Zensar Technologies

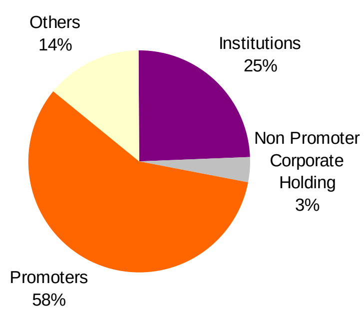
Ugly Duckling

Zen(sar) and the art of growing

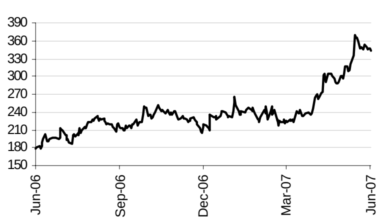
Buy; CMP: Rs342

Company details	
Price target:	Rs484
Market cap:	Rs818 cr
52 week high/low:	Rs380/176
NSE volume: (No of shares)	47,688
BSE code:	504067
NSE code:	ZENSARTECH
Sharekhan code:	FUJICIM
Free float: (No of shares)	1.0 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	13.9	52.5	55.9	91.5
Relative to Sensex	12.3	39.6	51.9	43.1

Key points

- **Strengthening its portfolio of service offerings:** Zensar Technologies (Zensar) has effectively utilised the inorganic route to gain the required critical mass in the fast growing enterprise solutions segment (through the acquisition of OBT Global and ThoughtDigital), to strengthen its footprint in under-penetrated geographies such as Japan (through joint venture with Eza, Japan), and to gain access to marquee clients.
- **Maintaining the growth momentum:** Zensar is well poised to report a healthy growth of over 40% in FY2008. It is witnessing a strong traction in its organic business and the incremental revenues of Rs110 crore from the recent inorganic initiatives would only add to the overall growth momentum in its revenues. Consequently, even after factoring in the adverse impact of the rupee appreciation, the company is expected to achieve its stated revenue guidance of Rs850 crore in FY2008.
- **Margins are sustainable:** Zensar is also expected to buck the general declining trend in margins in FY2008. That's because some of its relatively new businesses of ITS and BPO that have been in the investment mode are expected to show a substantial improvement in their margins. It also has other margin levers like a favourable revenue mix and lower overhead costs to cushion against the adverse impact of wage hikes, the appreciation in the rupee and the consolidation of the relatively lower-margin revenues of ThoughtDigital.
- **Key concern of stake sale by Fujitsu has been dispelled:** The acquisition of the entire stake of Fujitsu in Zensar by the RPG group has eliminated a key concern that was a drag on the stock's valuations.
- **Attractive valuations:** At the current market price the stock trades at 10.6x FY2008 and 8.2x FY2009 estimated earnings; the valuations are extremely attractive considering the estimated earnings growth of 33% CAGR over FY2007-09. We recommend Buy on the stock with a price target of Rs484.

Company background

Pune-based Zensar, promoted by the RPG group, is a mid-sized software service company. It has employee strength of over 3,700 professionals and a base of 236 active clients.

Key financials	FY2005	FY2006	FY2007	FY2008E	FY2009E
Net sales (Rs cr)	344.9	428.8	605.9	853.6	1041.4
Net profit (Rs cr)	19.9	35.7	58.8	79.1	103.4
No of shares (crore)	2.3	2.3	2.4	2.4	2.4
EPS (Rs)	8.7	15.5	24.4	32.6	42.1
% y-o-y change	-	*78.0*	*57.8*	*33.6*	*29.2*
PER (x)	39.4	22.1	14.0	10.5	8.1
Price/BV (x)	5.2	4.4	3.5	2.7	2.1
EV/EBIDTA(x)	23.9	14.0	10.0	7.0	5.2
RoCE (%)	13.2	21.2	23.7	27.3	28.7
RoNW (%)	15.6	22.9	27.8	28.1	27.5

The clients include reputed names like Cisco, National Rid, Marks and Spencers, Logitech, Danaher Corporation and Electronic Arts. It has continuously invested in expanding the range of its service offerings over the past few years. The company's business is divided into four key service lines.

