Prabhudas Lilladher

Sector Report

Industry: Information Technology

The Right Choice

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April 09, 2012

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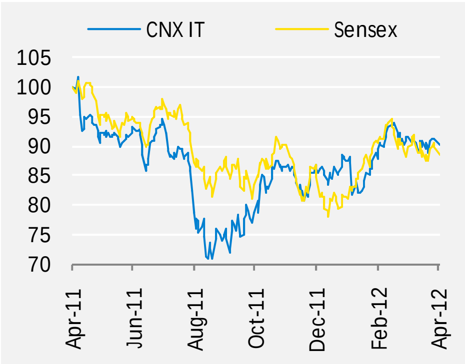
Sensex v/s CNX IT



Source: Bloomberg

Stock Performance

(%)	1M	6M	12M
Sensex	**(0.8)**	**9.1**	**(12.5)**
CNX IT Index	**(0.1)**	**16.9**	**(11.6)**
CMC	**(0.9)**	**22.8**	**(11.2)**
eClerx Services	(5.5)	0.4	(3.5)
Geometric	1.5	69.8	10.0
Hexaware Tech.	**2.4**	**45.6**	**72.4**
KPIT Cummins	(15.0)	7.2	(8.6)
Mphasis	0.5	26.0	(7.6)
MindTree	12.1	49.5	30.3
NIIT Tech.	**11.0**	**34.8**	**42.4**
Polaris Software	(5.3)	24.8	(20.5)
Persistent Systems	5.6	10.8	(17.1)
Rolta India	(6.8)	30.4	(37.5)
Tech Mahindra	11.5	26.6	(3.7)

We are initiating coverage on niche mid-cap players, mainly, *NIIT Tech* (**BUY**, TP: Rs350, CMP: Rs265), *CMC* (**Accumulate**, TP: Rs1,200, CMP: Rs978), and *Hexaware* (**Reduce**, TP: Rs100, CMP: Rs118). The gap between large-cap and mid-cap is widening. However, we think growth is still achievable in an age of budgetary austerity with niche services.

- **Undifferentiated valuations:** The share price currently is not factoring in upside to earnings estimates and implies slower growth than Tier-1. We are confident that business mix and scale can sustain the share gains in the niche segments they operate. Moreover, upcoming corporate's cost cognizance as the top-most priority would give an edge to the mid-tier companies, who have service offering at a discount compared to larger players. We think compelling valuations create a good entry point.

- **Differentiated business model distinguish each from others:** The breadth of services being offered across the verticals for Tier-1 encompasses all the service offerings by mid-tier companies. Despite tough competitive landscape, NIIT Tech (edge in Travel, Transportation & Logistic), CMC (Strong India presence), and Hexaware (Peoplesoft advantage) continue to hold their ground. We expect many of the mid-tier and specialized clients would prefer to work with the companies that can offer more customized service and attention.

- **What to own?** We favour *NIIT Technologies* and *CMC*. Our analysis indicates that they can continue to capture market share, but valuations appear low relative to their fundamental growth outlook. We think they are best positioned for multiple expansions as operating margin expand along with growth momentum.

- **What to avoid?** We think that *Hexaware* is fairly valued in our base case, but faces the highest probability of downside risk in our bear case. The company has already stretched the margin levers, expanding operating margin in-line with Tier-1 players. We see current run-up in the stock price is not only valuing the growth momentum, but also acquisition premium. As the acquisition rumours wind down, we think the valuation overhang will increase. The current valuation leaves little room for disappointment. Our base case factors in 20% downside risk from the current level.

Exhibit 1: Valuation Summary

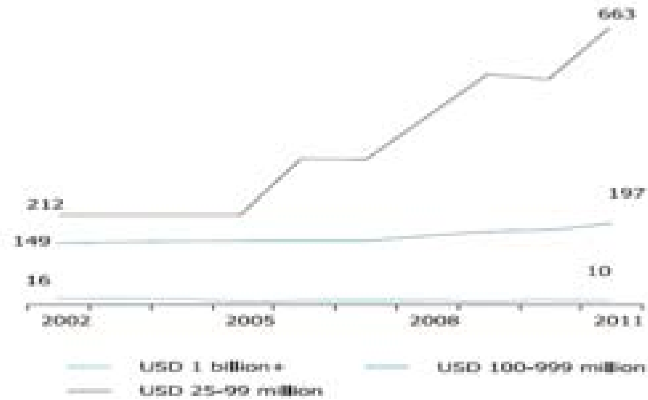
	Rating	CMP	Target	Upside	Revenues (Rs m)			EPS (Rs)			*EPS CAGR*
					2012	**2013**	**2014**	**2012**	**2013**	**2014**	
NIIT Technologies	BUY	265	350	32.3%	15,737	18,970	21,734	34.0	40.5	45.5	*15.7%*
CMC Ltd	Accumulate	978	1200	22.8%	14,640	17,560	20,045	50.1	70.4	81.7	*27.6%*
Hexaware Technologies*	Reduce	118	100	-15.6%	14,505	18,515	21,029	9.1	10.7	11.3	*11.5%*

Source: Company Data, PL Research ** Y/e Dec*

Smaller size contract improve mid-tier competitiveness

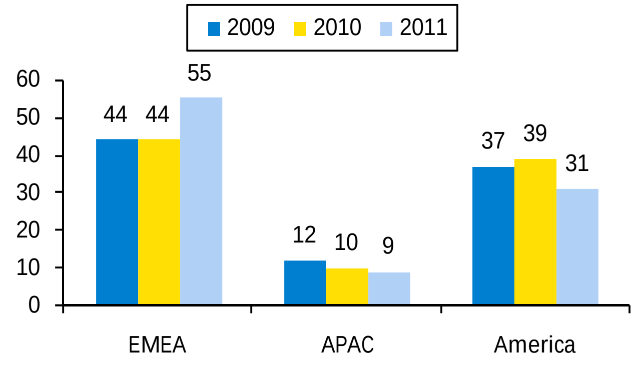
Despite lingering concerns about the global economy and financial obstacles in 2011, the global outsourcing market recorded a healthy growth amidst record contracting activities during the year. The TCV of IT outsourcing deals in 2011 at US$95bn was 3% higher than 2010 and also the highest since 2005 with a record total number of deals at 870.

Exhibit 2: IT-BPO TCV (numbers) – Smaller deal gaining prominence



Source: TPI, PL Research

Exhibit 3: Region-wise contract awarded (USD bn)



Source: TPI, PL Research

The intensified contracting activity is the result of a decade-long rise in the smallest size contracts. While the numbers of mega deals and mid-range contracts awarded has remained relatively stable since 2002, those valued at US$100m or less have more than tripled. Annual deals for the deal sizes between US$25-99m (smaller size contracts) have risen from 212 in 2002 to 663 in 2011 accounting for 76% of the total 870 deals in 2011, while deal size between US$100-999m, have risen from 149 to 197. Mega deals ($1bn +), on the other hand, have gone down from 16 to 10 over the similar period.

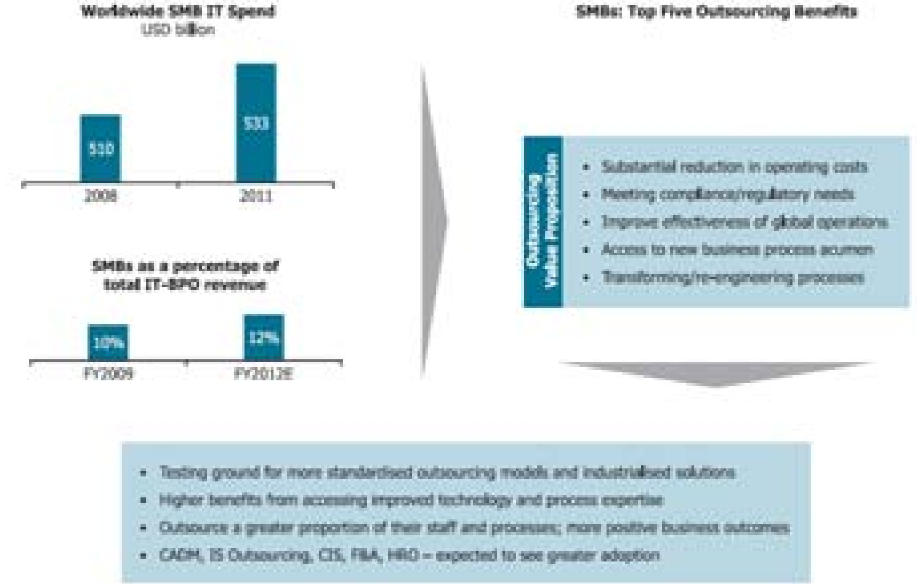
According to NASSCOM, this shift in trend has been fueled by a) contraction in cash flows generally, b) some buyer dissatisfaction with large size contracting as well by suppliers expanding their capabilities, which is in turn, challenging clients to implement more sophisticated governance models and c) prompting service providers to team together to win and deliver business.

We believe that the contraction in deal size has improved the ability of mid-tier companies to compete for deals. The companies like Hexaware (hunters), NIIT Tech (elephant hunters) and CMC (alliance with TCS) have differentiated strategy to capture the market share in their respective strengths.

Peer-to-peer: SMB focus fit in the strategic suite

The strength of mid-tier IT companies to cater to the specific needs of customers suits well for the SMB. The focus of Tier-1 is to target deep-pocket large enterprise and they have ignored the need of SMB for long. However, the prominence of IT spend by SMB has put mid-tier in spotlight.

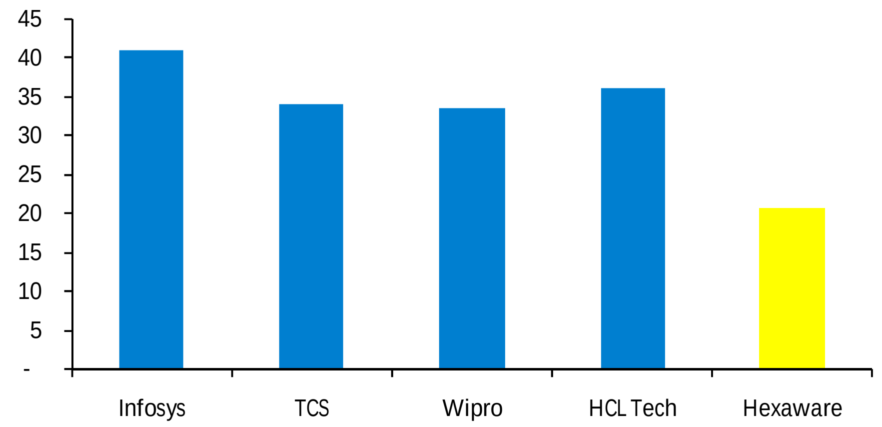
Exhibit 4: Cost cognizant of SMB: Strategic fit for mid-tier



Source: Gartner, HfS, TCS, NASSCOM, PL Research

SMB IT landscape is evolving dramatically with the steady increase in the use of IT and reliance on it systems. SMBs are beginning to use IT to strategically differentiate themselves from competitors. SMBs try to mirror larger enterprises in software adoption trends, albeit on a smaller scale.

Exhibit 5: Billing Rate ($/hr): Mid-tier provides good alternative for cost cognizant clients



Source: Company Data, PL Research

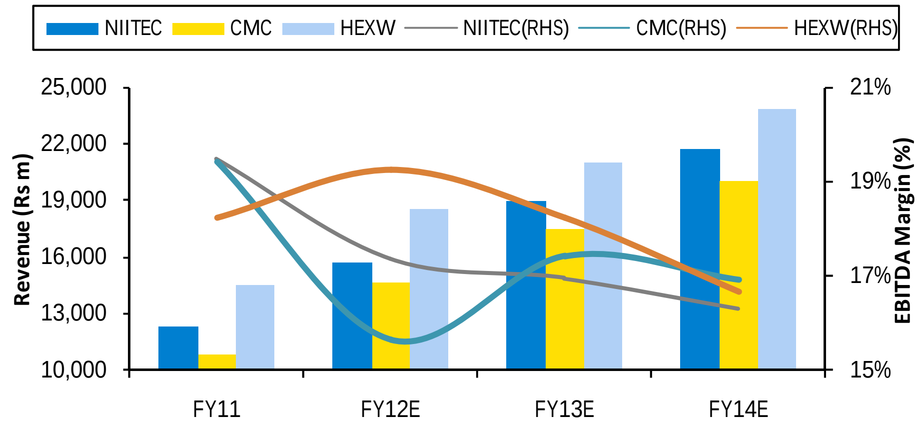
Company Summary

Exhibit 6: Summarizing the three: NIIT / CMC / Hexaware

	NIIT Technologies	CMC	Hexaware
Rating	BUY/TP: Rs350 (Upside: 32.3%)	Accumulate/TP: Rs1,200 (Upside: 22.8%)	Reduce/TP: Rs100 (Downside: 15.6%)
Investment Thesis	The niche presence of the company in few verticals has helped them build their strength. The company has gone much deeper in the niche to provide specialized solution to the clients. NIIT Tech has differentiated from tier-1 in terms of vertical presence and by offering hyper-specialization to the client. The company' strength in travel & transportation and BFSI (Investment Management & Insurance) is rated one of the best in terms of customer satisfaction. Key drivers **1)** TTL – Size & agility and room for positive surprise **2)** Insurance – IP led growth in non-life market **3)** Order Intake strength still not captured in growth	CMC stands out from the rest of its IT peers on geographical exposure, growth, visibility; however, there is lumpiness in its growth due to strong Indian presence. CMC is well placed to benefit from the continuing public sector IT demand, given the governments drive to use IT to improve public sector efficiency and the Government's long-term investment programmes in Education and e-Governance. Key drivers **1)** Under-penetrated Indian market and local government market gives organic growth prospects **2)** Differentiated business model **3)** Organic revenue growth and quality of earnings strong	Hexaware, one the best performing stocks among mid-cap in CY11, has factored in positives ahead of fundamentals. Three reasons for our bearish view – growth seems less secure as discretionary spend trajectory disappoints, there is limited leverage as the best growth profile era is over and last but not the least – valuation is full. We are keeping our CY12 forecasts close to the guidance, but have lower margin profile than what the company had delivered at the end of Q4CY11. Key arguments **1)** Discretionary spend losing steam, momentum at risk **2)** Best is behind us, growth less secure **3)** Risk-Reward skewed to downside
Business Mix	TTL: 36%, BFSI: 39%, Govt.: 4%	CS: 23%, SI: 57%, ITES: 14%, E&T: 4%	BFSI: 35%, TTL: 20.7%, Emerging: 34.4%
Top Client Mix	Top 5: 29%, Top 10: 44%, Top20: 58%	NA	Top: 13.9%, Top 5: 38.9%, Top 10: 52.6%
Other top Attributes	Strength – Verticals like Travel, Transportation and Logistics, Insurance (Non-life); IP-Led growth Weakness – Concentrated presence in verticals that are cyclical in nature	Strength – Presence in India with long standing relationship with PSUs like Indian Railways: Alliance with TCS to help expand foot-print globally Weakness – Expanding presence outside India is a "me too" approach	Strength – Presence in HRM software like PeopleSoft, verticals like BFS (especially Asset Management) Weakness – Portfolio (80%+) exposed to discretionary spend
Valuation	Trading at 6.5x FY13e earnings estimates EPS CAGR (FY12-13E)- 16%	Trading at 14x FY13e earnings estimates EPS CAGR (FY12-13E)- 28%	Trading at 11x FY13e earnings estimates EPS CAGR (CY11-13E)- 11.5%
Risk to target	Earning of the company is exposed to cyclical sectors. Gloomy macro-economic outlook would have double whammy on the profitability and revenue momentum of the company.	Exposed to government sector, revenue growth is exposed to long technology upgrade cycle of PSE. Diversification to non-Indian geographies debunks the same problem as other mid-tier companies.	We are factoring in downside due to unfavourable risk-reward. However downside could be restricted if 1) Stake sell-out by the management 2) Return of discretionary spend i.e. stronger industry fundamental than anticipated.

