

Company Focus

4 January 2008 | 11 pages

Sasken Communication Technologies (SKCT.BO)

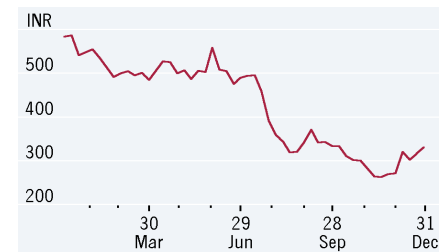
 Change in opinion
 Rating change
 Target price change
 Estimate change

Downgrade to Sell: Business Challenges; Recent Outperformance

- Downgrade to Sell** — Stock appreciated by ~23% over the last two months, outperforming the BSEIT index by ~30%. Business remains challenging with sluggishness in telecom OEMs and delays in product launches. With the stock at premium valuation to mid-cap IT peers, we downgrade it to Sell/High Risk.
- Services business environment challenging** — Telecom OEM environment still remains challenging, highlighted by sluggish results in that segment for peer Wipro. Ovum's latest report highlights decline in global capex by wireless players – the sweet spot for Sasken in recent past. With wireline capex still sluggish, any slowdown in mobile capex could further impact Sasken business.
- Product business investments scaled down** — Product business investments are scaled down due to delays in certain products launches. While this should lead to better near-term financials (Sasken might still meet its EBITDA breakeven target in products), this could be negative in the longer run as investors expected significant non-linear growth prospects in that business.
- Margin recovery a challenge** — Sasken's business model, with a high offshore component, has been hit hard by a strong INR. Management's guidance of 17-21% EBITDA margins in services looks aggressive, with the rupee continuing to appreciate further.
- Downgrading estimates and target price** — We are also downgrading our FY09 and FY10 EPS estimates by 3% and 8% respectively due to a difficult business environment. Our new SOTP-based target price is Rs333.

Sell/High Risk	3H
<i>from Buy/High Risk</i>	
Price (04 Jan 08)	Rs348.60
Target price	Rs333.00
<i>from Rs372.00</i>	
Expected share price return	-4.5%
Expected dividend yield	1.4%
Expected total return	-3.0%
Market Cap	Rs9,954M
	US\$254M

Price Performance (RIC: SKCT.BO, BB: SACT IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	229	8.09	-40.2	43.1	2.5	8.7	0.9
2007A	393	13.76	70.2	25.3	2.3	9.7	0.9
2008E	485	16.82	22.2	20.7	2.2	11.1	1.4
2009E	653	22.64	34.6	15.4	2.0	13.9	2.9
2010E	816	28.26	24.8	12.3	1.9	16.0	2.9

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	43.1	25.3	20.7	15.4	12.3
EV/EBITDA adjusted (x)	18.8	14.2	18.2	11.8	10.6
P/BV (x)	2.5	2.3	2.2	2.0	1.9
Dividend yield (%)	0.9	0.9	1.4	2.9	2.9
Per Share Data (Rs)					
EPS adjusted	8.09	13.76	16.82	22.64	28.26
EPS reported	8.09	13.76	16.82	22.64	28.26
BVPS	138.10	150.09	159.24	170.63	187.70
DPS	3.01	3.00	5.00	10.00	10.00
Profit & Loss (RsM)					
Net sales	3,081	4,683	5,486	6,773	8,516
Operating expenses	-2,779	-4,262	-5,182	-6,255	-7,911
EBIT	303	420	304	518	604
Net interest expense	0	0	0	0	0
Non-operating/exceptionals	63	73	292	273	391
Pre-tax profit	365	493	596	791	995
Tax	-69	-101	-110	-137	-180
Extraord./Min.Int./Pref.div.	-68	0	0	0	0
Reported net income	229	393	485	653	816
Adjusted earnings	229	393	485	653	816
Adjusted EBITDA	472	638	528	789	924
Growth Rates (%)					
Sales	27.4	52.0	17.2	23.5	25.7
EBIT adjusted	42.0	38.8	-27.7	70.4	16.8
EBITDA adjusted	33.0	35.0	-17.2	49.3	17.1
EPS adjusted	-40.2	70.2	22.2	34.6	24.8
Cash Flow (RsM)					
Operating cash flow	149	218	894	853	1,079
Depreciation/amortization	170	218	224	271	319
Net working capital	-250	-393	184	-71	-56
Investing cash flow	-454	-451	-316	-587	-701
Capital expenditure	-454	-449	-316	-587	-701
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	2,332	1,174	-348	-512	-439
Borrowings	-3	904	-183	-183	-110
Dividends paid	-96	-98	-164	-329	-329
Change in cash	2,027	941	230	-246	-61
Balance Sheet (RsM)					
Total assets	4,243	5,908	6,297	6,586	7,265
Cash & cash equivalent	2,015	717	1,631	914	477
Accounts receivable	653	1,108	1,172	1,392	1,750
Net fixed assets	1,011	2,996	2,494	3,386	4,258
Total liabilities	392	1,694	1,759	1,723	1,915
Accounts payable	0	0	0	0	0
Total Debt	12	916	733	550	440
Shareholders' funds	3,850	4,218	4,538	4,863	5,349
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	15.3	13.6	9.6	11.6	10.8
ROE adjusted	8.7	9.7	11.1	13.9	16.0
ROIC adjusted	14.8	10.2	4.8	9.3	8.7
Net debt to equity	-52.0	4.7	-19.8	-7.5	-0.7
Total debt to capital	0.3	17.8	13.9	10.2	7.6

