



## Subex Azure

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,093	SUBX IN
	REUTERS CODE
S&P CNX: 4,083	SUBX.BO

31 January 2007

Buy

Previous Recommendation: Buy

Rs726

Equity Shares (m)	34.7
52-Week Range	803/355
1,6,12 Rel. Perf. (%)	9/50/37
M.Cap. (Rs b)	25.2
M.Cap. (US\$ b)	0.6

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	1,814	379	17.4	36.3	41.7	8.7	24.8	23.9	8.5	30.7
3/07E	3,627	652	18.9	8.7	38.4	2.9	12.5	13.0	7.0	34.4
3/08E	5,802	1,521	43.8	131.7	16.6	2.5	16.2	16.0	4.2	13.0

- Results in-line; lower tax rate and depreciation compensate for lower operational profits:** Subex Azure registered product revenues of Rs758m in 3QFY07 (v/s our estimate of Rs755m). However EBITDA margins were lower than expected at 20.7% (estimate of 23.9%) due to faster than expected integration and restructuring of Azure, UK. Lower tax rate and lower than expected depreciation led to consolidated PAT being in line with estimates.
- Performance 4QFY07 onwards to reflect benefits of Azure integration/restructuring:** Subex has already completed the integration/ restructuring of Azure, UK in December 2006, versus the earlier expectation of completion by 4QFY07. We expect the performance from 4QFY07 to reflect integration benefits on a sustainable basis.
- Syndesis acquisition to result in significant dilution in near-term, but will be a long-term growth driver:** With the acquisition of Syndesis, Subex has expanded its market within Telecom OSS from US\$500m to US\$2.5b by including service fulfillment and service assurance through Syndesis. The acquisition price of US\$164.5m would be funded through GDR/FCCB issue of US\$200m.
- We reiterate our Buy recommendation:** Considering the completion of Azure integration (one of the main risks perceived earlier) as well as expansion of addressable market with Syndesis acquisition, we expect Subex Azure to continue outperforming. We have not revised our estimates (excluding Syndesis and GDR issue) post 3QFY07 results. Trading at 16.6x FY08E, 12.6x FY09E (excluding Syndesis) and appears attractive on FY09 basis. **Buy**.

### QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
<b>Revenues</b>	<b>412</b>	<b>419</b>	<b>487</b>	<b>494</b>	<b>434</b>	<b>1,031</b>	<b>1,062</b>	<b>1,100</b>	<b>1,814</b>	<b>3,627</b>
Q-o-Q Change (%)	16.2	1.6	16.4	1.3	-12.0	137.3	3.0	3.6	55.7	99.9
Direct Expenses	241	235	261	286	339	668	551	529	992	2,087
Sales, General & Admin. Expenses	59	51	93	75	58	202	291	253	320	804
<b>Operating Profit</b>	<b>112</b>	<b>133</b>	<b>133</b>	<b>132</b>	<b>38</b>	<b>161</b>	<b>220</b>	<b>317</b>	<b>502</b>	<b>736</b>
Margins (%)	27.3	31.8	27.2	26.8	8.8	15.7	20.7	28.8	27.7	20.3
Other Income	4	4	17	4	49	82	29	20	29	181
Depreciation	23	22	22	24	28	38	23	27	92	117
Interest	6	6	5	9	9	19	20	19	27	67
<b>PBT bef. Extra-ordinary</b>	<b>87</b>	<b>109</b>	<b>123</b>	<b>103</b>	<b>51</b>	<b>186</b>	<b>206</b>	<b>291</b>	<b>412</b>	<b>734</b>
Provision for Tax	2	6	5	19	6	23	14	34	33	77
Rate (%)	2.1	5.1	3.7	18.2	11.3	12.1	7.0	11.8	8.1	10.5
<b>PAT bef. Extra ordinary</b>	<b>86</b>	<b>103</b>	<b>119</b>	<b>84</b>	<b>45</b>	<b>164</b>	<b>191</b>	<b>257</b>	<b>379</b>	<b>657</b>
Extra ordinary items	0	0	0	0	5	0	0	0	0	5
<b>PAT aft. Extra ordinary</b>	<b>86</b>	<b>103</b>	<b>119</b>	<b>84</b>	<b>40</b>	<b>164</b>	<b>191</b>	<b>257</b>	<b>379</b>	<b>652</b>
Q-o-Q Change (%)	5.7	20.6	15.1	-29.2	-46.7	265.2	16.8	34.4	47.3	72.1

