

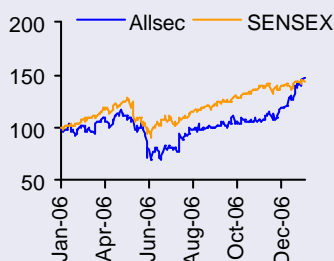
Allsec Technologies Ltd (Q3 FY07) - Investment Update

| | |
|-----------------------|-------------|
| Recommendation | HOLD |
| CMP | Rs351 |
| Target Price | Rs415 |
| Upside | 18.2% |
| 52 Wk H/L | Rs362/142 |
| Market cap | Rs5.35bn |
| Face value | Rs10 |
| BSE code | 532633 |
| NSE code | ALLSEC |

Share holding pattern

| Dec '06 | (%) |
|---------------------------|------|
| Promoters | 26.7 |
| Foreign VCs/Institutions | 42.4 |
| Domestic MFs/Institutions | 10.6 |
| Indian Public | 10.0 |
| Others | 10.3 |

Share price chart



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After recording robust performance in the previous quarter, Allsec delivered disappointing results for Q3 FY07. Revenues and earnings were sequentially lower by 11.7% and 6.1% respectively. Though Q3 has traditionally been the weakest quarter in a fiscal, the weakness was accentuated by regulatory issues at the end of second largest client and failure of new recruitment process tested. The only positive takeaway was expansion in OPM by 40 bps qoq. In the light of above performance, we are downgrading EPS forecasts of FY07 and FY08 by ~12% and ~8% respectively. We revise our outlook to HOLD with a 12-month target price of Rs415 and are positive about Caryle's commitment to company's growth.

Financial highlights

| Period (Rs mn) | 12/06 (3) | 09/06 (3) | Growth (%) qoq | 12/05 (3) | Growth (%) yoy |
|----------------------|-----------|-----------|----------------|-----------|----------------|
| Sales | 272 | 308 | (11.7) | 241 | 13.1 |
| Expenditure | (192) | (219.3) | (12.3) | (169) | 13.9 |
| Operating profit | 80 | 89 | (10.3) | 72 | 11.3 |
| Other income | 11 | 6 | 81.0 | 1 | - |
| Interest | (1) | (0) | - | (1) | 77.0 |
| Depreciation | (20) | (20) | (1.5) | (16) | 27.4 |
| PBT | 70 | 75 | (6.5) | 56 | 24.6 |
| Tax | (0) | (1) | (54.3) | (1) | - |
| PAT | 70 | 74 | (6.1) | 55 | 25.5 |
| OPM (%) | 29.3 | 28.9 | - | 29.8 | - |
| Equity | 152.3 | 152.3 | - | 120.6 | - |
| EPS (Rs) Annualized | 18.3 | 19.5 | - | 14.6 | - |
| P/E (x) at CMP Rs351 | 19.2 | - | - | - | - |

- √ Revenues de-grew by 11.7% sequentially and represented just 13.1% yoy growth at Rs272mn. The de-growth resulted from lower business volumes from the top clients of the company especially the Top 2, Compucredit and an US based ISP/Directory services provider respectively.
- √ Traditionally, Q3 of any fiscal (8.3% qoq de-growth in Q3 FY05 and 0.5% qoq flattish growth in Q3 FY06) has been weaker for the company. Company had anticipated a flattish growth in Q3 FY07 too but the unforeseen sharp qoq de-growth in the second largest account due to regulatory issues led to sequential de-growth in overall revenues.
- √ For the second consecutive quarter (post de-growth of 16.4% qoq in Q2 FY07), revenues from Compucredit de-grew by ~5.8% qoq from about Rs93mn to Rs87mn. Revenues from the second client declined by about Rs20mn on sequential basis from Rs60mn to Rs40mn. The contribution of the Top and Top 3 clients stood at 32% (v/s 30% in Q2 FY07) and 62% (v/s 65% in Q2 FY07) respectively. Average realizations were between 11.5-12\$/hr, similar to previous quarter.
- √ Company has classified the sequential de-growth in Top accounts as a quarterly aberration and expects growth resumption in coming quarters. None of the jobs/processes run for top clients were terminated during the quarter.
- √ There was a marginal shift in voice/non-voice revenue mix on sequential basis from 80/20 to 79/21. Of the non-voice contribution, about 16% came from Quality Assurance (CQM) and balance 5% from HR/Payroll processing services.

