

June 7, 2006

FOR PRIVATE CIRCULATION

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Stock details

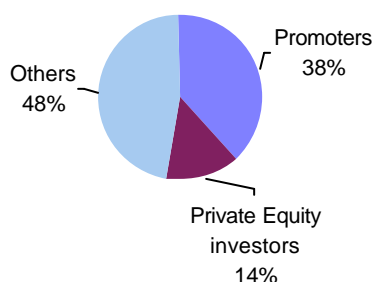
BSE code	: 532735
NSE code	: 13414
Market cap (Rs mn)	: 1,990
Free float (%)	: 61.7
52-wk Hi/Lo (Rs)	: 325 / 135
Avg. daily volume (mn)	: 53000
Shares o/s (mn)	: 13.54

Summary table

Rs mns	CY04	CY05	CY06E	CY07E
Revenues	1,323	1,574	1,966	2,443
Growth (%)	8.1	18.9	24.9	24.3
EBITDA	64	194	277	357
EBITDA margin (%)	4.8	12.3	14.1	14.6
Net profit	2	125	190	247
Net cash (debt) (51)	14	655	786	
EPS (Rs)	0.1	4.9*	14.0	18.3
Growth (%) (108.4)	5,725.2	52.2	30.1	
CEPS	2.0	6.8	18.8	24.6
DPS (Rs)	0.0	0.0	1.5	2.0
RoE (%)	0.4	22.2	18.1	15.5
RoCE (%)	3.0	22.3	19.5	17.3
EV/Sales (x)	3.0	2.5	1.0	0.8
EV/EBITDA (x)	61.6	20.0	7.4	5.8
P/E (x)	1,764	30.3	10.5	8.1
P/Cash Earnings	75.0	21.7	7.8	6.0
P/BV (x)	7.4	6.2	1.3	1.2

CY05	Q1	Q2	Q3	Q4
Sales (Rs mn)	365	391	396	422
EPS (Rs)	1.3	2.0	3.5	2.4

Source: Company & Kotak Securities - Private Client Research; * Face value of Rs.2 per share

Shareholding pattern


Source: Company RHP

R Systems International Ltd (RS)

Price: Rs. 147

Recommendation: BUY

Target Price: Rs. 244

RS is a vertically focused company operating in the high growth area of third-party product development services. The company also has a suite of products in the areas of retail lending (Indus) and supply chain management (ECnet). Consistent high growth in outsourced and off-shored product development services, along with longstanding relationships with large corporations, makes us optimistic on the future growth prospects of RS. Recent entry into the US for Indus suite of products and potential acquisitions may provide further upsides. We expect revenues and profits to grow at a CAGR of 25% and 41%, respectively over CY05-CY07. At 8.1x CY07E earnings, the stock offers an upside of 65%. BUY with a one-year price target of Rs.244.

Investment argument

- **Present in the fast growing product development services space.** Outsourcing and offshoring on product development services is still at a nascent stage. The need to compress time-to-market, pressure of introducing newer products and relatively lower costs are expected to result in increasing demand for off-shoring these services. The product and technology services market in India is expected to grow to \$8-10bn by 2008, according to a NASSCOM-McKinsey estimate.
- **End-to-end services within product development / engineering.** Within this space, RS provides services ranging from product conceptualization and development to product maintenance and support, providing stability in revenue growth (iPLM services). Dependence on product development services only leads to volatility and unpredictability because of the project-based nature on these services. Maintenance and other support services are annuity type of services and, hence, relatively more stable.
- **Long-standing relationships with marquee clientele.** While RS has start ups and software tool development companies as its customers, it also serves a set of large customers like Virgin, UK, Siemens, Open Solutions, InstallShield, TMA Resources, etc. In its products business, RS has clients like GE Consumer Finance, ABN Amro, Standard Chartered, etc. A few of the large clients have been with the company for more than six years and receive a broad range of services from RS under a Master Service Agreement (MSA).
- **Products in high growth areas.** RS has a set niche offerings in the banking & finance and manufacturing and logistics industries, by virtue of acquisition of Indus and ECnet. The focus area of retail lending is expected to achieve a double-digit growth rate in BRIC economies and also in central/Eastern Europe, Latin America, Middle East and in Southeast Asia. While the space has several competitors, we believe the company has a strong lending suite of products and is also a leading player in the collections business. GE Consumer Finance is the anchor client for the lending suite of products with about 15% share of company's overall revenues.
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- **Strong growth expected in earnings.** We expect the company's revenues, primarily from the iPLM space, to grow at a fast clip. An increase in proportion of offshore services and better leverage on past investments are expected to result in improvement of EBDITA margins from 12.3% in CY05 to 14.6% in CY07. Consequently, profits are expected to grow at a CAGR of 41% to Rs.247mn in CY07.

