

FIRST GLOBAL

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India Research



Sector: Information Technology

What Happened Last Quarter

Polaris Software Labs (POL.IN/POLS.BO)

Outperform

(CMP: Rs.164.85 Mkt. Cap: Rs. 16.21 bn, \$0.39 bn, May 11, '07)

Relevant Index: S & P CNX Nifty: 4076.65, May 11, '07

Ongoing reduction in business concentration, both in terms of geographies & customer base, and rising share of Intellect-led business keeps faith in strengthening business model intact

Reasonable valuations lend enough room for further expansion in light of ongoing improvement in return ratios

Last report's recommendation: Outperform (MP: Rs. 229.35, Feb 1, '07)

Relevant Index: CNX Nifty: 4137.20 (Feb 1, '07)

Relative performance since last rating change (Dec 14, '06): CNX Nifty: Up 6.1%, Polaris: Up 14.6%

May 11, 2007

Research Contact: Associate Director, Research: Hitesh Kuvelkar Mob. +91 9833 732633

Email: hiteshk@fglobal.com

Sales Offices: India Sales: Tel. No: +91-22-4001 2440

Email: indiasales@fglobal.com /

fgindiasales@bloomberg.net

US Sales: Tel. No: 1-212-2276611 Email: us@fglobal.com

Asia & Europe Sales: Tel.: 44-207-959 5300 Email: uk@fglobal.com

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IMPORTANT DISCLOSURES CAN BE FOUND AT THE END OF THIS REPORT.



Price and Rating History Chart

Ratings Key

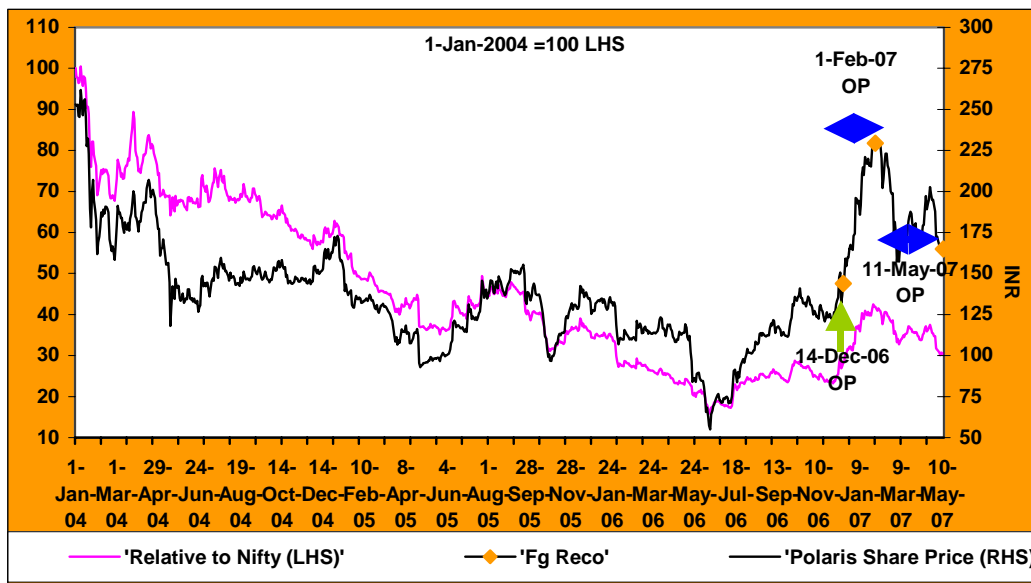
	B = Buy	BD = Buy at Declines	OP = Outperform
Positive Ratings	S-OP = Sector Outperform	M-OP = Market Outperform	MO-OP = Moderate Outperform
Neutral Ratings	H = Hold	MP = Market Perform	SP = Sector Perform
Negative Ratings	S = Sell	SS = Sell into Strength	UP = Underperform
	A = Avoid	MO-UP = Moderate Underperform	S-UP = Sector Underperform

ST: Short Term

MT: Medium Term

LT: Long Term

Polaris Software (POLS)



