investor's eye

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Offshore	03-Mar-05	330	**1,075**	1,760
Aditya Birla Nuvo	06-Dec-05	714	**1,199**	1,280
Ceat	28-Nov-06	122	**128**	190
Lupin	06-Jan-06	403	**547**	670
Thermax	14-Jun-05	124	**376**	425

Sharekhan Ltd
A-206, Phoenix House, 2nd Floor, Senapati Bapat Marg, Lower Parel, Mumbai - 400013, India.

Tata Elxsi

Emerging Star

Stock Idea

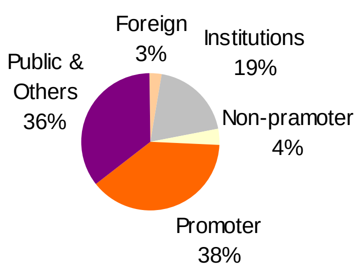
Designed to grow

Buy; CMP: Rs232

Company details

Price target:	Rs320
Market cap:	Rs724 cr
52 week high/low:	Rs270/147
NSE volume: (No of shares)	87,469
BSE code:	500408
NSE code:	TATAELXSI
Sharekhan code:	TATAELX
Free float: (No of shares)	1.9 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-4.2	1.5	52.3	8.4
Relative to Sensex	-2.5	-7.8	3.2	-24.0

Key points

- **Niche player with distinct competitive strengths:** Tata Elxsi Ltd (TEL) has built the required scale of operations and established strong client relationships with leading global companies to effectively tap the huge opportunity emerging in the niche segment of product design and engineering space. In this space, the size of the opportunity for the domestic companies is estimated to more than double to $6.6 billion by 2010. TEL also has the advantage of having developed reusable components (intellectual property to provide faster and more valuable proposition to the customers) and is investing to boost its delivery capabilities in the high-end services like VLSI and chip design.
- **Aggressive expansion plans:** TEL has aggressive expansion plans in terms of the capital expenditure on physical infrastructure and employee addition. This clearly reflects the management's growing confidence in the revenue growth visibility over the next few years.
- **Improving margins:** The shift in the revenue mix in favour of the high-margin software development service business has significantly improved the company's operating margins in the past two years (up by 490 basis points to 19.8% in FY2006). The trend is expected to continue and further boost margins by 250 basis points during FY2006-08, in spite of the aggressive expansion plans and rising wage inflation.
- **Attractive valuations and decent dividend yield:** Revenues and earnings are estimated to grow at a robust rate of 26.8% and 34.5% respectively, during the period FY2006-08. Moreover, the company offers a decent dividend yield of 2.8% (based on the 65% dividend given in FY2006), which is likely to limit the downside risk. We recommend Buy call on TEL with a one-year target price of Rs320.

Company background

TEL, part of the Tata group, has successfully transformed itself from being a hardware centric system integration company to an established player in the niche segment of product design and engineering services. It addresses diverse industries such as automotive, consumer electronic, entertainment, semiconductor and telecom equipment manufacturers.

Key financials

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs crore)	26.4	34.5	47.8	62.3
No of shares (crore)	3.1	3.1	3.1	3.1
EPS (Rs)	8.4	11.0	15.3	19.9
% y-o-y change	-	*30.6*	*38.6*	*30.4*
PER (x)	27.5	21.1	15.2	11.7
Price/BV (x)	13.2	11.0	8.2	5.8
EV/EBIDTA (x)	19.8	15.2	11.2	8.5
Dividend yield (%)	2.4	2.8	3.0	3.2
RoCE (%)	54.0	57.5	59.2	55.6
RoNW (%)	111.6	98.6	82.7	66.7

Its business can be broadly classified into two segments: software development services (SDS) and system integration (SI). The SDS business contributed around 80% of the total turnover in FY2006 and can be further categorised into three divisions: product design services (PDS); innovation, design and engineering (IDE); and visual computing labs (VCL).

PDS, the key growth driver

TEL offers a comprehensive range of services spanning the entire product development/design lifecycle to aid global customers in developing and deploying technology products, covering both hardware design and embedded software development (and other middleware software). The company has an edge over its peers in terms of a portfolio of reusable components and frameworks that can be bundled along with the services to provide a unique value proposition to the customers.

As on March 2006, the PDS segment employed around 1,900 professionals and provided around 85% of the total SDS revenues (and around 67% of the company's total turnover) for FY2006. It is a relatively high-margin business and is growing at a healthy range of 28-30%. Some of the large clients include reputed global companies like Cisco, Canon, Motorola, Hitachi, Texas Instruments and Pinnacle Systems.

