Firstsource Solutions (FIRSOU)

ICICI direct Research

CMP: ₹ 116 | Target: ₹ 105 (-10%) | Target Period: 12 months | **REDUCE**

February 4, 2023

Company Update

ICICI Securities – Retail Equity Research

Weak performance continues; some recovery in Q4…

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 23,627 employees across the US, UK, India and Philippines

Q3FY23 Results: FSL reported weak numbers in Q3FY23.

- Revenue declined 0.9% QoQ in CC terms & 2.1% in dollar terms
- EBIT margins improved ~100 bps QoQ to 9.4%
- Revenue guidance revised to -2% to -1% in CC for FY23

What should investors do? FSL's share price has grown by ~2.7x in the past five years (from ~₹ 41 in February 2018 to ~₹ 116 levels in February 2023).

- We maintain our **REDUCE** rating on the stock

Target Price and Valuation: We value FSL at ₹ 105 i.e. 12x P/E on FY25E.

Key triggers for future price performance:

- Recovery in refinancing and collections volumes, which has been a weak link in the performance. We expect rupee revenues to increase at a CAGR of 4.6% in FY22-25E
- Inorganic opportunities in adjacent capabilities may help to address the growth concerns
- Margin recovery due to cost rationalisation programmes. We are currently estimating EBIT margins of 11.4% for FY25E

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 ₹ 4,920

firstsource Stay Ahead

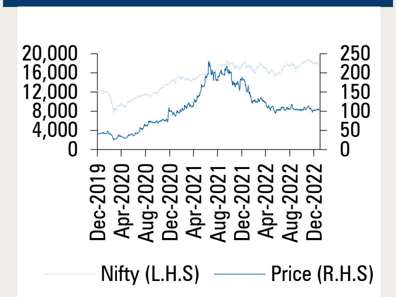
Particulars

Particular	Amount
Market Cap (₹ Crore)	7,965.5
Total Debt (₹ Crore)	1,009.7
Cash and Invests (₹ Crore)	208.3
EV (₹ Crore)	8,766.9
52 week H/L	169/ 93
Equity capital	697.0
Face value	10.0

Shareholding pattern

	Mar-22	Jun-22	Sep-22	Dec-22
Promoters	54	54	54	54
FII	8	8	8	8
DII	15	15	13	14
Public	24	24	25	24

Price Chart



Recent event & key risks

- Revenue guidance revised to -2% to -1% for FY23
- **Key Risk:** (i) Better than expected revenue growth (ii) Better than expected margins

