



## Hexaware Technologies

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,724	HEXW IN
	REUTERS CODE
S&P CNX: 3,678	HEXT.BO

19 October 2006

Buy

Previous Recommendation: Buy

Rs168

Equity Shares (m)	132.1
52-Week Range (Rs)	182/99
1,6,12 Rel. Perf. (%)	-1/-4/6
M.Cap. (Rs b)	22.2
M.Cap. (US\$ b)	0.5

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
12/05A	6,787	915	7.2	32.3	23.3	6.4	29.8	32.4	3.1	19.4
12/06E	8,453	1,271	9.6	32.9	17.5	3.0	23.2	25.1	2.1	13.3
12/07E	11,200	1,597	12.1	25.8	13.9	2.5	19.6	21.9	1.6	10.5

- Sales growth lower than estimate, higher other income props profit growth:** Hexaware reported sales growth 8.7% QoQ to Rs 2.25b against our expectation of 2.29b. Volume growth was lower than estimated with higher than expected onsite contribution. Pricing improved by 0.3% onsite and 0.7% offshore. Other income was higher than estimated at Rs80m. PAT growth was almost in line with expectation at Rs0.35b, up 16.5% QoQ.
- Employee/ infrastructure addition, order booking and client addition continue to be robust:** Hexaware added 757 (Net) employees during 3QCY2006, the highest in a single quarter. The company also added 11 new clients including 3 in PeopleSoft and 3 in BFSI. Outstanding order book continued to remain higher than US\$225m, with the addition of US\$43m of new orders.
- 4QCY06 guidance counts further margin upside:** 4QCY06 growth guidance of 5% QoQ in revenues and 6.7% QoQ in PAT assumes some margins improvement in 4QCY06. The company's primary margin lever is improvement in utilization rates as the freshers added in 3QCY06 would become billable in 4QCY06 and higher offshoring.
- Outlook and view:** At CMP, the stock is trading at 17.5x CY06E and 13.9x CY07E. We reiterate **Buy** for a target price of Rs180 (Upside of 7%). Considering our target price, the upside is limited. With a war chest of over US\$100m, the management is looking at possible acquisition with target size of US\$20-35m. The company's efforts for inorganic growth in near future can result into higher EPS estimates as well as higher upside than estimated.

### QUARTERLY PERFORMANCE

(Rs Million)

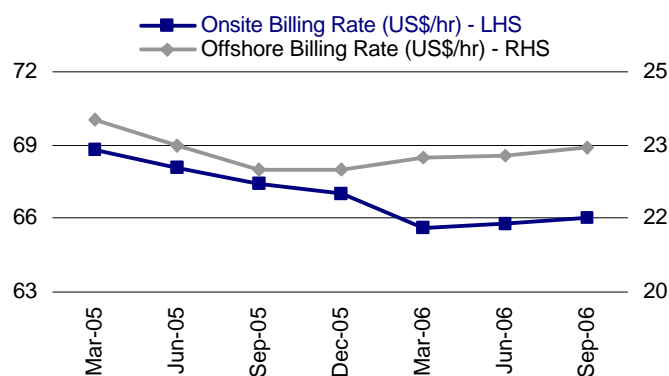
Y/E DECEMBER	CY05				CY06				CY05	CY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
<b>Revenues</b>	<b>1,641</b>	<b>1,650</b>	<b>1,756</b>	<b>1,740</b>	<b>1,762</b>	<b>2,069</b>	<b>2,250</b>	<b>2,373</b>	<b>6,787</b>	<b>8,453</b>
Q-o-Q Change (%)	4.5	0.6	6.4	-0.9	1.2	17.4	8.7	5.5	24.3	24.6
Direct Expenses	1,002	1,032	1,083	1,056	1,080	1,324	1,412	1,484	4,173	5,301
Sales, General & Admin. Expenses	361	371	374	421	388	434	477	503	1,526	1,802
<b>Operating Profit</b>	<b>278</b>	<b>248</b>	<b>298</b>	<b>263</b>	<b>294</b>	<b>311</b>	<b>361</b>	<b>386</b>	<b>1,087</b>	<b>1,351</b>
Margins (%)	16.9	15.0	17.0	15.1	16.7	15.0	16.0	16.3	16.0	16.0
Other Income	27	18	27	74	35	46	80	80	146	241
Depreciation	54	53	57	57	46	46	55	59	221	207
<b>PBT bef. Extra-ordinary</b>	<b>251</b>	<b>213</b>	<b>269</b>	<b>280</b>	<b>282</b>	<b>311</b>	<b>385</b>	<b>406</b>	<b>1,012</b>	<b>1,385</b>
Provision for Tax	19	18	28	32	22	13	39	41	97	115
Rate (%)	7.5	8.6	10.4	11.5	7.8	4.3	10.0	10.0	9.6	8.3
<b>PAT bef. Extra-ordinary</b>	<b>232</b>	<b>195</b>	<b>241</b>	<b>248</b>	<b>260</b>	<b>298</b>	<b>347</b>	<b>366</b>	<b>915</b>	<b>1,271</b>
Share of Profit in Associate Companies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Net Income</b>	<b>232</b>	<b>195</b>	<b>241</b>	<b>248</b>	<b>260</b>	<b>298</b>	<b>347</b>	<b>366</b>	<b>915</b>	<b>1,271</b>
Q-o-Q Change (%)	8.3	-16.3	23.7	2.9	5.1	14.4	16.5	5.5	43.6	38.8

