

SELL

TP: Rs 490 | ▼ 16%

ECLERX SERVICES

| IT Services

| 03 August 2019

No sign of respite on margins; cut to SELL

eClerx (ECLX) underperformed sharply in the Jun'19 quarter as operating margins continued to sink well below estimates. An increasing onsite revenue mix and limited margin triggers will keep a lid on earnings growth, in our view. We slash our already below-consensus EPS estimates for FY20/FY21/FY22 by 21%/18%/16% and downgrade the stock from REDUCE to SELL on dimming growth visibility. We further lower our target P/E from 9x to 8.1x and bring our Jun'20 TP down from Rs 660 to Rs 490.

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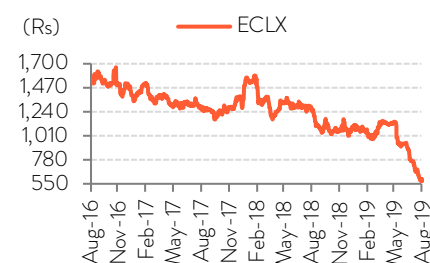
Operating margins sink again: ECLX reported historical low EBIT margins of 13.8% (inclusive of Ind-AS 116 changes), down 480bps QoQ/580bps YoY and lower than our/consensus estimates of 17.3% margins. Consequently, reported EBIT at Rs 489mn fell 22% short of expectations. Revenues at US\$ 50.9mn declined 0.6% QoQ vs. our estimate of 1.5% QoQ growth.

Ticker/Price	ECLX IN/Rs 581
Market cap	US\$ 314.2mn
Shares o/s	38mn
3M ADV	US\$ 0.3mn
52wk high/low	Rs 1,290/Rs 556
Promoter/FPI/DII	50%/25%/25%

Source: NSE

Persistent business risks: Over the past three years, the twin troubles of offshore revenue leakage (-3.6% CAGR) and onsite business growth (+30.6% CAGR) with an inherently lower margin profile have cramped ECLX's operational performance. We see continued business risks from a lack of visibility on offshore business growth and deflation in revenue productivity. As to the latter, dollar revenue per delivery employee has declined at a 2.3% CAGR over FY17- FY19 despite the onsite revenue mix rising to 22.3% in FY19 vs. 13.5% in FY17. Onsite revenue productivity has also fallen at a 19% CAGR for FY17-FY19.

STOCK PERFORMANCE



Source: NSE

Downgrade to SELL: We reduce our already below-consensus EPS estimates for FY20/FY21 by 21%/18% as we prune EBIT margin assumptions to 15.5%/16.4% vs. 18.5%/19% earlier to bake in the rising share of onsite revenue. Consensus earnings build in >200bps margin expansion over FY19-FY21 and are at risk of downgrade. Cut to SELL.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19P	FY20E	FY21E	FY22E
Adj. net profit (Rs mn)	2,887	2,283	1,824	2,246	2,500
Adj. EPS (Rs)	74.5	60.1	48.4	59.7	66.4
Adj. EPS growth (%)	(15.7)	(19.4)	(19.3)	23.2	11.3
Adj. ROAE (%)	23.9	20.2	16.8	19.2	19.8
Adj. P/E (x)	7.8	9.7	12.0	9.7	8.7
EV/EBITDA (x)	5.0	5.7	6.4	5.2	4.4

Source: Company, BOBCAPS Research

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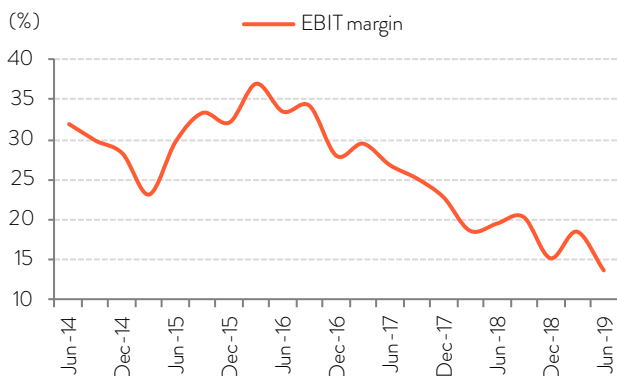
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Earnings call highlights

