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Tata Elxsi Ltd.

Rs. 229

Analyst
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Nifty: 3777; Sensex: 13073

Key Stock Data

Sector	IT Services
Bloomberg/Reuters	TELX@IN/TTEX.BO
Shares o/s (m)	31.1
Market cap (Rs m)	7,131
Market cap (US$ m)	160
3-m daily average vol.	54,329

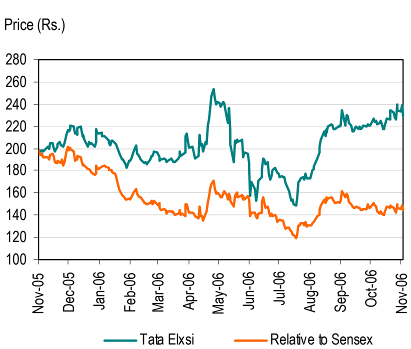
Price Performance

52-week high/low			Rs262/147
	-1m	-3m	-6m
Absolute (%)	1.9	30.5	15.6
Rel to Sensex (%)	(3.8)	11.8	(41.5)

Shareholding Pattern (%)

Promoters	38.15
FIIs/NRIs/OCBs/GDR	5.10
MFs/Banks/FIs	16.69
Non Promoter Corporate	3.48
Public & Others	36.58

Stock vs Relative to Sensex



Source: Capitaline

Summary

Product Designing and Product R&D, for global Consumer Electronics, Telecommunication and Automotive Industry holds the core activity of the software services segment of the company. Through this, the company helps the OEMs in getting immediate market for their products. Now with the expansion of development centers at Chennai and Bangalore and by concentrating on technology and IP (intellectual property) as against hitherto client specific services, the company has now developed a good platform for reaping the growing opportunity in engineering outsourcing services into the country.

Investment highlights

- **Product design – Increasing margin by concentrating on technology and IP**

Recently with the commissioning of new facilities at Chennai and Pune and by adding its focus more towards the telecom engineering design services the company has given a new dimension for growth to its software business. The company currently has technological association with Texas Instruments, Nokia and Symbian (Major smart mobile phones today runs through the Symbian Operating System).

We expect the increased spending in convergence (Telecommunication and Media) both from the service providers and equipment suppliers will accelerate the growth of revenue in the product design service business of the company. With the increased third-party outsourcing of product designing and R&D into the country along with the better understanding of the customer need and better customer relation, we expect the company's software development and service revenue would grow by more than 35% CAGR over ensuing five years, against the ruling industry average of 29%.

Currently the product designing business of the company has been predominantly driven by its customers from industrial segments like Automotive (Automotive designing and Electronics), Telecommunication and Consumer Electronics (Convergence Equipments). Now with increased investment in people and facilities, the company plans to become more technology driven. We expect this strategy will improve the margins in the software business. We expect operating margin of 23% by FY08. The glaring testimony of this is the development of "IEEE-16e mobile WiMax controller" by the company.

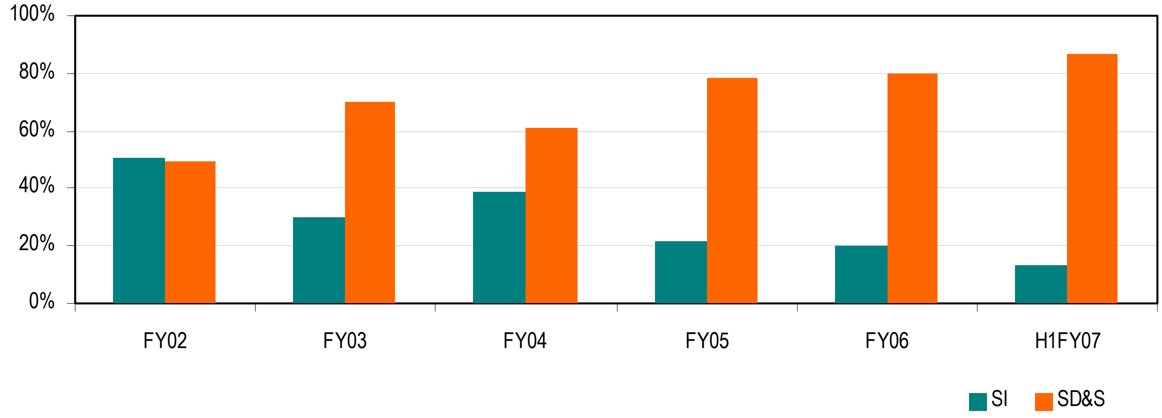
- **Visual computing – Going up in the value chain**

This division contributes around 8% of the total turnover of the company. Currently this division is developing teams that would specialize in things like pre-visualization, programming, research and development for the film and animation projects. The division is now taking a pro-active approach for its projects to move up in the value chain. This not only facilitates the company in faster completion of the projects but also make savings on its production budgets. By now this division has developed good credential for its project execution skills, both in the country and abroad.

