

BUY

Rs 597

Sensex: 11,939 Nifty: 3,556

Stock data

Bloomberg	SUBX IN
Reuters	SUBX.BO/SUBX.NS
Shares outg (mn)	21.8
Market cap (Rs bn)	13
Market cap (US\$ mn)	293
3-m dly avg vol	51,718

Share price performance

52-week high/low (Rs)	650/171		
	-1m	-3m	-12m
Abs (%)	39.5	50.4	214.1
Rel* (%)	31.0	29.5	132.4

*to Nifty

Financial Snapshot

Rs mn

YE March	FY05	FY06E	FY07E
Net Sales	1,166	1,795	2,375
% change	32.6	50.9	35.0
Net Income	253	391	684
% change	42.7	54.5	74.6
EPS (Rs.)*	12.6	18.0	31.3
% change	31.0	43.0	73.7
P/E(x)	47.5	33.2	19.1
ROE (%)	24.9	25.7	32.3
ROCE (%)	20.6	24.9	32.4

*Excluding Azur solutions

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Subex Systems

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Acquires Azure Solutions

- ◆ **The deal:** Subex Systems has announced the acquisition of UK based Azure Solutions for USD140mn. The deal includes USD4mn in cash and the issue of 12.13 million new GDRs issued. (each GDS represents one equity share). The combined entity would be renamed Subex Azure Solutions. Azure that was spun off from BT in April 2003, currently has New Ventures Partners, Intel Capital and Doughty Hanson Technology Ventures as shareholders. These now become the shareholders of Subex Azure Systems.
- ◆ **Advantage to Subex:** With the acquisition of Azure, Subex would become the largest player in telecom software products that aid in “revenue assurance” and “fraud management” with a 25% global market share in each. The acquisition would add interconnect billing, inter-party management and margin management (apart from the fraud management and revenue assurance solutions of Azure) solutions to the existing portfolio. We believe that these new products would permit Subex to cross sell to existing clients.
- ◆ **Integration would be a challenge:** The integration of the two entities is expected to take 10-12 months and we believe it to be a significant challenge for Subex. The integration is likely to lead to the elimination of several overlapping functions and increase severance costs in FY07E. However, post consolidation, we expect significant cost savings due to integration of sales and product development teams.
- ◆ **Guidance:** Subex has guided for consolidated products revenues of Rs2,500mn and Rs 4,500mn and net profit of Rs650mn and Rs1,500mn – implying an EPS of Rs18 and Rs42 in FY07E and FY08E, respectively.
- ◆ **Financials:** Since the merger would be effective June 2006, the full impact of the merger would be felt from FY08E onwards. It is difficult to forecast FY07E and FY08E numbers of the merged entity, though we believe that the EBITDA margins of Subex are likely to fall in FY07E on account of a) the higher cost structure of Azure (due to higher development costs) and b) integration costs.
- ◆ **Valuations:** Subex has out performed the sensex and the IT index in the last few weeks on account of speculation on the impending merger. At the current FY07E PER of 35X, the stock looks richly valued and is likely to under perform the IT index in the near term. However, with its EPS expected to grow at a two-year (FY06-08E) CAGR of 52.8% (fully diluted) on account of a) increased traction in the products business and b) increased synergies between Subex and Azure from FY08E, the stock is likely to outperform the index in the longer term. Hence, we maintain a Buy on the stock.

The Q4FY06 highlights

- ◆ Subex reported 8.3% sequential increase in revenues to Rs483mn with products business growing 10.7% QoQ and the services business growing 4.5% QoQ. We believe that the growth in the products business was due to higher license fee revenues.
- ◆ The EBITDA margins of the company declined 240 bps on account of a) higher employee ramp up in anticipation of the Azure acquisition led to higher manpower costs and b) higher G&A expenses.
- ◆ The company reported a 29.2% sequential decline in the net profit to Rs 84mn due to a) lower EBITDA, b) lower other income and c) higher taxes with higher provisioning for its US services business.

Quarterly result table

Rs mn

	Q4FY06	Q3FY06	QoQ (%)	Q4FY05	YoY (%)
Revenues	483	446	8.3	355	36.0
Products	302	273	10.7	225	34.6
Services	180	173	4.5	130	38.6
Staff cost	280	244	14.5	189	48.3
Operating Expenditure	64	52	24.3	51	25.5
Cost of Equipment and Software	6	17	-61.8	7	-8.3
EBITDA	132	133	-0.4	108	22.5
<i>EBITDA margin (%)</i>	27.4	29.8		30.4	
Interest	9	5	95.7	8	20.5
Depreciation	24	22	9.2	24	-1.8
Other income	4	17	-77.5	3	43.1
PBT	103	123	-16.7	78	31.0
Tax	19	5	307.0	-2	
PAT	84	119	-29.2	81	3.8

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