IDE, huge potential to scale up

It is a relatively new business aimed at providing styling as well as mechanical product design and engineering services to automotive, consumer electronic and fast moving consumer goods companies. The business contributes around 10% of the SDS revenues and less than 9% of the total turnover. It is estimated to grow at a compounded annual growth rate (CAGR) of 20% over the next three years.

VCL, at a nascent stage

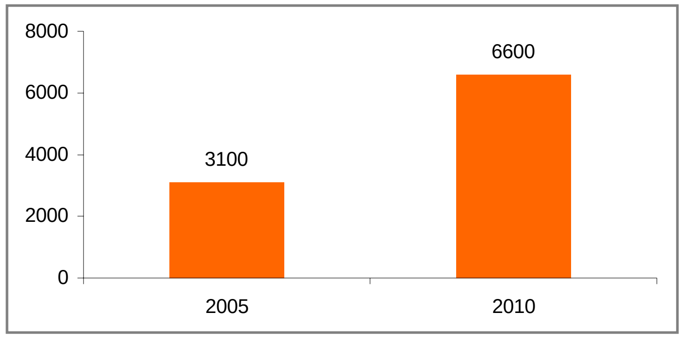
TEL offers special effects and animation content and post-production services to advertisement and film industry through the VCL business division. It employs roughly around 100 professionals and contributes around 5% of the SDS revenues. As part of its long-term growth strategy, the company aims to form alliances with leading film studios (in the USA and Europe) and also possibly foray into production of a full-length animation movie.

Investment arguments

Established player with inherent strengths in a niche segment

With an employee base of around 1,900 professionals and an annual revenue run rate of around $45 million, the company has built the required scale to leverage its inherent strengths and effectively tap the huge opportunity emerging in the product engineering and design service space. The size of the outsourcing potential in the research & development and engineering design service space is estimated to more than double to $6.6 billion by 2010, up from around $3.1 billion in 2005.

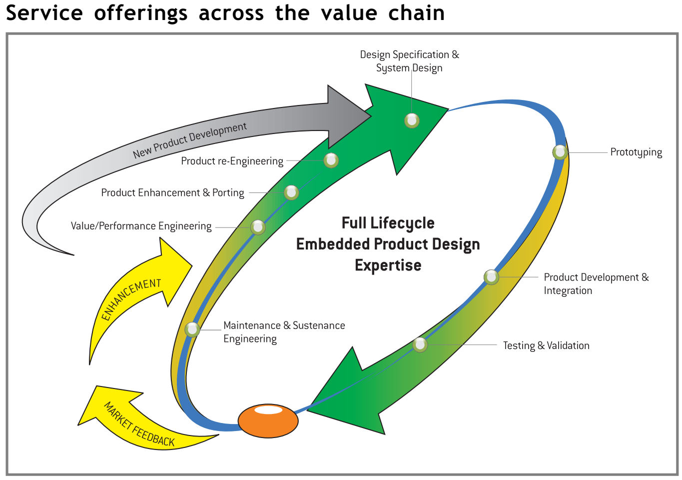
Outsourcing opportunity ($ million)



Source: Industry Research

In terms of competitive advantages, the company has a strong relationship with leading global companies (across various industry verticals) like Texas Instruments (semiconductor), Motorola (telecom equipment), Cisco (network management), Canon and Hitachi (industrial and office automation), and Shimadzu (instrumentation). Second, it has also invested in building frameworks and reusable components (intellectual property) that provide it an edge over some of its peers. Third, the company has a comprehensive range of services, which includes full lifecycle design expertise, from product specification to design, development and deployment of the same. Moreover, in addition to its proven capabilities in embedded software development services, the company is investing substantially to aggressively expand its delivery capabilities in high-end services like very large-scale integration (VLSI) and chip design. Consequently, we expect the PDS business to contribute significantly in driving the overall revenue growth of the company.

