

# Limited catalysts ahead

## Limited catalysts ahead; Underperform

Post disappointing 4Q, we tweak CY10E earnings to factor in cut in margins and retain Underperform rating on the stock with a PO of Rs75. We forecast muted 1% YoY growth in revenues during CY10E and ~400bps YoY EBIT margin decline leading to 12% YoY decline in recurring profits during CY10E. With management guidance for weak 1Q revenues and margins likely to be weak during next two quarters, we see limited catalysts ahead for the stock. Retain Underperform rating.

## 4Q results :Margin worse than expected

Hexaware 4Q revenues declined 4% QoQ to Rs2.5bn in line with BofAMLe. EBIT margins declined ~600bps QoQ to 15%, 200bps lower than expected. Reversal of one off benefits reported in 3Q, lower billing days and cross currency fluctuations impacted margins. PAT declined by 13% QoQ, beating BofAMLe by 10%, largely driven by lower tax rates and forex losses. The company added seven new clients including five Fortune 500 clients.

## 1Q: Weak guidance, margins to fall

For 1QCY10, management has guided for 7% to 11% QoQ decline in revenues. A few of its top clients have kept projects on hold due to delay in the budgeting process. It expects these projects to start from 2Q onwards. We forecast EBIT margins to fall 600bps during 1Q driven by 1) sharp decline in revenues and 2) roll back of salary cuts implemented last year. Given its plans to increase salaries in 2Q, we expect margins to remain subdued in 2Q as well.

## CY10: Subdued growth

Given weak 1Q and limited margin levers (75% Utilization), CY10 is unlikely to be exciting. We see limited catalysts ahead the ky risk: is a failure for large deal wins.

## Estimates (Dec)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	1,101	590	1,343	1,185	1,551
EPS	7.65	4.10	9.34	8.17	10.70
EPS Change (YoY)	-11.4%	-46.4%	127.7%	-12.5%	30.9%
Dividend / Share	0.741	0.420	1.00	1.18	2.14
Free Cash Flow / Share	(0.785)	(3.27)	(0.649)	3.32	8.12

## Valuation (Dec)

	2007A	2008A	2009E	2010E	2011E
P/E	9.51x	17.75x	7.80x	8.91x	6.80x
Dividend Yield	1.02%	0.577%	1.38%	1.62%	2.94%
EV / EBITDA*	7.85x	7.31x	4.66x	5.94x	5.20x
Free Cash Flow Yield*	-1.07%	-4.45%	-0.891%	4.56%	11.16%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.

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## Stock Data

Price	Rs72.80
Price Objective	Rs75.00
Date Established	22-Sep-2009
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs20.50-Rs102.80
Mrkt Val / Shares Out (mn)	US\$228 / 145.0
Average Daily Volume	715,642
BofAML Ticker / Exchange	XFTCF / BSE
Bloomberg / Reuters	HEXW IN / HEXT.BO
ROE (2009E)	19.4%
Net Dbt to Eqty (Dec-2008A)	-40.1%
Est. 5-Yr EPS / DPS Growth	10.0% / 10.0%
Free Float	74.0%

## Key Changes

(Rs)	Previous	Current
2009E EPS	9.04	9.34
2010E EPS	8.45	8.17
2011E EPS	10.31	10.70
2009E EBITDA (m)	2,094.5	2,023.0
2010E EBITDA (m)	1,778.5	1,587.6
2011E EBITDA (m)	1,795.3	1,811.9

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## iQprofile<sup>SM</sup> Hexaware Technologies Ltd.

