

Tulip IT Services

CMP: Rs 267

Target: Rs 383

BUY

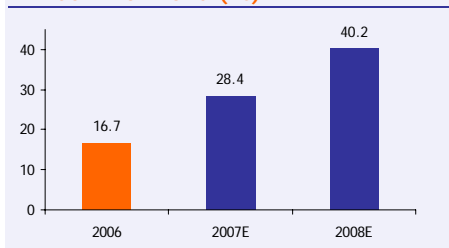
BSE Code 532691
NSE Code TULIP

Financial Summary

(Rs mn)	FY06	FY07E	FY08E
Sales	5,084.4	6,695.0	8,065.6
Growth (%)	48.6	31.7	20.5
Net profit	484.6	823.7	1,166.6
Growth (%)	248.4	70.0	41.6
EPS (Rs)	16.7	28.4	40.2
Growth (%)	44.2	70.0	41.6
P/E (x)	16.0	9.4	6.6
ROE (x)	25.9	32.4	33.1
EV/EBITDA(x)	12.8	8.3	6.2

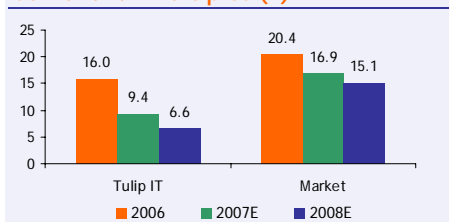
Source: Company; Brics PCG Research

Annual EPS Trend (Rs)



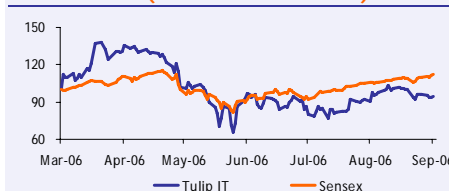
Source: Brics PCG Research

Current P/E Multiples (x)



Source: Brics PCG Research

Price Chart (Relative to Sensex)



Source: Capitaline

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We are revising our estimates and target for Tulip IT Services in order to incorporate the higher-than-expected demand for its wireless IP/VPN corporate data services (CDS) as well as a shift in our valuation method. We have upgraded our FY07 and FY08 EPS estimates to Rs 28.4 and Rs 40.2 from Rs 22.3 and Rs 29.5 respectively. We reaffirm our BUY recommendation with a revised March '07 target of Rs 383, which is 12% lower than our previous target of Rs 437. This revision is mainly because we have switched from a P/E-based valuation model to the DCF method which we feel is more appropriate given the recurring nature of revenues from Tulip's high-margin CDS business. In our opinion, the company's current valuations do not factor in the high growth and profitability of its CDS business and the expected growth in coming quarters.

CDS to fuel growth

In FY05, Tulip forayed into the business of providing connectivity solutions to corporates through last mile wireless networks. Since then this segment has grown exponentially from 2,900 connects in March '05 to 15,000 connects as of June '06, which is a compounded monthly growth rate of 12%. To expand its coverage across cities Tulip raised funds of Rs 1.1bn through an IPO and debt issues. The company has already expanded to 540 cities, far more than the 130 promised in its IPO prospectus.

With its extensive reach and brand recognition, we expect the growth in number of connects to increase at a much faster pace. Tulip has already added a total of 5,476 connects in Q1FY07, which is almost 60% of the total connects as at the end of FY06. We expect the number of connects to grow by 215% in FY07 and at a CAGR of 110% between the period FY06-09.

Network Integration segment to remain subdued

Tulip is currently one of the leading network integrators in the country. According to *Voice & Data* magazine, the company is the fourth largest player in the market, next to Wipro, Datacraft and HCL Comnet. However, we expect the network integration (NI) segment to grow at a much slower rate than CDS, with a CAGR of 12.5% projected over FY06-09. Our low growth assumption is despite the fact that the NI business grew by 23% in FY06. In our view, since this segment offers much lower profitability as compared to CDS, the management is more likely to focus its resources towards CDS. Higher-than-anticipated growth in NI would be a positive upside to our conservative forecast for this segment.

Network Integration market

Revenue (Rs mn)	2004	2005	2006	CAGR (%)
Wipro Infotech	3,230	4,860	6,700	44.0
Datacraft	3,500	4,660	5,400	24.2
HCL Comnet	2,540	3,760	4,910	39.0
Tulip IT	2,760	3,040	4,090	21.7
HCL Infosystems	1,680	2,780	2,450	20.8
GTL	2,340	2,240	2,290	(1.1)
Others	17,670	20,300	25,350	19.8
Total	33,720	41,640	51,190	23.2

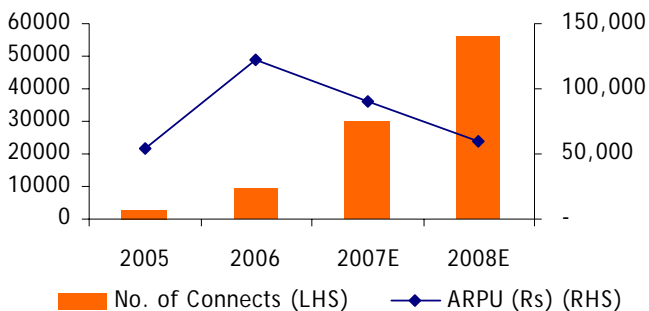
Source: Voice & Data

Average revenue expected to decline, but overall margins to remain strong

We expect the average revenue per user (ARPU) for the CDS business to decline in the coming years due to:

- Entry of competitors:** The possibility of competitors entering into the business of providing connectivity through last mile wireless networks is high considering the large profit margins in the business. Though Tulip has the first mover's advantage in the market we believe that the presence of competition would certainly put pressure on the company's pricing strategy.
- Low bandwidth solutions:** One of the USPs of Tulip's CDS business is its delivery of connectivity products with 2 kbps-32 kbps bandwidth, the pricing of which is lower than the company's current average pricing. We believe that in future a significant portion of the connect addition would take place for such products which ultimately would bring down the average pricing and thus ARPU of the business.
- Need to build higher volumes:** Tulip currently charges rates which are at par with its competitors for bandwidth requirements of 64 kbps or higher. The company may decrease its prices to facilitate higher volume growth.

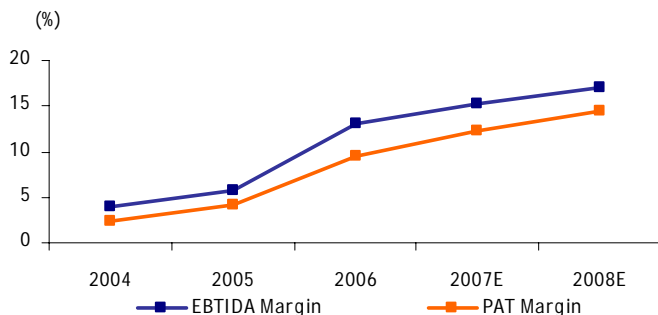
ARPU trend



Source: Company; Brics PCG Research

With the decline in ARPU, we also expect the company's operating profit margins to fall in coming years. However, as the contribution from the CDS business grows each year, we expect Tulip's overall margins to improve.

Profit margin trend



Source: Company; Brics PCG Research

Revenue and EPS estimates revised upwards

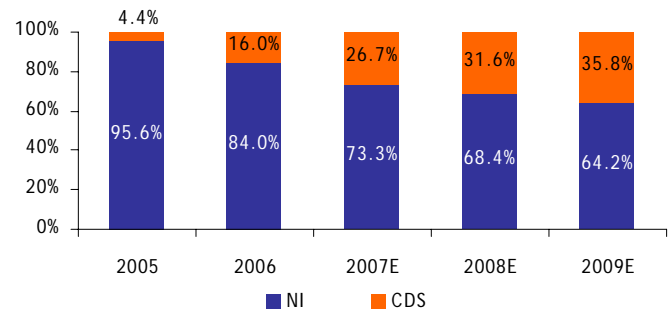
Considering Tulip's FY06 financial performance we are revising our revenue and EPS estimates for FY07 and FY08 upwards. In FY06, the company recorded revenues of Rs 5,084mn against our expectation of Rs 4,755mn. The EPS on fully expanded equity base was Rs 16.7 against our estimate of Rs 13.1.