- **System integration – Becoming selective**

We are not expecting any good spike in the revenue in the system integration business. However, we do expect that by concentrating on high margin projects in the broadcasting space (FM studios and TV studios) the company would definitely maintain its margins at current level.

Figure 1: Revenue mix



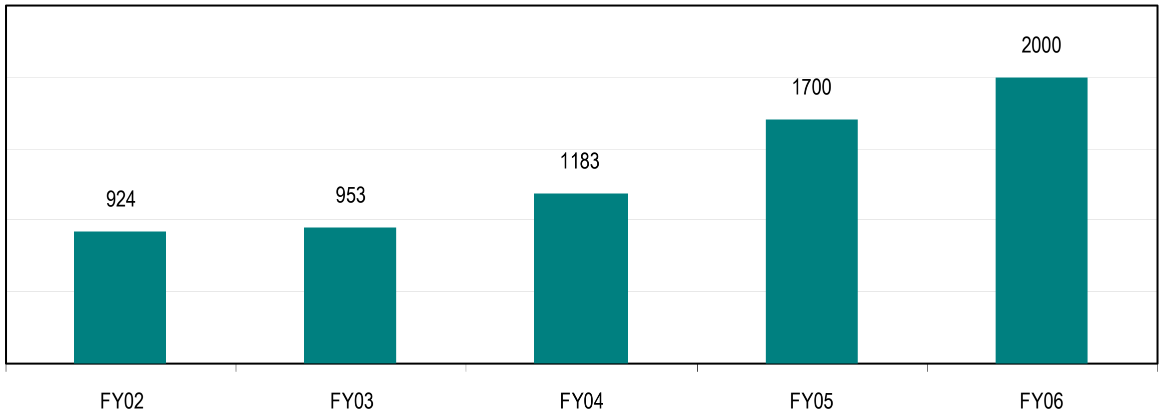
SI: System Integration; SD&S: Software Design and Services (Product Design and Visual Computing)

Source: Company reports; IDBI Capital Market Services

Expansion without the dilution of equity

At present, the company has four development centers at Bangalore, Thiruvanathpuram, Chennai and Pune. The first stage of development centers at Chennai and Pune has become fully operational by housing 100 engineers each. The second phase of the development center at Bangalore has been completed and the third phase is underway for completion. The current head-count of the company is 2000 (20% of whom are post Graduate and doctorates) and it plans to add 700 people with the full operation of the additional facility at Bangalore. Looking at the tremendous growth opportunity the company also plans to double its headcount in one and half years time period. Further to provide better service to the client, the company also planning for a near-shore facility in Japan in first quarter of FY08. The company plans to fund the entire expansion through internal accruals.