Key Income Statement Data (Dec)	2007A	2008A	2009E	2010E	2011E
<b>(Rs Millions)</b>					
Sales	10,398	11,520	10,386	9,970	11,362
Gross Profit	3,725	4,458	4,743	4,026	4,595
Sell General & Admin Expense	(2,524)	(3,170)	(2,720)	(2,439)	(2,784)
Operating Profit	968	1,019	1,753	1,310	1,501
Net Interest & Other Income	265	14	310	338	340
Associates	NA	NA	NA	NA	NA
Pretax Income	1,233	1,032	2,063	1,648	1,840
Tax (expense) / Benefit	(133)	(155)	(103)	(132)	(289)
Net Income (Adjusted)	1,101	590	1,343	1,185	1,551
Average Fully Diluted Shares Outstanding	144	144	144	145	145

### Key Cash Flow Statement Data

Net Income	1,101	878	1,960	1,516	1,551
Depreciation & Amortization	232	270	270	278	311
Change in Working Capital	(4)	901	(1,116)	(75)	(109)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(437)	(1,364)	(680)	(662)	0
Cash Flow from Operations	892	685	434	1,057	1,754
Capital Expenditure	(1,005)	(1,154)	(528)	(576)	(576)
(Acquisition) / Disposal of Investments	2,292	(1,409)	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	1,287	(2,563)	(528)	(576)	(576)
Shares Issue / (Repurchase)	33	0	0	0	0
Cost of Dividends Paid	(300)	(85)	(170)	(200)	(363)
Cash Flow from Financing	(265)	69	(170)	(200)	(363)
Free Cash Flow	(113)	(469)	(94)	481	1,178
Net Debt	(895)	(2,654)	(1,133)	(1,414)	(2,229)
Change in Net Debt	(1,914)	1,978	264	(281)	(815)

### Key Balance Sheet Data

Property, Plant & Equipment	3,277	4,498	4,086	4,385	4,651
Other Non-Current Assets	2,362	84	1,461	1,462	1,463
Trade Receivables	2,160	2,065	1,593	1,530	1,743
Cash & Equivalents	902	2,849	1,140	1,422	2,236
Other Current Assets	1,158	1,035	1,139	1,240	1,341
Total Assets	9,859	10,531	9,420	10,039	11,435
Long-Term Debt	0	195	0	0	0
Other Non-Current Liabilities	NA	NA	NA	NA	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	2,792	3,711	2,227	2,191	2,397
Total Liabilities	2,800	3,906	2,234	2,198	2,404
Total Equity	7,059	6,625	7,185	7,840	9,030
Total Equity & Liabilities	9,859	10,531	9,420	10,038	11,434

### iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	15.2%	12.6%	26.5%	19.7%	18.4%
Return On Equity	17.0%	8.6%	19.4%	15.8%	18.4%
Operating Margin	9.3%	8.8%	16.9%	13.1%	13.2%
EBITDA Margin	11.5%	11.2%	19.5%	15.9%	15.9%

### iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	0.8x	1.2x	0.3x	0.9x	1.1x
Asset Replacement Ratio	4.3x	4.3x	2.0x	2.1x	1.9x
Tax Rate (Reported)	10.8%	15.0%	5.0%	8.0%	15.7%
Net Debt-to-Equity Ratio	-12.7%	-40.1%	-15.8%	-18.0%	-24.7%
Interest Cover	NA	NA	NA	NA	NA

### Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 8.

### Company Description

Hexaware is a mid-tier Indian IT services company. Under the leadership of chairman Atul Nishar and vice chairman and CEO Chandrashekar (ex-Wipro Technologies), Hexaware has differentiated itself from its mid-tier peers and built up niche positions in Germany, the airlines vertical, and PeopleSoft implementation and support services. Banking, financial services, and insurance (BFSI) is the largest vertical, contributing more than 42.2% of revenues.

### Investment Thesis

Hexaware has high exposure to Peoplesoft which is showing a declining trend. Key concerns are on margins which could be impacted due to higher than expected salary hikes and likely back ended growth rates which could impact near term stock performance.

