

I-FLEX SOLUTIONS

INR 1,111

*Margins improve, but concerns persist***ACCUMULATE**

i-flex Solutions' (i-flex) Q3FY08 results were below expectations. Revenues, at INR 6.2 bn, were up 7.6% Q-o-Q and 11.2% Y-o-Y, while net profits, at INR 1.07 bn, were up 22.1% Q-o-Q and down 4.1% Y-o-Y. The products business, at INR 3.6 bn, grew 10% Q-o-Q, in line with expectations, with major contribution (75%) from implementation and AMC fees; license fees accounted for only 24% of product revenues, showing a moderate growth trend. The lower proportion of high margin license fee contribution resulted in significantly lower net profits for the quarter than our expectation. The license fees tank is about USD 81.2 mn, almost flattish from USD 80 mn in the previous quarter. The services business has underperformed in Q3FY08 with revenues from this segment growing a modest 6% Q-o-Q. While EBITDA margins improved by 490bps to 21.5% vis-à-vis 16.6% in the previous quarter, they still lag 22.6% posted in the corresponding quarter of the previous year.

i-flex's services business is an under performer with margins being a concern and volatile. Though Q3FY08 EBITDA margins have improved, we believe consistency coupled with more sustainable growth across business lines is still missing, while KPO business, with negative EBITDA, is yet to bear fruits.

The company saw superior growth in FY07 on the back of products catering to regulations such as Sarbans Oxley (SOX), Basel II, and Anti-Money Laundering. We believe growth has moderated as most of the big financial institutions and banks are in a matured phase of implementing these solutions. Added to this, sub-prime and credit related issues in the BFS segment in the US throw an uncertainty dimension in terms of new license sales.

Adjusting for the much weaker-than-expected product sales on back of U.S subprime concerns and EBITDA volatility, we have revised our EPS estimates marginally for FY08E and FY09E downwards ~3% to INR 45.05 and 5% % to INR 50.9, respectively based on Indian GAAP.

i-flex's cost management has been unimpressive; S,G&A costs still remain high at >25% of revenues and EBITDA margins are volatile even on an expanding revenue base. The topline growth has not translated into a sustainable bottom line growth, as the latter grew at just half the rate of 36% CAGR during 2004-07.

At CMP of INR 1,095, the stock is trading at P/E of 24x and 21.5x on our FY08E and FY09E earnings, respectively. We are maintaining our 'ACCUMULATE' recommendation on the stock for the above given reasons. The only positive trigger we see at current levels for the stock is open purchase offer by Oracle.

Financials

Year to March	Q3FY08	Q2FY08	Growth %	Q3FY07	Growth %	FY07	FY08E
Revenue (INR mn)	6,196	5,758	7.6	5,574	11.2	20,609	23,715
Gross profit (INR mn)	2,932	2,512	16.7	2,605	12.6	9,543	10,830
EBITDA (INR mn)	1,330	954	39.5	1,260	5.6	4,425	4,680
Net profit (INR mn)	1,067	874	22.1	1,112	(4.1)	3,723	3,689
EPS basic (INR)	13.2	10.8	22.1	13.7	(4.1)	46.0	45.5
P/E (x)						23.8	24.0
EV/EBITDA (x)						18.9	18.7
Market cap/ Rev. (x)						4.5	3.8

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Bloomberg : IFLEX IN

Market Data

52-week range (INR) : 2,630 / 900
Share in issue (mn) : 83.7
M cap (INR bn/USD mn) : 94.2 / 2,362.6
Avg. Daily Vol. BSE/NSE ('000) : 64.0

Share Holding Pattern (%)

