

TULIP IT SERVICES

INR 613

Blooming tale

BUY



Tulip IT's Q3FY07 results were in line with our expectations in terms of profitability and margins. Revenues jumped 20% Q-o-Q and 64% Y-o-Y to INR 2.2 bn, driven by strong growth in both network integration (NI) and IP VPN business segments. Changing revenue mix led to stronger EBITDA and net profit margins of 17.7% (up 216bps Q-o-Q) and 12.4% (up 146bps Q-o-Q), respectively. The impact of softer IP VPN ARPUs (down 4% Y-o-Y) was more than offset by strong subscriber accretion of 10,908 in the quarter.

In the backdrop of stronger than expected revenue growth across both business segments over the last few quarters, we are revising our FY07 and FY08 estimates upwards. At INR 613, the stock trades at 9.6x FY08 and 7.3x FY09 revised EPS estimates. Despite significant run-up in valuations since we initiated coverage on the stock, we maintain our positive outlook on Tulip, given strong traction in its high margin enterprise connectivity business and stable growth in the network integration segment. We believe valuations continue to remain attractive on an absolute basis and maintain our 'BUY' recommendation.

Key quarterly highlights

- Q3FY07 revenue was up 20% Q-o-Q and 64% Y-o-Y to INR 2.2 bn, driven by strong growth in both NI and IP VPN business segments. NI revenues were up 17.5% Q-o-Q and 17.7% Y-o-Y to INR 1.4 bn. IP VPN revenues jumped 24% Q-o-Q and almost 400% Y-o-Y to INR 830 mn, driven by strong subscriber accretion of 10,908 in the quarter. Total subscriber base stood at over 35,014 at the quarter end.
- IP VPN services were extended to 100 additional cities, taking the total number of cities/towns under coverage to 650. Around 67 new customers were added during the quarter, taking the total number of customers to 406.
- Blended ARPU fell 4% Q-o-Q to around INR 42,000. We attribute the ARPU decline primarily to a changing customer mix (with higher share of lower ARPU low bandwidth customers), rather than to a fall in absolute tariffs.
- Employee costs jumped sharply in the quarter, by 99% Q-o-Q and 203% Y-o-Y, to INR 76 mn. The spike in staff costs was primarily on account of the recruitment of key personnel (from Cisco) at the top management level (employee expenses comprised ~INR 34 mn of one-time joining bonus). Depreciation costs also jumped 25% Q-o-Q, primarily on account of higher utilisation of IP VPN assets.
- EBITDA margin was up 216bps Q-o-Q to 17.7% and net profit margin was up 146bps Q-o-Q to 12.4%. We believe the changing revenue mix (with an increasing contribution from the more profitable IP VPN segment) is the key reason for margin expansion.

Financials

Year to March	Q3FY07	Q3FY06	% change	Q2FY07	% change	FY06	FY07E
Revenues (INR mn)	2,220	1,350	64.4	1,851	19.9	5,081	7,873
EBITDA (INR mn)	393	157	150.0	287	36.6	662	1,318
Adjusted net profit (INR mn)	275	119	131.5	202	35.9	491	941
EPS (INR)						16.9	32.5
PE (x)						36.2	18.9
EV/EBITDA (x)						27.3	13.8
ROE (%)						42.1	40.5

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Market Data

52-week range (INR) : 652 / 162
Share in issue (mn) : 29.0
M cap (INR bn/USD mn) : 17.8 / 401.8
Avg. Daily Vol. BSE ('000) : 1,442.3

Share Holding Pattern (%)

Promoters : 69.0
MFs, FIs & Banks : 9.5
FIIIs : 11.6
Others : 9.9

* Upgrading estimates on stronger business outlook

We are revising our estimates for FY07 and FY08 upwards to incorporate upside surprises in the NI business (on possible government tender wins) and stronger subscriber growth in the IP VPN segment.

