

I-FLEX SOLUTIONS

INR 2,277

*Product traction to play out longer-term*

BUY

i-flex Solutions' Q4FY07 results were below expectations. Revenues reported at INR 5.8 bn were up 5.3% Q-o-Q and 26.6% Y-o-Y, while net profits at INR 776 mn were flat Q-o-Q and down 33.6% Y-o-Y. The products business at INR 3.2 bn grew 1.1% Q-o-Q, below expectations, with major contribution (78%) from implementation and AMC fees; license fees accounted for only 22% of product revenues in a seasonally strong quarter. The lower proportion of high margin license fee contribution resulted in significantly lower net profits for the quarter than our expectations. However, license fees tank is at an all-time high at USD 82.5 mn, up from USD 73.6 mn last quarter. We also note that substantial license fees have been deferred for the purpose of revenue recognition as per US GAAP (USD 31.4 mn in March 2007 versus USD 12.7 mn in March 2006) and will be recognised as revenues in the coming quarters. The services business has performed creditably in Q4FY07 with revenues from this segment, growing 10% Q-o-Q.

i-flex's product suite (through Reveleus) addresses areas such as governance, risk management, and compliance. Reveleus has won a large deal with a top-tier financial institution from the US. Financial services firms are paying greater attention to the aforementioned areas due to regulations such as Sarbans Oxley (SOX), Basel II, and Anti-Money Laundering. We believe that factors such as superior product architecture, history of successful multi-country roll outs, prestigious customer wins along with increased product portfolio from the Mantas acquisition will ensure that i-flex sustains its high growth. We remain excited on the prospects of the company in view of the quality of deals in the pipeline and the company's superior and comprehensive positioning in the financial services segment.

Adjusting for the much weaker than expected product sales for the quarter, we have revised our EPS for FY08E and FY09E downwards by ~9.6% to INR 52.4 and 6.8% to INR 67.6, respectively. Our revised estimates take into account lower than expected license fees. At a CMP of INR 2,277, the stock trades at P/E of 43.5x and 33.7x on our FY08E and FY09E revised earnings, respectively. We maintain our 'BUY' recommendation; but we note that the current valuations factor in i-flex's market leadership in the packaged banking products space.

Financials

Year to March	Q4FY07	Q3FY07	Growth %	Q4FY06	Growth %	FY08E	FY09E
Revenue (INR mn)	5,794	5,502	5.3	4,577	26.6	26,974	34,594
Gross profit (INR mn)	2,586	2,410	7.3	2,298	12.5	12,388	15,856
EBITDA (INR mn)	1,093	1,064	2.6	1,313	(16.8)	5,725	7,426
Net profit (INR mn)	777	773	0.5	1,169	(33.6)	4,347	5,580
EPS basic (INR)	9.6	9.5	0.4	15.5	(38.3)	52.4	67.6
P/E (x)						43.5	33.7
EV/EBITDA (x)						31.6	24.3
Market cap/ Revenue (x)						7.0	5.5

May 08, 2007

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Reuters : IFLX.BO
Bloomberg : IFLEX IN

Market Data

52-week range (INR) : 2,545 / 840
Share in issue (mn) : 83.2
M cap (INR bn/USD mn) : 189.5/4,636.7
Avg. Daily Vol. BSE/NSE ('000) : 193.6

Share Holding Pattern (%)

Promoters : 81.0
MFs, Fls & Banks : 0.8
Fls : 0.7
Others : 17.5

Result Highlights

- ◆ Revenues, reported at INR 5.8 bn, were up 5.3% Q-o-Q and 27.0% Y-o-Y. Net profit at INR 777 mn was almost flat Q-o-Q and down 33% Y-o-Y, which is the worst ever performance Y-o-Y at the net profit level.
- ◆ Gross margins increased 60bps Q-o-Q to 44.6%, but on a Y-o-Y basis it was down 560bps. EBITDA stood at INR 1.1 bn and the EBITDA margin was at 18.9% as against 19.3% in the previous quarter and 28.7% in the corresponding quarter last fiscal.
- ◆ The company added 30 new clients, of which, 16 were in the products business.
- ◆ The company added 522 net employees, taking the total headcount to 9,068, an increase of 32% Y-o-Y.

* Products business

- ◆ Product revenues stood at INR 3.2 bn, down 1% Q-o-Q and up 22.0% Y-o-Y. The Q4 tends to be a seasonally strong quarter for i-flex because the products business records its strongest performance typically in this quarter. In this context, the products performance in Q4FY07 growth is relatively weak.
- ◆ License fees at INR 705 mn showed a sharp decline of 11% Q-o-Q and 46% Y-o-Y, indicating that the pace of fresh deal sign-ups is not as fast as in the past and revenue recognition for the contracted deals could kick in later as the company executes its milestone projects. Deferred revenues stand at USD 31.4 mn, up from USD 12.7 Y-o-Y.
- ◆ EBITDA margin stood at 27.8%, against 31.8% in Q3FY07.
- ◆ The product revenue tank size currently stands at USD 82.5 mn, up from USD 73.6 mn in the previous quarter.
- ◆ The license fee revenue contribution to total product revenues stood at 22% (50% in Q4FY06).

* Services business

- ◆ Services revenues stood at INR 2.45 bn, up 10.1% Q-o-Q and 29.3% Y-o-Y.
- ◆ The highlight in the services business was the extremely robust growth in offshore contribution, which increased 33% sequentially from Q3FY07. Offshore revenues contributed 35% to total services revenues for the quarter, marking the highest for six quarters. For FY07, offshore revenues contributed just over 30% of services revenues.
- ◆ EBITDA margins for the quarter were 23.8%, significantly up from 15.4% in the previous quarter, led by increased utilisation and number of billing days.

* KPO business

- ◆ KPO revenues stood at INR 143 mn, up 32.7% Q-o-Q and 112.8% Y-o-Y.
- ◆ At the EBITDA level, this division still remains in the investment mode with a loss of INR 51.1 mn, compared with loss of INR 24.7 mn in the previous quarter.

*** A relatively muted Q4FY07 ends an overall good FY07**

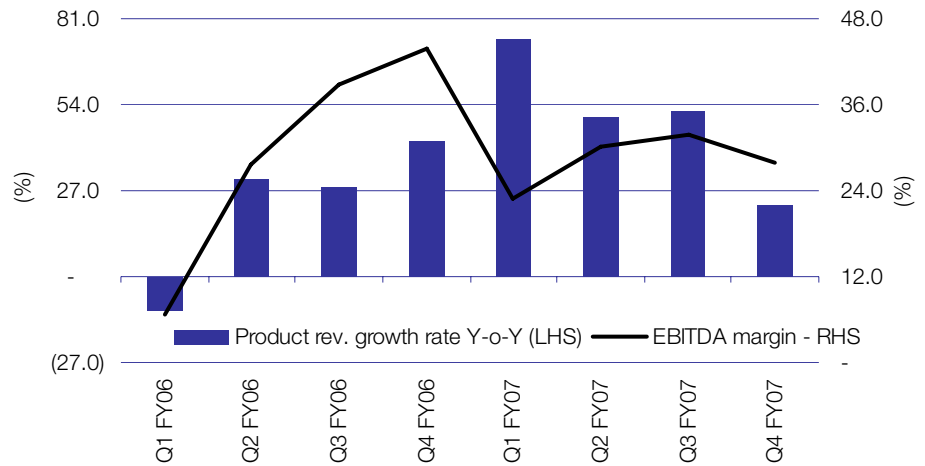
i-flex reported revenues of INR 2.0 bn and net profits of INR 277 mn in FY07, growth of 37.4% and 26.4% respectively over FY06, as per US GAAP. The net profit margin in FY07, at 13.6%, was however lower than that in FY06 at 14.8%. Organic growth amounted to about 33% of annual growth, while acquisitions contributed to the balance 4.4% growth. Products held a 56% share of the overall revenue pie, which grew to 57.2% in FY07 over FY06 (48% excluding acquisitions) . Services business grew respectably at 27.6% Y-o-Y.

