

KPIT Cummins Limited

"Revol" can be the next 'Revol'tion

KPIT Cummins Infosystems Limited (KPIT) is a Pune (Mah) based mid-size IT company, with primary focus on manufacturing (automotive, hi-tech and semiconductors). KPIT is an auto-focused service provider and generates majority of its revenues (~26%) from this segment followed by BFSI, Energy and utility verticals. It derives majority of its revenues from the US (~70%) followed by, Europe (~20%) and Rest of the world (~10%). It is backed by a team of 6,200+ professionals and operations spread across 3 delivery centers (Pune, Bangalore and Noida with a total seating capacity of 7,000 people).

Investment rationale

Improvement in Onsite billing rate and overall average billing rate

Post acquisition and Integration of Sparta (deal worth USD38m), KPIT's onsite billing rates have surged from ~USD68/hr to ~USD95/hr due to higher billing rates of Sparta (~120/hr). We believe this leaves a room for margin expansion in coming quarters.

"Revol" can be the next 'Revol'tion in the automotive space

KPIT recently announced 50:50 JV with Bharat Forge to manufacture and market indigenously developed "A plug in parallel hybrid solution" named "Revol" for automobiles. This will not only improve the fuel efficiency (~60%) of the vehicles but also will reduce emission by ~35%.

Inorganic growth and SPARTA's SAP tie-up

KPIT has till date acquired eight companies, of which the most recent was, "SPARTA"; this along with SPARTA's tie-up with SAP will help it to strengthen its offering for the manufacturing vertical.

Valuation and outlook

At the CMP of INR166, KPIT is trading at 11.8x our FY12e EPS of INR14. In view of KPIT's strong presence in the automotive sector and launch of its promising product "Revol", we believe company's revenues and margins will witness a considerable upsurge going forward. We initiate coverage on KPIT at 14x FY12e EPS estimate of INR14 implying a target price of INR196, which provides an upside of 18% at current levels. Therefore, we recommend a BUY at current levels.

Key financials

Year ended Mar 31st	2008	2009	2010	2011e	2012e
Net revenues (INRm)	5,835	7,932	7,316	9,934	12,577
EBITDA (INRm)	733	1,834	1,614	1,481	1,771
EBITDA* growth (%)	3.6	150.2	(12.0)	(8.2)	19.6
PAT (INRm)	513	658	857	956	1,221
PAT* growth (%)	1.8	28.3	30.3	11.5	27.7
EPS (INR)	6.6	8.4	10.9	11.8	14.1
EPS growth (%)	20.2	28.7	29.5	8.0	27.7
P/E (x)	25.3	19.7	15.2	14.1	11.8
P/BV (x)	4.9	7.9	3.4	2.2	2.0
EV/EBITDA (x)	17.5	7.0	7.9	8.6	7.2
RoE (%)	19.4	40.4	22.1	16.0	17.1

Note: *ex-one time items; Source: Company, Antique



24 March, 2011

RECO : BUY
CMP : INR166
Target Price : INR196
Potential Return : 18%

Market data

Sector	:	Information Technology
Market Cap (INRbn)	:	12
Market Cap (USDm)	:	300
O/S Shares	:	79
Free Float (m)	:	53
52-wk HI/LO (INR)	:	193/88
Avg Daily Vol ('000)	:	823
Bloomberg	:	KPIT IN
Reuters	:	KPIT.BO

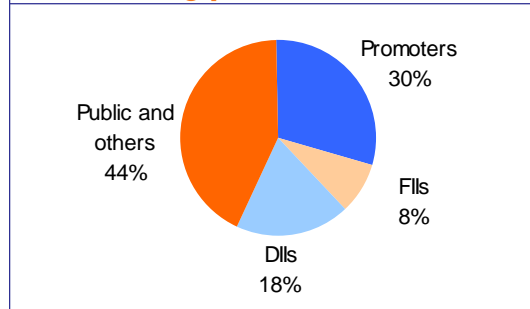
Source: Bloomberg

Returns (%)

