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On-line Share Trading

Initiating Coverage

Tulip IT Services (TULITS)

Current price	Target price
Rs 1070	Rs 1185
Potential upside	Time Frame
10%	12 months

PERFORMER

Riding the connectivity boom …

Analysts' Names

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Tulip IT Services is the market leader in Internet protocol/Virtual Private Network (IP/VPN) connectivity, and fourth biggest player in the network integration space. The opportunity in the IP/VPN space is huge and increasing. The company plans to become an end-to-end solutions provider, and is also looking for global expansion. We are confident about the company's ability to maintain its dominant position and expect it to register a robust 39.1% CAGR in revenue over FY06-09E. We initiate coverage on the stock with a PERFORMER rating.

- **Growing opportunity in IP/VPN segment**

IP/VPN is fast gaining acceptance among corporate entities for data connectivity being cost effective and easy to rollout. The IP/VPN market has witnessed a 31% CAGR in last three years. The size of the market has been estimated at Rs 1,200 crore by 2009 as demand for applications such as ERP (enterprise resource planning), CRM (customer relationship management) and CBS (core banking solution) increase. Tulip, with its first mover advantage, is well positioned to capture this opportunity.

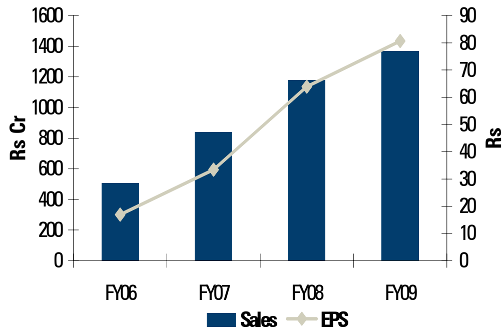
- **Market leader in IP/VPN wireless space**

Tulip is the market leader in the IP/VPN space with a market share of over 28%. Its presence in more 1,000 cities combined with its ability to rapidly rollout network over difficult terrains, even in places where there are no copper lines, with high up-time and low latency, gives the company an edge over competitors. This is a high-margin business and is set to drive profitability going forward.

- **e-governance to boost network integration business**

Central and state governments are promoting e-governance and rural connectivity and around Rs 3,334 crore has been allocated for this initiative. More than 20 states are expected to set up state-wide area networks (SWAN). The average size of each project is estimated at Rs 100 crore. Tulip has already bagged tenders for Haryana, West Bengal and Assam, and is set to take capitalise on emerging opportunities in this space.

Sales & EPS trend



Stock metrics

Promoters holding	68.96%
Market Cap	Rs 3228 crore
52 Week H/L	1154 / 503
Sensex	20,469
Average volume	18,629

Comparative return metrics

Stock return (%)	3 M	6M	12M
Tulip IT	26.2	40.1	104.2

Valuations

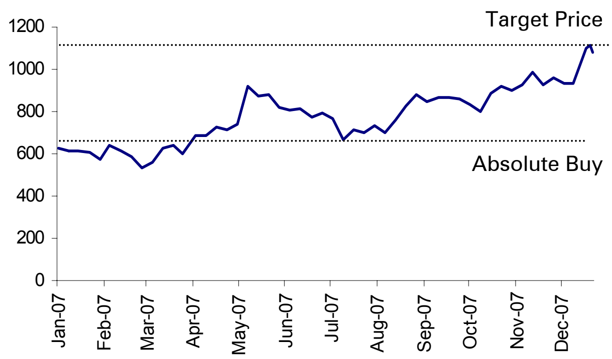
At the current price of Rs 1,075, the stock is available at an EV/EBIDTA of 14.84x FY08E and 11.60x FY09E earnings. The stock trades at a P/E of 16.81x FY08E EPS of Rs 63.95 and 13.33x FY09E EPS of Rs 80.65. We have valued the company on SOTP (sum-of-the-parts) basis to arrive at a target price of Rs 1,185, at 14.69x FY09E EPS of Rs 80.65, which gives up an upside potential of 10% over a 12-month perspective.

Exhibit 1: Key Financials

Year ending March 31	FY06	FY07	FY08E	FY09E
Net Profit (Rs crore)	48.99	96.97	185.45	233.87
Shares in issue (in crore)	2.90	2.90	2.90	2.90
EPS (Rs)	16.89	33.44	63.95	80.65
% Growth	NA	97.90	91.30	26.11
P/E (x)	63.63	32.15	16.81	13.33
Price / Book (x)	16.71	11.15	6.86	4.59
EV/EBIDTA (x)	48.02	24.52	14.84	11.60
RoE (%)	26.26	34.69	40.78	34.47
RoCE (%)	23.70	27.78	16.31	17.44

Source: ICICIdirect Research

Price Trend



Company Background

Tulip is an IT infrastructure and connectivity provider and offers network integration services, rural / state wide networks and intra-city and inter-city IP/VPN connectivity. Having started operations in 1992 as a re-seller of software and hardware products, the company has continuously enhanced its business model and capitalised on the opportunity at the right time by foraying into higher margin businesses having synergy with its existing businesses. Being the fourth largest network integrator in India, Tulip diversified into the providing IP/VPN wireless based connectivity solutions in 2004. It has a wide network across 1000 cities comprising leased lines and fibre optic cables from multiple service providers coupled with its own MPLS- (multi-protocol label switching) based wireless network.

