Stock Update

Zensar Technologies Ltd.

July 15, 2024

Zensar Technologies Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
IT Consulting & Software	Rs 769.70	Buy in Rs 760-780 band and add on dips in Rs 685-700 band	Rs 843	Rs 905	2-3 quarters

HDFC Scrip Code	ZENTEC
BSE Code	504067
NSE Code	ZENSARTECH
Bloomberg	ZENT IN
CMP July 12, 2024	769.70
Equity Capital (Rs Cr)	45.3
Face Value (Rs)	2.0
Equity Share O/S (Cr)	22.7
Market Cap (Rs Cr)	17,447
Book Value (Rs)	156.0
Avg. 52 Wk Volumes	17,31,640
52 Week High	788.0
52 Week Low	397.3

Share holding Pattern % (June, 2024)	
Promoters	49.2
Institutions	34.8
Non Institutions	16.0
Total	100

* Refer at the end for explanation on Risk Ratings

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Our Take:

Zensar Tech is a Pune based IT Services Company with revenues diversified across various service offerings, such as the digital application services (DAS) comprising core application services and digital services. The digital foundation services comprise cloud, digital led next gen core infrastructure service and core infrastructure services. Its clientele is distributed across the manufacturing (industrial and hi-tech), retail, and banking and financial services (BFSI) domains, resulting in sector wise diversification. With more than 10,500 employees across 33 locations, Zensar provides engineering and technology solutions to more than 145+ leading companies.

Zensar Teach deal pipeline has remained strong in Q4FY24, led by significant contract wins in the Banking, Financial Services, and Insurance (BFSI), Healthcare, and Manufacturing. Order book in Q4FY24 stood at US$ 181.5 mn, an increase of 8.4% QoQ. The full-year order book was at US$698 mn, an increase of 22% YoY. We expect that the margins could see marginal improvement here led by improved service mix, optimising employee pyramid, rationalisation of SG&A and hiring costs, and improved utilisation.

Zensar continues to strengthen its go-to-market along with stated focus areas. The company has continued focus on strategy execution and long term growth led by Advanced Engineering, Experience Services, and other service lines. The company is also focused on clients with revenues greater than US$2 bn. We expect strong revenue growth momentum going ahead and expect 8%/13.1% revenue growth in FY25E/FY26E, respectively.

On Feb 08, 2023, we had issued Stock Update report (Link) on Zensar Tech Ltd and recommended to buy in the Rs 243-248 band and add further on dips to Rs 215-220 band for base case target of Rs 276 and bull case target of Rs 296. The stock achieved its both targets before expiry of the call. Given healthy growth outlook, and expectation of strong set of numbers in H1FY25, we have now revised earnings and increased target price for the stock.

Valuation & Recommendation:

Zensar is poised well for registering revenue growth in the medium to long term. We believe Zensar Tech will deliver long term sustainable growth led by a healthy deal pipeline and strong execution. Zensar has grown organically and inorganically over the years. The company expects EBITDA margin to stabilise in mid-teens; higher fresher intake and near-shore locations will reduce dependence on subcontractors and increase utilisation. Driving deal momentum, annuity revenues, increasing investment in sales & talent, leadership and tuck in acquisition to build capability bode well for long term revenue growth.

We believe the base case fair value of the stock is Rs 843 (23.75x FY26E EPS) and the bull case fair value of the stock is Rs 905 (25.5x FY26E EPS) over the next two to three quarters. Investors can buy in Rs 760-780 band and add further on dips in the Rs 685-700 band (19.5x FY26E EPS). At the LTP of Rs 769.7, the stock is trading at 21.7x FY26E EPS.

