

Ransomware & Supply side issues dents growth/OPM

- Nucleus reported 12.4% QoQ decline in Revenue at Rs 1.08Bn well below our estm of 4.5% QoQ growth. The Revenue decline was due to hyper attrition in the resources (10% of resources exited on net basis in Q1) and ransomware attack in last week of May, resulting in loss of days in some projects. Nucleus to announce Capital Allocation Policy by Q2FY22.
- Order Book stood at Rs. 5.3Bn up 11.9% QoQ (up 18.8% YoY basis). The unusual increase in order book was due to lower revenue conversion and steady demand. Product Order Book increased by 8.9% QoQ.
- Nucleus reported EBIT loss of Rs. 14mn (EBIT Margin: -1.4%). This was due to negative operating leverage and steep wage hike for employee to control attrition (Employee Expense up 14.8% QoQ).
- We believe the strong order would support sharp revenue recovery in H2FY22 however, the margins are likely to remain subdued as supply side challenges would continue to haunt. Given its robust long term potential and compelling valuations (EV/Sales of 2x on TTM basis) we remain cautiously optimistic on the stock and maintain Buy rating on the stock with a DCF based TP of Rs 700 (implies ~20x on FY23E earnings).

Supply Side issues can further impact margins and order conversion

Nucleus has witnessed softer revenue conversion due to slower deal ramp-up and signings due to lockdown in Asian countries, severe attrition impacting the order conversion (attrition peaked to 40% - monthly annualised), ransomware impacting some project implementations. While ransomware impact is largely one-time in nature, we believe the supply side related issues could likely to continue for some more time as IT industry faces supply side challenges in near-term. Given the Nucleus small employee base of 1,732, even resources movement of 200 (which is minuscule for large IT players) could impact the business operations. Even after the hike (effective Apr'21), companies' commentary noted that they are cautiously observing the situation. We remain cautious on revenue conversion despite having strong order book given difficult to gauge (in terms of severity and length) supply side situation which could disrupt operations. Given the increase in employee compensation, plan to hire 500 freshers from non-metro and alternate hiring for replacements, the margins are likely to remain subdued for FY22E and FY23E.

Q1FY22 Result (Rs Mn)

Particulars	Q1FY22	Q1FY21	YoY (%)	Q4FY21	QoQ (%)
Revenue	1,084	1,283	(15.5)	1,242	(12.7)
Total Expense	1,068	910	17.3	924	15.5
EBITDA	17	373	(95.5)	318	(94.7)
Depreciation	31	36	(13.1)	32	(2.5)
EBIT	(14)	337	(104.3)	286	(105.0)
Other Income	108	130	(16.6)	72	49.2
Interest	3	3	(3.8)	3	(10.7)
EBT	91	464	(80.4)	355	(74.4)
Tax	31	101	(69.2)	82	(61.9)
RPAT	60	363	(83.5)	274	(78.1)
APAT	60	363	(83.5)	274	(78.1)
			(bps)		(bps)
Gross Margin (%)	15.0	40.9	(2590)	35.3	(2034)
EBITDA Margin (%)	1.6	29.1	(2753)	25.6	(2403)
NPM (%)	5.5	28.3	(2277)	22.0	(1649)
Tax Rate (%)	34.1	21.8	1238	23.0	1114
EBIT Margin (%)	(1.3)	26.3	(2761)	23.0	(2433)

CMP	Rs 601		
Target / Upside	Rs 700 / 17%		
NIFTY	16,364		
Scrip Details			
Equity / FV	Rs 290mn / Rs 10		
Market Cap	Rs 17bn		
	USD 235mn		
52-week High/Low	Rs 766/ 440		
Avg. Volume (no)	199,598		
Bloom Code	NCS IN		
Price Performance			
1M	3M	12M	
Absolute (%)	(13)	9	35
Rel to NIFTY (%)	(18)	(5)	(11)

Shareholding Pattern

	Dec'20	Mar'21	Jun'21
Promoters	67.6	67.6	67.6
MF/Banks/FIs	0.9	0.8	0.8
FII	7.1	7.0	7.0
Public / Others	24.4	24.7	24.7

Valuation (x)

	FY21A	FY22E	FY23E
P/E	14.8	32.5	17.2
EV/EBITDA	9.6	29.8	11.5
ROE (%)	19.1	7.8	13.7
RoACE (%)	19.3	7.9	13.8

Estimates (Rs mn)

	FY21A	FY22E	FY23E
Revenue	5,135	4,847	6,170
EBITDA	1,293	410	1,001
PAT	1,180	536	1,015
EPS (Rs.)	40.6	18.5	35.0

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Exhibit 1: Quarterly performance versus estimates

(Rs mn)	Actual	Estimates		% Variation		Comment
		Dolat	Consensus	Dolat	Consensus	
USD Revenue	14.8	17.6	NA	(16.0)	NA	Revenues slip on hyper-attrition and ransomware attack
INR Revenue	1,084	1,298	NA	(16.5)	NA	
EBIT	(14)	284	NA	(105.1)	NA	OPM cracked on weak revenue
EBIT, margin	(1.3)	21.9	NA	(2323 bps)	NA	and wage hike impact
PAT	60	288	NA	(79.1)	NA	PAT impact was lower on better other income in the quarter

Source: DART, Company

Change in Estimates

Factoring in the sharp decline in revenues in Q1 and also the cautious outlook for the near term we have curtailed our revenue estimates by 15%/6.5% for FY22/FY23E respectively. Given the weak revenue traction and persistent supply side constraints we have taken sharp cut in OPM to 5.8%/13.9% for FY22/FY23E respectively. On overall basis the earnings cut is to the tune of 59%/31% for FY22/FY23E. Despite the sharp cut in estimate, we believe that the company holds a strong potential of a sharp recovery backed by large order book and improving demand scenario in the market. We have turned quite conservative in our approach as it would be very difficult to map the recovery timing given rising supply-side challenges.

Exhibit 2: Change in Estimates

(In Mn)	FY21A	FY22E			FY23E		
	Actual	Old	New	% chg	Old	New	% chg
USD Revenue	69.4	77	66	(14.9)	87	82	(6.5)
YoY growth, %	(6.1)	11.1	-5.5	(1661 bps)	25.8	17.7	(812 bps)
INR Revenue	5,135.3	5,696	4,847	(14.9)	6,595	6,170	(6.4)
Growth %	(1.4)	10.9	-5.6	(1654 bps)	28.4	20.2	(827 bps)
EBIT	1,154.7	1,301	282	(78.3)	1,472	859	(41.7)
EBIT Margin, %	22.5	22.8	5.8	(1701 bps)	22.3	13.9	(840 bps)
PAT	1,179.5	1,313	536	(59.2)	1,480	1,015	(31.4)
EPS (Rs. Abs)	40.6	45.2	18.5	(59.2)	51.0	35.0	(31.4)

Source: DART, Company

Exhibit 3: Key Revenue Assumptions in Our Estimates

Key Assumptions	FY20A	FY21A	FY22E	FY23E
USD Revenue (Mn)	73.9	69.4	65.6	81.7
USD Revenue growth (%)	5.6	(6.1)	(5.5)	17.7
INR Revenue growth (%)	7.6	(1.4)	(5.6)	27.3
EBIT Margins (%)	15.5	22.5	5.8	13.9
EPS growth (%)	19.2	32.5	-54.5	89.4

Source: DART, Company

Exhibit 4: Quarterly Trend

Rs mn	Q1FY21	Q2FY21	Q3FY21	Q4FY21	Q1FY22	YoY	QoQ	YTDFY22	YTDFY21	YoY
USD Revenue	17.3	18.4	16.8	16.9	14.8	(14.7)	(12.4)	14.8	17.3	(14.7)
INR Revenue	1,283	1,370	1,240	1,242	1,084	(15.5)	(12.7)	1,084	1,283	(15.5)
Operating Expenses	910	1,033	975	924	1,068	17.3	15.5	1,068	910	17.3
Employee Expenses	759	913	830	803	922	21.5	14.8	922	759	21.5
as % of sales	59.1	66.7	67.0	64.7	85.0	2590 bps	2034 bps	85.0	59.1	2590 bps
Other Expenses	151	120	145	121	146	(3.8)	20.3	146	151	(3.8)
as % of sales	11.8	8.7	11.7	9.7	13.4	163 bps	368 bps	13.4	11.8	163 bps
EBITDA	373	337	265	318	17	(95.5)	(94.7)	17	373	(95.5)
Depreciation	36	36	35	32	31	(13.1)	(2.5)	31	36	(13.1)
EBIT	337	301	231	286	(14)	(104.3)	(105.0)	(14)	337	(104.3)
Finance Cost	3	3	4	3	3	(3.8)	(10.7)	3	3	(3.8)
Other Income	130	91	103	72	108	(16.6)	49.2	108	130	(16.6)
PBT	464	389	330	355	91	(80.4)	(74.4)	91	464	(80.4)
Total Tax	101	95	81	82	31	(69.2)	(61.9)	31	101	(69.2)
Reported PAT	363	295	248	274	60	(83.5)	(78.1)	60	363	(83.5)
Reported EPS	12.5	10.1	8.5	9.4	2.1	(83.4)	(78.0)	2.1	12.5	(83.4)
Margins (%)						(bps)	(bps)			(bps)
EBIDTA	29.1	24.6	21.4	25.6	1.6	(2,753)	(2,403)	1.6	29.1	(2,753)
EBIT	26.3	22.0	18.6	23.0	(1.3)	(2,761)	(2,433)	(1.3)	26.3	(2,761)
PBT	36.2	28.4	26.6	28.6	8.4	(2,777)	(2,020)	8.4	36.2	(2,777)
PAT	28.3	21.5	20.0	22.0	5.5	(2,277)	(1,649)	5.5	28.3	(2,277)
Effective Tax rate	21.8	24.3	24.7	23.0	34.1	1,238	1,114	34.1	21.8	1,238

Source: DART, Company

What to expect Next Quarter

We expect sharp revival led by sustained traction and pent-up volumes to drive sequential growth of 4.6% QoQ in Q2FY22E along with partial recovery in profitability by 363bps on operating leverage as it would continue to invest into resource pool to cover up for high attrition it witnessed in H1CY21.

Exhibit 5: What to expect Next Quarter

(Rs Mn)	Q2FY22E	Q1FY22	Q2FY21	QoQ (%)	YoY (%)
USD Revenue	15.5	14.8	18.4	4.6	(15.9)
INR Revenue	1,145	1,084	1,370	5.6	(16.4)
EBIT	26	(14)	301	(282.9)	(91.3)
PAT	102	60	295	69.9	(65.4)
EPS (Rs. Abs)	3.5	2.1	10.1	69.6	(65.4)
EBIT Margin (%)	2.3	(1.3)	22.0	363 bps	(1969 bps)

Source: DART, Company

Valuation

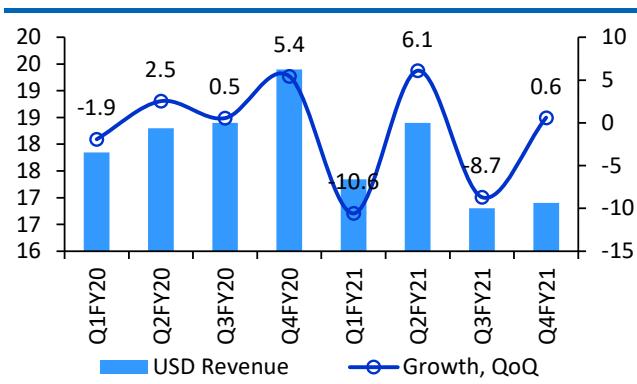
Software companies' performance by nature is bit volatile on year to year basis and thus it is better to be valued on DCF basis to capture the true potential in near-to-medium term. We have factored in Revenue CAGR of 11.5% (earlier 12.5%) over FY21-25E, stable EBIT margin at ~18.5% (earlier 21%) and Terminal growth rate of 2%. Taking these assumptions, we have arrived at TP of Rs. 700 per share (earlier Rs. 760) and BUY Rating for the stock.

Key Highlights of the Earning Call

- **Revenue:** Nucleus Software reported 12.7% QoQ decline in Revenue at Rs. 1,084mn. The steep decline in revenue was due to 1) Attrition (extreme surge in demand of skilled people) impacting operations, 2) 2nd wave impacting implementation, 3) Ransomware impacting some projects (last week of May'21) in terms of timed delayed (highlighted no client or work loss). Product Revenue declined 14.4% QoQ to Rs. 899Mn. The Project and Services Revenue declined 3.5% QoQ to Rs. 185Mn.
- **OPM:** EBIT stood negative at Rs. 14Mn against our estimate of Rs. 284Mn. The Employee Cost was increased by 14.8% QoQ as Nucleus offered hike to employees in July'21 (but effective from April'21, thus acting as bonus payout) to control attrition (currently 30% - monthly annualized, peaked at 40% - monthly annualized). Nucleus lost 10% of resources in one quarter on net basis and ~20% of resources in one year (headcount: 1732 – June'21, 1932 – March'21 and 2170 - June'20). The demand for skilled resources is very high due to increase demand for digitalization work across the Globe. The overall outlook for cost is unclear as per management, and just expect gradual recovery over time.
- **PAT:** The PAT stood at Rs. 60Mn (down 78.1% QoQ), entirely led by non-operating revenues (Other income for the quarter stood at Rs108mn on its Rs7bn+ cash position).
- **Order Book:** The Order Book stood at Rs. 5,349mn (up 11.9% QoQ). The Order Book has a mix of short and long term orders and some of them are not immediately executable.
- **Outlook:** Nucleus highlighted that it is witnessing strong demand environment. It also highlighted it is now seeing improved business and orders from NBFC segment. Nucleus is also witnessing demand for digital transformation work in Middle East (they are focusing on it and setting a premium position). It is also pushing the high-in-demand solution for Buy-Now-Pay-Later category to its existing clients (5+ deals in review).
- **Dividend and Buyback:** Nucleus highlighted that the board is going to discuss and articulate the dividend and overall capital allocation policy in the next board meeting.

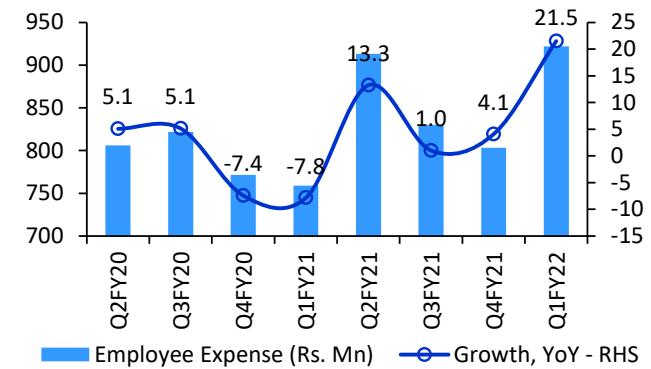
Charts

Exhibit 6: Revenue declined 12.4% QoQ...



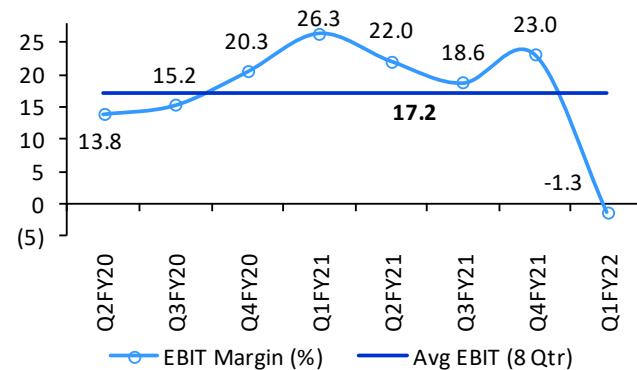
Source: Company, DART

Exhibit 7: Employee Expense zoomed up as Nucleus announced wage hike effective Apr'21



Source: Company, DART

Exhibit 8: EBIT Margin turned negative due to wage hike and sharp revenue drop



Source: Company, DART

Exhibit 9: Product Business Order Book has improved



Source: Company, DART

Exhibit 10: Service Biz. Order book has seen strong growth



Source: Company, DART

Exhibit 11: Net New Orders have improved by 16% QoQ



Source: Company, DART

Profit and Loss Account

(Rs Mn)	FY20A	FY21A	FY22E	FY23E
Revenue	5,208	5,135	4,847	6,170
Total Expense	4,266	3,842	4,436	5,169
COGS	3,223	3,306	3,822	4,483
Employees Cost	0	0	0	0
Other expenses	1,044	536	615	686
EBIDTA	942	1,293	410	1,001
Depreciation	135	139	128	142
EBIT	807	1,155	282	859
Interest	11	12	12	10
Other Income	372	396	447	492
Exc. / E.O. items	0	0	0	0
EBT	1,168	1,538	718	1,341
Tax	278	359	181	326
RPAT	890	1,180	536	1,015
Minority Interest	0	0	0	0
Profit/Loss share of associates	0	0	0	0
APAT	890	1,180	536	1,015

Balance Sheet

(Rs Mn)	FY20A	FY21A	FY22E	FY23E
Sources of Funds				
Equity Capital	290	290	290	290
Minority Interest	0	0	0	0
Reserves & Surplus	5,318	6,430	6,734	7,459
Net Worth	5,609	6,720	7,024	7,749
Total Debt	31	40	40	40
Net Deferred Tax Liability	(51)	14	14	14
Total Capital Employed	5,588	6,775	7,078	7,803

Applications of Funds

Net Block	308	245	242	244
CWIP	2	5	5	5
Investments	2,309	1,766	1,766	1,766
Current Assets, Loans & Advances	4,960	6,831	7,131	7,865
Inventories	0	0	0	0
Receivables	1,044	996	1,057	1,117
Cash and Bank Balances	883	449	437	776
Loans and Advances	3	1	1	1
Other Current Assets	591	806	807	807
Less: Current Liabilities & Provisions	1,991	2,072	2,065	2,077
Payables	184	154	146	159
Other Current Liabilities	1,807	1,918	1,918	1,918
<i>sub total</i>				
Net Current Assets	2,969	4,759	5,066	5,788
Total Assets	5,588	6,775	7,078	7,803

