KPIT Cummins Infosystems – BUY

CMP Rs76, Target Rs115

Sector: Information Technology	
Sensex:	15,912
CMP (Rs):	76
Target price (Rs):	115
Upside (%):	51.1
52 Week h/l (Rs):	93/20
Market cap (Rscr) :	594
6m Avg vol ('000Nos):	439
No of o/s shares (mn):	78
FV (Rs):	2
Bloomberg code:	KPIT IB
Reuters code:	KPIT.BO
BSE code:	532400
NSE code:	KPIT

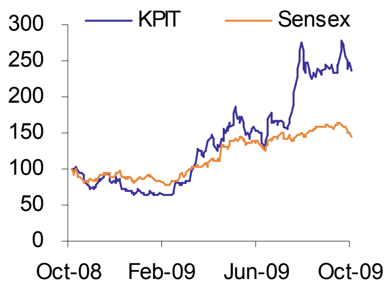
Prices as on 04 Nov, 2009

Shareholding pattern	
September '09	**(%)**
Promoters	27.3
Institutions	21.2
Non promoter corp hold	10.4
Public & others	41.2

Performance rel. to sensex

(%)	1m	3m	1yr
KPIT	5.0	40.9	88.0
Mindtree	6.0	31.9	79.6
Mastek	0.3	18.0	(15.9)
Infotech	(2.6)	9.6	17.4

Share price trend



Post the conference call organized for revealing details of Sparta Consulting (Sparta) acquisition, we upgrade KPIT's earnings estimates and target price. Sparta is one of the fastest growing SAP consultancies in North America. The acquisition would strengthen KPIT's SAP services capabilities enabling it to offer high-end SAP solutions to its existing customers. Further, the IT services capabilities of KPIT would be leveraged for providing more value to Sparta's customers. We expect this acquisition to add US$10mn and US$38mn revenues in FY10 and FY11 respectively.

Sparta's operating margin is expected to improve from current ~12% to 14-15% by the end of FY11. On consolidated basis, management does not foresee OPM declining below 20% in FY11. With only 30% of the US$38mn consideration to be paid upfront (balance over next three years), the payback of this transaction is expected at less than three years. We are convinced about KPIT's strategy of strengthening capability in fast growing areas at reasonable cost and without straining balance sheet in an improving demand scenario. The acquisition is expected to be EPS accretive from FY10. We maintain BUY on KPIT and upgrade target price by 8% to Rs115.

Sparta Consulting – a fast growing SAP services provider

Incorporated about 18 months back, Sparta Consulting is one of the fastest growing SAP consultancies in North America. Its revenues have grown at exceptional pace over the past one year despite the business environment being extremely challenging, especially for discretionary services like ERP implementation, support and consulting. Sparta is expected to earn revenues of ~US$25mn, OPM of ~12% and break-even at the net income level in CY09. The company has ~250 consultants and a top management team with impressive track record. The current management team has earlier successfully created and grown an enterprise consulting business, Rapidigm, with annual revenues of over US$250mn. This was later sold-off to Fujitsu. ~100 consultants are based out of the company's offshore centre (SEZ) in Noida. As the company has been providing high-end SAP services, its billing rates, both onsite (US$135-200/hour) and offshore (US$25-35/hour), are 15-20% higher than most of the other offshore vendors.

Valuation summary

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Revenues	6,005	7,846	7,418	9,126
Yoy growth (%)	29.5	30.7	(5.5)	23.0
Operating profit	923	1,678	1,632	1,757
OPM (%)	15.4	21.4	22.0	19.3
Reported PAT	513	659	976	1,062
Yoy growth (%)	1.6	28.4	48.2	8.9
EPS (Rs)	6.6	8.4	12.5	13.6
P/E (x)	11.5	9.0	6.1	5.6
EV/EBITDA (x)	6.6	3.2	3.2	2.9
RoE (%)	21.9	30.1	36.6	25.1
RoCE (%)	20.0	25.6	32.2	26.1

Source: Company, India Infoline Research

No customer overlap imply significant cross-selling opportunity

Sparta's acquisition would enable KPIT to offer value-added SAP solutions to its existing large clientele

Contrarily, the IT services capabilities of KPIT would provide more value to Sparta's customers

Sparta clientele comprise of 25 customers from Hi-Tech and Energy & Utilities verticals. With ~90% of KPIT's revenues coming from the manufacturing industry, the two companies do not have any customers in common. KPIT's current SAP practice is US$25-30mn pa (~20% of overall revenues) in size with 700+ consultants and attracts an OPM of ~20%. Sparta's acquisition would strengthen KPIT SAP services capabilities which would enable the latter to offer value-added SAP solutions to its Automotive, Hi-Tech and Industrials clients. Contrarily, the IT services capabilities of KPIT would be leveraged for providing more value to the customers of Sparta. Further, KPIT reliance on its top customer, Cummins, would decline materially from present 32% to ~27% in FY11 thereby lending more stability to the topline.

Growth to accelerate; KPIT's revenues to grow by 23% in FY11

The combined SAP practice would act as tough competition to Tier-I vendors in pursuing large deals (US$25mn+)

We expect this acquisition to add US$10mn and US$38mn revenues in FY10 and FY11 respectively

With 1,000+ consultants, the combined SAP practice would act as tough competition to Tier-I vendors in pursuing large (US$25mn+), multi-year, multi-service deals. Sparta has recently won two deals of greater than US$10mn in size. With global demand for SAP based services growing at 20%+ yoy, management believes that this practice has the potential to grow into a US$100mn+ business in next three years. Further, Sparta's management commitment to growth would be considerably high as major portion of the consideration is based on revenue and EDITDA milestones to be achieved over next three years. With financial integration likely from December 2009, we expect this acquisition to add US$10mn and US$38mn revenues in FY10 and FY11 respectively.

Post-integration operating margin could decline by 100-200bps

Due to lower profitability of Sparta, the combined OPM would be 100-200bps lower than stand-alone margin in FY10E and FY11E

On consolidated basis, management does not foresee OPM declining below 20% in FY11

Due to lower profitability of Sparta, the combined OPM would be 100-200bps lower than stand-alone margin in FY10E and FY11E. With 50%+ consultants working onsite, the onsite:offshore revenue mix of Sparta is highly skewed towards onsite, unlike KPIT. Another reason for lower profitability could be lower SG&A and fixed cost (significant investments in Noida facility) leverage with company being in the initial growth-investment phase. However, robust revenue pick-up from cross-selling and improvement in discretionary IT spending globally is expected to improve Sparta's operating margin from current ~12% to 14-15% by the end of FY11. On consolidated basis, management does not foresee OPM declining below 20% in FY11.

Acquisition to be EPS accretive from FY10

~70% of the consideration of uS$38mn to be paid over next three years on Sparta achieving certain revenue and EBITDA milestones.

The payback of this transaction is expected by management at less than three years.

The payment for this US$38mn (including US$4mn bonus) acquisition has been structured in a prudent way with only 30% of the amount to be paid upfront and the balance 70% to be paid over next three years on Sparta achieving certain revenue and EBITDA milestones. Initial payment would be met from KPIT's current ample liquidity (cash balance of Rs1.63bn as at Q2 FY10-end) and the future payouts could be met from combined internal cash flows. The payback of this transaction is expected by management at less than three years. We estimate this acquisition would be EPS accretive from FY10. We are also convinced by KPIT's strategy of strengthening capability in fast growing areas at reasonable costs, without causing any strain to balance sheet, in an improving business environment.

Upgrade earnings and target price; Maintain BUY

Upgrade FY10 and FY11 EPS of KPIT by 4% and 15% respectively as higher revenue estimates

As the acquisition is estimated to be EPS accretive, it is likely to improve RoE and ROCE by 200-300bps in FY11

We upgrade FY10 and FY11 EPS of KPIT by 4% and 15% respectively as we factor higher revenues by 7% and 24% in both these years. We have lowered OPM assumptions for FY10 and FY11 by 70bps and 120bps respectively for reasons mentioned above. As the acquisition is estimated to be EPS accretive, it is likely to improve RoE and ROCE by 200-300bps in FY11. We maintain BUY on KPIT and upgrade target price by 8% to Rs115.

Financials

Income statement

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Revenue	6,005	7,846	7,418	9,126
Operating profit	**923**	**1,678**	**1,632**	**1,757**
Depreciation	(255)	(436)	(322)	(422)
Interest expense	(75)	(45)	(21)	(20)
Other income	9	(418)	(99)	30
Profit before tax	**602**	**778**	**1,190**	**1,345**
Taxes	(76)	(120)	(214)	(282)
Minorities/others	(13)	-	-	-
Net profit	**513**	**659**	**976**	**1,062**

Balance sheet

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Equity capital	156	156	156	156
Reserves	2,529	1,537	3,480	4,669
Net worth	**2,685**	**1,693**	**3,636**	**4,826**
Debt	865	1,185	1,005	1,005
Total liabilities	**3,550**	**2,878**	**4,641**	**5,830**
Fixed assets	1,681	1,795	1,973	2,301
Intangible assets	-	-	540	540
Investments	1	-	-	-
Net working capital	**1,868**	**1,083**	**2,128**	**2,989**
Sundry debtors	1,432	1,776	1,679	2,065
Cash	740	1,671	1,742	1,861
Other current assets	530	742	702	863
Sundry creditors	(546)	(2,696)	(1,607)	(1,323)
Other current liab	(287)	(410)	(388)	(477)
Total assets	**3,550**	**2,878**	**4,641**	**5,830**

Cash flow statement

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Profit before tax	602	778	1,190	1,345
Depreciation	255	436	322	422
Tax paid	(76)	(120)	(214)	(282)
Working capital Δ	(347)	1,717	(974)	(743)
Operating cashflow	433	2,812	324	742
Capital expenditure	(163)	(551)	(1,040)	(750)
Free cash flow	**270**	**2,261**	**(716)**	**(8)**
Equity raised	231	(1,596)	1,031	200
Investments	48	1	-	-
Debt finag/diposal	(358)	320	(180)	-
Dividends paid	(64)	(55)	(64)	(73)
Other items	(13)	-	-	-
Net Δ in cash	**114**	**931**	**71**	**119**

Key ratios

Y/e 31 Mar	FY08	FY09	FY10E	FY11E
Growth matrix (%)				
Revenue growth	29.5	30.7	(5.5)	23.0
Op profit growth	30.4	81.8	(2.7)	7.7
EBIT growth	12.9	21.6	47.0	12.8
Net profit growth	1.6	28.4	48.2	8.9
Profitability ratios (%)				
OPM	15.4	21.4	22.0	19.3
EBIT margin	11.3	10.5	16.3	15.0
Net profit margin	8.5	8.4	13.2	11.6
RoCE	20.0	25.6	32.2	26.1
RoNW	21.9	30.1	36.6	25.1
RoA	12.4	12.7	15.5	14.9
Per share ratios				
EPS	6.6	8.4	12.5	13.6
Dividend per share	0.7	0.6	0.7	0.8
Cash EPS	9.9	14.0	16.6	19.0
Book value per share	34.5	21.7	46.6	61.8
Valuation Ratios				
P/E (x)	11.5	9.0	6.1	5.6
Price/CEPS	7.7	5.4	4.6	4.0
Price/Book (x)	2.2	3.5	1.6	1.2
EV/EBITDA (x)	6.6	3.2	3.2	2.9
Payout (%)				
Dividend payout	12.4	8.3	6.6	6.9
Tax payout	12.6	15.4	18.0	21.0
Liquidity ratios				
Debtor days	87	83	83	83
Inventory days	0	0	0	0
Creditor days	33	125	79	53

Du-Pont Analysis

Y/e 31 Mar (Rs m)	FY08	FY09	FY10E	FY11E
Tax burden (x)	0.85	0.85	0.82	0.79
Interest burden (x)	0.89	0.94	0.98	0.98
EBIT margin (x)	0.11	0.10	0.16	0.15
Asset turnover (x)	1.45	1.51	1.18	1.28
Financial leverage (x)	1.76	2.37	2.37	1.69
RoE (%)	**21.9**	**30.1**	**36.6**	**25.1**

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

India Infoline Ltd. One India Bull Center, Jupiter Mill Compound, 841, Senapati Bapat Marg, Nr, Elphinstone Road, Lower Parel (W), Mumbai 400 013.

For Research related queries, write to: Amar Ambani at amar@indiainfoline.com or research@indiainfoline.com
For Sales and Account related information, write to customer care: info@5pmail.com or call on 91-22 4007 1000