January 7, 2013

KPIT Cummins Ltd (KPISYS)

₹ 110

Unique DNA but likely priced in…

KPIT Cummins Infosystems (KPIT) is a differentiated manufacturing, automotive and energy & utilities vertical play that could aid investors aspiring to diversify their midcap, BFSI focused, IT portfolio. Notably, it is among the few midcap companies that consistently spends on R&D and has filed ~40 patents. Despite concerns over acquisition led growth, generic for midsized IT companies, organic revenues grew at ~26% CAGR during FY07-12, while consolidated revenues and PAT grew at 41.3% and 53.7% CAGR, respectively, during FY02-12. We are modelling revenues/PAT CAGR of 34.7%/34.9%, respectively, during FY11-14E coupled with 82 bps EBITDA margin expansion in FY13E to 15.4%, led by improvement in below company average SBU margins. Though growth is not scarce at KPIT, concerns related to weak cash generation continue to take centre stage in the current macro. We would wait for attractive entry points to accumulate the stock. Initiate with HOLD and TP of ₹ 120.

US$ revenue guidance backed by order book; rupee assumption at ₹ 50/$

KPIT has guided for an industry leading 32-35% US$ revenue growth in FY13E. Analysing guided vs. actual revenue growth during FY07-12 suggests that except for FY09 (missed) and FY10 (did not guide), KPIT exceeded its guidance in all of the remaining years and instils confidence in the guidance building process. Discussion suggests that 70% of the current $ guidance is backed by the order book. KPIT's rupee revenue growth guidance (36-39%) assumes a conservative average ₹/$ rate of 50 & could help absorb any likely impact of an appreciating rupee. The rationale is that the rupee has to trade below 33.6/$ for the remainder of FY13 for the FY13E average to fall below 50/$.

Prudent rupee assumption may cushion likely EBITDA margin expansion

KPIT has guided for a 50-100 bps improvement in FY13E EBITDA margins to 15-15.5% assuming 1) wage hikes, 2) margin improvement of ~400-500 bps in SAP SBU and ~300 bps in automotive SBU to 11-12% and 19-20%, respectively, and 3) average rupee rate of 50/$. Notably, margin expansion appears a function of operational efficiency as the rupee assumption built in is modest relative to fiscal year-to-date average of ~₹ 53/$ and could help buffer the likely impact of the appreciating rupee.

Growth to support valuations

Acknowledging that growth has a profound impact on valuations and that concerns related to 1) midas M&A touch, 2) acquisition led growth and 3) weak cash conversion and generation, have been frequently debated, they remain genuine and continue to attract investor attention. Consequently, we initiate with HOLD rating and a TP of ₹ 120.

Exhibit 1: Key financials

	FY10	FY11	FY12	FY13E	FY14E
Net Sales (₹ crore)	732	1023	1500	2183	2501
EBITDA (₹ crore)	161	152	218	335	389
Net profit (₹ crore)	86	95	145	205	230
EPS (₹) - diluted	5.4	5.7	8.1	10.4	11.7
PE (x)	20.4	19.3	13.6	10.6	9.4
EV to EBITDA(x)	12.4	13.2	9.2	6.0	5.2
Price to book (x)	3.9	2.8	2.1	1.5	1.3
RoNW (%)	31.2	19.1	22.1	23.2	19.9
ROCE(%)	33.5	18.6	21.3	24.9	22.9

Source: Company, ICICIdirect.com Research

Rating matrix

Rating	:	**Hold**
Target	:	₹ 120
Target Period	:	12 months
Potential Upside	:	9%

YoY Growth (%)

	FY11	FY12	FY13E	FY14E
Net Sales	39.8	46.6	45.5	14.6
EBITDA	-5.7	43.3	53.7	16.1
Net Profit	10.3	53.7	40.7	12.5

Current & target multiple

	FY11	FY12	FY13E	FY14E
PE (x)	19.3	13.6	10.6	9.4
EV to EBITDA(x)	13.2	9.2	6.0	5.2
Price to book (x)	2.8	2.1	1.5	1.3
Target PE	21.1	14.9	11.6	10.3
Target EV/EBITDA	14.3	10.0	6.5	5.6
Target P/BV	3.1	2.3	1.6	1.4

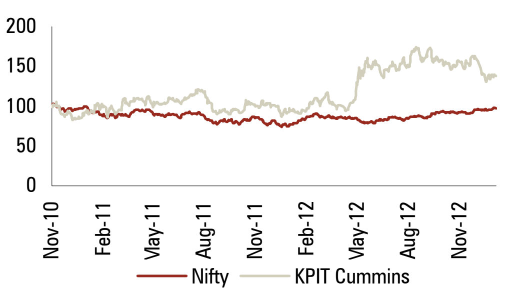
Stock Data

Bloomberg/Reuters Code	KPIT in equity/ KPIT.NS
Sensex	19784
Average Volumes (yearly)	469504
Market cap (₹ crore)	₹ 1950 crore
52 week H/L (₹)	142/68
Equity capital	₹ 35 crore
Face value	2
DII Holding (%)	13.6
FII Holding (%)	26.7

Comparative return matrix (%)

Returns (%)	1M	3M	6M	12M
KPIT Cummins	(11.4)	(9.7)	(6.6)	48.7
Mindtree	(1.6)	7.8	(0.2)	74.2
NIIT tech	(9.3)	(12.9)	(12.1)	31.3
eClerx	(6.4)	(12.1)	5.4	(4.2)

Price movement



Analyst's name

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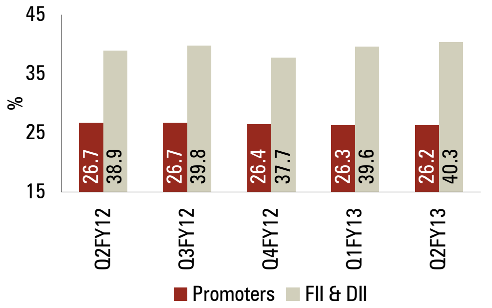
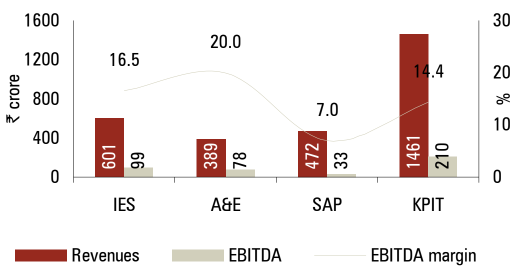
Shareholding pattern (Q2FY13)

Shareholder	Holding (%)
Promoters	26.2
FII	26.7
DII	13.6
Others	33.5

FII & DII holding trend (%)



SAP SBU and Systime (part of IES) continue to drag company EBITDA margins



Source: FY12 data, Company, ICICIdirect.com Research

Company background

KPIT Cummins (KPIT) was incorporated in 1990 (IPO in 1999) as KPIT Infosystems and was later merged with Cummins Infotech to form KPIT Cummins Infosystems Ltd. KPIT provides product engineering solutions and IT & consulting solutions & services to customers across manufacturing, automotive, industrial equipment, utilities and semiconductor sectors. The company focuses on select strategic business units (SBUs, integrated enterprise solutions, auto & engineering & SAP) and has filed 40 patents in the automotive and semiconductor domains. Headquartered in Pune, KPIT has 8100+ employees, eight development centres (mainly in Pune and Bangalore) and offices in 13 countries including the UK, China, Brazil, France, South Africa, Germany, the US, Japan, Singapore and South Korea. In FY12, KPIT earned 69.6% of its revenues from the US, 18.2% from Europe and 12.2% from the rest of the world.

Business description

KPIT primarily focuses on three SBUs viz. auto & engineering, integrated enterprise solutions and SAP. The company has reorganised its business structure in FY11, adopting a practice based approach and aligning its sales, delivery & people functions along practices with the objective of 1) enhancing its domain knowledge and 2) mining & scaling large customers

Auto & engineering SBU

Auto & engineering SBU (A&E SBU) accounted for 28.5% of FY12 revenues (including semiconductor business (2.6%)) and provides engineering & embedded solutions to automotive customers. SBU revenues grew 50% YoY in FY12 and have won cumulative $50+ million worth of business. At 19-20%, EBITDA margins of the SBU are among the highest led by specialised IP offerings. Note, KPIT invests ~6% of the units' revenues on R&D as it is key to the SBU growth. Acquisition of In2soft Gmbh in 2010 for $4 million added vehicle diagnostics capabilities across Europe. FY11 saw KPIT entering the defence segment working in areas of R&D labs; supply chain sourcing and associated maintenance repair and overhaul activities. Typical projects include vision systems, hybridisation, robotics, navigation systems and unmanned vehicles. KPIT had set up a Chinese subsidiary to capture the growth in the second largest automobile market. The company has also acquired 20% strategic stake in GAIA Systems Solutions Inc., an embedded software specialist based in Japan. Currently, the auto SBU has ~2500+ engineers, counts top 9 out of the top 12 OEMs as its customers and has filed for 34 patents.

Integrated enterprise solutions SBU (IES)

The IES SBU accounted for 40.1% of FY12 revenues. It grew 57% YoY in FY12 and won cumulative $60+ million worth of deals. EBITDA margins were at ~15% in FY12. Majority of Cummins' revenues are categorised under this SBU. The unit focuses on Oracle practice and provides business process management (BPM), manufacturing execution systems (MES), enterprise asset management (EAM), supply chain management (SCM) & warehouse management systems (WMS) to manufacturing and energy utilities' customers. KPIT's Oracle consulting & implementation capability was strengthened by the acquisition of 1) CPG solutions in 2010 for $11 million and 2) 76.2% stake in Systime, the world's largest JD Edwards solution provider.

