



Sasken Communications

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,283	SACT IN
	REUTERS CODE
S&P CNX: 4,148	SKTC.BO

25 January 2007

Buy

Previous Recommendation: Buy

Rs545

Equity Shares (m)	28.1
52-Week Range	624/240
1,6,12 Rel. Perf. (%)	0/72/15
M.Cap. (Rs b)	15.3
M.Cap. (US\$ b)	0.3

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
3/06A*	3,081	229	10.6	-21.4	51.3	4.0	11.3	11.3	4.9	28.0
3/07E*	4,879	492	17.5	64.5	31.2	3.6	12.0	11.7	3.2	19.3
3/08E*	6,974	864	30.3	73.6	18.0	3.0	18.4	16.6	2.2	11.4

- Lower revenue growth and fall in margins impact profit growth:** Sasken reported revenue growth of 11.5% QoQ to Rs1.3b. Services revenue was up 14% QoQ, while products declined 33.6% QoQ. Consolidated EBITDA margins were down 380bp due to fall in both services and product margins. Consequently, net profit at Rs119m was flat as compared to the previous quarter.
- Services to pick up after seasonal slump, expect volume growth to remain strong post FY08:** We expect to see continued momentum in offshoring; management expects organic growth rates to remain robust in FY08, as well. Pricing, SG&A leverage and utilization rates would help retain services margins at 22-23% in FY08.
- Products on track post FY07, breakeven in 4QFY07 contingent on e-Series success:** Product business is on track with 7 new launches expected from 1QFY07 onwards. Product metrics in terms of design-ins, models launched and expected design wins have also shown marked improvement. We expect break even in FY08, due to pick-up in royalty revenue and a significant improvement in profitability.
- Outlook and view:** The demand outlook for services and the targeted milestones for products continue to remain strong. Nevertheless, we have downgraded our FY07 EPS estimate by 4.5% to Rs17.5, to factor in the lower than anticipated performance in 3QFY07. We have also built in more conservatism in our Rs/US\$ rate for FY08 and FY09, resulting in marginal downgrade in EPS to Rs30.3 and Rs39.4, respectively from Rs31 and Rs39.9. The stock is trading at 18x FY08E and 13.8x FY09E EPS. We continue to remain positive on Sasken given the anticipated ramp ups in revenue, and the anticipated improvement in profitability in products in FY08. We maintain **Buy** with a price target of Rs690 (based on FY09 financials), an upside of 26.5% from current levels.

QUARTERLY PERFORMANCE

Y/E MARCH	(Rs Million)									
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenues	677	864	759	781	911	1,175	1,310	1,482	3,081	4,879
Q-o-Q Change (%)	-9.1	27.5	-12.1	2.8	16.7	29.0	11.5	13.1	27.4	58.4
Direct Expenses	466	569	524	536	628	751	877	937	2,095	3,193
Sales, General & Admin. Expenses	134	161	159	139	157	211	245	256	594	868
Operating Profit	77	134	77	105	126	214	189	290	393	818
Margins (%)	11.4	15.5	10.1	13.5	13.9	18.2	14.4	19.5	12.7	16.8
Other Income	20	20	7	17	8	12	31	8	64	58
Depreciation & Amortization	35	3	3	48	43	49	55	62	90	210
Interest	0	0	0	0	0	24	10	15	1	49
PBT bef. Extra-ordinary	61	150	80	73	91	152	154	220	365	618
Provision for Tax	14	34	11	11	5	33	35	53	69	126
Rate (%)	22.3	22.4	13.2	14.5	5.4	21.9	22.8	24.0	18.8	20.4
PAT bef. Extra-ordinary	48	117	69	63	86	119	119	168	297	492
Q-o-Q Change (%)	-56.4	144.6	-40.5	-9.5	37.6	37.5	-0.1	41.1	30.3	65.7
Extra-ordinary	0	0	68	0	0	0	0	0	68	0
Net profit after Extra-ordinary	48	117	2	63	86	119	119	168	229	492
Q-o-Q Change (%)	-56.4	144.6	-98.4	3,318.7	37.6	37.5	-0.1	41.1	0.6	114.5

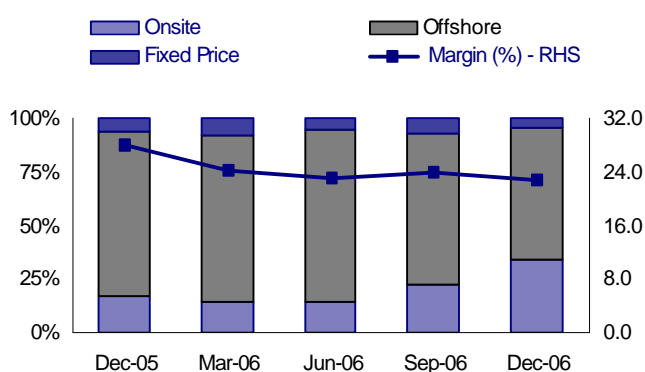
E: MOST Estimates

Lower revenue growth and fall in margins impact profit growth

Sasken reported revenue growth of 11.5% QoQ to Rs1.3b, lower than our estimate of Rs.1.4b. Rupee appreciation impacted revenue realizations by 2.5%. Services revenue was up 14% QoQ, while products declined 33.6% QoQ due to phasing out of older model shipments on account of introduction of new model in November 2006.

Onsite revenue in services grew 72% QoQ due to full quarter integration of Botnia (approx. Rs255m in revenue), while offshore declined 0.8% QoQ, primarily due to lower growth in Sasken Network Engineering on account of completion of a large project during the quarter. Organic services revenue for the quarter remained flat due to transition of work for a top US client to Mexico and India, where the billing rates are lower. Organic volumes grew 1% QoQ. Services margins at 22.6% were down 110bp during the quarter; organic margins were up at 24.2%, while margins in Botnia were low at 17.5% due to lower utilization rates on account of the holiday season.

BOTNIA DEPRESSES SERVICES MARGIN DURING THE QUARTER



Source: Company/Motilal Oswal Securities

Product margins, however, were much lower with product EBITDA declining to a negative Rs96m from a negative Rs47m in the previous quarter. This was primarily on account of lower capitalization of R&D expenses (Rs40m v/s Rs65m in 2QFY07) of the e-series product, which resulted in greater expenses flowing into the P&L during the quarter. R&D costs were also higher at Rs50m due to investments in product enhancements and higher patent filing costs.

PRODUCTS (RS M)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Revenue	22	275	36	63	42
EBITDA	-85	-174	-71	-47	-96

Source: Company/Motilal Oswal Securities

SG&A was also higher by 80bp due to restructuring of sales team and addition of new sales head. EBITDA margin was down 380bp v/s our expectation of 140bp decline due to the above reasons. Net profit at Rs119m was flat as compared to the previous quarter due to slower revenue growth and decline in margins.

During the quarter, the company announced the formation of TACO Sasken Automotive Electronics Pvt Ltd, a joint venture with Tata AutoComp Systems Ltd. The JV plans to focus on automotive electronics products in the areas of telematics, infotainment and occupant convenience. Sasken plans to invest US\$5m in this JV over the next 3 years for product development. While the JV would enable Sasken to enter a potentially lucrative market, we expect revenue contribution from the JV to be negligible over the near term.

Services to pick up after seasonal slump, expect volume growth to remain strong post FY08

While organic growth in services business remained flat during the quarter due to offshore transition in the TI account and completion of projects in Sasken Network Engineering, the management expects volume growth to be strong over the forthcoming quarters. While consolidation in the client base is yet to be fully completed, the company expects to see continued momentum in offshoring, with organic growth rates likely to be strong in FY08 as well.

Botnia, which was integrated from September 2006, would also contribute to volume growth post FY07. Since the offshoring potential of existing business from Botnia is low, we do not anticipate revenue decline due to transition of existing work. Given the US\$14-15m revenue contribution from Botnia in FY07, we expect full year integration to add to the pace of growth in the services business.

The company has recently achieved price hikes in renegotiations with top clients, which is expected to improve overall realizations by 1-2% from 4QFY07. Additionally, it

has sufficient margin levers in terms of SG&A leverage (currently high at 18.3%) and utilization rates, which would help retain organic services margins at 22-23% despite expected wage hikes in FY08. Margins from Botnia, which were down to 17.5% during the quarter, are expected to improve from 4QFY07 onwards (July and December being holiday seasons, with lower utilizations), which would help sustain consolidated services margins at 22-23% in FY08 as well.

Products on track post FY07, breakeven contingent on e-Series success

While product revenue and margins were below expectations during the quarter, Sasken's product business seems to be on track with several new model launches carrying Sasken's IP expected to be launched from 4QFY07 onwards. Including the NEC903i phones for DoCoMo that was launched in November 2006, the company has 7 new model shipments lined up over FY08, of which 3 are expected to report royalty revenue in 1HFY08 itself (in addition to the NEC903i). Product metrics in terms of design-ins, phone models launched and expected design wins have also shown marked improvement during the quarter, suggesting that the company is on track for products business post FY07.

Product margins, which deteriorated during the quarter due to slower revenue growth and lower capitalization of R&D expenses are expected to breakeven in 4QFY07, provided the company is able to secure its first win for its e-Series "Aria" platform. The company is currently in discussion with two potential clients (one in the US and one in China) and is confident of winning at least one of the two. In FY08, we expect product revenue to pick up with inflow of royalty revenue (likely to be back ended given the anticipated shipment schedule) and anticipate significant improvement in profitability due to the above reasons. While our estimates do not factor in the same in 4QFY07, any wins in this space would be an upside to our estimates both in terms of revenue and margins.

Outlook and view

While 3QFY07 was disappointing on products and services front, both the demand outlook for services and the targeted

milestones for products continue to remain strong. The company has sufficient margin levers as discussed earlier to maintain service margins at 22-23%, while product margins are expected to improve significantly post FY07 with increase in shipments. However, due to the lower than anticipated performance in 3QFY07 we have downgraded our FY07 EPS estimate by 4.5% to Rs17.5. We have also built in more conservatism in our Rs/US\$ rate for FY08 and FY09 resulting in marginal downgrade in EPS to Rs30.3 and Rs39.4 from our earlier expectation of Rs31 and Rs39.9 for FY08 and FY09, respectively. The stock is trading at 18x FY08E and 13.8x FY09E EPS. We continue to remain positive on Sasken given the anticipated ramp ups in revenue in both services and products and improvement in profitability due to anticipated breakeven of products in FY08. We maintain **Buy** with a price target of Rs690 (based on FY09 financials), an upside of 26.5% from current levels.

VALUATION

PARTICULARS	RS	M	REMARKS
Services Business			
FY09E EBITDA	1,623		
EV/EBITDA multiple	11.0		11x FY09E service EBITDA
x FY09E EBITDA			
Services EV	17,856		
Value per share (Rs)	592		
Product Business			
FY09E Sales	1,099		
EV/Sales multiple x			TTP.com was acquired by Motorola
FY08E Sales	2.8		at 2.8x Sales despite being loss making with high client concentration.
Product EV	3,076		
Value per Share (Rs)	102		
Total EV	20,931		
Less: Current Debt	865		
Add: Curr.Cash and Bank	747		
Net EV	20,814		
Current O/S Shares	28.2		
Expected Dilution from likely US\$50m Fund Raising	2.0		We have taken dilution to the extent of only 50% of likely US\$50m raising (at Rs575) as we believe that fund requirements for facility expansion and working capital would be lower than US\$50m
Likely Diluted Equity shares (m)			30.2
Value per Share (Rs) (without Dilution)			738
Upside from Current Levels (%)			35.2
Value per share (Rs) (with likely Dilution at Rs 575)			690
Upside from Current Levels (%)			26.5

Sasken Communications: an investment profile

Company description

Sasken Communications is a niche player in the Telecom R&D services space with specialty focus on Network OEMs, Semiconductor manufacturers and Terminal Devices. Sasken's product lines cut across about 80% of the world's total handset market in terms of offering functionality. Sasken employs more than 3,500 people. Its key clients include Nokia-Siemens, Lucent-Alcatel, Nortel, Texas Instruments and other Tier I OEMs, semiconductor vendors and handset manufacturers.

Key investment arguments

- ✍ Credible tier-2 Indian IT services vendor with niche offerings.
- ✍ One of the top 3 players in the Telecom R&D space with leadership in wireless technology.
- ✍ Products business is poised for take-off with 8 new models for shipping in CY2007.

Key investment risks

- ✍ Product revenue dependent on handset shipments by clients.
- ✍ High dependence on the Telecom vertical with high client concentration exposes it to greater risk in case of any slow down in this sector.

Recent developments

- ✍ Announced the formation of TACO Sasken Automotive Electronics Pvt. Ltd., a JV with Tata AutoComp Systems Ltd., to focus on automotive electronics products.
- ✍ The NEC903i phones for DoCoMo, bearing Sasken's IP launched in November 2006.

Valuation and view

- ✍ Revenue CAGR of 50.4% and earnings CAGR of 70.6% over the next two years.
- ✍ Valuations at 13.8x FY09E earnings offer room for upside.
- ✍ Maintain **Buy** with target price of Rs690.

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 are going to them whilst niche players benefit due to lack of offshore competition in their segments.

COMPARATIVE VALUATIONS

		SASKEN	SUBEX	GEOMETRIC
P/E (x)	FY07E	31.2	38.3	21.3
	FY08E	18.0	16.5	12.9
P/BV (x)	FY07E	3.6	2.8	3.7
	FY08E	3.0	2.4	3.0
EV/Sales (x)	FY07E	3.2	7.0	2.3
	FY08E	2.2	4.2	1.3
EV/EBITDA (x)	FY07E	19.3	33.0	12.9
	FY08E	11.4	13.0	7.5

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.05	DEC.05
Promoter	26.8	27.1	26.0
Domestic Inst	3.3	4.3	1.1
Foreign	48.1	47.3	46.0
Others	21.9	21.3	27.0

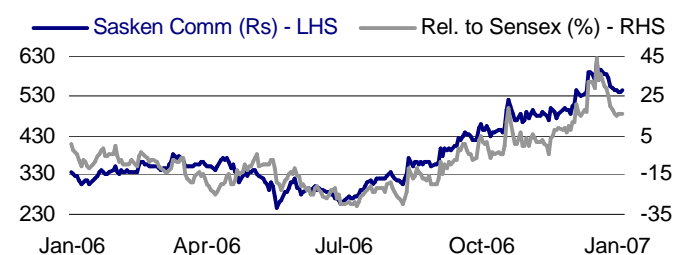
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	17.5	17.6	-0.5
FY08	30.3	30.0	0.9

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
545	690	26.5	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Sales	2,418	3,081	4,879	6,974	8,858
Change (%)	45.5	27.4	58.4	42.9	27.0
Software Develop. Exp.	1,523	2,005	3,193	4,315	5,500
SG&A	533	538	868	1,284	1,582
EBITDA	362	538	818	1,375	1,777
% of Net Sales	15.0	17.5	16.8	19.7	20.1
Depreciation	148	236	210	281	341
Interest	5	1	49	80	90
Other Income	37	64	58	105	115
PBT	245	365	618	1,119	1,461
Tax	17	69	126	255	327
Rate (%)	7.1	8.8	20.4	22.8	22.4
PAT	228	297	492	864	1,134
Change (%)	24.3	30.3	65.7	75.7	31.3
Extra-ordinary items	0	68	0	0	0
Reported PAT	228	229	492	864	1,134
Change (%)	24.3	0.6	114.5	75.7	31.3