- The application portfolio management (APM) line largely compromises the traditional application development and maintenance services, and the newly introduced infrastructure management and testing services. It contributed 53.8% of the total revenues in FY2007.
- The enterprise application service (EAS) line is one of the fastest growing service lines and encompasses the implementation of enterprise wise products (ERP, CRM, data warehousing, business intelligence and other packaged products) from Oracle and SAP. It grew by 82.8% and contributed 28.1% of the total turnover in FY2007.
- The innovative technology solution (ITS) line includes services such as product engineering, embedded software and application modernisation services based on the in-house developed solution blueprint framework. The business reported a decline in FY2007 and contributed 6.6% to the total turnover.
- The business process outsourcing (BPO) division is focused on non-voice based services like knowledge process outsourcing and human resource shared services. It reported a growth of 176.4% on a relatively small base and contributed around 4% of the total revenues in FY2007.

Investment arguments

Focus on scaling up capabilities in fast-growing service offerings

Zensar has invested in broadening its portfolio of service offerings in the past couple of years. It has focused on developing and deepening its capabilities in the fast-growing enterprise solutions space through a mix of organic and inorganic initiatives. The company has built a base of around 1,000 employees in the EAS practice and is among the leading offshore vendors in the Oracle consulting practice.

The other relatively new business lines that have been developed by the company are: ITS and BPO services. Moreover, the company has introduced infrastructure management and testing services to boost its traditional business of application management and has emerged as an end-to-end integrated service provider.

Apart from the organic efforts, the company has effectively utilised the inorganic route to ramp up its capabilities and expand its geographical reach. In the EAS segment, the company has made two acquisitions in the past six quarters. The acquisition of OBT Global in December 2005 enabled the company to establish itself in the SAP consulting space. On the other hand, the acquisition of ThoughtDigital in February 2007 boosted its presence in the east coast of America in the Oracle consulting space. ThoughtDigital has a base of 40 active clients including reputed top-tier companies such as Merrill Lynch, Gartner, Cingular, Swiss Re and Swatch, and is a profitable company. Both the acquired entities have been acquired at a reasonably attractive valuation of 0.9x their trailing annual sales. The acquisition of ThoughtDigital was funded through a debt of $15 million and internal accrual of $10 million, totaling to $25 million.

In addition to the two acquisitions, Zensar has formed a joint venture with the Tokyo-based Eza in March 2007. As part of the deal, Eza would transfer its entire existing order book, employee base (a 30-member team), technology and intellectual property to the joint venture. Eza has a strong presence in Japan and has relationship with marquee clients like NEC, Unisys and Japan Railways. Zensar would have the controlling stake of 60% in the joint venture company.

Poised to outperform the industry

In spite of the adverse impact of the steep appreciation in the rupee, the company is expected to meet the stated guidance of Rs850 crore of revenues in FY2008. The incremental revenues of around Rs110 crore from the recent inorganic initiatives (including the acquisition of a 100% stake in ThoughtDigital and the joint venture with Eza in the latter half of Q4FY2007) would account for around 18% of the growth in the revenue base in FY2007.

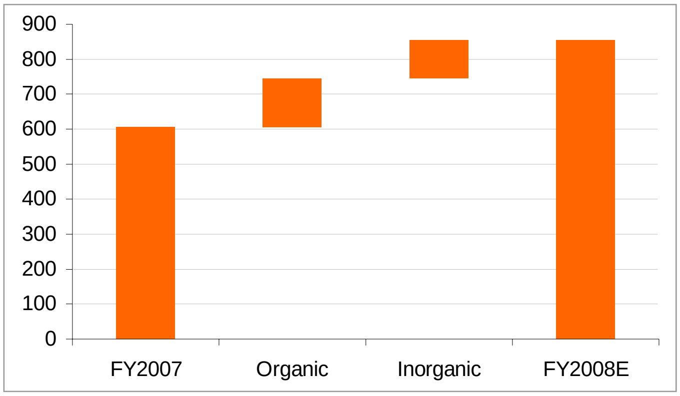
The organic revenues are estimated to grow by 24% (in rupee terms) in FY2008, after factoring in a 10% appreciation in the rupee against all the other major currencies. We have also not factored any increase in the billing rates in our estimates. In terms of service offerings,

