

INFOTECH ENTERPRISES



Impressive revenue traction; margins tumble

Rising cost of business impacts profits; downgrading earnings by 11%

Infotech Enterprises' (IEL) Q1 revenues were in line with expectations, while net profits were significantly lower than our estimates. Wage increase, currency impact and, mainly, rise in other operating costs (overheads) drove down the operating profit margins. EBITDA margins now stand at 16%, down from 21.6% in Q4FY10. Since the rise in costs are of recurring nature, we are revising our margin assumption down to 18.3% for FY11 from 20.8% earlier, leading to 11% downgrade in EPS estimate at INR 14.1.

Revenue outlook continues to be healthy for both business segments

The engineering (EMI) segment has continued to post strong volume growth (double digit; including inorganic) for the past two quarters, with equally strong outlook. Overall, with healthy demand trend from the US across aero, hi-tech and heavy engineering verticals, the EMI segment is expected to grow 30% plus (including inorganic) for FY11. Further, visibility in the UTG segment has improved with recent win and stronger pipeline which will reduce the drag on the overall revenue growth. We expect IEL to grow 22% in FY11, achieving revenues of USD 245 mn.

Usage of cash could incrementally become more critical

IEL has done extremely well in building up its cash position (currently at INR 4.05 bn) since the past six quarters. It has added INR 180 mn (on average) to its cash balance (each quarter), post capex, working capital needs and dividend payout. However, we see the usage of cash (as the company has been conservative in its M&A moves) becoming more critical as the cash balance continues to depress return ratios. We believe any increase in dividend (consistent or special) will positively impact the earnings multiple and increase the reported return ratios.

Outlook and valuations: Focus on operating margins; maintain 'BUY'

We see the rising overhead and compensation cost impacting IEL's profitability, leading to 11% downward revision in FY11 EPS. Despite that, Infotech is one of the best quality mid-tier companies with 30% plus core ROEs (ex-cash), higher growth visibility and consistency. At CMP of INR 176, the stock is trading at a P/E of 12.4x FY11E and 10.4x FY12E earnings. We maintain 'BUY/SO' on the stock.

Financials

Year to March	Q111	Q410	Growth %	Q110	Growth %	FY10	FY11E
Revenue (INR mn)	2,529	2,441	3.6	2326	8.7	9,531	11,116
EBITDA (INR mn)	404	526	(23.2)	524	(22.8)	2,083	2,037
Net profit (INR mn)	329	514	(36.0)	462	(28.9)	1,709	1,564
Diluted EPS (INR)	3.0	4.6	(36.2)	4.2	(29.3)	15.4	14.1
Diluted P/E (x)						11.4	12.4
EV/EBITDA (x)						7.0	6.8
EV/Revenues (x)						1.5	1.3

July 14, 2010

Reuters: INFE.BO Bloomberg: INFTC IN

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	High
Sector Relative to Market	Equalweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 176
52-week range (INR)	:	206 / 83
Share in issue (mn)	:	111.0
M cap (INR bn/USD mn)	:	20 / 418
Avg. Daily Vol. BSE/NSE ('000):	:	154.4

SHARE HOLDING PATTERN (%)

Promoters*	:	23.2
MFs, FIs & Banks	:	9.8
FIIIs	:	19.1
Others	:	47.8
* Promoters pledged shares (% of share in issue)	:	0.7

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	(4.2)	5.5	2.3
3 months	4.4	1.5	(4.3)
12 months	114.4	35.9	75.0

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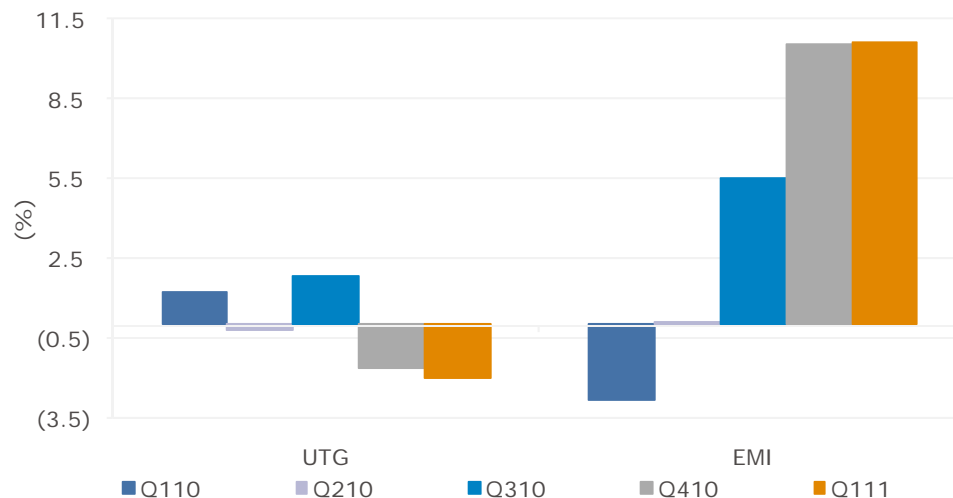
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- Strong volume growth in EMI continues; UTG yet to see uptick

IEL has reported yet another quarter of strong volume growth in EMI segment. Volumes were up 10.6% sequentially on the back of 10.5% in the previous quarter. Ramp up of new projects along with consolidation of Daxcon revenues is leading to this high growth. However, in UTG volumes declined in past 2 quarters due to project conclusion from large client (Swisscom).

Chart 1: Q-o-Q volume growth for UTG and EMI business segments

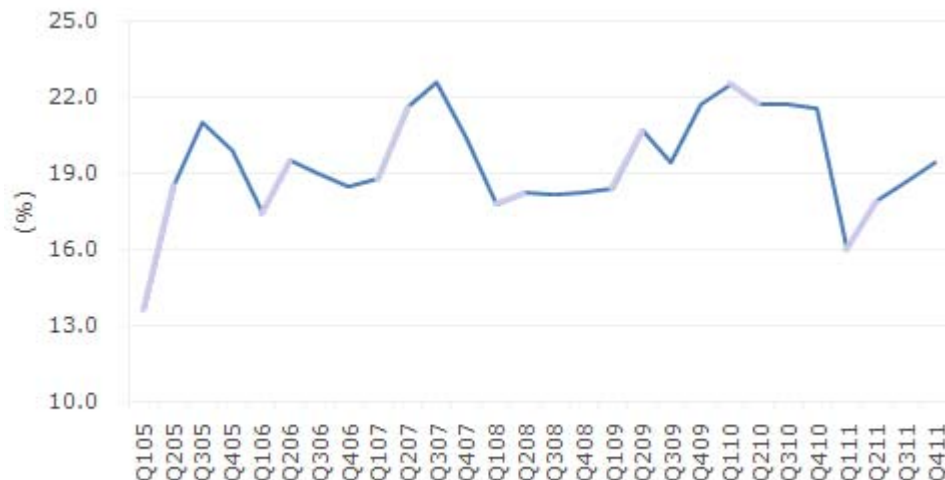


Source: Company, Edelweiss research

- Margin outlook for FY11: revised down to 18.3%

EBITDA margin for FY10 was at 21.9%. However, compensation increase, cross-currency movement, and increase in other operating expense (power, telecommunication and other overheads) will lead to margin contracting by ~350bps, to 18.3%. From chart 1, we can see that first quarter has impact of salary increase which fades off as revenue growth continues going into the fiscal. We believe this trend will continue, but despite the Q4FY11 exit margin increasing to 20%, the full year margins will hit only 18.3%.

Chart 2: EBITDA margin decline in Q1FY11, will improve for next three quarters

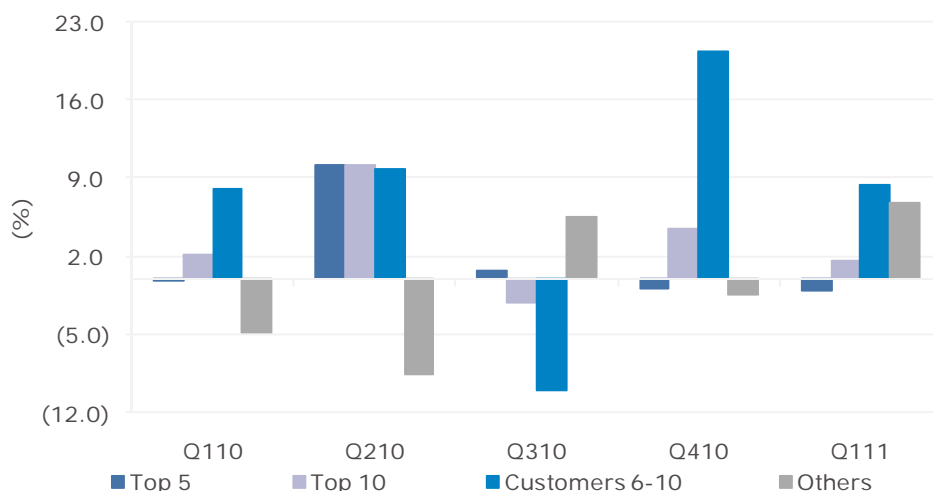


Source: Company, Edelweiss research

▪ Key highlights

- Revenue, at INR 2.53 bn, was up 3.6% Q-o-Q and 8.7% Y-o-Y, driven by strong Q-o-Q volume growth of 10.6% in EMI; it was, however, offset by adverse currency impact of 2.9%. In USD terms, revenue for the quarter was at USD 55.4 mn, up 4.3% Q-o-Q and 15.9% Y-o-Y.
- Gross profit has declined 3.2% Q-o-Q, due to wage hike. Gross margin declined steeply by 270bps Q-o-Q, and 730bps compared with Q3FY10 due to wage hike during the current quarter and decent employee addition in the past two quarters.
- EBITDA, at INR 404 mn, was down 23.2% Q-o-Q. EBITDA margins, at 16%, declined sharply by 560bps on account of adverse cross-currency movement, salary hike and increase in overheads. Because of project completion in UTG, volumes were down 2% Q-o-Q (1.6% in Q4FY10).
- Net profit, at INR 329 mn, was down 36% over the previous quarter on account of lower operating profits, lower other income (INR 81.0 mn versus INR 179 mn in Q4FY10), increase in depreciation (up 25.7% Q-o-Q) and higher tax rate (20.2%). Net margin for the quarter stood at 13.0% against 21.1% in Q4FY10, resulting in decline of ~800bps Q-o-Q.
- **Segmental performance:** The EMI segment grew 8.3% Q-o-Q, whereas UTG declined 6.2%, in INR terms.
 - **Strong growth in EMI continued:** Growth in EMI during the current quarter was led by strong volume growth of 10.6% on the back of 10.5% in the previous quarter. On organic basis (excluding Daxcon), the revenue growth was even higher at 8.8% Q-o-Q in EMI.
 - **Subdued performance continues in UTG:** The UTG segment continues its southward movement on account of some project completion leading to volume decline of 2.0% Q-o-Q. This is the third successive quarter when UTG has posted revenue decline (6.3% Q-o-Q). The quarterly run rate has come down from INR 866 mn in Q2FY10 to INR 747 mn in the past three quarters. However, the management is confident to get the revenue run rate back to Q4FY10 levels by next quarter and Q2FY10 levels by year end with the few deals in the pipeline.
- **Impressive performance by top 6-10 clients:** Top 6-10 clients reported sequential growth of 8.3%. Cross currency led to sequential decline by 1.2% in the top 5 clients. It was heartening to see beyond top 10 clients reporting 6.8% growth over the previous quarter.

Chart 3: Top 6-10 clients grew ahead of company



Source: Company, Edelweiss research

- The company added 12 new clients in the quarter - 6 each in UTG and EMI.
- **Geographical split:** North America's (N.A.) share in revenue has increased for the second consecutive quarter by 4.1% and now stands at 52.2%. N.A. and Asia/Australia grew 12.4% and 6.2%, respectively, whereas Europe declined 6.8% over Q4FY10.
- **Employee metrics:** Infotech had net addition of 32 employees (gross adds of 453) during the quarter. EMI had net addition of 105 employees, while UTG saw decline of 82 employees during the quarter. Management's target net addition is of 1,678 people for FY11 and 400 employees for the next quarter. This indicates that the company is preparing itself for H2 and FY12 as well.
- Utilisation for UTG and EMI segments was at 78% (79% in Q4) and 70% (69% in Q4), respectively. The management also indicated there is some room still left to improve utilisation rate (EMI – 75% and UTG –80%).
- Capex for the quarter was at INR 104 mn vis-a-vis INR 61 mn in Q4FY10. The target capex for the full year will be INR 1.7 bn. However, we are building in only INR 1.1 bn for FY11.
- Current cash and equivalents in hand stand at INR ~4.05 bn, i.e. INR 36/share as at June 2010 end.
- **Hedge position:** Infotech's current hedge position stands at USD 21.0 mn (old hedges of USD 7 mn @ 40.5 and USD 14 mn @ 47.62), GBP 3.7 mn @ 76 and EUR 6.3 mn @ 66.2.

Financials snapshot**(INR mn)**

Year to March	Q111	Q410	Growth %	Q110	Growth %	FY10	FY11E	FY12E
Total revenues	2,529	2,441	3.6	2,326	8.7	9,531	11,116	12,913
Employee cost	1,567	1,447	8.3	1,336	17.3	5,427	6,682	7,425
Travel expenses	164	153	7.0	114	43.7	551	685	801
Cost of purchases	86	57	51.9	86	0.3	323	384	387
Operating & admin expenses	308	258	19.6	267	15.3	1,147	1,328	1,582
Total expenditure	2,125	1,915	11.0	1,802	17.9	7,449	9,079	10,195
EBITDA	404	526	(23.2)	524	(22.8)	2,083	2,037	2,718
Depreciation & amortization	117	93	25.7	118	(0.7)	436	515	667
EBIT	287	433	(33.7)	406	(29.2)	1,647	1,522	2,051
Other income	81	179	(54.8)	163	(50.4)	464	347	321
Interest expense	2	25	(90.4)	2	0.0	31	2	0
PBT	366	587	(37.7)	567	(35.5)	2,080	1,867	2,372
Tax	74	103	(27.9)	150	(50.6)	505	415	569
Reported net profit	292	484	(39.8)	417	(30.0)	1,575	1,452	1,803
Share of IASI profit	37	30	24.7	41	(11.1)	129	112	100
Minority interest	1	(0)		4	0.0	5	0	0
Adjusted net profit	329	514	(36.0)	462	(28.9)	1,709	1,564	1,903
Diluted EPS (INR)	3.0	4.6	(36.2)	4.2	(29.3)	15.4	14.1	16.9

as % of net revenues

Employee cost	62.0	59.3		57.4		56.9	60.1	57.5
Travel expenses	6.5	6.3		4.9		5.8	6.2	6.2
Cost of purchases	3.4	2.3		3.7		3.4	3.5	3.0
Operating & admin exp.	12.2	10.6		11.5		12.0	11.9	12.3
EBITDA	16.0	21.6		22.5		21.9	18.3	21.1
EBIT	11.4	17.7		17.5		17.3	13.7	15.9
Reported net profit	13.0	21.1		19.9		17.9	14.1	14.7
Tax rate	20.2	17.5		26.4		24.3	22.2	24.0

- **Company Description**

Infotech is a 7,650 plus employee software services company with competencies in: (a) GIS services (catering to utility, transportation, and government segments); (b) engineering design services (for engineering, manufacturing, and industrial products verticals); and (c) software services (to clients in data and technology services, engineering design, and IT services). The company's past twelve month revenues stood at INR 9.7bn (USD 209 mn).

- **Investment Theme**

Outsourcing of engineering services is expected to reach USD 38-50 bn by FY20E compared with USD 2 bn now, as per a Nasscom-Booz Allen Hamilton study. As one of the leading offshore engineering services firms for the manufacturing industry, Infotech is poised to grab the increasing opportunities. The company has strong domain knowledge and complete solution capability in the GIS segment along with healthy pipeline of deals. The company's skills in the areas of mapping and designing across diverse segments and in a variety of end-user IT environments give it an edge. We expect Infotech's net profits (ex-forex) to grow at a CAGR of 16% each over FY10-12E.

- **Key Risks**

Significant appreciation of INR against USD, EUR, and GBP.

Inadequate availability of skilled manpower.

Sustained slowdown in engineering services spending

Financial Statements

Income statement

(INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net revenue	6,741	8,898	9,531	11,116	12,913
Cost of revenues	3,566	4,896	5,427	6,682	7,425
Gross profit	3,175	4,001	4,104	4,434	5,488
Total SG&A expenses	1,956	2,216	2,022	2,397	2,770
S&M expenses	1,008	959	874	1,069	1,188
G&A expenses	948	1,258	1,147	1,328	1,582
EBITDA	1,219	1,785	2,083	2,037	2,718
Depreciation & Amortization	366	466	436	515	667
EBIT	854	1,320	1,647	1,522	2,051
Other income	225	(295)	464	347	321
Interest expenses	38	40	31	2	-
Profit before tax	1,041	985	2,080	1,867	2,372
Provision for tax	246	140	505	415	569
Core profit	795	844	1,575	1,452	1,803
Profit after tax	795	844	1,575	1,452	1,803
Minority int. and others - paid/(recd.)	(72)	(80)	(134)	(112)	(100)
Profit after minority interest	868	925	1,709	1,564	1,903
Basic shares outstanding (mn)	102	107	111	111	113
Basic EPS (INR)	8.5	8.7	15.4	14.1	16.9
Diluted equity shares (mn)	102	107	111	111	113
Diluted EPS (INR)	8.5	8.7	15.4	14.1	16.9
CEPS (INR)	12.1	13.0	19.4	18.8	22.8
Dividend per share (INR)	0.6	0.8	2.0	2.5	2.3
Dividend (%)	25.3	30.0	40.0	50.0	45.0
Dividend payout (%)	10.3	10.5	15.2	20.7	15.6

