Firstsource Solutions (FIRSOU)

CMP: ₹ 103 | Target: ₹ 93 (-9%) | Target Period: 12 months | **REDUCE**

November 4, 2022

Company Update

Revenue, margin guidance revised further 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 23,932 employees across the US, UK, India and Philippines

Q2FY23 Results: FSL reported weak numbers.

- US$ revenues fell 2.1% QoQ in dollar terms and were up 0.2% in CC terms
- EBIT margins improved ~50 bps QoQ to 8.4%
- Revenue guidance revised downward to -2 to 0% in CC for FY23

What should investors do? FSL's share price has grown by ~2.5x in the past five years (from ~₹ 42 in November 2017 to ~₹ 103 levels in November 2022).

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

Target Price and Valuation: We value FSL at ₹ 93 i.e. 11x 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 dollar revenues to increase at a CAGR of 3.1% 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 to decline by 60 bps over FY22-25E

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

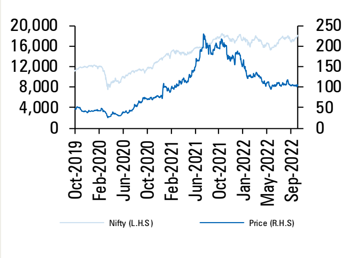
- Consistent growth aided by continued strong TCV and inorganic opportunities
- BUY with a target price of ₹ 4,370

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	209/ 93
Equity capital	697.0
Face value	10.0

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoters	54	54	54	54
FII	10	8	8	8
DII	15	15	15	13
Public	22	24	24	25

Price Chart



Recent event & key risks

- Revenue and EBIT margin guidance further revised downwards to -2 to 0% for FY23
- **Key Risk:** (i) Better than expected revenue growth (ii) Better than expected margins

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ICICI Securities – Retail Equity Research

Key Financial Summary

Key Financials	FY20	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 year CAGR (FY22-25E)
Net Sales	4,099	5,078	5,921	10.7%	6,007	6,245	6,652	4.0%
EBITDA	629	799	960	17.0%	805	843	1,031	2.4%
Margins (%)	15.3	15.7	16.2		13.4	13.5	15.5	
Net Profit	340	362	537	13.9%	408	452	589	3.1%
EPS (₹)	4.9	5.2	7.7		5.9	6.5	8.5	
P/E	21.4	20.1	13.6		17.9	16.1	12.4	
RoNW (%)	12.3	12.9	17.7		12.8	13.4	16.4	
RoCE (%)	11.1	15.4	14.5		11.8	12.5	15.4	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- FSL reported revenue of US$187 mn for the quarter, down 2.1% QoQ while in CC terms it was up 0.2% QoQ. In rupee terms, the company reported revenue of ₹ 1,488.2 crore up 1.1% QoQ. Organic growth excluding BFS decline was up 12.8% YoY. The company indicated that the overall market scenario has worsened with continued rise in interest rate impacting the business adversely. Due to this, FSL is now lowering its guidance to -2 to 0% in CC terms from the earlier 2-4% for FY23. The company indicated that the guidance revision is due to added pressure in mortgage business, slower than anticipated growth in delinquencies impacting collection business and some deal delay in healthcare business
- Geography wise, US (67% mix) declined 3.8% QoQ while UK (31% mix) grew 1.8% QoQ. In CC terms, vertical wise BFSI (43% mix) declined 10.2% YoY while healthcare and communications, media & tech (CMT) grew 12.9% & 14.2% YoY, respectively
- EBIT margin of the company increased ~50 bps QoQ to 8.4%. FSL indicated that margins improved due to its vigorous cost rationalisation activities wherein employee cost reduced 80 bps QoQ. The company indicated that margins will be impacted due to macroeconomic headwinds and it is now reducing the margin guidance for FY23 to 9-9.5% from 10-10.5% given earlier
- On the BFS front, mortgage (revenue of US$25 mn in Q2, ~13% of revenue mix) was impacted due to continued higher interest rate, sharp downward movement in home sales and collapse of the refinance market. The company indicated that high interest rate had led to a decline of 86% in refinance volume and 42% decline in purchase volume resulting in 55% decline in mortgage business in FY23, implying headwinds of 15% to overall business. The company indicated that it had expected the mortgage business to bottom out in Q2 but has now indicated that the mortgage business will be impacted for a few more quarters. FSL also indicated that client additions are healthy with the addition of 12 new clients in mortgage business but volume generation is low from existing as well as new clients. The company further indicated that Stonehill (acquisition company) was impacted by macro headwinds. It is expecting 25-35% erosion in its business since acquisition
- In the collections business, the company indicated that it is witnessing a unique economic situation wherein delinquencies are slower despite rising interest rates. The company indicated that it could be due to lower unemployment rates and a strong household balance sheet in the US witnessed in the last 40 years. FSL, however, expects delinquencies to rise in coming quarters as the total outstanding credit card revolving debt hit a high of US$1.15 trillion, up 15% YoY. The company further indicated that delinquencies in Q2 were 1.81% compared to 1.66% in Q1. FSL, during the quarter, added nine new clients. The company further indicated that it is diversifying its collection business by moving towards fintech companies but also mentioned that the business with fintech are of smaller ticket size and will take some time to ramp up the business
- In the UK, BFS the company indicated that growth is strong with 11.9% YoY growth across mortgage & customer experience. FSL further indicated that demand and pipeline remains strong despite political uncertainties and high inflation. However, it mentioned that high inflation and high talent cost is putting pressure on the company on fulfilment and ramp up of onshore work. The company won two notable wins here. One was with international fintech for automation of its lead generation, third party referral, KYC and payment screening and sanction screening processes; while the other was with a Neo bank, which selected FSL as its operations partner to deliver customer experience

- In the healthcare vertical, the company indicated that it witnessed some weakness in provider business, which was offset by strong growth in HPHS business. The company indicated that it has made inroads in eight of the top 10 healthcare clients but is witnessing some delay in large deals due to rigorous renewal process leading to delayed decision making
- In CMT vertical, the company indicated that growth across top clients was steady. It expects a ramp up in demand. The company expects strong growth in CMT vertical next year as clients are inclined towards increased off shoring to India, Philippines & Mexico due to onshore talent headwinds. FSL indicated that it won a few marquee wins in the last few quarters and is witnessing traction in the US and UK CMT market. The company indicated that tech vertical will be the growth driver for it in short to medium term
- The company's offshore headcount declined by 1,338 while onshore headcount increased marginally by 36 taking the total net decline to 1,302 during the quarter. FSL further indicated that the offshore attrition increased by 190 bps to 45.7% while onshore attrition declined 490 bps to 52%. The company indicated that attrition is expected to remain in a similar range in H2 also
- On the future outlook the company indicated that its investment in HPHS is now bearing results and to supplement the mortgage & collection business it will invest in the following adjacent verticals to drive the next phase of growth:

  a) Moving to other consumer lender products and broaden retail & SME banking by leveraging its expertise in mortgage, collections & UK BFS segments

  b) Explore select additional verticals in CMT segment of digital media & edtech space

  c) Diversify collections by exploring the fintech, utilities & communications through digital collections platforms

Exhibit 1: P&L

₹ crore	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	Comments
Revenue	1,488.2	1,428.6	4.2	1,472.4	1.1	Mortgage business detoriates further. Also, collections business has not ramped up at expected levels leading to impact on revenue growth
Employee expenses	952.7	972.8	-2.3	959.7	-0.8	
Gross Margin	535.6	455.8	17.5	512.6	4.5	
Gross margin (%)	36.0	31.9	408 bps	34.8	117 bps	
SG&A expenses	343.8	217.1	58.4	331.6	3.7	
EBITDA	191.7	238.7	-19.7	181.0	5.9	
EBITDA Margin (%)	12.9	16.7	-383 bps	12.3	59 bps	
Depreciation & amortisation	66.3	59.7	11.0	63.9	3.7	
EBIT	125.4	179.0	-29.9	117.1	7.1	
EBIT Margin (%)	8.4	12.5	-410 bps	8.0	48 bps	Margins improved due to cost rationalisation activities
Other income (less interest)	29.5	-14.8	-299.2	-12.3	-339.4	Other income includes onetime adjustments of fair value liability for contingent considerations
PBT	154.9	164.2	-5.6	104.8	47.9	
Tax paid	25.5	29.3	-12.9	19.7	29.8	
PAT	129.4	134.9	-4.1	85.1	52.1	

