Global Equity Research - India

Initiating Coverage

18 May 2006

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KARVY STOCK BROKING LIMITED

Sector: IT Services

3i Infotech (Rs195)

Out Performer

Headed for continued strong growth

Target Price: Rs240

We are initiating coverage on 3i with an Out performer rating, since we expect its revenues and profits to grow at a CAGR of 30% and 33% respectively over the next 3 years; primarily aided by a combination of strong product revenue growth, enabling its margins to expand modestly over the same period. For it to sustain the revenue growth at that pace, it has already put in place a fairly well diversified business model, with revenues from products accounting for close to 50% and the balance coming from services - which too is experiencing relatively strong growth. Within the product space it has products for every segment of the BFSI vertical and as well as in the ERP segment for diverse industries. Besides revenues from its anchor client ICICI group accounts for 18% of revenues, this in turn results stability to its revenue model.

Strong order book enhances visibility: At the beginning of FY06, 3i had an order book of Rs1.88bn of which Rs622mn was from products and Rs1257mn was from services. Now at the beginning of FY07, 3i's order book has surged by 41.5% to Rs2.66bn and products and services account equally of the order backlog. Against this backdrop we expect its product and services business to report strong growth numbers over the next few years. The dependence on ICICI group has been seeing a steady decline and the growth going forward would be driven by non-ICICI clients, as the company has added 15 new clients with a run rate of US$1mn and added one more client in US$5mn category. Finally the product business is making in-roads into the US geography and in the insurance product space the company has 7 sites as against one at the end of FY05. In the ERP space the company has more than 20 sites against 3 till FY05. In FY06 against an order book of Rs1.88bn 3i eventually closed the year with revenues of Rs4.2bn and for FY07 we expect 3i to report revenues Rs5.5bn on an order book of Rs2.66bn.

Fairly de-risked revenue model: Unlike other IT companies' who derive most of their revenues from services, 3i derives around 47% of revenues from products and 53% comes from services, thereby it has a good mix of products and services' revenues. Within the product business, it has a well spread product portfolio between the 3 products (insurance, banking and ERP) thereby reducing the risk to the product business as compared to the risks associated with the companies that are catering to a single segment. We believe the company has a decent mix of products and services and the lower dependence on any single product segment has de-risked the business model of the company. Being a late entrant to the business of IT services the company adopted an in-organic approach to grow its business, increase its offerings and to penetrate new markets, and at the same time deriving significant portion of revenues from its parent, which over the years has been coming down.

Valuations look attractive: We recommend the stock as an Out performer, since it is trading at attractive valuations to some of its peers like Polaris and Hexaware, which too in the BFSI and ERP solutions space, however are trading at much expensive valuations and are reporting muted earnings growth. Since the company is adding new products and services to its portfolio - the eventual earnings growth could be higher than what we have projected. Though the debt to equity ratio is quite high for a technology company, the return on equity would see a steady improvement and the quality of receivables are good and it has been provisioning of its doubtful debts. We expect the company to grow its earnings by 33% CAGR and the stock are trading at 13xFY07E and 9.7xFY08E with a MCap/Sales of less than 1.8x.

3i Infotech

		Y/E March (Rs Mn)	FY2005	FY2006E	FY2007E	FY2008E	FY2009E
Reuters/Bloomberg code	TIIN.BO / NA	Revenues	2,892	4,178	5,503	7,127	9,111
Market cap (Rs mn)	9,806	Op profit	481	858	1,156	1,532	2,004
Market cap (US$ mn)	220	Net profit	321	574	759	1,013	1,347
Shares outstanding (mn)	53	Earnings/Share	6.1	10.7	14.3	19.1	25.4
52-week High/Low (Rs)	213/95	EPS growth (%)	372.2	76.5	33.8	33.5	33.0
		EPS (After FCCB Conversion)	5.2	9.2	12.2	16.4	21.7
Major shareholders (%)		Operating margin (%)	16.6	20.5	21.0	21.5	22.0
Promoters	54.0	PER (x)	30.5	17.3	12.9	9.7	7.3
FIIs	3.5	P/BV (x)	16.4	3.1	2.7	2.3	1.8
Banks/MFs	9.5	Price/Sales (x)	3.4	2.3	1.8	1.4	1.1
Public	33.0	EV/EBIDTA (x)	21.0	10.6	8.6	6.9	5.7
		Return on Equity	18.3	20.9	23.3	25.2	26.6

Source: Company & Karvy Estimates

Investment Positives

Strong order book

At the beginning of the last fiscal the order book was Rs1.88bn of which Rs622mn (33% of order book) was from the products and Rs1257mn was from the services. At the beginning of the current fiscal the order book has surged by 41.5% to Rs2.66bn of which products and services account equally of the order backlog. Against this backdrop we expect its product and services business to report strong growth numbers over the next few years. The dependence on ICICI group has been seeing a steady decline and the growth going forward would come from non-ICICI clients, since the company has added 15 new clients (to 17) in the US$1mn run rate category and added one more client with a run rate of US$5mn, thus taking the tally to 2. Finally the product business is making serious in-roads into the US geography and in the insurance product space the company has 7 sites as against one at the end of FY05. In the ERP space 3i has more than 20 sites going as against 3 till FY05. The slew of small acquisitions which it did in FY06 would enable it to strengthen its product and services portfolio further. In FY06 against an order book of Rs1.88bn - the company eventually closed the year with revenues of Rs4.2bn and for FY07 we expect 3i to report revenues Rs5.5bn on an order book of Rs2.66bn.

Headed for continued strong growth

Against this backdrop, we expect 3i revenues and net profit to grow at a CAGR of 30% and 33% respectively over the next few years primarily aided by a combination of strong product revenue growth, in the process enabling its margins to expand modestly over the same period. For it to sustain the growth at that pace, it has already put in place a fairly well diversified business model, with revenue from products accounting for close to 50% of revenues and the balance coming from services, which too is experiencing relatively strong growth. Within the product space it has products for every segment of the BFSI vertical and as well as in the ERP segment. Besides revenues from its anchor client ICICI group accounts for 18% of revenues, this in turn results stability to its revenue model. Over the last few years, it has developed and rolled out number of solutions for the banking, insurance and financial services vertical, besides it has a presence in the ERP segment through its ORION product.

Fairly de-risked revenue model

Unlike other IT companies' who derive most of their revenues from services, 3i derives around 47% of revenues from products and 53% comes from services, thereby has a good balance between products and services. Within the product business, it has a well spread product portfolio between the three products (insurance, banking and ERP) thereby reducing the risk to the product business as compared to the risks associated with the companies that are catering to a single segment. What we believe is the company has a decent mix of products and services and the lower dependence on any single product segment has de-risked the business model of the company. Being a late entrant to the business of IT services the company adopted an in-organic approach to grow its business, increase its offerings and to penetrate new markets, and at the same time deriving significant portion of revenues from its parent, which over the years has been coming down. Post its portfolio re-structuring, the 3i management now believes that its portfolio of products and services are stable and going forward it would keep adding incrementally instead of the aggressive churn that it adopted between FY02 - 04.

Product revenues would maintain the momentum

The product revenues over the last 3 years have gone up by 5.8x to Rs1950mn, with revenues from insurance products accounting for 37% of FY06 product revenues, followed by banking 34%, ERP-29% and capital market account in-significant at this point of time, since it is a latest addition to its product portfolio. In the insurance and ERP space 3i has positioned as a leading player in the Middle East market and is making efforts to penetrate into the African and other developed markets. We expect 3i to nearly double its sales and marketing strength over the next 3 years, which would enable it to increase its order book by 35% YoY resulting in doubling of the order book over the same period. We do not expect any significant change to the "order executed to orders in hand ratio" which we expect would hover around 80% levels. Within the product revenues - license fees would account between 38 - 40% of revenues, implementation fees would hover between 42 - 44% and the balance would come from annual maintenance charges. Since we expect the order book to grow at a decent pace, and the mix tilting towards products we expect the revenues from products to grow by 35% CAGR over the next 3 years mainly through the organic route. We have factored a modest increase in the revenue/license from Rs3.8mn in FY06 to Rs4.1mn by FY09.

Insurance vertical would be the pile driver of growth

In the insurance product segment, we don't foresee 3i to encounter any serious competition as there is no single large player in the insurance product space, though there are some niche players globally. Since the market for insurance products are large, 3i is looking at the global markets by not only selling the shrink wrap product but also customizing to the clients requirements. This is obvious from the fact that its products have been installed in US, Middle East, Africa and of course in the domestic market as well. The insurance product has been sold to some of the best insurance companies like AIG, Liberty Mutual, and in the domestic market it has managed to sell it to Oriental Insurance.