Research Analyst

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Key Financial Summary

Key Financials	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 year CAGR (FY22-25E)
Net Sales	5,078	5,921	10.7%	6,032	6,331	6,775	4.6%
EBITDA	799	960	17.0%	826	950	1,050	3.0%
Margins (%)	15.7	16.2		13.7	15.0	15.5	
Net Profit	362	537	13.9%	433	531	605	4.0%
EPS (₹)	5.2	7.7		6.2	7.7	8.7	
P/E	22.2	15.0		18.6	15.2	13.3	
RoNW (%)	12.9	17.7		13.5	15.6	16.6	
RoCE (%)	15.4	14.5		12.0	14.0	14.9	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported a revenue of US$183 mn, down 2.1% QoQ while in CC terms revenue declined 0.3%. In rupee terms, FSL reported a revenue of ₹1,504.9 crore, up 1.1% QoQ. The company indicated that the organic business excluding mortgage & acquisitions grew 18.6% YoY in CC terms. FSL indicated that slowdown in mortgage business, slower rampup in the collections business & slower decision making in healthcare deals impacted the revenue growth of the company
- **Guidance:** The company indicated that due to impact of changes in the macro environment on the company's core & acquired business led to the constant changes in the guidance numbers for the year. FSL is now guiding for CC revenue growth of -2% to -1% for FY23 and excluding mortgage business & acquisitions it is guiding for a revenue growth of 12.5-14.5% for the year. For the whole year, the company is guiding operating margin band of 9.25-9.5%
- For Q4 the company is guiding for revenue growth in the range of 1-5% & aspiring exit operating margin band of 11.5-12%. FSL further indicated that this band will be the new base for FY24 margins and the levers for margin improvement in Q4 are increase in revenue & the continuance of cost rationalisation programs
- Geography wise, US (65% mix) declined 5.5% QoQ while UK (34% mix) reported strong growth of 6.6% QoQ. Vertical wise in CC terms BFS (42% of mix) declined 14.1% YoY and excluding mortgage & acquisitions BFS grew 30% YoY. Health care & CMT reported growth of 7.2% & 17.5% YoY in CC terms
- EBIT margin of the company increased ~100 bps QoQ to 9.4% as it continues its cost rationalisation activities. FSL also indicated that some expenses during the quarter were also attributed to lower revenue generated during the quarter. The company indicated that cost rationalisation led savings i.e. 70% mix, are sustainable while 30% savings may be come up again in subsequent quarters as they are linked to revenue growth
- The company, during the quarter reported PAT of ₹ 157.9 crore, up 22% QoQ with other income of ₹ 62.5 crore. FSL mentioned that the other income was high due to reversal of the provision of ₹ 27.9 crore towards variable pay out for acquired companies as they did not meet the revenue target (due to adverse market conditions). The company also indicated that other income also included an amount of ₹ 31.9 crore from a mortgage contract as it had contingent pay out clause and based on recent revaluation of revenues it generated other income
- On the BFS front, mortgage business continues to be under pressure due to macro environments. The company indicated that the mortgage business declined 20% QoQ in Q3 & contributed ~10% of Q3 revenues and the company further expects the revenue contribution to decline to 8-8.5% in Q4FY23. The company indicated that interest rate may likely slow down its pace and bring in some volume back in this business
- The company further mentioned that the mix between origination & servicing was at 35/65 and now it is also witnessing pressure in the servicing side as well. FSL further indicated that it expects that as home purchase volumes picks up it will see some uptick in the originating business but not in the refinance business. The company also said that though servicing business is now witnessing pressure it does not expect additional adverse impact as it is already down to 8-9% of overall revenues

- In the collections business the company indicated that ramp up in volumes is not at the expected levels despite high inflation & high interest rates due to low unemployment rate & strong US household balance sheet. The company indicated that delinquencies grew steadily to 2.08 in Q3 from 1.85 in Q2FY23. FSL, however, indicated that it expects a strong Q4 in collections business. The company also indicated that legal collection business is still impacted by Covid lag but mentioned that legal delinquencies are rising. FSL further mentioned that clients are planning for capacity due to possible stability in rates, which is likely building up strong deal pipeline across diversified industry verticals. FSL during the quarter added seven new clients
- In the UK, in BFS segment the company indicated that its increased focus to grow business in the region is bearing results. FSL further indicated that the demand & adoption of digital remains strong despite political & macro uncertainty. The company expects Europe region to steadily grow not only in Q4 but also in next fiscal year
- The company indicated that Healthcare segment grew 7.2% YoY in CC terms. FSL indicated that its strategy to focus on top clients is leading to growth in the vertical. The company indicated though the growth has slowed down due to delayed decision making, the pipeline remains strong. FSL further indicated that growth in the vertical will be driven by increased digital adoption, increased BpaaS adoption & vendor consolidation. The company also mentioned that the slowdown in the vertical is due to longer evaluation process by the clients and longer implementation process in case the switching of vendors in vendor consolidation deals
- In CMT vertical, the company indicated that it witnessing steady growth in clients. FSL indicated that the US region CMT vertical performance is growing strongly. The company added that US CMT grew 63.8% YoY in CC terms and it expects it to grow strongly, going forward. The company added four new clients during the quarter including two major tech companies
- The company's net employees declined by 305 bringing the total employees to 23,627. FSL's onshore attrition declined 480 bps to 47.2% while its offshore attrition declined 130 bps 44.4%
- The company indicated that the growth in the medium term will be driven by: a) growing by building adjacent vertical capabilities, acquiring new clients & growing strategic account, b) diversifying its BFS business & continue to grow its Health & CMT verticals to make the company's business less cyclical
- On the M&A front the company mentioned that the acquisitions of Stonehill and ARSI did not fare as per expectations as the impact of macro headwinds was more severe on their businesses
- The company declared an interim dividend of ₹ 3.5 per share

Exhibit 1: P&L

₹ crore	Q3FY23	Q3FY22	YoY (%)	Q2FY23	QoQ (%)	Comments
Revenue	1,504.9	1,463.8	2.8	1,488.2	1.1	Revenue degrew by 0.9% QoQ in CC terms & 2.1% QoQ in dollar terms due to the continous pressure in mortgage business & slower than expected ramp up in collections business
Employee expenses	986.1	967.6	2.1	952.7	3.9	
Gross Margin	518.9	496.2	4.6	535.6	-3.1	
Gross margin (%)	34.5	33.9	58 bps	36.0	-151 bps	
SG&A expenses	309.2	258.3	19.7	343.8	-10.1	
EBITDA	209.7	237.9	-11.9	191.7	9.4	
EBITDA Margin (%)	13.9	16.3	-232 bps	12.9	105 bps	
Depreciation & amortisation	68.7	61.7	11.4	66.3	3.7	
EBIT	140.9	176.2	-20.0	125.4	12.4	
EBIT Margin (%)	9.4	12.0	-267 bps	8.4	94 bps	Margins continue to improve due to cost rationalisation activities
Other income (less interest)	42.7	-14.8	-388.6	29.5	44.9	Other income includes reversal of provsion of ₹27.9 crore towards variable payout & revalution of contingent liability of ₹31.9 crore
PBT	183.7	161.4	13.8	154.9	18.6	
Tax paid	25.7	25.9	-0.6	25.5	0.9	
PAT	157.9	135.5	16.5	129.4	22.0	

Source: Company, ICICI Direct Research

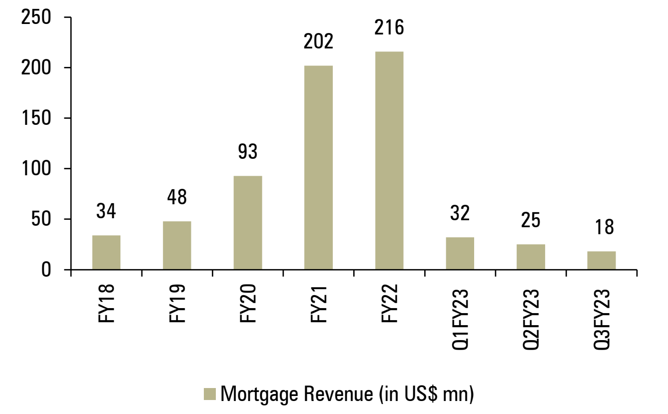
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	6,007	6,032	0.4	6,245	6,331	1.4	6,652	6,775	1.9	We are building in some recovery in BFSI vertical on steady rise in deliquencies in FY25
EBIT	535	567	6.1	587	690	17.6	758	772	1.9	
EBIT Margin (%)	8.9	9.4	50 bps	9.4	10.9	150 bps	11.4	11.4	0 bps	Margin expansion built up in FY24 on management guidance of margin
PAT	408	433	6.0	452	531	17.6	589	605	2.7	
EPS (₹)	5.9	6.2	6.0	6.5	7.7	17.6	8.5	8.7	2.7	

