

i-flex solutions

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,360	IFLEX IN
	REUTERS CODE
S&P CNX: 3,664	IFLX.BO

5 May 2006
Buy
Previous Recommendation: Buy
Rs1,301

Equity Shares (m)	76.2
52-Week Range (Rs)	1,475/633
1,6,12 Rel. Perf. (%)	-12/-5/9
M.Cap. (Rs b)	99.2
M.Cap. (US\$ b)	2.2

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	RATIO	(X)	(%)	(%)	SALES	EBITDA
3/06A	14,835	2,190	28.7	5.9	45.3	8.2	19.5	24.2	6.0	30.3
3/07E	19,403	3,424	44.9	56.3	29.0	6.6	25.1	31.1	4.5	19.1
3/08E	24,259	4,330	56.8	26.5	22.9	5.3	25.6	31.6	3.6	15.0

- ✦ i-flex reported revenue growth of 15.4% QoQ at Rs4.6b, higher than our estimate of Rs4.4b, on the back of 25.4% QoQ growth in product revenue, which was driven by 115% QoQ growth in license fees.
- ✦ Revenue from Citigroup grew 9% QoQ, while its revenue contribution declined to 36% from 38% in 3QFY06. Tank size declined to \$65m due to license fee bookings of \$29.5m during the quarter. 27 customers were added during the quarter, including two Tier I banks for FLEXCUBE and one Tier I bank for Reveleus Basel II.
- ✦ Services revenue grew 4.7% QoQ, with revenue from all top customers excluding Citigroup declining during the quarter. KPO revenue declined 5.9% QoQ to Rs67m. Onsite billing rates (derived) in the services business were up 9% QoQ, while offshore billing rates (derived) declined 8% QoQ.
- ✦ The company added 217 (net) employees during the quarter, including 145 in the products business and 55 in KPO.
- ✦ EBITDA margin improved to 28.7% from 24% in 3QFY06, boosted by greater growth in license fee revenue. However, this was 50bp less than expected due to the lower margins in the services business.
- ✦ Net profit at Rs1.17b was higher than expectation of Rs897m due to higher other income of Rs105m and lower tax outgo at 7.8% (as against 30% in 9mFY06).
- ✦ We expect i-flex to report revenue growth of 30.8% and 25% and profit growth of 56.3% and 26.5% in FY07E and FY08E respectively, driven by strong growth in the products business. On an estimated EPS of Rs56.8 in FY2008E, the stock trades at a P/E of 22.9x. Maintain **Buy** with a price target of Rs1,420.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Revenues	2,262	2,606	3,052	3,484	2,701	3,593	3,965	4,577	11,404	14,835
Q-o-Q Change (%)	5.6	15.2	17.1	14.2	-22.5	33.1	10.3	15.4	41.6	30.1
Direct Expenses	1,195	1,462	1,665	1,627	1,743	2,074	2,051	2,279	5,948	8,148
Sales, General & Admin. Expenses	580	584	757	765	822	968	963	985	2,686	3,738
Operating Profit	487	560	631	1,093	135	551	950	1,313	2,770	2,950
Margins (%)	21.5	21.5	20.7	31.4	5.0	15.3	24.0	28.7	24.3	19.9
Other Income	148	70	-80	89	70	115	-12	105	227	277
Depreciation	62	80	86	109	113	113	127	152	337	505
Share of Associate Company Loss	0	0	1	1	3	-2	-3	-1	1	-3
PBT	573	549	464	1,072	90	555	814	1,267	2,658	2,726
Provision for Tax	147	121	107	252	31	151	255	98	627	535
Rate (%)	25.6	22.0	23.1	23.5	34.5	27.2	31.4	7.8	23.6	19.6
PAT	426	429	357	820	59	404	559	1,169	2,031	2,190
Q-o-Q Change (%)	-11.9	0.6	-16.8	130.0	-92.8	589.0	38.3	109.3	19.2	7.8

E: MOST Estimates

Oracle association helps gain entry into Tier I US banks, push up license fee growth