In the banking product space 3i has sold products (which offer different functionalities) in more than 30 countries and carry out most of the banking requirements with a wide range of products in retail, consumer, corporate and investment banking spaces, by offering modules like treasury, risk management and core banking solutions. Going forward 3i is looking at the emerging markets in a big way by focusing on the retail and consumer banking segments with the core banking solutions as the back-bone, since the banking regulations, (with Basle-II norms) are falling in space in most of the emerging markets. Though the company is optimistic about this space, our reading is the competition is likely to be stiff, since there are well established and well entrenched products like Flexicube, Finacle, Quartz, Orbitech and host of products competing in the same space.

The ERP segment in which the company operates is already quite crowded with the presence of several leading players which includes SAP, Oracle and Marshal. However 3i has able to create some niche by targeting SME segments in the manufacturing, retail, logistics, distributions, fashion and trading industries by integrating all facets of the business. For growing the ERP business 3i has adopted a different strategy by entering into partnerships with system integrators and forging strategic alliances, to grow in size and to acquire more business in newer geographies, which has helped the company to penetrate into new markets.

Services' too entering the growth phase

After two years of consolidation, we expect software services revenues to grow by 26% in FY07 and 31% in FY08 aided evenly by offshore and onsite revenues, since 3i offers a comprehensive range of services covering customized software development, maintenance and support services and system integration. Within the services revenues' - the software services revenues account for 77.5%, BPO services 16.1% and the balance is accounted by e-governance. We have built in a 3.5% appreciation of the rupee and expect the utilization rate of its onsite resources would be close to

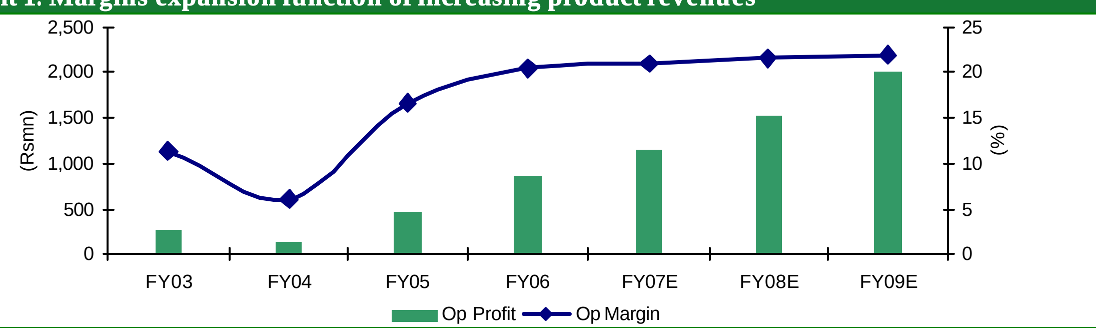
95%, whereas the offshore utilization rates to around 60% levels and assumed the blended billing rates to hover at the current levels.

The revenues from BPO which were seeing steady steep decline over the past many years, since the ICICI group took certain processes in-house, rebounded in FY06, with productivity per agent improving significantly. On the back of modest increase to productivity - we expect its BPO services revenues to grow by 13% for FY07 and for the subsequent two years expect the growth to hover 19% YoY. The e-governance business is a new addition to its services revenue's portfolio and is expected to report strong growth rates.

Margins to witness steady improvement

On the back of stronger growth in the products' business, as products enjoys a better margin vis-à-vis services' and leveraging SGA expenses on a higher revenue base, would enable it to improve its margins by 50bps annually for the next for the new few years. In FY05 SGA expenses as a percentage of revenues was 26.2%, which it pruned down to 23.2% in FY06 and we expect the same trend to continue albeit on a much lower pace. In FY06 3i managed to bring down the cost of revenues to operating revenues by 100bps to 56.2% from 57.2% in FY05. Going forward, the cost of revenues as a percentage of revenues would decline modestly, enabling the margins to improvement to sustain. Since we do not expect any significant increase debt component or any steep increase to capital expenditure the increase in interest cost and depreciation would be line with the topline growth. After factoring higher provision for taxation we expect 3i to grow its net profit by 34% for FY07 and 33%YoY growth for the next 2 years. The growth in net profit would be aided by a combination of strong revenue growth and modest increase to margins, primarily aided by the high margin product business.