Source: Company, ICICI Direct Research

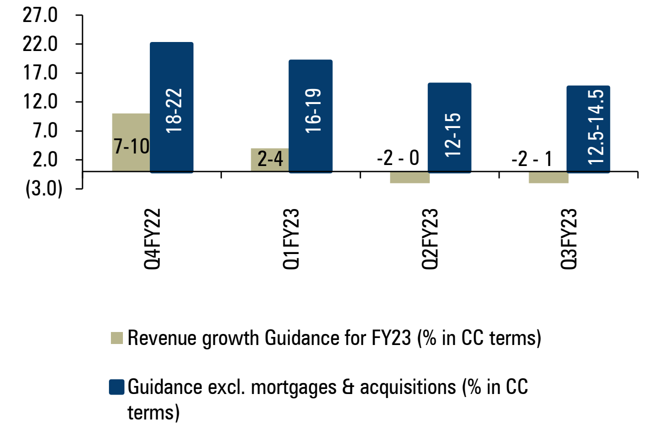
Key Metrics

Exhibit 3: Mortgage business continues to be weak



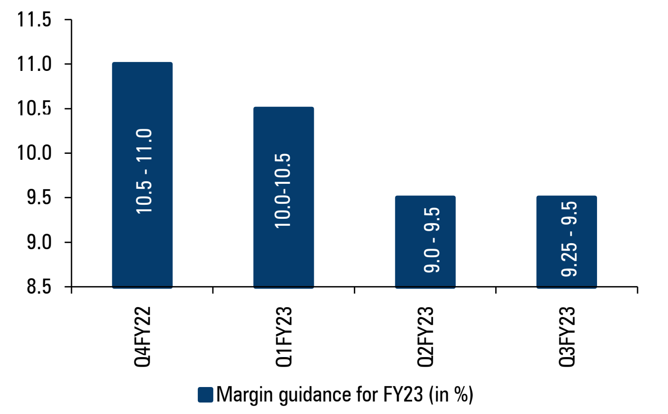
Source: Company, ICICI Direct Research

Exhibit 4: Resulting revenue guidance revised again



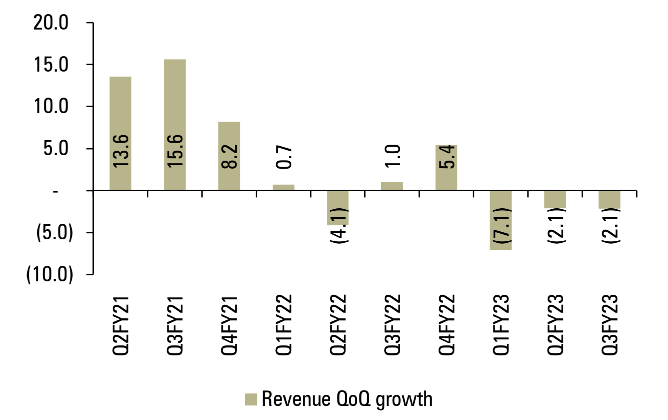
Source: Company, ICICI Direct Research

Exhibit 5: As also margin guidance



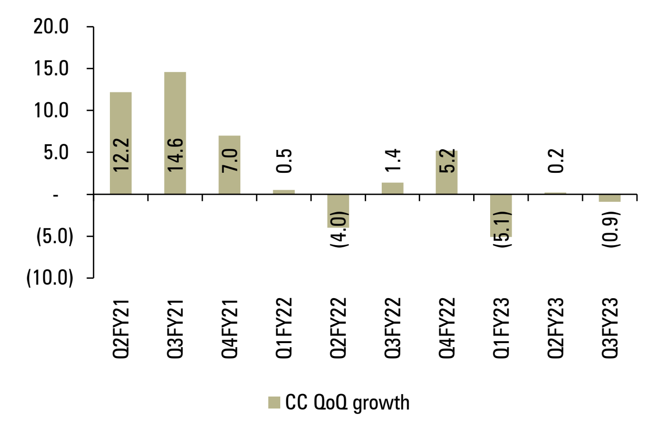
Source: Company, ICICI Direct Research

Exhibit 6: QoQ dollar revenue growth trend



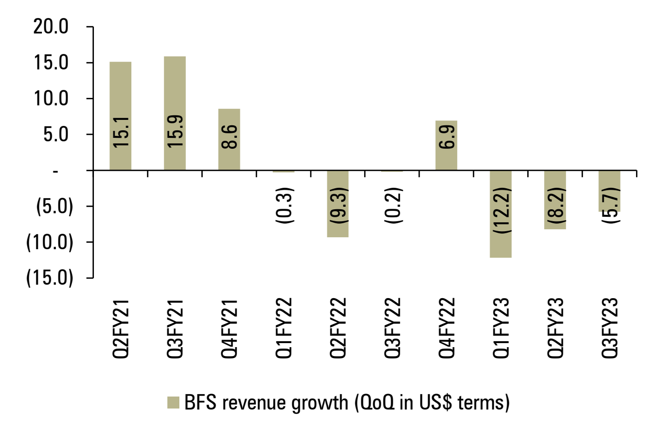
Source: Company, ICICI Direct Research

Exhibit 7: QoQ CC growth trend



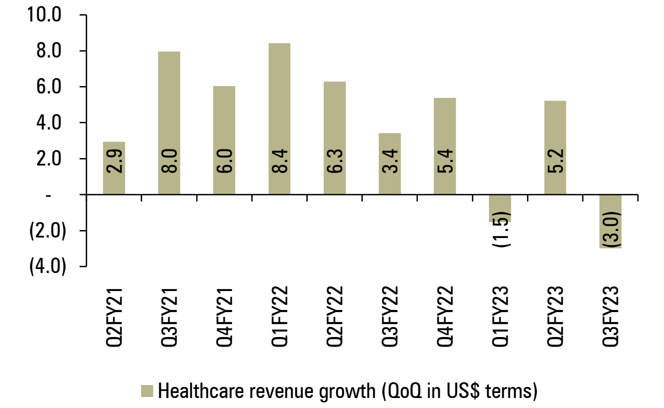
Source: Company, ICICI Direct Research

Exhibit 8: BFS impacted; continues to be weak



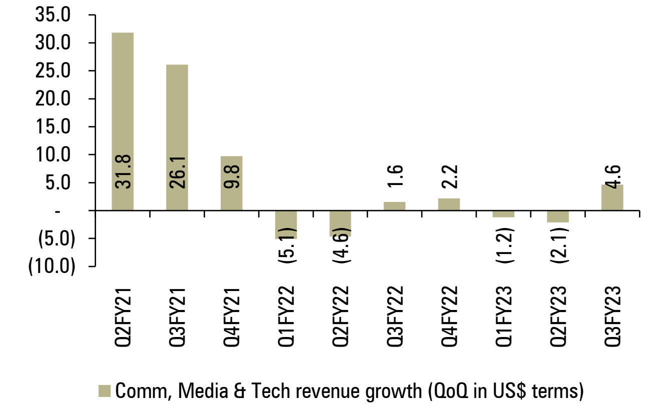
Source: Company, ICICI Direct Research

Exhibit 9: Healthcare revenue QoQ growth trend



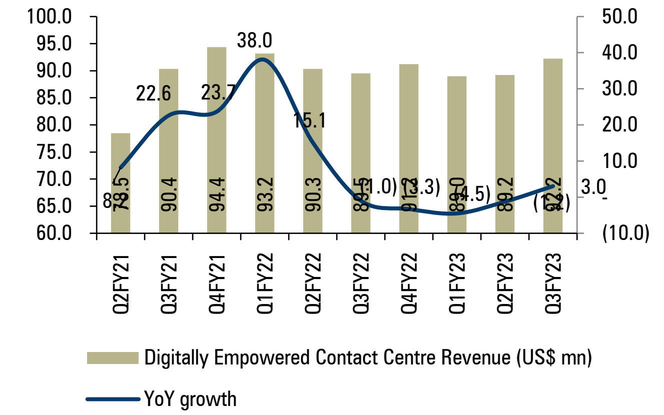
Source: Company, ICICI Direct Research

Exhibit 10: CMT QoQ growth trend



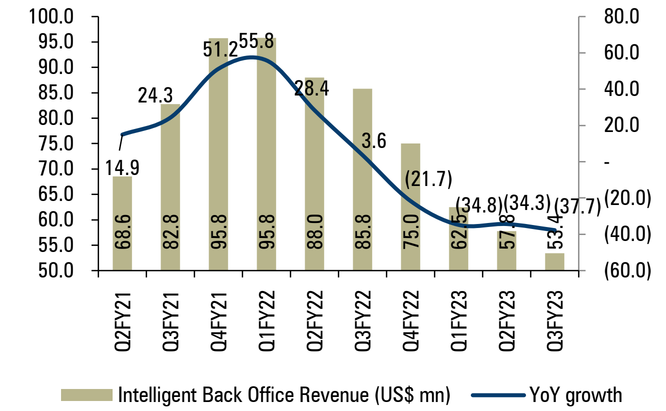
Source: Company, ICICI Direct Research

Exhibit 11: DECC revenue with YoY growth



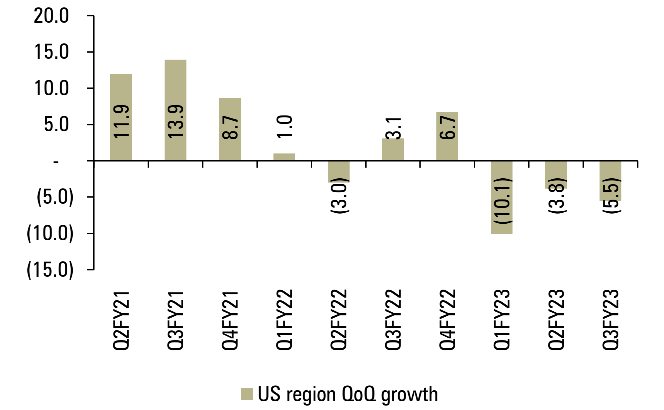
Source: Company, ICICI Direct Research

Exhibit 12: Intelligent back office revenue with YoY growth



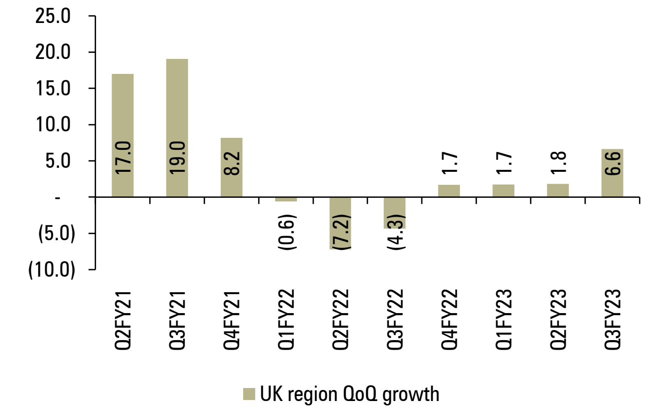
Source: Company, ICICI Direct Research

Exhibit 13: US region still impacted by macros



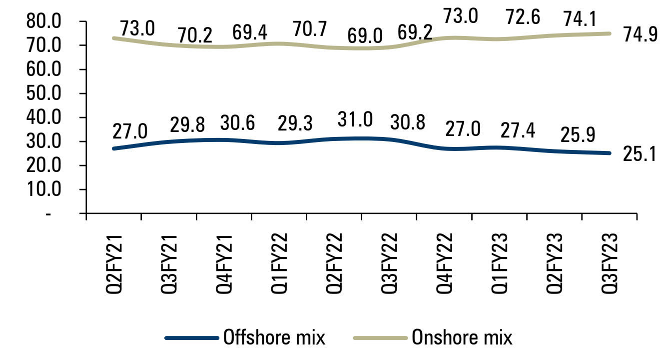
Source: Company, ICICI Direct Research

Exhibit 14: UK region growth aided by recent wins



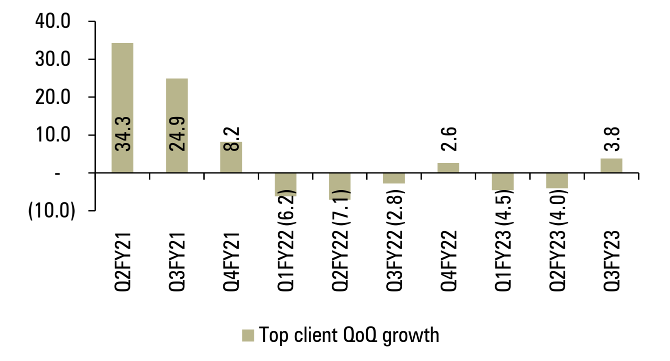
Source: Company, ICICI Direct Research

Exhibit 15: Onshore/ Offshore mix trend



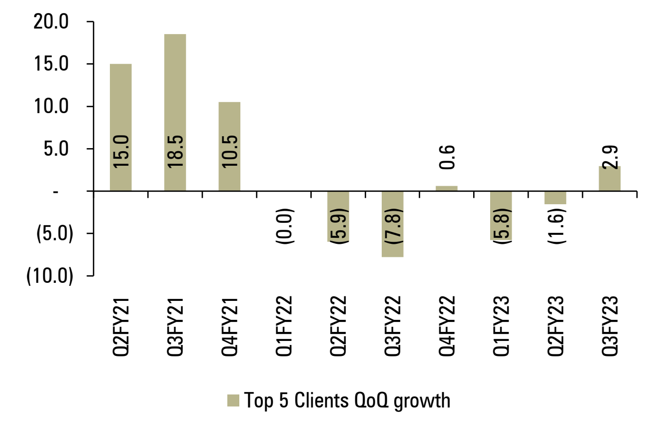
Source: Company, ICICI Direct Research

Exhibit 16: Top client QoQ growth trend



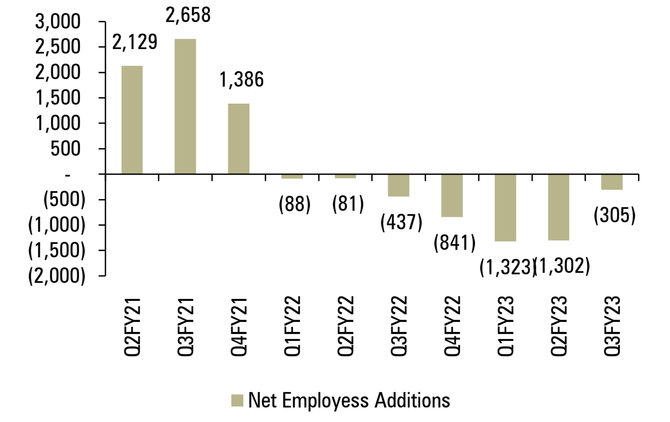
Source: Company, ICICI Direct Research

Exhibit 17: Top five clients QoQ growth trend



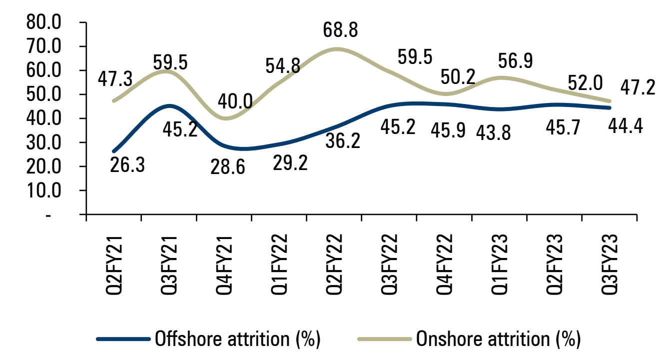
Source: Company, ICICI Direct Research

Exhibit 18: Cost rationalisation impacting net adds



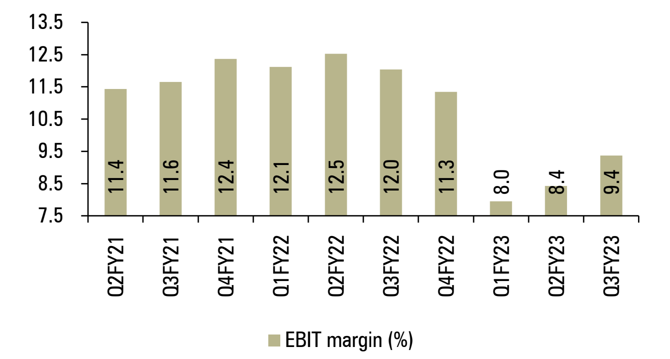
Source: Company, ICICI Direct Research

Exhibit 19: Attrition continues to remain elevated



Source: Company, ICICI Direct Research

