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INDIA / ITES SERVICES

Man Financial

Firstsource Solutions

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Poised for re-rating

We initiate coverage on Firstsource Solutions Ltd (FSL) with a 'BUY' rating and a price target of Rs 97 (+23%). FSL is the only India-listed pure play BPO vendor of significant scale. FSL offers a blended onshore/offshore delivery model, focuses on key verticals, and has a geographically diversified revenue mix. Despite having better earnings growth prospects vis-à-vis peers over FY07-FY09E, we find that FSL is quoting at a P/E discount of ~33% and ~31% for FY08E and FY09E (though discount on FY07 is only ~7%) to WNS Holdings. Given FSL's better growth prospects, coupled with improving ROEs through sustainable operating margins, we believe such a high discount is unwarranted and hence value FSL at 21.6x FY09E earnings of Rs 4.5, a 10% discount to WNS' FY09E P/E multiple.

Investment Rationale

- Strong performance to be driven by an early lead in the high-growth verticals, farming existing client accounts, business from the Metavante channel and increasing contribution from acquisitions. Revenues, EBITDA and Net profits are expected to grow at 39%, 41% and 46% CAGR over FY07-09E.
- FSL typically starts the year with a 90%-plus revenue visibility. Besides, it is less susceptible to a potential US slowdown due to dependence on continuous IT spends.
- The company has a natural hedge (which its competitors with India-based delivery capabilities lack) as it offers a blended onsite/near shore offshore delivery model.
- ROIC and ROE expansion to 20% and 15.4% in FY09E (vs. 13.2% and 12.9% in FY07) to be led by sustainable high operating margins and improved contribution from acquisitions.

Risks

- Higher-than-anticipated appreciation in the Indian rupee could impact our earnings estimates negatively. We have assumed a US$/Re exchange rate of Rs 41 and Rs 40 for FY08 and FY09, respectively. *(Also refer to our earnings sensitivity analysis to US$/Re rate on Pg 5)*

Valuation

- FSL is quoting at a P/E and EV/EBITDA of 20 and 13.5 on FY08E and 16.2 and 10.5 on FY09E, respectively. Our target price is based on 21.6x FY09E earnings, a 10% discount to WNS's FY09E P/E multiple.

BUY / Rs 79
Target Rs 97(+23%)

Sector (Relative to market)

OW	N	UW
	■	

Stock (Relative to market)

B	OP	N	UP	S
■				
> 10%	5% to 10%	5% to –5%	-5% to -10%	< -10%

This note should be read for
- Our take on the business
- Valuation and Target price
- Earnings sensitivity to US$/Re rate

Bloomberg code :	FSOL IN
Reuters code :	FISO.BO
www.firstsource.com	
BSE Sensex :	14868
NSE Nifty :	4333

Company data

O/S shares :	425mn
Market cap (Rs) :	33bn
Market cap (USD) :	815mn
52 - wk Hi/Lo (Rs) :	93 / 62
Avg. daily vol. (3mth) :	2.1mn
Face Value (Rs) :	10

Share holding pattern, %

Promoters :	25.0
FII / NRI :	58.5
FI / MF :	1.9
Non Promoter Corp. Holdings :	6.0
Public & Others :	8.6

Price performance, %

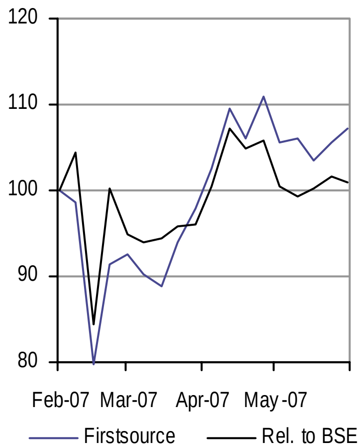
	1mth	3mth	1yr
Abs	-5.2	-8.9	NA
Rel to BSE	-4.3	-16.9	NA

Valuation summary

Y/E Mar, Rs mn	FY2005	FY2006	FY2007	FY2008E	FY2009E
Net Sales	3,219	5,488	8,298	12,202	16,202
Growth, %	79.6	70.5	51.2	47.1	32.8
Core EBIDTA	517	799	1,644	2,530	3,259
EBIDTA margins, %	16.1	14.6	19.8	20.7	20.1
Net profit	181	247	973	1,678	2,069
PAT margin, %	5.6	4.5	11.7	13.8	12.8
EPS, Rs	0.9	1.2	2.3	3.9	4.9
EPS Growth, %	638%	35%	87%	73%	23%
PER, x	87.6	64.6	34.5	20.0	16.2
EV/EBIDTA, x	67.0	43.7	21.6	13.5	10.5
EV/Net Sales, x	10.8	6.4	4.3	2.8	2.1
Price/Book Value, x	3.9	3.6	3.1	2.7	2.3
ROIC, %	5.2	6.0	13.2	16.5	20.1
ROE, %	5.7	5.8	12.9	14.5	15.4
Dividend Yield, %	-	-	-	-	-

