

REDUCE

TP: Rs 450 | ▲ 4%

ECLERX SERVICES

IT Services

08 November 2019

Cost control saves margins; no respite from structural challenges

eClerx (ECLX) reported a margin beat for Q2FY20 (EBIT margin at 16.9%), albeit backed largely by marketing cuts, while dollar revenue was a miss (–1.6% QoQ). We see no respite from structural challenges as the onsite revenue mix continues to inch up and the risk of offshore revenue contraction heightens. We thus cut our target P/E multiple to 7.2x (from 8.1x), rolling forward to a reduced Sep'20 TP of Rs 450 (from Rs 490). Post the 20%+ correction over the last three months, we up our rating a notch to **REDUCE** from **SELL**.

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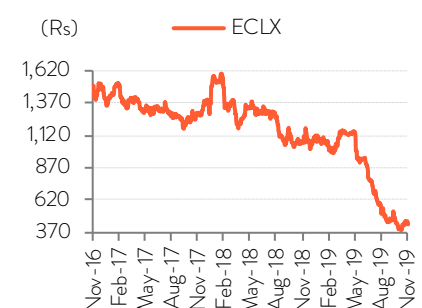
Revenue miss; steep cost control aids margin improvement: Dollar revenue contracted sequentially by 1.6% QoQ, falling short of our estimate of 1.4% QoQ growth. However, ECLX reported above-expected operating margins on the back of material cost optimisation. EBIT margins excluding hedging gains increased by 240bps QoQ (vs. ~170bps estimated), largely due to sales and marketing expense reduction (–220bps QoQ as a % of revenue; –13.6% QoQ in absolute terms). Gross margin expansion was limited to 60bps QoQ.

No respite from structural challenges: In Q2FY20, onsite revenues increased by 7% QoQ to contribute 25% of revenues while higher-margin offshore revenues declined by 4% QoQ (in dollar terms).

Muted top 10 client outlook: Revenues from the company's top 10 clients (65.5% share) contracted for the third consecutive quarter, clocking a 2.5% QoQ decline. Management shared a soft outlook for the top 10 accounts driven by an increasing preference for automation over outsourcing among larger clients.

Ticker/Price	ECLX IN/Rs 432
Market cap	US\$ 229.1mn
Shares o/s	38mn
3M ADV	US\$ 0.3mn
52wk high/low	Rs 1,230/Rs 388
Promoter/FPI/DII	50%/25%/25%

Source: NSE

STOCK PERFORMANCE

Source: NSE

KEY FINANCIALS

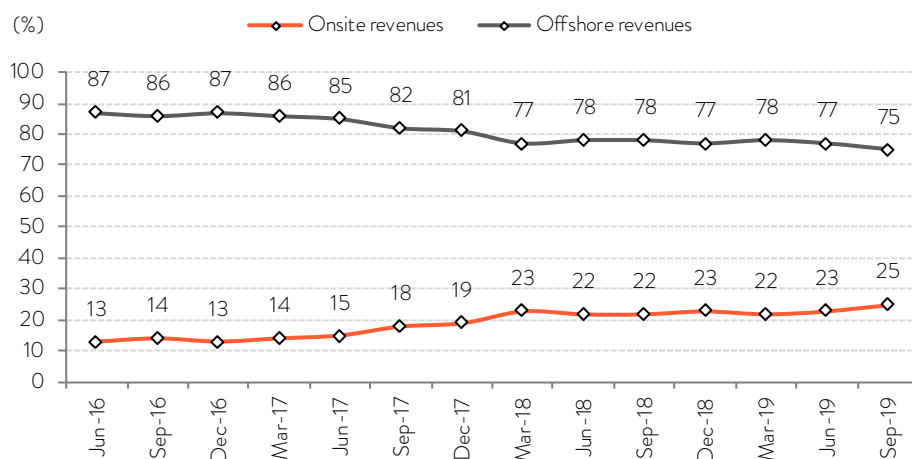
Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	13,651	14,305	14,372	16,119	18,066
EBITDA (Rs mn)	3,668	3,092	2,979	3,541	4,053
Adj. net profit (Rs mn)	2,887	2,283	1,748	2,240	2,506
Adj. EPS (Rs)	74.5	60.1	46.4	59.5	66.6
Adj. EPS growth (%)	(15.7)	(19.4)	(22.7)	28.2	11.8
Adj. ROAE (%)	23.9	20.2	16.1	19.2	19.9
Adj. P/E (x)	5.8	7.2	9.3	7.3	6.5
EV/EBITDA (x)	3.5	3.9	4.6	3.6	3.0