Shareholding pattern

Shareholder	% holding
Promoters	68.96
Institutional investors	24.68
Other Investors	6.35

Promoter & Institutional holding trend

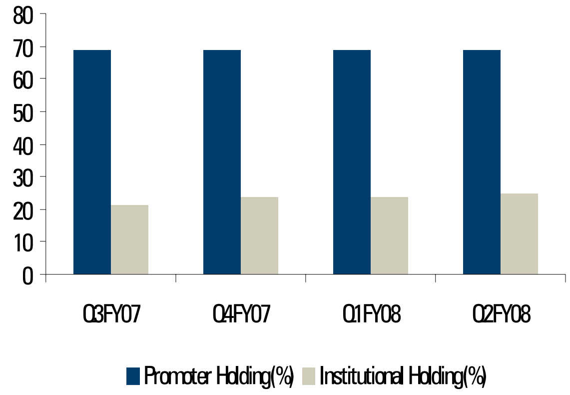
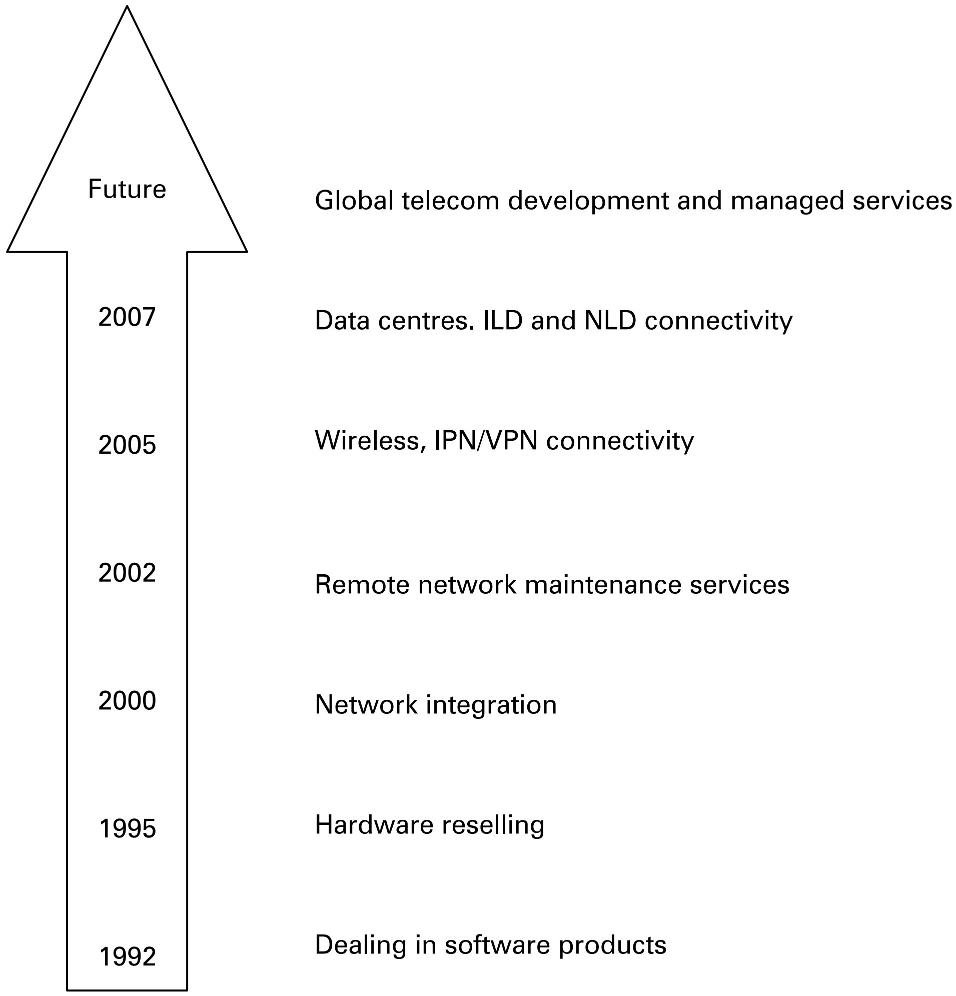


Exhibit 2: Company's growth path



Source: ICICIdirect Research

BUSINESS BACKGROUND

Tulip IT Services currently has two main areas of business – network integration and management services, and IP/VPN wireless connectivity.

- **Network integration and management services**

In the network integration business, the company designs and develops network solutions for its clients. It also assists clients identify and provide equipment for the networks, integrating and implementing the rollouts, post implementation and maintenance services. The company has also started providing remote management services through its NOCs (network operation centres.

Exhibit 3: Tulip has the fourth largest market share

		Revenues (Rs crore)			
Rank	Company	FY06	FY07	% growth	Market share (%)
1	Wipro Infotech	670	1,028	53.4	15.3
2	HCL Comnet	491	812	64.4	12.1
3	Datacraft	519	675	30.1	10.0
4	**Tulip IT Services**	**426**	**525**	**23.2**	**7.8**
5	HCL Infosystems	345	524	51.9	7.8
6	GTL	229	274	19.7	4.1
7	Others*	2,539	2,896	14.1	43.0
		5,219	**6,734**	**29**	**100.0**

Source: Voice & Data

*Others include Secure Energy, Targus Tech, HP, IBM, Tata Infotec, CMC, Network Solutions, Ramco, etc

Tulip is the fourth largest network integrator provider in the country with a market share of more than 7%. However, this space is highly fragmented and vey competitive. The size of this segment is estimated at ~ Rs 6,734 crore according to *Voice and Data*. It is a trading business and margins are low, with not much of growth expected. During FY07, this segment grew by 23% and registered a revenue of Rs 525.26 crore (62.5% of top line).