Promoters : 80.6
MFs, Fls & Banks : 1.9
Fls : 0.4
Others : 17.1

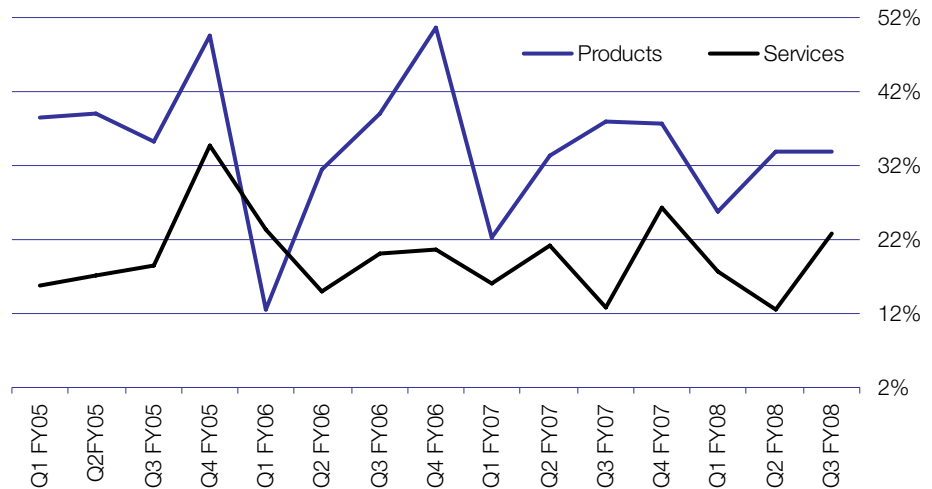
Key highlights

- ◆ Revenues, at INR 6.2 bn, were up 7.6% Q-o-Q and 11.2% Y-o-Y. Net profit, at INR 1.07 bn, was up 22% Q-o-Q and down 4% Y-o-Y.
- ◆ i-flex’s consolidated EBITDA margins increased by 490bps on account of a 1000bps improvement in EBITDA margins of the services business. The expansion in services margins was mainly driven by the benefits accrued to the company from economies of scale, higher proportion of offshore revenues, and higher utilisation levels. Product margins, in contrast, increased only 10bps despite a 38.0% increase in license fee revenues Q-o-Q.
- ◆ The company added 14 new customers, including 9 for products business line.
- ◆ DSO improved to 102 days from 110 days in the previous quarter.
- ◆ During Q3FY08, i-flex’s revenues from the products business increased 10% sequentially, driven by a 38.0% Q-o-Q increase in license revenues.
- ◆ The share of license fees in total product revenues increased from 18.9% in Q2FY08 to 23.7% in Q3FY08.
- ◆ The company signed USD 23.3 mn of new licenses in Q3FY08.
- ◆ Its tank size increased only marginally from USD 80 mn to USD 81.2 mn.

*** Margins improve, but lack consistency**

i-flex’s EBITDA margins have been very erratic, both across product and services segments. While product line margins are trending towards the 27-30% range, services business margins have been in the downward mode since the past four quarters. We expect them to trend up in the 14-15% range in the near term. This should result in overall EBITDA margins of 20-22% for FY08E.

Chart 1: Product and service EBITDA margin trend



Source: Company, Edelweiss research

*** Outlook and valuations: concerns still persist; maintain ‘ACCUMULATE’**

At CMP of INR 1,095, the stock is trading at PE of 24x and 21.5x on our FY08E and FY09E revised earnings, respectively. The stock is trading at a forward PEG of over 1x, given our CAGR earnings growth estimate of nearly 15% over FY07-10. We maintain our ‘ACCUMULATE’ recommendation, but we note that current valuations factor in i-flex’s continued leadership in the packaged banking products space.

