Parul Inamdar Senior Research Analyst
91-22-**6632 2243** ParulInamdar@PLIndia.com

Prabhudas Lilladher
Fulfilling investors' needs since 1944

IPO Note

Tanla Solutions

Subscribe | **Price Band: Rs 230-265** | **November 30, 2006**

Play on VAS in the Mobile domain

We are positive regarding the prospects of Tanla Solutions, which intends to raise nearly Rs 3.9bn at the upper end of the price band to fund its expansion and acquisition plans. Post-IPO, the promoters would hold approx. 34.9% of the equity, down from the current holding of 46.4%. A provider of integrated telecom infrastructure solutions and products, the company is already listed on the Hyderabad Stock Exchange. It is now coming out with a follow-on offer and will list on the BSE and NSE. It has successfully transitioned from being a telecom product licensing company to providing telecom products and services on a revenue-sharing / pay-for-use revenue model.

Offer Details

(number of shares, in millions)

Pre-Issue	34.12
Public Issue	**15.88**
Fresh Issue	**14.29**
Total Issue Size	15.88
Net Issue to the Public	14.29
Of which:	
Retail Portion	5.00
QIB's	6.80
Non-Institutional	2.14
Mutual Funds	0.35
Post-Issue	**50.00**

In its follow-on public offering, Tanla Solutions is issuing 15.88m shares. The issue opens December 11 and closes December 14. The offer, which is being made at an indicative price band of Rs 230-265, is expected to raise Rs 3,287m (or Rs 3,787m at the higher end of band). The proceeds would be utilized towards setting up infrastructure for a Development Centre at Hyderabad (Rs 773m), for a Backup/ Disaster Recovery Centre at Bangalore (Rs 128m), establishing overseas marketing offices (Rs 41m), expanding and upgrading research and development facilities (Rs 220m), regional and global expansion and acquisitions (Rs 200m), working capital (Rs 284m), contingencies (Rs 104m) and for general corporate purposes (Rs 1,750m).

Post-issue, the equity would rise by 46.6%, to 50m shares, diluting the promoters' holdings from 46.4% to 34.9%. The equity capital would increase from Rs 68m to Rs 100m.

Company Background and Business

Launched in 1995 to establish a dairy farm, dairy processing and a mineral water processing plant, this company was taken over by the present promoters from the previous ones in 2000. The name was changed to Tanla Solutions Ltd. in order pursue information technology and allied activities. Commercial activity in the new line of business was started in 2000, focusing on telecom signaling solutions and messaging infrastructure. In 2004, the company acquired a telecom services company in the UK, Techserv Teleservices (UK) Ltd. [now Tanla Solutions (UK) Ltd.] and a software development company, Smartnet Communications Systems Pvt. Ltd. (Delhi). In 2005 it acquired Mobizar Ltd. (now Tanla Solutions Ltd.), an aggregator service provider in the UK.

Tanla Solutions now provides integrated telecom infrastructure solutions and products. It is already listed on the Hyderabad Stock Exchange. The company is now coming out with a follow-on offer and will then list on the BSE and NSE.

Its business can be divided into three segments:

Telecom Signaling Solutions (TSS) This contributes about 20% to the top line and works at an EBITDAM of 85-90%. In TSS, it has developed following products:

> **Short Message Service Centers (SMSC)** SMSCs reside in the mobile operator's network and enable operators to send and receive messages.
>
> **Missed Call Alerts** Notifies users about calls missed while handsets were switched off or when customers were not in network area.
>
> **Multimedia Messaging Service Centers (MMSC)** Deliver audio, text, pictures and video between different devices and technologies.
>
> **Single IMSI, Multiple MSISDN (SIMM)** Allows mobile operators to offer local numbers to frequent roamers within regions and countries.
>
> Other services include ring-back tones, call-routing solutions, 'welcome-roamers' messages sent by mobile operators to roamers, etc.

Messaging Applications and Billing (Aggregators) Services This contributes about 65% to the top line and works at an EBITDAM of 37-40%. It provides a single point of interface between mobile communications products and services developers (content providers) and mobile network operators. It is very important and critical that an aggregator offers end-to-end services and, at the same time, is connected to all the telecom operators of the country. With its subsidiary, Tanla Mobile Ltd. (UK), the company takes care of both the critical factors. It offers the following services on its aggregator platform:

> **SMS, EMS and MMS Gateway** Used to send picture messages, ring tones, operator logos, images, audio & video clips and graphics.
>
> **Micro-payments** Sends a reverse billing SMS to users and charges them.
>
> **Interactive TV Services** A platform that can communicate with interactive television.
>
> **Content Management System** Allows service providers to provide content such as videos, ring tones, images, wallpapers, etc. and integrates with the billing systems.

Video Gateway Allows service providers to deliver live or recorded video content to end users' 3G handsets.

Billing Allows for real-time statistics and live reconciliation of messaging/ data transactions with mobile network operators.

Offshore Development Services This contributes about 13% to the top line and works at an EBITDAM of 68-70%. It provides technological expertise to customers (content providers) who do not have substantial in-house technical expertise. Since most of its customers are located outside India, it is called Offshore Development Services.

