

# Polaris Software Lab

Bloomberg: POL IN EQUITY

Recommendation: BUY

Reuters: POLS.BO



## INITIATING COVERAGE

## 'Intellect' inside

We initiate coverage on Polaris with a BUY rating and TP of Rs225. The factors underlying our positive standpoint: (a) high exposure (94% of revenues) to the BFSI sector, which is expected to be the primary growth driver in the near term; (b) strong growth expected in the products business 'Intellect', which has higher-than-company-average margins (~23% v/s 16.4%); and (c) cheap valuations (9.0x on FY11E and 8.7x on FY12E EPS), which is closer to the lower end of the midcap range (8-12x). While the common perception is that the Citigroup stake sale (since Sep-09) is an overhang, the stock has outperformed (29% in absolute terms and 10% v/s Sensex) over the same period.

- High BFSI exposure is expected to be a boon:** With 94% of revenues arising from the BFSI vertical, Polaris has the highest exposure to this segment amongst peers. We believe that this could be an advantage as while IT spend in other verticals has picked up, BFSI would continue to be the primary growth driver in the near term.
- 'Intellect' is expected to witness strong growth:** Polaris' product business 'Intellect' has been gaining traction and is expected to grow faster than the company average (32.4% CAGR over FY10-12E). Robust deal wins (avg. of 16 wins for the last four quarters) and ramp-up in deal sizes (2 US\$5mn deal wins in 4QFY10) are expected to add to the growth momentum. Further 'Intellect' has a strong foothold in APAC (ranked third by Forrester in terms of deal wins). This augurs well for the company as the region is the most active in terms of deal origination (33% of total).
- Services business to be driven by top 5 accounts:** We believe that ramp-ups from top 5 accounts would drive ~3% CQGR in the services business in FY11E (-5.4% YoY in FY10). Despite the stake sale, Citigroup (top account, ~43% of revenue) is expected to grow in-line with company average in the near term.
- Initiate coverage with BUY and a target price of Rs225:** Our target price implies a PE multiple of 11x on FY12E EPS. The stock is currently trading at 9.0x and 8.7x on FY11E and FY12E EPS respectively. We believe valuations appear cheap v/s the midcap universe (8-12x) given the robust growth expectation and a PE re-rating from hereon is warranted.

### Exhibit 1: Valuation summary

Y/E March	FY08	FY09	FY10	FY11E	FY12E
Net Sales (Rs mn)	10,993	13,779	13,538	15,187	17,741
Sales growth (YoY %)	6.5	25.3	(1.8)	12.2	16.8
EBITDA (Rs mn)	1,181	2,335	2,220	2,203	2,467
EBITDA (%)	10.7	16.9	16.4	14.5	13.9
Adjusted Net Profit	731	1,307	1,528	1,966	2,034
EPS (Rs)	7.4	13.2	15.5	19.9	20.6
EPS Growth (YoY %)	(27.2)	78.9	17.1	28.4	3.5
ROCE (%)	11.4	25.3	22.6	19.7	18.9
ROE (%)	11.5	18.2	18.5	20.7	18.6
PE (x)	24.1	13.5	11.5	9.0	8.7
Price/Book Value (x)	2.7	2.3	2.0	1.7	1.5
EV/EBITDA (x)	13.7	6.1	5.7	5.3	4.3

Source: Company, Ambit Capital research

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### Recommendation

<b>CMP:</b>	Rs178
<b>Target Price:</b>	Rs225
<b>Upside (%)</b>	26
<b>EPS (FY11E):</b>	Rs19.9
<b>Variance from consensus (%):</b>	-3.2

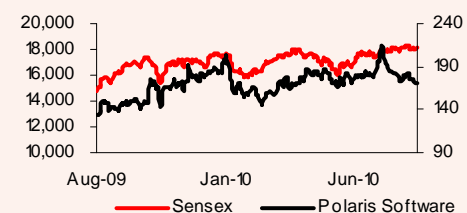
### Stock Information

<b>Mkt cap (mn):</b>	Rs17,671/US\$379
<b>52-wk H/L:</b>	Rs215/134
<b>3M Avg. daily vol. (mn):</b>	2
<b>Beta (x):</b>	1.1
<b>BSE Sensex:</b>	18,409
<b>Nifty:</b>	5,544

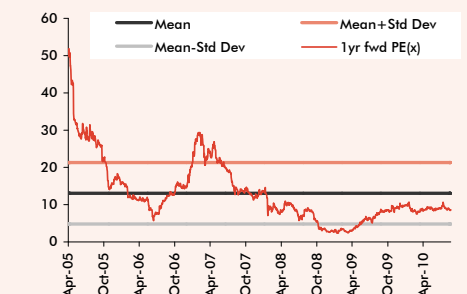
### Stock Performance (%)

	1M	3M	12M	YTD
Absolute	-1.8	3.5	28.9	-3.1
Rel. to Sensex	-3.2	-7.6	6.7	-8.1

### Performance v/s Sensex (%)



### 1-year forward P/E



Source: Bloomberg, Ambit Capital research

## Company Financial Snapshot

### Profit and Loss (consolidated)

(Rs mn)	2009-10	2010-11E	2011-12E
Net Sales	13,538	15,187	17,741
Operating Exp	11,317	12,984	15,274
EBITDA	2,220	2,203	2,467
Depreciation	350	333	390
Other income	(83)	439	532
PBT	1,788	2,309	2,608
Tax	255	343	574
PAT	1,532	1,966	2,034
Minority interest	(4)	-	-
PAT after Minority interest	1,528	1,966	2,034

### Company Background

Polaris was incorporated by Mr. Arun Jain in 1993 with Citibank as its key client. The company started with providing solutions to Citibank India and later expanded operations to include other global divisions and also diversify into other large BFSI accounts. The company currently works with 10 of the top 15 banks and 6 of the top 10 insurance companies with client base exceeding 200. Polaris has a dedicated focus on the BFSI space (94% of revenues) with an end-to-end offering – IT services (75.5% of revenues), product (23% of revenues) and BPO (1.5% of revenue).

### Profit and Loss Ratios

EBITDA Margin (%)	16.4	14.5	13.9
PAT Margin (%)	11.3	12.9	11.5
P/E (x)	11.5	9.0	8.7
EV/ EBITDA (x)	5.7	5.3	4.3

### Balance Sheet (consolidated)

(Rs mn)	2009-10	2010-11E	2011-12E
<b>Total Assets</b>	<b>11,805</b>	<b>13,708</b>	<b>15,677</b>
Fixed Assets	2,271	2,714	2,924
Current Assets	8,822	10,213	11,972
Other Assets	712	781	781
<b>Total Liabilities</b>	<b>11,805</b>	<b>13,708</b>	<b>15,677</b>
Total Net Worth	8,725	10,162	11,649
Total Debt	25	29	29
Current Liabilities	3,026	3,487	3,969
Other liabilities	30	30	30

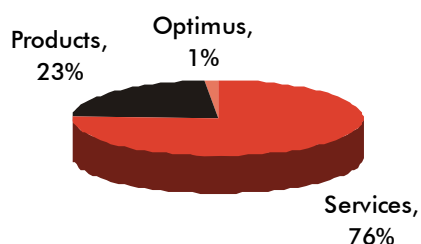
### Cash Flow (consolidated)

Cash Flow (Rs mn)	2009-10	2010-11E	2011-12E
Net profit before taxation	1,788	2,309	2,608
Depreciation/amortisation	350	333	390
(Inc)/dec in working capital	829	(243)	(197)
Others	(442)	292	(37)
Net cash from operations (a)	2,525	2,692	2,764
(Inc)/dec in investments	-	(200)	-
Capex	(355)	(775)	(600)
Others	(200)	(490)	(532)
Cash flow from inv. (b)	(556)	(1,466)	(1,132)
Inc/(dec) in capital	1	-	-
Dividends paid + dividend tax	(15,740)	(22,874)	(27,060)
Inc/dec in loans	14	4	-
Others	(323)	(203)	(529)
Financial cash flow ( c )	(308)	(198)	(529)
Net inc/dec in cash (a+b+c)	1,662	1,028	1,103
Opening cash balance	3,332	4,994	6,021
Closing cash balance	4,994	6,021	7,124

### Balance Sheet Ratios

RoE (%)	18.5	20.7	18.6
RoCE (%)	22.6	19.7	18.9
Net Debt/ Equity (x)	(0.6)	(0.6)	(0.6)
Total Debt/ Equity (x)	0.0	0.0	0.0
P/BV (x)	2.0	1.7	1.5

