India Equity Research | Telecom Result Update

TULIP IT SERVICES

INR 729

Sunnyside up

BUY

Edelweiss
Ideas create, values protect

Impressive operating performance, though margin pressures evident

Tulip IT's (TITSL) Q4FY07 results were in line with our expectations. Topline grew at a healthy clip by 31% Q-o-Q and 64% Y-o-Y, driven by strong revenue growth in both the network integration (NI) and enterprise connectivity businesses. IP VPN segment's revenues jumped 50% Q-o-Q, led by unprecedented subscriber accretion of 16k during the quarter (vis-à-vis an average 8.5k in the past three quarters). On an absolute basis, EBITDA jumped 22% Q-o-Q to INR 477 mn and net profits 20% Q-o-Q to INR 330 mn led by strong topline growth. Despite the strong traction in revenue growth, operating and net profit margins fell sequentially by 129bps and 103bps, respectively. The dip in margins was on account of a 150bps increase in direct costs and SG&A expenses as a share of revenues coupled with higher depreciation and interest expenses (up 39% and 32% Q-o-Q, respectively).

Calibrating estimates to incorporate margin pressures

We have revised our revenue estimates for both NI and IP VPN segments upwards, given strong traction in the IP VPN subscriber accretions and accelerated revenue growth in the NI business. While the operating performance in the quarter and FY07 has been impressive, we believe that certain concerns on margins for the IP VPN business have cropped up. Despite the strong topline growth in the IP VPN segment in Q4FY07 and the segment's higher share in the revenue mix, the bottomline growth has been marginally disappointing. We see increasing cost pressures primarily on account of expansion of the IP VPN network in remote areas (with likely low subscriber density/usage) and switch to licensed spectrum in the existing areas of operations. Also, given higher depreciation (on account of stronger capex) and interest expenses (due to higher debt to fund the long gestation NI projects), we believe that growth in margins will be lower than our earlier estimates.

Our revised revenue estimates stand at INR 12 bn and INR 14.8 bn for FY08 and FY09, respectively (up 17% and 19%, respectively, over our earlier estimates). On the back of lower margin expectations, we are revising our earnings estimates for FY08 and FY09 downwards by 7% and 10% to INR 1.7 bn and INR 2.2 bn, respectively. Despite a downward revision of our estimates, bottomline growth remains impressive at 51% CAGR over FY07-09E. At INR 729, the stock trades at a P/E of 9.8x and EV/EBITDA of 7.4x revised FY09 estimates. We continue to like the stock, given the attractive valuations on an absolute basis, coupled with impressive return ratios (RoAE of 48% and 39% and RoACE of 40% and 35% in FY08E and FY09E, respectively); we reiterate our 'BUY' recommendation.

Financials

Year to March	Q4FY07	Q4FY06	*% change*	Q3FY07	*% change*	FY07UA	FY08E
Revenues (INR mn)	2,910	1,776	*63.8*	2,220	*31.1*	8,408	12,030
EBITDA (INR mn)	477	263	*81.7*	393	*21.6*	1,339	2,367
Adj. net profit (INR mn)	330	209	*57.9*	275	*20.2*	946	1,717
EPS (INR)						32.6	59.2
P/E (x)						22.3	12.3
EV/EBITDA (x)						16.6	9.4
ROAE (%)						40.7	47.5

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Reuters	:	TULP.BO
Bloomberg	:	TITSL IN

Market Data

52-week range (INR)	:	836 / 162
Share in issue (mn)	:	29.0
M cap (INR bn/USD mn)	:	21.1 / 517.1
Avg. Daily Vol. BSE ('000)	:	788.9

Share Holding Pattern (%)

Promoters	:	69.0
MFs, FIs & Banks	:	6.0
FIIs	:	17.7
Others	:	7.3

Key quarterly highlights

* Strong topline growth across all business segments

TITSL's Q4FY07 net revenues grew at a robust 31% Q-o-Q and 64% Y-o-Y to INR 2.9 bn. Revenue growth momentum was led by an impressive growth in the IP VPN segment revenues (up 50% Q-o-Q to INR 1.2 bn) and NI segment revenues (up 20% Q-o-Q to INR 1.7 bn). Share of the IP VPN segment in the overall revenue mix jumped from 37% in Q3FY07 to 43% in Q4FY07.