Financial snapshot								(INR mn)
Year to March	Q3FY08	Q2FY08	Growth %	Q3FY07	Growth %	FY07	FY08E	FY09E
Products	3623	3294	10.0	3303	9.7	11211	13513	16216
Services	2456	2313	6.1	2143	14.6	8920	9667	11117
KPO	98	131	(24.8)	108	(8.9)	445	464	510
Others(JV)	19	19	(0.3)	21		34	70	70
Total revenues	6196	5758	7.6	5574	11.2	20609	23715	27914
Products	1537	1391	10.5	1209	27.2	4351	5681	6892
Services	1661	1775	(6.4)	1673	(0.7)	6391	6874	8060
KPO	62	76	(18.8)	70	(12.3)	298	312	383
Others(JV)	4	4	(1.6)	17		26	17	28
Direct costs	3264	3246	0.6	2969	9.9	11066	12884	15363
Gross profit	2932	2512	16.7	2605	12.6	9543	10830	12551
Products	854	787	8.6	836	2.1	3039	3257	3649
Services	237	246	(3.6)	196	21.3	796	906	1112
KPO	41	82	(50.4)	62	(34.8)	238	228	255
Others(JV)	13	9		1		1	39	39
Corporate G & A	457	434	5.3	249	83.4	1046	1720	1954
Total overhead expenditure	1602	1558	2.8	1345	19.1	5119	6151	7009
EBITDA	1330	954	39.5	1260	5.6	4425	4680	5543
Depn & Amrtz						25	26	25
Products	87	85	2.8	76	13.9	307	340	374
Services	64	76	(15.8)	61	5.0	241	263	287
KPO	5	8	(28.7)	6	(9.3)	25	25	31
Others(JV)	1	1	(34.3)	1	(12.1)	6	4	4
Corporate	34	25		19		74	112	168
Total depn & amrtz	191	195	(2.2)	163	17.1	653	744	864
EBIT	1139	758	50.2	1096	3.9	3771	3935	4678
Share of associate co. loss	(2)	2	(216.7)	2	(233.9)	8	(1)	0
Other income	59	207	(71.5)	63	(7.1)	360	244	0
Profit before tax	1195	967	23.6	1162	2.9	4139	4179	4678
Provision for tax	(129)	(94)	37.4	(50)	157.5	(416)	(489)	(561)
Reported net income	1067	874	22.1	1112	(4.1)	3723	3689	4117
EPS basic (INR)	13.2	10.8	22.1	13.7	(4.1)	46.0	45.5	50.9
as % of revenue								
Gross profit	47.3	43.6		46.7		46.3	45.7	45.0
SG&A	25.9	27.1		24.1		24.8	25.9	25.1
EBITDA	21.5	16.6		22.6		21.5	19.7	19.9
EBIT	18.4	13.2		19.7		18.3	16.6	16.8
Reported net profit	17.2	15.2		19.9		18.1	15.6	14.7
Tax rate	(10.8)	(9.7)		(4.3)		(10.1)	(11.7)	(12.0)

Company Description

i-flex is a leading software vendor for the banking and financial services vertical. It provides technology products, custom applications and services, consulting services, IT infrastructure services, and KPO services focused specifically on the financial industry. The company's product suite comprises FLEXCUBE, DAYBREAK, Reveleus, CASTEK, and recently acquired Mantas' behavior detection platform. Its core banking product, FLEXCUBE has been ranked world's No. 1 selling core banking solution for four years in a row since 2002 by the UK-based International Banking Systems (IBS). i-flex's services business, focused on BFSI segment, has also grown rapidly and currently contributes ~42% to the total revenues. The company employs over 11,000 people and its revenues for the past twelve months (TTM) stood at INR 17. bn (USD 433 mn).

Investment Theme

i-flex is a clear leader in the Indian financial services space. Its strong product portfolio has an extremely comprehensive range of solutions for the financial services industry. Besides developing a strong product suite, the company has been constantly expanding its capabilities through organic and inorganic routes. However the company has shown consistent lackluster performance on the operational side especially in S, G & A costs management.

Key Risks

Key risks to our investment theme include: (a) Open purchase offer by Oracle corp., (b) sustained slowdown in the US' BFSI segment,, and (c) significant appreciation of rupee against US dollar, Euro, and GBP.

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Coverage group(s) of stocks by primary analyst(s): Information Technology:

Geometric, HCL Tech, Hexaware, i-flex, i-Gate, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, and Wipro

i-flex Solutions



Recent Research

Date	Company	Title	Price (INR)	Recos
4-Feb-08	Moser Baer	Optical media still a drag; Result Update	208	Accumulate
01-Feb-08	Mphasis	Traction remains strong; profitability needs to pick up Result Update	248	Buy
01-Feb-08	Rolta India	Zooming ahead Result Update	252	Buy
23-Jan-08	Rolta India	Acquires 'TUSC' - Expands service portfolio; Event Update	539	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	110	43	15	2	188

* 12 stocks under review / 6 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	88	74	26

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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