- √ Despite significant de-growth in revenues, OPM improved by 40bps on sequential basis to 29.3%. The margin expansion resulted from sharp decline in all cost heads sequentially. Connectivity cost was lower in line with market trend while manpower cost was lower with decline in total number of quarter ending employees. SG&A cost was also slightly lower on sequential basis and has been flattish for the past four quarters.
- √ Other Income jumped sequentially from Rs6mn to Rs11mn with higher treasury income earned on huge surplus funds (majority from Carlyle investment) parked in various liquid investments. Company had Cash & Cash equivalents worth Rs1.1bn (about US\$25mn) at the end of the quarter. The higher Other Income on sequential basis aided towards relatively lower de-growth of 6.1% in earnings on sequential basis.
- √ Quarter ending manpower stood at 2,502 further segregated into about 2,222 on stand-alone basis and about 280 in B2K. During the quarter, company witnessed drastic reduction of about 382 people on consolidated basis resulting from inadequacy of a new recruitment process tried and higher attrition (~20%). B2K added ~150 people in the quarter while Allsec stand-alone faced decline in employee strength by ~400 people. To avoid recurrence of such situation, company has reverted to its old recruitment process.
- √ No new clients were added in the quarter and company had about 26-27 active relationships at the end of the period. The client acquisition efforts were intentionally scaled down (as also reflected in lower SG&A) as company had to cope with decline in employees as well as serve the demand from existing clients.
- √ The seat utilization (no of people/no of seats) stood at 1.1x on consolidated basis and 1.3x on stand-alone basis. Management expressed apprehensions about not meeting the overall break-even target for B2K for full year FY07. With about 280 people, B2K had a seat utilization of 0.5x.
- √ Company intends to acquire 2-3 companies from the huge cash balance. New vertical/service expertise, new geography, established client base and good profitability are the key rationale/criteria behind company's inorganic growth strategy. Management is keen on establishing presence in the US region and expects to close one transaction before the end of the fiscal.
- √ Post the completion of open offer (made subsequent to preferential allotment), Carlyle's stake in the company has risen to ~27.5%. As nominee directors, Mr. Daniel A. D'Aniello, co-founder of The Carlyle Group and Mr. Shankar Narayanan, Managing Director, Asia Growth Capital Fund of The Carlyle Group were inducted on the Allsec Board. The induction of key Carlyle members especially Mr. D'Aniello (Allsec being the first Asian company where he has joined) reflects the strong commitment of the group towards company's growth.
- √ With regards Q4 FY07, management expects resumption in sequential growth and strong yoy growth in revenues. For operating margin, expectations are of sequential decline (about 100-150 bps) with corrective salary action (hike of 15-16%) taken across the board effective January 1st 2007.

Downward revision in estimates but still recommend HOLD

We are revising downwards our FY07 and FY08 consolidated EPS forecasts by ~12% and ~8% respectively to factor Q3 FY07 underperformance (vis-à-vis our estimate) of the company. We now expect FY07 EPS at Rs17 (against earlier estimate of Rs19.3) and FY08 EPS at Rs25.9 (against earlier estimate of Rs28.1).

On the positive side, we are very excited about company's growth prospects in FY08 and thereafter after sensing strong Carlyle commitment towards it. The company is believed to have already started approaching Carlyle's investee companies and any breakthrough here would mean dramatic business on current size and scale. Management expects accelerated growth in FY08 with operating margin moving in a narrow band.

