# IT Services

*One + One = Eleven*

**PhillipCapital (India) Pvt. Ltd.**

## IT SERVICES: Sector Update

29 September 2014

### In the segmented Indian IT space, diversification is the key to higher valuations

The Indian IT services space is clearly divided in two segments – top-5 (including TechM) and the midcaps. They differ primarily on revenue diversification (client, vertical, or geography). The market tends to ascribe a premium to higher diversification, and hence the top-5 segment has always traded at a significant premium to the midcap segment.

### Tech Mahindra has shown the way – how to get re-rated in the Indian IT space

The transition of Tech Mahindra from a midcap telecom solutions vendor to a top-5 company is a classic case of how to get rerated in the Indian IT space. TechM (pre-merger with Satyam) had strong vertical (telecom) and client (BT) concentration. After the merger, it has evolved into a fully-equipped end-to-end service provider, leading to a significant rerating of its stock and the top-4 bracket expanded to top-5 to include TechM. In fact, TechM now trades at premium to HCL Tech and Wipro.

### PE firms are on an acquisition spree; mostly in midcap IT companies

In the last 5 years, many private equity players have invested in the Indian IT midcap space — mainly into companies with niche strength in focused domains. While in most cases they have acquired a minority stake, there are deals such as Barings-Hexaware, where Barings now holds 71% stake in Hexaware.

### Merger of two or more of these companies would lead to a superior 'Integrated Entity'

We see the high PE stakes in IT midcaps as a possible precursor to our hypothesis playing out, which is — **one or more PE firms may facilitate the merger of two or more midcap IT companies** — the crux of this report. This would lead to a bigger, well-diversified 'Integrated Entity' (IE) with superior growth potential, and hence higher valuation.

### Such an IE would command a much higher multiple – in-line with the top-5

We have analysed the possibility of such an event taking five niche midcap IT companies, which have significant PE presence and can benefit (if our hypothesis comes true). They operate in a niche domain (KPIT in auto, NIIT in travel, and Polaris in BFSI) and would be suitable candidates for such a merger. We created four hypothetical Integrated Entities merging three different midcap companies from this set and then analysed the overall profile of these IEs with respect to clients, revenue diversification, and operating margins.

Our analysis reveals that the hypothetical integration would lead to the formation of a well-diversified full-service IT company with a sizeable revenue base; one that can maintain its competitive edge in niche domains. Its profile would be close to the profiles of the top-5 players, which would lead to a significant rerating of the IE.

### Very few integration challenges, as the companies have very similar employee profiles

We also analysed the post-merger issues that this hypothesis could face and found that the salary levels in most of these companies are very similar and so is the onsite:offshore structure. The integration would not face many hurdles apart from few soft ones such as work culture and common assets.

### KPIT, Hexaware, and NIIT Tech are best placed to capitalise our theory

We conclude that in the event of such a merger movement, KPIT, Hexaware and NIIT Tech are the most likely beneficiaries – they operate in highly niche domains and would provide superior diversification to most of the possible combinations.

We do realise the high imaginary quotient of our premise and that such a theory is easier said than implemented; its execution would involve multiple challenges. However, such a strategy could be implemented well by firms such as Barings (which holds a majority stake in one of these companies), which are only looking for higher valuation to exit. As TechM has demonstrated – this is one of the shortest and proven route to rerating and higher valuations in the Indian IT space.

## Companies Covered

**NIIT Technologies**

| | |
|---|---|
| CMP | Rs387 |
| Reco | BUY |
| Target Price | Rs490 |
| Upside | 27% |

**KPIT Technologies**

| | |
|---|---|
| CMP | Rs162 |
| Reco | BUY |
| Target Price | Rs190 |
| Upside | 16% |

**Hexaware Technologies**

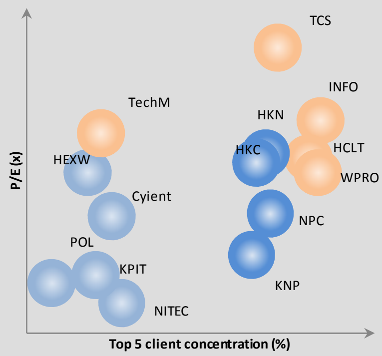
| | |
|---|---|
| CMP | Rs197 |
| Reco | NOT RATED |

**Polaris Financial Technologies**

| | |
|---|---|
| CMP | Rs256 |
| Reco | NOT RATED |

**Cyient Ltd**

| | |
|---|---|
| CMP | Rs450 |
| Reco | NOT RATED |





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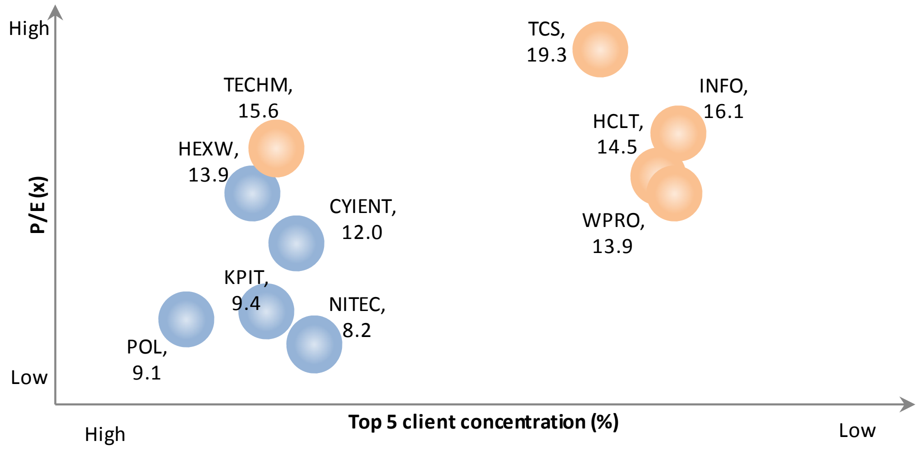
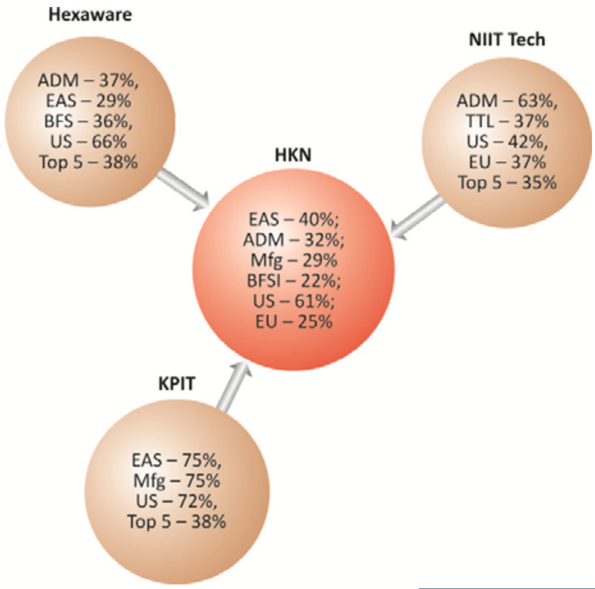
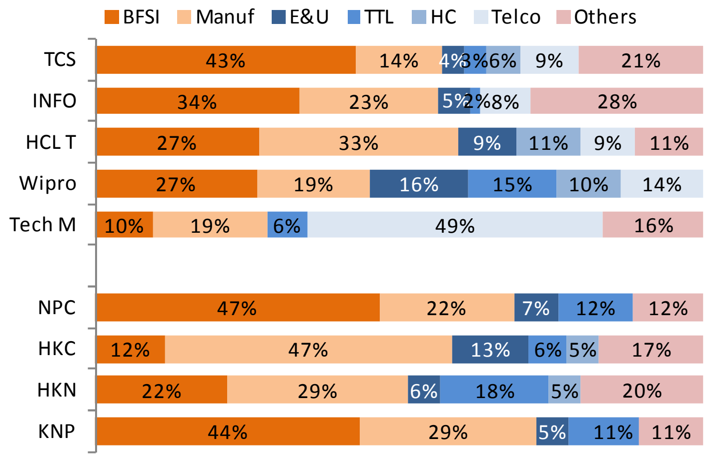
# Key Charts in the report

### Indian IT space remains clearly divided into two segments – Top-5 and Midcaps

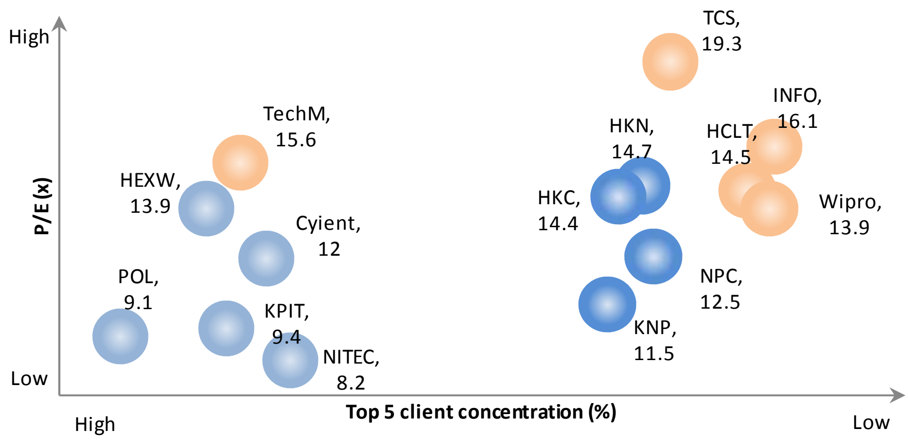



### Few of these midcap companies could be merger together to form Integrated Entity (IE) with a much superior profile




### These IEs will trade at higher valuations than the constituent companies – leading to significant value creation




Source: PhillipCapital India Research

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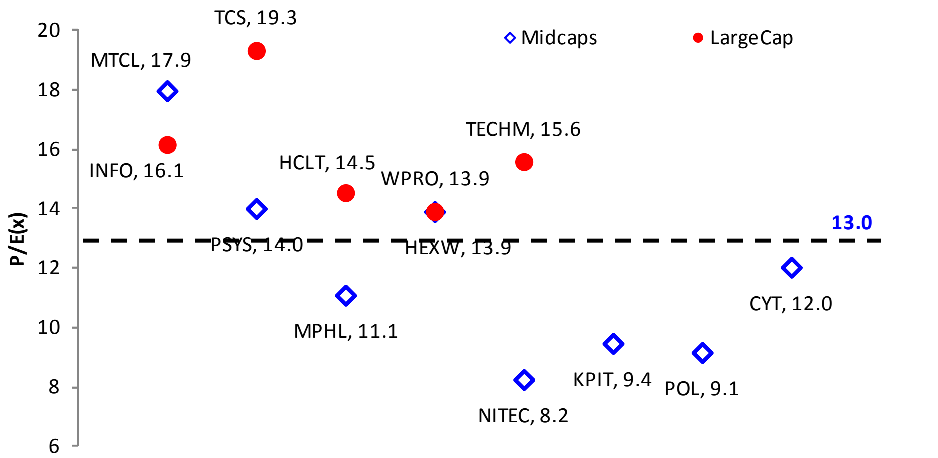
## Companies Section

## Indian IT space – Clearly segmented

The Indian IT services space is clearly divided into two segments – the top-5 companies according to size (earlier top-4 with Tech Mahindra being the recent inclusion) and the rest of the companies (primarily the midcaps). Some firms do tend to fall in-between the two categories (like Mindtree and Mphasis), but such instances are few. The primary difference between the companies in the two segments is revenue concentration in terms of client, vertical, or geography. The market tends to give a premium to diversification and hence the top-5 segment has always traded at a significant premium to the midcap segment.

**Clear demarcation between the valuation for midcap and top-5 segment**



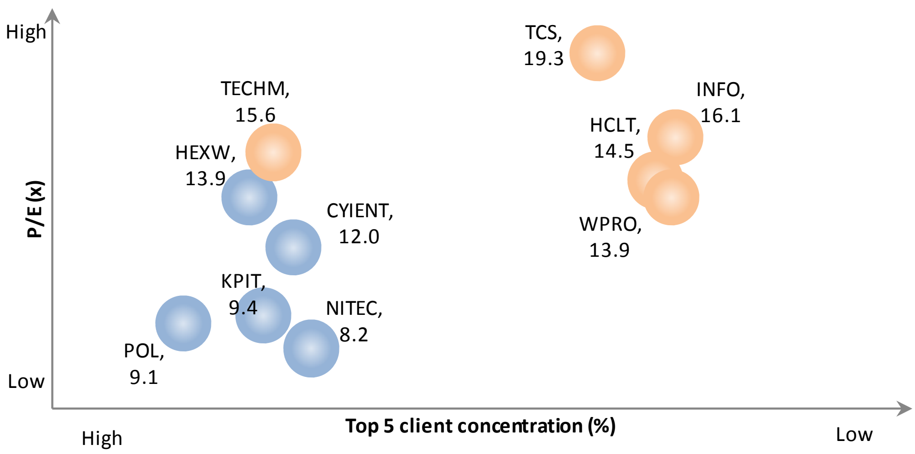

Source: PhillipCapital India Research, Bloomberg Estimates

The premium given by the market is justified to a large extent. Most of the midcap companies tend to create a niche domain around single/few of its verticals to maintain a competitive edge and try to mine more deals from the same clients. This involves multiple business risks — particularly –

1. Client-specific issues can lead to a substantial revenue loss and hence high volatility,
2. Midcap IT companies have low pricing power in negotiating renewals, and
3. The companies being small in size (owing to operating in niche domains) are not able to qualify for many large deals.

On the other hand, large caps (valued at a 17-60% premium to midcaps), have lower client concentration, diversified verticals, and stronger pricing power.

**Valuations remain inversely proportional to client concentration**




Source: PhillipCapital India Research, Bloomberg Estimates

This difference in valuation leads us to believe that revenue diversification is the only way for midcaps to be included into the top bracket of the Indian IT services sector. The recent rerating of TechM lends credence to this theory. Tech Mahindra, post integration with Satyam, transformed itself into a full-range IT services provider — its top client share reduced from 37% to 11% and its dependency on the telecom vertical reduced from 97% to 49% of revenues. This led to a significant rerating of its stock; it now trades at 14x FY16 P/E (in fact, at a premium to Wipro and HCL Tech) vs. at 9x before the merger.

**Valuations**

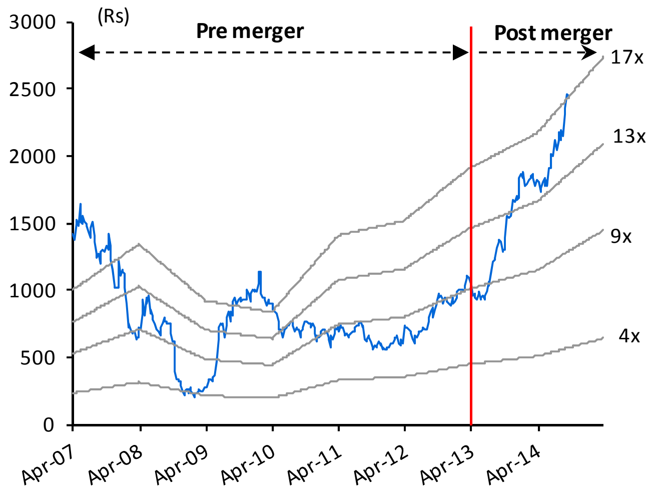
| | CMP | M-Cap | ROE (%) | | P/E (x) | | P/BV (x) | | EV/EBITDA (x) | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Companies** | **Rs** | **Rs bn** | **FY15E** | **FY16E** | **FY15E** | **FY16E** | **FY15E** | **FY16E** | **FY15E** | **FY16E** |
| NIIT Tech | 391 | 23.7 | 14.5 | 15.8 | 11.0 | 9.0 | 1.6 | 1.4 | 6.2 | 5.0 |
| Hexaware* | 197 | 59.2 | 28.4 | 30.7 | 14.2 | 13.0 | 4.0 | 4.0 | 9.9 | 9.0 |
| Polaris* | 253 | 25.2 | 14.7 | 14.9 | 10.0 | 8.6 | 1.5 | 1.3 | 4.5 | 3.8 |
| Cyient* | 450 | 50.1 | 18.7 | 18.6 | 14.6 | 12.6 | 2.7 | 2.3 | 8.7 | 7.4 |
| Mastek* | 300 | 6.8 | 9.3 | 10.4 | 11.6 | 9.6 | 1.1 | 1.0 | 6.1 | 5.0 |
| Persistent | 1,382 | 55.3 | 21.8 | 22.3 | 13.3 | 10.8 | 2.9 | 2.4 | 8.4 | 6.9 |
| KPIT | 162 | 32.4 | 18.1 | 17.4 | 10.7 | 9.2 | 1.9 | 1.6 | 6.8 | 5.9 |
| **Average** | | | 17.9 | 18.6 | 12.2 | 10.4 | 2.2 | 2.0 | 7.2 | 6.1 |
| | | | | | | | | | | |
| TCS | 2,715 | 5,318 | 32.4 | 32.4 | 23.3 | 19.3 | 7.5 | 6.2 | 18.6 | 15.7 |
| Infosys | 3,705 | 2,117 | 22.0 | 21.1 | 18.2 | 16.1 | 4.0 | 3.4 | 12.6 | 10.7 |
| Wipro | 586 | 1,443 | 22.3 | 22.1 | 16.1 | 13.9 | 3.6 | 3.1 | 11.7 | 10.0 |
| HCL Tech | 1,713 | 1,211 | 29.1 | 27.0 | 16.5 | 14.5 | 4.8 | 3.9 | 11.5 | 9.8 |
| Tech Mahindra | 2,520 | 589 | 23.1 | 22.8 | 19.7 | 15.6 | 4.6 | 3.6 | 12.2 | 9.5 |
| **Average** | | | 25.8 | 25.1 | 18.7 | 15.9 | 4.9 | 4.0 | 13.3 | 11.1 |

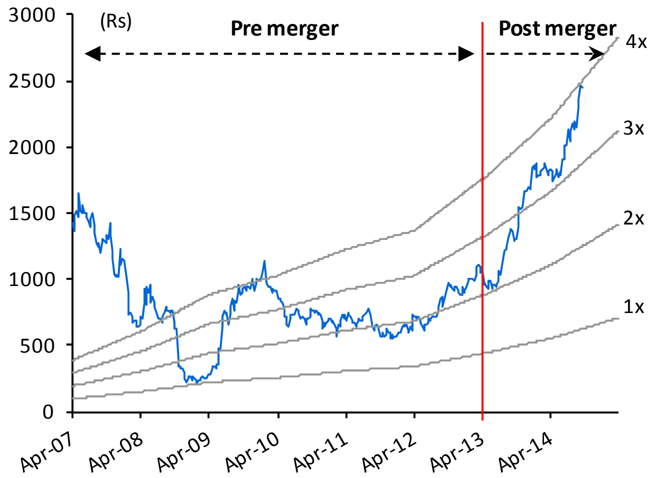
Source: PhillipCapital India Research, Bloomberg Estimate *(*Based on consensus estimates)*

## Tech Mahindra – Evolution from midcap to top-5

Tech Mahindra's transition from a midcap telecom solutions vendor to one among the top-5 (listed) IT companies in India is a result of its merger with Satyam. Before the merger, TechM had strong vertical and client concentration, which was a major cause of its sluggish growth over FY10-11. Telecom, its single largest vertical contributing a huge 97% of its revenues, and BT, its largest client, provided around 45% of its revenues. The company had only a 9% revenue CAGR over FY10-12, with an EBITDA-margin contraction of 770bps.

