

Hexaware Technologies

STOCK INFO. BLOOMBERG
BSE Sensex: 8,122 HEXW IN
REUTERS CODE
S&P CNX: 2,468 HEXT.BO

18 October 2005

Sell
Previous Recommendation: Sell
Rs106

Equity Shares (m)	121.5	YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
52-Week Range (Rs)	165/90	END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
1,6,12 Rel. Perf. (%)	0/-57/-38	12/04A	5,459	637	5.3	257.3	19.8	5.3	26.3	29.4	2.5	17.1
MCap. (Rs b)	12.8	12/05E	6,673	893	7.1	32.6	14.9	3.9	28.5	30.9	1.9	11.4
MCap. (US\$ b)	0.3	12/06E	7,454	995	7.6	7.4	13.9	3.1	24.3	26.6	1.6	9.5

Hexaware Technologies reported 6.4% sequential revenue growth at Rs1,756m, driven by strong performance in the R&D and manufacturing verticals and growth in the US geography.

Net employee addition for the quarter was muted at 167, indicating a weaker pipeline for the next quarter. Top client contribution declined by 1.7% QoQ, while Top 2-5 clients grew at a robust 10% QoQ.

EBITDA margins were up 200bp to 17% due to lower cost of revenue and SG&A, improvement in utilization levels at 68% (up from 67% in 2QCY05), and greater offshore composition at 39.5% (up from 38.3% in 2QCY05).

Net profit at Rs241m was up 23.7% QoQ; on account of the improvement in margins and higher other income at Rs27m (up 49% QoQ). The company reported an EPS of Rs1.9 for the quarter.

While the company revised its annual earnings guidance upwards from \$18-19m to \$19.5m due to improvement in margins, slower employee ramp up indicates slower growth in 4QCY05 with the buy-out of the PeopleSoft centre. We expect earnings to grow by 40% in CY05 and 12.4% in CY06. On an expected EPS of Rs7.6 for CY06E, the stock is trading at a PE of 14.6x. We maintain a **Sell** on the stock.

QUARTERLY PERFORMANCE									(Rs Million)	
Y/E DECEMBER	CY04				CY05				CY04	CY05E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Revenues	1,144	1,283	1,462	1,570	1,641	1,650	1,756	1,626	5,459	6,673
Q-o-Q Change (%)	1.7	12.2	13.9	7.4	4.5	0.6	6.4	-7.4	36.4	22.2
Direct Expenses	719	810	914	950	1,002	1,032	1,083	996	3,392	4,113
Sales, General & Admin. Expenses	293	309	314	364	361	371	374	358	1,280	1,463
Operating Profit	132	165	234	256	278	248	298	272	787	1,097
Margins (%)	11.5	12.8	16.0	16.3	16.9	15.0	17.0	16.8	14.4	16.4
Other Income	29	35	14	19	27	18	27	27	98	98
Depreciation	29	34	48	50	54	53	57	49	161	212
PBT bef. Extra-ordinary	132	166	201	225	251	213	269	250	724	983
Provision for Tax	17	24	35	11	19	18	28	25	86	90
Rate (%)	12.6	14.2	17.6	4.8	7.5	8.6	10.4	10.0	11.9	9.2
PAT bef. Extra-ordinary	115	142	166	215	232	195	241	225	637	893
Share of profit in associate companies	10.3	20.2	126.9	0.0	0.0	0.0	0.0	0.0	157.3	0.0
Net Income	126	162	292	215	232	195	241	225	795	893
Q-o-Q Change (%)	-90.2	29.2	80.3	-26.6	8.3	-16.3	23.7	-6.3	47.3	40.1

E: MOST Estimates

1,609

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Revenue up 6.4% QoQ

Hexaware reported revenue of Rs1,756m for 3QCY05, fuelled by strong performance in its enterprise solutions (due to revival in the PeopleSoft business) and R&D domains, which grew by 11.6% and 19.7% QoQ, respectively. Of the company's verticals, Manufacturing and Airlines grew robustly at 12.1% QoQ and 9.7% QoQ, respectively.

