ILFS INVESTSMART
Institutional Equity

IT Services

Subex Azure

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Results below expectations; 'Buy' maintained

Buy

Rs643

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Market cap	
Rs bn	22
US$ mn	546
Avg 3m daily volume	76,578
Avg 3m daily value	
Rs mn	46
Shares outstanding (mn)	35
Reuters	SUBX.BO/SUBEX.NS
Bloomberg	SUBX IN
Sensex	13,765
Nifty	4,077

Subex Azure Ltd's (Subex) Q4FY07 revenue fell 17% sequentially to Rs882mn, much below our expectations. However, net profit grew 44.4% sequentially to Rs276mn on account of higher forex gains and deferred tax credit.

Subex has guided for consolidated (Subex Azure + Syndesis) product revenue of US$150mn and net profit of US$38mn in FY08E. Though we believe that the revenue is achievable on the back of strong order backlog and order pipeline; more than expected redundancy cost (due to Syndesis acquisition) could have a negative impact on the bottomline. We expect the combined entity to post revenue of Rs7.45bn and net profit of Rs1.5bn in FY08E, implying an EPS of Rs43.4. Further, we expect the company to post an EPS of Rs63.4 in FY09E, implying a two year EPS CAGR of 80.6%.

Currently, the stock is quoting at 15.2x FY08E and 10.4x FY09E earnings. We maintain 'Buy' on the stock.

Key highlights of Q4FY07:

- Lower license fee impacts product revenue: Subex reported product revenue of Rs579mn in Q4FY07, as against Rs758mn in Q3FY07, a sequential decline of 23.6%. Revenue declined on account of 51% sequential decline in license fee, as some of the contracts shifted to Q1FY08E. Due to lower license fee booking, the company missed its FY07 product revenue guidance. The company's product revenue in FY07 was at Rs2.28bn, as against the guidance of Rs2.4bn.

- Reports negative EBITDA : Subex reported a loss of Rs 18mn at the EBITDA level in Q4FY07 as against a profit of Rs 220mn in Q3FY07. The loss was on account of:

  a) Lower license fee booking, leading to lower product revenue.

  b) Redundancy cost of Rs240mn in Q4FY07.

  c) Higher provisioning for bad and doubtful debts

Shareholding (%)

Promoters	*8.7*
FII's	*15.0*
MFs	*14.6*
Others	*61.7*

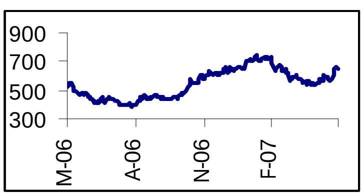
Share price performance

52-week high/low (Rs) 790/380

	-1m	-3m	-12m
Abs (%)	18.4	-10.3	21.6
Rel* (%)	12.4	-6.8	12.0

*to Nifty

Stock chart



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- Forex gains and deferred tax credit boosts net income: Sequentially, the company's EBITDA declined 73.9% and net income increased 44.4% to Rs276mn. This was on account of:

  a) Forex gains of Rs204mn in Q4FY07 due to restatement of liabilities towards FCCBs.

  b) Deferred tax credit of Rs154.4mn due to brought forward unabsorbed losses in Subex Azure (UK) Ltd. (formerly Azure).

- Higher than expected redundancy cost impacts net profit in FY07: Though Azure's integration with Subex was completed ahead of schedule in Q3FY07, as against the earlier estimate of Q4FY07; redundancy cost of Rs430mn was much higher than expected at Rs300-350mn. The company expensed Rs360mn of the cost (Rs240mn in Q4FY07) in FY07 and capitalised the rest (Rs69mn) to be ammortised till 2010. Out of the capitalised sum, Rs23mn was ammortised in FY07.

- Higher other income and lower tax helps achieve net profit guidance: At the start of FY07, Subex had guided for product revenue of Rs2,400mn and net profit of Rs650mn. Though the company failed to achieve its product revenue guidance (Rs2,288mn against the guided amount of Rs2,400mn) on account of lower license fee booking; the company was able to achieve its net profit guidance (Rs677mn in FY07 as against the guided amount of Rs650mn). However, net profit guidance was met mainly on account of higher other income (as result of forex gains in Q4FY07) and deferred tax credit (due to carried forward losses in Subex Azure (UK)). In the absence of these, we believe it would have been difficult for the company to achieve its net profit guidance.

