

## Company Focus

1 February 2008 | 9 pages

# Northgate Technologies (NOTC.BO)

## Buy: 3Q FY08 Results - Charting a Safe Course in Troubled Times

- **Solid 3Q: Demand outlook remains strong** — Northgate delivered a solid 3Q, comfortably beating our estimates. The results were punctuated by numerous milestones, including a number of key wins in its Globe7 Powered Services (aka managed hosting) offering and the launch of 2 new web sites. With the online advertising market remaining strong, especially in India and China, we continue to be attracted to Northgate's diversified (both product & geography) rev model, and hence reiterate our Buy/Medium Risk and Rs700 target price.
- **3Q FY08: Top & bottom beat** — Revs of Rs1,405m (+61.8% yoy) beat our Rs1,385m estimate. Net profit of Rs141m (-6.5% yoy) also beat our Rs134m estimate. No guidance was given; our 4Q FY08 estimate is unchanged.
- **Globe7** — Globe7 includes both the company's VoIP and managed hosting offerings (known as "Globe7 Powered Services"). Globe7 revs were Rs250m (17.8% of total revs), growing 35% qoq and almost 100% yoy for 9M FY08. Key new Powered Services wins include Tencent, Chinatimes.com, and on VoIP, Northgate contracts with Focus Media's Allyes for additional advertising.
- **Bharatstudent.com** — Bharatstudent is now the No. 1 social networking site in India targeting 16-24-year olds, according to comScore. Revs are still small, at Rs30m, but the company has an order book for US\$12m in advertising for the coming year. The site is still loss-making, but should breakeven by 4Q FY09.
- **Eggad.com & Ziddu.com** — Finally, the company has launched a new online gaming site (eggad) and a hosting/download portal (ziddu).

<b>Buy/Medium Risk</b>	<b>1M</b>
Price (01 Feb 08)	Rs500.00
Target price	Rs700.00
Expected share price return	40.0%
Expected dividend yield	0.0%
<b>Expected total return</b>	<b>40.0%</b>
Market Cap	Rs17,429M
	US\$444M

### Price Performance (RIC: NOTC.BO, BB: NORT IN)



Figure 1. Statistical Abstract

Year to 31 Mar	Revenues (Rs Mils.)	Net profit (Rs Mils.)	EPS (Rs)	EPS Growth (%)	P/E (x)	EV/EBITDA (x)
FY06	1,059	246	9.27	282.1	54.0	43.4
FY07	2,946	574	18.60	133.7	26.9	26.7
FY08E	5,360	652	18.82	13.5	26.6	18.5
FY09E	7,463	668	18.76	2.5	26.6	12.5
FY10E	10,448	853	23.82	27.6	21.0	9.1

Source: Company Reports and Citi Investment Research estimates

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<sup>1</sup>Citigroup Global Markets Asia