REVENUE BY SERVICE OFFERING (RS M)

	SEP-04	DEC-04	MAR-05	JUN-05	SEP-05
Research & Development	42	36	28	26	32
QoQ growth (%)	10.1	-14.8	-22.8	-5.3	19.7
PeopleSoft	585	680	694	678	757
QoQ growth (%)	16.9	16.3	2.1	-2.3	11.6

Source: Company/Motilal Oswal Securities

REVENUE BY DOMAIN

	SEP-04	DEC-04	MAR-05	JUN-05	SEP-05
Airlines and Transport	234	218	254	261	286
QoQ growth (%)	13.2	-6.7	16.5	2.5	9.7
BFSI	608	688	768	733	741
QoQ growth (%)	7.5	13.1	11.6	-4.6	1.1
Manufacturing/Ent. Solutions	547	586	522	551	618
QoQ growth (%)	22.5	7.1	-10.9	5.7	12.1

Source: Company/Motilal Oswal Securities

The top client's contribution declined by 1.7% QoQ, while the top 2-5 clients grew at a robust 10% QoQ and the top 5-10 clients grew by 3.4% QoQ.

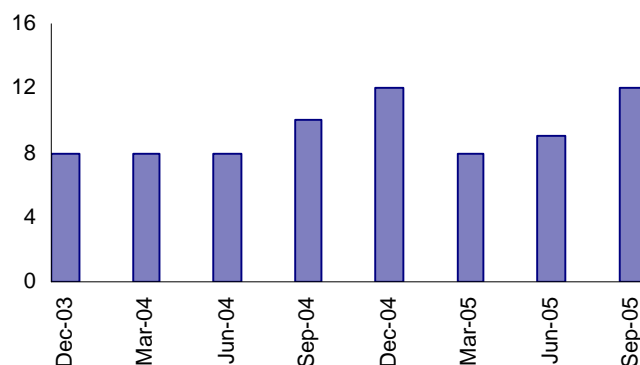
CLIENT CONCENTRATION

	SEP-04	DEC-04	MAR-05	JUN-05	SEP-05
Top client	195.9	221.4	223.1	216.2	212.4
QoQ growth (%)	35.1	13.0	0.8	-3.1	-1.7
Top 5 excl Top client	407.9	458.5	551.2	486.9	535.5
QoQ growth (%)	8.5	12.4	20.2	-11.7	10.0
Bottom 5 in Top 10 clients	206.1	240.2	241.2	290.5	300.2
QoQ growth (%)	-3.8	16.5	0.4	20.4	3.4

Source: Company/Motilal Oswal Securities

The company added 12 new clients this quarter, taking up the active client base to 120 (up from 115 in 2QCY05). Of the clients added, seven were in the PeopleSoft domain. During the quarter, Hexaware won two contracts worth US\$5m from two major financial services conglomerates for independent testing services.

CLIENT ADDITIONS (NOS)

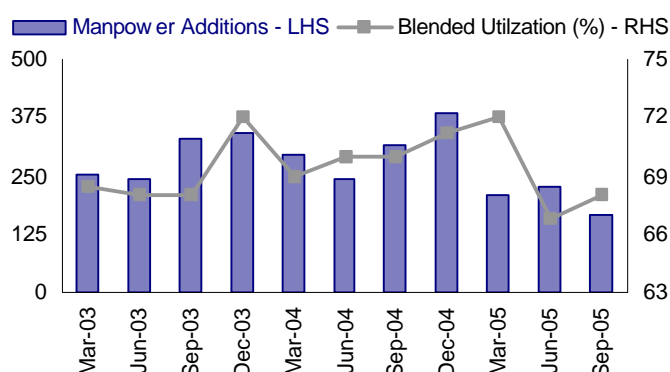


Source: Company/Motilal Oswal Securities

Net employee addition lowest in the last 11 quarters

While industry players reported robust employee addition during the September quarter, Hexaware's net employee addition has been the lowest for the company in the last 11 quarters. Typically, employee addition during the quarter is an indication of the expected business momentum in the coming quarters, which is based on the project pipeline for the company. Low net employee addition at 167, despite the loss of 750 employees with the transfer of the PeopleSoft ISC to Oracle, therefore is an indication that growth is likely to taper off with the termination of the PeopleSoft ISC by the end of October.

