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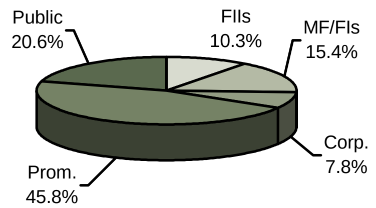
# 3i Infotech

## Hold – Upgrade target price to Rs.337

| Recommendation | Hold |
|---|---|
| **Price (Rs)** | **312** |
| **Price target /upside** | **337/8%** |
| 52 week high/low | 323/123 |
| Shares o/s (mn) | 56.31 |
| Market cap (Rs mn) | 17,593 |
| Market cap (US$ mn) | 430 |
| Avg daily vol (mn) | 0.97 |
| Bloomberg | III IN |
| Reuters | TIIN.BO |

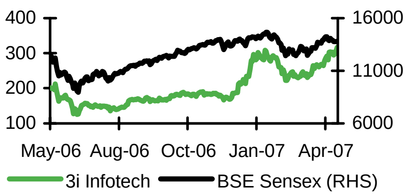
*Source:Bloomberg*

### Shareholding pattern (%)




*Source: Capitaline*

### Price performance




*Source: Capitaline*

### Performance (%)

| | 1M | 3M | 12M | YTD |
|---|---|---|---|---|
| Absolute | 16.9 | 8.0 | 57.2 | 66.6 |
| Rel. to sensex | 12.0 | 8.4 | 38.3 | 64.4 |

*Source: Bloomberg*

### Key financials (Rs mn)

| Yr toMar | 2006 | 2007 | 2008E | 2009E |
|---|---|---|---|---|
| Sales | 4,178 | 6,553 | 10,279 | 12,931 |
| % change | 44.5 | 56.8 | 56.9 | 25.8 |
| EBIDTA | 858 | 1,322 | 2,019 | 2,592 |
| EBIDTA mgn (%) | 20.5 | 20.2 | 19.6 | 20.0 |
| Net profit | 574 | 1,037 | 1,508 | 2,001 |
| EPS (Rs) | 9.1 | 17.4 | 19.3 | 25.9 |
| % change | 34.0 | 90.0 | 11.0 | 34.4 |
| RoE (%) | 18.8 | 27.2 | 15.5 | 17.4 |
| Net D/E (%) | 20.2 | 114.3 | 6.4 | (1.5) |
| P/E (x) | 34.1 | 18.0 | 16.2 | 12.0 |
| P/BV (x) | 6.2 | 4.9 | 2.5 | 2.1 |
| EV/EBIDTA (x) | 20.2 | 16.5 | 8.5 | 6.3 |
| Div payout (%) | 25.7 | 12.1 | 8.2 | 6.2 |

*Source: Company, Ambit Capital Research estimates*

3i Infotech capped FY07 with a ~57% yoy growth in revenues and an 81% yoy growth in PAT, the EBITDA margins at 20.2% declined by 30bps over FY06, mainly on account of a change in accounting policy, leading to expensing of product development expenses, which were earlier capitalized. Excluding this item the margins expanded by ~370bps. The net margins of the company showed an improvement of 210bps.

The company has given a strong guidance implying a revenue growth of 53%-68% and PAT growth in the range of 40-49%. The EPS growth though would be impacted by the anticipated dilution on account of the three FCCB's amounting to ~$110mn over the past 12-months.

We expect the revenue and PAT to show a CAGR of 40.5% and 38.7% over the period FY07-FY09E, the EPS growth would be depressed at 22.1% CAGR over the same period considering all the FCCB dilutions.

Based on our projections the stock is currently trading at a P/E of 16.2x FY08E and 12x FY09E fully diluted earnings. At this price we believe the stock is fairly valued. We recommend a hold on the stock and upgrade the target price to Rs.337 based on an FY09E P/E multiple of 13x, an upside of 8% from current levels.

## Key highlights

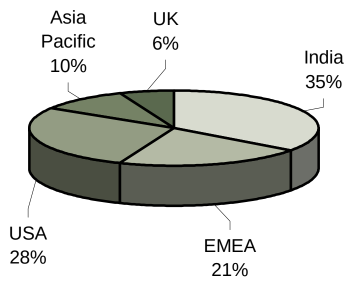
**Strong Guidance:** The Company has guided for revenue growth in the range of 53%-68% and PAT in the range of 40-49%. In terms of fully diluted EPS (considering all FCCB dilutions) this works out to an EPS of Rs.18.5-Rs19.8, implying an increase of 6.5%-14% yoy.