### Revenue Breakdown



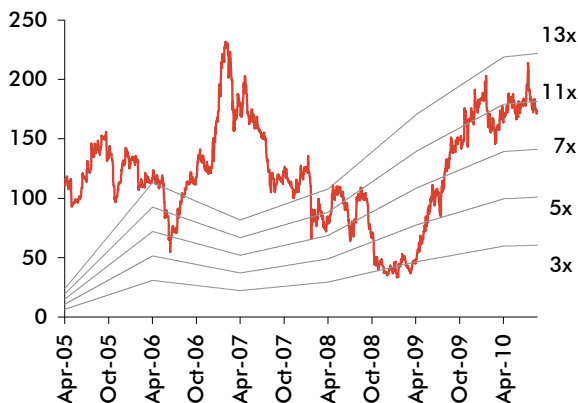
### Rating



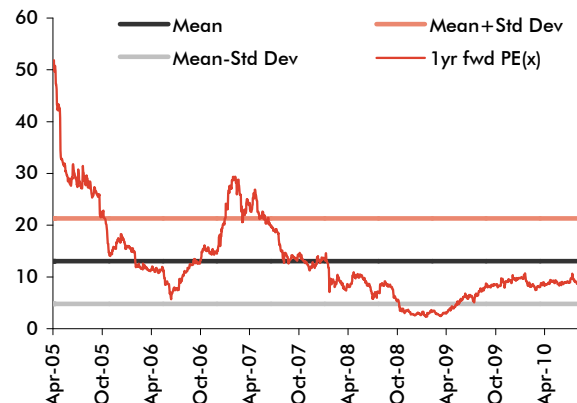
# Attractive valuations, initiate with a BUY and TP of Rs225

- **Initiate with a BUY, target price of Rs225:** We initiate coverage on Polaris with a BUY recommendation and March-2011 target price of Rs225. Our target price implies an upside potential of 30% from the current levels. The stock currently trades at a PE multiple of 9.0x and 8.7x on FY11E and FY12E EPS respectively. Our target price implies a PE multiple of 11x on FY12E EPS.
- Historically, Polaris has traded in a very broad range of 5x-21x on a 1-year forward PE multiple basis. The stock has also traded in a band of 3x-6x in FY09 during the downturn. However although the stock has got re-rated with the recovery cycle in FY10, it still trades at 9.0x on a 1-yr forward PE basis. We believe that further re-rating to 11x is warranted with robust growth, particularly in the products business.
  - Polaris currently trades at the lower band of the 1-yr fwd PE multiple of the midcap universe (8-12x), while historically it has traded within the midcap universe PE band (refer exhibit 4).
  - Polaris currently trades at 59% discount to Infosys v/s average of 47% in the last four years. Our target PE multiple of 11x is close to its historical average discount to Infosys' PE (refer exhibit 3).

**Exhibit 2: Historical one-year forward PE band**

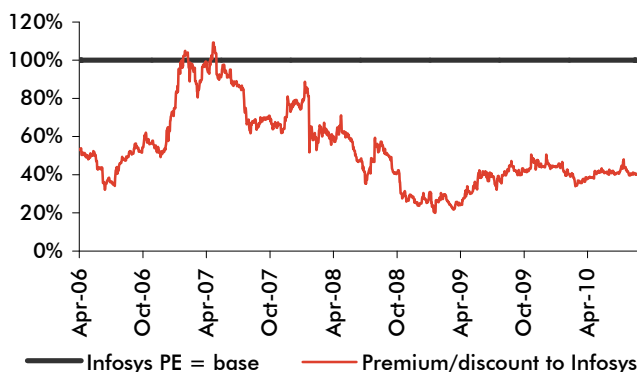


Source: Ambit Capital research, Bloomberg



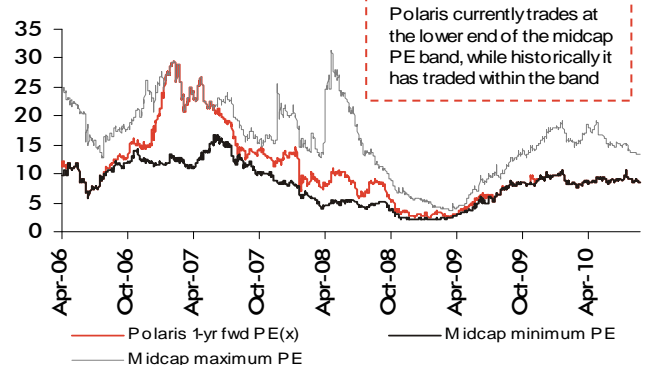
Source: Ambit Capital research, Bloomberg

**Exhibit 3: Polaris' premium/discount to Infosys**



Source: Ambit Capital research, Bloomberg

**Exhibit 4: Polaris comparison with the midcap universe**



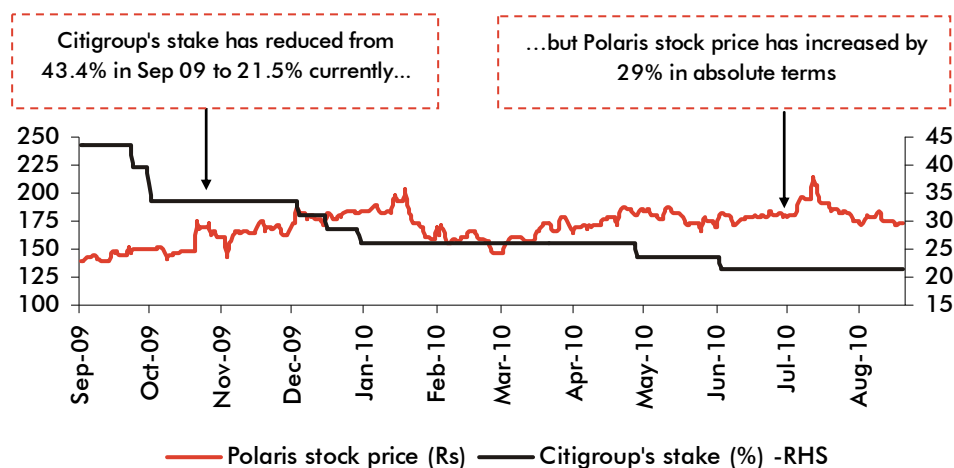
Source: Ambit Capital research, Bloomberg

Our assumptions factor in: (a) US\$ revenue CAGR of 17.9%; (b) EBITDA CAGR of 5.4%; and (c) PBT CAGR of 20.8% over FY10-12E. We believe that US\$ revenue growth would be an important metric to consider as the EPS CAGR of 15.3% would appear lower. This is due to our assumptions of: (a) rupee appreciation of 4.5% and 1.2% in FY11E and FY12E respectively; and (b) tax rate of 14.8% in FY11E and 22.0% in FY12E v/s 14.3% in FY10.

## Stock price performance has been good despite Citigroup's stake sale

- Citigroup has a stake in the company through its investment vehicle Citigroup Venture Capital (CVC). CVC's holding has been constantly reducing from 43.4% in September 2009 to 21.5% in June 2010. However, the stock price has gone up by 29% in absolute terms and outperformed the Sensex by 10% over the same period. Management mentioned that Citigroup's stake in the company is only a financial investment and does not anticipate any impact on the business momentum from Citigroup due to the stake sale.

### Exhibit 5: Polaris stock performance during Citigroup stake sale period



Source: Bloomberg, BSE

### Exhibit 6: Financial assumptions

Particulars	FY10	FY11E	FY12E
Consol. US\$ revenue growth (YoY %)	-5.3	17.3	18.3
IT Services US\$ revenue growth (YoY%)	-5.6	12.8	16.3
% of revenue	77.8	74.8	73.6
Products US\$ revenue growth (YoY%)	7.8	40.2	25.0
% of revenue	19.8	23.7	25.1
USD/INR assumption (Rs)	47.5	45.4	44.8
(Appreciation)/ Depreciation (%)	3.6	-4.5	-1.2
EBITDA margin (%)	16.4	14.3	13.9
Change in EBITDA margin (bps)	-55	-190	-60
PBT (YoY %)	18.6	29.2	12.9
EPS (YoY %)	17.1	28.4	3.5

Source: Company, Ambit Capital research

**Exhibit 7: Comparison with consensus**

Rs mn	Bloomberg est.		Ambit Capital est.		Difference to consensus	
	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
Sales	15,350	17,693	15,187	17,741	-1.1%	0.3%
EBITDA	2,279	2,707	2,203	2,467	-3.3%	-8.9%
Profit	2,045	2,184	1,966	2,034	-3.8%	-6.8%
EPS (Rs)	20.6	22.0	19.9	20.6	-3.2%	-6.3%

Source: Bloomberg, Ambit Capital research

## Exhibit 8: Peer Comparison

	Revenue (mn)			Net Profit (mn)			ROE (%)			P/E(x)			EV/EBITDA (x)			Price/Book Value (x)		
	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E
	CY09	CY10E	CY11E	CY09	CY10E	CY11E	CY09	CY10E	CY11E	CY09	CY10E	CY11E	CY09	CY10E	CY11E	CY09	CY10E	CY11E
<b>Tier-1 (Rs)</b>																		
Infosys	227,420	268,827	332,024	62,740	68,082	84,813	30.3	26.9	28.0	25.6	23.4	18.8	18.5	16.1	12.9	6.9	5.8	4.8
TCS	300,289	358,497	438,038	68,895	78,521	92,666	37.4	33.2	31.1	24.6	21.6	18.3	18.9	16.0	13.0	8.3	6.5	5.2
Wipro	271,957	313,435	376,059	46,118	52,684	56,357	26.6	14.3	10.1	21.9	19.3	17.9	18.0	9.5	8.1	5.1	1.9	1.7
HCL Tech	125,650	151,623	182,597	12,136	18,802	21,378	20.9	26.9	25.1	22.7	14.8	13.1	10.6	8.6	7.0	4.2	3.5	2.9
<b>Tier-2 (Rs)</b>																		
Mphasis	49,358	57,351	65,957	10,332	10,904	11,986	37.1	29.9	25.7	12.2	11.8	10.9	10.7	9.4	8.2	4.0	3.1	2.4
Tech Mahindra	46,254	47,908	53,763	7,005	7,060	7,647	29.0	21.3	19.6	12.4	13.2	12.1	9.9	12.2	10.8	3.0	2.5	2.1
Mindtree	12,960	15,006	17,895	2,149	1,407	2,047	35.2	18.2	22.9	9.6	14.9	10.4	8.8	9.9	7.1	3.1	2.6	2.1
Patni	31,461	32,288	36,931	5,866	5,509	5,566	18.4	14.6	13.2	11.6	12.8	12.6	-2.7	-2.8	-2.5	1.9	1.8	1.6
Infotech	9,531	11,033	13,097	1,709	1,560	1,877	20.4	15.5	15.7	10.1	11.1	10.0	8.0	8.0	6.6	1.9	1.6	1.4
Hexaware	10,386	10,088	11,910	1,342	812	1,361	17.7	9.0	13.1	8.1	13.5	8.1	4.8	9.4	6.1	1.3	1.2	1.1
KPIT Cummins	7,316	8,654	10,771	857	937	1,176	31.2	22.3	23.2	16.3	15.2	12.3	4.4	5.2	4.1	3.6	3.3	2.7
Sasken	5,742	6,291	7,402	755	787	830	15.0	15.0	14.6	7.3	7.2	6.7	3.0	2.8	2.4	1.1	1.0	0.9
Oracle Financial Solutions	28,740	32,238	36,083	7,737	10,100	10,954	19.8	20.7	18.6	22.5	17.2	15.9	15.1	13.1	10.4	4.1	3.3	2.7
Polaris	13,538	15,187	17,741	1,528	1,966	2,034	18.5	20.7	18.6	11.5	9.0	8.7	5.7	5.3	4.3	2.0	1.7	1.5
Persistent	6,012	7,717	9,926	1,150	1,447	1,609	22.3	20.6	19.2	16.5	13.1	11.8	9.2	8.3	5.3	3.0	2.5	2.1
<b>Global peers</b>																		
Temenos (CHF)	370	445	503	69	95	120	27.2	27.9	27.0	24.6	18.1	15.1	12.7	10.2	8.9	5.6	4.7	3.7
Misys (GBP)	782	861	938	44	74	86	14.9	23.3	22.6	32.5	17.9	15.0	7.2	6.1	5.5	4.1	3.4	2.8
FISERV (US\$)	4,077	4,056	4,200	476	600	650	16.9	16.4	15.3	14.6	12.7	11.6	7.4	7.0	6.7	2.5	2.2	1.9
Fidelity National Information services (US\$)	3,770	5,196	5,438	106	680	730	1.8	10.9	9.5	18.4	13.2	11.0	8.1	7.5	6.8	1.2	1.2	1.2

Source: Company, Ambit Capital research

# Investment Highlights

We initiate coverage on Polaris with a BUY rating, underpinned by our belief of pick up in growth momentum driven by the upswing in BFSI IT spend and strong growth in the product (Intellect) business. This coupled with attractive valuations at 9.0x FY11E and 8.7x FY12E EPS warrants a re-rating from hereon.

## Higher exposure to BFSI is expected to be an advantage

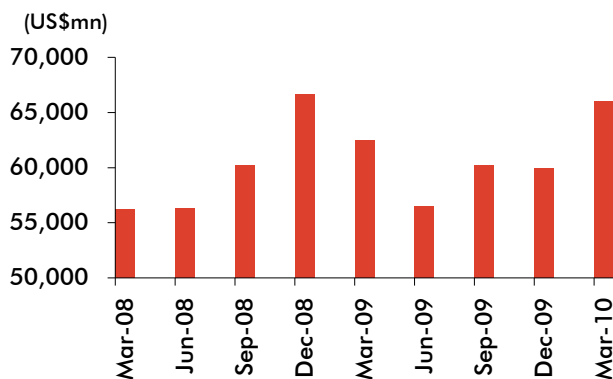
- Polaris’s strength lies in the BFSI sector, which contributes 93% (TTM) of its revenue (highest revenue contribution amongst peers). The global financial system stability, which has been underpinned by governmental support and reduced uncertainty among investors, has led to a faster expected recovery in the BFSI sector. We believe that while other verticals have picked up, BFSI would continue to be the primary growth driver in the near term. Our analysis of the top 15 banks revenue and profit growth trajectory also indicates a pick up. We believe that Polaris is well-positioned to ride the demand recovery in the BFSI vertical.

**Exhibit 9: Polaris has the highest revenue contribution from BFSI**

BFSI revenues (TTM)	% of revenue	US\$ mn
Infosys	34.8	1,759
TCS	45.1	2,999
Wipro	26.1	1,193
HCL Tech	25.7	694
Polaris	93.0	277
Hexaware	40.4	212
KPIT	6.1	164
Mphasis	41.0	1,055
Patni	42.2	677
Mindtree	17.1	287

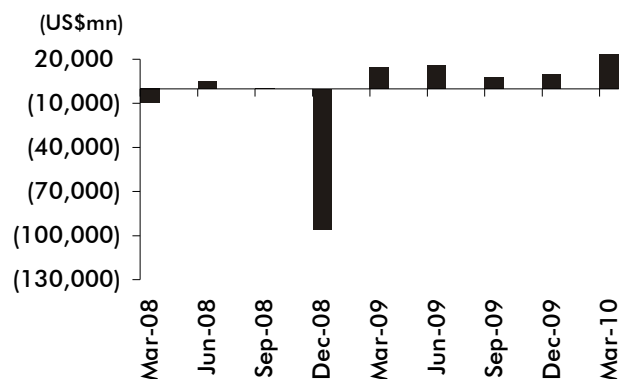
Source: Ambit Capital research

**Exhibit 10: Revenues of top 15 outsourcers - BFSI**



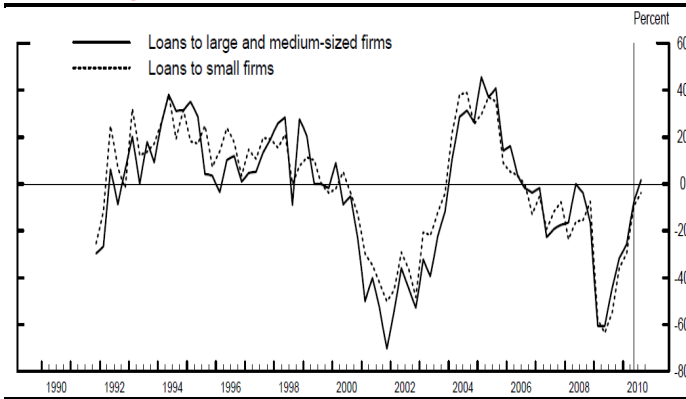
Source: Company, Ambit Capital research, Note: Dec 08 spike is primarily due to M&A activity

**Exhibit 11: PAT of top 15 outsourcers - BFSI**



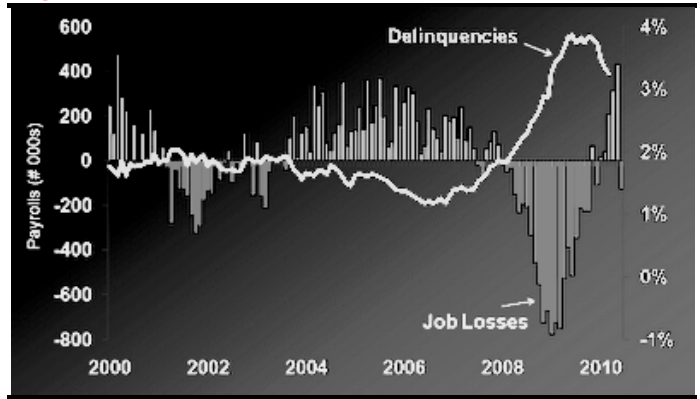
Source: Company, Ambit Capital research

**Exhibit 12: Net business loan demand no longer contracting**



Source: Federal Reserve

**Exhibit 13: Consumer loan delinquencies are showing improvement**



Source: American Bankers Association

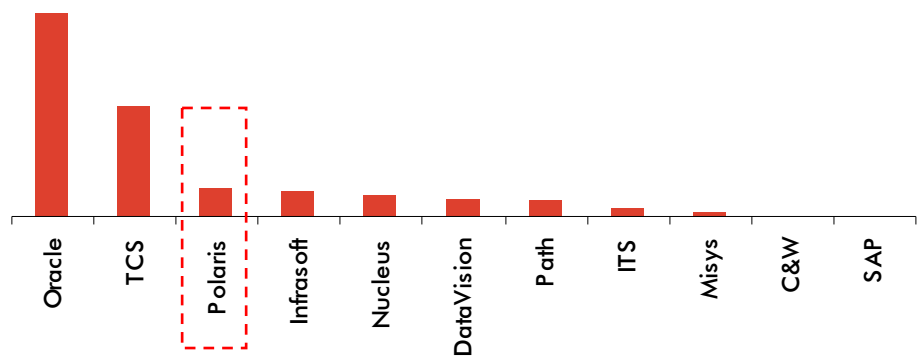
### ‘Intellect’ business to witness strong growth

Intellect Suite — the product portfolio of Polaris, which was built through the acquisition of Citibank’s IT arm, Orbitech (2002), has been gaining traction. Intellect is a service-enabled, component-based core banking system and competes with off-the-shelf core banking products such as ‘Flexcube’ from Oracle Financial Solutions and ‘T24’ from Temenos.

#### Strong presence in APAC which is the most active in deal origination

- According to Celent Research, Polaris ranks third in terms of the number of deal wins in APAC (2009), which has also been the most active region in terms of deal origination (one-thirds the total deals across regions). Unlike North America and Western Europe that have taken to legacy transformation years ago, developing countries in Asia, LATAM are currently at various stages of transformation. Polaris has a strong presence in Emerging markets (30% of total revenues) and majority of these revenues are product-driven.

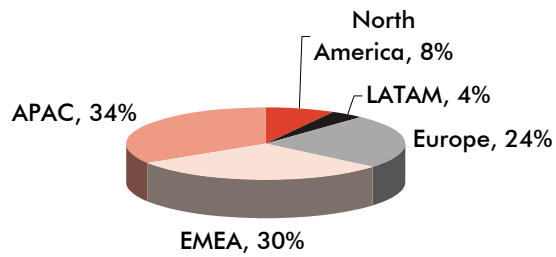
**Exhibit 14: Polaris has been ranked 3<sup>rd</sup> in APAC in terms of deal wins (2009)**



Source: Celent Research



**Exhibit 15: Geographic distribution of core banking deals**



Source: Celent Research

**Exhibit 16: Geographic perspectives on core banking market**

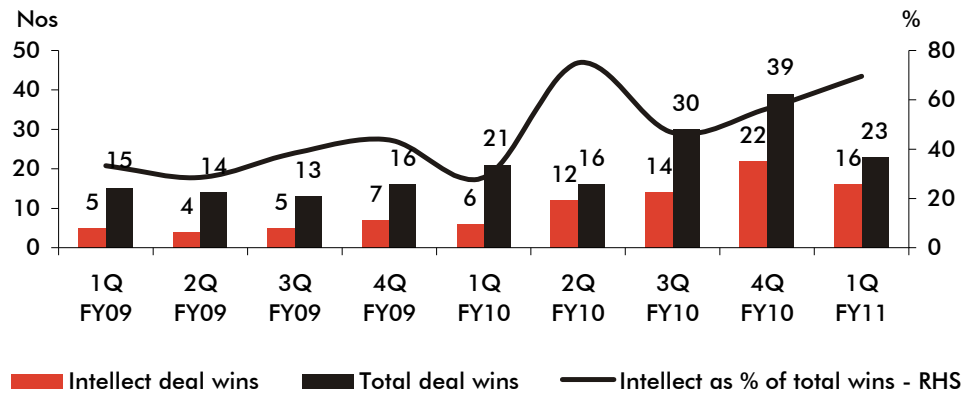
US	Has been the slowest in core banking replacements, particularly large banks. Majority of these replacements and enhancements are driven by smaller banks and credit unions which are growing relatively more aggressively.
Europe	While in-house solutions still dominate the market, third party solutions are gaining traction driven by regulations and regional initiatives.
APAC	Most of the regional banks are gearing up to compete with global banks that are establishing a strong presence in this region and hence it is the most active in terms of replacements and enhancements.

Source: Industry

## Intellect deal wins have been robust

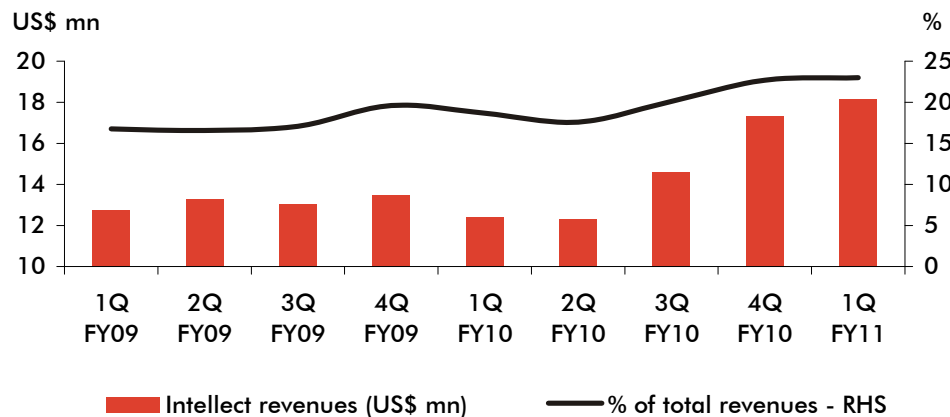
- Polaris has been securing good deal wins in the products (Intellect) business. The company has been clocking an average of 16 deal wins per quarter in the last four quarters. Deal sizes are also witnessing an improvement with the company having signed two US\$5mn deals in 4QFY10.

**Exhibit 17: Intellect deal wins have been consistently rising**



Source: Company, Ambit Capital research

**Exhibit 18: Strong revenue growth trajectory in products witnessed in the last 3 quarters**



Source: Company, Ambit Capital research

## Intellect's modular approach is well suited

- **Intellect's modular solutions offer flexibility ...:** While Intellect is designed to be a full-fledged core banking product, its differentiation lies in the fact that it offers the flexibility of modular solutions suited to customers' requirements rather than a boxed product. Intellect currently has 25 modules from which the clients can pick and choose the specific functionalities they want to deploy.
- **... and is suitable for midsize as well as large banks:** Modular solutions give the midsize banks which are looking at quickly ramping up market share, an expedient option along with the convenience of customization. Further, tier-1 banks, particularly in developed countries, which have already upgraded the legacy systems, would also consider modular solutions to enhance their systems. Even larger banks in Emerging countries are increasingly not opting for big-bang replacements where all systems are replaced in one go, as the size of their operations is not conducive to such implementations. Thus, the modular approach appears to be a logical option for both the midsize and large banks.

- **Appropriate strategy to compete with incumbent players:** We note that core banking customers generally tend to be sticky and Polaris's modular approach is appropriate given that it is also a relatively younger player in this territory (Intellect is 5 years old, Temenos-18, Finacle-10 and OFSS-14).

## Strong cash position places it in a favorable position

- Polaris cash on books of Rs5.1 bn (29% of current market cap) as on 30 June 2010. Polaris has been making niche acquisitions to fill gaps in its portfolio and all these acquisitions have been funded through internal accruals. We believe that Polaris's strong cash position places it in a favorable position to gainfully use the acquisition strategy to propel its overall growth engine.
- The recent Lasersoft acquisition (October 2009) is noteworthy — it has strengthened its core banking portfolio and staged an entry into cooperative banks in India and APAC. While Polaris has been strong in the modular solutions, it has lagged in the full-fledged core banking deals (~21 installations globally till date). Lasersoft is a proven core banking platform in India (78 live installations including 7 for core banking) with strong reference sites such as Corporation Bank, Catholic Syrian Bank etc. We believe that the opportunity of taking the platform to APAC could also spell an interesting opportunity.

### Exhibit 19: Recent acquisitions to fill portfolio gaps

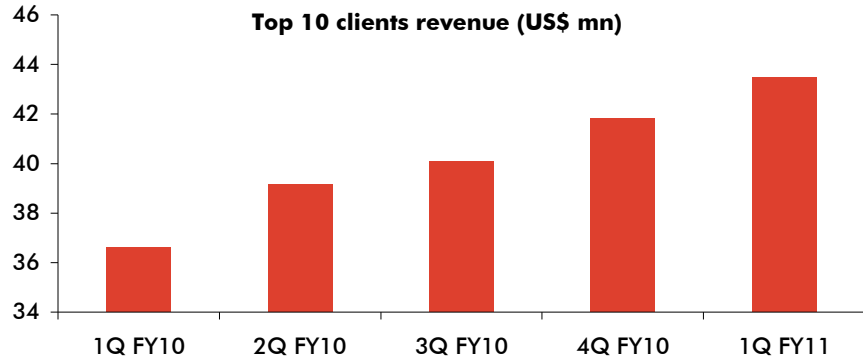
Date	Company name	Deal size	Financials	Valuation	Other details
Mar-10	Indigo TX	na	na	na	GO TX is an enterprise brokerage solution for the securities market based on SAAS model (pay per use model). Designed to help brokers trading in multiple instruments such as equities, derivatives and commodities in a single platform window, integrating the front, middle and back-office functions.
Oct-09	Lasersoft	US\$11.2 mn - upfront payment of US\$7.6 mn and rest contingent on performance over the next 2 years	Revenues of Rs370 mn and profit of Rs75 mn in FY09	Price/Sales of 1.3x and PE of 7x	Well established footprint in India with around 78 live installations at the time of acquisition. Strong client base particularly in the co-operative and rural banks with leading names such as Corporation Bank, SBI, ICICI Bank, Catholic Syrian Bank, Andhra Bank.
Sep-08	SEEC	US\$8 mn which included an upfront payment of US\$3 mn	na	na	Products in the insurance space - life and non-life. Had ~20 clients with marquee names such as New York Life, Country Financial, and Prudential Financial.

Source: Company, Ambit Capital research

## Services business to be driven by ramp-ups in top 5 clients

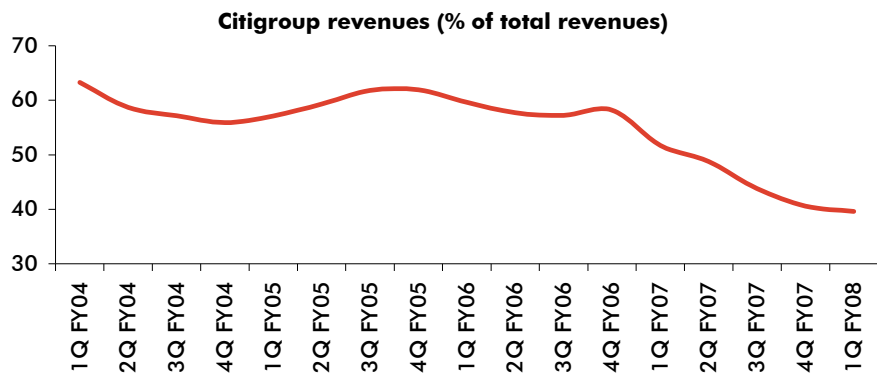
We believe that ramp-ups from top 5 accounts in the services business would drive ~3% CQGR in the services business in FY11E (v/s -5.4% YoY in FY10). Polaris has been successfully reducing dependency on its top client — Citigroup. Our channel checks suggest that Citigroup's current revenue contribution is ~43% and despite the stake sale, Citigroup is expected to grow in-line with the company average in the near term.

**Exhibit 20: Top 10 clients have been growing well in the last 5 quarters**



Source: Company

**Exhibit 21: Polaris has reduced its top client dependency over the years**



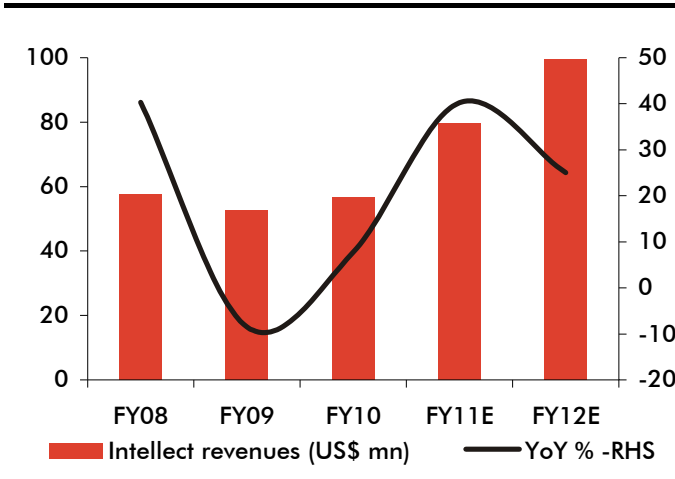
Source: Company, Ambit Capital research

# Financial Analysis

## Revenue growth expected to be driven by Intellect and top 5 accounts

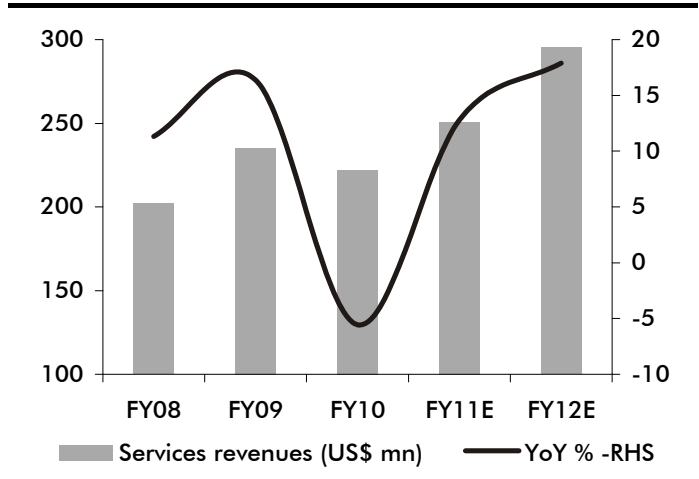
- We expect Polaris's revenue growth to be driven by robust growth in the products business (Intellect) and top 5 clients in the services business. We expect Intellect business to grow at 32.4% CAGR over FY10-12E and revenue contribution to increase to 25% by FY12E (v/s 19.8% in FY10). We expect Intellect growth to be led by: (a) market expansion as Intellect still remains underpenetrated in many countries offering scope for expansion (currently present in 30 countries and management target of 50 by 2013) and (b) cross opportunity to the current client base. We expect services business to grow at 14.5% CAGR over FY10-12E driven by ramp-ups in top 5 accounts.

**Exhibit 22: Intellect revenue expected to grow at 32.4% CAGR over FY10-12E**



Source: Company, Ambit Capital research

**Exhibit 23: Services revenue expected to grow at 14.5% CAGR over FY10-12E**



Source: Company, Ambit Capital research

## Margin pressure could be offset partially by improvement in products revenue contribution

- Polaris's EBITDA margin has been at ~17% in FY09/10. In FY10 the EBITDA margin was maintained despite a decline in revenues (-5.3% YoY due to the downturn). Primary margin levers utilized: (a) offshore revenue mix increase of 5.2%; (b) improvement in utilization levels of 1.1%; (c) rupee appreciation of 3.6%; (d) stable salary costs and (e) increased revenue contribution from products business (+2.5%) where margins are higher (~23%) than the company average.
- However, we expect margins to decline by 190 bps over FY10-12E primarily due to: (a) wage hikes – 15% normal hike and 7% due to reinstatement of variable pay in FY11E; (b) tapering off in the utilization levels to sustainable levels of ~76% and (c) higher attrition (lateral recruitment is expensive).
- Margin pressures could be offset partially by improvement in the product revenue contribution which infuses higher non-linearity (+5% over FY10-12E). A longer term margin driver could be the increase in average deal sizes leading to higher annual maintenance contract (AMC) revenues which lend higher revenue predictability (typically AMCs/Implementation revenues are a variable of the license fees). Currently, Polaris's product revenue mix is at

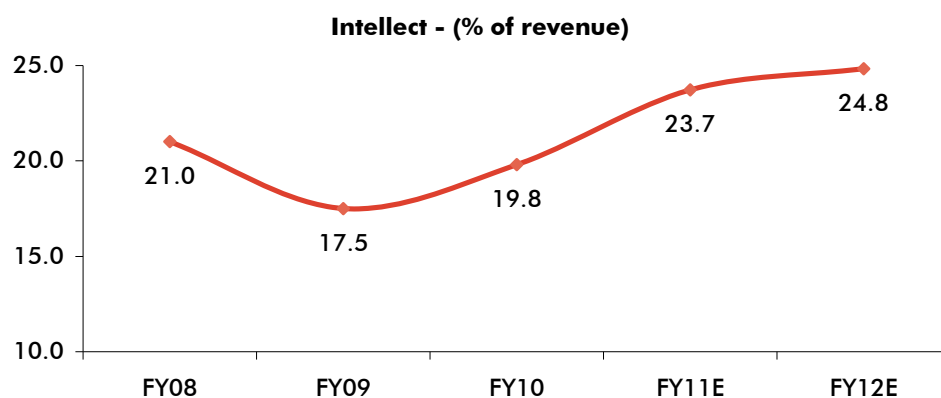
40:60 for license and implementation/customization with no meaningful AMC revenues. AMCs constitute ~50% of revenues for global product companies.

**Exhibit 24: Polaris has optimized margin levers well in the last 2 years**

	FY09	FY10
Revenue (US\$) -% change	10.1	-5.2
EBITDA margin (%)	16.9	16.4
% change	6.2	-0.5
<b>Primary levers utilized</b>		
Offshore mix	43.9	49.1
% change	2.8	5.2
Utilization	79.9	81.0
% change	4.4	1.1
Salary costs	64.3	64.3
% change	-3.5	0.0
Rupee appr/(depr) - % change	13.9	3.6
Intellect revenue (% of revenue)	17.5	19.8

Source: Company, Ambit Capital research

**Exhibit 25: Increasing contribution from products could help offset some margin pressure as most other levers appear optimally utilized**



Source: Company, Ambit Capital research

**Exhibit 26: Revenue contribution from AMCs is at 20-50% for global product companies, presenting scope for improvement for Polaris in the longer term**

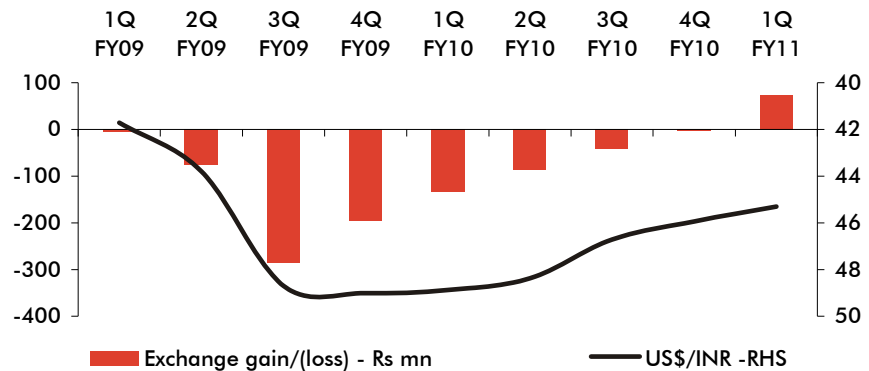
% of total revenue – CY09/FY10	License	Implementation and others	Support
Temenos	34.0	34.4	31.6
OFSS	18.0	59.0	23.0
Misys		41.1	58.9
SAP	24.4	23.2	52.4

Source: Company, Ambit Capital research

## Forex gains to aid net profit growth

- We expect PBT to grow strongly at 20.8% CAGR aided by foreign exchange gains. While the company reported significant forex losses over the last two years (Rs563 mn in FY09-38% of PBT and Rs 264 mn in FY10-15% of PBT), we expect forex gains to boost bottom-line going forward. Polaris follows cash-flow hedge accounting and currently has US\$75mn of hedges (July 2010-March 2011) @ avg. rate of 48.28 and US\$77 mn for FY12E @ avg. rate of Rs49. However, increase in effective tax rate to 22% in FY12E (given the sunset clause on STPI benefits under Sec10 (A)/(B)) is expected to keep PAT CAGR relatively lower at 15.4%.

**Exhibit 27: Exchange losses have been tapering off since the US\$/INR appreciation**

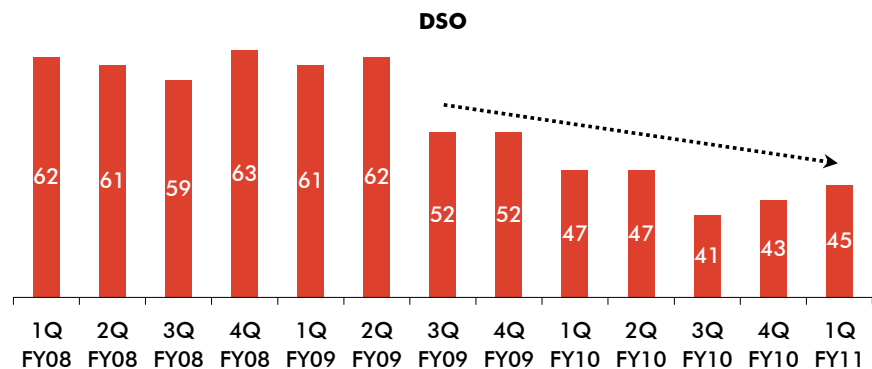


Source: Company, Ambit Capital research, Bloomberg

## Sharp reduction in receivable days

- Polaris has a strong debt-free balance sheet with healthy cash on books at Rs5.1 bn as on 1QFY11 (29% of current market cap). The company has reduced DSOs from 70 in FY08 to 45 in 1QFY11 with a significant improvement in the collections process. Going forward, we expect strong cash flow generation to be maintained.

**Exhibit 28: DSOs have shown remarkable decline since 3Q FY09**



Source: Company

## Carrying cost of IP on books is nil

- Polaris has been investing in the products business ever since the Orbitech merger (2002). The cost of developing the products was capitalized till December 2005. However, effective January 2006, when the company started marketing and selling the products, these costs were amortized and also the company began to expense the incremental costs in the P&L account. In FY09, Polaris wrote off the remaining intangibles (Rs1.17bn, proceeds from the AIG SS JV stake sale), and currently the carrying cost of IP on books is nil.

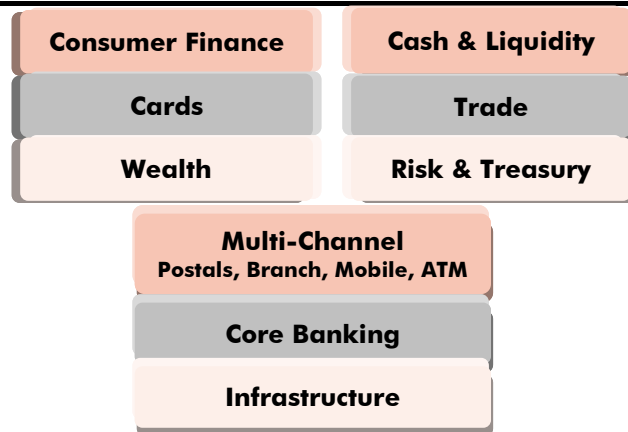
# Company background

Polaris was incorporated by Mr. Arun Jain in 1993 with Citibank as its key client. The company started with providing solutions to Citibank India and later expanded operations to include other global divisions and also diversify into other large BFSI accounts. Polaris has a dedicated focus on the BFSI space (94% of revenues) with an end-to-end offering – IT services (75.5% of revenues), product (23% of revenues) and BPO (1.5% of revenues).

