Firstsource Solutions (FIRSOU)

ICICI direct Research

CMP: ₹ 113 | Target: ₹ 110 (-3%) | Target Period: 12 months | HOLD

May 6, 2023

CC growth guidance of 2-5% for FY24…

About the stock: Firstsource Solutions (FSL) provides business process services to BFSI, communication, media, tech and healthcare.

- The company generates 66% revenues from the US and 33% 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 23,018 employees across the US, UK, India and Philippines

Q4FY23 Results: FSL reported decent numbers in Q4FY23.

- Revenue increased 2.5% QoQ in CC terms & 3.8% in dollar terms
- EBIT margins improved ~220 bps QoQ to 11.6%
- Added 73 new clients in FY23

What should investors do? FSL's share price has grown by ~1.8x in the past five years (from ~₹ 64 in May 2018 to ~₹ 113 levels in May 2023).

- We change our rating on the stock from REDUCE to **HOLD**

Target Price and Valuation: We value FSL at ₹ 110 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 8.9% in FY23-25E
- 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 11.9% 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 ₹ 5,170

firstsource Stay Ahead

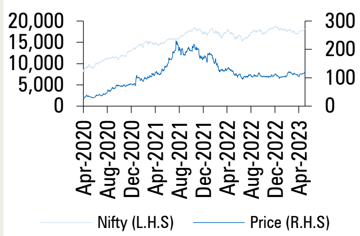
Particulars

Particular	Amount
Market Cap (₹ Crore)	7,688.5
Total Debt (₹ Crore)	827.0
Cash and Invests (₹ Crore)	215.1
EV (₹ Crore)	8,300.4
52 week H/L	125/ 93
Equity capital	697.0
Face value	10.0

Shareholding pattern

	Jun-22	Sep-22	Dec-22	Mar-23
Promoters	54	54	54	54
FII	8	8	8	9
DII	15	13	14	15
Public	24	25	24	22

Price Chart



Recent event & key risks

- Guidance for FY24: Revenue growth of 2-5% and EBIT margin of 11-12%
- **Key Risk:** (i) Better than expected revenue growth (ii) Lower than expected margins

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Company Update

ICICI Securities – Retail Equity Research

Key Financial Summary

Key Financials	FY21	FY22	FY23	5 year CAGR (FY18-23)	FY24E	FY25E	2 year CAGR (FY23-25E)
Net Sales	5,078	5,921	6,022	11.2%	6,424	7,137	8.9%
EBITDA	799	960	827	12.5%	976	1,135	17.2%
Margins (%)	15.7	16.2	13.7		15.2	15.9	
Net Profit	362	537	514	9.5%	539	636	11.3%
EPS (₹)	5.2	7.6	7.3		7.7	9.1	
P/E	21.7	14.9	15.4		14.7	12.5	
RoNW (%)	12.9	17.7	15.3		15.1	16.6	
RoCE (%)	15.4	14.5	14.5		15.0	16.6	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported a revenue of US$190 mn, up 3.8% QoQ and down 7.5% YoY. In CC terms, revenue increased 2.5% QoQ and was down 2.8% YoY. In rupee terms, the company reported revenue of ₹ 1,556.8 crore, up 3.4% QoQ. FSL said the mortgage business contributed ~9%, i.e. 17.1 mn, in Q4. The company further mentioned that originating business revenue in Q4 was at US$5.7 mn (one-third of mortgage revenue) and servicing business was at US$11.4 mn (two-third of mortgage business)
- Geography wise US region (63.3% of mix) reported growth of 1.3% QoQ after declining for three successive quarters in FY23 while YoY the revenue declined 17.2%. UK region (36.3% of mix) continued its growth momentum reporting growth of 10.5% QoQ & 22% YoY
- Vertical wise BFSI (40.3% of mix) arrested its decline and reported flattish Q4 revenue while healthcare reported muted growth of 0.8% QoQ. CMT vertical reported strong growth of 7.2% QoQ and diverse vertical also reported robust growth of 81.7% QoQ albeit on a small base continuing its robust momentum in the utility subsegment
- EBIT margin of the company improved 220 bps QoQ to 11.6% in Q4 on the back of revenue recovery during the quarter and continued cost optimisation actions of the company. The company after the Q3FY23 results had guided for EBIT margin in the range of 11.5-12% while the exit margins of the company in Q4 came near the lower end of its guidance
- For FY23, revenue declined 1.1% in CC terms while in dollar terms revenue declined 5.6% to US$750 mn. The company said the mortgage business declined steeply to US$92-93 mn in FY23 compared to US$216 in FY22. FSL mentioned that excluding mortgage and acquisitions, revenue grew 13.7% in CC terms in FY23. The EBIT margin declined ~260 bps in FY23 to 9.4% primarily due to a decline in the mortgage & acquired business. FSL added that due to the corrective actions taken in H2FY24 the decline in margin was arrested
- **Mortgage business:** The company said that the last 12-18 months were turbulent for the mortgage business, which impacted its overall performance. FSL, however, indicated that interest rate volatility is likely to have peaked out. The company also mentioned that the mortgage business now contributes less than 9% of overall revenue. Hence, it does not expect significant impact on the revenue of the company in case of any uncertain event. FSL also added that it is diversifying the origination business by adding new clients. Also, the pipeline of the company consists more of servicing and capital markets business. FSL mentioned that it expects moderate growth in mortgage business from H2FY24 on the back of recent wins & pipeline
- **Collections business:** In the collections business, FSL said the US card delinquency increased to 2.25% vs. 2.09% in the last quarter. The company also added that consumer credit matrix continued to soften, which is a good indication for its collections business. FSL also mentioned that with the high consumer debt, increasing credit tightening and low delinquency compared to 2020 levels in the US, it expects the collection business to pick up gradually throughout FY24. The company said that it added six new clients in Q4FY23 and its strategy for FY24 collections business is: 1) diversify business by adding cross industry clients in fintech, telecom & utilities, 2) expand geographically to UK region, 3) reduce new client onboarding timeline & 4) drive revenue and margin growth in legal collection business
- UK BFS: On UK BFS, the company mentioned that the growth is strong and is led by expansion across key client relations by expanding to other division of clients. FSL also added that it expects the growth momentum to continue due to client additions. It will also help FSL to diversify the overall BFS segment of the company

