Company In-Depth

29 March 2007 | 24 pages

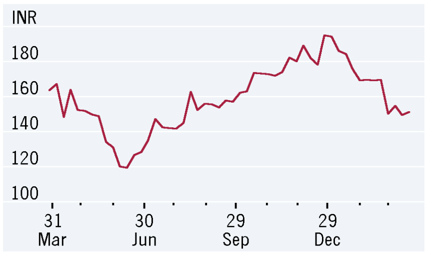
Hexaware Technologies (HEXT.BO)

Initiating at Buy: Growth Returns

- Target price Rs214, implying a total return of 36% — We expect a 30% revenue CAGR (33% in US$ terms) and a 27% net profit CAGR (EPS: 25% CAGR) in 2006-09. Our target is based on 17x the average EPS for 2007E-08E.
- Building sustainable niche businesses — Hexaware has carved a niche for itself in the transportation vertical and HR-IT domain (now 17% and 30% of revenue, respectively), leveraging its ties with Air Canada and PeopleSoft/Exult. The acquisition of FocusFrame has helped Hexaware develop a scalable testing practice. With US$75m in cash, Hexaware could expand/deepen its offerings.
- Oracle committed to the PeopleSoft platform — Our US software analyst believes that Oracle is committed to PeopleSoft, as evidenced by the Applications Unlimited program. With Oracle releasing new PeopleSoft versions, Hexaware should continue to enjoy good traction. Moreover, "Fusion" adoption is expected to be slow, which gives Hexaware good visibility over the next few years.
- Back to strong growth in 2007E — Hexaware's revenues grew from US$51m in 2002 to US$154m in 2005. Growth in 2006 was only 22% due to the transfer of India Service Center to Oracle. We expect revenue growth of 46% in US$ terms in 2007 as organic growth returns and the testing practice achieves scale.
- Valuation looks attractive — The stock has underperformed the BSE IT Index by 24% over the past 12 months, and 13% YTD. It trades at 11.4x 2008E earnings, which looks attractive versus an earnings growth estimate of 25%.
- Key risks — Supply-side challenges, currency fluctuation and competition from tier-one players.

Buy/Medium Risk	1M
Price (29 Mar 07)	Rs159.00
Target price	Rs214.00
Expected share price return	34.6%
Expected dividend yield	1.3%
Expected total return	**35.8%**
Market Cap	Rs20,966M
	US$490M

Price Performance (RIC: HEXT.BO, BB: HEXW IN)



See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	913	7.50	49.1	21.2	5.5	29.7	0.4
2006A	1,242	9.02	20.2	17.6	3.5	26.2	1.0
2007E	1,647	11.30	25.3	14.1	2.6	22.2	1.3
2008E	2,030	13.91	23.0	11.4	2.2	21.0	1.5
2009E	2,548	17.45	25.5	9.1	1.8	22.1	1.8

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	21.2	17.6	14.1	11.4	9.1
EV/EBITDA adjusted (x)	18.4	14.7	9.7	7.2	5.3
P/BV (x)	5.5	3.5	2.6	2.2	1.8
Dividend yield (%)	0.4	1.0	1.3	1.5	1.8
Per Share Data (Rs)					
EPS adjusted	7.50	9.02	11.30	13.91	17.45
EPS reported	7.50	9.02	11.30	13.91	17.45
BVPS	29.11	45.46	61.94	73.43	88.08
DPS	0.60	1.60	2.00	2.40	2.80
Profit & Loss (RsM)					
Net sales	6,787	8,482	11,944	14,762	18,730
Operating expenses	-5,913	-7,360	-10,283	-12,650	-15,933
EBIT	**874**	**1,122**	**1,661**	**2,112**	**2,798**
Net interest expense	139	241	227	242	273
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**1,012**	**1,363**	**1,888**	**2,354**	**3,071**
Tax	-100	-120	-241	-324	-523
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**913**	**1,242**	**1,647**	**2,030**	**2,548**
Adjusted earnings	913	1,242	1,647	2,030	2,548
Adjusted EBITDA	1,084	1,322	1,903	2,414	3,179
Growth Rates (%)					
Sales	24.3	25.0	40.8	23.6	26.9
EBIT adjusted	43.1	28.4	48.1	27.1	32.4
EBITDA adjusted	40.5	22.0	43.9	26.9	31.7
EPS adjusted	49.1	20.2	25.3	23.0	25.5
Cash Flow (RsM)					
Operating cash flow	**537**	**1,032**	**1,110**	**1,732**	**1,985**
Depreciation/amortization	210	200	241	301	381
Net working capital	-485	-202	-552	-357	-671
Investing cash flow	**-173**	**-1,768**	**-1,153**	**-989**	**-1,343**
Capital expenditure	-173	-1,768	-1,153	-989	-1,343
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**40**	**2,962**	**-88**	**-151**	**-185**
Borrowings	10	-61	0	0	0
Dividends paid	-164	-247	-315	-393	-458
Change in cash	**403**	**2,227**	**-131**	**592**	**457**
Balance Sheet (RsM)					
Total assets	**4,713**	**9,211**	**10,985**	**13,130**	**15,934**
Cash & cash equivalent	1,187	3,414	3,283	3,875	4,331
Accounts receivable	1,836	2,063	2,618	3,236	4,105
Net fixed assets	933	2,501	3,413	4,101	5,062
Total liabilities	**1,239**	**1,712**	**2,153**	**2,661**	**3,375**
Accounts payable	0	0	0	0	0
Total Debt	62	0	0	0	0
Shareholders' funds	**3,474**	**7,500**	**8,832**	**10,469**	**12,559**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.0	15.6	15.9	16.3	17.0
ROE adjusted	29.7	26.2	22.2	21.0	22.1
ROIC adjusted	36.9	31.3	29.5	29.4	30.7
Net debt to equity	-32.4	-45.5	-37.2	-37.0	-34.5
Total debt to capital	1.7	0.0	0.0	0.0	0.0

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Contents

Figure 1. Background

Hexaware is India's 12th-largest IT services exporter, according to NASSCOM's ranking for 2006. Established in 1992, Hexaware was merged with the software division of Aptech in Feb 2001. The merged entity was later de-merged from the training arm of Aptech, and was listed as Hexaware Technologies.

