

Polaris Software Lab Ltd

Strong product momentum backed by cheap valuations – Initiating with a Buy

We are initiating coverage on Polaris Software with a Buy rating and a December '10 price target of Rs 275, implying a 48% upside from current levels. Polaris is a mid cap IT services company which earns ~85% of its revenues from the BFSI sector. The company's foray into banking products has begun to bear fruit, with its offering – Intellect – gaining strong traction over the past 3–4 quarters. A further uptick in IT budgets from BFSI clients should further help services business in our view. As such, we model for a 15%/22% revenue/EPS CAGR over the next two years with risks to the upside. With FY11E P/E at just 9x, earnings delivery should lead to continued share price appreciation in our view.

Key beneficiary of BFSI rebound: We believe that Polaris is set to return to its growth trajectory as IT spending in the BFSI space gathers steam. The company had a poor FY10 as major banking clients cut back on their IT spending budgets. However, signs of a recovery are clearly evident with the company recording a 4% QoQ growth in Q4FY10. One of its products, Intellect, has begun to show strong traction among clients, growing 17% QoQ in Q4 with 22 deal signings during the quarter after 14 in Q3 and 12 in Q2. As IT spending continues to pick up, we model for 14%/15% revenue growth in FY2011/2012.

Margins look manageable as product mix improves: The Polaris management has guided towards slight margin pressure as it looks to bring down utilisation to prepare spare capacity for business expansion. However, we believe this will be balanced out by the rising mix of the products business, which has better margins than the services segment. Further, there could be significant gains hedging gains below the operating level. As such, we estimate EPS to grow by 32% in FY2011 with risks to the upside.

Cheap valuation, buy the stock with a potential 48% upside: Polaris currently trades at only 9x FY11E P/E, which is a 50% discount to the average large cap peer valuation. We believe the valuation gap would close out as Polaris delivers growth in line with its peers. We base our December '10 price target of Rs 275 on a 12-month forward multiple of 12x P/E given the company's strong EPS growth profile of 22% over the next two years.

CMP	TARGET	RATING	RISK
Rs 185	Rs 275	BUY	HIGH

BSE	NSE	BLOOMBERG
532254	POLARIS	POL IN

Company data

Market cap (Rs mn / US\$ mn)	18,392 / 414
Outstanding equity shares (mn)	99
Free float (%)	54.0
52-week high/low (Rs)	204 / 67
2-month average daily volume	1,127,000

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Polaris	185	13.4	16.5	15.9
CNX IT	5,981	2.1	6.9	18.5
Sensex	17,586	0.3	7.5	10.6

Valuation matrix

(x)	FY09	FY10	FY11E	FY12E
P/E @ CMP	14.5	12.0	9.1	8.0
P/E @ Target	21.6	17.8	13.5	11.9
EV/EBITDA @ CMP	5.8	6.0	5.3	4.5

RCML vs consensus

Parameter	FY11E		FY12E	
	RCML	Cons	RCML	Cons
Sales (Rs mn)	15,462	15,170	17,754	17,486
EPS (Rs)	20.4	20.8	23.1	22.3

Financial highlights

(Rs mn)	FY09	FY10	FY11E	FY12E
Revenue	13,779	13,538	15,462	17,754
Growth (%)	25.3	-1.8	14.2	14.8
Adj net income	1,259	1,528	2,019	2,288
Growth (%)	71.9	21.2	31.9	13.3
EPS (Rs)	12.8	15.5	20.4	23.1
Growth (%)	71.9	21.2	31.9	13.3

Profitability and return ratios

(%)	FY09	FY10	FY11E	FY12E
EBITDA margin	16.6	16.4	16.3	16.7
EBIT margin	13.8	13.8	13.9	14.5
Adj PAT margin	9.1	11.3	13.1	12.9
ROE	17.3	18.6	21.1	20.0
ROIC	29.7	34.5	42.0	45.2
ROCE	21.8	19.5	18.9	17.6





Fig 1 - Polaris - Quarterly model

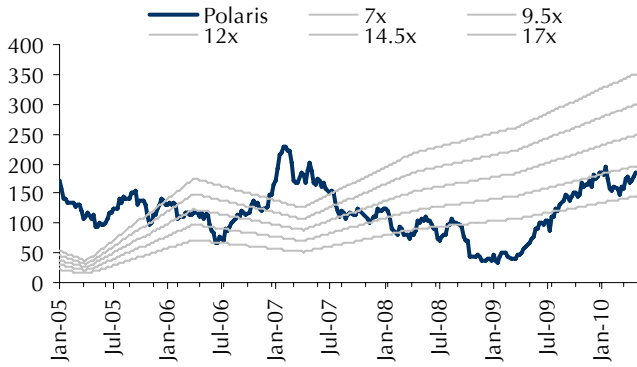
(Rs mn , year-end March)	FY10				FY11E				FY12E				FY09	FY10	FY11E	FY12E	FY13E
	Q1	Q2	Q3	Q4	Q1E	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E					
Revenue	3,255	3,383	3,389	3,510	3,604	3,771	3,949	4,138	4,254	4,374	4,499	4,627	13,779	13,538	15,462	17,754	19,888
Depreciation	84	87	86	92	91	92	93	94	95	97	98	100	388	350	370	389	383
COGS (Excl. dep)	2,079	2,207	2,185	2,231	2,343	2,432	2,527	2,628	2,744	2,813	2,884	2,957	8,854	8,701	9,930	11,397	12,846
Gross Profit	1,092	1,089	1,118	1,187	1,171	1,247	1,329	1,416	1,415	1,465	1,517	1,571	4,538	4,486	5,162	5,968	6,659
EBIT	468	451	461	489	459	507	564	621	602	629	657	686	1,899	1,870	2,151	2,574	2,857
EBITDA	552	539	548	581	550	599	657	715	697	725	755	786	2,287	2,220	2,521	2,963	3,240
Net Other Income	-92	-47	6	51	72	80	87	95	99	107	115	123	-454	-82	334	444	563
Pre Tax Profit	376	404	467	540	531	587	651	715	701	736	772	809	1,445	1,788	2,485	3,018	3,419
Tax	58	48	66	83	102	111	121	132	169	177	185	199	209	255	466	730	821
Net Profit	318	352	401	457	429	476	530	584	532	559	587	610	1,259	1,528	2,019	2,288	2,599
EPS (Rs)	3.2	3.6	4.1	4.6	4.3	4.8	5.4	5.9	5.4	5.6	5.9	6.2	12.8	15.5	20.4	23.1	26.3
Margins (%)																	
Gross Margin	33.6	32.2	33.0	33.8	32.5	33.1	33.6	34.2	33.3	33.5	33.7	33.9	32.9	33.1	33.4	33.6	33.5
Operating Margin	14.4	13.3	13.6	13.9	12.7	13.5	14.3	15.0	14.2	14.4	14.6	14.8	13.8	13.8	13.9	14.5	14.4
EBITDA Margin	17.0	15.9	16.2	16.6	15.3	15.9	16.6	17.3	16.4	16.6	16.8	17.0	16.6	16.4	16.3	16.7	16.3
Net Margin	9.8	10.4	11.8	13.0	11.9	12.6	13.4	14.1	12.5	12.8	13.0	13.2	9.1	11.3	13.1	12.9	13.1
Sequential Growth (%)																	
Revenue	(3.5)	3.9	0.2	3.6	2.7	4.6	4.7	4.8	2.8	2.8	2.8	2.9	25.3	(1.8)	14.2	14.8	12.0
Gross Profit	(8.6)	(0.3)	2.6	6.2	(1.4)	6.5	6.6	6.6	(0.1)	3.5	3.5	3.5	47.0	(1.1)	15.1	15.6	11.6
EBIT	(3.3)	(3.5)	2.2	6.1	(6.2)	10.5	11.2	10.0	(3.0)	4.5	4.4	4.4	163.1	(1.5)	15.0	19.6	11.0
EBITDA	(3.0)	(2.5)	1.7	6.1	(5.4)	9.0	9.7	8.7	(2.4)	4.1	4.1	4.1	93.5	(2.9)	13.6	17.5	9.3
Net Profit	16.9	10.6	13.9	14.1	(6.2)	11.0	11.3	10.2	(8.9)	5.0	5.0	4.0	72.0	21.4	32.1	13.3	13.6
EPS	16.9	10.5	13.7	14.0	(6.2)	11.0	11.3	10.2	(8.9)	5.0	5.0	4.0	71.9	21.2	31.9	13.3	13.6
Y/Y Growth (%)																	
Revenue	2.7	(3.7)	(9.0)	4.1	10.7	11.5	16.5	17.9	18.0	16.0	13.9	11.8	25.3	(1.8)	14.2	14.8	12.0
Gross Profit	19.2	(2.0)	(15.0)	(0.6)	7.2	14.5	18.9	19.3	20.9	17.5	14.2	10.9	47.0	(1.1)	15.1	15.6	11.6
EBIT	66.0	(3.4)	(30.7)	1.2	(1.9)	12.4	22.3	26.8	31.2	24.0	16.4	10.6	163.1	(1.5)	15.0	19.6	11.0
EBITDA	42.3	(6.3)	(27.4)	2.1	(0.4)	11.2	20.0	22.9	26.7	21.0	14.9	10.0	93.5	(2.9)	13.6	17.5	9.3
Net Profit	17.9	2.0	7.8	68.0	34.8	35.3	32.3	27.7	24.0	17.3	10.7	4.5	72.0	21.4	32.1	13.3	13.6
EPS	17.9	2.0	7.6	67.5	34.4	34.9	32.1	27.7	24.0	17.3	10.7	4.5	71.9	21.2	31.9	13.3	13.6

