

**CMP: INR 116**

**Rating: Reduce**

**Target Price: INR 101**

**Stock Info**

BSE	532809
NSE	FSL
Bloomberg	FSOL:IN
Reuters	FISO.BO
Sector	IT Enabled Services
Face Value (INR)	10
Equity Capital (INR Cr)	697
Mkt Cap (INR Cr)	7,844
52w H/L (INR)	167/ 93
Avg Yearly Vol (in 000')	3300

**Shareholding Pattern %**

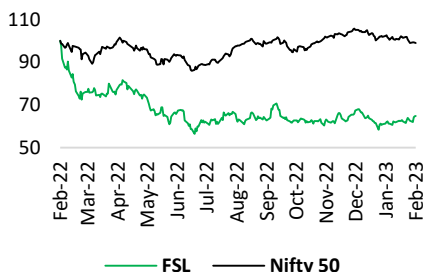
(As on Dec, 2022)

Promoters	53.66
FII	8.41
DII	14.81
Public & Others	24.82

**Stock Performance (%)**

	1m	6m	12m
FSL	10.7	11.05	-29.4
Nifty 50	-2.61	2.12	1.12

**FSL Vs Nifty 50**



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**First Source Solutions Ltd (FSL) in Q3FY23, revenue above our estimates and narrowed FY23 guidance from -2%-0% to -2%-1% in cc term excluding mortgage and acquisitions, expect growth of 12.5% to 14.5%:** The company reported revenue at INR15,049 mn (US\$ 183 mn against estimate of US \$ 193 mn ), y/y growth of 2.8% against our estimate of INR 14, 930 and de-growth of 0.3% in Constant Currency.

**Expansion in Margin led by cost action:** Operating Margin at INR 1,409 mn against our estimate of INR 1,320 mn. Margin at 9.4% above our estimate of 8.8% led by cost management and strong pipeline. The company has guided for operating margins to land in the range of 9.25% to 9.5% for FY23. The company is in plan to hit a normalized margin range in Q4 from the revenue growth and the net impact of YTD cost actions.

**PAT Higher due to reversal of the provision:** The company, during the quarter reported Profit After Tax (PAT) at INR 1,579 mn against our estimate of INR 1,319 mn as the other income was high due to reversal of the provision of INR 27.9 crore towards variable pay out for acquired companies as they did not meet the revenue target (due to adverse market conditions). The company also indicated that other income also included an amount of INR 31.9 crore from a mortgage contract as it had contingent pay out clause and based on recent revaluation of revenues it generated other income.

**Steady Collection Segment:** In the collection segment, FSL remains on track, but the pace is still picking up. Overall US card delinquencies rose steadily 2.08% against 1.85% in the last quarter and charge-offs were it 2.02% against 1.86% last quarter. These are still lower than historical averages, despite rising interest rates high inflation and higher outstanding debt towards the standards. This is primarily due to the still very low unemployment rate and the strong housing in the US that seen in the past 40 years.

**Valuations**

The company has reassessed growth visibility and lowered guidance to -2%-0% from -2%-1% for the FY23 in the CC term. The guidance adjustment is due slowdown in the mortgage business, the slower ramp-up in the collections business & slower decision-making in healthcare deals that impacted the revenue growth of the company. Q4FY23e is expected in the range of 1-5% & aspiring exit operating margin band of 11.5-12% led by the continuance of cost rationalization programs. We believe Inorganic opportunities in adjacent capabilities may help to address the growth concerns **We value FSL at a PE of 12x to its FY25E EPS of INR 8.4, which yields a target price of INR 101 per share (earlier target price; of INR 93 per share). We maintain our rating to Reduce on the stock.**

**Exhibit 1 Financial Performance**

Particular	FY22	FY23E	FY24E	FY25E
Sales	5,921	6,099	6,709	7,380
EBIT	710	571	691	778
Reported PAT	537	412	511	588
EBITM (%)	12.0%	9.4%	10.3%	10.5%
PE (x)	14.7	19.7	15.8	13.8
EPS	7.9	5.9	7.3	8.4