### Stock Data

Price to Book Value 1.5x

## Limited catalysts ahead; Underperform

Post disappointing 4Q, we tweak our CY10 estimate to factor in cut in margins and retain our Underperform rating on the stock with a PO of Rs75. We forecast muted 1% YoY growth in revenues during CY10 and ~400bps YoY margin decline leading to 12% decline in recurring profits during CY10. With management guidance of weak 1Q revenues and margins likely to be weak during the next two quarters, we see limited catalysts ahead for the stock. We retain our Underperform rating.

### Disappointing 4Q

Hexaware 4Q revenues declined 4% QoQ to Rs2.5bn in line with BofAMLe. EBIT margins declined ~600bps QoQ to 15%, 200bps lower than expected. Management attributed the fall in margins to a reversal in one off benefits reported in 3Q, lower billing days and cross currency fluctuations impacted margins.

PAT though declined by 13% QoQ, beating BofAMLe by 10%, largely driven by lower tax rates and forex losses. It added seven new clients including five Fortune 500 clients.

### Weak revenue guidance

For 1QCY10, management has guided for a 7% to 11% QoQ decline in revenues. A few of its top clients have kept projects on hold due to delay in the budgeting process. Management expects these projects to start from 2Q onwards.

### 1Q margins to fall 600bps

We forecast EBIT margins to fall 600bps during 1Q driven by 1) sharp decline in revenues and 2) roll back of salary cuts implemented last year. Given its plans to hike salaries in 2Q, we expect margins to remain subdued in 2Q as well.

### CY10 likely to disappoint

Given weak 1Q, subdued and limited margin levers (75% Utilization), CY10 is unlikely to be exciting. See limited catalysts ahead.

### Other key highlights

- Hexaware added seven new clients during the quarter, including five Fortune 500 clients.
- It added 234 net employees (largely new employees), an increase of 5% during the quarter.
- Debtors days reduced further to 56 days during the quarter.
- Cash & cash equivalents now stands at Rs4.3bn (Rs30/share).
- Management commented that the deal pipeline was strong and it expects to close a few large deals during 1Q, which should help improve revenue visibility.

## Quarterly analysis

Table 1: 4Q CY09 results

INR mn	4Q CY09	3Q CY09	QoQ	4Q CY08	YoY	BofAMLe	Variation
Revenue	2520	2632	-4.3%	3059	-18%	2515	0.2%
Direct Costs	1435	1365	5.1%	1739	-17%	1384	3.7%
<b>Gross Profit</b>	<b>1085</b>	<b>1267</b>	<b>-14.4%</b>	<b>1320</b>	<b>-18%</b>	<b>1131</b>	<b>-4.0%</b>
SG&A Expenses	635	644	-1.4%	770	-18%	615	3.2%
<b>EBITDA</b>	<b>450</b>	<b>623</b>	<b>-27.8%</b>	<b>550</b>	<b>-18%</b>	<b>515</b>	<b>-12.7%</b>
Depreciation	65	67	-3.0%	70	-7%	78	-16.9%
<b>EBIT</b>	<b>385</b>	<b>556</b>	<b>-30.8%</b>	<b>480</b>	<b>-20%</b>	<b>437</b>	<b>-11.9%</b>
Other Income	84	77	9.1%	54	56%	75	11.6%
Forex Losses	-105	-198	-47.0%	na	na	-148	-29.2%
<b>PBT</b>	<b>364</b>	<b>435</b>	<b>-16.3%</b>	<b>534</b>	<b>-32%</b>	<b>364</b>	<b>0.0%</b>
Tax	4	21	-81.0%	75	-95%	36	-89.0%
<b>PAT</b>	<b>360</b>	<b>414</b>	<b>-13.0%</b>	<b>459</b>	<b>-22%</b>	<b>328</b>	<b>9.9%</b>
Reported PAT	360	414	-13.0%	459	-22%	328	9.9%
Recurring PAT	360	414	-13.0%	459	-22%	328	9.9%
<b>Margins</b>			<b>bps</b>		<b>bps</b>		<b>bps</b>
Gross Margin	43.1%	48.1%	(508.3)	43.2%	(10)	45.0%	(191)
EBITDA Margin	17.9%	23.7%	(581.3)	18.0%	(12)	20%	(264)
EBIT Margin	15.3%	21.1%	(584.7)	15.7%	(41)	17%	(210)
PAT Margin	14.3%	15.7%	(144.4)	15.0%	(72)	13%	126
Effective Tax Rate	1.1%	4.8%	(372.9)	14.0%	(1295)	10%	(890)