Source: Company, Man Financial Research Estimates

Price vs. Sensex



Source: Bloomberg, Man Financial Research

ABOUT FIRSTSOURCE SOLUTIONS LTD

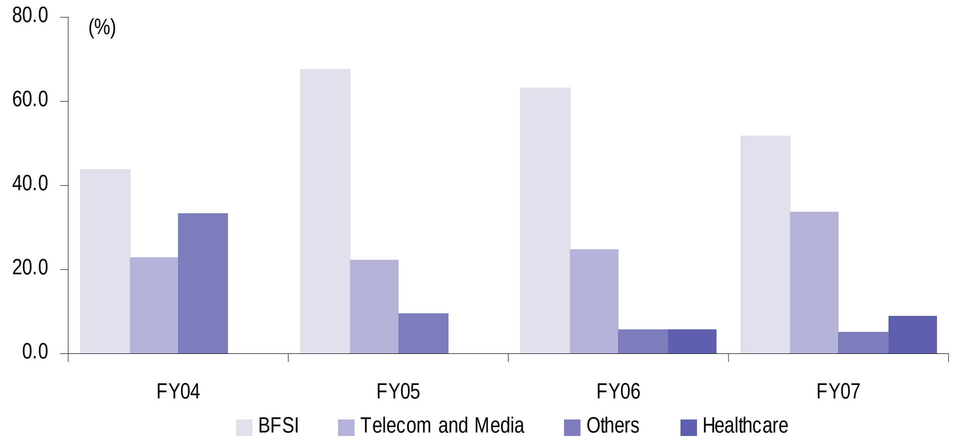
- FSL (formerly, ICICI One source) is the third largest pure play BPO services provider in India after Genpact and WNS Holdings (according to Nasscom Annual Rankings 2006).

- FSL has gone through a rapid scale-up growing from 4009 employees in FY04 to a strength of 15,314 at the end of Q1FY08. The company also added up 4,500 seats to take the total seat capacity to 11,286 at the end of FY07, with ~78% of the seat capacity based in India.

- FSL has 24 delivery centres across geographies with 15 in India, 6 in the US, 2 in Ireland and 1 in Argentina. The company is building a 500-seat capacity centre in Philippines, the first phase of which is expected to come on stream in H1FY08.

- The company focuses on three key verticals—banking, financial services and the insurance industry (BFSI), telecom, media and healthcare. FSL has been reducing its high dependence on the BFSI vertical, which accounted for 51.8% of revenues in FY07 (vs. 67.8% in FY05) through both organic as well as inorganic growth in other verticals.

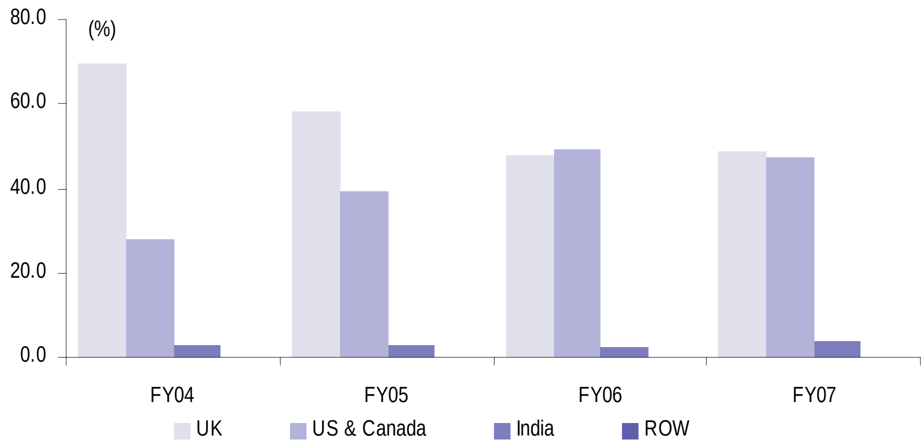
BFSI, major vertical share has been coming down



Source: Company, Man Financial Research

FSL is well-placed in terms of geographical diversification of revenues as it derives an almost equal proportion from the US and UK geographies.

Geographical break-up of revenue



Source: Company, Man Financial Research

The company has grown the number of active clients to 76 in FY07 (as against 21 in FY04). FSL's clients of note include BSkyB, Capitalone, LloydsTSB, Vodafone and Wachovia. The company has brought down the top client concentration from 26.9% in FY04 to 14.5% in FY07.

Client concentration

	FY04	FY05	FY06	FY07
Top client	26.9	21.2	16	14.5
Top 5	65.2	56.7	50.6	51.4
Top 10	84.3	78.9	72.7	67.5
Top 20	99.1	94.4	89.8	84.3

Source: Company, Man Financial Research

Rating and price target

The company is the largest pure play offshore BPO services provider listed in India and thus, does not have any similar India-listed peer. Genpact, the largest BPO services provider, according to Nasscom rankings, has followed suit with WNS Holdings (second according to Nasscom 2006 rankings) and EXL Services, both of which got listed on the NYSE last year.

