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Stock Update

Firstsource Solutions Ltd.

22-June-2021

RETAIL RESEARCH

Firstsource Solutions Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
IT Services - BPO/KPO	Rs. 164.5	Buy on dips to Rs 147 -151 band & add more on dips to Rs 132-136 band	Rs. 173	Rs. 187	2 quarters

HDFC Scrip Code	FIRSOL
BSE Code	532809
NSE Code	FSL
Bloomberg	FSOL IN
CMP June 21, 2021	164.5
Equity Capital (Rs cr)	696.6
Face Value (Rs)	10.0
Equity Share O/S (cr)	69.6
Market Cap (Rs cr)	11450.8
Book Value (Rs)	40.2
Avg. 52 Wk Volumes	4950734
52 Week High	173.4
52 Week Low	35.0

Share holding Pattern % (Mar, 2021)	
Promoters	53.7
Institutions	24.8
Non Institutions	21.5
Total	100.0

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Our Take:

Firstsource Solutions Ltd (FSL), a formidable player in the business process management space, has been consistently focusing on three high growth industry segments - BFS, Healthcare and CMT (Communication, Media and Telecom) across North America and the UK and has been systematically investing in building capabilities and expanding client base in the born-digital as well as new-age client segments of these industries. These include FinTech, HealthTech, Streaming and Digital media.

The company posted robust Constant currency (CC) growth of 31.7%/23.8% YoY in Q4FY21/Q3FY21. EBITDA expanded 210bps to 16% in Q4FY21 from 13.9% in Q2FY19. For the entire year FY21, it reported a stellar 17.9% organic growth after years of underperformance along with sharp uptick in its return ratios and cash collections. As far as FY22 growth guidance is concerned, the company has guided for revenue growth of 15–18% in CC terms with a normalized EBIT margin of 11.8–12.3%. Post the revamp in top management in FY20 when Mr. Vipul Khanna joined as a new CEO & MD (Ex-Cognizant), the business strategy was to fill the gaps in existing offering. Strong performance for FY21 along with aggressive growth guidance for FY22 reinstates our positive view on the company.

FSL has seen healthy client wins of 11 new clients in Q4FY21 and 54 in FY21. It has also witnessed healthy headcount addition (up ~3x in FY21 - 6801 net additions in FY21 v/s 2491 in FY20) indicating robust demand in coming quarters. FSL continues to focus on efforts to improve sales momentum on a continuous basis and its renewed strategy augurs well towards adding stability and drivers to revenue profile.

FSL is well positioned to strengthen client's business processes, increase productivity and drive revenue growth with expertise in Analytics, Intelligent Automation (IA), Agent Productivity and enhancing customer experience. This expertise will prove to be beneficial to drive operational efficiencies, gaining market share and maintaining relationship with customers. Company has a diversified, well-balanced portfolio along with geo-delivery mix and continued focus on digital.

On 26 Oct, 2020, we had initiated coverage report on Firstsource Solutions Ltd and recommend to buy at LTP at Rs 73.4 and add further on dips to Rs. 65 for base case target of Rs 82 and bull case target of Rs 89. The stock has achieved its both targets in Dec 2020. Given healthy growth outlook and strong set of numbers in Q4FY21, we have now revised earnings and increased target price for the stock.

Valuation & Recommendation:

FSL is a provider of a range of business process management services across the customer life cycle delivered through transaction processing. The company is focused on industries like Banking & Financial Services, Healthcare, Communications, Media & Tech. These industries are engaged with structural changes brought about their technology, changing consumer preferences, regulatory policy and off late macroeconomic factors catalysed by the pandemic. We expect, FSL's revenue/PAT to grow at a CAGR 16.7/36% over FY21–23E which will be mainly driven by 1) new logo-wins in BFS, media and technology 2) higher contribution from top clients 3) recovery in mortgage business, and 4) improved traction in UK BFS & retail business. Segment-wise, we expect BFSI (contributes ~50% of revenues) to continue to lead with accelerated growth over FY21-23. Going forward, we expect consistent improvement in return ratios which will be on the back of better free cash flow generation and higher dividend payout.