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Services revenues – challenges continue

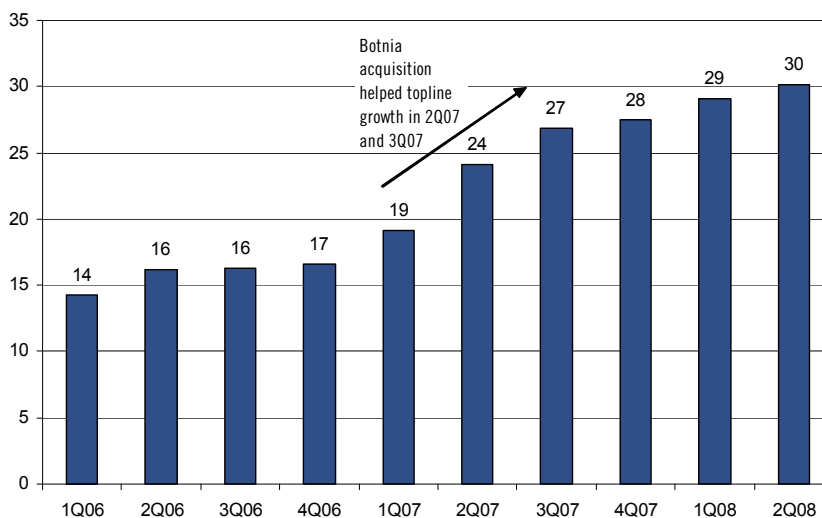
Figure 1. Earnings revision table

FYE	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
31 Mar				
2008E	485	16.82	0.0	5.00
Prev	485	16.82		5.00
2009E	653	22.64	-3.3	10.00
Prev	675	23.40		10.00
2010E	816	28.26	-8.4	10.00
Prev	891	30.86		10.00

Source: Citi Investment Research

Sasken's services business has struggled over the past few quarters due to sluggishness in services revenue due to restructuring in telecom OEMs space. Mobile handset space has been the sweet spot while other areas continue to be sluggish. Ovum (telecom consulting firm) latest report indicates some sluggishness in mobile capex, which could make it more challenging for Sasken going forward. Our channel checks indicate that Nokia, one of Sasken's large customers, is giving business to vendors who are ready to buy some of their R&D centers on their books – Sasken's small size makes it difficult for it to adopt this model. This could increase challenges for growth in the services business.

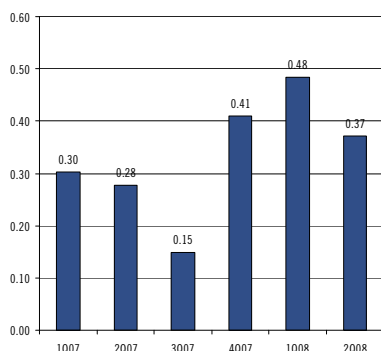
Figure 2. Services revenue (US\$ m)



Source: Company Reports

According to Ovum's report, mobile capex was down 18.2% YoY in 3Q07 led by Sprint Nextel. Capital spending on fixed networks should grow slowly over the next five years, reaching a level of around \$141 bn, while mobile capex should grow three times faster than fixed, surpassing fixed in 2009, and exceeding \$150 bn by 2012.