Firstsource is well stacked up against competition

	Firstsource	WNS Holdings*	EXL Services**	Genpact**
Key Verticals addressed	BFSI, Telecom & Media, Healthcare	Travel/Transportation, BFSI	BFSI, Utilities, Healthcare & Media	BFSI, Manufacturing, healthcare & others
No. of delivery centres	24 centers		7	25 delivery centres with a presence in India, China, Hungary, Mexico & Philippines
Headcount	14,396	15,084	8,200	~28,000 employees
Attrition, %	42.2	40	39	21
Number of seats	11,286	8,713	4,817	N.A
Client concentration	Top client-14.5%	Top client-18%	Top client-33.8%	Top client GE-73.9% in CY06
	Top 5 clients-51.4%	Top 5 clients-55%	Top 3 clients-59%	Non GE-24.1% in CY06
	Top 10 clients-67.5%	Top 10 clients-70%	Top 10 clients-N.A	
Key Horizontal offerings	Customer Support, Research and Analytics	Administration, Customer support, Research	Administration, Customer Support, F& A	F& A, collections/customer services, Insurance. Supply Chain/Procurement Analytics, IT Infrastructure, enterprise applications
Geographical break-up of revenues	US & Canada-47.3%	UK-54%	N.A	N.A
	UK-48.7%	North America-23%	N.A	N.A
	India-3.8%	ROW-23%	N.A	N.A
	ROW-2%			
Top clients	Lloyds TSB, Capital one, BskyB	British Airways, Travelocity, Aviva	Norwich Union(Aviva Group Co), Centrica, Dell, American Express	GE, GE group companies
Whether BOT	No	Yes	Yes	
Revenues, FY07	Rs 8168mn ~US$ 200mn	US$ 213mn	US$ 133mn	US$ 613mn
Revenues, FY08E	Rs 12202mn	US$ 306mn	US$ 170mn	N.A
Revenues, FY09E	Rs 16202mn	US$ 403mn	US$ 201mn	N.A
Rev CAGR FY07-09E	39.7%	37.0%	23.0%	
EBITDA, FY07	Rs 1664mn	US$ 38.7mn	US$ 21.5mn	US$ 138mn
EBITDA, FY08E	Rs 2530mn	US$ 50.9mn	US$ 23.8mn	N.A
EBITDA, FY09E	Rs 3249mn	US$ 66.7mn	US$ 30.4mn	N.A
EBITDA CAGR FY07-09E	41.0%	31.0%	19.0%	
Net profits, FY07	Rs 972mn	US$ 29.1mn	US$ 14.2mn	US$ 35mn
Net profits, FY08E	Rs 1678mn	US$ 30.8mn	US$ 16.2mn	N.A
Net profits, FY09E	Rs 2061mn	US$ 44.6mn	US$ 19.8mn	N.A
Net profit CAGR FY07-09E	46.0%	24.0%	18.0%	
ROE %, FY07	12.9	23.7	15.7	N.A
ROE %, FY08E	14.5	18.7	14.9	N.A
ROE %, FY09E	15.4	21.9	15.8	N.A
P/E, FY07	34.7	37.1	36.9	N.A
P/E, FY08E	20.3	31.8	27.7	N.A
P/E, FY09E	16.5	23.9	22.7	N.A

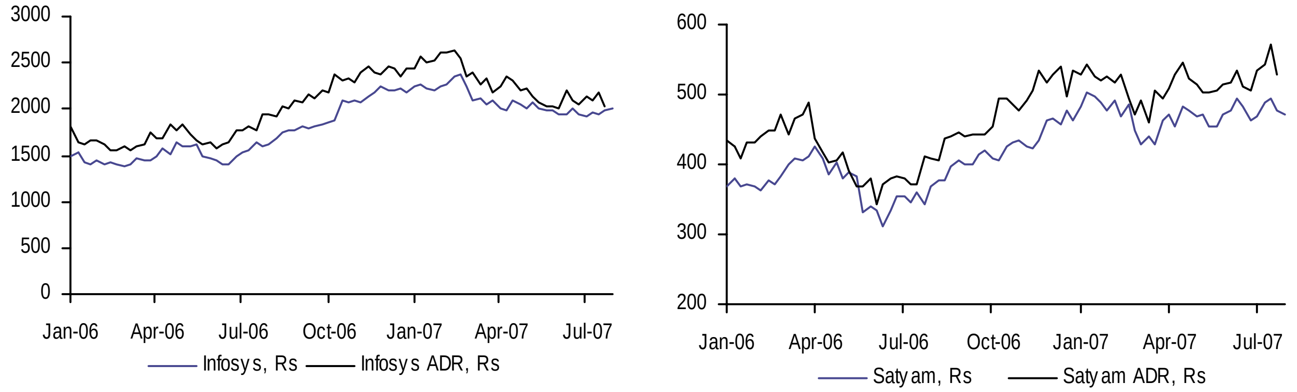
Source: Company, Man Financial Research

*-Bloomberg Consensus estimates

**- EXL Services and Genpact follow the Jan-Dec accounting period

WNS Holdings trades at a P/E of 30.5x and 23.9x on FY08E and FY09E, a significant premium to the India-based IT services companies like Infosys, Satyam and Wipro. We believe that valuation multiples for pure play BPO service providers like WNS Holdings that trade in the foreign markets would continue to be rich vis-à-vis the IT service vendors. This is despite their being smaller in size (Genpact, the biggest India-centric BPO provider had sales of US$ 613mn in CY06) and having a higher client concentration (players like WNS Holdings, Firstsource and EXL services have a top client concentration ranging between 15-34%). This is on account of high revenues visibility (longer nature of engagements lead to high revenue visibility), higher earnings growth coupled with their foreign listing. Also worth noting is that the P/E premium to the ADRs of the Indian IT services players like Infosys, Satyam and Wipro is currently in the range of 8-10%.

Infosys and Satyam's ADRs have quoted on an average at ~11% premium to their local shares



Source: Bloomberg, Man Financial Research

We believe that Firstsource is closest to WNS Holdings in terms of scale. At the current price, Firstsource quotes at a P/E discount of 33% on FY08E and 31% on FY09E to WNS Holdings. We feel that such a high discount to WNS is unwarranted given that Firstsource has built up incremental capacity ahead of demand, which should start contributing from FY08 onwards (FSL has added 4,500 seats over FY07), increasing ROEs on account of sustainable margins and higher contribution from the acquisitions and we believe that the premium gap should be around 10% (on account of lower ROE as compared with WNS Holdings). Hence, we attribute a 1-year price target of Rs 97 (+23%), based on 1-year forward PER of 21.6 on FY09E earnings.

Firstsource's earnings sensitivity to US$ /Re exchange rate

	FY08E			FY09E		
US$/Re	41	40	39	41	40	39
Fully Diluted EPS E	3.6	3.5	3.43	4.7	4.5	4.3
P/E	21.9	22.6	23.0	16.8	17.6	18.4
TP, on 21.6x FY09E earnings				102	97	93
% upside to CMP				29%	23%	18%

Source: Man Financial Research Estimates

Price Performance

Rs, %	CMP Close	1M	3M	6M	1Year	YTD
BSE Sensex	14,936	1.9	7.7	4.7	38.9	8.3
Nifty	4,346	0.6	6.3	5.0	38.1	9.6
Firstsource solutions	79	(6.0)	(3.5)	N.A.	N.A.	N.A.
Allsec Technologies	210	(15.5)	(27.6)	(42.7)	(0.9)	(27.0)

Source: Bloomberg

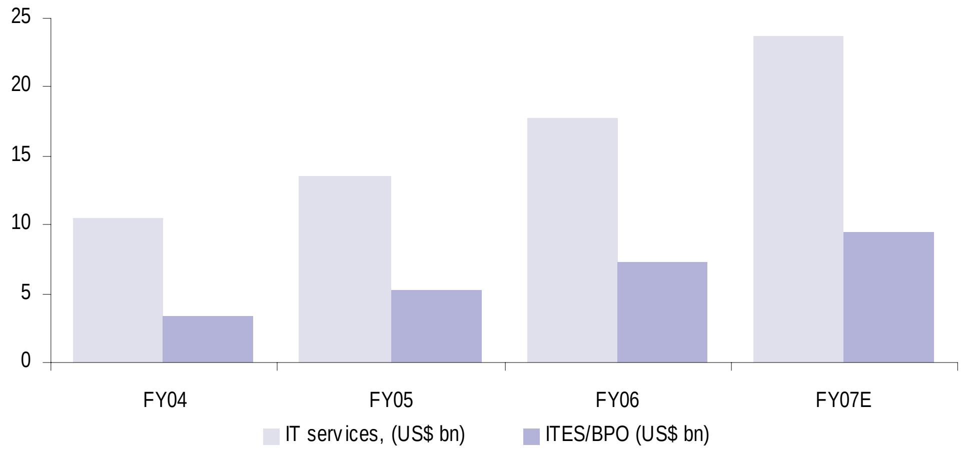
INVESTMENT RATIONALE

Early mover in a rapidly growing, under-penetrated industry

Firstsource is an early leader in an under-penetrated space.

The India-based offshore BPO market is still emerging from infancy having so far been overshadowed by their better-known brethrens from the IT services industry. (In FY06, Indian BPO revenues were at US$ 7.2bn vs. US$ 17.8bn for IT services)

Indian BPO revenues growing faster than Indian IT services revenues



Source: Nasscom

We believe that this is set to change with the Indian BPO industry having attained a respectable size mass, both in terms of revenues and workforce, BPOs would usher in the next wave of growth in India. Besides, the Indian BPO players have been able to achieve a critical level of maturity in process delivery, which makes us more confident on the sustainability of growth for the industry as it supplements the foremost offshore cost leverage that triggered the initial growth in the space. FSL has been able to establish an early leadership position in this space having been ranked as the third largest pure play BPO vendor after Genpact and WNS Holdings and fifth overall (after including the BPO arms of IT companies) in the Nasscom 2006 rankings. We expect FSL to continue on strong revenue CAGR of 39% over FY07-09E and record revenues of Rs 16,202mn in FY09E.

Firstsource has achieved early leadership in the BPO space with ~15,300 employees and revenues of Rs 8,168mn in FY07.

Rs mn	FY04	FY05	FY06	FY07
Employees, nos	4007	6147	8350	14396
Revenues	1792	3219	5488	8168
Revenue gwth, %		79.6	70.5	48.9
EBITDA mrgn, %	10.8	16.1	14.6	19.8
Net Profit, Rs mn	6	181	247	972
Net profit gwth, %		2864	36.2	294.1

Source: Company, Man Financial Research Estimates

We expect momentum to continue and Firstsource to chart revenue CAGR of 39% with margins to be sustainable at ~19-20% levels through benefits of economies of scale over FY07-09E.

