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December 12, 2006

Nucleus Software Exports

Emerging Star

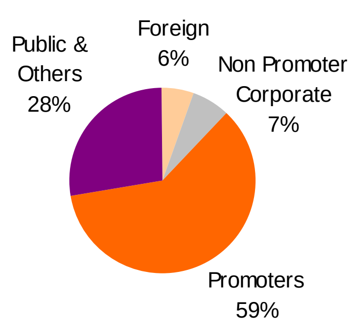
Product play

Buy; CMP: Rs497

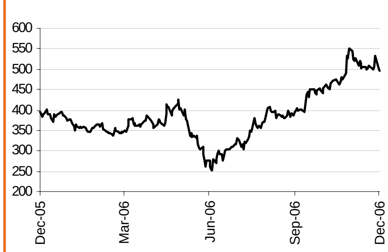
Company details

Price target:	Rs680
Market cap:	Rs801 cr
52 week high/low:	Rs575/245
NSE volume: (No of shares)	17,726
BSE code:	531209
NSE code:	NUCLEUS
Sharekhan code:	NUCSEX
Free float: (No of shares)	0.64 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-8.8	29.7	84.7	27.3
Relative to Sensex	-9.6	11.7	34.1	-15.1

Key points

- **Niche player with established presence:** Nucleus Software Exports Ltd (NSEL) is a niche player offering software products and services to companies in the banking and financial service space. It has established itself globally with product installation base of over 250 application modules in more than 30 countries.
- **Product business drives growth:** The product business grew exponentially in FY2006, on the back of some impressive order wins like the $12-million multi-year deal with GMAC. Apart from this, it added 21 new clients and bagged orders for 38 new installations in FY2006. In the first half of FY2007 also, the company added 14 new clients and continued to grow its pending order book that stood at Rs135 crore as on September 2006. Consequently, we expect the product revenues to grow at a CAGR of 67% over FY2006-08.
- **Margins are sustainable:** In spite of the cost pressures and the aggressive employee addition targets for this year, the company is likely to sustain its overall profitability. The growing contribution from the high-margin product business is expected to mitigate the adverse impact of the rising wage bill and the expansion-related pressures in the intermediate term.
- **Alliance could throw positive surprises:** The initiatives to forge joint marketing alliances with global technology giants and develop a network of channel partners could result in higher-than-expected order bookings. The partnership model has already started yielding results.
- **Valuation:** Revenues and earnings are estimated to grow at CAGR of 38% and 40% respectively over FY2006-08E. At the current price the stock trades at 11x its FY2008 earnings, which is relatively cheaper compared with the peer companies. We recommend a Buy on NSEL with a one-year price target of Rs680.

Company background

NSEL's flagship product FinnOne is a comprehensive suite of retail banking product and consists of various application modules like loan origination, customer acquisition, recovery management, delinquency and general accounting system.

Key financials

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	20.6	37.0	57.4	72.9
No of shares (cr)	1.6	1.6	1.6	1.6
EPS (Rs)	6.4	23.0	35.7	45.3
% y-o-y change	-	*260.4*	*55.1*	*26.9*
PER (x)	38.9	21.6	13.9	11.0
Price/BV (x)	9.5	7.0	4.9	3.5
EV/EBIDTA(x)	26.2	15.7	10.4	7.9
Dividend yield (%)	0.5	0.7	0.9	1.1
RoCE (%)	30.9	38.0	40.3	37.0
RoNW (%)	24.5	32.3	35.0	32.2

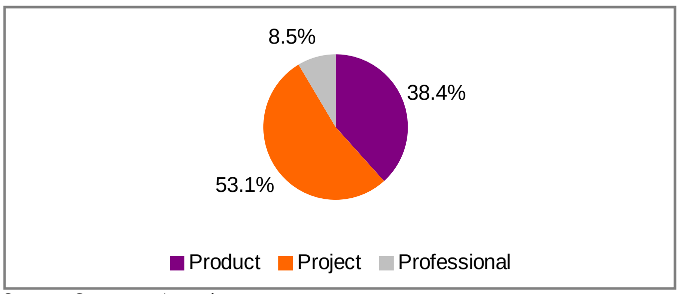
It has been ranked as the eighth highest selling product by the International Banking Systems (IBS; a leading publication house that ranks various banking software product companies in terms of the number of sales of a product globally) for 2005.

The ranking has improved consecutively over the last two years, up from the 15th position in 2003 and the 10th position in 2004. The FinnOne product has the distinction of being one of the leading universal banking solution with 120 customers spanning four continents, including reputed names like GE Capital, Citibank N.A, American Express Bank, Bank of America, BNP Paribas, Standard Chartered Bank, Shinsei Bank, HDFC Bank, Shensei Bank and Tokyo Star Bank amongst others.

