

**Sector: Information Technology**

Sensex:	15,405
CMP (Rs):	77
Target price (Rs):	115
Upside (%):	49.4
52 Week h/l (Rs):	103 / 25
Market cap (Rscr) :	1,298
6m Avg vol ('000Nos):	4,224
No of o/s shares (mn):	169
FV (Rs):	10
Bloomberg code:	III IB
Reuters code:	TIIN.BO
BSE code:	532628
NSE code:	3IINFOTECH

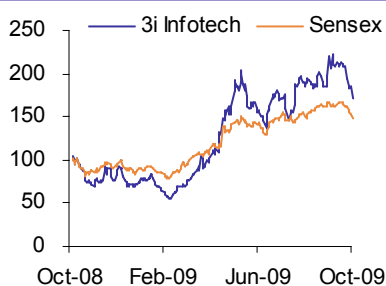
Prices as on 03 Nov, 2009

**Shareholding pattern**

<b>September '09</b>	<b>(%)</b>
Promoters	30.0
Institutions	39.1
Non promoter corp hold	7.6
Public & others	23.3

**Performance rel. to sensx**

(%)	1m	3m	1yr
3i Infotech	(12.0)	2.4	23.9
Mindtree	6.3	31.9	68.6
Mastek	2.4	22.0	(19.4)
Infotech	(5.9)	3.4	7.2

**Share price trend**

**One of the most diversified plays in mid-cap IT space**

3i's revenues are evenly distributed across three business segments viz IT products, IT services and BPO and are derived from multiple geographies and clients. In the mid-cap IT space, there is no other company as diversified as 3i. A diversified business model helped company in sustaining its revenue and profitability in past five quarters, when the operating environment was extremely challenging.

**High dependence on BFSI sector has become a positive**

With IT spends in the BFSI vertical recovering faster than other verticals, 3i's high dependence (70% of revenues) on this sector should drive a faster growth than peers. Some of the large offshore vendors have witnessed a marked revival in BFSI revenues in the past two quarters. 3i represents the most leveraged bet on sustained recovery in BFSI sector. A wide range of offerings should enable company to increase wallet share amongst its BFSI customers.

**Operating cash flows and Balance Sheet to improve radically**

With recent QIP of Rs3.1bn and material FCCB buy-back, 3i has taken significant steps to improve cash flow and to reduce its indebtedness. We expect company to further repay Rs3.5-4bn of debt over next 1.5 years and reduce its D/E to 1x by FY11-end from 2.5x as at FY09-end. Operating cash flows are estimated to be higher than PAT in FY10 and FY11. Robust equity accretion would reduce goodwill/equity to 1x by FY11-end from 1.8x as at FY09-end.

**Trading at 5.2x FY11 P/E; significant re-rating inevitable**

3i infotech has been trading at material discount to mean mid-cap IT valuations over the past two years due to concerns regarding its highly leveraged balance sheet and dominant BFSI exposure. With substantial reduction in these risks, the valuations are likely to converge towards the mean. After two years, we re-initiate coverage on 3i infotech with a BUY rating and 1-year target price of Rs115. We have assigned a FY11 P/E multiple of 7.7x, ~10% discount to the mean.

**Valuation summary**

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Revenues	12,053	22,856	25,444	29,087
Yoy growth (%)	83.9	89.6	11.3	14.3
Operating profit	2,549	4,344	4,902	5,439
OPM (%)	21.1	19.0	19.3	18.7
Pre-exceptional PAT	1,766	2,561	2,245	2,574
Reported PAT	1,766	2,820	2,524	2,574
Yoy growth (%)	70.2	45.0	(12.3)	14.6
EPS (Rs)	13.0	19.1	13.0	14.9
P/E (x)	5.9	4.0	5.9	5.2
Price/Book (x)	1.6	1.1	0.9	0.8
EV/EBITDA (x)	8.3	6.9	6.0	5.3
Net Debt/Equity (x)	1.7	2.1	1.1	0.9
RoE (%)	32.7	31.6	18.1	15.9
RoCE (%)	15.5	14.1	11.1	11.7