- **IP/VPN wireless connectivity**

Tulip provides IP/ VPN wireless connectivity services through its brand, Tulip Connect. The main purpose of VPN is to provide virtual capabilities similar to private leased lines at much lower cost by using shared public infrastructure. It allows users at remote locations to access secure private network without installing expensive leased or private lines. VPN is a secure and cheaper alternative to private leased lines. Besides providing data integrity and protection against unauthorised access and intrusion, IP / VPN is an extremely scalable network architecture enabling rapid network roll-out. The company provides inter-city and intra-city data connectivity specifically to corporate clients based on a hybrid strategy. Inter-city connectivity is provided through leased lines and fibre optic cables from MSPs (multiple service providers) like BSNL, Bharti, Reliance, VSNL, GAIL, Railtel, and Power Grid. Intra-city connectivity is provided wirelessly through its own network. Most existing players, mainly ISPs, provide intra-city connectivity using BSNL's copper infrastructure. Tulip uses the wireless technology for intra-city connectivity. It faces no competition and is the market leader in this segment.

INVESTMENT RATIONALE

- **Growing opportunity in IP/VPN segments**

IP/VPN market estimated to be Rs 1,200 crore by 2009

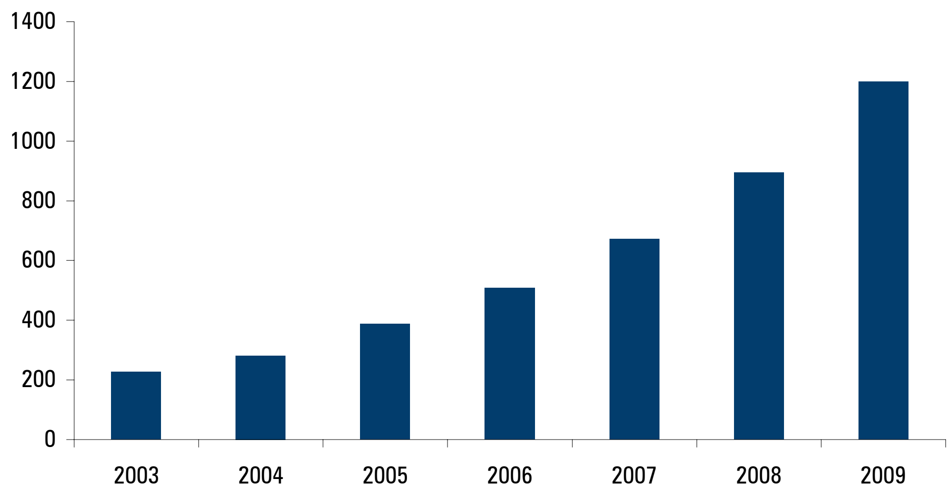
As companies expand to newer geographies, there is increasing demand for network solutions and connectivity for real-time data communication. IP/VPN scores over VSAT, ISDN and IPLC (International Private Leased Circuit) due to its low cost and bandwith requirements. Though IP/VPN is a new technology, it is gaining importance due to the ease of implementation in providing connectivity to small towns in a cost-effective manner. These services are used catered to banks, financial institutions, corporate for connecting their branches, dealers, C&F agents, vendors, retailers, and also IT and ITES companies.

The IP/ VPN market witnessed a 31% CAGR in the last three years. It is expected to grow to Rs 1,200 crore by 2009 from the current Rs 672 crore as demand for applications such as ERP, CRM and CBS increases.

Demand for ERP, CRM and CBS to be key growth drivers

Accoring to International Data Corporation (IDC), the CRM market in India is expected to touch $11 billion by 2008 (8.9% CAGR over 2004-2008). The key verticals driving this growth are banking, finance, insurance, telecom, utilities, manufacturing and healthcare sectors. The ERP market is expected to witness a 25.2% CAGR over the next 5 years and is projected to be worth $250 million by 2009 according to an ARC Advisory Group. With banks planning to connect more than 75,000 branches to a centralised CBS to enable real time gross settlement, we believe demand for data connectivity is only set to grow. Tulip, with its first mover advantage, is well set to capture this opportunity using IP/VPN technology.