Since our BUY recommendation in September 2006, the stock price has run-up sharply by 46%. After considering estimates revision and recent rally in share price, we downgrade the stock to HOLD with a 12-month target price of Rs415 based on 16x FY08E EPS. Our FY08 earnings estimate has an upside risk from acquisitions and at the same time there is P/E re-rating potential from initiation of Carlyle business flow and recent domestic BPO listings in India and abroad.

Quarterly Trend (Stand-alone)

| Period (Rs mn) | Q1 FY05 | Q2 FY05 | Q3 FY05 | Q4 FY05 | Q1 FY06 | Q2 FY06 | Q3 FY06 | Q4 FY06 | Q1 FY07 | Q2 FY07 | Q3 FY07 |
|---------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Sales | 124 | 152 | 139 | 161 | 183 | 240 | 241 | 259 | 277 | 308 | 272 |
| % qoq growth | - | 22.3 | (8.3) | 15.9 | 13.7 | 30.9 | 0.5 | 7.7 | 6.6 | 11.5 | (11.7) |
| Expenditure | (89) | (107) | (103) | (117) | (131) | (170) | (169) | (186) | (200) | (219) | (192) |
| Operating profit | 35 | 45 | 36 | 44 | 53 | 70 | 72 | 74 | 77 | 89 | 80 |
| % qoq growth | - | 28.2 | (20.9) | 22.8 | 20.1 | 33.3 | 2.7 | 2.2 | 4.1 | 16.4 | 10.3 |
| OPM (%) | 28.3 | 29.7 | 25.6 | 27.1 | 28.7 | 29.2 | 29.9 | 28.3 | 27.7 | 28.9 | 29.3 |
| Other income | 1 | (1) | 0 | 0 | 0 | 1 | 1 | 9 | 11 | 6 | 11 |
| Interest | (4) | (4) | (3) | (3) | (2) | (2) | (1) | (0) | (0) | (0) | (1) |
| Depreciation | (10) | (10) | (11) | (10) | (10) | (18) | (16) | (17) | (20) | (20) | (20) |
| PBT | 23 | 30 | 21 | 31 | 41 | 51 | 56 | 65 | 67 | 75 | 70 |
| Tax | 0 | 0 | 8 | 6 | (1) | 7 | (1) | (1) | 1 | (1) | (0) |
| ETR (%) | - | - | (38.5) | (18.9) | 1.6 | (14.4) | 1.2 | 2.0 | (1.2) | 0.9 | 0.4 |
| PAT | 23 | 30 | 29 | 37 | 40 | 58 | 56 | 63 | 68 | 74 | 70 |
| % qoq growth | - | 33.7 | (3.1) | 26.3 | 8.5 | 45.4 | (4.7) | 13.9 | 7.2 | 9.2 | (6.1) |
| NPM (%) | 18.2 | 19.9 | 21.1 | 23.0 | 21.9 | 24.3 | 23.1 | 24.4 | 24.5 | 24.0 | 25.6 |
| Equity | 43.5 | 43.5 | 43.5 | 88.2 | 119.6 | 120.6 | 120.6 | 120.8 | 120.8 | 152.3 | 152.3 |
| EPS (Rs) Annualized | 20.8 | 27.8 | 26.9 | 16.8 | 13.4 | 19.3 | 18.4 | 21.0 | 22.5 | 19.5 | 18.3 |

Financials

Projected Income Statement

| Period (Rs mn) | FY04 (12) | FY05 (12) | FY06 (12) | FY07P (12) | FY08P (12) |
|---------------------------|--------------|--------------|--------------|---------------|---------------|
| Net sales | 251 | 578 | 939 | 1,326 | 1,824 |
| Operating expenses | (352) | (406) | (677) | (986) | (1,335) |
| Operating profit | (102) | 172 | 262 | 340 | 489 |
| Other income | 0 | 0 | 15 | 40 | 50 |
| PBIDT | (102) | 172 | 276 | 379 | 539 |
| Interest | (15) | (14) | (5) | (3) | (3) |
| Depreciation | (49) | (41) | (68) | (100) | (116) |
| Def rev exp w/off | (7) | (1) | (0) | 0 | 0 |
| Profit before tax | (173) | 115 | 203 | 276 | 420 |
| Tax | 3 | 10 | 4 | (0) | (0) |
| Profit after tax | (170) | 125 | 207 | 276 | 420 |
| Adjusted profit after tax | (170) | 125 | 207 | 276 | 420 |

