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ESPIRITO SANTO
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Quick Insight| Technology | 24th March 2011

Redington (India)

Cheap valuations and strong fundamentals

Despite consistent earnings growth and ROE >20%, Redington's shares have been hit recently by concerns about the Middle East which contributes to around 40% revenues, as well as restructuring of the HP distribution channel. But revenue contribution from crisis hit economies is insignificant with the bulk of revenues coming from UAE and Saudi. Meanwhile our channel checks suggest India revenues should grow by >20% in CY11 indicating strong growth outside of HP, driven by e-governance, enterprise and SME spending. We reiterate our Buy.

Middle East crisis is weighing heavily on the stock price performance

Redington's share price performance has been subdued in the past three months largely due to the geopolitical crisis in middle east, and overhang of HP losing market share in India to Dell. While investor worries are understandable given that Middle East and North Africa (MENA) contributes to around 40% of Redington's consolidated revenues, the question is will Redington be able to offset this through growth in other geographies? We think so.

a) **Crisis hit economies contribute to <3% of MENA sales:** Middle East contributes to 40% of Redington's consolidated revenues. Whilst c.40% of revenues from the Middle East means the current crisis in Middle East is a concern for Redington, the revenue contribution from the crisis hit economies (Egypt and Libya) is insignificant with the bulk of revenue coming from UAE, Saudi Arabia and North Africa indicating minimal impact.

b) **New OEM partnerships to drive growth in domestic market:** Redington currently distributes iPods, desktops and notebooks for Apple and has entered into an agreement to distribute the iPAD. The total tablet market in India is expected to be around $800m consisting of 1m units at a price point of Rs36,000. Secondly, it has entered into an agreement with Dell to distribute its Smart phones in southern India. While Dell distributes its computers and notebooks directly to its channel partners (i.e. no distributor in between) this agreement to distribute smart phones through Redington indicates that Dell is willing to experiment with its distribution in India after witnessing success with Redington in the middle east market where it follows the distributor structure. Moreover, sales of Blackberry are expected to jump 3x in FY11. These new OEM partnership have helped Redington to offset the gradual decline in sales from HP. Moreover, given Redington's distribution capabilities we don't rule out the Apple (iPAD) contract getting extended to iPhones and Dell (Smartphone) contract getting extended to notebooks.

c) **Channel checks also indicate 20% growth for CY11:** Redington is expected to grow its India revenue by >30% in FY11despite restructuring at HP. Moreover, our channel checks with Redington's channel partners indicate 20% YoY growth in CY11. the bulk of this growth is coming from capex spending from enterprise customers, SMEs and government on e-governance projects (R-ARDRP and SWAN).

Valuation: Deserve premium due to its ability to manage risks

Redington deserves to trade at a premium due to its ability to manage risks. Its bad debts and inventory write-offs have remained <0.07% and <0.05% of sales in the last five years is a testimony to this. The fact that it will be growing its India revenues>30% in FY11 despite revenue from HP falling from early 30s to early 20s is further evidence of its robustness. Its ability to fund channel partners and pass on the increasing cost of funds to them indicates limited impact on Redington's financials due to increasing cost of borrowings. We expect sales and earnings to grow at an 18% and 22% CAGR respectively over FY10-13. Our three stage FCFE points to a valuation of Rs98. Retain BUY.

Accounting & corporate governance	AMBER
Franchise Strength	GREEN
Earnings Momentum	GREEN

BUY

32% Upside

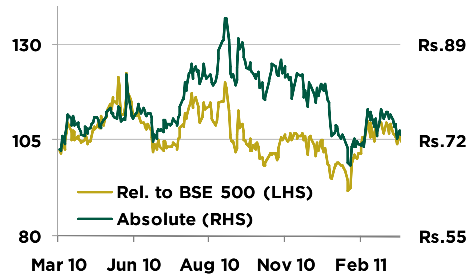
Fair Value (₹)	Rs 98

Bloomberg Code	REDI.IN
Share Price	Rs 74
Market Capitalisation	$645m /₹ 29bn
Free Float / FII holding	71%/31%
ADV	$1.75m/₹75m

₹m (unless s stated) Mar YE	2010A	2011E	2012E	2013E
Revenue (INR m)	137,578	162,794	191,296	223,077
Growth	8.6%	18.3%	17.5%	16.6%
EBITDA (INR m)	3,448	4,699	5,758	7,070
EBITDA margin	2.5%	2.9%	3.0%	3.2%
PAT (INR m)	1,843	2,260	2,756	3,324
EPS dil. (Rs.)	4.7	5.8	7.0	8.5

X (unless stated)	2010A	2011E	2012E	2013E
P/E	15.8	12.8	10.5	8.7
EV/Sales	0.3	0.2	0.2	0.2
EV / EBITDA	10.1	7.4	6.0	4.9

Historical Share price performance



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Geopolitical risk & HP weigh on shares

1. **Geopolitical crisis in Middle East (40% of revenues):** Redington gets about 40% of its revenues from the Middle East. A substantial proportion of IT distribution in the MEA region is funneled through free trade centres based in Jebel Ali. Most regional distributors resell IT products from their warehouses in this port city. However, it is difficult to penetrate deep into faster growing regions to reach reasonable scale. Several national distributors choose to work primarily out of Jebel Ali as they are incapable of taking currency risks and prefer local relationships. Redington is the only distributor that has a presence in all the Middle Eastern countries with more than 3,500 active accounts at the end of 2009. This affords it greater reach that makes it a default choice for product vendors and its greater operating scale help it increase operational efficiency. But the current crisis in Middle East also means that it will be impacted due to its physical operations across the region.

2. **Restructuring at HP and subsequent loss of market share in India to Dell:** In the first quarter of 2010, HP started losing market share to Dell. Dell, which earlier depended primarily on a direct-sales model and focused on the enterprise and corporate segment, went in for a major overhaul of its strategy in 2007. It launched its retail and partnership model for the first time in India in 2008. At the same time, Dell did not ignore the direct sales model. According to the company, even now 90-95% of its enterprise customers use the direct-sales model. This forced HP to change its Personal Systems Group (PSG) distribution model in April 2010. However, for HP things didn't change fast enough and its new distribution strategy faced initial teething problems. As a result Dell market share went up from 14.0% in Q4CY09 to 17% in Q3CY10 and HP market share fell from 17.0% in Q4CY09 to 14.5% in Q3CY10. This weighed on Redington as it used to get >30% of its India revenues from HP, the PSG portfolio contributed to 56% of India revenue from sale of HP products and the top two players, Redington and Ingram, were controlling 70% of the Indian market for HP.

Table 1 Dominant market leader in MEA

Name	FY09 Sales ($m)	Staff	Channel Partners
Redington	1,190	400	3,520
Metra	530	900	3,000
Emitac	358	200	1,300
Almasa	355	200	1,200
FDC	344	200	600
Aptec	336	300	3,000
BDL Gulf	320	285	2,700
Logicom	280	170	2,000
Jumbo IT	269	65	250
Asbis	206	90	900

Source: ITP.NET

However, Redington can counter these issues;

1. **Crisis hit economies contribute to <3% of MENA sales:** Bulk (97%) of MENA (Middle East and North Africa) revenues come from UAE, Saudi Arabia and North African operations (Nigeria, Uganda, Ethiopia, Kenya and Tanzania) leaving 3% of MENA revenue exposed to countries like Egypt, Libya, Yemen, Lebanon, Jordon, Qatar, Kuwait, Bahrain and Iran. With stock markets opening in Egypt, the situation is slowly returning to normalcy and the management indicated that the DSO haven't changed in middle east and there is no increase in provision for doubtful debts due to the crisis. Having said that, if the crisis spreads to Saudi Arabia and/or United Arab Emirates then sales from Middle East will get impacted.

2. **Domestic market – growth uninterrupted despite restructuring at HP:** Redington has been witnessing a steady decline in revenues from HP. Redington's India revenue from HP declined from 40% of sales in FY07 to around 32-33% in FY10. However, it has now fallen to 23% after HP changed its India distribution strategy in April 2010 following market share loss to Dell. Under the new distribution strategy, Redington has become an exclusive distributor for HP in select states unlike earlier wherein it was the PAN India distributor for HP. While initially the new model didn't seem to work for HP, slowly it seems to be working, with HP regaining its number 1 position in India in Q4CY10 after three quarters (source: Gartner and IDC).Despite such a big drop from its top customer in India, Redington is expected to grow its India revenue by 30% in FY11. The bulk of this growth is coming from spending by government in ambitious projects such R-ARDRP (Restructured Accelerated Power Development and Reforms Program), SWAN (State Wide Area Networks) and also from general capex spending by enterprise and SMEs. Moreover, our channel checks indicate that HP's new distribution strategy is not working to their expectations and they may have to change their distribution

Table 2 HP New PSG structure

Department	Head	Products
Emerging Business	Rajat Mehta	Blade PCs, Thin computing solutions, retail point of sales products
IDC and Attach	Sanjeev Pathak	Accessories portfolio of desktops and notebooks
Desktop	Meraj Ahmad	Desktops
Mobility	Ketan Patel	Pro notebook and pavilion notebook

Source: CRN

strategy yet again. Additionally, Dell has become the preferred notebook computer in past one year, followed by Sony and then HP making us believe that the regaining of number one position by HP could be due to its dominance in the desktop segment and/or some variation in the inventory channel on a sequential basis. If HP goes back to the older distribution structure, it will once again benefit the larger players like Redington and Ingram.

