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Technology

Midcaps: Going bottom-up

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Technology: Midcaps — Going bottom-up

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Prices as on 18 September 2012

HEXW	Hexaware Technologies
KPIT	KPIT Cummins
MTCL	MindTree
NITEC	NIIT Technologies
PSYS	Persistent Systems
TECHM	Tech Mahindra

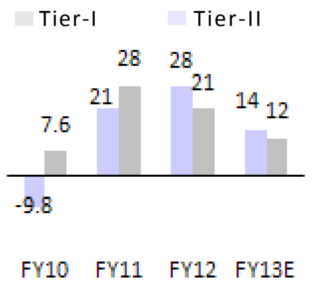
Technology

Midcaps: Going bottom-up

Revenue traction not thwarted; Upside potential despite margin concerns

- **Tier-II IT companies' revenue growth outperformance to their Tier-I counterparts in FY12 was the first in 5 years, and the trend should repeat in FY13. Disaggregation of large deals into smaller ones, and Tier-II's necessary steps on a small base facilitated the same.**
- **Ample room to grow top-accounts implies potential for sustained growth. But margins remain the key concern going forward, with company specific headwinds at KPIT, PSYS and NITEC in addition to secular structural concerns.**
- **Margin concerns compounded with greater dependency on top-clients justify significant discount in valuation multiples for Tier-II.**
- **We prefer companies where business models exhibit clear scalability and / or differentiation. TECHM, HEXW, KPIT, are our preferred picks. Valuation remains attractive at MTCL.**

YoY USD revenue growth - (%)



Well-rewarded growth outperformance at Tier-II; we assess the strength in fundamentals at current multiples

Over FY07-11, tier-I IT outgrew Tier-II IT in each year. The trend reversed in FY12 and going by the respective guidance for FY13, this will be the second consecutive year of Tier-II's outperformance. While HEXW and KPIT are set to lead industry growth, none of NITEC, PSYS and MTCL expects to grow below the NASSCOM band. We believe this growth outperformance will sustain in FY14 as well. YTD stock returns in our Tier-II universe have been more-than-impressive, at 56-88% (ex-Persistent, which yielded 28% return). HEXW, KPIT remain strong with little difference in commentary / outlook / performance, meriting high multiples, so also TECHM, which appears more sanguine; while margins clearly are a concern at NITEC and PSYS.

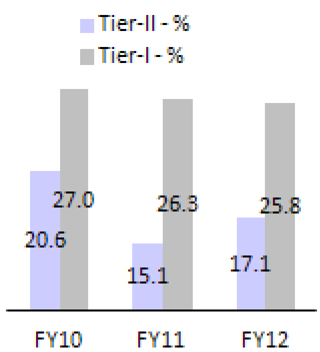
Change in contr from top-10 clients over FY10-12 (pp)

Hexaware	3.1
Mindtree	3.2
Persistent	4.8
NIIT Tech	-3.1
TCS	-3.1
Infosys	-1.6
Wipro	-0.1
HCL	-1.92

Necessary steps on a low base helped by disaggregation of larger deals

With the exception of HEXW, revenue proportion from onsite increased by 8-12pp over the past 3 years across tier-II, indicating acceptability of the fact that offshore delivery-led growth, which was a disruptive force over 2000- 2005, is no longer a big differentiator. Secondly, revenue from top- 10 accounts have grown at a CAGR of 26% at Tier-II over FY10-12, v/s 19% at Tier-I. Disaggregation of large deals has meant steady increase in USD25-99m TCV bucket, implying more deals where tier-II get qualified, thereby boosting their absolute deal wins.

EBITDA margins



Growth has cost margins, notwithstanding currency tailwind in recent quarters

Over FY10-12, EBITDA margin declined 350bp across Tier-II v/s 120bp across Tier-I. The margin gap between the two group of peers in FY12 was 840bp. Scale equips the larger companies with levers of (1) lower SGA, and (2) better ability to manage pyramid. However, the last four quarters have seen a sharp up-tick in margins across the mid-tier companies. Over 1QFY12-1QFY13, aggregate EBITDA margin across the top-tier has inched up by 140bp, while the expansion in their smaller counterparts was 510bp, amid lower re-investment of currency benefits relative to Tier-I.

Growth not thwarted, but deals disaggregation not a sustainable factor

We believe there exists enough opportunity for the smaller players to continue growing at a healthy pace given: [1] Greater agility in adapting to the changing environment and to cater to demand in the next-gen services, and [2] Ample room to increase their share of wallet with top accounts. However, we do not see deal disaggregation as a tenable reason for long term growth outperformance sustenance, as larger players will coming knocking at the same doors sooner than later.

Watch out for margin headwinds across the tier-II ahead

While almost all recent quarters' the margin surge in Tier-II is explained away by two factors - currency and SGA; going forward, we keep our margin estimates conservative due to: [1] limited scope for SGA rationalization, [2] increasing competition and [3] company-specific headwinds - for example Offshore wage hikes at PSYS, transition costs on large deals, and hardware components in Government orders at NITEC and acquisitions at KPIT. We believe that Tier-II will continue to warrant a significant discount to its larger peers, given inherently higher risk from [1] greater revenue dependency on top clients, and [2] higher concerns and volatility in margins.

EBITDA Margin (%)

	FY12	FY13E	FY14E
HEXW	22.6	22.5	22.1
KPIT	13.9	16.3	16.3
MTCL	15.3	19.7	18.4
NITEC	17.0	17.9	15.8
PSYS	23.2	26.5	23.5
TECHM	16.7	18.9	17.6

Prefer companies where business reflects 'Scalability' and / or 'Differentiation

After the tier-II IT stocks having been collectively rewarded, we look bottom-up hereon. Our picks are companies which exhibit enough potential to scale and / or are clearly differentiated in their offerings, helping them be first choice vendors for clients in their chosen space. With this perspective, we like HEXW, which continues to scale efficiently, TECH M, where potential for mining in top-accounts remains significant (post the integration with Satyam) and acquisition of HGS further brings down the dependency on BT. We also like KPIT, which has managed to carve a clear niche for itself, and believe that continued success in large deals, a prowess it substantiated in FY12 will help profitability and cash flow improvement. Margin sustainability is our key concern at NITEC and PSYS. While revenue dependency on intensely competed areas begs for more differentiation at MTCL, its valuation still remains attractive.

Top Picks

- ✓ Tech Mahindra
- ✓ Hexaware

Comparative valuations

Company	TP/TM*	%	Rating	EPS (INR)			P/E (x)			ROE (%)			FY12-14 CAGR (%)	
	(INR/x)	Upside		FY12	FY13E	FY14E	FY12	FY13E	FY14E	FY12	FY13E	FY14E	USD Rev	EPS
Mid-cap companies														
Tech Mahindra	1,110 / 11	22	Buy	70.4	87.2	101.0	13.0	10.5	9.0	30.2	26.6	21.0	4.7	19.8
Hexaware	167 / 12	34	Buy	8.9	12.1	13.9	13.9	10.3	8.9	26.6	34.4	35.2	18.6	24.8
Mindtree	882 / 10	29	Buy	53.7	84.0	88.2	12.8	8.2	7.8	25.2	27.1	24.9	12.9	28.1
NIIT Tech.	317 / 8	9	Neutral	33.0	41.2	39.6	8.8	7.1	7.4	23.7	23.3	19.7	15.1	9.5
KPIT Cummins	156 / 11	22	Buy	8.0	12.5	14.2	16.0	10.2	9.0	18.5	27.8	24.8	27.0	33.1
Persistent	476 / 9	15	Neutral	34.6	49.8	52.9	12.0	8.3	7.8	17.6	20.6	18.7	14.8	23.7
Mphasis	367 / 9	(6)	Sell	39.4	37.8	40.8	9.9	10.4	9.6	23.1	18.9	17.5	(1.9)	1.7
Large-cap companies														
TCS	1,340 / 17	4	Neutral	54.4	71.6	78.8	23.7	18.0	16.3	36.7	38.3	33.7	15.9	20.4
Infosys	2,900 / 16	12	Buy	145.5	166.5	180.7	17.9	15.6	14.4	28.0	27.3	25.8	9.6	11.4
Wipro	422 / 15	11	Buy	22.7	26.0	28.2	16.8	14.7	13.5	21.2	20.7	19.4	8.0	11.4
HCL Tech	666 / 14	20	Buy	35.1	46.3	47.6	15.9	12.0	11.7	26.0	27.8	25.8	14.8	16.5
Cognizant	-	-	Not Rated	2.9	3.5	4.1	24.1	19.9	17.0	23.4	24.8	23.6	19.3	19.0

* TP: Target Price, TM - Target Multiple based on FY14EPS Source: MOSL

Tier-II Summary

What we like	What concerns us
Mid-tier IT	
✓ Growth outperformance to large caps	× Growth aggression could lead to high risk deals
✓ Room to drive growth by mining key accounts	× Margins have ridden the currency wave, structural threats remain
✓ Lesser decision delays/ramp downs in their universe of clients	× Deteriorating talent quality
✓ Healthy pipeline of deals in USD5-25m range	× Increasing competition from top-tier in smaller sized deals
Hexaware	
✓ Large deal prowess established over the last couple years	× Commoditized Services outside of PeopleSoft and BI
✓ Leadership and opportunity in PeopleSoft	× Dependence on Capital Markets segment
✓ Pure-Services nature of deals limits margin and execution risks	
✓ Dividend Payout	
MindTree	
✓ Success of revised strategy reflected in ITS growth	× High revenue proportion from commoditized services
✓ Continued traction in IT Services	
✓ Strategy mishaps behind the company	× Continued growth challenges in PES
KPIT Cummins	
✓ Niche differentiated with clear domain expertise in Automotive solutions	× Low margin profile of acquisitions
	× Continued inroganic foray may keep FCF low
✓ Successful integration of multiple acquisitions	× Inability to bag large deals could stunt organic growth
✓ Suite of services in place to bag multi-service large deals from clients in focus verticals	
Persistent	
✓ Clear leadership in new-age technologies like Cloud, Analytics, Mobility and Collaboration	× Offshore wage hikes imply significant margin headwinds
✓ Marquee clients	× Scalability remains a challenge
✓ Partnership model helping sell directly to the end customer	× IP-led business increases lumpiness, mars presdictability
✓ IP-led businesses thrust to help offset margin headwinds	
NIIT Technologies	× Thrust on growing order book could introduce higher-risk deals
✓ Balanced geographic portfolio and select vertical focus	× Revenues from Government contracts dilutive to margins due to hardware elements
✓ Reference of large deals in FY12 could be handy in future	
✓ Portfolio of non-linear revenues	
Tech Mahindra	
✓ Strong traction in Emerging markets, prowess in Managed Services helping build pipeline in developed markets	× Continued dependency on Telecom vertical (~47% of revenues even after merger
	× Uncertainty in BT account
✓ Scalability potential of the merged entity from cross sell of strengths	
✓ Successful completion in turnaround of Satyam	

Methodology

We develop a methodology to objectively arrive at a discount that tier-II stocks should trade at to their tier-I counterparts. We rate the fundamentals of each company relative to the benchmark rating that is for Tier-I, out of a maximum possible score of 100. These factors correspond to the initials of the word "MIDCAP". If a company's score is 75, for example, then it should trade at a multiple which is at a 25% discount (100-75) to our target tier-I multiple.

We have considered the following factors in our analysis

M Management focus and strategy (Benchmark Rating: 5)

We look at what is the key strategy of the management that is at work on the ground - Factors like whether there is a clear differentiation in terms of offerings v/s the rest of the pack earn a higher score. Also, empirical record of successful growth in revenues and profits would substantiate the same.

I IT mix (Benchmark Rating: 15)

We rate companies on their vertical mix, services mix and geography mix on a scale of 5 each. Significantly higher exposure to commoditized segments and over-dependence on a particular geography would warrant a low score.

D Deals prowess (Benchmark rating: 10)

Two factors that we consider in this case are: [1] whether the company has the necessary engine in place to be able to bag large deals (example: scale of multiple services) and [2] large deals references.

C Client concentration risk (Benchmark rating: 10)

We consider the revenue from top-10 clients and compare the same with 25-30% range for the top-tier. Also, how the dependency on top customer and top-10 clients have moved over time.

A Ability to scale and attrition (Benchmark rating: 20)

Ability to scale (Benchmark rating: 15) - The key indicators that we observe are: [1] performance on client mining over the years [2] strengths/weaknesses that will facilitate/impede scalability and [3] Scaling potential in focus areas

Attrition (Benchmark rating: 5) - Companies with an attrition rate close to 20% in IT services even in the current environment have an obvious cause for concern, as it does not ease off any pressures on the wage hikes.

P Profit and payout (Benchmark rating: 40)

Profit quality (Benchmark Rating : 15) - We take a look at the average 'operating' RoE over 4 years (FY11-14E), and the score is company's RoE in proportion to operating RoE of the industry leader (TCS), scaled to 15

Profit growth (Benchmark rating: 15) - We compare our expected EPS CAGR over FY12-14 with that of the leader. KPIT, which we expect to grow the fastest, gets a rating of 15, while score for others is proportionate to their EPS CAGR relative to KPIT.

Payout ratio (Benchmark rating: 10) - One of the determinants of P-E multiple, we take a look at the payout % over the years and rate the companies accordingly. Companies with a payout of 20%+ score high.

MIDS Model - Midcap IT Discount Score Model

		Benchmark	HEXW	MTCL	PSYS	KPIT	NITEC	TECHM
M	**Management**	**5**	**3.5**	**3.5**	**3.0**	**4.0**	**3.0**	**4.0**
	Management Focus and Strategy	5	3.5	3.5	3.0	4.0	3.0	4.0
I	**IT Mix**	**15**	**10.0**	**7.5**	**8.5**	**10.5**	**9.5**	**10.5**
	Industry Mix	5	3.5	2.5	2.5	3.5	3.5	2.5
	Geography mix	5	3.5	3.0	2.5	3.5	3.5	4.5
	Services Mix	5	3.0	2.0	3.5	3.5	2.5	3.5
D	**Deals**	**10**	**7.0**	**7.0**	**5.0**	**7.0**	**6.0**	**7.5**
	Deals signings prowess	10	7.0	7.0	5.0	7.0	6.0	7.5
C	**Client Concentration**	**10**	**6.0**	**7.0**	**6.0**	**7.0**	**7.0**	**7.0**
	Concentration risk	10	6.0	7.0	6.0	7.0	7.0	7.0
A	**Ability to scale & Attrition**	**20**	**14.5**	**12.5**	**8.5**	**14.0**	**9.0**	**14.0**
	Ability to scale/Client mining	15	10.5	10.5	6.0	12.0	6.0	12.0
	Attrition management	5	4.0	2.0	2.5	2.0	3.0	2.0
P	**Profit & Payout**	**40**	**34.0**	**24.0**	**27.0**	**26.0**	**18.5**	**23.0**
	Profit Growth	15	12.0	12.0	12.0	15.0	4.0	10.0
	Profit Quality (mainly RoE/O. Inc.)	15	12.0	10.0	9.0	9.0	7.5	10.0
	Payout	10	10.0	2.0	6.0	2.0	7.0	3.0
	Total midcap score	**100**	**75.0**	**61.5**	**58.0**	**68.5**	**53.0**	**66.0**
	Discount (%)		**25.0**	**38.5**	**42.0**	**31.5**	**47.0**	**33.0**
	Tier I average target P/E (x)		16.0	16.0	16.0	16.0	16.0	16.0
	Stock target P/E (x)		**12.0**	**10.0**	**9.0**	**11.0**	**8.0**	**11.0**
	FY14E EPS (INR)		13.9	88.2	52.9	14.2	39.6	101.0
	Target Price (INR)		**167**	**882**	**476**	**156**	**317**	**1,110**
	CMP (INR)		124	686	415	128	292	913
	Upside (%)		34	29	15	22	9	22
	Rating		**Buy**	**Buy**	**Neutral**	**Buy**	**Neutral**	**Buy**

Valuation v/s fundamentals at current multiples

59-82% increase in stock prices (YTD ex-PSYS); outperformance to leading peers manifested since January 2012

- **YTD absolute returns ranging between 59-82% result from more-than-merited discount that prevailed and much awaited revenue growth outperformance on a low base.**
- **Comparing fundamentals with the last time when PEs were at these levels, HEXW and KPIT see comparable traction, TECHM has been steadying, while margin pressures have increased at NITEC.**

The surge in tier-II IT stocks was a function of higher-than-warranted discounts and much awaited growth outperformance to Tier-I

The markets have rewarded the growth outperformance by the smaller players, with YTD absolute returns ranging between 59% and 82% (except PSYS, where the return stands at 28%). Part of the surge is explained by a more-than-merited discount at which the tier-II was valued, as top-tier grew out of the downturn and the smaller players struggled to maintain margins. At the same time, the performance on revenue growth by Tier-II however, was a positive surprise for the markets.