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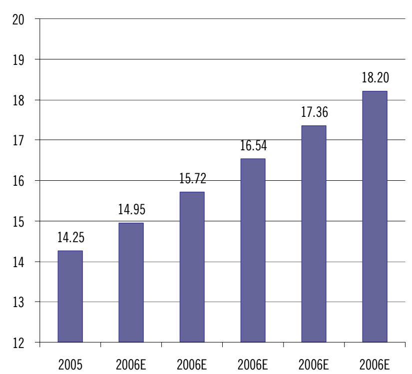
Figure 2. IT Services Spend in Transportation (US$ Billion)



Source: IDC, 2006; Citigroup Investment Research

Niche Player

Hexaware is a niche player with a competitive edge over larger players in areas where it has expertise. Over the past few years, it has entered the under-penetrated/under-served markets (by offshore IT players). After acquiring a few clients, Hexaware leveraged these ties to develop expertise in broader areas so as to pursue its go-to-market strategy. Hexaware has a niche in HR-IT due to its Exult / PeopleSoft ties, in the transportation vertical through its Air Canada and Lufthansa relationships, and in Germany through Deutsche Leasing and Lufthansa.

Leveraging ties to create sustainable niches

Hexaware's strategy is to focus on niche areas. It has leveraged its client relationships to build domain knowledge that can help it compete with other offshore players.

From Air Canada to the transportation vertical: Hexaware did work for Air Canada and Lufthansa a few years back, and developed the relationship into transportation vertical expertise. The company is now one of the top 5 offshore vendors in this space. Hexaware works with more than 15 clients in the transportation vertical, and derives more than 17% of its revenues from them. Globally, IT services spend was an estimated US$14.25bn in 2005, which IDC expects will grow at a 5% CAGR over 2005-10.

From PeopleSoft to HR-IT: PeopleSoft has been Hexaware's client since the late 1990s. Hexaware's relationship grew with time, and it was chosen to set up India Service Center for PeopleSoft in 2002. Exult (now acquired by Hewitt) was another key relationship for Hexaware in the Human Resource (HR) space. Hexaware used these ties to its advantage, and has built expertise in HR processes. It leveraged this relationship to be recognized as a well-known offshore company in the HR-IT space. In 2004 Gartner placed Hexaware in the niche quadrant for PeopleSoft services globally.

Developing new niche areas — testing services and asset management

Hexaware's organic and inorganic strategies focus on enhancing its niche positioning. The company has been trying to leverage its ties with Eagle to build portfolio management IT expertise for the asset-management vertical. Moreover, the company has been incubating testing practise over the past few years. It acquired FocusFrame to provide scale and depth to the business. We believe Hexaware can develop new niche areas in the testing practice. Management has a track record of looking at new opportunities to maintain its edge over other offshore players, helping the company to grow faster than the rest of the mid-tier pack.

FocusFrame acquisition — consolidating testing

Hexaware acquired FocusFrame in November 2006 in an all-cash deal of US$34.3m. FocusFrame was a US-based IT services firm focused on testing in the ERP space and custom applications. FocusFrame essentially worked on higher-end consulting and testing projects, with onsite hourly billing rates of as much as US$100.

Profile: FocusFrame has 200 consultants. Its revenue was US$24m, with a PBT margin of 14% in 2006. The company has grown 40-50%, with 85% of its revenue coming from the US and 15% from Europe. FocusFrame is a premium partner of Mercury and has expertise in automated testing. FocusFrame has patented a technology framework of testing SAP implementation, called SAP accelerator. The company expects good revenues from this in 2007. The company has a development center in Mexico with around 75 consultants.

Hexaware's testing practice: Before the acquisition, Hexaware had more than 400 employees in this practice, with revenues close to US$12m (+100% yoy). Hexaware has expertise in manual testing but lacks expertise in automated testing.

Drivers of acquisition and targets: FocusFrame complements Hexaware's testing practice, and management expects US$100m of revenue from the combined testing practice in 3 years' time. We believe Hexaware and FocusFrame have complementary skill sets within the testing space, and are a good strategic fit. Also, SAP accelerator of FocusFrame could be well leveraged with Hexaware's global sales force.

Valuation: Hexaware paid US$25m as upfront payment for the acquisition and US$9.3m would be paid as earn-outs over 24 months, contingent on achieving the projected revenue and margin targets. The acquisition payout values FocusFrame at 1.4x revenue and 10.3x 2006 profit before tax. We believe this valuation is reasonable, given FocusFrame's 40-50% growth and the value it brings to Hexaware.

More inorganic activities?

We believe Hexaware will continue to look for acquisitions in the European geography and in the SAP skill set to enhance its niche positioning.

As of December 2006, Hexaware had US$75m in cash reserves after paying an upfront amount of US$25m for the FocusFrame acquisition. Management has indicated that the cash could be used for further inorganic activities. We believe its inorganic efforts will focus on acquiring smaller companies overseas to enhance its existing niche capabilities and/or build new niche offerings. We believe Hexaware will continue to look for acquisitions in the European geography and in the SAP skill set so as to enhance its niche positioning.

Proactive investment in infrastructure

Hexaware has been proactive in investing for the future. It has a 27-acre land in Chennai, India, where it is developing a campus-style development center. The first phase is likely to be completed by 3Q07. The development center has been approved as a SEZ facility for Hexaware. The company has also acquired 25 acres of land in Pune's Hinjewadi Infotech Park – Phase III (an approved SEZ area), and has acquired another 14 acres in the proposed SEZ area in Mumbai.