MANPOWER ADDITIONS DOWN

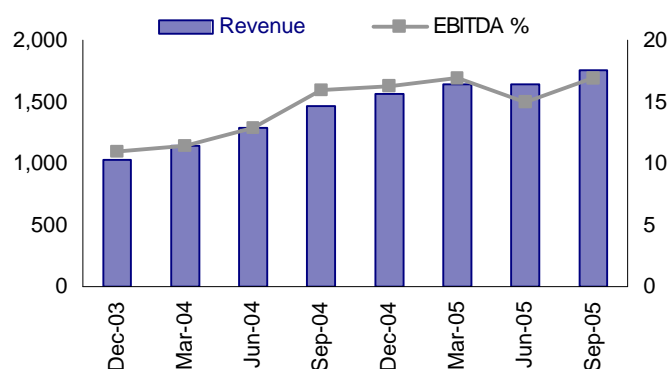


Source: Company/Motilal Oswal Securities

EBITDA margin up 200bp on lower SG&A and better employee utilization

EBITDA margin for the quarter was up 200bp to 17% due to lower cost of revenue and SG&A, improvement in utilization levels at 68% (up from 67% in 2QCY05), and greater offshore composition at 39.5% (up from 38.3% in 2QCY05). While we expect EBITDA margin to stay more or less flat in 4QCY05, we believe that margins in CY06 could be impacted by the loss of ISC revenue, which earned the highest margins for the company due to high offshore component and high utilization. The company has indicated that while margins are likely to be impacted as a result of the loss of ISC revenue, margins are likely to recover to current levels by the end of CY06.

MARGIN IMPROVEMENT



Source: Company/Motilal Oswal Securities'

Net profit at Rs241m was up 23.7% QoQ; on account of the improvement in margins and greater other income at Rs27m (up 49% QoQ). The company reported an EPS of Rs1.9 for the quarter.

Revision in profit guidance

Hexaware has raised its net profit guidance for CY05 to US\$19.5m from US\$18 -19m. However, the company has retained its revenue guidance at US\$153m, which implies a sequential decline of 8% in revenue and 24% in net profit in 4QCY05, primarily due to the impact of the loss of revenue from the PeopleSoft ISC.

Valuation and view

Hexaware would lose its largest revenue stream on November 2, when the PeopleSoft ISC is transferred to Oracle. Given that the ISC revenues were highly offshore-centric and the utilization levels were higher, we expect an adverse impact on Hexaware's margins for a few quarters after the transfer, until the rest of the business picks up speed. Therefore, we expect margins to stay in the 16-17% range in CY06. We expect earnings to grow by 40% in CY05 and 12.4% in CY06. On an expected EPS of Rs7.6 for CY06E, the stock is trading at a PE of 14.6x. We maintain a **Sell** on the stock

KEY METRICS

	3QCY05	QOQ GR.(%)	YOY GR.(%)	2QCY05	3QCY04
Revenue by geography					
USA (%)	76.7			74.9	72.6
USA (Rs Mn)	1,346.6	8.9	26.9	1,236.2	1,061.4
Europe (%)	20.0			21.8	21.1
Europe (Rs Mn)	351.1	(2.4)	13.8	359.8	308.5
RoW (%)	3.3			3.2	6.3
RoW (Rs Mn)	57.9	9.7	(37.1)	52.8	92.1
Revenue by service offering					
E-commerce/Application Management (%)	40.1			41.4	38.1
E-commerce/Application Management (Rs Mn)	704.0	3.0	26.4	683.3	557.0
R&D (%)	1.8			1.6	2.9
R&D (Rs Mn)	31.6	19.7	(25.5)	26.4	42.4
Enterprise Solutions (%)	43.1			41.1	40.0
Enterprise Solutions (Rs Mn)	756.7	11.6	29.4	678.3	584.8
HR IT Solutions (%)	7.0			7.0	2.6
HR IT Solutions (Rs Mn)	122.9	6.4	223.3	115.5	38.0
Others (%)	8.0			8.9	16.4
Others (Rs Mn)	140.5	(4.4)	(41.4)	146.9	239.8
Ent-ps	658.3	11.6	29.4	590.1	508.8
Revenue by Domain					
Airlines and Transport (%)	16.3			15.8	16.0
Airlines and Transport (Rs Mn)	286.2	9.7	22.3	260.8	233.9
Finance and Banking and Insurance (%)	42.2			44.4	41.6
Finance and Banking and Insurance (Rs Mn)	740.9	1.1	21.8	732.8	608.2
Manufacturing/Ent. Solutions (%)	35.2			33.4	37.4
Manufacturing/Ent. Solutions (Rs Mn)	618.0	12.1	13.0	551.2	546.8
Others	6.3			6.4	5.0
Others (Rs Mn)	110.6	4.7	51.3	105.6	73.1
Client data					
- Repeat Business	90.4			88.8	82.9
- Number of clients billed	120			115	103
- Number of new clients added	12			9	10
>\$1 mn clients	29			28	25
<\$5 mn clients	21			20	19
\$5-\$10mn clients	4			4	4
>\$10mn clients	4			4	2
- No. of Fortune 500 customers	-			-	-
Client concentration					
- Top client	12.1			13.1	13.4
- Share of top 5 clients in total revenue	42.6			42.6	41.3
- Share of top 10 clients in total revenue	59.7			60.2	55.4
Top client	212.4	(1.7)	8.4	216.2	195.9
Top 5 clients	747.9	6.4	23.9	703.1	603.8
Top 5 excl Top client	535.5	10.0	31.3	486.9	407.9
Top 10 clients	1,048.1	5.5	29.4	993.5	809.9
Bottom 5 in Top 10 clients	300.2	3.4	45.6	290.5	206.1
Remaining clients	707.5	7.7	8.5	656.9	652.0