E: MOST Estimates

**Sales growth lower than estimate, margins marginally higher, higher other income props profit growth**

Hexaware reported sales growth 8.7% QoQ to Rs 2.25b against our expectation of 2.29b. Volume growth was lower than estimated with higher than expected onsite contribution. Onsite composition of revenue for the quarter increased to 61.1% from 60.4% in 2QCY06. Besides, higher onsite growth and rupee depreciation growth in revenue was led by pricing improvement of 0.3% onsite and 0.7% offshore.

**PRICING INCHING UPWARDS**

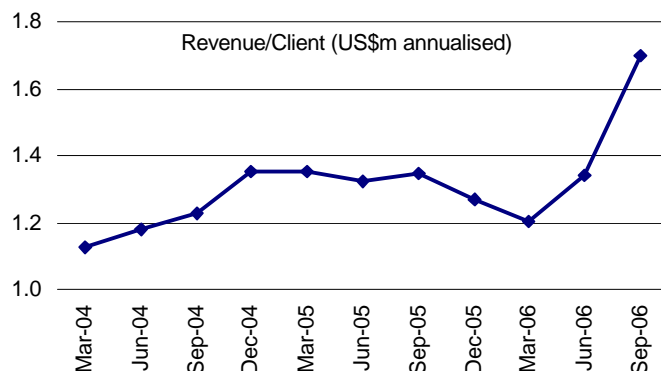


Source: Company/ Motilal Oswal Securities

PeopleSoft business continued to lead growth, it grew 13% QoQ, and HR IT grew 10%, while application management services grew slower at 5.5% QoQ. Europe also slowed down to 5% growth after strong double digit growth for the past 3 quarters. America also grew slower at 7.3%, while the rest of the world grew 54% QoQ.

The top client declined by 4.4% during the quarter due to completion of a large project in the previous quarter. Top 2-5 clients grew strongly at 21% QoQ. The company is in the process on eliminating fringe clients, which has resulted in active client base decreasing to 119 from 141 in the previous quarter despite adding 11 new clients. This has resulted in improved revenue per client, which was up 27% QoQ.

**CLIENT RATIONALIZATION RESULTS IN SHARP UPSWING IN REALIZATION/ CLIENT**



Source: Company/ Motilal Oswal Securities

Hexaware reported 16% EBITDA margin against our expectation of 15.9% (15% in 2QCY06). This was due to improvement in utilization rates, which pushed up gross margins during the quarter by 120bp. SG&A increased by 20 bp during the quarter. Other income was higher than estimated at Rs80m despite small forex losses due to return on higher cash on books (>US\$100m). Other income was driven by Rs63m of recurring income, which is expected to result in higher other income over the forthcoming quarters as well. Tax rate was higher at 10%. PAT growth was almost in line with expectation with 15.4% QoQ growth at Rs0.35b.

**Employee addition, order booking and client addition continue to be robust**

Hexaware added 757 (Net) employees during 3QCY06, the highest in a single quarter. Of this, 500 were freshers who are expected to become billable with a one quarter lag. The company is currently in the process of adding infrastructure in Chennai, and is planning to add facilities in Pune and Navi Mumbai in order to be able to scale up for faster business traction.

The company also added 11 new clients including 3 in PeopleSoft and 3 in BFSI. The PeopleSoft business is gaining greater traction due to improvement in license sales of PeopleSoft software and Oracle's recent announcements to continue with enhancements and upgrades to PeopleSoft. However, Hexaware plans to restrict the business from PeopleSoft as a proportion to its revenue at the current levels. This is to reduce risk of revenue loss when PeopleSoft is replaced with Oracle Fusion post 2010.

#### CLIENT ADDITIONS (NOS)

	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06
New Clients Added	12	10	11	15	11
PeopleSoft	7	4	7	4	3
Non - PeopleSoft	5	6	4	11	8

Source: Company/ Motilal Oswal Securities

Outstanding order book continued to remain higher than US\$225m, with the addition of US\$43m of new orders, indicating sales growth visibility going forward. The company expects greater traction in HR IT services based on Oracle and SAP.

#### 4QCY06 guidance counting further margin upside

Hexaware expects revenue of US\$51m during 4QCY06 (QoQ growth of 5%) with higher growth in PAT at 6.7% to US\$8m indicating that Hexaware expects margins to

continue to improve in 4QCY06. The company's primary margin lever is improvement in utilization rates as the freshers added in 3QCY06 would become billable in 4QCY06 and also improving offshore contribution. Allowing for likely rupee appreciation during the quarter, we expect margins to improve by 30bp in 4QCY06.

#### Acquisitions could result in possible re-rating

With a war chest of over \$100m, the management is looking at possible acquisition with target size of US\$20-35m. The management is currently evaluating various opportunities in this regard and we expect the announcement of acquisition could be in the near term. The management has indicated that the acquisitions are not likely to result in earnings dilution for the company. Any positive development in this regard is likely to result in possible re-rating of the stock.

#### Outlook and view

At CMP, the stock is trading at 17.5x CY06E and 13.9x CY07E. We reiterate **Buy** for a target price of Rs180 (Upside of 7%). Considering our target price, the upside is limited. However, with company's efforts for inorganic growth in near future can result into higher EPS estimates as well as higher upside than estimated.

## 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 5,000 people. Its key clients include 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 Germany, in terms of client profile.
- ☞ Scale player in its chosen niches of PeopleSoft technology, Airlines vertical and European geography.

### Key investment risks

- ☞ Oracle might phase out PeopleSoft after 2-3 years.
- ☞ Equity allotment to General Atlantic might result in equity dilution which could impact valuation adversely.

### Recent developments

- ☞ General Atlantic invested Rs3b (US\$67.6m) in Hexaware through preferential allotment of 14.99% equity stake post conversion.
- ☞ Outstanding order book of US\$225m, US\$43m of which was added in 3QCY06.

### Valuation and view

- ☞ Revenue CAGR of 28.5% and earnings CAGR of 32.1% over the next two years.
- ☞ Trading at 13.9x CY07E, possible acquisition can re-rate the stock.
- ☞ Maintain **Buy** with target price of Rs180.

### 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

		HEXAWARE	MPHISIS BFL	I-FLEX
P/E (x)	CY06E	17.5	28.2	34.9
	CY07E	13.9	22.0	26.4
P/BV (x)	CY06E	3.0	6.2	7.0
	CY07E	2.5	4.9	5.8
EV/Sales (x)	CY06E	2.1	2.9	4.9
	CY07E	1.6	2.3	3.7
EV/EBITDA (x)	CY06E	13.3	17.1	23.2
	CY07E	10.5	12.8	16.8

#### SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	25.7	25.9	32.3
Domestic Inst	7.7	7.0	8.2
Foreign	54.4	54.7	38.7
Others	12.2	12.4	20.8

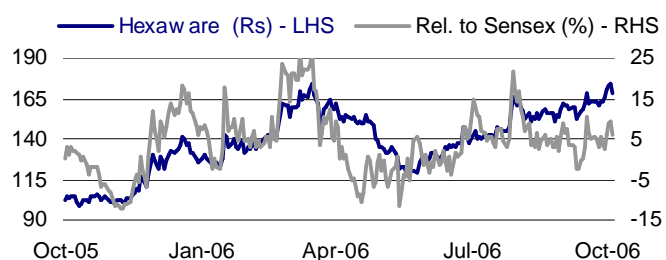
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
CY06	9.6	9.2	4.3
CY07	12.1	11.5	5.7

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
168	180	7.1	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006 E	2007 E	2008 E
<b>Sales</b>	<b>5,459</b>	<b>6,787</b>	<b>8,453</b>	<b>11,200</b>	<b>14,337</b>
Change (%)	61.0	24.3	24.6	32.5	28.0
Cost of Services	3,392	4,173	5,301	7,252	9,584
SG&A Expenses	1,280	1,526	1,802	2,258	2,724
<b>EBITDA</b>	<b>787</b>	<b>1,087</b>	<b>1,351</b>	<b>1,689</b>	<b>2,028</b>
% of Net Sales	14.4	16.0	16.0	15.1	14.1
Depreciation	161	221	207	280	358
Other Income	98	146	241	371	468
<b>PBT</b>	<b>724</b>	<b>1,012</b>	<b>1,385</b>	<b>1,779</b>	<b>2,136</b>
Tax	86	97	115	182	214
Rate (%)	11.9	9.6	8.3	10.2	10.0
<b>PAT</b>	<b>637</b>	<b>915</b>	<b>1,271</b>	<b>1,597</b>	<b>1,922</b>
Share of profit in associate	0	0	0	0	0
<b>Net Income</b>	<b>637</b>	<b>915</b>	<b>1,271</b>	<b>1,597</b>	<b>1,922</b>
Change (%)	165.8	43.6	38.8	25.7	20.3

BALANCE SHEET					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006 E	2007 E	2008 E
Share Capital	233	239	264	264	264
Convertible Pref Sh. Cap	0	0	1,500	1,500	1,500
Share Premium	1,719	1,750	3,228	3,228	3,228
Reserves	718	1,486	2,505	3,781	5,271
<b>Net Worth</b>	<b>2,670</b>	<b>3,474</b>	<b>7,497</b>	<b>8,773</b>	<b>10,264</b>
Loans	52	62	0	0	0
<b>Capital Employed</b>	<b>2,722</b>	<b>3,536</b>	<b>7,497</b>	<b>8,773</b>	<b>10,265</b>
Gross Block	1,402	1,564	2,264	3,014	3,664
Less : Depreciation	541	633	840	1,120	1,478
<b>Net Block</b>	<b>861</b>	<b>931</b>	<b>1,424</b>	<b>1,894</b>	<b>2,186</b>
Other LT Assets	67	30	25	20	20
Investments	393	653	753	803	853
<b>Curr. Assets</b>	<b>2,437</b>	<b>3,090</b>	<b>6,557</b>	<b>7,885</b>	<b>9,487</b>
Debtors	1,361	1,836	2,009	2,901	3,384
Cash & Bank Balance	391	534	3,578	3,714	4,506
Loans & Advances	685	720	970	1,270	1,598
Other Current Assets	0	0	0	0	0
<b>Current Liab. &amp; Prov</b>	<b>1,145</b>	<b>1,170</b>	<b>1,462</b>	<b>1,929</b>	<b>2,382</b>
Creditors	165	173	290	323	462
Other liabilities	606	587	764	1,056	1,271
Provisions	373	411	407	549	649
<b>Net Current Assets</b>	<b>1,293</b>	<b>1,920</b>	<b>5,095</b>	<b>5,956</b>	<b>7,105</b>
Misc. Expenses	0	0	0	0	0
<b>Application of Funds</b>	<b>2,722</b>	<b>3,536</b>	<b>7,497</b>	<b>8,773</b>	<b>10,264</b>

