

CMP: ₹ 105

Target: ₹ 95 (-9%)

Target Period: 12 months

August 5, 2022

Weak performance; guidance revised downward...

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 27% 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 26,557 employees across the US, UK, India and Philippines

Q1FY23 Results: FSL reported weak numbers.

- US\$ revenues declined 5.1% QoQ in CC terms and 7.1% in dollar terms
- EBIT declined ~340 bps QoQ to 8%
- Revenue guidance revised downward to 2-4% in CC for FY23

What should investors do? FSL's share price has grown by ~3.1x over the past five years (from ~₹ 34 in August 2017 to ~₹ 105 levels in August 2022).

- We change our rating from HOLD to **REDUCE**

Target Price and Valuation: We value FSL at ₹ 95 i.e. 12x P/E on FY24E.

Key triggers for future price performance:

- Recovery in refinancing and collections volumes, which has been a weak link in the performance. We expect dollar revenues to increase at a CAGR of 4.4% in FY22-24E
- Inorganic opportunities in adjacent capabilities may help to address the growth concerns
- Margin recovery due to cost rationalisation programmes. We expect EBIT margins to decline 130 bps in FY22-24E

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

- Consistent growth aided by continued strong TCV and inorganic opportunities
- BUY with a target price of ₹ 4,200

REDUCE



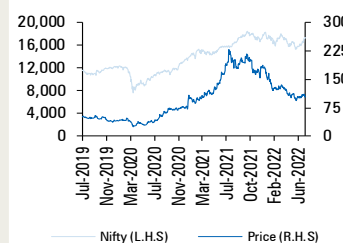
Particulars

Particular	Amount
Market Cap (₹ Crore)	7,210.2
Total Debt (₹ Crore)	1,009.7
Cash and Invests (₹ Crore)	208.3
EV (₹ Crore)	8,011.6
52 week H/L	222/ 93
Equity capital	697.0
Face value	10.0

Shareholding pattern

	Sep-21	Dec-21	Mar-22	Jun-22
Promoters	54	54	54	54
FII	11	10	8	8
DII	14	15	15	15
Public	22	22	24	24

Price Chart



Recent event & key risks

- Revenue and EBIT margin guidance revised downward
- Key Risk:** (i) Better than expected mortgage performance (ii) Better than expected margins

Research Analyst

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Key Financial Summary

Key Financials	FY20	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	2 year CAGR (FY22-24E)
Net Sales	4,099	5,078	5,921	10.7%	6,156	6,644	5.9%
EBITDA	629	799	960	17.0%	893	983	1.2%
Margins (%)	15.3	15.7	16.2		14.5	14.8	
Net Profit	340	362	537	13.9%	473	551	1.3%
EPS (₹)	4.9	5.2	7.7		6.8	7.9	
P/E	21.4	20.1	13.6		15.4	13.2	
RoNW (%)	12.3	12.9	17.7		14.7	16.1	
RoCE (%)	11.1	15.4	14.5		13.5	14.9	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- FSL reported revenue of US\$191 mn for the quarter, down 7.1% QoQ while in CC terms it reported a decline of 5.1% QoQ. In rupee terms the company reported revenue of ₹ 1,472.4 crore down by 4.6% QoQ. The revenue decline was due to worsening of macros impacting mortgage business. FSL has revised downward revenue guidance to 2-4% in CC in FY23 vs. 7-8% given earlier. It also revised downward revenue growth guidance ex mortgage and acquisitions to 16-19% now from 18-22% given earlier. The company indicated that delinquency rate in the US is gradually moving and now they are at 1.7 vs 1.54 in Q3FY22. Hence, recovery in collections business has been slower than expectations. On origination side. HPHS continues to perform strongly due to robust deal pipeline from large health plans. Healthcare added five new clients across revenue cycle management and integrated care services in Q1
- Geography wise, US (68% mix) declined 10.1% QoQ while UK (30% mix) grew 1.7% QoQ. Vertical wise BFSI (46% mix) declined 12.2% QoQ. Healthcare and communications, media & tech (CMT) reported decline of 1.5% & 1.2% QoQ, respectively
- The company earlier guided for mortgage business annual revenue to be in the range of US\$125-135 mn for FY23. The quarterly revenue run rate has come down from US\$45-47 mn in Q4FY22 to US\$32 mn in Q1FY23. FSL expects further weakness in this business in Q2 and expects it to be around US\$25 mn. It indicated that this business is expected to witness recovery only from Q4 onwards. The company indicated it is looking to re-align manpower costs in mortgage business in proportion to the slowing demand as the company of the opinion that it did aggressive hiring in the earlier quarters
- The company indicated that it is planning to continue its investments in healthcare & CMT verticals to cater to the ongoing demand. FSL expects demand to pick up in HPHS business from Q2 onwards. The company indicated that it is witnessing increased demand in healthcare vertical in UK region but supply side challenges persists in the region
- EBIT margin of the company declined ~340 bps QoQ to 8%. The decline was due to rise in SG&A expenses by 5.4% QoQ. The company also indicated that it has changed its accounting policy, which will have an impact of 80-90 bps on margins for FY23. FSL indicated that margins will improve from Q2 onwards and expects cost rationalisation initiatives to start benefiting from Q2 onwards. The company indicated that margin will be back to 11.5-12% by Q4 and expects margins for FY23 to be in the range of 10-10.5%
- FSL opened new satellite centre in Mexico and will open a new centre in Philippines
- The company indicated that it is facing supply side challenges in the US and UK. FSL's on-shore attrition increased 570 bps to 56.9% while its offshore attrition declined 210 bps to 43.8%. The employee count has reduced by 1,323 bringing its total headcount to 25,234
- The company indicated that it is currently focusing on smooth integration of the recent acquisition and synergy benefits thereafter. At this point of time, it is not looking for any further inorganic opportunities
- The company indicated that its outcome based projects have price hike clause in the agreement and, hence, was able to take price hike in couple of projects due to rise in costs
- The company reported a tax rate of 18.8% for Q1FY23 and has guided the tax rate to be in the range of 18-20% for FY23

