

Technology

Target price Rs95

Earnings revision

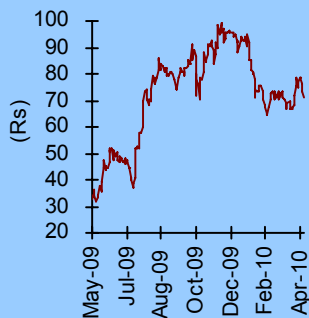
(%)	CY10E	CY11E
Sales	↓ 0.7	↓ 0.3
EBITDA	↓ 2.1	↓ 0.3
EPS	↓ 0.1	↑ 0.9

Shareholding pattern

	Sep '09	Dec '09	Mar '10
Promoters	28.7	28.6	28.5
Institutional investors	41.0	45.0	43.3
MFs and UTI	0.3	3.5	2.9
Insurance Cos.	3.7	3.7	3.7
FII	37.0	37.8	36.7
Others	30.3	26.4	28.2

Source: www.nseindia.com

Price chart



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INDIA

Hexaware Technologies

BUY
 Maintained
Rs71

Gain after pain

Reason for report: Q1CY10 results review and earnings revision

Post sharp dollar revenue decline of 10.1% QoQ in Q1CY10, Hexaware management has guided for a healthy 7-9% QoQ growth in revenues for Q2CY10 on the back of increased confidence about demand revival and growth beyond Q2CY10. We reiterate that changed management strategy of increased focus on account mining with best-of-the-breed service offerings is likely to provide positive surprises going forward.

- **Maintain BUY**, with target price of Rs95/share based on target P/E of 10x core EPS of four quarters ending March '11 + idle cash/share of Rs24. Our optimistic stance is owing to: i) Hexaware's pursuit of several deals, couple of which are large, besides likely ramp-up of delayed projects in impending quarters; ii) guidance of 1,000 net employee additions (including 50% freshers) in CY10 constituting 19% of CY09 base; iii) management confidence about growth continuing beyond Q2CY10 and resulting margin pick-up from H2CY10; iv) estimated CY10 EPS continues to factor-in the huge forex loss that constitutes 20-25% of PBT; the unfavourable hedges are expiring by Q3CY10; v) net cash being as high as 42% of current market price. Key risks to our recommendation are: i) high client concentration and ii) slower-than-expected revival in western economies and discretionary spend.
- **Q1CY10 results in line on operational front**, with dollar revenue decline of 10.1% QoQ (I-Sec: 9.1%) and EBITDA margin of 8.2% (I-Sec: 8.3%). However, lower-than-expected forex loss and tax rate led to higher-than-expected PAT at Rs116mn (I-Sec: Rs86mn). Offshore billing rates (ex Focus Frame and Caliber Point) declined ~3% in constant currency. Q1CY10 margin drop of 970bp was owing to: i) 130bps decline through forex movement; ii) 250bps impact via reinstatement of Q2CY09 wage-cut; iii) 590bps impact of volume & billing rate decline.
- **Q2CY10 margin to remain suppressed, with pick-up from H2CY10.** Management expects to recoup part of the 590bps margin loss in Q1CY10 due to volume decline in Q2CY10, which would be offset by margin pressure from: i) offshore wage hikes of 15%, effective Q2CY10 (impact of 250-300bps); ii) rupee appreciation/any cross currency impact; iii) investment in sales/marketing and horizontal practices, iv) some billing-rate pressure. Despite management expectation of muted margin in Q2CY10, we expect marginal improvement QoQ. Q3CY10 margin headwind is likely to be onsite wage hikes (we estimate 2-3% hike), which is likely to be more than compensated through volume increases and productivity/cost efficiencies gains.
- **Increased management confidence on demand revival**, with nine new client additions across various verticals/services lines. Management expects existing clients to grow beyond Q1CY10, with expected revenue growth in top-5 clients in Q2CY10 due to improving deal pipeline.