Attractive valuations

- The stock is currently trading at 10.5x CY06 and 8.1x CY07 earnings. We believe these valuations do not fully capture the improving fundamentals and the potentially high earnings growth of the company. We recommend a BUY on RS with a price target of Rs.244, which is supported by our DCF analysis.

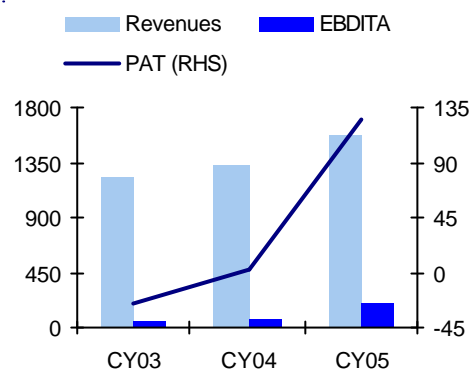
Concerns

- A deceleration in major user economies may impact the discretionary spending of clients, in turn, impacting the revenue growth of the company.
- Rupee appreciation beyond our assumed level of 43 per dollar by CY07 end, may impact the financials of the company.

Company Background

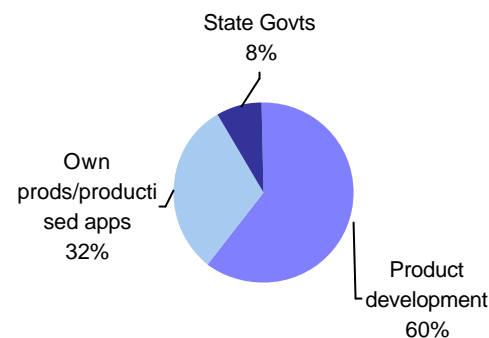
Set up in 1993 by Mr. Satinder Rekhi and Mr. Gurjot Oberoi, RS started off with a focus on outsourced and offshore product development services. Initially, the services were provided on mainly an on-site basis. Intel acquired an equity stake in RS in 2001 and RS started working as a porting and tuning centre for the Itanium chip of Intel in Noida, Delhi.

Past financials (Rs mn)



Source : Company

CY05 Revenue break up (Rs mns)



Source : Company

RS came out with an IPO in March 2006, wherein it offered 4.4mn shares (2.825mn new shares and 1.58mn shares from existing investors) at Rs.250 per share. The promoters' holding in the company, consequently, came down to 38.3%. Post issue, GE and Intel together hold about 13% stake in the company.

The company has been focusing on a few verticals like banking/financial services, manufacturing/logistics and technology/internet services. Of these, the expertise in banking & financial services and manufacturing was acquired from Indus and ECnet, which were acquired in 2002 and 2004, respectively. GE, a common shareholder, facilitated the Indus merger.

Currently, the company has development centers at three locations in India namely. Delhi, Pune and Chennai and in the US and Singapore. On a consolidated level, the company currently employs about 1,375 employees (1,301 as on December 2005) of which, about 1,200 are technical people.

INVESTMENT POSITIVES

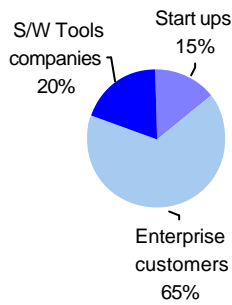
PRODUCT DEVELOPMENT SERVICES

Strong growth expected in product development services

According to industry sources, the global product development services industry is currently a \$10-\$12bn industry. Of this, the outsourced and offshore product development market in India is estimated to be about \$3bn and is expected to grow at a rapid pace in the future.

