Zensar Technologies (ZENTE)

ICICI direct Research

CMP: ₹ 340 | Target: ₹ 370 (9%) | Target Period: 12 months | HOLD

May 13, 2023

Focusing on margin improvement; aiming for mid teen margins in near term…

About the stock: Zensar Technologies (Zensar) offers application & IMS services to hi-tech, manufacturing, retail and BFSI.

- Zensar has grown organically and inorganically over the years
- Net debt free and healthy double digit return ratio (with RoCE of 19%)

Q4FY23 Results: Zensar reported a margin recovery in Q4FY23.

- Revenue increased 0.4% QoQ in CC terms while services revenue grew 2% QoQ in CC terms
- EBITDA margins improved ~320 bps QoQ to 14.5%
- Won TCV of US$174.9 million, up 34% QoQ

What should investors do? Zensar's share price has grown by ~1.4x over the past five years (from ~₹ 240 in May 2018 to ~₹ 340 levels in May 2023).

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

Target Price and Valuation: We value Zensar at ₹ 370 i.e. 14x P/E on FY25E.

Key triggers for future price performance:

- The company has added four services lines in the recent one to one and a half years, which has increased the addressable market and subsequently revenue growth opportunities
- Moderation of subcontractor costs, which is expected to be one of the levers for margin expansion apart from pricing, utilisation improvement, more offshoring, etc
- Expect revenue growth at CAGR of 8.4% over FY23-25E

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

- Key beneficiary of growth in digital technologies and exposure to growth segments like healthcare & BFSI
- BUY with a target price of ₹ 5,170

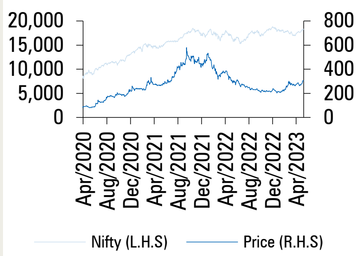
Particulars

Particular	Amount
Market Cap (₹ Crore)	7,701
Total Debt (₹ Crore)	-
Cash & Invets (₹ Crore)	1,179
EV (₹ Crore)	6,522
52 week H/L	323 / 202
Equity capital (₹ Crore)	45
Face value	₹ 2

Shareholding pattern

	Jun-22	Sep-22	Dec-22	Mar-23
Promoter	49	49	49	49
FII	16	13	11	11
DII	14	9	11	16
Public	21	29	29	24

Price Chart



Recent event & key risks

- New CEO joined in December 2022
- **Key Risk:** (i) Better-than-expected revenue (ii) Longer than expected recovery in key verticals