Low profitability of the products business (26% in FY07 versus 33% in FY06), however, continues to cause concern.

*** Product squeeze in the quarter unseasonal, but long-term outlook remains buoyant**

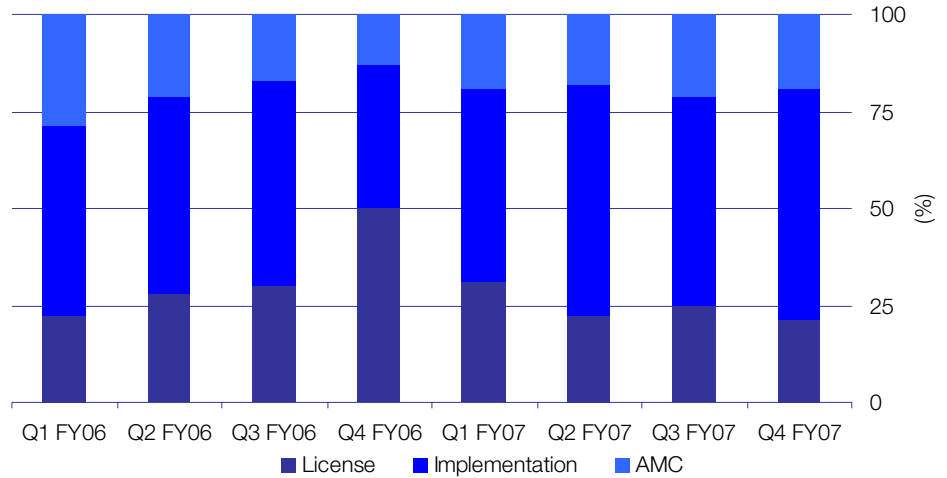
The lower than expected performance of the products business in Q4FY07, especially license fees, depressed profitability for the quarter vis-à-vis our expectations. Notably, chart 1 indicates that the products segment had a relatively weak quarter from a Y-o-Y growth and EBITDA margin perspective. In addition, chart 2 shows that the contribution from license fees (as a percentage of product sales) is also muted compared with the previous quarters, more so given that Q4 tends to be seasonally strong. Chart 3 shows that annual EBITDA margins for the products business in FY07 at 25.9% was the weakest in recent years.