Service offerings across the value chain

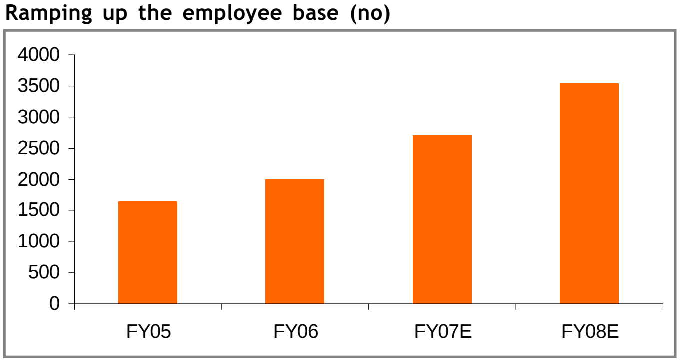


Aggressive expansion plans

TEL is investing in expanding its delivery capabilities both in terms of capital expenditure (capex) on the physical infrastructure and aggressive employee addition. It has recently set up development centres in Chennai and Pune; and is expanding the capacity at its centre in Bangalore. The combined capex on the planned expansion would be in the range of Rs25-30 crore in the current fiscal. The capex would be funded largely through internal accruals and is not likely to result in any equity dilution. Going forward, the company would further expand the physical infrastructure in a phased manner and is also exploring the possibility of setting up a near-shore development centre in Japan.

In terms of its employee base, the company is looking at increasing the same by over 35% in the current fiscal (addition of around 700-800 employees). It has already indicated aggressive recruitment plans for FY2008 also, and is expected to ramp up the employee base to around 3,600-3,800 professionals by March 2008 (up from 2,000 in FY2006). We believe that the aggressive capex and employee addition clearly reflect the management's growing confidence in the revenue growth visibility and its ability to scale up the business.

Ramping up the employee base (no)



Source: Company, Sharekhan Research

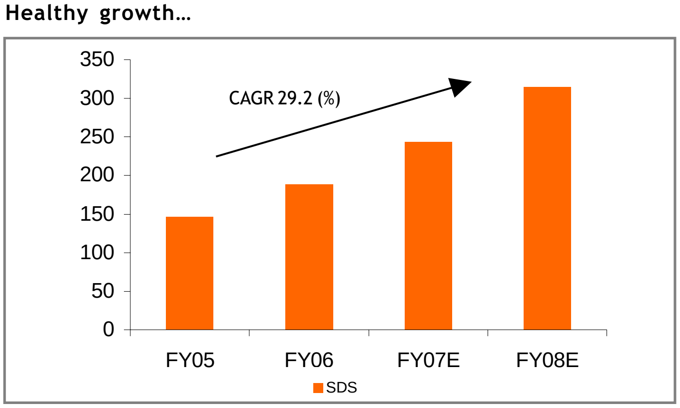
Margins to remain firm due to the changing revenue mix

In spite of the aggressive expansion plans and growing cost pressures (especially from the wage inflation), the company is expected to not only sustain its profitability but also improve its operating profit margin (OPM) over the next two years. In the past also, the OPM has improved substantially to 19.8% in FY2006, up 490 basis points from 14.9% in FY2004. The margin expansion was driven largely by the favourable shift in the revenue mix towards the high-margin SDS business, which contributed 80% of the turnover in FY2006 (as compared to 71% in FY2004). We expect this favourable trend to continue in the coming quarters with the contribution from SDS business estimated to grow to 85% of the total turnover by FY2008. Consequently, the OPM is estimated to improve by 250 basis points over the two-year period FY2006-08.

Foothold in evolving businesses

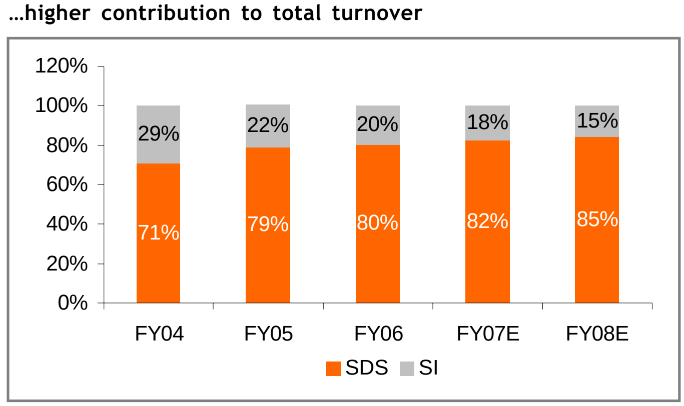
In addition to the PDS business segment, the company has established its presence in mechanical design and engineering, and animation and special effect segments through a team of roughly around 100 professionals in each of the two business units. Though these businesses are relatively much smaller in size and have lower margins, (as compared with the PDS business at this point of time), they have the potential to scale up substantially in future. For instance, National Association of Software and Service Companies estimates that the market opportunity in the outsourcing of the animation content development and post-production service industry alone would grow to $950 million by 2009. The outsourcing from the gaming industry would also add $300 million worth market opportunity for the domestic companines. We expect these two businesses to grow at a CAGR of 18% over the two-year period FY2006-08. The profitablility of these businesses is also likely to improve with the scale up in operations.

Healthy growth...



Source: Company, Sharekhan Research

...higher contribution to total turnover



Source: Company, Sharekhan Research

Additional trigger in form of merger with TCS

Though the management has categorically denied any possibility of a merger with the group's larger software service company, Tata Consultancy Services (TCS), we believe that the Tata group is likely to eventually consolidate all of its software service businesses into one company. It has already initiated the consolidation process by amalgamating of Tata Infotech with TCS.

Decent dividend yield

TEL has a liberal dividend policy with an average dividend pay-out ratio of 72.6% over the past three years. At the prevailing market price also, the dividend yield on the last year's dividend of 65% works out to a healthy 2.8%. We expect the company to further increase the dividend rate (even after factoring in a decline in the dividend pay-out ratio) in the current fiscal, which should limit the downside to the stock.

Concerns

Inconsistent growth on quarterly basis

TEL tends to show a high level of volatility in its quarterly results due to the project-based nature of the business. The financial performance is strongly influenced by the completion of a specific large project in the SDS business. Similarly, the system integration business is also non-linear in nature and is highly volatile on a quarterly basis. Moreover, the company is dependent on its largest client for 18% of the revenues and that too is a cause for concern.

Ability to manage the aggressive ramp-up

The biggest risk to our estimates is the management's ability to manage such sharp ramp-up in its employee base. Moreover, the efforts taken to broaden the employee base through recruitment of a higher proportion of fresh graduates would test the company's management skills.

Valuation

TEL's revenues and earnings are estimated to grow at a healthy CAGR of 26.8% and 34.5% respectively over the period FY2006-08. At the current price the stock trades at 11.7x its FY2008E earnings; the valuation doesn't factor in the robust earnings growth expected over FY2006-08 and the premium commanded by an established player operating in a fast-growing niche segment. We recommend a Buy call with a one-year target price of Rs320.

Financials

Profit and loss account Rs (cr)

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net sales	185.8	235.6	298.7	379.1
Total expenditure	150.0	189.0	234.8	295.9
EBITDA	35.8	46.7	63.9	83.3
Other income	1.1	0.7	0.6	0.6
Interest	0.1	0.2	0.2	0.2
Depreciation	5.0	6.7	9.0	11.5
PBT	31.9	40.6	55.6	72.4
Tax	5.4	6.1	7.7	10.1
PAT	26.4	34.5	47.8	62.3

Balance sheet Rs (cr)

Particulars	FY2005	FY2006	FY2007E	FY2008E
Share capital	31.1	31.1	31.1	31.1
Reserves and surplus	23.6	34.8	57.5	93.0
Networth	54.7	65.9	88.7	124.1
Total debt	0.0	0.0	0.0	0.0
Deferred tax liabilities	2.3	3.5	4.2	5.0
Minority interest	0.0	0.0	0.0	0.0
Capital employed	57.0	69.4	92.9	129.1
Net fixed assets	34.8	45.3	61.3	74.8
CWIP	1.1	3.2	4.0	5.0
Net current assets	21.1	21.0	27.6	49.4
Capital deployed	57.0	69.4	92.9	129.1

Valuation

Particulars	FY2005	FY2006	FY2007E	FY2008E
EPS (Rs)	8.4	11.0	15.3	19.9
P/E	27.5	21.1	15.2	11.7
Book value	17.6	21.2	28.5	39.9
Price/BV	13.2	11.0	8.2	5.8
Market cap/Sales	3.9	3.1	2.4	1.9
EV/Sales	3.8	3.0	2.4	1.9
EV/EBIDTA	19.8	15.2	11.2	8.5
Dividend yield (%)	2.4	2.8	3.0	3.2

Key ratios (%)

Particulars	FY2005	FY2006	FY2007E	FY2008E
OPM	19.3	19.8	21.4	22.0
NPM	14.2	14.7	16.0	16.4
RoCE	54.0	57.5	59.2	55.6
RoNW	111.6	98.6	82.7	66.7

The author doesn't hold any investment in any of the companies mentioned in the article.