The highlights of the quarter were the Tier I client acquisitions made by the company's flagship product - FLEXCUBE, and the Reveleus Basel II solution. FLEXCUBE won two deals with global multi-national banks, headquartered in Europe and a Tier I bank in North America; Reveleus Basel II also added a Tier I banking institution in North America, thereby gaining entry into the hitherto elusive Tier I banks. FLEXCUBE had a total of 17 client wins, while Reveleus Basel II added 3 clients during the quarter. Reveleus Basel II was the first product to have a re-seller agreement with Oracle, while i-flex the re-seller agreement for FLEXCUBE was signed in December 2005.

CLIENT ADDITIONS (NO'S)

	MAR-05	JUN-05	SEP-05	DEC-05	MAR-06
Products	13	16	8	20	21
Total	16	33	16	22	27

Source: Company/ Motilal Oswal Securities

i-flex reported revenue growth of 15.4%QoQ at Rs4.6b, higher than our estimate of Rs4.4b, on the back of 25.4%QoQ growth in product revenue, which was driven by 115%QoQ growth in license fees. Contribution of license fees to product revenue jumped to 50% as against 30% in 3QFY06. Implementation fees and AMC revenue, however, declined 12.4% and 4.1%QoQ respectively during the quarter.

PRODUCT REVENUE (RS M)

	MAR-05	JUN-05	SEP-05	DEC-05	MAR-06
License Fees (%)	44.6	22.1	28.0	30.0	50.0
License Fees (Rs M)	817	252	482	626	1,309
QoQ Growth %	42.6	-69.1	91.1	30.0	109.0
Implementation Fees (%)	37.0	49.0	51.0	53.0	37.0
Implementation Fees (Rs M)	678	560	878	1,107	969
QoQ Growth %	-37.0	-17.4	56.7	26.1	-12.4
AMC (Rs M)	330	331	361	355	340
AMC (%)	18.0	29.0	21.0	17.0	13.0
QoQ Growth %	28.4	0.5	9.0	-1.8	-4.1

Source: Company/ Motilal Oswal Securities

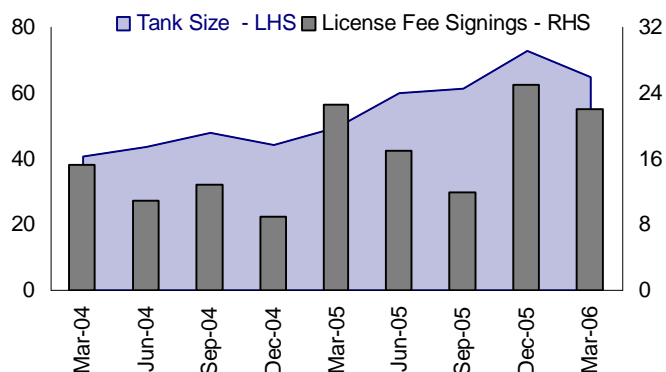
Product revenue from Europe and the US declined 1.5% and 2.1% QoQ respectively after strong growth in 3QFY06, while the Middle East & Africa and Asia Pacific grew by a

whopping 96% and 79.2% QoQ respectively. Citigroup, which grew 82% in 3QFY06 the quarter on account of a large deal win, declined 5.9%QoQ taking the revenue contribution from Citigroup to 18% from 24% in 3QFY06.

License fee booking at \$29.5 brings down tank to \$65m – Tank size to pick up in the coming quarters

The tank size at the end of 4QFY06 declined to \$65m from a historical high of \$72.5m due to an all time high in license fee bookings at \$26.5m. While the full fledged re-selling of Reveleus Base II through Oracle's sales channels has already begun, the same is yet to start in the case of FLEXCUBE since the training and orientation of the Oracle sales force for FLEXCUBE is yet to be completed. Therefore the Tier I win in 4QFY06 for FLEXCUBE has come through i-flex's own sales channels.