We believe that expected acceleration in revenue growth momentum, stability in margins, strong consistent execution, delivery on guidance and strong cash generation would support valuations. **We believe the base case fair value of the stock is Rs 173 (18.0x FY23E EPS) and the bull case fair value of the stock is Rs 187 (19.5x FY23E EPS) over the next two quarters. Investors can buy on dips to Rs 147-151 band (14.5x FY23E EPS) and add further on dips in the Rs 132-136 band (14x FY23E EPS). At the LTP, the stock is trading at 17.1x FY23E EPS.**

Financial Summary (Consolidated)

Particulars (Rs Cr)	Q4FY21	Q4FY20	YoY (%)	Q3FY21	QoQ (%)	FY20	FY21	FY22E	FY23E
Total Operating Income	1463	1080	35.4	1365	7.1	4099	5078	6009	6921
EBITDA	234	164	42.7	210	11.4	629	804	979	1121
Depreciation	53	47	12.6	51	4.0	185	206	246	264
Other Income	-2	1	-430.5	1	-256.0	9	1	9	10
Interest Cost	14	14	-3.7	13	7.9	58	52	45	42
Tax	9	12	-24.8	27	-67.3	55	70	126	157
RPAT	157	92	71.0	121	29.4	340	477	572	668
APAT	47	92	-49.0	121	-61.4	340	362	572	668
Diluted EPS (Rs)	0.7	1.3	-47.7	1.8	-61.2	4.9	5.1	8.2	9.6
RoE-%						12.4	17.1	19.3	20.1
P/E (x)						33.6	31.7	20.0	17.1

(Source: Company, HDFC sec)

FSL Q4FY21 results key takeaway

- FSL's reported above expectation numbers in Q4FY21. Revenue grew by 7.1% QoQ to Rs 1,463 crore in rupee terms and US dollar revenues increased 8.2% QoQ to US$199.9 mn.
- EBIT margins increased 60 bps QoQ to 12.6% mainly led by higher gross margins. The company has incurred one off exceptional expense of Rs. 109 crore towards increase in value of options granted in its mortgage business to a strategic partner. Hence, PAT declined 61% QoQ to Rs. 46.7 crore. Adjusting for the exceptional item, PAT increased 8.1% QoQ to Rs. 130.9 crore.
- FSL has guided 15-18% YoY growth in FY22E revenues in constant currency terms and operating margins in the range of 11.8-12.3%.

Key updates

Acquisition of Patient Matters could add synergic advantages in healthcare space

On December 23, 2020, FSL acquired a 100% stake in the Florida-based healthcare revenue cycle management solutions provider Patient Matters for a cash consideration of US$13 mn. Patient Matters unifies disparate registration, bill estimation, and financial services with intelligent workflows and eligibility services, improving revenue realization for hospitals.

The acquisition complements FSL’s provider business on two dimensions: strengthening presence in large markets like Texas and New York and adding new capabilities of pre-authorization and patient bill estimation at the front-end of the RCM cycle. FSL also plans to consolidate its healthcare provider brands MedAssist and Patient Matters under its enterprise umbrella.

Patient Matters has a revenue run rate of about US$17 mn per annum, when it was acquired. FSL had received one month revenue in Q3FY21 and now got full quarter in Q4FY21, run rate for Q4 FY21 was between US$4 mn to US$ 4.5 mn. The company has integration plan calls for reasonable revenue synergies between its business and Patient Matters for the next two years, and the company is starting to see good cross-sell happening.

