Genpact Limited (G)

Baird Facts

Price ($) (5/15/20): 32.71
52WK H-L ($) : 45 - 19
Market Cap (mil): 6,428
Shares Out (mil): 196.5
Float (mil): 175.0
Avg. Daily Vol (mil): 1.86
Dividend ($) : 0.24
Yield (%): 0.7
Rating: Outperform
Suitability: Q2
Price Target ($) : 44
L-Term Rev. Gr Rate Est: 10%
L-Term EPS Gr Rate Est: 15%
Debt/Cap: 54.9%
ROE: 22.0%
Outperform Speculative Risk FY Dec 2019A 2020E 2021E
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Company Description
Genpact is an industry-leading offshore business process outsourcing (BPO) firm serving primarily large corporations in the US, Europe and Asia. The company executes more than 3,000 processes from its ~75 delivery centers and primarily serves clients in the Banking, Financial Services and Insurance, (~40%), and Manufacturing/Healthcare (~35% of revenue) industries. General Electric, Genpact’s former parent company, is the largest client at ~13% of revenue. Since its separation from GE, Genpact has significantly diversified its client base by aggressively growing Global Client revenue.

Revenue Profile
Leading provider of offshore business process outsourcing services (primarily from India, but diversifying across several geographies). Services include finance and accounting, customer service and collections, analytics, supply chain management, and IT services (ERP implementations and technical help desk). General Electric is largest client (~13% of revenue). Revenue is generated from BPO solutions (~84% of total) and IT services (~16%).

Metrics
- Employees – 97.4k; Revenue/employee = ~$38k annually
- Centers – 93; Revenue/center = ~$38 million annually
- Client Concentration – General Electric ~13% of revenue (down significantly from 91% in 2005) due to very strong growth in other clients along with acquisitions diluting GE’s contribution.
- Clients – Over 700 "global" clients (non-GE); 24 clients >$25 million per year; 129 clients >$5 million per year.
- Business Concentration – BPO ~85% of revenue (F&A ~40% of BPO; Customer Service/Collections ~35%; Supply Chain/Analytics 10-15%; Other 10-15%); IT Services ~15% (Includes Headstrong, ERP Implementation, and other project-based services).
- Vertical Concentration - BFSI (~29% of total revenue), Consumer/Retail/Life Science/Health (~33%), and Hi-Tech/Manufacturing/Services (~38%)
- Attrition – 26% annualized (recent range 24-30%)
- Currency Sensitivity – Genpact enters into non-speculative hedges two to three years out (we believe roughly 85-90% of currency exposure is hedged over next two to three years).

Competition
BPO Competitors
- Pure-BPO providers – Genpact, WNS, Firstsource, 24/7
- BPO divisions of Indian-based IT Services providers -- TCS BPO (Tata), Infosys BPO (Infosys), Cognizant BPO, Wipro BPO (Wipro), HCL BPO (HCL Technologies)
- Multinationals – Accenture, Capgemini, HP, IBM
- Captive operations (in-house offshore operations)

Market – Worldwide outsourced BPO market of roughly $330-340 billion in 2019, and is expected to grow at a mid/high-single digit yoy growth CAGR.
- Market share – We estimate India BPO delivery is ~$35 billion and Rest of the World delivery is ~$300 billion.

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Market growth - We estimate India BPO growth is high-single-digit/low-double digit yoy growth and Rest of the World is mid-single-digit yoy growth (pretty similar to GDP growth).

Quick Summary
- Q1 results were good across the board.
  - Non-GAAP EPS of $0.53 was above our/consensus $0.45 estimate. Variance to our estimate was driven by revenue (+$0.02), operating margin (+$0.02), fx gain (+$0.05), other income (-$0.02), and tax (+$0.01).
  - Revenue of $923 million was ~3% above consensus $894 million, growing +14% constant-fx (+13% in Q4). Management noted COVID-19 was ~$7 million headwind (~1%) to revenue, largely due to supply constraints given security issues with work from home for Banking/Capital Market clients.
  - Revenue from Global Clients (87% of revs) +15% yoy constant-fx to $802 million (consensus was $779 million) vs. +8% last quarter.
  - GE (13% of revenues) +12% yoy to $122 million, (consensus $117 million) vs. +61% yoy last quarter.
- 2020 guidance not provided on Q1 call given COVID-19 uncertainty. Rightpoint is expected to contribute ~2.5% to revenue.
- Q2 Guidance/Commentary (provided on Q1 call)
  - Revenue: Expected to be down 4-6% yoy (down 3-5% yoy constant-fx). This implies revenue around $830-845 million, and down ~8-10% sequentially (down ~$75-90 million sequentially). Expects Q2 to be the lowest revenue quarter for the year; has line of sight to improving revenue profile in May/June. ~40% of the sequential decline is from supply constraints; ~60% is from lower demand.
  - Margins: Expected to be the lowest margin quarter for the year; expects margins to improve from Q2 level.
- Interesting commentary from the Q1 call:
  - Customer delivery: >95% of overall revenue is currently being delivered; only supply constraint is Banking/Capital Markets, given security concerns with work from home.
  - Liquidity: As of April 30, cash balance was over $700 million after drawing an incremental $330 million of debt (add ~$2 million/quarter to interest expense; we estimate ~$0.01 to EPS).
  - Sub-verticals: Noted every sub-vertical saw nice growth; sounded like one of the most broad-based strong quarters in recent years.
  - Our $44 price target reflects ~19X our NTM EPS a year from now of $2.30 (using year ending 6/30/22). This reflects a multiple about 5% below the S&P's NTM P/E and slightly below the three-year average of a 1% discount (range -17% discount to +14% premium). We think this could improve as the industry as the mix of business and growth rate are improving.

Investment Thesis

Strong growth in offshore BPO. We expect Genpact to participate in strong industry growth, which we expect to be in the double-digit range over the next few years. We expect growth to be driven by large potential savings (20-40% over time) and client/prospect realization of process excellence.

Solid revenue visibility. A large majority of Genpact's revenue is generated from non-discretionary/recurring client processes. We believe this will lead to consistent delivery of results, and provides some insulation from economic weakness.

Limited client/process attrition. Genpact has had limited client/process attrition due to the non-discretionary nature of the work, length of process implementations, and the expanding nature of contracts (as clients shift more work offshore).

Client concentration has been vastly reduced. While GE represented over 90% of revenue in 2005, this has been reduced to ~13% given aggressive growth from non-GE clients and recent acquisitions.

Risks & Caveats

Rising labor costs. Indian wage rates have recently been increasing in the high single digits and attrition rates within BPO remain around 20-40% per year (creating high recruiting/training costs). Given several demands on the labor supply (BPO, IT, retail), we believe rising labor costs could continue.

Client concentration. Genpact has one large client comprising ~13% of total revenue (GE). While this has declined from 91% in 2005 (and we expect declines to continue), loss of part of GE revenue could significantly impact results.

Clients/prospects could choose in-house alternatives. While outsourcing offers local knowledge (hiring, training, management), process expertise (outsourcers learn hundreds of processes), and contractual pricing (rather than the unknown of setting up an operation), some clients or prospects could choose to open their own captive facilities.

Currency fluctuations. With the majority of expenses denominated in Indian rupees and other foreign currency, and with roughly 60-80% of revenue denominated in US dollars, Genpact is subject to fluctuations in currency impacting operating results. While the company hedges at least some of its exposure three years out, we believe the renewal of hedges at less favorable rates remains a significant risk.
Managing rapid growth. The industry's rapid growth can add complexity, as the company could experience poor execution without the correct matching of staffing and infrastructure to demand.

Competitors could become aggressive. Competitors could become aggressive with either pricing or wage rates, particularly new entrants attempting to gain market share.

Onshore sensitivity to offshore movement. For several years, the use of offshore labor has been a political issue. If US/UK companies become concerned with public backlash, they could choose to reduce reliance on offshore resources.

Offshore political/geographical risk. We view India as a reasonably stable area from a political/geographical standpoint, though believe that it is less stable than areas such as North America or Europe. Given 75% of the company’s expenses are generated from India, we believe that events such as wars, terrorist attacks, or changes in Indian labor legislation could impact results. In addition, we acknowledge the risk of the US Government modifying tax rates of offshore operations.

Limited float/insider selling. About 85% of shares are freely traded. With significant private equity (~8-10% is Bain; lock up ended in April 2015), along with client and insider ownership, there is risk of selling pressuring the stock.

Supplemental Information

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<tr>
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<th>Q1-19</th>
<th>Q2-19</th>
<th>Q3-19</th>
<th>Q4-19</th>
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<tr>
<td>Organic Revenue Growth</td>
<td>17%</td>
<td>20%</td>
<td>18%</td>
<td>11%</td>
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<td>Revenue from GE (includes shifts)</td>
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<td>81%</td>
<td>88%</td>
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<tr>
<td>Revenue from Global Clients</td>
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<td>Global Clients IT</td>
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<td>BPO Revenue Growth</td>
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<td>IT Services Organic Growth</td>
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<td>Gross Margin (GAAP)</td>
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<td>Operating Margin (GAAP)</td>
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<td>Operating Margin (Adjusted)</td>
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<td>GAAP EPS</td>
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<td>Non-GAAP EPS (company def.)</td>
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<td>FCF/Share</td>
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<td>Debt (millions)</td>
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<td>TTM Debt/EBITDA</td>
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<tr>
<td>TTM Net Debt/EBITDA</td>
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<td>1.7</td>
<td>1.4</td>
<td>1.7</td>
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Source: Company Reports, Baird Estimates
Appendix - Important Disclosures and Analyst Certification

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1 Robert W. Baird & Co. Incorporated makes a market in the securities of G.

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