Figure 2: Number of employees

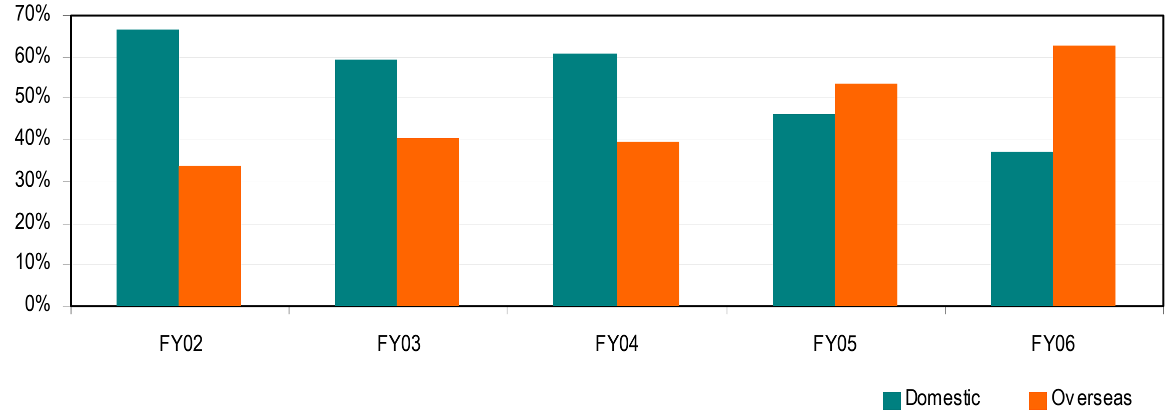


Source: Company reports; IDBI Capital Market Services

Toning up global delivery model

Currently the company derives 71% of its revenue from export of the designed products and services. Initially the company's engagements with the clients used to be predominantly on Time and Material basis. Now with the increased technological competence and better experience, the company has graduated its engagement with its customers, in a way that involves full life cycle design and turnkey projects implementation and provision of Offshore Competency Centers (OCCs) for the customers. These OCCs helps customers in utilizing company's lab infrastructure and other facilities by ensuring zero risk productivity from day-one. We believe sustained growth in software design revenue in coming years, by virtue of its hybrid business model which offers reusable technology platform to its customers.

Figure 3: Exports of services are on the rise

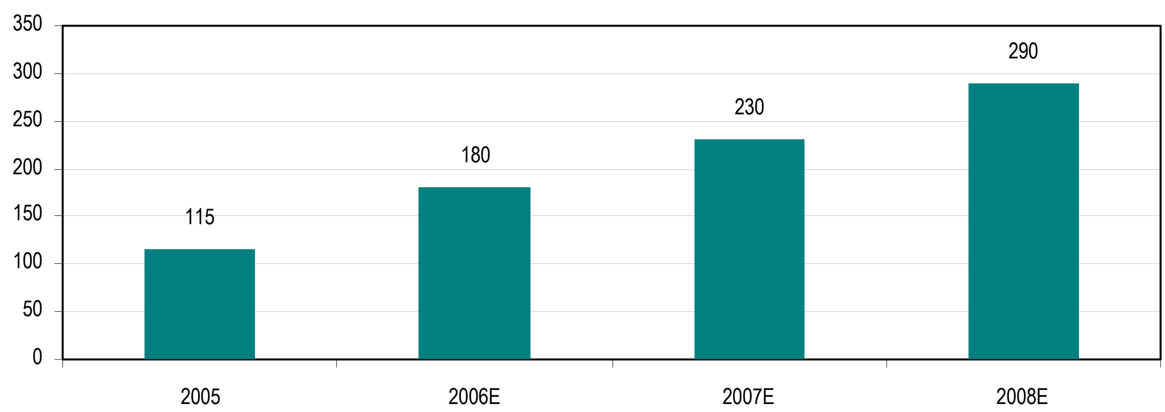


Source: Company reports; IDBI Capital Market Services

One of the first movers in IEEE-16e

IEEE-16e mobile WiMax is going to be the next disruptive technology for the telecom industry. Although, as compared to other emerging 3G technologies like WCDMA and EVDO, this technology has relatively low utility in terms of voice, but has a considerable edge on data application. Besides that, in terms of spectral efficiency and Capex, WiMax has a definite edge over the above-mentioned two emerging 3G technologies. Therefore as telecom service providers (particularly in other countries for now) go for the rollout of WiMax infrastructure there would be a tremendous opportunity for the OEMs to supply these equipments. At the same time with the consistent change in the application of the technology the product life cycle would pose a challenge for the telecom OEM players. Therefore the customized embedded technology service outsourcing would be the most preferable choice for the telecom equipment OEMs for developing their IPs. The international WiMax forum has just started giving the certification for the products to be used in the WiMax application which will offer economy of scale of manufacturing to keep the cost of the equipment low. In this context, the association with TI by the company is timely, as it would not only provide the company a good business opportunity for the customization need for the OEM players but also one of the first mover advantage for the company in this space.

Figure 4: WiMax Infrastructure Estimates for US (US $m)



Source: Telecommunication Industry Association (TIA)

Overview of Indian electronics design

As of now, Indian design organizations are fast moving beyond simple labour cost arbitrage for becoming true contributors to product innovation. Thus, along with captive design centers by the OEMs, the third party design centers are coming up rapidly. Coupled with fundamental strength in labour cost arbitrage the Indian design market is moving very fast because of the strategic focus of the designing work by the OEMs and secondly the strength of the Indian designers to enable the OEMs to fast market their products.