Changes in estimates

Table 3 Estimates changes

	NEW Estimates			OLD Estimates			Changes to estimates		
(Rs m)	**FY11**	**FY12**	**FY13**	**FY11**	**FY12**	**FY13**	**FY11**	**FY12**	**FY13**
Revenue	162,794	191,296	223,077	162,794	189,743	221,295	0.0%	0.8%	0.8%
EBITDA	4,699	5,758	7,070	4,699	5,709	6,977	0.0%	0.9%	1.3%
Net Profit	2,260	2,756	3,324	2,264	2,729	3,268	-0.2%	1.0%	1.7%

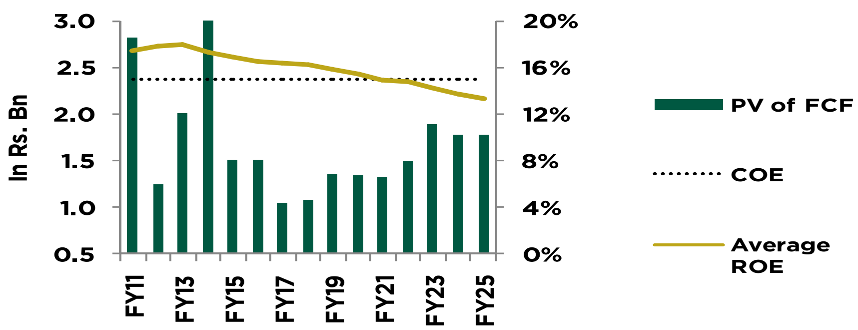
Source: ESIB inc Execution Noble estimates

Whilst we largely retain our estimates, we have moderated our growth assumptions for the Middle East market given the unrest and slower than expected economic recovery in the region. We also factor revenue and earnings from its Turkish acquisition, Arena Bilgisayar, and marginally increase our estimates for the domestic business given the new OEM partnerships and channel checks. On a consolidated basis our revenue and earnings estimates have gone up by 1% over the next two years.

Valuations

We continue to use FCFE to value Redington as it captures the impact of debt raised to finance its channel partners and takes into account the effect of interest cost as a result of this financing. Our FCFE metric is "Net Profit- change assets+ change in liabilities". Redington trades at 30% discount to its Tiwanese peer, Synnex, with similar revenue and earnings growth prospects which we feel is unjustified. Our FCFE valuation points to a fair value of Rs98, implying 32% upside. The average ROE over FY11 to FY25 works out to 16.3% while our cost of equity assumption is 15% and perpetuity growth is 5%.

Figure 1 Redington's FCFE profile



Source: Execution Noble, Bloomberg

Espirito Santo versus consensus

Our FY11 and FY12 estimates for revenues are 2% lower than consensus as we do expect a marginal impact due to the lingering Middle East crisis. However, our FY13 revenue is in line with consensus as we expect North African business to compensate for sluggish growth in Middle East. We are positive on Redington's ability to manage risks and pass on the excess cost of funds to the borrowers and this is getting reflected in higher than consensus estimates for EBITDA. Our earnings estimates are 4% and 5% lower than consensus for FY12 and FY13 due to higher tax rates. The corporate tax rates in North African region are about 30% when compared with zero tax rates in Middle East. A high growth in the North African market is expected to result in a higher corporate tax rate for Redington.

Table 4 Espirito Santo versus Consensus

Name	Ex Noble	Cons	% Divergence
Sales (Rs mn)			
FY11	162,794	166,471	-2.2%
FY12	191,296	196,496	-2.6%
FY13	223,077	223,966	-0.4%
EBITDA (Rs mn)			
FY11	4,699	4,536	3.6%
FY12	5,758	5,715	0.8%
FY13	7,070	6,854	3.1%
EPS (Rs)			
FY11	5.8	5.8	-1.0%
FY12	7.0	7.3	-3.9%
FY13	8.5	9.0	-5.4%

Source: Execution Noble estimates

Relative valuation

Table 5 Comparative valuation for Redington (India)

