

IT Services

Engineering R&D: The Desert Rose

INDIA | IT SERVICES | Sector Update

1 June 2017

ERD: Mammoth opportunity for Indian IT companies

Engineering research and development (ERD) has emerged as the next-gen domain for the Indian IT industry. In this domain, Indian IT companies have seen robust growth over the last five years (15% CAGR). More importantly, the quality of work being outsourced to these companies has evolved significantly — to innovation and development-driven high-end projects from cost-arbitrage-driven low-end tasks. Having extensively tapped BFSI and manufacturing across the US and Europe through a wide palette of service lines such as ADM, IMS, and BPO, Indian IT companies are now looking at the huge potential in ERD.

In CY15, global ERD spend grew by ~3% to US\$ 1.5tn. However, the engineering services outsourcing (ESO) market stands at US\$ 80bn – only 6% of the total global ERD spend. Of this, China has the largest share (25%), driven by its manufacturing industry. India comes a close second at 24%, driven primarily by its captives (55%) and third-party outsourcers (45%). We expect an uptick in the ESO market – driven by global competition, reducing time-to-market for products, and cost pressures faced by engineering companies – which should lead to strong growth for Indian ESO players.

Changing trends in the ERD space augur well for Indian IT companies

Historically, most global engineering companies have been reluctant to outsource their R&D – because of obvious concerns of intellectual property theft and perception of inferior capabilities of the Indian companies. However, over the last two decades, ERD outsourcing deals have grown significantly with new client joining the bandwagon and existing clients outsourcing larger and more strategic shares of their ERD work.

Indian IT services companies are now able to contribute more to the client than just being a relatively inexpensive alternative. What works in their favour is the abundant pool of engineers, which the country produces every year. ERD, being a highly technical domain, requires engineers trained on specific CAD/CAM platforms, whereas most traditional IT services contracts employ IT graduates.

HCL Tech the leader in this segment; Cyient and LTTS expanding their bases

HCL is the leading Indian IT company in the ERD space, with revenues of US\$1.3bn from the segment. It has done remarkably well, snatching first-mover advantage in this domain from TCS (US\$857mn) and Wipro (US\$545mn). It has developed deep domain expertise in aviation and electronics, and recently acquired Geometric Ltd and Butler America Ltd, to strengthen its offerings in the ERD domain.

In the midcap IT ERD space, LTTS and Cyient are the leading players. While LTTS derives 100% of its revenues (US\$484mn) from ERD, Cyient derives 62% of its revenues (US\$334mn) from ERD. Both have distinct competencies in different verticals – Cyient is well placed in aerospace and transport, while LTTS has core expertise in automotive, industrial products, and process design. Both have a long-standing relationship with marquee clients, and are expanding their presence in other domains.

Outlook and valuation

In the wake of shrinking deal sizes in the traditional IT services domain and cannibalisation of revenues by new-age digital platforms, we expect ERD to provide some respite to Indian IT services companies. Companies with large ERD practice (like HCLT, LTTS and Cyient) will be able to significantly mitigate the impact of a slowdown in other service lines.

Currently, LTTS (13x FY19E P/E) and Cyient (11x FY19E P/E) are trading in line with the IT midcap average. We believe these companies deserve a higher multiple than their 'traditional' IT services peers. We initiate coverage on LTTS with a target of Rs 850 (@ 15x FY19E P/E) and Cyient with target of Rs 570 (@ 13x FY19E P/E). We recommend investors BUY these two stocks over traditional IT services companies.

Companies

LTTS

Reco	BUY
CMP, Rs	735
Target Price, Rs	850

CYIENT

Reco	BUY
CMP, Rs	495
Target Price, Rs	570

Vibhor Singhal (+ 9122 6246 4109)
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Engineering Research & Design (ERD)

Engineering research and development (ERD) has emerged as the next-gen domain for the Indian IT industry. In this domain, Indian IT companies have seen robust growth over the last five years (15% CAGR); more importantly, the quality of the work being outsourced to the Indian companies has evolved significantly—to innovation and development-driven high-end projects from cost-arbitrage-driven low-end tasks. Having extensively tapped BFSI and manufacturing across US and Europe through the wide palette of service lines such as ADM, IMS, and BPO, Indian IT companies are now looking at the huge potential in the ERD domain.

Engineering Research & Development – as the name suggests, involves research and development in various engineering domains. The segment is primarily related to sectors that involve high-end engineering capabilities such as automotive, aerospace, telecom, electronics, and medical devices. Companies in these sectors spend huge amounts of resources to continuously develop new products or product enhancements.

Breaking down global ERD

In CY15, global ERD spend grew by ~3% to US\$ 1.5tn. Automotive and consumer electronics sectors accounted for over 25% of this spend — automotive driven by safety and emission-efficiency requirements and consumer electronics by increasing demand for new products/interfaces. US and Europe continued to account for over 2/3rd of this spend, with Asia (excluding Japan) constituting 14% and growing fast.

By sectors: Automotive, aerospace, electronics, medical devices to see continued high levels of investment in engineering R&D. Key drivers of this spend:

- **Automotive:** Regulatory compliance, green energy, enhanced customer experience, energy efficiency, higher electronics content.
- **Aerospace:** Innovation in product design, green energy.
- **Medical devices:** Regulatory compliance, innovation in product design, enhanced customer experience.
- **Consumer electronics:** Innovation in product design, enhanced customer experience, digitisation.

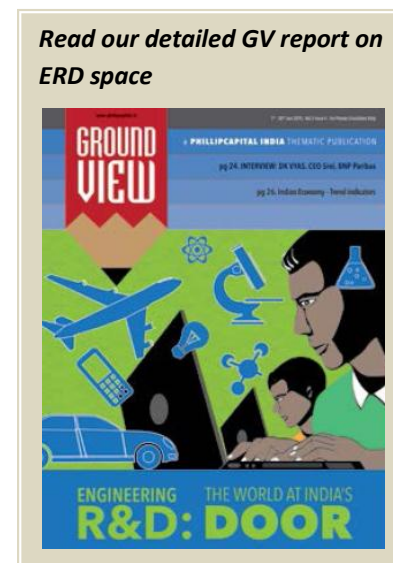
Regions: The US continues to spearhead global investment in ERD, accounting for over 35% of global spend, followed by Europe, Japan, and China.

Companies: In FY16, Volkswagen stood out as the highest spender on R&D at US\$ 13.2bn. Samsung, Amazon, Alphabet and Intel fill up the remaining spots in the top-5. Among the top-20 R&D spenders across the globe, five belonged to the automotive sector, seven were from healthcare, and three were from software & internet. Geographically, the US and Europe accounted for eighteen of the top-20 R&D spenders (thirteen and five respectively) while one company from Japan figured on the list. Focusing on ERD expenditure, the following companies claim the top-5 spots in their respective segments:

Top ERD spenders in different segments

Automotive	Aerospace	SW & Electronics	Medical Services	Core manufacturing
Volkswagen	Boeing	Amazon	J&J	Caterpillar
Toyota	EADS	Alphabet	GE	Cummins
GM	Lockheed Martin	Intel	Medtronic	Komatsu
Ford	General Dynamics	Microsoft	Siemens	Mitsubishi
Daimler	Dassault Aviation	Apple	Baxter	ABB

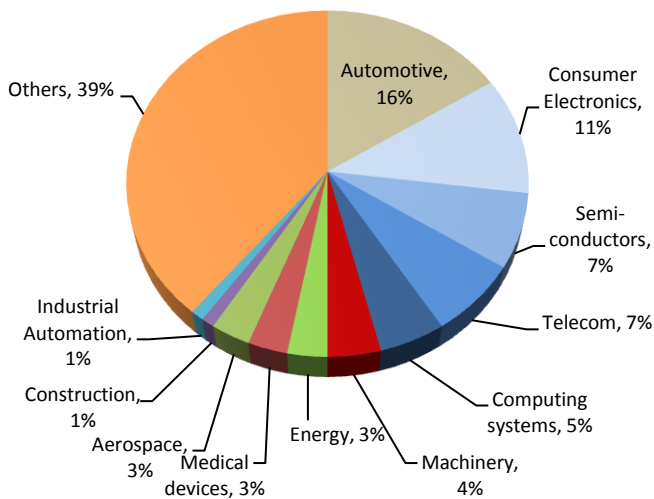
Source: PhillipCapital India Research



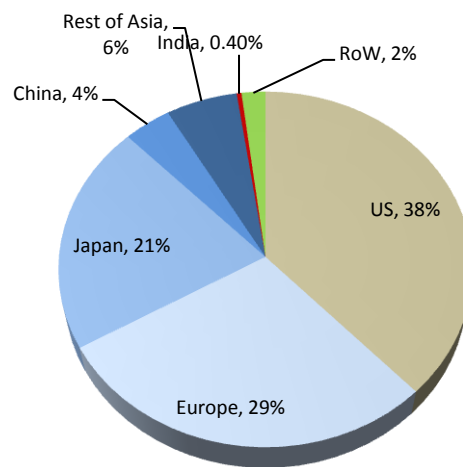
Top ERD spenders across the globe

Company	ERD spend (US\$ bn)	ERD spend as % of sales	Country	Sector
Volkswagen	13.2	2.5%	Germany	Automotive
Samsung	12.7	6.4%	South Korea	Computing and Electronics
Amazon	12.5	10.2%	US	SW & Internet
Alphabet	12.3	14.9%	US	SW & Internet
Intel	12.1	20.1%	US	Computing and Electronics
Microsoft	12.0	13.4%	US	SW & Internet
Roche	10.0	19.0%	Swiss	Healthcare
Novartis	9.5	16.8%	Swiss	Healthcare
J&J	9.0	11.0%	US	Healthcare
Toyota	8.8	3.5%	Japan	Automotive

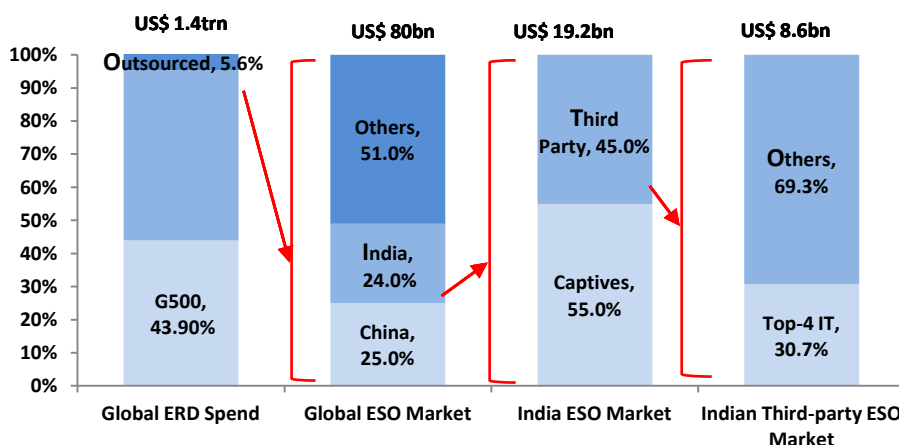
Source: PhillipCapital India Research

Global R&D spend – by industries


Source: Zinnov, PhillipCapital India Research

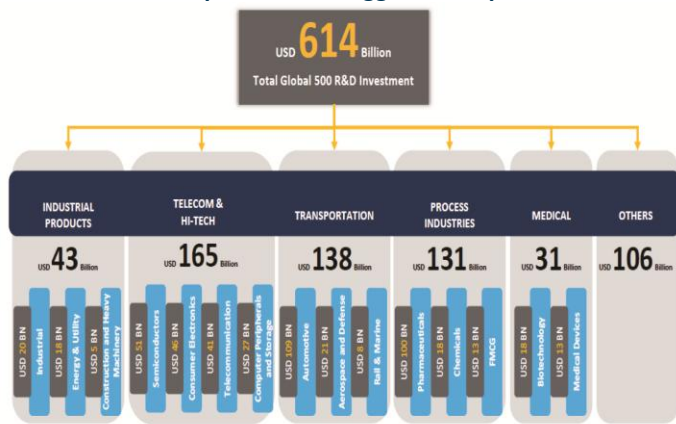
Global R&D spend – by geographies

ERD Outsourcing: Huge growth potential

Currently, the engineering services outsourcing (ESO) market stands at US\$ 80bn – only 6% of the total global ERD spend. Of this, China has the largest share (25%), driven by its manufacturing industry. India comes a close second at 24%, driven primarily by its captives (55%) and third-party outsourcers (45%). Of the third-party outsourcers, India’s top-4 IT companies have almost 30% market share.

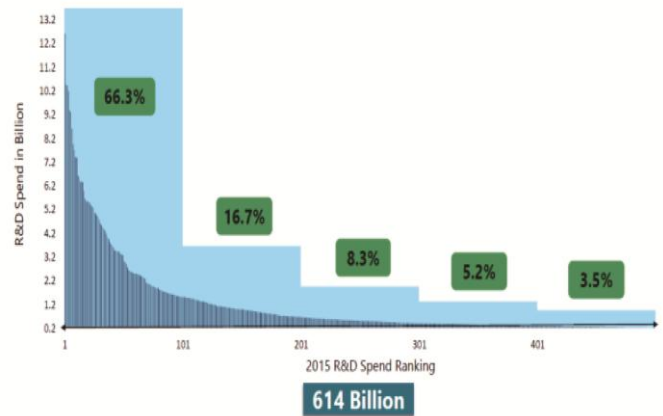
The global ERD-ESO market


Source: NASSCOM, Zinnov, PhillipCapital India Research

Telecom and Transport are the biggest ERD spenders

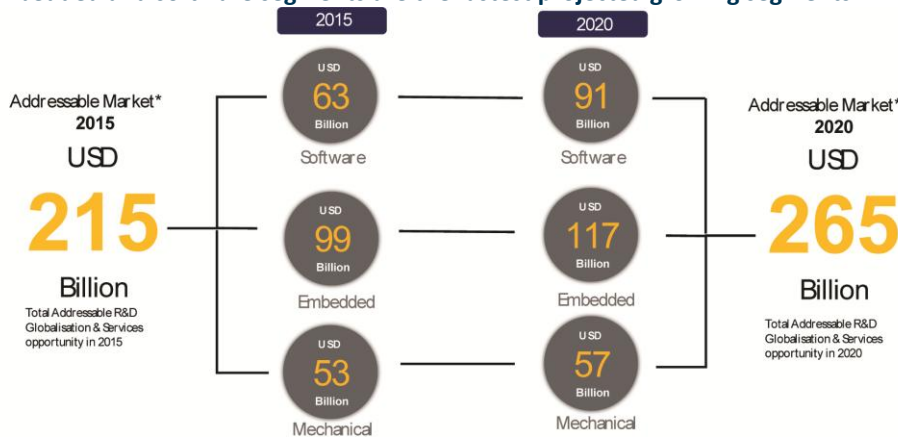


Contribution of G500 R&D spenders



Source: Zinnov research, PhillipCapital India Research

Embedded and software segments are the fastest projected growing segments



* Opportunity includes market for captives, Offshore R&D service providers and onshore R&D service providers
 Source: Zinnov research, PhillipCapital India Research

Evolution of ESO industry

Traditionally, R&D has been viewed as intellectual property and as a core activity. Outsourcing or partnering for R&D was considered a threat to the functioning of an organisation. However, lately, companies have been forced to consider outsourcing ERD due to the global competition, reducing time-to-market for products, and cost pressures. This shift has led to a significant change in the ERD services portfolio, with greater emphasis on product engineering and innovation compared to staff augmentation. The focus is not on products alone, but also on the ecosystem of services around the product, including its geo-specific variants and platforms.

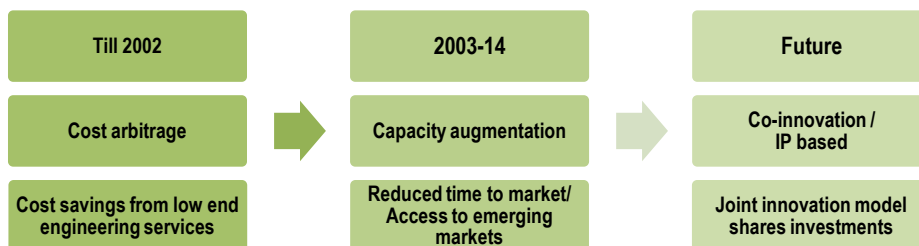
The evolution of the Indian ESO industry can be broken down into three phases defined by the nature of work and the changing outsourcing business model.

Generation 1, until 2002—cost arbitrage: The first stage of ESO was largely based on cost arbitrage. Original Equipment Manufacturers (OEMs) and Independent Software Vendors (ISVs) leveraged Engineering Service Providers (ESPs) for engineering support by using staff-augmentation models. ESPs were able to provide scale, whenever and wherever required, with abundant talent pool across the globe. Project execution was limited to basic activities such as scanning and digitising of engineering drawings to engineering change order management. Product engineering was considered to be a core and IP-centric activity and therefore beyond the realms of outsourcing.

Generation 2, 2003-2014—capacity augmentation: The second stage was the movement to capacity augmentation from pure cost arbitrage. The second stage can be broken down into two phases: (1) 2003- 2010 and (2) 2010-2014. In the first phase, growth in ESP was driven by customers’ need to reduce time-to-market, which the ESPs provided by use of relevant manpower and capacity augmentation. ESPs helped them to accelerate product development and provide need-based scale. The second phase was mainly to gain access to emerging markets, as these markets became important due to rising customer spends. However, project execution remained largely related to non-core product development and helping customise on-going designs for faster market launches. Partial product engineering was outsourced; but core R&D activity and IP-centric were still off limits for outsourcing.

Generation 3, The future - 2014 onwards: The third stage is largely driven by globalisation, reducing R&D spends, and product lifecycle pressures. Managements are focused on developing effective outsourcing strategies that drive significant improvement in global ERD operations. The ESO market has seen substantial growth and has evolved to encompass a broad range of new product development, value engineering, and product-support functions. The future growth of the ESO industry will be driven by product innovation capabilities and by how players collaborate with customers to share the risk-reward of R&D investments.

Evolution of the ESO industry



Source: PhillipCapital India Research

Levers for outsourcing R&D

There are four major motivations for outsourcing: Efficiency, market, resource, and technology.

- **Efficiency factors:** Outsourcing largely to improve efficiency in terms of cost and increase the management bandwidth to focus on core activities. With reducing budgets and R&D spends, companies are looking to expand their footprint in low-cost countries to leverage the cost differential in the engineering effort.
- **Market factors:** Increase in per-capita income in emerging markets has resulted in increasing consumer spends. Also, phased launches across the globe are no longer considered effective, as global/local competition can enter emerging markets quickly due to shortening product lifecycles. Outsourcing has helped customers improve access to global markets with an ability to address emerging and adjacent markets simultaneously. It can also help companies meet temporary product development needs, without imposing a long-term commitment.
- **Resource factors:** As the technological complexity of product engineering is increasing at a rapid pace, it is becoming increasingly difficult for ERD companies to get a flexible pool of engineers with the relevant capabilities and competencies. Outsourcing allows them to address technological and process innovations, when size and/or time constraints prevent them from establishing these capabilities in-house. Obtaining the necessary expertise and skills outside can help a company move ahead of its competitors.
- **Technology factors:** The world is becoming more connected, with consumers expecting seamless experience across devices with advanced features and

functionalities. OEMs and ISVs need to ensure that the product platform can integrate with an entire ecosystem of devices with different form factors, and can be consumed in different ways (touch, voice, video). All this has increased the importance of embedded software as a means to merge the device with the application to provide a seamless experience.

What can be outsourced?

ERD is currently in its early days of outsourcing (relatively) where customers are facing the same kind of questions that haunted those who chose to outsource functions such as CRM and ERP a while back. The key question is – which function to outsource, and which to retain in-house. It represents a classic dilemma for any industry, where the company tries to determine what its ‘core’ business functions are (critical to success, important to clients) and what are relatively ‘non-core’. Once the company is able to resolve this dilemma, it just needs to map the delivery capability of the vendor—which is a function of the vendor’s vertical expertise, global footprint, scale, and value proposition—and take a decision accordingly.

While the product development and lifecycles of various ERD verticals (aerospace, automotive, consumer electronics) differ significantly, functions that they can/cannot, or rather would/would not outsource are fairly similar.

Over the last two decades, ESO vendors have established strong credentials in product lifecycle management (production support, integration testing, and software design) by building/investing in vertical domain knowledge and technical competencies. Because of these enhanced capabilities, the range of functions that are strong candidates for outsourcing in the product development stage has expanded significantly.

ESO vendors have expanded their value analysis/value engineering (VA/VE) proposition across all verticals, especially in the last five years.

The outsourcing matrix



Source: ISG, PhillipCapital India Research

Building on the domain knowledge and technical expertise of the last two decades of work in the ERD space, these ESO vendors have expanded their value analysis/value engineering (VA/VE) proposition across all verticals, especially in the last five years.

They now offer full services for computer-aided engineering/computational fluid dynamics (CAE/CFD) analysis, full product development, prototype build and testing, and manufacturing support across nearly half the industry verticals. Customers are increasingly outsourcing domains such as applied research, system analysis, and algorithm-development.