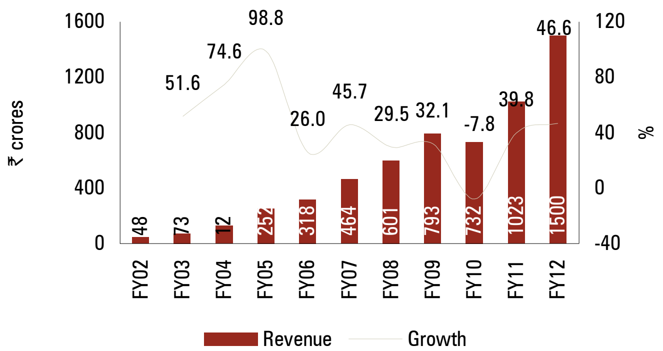
SAP SBU (SBU)

The SAP SBU contributed 31.5% of FY12 revenues and grew 57% YoY. Though the SBU has won cumulative $100 million worth of deals, notable being three deals in excess of $20 million each, its EBITDA margins (~9-10%) are lower than the company average led by investments in the small & medium enterprises segment (SME) business with creation of templatized solutions like "SUNAS". The SBU offers transformational core ERP implementation and support along with business intelligence. Acquisition of Sparta Consulting Inc for $38 million in FY10 helped expand the geographical footprint of SAP practice to the US and energy & utilities segment vs. India automotive and industrial earlier. Implementation (mostly onsite) accounts for a majority (~85%) of SBU projects while maintenance accounts for the rest leading to lower than company average EBITDA margins.

Semiconductor solutions group SBU (SSG SBU) – hardware divested

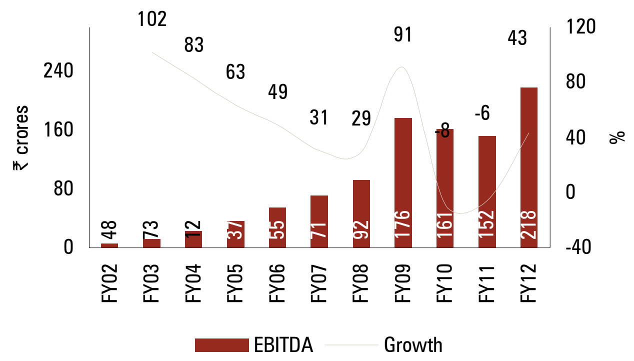
The SSG SBU accounted for 2.6% of FY12 revenues. It grew ~12.4% YoY and was operating at break-even levels. KPIT works with semiconductor companies, offering services to the automotive industry, in the areas of chip designing and verification process and includes analog mixed signal (AMS) and system on chip (SoC) practices. Recently, KPIT hived off the hardware design practice as a separate entity in partnership with Sankalp Semiconductor Pvt Ltd while the software services practice of SSG would remain part of A&E SBU. KPIT would hold 15% in Sankalp.

Exhibit 2: Revenues grow at 41.1% CAGR during FY02-12



Source: Company, ICICIdirect.com Research

Exhibit 3: …while average EBITDA margin were 16.7%



Source: Company, ICICIdirect.com Research

Exhibit 4: SBU contribution over last 5 quarters

$ million	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13
Intergrated Enterprise Solutions	27.1	26.8	40.6	43.5	47.5
Auto & engg	19.4	20.2	21.9	23.2	25.2
SAP	21.5	24.5	30.9	31.3	30.7
Semi conductor Solutions Group*	2.3	1.9	2.0	-	-

*Source: Company, ICICIdirect.com Research, *Semi conductor software business is merged with the A&E SBU from Q1FY13 whereas the hardware business has been divested.*

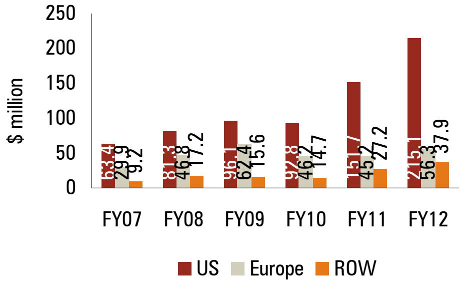
From a verticals perspective, automotive & transportation (A&T) contributed 38.8% of Q2FY13 revenues, manufacturing 32.4%, energy & utilities (E&U) 15.3% while others (includes 2-3% of defence and government plus the non core verticals of acquired companies) contributed 13.5%. Note, KPIT had divested its diversified financial services (DFS) business to Infrasoft Technologies.

Exhibit 5: Manufacturing, auto dominate with 70% revenue contribution

Verticals	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13
Manfacturing	66.4	70.9	35.0	32.2	33.6
Automotive & transportation	NA	NA	35.4	38.9	40.1
E&U	7.0	8.0	11.0	13.5	15.8
Others	15.1	12.4	15.6	13.5	13.9

Source: Company, ICICIdirect.com Research

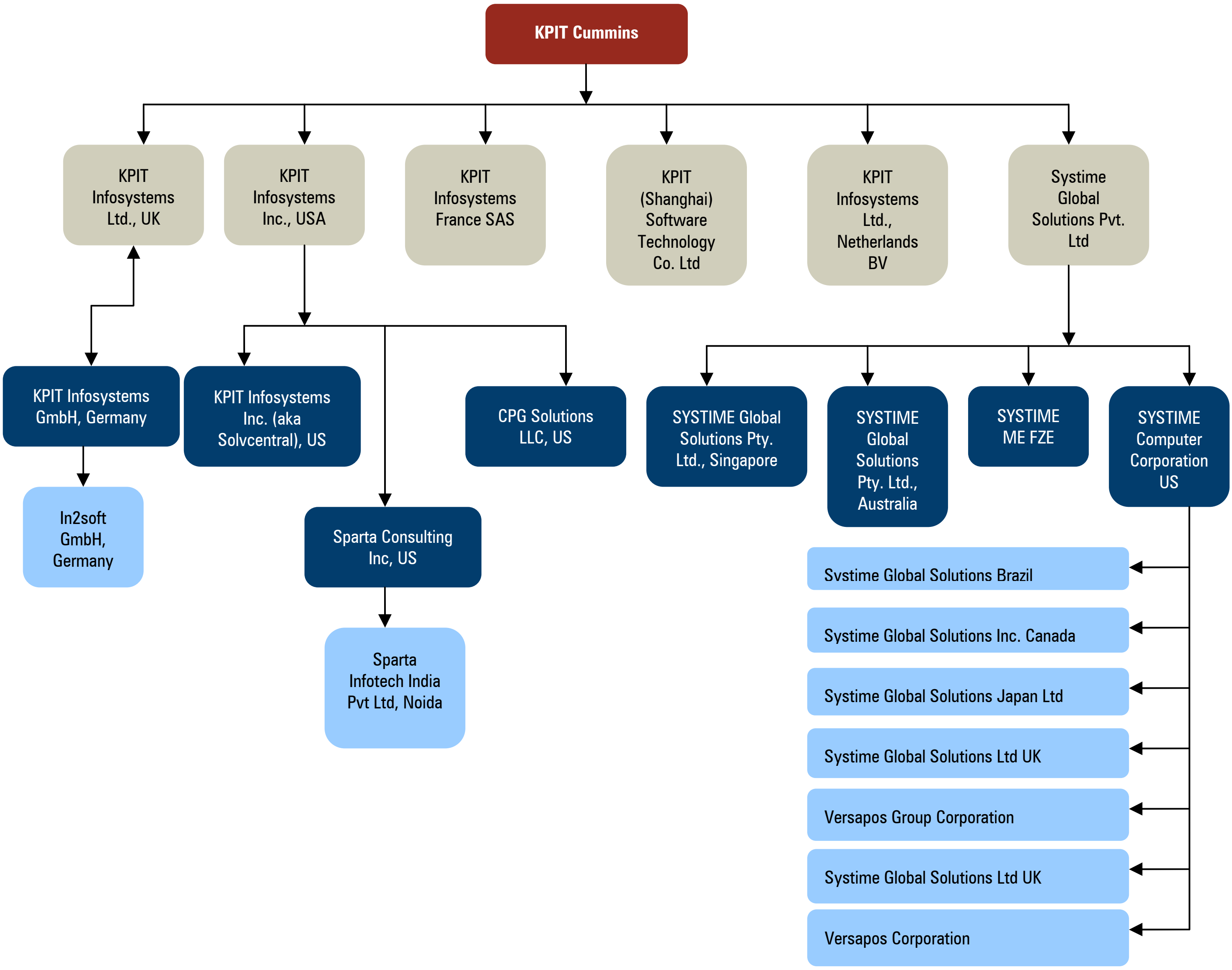
The US contribution has risen to 69.6% in FY12 vs. 61.9% in FY07 led by acquisitions



Source: Company, ICICIdirect.com Research

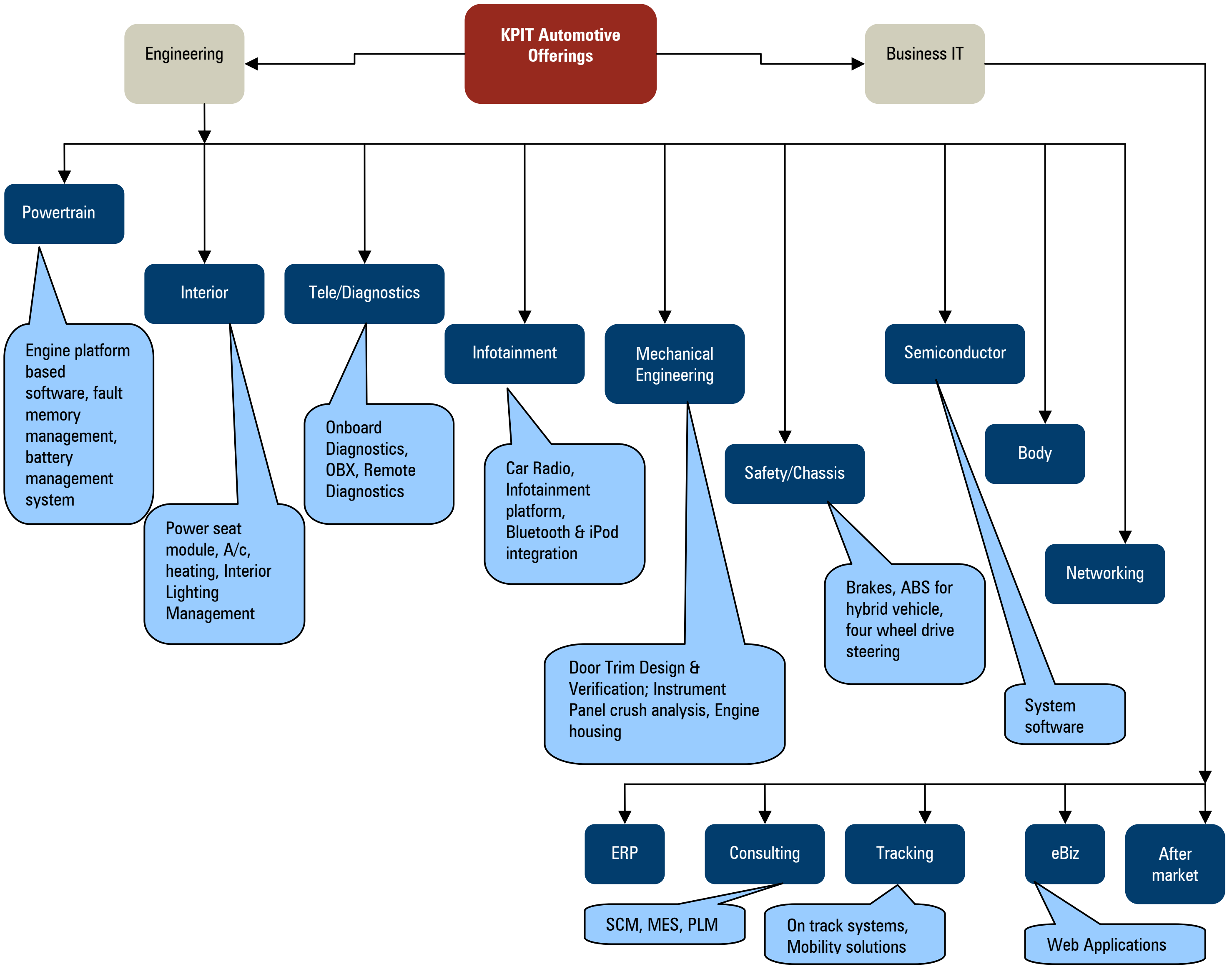
From a geographic perspective, the US contributed 69.6% of FY12 revenues and grew at 27.7% CAGR during FY07-12. Europe and rest of the world contribution increased and declined 11 percentage point (pp) and 3.3 pp, respectively, during FY07-12. Conversely, in absolute terms, they grew 13.5% and 32.8% CAGR, respectively, during the same period.

Exhibit 6: Organisation structure



Source: Except Systime (76.2%) others are 100% subsidiary companies, Company, ICICIdirect.com Research

Exhibit 7: Automotive offerings - an illustration



Source: Company, ICICIdirect.com Research

Management Profile

Ravi Pandit, Chairman & Group Chief Executive Officer: Ravi Pandit is a gold medallist and fellow member of the Institute of Chartered Accountants of India and an associate member of the Institute of Cost and Works Accountants of India. With a masters degree from Sloan School of Management, MIT, Cambridge, US, Mr Pandit has extensive experience of over three decades in the fields of information technology. He is also a member of the Core-Group on Automotive Research Programme Committee (CAR), a Government of India (GoI) initiative for automotive industry and is on the Technology Development Board formed by the Department of Science and Technology, Government of India.

Kishor Patil, Managing Director & Chief Executive Officer: A chartered accountant by profession, Mr Patil began his career as a practitioner in Kirtane & Pandit Chartered Accountant, in 1983, and was a partner a year later. Mr Patil is responsible for defining KPIT Cummins' technology and customer acquisition strategy across six continents. He has been instrumental in building KPIT from a start-up to one of the world's largest, most recognised engineering services providers for the manufacturing industry. Under his leadership, the company has filed 33+ patents and developed over 100 IPs in cutting-edge automotive and semiconductor technology areas.

Sachin Tikekar, Board Member, President - Strategic Relationships and Business Transformation: Sachin Tikekar is a co-founder of KPIT Cummins and has played various leadership roles over the years. In his current role, he is involved in building and growing strategic relationships and developing transformational solutions for key customers and partners. He is also responsible for business growth in Europe as an Executive Sponsor. Prior to assuming the current role, Mr Tikekar was the Chief People Officer (CPO) responsible for aligning people policies, improving employee touch points, imbibing KPIT culture in the organization, accelerating learning opportunities for employees globally and fostering innovation in attracting, nurturing and retaining superior talent. He was also Chief Operating Officer of the US operations and was instrumental in building the company's sales presence across the US, Asia and Europe. He has done his Masters in Strategic Management and International Finance from Temple University's Fox School of Business and Management, Pennsylvania.

Pawan Sharma, President and Head of Integrated Enterprise Services: Pawan Sharma heads the integrated enterprise solutions business unit and is a global business leader for Oracle solutions and services at KPIT Cummins. Mr Sharma is an accomplished leader and a pioneer in executing outcome based models. Prior to joining KPIT Cummins, he co-founded the BPO business at HCL Technologies and has led country operations with companies like HCL, HP and IBM focusing on consulting and software. An engineer by profession, he has been an active member on the Standards Board of JD Powers & Software Support Professional Association - US, PMI US Board of Special Initiative Group on Strategic Outsourcing and as the founder, CEO and President of PMI North India Chapter.

Pankaj Sathe, Chief People & Operations Officer: Pankaj Sathe is the Chief People & Operations Officer at KPIT Cummins. In this role, he is responsible for the global people function encompassing – HR, recruitment, training & development and overseeing operations of all the Strategic Business Units (SBUs). In addition to managing enterprise wide resource planning to support business growth and expansion, he also drives the process excellence & Six Sigma groups and shoulders executive management responsibility for global marketing. Based in the UK, Mr Sathe has been instrumental in KPIT Cummins' growth in Europe – France, Germany and Scandinavia, where he successfully established a local presence and expanded business organically as well as inorganically. Prior to joining KPIT Cummins, he worked with companies like HCL, Ranbaxy and Godrej in the areas of sales, marketing and business management. He holds engineering and masters in business administration degree and is an active member of IEEE.

Anup Sable, Sr. VP & Head, Automotive & Allied Engineering: Anup Sable started his career as a research engineer at the Automotive Research Association in India (ARAI) and later joined KPIT in 1994. With over 15 years of experience in the field of automotive electronics, Mr Sable has played a key role in setting up the automotive electronics practice at KPIT. He holds an engineering degree from Government College of Engineering, Pune where he was awarded the Best Outgoing Mechanical Engineer. He has authored numerous articles on automotive technologies and electronics in particular.

Anil Patwardhan, Vice President and Head - Corporate Finance and Governance: Anil Patwardhan heads the global finance and legal affairs for KPIT Cummins. His accounts & finance career spans 25+ years with the initial years at the Kirloskar group followed by 10+ years in Raymond's group and Praj. Mr Patwardhan has been with KPIT Cummins for the last 10 years and was conferred the CFO of the Year award for 2010, by the Institute of Chartered Accountants of India. He is a commerce graduate and a chartered account and areas of specialisation include forex and treasury management.

Lokesh Sikaria, Head, SAP Strategic Business Unit: Lokesh Sikaria is Business Leader, SAP Services at KPIT Cummins. Prior to this, Mr Sikaria was the CEO at Sparta Consulting, which merged with KPIT Cummins in 2009. Mr Sikaria brings in 15+ years of SAP implementation service experience and his career includes his stint with Rapidigm as the Chief Operating Officer during which he cultivated Rapidigm's SAP Practice into one of the 10 largest SAP consulting practices in the US. He further established Rapidigm's offshore operations driving its global delivery model. He began his career at PricewaterhouseCoopers in San Francisco and received multiple awards during his tenure. He holds an engineering degree from University of California, Berkeley.

Investment Rationale

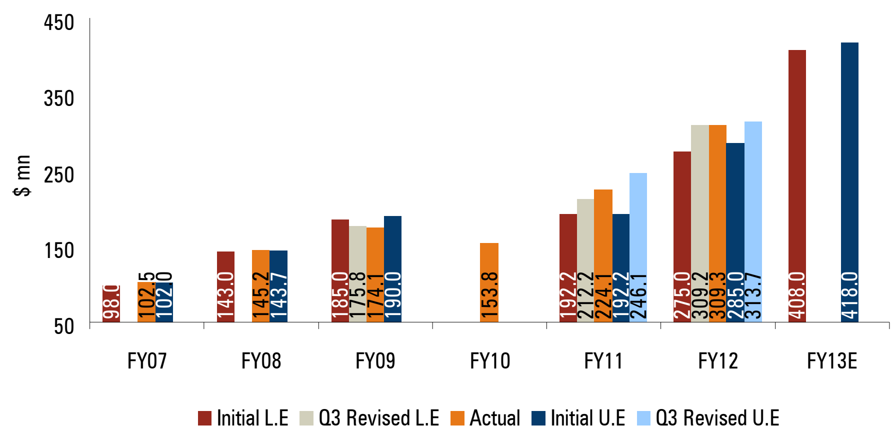
We expect new deal wins in focus verticals, a healthy order book and M&As to help achieve above industry average revenue growth while EBITDA margin expansion at below company average SBUs and revenue growth could drive margin consolidation. We are modelling revenues to grow 45.5% and 14.6% YoY in FY13E and FY14E, respectively, and ~82 bps expansion in FY13E EBITDA margins to 15.4% vs. 14.5% in FY12. Though headwinds from appreciating rupee persists, KPIT's revenue growth and EBITDA margin guidance assumes a conservative average ₹/$ rate of 50. From a Mcap/sales and EV/EBITDA metric, KPIT trades at 0.9x and 6.0x on FY13E; 0.8x and 5.2x on FY14E basis, respectively. KPIT's P/E is modestly rich relative to peers (9.4x FY14E EPS vs. 8.4x for peers), but is justified given industry leading growth. However, concerns related to 1) Midas M&A touch, 2) acquisition led growth and 3) weak cash conversion and generation, continue to attract investor attention in the current macro Though growth is not scarce at KPIT, concerns related to weak cash generation continue to take centre stage in the current macro. We would wait for attractive entry points to accumulate the stock. Initiate with HOLD and TP of ₹ 120

US$ revenue guidance backed by order book; rupee assumes ₹ 50/$

KPIT has guided for an industry leading 32-35% US$ revenue growth in FY13E. Analysing guided vs. actual revenue growth during FY07-12 suggests that except for FY09 (missed) and FY10 (did not guide), KPIT exceeded its guidance in all of the remaining years and instils confidence in the guidance building process. Discussion suggests that 70% of the current $ guidance is backed by the order book. KPIT's rupee revenue growth guidance (36-39%) assumes a conservative average ₹/$ rate of 50 & could help absorb any likely impact of an appreciating rupee. The rationale is that the rupee has to trade below 33.6/$ for the remainder of FY13 for the FY13E average to fall below 50/$.

As a policy, KPIT guides at the end of Q4 and reviews the same in Q3 of guided year

Exhibit 8: KPIT exceeded its $ revenue guidance except for FY09



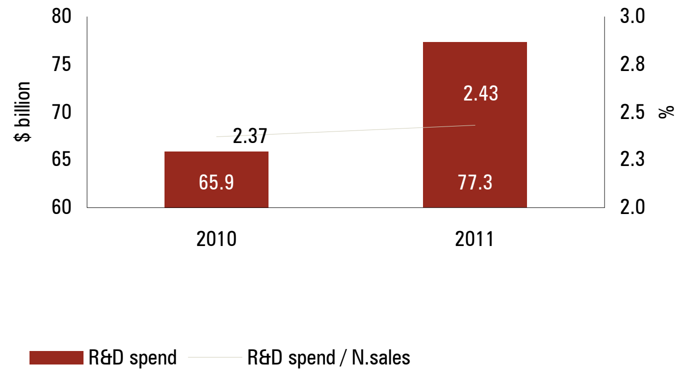
Source: Company, ICICIdirect.com Research, L.E.-Lower end, U.E.- Upper end

Increasing demand of Auto Electronics to fuel Auto vertical growth

Greater number of features in autos such as safety, security and in-car infotainment has created a market of $102 billion

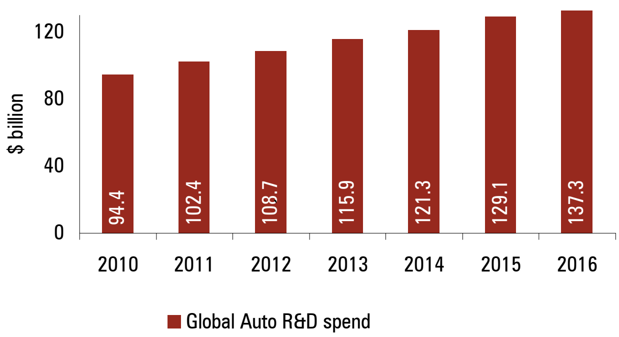
Globally, the automotive industry continues to face competitive, cost & pricing pressure led by rising raw material prices, shift towards greener technology, regulatory changes and related emission targets and incremental features such as safety, security & in-car infotainment. This has accelerated adoption of IT and electronics to improve productivity and efficiency. The global auto R&D market is expected to exceed ~$116 billion in 2013 with increased demand for Auto electronics as electronics cost (hardware plus software) rises to 30% of the total vehicle value in 2015 vs. 12% in 2000. Essentially, cost of software could rise to 15% of the total value vs. 2% in 2000 and bodes well for focused players such as KPIT.

Exhibit 9: Generally OEMs annually spend ~2-3% of their revenues on R&D



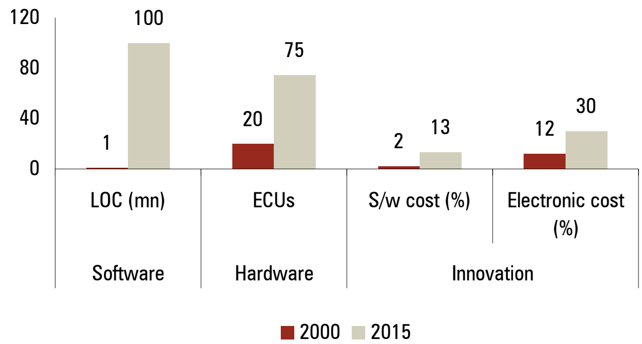
*Source: Bloomberg, ICICIdirect.com Research, ** Top 15 OEMs in the world*

Exhibit 10: Auto R&D spend likely to reach $116 billion in 2013



Source: Company, Thomson Financials; Market interviews; Roland Berger Analysis ICICIdirect.com Research

Exhibit 11: Electronic costs could rise to 30% of vehicle value in 2015

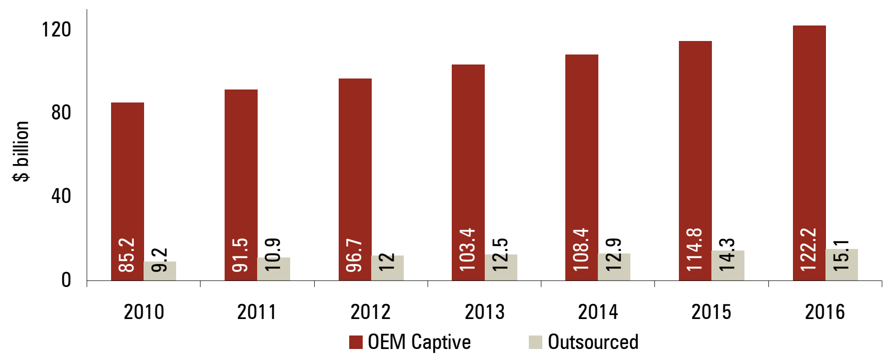


Source: Company, ICICIdirect.com Research

Outsourcing contribution in R&D spends rising

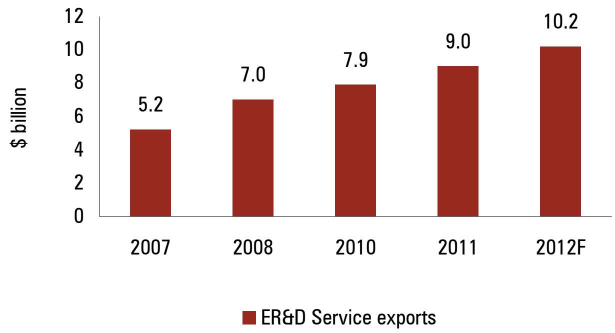
Globally, the automotive industry spent ~$102 billion on R&D (hardware plus software in 2011) with OEM captives accounting for ~89% of the available pie with the rest being outsourced. Notably, outsourced contribution could rise to 10.8% in 2013 vs. 9.7% in 2010 led by higher CAGR of 8.6% during 2010-16 vs. 6.2% CAGR in overall R&D spends. Domestically, engineering R&D (ER&D), software product and offshore software product development (OPSD) segment constitutes ~20% of the total IT-BPO export revenues. ER&D exports, which typically involve R&D for hardware and software, accounted for ~14.8% of total FY12 IT sector exports and grew at 14.4% CAGR during FY07-12 vs. 16.9% CAGR in IT exports. Within ER&D, automotive ER&D exports grew at 15.5% CAGR during FY08-12 driven by increasing usage of electronics across various devices & products. Embedded systems, integral to ER&D & KPIT, grew at 9.5% CAGR during FY09-11 vs. 11.8% growth in IT exports.

Exhibit 12: Outsourced R&D likely gaining share from captives



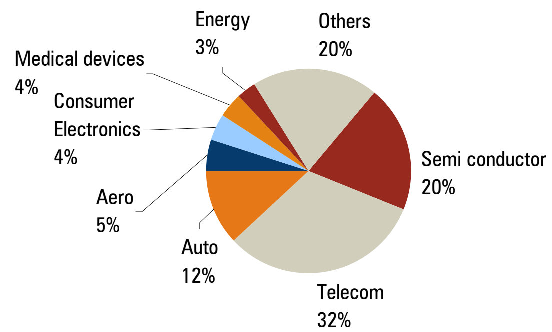
Source: Company, Thomson Financials; Market interviews; Roland Berger Analysis ICICIdirect.com Research

Exhibit 13: ER&D exports outgrew IT exports during FY07-12F



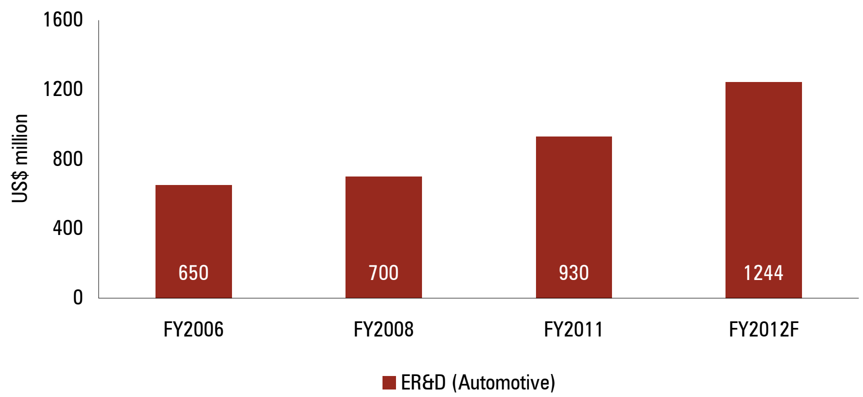
Source: NASSCOM, ICICIdirect.com Research

Exhibit 14: Autos, telecom & semicons. lead FY12F ER&D exports



Source: NASSCOM, ICICIdirect.com Research

Exhibit 15: Automotive ER&D exports grow at 15.5% CAGR during FY08-12 vs. 9.9% for ER&D

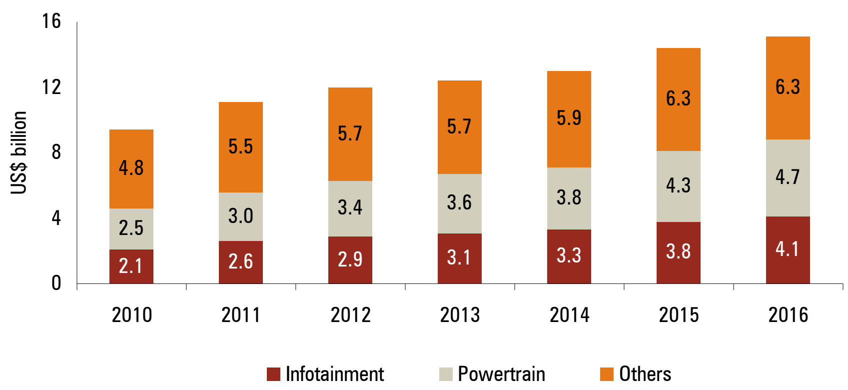


Source: NASSCOM, ICICIdirect.com Research

KPIT's focus areas likely to grow faster than the Industry average

KPIT focuses on the right mix within auto-electronics as rising proportion of electronics is driven by increasing application in power train and infotainment. The power train and infotainment market could increase to $4.7 billion and $4.1 billion in 2016 vs. $2.5 billion and $2.1 billion, in 2010 respectively. Further, their contribution in the total Auto Electronics space could rise to 31% (27% in 2010) and 27% (23%), respectively, in 2016. Note, power train & infotainment (electronics/electrical) are the largest practices for KPIT in the A&E SBU and could help gain market share of the incremental spending.

Exhibit 16: KPIT's focus areas likely to grow faster than the industry average



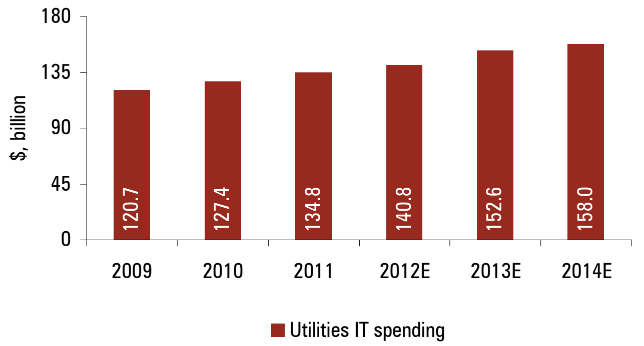
Source: Company information; Thomson Financials; Market interviews; Roland Berger Analysis

Investments in information, operational and consumer related technology solutions in US SME market to drive energy and utilities vertical growth

Focus on US & SME market to drive E&U vertical growth

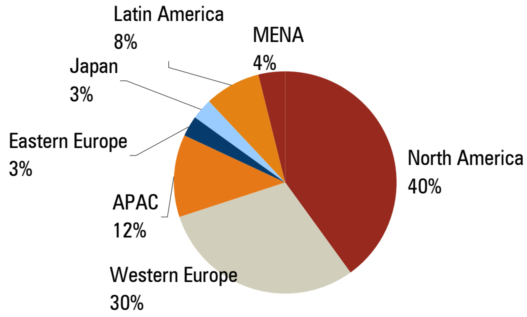
Globally, the E&U industry IT spending has been increasing as part of their modernisation process, in both business and technology solutions. Hence, IT spending of the utility vertical is likely to reach ~$140 billion in 2012, growth of 4.5% YoY. North America, the current company focus, is the highest spender and likely accounts for 40% of overall spending while Europe accounts for 30%. Overall, we expect the utility vertical IT spending to grow at 5.4% CAGR during 2011-14E. KPIT primarily helps SME energy & utility enterprises in North America to upgrade their IT infrastructure. Investments in smart meters, grid operations, customer management and business services could see US utilities spending an incremental ~$23 billion dollars between 2011 and 2014.

Exhibit 17: Utilities IT spending may grow at 5.4% CAGR in CY11-14E



Source: Company, Gartner - Forecast: Enterprise IT Spending in Utilities , Worldwide, 2009-2015, 3Q11 Update ICICIdirect.com Research

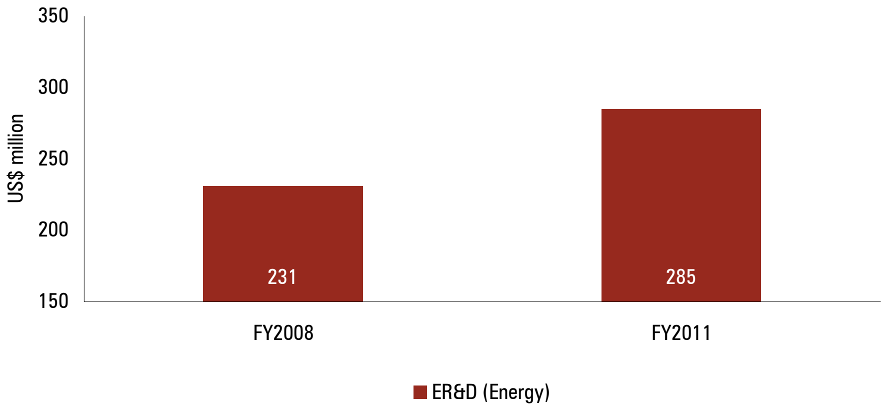
Exhibit 18: KPIT's focused market spends highest on IT



Source: Company, ICICIdirect.com Research

Energy ER&D exports driven by demand in geospatial services, feasibility, conceptual studies, etc

Exhibit 19: Energy ER&D exports grow at 6% CAGR during FY08-FY12E

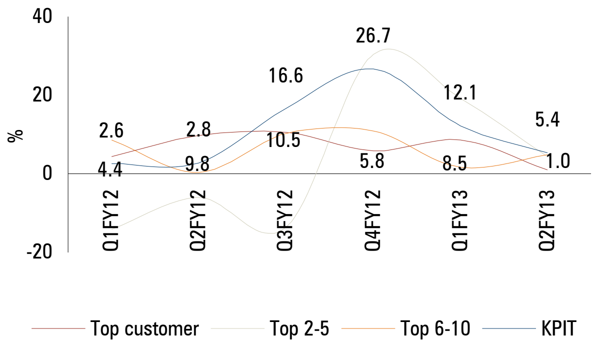


Source: NASSCOM, ICICIdirect.com Research

Cummins guidance revision remains a risk but dependency has also reduced

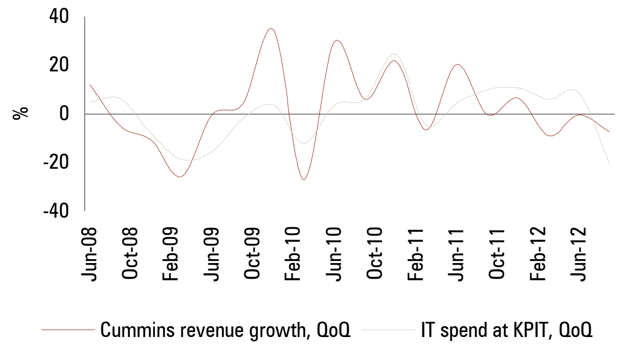
KPIT's largest customer Cummins accounted for 21.5% of FY12 revenues vs. 40.8% in FY07. Despite a likely 40-45% cut in the IT offshoring budget by Cummins during recession, KPIT managed to increase its absolute contribution to $66.5 million vs. $41.8 million in FY07. Cummins' business can be classified as business IT (IES SBU, oracle practice) and engineering IT (A&E SBU, embedded systems). Business IT typically accounts for 2/3 ($45-$47 million) of Cummins' total contribution while engineering IT accounts for the rest (~$19 million). Discussions suggest that KPIT's market share stands at 85% of the total Cummins engineering IT outsourced budget and 40% of business IT outsourcing spends Though Cummins pared its 2012 revenue guidance in August, we believe, Oracle systems standardisation across Cummins' global factories could help sustain revenue momentum.

Exhibit 20: Client growth trends for last six quarters



Source: Company, ICICIdirect.com Research

Exhibit 21: Cummins account growth imperative for KPIT



Source: Company, ICICIdirect.com Research

Complementary inorganic growth strategy to help achieve aspirational goal in CY13

Over time, KPIT benefited from its acquisition strategy with the inorganic route complementing organic growth (~26% CAGR during FY07-12) by design. The company has successfully acquired and integrated a variety of companies, with acquired companies cumulatively adding $315 million to revenues, 2.85x its acquisition price. Notable among them are Cummins Infotech (FY12 revenues of $66 million vs. $1 million at the time of acquisition), CG Smith Software ($45 million vs. $6.3 million) & Sparta Consulting ($72 million vs. $25 million). Appreciably, KPIT has been able to retain key management personnel of the acquired entities, a key acquisition criterion for KPIT, as acquisitions not only help fill the service line and vertical capability gap but also management depth.

Exhibit 22: Currently acquired companies contribute $315 million , 2.85x of acquisition price

	Year	Revenue at the time		Rationale for acquisition
$ million		of acquisition	in FY12	
Cummins Infotech	2002	1	66	Manufacturing vertical focus
Panex Consulting	2003	7.2	25	SAP practice focus
SolvCentral.com	2005	3.5	20	SAP Practice
Pivolis	2005	1.5	5	Business Intelligence practice
CG Smith Software	2006	6.3	45	Auto electronics domain focus
Harita TVS	2008	1	8	MEDS Practice
Sparta Consulting	2009	25	72	SAP Practice/ US geography presence
In2Soft	2010	4	6	Vehicle Diagnostic & Telematics Expertise
CPG	2010	11	15	Oracle Consulting
SYSTIME	2011	50	53	Oracle Consulting,JDE specialist

Source: Company, ICICIdirect.com Research

Exhibit 23: Midcap IT companies continue to grow through acquisitions

	KPIT Cummins	Mindtree	TechMahindra	Mphasis	NIIT Tech	Infotech Enterprises
2006	CG Smith Software				NIIT Insurance Technologies	
2007		TES PV Electronic Solutions	ipolicy Networks			Geospatial Integrated Solutions Pvt. Ltd.
2008	Harita TVS	Aztecsoft Ltd	Servista Ltd.		NIIT Airline Technologies	TTM India Pvt Ltd,Time to Market Inc
2009	Sparta Consulting	Kyocera Wireless Technologies	Satyam Computers	MphasiS FinSolutions Pvt Ltd		Operational Assets
2010	In2Soft	7strata		Fortify Infrastructure Services	Preferr	Daxcon Engineering Inc.;Wellsco Inc.
2011	CPG Solutions, SYSTIME			Wyde Corporation	Proyecta Sistemas de Informacion	
2012			Hutchison Global Services Ltd.; Comviva Technologies	Digital Risk	Philippines Development Center	

Source: Company, ICICIdirect.com Research

Among few midcaps that focus on technological innovation

KPIT is among the few midcaps IT companies which have been continuously investing in R&D. Historical investments led to successful product outcomes such as Revolo. Noticeably, the company has filed 40 patents in the areas of power train, vehicle safety, infotainment, green technology and battery management. We believe monetisation of intellectual property could drive non-linear initiatives and help benefit operating margins.

Reasonable on Mcap/sales but expensive on EV/EBITDA & Mcap/CFO metric

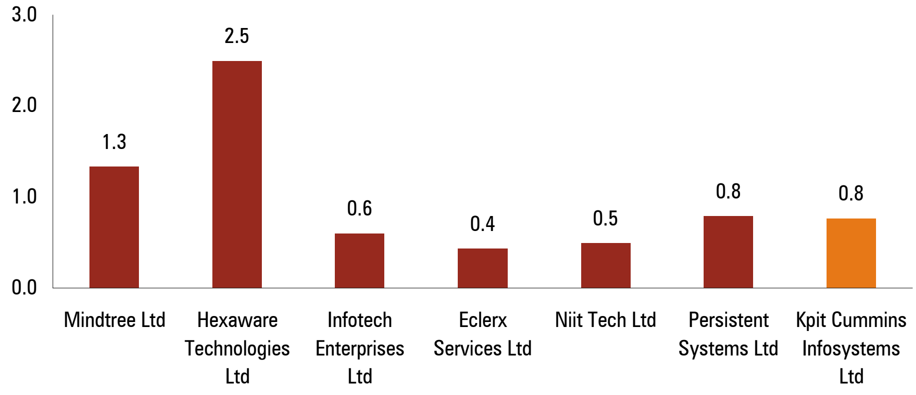
On the Mcap/sales metric, the stock is trading at 0.9x and 0.8x its FY13E and FY14E sales vs. peer group average of 1.5x and 1.4x, respectively. Further, on the EV/EBITDA metric, the stock is trading at 6x and 5.2x its FY13E and FY14E EBITDA vs. peer group average of 5.4x and 5x, respectively. KPIT is trading at 0.8x PE/G based on our FY14E EPS estimate below peer group average of 1.1x. That said, on Mcap/operating cash flow basis, KPIT is trading at expensive valuations of 18.2x vs. peer group average of 13.2x.

Exhibit 24: Peer valuation

Name	Price (₹)	Dil. EPS (₹)		P/E (x)			EV/EBIDTA (x)			PEG (x)		Mcap/Rev (x)		
		FY13E	FY14E	FY12	FY13E	FY14E	FY12	FY13E	FY14E	FY13E	FY14E	FY12	FY13E	FY14E
Mindtree Ltd	694	75.4	80.3	12.8	9.2	8.6	10.1	6.2	6.1	0.2	1.3	1.5	1.2	1.1
Hexaware Technologies Ltd	90	9.1	10.9	9.9	8.3	8.1	8.4	5.5	5.3	0.4	3.1	1.8	1.4	1.2
Infotech Enterprises Ltd	177	20.5	23.1	12.2	8.6	7.7	5.6	4.2	3.8	0.2	0.6	1.3	1.0	0.9
Eclerx Services Ltd	699	58.5	71.6	13.2	12.0	9.8	9.4	7.3	6.4	1.2	0.4	4.4	3.2	2.8
Niit Tech Ltd	257	37.0	41.7	7.8	6.9	6.2	4.8	3.9	3.5	0.5	0.5	1.0	0.8	0.7
Persistent Systems Ltd	531	35.4	46.8	15.0	11.3	10.1	7.7	5.5	5.1	0.4	0.8	2.1	1.7	1.5
Average				**11.8**	**9.4**	**8.4**	**7.7**	**5.4**	**5.0**	**0.5**	**1.1**	**2.0**	**1.5**	**1.4**
Kpit Cummins Infosystems Ltd	110	10.4	11.7	13.6	10.6	9.4	9.2	6.0	5.2	0.4	0.8	1.3	0.9	0.8

Source: Company, ICICIdirect.com Research

Exhibit 25: Trading at 0.8x PEG based on FY14E estimate; modestly below peer group of 1.1x



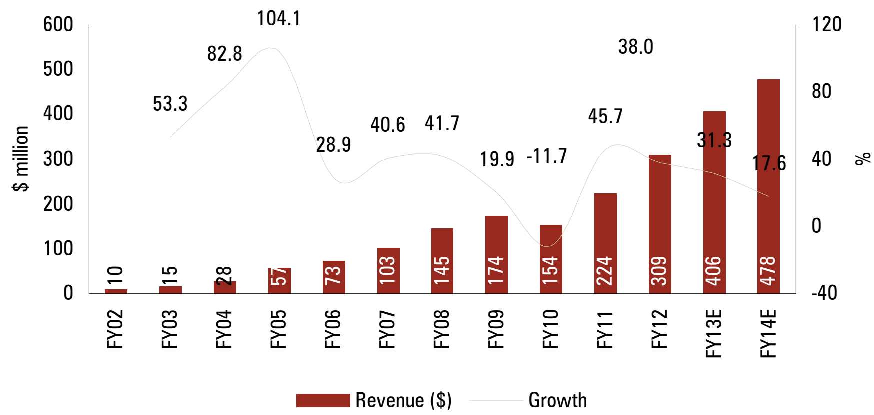
Source: Company, ICICIdirect.com Research

Key Financials

Modelling FY13E, FY14E revenues to grow 45.5%, 14.6%, respectively

We expect FY13E and FY14E revenues to grow 45.5% and 14.6% YoY to ₹ 2182.6 crore and ₹ 2500.2 crore, respectively. The growth would be driven by mining of existing and new customer in IES and A&E SBU. For FY13E we expect $ revenues to grow 31.3% in-line with guidance. Our estimates assumes an average $/₹ rate of 53.8 vs. guided $/₹ rage of 50.

Exhibit 26: Revenues to grow at 20.2% CAGR during FY10-13E

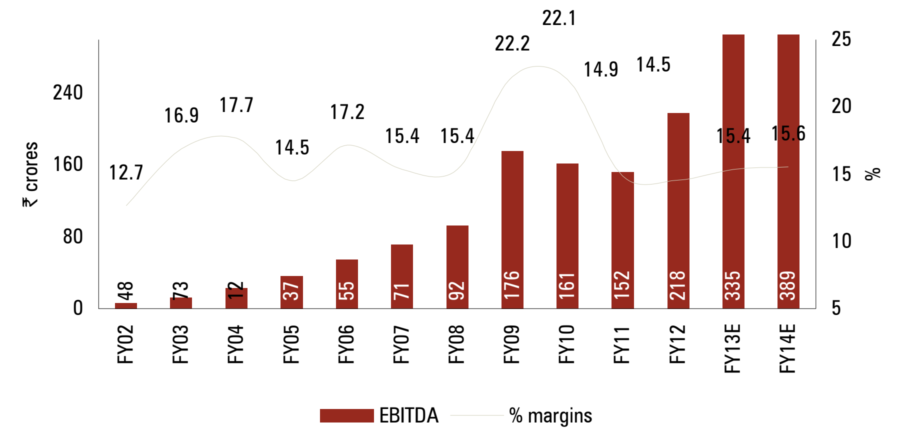


Source: Company, ICICIdirect.com Research

Modelling EBITDA margin to improve in FY13E/FY14E

KPIT has guided for a 50-100 bps improvement in FY13E EBITDA margins to 15-15.5% assuming 1) wage hikes, 2) margin improvement of ~400-500 bps in SAP SBU and ~300 bps in automotive SBU to 11-12% and 19-20%, respectively, and 3) average rupee rate of 50/$. Notably, margin expansion appears a function of operational efficiency as the rupee assumption built in is modest relative to fiscal year-to-date average of ~₹ 53/$ and could help buffer the likely impact of the appreciating rupee. We expect FY13E EBITDA margins to increase 82 bps YoY to 15.4% vs. 14.5% in FY12 led by YoY margin improvement in Systime and SAP SBU. For FY14E, we expect EBITDA margins to expand 19 bps YoY to 15.5% led by employee pyramid rationalisation. Our estimates assume average ₹/$ rate of 53.8 for FY13E and 52.4 for FY14E. As a rule of thumb, every 100 bps depreciation in the rupee impacts margins by 28-30 bps. A significant appreciation or depreciation of the rupee could lead to estimate revisions.

Exhibit 27: EBITDA margins to improve 82 bps in FY13E

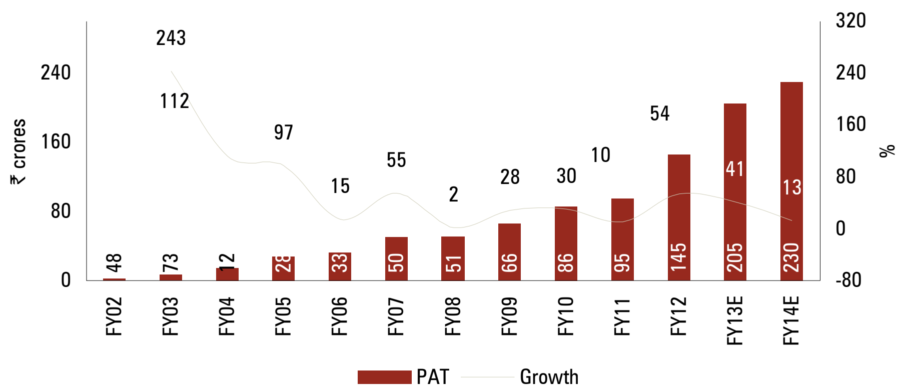


Source: Company, ICICIdirect.com Research

Modelling PAT growth of 41.5% & 12.9% in FY13E, FY14E, respectively

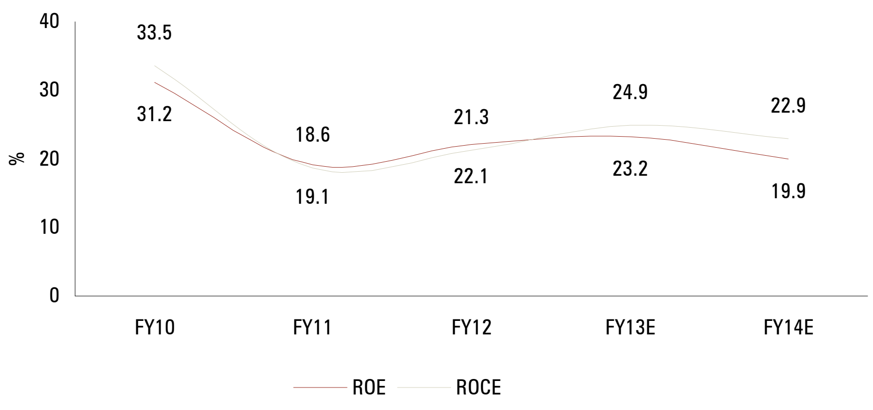
We are modelling PAT margins of 9.4% and 9.3%, respectively, in FY13E and FY14E, which translates to YoY growth of 41.3% and 12.9% in FY13E and FY14E, respectively, likely aided by EBITDA margin expansion. We expect RoCE and RoE to improve in FY13E to 25.7% and 28.3% from 22.1% and 21.3% in FY12 respectively.

Exhibit 28: PAT margins to grow at 34.8% CAGR in FY10-13E



Source: Company, ICICIdirect.com Research

Exhibit 29: RoE greater than RoCE in FY12 due to hedge gains lead other income of ₹ 12.8 crore



Source: Company, ICICIdirect.com Research

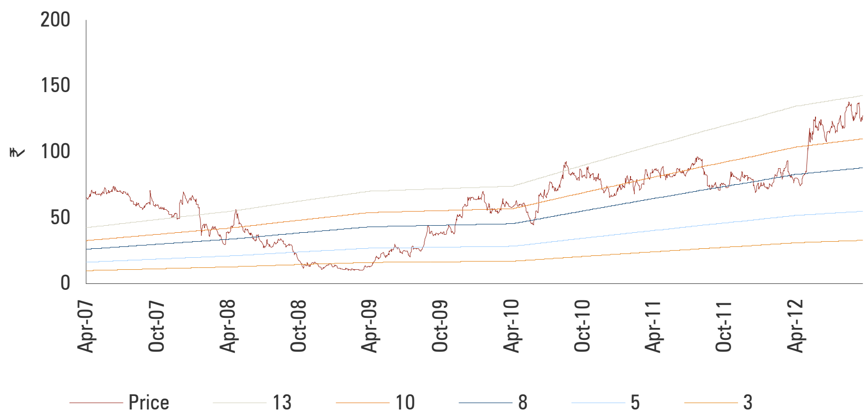
Valuations

KPIT is trading at 0.8x PE/G, reasonable relative to peers, considering superlative revenue growth guidance but cash generations remains a concern and dictates our rating. We are initiating coverage on the stock with a **HOLD** rating and target price of ₹ 120

At current levels, KPIT is trading at 10.7x and 9.4x our FY13E and FY14E diluted EPS estimate of ₹ 10.3 and ₹ 11.7, respectively. On the Mcap/sales metric, the stock is trading at 0.9x and 0.8x its FY13E and FY14E sales vs. peer group average of 1.5x and 1.4x, respectively. Further, on EV/EBITDA metric, the stock is trading at 6x and 5.2x its FY13E and FY14E EBITDA vs. peer group average of 5.4x and 5x, respectively. Though P/E is rich relative to peers at 9.4x FY14E EPS vs. 8.4x for peers, the PE/G justifies the premium (0.8x vs. 1.1x for peers). However, concerns related to 1) midas M&A touch, 2) acquisition led growth and 3) weak cash conversion and generation, continue to attract investor attention. Though growth is not scarce at KPIT, concerns related to weak cash generation continue to take centre stage in the current macro. We would wait for attractive entry points to accumulate the stock. Initiate with HOLD and TP of ₹120.

At current levels, KPIT is trading at 10.7x and 9.4x our FY13E and FY14E diluted EPS estimate of ₹ 10.3 and ₹ 11.7, respectively

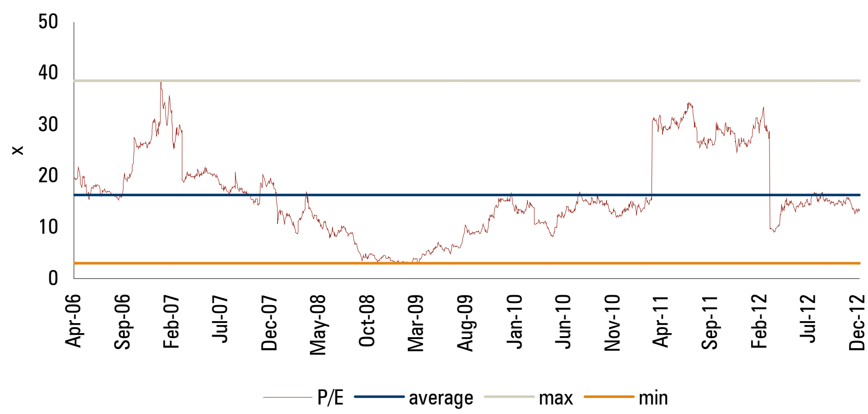
Exhibit 30: One year forward PE(x) chart



Source: Company, ICICIdirect.com Research

KPIT is trading at 13.5x its trailing twelve month (TTM) EPS, below its historical average of 16.3x

Exhibit 31: Trading at 13.5x its TTM EPS and below its historical average of 16.3x



Source: Company, ICICIdirect.com Research

Risk & concerns

Sparta acquisition helps revenue growth, price realisations but not margins

Analysing pricing trends since Q1FY10 emphasises the Sparta acquisition impact on KPIT's price realisations. Given the inherent nature of SAP implementation projects, onsite billing increased 65.5% QoQ to $110.3 in Q1 vs. $66.6 in Q3FY10. Interestingly, though Sparta's revenues grew ~60% since acquisition to $72 million in FY12, the margin performance has lagged. Sparta had PAT margins of ~2.7% in 2012 vs. 4.4% in 2011 and 3.6% in 2010.

Exhibit 32: Margin improvement at Sparta could lift overall margin profile of KPIT

₹ crore	2010	2011	2012
Sparta Consulting			
Revenue**	251.7	269.1	409.0
YoY growth		6.9	51.9
PAT	9.0	12.0	11.1
YoY growth		32.8	(7.0)
PAT margin	3.6	4.4	2.7

Source: Company, ICICIdirect.com Research

Cash flow conversion weak relative to peers

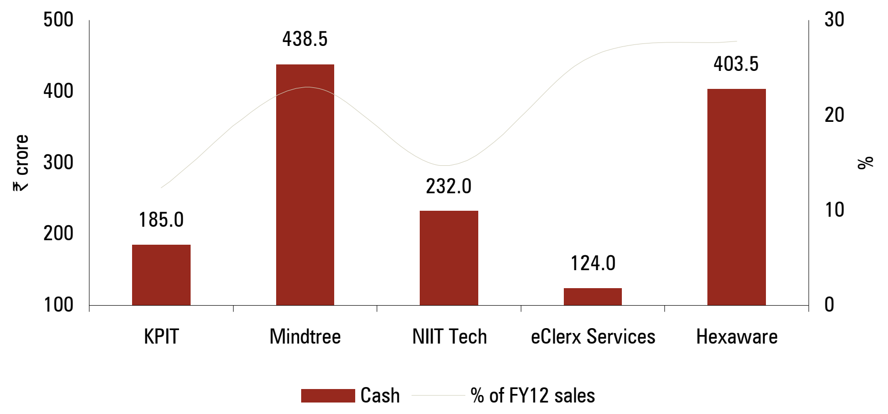
Analysing data since FY08 suggests KPIT converted an average 54.2% of its EBITDA to cash flow from operations vs. 81.5% for MindTree and 52.9% for NIIT Tech. This coupled with generous M&A spending led to a cash balance of ₹ 185 crore (Q2FY13 end), modest relative to MindTree (₹ 439 crore) and NIIT Tech (₹ 232 crore). During Q3FY12, KPIT made a preferential allotment of 1.296 crores of equity shares for $ 30 million. Additionally, KPIT also raised ECBs worth $20 milllion. Thus, by Q3, the debt to $65 million from $ 45 million and outstanding shares to 19.1 crores from 17.8 crores.

Exhibit 33: Cash flow conversion weak relative to peers led by acquisitions

	FY08	FY09	FY10	FY11	FY12	Average
CFO (₹ crore)						
Mindtree	91.4	179.8	227.3	43.3	206.9	
KPIT	44.1	120.6	107.6	64.3	100.5	
NIIT Tech	117.4	150.4	147.5	55.4	164.3	
CFO/EBITDA (%)						
Mindtree	72.9	147.3	92.5	24.4	70.6	81.5
KPIT	47.8	68.4	66.6	42.3	46.1	54.2
NIIT Tech	66.6	85.2	78.1	23.0	61.7	62.9

Source: Company, ICICIdirect.com Research

Exhibit 34: At end of Q2FY13, KPIT had cash balance of ₹ 185 crore, modest relative to peers



Source: Company, ICICIdirect.com Research

Managing high expectation may be a challenge

KPIT grew at 21.1% CAGR during FY09-12 and has guided for dollar revenue growth of 32-35% in FY13E, ahead of Nasscom's 11-14% (currently revised downwards to lower end) average growth for the industry. Though the management commentary suggests order book visibility on 70% of the guided revenue growth, we believe a modest deviation in the FY13E performance could alter FY14E estimates and undermine P/E multiple as current valuations implicitly envisage comparable growth in FY14E as well.

Receivables grow faster, unbilled slower than revenues; provisions decline

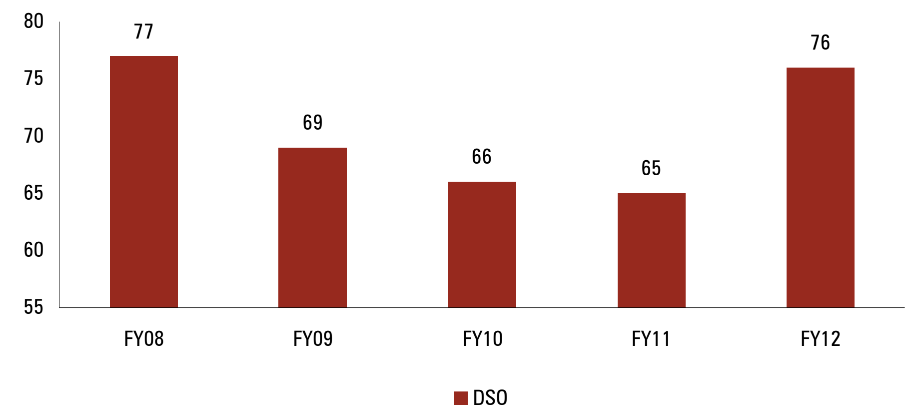
During FY09-12, account receivables grew at 35% CAGR, faster than the revenue CAGR of 23.7% while unbilled revenues fared better and grew at 7.8% CAGR. During the same period, DSO increased by seven days to 76 days vs. 69 days in Q1FY08 while provisions have declined to 0.11% of FY11 debtors vs. 2.7% in FY10.

Exhibit 35: Unbilled fine but receivables grow faster than revenues

	FY09	FY10	FY11	FY12	CAGR
Unbilled revenue	4.2	3.6	3.5	5.3	7.8%
As % of sales (%)	*0.5*	*0.5*	*0.3*	*0.4*	
Debtors	177.6	138.8	228.8	438.0	35.1%
As % of sales (%)	*22.4*	*19.0*	*22.4*	*29.2*	
Sales	793.2	731.6	1,023.0	1,500.0	23.7%

Source: Company, ICICIdirect.com Research

Exhibit 36: After consolidating during FY09-11, DSO picks up in FY12 to 76 days

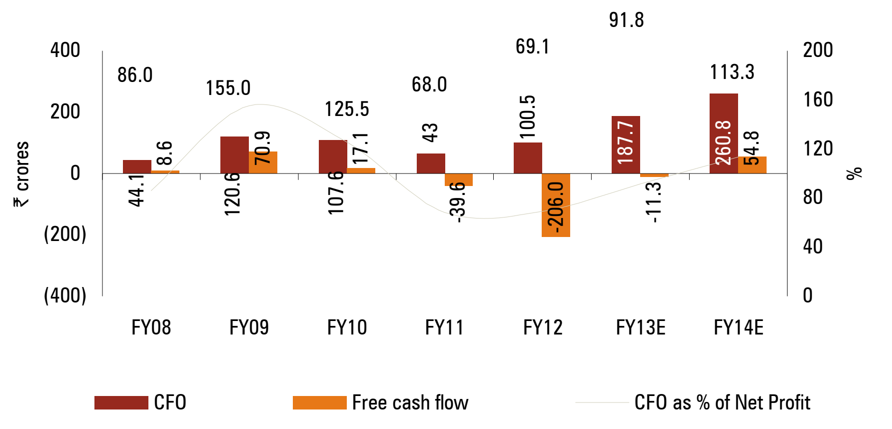


Source: Company, ICICIdirect.com Research

FCF generation weak led by acquisition; dividend yields could improve

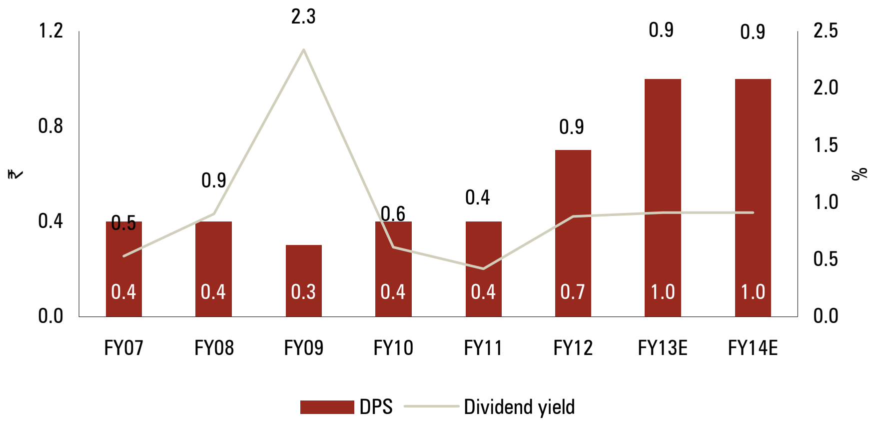
Though operating cash flow generation has been decent, free cash flow (FCF) has been weak led by acquisitions. (FCFF has also been adjusted for purchase consideration and earn outs adjusted for acquisitions. Note, expected earn out payments of ~$44 million in the next 18 months could moderate FCF generation in FY13E and FY14E. The company is expected to pay $18 million to $ 20 million for Sparta and CPG in Q3FY13 whereas ~ $ 24 million for Systime by Q1FY14. Further, despite paying dividends every year since FY08, yields are modest at 0.9% for FY12 and could improve. Finally, we are modelling ₹ 1 each dividend payment in FY13E and FY14E which represents yield of 0.9% at the current market price.

Exhibit 37: FCF generation could improve



Source: Company, ICICIdirect.com Research

Exhibit 38: Dividend yields modest and may improve



Source: Company, ICICIdirect.com Research

Revenue concentration risk

KPIT derives ~70-80% of its revenues from the manufacturing and automotive verticals and could be adversely impacted by a demand slowdown in these verticals. That said, revenue diversification through defence and energy & utilities (~12% of revenues) space could alleviate revenue concentration risks.

Sharp rupee appreciation could impact earnings

KPIT awarded average offshore wage hikes of 10-12% and 2-4% onsite effective Q1FY13, which impacted Q1FY13 margins by 300 bps. The margin impact was cushioned by currency (up 230 bps), which depreciated 7.4% in Q1FY13 vs. Q4FY12. KPIT has guided for 50-100 bps improvement in FY13E EBITDA margin led by improvement in SAP & Systime margins and general tailwinds from currency.

Elevated attrition may lead to above industry average wage inflation considering dissimilarity in associate profile vs. peers

Though KPIT's attrition is in line with MindTree it is still relatively higher than NIIT Tech. Note, the profile of KPIT's associates is modestly different considering the company engages with colleges to adapt their curriculum as per its skill requirement. Elevated attrition remains a risk to revenue growth and could lead to higher wage inflation.

Exhibit 39: Though moderated, attrition continues to be at elevated level

(%)	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13
Mindtree	21.7	19.4	18.2	17.0	14.7
NIIT Tech	13.4	12.5	12.1	12.4	12.7
KPIT	22.0	17.0	17.5	17.0	17.0

Source: Company, ICICIdirect.com Research

Tables and ratios

Exhibit 40: Profit & loss account

(₹crore)	FY10	FY11**	FY12	FY13E	FY14E
Total Revenues	732	1,023	1,500	2,183	2,501
Growth (%)	(7.8)	39.8	46.6	45.5	14.6
Total Operating Expenditure	570	871	1,282	1,847	2,112
EBITDA	161	152	218	335	389
Growth (%)	(8.4)	(5.7)	43.3	53.7	16.1
Depreciation	31	41	44	53	65
Other Income	(25)	0	13	10	14
Interest	3	1	8	15	16
PBT before Exceptional Items	103	110	179	276	322
Growth (%)	32.0	7.4	62.0	54.7	16.5
Tax	17	15	44	76	89
PAT before Exceptional Items	86	95	132	197	230
Exeptional items	-	-	(10)	(8)	-
PAT before MI	86	95	142	205	230
Minority Interest & Pft. from associates	-	-	3.5	(0.5)	-
PAT	86	95	145	205	230
Growth (%)	30.2	10.3	53.7	40.7	12.5
EPS*	5.4	5.7	8.1	10.4	11.7
EPS (Growth %)	28.4	5.3	42.1	28.2	12.5

Source: Company, ICICIdirect.com Research, EPS adjusted for bonus in FY11

Exhibit 41: Balance sheet

	FY10	FY11**	FY12	FY13E	FY14E
Equity	17	18	36	36	36
Reserves & Surplus	370	585	677	1,015	1,223
Networth	387	603	713	1,051	1,258
Minority Interest	-	1	33	36	39
Loans	111	93	222	282	232
Source of funds	885	1,300	1,680	2,419	2,788
Gross Block	251	294	382	447	522
Acc.dep	128	168	215	268	333
Net Block	124	126	167	179	189
CWIP	29	32	19	19	19
Investments & godwill	170	130	725	496	627
Debtors	139	229	438	531	579
Cash & Cash equivalents**	105	208	147	331	311
Loans and advances	68	33	60	87	125
Others	-	73	53		
Current liabilities	108	170	282	131	158
Provisions	23	20	49	50	58
Application of funds	885	1,300	1,680	2,419	2,788

Source: Company, ICICIdirect.com Research

Exhibit 42: Cash flow statement

	FY10	FY11**	FY12	FY13E	FY14E
Net profit before Tax	103	110	189	276	322
Depreciation	31	41	44	53	65
(inc)/dec in Current Assets	32	-	-	-	-
(inc)/dec in current Liabilities	(49)	-	-	-	-
CF from operations	108	64	100	188	261
Other Investments	(136)	(9)	21	10	14
(Purchase)/Sale of Fixed Assets	(24)	(42)	(60)	(65)	(75)
CF from investing Activities	(143)	(67)	(283)	(190)	(193)
Inc / (Dec) in Equity Capital	3	120	7	162	-
Inc / (Dec) in sec.loan Funds	(4)	(10)	120	60	-
Dividend & Divendend tax	(5)	(6)	(7)	(21)	(22)
Interest Paid on Loans	(7)	(4)	(7)	(15)	(16)
CF from Financial Activities	(13)	104	108	186	(88)
Exchange rate differences	(4)	3	(2)	-	-
Opening cash balance	146	100	208	147	331
Closing cash	100	208	147	331	311

Source: Company, ICICIdirect.com Research

Exhibit 43: Key ratios

	FY10	FY11**	FY12	FY13E	FY14E
Per Share Data					(₹)
EPS-diluted	5.4	5.7	8.1	10.4	11.7
Cash Per Share	5.6	11.7	8.3	18.6	17.5
BV	28.1	39.3	52.7	75.2	84.1
Operating profit per share	7.4	6.3	9.8	15.9	18.3
Operating Ratios					(%)
EBITDA/Total Revenues	22.1	14.9	14.5	15.4	15.6
PBT/Total Revenues	14.0	10.8	11.9	12.7	12.9
PAT/ Total Revenues	11.7	9.2	9.7	9.4	9.2
Return Ratios					(%)
RoNW	31.2	19.1	22.1	23.2	19.9
RoCE	33.5	18.6	21.3	24.9	22.9
RoIC	51.6	25.2	27.2	31.5	29.7
Valuation Ratios					(x)
P/E	20.4	19.3	13.6	10.6	9.4
EV / EBITDA	12.4	13.2	9.2	6.0	5.2
Price to Book Value	3.9	2.8	2.1	1.5	1.3
EV/Total Revenues	2.7	2.0	1.3	0.9	0.8
MCap/Total Revenues	2.7	1.9	1.3	0.9	0.8
Total Revenues/ Equity	1.9	1.7	2.1	2.1	2.0
Turnover Ratios					(times)
Debtors Turnover Ratio	4.6	5.6	4.5	4.5	4.5
Creditors Turnover Ratio	3.9	7.4	6.6	10.6	17.3
Fixed Asset Turnover ratio	5.5	8.2	10.2	12.6	13.6
Solvency Ratios					(times)
Debt / Equity	0.3	0.2	0.3	0.3	0.2
Current Ratio	2.4	2.0	1.5	1.7	1.8
Quick Ratio	2.4	2.0	1.5	1.7	1.8
Debt / EBITDA	0.7	0.6	1.0	0.8	0.6

Source: Company, ICICIdirect.com Research

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