Represents an Upgrade



Represents a Downgrade



Represents Reiteration of Existing Rating

Details of First Global's Rating System given at the end of the report



Financial Snapshot

Key Financials									
YE 31st, March (Rs. in mn.)	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
Operating Revenue	2,782	2,840	4,283	6,464	7,871	8,251	10,324	12,801	15,362
<i>Revenue Growth (Y-o-Y)</i>		2.1%	50.8%	50.9%	21.8%	4.8%	25.1%	24.0%	20.0%
EBIDTA	630	609	840	1,152	972	763	1,596	2,202	2,688
<i>EBIDTA Growth (Y-o-Y)</i>		-3.3%	37.8%	37.2%	-15.6%	-21.5%	109.2%	37.9%	22.1%
Net Profit	597	589	545	699	580	213	1,010	1,398	1,743
<i>Net Profit Growth (Y-o-Y)</i>		-1.4%	-7.4%	28.1%	-16.9%	-63.3%	374.1%	38.3%	24.7%
Shareholders Equity	1,901	2,389	4,335	4,904	5,311	5,409	6,015	7,077	8,485
Number of Outstanding shares (mn)	34.1	51.2	97.3	97.7	98.0	98.2	98.3*	98.3	98.3
Key Operating Ratios									
Year ended 31st, March	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
EPS (Rs)	17.5	11.5	5.6	7.1	5.9	2.2	10.3	14.2	17.7
<i>EPS Growth (Y-o-Y)</i>		-34.2%	-51.3%	27.6%	-17.2%	-63.4%	373.9%	38.3%	24.7%
CEPS (Rs.) (Excl. Extra-Ordinaries)	18.4	11.2	7.0	10.3	9.0	6.6	15.2	20.0	24.3
EBIDTA (%)	22.6%	21.4%	19.6%	17.8%	12.4%	9.2%	15.5%	17.2%	17.5%
NPM (%)	21.4%	20.7%	12.7%	10.8%	7.4%	2.6%	9.8%	10.9%	11.3%
RoE (%)	61.2%	27.0%	15.9%	14.9%	11.2%	3.9%	17.7%	21.4%	22.4%
RoCE (%)	61.4%	27.1%	16.1%	15.0%	11.3%	4.0%	17.8%	21.5%	22.5%
Book Value per share (Rs.)	55.3	46.5	44.3	50.0	54.1	55.0	61.2	71.9	86.2
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dividend Payout (%)	10.5%	15.2%	35.2%	27.6%	33.8%	65.7%	25.0%	22.0%	19.2%
Valuation Ratios									
Year ended 31st, March	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
P/E (x)							16.0	11.6	9.3
P/BV (x)							2.7	2.3	1.9
P/CEPS (x)							10.9	8.3	6.8
EV/EBIDTA (x)							9.6	6.8	5.4
Market Cap. / Sales (x)							1.6	1.3	1.1
Dividend Yield (%)							1.4%	1.7%	1.8%
DuPont Model									
Year ended 31st, March	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
EBIDTA/Sales (%)	22.6%	21.4%	19.6%	17.8%	12.4%	9.2%	15.5%	17.2%	17.5%
Sales/Operating Assets (x)	4.8	2.1	1.8	1.8	1.9	2.0	2.3	2.4	2.4
EBIDTA/Operating Assets (%)	107.9%	44.7%	35.3%	31.4%	23.8%	18.5%	35.0%	41.2%	42.2%
Operating Assets/ Net Assets (x)	0.6	0.6	0.7	0.8	0.8	0.8	0.8	0.8	0.8
Net Earnings/ EBIDTA (%)	94.8%	96.7%	65.0%	60.6%	59.7%	27.9%	63.3%	63.5%	64.8%
Net Assets/ Equity (x)	0.98	0.99	0.98	1.00	0.99	0.99	1.00	1.00	1.00
Return on Equity (%)	61.2%	27.0%	15.9%	14.9%	11.2%	3.9%	17.7%	21.4%	22.4%