Governments of several states (including Haryana, Maharashtra, Punjab, and West Bengal) have floated tenders for setting up state wide area networks (SWANs). While the NI business is currently growing at a steady pace, Tulip is aggressively targeting government tenders for furthering growth in this business segment. We see potential upsides to our NI revenue estimates on account of possible government tender wins; we have revised our NI estimates upwards for FY07 to INR 5.1 bn (versus previous estimate of INR 4.9 bn) and for FY08 to INR 6 bn (versus previous estimate of INR 5.6 bn), respectively.

We have also revised our IP VPN subscriber estimates upwards in the light of stronger than expected subscriber accretion over the past few quarters. We see stronger traction in the low bandwidth IP VPN subscribers and expect almost 60% of subscriber accretions from this segment over FY07-09E. While we expect blended ARPUs to decline on account of the changing customer mix (towards lower ARPU, low bandwidth customers), we do not see this significantly impacting IP VPN revenue growth or profitability. Margin stability is expected to be derived from lower ARPU customers yielding margins at par with higher ARPU customers along with strong subscriber volumes driving economies of scale.

We expect the share of IP VPN segment in overall revenues to grow from 36% in FY07E to 44% in FY09E. We believe that the changing revenue mix will lead to significant margin expansion over FY07-09E; we estimate an EBITDA margin of 24.7% (versus 13% in FY06) and net profit margin of 19.6% (versus 9.7% in FY06) in FY09E.

However, our revised margin estimates for FY07-08E are slightly lower than our previous estimates on account of higher employee and depreciation expenses. We have revised employee expenses for FY07E and FY08E upwards by 39% and 21%, respectively, led by higher-than-expected employee base coupled with recruitment of key personnel (from Cisco) at the top management level. Higher depreciation charges are primarily on account of higher IP VPN asset utilization (however, we do not anticipate any parallel increase in IP VPN capex on account of stronger subscriber accretion).

Table 1: Revised estimates

	FY07E		FY08E		FY09E*	Remarks
	New	Old	New	Old		
IP VPN subscriber base	44,956	42,630	85,456	81,395	130,456	Accelerated IP VPN subscriber growth and government tender wins driving revenue growth
Revenue (INR mn)	7,873	7,375	10,304	9,442	12,375	
EBIDTA (INR mn)	1,318	1,235	2,397	2,224	3,058	
Net profit (INR mn)	941	928	1,850	1,738	2,423	Higher employee and depreciation costs leading to marginally lower margins over FY07-08
EBITDA margin (%)	16.7	16.7	23.3	23.6	24.7	
Net margin (%)	12.0	12.6	18.0	18.4	19.6	
Fully diluted EPS (INR)	32.5	32.0	63.8	59.9	83.5	

Source: Edelweiss research

*introducing FY09E estimates

* Outlook and valuations

At INR 613, the stock trades at a P/E of 9.6x and 7.3x, and EV/EBITDA of 7.2x and 5.1x FY08E and FY09 estimates, respectively. We continue to remain positive on the overall business prospects for Tulip as an integrated provider of network equipment and connectivity for enterprises. We maintain our **'BUY'** recommendation given an extremely encouraging profitability outlook and attractive valuations on an absolute basis.

Company Background

Tulip operates in two principle lines of business – network integration and management services and enterprise connectivity services.

Under the network integration segment, Tulip provides the entire gamut of services from network design and development to remote network management and maintenance. Tulip was the fourth-largest network integrator in India in FY06 with a market share of 7.8%.

The enterprise connectivity segment entails providing inter-city and intra-city wireless IP VPN connectivity to enterprises. Tulip's IP VPN network is spread across 650 cities and comprises leased lines and fibre optic cables from multiple service providers coupled with its own MPLS based wireless network.

Investment theme

We are positive on Tulip's business prospects as an integrated provider of network equipment and connectivity for enterprises. Being a significant player in a niche but fast growing IP VPN market (expected to double over FY07-09E to INR 12 bn as per Frost & Sullivan estimates), we see strong traction in the IP VPN business driving revenue growth and profitability for Tulip. While we expect the NI business to be significantly topline accretive, segment margins will continue to remain squeezed on account of intense competitive pressures. We see significant margin expansion over FY07-09E on account of the changing revenue mix (with share of IP VPN revenues expected to increase from ~16% in FY06 to ~44% in FY09E). We expect revenues to grow at a CAGR of 35% to INR 12.4 bn and net profits at a CAGR of 70% over FY07-09E to INR 2.4 bn.

