

February 25, 2020

Zensar Technologies Limited: Ratings reaffirmed; Outlook revised to Negative

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term/Short-term - Fund-based/Non-fund based	191.00	177.00	[ICRA]AA+/ [ICRA] A1+; reaffirmed; outlook revised to negative from stable
Long-term - Non-fund based	-	14.00	[ICRA]AA+; reaffirmed; outlook revised to negative from stable
Total	191.00	191.00	

*Instrument details are provided in Annexure-1

Rationale

The revision in outlook to Negative from Stable for Zensar Technologies Limited (ZTL) takes into account the revenue decline as well as the margin contraction during Q3 FY2020. The de-growth is a result of certain one-time discounts, the impact of furloughs in Q3 and client ramp-downs in the retail segment. The management expects a continued slowdown in the retail vertical in the near term though it is expected to stabilise by FY2021 with ZTL's expansion into the consumer services and supply chain management with lower reliance on front-end retail. The operating and net margins reduced to 6.8% and 4.0% in Q3 FY2020, versus operating and net margins of 10.7% and 5.5%, respectively, in Q3 FY2019. The Q3 FY2020 profitability was adversely impacted by the decline in revenues (3.5% impact), the seasonal impact of a higher pass through product sales (0.9% impact) and a lower capacity utilisation and ramp-down in business (2.1%). As per the management, if the OPBITDA were adjusted for seasonal impact (revenue decline and seasonal change in business mix), it would result in an operating margin of 11.2% in Q3 FY2020 as opposed to reported OPBITDA of 6.8% in Q3 FY2020.

The ratings remain constrained by the moderately high customer concentration risk arising out of the dependence for revenues on a single client, mitigated to a large extent by the strong and established relationship with the customer. While increasing the scale and the size of its operations, a leveraged funding structure for future acquisitions could materially impact the company's financial risk profile. Further, a large cross-border acquisition would entail careful integration of operations to realise likely synergies. Profitability remains susceptible to pricing pressures, wage inflation, adverse foreign exchange rate fluctuations and a general stagnation and negative headwinds in business across the US, Europe and South Africa.

The ratings derive comfort from the healthy financial profile of ZTL characterised by the recurring free cash flows and a strong cash and cash equivalent position. The recent acquisitions have led to a build-up in debt Rs. 300.4 crore as on March 31, 2019 and Rs. 323.1 crore as of December 2019, (excluding operating lease obligations), though the coverage indicators remain comfortable. The liquidity profile remains supported by significant cash and liquid investments of Rs. 417.6 crore as of March 2019 and Rs. 656.4 crore as of December 2019. In FY2019, the operating income (OI) grew by 27.6% YoY – led by 29.2% YoY growth in application managed services (AMS) and 19.8% YoY growth in infrastructure managed services (IMS). The OI growth was driven by acquisitions – coupled with a growth in the base application management services (AMS) vertical; while, the infrastructure management services (IMS) division growth was driven by cloud infrastructure services. The ratings also take into account the broad client base, the diversified revenue base across geographies as well as the presence in multiple verticals, all of which lend diversification and stability to the revenues. The acquisitions of Foolproof Limited (November 2016), Keystone Limited (April 2017), Cynosure Inc. (April 2018) and Indigo Slate (July 2018) have diversified ZTL's service offerings (digital services) and expanded its addressable market while adding to its growth potential. The company's revenue contribution from digital services grew to 45.4% as of March 2019 and 54.1% as of December 2019 from 38.1% in March 2018. With a healthy order book as of December

2019; a growing digital presence; the integration of acquisitions; the growth prospects of cloud infrastructure services; and, a focused effort to scale up top-tier growth accounts; ZTL's revenues and profitability are expected to improve from the current levels and will remain the key monitorable.

Key rating drivers and their description

Credit strengths

Healthy revenue visibility in the digital space for AMS and IMS despite continued softness in the retail quarter – ZTL's revenues from the digital segment grew – from 5.0% in FY2014 to 45.4% as of March FY2019 and 54.1% as of December 2019. In FY2019, the OI grew by 27.6% YoY, led by 29.2% YoY growth in AMS and 19.8% YoY growth in IMS. The growth in AMS was driven primarily by the recent acquisitions of Cynosure and Indigo Slate, coupled with 11.0-12.0% growth in base AMS business. Cynosure is a licensed Guidewire Software partner in the property and casualty (P&C) insurance segment; while Indigo Slate is a digital marketing customer experience agency. The IMS division grew primarily led by cloud infrastructure services, which has healthy growth prospects and is margin accretive providing growth levers for the future.

The retail segment witnessed a 32.2% YoY and a 17.9% YoY de-growth in Q3 FY2020 and 9M FY2020 respectively. The retail vertical declined sharply as ZTL strategically exited from some tail-end retail clients coupled with the overall softness in the front-end retail environment. Increasing competition from online platforms, shutdown and consolidation of brick-and-mortar stores have led to a decline in the retail environment. The vertical is expected to remain soft over the next few quarters but will stabilise by FY2021 with the company's expansion into consumer services and supply chain management.