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	54.0	26.9	26.6	26.6	21.0
EV/EBITDA adjusted (x)	55.2	28.3	19.3	12.2	9.1
P/BV (x)	16.1	6.5	2.7	2.5	2.2
Dividend yield (%)	0.4	0.8	0.0	0.0	0.0
<b>Per Share Data (Rs)</b>					
EPS adjusted	9.27	18.60	18.82	18.76	23.82
EPS reported	9.27	18.60	18.82	18.76	23.82
BVPS	31.14	77.48	181.97	203.90	228.70
DPS	2.00	4.00	0.00	0.00	0.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	1,059	2,946	5,360	7,463	10,448
Operating expenses	-796	-2,415	-4,689	-6,744	-9,500
<b>EBIT</b>	<b>263</b>	<b>530</b>	<b>672</b>	<b>719</b>	<b>948</b>
Net interest expense	-2	-3	0	0	0
Non-operating/exceptionals	7	65	5	0	0
<b>Pre-tax profit</b>	<b>268</b>	<b>592</b>	<b>676</b>	<b>719</b>	<b>948</b>
Tax	-25	-22	-26	-50	-95
Extraord./Min.Int./Pref.div.	3	4	1	0	0
<b>Reported net income</b>	<b>246</b>	<b>574</b>	<b>652</b>	<b>668</b>	<b>853</b>
Adjusted earnings	246	574	652	668	853
Adjusted EBITDA	314	599	818	1,263	1,713
<b>Growth Rates (%)</b>					
Sales	58.7	178.1	82.0	39.2	40.0
EBIT adjusted	241.2	101.5	26.7	7.0	31.9
EBITDA adjusted	222.6	90.7	36.6	54.4	35.7
EPS adjusted	233.8	100.7	1.2	-0.3	26.9
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>-61</b>	<b>-260</b>	<b>172</b>	<b>581</b>	<b>881</b>
Depreciation/amortization	51	68	146	544	766
Net working capital	-409	-890	-734	-682	-833
<b>Investing cash flow</b>	<b>-148</b>	<b>-621</b>	<b>-1,501</b>	<b>-1,493</b>	<b>-627</b>
Capital expenditure	-123	-483	-1,501	-1,493	-627
Acquisitions/disposals	0	0	0	0	0
<b>Financing cash flow</b>	<b>395</b>	<b>1,177</b>	<b>3,138</b>	<b>0</b>	<b>0</b>
Borrowings	-16	0	0	0	0
Dividends paid	-14	-31	-77	0	0
<b>Change in cash</b>	<b>186</b>	<b>293</b>	<b>1,809</b>	<b>-912</b>	<b>254</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>1,047</b>	<b>2,805</b>	<b>6,622</b>	<b>7,351</b>	<b>8,287</b>
Cash & cash equivalent	200	496	2,301	1,390	1,644
Accounts receivable	406	1,403	2,144	2,836	3,657
Net fixed assets	212	596	1,866	2,815	2,676
<b>Total liabilities</b>	<b>171</b>	<b>247</b>	<b>280</b>	<b>340</b>	<b>423</b>
Accounts payable	107	144	254	314	397
Total Debt	0	0	0	0	0
<b>Shareholders' funds</b>	<b>876</b>	<b>2,559</b>	<b>6,344</b>	<b>7,012</b>	<b>7,865</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	29.6	20.3	15.3	16.9	16.4
ROE adjusted	44.8	33.6	14.6	10.0	11.5
ROIC adjusted	52.7	40.8	22.8	14.5	15.0
Net debt to equity	-22.8	-19.4	-36.3	-19.8	-20.9
Total debt to capital	0.0	0.0	0.0	0.0	0.0

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## Solid Outlook

Despite concerns over slowing US and European economies, Northgate sees strong advertising demand from its key markets and has a solid order book.

### Managed hosting business on track

Globe7 generated Rs250m revenues in 3Q FY08, representing 17.8% of total revenues. This represents growth of 35% qoq, and on a 9M FY08 basis, approximately 100% yoy growth.

In terms of its key contracts for its managed hosting services, which is called Globe7 Powered Services, its VOIP product for Sina has already been finished and delivered to Sina. We expect this product to be launched in the near term.

With regards to Tencent, Northgate is working with them to launch a portal aimed at students, similar to its own Bharatstudent.com. The portals will be launched to all the QQ users, who are in the young/student demographic. The site is a community, social networking site, where students can come to chat, blog, upload and view photos, etc.

The product is being developed and is tentatively named Longhaier (meaning "Dragon Child" in Chinese).

Moreover, for the new version of Globe7, which has just being launched, Northgate signed with Focus Media to sell 50% of the advertising inventory, to generate additional revenues.

### Bharatstudent tracking well

Bharatstudent.com generated Rs30m revenues in 3Q FY08, with 50% of the revenues from online advertising and 50% from its study abroad programs. Bharatstudent is now among India's top 25 websites in India and among the top 5 social networking websites in India, according to Alexa.com, as of end-January. In total, the website has exceeded 3m cumulative registered users and is generating over 60m page views per month.

