

25th April 2007**BUY**

Price Rs174	Target Price Rs226
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Sensex - 14,137**Price Performance**

(%)	1M	3M	6M	12M
Absolute	6	(2)	0	8
Rel. to Sensex	(0)	(2)	(11)	(9)

Source: Capitaline

Stock Details

Sector	IT Services
Reuters	HEXT.BO
Bloomberg	HEXW@IN
Equity Capital (Rs mn)	266.05
Mkt. Cap (Rs bn)	23.2
FV/Share	2
52 Week H/L	259445
Daily Avg Volume (No of shares)	359920
Daily Avg Turnover (US\$ mn)	1.0

Shareholding Pattern (%)

Promoters	25.5
FII's /NRI's	54.8
Institutions	7.4
Private Corp	1.3
Public	11.1

Source: BSE,31.03.2007

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Hexaware posted revenue growth of 10.1% qoq (11.7% in US\$ terms) to Rs 2.64 bn, in line with our expectations and company's guidance driven by consolidation of recently acquired FocusFrame (full quarter). Offshore billing showed a remarkable improvement of 1.5% qoq, while onsite billing was up 0.6% qoq. EBITDA margins remained flat 14.9%, despite consolidation of lower margin business from Focus Frame, one-time business restructuring expenses (~US\$1m), and rupee appreciation. EBITDA jumped by 10.7% to Rs 395 mn. However, due to higher taxation of FocusFrame (effective tax rate increased from 12% in Q4CY06 to 13.5% in Q1CY07) and lower other income (15% qoq fall). PAT grew only by 4.3% to Rs 352 mn, in line with the company's guidance but lower than our expectations of Rs 373 mn.

Key Highlights for Q1CY07

- Order book additions for Q1CY07 were highest at US\$ 61 mn, while outstanding order book position stood at US\$ 260 mn, up from US\$ 240 mn in the previous quarter. Orders executable over one year stood at US\$ 170 mn, reflecting strong visibility of future revenue stream.
- 2 orders in excess of US\$ 10 mn won during Q1CY07.
- Additions of 20 new clients taking active clients to 151 (including clients of FocusFrame), 50 of which belonged to Fortune 500.
- Of the additions, 12 were from North America, 2 from Europe, 4 from APAC region and 2 for Caliber Point. Based on business competencies, 8 new clients were added in Testing, 4 in ERP, 2 in BI & BA, 3 in Application Management, 2 in BPO, and one in Product Engineering space.
- Utilizations increased by 250 bps to 70.7% qoq
- Attritions increased to 16.1%, up from 15% in Q1CY06. Total headcount of 5751, a net reduction of 78 resources over Q4CY06.
- Hedges in excess of US\$ 60 mn @ 44.73.

Guidance for Q2CY07

The company has provided the following guidance for quarter ending June 30, 2007. Revenues to be in the range of \$64 mn to \$65 mn - a growth of 6.5% to 8.1% qoq. PAT in the range of \$7.0 mn to \$7.2 mn at an exchange rate assumption of Rs 42/\$. This includes the impact of the proposed annual salary increase of 14-15% for offshore and 4-5% for onsite technical employees. Capex of Rs 1-1.2 bn for CY07. Employee additions in the range of 1500-2000 for CY07.

Key Financials

Dec end	Rev	EBITDA	EBITDA	PAT	EPS	ROE	EV/	P/BV	Div	P/E
(Rsmn)		(%)	(%)			(%)	EBITDA (x)	(x)	Yield	
CY05	6,787	1,085	16.0	915	7.5	25.7	18.1	5.8	0.7	23.1
CY06	8,482	1,322	15.6	1,242	9.0	16.6	15.9	3.3	0.7	19.3
CY07E	11,941	1,786	15.0	1,559	11.1	19.0	11.7	2.7	0.7	15.7
CY08E	15,425	2,305	14.9	2,057	14.6	21.	10.6	2.3	0.7	11.9

Source : Company, Emkay Research

Integration with FocusFrame on track

Q1CY07 is the first quarter with full consolidation of FocusFrame metrics (annual run rate US\$ 25 mn). The delivery for four joint wins commenced with representation from both entities while multiple prospects are being pursued jointly by both the organizations. On the marketing front, a unified service offering suite of solutions is being rolled out to the global sales and marketing teams. All the key personnel from Focus Frame continue to make significant contribution. Since larger share of FocusFrame revenues are derived from onsite locations, we believe the consolidated profitability ratios would be impacted.

Focus on newer services

We believe newer services such as testing, asset management solutions, SAP-HR IT, etc would be the growth drivers of the company, besides ERP (PeopleSoft) and traditional ADM. These newer services are expected to grow at a faster rate and contribute better margins compared to traditional ADM. Testing services which currently contributes 17.5% of revenues in Q1CY07 is expected to contribute 25% by CY08E.

Margin Levers available

The management of Hexaware is optimistic of improving margins by 100 bps during CY07 driven by better productivity, improvement in pricing, increased utilizations, increased offshoring (38.8% for CY06) and more hiring of freshers. However, we believe most of the improvements in margins would be offset by annual wage inflation (offshore 15%+ and onsite 3-5%), higher SGA expenses, integration costs of FocusFrame, consultancy cost and higher taxation. We expect EBITDA margins to fall by 60 bps yoy to 15.0% for CY07E.

Future outlook and valuations

We expect Hexaware to post 35% CAGR in revenues and 29% CAGR in profits for CY06-08E. We expect FDEPS of Rs 11.1 and Rs 14.6 for CY07E and CY08E respectively based on equity base of 140.5 mn shares. At CMP of Rs 174, the stock trades at a P/E of 15.7x and 11.9x and EV/EBITDA of 12.2x and 10.9x based on CY07E and CY08E respectively. We reiterate BUY with one year price target of Rs 226 (15.5x CY08E FDEPS of Rs 14.6).