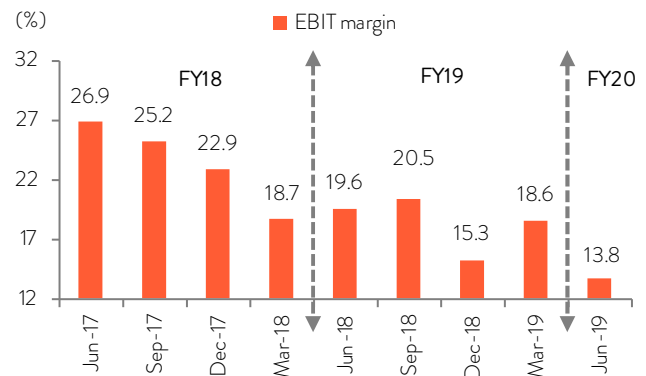
- Outlook:** Management was noncommittal on revenue and operating margin outlook due to the increasing share of short tenured project revenues, higher roll-offs and rising onsite revenue mix. However, it indicated that deal wins and the deal pipeline remain healthy.
- Margin levers:** ECLX expects a favourable hedging position, absence of bulk fresh graduate intake, Pune facility consolidation gains, and better profitability of managed service contracts to aid operating margins. At the same time, the increasing onsite revenue mix, short-term projects, statutory minimum wage revision in Maharashtra, and possible delay in discretionary projects in the UK will pose operating margin headwinds.
- Losses at Fayetteville:** Management acknowledged that the ‘Fayetteville’ delivery facility is making operational losses as initial projects were contracted at aggressive pricing. At present, 150 out of 250 seats are being utilised.

FIG 1 – EBIT MARGIN FALLS TO HISTORIC LOW...