FSL - ESG Disclosure Score*

Score	FY20	FY21	FY22
Environmental	2.1	2.4	3.8
Social	9.7	11.7	10.5
Governance	78.6	78.6	78.6
Overall ESG Score	**30.2**	**31.0**	**31.0**

*Source: Blomberg, ICICI Direct Research, *Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures*

- Healthcare: The company mentioned that healthcare segment growth has remained steady and grew 8.7% YoY in CC terms but the growth has slowed down recently due to conclusion of project-based engagements, delays in deal closure and softness in the provider segment. FSL mentioned that the recent regulation by the US government to remove automatic renewal health insurance (which was imposed during the Covid time) likely led to volume pick-up as it expects 5-14 mn people in the US to be out of this auto renewal. However, FSL added that volume pick-up would be more gradual in nature as state wise decision could be different from this order in the US. FSL mentioned that in the last 18 months it has won several marquee logos and aims to scale them up in FY24. The company expects sustained growth from H2FY24 onwards in the healthcare segment. For FY24, it expects to be looking at mid-single digit growth
- Other verticals: The CMT vertical grew 14% YoY in FY23 on the back of scaling up of its US operations and by scaling up new capabilities and markets by making inroads in edtech, digital media & tech verticals. FSL added that US CMT now contributes 4% to total revenue. It expects the growth momentum to continue as it has added several marquee logos during the year. The company also mentioned that the utility segment in the diverse industry is growing well. It is scaling up its operations with one of top three utility providers in the UK. FSL added that it is now one of the top three outsourcing partners for the utility company and expects to scale up this account further in FY24
- The company indicated that due to the cyclical nature of its business the macro headwinds impacted its operations in FY23. FSL added that the macro uncertainty still persists and it is working to reduce the cyclic impact on its business by: i) diversifying the BFS & CMT business while also expanding in the healthcare segment; ii) growing in adjacent capability by adding new clients and growing strategic accounts and iii) building digital solutions especially capability to leverage the generative AI solutions
- **Guidance:** The company, for FY24, is guiding for revenue growth of 2-5% in CC terms. FSL mentioned that the guidance in including an impact of: i) -3% impact due continued decline of mortgage business in FY24 and -3% impact due to change in onshore/offshore re-balancing of certain client need. The company further indicated that it expects revenue to decline 1-2.5% in Q1FY24 while CQGR growth of 3.5-5% is expected from Q2FY24 to Q4FY24. FSL mentioned that it expects Q1FY24 revenue to decline due to seasonality impact in the collection business, conclusion of certain project-based deals and delay in start of new deals. The company added that it is confident of achieving its guided revenue growth on the back of a revival in the healthcare & provider segment, deal ramp up and its strong pipeline
- The company mentioned that it has won a five year deal with an edtech client with a TCV of US$50-60 mn
- FSL mentioned that it is building capabilities in adjacent areas and has launched consulting practices and data integrity practices. The company also added that it has converted four consulting engagements in annuity programs
- As far as threat from chatGPT, the company mentioned that there could be an immediate threat on its business where data sourcing or voice to text conversion kind of work, which is approx. 10-15% of its business. The company mentioned that rest 85-90% business involves certain complex data judgment as well as human intelligence which current version of chatGPT may not fulfil. The company also mentioned that chatGPT could be a long-term threat for 85-90% of its business subject to significant investments to be made in chatGPT technology to be able to incorporate that level of intelligence. The company also mentioned that till that time, it will also make investments to tackle this threat.