Exhibit 1: P&L

	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)	Comments
Revenue	1,472.4	1,484.8	-0.8	1,543.9	-4.6	Continued pressure on mortgage business impacting revenues
Employee expenses	959.7	1,021.9	-6.7	984.5	-2.8	
Gross Margin	512.6	462.9	10.7	559.4	-8.4	
Gross margin (%)	34.8	31.2	364 bps	36.2	-142 bps	
SG&A expenses	331.6	224.6	47.7	314.6	5.4	
EBITDA	181.0	238.3	-24.1	244.8	-26.1	
EBITDA Margin (%)	12.3	16.1	-376 bps	15.9	-357 bps	Margins impacted by increase in SG&A expenses and manpower expenses
Depreciation & amortisation	63.9	58.4	9.5	69.7	-8.3	
EBIT	117.1	180.0	-34.9	175.1	-33.2	
EBIT Margin (%)	8.0	12.1	-417 bps	11.3	-339 bps	
Other income (less interest)	-18.7	-14.6	28.3	-18.8	-0.5	
PBT	98.4	165.4	-40.5	156.4	-37.1	
Tax paid	19.7	31.7	-38.0	23.6	-16.7	
PAT	85.1	134.5	-36.7	132.4	-35.7	

Source: Company, ICICI Direct Research

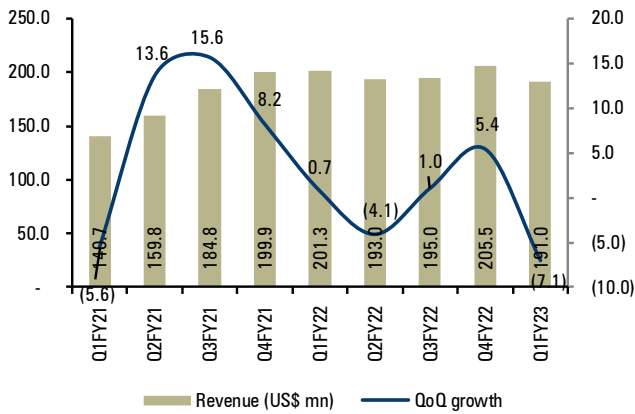
Exhibit 2: Change in estimates

(₹ Crore)	FY23E			FY24E			Comments
	Old	New	% Change	Old	New	% Change	
Revenue	6,493	6,156	-5.2	7,266	6,644	-8.6	Revenue aligned as per FY23 guidance
EBIT	696	616	-11.6	808	711	-12.0	
EBIT Margin (%)	10.7	10.0	-72 bps	11.1	10.7	-42 bps	EBIT margins aligned as per FY23 guidance
PAT	537	473	-12.0	629	551	-12.3	
EPS (₹)	7.7	6.8	-12.0	9.1	7.9	-12.3	