Figure 3. Products revenue (US\$ m)



Source: Company Reports

Product business – scaling down investments

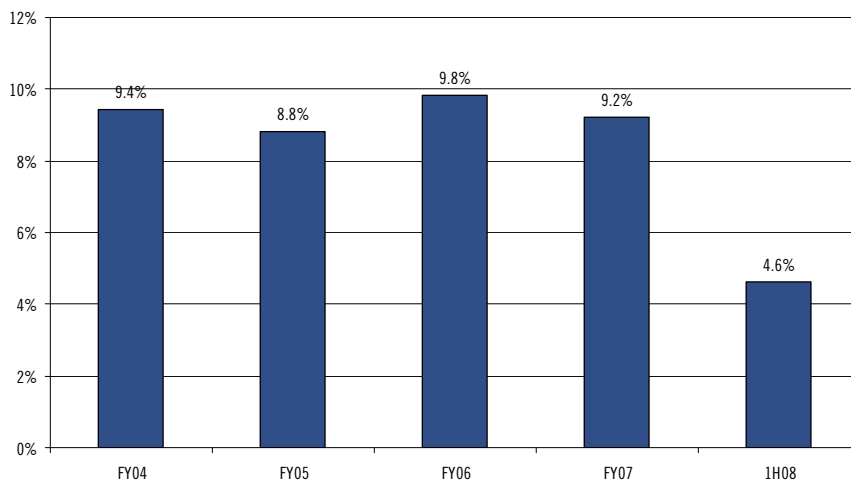
With revenues getting delayed further, Sasken is scaling down investments. While this appears prudent in the short run, as this should help improve near-term in profitability in the business, we think investors will have to scale down their expectations from this part of the business.

Also Sasken's royalty model has not really been playing out as per earlier expectation.

Margins – still challenging

Sasken's margins fell sharply in 1Q due to the sharp appreciation in the rupee. With a very high proportion (~85%+) of revenues coming from offshore and low margin levels, the impact of the appreciating rupee on Sasken has been very significant. With revenue growth expected to remain sluggish, offshore proportion expected to remain high and the rupee appreciating further, it might be difficult for Sasken to meet its margin guidance.

Figure 4. Services business margin – Challenged by high offshore and strong INR



Source: Company Reports

Figure 5. SOTP based Target Price

Sum of parts valuations		
Services EBITDA (FY09E)	Rs m	853
EV/EBITDA multiple services	(x)	9.0
EV of services	Rs m	7,680
Products sales (FY09E)	Rs m	722
EV/sales multiple for Products	(x)	3.0
EV of products	Rs m	2,165
Value of service per share	Rs	266
Value of products per share	Rs	75
Cash per share (end of FY07)	Rs	(8)
Sasken's price per share	Rs	333

Source: Citi Investment Research

Downgrade to Sell – SOTP of Rs333

We are downgrading our FY09 & FY10 EPS by 3% and 8% respectively primarily on account of slightly lower margins. Our new SOTP based target price is Rs333 as we value services business at 9x FY09E EBITDA (against 10x earlier). We do not ascribe any premium to Sasken's services business as we expect this business to remain challenging due to high sector concentration and challenges in the telecom OEM space.

Figure 6. Sasken – 12m forward PER Chart



Source: DataStream, Company data and Citi Investment Research estimates

Figure 4. Indian IT: valuation comparison

Company	RIC	CIR	Mkt cap	CMP	TP	P/E (x)		EV/EBITDA (x)		EV/Sales(x)		P/BV (x)		Div. Yield (%)	
Name	Code	Rating	(US\$m)	(Rs)	(Rs)	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
TCS	TCS.BO	1L	25,076	1,005	1,290	19.1	16.4	15.5	13.2	4.1	3.4	7.7	5.7	1.4%	1.6%
Infosys	INFY.BO	1L	24,680	1,695	2,190	21.1	17.8	17.6	14.3	5.4	4.4	6.5	5.0	0.9%	1.2%
Wipro	WIPR.BO	1L	18,492	497	565	21.8	17.6	16.8	12.7	3.4	2.7	5.8	4.7	1.4%	1.6%
Satyam	SATY.BO	1M	7,207	422	565	17.1	14.2	13.7	11.3	3.0	2.4	4.1	3.4	1.7%	2.4%
HCL Tech	HCLT.BO	1M	5,321	314	365	17.4	14.8	12.4	10.2	2.5	2.0	3.4	3.0	2.5%	2.5%
I-Flex	IFLX.BO	3M	3,165	1,483	1,570	39.0	25.5	26.0	17.0	4.6	3.5	6.4	5.1	0.0%	0.0%
Tech Mahindra	TEML.BO	3H	3,465	1,120	1,330	19.0	14.3	16.9	12.0	3.5	2.7	8.2	5.1	0.2%	0.3%
Mphasis	MBFL.BO	1M	1,544	290	360	23.6	16.1	13.2	9.8	2.3	1.6	5.1	4.0	1.0%	1.0%
Patni*	PTNI.BO	1H	1,134	320	475	9.7	9.5	5.6	5.6	1.2	1.0	1.7	1.5	1.1%	1.6%
MindTree	MINT.BO	3H	494	512	487	20.3	15.5	16.0	12.2	2.5	1.9	3.7	3.0	0.5%	0.6%
Hexaware*	HEXT.BO	1M	311	85	122	10.7	9.0	6.7	5.6	0.8	0.7	1.5	1.4	2.1%	2.8%
KPIT	KPIT.BO	1M	252	127	130	18.1	13.7	11.3	8.9	1.7	1.3	3.7	3.0	0.4%	0.6%
Sasken	SKCT.BO	1H	254	349	333	20.7	15.4	19.2	12.9	1.9	1.5	2.2	2.0	1.4%	2.9%