We now expect Tulip to record revenues of Rs 6,695mn in FY07 and Rs 8,066mn in FY08, an upward revision of 8% and 12% respectively. The EPS estimates for these two years now stand at Rs 28.4 and Rs 40.2, revised upwards by 27% and 36% respectively. We expect the company's revenue and EPS to grow at a CAGR of 23% and 46% respectively over the period FY06-09.

CDS potential not fully built into current valuations

At the current price of Rs 267, Tulip is trading at 9.4x and 6.6x on FY07 and FY08 expected earnings of Rs 28.4 and Rs 40.2 respectively. We believe that the current valuations do not fully capture the potential growth in the company's CDS business.

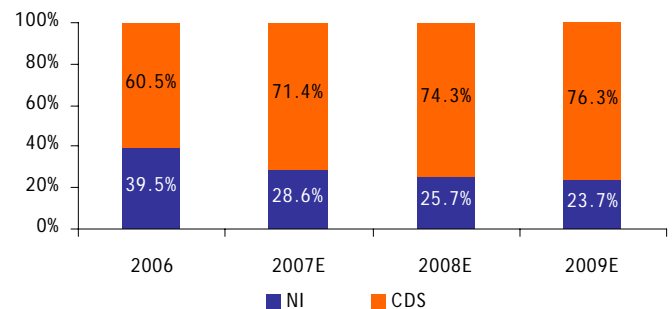
CDS contribution to Total revenues



Source: Company; Brics PCG Research

In FY06 CDS contributed 16% of the total revenues with the balance coming in from NI. However, according to our estimates, out of the operating profit of Rs 660mn, 60% was contributed by CDS and only 40% by NI. We expect the contribution of CDS to operating profits to increase further as its share in overall revenue rises.

CDS contribution to Total operating profit*



Source: Brics PCG Research; * Operating profit break-up not reported by Tulip

In order to lend a perspective on growth expected from the connectivity business and valuations given to such companies, we have provided a comparison between Tulip and Sify (see tables below) although Sify is not a direct competitor.

Sify offers internet and data connectivity to three main verticals—corporates, households and internet portals. Out of the three verticals, CDS is the only EBITDA positive business that the company has with other verticals incurring losses in FY06. In terms of valuation Sify is trading at 65x and 28.5x on expected FY07 and FY08 earnings respectively (Bloomberg estimates). While Tulip's CDS business size and nature may not warrant similar valuations, we believe the current valuations are certainly cheap.

Valuation

We have switched from a P/E-based valuation model to the DCF method which we feel is more appropriate in view of the recurring nature of revenues from the company's high-margin CDS business. We have determined Tulip's enterprise value by applying the DCF model separately for NI and CDS.

DCF Model: Key assumptions

Parameter	Value
Cost of debt	10.0%
Beta	1.2
Risk free rate	8.0%
Market risk premium	7.0%
Cost of equity	16.4%
Costs of Capital	15.8%
Terminal growth rate	
NI	2.5%
CDS	3.5%

Source: Brics PCG Research

Tulip vs Sify - Comparison

	FY06			FY07E		
	Sales (Rs mn)	EBITDA (Rs mn)	OPM (%)	Sales (Rs mn)	EBTIDA (Rs mn)	OPM (%)
Sify - CDS	2,531.1	1,018.3	40.2	3,408.8	1,356.3	39.8
Sify - Overall	4,606.4	204.1	4.4	5,982.8	217.4	3.6
Tulip IT - CDS	814.9	399.6	49.0	1,788.2	729.3	40.8
Tulip IT - Overall	5,081.7	660.1	13.0	6,695.0	1,021.1	15.3

