

Weaker than expected FY23 guidance

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

Q4FY22 Results: FSL reported weak numbers on the margins front.

- US\$ revenues increased 5.4% QoQ to US\$205.5 million (mn); growth driven by recent acquisitions in our view
- EBIT declined 60 bps QoQ to 11.3%
- The company expects mortgage business to decline 40% in FY23

What should investors do? FSL's share price has grown by ~3.4x over the past five years (from ~₹ 33 in May 2017 to ~₹ 112 levels in May 2022).

- We continue to maintain our **HOLD** rating

Target Price and Valuation: We value FSL at ₹ 127 i.e. 14x P/E on FY24E.

Key triggers for future price performance:

- Improvement in provider, collection segment, diversification in CMT segment, new logo wins, focus on client mining cross selling of platforms business and hiring of leaders bodes well for long term revenue growth
- Revenue guidance revised downward to 7-10% due to slowdown in mortgage business. We expect dollar revenues to increase at a CAGR of 3.9% in FY22-24E
- We expect margins to decline in FY23E due to ARSI acquisition (low margin business) and overall we expect margin contraction of 90 bps in FY22-24E

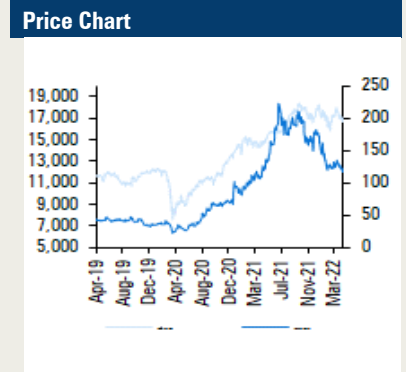
Alternate Stock Idea: Apart from FSL, in our IT coverage we also like Mastek.

- Growth in new logo acquisition, increasing deal size, expansion of sales, marketing and market share gains to drive revenues
- HOLD with a target price of ₹ 3,100



Particulars	
Particular	Amount
Market Cap (₹ Crore)	7,690.8
Total Debt (₹ Crore)	1,009.7
Cash and Invests (₹ Crore)	208.3
EV (₹ Crore)	8,492.2
52 week H/L	116.9/ 242.9
Equity capital	697.0
Face value	10.0

Shareholding pattern				
	Jun-21	Sep-21	Dec-21	Mar-22
Promoters	54	54	54	54
FII	12	11	10	8
DII	15	14	15	15
Public	19	22	22	24



- Recent event & key risks**
- Revenue and EBIT margin guidance revised downward
 - Key Risk:** (i) Quicker than expected recovery in mortgage business (ii) Lower than expected margins