Source: Company data, BofA Merrill Lynch Global Research estimates

## Financials

**Table 2: Profit and Loss Statement**

Year to December (Rs.mn)	CY07	CY08	CY09E	CY10E	CY11E
Revenues	10,398	11,520	10,386	9,970	11,362
Cost of sales	6,673	7,061	5,643	5,944	6,766
Gross profit	3,725	4,458	4,743	4,026	4,595
SG&A	2,524	3,170	2,720	2,439	2,784
EBIDTA	1,201	1,289	2,023	1,588	1,812
Other Income	264.9	14	310	338	340
Exchange loss		(288)	(617)	(331)	-
Depreciation	232	270	270	278	311
EBIT	968	1,019	1,753	1,310	1,501
Profit before Tax	1,233	744	1,446	1,317	1,840
Provision for Tax	133	155	103	132	289
PAT before share of associate	1,101	590	1,343	1,185	1,551
Profit share of associate	-	-	-	-	-
Profit before extraordinary items	1,101	590	1,343	1,185	1,551
Extraordinary items/ Forex Losses	(1,030)	(288)	-617	-331.2	-
Adjusted Net Profit	70.79	301.83	726.00	854.06	1,551.45
Minority interest in loss of subsidiary	(1.50)				
PAT and Minority interest	72	302	726	854	1,551
Recurring PAT	1,102	590	1,343	1,185	1,551

Source: BofA Merrill Lynch Global Research

**Table 3: Balance Sheet**

As at 31st December	CY07	CY08	CY09E	CY10E	CY11E
Share Capital	287	287	290	290	290
Reserves & Surplus	6,771	6,338	6,894	7,548	8,736
Shareholders funds	7,059	6,625	7,185	7,840	9,030
Debt	-	195	-	-	-
<b>Source of funds</b>	<b>7,067</b>	<b>6,820</b>	<b>7,192</b>	<b>7,848</b>	<b>9,037</b>
Gross Fixed Assets	3,347	4,103	4,631	5,207	5,783
Accumulated depreciation	997	1,202	1,472	1,750	2,061
Net Fixed Assets	2,350	2,900	3,158	3,457	3,721
Capital WIP	927	1,597	927	928	929
Investments	2,310	0	1,409	1,409	1,409
Sundry Debtors	2,160	2,065	1,593	1,530	1,743
Cash	902	2,849	1,140	1,422	2,236
Others	1,158	1,035	1,139	1,240	1,341
Current Assets:	4,221	5,950	3,873	4,193	5,323
Payables	2,333	3,008	1,524	1,487	1,694
Provisions	459	704	704	704	704
Current Liabilities	2,792	3,711	2,227	2,191	2,397
Working Capital	1,428	2,239	1,646	2,002	2,926
Deferred Tax asset	52	84	52	53	54
Others					
<b>Application of funds</b>	<b>7,067</b>	<b>6,820</b>	<b>7,193</b>	<b>7,849</b>	<b>9,039</b>

Source: Company data, BofA Merrill Lynch Global Research estimates

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**Table 4: Cash Flow Statement**