Key risks to investment theme

We see competition from integrated players like Bharti Airtel, Reliance Communications and BSNL as the key risk to Tulip's profitability and market share. With the SME segment (currently the key market for Tulip) being considered as a lucrative opportunity by several large players, we believe that added competitive pressure will significantly increase the risk quotient for Tulip.

Also, the emergence of new cost-effective and more efficient technologies may directly impact Tulip's business – particularly since it operates in a niche segment and offers a single technology to its customers. Adopting new technologies or switching over to new service offerings may require significant capex that may not be viable for Tulip.

(INR mn)

Financials snapshot								
Year to March	Q3FY07	Q3FY06	% change	Q2FY07	% change	FY06	FY07E	FY08E
Network integration segment	1,390	1,181	17.7	1,183	17.5	4,267	5,077	6,042
IP VPN	830	169	391.2	668	24.2	815	2,796	4,261
Total revenues	2,220	1,350	64.4	1,851	19.9	5,081	7,873	10,304
Raw materials	1,708	1,147	48.9	1,484	15.1	4,142	6,142	7,440
Staff costs	76	25	202.9	38	99.1	99	197	203
Other costs	43	21	109.3	41	5.1	179	216	263
Total expenses	1,827	1,193	53.2	1,564	16.8	4,419	6,555	7,906
EBITDA	393	157	150.0	287	36.6	662	1,318	2,397
Depreciation	57	4	1,239.6	46	25.3	43	172	228
PBIT	335	153	119.5	242	38.8	619	1,146	2,169
Interest	38	18	117.7	17	127.0	64	110	103
Other income	2	1	34.9	1	193.3	12	27	60
PBT	299	137	118.9	226	32.6	567	1,064	2,126
Tax	24	18	35.9	23	3.9	76	122	276
Reported net profit	275	119	131.5	202	35.9	488	941	1,850
Adjusted net profit	275	119	131.5	202	35.9	491	941	1,850
Equity capital(FV:INR10)	290	290		290		290	290	290
# of shares (mn)	29	29		29		29	29	29
Adjusted EPS (INR)	9.5	4.1		7.0		17	32	64
PE (x)						36.2	18.9	9.6
EV/EBITDA (x)						27.3	13.8	7.2
as % of net revenues								
Raw materials	76.9	85.0		80.2		81.5	78.0	72.2
Staff costs	3.4	1.9		2.1		1.9	2.5	2.0
Other costs	2.0	1.5		2.2		3.5	2.7	2.6
EBITDA	17.7	11.6		15.5		13.0	16.7	23.3
Adjusted net profit	12.4	8.8		10.9		9.7	12.0	18.0
Tax rate	8.2	13.1		10.4		13.4	11.5	13.0

Operating metrics					
Year to March	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Q3FY07
IP VPN connects	5,950	9,513	14,980	24,106	35,014
Net adds Q-o-Q		3,563	5,467	9,126	10,908
IP VPN customers	126	239	296	339	406
Cities covered	130	350	540	550	650

Financial Statements

Income statement

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	3,422	5,081	7,873	10,304	12,375
Direct costs	3,088	4,142	6,142	7,440	8,762
Employee costs	62	99	197	203	241
Other expenses	73	179	216	263	315
Total operating expenses	3,223	4,419	6,555	7,906	9,318
EBITDA	199	662	1,318	2,397	3,058
Depreciation and amortisation	10	43	172	228	286
EBIT	189	619	1,146	2,169	2,772
Interest expenses	35	64	110	103	96
Other income	6	12	27	60	109
Profit before tax	160	567	1,064	2,126	2,785
Provision for tax	27	76	122	276	362
Extraordinary items	(5)	4	-	-	-
Reported profit	139	488	941	1,850	2,423
Adjusted net profit	134	491	941	1,850	2,423
Shares outstanding	20.0	29.0	29.0	29.0	29.0
Dividend per share	-	1.0	1.0	2.0	3.0
Dividend payout (%)	-	5.9	3.1	3.1	3.6