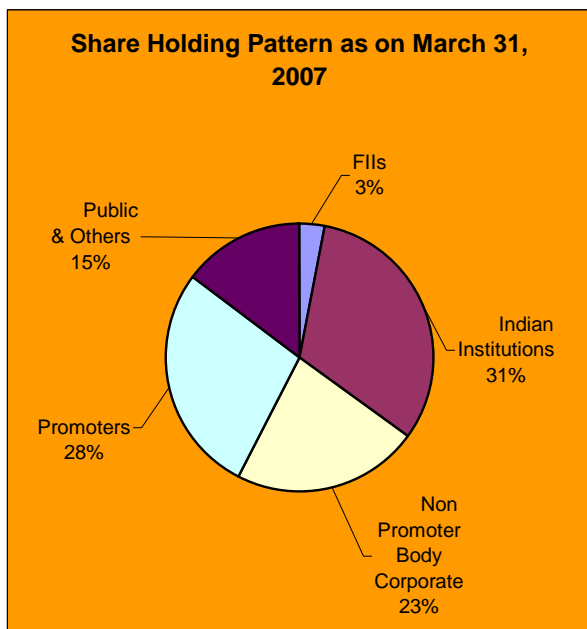


Common Sized Profit & Loss Account									
Year ended 31st, March	2001	2002	2003	2004	2005	2006	2007	2008E	2009E
Operating Revenue	100%	100%	100%	100%	100%	100%	100%	100%	100%
Software Development Expenses	54.0%	57.0%	51.7%	58.2%	66.0%	70.9%	63.9%	62.5%	62.0%
S G & A Expenses	23.4%	21.6%	28.7%	24.0%	21.7%	19.8%	20.6%	20.3%	20.5%
EBITDA	22.6%	21.4%	19.6%	17.8%	12.4%	9.2%	15.5%	17.2%	17.5%
Other Income	1.6%	4.1%	1.6%	0.7%	1.7%	1.0%	1.0%	0.3%	0.3%
Depreciation and Amortization	2.5%	3.4%	4.4%	5.1%	5.2%	6.0%	4.7%	4.4%	4.2%
Interest	0.0%	0.0%	0.3%	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%
PBT	21.7%	22.1%	16.5%	13.1%	8.7%	4.2%	11.7%	13.0%	13.5%
Tax	0.2%	1.4%	3.8%	2.3%	1.4%	1.6%	1.9%	2.1%	2.2%
Net Profit	21.4%	20.7%	12.7%	10.8%	7.4%	2.6%	9.8%	10.9%	11.3%