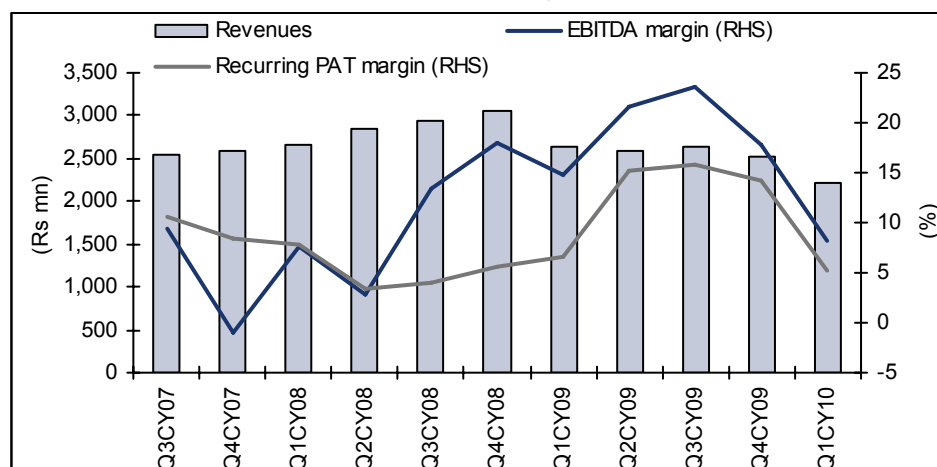
Market Cap	Rs4.1bn/US\$230mn
Reuters/Bloomberg	HEXT.BO/HEXW.IN
Shares Outstanding (mn)	144
52-week Range (Rs)	99/19
Free Float (%)	71.5
FII (%)	36.7
Daily Volume (US\$'000)	3,150
Absolute Return 3m (%)	(12.1)
Absolute Return 12m (%)	117.3
Sensex Return 3m (%)	7.0
Sensex Return 12m (%)	44.2

Year to December	2008	2009	2010E	2011E
Revenue (Rs mn)	11,520	10,386	9,469	10,755
Net Income (Rs mn)	590	1,343	881	1,566
EPS (Rs)	4.1	9.3	6.1	10.9
% Chg YoY	(46.5)	127.1	(34.4)	77.7
P/E (x)	17.3	7.6	11.6	6.5
CEPS (Rs)	5.8	10.7	7.5	12.5
EV/E (x)	6.2	3.0	4.6	2.6
Dividend Yield (%)	0.7	2.0	1.2	2.3
RoCE (%)	10.8	21.0	8.7	10.4
RoE (%)	8.6	17.8	9.6	14.9