	1m	3m	6m	12m
Absolute	8	(18)	(2)	11
Relative	12	(12)	(9)	2

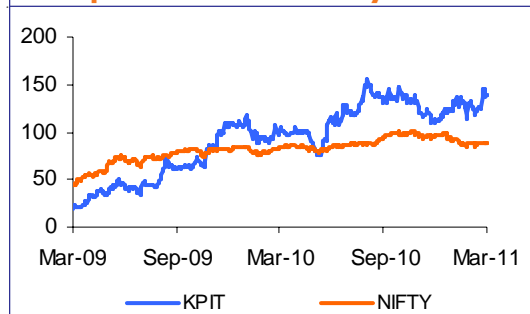
Source: Bloomberg

Shareholding pattern



Source: BSE

Price performance vs Nifty



Source: Bloomberg

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Company profile

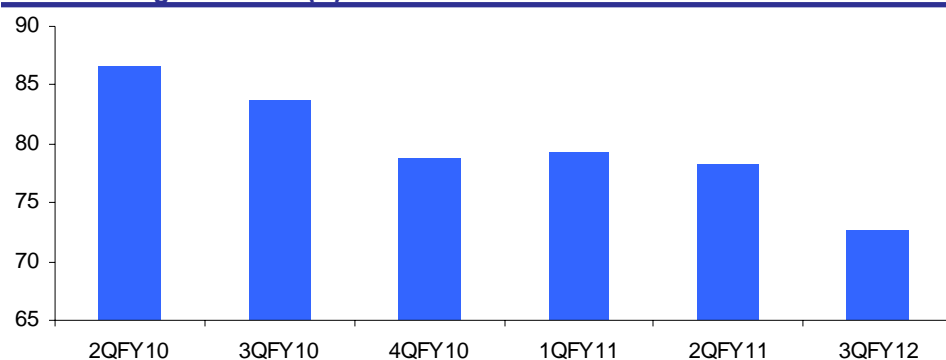
KPIT Cummins Infosystems Limited (NSE: KPIT) is a Pune (Mah) based leading Auto focused technology solutions provider promoted by S.B. (Ravi) Pandit in 1990. The company came out with an IPO in 1999 which was oversubscribed 42x of its issue. Thereafter, it merged with Cummins Infotech Limited (CIT) in 2003 in swap ratio of .34 share of KPIT for each one share of CIT, thereby implying issuance of a total 7,04,000 shares by KPIT plus an additional issuance of stock options of 19,33,000 to CIT. Post amalgamation, the company was rechristened as KPIT Cummins Infosystems Limited. This amalgamation gave a significant boost to company's revenue as Cummins Inc. alone started contributing almost 50% of the total revenues, thereby giving KPIT the much needed inorganic boost. The company claims to have 50+ client relationships in the auto space with track record of executing 1,500+ projects. It drives ~80% of its revenue from manufacturing followed by BFSI and Energy and Utilities.

Business model

Manufacturing

KPIT Cummins has strategically focused on a few sectors and had developed expertise in these verticals to not only gain market share but also grow its clientele. The company has established itself as a niche player in the manufacturing sector comprising automotive, semiconductors and industrials verticals and also derives ~7% and ~3% of revenues from BFSI and Energy and Utilities verticals, respectively. Recently, Cummins Inc. revised its annual revenue guidance for FY11e; we believe this will also be a positive for the company.

Manufacturing - Revenues (%)



Source: Company, Antique

Automotive: KPIT Cummins is primarily a "manufacturing" (auto electronics) domain expertise company. It works in collaboration with OEM software vendors to develop and deliver embedded solution to the automotives. Its software development expertise includes embedded solutions for engines, safety features, improvement of fuel efficiencies, reducing emissions, and infotainment and software architecture space. Out of the top ten auto OEMs globally, 7 to 8 are clients of KPIT, which envisages company's strong foothold in the automotive space. Increasing demand in developed countries for hybrid vehicles will complement company's recently launched hybrid solution called "Revolvo" to post higher revenue growth. Currently, it derives ~26% of the revenues from this vertical, which we believe will grow faster than the overall growth of the company primarily due to its domain expertise and launch of "Revolvo".