*Quarterly average number of shares

** Other Income includes income from associates

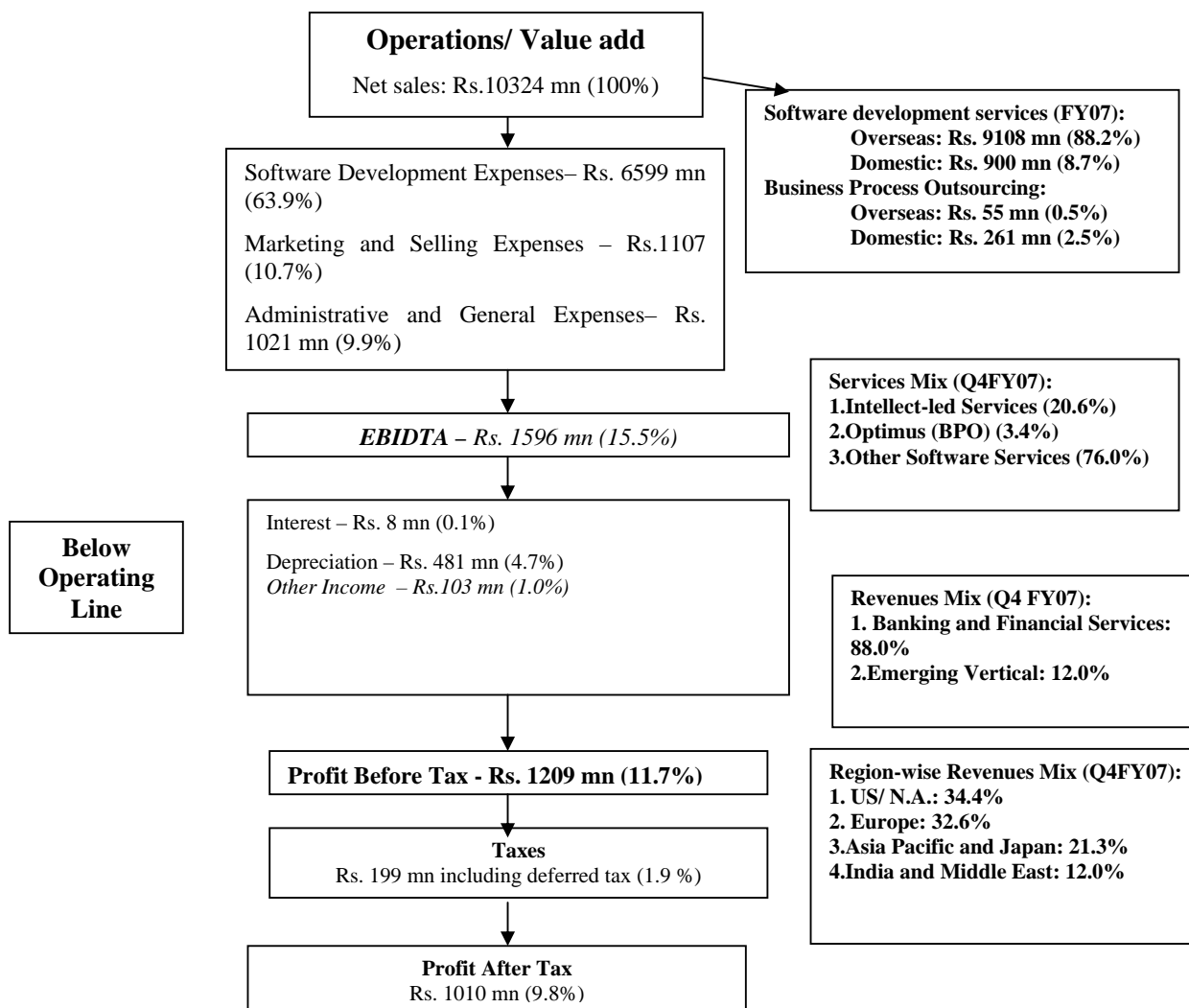
Key Statistics



Industry:	Mid Cap IT
52 Week Hi/Lo:	Rs.237.25/51.8
CMP:	Rs. 164.85
Avg Daily Vol (20 days):	1.15 mn
Avg Daily Val (20 days):	Rs. 214.64 mn
Performance over 52 weeks:	
Polaris:	Up 40.90%
Nifty:	Up 11.69%



Polaris' Business in Pictures... (FY07)



Assets
Rs. 6578.1 mn

Balance Sheet

Liabilities
Rs. 6578.1 mn

Fixed Assets – **Rs. 1945 mn (25.7%)**
Capital WIP – **Rs. 286 mn (3.8%)**
Investments – **Rs. 412 mn (5.4%)**
Current Assets – **Rs. 2731 mn (36.1%)**
Loans & Advances – **Rs. 2186 mn (28.9%)**

Equity – **Rs.493 mn (6.5%)**
Reserves – **Rs. 5523 mn (73.1%)**
Debt – **Rs. 13 mn (0.2%)**
Creditors – **Rs. 1039 mn (13.7%)**
Provisions – **Rs. 457 mn (6.0%)**
Deferred Tax Liability – **Rs. 2.8 mn (0.0%)**
Other Current Liability – **Rs. 32 mn (0.4%)**



What Happened Last Quarter...

After delivering a stellar performance in the past three quarters, Polaris Software Labs (POL.IN/POLS.BO) came up with a disappointing show in Q4 FY07. The company's results were lower than our expectations, largely due to the appreciation of the Indian Rupee (INR) and a slight decline in the onsite billing rate in the quarter. Polaris' topline grew by 36.2% Y-o-Y, but declined by 1.2% sequentially to Rs.2.7 bn in Q4 FY07, as against our estimate of Rs.2.9 bn. The EPS for Q4 FY07 came in at Rs.2.2, as compared to our estimate of Rs.3.5. The EBITDA margin declined by a whopping 542 bps sequentially to 11.9%, while the net profit margin declined by 388 bps sequentially to 7.9%. However, the outlook for Polaris remains robust due to the ongoing reduction in business concentration, both in terms of geographies as well as customer base, and the rising share of Intellect led business.

Polaris' high margin Intellect Suite business grew by 10.3% sequentially and accounted for 20.6% of the topline, as compared to 18.5% in Q3 FY07. Further, the company continued to break free from its over-dependence on the Citi Group, whose revenue contribution declined further from 58.2% in Q4 FY06 and 43.8% in Q3 FY07 to 40.6% in the quarter. Further, in Q4 FY07, the company added 12 new customers spread across various geographies.

In FY07, Polaris posted a robust topline growth of 25.1% to Rs.10324 mn, which was slightly lower than our estimate of Rs.10547 mn. The EBITDA grew by 109.5% to Rs.1596 mn, while the EBITDA margin improved from 9.2% in FY06 to 15.5% in FY07. The EPS for FY07 stood at Rs.10.3, which was slightly lower than our estimate of Rs.11.6.

Management has guided for a topline growth of 25% in FY08E. We expect the company to post a topline growth of 24.0% and 20.0% in FY08E and FY09E respectively. Taking into account the partial impact of a strong INR, we have lowered our EBITDA margin estimate for FY08E to 17.2%, as compared to our previous estimate of 18.0%, while our EBITDA margin estimate for FY09E stands at 17.5%. Consequently, our EPS estimates for FY08E and FY09E are Rs.14.2 (compared to

Polaris still trades at a reasonable P/E of 16.0x (ttm) and 11.6x FY08E, which we believe, lends enough room for further expansion, given the ongoing improvement in return ratios. We, therefore, reiterate our rating of Outperform on Polaris

our previous estimate of Rs.15.0) and Rs.17.7 respectively. We expect the RoE to improve from 17.7% in FY07 to 21.4% in FY08E and further to 22.4% in FY09E. The stock has outperformed the market since we spotted the ongoing strategic transformation in the company's business model and is up 14.6%, as against a rise of 6.1% in the Nifty. Polaris still trades at a reasonable P/E of 16.0x (ttm) and 11.6x FY08E, which we believe, lends enough room for further expansion, given the ongoing improvement in return ratios. We, therefore, reiterate our rating of Outperform on Polaris.



Comparative Valuations (Mid-cap Indian IT companies)

Company	P/E (x)		P/S (x)		P/BV (x)		EV/Sales (x)		EV/EBITDA (x)		EBITDA %	ROE (%)	RoCE (%)	Annual EPS Growth	Annual Sales Growth
	ttm	FY 08E	ttm	FY 08E	ttm	FY 08E	Ttm	FY 08E	ttm	FY 08E	FY 08E	FY 08E	FY 08E	(09/08)	(09/08)
Polaris	16.0	11.6	1.6	1.3	2.7	2.3	1.5	1.2	9.6	6.8	17.2%	21.4%	21.5%	24.7%	20.0%
Infotech	20.7	17.2	3.1	2.1	6.1	5.2	3.0	2.1	14.3	10.5	19.7%	30.2%	31.1%	26.0%	44.4%
Sasken	31.5	21.0	2.9	2.0	3.3	2.9	3.0	2.0	19.2	11.4	17.8%	14.8%	12.4%	48.0%	38.0%
Tata Elxsi	19.5	14.5	3.2	2.5	10.8	7.7	3.1	2.4	14.3	10.3	23.2%	62.3%	60.7%	29.3%	26.5%

Sources: Company Reports, FG Estimates and Consensus Estimates.