Source: Company, ICICI Direct Research

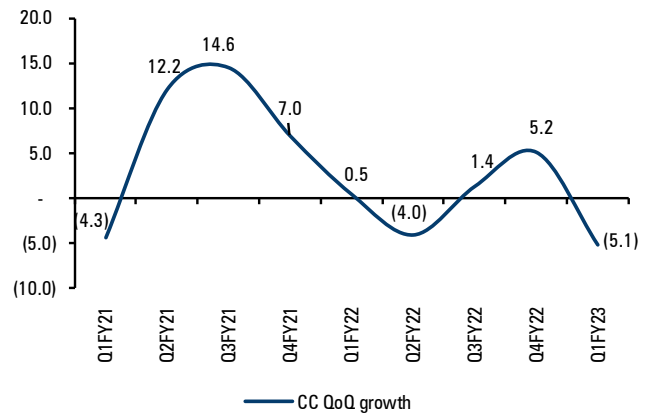
Key Metrics

Exhibit 3: Revenue (in US\$ mn) with YoY growth



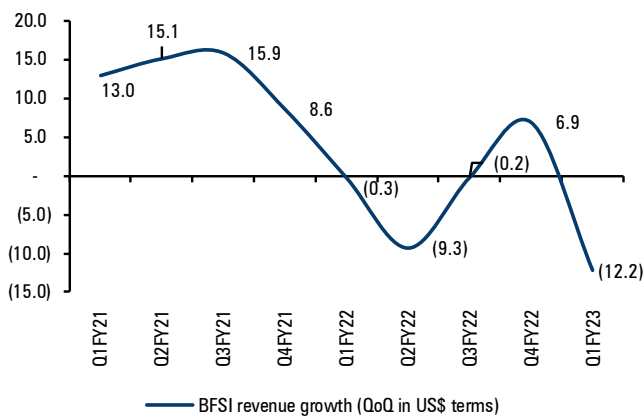
Source: Company, ICICI Direct Research

Exhibit 4: QoQ CC growth



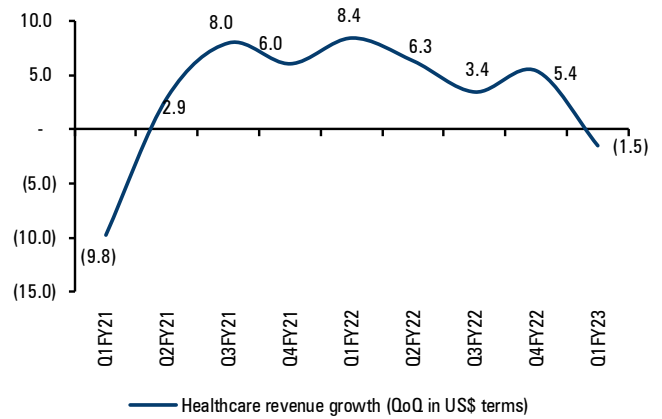
Source: Company, ICICI Direct Research

Exhibit 5: BFSI revenue growth



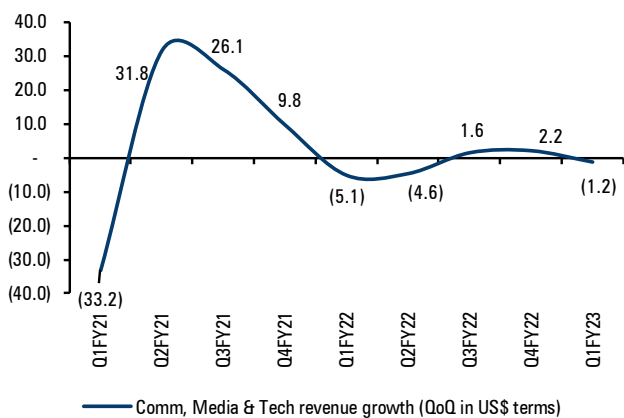
Source: Company, ICICI Direct Research

Exhibit 6: Healthcare revenue growth



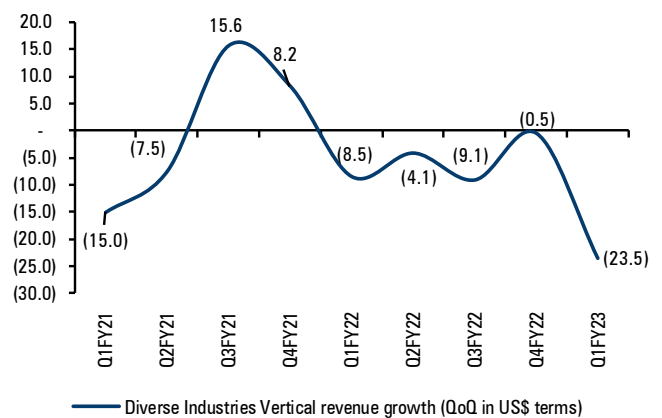
Source: Company, ICICI Direct Research

Exhibit 7: Communication, media & tech growth



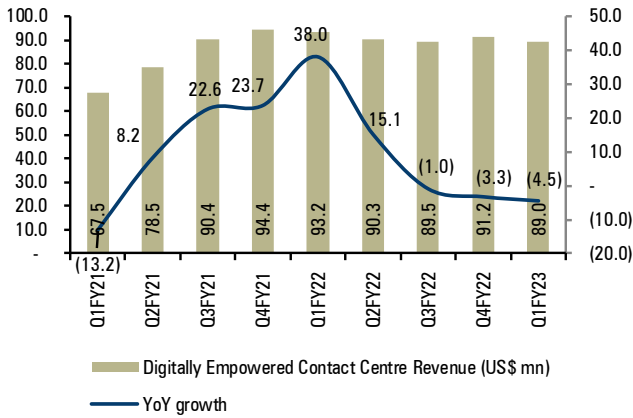
Source: Company, ICICI Direct Research

Exhibit 8: Diverse industries growth



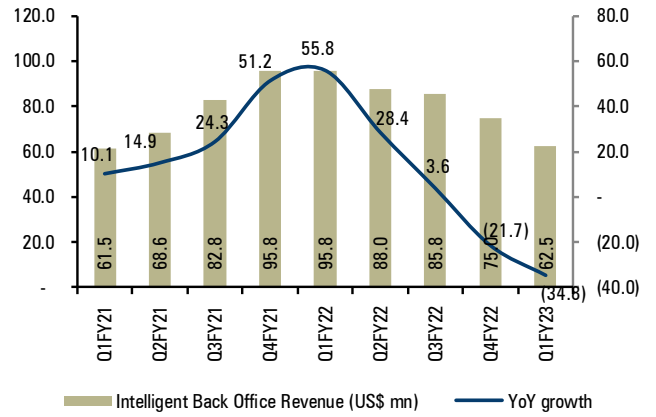
Source: Company, ICICI Direct Research

Exhibit 9: Digitally empowered contact centre revenue with YoY growth



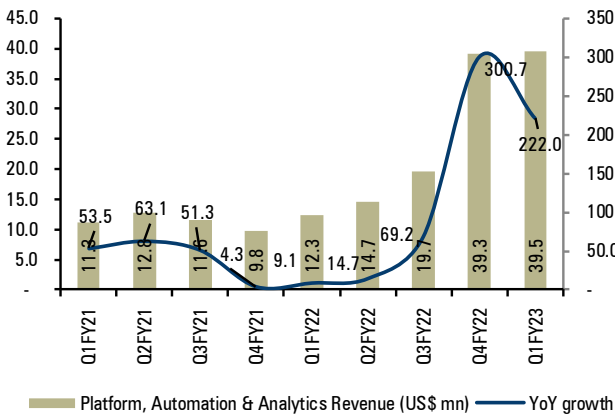
Source: Company, ICICI Direct Research

Exhibit 10: Intelligent back office revenue with YoY growth



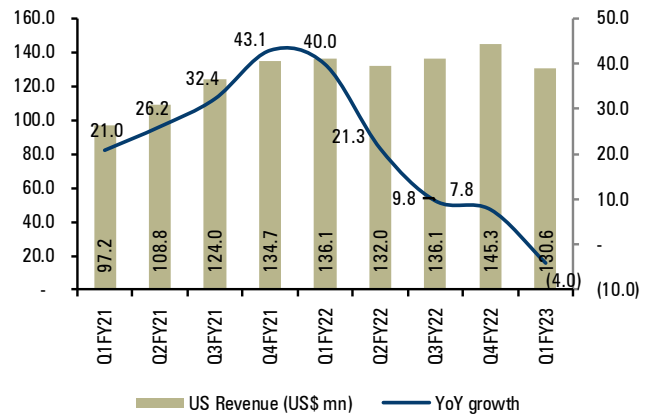