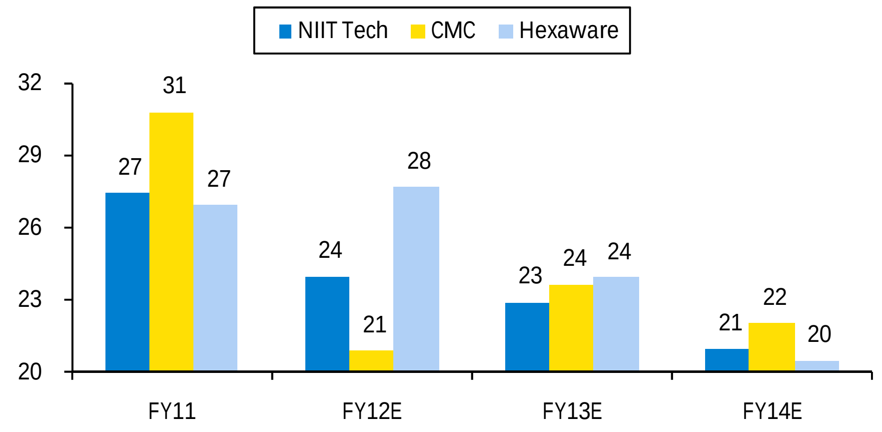
Source: Company Data, PL Research

Exhibit 7: Revenue FY11-13E (CAGR) – NIITEC (21%), CMC (23%), HEXW (18%)



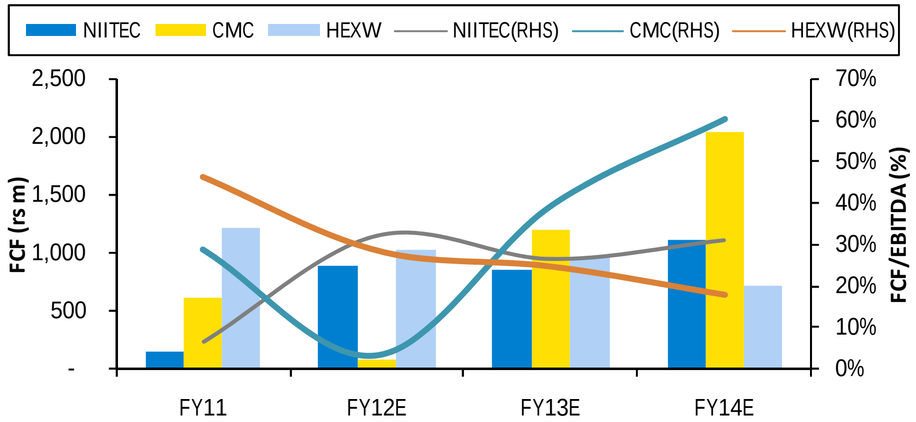
Source: Company Data, PL Research

Exhibit 8: RoE: CMC RoE suppressed due to impact on margin (higher onsite)



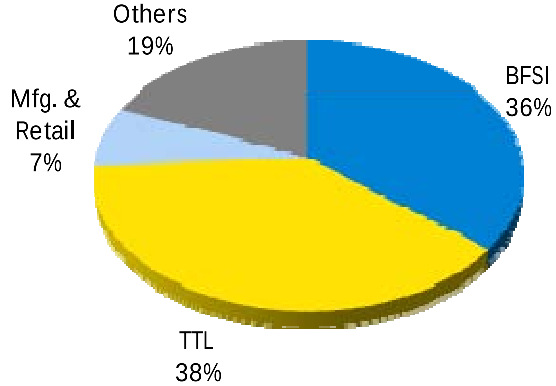
Source: Company Data, PL Research

Exhibit 9: FCF – CMC conversion likely to improve after SEZ construction is over



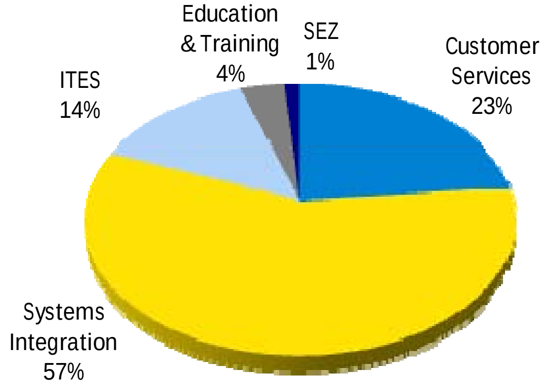
Source: Company Data, PL Research

Exhibit 10: NIIT Tech – Edge in Travelling, Transportation & Logistic



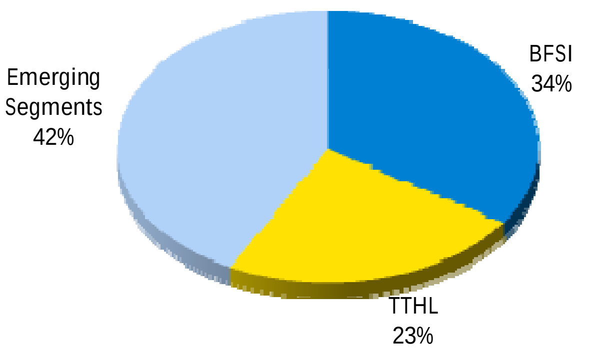
Source: Company Data, PL Research

Exhibit 11: CMC – Default choice as System Integrator for PSE



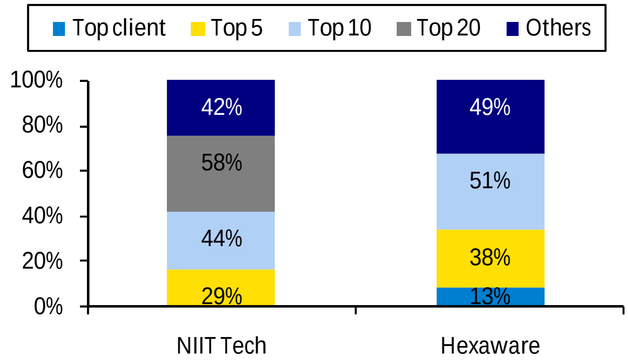
Source: Company Data, PL Research

Exhibit 12: Hexaware – BFSI with a difference (Asset Management)



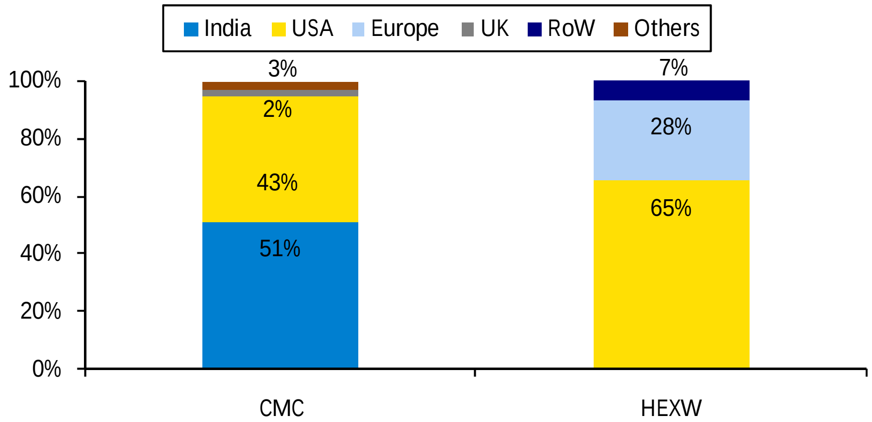
Source: Company Data, PL Research

Exhibit 13: NIIT Tech portfolio more diversified



Source: Company Data, PL Research

Exhibit 14: CMC – Moving for diversification



Source: Company Data, PL Research

COMPANIES

Prabhudas Lilladher

NIIT Technologies

Zero turbulence

April 09, 2012

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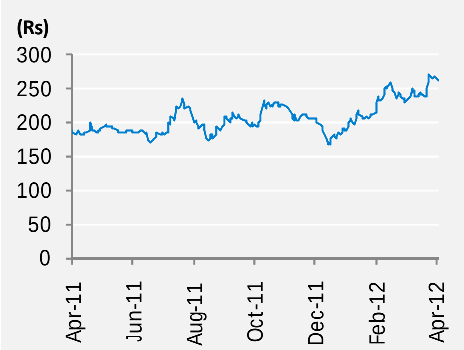
Rating	**BUY**
Price	Rs265
Target Price	Rs350
Implied Upside	32.1%
Sensex	17,222
Nifty	5,234

(Prices as on April 09, 2012)

Trading data			
Market Cap. (Rs bn)			15.7
Shares o/s (m)			59.3
3M Avg. Daily value (Rs m)			49.6
Major shareholders			
Promoters			39.18%
Foreign			23.49%
Domestic Inst.			12.41%
Public & Other			24.92%
Stock Performance			
(%)	**1M**	**6M**	**12M**
Absolute	11.5	34.8	42.3
Relative	12.3	25.8	54.8
How we differ from Consensus			
EPS (Rs)	**PL**	**Cons.**	***% Diff.***
2013	40.5	38.7	*4.6*
2014	45.5	41.0	*11.1*

Price Performance (RIC: NITT.BO, BB: NITEC IN)



Source: Bloomberg

We initiate coverage on NIIT Technologies (NIIT Tech) with a '**BUY**' rating and a target price of Rs350. In our view, the stock is trading at a discount to peers despite improving margin profiles and order book. The current multiple 6.5x FY13e earnings estimates is ~30% discount to peers. Our thesis of '**BUY**' rests on three pillars.

- **TTL – Size & agility and room for positive surprise:** The company has niche presence in Travel, Trasportation & Logistic (38% revenue). A specialized presence in the segments and small size gives room for strong growth. It is rated as one of the most prefered vendor in the space. We are factoring in modest growth expectation of 2.8% CQGR over the next five quarters, despite reporting strong growth of 10% CQGR over the last 11 quarters.

- **Insurance – IP led growth in non-life market:** NIIT Tech derives ~36% of revenue from BFSI sector, led by 27% from Insurance. The company's IP (ROOM Solution) in general insurance gives them unique capability to drive growth ahead of peers. The revenue growth has been steady at 6.5% CQGR over the last seven quarters. We expect stronger growth for Insurance than overall growth, yielding positive surprise on operating margin.

- **Order Intake strength still not captured in growth:** Revenue growth over the forward two quarters follows the trajectory of the order intake at the beginning of the period. Our analysis suggests that NIIT Tech, therefore, has a low downside risk because forward revenue forecasts does not exceed its current level of order intake grew by 143% YoY for 9MFY12 (v/s 9MFY11)

- **Valuation and Recommendation – BUY with Target Price Rs 350:** NIIT Tech is a unique IT services provider for TTL and Insurance sector (non-life) with a 28-year heritage. NIIT Tech is best positioned in the niche IT space to meet or exceed our above consensus forward estimates and grows faster than peers. With a P/E multiple of 6.5x, is at steep discount compared to the peer group, moreover with a predicted EPS growth CAGR of 16%, the valuation looks compelling.

Key financials (Y/e March)	**2011**	**2012E**	**2013E**	**2014E**
Revenues (Rs m)	12,323	15,737	18,970	21,734
Growth (%)	*34.9*	*27.7*	*20.5*	*14.6*
EBITDA (Rs m)	2,404	2,730	3,214	3,544
PAT (Rs m)	1,821	2,017	2,400	2,700
EPS (Rs)	30.7	34.0	40.5	45.5
Growth (%)	*43.0*	*10.8*	*19.0*	*12.5*
Net DPS (Rs)	4.3	3.0	3.0	3.0

Profitability & Valuation	**2011**	**2012E**	**2013E**	**2014E**
EBITDA margin (%)	*19.5*	*17.3*	*16.9*	*16.3*
RoE (%)	*27.4*	*24.0*	*22.9*	*21.0*
RoCE (%)	*27.1*	*23.9*	*22.8*	*20.9*
EV / sales (x)	1.2	0.9	0.7	0.6
EV / EBITDA (x)	6.1	5.1	4.1	3.5
PE (x)	8.6	7.8	6.5	5.8
P / BV (x)	2.1	1.7	1.4	1.1
Net dividend yield (%)	*1.6*	*1.1*	*1.1*	*1.1*

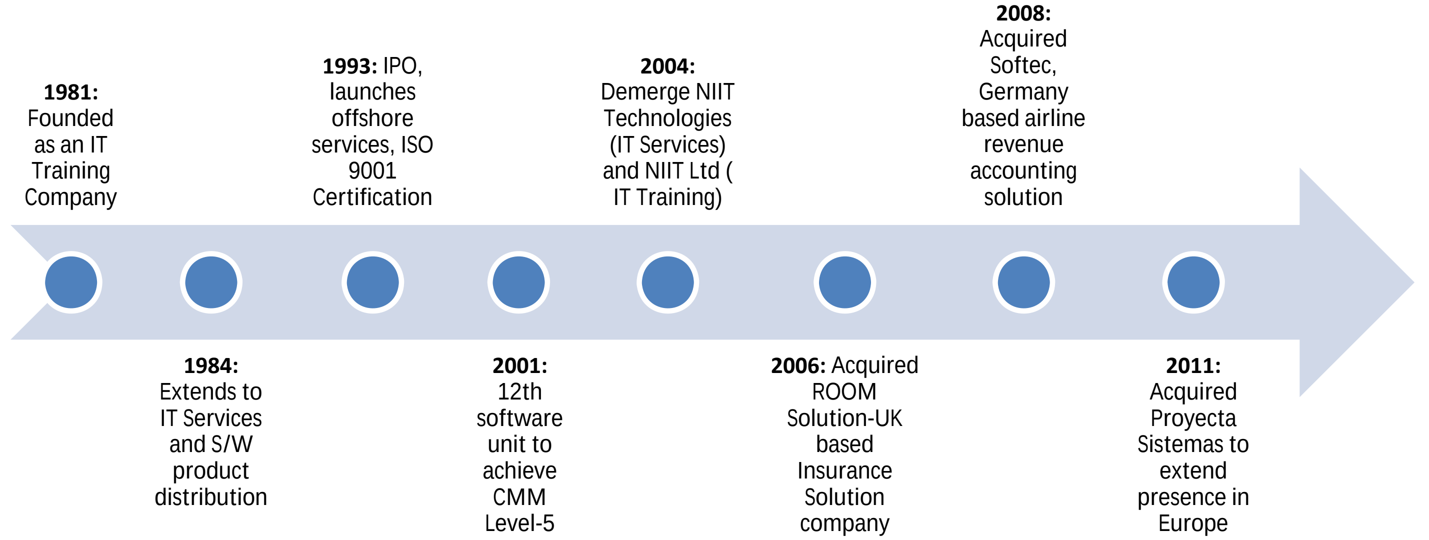
Source: Company Data; PL Research

Company Report

Company Snapshot

The company was founded in 1981 as an IT training company by Mr. Rajendra Powar (currently Chairman & Managing Director - NIIT Tech and NIIT Limited) and Mr. Vijay Thadani (Director-NIIT Tech, CEO-NIIT Ltd).

Exhibit 1: NIIT Technologies - A historic perspective



Source: Company Data, PL Research

NIIT Tech has customers in North America, Europe, Middle-East, Asia and Australia with services ranging from ADM, Managed Services, and BPO for verticals like Financial Services, Insurance, Travel, Transportation & Logistics, Manufacturing, Healthcare and Government sectors. The company has clients like BA, Sabre, DBS, SEI, ING Group, SITA, Holcim, Amlin, Toyota, Iberia etc.

Exhibit 2: NIIT Tech – Vertical presence

Banking Financial & Insurance	Travel, transportation & logistic	Manufacturing & Distribution
Revenue: Rs4.4bn (9 months) **Revenue Contribution:** 38.7% **Growth:** 5.2% CQGR (over last 11 Qtrs)	**Revenue:** Rs4.1bn (9 months) **Revenue Contribution:** 36.3% **Growth:** 10% CQGR (over last 11 Qtrs)	**Revenue:** Rs0.9bn (9 months) **Revenue Contribution:** 8% **Growth:** 0% CQGR (over last 11 Qtrs)
Services for Risk & Investment management IP Solution for non-life Insurance	Revenue accounting and operations management platforms Services for travel distribution & surface transportation company	Solution like Procure-Easy and mKonnect for manufacturing industry Services around manufacturing and distribution industry
ING Group, SEI, Amlin, AXA	BA Sabre, SITA	Toyota, Holcim

Source: Company Data, PL Research

Size gives agility and room for strong growth

The niche presence of the company in few verticals has helped them build their strength. The company has gone much deeper in the niche to provide specialized solution to the clients. NIIT Tech has differentiated from Tier-1 in terms of vertical presence and by offering hyper-specialization to the client. The company' strength in travel & transportation and BFSI (Investment Management & Insurance) is rated one of the best in terms of customer satisfaction. We expect the size and hyper-specialization to give strong growth opportunity to the company.

Exhibit 3: Customer Satisfaction ranking

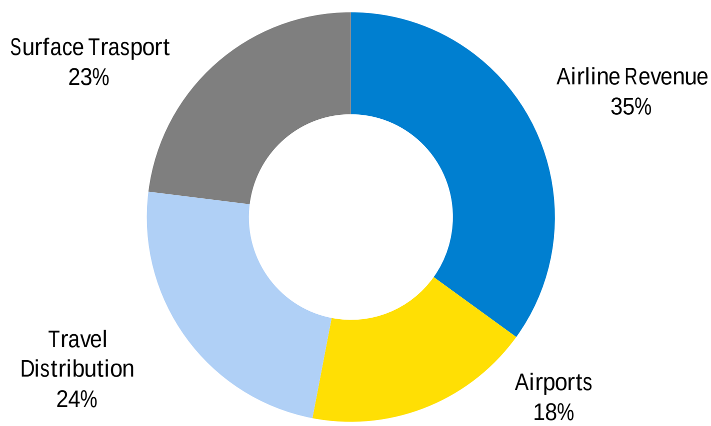
1	*Acxiom*
2	*CIBER*
3	**NIIT Technologies**
4	*iGATE*
5	*Critigen*
6	*Microsoft*
7	*Infosys*
8	*Logica*
9	*British Telecom*
10	*Oracle*
11	*Orange Business Services*
12	*Dell*
13	*Capgemini*
14	*HCL*
15	*AT&T*
16	*Accenture*
17	*Telstra*
18	*Telefonica*
19	*IBM*
20	*Siemens IT Solution*

Source: Black Book of Outsourcing, PL Research

Travel & Transportation: No turbulence in growth

The fastest growing vertical of the company is the strongest niche as well. The company drives 38% revenue from this vertical with 50+ clients. The company holds IP assets **1)** Revenue Accounting **2)** Route Profit Analyzer **3)** Airline Operations **4)** Revenue Analytics. The company has long standing relationship with some of the market leaders like British Airways, Sabre, Virgin Group, DB etc.

Exhibit 4: NIIT Tech – 3/4th of overall revenue is dependent on travel industry



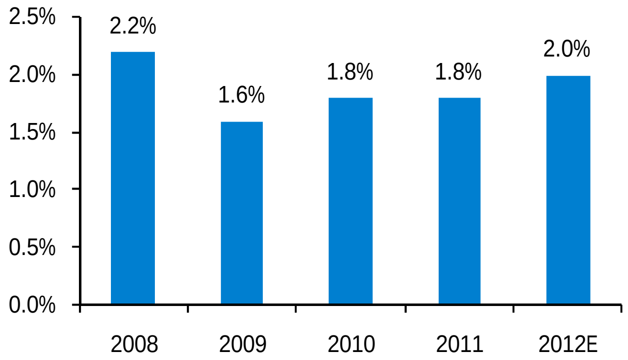
Source: Company Data, PL Research

NIIT Technologies is a leader in the almost fractured airlines IT services sector. The cornerstone of the IT services is the suit of IP solutions that is difficult to build. For example, technology provider ITA and its airline partner spent over four years trying to develop a reservation system and eventually discontinued the project.

The long-term contract (due to critical nature of the business) and customer pipeline provide visibility and growth in the tough economic environment. The relationship of clients like BA (15 years), Sabre (8 years), Virgin Group (6 years) etc. with NIIT Tech is longstanding.

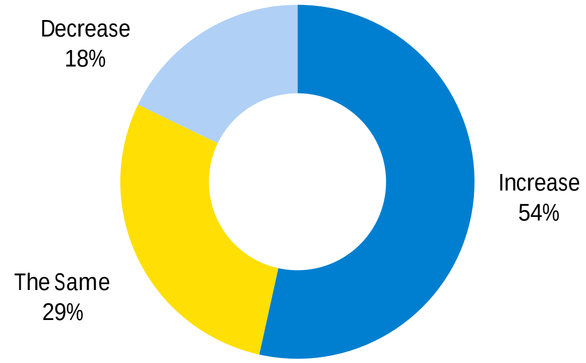
Airline industry most optimistic than recent years: According to a survey conducted by SITA (one of the client of NIIT-Tech), the business environment continues to show optimism. Airline's operational IT&T spend has stabilized at 1.8% of revenue, but on the back of rising revenues, represents an increase in absolute terms for the second consecutive year. The outlook for 2012 remains positive, with 54% of airlines expecting IT&T spend to increase in 2012.