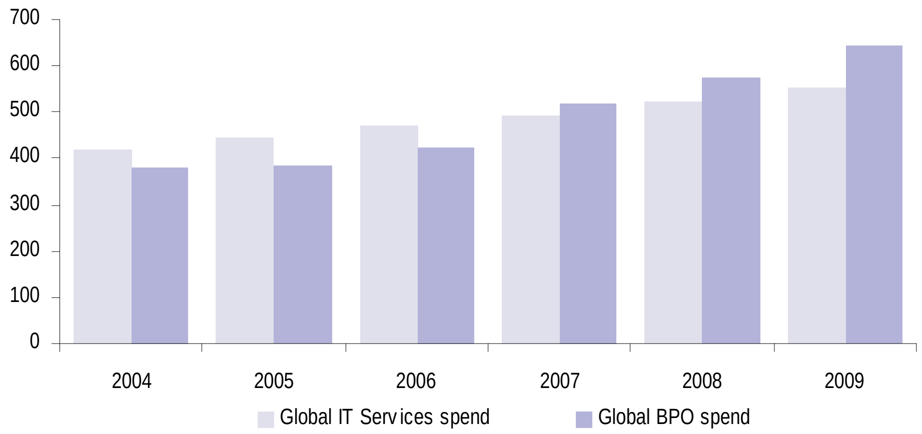
Nasscom Rankings

	2004	2005	2006
1	WNS	WNS	Genpact
2	Wipro BPO	Wipro BPO	WNS
3	IBM Daksh	HCL BPO	Wipro BPO
4	Convergys	IBM Daksh	HCL BPO
5	HCL BPO	Firstsource	Firstsource
6	Zenta	EXL	IBM Daksh
7	Firstsource	Mphasis BPO	Progeon

Source: Nasscom

Nasscom expects that the BPO market would grow at a 11% CAGR from US$ 422bn in CY05 to US$ 642bn in CY09 and exceed the market size for IT services (expected to be at ~US$ 533bn by CY09).

Global IT services and BPO spend estimates



Source: Nasscom

Global BPO spends expected to outstrip IT spends by CY09.

Nasscom further estimates the total addressable offshore market size to be ~US$ 120-150bn currently with the offshore penetration barely at ~9% levels.

(US$ bn)	Current Market Size*	Growth over CY05-10
Global BPO Industry	422	11
Offshore BPO Industry	11.4	37
Indian BPO Industry	5.1	37

Source: Nasscom *as per Nasscom Mckinsey report 2005

The Indian vendors are expected to maintain their current dominance levels on the back of increasing scale and maturity and low penetration levels

The Indian-based BPO vendors account for ~46% of the offshore BPO market, having grown at a 45.5% CAGR over FY04-FY06, and we expect the dominance by the India-based players to continue driven by lower penetration levels, the strong customer demand for offshore BPO services, the increasing scale and the 'maturity of the processes' of the Indian vendors.

Addresses 60% of the offshore pie

Firstsource is primarily focused on providing services to three verticals, namely, banking and financial services, telecom & media, and healthcare that account for ~60% of the offshore addressable opportunity of US$ 120-150bn.

Firstsource focuses on 3 key verticals, namely BFSI, Telecom/Media and Healthcare that account for ~60% of the addressable opportunity.

Break-up of offshore addressable opportunity

Verticals	Total addressable market	Offshore BPO pentration (%)
Retail Banking	US$ 35-40 bn	9
Insurance	US$ 25-30 bn	6
Auto manufacturing	US$ 10-12 bn	9
Travel and Transportation	US$ 10-12 bn	3
Telecom	US$ 8-10 bn	9
Pharmaceuticals	US$ 4-5 bn	8
Others	US$ 10-15 bn	9
Total Offshore addressable market	US$ 120-150 bn	9

Indian BPO revenues vertical break-up

(In US$ bn)	2005	2010E
Retail Banking	1.6	7.6
Insurance	0.8	4.8
Telecom	0.4	1.7
Pharma/Healthcare	0.2	0.9
Manufacturing	0.5	2
Travel/Hospitality	0.2	1.3
Horizontals	0.9	4.5
Others	0.6	2.5

Source: Nasscom

BFSI: Broad offering, in-depth knowledge, 'Go to market' with Metavante

FSL provides a comprehensive bouquet of services in the BFSI vertical that include customer service management, collections and research and analytics, which is ably backed by in-depth knowledge in retail banking of the promoter, ICICI Bank. Firstsource has entered into a strategic tie-up with Metavante, a financial technology subsidiary of Marshall and Ilsley Corporation that enjoys a dominant position in the mid-market segment and is the third largest banking technology and payments processor in the US after Fidelity and Fiserve. Under the tie-up arrangement, FSL has access to Metavante's technology platform besides being the exclusive offshore partner and preferred onshore vendor for BPO services to both Metavante and its clients.

The company is well positioned in these verticals with a broad range of offerings, strategic tie –ups and inorganic moves and multiple shore delivery capabilities.

This vertical alone accounts for US$ 60-75bn of the addressable opportunity with penetration levels at 8-9%, currently. Most of the mid-sized banks, insurance companies and almost all asset management companies have been reluctant in embracing offshoring. We believe that the combined ***'Go to Market'*** with Metavante gives FSL an opportunity to make headway into this particular segment that would have otherwise been off its radar, by leveraging Metavante's relationships. It also provides Firstsource the access to Metavante's technology platform, which could help FSL to develop high-end platform-based service offerings. Firstsource has already been seeing initial traction, winning three customers through the Metavante channel.

