Prabhudas Lilladher

Tata Elxsi

Primed for growth

May 26, 2008

Rating	Not Rated
Price	Rs201
Target Price	NA
Implied Upside	NA
Sensex	16,349

(Prices as on May 26, 2008)

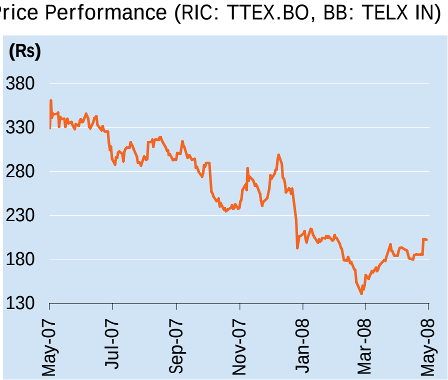
Trading Data	
Market Cap. (Rs bn)	6.3
Shares o/s (m)	31.1
Free Float	56.5%
Avg. Daily Vol ('000)	48.8
Avg. Daily Value (Rs m)	8.8

Major Shareholders	
Promoters	43.5%
Foreign	6.3%
Domestic Inst.	16.0%
Public & Others	34.2%

Stock Performance

(%)	1M	6M	12M
Absolute	9.9	(14.8)	(37.7)
Relative	14.5	0.3	(51.7)

Price Performance (RIC: TTEX.BO, BB: TELX IN)



Source: Bloomberg

- **Core PDS segment expected to drive growth:** Management expects the core business segment Product Design Services (PDS) to act as growth driver going forward. Product Design Services (PDS) which comprises about 65% revenues, involves designing technology products for diverse verticals like Consumer Electronics, Wireless Communication and Automotive Electronics.

  In the last fiscal, currency woes compounded by delays in project ramp-ups had clouded business performance besides eroding margins. Current management commentary points towards strong demand environment and confidence in restoring back lost margins.

- **Low US exposure to provide cover for growth:** The company derives only 30% of its revenues from the US (with UK and Japan contributing a further 30% each). This we believe reduces its risk profile. Its revenue profile also shields it from demand uncertainty and challenging market environment facing IT services sector.

- **Animation & special effects to aid growth:** Over the last few years, the Visual Computing Labs (VLC) segment has not grown to expectations. However, with the imminent release of its first 3-D animation movie project (co-produced by Disney and Yash Raj productions) towards the end of this calendar year, the segment seems to be seeing action. Management indicates it expects more orders from international movie studios upon successful completion of the current movie.

- **Financials and Valuations:** Our first-cut estimates for Tata Elxsi imply a revenue growth of 35% in FY09 with EBITDA margin improvement of at least 150-200 bps. We think the worst is largely behind for the company and at 9.5x FY09E and 6.4x FY10E earnings the stock is attractive.

Key financials (Y/e March)	FY05	FY06	FY07	FY08
Revenue (Rs m)	1,858	2,356	3,080	4,020
Growth (%)	*21.0*	*26.8*	*30.7*	*30.5*
EBITDA (Rs m)	358	467	691	748
PAT (Rs m)	263	343	521	528
EPS (Rs)	8.4	11.0	16.7	17.0
Growth (%)	*49.8*	*30.6*	*51.8*	*1.4*
Net DPS (Rs)	5.5	6.5	7.0	7.0

Source: Company Data; PL Research

Profitability & valuation	FY05	FY06	FY07	FY08
EBITDA margin (%)	*19.3*	*19.8*	*22.4*	*18.6*
RoE (%)	*51.1*	*56.9*	*65.8*	*49.7*
RoCE (%)	*51.2*	*57.1*	*66.0*	*51.0*
EV / sales (x)	3.3	2.6	2.0	1.5
EV / EBITDA (x)	17.1	13.1	8.8	8.1
PE (x)	23.8	18.2	12.0	11.9
P / BV (x)	11.5	9.5	6.8	5.2
Net dividend yield (%)	*2.7*	*3.2*	*3.5*	*3.5*

Source: Company Data; PL Research

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Management representatives:
Mr. Madhukar Dev, CEO & Managing Director
Mr. Vijay Krishnamurthy, CFO

Q: Please provide a brief description of the major operating segments/divisions of TE

A: We have two broad segments viz Systems Integration(SI) division comprising about 15% revenues with the rest coming from the Software Development & Services (SDS) segment.