## Orbitech merger

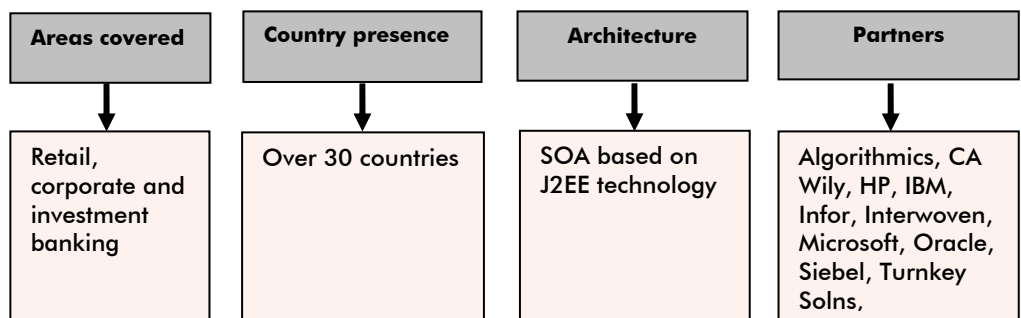
Polaris leapfrogged into the IT products space in FY03 by acquiring a 100% stake in Citigroup’s subsidiary, Orbitech Solutions. Post the integration, Polaris branded its product business under the ‘Intellect’ suite and launched it in January 2006. Intellect is a core banking platform which has a modular set of offerings. Given the SOA-based architecture, the product is compatible with banks’ current legacy systems as well. Intellect currently has 8 target platforms and 25 independent saleable modules. Each of the products is live in about 5 reference sites.

**Exhibit 29: Intellect platforms**



Source: Company, Ambit Capital research

**Exhibit 30: Overview of Intellect**



**Other Highlights**

- Non-stop 24 x 7 banking with real-time availability
- End-to-end information security through single sign-on
- Risk control through Credit Exposure Tracking, KYC and Fraud Early Warning
- Straight Through Process (STP) for automated transaction processing from initiation to execution
- Parameterized product definition for fast time to market

Source: Company, Ambit Capital Research

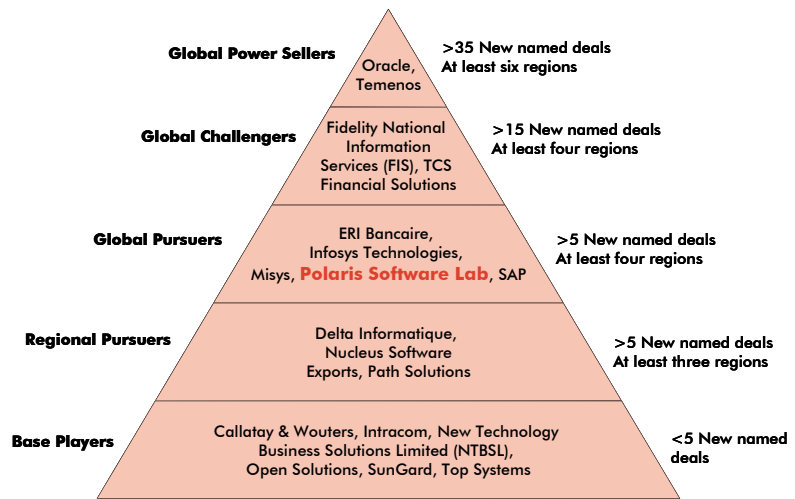


**Exhibit 31: Leading real-time core systems targeted at large banks (assets >US\$20bn)**

Vendor	System
Accenture	Alnova Banking
CSC	Hogan Banking
FIS	Profile
Fiserv	Signature from Fiserv
Infosys	Finacle
Misys	BankFusion
Oracle Financial Services	Flexcube
Polaris	Intellect
SAP	SAP for Banking
Sungard	Ambit
TCS	BaNCS
Temenos	T-24

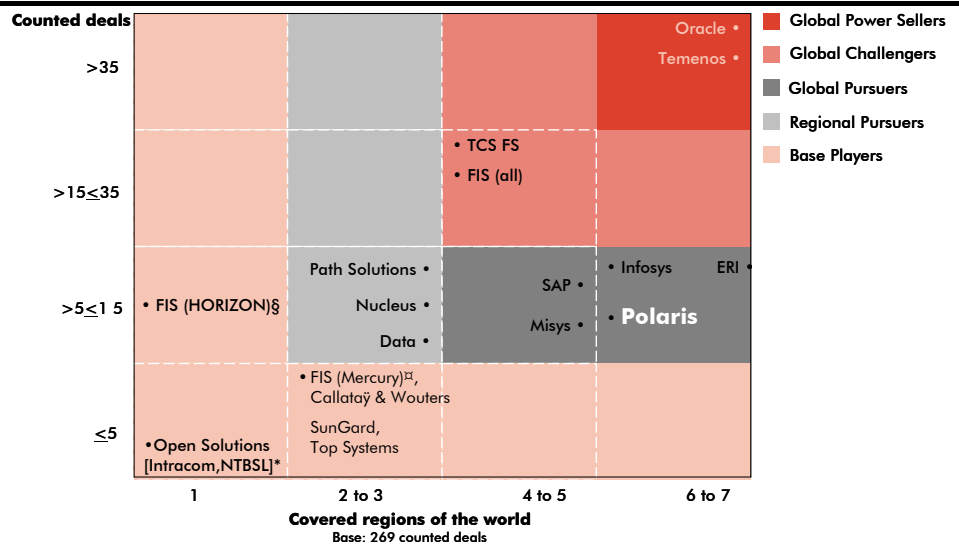
Source: Forrester

**Exhibit 32: Polaris is ranked in the Global Pursuers category in the core banking products market**



Source: Forrester

**Exhibit 33: Global banking platform vendors: The level of global success**



Source: Forrester; Note: \*Brackets indicate no new deals; §HORIZON is FIS's banking platform with the most counted deals. ‡Mercury is FIS's banking platform with counted deals in the most regions of the world.

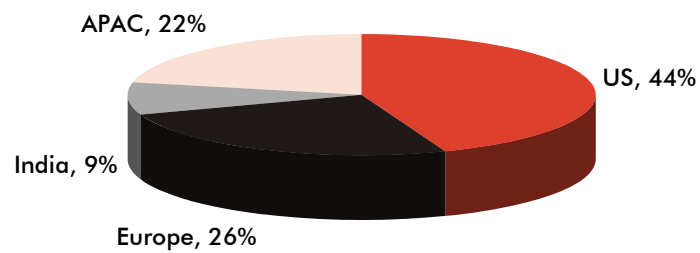
## Optimus

Optimus was established in FY03 to offer back office services to the BFSI vertical. The subsidiary has been restricted to providing BPO services for domestic clients and currently contributes 1.5% to overall revenues. We expect Optimus to remain non-core to the company's strategy and do not expect meaningful growth ahead unless there is an inorganic initiative.

## Geographical presence

- Polaris has a well-diversified revenue base. A majority of the US and Europe revenues is from the services business while the products business has high exposure to the APAC region.

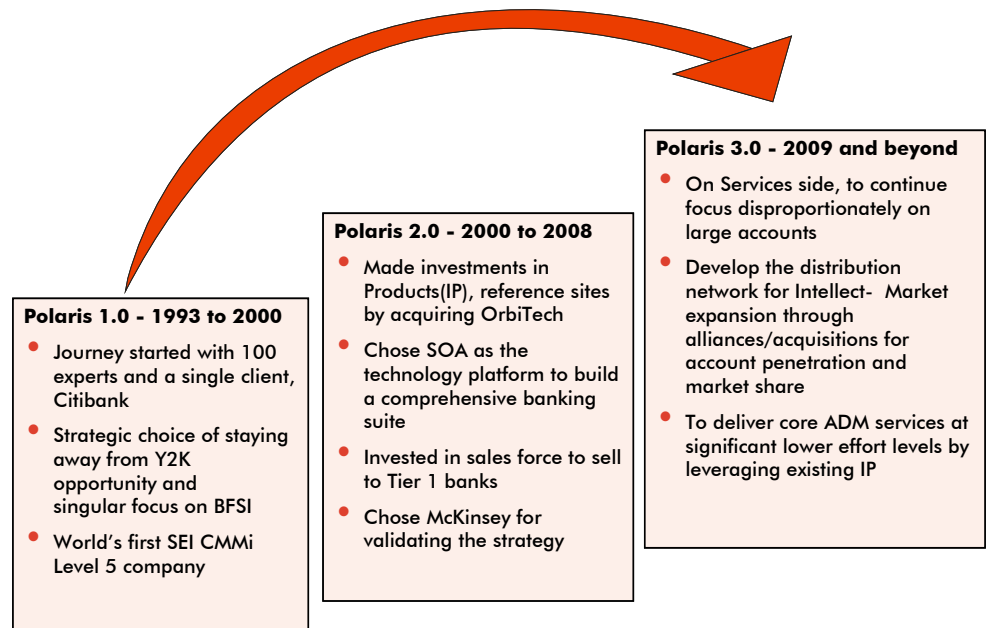
**Exhibit 34: Geo-wise revenue contribution (TTM)**



Source: Company

# Annexure

## Exhibit 35: Polaris's evolution



Source: Company, Industry

# Financials

## Exhibit 36: Profit & loss statement

Y/E March	FY08	FY09	FY10	FY11E	FY12E
<b>Net sales</b>	<b>10,993</b>	<b>13,779</b>	<b>13,538</b>	<b>15,187</b>	<b>17,741</b>
Growth (%)	6.5	25.3	-1.8	12.2	16.8
<b>EBITDA</b>	<b>1,181</b>	<b>2,335</b>	<b>2,220</b>	<b>2,203</b>	<b>2,467</b>
EBITDA (%)	10.7	16.9	16.4	14.5	13.9
Growth (%)	-26.8	97.7	-4.9	-0.8	12.0
Depreciation & amortisation	460	505	350	333	390
<b>EBIT</b>	<b>721</b>	<b>1,830</b>	<b>1,870</b>	<b>1,870</b>	<b>2,076</b>
Interest	8	7	9	10	12
Other non-operational income/expense (net)	181	-316	-73	450	544
<b>PBT</b>	<b>894</b>	<b>1,507</b>	<b>1,788</b>	<b>2,309</b>	<b>2,608</b>
Taxes	161	209	255	343	574
Minority interest	-2	9	-4	0	0
<b>Net profit</b>	<b>731</b>	<b>1,307</b>	<b>1,528</b>	<b>1,966</b>	<b>2,034</b>
Margin (%)	6.6	9.5	11.3	12.9	11.5
Diluted share capital (mn)	98.8	98.7	98.8	98.8	98.8
<b>EPS (Rs)</b>	<b>7.4</b>	<b>13.2</b>	<b>15.5</b>	<b>19.9</b>	<b>20.6</b>
Growth (%)	-27.2	78.9	17.1	28.4	3.5

Source: Company, Ambit Capital research

## Exhibit 37: Cash flow statement

Y/E March	FY08	FY09	FY10	FY11E	FY12E
Net profit before taxation	893	1,516	1,788	2,309	2,608
Depreciation/amortisation	460	505	350	333	390
(Inc)/dec in working capital	-196	931	829	-243	-197
Others	-296	-531	-442	292	-37
<b>Net cash from operations (a)</b>	<b>862</b>	<b>2,421</b>	<b>2,525</b>	<b>2,692</b>	<b>2,764</b>
(Inc)/dec in investments	0	0	0	-200	0
Capex	-390	-355	-355	-775	-600
Others	39	-22	-200	-490	-532
<b>Cash flow from inv. (b)</b>	<b>-351</b>	<b>-377</b>	<b>-556</b>	<b>-1,466</b>	<b>-1,132</b>
Inc/(dec) in capital	0	0	1	0	0
Inc/dec in loans	-5	-5	14	4	0
Others	-117	-345	-323	-203	-529
<b>Financial cash flow ( c )</b>	<b>-121</b>	<b>-349</b>	<b>-308</b>	<b>-198</b>	<b>-529</b>
Net inc/dec in cash (a+b+c)	389	1,694	1,662	1,028	1,103
Opening cash balance	1,161	1,710	3,332	4,994	6,021
<b>Closing cash balance</b>	<b>1,550</b>	<b>3,404</b>	<b>4,994</b>	<b>6,021</b>	<b>7,124</b>

Source: Company, Ambit Capital research

**Exhibit 38: Balance sheet**

Y/E March	FY08	FY09	FY10	FY11E	FY12E
Share capital	493	493	495	495	495
Reserves & surplus	6,082	7,233	8,230	9,667	11,154
Networth	6,575	7,727	8,725	10,162	11,649
Loans	8	4	25	29	29
Deferred tax liabilities	69	66	30	30	30
<b>Sources of funds</b>	<b>6,652</b>	<b>7,797</b>	<b>8,780</b>	<b>10,221</b>	<b>11,708</b>
Fixed assets	4,667	5,283	5,599	6,199	6,799
Less: Depreciation/amortisation	2,583	3,137	3,452	3,785	4,175
Net block	2,084	2,146	2,147	2,414	2,624
CWIP	50	143	125	300	300
Goodwill	0	199	506	557	557
Other assets	266	193	206	224	224
Investments	783	2,347	3,755	3,955	3,955
Current assets	5,317	5,279	5,067	6,258	8,017
Sundry debtors	2,104	2,031	1,746	1,914	2,187
Cash & bank balance	768	1,054	1,237	2,066	3,169
Other current assets	1,513	1,422	1,257	1,367	1,597
Loans & advances	932	772	827	911	1,064
Current liabilities & provisions	1,848	2,509	3,026	3,487	3,969
Current liabilities	1,400	2,043	2,462	2,533	2,939
Provisions and others	447	466	564	953	1,030
Net current assets	3,470	2,769	2,041	2,771	4,048
<b>Application of funds</b>	<b>6,652</b>	<b>7,797</b>	<b>8,780</b>	<b>10,221</b>	<b>11,708</b>

Source: Company, Ambit Capital research

**Exhibit 39: Key ratios**

Y/E March	FY08	FY09	FY10	FY11E	FY12E
ROCE (%)	11.4	25.3	22.6	19.7	18.9
ROE (%)	11.5	18.2	18.5	20.7	18.6
Debt-equity ratio (x)	0	0	0	0	0
Valuation ratios (x)					
PER	24.1	13.5	11.5	9.0	8.7
PBV	2.7	2.3	2.0	1.7	1.5
EV/EBITDA	13.7	6.1	5.7	5.3	4.3
EV/Sales	1.5	1.0	0.9	0.8	0.6
Turnover ratios (no.)					
Debtor days	70	54	47	46	45
Creditor days	40	39	49	51	52

Source: Company, Ambit Capital research

# Technical View — Polaris Software — Buy with an upside target of Rs205

Exhibit 40: Daily chart



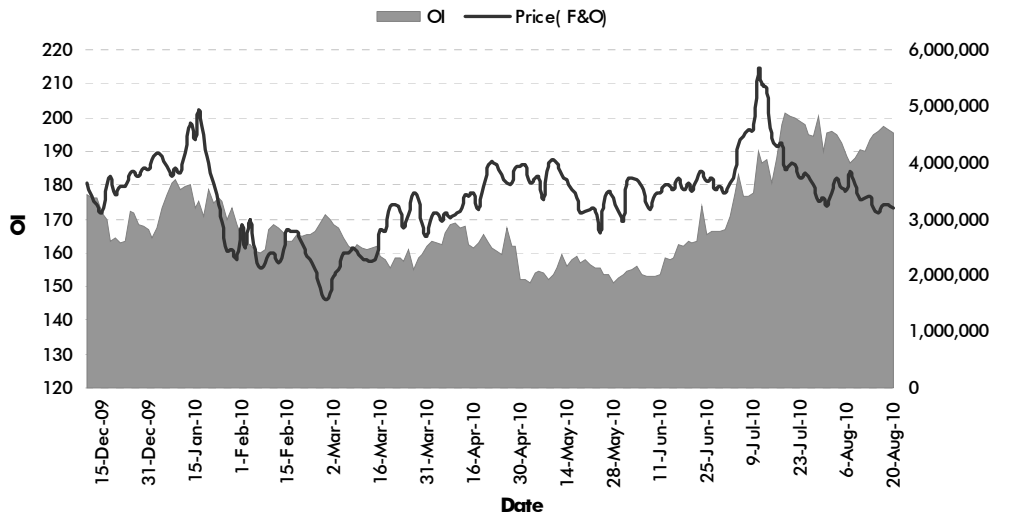
Source: MetaStock

- Polaris is looking strong on the chart.
- The daily MACD is curving upward signaling that downside is limited.
- In the weekly chart the pattern formation is interpreting a bullish view.
- The stock also had good correction in last couple of weeks and is now consolidating in Rs168 to Rs180 trading band,
- In the short term, the stock is ready for an uptrend and we advise traders to Buy the stock with an upside target of Rs205 and downside support of Rs168.

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# Derivative View — Polaris

**Exhibit 41: Daily chart**



Source: MetaStock

The stock has seen addition of short positions in its recent decline from 183 levels with open interest increasing by around 14%. We think that the stock has strong support in the 167-170 range from where some amount of short covering should set in leading the counter higher. We would recommend going long at the current levels and in any declines till 167-170 in the counter for an upside target of 188-195 in the short to medium term.

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## Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	> 15%
Hold	5% to 15%
Sell	<5%

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