Common size metrics

Year to March	FY08	FY09	FY10	FY11E	FY12E
Cost of revenues	52.9	55.0	56.9	60.1	57.5
Gross margin	47.1	45.0	43.1	39.9	42.5
G&A expenses	14.1	14.1	12.0	11.9	12.3
S&M expenses	14.9	10.8	9.2	9.6	9.2
SG&A expenses	29.0	24.9	21.2	21.6	21.4
EBITDA margins	18.1	20.1	21.9	18.3	21.1
EBIT margins	12.7	14.8	17.3	13.7	15.9
Net profit margins	11.8	9.5	16.5	13.1	14.0

Growth ratios (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	24.3	32.0	7.1	16.6	16.2
EBITDA	7.6	46.4	16.7	(2.2)	33.4
EBIT	(2.7)	54.6	24.8	(7.6)	34.7
PBT	11.9	(5.4)	111.2	(10.2)	27.0
Net profit	7.0	6.2	86.5	(7.8)	24.1
EPS	(5.6)	2.2	77.9	(8.5)	19.5

Balance sheet**(INR mn)**

As on 31st March	FY08	FY09	FY10E	FY11E	FY12E
Equity capital	1,241	276	553	553	563
Share premium account	2,605	3,601	3,338	3,338	3,938
Reserves & surplus	2,878	3,826	5,343	6,575	8,173
Shareholders funds	6,724	7,703	9,234	10,466	12,674
Minority interest (BS)	3	3	-	-	-
Borrowings	424	195	40	-	-
Sources of funds	7,152	7,901	9,274	10,466	12,674
Gross block	3,777	4,614	5,564	6,764	7,414
Accumulated depreciation	1,793	2,189	2,625	3,140	3,807
Net block	1,983	2,424	2,939	3,624	3,606
Capital work in progress	311	584	300	200	350
Deferred tax asset	(16)	165	165	165	165
Investments	2,293	402	900	1,200	1,350
Sundry debtors	2,170	2,628	2,611	2,893	3,467
Cash and equivalents	1,193	3,334	4,116	4,352	5,720
Loans and advances	442	603	753	942	1,224
Total current assets	3,805	6,564	7,480	8,187	10,411
Sundry creditors and others	506	822	914	1,168	1,477
Others current liabilities	382	1,025	1,117	1,168	1,209
Provisions	337	392	479	574	522
Total current liabilities & provisions	1,226	2,238	2,510	2,910	3,208
Net current assets	2,580	4,326	4,970	5,278	7,203
Uses of funds	7,152	7,901	9,274	10,466	12,674
Book value per share (INR)	65.8	72.3	83.4	94.6	112.5

Free cash flow**(INR mn)**

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Net profit	868	925	1,709	1,564	1,903
Depreciation	366	466	436	515	667
Others	(13)	(152)	33	(107)	(100)
Gross cash flow	1,220	1,238	2,177	1,972	2,470
Less: Changes in WC	423	(593)	24	136	531
Operating cash flow	797	1,831	2,152	1,836	1,939
Less: Capex	1,391	944	666	1,100	800
Free cash flow	(593)	887	1,487	736	1,139

Cash flow metrics

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Cash flow from operations	1,220	1,238	2,177	1,972	2,470
Cash for working capital	(423)	593	(24)	(136)	(531)
Operating cash flow	797	1,831	2,152	1,836	1,939
Net purchase of fixed assets	(1,391)	(944)	(666)	(1,100)	(800)
Net purchase of investments	(1,821)	1,797	(34)	47	171
Others in Cash Flow Metrics	-	-	129	112	100
Investing cash flow	(3,212)	853	(570)	(941)	(529)
Dividends	(72)	(79)	(105)	(267)	(332)
Proceeds from issue of equity	3,028	32	13	-	610
Proceeds from LTB/STB	152	(221)	(155)	(40)	-
Interest paid & other items	(37)	(40)	(31)	(2)	-
Financing cash flow	2,869	(559)	(773)	(659)	(43)
Exchange rate differences	(6.4)	(31.8)	-	-	-
Net cash flow	448	2,092	809	236	1,367

Profitability & efficiency ratios

Year to March	FY08	FY09	FY10E	FY11E	FY12E
ROAE (%)	18.0	12.8	20.2	15.9	16.4
ROACE (%)	21.9	21.4	20.8	17.3	19.9
Debtors days	102	98	100	90	90
Payable days	26	27	33	34	37
Cash conversion cycle (days)	76	71	67	56	53
Current ratio	3.1	2.9	3.0	2.8	3.2

Operating ratios

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Total asset turnover	1.3	1.2	1.1	1.1	1.1
Fixed asset turnover	4.6	4.0	3.6	3.4	3.6
Equity turnover	1.4	1.2	1.1	1.1	1.1

Valuation parameters

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Diluted EPS (INR)	8.5	8.7	15.4	14.1	16.9
Y-o-Y growth (%)	(5.6)	2.2	77.9	(8.5)	19.5
CEPS (INR)	12.1	13.0	19.4	18.8	22.8
Diluted PE (x)	20.7	20.3	11.4	12.4	10.4
Price/BV (x)	2.7	2.4	2.1	1.9	1.6
EV/Revenues (x)	2.4	1.8	1.7	1.4	1.1
EV/EBITDA (x)	12.2	8.5	7.0	6.8	4.7
EV/EBITDA (x) +1 yr forward	9.0	7.9	7.7	5.6	-
Dividend yield (%)	0.3	0.4	1.1	1.3	1.2



RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
HCL Technologies	HOLD	SP	H	Hexaware Technologies	BUY	SO	M
Info Edge	BUY	SO	M	Infosys Technologies	HOLD	SU	L
Infotech Enterprises	BUY	SO	H	Mphasis	HOLD	SU	M
Patni Computer Systems	HOLD	SU	M	Tata Consultancy Services	BUY	SO	L
Wipro	BUY	SP	L				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect

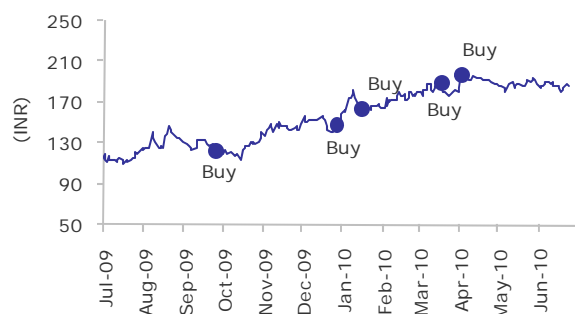
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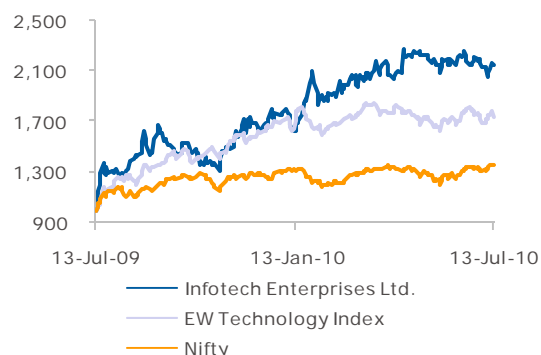
Coverage group(s) of stocks by primary analyst(s): IT

HCL Technologies, Hexaware Technologies, Infosys Technologies, Info Edge, Infotech Enterprises, Mphasis, Patni Computer Systems, Tata Consultancy Services, Wipro

Infotech Enterprises



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	109	52	12	177
* 4 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	108	54	15	

Recent Research

Date	Company	Title	Price (INR)	Recos
13-Jul-10	Infosys Technologies	Price decline shadows strong volume growth and raised guidance; <i>Result Update</i>	2,797	Hold
05-Jul-10	IT	Robust demand environment continues; <i>Result Preview</i>		
16-Jun-10	Wipro	On an improvement drive; <i>Visit Note</i>	409	Buy

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