KPIT has established itself as a niche player in the manufacturing sector

Out of the top ten auto OEMs globally, 7 to 8 are KPIT's clients

Semiconductor & Hi-Tech: KPIT Cummins provides embedded solutions to semiconductor manufacturers. The company has been able to prove its domain expertise in this space and works with 5-6 top semiconductor players.

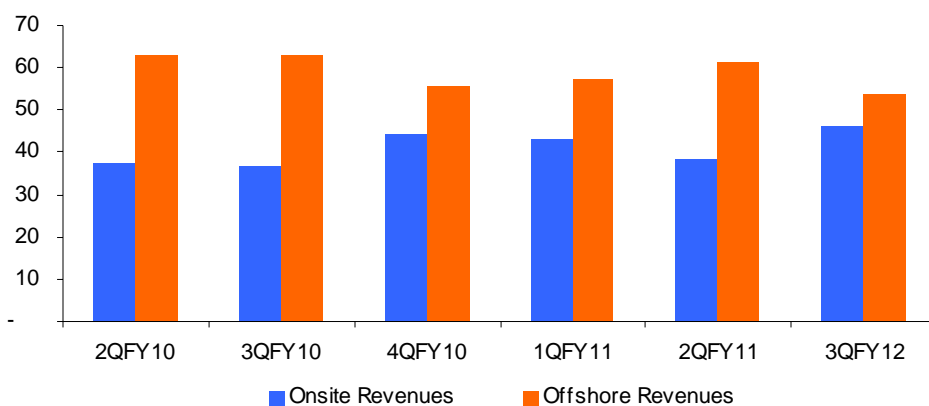
It competes with German vendors but has an edge over others when it comes to end-to-end solutions. It currently provides embedded solution to software vendors in US, Europe, Korea, India, Japan and China and derives ~7% of total revenues from this vertical.

Industrials and farm equipments: KPIT is into implementation of SAP and Oracle ERPs for industrials and farm equipment segments. It has successfully accomplished more than 200 ERP implementations in the last three years.

Acquired SPARTA in October 2009 for USD38m (USD8m cash down)

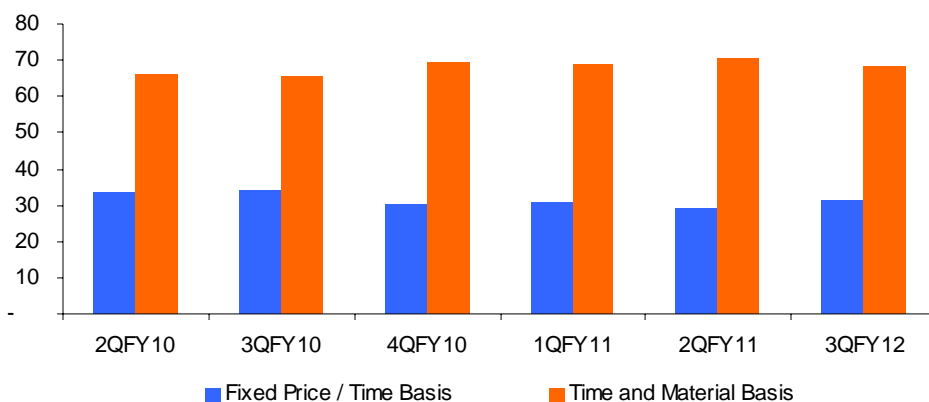
The company also acquired SPARTA, a US-based company with USD25m revenues, in October 2009 for USD38m. Driven by SPARTA's deal, KPIT expects to derive USD35-38m revenues in FY11. It is also into implementation of customised business intelligence solutions and currently derives ~51% of its revenues from this vertical.