Revenue by Industry

Rs mn	FY04	FY05	FY06	FY07
BFSI revenues	786	2183	3485	4231
in % terms	*43.9*	*67.8*	*63.5*	*51.8*
Telecom and Media	408	725	1372	2769
in % terms	*22.8*	*22.5*	*25.0*	*33.9*
Healthcare	0	0	313	751
in % terms			*5.7*	*9.2*
Others	597	311	318	417
in % terms	*33.3*	*9.7*	*5.8*	*5.1*

Source: Company, Man Financial Research Estimates

Telecom and Media: End-to-end offering, multiple shore delivery

FSL provides a whole gamut of services that includes customer acquisition, service fulfillment support, churn management and collections. FSL counts two of the world's top-10 telcos among its customers and provides end-to-end services that span the entire customer cycle with an inherent advantage of delivery from multiple locations. Its proven track record in the vertical helped it to win a customer handling engagement from Hutch for their south and east territory, which when scaled up to full capacity, would be 2,000 seats and is expected to contribute to ~10% of the revenues in FY08E.

Healthcare: Given inorganic fillip to capabilities

FSL has been focusing on the insurance payers segment that includes health insurance companies and third-party administrators, who are reeling under cost pressures. The company acquired capabilities of claims processing, claims pricing, mail/document management, etc. through the acquisition of RevIT in March '06. The company made another inorganic move by acquiring BPM in Q3FY07, a profitable and growing business which has given a fillip to the company's service offerings by the addition of claims adjudication capabilities, along with bringing 12 clients into the fold (of which four are amongst the top-10 healthcare payers).

We believe that after the acquisition, FSL is well placed to take advantage of growing opportunities in this vertical with its end-to-end service offerings, near-shore presence in the US (three facilities with 600-seat capacity) and strong domain expertise of the BPM management.

High growth to continue

Farming existing clients

FSL has been able to establish a number of marquee client relationships that include 3 of the 5 largest US banks, 2 of the world's top-10 telcos, 3 'Fortune 100' healthcare companies, amongst others. FSL has demonstrated the ability to grow and farm these client relationships having been able to increase the number of clients contributing more than Rs 500mn revenues annually to 5 in FY07 (vs. nil in FY04)

Client mining in strong vein

Income from Services	FY04	FY05	FY06	FY07
Less than Rs 50mn	12	8	33	52
50 mn to 250mn	8	10	14	17
Rs 250 mn to Rs 500mn	1	5	4	2
Greater than Rs 500mn	0	1	3	5

Source: Company, Man Financial Research

Firstsource has exhibited strong client mining capabilities

We believe that given the nature of the BPO business (long-term contracts), vendors can achieve greater traction with a client by gaining the client's confidence through timely execution. FSL is well positioned to further farm some of its existing client accounts, both through existing services and cross-selling (as they have significant outsourcing requirements of their own) and hence, become a one-stop offshore partner for them. Also, these clients provide FSL with a referencable customer base that it could leverage to win business from new clients.

Blended onshore/ near-shore/offshore delivery model

FSL has been building a blended 'onshore/near shore-offshore' business model unlike most other Indian BPO vendors who are largely offshore centric. We believe that this kind of a delivery model helps FSL to gain an entry in the case of those clients that might have otherwise been reluctant to engage with a pure offshore vendor. Once the client is comfortable with it, FSL could transition the work to lower-cost locations like India and the Philippines. Besides, an onsite presence in a few service lines, like customer care work, gives FSL an edge over competition as well as a natural currency hedge, to some extent, which pure offshore-centric BPO vendors lack.

Blended delivery model provides a natural forex hedge lacked by most of the competition.

Inorganic impetus

FSL has made six acquisitions in the past, starting with Customer Asset Management in the year 2002 to the latest acquisition of Business Process Management (BPM) in December ’06.

Inorganic moves to enter newer areas and beef up capabilities

Acquired Company	Date	Amount paid	Key rationale
Customer Asset India Pvt Ltd	May '02	US$ 19.3mn	Was used to kickstart operations in the business, provide customer services and fulfillment services in BFSI, telecom and media verticals
First Ring Inc	July '03	US$ 13mn	Added customer acquisition service to the BFSI portfolio, Provided presence in the US.
Pipal Research	July' 04	US$ 3.28mn (for 51% stake)	Gets entry into the R & A space. Pipal offers business and marketing research in BFSI
Account Solutions Group	Sep '04	US$ 29.08mn	Kicks off entry into the collections business.
Rev IT	March '05	US$ 21.27mn	Healthcare is added to the serviced verticals
BPM	Dec '06	US$ 31.5mn	Adds claims adjudication capabilities in healthcare, 3 centres in the US

Source: Company, Man Financial Research

Firstsource has been proactive in inorganic moves, to complement organic growth

We believe that the inorganic moves of the company have been well-considered decisions and have complemented the organic growth of the company. These steps have mostly been undertaken to add new service capabilities, to acquire customers, or to gain near-shore presence. The company has demonstrated the ability to seamlessly integrate the acquired companies (with most of the acquired companies’ managements working even after the integration).

Sticky revenues, high visibility: Less susceptible to potential slowdown

FSL depends on clients’ operating budget and is hence less susceptible to any kind of slowdown in IT spending.

We believe that FSL is in a sweet spot and much better placed vis-à-vis some of its peers from the IT services industry if a potential slowdown in the US comes calling. This is because BPO revenues are derived from the client’s core operations. The higher dependence on the ongoing operating IT budget of clients, (unlike the dependence on the discretionary IT spend for the IT services players) leaves offshore BPO vendors in a less vulnerable situation if the US slowdown was to become a reality. We feel that since FSL targets continuous IT spend, there would be no negative impact of any slowdown in the US, whereas IT services companies could be affected negatively in the short run as clients cut down their new application development budgets.

