



Hexaware Technologies

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,356	HEXW IN
	REUTERS CODE
S&P CNX: 4,146	HEXT.BO

15 February 2007

Buy

Previous Recommendation: Buy

Rs174

Equity Shares (m)	132.2
52-Week Range (Rs)	205/110
1,6,12 Rel. Perf. (%)	-6/-19/-12
M.Cap. (Rs b)	23.0
M.Cap. (US\$ b)	0.5

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
12/06E	8,482	1,242	9.4	29.8	18.5	3.1	22.7	24.8	2.3	15.0
12/07E	12,213	1,697	12.8	36.7	13.5	2.6	20.8	23.2	1.6	11.0
12/08E	15,601	2,075	15.7	22.3	11.1	2.2	21.5	23.9	1.2	8.4

- Revenues in line, rupee appreciation impacting operational profit:** Hexaware registered 10.7% growth (in dollar terms) in sales including Focus Frame during 4QCY06. Excluding Focus Frame, we believe Hexaware has registered revenues of US\$51.8m (growth of 6.7% QoQ) versus our estimate of US\$52.2m. EBITDA margins have declined by 110bp QoQ due to rupee appreciation. With lower margins, Hexaware registered PAT of Rs338m (QoQ decline of 2.7%, including Focus Frame) versus our estimate of Rs367m (5.9% growth, excluding Focus Frame).
- Witnessing strong traction in business:** Hexaware won US\$40m new business during 4QCY06 to increase its order book to US\$250m (US\$170m for CY07). It is pursuing three large deals worth >US\$10m each and hoping to win two of them. Management expects to double sales and PAT in the next 8-10 quarters (CAGR of 35-40%).
- 1QCY07 guidance higher than peers due to Focus Frame:** Hexaware has guided 9.7-11.6% QoQ growth (in dollar terms) in sales in 1QCY07, with 2.8-5.4% growth in PAT. However, if we exclude Focus Frame, organic revenue guidance is lower at 2.4-4.3%. Hexaware expects organic revenue growth to pick up from 2QCY07 onwards.
- Valuation and view:** Management expects gross and EBITDA margins to improve by 100-150bp during CY07 after integrating Focus Frame. However, we believe that wage inflation is likely to put pressure on margins. Management is also confident of outperforming the industry growth rates (organically as well as inorganically) in CY07. Considering higher rupee appreciation than earlier estimated, we have downgraded our PAT estimates (including Focus Frame) by 1% for CY07 and CY08. We continue to remain confident in Hexaware's niche capabilities in HR IT, Peoplesoft, Testing and Airline/Transportation vertical. The stock is trading at 14.6x CY07E and 12x CY08E EPS (diluted), we maintain **Buy** with a target price of Rs220 (15x diluted CY08E), upside of 26.4%.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E DECEMBER	CY05				CY06				CY05	CY06*
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q*		
Revenues	1,641	1,650	1,756	1,740	1,762	2,069	2,250	2,402	6,787	8,482
Q-o-Q Change (%)	4.5	0.6	6.4	-0.9	1.2	17.4	8.7	6.8	24.3	25.0
Direct Expenses	1,002	1,032	1,083	1,056	1,080	1,324	1,412	1,501	4,173	5,318
Sales, General & Admin. Expenses	361	371	374	421	388	434	477	544	1,526	1,842
Operating Profit	278	248	298	263	294	311	361	357	1,087	1,322
Margins (%)	16.9	15.0	17.0	15.1	16.7	15.0	16.0	14.9	16.0	15.6
Other Income	27	18	27	74	35	46	80	79	146	241
Depreciation	54	53	57	57	46	46	55	53	221	200
PBT bef. Extra-ordinary	251	213	269	280	282	311	385	384	1,012	1,363
Provision for Tax	19	18	28	32	22	13	39	46	97	120
Rate (%)	7.5	8.6	10.4	11.5	7.8	4.3	10.0	12.0	9.6	8.8
Net Income	232	195	241	248	260	298	347	338	915	1,242
Q-o-Q Change (%)	8.3	-16.3	23.7	2.9	5.1	14.4	16.5	-2.7	43.6	35.8

E: MOST Estimates, * Including Focus Frame for 1 month

Revenues in line, rupee appreciation affecting operational profit

Hexaware registered 10.7% growth (in dollar terms) in sales including Focus Frame (merged w.e.f. 28th November 2006) during 4QCY06. Excluding Focus Frame, we believe Hexaware has registered revenues US\$51.8m (growth of 6.7% QoQ) v/s our estimate of US\$52.2m. Offshore revenue contribution has declined QoQ to 38.4% from 38.9% due to integration of Focus Frame (onsite centric). We expect offshore contribution to decline further in 1QCY07 due to full quarter integration of focus frame.

Sales growth was all across in terms of Geography, clients, verticals and service offerings.

CLIENT CONTRIBUTION & GROWTH (%)

	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Top Client	12.1	9.2	9.7	9.1	8	8.3
Growth (%)	-1.7	-24.6	6.7	10.2	-4.4	10.8
Top 5 Client	42.6	32.6	31.9	31.1	32.5	32.7
Growth (%)	6.4	-24.2	-0.9	14.5	13.6	7.4
Top 2-5 Client	30.5	23.4	22.2	22	24.5	24.4
Growth (%)	10.0	-24.0	-4.0	16.4	21.1	6.3
Top 10 Client	59.7	49.3	47.4	45.8	47.1	47.7
Growth (%)	5.5	-18.2	-2.7	13.5	11.8	8.1
Top 6-10 Client	17.1	16.7	15.5	14.7	14.6	15
Growth (%)	3.4	-3.2	-6.0	11.4	8.0	9.7

Source: Company/Motilal Oswal Securities

GROWTH ACROSS SERVICES (RS M)

	SEP-05	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
E-commerce/ Application	704	750	860	1,034	1,091	1,155
QoQ (%)	3.0	6.5	14.6	20.3	5.5	5.9
R & D	32	35	16	17	20	22
QoQ (%)	19.7	10.1	-54.4	4.4	22.3	6.8
Peoplesoft	757	665	599	674	760	831
QoQ (%)	11.6	-12.2	-9.9	12.6	12.7	9.3
HR IT Solutions	123	120	122	145	160	175
QoQ (%)	6.4	-2.3	1.2	19.1	10.3	9.8
Others	140	172	166	199	218	219
QoQ (%)	-4.4	22.6	-3.9	19.9	9.9	0.2

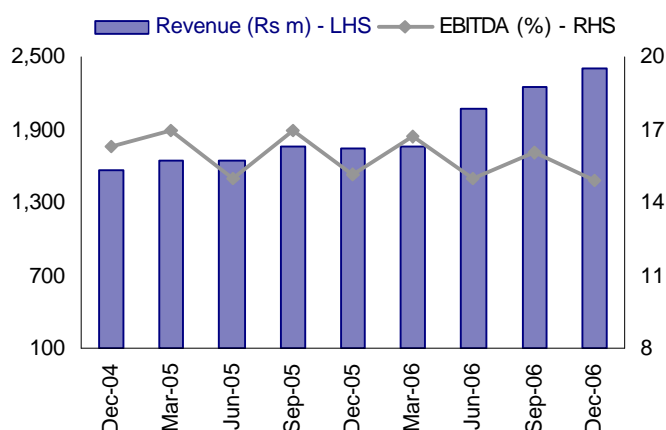
Source: Company/Motilal Oswal Securities

Rupee appreciation affecting EBITDA margins

EBITDA margin have declined QoQ by 110bp to 14.9% (including Focus Frame) v/s our estimate of 16.2% (excluding Focus Frame). Lower margins were due to

higher than expected rupee appreciation and consolidation of low margin Focus Frame (for around 1 month in 4QCY06). Rupee appreciation affected margins by 130bp (65bp impact each on gross margin as well as on SG&A). It had also incurred onetime integration cost of US\$0.25m in 4QCY06, affecting margin adversely by 50bp.

RUPEE APPRECIATION AFFECTING MARGINS



Source: Company/Motilal Oswal Securities

With lower margins, Hexaware registered PAT of Rs338m (QoQ decline of 2.7%, including Focus Frame) v/s our estimate of Rs367m (5.9% growth, excluding Focus Frame).

Witnessing strong traction in business

Hexaware won US\$40m new business during 4QCY06 to increase its order book to US\$250m (US\$170m for CY07). Hexaware is also witnessing good traction in its existing business (non Focus Frame). Hexaware has already started witnessing good traction from a leading US bank (new project ramp up impacted in CY06 due to vendor consolidation) and expects ramp up from CY07 onwards. Hexaware is pursuing 3 large deals worth more than US\$10m each and hoping to win two of them (we believe one deal in Transportation vertical).

However, we believe that work from one of the top BFSI customer from Germany may slow down due to completion of a large project. The management is very confident of ramp up within the same client going forward.

Hexaware expects margins to improve in CY07

Management expects Gross and EBITDA margins to improve by 100-150bp during CY07 after integrating Focus Frame. It expects margins savings from utilization rates, broadening of employee pyramid, SG&A leverage as well improvement in offshoring of Non-Focus Frame business. However, we believe that wage inflation is likely to put pressure on margins. We also believe that full year integration of Focus Frame whose EBITDA margins are lower than Hexaware's margin of 15-16%, will also have some adverse impact on the CY07 margins. These factors couple with likely rupee appreciation in CY07 as well, we expect margin will decline in CY07. We expect PAT growth to be back ended in 2HCY07.

Focus Frame's integration progress ahead of schedule – to drive synergies

Focus Frame integration progress (in terms of employee, Technology, functions) is ahead of schedule. Most of the key employee are continuing (attrition almost NIL). Management seems very confident to drive testing revenues to US\$100m p.a. in 3 years (Focus Frame CY06E revenues US\$24m, current annual run rate of testing business is around US\$34m p.a). With Focus Frame, Hexaware is pursuing 11 new deals on testing front. Focus Frame Accelerator platform (automated testing tool) is strengthening Hexaware's relations strongly with HP and SAP. Hexaware is also looking at possibility of becoming global partner for SAP, where it has good traction on HR front. Management expects full integration to complete by CY07.

Full year integration of focus frame in CY07 will increase onsite composition of revenues and will affect the margins adversely (Focus Frame's PBT margins are around 14% and PAT margins are little lower than 10%).

1QCY07 guidance higher than peers due to Focus Frame

Hexaware has guided for 9.7-11.6% QoQ growth (in dollar terms) in sales in 1QCY07 with 2.8-5.4% growth in PAT. However if we exclude Focus Frame, organic revenue guidance is expected to be lower at 2.4-4.3%. Hexaware expects the organic revenue growth to pick up from 2QCY07 onwards. During 1QCY07, Hexaware is looking to spend US\$1m towards restructuring some of the processes for future growth (onetime), likely to impact margins by 170bp. Besides this, guidance is based on Rs/US\$ rate of Rs44 (appreciation of 1.5%), which will further impact margins adversely in 1QCY07.

Valuation and view

Despite muted guidance for PAT for 1QCY07, management expects gross and EBITDA margins to improve by 100-150bp during CY07 after integrating Focus Frame. However, we believe that wage inflation is likely to put pressure on margins. Management is also confident in terms of outperforming the industry growth rates (organically as well as inorganically) in CY07. We expect PAT growth to be back ended in 2HCY07. Management expects to add 2,000 net employees (1/3rd being fresher) in CY07 (expects to keep the bench lower by improving utilization) and plans to increase the employee size to around 10,000 by CY08 from current size of 5,829. Management also expects to double sales and PAT in the next 8-10 quarters (CAGR of 35-40%).

Considering higher rupee appreciation than earlier estimated, we have downgraded our PAT estimates (including Focus Frame) by 1% for CY07 and CY08. We continue to remain confident in Hexaware's niche capabilities in HR IT, Peoplesoft, Testing and Airline/Transportation vertical. We reiterate our positive outlook. At CMP, it is trading at 14.6x CY07E and 12x CY08E EPS (diluted), we maintain **Buy** with a target price of Rs220 (15x diluted CY08E), upside of 26.4%.

Hexaware Technologies: an investment profile

Company description

Hexaware is a niche IT-services vendor ranked amongst the top five Indian IT companies in Germany and has the reputation of winning the single-largest deal ever by an Indian IT company in that geography. It employs more than 6,000 people. Its key clients include Citibank, Deutsche Leasing, Air Canada and AXA.

Key investment arguments

- ✍ Credible tier-2 Indian IT services vendor with niche offerings.
- ✍ One of the top five Indian IT companies in Germany, in terms of client profile.
- ✍ Scale player in its chosen niches of PeopleSoft technology, Airlines vertical and European geography.

Key investment risks

- ✍ Oracle might phase out PeopleSoft after 2-3 years.
- ✍ Preference shares allotment to General Atlantic might result in equity dilution which could impact valuation adversely.

Recent developments

- ✍ Acquired US based Testing consulting firm Focus Frame for US\$34m (CY06E revenues US\$24m) in November 2006.
- ✍ Outstanding order book of US\$250m, US\$40m of which was added in 4QCY06.

Valuation and view

- ✍ Revenue CAGR of 35.6% and earnings CAGR of 29.2% over the next two years (CY06-CY08E).
- ✍ Trading at 12x CY08E (diluted) which looks attractive.
- ✍ Maintain **Buy** with target price of Rs220.

Sector view

- ✍ Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- ✍ Indian offshore vendors gaining market share in competition with MNCs.
- ✍ Prefer large companies as bulk of volumes going to them while niche players benefit due to lack of offshore competition in their segments.

COMPARATIVE VALUATIONS

		HEXAWARE	MPHASIS BFL*	I-FLEX
P/E (x)	CY06E	18.5	36.1	50.1
	CY07E	13.5	20.8	34.2
P/BV (x)	CY06E	3.1	10.2	7.1
	CY07E	2.6	8.0	6.1
EV/Sales (x)	CY06E	2.3	4.1	7.1
	CY07E	1.6	3.2	5.2
EV/EBITDA (x)	CY06E	15.0	23.9	37.3
	CY07E	11.0	16.5	24.3

* P/E diluted with EDS (I)

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoter	25.7	25.7	31.9
Domestic Inst	7.1	7.7	6.6
Foreign	55.7	54.4	43.0
Others	11.6	12.1	18.5

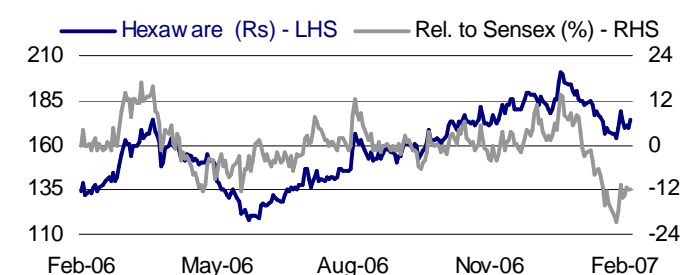
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
CY07	11.9	12.0	-0.7
CY08	14.6	-	-

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
174	220	26.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006E	2007E	2008E
Sales	5,459	6,787	8,482	12,213	15,601
Change (%)	61.0	24.3	25.0	44.0	27.7
Cost of Services	3,392	4,173	5,318	7,897	10,481
SG&A Expenses	1,280	1,526	1,842	2,495	2,866
EBITDA	787	1,087	1,322	1,820	2,252
% of Net Sales	14.4	16.0	15.6	14.9	14.4
Depreciation	161	221	200	281	374
Interest	0	0	0	0	0
Other Income	98	146	241	356	422
PBT	724	1,012	1,363	1,895	2,300
Tax	86	97	120	198	224
Rate (%)	11.9	9.6	8.8	10.4	9.8
PAT	637	915	1,242	1,697	2,075
Share of profit in associate	0	0	0	0	0
Net Income	637	915	1,242	1,697	2,075
Change (%)	165.8	43.6	35.8	36.6	22.3

BALANCE SHEET					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006E	2007E	2008E
Share Capital	233	239	264	264	264
Convertible Pref Sh. Cap	0	0	1,500	1,500	1,500
Share Premium	1,719	1,750	3,228	3,228	3,228
Reserves	718	1,486	2,483	3,836	5,444
Net Worth	2,670	3,474	7,476	8,829	10,437
Loans	52	62	0	0	0
Capital Employed	2,722	3,536	7,476	8,829	10,438
Gross Block	1,402	1,564	3,296	4,046	4,696
Less : Depreciation	541	633	795	1,076	1,450
Net Block	861	931	2,501	2,970	3,246
Other LT Assets	67	30	-3	20	20
Investments	393	653	753	803	853
Curr. Assets	2,437	3,090	5,751	6,968	8,849
Debtors	1,361	1,836	2,063	3,626	3,641
Cash & Bank Balance	391	534	2,455	2,133	3,297
Loans & Advances	685	720	1,234	1,209	1,911
Other Current Assets	0	0	0	0	0
Current Liab. & Prov	1,145	1,170	1,726	2,032	2,631
Creditors	165	173	339	331	524
Other liabilities	606	587	981	1,114	1,413
Provisions	373	411	406	587	694
Net Current Assets	1,293	1,920	4,025	4,936	6,218
Misc. Expenses	0	0	0	0	0
Application of Funds	2,722	3,536	7,476	8,829	10,437

E: M0St Estimates

RATIOS					
Y/E DECEMBER	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS	5.5	7.2	9.4	12.8	15.7
Fully Diluted EPS	5.5	7.2	8.7	11.9	14.6
Cash EPS	6.0	8.6	21.8	29.9	37.1
Book Value	20.2	26.3	56.6	66.8	79.0
DPS	10	14	19	2.6	3.1
Payout %(Incl.Div.Taxes)	18.3	20.0	20.0	20.0	20.0
Valuation (x)					
P/E		24.0	18.5	13.5	11.1
Diluted P/E				14.6	12.0
Cash P/E		20.3	8.0	5.8	4.7
EV/EBITDA		20.1	15.0	11.0	8.4
EV/Sales		3.2	2.3	1.6	1.2
Price/Book Value		6.6	3.1	2.6	2.2
Dividend Yield (%)		0.8	1.1	1.5	1.8
Profitability Ratios (%)					
RoE	26.4	29.8	22.7	20.8	21.5
RoCE	29.5	32.4	24.8	23.2	23.9
Turnover Ratios					
Debtors (Days)	91	99	89	108	85
Fixed Asset Turnover (x)	3.9	4.3	2.6	3.0	3.3
Leverage Ratio					
Debt/Equity Ratio (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E DECEMBER	2004	2005	2006E	2007E	2008E
CF from Operations	805	1,130	1,202	1,624	2,352
Cash for Working Capital	-388	-431	-193	-1,274	-476
Net Operating CF	417	699	1,009	350	1,876
Net Purchase of FA	-364	-175	-1,968	-650	-650
Net Purchase of Invest.	9	-201	141	306	372
Net Cash from Invest.	-356	-377	-1,827	-344	-278
Equity and other related item	37	31	1,505	0	0
Proceeds from Pvt. Place.	0	0	1,500	0	0
Proceeds from LTB/STB	26	10	-61	0	0
Interest/ Dividend Payment	-49	-220	-204	-327	-434
Cash Flow from Fin.	14	-179	2,739	-327	-434
Free Cash Flow	53	524	-959	-300	1,226
Net Cash Flow	75	143	1,921	-322	1,164
Opening Cash Balance	316	391	534	2,455	2,133
Add: Net Cash	75	143	1,921	-322	1,164
Closing Cash Balance	391	534	2,455	2,133	3,297



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Hexaware Technologies

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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