Source: Company, ICICI Direct Research

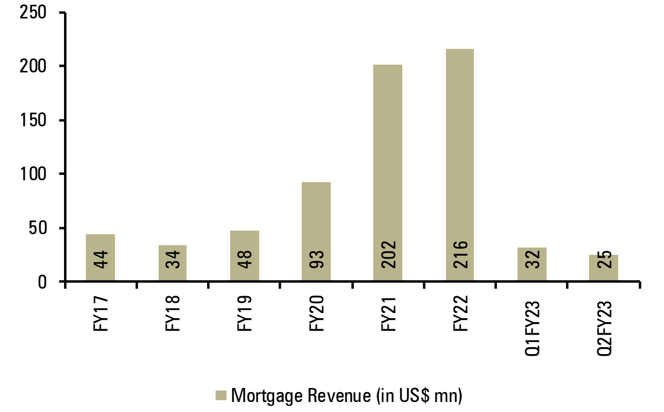
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	6,156	6,007	-2.4	6,644	6,245	-6.0	6,652	Realigned numbers on weak performance of mortage and collections business for few more quarters
EBIT	616	535	-13.2	711	587	-17.4	758	
EBIT Margin (%)	10.0	8.9	-110 bps	10.7	9.4	-130 bps	11.4	Margin recovery to take some more quartes
PAT	473	408	-13.7	551	452	-18.0	589	
EPS (₹)	6.8	5.9	-13.7	7.9	6.5	-18.0	8.5	