However, outsourcing vendors still have a long way to go before they can hit the most lucrative target – getting their customers to outsource corporate technology planning. This domain would include R&D architecture and planning, IP management, and technology strategy. It is interesting that outsourcing growth in mechanical and hardware product development has been half of the outsourcing growth in electronics, software, and embedded software product development. The main reason is that manufacturing (broadly) requires far more specific expertise in industry, domain, and products than electronics/software. Because of this, the growth trajectory for outsourcing in the manufacturing vertical will always lag behind electronics and software.

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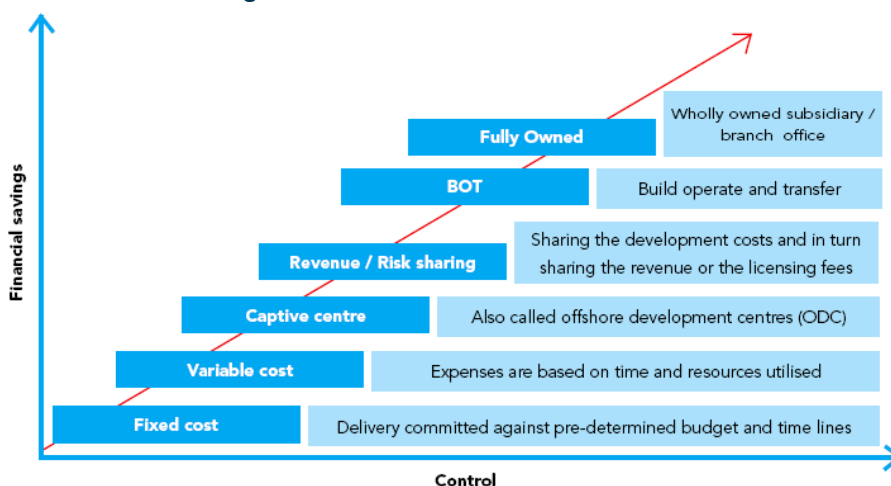
Models for outsourcing ERD

Typically, engineering services continue to be delivered primarily through hourly, daily, weekly, or monthly rates-based pricing models, staff augmentation relationships, or time and material (T&M) projects of various forms. These less-mature resource-based pricing models reflect the conservative nature of the client base, specifically, the lack of sourcing maturity within the engineering services community.

However, of late, buyers of engineering services are shifting towards more mature and advanced sourcing relationships that provide more predictable, stable, and higher quality of services and deliver the anticipated and contracted value to them. Chances of product success are higher if the service providers also have financial incentives to achieve business outcomes and hit target service levels and performance metrics.

Fixed cost outsourcing/subcontracting is one of the fastest methods and is best applicable for a short-term (project), when the outsourcing element is clearly a separate function – the two parties agree to a fixed cost that includes the vendor’s margins. The control of the project (budget, timelines, and quality) can be a challenge here. Also, IPR issues need to be considered. This model requires constant information sharing. Companies usually start with this model and graduate to other models over a period.

Models for outsourcing



Source: ISG, PhillipCapital India Research

Variable cost outsourcing is a contract where the work is paid by the actual working hours and resources used (the standard industry time-and-material format). Here the buyer gets a better picture of the actual costs and price levels than in the fixed cost model. Also, if the project is done in phases, the risks are generally lower, as it is possible to regularly follow the development of the work.

Captives: With IP being one of the biggest concerns in the ERD space, many companies are using captives to simultaneously preserve control and exploit the benefits of outsourcing. On a large or long-term operational level, captives provide lower costs than prices charged by vendors. Recently, captives have been rapidly expanding their engineering capacities in India. With the Indian government encouraging FDI in setting up R&D facilities (captive R&D centres) many multinationals have increased investments in R&D in projects.

According to an Infosys study, about 70% of companies that have set up captives in India have done so through wholly owned subsidiaries. More innovative models, which involve a financial or operational partnership (e.g., JVs) with established Indian entities, are not widely popular. Negligible numbers have been created on a Build-Operate-and-Transfer model.

Difference between ESO and other IT service lines

ERD is fundamentally completely different from other traditional service lines of IT services companies. While traditional service lines such as ADM, enterprise application, and IMS require little engineering background and training, ERD requires a high level of understanding of engineering concepts and principles. Also, the kind of training that is required for ERD service lines is completely different from other domains — traditional service lines require a ‘developer’ to be trained in various coding languages and platforms (C++, Java, .net) while ERD requires ‘engineers’ to be trained on various CAD/design platforms (CATIA, SolidWorks, Pro/E). The deliverables are also completely different for traditional service lines and ERD.

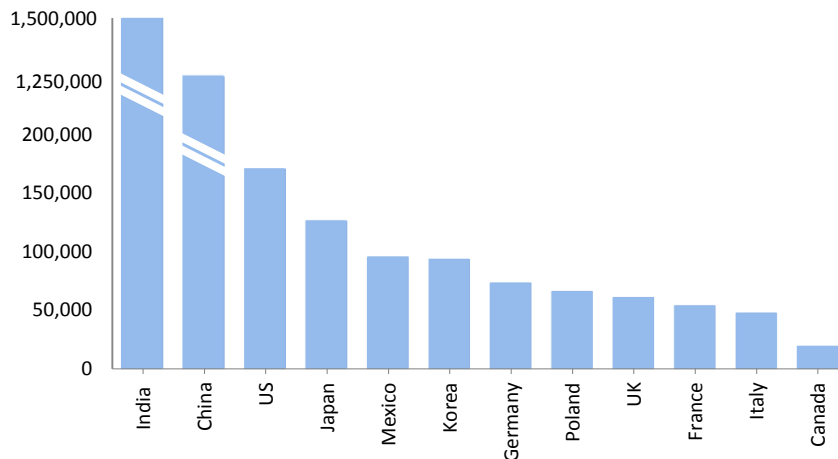
Poles apart – ERD and other traditional IT service lines

Parameter	Traditional service lines	Engineering research and design
Educational/technical qualification of the 'developer'	Software developers	Engineers—preferably mechanical/electrical
Training to be imparted to the 'developer' before induction	Various software platforms like Java, .net, C++	Various engineering design platforms like CATIA, SolidWorks, Pro/E
Nature of project deliverable	Customised software solution, with post-delivery maintenance	Parts of the Product Life-cycle Management (PLM), that can be integrated with various such deliverables from across the globe
Failure risk	Medium - Problems in the deliverable can be fixed in post-delivery maintenance period	High - Problems in deliverable can lead to faulty product design for the client; can lead to potential loss of client
Major verticals	BFSI, manufacturing, telecom - across the spectrum	Manufacturing - auto, aerospace, consumer electronics; healthcare - medical devices
Project duration	Medium to long: varying from 2- 7 years (for IMS)	Short: Less than 12-18 months

Source: PhillipCapital India Research

Indian IT companies: The supply advantage

While the complexity of the ERD vertical is a challenge for Indian IT companies, it also offers a much bigger and lucrative opportunity. The segment requires engineers (with a high level of understating of the various domains) to be trained on various design platforms – this places Indian IT companies on a superior pedestal vs. global competitors, primarily because of India’s mammoth pool of engineers.

India accounts for the largest pool of engineers graduating every year


Source: OECD, AICTE, PhillipCapital India Research

India churns out about 1.5mn engineers every year, from around 6,000 engineering colleges spread across the country. This is, by far, the highest pool of engineers that any country possesses; China comes second at 1.25mn and the US is a distant third at 170,000. Indian IT companies are in an excellent position to leverage this huge pool of engineers to establish their presence in the ERD domain.

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Potential for Indian IT companies

Indian IT companies have an unprecedented opportunity to make ERD their forte over the next decade. The opportunity is driven by both demand- and supply-side factors. On the demand side, there is an increasing level of acceptance of the ESO model, driven by the need for companies to reduce cost, reduce time-to-market, and capture emerging-market opportunities. On the supply side, Indian companies have the world’s largest pool of engineers at their disposal, providing them a highly competitive and inimitable advantage. Indian companies can enhance their presence in the ERD domain on three fronts:

- **New clients:** Leveraging their performance with the existing client base in the ERD domain, Indian IT companies can tap new clients — companies that have not outsourced till date.
- **Cross-selling to existing clients:** Indian IT companies currently service companies that spend significantly on ERD, but have outsourced other IT operations (ADM, IMS). Cross-selling to these companies should be relatively easy.
- **Moving up the value chain for existing ERD clients:** In addition, companies can move up the value chain by engaging with their existing ERD customers on a more strategic level and capturing a larger share of their wallet.

Amongst the Indian IT companies, HCL Tech and TCS have a significant presence in the ERD domain and are the potential beneficiaries of increased outsourcing towards this domain. Amongst the smaller companies, LTTs, Cyient and Geometric Software’s businesses are inclined towards this domain and could be potential beneficiaries.

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Key ESOs in each vertical

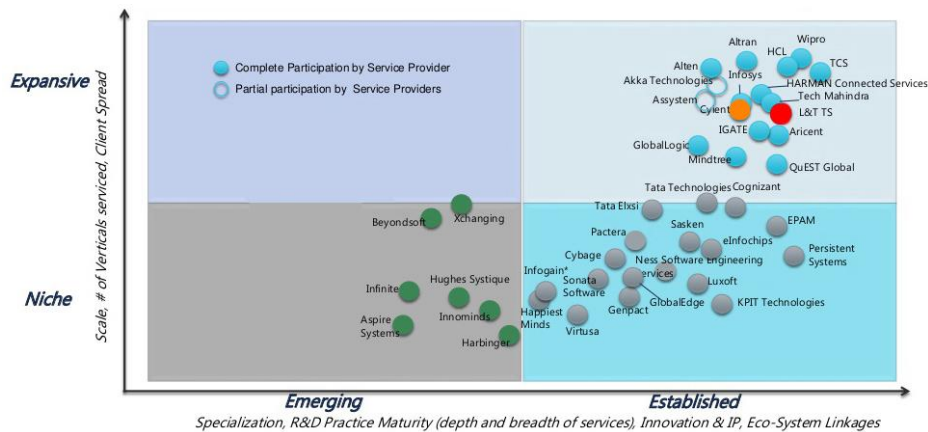
	Automotive	Aerospace	Energy & Utilities	Consumer Electronics
Captives	Bosch Daimler Ford	Airbus Honeywell	Shell Petrofac Schlumberger	Samsung LG Phillips
Third party	KPIT Infosys Tata Technologies	Cyient HCLT Tech Mahindra TCS	Wipro Quest Geometric Aker Solutions	TCS MindTree HCLT Tata Elxsi

Source: PhillipCapital India Research

Key strengths of the key companies

TCS	Infosys	HCLT	Wipro	Tech Mahindra
All sectors - Auto/Aero/Consumer Electronics	Overall weak presence - mainly Aerospace	Avionics	Medical devices	Product design
LTTs	Quest	Cap Gemini	IBM	Accenture
Industrial products	After sales - esp for aerospace	Technical Publication / Documentation	Process Consultation / PLM implementation	Process Consultation / PLM implementation

Source: PhillipCapital India Research

Competitive analysis of ERD companies - Zinnov


Source: LTTs, Zinnov, PhillipCapital India Research

HCLT closing in on the top ERD outsourcing companies in the world

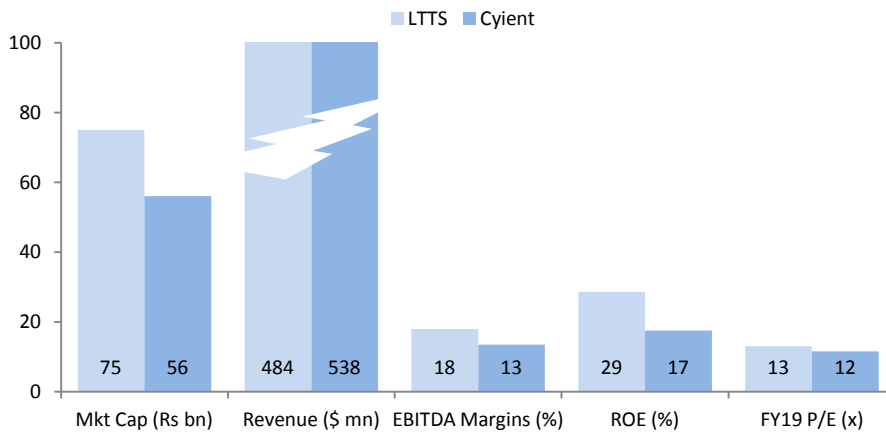
	Country	Market Cap (US\$ bn)	ERD Revenue (US\$ bn)
Altran Technologies	France	2.5	2.2
Alten SA	France	2.1	1.8
HCLT	India	18.7	1.3

Source: Companies, PhillipCapital India Research

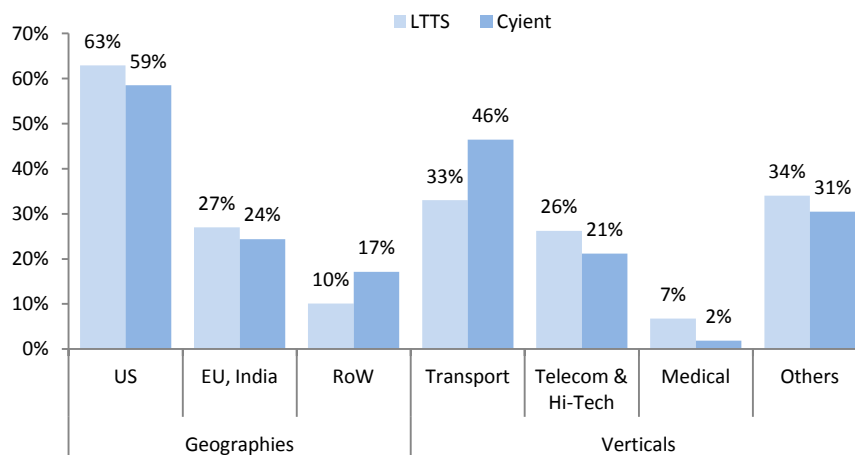
ERD outsourcing – the two fraternal twins

Amongst the listed IT mid-cap companies, LTTS and Cyient are the leaders in the ERD space and have very similar profile. LTTS derives 100% of its revenues from ERD vs. Cyient’s 62%. LTTS has expertise in automotive and industrial products while Cyient is strong in aerospace and railways. Cyient has slightly inferior margins (13% vs. 18% for LTTS) and ROEs (17% vs. 29% for LTTS) – but superior clientele (Boeing, P&W, Airbus, IBM).

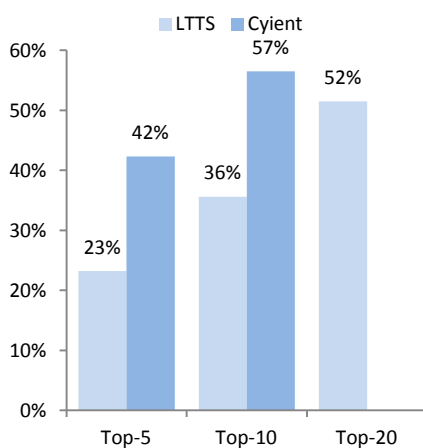
Financials and valuation comparison



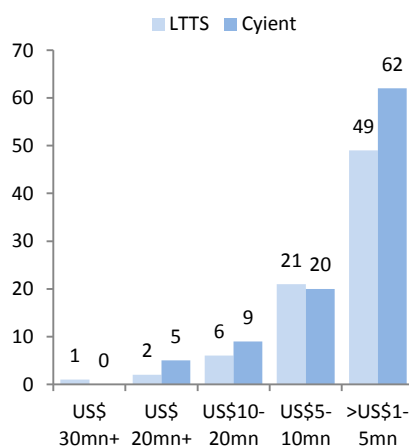
Comparison of revenue break-up – geography and vertical



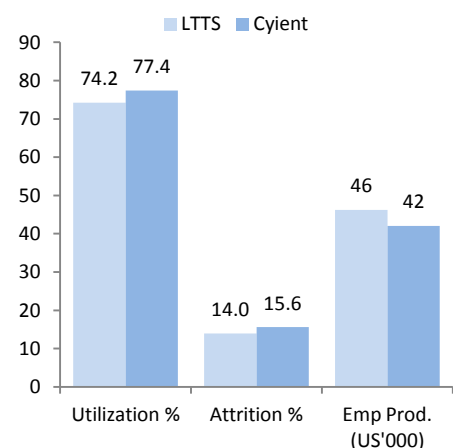
Top clients concentration



Number of clients



Employee metrics



Source: Company, PhillipCapital India Research

Companies Section

L&T Technology Services (LTTS IN)

Engineering is in the DNA

INDIA | IT SERVICES | Initiating Coverage

L&T Technology Services (LTTS) is a mid-cap IT company, focused on the engineering services segment. In FY17, its revenue was US\$ 484mn, with EBITDA margins of 18%. It provides research and design outsourcing services to engineering companies across the world. Its clientele includes marquee names like BMW, Caterpillar, John Deere, and Intel.

ERD – Huge growth potential: ERD has emerged as the next-gen domain for the Indian IT industry, within which Indian IT companies have seen robust growth over the last five years (15% CAGR). More importantly, the quality of the work being outsourced to the Indian companies has evolved significantly – to innovation and development- driven by high-end projects from cost-arbitrage driven low-end tasks. With only 5% of the global ERD spend currently outsourced, we see a huge opportunity over the next decade.

LTTS has a significant presence in the ERD space, and works with 44 of the top-100 global ERD spenders. It derives 33% and 26% of its revenues from transportation and industrials, with marquee clients like BMW, Caterpillar, John Deere, and Intel. It has a focussed strategy of ‘farming’ 30 existing customers, which can be scaled up to the US\$ 50mn category from current US\$ 10mn) and ‘hunting’ 90 other customers (including potential customers). It employs 10,400+ engineers, with revenue productivity of US\$ 50k – comparable with the IT services industry. Attrition remains moderate at 14% and utilisation at 76%.

Strong capabilities in niche domain – industrial products: LTTS is the leader in the industrial products segment (26% of revenue) mainly due to its rich heritage (parent L&T). In this segment, it is associated with some big clients such as Caterpillar, John Deere, Rockwell Automation, Danaher, and Eaton. It has technological alliances with Microsoft, Microchip, Texas Instruments, Renesas, National Instruments, OPC Foundation, Siemens PLM, and Dassault Systems. With its roots in engineering, LTTS possesses the required capabilities to service larger players in the industrials segment.

Competitive advantage in the process design space: Process design is a segment with very little presence of Indian/Global ESO companies. This domain involves complete/part design of plants for various chemical, FMCG and Petroleum companies. LTTS has a competitive advantage in this domain, and has been able to make inroads into many clients (Shell, Unilever, P&G) because of its parent company L&T. Process design business tends to be more sticky, as clients prefer to outsource incremental work to incumbent vendor, who has designed its existing plants, even if it is in a different geographic location. Currently, this segment is reeling under the pressure of lower incremental capex by the clients. But as capex in this segment picks up, LTTS should benefit immensely from the same.

Valuations attractive: We expect revenue CAGR of 12.5% over FY17-19E – highest in our coverage universe. The management is confident of growing in double digits in FY18E, and we believe it will be able to achieve this because of acceleration in top clients, strong growth across its target verticals – industrial products, automotive and hi-tech. We like LTTS’ portfolio as it is the only pure-play ERD player in the listed Indian IT space.

We expect the growth of Indian IT services companies to be under pressure over the next few years (*read our recent detailed reports [here](#) and [here](#)*). However, the ERD segment should buck this trend, and companies such as LTTS – which are not impacted by the current digital transformation cycle – will benefit. They deserve a higher multiple than traditional IT services companies – whose business is being rapidly cannibalised.

We value LTTS at 15x FY19E earnings – in line with Infosys and at a premium to large-cap peers. Our target multiple for LTTS is also at premium to Cyient (*which we value at 13x*) because 100% of LTTS’ revenues is being derived from ERD, as against 62% for Cyient. Our target of Rs 850 represents 16% upside. We initiate coverage with a BUY rating.

