

CMP	Rs.180	Absolute	Buy
Target	Rs 230	Relative	Outperform

Retain positive stance despite near-term margin pressures

A disappointing quarter on margins – but all elements of our core thesis remain intact

We retain our BUY on Polaris despite a disappointing quarter on margins and indications from management that further margin weakness lies ahead for the next two-three quarters. We believe the key dampener in this regard is the company's excessive reliance on laterals vs peers – we believe only 15% of gross employee additions for Polaris comprises freshers, vs ~50% for large cap- and ~30-35% for mid cap -peers. An attrition rate in the ~19-21% range (LTM) serves to exacerbate this. Still, we see good reasons to BUY into Polaris, specifically: traction on the products business continues unabated, deal pipeline remains at healthy levels and overall, our thesis on margin improvement hinged on structurally greater proportion of products in the revenue mix remains unchanged. Reiterate BUY.

Highlights of the quarter's performance

- **Margin disappointment:** EBITDA margins came in at just 13.1% vs our 14.4% estimate – clearly a disappointment in our view. Management flagged that costs related to ~950 employees added towards the end of 2Q were included for the whole of 3Q, resulting in an additional cost of Rs 100mn. On the plus side, they indicated they had not given a second round of wage hikes unlike some of the other IT mid-caps. For the near term, they see few levers for material margin improvement as they seek to capture growth opportunities available in the improving environment. With these constraints, the key for material margin improvement for Polaris, in our view, is to exhibit strong revenue momentum.
- **Product momentum strong:** Product momentum for Polaris continues to be robust with management indicating a US\$ 120mn+ sales pipeline for Intellect and >Rs 2bn pipeline for Laser Soft and also that they are participating in seven-eight deals worth >Rs 200mn each. Commentary on revenues especially on the products side continues to be strong, which is encouraging in our view – for instance, the CEO indicated a lot of interest among clients and prospects for Polaris' products in SIBOS, the banking industry technology conference.
- **Key metrics:** Polaris saw a 171bps offshore shift in its revenue mix this quarter to 56.2% of revenues. Separately, they indicated that pricing should see an upward bias, though they cautioned these revisions may be modest rather than steep.
- **Valuation and Recommendation:** We value Polaris at 10x-Jun-12 EPS. We reiterate our BUY/OPF on the stock with a Rs 230 target price.

Financial summary

Year	Revenues (Rs. bn)	EBITDA (Rs. bn)	PAT (Rs. bn)	EPS (Rs.)	P/E(x)	EV/EBITDA(x)
FY10	13,538	2,220	1,529	15.3	11.4	5.6
FY11E	15,729	2,183	1,970	19.7	8.9	5.7
FY12E	19,032	2,678	2,211	22.1	7.9	4.7

3QFY11 Update

Date: Jan 27, 2010

Market Data

SENSEX	18684
Nifty	5604
Bloomberg	POL IN
Shares o/s	99.8mn
Market Cap	Rs 18bn
52-wk High-Low	Rs 215-132
3m Avg. Daily Vol	Rs 146mn
Index member	BSE Midcap

Latest shareholding (%)

Promoters	29
Institutions	34
Public	37

Stock performance (%)

	1m	3m	12m
Polaris	0	5	3
CNXIT	-1	8	24
Nifty	-5	-5	14

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Polaris

Quarterly Financial Results

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Quarterly financial results								
Rs. mn\Period	31-Dec-10	30-Sep-10	yoy Growth	30-Sep-10	qoq Growth	FY10	FY11E	yoy Growth
Revenues	3,999	3,389	18.0%	3,883	3.0%	13,538	15,729	16.2%
Software development	2,722	2,185	24.6%	2,551	6.7%	8,701	10,576	21.6%
Gross Profit	1,277	1,204	6.1%	1,332	-4.1%	4,837	5,153	6.5%
Selling & Marketing exp	433	361	19.9%	410	5.5%	1,450	1,687	16.3%
General & Administrative	321	295	8.6%	316	1.5%	1,166	1,283	10.0%
EBITDA	524	548	-4.4%	606	-13.6%	2,220	2,183	-1.7%
Depreciation	87	86	1.1%	84	3.7%	350	354	1.2%
EBIT	437	461	-5.4%	522	-16.4%	1,870	1,829	-2.2%
Other income	197	-243	nm	62	215.3%	-73	514	nm
PBT	602	467	nm	584	3.1%	1,797	2,343	30.4%
Tax	101	66	52.0%	90	12.1%	255	368	44.3%
PAT	502	401	25.1%	495	1.4%	1,529	1,967	28.7%
Diluted EPS (Rs.)	5.02	4.05	24.0%	4.82	4.3%	15.31	19.70	28.7%
Gross Margin	31.9%	35.5%		34.3%		35.7%	32.8%	
EBITDA Margin	13.1%	16.2%		15.6%		16.4%	13.9%	
PAT Margin	12.5%	11.8%		12.7%		11.3%	12.5%	
Tax rate	16.7%	14.2%		15.4%		14.2%	15.7%	
Onsite revenues	43.8%	49.9%		45.5%		50.8%	45.7%	
Offshore revenues	56.2%	50.1%		54.5%		49.2%	54.3%	
Employees	10,850	9,324	16.4%	10,678	13.1%	9,512	10,862	14.2%

Polaris

Business Overview

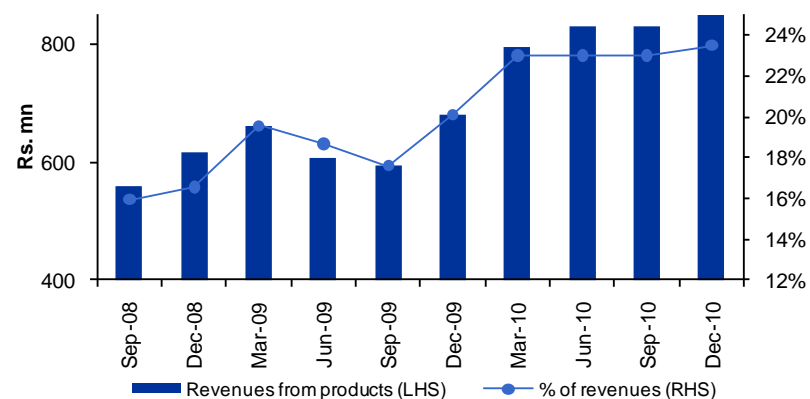
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Key estimate revision

	FY11E			FY12E		
	New	Old	Change	New	Old	Change
Revenues (US\$ Mn)	342	346	1%	411	423	3%
USD/INR assumption	46	46	0%	45	45	0%
Revenues (Rs. Mn)	15,567	15,729	1%	18,503	19,032	3%
EBITDA (Rs. Mn)	2,315	2,183	-6%	2,871	2,678	-7%
EBITDA Margin	14.9%	13.9%	-99bps	15.5%	14.1%	-144bps
EPS (Rs.)	20.7	19.7	-5%	23.6	22.1	-6%

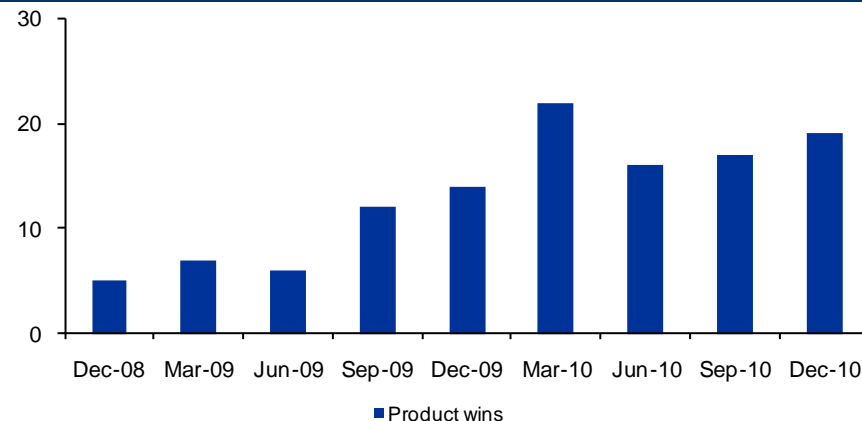
All figures in Rs. mn, except EPS, which is in Rs.

Products forming an increasing proportion of the business



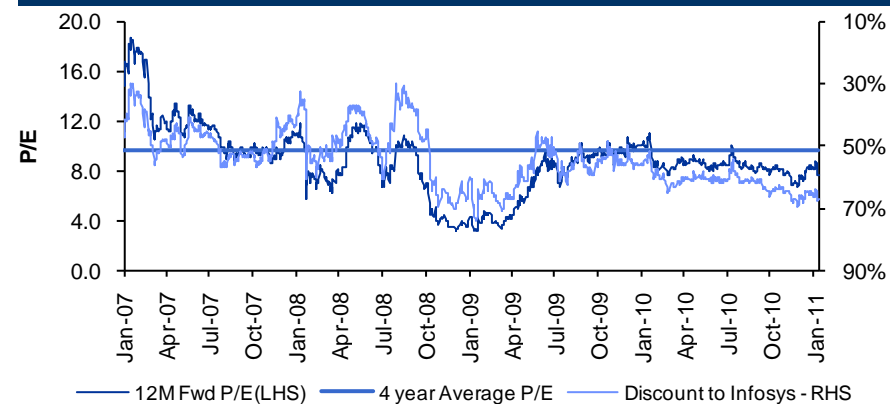
Source: Company data, Spark Capital

Intellect product wins – strong momentum



Source: Company data, Spark Capital

Polaris 12-m forward P/E



Source: Bloomberg, Spark Capital

Polaris

Financial Summary

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Abridged Financial Statements

Rs. mn	FY09	FY10	FY11E	FY12E
Profit & Loss				
Revenues	13,779	13,538	15,729	19,032
Software development expenses	8,854	8,701	10,576	12,879
Gross Profit	4,925	4,837	5,153	6,154
Selling & Marketing exp	1,368	1,450	1,687	1,970
General & Administrative exp	1,223	1,166	1,283	1,505
EBITDA	2,335	2,220	2,183	2,678
Depreciation / Ammortisation	505	350	354	463
EBIT	1,830	1,870	1,829	2,216
Other income	-314	-86	512	617
PBT	1,516	1,784	2,341	2,833
Tax	209	255	368	622
PAT	1,307	1,529	1,972	2,211
Diluted EPS (Rs.)	13.2	15.3	19.7	22.1
Balance sheet				
Paid up capital	493	495	496	496
Reserves & surplus	7,233	8,230	9,796	11,422
Secured loans	4	25	52	52
Deferred Tax Liability	66	30	27	27
Total liabilities	7,797	8,780	10,395	12,021
Goodwill	199	506	644	644
Net fixed assets	2,157	2,271	2,981	3,268
Investments	2,442	3,897	116	116
Deferred tax assets	97	64	86	86
Current assets, loans and adv.	5,410	5,067	10,090	12,065
Current liabilities and provisions	2,509	3,026	3,521	4,158
Net current assets	2,901	2,041	6,569	7,907
Total assets	7,797	8,780	10,395	12,021

Key metrics

	FY09	FY10	FY11E	FY12E
Cashflow				
Operations	2,417	2,540	1,851	2,062
Investing	-282	-522	-598	-378
Financing	-349	-308	-638	-580
Free cash flow	2,047	2,194	1,001	1,312
Opening cash	1,737	3,496	5,134	5,662
Closing cash	3,496	5,134	5,662	6,761
Growth				
Revenues	25.3%	-1.8%	16.2%	21.0%
EBITDA	97.6%	-4.9%	-1.7%	22.7%
PAT	78.5%	16.9%	29.0%	12.1%
EPS	78.6%	15.9%	28.7%	12.4%
Margins				
EBITDA	16.9%	16.4%	13.9%	14.1%
EBIT	13.3%	13.8%	11.6%	11.6%
PAT	9.5%	11.3%	12.5%	11.6%
Return				
ROE	18.3%	18.6%	20.7%	19.9%
ROCE	18.2%	18.5%	20.6%	19.8%
Valuation				
Fully diluted shares (mn)	98.9	99.8	99.8	99.8
Market cap (Rs. mn)	17,185	17,311	17,311	17,311
EV (Rs.mn)	12,465	12,465	12,465	12,465
EV/Sales (x)	0.9	0.9	0.8	0.7
EV/EBITDA (x)	5.3	5.6	5.7	4.7
P/E (x)	13.1	11.3	8.8	7.8
P/E ex-cash (x)			7.2	6.6
EPS(E) / Current market price	7.6%	8.7%	11.3%	12.7%

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Absolute Rating Interpretation

BUY	Stock expected to provide positive returns of > 15% over a 1-year horizon
ADD	Stock expected to provide positive returns of <=15% over a 1-year horizon
REDUCE	Stock expected to fall <=15% over a 1-year horizon
SELL	Stock expected to fall >15% over a 1-year horizon

Relative Rating Interpretation

OUTPERFORM	Stock expected to outperform sector index /sector peers in our coverage
UNDERPERFORM	Stock expected to underperform sector index/ sector peers in our coverage

Recommendation History

Date	CMP	Target price	Absolute Rating	Relative Rating
10-Jan-11	182	225	BUY	OPF
14-Dec-10	165	225	BUY	OPF
20-Oct-10	175	225	BUY	OPF
11-Oct-10	171	225	BUY	OPF
29-Jul-10	183	225	BUY	OPF

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