Source: Company; Brics PCG Research; Bloomberg Estimates

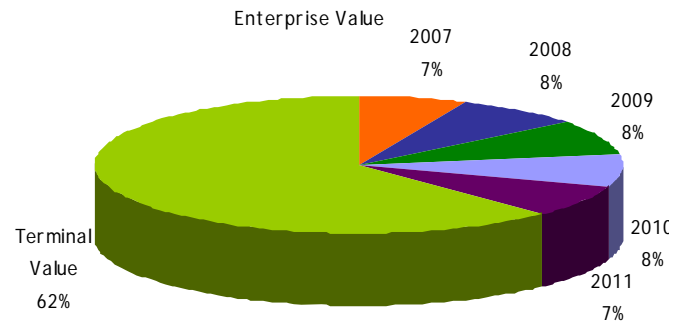
Sify valuations

	CDS as % of Overall				EV/EBITDA '07 (x)	EV/Sales '07 (x)	P/E '07 (x)
	Sales '06	EBITDA '06	Sales '07	EBITDA '07			
Sify	54.9	498.9	57.0	624.0	62.8	2.3	65.0
Tulip IT	16.0	60.5	26.7	71.4	8.3	1.3	9.4

Source: Brics PCG Research

According to our valuation model, the March '07 enterprise value of Tulip should be Rs 11,868.2mn. Going by our estimates, approximately 85% of the enterprise value should be attributed to the CDS business and the balance 15% to the NI business. This is in line with the contribution of each segment to the total profits.

Enterprise value distribution



Source: Brics PCG Research

Due to the altered valuation model, our March '07 target price stands revised from Rs 437 to Rs 383, a reduction of 12%. We believe that the current valuations of the company are cheap and are set for a re-rating as the company's CDS business ramps up in the coming quarters. **BUY.**

Financials

Profit & Loss Statement

Year-end Mar (Rs mn)	FY05	FY06	FY07E	FY08E
Revenues	3,422.1	5,084.4	6,695.0	8,065.6
% change	24.6	48.6	31.7	20.5
EBITDA	199.5	662.7	1,021.1	1,370.0
% change	85.5	232.2	54.1	34.2
Depreciation	10.0	43.0	81.5	131.0
EBIT	189.5	619.7	939.6	1,239.0
% change	88.8	227.0	51.6	31.9
Interest	35.3	63.6	79.8	71.1
Other income	6.3	11.8	61.1	108.0
EBT	160.4	567.8	920.9	1,275.9
% change	98.9	254.0	62.2	38.6
Tax	26.5	78.0	97.2	109.3
As % of EBT	16.5	13.7	10.6	8.6
Net income (adjusted)	139.1	484.6	823.7	1,166.6
% change	110.4	248.4	70.0	41.6
Shares outstanding (m)	12.0	29.0	29.0	29.0
EPS (Rs)	11.6	16.7	28.4	40.2
DPS (Rs)	11.6	16.7	28.4	40.2
CEPS (Rs)	12.4	18.2	31.2	44.8

Source: Company; Brics PCG Research

Cash Flow

Year-end Mar (Rs mn)	FY05	FY06	FY07E	FY08E
EBT	160.4	567.8	920.9	1,275.9
Depreciation	10.0	43.0	81.5	131.0
Chnge in working capital	(205.4)	(979.1)	169.1	(25.6)
Operating cash flow	(35.1)	(368.3)	1,171.5	1,381.3
Interest	35.3	63.6	79.8	71.1
Other income	(2.3)	(11.4)	(60.7)	(107.6)
Tax	5.2	(91.2)	(97.2)	(109.3)
Cashflow from opertns	(19.3)	(407.4)	1,093.4	1,235.5
Capex	(145.0)	(574.3)	(332.0)	(223.4)
(Inc)/dec in investments	(56.0)	(381.7)	-	-
Cashflow from investing	(201.0)	(956.0)	(332.0)	(223.4)
Dividend paid	-	(33.1)	(48.9)	(65.2)
Proceeds from equity	140.0	948.0	-	-
Inc/(dec) in debt	114.8	518.2	10.6	(24.1)
Interest paid	(35.3)	(63.6)	(79.8)	(71.1)
Cashflow from financing	219.5	1,369.7	(118.2)	(160.4)
Change in cash	(0.8)	6.2	643.2	851.7