Exhibit 5: Operational IT&T spend as % of revenue



Source: SITA, PL Research

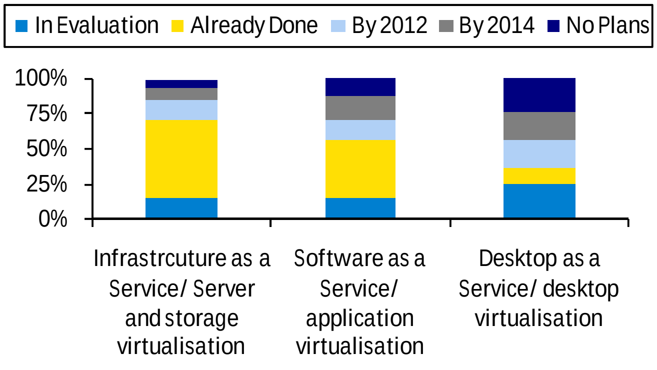
Exhibit 6: Outlook for 2012



Source: SITA, PL Research

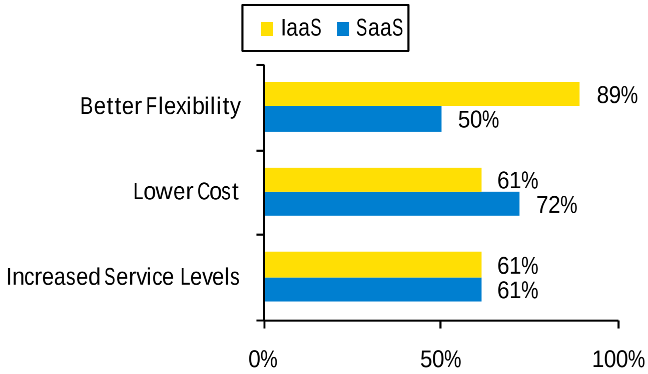
Cloud – The demand driver: Implementation of all virtualization and cloud services has increased, with Infrastructure-as-a-Service as the airlines' main area of investment. Almost nine out of 10 respondents chose Infrastructure Virtualization/Service in order to achieve "Better agility & flexibility". Priorities for Software-as-a-Service/Software virtualization differ slightly, with 72% of respondents considering it for its potential to "lower cost". ***For cloud services NIIT-Tech has partnered with Hitachi.***

Exhibit 7: Level of cloud implementation



Source: SITA, PL Research

Exhibit 8: Top reasons for choosing cloud computing



Source: SITA, PL Research

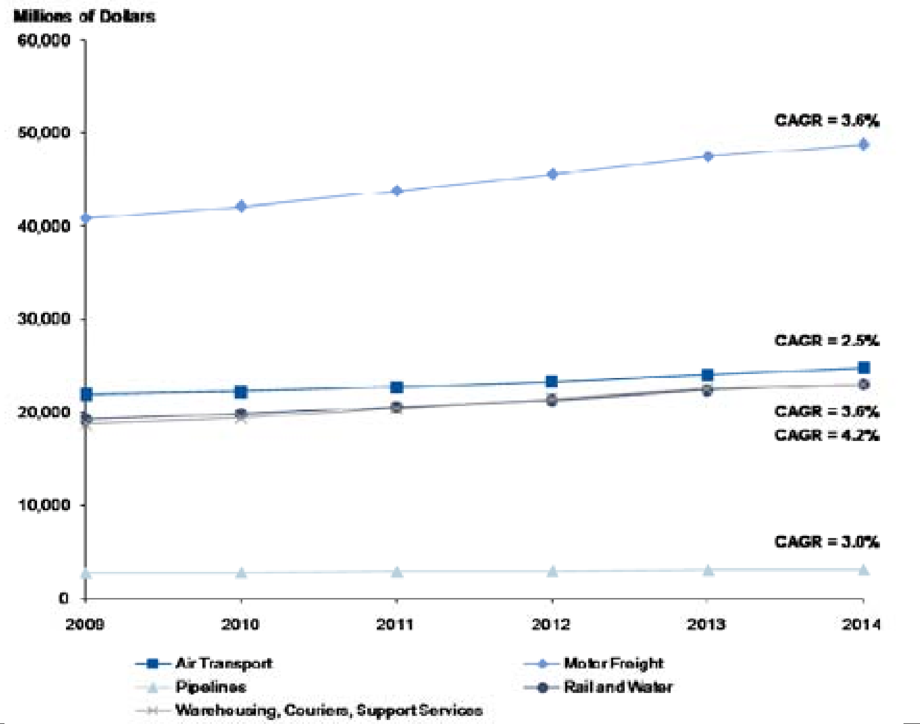
NIIT-Tech's edge in TTL vertical

NIIT Technologies offerings in TTL encompass Website Analysis, Reporting, Airport Portal, Product Evaluation, Procurement Process and Portfolio Assessment Analysis. NIIT-Tech ranked as the best IT Services company for Travel, Transportation and Logistic vertical by "Black Book of Outsourcing".

The global transportation industry was hit hard by the 2008-2009 economic crisis. As demand for consumer goods plummeted, cargo shipments dropped in parallel. Simultaneously, discretionary passenger travel declined sharply, especially the business class and full-fare coach class segments. Carriers suddenly had excess capacity, lost pricing power and experienced serious financial losses. The transportation industry is now beginning to recover and the IT investment climate should improve in 2011. According to Gartner

- The transportation industry had spent ~$110bn on IT in 2011. This includes purchases of all computer and communications equipment, software products, IT services and telecommunications services. It also includes transportation carriers' internal spending for IT-related labor and burden costs.
- TTL ranked 8th (among 11) in terms IT spending by industry tracked by Gartner.
- NA and Western European carriers generated 64% of global IT spending.
- Asia/Pacific is the fastest-growing region for IT spending, with a 7.3% compound annual growth rate (CAGR) from 2009 through 2014.

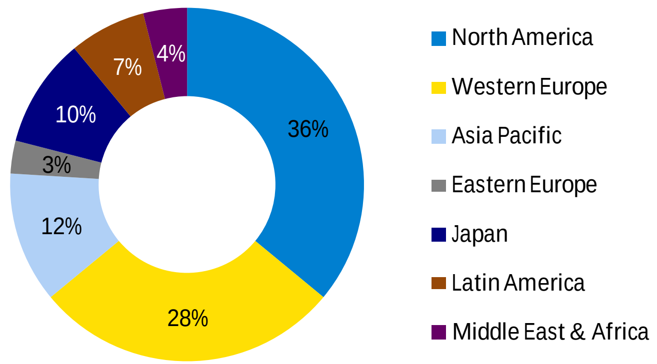
Exhibit 9: Air Transport IT spend likely to grow at a CAGR of 2.5% over next 3 years



Source: Gartner, PL Research

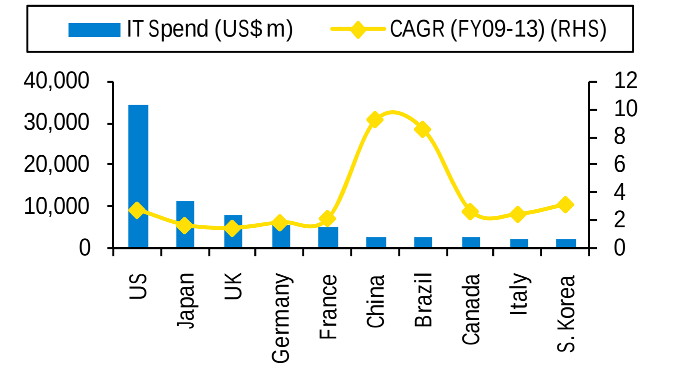
The top country markets are shown in Exhibit 9. Notable are the current dominance of the US market and the arrival of two emerging markets— China and Brazil — at the No. 6 and No. 7 spots in IT spending, which can be said to have fully emerged.

Exhibit 10: NA and Europe contributes a 3/4th of total IT spend in TTL



Source: Gartner, PL Research

Exhibit 11: IT spend from the US is expected to grow at a CAGR of 2.8%

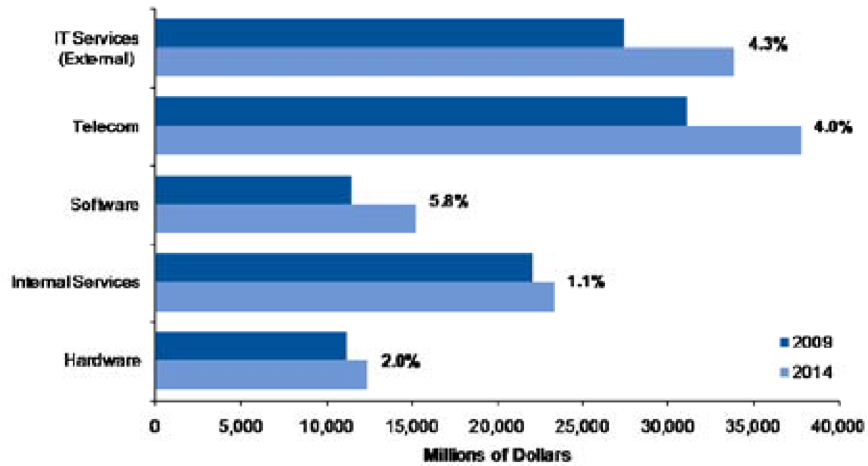


Source: Gartner, PL Research

According to Gartner's forecast, the IT services expense for TTL industry is likely to grow faster than other technology spending. The internal services sector includes spending inside carriers' IT organizations for employee salary, burden and training. As such, internal services are actually a "competitor" for the IT budget dollar, as management may direct discretionary dollars toward either internal or external sources of solutions and services. Software products, IT services and telecommunications services each have attractive growth rates in the transportation industry.

We see NIIT Tech to win wallet share in both IT Services and Internal Services, where the company remains critical for the business strategy of clients. Due to smaller size, the focused approach to each client has helped them gain clients' confidence.

Exhibit 12: Growth in IT Services component is the strongest



Source: Gartner, PL Research

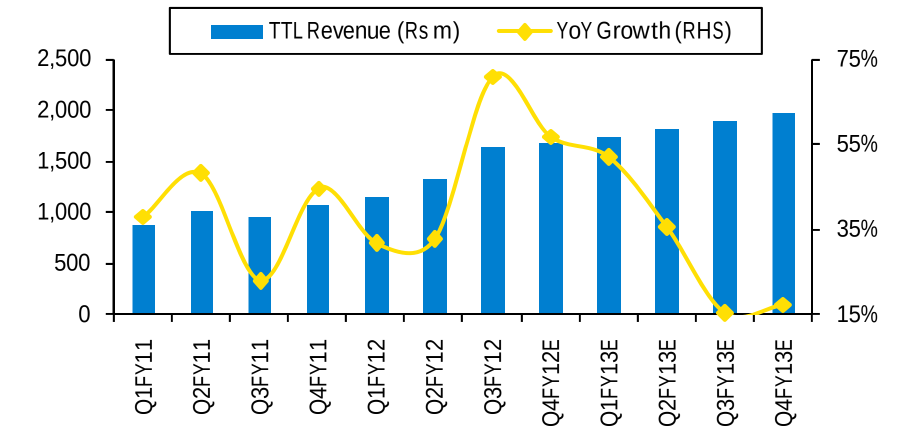
Growth likely to be driven from TTL sector

In terms of vendor class, large offshore firms ranked lower in priority for clients' top spending, likely due to a less diverse business model (low penetration in nonfinancial services verticals) and higher exposure to clients' discretionary spending. Due to business critical nature (despite keeping the lights on work) of IT work done by vendors, the clients prefer to work with nimble-footed small and medium sized vendors rather than large vendors.

We expect the growth for NIIT Tech to be led by TTL vertical. We expect the revenue contribution to reach 40% by FY14. We expect growth to moderate, going forward. However, the moderated expectation would yield growth of 23.5% CAGR (FY11-14E).

NIIT Tech currently has less than 0.2% market share in global transport, travel and logistic industry. We expect the strength of the company to play out.

Exhibit 13: Even moderated growth would translate to 3.8% CQGR over the next 5 qtrs

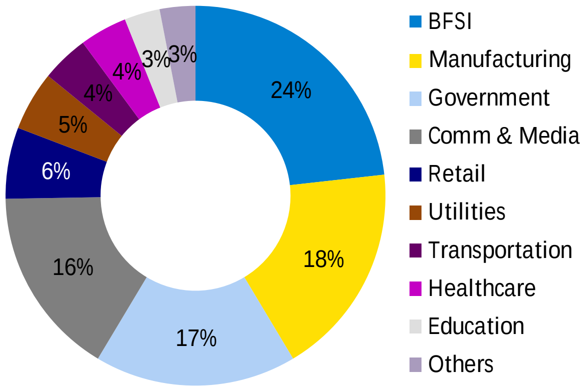


Source: Company Data, PL Research

IP-led growth for BFSI

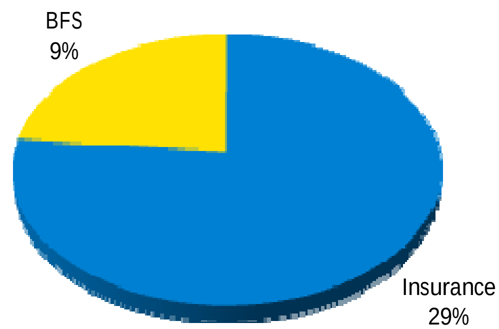
BFSI continues to dominate the IT spend priority for all the Indian IT companies. According to Gartner, 24% of total IT spend is BFSI. It contributes 36% of revenue for NIIT Tech. The company currently has ~50+ clients in the vertical.

Exhibit 14: IT spend continues to be dominated by BFSI



Source: Gartner, PL Research

Exhibit 15: NIIT Tech: 75% of BFSI revenue contribution from Insurance

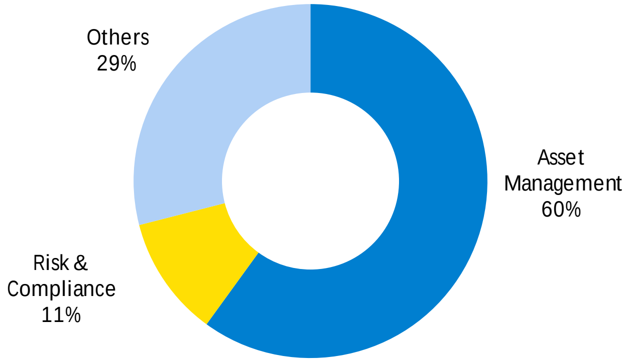


Source: Gartner, PL Research

The services in Banking and Financial Services encompass Investment, Wholesale and Retail Banking. The company has IP partnership for BFS segment

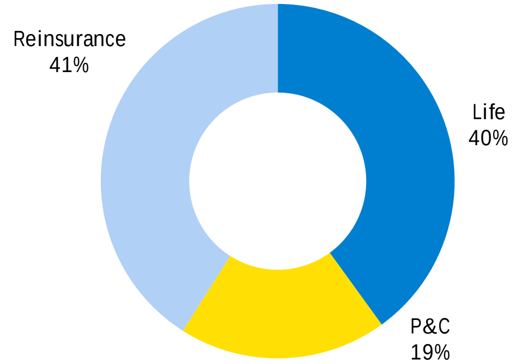
- **Data Vision (Core Banking Solution)** – Alliance with Pune (India) based CBS company, NIIT Tech targets co-operating and tier-2-4 banks.
- **Process Unity (Risk and Compliance Solution)** – Partnership with Massachusetts (US) based risk management company to target AMC business

Exhibit 16: BFS – Leveraging partners IP for service growth



Source: Company Data, PL Research

Exhibit 17: Insurance – Growth led by IP assets

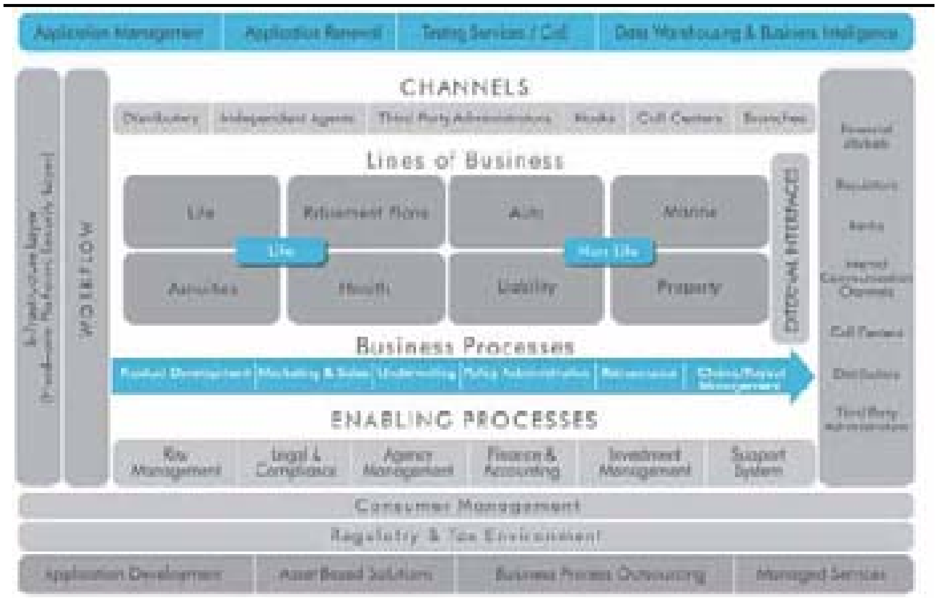


Source: Company Data, PL Research

Insurance – Uniquely positioned

NIIT Tech BFSI vertical has grown at a CQGR of 6.5% QoQ over the last seven quarters. The company offers range of solutions to optimize cost and improve business competitiveness. NIIT Tech has been ranked by "Black Book of Outsourcing" as top BPO and ITO vendor in the Insurance sector.

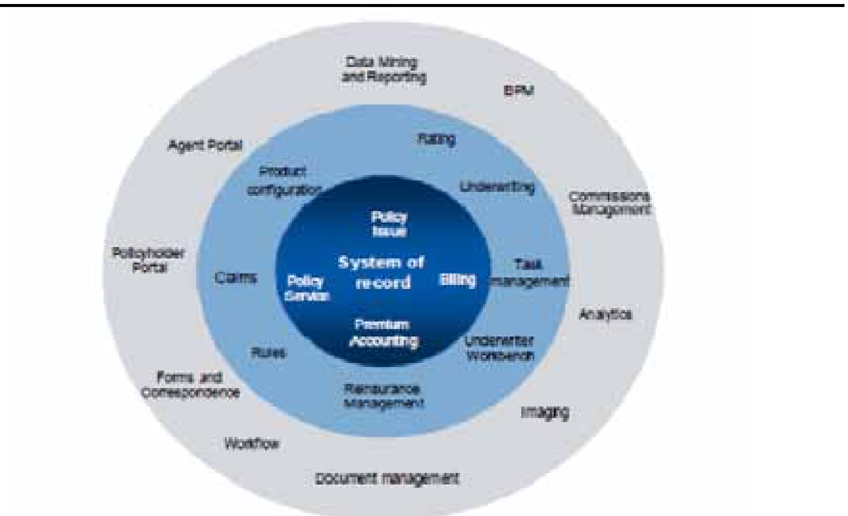
Exhibit 18: Insurance Solution – Positioned uniquely



Source: Company Data, PL Research

NIIT Insurance Technologies (erstwhile Rooms Solutions) which is NIIT Technologies' wholly-owned subsidiary has its Insurance Platform "Subscribe", which has a sizable share in Lloyds insurance market.