Financial Summary:

Particulars (Rs Cr)	Q4FY24	Q4FY23	YoY (%)	Q3FY24	QoQ (%)	FY22	FY23	FY24	FY25E	FY26E
Total Operating Income	1230	1213	1.4	1204	2.1	4244	4848	4902	5292	5986
EBITDA	203	176	15.5	208	-2.2	657	552	872	889	1013
Depreciation	24	35	-32.5	31	-24.0	185	183	134	101	110
Other Income	52	27	91.5	42	23.8	138	103	159	162	187
Interest Cost	3	6	-55.6	6	-56.3	35	28	21	10	8
Tax	55	42	30.4	50	9.7	153	117	211	230	270
APAT	173	119	45.4	162	7.2	416	328	665	710	811
Diluted EPS (Rs)	7.6	5.2	45.4	7.1	7.2	18.2	14.3	29.1	31.1	35.5
RoE-%						16.5	11.6	20.3	18.7	18.9
P/E (x)						42.2	53.6	26.4	24.8	21.7
EV/EBITDA (x)						24.9	28.8	17.6	16.6	14.1

(Source: Company, HDFC sec)

Q4FY24 Result Update

- Zensar Tech revenue was inline with estimates and profitability was above expectations in Q4FY24. Consolidated revenue grew by 2.1% QoQ and 1.4% YoY to Rs 1230 crore. In Q4FY24, the company reported revenue of $148.1M, sequential QoQ growth of 2.4% in reported currency and 2.0% in constant currency (CC).
- EBIT was up by 1.3% QoQ to Rs 179 crore and it was at Rs 119 crore in Q4FY23. EBIT margin unchanged QoQ to 14.6% in Q4FY24 and 11.6% in Q4FY23. Net profit grew to Rs 173 crore in Q4FY24, supported by other income. Other income increased primarily due to resizing and termination of leased premises, and one-time impact due to settlement of pending adjustments related to earlier acquisitions. Net profit was at Rs 162 crore in Q3FY24 and Rs 119 crore in Q4FY23. Net Profit margin stood at 14.1% in the quarter.
- Revenue contribution from Digital was at 81.6% in Q4FY24 vs. 81.5% in Q3FY24, 81.8% in Q2FY24, 81.7% in Q1FY24 and 82.6% in Q4FY23.
- US region reported a services revenue growth of 4.3% QoQ in reported currency and 4.2% QoQ in constant currency. Europe region reported a revenue decline of 1.2% QoQ in reported currency and 3.1% QoQ in constant currency. South Africa reported a revenue decline of 2.3% QoQ in reported currency and 2.0% QoQ in constant currency.
- Banking and Financial Services reported a revenue growth of 2.5% QoQ in reported currency and 2.0% QoQ in constant currency. Manufacturing and Consumer Services reported a revenue growth of 3.0% QoQ in reported currency and 2.3% QoQ in constant

currency. Hitech reported a revenue growth of 0.8% QoQ in reported currency and 0.7% QoQ in constant currency. Healthcare and Life Sciences reported a revenue growth of 3.6% QoQ in reported currency and 3.5% QoQ in constant currency.

- Number of active clients was at 148 in Q4FY24, on QoQ, it added 1 customer in the quarter.

Q1FY25 Result Preview

- Zensar Tech could report 3% QoQ and 3.2% YoY growth in revenue to Rs 1,267 crore in Rupee terms. The company could report net profit at Rs 168 crore in Q1FY25. EBIT margin could decrease by 10bps QoQ and 80bps YoY to 14.5% (high base). The management commentary on organic revenue growth, deal pipeline, and update on order execution would be key monitorables.