Diversified presence across various service lines and verticals – The company's revenues are diversified across various service offerings, such as the application management services comprising application development and support services; the testing services and product engineering; the infrastructure management services; and the digital offerings. Further, its clientele is distributed across the manufacturing (industrial and hi-tech), retail, and banking and financial services (BFSI) domains, resulting in sectoral diversification. Manufacturing (Hitech) and BFSI (Insurance) are the focus verticals for the company's management, going forward. The Hitech vertical grew by 34.8% YoY and 13.2% YoY in FY2019 and 9M FY2020, respectively – while BFSI grew – by 45.8% YoY and 19.3% YoY in FY2019 and 9M FY2020, respectively. The growth in BFSI was led by the insurance vertical post acquisition of Cynosure in FY2019. The retail segment is expected to remain soft in the near term but will recover shortly, with expansion into consumer services and supply chain management business domains.

Strong capital structure with net cash position coupled with recurring cash flows – Despite the debt-funded capex of Rs. 300.4 crore as on March 2019, the financial profile remains healthy supported by a strong cash and cash equivalent position of Rs. 417.6 crore; and recurring accruals of Rs. 331.0 crore as on March 31, 2019. The company continued to maintain a net cash position of Rs. 117.2 crore as on March 31, 2019. In 9M FY2020, the debt levels were recorded at Rs. 323.1 crore (excluding operating lease liabilities) with cash and cash equivalents of Rs. 656.4 crore, maintaining a net cash position of Rs. 333.3 crore.

Part of a large, established and diversified Group imparts financial flexibility – ZTL is part of the ~Rs. 255-billion (FY2019 revenues) RPG Group, which has a diversified presence in infrastructure, tyres, technology and pharmaceuticals. ZTL derives financial flexibility and benefits from the strong management lineage of the Group.

Credit challenges

Moderate scale of operations with a moderately high dependence on a single client; supported by strong and established relationship – With revenues – of Rs. 3,966.3 crore as on March 31, 2019 and revenues of Rs. 3163.9 crore

on December 31, 2019, ZTL is a mid-sized information technology (IT) company in the \$177–181 billion Indian IT industry¹. The company derived 36.5% of its revenues from its top five clients in FY2019 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.

Margins vulnerable to wage inflation, forex fluctuations and pricing pressure; one-time expenses and overall revenue decline impacted margins adversely in Q3FY2020 – ZTL recorded operating margins of 12.1% in FY2019 and 11.6% in 9M FY2020 (6.8% in Q3 FY2020) and net margins of 8.0% in FY2019 and 6.3% in 9M FY2020. The operating margins were adversely impacted in Q3 FY2020 due to the decline in revenues (3.5% impact), seasonal impact of a higher pass through product sales (0.9%) and the lower capacity utilisation and ramp-down in business (2.1%). As per management, if the OPBITDA were adjusted for seasonal impact (revenue decline and seasonal change in business mix), it would result in an operating margin of 11.2% in Q3 FY2020 opposed to the reported OPBITDA of 6.8% in Q3FY2020. But, given the intense competition in the industry, ZTL's profit margins are susceptible to the pricing pressures and the wage inflation. Further, much of the revenues and margins are exposed to forex risks, although ZTL's hedging mechanisms mitigate the same to an extent. Existing in a highly labour-intensive business, the company faces the key challenges of the availability and the retention of a skilled workforce. ZTL is also exposed to the hiring norms of the countries it operates in.

Intense competition from established Indian and foreign-based IT service providers – The increasing competition and pricing pressures from the existing incumbents may impact the company's future growth and profitability indicators. ZTL is adapting to the changing technology landscape by focusing on digital technologies.

Liquidity position: Strong

The company generated healthy funds flow from operations (FFOs) of Rs. 301.6 crore in FY2019 supported by a healthy revenue growth and an improvement in accruals. The liquidity is supported by a significant cash and cash equivalents of Rs. 417.6 crore in FY2019 (Rs. 656.4 crore in 9M FY2020) and the unutilised fund-based limits. ZTL's average utilisation of fund-based and non-fund based limits (fungible limits) for the 12 months ended November 2019 was 2.5% of the sanctioned limits. It has a modest capex plan of ~Rs. 70 crore in CY2020 to be financed by internal accruals. Going forward, the free cash flows could come under pressure if the company continues with the large debt-funded acquisitions.

Rating sensitivities

Positive triggers – A rating upgrade for ZTL is unlikely in the medium term given the moderate scale of operations and the size of the company. However, the outlook could be revised to Stable if the company demonstrates a healthy growth in revenues and that in the operating margins in excess of 15.0% on a sustained basis.

Negative triggers – Negative pressure on ZTL's rating could arise in case of sizeable debt-funded acquisitions, which could significantly impact the financial profile and the liquidity position. Specific credit metrics that could lead to a downgrade of ZTL's ratings include Total Debt/OPBITDA exceeding 1.25 times.

¹ Source: Nasscom

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Information Technology (Services) Industry
Parent/Group Support	Not Applicable
Consolidation	For arriving at the ratings, ICRA has considered the consolidated financials of ZTL. As on March 31, 2019 the company had seven subsidiaries and 16 step-down subsidiaries, which are listed in Annexure-2.

About the company

ZTL is among the top software service providers in India. Based out of Pune, it was, initially, a joint venture between RPG Enterprises and Fujitsu Limited, and started functioning with its present organisational structure from 2001. The company employs ~9,951 associates and enjoys a footprint across more than 22 countries, providing IT/ITeS solutions to many Fortune 500 companies. It has over 300 customers and provides services, including IT consulting, application development and maintenance, and package implementation. Currently, the business segments are—application management services (including application development, Oracle and SAP work and digital services), and, IMS and cloud digital services.

In 9M FY2020, the company reported a net profit of Rs. 199.6 crore on an operating income (OI) of Rs. 3163.9 crore, compared to a net profit of Rs. 235.5 crore on an OI of Rs. 2908.9 crore in 9M FY2019.

Key financial indicators (audited)

	FY2018	FY2019
Operating Income (Rs. crore)	3107.7	3966.3
PAT (Rs. crore)	246.5	318.7
OPBDITA/OI (%)	11.7%	12.1%
RoCE (%)	22.7%	24.5%
Total Outside Liabilities/Tangible Net Worth (times)	0.3	0.6
Total Debt/OPBDITA (times)	0.0	0.6
Interest Coverage (times)	16.1	12.9
DSCR	12.5	10.6

Source: Company data

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for the past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years								
		Type	Amount Rated	Amount Outstanding	Rating		FY2019		FY2018				FY2017	
					25-Feb-2020	27-Dec-2019	25-Jan-2019	01-Aug-2018	09-May 2018	26-Mar-2018	15-Dec-2017	28-Jul-2017	29-Sep-2016	
1	Fund based/non fund based	Long term / short term	177.00	-	[ICRA]AA+ (Negative) / [ICRA] A1+	[ICRA]AA+ (Stable)/ [ICRA] A1+	[ICRA]AA+ (Stable)/ [ICRA] A1+	-	-	-	-	-	-	-
2	Non-fund based	Long Term	14.00	-	[ICRA]AA+ (Negative)	[ICRA]AA+ (Stable)	-	-	-	-	-	-	-	-
3	Fund-based	Long term / short term	-	-	-	-	-	[ICRA]AA+ (Stable)/ [ICRA] A1+	[ICRA]AA+ (Stable)/[ICRA] A1+; removed from ratings watch	[ICRA]AA+ (Stable)/ [ICRA] A1+ &	[ICRA]AA+ (Stable)/ [ICRA] A1+	[ICRA]AA+ (Stable)/ [ICRA] A1+	[ICRA]AA+ (Stable)/ [ICRA] A1+	[ICRA]AA+ (Stable)/ [ICRA] A1+

Amount in Rs. crore; &- placed on ratings watch with developing implications

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Long-term/Short-term-Fund based/ Non-fund based	NA	NA	NA	177.00	[ICRA]AA+(Negative)/[ICRA]A1+
NA	Long-term - Non-fund based	NA	NA	NA	14.00	[ICRA]AA+(Negative)

Source: Company data

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Zensar Technologies Inc.	100%	Full Consolidation
Professional Access Limited, USA	100%	Full Consolidation
PSI Holding Group Inc., USA	100%	Full Consolidation
Zensar Technologies IM Inc.	100%	Full Consolidation
Zensar Technologies IM B.V.	100%	Full Consolidation
Zensar Technologies (Shanghai) Company Ltd.	100%	Full Consolidation
Zensar Info Technologies (Singapore) Pte. Ltd.	100%	Full Consolidation
Zensar Technologies (Singapore) Pte. Ltd., Singapore	100%	Full Consolidation
Zensar Technologies (UK) Ltd., UK	100%	Full Consolidation
Foolproof Ltd., UK	100%	Full Consolidation
Knit Ltd., UK	100%	Full Consolidation
Foolproof (SG) Pte. Ltd.	100%	Full Consolidation
Keystone Logic Inc., USA	100%	Full Consolidation
Zensar IT Services Ltd., India	100%	Full Consolidation
Zensar (Africa) Holdings (Pty) Ltd., South Africa	100%	Full Consolidation
Zensar (South Africa) (Pty) Ltd., South Africa	75%	Full Consolidation
Cynosure Inc., USA	100%	Full Consolidation
Cynosure Interface Services Private Limited	100%	Full Consolidation
Cynosure APAC Pty Ltd.	100%	Full Consolidation
Keystone Logic Mexico S. DE R.L. DE C.V	100%	Full Consolidation
Keystone Technologies Mexico S. DE R.L. DE C.V	100%	Full Consolidation
Zensar Technologies (Canada) Inc.	100%	Full Consolidation
Indigo Slate Inc. USA	100%	Full Consolidation

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