- IP VPN revenue growth was led by accelerated subscriber accretion of 16,362 during the quarter, taking the total subscriber base to 51,376. IP VPN ARPUs were relatively flat Q-o-Q at INR 42,000, indicating that competitive pricing pressures have not yet kicked in and TITSL continues to enjoy considerable pricing power for its services currently. The IP VPN network was extended to 150 additional cities, taking the total number of cities under coverage to 800. Around 130 new customers were added during the quarter, taking the total number of customers to 536.
- The sequential jump in NI revenues was largely on account of stronger project billings, led by the year end spurt in IT spending by corporates. During the quarter, TITSL has won an INR 700 mn order from the Haryana government to set up a state-wide area network (SWAN); the project execution is likely to commence in Q1FY08, with revenues spread over the next five years.

* Growth impressive but margins disappoint

Q4FY07 EBITDA jumped 22% Q-o-Q and 82% Y-o-Y to INR 477 mn. Net profits also grew at a healthy pace by 20% Q-o-Q and 58% Y-o-Y to INR 330 mn. However, despite the higher contribution from the more profitable IP VPN business, Q4FY07 EBITDA margins declined by 129bps and net profit margins by 103bps Q-o-Q.

- Direct costs as a percentage of sales increased 30bps Q-o-Q to 77.2%. Since the NI business is largely commoditised, we believe, its operating margins were steady in the quarter. We, therefore, expect cost pressures on the more profitable IP VPN segment. We believe the network expansion into remote areas, where subscriber volumes and usage are likely to be relatively lower, has driven up the per subscriber cost. Lower operating leverage coupled with relatively lower ARPUs in these remote geographies, has led to pressures on operating margins for the IP VPN segment.
- Staff costs jumped 23% Q-o-Q to INR 93 mn, as TITSL continued to expand its team at the top management level, even as the total employee base in FY07 grew 55% to 1,545. For FY07, the sharp increase in staff and SG&A expenses have been key reasons for the ~80bps differential on the operating margin front vis-à-vis our expectations.
- Depreciation was up 39% Q-o-Q to INR 80 mn, driven by strong capex and higher IP VPN asset utilisation. Interest expenses also jumped 32% Q-o-Q, as the company raised INR 400 mn of debt in Q4FY07 primarily to fund its NI project in Haryana.

Calibrating estimates

* Upgrading revenue estimates on improved visibility

We revise our revenue expectations for both NI and IP VPN segment upwards, given strong traction in the IP VPN subscriber accretions and accelerated revenue growth in the NI business.

We estimate NI revenues to grow at a robust CAGR of 25% over FY08-09E. Our positive outlook stems from a strong industry growth scenario (30% CAGR over FY07-09E), particularly as opportunities emerge from government initiatives in the form e-governance projects and SWANS. TITSL is aggressively targeting SWAN tenders to boost revenues from its NI business and then leverage the tender wins to expand its IP VPN business (by providing network connectivity). With industry veterans joining TITSL's management team, we expect strong growth in the NI segment and therefore, incorporate upsides to our revenue estimates for FY08-09. Our revised NI estimates stand at INR 6.6 bn and INR 8.2 bn for FY08 and FY09, respectively (up 9% and 18% respectively over our earlier estimates).

The strong traction in the IP VPN subscriber volumes over the past two quarters has led to an improved visibility on the connect additions, going forward. We, therefore, see upsides to our subscriber estimates for FY08-09. While we see stronger subscriber volumes over FY08-09E, we believe pricing pressures are likely to kick in on account of competition from integrated telecos which are now aggressively targeting the SMB market with integrated product offerings. Also, higher accretion of low usage/low revenue customers is likely to drive blended ARPUs further downwards. We estimate ~60% of TITSL's new connects to be low usage customers.

