

Sasken Communication Technologies

 BSE code: 532663
 NSE code: SASKEN

CMP: Rs 505
Target: Rs 647
BUY

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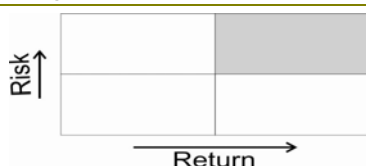
Company data

Particulars	
Market cap (Rs bn / US\$ mn)	14.4 / 351
Outstanding equity shares (mn)	28.5
52-week high/low (Rs)	624 / 241
2-month average daily volume	69,206

Financial snapshot

Particulars	FY07	FY08E	FY09E
Sales (Rs mn)	4,750.8	6,647.9	8,547.6
Growth (%)	54.2	39.9	28.6
Adj net profit (Rs mn)	441.2	777.5	1,198.4
Growth (%)	92.5	76.2	54.1
FDEPS (Rs)	15.8	26.9	40.1
Growth (%)	81.7	70.5	49.2
P/E (x)	32.0	18.8	12.6
RoE (%)	10.9	16.9	22.0

Risk-return profile



Shareholding pattern

(%)	Mar-07	Dec-06
Promoters	26.4	26.8
FIs	19.2	19.9
Banks & FIs	5.1	3.3
Public	49.3	50.0

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Sasken	505	1.9	1.8	1.0
Sensex	14,163	1.7	12.9	4.0
BSE Tech	4,996	2.5	1.4	(3.6)

Sasken Communication Technologies' FY07 Annual Report reiterated the company's resolve to pursue the hybrid business model of offshored R&D services and intellectual property (IP) based products. Though the contribution of products to revenues declined further in FY07, the management is upbeat about the future prospects of its products business. FY07 in particular has been an excellent year in terms of expansion of the order pipeline. Profits from services continued to offset the losses incurred by the products business which is still in investment mode. In FY07, in order to increase its offerings and reach, Sasken acquired iSoftTech and Botnia Hightech. Through the Botnia (now Sasken Finland Oy) acquisition, the company has become one of the top 10 preferred services providers to a global Tier-1 telecommunication company.

Annual Report highlights

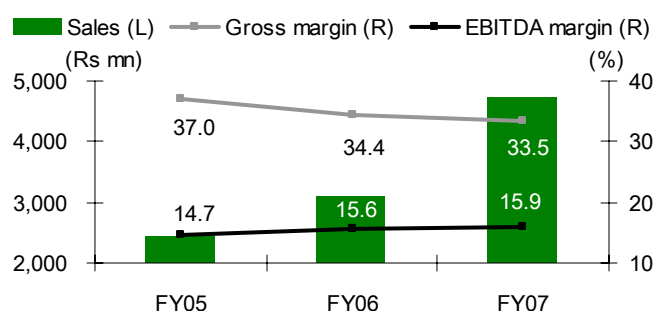
Services touch US\$ 100mn mark

During FY07, the services segment grew by 61% YoY in rupee terms and reached the US\$ 100mn mark, a growth of 58% in dollar terms. The growth was driven by both organic and inorganic efforts. The organic growth in services was at ~36% over FY06. Due to the Botnia acquisition, Sasken was able to expand its services offerings in hardware and mechanical design, RF design and testing apart from obtaining a strategic proximity centre in the telecom belt of Europe.

Products witness increased traction from large handset vendors

Despite a decline in revenue contribution from products to less than 5% in FY07 from ~9% in FY06, the fiscal was witness to global handset vendors signing up for Sasken's products for their mobile phones due to be launched in FY08.

