

SELL

TP: Rs 490 | ▼ 22%

ECLERX SERVICES

| IT Services

| 31 January 2020

Good show but repeat act unlikely – downgrade to SELL

A mix of favourable yet transient dynamics saw eClerx (ECLX) staging a surprising operational beat in Q3FY20 (revenue up 3% QoQ, EBIT margin up 590bps). We do not expect a repeat performance anytime soon as management has not only guided for a soft Q4 due to offshore weakness and new project delays, but also reiterated a weak and volatile growth outlook. We raise FY21/FY22 EPS by 4%/3% and roll to a Mar'21 TP of Rs 490 (Rs 450 earlier). Growth visibility remains poor – cut to SELL from REDUCE.

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Surprisingly good quarter....: ECLX reported a beat on both revenue and operating margins in Q3. Revenue at US\$ 51.8mn increased 3.4% QoQ alongside 22.8% EBIT margins (+590bps QoQ). EBIT at Rs 856mn (+42% QoQ, +56% YoY) was 47% ahead of our estimate.

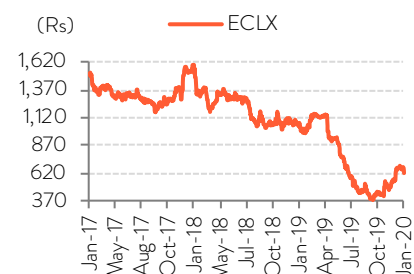
Ticker/Price	ECLX IN/Rs 626
Market cap	US\$ 329.8mn
Shares o/s	38mn
3M ADV	US\$ 1.1mn
52wk high/low	Rs 1,175/Rs 388
Promoter/FPI/DII	50%/25%/25%

Source: NSE

...led by favourable but transitory factors: A convergence of unexpected revenue flows and other one-offs helped the company stage a surprise in Q3 – these included (1) project delays and thus below-expected calendar year-end roll-offs (likely adverse spillover effect in Q4), (2) milestone revenue accrual in fixed price engagements, (3) short-term project revenue in CLX business, and (4) upward rate revisions for full time employees (FTE) at select large clients.

Repeat show unlikely in near term: Management has guided for a soft Q4FY20 due to continued pressure in the offshore business and delays in new project ramp-up. ECLX further indicated a weak and volatile outlook, with muted commentary on business prospects from the top 10 clients.

STOCK PERFORMANCE



Source: NSE

Cut to SELL: Changing business dynamics over the last three years have structurally impaired the company's profit and growth profile. Even though margins appear to be bottoming out, growth visibility looks cloudy. SELL.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	13,651	14,305	14,481	15,934	17,997
EBITDA (Rs mn)	3,668	3,092	3,365	3,665	4,129
Adj. net profit (Rs mn)	2,887	2,283	2,080	2,337	2,573
Adj. EPS (Rs)	74.5	60.1	55.3	62.1	68.3
Adj. EPS growth (%)	(15.7)	(19.4)	(8.0)	12.3	10.1
Adj. ROAE (%)	23.9	20.2	19.0	19.8	20.1
Adj. P/E (x)	8.4	10.4	11.3	10.1	9.2
EV/EBITDA (x)	5.5	6.3	6.0	5.6	4.8

Source: Company, BOBCAPS Research

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FIG 1 – DEC'19 QUARTER PERFORMANCE

(Rs mn)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	9MFY20	9MFY19	YoY (%)
Revenues (US\$ mn)	51.8	50.2	3.2	50.1	3.4	152.8	149.6	2.1
Revenue	3,755	3,576	5.0	3,565	5.3	10,866.7	10,654.0	2.0
Operating Expenditure	2,723	2,905	(6.3)	2,785	(2.2)	8,394.3	8,369.0	0.3
Cost of revenues	1,891	1,830	3.3	1,910	(1.0)	5,724	5,282	8.4
as % of sales	50.4	51.2	-	53.6	-	52.7	49.6	-
SG&A expenses	832	1,075	(22.6)	875	(4.9)	2,670	3,087	(13.5)
as % of sales	22.2	30.1	-	24.5	-	24.6	29.0	-
EBITDA	1,032	671	53.8	780	32.3	2,472	2,285	8.2
Depreciation	176	123	42.9	177	(0.6)	525	319	64.3
EBIT	856	548	56.2	603	42.0	1,948	1,966	(0.9)
Other Income	115	(4)	-	87	-	284	373	-
PBT	970	544	78.5	690	40.7	2,232	2,339	(4.6)
Total Tax	222	154	43.9	206	7.8	559	649	(13.9)
Adjusted PAT	749	390	92.2	484	54.7	1,673	1,690	(1.0)
(Profit)/loss from JV's/Ass/MI	-	-	-	-	-	0	0	-
APAT after MI	749	390	92.2	484	54.7	1,673	1,691	(1.0)
Extra ordinary items	0	0	--	0	0	0	0	-
Reported PAT	749	390	92.2	484	54.7	1,673	1,691	(1.0)
Reported EPS	18.6	10.3	81.5	11.6	60.5	41	44	(7.5)
Margins (%)			(bps)		(bps)			(bps)
EBIDTA	27.5	18.8	870	21.9	560	22.8	21.4	130
EBIT	22.8	15.3	750	16.9	590	17.9	18.4	(50)
EBT	25.8	15.2	1,060	19.3	650	20.5	22.0	(140)
PAT	19.9	10.9	900	13.6	640	15.4	15.9	(50)
Effective Tax rate	22.9	28.4	(550)	29.8	(700)	25.0	27.7	(270)