Source: Company, BOBCAPS Research

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FIG 1 – ONSITE REVENUE MIX CONTINUES TO INCH UP

Source: Company, BOBCAPS Research

FIG 2 – SEP'19 QUARTER PERFORMANCE

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Y-o-Y (%)	Q-o-Q (%)	H1FY20	H1FY19	Y-o-Y (%)
Revenues (US\$ mn)	49.2	50.2	50.2	51.2	50.9	50.1	(0.2)	(1.6)	101.0	99.4	1.6
Revenue	3,519	3,559	3,576	3,651	3,547	3,565	0.2	0.5	7,112.0	7,078.0	0.5
Operating Expenditure	2,736	2,728	2,905	2,844	2,886	2,785	2.1	(3.5)	5,670.9	5,464.0	3.8
Cost of revenues	1,722	1,730	1,830	1,777	1,923	1,910	10.4	(0.7)	3,833	3,452	11.0
as % of sales	48.9	48.6	51.2	48.7	54.2	53.6	-	-	53.9	48.8	-
SG&A expenses	1,014	998	1,075	1,067	963	874	(12.4)	(9.2)	1,837	2,012	(8.7)
as % of sales	28.8	28.0	30.1	29.2	27.1	24.5	-	-	25.8	28.4	-
EBITDA	783	831	671	807	661	780	(6.1)	18.0	1,441	1,614	(10.7)
Depreciation	93	103	123	128	172	177	72.2	3.1	349	196	77.7
EBIT	690	728	548	679	489	603	(17.2)	23.3	1,092	1,418	(22.9)
Other Income	185	193	(4)	96	82	87	-	-	169	378	-
PBT	874	921	544	775	572	690	(25.1)	20.7	1,262	1,795	(29.7)
Total Tax	274	221	154	183	131	206	(6.8)	57.1	337	495	(31.9)
Adjusted PAT	600	700	390	592	441	484	(30.8)	9.9	925	1,301	(28.9)
(Profit)/loss from JV's/Ass/MI	(1)	1	-	-	-	-	-	-	0	0	-
APAT after MI	602	699	390	592	441	484	(30.7)	9.9	925	1,301	(28.9)
Extra ordinary items	0	0	0	0	0	0	-	-	0	0	-
Reported PAT	602	699	390	592	441	484	(30.7)	9.9	925	1,301	(28.9)
Reported EPS	15.7	18.1	10.3	15.6	10.6	11.6	(35.8)	9.9	22	34	(34.4)
Margins (%)							(bps)	(bps)			(bps)
EBITDA	22.3	23.3	18.8	22.1	18.6	21.9	(150)	320	20.3	22.8	(250)
EBIT	19.6	20.5	15.3	18.6	13.8	16.9	(350)	310	15.4	20.0	(470)
EBT	24.8	25.9	15.2	21.2	16.1	19.4	(650)	320	17.7	25.4	(760)
PAT	17.1	19.6	10.9	16.2	12.4	13.6	(610)	120	13.0	18.4	(540)
Effective Tax rate	31.3	24.0	28.4	23.6	22.9	29.8	580	690	26.7	27.6	(90)

Source: Company, BOBCAPS Research

FIG 3 – SEP'19 QUARTER OPERATING METRICS

Particulars	Q2FY20 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by Geography (%)			
North America	67.0	(1.6)	6.6
Europe	27.0	(1.6)	(1.8)
ROW	6.0	(1.6)	(23.6)
Client contribution to revenue			
Top 10	65.5	(2.4)	(7.1)
Non-Top 10	34.5	0.0	16.1
Total Employees (nos)	9,123	(3)	(4.2)
Billing Mix			
FTE	73.0	(1.6)	(0.2)
Managed Services Revenues	28.0	(1.6)	7.5
Onsite Revenues	25.0	7.0	13.4
Offshore Revenues	75.0	(4.1)	(4.0)
Currency Concentration			
USD	81.0	(0.3)	(1.4)
Euro	11.0	8.3	22.0
GBP	6.0	(15.6)	(14.5)

Source: Company, BOBCAPS Research

Valuation methodology

We believe that lower revenue productivity, weaker margins, dimmer growth visibility and an increasing mix of non-annuity business now render ECLX comparable to BPO rather than IT services players. We thus value the stock at a lower P/E multiple of 7.2x (vs. 8.1x earlier), a 20% discount to the five-year average 12-month forward P/E of BPO peer Firstsource Solutions (FSOL: Not Rated). Rolling valuations forward, we arrive at a revised Sep'20 TP of Rs 450 (vs. Rs 490 earlier).