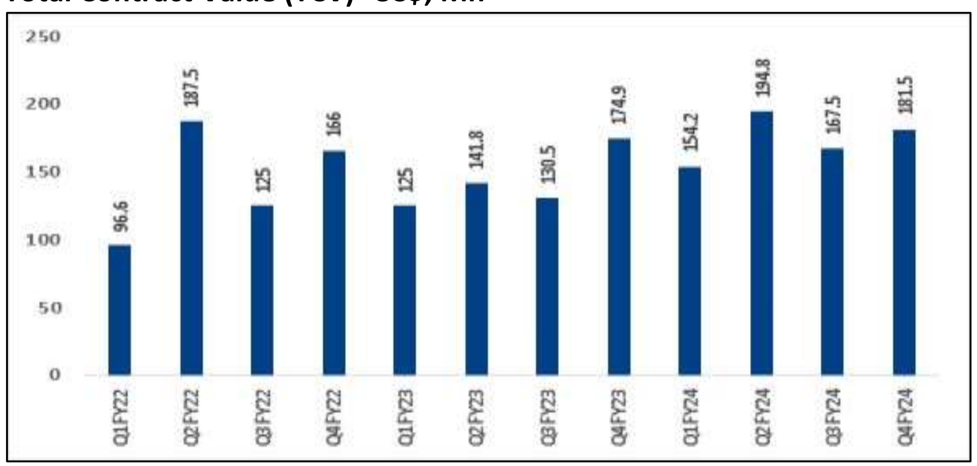
Key Updates

Expectations of healthy deal wins and a strong deal pipeline going forward

Zensar Teach deal pipeline has remained strong in Q4FY24, led by significant contract wins in the Banking, Financial Services, and Insurance (BFSI), Healthcare, and Manufacturing. Order book in Q4FY24 stood at US$ 181.5 mn, an increase of 8.4% QoQ. The full-year order book was at US$698 mn, an increase of 22% YoY. Its total contract value (TCV) of deal wins was US$ 167.5 mn in Q3FY24, US$ 194.8 mn in Q2FY24, US$ 154.2 mn in Q1FY24, with the company maintaining a healthy mix of large and mid-sized deals, including renewals and new deals. Book-to-bill stood at 1.2x of FY24 revenue.

Zensar's deal pipeline has remained strong and focused on large deals in the application and infrastructure management services, bundled with hardware and software offerings. The company is working on a few large deals and cross-selling or value-added deals have contributed to new business from existing clients.

Total Contract Value (TCV)- US$, Mn



Zensar is focused on new logos as well as mining existing clients. The pipeline remains strong and is expected to continue growth momentum on the back of new deal signings and a strong pipeline across the geographies. The company focuses on increasing client engagement and farming more business from existing accounts. This could help to improve the top client account and grow in the long term.

Utilisation management, pyramid optimization, and cost rationalization to maintain sustainable margins

Zensar Tech EBIT margin unchanged QoQ to 14.6% in Q4FY24 and 11.6% in Q4FY23 and net Profit margin stood at 14.1% in Q4FY24, and EBIT margin in FY24 ramped up to 15.1% from 7.6% in FY23.

Utilization improved by 300 basis points sequentially and 230 bps YoY. The next leg of expansion will be led by levers such as offshoring, pricing benefits, reducing dependence on subcontractors, and utilisation. The company has completely revamped its supply side and bought in processes to gauge demand in the near term and to evaluate internal resources before external hiring.

Taking into the consideration the margin levers like improved service mix, automation, optimising employee pyramid, rationalisation of SG&A and hiring costs, and improved utilization, the company expects that the margins have bottomed out. Besides, the company has many levers like offshoring, automation and lower sub-contracting cost, which could help to report healthy margins, going forward. Over the next 2-3 quarters, this could be supplemented by other margin levers. We expect that, the company could report stable EBIT margin for FY25E/FY26E, respectively.

Focus on BFSI, Healthcare and new services to perform well going forward

Zensar's Banking & Financial Services (BFS) segment contributed 38.6% to the revenue in Q4FY24, and Health and Life Science contributed 10% in Q4FY24. It looks to explore new sectors like Healthcare and Life Sciences, with defined strategies for growth and client engagement. Macro uncertainties leading to delayed spending decisions pose a challenging environment for Zensar Tech and the company could see impact in the near term. However, the company is closer to clients to understand their needs and continue to provide solutions in terms of cost-saving solutions. Besides, the company is focused on clients with revenues greater than $2 bn and plans to cross sell the same to existing clients thereby improving growth in longer run and further, the company could add one or two more verticals going forward.

Strong fundamentals led by healthy debt protection metrics and liquidity

- Zensar's portfolio has witnessed multiple challenges over the past, however, the lead indicators of deal wins and pipeline continue to look strong. The company has reported stable growth in the past, reported ~8% revenue CAGR and PAT CAGR of ~11% over the last decade. We expect this rate to rise and revenue to grow by 10.5% CAGR and PAT to grow by 10.4% CAGR over the FY24-FY26E.
- We expect EBIT Margins at 14.9% in FY25E and 15.1% in FY26E, EBIT could be at Rs 787/902 crore in FY25E/FY26E, respectively.
- Zensar is now a zero-debt company with highest ever net cash position of US$ 261.7 mn as on March 31, 2024, it has enough cash balances on its books and is looking for M&A opportunity to accelerate the growth of the company.