Source: Company, ICICI Direct Research

Exhibit 11: Platform automation revenue with YoY growth



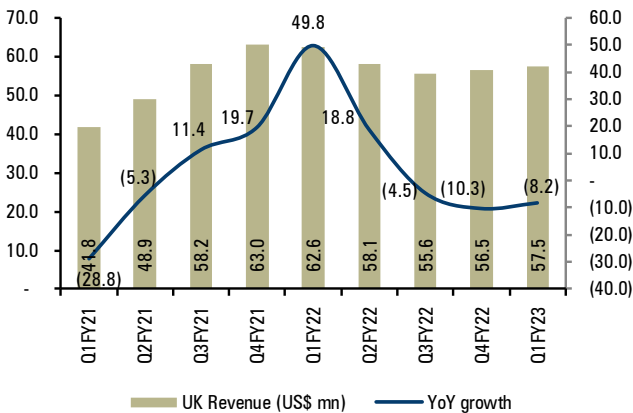
Source: Company, ICICI Direct Research

Exhibit 12: US region revenue with YoY growth



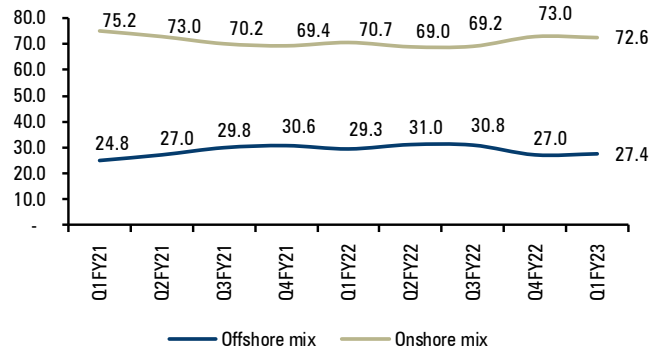
Source: Company, ICICI Direct Research

Exhibit 13: UK region revenue with YoY growth



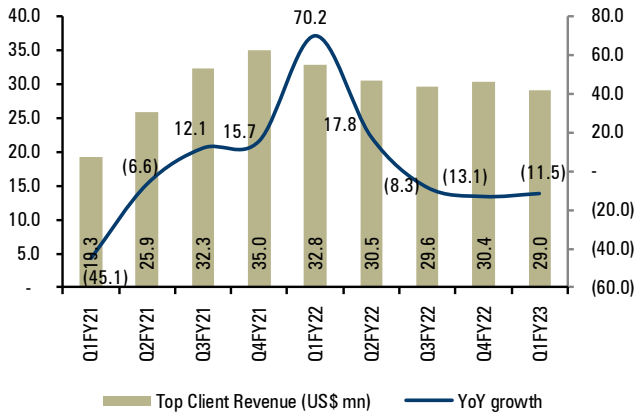
Source: Company, ICICI Direct Research

Exhibit 14: Offshore & onshore mix trend



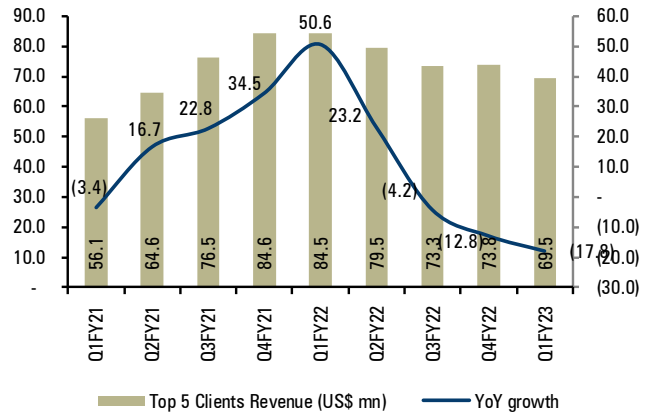
Source: Company, ICICI Direct Research

Exhibit 15: Top client revenue with YoY growth



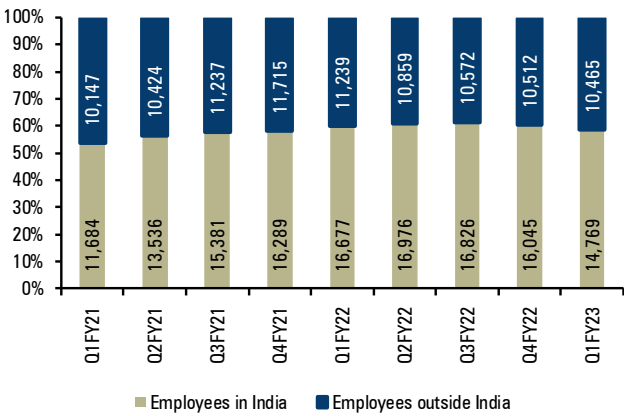
Source: Company, ICICI Direct Research

Exhibit 16: Top five clients revenue with YoY growth



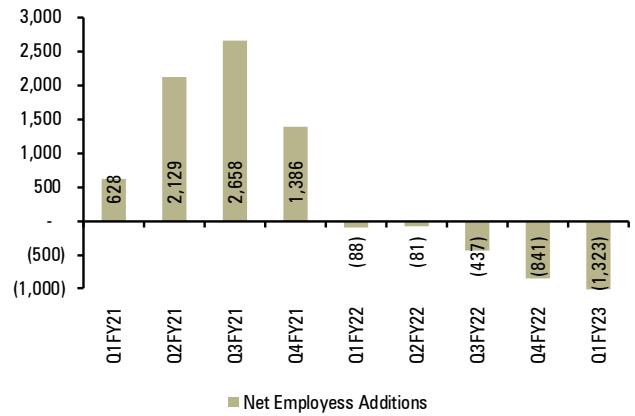
Source: Company, ICICI Direct Research

Exhibit 17: Employee mix



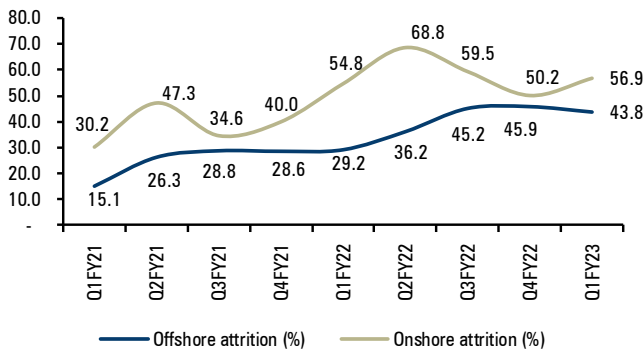
Source: Company, ICICI Direct Research

Exhibit 18: Net employee addition trend



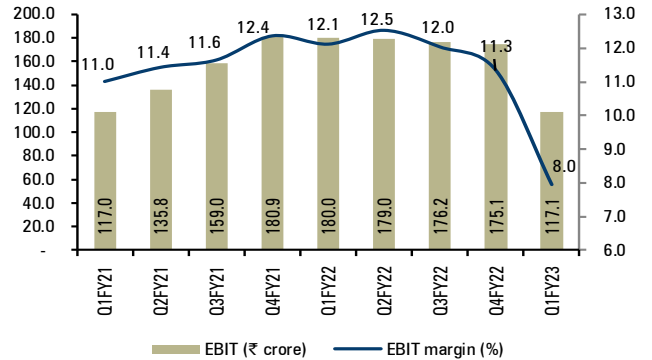
Source: Company, ICICI Direct Research

Exhibit 19: Attrition trend



Source: Company, ICICI Direct Research

Exhibit 20: EBIT margin (%) Trend



Source: Company, ICICI Direct Research

Financial summary

Exhibit 21: Profit and loss statement				
	₹ crore			
	FY21	FY22	FY23E	FY24E
Total Revenues	5,078	5,921	6,156	6,644
Growth (%)	23.9	16.6	4.0	7.9
Employee expenses	3,467	3,947	3,971	4,512
Other Expenses	812	1,015	1,293	1,149
EBITDA	799	960	893	983
Growth (%)	27.1	20.1	(7.0)	10.2
Depreciation & Amortization	206	249	277	272
Other Income	1	(0)	4	4
Interest	52	63	29	27
PBT before Exceptional Item	432	647	590	688
Growth (%)	9.5	49.8	(8.8)	16.5
Tax	70	111	118	138
PAT before Excp Items	362	536	472	550
Exceptional items				
PAT before MI	362	536	472	550
Minority Int & Pft. from assoc	(0)	(1)	(1)	(1)
PAT	362	537	473	551
Growth (%)	6.5	48.6	(12.0)	16.5
EPS	5.2	7.7	6.8	7.9
EPS (Growth %)	6.5	48.3	(12.0)	16.5

Source: Company, ICICI Direct Research

Exhibit 22: Cash flow statement				
	₹ crore			
	FY21	FY22	FY23E	FY24E
Profit before Tax	432	453	590	688
Depreciation & Amortization	206	88	277	272
WC changes	290	(54)	81	(46)
Other non cash adju.	48	(72)	(92)	(113)
