

## SASKEN COMMUNICATION TECHNOLOGIES

INR 337

*Near term pressure to continue***ACCUMULATE**

We recently met the management of Sasken Communication to get an update on the company's business. We continue to maintain a cautious view on the company from the short to medium term perspective on the back of – a) high sensitivity on operating margins due to rupee appreciation (1% change = 70bps on EBITDA margins); b) slowdown of growth on the NEMs side for the services business, absence of revival signs; c) lack of pick-up in growth for the products segment; and d) acceptance of 'E-Series' taking much longer than anticipated. However, from the long term perspective, we believe FY09 is likely to see products contributing to operating profits, thereby, providing non-linear profit growth. Also, growth in the services business will pick up with projects from NEMs and improved growth from the semiconductor segment, in our view. This will help Sasken withstand the rupee-appreciation pressure and improve margins.

We have revisited our assumptions for H2 of FY08 and full year FY09 to take into account the current outlook, pricing increases of ~3% for FY09, and delay in launch of some handsets on the products side. This has resulted in revision of our EPS estimate to INR 13 and INR 24 for FY08E and FY09E from earlier INR 16 and INR 28, respectively. At CMP of INR 337, the stock is trading at P/E of 26.2x and 14.1x and on an EV/revenue basis at 1.7x and 1.4x for FY08E and FY09E, respectively. We continue to maintain our 'ACCUMULATE' rating on the stock.

**Key takeaways****\* Going aggressively after billing rate increases**

One of the important levers that Sasken is working on is to improve its realisations by increasing its billing rates aggressively. The management also stated that it is pushing the clients for increasing their rates to the tune of 8-10% and in some case more than 10%, which is a potent force for margin improvement. We believe this is a smart move by the company that will also unveil its value proposition and stickiness with the client. We however believe that rate increases of ~8-10% are unlikely and have therefore assumed a ~3-5% increase for FY09, realistically.

**\* Utilisation improvement expected but rupee appreciation to take-away the benefit**

Sasken is running a tight shift on utilisation to provide cushion to the margins. Further, improvement in the utilisation by ~1-2% is expected for the quarter from the reported 76% last quarter. This will have a positive impact on the operating margins by ~ 50bps for 1%. However, the rupee appreciation of 2.6% for the current quarter is expected to take away this impact.

**Financials**

| Year to March           | FY06   | FY07  | FY08E  | FY09E |
|-------------------------|--------|-------|--------|-------|
| Revenues (INR mn)       | 3,081  | 4,751 | 5,759  | 7,325 |
| Rev. growth (%)         | 27.4   | 54.2  | 21.2   | 27.2  |
| EBITDA (INR mn)         | 482    | 755   | 713    | 1,355 |
| Net profit (INR mn)     | 229    | 441   | 368    | 681   |
| Shares outstanding (mn) | 27.9   | 28.5  | 28.6   | 28.6  |
| EPS basic (INR)         | 9.1    | 15.7  | 12.9   | 23.8  |
| EPS growth (%)          | (34.9) | 72.9  | (18.0) | 85.1  |
| P/E (x)                 | 37.1   | 21.5  | 26.2   | 14.1  |
| EV/EBITDA (x)           | 15.8   | 13.0  | 13.6   | 7.4   |
| ROE (%)                 | 11.3   | 10.9  | 8.0    | 13.1  |

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Reuters : SKCT.BO

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**Market Data**

52-week range (INR) : 624 / 250  
 Share in issue (mn) : 28.5  
 M cap (INR bn/USD mn) : 9.6 / 244.2  
 Avg. Daily Vol. BSE ('000) : 176.9

**Share Holding Pattern (%)**

Promoters : 26.4  
 MFs, FIs & Banks : 10.9  
 FII's : 19.0  
 Others : 43.7



\* **Healthy growth in handset services business continues**

The handset services business, contributing 35% to the services revenues, continues to see healthy growth. Two of the new contracts signed last quarter are in a ramp up mode, helping the company to grow its Indian business by 100%. Sasken Finland continues to grow with quarterly run-rate of ~USD 7-8 mn. We believe getting people who can be easily deployed in this segment is a challenge, as demand is not a constraint here. Also, attrition (that currently increased to ~ 22% at the company level) could hinder growth, going forward.