Projected Balance Sheet

| Period (Rs mn) | FY04 (12) | FY05 (12) | FY06 (12) | FY07P (12) | FY08P (12) |
|---------------------------|--------------|--------------|--------------|---------------|---------------|
| Sources | | | | | |
| Equity Share Capital | 177 | 88 | 121 | 162 | 162 |
| Pref Share Capital | 0 | 0 | 49 | 49 | 49 |
| Share Premium | 0 | 124 | 461 | 1,486 | 1,486 |
| Other reserves | (152) | (23) | 117 | 300 | 591 |
| Net Worth | 25 | 190 | 699 | 1,948 | 2,238 |
| Loan Funds | 115 | 72 | 2 | 0 | 0 |
| Total | 140 | 262 | 749 | 1,997 | 2,287 |
| Uses | | | | | |
| Gross Block | 238 | 257 | 599 | 639 | 829 |
| Accd Depreciation | (78) | (119) | (209) | (309) | (425) |
| Net Block | 159 | 138 | 389 | 329 | 403 |
| Capital WIP | 0 | 16 | 2 | 0 | 0 |
| Total Fixed Assets | 159 | 154 | 391 | 329 | 403 |
| Goodwill | 0 | 0 | 48 | 48 | 48 |
| Investments | 0 | 0 | 0 | 1,100 | 1,400 |
| Total Current Assets | 79 | 151 | 466 | 741 | 752 |
| Total Current Liabilities | (104) | (68) | (178) | (242) | (338) |
| Net Working Capital | (25) | 83 | 288 | 498 | 415 |
| Miscellaneous exp | 2 | 10 | 0 | 0 | 0 |
| Def Tax assets | 3 | 15 | 22 | 22 | 22 |
| Total | 140 | 262 | 749 | 1,997 | 2,287 |

Projected Cash Flow Statement

| Period (Rs mn) | FY04 (15) | FY05 (12) | FY06 (12) | FY07P (12) | FY08P (12) |
|---|----------------------|----------------------|----------------------|-----------------------|-----------------------|
| Pre Tax income from operations | (173) | 115 | 188 | 237 | 370 |
| Depreciation | 49 | 41 | 68 | 100 | 116 |
| Expenses (deferred)/written off | (2) | (8) | 9 | 0 | 0 |
| Deferred Tax Asset/liability | (3) | (11) | (8) | 0 | 0 |
| Pre tax cash from operations | (128) | 137 | 258 | 337 | 486 |
| Other income/prior period ad | 0 | 0 | 15 | 40 | 50 |
| Net cash before tax | (128) | 137 | 273 | 376 | 536 |
| Tax | 3 | 10 | 4 | (0) | (0) |
| Cash profits | (125) | 147 | 277 | 376 | 536 |
| (Inc)/Dec in trade working capital | | | | | |
| -Inventories | 0 | 0 | 0 | 0 | 0 |
| -Sundry debtors | (55) | (41) | (110) | (52) | (72) |
| -Sundry creditors | 104 | (39) | 39 | 44 | 55 |
| -Others | 0 | 3 | 71 | 21 | 40 |
| Net trade working capital | 49 | (77) | (0) | 13 | 24 |
| Operating activities | (76) | 70 | 277 | 389 | 559 |
| (Add)/Dec in fixed assets | | | | | |
| (Add)/Dec in Goodwill | 0 | 0 | (48) | 0 | 0 |
| (Add)/Dec in Investments | 0 | 0 | 0 | (1,100) | (300) |
| (Inc)/Dec in Loans/advances | (19) | (8) | (37) | (220) | 60 |
| Investing activities | (228) | (44) | (390) | (1,358) | (430) |
| Inc/(Dec) in debt | | | | | |
| Inc/(Dec) in equity/premium | 177 | 35 | 419 | 1,066 | (0) |
| Direct add/(red) to reserves-Spl.item | 18 | 16 | 1 | 0 | 0 |
| Dividends | 0 | (12) | (69) | (92) | (129) |
| Financing activities | 309 | (3) | 281 | 972 | (129) |
| Cash generated/(utilised) | 5 | 23 | 168 | 4 | (0) |
| Cash at start of the year | 0 | 5 | 28 | 196 | 200 |
| Cash at end of the year | 5 | 28 | 196 | 200 | 200 |