Expectation of strong traction in healthcare and CMT could help to generate revenue going forward

FSL has revamped its growth and operating strategy coupled with new hiring across the senior management. Company plans to enhance domain depth into adjacent areas of growth. The company is expanding into provider network support, building on historical strength of claims adjudication and member service. FSL is a large player in the Healthcare vertical, and has a presence across 1000+ hospitals in the US. Despite historically this segment being a laggard, we expect improvement in the business outlook in healthcare (especially provider business) which will be mainly led by performance efficiency, reduction in operating costs and higher growth on the back of acquisition of Patient Matters (cross sell opportunities), traction in tele health & patient monitoring.

Also we expect, going forward, improvement in banking verticals (led by growth in collection & fintech and UK banking). Besides, FSL expects communication, media & technology to gain traction led by improvement in top client and addition of new logos in US & UK in media & e-commerce. We expect 19.9% and 15.7% revenue growth in FY22E and FY23E.

Favourable long term outlook of mortgage industry to bring more opportunity going forward

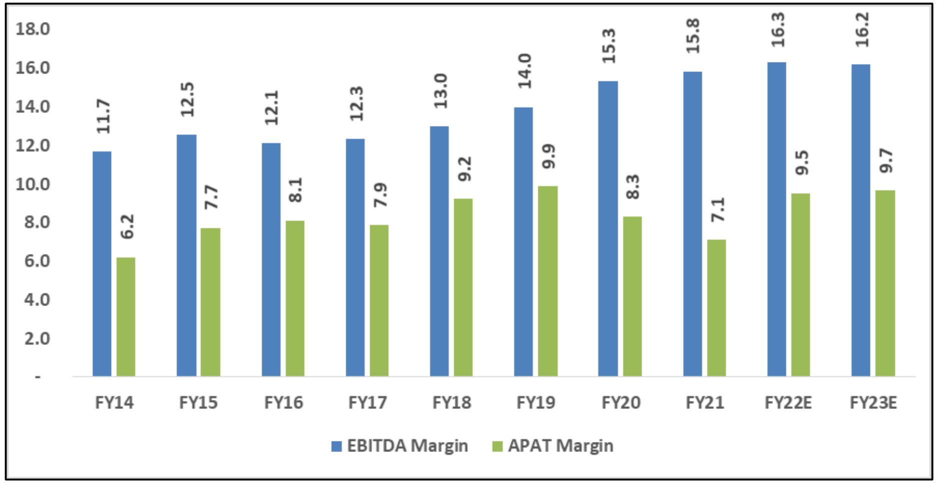
The mortgage industry has benefited from the low interest rate environment in the last couple of years. The growth rates for both refinance and new home purchases have been at multi year highs. And as expected, the refinance market is now starting to slow, although home purchase financing remains strong. We expect industry financing volumes to taper in FY22. FSL has been preparing for this and adding new clients and scaling its services segment. In the last 12 months, FSL added 31 new clients in mortgage business, which will continue to ramp into the new fiscal. Mortgage servicing could see steady growth, as FSL continues to sell new services to its existing clients. Low-interest rates in the US should once again drive refinance volumes and new home sales in the foreseeable future, which should augur well for FSL given its comprehensive offerings in BFSI. Based on these trends, the company is confident of delivering a growth year for mortgage, though this growth will likely to be modest relative to FY21.

Margins could ramp up led by cost rationalisation efforts and operational efficiencies

FSL is leveraging advanced tools and platforms including Intelligent Automation (IA) in a highly-regulated environment, and strengthen relationships with their customers, while clients are able to achieve a low-cost operating model. The company has been adopting Digital Technologies which can benefit its businesses to improve user experience, and improve operational efficiency in a cost effective manner. Company has adopted multi-cloud and hybrid cloud platforms (combination of many cloud platforms). These include migration of various enterprise grade applications, server workload and telephony infrastructure to multi-cloud platforms across geographies and businesses. Company has also invested significantly in a cloud based Next Generation Cyber-Security solution, covering the entire horizon of Endpoints, Servers and Network security, integrated with Cisco Threat Response and Threat intelligence. The company added Artificial Intelligence (AI) and Machine Learning (ML) capabilities to Digital Collections platform and recently launched a BFS bot store starting with COBOTs for the mortgage sector.