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Company Update

ICICI Securities – Retail Equity Research

Key Financial Summary

(₹ Crore)	FY21	FY22	FY23	5 Year CAGR (FY17-22)	FY24E	FY25E	2 Year CAGR (FY23-
Net Sales	3,781	4,244	4,848	9.2%	5,085	5,696	8.4%
EBITDA	685	657	552	8.2%	707	842	23.5%
EBITDA Margin (%)	18.1	15.5	11.4		13.9	14.8	
Reported PAT	300	416	328	6.3%	488	596	34.9%
EPS (₹)	13.2	18.3	14.4		21.5	26.3	
P/E	25.8	18.6	23.5		15.8	12.9	
ROE (%)	12.8	15.5	11.0		14.8	16.2	
ROCE (%)	18.9	15.5	11.3		15.6	17.2	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported revenue of US$147.5 mn, up 1.1% QoQ while in CC terms revenue grew 0.4% QoQ. The services revenue came in at US$145.8 mn, up 2.7% QoQ (2% QoQ in CC terms) while the pass through revenue during the quarter was US$1.7 mn. In rupee terms, the company reported revenue of ₹ 1,212.7 crore, up 1.3% QoQ
- Vertical wise in CC terms on a QoQ basis, hitech, manufacturing & insurance grew 7.5%, 4.3% & 8%, respectively, while consumer services, banking & emerging declined 12.7%, 2.1% & 6.7%, respectively
- Geography wise in CC terms US region (70.3% of mix) grew 1.4% QoQ while Europe region declined 5.7% QoQ. South Africa region grew 4.3% QoQ during the quarter
- The company continues its margin improvement endeavour and during the quarter the EBITDA margin improved 320 bps QoQ to 14.5%. The company mentioned that the levers for margin improvement were as follows: i) +230 bps impact of decline in cost of delivery due to lower subcontractor cost & operational efficiency, ii) +190 bps impact due to increase in utilisation and iii) +30 bps impact of currency benefits mitigated by the headwinds impact of 130 bps due to increase in SG&A expenses due to reversal of one-time benefit in Q3. The company also mentioned that its subcontractor cost during the quarter declined 330 bps QoQ to 12.1%
- For FY23, the company reported revenue of US$604.3 mn, up 6.1% while in CC terms revenue grew 10.3%. In rupee terms revenue grew 14.2% to ₹ 4,848.2 crore. The EBITDA margin in FY23 declined 410 bps to 11.4% while in absolute terms EBITDA came in at ₹ 552.3 crore. The company, for the year, reported PAT of ₹ 327.5 crore while PAT margin came in at 6.8%
- The company indicated that the demand environment continues to be challenging and it is witnessing a delay in decision making from clients. It said that a delay in decision making is visible specially in hi-tech and consumer verticals. The company, however, indicated that it continues to be closer to clients to understand their needs and continue to provide solutions in terms of cost saving solutions, etc. Zensar indicated that Q4 performance came in strong due to strong execution and on account of strong wins. Q1FY24 is expected to another better quarter for them as deal wins is an indicator of revenue visibility. The company indicated that it is not facing any headwinds in BFSI space as its clients are skewed towards insurance sub verticals. Hence, it does not expect any material impact of recent regional bank crisis in US. The company indicated that the UK market continues to be a growth driver for it due to client relationships and same is applicable for the South Africa region where the growth momentum is likely to continue, going forward, while it also mentioned that revenue from three clients could not be recognised in Q4 due to lack of proper documentation, which is likely to reflect in next quarter's revenues
- Regarding the addressable market, the company mentioned that the addressable market for it has increased substantially in the last two years. The company mentioned that two years back they were offering only two service lines, which were infrastructure management and application development and management (ADM). Zensar mentioned that over the last two years it has added four services lines i) SaaS with salesforce, Oracle and SAP, ii) data & analytics (which was one of the key spend areas from the clients, which Zensar was not addressing properly, it has now taken corrective action on the same), iii) advanced engineering & iv) customer experience through dedicated design centres. The company mentioned that these four new service lines collectively now contribute 35% of revenue for it. The company indicated that it may add one or two more verticals
- The company mentioned that it has cash & investments of US$201.5 mn as on March 2023. It indicated that it is looking at M&A opportunities but it would be from more opportunistic point of view. The new CEO, however,

mentioned that inorganic opportunities cannot be a substitute for organic growth. He further mentioned that he is currently focusing on scaling up existing services lines. On vendor consolidation, the company mentioned that it is zero sum game. The company, however, is confident that it will gain market share in case any vendor consolidation happens at their existing client side on account of relationships it has developed over the years

- The company indicated that to serve the addressable market in most efficient way and capture growth opportunities, it has made certain organisation changes. Zensar mentioned that it is looking for more collaborative approach where capabilities are integrated. The company mentioned that i) it has appointed chief business officer ii) it has created separate new function for new growth areas, where multi service line deals can be catered. Zensar also welcomed its chief operating officer. The company indicated that it made the structure more accountable. Hence, there are certain targets given to them to achieve. It also mentioned that it has revamped its sales incentive plans to encourage more cross selling opportunities across verticals

- On margins, the company mentioned that as per its earlier guidance, it was supposed to reach mid teen EBITDA margins by Q2FY24 but the company reached it in Q4FY23 itself. It also mentioned that it is not only likely to sustain these margins, going forward, but likely to reach mid teen yearly margins in next couple of years (this including regular wage hikes in Q2). The company also indicated that although headcount may have reduced this quarter but the billed headcount has increased. The company also mentioned that reduction of subcontractor's costs was one of the main levers for margin expansion in Q4 and further reduction is possible, which will aid margin expansion despite its continued investments in sales and marketing. Zensar also mentioned that hi-tech revenues generally pick up in Q4 after reversal of furlough impact in Q3 (large impact in last week of December and relatively lower impact in first week of January) and there is no different trend this year