Revenue vs margins



Source: Company, Religare Research

Overall strong financial performance

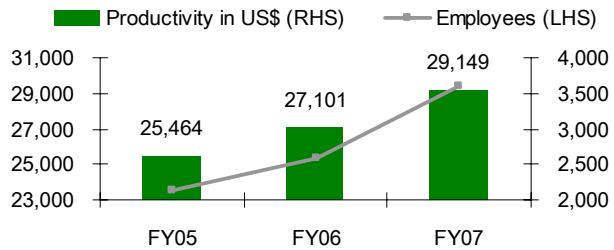
On a consolidated basis, Sasken's revenue and EBITDA grew by 54% and 57% respectively over FY06. Net profit excluding exceptional items grew 49% YoY. The adjusted net profit growth was higher at 93% YoY as the company had an exceptional expense of Rs 67.6mn in FY06. The gross profit margins in FY07 declined by 90bps YoY as the company gave 15% salary hikes to its employees during the year. The EBITDA margin, however, expanded by 25bps due to a strict check on SG&A costs.

7% CAGR improvement in employee productivity over FY05-FY07

Employee productivity on the rise

Sasken's total employee base at the end of FY07 stood at 3,611 employees. The number of employees in the company has grown at a CAGR of 30.5% over FY05-FY07. In comparison, revenues grew at a CAGR of ~40%, from US\$ 54mn in FY05 to US\$ 105mn in FY07. The employee productivity (revenue per employee) has improved consistently over this period despite a de-growth in the products segment, which is usually the high operating leverage business. We believe that employee productivity has further room to witness non-linear growth as the contribution of products in revenues would increase from FY08 onwards.

Employee productivity



Source: Company, Religare Research

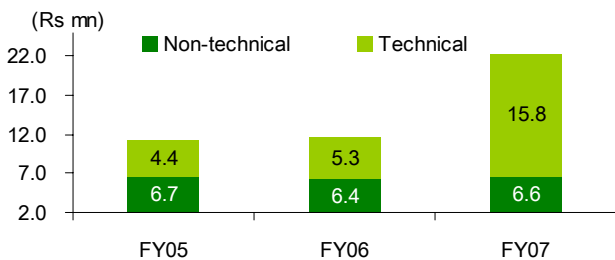
Increased investment in human resources development...

In order to keep abreast with the rapid pace of technological advances, Sasken has been consistently investing in the development of skills and competencies of its employees. In FY07, the company spent Rs 15.8mn on technical competency development, a growth of ~200% over FY06. On an average, Sasken invests ~5% of its net profits in enhancement of skills and knowledge of its employees.

...has resulted decrease in attrition rates

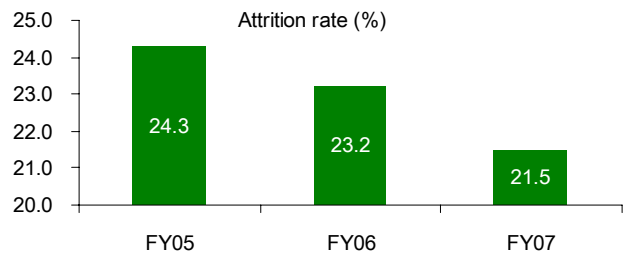
Attrition in middle-level employees has been one of Sasken's key concerns. However, through concerted efforts like remuneration benchmarking and competency enhancement, the company has been successful in slowing down the attrition rate. In our opinion, being a mid-sized IT services company, attrition would remain higher than larger players, though Sasken does have further room to bring it down.

Investment in competency development



Source: Company

Attrition rates



Source: Company

Segmental performance

Services grow stronger; products still in investment mode

Driven by 36% organic growth and the acquisition of Sasken Finland, the services business grew at 61% YoY (including network engineering services). The products business, however, witnessed a decline of 17.4% YoY as the segment is still in the investment phase. The company invested ~Rs 387mn in product development, of which nearly 50% was expensed during the year itself and the rest was capitalised. Due to these investments the profitability in the product segment witnessed a decline.