A NASSCOM - McKinsey study has estimated that the overall product and technology services market in India would grow to \$8bn-11bn by 2008. The main factors driving this fast growth are the need on the part of the product companies to reduce the time-to-market and the constant need to introduce new products/re-engineer existing products on new technologies. Also, lower costs and better value for money are important considerations leading to the growth of the offshore services.

CY05 revenue break up - Prod Devt services



Source : Company

Proprietary framework

Enterprise clients provide stability to revenues

Long-term relationships provide higher visibility

Focused approach/broad range of services

From its initial stages, RS has focused on the outsourced product development services space and on developing its own products. About 60% of RS' CY05 revenues came from product development services.

RS provides a range of services like product definition, product development and product sustenance/support. The broad range of services allows RS to penetrate the client deeper, resulting in sustained and long-lasting relationships.

Also, provision of product sustenance and support services provides the much needed revenues stability and visibility, being annuity-based. Product development services, by their very nature, are project based and hence, volatile.

psuite framework

Building on the expertise and experience gained in this space, RS has developed its own psuite framework, which allows the company to improve the operational efficiency by automating several processes while providing services. The framework consists of the company's best practices, tools and methodologies, which allow the software product companies and service providers to reduce the time-to-market, work collaboratively across the lifecycle and extend the life of and enhance products.

A mix of start-ups and enterprise clients

RS' broad range of services has allowed it to penetrate clients deeper. RS has serviced about 50 clients till date, which include Fortune 1000 companies. The clients of RS are a mix of technology start-ups and enterprise customers.

While the technology start-ups help RS in keeping abreast of the latest technologies, enterprise customers provide relatively more stable and sustainable revenue stream. Currently, technology start-ups contribute about 15% of the product development services revenues while mature enterprises contribute about 65%. Software tools companies bring in the balance revenues.

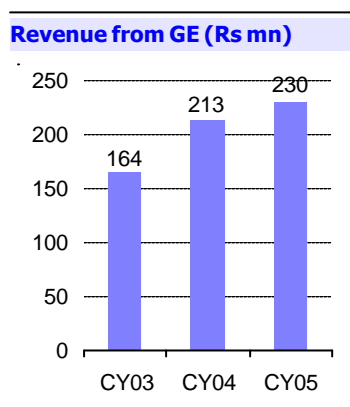
Long-standing relationships

The major clients of RS include companies like Virgin, UK, Siemens, Open Solutions, InstallShield, Hansen, TMA Resources, Department of Social Services, USA, etc. In its products business, RS has clients like GE Consumer Finance, ABN Amro, Standard Chartered, etc. While a few of the several RS clients have been with the company for more than a year, RS is serving a few of its top clients for more than six to seven years.

The company is providing product development services to the clients, which helps them in growing their core businesses and to that extent, ensures the stickiness of these clients to RS.

For Open Solutions (a mid-sized retail banking products company) RS is internationalizing their US-centric products. The relationship has grown 18 months old with the team size growing to 75. On the other hand, RS is helping Virgin, UK (a music group) in its internet music service launch. About 50 people are working in this relationship, which is more than a year old.

The company is also associated with Myrio, a Siemens subsidiary, which has software for launching IPTV. The relationship has grown from three employees to more than 60 now. The other major clients of RS are Watchguard (an internet company in the security space) and Installshield, a performance testing tools company.



Source : Company

Strong offering in retail lending

Clientele includes GE Consumer Finance, ABN Amro, Standard Chartered, etc

GE-15% of revenues

GE, the top client of RS, accounted for about 15% of the company's CY05 revenues. The Top 5 and Top 10 clients contributed 34% of CY05 revenues.

The GE relationship has grown consistently over the past three years. Currently, the GE relationship is only restricted to the Indus suite of products as GE has availed of a global license of the Indus Lending Solutions Product. RS is now pitching for the outsourced product development services from GE and hopes to win contracts in this business also.