Chart 1: Products had a slow quarter in Q4FY07



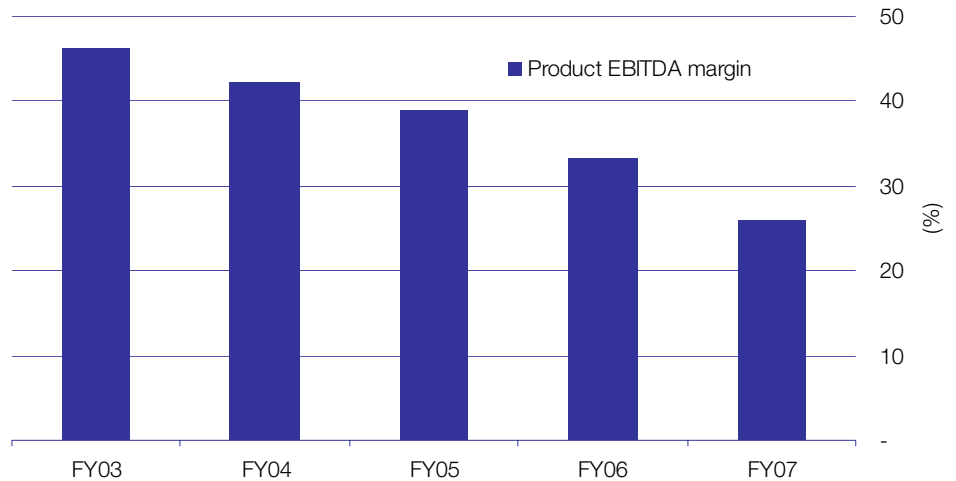
Source: Company, Edelweiss research

Chart 2: Contribution from license fees is relatively muted in Q4FY07



Source: Company, Edelweiss research

Chart 3: Product EBITDA margin (%) is the weakest in recent years



Source: Company, Edelweiss research

However, we note that deferred license fees revenues have increased to USD 31.4 mn, an increase of USD 18.7 mn from USD 12.7 mn in Q4FY06. These will be recognized as revenues in the coming quarters and have been factored in our estimates for FY08. Also, the license fees tank (conservatively estimated by the management) stood at USD 82.5 mn versus USD 73.6 in Q3FY07 and USD 65 mn in Q4FY06 (27% increase, Y-o-Y).

In the long-term, momentum in the products story remains strong and sustained. i-flex has considerably expanded the width of its product suite offerings with its acquisition of Reveleus and Mantas. Reveleus, its flagship governance, risk and compliance solution is finding resonance in the US with a significant Tier-I win in this quarter. The company indicates that with this win, Reveleus has 4 of the top 10 banks in the US as its clients. Mantas is also asserting its traction with 3 client wins in this quarter, indicating that these two entities standalone are capable of winning business on the strength of their core proposition.

*** Core banking solutions finding resonance in the market**

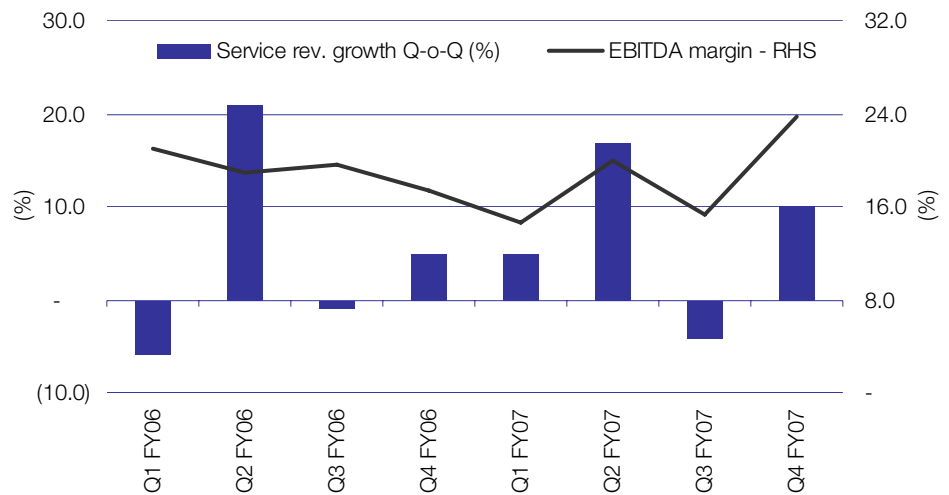
i-flex has a clearly articulated strategy centered on competitive differentiation, cost reduction, customer intimacy, and compliance adherence and management. This kind of positioning is finding acceptance and customer sign-ups are increasingly defining the trend towards core banking solutions. The company has already marked its presence in the core-banking replacement and multi-country deployment market for global financial institutions in Europe. Further, its diversified product wins for the recent quarters are indicative of its increasing traction in other markets such as Japan, Middle East, and Latin America.

However, we believe that the much opportunity resides in the core banking replacement market in the US. The US is slow to embrace non-local service providers and non-legacy systems and only a few local legacy vendors dominate this geography. i-flex has made a dent here by winning Peoplebank deal. The company has been commissioned to deploy a core retail banking platform for Peoplebank that interfaces with local payment providers, complies with regulatory norms, and measures and manages risks among other mandatory requirements. The company believes that this is a significant stepping ground and represents the very first instance of a non-local vendor replacing and redeploying a core banking platform. We believe penetration potential here will be significant in terms of adding to revenues. We expect success of i-flex’s initiatives in the US playing out more significantly in FY09. In our opinion i-flex should be more stringent in its product-related expenses (especially SG&A), more so as it seeks to extend its leadership and footprint in the developed markets like the US.

*** Services: A decent performer with defined focus**

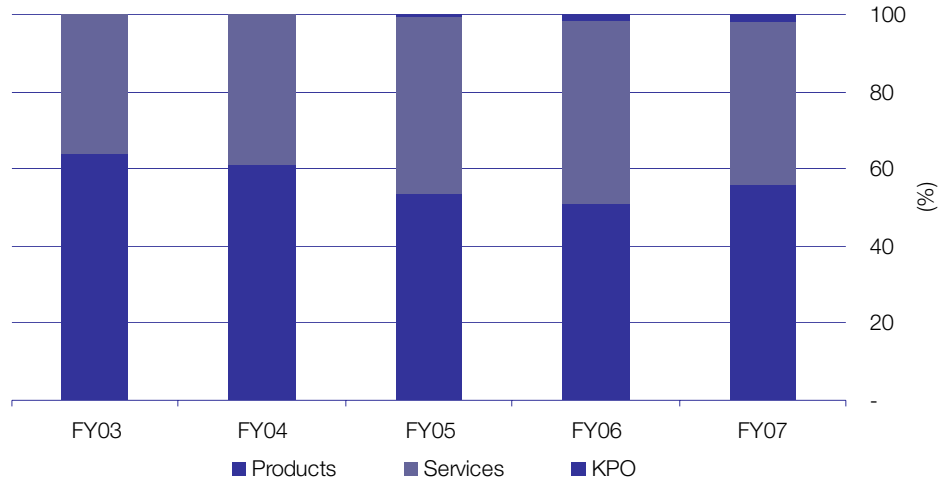
i-flex’s services revenues for Q4FY07 registered a strong 10.1% growth Q-o-Q, driven primarily by increase in offshore revenues (33% growth Q-o-Q) with markedly improved EBITA (23.8% of revenues). This growth was services’ strongest growth in the recent quarters, as chart 4 shows. Services registered revenues of INR 9 bn in FY07, growing ~28% over FY06, contributing ~44% to revenues in FY07 (see chart 5); EBITDA margins of 18.8% were comparable with those in the past (see chart 6).