1 June 2017

BUY

CMP RS 735

TARGET RS 850 (+16%)

COMPANY DATA

O/S SHARES (MN) :	102
MARKET CAP (RSBN) :	75
MARKET CAP (USDBN) :	1.2
52 - WK HI/LO (RS) :	931 / 731
LIQUIDITY 3M (USDMN) :	0.7
PAR VALUE (RS) :	10

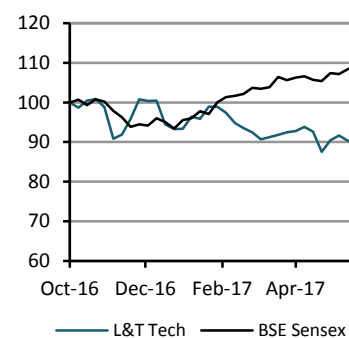
SHARE HOLDING PATTERN, %

	Mar 17	Dec 16	Sep 16
PROMOTERS :	89.8	89.8	89.8
FII / NRI :	3.5	3.6	3.5
FI / MF :	1.1	1.5	1.6
NON PRO :	0.3	0.1	0.4
PUBLIC & OTHERS :	5.4	4.9	4.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-0.2	-5.4	Na
REL TO BSE	-2.9	-11.8	na

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

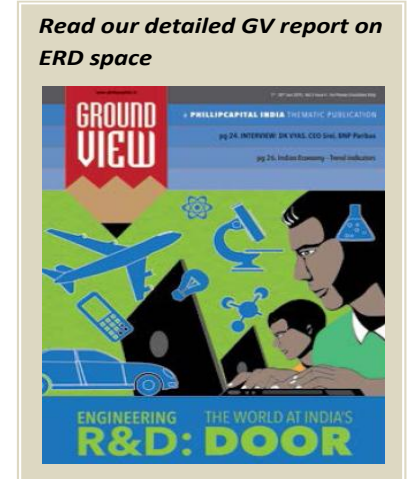
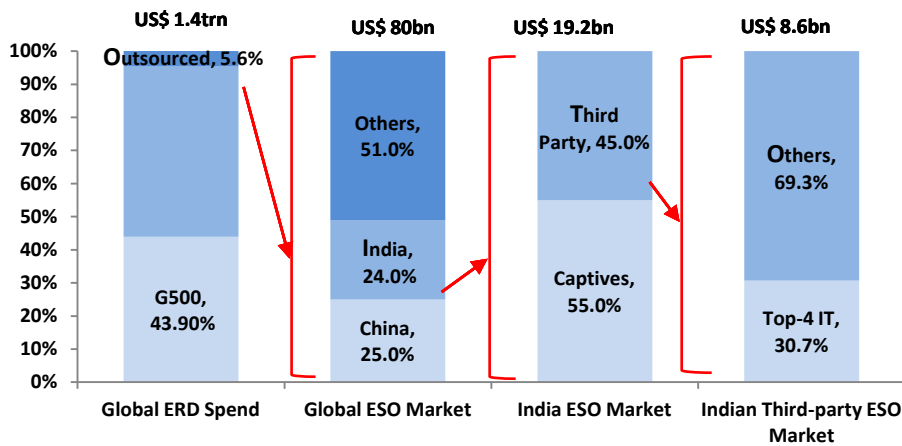
Rs mn	FY17	FY18E	FY19E
Net Sales	32,483	35,236	39,803
EBIDTA	5,847	6,520	7,576
Net Profit	4,250	4,858	5,729
EPS, Rs	41.8	47.8	56.3
PER, x	17.6	15.4	13.0
EV/EBIDTA, x	13.2	11.6	9.6
P/BV, x	5.0	4.0	3.2
ROE, %	28.6	25.9	24.3

Source: PhillipCapital India Research Est.

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sdhruve@phillipcapital.in

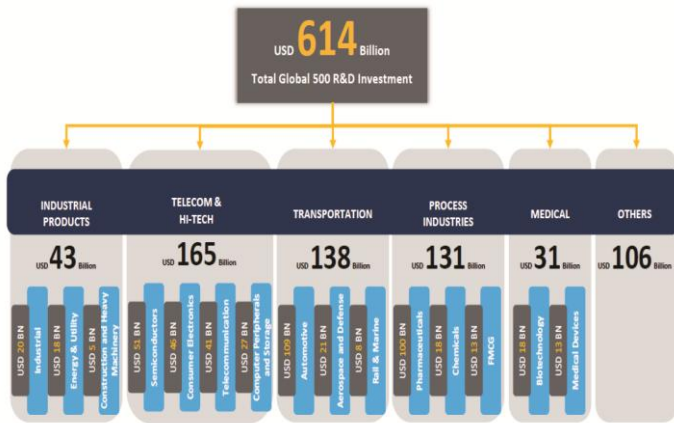
Vibhor Singhal (+ 9122 6246 4109)
vsinghal@phillipcapital.in

The global ERD-ESO market

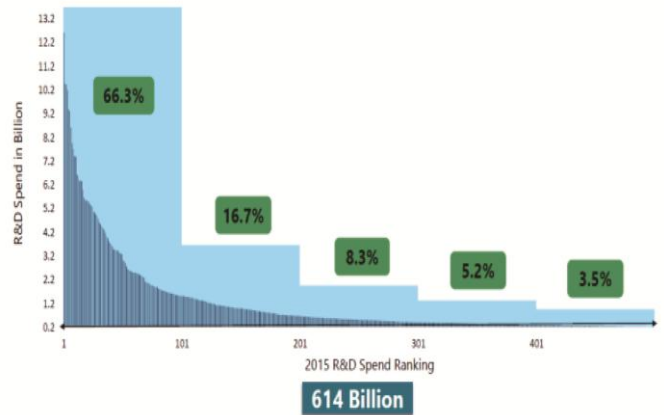


Source: NASSCOM, Zinnov, PhillipCapital India Research

Telecom and Transport are the biggest ERD spenders

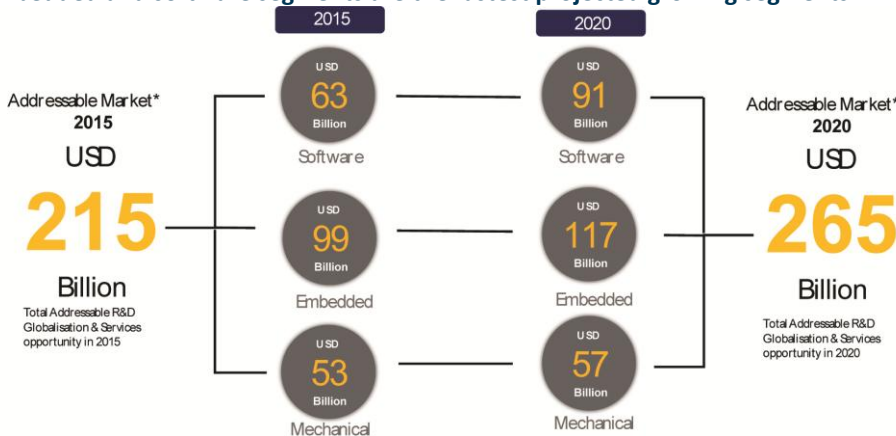


Contribution of G500 R&D spenders



Source: Zinnov research, PhillipCapital India Research

Embedded and software segments are the fastest projected growing segments



* Opportunity includes market for captives, Offshore R&D service providers and onshore R&D service providers

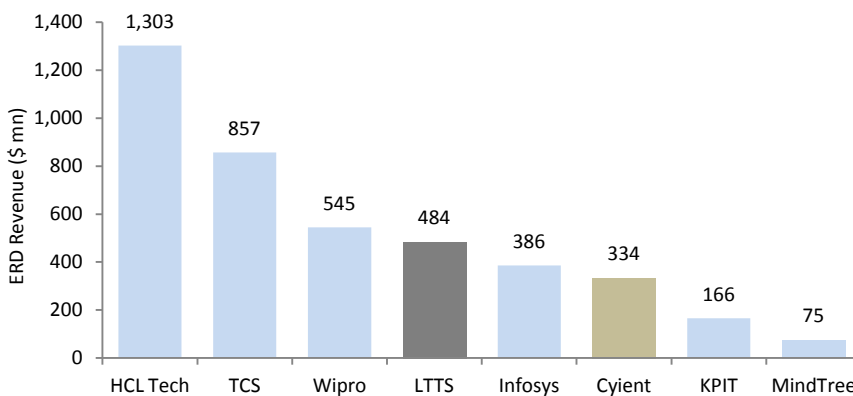
Source: Zinnov research, PhillipCapital India Research

Strong presence in ERD, with marquee clientele

LTTS has a significant presence in the ERD space and works with 44 of the top-100 global ERD spenders. In fact, it is the only pure-play ERD company in the Indian listed IT space. Its FY17 revenues were US\$ 484mn – of which 59% comes from Transportation and Industrial Products. It provides services to companies like BMW, Honda, Boeing, Airbus, Daimler, Thales, UTC etc. In FY17, it reported US\$ revenue growth of 3.4% - below industry growth of 7%. It reported EBIT margin of 16.1% in FY17 (15.0% in FY16).

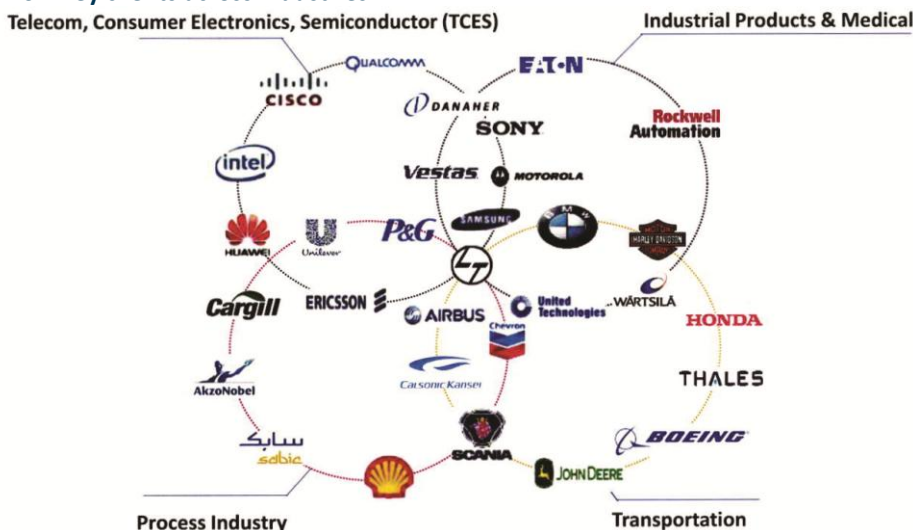
Incorporated in 2012, LTTS was formed by the merger of Product Engineering Services (PES – a wholly owned subsidiary of L&T Infotech), and Integrated Engineering Services (IES – a wholly owned subsidiary of L&T) in 2014, and is now majority owned by the L&T group (90%). It has 10,400+ employees spread across its 12 global delivery centres and 27 sales offices.

Indian IT – ERD revenue comparison (USD mn)



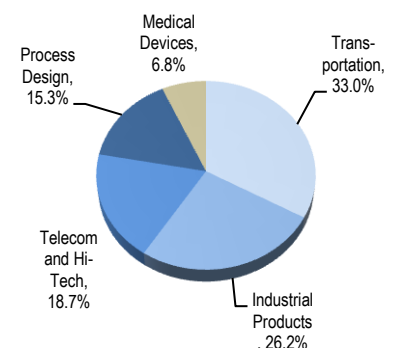
Source: Company, PhillipCapital India Research

LTTS – key clients across industries

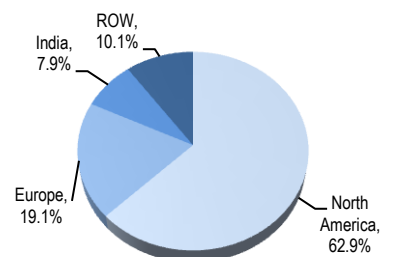


Source: Company, PhillipCapital India Research

LTTS revenue break-up – Industry wise



LTTS revenue break-up – Geography



Source: Company, PhillipCapital India Research

Transportation – the growth driver

Transportation is LTTS’ biggest revenue segment, and generates 34% of its total revenue. Under the transportation vertical, it provides services to the following sectors/segments:

- **Automotive:** ERD mechanical, embedded, and software engineering services – including areas of body control modules, automated driver assistance systems, telematics, and infotainment
- **Off-highway equipment:** New product development, value engineering, and M2M connectivity for excavators, harvesters, combines, and headers, planters, balers, backhoe loaders, and all-terrain vehicles
- **Aerospace:** Structural design, electrical and avionics systems
- **CV manufacturers:** Body design and product localisation. It offers its solutions through alliances with different partners.

Transportation is LTTS’ biggest revenue segment, and generates 34% of its total revenue

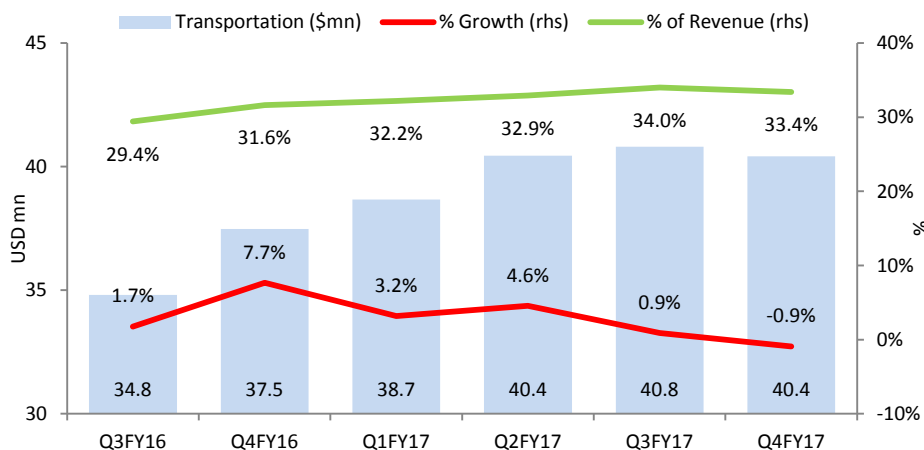
The company is associated with some marquee clients such as BMW, Calsonic Kansei, Scania, Harley Davidson, Honda, Boeing, Airbus, Thales, and Daimler.

LTTS transportation vertical: Alliances with different technology partners



Source: Company, PhillipCapital India Research

Transportation is the largest vertical for LTTS



Source: Company, PhillipCapital India Research

Automotive: In this segment, it works with three of the world’s top-10 auto manufacturers. Key trends shaping the auto industry are –

- **Stricter Regulations:** Emission and fuel economy regulations are getting tougher. As per PwC, in the US and Europe, by 2025, cars will need to have a fuel economy of 60 miles/gallon. Meeting these standards would entail significant improvements in internal combustion engine and powertrain.
- **Safety First:** The advent of autonomous vehicles has raised questions of safety. Countries in the US, Europe, and Japan have now made it mandatory for OEMs to deliver safer vehicles – equipped with advanced driver assistance systems like camera, radar, and Lidar – that help keep the driver alert.

LTTs management sees tremendous traction in this segment. The way Tesla has focused on fuel-efficient energy cars has changed the dynamics of the automotive industry. The core business of auto electronics, which was earlier handled by OEMs’ in-house, has now become non-core for them – resulting in outsourcing.

Aerospace: LTTs offers comprehensive engineering services (mechanical and avionic) to the aerospace industry, and defence OEMs and their suppliers. Its service offerings span the entire product life cycle – from concept design to reverse engineering, modelling and analysis, virtual testing, flight-control testing systems, prototyping, physical testing certification, support, and manufacturing. As per WSJ, commercial aircraft orders are likely to see a CAGR of 5% over the next 20 years. However, aerospace being a cyclical business, revenue growth profile remains lumpy, and is expected to remain the same.

Off-highway: Off-highway vertical provides new product design and development services to leading off-highway machinery manufacturers and their suppliers, and engineering solutions to off-highway equipment and tyre industry. This industry is going through a period of uneven growth. While the US domestic construction market is recovering, industrial segments such as mining and agriculture are seeing stress – driven by a sharp decline in crude oil prices and deceleration in China.

Railways: LTTs partners with global rail industry leaders, providing them with a wide range of end-to-end highly customised engineering solutions to meet requirements for innovations, reduced time-to-market, and cost-effective product development.

Use Cases:

- LTTs developed a turnkey Infotainment Digital Media Receiver including Mechanical, Embedded and Pre-Compliance Testing Support for a leading Tier-1 OEM.
- It developed a Column Friction Device (ASIL B ECU) for a leading North American Tier-1 OEM. The ECU was designed to monitor the steering wheel of a car continuously and take a decision when to lock or unlock the steering column.
- For a leading Japanese Tier-1, LTTs supported a 12” TFT instrument cluster. LTTs was responsible for complete software, HMI, Hardware Design, Validation and Pre-Compliance Test Support.
- LTTs worked as a partner in Hybrid Electric Vehicle Program for a large European OEM. It worked in the areas of software development for critical sub-systems, continuous integration, validation of e-Drive and battery management systems.

Industrial products – core domain expertise

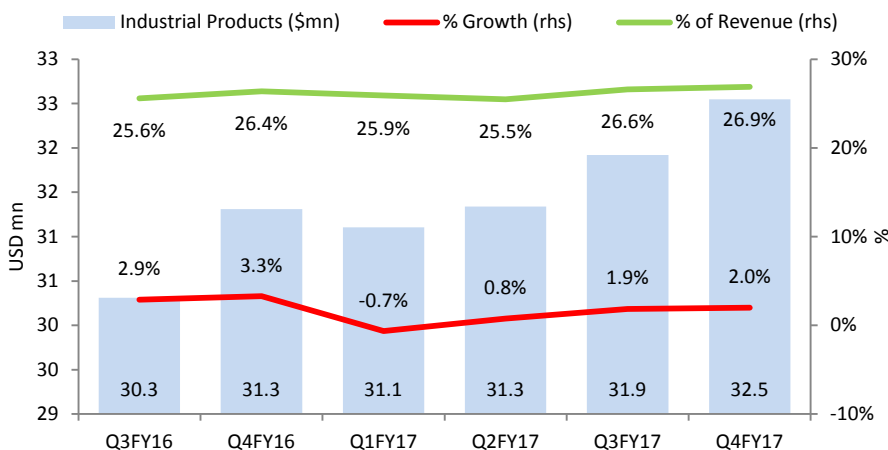
Industrial products is the second biggest revenue segment for LTTS at 26% of its total revenue. LTTS is the leader in this domain, mainly due to the rich heritage it has gained from its parent L&T. It has a presence in:

- **Power, electrical, drive, and utilities:** Focus areas include conventional and non-conventional power generation, transmission, distribution equipment, and utilities equipment.
- **Building automation:** Includes Building Energy Management Systems (iBEMS), lighting and accessories, heating, ventilation, and air conditioning (HVAC), safety, security and access control solutions, and elevators and escalators.
- **Home and office products:** Includes white goods such as kitchen appliances and office equipment.
- **Machinery:** Includes machines and equipment manufacturers in precision, processing, packaging, and power and tool machines.

Industrial products is the second biggest revenue segment for LTTS at 26% of its total revenue

In this segment, LTTS is associated with some big clients such as Caterpillar, John Deere, Rockwell Automation, Danaher, and Eaton. It has technological alliances with Microsoft, Microchip, Texas Instruments, Renesas, National Instruments, OPC Foundation, Siemens PLM and Dassault Systems. With its roots in engineering, it possesses capabilities to service larger players in industrials. This segment has historically performed well and is likely to grow faster than the company average due to its strong relationships with its existing clients.

LTTS is the leader in Industrial products – mainly due to rich heritage from L&T



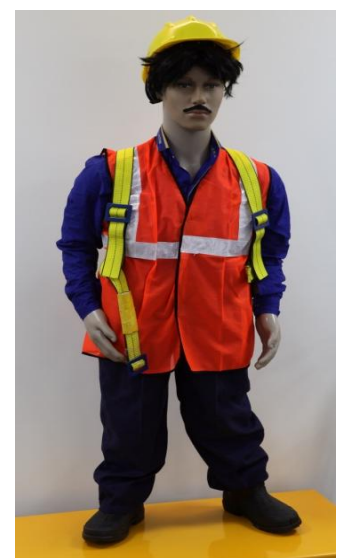
Source: Company, PhillipCapital India Research

Use Case: Connected Worker

For a leading construction client, LTTS designed end-to-end data transmission device on the workers (smart watches, ID cards), central data collection device, and worker productivity and safety analysis software, with long battery life support. It conceptualized the solution and developed sensor node modules, firmware, end-user application, administration and monitoring portal displaying integrated alert systems to supervisors for monitoring PPE. System integration was completed across the transmission devices, sensors, transmission to the cloud and collection devices.

