

JULY 20, 2011

RESULT

Coverage view: **Attractive**

Price (Rs): **175**

Target price (Rs): **175**

BSE-30: **18,502**

In-line revenues; one-offs aid margins. Polaris' reported recurring net income of Rs426 mn beat our estimate by 10% on the back of better-than-expected margin performance. Revenue growth (+4% qoq reported, +2.5% organic) was in line with our expectations. We understand that one-off provision reversals aided margin improvement, even as the management did not quantify the extent of reversal. Sustainability of margins remains key and we would wait for a quarter or two before turning positive on the stock. Maintain SELL with an unchanged TP of Rs175/share.

Company data and valuation summary

Polaris Software Lab

Stock data

52-week range (Rs) (high,low) 214-131

Market Cap. (Rs bn) 17.5

Shareholding pattern (%)

Promoters 29.0

FIs 24.5

MFs 11.6

Price performance (%)

Absolute 6.7 (14.1) (4.5)

Rel. to BSE-30 0.9 (9.6) (7.7)

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	19.3	19.5	22.3
EPS growth (%)	25.7	0.9	14.2
P/E (X)	9.1	9.0	7.9
Sales (Rs bn)	15.9	19.4	22.8
Net profits (Rs bn)	1.9	1.9	2.2
EBITDA (Rs bn)	2.1	2.5	3.0
EV/EBITDA (X)	5.8	4.5	3.5
ROE (%)	20.2	17.3	17.1
Div. Yield (%)	2.1	2.2	2.3

1QFY12 results – margin beats surprises, revenue performance in line with expectation

Polaris reported recurring (excluding proceeds from surplus real estate monetization) net income of Rs426 mn (down 11% qoq, down 9% yoy), 10% higher than our estimate. Net income outperformance was driven by a 200 bps beat on EBITDA margins, even as revenues came marginally below estimate. Revenues of US\$100.7 mn (versus our estimate of US\$101 mn) included acquisition contribution of US\$1.5 mn – +4.1% qoq on reported basis, +2.5% organic. Margin performance was surprising given headwinds in the form of wage hikes and Rupee appreciation. Management attributed margin improvement to better realizations, lower SI revenues, and one-off provision reversals.

Sustainability of margins key to stock performance; our confidence remains low

Polaris has shown reasonable revenue traction for the past several quarters and indicates that the momentum remains strong. The company has also raised its FY2012E revenue guidance to US\$430-440 mn from US\$425-435 mn earlier. Even as we believe revenue momentum for the company can sustain, we have reservations on building in margin improvement from 1QFY12 levels. Margin headwinds in the form of stronger Rupee and tight supply-side environment in the industry continue and the company has limited levers to improve margins – utilization remains high at 81%, there is little leverage on the SG&A front (the company has also communicated its intent to keep investing in the S&M engine).

Raise EPS estimates, maintain SELL

We have revised our FY2012E and FY2013E EPS estimates to Rs19.5 and Rs22.3 from Rs18.9 and Rs20.9, earlier, respectively. We note that our EPS estimates represent recurring earnings and do not factor in surplus real estate sales proceeds that the company is building into its FY2012E EPS guidance of Rs21.95-Rs22.35. Revision in EPS estimates is primarily driven by (1) increase in margin assumptions, and (2) change in Re/US\$ rate – to 44.7 and 45.6 for FY2012E and FY2013E versus 45.5 and 44 earlier, respectively. Our target price of Rs175/share implies P/E of 8X FY2013E earnings, reflecting the risks associated with our margin assumptions, as discussed earlier.

Kawaljeet Saluja
kawaljeet.saluja@kotak.com
Mumbai: +91-22-6634-1243

Rohit Chordia
rohit.chordia@kotak.com
Mumbai: +91-22-6634-1397

Shyam M.
shyam.m@kotak.com
Mumbai: +91-22-6634-1470

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Polaris Software Interim Results - 1QFY12 (Rs mn)