Source: Company, ICICI Direct Research

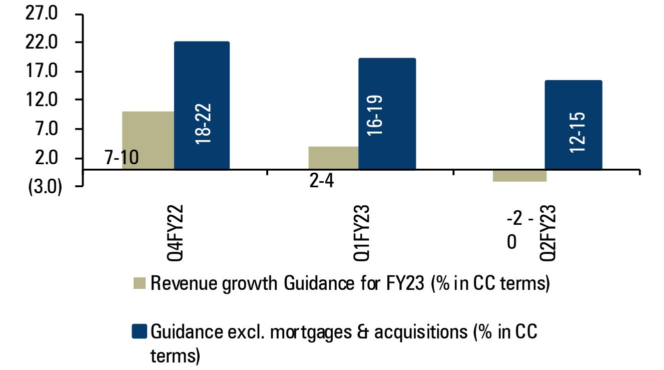
Key Metrics

Exhibit 3: Mortgage business continues to be weak



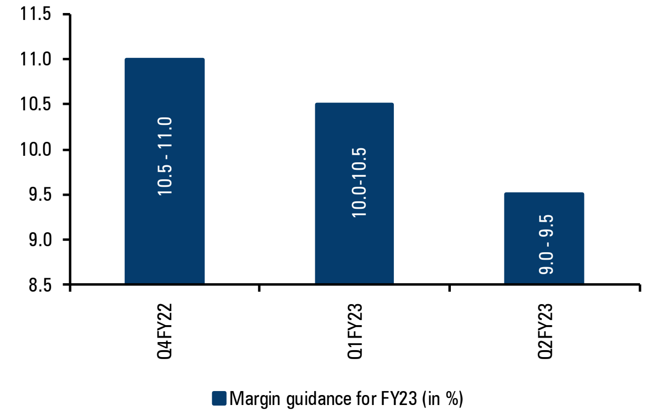
Source: Company, ICICI Direct Research

Exhibit 4: Resulting revenue guidance downward



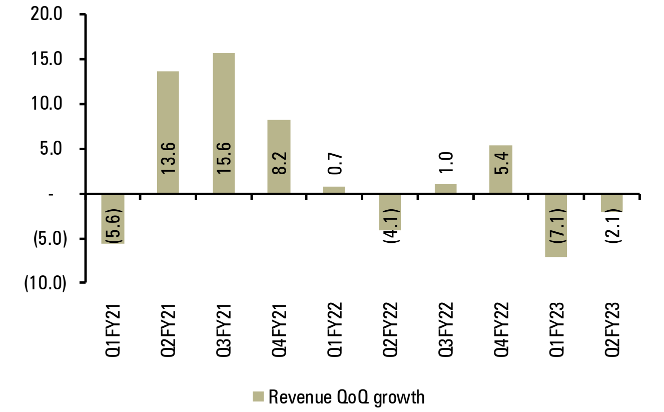
Source: Company, ICICI Direct Research

Exhibit 5: As also margin guidance



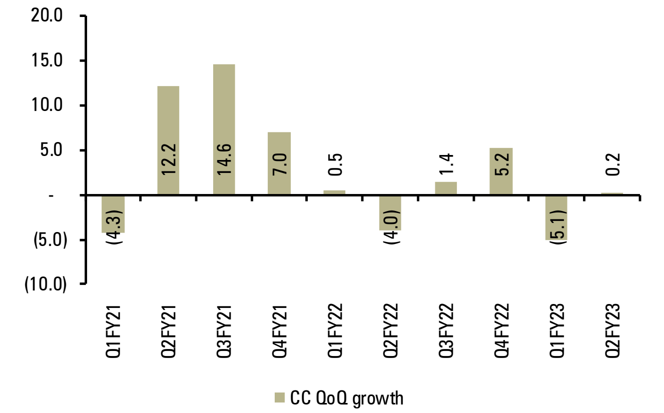
Source: Company, ICICI Direct Research

Exhibit 6: QoQ dollar revenue growth trend



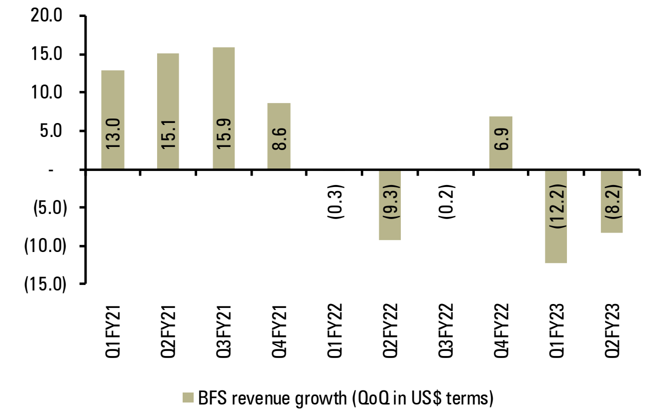
Source: Company, ICICI Direct Research

Exhibit 7: QoQ CC growth trend



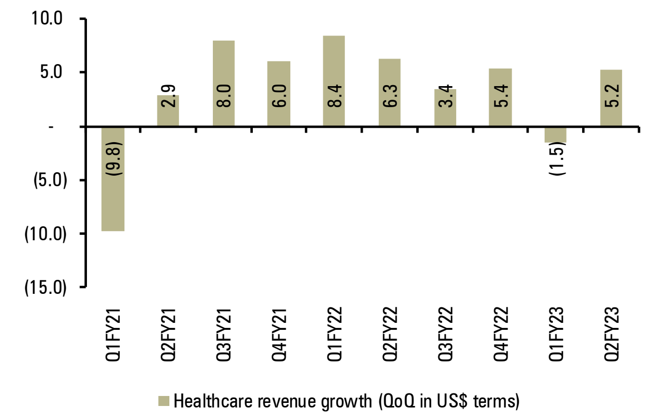
Source: Company, ICICI Direct Research

Exhibit 8: BFS impacted; continues to be weak



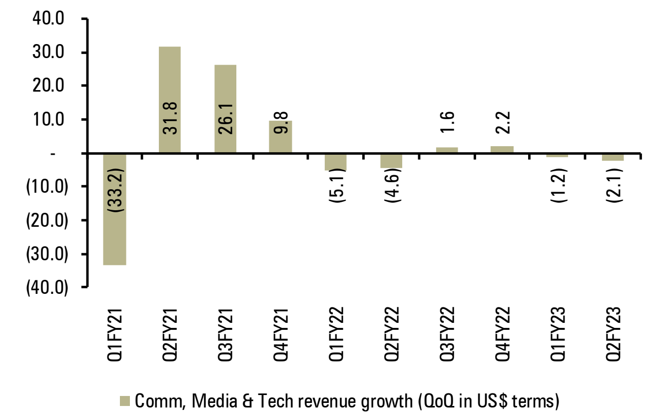
Source: Company, ICICI Direct Research

Exhibit 9: Healthcare revenue QoQ growth trend



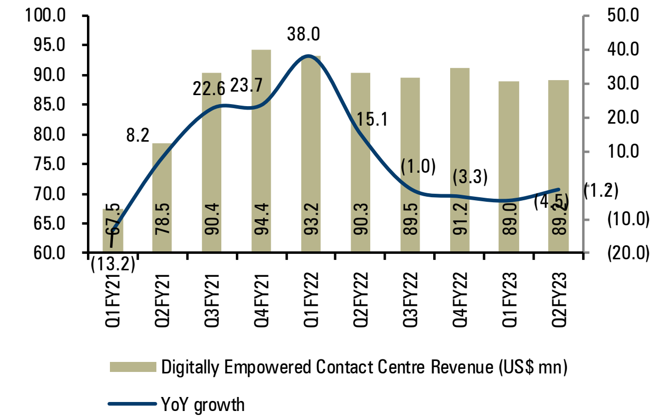
Source: Company, ICICI Direct Research

Exhibit 10: CMT QoQ growth trend



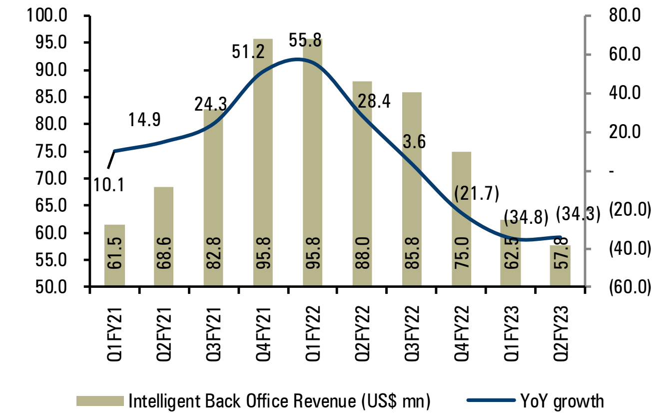
Source: Company, ICICI Direct Research

Exhibit 11: DECC revenue with YoY growth



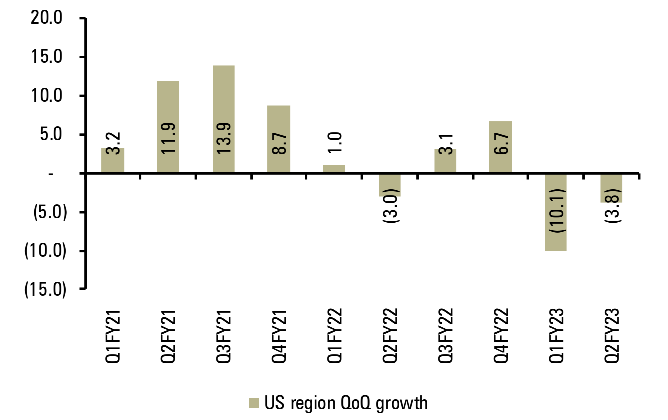
Source: Company, ICICI Direct Research

Exhibit 12: Intelligent back office revenue with YoY growth



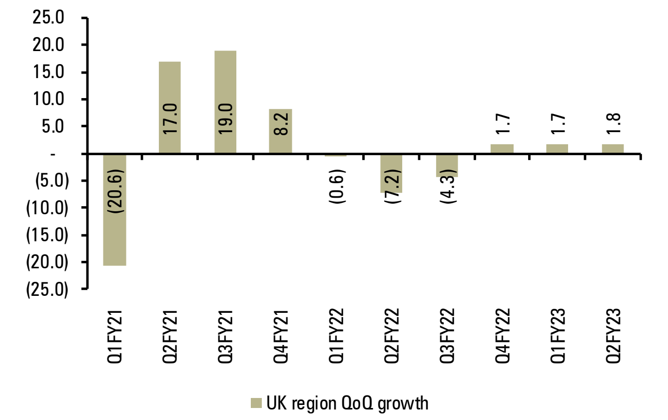
Source: Company, ICICI Direct Research

Exhibit 13: US region impacted by unfavourable business environment



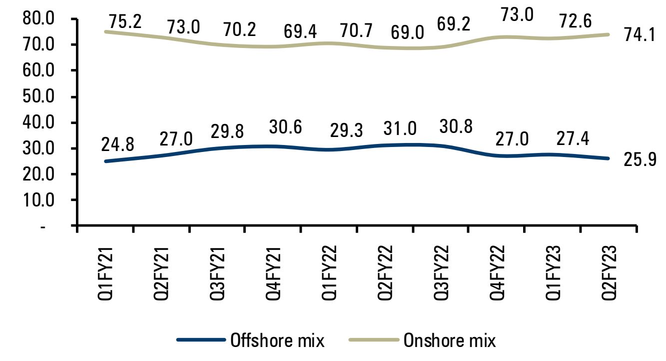
Source: Company, ICICI Direct Research

Exhibit 14: UK region growth steady despite political uncertainties & high inflation