Source: Arihant Research, Company Filings

## Exhibit 2: Q3FY23 - Quarterly Performance (Consolidated)

Consolidated (in INR Cr)	Q3FY23	Q2FY23	Q3FY22	Q-o-Q	Y-o-Y
<b>Revenue (CC Terms) (Mn USD)</b>	<b>183</b>	<b>187</b>	<b>195.4</b>	<b>-2.1%</b>	<b>-6.3%</b>
<b>Net Revenue</b>	1,505	1,488	1,464	1.1%	2.8%
Employee cost	986	953	968	3.5%	1.9%
Other Expenses	309	344	258	-10.1%	19.7%
<b>EBITDA</b>	<b>210</b>	<b>192</b>	<b>238</b>	<b>9.4%</b>	<b>-11.9%</b>
<b>EBITDA margin %</b>	<b>13.9%</b>	<b>12.9%</b>	<b>16.3%</b>	<b>105bps</b>	<b>-337bps</b>
Depreciation	69	66	62	3.7%	11.5%
EBIT	141	125	176	12.4%	-20.0%
<b>EBIT margin %</b>	<b>9.4%</b>	<b>8.4%</b>	<b>12.0%</b>	<b>94bps</b>	<b>-267bps</b>
Other Income	62	49	0		
Finance costs	20	20	15	-0.7%	30.6%
<b>PBT</b>	<b>183.7</b>	<b>155</b>	<b>161</b>	<b>18.6%</b>	<b>13.8%</b>
Exceptional item	-	-	-		
<b>PBT and share net profit</b>	<b>184</b>	<b>155</b>	<b>161</b>	<b>18.6%</b>	<b>13.8%</b>
Tax Expense	26	26	26	0.9%	-0.6%
Effective tax rate %	14.0%	16.5%	16.1%	-246bps	-203bps
<b>PAT</b>	<b>157.9</b>	<b>129.4</b>	<b>135</b>	<b>22.0%</b>	<b>16.6%</b>
Non-controlling interest	-0	-0	-0	-50.0%	-83.3%
<b>Consolidated PAT</b>	<b>157.923</b>	<b>129.40</b>	<b>135.45</b>	<b>22.0%</b>	<b>16.6%</b>
<b>Reported PAT</b>	<b>157.92</b>	<b>129.40</b>	<b>135.45</b>	<b>22.0%</b>	<b>16.6%</b>
<b>PAT margin %</b>	<b>10.5%</b>	<b>8.7%</b>	<b>9.3%</b>	<b>180bps</b>	<b>13.4%</b>
<b>EPS (INR)</b>	<b>2.3</b>	<b>1.9</b>	<b>2.0</b>	<b>22.1%</b>	<b>16.6%</b>

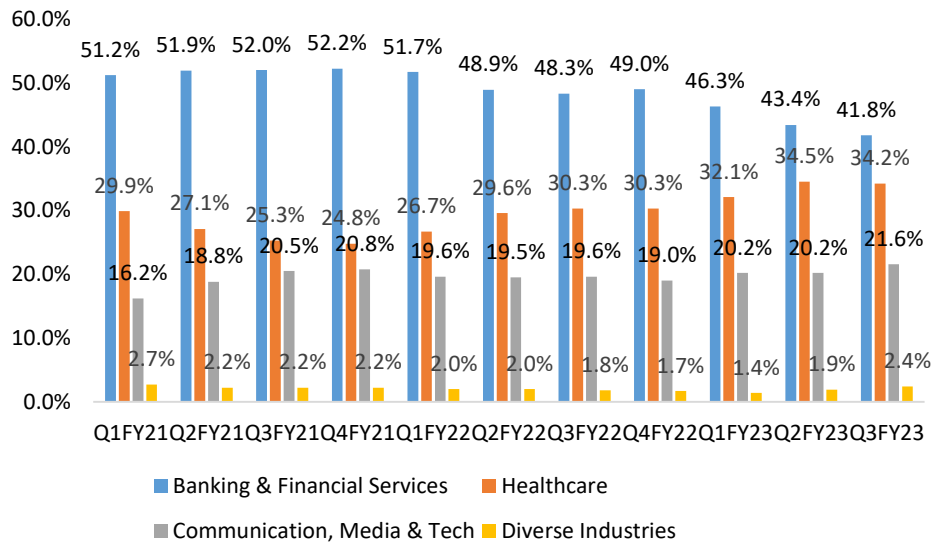
Consolidated (in INR Cr)	Q3FY23	Q2FY23	Q3FY22	Q-o-Q	Y-o-Y
Banking and Financial Services	626	639	698.845	-2.1%	-10.4%
Healthcare	514	508	438.062	1.0%	17.3%
Communication, Media and Technology	329	296	282.704	11.0%	16.3%
Diverse Industries	35	30	26.03	17.2%	34.1%