\* **Motorola to launch four new models in Europe by February 2008**

Last quarter Motorola launched its first symbian based high-end phone (Moto RIZR Z8), carrying Sasken's software. We understand that Sasken is further working with Motorola to introduce other variants on the same platform and four of them are expected to be launched over February 2008. This will add to the royalty revenue stream and add higher visibility.

\* **Increase in attrition, a concern**

Attrition for Sasken, which is already higher than its peers, is expected to increase further. Our discussion suggests an increase of two percentage points, to ~22%, which will further put pressure on the margins. Nevertheless, this will help Sasken to bring down the average experience and provide opportunity to replace them by hiring fresher's after requisite training.

\* **Lenovo deal – unlikely to generate any revenues**

In April 2007, Sasken had announced its first win in Application Framework – 'E-Series' from Lenovo mobile. This deal, as it stands currently, is unlikely to yield any revenues, as Lenovo has now decided to buy the framework from a semiconductor provider. Thus, Sasken is now working with TI, which controls 60% of the semiconductor handset market, to jointly 'go to market' with its Application Framework - 'E-series'. Acceptance by TI for this framework can be a big boost for Sasken and can totally change the company's positioning, in our view.

\* **Valuations**

We have revisited our assumptions for H2FY08 and full year FY09, to take into account the current outlook, pricing increases of ~3% for FY09, and delay in launch of some handsets on the products side. This has resulted in revision of our EPS estimate to INR 13 and INR 24 for FY08E and FY09E, from earlier INR 16 and INR 28, respectively. At CMP of INR 337, the stock is trading at P/E of 26.2x and 14.1x and on an EV/revenue basis at 1.7x and 1.4x for FY08E and FY09E, respectively. We continue to maintain our '**ACCUMULATE**' rating on the stock.

## Company Description

Sasken is a communication software design and development company, focused on the wireless and broadband software space. It offers a hybrid model of services and products, and works with network OEMs, semiconductor vendors, terminal devices OEMs, and operators across the world. It provides embedded communication software across the entire communication value chain, application software services for service providers, and also works in planning, deploying and managing wireless networks. The company's past twelve months (TTM) revenues stood at INR 5.4 bn (USD 126.0 mn) and it employs around 3,700 people at its offices in India, China, Finland, Germany, Japan, Mexico, Sweden, UK, and the US.

## Investment Theme

Sasken's services business has a well-aligned portfolio, capturing a gamut of outsourced embedded R&D spends across the telecom value chain. The company is getting increasing traction with handset vendors on the services side, while business from network OEM space that accounts for nearly two-thirds of the outsourced R&D spend, is undergoing consolidation phase there by impacting Sasken's revenues. Sasken's product suite now stands adopted on sixteen platforms and is likely to witness a surge in revenues post FY08. Through the platforms of its silicon partners, Sasken's products are set to be launched by the leading global handset vendors. The company will stand to earn licensing and sub-licensing fees, apart from royalty income from this opportunity.

## Key Risks

The key risks to our investment theme include: (a) Sustained slowdown in the NEMs space, (b) product revenues linked to success of handsets (consumer product), and (c) appreciation of the rupee against the US dollar, GBP, and Euro.