Table 1: Q1CY10 results review*(Rs mn, year ending December 31)*

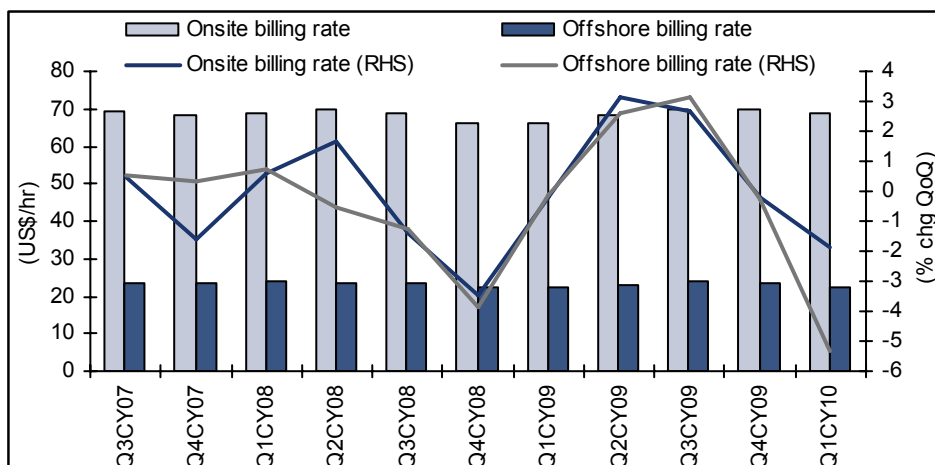
	Q1CY10	Q4CY09	Q1CY09	% chg (QoQ)	% chg (YoY)	I-Sec estimates	% Variance
Net Sales	2,220	2,520	2,643	(11.9)	(16.0)	2,249	(1.3)
Cost of revenues	1,420	1,435	1,486	(1.0)	(4.4)	1,450	(2.0)
SGA expenses	617	635	765	(2.8)	(19.3)	614	0.6
Total Expenses	2,038	2,070	2,251	(1.5)	(9.5)	2,064	(1.2)
EBITDA	182	450	392	(59.6)	(53.6)	186	(2.2)
Depreciation	59	65	67	(9.2)	(11.9)	62	(4.6)
Forex gain/(loss)	(75)	(105)	(198)			(99)	
Other Income	77	84	78	(8.3)	(1.3)	70	10.0
Recurring pre-tax income	125	364	205	(65.7)	(39.1)	95	31.0
Taxation	9	4	32	125.0	(71.9)	10	(5.5)
Minority Interest	0	0	0			0	
Equity interest of affiliates	0	0	0			0	
Recurring Net Income	116	360	173	(67.8)	(33.1)	86	35.1
Extraordinary income/(expense)	0	0	0			0	
Reported Net Income	116	360	173	(67.8)	(33.1)	86	35.1
Ratios (%)							
EBITDA margins	8.2	17.9	14.8			8.3	
EBIT margins	5.5	15.3	12.3			5.5	
Recurring Net profit margins	5.2	14.3	6.5			3.8	

Source: Company data, I-Sec Research

Chart 1: Consolidated revenues and margins

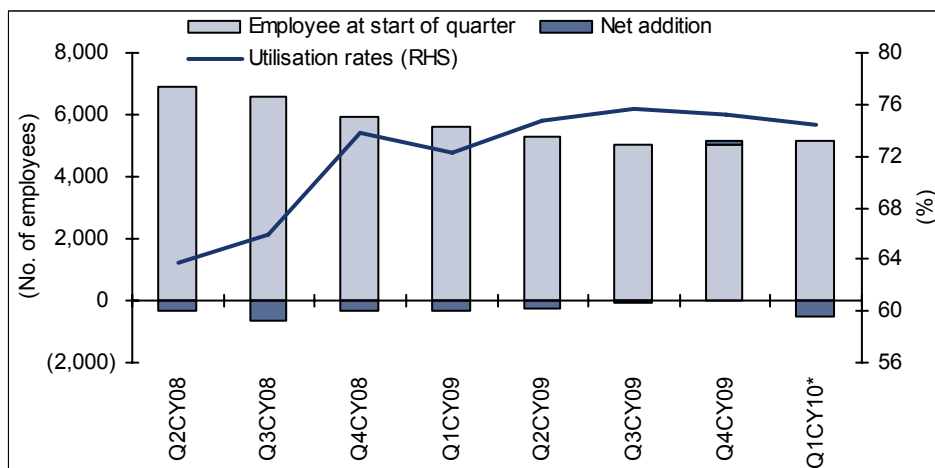
Source: Company data, I-Sec Research

Chart 2: Billing rates, ex Focus Frame and Caliber Point (QoQ)



Source: Company data, I-Sec Research

Chart 3: Employee additions (utilisation rates ex Focus Frame and Caliber Point)



Source: Company data, I-Sec Research

*Including Focus Frame

Table 2: QoQ revenue growth by vertical (US dollar)

(%)	Q1CY09	Q2CY09	Q3CY09	Q4CY09	Q1CY10
BFSI	(12.5)	(1.3)	5.5	0.0	(13.3)
TTHL	(5.6)	1.9	1.7	8.4	(3.9)
Emerging segments	(20.6)	5.1	(1.9)	(5.7)	(9.6)

Source: Company data, I-Sec Research

Table 3: Client orientation*(No. of clients)*

Client concentration	Q1CY09	Q2CY09	Q3CY09	Q4CY09	Q1CY10
QoQ dollar revenue growth (%)*					
Top client	(21.0)	7.0	(5.8)	(10.8)	(25.1)
Top-5 clients	(9.1)	(0.4)	6.3	0.5	(14.1)
Top-10 clients	(9.6)	0.8	4.7	(2.0)	(12.2)
Top 2-5 clients	(1.1)	(4.4)	13.5	6.0	(9.5)
Top 6-10 clients	(10.8)	3.6	1.3	(7.3)	(7.7)
No. of active clients billed	168	166	159	157	156
New clients added	9	10	9	7	9
Revenue / Billed client (Annualised)	1.25	1.29	1.37	1.38	1.24
Repeat Business (%)	93.4	97.3	96.4	96.9	96.1
Client mining (LTM):					
>US\$1mn	51	49	47	47	47
US\$1-5mn	40	40	38	39	39
US\$5-10mn	7	6	6	4	4
>US\$10mn	4	3	3	4	4

* Excluding Focus Frame and Caliber Point

Source: Company data, I-Sec Research

Table 4: QoQ revenue growth by service lines and segments (US dollar)*(%)*

	Q1CY09	Q2CY09	Q3CY09	Q4CY09	Q1CY10
Application Development & Maint (ADM)	(7.5)	3.5	6.0	3.1	(8.8)
Enterprise Application Services (EAS)	(18.2)	(3.9)	0.2	(1.7)	(19.4)
Testing/BTO	(31.7)	8.1	(16.6)	(13.1)	(4.7)
Business Intelligence & Analytics	(17.6)	6.7	12.3	(2.2)	(20.0)
BPO	(3.7)	4.9	(2.7)	0.6	(2.2)
Others	(8.5)	(27.2)	62.7	(19.5)	100.5

Source: Company data, I-Sec Research

Financial Summary

Table 5: Profit and Loss statement
(Rs mn, year ending December 31)

	CY08	CY09	CY10E	CY11E
Operating Revenues (Sales)	11,520	10,386	9,469	10,755
Operating Expenses	10,293	8,363	8,294	9,011
EBITDA	1,227	2,023	1,175	1,744
% margins	10.7	19.5	12.4	16.2
Depreciation & Amortisation	284	270	249	285
Interest & Finance Chgs	0	0	0	0
Other Income	(198)	(307)	49	536
Recurring PBT	745	1,446	976	1,995
Add: Extraordinaries exps / (Inc)	0	0	0	0
Less: Taxes	155	103	94	429
- Current tax	177	174	146	449
- Defrd tax / MAT Cr / others	(22)	(71)	(52)	(20)
Net Income (Reported)	590	1,343	881	1,566
Recurring Net Income	590	1,343	881	1,566

Source: Company data, I-Sec Research

Table 6: Balance sheet
(Rs mn, year ending December 31)

	CY08	CY09	CY10E	CY11E
Assets				
Total Current Assets	5,950	6,901	5,465	6,047
of which cash and deposits	2,849	4,262	2,956	3,213
Total Current Liabilities & Provisions	3,711	2,710	1,980	2,314
Net Current Assets	2,239	4,191	3,485	3,733
Investments	0	0	2,500	3,000
of which Other Marketable	0	0	2,500	3,000
Net Fixed Assets	2,900	2,899	2,950	3,165
Tangible assets	1,604	1,618	1,687	1,902
Intangible assets	1,296	1,280	1,263	1,263
Capital Work-in-Progress	1,597	1,460	1,460	1,460
Total Assets	6,736	8,550	10,395	11,358
of which cash and equivalents	2,849	4,262	5,456	6,213
Liabilities				
Borrowings	195	163	640	500
Deferred Tax Liability	(84)	(110)	(164)	(209)
Minority Interest	0	0	0	0
Equity Share Capital	287	288	288	288
Face Value per share (Rs)	2	2	2	2
Preference Share Capital	0	0	0	0
Reserves & Surplus	6,338	8,209	9,631	10,779
Net Worth	6,625	8,497	9,919	11,067
Total Liabilities	6,736	8,550	10,395	11,358

Source: Company data, I-Sec Research

Table 9: Quarterly trend
(Rs mn, year ending December 31)

	Jun-09	Sep-09	Dec-09	Mar-10
Net sales	2,591	2,632	2,520	2,220
% growth (YoY)	(8.9)	(10.7)	(17.6)	(16.0)
Recurring EBITDA	558	623	450	182
Margin (%)	21.5	23.7	17.9	8.2
Other income	(45)	(121)	(21)	2
Extraordinaries Inc / (Loss)	0	0	0	0
Recurring Net Income	396	414	360	116

Source: Company data, I-Sec Research

Table 7: Cashflow statement
(Rs mn, year ending December 31)

	CY08	CY09	CY10E	CY11E
Operating Cash flow before W Cap changes	722	1,254	816	1,451
Working Capital Inflow / (Outflow)	0	124	187	(237)
Capex	(1,270)	(131)	(300)	(500)
Free Cash flow	(547)	1,247	702	714
Cash Flow from other Invst Act (Ex Capex)	2,425	296	(2,237)	(158)
Proceeds from Issue of Share Capital	(1)	(1)	0	0
Inc/(Dec) in Borrowings / Deferred Liabilities	169	(32)	477	(140)
Dividend / Interest paid	(99)	(98)	(250)	(158)
Increase/(Decrease) in Cash	1,947	1,413	(1,307)	258

Source: Company data, I-Sec Research

Table 8: Key ratios
(Year ending December 31)

	CY08	CY09	CY10E	CY11E
Per Share Data (Rs)				
Earnings per share (Basic Recu.)	4.1	9.3	6.1	10.9
Diluted Earnings per share	4.1	9.0	5.9	10.5
Cash earnings per share	5.8	10.7	7.5	12.5
Dividend per share	0.5	1.4	0.9	1.6
Book Value per share	46.1	59.0	68.9	76.9
Growth Ratios (%)				
Operating Income (Sales)	10.8	(9.8)	(8.8)	13.6
EBITDA	36.3	64.9	(41.9)	48.3
Recurring Net Income	(46.5)	127.6	(34.4)	77.7
Diluted Recurring EPS	(47.0)	121.9	(34.4)	77.7
Diluted Recurring CEPS	(36.2)	79.7	(30.5)	67.9
Valuation Ratios (x)				
P/E	17.3	7.6	11.6	6.5
P/CEPS	12.1	6.6	9.5	5.7
P/BV	1.5	1.2	1.0	0.9
EV / EBITDA	6.2	3.0	4.6	2.6
EV / Sales	0.7	0.6	0.6	0.4
EV / FCF	(17.7)	4.9	7.7	6.3
Operating Ratio				
Software Development Expenses/Sales (%)	61.3	54.3	62.0	60.5
SG&A/Sales (%)	28.0	26.2	25.6	23.3
Other Income / PBT (%)	(26.6)	(21.2)	5.0	26.9
Effective Tax Rate (%)	20.8	7.1	9.6	21.5
NWC / Total Assets (%)	21.3	36.9	27.8	26.9
Fixed Asset Turnover (x) on average	4.4	3.6	3.2	3.5
Receivables (days) on average	67	63	57	56
Payables (days) on average	16	21	20	16
D/E Ratio (x)	0.0	0.0	0.1	0.0
Return/Profitability Ratio (%)				
Recurring Net Income Margins	5.1	12.9	9.3	14.6
RoIC (Based on Avg)	19.1	38.9	17.6	21.9
RoCE (Based on Avg)	10.8	21.0	8.7	10.4
RoNW (Based on Avg)	8.6	17.8	9.6	14.9
Dividend Payout Ratio	16.3	17.6	16.4	17.6
Dividend Yield	0.7	2.0	1.2	2.3
EBITDA Margins	10.7	19.5	12.4	16.2

Source: Company data, I-Sec Research

I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

BUY: +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

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