- We expect the FCF to remain positive, going forward, even after factoring in annual capex. Because of cost rationalization efforts, the company could see growth in profitability as well as better return ratios in the future.
- The expectation of a rise in net profit margin could result in a healthy return ratio. We expect RoE at 18.5-19% for FY25E to FY26E.
- The company has been maintaining a healthy dividend pay-out over the past.

What could go wrong?

- Indian rupee appreciation against the USD/Eur, pricing pressure, retention of the skilled headcounts, strict immigration norms and rise in visa costs are key concerns.
- The increasing competition and pricing pressures from the existing incumbents may impact the company's future growth and profitability indicators. Zensar is adapting to the changing technology landscape by focusing on digital technologies.
- Zensar derived ~28% of its revenues from its top 5 clients, ~41% from the top 10 clients, and ~57% from top 20 clients in Q4FY24 with moderately high dependence on a single client, exposing it to client concentration risks. However, this risk is partially mitigated by a strong and established relationship and the growing wallet share of business with the client.
- Inability to grow organically. The company historically has mainly grown on the back of acquisitions. If it cannot turn around any acquisitions, it can impact the margins in the near term.
- A steep fall in revenue or sustained deterioration in the margins of Zensar Tech can impact cash generation.
- Any change in the contract terms from large clients like non-renewal of contracts or higher discounts due to aggressive competitive intensity can impact the sustainability and scalability of such clients.
- Margins of Zensar are lower than of its similar-sized peers. However, margins will improve going forward driven by operating leverage, a decline in many of the one-time investments on building capabilities, and higher contributions from higher-margin offshore and digital services.
- Zensar’s revenue from the Hi-Tech vertical has been declining over the past, revenue contribution declined to 25.5% in Q4FY24 from 27.6% in Q4FY23, and Hi-tech remained under pressure. We could see recovery, once interest rates moderate in the US.
- Any major cut in US technology budgets, particularly in digital, could hit the expected growth surge at Zensar.

Operating Metrics

Performance by Geography

%	Q1FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	Q3FY24	Q4FY24
Americas	70.9	71.6	70.0	70.3	69.4	66.1	66.0	67.2
Europe	18.1	17.4	18.7	18.1	19.2	21.6	21.4	20.8
RoW	11.0	11.0	11.3	11.6	11.4	12.3	12.5	12.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Performance by Verticals

%	Q1FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	Q3FY24	Q4FY24
Hitech	31.1	31.8	29.4	30.7	29.7	27.2	25.9	25.5
Manufacturing & Consumer Services	26.9	24.7	24.5	23.4	24.2	25.9	26.1	26.3
Banking & Financial Services	32.7	33.7	35.0	35.8	36.3	37.3	38.6	38.7
Healthcare & Life Sciences	9.3	9.8	11.1	10.1	9.8	9.6	9.4	9.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Client Metrics

%	Q1FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	Q3FY24	Q4FY24
Top 5 % of revenue	33.3	34.6	31.9	34.3	34.0	31.5	29.2	28.3
Top 10 % of revenue	45.2	45.5	44.7	46.1	45.2	42.2	40.6	40.8
Top 20 % of revenue	61.2	60.7	61.3	61.4	61.7	58.3	57.5	57.2
1+ mn (Nos)	86	87	87	84	87	84	84	85
5+ mn (Nos)	26	28	28	29	29	29	32	31
10+ mn (Nos)	13	13	15	14	14	14	14	14
20+ mn (Nos)	4	3	4	4	4	4	4	4

Employee Metrics (Nos)

Nos	Q1FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24	Q2FY24	Q3FY24	Q4FY24
Total Headcount	11559	11250	10845	10563	10540	10330	10225	10349
Gross addition	1220	1194	593	552	654	643	627	816
Attrition (%)	28	26	23	20	16	13	12	11
Utilisation (%)	80.7	80.7	77.6	81.4	82.5	83.1	80.7	83.7