Source: Motilal Oswal Securities

Hexaware Technologies: an investment profile

Company description

Hexaware is a niche IT-services vendor ranked amongst the top five Indian IT companies in Germany and has the reputation of winning the single-largest deal ever by an Indian IT company in that geography. It employs more than 4,000 people and carries the reputation of managing one of the largest PeopleSoft development centres outside USA. Its key clients include PeopleSoft, Citibank, Deutsche Leasing, Air Canada and AXA.

Key investment arguments

- Credible tier-2 Indian IT services vendor with niche offerings
- One of the top five Indian IT companies, in terms of client profile, in Germany
- Scale player in its chosen niches of PeopleSoft technology, Airlines vertical and European geography

Key investment risks

- Oracle is consolidating its vendor base and discontinuing 'pure' PeopleSoft vendors like Hexaware
- Pressure to increase SG&A spend to diversify away from PeopleSoft resulting in lower margin expansion
- Employee attrition increasing due to fear of business getting impacted

Recent developments

- PeopleSoft's India Service Center run by Hexaware to be transferred to Oracle effective Nov 2, 2005
- Revised its net profit guidance to \$19.5m from \$18-19m guided earlier, retained revenue guidance at \$153m
- Hexaware won two contracts worth USD5m from two major financial services conglomerates for independent testing services

Valuation and view

- Revenue CAGR of 17% and earnings CAGR of 25% over the next two years
- Valuations at 14.9x CY05 earnings appear expensive, given weak outlook
- Maintain **Sell** with a target price of Rs100.

Sector view

- Various CIO surveys indicate increasing share of offshore spending in IT budgets
- Indian offshore vendors gaining market share in competition with MNCs
- Prefer large companies as bulk of volumes going to them while niche players benefit due to lack of offshore competition in their segments

COMPARATIVE VALUATIONS

		HEXWARE	MPHASIS BFL	IFLEX
P/E (x)	CY05E	14.9	12.9	29.8
	CY06E	13.9	10.7	18.7
P/BV (x)	CY05E	3.9	4.0	5.9
	CY06E	3.1	2.8	4.7
EV/Sales (x)	CY05E	1.9	1.8	4.2
	CY06E	1.6	1.2	2.8
EV/EBITDA (x)	CY05E	11.4	9.1	17.9
	CY06E	9.5	6.2	10.8

SHAREHOLDING PATTERN (%)

	SEP.05	JUN.05	SEP.04
Promoters	32.3	32.6	35.8
Domestic Institutions	8.2	9.1	7.1
FII's/FDIs	38.7	45.8	40.7
Others	20.7	12.5	16.4

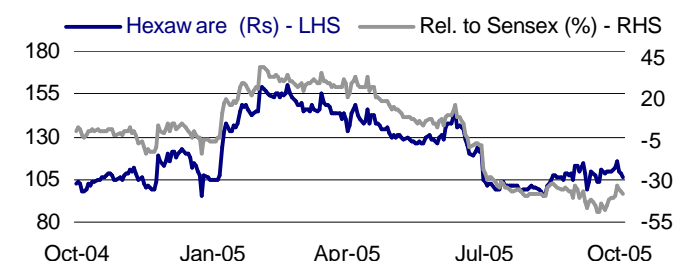
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
CY05	7.1	7.1	0.0
CY06	7.6	8.8	-13.6