**TechM: Clear indication of re-rating in P/E and P/BV valuations after merger with Satyam**

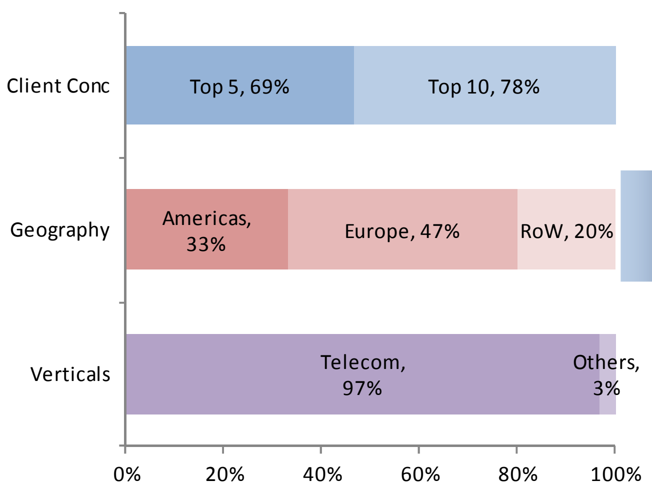


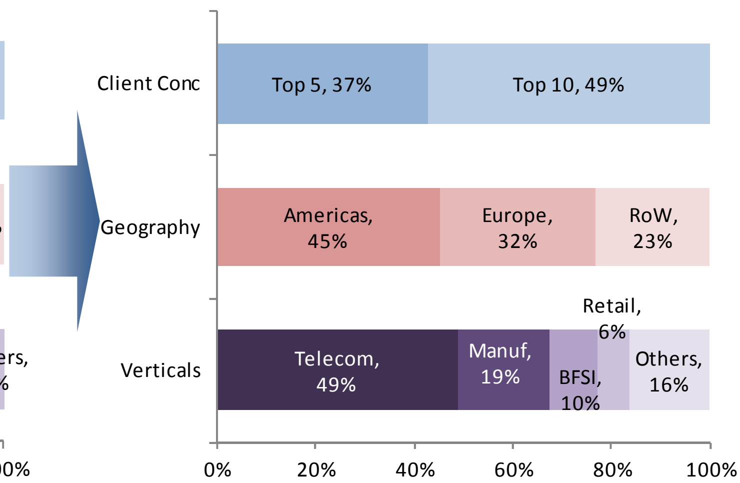




Source: PhillipCapital India Research

Its merger with Satyam in 2013 led to a dilution of its clientele and vertical concentration, thereby reducing its business risks. The evolution of TechM from a telecom services vendor to a fully equipped end-to-end service provider resulted in a strong revenue CQGR of 4.2% over Q1FY13-Q1FY15. Its focused verticals – telecom, BFSI, manufacturing, and retail – all saw above-industry-average growth in this period. Its margins improved by a robust 450bps after the merger.

**Evolution of TechM's business profile after merger**




Source: Company, PhillipCapital India Research

Today TechM is one of the preferred IT vendors for telecom companies. It has been able to add key large clients such as AT&T and Verizon to its portfolio. Its telecom division has seen a CQGR of 8.9% (excluding BT) over the last six quarters. It has also devised a strategy to cross-sell expertise in telecom services to networking and communications segment of all non-telecom verticals, which will enable diversification with low incremental investments.

TechM's multi-vertical focus will help it to bag large deals where it can cross sell its expertise in telecom services along with Satyam's enterprise-level outsourcing capabilities. The belief has led to the traditional 'Top-4' bracket in the Indian IT services space expanding to 'Top-5'. Currently, TechM trades at 15.6x our FY16 earnings, at premium to HCL Tech (14.5x FY16) and Wipro (13.8x FY16).

However In the history of Indian IT Services companies, only a few have managed to make that transition. The journey from midcap to top-bracket entails adding new clients across geographies and verticals – a mammoth task for any company that has been focussed on a niche domain. Such an aspiring company would have to compete with incumbents in new domains. It remains an arduous task to accomplish organically. However, an inorganic route (such as TechM's acquisition of Satyam) could prove to be a shortest and proven way out.

## PE firms on an acquisition spree in the mid-cap space

In the last 5 years, private equity players have invested heavily in the Indian IT midcap space. Companies with niche strength in focused domains – either horizontals or verticals – are attracting stronger attention from PE investors, whose primary target is to improve their overall portfolio value by turning around the operational performance of the company. They target companies that have differentiated domain expertise and capabilities, but who are performing below-par primarily due to size issues or lack of diversity in approach.

**PE firms invested in midcap IT companies**

| | CMP Rs | Mkt Cap Rs bn | Promoter Stake | Major PE | Total Stake held by PE firms |
|---|---|---|---|---|---|
| Hexaware | 197 | 59 | - | Barings | 71.0% |
| KPIT | 162 | 32 | 22.2% | Chrys Capital, CX Partners, ACACIA Partners, APAX Partners | 24.0% |
| NITEC | 389 | 24 | 31.0% | EdgBaston Japan Equity | 3.9% |
| Polaris | 253 | 25 | 29.1% | Citi Venture Capital | 17.5% |
| Zensar | 576 | 26 | 48.2% | Electra Partners | 23.5% |
| Cyient | 450 | 50 | 22.3% | First Carlyle | 9.9% |
| Mphasis | 438 | 92 | 60.5% | Barings India | 3.8% |
| Persistent Systems | 1382 | 55 | 39.0% | Apax partners, SAIF partners | 6.8% |

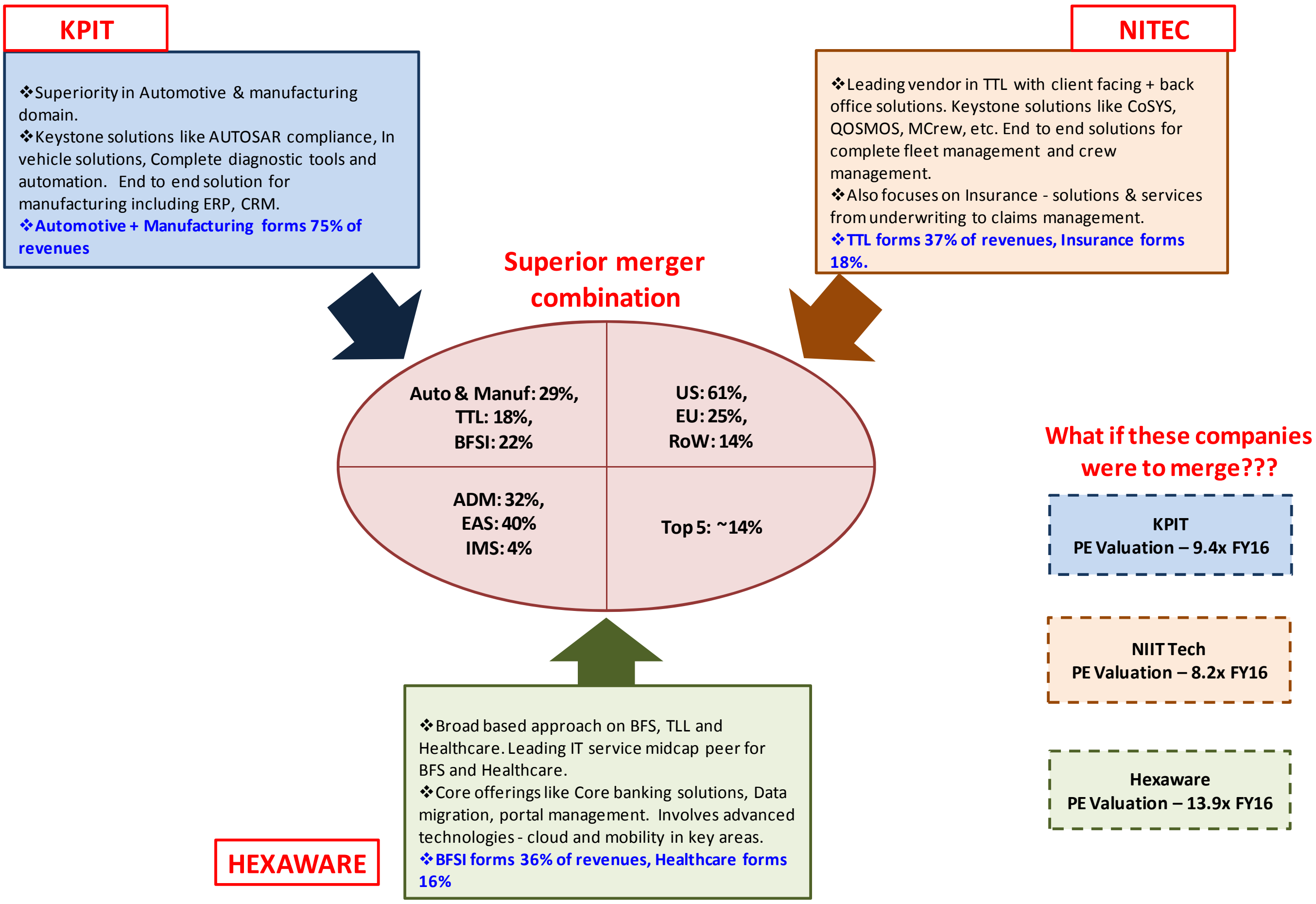
Source:PhillipCapital India Research

With PE firms acquiring minority or majority (Hexaware) stakes in companies intending to turnaround operations and exit at a later date at higher valuation, we see an interesting and exciting theme playing out in these PE-held midcap IT companies. We analyse this theme in detail in the next section.

## Our hypothesis: Merging midcaps = higher valuations

We see the high PE stakes in the IT midcap companies as a precursor to an interesting theme that can play out in the Indian IT services space. We think there is a high probability of more such transactions happening after which a single or multiple PE firms might then bring together two or more midcap companies and merge them to form one entity. This would lead to improved revenue traction and diversification along with the possibility of strong synergies. It could also lead to a significant re-rating of the merged entity (vs. individual pre-merger entities' ratings) and enable PE investors to exit at much higher valuations.

**What if three of these companies were to merge?**




Source: PhillipCapital India Research

If we analyse the primary differences between the top-bracket and midcap IT companies, we realise that the latter trade at a discount to the former primarily due to:

- Small size, limiting access to large deals
- Client and vertical concentration
- Lower corporate governance

If these IT companies are merged, matching synergies could provide higher valuations, in-line with the ones that large cap IT companies command (TechM being a good example) since their profiles will be very similar to the top-5. While there would certainly be a significant discount (initially) due to integration issues, promoter concerns, and growth potential with the merged entity, TechM's eventual rerating has demonstrated that the market is willing to ascribe a multiple that is similar to the top bracket if the integration is smooth and the merged entity's growth prospects are bright.

**What valuations would you give to the merged entity ?**

| | Merged Entity | TCS | HCL Tech | Tech M | Infosys | Wipro |
|---|---|---|---|---|---|---|
| **Major Verticals** | | | | | | |
| BFSI | 22% | 43% | 27% | 10% | 34% | 27% |
| Auto & Manuf | 29% | 9% | 33% | 19% | 23% | 19% |
| E&U | 6% | 4% | 9% | - | 5% | 16% |
| Retail & TTL | 18% | 17% | 8% | 6% | 17% | 15% |
| **Major Horizontals** | | | | | | |
| ADM | 32% | 42% | 28% | NA | 35% | 20% |
| IMS | 4% | 12% | 34% | NA | 7% | 24% |
| EAS | 40% | 15% | 17% | NA | 33% | 28% |
| **Major Geographies** | | | | | | |
| Americas | 61% | 53% | 56% | 45% | 61% | 50% |
| Europe | 25% | 29% | 32% | 32% | 24% | 29% |
| RoW | 14% | 18% | 12% | 23% | 15% | 21% |
| **P/E Valuation (FY16)** | **--** | **19.3** | **14.5** | **15.6** | **16.1** | **13.9** |

Source: PhillipCapital India Research

We recognise that this scenario involves HUGE challenges in terms of merging the companies' internal operations. For example, some of them focus on pure IT services, while others are majorly into product engineering. The mismatch in onsite and offshore efforts poses a considerable challenge. Salary levels would have to be eventually matched, which would create margin risks. Some would have assets in common geographies and verticals, which could remain highly under-utilised after the merger.

Notwithstanding the multiple issues that our hypothesis presents (before and after such a merger) we do believe that such a development is possible and executable. TechM's rerating has shown the industry, and specifically midcaps, the route to achieve higher multiple and valuation in the Indian IT space. Whether and what part of this hypothesis materialises into real action – only time will tell.

## Possible targets: best fits for our hypothesis

To identify companies that best suit our hypothesis, we thoroughly skimmed the IT-midcap space. We specifically looked for candidates which had:

1) Similar revenue base and margin profile
2) A niche domain constituting bulk of its revenues
3) High client concentration
4) Strong revenue and growth profile
5) Low promoter holding and/or high PE holding

Niche domain and high client concentration ensures minimum overlap when and if these companies merge with another entity. Similarly, low promoter holding makes sure that external investors would not find it too difficult to acquire majority stake and integrate these firms. The following companies make it to our list of probable candidates.

## Segmental snapshot of the selected companies

| (US$ mn) | Revenue size | | | | | Contribution to revenue | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | HEXW | KPIT | NITEC | Polaris | Cyient | HEXW | KPIT | NITEC | Polaris | Cyient |
| **Total revenues** | **388** | **444** | **384** | **413** | **363** | | | | | |
| **EBITDA Margins** | **22%** | **16%** | **15%** | **10%** | **19%** | | | | | |
| **Service lines** | | | | | | | | | | |
| ADM | 144 | - | 238 | 259 | - | 37% | - | 63% | 63% | - |
| IMS/Managed Services | - | - | 61 | - | - | - | - | 12% | - | - |
| EAS | 114 | 335 | 27 | - | 130 | 29% | 75% | 10% | - | 35% |
| Engg Services | - | 110 | - | - | 229 | - | 25% | - | - | 64% |
| Testing/QATS | 52 | - | - | 57 | - | 13% | - | - | 14% | - |
| Business Intelligence & Analytics | 40 | - | - | - | - | 10% | - | - | - | - |
| BPO | 16 | - | 23 | 2 | - | 4% | - | 6% | - | - |
| HR IT | - | - | - | - | - | - | - | - | - | - |
| IP based rev | - | - | 35 | - | - | - | - | 9% | - | - |
| Others + RIMS | 22 | - | - | 7 | 4 | 6% | - | - | 2% | 1% |
| Products | - | - | - | 88 | - | - | - | - | 21% | - |
| **Geographies** | | | | | | | | | | |
| America | 257 | 321 | 169 | 193 | 205 | 66% | 72% | 42% | 47% | 57% |
| Europe | 105 | 63 | 138 | 92 | 106 | 27% | 14% | 37% | 22% | 28% |
| Row | 26 | 60 | 77 | 129 | 52 | 7% | 14% | 21% | 31% | 15% |
| **Verticals** | | | | | | | | | | |
| BFS | 138 | - | 61 | 360 | - | 36% | - | 15% | 84% | - |
| Insurance | - | - | 70 | 53 | - | - | - | 18% | 16% | - |
| Healthcare | 63 | - | - | - | - | 16% | - | - | - | - |
| Manufacturing | - | 331 | 26 | - | 229 | - | 75% | 7% | - | 64% |
| Retail | - | - | - | - | - | - | - | - | - | - |
| TTL | 74 | - | 150 | - | - | 19% | - | 37% | - | - |
| E&U | - | 68 | - | - | 86 | - | 15% | - | - | 23% |
| Defence & Govt | - | - | - | - | 44 | - | - | - | - | 12% |
| Others | 113 | 45 | 77 | - | 4 | 29% | 10% | 23% | - | 1% |
| **Client Concentration** | | | | | | | | | | |
| Top 5 clients | 149 | 167 | 134 | 175 | 130 | 38% | 38% | 35% | 42% | 36% |
| Top 10 clients | 206 | 208 | 183 | 232 | 180 | 53% | 47% | 48% | 56% | 50% |

Source: Company, PhillipCapital India Research

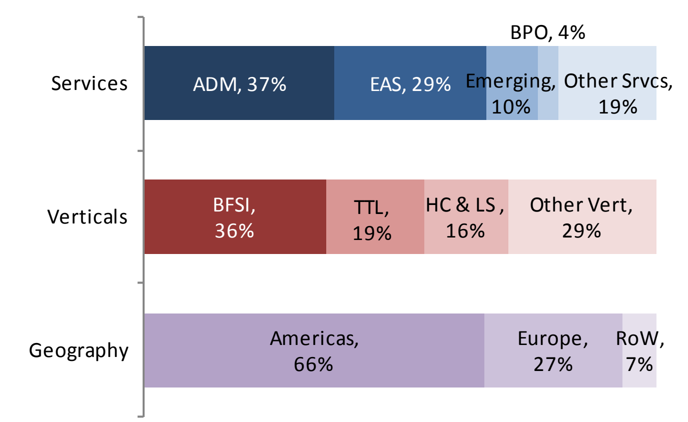
# Hexaware: Well Diversified Profile

| | |
|---|---|
| **Promoter Holding:** 71% (Barings PE) | |
| **PE on-board holding:** Barings PE (71%) | **Market Cap:** Rs 59.2bn |
| **Major Verticals:** Diversified - BFSI, TTL | **Revenue:** US$388mn |
| **Top clients:** Bank of America, Airbus | **EBITDA:** Rs5.1bn |
| **No of Employees:** 8,854 | **PAT:** Rs3.8bn |

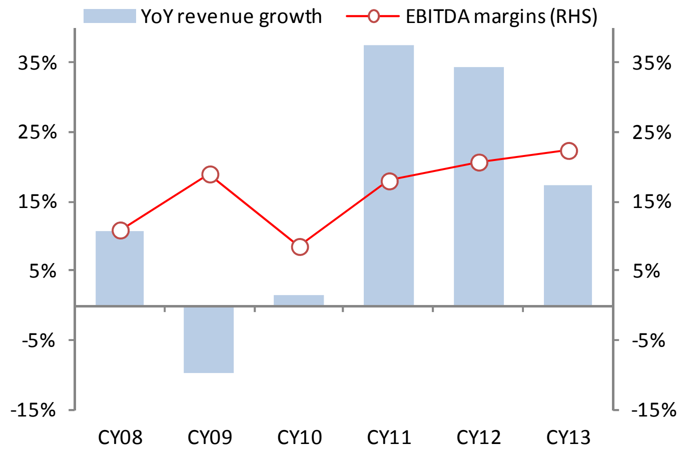
Hexaware specialises in providing clients with management and technology solutions in enterprise application services. It operates as a complete packaged solutions offshore service provider for all major platforms such as PeopleSoft, Oracle, SAP, Salesforce, and Microsoft. It is also a leading global provider of IT and BPO services focusing on delivering technology solutions in Business Intelligence, Business Analytics, Enterprise Applications, HR-IT, and Legacy Modernisation. In its focused service lines (EAS + BI), it has clocked a strong CAGR of 19% over the last 4 years.

Hexaware has seen revenue CAGR of 16% over the last three years and currently has a quarterly revenue rate of US$ 102mn. It operates at an EBITDA margin of 20%, which has expanded by 438bps over the last two years. Superior ROE of 29% and robust cash flow generation (OCF = 114% of PAT, 3-year average) make the company a high performer in the IT-midcap space. Its investments in mobility and cloud have significantly improved its deal-win capabilities over the past few quarters and should hold the company in good stead, as the world moves towards adoption of SMAC technologies.

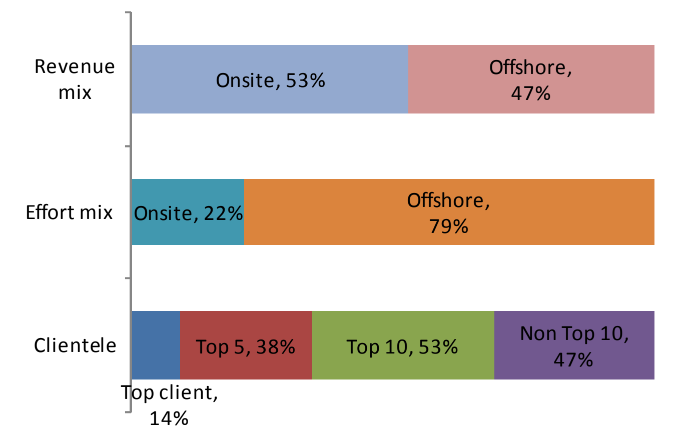
### Segmental revenue profile



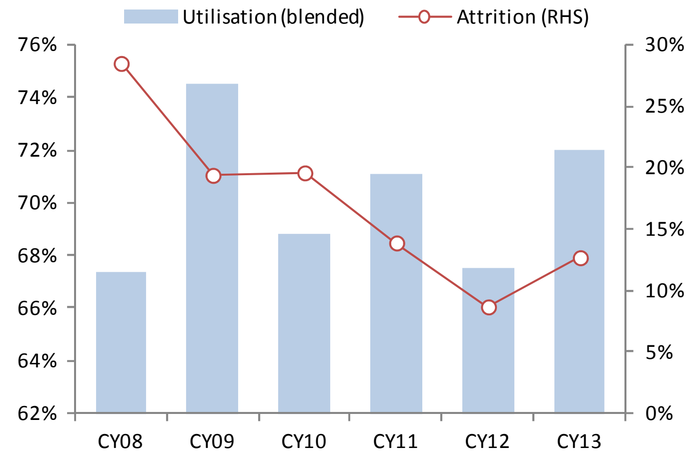

### Revenue growth and margin profile




### Client and employee profile




### Utilisation and attrition




Source: Company, PhillipCapital India Research

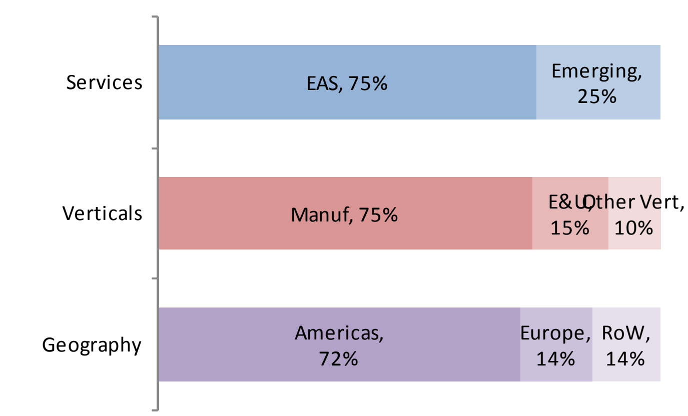
# KPIT Technologies: Niche player in Automotive space

| | |
|---|---|
| **Promoter Holding:** 22.2% | |
| **PE on-board holding:** Chrys Capital (13.6%), CX Partners (5.9%) | **Market Cap:** Rs 32.4bn |
| **Major Verticals:** Auto & Manufacturing | **Revenue:** US$ 444mn |
| **Top clients:** Cummins, Dorf Ketal | **EBITDA:** Rs 4.2bn |
| **No of Employees:** 9,296 | **PAT:** Rs 2.5bn |

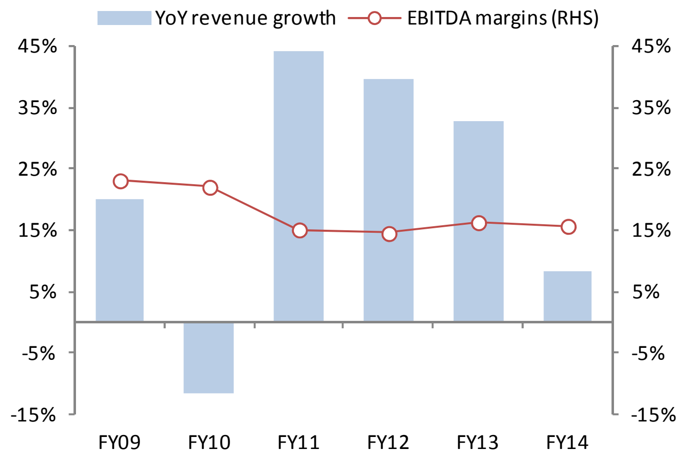
KPIT Technologies is a niche IT Company focused on automotive, manufacturing, and energy and utilities domains — the three constitute over 90% of its topline and the management envisions each vertical as a US$ 1bn+ potential opportunity. It is the largest-third party vendor in the automotive domain (excluding auto OEMs and captives), and works with 9 out of 12 top auto OEMs of the world. Its prime focus is on integrated enterprise solutions and engineering services, which have reported strong CAGRs of 39% and 23% over FY11-14.

KPIT has been THE most aggressive IT Company in terms of inorganic growth. It has acquired eight companies since its merger with Cummins Infotech in 2002. The acquisitions have helped it post revenue CAGR of 24% over FY09-13, which is much higher than its peers. It currently has a quarterly revenue rate of US$ 115mn with EBITDA margins at 15% and RoE of 18%.

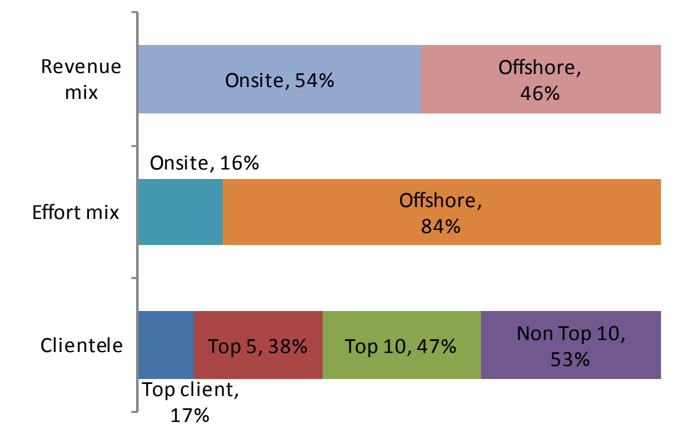
### Segmental revenue profile



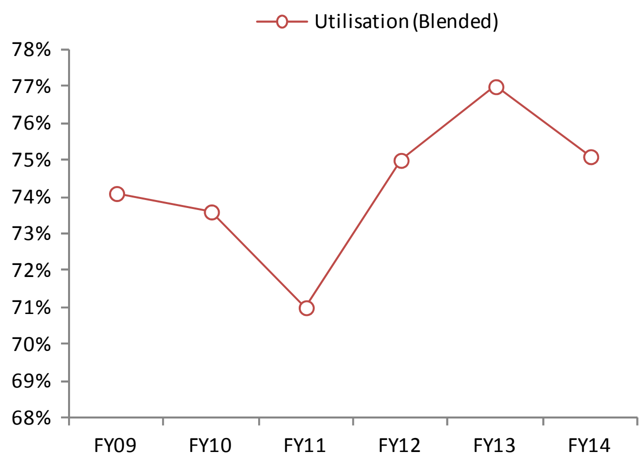

### Revenue growth and margin profile




### Client and employee profile




### Utilisation and attrition




Source: Company, PhillipCapital India Research

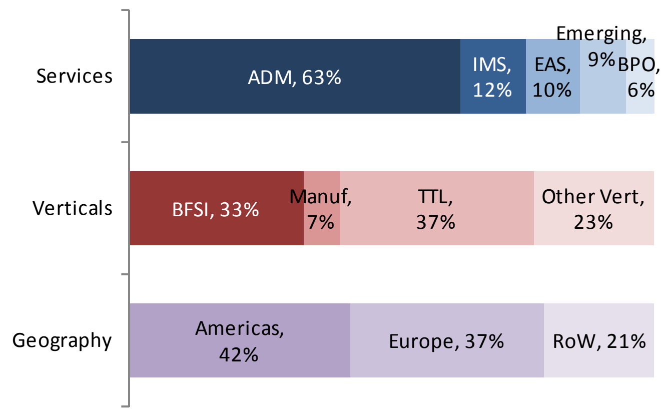
# NIIT Tech: Niche player in Travel and Logistics

| | |
|---|---|
| **Promoter Holding:** 31% | |
| **PE on-board holding:** Edgbaston Asian Equity (3.9%) | **Market Cap:** Rs 23.7bn |
| **Major Verticals:** TTL, Insurance | **Revenue:** US$ 384mn |
| **Top clients:** British Airways, Virgin Airways, Morris Communications | **EBITDA:** Rs 3.5bn |
| **No of Employees:** 8,290 | **PAT:** Rs 2.3bn |

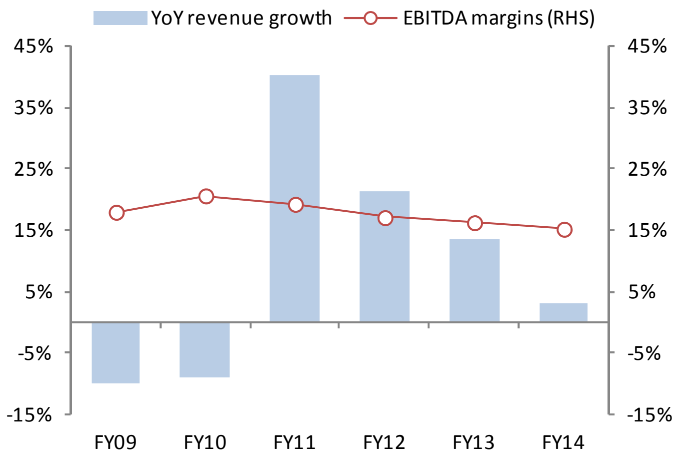
NIIT Tech (NITEC) has carved a niche for itself in the travel, transport and logistics (TTL) space with an annual revenue run rate of US$ 145mn (37% of total revenues) – second only to TCS (US$ 464mn) and the largest among midcaps. It provides platform- and IP-based solutions for key verticals with strong domain expertise in fleet handling (cost-side) as well as customer interface and ticketing (revenue-side) platforms. NITEC currently has a quarterly revenue run rate of US$ 97mn, EBITDA margins of 15%, and RoE of 16%. Its primary focus vertical, TTL, has seen revenue CAGR of 18% over the last 3 years.

NITEC has differentiated itself as a value provider to its clients by deploying outcome-based and transaction-based operating models along with the traditional T&M model. Its engagements with large clients such as Morris Communications, Carey International, and Caesars Entertainment are a few examples of its successful non-linear model implementation in the IT outsourcing space.

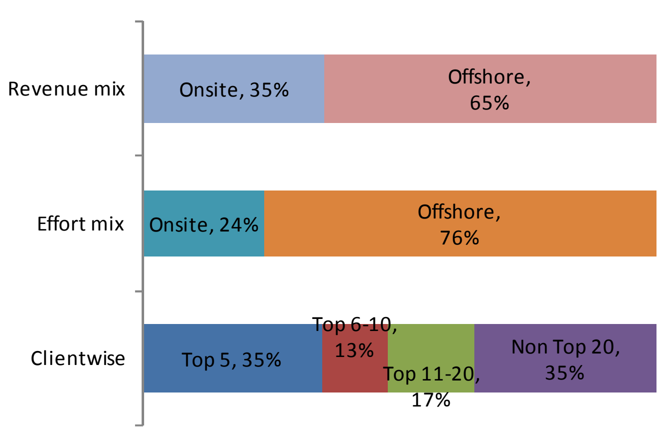
**Segmental revenue profile**



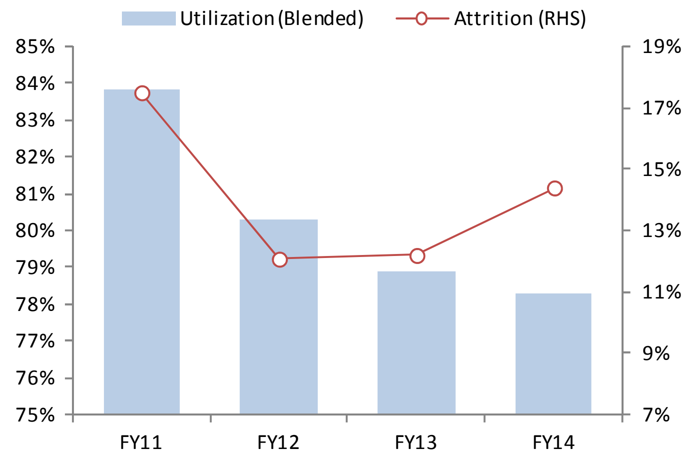

**Revenue growth and margin profile**




**Client and employee profile**




**Utilisation and attrition**




Source: Company, PhillipCapital India Research

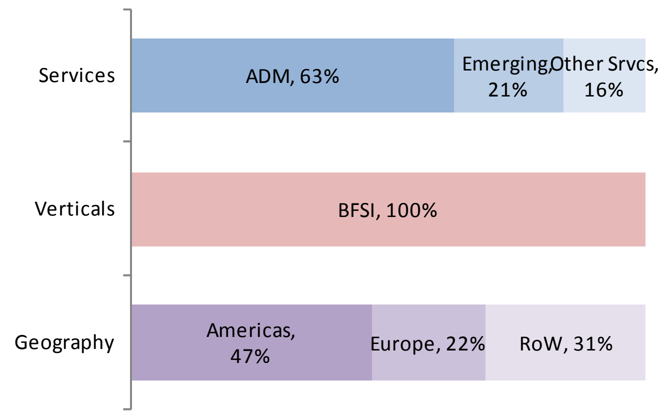
# Polaris FT: Focussed on BFSI

| | |
|---|---|
| **Promoter Holding:** 29.1% | |
| **PE on-board holding:** Citi Venture Capital (17.5%) | **Market Cap:** Rs 25.2bn |
| **Major Verticals:** BFSI | **Revenue:** US$ 413mn |
| **Top clients:** Citi, Bank of America | **EBITDA:** Rs 2.5bn |
| **No of Employees:** 11,820 | **PAT:** Rs 2bn |

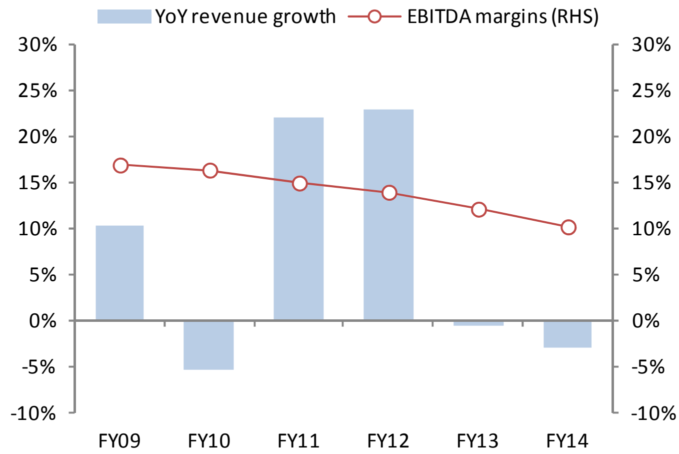
Polaris FT is a recognised global leader in specialty application development for the BFSI sector with a comprehensive portfolio of products, legacy-modernisation services, and consulting. It leverages methods from its global relationships and combinations of solutions and services to its advantage in delivering business benefits to its BFSI customers – its largest clients are CITI Group and BofA.

It has seen revenue CAGR of 10% over the last 4 years, with services seeing a CAGR of 9.8% and products 11.6%. It currently has a quarterly revenue run rate of US$ 105mn, EBITDA margins of 10%, and RoE of 14%.

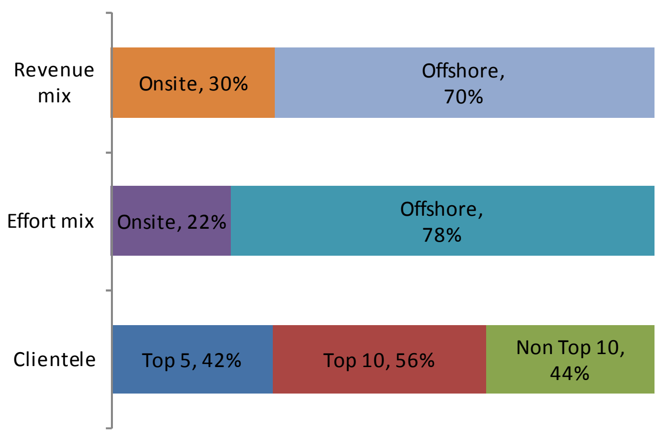
### Segmental revenue profile



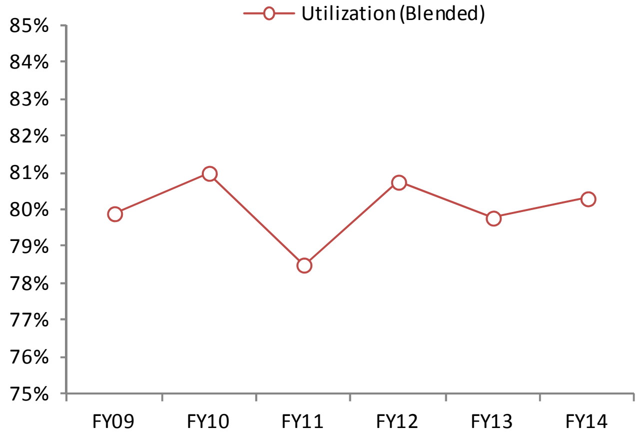

### Revenue growth and margin profile




### Client and employee profile




### Utilisation and attrition




Source: Company, PhillipCapital India Research

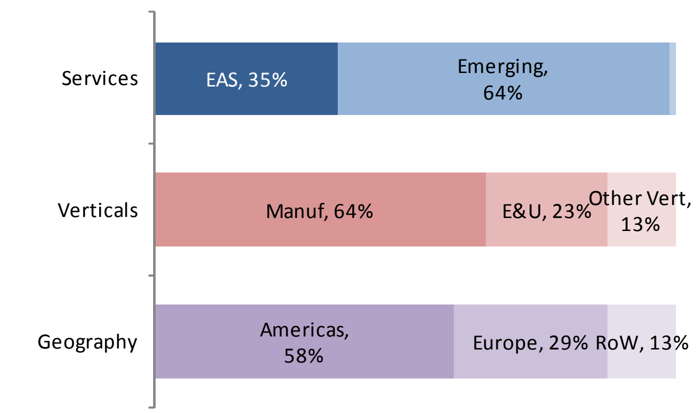
# Cyient: Niche player in Aviation space

| | |
|---|---|
| **Promoter Holding:** 22.3% | |
| **PE on-board holding:** First Carlyle (9.9%) | **Market Cap:** Rs 50.1bn |
| **Major Verticals:** Aerospace, Hi tech, E&U, Telecom | **Revenue:** US$ 363mn |
| **Top clients:** Pratt & Whitney, Alstom, KPN Telecom, Bombardier, Airbus | **EBITDA:** Rs 4.1bn |
| **No of Employees:** 12,094 | **PAT:** Rs 2.7bn |

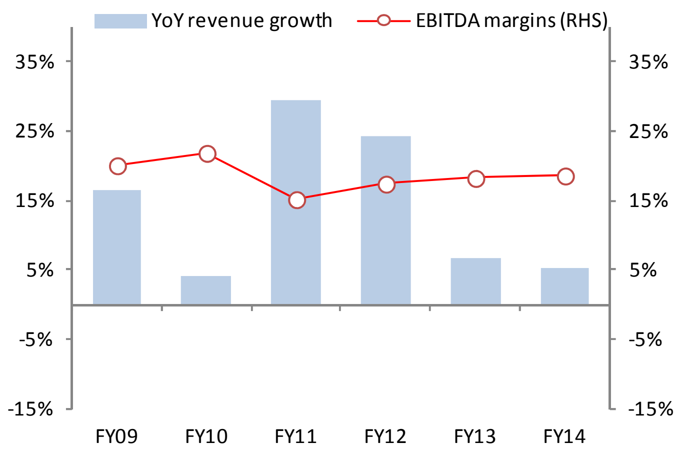
Cyient (formerly Infotech Ent) is a niche player in the least-explored areas of aircraft manufacturing and aerospace engineering — it derives 33% of its revenues from this vertical. Collective data from research firms such as Gartner and IDC indicates that aerospace engineering spends are seeing a large recovery, especially in the US. With strong domain expertise and an improved product line, Cyient is set to be the largest beneficiary from this huge global potential. It is in the midst of a product-development cycle, which could enhance its deal win ratio significantly in the space. It has seen traction in non-aerospace verticals and expects weak accounts to improve over the next two years.

Cyient currently has quarterly revenue run rate of US$ 104mn, EBITDA margins of 15%, and RoEs of around 18%. Over FY12-14, it saw muted 6.9% revenue CAGR (USD), while EBITDA and PAT CAGRs were higher at 23% and 28% – aided by margin expansion (120bps over the same period) and rupee depreciation.

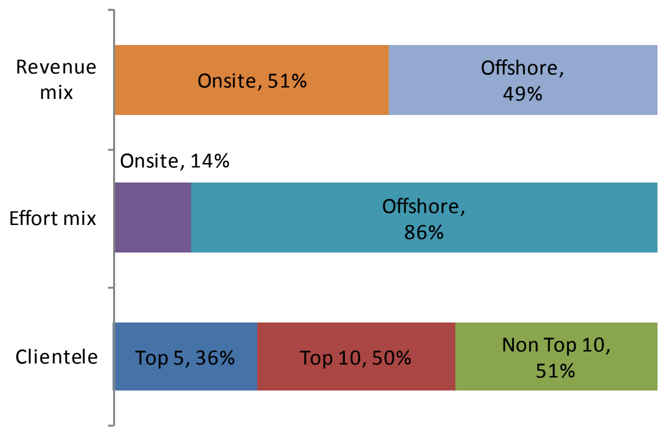
**Segmental revenue profile**



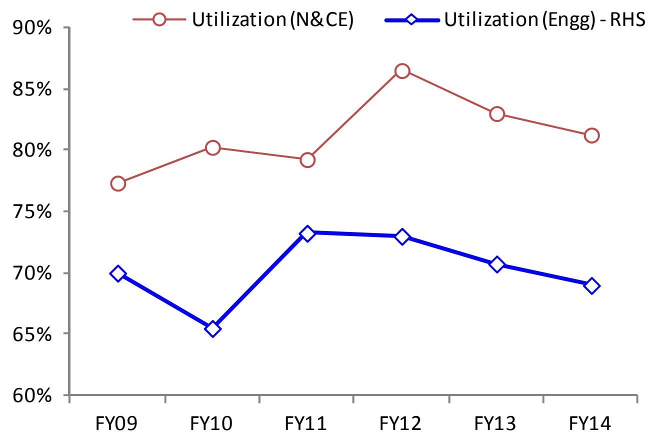

**Revenue growth and margin profile**




**Client and employee profile**




**Utilisation and attrition**




Source: Company, PhillipCapital India Research

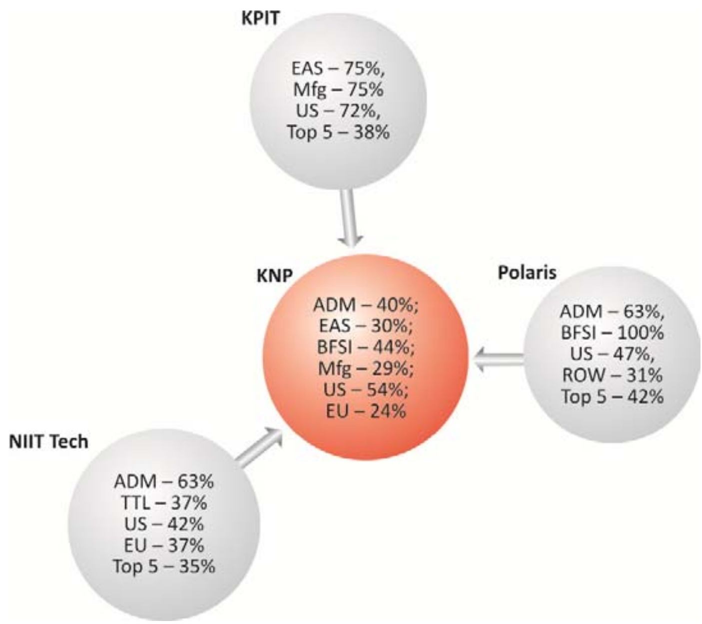
# One + One = Eleven
# Integrated entities will have a much superior profile

Analysing the revenue and client profiles of these companies, we have come up with four Integrated Entities (IEs) that would be able to deliver strong growth and superior RoEs, with least overlaps in service lines. They will be entities with a diversified end-to-end services portfolio and presence in most key verticals, geographies, and service lines.

## KNP = KPIT + NIIT + Polaris

KNP is a (hypothetical) integration of KPIT Technologies (US$ 444mn topline), NIIT Tech (US$ 384mn) and Polaris (US$ 413mn). The IE formed will benefit from KPIT's strong presence in automotive, Polaris's dominance in BFSI, and NIIT's leadership in TTL. KPIT's over-dependence on US (72%) will also be mitigated to a large extent by the NIIT's strong presence in Europe and Polaris' in the RoW.

**KNP: Business profile of the Integrated Entity**




| | KPIT | NITEC | Polaris | KNP | Rev share |
|---|---|---|---|---|---|
| **Topline** | **444** | **384** | **413** | **1,241** | |
| **EBITDA margins** | **16%** | **15%** | **10%** | **14%** | |
| **Key verticals** | | | | | |
| BFSI | - | 128 | 413 | 541 | 44% |
| Auto, Manf | 331 | 26 | - | 357 | 29% |
| E&U | 68 | - | - | 68 | 5% |
| Travel, Transport | - | 142 | - | 142 | 11% |
| Others | 45 | 88 | - | 133 | 11% |
| **Geography** | | | | | |
| US | 321 | 162 | 193 | 676 | 54% |
| EU | 63 | 141 | 92 | 296 | 24% |
| ROW | 60 | 81 | 128 | 269 | 22% |
| **Horizontals** | | | | | |
| ADM | - | 242 | 259 | 501 | 40% |
| IMS | - | 48 | - | 48 | 4% |
| EAS | 334 | 39 | - | 374 | 30% |
| Engg Services | 110 | - | - | 110 | 9% |
| IP + Products | - | 34 | 88 | 122 | 10% |
| Others | - | 21 | 66 | 87 | 7% |

Source: PhillipCapital India Research

Without taking merger synergies into account, the IE KNP will have a revenue base of US$ 1.24bn, and EBITDA margins of 14%. BFSI will constitute 44% of its revenues, followed by manufacturing (29%) and TTL (11%). The firm will also have 24% of its revenues coming from Europe – reducing its dependence on US to 54%. Top-5 clients contributed 35-42% of the three entities' revenues before merger — this will come down to around 21% after the integration.

**KNP: SWOT analysis**

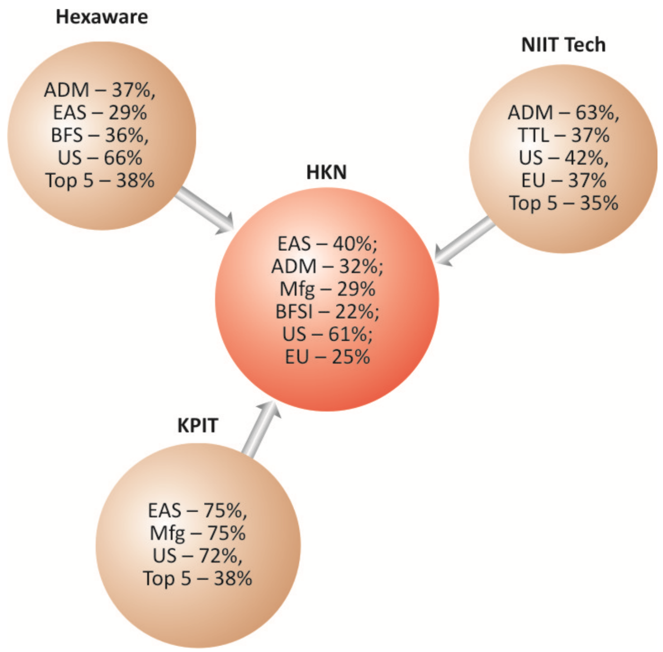
| Strength | Weakness | Opportunity | Threat |
|---|---|---|---|
| Strong presence in BFSI, auto and TTL | Near absence of IMS as a service line | Growing opportunities in IP-led business | High level of competition in BFSI services |
| Diversified geographic mix | Negligible presence in retail, telecom and healthcare | Larger revenue base would open the doors of large clients and deals | Revenue diversification might lead to loss of focus in key verticals |

Source: PhillipCapital India Research

## HKN = Hexaware + KPIT + NIIT Tech

HKN is our hypothetical integration of Hexaware (US$ 388mn topline), KPIT (US$ 444mn) and NIIT Tech (US$ 384mn). The IE formed will benefit from Hexaware's strong presence in BFSI, KPIT's strong presence in automotive, and NIIT's leadership in TTL. KPIT's over-dependence on US as a geography (72%) will be mitigated to a large extent by the NIIT's and Hexaware's presence in Europe. HKN's low exposure towards the low-margin RoW gives a better mix for this IE.

### HKN: Business profile of the Integrated Entity




| | KPIT | NITEC | HEXW | HKN | Rev share |
|---|---|---|---|---|---|
| **Topline** | **444** | **384** | **388** | **1,216** | |
| **EBITDA margins** | **16%** | **15%** | **22%** | **18%** | |
| | | | | | |
| **Key verticals** | | | | | |
| BFSI | - | 128 | 138 | 266 | 22% |
| Auto, Manf | 331 | 26 | - | 357 | 29% |
| E&U | 68 | - | - | 68 | 6% |
| Travel, Transport | - | 142 | 74 | 216 | 18% |
| Others | 45 | 88 | 176 | 309 | 25% |
| | | | | | |
| **Geography** | | | | | |
| US | 321 | 162 | 257 | 741 | 61% |
| EU | 63 | 141 | 105 | 309 | 25% |
| ROW | 60 | 81 | 25 | 166 | 14% |
| | | | | | |
| **Horizontals** | | | | | |
| ADM | - | 242 | 144 | 386 | 32% |
| IMS | - | 48 | - | 48 | 4% |
| EAS | 334 | 39 | 114 | 487 | 40% |
| Engg Services | 110 | - | - | 110 | 9% |
| IP + Products | - | 34 | - | 34 | 3% |
| Others | - | 21 | 130 | 151 | 12% |

Source: PhillipCapital India Research

HKN will have a revenue base of US$ 1.2bn, and EBITDA margins of 18%. Manufacturing will constitute 29% of its revenues, followed by BFSI (22%) and TTL (18%). The firm will also have 25% of its revenues coming from Europe – reducing dependence on US to 61%. Top-5 clients contributed 35-38% of the three entities' revenues before merger — this will come down to around 19.5% after the integration.

### HKN: SWOT analysis

| Strength | Weakness | Opportunity | Threat |
|---|---|---|---|
| Strong presence in manufacturing and TTL | Near absence of IMS as a service line | Early bird in Middle East and other RoW markets | Revenue diversification might lead to loss of focus in key verticals |
| Diversified geographic mix | Negligible presence in E&U, telecom and healthcare | Larger revenue base would now open the doors of large clients and deals | - |

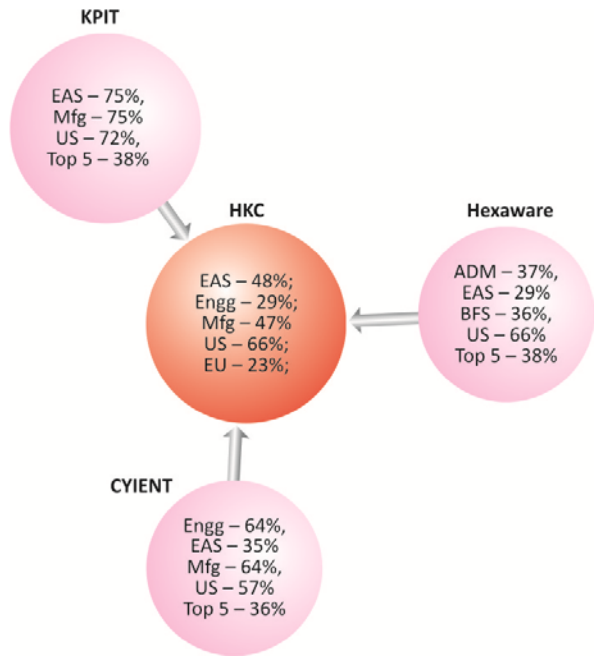
Source: PhillipCapital India Research

## HKC = Hexaware + KPIT + Cyient

HKC is our hypothetical integration of Hexaware (US$ 388mn topline), KPIT Technologies (US$ 444mn) and Cyient (US$ 363mn). The IE formed will have a larger inclination towards manufacturing through KPIT and Cyient, which would be balanced by Hexaware's strong presence in BFSI and Cyient's presence in E&U. KPIT's over-dependence on US as a geography (72%) will also be mitigated to an extent by Hexaware's and Cyient's presence in Europe; all three companies have low presence in the RoW.

HKC will have a revenue base of US$ 1.2bn, and EBITDA margins of 19%. Auto and manufacturing will constitute 47% of its revenues, followed by E&U (13%), and BFSI (12%). Europe will contribute to 23% of its revenues – marginally reducing dependence on the US to 66%. Top-5 clients contributed 36-38% of the three entities' revenues before merger — this will come down to around 20.5% after the integration.

### HKC: Business profile of the Integrated Entity




| | HEXW | KPIT | Cyient | HKC | Rev share |
|---|---|---|---|---|---|
| **Topline** | **388** | **444** | **363** | **1,195** | |
| **EBITDA margins** | **22%** | **16%** | **19%** | **19%** | |
| | | | | | |
| **Key verticals** | | | | | |
| BFSI | 138 | - | - | 138 | 12% |
| Auto, Manf | - | 331 | 231 | 562 | 47% |
| E&U | - | 68 | 85 | 152 | 13% |
| Travel, Transport | 74 | - | - | 74 | 6% |
| Others | 176 | 45 | 48 | 269 | 22% |
| | | | | | |
| **Geography** | | | | | |
| US | 257 | 321 | 207 | 785 | 66% |
| EU | 105 | 63 | 103 | 271 | 23% |
| ROW | 25 | 60 | 54 | 139 | 12% |
| | | | | | |
| **Horizontals** | | | | | |
| ADM | 144 | - | - | 144 | 12% |
| IMS | - | - | - | - | 0% |
| EAS | 114 | 334 | 128 | 576 | 48% |
| Engg Services | - | 110 | 231 | 341 | 29% |
| IP + Products | - | - | - | - | 0% |
| Others | 130 | - | 4 | 134 | 11% |

Source: PhillipCapital India Research

### HKC: SWOT analysis

| Strength | Weakness | Opportunity | Threat |
|---|---|---|---|
| Strong presence in auto and aerospace engineering | Negligible presence in IMS/managed services | Huge outsourcing opportunity yet to unravel in aerospace engineering | Overlap of clients on similar EAS services between KPIT and Cyient |
| Diversified geographic mix | Negligible presence in telecom, healthcare and retail | Larger revenue base would now open the doors of large clients and deals | Revenue diversification might lead to loss of focus in key verticals |

Source: PhillipCapital India Research

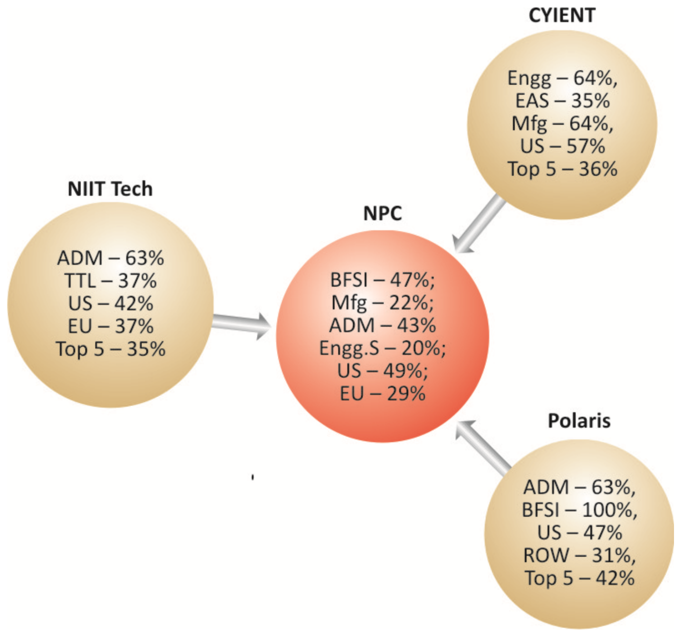
NPC

## NPC = NIIT Tech + Polaris + Cyient

NPC is a hypothetical integration of NIIT Tech (US$ 384mn), Polaris (US$ 413mn) and Cyient (US$ 363mn). This IE will benefit from NIIT Tech's leadership in TTL, Cyient's niche in aerospace engineering and Polaris' strong presence in BFSI. Cyient's over-exposure to the US (58%) will be mitigated to a large extent by NIIT Tech's presence in Europe and Polaris' in RoW.

IE NPC will have a revenue base of US$ 1.16bn, and EBITDA margins of 15%. BFSI will constitute 47% of its revenues, followed by manufacturing at 22%. The firm will also get 29% of its revenues from Europe – highest amongst the IEs formed by us, and much closer to the profile of Top-5. Top-5 clients contributed 35-42% of the three entities' revenues before merger — this will come down to around 19% after the integration

### NPC: Business profile of the Integrated Entity




| | Cyient | NITEC | Polaris | NPC | Rev share |
|---|---|---|---|---|---|
| **Topline** | **363** | **384** | **413** | **1,160** | |
| **EBITDA margins** | **19%** | **15%** | **10%** | **15%** | |
| | | | | | |
| **Key verticals** | | | | | |
| BFSI | - | 128 | 413 | 541 | 47% |
| Auto, Manf | 231 | 26 | - | 257 | 22% |
| E&U | 85 | - | - | 85 | 7% |
| Travel, Transport | - | 142 | - | 142 | 12% |
| Others | 48 | 88 | - | 135 | 12% |
| | | | | | |
| **Geography** | | | | | |
| US | 209 | 162 | 193 | 564 | 49% |
| EU | 107 | 141 | 92 | 340 | 29% |
| ROW | 47 | 81 | 128 | 256 | 22% |
| | | | | | |
| **Horizontals** | | | | | |
| ADM | - | 242 | 259 | 501 | 43% |
| IMS | - | 48 | - | 48 | 4% |
| EAS | 128 | 39 | - | 167 | 14% |
| Engg Services | 231 | - | - | 231 | 20% |
| IP + Products | - | 34 | - | 34 | 3% |
| Others | 4 | - | 154 | 158 | 14% |

Source: PhillipCapital India Research

### NPC: SWOT analysis

| Strength | Weakness | Opportunity | Threat |
|---|---|---|---|
| Leadership in TTL; strong presence in aerospace and BFSI | Higher exposure in RoW – low margin regions | Cross selling of engineering services and EAS in focused verticals | Strong competition in BFSI |
| Strong clientele with many Fortune-500 companies in the portfolio | Negligible presence in retail, telecom and healthcare | Strong presence in Europe, which is expected to be the next growth driver | Revenue diversification might lead to loss of focus in key verticals |

Source: PhillipCapital India Research

We believe these four IEs will have far superior revenue and earnings profile than any of the individual constituent companies could have aspired to achieve on their own – organically or inorganically. The IEs will be much better placed to compete with the top-5 Indian IT services companies. Their expertise of niche domains will ensure superior growth profile. Revenue and client diversification will shield from revenue volatility and over-dependence on a key client, vertical, or geography.

**Business profile of the Integrated Entities**

| | Revenues | | | | % contribution to revenues | | | |
|---|---|---|---|---|---|---|---|---|
| **In US$ mn** | **KNP** | **HKN** | **HKC** | **NPC** | **KNP** | **HKN** | **HKC** | **NPC** |
| **Overall revenues** | **1,241** | **1,216** | **1,195** | **1,160** | | | | |
| **EBITDA Margins** | **14%** | **18%** | **19%** | **15%** | | | | |
| **Key verticals** | | | | | | | | |
| BFSI | 541 | 266 | 138 | 541 | 44% | 22% | 12% | 47% |
| Auto, Manf | 357 | 357 | 562 | 257 | 29% | 29% | 47% | 22% |
| E&U | 68 | 68 | 152 | 85 | 5% | 6% | 13% | 7% |
| Travel, Transport | 142 | 216 | 74 | 142 | 11% | 18% | 6% | 12% |
| Healthcare | - | 63 | 63 | - | 0% | 5% | 5% | 0% |
| Telecom | - | - | - | 135 | - | - | - | 12% |
| Others | 133 | 246 | 206 | | 11% | 20% | 17% | - |
| **Geography** | | | | | | | | |
| US | 676 | 741 | 785 | 564 | 54% | 61% | 66% | 49% |
| EU | 296 | 309 | 271 | 340 | 24% | 25% | 23% | 29% |
| ROW | 269 | 166 | 139 | 256 | 22% | 14% | 12% | 22% |
| **Horizontals** | | | | | | | | |
| ADM | 501 | 386 | 144 | 501 | 40% | 32% | 12% | 43% |
| IMS | 48 | 48 | - | 48 | 4% | 4% | 0% | 4% |
| EAS | 374 | 487 | 576 | 167 | 30% | 40% | 48% | 14% |
| Engg Services | 110 | 110 | 341 | 231 | 9% | 9% | 29% | 20% |
| BI & Analytics | - | 40 | 40 | - | 0% | 3% | 3% | 0% |
| BPO | 21 | 37 | 16 | 21 | 2% | 3% | 1% | 2% |
| IP + Products | 122 | 34 | - | 34 | 10% | 3% | 0% | 3% |
| Others | 66 | 74 | 78 | 158 | 5% | 6% | 7% | 14% |

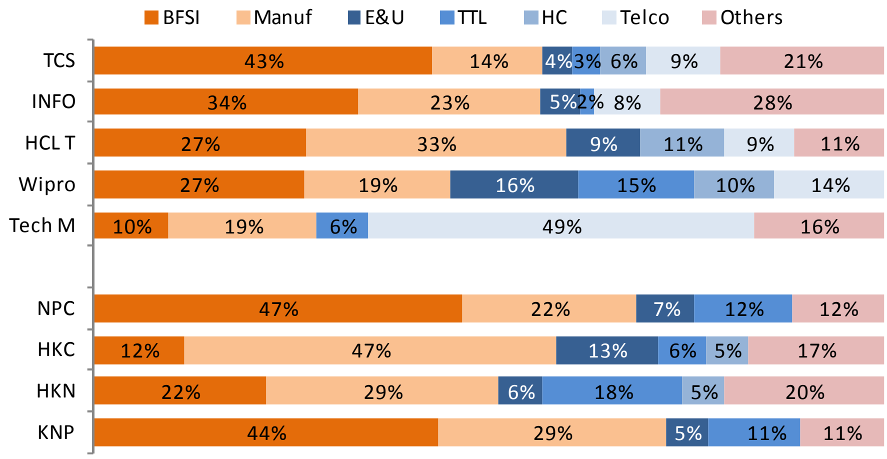
Source: PhillipCapital India Research

# Comparison of the IEs with the top-5

The idea of hypothetically integrating these select midcap companies was to form IEs that have a similar profile to the top-5, and hence command a similar valuation multiple. What we found interesting is that almost ALL of the IE combinations resemble one of the top-5 Indian IT services companies.