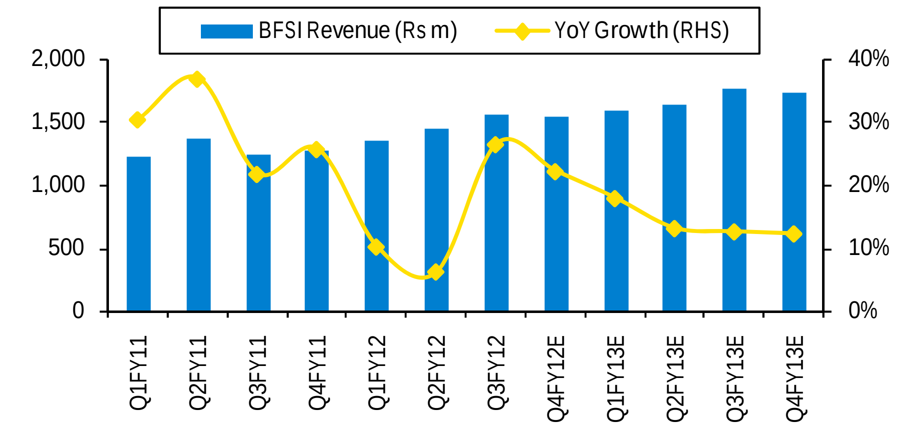
Exhibit 19: Ipf3 (released in 2009 by NIIT Tech) – Formerly marketed as Subscribe



Source: Celent, PL Research (Does not offer commission management)

NIIT Tech derives ~36% of revenue from the BFSI sector. The revenue growth has been steady at 6.5% CQGR over the last seven quarters. However, the revenue contribution has come down from 44% to 36% due to stronger growth in TTL vertical. The company seeks to build out more of the in-demand capabilities. We think that it is capable of sustaining solid organic growth as well. We see growth in Insurance to make margin stickier due to asset leverage.

Exhibit 20: BFSI Revenue – Factoring steady revenue growth

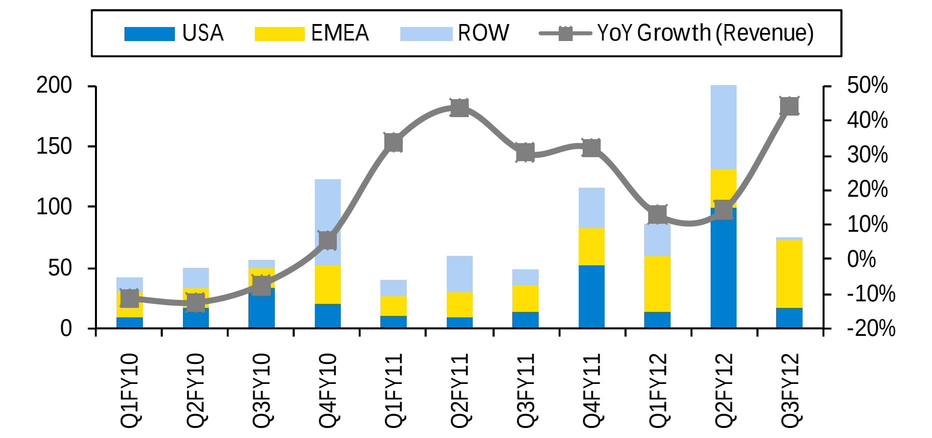


Source: Company Data, PL Research

Growth – Order pipeline strong

Order intake is a leading indicator for near-term revenue growth. Historically, revenue growth over the forward two quarters follows the trajectory of the order intake at the beginning of the period, as shown by the stack bars and line graph in *Exhibit 20.* Our analysis suggests that NIIT Tech, therefore, has a low downside risk because forward revenue forecasts is not exceeding its current level of order intake (i.e. it must miss-out on few projects to not meet our forward revenue expectations based on its own historical standards).

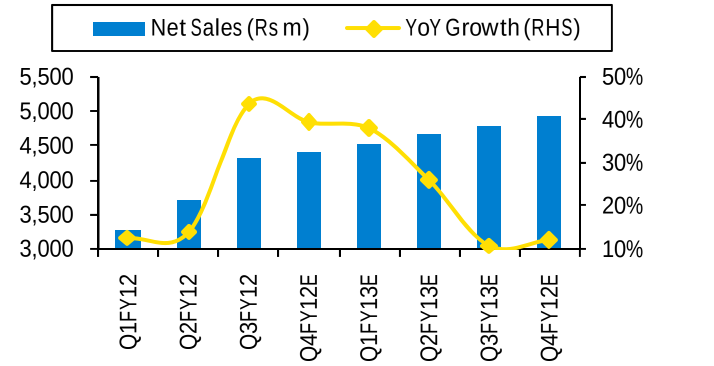
Exhibit 21: Order Intake (US$ m): Q4 strongest leaves room for positive surprise



Source: Company Data, PL Research

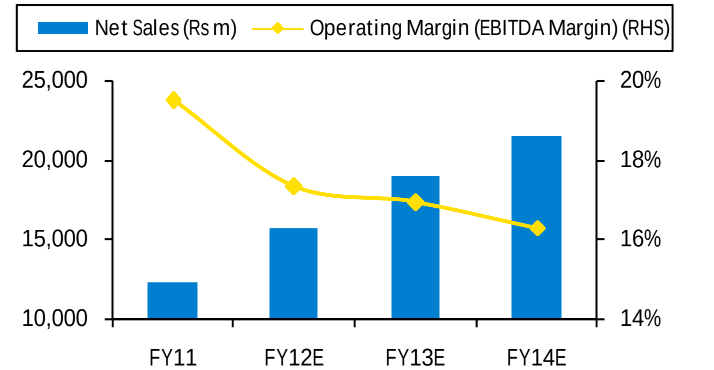
Order flow trends as of last quarter are consistent with our outlook for strong growth in TTL vertical. As of the most recently reported quarter, NIIT Tech showed ~53% YoY backlog growth.

Exhibit 22: Moderate growth expectation over next 5 quarters



Source: Company Data, PL Research

Exhibit 23: … however, expect company to retain margin

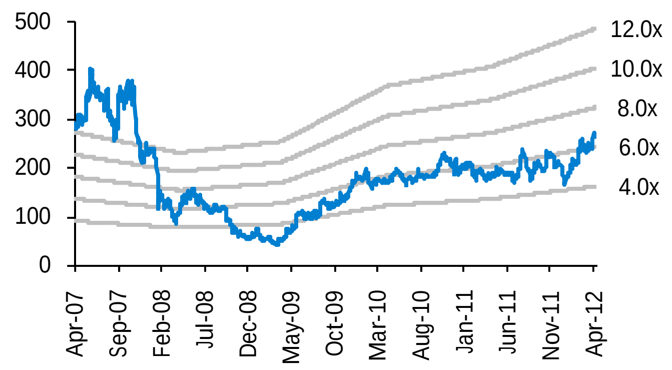


Source: Company Data, PL Research

Valuation – Price not factoring growth momentum

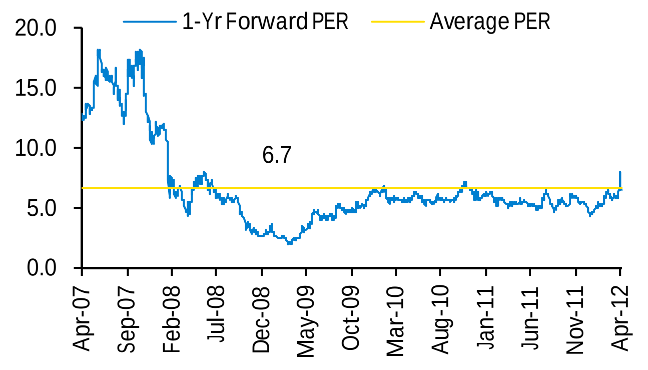
We initiate coverage on NIIT Tech with '**BUY**' rating and a target price of Rs350 (30% upside potential). NIIT Tech is a unique IT services provider for TTL and Insurance sector (non-life) with a 28-year heritage. Our expansion of IT services coverage increases our conviction that NIIT Tech is best positioned in the niche IT space to meet or exceed our above consensus forward estimates and grows faster than peers. With a P/E multiple of 6.5x, is lower than the peer group, and not factoring in a predicted EPS growth CAGR of 16%, the valuation looks compelling.

Exhibit 24: P/E band – Early stage of re-rating



Source: Company Data, Bloomberg, PL Research

Exhibit 25: Price not factoring strong order-book



Source: Company Data, Bloomberg, PL Research

Income Statement (Rs m)

Y/e March	2011	2012E	2013E	2014E
Net Revenue	**12,323**	**15,737**	**18,970**	**21,734**
Software Dev. Exp.	7,768	9,834	11,751	13,847
Gross Profit	4,555	5,903	7,219	7,888
Employee Cost	2,151	3,173	4,004	4,344
Other Expenses	—	—	—	—
EBITDA	**2,404**	**2,730**	**3,214**	**3,544**
Depr. & Amortization	315	347	398	441
Net Interest	—	—	—	—
Other Income	89	378	462	533
Profit before Tax	**2,178**	**2,761**	**3,278**	**3,635**
Total Tax	324	718	852	909
Profit after Tax	**1,854**	**2,043**	**2,426**	**2,726**
Ex-Od items / Min. Int.	33	26	26	26
Adj. PAT	**1,821**	**2,017**	**2,400**	**2,700**
Avg. Shares O/S (m)	**59.3**	**59.3**	**59.3**	**59.3**
EPS (Rs.)	**30.7**	**34.0**	**40.5**	**45.5**

Cash Flow Abstract (Rs m)

Y/e March	2011	2012E	2013E	2014E
C/F from Operations	663	1,917	2,418	2,794
C/F from Investing	(374)	(1,034)	(1,560)	(1,687)
C/F from Financing	(525)	(177)	(177)	(177)
Inc. / Dec. in Cash	(236)	706	681	930
Opening Cash	1,430	1,194	1,900	2,582
Closing Cash	1,194	1,900	2,582	3,512
FCFF	441	1,104	1,178	1,377
FCFE	334	1,104	1,178	1,377

Key Financial Metrics

Y/e March	2011	2012E	2013E	2014E
Growth				
Revenue (%)	34.9	27.7	20.5	14.6
EBITDA (%)	27.3	13.6	17.7	10.2
PAT (%)	44.2	10.8	19.0	12.5
EPS (%)	43.0	10.8	19.0	12.5
Profitability				
EBITDA Margin (%)	19.5	17.3	16.9	16.3
PAT Margin (%)	14.8	12.8	12.7	12.4
RoCE (%)	27.1	23.9	22.8	20.9
RoE (%)	27.4	24.0	22.9	21.0
Balance Sheet				
Net Debt : Equity	(0.1)	(0.2)	(0.2)	(0.2)
Net Wrkng Cap. (days)	21	—	—	—
Valuation				
PER (x)	8.6	7.8	6.5	5.8
P / B (x)	2.1	1.7	1.4	1.1
EV / EBITDA (x)	6.1	5.1	4.1	3.5
EV / Sales (x)	1.2	0.9	0.7	0.6
Earnings Quality				
Eff. Tax Rate	14.9	26.0	26.0	25.0
Other Inc / PBT	4.1	13.7	14.1	14.7
Eff. Depr. Rate (%)	6.8	6.4	6.0	5.5
FCFE / PAT	18.3	54.7	49.1	51.0

Source: Company Data, PL Research.

Balance Sheet Abstract (Rs m)

Y/e March	2011	2012E	2013E	2014E
Shareholder's Funds	7,478	9,344	11,593	14,143
Total Debt	110	110	110	110
Other Liabilities	43	43	43	43
Total Liabilities	**7,631**	**9,497**	**11,746**	**14,296**
Net Fixed Assets	3,330	4,017	5,179	6,424
Goodwill	—	—	—	—
Investments	443	443	443	443
Net Current Assets	3,716	4,895	5,982	7,286
Cash & Equivalents	*1,194*	*1,900*	*2,582*	*3,512*
Other Current Assets	*5,029*	*6,016*	*7,081*	*7,991*
Current Liabilities	*2,508*	*3,021*	*3,680*	*4,216*
Other Assets	143	143	143	143
Total Assets	**7,631**	**9,497**	**11,746**	**14,296**

Quarterly Financials (Rs m)

Y/e March	Q1FY12	Q2FY12	Q3FY12	Q4FY12E
Net Revenue	**3,288**	**3,711**	**4,330**	**4,408**
EBITDA	**609**	**550**	**780**	**791**
% of revenue	*18.5*	*14.8*	*18.0*	*18.0*
Depr. & Amortization	78	83	92	94
Net Interest	—	—	—	—
Other Income	39	115	174	50
Profit before Tax	**570**	**582**	**862**	**747**
Total Tax	151	151	224	192
Profit after Tax	**413**	**458**	**640**	**558**
Adj. PAT	**413**	**458**	**640**	**558**

Source: Company Data, PL Research.

Prabhudas Lilladher

CMC

Diversification is the key

Company Report

April 09, 2012

Shashi Bhusan
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Pratik Shah
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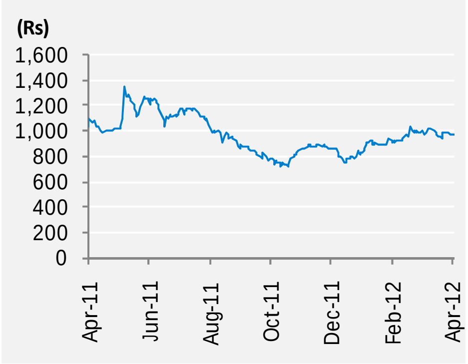
Rating	**Accumulate**
Price	Rs978
Target Price	Rs1,200
Implied Upside	22.7%
Sensex	17,222
Nifty	5,234

(Prices as on April 09, 2012)

Trading data			
Market Cap. (Rs bn)			29.6
Shares o/s (m)			30.3
3M Avg. Daily value (Rs m)			22.8
Major shareholders			
Promoters			51.12%
Foreign			19.33%
Domestic Inst.			21.11%
Public & Other			8.44%
Stock Performance			
(%)	**1M**	**6M**	**12M**
Absolute	(1.0)	22.2	(11.4)
Relative	(0.2)	13.2	1.1
How we differ from Consensus			
EPS (Rs)	**PL**	**Cons.**	***% Diff.***
2013	70.4	72.2	*-2.4*
2014	81.7	94.0	*-13.1*

Price Performance (RIC: CMC.BO, BB: CMC IN)



Source: Bloomberg

We initiate coverage on CMC (Computer Maintenance Corporation) with an '**Accumulate**' rating and a target price of Rs1,200. CMC stands out from the rest of its IT peers on geographical exposure, growth, visibility; however, there is lumpiness in its growth due to strong Indian presence. CMC is well placed to benefit from the continuing public sector IT demand, given the governments drive to use IT to improve public sector efficiency and the Government's long-term investment programmes in Education and e-Governance.

- **Under-penetrated Indian market and local government market gives organic growth prospects:** CMC's strong presence with the Indian government and PSUs gives room for expanding footprints by cross-selling opportunities. According to Gartner, government IT spends is expected to grow at CAGR of 13% (FY11-14E).
- **Differentiated business model:** CMC is well established to exploit the global market synergy due to its parentage with TCS (holds 51% stake). The company's joint go-to-market strategy with TCS gives them well-experienced partner for the access of global markets. Moreover, it also gives access of marquee clients along with higher revenue visibility (~54% revenue). The well established model of sub-contracting (contract employees: ~54%) makes the model flexible.
- **Organic revenue growth and quality of earnings strong:** CMC's organic revenue growth hit ~6.5% CQGR over the last 11 quarters and is forecast by the company to exceed ~4% in FY13. With 85% of PBIT now derived from outside the traditional CS and E&T, from high margin portfolio SI and ITES, which is growing faster than traditional portfolio of CMC. FCF conversion and DSO of CMC is in line with the larger peers despite high exposure to government sector.
- **Valuation & Recommendation – Accumulate with a target price of Rs1,200:** (i) We believe CMC's 2-year growth prospects (16% pa revenues, 17.5% pa EBITDA on our estimates) are much stronger than peers (ii) Nevertheless, at these levels CMC's rating looks undemanding. Traditionally, CMC trades at a premium to the mid-cap IT Services companies. We value the company at 17x FY13 earnings estimate with a target price of Rs1,200.