**Order book provides considerable cushion:** The company's combined order book of Rs.5687mn, represents ~55% of our projected FY08E revenues. A heartening feature of the increase in order book has been a 69% qoq increase in the services order book in Q4FY07 on e-governance and US related orders. The overall order book has increased by in excess of 32% qoq for the last two quarters. We expect the services and products growth to be more even this year.

**Improvements in margins on products and services:** The gross margins on both products and services have improved over FY06 by 190bps and 180bps respectively. The current gross margins on products are ~54.3% and on services is ~38%. Though we expect a decline of 60bps in EBITDA margins in FY08 on account of full year impact of acquisitions, wage inflation on the services side and ramp up on BPO front. We further see the net margins being impacted by higher tax rate on account to MAT, as the current effective tax rate is ~4.9%.

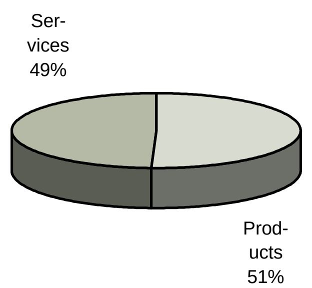
**Inorganic triggers:** The company has ~$50mn from its FCCB kitty remaining, which would be utilized for acquisitions over the next 18 months. We have not taken this into consideration in terms of our valuation, but if these acquisitions materialize, at similar valuations as previous acquisitions, the stock returns could be impacted positively.

**Geographical mix**




Source: Company, Ambit Capital Research

**Product services mix**




Source: Company, Ambit Capital Research

## Expanded services and product portfolio

The company has during the year expanded its service and product offerings through focused acquisitions. On the products side the major expansion has happened in its capital market portfolio, whereas on the services side-BPO services and its IT consulting and application development and maintenance have been perked up.

**Expansion of geographical footprint:** The Company has expanded its geographical footprint to UK through the acquisition of Rhyme Systems. This will be used as a vehicle for cross selling its other BFSI products and services in this market. The diversified geographical mix would help the company minimize the impact of the rupee appreciation as only 28% of its revenues are derived out of Americas.

**Expansion of services:** The Company has expanded its BPO offerings to mutual funds and insurance. The areas it will focus in are mutual fund accounting and investor servicing, registrar and transfer services. In addition the company intends to provide managed services and consulting services in the area of e-governance. The company has further expanded its offerings in the capital markets space through the Rhyme acquisition, Datacons and SDG acquisitions in FY07.

**Expansion of products:** The company has added to its capital market portfolio through a wide range of products targeted towards private wealth management, mutual funds, brokerages to anti money laundering and control/compliance systems.

# Key financials

## Balance sheet

| Year to Mar (Rs mn) | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Cash & equivalents | 162 | 2,604 | 986 | 2,850 | 3,696 |
| Debtors | 1,389 | 2,111 | 3,196 | 4,787 | 6,023 |
| Loans & Advances | 304 | 448 | 703 | 1,103 | 1,388 |
| Investments | 22 | 1 | 0 | 0 | 0 |
| Fixed Assets | 1,808 | 2,238 | 1,593 | 1,688 | 1,779 |
| Goodwill on Consolidation | 355 | 704 | 5,780 | 5,780 | 5,780 |
| Other Assets | 236 | 139 | 118 | 118 | 118 |
| **Total assets** | **4,276** | **8,246** | **12,377** | **16,327** | **18,784** |
| Debt | 1,454 | 3,350 | 6,200 | 3,509 | 3,509 |
| Other liabilities | 911 | 1,210 | 1,616 | 2,535 | 3,188 |
| **Total liabilities** | **2,365** | **4,560** | **7,816** | **6,044** | **6,698** |
| Shareholders' equity | 1,810 | 1,530 | 1,563 | 1,744 | 1,744 |
| Reserves & surpluses | 101 | 2,155 | 2,998 | 8,540 | 10,343 |
| **Total networth** | **1,911** | **3,686** | **4,561** | **10,283** | **12,086** |
| Net working capital | 783 | 1,353 | 2,283 | 3,356 | 4,222 |
| Net debt/ (cash) | 1,292 | 746 | 5,214 | 659 | (187) |