(Source: Company, HDFC sec)

Peer Comparison

Rs in Cr	Mkt Cap	Revenue			EBIT			PAT			RoE-%			P/E (x)		
		FY24	FY25E	FY26E	FY24	FY25E	FY26E	FY24	FY25E	FY26E	FY24	FY25E	FY26E	FY24	FY25E	FY26E
Birlasoft	20219	5278	5753	6671	751	843	1019	611	680	817	22.7	20.6	21.2	33.1	29.8	24.7
Zensar Tech	17447	4902	5292	5986	738	787	902	665	710	811	20.3	18.7	18.9	26.4	24.8	21.7
Cyient	20386	7147	7808	9169	1036	1138	1418	749	816	1026	19.4	18.3	20.8	27.1	24.9	19.8

(Source: Company, HDFC sec)

Financials

Income Statement

(Rs Cr)	FY22	FY23	FY24	FY25E	FY26E
Net Revenues	**4244**	**4848**	**4902**	**5292**	**5986**
Growth (%)	15.7	14.2	1.1	8.0	13.1
Operating Expenses	3587	4296	4030	4403	4973
EBITDA	**657**	**552**	**872**	**889**	**1013**
Growth (%)	**-4.0**	**-15.9**	**57.8**	**2.0**	**13.9**
EBITDA Margin (%)	**15.5**	**11.4**	**17.8**	**16.8**	**16.9**
Depreciation	185	183	134	101	110
EBIT	**472**	**369**	**738**	**787**	**902**
Other Income	138	103	159	162	187
Interest expenses	35	28	21	10	8
PBT	**574**	**444**	**876**	**940**	**1081**
Tax	153	117	211	230	270
RPAT	**421**	**328**	**665**	**710**	**811**
APAT	**416**	**328**	**665**	**710**	**811**
Growth (%)	19.0	-21.3	103.0	6.7	14.2
EPS	18.2	14.3	29.1	31.1	35.5

Balance Sheet

As at March	FY22	FY23	FY24	FY25E	FY26E
SOURCE OF FUNDS					
Share Capital	45	45	45	45	45
Reserves	2642	2931	3517	3978	4505
Shareholders' Funds	**2687**	**2976**	**3562**	**4023**	**4550**
Long Term Debt	0	0	13	13	13
Net Deferred Taxes	-54	-96	-110	-110	-110
Long Term Provisions & Others	354	287	219	322	364
Minority Interest	**0**	**0**	**0**	**0**	**0**
Total Source of Funds	**2987**	**3167**	**3684**	**4248**	**4817**
APPLICATION OF FUNDS					
Net Block & Goodwill	1285	1174	1034	1012	992
CWIP	1	0	5	5	5
Other Non-Current Assets	83	36	39	59	66
Total Non Current Assets	**1368**	**1210**	**1079**	**1076**	**1063**
Inventories	0	0	0	0	0
Trade Receivables	797	730	732	783	886
Cash & Equivalents	1206	1676	2240	2794	3296
Other Current Assets	447	410	487	529	599
Total Current Assets	**2449**	**2816**	**3459**	**4107**	**4780**
Short-Term Borrowings	0	0	0	0	0
Trade Payables	316	277	310	326	368
Other Current Liab & Provisions	514	581	545	609	658
Total Current Liabilities	**830**	**858**	**854**	**934**	**1026**
Net Current Assets	1619	1957	2605	3172	3754
Total Application of Funds	**2987**	**3167**	**3684**	**4248**	**4817**

(Source: Company, HDFC sec)