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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%	6,493	7,266	10.8%
EBITDA	629	799	960	17.0%	974	1,119	8.0%
Margins (%)	15.3	15.7	16.2		15.0	15.4	
Net Profit	340	362	537	13.9%	537	629	8.2%
EPS (₹)	4.9	5.2	7.7		7.7	9.1	
P/E	22.9	21.5	14.5		14.5	12.4	
RoNW (%)	12.3	12.9	17.7		16.6	18.0	
RoCE (%)	11.1	15.4	14.5		15.2	16.7	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported revenue of US\$205 mn for the quarter, up 5.4% QoQ. The revenue growth for the quarter was largely driven by recent acquisitions in our view, while organic growth could have been muted. For FY22, it reported revenues of US\$794 mn (16% growth) while growth in CC 14.6% which was better than guided 14-14.5% growth
- Geography wise, US (71% mix) grew 6.7% QoQ while UK (28% mix) grew 1.7% QoQ. Vertical wise BFSI (49% mix) reported 6.9% QoQ growth while healthcare (30% mix) grew 5.4% QoQ
- The company has revised downward revenue guidance of FY23 to 7-10% in CC vs. 14-14.5% growth guidance given for FY22. The downward revision is on the back of slowdown in mortgage business for the company. The company expects mortgage business to report revenues in the range of US\$125-135 mn in FY23 vs. US\$216 mn revenues reported in FY22 i.e. ~38% downward revision. Ex- mortgage business and recent acquisitions, it is guiding revenue growth of 18-21% in FY23
- In mortgage, on collections business, the company mentioned that credit card delinquencies have started picking up from 1.54% in Q3 to 1.62% in Q4. However, it is expected to be a gradual recovery and it does not expect an accelerated pace in delinquencies. In refinancing volumes, the company mentioned that since we are in the interest rate hike cycle, this business would be in the slow lane in the medium term
- The company indicated that healthcare business is expected to do well in FY23 on the back of continued momentum HPHS and recovery in the provider business which was impacted in FY22 due to Covid
- EBIT margins for Q4 declined 70 bps to 11.3% due to rise in other expenses. The company achieved EBIT margins of 12% in FY22 vs. guided band of 11.8-12%. The company revised downward EBIT margin guidance for FY23. It is now guiding EBIT margin band of 10.5-11% in FY23. The company also mentioned that downward revision of EBIT margin is on an account of integration of recently acquired ARSI, which has lower margins vs. company margins. the company expects EBIT margins to gradually pick up over the next quarters and will be at similar level that of company in Q4FY23. The company also mentioned that they are looking to exit FY23 at 11.5%-12% EBIT margins and there is further scope to improve 40-50bps in FY24
- FSL opened new satellite centre in UK. It expects healthy growth from UK market in FY23 vs. modest growth in FY22. The UK market has been challenging especially from supply side perspective
- The company mentioned that attrition has picked up in FY22 due to Covid and work from home culture. The company is taking the following steps to bring down attrition in FY23 i) wage correction in front line staff ii) investment in leadership iii) Hybrid working models
- FSL did three acquisitions in the last 18 months. It is open to some tuck in acquisitions, going forward
- The company mentioned that it has got price hike from couple of clients in FY22 due to rise in costs. FSL mentioned that clients are now open for price hikes and it expects price hikes whenever the contracts come up for renewals
- The demand environment continues to be strong especially in the healthcare and communication sectors. The company did not anticipate slowing down large deals
- FSL guided for 18-20% tax rate for FY23

Exhibit 1: P&L

	Q4FY22	Q4FY21	YoY (%)	Q3FY22	QoQ (%)	Comments
Revenue	1,543.9	1,462.8	5.5	1,463.8	5.5	Revenue driven by BFSI which grew by 6.9% on the back of acquisitions
Employee expenses	984.5	1,005.7	-2.3	967.6	1.9	
Gross Margin	559.4	457.2	22.4	496.2	12.7	
Gross margin (%)	36.2	31.3	498 bps	33.9	234 bps	
SG&A expenses	314.6	222.9	41.1	258.3	21.8	
EBITDA	244.8	234.2	4.5	237.9	2.9	
EBITDA Margin (%)	15.9	16.0	-16 bps	16.3	-40 bps	
Depreciation & amortisation	69.7	53.4	30.6	61.7	12.9	
EBIT	175.1	180.9	-3.2	176.2	-0.6	
EBIT Margin (%)	11.3	12.4	-102 bps	12.0	-69 bps	Margins declined due to increase in other expenses
Other income (less interest)	-18.8	-13.7	36.7	-14.8	26.8	
PBT	156.4	167.2	-6.5	161.4	-3.1	
Tax paid	23.6	8.7	172.4	25.9	-8.8	
PAT	132.4	46.7	183.6	135.5	-2.3	

Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

(₹ Crore)	FY23E			FY24E			Comments
	Old	New	% Change	Old	New	% Change	
Revenue	6,576	6,493	-1.3	7,621	7,266	-4.7	Revenue aligned as per FY23 guidance
EBIT	744	696	-6.5	901	808	-10.3	
EBIT Margin (%)	11.3	10.7	-60 bps	11.8	11.1	-70 bps	EBIT margins aligned as per FY23 guidance
PAT	575	537	-6.6	702	629	-10.5	
EPS (₹)	8.2	7.7	-6.6	10.0	9.1	-10.5	