## Financial Statements

| <b>Income statement</b>       |             |             |             |              | <b>(INR mn)</b> |
|-------------------------------|-------------|-------------|-------------|--------------|-----------------|
| <b>Year to March</b>          | <b>FY05</b> | <b>FY06</b> | <b>FY07</b> | <b>FY08E</b> | <b>FY09E</b>    |
| Revenues                      | 2,418       | 3,081       | 4,751       | 5,759        | 7,325           |
| Cost of revenues              | 1,308       | 1,887       | 2,962       | 3,729        | 4,249           |
| Research and development      | 215         | 132         | 196         | 282          | 403             |
| SG&A                          | 535         | 578         | 838         | 1,036        | 1,319           |
| Other operating costs         | 4           | 3           | 0           | 0            | 0               |
| EBITDA                        | 355         | 482         | 755         | 713          | 1,355           |
| Depreciation and amortisation | 142         | 179         | 266         | 413          | 536             |
| EBIT                          | 213         | 303         | 489         | 300          | 819             |
| Interest expenses             | 5           | 1           | 45          | 40           | 62              |
| Other income                  | 37          | 64          | 98          | 234          | 110             |
| Extraordinary items           | -           | 68          | 0           | 0            | 0               |
| PBT                           | 245         | 298         | 542         | 493          | 867             |
| Provision for tax             | 17          | 69          | 101         | 126          | 186             |
| Profit after tax              | 228         | 229         | 441         | 368          | 681             |
| Reported PAT                  | 228         | 229         | 441         | 368          | 681             |
| EPS (INR)                     | 13.9        | 9.1         | 15.7        | 12.9         | 23.8            |
| Dividend (%)                  | 30.0        | 30.0        | 34.0        | 40.0         | 45.0            |
| Dividend pay out (%)          | 25.3        | 41.7        | 24.7        | 36.3         | 22.1            |

### Common size metrics - as % of revenues

| <b>Year to March</b>     | <b>FY05</b> | <b>FY06</b> | <b>FY07</b> | <b>FY08E</b> | <b>FY09E</b> |
|--------------------------|-------------|-------------|-------------|--------------|--------------|
| Cost of revenues         | 54.1        | 61.2        | 62.3        | 64.7         | 58.0         |
| Research and development | 8.9         | 4.3         | 4.1         | 4.9          | 5.5          |
| SG&A                     | 22.1        | 18.7        | 17.6        | 18.0         | 18.0         |
| EBITDA margin            | 14.7        | 15.6        | 15.9        | 12.4         | 18.5         |
| Net profit margin        | 9.4         | 7.4         | 9.3         | 6.4          | 9.3          |

### Growth metrics (%)

| <b>Year to March</b> | <b>FY05</b> | <b>FY06</b> | <b>FY07</b> | <b>FY08E</b> | <b>FY09E</b> |
|----------------------|-------------|-------------|-------------|--------------|--------------|
| Revenues             | 45.5        | 27.4        | 54.2        | 21.2         | 27.2         |
| EBITDA               | 29.6        | 35.7        | 56.7        | (5.6)        | 90.1         |
| PBT                  | 51.3        | 21.5        | 82.0        | (8.9)        | 75.7         |
| Reported net profit  | 24.2        | 0.6         | 92.5        | (16.7)       | 85.1         |

