

Company Flash

15 October 2007 | 8 pages

Sasken Communication Technologies (SKCT.BO)

Buy: 2QFY08 Results – Look Beyond Headline Numbers

- Quarterly results below estimates** – Sasken reported revenues of Rs1.43 bn (Rs1.33 bn, excluding the Rs105 mn one-time compensation from a tier-one customer, vis-à-vis our expectations of Rs1.36 bn). Profits came in at Rs143 mn (~Rs74mn, excluding the one-time benefit, vs. expectations of Rs84 mn).
- Services business muted** – Excluding one-time compensation, top-line growth was muted at ~4% qoq in \$ terms mainly due to a shift toward offshore and lower utilization in Botnia due to the holiday season in Finland.
- Products business improving** – This segment delivered robust revenue growth of 16% QoQ along with a reduction in losses. The EBITDA margins improved to -37% (from -57% in Q1).
- Management reiterates guidance** – Management reiterated guidance of services revenues growing 20-25% (over \$110m revenue run rate in Q4) and 15-17% EBITDA margins. In products, it expects EBITDA breakeven by Q4FY08. With the sharp rupee appreciation, this remains an uphill task in our view.
- Tier-2 players feeling the pinch** – We believe that steep INR appreciation, supply-side challenges and possible demand slowdown is taking its toll. Scale players are better placed in such an environment.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	229	8.09	-40.2	40.6	2.4	8.7	0.9
2007A	452	15.86	96.1	20.7	2.2	11.2	0.9
2008E	570	19.97	26.0	16.5	2.0	12.9	1.5
2009E	931	32.64	63.4	10.1	1.8	18.9	3.0
2010E	1,189	41.69	27.7	7.9	1.5	21.0	3.0

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

Buy/Medium Risk	1M
Price (15 Oct 07)	Rs328.55
Target price	Rs505.00
Expected share price return	53.7%
Expected dividend yield	0.9%
Expected total return	54.6%
Market Cap	Rs9,364M
	US\$239M

Price Performance (RIC: SKCT.BO, BB: SACT IN)



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Other Key Highlights

- The one-time compensation from the Tier – 1 client was due to the client not meeting minimum revenue commitment.
- Botnia revenues declined 16% qoq to \$6.3m due to August being a holiday month in Finland. Management expects growth to revert in Q3.
- After the blip of 1QFY08 where the company had a decline in the number of employees (~100), the net adds for this quarter were 143. Management scaled down the guidance to ~500 adds for the full year as it is focusing on increasing utilization to 77-80% levels.
- Sasken also reported 2 design wins this quarter: one for the satellite communications market (Inmarsat) and the other for its multimedia subsystem with a global tier-one name.

Figure 1. Key financials

	2Q07	1Q08	2Q08	QoQ	YoY
Revenue	1,175.45	1,283.72	1,432.33	11.6%	21.9%
Cost of revenue	708.56	847.42	896.07	5.7%	26.5%
R&D costs	42.11	90.01	50.03	-44.4%	18.8%
Gross profit	424.78	346.29	486.23	40.4%	14.5%
Gross margins	36.1%	27.0%	33.9%	697bp	-219bp
SG&A expenses	204.63	247.26	251.65	1.8%	23.0%
EBITDA	220.15	99.03	234.58	136.9%	6.6%
EBITDA margin	18.7%	7.7%	16.4%	866bp	-235bp
Dep and Amort.	55.93	104.45	103.19	-1.2%	84.5%
EBIT	164.22	(5.42)	131.39	-2524.1%	-20.0%
EBIT margin	14.0%	-0.4%	9.2%	960bp	-480bp
Profit before tax	152.23	90.33	199.98	121.4%	31.4%
Tax provision	33.35	26.48	56.68	114.0%	70.0%
Profit from operations	118.88	63.85	143.30	124.4%	20.5%
Reported profit	118.88	63.85	143.30	124.4%	21%
EPS - basic	4.26	2.24	5.03	124.4%	18%
EPS - diluted	4.19	2.21	4.97	124.4%	18%

