

i-flex solutions

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,680	IFLEX IN
	REUTERS CODE
S&P CNX: 3,131	IFLX.BO

28 July 2006

Buy
Previous Recommendation: Buy
Rs1,319

Equity Shares (m)	76.5
52-Week Range (Rs)	1,475/750
1,6,12 Rel. Perf. (%)	19/6/15
M.Cap. (Rs b)	100.9
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	45.9	7.4	17.6	21.8	6.2	31.1
3/07E	20,064	3,289	43.0	49.6	30.7	6.2	22.0	27.0	4.5	20.9
3/08E	25,851	4,304	56.3	30.8	23.4	5.1	23.9	29.3	3.5	15.8

- i-flex reported revenue decline of 11% QoQ to Rs4.08b, against our estimate of Rs4.14b. Product revenue declined 23.6% QoQ, with license fees dropping by 52.4%. Implementation revenue grew 3% QoQ while AMC revenue grew 11.6% QoQ.
- Services revenue grew 4.9% QoQ, driven by Top 10 customers (nonciti), which grew 14.5% QoQ versus 3.6% growth in Citi. KPO revenues grew 36.6% during the quarter to Rs92m, as against expectation of Rs73m.
- The company added 243 (net) employees during the quarter, including 163 in the products business and 74 in KPO. The employee base in services saw a decline of 45.
- EBITDA margin declined to 11.2% in 3QFY06 as compared with 28.7% in 4QFY06, due to higher-than-expected salary hikes. SG&A expenses increased 330bp during the quarter.
- Other income at Rs200m was higher than our expectations of Rs84m. Net profit declined by 64.5% QoQ to Rs415m, against our expectation of Rs592m due to higher-than-expected fall in margins.
- We expect i-flex to report revenue growth of 35.2% and 28.8% and profit growth of 50.2% and 30.8% in FY07E and FY08E respectively. On our revised EPS estimate of Rs56.3 in FY08E, the stock trades at a PE of 23.4x. Maintain **Buy** with a target price of Rs1,440 considering expected outperformance in the product business in future considering higher traction through Oracle and resulting robust performance beyond FY08.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07E				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Revenues	2,701	3,593	3,965	4,577	4,075	4,571	5,387	6,030	14,835	20,064
Q-o-Q Change (%)	-22.5	33.1	10.3	15.4	-11.0	12.2	17.9	11.9	30.1	35.2
Direct Expenses	1,743	2,074	2,051	2,279	2,605	2,687	2,855	3,051	8,148	11,199
Sales, General & Admin. Expenses	822	968	963	985	1,012	1,019	1,199	1,349	3,738	4,579
Operating Profit	135	551	950	1,313	458	866	1,333	1,630	2,950	4,286
Margins (%)	5.0	15.3	24.0	28.7	11.2	18.9	24.7	27.0	19.9	21.4
Other Income	70	115	-12	105	200	100	75	79	277	454
Depreciation	113	113	127	152	160	166	181	201	505	708
Share of Associate Company Loss	3	-2	-3	-1	-2	-1	-2	-1	-3	-6
PBT	90	555	814	1,267	500	801	1,229	1,508	2,726	4,038
Provision for Tax	31	151	255	98	85	150	230	283	535	749
Rate (%)	34.5	27.2	31.4	7.8	17.1	18.8	18.8	18.8	19.6	18.5
PAT	59	404	559	1,169	415	651	998	1,226	2,190	3,289
Q-o-Q Change (%)	-92.8	589.0	38.3	109.3	-64.5	57.0	53.4	22.8	7.8	50.2

E: M0St Estimates

Note: In the interest of timeliness, this report has not been edited.

Seasonal slump in tank, license fee bookings declining as well

Product revenue declined 23.6% QoQ growth, with license fee dropping by 52.4% QoQ to 31.2% of product revenue from 50% in the previous quarter. Implementation revenue grew 3% QoQ while AMC revenue grew 11.6% QoQ.