Industry Update

Mutual Fund

Positive sentiment bolsters equity AUMs

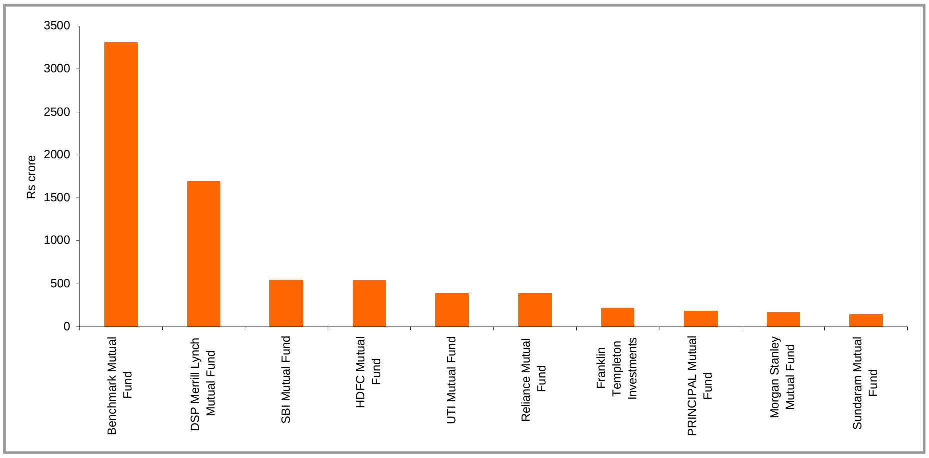
Industry news

- **Aviva quits StanChart Mutual Fund race:** There seems to be a twist in the tale of the ongoing sale of Standard Chartered Bank's local asset management arm. Aviva, the UK's biggest insurance group and the highest bidder for the mutual fund, has walked out of the bidding process. This leaves the door open for Swiss banking major UBS, which was the second-highest bidder.
- **Pioneer MF is back:** Pioneer quit India about four years ago when it sold its mutual fund to Templeton. Now, Pioneer may be making a comeback to India with a big bang! The US-based player is in talks with Bank of Baroda to launch its asset management, private equity and wealth management businesses.
- **R Rajagopal appointed Head - Equities of DBS Chola MF:** DBS Chola Mutual Fund has announced the appointment of R Rajagopal as Head - Equities. Mr Rajagopal will be responsible for managing DBS Chola Equity Funds. He has over 14 years of experience in managing equities.
- **Canara Bank to sell MF arm stake to Robeco:** Canara Bank, planning to sell a stake in its fully owned mutual fund arm in December, is likely to finalise Netherlands-based Robeco for the proposed joint venture. The bank is likely to retain 51% or more stake in its mutual fund arm after the stake sale. Most fund officials feel the deal would be valued at 6-7% of assets under management.
- **Reliance Growth, Reliance Vision top global list:** Reliance Growth and Reliance Vision, two equity funds managed by Reliance Mutual Fund, have been ranked as the top two funds globally, based on their five-year performance track record. The ranking is as per data from the internationally acclaimed Lipper, which benchmarks the top 20 performers from a global universe of open-ended equity funds.
- **Franklin Templeton to acquire 100% stake in its Indian AMC:** Franklin Templeton Investments has agreed in principle to acquire full control of its joint venture in India, subject to regulatory approvals and to execution of a formal agreement. Franklin Templeton will buy out the 25% stake in the asset management company's (AMC's) total equity paid-up capital held by Hathway Investments, a member of the Rajan Raheja group of companies.

Highlights

- The assets under management (AUM) for equity funds increased by 6.2% to Rs135,851 crore in November 2006. The rise in the equity AUM was higher than the market movement of 5.2%.
- Fund managers made purchases worth Rs12,675 crore and remained net sellers to the tune of Rs25 crore during the month.
- Equity mutual funds registered a net inflow of Rs2,147 crore. Even as the redemption volumes were higher compared to the previous month, the inflows into new and existing schemes were strong enough to counter the higher redemption volumes.
- Mutual funds are sitting on Rs9,158 crore of cash, waiting to deploy the same in the market. Of this, Rs7,487 crore of cash lies with the existing mutual funds, while the remaining Rs1,671 crore has been mobilised through new fund offerings (NFOs).
- Amongst all sector funds, banking funds have generated the highest returns in November 2006. Banking and technology funds have outperformed the Sensex, whereas funds in the auto, fast moving consumer goods (FMCG) and pharmaceutical sectors have underperfomed the Sensex.
- Mutual funds have slashed their exposure to banking, metal and electronics companies, and have bought stocks in the housing & construction, computers and telecom sectors.

- **Major movers for November 2006**



The AUM of equity mutual funds increased by 6.2% from Rs127,943 crore in October 2006 to Rs135,851 crore in November 2006. The rise in the equity AUM was higher than the market movement of 5.2%. The AUM for the equity-diversified funds surged by 3.8%, whereas that of tax planning and sector funds rose by 7.0% and 3.4% respectively. The index funds saw a massive increase of 57.7% in their AUM.