Exhibit 4: IP/VPN market size



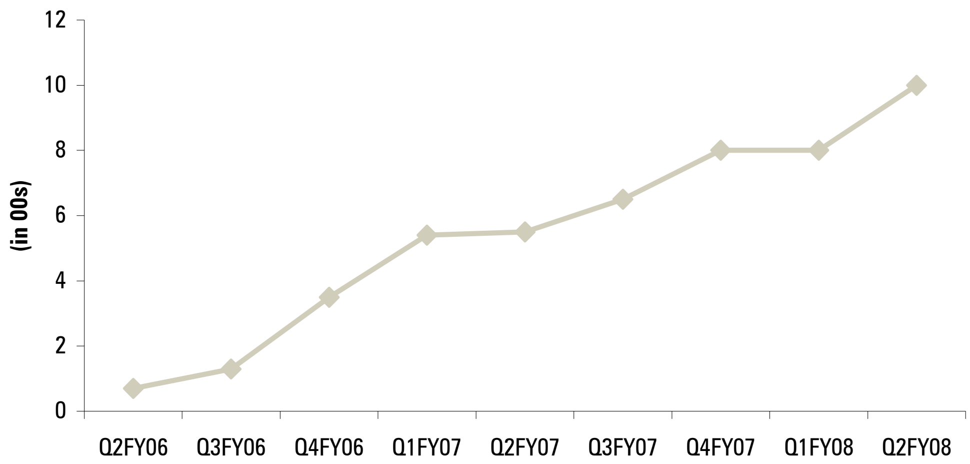
Source: Frost & Sullivan

▪ **Market leader in IP/VPN wireless space**

Tulip provides connectivity through IP/VPN space and has a 28% market share in the MPLS (multi-protocol label switching) and IP/VPN market. Competitors like Bharti Airtel, Reliance Communications and VSNL provide connectivity through leased lines. Sify depends on BSNL or MTNL's copper lines to provide connectivity. Tulip, through its wireless last-mile connectivity, is able to overcome dependence on last mile owners. This helps the company rapidly rollout its network, even over difficult terrains and in places where there are no copper lines, and with high uptime and low latency. This has given the company a presence in over 1,000 cities. It would take competitor at least two years to have this reach. The company plans to maintain its leadership by increasing the number of connects from the current 75,837 to ~1.6 lakh by 2009.

Tulip is the leader with a 28% market share in the IP/VPN space

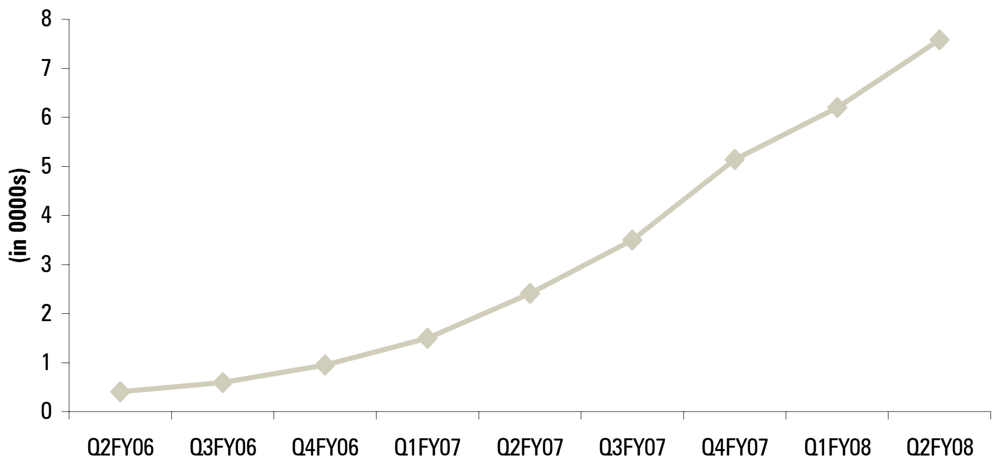
Exhibit 5: Increase in number of cities in which Tulip has a presence



Presence in 1,000 cities with more than 75000 connects

Source: ICICIdirect Research

Exhibit 6: Number of connects



Source: ICICIdirect Research

e-governance to boost network integration business

The Central and state governments are taking steps to promote e-governance and rural connectivity across the country. Around Rs 3,334 crore has been allocated for the National eGovernance Plan (NeGP). More than 20 states are expected to set up state-wide area networks (SWAN). The average size of each project is estimated at Rs 100 crore. The National Mission Mode Project on e-Governance in municipalities is also being formulated by the Ministry of Urban Development. The project plans to cover more than 400 cities by 2010.

Central govt. has allocated more than Rs 3,000 crore for e-governance

Tulip has already been awarded contracts by the West Bengal, Haryana and Assam state governments to develop the next phase of the SWAN projects on a BOOT (build, own, operate & transfer) model. Many other states are expected to come issue tenders soon for implementation of e-governance programmes. We believe Tulip is a very strong contender to bag these contracts with its strong capabilities in network integration, pan-India presence and proven track record.

Tulip has already been awarded projects by three state governments

Under the SWAN project, Tuilip will design the network, supply equipment, implement design and manage the same for five years. For providing connectivity, BSNL has first right of refusal. If BSNL backs out, Tulip with its end-to-end connectivity solutions can get the order and thereby get business for its IP/VPN vertical.

To become an end-to-end solutions provider

In order to become end-to-end solution provider, Tulip has launched its managed services portfolio, including data centre services and video services for enterprises. Enterprises can host important data at a data centre which houses large amount of electronic equipment like computers, servers and communications equipment. The company plans to lease out space in its data centres to small and medium enterprises. It plans to invest Rs 80 crore and would set up data centres in Mumbai, Chennai, Bangalore and Hyderabad. The one is Delhi is already operational. The Internet data centre market in India is expected to grow to around $200 million by 2009. The market for video conferencing, excluding the bandwidth component, is around $25 million and is expected to witness a 21% CAGR over the next 3 years.

Rs 80 crore capex to set-up data centres in 4 cities

Tulip also plans to lay around 500 km of optical fibre within major cities like Delhi, Mumbai, Chennai, Bangalore, Hyderabad and Kolkata. The objective is to cover major commercial hubs and provide high bandwidth connectivity (more than 2Mbps) to customers who have offices in these cities. The move will also strengthen its last mile capabilities.