Key financials (Y/e March)	**2011**	**2012E**	**2013E**	**2014E**
Revenues (Rs m)	10,844	14,640	17,560	20,045
Growth (%)	*23.8*	*35.0*	*19.9*	*14.2*
EBITDA (Rs m)	2,107	2,289	3,058	3,395
PAT (Rs m)	1,794	1,519	2,134	2,475
EPS (Rs)	59.2	50.1	70.4	81.7
Growth (%)	*25.3*	*(15.3)*	*40.4*	*16.0*
Net DPS (Rs)	11.6	2.0	3.0	3.3

Profitability & Valuation	**2011**	**2012E**	**2013E**	**2014E**
EBITDA margin (%)	*19.4*	*15.6*	*17.4*	*16.9*
RoE (%)	*30.8*	*20.9*	*23.7*	*22.0*
RoCE (%)	*28.8*	*19.5*	*21.9*	*20.0*
EV / sales (x)	2.7	2.0	1.6	1.3
EV / EBITDA (x)	13.8	12.7	9.1	7.7
PE (x)	16.5	19.5	13.9	12.0
P / BV (x)	4.5	3.7	2.9	2.4
Net dividend yield (%)	*1.2*	*0.2*	*0.3*	*0.3*

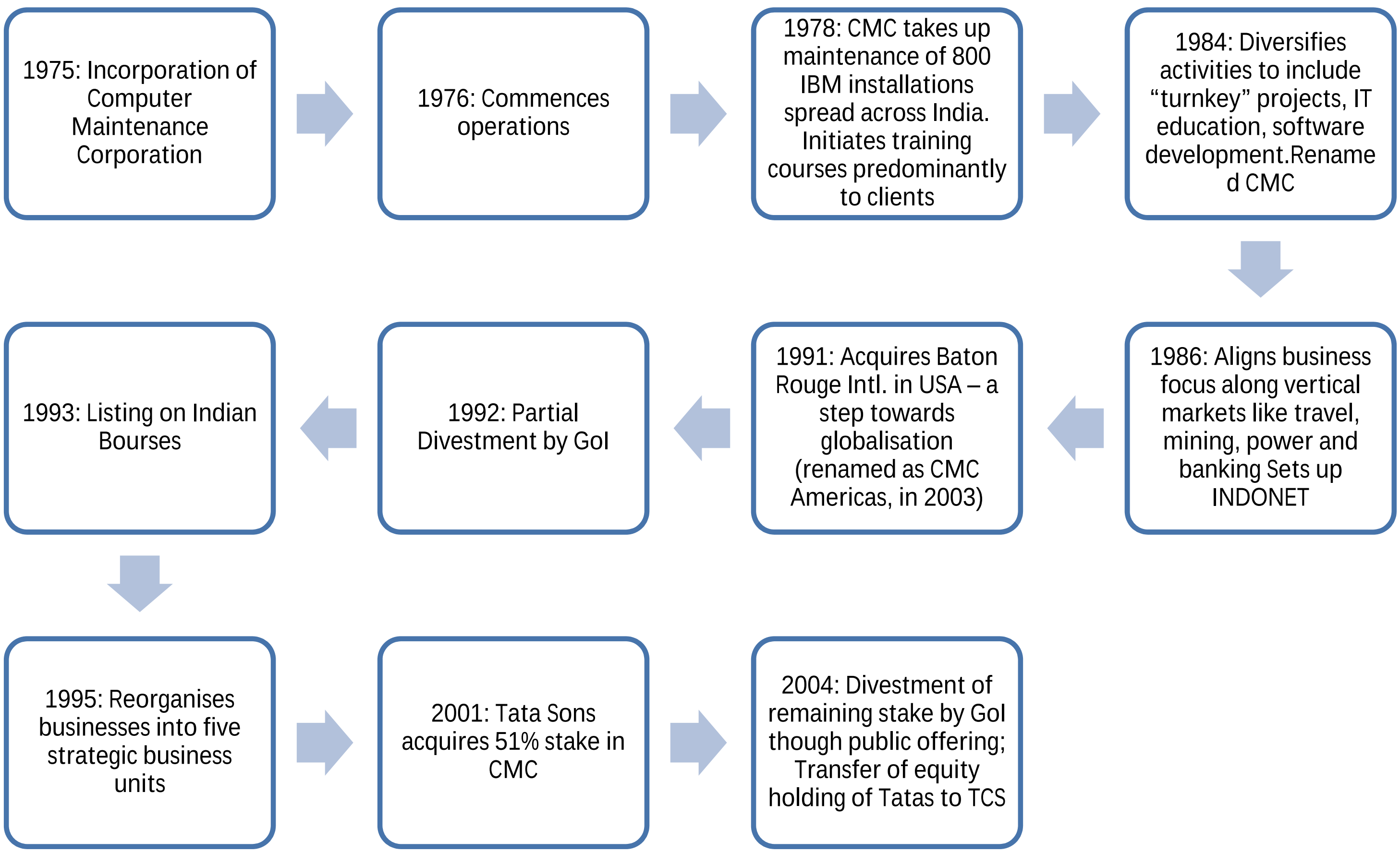
Source: Company Data; PL Research

Evolution – A long journey

CMC is one of the oldest Information Technology services companies in India. CMC, now a subsidiary of TCS, was incorporated on December 26, 1975 by Government of India. On August 19, 1977, it was converted into a public limited company.

During the year 1978, when IBM wound up its operations in India, CMC took over the maintenance of IBM installations at over 800 locations around India and subsequently, maintenance of computers supplied by other foreign players. CMC's R&D facility was set up in 1982 at Hyderabad.

The business of CMC is structured around four Strategic Business Units (SBUs): 1) Customer Services (CS) 2) IT enabled Services (ITeS) 3) Systems Integration (SI) 4) Education and Training (E&T)



Business Overview – Balanced mix of services offerings

Customer Services	System Integration	ITES	Education & Training	CMC Americas
Hardware supply & support services, network design/ implementation services, Infrastructure Services	Project implementation, integration & Maintenance of software products/ solutions, Embedded System	Forms processing, data centre services, Web design & hosting, Value added EDI, BPO	Software and hardware training through 200 centres to corporate and retail clientele, Vocational training, Elearning and BPO Training	International Services, IT Outsourcing, Engineering Services
23.5% of Revenue, 7.6% CQGR in last 8 qtrs, PBIT Margin: 8.1%	57% of Revenue, 8.4% CQGR in last 8 qtrs, PBIT Margin: 22.9%	14% of Revenue, 8.9% CQGR in last 8 qtrs, PBIT Margin: 31%	4% of Revenue, 5.6% CQGR in last 8 qtrs, PBIT Margin: 10.4%	CMC eBiz - Onsite KPO, Digitization Services

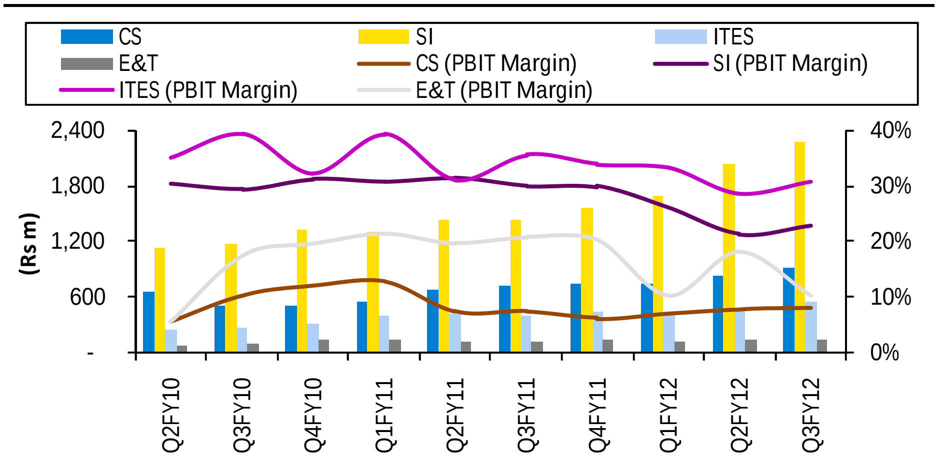
Source: Company Data, PL Research

Two cylinders not four – Stronger margin business as a growth driver

CMC fired on two out of four cylinders in the period FY11-12, with strong divisional performances from SI and ITES being relatively weaker performances in Education and CS. In FY12, CMC shifted to three cylinders with the buoyant performance in CS, meaning only Education was holding the group back.

CMC revenue composition has improved over the last two years in favour of better margin businesses like SI (CQGR: 8.4%, PBIT: 22.9%) and ITES (CQGR: 8.9%, PBIT: 31%). In a drive to improve the profitability of the company, the growth from the lower margin businesses like CS and E&T has not been ignored.

Exhibit 1: Improving business mix – Strong growth from high margin SI & ITES



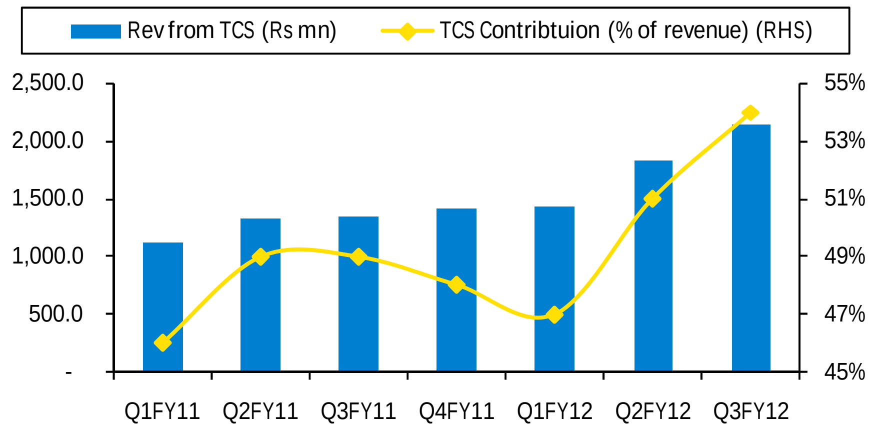
Source: Company Data, PL Research

TCS alliance – critical to business success

TCS has controlling stake of 51% in CMC. Alliance with TCS has helped CMC to penetrate new markets, and build new competencies. CMC's core capabilities in Infrastructure, key solutions, ITES and E&T, coupled with TCS's global presence, marketing network and client relationship, present a win-win situation for both. Currently, CMC has ~10 sales professionals to:

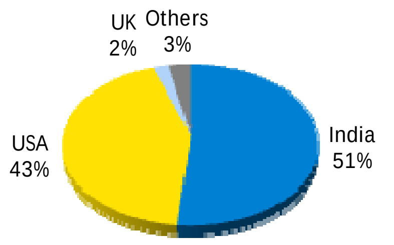
- Opportunities in India: For projects like MCA, e-Passport, CBEC, SWAN, Banks
- Global penetration: Embedded Systems, technology solutions and ITES in UK, Europe and USA with access to some of the marquee clients
- TCS-CMC go-to-market synergy: GTM accounts for 67% of CMC's business in US and ~50% of total revenue, driving growth in international market.

Exhibit 2: Revenue from TCS over last 7 quarters grew at a CQGR of 11.3%



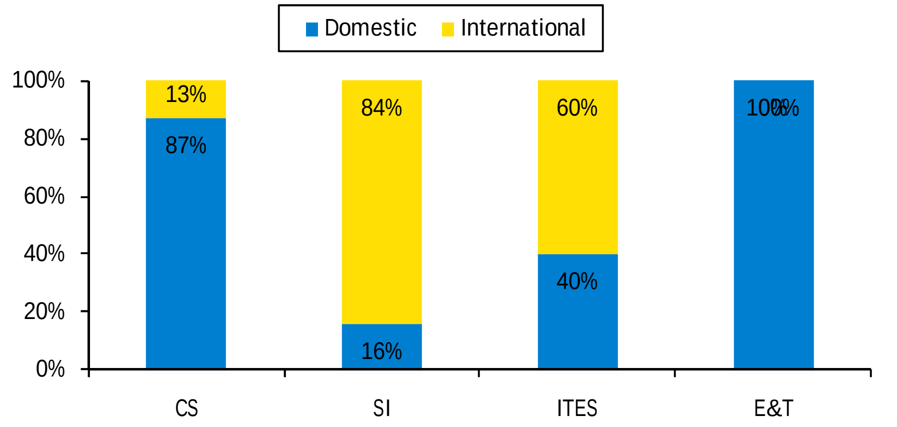
Source: Company Data, PL Research

Exhibit 3: Diversification to the US



Source: Company Data, PL Research

Exhibit 4: ~40% of US business comes from TCS relationship



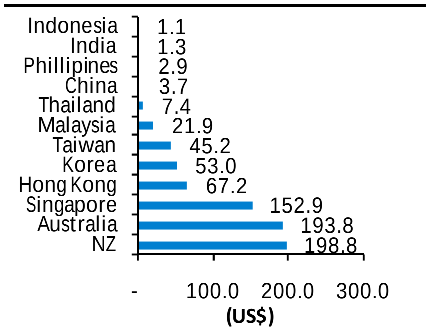
Source: Company Data, PL Research

In the GTM deals won with TCS, 15% of deal-value is retained by TCS.

CMC 3.0 – A roadmap for US$1bn enterprise

CMC is aiming to be a US$1bn revenue by 2020 and be a top 20 system engineering and integration company. The company currently has ~$250m revenue and aiming to grow at ~18% CAGR over the next decade. The key drivers for the growth of the company would be:

Exhibit 5: Per capita IT spend by govt.



Source: EIU, PL Research

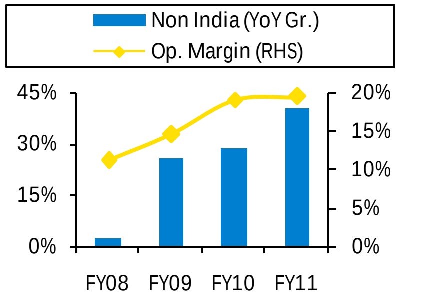
- **Government contracts:** CMC enjoys strong goodwill in the corridors of the government and has a legacy association with development projects of Railways and Defence. We expect government's focus on eGovernance projects would be a strong growth driver for the company. The Government, while recognising IT as a thrust area for growth, had given a directive to all government departments to allocate up to 3% of their annual budgets to computerization. The management expects more projects such as MCA, ePassport, VAT, eGovernance, GST and UID to be launched, with trend bound to proliferate in the future.

Exhibit 6: Government IT spend continues to lead the chart of IT spend in India

US$ bn (India)	2010	2011	2012E	2013E	2014E	2015E	*5 Year CAGR*
Banking & Securities	4.5	5.2	5.6	6.2	7.1	8	*12.2%*
Comm., Media & Services	5.5	6.3	6.8	7.5	8.4	9.3	*11.1%*
Education	0.8	0.9	1	1.1	1.2	1.4	*11.8%*
Government	**5**	**5.8**	**6.6**	**7.3**	**8.3**	**9.3**	***13.2%***
Healthcare Providers	0.9	1.1	1.1	1.2	1.2	1.3	*7.6%*
Insurance	1.2	1.4	1.5	1.6	1.9	2.1	*11.8%*
Manufacturing & Natural Res.	5.7	6.6	7.3	8.1	9.1	10.1	*12.1%*
Retail	1.4	1.7	1.9	2.1	2.4	2.7	*14.0%*
Transportation	1.5	1.7	1.8	2	2.3	2.6	*11.6%*
Utilities	1.1	1.3	1.4	1.6	1.8	2	*12.7%*
Wholesale Trade	0.8	1	1	1.1	1.3	1.4	*11.8%*
Total	**28.5**	**32.9**	**36**	**39.7**	**45**	**50.2**	***12.0%***

Source: Gartner, Company Data, PL Research

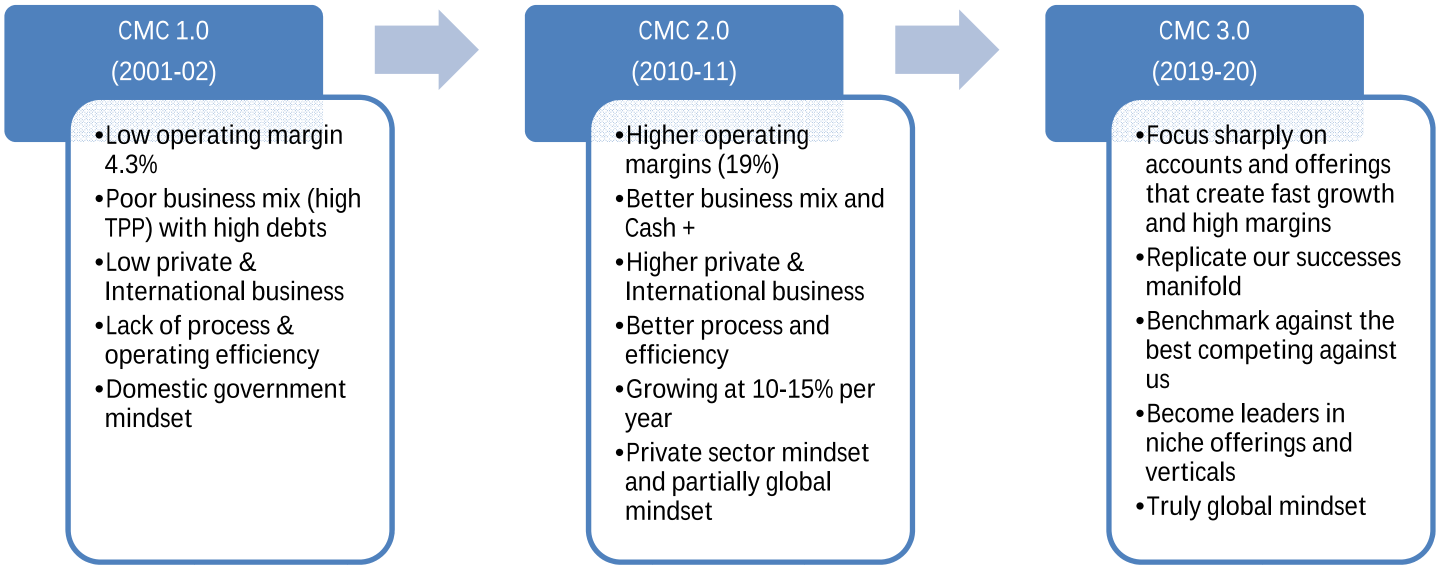
Exhibit 7: Non-India driving margin



Source: Company Data, PL Research

- **International Business:** CMC has improved to a balanced mix of India and non-India revenue, with equal contribution coming in from both the segments. It has helped the company to improve margin profile of the overall business. CMC currently has ~120 onshore persons for delivery centres in USA. The company is looking to exploit growth opportunities in Eastern Europe, Africa, Middle East, and other emerging economies.

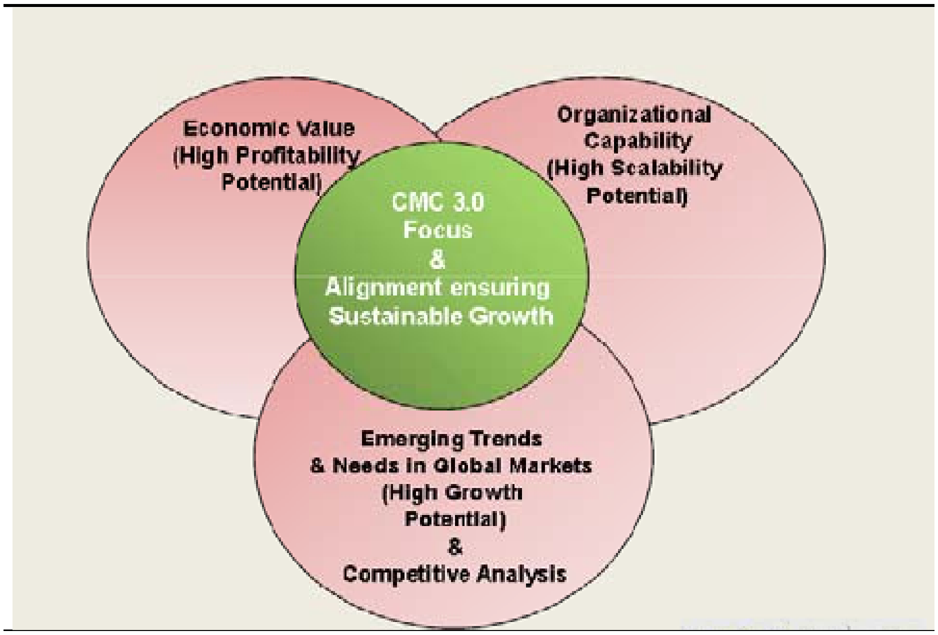
CMC Strategy shift



Source: Company Data, PL Research

CMC is now more focused to drive growth along with maintaining profitability. The global markets make a key for their growth strategy; however, the company is not looking to increase revenue contribution from the global market above its current level of ~55%. The company has set their focus on niche offerings like non-life insurance solution, port solution, e-governance to drive the growth.