Source: Company, BOBCAPS Research

FIG 2 – DEC'19 QUARTER OPERATING METRICS

Particulars	Q3FY20 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by Geography (%)			
North America	66.0	1.9	8.6
Europe	28.0	7.2	5.3
ROW	6.0	3.4	(21.0)
Client Contribution to Revenue			
Top 10 (%)	65.1	2.7	(3.2)
Non-Top 10 client revenues	34.9	4.6	10.4
Total Employees	8,785	(4)	(7.6)
Billing Mix			
FTE	69.0	(0.9)	(0.3)
Managed Services Revenues	31.0	14.5	18.5
Onsite Revenues	25.0	3.4	12.2
Offshore Revenues	75.0	3.4	0.5
Currency Concentration			
USD	80.0	2.1	1.2
Euro	12.0	12.8	21.4
GBP	6.0	3.4	(13.3)

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 (unchanged), a 20% discount to the five-year average 12-month forward P/E of BPO peer Firstsource Solutions (FSOL: Not Rated). Post the Q3 beat, we raise FY21/FY22 EPS by 4%/3% – on rolling valuations forward, we arrive at a revised Mar'21 target price of Rs 490 (vs. Rs 450 earlier).

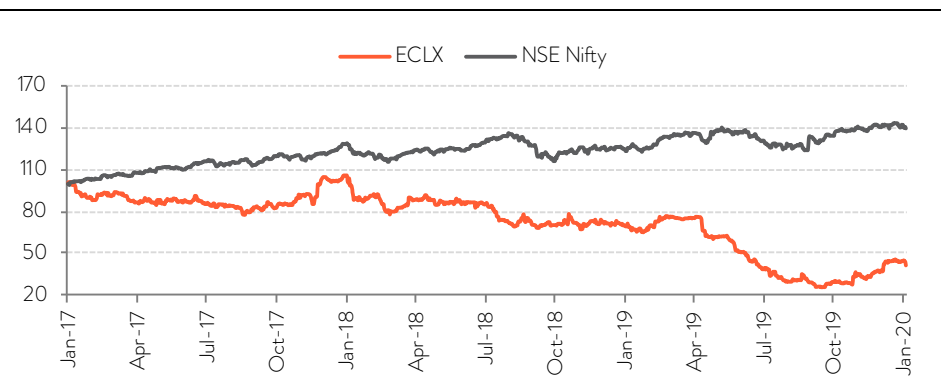
Over the last three years, ECLX has undergone a structural downward reset to operating margins led by a changing business mix in favour of onsite revenues. Even though margins appear to be bottoming out, growth visibility remains a concern. Cut to SELL from REDUCE.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	203.1	203.5	0.2	226.4	223.8	(1.2)	257.9	256.9	(0.4)
YoY growth (%)	1.1	1.4	-	11.5	10.0	-	13.9	14.8	-
Revenues	14,372	14,481	0.8	16,119	15,934	(1.1)	18,066	17,997	(0.4)
EBIT	2,289	2,669	16.6	2,759	2,883	4.5	3,159	3,236	2.4
EBIT margins (%)	15.9	18.4	-	17.1	18.1	-	17.5	18.0	-
Net Profits	1,748	2,080	19.0	2,240	2,337	4.3	2,506	2,573	2.7
EPS (Rs)	46.4	55.3	19.0	59.5	62.1	4.3	66.6	68.3	2.7

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Upside risks to our 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	14,481	15,934	17,997
EBITDA	3,668	3,092	3,365	3,665	4,129
Depreciation	483	447	695	782	894
EBIT	3,185	2,645	2,669	2,883	3,236
Net interest income/(expenses)	0	0	(179)	(152)	(140)
Other income/(expenses)	390	469	360	470	429
Exceptional items	213	0	0	0	0
EBT	3,787	3,114	2,851	3,201	3,524
Income taxes	896	832	771	864	952
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	4	0	0	0	0
Reported net profit	2,887	2,283	2,080	2,337	2,573
Adjustments	0	0	0	0	0
Adjusted net profit	2,887	2,283	2,080	2,337	2,573

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	1,984	2,183	2,465
Provisions	60	78	79	87	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	10,949	11,879	12,904
Shareholders' fund	12,054	10,505	11,333	12,263	13,288
Total liabilities and equities	14,311	12,758	13,612	14,749	16,068
Cash and cash eq.	4,403	2,519	3,559	4,471	5,400
Accounts receivables	2,328	2,352	2,380	2,619	2,958
Inventories	0	0	0	0	0
Other current assets	2,371	2,547	2,579	2,838	3,205
Investments	1,653	1,653	1,653	1,653	1,653
Net fixed assets	1,215	1,346	1,099	828	510
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	13,612	14,749	16,068

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	4,278	2,729	2,775	3,118	3,466
Interest expenses	(142)	(469)	(181)	(318)	(289)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(27)	(204)	(35)	(291)	(413)
Other operating cash flows	(1,058)	0	0	0	0
Cash flow from operations	3,050	2,057	2,559	2,510	2,765
Capital expenditures	(415)	(429)	(449)	(510)	(576)
Change in investments	861	0	0	0	0
Other investing cash flows	(183)	469	181	318	289
Cash flow from investing	263	40	(268)	(192)	(287)
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)	(1,252)	(1,406)	(1,548)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(3,035)	(3,981)	(1,252)	(1,406)	(1,548)
Changes in cash and cash eq.	278	(1,884)	1,040	912	930
Closing cash and cash eq.	4,403	2,519	3,559	4,471	5,400

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	74.5	60.1	55.3	62.1	68.3
Adjusted EPS	74.5	60.1	55.3	62.1	68.3
Dividend per share	1.0	1.0	27.6	31.0	34.2
Book value per share	320.2	279.1	301.1	325.8	353.0

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	1.5	1.4	1.4	1.3	1.1
EV/EBITDA	5.5	6.3	6.0	5.6	4.8
Adjusted P/E	8.4	10.4	11.3	10.1	9.2
P/BV	2.0	2.2	2.1	1.9	1.8

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	76.2	73.3	73.0	73.0	73.0
Interest burden (PBT/EBIT)	118.9	117.7	106.8	111.0	108.9
EBIT margin (EBIT/Revenue)	23.3	18.5	18.4	18.1	18.0
Asset turnover (Revenue/Avg TA)	96.5	105.7	109.8	112.4	116.8
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.2
Adjusted ROAE	23.9	20.2	19.0	19.8	20.1

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	1.2	10.0	12.9
EBITDA	(21.8)	(15.7)	8.8	8.9	12.7
Adjusted EPS	(15.7)	(19.4)	(8.0)	12.3	10.1
Profitability & Return ratios (%)					
EBITDA margin	26.9	21.6	23.2	23.0	22.9
EBIT margin	23.3	18.5	18.4	18.1	18.0
Adjusted profit margin	21.2	16.0	14.4	14.7	14.3
Adjusted ROAE	23.9	20.2	19.0	19.8	20.1
ROCE	38.2	32.8	32.9	35.9	40.1
Working capital days (days)					
Receivables	60	60	60	57	57
Inventory	0	0	0	0	0
Payables	65	64	65	62	61
Ratios (x)					
Gross asset turnover	11.0	11.2	11.8	16.5	26.9
Current ratio	4.5	3.6	4.1	4.4	4.5
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.4)	(0.2)	(0.3)	(0.4)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

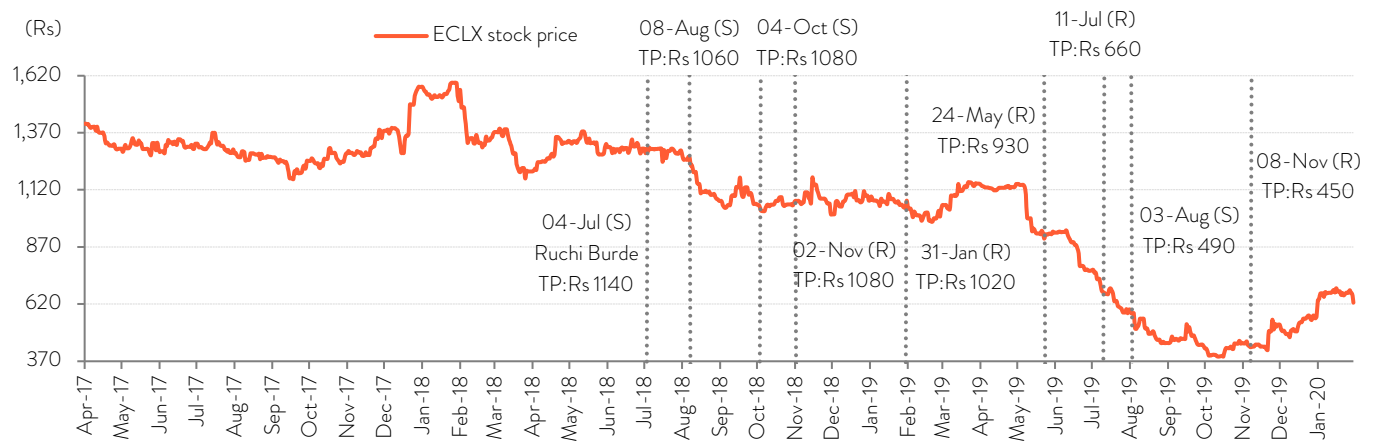
ADD – Expected return from >+5% to +15%

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)



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

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