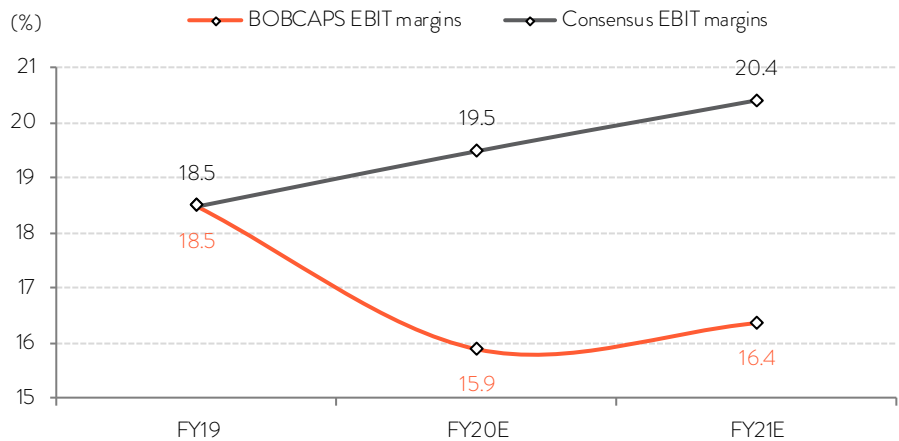
Source: Company, BOBCAPS Research

FIG 2 – ...AND REMAINS HIGHLY VOLATILE



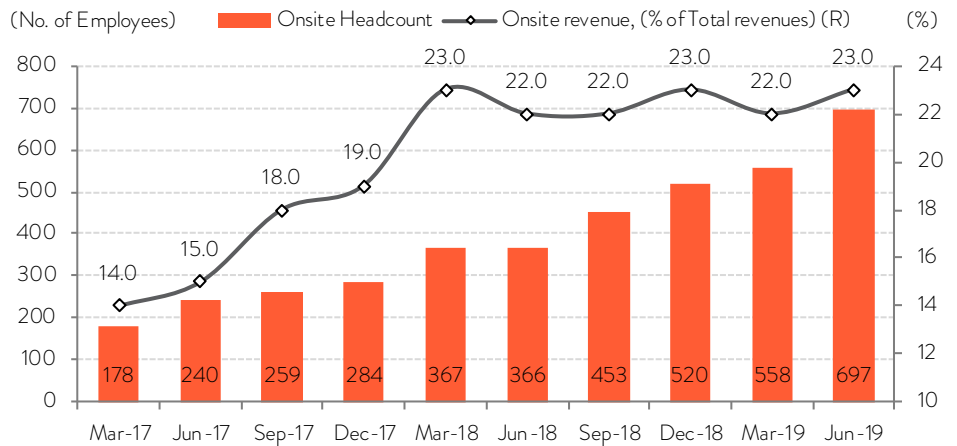
Source: Company, BOBCAPS Research

FIG 3 – WE SEE DOWNSIDE RISK TO CONSENSUS



Source: Company, BOBCAPS Research

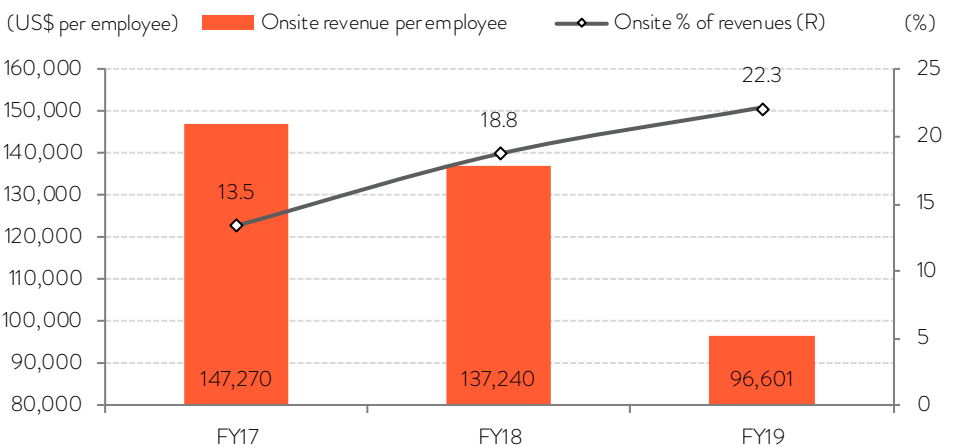
FIG 4 – ONSITE HEADCOUNT CONTINUES TO INCH UP



Source: Company, BOBCAPS Research

FIG 5 – ONSITE REVENUE PRODUCTIVITY FELL AT 19% CAGR OVER FY17-FY19

Reduced onsite productivity implies significantly lower onsite revenue per employee for incremental engagements over the last two years



Source: Company, BOBCAPS Research

FIG 6 – OUR SCENARIO ANALYSIS SUGGESTS ELUSIVE ONSITE PROFITABILITY

Before acquisition of CLX in FY16, ECLX largely had an offshore delivery model and enjoyed average 35% EBIT margins (FY11-FY15)

These historic offshore operating margins inform our scenario analysis and suggest ECLX's onsite operations are yet to stabilise

Scenario analysis	FY19		
% of onsite revenue	22.3		
% of offshore revenue	77.8		
EBIT margins excluding hedging gains or losses (%)	16.7		
	Scenario 1: assumed offshore EBIT margins of 25%	Scenario 2: assumed offshore EBIT margins of 30%	Scenario 3: assumed offshore EBIT margins of 35%
Offshore EBIT margins (assumed)	25	30	35
Onsite EBIT margin (implied)	(12.5)	(30.0)	(47.5)