The company recently received its ILD license. This will address the needs of customers for international voice, video and data connectivity. The international connectivity market is expected to double from over Rs 1,800 crore in 2006 to over Rs 3,600 crore in 2012. The ILD license will allow Tulip to offer a wide array of network carriage services for international connectivity to customers from an integrated platform and to provide international leased circuits to subscribers. This will further strengthen company's position as an end to end solution provider.

ILD license will enable international connectivity

- **Triggers for future growth**

Acquisition on cards in the infrastructure management space

Tulip plans to acquire a company in the infrastructure management space that would enable it to offer remote infrastructure management services. We believe this acquisition would expand the company's geographical reach alongwith international presence.

The company has also applied for six universal access service licenses in circles B & C. If the company is allotted this license, it will also be able to deliver voice services depending on the number of cities for which it gets the license. This would enable the company foray into the competitive voice space.

RISKS & CONCERNS

- **Competition from integrated telecom players**

Competition and changing technology could hamper profitability

The entry of integrated telecom players such as Bharti, Reliance and BSNL into the niche IP/VPN space could affect the industry dynamics. These players could increase competition which could lead to a price war similar to the voice market and affect margins and profitability.

- **Change in technology**

The emergence of newer and cost-effective technologies could affect Tulip's profitability. Adaptation of 3G and WiMax will provide low-cost wireless broadband connectivity over long distances. Further, the upgrading to newer technologies will require higher capex which may not be viable. However, we feel that wide acceptance of WiMax to be only post FY10.

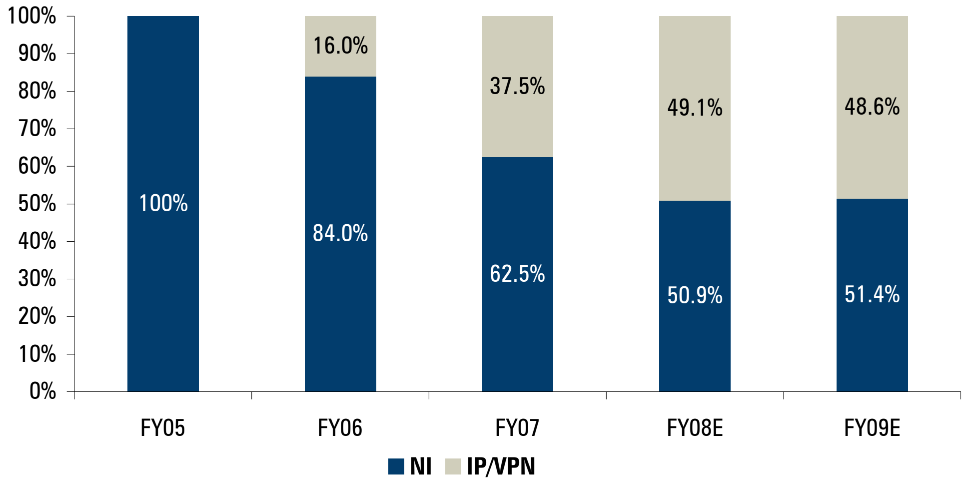
FINANCIALS

- **Changing revenue mix**

Tulip has traditionally been in the network integration and related services. This is a highly competitive segment. Margins are low and not much growth is expected. In FY06, the company made a conscious decision to foray into the IP/VPN market. It is now the leader in this segment. This change is expected to alter the revenue mix from 16% in FY06 to 49% in FY09E in favour of IP/VPN segment.

Data connectivity to contribute 49% to the topline from 16% in FY06

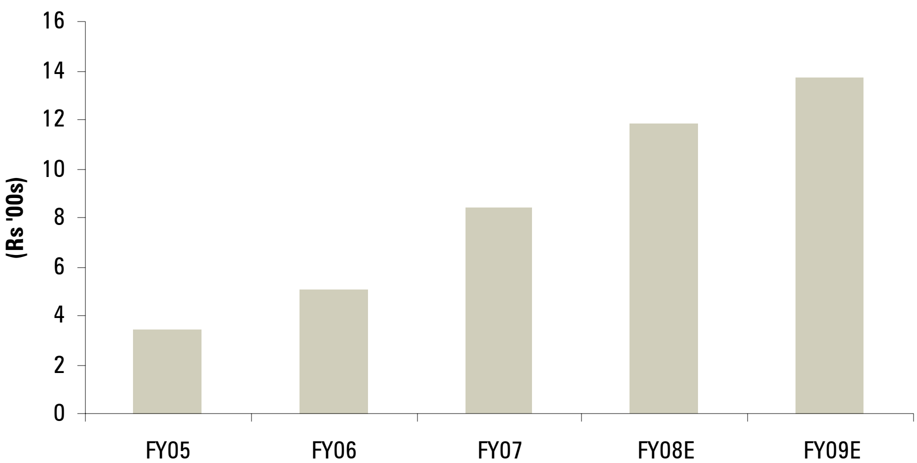
Exhibit 7: Change in product mix (% of revenue)



Source: ICICIdirect Research

We expect an 18.1% CAGR in revenues from network integration segment to grow to Rs 703.1 crore in FY09 from Rs 426.68 crores in FY06. Revenues from the IP/VPN segment should witness a 100.3% CAGR to Rs 655.12 crore from Rs 81.49 crore over the same period. This will help the company to more than double its revenues.