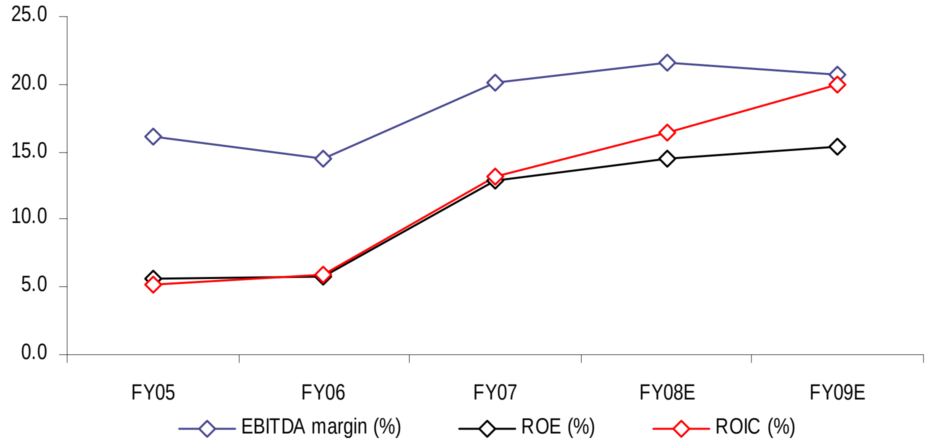
Firstsource starts the year with ~90% visibility on revenue front

On account of a high dependence on the operating IT budget of clients and the long-term nature of the contracts (typically in the range of 3-5 years), FSL has a high visibility on the revenue front (starts the year with a revenue visibility of at least 90%). Besides there is high ‘stickiness’ to BPO revenues on account of high switching costs associated with moving work from one vendor to another. The high switching costs related to moving work from one vendor to another also provides FSL the opportunity to farm the client while offshoring additional processes.

Margins and Return ratios to inch upwards

FSL has been expanding at a rapid pace, being in heavy investment mode, and has hence, suffered from low margins. However, despite being in the scale-up phase, its margins have improved significantly from 10.7% to 19.8% over FY04-07. We believe that FSL has reached a stage of stable and sustainable margins, going forward, that would primarily be driven by economies of scale, change in process mix as the company scales up transaction processing capabilities, improvement in utilization and SG &A efficiencies.

ROE and ROIC expansion to be led by sustainable margins



Source: Company, Man Financial Research Estimates

FSL has suffered from low return ratios (ROE and ROIC) because of a large amount of goodwill (on account of a large number of acquisitions) in the balance sheet (Rs 5419mn, ~43% of the total assets at the end of FY07). We believe that FSL's return ratios would head northward (ROIC and ROE to improve to 20% and 15.4% in FY09E from 13.2% and 12.9% in FY07) from here, both on account of sustained higher margins as well as the improving contribution from the acquisitions.

Valuation discount to peers unwarranted given better prospects

Firstsource lacks any India listed peers and we feel that the US listed WNS Holdings and EXL Services serve as the real comparables to it*. (Please refer to our table on Page 4 for details)* with WNS Holdings coming closest to Firstsource in terms of scale (revenues and manpower), similar client concentration (top client accounted for 14.5% of FY07 revenues for FSL Vs 18% for WNS).

Firstsource stacked better than WNS Holdings

	Firstsource	WNS Holdings	% Discount
Rev CAGR FY07-09E	39.7%	37.0%	n.a
EBITDA CAGR FY07-09E	41.0%	31.0%	n.a
Net Profit CAGR FY07-09E	46.0%	24.0%	n.a
P/E, FY07	34.5	37.1	7.1%
P/E, FY08E	20.3	30.5	33.4%
P/E, FY09E	16.5	23.9	31.0%

Source: Company, Man Financial Research Estimates

We see that the P/E discount to WNS on FY07 basis is ~7% (in line with the discount to local prices and ADR prices of Indian IT companies like Infosys, Satyam and Wipro). However the discount on FY08E and FY09E is ~33% and 31%, which we believe is unwarranted given Firstsource's improving ROE's (ROE's to expand from 12.9% currently to 15.4% in FY09E), sustainable margins going forward and feel that the valuation discount to WNS should narrow to 10% and hence value Firstsource at 21.6x FY09E earnings.

FINANCIALS

Income Statement

(Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Net sales	3,219	5,488	8,298	12,202	16,202
Growth, %	*79.6*	*70.5*	*51.2*	*47.1*	*32.8*
Other income	16	12	146	211	120
Total income	3,235	5,499	8,443	12,414	16,322
Operating expenses	-2,702	-4,689	-6,654	-9,672	-12,943
EBITDA	517	799	1,644	2,530	3,259
Growth, %	*168.3*	*54.5*	*105.8*	*53.9*	*28.8*
Margin, %	*16.1*	*14.6*	*19.8*	*20.7*	*20.1*
Depreciation	-330	-451	-641	-798	-927
EBIT	187	347	1,002	1,732	2,333
Growth, %	*789.2*	*85.8*	*188.7*	*72.8*	*34.7*
Margin, %	*5.8*	*6.3*	*12.1*	*14.2*	*14.4*
Interest paid	-29	-89	-122	-12	-40
Pre-tax profit	173	270	1,026	1,931	2,413
Tax provided	3	-27	-60	-260	-350
Profit after tax	176	243	966	1,672	2,063
Net Profit	181	247	973	1,678	2,069
MAN Net profit	181	247	973	1,678	2,069
Growth, %	*2,864.0*	*36.2*	*294.1*	*72.5*	*23.3*
Extraordinary items: Gains/(Losses)	0	0	0	0	0
Unadj. shares (m)	200.7	201.9	425.1	425.1	425.1
Wtd avg shares (m)	200.7	201.9	425.1	425.1	425.1