The company also has other software products like Cash@Will (cash management), FMS (fraud management), BankOnet (Internet banking), Trade Facto (trade finance) and PowerCARD (credit card system). By the end of FY2006, the company had implemented 250 application modules in 30 countries globally.

In addition to the product business, NSEL offers project-oriented customised application development and maintenance services. Through its wholly-owned subsidiary, Virstra i-Technology, the company operates a dedicated development centre for one of its large clients.

Revenue break-up (FY2006)



Source: Company, Annual report

Investment arguments

GMAC deal provided the initial fillip

After two years of flat growth, the product revenues grew at an exponential rate of 115% to Rs56.8 crore during the fiscal ended March 2006. NSEL got the required fillip after bagging the $12-million multi-year order to roll out loan and collection management module of the FinnOne suite at several locations for General Motors Acceptance Corporation (GMAC, a wholly-owned subsidiary of the General Motors group and one of the world's largest auto finance companies).

NSEL had implemented the FinnOne modules for GMAC in India and several other Asian locations like Taiwan, Indonesia, Thailand and China over a period of four years, 2000-04. The relationship with GMAC was further strengthened by the order in early 2005 to implement modules of FinnOne across various locations in Europe, Latin America and the Asia pacific region. The order is providing steady revenues of around Rs5 crore in each quarter, which is likely to continue over the next six quarters.

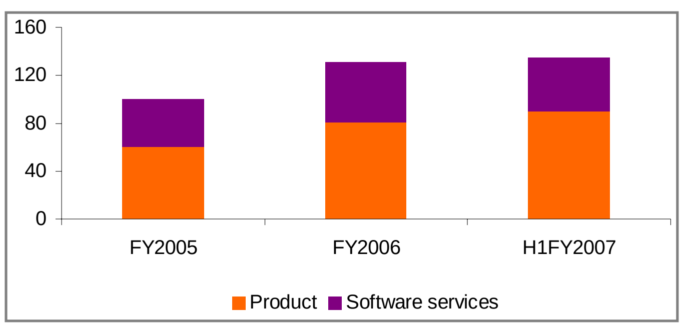
What's more, there is scope to further scale up the relationship with GMAC by penetrating into the other geographies like North America and getting orders to implement the other modules of the FinnOne suite like loan origination, which has been recently implemented at the Chinese operations of GMAC. Moreover, the GMAC deal involving the implementation of its flagship product across several locations would be a strong reference point to bid for business from the other retail lending institutions globally.

Strong order book to drive growth

In addition to the GMAC deal, the company has been able to add around six new clients (on an average) in each of the last six quarters. What's more, many of these clients have been acquired in newer geographies like Australia, Africa and the Middle East (top four banks in the UAE have chosen to implement the lending module of the FinnOne suite). In all, the company has added 35 new clients to implement various modules of FinnOne suite during the past 18 months.

Consequently, the order backlog has grown from around Rs100 crore at the end of March 2005 to Rs131 crore at the end of FY2006. What's more, the same has inched up further to Rs135 crore as on September 2006, in spite of the healthy revenue growth of 53% during the first half of this fiscal. The pending order book in its product business is at a record high level of Rs90 crore (this is excluding the $2.3-million product order booked in October 2006). We expect the revenues from the product business to grow at compounded annual growth rate (CAGR) of 67% over the two-year period FY2006-08.

Order book (Rs crore)



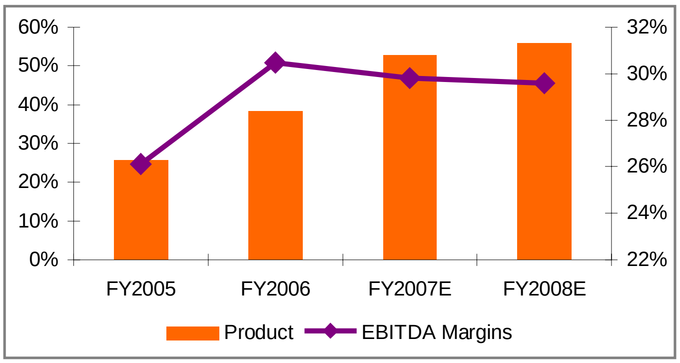
Source: Company, Sharekhan Research

Margins are sustainable

NSEL has shown a dramatic improvement in its profitability during the two-year period FY2004-06. The earnings before interest, tax, depreciation and amortisation (EBITDA) margin has improved from 19% to 30.5% in this period. The improvement in the margin has been driven largely by the growing contribution of the high-margin product business and the savings in the selling, general and administration cost as a percentage of sales.

Going forward, the company is expected to maintain its margins in the narrow range of 28-31%, largely due to the continued increase in the revenue contribution from the relatively faster growing product business. The product business is projected to be growing at a CAGR of 67% over FY2006-08E as compared with the software service business, which is estimated to grow at 17-18% in the same period. As a result, the product business is expected to contribute around 56% of the total revenues in FY2008, up from 38.4% in FY2006.

