Intellect Design Arena (INDA IN)

Unique fin-tech product play

INDIA | IT Services | Initiating Coverage

11 October 2017

- **Digital is becoming a structural trend and is expected to grab a large chunk of tech spends in the next few years. INDA is focused on 'digital-transformation' products for banking, insurance, and other financial services.**
- **Unique product play – different from the highly-competitive IT-services companies.**
- **INDA has invested ~US$ 200mn into product development over a decade. It is now in the break-even phase of its product cycle. It has developed world's first design centre (called 8012) focused on financial technology, and products such as 'Digital 360'.**
- **Global transaction banking revenues are seen touching US$ 509bn by 2021 (from current US$ 189bn). INDA's transaction banking product is its biggest revenue driver.**
- **INDA is at an inflection point – expect USD revenue CAGR of 12% over FY17-19, full year operating margins breaking-even and the company turning profitable on full year basis in FY18.**
- **Won 63 deals in FY17, signalling strong demand for its products.**

INDA is well-poised to ride the digital wave: Market expert Gartner predicts 'digital' will be a US$ 50bn opportunity over the next five years. INDA is well-poised to ride the digital spending wave from banks due to proactive investments in digital banking and into its design centre. The same can be gauged from the deal wins as the company generated 60% of revenue from Digital with 60%+ deal pipeline in digital. Its capabilities in Digital have led to a 70% conversion rate for digital transformational deals with average deal size more than doubling in the last few years.

Diversified product portfolio across touch points, geographies, and clients: Since INDA's product portfolio is well diversified, the risk attached to single-product companies does not exist. It has carefully invested into four lines (to de-risk its portfolio), which touches all points – banking, financial services, and insurance. In the proliferation phase of its product cycle, INDA should easily increase wallet share from these clients. Deal wins with central banks (RBI and the Central Bank of Sweden) increases confidence and trust in the company. It has the right geographical mix – 47% of its revenues come from high-income countries (where banks are looking at software upgradation) and 53% from low-income ones (where banks are exploring first-time investments for core banking).

Investing to widen scope: INDA has invested roughly US$ 20mn annually (for ten years) in developing products. It has consistently spent on R&D to modernise its product offering. After its demerger with Polaris, INDA's management focused on selling in high-income countries, which led to an increase in S&M in FY15-17. The benefits of these investments are digital-ready products and deal wins in high-income countries.

Outlook and valuations

INDA should see 12% USD revenue CAGR over FY17-19 led by multiple growth engines. With increasing acceptance in the US and in Europe, the share of its license fees should improve, thus improving profitability.

Globally IT product companies are trading at an average CY18 EV/sales of 4x. In recent M&A transactions also, average acquisition price has been 4x EV/sales. INDA trades at 1.3x FY19 EV/sales — a significant discount to global IT product companies and M&A transaction valuations. The company is in the third stage of its product cycle, which warrants a discount – however, a discount of 70% is unwarranted.

When compared with the EV/sales valuations of Indian IT-services companies, we find that INDA trades at a discount of 30-50% to top-4 companies. We value INDA at 2x FY19 EV/sales (a 50% discount to global players, and discount to Majesco, which we value at 3x EV/Sales) to arrive at our target of Rs 170.

BUY

CMP RS 128

TARGET RS 170 (+33%)

COMPANY DATA

O/S SHARES (MN) :	125
MARKET CAP (RSBN) :	16
MARKET CAP (USDBN) :	0.3
52 - WK HI/LO (RS) :	180 / 97
LIQUIDITY 3M (USDMN) :	1.2
PAR VALUE (RS) :	5

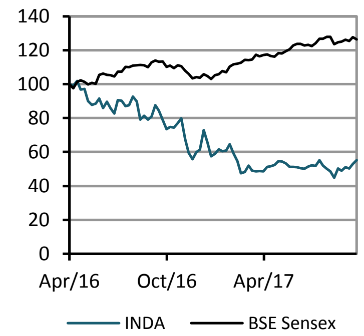
SHARE HOLDING PATTERN, %

	Jun 17	Mar 17	Dec 16
PROMOTERS :	29.4	29.4	29.6
FII / NRI :	11.9	11.1	8.0
FI / MF :	7.9	7.4	7.6
NON PRO :	22.7	14.3	18.7
PUBLIC & OTHERS :	28.2	37.7	35.3

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	18.1	13.6	-22.5
REL TO BSE	17.3	13.0	-36.2

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY17	FY18E	FY19E	FY20E
Net Sales	9,110	10,040	11,187	12,469
EBIDTA	(276)	756	906	1,105
Net Profit	(205)	299	447	589
EPS, Rs	(2.0)	2.4	3.6	4.7
PER, x	(63.0)	53.5	35.7	27.1
EV/Sales, x	1.5	1.5	1.3	1.2
P/BV, x	2.2	1.9	1.8	1.7
ROE, %	(3.4)	3.6	5.1	6.3

Source: PhillipCapital India Research Est.

Shyamal Dhruve (+ 9122 6246 4110)
sdhruve@phillipcapital.in

Vibhor Singhal (+ 9122 6246 4109)
vsinghal@phillipcapital.in

The CBS competitive landscape

Globally, there are ONLY 50-60 companies that provide a full-service CBS (core banking software). The complex nature of the industry, strict regulators, and the high cost associated with failure are the biggest entry barriers for this industry. Over half of the companies with CBS solutions, expectedly, are from the US while 25% are from Europe (mainly from Switzerland, France and UK); the rest are from emerging markets.

Leading CBS companies across the world

Name	Country of Origin	Products
Temenos	Switzerland	T24; T24 for Microfinance and Community Banking (MCB) formerly eMerge; GLOBUS; TEMENOS CoreBanking (TCB)
OFSS	USA	Oracle Banking Platform, Flexcube (formerly i-flex Solutions), Microbanker, Finware
Infosys Technologies	India	Finacle
FIS | Fidelity National Information Services (FNIS	USA	Corebank, FIS Alltel Systematics, Sanchez Profile, Horizon ACBS (Advanced Commercial Banking System), Kordoba, ALLprofits, MiSER, BancPac, Metavante
Fiserv	USA	ICBS (International) | Signature by Fiserv, - Fiserv CBS (US); Basys/Metabank; Catapult; Premier; Acumen
TCS FS	India	TCS BaNCS Universal, Retail, Private, Wholesale core banking and treasury suite
Misys	UK	FusionBanking Essence, BankFusion Universal Banking, Equation, BankFusion Equation, Equation Islamic Banking, Midas Plus, BankFusion Mida
SAP	Germany	SAP for Banking, Corebanking; SAP R/3
D + H (Harland Financial)	USA	Phoenix International PhoenixEFE
Intellect	India	Intellect Suite - OrbiOne, BankWare; BankNow
Silverlake Axis	Malaysia	Silverlake - SIBS, Silverlake Integrated Islamic Banking System (SIIBS)
Avaloq	Switzerland	Avaloq Banking Suite
SAB	France	SAB AT
Sopra Banking Software	France	Sopra Banking Suite integrated core banking solution < the result of merging Callataÿ & Wouters' Thaler, and Delta-Bank, with Sopra's own Evolan in 2012 + Tieto Financial Services UK, and (next, as of Nov 2013) COR&FJA Banking Solutions GmbH of Germany
InfrasoftTech	India	OMNIEnterprise
Olympic ERI Bancaire		Olympic
Nucleus Software	India	FinnOne Neo
Sungard Ambit	USA	Ambit EBS (Enterprise Banking Suite) core banking - Retail banking, Corporate banking (formerly System Access Symbols)
Datapro Inc		Datapro eIBS (e-IBS) CORE
Jack Henry & Associates	USA	Jack Henry Banking - SilverLake; CIF 20/20; Core Director for US market
Neptune Software	Paris	Rubikon universal core banking system (Java platform), Orbit microfinance retail banking, Equinox
ASI - Arango Software International		ABANKS (AB@NKS) core banking
Alnova Financial Solutions	Ireland	Alnova Banking Solutions (Accenture) 'A la Carte'; Alnova Jetbank, Altamira
Infopro	Malaysia	ICBA, eICBA
TietoEnator	Finland	TietoEnator Financial Solutions, PBS Core Banking (Nordic solution) - (includes AttentiV)
ITS - International Turnkey Systems	Finland	ETHIX total banking solution | ITS Core Banking Solution (Phoenix for ME), ITS Islamic Banking Solution
Path Solutions	Kuwait	iMAL, iWINDOW, iSHRAQ
Fiserv	USA	TCBS/TCCUS: DNA platform | TCBS - The Complete Banking Solution, TotalPlus (outsourced) core banking, TCCUS - The Complete Credit Union Solution
Computer Sciences Corporation (CSC)	USA	Hogan, CSC/IBS, Celeriti, K3000
Craft Silicon		Craft Silicon Bankers Realm (BR)
Trust Systems		TrustBank online core banking, TrustBankCBS, MicroFinS
Fern Software	UK	Abacus OneWorld, Focus SQL, M2
BML Istisharat	Lebanon	ICBS (Integrated Computerized Banking System)
ICSFS ICS Financial Systems (formerly ICS)	Jordan	ICS BANKS
BankVision Software		Core BankVision
telekomsigma (formerly SIGMA)	Indonesia	alphaBITS Conventional and Syariah
Saraswat Infotech Limited (SIL)		SwiftCore core banking solution
Microlink		MiBS conventional and islamic universal core banking
Cobiscorp | Cobis Systems Corporation (Macosa SA, MicroBanx Systems merged)		COBIS Core Banking | COBIS UBS (universal banking solution)

Source: Celent, PhillipCapital India Research

Key criteria for selecting a core banking product

Despite the need to migrate to a more advanced platform, there are many challenges while implementing core banking software, largely because of the risk of implementation failures and banks' inertia to understand the necessary technology change that will align with their business goals.

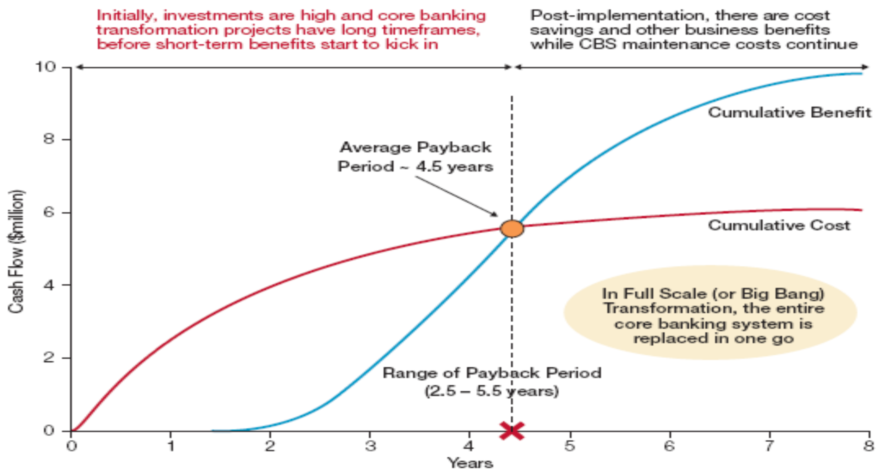
While judging the competitive strength of a CBS company, the key criteria that banks evaluate is the maturity of product, which can be broadly defined by the vendor capabilities and credentials. This can be measured in terms of:

1. **Clientele**: A vendor's clientele is the most important testimony of its capabilities and credentials. If a vendor has delivered CBS for a large multinational bank, and is running it successfully, other banks gain confidence in its capabilities. Similarly, a bank with a diversified service mix would prefer an integrated CBS already deployed at banks with similar services (or at individual banks offering each of those services separately).

2. **Financial stability:** Core banking replacement generally is a long-drawn process and financial strength and business continuity are very important attributes for evaluating any vendor. The proportion of implementation and maintenance is higher in total cost of ownership (TCO). Typically, payback for most core-banking replacements takes 4-5 years. Transforming core-banking systems brings associated changes to operating processes, surrounding systems, interfaces, hardware and network configurations, and requires re-skilling and re-deployment of people.

A core banking solution, once implemented, should be robust, scalable, and future-proof, and serve the business' interest for at least 10 years.

Total cost of ownership of CBS



Source: Capgemini Research, PhillipCapital India Research

3. **Continued R&D expense for future development:** Banks vehemently gauge the vendor's ability and intent to commit finance, resourcing, and infrastructure to continuously enrich their solution offering to meet contemporary banking requirements. Some of the criteria they look into, are the number of customer sites across the globe, profile of client banks, contribution of the financial solutions business to vendor revenues, track record, and vendor's investment in the core-banking space.

R&D spend as % of revenue for leading CBS solution providers

	FY15	FY16	FY17
Temenos	29.7	28.2	27.5*
Jack Henry	5.7	6.0	5.9
Guidewire	24.6	26.5	25.3

Source: Companies, PhillipCapital India Research; * for H1CY17

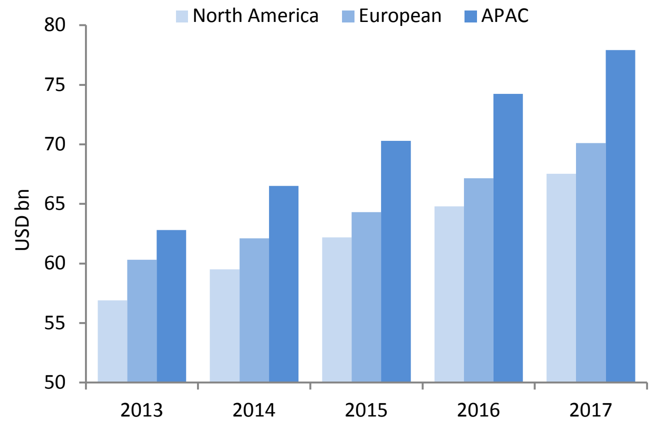
Digital – a mammoth opportunity in the banking space

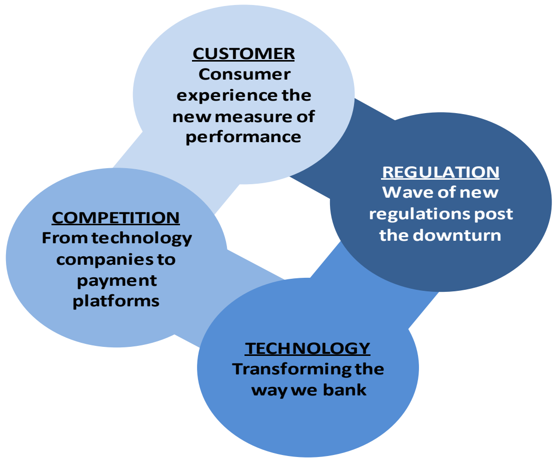
'Digital' is increasingly becoming a structural trend and this segment is likely to grab a large chunk of tech spends in the next few years. Gartner estimates that by 2018, 25% of businesses will employ a Chief Digital Officer (CDO) and that over 20% of CIOs have already started taking on the mantle of a CDO. Thus, the digital wave would be the largest disruptor in the financial spectrum.

Industry estimates peg digital disruption as a US$ 50bn opportunity

Industry estimates peg digital disruption as a US$ 50bn opportunity. Currently, investments in the digital space are being made only in channel systems, but we expect digital/transformation initiatives to dominate investments going ahead. Industry experts estimate a ~5% increase in core-banking spending in 2018 and IT spends from banking to accelerate as well.

Discretionary IT spending – a primary driver of spends





Source: Celent, PhillipCapital India Research

Changing drivers for digital spend – from regulation to competition

After the financial crisis of 2009, regulation and compliance have been the biggest drivers of BFSI spending, especially over 2012-15. As regulators across the world tightened the screws on financial institutions (to prevent a repeat of the sub-prime crisis), these institutions had to significantly increase their spending in order to adhere to the new strict regulations.

Fin-tech companies are now emerging as the biggest driver of technology spends

However, over the last few years, competition from fin-techs is now emerging as the biggest driver of technology spends. Financial technology, also known as fin-tech, is a line of business based on using software to provide financial services. Fin-tech companies are generally start-ups founded with the purpose of disrupting incumbent financial systems and corporations that rely less on software. Over the last five years, companies such as Moven, TransferWise, and m-Pesa have spawned across the globe, giving tough competition to the 'regular' financial institutions.

In its global banking annual review, McKinsey predicts that financial institutions will face a 'high-stakes struggle to defend their business models against digital disruption'. The review also says that last year, banks earned revenues of US$ 1.75tn from origination and sales activities, on which the RoE was 22%, but they made US$ 2.1tn from balance-sheet provision on which the RoE was only 6%. New fin-tech companies are focused on targeting the origination and sales activity – the most lucrative part of their business.

Technology spends today are focused on offering integrated services with multichannel delivery across online/mobile platforms. In line, financial institutions have stepped up spending on mobile/online banking platforms, to provide a unique experience to their customers.