Cash Flow

(Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Pre-tax profit	173	270	1,026	1,931	2,413
Depreciation	330	451	641	798	927
Chg in working capital	52	-59	-1,033	-590	-762
Total tax paid	0	29	-51	-224	-317
Other operating activities	0	0	0	0	0
Cash flow from operating activities	555	691	584	1,915	2,261
Capital expenditure	-2,895	-1,061	-2,637	-998	-900
Chg in investments	0	0	-1,153	0	0
Chg in marketable securities	0	0	0	0	0
Other investing activities	0	0	0	0	0
Cash flow from investing activities	-2,895	-1,061	-3,789	-998	-900
Free cash flow	-2,340	-371	-3,205	917	1,361
Equity raised/(repaid)	1,625	16	5,369	0	0
Debt raised/(repaid)	842	258	676	-1,492	0
Dividend (incl. tax)	0	0	0	0	0
Other financing activities	0	0	0	0	0
Cash flow from financing activities	2,528	271	6,045	-1,485	6
Net chg in cash	188	-99	2,840	-568	1,367

Balance Sheet

(Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Cash & bank	269	170	3,010	2,442	3,809
Marketable securities at cost	0	0	0	0	0
Debtors	619	1,007	1,364	1,856	2,455
Inventory	0	0	0	0	0
Loans & advances	318	457	1,306	1,792	2,369
Other current assets	0	0	0	0	0
Total current assets	1,206	1,635	5,680	6,089	8,633
Investments	0	0	1,153	1,153	1,153
Gross fixed assets	5,639	6,648	9,311	10,311	11,211
Less: Depreciation	-1,077	-1,487	-2,171	-2,969	-3,896
Add: Capital WIP	55	64	82	80	80
Net fixed assets	4,617	5,226	7,221	7,422	7,395
Non-current assets	0	0	0	0	0
Total assets	5,827	6,865	14,060	14,669	17,187
Current liabilities	668	1,094	1,195	1,568	1,895
Provisions	0	97	180	231	351
Total current liabilities	668	1,191	1,376	1,799	2,247
Non-current liabilities	1,043	1,300	1,976	484	484
Total liabilities	1,710	2,491	3,351	2,283	2,731
Paid-up capital	2,007	2,019	4,251	4,251	4,251
Reserves & surplus	2,054	2,306	6,415	8,093	10,162
Shareholders' equity	4,117	4,373	10,709	12,387	14,456
Total equity & liabilities	5,827	6,865	14,060	14,669	17,187

Source: Company, Man Financial Research Estimates

Ratios Fundamentals

	FY05	FY06	FY07E	FY08E	FY09E
Return on assets (%)	4.6	4.8	10.0	11.7	13.1
Return on equity (%)	5.7	5.8	12.9	14.5	15.4
Return on Invested capital (%)	5.2	6.0	13.2	16.5	20.1
RoIC/Cost of capital (x)	0.4	0.5	1.0	1.2	1.5
RoIC - Cost of capital (%)	(7.7)	(6.9)	0.2	3.1	6.7
Return on capital employed (%)	5.1	5.5	11.3	13.0	14.8
Cost of capital (%)	12.9	12.8	13.0	13.4	13.4
RoCE - Cost of capital (%)	(7.8)	(7.3)	(1.7)	(0.4)	1.4
Asset turnover (x)	0.9	1.0	1.2	1.3	1.6
Sales/Total assets (x)	0.8	0.9	0.8	0.8	1.0
Sales/Net FA (x)	1.0	1.1	1.3	1.7	2.2
Working capital/Sales (x)	0.1	0.1	0.2	0.2	0.2
Fixed capital/Sales (x)	1.0	0.9	0.5	0.5	0.5
Receivable days	70.2	67.0	60.0	55.5	55.3
Inventory days	-	-	-	-	-
Payable days	-	29.6	49.7	45.9	43.7
Current ratio (x)	1.8	1.4	4.5	3.7	4.3
Quick ratio (x)	1.8	1.4	4.5	3.7	4.3
Interest cover (x)	6.4	4.1	12.9	142.0	58.3
PER (x)					
PEG (x) - y-o-y growth	87.6	64.6	34.5	20.0	16.2
Price/Book (x)	0.1	1.8	0.4	0.3	0.7
Yield (%)	3.9	3.6	3.1	2.7	2.3
EV/Net sales (x)	-	-	-	-	-
EV/EBITDA (x)	10.8	6.4	4.3	2.8	2.1
EV/EBIT (x)	67.0	43.7	21.6	13.5	10.5
EV/NOPLAT (x)	185.3	100.5	35.5	19.7	14.6
EV/CE	66.6	45.2	22.5	15.0	11.7
EV/IC (x)	6.7	6.1	2.8	2.6	2.2

Source: Company, Man Financial Research Estimates

Man Financial

NOTES

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