INDIA

IT services

Hexaware Technologies

Initiation **11 December 2010**

SELL

Target Price: Rs81

CMP: Rs97*

Downside: 17%

**as on 10 December 2010*

Further Re-rating Unlikely

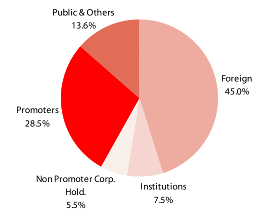
We initiate coverage on Hexaware Tech (HEXW) with a SELL rating and a one year target price of Rs81. Hexaware is a mid-tier IT services company which positions itself as a specialist in Enterprise Application Software (EAS) especially PeopleSoft, SAP ERP and Quality Assurance Services. While the dependence on Enterprise Solutions has led to the recent growth, its discretionary nature lends volatility to the company's revenue. Lack of visibility in steady state income is coupled with lack of vertical expertise, poor client mining record, below par operating margin and low return ratios. We believe the market is pricing in the best and could be negatively surprised by the company's results in 2011 and 2012.

- **Discretionary spending to slow down.** Hexaware's niche positioning in the EAS space exposes it to the vagaries of discretionary spending. We believe the uptick in discretionary projects in recent quarters was due to pent up demand and pick up in US economy which is not sustainable. As pent up demand subsides in 2011 and economic growth weakens, discretionary spending would ebb, directly impacting companies like Hexaware which focuses on EAS. We model revenue CAGR of 11% from CY09-CY12E.
- **Lack of breadth and differentiation in offerings caps client's wallet share.** With significant competition in EAS, low diversification across other horizontals and lack of vertical expertise, Hexaware would find it increasingly difficult to gain incremental share of the client's wallet. The company re-aligned itself only in 2009 to become more vertically oriented.
- **Poor client mining.** Hexaware's $1mn+ client list is shrinking. This is despite a high SG&A expense. We attribute this poor client mining record to its lack of vertical expertise and limited service offerings. We therefore are wary of the sustainability of Hexaware's recent growth which was largely led by its top 5 clients.
- **Margins to remain Achilles heels.** At 8.5% (Q3CY10), Hexaware operates at one of the lowest EBITDA margins in the industry. High attrition, high onsite mix and very high SG&A expenses are expected to keep the margins low. We have modelled peaking out of SG&A expenses in absolute terms giving an EBITDA expansion of 200bps in best case.
- **Valuation expensive. Discount to Infosys should widen.** Recent outperformance is factoring in the deal flows and discretionary spending to continue in 2011, which we are sceptical about. With uncertainty over macro environment, the PE discount between Tier-I and mid-Tier IT companies should widen. We value the stock at 9x CY12 FDEPS giving us a target price of Rs80. DCF target price is Rs82.1.
- **Key risk.** Improved license sale of SAP and PeopleSoft, higher IT budget for 2011 leading to high discretionary spending would pose a risk to our SELL rating.

Key Data

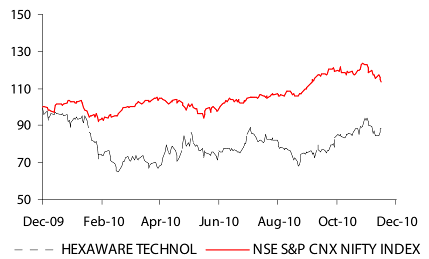
Bloomberg Code	HEXW IN
Reuters Code	HEXT.BO
Current Shares O/S (mn)	145.2
Diluted Shares O/S(mn)	145.2
Mkt Cap (Rsbn/USDmn)	14.1/313.7
52 Wk H / L (Rs)	105/64
Daily Vol. (3M NSE Avg.)	1,417,197
Face Value (Rs)	2
USD = Rs45.1	

Shareholding Pattern (%)



As on 30 September 2010

One Year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
Hexaware Tech.	6.2	29.5	2.2
NIFTY	(3.5)	14.4	14.5

Source: Bloomberg, Centrum Research
**as on 10 December 2010*

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Y/E Dec (Rsmn)	Revenue	*YoY (%)*	EBITDA	*EBITDA (%)*	Adjust. PAT	*YoY (%)*	Fully DEPS	*RoE (%)*	*RoCE (%)*	P/E (x)	EV/EBITDA (x)
CY08	11,519	*10.8*	1,226	*10.6*	590	*(52.7)*	4.0	*8.6*	*12.5*	24.6	9.3
CY09	10,386	*(9.8)*	2,023	*19.5*	1343	*127.5*	9.0	*17.8*	*20.5*	10.8	5.0
CY10E	10,512	*1.2*	858	*8.2*	716	*(46.7)*	6.4	*10.5*	*6.5*	15.3	11.6
CY11E	12,620	*20.1*	1,307	*10.4*	1203	*68.0*	8.1	*12.0*	*10.1*	12.1	7.1
CY12E	14,210	*12.6*	1,525	*10.7*	1323	*10.0*	8.9	*12.0*	*11.0*	11.0	6.1

Source: Company, Centrum Research Estimates

Please refer to important disclosures/disclaimers in Appendix A

Shareholding pattern (%)

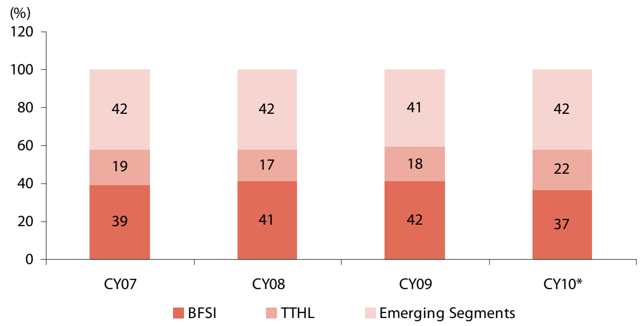
	Q4 09	Q110	Q210	Q310
Promoter	28.65	28.50	28.52	28.45
FIIs	37.76	36.68	36.85	36.28
Dom inst.	7.19	6.62	7.05	7.47
Public & others	26.4	28.30	27.68	27.80
Total	**100.00**	**100.00**	**100.00**	**100.00**

Source: BSE

Company Background

Hexaware Technologies is listed on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) in India and has GDRs listed on the London Stock Exchange (LSE). Hexaware is a global provider of information technology (IT) and process outsourcing services. It focuses on three verticals: Banking, Financial Services and Insurance (BFSI); Travel, Transport, Hospitality and Logistics (TTHL), and emerging verticals, including life sciences and healthcare, manufacturing and professional services. The company's technology solutions include enterprise solutions, business intelligence and analytics, quality assurance and testing services, human resource IT services, application development and management, technology consulting services and business process outsourcing services

Vertical Split



Source: Company, Centrum Research
** Till Q2*

Key events/timeline

- 1990: Company is formed in India
- 1995: Begins operations in India
- 2001: Merges with the software division of Aptech
- 2001: Hexaware goes public in January
- 2005: Ranked 11th in NASSCOM top 20.
- 2006: Hexaware acquires FocusFrame in November.
- 2008: Appoints P. R. Chandrasekar as CEO & Prateek Aggarwal as CFO in June.
- 2008: Acquired the remaining stake from its JV partner Pemtrad International, to convert RiskTech into a wholly owned subsidiary.

Source: Company, Centrum Research

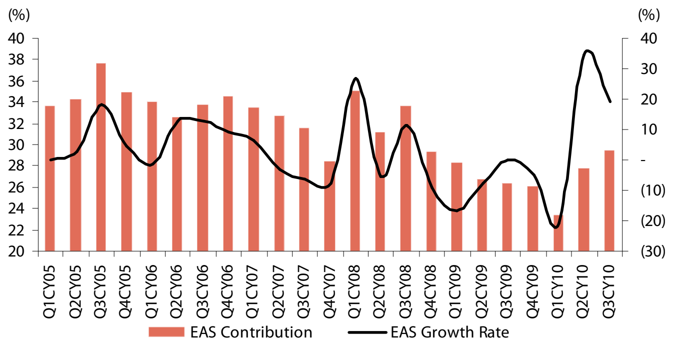
Name of the Person	Designation	Particulars
Atul Nishar	Founder and Chairman	Atul Nishar is an FCA (Fellow of the Institute of Chartered Accountants of India) and received his Bachelor Degrees in Commerce and Law from University of Bombay. He is the driving force of Hexaware's strategic direction and marketing focus. Under his leadership, Hexaware Technologies has grown into a multi-million dollar, global software and BPO services corporation, listed on Indian and London Stock Exchanges.
P R Chandrasekar	Global CEO and Vice President	P.R.Chandrasekar has a degree in Engineering from the Indian Institute of Technology, Madras (IIT-M) and has done his MBA from the Jamnalal Bajaj Institute of Management Studies, Mumbai University. He has a successful track record of driving revenue growth for a company including experience in mergers and acquisitions, business development, channel development and strategic initiatives.
Prateek Aggarwal	CFO	Prateek is a Management graduate from IIM-Calcutta and a Commerce Graduate from Delhi University. He has over 18 years of strong and varied experience in a diverse set of financial & operational roles.
Rajiv Pant	President - North America Operations	He has a dual degree from Birla Institute of Technology and Science (BITS), Pilani with a Master of Science in Chemistry and Master of Management Studies. Rajiv Pant heads the North American Operations for Hexaware. He joined Hexaware from Wipro Technologies, where he was Vice President of Enterprise Solutions spending nearly a decade in roles of increasing responsibility. Pant has also worked with Apple Computer and Microsoft.
Ramanan R V	President Global Delivery & Chief Software Architect	R V Ramanan holds a Post Graduate degree in Technology from IIT Delhi. Ramanan has been with Hexaware for over seven years. He has been instrumental in establishing new service offerings and growing the Testing (QATS) and Business Intelligence & Analytics horizontal practices at Hexaware.
R U Srinivas	Chief Executive Officer, Caliber Point	R U has worked for nearly 2 decades across India, Singapore and the US in leading global companies across various industries including Audit, Banking, IT and ITES companies, in a wide range of roles including Mergers and Acquisitions, Finance, Corporate Planning, Quality and Operations.
Deependra Chumle	Chief People Officer	Deependra is a Commerce graduate and an MBA from Pune. He has 23 years of experience in Human Resources with an in depth industry knowledge of Hotels, Banking, IT and ITES.

Source: Company, Centrum Research

Investment Rationale

- Hexaware, which depends on EAS for almost a third of its revenue, could see its revenue taking a hit in 2011 and 2012 as pent up demand subsides and discretionary spending ebbs due to slower US economy. We model a revenue growth of 20% in CY11E and 13% in CY12E.
- Focus on horizontals like EAS, lack of breadth in service lines and the lack of vertical expertise is keeping Hexaware from gaining incremental wallet share of its clients. Apart from the top 5 clients who led the recent growth, its client mining record has been poor.
- Hexaware has one of the lowest EBITDA margins in the industry. With high attrition levels putting pressure on gross margin, even lowering SG&A as a percentage of sales would not help the margin significantly. We model a 200 bps improvement in EBITDA margin.
- With low margins, volatile earnings and uncertain macro conditions, PE discount to Infosys should widen. We value the stock at 9x CY12E FDEPS.

Exposure to discretionary projects makes earnings volatile



Source: Company, Centrum Research

Summary Financial

Y/E Dec (Rsmn)	CY08	CY09	CY10E	CY11E	CY12E
Key Income Statement Data					
Net Sales	11,519	10,386	10,512	12,620	14,210
-Growth (%)	*10.8*	*(9.8)*	*1.2*	*20.1*	*12.6*
EBIDTA	1,226	2,023	858	1,307	1,525
-EBIDTA margin (%)	*10.6*	*19.5*	*8.2*	*10.4*	*10.7*
Depreciation	284	270	237	260	293
EBIT	942	1,753	621	1,047	1,232
Interest expenses	-	-	-	-	-
PBT from operations	942	1,753	621	1,047	1,232
Other non operating income	181	310	490	318	428
PBT	745	1,446	1,017	1,431	1,726
-PBT margin (%)	*6.5*	*13.9*	*9.7*	*11.3*	*12.1*
Provision for tax	155	103	67	228	403
Net profit	590	1,343	716	1,203	1,323
-Growth (%)	*(52.7)*	*127.5*	*(46.7)*	*68.0*	*10.0*
-Net profit margin (%)	*5.1*	*12.9*	*6.8*	*9.5*	*9.3*
Key Cash Flow Statement Data					
Cash generated from operations	1,586	1,478	956	1,415	1,534
Cash flow from investing activities	1,110	(1,189)	(980)	(1,100)	(1,100)
Cash flow from financing activities	69	(223)	(32)	(404)	(437)
Net cash increase/ (decrease)	1,864	66	(56)	(89)	(3)
Key Balance Sheet Data					
Shareholders fund	7,860	8,903	9,520	10,519	11,604
Debt	194	162	464	264	64
Minority Interest	(1,234)	(405)	-	-	-
Total Capital Employed	6,820	8,660	9,984	10,783	11,668
Fixed Assets	4,498	4,358	4,629	4,969	5,277
Investments					
Net current assets	3,507	4,636	5,193	5,652	6,230
Total Assets	6,820	8,660	9,984	10,783	11,668
Key Ratios (%)					
ROCE	*12.5*	*20.5*	*6.5*	*10.1*	*11.0*
ROIC	*16.5*	*30.4*	*9.2*	*13.6*	*14.4*
ROE	*8.6*	*17.8*	*10.5*	*12.0*	*12.0*
Turnover Ratios					
Asset turnover ratio (x)	1.1	0.9	0.8	0.9	0.9
Working capital cycle (days)	23.4	63.4	84.8	86.5	91.7
Average collection period (days)	65.4	53.6	63.1	57.5	58.4
Per share (Rs)					
Basic EPS	4.1	9.3	6.6	8.3	9.1
Fully diluted EPS	4.0	9.0	6.4	8.1	8.9
Book value	45.7	58.6	65.7	72.6	80.0
Solvency Ratios (%)					
Debt/Equity	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Interest Coverage	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Valuation Parameters (x)					
P/E	24.6	10.8	15.3	12.1	11.0
P/BV	2.1	1.7	1.5	1.3	1.2
EV/EBIDTA	9.3	5.0	11.5	7.1	6.1
EV/Sales	1.0	1.0	0.9	0.7	0.6
M-cap/Sales	1.2	1.4	1.3	1.1	1.0

Source: Company, Centrum Research Estimates

EBITDA margin improvement would not be significant

Investment Argument

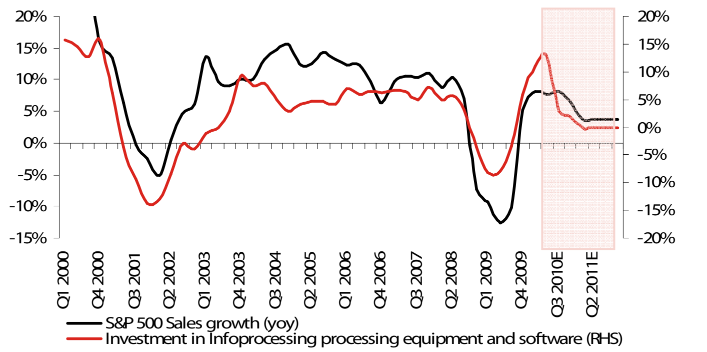
Discretionary spending to slow down as pent demand ebbs and US economy slows down

Recent discretionary spending pick up not sustainable

Discretionary spending has picked up in past few quarters, benefitting most Indian IT services firms including Hexaware. This was driven partly by pent up demand and partly by the recovery in US economy post the financial crisis. The spike in investment in information processing software and equipment in H12010 indicates a divergence from the long term trend with S&P500 sales. This we believe is due to conservative spending on discretionary and transformational projects during the downturn which was compensated for in the first half of 2010. We believe this pent up demand is not sustainable and will likely ebb going forward in 2011. 2011 in our opinion will be a year of normalization and possible slowdown in IT services spending in general and discretionary spending in particular. (Refer to our sector report: "*Focus on Macro and not the micro*" dated 19 Oct 2010).

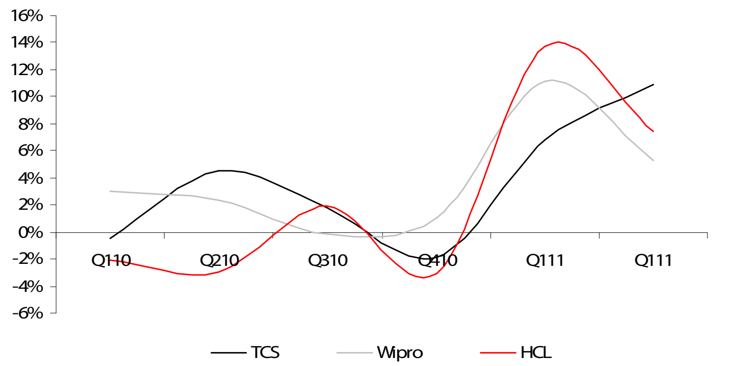
Apart from the pent up demand, US economic recovery in the first half of 2010 led to higher corporate profits and therefore higher spending on IT. Our base case scenario predicts a below trend US real GDP growth rate of 1-2% in 2011 versus a consensus expectation of 2.6%. In that case, the S&P sales growth would likely be below the consensus expectation of 5.8% (See exhibit 4) which will drive down the spending on discretionary projects.

Exhibit 1: Spike in IT capex is due to pent-up demand and one offs



Source: Bloomberg, Bureau of Economic Analysis, Centrum Research Estimates

Exhibit 2: Discretionary project revenue has picked up for most of the IT services companies : May not sustain in 2011



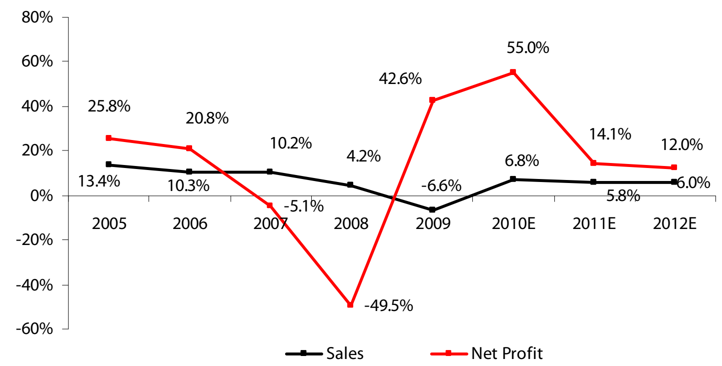
Source: Bloomberg, Centrum Research

Exhibit 3: Economic Scenarios and likely impact on Indian IT services sector

Economic scenario in 2011	Likely GDP growth	S&P 500 sales growth	Impact on Indian IT services	Probability – our view	Impact on earnings and valuations	% age of the street believing in this scenario explicitly or implicitly
Trend growth	2.5-3% YoY US real GDP growth, with about 1-2% inflation	7-11%	20%-30% revenue growth. Positive growth in IT budgets. Discretionary spend pick - continues. Stable pricing.	30%	Earnings upgrade cycle will continue for some more time. PE multiple could expand further with respect to the market. PE multiples likely to be at 1SD above mean.	90-95%
Below trend growth	1-2% real GDP growth. 0.5%-1% inflation	2-5%	15-20% revenue growth. Stagnant or moderately declining IT budgets. Discretionary spend gets pushed back. Moderate pricing pressure.	60%	Earnings upgrade cycle will stall and then reverse. PE multiples will contract moderately, both on an absolute basis and also with respect to the market. PE multiples are likely to be in line with mean/median	5-10%
Double dip situation	Negative real GDP growth with likely deflation	Negative	0-10% revenue growth. Reasonable cuts in IT budgets. Very little discretionary spending. Likely significant pricing pressure.	10%	Severe earnings downgrade cycle likely. PE multiple will contract dramatically on an absolute basis and also with respect to the market. PE multiples are likely to be 1SD below the average, or even lower.	0%

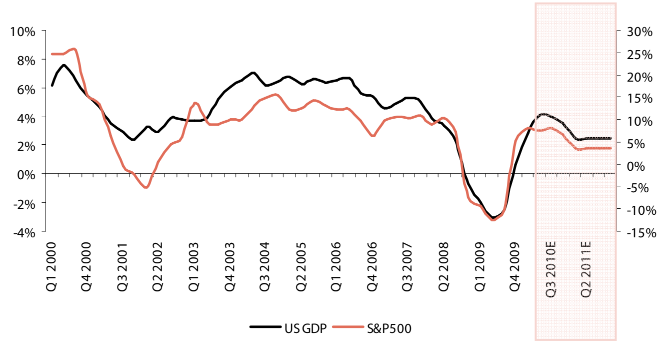
Source: Centrum Research

Exhibit 4: S&P 500 sales would be lower than expected in our base case (Below trend GDP growth) scenario



Source: Bloomberg, Centrum research

Exhibit 5: US economic recovery in first half resulted in higher S&P500 sales



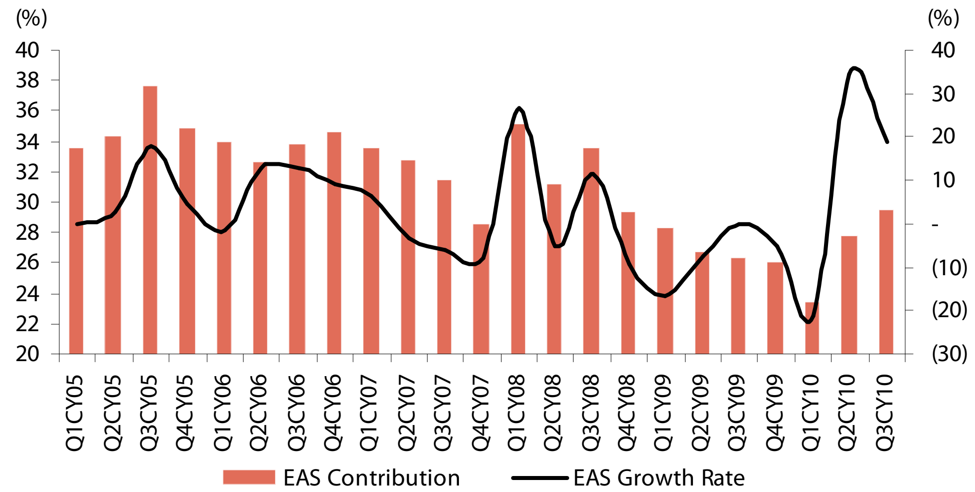
Source: Bloomberg, Centrum research

As Hexaware depends on discretionary spending for almost a third of its revenue, any decline in discretionary spending would have negative repercussions on its revenue.

Focus on Enterprise Software (EAS) makes the earnings volatile

Hexaware positions itself as a niche player in Enterprise Application Services (EAS) space especially in the implementation of Peoplesoft and SAP software. Because of its discretionary nature, the adoption and spending on such enterprise software is irregular. This directly impacts the revenue stream of players like Hexaware. This hypothesis is supported by revenue contribution from EAS which has been volatile over the years. With many smaller players providing implementation and support of SAP and Peoplesoft, we believe it is no longer a niche segment in the IT services space. As argued above, push back in discretionary spending in 2011 would impact Hexaware's revenue negatively going forward.

Exhibit 6: Growth of EAS has been volatile



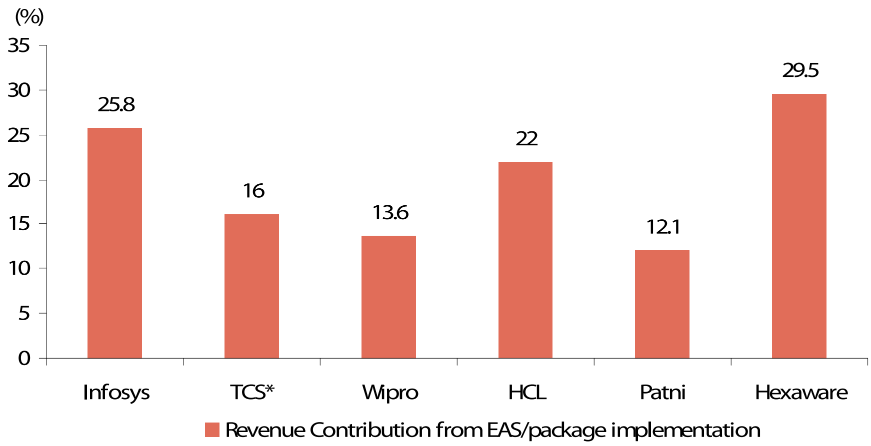
Source: Company, Centrum Research

Lack of differentiation in offerings caps client's wallet share

EAS targeted by most IT services firms

Enterprise solutions like Peoplesoft, SAP and Oracle services are among primary areas of focus for Hexaware. Although the company has positioned itself as a niche player in this segment, this space is no longer a niche in the industry. Most IT services firms, including Tier-I and Tier-II players, have EAS in their portfolio. This leaves Hexaware with very little differentiation in its service offerings. Mid tier IT services companies with limited delivery capabilities and commoditized service offerings would find it difficult to sustain their growth in case of vendor consolidation or weak macro environment.

Exhibit 7: Most of the IT services players are present in EAS implementation space



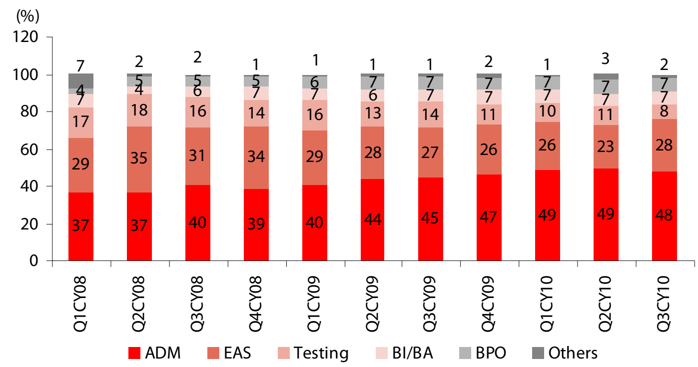
** Included BI for TCS, Source: Company, Centrum Research*

Lack of vertical expertise; largely a horizontal player

Hexaware lacks breadth in its horizontal offering as well as lacks any strong vertical expertise. The company re-aligned itself to become more focussed on verticals only in 2009. The verticals which it plans to address are BFSI, Travel, Transportation, Hospitality and Logistics (TTHL) and emerging verticals including healthcare and manufacturing. It is still early days for Hexaware to develop strong vertical expertise in these areas where others have decades of experience. TTHL is the only vertical where Hexaware has differentiated capabilities. Unless vertical capabilities are established, it would be difficult for Hexaware to increase the client's wallet share.

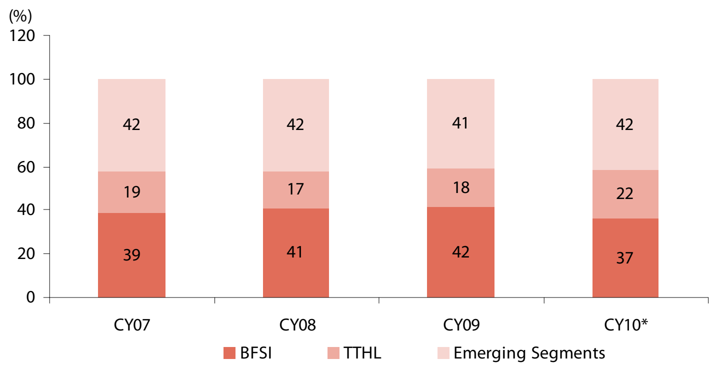
Even among horizontals, Hexaware's strength is concentrated to a few horizontals namely EAS, Application development and Maintenance (ADM) and testing services. ADM which is a low margin and low growth segment constitutes ~50% of Hexaware's revenue. Hexaware does not have presence in growth areas like Infrastructure Management Services (IMS) which has been the fastest growing horizontals in IT services.

Exhibit 8: Hexaware is present in traditional horizontals; absent in growth areas like IMS



Source: Bloomberg, Bureau of Economic Analysis, Centrum Research Estimates

Exhibit 9: Hexaware has limited vertical expertise



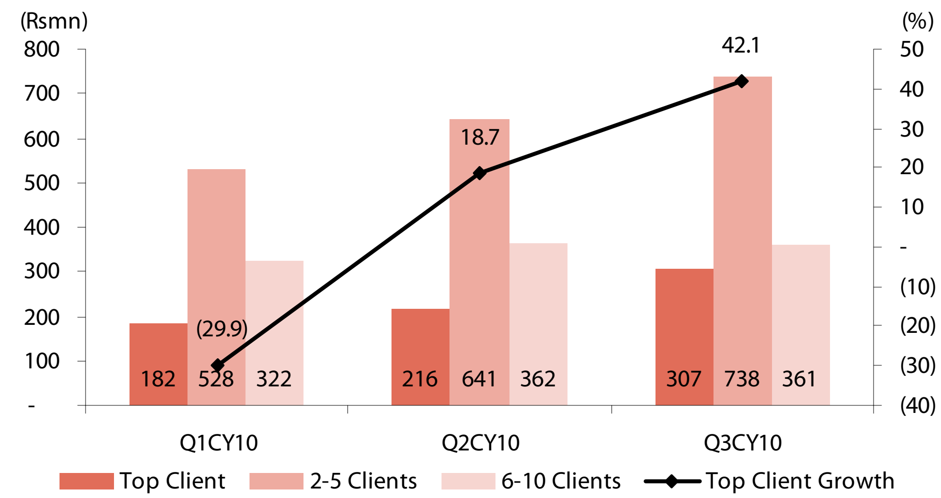
Source: Bloomberg, Centrum Research

Growth concentrated on a few clients

Volume growth led by the top client

Hexaware's double digit growth in the last two quarters was largely led by its top 5 clients and especially the top client who grew by 18.7% and 42.1% sequentially in Q2CY10 and Q3CY10 respectively. Top 10 clients excluding the top 5 clients grew only by 12.4% and -0.3% in the same period. This is against the overall company growth of 13% and 12% respectively. Recent large wins from existing customers could explain the growth in these accounts.

Exhibit 10: Top client has grown much faster than the company

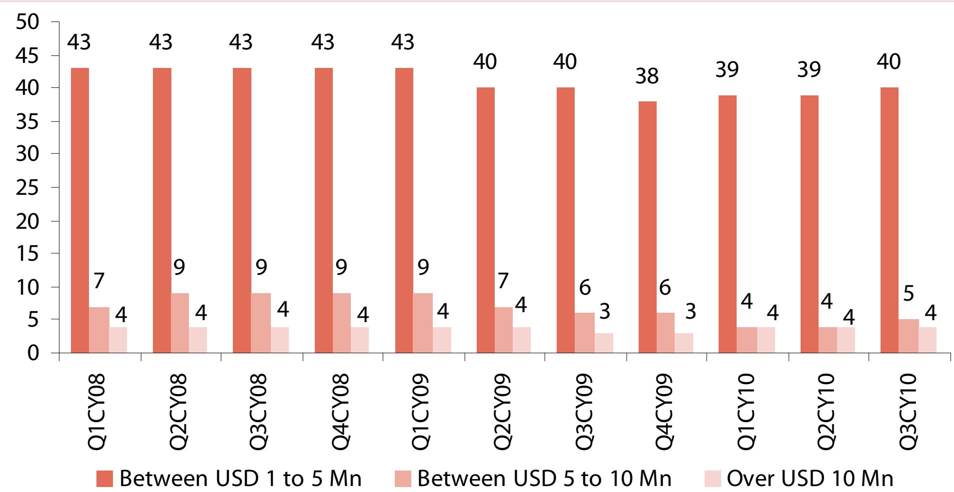


Source: Company, Centrum Research

Client mining has been poor

Hexaware has not been able to add clients with annual run rate of over $10mn for last three years. The number of clients with revenue of >$10mn has been stable at 4 while clients with revenue from $1mn-$5mn and from $5mn-$10mn have declined. This is despite very high expenditure on Sales and Marketing. The limited array of service offerings and the lack of any substantial vertical expertise could be some of the reasons for Hexaware's inability to make in-roads into the client's wallet share. This also explains the dependence on the top clients for majority of its revenue.

Exhibit 11: Number of clients above $1mn has been declining



Source: Company, Centrum Research

Making it vulnerable to concentration risk

Hexaware gets ~37% revenue from its top 5 clients and ~50% from its top 10 clients. It has not been able to diversify from these few large clients. This poses a concentration risk to the company as disruptions in the revenue stream from any of these top clients could prove detrimental to Hexaware.

Are large deals at exorbitant prices adding value to shareholders?

Hexaware has spent upfront a one time amount of ~$9.15mn as cost provisioning for the $110mn deal it won in Q2CY10. With the revenue from this deal spread over the next five years, a large upfront expenditure makes this deal value decretive. So while such deals can help the company boost its top line and meet revenue guidance, it would not add any shareholder value.

Exhibit 12: NPV of $110mn deal is negative even at higher than company's EBITDA margin

($mn)	CY10	CY11	CY12	CY13	CY14	CY15
Revenue		22	22	22	22	22
Project EBITDA (@12%)		2.64	2.64	2.64	2.64	2.64
Upfront Cost	(9.15)					
Discounted Cash Flow	(9.15)	2.3	2.0	1.8	1.5	1.3
NPV	**(0.2)**					
Discount Rate (WACC)	14.56%					

Source: Company, Centrum Research Estimate

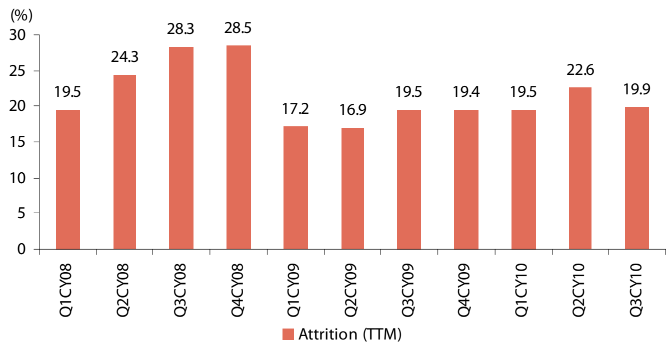
Financial Analysis

Margins to remain an Achilles heels

High attrition levels and onsite revenue mix to keep pressure on gross margin

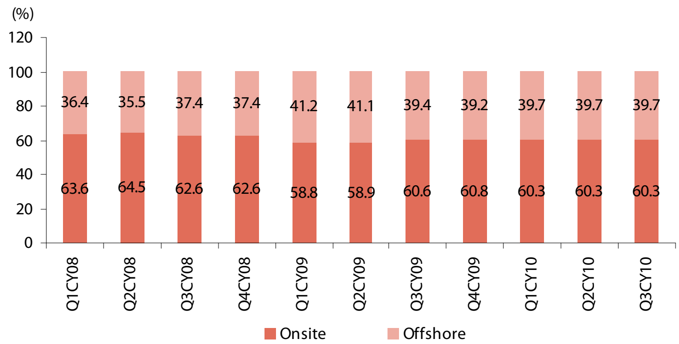
Hexaware has historically suffered from high attrition levels. Even during the downturn when attrition levels dropped across the Industry, Hexaware's numbers were high. Hexaware will face higher wage pressure to retain talent affecting its gross margin. A high onsite revenue mix due to the implementation of Enterprise software would mean that Hexaware cannot utilize the offshore leverage to counter margin pressures.

Exhibit 13: Company will face higher wage pressure to contain attrition



Source: Company, Centrum Research

Exhibit 14: High onsite mix has an adverse effect on margin



Source: Company, Centrum Research

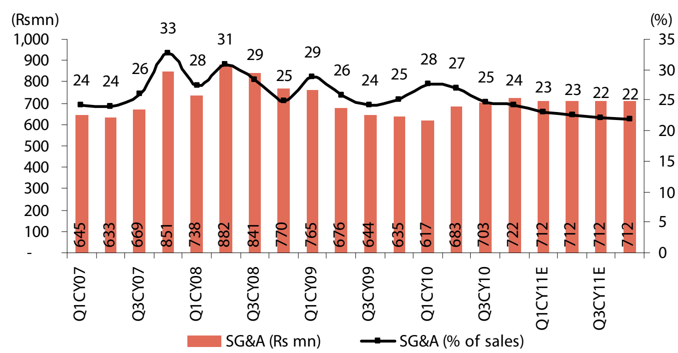
High SGA without significant output

At more than 25% of sales, Hexaware's SG&A expenses have been above the industry average. In spite of this, there has been a drop in the number of $1mn+ clients from its portfolio. This is one of the major reasons for the low operating margins of the company. We have tried to analyze the impact of SG&A peaking out (in absolute terms) to the EBITDA margin. The result is not very encouraging as the margin would improve only by 200bps in the best case scenario.

We model SG&A to peak out…

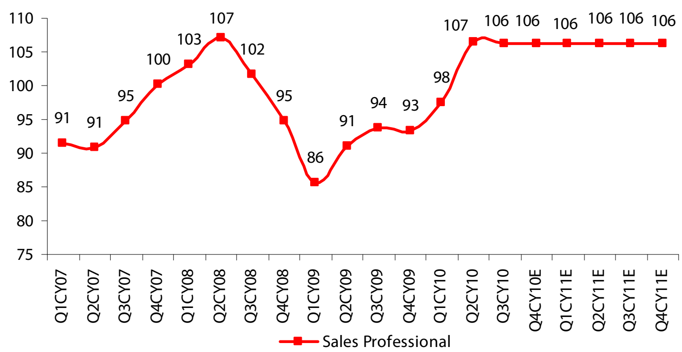
The company increased its sales headcount by more than 10% recently and would therefore not need further investment there. We estimate SG&A to peak out and stabilize on an absolute basis thus bringing down SG&A as a percentage of sales.

Exhibit 15: SGA could peak out in absolute terms



Source: Company, Centrum Research Estimates

Exhibit 16: Sales Personnel enough till CY11

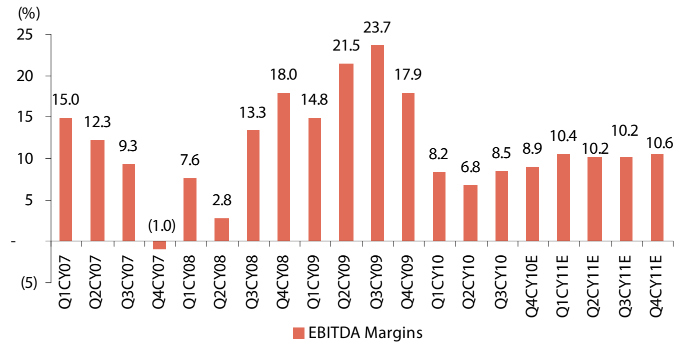


Source: Centrum Research Estimates

.. Still the EBITDA margin expansion would not be significant

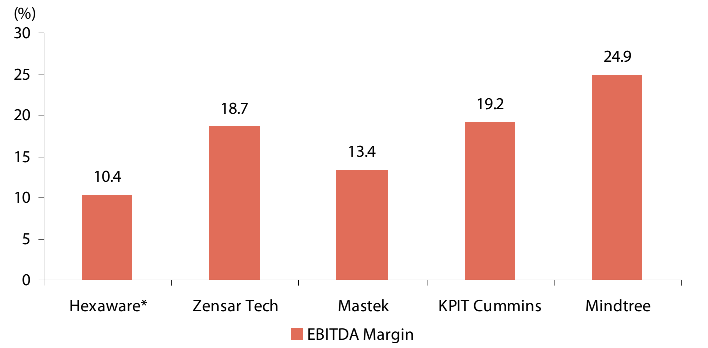
Considering the best case scenario with no further increase in the sales force, the improvement in EBITDA margins that we expect is ~210bps by Q4CY11. This will result in Q4CY11 EBITDA margin of 10.5% which is still way below the industry average. A comparison with the peer set of other Tier-II companies indicates that Hexaware's margin is lower than even its closest peers.

Exhibit 17: EBITDA Margins could improve by 200 bps



Source: Company, Centrum Research Estimates

Exhibit 18: But it would still remain below the peers

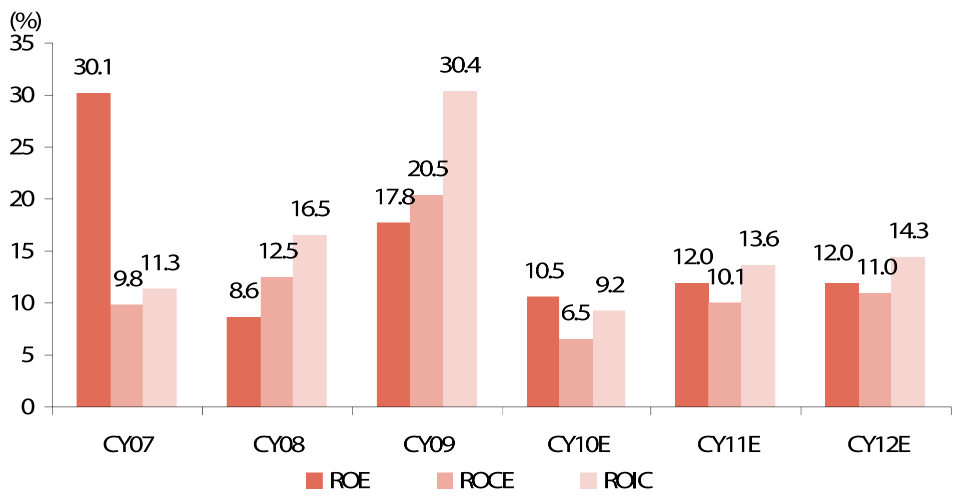


** CY11E EBITDA Margin for Hexaware, FY10 for others*
Source: Capitaline, Centrum Research

Return ratios will likely remain low

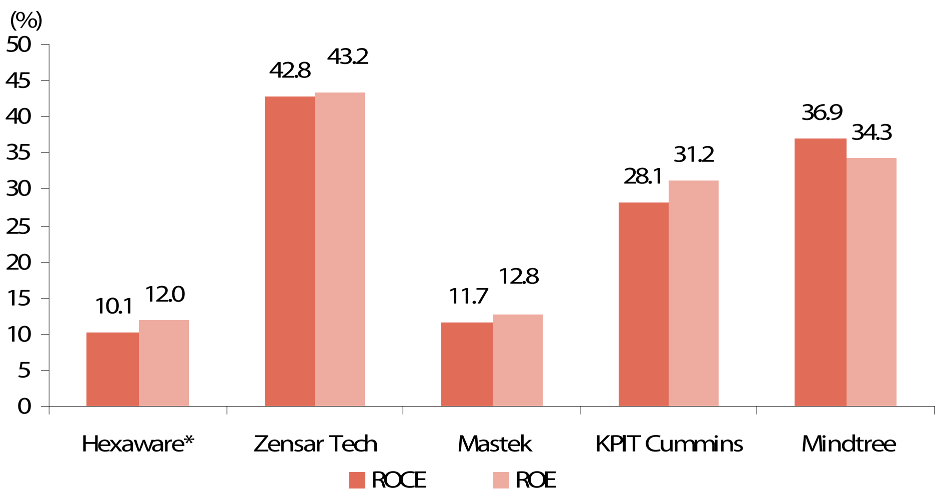
Low EBITDA margin would translate to lower return ratios. ROE is expected to remain constant due to an increase in effective tax rates while ROCE and ROIC (Return on Invested Capital) would improve marginally. It would however remain significantly below the industry average and its peer set.

Exhibit 19: Return Ratio would not improve significantly



Source: Company, Centrum Research Estimate

Exhibit 20: Hexaware has one of the lowest return ratios



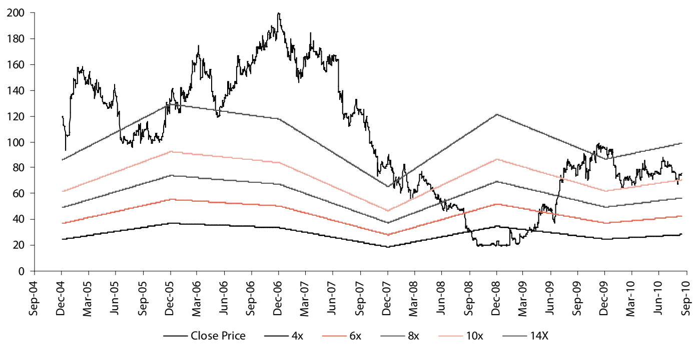
**CY11E return ratios for Hexaware; FY10 for others; Source: Capitaline, Centrum Research*

Valuation

Discount to Infosys should widen from current levels

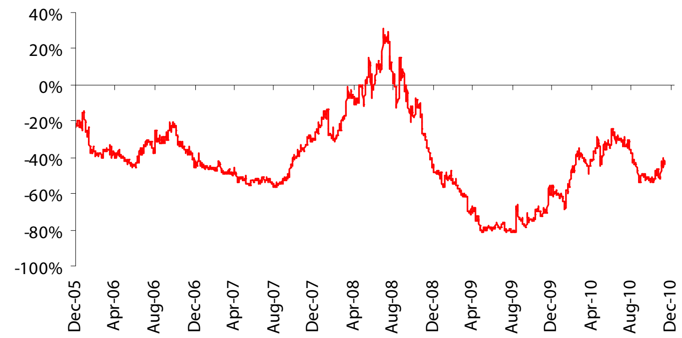
Hexaware has traded at an average discount of 57% to infosys over the last two years. The stock is currently trading at one year forward rolling PE of 13.22x, a discount of 47% to Infosys. With significantly low return ratios, poor margins, lack of differentiation in service offerings and past inconsistencies in its revenue and uncertain macro environment, the scrip warrants a higher discount to Infosys.

Exhibit 21: Price Band



Source: Bloomberg, Centrum Research Estimates

Exhibit 22: Hexaware's discount to Infosys has narrowed



Source: Bloomberg, Centrum Research

Target Price: Rs81, Downside: 17%; Sell

We have valued the company through the DCF and relative valuation methods and taken the average target price of Rs81 as the fair value.

Relative Valuation (P/E)

We value the stock at 9x CY12 FDEPS, at a discount of 57% to our Infosys target PE of 21x. We have taken the last two years' average discount as our base case. We believe with uncertainity over the macro environment and probability of discretionary spending push back relatively high, the discount between Tier-I and Tier-II firms should widen. 9x CY12 FDEPS gives us a target price of Rs80.

Exhibit 23: DCF Valuation

(Rsmn)	
WACC	14.56%
Ke	14.9%
Risk free rate	7.5%
Market Return	15.0%
Beta	0.98
Kd	7.64%
Terminal Growth Rate	4.0%
PV of Cash Flow till CY21	3,904
Terminal Value	19,441
PV of Terminal Value	3,806
Firm Value	7,710
Add: Cash & Equivalent	4,650
Less: Debt	464
Equity Value	11,896
Price/Share	**82.1**

Source: Company, Centrum Research

DCF Valuation

DCF Valuation gives a price of Rs 82.1/Share, an implied multiple of 9x. We have taken the revenue CAGR of 10% from CY13-CY21 and average EBIT margin of 7%.

Exhibit 24: Sensitivity with WACC and Terminal Growth

	WACC	12.6%	13.6%	14.6%	15.6%	16.6%
Terminal Growth Rate	**3.0%**	91.4	83.8	77.5	72.2	67.8
	3.5%	97.2	88.1	80.8	74.7	69.7
	4.0%	99.6	89.8	82.1	75.7	70.5
	4.5%	102.3	91.8	83.5	76.8	71.3
	5.0%	105.3	94.0	85.1	78.0	72.3

Source: Centrum Research

Summarizing both the valuation

Exhibit 25: Summary of Valuation

	P/E	DCF	Average
Target Price	79.9	82.1	81.0

Source: Centrum Research Estimates

We believe Rs82.2 is a fair value for the stock which gives a downside of 18% from current levels. We recommend a SELL.

Risks

Key upside risks

- More than expected business coming from PeopleSoft 9.1 launch.
- Increase in EAS revenue could improve the average billing rate for the company thus improving the top line and gross margin.
- Improvement in overall macro scenario.

Key downside risks

- Positioning as a niche player in the Enterprise Application space could be detrimental if enterprises stop their discretionary spending.
- Client concentration could be detrimental if the client ramps down projects. Top 5 clients drove the growth of the company recently.
- Inability of the company to improve its operating margins from current levels. We have modelled a 200 bp improvement in EBITDA margin till the end of CY12.
- Currency fluctuation remains a concern. It has to be seen if the company has learned from its past mistakes in its hedging policy.

Appendix

Exhibit 26: Assumption Table

	CY09	CY10E	CY11E	CY12E
Employees				
Closing Headcount	5,137	6,424	6,781	7,340
Gross Addition	469	2,421	1,600	2,000
Billing Rate ($/Hr)				
Onsite	68.6	71.1	72.6	72.6
Offshore	23.2	21.8	21.5	21.5
Volume Growth (%)				
Onsite	(15)	33	19	10
Offshore	(15)	14	12	18
Exchange Rate				
$/Rs	48.39	45.645	46.00	46.00

Source: Company, Centrum Research Estimates

Exhibit 27: Factsheet

	Q1CY08	Q2CY08	Q3CY08	Q4CY08	Q1CY09	Q2CY09	Q3CY09	Q4CY09	Q1CY10	Q2CY10	Q3CY10
PnL (Rsmn)											
Revenue	2,670	2,845	2,946	3,059	2,643	2,591	2,632	2,520	2,220	2,513	2,817
EBITDA	204	80	393	550	392	558	623	450	183	171	240
Adjusted PAT	209	95	116	171	173	396	414	360	117	176	156
Vertical Mix (%)											
BFSI	44.8	40.1	38.8	40.5	41.7	40.4	41.9	42.3	40.8	36.5	35.5
TTHL	17.9	17.3	15.1	15.4	17.1	17.1	17.1	18.7	20	21.7	24.7
Emerging Segments	42.1	37.3	42.6	46.1	44.1	42.6	41.2	42.5	41	39	41
Horizantal Mix (%)											
ADM	37.1	40.4	38.8	40.4	44	44.7	46.6	48.5	49.2	48	44.3
EAS	35.1	31.2	33.6	29.4	28.3	26.7	26.3	26.1	23.4	27.8	29.5
Testing / BTO	17.6	16.1	13.6	16.3	13.1	13.9	11.4	10	10.6	8.1	7.3
BI/BA	3.5	5.8	7.3	6.6	6.4	6.7	7.4	7.3	6.5	6.8	8.4
BPO	5.2	5	5.3	6	6.8	7	6.7	6.8	7.4	7	6.6
Others	1.5	1.5	1.4	1.3	1.4	1	1.6	1.3	2.9	2.3	3.9
Delivery (%)											
Onsite	63.6	64.5	62.6	62.6	58.8	58.9	60.6	60.8	60.3	60.3	60.3
Offshore	36.4	35.5	37.4	37.4	41.2	41.1	39.4	39.2	39.7	39.7	39.7
Utilization (%)											
Volume Growth	3.5	(15.1)	(10.7)	3.7	(6.8)	(3.0)	0.3	3.4	(3.7)	18.5	9.5
Price Growth	(1.8)	19.2	10.0	(10.0)	(8.8)	5.0	1.4	(4.2)	(6.7)	(4.5)	1.5
Clients Concentration (%)											
Top Client	10	12.1	13.6	13.1	11.9	12.6	11.5	10.3	8.2	8.6	10.9
Top 5 Client	33.2	32.6	30.6	32.7	34.2	33.7	34.7	35	32	34.1	37.1
Top 10 Client	47.2	48.4	46.9	48.1	50	49.9	50.6	49.8	46.5	48.5	49.9
Number of Client											
$10mn+	4	4	4	4	4	3	3	4	4	4	4
$5mn-$10mn	9	9	9	9	7	6	6	4	4	5	7
$1mn-$5mn	43	43	43	43	40	40	38	39	39	40	39
Employee Number	6,927	6,598	5,924	5,622	5,296	5,041	5,006	5,137	5,304	6,031	6,308
Attrition (%)- TTM	19.5	24.3	28.3	28.5	17.2	16.9	19.5	19.4	19.5	22.6	19.9

Source: Company, Centrum Research

Financials

Exhibit 28: Income Statement

Y/E Dec (Rsmn)	CY08	CY09	CY10E	CY11E	CY12E
Net Sales	11,519	10,386	10,512	12,620	14,210
-Growth (%)	*10.8*	*(9.8)*	*1.2*	*20.1*	*12.6*
Cost Of Revenue	7,062	5,643	6,929	8,466	9,338
% of sales	*61.3*	*54.3*	*65.9*	*67.1*	*65.7*
SG & A	3,231	2,720	2,725	2,847	3,347
% of sales	*28.0*	*26.2*	*25.9*	*22.6*	*23.6*
EBIDTA	1,226	2,023	858	1,307	1,525
-EBIDTA margin (%)	*10.6*	*19.5*	*8.2*	*10.4*	*10.7*
Depreciation	284	270	237	260	293
EBIT	942	1,753	621	1,047	1,232
Interest exp	-	-	-	-	-
PBT from operations	942	1,753	621	1,047	1,232
Other income	181	310	490	318	428
Forex (Gain)/loss	378	617	318	(66)	(66)
PBT	745	1,446	1,017	1,431	1,726
-PBT margin (%)	*6.5*	*13.9*	*9.7*	*11.3*	*12.1*
Provision for tax	155	103	67	228	403
Effective tax rate (%)	*20.8*	*7.1*	*6.6*	*15.9*	*23.4*
Net profit	*590*	*1,343*	*950*	*1,203*	*1,323*
Exceptional Items	-	-	*224*	-	-
Adjusted Net profit	590	1,343	716	1,203	1,323
-Growth (%)	*(52.7)*	*127.5*	*(46.7)*	*68.0*	*10.0*
-Net profit margin (%)	*5.1*	*12.9*	*6.8*	*9.5*	*9.3*

Source: Company, Centrum Research Estimates

Exhibit 29: Balance Sheet

Y/E Dec (Rsmn)	CY08	CY09	CY10E	CY11E	CY12E
Share capital	288	290	290	290	290
Preference capital	-	-	-	-	-
Reserves & surplus	7,572	8,613	9,230	10,229	11,314
Total shareholder's fund	7,860	8,903	9,520	10,519	11,604
Loan fund	194	162	464	264	64
Forex MTM	(1,234)	(405)	-	-	-
Total capital employed	**6,820**	**8,660**	**9,984**	**10,783**	**11,668**
Gross block	5,700	5,762	6,153	6,753	7,353
Accumulated depreciation	1,202	1,404	1,524	1,784	2,076
Net Block	4,498	4,358	4,629	4,969	5,277
Capital WIP	-	-	-	-	-
Net fixed assets	4,498	4,358	4,629	4,969	5,277
Cash and bank	2,849	4,262	4,678	5,089	5,586
Inventories	-	-	-	-	-
Debtors	2,065	1,526	1,818	1,987	2,273
Other current assets	1,035	1,113	1,362	1,490	1,704
Total current assets	5,949	6,901	7,858	8,566	9,563
Current liabilities and provisions	2,442	2,265	2,666	2,914	3,334
Net current assets	3,507	4,636	5,193	5,652	6,230
Other non current liabilities (MTM)	1,269	444	-	-	-
Deferred tax assets	84	110	162	162	162
Total assets	**6,820**	**8,660**	**9,984**	**10,783**	**11,668**

Source: Company, Centrum Research Estimates

Exhibit 30: Cash flow

Y/E Dec (Rsmn)	CY08	CY09	CY10E	CY11E	CY12E
Cash flow from operating					
Profit before tax	745	1,445	1,017	1,431	1,726
Depreciation	284	271	237	260	293
Other non cash charges	(107)	(215)	(39)	-	-
Operating profit before WC change	922	1,501	1,215	1,691	2,019
Working capital adjustments	901	201	(140)	(48)	(81)
Tax Paid	(237)	(224)	(119)	(228)	(403)
Net cash generated from operating	**1,586**	**1,478**	**956**	**1,415**	**1,534**
Cashflow from investing					
Capex	(1,154)	(252)	(2,230)	(600)	(600)
Proceeds from sales of assets	5	170	1,722	-	-
Investments	2,292	(1,249)	(500)	(500)	(500)
Acquisition	(121)	-	-	-	-
Dividend/Interest Income	88	142	28	-	-
Net cash from investing	**1,110**	**(1,189)**	**(980)**	**(1,100)**	**(1,100)**
CF from financing					
Proceeds from share capital and premium	(1)	2	-	-	-
Borrowings	168.7	(24.4)	302.0	(200.0)	(200.0)
Addition to reserves	-	-	(164.0)	-	-
Interest paid	(13.8)	(17.5)	-	-	-
Dividend paid	(85)	(183)	(170)	(204)	(237)
Net cashflow from financing	**69**	**(223)**	**(32)**	**(404)**	**(437)**
Exceptional Item	(901)				
Net cash increase/(decrease)	**1,864**	**66**	**(56)**	**(89)**	**(3)**

Source: Company, Centrum Research Estimates

Exhibit 31: Key Ratios

Y/E Dec	CY08	CY09	CY10E	CY11E	CY12E
Profitability ratios (%)					
EBIDTA margin	*10.6*	*19.5*	*8.2*	*10.4*	*10.7*
PBIT margin	*8.2*	*16.9*	*5.9*	*8.3*	*8.7*
PBT margin	*6.5*	*13.9*	*9.7*	*11.3*	*12.1*
PAT margin	*5.1*	*12.9*	*6.8*	*9.5*	*9.3*
Return ratios (%)					
ROCE	12.5	20.5	6.5	10.1	11.0
ROIC	16.5	30.4	9.2	13.6	14.4
ROE	8.6	17.8	10.5	12.0	12.0
Turnover Ratios					
Asset turnover ratio (x)	1.1	0.9	0.8	0.9	0.9
Working capital cycle (days)	23.4	63.4	84.8	86.5	91.7
Average collection period (days)	65.4	53.6	63.1	57.5	58.4
Per share (Rs)					
Basic EPS	4.1	9.3	6.6	8.3	9.1
Fully diluted EPS	4.0	9.0	6.4	8.1	8.9
Book value	45.7	58.6	65.7	72.6	80.0
Solvency Ratio (%)					
Debt-equity	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Interest coverage ratio	-	-	-	-	-
Valuation (x)					
P/E	24.6	10.8	15.3	12.1	11.0
P/BV	2.1	1.7	1.5	1.3	1.2
EV/EBIDTA	9.3	5.0	11.5	7.1	6.1
EV/Sales	1.0	1.0	0.9	0.7	0.6
M-cap/Sales	1.2	1.4	1.3	1.1	1.0

Source: Company, Centrum Research Estimates

Appendix A

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Buy: Expected outperform Nifty by>15%, **Accumulate:** Expected to outperform Nifty by +5 to 15%, **Hold:** Expected to outperform Nifty by -5% to +5%, **Reduce:** Expected to underperform Nifty by 5 to 15%, **Sell:** Expected to underperform Nifty by>15%

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