Relative and Absolute comparison

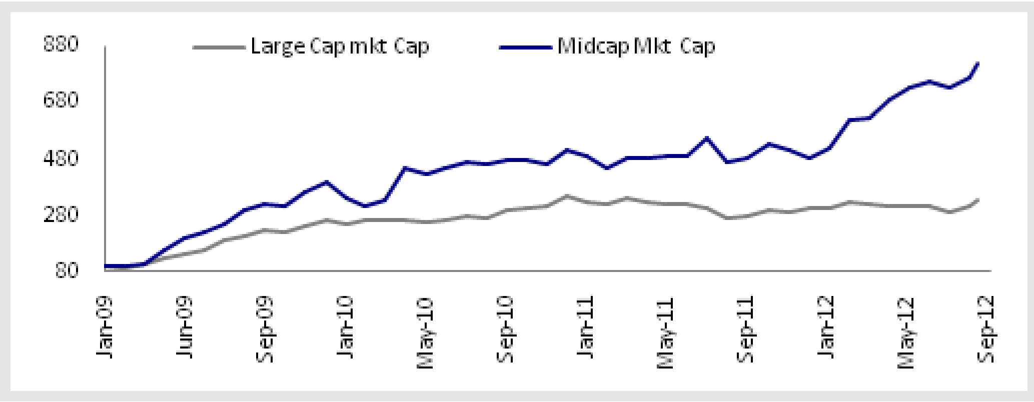
	Relative					Absolute				
Company	**1m**	**3m**	**6m**	**12m**	**YTD**	**1m**	**3m**	**6m**	**12m**	**YTD**
Sensex	-	-	-	-	-	4	9	6	9	19
Mindtree	8	9	48	98	63	12	18	54	107	82
Hexaware	10	(1)	12	70	63	15	8	17	79	82
KPIT	(10)	5	50	68	55	(6)	14	56	77	75
NIIT Tech	11	(3)	17	33	46	16	6	23	42	65
Persistent	5	11	27	29	8	9	20	33	38	28
Tech Mahindra	7	21	42	34	39	12	30	47	43	59
Mahindra Satyam	8	26	43	45	42	13	35	49	54	61
Infosys	9	(5)	(14)	1	(24)	13	4	(8)	10	(4)
TCS	7	2	16	27	3	11	11	22	37	23
Wipro	6	(11)	(14)	3	(21)	10	(2)	(8)	12	(2)
HCLT	1	11	12	36	31	6	20	17	45	50
Cognizant	7	8	(13)	0	(9)	11	17	(7)	9	10

Source: Company, MOSL

When compared to individual stocks in Tier-I that have performed, Tier-II break-out manifested since January 2012

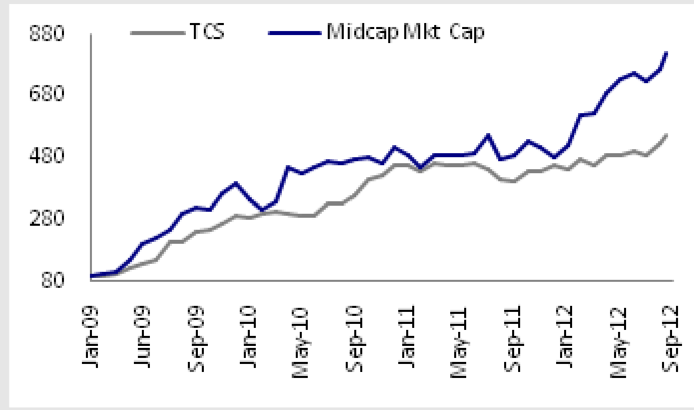
When looked at the stock price movements from January 2009, tier-II stocks have outperformed their tier-I counterparts. We note that this can partly be attributed to underperformance at Wipro and Infosys, whose contribution to the tier-I basket is significant. When we compare the tier-II basket with individual companies in Tier-I that have performed comparably - viz. TCS and HCL, we notice that the valuations have largely matched, but for the period from January 2012, the time from when tier-II stocks have moved into a different orbit.

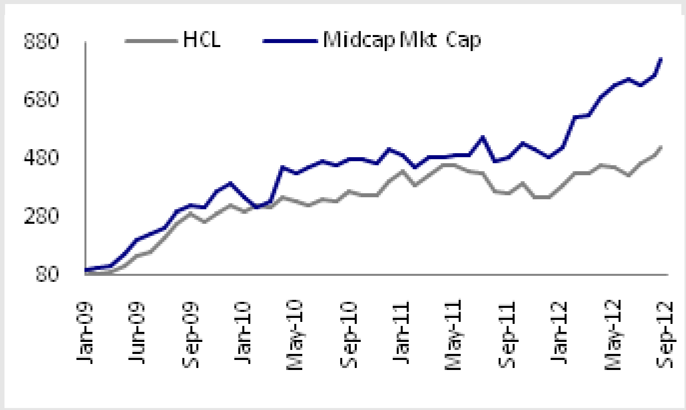
Outperformance to tier-I IT has visible since January 2009 (Indexed at 100)



Source: Company, MOSL

When compared with TCS and HCL Tech, outperforms manifested only from January 2012 (Indexed at 100)



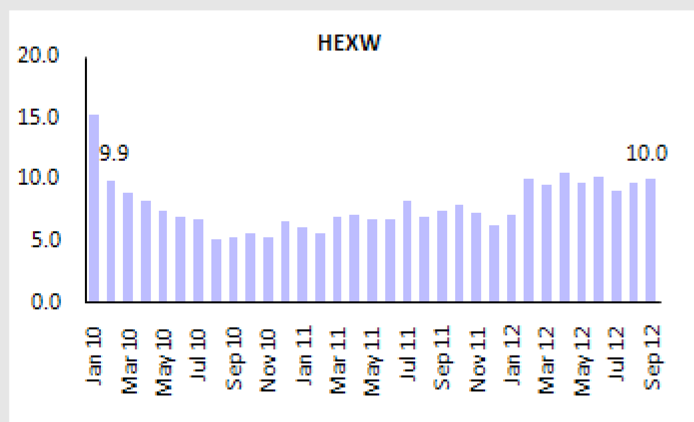


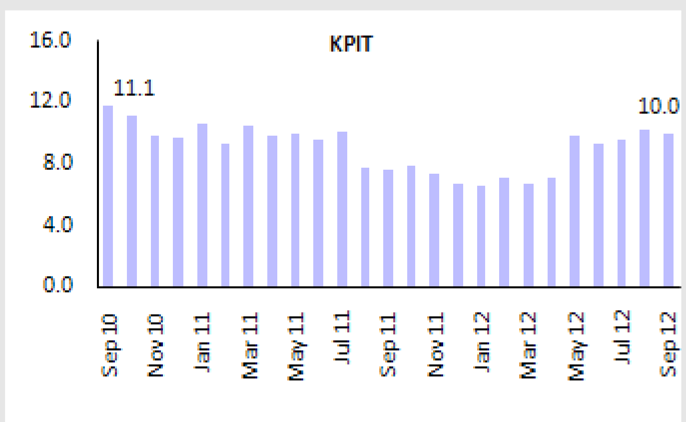
Source: Company, MOSL

Comparing the fundamentals with the last time when PEs were at similar levels

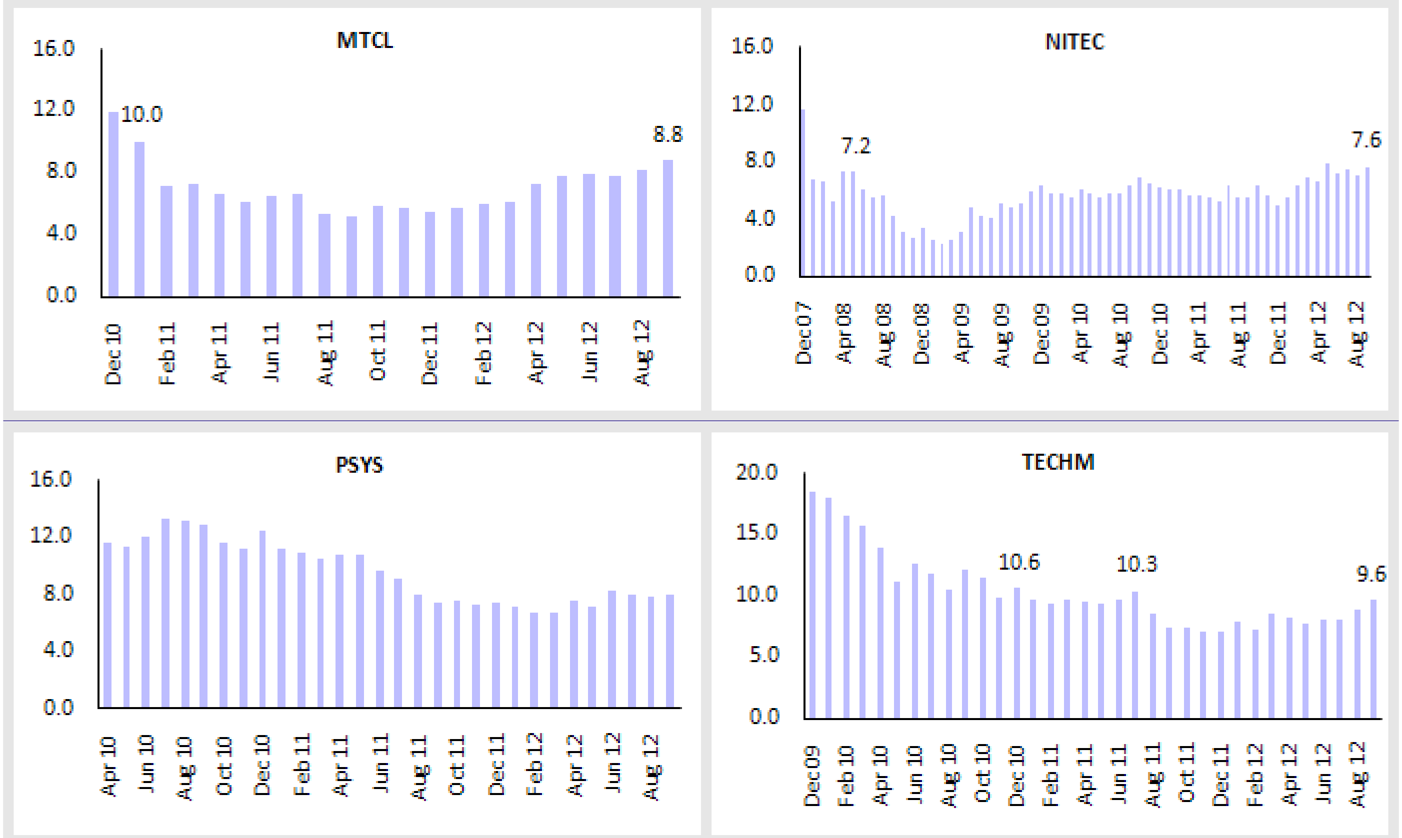
With the environment still challenging and little having changed over the last few months, expectations of higher earnings can only be explained by continued weakness in the INR v/s the USD. Also, stocks like MTCL and PSYS are highly sensitive to currency changes given their higher proportion of offshoring. But 60-80% stock upsides are also a function of some P-E re-rating across the group of stocks. We take a look at the prevailing P-Es of each of the stocks, and note the last time in near-to-medium term history when the companies had a similar multiple; and go on to compare the fundamentals governing individual stocks back then, with those today.

A look back in time, to identify the last time when P-Es (x) were at similar levels to that seen today





A look back in time, to identify the last time when P-Es were at similar levels to that seen today



- At **HEXW**, performance was on the up in Feb 2010 when organic growth guidance for CY11 was best in industry and margins were increasing steadily from a low base. The solidarity continues till date.
- **KPIT's** organic and overall revenue growth traction was no different in October 2010, and while the guided margin band is now lower at 15-18%, the capabilities post the acquisitions are much higher.
- **MTCL** struggled on the OPM front the in January 2011, while revenue growth was commendable despite turbulent phase in the PES segment. The trends today seem to have reversed on the front of margins and revenues, while PES remains sluggish.
- **NITEC** is trading at a higher multiple than that witnessed for a while now, but the margin trajectory and revenue quality, have both, been gradually trending south.
- **TECHM** in July 2011 was witnessing continued impressive recovery in profitability and revenue stability in the acquired entity Mahindra Satyam, while BT revenues stabilized. BT is uncertain today, but rest of the business appears to be on a much stronger footing.
- **PSYS** has had a limited history of listing, in which the P-E seems to have contracted as the prices have adjusted to factor in disappointments post the IPO euphoria.

Comparing fundamental with those prevaling at similar PEs last time

Company PE (1yr fwd)	Expectations	Time when PE compared	Performance then	Our Remarks
Hexaware/ 10.0x	CY11-13 USD revenue CAGR estimate of 18.6% EBITDA margin to stay in the early 20's	February 2010	33% organic USD revenue growth in CY11 (v/s guidance of 27.5%) 4th quarter of the 9 continuous quarters of OPM expansion	High P-E merited on sustainable improvement in performance, amid momentum in deal signings
KPIT Cummins/ 10x	USD revenue growth guidance of 32-35% in FY13 (21-24% organic) PAT growth guidance of 15-20%. OPM expectation of 15-18% USD1b vision by 2017 (USD420m in FY13), 18% EBITDA margin	October 2010	8% QoQ volume growth and 10% USD revenue growth (organic) Expectation of exceeding organic growth guidance of 25%. Guided for 18-20% OPM	Revenue growth expectations remain high. Acquisitions to keep profitability at lower end of guided band, and impending cash outflows (USD45-50m up til FY14) will keep FCF in check. Large deal wins will be key
Mindtree/ 8.8x	ITS continues to grow at industry leading rates, while PES sluggish. Moderated its stance in 1Q for FY13 from above-industry growth to growth in the industry band OPM expanded due to currency and also PES rationalization	January 2011	Revenue growth in FY11 of 21% with IT Services growing 31% EBITDA margin however, struggled in low double digits - severance payouts and sunk costs in the NIW space	The company' s back-to-basics approach has been bearing fruit, and valuations look attractive at current multiples.
NIIT Technologies/ 7.6x	Despite a weak 1Q (seasonality), remains confident of growing above industry average in FY13 Growth has come at the cost of margins, further pressure given nature of order book (CCTNS)	-	Multiple highest in the last many years	Generated healthy cash and maintained a strong payout. These positives are weighed down by pressures on OPM. Stable OPM essential for upside
Persistent Systems/ 8.2x	Expects to beat a 'conservative' Nasscom guidance on a small base, despite a weak 1Q Highly volatile margins on high sensitivity to currency, headwinds from wage hike	-	Multiple at the lower end in the small history of trading, having adjusted for the disappointment following post-IPO Euphoria	Given high proportion of offshore employees, a 10% offshore wage hike is 440bp headwind on margins. Scalability and IP success imperative for a re-rating
Tech Mahindra/ 9.6x	Satyam and non-BT pie of TECHM are expected to grow at least in line with the industry average Margins have shown a significant increase, expect them correct by ~200bp in the near-term	July 2011	Significant outperformance in PAT by Satyam and stable revenues from BT Margins at Satyam continued to surprise, that at TECHM came under pressure, BT projects came for restructuring	The merged entity has a healthy scope to scale through client mining. Stabilizing margins at current level is a positive. BT pressures may moderate.