BPO initiative

Hexaware invested in a BPO subsidiary, CaliberPoint, in early 2004. CaliberPoint focuses on the healthcare vertical and HRO (HR outsourcing), F&A (finance and accounting) horizontals. The company is making profits, and we estimate a 2006 revenue of US$6m-7m. CaliberPoint employs close to 1,000 employees, and has plans to leverage its combined IT-BPO expertise to win large deals. So far Hexaware has won just one IT-BPO joint deal; however, management remains confident of cross-selling its expertise across these two broad service lines. Management believes that BPO is still in its infancy, and has not shared further details with investors.

Sales and account management

At Hexaware, sales and account management are categorized into hunting and farming jobs, respectively. Nine key client accounts, referred to as strategic clients, are treated like strategic business units (SBU). Delivery, account management and sales are all integrated with its P&L responsibilities. 41 clients are seen as key account management focus, with each client having a dedicated account manager. Targets are based on the growth of that account and the share of the client's IT budgets. Around 25 sales personnel have hunting responsibilities, who are in turn supported by about 20 pre-salespersons offshore.

Future of PeopleSoft — Oracle strategy of "applications unlimited"

Oracle undertook "Application Unlimited program" (in April 2006) to protect client investment in the ERP solutions of its acquired companies — PeopleSoft, JDEdwards and Siebel. Under this program, Oracle has committed to developing the applications even after the arrival of Fusion applications, and beyond the previously announced 2013 deadline. Oracle has promised continued new releases that will include new functionality, not just maintenance updates. Oracle would provide greater product roadmap visibility based on customer feedback and would have dedicated development teams. Also, there would be no forced upgrades with lifetime support availability.

View of our US Software analyst

Our US software analyst, Brent Thill, believes that Oracle is committed to the "Application Unlimited" program, as demonstrated by new major releases across all of Oracle's application product lines, including PeopleSoft. From the date of availability, Oracle would continue to provide premium support for the first five years while extended support would be available for a further three years for some releases. In a stripped down version, sustaining support will be available for as long as the customer licenses the Oracle products after expiry of premium and/or extended support.

ERP implementation is a long-term investment, and most clients would continue with their PeopleSoft implementation and opportunistically augment it with Fusion applications. As the adoption curve of new applications could be flat initially, the real impact of this may not be visible until 2009.

Moreover, Oracle released PeopleSoft 9.0 (a newer version of ERP applications) in early 2007 and management has stated that their intention is to continue to release updates — reinforcing its commitment to clients' investment in the PeopleSoft ERP package.

Takeaways for Hexaware

Hexaware should continue to benefit from the "Application Unlimited" program of Oracle

Hexaware has expertise in the HR domain, and has one of the largest PeopleSoft practices among offshore IT services vendors. As larger players focus on growing opportunities in other ERP products, Hexaware is likely to continue to have a better chance of winning support contracts, upgrade projects and augment Fusion with PeopleSoft.

We believe that this is unlikely to affect Hexaware's revenue stream, at least for the next three years. However, the company is likely to reduce dependence on PeopleSoft to ensure that it is contained within a certain percentage of the company's revenue.

Business model

Hexaware focuses on a few niche business areas; in verticals, they are transportation, BFSI (banking, financial services and insurance) and manufacturing. Hexaware has built its business by scaling up in niche areas — like ERP (Oracle/SAP) in horizontals, airlines and BFSI in verticals, and Europe in geographies. Caliber Point, a BPO subsidiary of Hexaware, employs close to 1,000 people and works across F&A (finance and accounting) and HRO horizontals and the healthcare vertical. As of December 2006, Hexaware employed close to 6,000 people across its IT and BPO operations, and had more than 125 clients.

Key risks

Ability to maintain an edge over key players remains a key challenge for Hexaware

In addition to sector-wide risks such as supply-side challenges, currency fluctuations, visa issues and US/global slowdown, we believe Hexaware has additional challenges because of its niche positioning. We believe maintaining an edge over other players is key to the company's success. As Hexaware grows bigger, it would have to develop more niche areas for scalability.

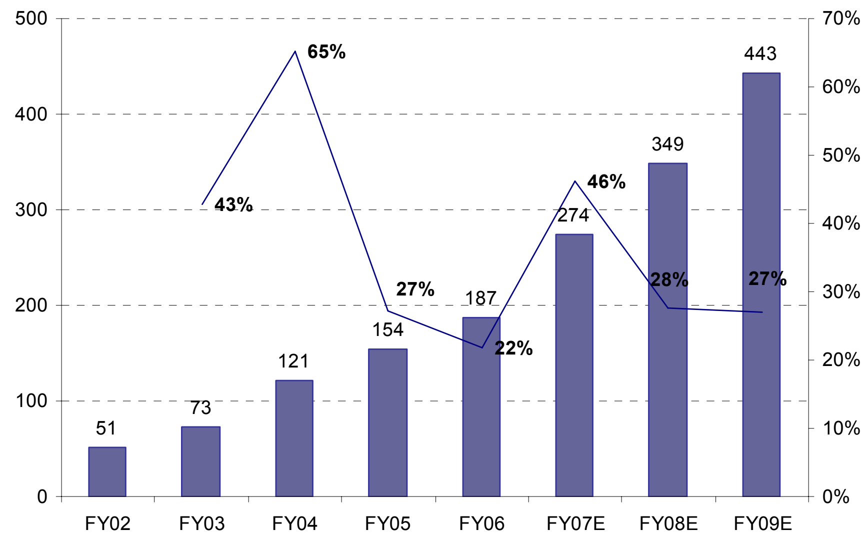
Our net profit estimates are above Bloomberg BST consensus; however, our EPS estimates are below Bloomberg BST consensus estimates as we have used fully diluted numbers. We expect consensus EPS estimates will be adjusted as the time for GAP dilution nears.

Financial Highlights

Revenue and growth trajectory

Hexaware's revenue jumped between 2002 and 2005, from US$51m to US$154m. In Nov 2005, Oracle exercised its option to acquire the BOT contract for India Service Center (ISC). As a result, 2006 saw a growth rate of just 22%. Excluding the ISC center, revenue growth was 40% in CY06.