Onsite/offsite revenues (%)



Source: Company, Antique

Revenues (%) by contracts : Fixed Price vs. Time and Material



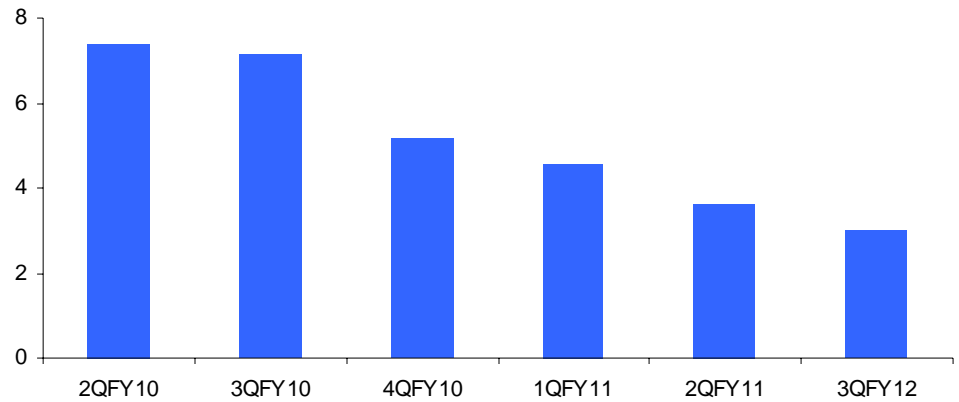
Source: Company, Antique

~7% of total revenues is derived from BFSI segment

BFSI

The company derives ~7% of total revenues from BFSI and expects its contribution to decline primarily due to ramp up of manufacturing vertical triggered by SPARTA and launch of Revolo going forward. Management strategically intends to focus on manufacturing vertical and will not commit investments in this vertical.

BFSI - Revenues (%)



Source: Company, Antique

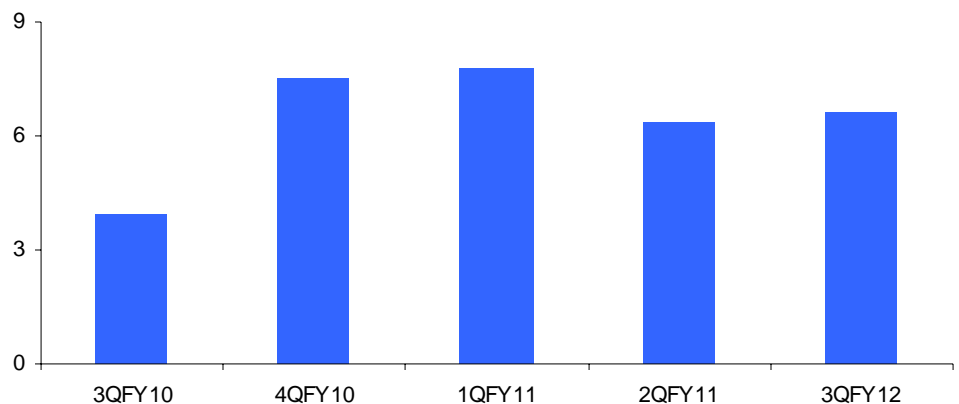
Energy and Utilities

Has signed two deals in Indian defense space

Post acquisition of SPARTA, this vertical has contributed ~3% to the total revenues. The company has been able to successfully extend its embedded solutions to this vertical. The company has signed two deals in Indian defense space and is assisting in development of unmanned vehicles and vision systems.

Company's service offering includes application development & maintenance, implementation of software packages, supply chain management solutions, embedded software and networking solutions for automotive companies, development of business intelligence tools, chip design, verification and testing for semiconductor companies, ERP consulting, risk management and compliance services, transaction processing, technology based and knowledge-based services.