The company's client list includes some marquee names such as Virgin, Oasis, Vodafone, 3, O2, etc. In just two years, it has tied up with about 40 content providers and almost all the mobile operators in the UK. This says much about its strong client relationship management.

In September 2006, it had over 200 employees and has seating capacity for over 350 employees, spread over 30,000 sq. ft.

The company's business model has evolved over the years from merely telecom product licensing to providing products and services on a revenue-sharing/pay-for-use revenue model.

Geographical presence

At present, about 98% of its revenue arises from exports and the company will maintain its revenue mix at this level. In European markets, the mobile operator passes on about 80-82% of the revenue to the aggregators, who, in turn, pass on about 24-26% to the content providers. In effect, the aggregators enjoy as much as 56% of the share. Such a high-revenue-sharing model has been the motivating factor for the company to expand its business into Europe rather than in the domestic market. Moreover, in the European market, charges for various non-voice services ranges between 50 pence and £5 per service; whereas, in the domestic market, they are priced at about Rs 1 to Rs 5.

In future, the focus would be to tap the US and Australian markets as well. The company is expected to begin operations in the US market from Q1 FY08.

Industry

At present, the company operates in the non-voice segment of the mobile industry. Globally, this segment is expected to grow from $61bn in 2004 to $189bn in 2009, thus registering a 25% CAGR from FY04 to FY09. According to 'Mobile Messaging – 2005 Edition', by 2010 of the total messaging market of $120bn, the global SMS market would account for $70bn in revenue. Currently, the non-voice segment is driven by SMSs, which account for nearly 70% of revenue from non-voice applications worldwide. IDC estimates that the non-voice market in Western Europe would be a more than $15.4bn industry, which would include a variety of services like SMS and MMS.

The non-voice market segment can be divided into:

Short Messaging Service (SMS)

Enhanced Messaging Services These are like SMS, but have special text formatting, animation, pictures, icons, sound effects and special ring tones.

Multimedia Messaging Service (MMS) This is a data service which can combine audio, video and pictures along with text.

Other data services This includes services like data networking, browsing and entertainment services (downloading of games, wallpapers, etc.)

In terms of usage geographically, Europe is the largest telecom market, with revenue of $931bn in 2005. In spite of reaching saturation, total traffic from messaging in Europe is expected to grow by 92% in the next five years. In Europe, the UK has the most competitive market, with five major mobile operators and a 3G operator. The pre-paid wireless market in the US is expected to grow from $4,500m in 2004 to $8,750m by 2011. In terms of use of value-added services and entertainment services, this market lags behind most European and Asian markets. Hence, there is vast potential for selling such services.

The non-voice segment in the telecom industry has strong entry barriers in the form of high technical expertise and credentials, strong research and development teams, and high-tech and scalable infrastructure. Also, there is constant pressure on aggregators to bring in innovative products and add value to mobile operators.

Promoters

D. Uday Kumar Reddy, Chairman and Managing Director: One of the founders of Tanla Solutions, with an MBA from Manchester Business School (UK), his strategic insights, operational expertise and technological & financial skills have enabled the company's growth in revenue and profitability.

Gautam Sabharwal, Director, Global Business Development: An MBA from the UK, he is responsible for handling Tanla's global marketing and sales. He has vast experience in the telecom services industry in the emerging telecom services market of Europe.

Satish Kathirisetti, Director & CTO: An M.E. from the Madras Institute of Technology, he has vast experience and expertise in the areas of Telecom and Systems Engineering. He is responsible for product strategy and technical direction of the company's solutions. He looks after the research and development activities of the company.

Anoop Roy Kundal, Director, Operations: A B.Tech from IIT, Delhi, he is responsible for the company's product delivery and operations. With more than six years' experience in object-oriented designs and enterprise software development, he has been a key member at SmartNet (an IT solutions company) and has expertise in architectural designs and applications development and deployment.

Navnit Chachan, Director, Research and Development: A B.Tech from IIT, Delhi, he works in designing, developing, implementing and enhancing software programs in various operating systems. Prior to joining Tanla Solutions, he worked with Reliance Industries.

Amit Gupta, Director, Solutions and Reference Architecture: A B.Tech from IIT, Delhi, he has vast experience in software engineering and ERP. He has extensive knowledge in the BFSI and manufacturing verticals. Prior to joining Tanla, he worked with Ernst & Young and KPMG.

Financials

From FY04 to FY06 revenue has had a 232% CAGR to Rs 630m; PAT, a 215% CAGR to Rs 302m. EBITDAM and PATM for FY06 stand at 55.7% and 48%.

For H1 FY07, the company reported revenue and PAT of Rs 870m and Rs 357m and EBITDAM and PATM of 51.3% and 41%.

The EPS for FY06 (on the fully diluted equity capital of Rs 100m) stands at Rs 6.05. For H1 FY07, it is projected at Rs 7.14 (on the post-issue capital). At the upper and lower ends of the price band, the stock is available at, respectively, 43.8x and 38x FY06A earnings. On annualising the H1 FY07 EPS of Rs 7.14, the stock would be quoting at 18.6x and 16.1x FY07E earnings.