High-margin product revenues to support its profitability



Source: Company, Annual report

Strategy to form alliances has started yielding results

NSEL has adopted a strategy to form alliances with leading global technology companies to jointly bid for large orders as a consortium partner. Over the past couple of years, it has formed joint marketing alliances with Hewlett Packard (HP), Oracle, IBM, Sun, Intel and Fujitsu. It has attained the highest level of partner status (Principal Partner) with Sun at a global level and has recently received an award from Oracle for its middleware solution.

The strategy has started yielding results with the company bagging an order from a public sector bank in India as part of the consortium team led by HP. NSEL has indicated that the realisations are actually better in such deals due to the brand image and premium pricing commanded by the global technology company leading the consortium. Moreover, the alliances have considerably improved the company's marketing reach.

To further boost its product business, NSEL has also signed agreements with a slew of channel partners in various geographies. The company expects to improve its presence in the developed markets like Europe through the channel partners.

Conservative accounting policy, healthy balance sheet

NSEL follows a conservative accounting policy of expensing the entire expenditure related to research & development of software products in the corresponding quarter itself, unlike some of the other companies that amortise the same over the life of the product.

NSEL is a zero-debt company and had cash & cash equivalents of Rs74.3 crore as on March 2006. It expects to comfortably fund its aggressive capital expenditure plans (planned capital expenditure of Rs25-30 crore in FY2007) to expand its infrastructure through internal accruals. We expect the company to report a healthy return on capital employed of over 40% in the current fiscal.

Investment concerns

High client concentration and a growing dependence on product revenues

The top five clients contributed over 73% of the total turnover in FY2006, which is relatively on the higher side and could result in a pronounced impact on the performance in case the business from even one of the large customers slows down. Moreover, the growing dependence on the product revenues could result in higher volatility in the quarterly performance due to the non-linear nature of the product business.

Rising employee cost

NSEL has a fairly high attrition rate of around 17% in spite of the aggressive correction effected in the salary level during the current fiscal. Moreover, the company has set an aggressive employee addition target in FY2007 (planned increase of 50% in its employee base). The expected increase in the contribution from the high-margin product revenues is likely to support the margins. Moreover, the company is broadening its employee pyramid by aggressively recruiting freshers to support its margins.

Valuation

The consolidated revenues and earnings are estimated to grow at CAGR of 38% and 40% respectively over the two-year period of FY2006-08E. At the current price NSEL trades at 11x its FY2008 earnings; the valuation is relatively cheaper compared with that of the peer companies. We recommend a Buy call on NSEL with a one-year price target of Rs680 (15x FY2008 estimated earnings of Rs45.3 per share).

Financials

Profit and loss account

Rs (cr)

Particulars	FY05	FY06	FY07E	FY08E
Net sales	103.0	148.2	222.4	283.7
Total expenditure	76.1	103.0	156.1	199.8
EBITDA	26.9	45.2	66.2	83.9
Other income	2.6	3.1	6.5	8.4
Depreciation	3.5	4.8	6.8	8.6
PBT	26.0	43.5	66.0	83.8
Tax	5.4	6.5	8.6	10.9
PAT	20.6	37.0	57.4	72.9

Valuation

Particulars	FY05	FY06	FY07E	FY08E
EPS (Rs)	12.8	23.0	35.7	45.3
P/E	38.9	21.6	13.9	11.0
Book value	52.3	71.2	101.8	140.7
Price/BV	9.5	7.0	4.9	3.5
Market cap/Sales	7.8	5.4	3.6	2.8
EV/Sales	7.5	5.1	3.4	2.6
EV/EBIDTA	26.2	15.7	10.4	7.9
Dividend yield (%)	0.5	0.7	0.9	1.1

Balance sheet

Rs (cr)

Particulars	FY05	FY06	FY07E	FY08E
Share capital	16.1	16.1	16.1	16.1
Reserves and surplus	68.0	98.6	147.8	210.6
Networth	84.1	114.7	163.9	226.7
Total debt	0.0	0.0	0.0	0.0
Capital employed	84.1	114.7	163.9	226.7
Net fixed assets	27.7	29.0	40.2	49.6
CWIP	0.7	1.0	2.0	1.0
Investments	48.7	50.0	70.0	98.0
Deferred tax assets	0.2	0.0	0.0	0.0
Net current assets	6.8	34.7	51.7	78.0
Capital deployed	84.1	114.7	163.9	226.7

Key ratios (%)

Particulars	FY05	FY06	FY07E	FY08E
GPM	42.0	45.7	43.8	43.1
OPM	26.1	30.5	29.8	29.6
NPM	20.0	25.0	25.8	25.7
RoCE	30.9	38.0	40.3	37.0
RoNW	24.5	32.3	35.0	32.2

The author doesn't hold any investment in any of the companies mentioned in the article.