We upgrade our IP VPN subscriber expectation by 22% and 20% to 10.4 mn and 15.6 mn subscribers for FY08-09E. On an average, we estimate quarterly net adds of 13,100 over FY08-09E vis-à-vis our previous estimate of 10,500. We estimate blended recurring ARPUs to decline at a CAGR of 14% over FY07-09E to ~INR 32,000 on account of competitive pricing pressures. Our revised revenue estimates for the IP VPN business are INR 5.5 bn and INR 6.6 bn for FY08 and FY09, respectively.

* Rising costs to play spoil sport

We expect margin pressures to arise on the more profitable IP VPN business, as we believe that margins on the largely commoditised NI business are likely to remain steady. Despite the higher share of IP VPN revenues over FY08E-09E in our new estimates (~45% versus 42% previously), we expect margin pressures on account of higher operating costs, going forward.

We see increasing cost pressures primarily on account of expansion of the IP VPN network into remote areas (with likely low subscriber density/usage) and switch to licensed spectrum in the existing areas of operations. Vis-à-vis our previous estimates, we, therefore, estimate direct opex (as a share of revenues) to be higher by 184bps and 351bps in FY08E and FY09E, respectively, to 74% over FY08-09E. This, coupled with higher employee costs (up 94% and 84% from our previous estimates) on account of a rising employee base, is expected to drive EBITDA margins further down from previously estimated levels.

Besides higher opex, we expect net margins to be under pressure due to higher depreciation (on account of stronger than previously anticipated capex) and stronger interest expenses (on higher debt funding long gestation NI projects). As per revised management guidance, we have increased our capex estimates for FY08-09E to incorporate additional capex of INR 250 mn for setting up data centres in Bangalore and Kolkata (in FY08E), besides probable upgradation costs to higher technology platforms like WiMAX in FY09E. Our revised capex estimates stand at INR 718 mn and INR 586 mn for FY08E and FY09E respectively vis-à-vis our earlier estimates of INR 445 mn and INR 417 mn. Also, we believe working capital requirements are likely to increase going forward, given the increased management focus on long gestation government NI projects. Given our increased capex estimates over FY08-09E on the IP VPN business and higher working capital requirements on the NI business, we believe that internal accruals are unlikely to suffice the overall funding needs and believe that TITSL is likely to require additional capital to partly fund the initial leg of these projects We have therefore factored in additional debt of INR 250 mn in FY08E on this account. We see pressures on free cash flow (FCF) arising on account of increased funding requirements and therefore believe that TITSL is likely to turn FCF positive in FY09E versus our previous expectation of FY08E.

Our revised EBITDA margin estimates stand at 19.7% over FY08-09 and net profit margins at 14.3% and 14.6% for FY08 and FY09, respectively. On an absolute basis, EBITDA estimates stand revised downwards by a marginal ~1% for FY08 and ~5% for FY09 to INR 2.4 bn and INR 2.9 bn, respectively. Our revised net profit estimates stand at INR 1.7 bn for FY08 and INR 2.2 bn for FY09 (lower by 7% and 10% respectively vis-à-vis our previous estimates).