HKP (Hexaware, KPIT and Polaris) is similar to TCS with BFSI emerging as the key vertical followed by manufacturing, while the size of other verticals are small. Horizontal-wise, the two traditional services - ADM and EAS - constitute bulk of the revenues (around 70%).

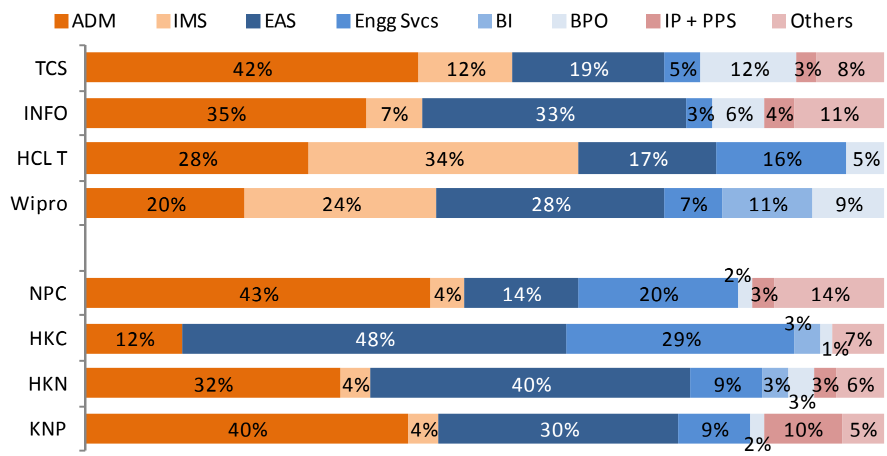
### Vertical-wise comparison with top 5




Source: Company, PhillipCapital India Research

HKC (Hexaware, KPIT and Cyient) has a strong base in manufacturing, while BFSI and E&U remains the next two verticals with close to 15% revenue contribution. Horizontal-wise, the company remains heavily dependent on enterprise solutions. However, emerging service lines led by engineering services and integrated enterprise solutions have grown stronger than the traditional services in the recent 4-5 quarters indicating an enrichment of overall portfolio – a trend that should further enhance after integration.

### Horizontal-wise comparison with top 5

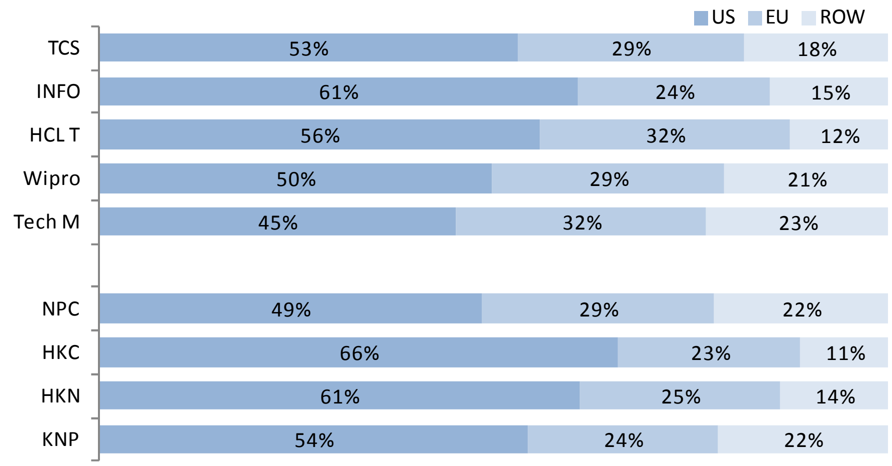



Source: Company, PhillipCapital India Research

HKN (Hexaware, KPIT and NIIT Tech) is truly diversified across verticals – more on the lines of Wipro and Infosys. While ADM and EAS service lines constitute around 70% of its revenues, its presence in IMS (through NIIT Tech) and emerging services lines (about 28% of revenues) enhance the overall quality of the portfolio.

KNP (KPIT, NIIT Tech, and Polaris) has a good mix of revenues with large verticals - BFSI and manufacturing - contributing to a bulk of the revenues (73%), while TTL and emerging verticals together form 22%. The service mix is similar to HKN, with emerging segment (IP+PPS) contributing to around 10% - a major source for nonlinear revenues.

**Geography-wise comparison with top 5**




Source: Company, PhillipCapital India Research

Geography-wise, the US forms the largest chunk of revenues for ALL IEs, followed by Europe and RoW, which is the normal revenue structure of IT services companies. Amongst the four, HKN comes the closest to top 5 in terms of geography mix. The most undesirable formation is that of KNP, which has a higher exposure to RoW (predominantly remains a low-margin region). A negative factor is that almost all the IEs' exposure to Europe (which we expect to be the next frontier of growth for the Indian IT services industry – read our detailed report ***here***) remains significantly lower than the top-5.

We find that the IEs resemble the top-5 in terms of revenue diversification across verticals, and service lines. Their exposure to Europe, from where the next leg of growth should come, remains lower than the top-5.

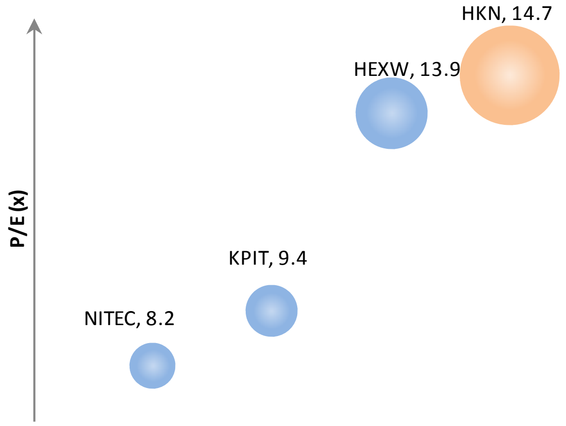
However, the profile of these IEs surely takes them to a higher platform — one where they will be able to command a much superior multiple than the individual multiples the constituent companies currently command. The multiple may be little lower than what the top-5 trade at, but their rerating can lead to significant value creation.

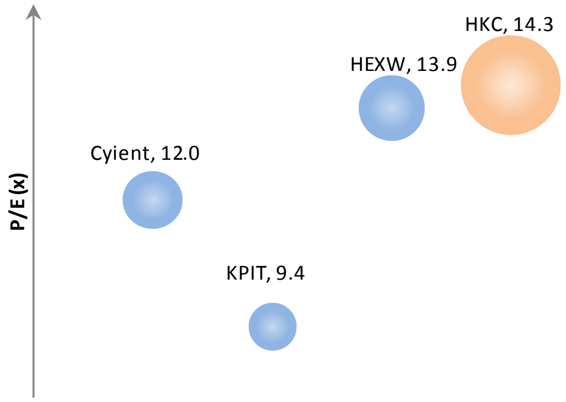
## Significant rerating potential for the IEs

Based on our SWOT analysis, after integration, these IEs should trade at a significant premium to the average multiples of their constituent companies. Interestingly, there is a huge disparity in the multiples that these individual midcap companies are currently trading at.

The most attractive combination is HKN (Hexaware + KPIT + NIIT Tech), which has a more diversified business model and employs more nonlinear projects – making it highly lucrative for investment. This combination also offers better growth prospect and has a larger addressable market. **We have assigned a premium of 35% to HKN over the current average multiple of its constituents**.

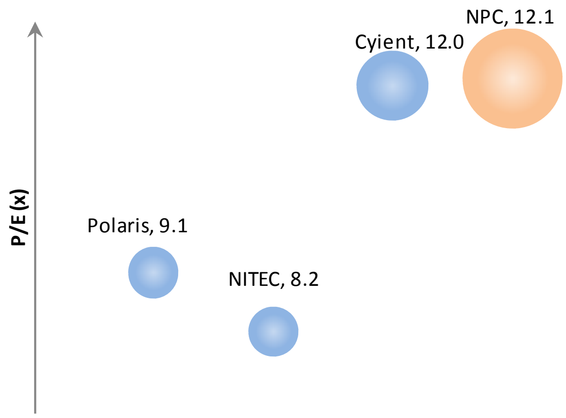
### The most attractive IEs and their valuation potential

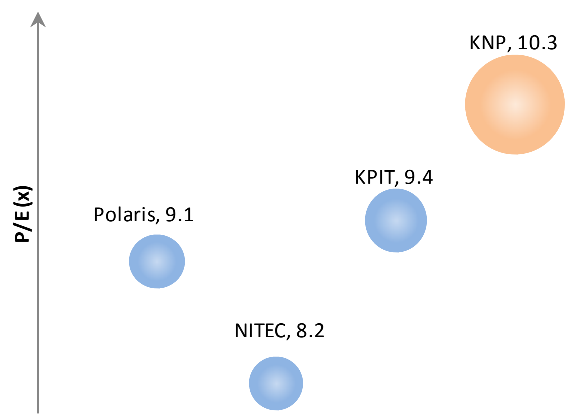



HKC (Hexaware + KPIT + Cyient) and NPC (NIIT Tech + Polaris + Cyient) also appear quite attractive, but inferior to HKN. Therefore, **we provide a lower 20% premium to HKC and NPC (over the current average multiple of constituents)**. To **KNP** (KPIT + NIIT Tech + Polaris), which appears to be the least attractive IE in our analysis, **we provide a 15% premium**.

### IEs with relatively inferior profile and their valuation potential




Source: PhillipCapital India Research

While KNP might appear to be the least attractive IE, the entity would still be much stronger than its constituent companies, would still trade at a premium to their average, and lead to significant value creation in the Indian IT space.

## Integration challenges: not insurmountable

We realise that our hypothesis looks good on paper, but in reality, it would involve multiple challenges of high magnitude. Integration of two companies is an arduous task and it takes even experienced companies decades to realise the synergies of a merger. However, we believe that integrating the selected companies might not be as difficult a task as it appears to be. Few key reasons for this:

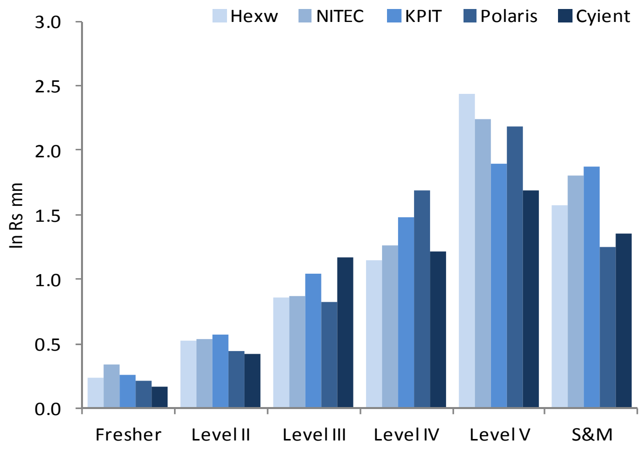
1) **Similar employee base**: Most of the Indian IT services companies (including the Top-5) hire candidates from the same engineering colleges with similar profiles. They are put through similar training programs on various platforms, and are readily/frequently transferred across projects and platforms.
2) **Minimum client overlap**: None of the companies we selected have a strong presence in a domain in which the other company is significantly present. In fact, this will be the key to the successful integration of these companies.
3) **Little difference in delivery capabilities**: All the companies selected have similar delivery capabilities across various platforms. It's the management focus and vision and the strength of the S&M team that differentiates them, in our opinion.

**Salary levels**

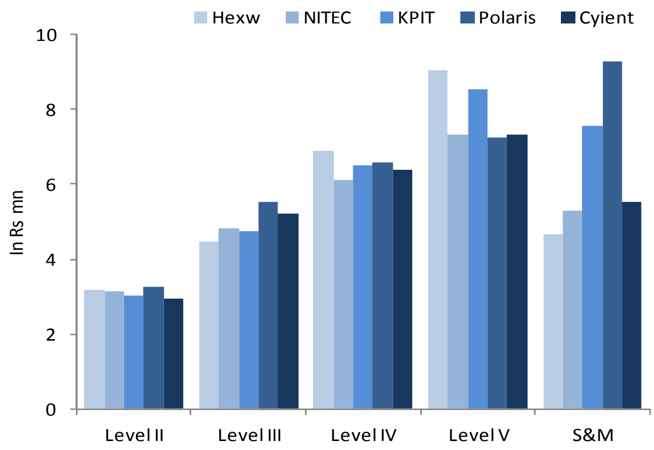
Salary level is one of the most contentious issue in a merger. If the salary levels at the two companies being merged are vastly different, it becomes an arduous task for the HR of the integrated company to match them and manage expectations.

However, our analysis of the salary levels at these companies, reveals that they are very similar even at different hierarchy levels . The onsite salaries for the technology staff remain amazingly same across companies at various levels. Offshore salary levels, too, are very similar – but show a little variation at higher levels. S&M salaries, on the other hand, are comparable at offshore locations, but depict high variation at onsite levels.

**Offshore salary levels**




**Onsite salary levels**




Source: PhillipCapital India Research, Glassdoor.com

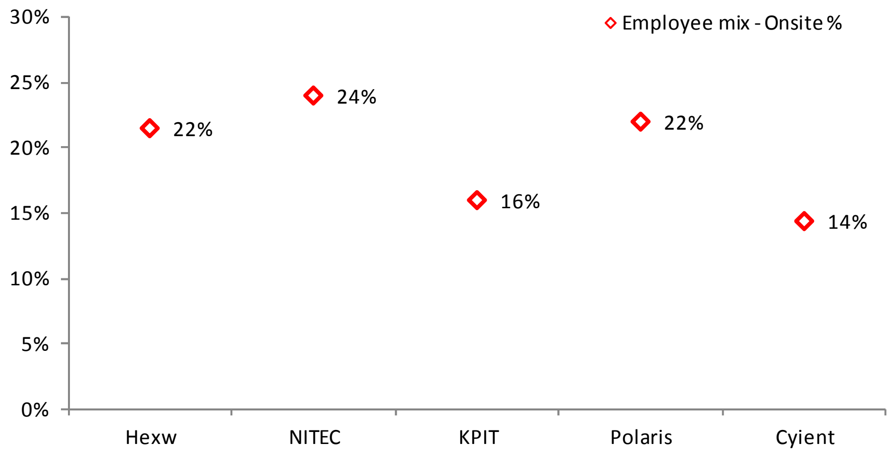
Hence, we see that managing salaries of the integrated entities will not be a major impediment to their smooth integration — this resolves one of the biggest issues that a merger typically faces.

**Onsite/Offshore mix**

The onsite:offshore mix remains a key metric to watch out for while proposing the integration of these companies. The mix largely depends on the kind of projects that the company undertakes. The mix not only determines the margins for the company, but also keeps attrition under check (higher onsite opportunity leads to higher employee satisfaction and retention).

Apart from KPIT and Cyient, almost all companies operate at similar onsite:offshore levels with onsite forming 20-25%. KPIT and Cyient are much lower (between 14% and 16%, which enables them to report higher margins.

**Onsite:Offshore effort mix**




Source: Company, PhillipCapital India Research

**Soft issues**

Salary levels and delivery capabilities do not pose major challenges to the smooth implementation of our hypothesis. However, softer issues will be the ones that the management will have to handle with extreme caution. Such as:

1) **Work culture**: Most of these companies operate in completely different work environments. Some companies are highly result oriented and offer their employees flexible working hours as long as they deliver their target on time. Others are more process oriented and have a much more disciplined work environment. Integrating the two work cultures could be a long drawn out and painful process and could lead to significant attrition.
2) **Employee pyramid:** The employee pyramid in all the selected companies is different. Getting it to even out will be a difficult task and is sure to lead to exits of few key individuals.
3) **Common assets:** All Indian IT services companies (including top-5) operate in the same geographies, with the US and the UK being the primary ones, Northern Europe having a higher share than other parts of Europe, and APAC and Middle East completing the RoW pie. Companies would have common assets in those geographies (primarily S&M staff) many of whom would become redundant after integration. Relocating them to other regions/verticals would be difficult to manage and would lead to attrition in the pre-stabilisation period.
4) **Top Management:** And finally, one of the biggest issues will be – who will run the Integrated Entity? A PE-designed merger would provide exit to the PE investors, but would leave the IE with different sets of managements and promoters with differing stake sizes. Special care and prior planning and approval would have to be taken by the PE entities to ensure this does not become the biggest impediment in the integration process.

## Final verdict – Which companies will benefit

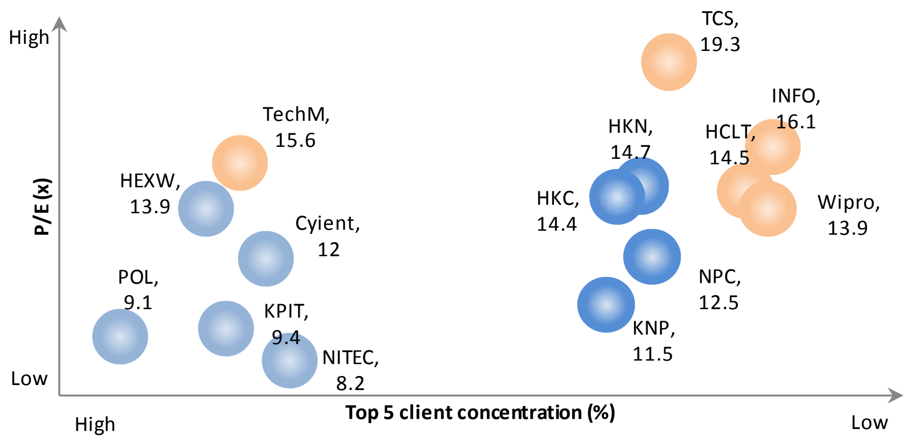
If two or more of such niche companies were to merge, the result will be a much stronger Integrated Entity. This IE will have superior growth prospects, access to large clients and deals, a diversified revenue base, and possible merger synergies. This should lead to a significant rerating of the IE, leading to considerable value creation for its investors.

Our analysis reveals that of the selected set of five companies, the merger of Hexaware, KPIT and NIIT Tech would form the most attractive entity (HKN) – it would be closest to the top-5 in terms of revenue profile. It would also face minimum post-integration issues, and maximum possible synergies. Other attractive entities would be HKC, NPC, and KNP, in that order.

If one were to invest now based on our hypothesis, then KPIT, and NITEC would be the most suitable candidates. KPIT operates in highly niche domains of automotive and manufacturing, which will provide further diversification to any entity it becomes a part of. NIIT Tech, too, would form a key constituent of any merger because of its strong presence in the relatively untouched TTL domain.

While Hexaware already has a diversified revenue profile and would be a strategic fit with most entities, its already rich valuations would limit the upside potential, even if it were to benefit from our hypothesis.

**Positioning of the Integrated Entities will be much closer to the top-5**




Source: PhillipCapital India Research

We do realise the high imaginary quotient of our premise and that such a theory is easier said than implemented; its execution would involve multiple challenges. However, with the relatively homogenous profile of midcap IT companies in India as far as employees are concerned, issues surrounding such a merger will not be insurmountable.

Such a merger strategy could be implemented well by firms such as Barings (which holds a majority stake in one of these companies), which are only looking for higher valuation to exit. At the end of the day, the PE firms are only looking at ways to enhance the valuation for their invested companies. And as TechM has demonstrated, this is one of the shortest and probably the easiest route to rerating and higher valuations in the Indian IT space.

# COMPANIES SECTION

# NIIT Technologies

*Daring to be different will pay off*

PhillipCapital

**PhillipCapital (India) Pvt. Ltd.**

IT SERVICES: Initiating Coverage

29 September 2014

### Niche in TTL domain; strong traction in insurance

NIIT Tech has created a strong presence in the travel, transport and logistics (TTL) domain, with end-to-end value-added solutions in its kitty. It has top-tier clients in aerospace (British Airways, Lufthansa, Emirates) and insurance verticals and continues to bag large deals. It has an annual revenue run rate of US$ 145mn (37% of total revenues) from the TTL vertical – second only to TCS (US$ 464mn) and the largest among midcaps.

### Bold initiatives to achieve US$ 1bn revenue in the next 5 years

NIIT Tech aspires to achieve US$ 1bn in revenues by the end of FY19 on the back of huge opportunities from the US and opening up of fresh deals in Europe. It has adopted a four-pronged strategy to execute its set corporate agenda, which seems pragmatic. It has created new senior management positions, which should strengthen its focus on execution levels.

It has appointed Mr Sudhir Chaturvedi, an IT veteran and ex Infoscian as its Chief Operating Officer and moved multiple segments under his charge. It has also separated TTL as an independent unit to focus better on large deals. These bold initiatives should help achieve its performance targets over the next 5 years.