Exhibit 8: Focus – A blend of growth, profitability and scalability

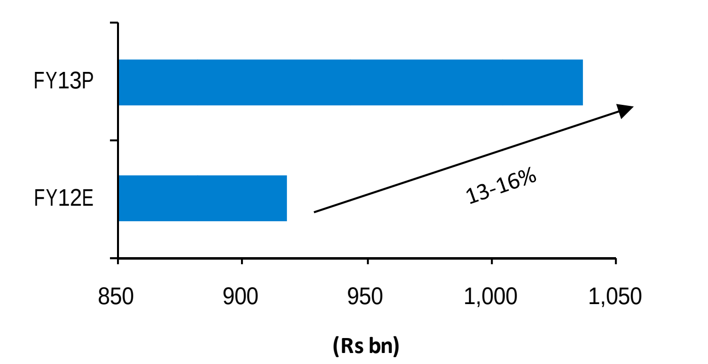


Source: Company Data, PL Research

Strong opportunity in the Indian Market - CMC unique advantage

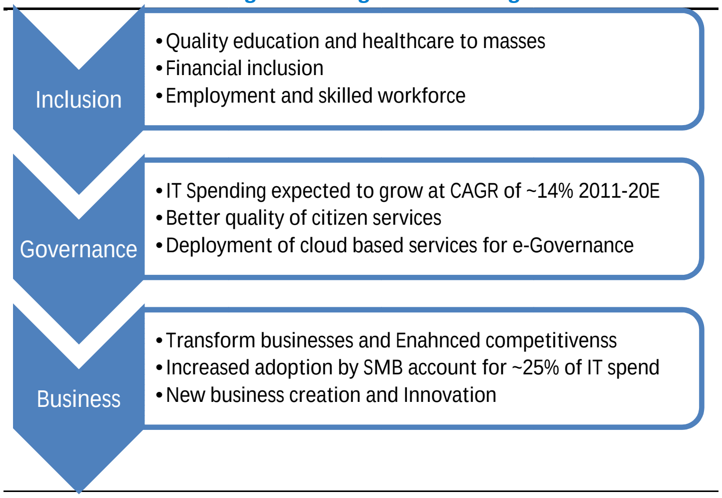
According to Nasscom, IT-BPO services will be instrumental in the economic and social rise of India in the coming decade. As result, the domestic IT-BPO market is expected to grow in parallel with the growth of the economy. The upbeat domestic IT-BPO spending trend will continue in FY13 as the industry is expected to grow at 13-16^ to reach Rs1,037bn (~$ 21bn). Manufacturing and energy verticals will be the major contributors to this growth while government with its focus on e-Governance, will continue to be major spender.

Exhibit 9: India IT-BPO: Grow faster than the export market



Source: NASSCOM, PL Research E-Expected P-Projected

Exhibit 10: Transforming India using IT: CMC strength critical for it



Source: NASSCOM, PL Research

Businesses in India have started to leverage IT to innovate and optimise/expand their businesses. Going forward, the trend is expected to intensify as enterprises in India continue to mature and go global. IT adoption in the SMB sector is also rising and currently accounts for ~25% of the total IT spend in India. The SMB sector is expected to grow up to a size of 65-70m units by 2020 as the maturity of SMBs will increase and more and more SMBs will transform into large enterprises.

Low-cost products and applications are being made available due to innovative technologies (cloud, mobility, collaboration, etc), leading to the emergence of a new class of consumers who had earlier not invested heavily in IT – leading to consumerisation of IT. This phenomena is likely to be aggravated by increasing personal income in the country, rising literacy rates, and urbanisation of Indian cities. More and more enterprise would change their spending pattern away from hardware/software to pay-per-use.

CMC is uniquely positioned to serve the need of Indian IT across the three levels (Exhibit 7). We believe the long-standing relationship with corporate in India and unique business model (contract and sub-contract) would give them the edge in domestic market.

Quality of earnings – Good if not the best

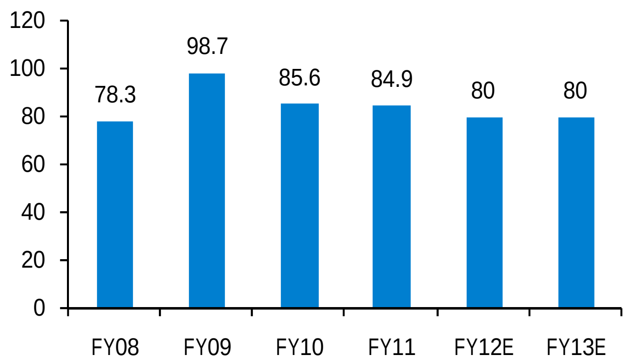
The quality of earnings for CMC has been in-line with the competitors for the similar line of businesses. We see the ability of the company to sustain good cash conversion and keeping DSOs in control to be the key reason to command better earnings multiple than mid-cap names. We expect return ratios of the company to sustain as we see no near-term pressure on margins.

DSO – In-line with the industry despite government exposure

The rich experience to work with government sector has helped CMC to maintain debtor days despite driving ~25% revenue from the government sector. It has debtor days of 84 (FY11) much lower than other peers who works with the government. According to the management, DSO days for the government contracts are in the range of 110-130 days compared to 60-80 days for the non-government sector work.

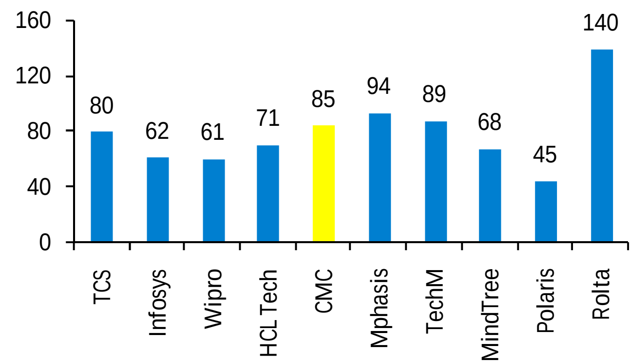
The decline in contribution from the government sector (already came down from ~65% in pre-TCS era to currently ~25%) due to slower than other sector leaves room for further improvement in DSOs.

Exhibit 11: DSO – In control despite high exposure to government



Source: Company Data, PL Research

Exhibit 12: In-line with the industry average



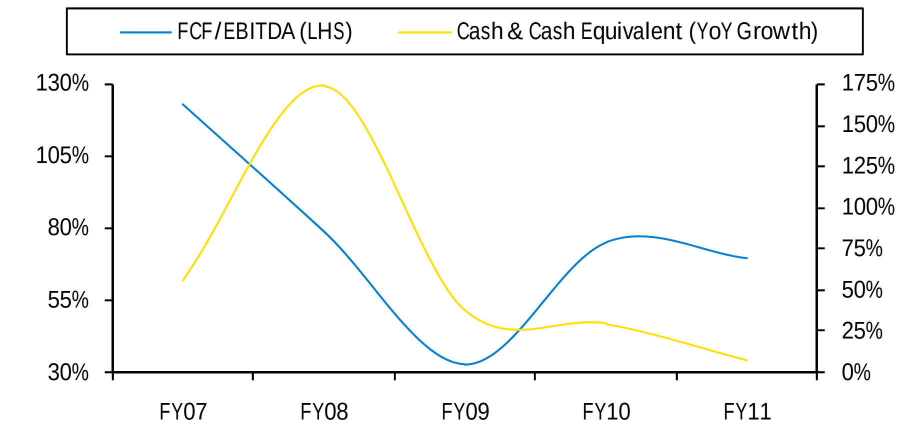
Source: Company Data, PL Research

Unrealized Balance Sheet potential

Over the last five years, Cash and cash equivalent of the company has grown 8x. The FCF/EBITDA conversion has been consistent at ~75%. CMC has announced a launch of SEZ in Hyderabad (India). It intends to spend up to Rs4.6bn on the construction. The company has already spent Rs2.3bn and likely to spend remaining by July 2013. The facility would house ~15-16k professionals. Moreover, CMC is going to lease ~13k seat facility to TCS and would charge a rental for the same.

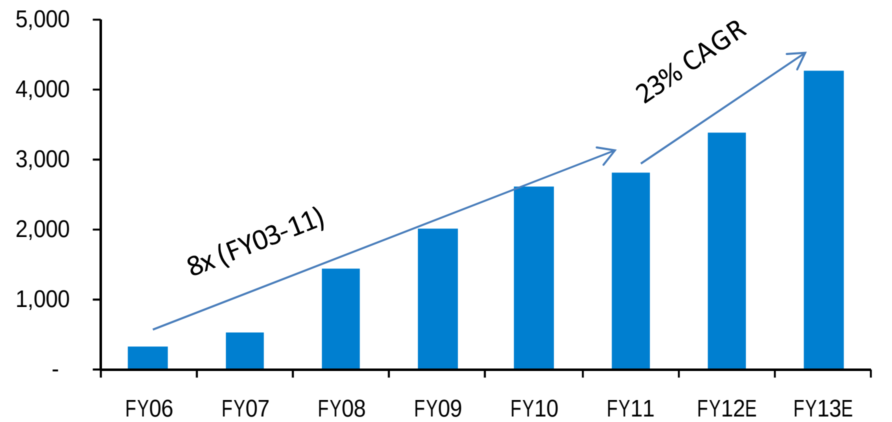
We believe that CMC can leverage the balance sheet to grow inorganically. However, our recent interaction with the management does not indicate so. Moreover, healthy free cash flow generation also leaves room for further upside for increase in dividend payout from currently ~15% (currently the company has dividend yield of ~1%).

Exhibit 13: Strong cash conversion has helped company build strong balance sheet



Source: Company Data, PL Research

Exhibit 14: Moderation in cash conversion in FY12E and FY13E is due to SEZ investment

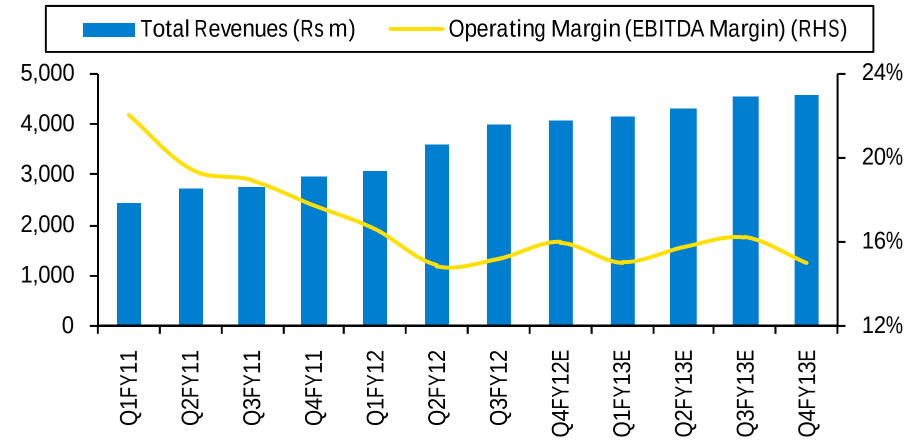


Source: Company Data, PL Research

Growth, but not at the cost of margin

The management objective was clear to deliver industry leading growth, but not at the cost of margin. The recent (last five quarters) down-tick in the margin is due to increasing composition from onsite (gone up from 20% to 40%). According to the management, the EBITDA margin is likely to improve by ~200-300bps as the project ramp-up reaches final stage, hence, increased offshoring.

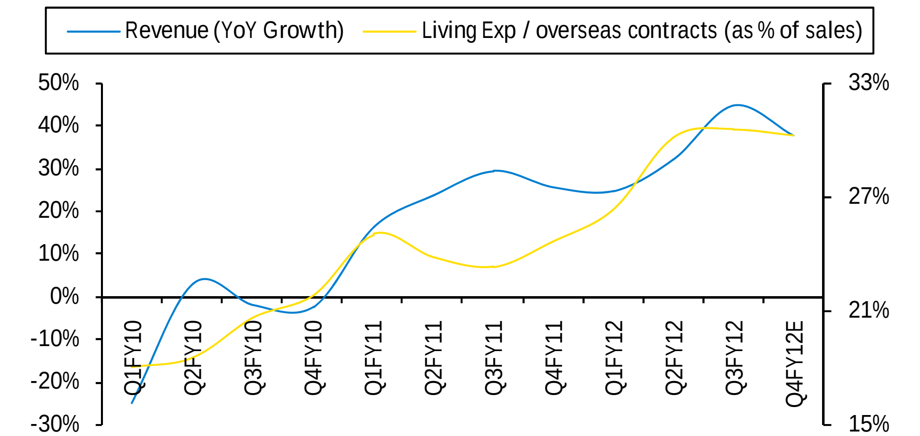
Exhibit 15: Room for margin improvement with steady growth



Source: Company Data, PL Research

CMC championed the art of sub-contracting. The sub-contractor helps them in reducing the cost and maintaining the variability in the cost. This helps CMC to take up more project-based work. About a third of overall employee base is sub-contracted. However, the composition of contracted employee has gone up significantly in the recent quarters (Q1FY09: 12.7%, Q3FY12: 30.5%). The sudden surge is largely due to onsite project ramp-up. We expect the sub-contracting to come down as offshoring leverage start taking over.

Exhibit 16: Subcontracting cost surged – Leaves room for margin expansion



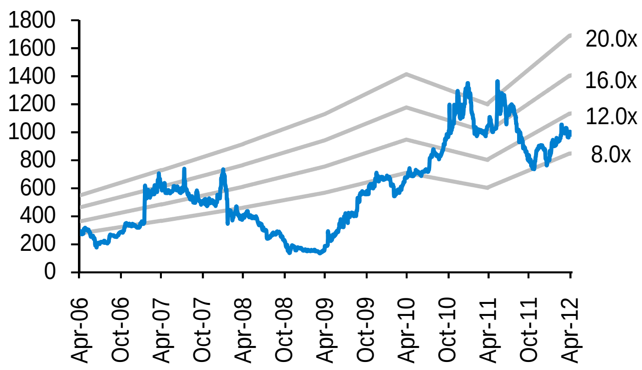
Source: Company Data, PL Research

Valuation – Support for more upside

At Rs978, UBM trades on 14x FY13E, on our estimates, a 20% discount to the Tier-1 piers, with a potential 5% EPS uplift to FY13 to reflect effective balance sheet redeployment (SEZ) that multiple would drop to 13.3x FY13, a 25% discount to the Tier-1 and, in our view, is cheap for the company, which is going to deliver high teens growth along with room for margin levers.

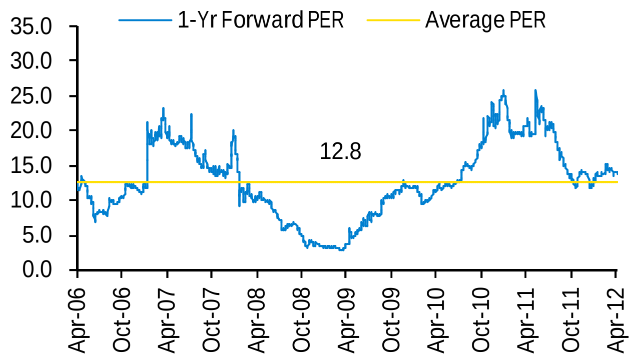
CMC can prudently leverage their balance sheet in order to improve return ratios. The current capex plan, along with increase in dividend pay-out, could boost the performance. In a period when the valuations of IT Services appear to be rising ahead of business fundamentals, CMCs ability to achieve higher multiples at these levels should not be considered unusual.

Exhibit 17: P/E band – Margin expansion would yield stock re-rating



Source: Company Data, Bloomberg, PL Research

Exhibit 18: Current P/E not factoring positive surprise on margin



Source: Company Data, Bloomberg, PL Research

Income Statement (Rs m)

Y/e March	2011	2012E	2013E	2014E
Net Revenue	**10,844**	**14,640**	**17,560**	**20,045**
Software Dev. Exp.	3,837	6,118	7,259	8,247
Gross Profit	7,007	8,522	10,301	11,798
Employee Cost	3,451	4,405	5,098	5,913
Other Expenses	1,448	1,827	2,146	2,489
EBITDA	**2,107**	**2,289**	**3,058**	**3,395**
Depr. & Amortization	105	224	319	364
Net Interest	1	3	3	3
Other Income	117	155	228	317
Profit before Tax	**2,118**	**2,218**	**2,963**	**3,345**
Total Tax	324	699	830	870
Profit after Tax	**1,794**	**1,519**	**2,134**	**2,475**
Ex-Od items / Min. Int.	—	—	—	—
Adj. PAT	**1,794**	**1,519**	**2,134**	**2,475**
Avg. Shares O/S (m)	**30.3**	**30.3**	**30.3**	**30.3**
EPS (Rs.)	**59.2**	**50.1**	**70.4**	**81.7**

Cash Flow Abstract (Rs m)

Y/e March	2011	2012E	2013E	2014E
C/F from Operations	1,616	1,546	2,258	2,646
C/F from Investing	(936)	(3,726)	(1,054)	(601)
C/F from Financing	(486)	(61)	(91)	(98)
Inc. / Dec. in Cash	194	(2,241)	1,113	1,946
Opening Cash	2,633	2,827	586	1,700
Closing Cash	2,827	586	1,700	3,646
FCFF	1,690	(262)	1,174	1,944
FCFE	1,557	(262)	1,174	1,944

Key Financial Metrics

Y/e March	2011	2012E	2013E	2014E
Growth				
Revenue (%)	23.8	35.0	19.9	14.2
EBITDA (%)	26.0	8.7	33.5	11.0
PAT (%)	25.3	(15.3)	40.4	16.0
EPS (%)	25.3	(15.3)	40.4	16.0
Profitability				
EBITDA Margin (%)	19.4	15.6	17.4	16.9
PAT Margin (%)	16.5	10.4	12.2	12.3
RoCE (%)	28.8	19.5	21.9	20.0
RoE (%)	30.8	20.9	23.7	22.0
Balance Sheet				
Net Debt : Equity	(0.1)	(0.1)	(0.2)	(0.3)
Net Wrkng Cap. (days)	—	—	—	—
Valuation				
PER (x)	16.5	19.5	13.9	12.0
P / B (x)	4.5	3.7	2.9	2.4
EV / EBITDA (x)	13.8	12.7	9.1	7.7
EV / Sales (x)	2.7	2.0	1.6	1.3
Earnings Quality				
Eff. Tax Rate	15.3	31.5	28.0	26.0
Other Inc / PBT	5.5	7.0	7.7	9.5
Eff. Depr. Rate (%)	6.0	7.0	7.5	7.5
FCFE / PAT	86.8	(17.2)	55.0	78.5

Source: Company Data, PL Research.