Table 1: Revised FY08-09E estimates

	FY08E		FY09E		Remarks
	New	Old	New	Old	
IP VPN subscriber base (nos)	104,140	85,456	156,540	130,456	Accelerated IP VPN subscriber growth and government tender wins to drive revenue growth
Revenue (INR mn)	12,030	10,304	14,773	12,375	
EBIDTA (INR mn)	2,367	2,397	2,916	3,058	Higher opex and depreciation to dampen profitability over FY08-09E
Net profit (INR mn)	1,717	1,850	2,160	2,423	
EBITDA margin (%)	19.7	23.3	19.7	24.7	Margin pressures on the IP VPN business to drive down blended margins over FY08-09E
Net margin (%)	14.3	18.0	14.6	19.6	
Fully diluted EPS (INR)	59.2	63.8	74.5	83.5	

Source: Edelweiss research

✻ Valuations and outlook

We have revised our EPS estimates for FY08 and FY09 downwards by 7% and 10% to INR 59 and INR 75, respectively. Despite a downward revision to our estimates, bottomline growth remains impressive at 51% CAGR over FY07-09E. At INR 729, the stock trades at a P/E of 9.8x and EV/EBITDA of 7.4x revised FY09 estimates. We continue to like the stock, given attractive valuations on an absolute basis, coupled with impressive return ratios (RoAE of 48% and 39% and RoACE of 40% and 35% in FY08E and FY09E respectively); we reiterate our 'BUY' recommendation.

Financials snapshot (INR mn)

Year to March	Q4FY07	Q4FY06	% change	Q3FY07	% change	FY07UA	FY08E	FY09E
Total revenues	2,910	1,776	*63.8*	2,220	*31.1*	8,408	12,030	14,773
Raw materials	2,247	1,390	*61.7*	1,708	*31.6*	6,585	8,908	10,978
Staff costs	93	32	*190.6*	76	*22.9*	248	394	443
Other costs	92	92	*0.5*	43	*112.1*	236	361	436
Total expenses	2,432	1,514	*60.7*	1,827	*33.1*	7,069	9,663	11,857
EBITDA	477	263	*81.7*	393	*21.6*	1,339	2,367	2,916
Depreciation	80	33	*143.6*	57	*39.1*	196	331	423
PBIT	398	230	*72.9*	335	*18.6*	1,143	2,036	2,493
Interest	50	15	*225.5*	38	*32.0*	126	160	173
Other income	21	12	*80.4*	2	*1,074.9*	25	32	80
PBT	369	226	*62.9*	299	*23.2*	1,041	1,908	2,400
Tax	38	17	*123.8*	24	*57.4*	96	191	240
Extra-ordinary items	-	4	*(100.0)*	-	-	0	0	0
Reported net profit	330	206	*60.6*	275	*20.2*	946	1,717	2,160
Adjusted net profit	330	209	*57.9*	275	*20.2*	946	1,717	2,160
Equity capital(FV:INR10)	290	290		290		290	290	290
# of shares (mn)	29	29		29		29	29	29
Adjusted EPS (INR)	11.4	7.2		9.5		33	59	74
PE (x)						22.3	12.3	9.8
EV/EBITDA (x)						16.6	9.4	7.4
as % of net revenues								
Raw materials	77.2	78.2		76.9		78.3	74.0	74.3
Staff costs	3.2	1.8		3.4		2.9	3.3	3.0
Other costs	3.2	5.2		2.0		2.8	3.0	3.0
EBITDA	16.4	14.8		17.7		15.9	19.7	19.7
Adjusted net profit	11.4	11.8		12.4		11.2	14.3	14.6
Tax rate	10.4	7.6		8.2		9.2	10.0	10.0

Table 2: Operating metrics (nos)

Year to March	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07
IP VPN connects	5,950	9,513	14,980	24,106	35,014	51,376
Net additions	-	3,563	5,467	9,126	10,908	16,362
IP VPN customers	126	239	296	339	406	536
Cities covered	130	350	540	550	650	800

Source: Company

Company Background

Tulip operates in two principle lines of business – network integration and management services and enterprise connectivity services. Under the network integration segment, Tulip provides the entire gamut of services from network design and development to remote network management and maintenance. Tulip was the fourth largest network integrator in India in FY06 with a market share of 7.8%. The enterprise connectivity segment entails providing inter-city and intra-city wireless IP VPN connectivity to enterprises. Tulip's IP VPN network is spread across 800 cities and comprises leased lines and fibre optic cables from multiple service providers coupled with its own MPLS based wireless network.