High growth on a low base finally playing out at Tier-II

Guidance of meeting/beating NASSCOM outlook; revenue proportion from onsite inches up

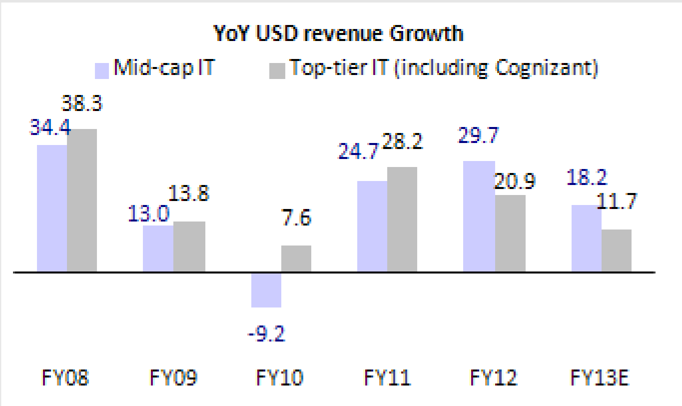
- **Tier-II IT companies outgrew Tier-I in FY12 and going by their respective guidance for FY13, this could be the second consecutive year of growth outperformance by Tier-II.**
- **Readiness to move away from offshoring as the sole differentiating model visible in trend of increased onshoring across tier-II**
- **Disaggregation of large deals into smaller ones have helped inch up absolute number of wins. Company specific strategies too, have facilitated growth amid the opportunity.**

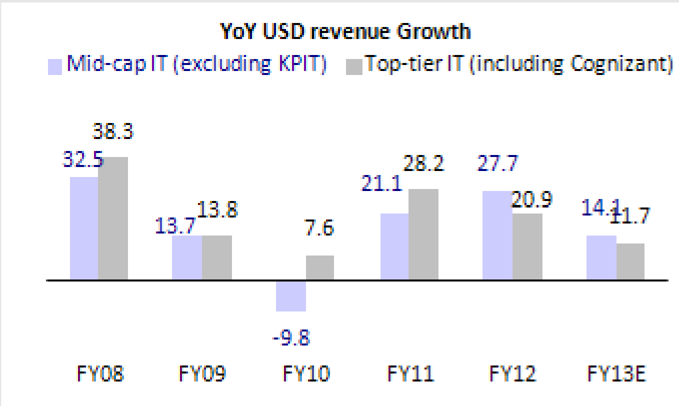
Aggregated Tier-II growth in FY13 expected to be above the NASSCOM band, while that at Tier-I is expected to be at the lower end of NASSCOM's guided band

FY13 to be second successive year of Tier-II IT outgrowing Tier-I

Over the last five financial years, tier-I IT outgrew Tier-II IT (our universe) in each year, but for FY12. Going by the respective guidance for FY13, this could be the second consecutive year of growth outperformance by Tier-II. Our Tier-II universe comprises of Hexaware Technologies (HEXW), MindTree (MTCL), Persistent Systems (PSYS), KPIT Cummins (KPIT) and NIIT Technologies (NITEC). Tier-I includes Cognizant along with the top-4 Indian IT companies. While we understand that growth in one company in particular, KPIT, was also contributed by multiple acquisitions, we observe that the trend does not change even if we exclude KPIT for the purpose of comparison.

No change in growth comparison trends (Tier-I v/s Tier-II) due to KPIT's inorganic growth





Source: Company, MOSL

Barring MTCL, which guided for revenue growth in NASSCOM band, every Tier-II company in our universe expects to beat upper end of NASSCOM guidance

Given a much smaller base of Tier-II than Tier-I (absolute revenues at Tier-I have been 18-20x that of Tier-II over this period), the base effect has never really been on show in the past, before FY12. Tier-II IT companies are likely to maintain the momentum of FY12 in FY13 as well. Each of these companies has categorically guided for at least meeting, if not beating the Nasscom outlook band of 11%-14%. We highlight remarks on FY13 growth outlook from each of the smaller companies:

- **Hexaware Technologies (HEXW)** has guided at least 20% growth in CY12. The company's growth in the recent quarters has been led by large deals executed for top clients, with the top-10 constituting 52% of revenue. HEXW expects the top-10 to contribute 50%+ in CY12 too, with overall company growth of at least 20%, indicating that revenue from the top clients has not peaked just yet.
- **Persistent Systems (PSYS)** expects to beat a 'conservative' Nasscom growth number, despite seeing a turbulent environment and some large project closures.

Mindtree lowered its outlook only after weak PES performance in 1QFY13, earlier it too had guided for growth higher than the top-end of the NASSCOM guidance

- **KPIT Cummins (KPIT)** has guided USD revenue growth of 32-35% in FY13, aided by the acquisition of Systime. Even excluding revenue from this acquisition, the like-to-like organic growth guidance for the year is 21-24%.
- **MindTree's (MTCL)** Product Engineering Services (PES) segment, which accounts for ~31% of its revenue, continues to struggle, leading the company to trim its outlook for FY13 to meeting the Nasscom estimate from beating it. This too implies 20%+ growth in IT Services (ITS) in FY13.
- **NIIT Technologies' (NITEC)** healthy order book lends strong revenue visibility, and despite a seasonally weak 1Q, the company expects to return to high growth rates for the rest of the year to beat Nasscom estimates.

As far as 1QFY13 is concerned, we observe greater polarization in growth across the top-tier (Tier-I) as as well as the mid-tier (Tier-II) companies. Collectively, however, the sequential growth rates are comparable. Over the full year, going by the outlook of the smaller companies mentioned above, and also the guidance across the top-tier, we expect the growth outperformance of the smaller companies to restore going forward in FY13.

Aggregated growth in 1QFY13 has been comparable, due to seasonality at NIIT Tech and PES weakness at Mindtree

1QFY13 growth comparison - greater polarization, aggregates similar

	4QFY12	1QFY13	QoQ Gr. (%)		4QFY12	1QFY13	QoQ Gr. (%)
TCS	2,648	2,728	3.0	Mindtree	105	106	0.4
Infosys	1,771	1,752	(1.1)	Hexaware	88	91	3.6
Cognizant	1,711	1,795	4.9	NIIT Tech	88	88	(0.8)
Wipro	1,536	1,515	(1.4)	KPIT Cummins	93	98	5.0
HCL Tech	1,048	1,080	3.0	Persistent	54	55	1.3
Top-tier	**8,714**	**8,870**	**1.8**	**Tier-II**	**429**	**437**	**2.0**

Source: Company, MOSL

Revenue proportion from onsite has increased across Tier-II with the exception of Hexaware

Readiness to changes visible at Tier-II; revenue proportion from onsite inches up

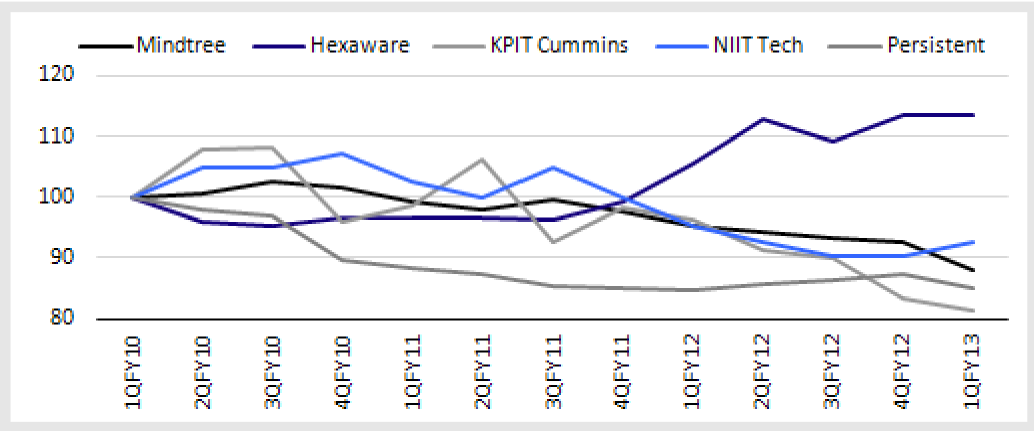
The smaller players have responded to the growth challenges posed in a changing landscape, as some of their metrics suggest in this period of high growth. Traditionally, greater offshoring was bait enough to bag contracts, facilitating growth in an underpenetrated industry, despite fairly commoditized offerings. However, offshore delivery-led growth, which was a disruptive force over 2000-2005, is no longer a big differentiator, thanks to the MNCs responding to competition.

IBM's estimated services headcount in India compares with that of Infosys (v/s 18,000 in 2005). Accenture, which reports its headcount from low cost locations reported 150,000+ employees. While offshore delivery being more integrated for Indian vendors v/s global MNCs is cited as a differentiator, we note that these differences are also fast fading.

Higher growth in the smaller players has seen the revenue proportion in the recent quarters inch up in favor of onsite, only one of the indicators that the industry is looking towards different deal structures in pursuit of market share. This is only essential given that the absence of larger deals for the leaders is making them knock on the doors of smaller sized opportunities too, adding to the competition.

Higher onsite revenues need not be a margin headwind, if they can facilitate greater incremental revenues from top-clients

With the exception of Hexaware, offshore revenue proportion down for Tier-II players



Source: Company, MOSL

In the longer run, we believe that greater on-shoring need not necessarily be a headwind to the margins, given the focus on growing top-accounts further, which in turn will drive greater offshoring. HEXW has already manifested this trend in the past couple of years, having seen its offshore proportion surge in recent quarters.

Growth drivers have differed across companies in FY12

On the back of stronger FY12 growth and expectation of a robust FY13, FY11-13 USD revenue CAGR is likely to be higher for the smaller players, contributed individually by every company. At least as far as FY12 is concerned, growth drivers have been different across companies:

- PSYS continues to play the outsourced product development (OPD) story, as it aligns its focus to the next wave of technological advancements seeing heightened investments by product developers - in the areas of Cloud, Mobility, Collaboration and Analytics.
- HEXW bagged six large deals in the past year and a half that have helped drive growth in its top clients. The contribution from top-10 clients increased to 52.6% in 4QCY11 from 46.5% in 1QCY10.
- Growth drivers at NITEC are two: (1) large deal wins like Eurostar and Morris JV, and (2) orders from the Indian government segment.
- KPIT has had a more inorganic focus, trying to add capabilities to its already existing portfolio of services. Even organically, it has depended on the strong performance of integrated companies.
- MTCL's 20%+ growth in FY12 despite a sluggish PES segment (33% of business) indicates robust traction in the ITS segment. However, higher PES exposure may put growth at risk in FY13.

Every company has had a different growth driver, large deals are coming the way of Tier-II more than before

Growth drivers differ across companies

Company	Growth Drivers
Hexaware	6 large deals in the span of 6 quarters driving growth from top-clients
KPIT Cummins	Acquired 10 companies in the past decade, including 4 in the last three years
Persistent	Outsourced Product Development + New initiatives of Cloud, Collaboration, Mobility and Analytics
Mindtree	IT Services - Particularly IMS and Travel & Transportation vertical
NIIT Tech	2-pronged drivers - Overseas large deals (Eurostar and Morris Communications) and Large orders in government segment

Source: Company, MOSL

Key accounts - A key differentiator

Revenue contribution from top-10 accounts has grown at Tier-II, reduced at Tier-I

- **Sub-20% growth rates could define the new normal for the larger players as incremental revenues continue to taper off on a high base.**
- **Over FY10-12, top-10 accounts at Tier-II grew at a CAGR 700bp higher than that at Tier-I. This is one segment where base effect is more likely than not playing out.**
- **Tier-II unanimously cited mining of key accounts among the key growth drivers, suggest ample room to seek further growth.**

Sub-20% growth rates could be the new normal for Tier-I

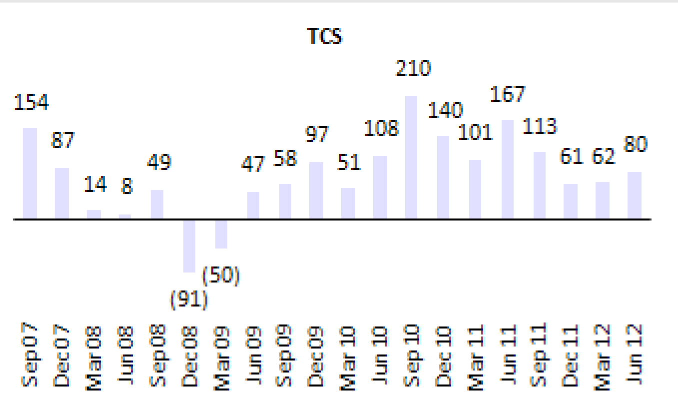
We understand that the USD750b+ market is still underpenetrated in many ways and there is a lot of opportunity to grow. While sustaining in double digits, sub-20% growth rates could define the new normal for the larger players, on two counts: [1] ever-increasing competition and decreasing differentiation, and [2] high base, especially in top clients, share of revenues from which is slowly inching down.

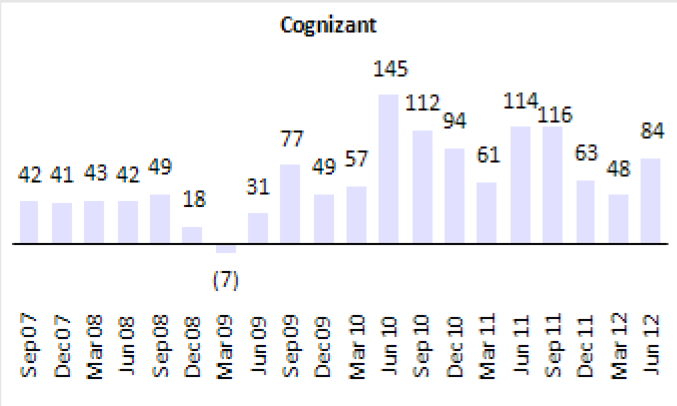
Incremental revenues for Tier-I have been declining, so also the contribution from top clients

We look at the trend in incremental revenue across companies and at a key explanatory factor of this trend - revenue growth in the top accounts. We assess the incremental revenue in the companies that have led growth across the top-tier - TCS, Cognizant and HCL Tech. Incremental revenues over the past few quarters have declined, most notably in TCS and also in the case of Cognizant and HCL Tech.

TCS added USD100m+ revenue QoQ in each of the six quarters from June 2010 to September 2011, and in none of the last three quarters. Cognizant added USD100m+ revenue QoQ in four of these six quarters, and in none of the last three quarters. HCL Tech, which saw a sustained period of adding USD50m+ revenue QoQ, has not done the same in the last five quarters.