### Multiple margin tailwinds ahead; strong S&M base boosts growth

We see the following tailwinds to its margins: 1) productivity improvements through increase in utilisations, 2) gaining large deals from high-margin regions (western markets), and 3) incremental offshoring. New initiatives on cost rationalisations to reduce G&A costs and an improvement in its GIS business will provide additional support to margin expansion; GIS margins (GIS business contributes 6-7% of total EBITDA) saw an expansion from 5% to 20% (average) during FY13-14.

Higher S&M spends will help it gain large deals in its focus verticals — NITEC's S&M spends remain the highest amongst its midcap peers. While its overall revenue CAGR of 13% (in the last 4 years) was primarily driven by its top-10 accounts (14% CAGR), its non-top accounts' growth was not far behind (12% CAGR). It continues to mine all its accounts while adding new large deals to its pipeline.

### Outlook and valuations – definite case for FURTHER re-rating

NITEC's executable orderbook has grown by 15% in FY14 and continues at a pace of 12% yoy in Q1FY15. While it could face some client-specific challenges in H1FY15, it should regain momentum in H2. We expect its new orderbook revenue to flow through from Q4FY15 leading to a 17% growth in FY16. EBITDA margins should be stable at 15-16% with PAT growth of 24% in FY16.

On our estimates, the stock is trading at 11.2x FY15 and 9.1x FY16 earnings. While it has run up 46% over the last 12 months, it still trades at a significant discount to its midcap peers. With a rich profile of built up orderbook, its visibility for growth in FY16 and FY17 is secured, with better margins. With a highly value-adding price model, it has a higher chance of adding high-margin large deals to its portfolio.

We value the company at 10x average of FY16-FY17 earnings – inline with our multiple for midcap IT companies including KPIT Technologies. Our price target of Rs 490, represents 27% upside from current levels. We initiate with a BUY rating.

**For detailed report, please Click here**

Please refer to Disclosures and Disclaimers at the end of the Research Report.

## BUY

**NITEC IN | CMP Rs 387**

**TARGET Rs 490 (+27%)**

**Company Data**

| | |
|---|---|
| O/S SHARES (MN) : | 61 |
| MARKET CAP (RSBN) : | 26 |
| MARKET CAP (USDBN) : | 0.4 |
| 52 - WK HI/LO (RS) : | 487 / 273 |
| LIQUIDITY 3M (USDMN) : | 2.3 |
| FACE VALUE (RS) : | 10 |

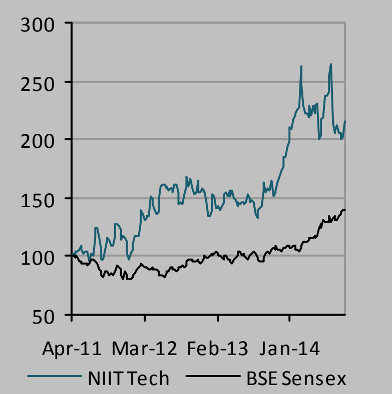
**Share Holding Pattern, %**

| | |
|---|---|
| PROMOTERS : | 31.1 |
| FII / NRI : | 34.4 |
| FI / MF : | 15.9 |
| NON PROMOTER CORP. HOLDINGS : | 4.1 |
| PUBLIC & OTHERS : | 14.6 |

**Price Performance, %**

| | 1mth | 3mth | 1yr |
|---|---|---|---|
| ABS | 17.6 | 1.8 | 53.6 |
| REL TO BSE | 14.6 | -6.6 | 19.3 |

**Price Vs. Sensex (Rebased values)**




Source: Bloomberg, Phillip Capital Research

**Other Key Ratios**

| Rs bn | FY15E | FY16E | FY17E |
|---|---|---|---|
| Net Sales | 23,745 | 26,614 | 30,249 |
| EBIDTA | 3,503 | 4,117 | 4,960 |
| Net Profit | 2,159 | 2,641 | 3,274 |
| EPS, Rs | 35.6 | 43.4 | 53.8 |
| PER, x | 11.2 | 9.1 | 7.4 |
| EV/EBIDTA, x | 6.3 | 5.1 | 4.1 |
| P/BV, x | 0.9 | 0.8 | 0.7 |
| ROE, % | 14.6 | 15.8 | 17.2 |

Source: Phillip Capital India Research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# Financials

## Income Statement

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **Net sales** | **23,050** | **23,745** | **26,614** | **30,249** |
| Growth, % | 14.0 | 3.0 | 12.1 | 13.7 |
| Employee expenses | 0 | 0 | 0 | 0 |
| Other Operating expenses | -19,534 | -20,242 | -22,497 | -25,289 |
| **EBITDA (Core)** | **3,516** | **3,503** | **4,117** | **4,960** |
| Growth, % | 6.7 | -0.4 | 17.5 | 20.5 |
| Margin, % | 15.3 | 14.8 | 15.5 | 16.4 |
| Depreciation | -619 | -745 | -775 | -836 |
| **EBIT** | **2,897** | **2,758** | **3,342** | **4,123** |
| Growth, % | 6.2 | (4.8) | 21.2 | 23.4 |
| Margin, % | 12.6 | 11.6 | 12.6 | 13.6 |
| Interest paid | 0 | 0 | 0 | 0 |
| Other Non-Operating Income | 288 | 237 | 288 | 377 |
| **Pre-tax profit** | **3,185** | **2,995** | **3,630** | **4,500** |
| Tax provided | -803 | -755 | -908 | -1,125 |
| Profit after tax | 2,382 | 2,240 | 2,723 | 3,375 |
| Others (Minorities, Associates) | -75 | -80 | -82 | -101 |
| **Net Profit** | **2,307** | **2,159** | **2,641** | **3,274** |
| Growth, % | 8.2 | (6.4) | 22.3 | 24.0 |
| **Net Profit (adjusted)** | **2,307** | **2,159** | **2,641** | **3,274** |
| Wtd avg shares (m) | 60 | 61 | 61 | 61 |

| | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **US$ Revenue ($ mn)** | **383.7** | **396.0** | **443.6** | **504.1** |
| Growth, % | 3.0 | 3.2 | 12.0 | 13.7 |
| Re / US$ (rate) | 60.1 | 60.0 | 60.0 | 60.0 |

## Balance Sheet

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| Cash & bank | 1,878 | 2,114 | 3,097 | 3,948 |
| Marketable securities at cost | 0 | 0 | 0 | 0 |
| Debtors | 5,643 | 5,985 | 6,635 | 7,459 |
| Inventory | 4 | 4 | 4 | 4 |
| Other current assets | 2,088 | 2,111 | 2,424 | 2,827 |
| Total current assets | 10,975 | 11,742 | 13,888 | 16,213 |
| Investments | 996 | 996 | 996 | 996 |
| Net fixed assets | 5,820 | 6,645 | 6,670 | 7,034 |
| Non-current assets | 0 | 0 | 0 | 0 |
| **Total assets** | **18,014** | **19,600** | **21,771** | **24,460** |
| | | | | |
| Total current liabilities | 4,497 | 4,437 | 4,623 | 4,850 |
| Non-current liabilities | 89 | 74 | 84 | 95 |
| Total liabilities | 4,586 | 4,511 | 4,706 | 4,945 |
| Paid-up capital | 607 | 607 | 607 | 607 |
| Reserves & surplus | 12,632 | 14,213 | 16,107 | 18,456 |
| Minorities | 189 | 269 | 351 | 452 |
| Shareholders' equity | 13,428 | 15,089 | 17,065 | 19,515 |
| **Total equity & liabilities** | **18,014** | **19,600** | **21,771** | **24,460** |

Source: Company, PhillipCapital India Research Estimates

## Cash Flow

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| Pre-tax profit | 3,185 | 2,995 | 3,630 | 4,500 |
| Depreciation | 619 | 745 | 775 | 836 |
| Chg in working capital | -1,534 | -591 | -977 | -1,247 |
| Total tax paid | -904 | -749 | -908 | -1,125 |
| Other operating activities | 0 | 0 | 0 | 0 |
| **Cash flow from operating activities** | **1,366** | **2,399** | **2,520** | **2,965** |
| Capital expenditure | -1,778 | -1,570 | -800 | -1,200 |
| Chg in investments | 0 | 0 | 0 | 0 |
| Chg in marketable securities | 0 | 0 | 0 | 0 |
| Other investing activities | 0 | 0 | 0 | 0 |
| **Cash flow from investing activities** | **-1,778** | **-1,570** | **-800** | **-1,200** |
| Free cash flow | -412 | 829 | 1,720 | 1,765 |
| Equity raised/(repaid) | 5 | 0 | 0 | 0 |
| Debt raised/(repaid) | 29 | -15 | 9 | 12 |
| Dividend (incl. tax) | -640 | -640 | -747 | -925 |
| Other financing activities | 626 | 62 | 0 | 0 |
| **Cash flow from financing activities** | **-39** | **-593** | **-738** | **-913** |
| Net chg in cash | -451 | 236 | 982 | 851 |

## Valuation Ratios & Per Share Data

| | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **Per Share data** | | | | |
| EPS (INR) | 38.2 | 35.6 | 43.4 | 53.8 |
| Growth, % | 7.1 | (6.9) | 22.0 | 24.0 |
| Book NAV/share (INR) | 219.4 | 244.2 | 274.8 | 313.5 |
| CFPS (INR) | 17.9 | 35.6 | 36.7 | 42.6 |
| DPS (INR) | 9.1 | 9.0 | 10.5 | 13.0 |
| **Return ratios** | | | | |
| Return on assets (%) | 14.3 | 11.9 | 13.2 | 14.6 |
| Return on equity (%) | 17.4 | 14.6 | 15.8 | 17.2 |
| Return on capital employed (%) | 17.7 | 14.5 | 15.7 | 17.3 |
| **Turnover ratios** | | | | |
| Asset turnover (x) | 2.3 | 1.9 | 2.0 | 2.0 |
| Sales/Total assets (x) | 1.4 | 1.3 | 1.3 | 1.3 |
| Sales/Net FA (x) | 4.4 | 3.8 | 4.0 | 4.4 |
| Working capital/Sales (x) | 0.2 | 0.3 | 0.3 | 0.3 |
| Receivable days | 89.4 | 92.0 | 91.0 | 90.0 |
| **Liquidity ratios** | | | | |
| Current ratio (x) | 3.3 | 3.5 | 4.0 | 4.5 |
| Quick ratio (x) | 3.3 | 3.5 | 4.0 | 4.5 |
| Dividend cover (x) | 4.2 | 3.9 | 4.1 | 4.1 |
| Total debt/Equity (%) | 0.7 | 0.5 | 0.5 | 0.5 |
| Net debt/Equity (%) | (13.5) | (13.8) | (18.0) | (20.2) |
| **Valuation** | | | | |
| PER (x) | 10.4 | 11.2 | 9.1 | 7.4 |
| PEG (x) - y-o-y growth | 1.5 | (1.6) | 0.4 | 0.3 |
| Price/Book (x) | 1.8 | 1.6 | 1.4 | 1.3 |
| Yield (%) | 2.3 | 2.3 | 2.6 | 3.3 |
| EV/Net sales (x) | 1.0 | 0.9 | 0.8 | 0.7 |
| EV/EBITDA (x) | 6.3 | 6.3 | 5.1 | 4.1 |
| EV/EBIT (x) | 7.7 | 8.0 | 6.3 | 4.9 |

# KPIT Technologies

*Bright Outlook; Worst already priced-in*

PhillipCapital

**PhillipCapital (India) Pvt. Ltd.**

IT SERVICES: Company Update

29 September 2014

### Niche play in the automotive domain

KPIT is the largest third-party vendor in the automotive domain (excluding auto OEMs and captives). Through its long-standing relationships with auto companies and a series of acquisitions (In2soft GmBh, Mechanical Design Services, and CG Smith Software), it has developed strong technical expertise in this domain. Today, it works with 9 out of the 12 top auto OEMs of the world.

For KPIT, the auto segment has grown at a robust rate of 18% over the last five years and formed around 25% of its topline in FY14. We expect it to continue this strong growth driven by technical expertise, strong relationships, and growth in the electronic component of vehicles across the globe.

### Expanding presence in manufacturing even excluding Cummins

KPIT's dependence on manufacturing and Cummins has decreased significantly over the last 10 years. Share of revenues from manufacturing has come down from 75% in FY02 to 41% in FY14, and Cummins from 48% to 17% over the same period. However, Cummins remains its largest client.

### Inorganic route drives growth, but challenges persist

KPIT has been THE most aggressive IT company in terms of inorganic growth. It has acquired eight companies since its merger with Cummins Infotech in 2002. While three of these have been in auto, others are spread across domains such as SAP, Oracle, and offshore consulting. While the acquisitions have helped it to report strong 30% revenue CAGR over the last five years, debt levels have increased to Rs4.4bn in FY14 (debt:equity 0.35x). It reported negative FCF for the last four years and its EBITDA margins fell to 16% in FY13 from 22% in FY10.

### Current outlook

KPIT has reported disappointing results for the last three consecutive quarters, because of its SAP division's inferior performance, which, according to the management, was driven by its inability to ramp-up the delivery capability of SAP's new HCM platform – SuccessFactors. This led to lower growth and lower margins due to increased investment. However, we believe the worst is behind and the division should report strong growth and margins from 4QFY15.

Management has maintained its earlier FY15 guidance of US$ revenue growth at 12-14% yoy and PAT growth at 18-21%, while remaining cautious on the visibility of new deal wins. KPIT has completed the merger of I-Cubed (PLM Solutions subsidiary), from which it expects to get around US$ 10mn incremental revenues in FY15. We believe this will be arduous and it might fail to achieve its target it (we assume 9.5% US$ revenue growth).

### Valuation

While KPIT has had a poor show in the last two quarters in terms of operating performance, the stock price already factors the negatives — it is currently trading at 9.1x FY16 P/E, significantly lower than its midcap peers and its historical average. We expect a ramp-up in SAP; this, along with its niche automotive and manufacturing verticals will be key growth drivers. We value the stock at 10x average of FY16 and FY17 earnings. Our price target of Rs 190 represents 16% upside from current levels. We upgrade to BUY.

Please refer to Disclosures and Disclaimers at the end of the Research Report.

## BUY

**KPIT IN | CMP RS 162**

**TARGET RS 190 (+16%)**

**Company Data**

| | |
|---|---|
| O/S SHARES (MN) : | 196 |
| MARKET CAP (RSBN) : | 34 |
| MARKET CAP (USDBN) : | 0.5 |
| 52 - WK HI/LO (RS) : | 191 / 130 |
| LIQUIDITY 3M (USDMN) : | 2.0 |
| FACE VALUE (RS) : | 2 |

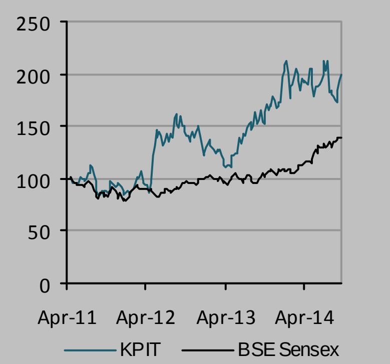
**Share Holding Pattern, %**

| | |
|---|---|
| PROMOTERS : | 22.2 |
| FII / NRI : | 54.9 |
| FI / MF : | 7.7 |
| NON PROMOTER CORP. HOLDINGS : | 1.7 |
| PUBLIC & OTHERS : | 13.5 |

**Price Performance, %**

| | 1mth | 3mth | 1yr |
|---|---|---|---|
| ABS | 15.1 | 4.0 | 30.4 |
| REL TO BSE | 12.1 | -4.4 | -3.8 |

**Price Vs. Sensex (Rebased values)**




Source: Bloomberg, Phillip Capital Research

**Key Ratios**

| Rs mn | FY15E | FY16E | FY17E |
|---|---|---|---|
| Net Sales | 29,219 | 33,095 | 37,841 |
| EBIDTA | 4,248 | 5,170 | 6,050 |
| Net Profit | 2,738 | 3,433 | 4,110 |
| EPS, Rs | 13.7 | 17.2 | 20.5 |
| PER, x | 11.4 | 9.1 | 7.6 |
| EV/EBIDTA, x | 8.0 | 6.4 | 5.3 |
| P/BV, x | 2.0 | 1.7 | 1.4 |
| ROE, % | 18.0 | 18.7 | 18.6 |

Source: Phillip Capital India Research

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PhillipCapital

# Financials

## Income Statement

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **Net sales** | **26,940** | **29,219** | **33,095** | **37,841** |
| Growth, % | 20.3 | 8.5 | 13.3 | 14.3 |
| Employee expenses | -18,180 | -20,951 | -23,457 | -26,704 |
| Other Operating expenses | -4,528 | -4,020 | -4,468 | -5,087 |
| **EBITDA (Core)** | **4,233** | **4,248** | **5,170** | **6,050** |
| Growth, % | 26.1 | 0.4 | 21.7 | 17.0 |
| Margin, % | 15.7 | 14.5 | 15.6 | 16.0 |
| Depreciation | -540 | -643 | -661 | -720 |
| **EBIT** | **3,693** | **3,605** | **4,508** | **5,330** |
| Growth, % | 28.0 | (2.4) | 25.1 | 18.2 |
| Margin, % | 13.7 | 12.3 | 13.6 | 14.1 |
| Interest paid | -287 | -167 | -163 | -148 |
| Other Non-Operating Income | -74 | 347 | 325 | 410 |
| **Pre-tax profit** | **3,332** | **3,785** | **4,671** | **5,591** |
| Tax provided | -941 | -1,047 | -1,238 | -1,482 |
| Profit after tax | 2,391 | 2,738 | 3,433 | 4,110 |
| Others (Minorities, Associates) | 0 | 0 | 0 | 0 |
| **Net Profit** | **2,391** | **2,738** | **3,433** | **4,110** |
| Growth, % | 18.7 | 14.5 | 25.4 | 19.7 |
| **Net Profit (adjusted)** | **2,391** | **2,738** | **3,433** | **4,110** |
| Wtd avg shares (m) | 187 | 186 | 186 | 186 |

| | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **US$ Revenue ($ mn)** | **444** | **487** | **552** | **631** |
| Growth, % | 8.3 | 9.7 | 13.2 | 14.3 |
| Re / US$ (rate) | 60.6 | 60.0 | 60.0 | 60.0 |

## Balance Sheet

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| Cash & bank | 1,908 | 3,487 | 4,028 | 4,471 |
| Marketable securities at cost | 0 | 0 | 0 | 0 |
| Debtors | 6,743 | 7,149 | 8,034 | 9,343 |
| Inventory | 0 | 0 | 0 | 0 |
| Other current assets | 1,505 | 2,019 | 2,268 | 2,607 |
| Total current assets | 10,156 | 12,655 | 14,330 | 16,422 |
| Investments | 1,741 | 1,247 | 2,247 | 3,247 |
| Net fixed assets | 8,155 | 8,862 | 9,701 | 10,481 |
| Non-current assets | 1,182 | 1,332 | 1,332 | 1,332 |
| **Total assets** | **21,234** | **24,096** | **27,610** | **31,482** |
| | | | | |
| Total current liabilities | 4,093 | 4,771 | 5,301 | 6,022 |
| Non-current liabilities | 4,390 | 4,080 | 3,930 | 3,330 |
| Total liabilities | 8,483 | 8,851 | 9,231 | 9,352 |
| Paid-up capital | 386 | 386 | 386 | 386 |
| Reserves & surplus | 12,366 | 14,860 | 17,993 | 21,745 |
| Minorities | 0 | 0 | 0 | 0 |
| Shareholders' equity | 12,751 | 15,245 | 18,379 | 22,130 |
| **Total equity & liabilities** | **21,234** | **24,096** | **27,610** | **31,482** |

Source: Company, PhillipCapital India Research Estimates

## Cash Flow

| Y/E Mar, Rs mn | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| Pre-tax profit | 3,332 | 3,785 | 4,671 | 5,591 |
| Depreciation | 540 | 643 | 661 | 720 |
| Chg in working capital | -1,968 | -391 | -604 | -928 |
| Total tax paid | -850 | -1,047 | -1,238 | -1,482 |
| Other operating activities | 0 | 0 | 0 | 0 |
| **Cash flow from operating activities** | **1,054** | **2,989** | **3,489** | **3,902** |
| Capital expenditure | -2,266 | -1,350 | -1,500 | -1,500 |
| Chg in investments | 295 | 494 | -1,000 | -1,000 |
| Chg in marketable securities | 0 | 0 | 0 | 0 |
| Other investing activities | 0 | 0 | 0 | 0 |
| **Cash flow from investing activities** | **-1,971** | **-856** | **-2,500** | **-2,500** |
| Free cash flow | -918 | 2,134 | 989 | 1,402 |
| Equity raised/(repaid) | 13 | -15 | 0 | 0 |
| Debt raised/(repaid) | 1,177 | -310 | -150 | -600 |
| Dividend (incl. tax) | -236 | -239 | -299 | -299 |
| Other financing activities | 220 | 10 | 0 | -59 |
| **Cash flow from financing activities** | **905** | **-554** | **-449** | **-958** |
| Net chg in cash | -13 | 1,580 | 540 | 444 |