## Income statement

| Year to Mar (Rs mn) | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Net sales | 2,892 | 4,178 | 6,553 | 10,279 | 12,931 |
| % growth | 26.2% | 44.5% | 56.8% | 56.9% | 25.8% |
| Cost of Revenue | 1,655 | 2,351 | 3,785 | 6,050 | 7,623 |
| SGA | 756 | 970 | 1,446 | 2,210 | 2,715 |
| **EBITDA** | **480** | **858** | **1,322** | **2,019** | **2,592** |
| % growth | 242.2% | 78.6% | 54.1% | 52.8% | 28.4% |
| Depreciation/ amortization | 188 | 261 | 169 | 206 | 259 |
| EBIT | 292 | 597 | 1,153 | 1,814 | 2,333 |
| Interest | 108 | 80 | 209 | 294 | 311 |
| Other Income | 29 | 62 | 155 | 128 | 210 |
| Pre-tax profit | 213 | 580 | 1,098 | 1,647 | 2,232 |
| Tax | (108) | 3 | 53 | 132 | 223 |
| **Net profit** | **321** | **577** | **1,045** | **1,516** | **2,009** |
| % growth | NA | 1 | 1 | 0 | 0 |
| Minority Interest | 0 | 2 | 7 | 7 | 7 |
| **Adjusted Net Profit** | **321** | **574** | **1,037** | **1,508** | **2,001** |

## Cash flow

| Year to Mar (Rs mn) | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| EBIT | 292 | 595 | 1,145 | 1,807 | 2,326 |
| Depreciation/ amortization | 188 | 261 | 169 | 206 | 259 |
| Tax paid | 108 | (3) | (53) | (132) | (223) |
| Other Adjustments | 35 | 100 | 17 | 0 | 0 |
| Net working capital | (172) | (570) | (931) | (1,073) | (866) |
| **Operating cash flow** | **452** | **383** | **347** | **807** | **1,496** |
| Capital expenditure/Acquisitions | (625) | (1,040) | (4,600) | (300) | (350) |
| Investments | 79 | 21 | 1 | 0 | 0 |
| **Investing cash flows** | **(546)** | **(1,019)** | **(4,599)** | **(300)** | **(350)** |
| Increase/ (decrease) in borrowings | 511 | 1,896 | 2,850 | (2,691) | 0 |
| Issuance of equity | (159) | 1,420 | 37 | 4,412 | (0) |
| Interest paid on borrowing | (108) | (80) | (209) | (294) | (311) |
| Dividend paid | (169) | (220) | (198) | (198) | (198) |
| Other Income | 29 | 62 | 155 | 128 | 210 |
| **Financing cash flow** | **104** | **3,079** | **2,634** | **1,356** | **(300)** |
| Net change in cash | 10 | 2,442 | (1,618) | 1,864 | 846 |
| **Closing cash balance** | **162** | **2,604** | **986** | **2,850** | **3,696** |

## Ratio analysis

| (%) | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| EBIDTA margin | 16.6 | 20.5 | 20.2 | 19.6 | 20.0 |
| Net profit margin | 11.1 | 13.7 | 15.8 | 14.7 | 15.5 |
| ROCE | 8.7 | 8.5 | 10.7 | 13.2 | 15.0 |
| Op. ROCE (excl cash) | 9.1 | 13.5 | 11.8 | 16.6 | 19.6 |
| Net debt to equity | 67.6 | 20.2 | 114.3 | 6.4 | (1.5) |
| Current ratio (x) | 2.0 | 4.3 | 3.0 | 3.4 | 3.5 |

## Valuation parameters

| | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| EPS (Rs) | 6.9 | 9.5 | 18.0 | 19.3 | 25.9 |
| Diluted EPS (Rs) | 6.8 | 9.1 | 17.4 | 19.3 | 25.9 |
| P/E (x) | 45.7 | 34.1 | 18.0 | 16.2 | 12.0 |
| P/BV (x) | 23.5 | 6.2 | 4.9 | 2.5 | 2.1 |
| EV/ EBIDTA (x) | 37.2 | 20.2 | 16.5 | 8.5 | 6.3 |
| EV/Sales(x) | 6.2 | 4.1 | 3.3 | 1.7 | 1.3 |