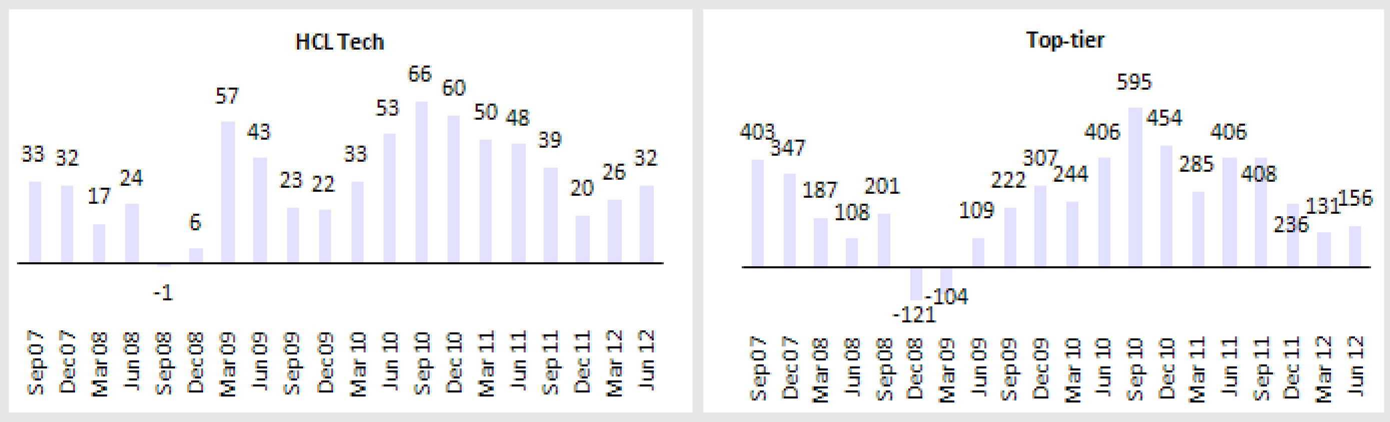
Incremental revenue trending down in the last four quarters, even for the growth leaders





Source: Company, MOSL

Incremental revenue trending down in the last four quarters, even for the growth leaders



Source: Company, MOSL

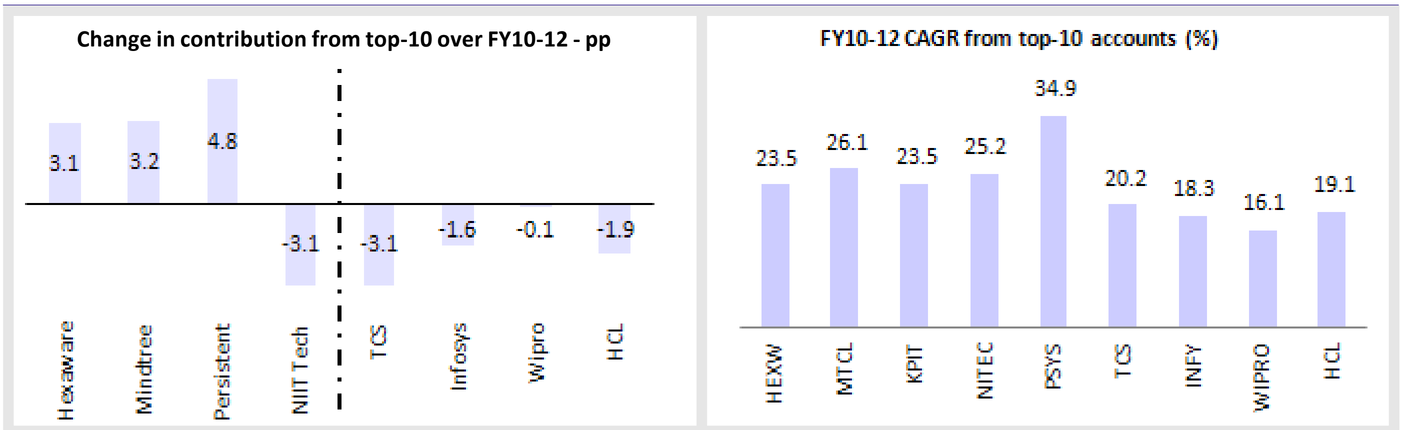
Revenue contribution from top-10 clients growing across Tier-II, declining across Tier-I

Trend of revenue movement in top clients at Tier-II contrasts with that of Tier-I

The success rate in mining of accounts is one of the key determinants of growth rates across the industry. We note that revenue contribution from the top-10 accounts has been flat or has declined across the Tier-I companies over FY10-12, while the same has grown across the Tier-II companies, except NITEC (we leave KPIT out of this analysis, given its multiple acquisitions during this period would have diluted the revenue concentration in top accounts).

As individual accounts grow larger in size, it is naturally difficult to draw higher and higher incremental dollars from them, explaining the drop in dependency on these accounts in Tier-I, and partly the lower growth rate across the group. This is one key piece of evidence of the base effect in play, impacting the collective growth across the heavyweights.

Divergent trends in the two groups (NITEC an exception) on revenue contribution from top-10 clients



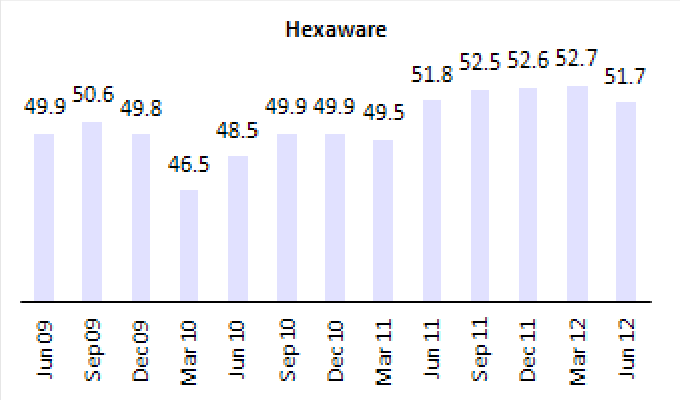
Source: Company, MOSL

Mining scope ample for smaller players - reflected in common theme of 'farming'

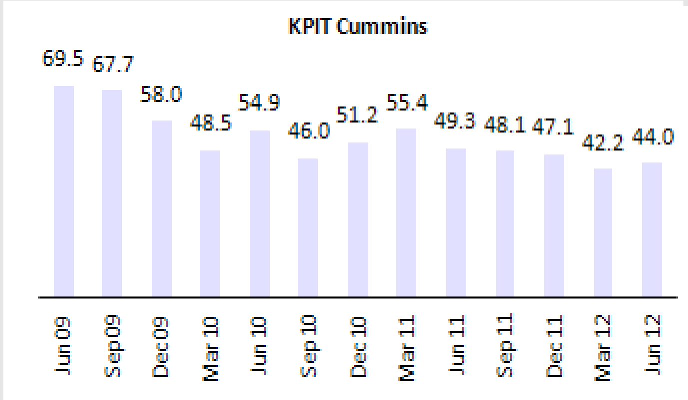
Hexaware has seen success in mining key accounts, others have cited it as their top agenda

HEXW's more than impressive show over the last two years was driven by its success in mining large accounts and expanding its share of clients' wallet by widening services offerings. This resulted in six large deals between July 2010-November 2011, ramp-ups in a couple of which in CY12 contributed towards a healthy guidance. HEXW has not been the sole company trudging this path; the strategy seems to be the key focus over the near-to-medium term for more companies that compare with HEXW in terms of size.

HEXW: Growth in last two years fuelled by large deals won with top clients



KPIT: Acquisitions diluted revenue contribution from top clients; focus back on growing the metric



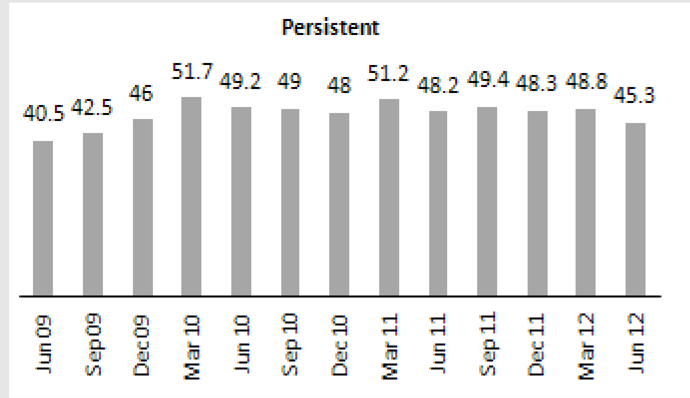
Source: Company, MOSL

Focus on key accounts back at KPIT, PYS has been trying with limited success thus far

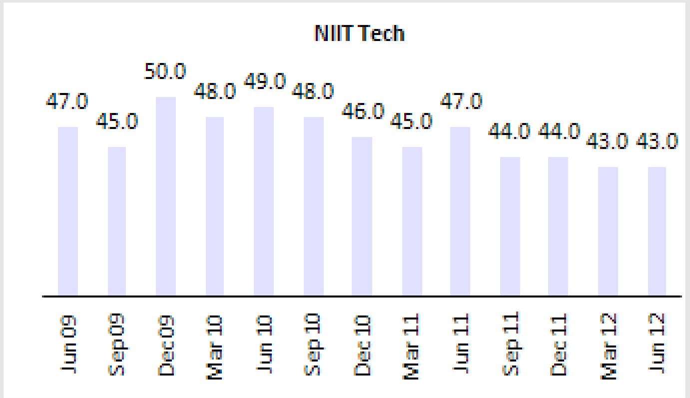
KPIT, which did away temporarily with its "Star Customers" focus, had set sights on expanding its breadth of offerings. Having achieved that by filling gaps through acquisitions, it is now directing its focus back on increasing revenue per client. It is targeting a select set of top clients that hold the potential to grow into much larger accounts. KPIT has set itself a goal of bagging at least five USD20m+ deals in the coming fiscal.

PSYS, like KPIT, articulated a similar strategy. It has been focused on next-gen technologies as far as its offerings to clients go, but alluded to the realization that it should be operating at much higher scale with the technical niche it offers to clients. One of the main ways sought to achieve that end now is by following an account-wise strategy, where the company will identify its growth accounts that hold to potential the scale up their business with PSYS. We cannot help but agree with this approach, as PSYS currently caters to multiple billion-dollar enterprises. Success, however, has eluded it in this endeavor thus far.

PSYS: Pick-up in revenue from top-clients; significant room to increase share of clients' wallet



NITEC: Thus far an exception, revenue from top clients should increase on the back of recent large deal wins



Source: Company, MOSL

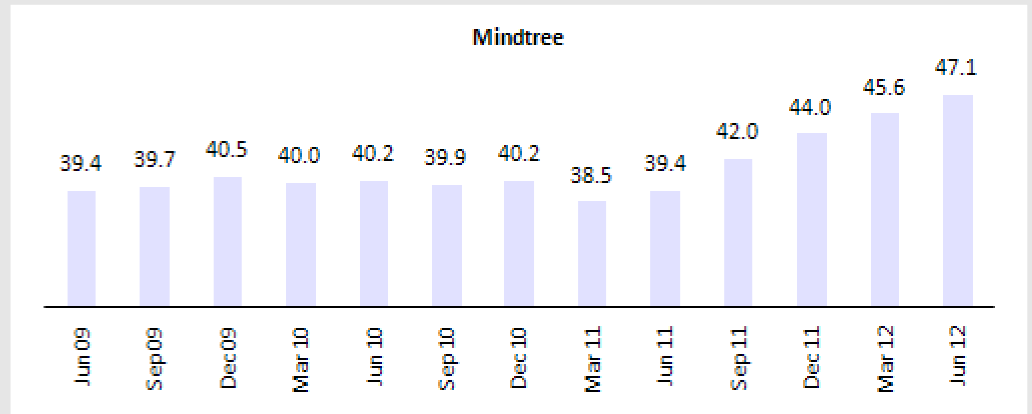
NITEC has won some large orders, but at the expense of margins

A couple of deals with the Indian Government, and the Eurostar deal and Morris Communications JV substantiate **NITEC's** focus on securing large orders in a tough environment. We believe the company is more open to experimenting with innovative deal structures to beat competition, which introduces a higher element of risk.

Successful account mining is reflected in the rise of contribution of top clients at **MTCL** as well, which unsurprisingly, has led the growth in IT Services, although the PES segment remains sluggish.

MTCL's increase in revenue proportion from top accounts has driven industry leading growth in ITS for the company

MTCL: Healthy growth from top accounts over the last five quarters



Source: Company, MOSL

Growth outperformance at the cost of margins...

... though favorable currency, lower SGA aided margins in recent quarters

- **Over FY10-12, EBITDA margin declined 350bp across Tier-II v/s 120bp across Tier-I.**
- **Scale equips the larger companies with levers of (1) lower SGA, and (2) better ability to manage pyramid..**
- **Last 4 quarters, however, saw sharp up-tick in margins across tier-II. Over 1QFY12-1QFY13, aggregate EBITDA margin across tier-I has inched up by 140bp, v/s 510bp at tier-II.**

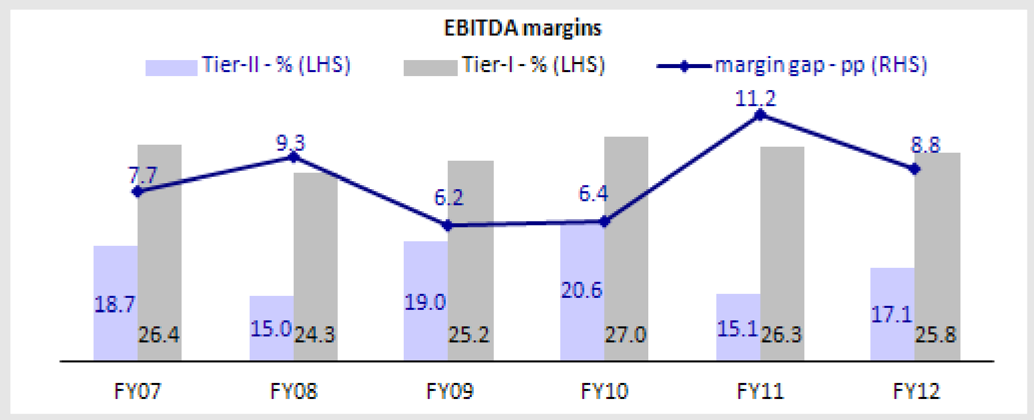
Tier-II players have struggled to match larger peers' profitability

While revenues grew better, EBITDA margin at Tier-II has underperformed Tier-I by 230bp over FY10-12

During the period of revenue growth outperformance, the smaller players' margins took a hit. Over FY10-12, EBITDA margin declined 350bp across our mid-cap universe v/s 120bp decline across the top-4. The rupee had depreciated by ~2% during the period. However, HEXW recovered most of its margin fall while its revenue surged, and PSYS benefited from the currency swing. Looking at the broader picture, niche/ differentiated or commoditized offerings, matching or discounted billing rates, discretionary-heavy or operations-heavy business mix, whichever way we look at it, mid-caps have struggled to match their profitability with that of their larger peers.

Scale explains the margin gap between the two groups, allowing for lower SGA and better pyramid management at Tier-I

Greater volatility in mid-tier margins, while on an average being ~8pp lower



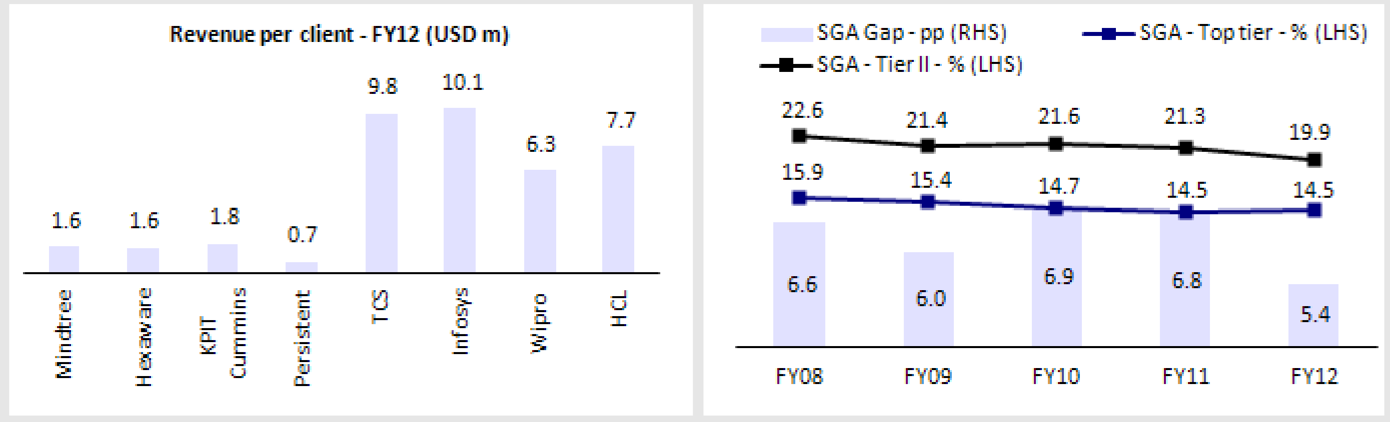
Source: Company, MOSL

Scale is the single most important factor that explains the margin gap, equipping the larger companies with levers like (1) lower SGA, and (2) better ability to manage pyramid.

Huge difference in revenue per client between Tier-I and Tier-II explains lower SGA dollars spend for per dollar of top-line

Lower SGA: Revenue differential between the leaders and the tier-2 players is disproportionate to the difference in the number of clients, implying a huge gap in revenue per client. This directly translates into fewer dollars spent on sales per dollar of revenue. This is clearly seen in the differential in SGA (selling, general and administrative expenses as a percentage of revenue), which has explained as high as 540-660bp of the margin differential over FY08-12. We note that this is after including bench costs of TCS within SGA, adjusting for which the differential would be even more.

Significant difference in client mining metrics across the two sets SGA has explained 540-660bp of the margin gap



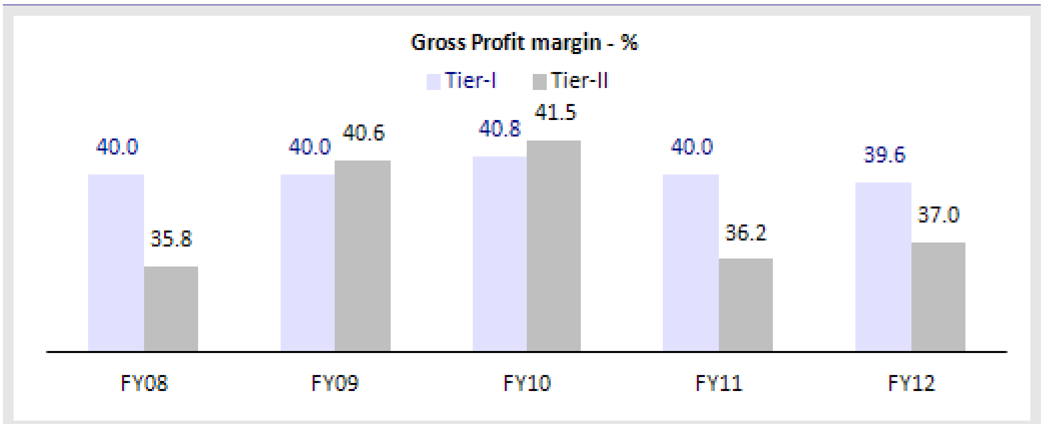
Source: Company, MOSL

Employees are more in proportion to clients than revenues, which explains the operating leverage for Tier-I at the gross level

Better ability to manage pyramid: With the help of scale, not only is the revenue per client higher, but also the revenue per employee. Costlier resources that drive business at the top can be expected to be in proportion to the number of clients, rather than the revenues. As a result, gross cost incurred as a percentage of revenue is significantly lower than that for smaller peers. Also, from the perspective of supply, while freshers' requirement is lower for the smaller players, it still remains a challenge to get on board quality talent from campuses. Tier-I companies and the MNCs, who enjoy the first few slots in colleges, mop up the best talent. The lateral proportion of smaller players is usually higher, and so is the attrition. Higher attrition leads to costly exercise of back-fill, a direct hit on gross margin. The impact of such a scenario is felt particularly in the high growth period, when demand for talent surges. This is substantiated by a drop in gross margins across the smaller players during FY10-12, when they managed to outgrow their larger peers. However, margins held on in the top-tier, aided to an extent by the employee pyramid.

Slight convergence of Gross margins in FY12, when revenue contribution from top accounts increased for the smaller players

Gross margin v/s top-tier took a dip in FY11, the key growth year during FY10-12



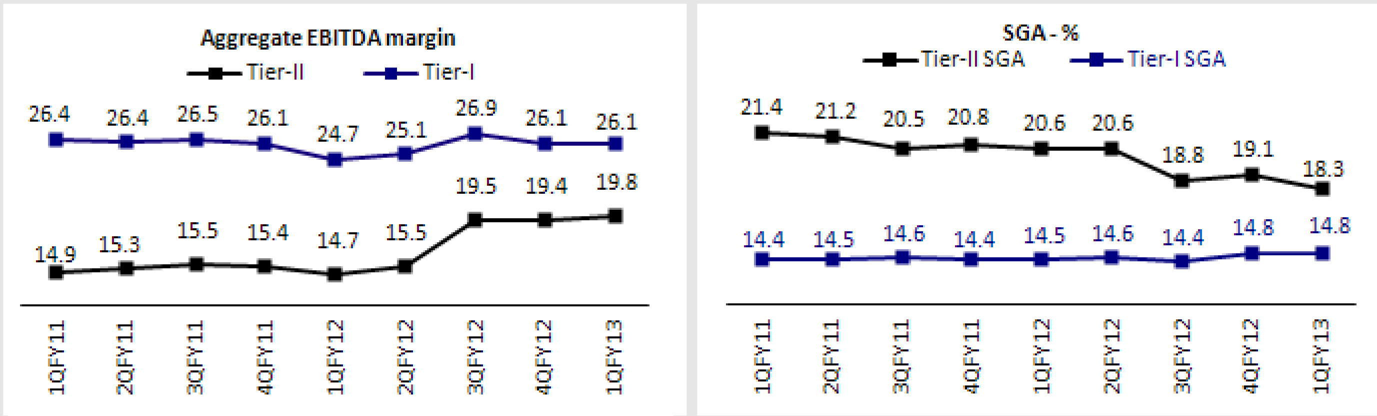
Source: Company, MOSL

Lower growth at Tier-I, SGA rationalization at Tier-II led to closing of the margin gap over the last few quarters

Margin upswing for Tier-II in recent quarters, led by lower SGA, INR depreciation

The last four quarters have seen a sharp up-tick in margins across the mid-tier companies, as high growth was also supported by lower SGA and favorable currency. Over 1QFY12-1QFY13, aggregate EBITDA margin across the top-tier has inched up by 140bp, while the expansion in their smaller counterparts was a healthy 510bp. SGA rationalization has been one of the key contributors to this uptick in margins for the Tier-II. SGA differential was 610bp in 1QFY12, and the gap was down to 350bp in 1QFY13, explaining 260bp of the 370bp outperformance in margins during this period.

370bp margin outperformance by Tier-II during 1QFY12-1QFY13, led by 260bp contribution from SGA



Source: Company, MOSL

Growth not thwarted...

... but profitability is the key concern

- **Penetration into key accounts still remains low at Tier-II. That, combined with its potential agility to adapt to changing technologies will help sustain healthy growth rates.**
- **Margins remain the key concern going forward - we observe company specific headwinds at KPIT, PSYS and NITEC in addition to secular structural concerns.**

Healthy growth on ample room to drive client mining v/s that at Tier-I should help sustain growth outperformance of Tier-II, so also agility to adapt to next-gen technologies

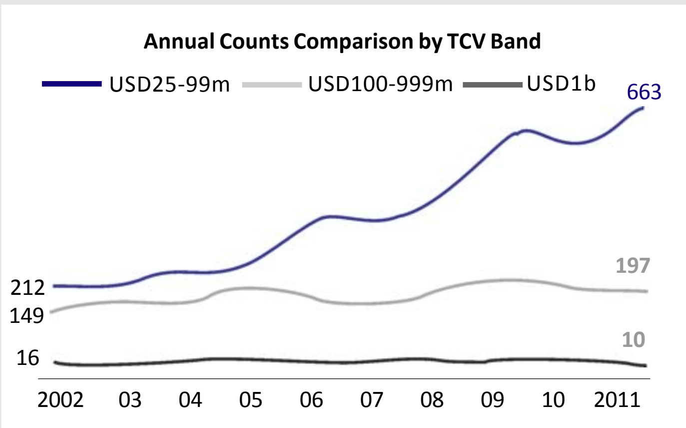
Growth outlook: Multiple factors to support continued outperformance

On the revenue growth front, we believe that two factors lend support to the smaller players' continued outperformance: [1] ample room to grow share of wallet in existing accounts, driving growth through improvement in client mining, and [2] greater agility in adapting to the changing environment and catering to next-gen services.

Also, high base of the large players and fewer billion-dollar deals will make it difficult for the larger players to grow at the same delta to their smaller counterparts as in the past. Revenues from top accounts for the bigger players have already shown signs of plateauing, a trend that could be a key determinant of growth rates across the two sets of companies going forward. However, we note that we do not expect growth rates to be disappointingly low for the top-tier. From our interactions with the managements, we understand that the companies see enough opportunity in the G-500 space of the G-2000 to drive growth. Greater presence of the smaller players is in the band of companies from G500-2,000. Top players' opportunity sighted in G-500, added to significantly lower revenue per client at tier-II suggests growth in tier-II is not thwarted just yet.

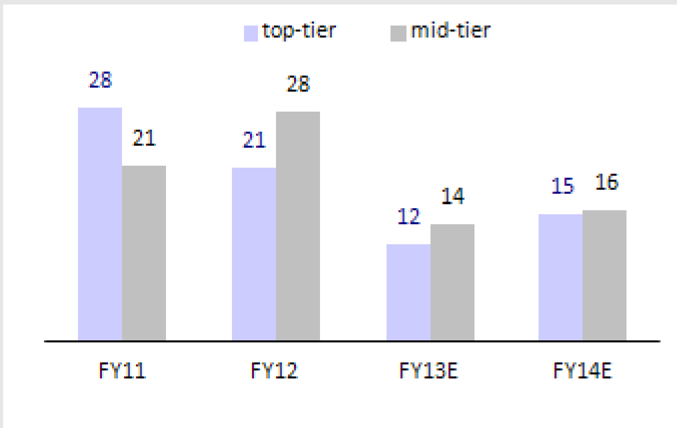
It is also noteworthy that the broader market shift is towards smaller contracts. According to TPI, over CY02-11, the number of USD1b+ deals has declined from 16 to 10. The number of deals in the USD100m-999m range was 149 in CY02, and increased to merely 197 in CY11. In comparison to these, USD25m-99m deals increased from 212 in CY02 to 663 in CY11. In the last few years, smaller players have managed to scale up to sizes where such deals become the sweet spot for them.

Number of USD25-99m deals far exceeded the higher TCV deals in the last decade



Source: TPI

Expect revenue growth at mid-tier to surpass larger peers in FY14, too



Source: Company, MOSL

Hiring more active at the smaller firms - Randstad

In order to understand the hiring activity on the ground across the two sets of companies, we interacted with the top management at Randstad India. Randstad is leading HR consulting firm (global # 2 HR Services provider) providing services ranging from Staffing, Search & Selection, HR Solutions and In-house Services.

- **Hiring numbers in smaller players intact, down at larger peers:** In smaller companies, hiring numbers this year are similar to that in the last year. Hiring activity has definitely slowed down in larger players like Infosys and IBM. Majority of demand for workforce today lies in the 2-5 years experience bracket. The hiring activity is much softer YoY at the entry level and senior level positions.
- **Hiring process has become more thorough over the years:** Hiring by companies is now a more rational and thorough process than 4-5 years ago. Earlier, while one in four shortlisted candidates stood a chance of getting selected, the same conversion rate today stands at one in eight.
- **Salary hikes on a lateral switch much lower than before:** Salary hikes that are now given on a switch are much lower than earlier. 15-20% is the new normal in terms of a hike during switch. Employees were commanding a hike of 25-30% "easily" in the good times.
- **Quality of both entry level and lateral talent has deteriorated:** Quality of talent has deteriorated over the years. That has also been one of the factors impacting the conversion ratios, apart from a weak growth environment. Even within the laterals, the quality of talent has been on the decline. This is reflected in the high amount of technical rejections that are now happening more than ever before. Even on the soft skills, there are notable shortcomings.
- **Companies open to hiring from non-engineering graduate pool:** Given the fall in quality of talent in the engineering graduate pool, larger companies are now more open to non-engineer graduates (including Bcom etc.) for services like testing and other areas requiring limited skills.

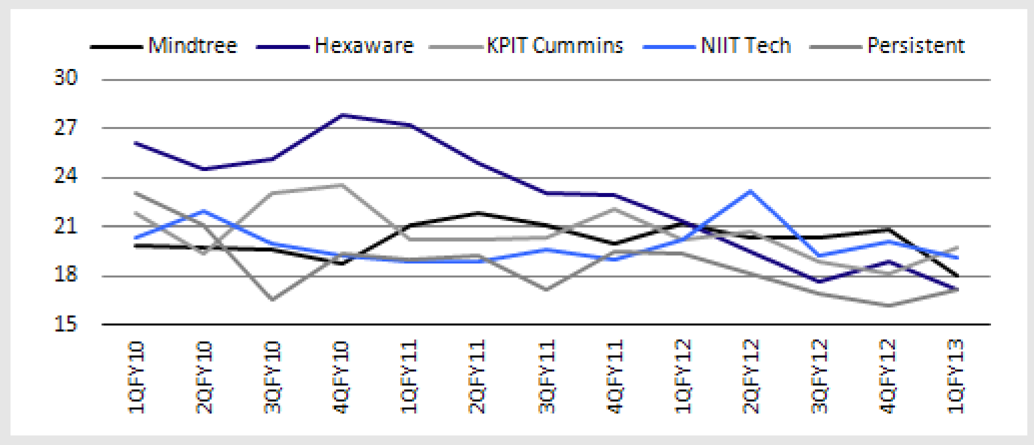
Margin expectations: Concerns on profitability despite the recent impressive show

Limited levers exist for continued further margin convergence

The recent quarters may have seen significant outperformance by the mid-tier. However, we remain concerned on the profitability of mid-tier companies. Almost all the margin surge in Tier-II is explained away by two factors - currency and SGA. Going forward, we do not see significant rationalization in SGA, as investments will be imperative to drive growth. This is especially the case given that the competition from the larger players is only expected to increase.

Also, sanguine growth rates will keep up the demand for talent and hence, attrition may remain high, necessitating continued wage hikes. At the same time, growth in the range of 20% will not be sufficient to offset the margin decline from increased wage costs resulting from 10-12% offshore wage hikes.

SGA rationalization has driven majority of the margin uptick

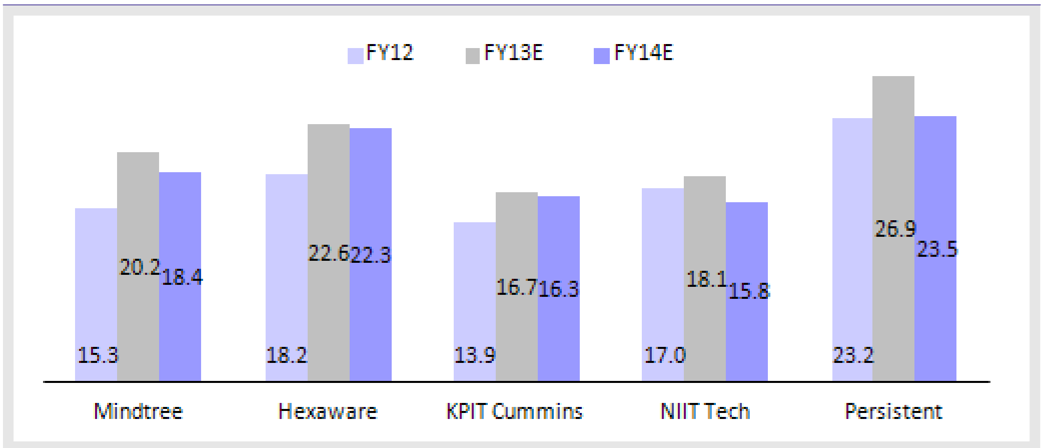


Source: Company, MOSL

SGA rationalization was the key lever that helped close the margin gap to Tier-I in recent quarters

We do not build in further margin expansion across the companies, and expect EBITDA margins to moderate across the board beyond FY13. In FY13, sharp INR depreciation should help grow margins.

Expect margins to contract across the board in FY14 on multiple challenges



Source: Company, MOSL

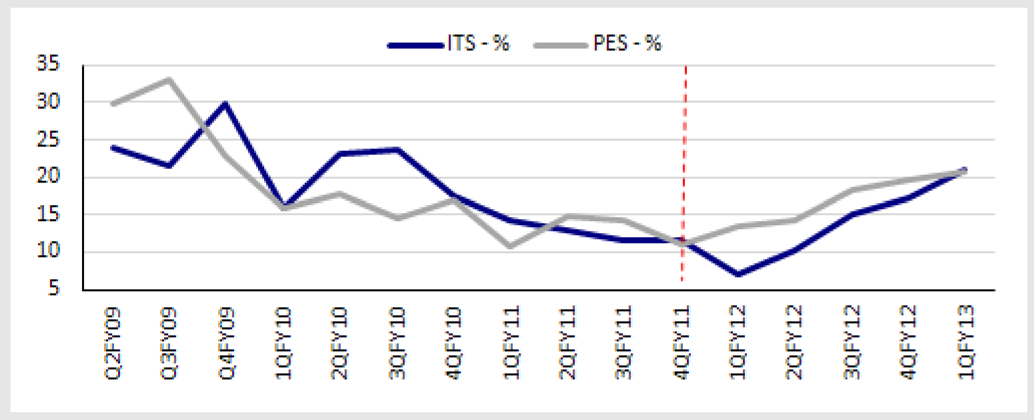
We model 50-160bp moderation in FY14 OPM for Tier-II

For individual companies, we see the following situation around margins:

MindTree (MTCL): While the company has shown impressive execution in IT Services, over 85% of its revenue is from services like ADM, IMS and testing. We see margins in these services gradually coming off. MTCL has improved margins in its PES segment, with focus on select clients amidst low growth visibility in the segment. Going forward, as the proportion of IT Services increases, so will the challenges on maintaining the margin profile.

While focus on profitability at PES has helped bridge margin gap with ITS, growth is essential to sustain margins

MTCL: Profitability at PES restored to that at ITS, but overall margin expansion will be challenging, going forward

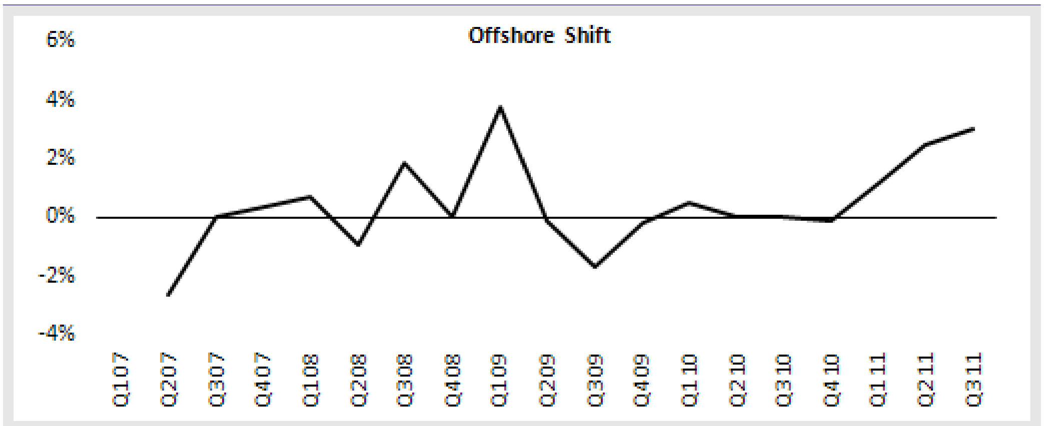


Source: Company, MOSL

Hexaware Technologies (HEXW): Increased offshoring on account of growth from top clients has been a positive for the company's margins - the proportion of offshore revenue increased by 700bp in the five quarters from 4QCY10 to 1QCY12. With little scope for further increase in the same, it remains to be seen how the company holds on to its margins.

HEXW guided for sustaining margins at current high levels, continued growth in top-accounts will be key

HEXW: Offshore mix shift has come to the aid of margins in the recent quarters

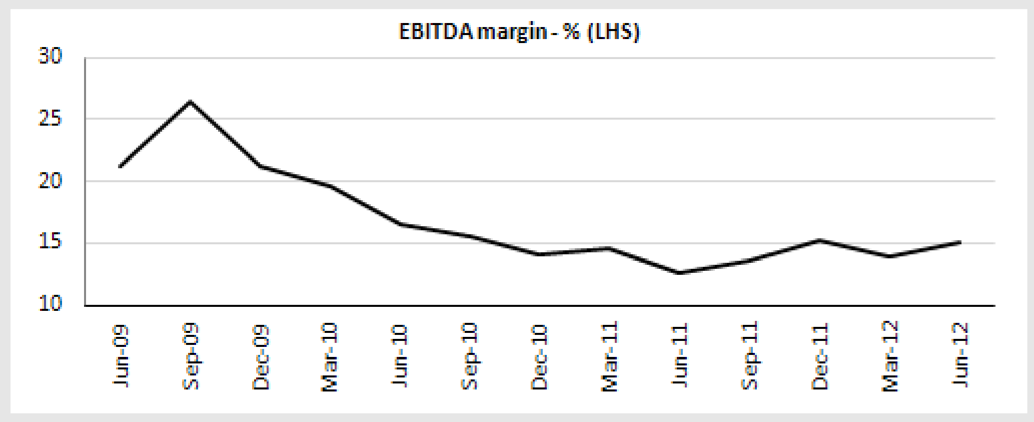


Source: Company, MOSL

KPIT Cummins (KPIT): Improvement in profitability of the acquisitions is a key lever for KPIT's margins. While it has successfully delivered that in its SAP SBU and also in the initial period of Systime, given our expectation of continued inorganic forays by the company in its quest to deliver on USD1b revenue target, we see margins remaining at the lower end of the guided band of 15-18%.

KPIT: EBITDA margin impacted by lower profitability of acquisitions

Continued inorganic foray, which generally entails integrating lower margin onsite acquisitions remains a margin headwind

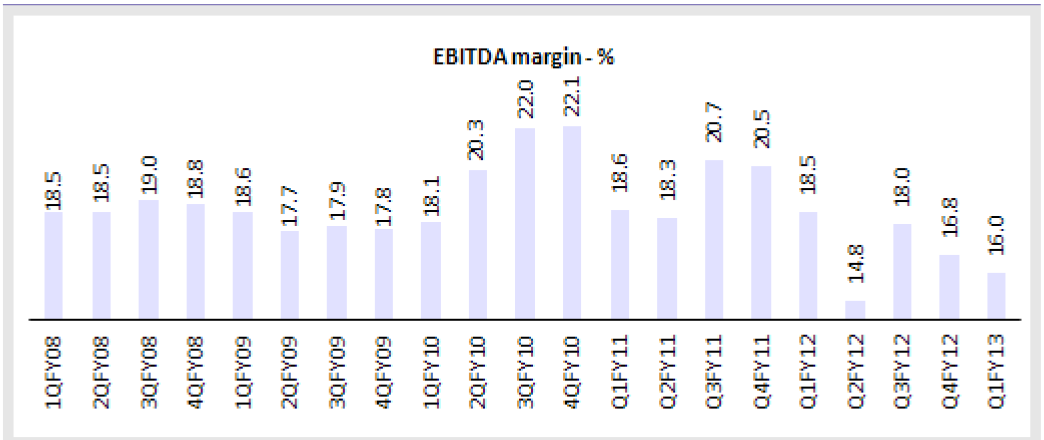


Source: Company, MOSL

NIIT Tech (NITEC): NITEC's EBITDA margin took a hit on increased transition costs at onsite on a couple of large deals. Also onsite proportion of revenue was higher during this period. With these two factors behind, margins should improve. However, risks to margins have increased due to [1] large government deals that the company is executing, which have a significant proportion of hardware element (~65%), and [2] innovative deal structuring to aggressively book orders.

NITEC: EBITDA margin declined due to transition costs in large deals; guidance of margin improvement, going forward

Transition costs in large deals and majority proportion of low margin hardware in government deals hurt margins

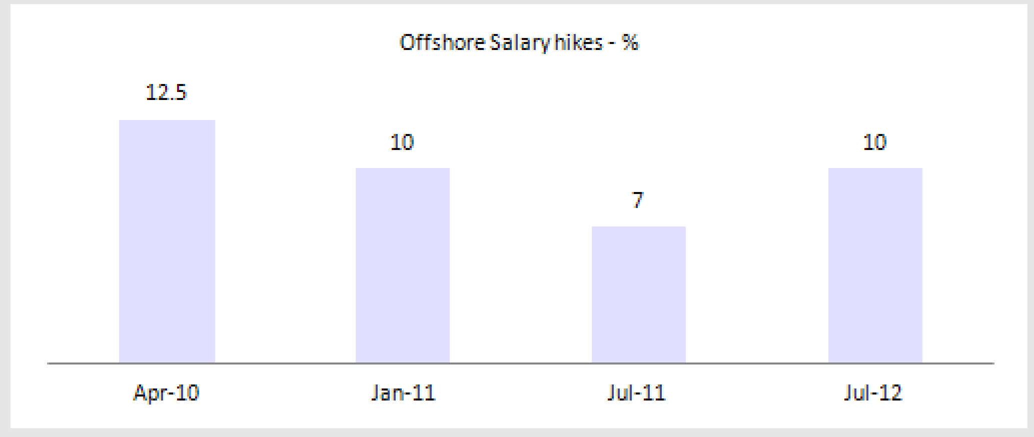


Source: Company, MOSL

Persistent Systems (PSYS): Given that 77% of PSYS' revenue comes from offshore, the proportion of offshore efforts is significantly high. Also, competition from captives has constantly put pressure on attrition rates, forcing the company to give frequent wage hikes. Additionally, wage hikes hurt PSYS more, as offshore wages constitute a higher proportion of revenue.

PSYS: Has given four wage hikes since FY10, and at the higher end of the industry in FY13, despite weak outlook

10% wage hike at offshore usually implies 400bp+ impact on the margins



Source: Company, MOSL

Return ratios: Ex-PSYS, equally impressive

Volatile operating profits for a couple for years, led by revenue challenges in the financial meltdown and different hedging policies adopted amid extreme currency fluctuations resulted in hefty swings in return ratios. However, in the stable year of FY12, when the mid-tier collectively reported stronger growth, the return ratios saw a fair degree of convergence. The only exception was PSYS, whose ratios are on the lower side.

Return ratios for FY12 comparable, excepting PSYS

Return ratios similar across peers in FY12, except Persistent

ROE - %	FY10	FY11	FY12
Mindtree	35.2	15.0	25.2
Hexaware	17.8	6.8	26.6
KPIT Cummins	31.2	20.0	22.4
NIIT Tech	26.1	27.4	23.7
Persistent	23.2	20.5	17.7
ROCE - %	**FY10**	**FY11**	**FY12**
Mindtree	25.4	14.6	25.6
Hexaware	22.6	7.5	23.8
KPIT Cummins	32.8	18.2	20.6
NIIT Tech	29.7	30.6	26.7
Persistent	17.7	16.2	14.7

Source: Company, MOSL

Cash generation: PSYS and NITEC stand out on 5-year aggregate

PSYS is the most noteworthy outperformer on the cash flow metrics when one looks at aggregate performance over the last five years. Despite the smallest scale of revenues, the company has generated the maximum absolute free cash flow (FCF) over FY08-12, followed by NITEC. However, the two companies have the lowest enterprise value.

MTCL was impacted by a couple of acquisitions in the PES space that did not click, followed by a failed venture into smartphones. Not only the investments, but the severance charges on employee retention in Kyocera and Smartphones foray explain the FCF troubles. These are now behind the company, and it generated its highest FCF in the last six years in FY12. In fact, MTCL leads the pack when one looks at the last two years of cash flow performance.

Extremely low margins in three out of the five years (5.1-10.7%) indicate subdued cash performance at **HEXW**. The company's DSOs are stable and no abnormally high capex is on the anvil. Hence, cash flows should improve. Increase in its payout ratio and a clear focus on organic growth are the cues of non-worrying position as far as its cash is concerned.

At **KPIT**, acquisitions have clearly taken their toll, and given the company's continued focus on growth through both organic and inorganic measures, cash flow improvement may have to wait.

Last 5-years cash generation contrasts EV among Tier-II companies

EV-FCF contrast going by last 5 years' cash generation (INR m)

	Mindtree	Hexaware	KPIT Cummins	NIIT Tech	Persistent
FY08-FY12 OCF	7,509	4,591	4,693	7,966	6,288
FY08-FY12 FCF	(356)	1,086	715	1,827	2,354
EV	26,023	31,297	23,292	14,121	11,621

Source: Company, MOSL

Pick businesses exhibiting Scalability, Differentiation

HEXW, TECHM with scope to scale, KPIT's differentiation worth the bet

- **Significant discount to Tier-I multiples is justified given: [1] greater revenue dependency on top clients, and [2] higher concerns and volatility in margins.**
- **Our picks are companies which exhibit enough potential to scale and / or are clearly differentiated in their offerings.**
- **We recommend buying HEXW, which continues to scale efficiently, TECH M, where post integration potential for mining in top-accounts remains significant, and KPIT, a niche player where large deals will help margins and offset acquisition-led cash flow pressures.**
- **Margin is our key concern at NITEC and PSYS. MTCL at 8x FY13E is a play on valuations.**

Hexaware Technologies (HEXW) is our preferred pick in the Tier-II IT pack with respect to confidence in its ability to scale and operate at a healthy profit margin. We expect USD revenue CAGR of 18.6% and EPS CAGR of 25% over CY11-13. The stock trades at 8.9x CY13E earnings. We initiate coverage with a **Buy** rating and a target price of INR167, which discounts our CY13E earnings by 12x.

We expect **MindTree (MTCL)** to grow its revenue at a CAGR of 13% and EPS at a CAGR of 28% over FY12-14. The stock trades at 8.2x FY13E and 7.8x FY14E earnings. Our target price of INR882 implies 29% upside, and discounts FY14E earnings by 10x. The company's revenue dependency in intensely competitive areas demands more differentiation, though valuations remain attractive. We initiate our coverage with a **Buy**.

KPIT Cummins (KPIT) is clearly the most differentiated business within the tier-II space, with impressive expertise in its chosen areas. We expect USD revenue CAGR of 27% and EPS CAGR of 33% over FY12-14E. Our target price of INR156 discounts FY14 earnings by 11x. Revolo represents an option value in the stock. We expect large deals to help sustain margins and offset cash flow headwinds from acquisitions. We initiate our coverage on KPIT with a **Buy**.

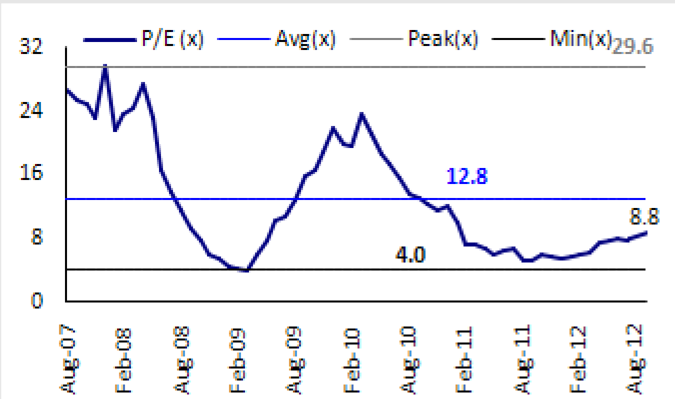
Increasing number of large orders from the government threaten to dent affected **NIIT Tech's (NITEC)** healthy cash flow conversion and operating profit margin. Further, the company's focus on expanding its order book to grow top-line could drive aggressive deal structuring, making us more cautious on its margins. We value NITEC's business at 8x FY14E earnings, given margin concerns (especially outside GIS and ROOM) and risk to balance sheet from high proportion of government contracts. Our target price is INR317. We initiate our coverage on NITEC with **a Neutral** rating.