Q1CY07 Results Analysis

Particulars (Rs mn)	Q4CY06	Q1CY07	% qoq
Revenues	2,402	2,644	10.1%
Direct costs	1,501	1,603	
Gross Profit	901	1,040	
Gross Margin	37.5%	39.4%	
SG&A	544	645	
EBITDA	357	395	10.7%
EBITDA Margin	14.9%	15.0%	
Dep & Amort	53	56	
Operating Profit	304	339	
Other Income (net)	79	68	
PBT	384	407	
Tax	46	55	
PAT	338	352	4.3%
Net Margin	13.6%	13.0%	
EPS (basic)	2.46	2.57	4.5%
EPS (diluted)	2.30	2.43	5.7%

Source : Company

Profit & Loss Statement

Dec ending (Rs mn)	CY05	CY06	CY07E	CY08E
Revenues	6,787	8,482	11,941	15,425
% growth	24%	25%	41%	29%
Direct costs	4,175	5,318	7,291	9,474
Gross Profit	2,611	3,164	4,650	5,952
Gross Margin	38.5%	37.3%	38.9%	38.6%
SG&A	1,526	1,842	2,864	3,647
as a % of revenue	22.5%	21.7%	24.0%	23.6%
EBITDA	1,085	1,322	1,786	2,305
% growth	38%	22%	35%	29%
EBITDA Margin	16.0%	15.6%	15.0%	14.9%
Dep & Amort	221	200	248	313
Operating Profit	865	1,122	1,539	1,992
Other Income (net)	148	241	302	387
PBT	1,012	1,363	1,841	2,379
Tax	97	120	249	321
as a % of PBT	9.6%	8.8%	13.5%	13.5%
PAT	915	1,242	1,592	2,057
% growth	44%	36%	28%	29%
Preference Dividend	-	-	33	-
Earnings to Equity shareholders	915	1,242	1,559	2,057
% growth	44%	36%	26%	32%
Net Margin	13.2%	14.2%	13.0%	13.0%
EPS (basic)	7.8	9.4	11.8	15.5
EPS (diluted)	7.5	9.0	11.1	14.6
% growth	50%	20%	23%	32%

Source : Company, Emkay Research

Balance Sheet

Dec ending (Rs mn)	CY05	CY06	CY07E	CY08E
Liabilities				
Equity Share Capital	240	268	289	289
Convertible Preference Shares		1,500	-	-
Share Premium	1,750	3,231	4,710	4,710
Reserves	1,564	2,501	3,920	5,585
Net Worth	3,554	7,500	8,919	10,583
Borrowings	62	0	-	-
Total Liabilities	3,616	7,500	8,919	10,583
Assets				
Goodwill	-	1,000	1,000	1,000
Gross Block	1,554	2,296	3,296	4,046
Less : Depreciation	621	795	1,042	1,355
Net Fixed Assets	933	1,501	2,253	2,690
Current Assets				
Cash & Cash equivalents	1,178	3,414	3,477	3,995
Debtors	1,852	2,063	2,723	3,485
Others	805	1,234	1,604	2,085
Total Current Assets	3,835	6,711	7,804	9,565
Total Current Liabilities	1,182	1,708	2,135	2,669
Working Capital	2,653	5,002	5,668	6,896
Deffered Tax	30	(3)	(3)	(3)
Total Assets	3,616	7,500	8,919	10,584

Source : Company, Emkay Research

Cash Flow

Dec ending (Rs mn)	CY05	CY06	CY07E	CY08E
PAT	915	1,242	1,592	2,057
Depreciation	80	174	248	313
Changes in working capital	(417)	(80)	(603)	(710)
Cash Flow from Operations	578	1,336	1,237	1,661
Net capital expenditures	(43)	(1,742)	(1,000)	(750)
Net Borrowings	10	1,439	0	0
Free Cash Flow to Equity	545	1,033	237	911
Dividend	(174)	(305)	(173)	(393)
Issue of Equity	32	1,509	0	0
Cash at the beginning	775	1,178	3,414	3,477
Cash at the end	1,178	3,414	3,477	3,995

Source : Company, Emkay Research

Ratios

Dec ending (Rs mn)	CY05	CY06	CY07E	CY08E
Per Share Data (Rs)				
Basic EPS	7.8	9.4	11.8	15.5
Diluted EPS	7.5	9.0	11.1	14.6
CEPS	9.5	10.3	12.9	16.9
BVPS	29.8	53.4	63.5	75.3
DPS	1.2	1.2	1.2	1.2
Valuation Ratios (x)				
P/E	23.1	19.3	15.7	11.9
P/CEPS	18.3	16.9	13.5	10.3
EV/EBITDA	18.1	15.9	11.7	10.6
EV/Revenues	2.9	2.5	1.8	1.6
P/BV	5.8	3.3	2.7	2.3
PEG	0.5	1.0	0.7	0.4
Dividend yield (%)	0.7	0.7	0.7	0.7
Growth Ratios				
Revenues	24.3	25.0	40.8	29.2
EBITDA	37.9	21.8	35.1	29.0
PAT	43.6	35.8	28.2	29.2
EPS	49.5	19.8	23.1	32.0
Margins (%)				
Gross Margin	38.5	37.3	38.9	38.6
EBITDA Margin	16.0	15.6	15.0	14.9
PAT Margin	13.2	14.2	13.0	13.0
Return Ratios (%)				
ROE	25.7	16.6	19.0	21.1
ROCE	25.3	22.4	19.0	21.1

Source : Company, Emkay Research

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