Investment Theme

We are positive on Tulip's business prospects as an integrated provider of network equipment and connectivity for enterprises. Being a significant player in a niche but fast growing IP VPN market (expected to double over FY07-09E to INR 12 bn as per Frost & Sullivan estimates), we see strong traction in the IP VPN business driving revenue growth and profitability for Tulip. While we expect the NI business to be significantly topline accretive, segment margins will continue to remain squeezed on account of intense competitive pressures. We expect revenues to grow at a CAGR of 33% to INR 14.8 bn and net profits at a CAGR of 51% over FY07-09E to INR 2.2 bn.

Key Risks

We see competition from integrated players like Bharti Airtel, Reliance Communications and BSNL as the key risk to Tulip's profitability and market share. With the SME segment (currently the key market for Tulip) being considered as a lucrative opportunity by several large players, we believe that added competitive pressure will significantly increase the risk quotient for Tulip.

Also, the emergence of new cost-effective and more efficient technologies may directly impact Tulip's business – particularly since it operates in a niche segment and offers a single technology to its customers. Adopting new technologies or switching over to new service offerings may require significant capex that may not be viable for Tulip.

Financial Statements

Income statement (INR mn)

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Income from operations	3,422	5,081	8,408	12,030	14,773
Direct costs	3,088	4,142	6,585	8,908	10,978
Employee costs	62	99	248	394	443
Other expenses	73	179	236	361	436
Total operating expenses	3,223	4,419	7,069	9,663	11,857
EBITDA	199	662	1,339	2,367	2,916
Depreciation and amortisation	10	43	196	331	423
EBIT	189	619	1,143	2,036	2,493
Interest expenses	35	64	126	160	173
Other income	6	12	25	32	80
Profit before tax	160	567	1,041	1,908	2,400
Provision for tax	27	76	96	191	240
Extraordinary items	(5)	4	-	-	-
Reported profit	139	488	946	1,717	2,160
Adjusted net profit	134	491	946	1,717	2,160
Shares outstanding	20.0	29.0	29.0	29.0	29.0
Dividend per share	-	1.0	1.0	2.0	3.0
Dividend payout %	-	5.9	3.1	3.4	4.0

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Operating expenses	94.2	87.0	84.1	80.3	80.3
Depreciation	0.3	0.8	2.3	2.8	2.9
Interest expenditure	1.0	1.2	1.5	1.3	1.2
EBITDA margins	5.8	13.0	15.9	19.7	19.7
Net profit margins	3.9	9.7	11.2	14.3	14.6

Growth metrics (%)

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Revenues	24.7	48.5	65.5	43.1	22.8
EBITDA	90.9	232.2	102.2	76.8	23.2
PBT	106.7	253.7	83.5	83.2	25.8
Net profit	107.3	266.8	92.5	81.6	25.8
EPS	107.3	266.8	92.5	81.6	25.8

Cash flow statement (INR mn)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net profit	139	488	946	1,717	2,160
Add: Depreciation	10	43	196	331	423
Add: E.O.Adjustments	0	0	-	-	-
Add: Deferred tax	4	(10)	-	-	-
Gross cash flow	153	521	1,142	2,048	2,583
Less: Dividends	-	29	29	58	87
Less: Changes in W. C.	205	979	710	1,347	1,174
Operating cash flow	(52)	(487)	403	643	1,322
Less: Change in investments	-	20	-	-	-
Less: Capex	145	574	1,195	718	586
Free Cash flow	(197)	(1,082)	(792)	(75)	736

Balance sheet (INR mn)