- The company won a strong TCV of US$174.9 mn, up 34% QoQ & 5.6% YoY. Zensar also mentioned that the TCV win was broad based across verticals and it is a healthy mix of new wins and renewals

- On the back of easing supply side challenges & employee retention efforts, the company's LTM attrition declined 300 bps QoQ & 810 bps YoY to 19.8%. The company mentioned that attrition will moderate further. The net employees during the quarter declined by 282 bringing the total employees to 10,563. Utilisation improved by 380 bps QoQ to 81.4% due to reversal of furloughs impact from Q3 & deployment of freshers increasing the billable employees of the company

- The revenue from its top five, 10, 20 clients increased by 8.7%, 4.3% & 1.3% QoQ, respectively. The company mentioned that it was mainly on the back of reversal of furloughs, which impacted Q3 performance. The company indicated that pass through revenues were US$6.6mn, US$3.9mn and US$1.7mn for Q2FY23, Q3FY23, Q4FY23, respectively. The company mentioned that its client relationships are sticky and long term. The company mentioned that some of the clients are with the company since long and few crises like in 2001, 2008 financial crisis, Covid did not impact its relationships with clients and they continue to be with the company. The company mentioned that growth that it is seeing is much more secular and not concentrated in any geography or vertical or client and also mentioned that new service lines are growing faster than traditional service lines

- The company declared a final dividend of ₹ 3.5 per share during the quarter

Exhibit 1: P&L

	Q4FY23	Q4FY22	YoY (%)	Q3FY23	QoQ (%)	Comments
Revenue	1212.7	1153.8	5.1	1197.6	1.3	Revenue increased 0.4% QoQ CC terms and 1.1% QoQ in dollar terms. Services revenue grew by 2% QoQ in CC terms
Employee expense	825.4	805.5	2.5	869.9	-5.1	
Gross Margin	387.3	348.3	11.2	327.7	18.2	
Gross margin (%)	31.9	30.2	175 bps	27.4	457 bps	
other expense	211.4	184.1	14.8	192.8	9.6	
EBITDA	175.9	164.2	7.1	134.9	30.4	
EBITDA Margin (%)	14.5	14.2	27 bps	11.3	324 bps	Margin improved due to the tailwinds of lower subcon cost, increase in utilization, operational efficiency mitigated by the headwinds of increase in SGA expenses
Depreciation & amortisation	35.1	48.1	-27.0	49.7	-29.4	
EBIT	140.8	116.1	21.3	85.2	65.3	
EBIT Margin (%)	11.6	10.1	155 bps	7.1	450 bps	
Other income (less interest)	20.9	63.4	-67.0	18.3	14.2	
PBT	161.7	179.5	-9.9	103.5	56.2	
Tax paid	42.4	48.9	-13.3	27.0	57.0	
PAT	119.3	130.6	-8.7	76.5	55.9	

Source: Company, ICICI Direct Research

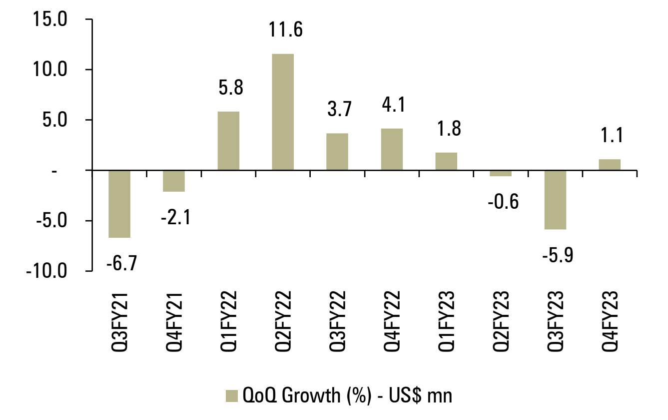
Exhibit 2: Change in estimates

	FY24E			FY25E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	
Revenue	4,810	5,085	5.7	5,169	5,696	10.2	Revenue increased on increasing addressable market for the company
EBITDA	601	707	17.5	734	842	14.7	
EBITDA Margin (%)	12.5	13.9	140 bps	14.2	14.8	58 bps	Margins and profitability likely to see substantial improvement after depressed numbers in FY23, as guided by management
PAT	312	488	56.6	406	596	46.7	
EPS (₹)	13.8	21.5	56.6	17.9	26.3	46.7	