*Source: Company, Ambit Capital Research estimates*

## Company business portfolio

**Products**

| Area | Product | Description |
|---|---|---|
| Insurance | Premia | The PREMIA insurance management solutions suite comprises PREMIA General Insurance, PREMIA Health, PREMIA Life (covering Agency Manage ment), PREMIA Property & Casualty and PREMIA Collaborator. |
| Banking | Kastle Banking Suite | This suite contains products for the following domains:<br>■ Core Banking<br>■ Treasury<br>■ Asset Liability Management (previously NEWTON)<br>■ Risk Management (previously Pinnacle)<br>■ Universal Lending (previously Triton)<br>■ Factoring<br>■ Anti Money Laundering<br>■ Wealth Management |
| ERP | Orion | ERP Package specifically verticalised for the following industries:<br>■ Auto Ancillary<br>■ Pharma<br>■ Chemical<br>■ IT Distribution<br>■ Engineering<br>■ Apparel |
| Anti Money Laundering and control | AMLOCK | Products acquired from SDG Software. The solution offers robust analytics in the Know Your Customer (KYC) and Transaction Analysis segments, specifically catered to Insurance, Banking and Capital Markets- Brokerages, MFs and Registrars |
| Capital Markets | **Mutual Funds**<br>MFund/AM<br>MFund/ISS<br>MFund/Dealing | These are products acquired from Datacons acquisition. They deal with:<br>■ Fund Accounting and Investment Management<br>■ Investor services<br>■ Front office automation |
| | Iboss<br>(Integrated Broker office solutions suite) | iBOSS is a comprehensive solutions suite for stockbrokers and traders, giving them absolute control over the entire trading process from order to settlement. It cost-efficiently streamlines and integrates all your operations spanning front office, risk management and back-office. Majority of the products in this suite are from the acquisition of SDG Software. |
| | **Asset Management**<br>RhymeSight Quasar | Products acquired through the Rhyme acquisition in UK. Rhyme has 8 of the top 11 Private Wealth Managements companies in the UK as its client.<br>The products deal with:The asset management products focus on the operations side of business:·<br>■ Clearing<br>■ Settlement<br>■ Order Management<br>■ Accounting |
| | **Brokerage**<br>Altimis Fiscal Arrow | The broking products address:<br>■ Stock Broking and Clearing (Web Enabled)<br>■ Order Management<br>■ Settlement |

# Company business portfolio (contd.)

| Services | |
|---|---|
| **Areas** | **Description** |
| e governance | The company bids for Indian Central Government/Govt. organization business and US projects related to e governance. These are lumpy but whenever the bids are successful the revenues can be significant. The recent deals in this area have been with LIC and citizens services in Karnataka (Nemmadi) |
| IT Consulting | Prime focus areas are Enterprise Architecture Integration(EAI)/Business Intelligence and IT Security. This practice was added through the acquisition of a US Based firm Innovative Business Solutions. |
| ADM/Package Implementation | This is the core bread and butter business for most Indian software services companies. The company has enhanced its offering in this space through recent acquisition of e-Enable in business intelligence space, G4 Software on the payment services space and select acquisi tions in the workflow and imaging space. Professional Access when it goes through would add marquee Investment banking clientele to the company. |
| BPO & Infrastructure Management | This was previously predominantly done for the ICICI Bank Group. But now the company is planning to target Indian companies and primarily banks/FIs to extend this offering in the Indian Market. With this in mind, the company has recently launched BPO offerings for the MF industry targeted towards:<br>■ Registrar and Transfer Services<br>■ Fund Accounting Services<br>And also launched the offering for the Insurance Sector<br>Another area being targeted in this space is Citizen services of the government or government run organizations.<br>It has augmented its BPO offering through the acquisition of Delta Services.<br>The company added 14 new clients in this segment in FY07. |

*Source: Company, Ambit Capital Research*

The company's significant successes in these segments are:

- **Insurance:** Made significant headways in the developed markets of the US and initial forays into UK. It retains its leadership position in Middle East and Africa.
- **Banking:** The company's universal lending solutions (erstwhile Triton) has been ranked #2 by IBS in the new name customer signed in 2006, behind Nucleus Software product FinnOneRetail. It had 11 wins in CY06. The company's universal lending solutions has market leadership in Malaysia.
- **Anti Money Laundering:** The Company's anti money laundering product has the leadership position in India.
- **Capital Markets:** The company's mutual fund products have a leadership position in India and Malaysia, whereas its private wealth management products have leadership position in UK.
- **E-governance**: The company has made significant headways in terms of securing orders from Life Insurance Corporation, Karnataka Government and consulting and managed services contracts from 3 states.

But we do believe that the acquisitions made to expand service/product portfolio and expand geographical footprint are have a repercussion on valuations and risk profile of the company.

## Dilutions impacting valuations

The company has over the past 12 months made three FCCB offering to fund its acquisition trail.

- $50mn FCCB convertible at Rs.230 (Zero coupon YTM 6.8%)
- EUR 15mn FCCB convertible at Rs.190 (Coupon of 1.5% YTM 5.8%)
- EUR 30mn FCCB convertible at 308.63 (Zero coupon YTM 6.9%)

The combined dilution due to the exercise of these FCCBs would be of the order of 19.9mn shares (~36% over FY06 equity). The company currently has around EUR 30mn from the recent FCCB and $10mn remaining from the previous issue, totally ~$50mn worth of cash available for further acquisitions.

The company is not averse to raising further resources for acquisitive growth to attain a larger presence in the BFSI vertical.