Balance Sheet Abstract (Rs m)

Y/e March	2011	2012E	2013E	2014E
Shareholder's Funds	6,540	7,999	10,042	12,419
Total Debt	1	1	1	1
Other Liabilities	—	—	—	—
Total Liabilities	**6,542**	**8,000**	**10,043**	**12,420**
Net Fixed Assets	2,036	2,933	3,639	3,775
Goodwill	3	3	3	3
Investments	2,262	2,262	2,262	2,262
Net Current Assets	2,152	2,714	4,051	6,291
Cash & Equivalents	*565*	*586*	*1,700*	*3,646*
Other Current Assets	*5,038*	*6,620*	*7,643*	*8,494*
Current Liabilities	*3,451*	*4,492*	*5,292*	*5,849*
Other Assets	88	88	88	88
Total Assets	**6,542**	**8,000**	**10,043**	**12,420**

Quarterly Financials (Rs m)

Y/e March	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Net Revenue	**2,941**	**3,056**	**3,577**	**3,962**
EBITDA	**521**	**507**	**532**	**604**
% of revenue	*17.7*	*16.6*	*14.9*	*15.2*
Depr. & Amortization	30	37	54	58
Net Interest	—	—	—	—
Other Income	28	26	49	39
Profit before Tax	**519**	**496**	**527**	**585**
Total Tax	79	147	201	171
Profit after Tax	**440**	**349**	**326**	**414**
Adj. PAT	**440**	**349**	**326**	**414**

Source: Company Data, PL Research.

Prabhudas Lilladher

Hexaware Technologies

Limited catalyst, stay on the side-line

Company Report

April 09, 2012

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Pratik Shah
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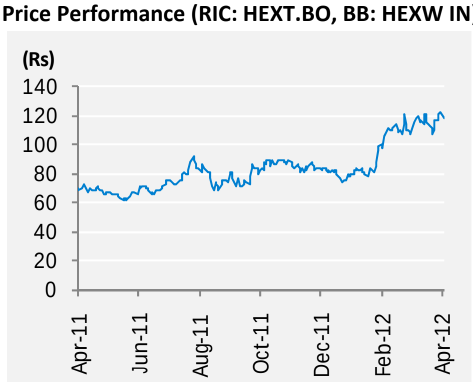
Rating	**Reduce**
Price	Rs118
Target Price	Rs100
Implied Upside	-15.3%
Sensex	17,222
Nifty	5,234

(Prices as on April 09, 2012)

Trading data			
Market Cap. (Rs bn)			34.8
Shares o/s (m)			293.5
3M Avg. Daily value (Rs m)			296.1
Major shareholders			
Promoters			28.16%
Foreign			41.44%
Domestic Inst.			9.42%
Public & Other			20.98%
Stock Performance			
(%)	**1M**	**6M**	**12M**
Absolute	1.8	44.5	71.7
Relative	2.6	35.5	84.2
How we differ from Consensus			
EPS (Rs)	**PL**	**Cons.**	***% Diff.***
2012	10.7	10.2	*5.6*
2013	11.3	11.2	*0.6*

Price Performance (RIC: HEXT.BO, BB: HEXW IN)



Source: Bloomberg

We intiate coverage on Hexaware with a '**Reduce**' rating and a target price of Rs100, implying 15% potential downside from the current level. Three reasons for our bearish view – growth seems less secure as discretionary spend trajectory disappoints, there is limited leverage as the best growth profile era is over and last but not the least – valuation is full.

- **Discretionary spend losing steam, momentum at risk:** Hexaware was the beneficiary of accelerated momentum in IT spend, particularly for ERP. The strong demand in 2010-11 gave it increased focus and renewed vigour in the vertical. But uncertainty around discretionary spend has put growth trajectory at risk. We believe that momentum is likely to decelerate as cost cognizance remains the central theme for CIOs.
- **Best is behind us, growth less secure:** Industry fundamentals appear to have peaked-out for this cycle. The enterprise's focus on cost-cutting means that application spending growth is likely to be subdued. Competitive positioning, execution and cash generation are the key. We believe that organic growth can drive 12% EPS growth for the next two years — an opportunity already reflected in a demanding rating of 11x times CY12 earnings. Our price target of Rs100 implies 15% potential downside and would put Hexaware at 9x CY12, still at par with its Indian technology peers, despite potential downside risk of growth prospects.
- **Risk-Reward skewed to downside:** The current run-up in the stock price factors in upside due to potential stake sale by promoters and current private equity holders. We believe that any failure of such talks would push the valuation back to fundamentals. If the stake sell-out happens, a potential open-offer could give upside to the current upside.
- **Valuation & Recommendation:** We are initiating coverage on Hexaware with a '**Reduce**' rating. We believe the stake-sell news, which is the primary reason why we have a volatility flag on the stock, has pushed the valuation that is not supported by fundamentals. Downside risk of discretionary spend cut could put earnings at risk.

Key financials (Y/e December)	**2010**	**2011**	**2012E**	**2013E**
Revenues (Rs m)	10,545	14,505	18,515	21,029
Growth (%)	*1.5*	*37.6*	*27.6*	*13.6*
EBITDA (Rs m)	938	2,646	3,569	3,836
PAT (Rs m)	1,077	2,668	3,148	3,319
EPS (Rs)	7.4	9.1	10.7	11.3
Growth (%)	*(45.6)*	*22.6*	*18.0*	*5.4*
Net DPS (Rs)	1.5	4.3	2.5	2.5

Profitability & Valuation	**2010**	**2011**	**2012E**	**2013E**
EBITDA margin (%)	*8.9*	*18.2*	*19.3*	*18.2*
RoE (%)	*11.9*	*26.9*	*27.7*	*23.9*
RoCE (%)	*11.7*	*26.8*	*27.7*	*23.9*
EV / sales (x)	1.2	2.1	1.6	1.4
EV / EBITDA (x)	13.8	11.4	8.4	7.7
PE (x)	16.0	13.0	11.0	10.5
P / BV (x)	1.8	3.4	2.8	2.3
Net dividend yield (%)	*1.3*	*3.7*	*2.1*	*2.1*

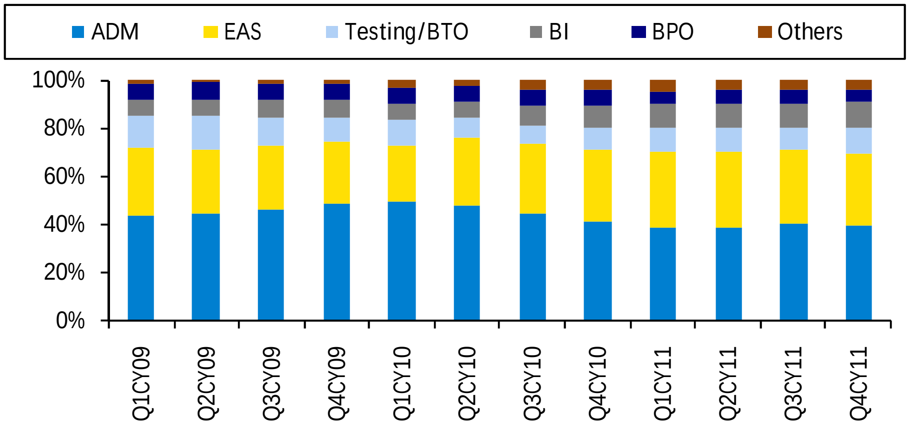
Source: Company Data; PL Research

We are initiating coverage on Hexaware with '**Reduce**' rating and target price of Rs100. We feel that the recent results of peers have introduced question marks over the strength and sustainability of growth as well as leverage within the business model. We are keeping our CY12 forecasts close to the guidance, but have lower margin profile than what the company had delivered at the end of Q4CY11. In the near term, we would highlight three issues on the shares - less confident about the growth, less leverage in the model and the stock is trading at a premium to the majority of the peers due to likelihood of getting acquired.

Discretionary spend losing steam, momentum at risk

Portfolio skewed towards discretionary: In the most recent quarter (Q4CY11), Hexaware reported 39.7% revenue from ADM (Application Development and Maintenance), 29.8% from EAS (Enterprise Application Services) and ~10.5% from BIA (Business Intelligence and Analytics). The service portfolio of Hexaware is skewed highly towards discretionary driving ~80% of revenue from the discretionary spends.

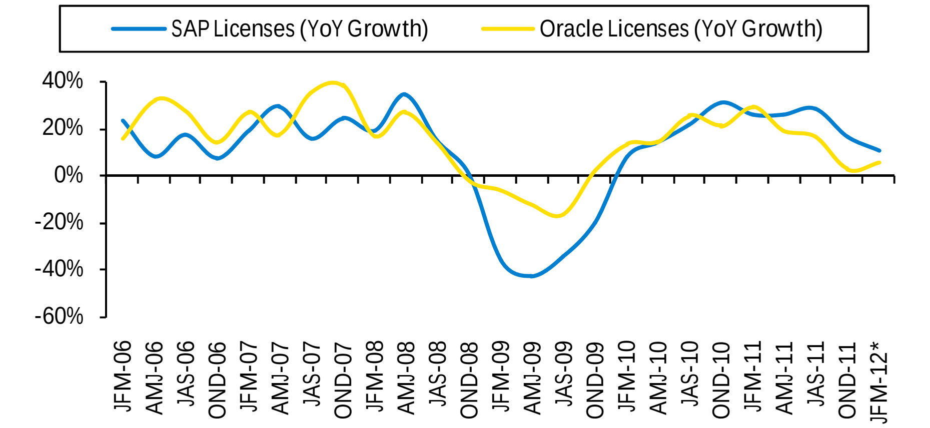
Exhibit 1: ~80% of service portfolio is skewed towards discretionary



Source: Company Data, PL Research

Discretionary losing steam: Despite currency headwinds for the last two years, Hexaware has managed to produce industry-leading revenue growth along with margin expansion. Indeed, in USD terms, its organic revenue CAGR of 20% in 2009-11 was one of the best among peers. Still, we are becoming less confident that this industry-leading performance can continue. Our view is based on two factors: first, the tapering growth in licenses sales for Oracle and SAP and second, cautious tone of clients toward discretionary spend. Hexaware's 2012 guidance is for 20% is USD terms for CY12. We do not see much in terms of upside risk to these targets.

Exhibit 2: Tapering growth trajectory of licenses sale of Oracle and SAP



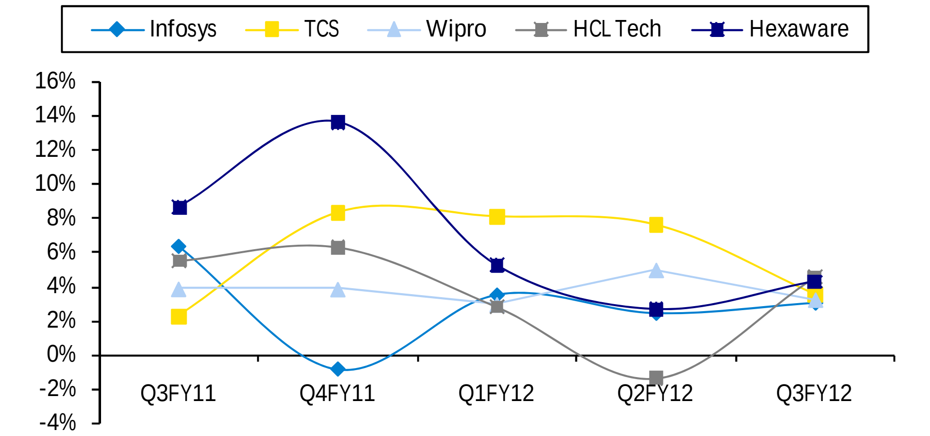
*Source: Company Data, PL Research, * Mid-Point of company's guidance*

Package Implementation still great, but high teen growth becoming tougher

Over the last four quarters, the growth from the package implementation for Tier-1 Indian IT companies along with Hexaware has moderated from high single-digit to mid single-digit. We expect further growth moderation in the ERP demand as the licenses sale for Oracle and SAP have tapered down.

Hexaware's ERP continues to confound to the most bullish of expectations, with strong growth again in Q4CY11 at 4.3% QoQ, ahead of licenses sales. Volumes continue to be stronger than peers. We expect volume growth to moderate as upgrade cycle comes to an end. This is competitive though, as the performance of Tier-1 indicates. We await the growth rates to slow to the teens in the second half as the tailwind of the contracts won by Hexaware gets over.

Exhibit 3: Growth moderated over last four quarters

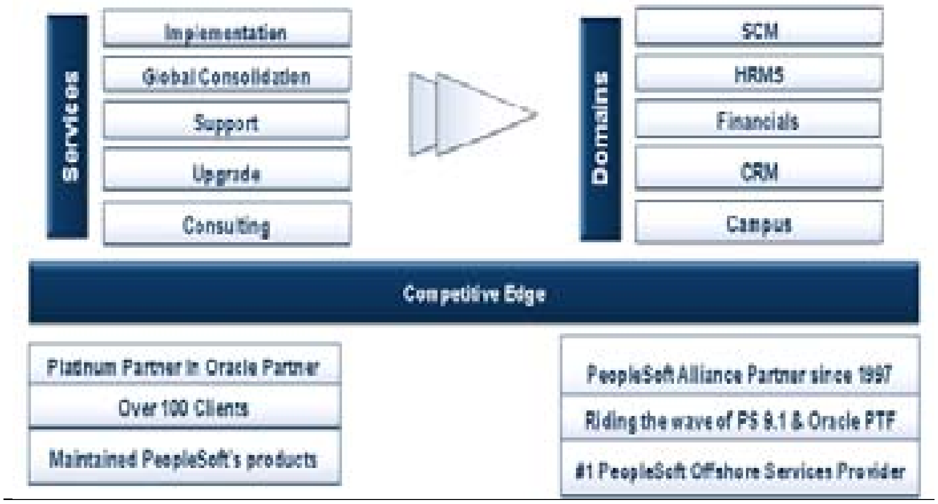


Source: Company Data, PL Research

Concentrated exposure to HR portfolio, expose revenue to a risk

In our opinion, ERP portfolio of Hexaware is skewed towards *PeopleSoft*. Gaining traction of Oracle HR platform is a key business indicator for the company's performance. The company has gained strong business traction from both, implementation and maintenance of *PeopleSoft*.

Exhibit 4: Hexaware – *PeopleSoft* Competency Overview



Source: Company Data, PL Research

65% of the overall engagement pertains to support, maintenance and keep-up of *PeopleSoft* for Hexaware. Demand was strong across all markets and services. The core business in Europe did well, growing 41% in CY11. This was the best result in Europe since CY07 and comes against an uncertain macroeconomic backdrop and is a positive for Hexaware. Licenses sale for Oracle was muted in the current quarter. Outside of Services and maintenance, we would expect growth rates at new implementation to remain weak in H2CY12.

Partnership with global players

- **Platinum Partnership with Oracle:** Hexaware is one of the select partners that achieved Platinum Partner status globally.
- **Global Managed Service Provider (MSP) for HP Software:** Customers to buy HP Software licenses directly from Hexaware without signing End User License agreement with HP.
- **SAP Global Portfolio Group:** Hexaware is a part of SAP's Global Portfolio Group managed by their Global Ecosystem and Partner Group (GEPG).

Hexaware's strategies to penetrate the geographies and verticals that are under-served by the large Indian IT vendors have played out really well. The company had growth momentum higher than its larger peers. The company has increased revenues by focusing on PeopleSoft and verticals such as BFSI and travel & transport.

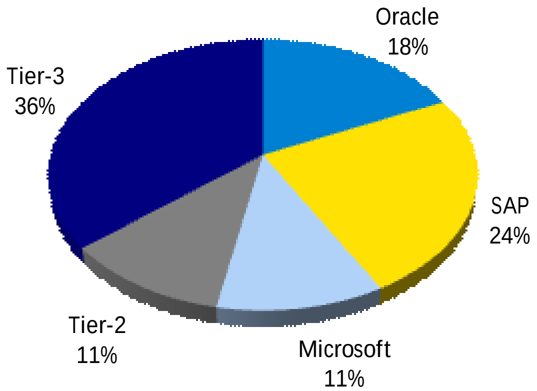
The PeopleSoft expertise was developed by establishing the build, operate, and transfer (BOT) centre for PeopleSoft, which was transferred to Oracle in November 2005. High dependence on the fewer service offering (Oracle's PeopleSoft) exposes Hexaware to the risk of any change in clients spending behaviour.

Exhibit 5: Sample ERP vendors – Focus of Hexaware is on Tier-1 vendors

Tier-1	Tier-2	Tier-3
SAP	Epicor	ABAS
Oracle	Sage	Activant Solutions Inc.
Oracle eBusiness Suite	Infor	Baan
Oracle JD Edwards	IFS	Bowen and Groves
Oracle Peoplesoft	QAD	Compiere
Microsoft Dynamics	Lawson	Exact
Salesforce.com	Ross	Netsuite

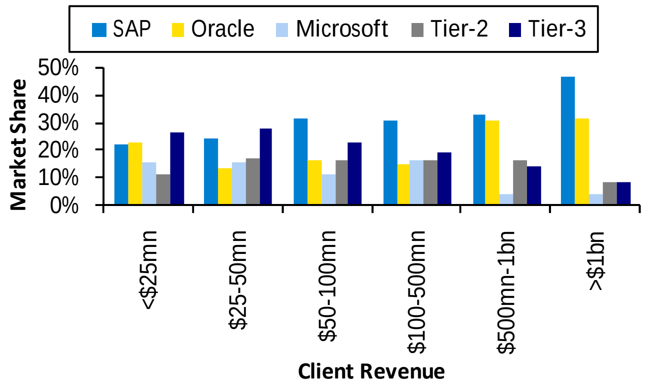
Source: PL Research

Exhibit 6: Oracle has a dominant share



Source: PL Research, Panorama Consulting

Exhibit 7: ...but weak $25-500m segment, key for Hexaware growth



Source: PL Research, Panorama Consulting

Oracle is dominant in less than US$25m client-revenue segment but weaker than peer in US$25-500m bracket, a key for Hexaware's next level of growth momentum.