FSL took various measures to rationalise costs like lower discretionary spend, furloughing of employees in the UK, lower travel cost and other cost efficiencies. Going forward, we expect a lot of cost pressures of the past to be offset and absorbed by technological execution and digital transformation which will enable consistently higher and sustainable profitability. However, multiple headwinds like wage hike, challenge in lateral hiring, investment in leadership, improving talent capabilities, training and sales cost could impact its margins. Taking the traction in outcome based revenues, improvement in digital segment, higher offshoring, and revenue growth is expected to offset the headwinds. Consequently, we expect EBITDA Margin at 16-16.5% band and PAT margin at 9.5-10% band over FY22-23E.

Margins (%)



(Source: Company, HDFC sec)

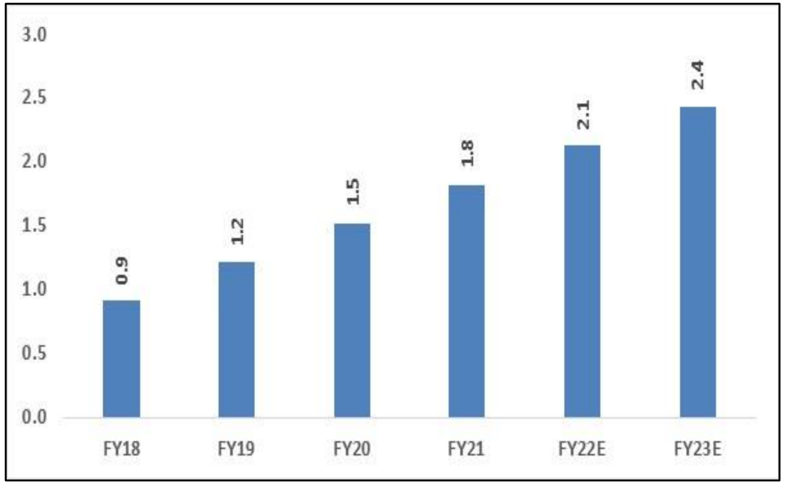
Strong fundamentals led by healthy debt protection metrics and liquidity

- FSL has sustained healthy operating performance in the competitive BPO industry with steady increase in operating income over the years. Company reported revenue and PAT CAGR at 9.5% and 10.1% over the FY11-FY21. Company has maintained EBITDA margin at 10-16% and PAT margin at 5-10% over the last one decade.

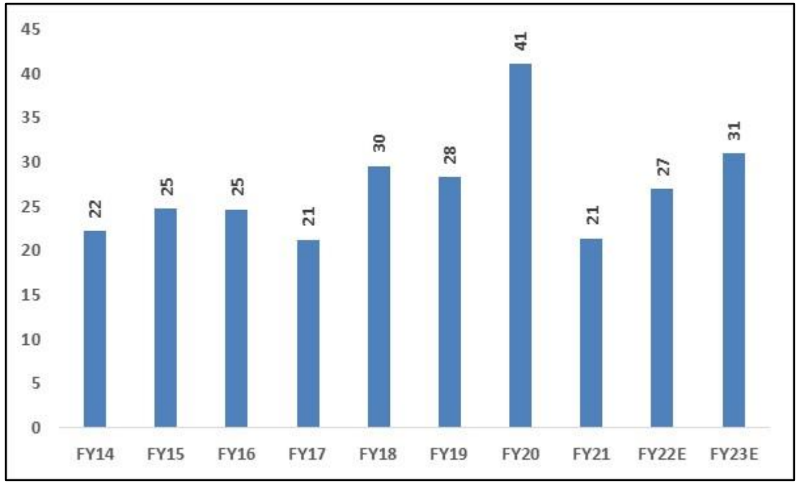
Firstsource Solutions Ltd.

- The company has continued to improve its financials aided by healthy cash accruals on the back of stable operating profitability and reduction in total debt. The capital structure continued to improve and stood comfortable with overall gearing at 0.2x in FY21 and 0.3x in FY20 as compared to 0.5x in FY17. The scheduled repayment of long-term loans and lower utilization of working capital borrowing coupled with accretion of the profit have helped the company to improve its capital structure.
- FSL has cash and cash equivalents of Rs 220 crore as on March 31, 2021 which provides additional liquidity back-up. FSL has attractive return ratios and Return on Equity stood at 17% in FY21. Because of cost rationalization efforts, the company could see growth in profitability as well as better return ratios in the future. Rise in net profit margin could help to increase its return ratios, we expect RoE at 19.3% and 20.1% in FY22E and FY23E, respectively.
- The net working capital cycle was moderate and reduced to 21 days in FY21 vs. 41days in FY20 due to the increase in creditor days as well as decrease in debtors. We expect the FCF to remain positive, going forward, even after factoring in annual capex.
- FSL has recommended a final dividend of Rs 3 per equity share (F.V of Rs 10 per equity share) in FY21, dividend payout stood at 57.7% in FY21 and dividend yield stood at 1.8% at current market price.

Dividend Yields (%)



Working Capital Cycle (Days)



(Source: Company, HDFC sec)

What could go wrong?

- The market for BPM services has become highly competitive over the years. Pressure from clients to cut costs through automation hurts revenue and entry of large IT players into BPO has further intensified competition as more clients look for integrated IT-BPO deals. Apart from this, most of large Companies are operating captive BPO centres.
- Indian BPO industry is facing stiff competition from low cost destinations like China, Philippines, Mexico, Brazil and Canada due to increasing domestic cost. Further rising attrition rate is impacting operating efficiency, productivity and profitability. Besides, pricing pressure and stricter information security and data protection regulations in US and UK could hit its business.
- FSL is exposed to foreign exchange fluctuation risk on cross currency exposure (revenues and cost in different currencies) wherein the company caters to international customers from the delivery centres in India and Philippines. Company has a policy to hedge its exposure on a twelve month rolling basis through forward cover contracts and options.
- Most of the contracts with existing clients are on long-term-basis; any change in the contract terms from large clients like non-renewal of contracts can impact the sustainability and scalability from such clients.
- Any imbalance in pricing on account of lower share of value add high profitable contracts against rising cost pressures can be a matter of concern and can impact earnings of FSL.
- The company has been enjoying with lower tax rate so far due to conducting its operation in Special Economic Zone (SEZ). Some SEZs have come out of tax relief by FY20, and some of the SEZs will come at the taxability for 50% in FY23. Therefore, the liability of higher tax payment could impact its profitability going forward.
- Uncertainties in Mortgage business growth and poor disclosures around agreement with client (like Exceptional charge of ~Rs 110 crore on account of increase in value of options granted in the mortgage business to a strategic partner) could weigh on further rerating in the near term.

Operating Metrics

Particulars	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21	Q4FY21
Revenue by Verticals								
Banking & Financial Services	35.6	40.4	42.9	42.8	51.2	51.9	52.0	52.2
Communications Media & Tech	27.2	22.0	21.9	22.9	16.2	18.8	20.5	20.8
Healthcare	33.5	34.5	32.4	31.3	29.9	27.1	25.3	24.8
Diverse Industries	3.7	3.1	2.8	3.0	2.7	2.2	2.2	2.2
Revenue by Service Lines								
Digitally Empowered Contact Centre	55.2	51.8	49.8	51.2	47.8	49.1	48.9	47.2
Intelligent Back Office	39.6	42.6	45.0	42.5	44.2	42.9	44.8	47.9
Platforms, Automation & Analytics	5.2	5.6	5.2	6.3	8.0	8.0	6.3	4.9
Revenue by Geography								
US	57.0	61.6	63.3	63.2	69.1	68.1	67.1	67.4
UK	41.6	36.9	35.3	35.3	29.7	30.6	31.5	31.5
Rest of World	1.4	1.5	1.4	1.5	1.2	1.3	1.4	1.1
Revenue by Delivery								
Offshore	22.5	22.8	25.2	25.6	24.8	27.0	29.8	30.6
Onshore	77.5	77.2	74.8	74.4	75.2	73.0	70.2	69.4
Top Clients Revenue								
Top client	24.9	19.8	19.5	20.3	13.7	16.2	17.5	17.5
Top 5 client-%	41.2	39.5	42.1	42.2	39.9	40.4	41.4	42.3
Other Metrics								
Total employees (end of period)	18,550	20,001	20,482	21,203	21,831	23,960	26,618	28,004
• Employees in India	9,305	10,493	10,982	11,450	11,684	13,536	15,381	16,289
• Employees outside India	9,245	9,508	9,500	9,753	10,147	10,424	11,273	11,715
Net Addition	-162	1,451	481	721	628	2129	2658	1386
Offshore Attrition	45.3	40.0	36.0	33.5	15.1	26.3	28.8	28.6
Onshore Attrition	46.8	54.6	45.8	41.9	30.2	47.3	34.6	40.0

Firstsource Solutions Ltd.

Change in Estimates

Rs in Cr	FY21		FY22E		FY23E
	Estimates	Actual	Old	Revised	New
Revenue	4572	5078	5060	6009	6921
EBIT	520	598	594	734	857
APAT	406	362	474	572	668
EPS	5.8	5.1	6.8	8.2	9.6

(Source: Company, HDFC sec)

Peer Comparison

Company, Rs in Cr	Mkt Cap, Cr	Sales			EBIT			PAT			ROE-%			P/E (x)		
		FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
eClerx	5954	1564	1820	1988	366	425	489	283	326	356	19.4	17.2	16.0	21.0	18.3	16.7
Firstsource Sol-	11451	5078	6009	6921	598	734	857	362	572	668	17.1	19.3	20.1	31.7	20.0	17.1

Firstsource Solutions Ltd.

Financials (Consolidated)

Income Statement

(Rs Cr)	FY19	FY20	FY21	FY22E	FY22E
Net Revenues	**3826**	**4099**	**5078**	**6009**	**6921**
Growth (%)	8.2	7.1	23.9	18.3	15.2
Operating Expenses	3291	3470	4274	5029	5800
EBITDA	**535**	**629**	**804**	**979**	**1121**
Growth (%)	**16.7**	**17.4**	**27.9**	**21.8**	**14.5**
EBITDA Margin (%)	**14.0**	**15.3**	**15.8**	**16.3**	**16.2**
Depreciation	74	185	206	246	264
EBIT	**461**	**444**	**598**	**734**	**857**
Other Income	4	9	1	9	10
Interest expenses	29	58	52	45	42
PBT	**436**	**394**	**547**	**697**	**825**
Tax	58	55	70	126	157
RPAT	**378**	**340**	**477**	**572**	**668**
APAT	**378**	**340**	**362**	**572**	**668**
Growth (%)	15.7	-10.1	6.5	58.1	16.9
EPS	5.5	4.9	5.1	8.2	9.6

Balance Sheet

As at March	FY19	FY20	FY21E	FY22E	FY22E
SOURCE OF FUNDS					
Share Capital	691	694	696	697	697
Reserves	2030	2072	2103	2431	2821
Shareholders' Funds	**2721**	**2765**	**2799**	**3128**	**3518**
Long Term Debt	7	3	85	65	50
Net Deferred Taxes	-185	-178	-222	-198	-205
Long Term Provisions & Others	7	414	497	449	405
Minority Interest	**1**	**1**	**1**	**1**	**1**
Total Source of Funds	**2550**	**3005**	**3159**	**3444**	**3768**
APPLICATION OF FUNDS					
Net Block & Goodwill	2225	2871	2998	3002	2958
CWIP	0	0	0	0	0
Other Non-Current Assets	369	361	332	322	332
Total Non Current Assets	**2593**	**3232**	**3329**	**3324**	**3290**
Current Investments	0	0	0	0	0
Inventories	0	0	0	0	0
Trade Receivables	387	557	577	691	815
Cash & Equivalents	169	191	220	319	442
Other Current Assets	295	357	435	413	403
Total Current Assets	**851**	**1104**	**1231**	**1424**	**1660**
Short-Term Borrowings	539	834	437	396	366
Trade Payables	90	95	279	247	228
Other Current Liab & Provisions	266	401	686	661	589
Total Current Liabilities	**895**	**1331**	**1402**	**1304**	**1183**
Net Current Assets	-44	-227	-170	119	478
Total Application of Funds	**2550**	**3005**	**3159**	**3444**	**3768**

Firstsource Solutions Ltd.

Cash Flow Statement

(Rs Cr)	FY19	FY20	FY21	FY22E	FY23E
Reported PBT	436	394	432	697	825
Non-operating & EO items	-12	-38	65	16	-26
Interest Expenses	29	58	52	45	42
Depreciation	74	185	206	246	264
Working Capital Change	-64	-135	290	-201	-257
Tax Paid	-63	-54	-70	-126	-157
OPERATING CASH FLOW (a)	**400**	**410**	**976**	**677**	**691**
Capex	-108	-95	-170	-249	-218
Free Cash Flow	292	316	806	428	472
Investments	-97	108	-181	-1	-1
Non-operating income	1	1	1	9	10
INVESTING CASH FLOW (b)	**-204**	**14**	**-350**	**-241**	**-209**
Debt Issuance / (Repaid)	-133	159	-376	-60	-45
Interest Expenses	-28	-58	-51	-45	-42
FCFE	130	417	378	323	386
Share Capital Issuance	14	-1	-57	0	0
Dividend	-125	-376	-204	-244	-279
FINANCING CASH FLOW (c)	**-273**	**-277**	**-689**	**-349**	**-365**
NET CASH FLOW (a+b+c)	**-77**	**148**	**-63**	**87**	**116**

Key Ratios

(Rs Cr)	FY19	FY20	FY21	FY22E	FY23E
Profitability Ratio (%)					
EBITDA Margin	14.0	15.3	15.8	16.3	16.2
EBIT Margin	12.0	10.8	11.8	12.2	12.4
APAT Margin	9.9	8.3	7.1	9.5	9.7
RoE	14.9	12.4	17.1	19.3	20.1
RoCE	14.9	11.8	15.5	16.9	18.0
Solvency Ratio (x)					
Net Debt/EBITDA	1.0	1.3	0.6	0.5	0.4
Net D/E	0.2	0.3	0.2	0.1	0.1
Per Share Data (Rs)					
EPS	5.5	4.9	5.2	8.2	9.6
CEPS	6.5	7.6	8.2	11.7	13.4
BV	39.4	39.9	40.2	44.9	50.5
Dividend	2.0	2.5	3.0	3.5	4.0
Turnover Ratios (days)					
Debtor days	36.9	49.6	41.5	42.0	43.0
Inventory days	0.0	0.0	0.0	0.0	0.0
Creditors days	8.6	8.5	20.0	15.0	12.0
Valuation (x)					
P/E	30.1	33.6	31.7	20.0	17.1
P/BV	4.2	4.1	4.1	3.7	3.3
EV/EBITDA	21.9	19.2	14.6	11.8	10.2
EV / Revenues	3.1	2.9	2.3	1.9	1.7
Dividend Yield (%)	1.2	1.5	1.8	2.1	2.4
Dividend Payout (%)	36.6	51.1	57.7	42.6	41.7

(Source: Company, HDFC sec)

Firstsource Solutions Ltd.

One Year Stock Price Chart

(Source: Company, HDFC sec)

Disclosure:

I**, Abdul Karim, (MBA),** authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. HSL has no material adverse disciplinary history as on the date of publication of this report. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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