We like **Persistent Systems' (PSYS)** chosen areas of play and its capabilities in the same. However, lack of predictability in a tough environment, coupled with concerns around margins and concentration risks (82.5% of FY12 revenue from US, revenue from top-10 clients up from 43.8% in FY10 to 48.6% in FY12) will constrain valuation multiples. Our target price for PSYS is INR476 (9x FY14E EPS). Greater visibility on revenue and factors that could limit headwinds to margins will be the key to higher confidence in the stock. We initiate coverage with a **Neutral** rating.

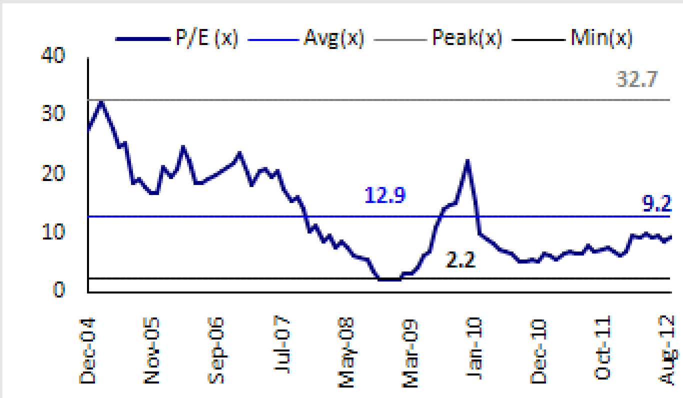
Tech Mahindra's TECHM performance outside BT has been commendable, and so has the turnaround at Satyam. Post the acquisition of HGS, Comviva and merger with Satyam, the share of BT is likely to fall to ~15%. Risk of revenue decline from the top client loom over the near-to-medium term, and BT's continued stake sale in TECHM is also a potential overhang. However, given the scale and capabilities that the merged entity has on offer, the potential to grow through better mining from existing accounts remains exciting, especially at Mahindra Satyam. We estimate the combined entity revenue at USD2.7b for FY13 and at over USD3b for FY14, with PAT of INR19b and INR20b, respectively. The stock trades at 10.5x FY13E and 9x FY14E EPS. We upgrade TECHM to **Buy**, with a price target of INR1,110, which discounts our FY14E EPS by 11x.

P/E bands

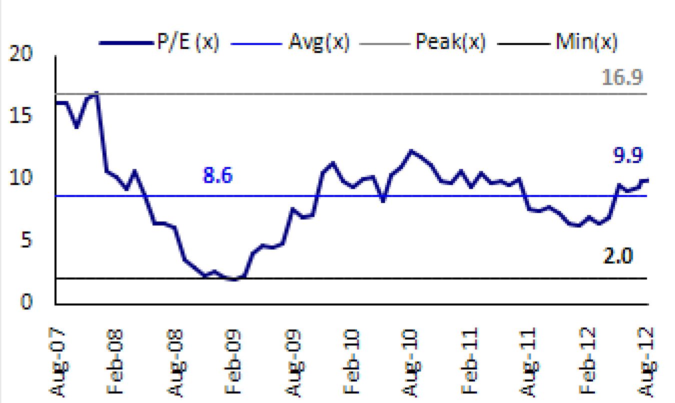
MindTree



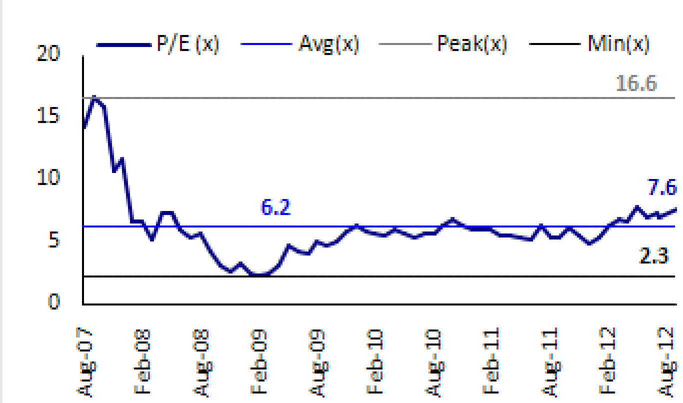
Hexaware Technologies



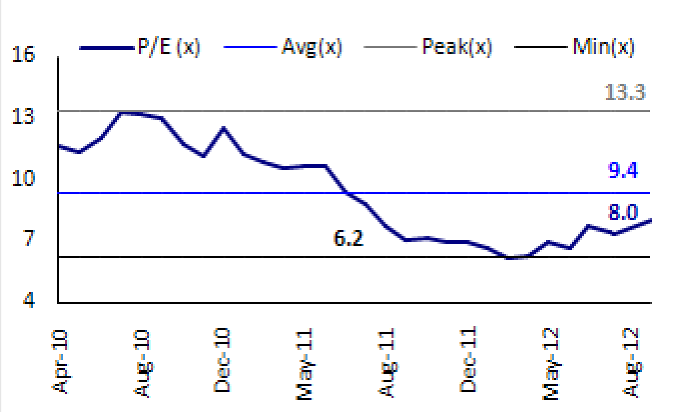
KPIT Cummins



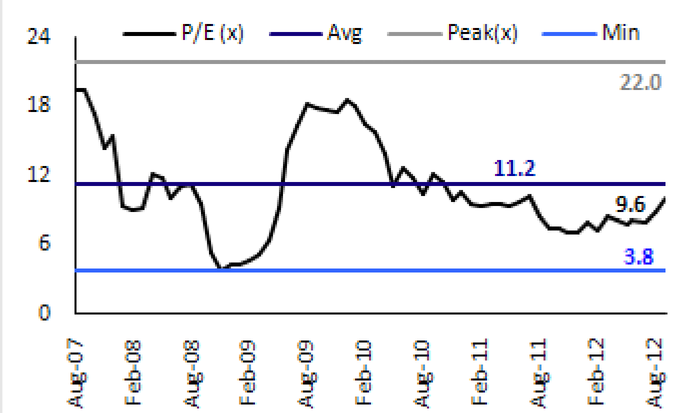
NIIT Tech



Persistent Systems



Tech Mahindra



Companies

BSE Sensex: 18,673 **S&P CNX: 5,670** **24 September 2012**

Hexaware Technologies

BSE SENSEX	S&P CNX
18,673	5,670

Bloomberg	HEXW. IN
Equity Shares (m)	295.7
52-Week Range (INR)	142/72
1,6,12 Rel. Perf. (%)	-4/0/52
M.Cap. (INR b)	36.8
M.Cap. (USD b)	0.7

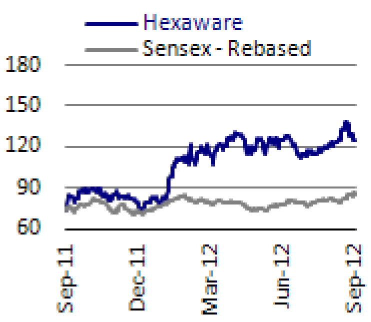
Valuation summary (INR b)

Y/E December	2011	2012E	2013E
Sales	14.5	19.8	23.2
PAT	2.7	3.6	4.2
EPS (INR)	8.9	12.1	13.9
EPS Gr. (%)	319.3	35.4	15.1
P/E (x)	14.5	10.3	8.9
P/BV (x)	3.7	3.7	3.4
RoE (%)	26.3	33.3	32.6
RoCE (%)	23.6	38.3	37.6
EV/Sales (x)	2.2	1.6	1.3
EV/EBITDA (x)	12.3	7.2	6.0

Shareholding pattern %

As on	Jun-12	Mar-12	Jun-11
Promoter	27.9	28.0	28.2
Dom. Inst	8.7	9.6	7.4
Foreign	52.6	51.4	48.5
Others	10.8	11.1	16.0

Stock performance (1 year)



CMP: INR124 | **TP: INR167** | **Buy**

Scaling efficiently

Building large deal prowess; Best dividend payout; Initiating with Buy

- **Hexaware Technologies (HEXW) is our preferred bet in the tier-II IT space exhibiting strong scalability potential. We estimate USD revenue CAGR of 18.6% over CY11-13.**
- **Its strategy to penetrate accounts through its areas of strength has proven successful; and decision to restrict to pure services deals reduces risks around revenue quality.**
- **~50% payout ratio is the best in the industry, deserving of higher multiples. The stock trades at 8.9x CY13E earnings. Buy with a target price of INR167 (12x CY13E earnings).**

Right strategy for a relatively small player

We believe HEXW's decision to develop core competence and differentiation in key areas - Capital Markets, Travel and Transportation, EAS and Testing - is the right approach for a relatively small player. The 'foot-in-the-door' obtained from flagship services like PeopleSoft helped it forge relationships, strengthened further by cross-selling services like IMS and BPO. Results of the approach are visible in the 6 large deals that HEXW has won in as many quarters. It continues to chase many more deals that are in the pipeline, now also from new customers.

Large deal references + expanding gamut of offerings = scalability

HEXW is our preferred bet in the tier-2 IT space as far as scalability potential is concerned. Large deals won by the company act as strong references in facilitating similar such wins in the future. It now has four services contributing more than 10% of its revenue v/s two, only two quarters ago.

Potential upgrade of PeopleSoft to help maintain growth trajectory

CQGR of 10.6% in EAS over last 8 quarters is largely attributed to upgradation of PeopleSoft users to version 9.1. Slowing discretionary environment has however, led to some EAS moderation in the last 3 quarters. Oracle may release a new version of PeopleSoft in CY13, and HEXW is well placed to tap that opportunity.

Focus on pure services reduces risks around revenue quality and margins

HEXW has restricted itself to pure services deals, reducing the risk around revenue quality. Despite the aggressive pursuit involved in the same, our margin concerns are alleviated by the comfort we take in: [1] scale of operations, now that much larger-sized deals are driving growth, [2] incrementally greater offshoring in such deals over the tenure, and [3]option to improve the pyramid over time .

Potential to scale, efficiency levers, healthy payout - Buy

In USD terms, we estimate revenue CAGR of 18.6% and EPS CAGR of 25% over CY11-13. The stock trades at 8.9x CY13E earnings. HEXW's ~50% payout ratio is among the best in the industry, deserving of higher multiples.We initiate coverage with a Buy and a target price of INR167 (~34% upside), which discounts our CY13E EPS by12x.

Hexaware Technologies

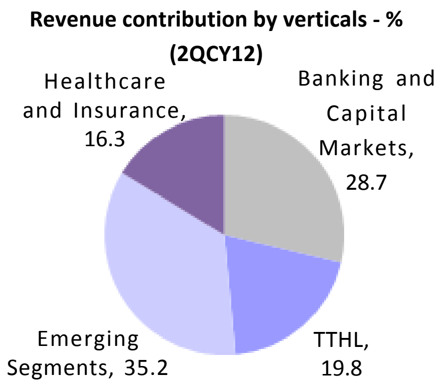
MID Score|Discount: **75|25%** CY13 P/E: **12x**

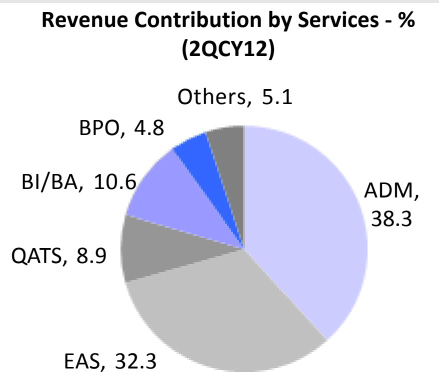
M : 4 / 5 Management focus and Strategy

- Hexaware is a leading global provider of IT & BPO and consulting services. The Company focuses on key domains such as BFSI, Travel, Transportation, Logistics, Life Sciences and Healthcare. Hexaware focuses on delivering business results and leveraging technology solutions by specializing in Business Intelligence & Analytics, EAS, Testing, RIMS and Legacy Modernization.
- Atul Nishar is the Founder & Chairman of Hexaware Technologies Limited, a company that he set up in India in 1990. Atul Nishar is a FCA (Fellow of the Institute of Chartered Accountants of India) and received his Bachelor Degrees in Commerce and Law from University of Bombay.

I : 10.5/15 IT Mix

- **Verticals (3.5/5):** large part of BFSI comes from Capital markets. Healthcare, Insurance and Travel are the other major verticals.
- **Geography (4/5):** Sizeable presence in Europe (~29% of revenues) but limited penetration in emerging economies (~7% revenues).
- **Services (3/5):** PeopleSoft comprises of nearly 1/4th of revenues, where HEXW enjoys clear leadership. Services outside PeopleSoft and BI commoditized.





D : 8 / 10 Deals

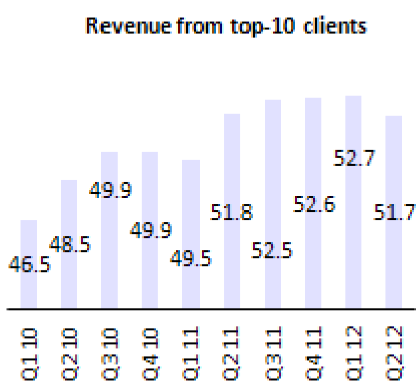
- 8 large deals over the last couple of years substantiate the company's deal signing prowess. Continues to chase 4 large deals in the pipeline

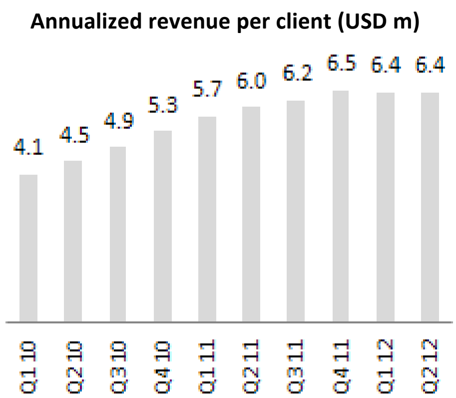
Jul-10	USD 60m over 5 years
Jul-10	USD110m over 5 years
Apr-11	USD10-15m annually in ADM and RIMS
May-11	USD25m+ in IMS over 3 years
Jul-11	USD177m in multiple services

Nov-11	USD250m in multiple services
Mar-12	2 deals USD10m+ each
Jun-12	BOT deal USD100m over 4 years

C : 7 / 10 Client Concentration

- Revenue contribution from top-10 clients has increased from 46.5% in 1QCY10 to 52% in 2QCY12.
- Ramp-downs in key accounts hurt the company in the previous downturn. Top customer contributes 15% of revenues v/s 8% in 1QCY10.