Source: Company, India Infoline Research

**One of the most diversified plays in mid-cap IT space**

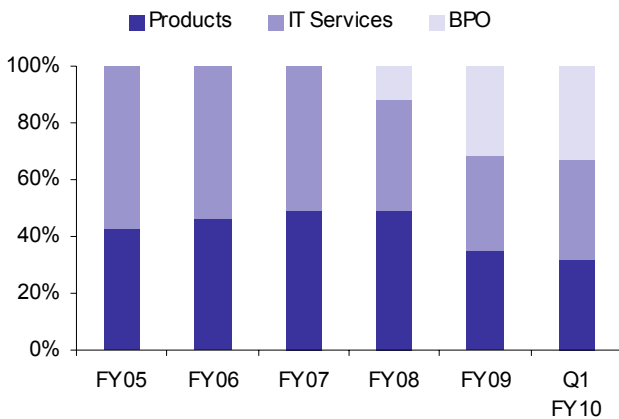
Over the years, 3i Infotech has evolved from a one client, one country and one offering company to a geographically diverse, multi business offering entity serving more than 1,500 clients globally. Presently, 3i's revenues are almost evenly distributed across its three business segments viz IT products, IT services and Transaction Services (BPO) and are derived from multiple geographies and clients. In the mid-cap IT space, there is no other company as diversified as 3i. Most of the peers' business model is either weighed towards a particular offering (some being pure-play/niche companies), developed markets (the US & UK; low focus on emerging markets) and few clients (high contribution of Top 5/10 clients).

*3i's revenues are evenly distributed across its business segments and are derived from multiple geographies and clients*

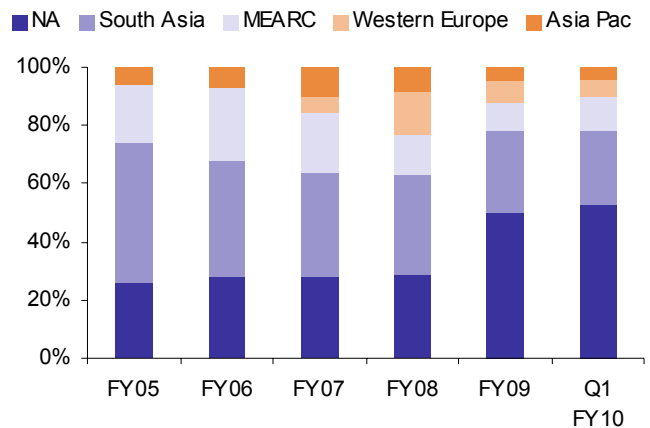
*Diversification driven by aggressive inorganic initiatives; 30+ acquisitions in past five years*

3i's accelerated diversification has been driven by its aggressive inorganic initiatives; 30+ acquisitions in past five years. A diversified business model helped company in sustaining its revenue and operating profitability over the past five quarters, when the operating environment was extremely challenging. The company intends to further de-risk its business by spreading across more geographies and offerings.

**Revenue mix by business segments**

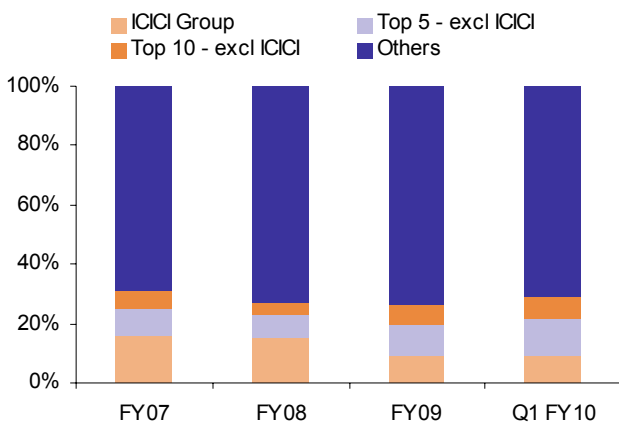


**Revenue mix by geographies**

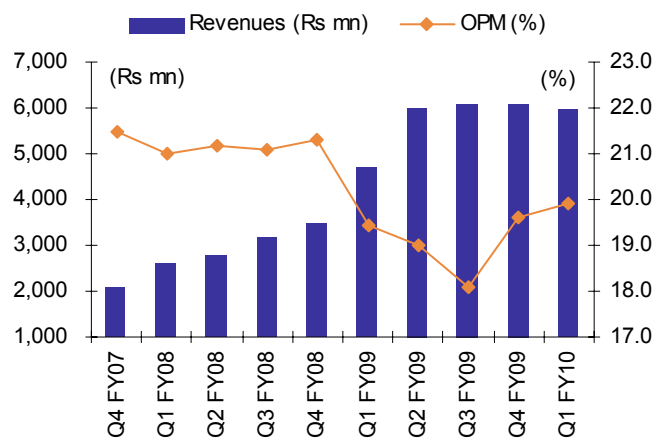


Source: India Infoline Research

**Revenue mix by clients**



**Revenue and OPM trend**



Source: India Infoline Research

In Q1 FY10, company derived 70.2% revenues from the BFSI sector

In 2008, BFSI industry had a dominant share of 41% in Indian IT services exports

Healthy BFSI revenue growth in past two quarters for large offshore vendors

Due to high dependence on BFSI, 3i infotech is the most leveraged bet on sustained recovery in this sector

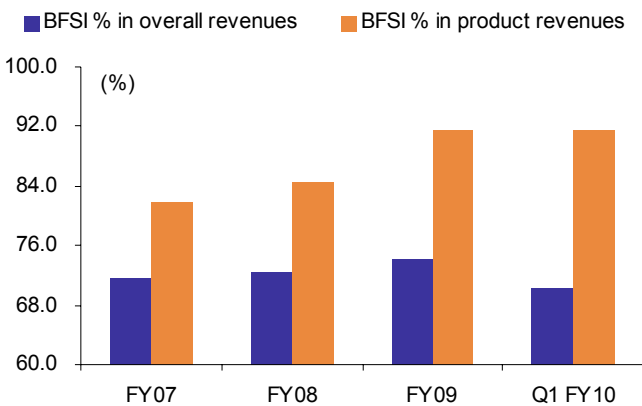
**High dependence on BFSI sector has become a positive**

With IT spends in the BFSI vertical recovering faster than other verticals, 3i's high dependence on this sector should drive a faster growth than peers. In Q1 FY10, company derived 70.2% revenues from the BFSI sector. In the Products segment, the dependence is higher at 91.5%. Over the years, 3i has developed, rolled out and acquired a broad range of solutions/service capabilities for the BFSI industry to position itself as a one-stop-shop.

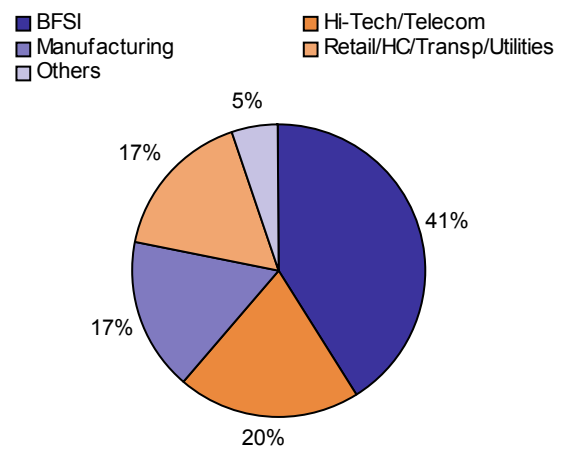
BFSI sector is the largest consumer of IT products, software services and transaction services globally. In 2008, BFSI industry had a dominant share of 41% in Indian IT services exports. During the recent global financial crisis, IT spends in this sector witnessed rationalization with some large well-known banks, insurers and financial services companies declaring bankruptcy or undergoing restructuring.