Figure 1. Hexaware — Revenue (US$ m)



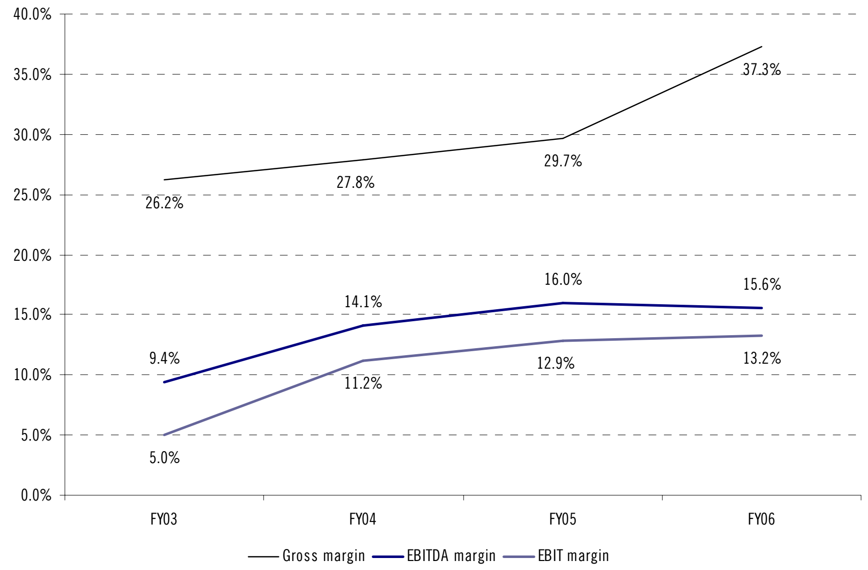
Source: Company Reports and Citigroup Investment Research estimates

We expect 46% revenue growth in US$ terms in 2007 as organic growth returns and the testing practice achieves scale. Over 2006-09, we forecast a 33% revenue CAGR in US$ terms and a 25% fully diluted EPS CAGR.

Margin expansion and levers

Hexaware's EBITDA margin expanded from 5.5% in 2002 to 16% in 2005. Margins declined by 38bps in 2006, partly because of the transfer of the more profitable (higher offshore component) ISC.

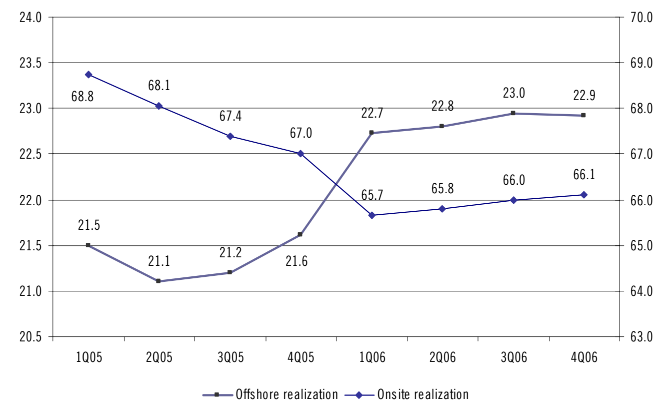
Figure 2. Hexaware Margins



Source: Company Reports

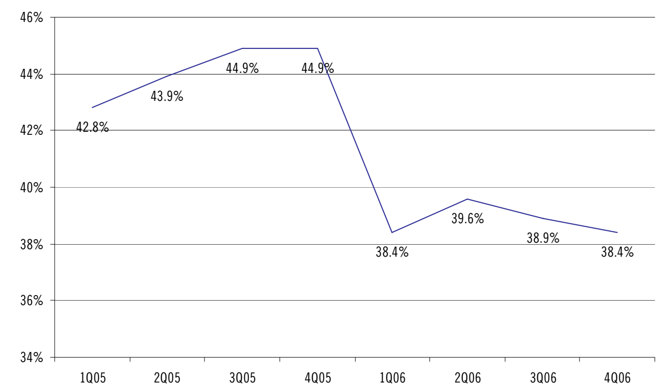
We expect a modest increase in EBITDA margin over the next three years as the headwinds of wage inflation and rupee appreciation are more than offset by margin levers such as better average realization, a higher offshore share, improving utilization, a flatter employee pyramid, and SG&A leverage.