Source: Company, ICICI Direct Research

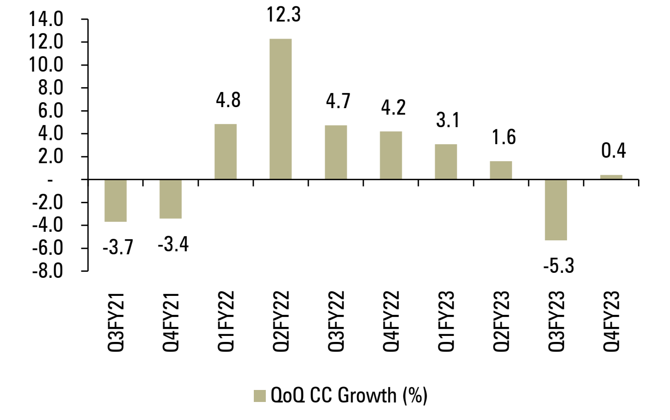
Key Metrics

Exhibit 3: Growth recovery after furlough impact in Q3



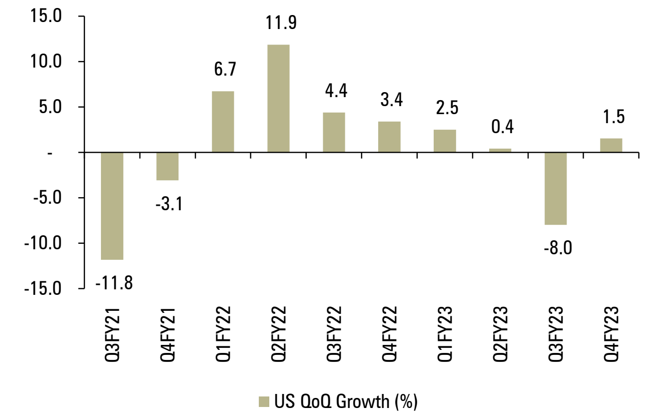
Source: Company, ICICI Direct Research

Exhibit 4: CC growth sees sharp rebound



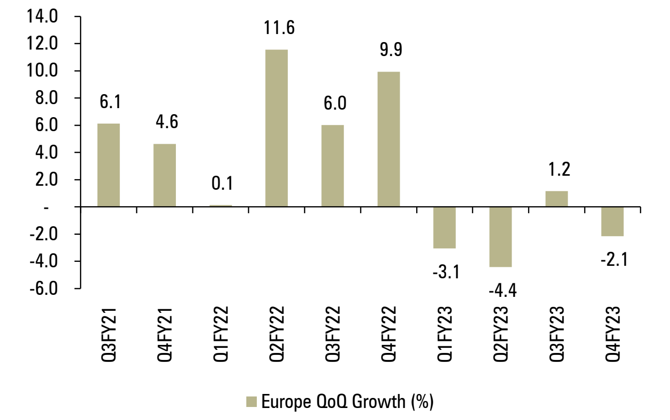
Source: Company, ICICI Direct Research

Exhibit 5: Furlough reversal leads to rebound in Q4



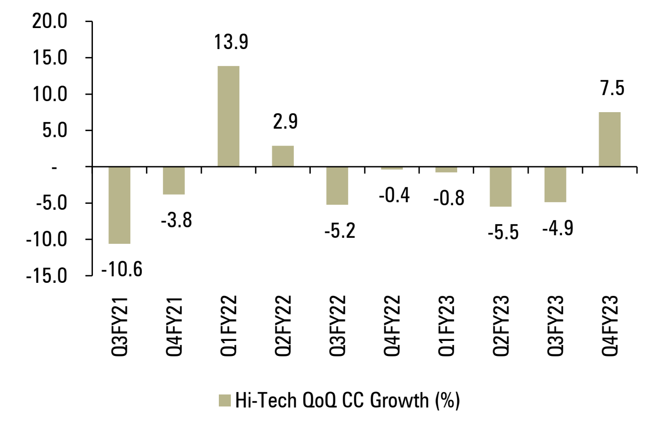
Source: Company, ICICI Direct Research

Exhibit 6: Client specific issues impact Europe region



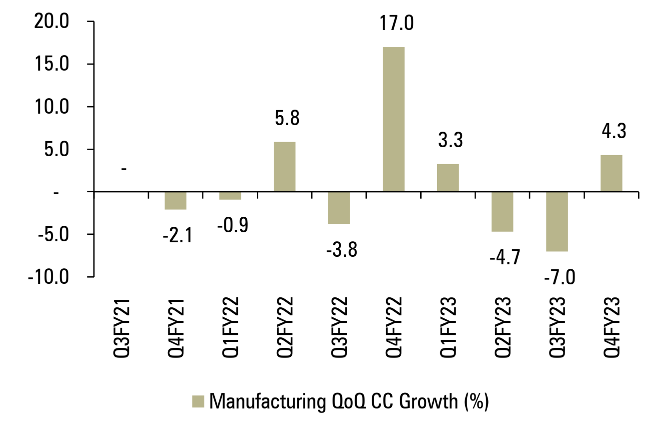
Source: Company, ICICI Direct Research

Exhibit 7: Hi-Tech sees reversal after furlough in Q3



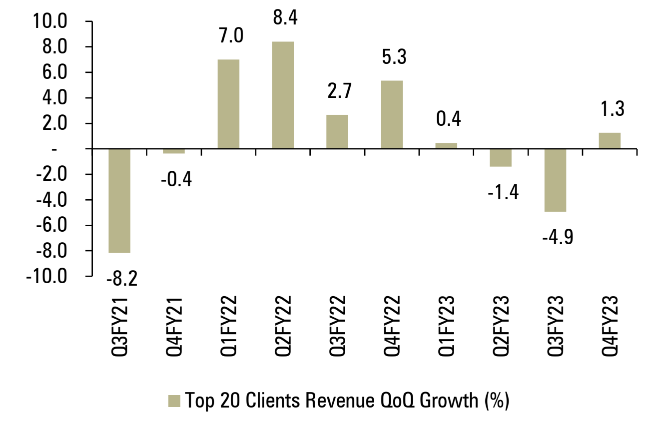
Source: Company, ICICI Direct Research

Exhibit 8: Manufacturing QoQ growth trend



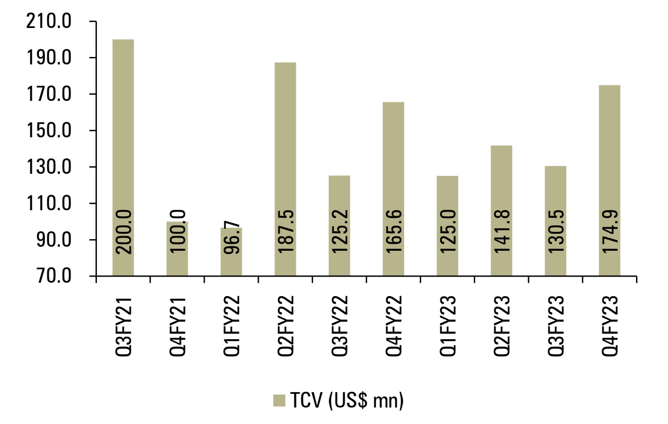
Source: Company, ICICI Direct Research

Exhibit 9: Top 20 clients QoQ growth



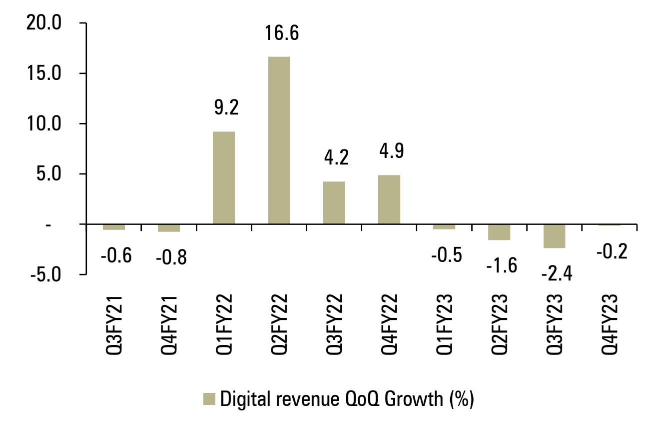
Source: Company, ICICI Direct Research

Exhibit 10: TCV win strong in Q4, up 34% QoQ