| <b>Balance sheet</b>              |              |              |              |              | (INR mn)     |
|-----------------------------------|--------------|--------------|--------------|--------------|--------------|
| <b>Year to March</b>              | <b>FY05</b>  | <b>FY06</b>  | <b>FY07</b>  | <b>FY08E</b> | <b>FY09E</b> |
| Equity share capital              | 171          | 279          | 285          | 286          | 286          |
| Share premium account             | 613          | 2,802        | 2,904        | 2,914        | 2,914        |
| Reserves                          | 635          | 768          | 1,031        | 1,715        | 2,245        |
| Total shareholders funds          | 1,419        | 3,850        | 4,220        | 4,915        | 5,445        |
| Borrowings                        | 15           | 12           | 916          | 944          | 600          |
| <b>Sources of fund</b>            | <b>1,434</b> | <b>3,862</b> | <b>5,136</b> | <b>5,859</b> | <b>6,045</b> |
| Gross fixed assets                | 1,603        | 2,036        | 4,509        | 5,559        | 6,759        |
| Depreciation                      | (733)        | (918)        | (1,230)      | (1,643)      | (2,179)      |
| Net fixed assets                  | 870          | 1,118        | 3,278        | 3,916        | 4,579        |
| Capital WIP                       | 8            | 34           | 50           | 20           | 50           |
| Investments                       | 6            | 1,865        | 368          | 8            | 8            |
| Deferred tax asset                | -            | 2            | 6            | 2            | 2            |
| Cash & bank balances              | 109          | 151          | 349          | 826          | 168          |
| Debtors                           | 541          | 653          | 1,108        | 1,262        | 1,565        |
| Inventories                       | 2            | 33           | 8            | 36           | 36           |
| Loans & advances                  | 237          | 385          | 747          | 200          | 270          |
| Other current assets              | -            | 0            | 0            | 454          | 454          |
| Total current assets              | 889          | 1,223        | 2,212        | 2,778        | 2,493        |
| Sundry creditors                  | 201          | 253          | 502          | 678          | 915          |
| Provisions                        | 84           | 115          | 276          | 156          | 172          |
| Other liabilities                 | 52           | 13           | 0            | 32           | 0            |
| Total current liabilities         | 338          | 381          | 778          | 865          | 1,087        |
| Working capital                   | 551          | 842          | 1,434        | 1,913        | 1,406        |
| <b>Application of funds</b>       | <b>1,434</b> | <b>3,862</b> | <b>5,136</b> | <b>5,859</b> | <b>6,045</b> |
| Book value per share (BVPS) (INR) | 87           | 138          | 148          | 172          | 191          |

| <b>Cash flow statement</b>           |              |                |              |              | (INR mn)       |
|--------------------------------------|--------------|----------------|--------------|--------------|----------------|
| <b>Year to March</b>                 | <b>FY05</b>  | <b>FY06</b>    | <b>FY07</b>  | <b>FY08E</b> | <b>FY09E</b>   |
| Cash flow from operations            | 353          | 391            | 613          | 587          | 1,169          |
| Cash for working capital             | (124)        | (306)          | (325)        | 452          | (168)          |
| <b>Net operating cashflow(A)</b>     | <b>229</b>   | <b>85</b>      | <b>288</b>   | <b>1,039</b> | <b>1,001</b>   |
| Net purchase of fixed assets         | (239)        | (472)          | (2,399)      | (1,020)      | (1,230)        |
| Net purchase of investments          | 22           | (1,800)        | 1,560        | 360          | 0              |
| Others                               | 1            | 0              | 4            | 234          | 110            |
| <b>Cash flow from investments(B)</b> | <b>(215)</b> | <b>(2,271)</b> | <b>(834)</b> | <b>(426)</b> | <b>(1,120)</b> |
| Proceeds from issue of equity        | 105          | 2,291          | 100          | 11           | 0              |
| Proceeds from LTB/STB                | 10           | (3)            | 777          | 28           | (344)          |
| Interest paid & other items          | (5)          | (1)            | (42)         | (40)         | (62)           |
| Dividend, interest & other items     | (48)         | (59)           | (138)        | (174)        | (195)          |
| <b>Cash flow from financing (C)</b>  | <b>68</b>    | <b>2,229</b>   | <b>740</b>   | <b>(135)</b> | <b>(539)</b>   |
| Exchange rate differences (D)        | -            | 0              | (10)         | 0            | 0              |
| <b>Change in cash(A+B+C) + (D)</b>   | <b>81.4</b>  | <b>43</b>      | <b>184</b>   | <b>477</b>   | <b>(658)</b>   |

**Ratios**

| Year to March   | FY05 | FY06 | FY07 | FY08E | FY09E |
|-----------------|------|------|------|-------|-------|
| ROE (%)         | 17.8 | 11.3 | 10.9 | 8.0   | 13.1  |
| ROCE (%)        | 18.0 | 8.7  | 10.6 | 7.2   | 12.2  |
| Debtor days     | 82   | 77   | 85   | 80    | 78    |
| Fixed asset T/O | 2.9  | 3.1  | 2.2  | 1.6   | 1.7   |

**Valuation parameters**

| Year to March            | FY05        | FY06          | FY07        | FY08E         | FY09E       |
|--------------------------|-------------|---------------|-------------|---------------|-------------|
| EPS (INR)                | 13.9        | 9.1           | 15.7        | 12.9          | 23.8        |
| <i>Y-o-Y growth (%)</i>  | <i>14.7</i> | <i>(34.9)</i> | <i>72.9</i> | <i>(18.0)</i> | <i>85.1</i> |
| BVPS (INR)               | 86.9        | 137.8         | 148.1       | 172.1         | 190.7       |
| PER (x)                  | 24.2        | 37.1          | 21.5        | 26.2          | 14.1        |
| Pr/CF (x)                | 25.3        | 23.5          | 13.6        | 12.3          | 7.9         |
| P/BV (x)                 | 3.9         | 2.4           | 2.3         | 2.0           | 1.8         |
| EV/EBITDA (x)            | 26.1        | 15.8          | 13.0        | 13.6          | 7.4         |
| EV/Revenues (x)          | 3.8         | 2.5           | 2.1         | 1.7           | 1.4         |
| Market cap/ revenues (x) | 3.9         | 3.1           | 2.0         | 1.7           | 1.3         |

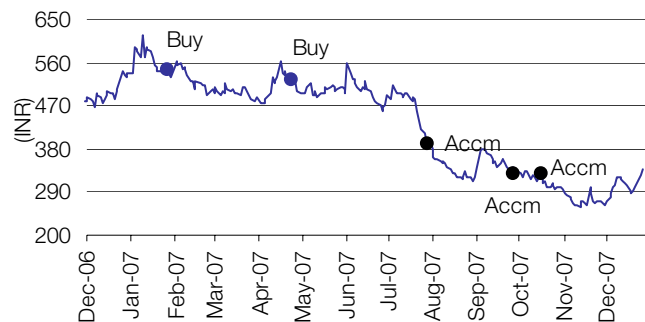
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**Coverage group(s) of stocks by primary analyst(s): Information Technology:**

Geometric, HCL Tech, Hexaware, i-flex, i-Gate, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, and Wipro

### Sasken Communication Technologies



### Recent Research

| Date     | Company | Title  | Price (INR) | Recos |
|----------|---------|--|-------------|-------|
| 13-12-07 | IT      | Is Hexaware the tip of the iceberg?<br><i>Sector Update</i>                |             |       |
| 04-12-07 | IT      | Selectively knocking on value's door;<br><i>Sector Update</i>              |             |       |
| 21-11-07 | IT      | Fact sheet   |             |       |
| 02-11-07 | IT      | Five themes gaining currency and one notable miss;<br><i>Sector Update</i> |             |       |

### Distribution of Ratings / Market Cap

**Edelweiss Research Coverage Universe**

|                      | Buy | Accumulate | Reduce | Sell | Total |
|----------------------|-----|------------|--------|------|-------|
| Rating Distribution* | 105 | 47         | 19     | 3    | 188   |

\* 13 stocks under review / 1 rating withheld

|                  | > 50bn | Between 10bn and 50 bn | < 10bn |
|------------------|--------|------------------------|--------|
| Market Cap (INR) | 99     | 67                     | 22     |

### Rating Interpretation

| Rating            | Expected to                                     |
|-------------------|---|
| <b>Buy</b>        | appreciate more than 20% over a 12-month period |
| <b>Accumulate</b> | appreciate up to 20% over a 12-month period     |
| <b>Reduce</b>     | depreciate up to 10% over a 12-month period     |
| <b>Sell</b>       | depreciate more than 10% over a 12-month period |

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