Figure 3. Average Onsite and Offshore Realizations



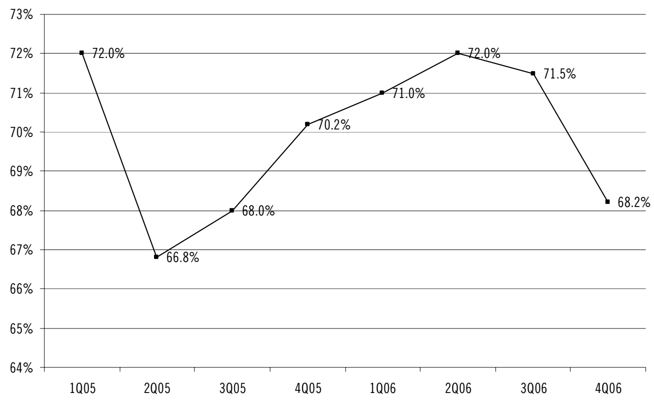
Source: Company Reports

Figure 4. Offshore Share of Realization



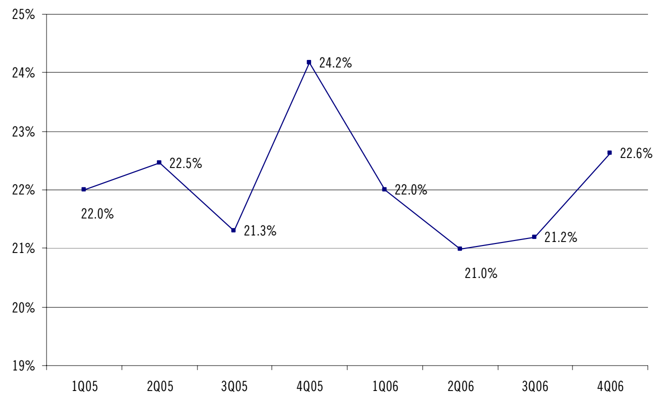
Source: Company Reports

Figure 5. Employee Utilization



Source: Company Reports

Figure 6. SG&A Expenses as % of Revenue



Source: Company Reports

Dilution

Hexaware has unexercised dilution on the back of employee stock option plans (ESOPs) and strategic investment by General Atlantic Partners (GAP). GAP infused Rs3bn in April 2006 in return for 10.6m common equity shares and 1.06m preference equity shares. Each preference share is convertible to 10 common equity shares in October 2007. Hexaware will pay a coupon of 2.95% on the preference share capital until the exercise date. If the conversion option is not exercised, Hexaware would pay a 5% coupon rate post the exercise date. There were outstanding ESOPs for ~3.5m common equity shares at end-Dec 2006. All our estimates are based on fully diluted equity shares.

Tax rates

Hexaware's effective tax rates range from 9% to 12% of profit before taxes. 2006 saw a lower tax outgo due to consolidation of its subsidiary, SpecSoft, which had accumulated losses on its books. We expect the tax rate to go up to 13-14% in the next two years, and to 17% in CY09 due to the sunset clause of the STPI (Software Technology Park of India) scheme.

Figure 7. Hexaware — Income Statement (Rs. in Millions)

Year to Dec 31	FY04	FY05	FY06	FY07E	FY08E	FY09E
Revenues	**5,459**	**6,787**	**8,482**	**11,944**	**14,762**	**18,730**
Growth	***61.0%***	***24.3%***	***25.0%***	***40.8%***	***23.6%***	***26.9%***
Cost of revenues	3,939	4,774	5,318	7,615	9,470	12,086
Gross profit	1,520	2,013	3,164	4,329	5,292	6,644
Gross margin	*27.8%*	*29.7%*	*37.3%*	*36.2%*	*35.8%*	*35.5%*
Operating expenses	748	929	1,842	2,426	2,879	3,465
EBITDA	**771**	**1,084**	**1,322**	**1,903**	**2,414**	**3,179**
EBITDA margin	***14.1%***	***16.0%***	***15.6%***	***15.9%***	***16.3%***	***17.0%***
Depreciation	161	210	200	241	301	381
Operating profit (EBIT)	**610**	**874**	**1,122**	**1,661**	**2,112**	**2,798**
Operating margin	***11.2%***	***12.9%***	***13.2%***	***13.9%***	***14.3%***	***14.9%***
Other income	113	139	241	227	242	273
Profit before tax	724	1,012	1,363	1,888	2,354	3,071
Income tax expense	91	100	120	241	324	523
Income from operations	632	913	1,242	1,647	2,030	2,548
Affiliates/Minority interest/EO item	0	0	0	0	0	0
Net income - reported	632	913	1,242	1,647	2,030	2,548
EPS - Basic	**5.51**	**7.75**	**9.48**	**12.00**	**14.24**	**17.87**
Growth		*40.5%*	*22.4%*	*26.6%*	*18.7%*	*25.5%*
EPS - Fully diluted	**5.03**	**7.50**	**9.02**	**11.30**	**13.91**	**17.45**
Growth		*49.1%*	*20.2%*	*25.3%*	*23.0%*	*25.5%*

Source: Company Reports and Citigroup Investment Research estimates

Figure 8. Hexaware — Balance Sheet (Rs in Millions)

Year to Dec 31	FY04	FY05	FY06	FY07E	FY08E	FY09E
Cash and equivalents	784	1,187	3,414	3,283	3,875	4,331
Other current assets	2,046	2,556	3,296	4,290	5,155	6,540
Total current assets	**2,830**	**3,743**	**6,711**	**7,573**	**9,029**	**10,872**
PPE, net	970	933	2,501	3,413	4,101	5,062
Other assets	67	37	0	0	0	0
Total Assets	**3,868**	**4,713**	**9,211**	**10,985**	**13,130**	**15,934**
Total Current Liabilities	1,145	1,170	1,708	2,150	2,657	3,371
Borrowings	52	62	0	0	0	0
Other liabilities	1	7	3	3	3	3
Total Liabilities	**1,197**	**1,239**	**1,712**	**2,153**	**2,661**	**3,375**
Total Equity	2,670	3,474	7,500	8,832	10,469	12,559
Total Liabilities and Equity	**2,670**	**3,474**	**7,500**	**8,832**	**10,469**	**12,559**

Source: Company Reports and Citigroup Investment Research estimates

Figure 9. Hexaware Technologies: Cash flow statement (Rs. m)

Year to Dec 31	FY04	FY05	FY06	FY07E	FY08E	FY09E
Net income	632	913	1,242	1,647	2,030	2,548
Depreciation	161	210	200	241	301	381
Other operating cash flows	-48	-101	-208	-227	-242	-273
Working capital changes	-300	-485	-202	-552	-357	-671
Cash flow from Operations	**445**	**537**	**1,032**	**1,110**	**1,732**	**1,985**
CapEx, acquisitions, divestures	-385	-173	-1,768	-1,153	-989	-1,343
Other investing cash flows	0	0	0	0	0	0
Cash flow from Investing	**-385**	**-173**	**-1,768**	**-1,153**	**-989**	**-1,343**
Borrowings	26	10	-61	0	0	0
Equity Changes	9	55	3,030	0	0	0
Dividends	-133	-164	-247	-315	-393	-458
Other financing cash flows	113	139	241	227	242	273
Cash flow from Financing	**16**	**40**	**2,962**	**-88**	**-151**	**-185**
Net cash flows	**77**	**403**	**2,227**	**-131**	**592**	**457**

Source: Company Reports and CIR Estimates

Valuation looks attractive

Over the past two years, Hexaware has traded in a range of 12-20x 12-month forward earnings based on the outlook for the business and margins. Our 12-month target price of Rs214 is based on 17x the average EPS for FY07E-08E, which is derived by applying a 20% discount to our target multiple for Satyam. We believe the discount is fair, as Satyam is a larger and more diversified company. For Hexaware, we expect a 30% revenue CAGR and a 27% net profit CAGR over FY06-09. However, dilution from the GAP stake and ESOPs lowers the fully diluted EPS CAGR to 25% over the same period. We use Satyam as a benchmark to value all mid-tier IT services companies.