While we expect the spending towards regulation, technology upgradation, and better customer experience to continue, spending in core banking systems is going to increase significantly over the next decade. With spends on digital and IoT taking care of the interface, we expect the focus of institutions to shift towards replacing and upgrading their legacy core banking platforms – which could provide seamless integrations with the digital interface and comply with the regulatory framework.

INDA – all set to ride the digital wave

We believe INDA is well-poised to reap the benefits of this spend on digital technology due to the twin forces of its 'Digital 360' platform and continued investments in its 'Design Centre'.

Digital 360 Bank: Digital 360 core banking solution is a proactive step from INDA. Digital 360's solutions are designed for institutions in any stage of their lifecycle. It not only improves customer experience, but also enables processes to improve internal efficiency. In addition, canvas technology and hub technology, differentiating features of Digital 360, are developed in its design centre.

- ***Canvas technology***: Targeting the 'digital out', which enables a bank to create a customised experience based on analytics, targeting customer experience.
- ***Hub technology***: Targeting 'digital in', which deals with internal processes/ efficiencies (focuses on processes internal to bank, consolidates different technologies in one product).

Components of INDA Digital 360

Source: Company, PhillipCapital India Research

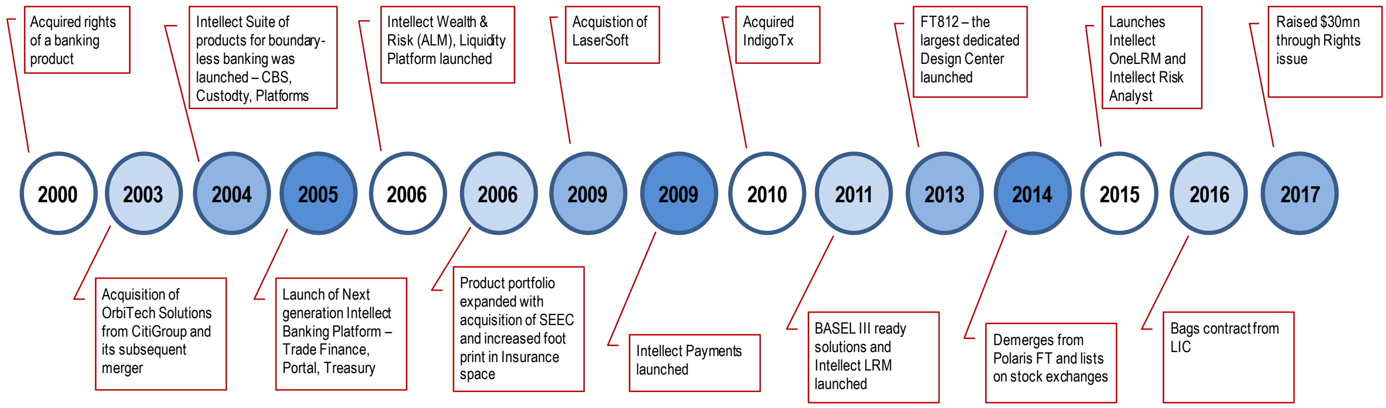
Design centre: INDA has a dedicated design centre in Chennai called FT 8012 – it is the world's first design centre focused on financial technology. This centre incorporates all three building blocks of the modern financial sector – business, operations, and technology (BOT). The enabling environment of the centre facilitates white-boarding of new banking ideas and accelerates the ideation-to-execution cycle.

INDA has spent US$ 5mn to build the centre, that have a dual purpose. In these workshops, INDA can display the functionality of its products across the customer experience, domain expertise, and technology experience. On the client side, it helps them to formulate the technology landscape.

INDA at an inflexion point

INDA has been investing into product development for almost a decade. In the past decade, it has invested approximately US$ 200mn in continuously upgrading its product offering. It is one of the few companies with a full spectrum of technology products for banking, financial services, and insurance.

History of INDA's product development

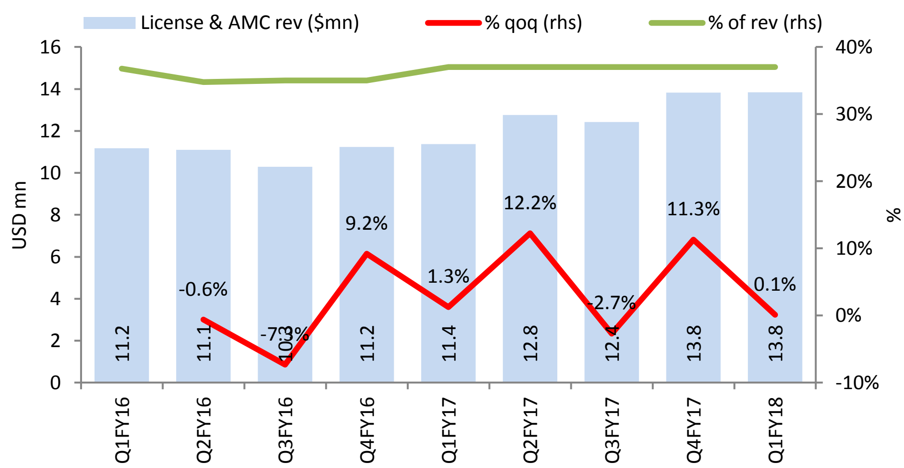


Source: Company, PhillipCapital India Research

Third phase of the product lifecycle

INDA is in the third phase of its product lifecycle, because of its sustained investments in the past decade. Typically, it makes 35-40% of its customer lifecycle revenues in the build-and-implement phase and the remaining 60-65% comes from maintaining and supporting the customer over the next ten years.

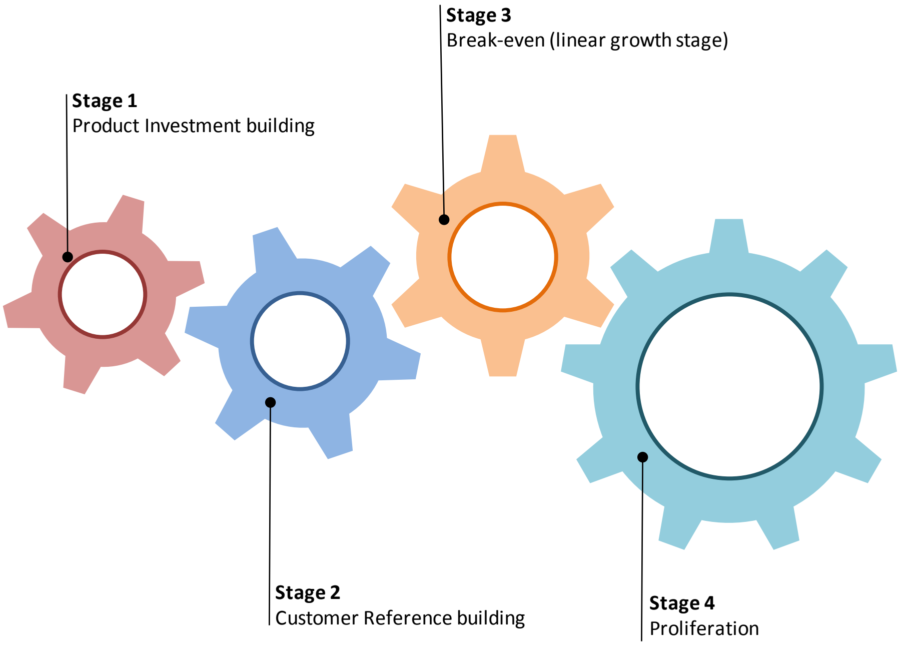
INDA License and AMC contribution



Source: Company, PhillipCapital India Research

A product company's lifecycle can generally be broken down into four phases – product building, customer reference, break-even, and proliferation. INDA has reported USD revenue CAGR of 16% in the last three years, gross profit margins of 50%, and operating losses. We believe it is at an inflection point of stage-3 and foresee USD revenue CAGR of 12% over FY17-19, and the company turning profitable in FY18 on a full year basis. We see: (1) linear growth in license and implementation revenues in the next two years, and (2) significant proliferation due to its diversified product portfolio kicking in.

Typical lifecycle of a product company



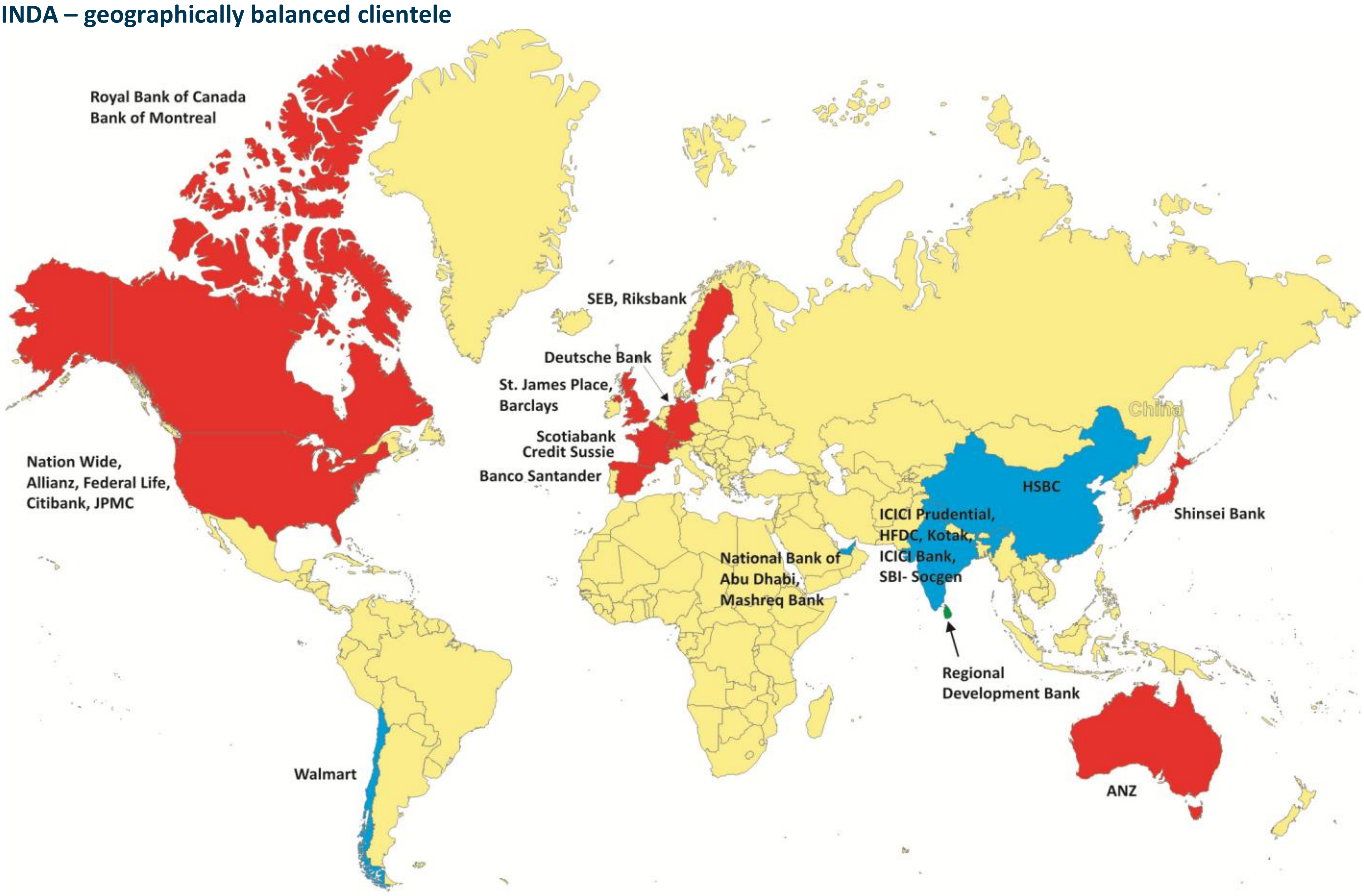
Source: Company, PhillipCapital India Research

We expect the company to generate profit on a full year basis in FY18

Strong clientele with geographical balance

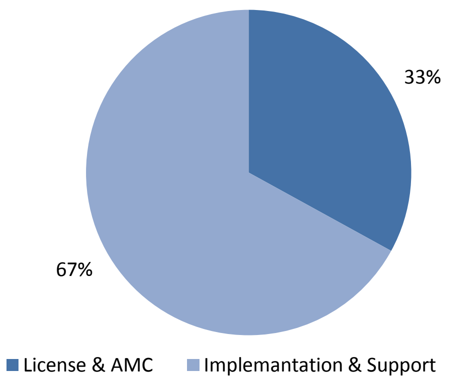
INDA caters to 200+ customers with an average implementation track record of 2+ products per client. In terms of geographical spread, 47% of its revenue comes from advanced economies and the rest from developing economies. Advanced-market contracts have high gross margins (55-60%) and a total contract value of a large client can reach to US$ 20-25mn in revenue over the years. Management's focus is to expand its reach in advanced markets. We believe successful execution of this strategy will increase operating leverage. Deal wins from the Reserve Bank of India (RBI) for central bank software, Life Insurance Corporation of India for insurance software, and GeM (Government of India e-market place) enhances its reference-ability.

INDA – geographically balanced clientele



Source: Company, PhillipCapital India Research

INDA – revenue breakup

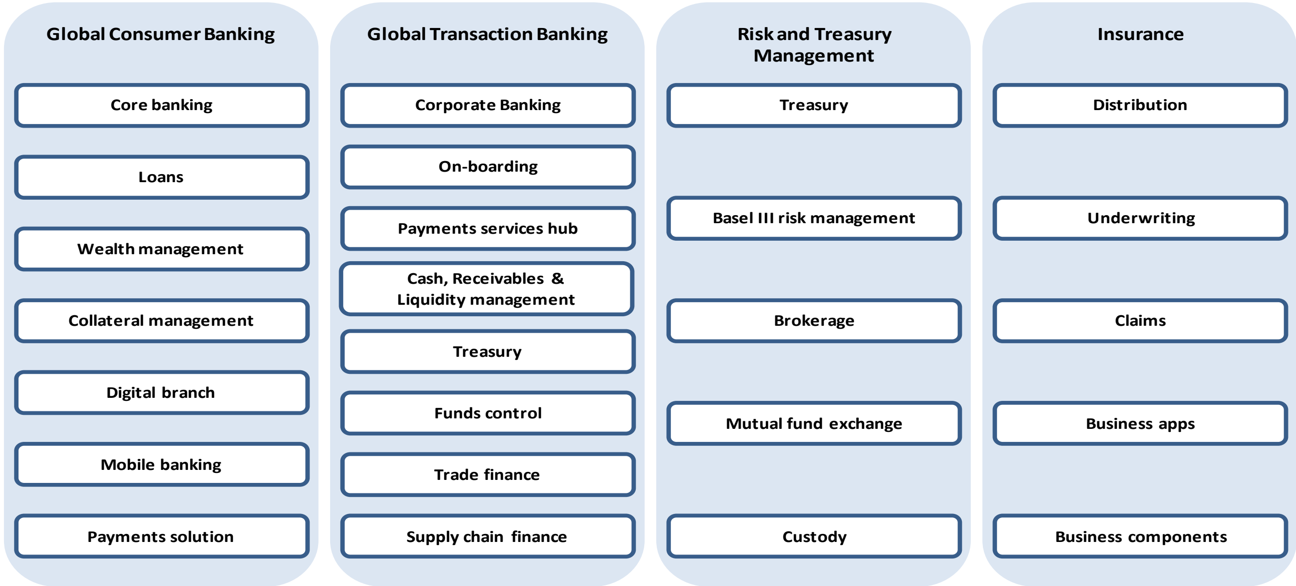


Source: Company, PhillipCapital India Research

Diversified portfolio

INDA has a large suite of 30 diversified products catering to banking, financial services, and insurance. Since it has developed the product suites over the last five years, they are digital ready. The suites have also used design thinking to differentiate themselves from legacy systems developed few years ago. It has carefully invested into four business lines to de-risk its portfolio. Each of these business lines has a separate leadership team.

INDA – Product portfolio



Source: Company, PhillipCapital India Research

➢ Global Transaction Banking (GTB)

GTB is designed for reducing the complexity between operations of banks and corporate customers. GTB is the highest revenue contributor for INDA. Its products encompass customer on-boarding, digital corporate online cash management, contextual payments, digital liquidity, digital supply chain finance and trade finance. Global consulting firm, BCG, forecasts that global revenues from transaction banking will touch US$ 509bn by 2021 from the current US$ 189bn. The division currently has 71 total customers with 20 wins in the last four quarters. The company has very healthy deal pipeline in GTB with 15 deals in the final stage of award.

INDA – Global Transaction Banking (GTB)

Domain	Clients	Competitors
Corporate banking exchange	HSBC	Fundtech
Customer on boarding	Barclays	Bottomline
payment services hub	Bank of Montreal	ACI
Receivables management	ANZ	
Cash management	JPMC	
Liquidity management	Banco Santander	
Funds Control	SEB, Sweden	
Trade Finance	Mashreq Bank, UAE	
Supply chain finance		
Treasury		

Source: Company, PhillipCapital India Research

The key market trends affecting the transaction banking segment are:

- Regulatory compliance
- New competition from Fintechs
- Open API Banking
- Real-time payments
- Interest rate
- SME growth demanding differentiated experience & products

As per industry estimates, banks spend 7-8% of their revenue on IT services and solutions – the largest expense compared to other verticals. Factors such as low growth, margin pressure, declining returns on equity, high competition and regulatory requirements are pushing banks towards more efficient and cost-effective IT solutions provided by third-party vendors.

With the increasing competition from Fintechs, this segment has seen numerous M&A transactions in the recent past, the notable among them being FIS acquiring Sungard, Vista equity partners acquiring D+H etc.

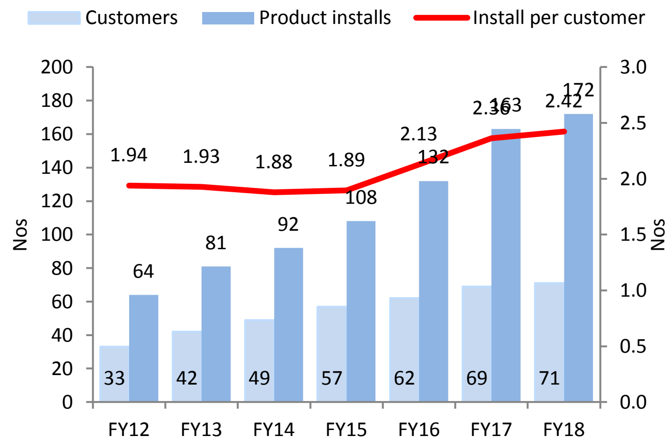
M&A transactions in the fintech space

Acquirer	Acquired	When	Acquisition price (USD bn)	Remarks	Revenue(USD bn)	EV/Sales
GTCR	BankServ	Aug 2011	0.3	Money transfer and payments	0.06	5.0
FIS	Clear2Pay	Sep 2014	0.5	Global payments	NA	NA
FIS	Sungard	Nov 2015	9.1	Core banking	2.8	3.3
Optimal payment	Skrill	Mar 2015	1.2	Digital payments business	0.3	3.6
SS&C Technologies	Advent Software	Feb 2015	2.4	Investment management software	0.4	6.1
D+H	Fundtech	Mar 2015	1.3	Transaction banking solutions	0.2	6.5
D+H	Harland Financial	Jul 2013	1.2	Core banking, lending and compliance	0.3	4.0
Vista equity partners*	D+H	Mar 2017	4.8	Global payments and lending	1.6	3.0
GTCR	Sage payment	Jun 2017	0.3	Accounting, payroll and payment solutions	0.2	1.5
MasterCard	Vocalink	Apr 2017	0.9	Global payments	0.2	4.5
Fiserv	Dovetail	Aug 2017	NA	Payments and liquidity management	NA	NA
Fiserv	Monitise	Jun 2017	0.1	Mobile banking and payments	0.1	1.0
Basware	Procserve	Apr 2015	0.1	E-procurement services provider	0.1	2.0

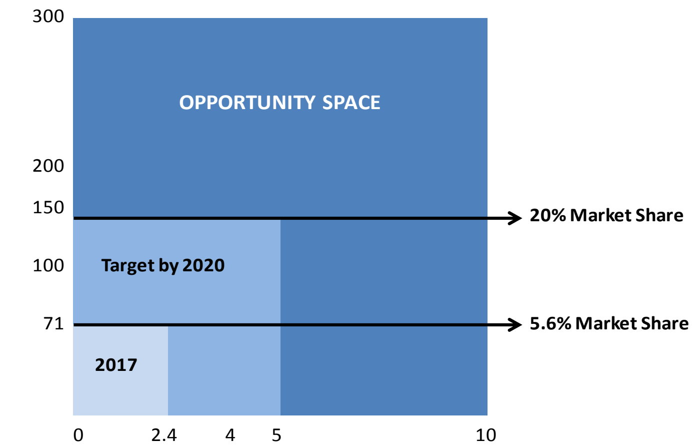
Source: PhillipCapital India Research; * merger with Misys

The number of customers in GTB has increased from 33 customers in FY12, to 71 customers as of today. Its market share in number of customers served stands at 24% (71 out of 300 banks) while 5.6% in terms of the revenue market share. The company aims to increase the customers served to 150, with revenue market share of 20% by 2020. The launch of newer products in the last few years provided it a significant opportunity to cross-sell its products to its existing customers. This has resulted in products/customer increasing to 2.42 products in FY18 from 1.94 in FY12.

Intellect has covered 24% of the addressable GTB market



Currently 2.42 products/customer



Source: Company, PhillipCapital India Research

➢ Global Consumer Banking (GCB)

GCB, INDA's consumer-banking business, is the preferred partner of leading global banks, driving its 'primary banker' aspiration. Intellect Quantum CBS is its specialist core-banking solution, specifically engineered for the unique requirements of central banks. INDA has a full-spectrum suite of consumer banking products spanning digital core, digital lending, wealth, mobile and internet banking, credit cards, and central banking. GCB is the large untapped market, with sharp focus on Tier 2 and Tier 3 banks. It is the second-largest revenue contributor for INDA. The company has 116 total customers with 23 wins in the last four quarters.

INDA – Global Consumer Banking (GCB)

Domain	Clients	Competitors
Core	Deutsche Leasing, Germany	Temenos
Loan Servicing	Shinsei Bank, Japan	Infosys
Debt management	Reserve Bank Of India	OFSS
Loan Origination	ICICI Bank, India	Jack Henry
Wealth	Riksbank, Sweden	TCS
Collateral & Limit Management	National Bank of Abu Dhabi	
Digital Branch	Walmart, Chile	
Cards		
Mobile & Internet		
Payments		

Source: Company, PhillipCapital India Research

➢ Integrated Risk & Treasury Management (iRTM)

iRTM is a cross-asset platform that covers the trade cycle. The product provides functions across front, middle, and back office, with an aim to improve the efficiency of trading functions. The company has 74 total customers with 16 wins in the last four quarters.

INDA – Integrated Risk & Treasury Management (iRTM)

Domain	Clients	Competitors
One Treasury	Citibank	SunGard
Basel III LRM with ZF Risk Visualisation	RBI	Murex
Brokerage	Credit Suisse	Misys
Mutual Fund Exchange	Scotia bank	
Custody	Deutsche Bank	
	HFDC, India	
	Kotak, India	
	SBI- Socgen	

Source: Company, PhillipCapital India Research

➢ Intellect SEEC (Insurance)

Intellect SEEC is insurance software that covers distribution, underwriting, and claims. The management's focus is on improving digital distribution, ML based intelligent underwriting and risk analysts. Key target markets are US, UK, and Canada. It signed 4 customers on cloud in US – the most difficult fort to crack. The company has 17 total customers, including 3 giants – LIC, SJP and a leading Canadian insurer. The company won four deals in the last four quarters.

INDA – Intellect SEEC

Domain	Clients	Competitors
Distribution	St. James Place, London	Guidewire
Underwriting	Nation Wide, US	Fineos
Claims	ICICI Prudential	
Business Apps	Allianz	
Business Component Software	Federal Life, Royal Bank of Canada, LIC of India	

Source: Company, PhillipCapital India Research

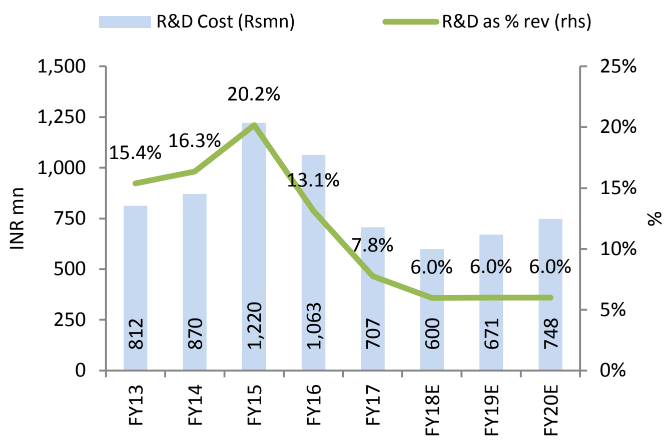
We believe there are significant synergies in these four product lines because of overlapping clientele. The management currently has 400+ installations across 200+ customers and has a cross-selling index of two. We believe its wide range of products provides it with the ability to cross-sell and also reduces the risk of having only 1-2 product lines.