Table 1: Indian product design market and opportunity

Service	2005 US$ m	2005 %	2015 US$ m	2015 %	CAGR (%)
Hardware and Board Design	140	4	1,642	4	28
VLSI Design	583	18	5,086	12	24
Embedded Software	2,530	78	36,344	84	31
Total	**3,253**		**43,072**		**29**

Source: Frost & Sullivan

Concerns – Attrition and technological risk

The cost of manpower will remain a major concern for the companies like Tata Elxsi. Currently the manpower cost constitutes 51% of the total turnover of the company. Recently the investment in the industry both from captive and third party service providers has gained good pace. In this context, in future the increase in attrition rate and rise in personnel cost cannot be ruled out. However, we believe, by imbibing the valued work culture of Tata group the company can quell the concern appreciably. On the other hand, as the company is increasingly investing in its technological IP, the technological risk will remain a concern going forward.

Half yearly performance

During the half year of 2007, the company has reported 34% rise in turnover to Rs.1,384m. The software revenue has contributed 87% of the total turnover of the company as against 80% during the whole period of last year. Thus the operating margin has improved by 200 basis points to 21%. The profit after tax is reported at Rs.221m.

Valuation

In terms of client and industry focus, the business of the company is quite comparable with the business of companies like Sasken Communication Technologies and that of KPIT Cummins. But so far as the kind of services goes, the company does not hold a long term association with the customers for the products it designs or customizes. Other companies provide both application and maintainace services to their clients and thus have long-term revenue visibility from its clients for the kind of design service they provide for. We believe, when the company plans to move its focus from customer driven to technology driven, the client association may undergo a change. Looking at the growth of design outsourcing into the country and increased global product design need for the convergence applications, we expect the turnover of the company would grow at 35% CAGR and with the improved margin; the net profit would grow at a CAGR of 44% during FY07-10. The stock is currently trading at 14.3x our FY07E EPS of Rs.16 and 10x FY08E EPS of Rs.23. Based on the improved technological and client focus we believe a target of Rs.300 achievable in a one-year time horizon.

Table 2: Q2FY07 performance (Rs m)

Year-end: March	Q2FY07	Q2FY06	Var. (%)	H1FY07	H1FY06	Var. (%)
Net sales	750	559	34	1,384	1,068	30
Total expenditure	594	444	34	1,093	864	26
Operating profit	156	114	37	291	204	43
OPM (%)	21	20	2	21	19	10
Other income	2	3	(39)	3	4	(25)
EBIDTA	158	117	35	294	208	41
Interest	1	2	(32)	1	2	(34)
Depreciation	20	17	18	39	32	20
Tax	18	13	36	33	23	46
Reported PAT	119	85	39	221	151	46
EPS (Rs.) (Annualized)	15	11		14	10	
Equity	311	311		311	311	
Face value	10	10		10	10	

Source: Company reports; IDBI Capital Market Services

Financial summary

Profit and loss account

(Rs. m)

Year-end: March	FY05	FY06	FY07E	FY08E
Sales	1,858	2,356	3,200	4,300
%Change	*21*	*27*	*36*	*34*
Cost of sales	302	351	408	445
Personnel expenses	927	1,197	1,632	2,236
Administrative and selling expenses	271	341	464	624
Total expenses	1,500	1,890	2,504	3,305
Operating profit	358	467	696	996
OPM (%)	19	20	22	23
Other Income	11	7	7	7
EBITDA	369	474	703	1,002
Interest	1	2	3	5
Depreciation	50	67	117	168
PBT	317	404	583	829
Tax	54	61	82	116
PAT	263	343	501	713
EPS (Rs.)	8	11	16	23
No. of shares (m)	31	31	31	31

Source: Company reports; IDBI Capital Market Services

Balance sheet

(Rs. m)

Year-end: March	FY05	FY06	FY07E	FY08E
Net block	348	453	708	988
Net current assets	211	210	218	381
Debt	0	0	0	0
Shareholders fund	547	659	896	1,313
PE (x)	28	22	15	10
P/BV	14	11	8	6
EV	7,438	7,438	7,438	7,438
EV/Sales	4	3	2	2
EV/EBITDA	20	16	11	7
EV/PAT	28	22	15	10
OPM (%)	19	20	22	23
NPM (%)	14	15	16	17
RONW (%)	48	52	56	54
ROCE (%)	46	49	52	50
Debt/Equity	0	0	0	0

Source: Company reports; IDBI Capital Market Services

Peer valuation – H1FY07 Performance

(Rs. m)

Year-end: March	Tata Elxsi India	Sasken Communication Technologies	KPIT Cummins Infosystem
Sales	1,384	2,087	2,163
PAT	221	205	227
OPM (%)	21	17	15
NPM (%)	16	10	11
EPS (Rs.)	14	15	25
RNOW (%)	56	7	22

Source: Company reports; IDBI Capital Market Services

Notes

Equity Sales/Dealing

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