Growing inorganically

Company	Date	Number of consultants	Practice	Annual revenue ($ mn)	Geography	Verticals
OBT	Dec-05	160	SAP	4.5	US, with ODC in India	Manufacturing, telecom, automotive
ThoughtDigital	Mar-07	120	Oracle	27.0	US	Communications & Media, Financial services, consumer goods

we expect a healthy growth in most of the new service lines, like EAS, BPO and ITS, in FY2009 whereas the traditional business of APM is expected to grow at a compounded annual growth rate (CAGR) of 22% over the next two years.

The inorganic push

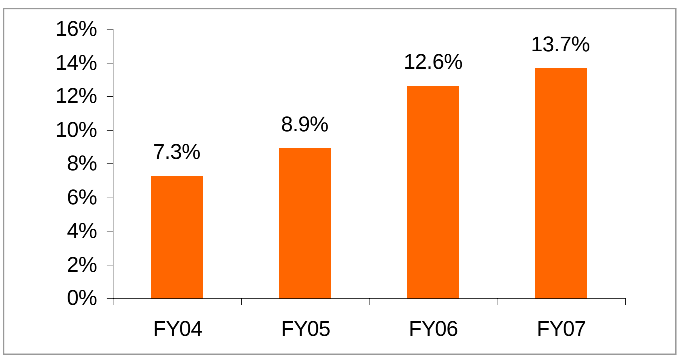


Source: Sharekhan Research

Cushioned against margin pressure

Zensar has shown a remarkable improvement in its operating profit margin (OPM) in the past couple of years. Despite the investments made in building capabilities in the relatively newer service lines, the company managed to gradually improve its margin by 480 basis points to 13.7% in FY2007 from 7.3% in FY2004.

Improving profitability



Source: Sharekhan Research

In this year also, the management expects to show a marginal improvement in the margins. The guidance implies a net margin of 10% (earnings guided at Rs85 crore on a revenue base of Rs850 crore) as against 9.7% in FY2007. The cumulative adverse impact of the steep appreciation in the rupee, wage inflation and consolidation of relatively low-margin business of ThoughtDigital is expected to be mitigated by the turnaround in the ITS business (Rs11 crore of development cost was written off in FY2007), better profitability in the BPO business and utilising the traditional margin levers like lower overhead cost as a percentage of sales, a favourable revenue mix, better employee productivity and higher realisation.

No more hangover of Fujitsu stake sale

Zensar was formed by the merger of Fujitsu ICIM and the erstwhile Zensar in March 2001 and was jointly promoted by the RPG group and Fujitsu, Japan. Recently, the RPG group acquired the entire stake of Fujitsu for an undisclosed sum and now controls the company with a majority stake of 57.8%. This largely eliminates the concerns related to the offloading of stake by Fujitsu that had been a drag on the stock's valuations.

Concerns

Possible downgrade in earnings guidance

Given the continued steep appreciation in the rupee, the company might not be able to achieve its earnings guidance of Rs85 crore in FY2008. We have factored in flat OPM and marginal decline in the net margins to reflect the impact of the increase in the interest outgo (a debt of $15 million for the acquisition of ThoughtDigital) and a higher effective tax rate in FY2008. Despite the possible downgrade (which is already factored in our estimates), the earnings are estimated to grow at a healthy rate of 36.4% in FY2008 and at a CAGR of 32.5% over the two-year period FY2007-09.

Lacks consistency in its quarterly performance

Zensar has shown a healthy growth in its quarterly revenues and earnings which have grown at a compounded quarterly growth rate of 8.8% and 23.5% respectively over the past seven quarters. However, it has shown a negative sequential growth in revenues and earnings in two of the seven quarters. This clearly reflects the lack of consistency in its quarterly performance that could limit the re-rating of the stock.