Investing to widen scope

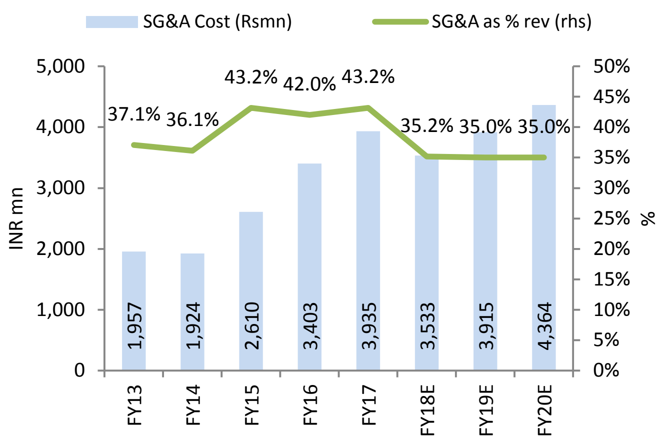
In FY17, 47% of INDA's revenue came from advanced economies. It invested in expanding its management and sales bandwidth in expensive advanced economies. Based on strong execution in its deal pipeline, we expect USD revenue CAGR of 12% over FY17-FY19.

Over the last few quarters, it has built a strong local sales team hired from competitors and clients – this reflected in its higher S&M costs (Rs 2.9bn for FY17 for 339 people) with an average client-acquisition period of 12-18 months. We expect these investments to fructify by FY18, as they are largely in advanced markets and there is a direct correlation between difficulties faced while entering a market and price realisation. We also see these investments aiding margins.

R&D declined in FY17 mainly due to change in accounting



Higher SG&A due to investment in S&M



Source: Company, PhillipCapital India Research

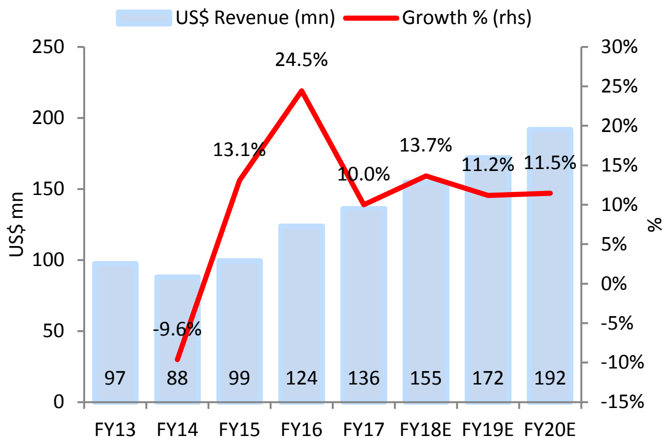
__Excluding R&D costs, margins are healthy__

INDA has strengthened its product offering through R&D investments of ~US$ 200mn over the last ten years. The company has 900+ employees in R&D department, of which more than 50% have 6+ experiences on its products. R&D cost decreased in FY17, mainly as the company changed its R&D accounting policy to capitalize for products which has higher self-life rather than expensing-out fully in previous years. Going ahead, It expects to invest US$ 20mn a year in R&D (including capitalization) for the next few years. These investments are equally divided among technological updates and functionality updates. We believe investments in R&D, especially in technology, will help INDA maintain its lead in digitally enabled products.

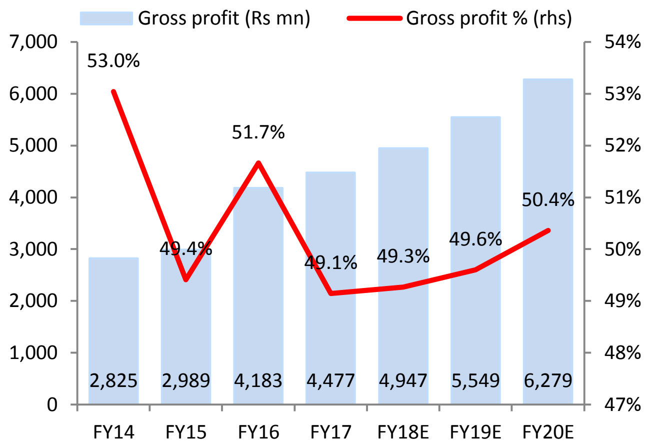
Financials

Intellect management had given an aspiration target of US$ 200mn revenue run-rate by FY18, with 50% gross margin, at the time of its demerger from Polaris in 2015. With revenue of US$ 136mn for FY17, it is evident that Intellect will fall way short of its guidance (reasons given below). We expect USD revenue at US$ 155/172mn in FY18/19.

INDA – revenue profile



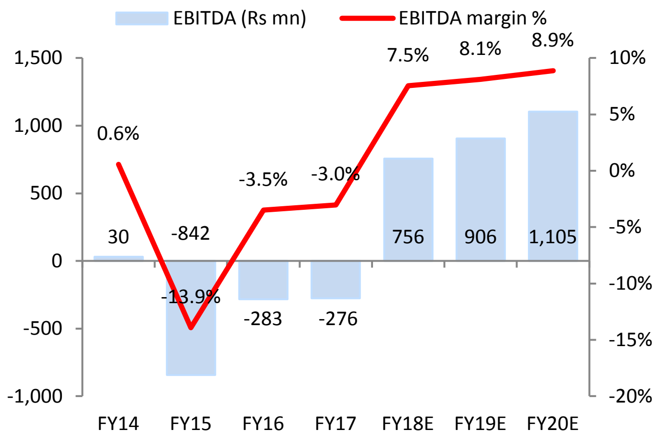
Gross profit profile



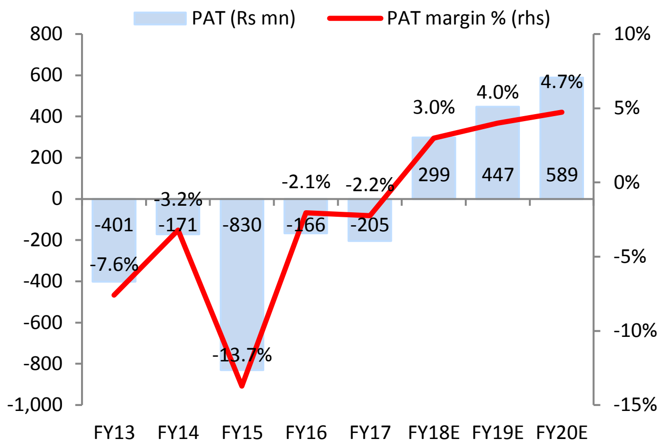
Source: Company, PhillipCapital India Research

The company has seen EBITDA-level profit for the last two consecutive quarters. We expect this trend to continue, as S&M cost is likely to remain steady (because of no new major product launch in the next few quarters). We expect INDA's EBITDA margin at 7.5%/8% for FY18/19 (vs. -3% in FY17).

EBITDA and margins profile



Earnings profile



Source: Company, PhillipCapital India Research

What went wrong in FY16-17?

At the beginning of FY16, INDA's management had sounded confident about breaking even/turning profitable by Q4FY16. Although the company turned profitable in Q4FY16, it was mainly due to the change in R&D expenses accounting (from expensing-out to capitalisation). Also, despite this change in accounting treatment, it went on to report losses for next three consecutive quarters (Q1FY17-Q3FY17) because of:

- **Unexpected global events such as Brexit:** Although INDA did not lose clients due to Brexit, the uncertainties surrounding Brexit resulted in few large deals being delayed by few quarters.
- **Delay in fund raising:** Its board (in June 2016) approved raising funds of Rs 3bn (through issuance of securities, including equity shares and/or other securities convertible into equity shares, including through public issue and/or on a private placement basis and/or preferential Issue or any other kind of issue by way of further public offer or rights issue or including through a QIP. In January 2017, the board approved raising Rs 2bn through a rights issue (5 shares for Rs 86 each for every 22 shares of the company). The rights issue was completed in September 2017.

Utilization of the rights issue proceeds (Aug-17)

Particulars	Rs mn
Long Term Working Capital	350
Global expansion - Sales and Marketing Expenses	500
New Product Development	200
Repayment of Working Capital Loans	450
General Corporate Purpose	457
Issue Related Expenses	33
Total Proceeds	**1,990**

Source: Intellect Rights issue document

- **Increase in DSO days to 180 (from 135days in Q1FY16)** – due to delay in collections. The company has already taken corrective action, as a result of which DSO days has now declined to 157 days in the last two quarters.