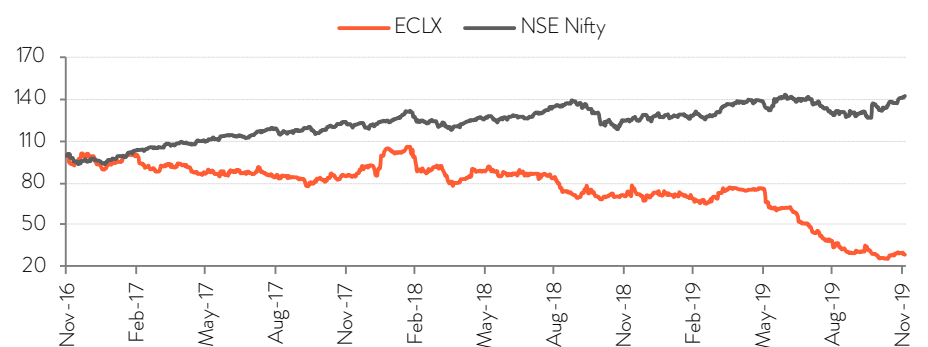
A structural downward reset to operating margins led by a changing business mix in favour of onsite revenues precludes a constructive outlook on ECLX. We remain negative on the stock but raise our rating a notch to REDUCE from SELL post the 20%+ price correction over the last three months.

FIG 4 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	210.8	203.1	(3.6)	238.2	226.4	(4.9)	269.1	257.9	(4.2)
YoY growth (%)	5.0	1.1	-	13.0	11.5	-	13.0	13.9	-
Revenues	14,865	14,372	(3.3)	16,941	16,119	(4.8)	18,852	18,066	(4.2)
EBIT	2,362	2,289	(3.1)	2,773	2,759	(0.5)	3,163	3,159	(0.1)
EBIT margins (%)	15.9	15.9	-	16.4	17.1	-	16.8	17.5	-
Net Profits	1,824	1,748	(4.2)	2,246	2,240	(0.2)	2,500	2,506	0.2
EPS (Rs)	48.4	46.4	(4.2)	59.7	59.5	(0.2)	66.4	66.6	0.2

Source: BOBCAPS Research

FIG 5 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Key upside risks to our earnings estimates include:

- a sharper recovery in demand especially for the offshore business,
- stronger-than-expected traction in large accounts, and
- sharp favourable currency movement.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	13,651	14,305	14,372	16,119	18,066
EBITDA	3,668	3,092	2,979	3,541	4,053
Depreciation	483	447	690	782	894
EBIT	3,185	2,645	2,289	2,759	3,159
Net interest income/(expenses)	0	0	(171)	(152)	(140)
Other income/(expenses)	390	469	322	462	414
Exceptional items	213	0	0	0	0
EBT	3,787	3,114	2,440	3,069	3,433
Income taxes	896	832	692	829	927
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	4	0	0	0	0
Reported net profit	2,887	2,283	1,748	2,240	2,506
Adjustments	0	0	0	0	0
Adjusted net profit	2,887	2,283	1,748	2,240	2,506

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	1,981	1,960	1,969	2,208	2,475
Provisions	60	78	79	88	99
Debt funds	63	63	63	63	63
Other liabilities	152	152	152	152	152
Equity capital	384	384	384	384	384
Reserves & surplus	11,669	10,120	10,816	11,709	12,707
Shareholders' fund	12,054	10,505	11,201	12,093	13,091
Total liabilities and equities	14,311	12,758	13,464	14,605	15,880
Cash and cash eq.	4,403	2,519	3,446	4,255	5,180
Accounts receivables	2,328	2,352	2,363	2,650	2,970
Inventories	0	0	0	0	0
Other current assets	2,371	2,547	2,559	2,871	3,217
Investments	1,653	1,653	1,653	1,653	1,653
Net fixed assets	1,215	1,346	1,101	836	519
CWIP	1	150	150	150	150
Intangible assets	2,220	2,220	2,220	2,220	2,220
Deferred tax assets, net	121	121	121	121	121
Other assets	0	0	0	0	0
Total assets	14,311	12,758	13,464	14,605	15,880