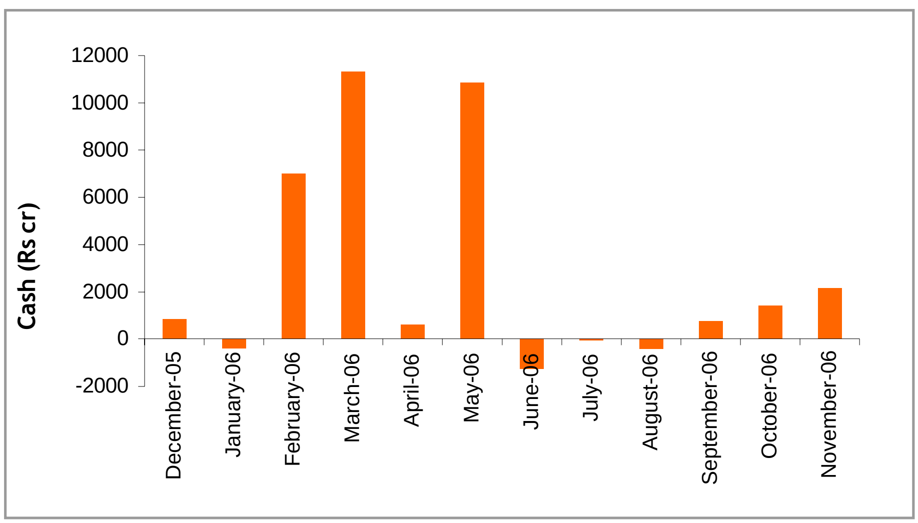
Benchmark Mutual Fund clocked the highest increase of 61.9%, amounting to Rs3,306 crore in its AUM. DSP Merrill Lynch Mutual Fund and SBI Mutual Fund followed Benchmark Mutual Fund and recorded increases of Rs1,687 crore and Rs543 crore respectively in their equity AUM. The top loser was Kotak Mahindra Mutual Fund, which saw its equity AUM declining by Rs70 crore, followed by ABN Amro Mutual Fund and JM Financial Mutual Fund.

- **Stock market activities for mutual funds**

Mutual funds turned net sellers of equities in November 2006.

Month	Purchase (Rs cr)	Sales (Rs cr)	Net (Rs cr)
Nov-06	12,675.21	12,700.04	-24.83

Equity fund flow

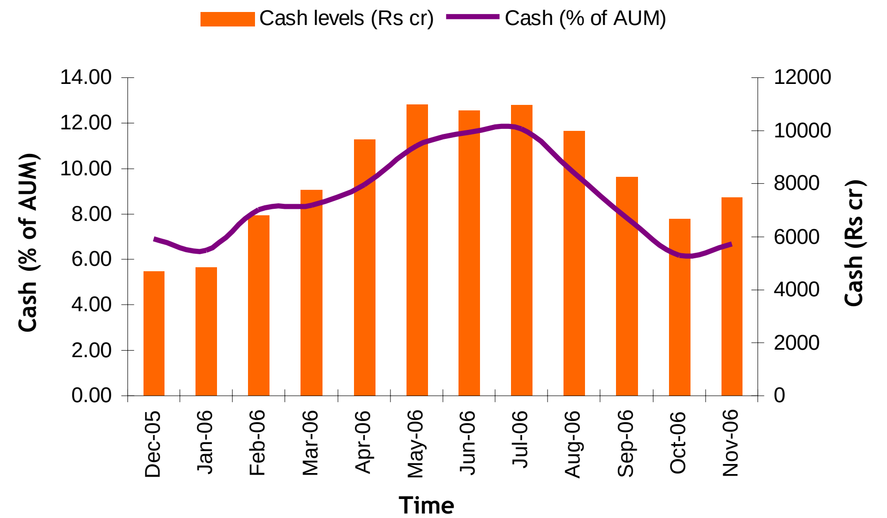


Fund flows into equity mutual funds continued their upward trend, with equity mutual funds registering a net inflow of Rs2,147 crore in November 2006. The rise in the fund flows in November as compared with October is mainly attributed to the higher amounts mobilised by the NFOs (Rs1,671 crore in November 2006 compared with only Rs1,466 crore in October 2006) and higher amounts of money flowing into the existing schemes. Even though the redemption volumes stood marginally higher at Rs7,154 crore, the higher NFO collections coupled with the higher amount flowing into the existing schemes were high enough to result in an overall increase in the net fund flow into equity mutual funds. The NFO collections include the amounts raised by DSP Merrill Lynch Small & Midcap Fund and SBI Arbitrage Opportunities Fund. The same however do not include the collections made by JM Financial Services Sector Fund, JM Telecom Sector Fund, Franklin Templeton Capital Safety Fund and Standard Chartered Arbitrage Fund. These funds were launched in November but did not close in the month, as the allotment of the units for these funds is not yet complete. The collections made by these funds (approximately Rs1,000 crore) will be reflected in the next month's fund flow figures.