As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	200	290	290	290	290
Reserves & surplus	266	1,576	2,492	4,152	6,225
Shareholders funds	466	1,866	2,782	4,442	6,515
Secured loans	238	756	1,396	1,646	1,646
Borrowings	238	756	1,396	1,646	1,646
Sources of funds	704	2,622	4,178	6,087	8,161
Gross block	227	800	1,995	2,713	3,299
Depreciation	31	73	269	600	1,023
Net block	196	727	1,726	2,113	2,276
Total fixed assets	196	727	1,726	2,113	2,276
Investments	0	20	20	20	20
Inventories	206	263	540	1,220	1,504
Sundry debtors	602	1,457	1,958	3,131	4,250
Cash and equivalents	88	467	315	491	1,227
Loans and advances	24	142	336	722	886
Total current assets	919	2,329	3,149	5,564	7,867
Sundry creditors and others	380	368	591	1,359	1,674
Provisions	22	86	125	249	327
Total CL & provisions	403	454	716	1,608	2,001
Net current assets	516	1,875	2,433	3,956	5,866
Net deferred tax	(10)	(2)	(2)	(2)	(2)
Misc expenses not w/o	1	1	1	1	1
Uses of funds	704	2,622	4,178	6,087	8,161
Book value per share (BV)	23	64	96	153	225

Ratios

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
ROAE (%)	41.0	42.1	40.7	47.5	39.4
ROACE (%)	37.4	37.2	33.6	39.7	35.0
Current ratio	2.3	5.1	4.4	3.5	3.9
Debtors (days)	64	105	85	95	105
Fixed assets t/o (x)	17.4	7.0	4.9	5.7	6.5
Average working capital t/o (x)	8.9	4.2	3.9	3.8	3.0
Debt/Equity	0.5	0.4	0.5	0.4	0.3

Valuations parameters

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Adjusted EPS (INR)	4.6	16.9	32.6	59.2	74.5
Y-o-Y growth	*107.3*	*266.8*	*92.5*	*81.6*	*25.8*
CEPS (INR)	7.2	18.4	39.4	70.6	89.1
PE (x)	157.8	43.0	22.3	12.3	9.8
Price/BV(x)	31.3	11.3	7.6	4.8	3.2
EV/Sales (x)	6.2	4.2	2.6	1.9	1.5
EV/EBITDA (x)	106.7	32.3	16.6	9.4	7.4

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Gautam Roy	-	2286 4305	Airlines, Textile
Ashutosh Goel	-	2286 4287	Automobiles, Auto Components
Vishal Goyal, CFA	-	2286 4370	Banking & Finance
Revathi Myneni	-	2286 4413	Cement
Sumeet Budhraja	-	2286 4430	FMCG
Harish Sharma	-	2286 4307	Infrastructure, Auto Components, Mid Caps
Priyanko Panja	-	2286 4300	Infrastructure, Engineering, Telecom
Hitesh Zaveri	-	2286 4424	Information Technology
Parul Inamdar	-	2286 4355	Information Technology
Priyank Singhal	-	2286 4302	Media, Retail
Prakash Kapadia	-	4097 9843	Mid Caps
Niraj Mansingka	-	2286 4304	Oil & Gas, Petrochemicals
Nimish Mehta	-	2286 4295	Pharmaceuticals, Agrochemicals
Manika Premsingh	-	4019 4847	Economist
Sunil Jain	-	2286 4308	Alternative & Quantitative
Yogesh Radke	-	2286 4328	Alternative & Quantitative

INSTITUTIONAL SALES		
Nischal Maheshwari	-	2286 4205
Rajesh Makharia	-	2286 4202
Shabnam Kapur	-	2286 4394
Balakumar V	-	(044) 4263 8283
Ashish Agrawal	-	2286 4301
Nikhil Garg	-	2286 4282
Swati Khemani	-	2286 4266
Neha Shahra	-	2286 4276
Priya Ramchandran	-	2286 4389
Anubhav Kanodia	-	2286 4361
Tushar Mahajan	-	2286 4439
Harsh Biyani	-	2286 4419
Nirmal Ajmera	-	2286 4258
Ankit Doshi	-	2286 4671
Dipesh Shah	-	2286 4434

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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