Figure 10. Indian IT Services Valuation comparison table

			Mkt cap	28 Mar	TP	P/E (x)		EV/EBITDA (x)		P/BV (x)		Div. Yield (%)	
Company	RIC Code	Rating	(US$ m)	Price (Rs)	(Rs)	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
Infosys	INFY.BO	1L	25,844	1,992	2,660	30.1	23.5	24.0	18.5	10.7	7.7	0.6%	0.8%
TCS	TCS.BO	1L	27,330	1,201	1,560	28.2	22.1	22.9	17.9	12.9	8.9	0.8%	1.0%
Wipro	WIPR.BO	1L	18,740	558	730	28.3	22.3	22.2	17.3	8.6	7.0	1.4%	1.8%
Satyam	SATY.BO	1M	7,006	456	582	22.3	18.1	17.5	13.6	5.6	4.6	1.3%	1.8%
HCL Tech	HCLT.BO	1M	4,392	288	385	18.8	15.7	13.5	10.8	4.1	3.6	2.8%	2.8%
Patni*	PTNI.BO	3M	1,212	373	405	21.8	13.9	8.5	7.3	2.4	2.0	0.7%	0.8%
I-Flex	IFLX.BO	3M	3,901	2,017	1,850	50.7	38.4	38.9	27.3	9.4	7.6	0.1%	0.1%
NIIT	NIIT.BO	1M	304	665	690	27.4	15.7	16.2	11.5	4.3	3.4	1.1%	1.1%
Sasken	SKCT.BO	1M	315	477	653	26.8	15.2	14.7	13.0	3.1	2.7	0.6%	1.0%
KPIT	KPIT.BO	1M	225	130	173	23.9	14.5	13.4	10.3	5.2	3.8	0.4%	0.4%
Hexaware*	**HEXT.BO**	**1M**	**501**	**164**	**214**	**18.1**	**14.5**	**15.1**	**10.0**	**3.6**	**2.6**	**1.0%**	**1.2%**

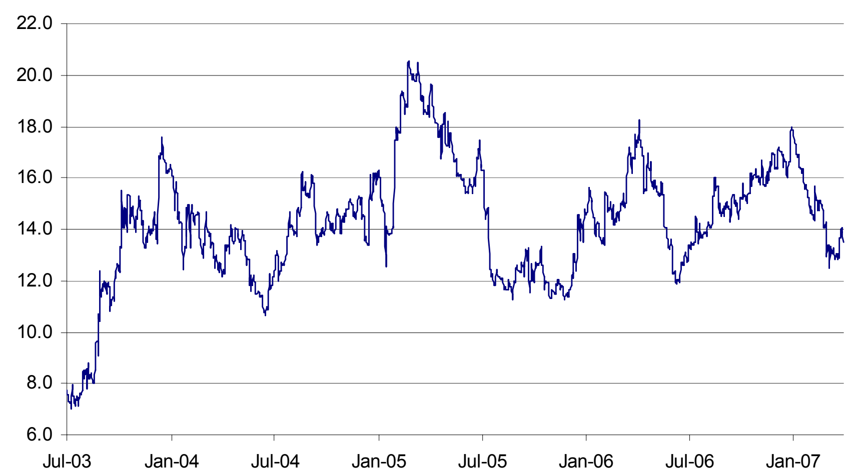
Source: Company Reports and Citigroup Investment Research estimates

* For Patni and Hexaware, FY07 refers to CY06 and FY08 refers to CY07

Figure 11. Hexaware — Valuation Band Chart

Source: DataStream, Company Reports and CIR Estimates

Figure 12. Hexaware — PER Valuation Chart



Source: Company Reports and Citigroup Investment Research estimates

Given our forecast earnings growth for FY06-09, we believe the stock should trade above the average P/E over the past three years. Current valuations look attractive compared with the Indian IT services universe.

Key Business Metrics

Figure 13. Key HR and Execution Metrics

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06
Total global headcount	4,044	4,271	4,438	3,646	4,124	4,271	4,438	5,829
Net addition	211	227	167	-792	478	147	167	1,391
Utilization level	72.0%	66.8%	68.0%	70.2%	71.0%	72.0%	71.5%	68.2%
Attrition rate	16.0%	16.0%	17.0%	17.0%	16.5%	14.0%	14.2%	15.0%
Avg. billing rate ($/hr)								
Onsite	68.75	68.05	67.40	67.00	65.65	65.80	66.00	66.10
Offshore	21.50	21.10	21.20	21.62	22.73	22.80	22.95	22.92

Source: Company Reports and Citigroup Investment Research estimates

Figure 14. Revenue Mix

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06
Geography wise								
USA	67.0%	74.9%	76.7%	76.7%	70.4%	69.4%	68.5%	69.1%
Europe	28.2%	21.8%	20.0%	20.0%	25.7%	26.5%	25.7%	25.5%
RoW	4.8%	3.2%	3.3%	3.3%	3.9%	4.1%	5.8%	5.4%
Technology wise								
eCommerce/Application Management	44.3%	41.4%	40.1%	40.1%	48.8%	50.0%	48.5%	48.1%
R&D/Embedded	1.7%	1.6%	1.8%	1.8%	0.9%	0.8%	0.9%	0.9%
PeopleSoft/ERP	42.3%	41.1%	43.1%	43.1%	34.0%	32.6%	33.8%	34.6%
HR IT	3.3%	7.0%	7.0%	7.0%	6.9%	7.0%	7.1%	7.3%
Others	8.5%	8.9%	8.0%	8.0%	9.4%	9.6%	9.7%	9.1%
Domain wise								
Airlines and Transport	15.5%	15.8%	16.3%	17.0%	18.6%	17.4%	16.9%	16.4%
BFSI	46.8%	44.4%	42.2%	46.0%	45.0%	44.8%	45.4%	46.5%
Manufacturing/Enterprises	31.8%	33.4%	35.2%	30.3%	30.4%	32.5%	33.4%	34.8%
Others	5.9%	6.4%	6.3%	6.7%	6.0%	5.3%	4.3%	2.3%