Software products

Through its acquisition of Indus and ECnet, RS acquired a range of software products catering to the banking & financial services and the manufacturing/logistics industries.

Lending suite of products

The set of products from the Indus Lending Solutions Business (LSI) caters to the retail lending industry. LSI is a modular application, which allows companies to automate their customer acquisition process and also allows tracking of the repayment schedules. It has a powerful customer servicing module wherein, delinquent accounts can be tracked all the way from early collections.

The suite of products is compatible with most of the core banking packages and hence complements most of the existing packages installed at the client sites.

Marquee clients

The suite of products has been able to attract some of the leading global names including GE Consumer Finance, ABN Amro, Standard Chartered, etc. About 150 employees are working on GE projects globally. On the other hand, the other relationships have also deepened with installations in about 10 countries for Standard Chartered and about seven countries for ABN Amro. This reflects the adoptability of the products to different countries.

Most of the clients for the LSI are across countries except the US, where it has no presence. The company has now started focusing on the US markets also and has already appointed two senior sales people in that geography. The company hopes to start yielding benefits during CY06.

Large companies like Pioneer, Panasonic, Hitachi and Yamaha are using the supply chain product from ECnet.

Long-term relationships

The company has adopted a strategy of penetrating clients through lower license fees. While helping the company in client penetration, over the long-term, this strategy pays off in terms of higher revenues from product upgrades, implementation, maintenance and support services. Currently, license fees contribute only about 15% of the product revenues.

We believe that competition in this line of business is immense with the company competing with players like London Bridge, 3i, Nucleus, Polaris, etc. However, with good reference clients and a strong suite of proved products, we believe the business should be able to achieve reasonable success in the future.

Public sector business

Currently working for states of California, Washington and Oregon

This practice forms a relatively smaller part of RS' revenues. RS provides diverse services to various government agencies to make them e-enabled by creating an architecture that allows the use of internet technologies in an effective yet simple manner.

The customers of RS include local and state agencies in the field of criminal justice, public safety, health and human services in the states of California, Washington and Oregon. The company has developed the award winning Megan's Law application for one of the public sector companies. RS has recently received a three-year order from the Department of Healthcare in the US, which is worth about \$5.6mn.

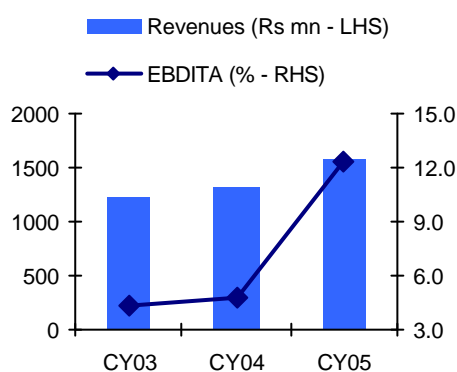
We believe this business will be a relative slow growth business as well as a steady one for RS.

Financials

Improving performance over the past Clientele includes GE Consumer Finance, ABN Amro, Standard Chartered, etc

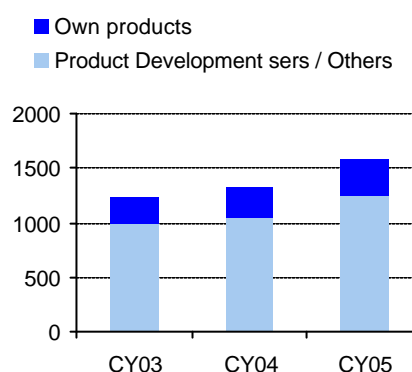
RS has achieved improved performance over the past two fiscals, based on a sustained growth in the product development services business and the revenues from its own products.

Past financial performance (Rs mn)



Source : Company

Revenue break up (Rs mn)



Source : Company

Growing EBITDA margins

The EBDITA margins have improved due to the increasing levels of offshore business and also better leverage on investments made. The offshore business contributed about 58% to CY05 revenues. There has been an improvement in margins over the quarters in CY05 with the margins reaching 16% in 4QFY05.