- Syndesis to be integrated from Q1FY08 onwards: Subex plans to integrate Syndesis from Q1FY08 onwards. Inorder to improve Syndesis' profitability, Subex plans to reduce the operational cost of Syndesis, on the same lines as that of Azure. However, the company doesn't expect redundancy cost to be as high as in Azure. It expects redundancy cost of about US$3mn in FY08E, as against US$9.5mn in Azure. Post integration, the company expects a cost saving of US$8mn in FY08E and US$12mn in FY09E in Syndesis. However, the key risk to it could be higher than expected redundancy cost, as was the case in Azure.

- Good visibility ahead: Subex has entered FY08E with an order backlog and AMC revenue of US$70mn. This coupled with a sales pipeline (orders bid for) of US$310mn at the end of Q4FY07 shows good visibility ahead. Historically, Subex has had a success rate of 35-40% in converting order pipelines to actual orders.

- Guidance: Subex has guided for product revenue of US$150mn and consolidated net profit of US$38mn in FY08E. Syndesis is expected to contribute US$50mn and US$9mn to the topline and bottomline in FY08E.

Further, the company expects to incur redundancy payment in excess of US$3mn (plans to expense US$3mn and capitalise the rest) as it reduces the number of employees in Syndesis by 120.

- Financials: We expect Subex to post consolidated revenue of Rs7.45bn in FY08E and Rs9.48bn in FY09E; the product division is likely to contribute Rs6.2bn and Rs8.1bn to the company's revenue respectively. We also expect Subex to post net profit of Rs1,509mn and Rs2,205mn in FY08E and FY09E, implying an EPS of Rs43.4 and Rs63.4 respectively, a two-year (FY07-09E) CAGR of 80.6%.
- Valuation: Currently, the stock is quoting at FY08E and FY09E PER of 15.2x and 10.4x respectively. With the company expected to grow at two year CAGR of 80.6%, we remain bullish on the stock and maintain 'Buy'.

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Table 1. Quarterly Result Table

	Q4FY07	Q3FY07	QoQ (%)	Q4FY06	YoY (%)
Revenues	882	1,062	-17.0%	494	78.5%
Products	579	758	-23.6%	313	84.6%
Services	303	304	-0.4%	180	68.0%
Expenditure	900	842	6.8%	362	148.9%
Cost of Equipment & Software	16	9	74.0%	6	151.0%
Personnel Cost	597	542	10.2%	280	113.3%
Other Expenditure	287	263	9.1%	64	347.1%
Commission on sales	-	28		11	
EBITDA	(18)	220		132	
EBITDA Margin	-2.1%	20.7%		26.8%	
Depreciation and ammortisation	37	23	58.1%	24	52.5%
EBIT	(55)	196		108	
EBIT Margin	-6.2%	18.5%		21.9%	
Interest	39	20	91.4%	9	315.4%
Other income	228	29	675.8%	4	5751.8%
PBT	134	206	-34.6%	103	30.7%
Taxes	(142)	14		19	
Tax rate	-105.4%	7.0%		18.2%	
PAT	276	191	44.4%	84	228.4%
NPM	31.3%	18.0%		17.0%	

Source: IISL research, company

Table 2. Estimates

Rs mn	FY06	FY07	FY08E	FY09E
Revenues	1,825	3,409	7,452	9,482
% growth	56.6%	86.7%	118.6%	27.2%
Net Income	405	676	1,509	2,205
% growth	53.8%	66.9%	123.4%	46.1%
EPS	18.6	19.4	43.4	63.4
% growth	42.3%	4.4%	123.4%	46.1%
PER(x)	35.4	33.9	15.2	10.4
ROE(%)	26.6%	13.2%	16.5%	20.2%
ROCE(%)	25.0%	3.9%	10.2%	12.8%

Source: IISL research, company

 # Do not contain Azure

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