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
106	100	-5.7	Sell

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)					
Y/E DECEMBER	2002	2003	2004	2005E	2006E
Sales	2,486	3,390	5,459	6,673	7,454
Change (%)	N.A.	36.4	61.0	22.2	11.7
Cost of Services	1,479	2,223	3,392	4,113	4,789
SG&A Expenses	864	856	1,280	1,463	1,449
EBITDA	143	311	787	1,097	1,216
% of Net Sales	5.8	9.2	14.4	16.4	16.3
Depreciation	143	150	161	212	224
Other Income	6	50	98	98	108
EO Item (net)					
PBT	6	211	724	983	1,100
Tax	-16	39	86	90	104
Rate (%)	-243.5	18.6	11.9	9.2	9.5
PAT	22	172	637	893	995
Share of profit in associate	35	157	0	0	0
Net Income	58	329	637	893	995
Change (%)		471.1	93.8	40.1	11.5

BALANCE SHEET (Rs Million)					
Y/E DECEMBER	2002	2003	2004	2005E	2006E
Share Capital	222	229	239	253	268
Share Premium	1,675	1,693	1,693	1,693	1,693
Reserves	222	239	746	1,639	2,634
Net Worth	2,120	2,161	2,678	3,584	4,595
Loans	187	26	52	41	41
Capital Employed	2,306	2,187	2,730	3,625	4,636
Gross Block	1,268	1,165	1,511	1,881	2,281
Less : Depreciation	376	49	541	753	977
Net Block	892	746	970	1,128	1,304
Other LT Assets	142	130	67	67	67
Investments	192	392	0	0	0
Curr. Assets	1,412	1,530	2,716	3,533	4,483
Debtors	547	888	1,361	1,371	1,389
Cash & Bank Balance	508	316	775	1,639	2,624
Loans & Advances	358	326	581	523	470
Current Liab. & Prov	324	612	1,023	1,103	1,218
Creditors	120	170	333	273	270
Other liabilities	174	343	470	541	622
Provisions	30	100	220	289	326
Net Current Assets	1,088	918	1,693	2,430	3,265
Misc. Expenses	-9	2	0	0	0
Application of Funds	2,306	2,187	2,730	3,625	4,636

E: MOST Estimates

RATIOS					
Y/E DECEMBER	2002	2003	2004	2005E	2006E
Basic (Rs)					
EPS	0.2	1.5	5.3	7.1	7.6
Cash EPS	12	2.4	6.0	8.2	18.2
Book Value	15.8	16.1	20.0	26.7	34.3
DPS	0.0	0.0	1.0	14	1.5
Payout %(Incl.Div.Taxes)	0.0	0.0	18.8	20.0	20.0
Valuation					
P/E		70.7	19.8	14.9	13.9
Cash P/E		44.0	17.7	12.8	5.8
EV/EBITDA		43.3	17.1	11.4	9.5
EV/Sales		4.0	2.5	1.9	1.6
Price/Book Value		6.5	5.3	3.9	3.1
Dividend Yield (%)		0.0	0.9	13	1.4
Profitability Ratios (%)					
RoE		15.4	26.3	28.5	24.3
RoCE		9.4	29.4	30.9	26.6
Turnover Ratios					
Debtors (Days)	80	96	91	75	68
Fixed Asset Turnover (x)	2.0	2.9	3.6	3.5	3.3
Leverage Ratio					
Debt/Equity Ratio(x)	0.1	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT (Rs Million)				
Y/E DECEMBER	2003	2004	2005E	2006E
CF from Operations	321	798	1,105	1,219
Cash for Working Capital	22	316	-127	-150
Net Operating CF	300	482	1,232	1,369
Net Purchase of FA	103	-346	-370	-400
Net Purchase of Invest.	-392	392	0	0
Net Cash from Invest.	-289	46	-370	-400
Proceeds from Pvt. Place.	25	10	14	16
Proceeds from LTB/STB	-161	26	-12	0
Dividend Payments	0	0	0	0
Cash Flow from Fin.	-136	36	2	16
Free Cash Flow	402	137	862	969
Net Cash Flow	-125	565	864	985
Opening Cash Balance	1,948	316	775	1,639
Add: Net Cash	-125	565	864	985
Closing Cash Balance	316	775	1,639	2,624

N O T E S

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Disclosure of Interest Statement	Hexaware Technologies
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
MOST is not engaged in providing investment-banking services.	

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