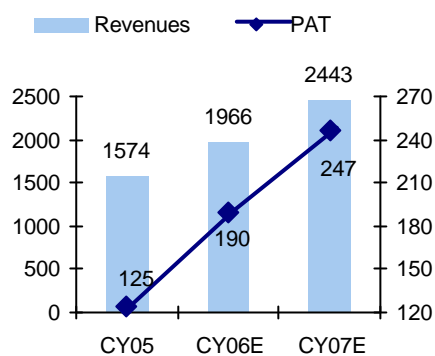
During CY05, RS added about 267 employees on a net basis to take the total number of technical employees to 1,131. This implies a net addition of about 31% to the base number of employees (864 as at CY04 end) during the fiscal. However, the revenues grew at a relatively slower rate as most of the additions were made offshore, which has lower billing rates.

Future prospects

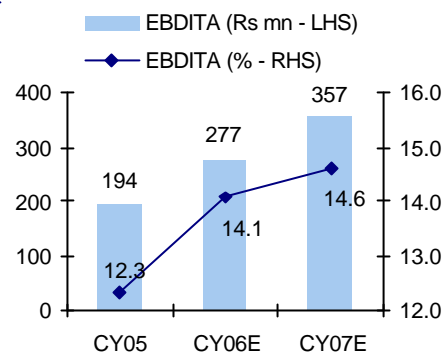
Product development services expected to drive growth

We expect RS to report relatively higher revenue as well as net profit growth as compared to the past. The growth is likely to be brought about by higher volumes in product development services and product revenues.

EBDITA margins are expected to expand to about 14.6% in CY07 on the back of higher off-shore revenues, cost control measures and better leverage on fixed costs. We have assumed tax rate at 13% in CY07.

Financial prospects (Rs mn)

Source : Company, Kotak Securities Private Client Research

Future profitability

Source : Company, Kotak Securities Private Client Research

The main assumptions are as under:

- Employee strength is expected to rise to 1,966 in CY07 as compared to 1,301 in CY05.
- Average realization rates are expected to remain stable at 4QCY05 levels.
- Rupee is expected to appreciate to 43 per dollar by CY07 end.
- Capex over CY06 and CY07 expected to be Rs.350mn.

Based on these assumptions, we expect PAT to grow at a CAGR of 41% to Rs.247mn in CY07, resulting into an EPS of Rs.18 in that fiscal.

DCF valuation

Free Cash Flow to Firm (Rs mn)										
	2003	2004	2005	2006E	2007E	2008E	2009E	2010E	2011E	2012E
PAT	(26)	2	125	190	247	272	314	360	406	438
Depreciation	64	48	49	65	86	127	144	160	175	192
Int (1-tax)	2.1	11.5	7.3	5.4	4.0	0.0	0.0	0.0	0.0	0.0
Capex	-	152	51	165	140	138	108	140	129	192
NWC change	-	38.5	46.8	136.3	36.4	52.4	24.1	21.5	57.5	82.6
Investments	0.0	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCFF	41	(129)	83	(41)	161	209	325	358	395	355
Discounted Value			-	(41)	150	171	232	223	215	1,524

Source: Kotak Securities - Private Client Research

The following grid below gives a sensitivity analysis based on various scenarios.

DCF Valuation (Rs mn)	
Total FCFF	2515
Less net debt (cash)	(786)
Shareholders' value	3,301
Value per share	244

Assumptions	
Grth FY09-12	Actual
Terminal Growth (%)	3.00
WACC (%)	14.44
Beta	1.20
Risk Free Rate (%)	7.00
Market Risk Premium (%)	6.50
Cost of Equity (%)	14.80
Cost of Debt (%)	5.00
Debt	70
Equity	1990
WACC (%)	14.44

Source: Kotak Securities - Private Client Research

Sensitivity analysis				
	WACC (%)			
Terminal Growth	12.5	13.5	14.5	15.0
2.0	368	249	234	226
3.0	284	261	244	235
4.0	303	276	256	245