Exhibit 8: Impressive growth in top-line



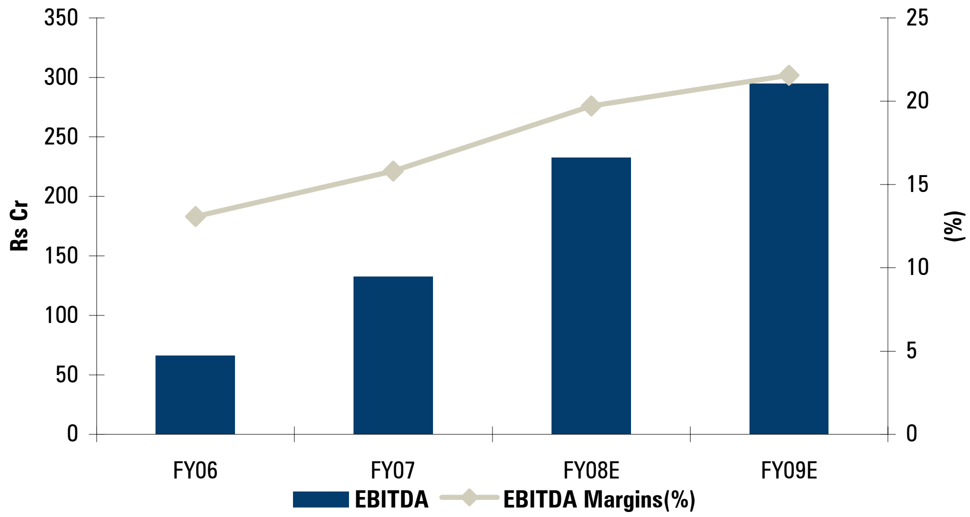
Source: ICICIdirect Research

- **Shift in business mix to improve margins**

With the shift in business mix towards the high-margin IP/VPN business, we expect the EBITDA margins to increase from 13.07% in FY06 to 21.56% in FY09.

Margins to expand significantly on back of higher share from IP/VPN vertical

Exhibit 9: EBITDA margins to improve



Source: Company, ICICIdirect Research

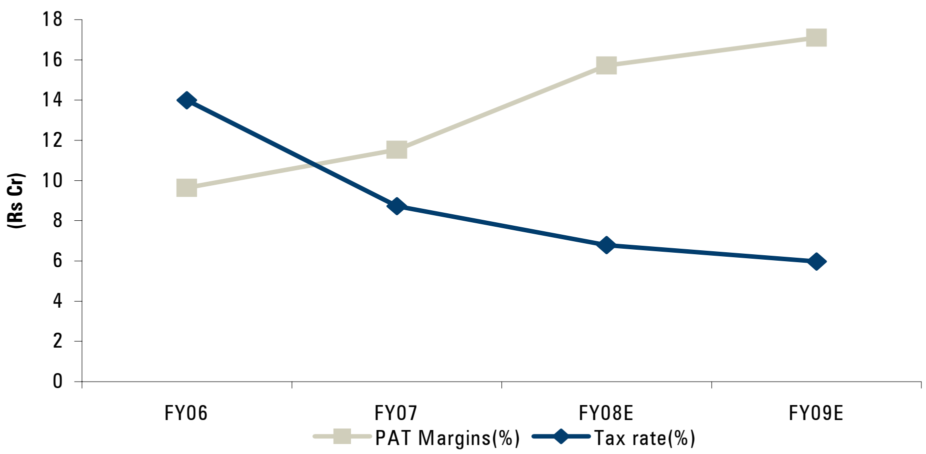
The growth in operating margins will be led by the revenue shift towards IP/VPN business. Margins from the IP/VPN segment are expected to be increase from 31.2% in FY07 to 38.31% in FY09E. The margin expansion would be on back higher utilisation of the same network by more subscribers. While we anticipate tariffs to decline due to rising competition, we expect economies of scale to kick-in as the reach increases with higher number of connects which would help revenue growth and profitability. However, margins in the network integration business are expected to be in the range of 6%-7%.

- **Improvement in PAT margins**

Tulip enjoys tax benefits under Sec 80IB for telecom service providers. It will pay nil income tax for first five years followed by exemption of 30% for next five years. This will help the company reduce its effective tax rate from 13.99% in FY06 to 5.97% in FY09E. We expect the PAT margins to increase 9.64% in FY06 to 17.1% in FY09.

PAT margins to increase on back of tax exemption

Exhibit 10: Improvement in PAT margins

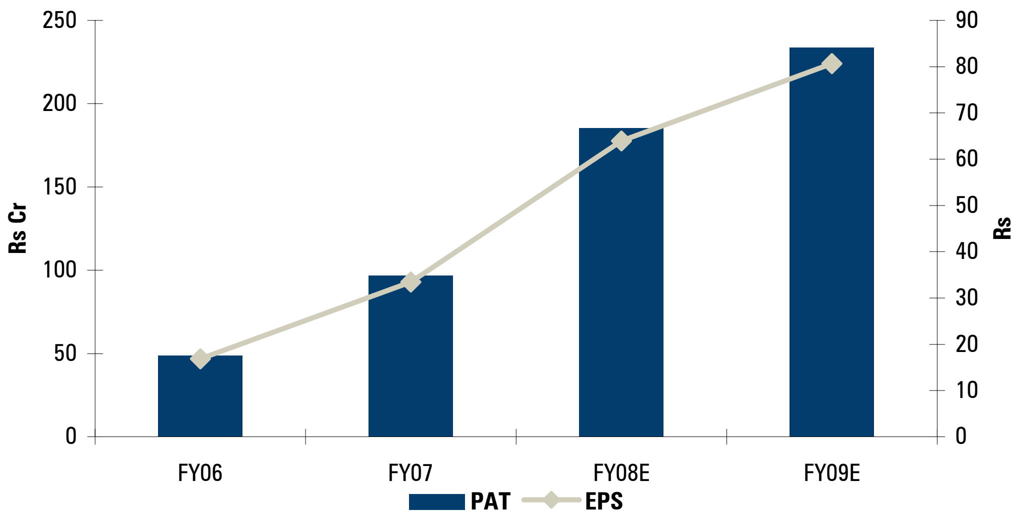


Source: ICICIdirect Research

- **PAT and EPS to quadruple**

We expect PAT to quadruple from Rs 48.99 crore in FY06 to Rs 233.87 crore in FY09 (68% CAGR) led by top line growth in IP/VPN vertical, expanding operating profit margins and reduced tax rates.

Exhibit 11: Growth in PAT and EPS



Source: Company, ICICIdirect Research

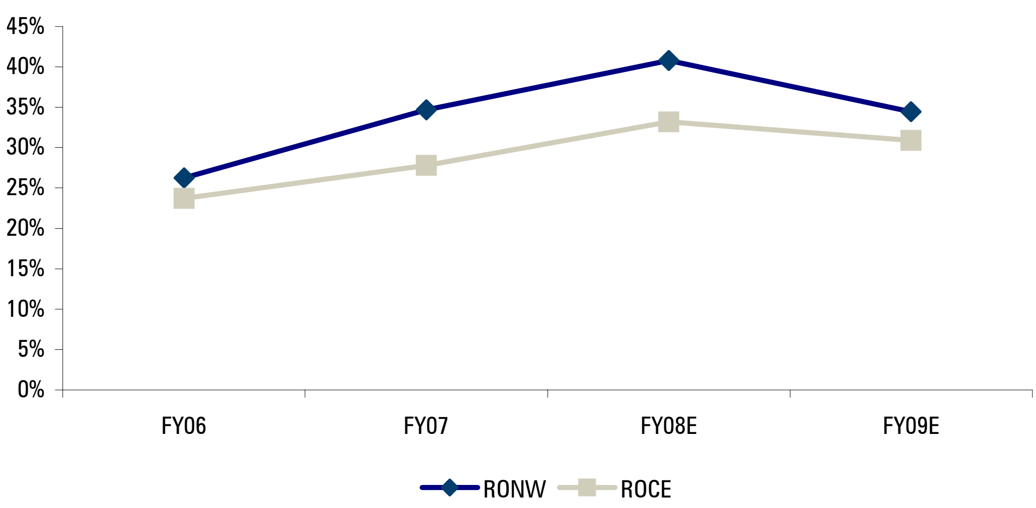
- **FCCB of $150 million for future expansion**

The company recently raised $150 million through a five-year zero coupon FCCBs priced at Rs 1,137. The company would use the money for expansion of existing network, development of new data centres, M&A activity and working capital requirement for SWAN orders. We expect an equity dilution of around 18% to 34.3 million shares

- **Return ratios to remain muted**

We expect return ratios to remain muted due to the recently concluded FCCB issue. However, they are expect to improve post FY09 as utilsation increase.

Exhibit 12: Growth in PAT and EPS



Source: Company, ICICIdirect Research

VALUATIONS

We believe the high-margin IP/VPN business will lead Tulip on an exponential growth trajectory for next two years. With margin expansion and leadership position in the space, the company is well set to become a dominant player in the telecom space.

Considering the company's presence in both the network integration and data connectivity space, there are no direct listed peer comparables. At the current price of Rs 1,075, the stock is available at an EV/EBIDTA of 14.84x FY08E and 11.60x FY09E earnings. The stock trades at a P/E of 16.81x FY08E EPS of Rs63.95 and 13.33x FY09E EPS of Rs 80.65. We have valued the company on a SOTP (sum-of-the-parts) method for network integration and data connectivity segment.

Data connectivity segment: Target EV/EBITDA multiple (FY09E) of 14x, value of Rs 1107.3 per share.

IP/VPN segment (Rs crore)

EV/EBIDTA (x)	14.00
EBIDTA (FY09E)	250.99
EV	3,513.82
Debt	100.00
Cash	397.35
Equity value	3,811.17
Equity shares (in crore)	2.90
Value per share (Rs)	**1,314.20**

Source: ICICIdirect Research

Network integration segment: Target PE multiple (FY09E) of 8x, value of Rs. 77.8/share.

Network integration (Rs crore)

PAT	28.20
EPS (Rs)	9.72
P/E (x)	8.00
Value per share (Rs)	**77.79**

Source: ICICIdirect Research

We arrive at the target price of Rs 1,185, 14.69x FY09E EPS of Rs 80.65, which gives us a 10% upside potential with a 12-month perspective.