Quarterly Result Analysis

YE 31st, March (Rs. in Mn.)	Q4 FY07	Q4 FY06	Y-o-Y %	Q3 FY07	Q-o-Q %	FY07	FY06	% Change
Total Operating Revenue	2708	1989	36.2%	2,740	-1.2%	10,324	8,251	25.1%
Total Revenue	2708	1989	36.2%	2,740	-1.2%	10,324	8,251	25.1%
Less:								
Software Development Expenses	1806	1,405	28.6%	1,696	6.5%	6599	5627	17.3%
Selling and Marketing Expenses	316	218	45.2%	305	3.5%	1107	817	35.5%
Administrative and General Expenses	264	252	4.6%	265	-0.2%	1021	1045	-2.2%
Total Cost	2386	1875	27.3%	2,266	5.3%	8728	7489	16.5%
EBIDTA from Operations	322	114	183.2%	474	-32.2%	1,596	762	109.5%
Less: Interest Paid	3	2.2	43.1%	2	86.8%	8	8	5.5%
Less: Depreciation	122	124	-2.1%	124	-2.1%	481	494	-2.7%
Non-Operating Income	41	52.3	-21.2%	43	-5.2%	103	85	20.5%
Profit before tax	238	39	504.9%	392	-39.1%	1,209	345	250.8%
Total Tax	24	18	35.1%	69	-64.4%	199	132	51.4%
Profit after Tax	214	21	903.6%	323	-33.7%	1,010	213	373.8%
Diluted EPS (Rs.)	2.2	0.2	901.1%	2.8	-21.2%	10.3	2.5	304.7%
No. of Shares- Diluted mn	98.3	98.2		98.3		98.3*	98.1	
EBIDTA (%)	11.9%	5.7%		17.3%		15.5%	9.2%	
PBT (%)	8.8%	2.0%		14.3%		11.7%	4.2%	
Net Profit Margin (%)	7.9%	1.1%		11.8%		9.8%	2.6%	

* Quarterly average number of shares

** Other Income includes income from associates



Key Highlights of Q4 FY07

Decline in onsite billing rate & appreciating INR impacts performance

- In Q4 FY07, Polaris' topline grew by 36.2% Y-o-Y, but declined by 1.2% sequentially to Rs.2708 mn. After maintaining the EBITDA margin at above 17% for the past two quarters, it nose-dived by 542 bps sequentially to 11.9% in the quarter. Further, the net profit margin declined by 388 bps sequentially to 7.9% in the quarter. A sequential decline in revenues as well the margins came on the back of a decline in the onsite billing rate from \$59.75 per hour in Q3 FY07 to \$59.67 per hour, coupled with a sharp appreciation of the INR over this period. However, the offshore billing rate improved from \$19.27 per hour in Q3 FY07 to \$19.32 per hour.

Billing rates per hour

	Billing Rates per hour in Q4 FY07	Billing Rates per Hour in Q3 FY07
Onsite (Average)	\$59.67	\$59.75
Offshore (Average)	\$19.32	\$19.27

Reduction in business concentration in terms of geographies & customer base continues...

- Although a decline in the onsite billing rate and a simultaneous appreciation of the INR impacted the company, the performance along other business parameters continued to improve. The Intellect Suite business, which accounted for 20.6% of the total revenues (up from 18.5% in Q3 FY07), grew by 10.3% sequentially to Rs.559 mn in Q4 FY07.

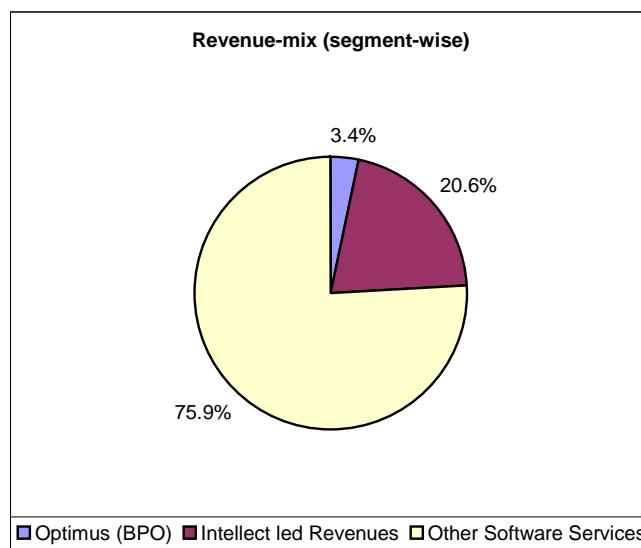
Rising share of the Intellect Suite businesses

	Contribution (% of Total Revenues)	Sequential Revenue Growth
Q1 FY07	14.8%	117%
Q2 FY07	16.7%	23%
Q3 FY07	18.5%	19%
Q4 FY07	20.6%	10%

- Optimus, Polaris's BPO arm posted a revenue growth of 117.3% Y-o-Y and 5.9% sequentially to Rs.93 mn. However, other software services declined by 4.2% sequentially to Rs.2055 mn, resulting in an overall sequential decline in revenues.



Revenue-mix: segment-wise in Q4 FY07



- The company's over-dependence on Citi Group continued to decline, resulting in a more de-risked business model. Revenues from the Citi Group declined from 58.2% in Q4 FY06 and 43.8% in Q3 FY07 to 40.6% in Q4 FY07.

Client Concentration (Revenue Contribution: Customer-wise)

	Q4 FY07	Q3 FY07	Q2 FY07
Citi Group	40.60%	43.80%	48.78%
Top Client*	11.10%	11.41%	12.05%
Top Five Clients*	34.50%	35.19%	38.75%

* Excluding Citi Group

- The company further reduced its geographical concentration. The revenue contribution from the US and North American market declined from 35.0% in Q3 FY07 to 34.4% in Q4 FY07, while the that from the European market increased from 31.6% in Q3 FY07 to 32.6% in Q4 FY07.

Other Highlights

- Polaris added 268 new professional to its total head count of 8668. The proportion of software professionals declined from 91.0% in Q3 FY07 to 90.3%, while that of selling and administrative professional increased from 9.0% in Q3 FY07 to 9.8% in Q4 FY07.
- Attrition rate slightly increased from 14.37% in Q3 FY07 to 14.52% in Q4 FY07.
- Onsite revenues contributed 57.9% to the topline in the quarter, down from 58.5% in Q3 FY07.

Onsite-offshore revenue-mix

	Revenue contribution in Q4 FY07 (%)	Revenue contribution in Q3 FY07 (%)
Onsite	57.9%	58.5%
Offshore	42.1%	41.5%



Earnings Model of Polaris (POL.IN/POLS.BO)

YE 31st, March (Rs. in mn.)	Q1FY07	Q2FY07	Q3FY07	Q4FY07	FY07	Q1FY08E	Q2FY08E	Q3FY08E	Q4FY08E	FY08E
Operating Revenue	2,321	2,556	2,740	2,708	10,324	3,023	3,221	3,305	3,253	12,801
Software Development expenses	1,500	1,597	1,696	1,806	6,599	1,889	2,000	2,049	2,062	8,001
Administrative and General Expenses	241	252	265	264	1,021	280	290	296	304	1,169
Marketing and Selling Expenses	220	266	305	316	1,107	332	354	364	379	1,429
	1,500	1,597	1,696	1,806	6,599	1,889	2,000	2,049	2,062	8,001
Total Cost	1,961	2,115	2,266	2,386	8,728	2,501	2,644	2,709	2,745	10,600
EBIDTA	360	441	474	322	1,596	521	577	597	507	2,202
Less: Depreciation	117	118	124	122	481	121	132	149	164	566
EBIT	243	323	350	200	1,115	400	444	448	343	1,636
Less: Interest	2	2	2	3	8	3	3	3	3	12
Add: Non-Operating Income**	9	9	43	41	103	8	8	15	10	40
PBT	250	330	392	238	1,209	405	450	460	350	1,664
Less: Total Tax	47	59	69	24	199	65	72	74	56	266
Profit after Tax	203	271	323	214	1,010	340	378	386	294	1,398
Shares Outstanding (mn)	98.2	98.2	98.3	98.3	98.3*	98.3	98.3	98.3	98.3	98.3
Diluted EPS (Rs.)	2.1	2.8	3.3	2.2	10.3	3.5	3.8	3.9	3.0	14.2
EBIDTA Margin (%)	15.5%	17.2%	17.3%	11.9%	15.5%	17.3%	17.9%	18.1%	15.6%	17.2%
EBIT (%)	10.5%	12.6%	12.8%	7.4%	10.8%	13.3%	13.8%	13.6%	10.5%	12.8%
PBT Margin (%)	10.8%	12.9%	14.3%	8.8%	11.7%	13.4%	14.0%	13.9%	10.7%	13.0%
NPM (%)	8.7%	10.6%	11.8%	7.9%	9.8%	11.3%	11.7%	11.7%	9.0%	10.9%
Effective Tax Rate (%)	18.8%	17.9%	17.6%	10.3%	16.5%	16.0%	16.0%	16.0%	16.0%	16.0%

*Quarterly average number of shares

** Other Income includes income from associates

Source: Company Reports, FG Estimates

Note: As the quarterly results are unaudited, there are minute variations with Annual audited data.



IMPORTANT DISCLOSURES

Price Target

Price targets (if any) are derived from a subjective and/or quantitative analysis of financial and non-financial data of the concerned company using a combination of P/E, P/Sales, earnings growth, discounted cash flow (DCF) and its stock price history.

The risks that may impede achievement of the price target/investment thesis are -

- Lower than expected ramping up of business can affect revenue growth.
- Lower billing rate may impact the margins of the company.
- Higher than expected attrition rate
- Exchange rate risk



Rating system of First Global

Our rating system consists of three categories of ratings: Positive, Neutral and Negative. Within each of these categories, the rating may be absolute or relative. When assigning an absolute rating, the price target, if any, and the time period for the achievement of this price target, are given in the report. Similarly when assigning a relative rating, it will be with respect to certain market/sector index and for a certain period of time, both of which are specified in the report.

Rating in this report is relative to: S&P CNX Nifty Index

Positive Ratings

(i) Buy (B) – This rating means that we expect the stock price to move up and achieve our specified price target, if any, over the specified time period.

(ii) Buy at Declines (BD) – This rating means that we expect the stock to provide a better (lower) entry price and then move up and achieve our specified price target, if any, over the specified time period.

(ii) Outperform (OP) – This is a relative rating, which means that we expect the stock price to outperform the specified market/sector index over the specified time period.

Neutral Ratings

(i) Hold (H) – This rating means that we expect no substantial move in the stock price over the specified time period.

(ii) Marketperform (MP) – This is a relative rating, which means that we expect the stock price to perform in line with the performance of the specified market/sector index over the specified time period.

Negative Ratings

(i) Sell (S) – This rating means that we expect the stock price to go down and achieve our specified price target, if any, over the specified time period.

(ii) Sell into Strength (SS) – This rating means that we expect the stock to provide a better (higher) exit price in the short term, by going up. Thereafter, we expect it to move down and achieve our specified price target, if any, over the specified time period.

(iii) Underperform (UP) – This is a relative rating, which means that we expect the stock price to underperform the specified market/sector index over the specified time period.

(iv) Avoid (A) – This rating means that the valuation concerns and/or the risks and uncertainties related to the stock are such that we do not recommend considering the stock for investment



FIRST GLOBAL

Nirmal, 6th Floor, Backbay Reclamation,
Nariman Point, Mumbai - 400 021, India.

Dealing Desk (India):

Tel.: +91-22-400 12 400

email: fgindiasales@bloomberg.net

FG Markets, Inc.

90 John Street, Suite 703,
New York, NY 10038

Dealing Desk (US):

Tel. No: +1-212-227 6611

email: us@fglobal.com

FIRST GLOBAL (UK) Ltd.

The Cobalt Building, 19-20, Noel Street,
London W1F 8GW, United Kingdom

Dealing Desk (UK & Europe):

Tel. No: +44-207-959 5300

email: uk@fglobal.com

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