MOVEMENT IN TANK SIZE (US\$ M)



Source: Company/ Motilal Oswal Securities

We believe that the association with the Oracle brand has helped propel i-flex into the big league and expect i-flex's products business to grow rapidly over the next few quarter as the benefits of the reseller agreement begin to kick in. Going forward, we expect tank size to increase rapidly, boosted by significant client wins that would accrue through the same

Citigroup pushes up services revenue by 4.7%QoQ

Services revenue grew 4.7%QoQ after declining 1.1%QoQ in 3QFY06, mainly due to 4.7%QoQ growth in the Citigroup

account. The other top 10 clients declined 2.7% QoQ, with the non-Citi top client declining sharply by 10.2% QoQ. The company added 6 clients during the quarter, including 4 in the US and 2 in Europe.

SERVICE REVENUES (RS M)

	MAR-05	JUN-05	SEP-05	DEC-05	MAR-06
Service Revenues	1,604	1,509	1,825	1805	1891
% Change QoQ	12.8	-5.9	20.9	-1.1	4.7

Source: Company/ Motilal Oswal Securities

The employee base in services declined to 3,578 from 3,581 in 3QFY06. However, the pick up in client additions during the quarter is likely to result into higher growth among non-Citi clients in the coming quarters.

KPO revenue declined 5.9% QoQ to Rs67m, with the addition of 3 US –based clients to Equinox during the quarter. KPO continues to have operational losses as it is still in the investment phase.

Strong license fee growth revives margins

The gross margins improved by 190bp to 50.2% from 48.3% in the previous quarter due to 50% QoQ growth in license fee revenue, which resulted in higher product revenues (57.2% contribution from 52.7% in 3QFY06) during the quarter. The company added 314 freshers in the last quarter, which also eased pressure on gross margins.

RECRUITMENT PATTERN (NOS)

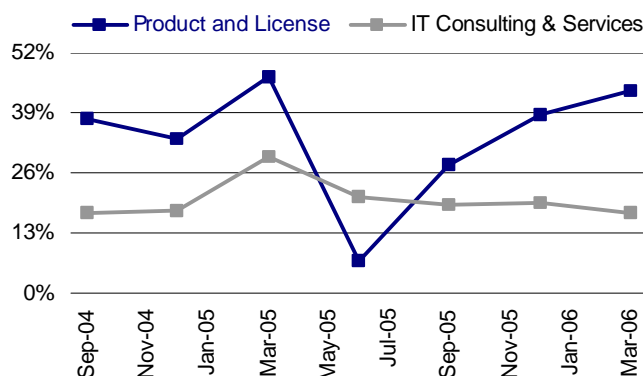


Source: Company/ Motilal Oswal Securities

General and administrative expenses for the quarter were also lower by 290bp during the quarter, a reduction of

12.6% QoQ in absolute terms due to 22% reduction in corporate overheads during the quarter. Product margins improved 5.2% to 43.9% during the quarter even as services margin declined 2.3% to 17.3% during the quarter. Consequently, EBITDA margin for the quarter improved to 28.7% from 24% in the previous quarter.

PRODUCT V/S SERVICES MARGINS



Source: Company/ Motilal Oswal Securities

i-flex had a forex loss of Rs9.7m during the quarter against a loss of Rs 83m in 3QFY06, which resulted in higher other income of Rs105m as against negative Rs12m during the quarter. The effective tax rate during the quarter was also lower at 7.8% as against 31.4% in the previous the quarter, which boosted the net profit to Rs1.17b, up 109.3% QoQ as against expectation of Rs897m.

Outlook and view

In our last update, we had highlighted how the Oracle acquisition has had a positive impact on the products business as reflected in the deal wins, especially amongst Tier-1 banks. The re-seller agreement with Oracle for the Reveleus Basel II suite has started yielding results with significant deal wins. We expect a similar upside to deal wins for FLEXCUBE as well in the coming quarters, which would result in faster growth for the products business.

We expect that services revenue, which grew 32.8% YoY, would grow slower in the coming quarters as the company shifts focus on integration of its products with Oracle sales channel. Additionally, the lack of employee addition during

the quarter indicates that the coming quarter is likely to be muted for the service business.