Source: Powered by dataCentral; Prices as on 04-Jan-08; *Using CY07E/CY08E for these companies (31-Dec year-ending)

Sasken Communication Technologies

Company description

Bangalore-based Sasken was established in 1989 and initially worked on electronic design automation projects. It now offers embedded software services to network equipment manufacturers, device manufacturers and service providers in the wireless and broadband space, and to semiconductor vendors. Key clients include large tier-one vendors such as Nokia and Nortel. Sasken has also been investing in a products business.

Investment strategy

We rate Sasken as Sell/High Risk (3H). M&A/Restructuring has led to slower growth for IT services vendors serving telecom OEM players. Sasken, with high concentration on the telecoms and embedded space, has been affected by this trend. We expect Sasken's services business to record revenue CAGR of 20% over FY07-10E. Margins have dropped significantly in services business on the back of strong INR and high offshore share. With sluggish revenue CAGR and INR appreciation, we do not see any sharp recovery in the same. The products business is in investment mode despite several design-wins. We still expect a reasonable ramp-up and a turnaround in the products business in FY08. However, scaling back of investments in the product business could harm long-term prospects as investors have been expecting non-linear growth from product business.

Valuation

Our 12-month target price of Rs333 is based on a sum-of-the-parts valuation for the services business and the loss-making products business. We apply an FY09E EV/EBITDA target of 9x for Sasken's services business (against 10x earlier), which is now in line with the target valuations of comparable mid-caps. We no longer ascribe any premium to the Sasken's services business (compared to other mid-cap IT services companies) as we expect this business to remain challenging. We value Sasken's products business at 3x EV/Sales, similar to the valuation Motorola paid for Sasken's largest competitor, TTPCom, and is supported by our forecast of 12%-plus margin in FY09. Our target price implies a P/E of 15x FY09E EPS.

Risks

Although our quantitative risk-rating system suggests Medium Risk, we rate Sasken as High Risk given the QoQ volatility inherent in the products business and delay in royalty revenues. Risks that could impede the stock from reaching our target price include: (1) high client concentration – strong growth from top few clients could change the revenue growth trajectory; (2) pick-up in IT services demand in the telecoms industry; (3) faster handset launches in which Sasken is involved, or strong customer response to the handsets; and (4) INR depreciation.

Sasken Communication Technologies

(SKCT.BO)

4 January 2008

Appendix A-1

Analyst Certification

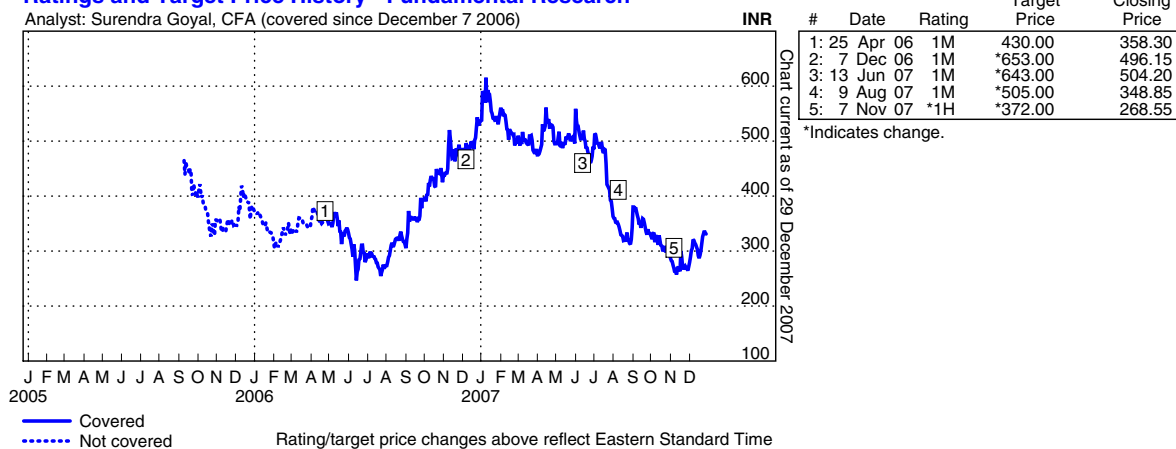
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Sasken Communication Technologies (SKCT.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal, CFA (covered since December 7 2006)



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