Source: Company; Brics PCG Research

Recommendation history

SN	Date	Event	Target	Reco
1	09/12/05	IPO Subscribe	-	BUY
2	05/04/06	Target price	437	BUY
3	22/09/06	Revised target	383	BUY

Source: Brics PCG Research

Balance Sheet

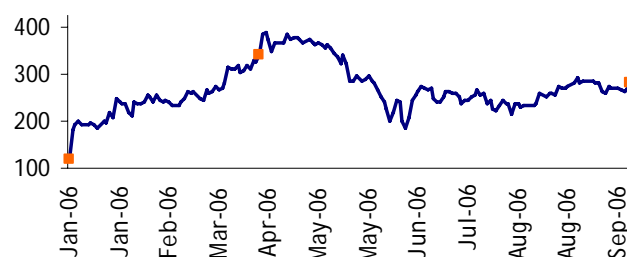
Year-end Mar (Rs mn)	FY05	FY06	FY07E	FY08E
Cash and cash equivalents	88.1	468.2	1,111.4	1,963.1
Accounts receivable	601.6	1,458.4	1,311.3	1,358.3
Inventories	205.6	262.5	336.9	397.6
Others	24.7	144.5	144.5	144.5
Current assets	920.1	2,333.6	2,904.1	3,863.4
LT investments	0.2	20.1	20.1	20.1
Net fixed assets	164.1	727.2	949.2	1,041.6
CWIP	32.1	-	-	-
Total assets	1,116.4	3,081.0	3,873.4	4,925.1
Payable	368.4	304.3	400.7	482.7
Others	34.3	150.8	162.0	174.1
Current Liabilities	402.7	455.1	562.7	656.8
LT debt	237.6	755.8	766.4	742.4
Other Liab (deferred tax)	9.9	1.9	1.9	1.9
Equity capital	260.0	290.0	290.0	290.0
Reserves	206.1	1,578.1	2,252.4	3,234.0
Net worth	466.1	1,868.0	2,542.3	3,523.9
Total Liabilities	1,116.4	3,081.0	3,873.4	4,925.1
BVPS (Rs)	39.7	64.5	87.7	121.6

Source: Company; Brics PCG Research

Ratio Analysis

Year-end Mar (Rs mn)	FY05	FY06	FY07E	FY08E
EBITDA margin (%)	5.8	13.0	15.3	17.0
Net profit margin (%)	4.1	9.5	12.3	14.5
EPS growth (%)	110.4	44.2	70.0	41.6
Receivables (days)	66.7	104.7	71.5	61.5
Inventory (days)	23.3	21.7	21.7	21.7
Payables (days)	39.3	21.8	21.8	21.8
Current ratio (x)	2.3	5.1	5.2	5.9
Interest coverage (x)	4.9	8.6	11.3	17.4
Debt/equity ratio (x)	0.5	0.4	0.3	0.2
Sales/Gross fixed assets (x)	17.6	6.4	6.1	6.1
ROE (%)	29.2	25.9	32.4	33.1
ROCE (%)	27.4	24.0	30.2	31.6
EV/Sales (x)	2.5	1.7	1.3	1.1
EV/EBITDA (x)	42.6	12.8	8.3	6.2
Price to earnings (x)	23.0	16.0	9.4	6.6
Price to book value (x)	6.7	4.1	3.0	2.2
Price to cash earnings (x)	21.5	14.7	8.5	6.0

Source: Company; Brics PCG Research



Source: Company; Brics PCG Research

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Definition: Large Cap = MCap > Rs30bn;

Mid Cap = MCap Rs5bn < Rs30bn;

Small Cap = MCap < Rs5bn

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