Cash levels

Liquidity

The absolute cash levels for all equity funds launched before November 2006 increased from Rs6,689 crore in October 2006 to Rs7,487 crore in November 2006. The cash as a percentage of the total corpus also followed a similar trend, increasing marginally to 6.7% of the total corpus in November 2006 from 6.2% in October 2006.

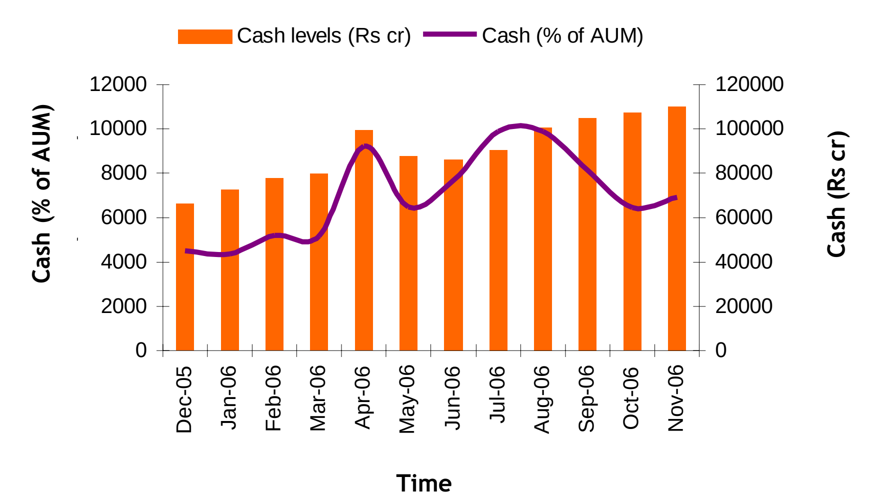


Note: Includes all equity funds in the industry launched before November 2006

Although this may signal that mutual funds may be expecting a short-term correction in the market, it is more likely that funds are holding cash more to counter the redemption requests, with investors wanting to book profits, with the market at an all-time high. Further, a large part of the increase in the cash levels can be attributed to the higher NFOs closing in November, with the NFO schemes sitting on large amounts of cash waiting to be deployed in the market. As seen below, excluding the impact of the newly launched schemes, the increase in the cash levels is more nominal.

Sentiments

Cash as a percentage of the total corpus (for all funds which are at least three months old) increased marginally from 6.0% in October 2006 to 6.3% in November 2006. This is probably because the funds are holding onto larger amounts of cash to counter the redemption requests, with investors inclined to book profits at such high levels.



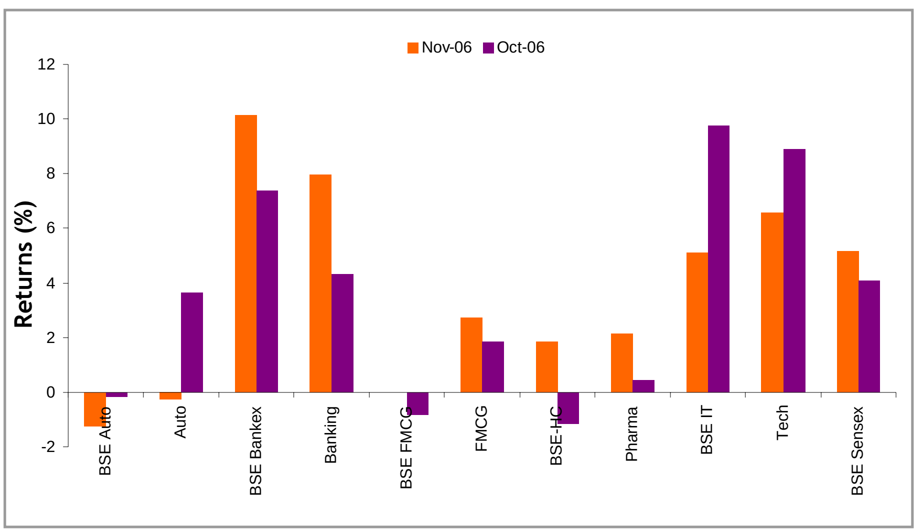
Note: Includes all equity funds in the industry with a NAV track record of three months+.