## Valuation Ratios & Per Share Data

| | FY14 | FY15E | FY16E | FY17E |
|---|---|---|---|---|
| **Per Share data** | | | | |
| EPS (INR) | 12.1 | 13.7 | 17.2 | 20.5 |
| Growth, % | 18.2 | 14.8 | 25.4 | 19.7 |
| Book NAV/share (INR) | 68.2 | 81.8 | 98.7 | 118.8 |
| CFPS (INR) | 5.0 | 15.0 | 17.0 | 18.7 |
| DPS (INR) | 1.1 | 1.1 | 1.4 | 1.4 |
| **Return ratios** | | | | |
| Return on assets (%) | 13.2 | 12.6 | 13.7 | 14.2 |
| Return on equity (%) | 18.8 | 18.0 | 18.7 | 18.6 |
| Return on capital employed (%) | 16.6 | 15.6 | 17.0 | 17.6 |
| **Turnover ratios** | | | | |
| Asset turnover (x) | 2.5 | 2.2 | 2.3 | 2.4 |
| Sales/Total assets (x) | 1.4 | 1.3 | 1.3 | 1.3 |
| Sales/Net FA (x) | 3.7 | 3.4 | 3.6 | 3.7 |
| Working capital/Sales (x) | 0.2 | 0.2 | 0.2 | 0.2 |
| Receivable days | 91.4 | 89.3 | 88.6 | 90.1 |
| **Liquidity ratios** | | | | |
| Current ratio (x) | 2.5 | 2.7 | 2.7 | 2.7 |
| Quick ratio (x) | 2.5 | 2.7 | 2.7 | 2.7 |
| Interest cover (x) | 12.9 | 21.6 | 27.6 | 36.0 |
| Dividend cover (x) | 11.8 | 13.3 | 13.3 | |
| Total debt/Equity (%) | 34.4 | 26.8 | 21.4 | 15.0 |
| Net debt/Equity (%) | 19.5 | 3.9 | (0.5) | (5.2) |
| **Valuation** | | | | |
| PER (x) | 13.0 | 11.4 | 9.1 | 7.6 |
| PEG (x) - y-o-y growth | 0.7 | 0.8 | 0.4 | 0.4 |
| Price/Book (x) | 2.4 | 2.0 | 1.7 | 1.4 |
| Yield (%) | 0.7 | 0.7 | 0.8 | |
| EV/Net sales (x) | 1.3 | 1.2 | 1.0 | 0.9 |
| EV/EBITDA (x) | 8.4 | 8.0 | 6.4 | 5.3 |
| EV/EBIT (x) | 9.6 | 9.4 | 7.4 | 6.1 |

# Hexaware Technologies

*Well diversified profile; expensive valuations*

PhillipCapital

**PhillipCapital (India) Pvt. Ltd.**

IT SERVICES: Company Update

29 September 2014

### Elite in enterprise application and BI services

Hexaware has an elite presence in enterprise application services providing clients with end-to-end solutions. It operates as a complete packaged solutions offshore service provider for all major platforms like PeopleSoft, Oracle, SAP, Salesforce, and Microsoft Solutions. It is a leading global provider of IT and BPO services, focusing on delivering technology solutions in business intelligence, business analytics, enterprise applications, HR-IT, and legacy modernisation. In its focused service lines (EAS + BI), it has clocked a strong CAGR of 16% in the past 4 years. Hexaware has also forayed into SMAC (disruptive technologies) by investing in mobility and cloud — this has significantly improved its deal-win capabilities over the past few quarters.

It had a quarterly revenue rate of US$ 102mn in H2CY14, EBITDA margins of 20%, and RoE of around 29%. For CY13, it clocked a revenue growth of 6% (below midcap average of 11%) on reduced client spends and a slow decision cycle. CY13 EBITDA margins stood at 22.4%, up 170bps, which improved RoEs to 31.6%.

### Diversified portfolio - an edge for stable business

As an offshore vendor, Hexaware has a more diversified portfolio in verticals and geographies than most of its midcap peers. Among verticals, banking and capital market (BCM) has the highest revenue share (36.5%), followed by TTL (19.2%), and healthcare and insurance at 14.3%. Typically, midcaps form a bias towards one domain, which forms a <50% revenue share; Hexaware chose to scale up its BCM vertical, giving stability to its business model.

Its geographic dispersion is also lucrative with the US leading the pack (65%), followed by Europe (27%); low-margin emerging markets form only 8% of its revenues. However, Hexaware has slightly high client concentration — top-5 clients bring in 37% and top-10 bring in 51% of its revenues.

### Stable margins, strong RoEs

Hexaware currently operates at an average EBITDA margin of 22% and provides average RoEs of 30%. It has a complete package of solutions for end-to-end IT operations, giving it an edge for scalability and pricing, and improving/maintaining its margins. The management expects wage inflation to manage the employee pyramid and higher onsite allocations to meet the customer demand. However, we believe that improving utilisation levels and higher offshoring will lead to better margins.

Hexaware continues to be an almost debt-free company with healthy cash position of Rs 6.6bn. Strong balance sheet strength will help it to seek newer avenues for expansion through M&A and/or by further scaling up capacity. By adopting effective receivable management system, it has improved DSO to 52 days vs. 75 days in CY11 thereby easing out its working capital cycle.

### At peak valuations – Low triggers for re-rating

Hexaware stock has run up significantly over the last 6 months (+30%). At current price of Rs 197, it trades at 13.9x FY16 (consensus FY16 EPS Rs14.2), which is at a premium to its historical valuations (9x) and midcap peer average (10.4x). While the company boasts of a well-diversified revenue profile and superior earnings growth potential, the valuations appear stretched at current levels.

Please refer to Disclosures and Disclaimers at the end of the Research Report.

## NOT RATED

**HEXW IN | CMP RS 197**

**Company Data**

| | |
|---|---|
| O/S SHARES (MN) : | 301 |
| MARKET CAP (RSBN) : | 59 |
| MARKET CAP (USDBN) : | 1 |
| 52 - WK HI/LO (RS) : | 201 / 112 |
| LIQUIDITY 3M (USDMN) : | 1.4 |
| FACE VALUE (RS) : | 2 |

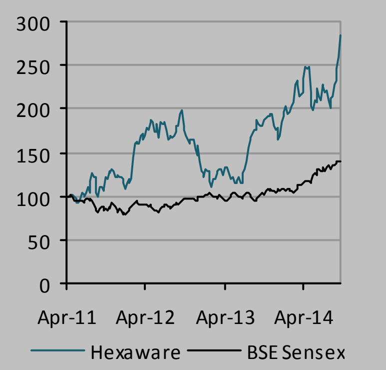
**Share Holding Pattern, %**

| | |
|---|---|
| PROMOTERS : | 63.8 |
| FII / NRI : | 23.4 |
| FI / MF : | 2.2 |
| NON PROMOTER CORP. HOLDINGS : | 2.0 |
| PUBLIC & OTHERS : | 8.6 |

**Price Performance, %**

| | 1mth | 3mth | 1yr |
|---|---|---|---|
| ABS | 25.3 | 36.2 | 57.8 |
| REL TO BSE | 22.4 | 27.9 | 23.6 |

**Price Vs. Sensex (Rebased values)**




Source: Bloomberg, Phillip Capital Research

**Key Ratios**

| Rs mn | CY11 | CY12 | CY13 |
|---|---|---|---|
| Net Sales | 14,505 | 19,482 | 22,853 |
| EBIDTA | 2,613 | 4,040 | 5,122 |
| Net Profit | 2,670 | 3,276 | 3,791 |
| EPS, Rs | 9.1 | 11.0 | 12.7 |
| PER, x | 20.9 | 17.2 | 15.0 |
| EV/EBIDTA, x | 19.7 | 13.5 | 10.5 |
| P/BV, x | 5.5 | 4.7 | 4.7 |
| ROE, % | 26.9 | 29.5 | 31.6 |

Source: Phillip Capital India Research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# Financials

## Income Statement

| Y/E Mar, Rs mn | CY10 | CY11 | CY12 | CY13 |
|---|---|---|---|---|
| **Net sales** | **10,546** | **14,505** | **19,482** | **22,853** |
| Growth, % | 2 | 38 | 34 | 17 |
| Employee expenses | -6,755 | -8,210 | -10,606 | -12,219 |
| Other Operating expenses | -9,640 | -11,892 | -15,441 | -17,731 |
| **EBITDA (Core)** | **905** | **2,613** | **4,040** | **5,122** |
| Growth, % | (54.2) | 188.6 | 54.6 | 26.8 |
| Margin, % | 8.6 | 18.0 | 20.7 | 22.4 |
| Depreciation | -242 | -247 | -324 | -386 |
| **EBIT** | **663** | **2,366** | **3,716** | **4,736** |
| Growth, % | (61.1) | 256.8 | 57.0 | 27.4 |
| Margin, % | 6.3 | 16.3 | 19.1 | 20.7 |
| Interest paid | -26 | -21 | -2 | -2 |
| Other Non-Operating Income | 555 | 482 | 438 | 373 |
| **Pre-tax profit** | **1,168** | **3,075** | **4,040** | **4,795** |
| Tax provided | -92 | -405 | -763 | -1,004 |
| Profit after tax | 1,076 | 2,670 | 3,276 | 3,791 |
| Others (Minorities, Associates) | 0 | 0 | 0 | 0 |
| **Net Profit** | **852** | **2,670** | **3,276** | **3,791** |
| Growth, % | (19.8) | 148.2 | 22.7 | 15.7 |
| **Net Profit (adjusted)** | **852** | **2,670** | **3,276** | **3,791** |
| Wtd avg shares (m) | 145 | 293 | 297 | 299 |

| | CY10 | CY11 | CY12 | CY13 |
|---|---|---|---|---|
| **US$ Revenue ($ mn)** | **231** | **308** | **364** | **388** |
| Growth, % | 7.7 | 33.3 | 18.3 | 6.4 |
| Re / US$ (rate) | 45.6 | 47.1 | 53.5 | 58.9 |

## Balance Sheet

| Y/E Mar, Rs mn | CY10 | CY11 | CY12 | CY13 |
|---|---|---|---|---|
| Cash & bank | 4,356 | 4,378 | 1,948 | 3,181 |
| Marketable securities at cost | 0 | 0 | 0 | 0 |
| Debtors | 2,131 | 2,993 | 3,649 | 3,236 |
| Inventory | 0 | 0 | 0 | 0 |
| Other current assets | 1,420 | 1,946 | 2,261 | 2,914 |
| Total current assets | 7,907 | 9,317 | 7,858 | 9,331 |
| Investments | 397 | 229 | 2,524 | 3,383 |
| Net fixed assets | 4,078 | 4,770 | 5,199 | 5,371 |
| Non-current assets | 4,657 | 5,194 | 7,927 | 8,981 |
| **Total assets** | **12,564** | **14,511** | **15,785** | **18,312** |
| | | | | |
| Total current liabilities | 2,785 | 4,316 | 3,616 | 5,839 |
| Non-current liabilities | 125 | 32 | 130 | 481 |
| Total liabilities | 2,910 | 4,349 | 3,746 | 6,320 |
| Paid-up capital | 290 | 587 | 593 | 601 |
| Reserves & surplus | 9,364 | 9,575 | 11,445 | 11,392 |
| Minorities | 0 | 0 | 0 | 0 |
| Shareholders' equity | 9,655 | 10,162 | 12,039 | 11,993 |
| **Total equity & liabilities** | **12,564** | **14,511** | **15,785** | **18,312** |

Source: Company, PhillipCapital India Research Estimates

## Cash Flow

| Y/E Mar, Rs mn | CY10 | CY11 | CY12 | CY13 |
|---|---|---|---|---|
| Pre-tax profit | 1,168 | 3,075 | 4,040 | 4,795 |
| Depreciation | 242 | 247 | 324 | 386 |
| Chg in working capital | -1,435 | 28 | -1,574 | -470 |
| Total tax paid | 448 | -283 | -771 | 1,570 |
| Other operating activities | 0 | 0 | 0 | 0 |
| **Cash flow from operating activities** | **424** | **3,067** | **2,019** | **6,282** |
| Capital expenditure | 37 | -939 | -753 | -557 |
| Chg in investments | 872 | 168 | -2,296 | -858 |
| Chg in marketable securities | 0 | 0 | 0 | 0 |
| Other investing activities | 0 | 0 | 0 | 0 |
| **Cash flow from investing activities** | **909** | **-771** | **-3,049** | **-1,416** |
| Free cash flow | 461 | 2,128 | 1,265 | 5,724 |
| Equity raised/(repaid) | 811 | -1,097 | 457 | 32 |
| Debt raised/(repaid) | -51 | -112 | 0 | 205 |
| Dividend (incl. tax) | -509 | -1,362 | -1,863 | -3,877 |
| Other financing activities | 0 | 0 | 0 | 0 |
| **Cash flow from financing activities** | **249** | **-2,571** | **-1,406** | **-3,640** |
| Net chg in cash | 1,582 | -275 | -2,436 | 1,226 |

## Valuation Ratios & Per Share Data

| | CY10 | CY11 | CY12 | CY13 |
|---|---|---|---|---|
| **Per Share data** | | | | |
| EPS (INR) | 5.9 | 9.1 | 11.0 | 12.7 |
| Growth, % | (37) | 55 | 21 | 15 |
| Book NAV/share (INR) | 66.5 | 34.6 | 40.6 | 40.2 |
| CFPS (INR) | (0.9) | 8.8 | 5.3 | 19.8 |
| DPS (INR) | 3.0 | 4.0 | 5.4 | 11.1 |
| **Return ratios** | | | | |
| Return on assets (%) | 9.1 | 19.8 | 21.6 | 22.2 |
| Return on equity (%) | 9.4 | 26.9 | 29.5 | 31.6 |
| Return on capital employed (%) | 11.8 | 26.9 | 29.3 | 30.8 |
| **Turnover ratios** | | | | |
| Asset turnover (x) | 1.9 | 2.2 | 2.5 | 2.5 |
| Sales/Total assets (x) | 0.9 | 1.1 | 1.3 | 1.3 |
| Sales/Net FA (x) | 2.5 | 3.3 | 3.9 | 4.3 |
| Working capital/Sales (x) | 0.1 | 0.0 | 0.1 | 0.0 |
| Receivable days | 73.8 | 75.3 | 68.4 | 51.7 |
| **Liquidity ratios** | | | | |
| Current ratio (x) | 2.8 | 2.2 | 2.2 | 1.6 |
| Quick ratio (x) | 2.8 | 2.2 | 2.2 | 1.6 |
| Dividend cover (x) | 2.0 | 2.3 | 2.0 | 1.1 |
| Total debt/Equity (%) | 1.2 | - | - | 1.7 |
| Net debt/Equity (%) | (48.1) | (45.3) | (37.1) | (53.0) |
| **Valuation** | | | | |
| PER (x) | 32.4 | 20.9 | 17.2 | 15.0 |
| PEG (x) - y-o-y growth | (0.9) | 0.4 | 0.8 | 1.0 |
| Price/Book (x) | 2.9 | 5.5 | 4.7 | 4.7 |
| Yield (%) | 1.6 | 2.1 | 2.8 | 5.9 |
| EV/Net sales (x) | 2.2 | 3.5 | 2.8 | 2.4 |
| EV/EBITDA (x) | 25.8 | 19.7 | 13.5 | 10.5 |
| EV/EBIT (x) | 35.2 | 21.7 | 14.6 | 11.4 |

# Polaris FT

*Needs to upgrade itself, fast*

PhillipCapital

**PhillipCapital (India) Pvt. Ltd.**

IT SERVICES: Company Update

29 September 2014

## NOT RATED

**POL IN | CMP RS 256**

**Company Data**

| | |
|---|---|
| O/S SHARES (MN) : | 100 |
| MARKET CAP (RSBN) : | 26 |
| MARKET CAP (USDBN) : | 0.4 |
| 52 - WK HI/LO (RS) : | 272 / 115 |
| LIQUIDITY 3M (USDMN) : | 6.7 |
| FACE VALUE (RS) : | 5 |

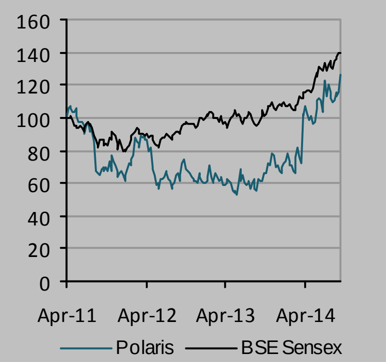
**Share Holding Pattern, %**

| | |
|---|---|
| PROMOTERS : | 29.1 |
| FII / NRI : | 25.5 |
| FI / MF : | 2.4 |
| NON PROMOTER CORP. HOLDINGS : | 5.5 |
| PUBLIC & OTHERS : | 37.5 |

**Price Performance, %**

| | 1mth | 3mth | 1yr |
|---|---|---|---|
| ABS | 16.6 | 30.7 | 120.4 |
| REL TO BSE | 13.6 | 22.3 | 86.2 |

**Price Vs. Sensex (Rebased values)**




Source: Bloomberg, Phillip Capital Research

**Key Ratios**

| Rs mn | FY12 | FY13 | FY14 |
|---|---|---|---|
| Net Sales | 20,492 | 22,586 | 23,947 |
| EBIDTA | 2,861 | 2,668 | 2,453 |
| Net Profit | 2,207 | 2,024 | 1,992 |
| EPS, Rs | 22.2 | 20.2 | 20.0 |
| PER, x | 11.3 | 12.4 | 12.5 |
| EV/EBIDTA, x | 8.4 | 9.1 | 9.2 |
| P/BV, x | 1.2 | 1.1 | 0.9 |
| ROE, % | 19.3 | 15.6 | 13.8 |

Source: Phillip Capital India Research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### Product + Services play

Being a recognised global leader in speciality application development for banking and financial services, Polaris has made a strong impact among the top-tier banks worldwide. With its comprehensive portfolio of products, smart legacy modernisation services, and consulting, it leverages methods from its global partnerships to its advantage in delivering business benefits to its BFSI customers. A combination with niche products and platforms and ADM + consulting services has helped it to mine its existing clients and add new businesses.

In the last 4 years, its revenue CAGR was 10% (services 9.8%, products 11.6%). It had a quarterly revenue run rate of US$ 105mn, EBITDA margins of 10%, and RoE of 14%. In FY14, North America contributed 47% of its revenues, Europe 22%, APAC 31%, and India 8%.

### Inferior portfolio led to dragged growth

Polaris underwent significant changes in its management and business operating structure, which led to loss of focus in its key verticals and clientele. It saw very few new product additions in the last 3-4 years. The change in the IT environment led by disruptive technologies (SMAC) has created significant challenges for the company to win larger new deals and also led to its losing business from a top client.

With a portfolio of traditional PPS and service lines, it will be difficult for the company to compete with its peers in the IT midcap domain. In the last 2 years, Polaris's revenues CAGR fell 1.7%, EBITDA CAGR fell 7.6% (margins fell by 380bps), and PAT declined at a CAGR of 5%. Top-5 client revenues fell at a CAGR of 1.1% and top-10 by 1.3%.

### Hiving off products for better focus

By the end of FY14, Polaris management initiated a move to hive off its product business into a separately listed company called Intellect Design arena. Motive behind this initiative was to 1) streamline the operations in products and services division separately, 2) gain access to partnering with global product giants (otherwise issues of confidentiality arises in product sharing), and 3) streamline S&M operations across segments. The new entity will focus on universal banking, risk and treasury management, transaction banking and the insurance products. Polaris FT will continue to run the services business focussed on solution services.

The management expects that after this, the services business would have a more linear cost structure; exclusion of R&D and product development costs would help gain margins. Polaris currently awaits the approval of Chennai High court for initiating the process of de-merger.

### Peak valuations – downside risk high

Polaris faces pricing pressures in new bids and rebids because of strong competition from other midcap players. Headwinds such as declining volumes leading to low utilisations, low-margin business leading to lower growth, will impact its overall margins significantly over the next few years.

Without a change in its current portfolio of services and products, Polaris will face strong competition from its peers and will continue to lose out on upcoming rebids as well as new phases. At current levels, the stock trades at 9.1x FY16 PE (consensus FY16 EPS Rs27.7) – inline with its historical average and midcap average.