Segmental performance

(Rs mn)	FY06	FY07	Growth (%)
Revenues			
Software services	2,582.4	4,255.1	64.8
Software products	275.1	227.3	(17.4)
Network Engineering services	223.8	288.8	29.1
Profit			
Software services	874.9	1,492.5	70.6
Software products	(42.4)	(204.6)	(382.4)
Network Engineering services	85.4	95.1	11.3
Profit margin (%)			
Software services	33.9	35.1	-
Software products	(15.4)	(90.0)	-
Network Engineering services	38.2	32.9	-

Source: Company

**Global R&D spend at US\$ 41bn
with only 15-20% offshored**

Management upbeat on offshoring of R&D services...

The management indicates that the headroom for growth in the offshored R&D services industry is still considerable and Sasken would certainly be a beneficiary of the opportunities considering its dominant market position. The estimated global R&D spend by network equipment manufacturers, semiconductors and wireless handset makers is ~US\$ 41bn. Of this, only 15-20% is estimated to be offshored to locations like India. Out of the offshored component, players like Sasken are involved in 40-50% of business, while the rest is handled by the captives of MNCs in India. The management expects the offshored component to grow steadily in the next 2-5 years.

...and also on opportunities in the products business

In 2006, more than 1 billion mobile handsets were shipped by global and marginal players. The market for handsets is expected to grow by 7-10% in 2007 with the introduction of many new handset platforms and chipset technologies during the year. Big players have primarily relied on in-house software capabilities for their mobile phones. However, the trend is now changing as:

- 1) The software content in mobile phones is increasing very rapidly
- 2) Handset vendors are forced to re-look at their strategy and produce as many phone models as possible with more features for customers to choose from
- 3) Time-to-market is decreasing due to increased competition
- 4) Cost pressures are forcing players to consider ready-to-market solutions from third party software providers like Sasken
- 5) The situation is ever more critical for marginal players who have to struggle to maintain their market share for survival

Acceptance of Sasken's products by a leading semiconductor player

Sasken has proved its product capabilities by getting approval from Texas Instruments (TI) regarding compatibility of its products with TI's LoCosto and OMAP platforms. So far only three other players have TI's confirmation regarding their ability to provide an integrated offering on its platforms.

**Approval from TI regarding
compatibility of products with
LoCosto and OMAP platforms**

Other product milestones

- ❖ Sasken's IP was present in over 4% of the phones shipped in 2005 and 7% of phones shipped in 2006, across the world.
- ❖ 8mn phones in the Japanese market carry Sasken multimedia software.
- ❖ Over 50mn phones with Sasken's wireless protocol stack and multimedia solutions have been shipped to date.

Source: Company

Shift in business model to capture growth opportunities

Sasken previously followed a license-fee based revenue model for its product business. However, from FY06 onwards the company has shifted to a royalty-based revenue model in order to capture the growing business opportunities. The table below shows the pipeline of products that would start shipping in FY08.

Sasken product pipeline

	Application Framework	Wireless Protocol Stacks (2.5G)	Wireless Protocol Stacks (3G)	Multimedia Subsystems (3G)
Design-ins	1	5	2	5
Design-wins	-	-	-	4
Tentative schedule for shipments to start	Q3/Q4FY08	Q2FY08	Q2-Q3FY08	Q1-Q2FY08

Source: Company

Other highlights

Mexico subsidiary profitable; exploring opportunities in China

Sasken's Mexico subsidiary has achieved financial break-even in FY07 and currently has more than 60 associates. The subsidiary recorded revenues and net profit of US\$ 2.8mn and US\$ 0.4mn respectively. Sasken has also set up a subsidiary in China to tap the opportunities for products and services in this market. The company has already signed Lenovo as a customer for its product.

Foraying into China; Lenovo signed on as a customer

Increased traction in Tier-1 customers

Sasken now has 3 clients contributing more than US\$ 10mn in annual revenues as compared to 2 clients in FY06. Of these 3 clients, 2 contribute more than US\$ 20mn in annual revenues. Also, the number of active customers with the company has increased to 84 from 60 in FY06.