PRODUCT REVENUE (RS M)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
License Fees (%)	22.1	28.0	30.0	50.0	31.2
License Fees (Rs M)	252	482	626	1,309	624
QoQ Growth %	-69.1	91.1	30	109	-52.4
Implementation Fees (%)	49.0	51.0	53.0	37.0	50.0
Implementation Fees (Rs M)	560	878	1,107	969	1,000
QoQ Growth %	-17.4	56.7	26.1	-12.4	3.2
AMC (%)	29.0	21.0	17.0	13.0	19.0
AMC (Rs M)	331	361	355	340	380
QoQ Growth %	0.5	9.0	-1.8	-4.1	11.6

Source: Company/ Motilal Oswal Securities

Product revenues from Europe and the US declined 22% and 6.2% QoQ due to a sharp decline in license fees. Contribution to revenues from Europe, however, grew to 39% from 32% in the previous quarter, while contribution from US stayed flat, indicating consistent traction from developed economies. Revenue contribution from Asia Pacific declined from 20% in 4QFY06 to 14% in 1QFY07.

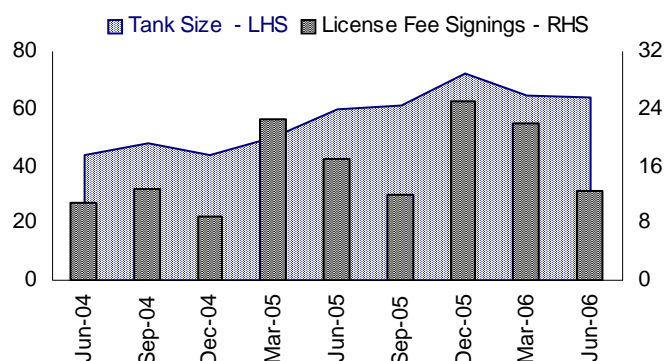
PRODUCT REVENUE BY GEOGRAPHY (RS M)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
USA	270	430	585	576	449
% change QoQ	-20.9	59.2	35.9	-1.5	-22.0
Middle East and Africa	346	361	334	655	465
% change QoQ	-29.1	4.6	-7.6	96.0	-29.0
Asia Pacific	234	344	292	524	277
% change QoQ	-39.6	46.9	-15.1	79.2	-47.1
Europe	271	534	856	838	786
% change QoQ	-53.8	96.8	60.5	-2.1	-6.2
Latin America & Caribbean	22	52	21	0	23

Source: Company/ Motilal Oswal Securities

The tank size at the end of 1QFY07 declined to US\$64m from a historical high of US\$72.5m in 3QFY06. License fee bookings also declined to US\$13.6m from an alltime high of US\$29.5m in the previous quarter.

MOVEMENT IN TANK SIZE (US\$ M)



Source: Company/ Motilal Oswal Securities

Absence of milestone revenue results in slower services growth

Services revenue grew 4.9% QoQ, slower than industry average growth rates seen during the quarter. This was due to lack of milestone payments during the quarter which resulted in the proportion of revenue from fixed price contracts declining sharply to 9% of services revenue from 14% in 4QFY06. This indicates that services revenues growth could be robust in coming quarters on the back of milestone achievement. The management has stated that billing rates saw an increase during the quarter.

SERVICE REVENUES (RS M)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Service Revenues (Rs M)	1,509	1,825	1805.1	1890.8	1983.7
% change QoQ	-5.9	20.9	-1.1	4.7	4.9

Source: Company/ Motilal Oswal Securities

The employee base in services declined to 3,533 from 3,578 in 4QFY06. Attrition, however, remained stable at 17% during the quarter.

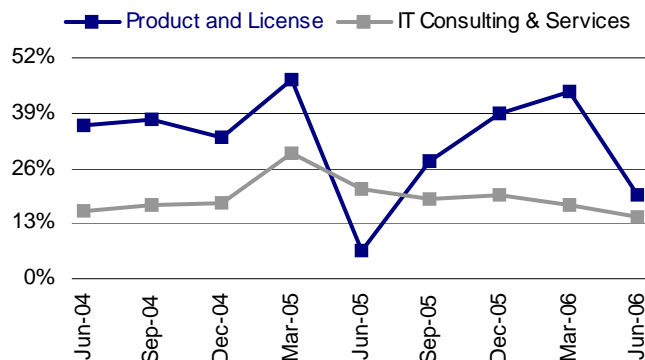
KPO (Equinox) revenue grew 36.6% QoQ to Rs92m during the quarter. Equinox was selected in the leadership category of the Global Outsourcing 100 by the International Association of Outsourcing Professionals.

Higher-than-industry salary hikes, ESOP charges impact margins

The company offered salary hikes of 15%-20% during the quarter, along with variable incentives being offered to key employees in the products business. Gross margins declined to 36.1% from 50.2% in 4QFY06. In addition, the company

assimilated an ESOP charge of Rs20m during the quarter, which also impacted margins. SG&A expenses also increased by 330bp during the quarter.

SHARP DECLINE IN PRODUCT MARGINS IMPACTS OVERALL MARGINS



Source: Company/ Motilal Oswal Securities

Product EBITDA margins declined to 14.9% during the quarter from 43.9% in 4QFY06 due to the impact of reduction in license fees and salary hikes. Services margins declined by a lower rate to 14.7% from 17.3% in the previous quarter. Operating loss in KPO declined significantly during the quarter to Rs5m from Rs26m loss in the previous quarter.

Forex gains, higher interest income arrest sharper fall in profits

i-flex had forex gains of Rs94m during the quarter. Interest income also increased to Rs105m due to rising interest rates. Other income, consequently, was up to Rs 200m, much higher than our estimate of Rs84m. Net profit declined by 64.5% QoQ to Rs415m, against our expectation of Rs 592m due to higher-than-expected fall in margins.

Outlook and view

While both tank size and license fee bookings have declined during the quarter, deal wins continued to be robust during the quarter. FLEXCUBE won 11 new clients, while Reveleus signed 3 deals during the quarter. The management has clarified that in certain Tier I deals, the master agreement would cover a certain number of countries for rollout but the license fees would be added to the tank only upon

confirmation from each country. We expect that this would result in higher additions to tank size as the year progresses considering i-flex's increasing involvement in Tier I banks both in USA and Europe.

The replacement market for core banking solutions is gaining momentum in developed markets such as US and Europe. i-flex is also gaining traction in newer markets such as China and Japan. With the deadlines for Basel II implementation approaching, Reveleus is also expected to gain greater traction. With the market for risk solutions expected to touch +US\$20b in CY2008, we expect sales for Reveleus to pick up over the coming quarters.

Additionally, the re-seller agreements with Oracle are expected to start kicking in towards the end of the year. We expect this to result in a significant upside to deal wins for both FLEXCUBE and Reveleus in the coming quarters, which would result in faster growth for the products business.

While services revenue has been growing slower than industry over the past few quarters, the company is confident of achieving industry average growth rates. This is due to expected traction from Tier I banks, where the company has made significant inroads. Equinox (the KPO arm of i-flex) reported strong operational performance during the quarter. Equinox is expected to achieve cash breakeven during FY07, which would improve overall margins, albeit marginally.

We expect i-flex to report revenue growth of 35.2% and 28.8% and profit growth of 50.2% and 30.8% in FY07E and FY08E respectively. Considering higher-than-expected salary hikes, we have revised our EPS estimates downward by 5% for FY07 to Rs43 (earlier Rs45.5) and by 2% for FY08E to Rs56.3 (from earlier Rs57.6). On our revised EPS estimate of Rs56.3 in FY08E, the stock trades at a P/E of 23.4x. **Maintain Buy** with a target price of Rs1,440 considering expected out performance in the product business in future due to higher traction through Oracle and resulting consistent robust performance beyond FY08.

i-flex solutions: an investment profile

Company description

i-flex solutions, the 7th largest software exporter according to Nasscom's 2006 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 280 financial institutions and its footprint spreads across 200 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 wins deal with Tier I bank in North America

Valuation and view

- 32% CAGR in revenue and 40% CAGR in earnings over FY06-08.
- We maintain **Buy** with a price target of Rs1,440, an upside of 9.2% 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	30.7	15.0	14.4
	FY08E	23.4	11.4	11.0
P/BV (x)	FY07E	6.2	2.3	4.3
	FY08E	5.1	2.0	3.2
EV/Sales (x)	FY07E	4.5	1.6	1.8
	FY08E	3.5	1.2	1.3
EV/EBITDA (x)	FY07E	20.9	9.8	8.6
	FY08E	15.8	7.3	6.1

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

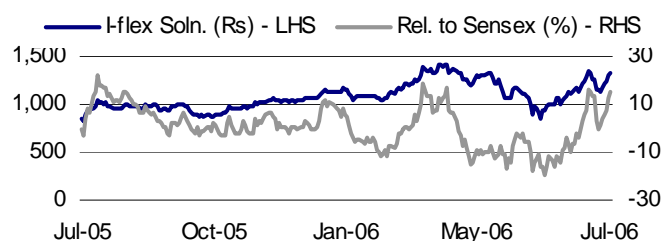
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	43.0	41.4	3.9
FY08	56.3	52.4	7.4