CF from operations	976	416	856	800
Capital expenditure	(173)	(38)	(153)	(165)
Δ in investments	(176)	(33)	-	-
Other investing cash flow	1	0	4	4
CF from investing Acti	(350)	(50)	(149)	(161)
Issue of equity	(57)	(46)	-	-
Δ in debt funds	(376)	(8)	(517)	-
Dividends paid	(204)	(238)	(289)	(336)
Other financing cash flow	(51)	(20)	(29)	(27)
CF from Financial Acti	(689)	(356)	(928)	(456)
Δ in cash and cash bank ba	(63)	9	(220)	183
Effect of exchange rate changes				
Opening cash	191	137	147	(73)
Closing cash	137	147	(73)	110

Source: Company, ICICI Direct Research

Exhibit 23: Balance sheet				
	₹ crore			
Particulars	FY21	FY22	FY23E	FY24E
Equity	696	697	697	697
Reserves & Surplus	2,103	2,336	2,520	2,735
Networth	2,799	3,033	3,217	3,432
Minority Interest	1	0	0	0
LT liabilities & provisions	461	867	867	867
Total Debt	604	1,010	493	493
Source of funds	3,865	4,910	4,578	4,793
Net fixed assets	749	1,026	714	699
CWIP	-	-	-	-
Goodwill	2,195	2,721	2,721	2,721
Other non current assets	655	541	818	860
Loans and advances	-	-	-	-
Current Investments	83	119	119	119
Debtors	577	961	699	755
Cash & Cash equivalents	137	90	(73)	110