We see the continuous dilutions to be an overhang on valuations and would depress the EPS growth CAGR to 22.1% over the period FY07-FY09E, even thought the PAT is expected to grow at ~38.7% over the same period. We have assumed the full dilution on account of all these FCCBs. Further, even though the revenues and profitability are increasing the return ratios are expected to show only a marginal improvement over this period on account of these dilutions, which is a concern.

## Larger acquisitions raising the risk profile

The company has till date made ~20 acquisitions (Product IPRs included). In the last 12 months the company has made ~9 acquisitions, one of which (Professional Access) is still to be finalized. If we compare the acquisitions made in the past and the recent ones, the company has started to make considerably larger acquisitions. While the typical ranges in the past have been below Rs300mn, the recent acquisitions have been done as high as Rs.2300mn.

**3i Infotech acquisition trail**

| Date | Company acquired | Areas | Price paid | Sales | MV/Sales |
|---|---|---|---|---|---|
| Nov,2006 | E-Enable Technologies | 50 people , BFSI - business intelligence | Rs 51.1 mn- 51% stake | Rs 65mn | 1.5 |
| Nov,2006 | Professional Access (still to be concluded) | Ecommerce for BFSI and Retail - 500 people, Clients: Goldman Sachs, JP Morgan, Duke Energy, Citibank | $12mn- 51% stake | $24mn | 1 |
| Nov,2006 | Stex, Genesis Imaging Allied Technologies | Workflow, document imaging and allied services | | Rs 65mn | |
| Oct,2006 | Rhyme Solutions | Asset Management, Brokerage and Private Wealth Management Products | GBP 28mn | GBP 15mn | 1.9 |
| Sep,2006 | G4 Software Technologies | 50 people, Payment Services RTGS, Swift, SEPA etc. | Rs 42 mn | Rs 84mn | 0.5 |
| Jul,2006 | Delta Services Edge Technologies | BPO (Acquired 51% stake) Services | | Rs 120mn | |
| Apr,2006 | Datacons | Mutual funds products and related services in India & Malaysia. Acquired MFunds/AM, Mfunds/ISS,Mfunds/Dealing | Rs400mn (has cash of Rs. 90 mn) | Rs. 220 | 1.8 |
| Nov,2005 | SDG Software Technologies Pvt Ltd | Anti Money Laundering and Capital Markets related products. Products acquired: AMLOCK and iBoss suite | Rs. 100 mn | Rs. 60 mn | 1.7 |
| Nov,2005 | FormulaWare Inc | ERP product for process manufacturing industries. Products acquired: Orion PFM | $ 1mn | $700,000 | 1.4 |
| Sep,2005 | Innovative Business Solutions Inc | Business Intelligence, IT Security Related software services | $ 3.6 mn | $ 7.2 mn | 0.5 |
| Early,2002 | IPR acquired from IMS, Korea | Core Banking product Newton. Now part of Kastle-Core Banking | | | |
| Jun,2002 | IPR acquired from ApnaLoan | Loan Origination product, previously called Triton, now part of Kastle-Universal Lending | | | |
| Nov,2001 | Insyst Technologies | ERP and Insurance Product. Products acquired: Premia & Orion | $ 10 mn | $ 2.5- 3 mn | 3.3 |
| Nov,2000 | Ajax Software Solutions | Asset Liability Management, Treasury Management Products | $ 4 mn | | |
| Jan,2001 | Command Systems Inc | Services | $ 38.3 mn | | |
| Jul,2000 | Object Xpert | Services | $ 3-5 mn | | |
| Jun,2000 | Ivory Consulting Group | Services | $ 8- 10 mn | $10 | 1 |

*Source: Company, Ambit Cap Research*

We believe larger acquisitions increase the risk in the business model. Further, acquisitions like Rhyme and Professional Access (still to be concluded) have lower margins than the company and would have a negative impact on the margins in the coming year, when their full year revenues are consolidated.

**Near Term margin compression:** We expect the EBITDA margins to be compressed by ~60bps in FY08E to touch ~19.6% levels,

- On account of the depression effect of lower margin acquisitions.
- Wage inflation on the services side of business, higher rental expenses and ramp up of the BPO business, might make the sustenance of gross margins in the services business at the current levels of 38% difficult. Though considering the geographical mix of the business the rupee impact would be considerably lower for 3i Infotech with US constituting ~28% of its FY07 revenues. The unconverted portion of FCCB money provides a hedge against the rupee appreciation in the intermediate term.
- **Higher effective Tax Rate:** We have assumed a higher effective tax rate of 8% for FY08E and 10% for FY09E, on account of MAT. This is considerably higher than the effective tax rate of 4.9% in FY06. The company would have a lower effective tax rate on account of tax free status of its Thailand and Malaysia subsidiaries and carry forward losses in its US subsidiary.