Exhibit 1: Margins expansion function of increasing product revenues



Source: Company and KSBL Research

Valuations are attractive

We are initiating coverage on the stock, because the valuations are attractive and recommend investors to accumulate the stock at the current levels with a 23% upside over the next one year - however we would like to highlight quite a few risk factors which are as follows:

- 3i would have to face intense competition from the domestic vendors, as the BFSI and ERP space is very crowded with too many players across tiers undercutting each other.

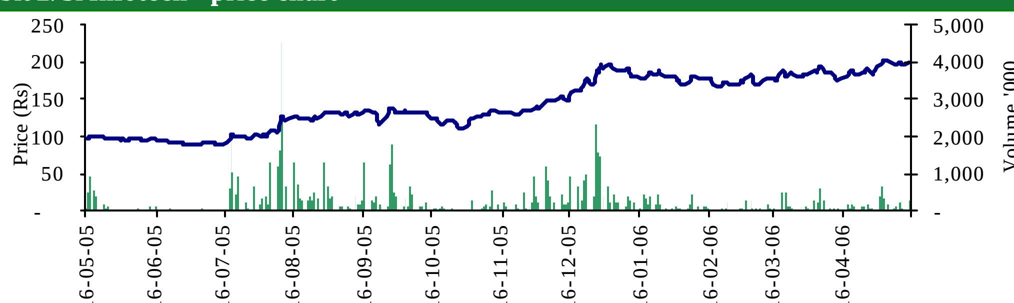
- Skewed client concentration is a cause of concern, though it is undertaking proactively to de-risk its revenue model. Though it has been successful it would still take good 4 to 6 quarters to report linear growth rates on a sequential quarter basis.

- Since product revenues would account 50% of revenues - quarterly volatility to revenue and profitability growth rates would occur from time to time as the product business intrinsically suffers from lumpiness.

- At the end of FY05 3i has intangibles worth Rs750mn, as a result of acquisitions made by the company in the past and capitalization of product developmental expenses. It continues to capitalize its product developmental expenses and the same are written off over a very long period and at the end of FY06 the intangibles would be worth close to Rs1bn.

Despite some of the shortcomings which we have stated above, we recommend the stock as an Out performer, since the company is trading at attractive valuations to some of its peers like Polaris and Hexaware, which too in the BFSI and space, are trading at much expensive valuations and are reporting muted earnings growth. Since it is adding new products and services to its portfolio, the eventual earnings growth could be higher than what we have projected. Though the debt to equity ratio is quite high for a technology company, which is mainly on account of FCCBs which would be converted into equity in FY2011. The return on equity would see a steady improvement and the quality of receivable are good and the company has not overstated profits by under provisioning of doubtful debts. Since its comparable peers are trading at relatively expensive valuations, 3i Infotech should trade at 12x - 14x forward earnings which would take the stock to Rs250 plus. However, as overall market is experiencing volatility we are not factoring any serious peer expansion - the growth in earnings itself will drive the stock price to the targeted levels.