Cash Flow Statement

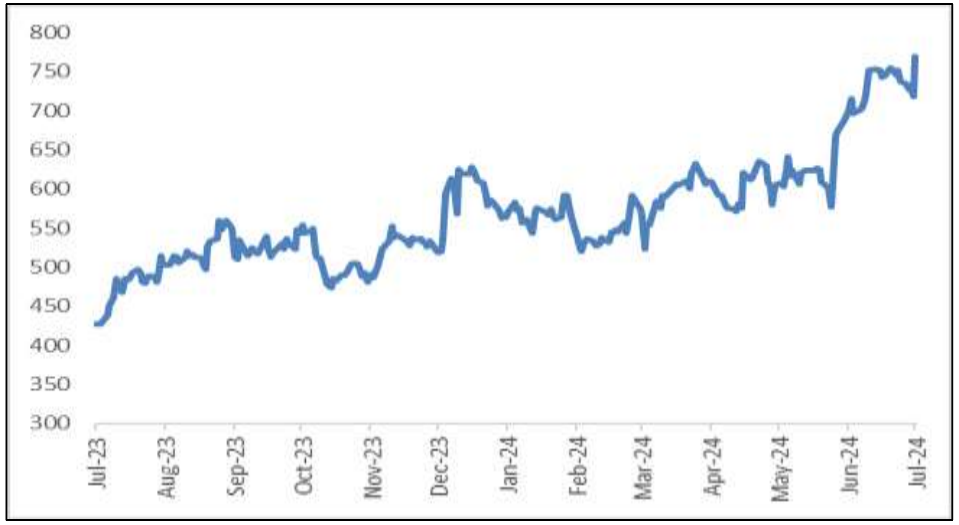
(Rs Cr)	FY22	FY23	FY24	FY25E	FY26E
Reported PBT	574	444	876	940	1,081
Non-operating & EO items	-63	-57	-116	-146	-169
Interest Expenses	33	26	19	10	8
Depreciation	185	183	134	101	110
Working Capital Change	-243	211	-48	72	-46
Tax Paid	-152	-93	-233	-230	-270
OPERATING CASH FLOW (a)	**335**	**714**	**632**	**746**	**714**
Capex	-247	-75	-9	-79	-90
Free Cash Flow	87	639	623	666	624
Investments	0	0	0	0	0
Non-operating income	20	30	63	146	169
INVESTING CASH FLOW (b)	**-227**	**-46**	**54**	**67**	**79**
Debt Issuance / (Repaid)	-97	-102	-70	0	0
Interest Expenses	-1	-4	-3	-10	-8
FCFE	-10	533	551	657	616
Share Capital Issuance	3	0	0	0	0
Dividend	-88	-113	-125	-248	-284
FINANCING CASH FLOW (c)	**-183**	**-219**	**-197**	**-258**	**-292**
NET CASH FLOW (a+b+c)	**-75**	**450**	**489**	**555**	**502**

Key Ratios

Particulars	FY22	FY23	FY24	FY25E	FY26E
Profitability Ratio (%)					
EBITDA Margin	15.5	11.4	17.8	16.8	16.9
EBIT Margin	11.1	7.6	15.0	14.9	15.1
APAT Margin	9.8	6.8	13.6	13.4	13.5
RoE	16.5	11.6	20.3	18.7	18.9
RoCE	14.2	10.6	18.2	16.8	16.9
Solvency Ratio (x)					
Net Debt/EBITDA	-1.8	-3.0	-2.6	-3.1	-3.2
Net D/E	-0.4	-0.6	-0.6	-0.7	-0.7
Per Share Data (Rs)					
EPS	18.2	14.3	29.1	31.1	35.5
CEPS	26.3	22.4	35.0	35.5	40.3
BV	117.7	130.3	156.0	176.2	199.3
Dividend	3.9	5.0	5.5	10.9	12.4
Turnover Ratios (days)					
Debtor days	68.5	54.9	54.5	54.0	54.0
Inventory days	0.0	0.0	0.0	0.0	0.0
Creditors days	27.2	20.9	23.0	22.5	22.4
Valuation (x)					
P/E	42.2	53.6	26.4	24.8	21.7
P/BV	6.5	5.9	4.9	4.4	3.9
EV/EBITDA	24.9	28.8	17.6	16.6	14.1
EV / Revenues	3.9	3.3	3.1	2.8	2.4
Dividend Yield (%)	0.5	0.6	0.7	1.4	1.6

(Source: Company, HDFC sec)

One Year Price chart



(Source: Company, HDFC sec)

HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions.
These stocks
have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

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