

March 15, 2017

Virtusa Consulting Services Private Limited

Instrument*	Rated Amount (in Rs. crore)	Rating Action
Non Convertible Debentures	2000.0	[ICRA]A+ (stable); reaffirmed
Total	2000.0	

*Instrument details are provided in Annexure-1

Rating Action

ICRA has re-affirmed the [ICRA]A+ (pronounced ICRA A plus) rating assigned to the Rs. 2,000.0 crore¹ Non-Convertible Debenture (NCD) Programme of Virtusa Consulting Services Private Limited (VCS)². The outlook on the long-term rating is stable.

Detailed rationale

The rating re-affirmation factors in VCS's strong parentage viz. Virtusa Corporation (Virtusa), an established Information Technology (IT) consultancy and IT enabled Services (ITeS) provider with annual revenues of US\$ 600 million in FY2016. Virtusa enjoys healthy business position characterised by a steady client base with repeat business and consistent new client addition; its global execution capabilities and an experienced management team. Further, the acquisition of Polaris Consulting & Services Limited (Polaris) has strengthened the position of the consolidated entity in the Business, Financial Services and Insurance (BFSI) segment with growth in addressable markets and client base. The rating also factors in the comfortable leverage profile of Virtusa with negative net debt status as on March 31, 2016 on account of its healthy cash balances and liquid investments.

The rating also factors in steady growth in VCS's operating income mirroring the trend in Virtusa along with healthy operating margins that are supported by fixed transfer pricing mechanism with Virtusa. The rating also takes into consideration the low working capital intensity of its operations resulting in healthy cash flow generation and sizeable cash holdings of the company, which has enabled it to comfortably meet the interest servicing requirements of the NCDs thus far.

However, the rating is constrained by the dependence of revenues of VCS on workflow from Virtusa, which remains susceptible to any adverse legislation in US/EU region that may restrict the outsourcing to low cost countries. Any reduction in business flow from Virtusa may adversely impact the revenues and cash flows of VCS, thereby impacting its ability to meet its debt servicing obligations. While so far, there have not been significant dividend payouts from VCS to Virtusa, any dividend payout or up-streaming of cashflows by VCS (to support Virtusa's own debt repayment commitment) may adversely impact its liquidity. ICRA also notes that VCS' own cash flows may not be sufficient to meet the bullet repayment of NCDs in April 2023, and the company would need to explore different options of funding including refinancing and support from the parent.

Furthermore, the rating takes into account the consistent decline in Virtusa's operating profitability in FY2016 and 9M FY2017 on account of increased acquisition and integration related expenditure and the pricing pressures faced from some of its clients. The rating also takes into consideration the revenue concentration risk faced by Virtusa with more than 50% of revenue being contributed by the BFSI

¹ 100 lakh = 1 crore = 10 million

² For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications

segment, exposing it to any slowdown in this segment. Further, the company faces relatively high client concentration and geographical concentration risks. In addition, similar to other companies in the industry, Virtusa faces challenges with respect to employee attrition rates and recovery of dues from clients. The profitability of VCS also remains exposed to adverse foreign exchange movement, given that majority of company's revenues are generated in US Dollars and a significant part of expenses are in Indian Rupees.

Key rating drivers

Credit Strengths

- Strong parentage with Virtusa being an established IT consultancy and ITeS services provider, with a proven track record of operations in the industry.
- Acquisition of Polaris has strengthened the position of the consolidated entity in the BFSI segment with increase in the client base and reach of the addressable markets
- Steady increase in operating income of VCS, along with healthy operating profitability supported by fixed transfer pricing arrangement with Virtusa.
- Sizeable cash holdings of VCS, which enabled the company to service the interest payments for FY2017 on standalone basis.
- Comfortable leverage profile of Virtusa as reflected by gearing of 0.31 time as on March 31, 2016.

Credit Weaknesses

- Significant proportion of VCS's revenue (~90%) is derived by workflow from Virtusa entities in North America and Europe, which may be impacted in case of any adverse macro-economic developments or legislations in these economies, which result in trimming of IT budgets, softening of new business opportunities or outsourcing of work to India.
- Decline in operating profitability of Virtusa Corporation during FY2016 (especially Q4 FY2016) and 9M FY2017 on account of pricing pressures and increased acquisition related expenses
- Inadequacy of VCS's own cash flows to service principal repayment of NCDs, thereby requiring funding support from Polaris or other group entities.
- High concentration in BFSI industry though mitigated by past track record of consistent performance
- High competitive intensity of the industry marked by presence of global and domestic competitors
- Exposure to volatility on account of foreign currency fluctuations and employee attrition

Detailed description of key rating drivers:

VCS is a multi-level step-down subsidiary of Virtusa, which is an established IT consultancy and ITeS provider with headquarters in Massachusetts, USA. VCS derives a major proportion of its revenues from other Virtusa entities in North America and Europe. VCS has a fixed transfer pricing arrangement with Virtusa, wherein it bills Virtusa at cost-plus fixed margin irrespective of the terms of Virtusa with the end customers. This arrangement has resulted in stable and healthy profitability for VCS, with operating profit margins in the range of 23-25% over the last four years.

VCS completed the acquisition of 74.89% stake in Polaris, a financial technology company for BFSI vertical, in FY2016. The acquisition has strengthened the position of the group in BFSI vertical by enhancing its client base and market reach. However, after the acquisition of Polaris, Virtusa's operating profitability has witnessed a decline in FY2016 and 9M FY2017 on account of increased acquisition related costs coupled with pricing pressure from its clients. The acquisition was funded through issue of Rs. 1,360 crore NCDs by VCS to group company Virtusa Cooperatief U.A. (Netherlands) and ultimately



through outside borrowings raised in the group. The NCDs carry an interest rate of 9% per annum, which VCS has been able to service thus far on account of its healthy cash flow position.

However, the revenues and cash flows of the company are dependent on workflow from Virtusa and may be affected by any adverse legislation or development in key markets such as US and Europe which restrict outsourcing or immigration. Further, the profitability of VCS remains vulnerable to competitive pressures from both within India and other low cost countries and to adverse foreign exchange movement given that majority of company's revenues are generated in US\$. However, the foreign exchange risk is hedged at Virtusa level primarily by entering into forward contracts.

Analytical approach: Not Applicable

Links to applicable criteria

Rating methodology for IT Services Industry (Non-Hardware)

http://www.icra.in/Files/Articles/Methodology_IT_Software_Final_Update.pdf

About the company:

VCS was incorporated in 2008 as a multi-level step-down subsidiary of Virtusa. Virtusa is headquartered in Massachusetts, USA, and provides IT services, which include IT consulting, application development and maintenance, systems integration and managed services. VCS is a major delivery center of Virtusa in India, accounting for 16% of Virtusa's revenues in FY2016. VCS has offices in Hyderabad, Pune and Bangalore. The company largely works on the work offshored by Virtusa and other group companies such as Virtusa Netherlands and Virtusa UK. VCS acquired a 74.89% stake in Polaris, a mid-sized financial technology company for BFSI vertical, in FY2016.

For FY2016, VCS reported profit after tax (PAT) of Rs. 101.2 crore on an operating income of Rs. 619.7 crore vis-à-vis PAT of Rs. 94.7 crore on an operating income of Rs. 517.9 crore for FY2015.

For FY2016, Virtusa reported profit after tax (PAT) of US\$ 44.8 million on an operating income of US\$ 600.3 million vis-à-vis PAT of US\$ 42.4 million on an operating income of US\$ 479.0 million for FY2015.

For FY2016, Polaris reported profit after tax (PAT) of Rs. 127.0 crore on an operating income of Rs. 2,037.2 crore vis-à-vis PAT of Rs. 167.2 crore on an operating income of Rs. 1,893.3 crore for FY2015.

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable



Rating history for last three years:

Table: Rating History

S. No.	Name of Instrument	Current Rating			Chronology of Rating History for the past 3 years		
		Type	Amount outstanding (Rs. crore)	Date & Rating	Date & Rating in FY2016	Date & Rating in FY2015	Date & Rating in FY2014
				March 2017	December 2015		
1	Non- Convertible Debentures	Long Term	2,000.0	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	NA	NA

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
Details of Instrument

Name of the instrument	Date of issuance	Coupon rate	Maturity Date	Size of the issue (Rs. crore)	Current Rating and Outlook
Non Convertible Debentures	29-February-2016	9%	15-April-2023	2,000.0	[ICRA]A+(Stable)

Name and Contact Details of the Rating Analyst(s):

Sabyasachi Majumdar
+91-124-4545304
sabyasachi@icraindia.com

Sachin Sachdeva
+91-124-4545307
sachin.sachdeva@icraindia.com

Rajat Jain
+91-124-4545844
rajat.jain@icraindia.com

Name and Contact Details of Relationship Contacts:

Jayanta Chatterjee
+91-80-43326401
jayantac@icraindia.com

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**Registered Office****ICRA Limited**

1105, Kailash Building, 11th Floor, 26, Kasturba Gandhi Marg, New Delhi 110001
Tel: +91-11-23357940-50, Fax: +91-11-23357014

Corporate Office**Mr. Vivek Mathur**

Mobile: +91 9871221122

Email: vivek@icraindia.com

Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon 122002
Ph: +91-124-4545310 (D), 4545300 / 4545800 (B) Fax; +91- 124-4050424

Mumbai**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

3rd Floor, Electric Mansion
Appasaheb Marathe Marg, Prabhadevi
Mumbai—400025,
Board : +91-22-61796300; Fax: +91-22-24331390

Kolkata**Mr. Jayanta Roy**

Mobile: +91 9903394664

Email: jayanta@icraindia.com

A-10 & 11, 3rd Floor, FMC Fortuna
234/3A, A.J.C. Bose Road
Kolkata—700020
Tel +91-33-22876617/8839 22800008/22831411,
Fax +91-33-22870728

Chennai**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

5th Floor, Karumuttu Centre
634 Anna Salai, Nandanam
Chennai—600035
Tel: +91-44-45964300; Fax: +91-44 24343663

Bangalore**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

'The Millenia'
Tower B, Unit No. 1004, 10th Floor, Level 2 12-14, 1 & 2,
Murphy Road, Bangalore 560 008
Tel: +91-80-43326400; Fax: +91-80-43326409

Ahmedabad**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

907 & 908 Sakar -II, Ellisbridge,
Ahmedabad- 380006
Tel: +91-79-26585049, 26585494, 26584924; Fax:
+91-79-25569231

Pune**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

5A, 5th Floor, Symphony, S.No. 210, CTS 3202, Range
Hills Road, Shivajinagar, Pune-411 020
Tel: + 91-20-25561194-25560196; Fax: +91-20-
25561231

Hyderabad**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

4th Floor, Shobhan, 6-3-927/A&B. Somajiguda, Raj
Bhavan Road, Hyderabad—500083
Tel:- +91-40-40676500