Source: Arian Research, Company Filings

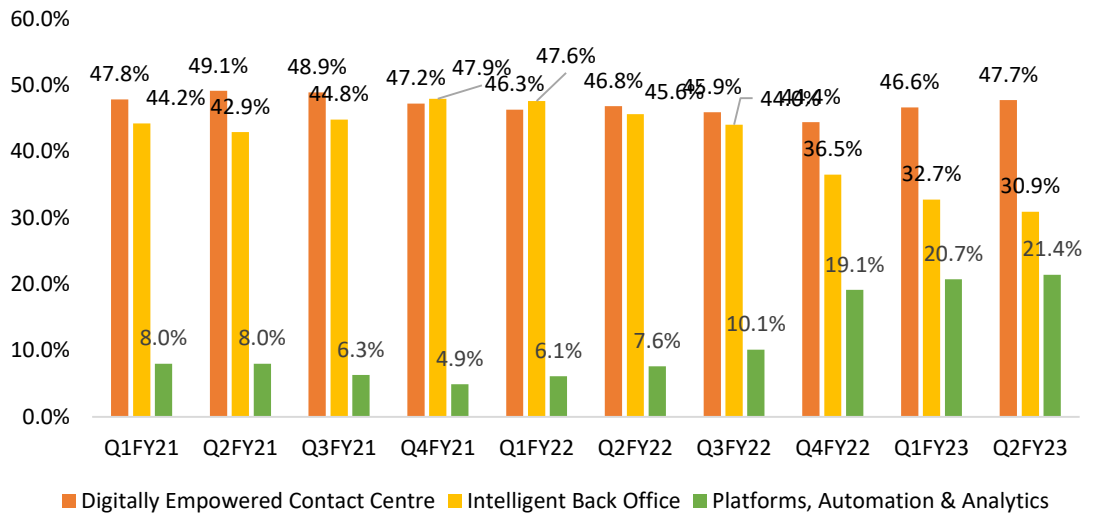
**Q3FY23 Conference call highlights**

- **Guidance:** The company indicated that due to impact of changes in the macro environment on the company's core & acquired business led to the constant changes in the guidance numbers for the year. The management expect revenue growth of minus 2% to minus 1%, excluding mortgage and acquisitions, we expect growth of 12.5% to 14.5%, we expect operating margins to land in the range of 9.25% to 9.5% for this fiscal year.
- **Q4FY23e:** the company is guiding for revenue growth in the range of 1-5% & aspiring exit operating margin band of 11.5-12%. FSL further indicated that this band will be the new base for FY24 margins and the levers for margin improvement in Q4 are increase in revenue & the continuance of cost rationalization programs
- **EBIT margin** of the company increased ~100 bps QoQ to 9.4% as it continues its cost rationalisation activities. FSL also indicated that some expenses during the quarter were also attributed to lower revenue generated during the quarter. The company indicated that cost rationalisation led savings i.e. 70% mix, are sustainable while 30% savings may be come up again in subsequent quarters as they are linked to revenue growth.
- FSL indicated that the organic business excluding mortgage & acquisitions grew 18.6% YoY in CC terms. FSL indicated that slowdown in mortgage business, slower ramp-up in the collections business & slower decision making in healthcare deals impacted the revenue growth of the company
- **Delinquency:** The US economy slowing down and delinquency is expected to rise. The company is seeing increased market activity and the clients need for capacity planning.
- **Deal pipeline** for collection is at its highest and possibly the most diversified. It has been across different industry segments. In this quarter, the company added seven new clients across FinTech Healthcare Finance and Communications. Diversifying beyond credit cards and BFS has been focus in the last quarter 4 months.
- **Portfolio:** The strong portfolio of late-stage and can collections underpinned by market leading digital collections platform and a strong momentum this year all position strongly to harness the likely volume growth over the coming quarters.
- **Geography wise:** US (65% mix) declined 5.5% QoQ while UK (34% mix) reported strong growth of 6.6% QoQ. Vertical wise in CC terms BFS (42% of mix) declined 14.1% YoY and excluding mortgage & acquisitions BFS grew 30% YoY. Health care & CMT reported growth of 7.2% & 17.5% YoY in CC terms.
- **Segments:** BFS front, mortgage business continues to be under pressure due to macro environments. The company indicated that the mortgage business declined 20% QoQ in Q3 & contributed ~10% of Q3 revenues and the company further expects the revenue contribution to decline to 8-8.5% in Q4FY23. The company indicated that interest rate may likely slow down its pace and bring in some volume back in this business. The company also mentioned that the mix between origination & servicing was at 35/65 and now it is also witnessing pressure in the servicing side as well. FSL further indicated that it expects that as home purchase volumes picks up it will see some uptick in the originating business but not in the refinance business. The company also said that though servicing business is now witnessing pressure it does not expect additional adverse impact as it is already down to 8-9% of overall revenues.
- On the M&A front the company mentioned that the acquisitions of Stonehill and ARSI did not fare as per expectations as the impact of macro headwinds was more severe on their businesses
- **The company indicated that the growth in the medium term will be driven by:** a) growing by building adjacent vertical capabilities, acquiring new clients & growing strategic account, b) diversifying its BFS business & continue to grow its Health & CMT verticals to make the company's business less cyclical.
- **Headcount:** The company's net employees declined by 305 bringing the total employees to 23,627. FSL's onshore attrition declined 480 bps to 47.2% while its offshore attrition declined 130 bps 44.4%.
- **In CMT vertical,** the company indicated that it witnessing steady growth in clients. FSL indicated that the US region CMT vertical performance is growing strongly. The company added that US CMT grew 63.8% YoY in CC terms and it expects it to grow strongly, going forward. The company added four new clients during the quarter including two major tech companies.

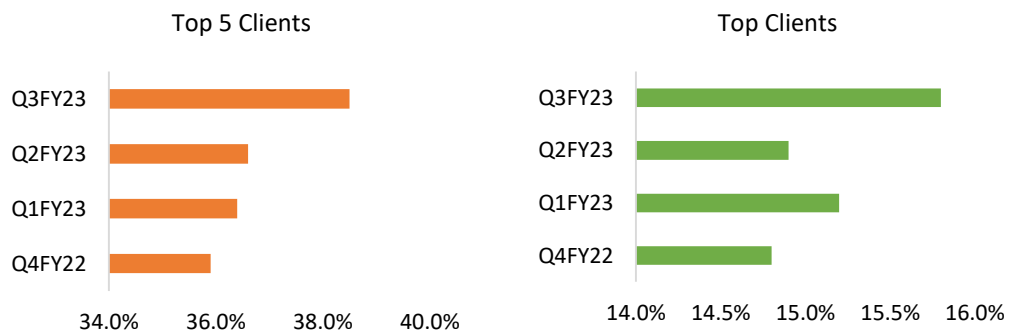
**Exhibit 3: Revenue Split by Verticals-Increase mix in Diverse industries**



**Exhibit 4: Revenue Split by Service line trend**



**Exhibit 5: Tech will become a good growth driver going forward and added new clients during this quarter.**



Source: Aриhant Research, Company Filings

## Key Financials

## Income Statement (INR Cr)

Year End-March	FY22	FY23E	FY24E	FY25E
<b>Revenues</b>	5,921	6,099	6,709	7,380
Change (%)	16.60%	3.0%	10.0%	10.0%
Employee costs	3,947	4,178	4,562	5,018
Other expenses	1,015	1,067	1,153	1,255
<b>Total Expenses</b>	<b>4,961</b>	<b>5,244</b>	<b>5,714</b>	<b>6,273</b>
<b>EBITDA</b>	<b>960</b>	<b>854</b>	<b>994</b>	<b>1,107</b>
<b>EBIDTA Margin</b>	<b>16.21%</b>	<b>14.01%</b>	<b>14.82%</b>	<b>15.00%</b>
Depreciation	249	283	303	329
<b>EBIT</b>	<b>710</b>	<b>571</b>	<b>691</b>	<b>778</b>
<b>EBIT Margin</b>	<b>12.00%</b>	<b>9.37%</b>	<b>10.31%</b>	<b>10.54%</b>
Interest	64	69	72	67
Other Income	1	1	1	1
<b>PBT</b>	<b>647</b>	<b>502</b>	<b>620</b>	<b>712</b>
Exceptional Items	0	0	0	0
<b>PBT after exceptional Items</b>	<b>647</b>	<b>502</b>	<b>620</b>	<b>712</b>
Tax	111	90	108	125
Rate (%)	17.1%	18.0%	17.5%	17.5%
<b>PAT</b>	<b>537</b>	<b>412</b>	<b>511</b>	<b>588</b>
<b>Margin</b>	<b>9%</b>	<b>7%</b>	<b>8%</b>	<b>8%</b>
<b>Consolidated PAT</b>	<b>537</b>	<b>412</b>	<b>511</b>	<b>588</b>
Change (%)	48.3%	-23.2%	24.2%	14.9%

## Cash Flow Statement (INR Cr)

Year End-March	FY22	FY23E	FY24E	FY25E
<b>PBT</b>	<b>647</b>	<b>502</b>	<b>620</b>	<b>712</b>
Cash From Operating Activities	798	1,086	940	1,048
Tax	94	90	108	125
Net Cash From Operations	704	996	831	923
<b>Capex</b>	<b>12</b>	<b>-65</b>	<b>-65</b>	<b>-66</b>
Cash From Investing	-595	-164	-164	-165
Borrowings	390	-50	-50	-50
<b>Finance cost paid</b>	<b>-58</b>	<b>-69</b>	<b>-72</b>	<b>-67</b>
Cash From Financing	-158	-363	-366	-352
<b>Net Increase/ Decrease in Cash</b>	<b>-49</b>	<b>468</b>	<b>301</b>	<b>406</b>
<b>Cash at the beginning of the year</b>	<b>132</b>	<b>83</b>	<b>551</b>	<b>852</b>
Cash at the end of the year	83	551	852	1,258

## Balance Sheet (INR Cr)

Year End-March	FY22	FY23E	FY24E	FY25E
<b>Sources of Funds</b>				
Share Capital	697	697	697	697
Reserves & Surplus	2,336	2,504	2,772	3,115
Non controlling interest	0	0	0	0
<b>Total Equity</b>	<b>3,033</b>	<b>3,201</b>	<b>3,469</b>	<b>3,813</b>
<b>Loan Funds</b>	<b>1,010</b>	<b>771</b>	<b>721</b>	<b>671</b>
Deferred Tax Liability (Net)	96	96	96	96
<b>Total Liability</b>	<b>5,709</b>	<b>5,588</b>	<b>5,851</b>	<b>6,193</b>
<b>Application of Funds</b>				
Gross Block	1,092	1,156	1,221	1,286
Less: Depreciation	742	880	1,064	1,321
Net Block	350	276	157	-34
CWIP	0	0	0	0
Financial Assets	1,195	1,481	1,861	2,353
Investments	119	119	119	119
<b>Sundry debtors</b>	<b>961</b>	<b>785</b>	<b>864</b>	<b>950</b>
Cash and bank	90	551	852	1,258
Other Current Assets	199	199	199	199
Total Current assets	1,421	1,707	2,087	2,579
Total Current liabilities	799	881	926	975
Total Non-Current assets	<b>4,288</b>	<b>3,881</b>	<b>3,765</b>	<b>3,614</b>
<b>Capital Employed</b>	<b>5,709</b>	<b>5,588</b>	<b>5,851</b>	<b>6,193</b>

## Key Ratios

Year End-March	FY22	FY23E	FY24E	FY25E
<b>Per share (INR)</b>				
EPS	7.9	5.9	7.3	8.4
BVPS	44	46	50	55
<b>Valuation (x)</b>				
P/E	14.7	19.7	15.8	13.8
P/BV	2.7	2.5	2.3	2.1
EV/EBITDA	9.4	9.7	8.0	6.8
<b>Return ratio (%)</b>				
EBIDTA Margin	16.2%	14.0%	14.8%	15.0%
EBIT Margin	12.0%	9.4%	10.3%	10.5%
PAT Margin	9.1%	6.8%	7.6%	8.0%
ROE	17.7%	12.9%	14.7%	15.4%
ROCE	12.4%	10.2%	11.8%	12.6%
<b>Leverage Ratio (%)</b>				
Total D/E	0.3	0.2	0.2	0.2
<b>Turnover Ratios</b>				
Asset Turnover (x)	4.2	3.6	3.2	2.9
Receivable Days	47	47	47	47
Payable days	14	14	14	14

Source: Arianth Research, Company Filings, Ace Equity, Bloomberg

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Stock Rating Scale	Absolute Return
BUY	>20%
ACCUMULATE	12% to 20%
HOLD	5% to 12%
NEUTRAL	-5% to 5%
REDUCE	-5% to -12%
SELL	<-12%

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