Other current assets	435	252	527	569
Trade payables	279	178	338	365
Current liabilities	604	567	732	790
Provisions	82	53	100	108
Application of funds	3,865	4,910	4,578	4,793

Source: Company, ICICI Direct Research

Exhibit 24: Key ratios				
(Year-end March)	₹ crore			
	FY21	FY22	FY23E	FY24E
Per share data (₹)				
EPS-diluted	5.2	7.7	6.8	7.9
DPS	3.0	3.8	4.1	4.8
BV	40.8	44.2	46.9	50.0
Operating Ratios (%)				
EBITDA Margin	15.7	16.2	14.5	14.8
PBT Margin	8.5	10.9	9.6	10.3
PAT Margin	7.1	9.1	7.7	8.3
Return Ratios (%)				
RoNW	12.9	17.7	14.7	16.1
RoCE	15.4	14.5	13.5	14.9
Valuation Ratios (x)				
P/E	20.1	13.6	15.4	13.2
EV / EBITDA	9.5	8.3	8.6	7.6
Price to Book Value	2.6	2.4	2.2	2.1
EV / Net Sales	1.5	1.4	1.2	1.1
Mcap / Net Sales	1.4	1.2	1.2	1.1
Turnover Ratios				
Debtor days	41	59	41	41
Creditors days	20	11	20	20
Solvency Ratios				
Total Debt / Equity	0.2	0.3	0.2	0.1
Current Ratio	1.0	1.5	1.0	1.0
Quick Ratio	1.0	1.5	1.0	1.0
Net Debt / EBITDA	0.5	0.8	0.5	0.3

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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