Source: Kotak Securities - Private Client Research

Profit and loss statement (Rs mn)				
(Year-end Dec 31)	CY04	CY05	CY06E	CY07E
Revenues	1,323	1,574	1,966	2,443
% change yoy	8.1	18.9	24.9	24.3
EBITDA	64	194	277	357
% change yoy	20.6	204.4	42.9	28.8
Depreciation	48	49	65	86
EBIT	15	145	212	271
% change yoy	(238.2)	837.9	46.3	27.8
Net Interest	12	8	6	5
Other Income	3	8	10	18
Earnings Before Tax	7	144	216	284
% change yoy	(126.2)	1,984.1	49.6	31.6
Tax	5	19	26	37
as % of EBT	3.3	69.1	13.5	12.0
Net Income adj	2	125	190	247
% change yoy	(108.4)	5,727.5	52.2	30.1
Shares outstanding (m)	25.7	25.7	25.7	13.5
EPS (Rs)	0.1	4.9	14.0	18.3
DPS (Rs)	0.0	0.0	1.5	2.0
CEPS	2.0	6.8	18.8	24.6

Balance sheet (Rs mn)				
(Year-end Dec 31)	CY04	CY05	CY06E	CY07E
Cash and cash equivalents	97	115	725	856
Accounts receivable	345	419	608	697
Others	102	116	120	125
Current Assets	544	650	1,452	1,677
LT investments	2	2	2	2
Net fixed assets	282	282	382	436
Total Assets	828	934	1,837	2,116
Payables	141	157	180	210
Others	60	84	118	146
Current liabilities	201	242	298	356
LT debt	147	101	70	70
Other liabilities(defrtd tax)	(30)	(22)	(20)	(15)
Equity & reserves	510	613	1,488	1,705
Total Liabilities	828	934	1,837	2,116
BVPS (Rs)	19.9	23.9	110.0	126.0

Cash flow statement (Rs mn)				
(Year-end Dec 31)	CY04	CY05	CY06E	CY07E
EBIT	15	145	212	271
Depreciation	48	49	65	86
Change in working capital	39	47	136	36
Change in other net current assets	-	-	-	-
Operating cash flow	25	147	141	320
Interest	12	8	6	5
Tax	5	19	26	37
Cash flow from operations	9	119	108	279
Capex	(152)	(51)	(165)	(140)
(increase)/decrease in investments	0	(0)	-	-
Cash flow from investing	(152)	(52)	(165)	(140)
Adjustment for depreciation	33	3	-	-
Adjustment for reserves	(13)	(22)	624	-
Total adjustments	20	(19)	624	-
Dividend paid	-	-	(23)	(31)
Other income	3	8	10	18
Proceeds from equity issue	-	0	84	-
Increase/(decrease) in debt	88	(46)	(31)	-
Deferred tax credit / Misc expn	9	8	2	5
Cash flow from financing	99	(30)	42	(8)
Change in cash	(25)	19	609	131
Opening cash	121	97	115	725
Closing cash	97	115	725	856

Ratio analysis				
(Year-end Dec 31)	CY04	CY05	CY06E	CY07E
EBITDA margin (%)	4.8	12.3	14.1	14.6
EBIT margin (%)	1.2	9.2	10.8	11.1
Net profit margin (%)	0.2	7.9	9.7	10.1
Adjusted EPS growth (%)	(108.4)	5,725.2	189.0	30.1
Receivables (days)	95.2	97.1	112.9	104.1
Inventory (days)	-	-	-	-
Sales / Net Fixed Assets (x)	4.7	5.6	5.1	5.6
Interest coverage (x)	1.3	17.2	33.4	56.4
Debt/ equity ratio (x)	0.3	0.2	0.0	0.0
ROE (%)	0.4	22.2	18.1	15.5
ROCE (%)	3.0	22.3	19.5	17.3
EV/ Sales (x)	3.3	2.8	1.2	0.9
EV/EBITDA (x)	68.9	22.4	8.3	6.5
Price to earnings (P/E)	1,979.5	34.0	11.8	9.0
Price to book value (P/B)	8.3	6.9	1.5	1.3
Price to cash earnings (x)	84.2	24.4	8.8	6.7

Source: Company; Kotak Securities - Private Client Research

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