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	171	279	285	288	291
Share Premium	613	2,802	2,859	2,973	3,084
Reserves	635	768	1,170	1,837	2,712
Net Worth	1,419	3,850	4,314	5,097	6,087
Loans	15	12	896	865	710
Deferred Tax Liability	0	-2	-10	-4	11
Capital Employed	1,434	3,860	5,200	5,958	6,808
Gross Block	1,603	1,895	4,437	4,837	5,387
Less : Depreciation	733	918	1,265	1,546	1,887
Net Block	870	977	3,171	3,290	3,500
CWIP	8	34	50	50	50
Investments	6	1,865	365	365	365
Capitalized software product	0	141	312	192	72
Curr. Assets	889	1,223	2,255	3,214	4,773
Debtors	541	653	1,250	1,400	1,966
Cash & Bank Balance	109	151	471	747	1,488
Loans & Advances	237	385	503	1,016	1,259
Other Current Assets	2	33	30	50	60
Current Liab. & Prov	338	381	953	1,152	1,952
Current Liabilities	254	266	685	570	1,024
Provisions	84	115	268	582	928
Net Current Assets	551	842	1,302	2,061	2,821
Capital Employed	1,434	3,860	5,200	5,958	6,808

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	13.5	10.6	17.5	30.3	39.4
Cash EPS	22.3	19.1	24.9	40.2	51.3
Book Value	84.3	137.8	153.3	179.1	211.7
DPS	3.0	3.0	3.5	6.1	7.9
Payout %(Incl.Div.Taxes)	22.2	36.6	20.0	20.0	20.0
Valuation (x)					
P/E		51.3	31.2	18.0	13.8
Cash P/E		28.6	21.9	13.6	10.6
EV/EBITDA		28.0	19.3	11.4	8.4
EV/Sales		4.9	3.2	2.2	1.7
Price/Book Value		4.0	3.6	3.0	2.6
Dividend Yield (%)		0.6	0.6	1.1	1.4
Profitability Ratios (%)					
RoE	17.8	11.3	12.0	18.4	20.3
RoCE	18.0	11.3	11.7	16.6	18.9
Turnover Ratios					
Debtors (Days)	66	71	71	69	69
Fixed Asset Turnover (x)	0.7	0.6	0.9	0.7	0.6
Leverage Ratio (x)					
Debt/Equity Ratio(x)	0.0	0.0	0.2	0.2	0.1

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006E	2007E	2008E	2009E
CF from Operations	353	391	716	1,245	1,584
Cash for Working Capital	-124	-306	-166	-568	-81
Net Operating CF	229	85	550	677	1,503
Net Purchase of FA	-239	-331	-2,420	-400	-550
Capitalisation of Product De	0	-141	-170	0	0
Net Purchase of Invest.	23	-1,799	1,558	105	115
Net Cash from Invest.	-215	-2,271	-1,032	-295	-435
Proceeds from Equity.	105	2,291	62	117	114
Proceeds from LTB/STB	10	-3	884	-31	-155
Interest Paid	-5	-1	-49	-80	-90
Dividend Payments	-43	-58	-96	-112	-197
Cash Flow from Fin.	68	2,229	802	-106	-328
Free Cash Flow	-10	-246	-1,870	277	953
Net Cash Flow	81	43	320	276	741
Opening Cash Balance	27	109	151	471	747
Add: Net Cash	81	43	320	276	741
Closing Cash Balance	109	151	471	747	1,488



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Disclosure of Interest Statement

Sasken Communications

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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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