	Curr	Price	Mkt Cap	EV	Sales CAGR (CY10-12)	EV/Sales CY11	EV/Sales CY12	EBITDA CAGR (CY10-12)	EV/EBITDA CY11	EV/EBITDA CY12	EPS CAGR (CY10-12)	P/E CY11	P/E CY12
India													
REDINGTON INDIA LTD	**INR**	**74.0**	**32,800**	**40,853**	**17%**	**0.2**	**0.2**	**23%**	**6.3**	**5.2**	**25%**	**10.8**	**8.7**
HCL INFOSYSTEMS LTD	INR	101.0	22,182	22,351	6%	0.2	0.2	13%	5.9	4.8	7%	8.8	7.8
	Median				**12%**	**0.2**	**0.2**	**18%**	**6.1**	**5.0**	**16%**	**9.8**	**8.3**
	Mean				**12%**	**0.2**	**0.2**	**18%**	**6.1**	**5.0**	**16%**	**9.8**	**8.3**
US													
TECH DATA CORP	USD	48.0	2,240	1,915	8%	0.1	0.1	11%	4.1	3.7	13%	9.7	8.7
INGRAM MICRO INC	USD	19.5	3,120	2,595	6%	0.1	0.1	11%	4.2	3.9	13%	8.9	7.9
AVNET INC	USD	33.4	1,214	1,501	14%	0.1	0.1	17%	5.7	5.0	13%	8.9	8.0
ARROW ELECTRONICS INC	USD	32.0	4,890	6,160	11%	0.2	0.2	15%	5.5	5.2	15%	7.7	7.2
SYNNEX CORP	USD	38.5	4,430	5,325	8%	0.3	0.2	10%	5.3	4.9	12%	8.0	7.3
BRIGHTPOINT INC	USD	12.0	807	855	13%	0.2	0.2	14%	7.4	6.5	34%	12.5	10.3
	Median				**10%**	**0.1**	**0.1**	**13%**	**5.4**	**5.0**	**13%**	**8.9**	**8.0**
	Mean				**10%**	**0.2**	**0.2**	**13%**	**5.4**	**4.9**	**17%**	**9.3**	**8.2**
Others													
SYNNEX TECHNOLOGY	TWD	67.0	101,300	115,100	21%	0.2	0.2	26%	17.8	14.3	21%	15.3	12.6

Source: Bloomberg, ESIB inc Execution Noble estimates

Table 6 Traffic Lights: criteria for judgement

Parameter	Traffic signal	Reasons
Accounting & governance	**AMBER**	We note that Redington has negative cash flow from operations as it purchases goods on cash and sells them on credit to its channel partners. Also with Redington using leverage to finance its debtors through its own NBFC, select balance sheet disclosure like equity and debt of NBFC, breakup of loans advanced to Redington and outside parties becomes necessary. In the absence of these, we give it a amber light.
Franchise strength	**GREEN**	Redington's substantially deeper market penetration as a result of its dominant market share in India (No. 2) and MEA (No. 1) make it a default choice for OEMs launching new products and new OEMs in the region. Its scale also helps it earn higher volume discounts from OEMs increasing its ability to earn fatter margins than peers. Proprietary strengths in credit assessment for financing channel partners keeps its relationships with 18000 partners in India and 3500 partners in MEA strong.
Earnings momentum	**GREEN**	While the stock is not widely covered, Bloomberg and Reuters show that there have been upgrades in the earnings estimates for the company following the Q3 FY11 results.

Source: ESIB inc Execution Noble, Bloomberg, Company data. For more details on how the traffic lights work, please refer to our 7 Jan 2010 note

Financials

All numbers are in Rs mn

Income statement (March year end)	2008A	2009A	2010A	2011E	2012E	2013E
India	**57,710**	**60,662**	**64,496**	**78,712**	**94,564**	**111,614**
Middle East Revenues	**50,990**	**65,915**	**72,827**	**83,636**	**96,054**	**110,378**
NBFC	**0**	**106**	**254**	**447**	**678**	**1,085**
Net income	**108,701**	**126,683**	**137,578**	**162,794**	**191,296**	**223,077**
Total expenses	106,242	123,536	134,129	158,095	185,537	216,007
EBITDA	**2,459**	**3,147**	**3,448**	**4,699**	**5,758**	**7,070**
Depreciation	100	127	234	163	203	248
EBIT	**2,359**	**3,020**	**3,214**	**4,537**	**5,555**	**6,821**
Interest Expenses	720	978	664	1,021	1,209	1,480
Interest Income	131	149	209	168	200	228
PBT (before EO)	**1,771**	**2,190**	**2,759**	**3,683**	**4,545**	**5,568**
Provision for Tax	410	500	639	1,089	1,385	1,755
Minority Interest	-	94	277	334	404	490
Profit After Tax	**1,361**	**1,597**	**1,843**	**2,260**	**2,756**	**3,324**
Weighted avg shares (mn)	392.4	392.4	392.4	392.4	392.4	392.4
Adjusted EPS (Rs)	**3.5**	**4.1**	**4.7**	**5.8**	**7.0**	**8.5**

