Zensar Technologies (ZENTE)

ICICI direct Research

CMP: ₹ 217 | Target: ₹ 225 (4%) | Target Period: 12 months | **HOLD**

October 23, 2022

Company Update

Macro concerns pushing revenue recovery…

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%)

Q2FY23 Results: Zensar reported weak numbers for Q2FY23.

- Revenue grew 1.6% QoQ in CC terms while dollar revenue fell 0.6% QoQ
- EBITDA margins declined ~280 bps QoQ to 8.5%
- Digital revenues declined 1.6% QoQ

What should investors do? Zensar's share price has grown by ~1.5x over the past five years (from ~₹ 149 in October 2017 to ~₹ 217 levels in October 2022).

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

Target Price and Valuation: We value Zensar at ₹ 225 i.e. 12x P/E on FY25E.

Key triggers for future price performance:

- Addressing supply side challenges, which are impacting its growth by continuous compensation interventions
- 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 7.8% over FY22-25E

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 ₹ 4,370

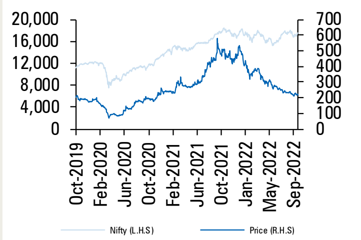
Particulars

Particular	Amount
Market Cap (₹ Crore)	4,940
Total Debt (₹ Crore)	-
Cash & Invets (₹ Crore)	1,020
EV (₹ Crore)	3,920
52 week H/L	539 / 208
Equity capital (₹ Crore)	45
Face value	₹ 2

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoter	49	49	49	49
FII	18	17	16	13
DII	14	13	14	9
Public	19	21	21	29

Price Chart



Recent event & key risks

- Macro concerns pushing revenue recovery
- **Key Risk:** (i) Better-than-expected revenue (ii) Longer than expected recovery in key verticals

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ICICI Securities – Retail Equity Research

Key Financial Summary

(₹ Crore)	FY21	FY22	5 Year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 Year CAGR (FY22-25E)
Net Sales	3,781	4,244	6.8%	4,819	5,060	5,313	7.8%
EBITDA	685	657	11.2%	578	718	754	4.7%
EBITDA Margin (%)	18.1	15.5		12.0	14.2	14.2	
Reported PAT	300	416	12.1%	283	395	421	0.4%
EPS (₹)	13.2	18.3		12.4	17.3	18.5	
P/E	16.5	11.9		17.5	12.5	11.7	
ROE (%)	12.8	15.5		9.8	12.4	12.1	
ROCE (%)	18.9	15.5		12.1	15.1	14.8	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported revenue of US$155 mn, down 0.5% QoQ in dollar terms while it was up 1.6% QoQ in CC terms. In rupee terms, revenue grew 2.6% QoQ to ₹ 1,234.6 crore. Digital services revenue continued to decline for a second successive quarter, reporting a decline of 1.6% QoQ
- Geography wise, US region (71.6% of the mix) grew by 0.4% QoQ while Africa & Europe regions declined by 0.6% & 4.4% QoQ respectively
- Vertical wise, in CC terms, banking, insurance & emerging posted revenue growth of 8.3%, 3.9% & 28.9% QoQ, respectively, while hi-tech, manufacturing & consumer services declined 5.5%, 4.7% & 2.5%, respectively
- EBITDA margins for the quarter declined ~280 bps QoQ to 8.5%. The company indicated that the margins declined due to the following factors:

  i) **Cost of delivery**: The company indicated that the increased cost of delivery impacted margins by ~70 bps. Zensar mentioned that increased cost of delivery was due to the wage hike rolled out by the company

  ii) **Lower utilisation & forex impact**: The company indicated that lower utilisation & currency depreciation impacted margins of the company by ~50 bps

  iii) **SG&A expenses**: The company indicated higher SG&A expenses led by elevated hiring expense impacted margins with a net effect of 160 bps
- The company indicated in Q1 the demand scenario is expected to remain challenging for the next three to four quarters, especially in hi-tech, manufacturing and retail sectors (59% of mix) due to macro challenges impacting this sectors. Zensar continued to face challenges in this part of their portfolio. The company indicated that they are still few quarters away from recovery in this verticals but secular long term demand is not diminishing. It expects furlough to be normal in Q3 and no incremental impact is visible due to furlough as of now. It also indicated that there is margin pressure across Fortune 500 companies, which is reflecting in slower decision making
- The company indicated that BFSI continues to perform well for them and growth is expected to be strong, going forward, due to addition of marquee clients as well as scaling up existing accounts. There are some challenges in BFSI space but Zensar is confident of navigating the same. The company will continue to invest in talent and capability enhancement. Recently acquired M3Bi is also integrating well and also driving the growth in this vertical. Zensar expects strong growth momentum not only for short term but even for long term to be strong in this vertical
- Insurance vertical is also doing well for the company. Zensar said it has a specialisation in the primary software used in P&C solutions in the verticals. The company indicated that clients in this vertical are optimising budgets and incremental opportunity is coming from cost optimisation programs. Zensar mentioned that it is looking to capitalise on both legs of future growth in this vertical i.e. revenue maximisation and cost optimisation. The company also mentioned that earlier they were focusing on project based revenues in this vertical. Hence, nature of revenues was lumpy, which it is trying to address now by shifting to more annuity revenues. Zensar also indicated that it has wins in some new areas and is geared up for strong growth, going ahead

- The company indicated that it is bottomed out as far as margin is concerned. The margin for the quarter was impacted by wage hike. Zensar indicated that wage hike given by it this year is probably the highest in last 10 years. There was an impact of 320 bps due to wage hike in this year vs. 250 bps last year. **The company indicated that higher attrition was also one of the factors for higher wage hike**
- The company maintained guidance of mid teen margin guidance in Q2FY24. Zensar indicated following margin levers, going forward:
  a) Attrition: The company expects attrition to stabilise, going forward, which will lead to margin improvement
  b) **Fresher hiring & utilisation**: The company indicated that it had revamped its fresher hiring program in FY22 and continued the same in FY23 to address its supply side challenges. Zensar indicated that it hired ~1600 freshers in FY22 & 450 freshers in H1FY23 and will continue to hire freshers to reduce its dependency on lateral hiring for pyramid optimisation. Zensar indicated that as the freshers are trained & deployed the utilisation will improve
  c) **Sub-contractor cost**: The sub-contractor cost for the quarter declined 220 bps QoQ to 14.3%. The company expects further moderation, going forward, which will lead to margin improvement
  d) **Price revision**: Zensar indicated that it is in continuous discussions with its clients for price hike due to elevated employee cost pressure
  e) **Offshore mix**: The company indicated that it continues to pursue its strategy to push for more off shore business mix to improve its margin
- The company's LTM attrition declined 180 bps QoQ to 26.3%. The company indicated that it expects attrition to moderate, going forward. Zensar added 1,294 employees during the quarter but the total headcount of the company declined 309 to 11,250
- The company TCV wins remains strong with a TCV of US$141.8 mn during the quarter, up 13.4% QoQ. The company's revenue from its top five, top 10 & top 20 clients reported grew 3.3%, 0.1 & -1.4%, respectively
- The company said the South Africa region continue to do well for them as there is continuous thrust on cloud transformation and data analytics spend across clients in BFSI and retail space. The company is also winning deals in Europe despite a challenging environment. In the US, traction is better in BFSI vertical but consumer sector is facing pressure

Exhibit 1: P&L

	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	Comments
Revenue	1,234.6	1,050.6	17.5	1,203.4	2.6	1.6% CC growth impacted by continued weakness in Hi-Tech, Manufacturing and Retail vertical
Employee expense	922	729	26.4	883	4.4	
Gross Margin	313	321	-2.7	321	-2.4	
Gross margin (%)	25.3	30.6	-526 bps	26.6	-130 bps	
other expense	207	160	29.5	184	12.5	
EBITDA	105	161	-34.6	136	-22.6	
EBITDA Margin (%)	8.5	15.3	-681 bps	11.3	-277 bps	Margins declined due to wage hike
Depreciation & amortisation	49	47	5.1	49	0.4	
EBIT	56	114	-50.9	87	-35.5	
EBIT Margin (%)	4.6	10.9	-634 bps	7.2	-269 bps	
Other income (less interest)	21	14	47.2	15	40.3	
PBT	77	129	-40.0	102	-24.4	
Tax paid	20	33	-38.1	27	-24.5	
PAT	57	96	-40.7	75	-24.4	

Source: Company, ICICI Direct Research

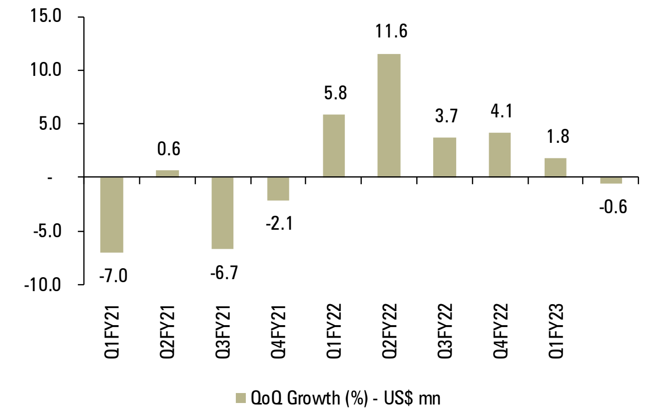
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	4,695	4,819	2.6	4,930	5,060	2.6	5,313	Tweaking numbers on H1 performanc
EBITDA	563	578	2.6	700	718	2.6	754	
EBITDA Margin (%)	12	12.0	0 bps	14.2	14.2	0 bps	14.2	
PAT	272	283	4.0	381	395	3.5	421	
EPS (₹)	12	12.4	4.0	16.8	17.3	3.5	18.5	

Source: Company, ICICI Direct Research

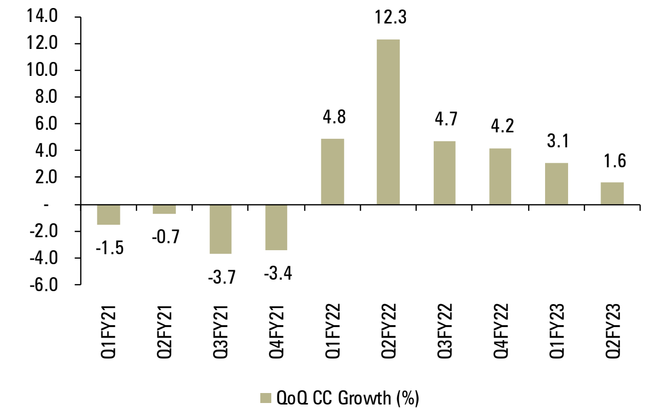
Key Metrics

Exhibit 3: QoQ dollar revenue growth



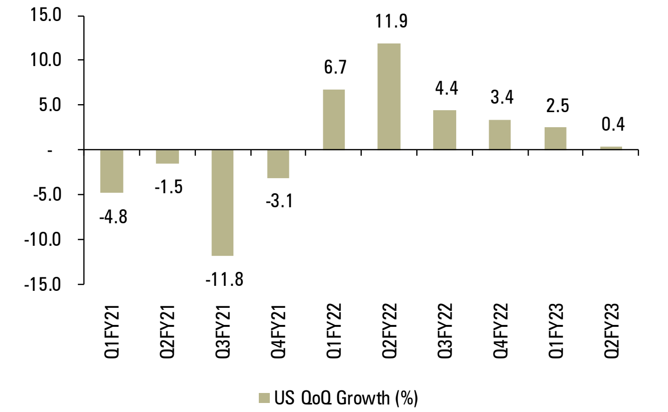
Source: Company, ICICI Direct Research

Exhibit 4: QoQ CC growth



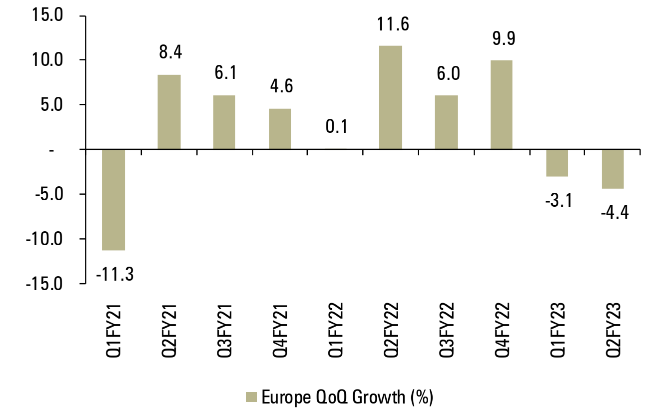
Source: Company, ICICI Direct Research

Exhibit 5: US QoQ growth



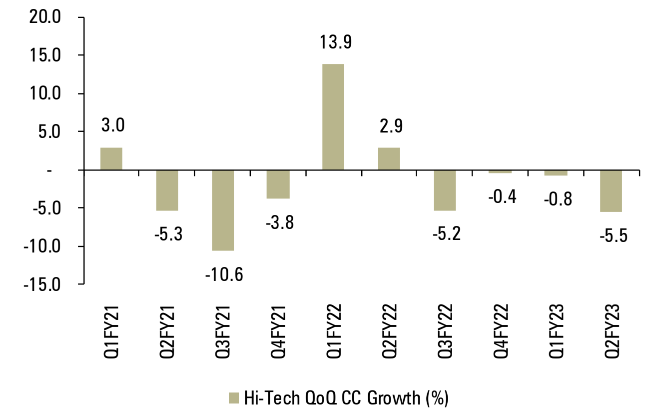
Source: Company, ICICI Direct Research

Exhibit 6: Europe QoQ growth



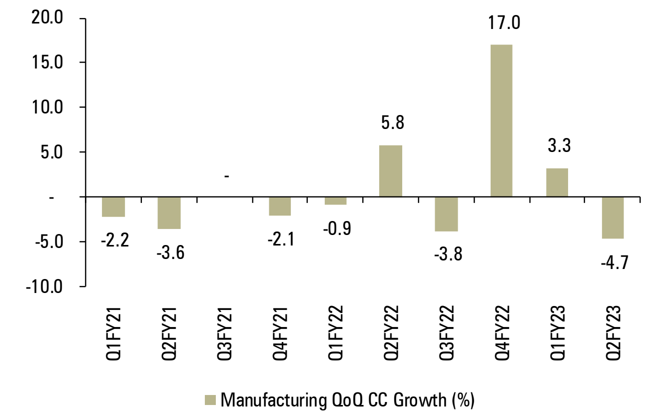
Source: Company, ICICI Direct Research

Exhibit 7: Hi-Tech QoQ CC growth



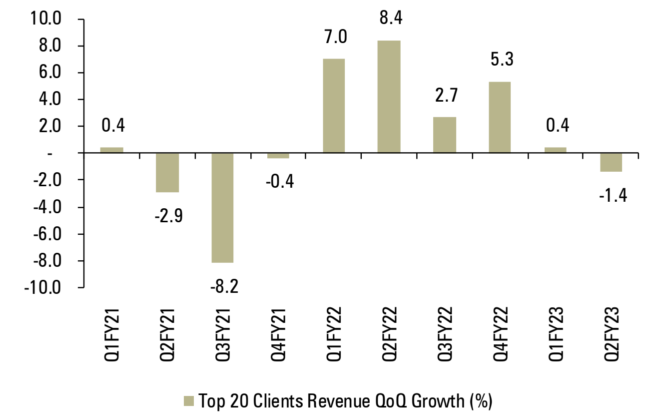
Source: Company, ICICI Direct Research

Exhibit 8: Manufacturing QoQ CC growth



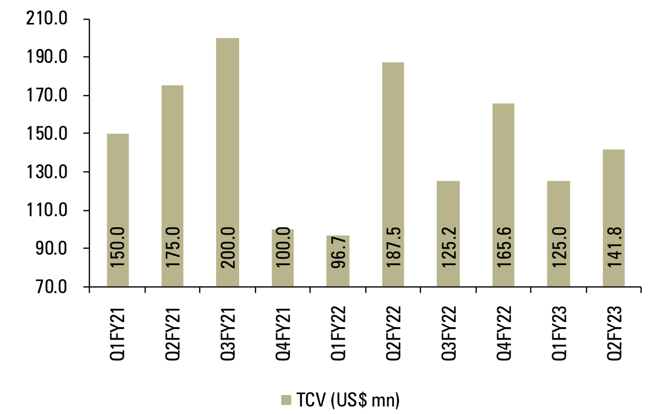
Source: Company, ICICI Direct Research

Exhibit 9: Top 20 clients QoQ growth



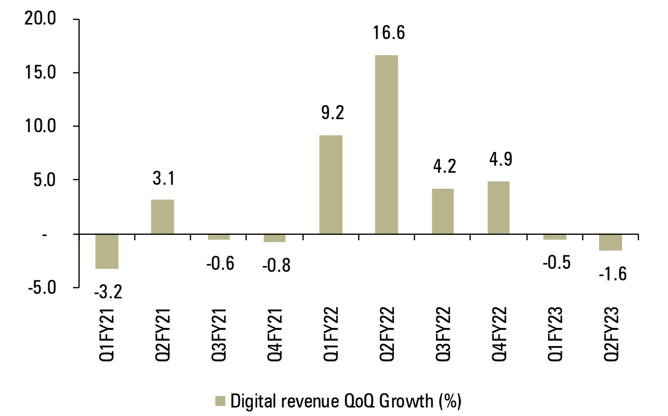
Source: Company, ICICI Direct Research

Exhibit 10: TCV trend



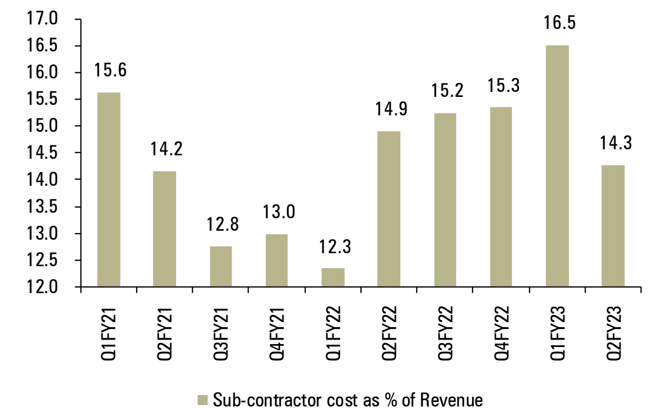
Source: Company, ICICI Direct Research

Exhibit 11: Digital revenue QoQ growth



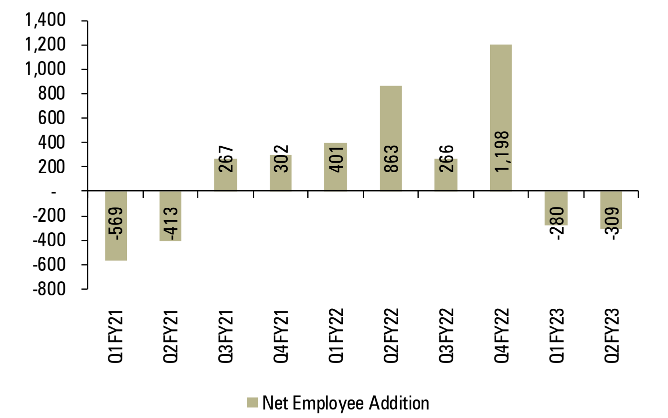
Source: Company, ICICI Direct Research

Exhibit 12: Sub-contractor cost trend



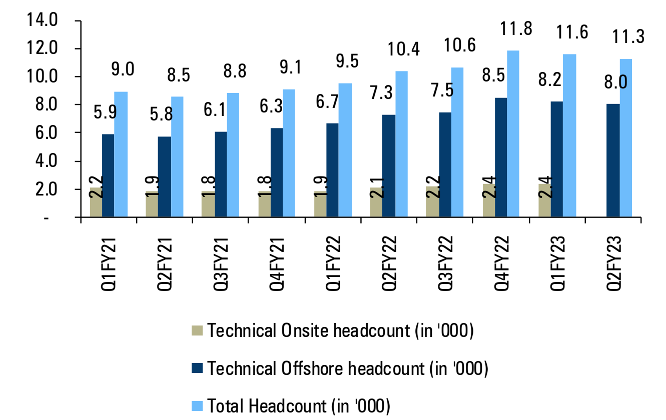
Source: Company, ICICI Direct Research

Exhibit 13: Net employee addition trend



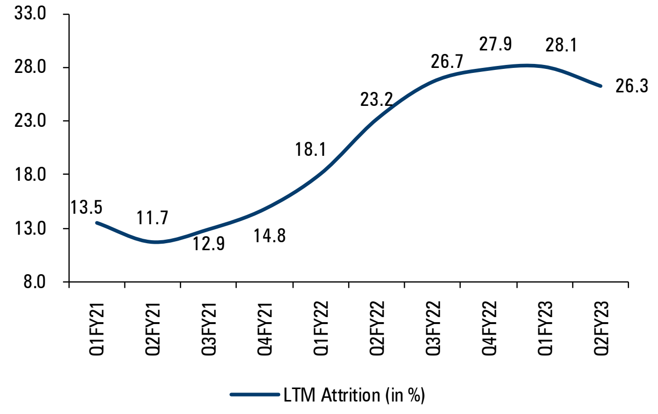
Source: Company, ICICI Direct Research

Exhibit 14: Headcount mix trend



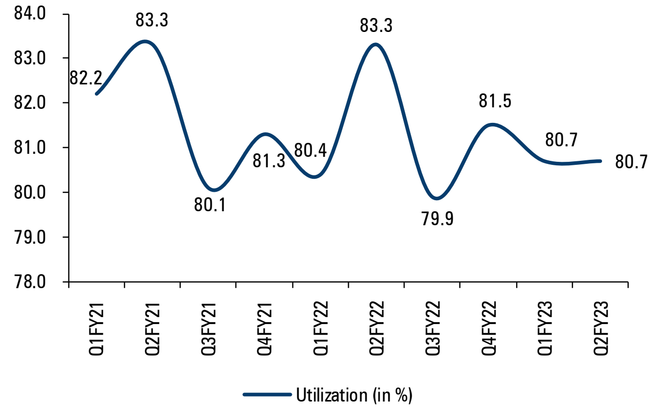
Source: Company, ICICI Direct Research

Exhibit 15: LTM attrition



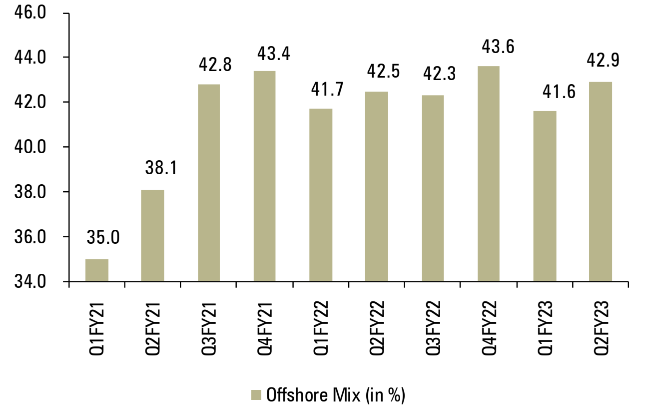
Source: Company, ICICI Direct Research

Exhibit 16: Utilisation



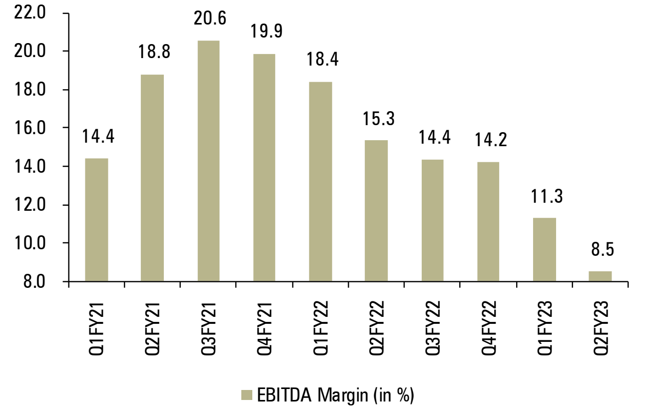
Source: Company, ICICI Direct Research

Exhibit 17: Offshore mix



Source: Company, ICICI Direct Research

Exhibit 18: EBITDA margin trend



Source: Company, ICICI Direct Research

Financial summary

Exhibit 19: Profit and loss statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Total Revenues	**4,244**	**4,819**	**5,060**	**5,313**
Growth (%)	12	14	5	5
Employee Benefit Expense	2,921	3,494	3,567	3,745
Other Expenses	666	747	774	813
EBITDA	**657**	**578**	**718**	**754**
Growth (%)	-4.1	-11.9	24.3	5.0
Depreciation	185	185	185	185
Other Income	138	42	47	47
Interest	35	40	40	40
PBT before Exceptional Items	574	395	541	577
Growth (%)	19.1	-31.2	36.9	6.6
Tax	153	107	146	156
PAT before Exceptional Items	421	288	395	421
Minority interest	5	6	-	-
PAT after exceptional items	**416**	**283**	**395**	**421**
Growth (%)	38.7	-32.1	39.7	6.6
Diluted EPS	18.3	12.4	17.3	18.5
EPS (Growth %)	38.7	-32.1	39.7	6.6

Source: Company, ICICI Direct Research

Exhibit 20: Cash flow statement ₹ crore

	FY22	FY23E	FY24E	FY25E
Profit before Tax	**574**	**395**	**541**	**577**
Depreciation	185	185	185	185
Change in working capital	(243)	14	(37)	(38)
Income Taxes Paid	(152)	(107)	(146)	(156)
CF from operations	**335**	**479**	**536**	**561**
Other Investments	214	42	47	47
(Purchase)/Sale of Fixed Assets	(233)	(63)	(66)	(69)
CF from investing Activities	**(17)**	**(21)**	**(18)**	**(22)**
Inc / (Dec) in Equity Capital	3	-	-	-
Inc / (Dec) in sec.loan Funds	-	-	-	-
Dividend & Dividend tax	(88)	(76)	(107)	(114)
Interest Paid on Loans	(1)	(40)	(40)	(40)
CF from Financial Activities	**(86)**	**(116)**	**(147)**	**(154)**
Net change in cash	233	342	371	385
Opening cash	699	856	1,147	1,468
Closing cash	**856**	**1,147**	**1,468**	**1,803**

Source: Company, ICICI Direct Research

Exhibit 21: Balance sheet ₹ crore

	FY22	FY23E	FY24E	FY25E
Equity	45	45	45	45
Reserves & Surplus	2,642	2,848	3,136	3,444
Networth	2,687	2,893	3,182	3,489
Total debt	-	-	-	-
Minority Interest	-	-	-	-
Other liabilities	354	354	354	354
Source of funds	**3,041**	**3,248**	**3,536**	**3,843**
Fixed assets	382	399	346	296
Intangible assets	180	92	75	60
Goodwill	724	724	724	724
Non current investments	161	161	161	161
Other non current assets	162	171	179	187
Current Investments	164	164	164	164
Cash Balance	856	1,147	1,468	1,803
Inventories	-	-	-	-
Debtors	797	747	784	823
Other current assets	447	442	456	470
Trade payables	316	275	288	303
Other Current liabilities	514	524	532	541
Application of funds	**3,041**	**3,248**	**3,536**	**3,843**

Source: Company, ICICI Direct Research

Exhibit 22: Key ratios ₹ crore

	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
Diluted EPS	18.3	12.4	17.3	18.5
BV	118.0	127.1	139.8	153.3
DPS	4.9	3.4	4.7	5.0
Cash Per Share	37.6	50.4	64.5	79.2
Operating Ratios (%)				
EBITDA Margin	15.5	12.0	14.2	14.2
PAT Margin	9.8	5.9	7.8	7.9
Debtor days	69	57	57	57
Creditor days	27	21	21	21
Return Ratios (%)				
RoE	15.5	9.8	12.4	12.1
RoCE	15.5	12.1	15.1	14.8
RoIC	23.3	20.3	28.0	30.3
Valuation Ratios (x)				
P/E	11.9	17.5	12.5	11.7
EV / EBITDA	6.0	6.3	4.6	3.9
Market Cap / Sales	1.2	1.0	1.0	0.9
Price to Book Value	1.8	1.7	1.6	1.4
Solvency Ratios				
Debt/Equity	-	-	-	-
Debt / EBITDA	-	-	-	-
Current Ratio	1.5	1.5	1.5	1.5
Quick Ratio	1.5	1.5	1.5	1.5

Source: Company, ICICI Direct Research

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Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%

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