Source: Company, RCML Research



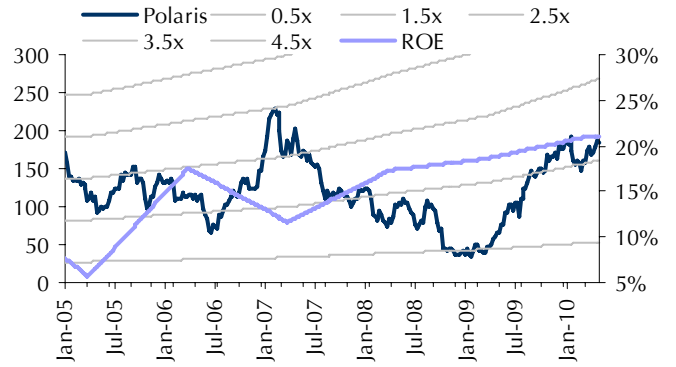
Band charts

Fig 2 - Polaris Software – 12m Fwd P/E bands



Source: Company, RCML Research

Fig 3 - Polaris Software – 12m Fwd P/B bands



Source: Company, RCML Research



Consolidated financials

Profit and Loss statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Revenues	13,538	15,462	17,754	19,888
<i>Growth (%)</i>	<i>(1.8)</i>	<i>14.2</i>	<i>14.8</i>	<i>12.0</i>
EBITDA	2,220	2,521	2,963	3,240
<i>Growth (%)</i>	<i>(2.9)</i>	<i>13.6</i>	<i>17.5</i>	<i>9.3</i>
Depreciation & amortisation	350	370	389	383
EBIT	1,870	2,151	2,574	2,857
<i>Growth (%)</i>	<i>(1.5)</i>	<i>15.0</i>	<i>19.6</i>	<i>11.0</i>
Interest	(9)	(14)	(14)	(14)
Other income	(73)	348	458	577
EBT	1,788	2,485	3,018	3,419
Income taxes	255	466	730	821
Effective tax rate (%)	14.3	18.8	24.2	24.0
Extraordinary items	-	-	-	-
Min into / inc from associates	(4)	-	-	-
Reported net income	1,528	2,019	2,288	2,599
Adjustments	-	-	-	-
Adjusted net income	1,528	2,019	2,288	2,599
<i>Growth (%)</i>	<i>21.2</i>	<i>31.9</i>	<i>13.3</i>	<i>13.6</i>
Shares outstanding (mn)	99.0	99.0	99.0	99.0
FDEPS (Rs) (adj)	15.5	20.4	23.1	26.3
<i>Growth (%)</i>	<i>21.2</i>	<i>31.9</i>	<i>13.3</i>	<i>13.6</i>
DPS (Rs)	1.8	2.5	2.5	2.5

Cash flow statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Net income + Depreciation	1,879	2,389	2,677	2,982
Non-cash adjustments	4	-	-	-
Changes in working capital	1,040	(55)	(106)	(121)
Cash flow from operations	2,922	2,334	2,571	2,861
Capital expenditure	(265)	(240)	(400)	(400)
Change in investments	4	-	-	-
Other investing cash flow	(506)	-	-	-
Cash flow from investing	(767)	(240)	(400)	(400)
Issue of equity	(530)	(44)	(44)	(44)
Issue/repay debt	21	-	-	-
Dividends paid	-	(247)	(247)	(247)
Other financing cash flow	(4)	-	-	-
Change in cash & cash eq	1,642	1,803	1,880	2,170
Closing cash & cash eq	5,042	6,845	8,725	10,895

Economic Value Added (EVA) analysis

Y/E March	FY10	FY11E	FY12E	FY13E
WACC (%)	12.1	12.1	12.1	12.1
ROIC (%)	34.5	42.0	45.2	47.9
Invested capital (Rs mn)	4,292	4,314	4,545	4,789
EVA (Rs mn)	962	1,289	1,506	1,716
EVA spread (%)	22.4	29.9	33.1	35.8

Balance sheet

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Cash and cash eq	5,042	6,845	8,725	10,895
Accounts receivable	1,746	2,041	2,282	2,559
Inventories	64	91	101	114
Other current assets	2,084	2,365	2,644	2,965
Investments	92	92	92	92
Gross fixed assets	5,599	5,839	6,239	6,639
Net fixed assets	2,271	2,142	2,152	2,169
CWIP	-	-	-	-
Intangible assets	-	-	-	-
Deferred tax assets, net	-	-	-	-
Other assets	506	506	506	506
Total assets	11,805	14,080	16,503	19,299
Accounts payable	-	-	-	-
Other current liabilities	3,056	3,603	4,029	4,517
Provisions	-	-	-	-
Debt funds	25	25	25	25
Other liabilities	-	-	-	-
Equity capital	495	495	495	495
Reserves & surplus	8,230	9,958	11,955	14,263
Shareholder's funds	8,725	10,453	12,450	14,757
Total liabilities	11,805	14,080	16,503	19,299
BVPS (Rs)	88.2	105.6	125.8	149.1

Financial ratios

Y/E March	FY10	FY11E	FY12E	FY13E
Profitability & Return ratios (%)				
EBITDA margin	16.4	16.3	16.7	16.3
EBIT margin	13.8	13.9	14.5	14.4
Net profit margin	11.3	13.1	12.9	13.1
ROE	18.6	21.1	20.0	19.1
ROCE	19.5	18.9	17.6	16.5
Working Capital & Liquidity ratios				
Receivables (days)	47	48	47	47
Inventory (days)	2	2	2	2
Payables (days)	n.m	n.m	n.m	n.m
Current ratio (x)	2.9	3.1	3.4	3.7
Quick ratio (x)	2.2	2.5	2.7	3.0
Turnover & Leverage ratios (x)				
Gross asset turnover	2.5	2.7	2.9	3.1
Total asset turnover	1.2	1.2	1.2	1.1
Interest coverage ratio	205.3	153.8	184.0	204.2
Adjusted debt/equity	0.0	0.0	0.0	0.0
Valuation ratios (x)				
EV/Sales	1.0	0.9	0.8	0.7
EV/EBITDA	6.0	5.3	4.5	4.1
P/E	12.0	9.1	8.0	7.0
P/BV	2.1	1.8	1.5	1.2