Balance Sheet	2008A	2009A	2010A	2011E	2012E	2013E
Equity Share Capital	**779**	**779**	**786**	**786**	**786**	**786**
Reserves & Surplus	**6,436**	**9,243**	**9,971**	**11,779**	**13,984**	**16,477**
Net Worth	**7,215**	**10,022**	**10,757**	**12,566**	**14,771**	**17,263**
Total debt	**7,840**	**9,830**	**11,486**	**14,721**	**18,821**	**24,371**
Minority Interest	-	2,413	2,403	2,737	3,141	3,631
Capital Employed	**15,054**	**22,265**	**24,646**	**30,023**	**36,733**	**45,265**
Net Block	679	765	847	1,126	1,421	1,649
Capital Work in Progress	34	115	121	121	121	121
Goodwill	535	-	-	-	-	-
Deferred Tax Asset	0	4	34	34	34	34
Total Current Assets	**19,009**	**23,305**	**29,511**	**31,169**	**37,553**	**44,898**
Cash and Bank Balance	**1,830**	**6,024**	**5,826**	**8,876**	**10,564**	**13,377**
Total Current Liabilities	**7,032**	**7,947**	**11,693**	**11,304**	**12,961**	**14,814**
Total Assets	**15,054**	**22,265**	**24,646**	**30,023**	**36,733**	**45,265**

Cash Flow	2008A	2009A	2010A	2011E	2012E	2013E
Pre-tax profits before EO items	**1,771**	**2,190**	**2,759**	**3,683**	**4,545**	**5,568**
Depreciation & amortisations	100	127	234	163	203	248
Interest Income	(131)	(149)	(209)	(168)	(200)	(228)
Interest expense	720	978	664	1,021	1,209	1,480
Cash flow before WC changes	**2,459**	**3,147**	**3,448**	**4,699**	**5,758**	**7,070**
WC changes	**(2,523)**	**(3,381)**	**(2,460)**	**(2,048)**	**(4,727)**	**(5,491)**
Cash flow from operations	**(64)**	**(234)**	**988**	**2,651**	**1,031**	**1,579**
Capex	**(341)**	**(297)**	**(252)**	**(441)**	**(499)**	**(477)**
FCF	**(406)**	**(531)**	**736**	**2,210**	**533**	**1,102**
Interest/dividend received	131	149	209	168	200	228
Cash flow from investing	**(275)**	**(133)**	**(145)**	**(274)**	**(299)**	**(249)**
Long term borrowings	1,827	1,990	1,656	3,235	4,101	5,550
Interest paid	(720)	(978)	(664)	(1,021)	(1,209)	(1,480)
Dividends paid (incl. tax)	(228)	(319)	(367)	(452)	(551)	(831)
Cash flow from financing	**879**	**693**	**625**	**1,762**	**2,340**	**3,238**
Net change in cash	**540**	**326**	**1,468**	**4,139**	**3,072**	**4,568**

Ratios	2008A	2009A	2010A	2011E	2012E	2013E
Year on year growth						
Net income	20%	17%	9%	18%	18%	17%
EBITDA growth	28%	28%	10%	36%	23%	23%
EBIT growth	31%	28%	6%	41%	22%	23%
EPS growth	34%	17%	15%	23%	22%	21%
Margins						
EBITDA margin	2.3%	2.5%	2.5%	2.9%	3.0%	3.2%
EBIT margin	2.2%	2.4%	2.3%	2.8%	2.9%	3.1%
Net margin	1.3%	1.3%	1.3%	1.4%	1.4%	1.5%
Returns						
ROCE	32.8%	27.0%	23.6%	28.6%	26.1%	25.2%
ROE	20.2%	18.5%	17.7%	19.4%	20.2%	20.8%
ROE (EX cash)	22.4%	25.5%	31.4%	32.5%	30.8%	29.4%
ROIC	14.5%	14.9%	14.0%	14.6%	14.0%	13.3%
Equity value						
P/E	21.3	18.2	15.8	12.8	10.5	8.7
Enterprise value						
EV/Sales	0.3	0.3	0.3	0.2	0.2	0.2
EV/EBITDA	14.1	11.0	10.1	7.4	6.0	4.9
EV/EBIT	14.7	11.5	10.8	7.6	6.2	5.1

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The relevant sector index is the DJ Stoxx sector subgroup which includes the subject company.

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