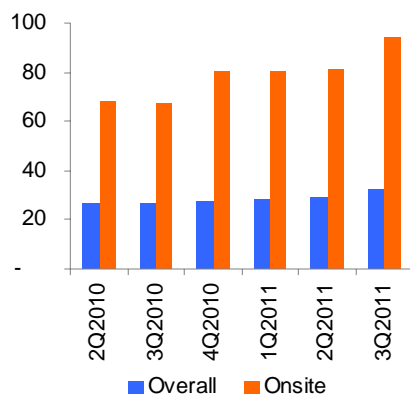
Energy and Utilities - Revenues (%)



Source: Company, Antique

Investment Rationale

Billing rates (USD/hr)



Source: Company, Antique

Developed "A plug in parallel hybrid solution" named "Revol" for automobiles

Improvement in Onsite billing rate and overall average billing rate

Post acquisition and Integration of SPARTA, KPIT's onsite billing rates have gone up from ~68USD/hour to ~95USD/hour due to higher billing rates of SPARTA (~120/hour). This also has a positive impact in the overall billing rate of the company from an average of ~USD27.5USD/hour to ~USD32/hour in the previous quarter. We believe going forward as SPARTA grows the onsite billing rate will improve further; this will positively impact the overall billing rate thereby enabling margins to improve further.

"Revol" can be the next 'Revol'tion in the automotive space

KPIT recently announced 50:50 JV with Bharat Forge to manufacture and market indigenously developed "A plug in parallel hybrid solution" named "Revol" for automobiles. This will not only improve the fuel efficiency (~60%) of the vehicles but also will reduce emission by ~35%. Collaboration with Bharat Forge will provide the much needed manufacturing expertise, access to all the major OEMs and required government liaisoning. Revol is a set up of hardware and software systems which includes a motor, a controller and a battery in its system. The product is best suited for consumers with very high usage for instance "Fleet owner".

Currently, the company is targeting existing vehicles and it can be easily retrofitted within 4-6 hours. Barring the cost of "Revol" which would vary from INR65,000-1,50,000 (depending on the size of vehicle), there is no other additional infrastructure requirement. The above solution is applicable to both gasoline and diesel engines vehicles with or without electronic engines (800cc-3litre). Currently, India has about ~12m vehicles (passenger and light commercial vehicles) on road, with a growth of ~15-16% CAGR. KPIT intends to target existing market i.e., existing cars on the road. Company, along with Bharat Forge, is trying to tie-up with OEMs and various other service centers.

We believe the major bottleneck while targeting existing cars and fleet owners would be to find a suitable financing option, as the solution would require anywhere between INR65,000-1,50,000 depending on the size of the engine (800cc-3litres).

Fleet owners' fleet comprises mainly low-end cars (Indica) that too mostly financed, and hence, committing such kind of upfront cost would be possible for only few established players like "MERU" or "Easycab". The company expects to report revenues of INR3-5bn in the JV, with 15% EBIT margins. It expects commercial production for the same to start by end of FY13e as per 3QFY11 earnings call. Even if we consider an average price of INR1.1lakh per unit, the company will have to sell 28,000-45,000 units which looks little difficult to achieve by FY13e.

Inorganic growth and SPARTA's SAP tie-up

KPIT has till date acquired eight companies, of which, three acquisitions have been done in the last five quarters (SPARTA, In2soft and CPG). SPARTA is a medium-sized enterprise (~USD25m revenues), whereas In2soft and CPG are two small companies with ~USD8m revenues each. SPARTA's acquisition will help KPIT to strengthen its offering for the manufacturing vertical.

KPIT acquired SPARTA for USD38m, which it expects to recover in the next three years. “SPARTA Consulting” has recently become a SAP gold channel partner authorised to resell SAP Business All-in-One and SAP Business Objects solutions to midsize and high-growth businesses in North America. This partnership complements company’s existing relationship with SAP as a services partner, expanding on SPARTA’s overall presence and investment in support of the SAP portfolio across the US. SPARTA intends to broaden its offerings by providing the SAP Business All-in-One and SAP Business Objects solutions - customised with SPARTA’s proprietary methodware, templates and accelerators to midsize companies in the utilities, wholesale distribution, high-tech and manufacturing verticals.

During 3QFY11 earnings call, the management mentioned that it has sufficient funds for day-to-day operations and any additional fund requirement will only be for future acquisitions. The board has also passed two resolutions: to increase the authorised capital and to issue fresh equity in the next 12 months.