According to comScore, Bharatstudent is now the #1 website targeting 16-24-year olds. Northgate is planning to open physical offices across the country for students, as they have contracted with ETS to be their test taking center operators, given Bharatstudent's target user base is students who study abroad and accordingly, would need to take ETS' exams (eg. GRE, GMAT). In addition, they have partnered with the British Education Council.

Going forward, online advertising will be the main revenue contributor for Bharatstudent. For FY08, the company expects 60-70% of revenue to be from advertising (both online and offline) and the rest from study abroad. The company's advertising contracts order book has already reached US\$12m.

The company expects Bharatstudent to break even by March 2009.

## Other new initiatives also gaining traction

Northgate has launched the commercial version of Egglad.com, an online gaming community website.

The company has also launched Ziddu.com, a web 2.0 file hosting and downloading website, which is now already generating more than 3m downloads per day. Via the website, users will be able to share (upload and download) any type of file or content.

## Adjusting our estimates

We have adjusted our estimates to reflect better than expected 3QFY08 results. To be conservative, we have kept our FY09E and FY10E estimates largely unchanged, though the advertising demand outlook appears strong.

**Figure 2. Northgate — Earnings Estimate Revisions**

	Revenues (Rs Mils.)			EPS (Rs)			EBITDA (Rs Mils.)		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
FY08E	5,340	5,360	0.4%	18.51	18.82	1.7%	806	818	1.4%
FY09E	7,434	7,463	0.4%	18.63	18.76	0.7%	1,220	1,263	3.5%
FY10E	10,408	10,448	0.4%	23.60	23.82	0.9%	1,717	1,713	-0.2%

Source: Citi Investment Research estimates

Figure 3. Northgate — Consolidated Income Statement (Rs in Millions)

Year to 31 Mar	FY06	1Q	2Q	3Q	4Q	FY07	1Q	2Q	3Q	4Q	FY08E	FY09E	FY10E
Net revenues													
Online advertising	489	394	NA	NA	NA	2,741	1,169	1,305	1,405	1,474	5,353	7,463	10,448
Telecommunications	558	75	NA	NA	NA	205	7	-	-	-	7	-	-
IT services	12	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total net revenues</b>	<b>1,059</b>	<b>469</b>	<b>637</b>	<b>819</b>	<b>1,020</b>	<b>2,946</b>	<b>1,176</b>	<b>1,305</b>	<b>1,405</b>	<b>1,474</b>	<b>5,360</b>	<b>7,463</b>	<b>10,448</b>
<i>YoY growth</i>	<i>58.7%</i>	<i>NA</i>	<i>NA</i>	<i>NA</i>	<i>NA</i>	<i>178.1%</i>	<i>150.6%</i>	<i>105.0%</i>	<i>71.4%</i>	<i>44.5%</i>	<i>82.0%</i>	<i>39.2%</i>	<i>40.0%</i>
Cost of revenues													
Traffic acquisition costs	148	178	314	515	713	1,720	795	830	852	922	3,399	4,657	6,634
Other cost of revenues	522	122	154	78	31	385	42	47	63	66	217	312	376
Total cost of revenues	670	300	468	593	721	2,105	837	877	915	987	3,616	4,969	7,010
<b>Gross profit</b>	<b>389</b>	<b>170</b>	<b>169</b>	<b>226</b>	<b>299</b>	<b>841</b>	<b>339</b>	<b>428</b>	<b>490</b>	<b>487</b>	<b>1,744</b>	<b>2,494</b>	<b>3,437</b>
<i>Gross margin</i>	<i>36.8%</i>	<i>36.1%</i>	<i>26.5%</i>	<i>27.6%</i>	<i>29.3%</i>	<i>28.5%</i>	<i>28.8%</i>	<i>32.8%</i>	<i>34.9%</i>	<i>33.0%</i>	<i>32.5%</i>	<i>33.4%</i>	<i>32.9%</i>
Selling and marketing expenses	21	31	16	8	47	79	73	156	203	236	669	933	1,306
General and administrative expenses	54	17	4	25	116	162	54	52	93	59	257	299	418
Miscellaneous expenditure written off	1	0	0	0	0	1	-	-	-	-	-	-	-
<b>EBITDA</b>	<b>314</b>	<b>121</b>	<b>148</b>	<b>193</b>	<b>136</b>	<b>599</b>	<b>212</b>	<b>219</b>	<b>194</b>	<b>192</b>	<b>818</b>	<b>1,263</b>	<b>1,713</b>
Depreciation and amortization	(51)	(16)	(17)	(19)	(16)	(68)	(18)	(18)	(52)	(58)	(146)	(544)	(766)
<b>Operating profit</b>	<b>263</b>	<b>105</b>	<b>131</b>	<b>173</b>	<b>120</b>	<b>530</b>	<b>194</b>	<b>201</b>	<b>142</b>	<b>135</b>	<b>672</b>	<b>719</b>	<b>948</b>
<i>Operating margin</i>	<i>24.8%</i>	<i>22.4%</i>	<i>20.6%</i>	<i>21.2%</i>	<i>11.8%</i>	<i>18.0%</i>	<i>16.5%</i>	<i>15.4%</i>	<i>10.1%</i>	<i>9.1%</i>	<i>12.5%</i>	<i>9.6%</i>	<i>9.1%</i>
Financial expenses	(2)	(0)	(0)	(0)	(2)	(3)	-	-	-	-	-	-	-
Other income	7	10	1	(16)	70	65	(6)	2	9	-	5	-	-
Profit before tax	268	115	132	158	188	592	188	203	151	135	676	719	948
Taxes	(25)	(2)	(1)	(8)	(11)	(22)	(4)	(1)	(11)	(9)	(26)	(50)	(95)
Minority interest	3	0	1	1	-	4	-	0	1	-	1	-	-
<b>Net profit</b>	<b>246</b>	<b>114</b>	<b>132</b>	<b>150</b>	<b>177</b>	<b>574</b>	<b>184</b>	<b>202</b>	<b>141</b>	<b>125</b>	<b>652</b>	<b>668</b>	<b>853</b>
<i>YoY growth</i>	<i>282.1%</i>	<i>0.0%</i>	<i>0.0%</i>	<i>0.0%</i>	<i>0.0%</i>	<i>133.7%</i>	<i>61.5%</i>	<i>53.2%</i>	<i>-6.5%</i>	<i>-29.3%</i>	<i>13.5%</i>	<i>2.5%</i>	<i>27.6%</i>
Basic EPS (Rs)	9.47	4.11	4.77	4.27	5.37	19.27	5.56	6.12	4.09	3.64	19.42	19.43	24.80
<b>Diluted EPS (Rs)</b>	<b>9.27</b>	<b>3.94</b>	<b>4.56</b>	<b>4.11</b>	<b>5.22</b>	<b>18.60</b>	<b>5.40</b>	<b>5.92</b>	<b>3.97</b>	<b>3.53</b>	<b>18.82</b>	<b>18.76</b>	<b>23.82</b>

Source: Company Reports and Citi Investment Research estimates

## Northgate Technologies

### Company description

Northgate is an innovative technology company with extensive research and development facilities in Hyderabad, India, and operations in the US, UK, Hong Kong, Singapore, China and India. Although Northgate has a global presence, its primary focus and growth strategies are set firmly on high-growth markets, particularly India and China. Its principal business is online advertising services, which it offers under the brand name Axill. Through this service, the company aggregates, positions and tracks Internet ads for online advertising agencies and other advertisers on websites controlled by third parties or by itself. The company generates revenue based on the number of Internet-user impressions, leads, sales or other actions that these ads generate.