- On the margin front, the company is guiding for EBIT margin of 11-12% for FY23. FSL added the levers for margin improvement will be: i) margin recovery across mortgage & acquired businesses & ii) increasing offshore mix
- The company's net employees declined by 609 bringing the total employees to 23,018. FSL's onshore attrition declined 490 bps to 42.3% while its offshore attrition increased by 50 bps 44.9%
- Revenue from top 10, top five clients increased 1.2%, 0.9% QoQ, respectively, in Q4FY23. FSL added that it is working to reduce the client concentration and the same is working as it able to scale strategic accounts and add new clients. The company during FY23 added 73 new clients with majority of the clients' additions in non-mortgage BFS, CMT and HPHS, which will be also help to diversify the business of the company
- FSL mentioned that it expects FY24 tax rate to be in the range of 18-20% as increase in tax rate in the UK will have an impact on the overall tax rate of the company
- The company reiterated that it has not made any payout to acquired companies in FY23 as they did not achieve the agreed targeted revenue. FSL, ,however mentioned that it will have to make a payout of US$4.5 mn to acquired companies in FY24 if they achieve the agreed targeted revenue for the fiscal year

Exhibit 1: P&L

₹ crore	Q4FY23	Q4FY22	YoY (%)	Q3FY23	QoQ (%)	Comments
Revenue	1,556.8	1,543.9	0.8	1,504.9	3.4	Revenue grew by 2.5% QoQ in CC terms & 3.8% dollar terms
Employee expenses	969.0	984.5	-1.7	986.1	-1.9	
Gross Margin	587.8	559.4	5.1	518.9	13.3	
Gross margin (%)	37.8	36.2	152 bps	34.5	328 bps	
SG&A expenses	343.7	314.6	9.2	309.2	11.2	
EBITDA	244.1	244.8	-0.3	209.7	16.4	
EBITDA Margin (%)	15.7	15.9	-18 bps	13.9	175 bps	
Depreciation & amortisation	64.2	69.7	-7.8	68.7	-6.5	
EBIT	179.9	175.1	2.7	140.9	27.6	
EBIT Margin (%)	11.6	11.3	21 bps	9.4	219 bps	Margins continue to improve due to cost rationalisation activities
Other income (less interest)	-8.0	-19.1	-58.2	42.7	-118.8	
PBT	171.9	156.0	10.2	183.7	-6.4	
Tax paid	30.6	23.6	29.4	25.7	18.7	
PAT	141.3	132.4	6.7	157.9	-10.5	

Source: Company, ICICI Direct Research

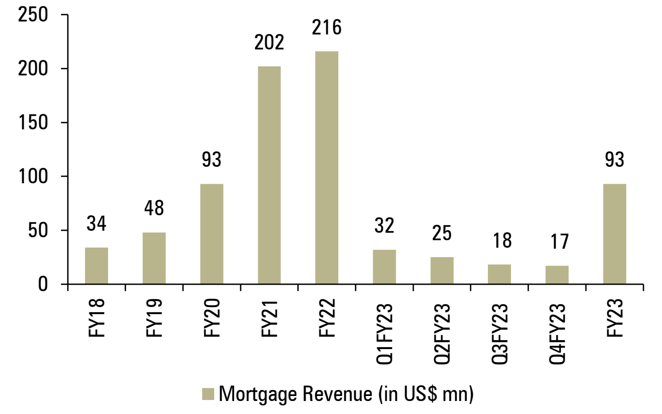
Exhibit 2: Change in estimates

	FY24E			FY25E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	
Revenue	6,331	6,424	1.5	6,775	7,137	5.3	We are building in some recovery in mortgage business in FY25
EBIT	690	713	3.3	772	849	10.0	
EBIT Margin (%)	10.9	11.1	20 bps	11.4	11.9	50 bps	We are baking in margin expansion due to cost optimisative initiatives
PAT	531	539	1.4	605	636	5.2	
EPS (₹)	7.7	7.7	1.4	8.7	9.1	5.2	