Client matrix

	FY06	FY07
Less than US\$ 1mn	50	75
Between US\$ 1mn and US\$ 3mn	6	3
Between US\$ 3mn and US\$ 10mn	2	3
Between US\$ 10mn and US\$ 20mn	1	1
Greater than US\$ 20mn	1	2
Total active clients	60	84

Source: Company

Growing Intellectual Property

Sasken has filed 39 patents out of which 15 have been granted so far. During FY07 the US Patent Office granted one more patent to the company. Sasken utilises these IPs in both services as well as products.

Future outlook

We expect Sasken's revenue and net profit to grow at a CAGR of 34% and 64.8% respectively over FY07-FY09. The growth would be driven by a CAGR of 30% and 100% in services and product revenues respectively. With expanding profit margins due to better profitability in products, we expect the FY08 and FY09 EPS to be at Rs 26.9 and Rs 40.1 respectively, a CAGR of 60% over FY07-FY09.

Valuation

SOTP approach

We have valued Sasken using a sum-of-the-parts (SOTP) valuation model, valuing the services and products businesses independently. For services, we have used a comparable universe of other tier-2 Indian IT services players. Sasken's growth and profit margins ratios are comparable to these players and even better in some cases. We value the services business at 13x and 16x FY08 EBITDA and EBIT respectively. The EV for the services business using the average of the two methods is Rs 620/share.

For the product business we have used an EV/Sales multiple of 3x, which we believe is justified considering the product profile and anticipated growth. Using the target multiple we achieve an EV of Rs 48/share for the product business. The FY07 net debt per share is Rs 20. Considering the above SOTP valuation we have a target price of Rs 647 for Sasken.

Buy with a target of Rs 647

At the current price, the stock is trading at 18.9x and 12.6x its FY08E and FY09E earnings of Rs 26.9 and Rs 40.1 respectively. On EV/EBITDA basis the FY08 and FY09 valuation multiples are 10.9x and 7.8x respectively. We maintain our Buy recommendation on the stock with a March 2008 target price of Rs 647.

Services and products contribute Rs 620 and Rs 48 to the EV/share

Maintain Buy with Mar-08 target of Rs 647

Financials

Profit and Loss statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Revenues	3,081.3	4,750.8	6,647.9	8,547.6
Growth (%)	27.4	54.2	39.9	28.6
EBITDA	481.8	755.0	1,376.1	1,916.2
Growth (%)	35.7	56.7	82.3	39.2
Depreciation	179.1	266.4	404.2	449.4
EBIT	302.7	488.5	971.9	1,466.8
Growth (%)	42.0	61.4	98.9	50.9
Interest	1.4	44.7	45.8	45.8
Other income	64.1	98.0	33.7	58.5
EBT	365.4	541.8	959.8	1,479.5
Growth (%)	48.9	48.3	77.1	54.1
Tax	68.6	100.6	182.4	281.1
Effective tax rate	18.8	18.6	19.0	19.0
Adj net income	229.1	441.2	777.5	1,198.4
Growth (%)	0.6	92.5	76.2	54.1
Shares outstanding (mn)	26.4	28.2	29.4	30.2
FDEPS (Rs)	8.7	15.8	26.9	40.1
DPS (Rs)	3.0	4.0	5.0	6.0
CEPS (Rs)	15.4	25.1	40.2	54.6