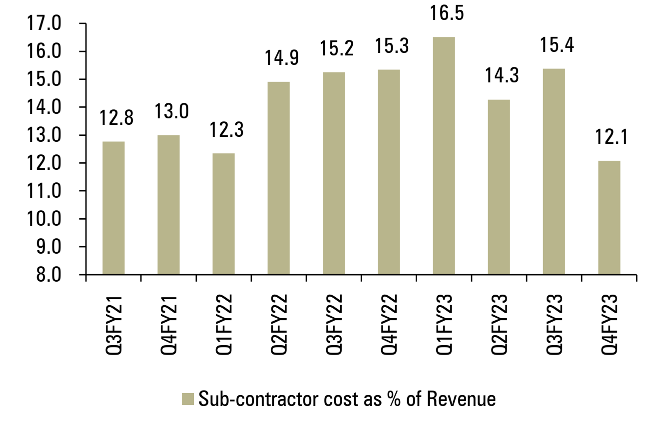
Source: Company, ICICI Direct Research

Exhibit 11: Digital revenue QoQ growth



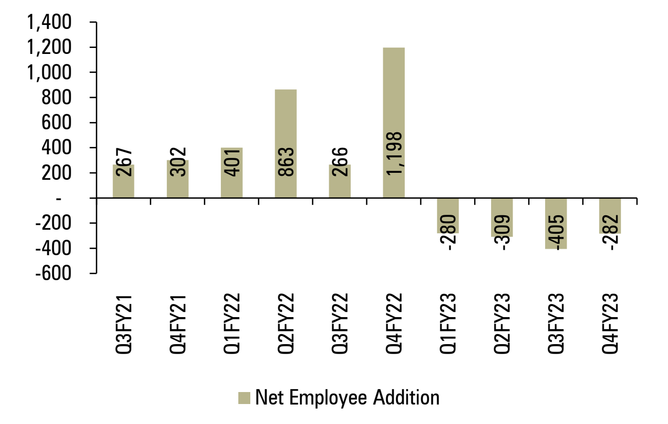
Source: Company, ICICI Direct Research

Exhibit 12: Subcontractor cost sees sharp decline



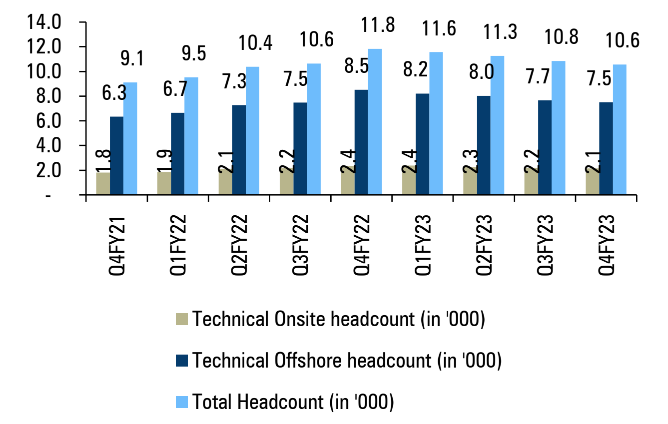
Source: Company, ICICI Direct Research

Exhibit 13: Net employee addition trend



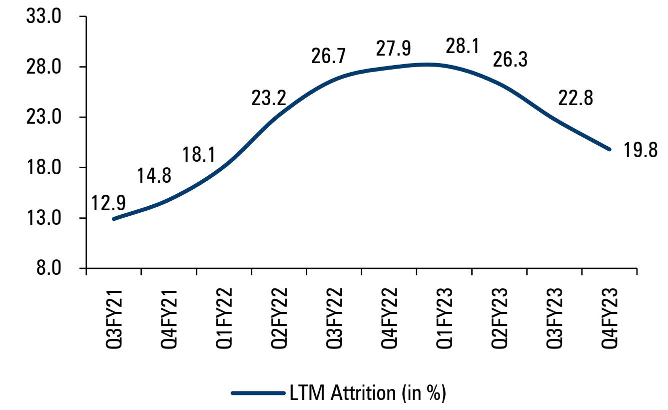
Source: Company, ICICI Direct Research

Exhibit 14: Headcount mix trend



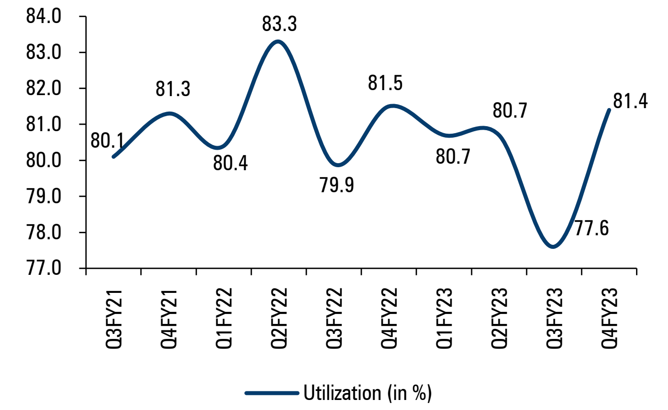
Source: Company, ICICI Direct Research

Exhibit 15: LTM attrition continues to decline



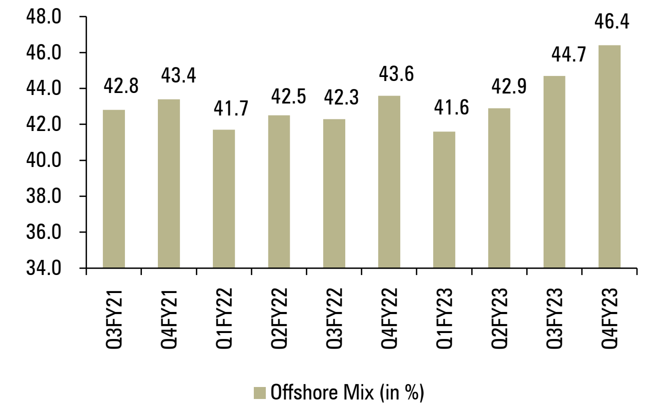
Source: Company, ICICI Direct Research

Exhibit 16: Utilisation improves in Q4



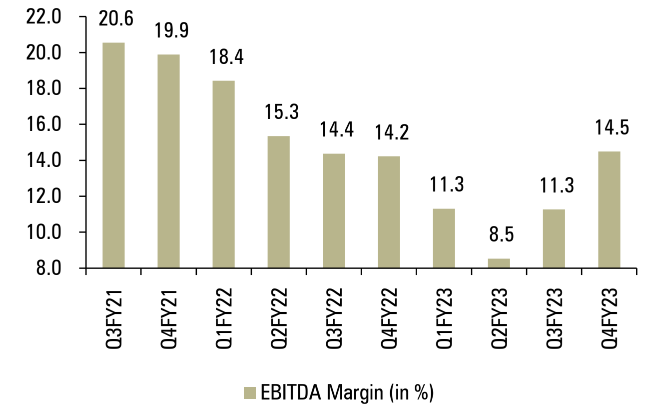
Source: Company, ICICI Direct Research

Exhibit 17: Offshore mix improving



Source: Company, ICICI Direct Research

Exhibit 18: Aiding in EBITDA margin improvement



Source: Company, ICICI Direct Research

Financial summary

Exhibit 19: Profit and loss statement ₹ crore

	FY22	FY23	FY24E	FY25E