FINANCIAL SUMMARY

Profit & Loss

(Rs Crore)

(Year-end March)	FY06	FY07	FY08E	FY09E
Sales	508.17	840.79	1179.79	1367.75
% Growth	NA	65.45%	40.32%	15.93%
Op Profit	66.43	132.80	232.73	294.86
% Growth	NA	99.90%	75.24%	26.70%
Other Income	1.18	2.35	18.00	18.00
Depreciation	4.30	15.84	40.22	54.51
EBIT	62.14	116.96	192.50	240.35
% Growth	NA	88.24%	64.59%	24.85%
Interest	6.35	13.07	11.55	9.63
Profit before Tax	56.96	106.24	198.95	248.72
% Growth	NA	86.52%	87.26%	25.02%
Taxation	7.97	9.27	13.50	14.85
Net Profit	48.99	96.97	185.45	233.87
% Change YoY	NA	97.93%	91.25%	26.11%

Top line to grow at a CAGR of 39% over FY06-09E

Bottom line to grow at a CAGR of 68% over FY06-09E

Balance Sheet

(Rs Crore)

(Year-end March)	FY06	FY07	FY08E	FY09E
Equity Share Capital	29.00	29.00	29.00	29.00
Reserves & Surplus	157.58	250.50	425.77	649.47
Secured Loans	75.58	141.60	125.50	100.00
Unsecured Loans	0.00	0.00	600.00	600.00
Deferred Tax Liability	0.19	0.80	0.00	0.00
Current Liabilities and Provisions	45.40	61.21	84.20	97.55
Total Liabilities	307.75	483.11	1264.47	1476.02
Gross Block	80.02	250.03	517.74	705.34
Accumulated Depreciation	7.30	22.91	63.13	117.65
Net Block	72.72	227.12	454.61	587.69
Capital WIP	0.00	22.62	30.00	50.00
Investments	2.02	0.02	0.02	0.02
Cash	1.01	2.46	389.47	397.35
Inventories	26.25	20.52	78.92	86.91
Trade Recievables	145.68	139.78	222.51	257.67
Loans and Advances	14.24	36.50	54.86	62.29
Fixed Deposit Receipts	45.74	34.00	34.00	34.00
Misc Exp	0.07	0.06	0.06	0.06
Total Assets	307.74	483.09	1264.45	1476.00

Raised FCCB of $150 mn

Cash Flow

(Rs Crore)

(Year-end March)	FY06	FY07	FY08E	FY09E
Profit after Tax	48.99	96.97	185.45	233.87
Depreciation	4.30	15.84	40.22	54.51
Cash Flow before WC Changes	51.96	116.16	224.88	288.39
Net Increase in Current Liabilities	5.13	15.81	22.99	13.35
Net Increase in Current Assets	-103.07	-10.63	-159.49	-50.58
Cash Flow after WC Changes	-45.98	121.34	88.37	251.16
Purchase of Fixed Assets	-57.40	-192.85	-275.10	-207.60
(Increase) / Decrease in Fixed Deposit Re	-37.32	11.74	0.00	0.00
(Increase) / Decrease in Investment	-2.00	2.00	0.00	0.00
Cash Flow from Investing Activities	-96.72	-179.11	-275.09	-207.60
Increase / (Decrease) in Secured Loans	51.82	66.01	-16.10	-25.50
Inrease / (Decrease) in Equity Capital	-3.00	0.00	0.00	0.00
Inrease / (Decrease) in Share Premium	97.80	0.00	0.00	0.00
Dividend Payment	-3.31	-6.79	-10.18	-10.18
Cash Flow from Financing Activities	143.32	59.23	573.73	-35.68
Op bal Cash & Cash equivalents	0.39	1.01	2.46	389.47
Closing Cash/ Cash Equivalent	1.01	2.46	389.47	397.35

Ratio Analysis

(Year-end March)	FY06	FY07	FY08E	FY09E
EPS	16.89	33.44	63.95	80.65
Cash EPS	18.38	38.90	77.82	99.44
Book Value	64.34	96.38	156.82	233.95
Operating Profit Per Share	22.91	45.79	80.25	101.68
Operating Margin (%)	13.07%	15.79%	19.73%	21.56%
Net Profit Margin (%)	9.64%	11.53%	15.72%	17.10%
RONW	26.26%	34.69%	40.78%	34.47%
ROCE	23.70%	27.78%	33.17%	30.87%
Debt Equity	0.41	0.51	0.28	0.15
Fixed Assets Turnover Ratio	6.99	3.37	2.43	2.14
Enterprise Value	3190.06	3256.61	2853.51	2820.13
EV/EBIDTA	48.02	24.52	12.26	9.56
EV/Sales	6.28	3.87	2.42	2.06
Sales to Equity	2.72	3.01	2.59	2.02
Market Cap	3117.50	3117.50	3117.50	3117.50
Market Cap to sales	6.13	3.71	2.64	2.28
Price to Book Value	16.71	11.15	6.86	4.59
PE	63.63	32.15	16.81	13.33
Working Capital/Sales	0.37	0.20	0.59	0.54
Debtors Turnover Ratio	0.29	0.17	0.19	0.19
Current Ratio	5.13	3.81	9.26	8.59
Quick Ratio	5.11	3.77	4.64	4.52
Creditors Turnover Ratio	0.09	0.07	0.07	0.07
Cash to Absolute Liabilities	0.02	0.04	4.63	4.07
Debtors to Sales	0.29	0.17	0.19	0.19
Effective Tax Rate	13.99%	8.73%	6.78%	5.97%
Dividend Per Share	1.00	2.00	3.00	3.00
Dividend Yield (%)	0.09%	0.19%	0.28%	0.28%

Margin expansion due to shift towards IP/VPN

Tax exemption to reduce effective tax rate

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and recommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;
Performer: Between 10% and 20%;
Hold: ±10% return;
Underperformer: -10% or more.

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