Strong growth, but lacking leverage

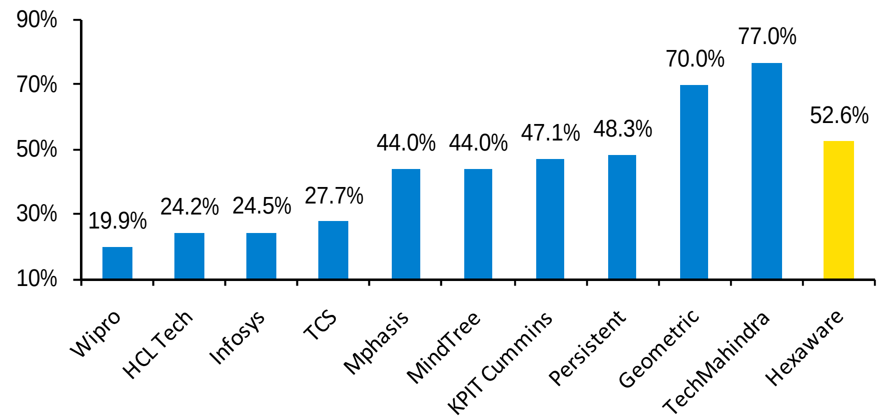
Hexaware reported a good CY11, with sales driven by strong demand across all geographies and service-line - the Enterprise Application Services markets are in good shape and Hexaware has benefited from its dominant position. ***We reiterate three reasons why we would remain on the sidelines with the stock:***

- Lack of leverage – Although the company has guided for at least 20% sales, we see little room for further expansion in the operating margin as most of the levers are stretched.
- Growth environment turns tougher – Challenges around discretionary spend put growth in tougher spot. We think the growth has peaked out in CY11 and we are likely to see moderation in growth for the company.
- Valuation - Priced at the top end of sector valuation - 11x CY12 estimates; despite moderating EPS growth

Lack of leverage

Client concentration continues to be a risk: Hexaware has got one of the highest exposures to the top 10 clients when compared to other mid-tier Indian IT companies. Tier-1 Indian IT services companies drive ~25% of revenue from their top 10 clients, whereas Tier-2 companies drives less than 50% of revenue from top 10 clients, when compared to Hexaware, which drives ~53% (seven percentage point increase over the last eight quarters) of revenue from them. We anticipate that the company needs to de-risk their business model from the concentrated growth.

Exhibit 8: Top 10 client concentration – Among the highest in peers

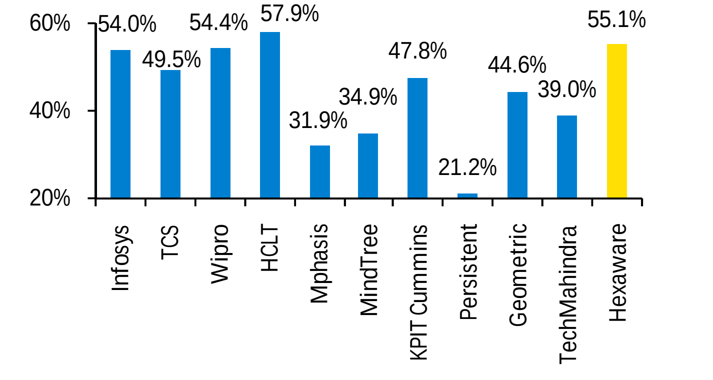


Source: Company Data, PL Research

Offshore leverage has been exploited effectively to gain margin expansion: In CY11, Hexaware clearly executed the stated objective of execution and increasing wallet share. The theme got accompanied by increasing offshore in CY11 helped Hexaware improve their operating margin. However, ~30% revenue exposure to Enterprise

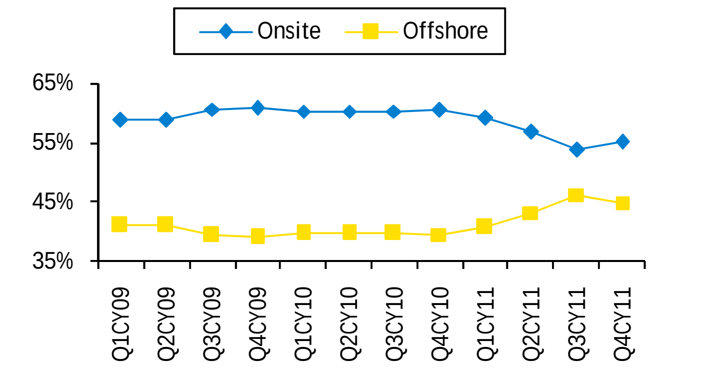
Application Services limits the scope of offshoring leverage for the company. The strong growth from top 10 clients has increased elbow room for the company to increase offshoring. We see that as the growth from the top 10 clients moderate, the scope of pushing offshore further is limited. The initial project ramp costs are something that is most likely to be the theme for CY12.

Exhibit 9: Business model of Hexaware more skewed toward onsite…



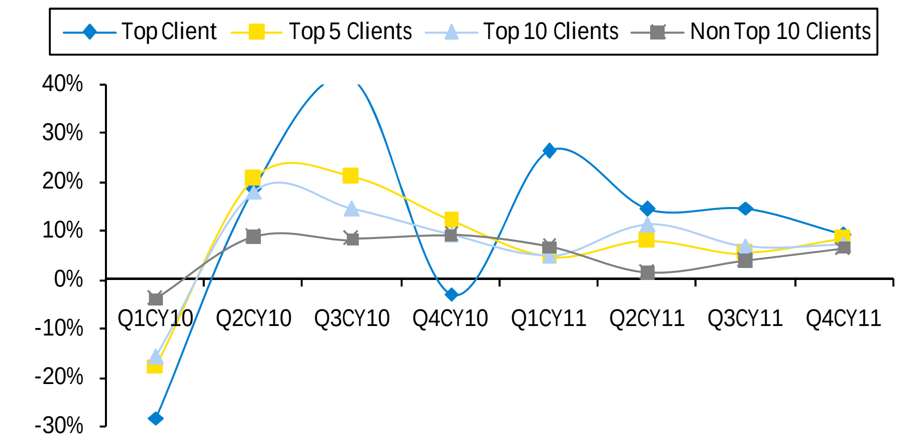
Source: Company Data, PL Research

Exhibit 10: …but offshore leverage has been exploited to the fullest



Source: Company Data, PL Research

Exhibit 11: Moderating growth from top clients

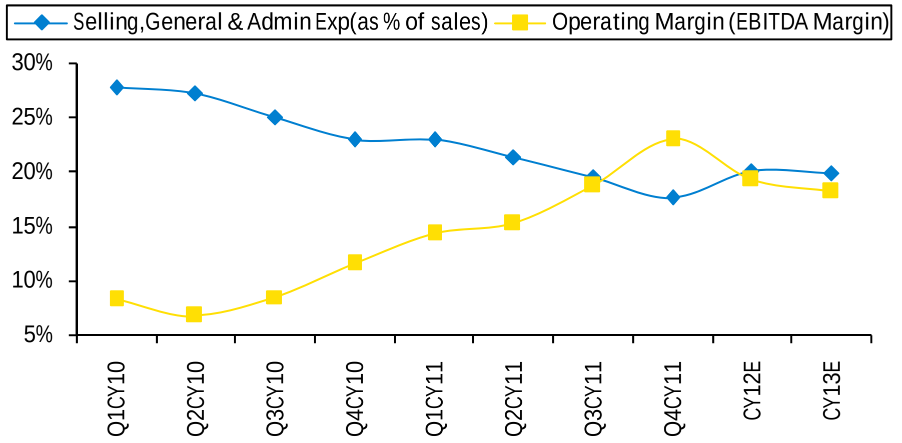


Source: Company Data, PL Research

Increased focus on client acquisition mean higher S&M costs: Till CY11, the company has managed to contain the cost and hence, the revenue growth has filtered down well at the bottom-line. It is interesting that the sales outperformance versus the company's plan did filter down to earnings - operating margin (EBITDA) for the company expanded to the highest level at 21.6%. The majority of the cost cut was in SG&A - where costs rose 24% over the last eight quarters (Q1CY10-Q4CY11) compared to 95% growth in revenue over the same period. As a proportion of sales, SG&A in Q4CY11 reached 17.7% versus 27.8% in Q1CY10.

Increasing S&M costs has to be the part of the company's strategy, as Hexaware seeks out growth in the new clients. This does mean that the company is building and managing many more sales channel relationships that it has in the past. The chart below shows Hexaware's SG&A cost base as a proportion of sales over the last eight quarters. After some stability, we expect SG&A costs to be on the rise again.

Exhibit 12: Cost rationalization pushed Operating margin to an all-time high



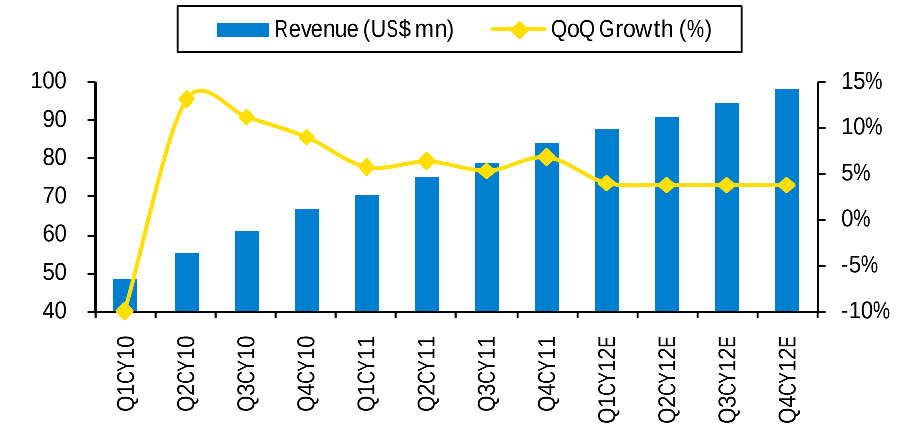
Source: Company Data, PL Research

Best is behind us, Growth less secure

Hexaware reported one of the strongest revenue growths in the last five years along with strong operating margin expansion. We see moderation in growth along with pressure on margins, going forward. Moreover, high exposure to discretionary portfolio exposes revenue to the uncertainty over guided momentum.

Guidance suggests limited leverage in CY12: Although there may be a hump in terms of the revenue growth in Q1CY12 (Hexaware mentioned some project win in CY11 would start to see ramp-up in CY11), we do think the strategic move to acquire new client increases S&M costs over the long-term. We see dormant deal activity for discretionary portfolio to start getting reflected in Hexaware's guidance from H2CY12. We expect Hexaware to at best achieve industry leading guidance with some pressure on margin.

Exhibit 13: Expect growth to moderate to low single digit (Guidance factors ~3.9% CQGR)



Source: Company Data, PL Research

Risk to recommendation

Stake sell-out by current management: The current management (promoters) is looking to exit the business. Promoters currently own ~28% stake in the company, whereas *General Atlantic* holds a little less than 15% and *ChrysCapital* 9.77%. In a likely exit by the promoters and private equity players, the acquiring company would have controlling stake in the company. Moreover, the company (or private equity player) acquiring this stake need to give an open offer as well. Any such deal could push the stock price for the short term.

Stronger industry fundamental than expected: Slump in discretionary spend in H2CY11 would start getting reflected in the growth of Hexaware, whose service portfolio is skewed more towards discretionary IT spend. However, positive commentary from Europe and the US macroeconomic recovery could swing the pendulum for a better CY12 than guidance.

Sharp currency depreciation: Supportive currency could be a wild card in our assumption. Any sharp depreciation in the currency could provide much needed cushion for operating for the company. Our assumption is based on the stretched margin lever of the company, but currency depreciation could provide support to the operating margin.

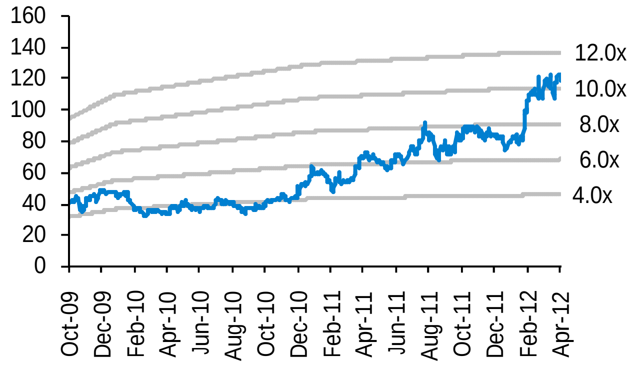
Valuations – growth already in the price, stay on the sideline

The business of Hexaware has seen a significant improvement in CY11 along with margin expansion. The improved performance has pushed the valuation of Hexaware. We expect Hexaware to deliver 12% CAGR over CY11-13E. However, we are valuing the company at 10x (long-term average) March-13 earnings estimates.

We believe that the stock price is currently not trading close to fundamentals. We think the recent media reports of stake sell-out by promoters have resulted in sharp jump. The enhanced service and product portfolio with the strong growth potential could further narrow the discount to Infosys, providing more upside to the stock.

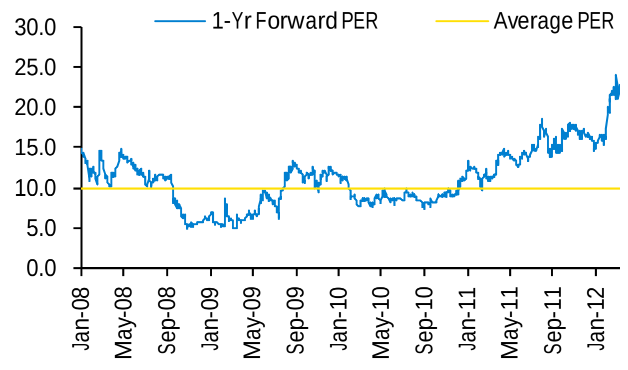
Valuation continues to expand as earnings outlook may be trimmed back: Hexaware is currently trading at a life-time high, with nearly 100% premium to its long-term trading average. Indeed, recently, it has begun to trade at a premium to Infosys, which is historically quite rare. Our fair value and price target of Rs100 are derived from our P/E model, based on 10x March-13 earnings estimate.

Exhibit 14: P/E band – Current price looks deviation from fundamental



Source: Company Data, Bloomberg, PL Research

Exhibit 15: Recent jump is more due to stake sale rumours



Source: Company Data, Bloomberg, PL Research

Income Statement (Rs m)

Y/e December	2010	2011	2012E	2013E
Net Revenue	**10,545**	**14,505**	**18,515**	**21,029**
Software Dev. Exp.	6,915	8,939	11,241	13,034
Gross Profit	3,630	5,566	7,274	7,995
Employee Cost	—	—	—	—
Other Expenses	2,692	2,920	3,705	4,159
EBITDA	**938**	**2,646**	**3,569**	**3,836**
Depr. & Amortization	242	248	333	417
Net Interest	—	—	—	—
Other Income	473	677	651	679
Profit before Tax	**1,169**	**3,075**	**3,886**	**4,098**
Total Tax	92	407	738	779
Profit after Tax	**1,077**	**2,668**	**3,148**	**3,319**
Ex-Od items / Min. Int.	—	—	—	—
Adj. PAT	**1,077**	**2,668**	**3,148**	**3,319**
Avg. Shares O/S (m)	**145.2**	**293.5**	**293.5**	**293.5**
EPS (Rs.)	**7.4**	**9.1**	**10.7**	**11.3**

Balance Sheet Abstract (Rs m)

Y/e December	2010	2011	2012E	2013E
Shareholder's Funds	9,655	10,161	12,576	15,163
Total Debt	112	—	—	—
Other Liabilities	13	—	—	—
Total Liabilities	**9,780**	**10,161**	**12,576**	**15,163**
Net Fixed Assets	4,078	4,785	6,303	7,989
Goodwill	—	—	—	—
Investments	397	—	—	—
Net Current Assets	5,122	5,214	6,111	7,012
Cash & Equivalents	*4,356*	*4,606*	*4,897*	*5,119*
Other Current Assets	*3,551*	*4,939*	*5,750*	*6,267*
Current Liabilities	*2,785*	*4,331*	*4,536*	*4,374*
Other Assets	182	162	162	162
Total Assets	**9,780**	**10,161**	**12,576**	**15,163**

Cash Flow Abstract (Rs m)

Y/e December	2010	2011	2012E	2013E
C/F from Operations	123	3,075	2,875	3,058
C/F from Investing	1,682	(1,853)	(1,852)	(2,103)
C/F from Financing	(275)	(1,137)	(733)	(733)
Inc. / Dec. in Cash	1,529	84	291	222
Opening Cash	2,992	4,522	4,606	4,897
Closing Cash	4,522	4,606	4,897	5,119
FCFF	358	1,222	1,023	955
FCFE	307	1,110	1,023	955

Quarterly Financials (Rs m)

Y/e December	Q1CY11	Q2CY11	Q3CY11	Q4CY11
Net Revenue	**3,185**	**3,341**	**3,660**	**4,319**
EBITDA	**455**	**511**	**686**	**994**
% of revenue	*14.3*	*15.3*	*18.7*	*23.0*
Depr. & Amortization	62	59	64	63
Net Interest	—	—	—	—
Other Income	188	267	160	62
Profit before Tax	**581**	**719**	**782**	**993**
Total Tax	44	116	136	111
Profit after Tax	**537**	**603**	**646**	**882**
Adj. PAT	**537**	**603**	**646**	**882**

Source: Company Data, PL Research.

Key Financial Metrics

Y/e December	2010	2011	2012E	2013E
Growth				
Revenue (%)	1.5	37.6	27.6	13.6
EBITDA (%)	(53.6)	182.1	34.9	7.5
PAT (%)	(45.1)	147.7	18.0	5.4
EPS (%)	(45.6)	22.6	18.0	5.4
Profitability				
EBITDA Margin (%)	8.9	18.2	19.3	18.2
PAT Margin (%)	10.2	18.4	17.0	15.8
RoCE (%)	11.7	26.8	27.7	23.9
RoE (%)	11.9	26.9	27.7	23.9
Balance Sheet				
Net Debt : Equity	(0.4)	(0.5)	(0.4)	(0.3)
Net Wrkng Cap. (days)	—	—	—	—
Valuation				
PER (x)	16.0	13.0	11.0	10.5
P / B (x)	1.8	3.4	2.8	2.3
EV / EBITDA (x)	13.8	11.4	8.4	7.7
EV / Sales (x)	1.2	2.1	1.6	1.4
Earnings Quality				
Eff. Tax Rate	7.9	13.2	19.0	19.0
Other Inc / PBT	26.3	22.0	16.7	16.6
Eff. Depr. Rate (%)	5.2	3.8	4.0	4.0
FCFE / PAT	28.5	41.6	32.5	28.8

Source: Company Data, PL Research.

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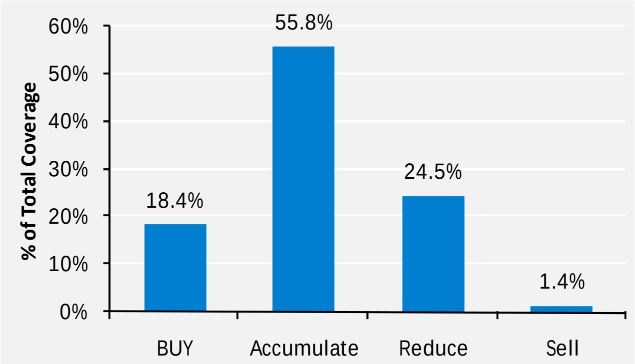

PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly