

View on stock - Firstsource Solutions Ltd.

September 22, 2008

Price: Rs37.30

CNX Midcap: 5298

MCap: Rs1597Cr (\$345mn)

52-wk High/Low: Rs90/29

Rating: Value Buy

Executive Summary

- Firstsource Solutions Ltd. (FSL) is a third party BPO service provider in the verticals of BFSI, telecommunications & media and healthcare. The company employs 18,353 personnel and provides services in the US, European and Asia-Pacific regions.
- While the company operates in the low margin BPO space, we have a **positive view** on the company due to factors including (i) management pedigree (promoted by ICICI) (ii) sustainable business model with decent size (iii) well-established track record in managing overseas acquisitions (iv) reducing contribution from the BFSI segment, impacted by the ongoing financial turmoil.
- The company's revenues and earnings grew at CAGR of 53.8% and 127.3% respectively over FY06-08. It has a good track record of inorganic growth as well.
- Nasscom, software body of India has set a target of \$60bn worth exports by the Indian IT industry by FY10. However given the recent, unprecedented banking and financial crisis in the US and other developed countries the target is unlikely to be achieved. The US and UK which were severely impacted in the ongoing crisis, account for almost 80% of aggregated revenues of Indian IT firms.
- Exchange rate fluctuations is another concern for Indian BPO industry. Crude and commodity price fluctuations and financial turmoil in the US have already increased the volatility of the currency trades multi-fold.
- FSL is vulnerable to the slowdown in the US economy and exchange rate fluctuations as 62% of its revenues is attributable to the US. In our view, overdependence on the US is a major risk.
- High proportion of onshore revenues (58%) is a negative. Of the manpower of 18,353, as many as 4,447 are outside India; we believe most of these may be 'onshore'. We perceive the high proportion of onshore revenues and personnel as a risk, in terms of lower margins.
- However, substantial reduction in exposure to the BFSI segment (the worst affected in the ongoing turmoil in the US financial markets) is a major positive. Contribution of BFSI segment reduced from 37.1% in Q1FY08 to 27.7% in Q1FY09. However, even such exposure to the US financial segment may be considered a risk in view of the problems in the US.
- The company reported 8.5% Q-o-Q revenue growth in Q1FY09 and a net loss of Rs50Cr. EBITDA margin declined from 16.6% in Q4FY08 to 14.8% in Q1FY09, due to a decline in grant income, seasonality factors and cost of work on Airtel contract, for which revenues are yet to be realised. However, the MTM loss of Rs80Cr on FCCBs is the reason behind the net loss.
- The pricing for contracts is generally based on the target margin levels, which ensures higher sustainability of margins. However this pricing strategy may also lead to risks associated with currency fluctuations and the more than expected increase in staff costs.
- Goodwill of Rs1888Cr (\$408mn) is reflected on the balance sheet, as a result of the three acquisitions. We believe goodwill can be a contentious issue; goodwill not written off may translate into a charge in future, impairing profitability going forward. We note that ROE increased from 8.7% in FY07 to 17.3% in FY08, mainly due to write off of Rs434Cr premium payable on redemption on FCCBs.
- The stock trades at 24x FY09E and 9.5x FY10E EPS. We believe the stock is a **value buy** at current levels, with a long term perspective.

Consolidated Quarterly Results

(RsCr)

	Q1FY07	Q4FY08	Q1FY09	(Q-o-Q) Growth	(Y-o-Y) Growth
Net Sales	273.11	375.62	407.89	8.6%	49.4%
Total Expenditure	214.83	313.37	347.38	10.9%	61.7%
EBITDA	58.28	62.25	60.51	-2.8%	3.8%
Other Income	4.80	3.61	1.68	-53.5%	-65.0%
Interest	-6.22	2.00	2.31	15.5%	NA
Forex Loss on FCCBs	-	19.25	80.16	316.4%	NA
PBDT	69.30	44.61	-20.28	NA	NA
Depreciation	18.89	22.70	22.33	-1.6%	18.2%
PBT	50.41	21.91	-42.61	NA	NA
Tax	9.63	6.22	8.46	-	-
Fringe Benefit Tax	0.39	1.06	0.51	-	-
Deferred Tax	-3.83	-5.99	-1.54	-	-
Reported Profit After Tax	44.22	20.62	-50.04	NA	NA
Minority Interest After NP	-0.09	-0.40	0.01	NA	NA
Net Profit after Minority Interest	44.31	21.02	-50.05	NA	NA
Extra-ordinary Items	0.00	0.00	0.00	-	-
Adj. Profit After Extra-ord. item	44.31	21.02	-50.05	NA	NA
PAT, before exchange loss on FCCB	44.31	40.45	30.11	-25.6%	-32.0%
EBITDA margin	21.3%	16.6%	14.8%	-1.7%	-6.5%
EPS (Rs) Including loss on FCCB	1.04	0.49	-1.17	-	-
EPS (Rs) Excluding loss on FCCB	1.04	0.95	0.70	-	-
Paid-up Equity Capital	425.16	427.31	427.31	-	-
Employee cost / Sales	55.8%	57.3%	58.4%	1.1%	2.6%