However, over the past couple of quarters there has been marked revival in demand from BFSI industry manifested in healthy revenue growth for large offshore vendors in this vertical. Other major consuming industries such as manufacturing, telecom/hi-tech, are expected to recover late. Due to significantly higher dependence on BFSI, 3i infotech represents the most leveraged bet on sustained recovery in this sector. Aided by a wide range of offerings, company is expected to increase wallet share amongst its BFSI customers.

**3i's high concentration in BFSI**

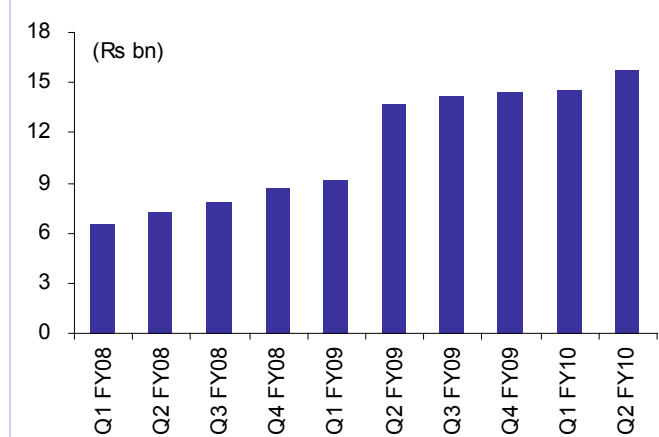
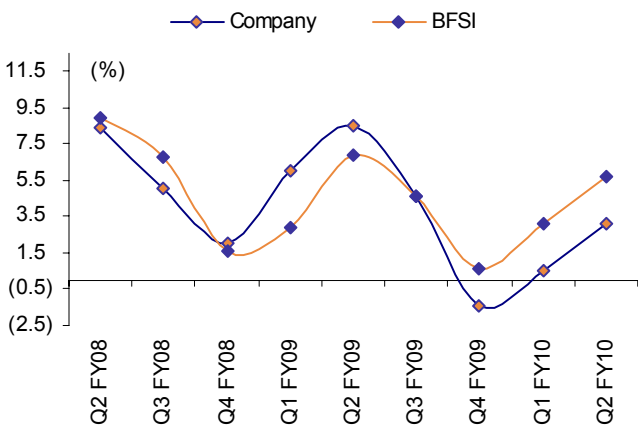


**Industry-wise break-up of FY08 IT exports**



Source: India Infoline Research

**Qoq growth in BFSI revenues higher for TCS 3i's order book (12-month) stands healthy**



Source: India Infoline Research

*3i Infotech is poised to realize the potential synergies of acquisitions over the next couple of years*

### 3i in a phase of consolidation after hectic inorganic activity

As mentioned below, 3i has made numerous acquisitions over the past five years to expand/strengthen its business offerings, geographical presence and client base. Most of them have been funded by debt (including FCCBs) in majority. Though these acquisitions provided significant synergies from cross-selling and up-selling, the actual realization has been restricted by deterioration in business conditions since July 2008. With the recent large acquisitions (Regulus, Accounting Frameworks, Objectsoft and J&B Software) fully integrated now and macro demand environment improving, 3i Infotech is poised to realize the potential synergies over the next couple of years. Further, proper cross-selling and up-selling within its 1,500+ clients would imply growth at optimum cost.