Chart 4: Services witnessed strong growth in Q4FY07



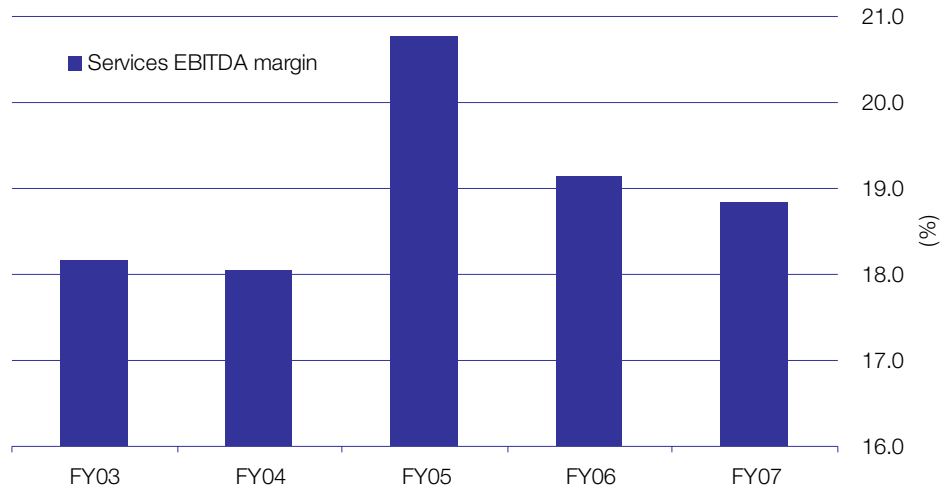
Source: Company, Edelweiss research

Chart 5: Services (including KPO) constituted 44% of i-flex’s revenues in FY07



Source: Company, Edelweiss research

Chart 6: Services EBITA (%) in FY07 has been comparable with previous years



Source: Company, Edelweiss research

We believe that i-flex’s services business is different from other tier-2 Indian IT services players in a few ways. First, the services business is focused on banking and financial services only. Second, it defines its focus less on larger-scale application outsourcing and more on in-demand opportunities such as MIFID and Basel-II, requiring a solution domain-led approach. Third, as many of such opportunities have a consulting and onsite implementation bias, i-flex’s onsite revenues are likely to continue to account for a greater proportion of the company’s services revenues. Based on all the above factors, we conclude that i-flex’s services business is unlikely to embrace mainstream opportunities and build scale, though it is capable of growing 30% annually over the next two years.

*** Management gets enhanced role in Oracle’s scheme of things**

The key members of i-flex’s management team – Rajesh Hukku (Chairman and MD), R.Ravishankar (CEO, International Operations and Business Development), and Deepak Ghaisas (CEO, India Operations and CFO) are assuming elevated positions within Oracle, taking leadership of Oracle’s financial services business unit. Rajesh Hukku will head this business unit with the other two also joining him to develop a unified and global strategy to manage Oracle’s

assets in this business unit and strategize for its growth. While we view this as testimony to i-flex's increasing visibility within Oracle and room for management to further push i-flex's joint go-to-market and product integration efforts with Oracle, this role could stretch management bandwidth going forward.

* **Downward revision in estimates**

Adjusting for the much weaker than expected product sales for the quarter, we have revised our EPS for FY08E and FY09E downwards by ~9.6% to INR 52.4 and 6.8% to INR 67.6, respectively. Our sales estimates are revised downwards 5.7% in FY08E to INR 27 bn and 5.1% in FY09E to INR 34.6 bn. On a two-year basis, we estimate sales, net profits, and the EPS to grow at a CAGR of 39%, 42%, and 40%, respectively. Our revised estimates take into account the increase in deferred license revenues, which will flow through FY08E.

Table 1: Revised estimates

	Earlier		Revised		% change	
	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
Revenue	28,619	36,496	26,974	34,594	(5.7)	(5.2)
Net Profit	4,814	6,073	4,347	5,581	(9.7)	(8.1)
EPS	57.9	72.5	52.4	67.6	(9.6)	(6.8)

Source: Edelweiss research

* **Valuations**

At a CMP of INR 2,277, the stock trades at P/E of 43.5x and 33.7x on our FY08E and FY09E revised earnings, respectively. The stock is trading at a forward PEG of over 1, given our CAGR earnings growth estimate of nearly 40% over FY07-09E. We maintain our 'BUY' recommendation, but we note that the current valuations factor in i-flex's continued leadership in the packaged banking products space.