E – Estimates

Important Ratios

Particulars	FY20A	FY21A	FY22E	FY23E
(A) Margins (%)				
Gross Profit Margin	38.1	35.6	21.2	27.3
EBIDTA Margin	18.1	25.2	8.5	16.2
EBIT Margin	15.5	22.5	5.8	13.9
Tax rate	23.8	23.3	25.3	24.3
Net Profit Margin	17.1	23.0	11.1	16.5
(B) As Percentage of Net Sales (%)				
COGS	61.9	64.4	78.8	72.7
Employee	0.0	0.0	0.0	0.0
Other	20.0	10.4	12.7	11.1
(C) Measure of Financial Status				
Gross Debt / Equity	0.0	0.0	0.0	0.0
Interest Coverage	72.0	94.6	24.1	85.9
Inventory days	0	0	0	0
Debtors days	73	71	80	66
Average Cost of Debt	73.2	34.5	29.2	24.9
Payable days	13	11	11	9
Working Capital days	208	338	382	342
FA T/O	16.9	21.0	20.1	25.3
(D) Measures of Investment				
AEPS (Rs)	30.7	40.6	18.5	35.0
CEPS (Rs)	35.3	45.4	22.9	39.9
DPS (Rs)	9.0	6.0	8.0	10.0
Dividend Payout (%)	29.4	14.8	43.3	28.6
BVPS (Rs)	193.1	231.4	241.9	266.8
RoANW (%)	16.6	19.1	7.8	13.7
RoACE (%)	17.0	19.3	7.9	13.8
RoAIC (%)	18.2	20.9	4.4	12.6
(E) Valuation Ratios				
CMP (Rs)	601	601	601	601
P/E	19.6	14.8	32.5	17.2
Mcap (Rs Mn)	17,447	17,447	17,447	17,447
MCap/ Sales	3.3	3.4	3.6	2.8
EV	14,156	12,459	12,221	11,547
EV/Sales	2.7	2.4	2.5	1.9
EV/EBITDA	15.0	9.6	29.8	11.5
P/BV	3.1	2.6	2.5	2.3
Dividend Yield (%)	1.5	1.0	1.3	1.7
(F) Growth Rate (%)				
Revenue	7.6	(1.4)	(5.6)	27.3
EBITDA	18.9	37.3	(68.3)	144.0
EBIT	16.4	43.1	(75.6)	204.4
PBT	21.2	31.7	(53.3)	86.9
APAT	19.2	32.5	(54.5)	89.4
EPS	19.2	32.5	(54.5)	89.4

Cash Flow

(Rs Mn)	FY20A	FY21A	FY22E	FY23E
CFO	747	1,149	583	1,100
CFI	(291)	(1,257)	(375)	(480)
CFF	(341)	(133)	(221)	(280)
FCFF	623	1,122	458	955
Opening Cash	445	568	323	310
Closing Cash	567	323	310	650

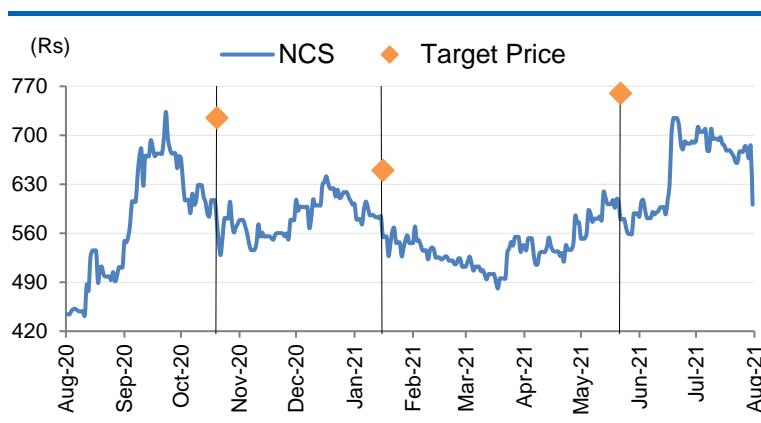
E – Estimates

DART RATING MATRIX

Total Return Expectation (12 Months)

Buy	> 20%
Accumulate	10 to 20%
Reduce	0 to 10%
Sell	< 0%

Rating and Target Price History



Month	Rating	TP (Rs.)	Price (Rs.)
Nov-20	BUY	725	577
Jan-21	BUY	650	555
Jun-21	Buy	760	580

*Price as on recommendation date

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