# Financials

## Income Statement

| Y/E Mar, Rs mn | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **Net sales** | **15,863** | **20,492** | **22,586** | **23,947** |
| Growth, % | 17.2 | 29.2 | 10.2 | 6.0 |
| Employee expenses | 0 | 0 | 0 | 0 |
| Other Operating expenses | -13,724 | -17,631 | -19,919 | -21,493 |
| **EBITDA (Core)** | **2,139** | **2,861** | **2,668** | **2,453** |
| Growth, % | -3.7 | 33.7 | -6.7 | -8.0 |
| Margin, % | 13.5 | 14.0 | 11.8 | 10.2 |
| Depreciation | -337 | -472 | -537 | -529 |
| **EBIT** | **1,802** | **2,388** | **2,131** | **1,924** |
| Growth, % | (3.6) | 32.5 | (10.8) | (9.7) |
| Margin, % | 11.4 | 11.7 | 9.4 | 8.0 |
| Interest paid | -11 | -17 | -25 | -12 |
| Other Non-Operating Income | 337 | 463 | 341 | 476 |
| **Pre-tax profit** | **2,383** | **2,837** | **2,515** | **2,389** |
| Tax provided | -359 | -630 | -490 | -397 |
| **Profit after tax** | 2,025 | 2,207 | 2,024 | 1,992 |
| Others (Minorities, Associates) | 0 | 0 | 0 | 0 |
| **Net Profit** | **2,025** | **2,207** | **2,024** | **1,992** |
| Growth, % | 32.5 | 9.0 | (8.3) | (1.6) |
| **Net Profit (adjusted)** | **2,025** | **2,207** | **2,024** | **1,992** |
| Wtd avg shares (m) | 99 | 99 | 100 | 100 |

| | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **US$ Revenue ($ mn)** | **348.3** | **428.0** | **425.7** | **413.2** |
| Growth, % | 22.0 | 22.9 | -0.5 | -2.9 |
| Re / US$ (rate) | 45.5 | 47.9 | 53.1 | 58.0 |

## Balance Sheet

| Y/E Mar, Rs mn | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| Cash & bank | 1,423 | 2,224 | 2,057 | 2,313 |
| Marketable securities at cost | 0 | 0 | 0 | 0 |
| Debtors | 2,272 | 3,722 | 4,075 | 3,622 |
| Inventory | 0 | 0 | 0 | 0 |
| Other current assets | 0 | 0 | 0 | 0 |
| Total current assets | 6,696 | 10,434 | 10,993 | 11,051 |
| Investments | 4,487 | 3,797 | 5,136 | 5,816 |
| Net fixed assets | 2,937 | 3,987 | 4,007 | 3,787 |
| Non-current assets | 0 | 0 | 0 | 0 |
| **Total assets** | **14,235** | **18,315** | **20,196** | **20,719** |
| | | | | |
| Total current liabilities | 3,805 | 4,473 | 5,528 | 5,098 |
| Non-current liabilities | 79 | 1,295 | 1,241 | 147 |
| Total liabilities | 3,885 | 5,768 | 6,768 | 5,245 |
| Paid-up capital | 496 | 497 | 498 | 498 |
| Reserves & surplus | 9,829 | 12,028 | 12,930 | 14,976 |
| Minorities | 25 | 22 | 0 | 0 |
| Shareholders' equity | 10,351 | 12,547 | 13,427 | 15,474 |
| **Total equity & liabilities** | **14,235** | **18,315** | **20,196** | **20,719** |

Source: Company, PhillipCapital India Research Estimates

## Cash Flow

| Y/E Mar, Rs mn | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| Pre-tax profit | 2,383 | 2,837 | 2,515 | 2,389 |
| Depreciation | 337 | 472 | 537 | 529 |
| Chg in working capital | -989 | -1,872 | -802 | 119 |
| Total tax paid | -93 | -973 | 700 | -724 |
| Other operating activities | 0 | 0 | 0 | 0 |
| **Cash flow from operating activities** | **1,637** | **464** | **2,949** | **2,313** |
| Capital expenditure | -496 | -1,522 | -557 | -310 |
| Chg in investments | -590 | 690 | -1,339 | -680 |
| Chg in marketable securities | 0 | 0 | 0 | 0 |
| Other investing activities | 0 | 0 | 0 | 0 |
| **Cash flow from investing activities** | **-1,086** | **-833** | **-1,896** | **-990** |
| Free cash flow | 1,141 | -1,058 | 2,392 | 2,003 |
| Equity raised/(repaid) | 1 | 1 | 0 | 0 |
| Debt raised/(repaid) | 33 | 1,181 | -77 | -1,121 |
| Dividend (incl. tax) | -203 | -753 | -348 | -580 |
| Other financing activities | -222 | 744 | -774 | 635 |
| **Cash flow from financing activities** | **-366** | **1,170** | **-1,221** | **-1,066** |
| Net chg in cash | 185 | 802 | -168 | 257 |

## Valuation Ratios & Per Share Data

| | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **Per Share data** | | | | |
| EPS (INR) | 20.4 | 22.2 | 20.2 | 20.0 |
| Growth, % | 32.0 | 8.8 | (9.1) | (0.9) |
| Book NAV/share (INR) | 104.4 | 126.3 | 133.9 | 155.4 |
| CFPS (INR) | 13.1 | (0.0) | 25.3 | 18.4 |
| DPS (INR) | 1.7 | 6.5 | 3.0 | 5.0 |
| **Return ratios** | | | | |
| Return on assets (%) | 15.6 | 13.6 | 10.6 | 9.8 |
| Return on equity (%) | 21.2 | 19.3 | 15.6 | 13.8 |
| Return on capital employed (%) | 21.2 | 18.3 | 14.3 | 13.2 |
| **Turnover ratios** | | | | |
| Asset turnover (x) | 3.4 | 3.0 | 2.6 | 2.7 |
| Sales/Total assets (x) | 1.2 | 1.3 | 1.2 | 1.2 |
| Sales/Net FA (x) | 5.6 | 5.9 | 5.7 | 6.1 |
| Working capital/Sales (x) | 0.1 | 0.2 | 0.2 | 0.2 |
| Receivable days | 52.3 | 66.3 | 65.8 | 55.2 |
| **Liquidity ratios** | 77.6 | 82.4 | 71.6 | 65.0 |
| Current ratio (x) | 33.8 | 66.6 | 55.1 | 55.5 |
| Quick ratio (x) | | | | |
| Interest cover (x) | 1.8 | 2.3 | 2.0 | 2.2 |
| Dividend cover (x) | 1.8 | 2.3 | 2.0 | 2.2 |
| Total debt/Equity (%) | 11.7 | 3.4 | 6.8 | 4.0 |
| Net debt/Equity (%) | 0.6 | 9.9 | 8.6 | 0.3 |
| **Valuation** | (13.2) | (7.9) | (6.7) | (14.7) |
| PER (x) | | | | |
| PEG (x) - y-o-y growth | 12.2 | 11.3 | 12.4 | 12.5 |
| Price/Book (x) | 0.4 | 1.3 | (1.4) | (14.0) |
| Yield (%) | 2.4 | 2.0 | 1.9 | 1.6 |
| EV/Net sales (x) | 0.7 | 2.6 | 1.2 | 2.0 |
| EV/EBITDA (x) | 1.5 | 1.2 | 1.1 | 0.9 |
| EV/EBIT (x) | 11.0 | 8.4 | 9.1 | 9.2 |

# Cyient Ltd.

*Flying high in the aerospace domain*

IT SERVICES: Company Update

PhillipCapital (India) Pvt. Ltd.

29 September 2014

### cNiche in aerospace engineering

Cyient (formerly Infotech Enterprises) is a niche player in the least-explored areas of aircraft manufacturing and aerospace engineering, deriving 33% of its revenues from the vertical. Collective data from research firms such as Gartner and IDC indicates that aerospace engineering spends are seeing a big recovery, especially in the US. With strong domain expertise and improved product line, Cyient is set to be the largest beneficiary from this huge potential outflow globally.

It is in the midst of a product-development cycle, which could enhance its deal win ratio significantly in the space. It has seen traction in non-aerospace verticals and expects weak accounts to improve over the next two years. Over the last two years, it has added large clients such as Pratt & Whitney, UTC, Aerospace Systems, Boeing, Airbus, and Honeywell.

It had a quarterly revenue run rate of US$ 104mn at the end of 1QFY14, EBITDA margins of 15%, and RoEs of around 18%. Over FY12-14, it saw a muted revenue CAGR (USD) of 6.9%, while EBITDA and PAT CAGR were 23% and 28%, respectively – mainly aided by currency rates and margin expansions.

### Inorganic revenues to drive growth

Cyient's management expects its strategic initiatives to diversify its current business; it expects to follow up with multiple smaller acquisitions to fill up gaps in service lines and focused geographies. The company has started searching for targets across geographies (size range of US$ 10-20mn). For FY15, it has shortlisted around 35 companies to acquire. We believe that it has taken an aggressive stance on inorganic growth with an aim to achieve its target of US$ 1bn in revenues in 4 years.

Cyient intends to create a strong domain niche in service lines such as embedded systems, operation technology in utilities, and product-realisation services. It also wants to strengthen the verticals surrounding medical devices, industrial automation, key areas like data analytics, and foraying into Europe for aerospace and Japan for hi-tech and embedded systems.

### Entered new verticals through Softential Inc

Cyient acquired Softential Inc to gain an edge on real-time monitoring of communication networks and business services. Softential is a key vendor in design and automation of service-management solutions, which is a key core IT process for the telecom industry (operators, service providers, cable companies, and public sector utilities). After this acquisition, it has ventured strongly into Europe for telecom and utilities, where the addressable market is more than US$ 15bn.

Currently, Softential provides incremental revenues of US$ 17mn. Management expects this to grow significantly in the coming years because of strong visibility in its current orderbook. We believe this business has a clear potential to leverage from the incremental offshoring opportunities in Europe, especially from verticals such as telecom.

### Valuations – Persuasive triggers for re-rating

At current levels, the stock trades at 12x FY16 (consensus FY16 EPS 37.5), which is at a premium to its historical valuations (8.5x) and midcap peer average (10.4x).

Please refer to Disclosures and Disclaimers at the end of the Research Report.

## NOT RATED

**CYL IN | CMP RS 450**

**Company Data**

| | |
|---|---|
| O/S SHARES (MN) : | 112 |
| MARKET CAP (RSBN) : | 53 |
| MARKET CAP (USDBN) : | 0.9 |
| 52 - WK HI/LO (RS) : | 483 / 115 |
| LIQUIDITY 3M (USDMN) : | 0.7 |
| FACE VALUE (RS) : | 5 |

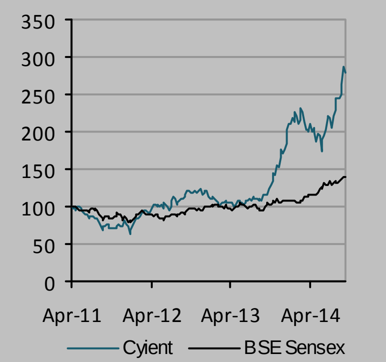
**Share Holding Pattern, %**

| | |
|---|---|
| PROMOTERS : | 22.3 |
| FII / NRI : | 53.3 |
| FI / MF : | 12.8 |
| NON PROMOTER CORP. HOLDINGS : | 5.9 |
| PUBLIC & OTHERS : | 5.8 |

**Price Performance, %**

| | 1mth | 3mth | 1yr |
|---|---|---|---|
| ABS | 18.5 | 35.7 | 156.3 |
| REL TO BSE | 15.5 | 27.3 | 122.0 |

**Price Vs. Sensex (Rebased values)**




Source: Bloomberg, Phillip Capital Research

**Key Ratios**

| Rs mn | FY12 | FY13 | FY14 |
|---|---|---|---|
| Net Sales | 15,531 | 18,731 | 22,064 |
| EBIDTA | 2,704 | 3,416 | 4,101 |
| Net Profit | 1,630 | 2,329 | 2,661 |
| EPS, Rs | 14.6 | 20.9 | 23.9 |
| PER, x | 30.7 | 21.5 | 18.8 |
| EV/EBIDTA, x | 16.5 | 12.6 | 10.0 |
| P/BV, x | 2.9 | 2.3 | 1.9 |
| ROE, % | 14.8 | 18.3 | 17.7 |

Source: Phillip Capital India Research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# Financials

## Income Statement

| Y/E Mar, Rs mn | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| **Net sales** | **11,880** | **15,531** | **18,731** | **22,064** |
| Growth, % | 24.6 | 30.7 | 20.6 | 17.8 |
| Employee expenses | -7,368 | -9,553 | -11,261 | -13,302 |
| Other Operating expenses | -10,077 | -2,860 | -3,312 | -4,113 |
| **EBITDA (Core)** | **1,804** | **2,704** | **3,416** | **4,101** |
| Growth, % | -13.4 | 50.0 | 26.3 | 20.1 |
| Margin, % | 15.2 | 17.4 | 18.2 | 18.6 |
| Depreciation | -486 | -494 | -636 | -720 |
| **EBIT** | **1,318** | **2,210** | **2,780** | **3,381** |
| Growth, % | (13.4) | 50.0 | 26.3 | 20.1 |
| Margin, % | 15.2 | 17.4 | 18.2 | 18.6 |
| Interest paid | -15 | -14 | -12 | -29 |
| Other Non-Operating Income | 296 | 168 | 398 | 187 |
| **Pre-tax profit** | **1,668** | **2,465** | **3,296** | **3,691** |
| Tax provided | -270 | -835 | -967 | -1,030 |
| Profit after tax | 1,398 | 1,630 | 2,329 | 2,661 |
| Others (Minorities, Associates) | -1 | 0 | 0 | 0 |
| **Net Profit** | **1,397** | **1,630** | **2,329** | **2,661** |
| Growth, % | (18.2) | 16.7 | 42.9 | 14.2 |
| **Net Profit (adjusted)** | **1,397** | **1,630** | **2,329** | **2,661** |
| Wtd avg shares (m) | 111 | 111 | 111 | 111 |

| | FY13 | FY14 | FY15E | FY16E |
|---|---|---|---|---|
| **US$ Revenue ($ mn)** | **260.7** | **323.6** | **344.9** | **363.3** |
| Growth, % | 29.6 | 24.1 | 6.6 | 5.3 |
| Re / US$ (rate) | 45.6 | 48.0 | 54.3 | 60.7 |

## Balance Sheet

| Y/E Mar, Rs mn | FY13 | FY14 | FY15E | FY16E |
|---|---|---|---|---|
| Cash & bank | 3,502 | 5,579 | 7,066 | 8,932 |
| Marketable securities at cost | 0 | 0 | 0 | 0 |
| Debtors | 2,678 | 4,468 | 5,388 | 6,347 |
| Inventory | 0 | 0 | 0 | 0 |
| Other current assets | 0 | 0 | 0 | 0 |
| Total current assets | 8,373 | 10,796 | 13,336 | 16,317 |
| Investments | 913 | 0 | 0 | 0 |
| Net fixed assets | 3,380 | 3,486 | 3,451 | 3,331 |
| Non-current assets | 0 | 0 | 0 | 0 |
| **Total assets** | **12,681** | **14,297** | **16,802** | **19,662** |
| | | | | |
| Total current liabilities | 2,382 | 2,602 | 3,013 | 3,448 |
| Non-current liabilities | 5 | 5 | 5 | 5 |
| Total liabilities | 2,388 | 2,607 | 3,019 | 3,454 |
| Paid-up capital | 556 | 556 | 556 | 556 |
| Reserves & surplus | 9,737 | 11,133 | 13,227 | 15,652 |
| Minorities | 0 | 0 | 0 | 0 |
| Shareholders' equity | 10,293 | 11,690 | 13,783 | 16,208 |
| **Total equity & liabilities** | **12,681** | **14,297** | **16,802** | **19,662** |

Source: Company, PhillipCapital India Research Estimates

## Cash Flow

| Y/E Mar, Rs mn | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|
| Pre-tax profit | 1,668 | 2,465 | 3,296 | 3,691 |
| Depreciation | 486 | 494 | 636 | 720 |
| Chg in working capital | -924 | -126 | -643 | -679 |
| Total tax paid | -255 | -835 | -967 | -1,030 |
| Other operating activities | 0 | 0 | 0 | 0 |
| **Cash flow from operating activities** | **974** | **1,997** | **2,322** | **2,702** |
| Capital expenditure | -712 | -600 | -600 | -600 |
| Chg in investments | 1,110 | 913 | 0 | 0 |
| Chg in marketable securities | 0 | 0 | 0 | 0 |
| Other investing activities | 0 | 0 | 0 | 0 |
| **Cash flow from investing activities** | **398** | **313** | **-600** | **-600** |
| Free cash flow | 0 | 0 | 0 | 0 |
| Equity raised/(repaid) | 1,230 | 1,397 | 2,094 | 2,425 |
| Debt raised/(repaid) | -38 | 0 | 0 | 0 |
| Dividend (incl. tax) | -261 | -324 | -752 | -654 |
| Other financing activities | -1,136 | -1,306 | -1,577 | -2,007 |
| **Cash flow from financing activities** | **-207** | **-233** | **-235** | **-235** |
| Net chg in cash | 1,165 | 2,077 | 1,486 | 1,866 |

## Valuation Ratios & Per Share Data

| | FY13 | FY14 | FY15E | FY16E |
|---|---|---|---|---|
| **Per Share data** | | | | |
| EPS (INR) | 12.6 | 14.6 | 20.9 | 23.9 |
| Growth, % | (59.2) | 16.7 | 42.9 | 14.2 |
| Book NAV/share (INR) | 92.5 | 105.1 | 123.9 | 145.7 |
| CFPS (INR) | 5.5 | 15.5 | 16.1 | 21.2 |
| DPS (INR) | 2.0 | 2.5 | 5.8 | 5.0 |
| **Return ratios** | | | | |
| Return on assets (%) | 11.8 | 12.1 | 15.0 | 14.7 |
| Return on equity (%) | 14.4 | 14.8 | 18.3 | 17.7 |
| Return on capital employed (%) | 14.5 | 14.9 | 18.3 | 17.9 |
| **Turnover ratios** | | | | |
| Asset turnover (x) | 2.2 | 2.6 | 2.9 | 3.2 |
| Sales/Total assets (x) | 1.0 | 1.2 | 1.2 | 1.2 |
| Sales/Net FA (x) | 3.6 | 4.5 | 5.4 | 6.5 |
| Working capital/Sales (x) | 0.2 | 0.2 | 0.2 | 0.2 |
| Receivable days | 82.3 | 105.0 | 105.0 | 105.0 |
| **Liquidity ratios** | | | | |
| Current ratio (x) | 3.5 | 4.1 | 4.4 | 4.7 |
| Quick ratio (x) | 3.5 | 4.1 | 4.4 | 4.7 |
| Dividend cover (x) | 6.3 | 5.9 | 3.6 | 4.8 |
| Total debt/Equity (%) | 0.1 | 0.0 | 0.0 | 0.0 |
| Net debt/Equity (%) | (34.0) | (47.7) | (51.2) | (55.1) |
| **Valuation** | | | | |
| PER (x) | 35.8 | 30.7 | 21.5 | 18.8 |
| PEG (x) - y-o-y growth | (0.6) | 1.8 | 0.5 | 1.3 |
| Price/Book (x) | 4.9 | 4.3 | 3.6 | 3.1 |
| Yield (%) | 0.4 | 0.6 | 1.3 | 1.1 |
| EV/Net sales (x) | 3.9 | 2.9 | 2.3 | 1.9 |
| EV/EBITDA (x) | 25.8 | 16.5 | 12.6 | 10.0 |
| EV/EBIT (x) | 35.4 | 20.1 | 15.5 | 12.2 |

## NOTES

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| | |
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| Paresh Jain | (9122) 6667 9948 |

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| Hrishikesh Bhagat | (9122) 6667 9986 |

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| Varun Vijayan | (9122) 6667 9992 |

**Midcap**

| | |
|---|---|
| Vikram Suryavanshi | (9122) 6667 9951 |

**Metals**

| | |
|---|---|
| Dhawal Doshi | (9122) 6667 9769 |

**Oil&Gas, Agri Inputs**

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|---|---|
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| Deepak Pareek | (9122) 6667 9950 |

**Pharma**

| | |
|---|---|
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| Neha Garg | (9122) 6667 9996 |

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|---|---|
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| | |
|---|---|
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**Database Manager**

| | |
|---|---|
| Vishal Randive | (9122) 6667 9944 |

**Sr. Manager – Equities Support**

| | |
|---|---|
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| Kishor Binwal | (9122) 6667 9989 |
| Sidharth Agrawal | (9122) 6667 9934 |
| Bhavin Shah | (9122) 6667 9974 |
| Dipesh Sohani | (9122) 6667 9756 |

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| | |
|---|---|
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**Execution**

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| Mayur Shah | (9122) 6667 9945 |

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