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Operating expenses	94.2	87.0	83.3	76.7	75.3
Depreciation	0.3	0.8	2.2	2.2	2.3
Interest expenditure	1.0	1.2	1.4	1.0	0.8
EBITDA margins	5.8	13.0	16.7	23.3	24.7
Net profit margins	3.9	9.7	12.0	18.0	19.6

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	24.7	48.5	54.9	30.9	20.1
EBITDA	90.9	232.2	99.0	81.9	27.5
PBT	106.7	253.7	87.5	99.9	31.0
Net profit	107.3	266.8	91.7	96.5	31.0
EPS	107.3	266.8	91.7	96.5	31.0

Cash flow statement

(INR mn)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	139	488	941	1,850	2,423
Add: Depreciation	10	43	172	228	286
Add: E.O.Adjustments	0	0	-	-	-
Add: Deferred tax	4	(10)	-	-	-
Gross cash flow	153	521	1,113	2,078	2,708
Less: Dividends	-	29	29	58	87
Less: Changes in W. C.	205	979	718	592	543
Operating cash flow	(52)	(487)	366	1,427	2,079
Less: Change in investments	-	20	-	-	-
Less: Capex	145	574	548	445	417
Free cash flow	(197)	(1,082)	(182)	983	1,662

Balance sheet

As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	200	290	290	290	290
Reserves & surplus	266	1,576	2,488	4,280	6,615
Shareholders funds	466	1,866	2,778	4,570	6,905
Secured loans	238	756	1,076	986	936
Borrowings	238	756	1,076	986	936
Sources of funds	704	2,622	3,854	5,555	7,841
Gross block	227	800	1,348	1,793	2,210
Depreciation	31	73	245	473	758
Net block	196	727	1,104	1,320	1,451
Total fixed assets	196	727	1,104	1,320	1,451
Investments	0	20	20	20	20
Inventories	206	263	473	655	819
Sundry debtors	602	1,457	2,041	2,672	3,209
Cash and equivalents	88	467	606	1,498	3,110
Loans and advances	24	142	315	412	495
Total current assets	919	2,329	3,436	5,237	7,634
Sundry creditors and others	380	368	553	687	814
Provisions	22	86	151	334	449
Total CL & provisions	403	454	704	1,021	1,263
Net current assets	516	1,875	2,731	4,216	6,371
Net deferred tax	(10)	(2)	(2)	(2)	(2)
Misc expenses not w/o	1	1	1	1	1
Uses of funds	704	2,622	3,854	5,555	7,841
Book value per share (INR)	23	64	96	158	238

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROAE (%)	41.0	42.1	40.5	50.3	42.2
ROACE (%)	37.4	37.2	35.4	46.1	41.4
Current ratio	2.3	5.1	4.9	5.1	6.0
Debtors (days)	64	105	95	95	95
Fixed assets t/o (x)	17.4	7.0	7.1	7.8	8.5
Average working capital t/o (x)	8.9	4.2	3.4	3.0	2.3
Debt/Equity	0.5	0.4	0.4	0.2	0.1

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Adjusted EPS (INR)	4.6	16.9	32.5	63.8	83.5
Y-o-Y growth	107.3	266.8	91.7	96.5	31.0
CEPS (INR)	7.2	18.4	38.4	71.6	93.4
PE (x)	132.8	36.2	18.9	9.6	7.3
Price/BV(x)	26.3	9.5	6.4	3.9	2.6
EV/Sales (x)	5.2	3.6	2.3	1.7	1.3
EV/EBITDA (x)	90.0	27.3	13.8	7.2	5.1

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INDIA RESEARCH		SECTOR	INSTITUTIONAL SALES	
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Sunil Jain	- 2286 4308	Alternative & Quantitative	Ankit Doshi	- 2286 4671
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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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