E: M O S t Estimates

RATIOS					
Y/E DECEMBER	2004	2005	2006 E	2007 E	2008 E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>5.5</b>	<b>7.2</b>	<b>9.6</b>	<b>12.1</b>	<b>14.6</b>
Fully Diluted EPS	5.5	7.2	9.0	11.3	13.7
Cash EPS	6.0	8.6	22.4	28.4	34.5
Book Value	20.2	26.3	56.8	66.4	77.7
DPS	10	14	19	2.4	2.9
Payout %(Incl.Div.Taxes)	18.3	20.0	20.0	20.0	20.0
<b>Valuation</b>					
P/E		23.3	17.5	13.9	11.5
Cash P/E		19.6	7.5	5.9	4.9
EV/EBITDA		19.4	13.3	10.5	8.3
EV/Sales		3.1	2.1	1.6	1.2
Price/Book Value		6.4	3.0	2.5	2.2
Dividend Yield (%)		0.9	1.1	1.4	1.7
<b>Profitability Ratios (%)</b>					
RoE	26.4	29.8	23.2	19.6	20.2
RoCE	29.5	32.4	25.1	21.9	22.4
<b>Turnover Ratios</b>					
Debtors (Days)	91	99	87	95	86
Fixed Asset Turnover (x)	3.9	4.3	3.7	3.7	3.9
<b>Leverage Ratio</b>					
Debt/Equity Ratio (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006 E	2007 E	2008 E
CF from Operations	805	1,130	1,236	1,508	2,177
Cash for Working Capital	-388	-431	-174	-710	-743
<b>Net Operating CF</b>	<b>417</b>	<b>699</b>	<b>1,062</b>	<b>798</b>	<b>1,434</b>
Net Purchase of FA	-364	-175	-898	-650	-650
Net Purchase of Invest.	9	-201	141	321	418
<b>Net Cash from Invest.</b>	<b>-356</b>	<b>-377</b>	<b>-757</b>	<b>-329</b>	<b>-232</b>
Equity and other related item	37	31	1,504	0	0
Proceeds from Pvt. Place.	0	0	1,500	0	0
Proceeds from LTB/STB	26	10	-62	0	0
Interest/ Dividend Payments	-49	-220	-204	-333	-411
<b>Cash Flow from Fin.</b>	<b>14</b>	<b>-179</b>	<b>2,739</b>	<b>-333</b>	<b>-411</b>
Free Cash Flow	53	524	164	148	784
<b>Net Cash Flow</b>	<b>75</b>	<b>143</b>	<b>3,044</b>	<b>136</b>	<b>791</b>
<b>Opening Cash Balance</b>	<b>316</b>	<b>391</b>	<b>534</b>	<b>3,578</b>	<b>3,714</b>
Add: Net Cash	75	143	3,044	136	791
<b>Closing Cash Balance</b>	<b>391</b>	<b>534</b>	<b>3,578</b>	<b>3,714</b>	<b>4,505</b>

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<b>Disclosure of Interest Statement</b>	<b>Hexaware Technologies</b>
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No



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