	CY07	CY08	CY09E	CY10E	CY11E
<b>Cash flow from operating activities</b>					
Net Profit Before tax	203	745	1446	1317	1840
Deprn and amortization	235	284	270	278	311
<b>Operating Profit before working capital changes</b>	1154	922	1716	1595	2152
Adj for :					
Trade and other receivables	-465	706	368	-37	-314
Trade and other payable	462	195	-1484	-38	206
<b>Cash generated from operations</b>	1151	1823	537	1189	2043
Direct taxes paid	-258	-237	-103	-132	-289
<b>Net cash from operating activities</b>	892	685	434	1057	1754
<b>Cash flow from investing activities</b>					
Additions to fixed assets	-1005	-1154	-528	-576	-576
proceeds from sale of investments	7726	6441	-1409	0	0
<b>Net cash used in investing activities</b>	-510	1155	-1937	-576	-576
<b>Cash flow from financing activities</b>					
dividend paid	-300	-85	-170	-200	-363
Net cash (used in)/ from financing activities	-265	69	-170	-200	-363
Net increase in cash and cash equivalents	117	1910	-1673	281	815
cash and cash equivalents at the beginning of the year	786	903	2813	1140	1422
Effect of exchange rate change on cash and cash equivalent					
Cash and cash equivalents at the end of the year.	903	2813	1140	1422	2236
Cash and Cash equivalents	3212	2849	2549	2831	3645

Source: Company data, BofA Merrill Lynch Global Research estimates

**Table 5: Ratios**

Year to 31st December	CY07	CY08	CY09E	CY10E	CY11E
<b>Growth (%)</b>					
Revenues	22.6	10.8	(9.8)	(4.0)	14.0
Net profit	(11.4)	(46.4)	127.7	(11.7)	30.9
EBIDTA	(9.2)	7.3	57.0	(21.5)	14.1
<b>Profitability (%)</b>					
EBITDA margin	11.55	11.19	19.5	15.9	15.9
Net Profit margin	10.6	5.1	12.9	11.9	13.7
ROE	1.0	4.4	10.5	11.4	18.4
ROCE	15.6	8.6	18.7	15.1	17.2
<b>Turnover (x)</b>					
Debtor days	76	65	56	56	56
Total Assets	1.5	1.7	1.4	1.3	1.3
Net fixed assets	4.4	4.0	3.3	2.9	3.1
<b>Valuation (x)</b>					
EPS (INR)- Diluted	7.7	4.1	9.3	8.2	10.7
CFPS (INR)	9.3	6.0	11.2	10.2	13.0
BVPS (INR)	49.2	46.1	50.0	54.5	62.8
DPS (INR)	0.74	0.42	1.00	1.18	2.14
P/ CF (x)	8.2	12.6	6.7	7.4	5.8
P/ BV (x)	1.5	1.6	1.5	1.4	1.2
EV/ EBITDA (x)	7.5	7.0	4.5	5.7	5.0
EV/ Net sales (x)	0.9	0.8	0.9	0.9	0.8

Source: Company data, BofA Merrill Lynch Global Research estimates

## Price objective basis & risk

### Hexaware Tech (XFTCF)

Our PO of Rs75 is at 0.7 PEG (ex cash) and implies a target multiple of 9x CY10E in line with other small cap peers. We believe this is fair given higher exposure to PeopleSoft (about 23pct of revs) and high exposure to US market (66pct) and concentration in Banking vertical (44%).

Downside risks: Slower than expected margin expansion, risk to PeopleSoft Implementation revenues and industry-wide risks of growing competition, wage pressures and Rupee appreciation. Upside risks: Large deal closures currently are being pursued by the company.

## Analyst Certification

I, Pratish Krishnan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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### India - Software & IT Services Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
BUY	Educomp Solu	EUSOF	EDSL IN	Pratish Krishnan
	Firstsource	FSSOF	FSOL IN	Mitali Ghosh
	Genpact Ltd	G	G US	Mitali Ghosh
	HCL	XHCLF	HCLT IN	Mitali Ghosh
	Infosys Tech	INFYF	INFO IN	Mitali Ghosh
	Infosys Tech - A	INFY	INFY US	Mitali Ghosh
	Mphasis Ltd	MPSSF	MPHL IN	Pratish Krishnan
	Rolta India	RLTAF	RLTA IN	Pratish Krishnan
	Rolta India-GDR	XLROF	RTI LI	Pratish Krishnan