Source: Company, BOBCAPS Research

FIG 7 – JUN'19 QUARTER PERFORMANCE

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	YoY (%)	QoQ (%)	FY20	FY19	YoY (%)
Revenues (US\$ mn)	49.2	50.2	50.2	51.2	50.9	3.5	(0.6)	50.9	49.2	3.5
Revenue	3,519	3,559	3,576	3,651	3,547	0.8	(2.8)	3,547.0	3,519.0	0.8
Operating Expenditure	2,736	2,728	2,905	2,844	2,886	5.5	1.5	2,886.0	2,736.0	5.5
Cost of revenues	1,722	1,730	1,830	1,777	1,908	10.8	7.4	1,908	1,722	10.8
as % of sales	48.9	48.6	51.2	48.7	53.8	-	-	53.8	48.9	-
SG&A expenses	1,014	998	1,075	1,067	978	(3.6)	(8.3)	978	1,014	(3.6)
as % of sales	28.8	28.0	30.1	29.2	27.6	-	-	27.6	28.8	-
EBITDA	783	831	671	807	661	(15.6)	(18.1)	661	783	(15.6)
Depreciation	93	103	123	128	172	83.7	34.1	172	93	83.7
EBIT	690	728	548	679	489	(29.0)	(27.9)	489	690	(29.0)
Other Income	185	193	(4)	96	82	-	-	82	185	-
PBT	874	921	544	775	572	(34.6)	(26.2)	572	874	(34.6)
Total Tax	274	221	154	183	131	(52.2)	(28.3)	131	274	(52.2)
Adjusted PAT	600	700	390	592	441	(26.6)	(25.6)	441	600	(26.6)
(Profit)/loss from JVs/Assoc/MI	(1)	1	-	-	-	-	-	0	-1	-
APAT after MI	602	699	390	592	441	(26.8)	(25.6)	441	602	(26.8)
Reported PAT	602	699	390	592	441	(26.8)	(25.6)	441	602	(26.8)
Reported EPS	15.7	18.1	10.3	15.6	10.6	(32.8)	(32.2)	11	16	(32.8)
Margins (%)						(bps)	(bps)			(bps)
EBITDA	22.3	23.3	18.8	22.1	18.6	(360)	(350)	18.6	22.3	(360)
EBIT	19.6	20.5	15.3	18.6	13.8	(580)	(480)	13.8	19.6	(580)
EBT	24.8	25.9	15.2	21.2	16.1	(870)	(510)	16.1	24.8	(870)
PAT	17.1	19.6	10.9	16.2	12.4	(470)	(380)	12.4	17.1	(470)
Effective Tax rate	31.3	24.0	28.4	23.6	22.9	(840)	(70)	22.9	31.3	(840)

Source: Company, BOBCAPS Research

FIG 8 – JUN'19 QUARTER OPERATING METRICS

	Q1FY20	Growth (%)	
	(% Contr. to revenue)	QoQ	YoY
Revenue by Geography			
North America	67	2.5	8.3
Europe	27	(7.4)	(0.2)
ROW	6	(0.6)	(22.4)
Client contribution to revenue			
Top 10	66	(3.4)	(3.7)
Non-Top 10 client revenues	34	5.5	13.1
Total Employees	9,495	0.1	(0.9)
Billing Mix			
FTE	73	(0.6)	0.0
Managed Services Revenues	28	(7.2)	25.9
Onsite Revenues	23	3.9	8.2
Offshore Revenues	77	(1.9)	2.1
Currency Concentration			
USD	80	(0.6)	(1.1)
Euro	10	(0.6)	1.4
GBP	7	(0.6)	18.3

Source: Company, BOBCAPS Research

Valuation methodology

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 cut our already below-consensus earnings estimates for FY20/FY21/FY22 by 21%/18%/16%. Diminishing business visibility and persistent profitability challenges drive our recommendation downgrade to SELL from REDUCE.

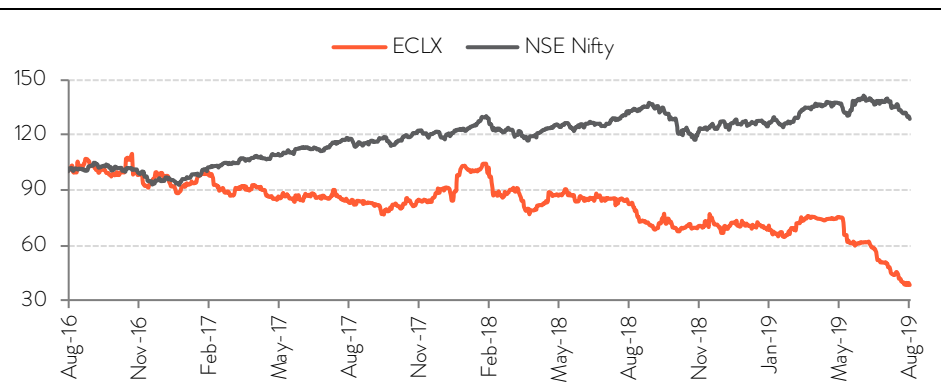
Moreover, we believe that deflation in revenue productivity, weaker margins, dimmer growth visibility and an increasing mix of non-annuity business now render the company comparable to BPO rather than IT services players. We thus value the stock at a lower P/E multiple of 8.1x (vs. 9x earlier), a 10% discount to the five-year average 12-month forward P/E of BPO peer Firstsource Solutions (FSOL: Not Rated). Our revised Jun'20 target price stands at Rs 490 (Rs 660 earlier).

FIG 9 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	217.3	210.8	(3.0)	245.8	238.2	(3.1)	277.0	269.1	(2.8)
YoY growth (%)	8.2	5.0	-	13.1	13.0	-	12.7	13.0	-
Revenues	15,552	14,865	(4.4)	17,392	16,941	(2.6)	19,575	18,852	(3.7)
EBIT	2,874	2,362	(17.8)	3,304	2,773	(16.1)	3,693	3,163	(14.4)
EBIT margins (%)	18.5	15.9	-	19.0	16.4	-	18.9	16.8	-
Net Profits	2,225	1,824	(18.0)	2,648	2,246	(15.2)	2,879	2,500	(13.2)
EPS (Rs)	61.2	48.4	(20.8)	72.8	59.7	(18.0)	79.2	66.4	(16.1)

Source: BOBCAPS Research

FIG 10 – 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	14,865	16,941	18,852
EBITDA	3,668	3,092	3,047	3,560	4,068
EBIT	3,185	2,645	2,362	2,773	3,163
Net interest income/(expenses)	0	0	(163)	(152)	(140)
Other income/(expenses)	390	469	311	456	401
Exceptional items	213	0	0	0	0
EBT	3,787	3,114	2,509	3,077	3,424
Income taxes	896	832	686	831	925
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	4	0	0	0	0
Reported net profit	2,887	2,283	1,824	2,246	2,500
Adjustments	0	0	0	0	0
Adjusted net profit	2,887	2,283	1,824	2,246	2,500

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19P	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	1,981	1,960	2,036	2,321	2,582
Provisions	60	78	81	93	103
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	10,847	11,741	12,737
Shareholders' fund	12,054	10,505	11,231	12,125	13,121
Total liabilities and equities	14,311	12,758	13,564	14,754	16,022
Cash and cash eq.	4,403	2,519	3,358	4,082	4,998
Accounts receivables	2,328	2,352	2,444	2,785	3,099
Inventories	0	0	0	0	0
Other current assets	2,371	2,547	2,647	3,017	3,357
Investments	1,653	1,653	1,653	1,653	1,653
Net fixed assets	1,215	1,346	1,122	876	574
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	13,564	14,754	16,022

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19P	FY20E	FY21E	FY22E
Net income + Depreciation	4,278	2,729	2,508	3,033	3,405
Interest expenses	(142)	(469)	(147)	(304)	(261)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(27)	(204)	(112)	(415)	(382)
Other operating cash flows	(1,058)	0	0	0	0
Cash flow from operations	3,050	2,057	2,249	2,314	2,762
Capital expenditures	(415)	(429)	(461)	(542)	(603)
Change in investments	861	0	0	0	0
Other investing cash flows	(183)	469	147	304	261
Cash flow from investing	263	40	(313)	(238)	(342)
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)	(1,097)	(1,351)	(1,504)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(3,035)	(3,981)	(1,097)	(1,351)	(1,504)
Changes in cash and cash eq.	278	(1,884)	838	725	916
Closing cash and cash eq.	4,403	2,519	3,358	4,082	4,998