The company has guided for net margins in the range of 14.5% - 15% for FY08E. We expect an 110bps decline in net margins in FY08E, to touch levels of 14.7%.

**Q4FY07 and FY07 performance analysis**

| (Rs mn) | Q4FY07 | Q3FY07 | Q4FY06 | qoq(%) | yoy(%) | FY07 | FY06 | yoy(%) |
|---|---|---|---|---|---|---|---|---|
| Sales | 2,102 | 1,716 | 1,200 | 22.5 | 75.2 | 6,553 | 4,178 | 56.8 |
| Gross profit | 907 | 733 | 533 | 23.7 | 70.3 | 2,768 | 1,827 | 51.5 |
| Gross profit margin(%) | 43.1 | 42.7 | 44.4 | | | 42.2 | 43.7 | 150bps decline* |
| SGA | 455 | 366 | 277 | 24.4 | 64.2 | 1,446 | 970 | 49.1 |
| SGA as of sales | 21.6 | 21.3 | 23.1 | | | 22.1 | 23.2 | 110bps improvement |
| EBITDA | 452 | 367 | 255 | 23.0 | 76.8 | 1,322 | 858 | 54.1 |
| EBITDA margin(%) | 21.5 | 21.4 | 21.3 | | | 20.2 | 20.5 | 30bps decline |
| Other income | 8 | 61 | 16 | | | 155 | 62 | 148.0 |
| PAT (before EOI) | 322 | 276 | 175 | 16.5 | 83.9 | 1,037 | 574 | 80.6 |
| PAT margin(%) | 15.3 | 16.1 | 14.6 | | | 15.8 | 13.7 | 210 bps increase |
| Diluted EPS (Rs) | 5.20 | 4.66 | 2.87 | 11.6 | 81.2 | 17.37 | 9.14 | 90.0 |

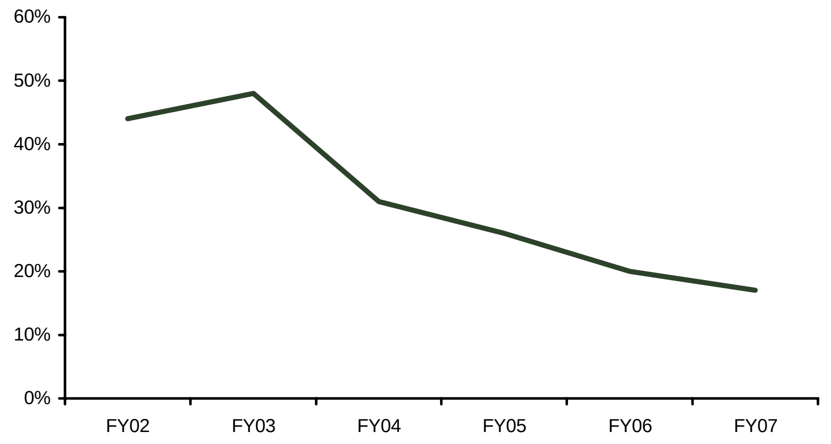
** partly due to accounting policy change related to expensing of product development expenses*
*Source: Company*

## Other highlights

**Change in Accounting Policy:** The Company has changed its accounting policy related to capitalization of product development expenses, which would now be expensed. This has created the software development cost element in the profit and loss statement. The company expects this to be ~4% of its revenues per annum. We believe this is a good step and removes one of the concerns related to the financial reporting expressed by investors.

**Reduced dependence on ICICI Bank:** The Company has been able to reduce its dependence on ICICI Bank as a customer to 17% in FY07. Further, the company has low client concentration with top 10 non-ICICI customers contributing just 15% of the revenues in FY07. But a key metrics to watch out for in the future as the company tries to cross sell services and products to its existing client base of in excess of ~500 customers, would be the client progression.

**Reducing ICICI Bank contribution (%)**




*Source: Company, Ambit Capital Research*

## Key negatives

**Slowdown seen in ERP Product:** The contribution of the ERP product, Orion has gone down from 13% to 9% in FY07, for Q4FY07 it is as low as 5%. The FY07 revenue growth in ERP segment has been of the order of 11%, which is considerably lower than the company growth. The company has acknowledged the competition being faced by SAP and Oracle in the space and expects to focus mainly on its BFSI product and services.

This highlights the risks of obsolescence in the products business. Orion was acquired by the company through its acquisition of Insyst Technologies in Nov,2001 and has served the company well during the last 15 years.

