

## IGATE GLOBAL SOLUTIONS

INR 385

*Growth intact, minor hiccups notwithstanding*

BUY



IGATE's Q4FY07 results were ahead of our expectations. Revenues at INR 2.1 bn were muted (sequentially flat), but net profit of INR 226 mn, up 41.7% Q-o-Q and 379.8% Y-o-Y, was ahead of our estimates. EBITDA margins for Q4FY07 stood at 15.3%, the highest since Q3FY01. This quarter completes a strong turnaround story for the company through FY07; profits grew nearly 200% in FY07, with EBITDA margins of 11.4% in FY07 (up 180bps from the FY06 level). Most importantly, the company has established a robust clientele which we believe, is likely to sustain its growth at healthy levels going forward.

We believe that iGATE's trajectory of EBITDA margins is likely continue to exhibit an uptrend and will be sustainable in the range of 16%-18% over the next two years. This, coupled with decent outlook on the IT-services business, is likely to translate into an EPS growth of 57.1% over FY07-09.

We have revised our EPS estimates for FY08E and FY09E downwards by 8.8% and 3.3% respectively on account of weakness seen in the company's iTOPS revenue segment. At CMP of INR 385, the stock trades at a P/E of 14.2x and 9.8x for FY08E and FY09E earnings respectively. The company's valuation on EV/EBITDA and EV/revenue for FY08E continues to be attractive at 7.4x and 1.2x, respectively. At a PEG of 0.25 we see the current valuations compelling. We maintain our 'BUY' recommendation on this stock.

## Key highlights of Q4FY07 and FY07

- Reported revenues (at INR 2.1 bn) are flat and below our growth estimate of 1.5% Q-o-Q. This tepidness is largely attributed to currency factors. Revenues for FY07 stood at INR 8.05 bn, up 26.6% from the FY06 level.
- Gross margins of 32.6% are up 140bps Q-o-Q and 260bps Y-o-Y, ahead of our expectations. The SG&A expenses declined by 7.5% Q-o-Q and 17.2% (as a percentage of revenues) as against 20.3% a year ago.
- EBITDA margin in Q4FY06 increased 260bps Q-o-Q and 570bps Y-o-Y, to 15.3%, averaging 11.4% in FY07 as against 9.6% in FY06. Notably, this is the highest level since Q3FY01. The management had guided to EBITDA margins exceeding 15% in Q4FY07, a year ago.

## Financials

| Year to March            | Q4FY07 | Q3FY07 | Growth % | Q4FY06 | Growth % | FY08E | FY09E  |
|--------------------------|--------|--------|----------|--------|----------|-------|--------|
| Revenue (INR mn)         | 2,101  | 2,107  | (0.3)    | 1,674  | 25.5     | 9,143 | 11,657 |
| Gross profit (INR mn)    | 684    | 658    | 4.0      | 502    | 36.3     | 3,036 | 3,998  |
| EBITDA (INR mn)          | 322    | 267    | 20.7     | 161    | 99.6     | 1,467 | 1,993  |
| Net profit (INR mn)      | 226    | 160    | 41.7     | 47     | 379.8    | 864   | 1,248  |
| EPS basic (INR)          | 7.2    | 5.1    | 41.8     | 1.5    | 377.5    | 27.2  | 39.2   |
| P/E (x)                  |        |        |          |        |          | 14.2  | 9.8    |
| EV/EBITDA (x)            |        |        |          |        |          | 7.4   | 4.9    |
| Market cap / Revenue (x) |        |        |          |        |          | 1.3   | 1.0    |

April 11, 2007

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## Market Data

52-week range (INR) : 432 / 145  
Share in issue (mn) : 31.6  
M cap (INR bn/USD mn) : 12.2 / 284.2  
Avg. Daily Vol. BSE ('000) : 43.9

## Share Holding Pattern (%)

Promoters : 81.9  
MFs, FIs & Banks : 2.2  
FIs : 5.3  
Others : 10.6

### Key highlights of Q4FY07 and FY07

- EBITDA margin in Q4FY06 increased 260bps Q-o-Q and 570bps Y-o-Y, to 15.3%, averaging 11.4% in FY07 as against 9.6% in FY06. Notably, this is the highest level since Q3FY01. The management had guided to EBITDA margins exceeding 15% in Q4FY07 a year ago.
- The company added six new customers during this quarter. Although only 25 clients were added in FY07, 40% of these additions (10 no.s) is in the million dollar category. The company's focus is on adding strategic clients, whom it can service across multiple lines of offerings.
- The headcount increased by 793, reaching 5,945 towards the year end. The company intends to add over 1000 personnel in FY08.
- EPS, in FY07, is INR 15.8 against our estimate of INR 14.3.
- Notably, offshore effort stood at over 75% of overall effort in FY07, higher than industry standards.

#### \* Enriched revenue composition to keep IT-services' growth intact

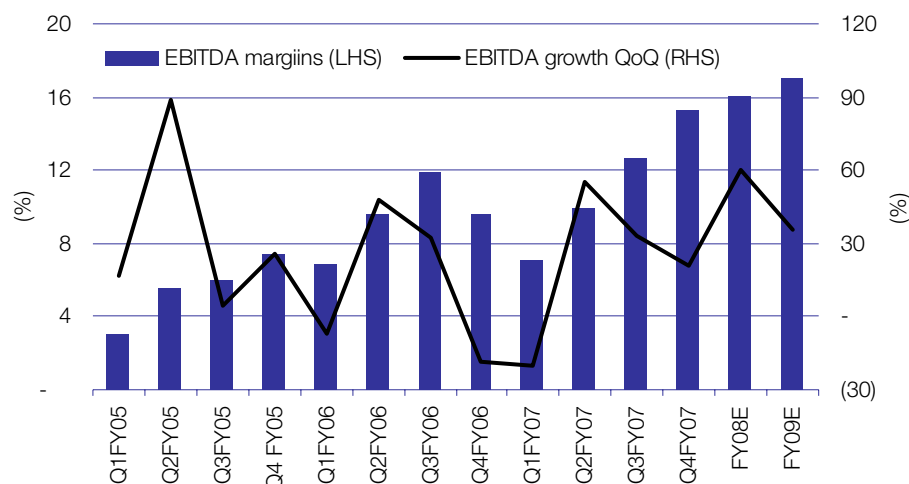
Over the last few years, iGATE is focused on its top ten clients, which has yielded desired results. Excluding revenues from GE (top client), the revenues from the other top nine clients have grown at an impressive 74.8% Y-o-Y. The offshore proportion of revenues is also increasing and currently stands at 47.5% of total revenues, the highest ever level and comparable with the best in the industry. iGATE has been focusing on getting a higher share of the client's total spend through introduction of newer services such as business intelligence, data warehousing, ERP, and infrastructure management. We believe this changing revenue composition, along with introduction of new high-margin services, will help iGATE maintain its growth rate of at least 25% in FY08 and FY09.

#### \* Uptrend in EBITDA margin to continue

We believe ongoing improvement in EBITDA is likely to continue in FY08 as well and is likely to reach a sustainable band of 16%-18%. Higher revenue share from new clients, who have been acquired at higher than the company's average billing rates, is one of the key margin drivers.

Cost rationalisation measures, including SG&A leverage and broad-basing of the employee pyramid, will also enable margin expansion. We forecast the company's EBITDA margin to expand to 16% in FY08E and 17.1% in FY09E.

**Chart1: Historical and forecasted EBITDA margins and EBITDA growth (Q-o-Q)**



Source: Company, Edelweiss research

\* **Weakness in the US sub-prime mortgage market to affect traction in iTOPS**

A significant proportion of iGATE's iTOPS revenues (about 10% of overall revenues) is exposed to the sub-prime mortgage market in the US. The company sees the weakness here affecting its growth in this segment, which it attributes to the rapid fall-off of two accounts. This will likely reflect in a weak Q1FY08E. We also believe that the temporary negative impact on profits is likely to be higher in Q1FY08E, given that iTOPS is relatively more profitable than IT-Services.

\* **Estimates revision for FY08E and FY09E**

We have accounted for the impact of the weakness of the sub-prime mortgage market in the US on iGATE, in our estimates for FY08 and FY09.

Our EPS for FY08E and FY09E now stands revised downwards by 8.8% and 3.9% respectively.

**Table 1: Revised estimates**

|                     | Earlier |        | Revised |        | % change |       |
|---------------------|---------|--------|---------|--------|----------|-------|
|                     | FY08E   | FY09E  | FY08E   | FY09E  | FY08E    | FY09E |
| Revenue (INR mn)    | 9,837   | 12,080 | 9,143   | 11,657 | (7.1)    | (3.5) |
| Net profit (INR mn) | 954     | 1,308  | 864     | 1,248  | (9.5)    | (4.6) |
| EPS (INR)           | 29.8    | 40.8   | 27.2    | 39.2   | (8.8)    | (3.9) |

Source: Edelweiss research

\* **Valuations**

At CMP of INR 385, the stock is valued at a P/E of 14.2x and 9.8x for FY08E and FY09E earnings, respectively. The company's valuation on EV/EBITDA and EV/revenue for FY08E continues to be attractive at 7.4x and 1.2x, respectively. Over the next two years, we estimate iGATE to earn cumulative cash profits of INR 3.1 bn., and post a cash-earnings growth of 41.4% CAGR over FY07-09. We expect the company's EPS growth to be among the highest in our set of companies over FY07-09E. **At a PEG of 0.25 we see the current valuations compelling.** We maintain our 'BUY' recommendation.

| Financials snapshot          |        |        |          |        |          | (INR mn) |       |        |
|------------------------------|--------|--------|----------|--------|----------|----------|-------|--------|
| Year to March                | Q4FY07 | Q3FY07 | Growth % | Q4FY06 | Growth % | FY07     | FY08E | FY09E  |
| Total revenues               | 2,101  | 2,107  | (0.3)    | 1,674  | 25.5     | 8,051    | 9,143 | 11,657 |
| Cost of revenues             | 1,417  | 1,449  | (2.2)    | 1,172  | 20.9     | 5,631    | 6,107 | 7,658  |
| Gross profit                 | 684    | 658    | 4.0      | 502    | 36.3     | 2,420    | 3,036 | 3,998  |
| SG&A expenses                | 362    | 391    | (7.5)    | 341    | 6.3      | 1,501    | 1,569 | 2,005  |
| EBITDA                       | 322    | 267    | 20.7     | 161    | 99.6     | 918      | 1,467 | 1,993  |
| Depreciation                 | 99     | 102    | (3.1)    | 95     | 4.5      | 398      | 482   | 540    |
| EBIT                         | 223    | 165    | 35.6     | 67     | 234.8    | 521      | 985   | 1,453  |
| Other income                 | 11     | (1)    | (885.7)  | (3)    | (479.3)  | 5        | 18    | 20     |
| Profit before interest & tax | 234    | 163    | 43.5     | 64     | 267.3    | 526      | 1,003 | 1,473  |
| Interest expense             | 7      | 7      | (2.8)    | 8      | (12.5)   | 29       | 16    | 3      |
| Profit before tax            | 227    | 156    | 45.6     | 56     | 307.5    | 497      | 987   | 1,470  |
| Tax provision                | 9      | 10     | (9.1)    | 9      | 4.7      | 35       | 167   | 257    |
| Adjusted net profit          | 218    | 146    | 49.3     | 47     | 362.8    | 462      | 820   | 1,213  |
| Extra ordinary income/(loss) | -      | -      |          | -      |          | (3)      | -     | -      |
| Minority interest recd.      | 8      | 14     |          | -      |          | 33       | 44    | 35     |
| Reported net profit          | 226    | 160    | 41.7     | 47     | 379.8    | 492      | 864   | 1,248  |
| EPS basic (INR)              | 7.2    | 5.1    | 41.8     | 1.5    | 377.5    | 15.9     | 27.2  | 39.2   |
| <b>as % of revenues</b>      |        |        |          |        |          |          |       |        |
| Gross profit                 | 32.6   | 31.2   |          | 30.0   |          | 30.1     | 33.2  | 34.3   |
| SG&A                         | 17.2   | 18.6   |          | 20.3   |          | 18.6     | 17.2  | 17.2   |
| EBITDA                       | 15.3   | 12.7   |          | 9.6    |          | 11.4     | 16.0  | 17.1   |
| Adjusted net profit          | 10.4   | 6.9    |          | 2.8    |          | 5.7      | 9.0   | 10.4   |
| Reported net profit          | 10.8   | 7.6    |          | 2.8    |          | 6.1      | 9.4   | 10.7   |
| Tax rate                     | 4.0    | 6.4    |          | 15.4   |          | 7.1      | 17.0  | 17.5   |

## Company description

iGATE Global provides services in the area of e-business, Business Intelligence, Custom Solutions, Application Re-engineering and Maintenance Outsourcing. The company delivers these solutions to its clients across industry verticals such as BFS, retail & distribution, manufacturing, telecommunications among others. The company has an integrated technology and operations model (ITOPS) that is aimed at providing and integrated service offering for its clients. The company has presence in 12 countries and has development centers in the US, UK, Canada, China, Malaysia, and India. It employs over 5,945 people and its revenues for the past twelve months (TTM) stood at INR 8.1 bn (USD 177.7 mn).

## Investment theme

iGATE has firmly demonstrated a turnaround, which we see lasting through FY09-FY10 period. The company is now through, with its restructuring and client rationalization exercise. The clients that have been added over the last 18 months (at higher billing rates) are now ramping up, contributing more than a third to its total revenues thereby pushing up the average realisations. iGATE is now focusing its efforts on getting a higher share of the clients total spend through introduction of newer services. These new services such as infrastructure management and testing have high potential and are scalable. We believe this changing revenue composition along with introduction of new high margin services will benefit iGATE over the long term.

## Key risks

Key risks to our investment theme include: (a) adequate availability of skilled manpower; (b) sustained slowdown in the US, as the company derives ~ 75% of its revenues from that region; and (c) significant appreciation of the rupee against USD.

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| Revathi Myneni    | - 2286 4413 | Cement                                    | Monil Bhala         | - 2286 4363       |
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| Priyanko Panja    | - 2286 4300 | Infrastructure, Engineering, Telecom      | Swati Khemani       | - 2286 4266       |
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| Sunil Jain        | - 2286 4308 | Alternative & Quantitative                | Dipesh Shah         | - 2286 4434       |
| Yogesh Radke      | - 2286 4328 | Alternative & Quantitative                |                     |                   |

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**RATING INTERPRETATION**

|                    |   |                     |   |
|--------------------|---|---------------------|---|
| <b>Buy</b>         | Expected to appreciate more than 20% over a 12-month period | <b>Reduce</b>       | Expected to depreciate up to 10% over a 12-month period     |
| <b>Accumulate</b>  | Expected to appreciate up to 20% over a 12-month period     | <b>Sell</b>         | Expected to depreciate more than 10% over a 12-month period |
| <b>Trading Buy</b> | Expected to appreciate more than 10% over a 45-day period   | <b>Trading Sell</b> | Expected to depreciate more than 10% over a 45-day period   |

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