Exhibit 20: EBIT margin aided by cost rationalisation



Source: Company, ICICI Direct Research

Financial summary

Exhibit 21: Profit and loss statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Total Revenues	**5,921**	**6,032**	**6,331**	**6,775**
Growth (%)	16.6	1.9	5.0	7.0
Employee expenses	3,947	3,897	4,305	4,560
Other Expenses	1,015	1,309	1,076	1,165
EBITDA	**960**	**826**	**950**	**1,050**
Growth (%)	20.1	(13.9)	14.9	10.6
Depreciation & Amortization	249	259	260	278
Other Income	(0)	4	4	4
Interest	63	31	31	31
PBT before Exceptional Item	647	540	663	745
Growth (%)	49.8	(16.6)	22.8	12.4
Tax	111	108	133	142
PAT before Excp Items	536	432	530	604
Exceptional items				
PAT before MI	536	432	530	604
Minority Int & Pft. from assoc	(1)	(1)	(1)	(1)
PAT	**537**	**433**	**531**	**605**
Growth (%)	48.6	(19.5)	22.8	13.8
EPS	7.7	6.2	7.7	8.7
EPS (Growth %)	48.3	(19.5)	22.8	13.8

Source: Company, ICICI Direct Research

Exhibit 22: Cash flow statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Profit before Tax	**453**	**540**	**663**	**745**
Depreciation & Amortizatio	88	259	260	278
WC changes	(54)	93	(28)	(42)
Other non cash adju.	(72)	(80)	(105)	(115)
CF from operations	**416**	**812**	**789**	**867**
Capital expenditure	(38)	(90)	(94)	(101)
Δ in investments	(33)	-	-	-
Other investing cash flow	0	4	4	4
CF from investing Acti	**(50)**	**(86)**	**(90)**	**(97)**
Issue of equity	(46)	-	-	-
Δ in debt funds	(8)	(311)	-	-
Dividends paid	(238)	(264)	(324)	(369)
Other financing cash flow	(20)	(31)	(31)	(31)
CF from Financial Acti	**(356)**	**(699)**	**(448)**	**(493)**
Δ in cash and cash bank ba	9	27	251	277
Effect of exchange rate changes				
Opening cash	137	147	173	425
Closing cash	**147**	**173**	**425**	**702**

Source: Company, ICICI Direct Research

Exhibit 23: Balance sheet ₹ crore

Particulars	FY22	FY23E	FY24E	FY25E
Equity	697	697	697	697
Reserves & Surplus	2,336	2,505	2,712	2,948
Networth	3,033	3,202	3,409	3,645
Minority Interest	0	0	0	0
LT liabilties & provisions	867	867	867	867
Total Debt	1,010	698	698	698
Source of funds	**4,910**	**4,768**	**4,975**	**5,211**
Net fixed assets	1,026	668	596	512
CWIP	-	-	-	-
Goodwill	2,721	2,721	2,721	2,721
Other non current assets	541	807	833	871
Loans and advances	-	-	-	-
Current Investments	119	119	119	119