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	4,278	2,729	2,438	3,022	3,400
Interest expenses	(142)	(469)	(151)	(310)	(274)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(27)	(204)	(13)	(349)	(389)
Other operating cash flows	(1,058)	0	0	0	0
Cash flow from operations	3,050	2,057	2,274	2,363	2,737
Capital expenditures	(415)	(429)	(446)	(516)	(578)
Change in investments	861	0	0	0	0
Other investing cash flows	(183)	469	151	310	274
Cash flow from investing	263	40	(295)	(206)	(305)
Equities issued/Others	87	(2,607)	0	0	0
Debt raised/repaid	53	0	0	0	0
Interest expenses	(3,135)	0	0	0	0
Dividends paid	(40)	(1,374)	(1,052)	(1,348)	(1,508)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(3,035)	(3,981)	(1,052)	(1,348)	(1,508)
Changes in cash and cash eq.	278	(1,884)	927	809	925
Closing cash and cash eq.	4,403	2,519	3,446	4,255	5,180

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	74.5	60.1	46.4	59.5	66.6
Adjusted EPS	74.5	60.1	46.4	59.5	66.6
Dividend per share	1.0	1.0	23.2	29.8	33.3
Book value per share	320.2	279.1	297.6	321.3	347.8

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	0.9	0.8	1.0	0.8	0.7
EV/EBITDA	3.5	3.9	4.6	3.6	3.0
Adjusted P/E	5.8	7.2	9.3	7.3	6.5
P/BV	1.3	1.5	1.5	1.3	1.2

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	76.2	73.3	71.6	73.0	73.0
Interest burden (PBT/EBIT)	118.9	117.7	106.6	111.2	108.7
EBIT margin (EBIT/Revenue)	23.3	18.5	15.9	17.1	17.5
Asset turnover (Revenue/Avg TA)	96.5	105.7	109.6	114.9	118.5
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.2
Adjusted ROAE	23.9	20.2	16.1	19.2	19.9

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	2.6	4.8	0.5	12.2	12.1
EBITDA	(21.8)	(15.7)	(3.7)	18.9	14.5
Adjusted EPS	(15.7)	(19.4)	(22.7)	28.2	11.8
Profitability & Return ratios (%)					
EBITDA margin	26.9	21.6	20.7	22.0	22.4
EBIT margin	23.3	18.5	15.9	17.1	17.5
Adjusted profit margin	21.2	16.0	12.2	13.9	13.9
Adjusted ROAE	23.9	20.2	16.1	19.2	19.9
ROCE	38.2	32.8	28.2	34.3	38.9
Working capital days (days)					
Receivables	60	60	60	57	57
Inventory	0	0	0	0	0
Payables	65	64	63	61	61
Ratios (x)					
Gross asset turnover	11.0	11.2	11.7	16.6	26.7
Current ratio	4.5	3.6	4.1	4.3	4.4
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.4)	(0.2)	(0.3)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

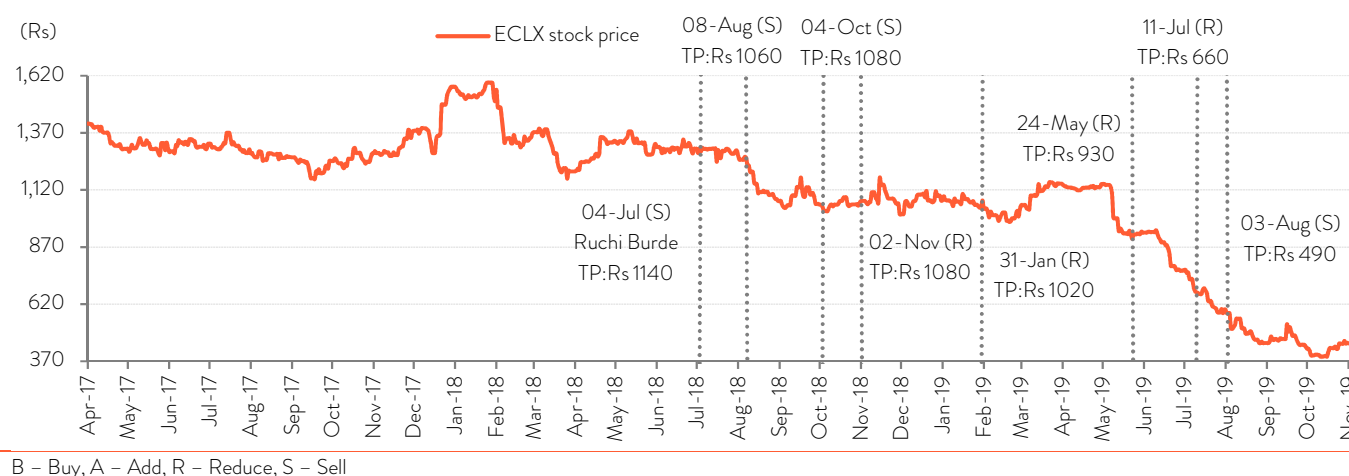
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: ECLERX SERVICES (ECLX IN)



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