Quarterly trend

Particulars	Q2FY10	Q3FY10	Q4FY10	Q1FY11E	Q2FY11E
Revenue (Rs mn)	3,383	3,389	3,510	3,604	3,771
YoY growth (%)	(3.7)	(9.0)	4.1	10.7	11.5
QoQ growth (%)	3.9	0.2	3.6	2.7	4.6
EBITDA (Rs mn)	451	461	489	459	507
EBITDA margin (%)	13.3	13.6	13.9	12.7	13.5
Adj net income (Rs mn)	352	401	457	429	476
YoY growth (%)	2.0	7.8	68.0	34.8	35.3
QoQ growth (%)	10.6	13.9	14.1	(6.2)	11.0

DuPont analysis

(%)	FY09	FY10	FY11E	FY12E	FY13E
Tax burden (Net income/PBT)	87.1	85.5	81.2	75.8	76.0
Interest burden (PBT/EBIT)	76.1	95.6	115.5	117.2	119.7
EBIT margin (EBIT/Revenues)	13.8	13.8	13.9	14.5	14.4
Asset turnover (Revenues/Avg TA)	1.5	1.2	1.2	1.2	1.1
Leverage (Avg TA/Avg equity)	1.3	1.3	1.3	1.3	1.3
Return on equity	17.3	18.6	21.1	20.0	19.1

Company profile

Polaris provides services and solutions to a variety of multinational clients. It focuses on companies in the banking and financial industry, which specialise in retail banking, credit cards, insurance, risk management, investment banking and a variety of telecom related activities.

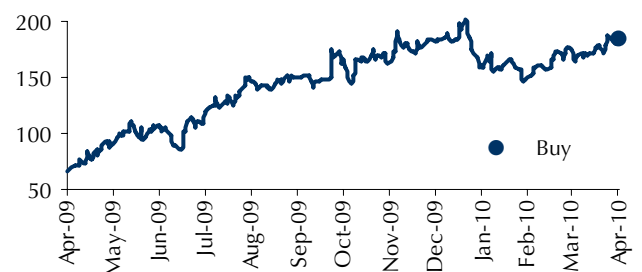
Shareholding pattern

(%)	Sep-09	Dec-09	Mar-10
Promoters	29.2	29.1	29.1
FIs	7.2	11.1	11.0
Banks & FIs	27.2	28.1	28.0
Public	36.5	31.8	31.9

Recommendation history

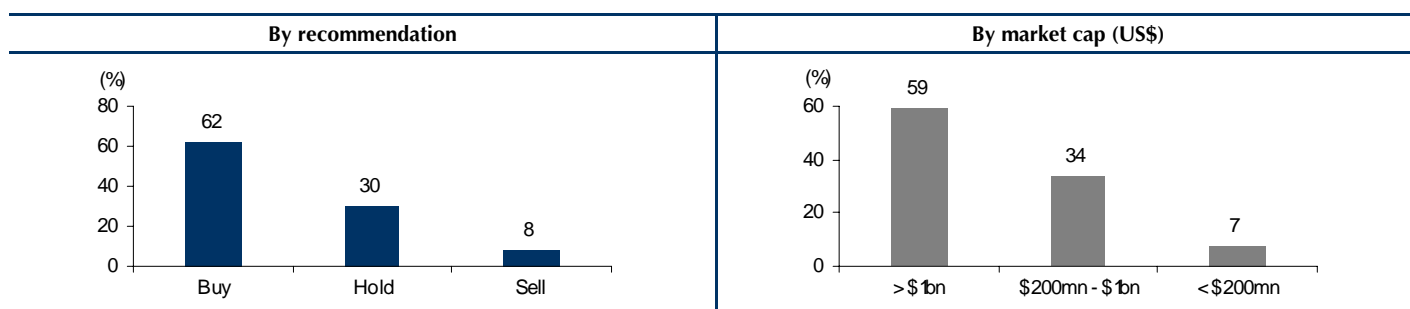
Date	Event	Reco price	Tgt price	Reco
30-Apr-10	Initiating Coverage	185	275	Buy

Stock performance





Coverage Profile



Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and -5%
Sell	Less than -5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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