On the margins front, we expect expansion in product margins from the current 33% to pre-FY06 levels of 38% by the end of FY08 due to strong growth in both license fees and implementation revenue. We expect service margins to stay more or less stable over the same period. We expect overall operating margins to improve from 19.9% in FY06 to 23.6% and 24.1% in FY07 and FY08 respectively.

The company would be moving to its own campuses in Mumbai and Pune over FY07 and FY08, which would increase the proportion of revenue coming from facilities that enjoy 10(A) benefits. Consequently, the management has indicated effective tax rates would be lower than the 19.6% in FY06 due to a greater proportion of revenue being exempt from tax.

We expect i-flex to report revenue growth of 30.8% and 25% and profit growth of 56.3% and 26.5% in FY2007E and FY08E respectively. On an estimated EPS of Rs56.8 in FY08E, the stock trades at a P/E of 22.9x. Maintain **Buy** with a price target of Rs1,420.

i-flex solutions: an investment profile

Company description

i-flex solutions, the 7th largest software exporter according to Nasscom's 2005 rankings, is the largest software products company in India primarily focused on the BFSI vertical. It was ranked as the largest seller of banking software by IBS in 2002, 2003, 2004 and 2005. Its products are used by over 200 financial institutions and its footprint spreads across 130 countries.

Key investment arguments

- ✍ Winning larger deals and improving win-rate post Oracle acquisition.
- ✍ Re-seller agreements with Oracle could help the company break into Tier I banks in US, Europe and Japan, which account for 85% of IT spending in the BFSI space.

Key investment risks

- ✍ Slower growth in the services businesses as Oracle is more of a product player
- ✍ Oracle might take over management control, which could lead to loss of entrepreneurship

Recent developments

- ✍ Oracle increased its stake in i-flex to 50.6%.
- ✍ Wins for FLEXCUBE include Tier I banks in US and Europe
- ✍ Reveleus wind deal with Tier I bank in North America

Valuation and view

- ✍ 27.9% CAGR in revenue and 40.6% CAGR in earning over FY06-08.
- ✍ We maintain **Buy** with a price target of Rs1420, an upside of 9.1% from current levels.

Sector view

- ✍ Various CIO surveys indicate increasing share of offshore spending in IT budgets
- ✍ Large Banks depending on 'in-house' software beginning to float RFPs for implementing third-party software

COMPARATIVE VALUATIONS

		I-FLEX	HEXAWARE	MPHISIS BFL
P/E (x)	FY07E	29.0	16.8	19.2
	FY08E	22.9	12.7	14.5
P/BV (x)	FY07E	6.6	2.6	5.6
	FY08E	5.3	2.3	4.2
EV/Sales (x)	FY07E	4.5	1.9	2.5
	FY08E	3.6	1.4	1.9
EV/EBITDA (x)	FY07E	19.1	11.4	11.8
	FY08E	15.0	8.1	8.4

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	47.7	43.1	43.1
Domestic Institutions	3.8	8.0	4.2
FII's/FDI's	24.4	23.6	23.2
Others	24.0	25.3	29.6

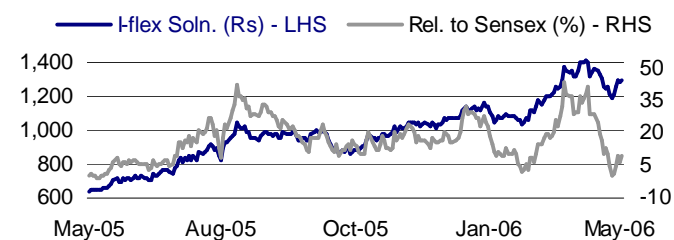
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	44.9	44.1	1.8
FY08	56.8	56.6	0.4