Key Ratios

| Period | FY04 (15) | FY05 (12) | FY06 (12) | FY07P (12) | FY08P (12) |
|---------------------------------|--------------|--------------|--------------|---------------|---------------|
| Per share ratios | | | | | |
| EPS (Rs) | (38.6) | 14.2 | 17.1 | 17.0 | 25.9 |
| Div per share (Rs) | 0.0 | 1.2 | 5.0 | 5.0 | 7.0 |
| Book value per share (Rs) | 5.6 | 21.5 | 57.9 | 120.3 | 138.3 |
| Valuation ratios | | | | | |
| P/E (x) | (9.1) | 24.7 | 20.5 | 20.6 | 13.5 |
| P/BV (x) | 62.3 | 16.3 | 6.1 | 2.9 | 2.5 |
| M Cap/Sales (x) | 6.2 | 5.4 | 4.5 | 4.3 | 3.1 |
| EV/Sales (x) | 6.6 | 5.4 | 4.3 | 3.3 | 2.2 |
| EV/EBIDTA (x) | (16.3) | 18.3 | 14.6 | 11.6 | 7.6 |
| Profitability ratios | | | | | |
| OPM (%) | (40.6) | 29.7 | 27.9 | 25.6 | 26.8 |
| PAT (%) | (67.7) | 21.7 | 22.0 | 20.8 | 23.0 |
| ROCE (%) | (113.0) | 49.4 | 27.7 | 14.0 | 18.5 |
| RONW (%) | (684.2) | 66.1 | 29.6 | 14.1 | 18.7 |
| Income Generation ratios | | | | | |
| NFATR (x) | 1.6 | 4.2 | 2.4 | 4.0 | 4.5 |
| TATR (S/CE) | 1.8 | 2.2 | 1.3 | 0.7 | 0.8 |
| ETR (x) | 10.1 | 3.0 | 1.3 | 0.7 | 0.8 |
| ROE De-composition | | | | | |
| NPM | (67.7) | 21.7 | 22.0 | 20.8 | 23.0 |
| TATR (S/CE) | 1.8 | 2.2 | 1.3 | 0.7 | 0.8 |
| Equity Multiplier | 5.6 | 1.4 | 1.1 | 1.0 | 1.0 |
| Du-Pont ROE | (684.2) | 66.1 | 29.6 | 14.1 | 18.7 |
| Liquidity ratios | | | | | |
| Current ratio (x) | 0.8 | 2.2 | 2.6 | 3.1 | 2.2 |
| Debtors days | 80 | 60 | 80 | 71 | 66 |
| Creditors days | 151 | 41 | 40 | 41 | 41 |
| Net WC/Sales (%) | (9.9) | 14.4 | 30.6 | 37.6 | 22.7 |
| Net WC/TCE (%) | (17.8) | 31.8 | 38.4 | 25.0 | 18.1 |
| WC cycle (days) | (71) | 20 | 40 | 30 | 25 |
| Leverage ratios | | | | | |
| Debt / Total equity (x) | 4.6 | 0.4 | 0.0 | 0.0 | 0.0 |
| Payout ratios | | | | | |
| Dividend payout (%) | 0.0 | 8.3 | 29.2 | 29.4 | 27.0 |
| Tax payout (%) | 1.8 | (8.5) | (2.1) | 0.2 | 0.1 |



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