

Company Flash

18 January 2008 | 8 pages

KPIT Cummins Infosystems (KPIT.BO)

Buy: Weak Results; Management Remains Confident

- Weak 3Q08 quarter** — Company reported revenue of Rs1.51b (exp: Rs1.55b), – up 1.3% QoQ and 29% YoY; in US\$ terms, revenue was US\$37m – up 4.3% QoQ and 42% YoY. While net profit at Rs141m was also below expectation (Rs144m). This makes full year guidance challenging for the company.
- Management expects to meet guidance, our estimates significantly below** — Management expects to meet revenue guidance comfortably (US\$145-148m) while for net profits, company hopes to meet lower end of guidance (Rs630m). In worst case of INR appreciating further to Rs38/USD, company expects to make profit of at least Rs.610m. Our estimate for FY08 was already at Rs557m.
- Pricing leverage expected to kick-in from 4Q** — Management indicated that average realization should increase by 4% QoQ in 4Q as they have got new contracts at 12-15% higher price points and have renegotiated seven key clients for similar hikes (effective 1st Jan-08).
- Low BFSI exposure; ATS show strong traction** — KPIT gets just 7% of its revenue from BFSI sector where most of the investor concerns are centered. Also, ATS (auto-electronics and semiconductor) continue to show strong traction – revenue from this segment has grown over 100% YoY during 9M08.
- Environment Challenging; Tier1 better placed** — Investor concerns continue to be on the slowing US economy and the impact on demand for IT services. We continue to believe that Tier 1s are better placed. Amongst mid-caps, we like Mphasis and Patni over others primarily because of EDS relationship and inexpensive valuations respectively.

Buy/Medium Risk	1M
Price (18 Jan 08)	Rs107.95
Target price	Rs130.00
Expected share price return	20.4%
Expected dividend yield	0.5%
Expected total return	20.9%
Market Cap	Rs8,402M
	US\$214M

Price Performance (RIC: KPIT.BO, BB: NKPIT IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	326	3.66	7.0	29.5	5.5	26.3	0.3
2007A	505	5.47	49.5	19.7	4.1	29.6	0.3
2008E	557	7.01	28.3	15.4	3.1	23.9	0.5
2009E	745	9.28	32.3	11.6	2.5	24.7	0.7
2010E	834	10.40	12.0	10.4	2.0	22.3	0.7

Source: Powered by dataCentral

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Figure 1. KPIT Cummins Infosystems – Key Financial

Rs m	3Q07	2Q08	3Q08	QoQ	YoY
Revenue (US\$ m)	26	36	37	4.3%	42.1%
Revenue	1,171	1,492	1,512	1.3%	29.1%
Cost of revenue	734	940	923	-1.8%	25.7%
Gross profit	437	553	589	6.6%	34.8%
Gross margin	37.3%	37.0%	39.0%	193bp	166bp
Operating expenses	258	318	351	10.5%	35.9%
EBITDA	178	235	238	1.3%	33.3%
EBITDA margin	15.2%	15.7%	15.7%	0bp	49bp
Depreciation and amortization	30	57	59	2.7%	93.6%
EBIT	148	178	179	0.8%	20.9%
EBIT margin	12.6%	11.9%	11.8%	-6bp	-80bp
Interest expenses	9	19	20	4.9%	110.4%
Other income	1	0	4	n.a.	n.a.
Profit before tax	140	159	163	2.6%	17.0%
Income tax expense	4	18	22	20.9%	407.0%
Income from operations	135	141	141	0.2%	4.3%
Minority interest	-2	0	0	n.a.	n.a.
Reported profit	137	141	141	0.4%	3.0%
EPS - basic	1.84	1.84	1.83	-0.5%	-0.7%
EPS - fully diluted	1.49	1.79	1.78	-0.6%	19.5%

Source: Company Reports

Figure 2. KPIT Cummins Infosystems – Key HR metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08
Total staff	2,544	2,809	3,119	3,256	3,601	3,939	4,152
- net add	422	265	310	137	345	338	213
Delivery staff	2,306	2,529	2,787	2,900	3,256	3,561	3,764
- net add	400	223	258	113	356	305	203
Support	208	249	298	318	306	334	334
Sales	30	31	34	38	39	44	44
Utilization rate							
- onsite	92.0%	93.0%	89.0%	87.0%	89.0%	93.7%	90.3%
- offshore	71.0%	72.0%	69.8%	68.0%	67.0%	70.5%	70.1%

Source: Company Reports

Figure 3. KPIT Cummins Infosystems – Revenue Mix

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08
Geography wise							
USA	64.8%	62.4%	62.3%	58.8%	57.7%	56.6%	54.5%
Europe	28.9%	28.7%	29.5%	29.7%	30.6%	32.5%	33.1%
Rest of world	6.4%	8.9%	8.3%	11.6%	11.8%	10.9%	12.4%
Vertical wise							
Manufacturing	77.3%	76.3%	77.5%	78.0%	78.4%	82.5%	82.5%
BFSI	8.7%	10.8%	10.6%	10.4%	9.7%	8.4%	8.4%
Others	14.0%	12.9%	11.9%	11.5%	12.0%	9.2%	9.1%
Contract type							
Time and material	90%	90%	91%	91%	90%	88%	86%
Fixed price	10%	10%	9%	9%	10%	12%	14%

Source: Company Reports

Figure 4. KPIT Cummins Infosystems – Key Client metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08
Clients added (organically)	5	5	4	4	7	5	4
Total clients	77	82	86	90	97	102	106
Total star clients (inc. Cummins)	10	13	15	17	18	21	23
Client concentration							
Top Client – Cummins	44.3%	42.0%	40.0%	37.5%	39.0%	39.1%	38.0%
Star Customers - Non Cummins	31.3%	35.7%	41.8%	43.0%	45.4%	41.5%	44.6%
Top 10 Client Billing	79.5%	76.3%	75.8%	74.2%	74.8%	72.3%	70.8%