Benefits for Customers

- Ensures compliance to global safety standards and eliminate undesirable workplace hazards
- Delivers total visibility into employee activities with robust safety monitoring system
- Cost-effective PPE monitoring solution, applicable across chemical, construction, mining and oil & gas industries

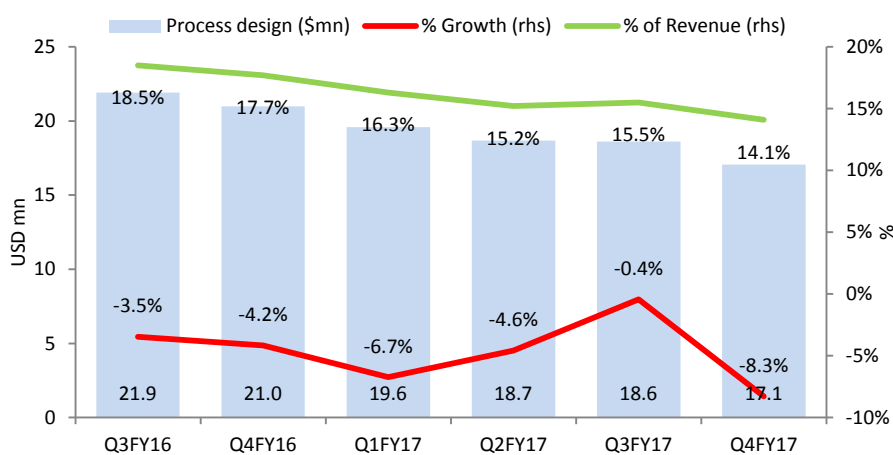


Process design – Competitive advantage

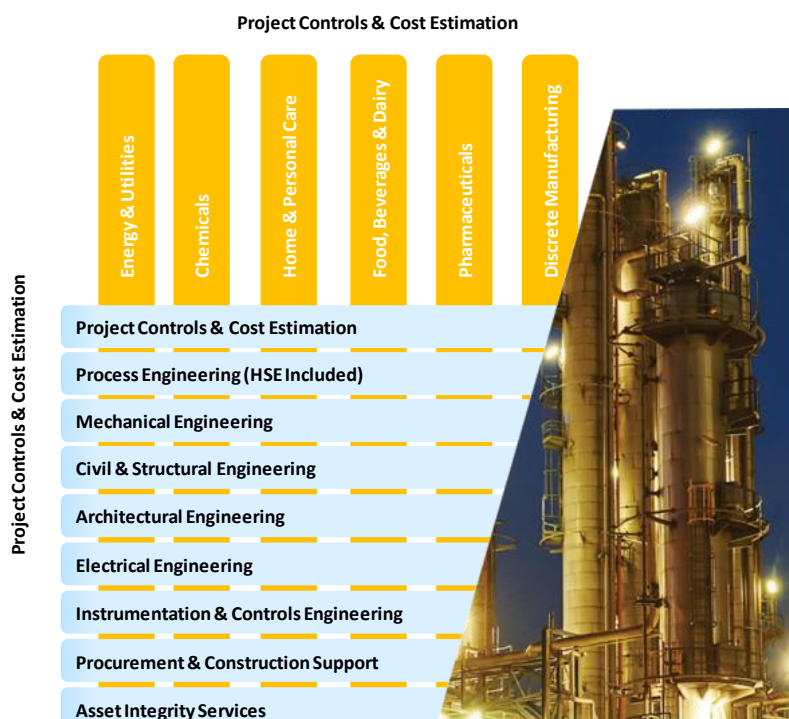
Process design generates 15% of its total revenue. In this segment, LTTS has a presence in:

- **FMCG:** It works with the world’s biggest FMCG/CPG companies in process design, basic and detailed design, development, refurbishment and support services, smart factory solutions, capex cost engineering, mechanical, civil, electrical engineering services for brownfield and greenfield manufacturing plants. This segment has reported muted growth in the last year due to stagnant capex. With an increase in capex, this segment should start growing again.
- **Speciality chemicals:** It provides services such as process design and development services, and basic and detailed design services – mainly for brownfield projects.
- **Oil and gas:** Works in asset optimisation, performance management, and sustenance services. Due to continued weakness in crude oil price, this segment saw a fall in FY17 revenues.

Process design recent performance was impacted by softness in crude oil prices



Industry vertical focus and Engineering capabilities



Source: Company, PhillipCapital India Research

WAGES (Water, Air, Gas, Electricity, Steam) Platform

With constant fluctuations in prices of commodities like coal, gas, and crude, companies are finding it difficult to maintain operational expenditure of their plants. To insulate themselves from changes in commodity prices, they explore different ways to minimise plant operating costs. With legacy systems as part of most companies’ core infrastructure, a natural starting point for them is to transition to smarter digital outfits, with advanced capabilities. WAGES solution (Water, Air, Gas, Electricity, Steam) developed by LTTS helps companies identify, audit, monitor, engineer, deploy, and meter wages. It includes measuring data on-site, conducting analysis, site auditing, producing assessment and reports, and consulting on potential energy-saving schema.

WAGES solution (Water, Air, Gas, Electricity, Steam) developed by LTTS helps companies identify, audit, monitor, engineer, deploy, and meter wages

Wages’ value proposition



Source: Company, PhillipCapital India Research

Use Cases of WAGES

LTTS completed the audit for 28 sites of a global manufacturing consumer packaged goods in four months. It identified potential opportunities for energy conversation worth US\$ 18mn for this client and aligned and cloud-hosted audit data at the enterprise level.

- For one of its industrial clients, LTTS evaluated and consulted on the energy consumption of a waste-heat recovery system, which resulted in reduced natural gas usage by 200 lb/hour and hot-water boiler requirements by half.
- For a beverage company, it designed and installed a zero liquid discharge facility across countries, reduced cost by 10%, and savings from design optimisation by 20%.

Process design is a segment with very little presence of Indian/Global ESO companies. This domain involves complete/part design of plants for various chemical, FMCG and Petroleum companies. LTTS has a competitive advantage in this domain, and has been able to make inroads into many clients (Shell, Unilever, P&G) because of its parent company L&T. Process design business tends to be more sticky, as clients prefer to outsource incremental work to incumbent vendor, who has designed its existing plants, even if it is in a different geographic location. Currently, this segment is reeling under the pressure of lower incremental capex by the clients. But as capex in this segment picks up, LTTS should benefit immensely from the same.

Telecom (lacklustre) and Hi-tech (bright spot)

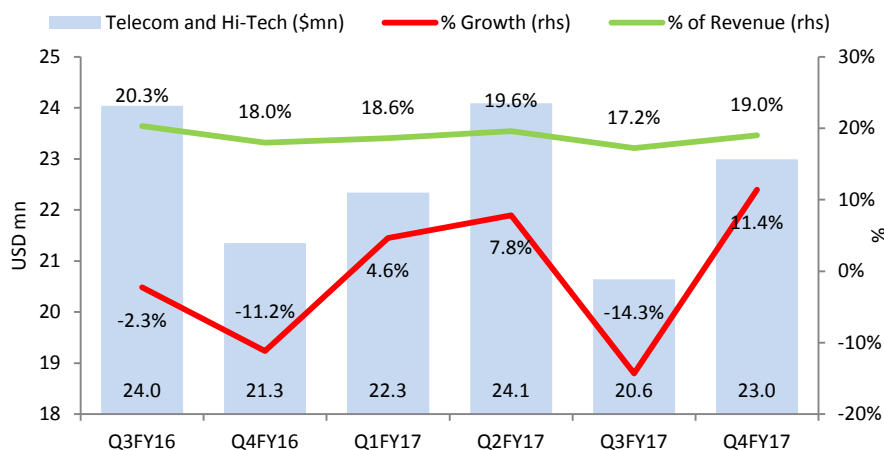
Telecom generates 18% of the total revenue. LTTTS has a presence in:

- **Telecom:** Works with network equipment manufacturers across the product-development lifecycle, including development of protocol stacks and network management systems along with maintenance and support.
- **Consumer Electronics:** Works with mobile device and tablet manufacturers, set-top box, and gateway manufacturers, and smart home and wearable-device manufacturers.
- **Semiconductors:** Works areas of application-specific integrated circuit (ASIC) design and verification, embedded software for chip and related validation services, reference board design, and radio-frequency (RF) design.

With the presence of almost all Indian IT companies apart from the global competitors, telecom remains highly competitive. With consolidation in the industry, LTTTS does not see major growth in its telecom domain. It expects growth to come from only the hi-tech segment. LTTTS' performance in telecom was affected in FY16, as it lost one of its biggest clients (annual run-rate from this client dropped to US\$ 4-5mn from US\$ 15mn a year earlier).

With consolidation in the industry, LTTTS does not see major growth in its telecom domain

Telecom has remained lumpy – due to the high competitive intensity



Source: Company, PhillipCapital India Research

Use Cases:

- **Created world's first dual-screen Smartphone:** Recognized as the hottest mobile devices in CES 2014. One-of-a-kind android phone with e-ink reader - L&T Technology Services was involved in complete software development, platform software design, development, and testing for the android phone.
- **Developed a Next-Gen STB with Multi-Tuner Support:** The next-gen cable STB with 8 Tuners and UI applications like EPG, DVR, RDVR, MR-DVR, PPV, SDN, VoD along with integration with 3rd party apps. Used Agile/Scrum based approach with predominant offshore implementation (>85%).
- **Provided support activities for a leading OEMs TD-LTE eNodeB:** Significant reduction in the turnaround time and 85% CQs resolved during transition across multiple modules.

Muted FY17; FY18 to report double-digit growth....

LTTS' FY17 revenue growth was impacted by a 15% decline in the process design. The decline was largely driven by delays in capex by its top clients in the US due to political uncertainties from elections and delay in decision making in telecom and hi-tech. Also, its strategy of "T30:A30" – where the company is focusing on prioritising its top-30 clients (which contribute 65% of the total revenue) that are in the range of US\$ 5-30mn and are scalable to US\$50mn over the next few years – resulted in muted performance from non-top-30 customers in FY17.

However, with (1) focus on T30 customers, (2) marquee client base, and (3) strong deal wins in FY17, it expects to report double-digit organic revenue growth for FY18 driven by:

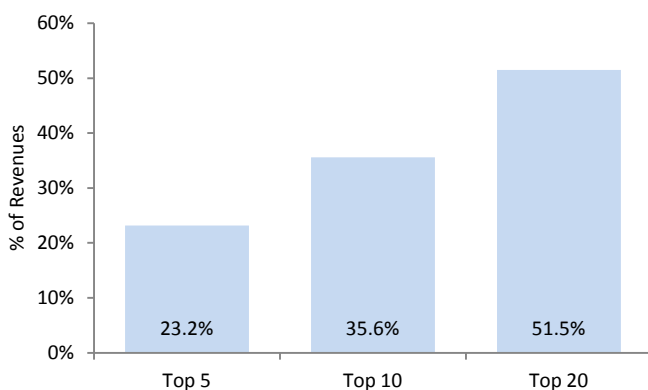
- **Transportation:** LTTS sees tremendous traction in this segment. OEMs are now treating auto electronics as non-core and outsourcing this activity.
- **Industrial products:** This segment has historically performed well and is likely to grow faster than company average due to its strong relationships with clients.

We believe its telecom segment is likely to remain weak due to higher competition as almost all Indian peers are present, while weakness in medical will be because it has not yet opened for outsourcing as estimated.

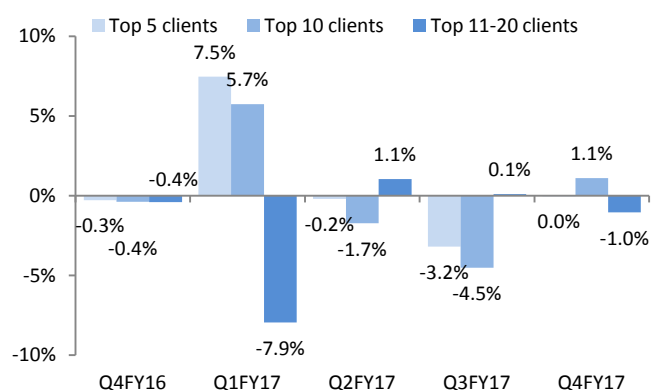
.... driven by marquee clients

Since its inception, LTTS has worked with G500 companies for R&D. Its clients include BMW, Intel, Caterpillar, P&G, Shell, John Deere, Rockwell Automation, UTC, Eaton, Danaher, Scania, and Calsonic Kansei. It works with 44 of top 100 global ERD spenders.

LTTS – Client concentration



LTTS – Top clients growth



Source: Company, PhillipCapital India Research

Focused acquisition strategy

LTTS has followed focused acquisition strategy for growth. Rather than just buying out revenues, it has made few but meaningful acquisitions in the last few years. In May 2017, it acquired US-based Esencia Technologies Inc, a provider of design services in Digital Signal Processing for Communications, Video Security, and Networking. This acquisition will help it enhance its delivery capabilities in Perceptual Computing, IoT, Advanced Silicon Products, and Wireless Networking Technologies.

LTTS – Acquisition history

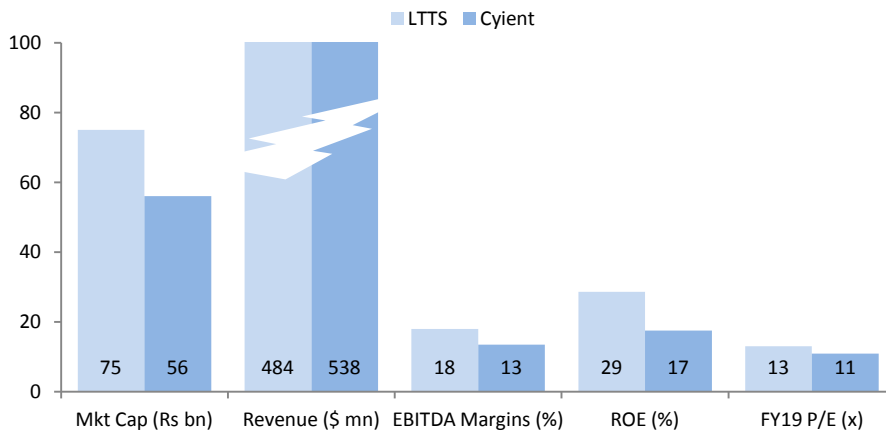
Time	Company	Remarks	Consideration
Jun '14	Thales Software India Pvt Ltd	74% of stake	Rs 60.4mn
July '14	Dell India	Engineering Services Division	Rs 13.6mn
Nov '14	Dell USA	Engineering Services Division	\$12.2mn
May '17	Esencia Technologies (US)	Embedded Systems and Perceptual Computing	NA

Source: Company, PhillipCapital India Research

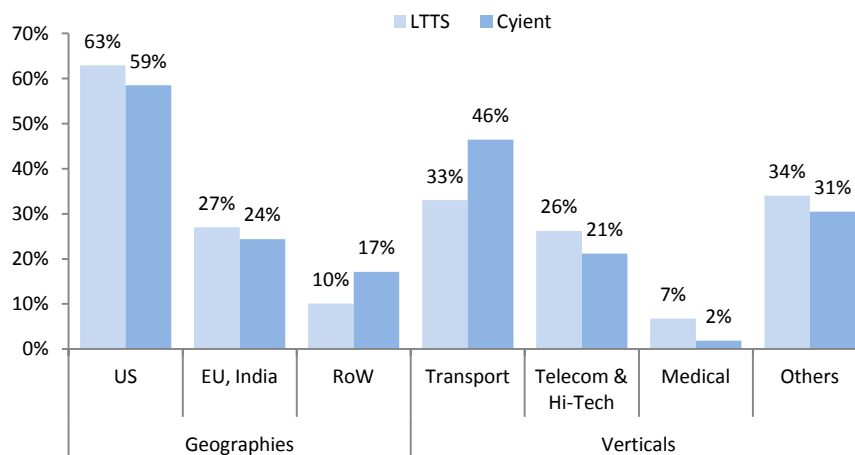
ERD outsourcing – comparison with Cyient

Amongst the listed IT mid-cap companies, Cyient and LTTS are the leaders in the ERD space and have very similar profile. Cyient derives 62% of its revenues from ERD vs. LTTS' 100%. Cyient is strong in aerospace and railways, while LTTS has expertise in automotive and industrial products. Cyient has slightly inferior margins (13% vs. 18% for LTTS) and ROEs (17% vs. 29% for LTTS) – but superior clientele (Boeing, P&W, Airbus, IBM).

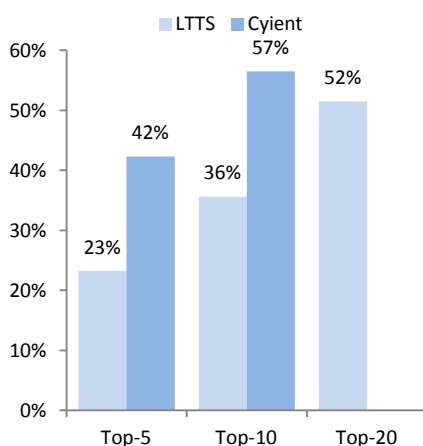
Financials and valuation comparison



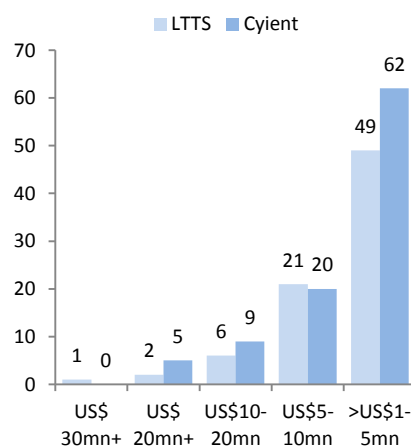
Comparison of revenue break-up – geographies and verticals



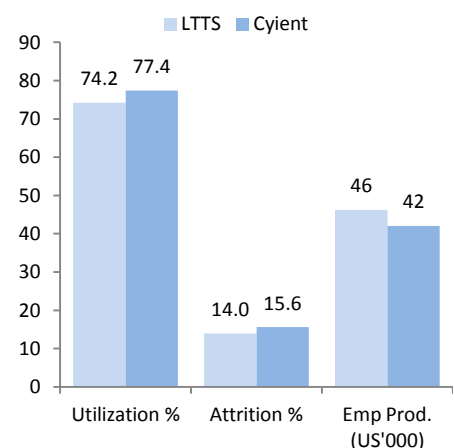
Top clients concentration



Number of clients



Employee metrics

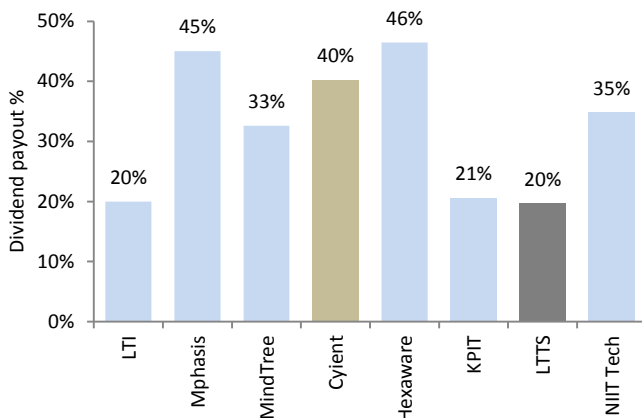


Source: Company, PhillipCapital India Research

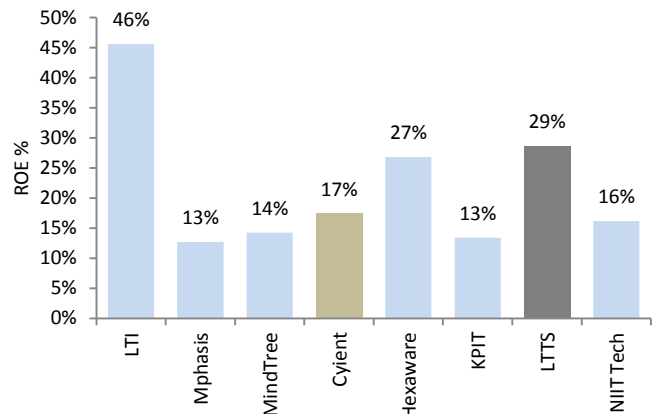
Metrics as good as any mid-cap IT company

LTTS had followed a high dividend payout policy of 80%+ over the last two years. This had resulted in ROEs of 38% – much superior to midcap and even large cap IT services companies. We note that only Hexaware and LTI (same group company) come close to LTTS’ high RoE driven by their parent company. However, after the listing, the company has changed its dividend policy to pay 20% of its net profit as dividend – resulting in lower RoE. On employee metrics such as utilisation (74.2%), attrition (14.0%), and employee productivity (US\$ 46k per head) – LTTS is broadly in line with the industry and the midcap average.