Source: Company, ICICI Direct Research

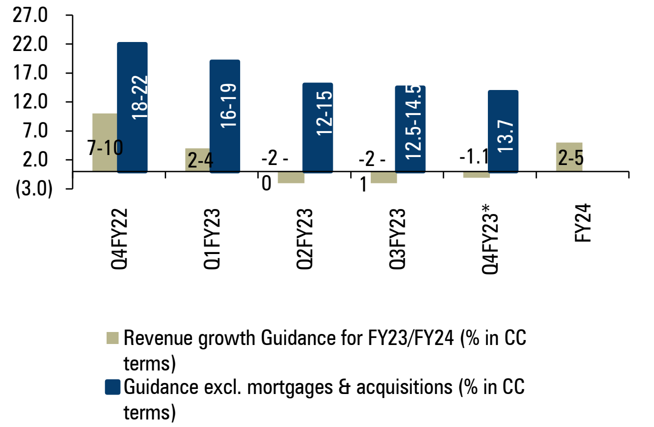
Key Metrics

Exhibit 3: Mortgage business declines to US$93 mn in FY23



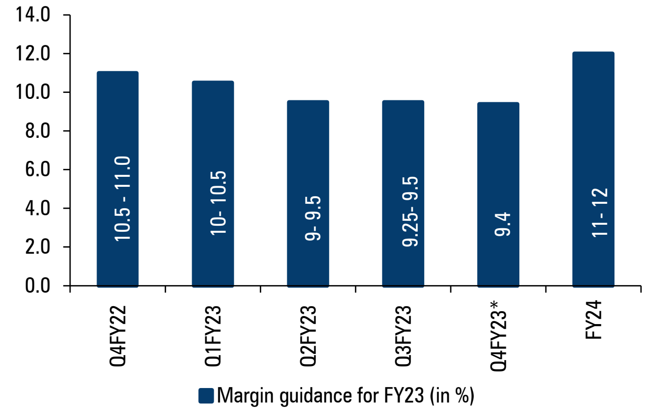
Source: Company, ICICI Direct Research

Exhibit 4: CC revenue growth guidance of 2-5% for FY24



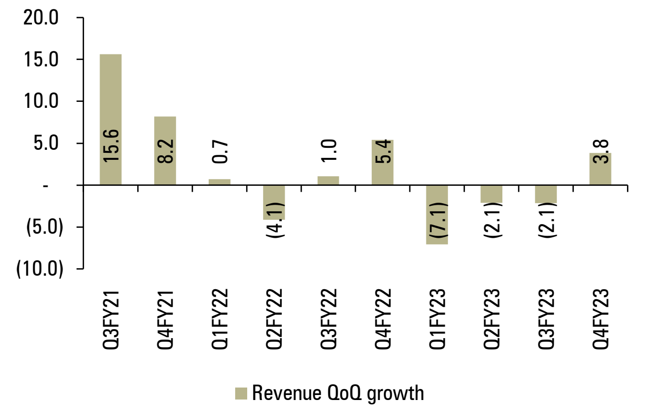
*Source: Company, ICICI Direct Research, *Q4FY23-actual numbers*

Exhibit 5: Expects EBIT margin of 11-12% in FY24



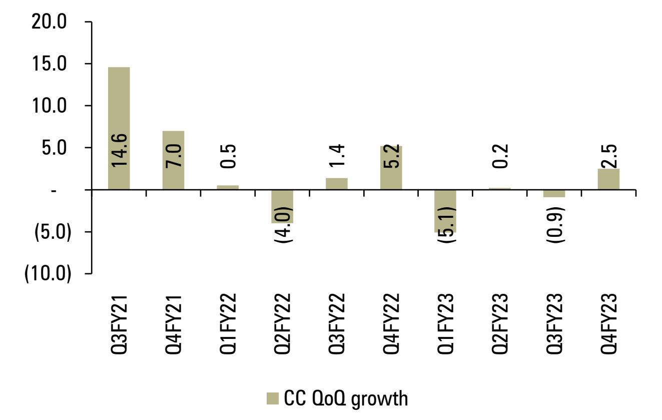
*Source: Company, ICICI Direct Research, *Q4FY23-actual numbers*

Exhibit 6: QoQ dollar revenue sees rebound



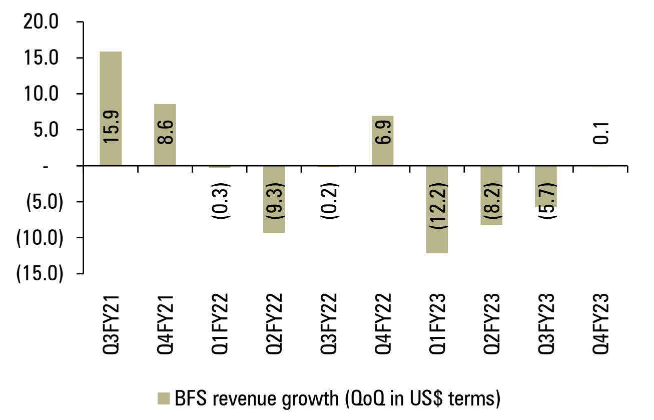
Source: Company, ICICI Direct Research

Exhibit 7: QoQ CC growth trend



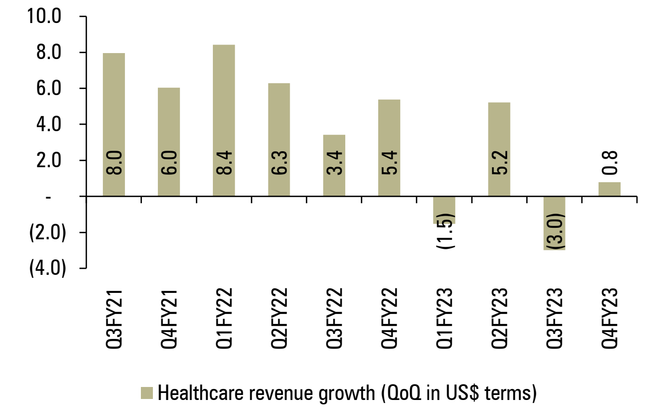
Source: Company, ICICI Direct Research

Exhibit 8: BFS segment likely bottomed out



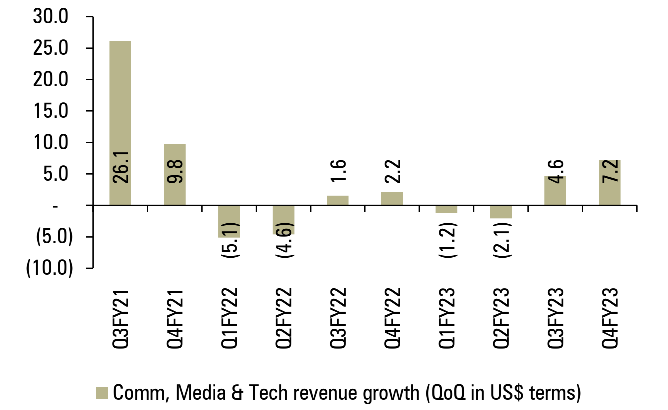
Source: Company, ICICI Direct Research

Exhibit 9: Healthcare impacted by project ending & delays



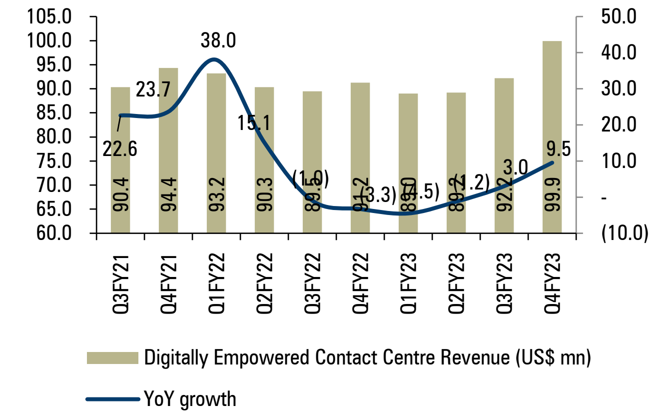
Source: Company, ICICI Direct Research

Exhibit 10: CMT strong due client addition & ramp ups



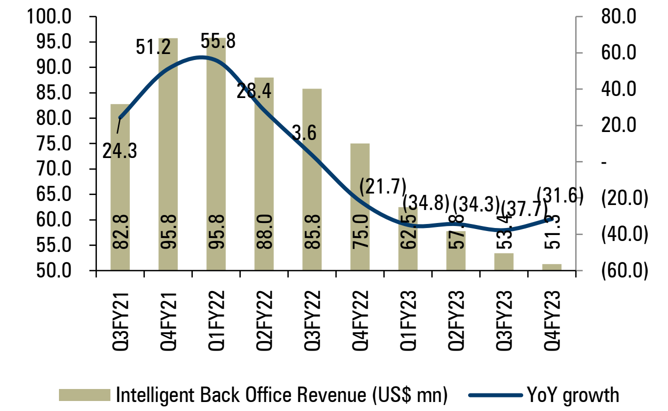
Source: Company, ICICI Direct Research

Exhibit 11: DECC revenue with YoY growth



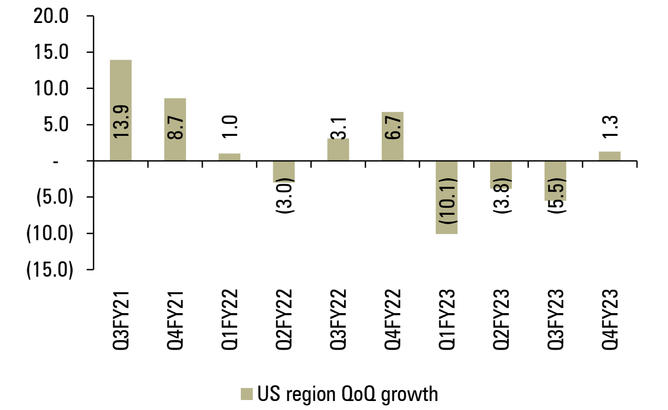
Source: Company, ICICI Direct Research

Exhibit 12: Intelligent back office revenue with YoY growth



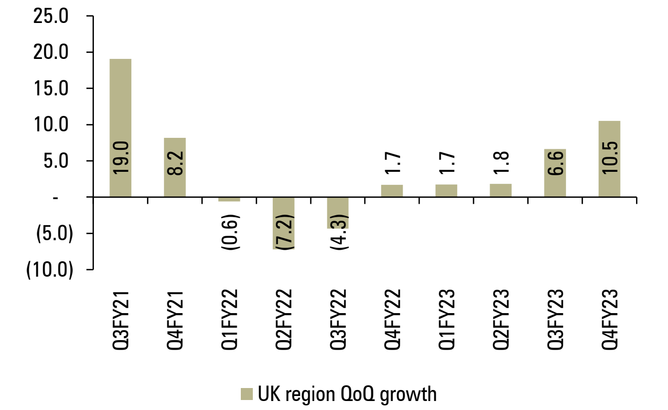
Source: Company, ICICI Direct Research

Exhibit 13: US region rebounds



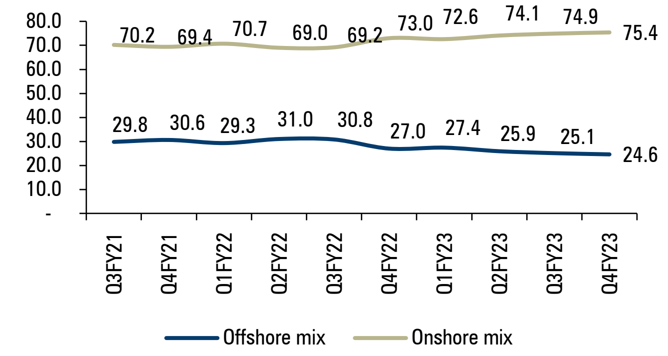
Source: Company, ICICI Direct Research

Exhibit 14: UK region growth aided by recent wins



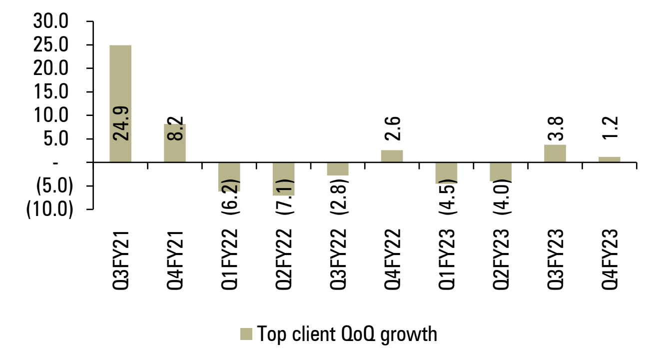
Source: Company, ICICI Direct Research

Exhibit 15: Onshore/ Offshore mix trend



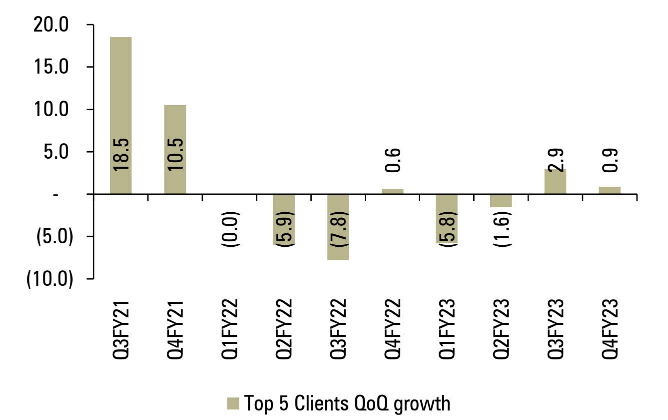
Source: Company, ICICI Direct Research

Exhibit 16: Top client QoQ growth trend