### Acquisition history

Date	Company	Segment	Consideration
Sep-05	IBSI	IT Services - Consulting	US\$3.6mn
Sep-05	Formula-ware Inc.	Products - ERP	US\$2.5mn
Nov-05	SDG Software	Products - BFSI	Rs160mn
Apr-06	Distinctive Solutions Inc	Products - BFSI	US\$1mn
May-06	Datacons Pvt Ltd	Products - BFSI	Rs355mn
Jul-06	Delta Services Pvt Ltd	BPO - BFSI	Rs250mn
Sep-06	G4 Software Tech	Products - BFSI	Rs34mn
Sep-06	Edge Tech Inc	IT Services - Consulting	US\$1.2mn
Oct-06	Rhyme Systems Ltd	Products - BFSI	GBP20.8mn
Nov-06	Stex Software Pvt Ltd	BPO - Document Management	Rs96mn
Nov-06	Genesis Technologies	BPO – Document Management	-
Nov-06	e-Enable Tech Pvt Ltd	IT Services - Consulting	Rs123mn
Nov-06	Corban Systems Inc	Products – BFSI	US\$1.1mn
Jan-07	WhizInfo Tech Inc	IT Services - Consulting	US\$4.1mn
Apr-07	Lantern Systems Inc	IT Services – IMS	US\$9.4mn
May-07	KNM Services Pvt Ltd	BPO	Rs29.2mn
May-07	aok In-house	BPO	Rs276.7mn
May-07	Black Barret Ltd	-	US\$10.2mn (51% interest)
May-07	Professional Access US	IT Services	US\$2.4mn (51% interest)
Jun-07	Transworks LLP	Hardware + Products - BFSI	US\$4.5mn
Aug-07	HCCA Services Pvt Ltd	BPO – BFSI	Rs181mn
Aug-07	Manipal Informatics	BPO	Rs28.2mn
Sep-07	ePower Inc	IT Services - Consulting	US\$7.7mn
Sep-07	Taxsmile.com Pvt Ltd	Products – BFSI	Rs40.8mn (51% interest)
Oct-07	Nile Technology	Products – BFSI	US\$0.7mn
Nov-07	J&B Software Inc	Products – BFSI	US\$26mn
Dec-07	Linear Systems Pvt Ltd	BPO – BFSI	Rs161mn
Dec-07	Objectsoft Group Inc	Products + IT Services	US\$17mn
Jan-08	Exact Technical Services	Products – BFSI	GBP1.5mn
Feb-08	Accounting Frameworks Ltd	Products – BFSI	GBP6.3mn
May-08	Locuz Entp Solutions	IT Services – IMS	Rs69mn (26% interest)
Jun-08	FinEng Solutions Ltd	Products – BFSI	Rs214mn (60% interest)
Jun-08	Regulus Group LLC	BPO	US\$112mn
Jun-09	JP Morgan Lockbox Business	Products – BFSI	US\$9.3mn

Source: Company

3i has taken significant steps to improve cash flow generation and to reduce its overall indebtedness

Rs3.2bn QIP issue and FCCB buy-back has already reduce leverage

3i to further likely repay Rs3.5-4bn of debt over the next 1.5 years

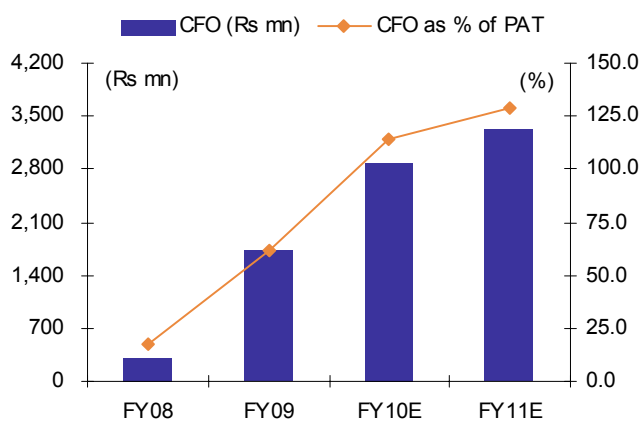
D/E to significantly improve to 1x by FY11-end

### Operating cash flows and Balance Sheet to improve radically

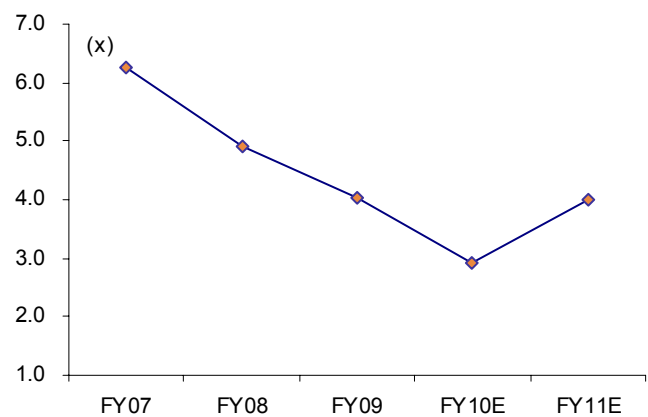
Key investment concerns for 3i has been depressed operating cash flows, highly leveraged balance sheet (D/E 2.5x FY09-end) and substantial goodwill (44% of total assets and 1.8x equity FY09-end). However, the company has taken significant steps to improve cash flow generation and to reduce its overall indebtedness over the past three quarters.