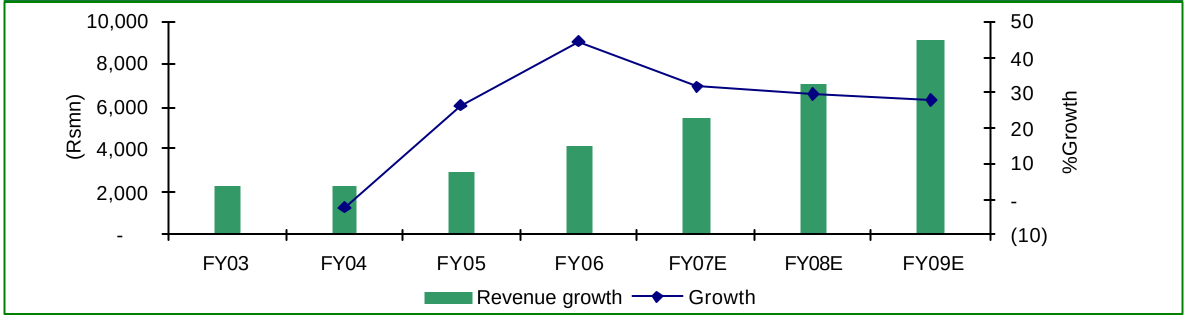
Exhibit 2: 3i Infotech - price chart



Source: C-Line

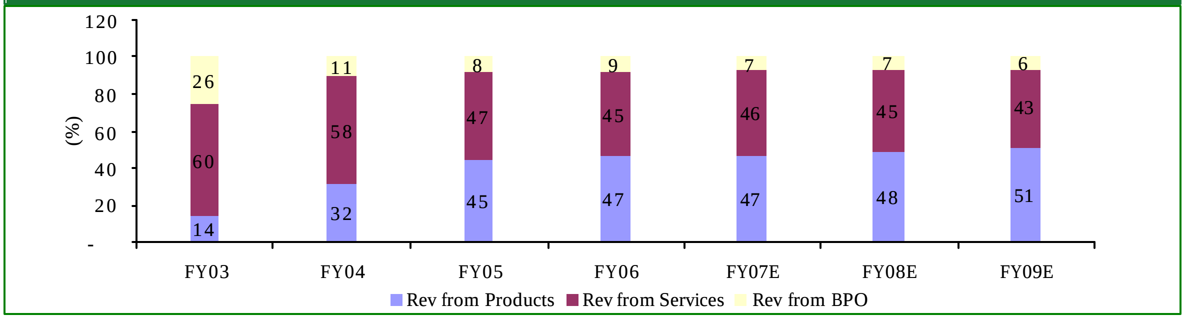
Quick snapshot of Financials

Exhibit 3: Revenues to go up by 30% CAGR



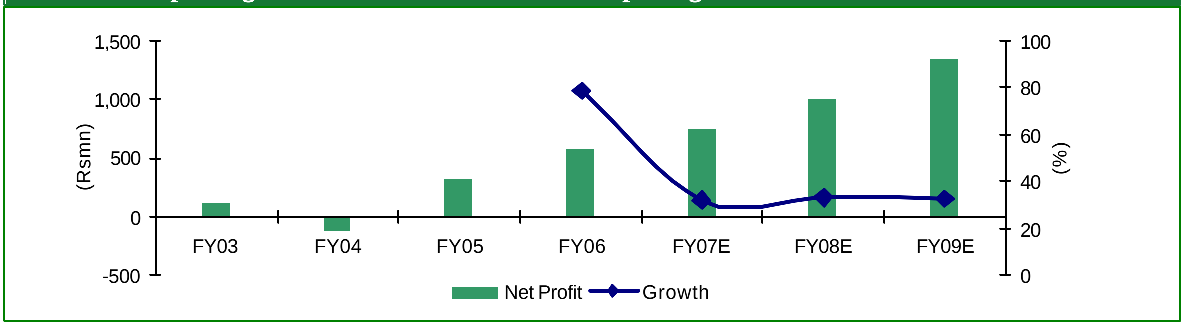
Source: Company and KSBL Research

Exhibit 4: Breakup of revenues



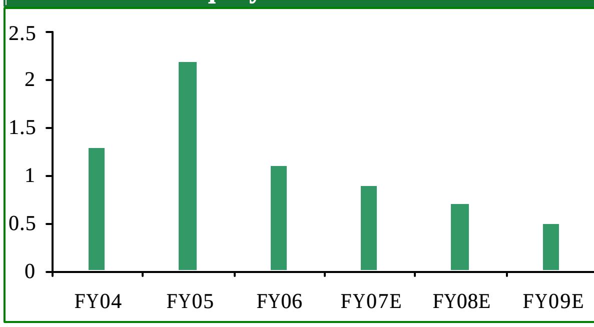
Source: Company and KSBL Research

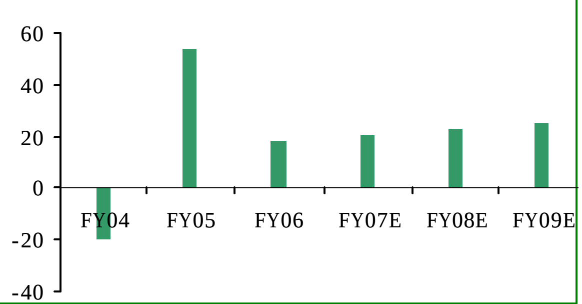
Exhibit 5: Net profit growth will be in line with the topline growth