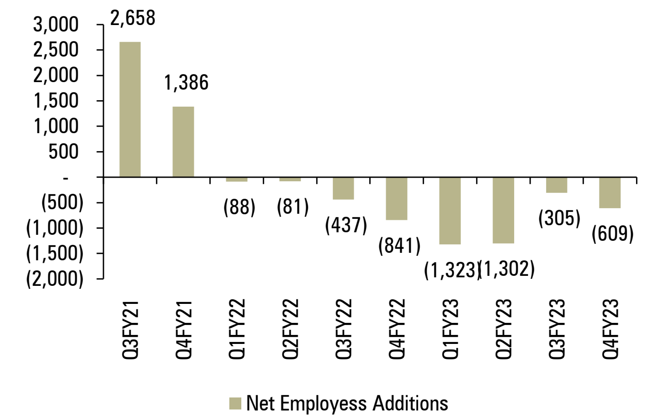
Source: Company, ICICI Direct Research

Exhibit 17: Top five clients QoQ growth trend



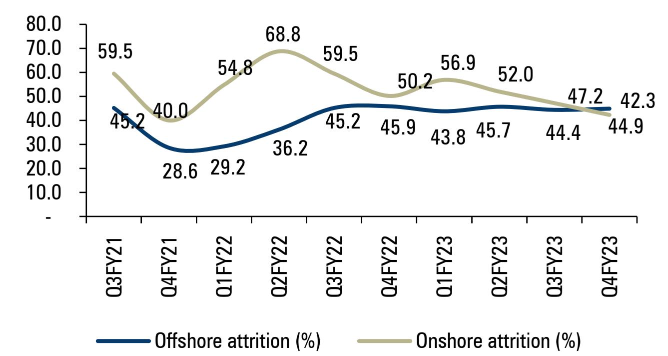
Source: Company, ICICI Direct Research

Exhibit 18: Cost rationalisation action continues



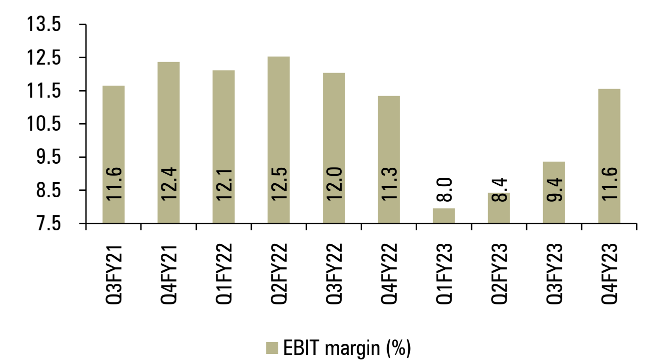
Source: Company, ICICI Direct Research

Exhibit 19: Attrition continues to remain elevated



Source: Company, ICICI Direct Research

Exhibit 20: EBIT margin back to normal range



Source: Company, ICICI Direct Research

Financial summary

Exhibit 21: Profit and loss statement ₹ crore

	FY22	FY23	FY24E	FY25E
Total Revenues	**5,921**	**6,022**	**6,424**	**7,137**
Growth (%)	16.6	1.7	6.7	11.1
Employee expenses	3,947	3,867	4,034	4,468
Other Expenses	1,015	1,328	1,413	1,535
EBITDA	**960**	**827**	**976**	**1,135**
Growth (%)	20.1	(13.9)	18.1	16.2
Depreciation & Amortization	249	263	263	285
Other Income	(0)	131	18	2
Interest	63	79	66	66
PBT before Exceptional Items	647	615	665	785
Growth (%)	49.8	(4.9)	8.1	18.0
Tax	111	102	126	149
PAT before Excp Items	536	514	539	636
Exceptional items				
PAT before MI	536	514	539	636
Minority Int & Pft. from associa	(1)	0	0	0
PAT	**537**	**514**	**539**	**636**
Growth (%)	48.6	(4.4)	4.9	18.0
EPS	7.6	7.3	7.7	9.1
EPS (Growth %)	45.8	(3.8)	4.9	18.0

Source: Company, ICICI Direct Research

Exhibit 22: Cash flow statement ₹ crore

	FY22	FY23	FY24E	FY25E
Profit before Tax	**647**	**615**	**665**	**785**
Depreciation & Amortization	249	263	263	285
WC changes	(188)	76	(37)	(66)
Other non cash adju.	(4)	(160)	(79)	(85)
CF from operations	**704**	**795**	**813**	**920**
Capital expenditure	(85)	(54)	(64)	(71)
Δ in investments	(33)	64	-	-
Other investing cash flow	0	1	18	2
CF from investing Activiti	**(595)**	**16**	**(45)**	**(69)**
Issue of equity	(135)	(42)	-	-
Δ in debt funds	244	(198)	(129)	-
Dividends paid	(238)	(238)	(329)	(388)
Other financing cash flow	(58)	(79)	(66)	(66)
CF from Financial Activiti	**(158)**	**(743)**	**(617)**	**(547)**
Δ in cash and cash bank balar	(49)	68	151	304
Effect of exchange rate changes				
Opening cash	137	83	152	303
Closing cash	**83**	**152**	**303**	**606**

Source: Company, ICICI Direct Research

Exhibit 23: Balance sheet ₹ crore

Particulars	FY22	FY23	FY24E	FY25E
Equity	697	697	697	697
Reserves & Surplus	2,336	2,670	2,880	3,128
Networth	3,033	3,367	3,577	3,825
Minority Interest	0	0	0	0
LT liabilties & provisions	867	598	598	598
Total Debt	1,010	827	698	698
Source of funds	**4,910**	**4,792**	**4,874**	**5,122**
Net fixed assets	904	673	571	449
CWIP	-	-	-	-
Goodwill	2,721	2,945	2,945	2,945
Other non current assets	662	638	653	681
Loans and advances	-	-	-	-
Current Investments	119	60	60	60
Debtors	961	1,038	1,108	1,232
Cash & Cash equivalents	90	156	303	606
Other current assets	252	155	165	183
Trade payables	178	231	247	275
Current liabilities	567	558	595	662
Provisions	53	83	88	98
Application of funds	**4,910**	**4,792**	**4,874**	**5,122**

Source: Company, ICICI Direct Research

Exhibit 24: Key ratios ₹ crore

(Year-end March)	FY22	FY23	FY24E	FY25E
Per share data (₹)				
EPS-diluted	7.6	7.3	7.7	9.1
DPS	3.5	3.5	4.7	5.5
BV	44.6	49.5	52.6	56.2
Operating Ratios (%)				
EBITDA Margin	16.2	13.7	15.2	15.9
PBT Margin	10.9	10.2	10.4	11.0
PAT Margin	9.1	8.5	8.4	8.9
Return Ratios (%)				
RoNW	17.7	15.3	15.1	16.6
RoCE	14.5	14.5	15.0	16.6
Valuation Ratios (x)				
P/E	14.9	15.4	14.7	12.5
EV / EBITDA	8.8	10.0	8.2	6.8
Price to Book Value	2.5	2.3	2.1	2.0
EV / Net Sales	1.4	1.4	1.2	1.1
Mcap / Net Sales	1.3	1.3	1.2	1.1
Turnover Ratios				
Debtor days	59	63	63	63
Creditors days	11	14	14	14
Solvency Ratios				
Total Debt / Equity	0.3	0.2	0.2	0.2
Current Ratio	1.5	1.4	1.4	1.4
Quick Ratio	1.5	1.4	1.4	1.4
Net Debt / EBITDA	0.8	0.7	0.3	0.0

Source: Company, ICICI Direct Research

RATING RATIONALE

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Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%

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