E: MOST Estimates, quarterly numbers are unconsolidated and yearly numbers are consolidated, financials w.e.f from 2QFY07 are including Azure, does not include Syndesis

### Revenues in line with estimate; license revenues show robust growth

Subex Azure registered consolidated product revenues of Rs758m (v/s our estimate of Rs755m). Standalone product revenues were Rs314.7m against Rs314.8m in 3QFY06 (however, with Azure acquisition and its integration, one cannot strictly compare the performance). During 3QFY07, license revenue growth was robust at 39.4% QoQ, indicating the demand for its products. However, this growth is largely on account of higher demand for its Revenue Assurance product, as its contribution (without BT) has increased to 36% from 28% in 2QFY07. Contribution of its Fraud Management product has declined to 50% from 55% in 2QFY07.

#### REVENUE BREAK-UP(RS M)

	2QFY07	3QFY07	CHG. (%)
License Revenue	260.8	363.7	39.4
AMC	133.0	119.3	-10.3
Customisation	46.0	28.4	-38.3
03rd Party	20.5	5.7	-72.2
Bureau (Managed Services)	51.1	51.1	0.0
BT Services	229.8	189.4	-17.6

Source: Company/Motilal Oswal Securities

### Product pipeline continues to be robust

Currently, Subex Azure has US\$175m worth of order pipeline (excluding BT) with expected hit ratio of 40% considering its leadership position, which indicates likely order wins of US\$70m in the next 12 months. Considering fresh order win worth US\$13m in 3QFY07 (including US\$5m as additional commitment in contracting stage delayed due to holiday season) and order backlog worth US\$11.3m to be executed in 4QFY07, we believe that Subex Azure has visibility for an order book of around US\$72m in the next 12 months. Besides these, annuity revenues worth US\$31 per year, Subex Azure has visible order bookings to the extent of US\$102m versus its guided revenues of US\$100m from products for FY08.

#### ROBUST PIPELINE (US\$M)

	2QFY07	3QFY07
Pipeline (Excluding BT)	170	175
Likely Hit Ratio (%)	40	40
Likely Order Bookings	68	70
Fresh Orders Won (Excluding BT)	13	8
- Additional Commitment (Ex BT)		5
Backlog To Be Executed in FY07 - Ex BT	20	11
Backlog To Be Executed in FY07 – BT	9	5

Source: Company/Motilal Oswal Securities

### EBITDA margins lower than expected due to restructuring cost

EBITDA margins were lower than expected 20.7% (estimate of 23.9%) due to faster than expected integration and restructuring of Azure, UK. We believe that this has resulted in higher than expected operational expenses towards restructuring, which are not likely to recur from 4QFY07. Subex has already laid off the required employees in Azure. Earlier indication was to lay off around 100 employees from Azure by paying them one-time compensation. Considering the completion of restructuring of Azure in 9MFY07 (indicative amount spent on restructuring Rs250-300m, around 7-8% of FY07E revenues, will not be recurring), we expect margins to improve significantly from 4QFY07.

Lower tax rate and lower than expected depreciation led to consolidated PAT being in line with our estimate at Rs191m (estimate Rs198m).

### Syndesis acquisition to result in significant dilution...

Subex Azure has entered into an agreement to acquire 100% holding of Toronto-based Syndesis Limited in an all cash deal on 18 January 2007 for US\$164.5m. The deal is likely to be financed through the ongoing GDR/FCCB issue of US\$200m. Assuming dilution at Rs700 per share for the acquisition price of US\$164.5m, equity will be diluted to the extent of 30%.

**...but resulting synergies a long-term positive**

- ✍ With Syndesis, Subex Azure will be able to enter the service fulfillment market within the telecom OSS (Operation Support System) market. This would increase its addressable market size from the current US\$500m to around US\$1.5b.
- ✍ With Syndesis, Subex Azure will also be able to tap the service assurance market within the telecom OSS space, as service fulfillment and service assurance are related areas. This will further expand the addressable market by another US\$1b. However, we believe that this will take time, as Subex Azure will really need to create this expertise either organically or inorganically.
- ✍ Total additional addressable market of US\$2b is likely to grow to US\$3.6b by 2010 (CAGR of 16% over 2006-2010).
- ✍ Currently, Subex Azure has 28 of the world's top-50 Telcos as its customers. With Syndesis, these will increase to 32 (Syndesis has 10 of the top-50 Telcos as its customers, of which 6 customers are common).
- ✍ Syndesis' revenues for 2006 were US\$45m out of an addressable market of US\$1b, indicating a market share of 4-5%. However, within fulfillment, Syndesis' market share was 10% for activation services. The management expects to increase its market share, going forward.

Given the expanded market size and dominant positioning in the revenue maximization space, we believe that Subex's product revenue visibility would be very strong over the next 2-3 years. The management is looking to restructure Syndesis by laying off some onsite staff (currently, Syndesis has 300 employees).

In the following table, we have shown the impact of the Syndesis acquisition on FY08 and FY09 financials based on our assumptions.

## IMPACT OF SYNDESIS ACQUISITION (RS M)

	CURRENT ESTIMATES		ESTIMATES WITH SYNDESIS	
	FY08E	FY09E	FY08E	FY09E
Sales	5,802	7,400	7,970	10,273
Change (%)	60.0	27.5	119.7	28.9
PAT	1,521	2,000	1,738	2,646
% to Sales	26.2	27.0	21.8	25.8
Change (%)	131.7	31.4	164.7	52.2
Equity	347	347	453	453
EPS (Rs)	43.8	57.6	38.4	58.4
P/E (x)	16.6	12.6	18.9	12.4

Source: Company/Motilal Oswal Securities

**Assumptions**

1. We have taken dilution to the extent of US\$164.5m at Rs700 per share
2. We have taken 10% growth in revenues of Syndesis in CY07/FY08 with 10% PAT margin, and 35% growth in CY08/FY09 with 22.5% PAT margin.
3. Syndesis acquisition is likely to be completed by March 2007; we have assumed full year consolidation for FY08.

**We reiterate our Buy recommendation**

Considering the completion of Azure integration (one of the main risks perceived earlier) as well as expansion of addressable market with Syndesis acquisition, we expect Subex Azure to continue outperforming. We have not revised our estimates (excluding Syndesis and GDR issue) post 3QFY07 results. The stock is trading at 16.6x FY08E and 12.6x FY09E (excluding Syndesis), and appears attractive on FY09 basis. We reiterate Buy, with a target price of Rs875 – upside of 20.4% (15x FY09E EPS after considering Syndesis acquisition).

## Subex Azure: an investment profile

### Company description

Subex Azure operates in a niche market, providing revenue maximization (RM) solutions to telecom service providers worldwide. Post its acquisition of Azure in April 2006, Subex's market share (in terms of revenues) has nearly doubled to 25%, making it the global leader in the Telecom OSS – RM segment. Its key clients BT, AT&T, T-Mobile, Vodafone, Orange, Tata Tele, Hutch, Idea etc.

### Key investment arguments

- Subex's market share (in terms of revenues) has nearly doubled to 25%, making it the global leader in the Telecom OSS – RM segment.
- With acquisition of Syndesis, addressable market of Subex will increase to US\$2.5b from current US\$500m and expected to grow to US\$4.5b over 2006-2010.

### Key investment risks

- Derives 100% of its product revenues from Telecom OSS market, any slowdown in the vertical will affect Subex significantly.
- Likely to dilute equity significantly post Syndesis acquisition, any delay/problem in restructuring of Syndesis will affect our estimates adversely.

### Recent developments

- Entered into an agreement to acquire 100% share holding in Syndesis Ltd, Toronto for US\$164.5m
- Raising US\$200m via GDR/FCCB in near future.

### Valuation and view

- Revenue CAGR of 43% and EPS CAGR of 75% over FY07-FY09E.
- Valuations at 12.6x FY09E earnings are attractive.
- Maintain **Buy** with target price of Rs875.

### 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

		SUBEX	SASKEN	GEOMETRIC
P/E (x)	FY07E	38.4	31.6	21.7
	FY08E	16.6	18.2	13.1
P/BV (x)	FY07E	2.9	3.6	3.6
	FY08E	2.5	3.1	2.9
EV/Sales (x)	FY07E	7.0	3.3	2.2
	FY08E	4.2	2.3	1.3
EV/EBITDA (x)	FY07E	34.4	19.5	12.5
	FY08E	13.0	11.5	7.4

#### SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoter	11.7	11.7	18.6
Domestic Inst	18.7	17.6	29.1
Foreign	49.1	50.6	16.1
Others	20.5	20.1	36.2

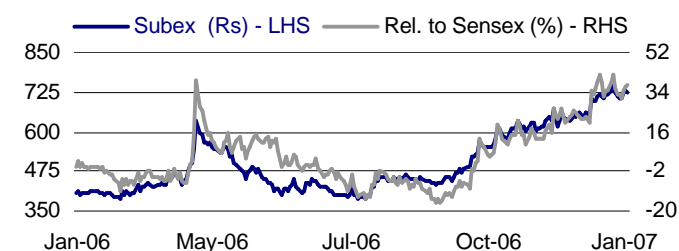
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	18.9	19.4	-2.4
FY08	43.8	43.9	-0.2

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
726	875	20.4	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
<b>Sales</b>	<b>1,166</b>	<b>1,814</b>	<b>3,627</b>	<b>5,802</b>	<b>7,400</b>	
Change (%)	32.6	55.7	99.9	60.0	27.5	
Software Develop. Exp.	668	992	2,087	3,141	3,900	
SG&A Exp.	142	320	804	771	1,047	
<b>EBITDA</b>	<b>355</b>	<b>502</b>	<b>736</b>	<b>1,890</b>	<b>2,452</b>	
% of Net Sales	30.5	27.7	20.3	32.6	33.1	
Depreciation	72	92	117	156	190	
Interest	24	27	67	50	35	
Other Income	7	29	181	44	48	
<b>PBT</b>	<b>266</b>	<b>412</b>	<b>734</b>	<b>1,727</b>	<b>2,276</b>	
Tax	9	33	77	205	276	
Rate (%)	3.4	8.1	10.5	11.9	12.1	
Minority Interest	0	0	0	0	0	
<b>PAT</b>	<b>257</b>	<b>379</b>	<b>657</b>	<b>1,521</b>	<b>2,000</b>	
Extraordinary items	0	0	5	0	0	
<b>Net Income</b>	<b>257</b>	<b>379</b>	<b>652</b>	<b>1,521</b>	<b>2,000</b>	
Change (%)	44.8	47.3	72.1	133.3	314	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
Share Capital	101	218	349	349	349	
Share Premium	542	656	6,912	6,912	6,912	
Reserves	598	937	1,512	2,853	4,621	
<b>Net Worth</b>	<b>1,241</b>	<b>1,811</b>	<b>8,773</b>	<b>10,113</b>	<b>11,882</b>	
Loans	309	14	508	264	161	
Deferred tax liability	-4	-8	-17	-15	-8	
Misc. Expenses	0	0	48	36	24	
<b>Capital Employed</b>	<b>1,546</b>	<b>1,817</b>	<b>9,216</b>	<b>10,327</b>	<b>12,011</b>	
Goodwill	309	309	7,021	7,021	7,021	
Gross Block	562	666	893	993	1,143	
Less : Depreciation	193	273	472	628	818	
<b>Net Block</b>	<b>369</b>	<b>393</b>	<b>421</b>	<b>365</b>	<b>325</b>	
CWIP	0	4	15	5	1	
Investments	0	0	0	0	0	
<b>Curr. Assets</b>	<b>1,068</b>	<b>1,441</b>	<b>2,919</b>	<b>4,355</b>	<b>6,775</b>	
Debtors	732	962	1,920	2,530	2,943	
Cash & Bank Balance	278	406	398	871	2,310	
Loans & Advances	57	74	252	407	791	
Other Current Assets	0	0	349	547	731	
<b>Current Liab. &amp; Prov</b>	<b>200</b>	<b>331</b>	<b>1,160</b>	<b>1,420</b>	<b>2,111</b>	
Creditors	60	160	566	247	641	
Other liabilities	99	104	404	684	663	
Provisions	41	66	191	489	806	
<b>Net Current Assets</b>	<b>868</b>	<b>1,111</b>	<b>1,758</b>	<b>2,936</b>	<b>4,664</b>	
<b>Application of Funds</b>	<b>1,546</b>	<b>1,817</b>	<b>9,216</b>	<b>10,327</b>	<b>12,011</b>	

E: M OSt Estimates, without including Syndesis

RATIOS						
Y/E MARCH	2005	2006	2007E	2008E	2009E	
<b>Basic (Rs)</b>						
<b>EPS*</b>	<b>12.8</b>	<b>17.4</b>	<b>18.9</b>	<b>43.8</b>	<b>57.6</b>	
Cash EPS*	16.1	21.5	22.0	48.4	63.3	
Book Value	123.2	83.2	251.4	290.4	341.7	
DPS	1.5	1.7	1.9	4.4	5.8	
Payout %(Incl.Div.Taxes)	11.4	10.0	10.0	10.0	10.0	
<b>Valuation (x)</b>						
P/E		41.7	38.4	16.6	12.6	
Cash P/E		33.8	33.0	15.0	11.5	
EV/EBITDA		30.7	34.4	13.0	9.4	
EV/Sales		8.5	7.0	4.2	3.1	
Price/Book Value		8.7	2.9	2.5	2.1	
Dividend Yield (%)		0.2	0.3	0.6	0.8	
<b>Profitability Ratios (%)</b>						
RoE	27.7	24.8	12.5	16.2	18.2	
RoCE	22.3	23.9	13.0	16.0	18.2	
<b>Turnover Ratios</b>						
Debtors (Days)	229	193	193	159	145	
Fixed Asset Turnover (x)	2.2	2.6	0.9	0.8	1.0	
<b>Leverage Ratio (x)</b>						
Debt/Equity Ratio(x)	0.2	0.0	0.1	0.0	0.0	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2005	2006	2007E	2008E	2009E	
CF from Operations	359	524	646	1,698	2,196	
Cash for Working Capital	61	206	705	802	344	
<b>Net Operating CF</b>	<b>298</b>	<b>318</b>	<b>-59</b>	<b>896</b>	<b>1,852</b>	
Net Purchase of FA	-351	-95	-155	-90	-146	
Goodwill on consolidation	0	0	-6,712	0	0	
Net Purchase of Invest.	5	16	181	44	48	
<b>Net Cash from Invest.</b>	<b>-345</b>	<b>-79</b>	<b>-6,687</b>	<b>-47</b>	<b>-98</b>	
Inc/dec in Equity	218	19	6,335	-9	-5	
Proceeds from LTB/STB	137	-60	494	-244	-103	
Dividend & Interest Payment	-63	-71	-92	-124	-207	
<b>Cash Flow from Fin.</b>	<b>292</b>	<b>-111</b>	<b>6,737</b>	<b>-376</b>	<b>-315</b>	
Free Cash Flow	-53	223	-214	806	1,706	
<b>Net Cash Flow</b>	<b>245</b>	<b>128</b>	<b>-8</b>	<b>474</b>	<b>1,439</b>	
<b>Opening Cash Balance</b>	<b>34</b>	<b>278</b>	<b>406</b>	<b>398</b>	<b>871</b>	
Add: Net Cash	245	128	-8	474	1,439	
<b>Closing Cash Balance</b>	<b>278</b>	<b>406</b>	<b>398</b>	<b>871</b>	<b>2,310</b>	



For more copies or other information, contact

**Institutional:** Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motiloswal.com

**Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021**

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**Subex Azure**

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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