Q: Please run us through the services rendered by the major segment viz. Software Development & Services (SDS)

A: The SDS segment comprises three major sub segments:

a. Product Design Services (PDS) which comprises 80-85% SDS revenues, involves designing technology products and associated hardware and software (product R&D)

b. Design & Engineering Services (DES) which comprises 8-10% SDS revenues involves industrial design and engineering (ex new auto models ,FMCG cartons etc)

c. Visual Computing Labs (VCL) which comprises 5-10% SDS revenues revolves creation of digital content for entertainment industry (animation & special effects)

Q: What is the forex exposure component in revenues? What is your hedging strategy to mitigate forex risk?

A: Roughly 30% of our revenues are denominated in USD, Yen and European (Euro and GBP) currencies each. The remaining 10% are in INR and other currencies.

We typically hedge 40-50% of receivables expected over next 12 months. We use options extensively thus effectively limiting downside risk and in a position to capture any upsides. Let me also add that we steer clear of exotics and structured products and prefer plain vanilla options.

Q: Kindly elaborate on the growth opportunities in the PDS segment.

A: Product Design Services (PDS) which comprises 80% SDS revenues is our primary segment and is showing good growth. We serve 4 major verticals viz Consumer Electronics, Multimedia, Wireless Communication and Automotive Electronics. In a minor way, we also serve medical electronics and semiconductor industries.

Q: Have you seen any slowdown in projects resulting from a weak macro environment?

A: No, we have not witnessed any slowdown in projects so far. It maybe because we are not directly exposed to BFSI segment. It could also be because we work on projects dealing with future product releases. Such projects are strategic and long term in nature and vital to the clients long term success.

Q: The VCL division seems a unique service offering. Kindly elaborate on its activities and prospects.

A: The VCL division was started some years back. It started with work involving special effects for Hollywood and Bollywood films. We have now acquired the skill sets to assist in production of animation movies. In fact, as we speak, we are in advanced stages of production for an animation movie called Roadside Romeo co-produced by Disney Studios and Yash Raj films. It involves 75 minutes of 3-D animation done exclusively by Tata Elxsi and is scheduled for a Diwali release in India later this year. I am pleased to share with you that Disney Studios is highly impressed with the quality of the work done. In fact, once the film is canned and delivered, we expect more orders from Disney and other international houses. Let me also add that in contrast to global practice wherein the animation developer shares in the revenues of the movie, we have opted for a fixed price contract that limits downside risks even though it also caps upside potential.

Q: SI is one of the oldest segments. Many Indian vendors appear to be bullish on opportunities in domestic markets. How do you view the growth prospects of the segment?

A: It needs to be understood that in Systems Integration (SI), we play in a niche hi-tech segment of the overall SI market unlike other players. We have observed that these niche segments have grown over time but not as much as overall plain vanilla SI market.

Our strategy in this segment is two fold:

a. We are trying to increase the service component in the work we do and also exploring to increase share of annuity based revenues therein

b. We are attempting to build competence in specialised areas like storage systems, news room consultancy in the Indian market which offerings we will thereafter take to the international markets

Q: What is the typical length of a project engagement?

A: Four or five years back, our project cycle time was about 4 months. It has gradually lengthened and is now about 7 odd months. Our longest engagement is about 22 months old with visibility extending to another 15 months down the line. But in general, we deal with small modules or projects lasting 6-7 months at a time.

Q: Such a short project cycle is apt to cause lumpiness in revenue flows. How do you manage to smoothen the flows?

There are two aspects to this:

a. Even if we have signed up a project, we try to time its beginning with the end of some other project to increase capacity utilisation. While this may delay starting time of projects, our clients understand this issue

b. The other thing to bear in mind is while a typical project may extend to say 6 months, as it progresses along, we may bag orders pertaining to newer versions of same product involving feature enhancements etc. So basically, there are regular modules/projects which flow in at frequent intervals thus smoothening out any apparent lumpiness in revenues

Q: We understand that as a policy you don't provide guidance on numbers. But how do you see growth prospects going forward?

A: We expect good growth going forward. We grew over 30% last fiscal and hope to better that this year and expect to improve margins. So far, we haven't seen any adverse fallout of a weakening global economy on our demand environment or deal pipeline. Various estimates peg the embedded engineering market at $40bn currently which is expected to double over the next few years. About 4-5years ago, major MNCs were hesitant to outsource critical engineering design work to India. That mindset has changed now which augurs well for Indian companies like us. Over the next few years we aim to emerge as one of the worlds leading engineering design houses.

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly