

TULIP IT SERVICES

INR 772

Refocusing

BUY



Tulip IT Services (TITSL) announced that it will be raising USD 125 mn through unsecured, zero coupon, convertible bonds. Further, TITSL has an option to increase the issue size by an additional USD 25 mn. The bonds are expected to be listed on the Singapore Exchange Securities Trading. The conversion price is fixed at INR 1,137 and the dilution on account of this issue, on conversion at the stated conversion price, will be 13.4-15.7% on the expanded capital base.

Shareholder approval for the issue of bonds is expected on July 5, 2007 and the closing of the issue of the bonds will be conditional upon such approval being given.

* **Proposed utilisation of funds**

TITSL is aggressively targeting e-governance/state wide area network (SWAN) tenders to boost revenues from its Network Integration (NI) business and then leverage the tender wins to expand its IP VPN business (by providing network connectivity). Total projected government spend on SWANs is estimated at ~INR 33 bn over the next three years. TITSL intends to utilize the issue proceeds primarily to meet the initial funding and working capital requirements for these long-gestation projects. Currently, TITSL has bid for tenders floated by several state governments including West Bengal, Uttaranchal, Karnataka, Punjab, Rajasthan, and Madhya Pradesh; ticket-size of each project ranges from INR 0.7-1 bn. Besides the e-governance projects, the management has also stated that the funds will be used for any future acquisitions in the NI space or probable overseas JV for providing IP VPN services. We await further clarity on this front.

* **What does this recent step of TITSL imply?**

Our earlier hypothesis of TITSL moving towards a far purer IP VPN play is under threat. We have seen TITSL making strong moves towards making its NI business segment far more prominent than what it would have been over the next two years. Compared to ~55-56% of revenues over FY08-09E respectively, we reckon the possibility of ~2-4% additional share in revenues over FY08E and FY09E respectively. This directly connotes profitability pressures and a downward shift in return ratios over the foreseeable future on account of a heavier balance sheet accruing out of a highly capital intensive NI business becoming relatively more prominent. We base our conclusion on two platforms: first, IP VPN business might be reaching a plateau in terms of growth as the management re-focuses on lower margin NI contracting businesses, and second, valuations are unlikely to witness a re-rating till the NI business displays outstanding results.

Financials

Year to March	FY06	FY07UA	FY08E	FY09E
Revenue	5,081	8,408	12,030	14,773
EBITDA (INR mn)	662	1,339	2,366	2,916
Net profit	491	946	1,717	2,160
Adjusted EPS (INR)	16.9	32.6	59.2	74.5
P/E (x)	45.6	23.7	13.0	10.4
EV/ EBITDA	34.2	17.5	9.9	7.8
ROAE (%)	42.1	40.7	47.5	39.4
ROACE (%)	37.2	33.6	39.7	35.0

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Market Data

52-week range (INR) : 937 / 209
Share in issue (mn) : 29.0
M cap (INR bn/USD mn) : 22.4 / 544.8
Avg. Daily Vol. BSE ('000) : 840.8

Share Holding Pattern (%)

Promoters : 69.0
MFs, FIs & Banks : 6.0
FIs : 17.7
Others : 7.3



* Details of FCCB issue

Tulip IT Services (TITSL) intends to raise USD 125 mn through unsecured, zero coupon, convertible bonds. Further, TITSL has an option to increase the issue size by an additional USD 25 mn. The conversion price is fixed at INR 1,137 and the dilution on account of this issue, on conversion at the stated conversion price, will be 13.4-15.7% on the expanded capital base.

Shareholder approval for the issue of bonds is expected on July 5, 2007 and the closing of the issue of the bonds (expected on or about July 26, 2007) will be conditional upon such approval being given.

Table 1: Details of the FCCB issue

Issue size	USD 125-150 mn (INR 5.1-6.2 bn)
Tenor	5 years
Conversion price	INR 1,137.2 (premium of 35% above the volume -weighted average price as on 26/6/2007 of INR 842.4)
Coupon	0%
Yield to maturity	7.375%
Listing	Singapore Exchange Securities Trading
Current equity shares	29 mn
Equity shares post dilution	33.5-34.4 mn
Dilution	13.4-15.7%

Source: Company

* Likely impact of fund-raising

Post the recruitment of key personnel from Cisco, this is the second step that TITSL has taken to further its NI business. The aggressive management focus on e-governance points towards stronger growth in the low margin NI segment going forward. We are likely to see pressures on blended margins going forward on account of likely stronger revenue share of NI business vis-à-vis IP VPN. We do not see any significant impact on our core business estimates for FY08, given that tenders for most of the SWAN projects for which bids have been floated are likely to be allotted over the next two quarters and revenues thereof are expected to kick in Q4FY08 onwards at the earliest. We are likely to see some upside to our revenue and profitability estimates for FY09 on this account. We have, however, not factored in the same in our estimates currently.

Table 2: First-cut estimates of incremental revenues from NI business

	FY08E	FY09E
Indian NI market (INR Bn)	88.2	114.7
SWAN projects - opportunity per year (INR Bn)	11.0	11.0
TITSL		
Current NI revenue estimates (INR Bn)	6.6	8.2
Estimated revenues from SWAN projects (INR Bn)	0.3	1.0
Total NI revenues (INR Bn)	6.8	9.2
Upside to current NI revenue estimates (%)	3.9	12.7
Upside to overall revenue estimates (%)	2.1	7.0
Total funds raised - issue size USD 125 mn (INR bn)	5.1	3.1
Funds utilised during the year (INR bn)	2.0	2.3
Balance funds (INR bn)	3.1	0.8
Cumulative amount utilised (%)	39.9	84.0

Source: Edelweiss research

* Outlook and valuations

We maintain our positive outlook on overall prospects of TITSL as an integrated provider of network equipment and connectivity to the small and medium enterprise segment. Also, we believe that TITSL could be an attractive acquisition target for large integrated telecom players, given the swift ramp-up in its IP VPN business with a presence in over 800 towns and a subscriber base of over 0.5 lakh in FY07.

Based on our current estimates, we expect a 33% CAGR in revenues and 51% CAGR in net profits over FY08-09E. At INR 772, the stock trades at a P/E of 13x and 10.4x and EV/EBITDA of 9.9x and 7.8x for FY08E and FY09E, respectively. Assuming that the FCCB gets fully converted at INR 1,137.2, the fully diluted EPS for FY08E and FY09E would stand at INR 50 and INR 63 respectively, resulting in P/E of 15.6x and 12.4x, respectively. We maintain our **'BUY'** recommendation.

Table 3: Dilution impact of FCCB issue (post approval)

	FY08E	FY09E
Current EPS estimates (INR)	59.2	74.5
Fully diluted EPS estimates (issue size of USD 125 mn)	51.2	64.5
P/E (x)	15.2	12.1
Fully diluted EPS estimates (issue size of USD 150 mn)	49.9	62.8
P/E (x)	15.6	12.4

Source: Edelweiss research

Financial Statements

Income statement		(INR mn)				
Year to March	FY05	FY06	FY07UA	FY08E	FY09E	
Income from operations	3,422	5,081	8,408	12,030	14,773	
Direct costs	3,088	4,142	6,585	8,908	10,978	
Employee costs	62	99	248	394	443	
Other expenses	73	179	236	361	436	
Total operating expenses	3,223	4,419	7,069	9,663	11,857	
EBITDA	199	662	1,339	2,366	2,916	
Depreciation and amortisation	10	43	196	331	423	
EBIT	189	619	1,143	2,035	2,493	
Interest expenses	35	64	126	160	173	
Other income	6	12	25	32	80	
Profit before tax	160	567	1,042	1,907	2,400	
Provision for tax	27	76	96	191	240	
Extraordinary items	(5)	4	-	-	-	
Reported profit	139	488	946	1,717	2,160	
Adjusted net profit	134	491	946	1,717	2,160	
Shares outstanding	20.0	29.0	29.0	29.0	29.0	
Dividend per share	-	1.0	1.0	2.0	3.0	
Dividend payout %	-	5.9	3.1	3.4	4.0	

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Operating expenses	94.2	87.0	84.1	80.3	80.3
Depreciation	0.3	0.8	2.3	2.8	2.9
Interest expenditure	1.0	1.2	1.5	1.3	1.2
EBITDA margins	5.8	13.0	15.9	19.7	19.7
Net profit margins	3.9	9.7	11.2	14.3	14.6

Growth metrics (%)

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Revenues	24.7	48.5	65.5	43.1	22.8
EBITDA	90.9	232.2	102.2	76.7	23.2
PBT	106.7	253.7	83.6	83.1	25.8
Net profit	107.3	266.8	92.6	81.5	25.8
EPS	107.3	266.8	92.6	81.5	25.8

Cash flow statement

Cash flow statement		(INR mn)				
Year to March	FY05	FY06	FY07E	FY08E	FY09E	
Net profit	139	488	946	1,717	2,160	
Add: Depreciation	10	43	196	331	423	
Add: E.O.Adjustments	0	0	-	-	-	
Add: Deferred tax	4	(10)	-	-	-	
Gross cash flow	153	521	1,142	2,048	2,583	
Less: Dividends	-	29	29	58	87	
Less: Changes in W. C.	205	979	711	1,347	1,174	
Operating cash flow	(52)	(487)	402	643	1,322	
Less: Change in investments	-	20	-	-	-	
Less: Capex	145	574	1,195	718	586	
Free Cash flow	(197)	(1,082)	(793)	(75)	736	

Balance sheet					
(INR mn)					
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Equity capital	200	290	290	290	290
Reserves & surplus	266	1,576	2,492	4,151	6,224
Shareholders funds	466	1,866	2,782	4,441	6,514
Secured loans	238	756	1,396	1,646	1,646
Borrowings	238	756	1,396	1,646	1,646
Sources of funds	704	2,622	4,178	6,087	8,160
Gross block	227	800	1,995	2,713	3,299
Depreciation	31	73	269	600	1,023
Net block	196	727	1,726	2,113	2,276
Total fixed assets	196	727	1,726	2,113	2,276
Investments	0	20	20	20	20
Inventories	206	263	541	1,220	1,504
Sundry debtors	602	1,457	1,958	3,131	4,250
Cash and equivalents	88	467	315	490	1,226
Loans and advances	24	142	336	722	886
Total current assets	919	2,329	3,151	5,563	7,866
Sundry creditors and others	380	368	592	1,359	1,674
Provisions	22	86	125	249	327
Total CL & provisions	403	454	717	1,608	2,001
Net current assets	516	1,875	2,433	3,955	5,865
Net deferred tax	(10)	(2)	(2)	(2)	(2)
Misc expenses not w/o	1	1	1	1	1
Uses of funds	704	2,622	4,178	6,087	8,160
Book value per share (BV)	23	64	96	153	225

Ratios

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
ROAE (%)	41.0	42.1	40.7	47.5	39.4
ROACE (%)	37.4	37.2	33.6	39.7	35.0
Current ratio	2.3	5.1	4.4	3.5	3.9
Debtors (days)	64	105	85	95	105
Fixed assets t/o (x)	17.4	7.0	4.9	5.7	6.5
Average working capital t/o (x)	8.9	4.2	3.9	3.8	3.0
Debt/Equity	0.5	0.4	0.5	0.4	0.3

Valuations parameters

Year to March	FY05	FY06	FY07UA	FY08E	FY09E
Adjusted EPS (INR)	4.6	16.9	32.6	59.2	74.5
Y-o-Y growth	107.3	266.8	92.6	81.5	25.8
CEPS (INR)	7.2	18.4	39.4	70.6	89.1
P/E (x)	167.2	45.6	23.7	13.0	10.4
Price/BV(x)	33.1	12.0	8.0	5.0	3.4
EV/Sales (x)	6.6	4.5	2.8	2.0	1.5
EV/EBITDA (x)	113.1	34.2	17.5	9.9	7.8

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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