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,301	1,420	9.1	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Sales	8,054	11,404	14,835	19,403	24,259
Change (%)	25.7	41.6	30.1	30.8	25.0
Cost of Goods Sold	3,656	5,948	8,148	10,102	12,708
Selling Expenses	1,157	1,529	2,038	2,665	3,254
G&A Expenses	996	1,157	1,700	2,057	2,451
EBITDA	2,244	2,770	2,950	4,579	5,847
% of Net Sales	27.9	24.3	19.9	23.6	24.1
Depreciation	147	337	505	696	888
Other Income	125	227	277	363	407
Share of (Losses)/ Profits of Associate Companies	-3	-1	3	5	5
PBT	2,219	2,658	2,726	4,251	5,371
Tax	515	627	535	827	1,041
Rate (%)	23.2	23.6	19.6	19.5	19.4
Net Income	1,704	2,031	2,190	3,424	4,330
Change (%)	-3.8	19.2	7.8	56.3	26.5

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	374	374	381	381	381
Reserves	8,565	9,947	11,756	14,723	18,403
Networth	8,938	10,321	12,137	15,104	18,784
Loans	23	32	32	32	32
Capital Employed	8,961	10,353	12,169	15,136	18,817
Gross Block	1,972	2,522	3,222	4,222	5,122
Less : Depreciation	847	1,184	1,689	2,384	3,273
Net Block	1,125	1,338	1,533	1,838	1,849
CWIP	17	22	500	450	100
Investments	380	66	166	216	266
Curr. Assets	9,014	11,505	13,309	16,593	21,147
Debtors	2,446	3,767	4,755	6,113	7,311
Cash & Bank Balance	5,662	6,631	7,744	9,600	12,875
Loans & Advances	559	408	469	539	620
Other Current Assets	347	700	340	340	340
Current Liab. & Prov	1,575	2,525	3,339	3,961	4,545
Creditors	140	128	165	205	250
Other liabilities	1,410	2,396	2,638	2,929	3,254
Provisions	24	0	535	827	1,041
Net Current Assets	7,439	8,980	9,970	12,632	16,601
Application of Funds	8,961	10,353	12,169	15,136	18,817

E: MOf Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	22.8	27.2	28.7	44.9	56.8
Cash EPS	24.8	31.7	35.4	54.1	68.5
Book Value	117.3	135.4	159.3	198.2	246.5
DPS	3.5	4.2	5.0	6.0	8.5
Payout %(Incl.Div.Taxes)	3.5	4.2	5.0	6.0	8.5
Valuation (x)					
P/E		47.9	45.3	29.0	22.9
Cash PE		41.1	36.8	24.1	19.0
EV/EBITDA		32.7	30.3	19.1	15.0
EV/Sales		8.0	6.0	4.5	3.6
Price/Book Value		9.6	8.2	6.6	5.3
Profitability Ratios (%)					
RoE	20.5	21.1	19.5	25.1	25.6
RoCE	26.7	27.5	24.2	31.1	31.6
Turnover Ratios					
Debtors (Days)	111	112	117	115	110
Asset Turnover (x)	4.1	4.5	4.6	4.6	4.7
Leverage Ratio					
Debt/Equity Ratio (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Cash Flow from Oper.	1,802	2,278	2,695	4,120	5,218
Cash for Working Capital	756	589	-123	806	694
Net Operating CF	1,046	1,689	2,818	3,314	4,524
Net Purchase of FA	-800	-555	-1,178	-950	-550
Net Purchase of Invest.	-123	178	-100	-50	-50
Net Cash from Inv.	-923	-376	-1,278	-1,000	-600
Proc. from Share Issue	30	49	7	0	0
Proceeds from LTB/STB	11	10	-32	0	0
Dividend Payments	-262	-402	-381	-457	-649
Net CF from Finan.	-221	-344	-407	-457	-649
Free Cash Flow	246	1,135	1,640	2,364	3,974
Net Cash Flow	-97	969	1,133	1,856	3,275
Open. Cash Balance	5,759	5,662	6,631	7,744	9,600
Add: Net Cash	-97	969	1,133	1,856	3,275
Close Cash Balance	5,662	6,631	7,764	9,600	12,875

N O T E S



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Disclosure of Interest Statement

i-flex solutions

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |

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