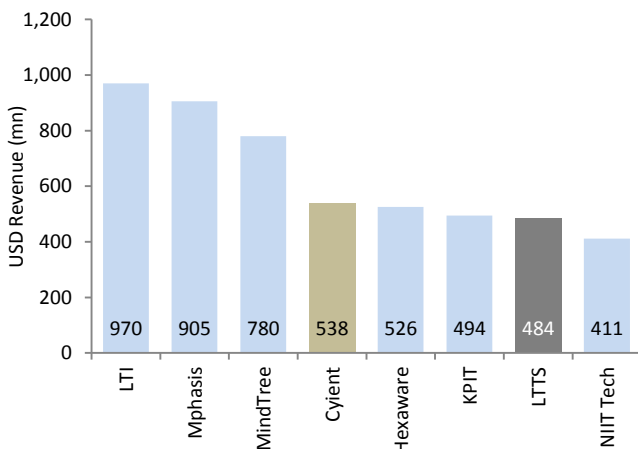
Dividend pay-out lowered after the IPO



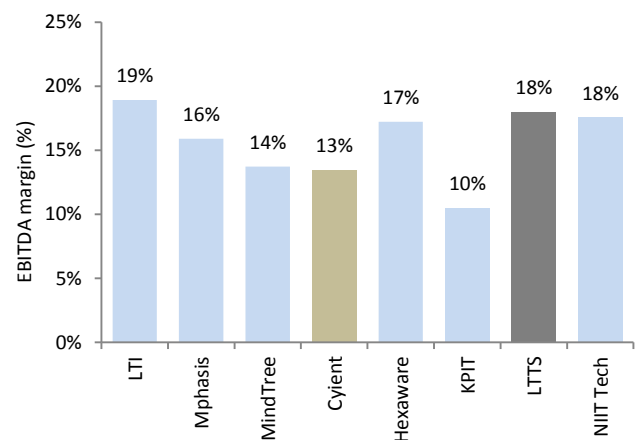
RoE among the best in the industry



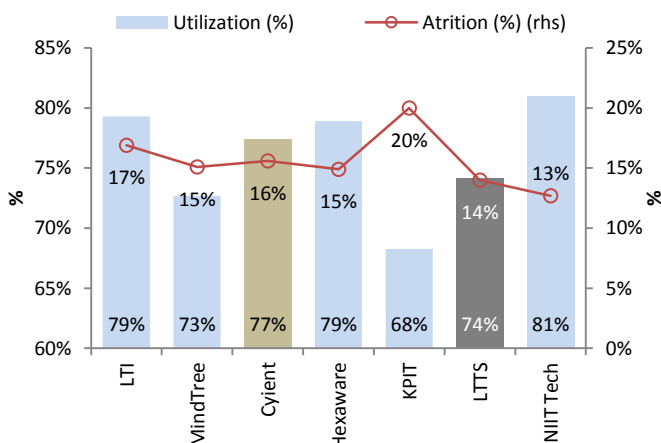
Midcap USD revenue comparison (US\$ mn)



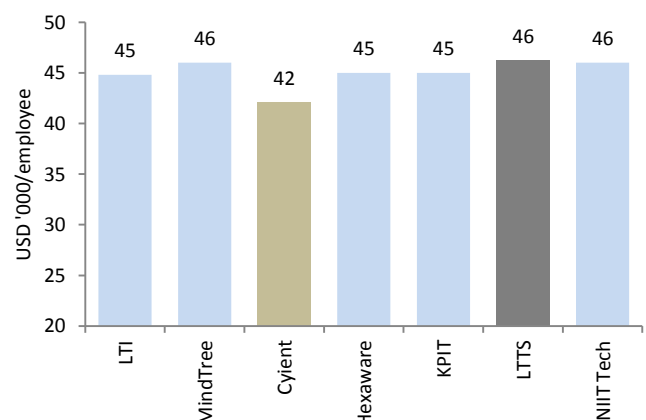
Midcap EBITDA margin comparison



Utilisation/attrition in line with the industry



Revenue productivity (USD '000/employee)



Source: Company, PhillipCapital India Research

Valuations attractive; initiate with BUY

We expect LTTS to report 12.5% USD revenue CAGR over FY17-19E. The management is confident of growing in double digits in FY18E, and we believe it will be able to achieve this because of acceleration in top clients, strong growth across its target verticals – industrial products, automotive and hi-tech. We like LTTS’ portfolio as it is the only pure-play ERD player in the listed Indian IT space. We expect earnings CAGR of 16% over FY17-19E despite investments in sales and marketing.

Currently, the stock trades at 13x FY19E EPS. These valuations, though at premium to its large-cap peers Wipro and TechM, are justifiable given tremendous growth opportunities in the ERD space and LTTS’ unique positioning. We believe it will continue to command premium valuations due to its strong revenue visibility and better business mix vs. its mid-cap peers. While large-cap peers such as HCLT are available at the same valuations, LTTS’ business mix is superior (with no exposure to the commoditised IT-services business).

We expect the growth of Indian IT services companies to be under pressure over the next few years because of their inefficient capital allocation policy of the last decade (detailed report [here](#)) and increasing uncertainty in the business environment across the world (detailed report [here](#)). However, we expect the ERD segment to buck this trend and companies such as HCLT, LTTS, and Cyient to benefit.

While we expect single-digit USD revenue growth for most IT services companies over the next three years, pure/part ERD companies should fare better on expectations of incremental outsourcing of ERD work. We incorporate 12%/13% US\$ revenue growth over next two years and 100bps margins improvement for LTTS – leading us to an EPS of Rs 56.5 for FY19E.

Our target of Rs 850 is based on 15x our FY19E EPS. We have assigned premium valuation to LTTS over its mid-sized peers due to superior growth rates, exposure to ERD, and better execution track record. We initiate coverage with a BUY rating.

Valuation table: Large-cap IT services

Companies	CMP Rs	M-Cap Rs bn	ROE (%)		P/E (x)		P/BV (x)		EV/EBITDA (x)	
			FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
TCS	2,555	5,033	30.6	27.1	18.5	17.9	5.7	4.8	15.2	14.3
Infosys	970	2,218	21.0	21.0	15.0	13.8	3.2	2.9	9.5	8.5
Wipro	542	1,319	14.7	14.1	15.6	14.7	2.3	2.1	10.4	9.4
HCL Tech	863	1,219	25.6	24.3	14.1	13.3	3.6	3.2	10.1	9.7
Tech Mahindra	399	350	13.8	14.3	14.2	12.5	2.0	1.8	8.9	7.3
LTTS	735	75	25.9	24.3	15.4	13.0	4.0	3.2	11.6	9.6

Valuation table: Mid-cap IT services

Companies	CMP Rs	M-Cap Rs bn	ROE (%)		P/E (x)		P/BV (x)		EV/EBITDA (x)	
			FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
MindTree	538	90	17.2	17.4	18.5	16.3	3.2	2.8	11.0	9.5
Persistent	608	49	15.5	15.1	14.9	13.7	2.3	2.1	9.6	8.7
KPIT	117	22	13.1	13.0	9.6	8.6	1.3	1.1	4.9	4.0
NIIT Tech	538	33	15.2	16.4	11.6	10.4	1.8	1.7	4.8	4.1
Cyient	495	56	17.3	17.9	13.4	11.3	2.3	2.0	8.5	6.8
LTTS	735	75	25.9	24.3	15.4	13.0	4.0	3.2	11.6	9.6

Source: Company, PhillipCapital India Research

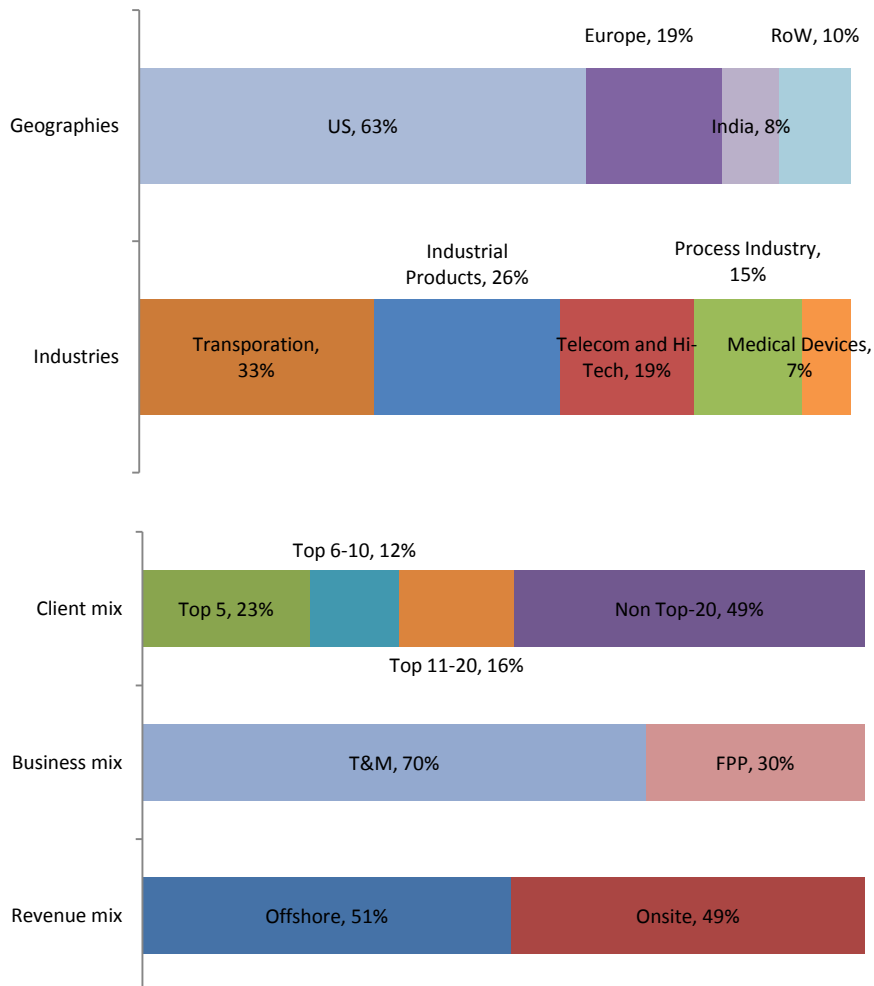
Management history/profile

LTSS does not have a long history. It was incorporated in 2012 with the major contributing subsidiaries of Product Engineering Services division (PES – a wholly owned subsidiary of L&T Infotech), and Integrated Engineering Services (IES – a wholly owned subsidiary of L&T) merging into it in 2014.

Key management personnel

- Dr Keshab Panda – MD and CEO:** Dr Keshab Panda has been serving as the CEO of LTSS since January 2015. He has 31 years of experience in IT and engineering services. Before joining LTSS, he was with Satyam Computer Services in various capacities.
- Mr P Ramakrishnan – CFO:** Mr P Ramakrishna has been CFO of LTSS from January 2016. He had been with the L&T group for last 24 years, having worked in different areas of finance and accounts covering treasury, corporate accounts, and corporate finance. He has graduate degree in Commerce (Honours) from University of Calcutta.

Revenue profile



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Net sales	30,662	32,483	35,236	39,803
Growth, %	17	6	8	13
Total income	30,662	32,483	35,236	39,803
Employee expenses	-19,681	-20,958	-22,431	-25,141
Other Operating expenses	-5,787	-5,678	-6,285	-7,085
EBITDA (Core)	5,194	5,847	6,520	7,576
Growth, %	30.3	12.6	11.5	16.2
Margin, %	16.9	18.0	18.5	19.0
Depreciation	-589	-625	-639	-663
EBIT	4,605	5,222	5,881	6,913
Growth, %	31.5	13.4	12.6	17.5
Margin, %	15.0	16.1	16.7	17.4
Interest paid	-15	-21	-20	-20
Other Income	835	591	616	746
Pre-tax profit	5,425	5,792	6,477	7,638
Tax provided	-1,239	-1,542	-1,619	-1,910
Profit after tax	4,186	4,250	4,858	5,729
Others (Minorities, Associates)	0	0	0	0
Net Profit	4,186	4,250	4,858	5,729
Growth, %	34.6	1.5	14.3	17.9
Net Profit (adjusted)	4,186	4,250	4,858	5,729
Wtd avg shares (m)	102	102	102	102

	FY16	FY17	FY18E	FY19E
US\$ Revenue (\$ mn)	468	484	542	612
Growth, %	9.3	3.4	12.0	13.0
Re / US\$ (rate)	65.5	67.1	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Cash & bank	834	674	2,234	5,061
Marketable securities at cost	0	0	0	0
Debtors	7,289	7,106	8,205	9,113
Inventory	0	0	0	0
Loans & advances	768	1,536	1,459	1,139
Other current assets	0	0	0	0
Total current assets	8,891	9,316	11,897	15,314
Investments	555	1,946	2,946	3,946
Net fixed assets	6,178	6,138	6,738	7,338
Less: Depreciation	0	0	0	0
Add: Capital WIP	143	23	23	23
Net fixed assets	6,321	6,161	6,761	7,361
Non-current assets	2,595	3,779	4,215	4,682
Total assets	19,423	21,525	26,143	31,626
Current liabilities	7,504	5,402	5,979	6,528
Provisions	1,232	1,271	1,404	1,559
Total current liabilities	8,736	6,673	7,383	8,087
Non-current liabilities	31	0	0	0
Total liabilities	8,767	6,673	7,383	8,087
Paid-up capital	3,000	203	203	203
Reserves & surplus	7,656	14,649	18,557	23,335
Shareholders' equity	10,656	14,852	18,760	23,538
Total equity & liabilities	19,423	21,525	26,143	31,626

Cash Flow

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Pre-tax profit	5,425	5,792	6,477	7,638
Depreciation	589	625	639	663
Chg in working capital	1,388	-3,832	-748	-351
Total tax paid	-1,902	-835	-1,619	-1,910
Cash flow from operating activities	5,501	1,750	4,749	6,041
Capital expenditure	-1,214	-465	-1,239	-1,263
Chg in investments	-555	-1,391	-1,000	-1,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	-1,769	-1,856	-2,239	-2,263
Free cash flow	3,732	-106	2,510	3,778
Equity raised/(repaid)	-7,500	-2,797	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-3,576	-834	-950	-950
Other financing activities	7,025	3,577	0	0
Cash flow from financing activities	-4,051	-54	-950	-950
Net chg in cash	-319	-160	1,560	2,828

Valuation Ratios

	FY16	FY17	FY18E	FY19E
Per Share data				
EPS (INR)	41.2	41.8	47.8	56.3
Growth, %	34.6	1.5	14.3	17.9
Book NAV/share (INR)	104.8	146.1	184.5	231.5
CEPS (INR)	47.0	47.9	54.1	62.9
CFPS (INR)	50.1	37.9	42.6	54.4
DPS (INR)	29.7	7.0	8.0	8.0
Return ratios				
Return on assets (%)	22.3	20.8	20.4	19.9
Return on equity (%)	39.3	28.6	25.9	24.3
Return on capital employed (%)	33.0	30.4	26.8	25.4
Turnover ratios				
Asset turnover (x)	2.4	2.8	2.7	2.9
Sales/Total assets (x)	1.6	1.6	1.5	1.4
Sales/Net FA (x)	5.1	5.2	5.5	5.6
Working capital/Sales (x)	0.0	0.1	0.1	0.1
Receivable days	86.8	79.8	85.0	83.6
Payable days	30.6	25.3	26.8	26.5
Working capital days	6.6	36.4	38.2	34.2
Liquidity ratios				
Current ratio (x)	1.2	1.7	2.0	2.3
Quick ratio (x)	1.2	1.7	2.0	2.3
Interest cover (x)	307.0	248.7	288.6	339.2
Dividend cover (x)	1.4	6.0	6.0	7.1
Total debt/Equity (%)	40.9	19.1	16.4	14.0
Net debt/Equity (%)	33.1	14.6	4.5	(7.5)
Valuation				
PER (x)	17.9	17.6	15.4	13.0
PEG (x) - y-o-y growth	0.5	11.5	1.1	0.7
Price/Book (x)	7.0	5.0	4.0	3.2
Yield (%)	4.0	1.0	1.1	1.1
EV/Net sales (x)	1.9	2.4	2.1	1.8
EV/EBITDA (x)	11.3	13.2	11.6	9.6
EV/EBIT (x)	12.7	14.7	12.8	10.5

Source: Company, PhillipCapital India Research Estimates

Cyient Limited (CYL IN)

All set for take-off

INDIA | IT SERVICES | Initiating Coverage

We initiate coverage on Cyient, with a BUY rating and target price of Rs 570. We believe Cyient is well-placed in the lucrative ERD space, which is isolated from the technological disruption and political uncertainties affecting the traditional IT-services companies.

ERD – Huge growth potential

ERD has emerged as the next-gen domain for the Indian IT industry, within which Indian IT companies have seen robust growth over the last five years (15% CAGR). More importantly, the quality of the work being outsourced to the Indian companies has evolved significantly – to innovation and development- driven by high-end projects from cost-arbitrage driven low-end tasks. With only 6% of the global ERD spend currently outsourced, we see a huge opportunity over the next decade.

Domain expertise in aerospace to drive growth

Cyient generates 37% of its revenues from aerospace. It works with companies like P&W, Boeing, Airbus, and Bombardier, and has a leadership position in the new engine designs. Zinnov has ranked it as a leader in the aerospace vertical. After acquiring Rangsons in 2015, it was able to extend its offerings from only design – to design *and* manufacturing.

Acquisitions to fill in the white spaces

Over the last few years, Cyient has acquired six companies across verticals and geographies. These acquisitions have helped it in enhance its capabilities and deepening its partnership with a few of its strategic clients (such as Pratt & Whitney). It has also invested for a minority stake in one start-up venture and made an IP investment through a partnership.

S3 strategy – paying rich dividends

With the acquisition of Rangsons, Cyient forayed into manufacturing and testing, expanding its capabilities in the product lifecycle. In FY16, it announced its 'S3' strategy, wherein the company is targeting 50% of revenues from systems, 30% from solutions, and 20% from services by 2020 vs. 80:20 share of services and systems at present.

Margins to recover by 120bps over FY17-19E

EBITDA margin has remained flat in FY17 due to higher sub-contracting cost and increased manufacturing cost in DLM. However, with multiple margin levers such as improvement in utilisation, higher offshoring, and employee-pyramid correction, we expect margins to improve 120bps over FY17-19E.

Outlook and valuations

We expect revenue CAGR of 12% over FY17-19E. It will achieve FY18E growth of 12% because of: (1) acceleration in top clients and (2) superior business mix. Recent acquisitions in Blom Aerofilms and Certon Software will lead to industry-leading growth. We expect earnings CAGR of 21% over FY17-19E, in spite of the continued investments for expanding delivery capabilities.

We expect the growth of Indian IT services companies to be under pressure over the next few years (*read our recent detailed reports [here](#) and [here](#)*). However, the ERD segment should buck this trend, and companies such as Cyient – which are not impacted by the current digital transformation cycle – will benefit. They deserve a higher multiple than traditional IT services companies – whose business is being rapidly cannibalised.

We value Cyient at 13x FY19E earnings – at a premium to its mid-cap peers (except LTTS). Our target multiple for Cyient is at discount to our target multiple for LTTS (which we value at 15x) because 62% of Cyient's revenues is being derived from ERD, as against 100% for LTTS. We initiate coverage with a BUY rating.

1 June 2017

BUY

CMP RS 495

TARGET RS 570 (+15%)

COMPANY DATA

O/S SHARES (MN) :	113
MARKET CAP (RSBN) :	57
MARKET CAP (USDBN) :	0.9
52 - WK HI/LO (RS) :	564 / 141
LIQUIDITY 3M (USDMMN) :	1.1
PAR VALUE (RS) :	5

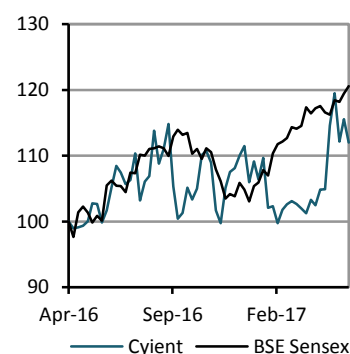
SHARE HOLDING PATTERN, %

	Mar 17	Dec 16	Sep 16
PROMOTERS :	22.2	22.2	22.2
FII / NRI :	71.9	57.5	57.1
FI / MF :	7.3	7.1	7.5
NON PRO :	4.1	3.7	3.7
PUBLIC & OTHERS :	9.4	9.5	9.5

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-6.2	6.5	7.9
REL TO BSE	-8.9	0.1	-10.9

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

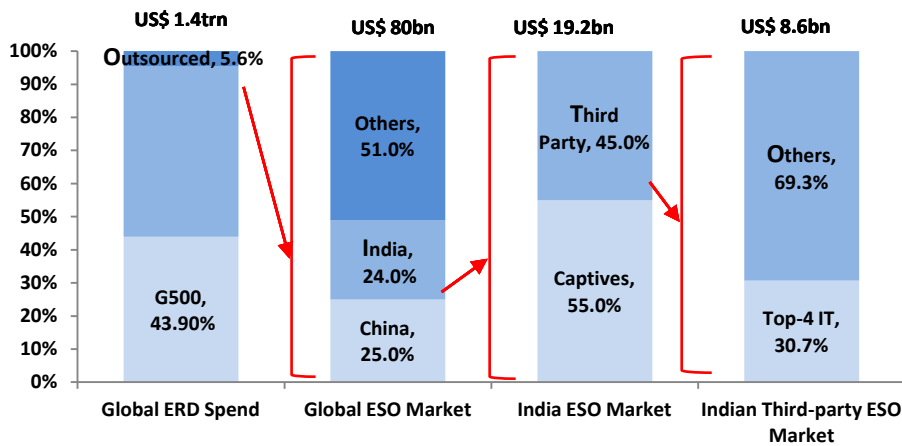
Rs mn	FY17	FY18E	FY19E
Net Sales	36,066	39,222	43,841
EBIDTA	4,850	5,405	6,399
Net Profit	3,701	4,156	4,908
EPS, Rs	32.9	36.9	43.6
PER, x	15.0	13.4	11.3
EV/EBIDTA, x	10.1	8.8	7.1
P/BV, x	2.6	2.3	2.0
ROE, %	17.5	17.3	17.9

Source: PhillipCapital India Research Est.

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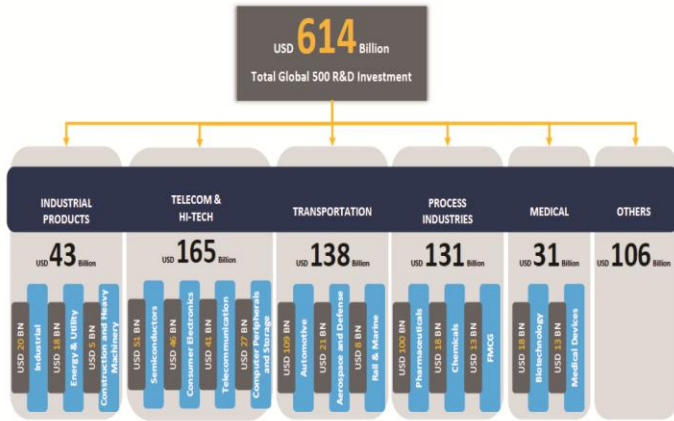
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vsinghal@phillipcapital.in

The global ERD-ESO market

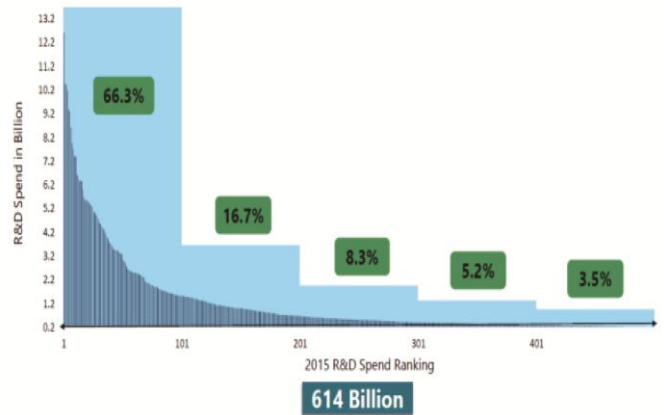


Source: NASSCOM, Zinnov, PhillipCapital India Research

Telecom and Transport are the biggest ERD spenders

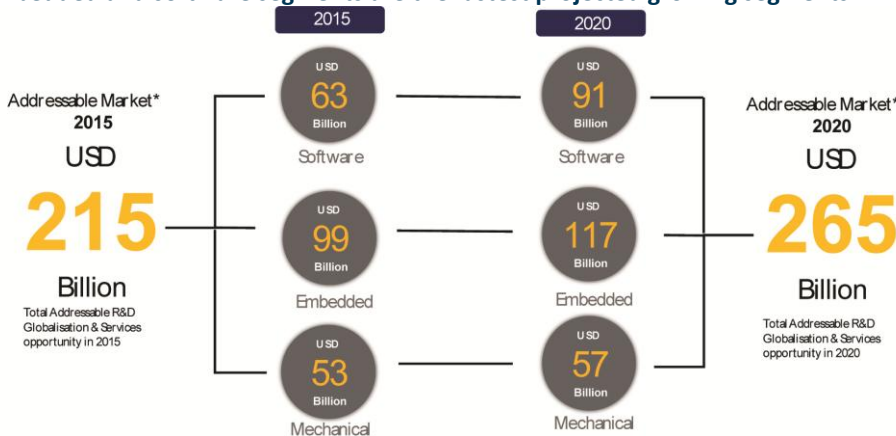


Contribution of G500 R&D spenders



Source: Zinnov research, PhillipCapital India Research

Embedded and software segments are the fastest projected growing segments



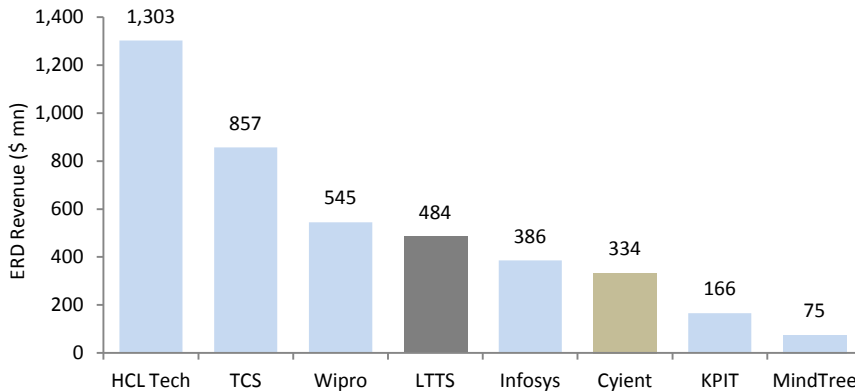
* Opportunity includes market for captives, Offshore R&D service providers and onshore R&D service providers

Source: Zinnov research, PhillipCapital India Research

Well positioned in the lucrative ERD space

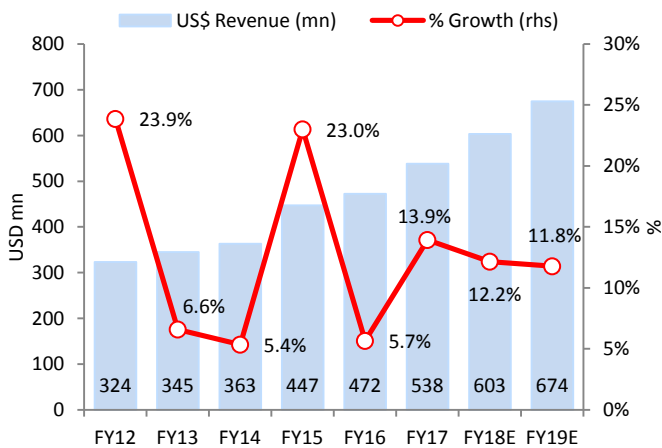
Cyient is a leading mid-sized player in the ERD segment, with FY17 revenues of US\$ 538mn, of which 58% came from aerospace and communications. It provides services to companies such as P&W, Boeing, Airbus, Dassault, Telstra, AT&T, and Verizon. It generates ~62% revenues from engineering services and the remaining 38% from data, networks, and operations. For FY17, it reported strong USD revenue growth of 14% led by communications (+35% yoy) and aerospace (+12% yoy).

Indian IT – ERD revenue comparison (USD mn)

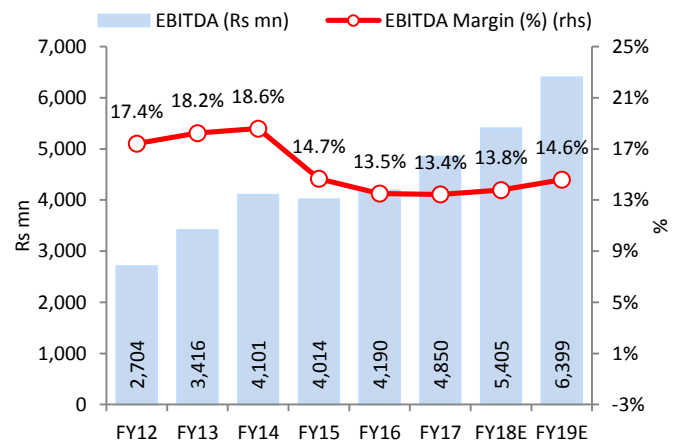


Source: Company, PhillipCapital India Research

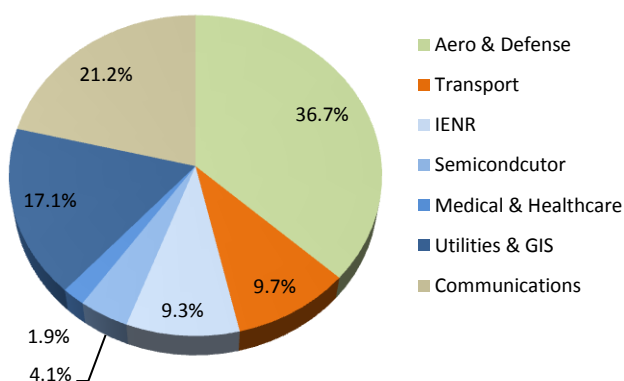
Cyient – US\$ Revenue trend



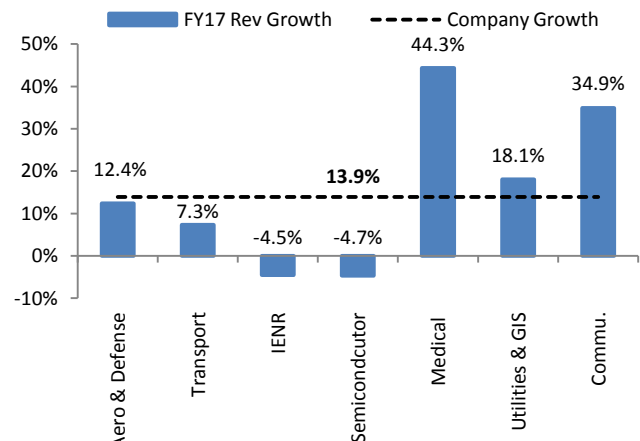
Cyient – EBITDA and EBITDA margin trend



Cyient – Revenue break-up across industries



Cyient – Revenue growth across industries



Source: Company, PhillipCapital India Research Estimates; IENR: Industrial, Energy & Natural Resources

Aerospace – Set to take off

Cyient is focusing on ramping up its capabilities in avionics and manufacturing services. It is also investing in new technologies like additive manufacturing, augmented reality, IoT, and analytics. We expect current growth momentum to continue because of the increasing outsourcing in the aerospace industry.

Aerospace is the largest vertical for Cyient, and generates 37% of its revenues.

Services worth US\$4bn may be procured from India by 2020

The aerospace industry was among the initial ERD offshorers to India, and Cyient managed to capture a sizeable market and wallet share with its value proposition. Rising demand for services related to smaller and efficient aircrafts, digitisation, and advanced avionics could increase India’s contribution to US\$ 4bn or 60% of the global offshoring by 2020 (Nasscom estimates). Though these services would typically be volume driven, commoditised in nature vs. design-related high-value business, Cyient is strengthening capabilities around the next wave of offshoreable services and is well placed to capture the addressable opportunity because of its presence across the value chain.

Aerospace is the largest vertical for Cyient, and generates 37% of its revenues.

Cyient – Top clients in aerospace segment

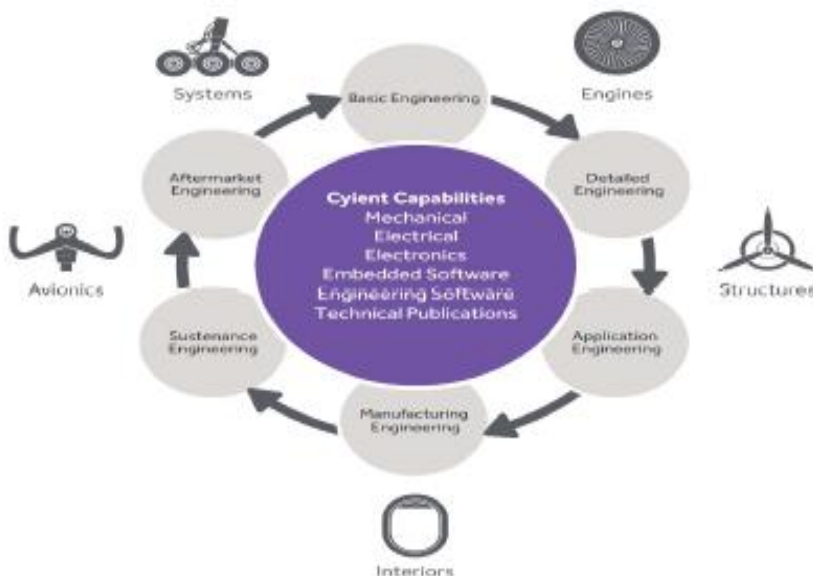
Client	Relationship (years)	Type of Work
Pratt & Whitney (UTC)	16	Provides engineering and supply-chain services for UTC and non-UTC companies in aerospace engineering, mechanical design, and software development – for military, commercial, and industrial applications.
DIEHL	8	Exclusive strategic and long term partner for delivering engineering services for A380, A350, VIP and legacy programs
Dassault Aviation	12	Providing engineering as well as defence-related business process and IT services to allow Dassault Aviation to satisfy offset obligations in India

Source: Company, PhillipCapital India Research

Spreading through the value chain – developing capability

Cyient’s revenues from the aerospace vertical come from solutions such as concept development to qualification of engine sub-systems, avionics systems, structures, aero systems, and interiors. Unlike its competitors, Cyient is present across the value chain, and with the acquisition of GSEA from P&W, it has enhanced its capabilities in maintenance, repair and operations (MRO) by adding predictive analytics.

Aerospace – present across the value chain

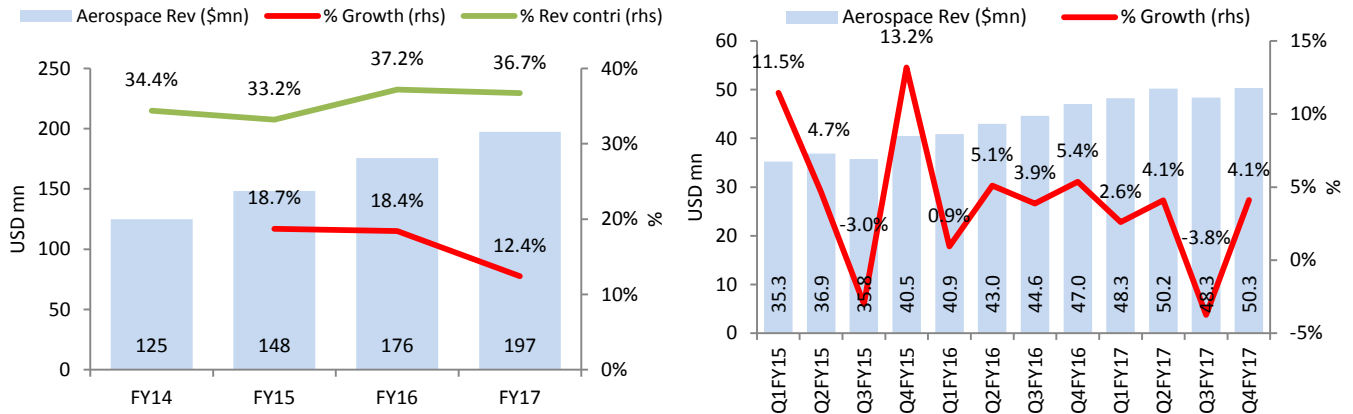


Source: Company, PhillipCapital India Research

Strong CAGR of 15% over FY15-17

Cyient’s revenue from aerospace saw weak growth in FY14 because of weakness in its key customer – Boeing (Boeing shifted part of its work in-house). However, after Cyient’s acquisition of Invati in 2015 and strong growth in its largest client Pratt & Whitney, it reported strong growth over FY15-17. Its aerospace USD revenue grew at a CAGR of 15.4% over FY15-17, significantly above the company average.

Aerospace has been the growth driver for Cyient



Source: Company, PhillipCapital India Research

Acquisition of GSEA to open new opportunities in MRO

In July 2015, Cyient acquired Singapore-based Global Services Engineering Asia (GSEA) from Pratt & Whitney for estimated US\$ 6mn. GSEA provides repairs, development, and validation for aero-gas-turbine engine components. This acquisition gave Cyient capabilities to provide aftermarket services for the aerospace industry in the APAC region.

Aircraft MRO: A mammoth opportunity

Maintenance, repair, and overhaul (MRO) services involve overhaul, repair, inspection, and modification of an aircraft/automobile or its components to keep it operational. The global aircraft MRO market is estimated to be around US\$ 61bn (annual revenue) and is expected to see a CAGR of 3.8% over 2012-20. India’s current MRO market size is likely to be around US\$ 750mn with 7% CAGR likely over the next seven years to reach US\$ 1.2bn by 2020.

The market for aircraft MRO is typically divided into four major segments – airframe heavy maintenance and modification, engine maintenance, line maintenance, and component maintenance and modifications.

Market segmentation for MRO

Line Maintenance

- *Performed approx every 100-150 flights hrs
- *Usually done overnight

Engine overhaul

- *Performed approx every 12-18 months
- *After every 5000 flight

MRO Market Segment & Type of MRO check

Airframe heavy maintenance & modification

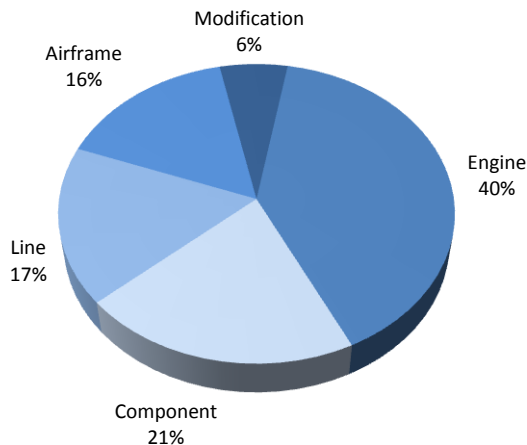
- *Most comprehensive check
- *Approx every 4-5 years

Component MRO

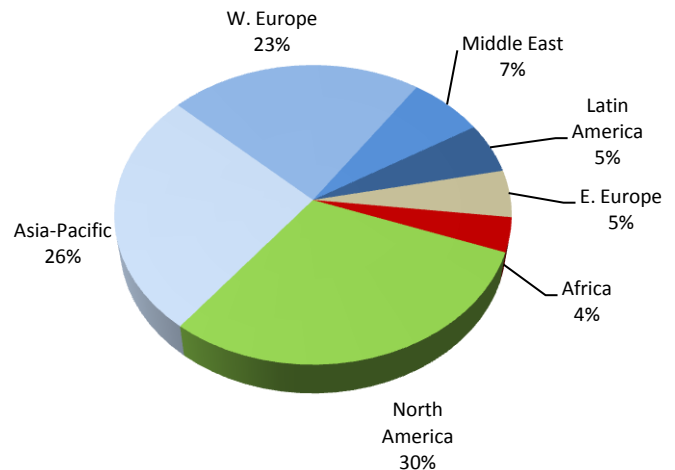
- *Performed approx every 3 months
- *Every 500-600 flight hours

Source: ICF International, PhillipCapital India Research

MRO market share by type



MRO market share by geographies



Source: ICF International, PhillipCapital India Research

The Indian MRO sector has the ability to absorb technology transfer at the depot level for aircraft and components, and has the potential of becoming an international hub for MRO needs. For a reputed MRO, there is a huge market waiting to be tapped, especially considering that engine, airframe, and MR blade and hubs facilities are non-existent in the region. Further, retrofitting of essential components such as CVRs, FDRs, transponders, sand filters, and even interiors, is desperately needed y the industry.

Most importantly, there are no MROs facilities between West Asia (Dubai) and South East Asia (Singapore); India is strategically located for over-flying and transiting – providing a location-specific opportunity. In fact, there is no MRO hub within a 5-and-a-half-hour fly zone over India.

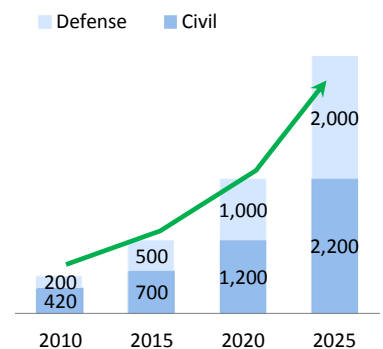
Indian civil aircraft MRO market

- At a nascent stage, US\$ 900mn in annual revenues – only 1% of the total global MRO market.
- Indian carriers are expected to double their fleet size by 2020 to 900-1,000 aircrafts. Rapidly growing aircraft fleet, growth in domestic traffic, and the increasing age of Indian aircrafts will lead to significant growth in MRO activities.
- By 2025, the market is likely to grow to US\$ 4.33bn (CAGR of 15%). However, it will still be smaller than the present market size of China (US\$ 12bn) and Singapore (US\$ 5bn).

Indian defence MRO market

- US\$ 500mn in annual revenues – only 0.5% of the total global MRO market. It is expected to grow to US\$ 2bn by FY25 (15% CAGR).
- India is poised to become a large defence aircraft market – as necessity for military MRO capabilities increases with higher military expenditure.
- The shelf-life/life-cycle of a typical aircraft/helicopter spans about 25-30 years. Considering that the age of more than 50% of its fleet is above 20 years, IAF will have to replace these with new procurements in the next 10-15 years.

Indian MRO market projection (2010-2025) (\$mn)



Source: ICF, PhillipCapital India Research

Communications – Infra upgrade to drive growth

Communications is the second-largest vertical for Cyient, and generates 21% of its revenues. Its clients include Telstra, British Telecom, AT&T and Verizon. The company provides services like network planning and design, GIS, physical and logical inventory solutions, business operations management, telecom infrastructure life-cycle management, system design, application management and sustenance.

Communications is the second-largest vertical for Cyient, and generates 21% of its revenues. Its clients include Telstra, British Telecom, AT&T and Verizon

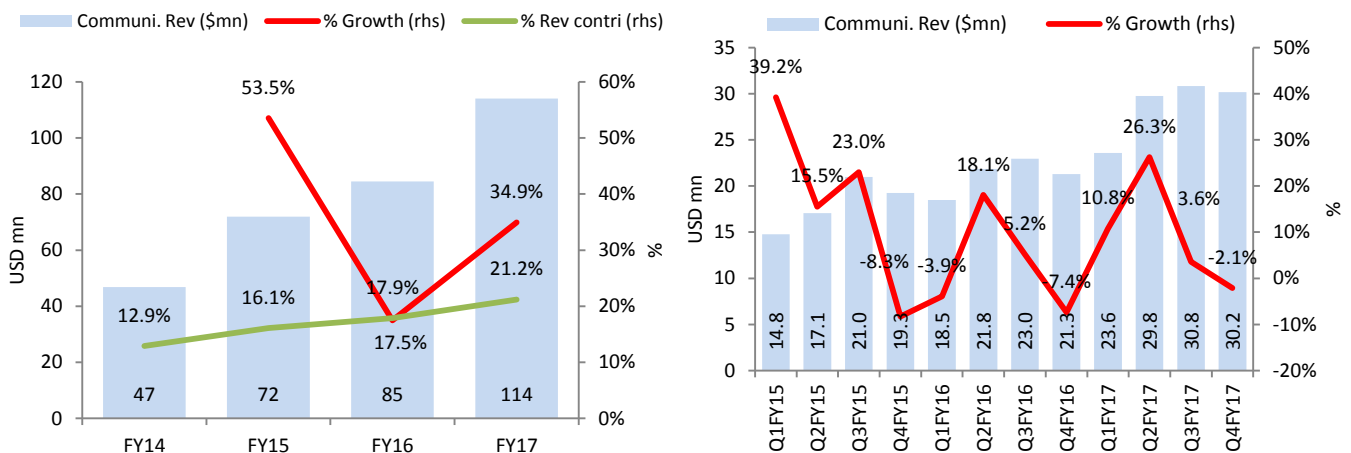
This segment has been impacted by the technological upgrades and M&As. However, we expect this segment to continue with the strong growth momentum based on:

- Opportunities in network rollout and upgradation
- Fibre deployment in Australia, New Zealand and the US
- Connect America Fund II (also known as Universal Service High-Cost program is the Federal Communications Commission’s program to expand access to voice and broadband services for areas where they are unavailable)
- Shift to the FTTH (Fibre-to-the-Node) and Hybrid Fibre-Coaxial (HFC) from FTTH (Fibre-to-the-Home).

Strong CAGR of 26% over FY15-17

This segment was the star performer for the company in FY17. Due to its industry-leading capabilities, the company enhanced its market share. Its USD revenue CAGR was 26% over FY15-17, significantly above the company average of 10%.

Communications has been volatile, but has still grown at scorching pace



Source: Company, PhillipCapital India Research

Currently, the demand for high-speed infrastructure is driving the growth in the industry. It will focus on building capabilities in wireless communication, small-cell design and deployment solutions around service assurance and analytics and executing fibre roll-out programs to gain momentum.

Rail transport: New project wins to drive growth

One of the largest offshore vendors in rail transportation and derives about 10% of its revenue from this vertical.

Wide range of solutions, strong base of engineers with tremendous experience

Cyient works on almost all segments – including rail infrastructure solutions, signalling solutions, rolling stocks, rail electronics, passenger train R&D, and locomotive design. It primarily competes with TCS and LTTs. It has benefitted from relatively less offshore competitors in this segment.

One of the largest offshore vendors in rail transportation and derives about 10% of its revenue from this vertical

Unlike other segments of engineering services, rail transportation is not impacted significantly due to the macroeconomic environment. According to Bombardier (a large client of Cyient), several large projects are planned in the next few years across Europe (new commuter line in London, several metro projects in Paris and London, and commuter and regional trains in Germany, Belgium, and Netherlands). In the US, orders are being placed to renew fleets for suburban services and urban centres across Canada and the US. Moreover, the deployment of new signalling standards in the US is likely to trigger a wave of investments.

Mining existing clients for growth

In the rail segment, Cyient’s top clients include Bombardier, Siemens, Alstom, GE, and Thales. It has achieved growth by mining clients such as Bombardier. For example:

- Siemens outsourced the entire signalling design of a project to the company to increase capacity at Whitby Station, served by Northern Railway in the UK in 2015. The work covered design, supply, installation, testing and commissioning. There are 100 full-time Cyient engineers working on this project at seven sites with cumulative 2mn+ hours of work delivered.

Over the years, Cyient has worked in major rail projects across the globe for signalling solutions. For example, it is working with Hyderabad Metro while has also worked with New York Metro, Melbourne Metro and London Underground (Metropolitan, District, and Victoria lines).

Top clients in transportations and number of years of association with Cyient

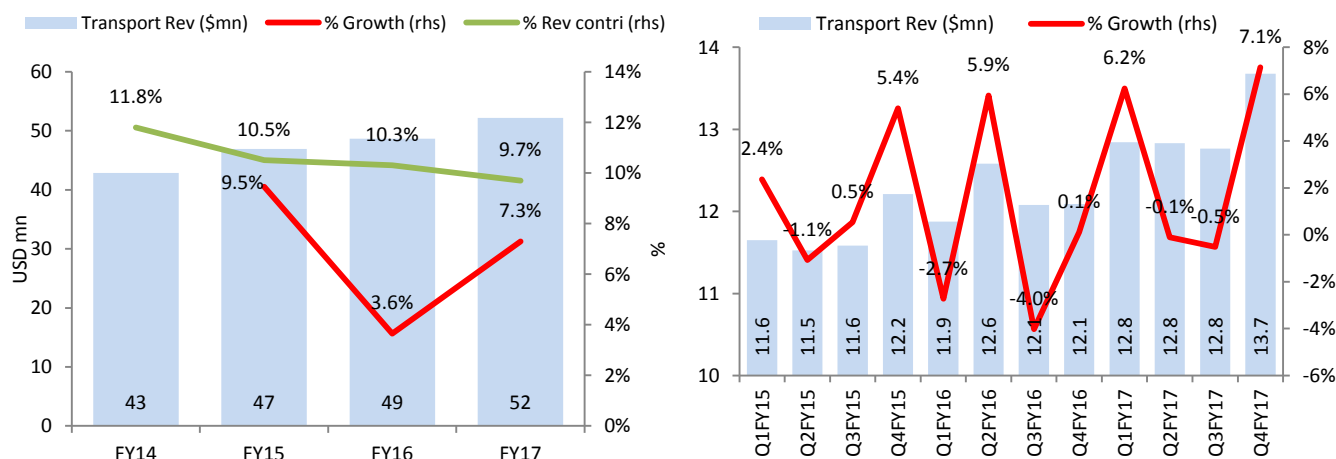
Client	Relationship (years)	Type of Work
Bombardier	13	A range of services in design engineering projects for the railway industry. The new engineering services unit will also execute projects in the areas of software development and embedded services.
Alstom transport	12	Engineering, design and analysis, technical publication, embedded and engineering software development services.

Source: Company, PhillipCapital India Research

Modest CAGR of 5.5% over FY15-17

Cyient reported modest revenue growth of 7.3% in the transport segment in FY17. As majority of its clients in the transport segment are in European region, the sharp depreciation in GBP and Euro against USD resulted in significant cross currency impact, resulting in moderate USD revenue growth. Adjusting for currency fluctuations, it reported CC growth of 11.6% for FY17.

Transportation segment has lagged the company growth



Source: Company, PhillipCapital India Research

Superior performance in Q4FY17 was driven by strong growth in rolling stocks and signalling. This segment is seeing increasing internationalisation and consolidation of OEMs, which is changing the composition of deals. With this, the focus has now shifted to efficiency and standardisation. The company is seeing increasing traction in APAC and India in digitisation and cyber security.

Utilities and Geospatial – Dealflow momentum

Utilities and geospatial is the third largest vertical for Cyient, contributing 17% to its revenues.

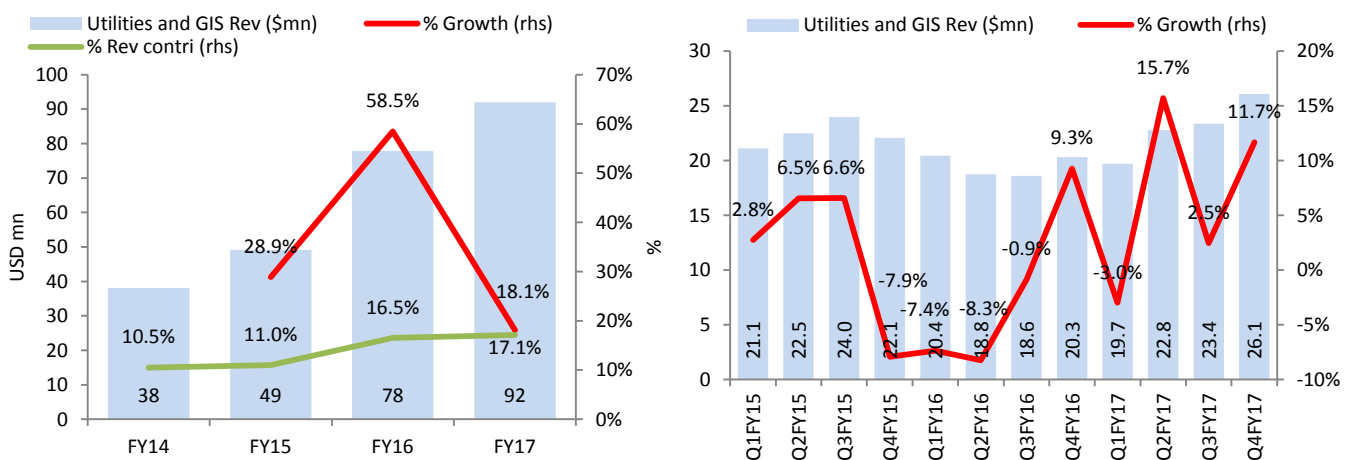
In the utilities segment, the company has worked with five of the top 10 leading global utilities based in the US. Its enterprise geospatial solutions provide an integrated systems view of utilities’ business processes that translates into significant cost savings and increased revenues for its customers. In the Geospatial space, Cyient works in the segments of airborne and mobile survey products, as well as bespoke services ranging from traditional aerial photography, LiDAR and oblique imagery to hyperspectral imaging, 3D modelling, and asset management. It works with clients such as TomTom, Southern California Edison, and Rural Payments Agency.

Utilities and geospatial is the third largest vertical for Cyient, contributing 17% to its revenues

Strong growth of 18% in FY17

The company witnessed strong traction in FY17 due to the strong deal flows witnessed in its top clients. The superior performance was also partially led by the Blom Aerofilms acquisition, which has now been integrated with Cyient UK.

Utilities and geospatial has delivered strong performance – both on revenue and dealflow side



Source: Company, PhillipCapital India Research

Grid-edge technology adaption is driving growth across the industry. AMI and smart meters national rollouts continue, generating more data, software, and analytics-related opportunities. Price-and-cost pressures are leading to emphasis on optimisation and efficient asset and work management services. We expect the current growth momentum to continue because of: (1) continuation of present aircraft development programs for the next two-years; and (2) increasing outsourcing in the aerospace industry.

Design-led manufacturing (formerly Rangsons)

Cyient acquired 74% stake in Mysore-based Rangsons Electronics, a leading electronics system design and manufacturing (ESDM) services company in January 2015 for estimated US\$ 50mn. Rangsons had over two decades of experience in developing the highly complex systems. The company is a qualified supplier to global OEMs across aerospace and defence, medical, automotive, telecommunications and industrial segments. Rangsons provides services from design-to-production and end-of-life support, which encompasses strong capabilities in managing new products introduction cycles, including prototyping, certification, and vendor management. The acquisition strengthened Cyient's expansion into high-technology, design-led systems and solutions – in line with its S3 (services, systems, and solutions) strategy.

DLM's financial performance

DLM	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	FY16	FY17
Revenue (\$mn)	9.2	6.0	10.5	10.9	12.6	10.1	13.5	14.8	16.0	40.0	54.4
% Growth qoq		-34.3%	73.2%	3.9%	16.3%	-20.2%	33.4%	10.2%	8.0%	NA	36.0%
Revenue	572	384	681	719	857	676	902	1,002	1,069	2,641	3,648
Gross Profit	55	51	81	86	108	32	105	111	105	326	353
Gross Profit Margin (%)	9.6%	13.3%	11.9%	12.0%	12.6%	4.7%	11.7%	11.1%	9.8%	12.4%	9.7%
EBITDA	26	8	30	26	43	-49	18	19	-3	107	-15
EBITDA Margin (%)	4.5%	2.2%	4.3%	3.7%	5.0%	-7.2%	2.0%	1.9%	-0.3%	4.1%	-0.4%
PBT	1	-25	-11	-13	-15	-92	-27	-19	-37	-64	-175
PBT Margin (%)	0.2%	-6.4%	-1.6%	-1.8%	-1.8%	-13.6%	-3.0%	-1.9%	-3.5%	-2.4%	-4.8%

Source: Company, PhillipCapital India Research

Strong order intake in FY17, more potential ahead

In FY16, DLM's revenues were impacted by muted pipeline and slippages in some of the accounts. However, with the strong order intake in FY17, this segment registered a strong growth of 36%, driven by new deal wins in its key critical areas of defence and aerospace. For FY18, management expects DLM business revenue to grow by 20% with margins at FY17 level (to improve to 5-10% in next two years). Two deal pipelines with huge potential:

- **Rafale:** Twin-engine medium multi-role combat aircraft – MMRCA. The Indian government will procure 36 Rafale fighter jets from France for € 7.9bn. These jets will be manufactured by Thales and Dassault, both of which are Cyient's clients.
- **Barak 8:** Also known as LR-SAM or MR-SAM. An Indian-Israeli surface-to-air missile, designed to defend against any type of airborne threat including aircraft, helicopters, anti-ship missiles, and UAVs. Israel Aerospace Industries (IAI) won two different deals of US\$ 2bn and US\$ 630mn to supply missile defence systems for India's army and navy. Cyient has strong presence in Israel through its subsidiary Cyient Israel.

S3 strategy paying rich dividends

Under the S3 strategy – by 2020, it will target 50% of revenues from systems, 30% from solutions, and the remaining 20% from services. Its current mix of services and systems is 80:20. With enhanced portfolio of offerings, Cyient will serve as the full-lifecycle partner for its clients. In the Solutions part, the company will define the problem and manually work on the solution part with the client. Cyient will own the IP of the product along with the client and be involved in the entire lifecycle of the product right from design to after-market. With the acquisition of Rangsons, Cyient forayed into the manufacturing and testing, expanding its capabilities in product lifecycle.

Focused acquisitions

The company acquired six companies in the last two years. Invati Insights, Softential, Rangsons and GSEA have fully integrated with Cyient and their performance is in line with the management's expectations. It is seeing good synergies with these acquisitions and already seen new client additions. The Blom and Certon acquisitions (2017) are being integrated with Cyient and it expects traction from these to start FY18 onwards.

Cyient has been undergoing significant organisational changes, geared towards:

- Gaining scale by increasing client focus and moving up the value chain
- Improving efficiencies across the organisation.

Organisational changes will help it to post significant gains, as it formulates a necessary structure to move to a higher plane.

Acquisition be the next growth driver for Cyient

Year	Acquired company	Country	Acquisition Price	Revenue	Valuation	Margin	Rationale
2015	Invati Insights.	India (Hyderabad)	NA	\$1mn	NA	NA	Strengthen its data analytics capabilities.
2015	Softential	USA	\$19mn	\$ 17 mn	0.9	25-30%	Business service management and service assurance (Designs, implements and manages systems and applications that monitor and control communication network)
2015	Rangsons Electronics	India (Mysore)	\$50mn	\$66mn	0.8	2-4%	Electronics System Design and Manufacturing (ESDM)
2016	Global Services Engineering Asia	Singapore	\$6mn	\$12mn	0.5	12-14%	Engineering and repair unit of the US-based aircraft engine manufacturer Pratt and Whitney. Strengthens the MRO practice. Got four year volumes commitment from P&W
2016	Blom Aerofilms	UK	NA	\$10mn	NA	10%	Geospatial solutions: data modelling, data acquisition and data processing. Has 40 employees in the UK.
2017	Certon Software	US	\$8mn	\$7mn	1.1	Low double digit	Verification and validation for avionics

Source: Company, PhillipCapital India Research

Acquisitions performance (as per Cyient Management)

	Performance	Integration	Synergy
Invati Insights	Red	Yellow	Green
Rangsons	Yellow	Green	Yellow
PW	Green	Green	Green
Blom	Blue	Green	Blue
Certon	Blue	Yellow	Green

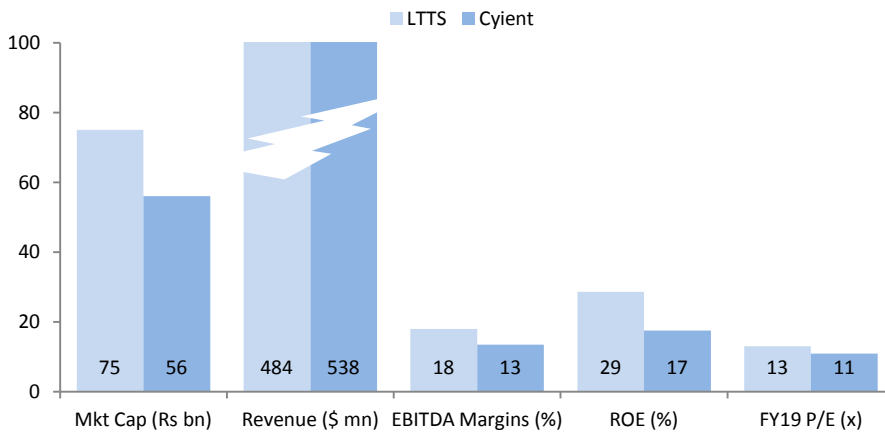
Source: Company, PhillipCapital India Research

Red: Low
Yellow: Medium
Green: High
Blue: Too early to say

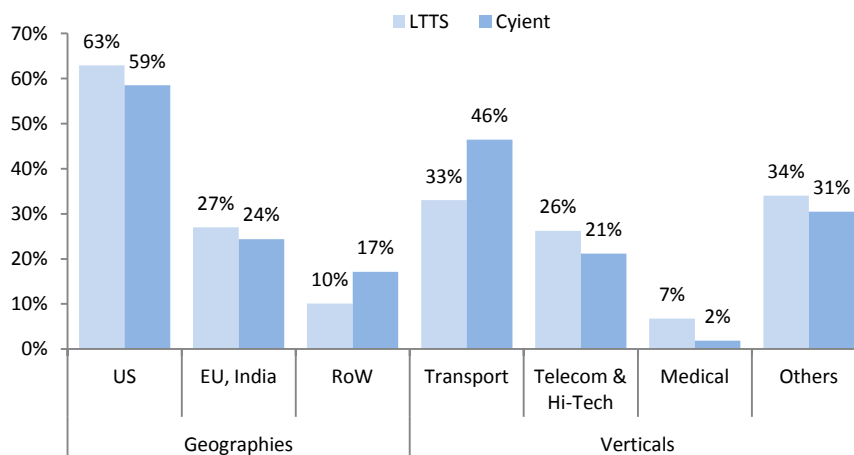
ERD outsourcing – comparison with LTTS

Amongst the listed IT mid-cap companies, Cyient and LTTS are the leaders in the ERD space and have very similar profile. Cyient derives 62% of its revenues from ERD vs. LTTS' 100%. Cyient is strong in aerospace and railways, while LTTS has expertise in automotive and industrial products. Cyient has slightly inferior margins (13% vs. 18% for LTTS) and ROEs (17% vs. 29% for LTTS) – but superior clientele (Boeing, P&W, Airbus, IBM).