## Valuations and outlook

***We recommend a HOLD on the stock with a 12-month target price of Rs337.***

*Note: We have assumed full dilution on account of FCCBs, but have not assumed any revenues from future acquisitions*

We expect the company to post a revenue growth CAGR of 40.5% over the period FY07-FY09E. We expect the growth from products to outpace the growth from services business, on account of the impact of full year revenues of Rhyme acquisition.

**Revenue growth**

| (%) | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|
| Products | 77.8 | 51.5 | 70.1 | 70.3 | 30.0 |
| Services | 2.3 | 38.8 | 45.2 | 43.1 | 20.7 |
| **Overall** | **26.2** | **44.5** | **56.8** | **56.9** | **25.8** |

*Source: Company, Ambit Capital Research estimates*

Our assumption of slower growth of the ICICI Bank business, would impact the growth in the services business, though the company has progressively reduced the ICICI Bank business over the years and in FY07, the ICICI Bank business too had shown a healthy 29% growth yoy. We believe reporting similar growth rates would be difficult.

On account of higher growth expectation in products, we expect the company's mix of product: services revenues to be skewed slightly further in terms of products.

**Business mix**

| (%) | FY04 | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|---|
| Products | 31.6 | 44.5 | 46.7 | 50.7 | 55.0 | 56.8 |
| Services | 68.4 | 55.5 | 53.3 | 49.3 | 45.0 | 43.2 |

*Source: Company, Ambit Capital Research estimates*

This mix might change in the favor of services if the Professional Access acquisition goes through. We have not incorporated this acquisition in our projections.

We expect the segmental gross margins of the company to be impacted on account of full year revenue impact of its recent acquisitions, which have a lower margin as compared to the stand-alone entity. Further on the services side, we expect the company to face downward margin pressures on account of wage inflation, higher rental expenses and increased investments in building its BPO and managed services practice.

**Gross margins**

| (%) | FY04 | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|---|
| Products | 45.8 | 51.3 | 52.4 | 54.3 | 53.5 | 53.0 |
| Services | 34.6 | 37.7 | 36.2 | 38.0 | 35.0 | 34.0 |
| **Overall** | **38.2** | **43.7** | **43.7** | **46.3** | **45.2** | **44.8** |

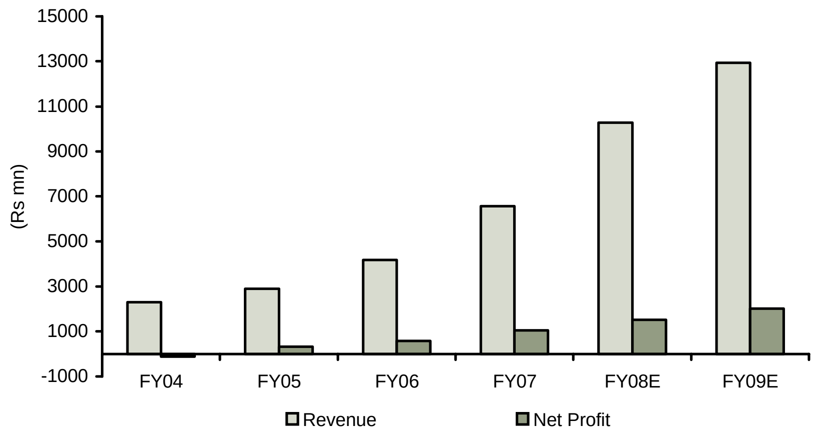
**Gross margin calculation excl. software development cost – related to product development, to allow like to like comparison*
*Source: Company, Ambit Capital Research estimates*

We expect the company to drive some synergies of scale and increased focus on BFSI vertical, to bring about efficiencies on the SG&A side. The company has shown a positive momentum on this front with an improvement of ~114bps over FY07.

On the net margin front we have assumed a higher effective tax rate of 8% for FY08E and 10% for FY09E, taking into consideration the impact of MAT. The company's effective tax rate as of FY06 was 4.9%.

Based on these factors, we expect the company to show a PAT CAGR of 38.7% over FY07-FY09E and considering the full impact of the FCCB dilution, the company is expected to post a diluted EPS CAGR of 22.1% over the same period.