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,319	1,440	9.2	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Sales	8,054	11,404	14,835	20,064	25,851
Change (%)	25.7	416	30.1	35.2	28.8
Cost of Goods Sold	3,656	5,948	8,148	11,199	14,632
Selling Expenses	1,157	1,529	2,038	2,460	3,070
G&A Expenses	996	1,157	1,700	2,119	2,489
EBITDA	2,244	2,770	2,950	4,286	5,660
% of Net Sales	27.9	24.3	19.9	21.4	21.9
Depreciation	147	337	505	708	902
Other Income	125	227	277	454	517
Share of (Losses)/ Profits of Associate Companies	-3	-1	3	6	6
PBT	2,219	2,658	2,726	4,038	5,281
Tax	515	627	535	749	977
Rate (%)	23.2	23.6	19.6	18.5	18.5
PAT	1,704	2,031	2,190	3,289	4,304
EO Item (net)	0	0	0	0	0
Net Income	1,704	2,031	2,190	3,289	4,304
Change (%)	-3.8	19.2	7.8	50.2	30.8

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	374	374	381	382	382
Reserves	8,565	10,923	13,241	15,909	19,379
Networth	8,938	11,298	13,623	16,291	19,762
Loans	23	22	20	20	20
Capital Employed	8,961	11,320	13,642	16,311	19,781
Gross Block	1,972	2,469	3,863	5,113	6,213
Less : Depreciation	847	1,184	1,689	2,397	3,299
Net Block	1,125	1,285	2,174	2,716	2,914
CWIP	17	970	893	803	703
Investments	380	66	59	199	249
Curr. Assets	9,014	11,605	14,639	17,627	22,115
Debtors	2,446	3,822	5,552	6,322	7,791
Cash & Bank Balance	5,662	6,631	6,864	8,845	11,592
Loans & Advances	559	454	798	1,000	1,250
Other Current Assets	347	698	1,425	1,460	1,482
Current Liab. & Prov	1,575	2,607	4,123	5,033	6,200
Creditors	140	128	140	250	250
Other liabilities	1,410	2,398	3,915	4,698	5,850
Provisions	24	80	69	85	100
Net Current Assets	7,439	8,998	10,516	12,593	15,915
Application of Funds	8,961	11,320	13,642	16,311	19,781

E: M O S t Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	22.8	27.2	28.7	43.0	56.3
Cash EPS	24.8	31.7	35.4	52.3	68.1
Book Value	117.3	148.3	178.8	213.0	258.4
DPS	3.5	4.2	5.0	7.5	9.8
Payout %(Incl.Div.Taxes)	3.5	4.2	5.0	7.5	9.8
Valuation (x)					
P/E		48.6	45.9	30.7	23.4
Cash PE		41.7	37.3	25.2	19.4
EV/EBITDA		33.2	31.1	20.9	15.8
EV/Sales		8.1	6.2	4.5	3.5
Price/Book Value		8.9	7.4	6.2	5.1
Profitability Ratios (%)					
RoE	20.5	20.1	17.6	22.0	23.9
RoCE	26.7	26.2	21.8	27.0	29.3
Turnover Ratios					
Debtors (Days)		111	112	117	115
Asset Turnover (x)		4.1	4.6	3.8	3.9
Leverage Ratio					
Debt/Equity Ratio (x)		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	2,438	2,695	3,997	5,206
Cash for Working Capital	756	607	1,335	139	652
Net Operating CF	1,046	1,832	1,360	3,859	4,554
Net Purchase of FA	-800	-1,450	-1,316	-1,160	-1,000
Net Purchase of Invest.	-123	419	7	-140	-50
Net Cash from Inv.	-923	-1,031	-1,309	-1,300	-1,050
Proc. from Share Issue	30	411	564	1	0
Proceeds from LTB/STB	11	-1	-2	-4	-3
Dividend Payments	-262	-242	-380	-576	-753
Net CF from Finan.	-221	168	182	-578	-756
Free Cash Flow	246	381	44	2,699	3,554
Net Cash Flow	-97	969	233	1,981	2,748
Open. Cash Balance	5,759	5,662	6,631	6,864	8,845
Add: Net Cash	-97	969	233	1,981	2,748
Close Cash Balance	5,662	6,631	6,864	8,845	11,593



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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 |
| 4. Investment Banking relationship with company covered | No |

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