Analysis of Q1FY09 Results

- FSL recorded Q-o-Q revenue growth of 8.7%. EBITDA margin fell from 16.6% in Q4FY08 to 14.8% in Q1FY09, impacted by slower revenue growth. As the Airtel contract is in the ramp-up stage, its contribution to revenues had not commenced. However, the company had to provide for the costs. The other factor is the decline in the grant income by Rs6.3Cr. The company was also affected by seasonality factor, as Q1 is the leanest quarter.
- Q1 Performance was impacted by forex losses (Rs80Cr, vis-à-vis Rs19Cr in FY98) on outstanding FCCBs. As a result, FSL reported net losses of Rs50.1Cr.
- While adverse impact of FCCBs is a negative, a cause for concern is the declining profitability of the core business, both on y-o-y and q-o-q basis, even without considering forex losses on FCCBs (EBITDA margin down from 21.3% in Q1-FY07 to 16.6% in Q4-FY07, to 14.8% in Q1-FY09, and net profit before FCCB losses down from Rs44.31Cr, to Rs40.45Cr, to Rs30.11Cr respectively).
- Client concentration (top 5 clients) improved from 31.2% to 30.9%, with the largest client accounting for less than 10% revenues in the quarter. However, attrition rate deteriorated from 28.3% in Q1FY08 to 38.7% in Q1FY09.

Management Guidance

FSL expects revenues to grow by 33-38% and EBIT margin at 9.5%.

Financial Snapshot

(RsCr)

	FY06	FY07	FY08	FY09E	FY10E
Net Sales	548.75	831.02	1298.79	1662.45	2094.69
<i>Growth</i>	-	51.4%	56.3%	28.0%	26.0%
Net Profit	24.80	92.26	128.13	66.50	167.58
<i>Growth</i>	-	272.0%	38.9%	-48.1%	152.0%
EBITDA margin	14.5%	20.1%	18.0%	14.0%	14.5%
EPS (Rs)	0.62	2.17	3.00	1.55	3.91
P/e (x)	-	33.3	12.2	24.0	9.5
P/s (x)	-	3.7	1.2	1.0	0.8
Paid-up Equity Capital	399.47	425.08	427.31	428.19	428.19

Company Background

Incorporated in 2001, Firstsource Solutions Ltd. (FSL) is a provider of BPO services in the verticals of BFSI, telecommunications, media and healthcare. The company operates from 36 global delivery centers and employs 18,353 personnel across India, the US, UK, Argentina and the Philippines.

Business Overview

FSL provides BPO services mostly to clients in North America, the UK and the APAC region. Its clients include 3 of the 5 largest US banks, 5 of the 10 largest credit card companies in the US, 2 of the world's top 10 telecom companies, 3 "Fortune 100" healthcare insurance companies and over 800 hospitals in the US.

It provides a comprehensive range of services to clients across the customer life cycle in each of its focus industries. FSL has in-depth domain knowledge in these industries with proven expertise in transferring business operations from clients to its delivery centers and in administering, managing and further improving these processes for its clients. It has till date successfully transferred over 500 processes covering a broad array of products and services to its service delivery centers.

Services offerings

BFSI	Telecommunications and Media	Healthcare
<p>Banking</p> <ul style="list-style-type: none"> Account enquiries and transfers Forex transactions Account and check processing <p>Card solutions</p> <ul style="list-style-type: none"> Activation and authorization Lost and stolen card reissuance, etc. <p>Collections Mortgage Banking</p> <ul style="list-style-type: none"> Loan origination processing Loan servicing Regulatory compliance <p>Insurance</p> <ul style="list-style-type: none"> Quotation requests Policy amendment/cancellation Data and trend analysis <p>Trust and asset management solutions</p> <ul style="list-style-type: none"> Middle and back office processes for debt and forex trade <p>Research and analytics</p>	<p>Telecommunications</p> <ul style="list-style-type: none"> New orders and disconnects Order provisioning and fulfillment Circuit design Customer service & disputes resolution Billing support Churn management Early/Late stage collections Skip tracing Fraud monitoring & prevention Contract Management <p>Media</p> <ul style="list-style-type: none"> Customer service Billing support DSL, DTH and cable products <p>Installation and Technical support</p> <ul style="list-style-type: none"> Networks team scheduling and ticket management <p>Research and analytics</p>	<p>Payor</p> <ul style="list-style-type: none"> Enrollment services Mail and document management Claims processing, pricing Claims adjudication and adjustment Provider database maintenance <p>Provider</p> <ul style="list-style-type: none"> Front-end patient services Eligibility services Receivables management Collections