In Q4 FY09 and Q1 FY10 combined, 3i retired (bought-back) FCCBs of Euro10mn and US\$33.6mn at ~50 discount. In September 2009, company raised Rs3.1bn net via QIP with the purpose of retiring a portion of its high cost debt. Post utilization of the proceeds, the D/E of the company would improve significantly to 1.6x. We expect 3i to further repay Rs3.5-4bn of debt over the next 1.5 years supported by healthy existing cash balance (~Rs1.7bn excluding QIP proceeds) and improved cash flow generation due to lower interest outflow and pick-up in business growth. We forecast D/E to decline to 1x by FY11-end, in-line with the management's long-term target. Further, with strong equity accretion, the goodwill/equity is estimated to reduce to 1x from 1.8x as at FY09-end.

#### Operating cash flow to increase

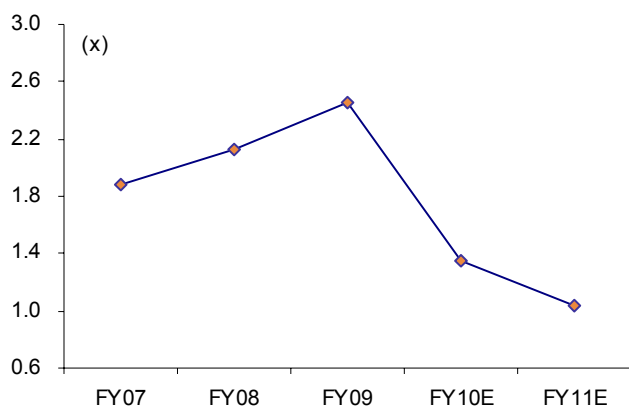


#### Interest coverage to improve in FY11E

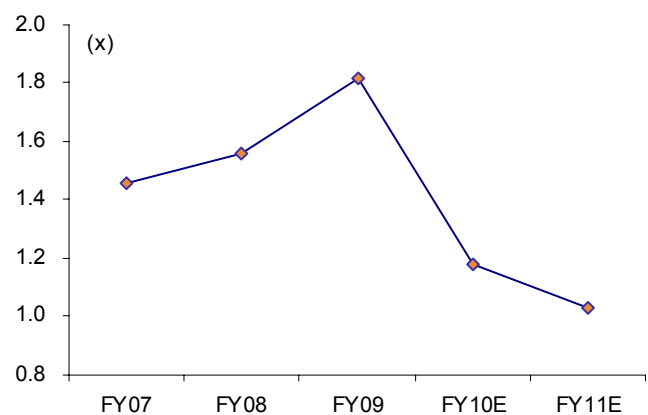


Source: India Infoline Research

#### Debt/Equity to decline significantly



#### Goodwill/Equity to fall substantially

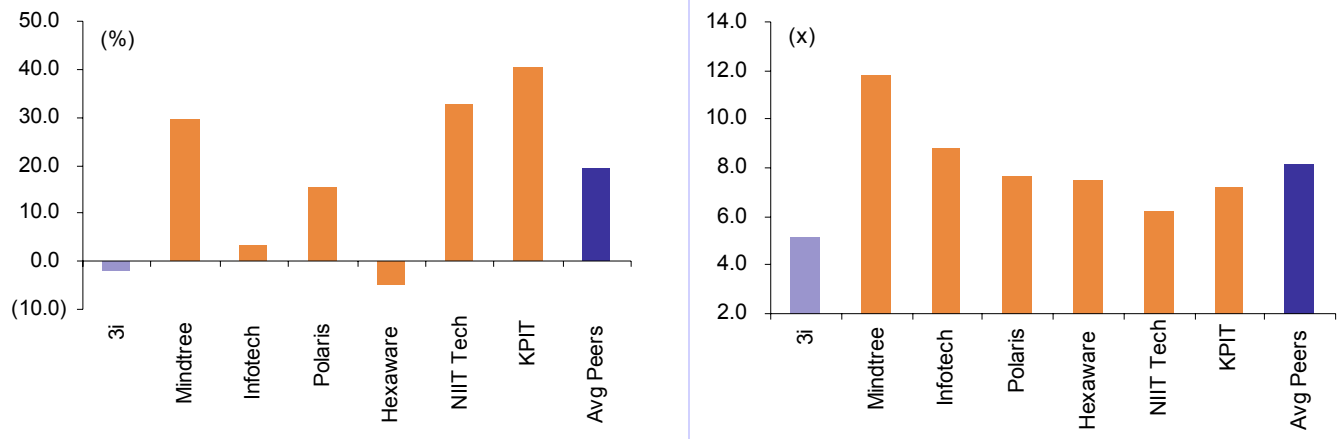


Source: India Infoline Research

### Trading at attractive 5.2x FY11 P/E; significant re-rating inevitable

3i infotech has been trading at material discount to mean mid-cap IT valuations over the past two years due to concerns regarding its highly leveraged balance sheet and dominant BFSI exposure. With substantial reduction in these risks, the valuations are likely to converge towards the mean. After two years, we re-initiate coverage on 3i infotech with a BUY rating and 1-year target price of Rs115. We have assigned a FY11 P/E multiple of 7.7x, ~10% discount to the mean.

#### Material underperformance by 3i in past 3m Trading at significant discount on FY11 P/E



Source: India Infoline Research