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**India - Software & IT Services Coverage Cluster**

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
	Tata Consultancy	TACSF	TCS IN	Mitali Ghosh
	Wipro	WIPRF	WPRO IN	Mitali Ghosh
	Wipro	WIT	WIT US	Mitali Ghosh
	Zee Entertainment	XZETF	Z IN	Pratish Krishnan
<b>NEUTRAL</b>				
	Patni	PATIF	PATNI IN	Mitali Ghosh
	Patni Computer	PTI	PTI US	Mitali Ghosh
	Tech Mahindra	TMHAF	TECHM IN	Pratish Krishnan
	WNS (Holdings) L	WNS	WNS US	Mitali Ghosh
<b>UNDERPERFORM</b>				
	Hexaware Tech	XFTCF	HEXW IN	Pratish Krishnan
	Infotech Enterprises Ltd	IFKFF	INFTC IN	Pratish Krishnan
	Mastek	MSKDF	MAST IN	Pratish Krishnan
<b>RVW</b>				
	Balaji Tele	BLJIF	BLJT IN	Bharat Parekh
	ExlService Holdi	EXLS	EXLS US	Mitali Ghosh
	Sun TV Network Ltd	SUTVF	SUNTV IN	Pratish Krishnan

**iQmethod<sup>SM</sup> Measures Definitions**

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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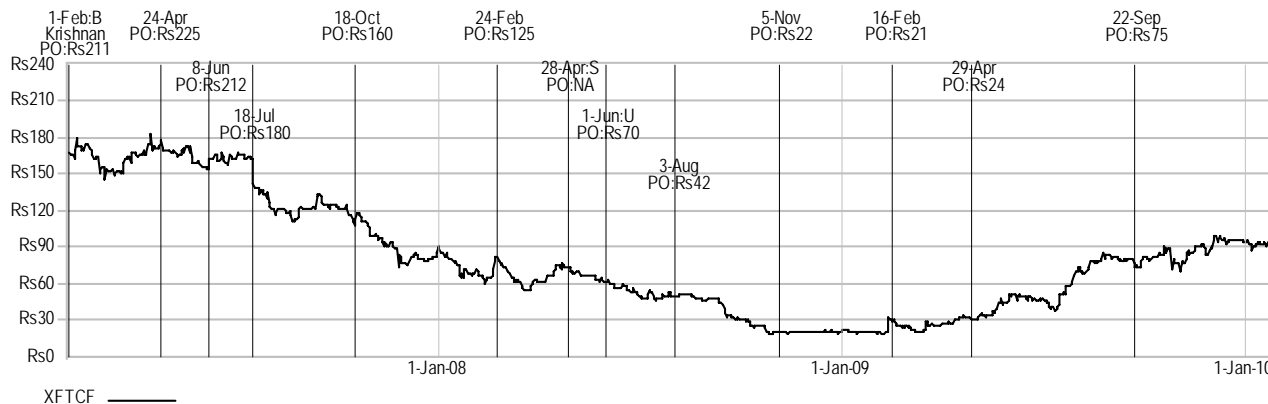
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### XFTCF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

\*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of January 31, 2010 or such later date as indicated.

BofAML price charts do not reflect analysts' coverage of the stock at prior firms. Historical price charts relating to companies covered as of December 31, 2008 by former Banc of America Securities LLC (BAS) analysts are available to BAS clients on the BAS website.\*

### Investment Rating Distribution: Technology Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	95	42.22%	Buy	60	66.67%
Neutral	60	26.67%	Neutral	42	80.77%
Sell	70	31.11%	Sell	30	47.62%

### Investment Rating Distribution: Global Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1699	50.78%	Buy	904	58.82%
Neutral	841	25.13%	Neutral	491	65.03%
Sell	806	24.09%	Sell	368	49.80%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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18 February 2010

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