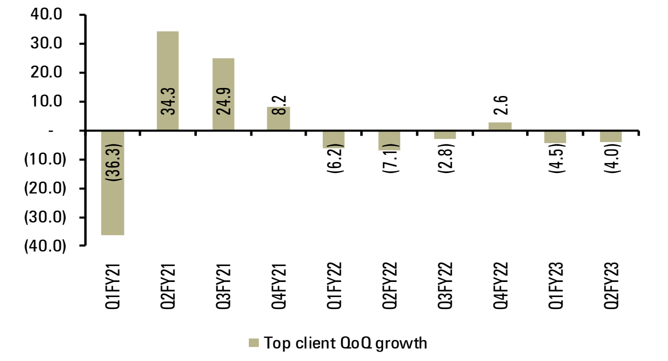
Source: Company, ICICI Direct Research

Exhibit 15: Onshore/ Offshore mix trend



Source: Company, ICICI Direct Research

Exhibit 16: Top client QoQ growth trend

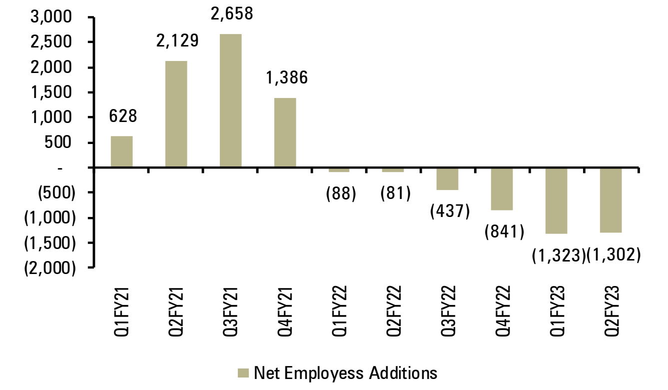


Source: Company, ICICI Direct Research

Exhibit 17: Top five clients QoQ growth trend

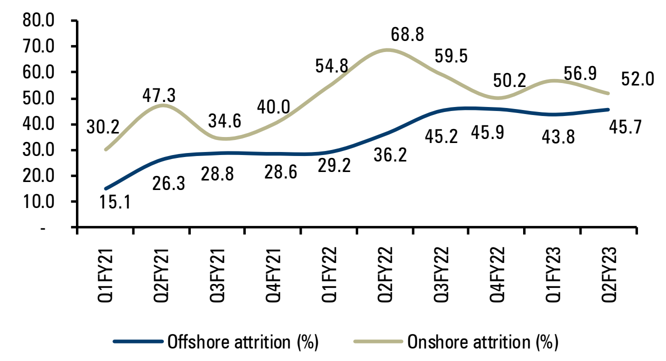
Source: Company, ICICI Direct Research

Exhibit 18: Cost rationalisation impacting net adds



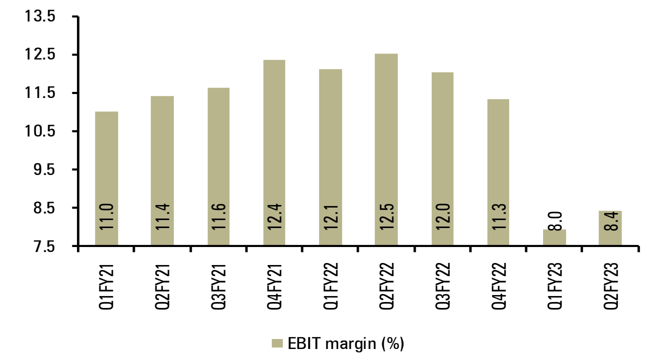
Source: Company, ICICI Direct Research

Exhibit 19: Attrition continues to remain elevated



Source: Company, ICICI Direct Research

Exhibit 20: EBIT margin sees some uptick



Source: Company, ICICI Direct Research

Financial summary

Exhibit 21: Profit and loss statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Total Revenues	**5,921**	**6,007**	**6,245**	**6,652**
Growth (%)	16.6	1.4	4.0	6.5
Employee expenses	3,947	3,880	4,247	4,477
Other Expenses	1,015	1,322	1,155	1,144
EBITDA	**960**	**805**	**843**	**1,031**
Growth (%)	20.1	(16.1)	4.7	22.3
Depreciation & Amortization	249	270	256	273
Other Income	(0)	4	4	4
Interest	63	29	27	27
PBT before Exceptional Iterr	647	509	564	735
Growth (%)	49.8	(21.3)	10.7	30.4
Tax	111	102	113	147
PAT before Excp Items	536	407	451	588
Exceptional items				
PAT before MI	536	407	451	588
Minority Int & Pft. from assoc	(1)	(1)	(1)	(1)
PAT	**537**	**408**	**452**	**589**
Growth (%)	48.6	(24.0)	10.7	30.3
EPS	7.7	5.9	6.5	8.5
EPS (Growth %)	48.3	(24.1)	10.7	30.4

Source: Company, ICICI Direct Research

Exhibit 22: Cash flow statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Profit before Tax	**453**	**509**	**564**	**735**
Depreciation & Amortizatic	88	270	256	273
WC changes	(54)	95	(23)	(38)
Other non cash adju.	(72)	(76)	(89)	(124)
CF from operations	**416**	**799**	**708**	**846**
Capital expenditure	(38)	(149)	(155)	(165)
Δ in investments	(33)	-	-	-
Other investing cash flow	0	4	4	4
CF from investing Acti	**(50)**	**(145)**	**(151)**	**(161)**
Issue of equity	(46)	-	-	-