Financial snapshot								(INR mn)
Year to March	Q4FY07	Q3FY07	Growth %	Q4FY06	Growth %	FY07	FY08E	FY09E
Products	3,206	3,172	1.1	2,619	22.4	11,898	14,586	18,778
Services	2,445	2,222	10.1	1,891	29.3	8,970	11,743	14,946
KPO	143	108	32.7	67	112.8	445	645	871
Total revenues	5,794	5,502	5.3	4,577	26.6	21,313	26,974	34,594
Products	1,456	1,339	8.8	841	73.1	4,856	5,612	7,379
Services	1,626	1,683	(3.4)	1,401	16.1	6,486	8,530	10,910
KPO	126	70	79.5	37	243.9	298	445	448
Direct costs	3,208	3,092	3.8	2,279	40.8	11,640	14,586	18,738
Gross profit	2,586	2,410	7.3	2,298	12.5	9,673	12,388	15,856
Products	857	824	4.0	627	36.7	3,033	3,909	4,957
Services	238	197	20.6	162	46.9	808	1,074	1,330
KPO	68	62	9.2	57	19.5	238	300	418
Corporate G & A	331	262	26.1	139	138.1	1,077	1,380	1,725
Total Overhead expenditure	1,494	1,346	11.0	985	51.7	5,156	6,662	8,430
EBITDA	1,093	1,064	2.6	1,313	(16.8)	4,518	5,725	7,426
Products	143	172	(16.6)	76	88.3	483	599	680
Services	78	61	26.7	56	39.4	247	348	440
KPO	7	8	(0.7)	7	9.9	31	46	65
Corporate	19	19	(0.9)	13	43.2	71	90	105
Total Depn & Amrtz	247	260	(4.8)	152	63.0	833	1,083	1,290
EBIT	845	805	5.0	1,162	(27.2)	3,685	4,643	6,136
Share of associate co. loss	(2)	(3)	(36.4)	(1)	172.1	(9)	(14)	(15)
Other income	26	(2)	(1176.7)	105	(74.9)	349	300	300
Profit before tax	874	806	8.5	1,267	(31.0)	4,043	4,957	6,451
Provision for tax	97	33	196.3	98	(1.0)	342	610	871
Reported net income	777	773	0.5	1,169	(33.6)	3,700	4,347	5,580
EPS basic (INR)	9.6	9.5	0.4	15.5	(38.3)	35.1	52.4	67.6
as % of revenue								
Gross profit	44.6	43.8		50.2		45.4	45.9	45.8
SG&A	25.8	24.5		21.5		24.2	24.7	24.4
EBITDA	18.9	19.3		28.7		21.2	21.2	21.5
EBIT	14.6	14.6		25.4		17.3	17.2	17.7
Reported net profit	13.4	14.0		25.5		17.4	16.1	16.1
Tax rate	11.1	4.1		7.8		8.5	12.3	13.5

Company Description

i-flex Solutions is a leading software vendor for the banking and financial services vertical. It provides technology products, custom applications and services, consulting services, IT infrastructure services, and KPO services focused specifically on the financial industry. The company's product suite comprises FLEXCUBE, DAYBREAK, Reveleus, CASTEK, and recently acquired Mantas' behaviour detection platform. Its core banking product, FLEXCUBE has been ranked world's No. 1 selling core banking solution for four years in a row since 2002 by the UK-based International Banking Systems (IBS). i-flex's services business, focused on BFSI segment, has also grown rapidly and currently contributes ~42% to the total revenues. The company employs over 9,000 people and its revenues for the past twelve months (TTM) stood at INR 20.4 bn (USD 465 mn).

Investment Theme

i-flex is a clear leader in the Indian financial services space. Its strong product portfolio has an extremely comprehensive range of solutions for the financial services industry. Besides developing a strong product suite, the company has been constantly expanding its capabilities through organic and inorganic routes. With several marquee names to its client roster such as Citigroup, Wells Fargo, World Bank, Wachovia, the company still has a long way to go. The recent collaboration of IBM, Oracle, and i-flex aimed at combining IBM's IT architectural leadership in banks and financial institutions, Oracle's banking-specific application solutions, and i-flex's core banking and risk solutions has compelling potential. Oracle can further enhance the penetration of Flexcube as a core banking solution across its significant client base particularly in the US where Flexcube has a relatively minor presence.

Key Risks

Key risks to our investment theme include: (a) adequate availability of skilled manpower, (b) sustained slowdown in the US' BFSI segment,, and (c) significant appreciation of rupee against US dollar, Euro, and GBP.

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RATING INTERPRETATION

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

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