Source: Company Reports

Figure 2. Key HR metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Total employees	2,897	3,373	3,512	3,611	3,513	3,656
- gross adds	469	675	350	290	199	476
- net adds	322	476	139	139	(98)	143
Utilization	79.1%	74.4%	73.6%	71.5%	72.5%	76.2%

Source: Company Reports

Figure 3. Geographic mix

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
North America	35.0%	32.0%	25.0%	25.0%	28.0%	35.0%
Europe	32.5%	39.0%	49.0%	49.0%	49.0%	44.0%
India	27.9%	24.0%	20.0%	19.0%	19.0%	19.0%
APAC	4.6%	6.0%	6.0%	8.0%	4.0%	2.0%

Source: Company Reports

Figure 4. Key client metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Client concentration						
Top5 clients	76.7%	77.3%	81.0%	75.0%	76.5%	74.2%
Top10 clients	87.2%	86.6%	89.0%	87.0%	87.8%	85.4%
Profile of Tier1 clients						
< US\$ 1 mn	13	13	14	14	14	13
US\$ 1-3 mn	1	0	0	3	3	3
US\$ 3-10 mn	2	3	2	3	2	3
US\$ 10-20 mn	1	1	2	1	1	1
US\$ 20m+	1	1	1	2	3	3

Source: Company Reports

Figure 5. Revenue profile

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Product revenue	3.9%	5.3%	3.2%	6.2%	6.6%	6.8%
- license fees	2.1%	4.0%	2.1%	2.3%	4.0%	4.4%
- royalties	1.5%	1.1%	0.5%	1.3%	1.5%	1.0%
- customization	0.3%	0.2%	0.6%	2.6%	1.1%	1.3%
Services revenue	96.1%	94.7%	96.8%	93.8%	93.4%	93.2%
- onsite	14.1%	21.4%	32.9%	31.4%	30.5%	25.1%
- offshore	76.6%	66.5%	59.2%	58.3%	59.8%	63.8%
- fixed price	5.4%	6.7%	4.6%	4.1%	3.1%	4.3%

Source: Company Reports

Sasken Communication Technologies

Company description

Bangalore-based Sasken was established in 1989 and initially worked on electronic design automation projects. It now offers embedded software services to network equipment manufacturers, device manufacturers and service providers in the wireless and broadband space, and semiconductor vendors. Key clients include large tier-one vendors such as Nokia and Nortel. Sasken has also been investing in a products business.

Investment strategy

We rate Sasken as Buy/Medium Risk (1M). Increasing competition is driving telecoms vendors to outsource software and services to countries such as India. R&D services are being outsourced from India. Sasken, with a strong focus on the telecoms and embedded space, is benefiting from this trend. We expect Sasken's services business to record a 28% CAGR over FY07-10. The acquisition of Botnia has helped in accelerating growth. The products business is in investment mode, but the number of design-ins is encouraging. We expect a ramp-up and a turnaround in the products business in FY08; we forecast a 68% CAGR in revenues over FY07-10 and see the business turning around from losses to a 30%-plus margin in FY10.

Valuation

Our 12-month target price of Rs505 is based on a sum-of-the-parts valuation for the services business and the loss-making products business. We apply an

FY09E EV/EBITDA target of 10x for Sasken's services business, which is supported by the target valuations of comparable mid-caps. We value Sasken's products business at 3x EV/Sales, similar to the valuation Motorola paid for Sasken's largest competitor, TTPCom, and is supported by our forecast 30%-plus margin in FY09. Our target price implies a P/E of 16x FY09E EPS - in line with target mid-cap valuations.

Risks

Our quantitative risk rating system, which tracks 260-day historical share price volatility, rates Sasken as Medium Risk. Risks that could impede the stock from reaching our target price include: (1) high client concentration; (2) slowdown in the telecoms industry; (3) delays in the handset launches in which Sasken is involved, or poor customer response to the handsets; (4) technology obsolescence; (5) wage inflation and currency appreciation; and (6) volatility in QoQ revenues, as investors are used to more linear models of growth for most Indian IT services companies.

Appendix A-1

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Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal, CFA (covered since December 7 2006)



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