KPIT Cummins Board on Feb 08, 2011 approved the proposal to issue preferential shares of 7.76m shares of INR2 each on a preferential basis to Warhol Limited, Mauritius (an affiliate of ChrysCap V LLC, Mauritius) at a price of INR145 per share for an aggregate amount of INR1.13bn, subject to shareholder and other regulatory approvals. The primary aim for this capital raising exercise is to fund future acquisitions. Though the company has been diversifying its geographic concentration by raising its revenue contribution from the RoW (9% in FY09 to 10% in FY10), relative stagnancy in Europe and a seeming revival in the US - revenue share from US has inched up. The company has been taking active steps to reduce its geographic concentration by increasing its regional strengths in Asia-Pacific regions (RoW) with acquiring new client in the region; KPIT aims to accelerate the diversification.

Prior to this, KPIT Infosystem merged with Cummins InfoTech in 2002, this enabled the company to strengthen its position in the semiconductor space. KPIT has transformed into a niche IT player with a competitive edge over larger players in its expertise area of auto & allied manufacturing space. The company has predominantly been a Manufacturing IT driven organisation, and it continues to remain so. However, its contribution to the total business has come down successively, with increasing focus on its other LoB like auto electronics growing 11.62% CQGR over eight quarters (1QFY09-4QFY10). Revenue from diversified financial services and global Business solutions has also built up traction, managing to remain flat to marginally positive in the declining revenue scenario. Amongst sectoral comparison, manufacturing sector dominates the overall business profile of the company, however apparently its total contribution to the overall business has declined in FY10, which can be classified as an aberration, due to the slower nature of revival in the manufacturing sector in comparison to other sectors like financial services, insurance, etc. KPIT’s business is more skewed towards America, with US accounting to nearly 70% of the total business (FY10).

Valuation and risk factors

Valuation and outlook

We believe company has been able to strengthen its position in the automotive segment. This coupled with SPARTA's acquisition has helped the company to increase its onsite billing rate to almost USD95/hour vs. its earlier rate of USD68/hour. Moreover, its venture with Bharat Forge for development of Revolo makes the company more lucrative. We maintain our positive stance and believe that the company would be able to post significant revenue and earnings growth in the coming quarters. At the CMP of INR166, the company is trading at 11.8x our FY12e EPS of INR14. We believe based on the fact that company has a very strong presence in the automotive sector coupled with its launch of promising product "Revolo" will give it the much needed boost in revenues and margins going forward. We initiate coverage on KPIT at 14x FY12e EPS estimate of INR14 implying a target price of INR196, which provides an upside of 18% at current levels. Therefore, we recommend a BUY rating on the stock.

Risk factors

- **High dependence on Auto and manufacturing verticals:** KPIT derives over 80% of its revenues from the Auto and Manufacturing vertical. This poses a threat as the fortunes of the company are linked to a single industry and any downturn in the Auto industry globally could have an adverse impact. The company is taking steps to diversify its industry base by entering the energy and utility space, which along with BFSI contributed almost 20% of its revenues in FY10. Going forward, KPIT is also looking at emerging sectors like defense.
- **Currency headwinds:** Significant rupee appreciation vis-à-vis US dollar, Euro and Pound could lead to revision in earnings growth.
- **Attrition:** The industry recently has been plagued by high attrition rates. With the turnaround in the demand environment, demand for manpower has also improved. The company saw attrition level increasing to 30% in 3QFY11 from the average rate of 16-17%. It had given a wage hike of 12% offshore and 2% onsite in 1QFY11 to curtail attrition and expects the impact to be witnessed in the coming quarters.

We initiate coverage with a BUY rating

Financials

Profit and loss account (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Revenues	5,835	7,932	7,316	9,934	12,577
Expenses	5,102	6,098	5,702	8,453	10,806
Operating Profit	478	1,397	1,306	1,146	1,369
Other income/(expense)	199	(574)	(253)	(12)	128
EBIDTA	733	1,834	1,614	1,481	1,771
Depreciation	255	436	308	336	402
Interest expense	75	45	27	20	8
Profit before tax	602	778	1,026	1,113	1,489
Taxes incl deferred taxation	89	120	169	157	268
Extra ordinary Items & others	-	-	-	-	-
Profit after tax	513	658	857	956	1,221
Recurring EPS (INR)	6.6	8.4	10.9	11.8	14.1

Balance sheet (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Share capital	156	156	157	174	174
Reserves & surplus	2,482	1,475	3,714	5,816	6,950
Networth	2,638	1,631	3,871	5,991	7,124
Debt	865	1,185	1,108	1,152	954
Deferred tax liability	47	63	51	70	70
Capital employed	3,550	2,878	5,030	7,213	8,148
Gross fixed assets	1,680	1,510	1,522	1,442	1,439
Net assets	1,680	1,510	1,522	1,442	1,439
Investments	1	0	747	468	1,068
Goodwill	-	285	950	1,292	1,292
Current assets, loans & advances					
Receivables	1,432	1,776	1,388	2,021	2,401
Loans and Advances	530	449	677	1,240	1,309
Cash Balance	740	1,671	1,052	2,308	2,626
Current liabilities & provisions					
Current Liabilities	833	2,813	1,306	1,558	1,986
Net current assets	1,868	1,083	1,811	4,011	4,349
Application of funds	3,550	2,878	5,030	7,213	8,149

Per share data

Year ended 31st Mar	2008	2009	2010	2011e	2012e
No. of shares (m)	78	78	79	81	87
BVPS (INR)	33.7	20.9	49.3	69.0	82.1
CEPS (INR)	9.8	14.0	14.8	14.9	18.7
DPS (INR)	0.7	0.6	0.7	1.0	1.0

Note: Share data is on weighted average

Margins (%)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
EBIDTA	12.6	23.1	22.1	14.9	14.1
EBIT	11.6	10.4	14.4	11.4	11.9
PAT	8.8	8.3	11.7	9.6	9.7

Source: Company, Antique

Cash flow statement (INRm)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
PBT	602	778	1,026	1,113	1,489
Depreciation & amortisation	255	436	308	336	402
Interest expense	75	50	27	20	8
Interest / Forex	(59)	(83)	47	(12)	(128)
Tax paid	(44)	(141)	(213)	(157)	(268)
Others (Inc WC Changes)	-387	166	(119)	(930)	(20)
CF from operating activities	442	1,206	1,076	370	1,483
Capital expenditure	(355)	(496)	(238)	(598)	(400)
(Purchase)/Sale of Investments	34	25	(747)	279	(600)
Income from investments	19	-	218	12	128
Acquisitions			(668)		
CF from investing activities	(302)	(471)	(1,435)	(307)	(872)
Inc/(Dec) in share capital	412		27	1,255	-
Inc/(Dec) in debt & WC	(278)	320	(37)	45	(198)
Dividends & Interest paid	(159)	(123)	(159)	(107)	(95)
CF from financing activities	(25)	197	(169)	1,192	(293)
Net cash flow	115	932	(527)	1,256	319
Opening balance	625	740	1,529	1,052	2,308
Closing balance	740	1,672	1,052	2,308	2,626

Growth indicators (%)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
Revenue	26	36	(8)	36	27
EBITDA*	4	150	(12)	(8)	20
PAT*	2	28	30	12	28
EPS*	20	29	29	8	28

Valuation (x)

Year ended 31st Mar	2008	2009	2010	2011e	2012e
PE	25.3	19.7	15.2	14.1	11.8
P/BV	4.9	7.9	3.4	2.2	2.0
EV/EBITDA	17.5	7.0	7.9	8.6	7.2
EV/Sales	2.2	1.6	1.7	1.3	1.0
Dividend Yield (%)	0.4	0.4	0.4	0.6	0.6

Financial ratios

Year ended 31st Mar	2008	2009	2010	2011e	2012e
RoE (%)	19.4	40.4	22.1	16.0	17.1
RoCE (%)	13.5	48.5	26.0	15.9	16.8
Debt/Equity (x)	0.3	0.7	0.3	0.2	0.1
EBIT/Interest (x)	6	31	48	56	161

Source: Company Antique

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