Δ in debt funds	(8)	(517)	-	-
Dividends paid	(238)	(249)	(276)	(359)
Other financing cash flow	(20)	(29)	(27)	(27)
CF from Financial Acti	**(356)**	**(888)**	**(396)**	**(480)**
Δ in cash and cash bank bε	9	(234)	162	205
Effect of exchange rate changes				
Opening cash	137	147	(88)	74
Closing cash	**147**	**(88)**	**74**	**280**

Source: Company, ICICI Direct Research

Exhibit 23: Balance sheet ₹ crore

Particulars	**FY22**	**FY23E**	**FY24E**	**FY25E**
Equity	697	697	697	697
Reserves & Surplus	2,336	2,495	2,671	2,901
Networth	3,033	3,192	3,368	3,598
Minority Interest	0	0	0	0
LT liabilties & provisions	867	867	867	867
Total Debt	1,010	493	493	493
Source of funds	**4,910**	**4,553**	**4,729**	**4,958**
Net fixed assets	1,026	717	708	693
CWIP	-	-	-	-
Goodwill	2,721	2,721	2,721	2,721
Other non current assets	541	805	826	860
Loans and advances	-	-	-	-
Current Investments	119	119	119	119
Debtors	961	682	709	755
Cash & Cash equivalents	90	(88)	74	280
Other current assets	252	514	535	569
Trade payables	178	330	343	365
Current liabilities	567	714	742	791
Provisions	53	97	101	108
Application of funds	**4,910**	**4,553**	**4,729**	**4,958**

Source: Company, ICICI Direct Research

Exhibit 24: Key ratios ₹ crore

(Year-end March)	**FY22**	**FY23E**	**FY24E**	**FY25E**
Per share data (₹)				
EPS-diluted	7.7	5.9	6.5	8.5
DPS	3.8	3.5	3.9	-
BV	44.2	46.5	49.1	52.4
Operating Ratios (%)				
EBITDA Margin	16.2	13.4	13.5	15.5
PBT Margin	10.9	8.5	9.0	11.0
PAT Margin	9.1	6.8	7.2	8.9
Return Ratios (%)				
RoNW	17.7	12.8	13.4	16.4
RoCE	14.5	11.8	12.5	15.4
Valuation Ratios (x)				
P/E	13.3	17.5	15.8	12.1
EV / EBITDA	8.2	9.4	8.7	7.0
Price to Book Value	2.3	2.2	2.1	2.0
EV / Net Sales	1.3	1.3	1.2	1.1
Mcap / Net Sales	1.2	1.2	1.1	1.1
Turnover Ratios				
Debtor days	59	41	41	41
Creditors days	11	20	20	20
Solvency Ratios				
Total Debt / Equity	0.3	0.2	0.1	0.1
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	0.6	0.4	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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