Total Revenues	**4,244**	**4,848**	**5,085**	**5,696**
Growth (%)	12	14	5	12
Employee Benefit Expense	2,921	3,500	3,534	3,914
Other Expenses	666	796	844	940
EBITDA	**657**	**552**	**707**	**842**
Growth (%)	-4.1	-15.9	28.0	19.1
Depreciation	185	183	147	159
Other Income	138	103	115	127
Interest	35	28	24	20
PBT before Exceptional Items	574	444	651	789
Growth (%)	19.1	-22.6	46.5	21.3
Tax	153	117	163	193
PAT before Exceptional Items	421	328	488	596
Minority interest	5	-	-	-
PAT after exceptional ite	**416**	**328**	**488**	**596**
Growth (%)	38.7	-21.3	49.0	22.1
Diluted EPS	18.3	14.4	21.5	26.3
EPS (Growth %)	38.7	-21.2	49.6	22.1

Source: Company, ICICI Direct Research

Exhibit 20: Cash flow statement ₹ crore

	FY22	FY23	FY24E	FY25E
Profit before Tax	**574**	**444**	**651**	**789**
Depreciation	185	183	147	159
Change in working capital	(242)	211	8	(61)
Income Taxes Paid	(152)	(93)	(163)	(193)
CF from operations	**336**	**714**	**552**	**588**
Other Investments	214	(497)	115	127
(Purchase)/Sale of Fixed Asse	(234)	(37)	(51)	(57)
CF from investing Activi	**(18)**	**(528)**	**65**	**70**