#### Some concerns to note

Though we are bullish on 3i Infotech and expect significant returns from the stock in the medium term, we would like to highlight few concerns representing the risk to our view and price target. These are 1) future impairment/amortization of goodwill could depress reported profits (however, in an improving business environment the likelihood is low) 2) outstanding ESOPs imply potential dilution of 15% on current equity over longer term (however, profit arrived as per SFAS 123 was only 3.5% lower than reported PAT in FY09) and 3) contingent liabilities worth Rs7.18bn, 2.8x FY09 PAT and 0.6x Q2 FY10-ending equity.



## Financials

### Income statement

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Revenue	12,053	22,856	25,444	29,087
<b>Operating profit</b>	<b>2,549</b>	<b>4,344</b>	<b>4,902</b>	<b>5,439</b>
Depreciation	(244)	(701)	(1,245)	(1,519)
Interest expense	(505)	(950)	(1,325)	(1,040)
Other income	183	191	203	240
<b>Profit before tax</b>	<b>1,983</b>	<b>2,885</b>	<b>2,534</b>	<b>3,121</b>
Taxes	(151)	(221)	(120)	(374)
Minorities and other	(66)	(104)	(170)	(172)
<b>Adj. profit</b>	<b>1,766</b>	<b>2,561</b>	<b>2,245</b>	<b>2,574</b>
Exceptional items	-	260	279	-
<b>Net profit</b>	<b>1,766</b>	<b>2,820</b>	<b>2,524</b>	<b>2,574</b>

### Balance sheet

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Equity capital	1,305	1,308	1,684	1,684
Reserves	5,135	8,063	13,019	15,124
<b>Net worth</b>	<b>6,441</b>	<b>9,370</b>	<b>14,704</b>	<b>16,809</b>
Minority interest	102	212	229	229
Preference capital	1,000	1,000	1,000	1,000
Debt	12,658	22,020	18,826	16,326
FCCBs redemp prem	362	1,095	1,127	1,127
<b>Total liabilities</b>	<b>20,563</b>	<b>33,697</b>	<b>35,886</b>	<b>35,491</b>
Fixed assets	2,931	6,924	7,689	8,439
Intangible assets	10,031	17,004	17,311	17,311
Investments	34	36	100	100
<b>Net working capital</b>	<b>7,162</b>	<b>9,348</b>	<b>10,330</b>	<b>9,185</b>
Inventories	0	111	123	141
Sundry debtors	2,720	4,831	5,378	6,148
Cash	2,666	3,196	3,464	1,380
Other current assets	4,799	6,090	6,779	7,750
Sundry creditors	(2,449)	(4,268)	(4,736)	(5,452)
Other current liab	(574)	(612)	(679)	(781)
Deff Tax Assets	405	386	457	457
<b>Total assets</b>	<b>20,563</b>	<b>33,698</b>	<b>35,886</b>	<b>35,491</b>