**Revenue and profitability**

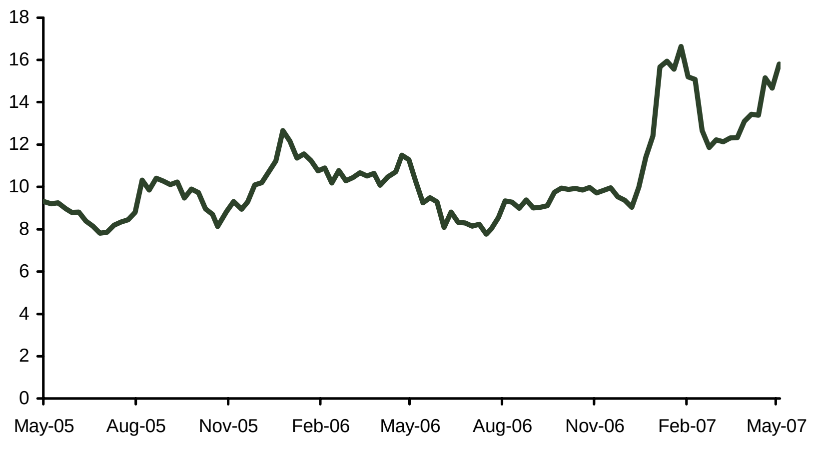



*Source: Company, Ambit Capital Research estimates*

At its CMP, the stock is trading at a P/E of 16.2x FY08E and 12x FY09E fully diluted earnings. On other parameters, it is trading at an EV/EBITDA of 8.5x FY08E and 6.3x FY09E and an EV/Sales of 1.7x FY08E and 1.3x FY09E.

The company has historically traded in the range of 7.8-16.6x 1-yr rolling forward PE. We arrive at the target price of Rs.337 at a PE of 13x FY09E earnings, nearer to the average of the historical range of valuations of the company. We recommend a Hold on the stock as the upside from current levels is of the order of 8%.

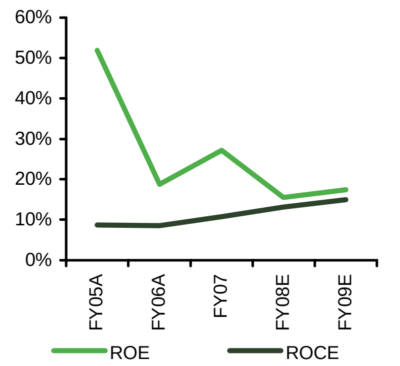
**1-year rolling forward PE band**




*Source: Capitaline, Ambit Capital Research estimates*

The company's return ratios have been impacted in FY08E on account of our assumption of full conversion of the FCCBs, without taking into consideration any revenues or profits from the acquisition kitty. We believe the equity dilutions, increased risk profile of the business, near term margin compression and consequent depression of the return ratios, would make re-rating of the multiples difficult in the near term, hence have attached the target multiple based on historical averages.

**Return ratio progression (%)**




*Source: Company, Ambit Capital Research estimates*

The stock has over past year since our previous recommendation appreciated by 129% and ytd has considerably run up by 67% on account of its robust performance. We believe the stock is currently fairly valued and offers limited upside. We would revisit our recommendation if the stock corrects or an inorganic trigger happens.

## Possible upside risks

### Acquisitions - Scenario analysis

We believe that the acquisition kitty of $50mn with the company, could have an impact in terms of taking the appreciation by 3% to 12% levels depending on the margins and valuation of the acquisitions, considering the historical range of valuations. Though we have not taken this into account into our valuations.

| | | | |
|---|---|---|---|
| Amount ($mn) | 50 | | |
| P/S multiple | 2 | 1.5 | 1 |
| Revenue ($mn) | 25 | 33 | 50 |
| **PAT Margins** | | **Price Impact (Rs)** | |
| 5% | 9 | 12 | 18 |
| 10% | 18 | 24 | 36 |
| Appreciation Range | 3% | to | 12% |

*Source: Ambit Capital Research @ Rs/$ 41.*

The company intends to complete these acquisitions over the next 18-month duration.

**Strategic Investor picking up stake:** ICICI Bank, the promoter of the company has expressed its intention of reducing their stake to less than 30% in 3i Infotech.

The company has done three FCCBs in the last one year, the dilution impact of those FCCB is expected to be ~19.9mn shares or ~36% of their FY06 equity. Two of these are in the money and the third one is also nearly in the money. On account of these dilutions the ICICI Bank stake would go lower than 35% from the current levels of 45%.

If a strategic investor picks up stake and brings in synergies, which could have positive implications for the stock.

## Downside risks

- Further equity dilution is a possibility as the company chases its desire to expand its BFSI portfolio.
- Increase in risk profile as the company embarks on larger acquisitions. Inability to leverage its larger acquisitions to cross sell services/products. The company has goodwill on account of consolidation of the order of 46% of its FY07P balance sheet size, and any write-downs could be a risk.
- High receivable days (incl. unbilled revenue) of the order of ~170 days.

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