Inc / (Dec) in Equity Capital	3	0	-	-
Inc / (Dec) in sec.loan Funds	(97)	(102)	(50)	(50)
Dividend & Dividend tax	(88)	(113)	(176)	(215)
Interest Paid on Loans	(1)	(4)	(24)	(20)
CF from Financial Activit	**(183)**	**(219)**	**(250)**	**(285)**
Net change in cash	135	(32)	367	373
Opening cash	699	856	728	1,095
Closing cash	**856**	**728**	**1,095**	**1,468**

Source: Company, ICICI Direct Research

Exhibit 21: Balance sheet ₹ crore

	FY22	FY23	FY24E	FY25E
Equity	45	45	45	45
Reserves & Surplus	2,642	2,931	3,243	3,625
Networth	2,687	2,976	3,289	3,670
Total debt	-	-	-	-
Minority Interest	-	-	-	-
Other liabilities	354	287	287	287
Source of funds	**3,041**	**3,263**	**3,575**	**3,956**
Fixed assets	382	326	294	255
Intangible assets	180	102	88	74
Goodwill	724	745	745	745
Non current investments	161	448	448	448
Other non current assets	162	181	152	164
Current Investments	164	451	451	451
Cash & Bank Balance	856	728	1,095	1,468
Inventories	-	-	-	-
Debtors	797	730	765	857
Other current assets	447	410	421	441
Trade payables	316	277	291	326
Other Current liabilities	514	581	592	622
Application of funds	**3,041**	**3,263**	**3,575**	**3,956**

Source: Company, ICICI Direct Research

Exhibit 22: Key ratios ₹ crore

	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
Diluted EPS	18.3	14.5	21.5	26.3
BV	118.0	131.4	145.2	162.0
DPS	5.0	5.0	7.8	9.5
Cash Per Share	37.6	32.1	48.3	64.8
Operating Ratios (%)				
EBITDA Margin	15.5	11.4	13.9	14.8
PAT Margin	9.8	6.8	9.6	10.5
Debtor days	69	55	55	55
Creditor days	27	21	21	21
Return Ratios (%)				
RoE	15.5	11.0	14.8	16.2
RoCE	15.5	11.3	15.6	17.2
RoIC	23.3	17.7	27.6	33.5
Valuation Ratios (x)				
P/E	18.6	23.5	15.8	12.9
EV / EBITDA	10.2	11.8	8.7	6.9
Market Cap / Sales	1.8	1.6	1.5	1.4
Price to Book Value	2.9	2.6	2.3	2.1
Solvency Ratios				
Debt/Equity	-	-	-	-
Debt / EBITDA	-	-	-	-
Current Ratio	1.5	1.3	1.3	1.4
Quick Ratio	1.5	1.3	1.3	1.4

Source: Company, ICICI Direct Research

RATING RATIONALE

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%

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ANALYST CERTIFICATION

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