Source: Company, ICICI Direct Research

Financial summary

Exhibit 3: Profit and loss statement					₹ crore
	FY21	FY22	FY23E	FY24E	
Total Revenues	5,078	5,921	6,493	7,266	
Growth (%)	23.9	16.6	9.7	11.9	
Employee expenses	3,467	3,947	4,415	4,897	
Other Expenses	812	1,015	1,104	1,250	
EBITDA	799	960	974	1,119	
Growth (%)	27.1	20.1	1.5	14.9	
Depreciation & Amortization	206	249	278	311	
Other Income	1	(0)	4	4	
Interest	52	63	29	27	
PBT before Exceptional Items	432	647	671	785	
Growth (%)	9.5	49.8	3.7	17.0	
Tax	70	111	134	157	
PAT before Excp Items	362	536	537	628	
Exceptional items					
PAT before MI	362	536	537	628	
Minority Int & Pft. from associates	(0)	(1)	(1)	(1)	
PAT	362	537	537	629	
Growth (%)	6.5	48.6	0.0	17.0	
EPS	5.2	7.7	7.7	9.1	
EPS (Growth %)	6.5	48.3	0.0	17.0	

Source: Company, ICICI Direct Research

Exhibit 4: Cash flow statement					₹ crore
	FY21	FY22	FY23E	FY24E	
Profit before Tax	432	453	671	785	
Depreciation & Amortization	206	88	278	311	
WC changes	290	(54)	49	(74)	
Other non cash adju.	48	(72)	(108)	(133)	
CF from operations	976	416	889	889	
Capital expenditure	(173)	(38)	(161)	(180)	
Δ in investments	(176)	(33)	-	-	
Other investing cash flow	1	0	4	4	
CF from investing Activities	(350)	(50)	(157)	(176)	
Issue of equity	(57)	(46)	-	-	
Δ in debt funds	(376)	(8)	(517)	-	
Dividends paid	(204)	(238)	(328)	(383)	
Other financing cash flow	(51)	(20)	(29)	(27)	
CF from Financial Activities	(689)	(356)	(967)	(504)	
Δ in cash and cash bank balance	(63)	9	(235)	209	
Effect of exchange rate changes					
Opening cash	191	137	147	(88)	
Closing cash	137	147	(88)	121	

Source: Company, ICICI Direct Research

Exhibit 5: Balance sheet					₹ crore
Particulars	FY21	FY22	FY23E	FY24E	
Equity	696	697	697	697	
Reserves & Surplus	2,103	2,336	2,546	2,791	
Networth	2,799	3,033	3,243	3,488	
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	4,603	4,848	
Net fixed assets	749	1,026	721	683	
CWIP	-	-	-	-	
Goodwill	2,195	2,721	2,721	2,721	
Other non current assets	655	541	847	913	
Loans and advances	-	-	-	-	
Current Investments	83	119	119	119	
Debtors	577	961	738	826	
Cash & Cash equivalents	137	90	(88)	121	
Other current assets	435	252	556	623	
Trade payables	279	178	357	399	
Current liabilities	604	567	772	865	
Provisions	82	53	105	118	
Application of funds	3,865	4,910	4,603	4,848	

Source: Company, ICICI Direct Research

Exhibit 6: Key ratios					₹ crore
(Year-end March)	FY21	FY22	FY23E	FY24E	
Per share data (₹)					
EPS-diluted	5.2	7.7	7.7	9.1	
DPS	3.0	3.8	4.6	5.4	
BV	40.8	44.2	47.2	50.8	
Operating Ratios (%)					
EBITDA Margin	15.7	16.2	15.0	15.4	
PBT Margin	8.5	10.9	10.3	10.8	
PAT Margin	7.1	9.1	8.3	8.7	
Return Ratios (%)					
RoNW	12.9	17.7	16.6	18.0	
RoCE	15.4	14.5	15.2	16.7	
Valuation Ratios (x)					
P/E	21.5	14.5	14.5	12.4	
EV / EBITDA	10.1	8.8	8.4	7.1	
Price to Book Value	2.7	2.5	2.4	2.2	
EV / Net Sales	1.6	1.4	1.3	1.1	
Mcap / Net Sales	1.5	1.3	1.2	1.1	
Turnover Ratios					
Debtor days	41	59	41	42	
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	0.2	

Source: Company, ICICI Direct Research

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Reduce: -15% to -5%;

Sell: <-15%



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