### Cash flow statement

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Profit before tax	1,983	2,885	2,534	3,121
Depreciation	244	701	1,245	1,519
Tax paid	(151)	(221)	(120)	(374)
Working capital Δ	(1,759)	(1,636)	(785)	(940)
Operating cashflow	317	1,729	2,876	3,325
Capital expenditure	(5,869)	(11,666)	(2,317)	(2,269)
<b>Free cash flow</b>	<b>(5,552)</b>	<b>(9,938)</b>	<b>558</b>	<b>1,056</b>
Equity raised	1,002	523	3,132	(99)
Investments	(32)	(3)	(64)	-
Debt finag/diposal	6,545	10,095	(3,162)	(2,500)
Dividends paid	(204)	(304)	(304)	(370)
Other items	(66)	157	108	(172)
<b>Net Δ in cash</b>	<b>1,692</b>	<b>531</b>	<b>268</b>	<b>(2,084)</b>

### Key ratios

Y/e 31 Mar	FY08	FY09	FY10E	FY11E
<b>Growth matrix (%)</b>				
Revenue growth	83.9	89.6	11.3	14.3
Op profit growth	92.9	70.4	12.8	11.0
EBIT growth	90.3	54.1	0.7	7.8
Net profit growth	70.2	45.0	(12.3)	14.6
<b>Profitability ratios (%)</b>				
OPM	21.1	19.0	19.3	18.7
EBIT margin	20.6	16.8	15.2	14.3
Net profit margin	14.6	11.2	8.8	8.8
RoCE	15.5	14.1	11.1	11.7
RoNW	32.7	31.6	18.1	15.9
RoA	9.7	8.3	5.7	6.3

### Per share ratios

	FY08	FY09	FY10E	FY11E
EPS	13.0	19.1	13.0	14.9
Dividend per share	1.5	1.5	1.5	2.0
Cash EPS	15.4	24.9	20.7	24.3
Book value per share	49.3	71.7	87.3	99.8

### Valuation Ratios

	FY08	FY09	FY10E	FY11E
P/E (x)	5.9	4.0	5.9	5.2
Price/CEPS	5.0	3.1	3.7	3.2
Price/Book (x)	1.6	1.1	0.9	0.8
EV/EBITDA (x)	8.3	6.9	6.0	5.3

### Leverage ratios

	FY08	FY09	FY10E	FY11E
Interest coverage	4.9	4.0	2.9	4.0
Net debt / equity	1.7	2.1	1.1	0.9
Net debt / op. profit	4.3	4.6	3.3	2.9

### Payout (%)

	FY08	FY09	FY10E	FY11E
Dividend payout	11.6	11.9	13.5	14.4
Tax payout	7.6	7.6	4.7	12.0

### Liquidity ratios

	FY08	FY09	FY10E	FY11E
Debtor days	82	77	77	77
Inventory days	0	2	2	2
Creditor days	74	68	68	68

### Du-Pont Analysis

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Tax burden (x)	0.86	0.87	0.86	0.80
Interest burden (x)	0.80	0.75	0.66	0.75
EBIT margin (x)	0.21	0.17	0.15	0.14
Asset turnover (x)	0.66	0.74	0.64	0.71
Financial leverage (x)	3.49	3.88	3.28	2.61
<b>RoE (%)</b>	<b>32.7</b>	<b>31.6</b>	<b>18.1</b>	<b>15.9</b>

**Recommendation parameters for fundamental reports:****Buy** – Absolute return of over +10%**Market Performer** – Absolute return between -10% to +10%**Sell** – Absolute return below -10%

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