	1QFY11	4QFY11	1QFY12	qoq % chg.	yoy % chg.	KIE	% Deviation
Revenues (US\$ mn)	78.9	96.7	100.7	4.1	27.6	101.0	(0.4)
Total Revenues	3,606	4,375	4,502	2.9	24.9	4,531	(0.7)
Cost of Revenues	(2,430)	(3,022)	(3,085)	2.1	27.0	(3,203)	(3.7)
Gross Profit	1,176	1,354	1,417	4.7	20.4	1,329	6.6
SG&A Expenses	(694)	(827)	(838)	1.3	20.7	(835)	0.3
EBITDA	482	527	579	9.9	20.1	494	17.2
Other income	142	133	116	(12.6)	(18.4)	123	(5.9)
Interest expense	(2)	(4)	(5)			(4)	
EBDT	622	656	691	5.3	11.0	614	12.5
Depreciation	(78)	(87)	(96)	10.1	22.5	(89)	7.5
Minority interest							
Pretax profits	544	569	595	4.5	9.4	525	13.3
Provision for Tax	(79)	(90)	(169)	89.0	115.4	(137)	23.2
Net Profit	465	480	426	(11.2)	(8.5)	388	9.8
Extraordinaries	1	96	20			90	
Net Profit reported	466	576	446	(22.6)	(4.4)	478	(6.7)
EPS - recurring (Rs)	4.7	4.8	4.3	(11.2)	(8.5)	3.9	
Margins (%)							
Gross margin	32.6	30.9	31.5			29.3	
SG&A expenses	19.3	18.9	18.6			18.4	
EBITDA margin	13.4	12.0	12.9			10.9	
EBIT margin	11.2	10.1	10.7			8.9	
Net profit margin	12.9	13.2	9.9			10.5	
Tax rate	16.9	18.7	39.8			35.4	

Source: Company, Kotak Institutional Equities estimates

Key changes to estimates, FY2012E-13E

	Revised		Earlier		Change (%)	
	FY2012E	FY2013E	FY2012E	FY2013E	FY2012E	FY2013E
Revenues (US\$ mn)	434	500	432	501	0.5	(0.3)
Revenues (Rs mn)	19,418	22,799	19,641	22,064	(1.1)	3.3
Revenue growth, US\$ (%)	24.6	15.1	24.0	16.1		
EBITDA (Rs mn)	2,541	2,978	2,471	2,639	2.8	12.9
EBIT (Rs mn)	2,143	2,514	2,093	2,199	2.4	14.3
Net profit (Rs mn)	1,943	2,219	1,884	2,088	3.1	6.3
EPS (Rs)	19.5	22.3	18.9	20.9	3.1	6.3
EBITDA margin (%)	13.1	13.1	12.6	12.0		
EBIT margin (%)	11.0	11.0	10.7	10.0		
Re/US\$ rate	44.7	45.6	45.5	44.0	(1.6)	3.7

Source: Kotak Institutional Equities estimates

Condensed consolidated financials for Polaris, 2010-2013E, March fiscal year-ends (Rs mn)

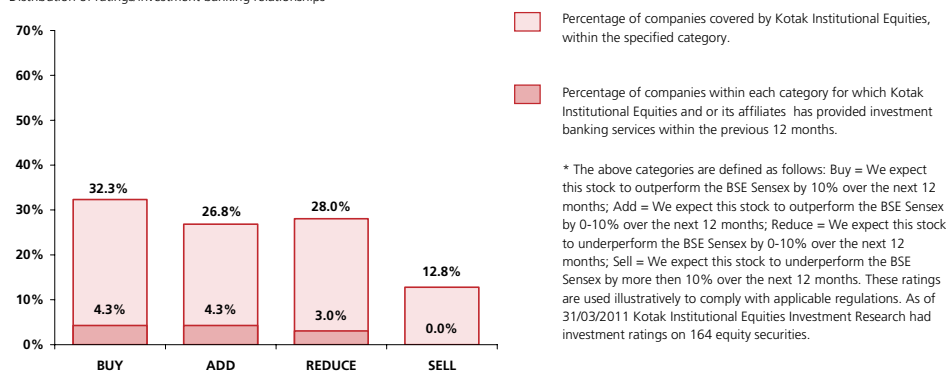
	FY2010	FY2011	FY2012E	FY2013E
Profit & Loss Model				
Revenues	13,538	15,863	19,418	22,799
EBITDA	2,220	2,139	2,541	2,978
Depreciation	(350)	(337)	(399)	(464)
EBIT	1,870	1,802	2,143	2,514
Other Income	(73)	494	515	527
PBT	1,788	2,285	2,639	3,022
Tax	(255)	(359)	(696)	(803)
Net Profit	1,533	1,926	1,943	2,219
Balance Sheet (Rs mn)				
Total Equity	8,725	10,325	12,074	13,814
Borrowings	25	83	83	83
Total capital	8,749	10,408	12,156	13,897
Net fixed Assets	2,271	2,937	3,341	3,794
Investments	3,897	3,843	3,843	3,843
Goodwill	506	644	644	644
Working Capital	2,041	2,891	4,235	5,522
- Cash	1,237	1,423	2,373	3,262
- Current Assets	3,830	5,274	6,482	7,642
- Current Liabilities	3,026	3,805	4,621	5,382
Total assets	8,749	10,408	12,156	13,897
Free Cash Flow (Rs mn)				
Cash generated from operations	2,163	2,085	2,220	2,139
Working Capital Changes	871	(914)	(393)	(399)
Capital expenditure	(429)	(941)	(803)	(917)
Tax	(290)	(359)	(696)	(803)
Free Cash Flow	2,315	(129)	328	19

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2011

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

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Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

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