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19P	FY20E	FY21E	FY22E
Reported EPS	74.5	60.1	48.4	59.7	66.4
Adjusted EPS	74.5	60.1	48.4	59.7	66.4
Dividend per share	1.0	1.0	24.2	29.8	33.2
Book value per share	320.2	279.1	298.4	322.1	348.6

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19P	FY20E	FY21E	FY22E
EV/Sales	1.3	1.2	1.3	1.1	0.9
EV/EBITDA	5.0	5.7	6.4	5.2	4.4
Adjusted P/E	7.8	9.7	12.0	9.7	8.7
P/BV	1.8	2.1	1.9	1.8	1.7

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19P	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	76.2	73.3	72.7	73.0	73.0
Interest burden (PBT/EBIT)	118.9	117.7	106.2	111.0	108.3
EBIT margin (EBIT/Revenue)	23.3	18.5	15.9	16.4	16.8
Asset turnover (Revenue/Avg TA)	96.5	105.7	112.9	119.6	122.5
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.2
Adjusted ROAE	23.9	20.2	16.8	19.2	19.8

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

Ratio Analysis

Y/E 31 Mar	FY18A	FY19P	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	2.6	4.8	3.9	14.0	11.3
EBITDA	(21.8)	(15.7)	(1.5)	16.9	14.3
Adjusted EPS	(15.7)	(19.4)	(19.3)	23.2	11.3
Profitability & Return ratios (%)					
EBITDA margin	26.9	21.6	20.5	21.0	21.6
EBIT margin	23.3	18.5	15.9	16.4	16.8
Adjusted profit margin	21.2	16.0	12.3	13.3	13.3
Adjusted ROAE	23.9	20.2	16.8	19.2	19.8
ROCE	38.2	32.8	28.9	33.8	38.0
Working capital days (days)					
Receivables	60	60	59	56	57
Inventory	0	0	0	0	0
Payables	65	64	62	59	61
Ratios (x)					
Gross asset turnover	11.0	11.2	12.0	17.0	26.0
Current ratio	4.5	3.6	4.0	4.1	4.3
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

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

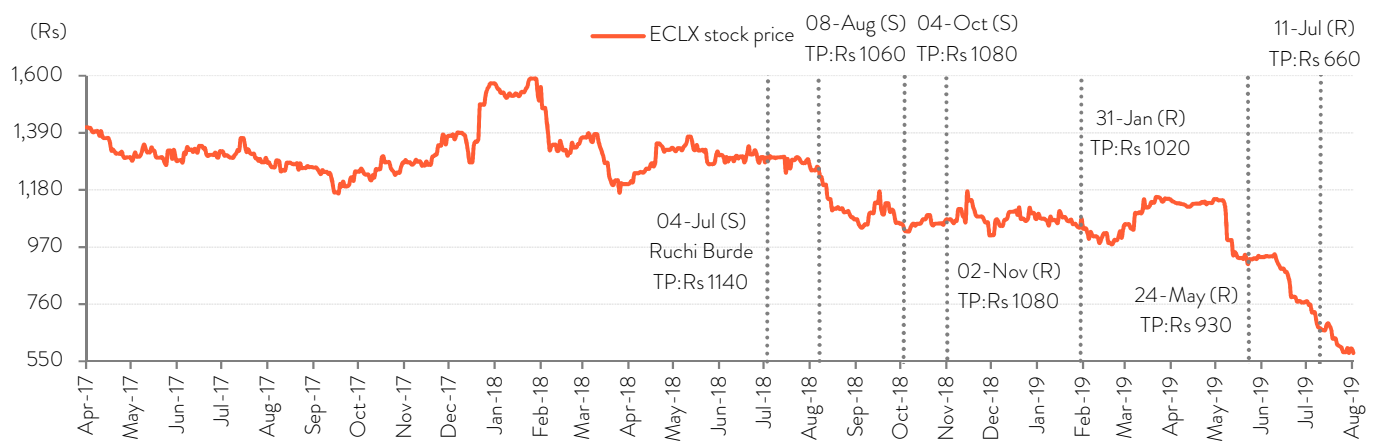
ADD – Expected return from >+5% to +15%

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)



B – Buy, A – Add, R – Reduce, S – Sell

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