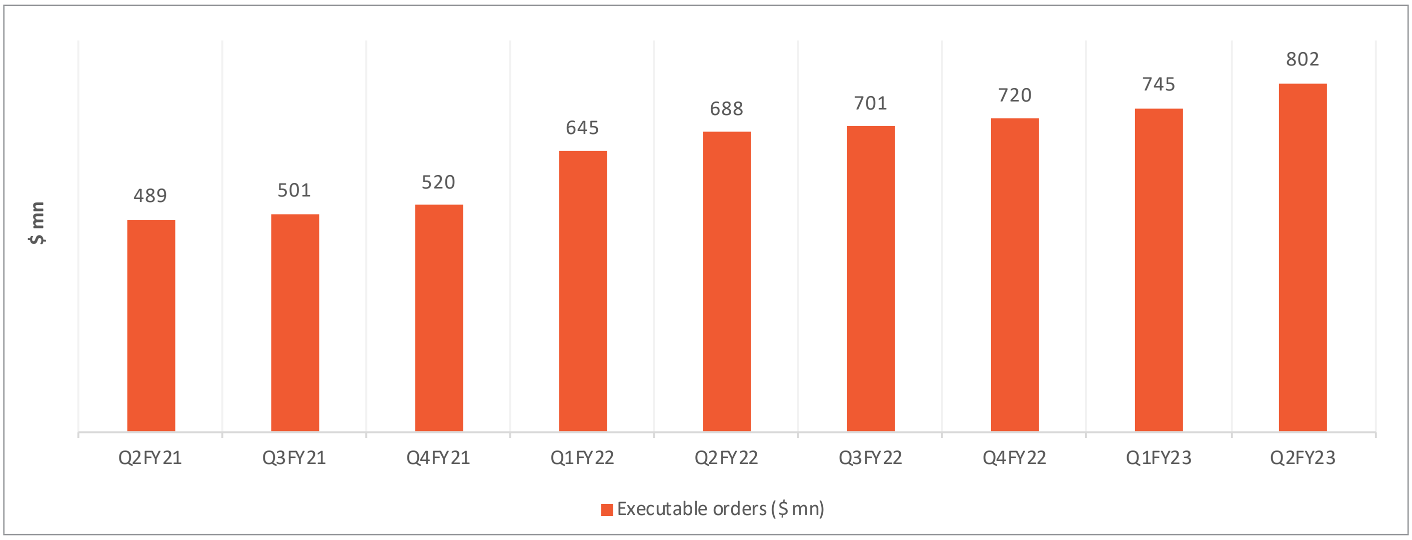
Source: Company; Sharekhan Research

Fresh order book above $300 million for consecutive 3 quarters



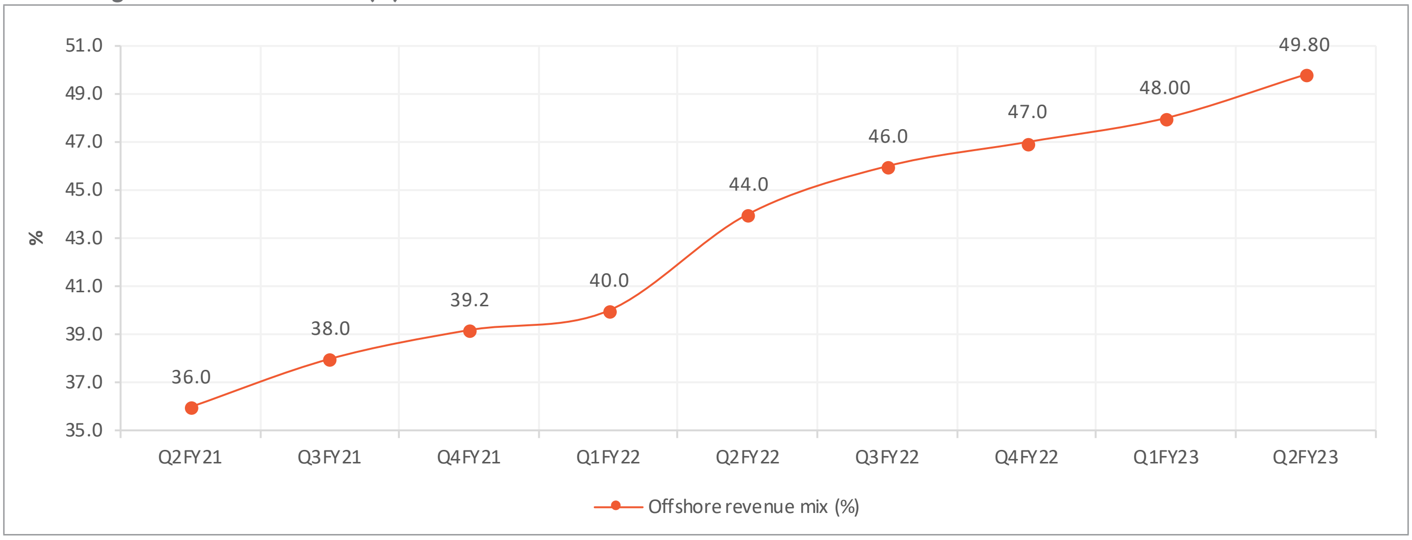
Source: Company; Sharekhan Research

Executable orders to be executed over next 12 months is 80% of FY23E revenue



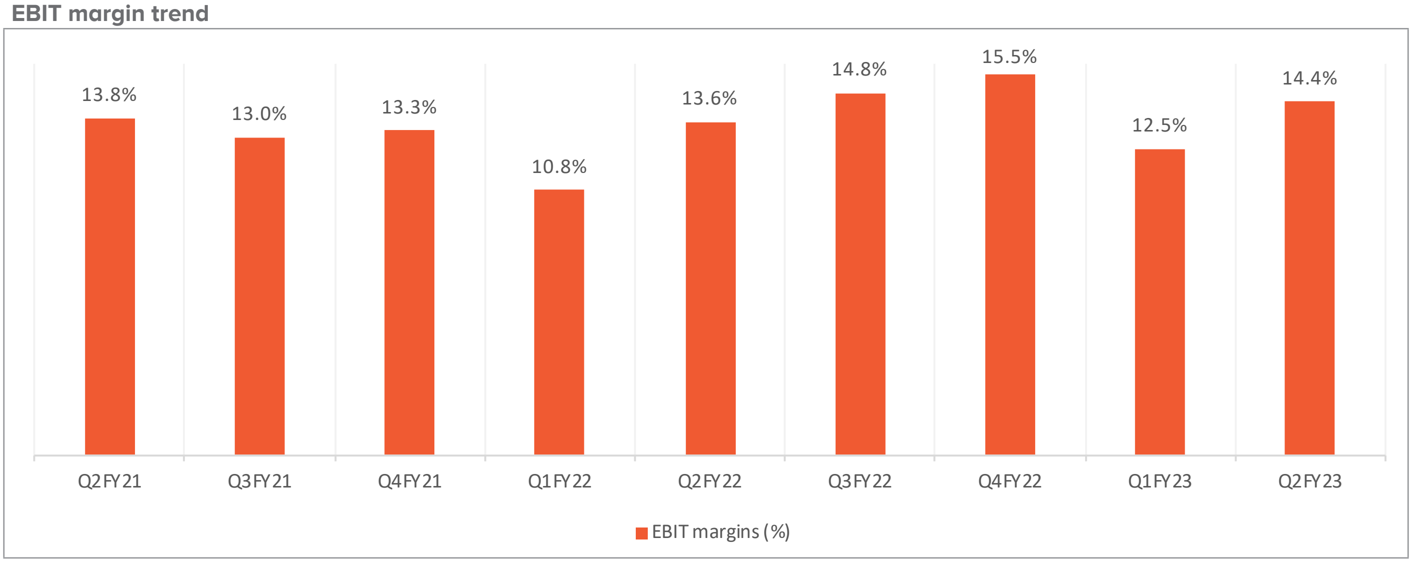
Source: Company; Sharekhan Research

Increasing offshore revenue mix (%) trend



Source: Company; Sharekhan Research

EBIT margin trend



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 infrastructure 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. Strong leadership, deep domain capability in select verticals, improved capability and marquee client base would help the company to sustain 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 the BFS vertical, new logo addition, investments in leadership team and strong execution. Further, its executable order bookings for the next 12 months remain 80% of our FY2023E revenue estimates. Coforge is expected to clock a revenue/earnings CAGR of 14%/19.5%, respectively over FY2022-25E, implies a high growth among top mid-tier peers. At CMP, the stock is trading at a valuation of 28x/24x/21x of its FY2023E/FY2024E/FY2025E earnings. 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 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) 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

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: Company Website

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

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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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