Source: Company Reports

Figure 5. Indian IT services – Valuation comparison table

Company Name	RIC Code	CIR Rating	Mkt cap (US\$m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		EV/Sales(x)	
						FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
TCS	TCS.BO	1L	22,595	904	1,290	17.2	14.7	13.9	11.8	3.7	3.0
Infosys	INFY.BO	1L	21,354	1,464	2,190	18.1	15.2	15.0	12.0	4.7	3.8
Wipro	WIPR.BO	1L	16,973	455	565	20.0	16.1	15.3	11.6	3.1	2.4
Satyam	SATY.BO	1M	6,370	373	565	15.1	12.5	11.9	9.7	2.6	2.0
HCL Tech	HCLT.BO	1M	4,511	266	365	14.7	12.5	10.3	8.4	2.1	1.7
I-Flex	IFLX.BO	3M	2,960	1,384	1,570	36.4	23.8	24.2	15.8	4.3	3.3
Tech Mahindra	TEML.BO	3H	2,808	906	1,330	15.4	11.6	13.6	9.7	2.9	2.2
Mphasis	MBFL.BO	1M	1,453	273	360	22.2	15.1	12.4	9.2	2.2	1.5
Patni*	PTNI.BO	1H	924	260	475	7.9	7.7	4.1	4.2	0.9	0.8
MindTree	MINT.BO	3H	419	433	487	17.1	13.1	13.5	10.3	2.1	1.6
Hexaware*	HEXT.BO	1M	278	76	122	9.6	8.1	5.7	4.7	0.7	0.6
KPIT	KPIT.BO	1M	214	108	130	15.4	11.6	9.7	7.6	1.5	1.1
Sasken	SKCT.BO	3H	201	276	333	16.4	12.2	15.3	10.3	1.5	1.2

Source: Citi Investment Research; *Using CY07E and CY08E for these companies (31-Dec year-ending).

KPIT Cummins Infosystems

Company description

KPIT Cummins Infosystems is a mid-tier IT services provider focused on two verticals: manufacturing services and BFSI (banking, financial services and insurance). Within these two verticals, the company is focused on a few key customers. Among service lines, in addition to regular application development and maintenance services, KPIT Cummins offers VLSI and embedded software services, package implementation, business intelligence, and BPO services. The company has close to 4,000 employees working for over 100 clients.

Investment strategy

We rate KPIT Cummins as Buy/Medium Risk (1M). With offshoring becoming mainstream, clients are increasingly using offshore for newer service areas like product engineering, embedded software, and engineering design services. KPIT Cummins has a head-start in the fast-growing embedded software and VLSI design services due to its Cummins and Renesas relationships. With client access to 7 of the top 10 auto OEMs and 13 leading tier 1 & 2 auto suppliers and five of top 10 semiconductor manufacturers, KPIT Cummins could become one of the top offshore vendors in auto electronics and semiconductor design - leading to 35% revenue and 36% earnings CAGRs over FY06-09E.

Valuation

Our 12-month target price is Rs130 based on 14x our FY09E EPS. Our target multiple is derived by applying a ~25% discount to our target multiple for peer Satyam. We apply this discount as Satyam is a large and diversified company while KPIT is a niche-focused mid-tier IT player. We believe 14x is a fair multiple given the strong growth that we expect from KPIT over the next three years. Our target multiple is also supported by an historical valuation range of 10-20x forward earnings (average 15x) for the KPIT stock over the past three years. We believe a P/E-based valuation is most appropriate given KPIT's profitable track record and widespread investor use of this metric.

Risks

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Appendix A-1

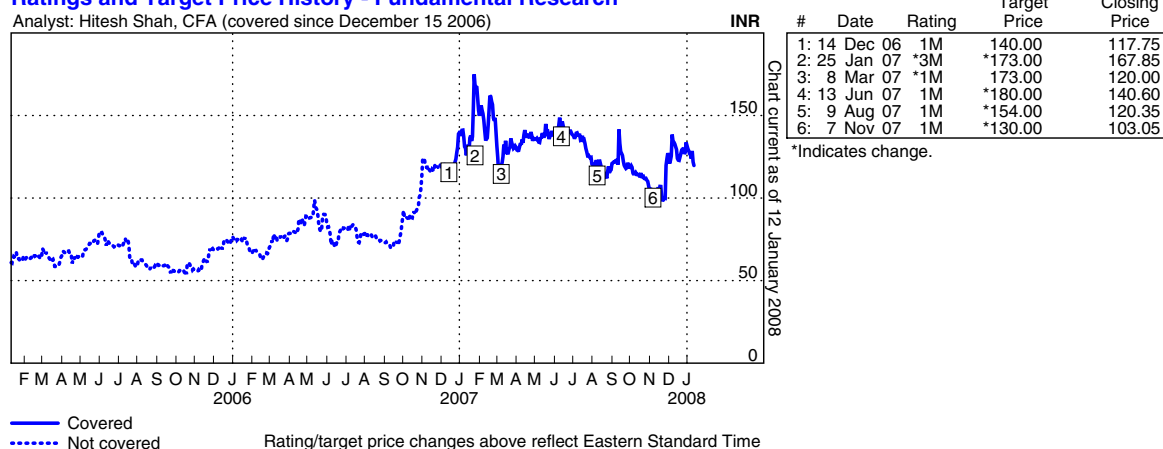
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Analyst: Hitesh Shah, CFA (covered since December 15 2006)



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KPIT Cummins Infosystems (KPIT.BO)

18 January 2008

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