What will drive revenue growth going ahead?

- **Government e-Marketplace (GeM) project**:

In March '17, Directorate General of Supplies and Disposal (DGS&D), the central purchase organization of Government of India, floated an RFP (Request for Proposal) to appoint a MSP (Managed Service Provider) to manage the Government e-Marketplace (GeM) portal. GeM is an online marketplace website which supports a number of functions for all the government departments, public sector units, universities etc. The GeM portal (GeM 1.0) is already running which has been developed by DGS&D with limited set of functionalities of GeM solution, catering to 120 product categories and one service category.

The MSP either can reuse the existing architecture and other components to develop the final GeM system or may develop new GeM (GeM 2.0). The implementation phase for GeM 2.0 shall be for a period of 10 months and the operation & maintenance shall be for a period of 5 years after the go-live of the system. The contract may be extended, at discretion of DGS&D, for additional 2 years.

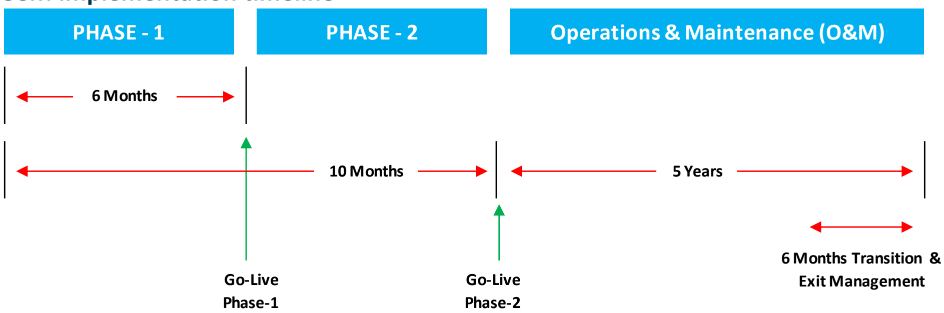
Intellect Design, along with Infibeam and Tata Communications, emerged as the lowest bidder to run the online platform. Intellect will procure goods while Infibeam and Tata Communications will manage eCommerce services and cloud services respectively. Intellect beat large competitors like TCS (partnered with Tata CLiQ), Sify (partnered with Amazon) and Flipkart to bag this project.

Based on the historical data, DGS&D estimates value of orders to reach Rs 1tn in the next five years. As per the RFP, the revenue for the winning bidder will be up to 0.5% of the total estimated value of orders. As per media reports, Intellect had bid for much lower percentage than this. Along with managing the GeM platform, the consortium will have to also provide technical support with minimum of 200 employees.

Our assumptions for GEM model:

- *We assume 0.2% bid value for the consortium on the total order value*
- *We also assume 60:35:5 share among Intellect:Infibeam:Tata Communication while building projections.*

GeM implementation timeline



Source: GeM RFP, PhillipCapital India Research

GeM can generate Rs 1bn annual revenue for INDA by year 5

Rs mn	Year 1	Year 2	Year 3	Year 4	Year 5
Estimated order value	25,000	75,000	200,000	500,000	1,000,000
Bidding value % *(assumed)*	0.2%	0.2%	0.2%	0.2%	0.2%
Revenue for the consortium	50	150	400	1,000	2,000
Intellect share % *(assumed)*	60%	60%	60%	60%	60%
Intellect revenue share	**30**	**90**	**240**	**600**	**1,200**
No of employees *(assumed)*	120	120	120	120	120
Salary per employee	2.00	2.12	2.25	2.38	2.52
Salary cost	240	254	270	286	303
Other expenses % *(assumed)*	5%	5%	5%	5%	5%
Other expenses	2	5	12	30	60
PBT	**(212)**	**(169)**	**(42)**	**284**	**837**

Source: GeM, PhillipCapital India Research

We have NOT YET factored in GeM financials in our estimates, as the deal is still in the implementation phase and revenue is likely to come from FY19 with increasing traction from FY20 onwards.

- **Deals like LIC, Utkarsh Small finance bank:**

In Q2FY17, Intellect bagged a deal from Life Insurance Corporation of India – the largest life insurance company in the world, to transform its e-business portal. The deal was valued at US$ 50mn over the next five years. Intellect won this deal against large competitors like CSC, HP, Infosys etc. As a part of the deal, Intellect standardized the entire portal platform application, web servers and consolidated all the applications to have a streamline view for all its stake holders like policy holders, distributors, agents, employees, and development officers.

In Oct 2017, Intellect announced the successful roll-out of its complete end-to-end Digital Core Banking solution at Utkarsh Small Finance Bank. One of the requirements was to have a Joint Liability Group solution which would enable the Bank to provide group loans to service its microfinance business. Intellect provided Utkarsh with a completely hosted Digital Core Banking solution that includes Loans, Deposits, Internet Banking, Mobile Banking, Digital Branch and Table Banking while also designing and developing the critical JLG solution in-house. It also provided complete offline capability and enabled remote users to continue working even without a network connection. We believe, this was the first of its kind deal across the world, where all the solutions provided were digital in nature.

We believe, deals like LIC (where it won against global competitors) and Utkarsh (first of its kind fully digital deal) demonstrates Intellect's superior product features and its ability to thwart competition.

Product companies vs. service companies

Differences with services companies

A product company's revenue and earnings profile is quite different from a services company in the following ways:

1) Revenue for a product company is largely a step function. License sales are important in the initial years, as they provide acceptability to the product. License sales percolate to one-time implementation revenue and annuity-based maintenance revenue. While license sales and implementation revenue requires frequent back-fill, the AMC grows over a period. A services company has fixed linear growth.
2) Product companies have higher research and development spends than services companies. Spends are for new-version development, future enhancements, and creating new products. R&D spends for products companies vary between 10-20% of their sales and large companies capitalise these spends. Services companies have higher employee expense.
3) Product businesses have inherent non-linearity. The product development cost is one-time and can be used to generate revenue multiple times through deployment across many clients. However, the break-even point for product companies takes much longer than services companies.
4) The progress of product companies is reviewed with comparing year-on-year results. Traction in license revenue in the initial years and increase in AMC in the mature phase are important indicators.
5) Initial years of product companies require significant investment in R&D and S&M (fixed cost). During this phase, they see losses on the operating front, if they expense R&D. Hence, these companies are valued on EV/sales to primarily value the enterprise on the sales capabilities in the coming years. After the company matures, it is valued in terms of P/E.

INDA has higher S&M as compared to IT services companies

SG&A as % of revenue	FY16	FY17	FY18E	FY19E
TCS	17.0%	17.1%	17.5%	17.4%
Infosys	12.4%	12.2%	12.0%	11.9%
Wipro	12.2%	13.2%	12.8%	12.5%
HCL Tech	12.7%	11.8%	11.7%	11.7%
Tech Mahindra	15.8%	18.9%	19.2%	18.6%
Majesco	33.7%	33.9%	33.6%	31.3%
Intellect Design	**42.0%**	**43.2%**	**35.2%**	**35.0%**

Source: Companies, PhillipCapital India Research

Outlook and valuations

We expect INDA to report 12% USD revenue CAGR over FY17-19, led by multiple growth engines such as digital products and diversified product portfolio mix through four business lines. The company is in the third stage of its product lifecycle, and with increasing acceptance in the US and in Europe, the share of license fees should improve, thus improving profitability.

We expect EBITDA margins to be 7.5%/8% in FY18/19. Higher share from advanced markets and increase in license fee and AMC share should aid gross-margin improvement (GM in developed markets is 55-60% while it is ~50% for the rest of world).

Globally IT product companies are trading at an average CY18 EV/sales of 4x. In recent M&A transactions also, average acquisition price has been 4x EV/sales. INDA trades at 1.3x FY19 EV/sales — a significant discount to global IT product companies and M&A transaction valuations. The company is in the third stage of its product cycle, which warrants a discount – however, a discount of 70% is too high in our opinion.

When compared with the EV/sales valuations of Indian IT-services companies, we find that INDA trades at a discount of 30-50% to top-4 companies. We value INDA at 2x FY19 EV/sales (a 50% discount to global players, and discount to Majesco, which we value at 3x EV/Sales) to arrive at our target of Rs 170.

Valuation: Global product companies

			Mcap	Revenue (mn)			EBITDA margin (%)			EV/Sales (x)		EV/EBITDA (x)		Rev CAGR (%)
Company	Currency	CMP	(bn)	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	
Temenos	CHF	103	7	634	796	877	37	39	40	9.7	8.8	25.3	22.3	17.6%
Fiserv	USD	128	27	5,505	6,027	6,387	34	37	36	5.2	4.9	14.2	13.5	7.7%
Jack Henry	USD	105	8	1,431	1,508	1,600	35	35	35	5.3	5.0	15.2	14.3	5.7%
Oracle Financial Services	INR	3,532	301	44,265	47,320	52,925	39	40	40	6.0	5.4	15.2	13.4	9.3%
FIS	USD	95	31	9,241	9,279	9,809	27	35	34	4.4	4.1	12.5	12.0	3.0%
ACI Worldwide	USD	24	3	1,006	1,035	1,118	32	27	25	3.3	3.1	12.5	12.1	5.4%
Guidewire	USD	79	6	514	624	724	9	18	20	8.5	7.4	48.1	36.8	18.6%
Intellect Design*	***INR***	***132***	***18***	***9,110***	***10,040***	***11,187***	***(3.0)***	***7.5***	***8.1***	***1.5***	***1.3***	***20.0***	***16.5***	***10.8%***
Majesco India*	***INR***	***491***	***12***	***8,275***	***8,193***	***9,883***	***3.8***	***0.2***	***5.1***	***1.2***	***1.0***	***620.8***	***19.6***	***9.3%***

Source: Bloomberg Estimates, PhillipCapital India Research; * PhillipCapital Estimates

Valuation: Indian IT companies

	CMP	Mcap	Revenue ($ mn)			EBITDA margin (%)			EV/Sales (x)		EV/EBITDA (x)		Rev CAGR (%)
Company	(Rs)	(Rs bn)	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	
TCS	2,492	4,910	17,575	18,823	20,119	27.4	26.5	26.3	3.8	3.5	14.4	13.3	7.0%
Infosys	933	2,144	10,208	11,026	12,045	27.2	26.8	26.9	2.7	2.4	10.0	8.9	8.6%
Wipro	290	1,411	7,705	8,131	8,601	21.3	20.7	20.8	2.1	1.9	10.1	9.2	5.7%
HCL Tech	910	1,299	6,975	7,816	8,427	22.1	22.1	22.1	2.2	2.0	10.3	9.3	9.9%
Intellect Design	***132***	***18***	***136***	***155***	***172***	***(3.0)***	***7.5***	***8.1***	***1.5***	***1.3***	***20.0***	***16.5***	***12.4%***
Majesco India	***491***	***12***	***122***	***126***	***152***	***3.8***	***0.2***	***5.1***	***1.2***	***1.0***	***620.8***	***19.6***	***11.7%***

Source: Companies, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E	FY20E
Net sales	**8,095**	**9,110**	**10,040**	**11,187**	**12,469**
Growth, %	33.8	12.5	10.2	11.4	11.5
Employee expenses	-3,913	-4,633	-5,093	-5,638	-6,190
Other Operating expenses	-4,466	-4,753	-4,191	-4,643	-5,175
EBITDA (Core)	**-283**	**-276**	**756**	**906**	**1,105**
Growth, %	(66.4)	(2.7)	(374.5)	19.8	21.9
Margin, %	(3.5)	(3.0)	7.5	8.1	8.9
Depreciation	-208	-241	-239	-264	-272
EBIT	**-491**	**-517**	**517**	**642**	**833**
Growth, %	(52.4)	5.3	(200.0)	24.1	29.7
Margin, %	(6.1)	(5.7)	5.2	5.7	6.7
Interest paid	-12	-113	-152	-131	-131
Other Income	198	365	162	180	189
Pre-tax profit	**-290**	**-239**	**527**	**690**	**891**
Tax provided	91	-28	-161	-192	-252
Profit after tax	**-200**	**-267**	**366**	**499**	**638**
Others (Minorities)	33	62	-68	-51	-50
Net Profit	**-166**	**-205**	**299**	**447**	**589**
Growth, %	(80.0)	23.3	(245.8)	49.8	31.6
Net Profit (adjusted)	**(166)**	**(205)**	**299**	**447**	**589**
Wtd avg shares (m)	101	101	125	125	125

	FY16	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**124**	**136**	**155**	**172**	**192**
Growth, %	24.5	10.0	13.7	11.2	11.5
Re / US$ (rate)	65.4	66.9	64.9	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E	FY20E
Cash & bank	539	1,161	2,579	2,774	3,026
Marketable securities	301	371	371	371	371
Debtors	1,511	2,048	2,152	2,239	2,389
Inventory	0	0	0	0	0
Other current assets	3,037	2,748	2,927	3,038	3,280
Total current assets	5,619	6,473	8,201	8,614	9,279
Investments	422	222	222	222	222
Net fixed assets	3,240	4,161	4,461	4,861	5,181
Non-current assets	720	874	918	960	998
Total assets	**10,125**	**11,842**	**13,915**	**14,769**	**15,792**
Total current liabilities	4,011	5,295	5,229	5,636	6,071
Non-current liabilities	1	564	414	414	414
Total liabilities	4,012	5,859	5,643	6,050	6,484
Paid-up capital	504	509	624	624	624
Reserves & surplus	5,609	5,475	7,647	8,095	8,684
Minorities	0	0	0	0	0
Shareholders' equity	6,113	5,983	8,272	8,719	9,308
Total equity & liabilities	**10,125**	**11,842**	**13,915**	**14,769**	**15,792**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E	FY20E
Pre-tax profit	-290	-239	527	690	891
Depreciation	208	241	239	264	272
Chg in working capital	-769	968	-421	148	-17
Total tax paid	-84	-17	-161	-192	-252
Other operating activities	0	0	0	0	0
Cash flow from operating activities	**-935**	**953**	**185**	**911**	**893**
Capital expenditure	-779	-1,162	-539	-664	-592
Chg in investments	-142	200	0	0	0
Chg in marketable securities	1,213	-70	0	0	0
Other investing activities	0	0	0	0	0
Cash flow from investing activities	**292**	**-1,032**	**-539**	**-664**	**-592**
Free cash flow	-643	-79	-354	246	301
Equity raised/(repaid)	3	5	116	0	0
Debt raised/(repaid)	0	563	-150	0	0
Dividend (incl. tax)	0	0	0	0	0
Other financing activities	84	70	1,874	0	0
Cash flow from financing activities	**121**	**701**	**1,772**	**-51**	**-50**
Net chg in cash	-523	622	1,418	195	252

Valuation Ratios

	FY16	FY17	FY18E	FY19E	FY20E
Per Share data					
EPS (INR)	(1.6)	(2.0)	2.4	3.6	4.7
Growth, %	(80.1)	23.3	(217.7)	49.8	31.6
Book NAV/share (INR)	60.7	59.4	66.2	69.8	74.5
CFPS (INR)	(7.3)	(7.8)	2.9	6.2	5.9
DPS (INR)	-	-	-	-	-
Return ratios					
Return on assets (%)	(1.9)	(1.8)	3.6	4.0	4.7
Return on equity (%)	(2.7)	(3.4)	3.6	5.1	6.3
Return on capital employed (%)	(3.0)	(3.0)	5.8	6.3	7.3
Turnover ratios					
Asset turnover (x)	2.0	1.8	1.7	1.8	1.9
Sales/Total assets (x)	0.8	0.8	0.8	0.8	0.8
Sales/Net FA (x)	2.7	2.5	2.3	2.4	2.5
Working capital/Sales (x)	0.1	(0.0)	0.0	0.0	0.0
Receivable days	68.1	82.1	78.2	73.0	69.9
Liquidity ratios					
Current ratio (x)	1.5	1.3	1.7	1.6	1.6
Quick ratio (x)	1.5	1.3	1.7	1.6	1.6
Total debt/Equity (%)	3.7	38.8	22.7	21.5	20.1
Net debt/Equity (%)	(12.0)	15.7	(11.2)	(12.9)	(14.8)
Valuation					
PER (x)	(77.7)	(63.0)	53.5	35.7	27.1
PEG (x) - y-o-y growth	1.0	(2.7)	(0.2)	0.7	0.9
Price/Book (x)	2.1	2.2	1.9	1.8	1.7
EV/Net sales (x)	1.5	1.5	1.5	1.3	1.2
EV/EBITDA (x)	(43.4)	(49.7)	19.7	16.2	13.1
EV/EBIT (x)	(25.0)	(26.5)	28.8	22.9	17.4

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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