Source: Company and KSBL Research

Exhibit 6: Debt equity **RoE**





Source: Company and KSBL Research

Profit & loss statement

(Rs mn)	FY2005	FY2006PE	FY2007E	FY2008E	FY2009E
Revenues from Products	1,288	1,950	2,565	3,442	4,607
Revenues from IT Services	1,370	1,871	2,533	3,208	3,932
Revenues from BPO Services	234	357	405	477	571
Total Revenues	2,892	4,178	5,503	7,127	9,111
YoY growth	26.2	44.5	31.7	29.5	27.8
Cost of Services	1,654	2,350	3,081	3,970	5,047
Admn & Selling expenses	758	970	1,266	1,625	2,059
Operating expenses	2,411	3,320	4,347	5,595	7,106
Operating profit	481	858	1,156	1,532	2,004
YoY growth	241.3	78.4	34.7	32.6	30.8
Operating margin	16.6	20.5	21.0	21.5	22.0
Other income	28.5	62.3	65.0	50.0	45.0
Depreciation	188.4	260.5	310.0	355.0	395.0
Interest	107.7	79.8	90.0	95.0	102.0
Pre-tax profit	213.3	580.0	820.5	1,132.4	1,552.4
Provision for taxation	(108.1)	12.7	61.5	118.9	204.9
Adjusted net profit	321.4	567.4	759.0	1,013.5	1,347.5
YoY growth	(372.2)	76.5	33.8	33.5	33.0
MAT credit entitlement	0.0	0.0	9.4	0.0	0.0
Minority Interest	0.0	0.0	2.3	0.0	0.0
Reported Net profit	321.4	574.5	759.0	1,013.5	1,347.5
Earnings/Share	6.1	10.7	14.3	19.1	25.4
Dividend/Share	1.8	2.0	2.5	3.0	4.0
Dividend payout	16.9	18.5	17.5	15.7	15.7

Balance sheet

(Rs mn)	FY2005	FY2006PE	FY2007E	FY2008E	FY2009E
Equity Capital	310.0	530.0	530.0	530.0	530.0
Pref Capital	1,500.0	1,000.0	1,000.0	1,000.0	1,000.0
Reserves & Surplus	298.1	2,616.0	3,108.9	3,827.0	4,820.1
Networth	608.1	3,146.0	3,639.0	4,357.0	5,350.2
Term loans from Banks	485.7	1,000.0	800.0	600.0	450.0
Rupee loans from Banks	822.4	350.0	250.0	200.0	150.0
FCCBs	0.0	2,217.5	2,217.5	2,217.5	2,217.5
Long term loans	1,308.1	3,567.5	3,267.5	3,017.5	2,817.5
Capital Employed	**3,407.2**	**7,713.5**	**7,906.5**	**8,374.5**	**9,167.7**
Gross Block	2,397.9	3,256.6	3,604.7	3,858.7	4,072.2
Depreciation	746.5	1,007.0	1,317.0	1,672.0	2,067.0
Capital WIP	79.1	95.0	110.0	125.0	140.0
Net fixed assets	1,730.5	2,344.6	2,397.6	2,311.7	2,145.1
Investments	866.5	866.5	866.5	866.5	866.5
Deferred tax assets	0.0	0.0	0.0	0.0	0.0
Current Assets Loans/Advances	1,676.2	5,606.3	6,000.7	6,824.1	8,167.6
Inventories	0.3	3.5	5.0	8.0	12.0
Sundry debtors	575.9	858.8	1,161.6	1,544.3	2,024.6
Unbilled revenues	411.0	501.4	632.8	784.0	956.6
Cash & bank	93.8	3,472.5	3,206.1	3,217.7	3,529.3
Loans & advances	595.1	770.1	995.1	1,270.1	1,645.1
Current Liab & Provisions	866.0	1,201.4	1,455.8	1,725.2	2,109.1
Sundry creditors	505.2	610.0	750.0	900.0	1,100.0
Other liab	140.0	152.0	180.0	210.0	240.0
Short term loans	111.9	145.0	190.0	235.0	310.0
Prov for retirement benefits	47.8	57.8	69.8	84.8	104.8
Prov for Eq dividend	54.0	106.0	132.5	159.0	212.0
Prov for Pref dividend	0.0	97.5	97.5	97.5	97.5
Dividend tax	7.1	33.1	36.0	38.9	44.8
Net Current assets	810.2	4,404.9	4,544.8	5,098.8	6,058.5
Misc expenditure	9.0	0.0	0.0	0.0	0.0
Capital Deployed	**3,407.2**	**7,713.5**	**7,906.5**	**8,374.5**	**9,167.7**

Ratio analysis

(Rs mn)	FY2005	FY2006E	FY2007E	FY2008E	FY2009E
ROCE (%)	9.4	8.6	11.5	14.7	18.0
ROE (%)	53.6	18.3	20.9	23.3	25.2
Operating ROCE	14.1	11.1	14.6	18.3	21.9
Fixed assets turnover ratio (x)	1.7	1.8	2.3	3.1	4.2
Total assets turnover ratio (x)	0.8	0.5	0.7	0.9	1.0
Avg. collection period (Days)	72	74	76	78	80
Cash & bank/share (Rs)	1.8	65.5	60.5	60.7	66.6
Cash & bank/Capital employed (%)	2.8	45.6	41.1	38.9	38.9
Gross margin (%)	42.8	43.8	44.0	44.3	44.6
Operating margin (%)	16.6	20.5	21.0	21.5	22.0
Pre-tax margin (%)	7.3	13.7	14.7	15.8	17.0
Net margin (%)	11.0	13.5	13.6	14.1	14.7
Revenue Mix					
Revenues from Products	44.5	46.7	46.6	48.3	50.6
Revenues from IT Services	47.4	44.8	46.0	45.0	43.2
Revenues from BPO Services	8.1	8.5	7.4	6.7	6.3
Cost Structure					
Salary & bonuses	39.7	39.8	40.4	40.8	42.3
Cost of outsourced services	22.3	21.3	20.4	19.8	18.8
Travelling & Communication	3.6	2.8	2.9	2.8	2.5
Recruitment & training	1.1	1.3	1.2	1.1	1.0
Selling & distribution expenses	3.5	3.7	3.6	3.5	3.4
General & Admn expenses	11.4	8.7	8.8	8.8	8.6
Prov for doubtful debts	1.9	1.8	1.7	1.6	1.3

Cash flow statement

(Rs mn)	FY2005	FY2006E	FY2007E	FY2008E	FY2009E
EBIT	292.5	597.5	845.5	1,177.4	1,609.4
Cash flow from operations	352.4	(213.4)	345.2	594.4	838.5
Other income	28.5	62.3	65.0	50.0	45.0
Extra-ordinary income	0.0	11.7	0.0	0.0	0.0
Depreciation	188.4	260.5	310.0	355.0	395.0
(-)Interest paid	107.7	79.8	90.0	95.0	102.0
(-)Dividends paid	134.7	203.5	230.0	256.5	309.5
(-)Tax paid	20.8	55.5	97.6	157.8	249.7
Net cash from operations	306.2	(217.6)	302.6	490.0	617.3
Capital expenditure	(874.6)	(363.0)	(269.0)	(228.5)	(105.7)
Free Cash Flow	(568.4)	(580.7)	33.6	261.6	511.6
Inc/(Dec) in long term borrowing	555.4	2,259.4	(300.0)	(250.0)	(200.0)
(Inc)/Dec in investments	0.0	0.0	0.0	0.0	0.0
Inc/(Dec) in Equity capital	1.8	2,200.0	0.0	0.0	0.0
Inc/(Dec) in Pref capital	0.0	(500.0)	0.0	0.0	0.0
Cash from Financial Activities	557.2	3,959.4	(300.0)	(250.0)	(200.0)
Opening Cash	105.0	93.8	3,472.5	3,206.1	3,217.7
Closing Cash	93.8	3,472.5	3,206.1	3,217.7	3,529.3
Change in Cash	(11.2)	3,378.7	(266.4)	11.6	311.6

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Stock Ratings		Absolute Returns	Stock Ratings		Absolute Returns
Buy	:	> 25%	Market Performer	:	0 - 15%
Out Performer	:	16 - 25%	Under Performer	:	< 0%

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