### Investment strategy

We rate Northgate shares Buy/Medium Risk with a Rs700 target price. Northgate is a leading provider of Internet marketing and ad technology services, combined with a number of unique products (VoIP, social networking)

and high-capacity, highly scalable data centers. It is a beneficiary of the strong secular growth in online advertising due to its online ad agency business, online ad serving technology, and multi-pronged aggregation strategy.

## Valuation

We use P/E as our primary valuation methodology as this is the most commonly used method to value high-growth Internet companies such as Northgate. We apply a 30x target P/E multiple on our 2010E (ending March) EPS estimate and round down to reach our target price of Rs700. We arrive at this target multiple based on an analysis of the various peer groups for Northgate. Our target multiple is set at a 10-20% discount to the China Internet peer group and 20-30% discount to the India Internet (ex-Northgate) peer group, which we believe are justified given Northgate's execution risk. We generally use P/E multiples based on earnings two years out because this tends to provide a more reasonable multiple for young, very fast-growing companies, and it tends to normalize near-term variations in peer-group multiples.

## Risks

We rate Northgate Technologies shares Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility, and given the company's execution risk in managing growth, balanced by a solid secular growth outlook. The following risks could prevent the shares from reaching our target price: (1) Broad and significant competition from major international peers in both Internet as well as other telecom and media companies; (2) Any interruption or failure in technology or communication systems; (3) Any delay or failure of plans to sell minority stakes in its Indian and Chinese businesses, which the company intends to carry out to help fund shortfalls in working capital; (4) Any inability to adapt to changing technology and technology standards, especially as the Internet and Internet advertising markets are characterized by rapidly changing technologies, evolving industry standards, frequent new product and service introductions and changing client demands; (5) High customer concentration (e.g. the top five advertising customers accounted for 97% of company's advertising revenues in FY07, and a single customer accounted for 47.8%, 35.5% and 14.6% of revenues in FY07, FY06 and FY05, respectively); (6) Regulatory risks; (7) Advertising space could be restricted by website publishers; (8) Broadband access restrictions on customers; and (9) Pricing pressure.

# Appendix A-1

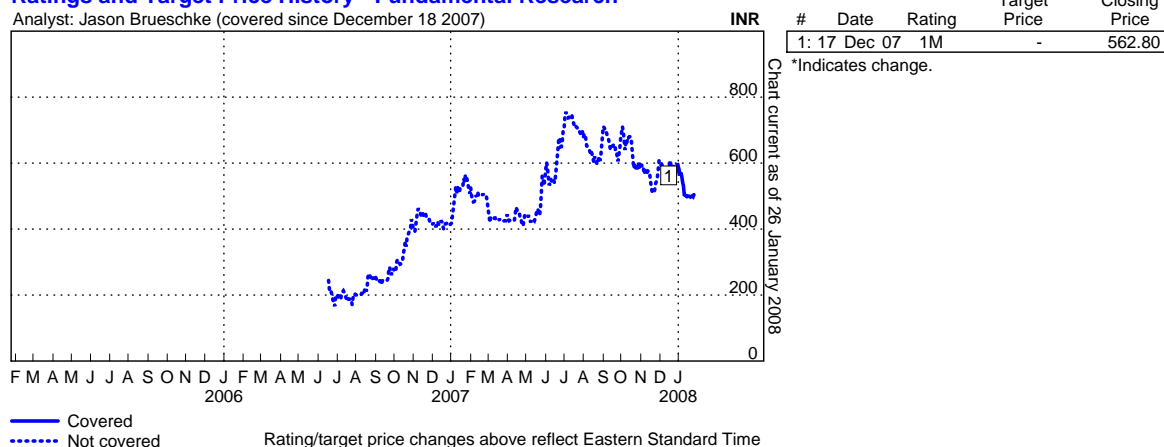
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