Valuation

Despite the concerns related to the appreciation of the rupee, Zensar's consolidated revenues and earnings are estimated to grow at a CAGR of 31.1% and 33.1% respectively over the two-year period FY2007-09. The higher than average industry performance over a sustained period of time is likely to result in the re-rating of the stock. Even at the current price the stock is trading at attractive valuations of 10.5x FY2008 and 8.1x FY2009 estimated earnings. This is a fairly large discount to the other comparable mid-sized companies. We recommend a Buy on the stock with a price target of Rs484 (11.5x FY2009 estimated earnings).

Peer comparison

Company	CMP (Rs)	EPS FY08	EPS FY09	P/E FY08	P/E FY09	EV/EBITDA FY08	EV/EBITDA FY09
Zensar	342	32.6	42.1	10.5	8.1	7.0	5.2
KPIT Cummins	144	9.0	11.8	16.0	12.2	10.5	8.1
Infotech Enterprise	378	24.5	32.0	15.4	11.8	10.2	7.9
NIIT Tech	535	42.5	51.4	12.6	10.4	8.1	6.4
Tata Elxsi	334	21.4	26.5	15.6	12.6	11.4	9.0

Financials

Profit & loss account

Rs (cr)

Particulars	FY05	FY06	FY07	FY08E	FY09E
Net sales	344.9	428.8	605.9	853.6	1041.4
Total expenditure	314.2	374.7	523.0	736.8	891.1
EBITDA	30.7	54.1	82.9	116.8	150.3
Other income	4.7	4.6	9.0	7.0	9.2
Interest cost	0.9	1.6	2.1	5.9	5.3
Depreciation	12.3	15.5	15.3	17.2	21.2
PBT	22.2	41.7	74.5	100.7	132.9
Tax	1.9	5.5	16.2	22.2	30.6
PAT	20.3	36.2	58.3	78.6	102.4
Minority share	0.3	0.5	-0.5	-0.5	-1.0
Net profit	19.9	35.7	58.8	79.1	103.4

Balance sheet

Rs (cr)

Particulars	FY05	FY06	FY07	FY08E	FY09E
Share capital	23.3	23.4	23.9	24.1	24.3
Reserves and surplus	129.6	157.8	210.1	279.5	372.6
Net worth	152.9	181.2	234.0	303.6	396.9
Total debt	14.5	15.1	80.9	66.0	66.0
Capital employed	167.4	196.3	314.9	369.6	462.9
Net fixed assets	54.3	67.8	94.7	117.5	141.3
CWIP	1.5	7.2	10.0	5.0	5.0
Deferred tax assets	1.8	1.8	1.8	1.8	1.8
Net current assets	109.8	105.9	169.9	206.7	276.3
Capital deployed	167.4	196.3	314.9	369.6	462.9

Valuation

Particulars	FY05	FY06	FY07	FY08E	FY09E
EPS (Rs)	8.7	15.5	24.4	32.6	42.1
P/E	39.4	22.1	14.0	10.5	8.1
Book value	65.6	77.4	97.9	126.0	163.4
Price/BV	5.2	4.4	3.5	2.7	2.1
EV/Sales	2.1	1.8	1.4	1.0	0.7
Market Cap/Sales	2.3	1.9	1.3	1.0	0.8
EV/EBIDTA	23.9	14.0	10.0	7.0	5.2
Dividend yield (%)	0.7	0.8	1.0	1.2	1.3

Key ratios (%)

Particulars	FY05	FY06	FY07	FY08E	FY09E
OPM	8.9	12.6	13.7	13.7	14.4
NPM	5.8	8.3	9.7	9.3	9.9
RoCE	13.2	21.2	23.7	27.3	28.7
RoNW	15.6	22.9	27.8	28.1	27.5

The author doesn't hold any investment in any of the companies mentioned in the article.