Profit & Loss Statements (RsCr)

For y.e. March 31,	2006	2007	2008
Net Sales	548.75	831.02	1298.79
Expenditure			
Operating Exps	24.16	49.91	62.16
Employee Cost	282.17	412.23	709.80
Power/Electricity Charges	8.22	11.02	17.93
Selling and Admin Exp.	146.12	184.52	268.28
Misc. Exps	8.41	6.52	6.25
Total Expenditure	469.08	664.20	1064.42
EBITDA	79.67	166.82	234.37
Other Income	1.37	13.30	44.94
Interest	8.93	13.34	50.04
PBDT	72.11	166.78	229.27
Depreciation	45.15	64.15	86.08
Profit Before Tax	26.96	102.63	143.19
Tax	2.70	6.01	12.65
Reported Profit	24.26	96.62	130.54
Minority Interest	-0.41	-0.63	-1.02
Extraordinary Items	-0.13	4.99	3.43
Adjusted Profit After Tax	24.80	92.26	128.13
EBITDA margin	14.5%	20.1%	18.0%
EPS (Rs)	0.62	2.17	3.00
Book Value (Rs)	10.82	25.09	17.32
Paid-up Equity Cap	399.47	425.08	427.31
Employee cost / Sales	N.A.	50.6%	57.4%
ROE	5.7%	8.7%	17.3%

Balance Sheets (RsCr)

As at March 31,	2006	2007	2008
Sources of Funds			
Share Capital	399.47	425.08	427.31
Reserves Total	32.75	641.47	312.73
Total Shareholders Funds	432.22	1066.55	740.04
Minority Interest	4.92	4.30	3.64
Secured Loans	73.11	71.20	59.66
Unsecured Loans	56.91	126.39	1195.52
Total Debt	130.02	197.59	1255.18
Total Liabilities	567.16	1268.44	1998.86
Applications of Funds			
Gross Block	664.84	931.05	2422.05
Less: Acc. Depr.	148.65	217.11	320.36
Net Block	516.19	713.94	2101.69
CWIP	6.42	8.20	8.92
Investments	0.00	115.25	22.12
Current Assets, Loans & Adv.			
Inventories	0.00	0.00	0.00
Sundry Debtors	100.69	133.54	205.38
Cash and Bank	28.29	312.58	105.91
Loans and Advances	45.73	133.48	145.07
Total Current Assets	174.71	579.60	456.36
Total Current Liabilities	130.55	148.46	608.68
Net Current Assets	44.16	431.14	-152.32
Misc. Exps not w/o	0.00	0.00	0.00
Net Deferred Tax	0.39	-0.09	18.45
Total Assets	567.16	1268.44	1998.86

Revenue Structure**Geographical Revenue break-up**

	FY07	FY08	Q1FY08	Q4FY08	Q1FY09
North America	47.3%	54.0%	44.9%	61.6%	61.8%
UK	48.7%	35.0%	44.0%	28.8%	27.9%
India	3.8%	10.8%	10.9%	9.5%	10.2%
Rest of world	0.2%	0.1%	0.2%	0.1%	0.1%

Segmental Revenue break-up

	FY07	FY08	Q1FY08	Q4FY08	Q1FY09
BFSI	51.8%	30.8%	37.1%	28.5%	27.7%
Telecom & Media	34.0%	36.0%	44.4%	29.1%	30.8%
Healthcare	9.1%	29.8%	13.7%	39.5%	39.0%
Others	5.1%	3.4%	4.8%	2.9%	2.5%

Offshore Onshore Revenue mix

	FY07	FY08	Q1FY08	Q4FY08	Q1FY09
Offshore	68.7%	50.4%	61.0%	42.0%	42.0%
Onshore	31.3%	49.6%	39.0%	58.0%	58.0%

Keynote Capitals Ltd.

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