Source: Company, Religare Research

Cash flow statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Net income	229.1	441.2	777.5	1,198.4
Depreciation	179.1	266.4	404.2	449.4
Other adjustments	(18.7)	-	-	-
Changes in WC	(306.0)	(394.7)	(496.5)	(394.9)
Operating cash flow	83.5	313.0	685.1	1,252.9
Capital expenditure	(471.9)	(466.7)	(505.0)	(680.0)
Investments	(1,799.5)	1,497.0	-	-
Other investing inc/(exp)	-	(2,035.0)	-	-
Investing cash flow	(2,271.5)	(1,004.6)	(505.0)	(680.0)
Free cash flow	(2,188.0)	(691.7)	180.1	572.9
Issue of equity	2,291.5	112.7	130.5	105.0
Issue/repay debt	(3.1)	904.5	-	-
Dividends paid	(57.6)	(128.3)	(165.4)	(203.9)
Others	-	-	-	-
Financing cash flow	2,230.8	889.0	(34.9)	(98.9)
Beg. cash & cash eq	108.7	151.4	348.8	494.0
Chg in cash & cash eq	42.8	197.3	145.2	474.1
Closing cash & cash eq	151.4	348.8	494.0	968.1

Source: Company, Religare Research

Recommendation history

Date	Event	Target (Rs)	Reco
22-May-07	Initiating Coverage	647	Buy
06-Jun-07	Sector Update	647	Buy
18-Jun-07	Company Update	647	Buy

Source: Religare Research

Balance sheet

(Rs mn)	FY06	FY07	FY08E	FY09E
Cash and cash eq	151.4	348.8	494.0	968.1
Accounts receivable	652.9	1,108.2	1,548.1	1,877.1
Inventories	33.5	8.0	-	-
Others current assets	385.3	747.0	1,032.1	1,251.4
Current assets	1,223.1	2,212.0	3,074.1	4,096.6
LT investments	1,865.1	368.1	368.1	368.1
Net fixed assets	1,011.2	2,995.5	3,200.2	3,534.7
CWIP	143.3	339.0	235.2	6.3
Total assets	4,242.7	5,914.6	6,877.6	8,005.7
Payables	266.4	502.1	722.4	876.0
Others	114.6	275.8	275.8	275.8
Current liabilities	381.0	777.9	998.3	1,151.8
LT debt	11.5	916.0	916.0	916.0
Other liabilities	-	3.2	3.2	3.2
Equity capital	279.4	285.0	294.0	302.0
Reserves	3,570.8	3,932.5	4,666.1	5,632.6
Net Worth	3,850.2	4,217.5	4,960.1	5,934.6
Total liabilities	4,242.7	5,914.6	6,877.6	8,005.7
BVPS (Rs)	145.6	149.6	168.7	196.5

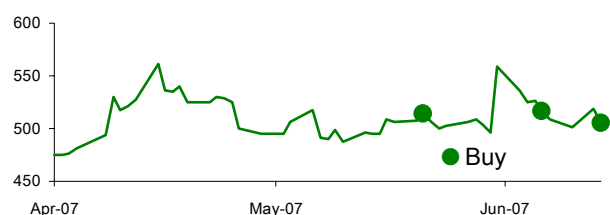
Source: Company, Religare Research

Financial ratios

	FY06	FY07	FY08E	FY09E
EBITDA margin (%)	15.6	15.9	20.7	22.4
EBIT margin (%)	9.8	10.3	14.6	17.2
Net profit margin (%)	7.4	9.3	11.7	14.0
FDEPS growth (%)	(36.1)	81.7	70.5	49.2
Receivables (days)	77.3	85.1	85.0	80.2
Inventory (days)	4.0	0.6	-	-
Payables (days)	31.6	38.6	39.7	37.4
Current ratio (x)	3.2	2.8	3.1	3.6
Interest coverage (x)	213.2	10.9	21.2	32.0
Debt/equity ratio (x)	0.0	0.2	0.2	0.2
ROE (%)	6.0	10.9	16.9	22.0
ROCE (%)	6.0	10.8	14.9	19.5
ROAE (%)	7.1	8.3	14.1	18.3
EV/Sales (x)	4.9	3.1	2.2	1.7
EV/EBITDA (x)	31.0	19.8	10.9	7.8
P/E (x)	58.2	32.0	18.9	12.6
P/BV (x)	3.5	3.4	3.0	2.6
P/CEPS (x)	32.7	20.1	12.6	9.3

Source: Company, Religare Research

Stock performance



Source: Religare Research

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