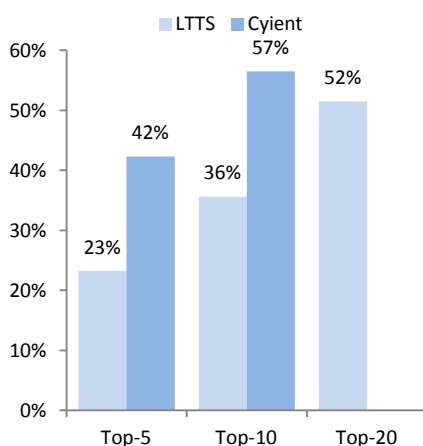
Financials and valuation comparison



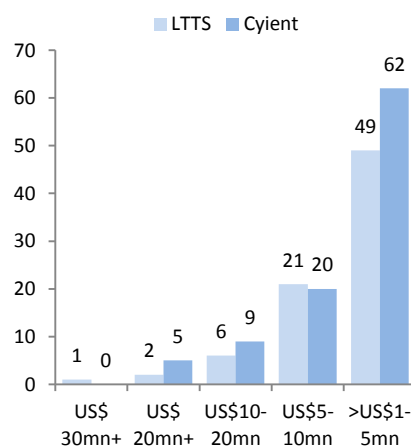
Comparison of revenue break-up – geography and vertical



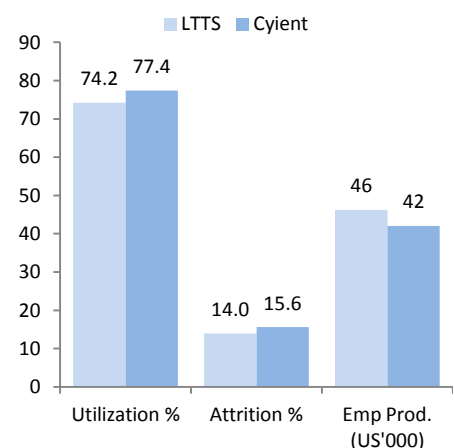
Top clients concentration



Number of clients



Employee metrics

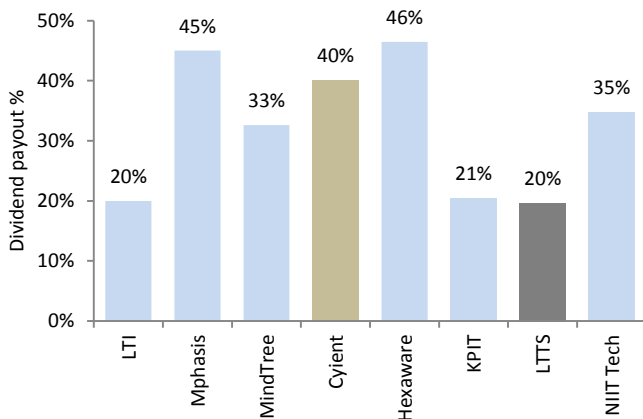


Source: Company, PhillipCapital India Research

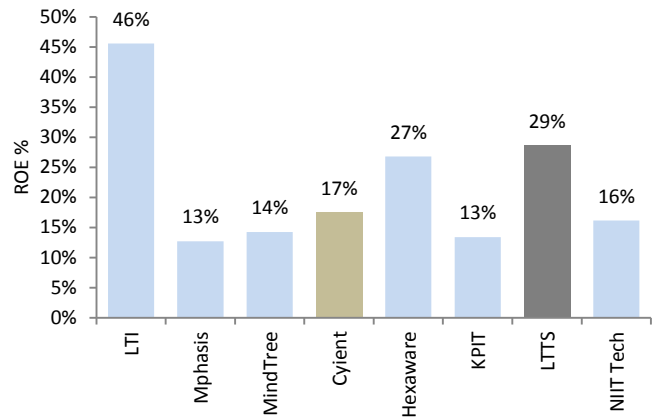
Metrics as good as any mid-cap IT company

Cyient has followed an efficient capital allocation policy. It has acquired five companies in the last 3 years. This has resulted in ROEs of 17% – lower than its large and mid-cap peers. On employee metrics such as utilisation (77.4%), attrition (15.6%), and employee productivity (US\$ 42k per head) – Cyient is broadly in line with the industry and the midcap average.

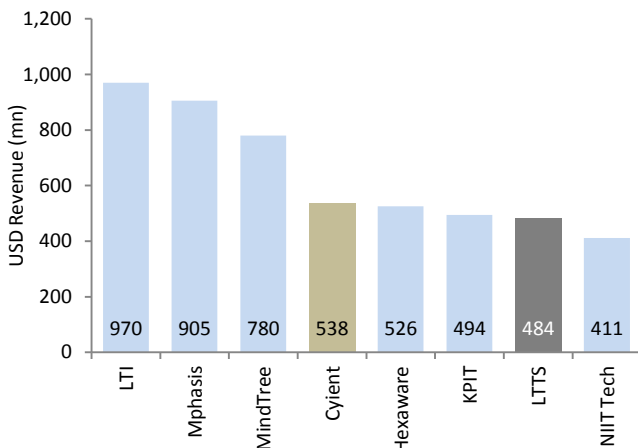
Payout among the best in the industry



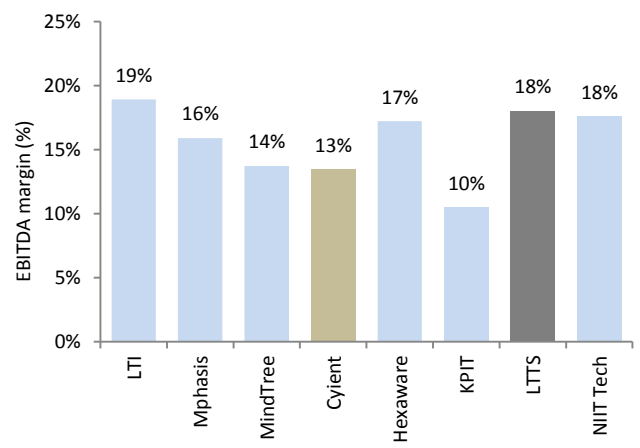
with ROEs below industry average



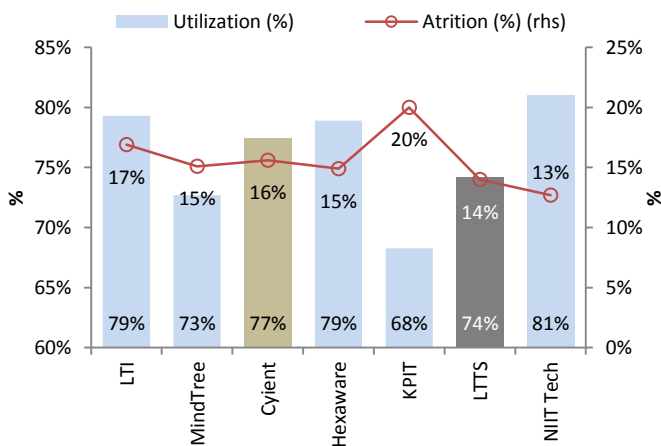
Midcap USD revenue comparison (US\$ mn)



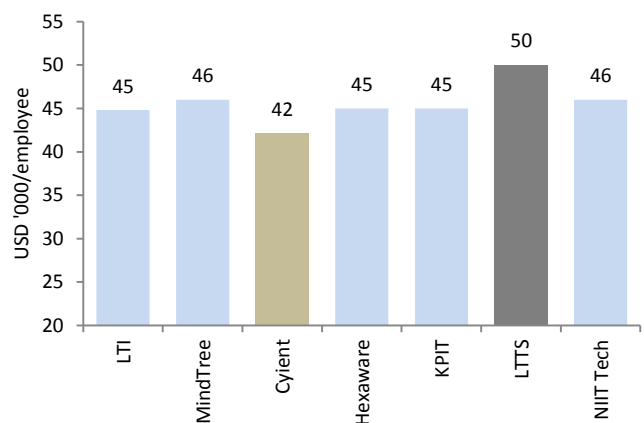
Midcap EBITDA margin comparison



Utilisation/attrition in line with the industry



Revenue productivity (USD '000/employee)



Source: Company, PhillipCapital India Research

Valuations attractive; initiate with BUY

We expect revenue CAGR of 12% over FY17-19E. It will achieve FY18E growth of 12% because of: (1) acceleration in top clients and (2) superior business mix. Recent acquisitions of Blom Aerofilms and Certon Software will lead to industry-leading growth. We expect earnings CAGR of 21% over FY17-19E, in spite of the continued investments for expanding delivery capabilities.

We believe companies like Cyient, which operate in ERD space (not impacted by the current digital transformation cycle), deserve a higher multiple than traditional IT services companies, whose business is being cannibalised at rapid rate.

Our target price of Rs 570 is based on 13x our FY19E EPS. We have assigned premium valuation to Cyient over its mid-sized peers due to superior growth rates, exposure to ERD, and better execution track record. Our target multiple for Cyient is at discount to our target multiple for LTTS (which we value at 15x) because 62% of Cyient's revenues is being derived from ERD, as against 100% for LTTS. We initiate coverage with a BUY rating.

We bake in 12% USD revenue growth over next two years and 120bps margins improvement – leading to an EPS of Rs 43.5 for FY19E.

Valuation table: Large-cap IT services

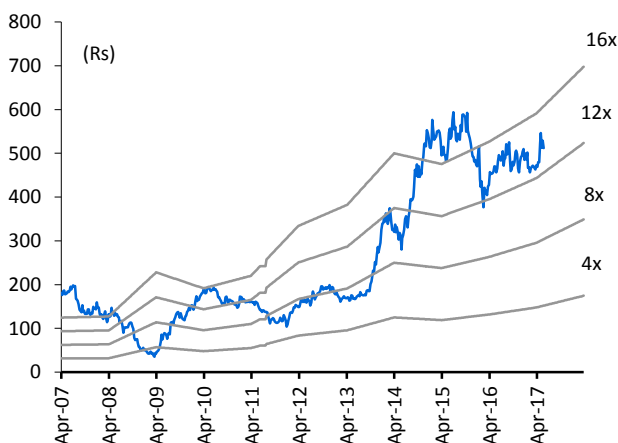
Companies	CMP Rs	M-Cap Rs bn	ROE (%)		P/E (x)		P/BV (x)		EV/EBITDA (x)	
			FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
TCS	2,555	5,033	30.6	27.1	18.5	17.9	5.7	4.8	15.2	14.3
Infosys	970	2,218	21.0	21.0	15.0	13.8	3.2	2.9	9.5	8.5
Wipro	542	1,319	14.7	14.1	15.6	14.7	2.3	2.1	10.4	9.4
HCL Tech	863	1,219	25.6	24.3	14.1	13.3	3.6	3.2	10.1	9.7
Tech Mahindra	399	350	13.8	14.3	14.2	12.5	2.0	1.8	8.9	7.3
Cyient	495	56	17.3	17.9	13.4	11.3	2.3	2.0	8.5	6.8

Valuation table: Mid-cap IT services

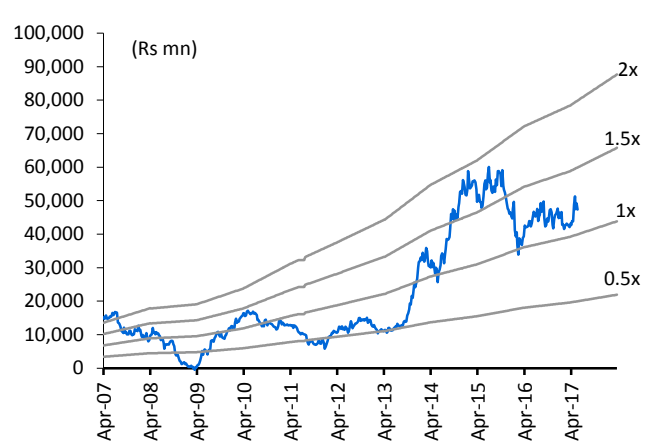
Companies	CMP Rs	M-Cap Rs bn	ROE (%)		P/E (x)		P/BV (x)		EV/EBITDA (x)	
			FY18E	FY19E	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
MindTree	538	90	17.2	17.4	18.5	16.3	3.2	2.8	11.0	9.5
Persistent	608	49	15.5	15.1	14.9	13.7	2.3	2.1	9.6	8.7
KPIT	117	22	13.1	13.0	9.6	8.6	1.3	1.1	4.9	4.0
NIIT Tech	538	33	15.2	16.4	11.6	10.4	1.8	1.7	4.8	4.1
LTTS	735	75	25.9	24.3	15.4	13.0	4.0	3.2	11.6	9.6
Cyient	495	56	17.3	17.9	13.4	11.3	2.3	2.0	8.5	6.8

Source: Company, PhillipCapital India Research

1-year forward P/E



1-year forward EV/Sales

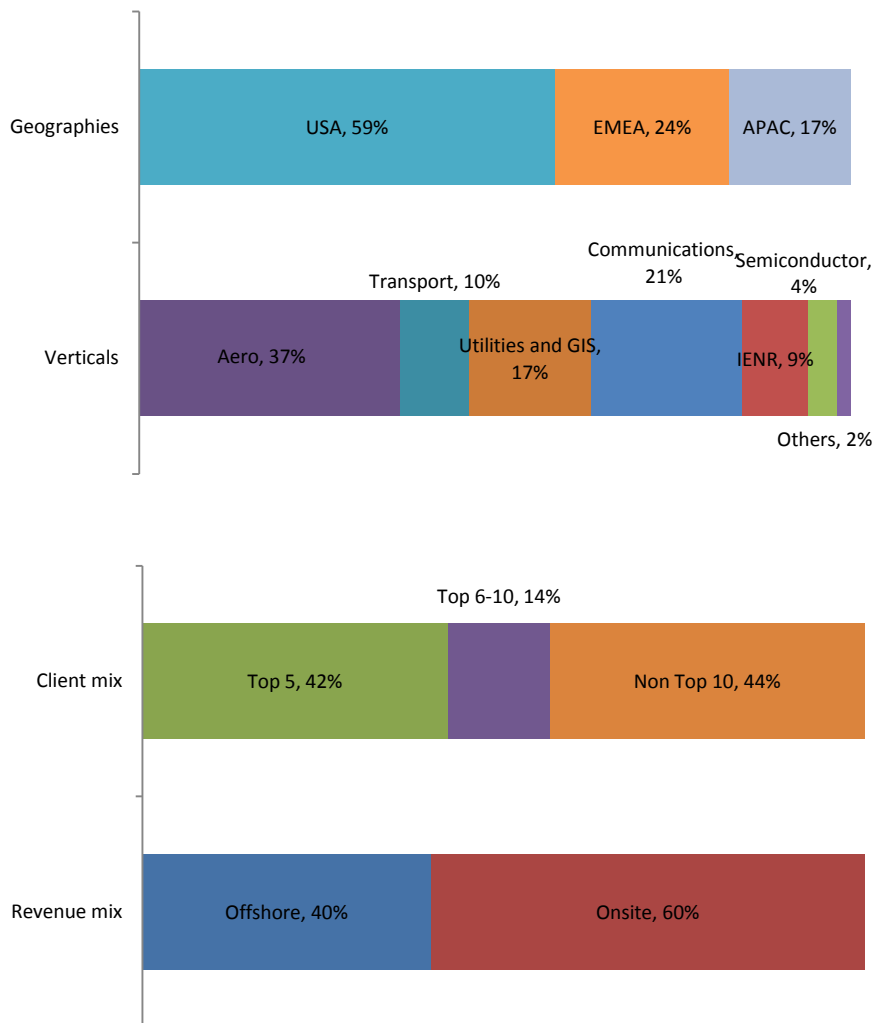


Source: Company, PhillipCapital India Research

Company background

- Incorporated in 1991 by Mr BVR. Mohan Reddy
- A mid-cap IT company that specialises in providing engineering solutions, network, and content engineering.
- Services: Product engineering, process engineering, utilities & telecom solutions, data accumulation, geospatial data services.
- Core services for these industries: Aerospace, consumer, energy, medical, oil & gas, mining, heavy equipment, hi-tech, transportation, telecom and utilities
- 38 delivery centres in North America, Europe, Middle East, and Asia Pacific.
- 25 years of experience. Long-term strategic relationships with global clients such as Pratt & Whitney, Bombardier, TomTom, Boeing, Swisscom, HIS, British Telecom, Philips, Hamilton Sundstrand, Tele Atlas
- Total 300+ clients, which include 30+ 'Fortune 500' organisations.

Revenue profile



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Net sales	31,009	36,066	39,222	43,841
Growth, %	13	16	9	12
Total income	31,009	36,066	39,222	43,841
Raw material expenses	0	0	0	0
Employee expenses	-20,151	-23,647	-25,559	-28,293
Other Operating expenses	-6,668	-7,569	-8,258	-9,149
EBITDA (Core)	4,190	4,850	5,405	6,399
Growth, %	4.4	15.8	11.4	18.4
Margin, %	13.5	13.4	13.8	14.6
Depreciation	-888	-953	-1,094	-1,231
EBIT	3,302	3,897	4,311	5,168
Growth, %	0.0	18.0	10.6	19.9
Margin, %	10.6	10.8	11.0	11.8
Interest paid	-192	-189	-176	-176
Other Income	1,064	874	1,108	1,235
Pre-tax profit	4,174	4,582	5,243	6,227
Tax provided	-1,011	-1,047	-1,206	-1,432
Profit after tax	3,163	3,535	4,037	4,795
Others (Minorities, Associates)	179	166	119	113
Net Profit	3,343	3,701	4,156	4,908
Growth, %	(4.8)	10.7	12.3	18.1
Net Profit (adjusted)	3,343	3,701	4,156	4,908
Wtd avg shares (m)	112	112	112	112

	FY16	FY17	FY18E	FY19E
US\$ Revenue (\$ mn)	472	538	603	674
Growth, %	5.7	13.9	12.2	11.8
Re / US\$ (rate)	65.7	67.0	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Cash & bank	6,949	8,781	9,907	11,914
Debtors	6,145	6,496	7,356	8,245
Inventory	979	935	1,059	1,187
Loans & advances	0	0	0	0
Other current assets	3,052	3,576	3,790	4,247
Total current assets	17,125	19,788	22,112	25,593
Investments	1,598	1,957	1,957	1,957
Gross fixed assets	6,672	7,775	8,375	8,975
Less: Depreciation	0	0	0	0
Add: Capital WIP	0	0	0	0
Net fixed assets	6,672	7,775	8,375	8,975
Non-current assets	1,737	1,743	1,895	2,124
Total assets	27,308	31,364	34,440	38,749
Current liabilities	6,087	7,632	7,770	8,568
Provisions	1,298	1,472	1,570	1,753
Total current liabilities	7,385	9,104	9,340	10,321
Non-current liabilities	1,551	1,061	1,061	1,061
Total liabilities	8,936	10,165	10,401	11,382
Paid-up capital	562	563	563	563
Reserves & surplus	17,810	20,636	23,476	26,804
Shareholders' equity	18,372	21,199	24,039	27,367
Total equity & liabilities	27,308	31,364	34,440	38,749

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17	FY18E	FY19E
Pre-tax profit	4,174	4,582	5,243	6,227
Depreciation	888	953	1,094	1,231
Chg in working capital	-534	882	-1,114	-721
Total tax paid	-993	-849	-1,206	-1,432
Cash flow from operating activities	3,535	5,568	4,017	5,304
Capital expenditure	421	-2,056	-1,694	-1,831
Chg in investments	-587	-359	0	0
Cash flow from investing activities	-165	-2,415	-1,694	-1,831
Free cash flow	3,370	3,153	2,323	3,473
Equity raised/(repaid)	0	1	0	0
Debt raised/(repaid)	705	-613	0	0
Dividend (incl. tax)	-921	-1,382	-1,316	-1,579
Other financing activities	-2,612	507	0	0
Cash flow from financing activities	-2,649	-1,321	-1,197	-1,466
Net chg in cash	721	1,832	1,126	2,007
Opening cash balance	6,229	6,949	8,781	9,907
Closing cash balance	6,949	8,781	9,907	11,914

Valuation Ratios

	FY16	FY17	FY18E	FY19E
Per Share data				
EPS (INR)	29.7	32.9	36.9	43.6
Growth, %	(4.9)	10.7	12.3	18.1
Book NAV/share (INR)	163.3	188.5	213.7	243.3
CEPS (INR)	37.6	41.4	46.7	54.6
CFPS (INR)	22.3	41.7	27.2	38.2
DPS (INR)	7.0	10.5	10.0	12.0
Return ratios				
Return on assets (%)	12.4	12.5	12.6	13.4
Return on equity (%)	18.2	17.5	17.3	17.9
Return on capital employed (%)	15.6	16.3	16.5	17.2
Turnover ratios				
Asset turnover (x)	2.5	3.0	3.0	3.0
Sales/Total assets (x)	1.2	1.2	1.2	1.2
Sales/Net FA (x)	4.2	5.0	4.9	5.1
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	72.3	65.7	68.5	68.6
Inventory days	11.5	9.5	9.9	9.9
Payable days	42.2	47.0	43.9	44.4
Working capital days	48.1	34.2	41.3	42.5
Liquidity ratios				
Current ratio (x)	2.8	2.6	2.8	3.0
Quick ratio (x)	2.7	2.5	2.7	2.8
Interest cover (x)	17.2	20.6	24.4	29.3
Dividend cover (x)	4.2	3.1	3.7	3.6
Total debt/Equity (%)	13.7	9.0	8.0	7.0
Net debt/Equity (%)	(32.8)	(41.6)	(41.4)	(43.7)
Valuation				
PER (x)	16.7	15.0	13.4	11.3
PEG (x) - y-o-y growth	(3.4)	1.4	1.1	0.6
Price/Book (x)	3.0	2.6	2.3	2.0
Yield (%)	1.4	2.1	2.0	2.4
EV/Net sales (x)	1.7	1.4	1.2	1.0
EV/EBITDA (x)	12.2	10.1	8.8	7.1
EV/EBIT (x)	15.5	12.5	11.1	8.8

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