Source: Company Reports and Citigroup Investment Research estimates

Figure 15. Key Client Metrics

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06	3Q06	4Q06
Client Data								
Repeat business	91.8%	88.8%	90.4%	89.0%	89.5%	85.9%	88.2%	88.4%
Total active clients	110	115	120	126	130	141	119	129
New Clients	8	9	12	10	11	15	11	12
Client Concentration								
Top client	13.6%	13.1%	12.1%	9.2%	9.7%	9.1%	9.0%	8.3%
Top 5 clients	47.2%	42.6%	42.6%	32.6%	31.9%	31.1%	32.5%	32.7%
Top 10 clients	61.9%	60.2%	59.7%	49.3%	47.4%	45.8%	47.1%	47.7%
Client relationship								
US$ 1mn+	27	28	29	30	31	36	40	41
US$ 1-5 mn	21	20	21	22	23	28	31	32
US$ 5-10 mn	3	4	4	4	5	5	5	5
US$ 10 mn+	3	4	4	4	3	3	4	4

Source: Company Reports and Citigroup Investment Research estimates

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Quant View — Contrarian

Hexaware is at the edge of the Contrarian quadrant bordering the Unattractive quadrant on our value-momentum map, with a relative valuation score close to fair value and moderately weak momentum scores. The stock looks fairly valued with a trailing PE of 17x, coupled with trend earnings growth of 24.2%. The combined effect of a dipping price momentum and recent negative earnings estimate revisions has resulted in a moderately weak momentum score.

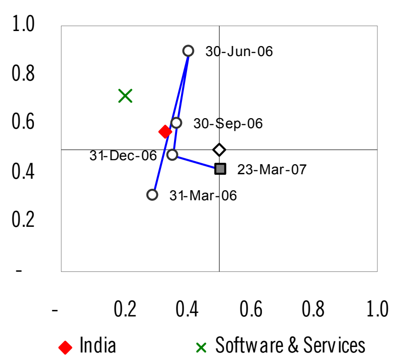
Compared with its country and sector peers, Hexaware ranks above them on valuation but below on momentum.

Our risk analysis suggests that Hexaware is a defensive stock and should outperform in a regime where value stocks beat growth and small-caps beat large-caps in the region.

Radar Screen Quadrant Definitions

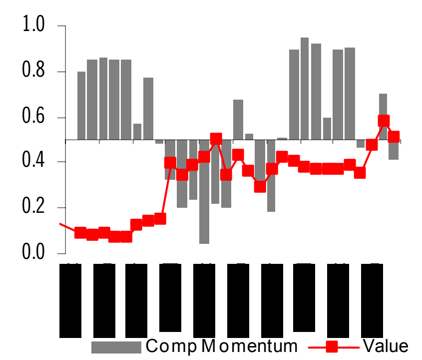
Glamor *Poor relative value but superior relative momentum*	Attractive *Superior relative value and superior relative momentum*
Unattractive *Poor relative value and poor relative momentum*	Contrarian *Superior relative value but poor relative momentum*

Figure 16. Radar Quadrant Chart History



Source: Citigroup Investment Research

Figure 17. Radar Valuation Momentum Ranks



Source: Citigroup Investment Research

Figure 18. Radar Model Inputs

IBES EPS (Actual and Estimates)			
FY(-2)	5.56	Implied Trend Growth % (3+2)	24.2
FY(-1)	7.76	Trailing PE (x)	17.3
FY0	7.76	Implied Cost of Debt (%)	8.99
FY1	11.98	StdMktCap	(0.25)
FY2	15.11		

Source: Worldscope, I/B/E/S

Figure 19. Macro Sensitivity

Region	0.53	Commodity ex Oil	(0.07)
Local Market	0.93	Rising Oil Prices	0.12
Sector	0.32	Rising Asian IR's	(0.17)
Growth Outperforms Value	(0.63)	Rising EM Yields	0.02
SmallCaps Outperform LargeCaps	0.68	Stronger US$ (vs Asia)	0.96
Widening US Credit Spreads	(0.16)	Weaker ¥ (vs US$)	(0.04)

Source: Citigroup Investment Research

Hexaware Technologies

Company description

Hexaware was established in 1992 and began international operations in 1995. In February 2001, it merged with the software division of Aptech. The merged entity was later de-merged from the training arm of Aptech and listed as Hexaware Technologies. In NASSCOM's 2006 rankings, Hexaware was the 12th-largest IT service exporter in India. It offers BPO service through 100% subsidiary CaliberPoint. Hexaware has built its business by scaling up in such niche areas as ERP, airlines and BFSI. It employs nearly 6,000 people in its IT and BPO operations, and has more than 125 clients.

Investment thesis

We rate Hexaware as Buy/Medium Risk (1M). Offshore IT outsourcing has now become the norm, with scale IT services players as well as smaller companies with niche focus benefiting. Hexaware has carved a niche for itself in several small though scalable areas, and has targeted under-penetrated markets. Ties with PeopleSoft/Exult have helped Hexaware develop expertise in HR-IT, and relationships with Air Canada/Lufthansa have led the company to the broader travel and transportation vertical. Hexaware is developing expertise in testing solution through organic and inorganic initiatives. We forecast a 30% revenue CAGR and a 25% EPS CAGR for Hexaware over 2006-09, driven by niche segments and the company's ability to mine clients.