Debtors	961	685	719	770
Cash & Cash equivalents	90	173	425	702
Other current assets	252	516	542	580
Trade payables	178	331	348	372
Current liabilities	567	717	753	805
Provisions	53	98	103	110
Application of funds	**4,910**	**4,768**	**4,975**	**5,211**

Source: Company, ICICI Direct Research

Exhibit 24: Key ratios ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS-diluted	7.7	6.2	7.7	8.7
DPS	3.8	3.8	4.6	-
BV	44.2	46.6	49.6	53.1
Operating Ratios (%)				
EBITDA Margin	16.2	13.7	15.0	15.5
PBT Margin	10.9	8.9	10.5	11.0
PAT Margin	9.1	7.2	8.4	8.9
Return Ratios (%)				
RoNW	17.7	13.5	15.6	16.6
RoCE	14.5	12.0	14.0	14.9
Valuation Ratios (x)				
P/E	15.0	18.6	15.2	13.3
EV / EBITDA	9.1	10.1	8.6	7.5
Price to Book Value	2.6	2.5	2.3	2.2
EV / Net Sales	1.5	1.4	1.3	1.2
Mcap / Net Sales	1.3	1.3	1.3	1.2
Turnover Ratios				
Debtor days	59	41	41	41
Creditors days	11	20	20	20
Solvency Ratios				
Total Debt / Equity	0.3	0.2	0.2	0.2
Current Ratio	1.5	1.0	1.0	1.0
Quick Ratio	1.5	1.0	1.0	1.0
Net Debt / EBITDA	0.8	0.5	0.2	(0.1)

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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