Sector allocation

Major shifts in the sector allocation for the equity-diversified category are as under:

Sector name	November 2006		October 2006		% change
	Amount (Rs cr)	% of net assets	Amount (Rs cr)	% of net assets	
Increase in exposure					
Housing & Construction	4980.7	5.8	3988.1	4.7	1.1
Computers - Software & Education	9750.2	11.3	8944.3	10.5	0.8
Telecom	4275.1	4.9	3774.9	4.4	0.5
Entertainment	2115.9	2.4	1743.1	2.0	0.4
Finance	1210.2	1.4	894.2	1.0	0.4
Engineering & Industrial Machinery	3088.7	3.6	2839.0	3.3	0.2
Decrease in exposure					
Miscellaneous	4079.1	4.7	4660.1	5.5	-0.7
Banks	6417.5	7.4	6829.4	8.0	-0.6
Metals	1044.9	1.2	1508.0	1.8	-0.6
Electronics	1335.2	1.5	1758.9	2.1	-0.5
Oil & Gas, Petroleum & Refinery	3402.2	3.9	3784.2	4.4	-0.5
Diversified	11856.6	13.7	12103.2	14.2	-0.5

Performance of sector funds



With the Sensex advancing by an appreciable 5.2% in November, most fund categories except technology and auto funds have generated significantly higher returns in November 2006 as compared with the returns clocked in October 2006. Banking and technology funds have outperformed the Sensex, whereas funds in the auto, FMCG and pharmaceutical sectors have underperfomed the Sensex by margins of 1-4%. Additionally, funds in the auto, FMCG, pharmaceutical and technology sectors have outperformed their respective benchmark indices (the BSE Auto, the BSE FMCG, the BSE Healthcare and the BSE IT indices) whereas the funds in the banking sector have underperformed the BSE Bankex index in November 2006. Banking funds gave the highest returns in November 2006, followed by technology and FMCG funds.

Sharekhan Stock Ideas

Evergreen

- HDFC Bank
- Infosys Technologies
- Reliance Industries
- Tata Consultancy Services

Apple Green

- Aditya Birla Nuvo
- ACC
- Apollo Tyres
- Bajaj Auto
- Balrampur Chini Mills
- Bank of Baroda
- Bank of India
- Bharat Bijlee
- Bharat Electronics
- Bharat Heavy Electricals
- Canara Bank
- Corporation Bank
- Crompton Greaves
- Elder Pharmaceuticals
- Grasim Industries
- Hindustan Lever
- Hyderabad Industries
- ICICI Bank
- Indian Hotels Company
- ITC
- Mahindra & Mahindra
- Marico
- Maruti Udyog
- Lupin
- Nicholas Piramal India
- Omax Autos
- Ranbaxy Laboratories
- Satyam Computer Services
- SKF India
- State Bank of India
- Sundaram Clayton
- Tata Motors
- Tata Tea
- Unichem Laboratories
- Wipro

Cannonball

- Allahabad Bank
- Andhra Bank
- Cipla
- Gateway Distriparks
- International Combustion (India)
- JK Cement
- Madras Cement
- Shree Cement
- Transport Corporation of India

Emerging Star

- 3i Infotech
- Aban Offshore
- Alphageo India
- Cadila Healthcare
- KSB Pumps
- Marksans Pharma
- Navneet Publications (India)
- New Delhi Television
- Nucleus Software Exports
- Orchid Chemicals & Pharmaceuticals
- ORG Informatics
- Solectron Centum Electronics
- Tata Elxsi
- Television Eighteen India
- Thermax
- TVS Motor Company
- UTI Bank

Ugly Duckling

- Ahmednagar Forgings
- Ashok Leyland
- BASF India
- Ceat
- Deepak Fertilisers & Petrochemicals Corporation
- Fem Care Pharma
- Genus Overseas Electronics
- HCL Technologies
- ICI India
- India Cements
- Indo Tech Transformers
- Jaiprakash Associates
- JM Financial
- KEI Industries
- NIIT Technologies
- Punjab National Bank
- Ratnamani Metals and Tubes
- Sanghvi Movers
- Saregama India
- Selan Exploration Technology
- South East Asia Marine Engineering & Construction
- Subros
- Sun Pharmaceutical Industries
- Surya Pharmaceuticals
- UltraTech Cement
- Union Bank of India
- Universal Cables
- Wockhardt

Vulture's Pick

- Esab India
- Orient Paper and Industries
- WS Industries India

Home