At the upper end of the price band, the market cap would be Rs 13.25bn; at the lower end, Rs 11.5bn.

Investment Positives

High but sustainable profitability ratios: The company enjoys high profitability ratios. With higher-than-its-peers H1 FY07 margins (51% EBITDAM, 41% PATM), the company is definitely well placed. Management is quite confident of sustaining this in the near future as well.

Extremely healthy return ratios: The company's return ratios are phenomenal: for FY06, return on capital employed (RoCE) was 118% and return on net worth (RoNW) was 103%. The main reason behind such high return ratios is the low capex required in the aggregation segment.

Huge potential: Ninety percent of the company's revenue derives from the UK. Still, its market share in the aggregation business is pegged at just about 2%. This market in the UK is highly fragmented, with the topmost vendor enjoying about a 15-16% market share. This opens up vast opportunities for the company to ramp up its operations and gain a larger share.

Untapped markets: The company will begin operating in the US market from Q1 FY08. At present, the US market lags behind the European market in terms of penetration and the use of value-added services and entertainment services. Revenue from prepaid wireless subscribers in the US are expected to clock a 10% CAGR from 2004 to 2011 to reach $8,75bn.

Attractive Valuations: On annualising the company's H1 FY07 earnings, at the upper end of the price band the stock is available at 18.6x Tanla's FY07E earnings, which, considering that the company is in a growth mode, is quite attractive.

Concerns

Industry specific risk: The company's presence in one vertical brings in an industry-specific risk. Any downturn in the telecom industry would affect the company's performance.

Geographical risk: About 90% of company's revenue derives from the UK. This implies an extremely high geographical concentration. Any downturn in mobile use in the UK could hamper the company's performance significantly.

High DSOs: Debtor outstanding days in this business are about 70-90. This follows the broader trend in the telecom industry, where a user is billed monthly and given a credit period of around 15-18 days. This broadly covers 45-48 days. Another 25-35 days go in passing on revenue from the mobile operator to the aggregator. For FY06, Tanla's DSOs rose to 137 days (from 72 days in FY05), also due largely to the high growth in revenue.

Conclusion

Considering the company's presence in the high-growth vertical (telecom), its outstanding and sustainable profitability ratios (both operating as well as net profit margins), extremely healthy return ratios (due to low capex), technical credentials in the telecom vertical, young yet experienced management and attractive valuations (18.5x annualised H1FY07 earnings) we recommend a **'SUBSCRIBE'** on the issue.

Income Statement *(Rs m)*

Y/e March	FY02	FY03	FY04	FY05	FY06	H1FY07
Net Sales	**9**	**16**	**57**	**224**	**630**	**871**
Expenditure						
Personnel Cost	3	2	4	14	34	35
Selling and Marketing Expenses	6	11	22	132	245	389
EBITDA	**0.3**	**2**	**31**	**78**	**351**	**446**
EBITDA Margin (%)	*3.8*	*15.1*	*54.0*	*34.9*	*55.7*	*51.3*
Depreciation	2	2	2	4	8	13
EBIT	**(2)**	**-**	**29**	**74**	**343**	**433**
Non-Operating Income	-	-	1	3	1	1
PBT	**(1)**	**0.8**	**30**	**77**	**344**	**434**
Tax	-	(0.1)	(0.3)	9	42	77
Tax Rate (%)	*-*	*(14.7)*	*(0.8)*	*11.5*	*12.1*	*17.3*
Profit after Tax	**(2)**	**1**	**30**	**68**	**302**	**357**

Balance Sheet *(Rs m)*

Y/e March	FY02*	FY03*	FY04*	FY05	FY06	Q1FY07
Sources of Funds						
Equity Share Capital	50	50	50	68	68	68
Reserves & Surpluses	-	-	11	85	367	734
Net worth	**50**	**50**	**61**	**153**	**435**	**802**
Total Funds Employed	**50**	**50**	**61**	**153**	**435**	**802**
Application of Funds						
Gross Block	17	22	28	36	110	215
Less: Depreciation	2	4	5	9	16	29
Net Fixed Assets	**15**	**18**	**22**	**27**	**94**	**186**
Capital Work-in-Progress	-	-	-	-	5	-
Goodwill	-	-	-	30	30	30
Current Assets						
Debtors	6	2	6	44	237	486
Days	*364*	*57*	*38*	*72*	*137*	
Cash	2	3	26	65	181	199
Loans & Advances	13	20	13	16	11	41
Current Liabilities / Provisions	**4**	**4**	**10**	**30**	**119**	**141**
Net Current Assets	**19**	**21**	**35**	**98**	**309**	**585**
Miscellaneous Expenses	14	8	2	-	4	10
Deferred Tax Assets	-	-	(1)	(1)	(7)	(9)
Total Assets	**50**	**50**	**61**	**153**	**435**	**802**

**Valuations at Rs 265 (higher end) and per-share calculations at diluted post-issue equity capital*

**FY02, FY03 and FY04 figures are standalone figures.*