Valuation

Our 12-month target price of Rs214 is based on 17x the average EPS for FY07E-08E, which is derived by using a 20% discount to our target multiple for Satyam of 21x. We believe the discount is fair, as Satyam is a larger and more diversified company. For Hexaware, we expect a 30% revenue CAGR and a 27% net profit CAGR over FY06-09. However, dilution from the GAP stake and ESOPs lowers the fully diluted EPS CAGR to 25% over the same period. We use Satyam as a benchmark to value all mid-tier IT services companies in our universe. We believe 17x is a fair multiple given the growth we expect for Hexaware over the next three years. Our target multiple is also supported by a two-year historical valuation range of 12-20x forward earnings. We believe a P/E-based valuation is appropriate given Hexaware's earnings track record and the widespread use of this methodology.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, rates Hexaware Technologies as Medium Risk. Risks that could impede the stock from reaching our target price include: (1) high client concentration; (2) a slowdown in the financial and transportation industry; (3) a slowdown in the US/global economies; (4) losing edge to scale players; (5) supply-side situation becoming more difficult — wage inflation being higher than that factored in our model; (6) upside surprises in currency appreciation; and (7) limited H1B visas.

Appendix A-1

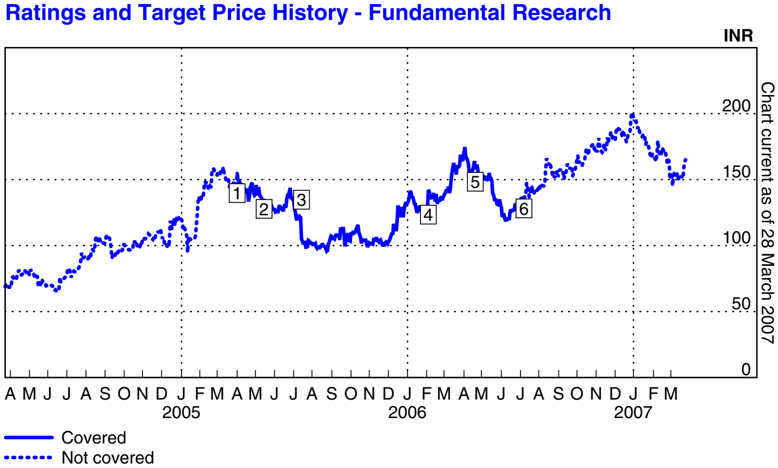
Analyst Certification

We, Hitesh Shah and Surendra Goyal, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Hexaware Technologies (HEXT.BO)

Ratings and Target Price History - Fundamental Research



#	Date	Rating	Target Price	Closing Price
1:	1 Apr 05	1M	176.00	154.73
2:	16 May 05	1M	*160.00	135.15
3:	14 Jul 05	*3H	*100.00	105.20
4:	3 Feb 06	*2M	*140.00	142.25
5:	20 Apr 06	*3M	*150.00	159.20
6:	7 Jul 06	Coverage suspended		

*Indicates change.

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% of companies in each rating category that are investment banking clients	45%	41%	34%
India -- Asia Pacific (118)	58%	14%	28%
% of companies in each rating category that are investment banking clients	48%	50%	39%
Citigroup Investment Research Quantitative World Radar Screen Model Coverage (6737)	29%	44%	27%
% of companies in each rating category that are investment banking clients	31%	24%	22%
Citigroup Investment Research Quantitative Decision Tree Model Coverage (334)	48%	0%	52%
% of companies in each rating category that are investment banking clients	50%	0%	47%
Citigroup Investment Research Quantitative European Value & Momentum Screen (602)	30%	41%	30%
% of companies in each rating category that are investment banking clients	50%	42%	33%
Citigroup Investment Research Asia Quantitative Radar Screen Model Coverage (1858)	20%	60%	20%
% of companies in each rating category that are investment banking clients	22%	18%	20%
Citigroup Investment Research Quant Emerging Markets Radar Screen Model Coverage (1252)	20%	60%	20%
% of companies in each rating category that are investment banking clients	28%	25%	26%
Citigroup Investment Research Australia Quantitative Top 100 Model Coverage (100)	30%	40%	30%
% of companies in each rating category that are investment banking clients	43%	50%	37%
Citigroup Investment Research Australia Quantitative Bottom 200 Model Coverage (172)	30%	40%	30%
% of companies in each rating category that are investment banking clients	4%	7%	10%
Citigroup Investment Research Australia Quantitative Scoring Stocks Model Coverage (10)	50%	0%	50%
% of companies in each rating category that are investment banking clients	20%	0%	60%

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Low Risk -- Triple A to Low Double A
Low to Medium Risk -- High Single A through High Triple B
Medium to High Risk -- Mid Triple B through High Double B
High to Speculative Risk -- Mid Double B and Below

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Citigroup Investment Research Quantitative Decision Tree model recommendations are based on a predetermined set of factors to rate the relative attractiveness of stocks. These factors are detailed in the text of the report. Each month, the Decision Tree model forecasts whether stocks are attractive or unattractive relative to other stocks in the same sector (based on the Russell 1000 sector classifications).
Citigroup Investment Research Quantitative European Value & Momentum Screen recommendations are based on a European consistent framework to measure relative

value and momentum for a large number of stocks across the European Market. Relative value and momentum rankings are equally weighted to produce a European attractiveness score for each stock. The scores are then ranked and put into deciles. A stock with a decile rating of 1 denotes an attractiveness score in the top 10% of the universe (most attractive). A stock with a decile rating of 10 denotes an attractiveness score in the bottom 10% of the universe (least attractive).
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For purposes of NASD/NYSE ratings-distribution-disclosure rules, membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model buy portfolio most closely corresponds to a buy recommendation; membership of the Citigroup Investment Research Quantitative Australian Scoring Stocks Model sell portfolio most closely corresponds to a sell recommendation. However, because Citigroup Investment Research Quantitative Australian Scoring Stocks Model recommendations are based on the relative attractiveness of a stock, they can not be directly equated to buy, hold and sell categories. Accordingly, your decision to buy or sell a security should be based on your personal investment objectives and only after evaluating the stock's expected absolute performance.

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