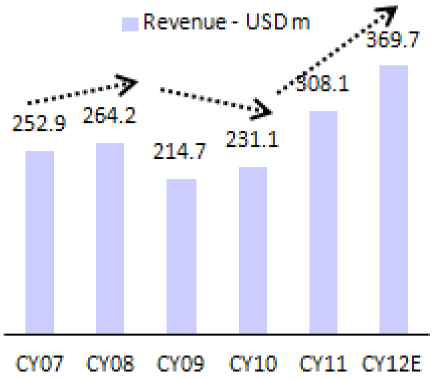


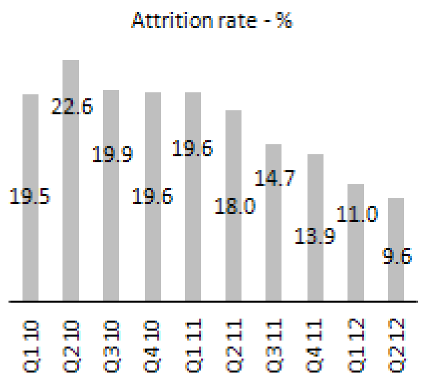


Hexaware Technologies

A: 14.5/20 Ability to scale and Attrition

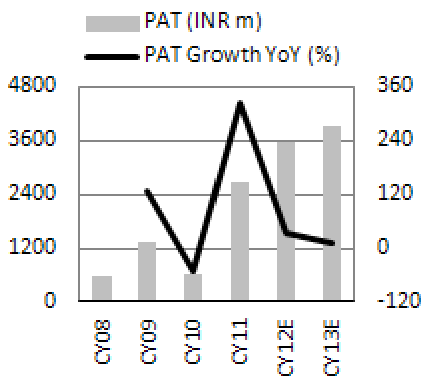
- **Ability to Scale (10.5/15):** Large deals won by the company provide strong references. It now has four services contributing 10%+ each to revenue v/s 2, only two quarters ago.
- **Attrition: (4/5):** Came down to single digits for the first time, better than even the top tier peers

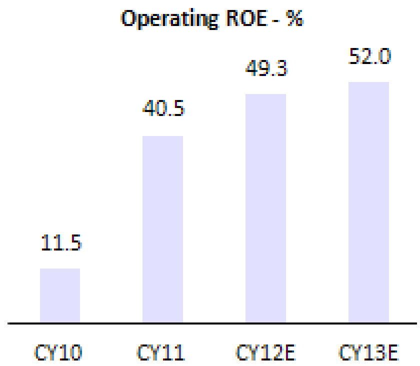




P : 34/40 P: Profit and Payout

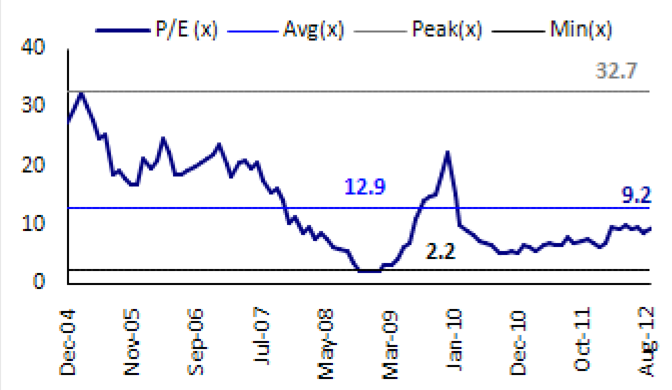
- **Profit Growth (12.5/15):** EPS CAGR of 21.4% over CY11-13, behind only KPIT and MTCL
- **Profit Quality (12/15):** Best operating ROE among the peers (4-year average operating ROE over CY10-13E is 35%+)
- **Payout Ratio (10/10):** At ~50% Payout ratio, HEXW's cash return to shareholders is best in the industry.





MID Score : 78 / 100 | P/E 12x Management focus and Strategy

	Hexaware	Benchmark	
M	Management	5	3.5
I	IT Mix	15	10.0
D	Deals	10	7.0
C	Client Concentration	10	6.0
A	Ability to scale & Attrition	20	14.5
P	Profit & Payout	40	34.0
	TOTAL MID SCORE	**100**	**75.0**
	Discount - %		25.0
	Tier I average target P/E		16.0
	Stock target P/E		12.0
	FY14E EPS - INR		13.9
	Target Price - INR		167
	Upside - %		34
	Rating		**Buy**



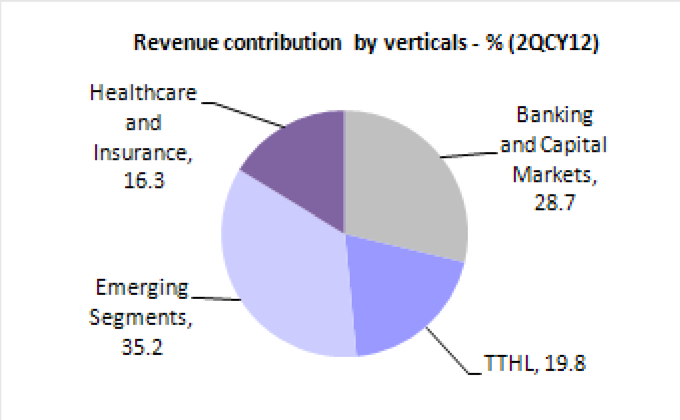
Built expertise in select offerings to carve out differentiated positioning

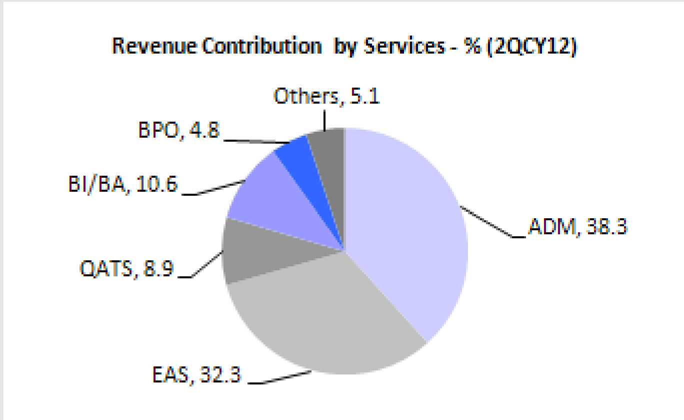
Focused on being the first choice vendor in select services (EAS, QATS, BI) and select verticals (BFSI, Travel/ Transport)

HEXW has developed core competence and differentiation in four key areas - two verticals and two horizontals. It has a strong track record and relationships in:

1. Verticals like (a) Banking, Financial Services and Insurance (BFSI), especially Asset Management Companies (AMCs), which account for over 50% of its BFSI revenue, and (b) Travel and Transportation - e-ticketing, cargo handling, crew scheduling, etc.
2. Service lines like (a) Enterprise Solutions, and (b) BI.

BFS and Travel/Transport are key verticals, EAS and ADM key Services



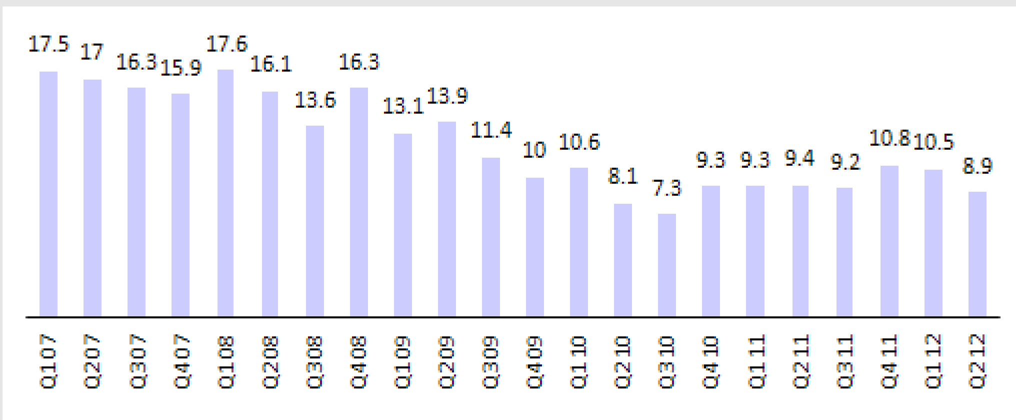


Source: Company, MOSL

QATS (Testing) was one of the focus areas which did not go according to plan in the downturn, but EAS revenues should feed into QATS

In Testing, HEXW acquired a US company called FocusFrame in late 2006 for USD34m. Testing, however, did poorly since then, with revenue contribution declining from 17.5% in 1QCY07 to just 9.2% in 3QCY11, before improving marginally to 10.5% in 1QCY12. However, it remains an area of expertise for the company. We expect Testing (Quality Assurance and Testing Services, QATS) to continue growing, as the pick-up in PeopleSoft sales, manifested in the growth of the EAS segment, should eventually translate into material upside for Testing, as well. In Enterprise Resource Planning (ERP) implementation, the testing phase follows the implementation phase. Hence, there is a lag of a couple of quarters.

Testing as a proportion of revenues picking up after the slide during the downturn



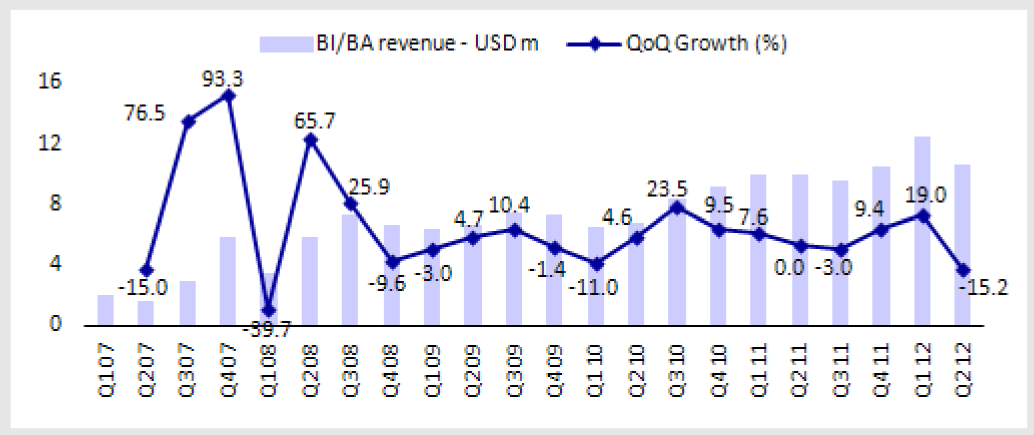
Source: Company, MOSL

Expanding service offerings in quest for multi-service deals

Has done well to scale up smaller services like IMS and BI - testimony to its cross-selling ability

In terms of new growth areas, HEXW is focusing on Healthcare, Infrastructure Management Services (IMS), BPO and Business Intelligence (BI). It has done exceptionally well in BI/Analytics, having grown the business from 6.4% of revenue in 1QCY09 to 12.5% in 1QCY12. Revenue from this segment has grown at a CQGR of 10.4% over the last 12 quarters. HEXW is now working with over 45 of its customers in this segment. Even IMS has been growing well; revenue contribution from this segment is likely to increase to 6% in CY12 from ~4% in CY11.

Revenues from BI/BA grew at a CQGR of 12.5% from 1QCY09 to 1QCY12, before cooling off in 2QCY12



Source: Company, MOSL

Conceptually, we agree with the areas where HEXW is driving its investments. One, there is an increasing trend towards combining IT Services and BPO within deals. Hence, it makes sense driving investments in BPO. Second, within IT Services, customers are increasingly looking at vendors with multi-service capabilities. Hence, it becomes imperative that vendors have capabilities across Testing and IMS, and not just EAS and Application Development and Maintenance (ADM).

The next leg - scaling up through quantum and size of deals

Post foot-in-the-door through flagship services, the company chased larger multi-service deals by cross selling more services

Barring PeopleSoft, where it may have a clear edge over peers, we believe that HEXW operates in a fiercely competitive space, fast getting commoditized. The proposition in such a situation for a company of HEXW's size would be technical expertise and delivery proficiency. Vertical alignment of the organization (similar to that of larger peers like TCS, Infosys and Wipro) may only evolve gradually. This could pose a challenge when it comes to competing for large multi-service deals.

HEXW's focused approach of targeting select offerings has helped it to demarcate its competitive positioning. The period of pent-up demand out of the downturn may just have been the inflexion point for HEXW, setting it back on the high growth trajectory (after the company's revenue de-grew from USD67m in 1QCY08 to USD48.6m in 1QCY10). It has sought to gradually build strengths in more services, adding on to EAS - by acquisitions in Testing (Focus Frame) and BPO (Caliber Point), BI/Analytics and now IMS.

The result of all this has manifested in HEXW winning six deals in as many quarters. Two of the largest deals are ramping-up through CY12, which is one factor driving the company's USD revenue growth guidance of "at least" 20%. On scalability, we like HEXW in the mid-cap space, given that the deal wins will act as strong references in helping it bag similar deals in the future. The company is presently chasing four large deals in the pipeline, each with a contract value of USD25m+, and is in the advanced stages of negotiations in one of them.

Post the 6 deals announced, the company has announced two more deals in the last couple of quarters, and is now chasing 4, in advanced stages in one of them

HEXW has won six deals over the last six quarters, with total contract value (TCV) exceeding USD600m. These include deals from European clients, as well.

Bagged six large deals between July'10 -Nov'11

Date	Size	Description
Jul-10	USD60m	- Contract extension with a multi-billion dollar enterprise
		- Extends over three year period
		- Services cut across EP, BI/BA, QATS
Jul-10	USD110m	- Fortune 500 Client
		- 5-year Period
		- Work to encompass 13 countries in Americas, UK, Continental Europe and APAC
		- ADM, RIMS and extending support and maintenance
Apr-11	USD10-15m annually	- Signed with an existing client in USA to support its Banking and Investment Management business
		- Services Offerings include ADM and support along with RIMS
May-11	USD25m+	- Remote IMS business in excess of USD25m over 3 years
		- Successful cross-sale of RIMS to an existing client, based out of Europe, in multi-vendor scenario
		- Expects to deploy 150+ employees on this engagement globally
Jul-11	USD177m	- USD77m existing business and USD100m potential from incremental business
		- spread over five years in the IMS and BPO space with an existing client based out of North America.
		- Services offered - ERP, BI / BA, QATS, BPO and ADM
Nov-11	USD250m	- Contract for 5 years starting January 2012
		- Client to be served by a team of 800 personnel from Chennai, Mumbai, Pune and Mexico
		- Client headquartered in UK
		- USD60m worth of incremental business
		- Services offered include ERP, BI/BA, QATS, ADM and RIMS

HEXW continues to chase large deals (USD25m+), with as many as six in the pipeline and two in advanced stages of negotiations as at the end of 1QCY12. Also, the pipeline now consists of a higher proportion of deals from new customers.

Growth visibility amidst uncertainty lends comfort

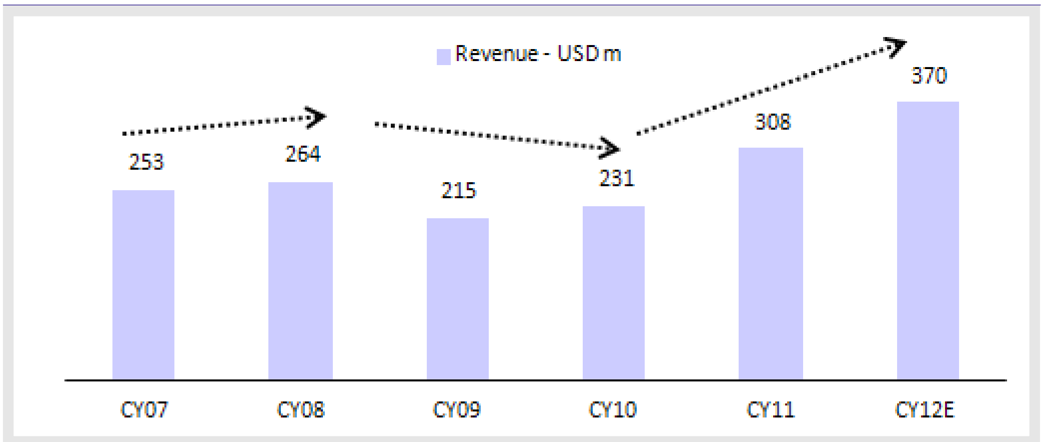
Ramp-up in couple of large deals lend growth visibility, so-far-so-good as far as 20%+ revenue growth outlook for CY12 is concerned

In comparison to Nasscom's 11-14% growth outlook for the industry, HEXW guided for a minimum of 20% revenue growth in CY12 in USD terms, and is well on track to achieve this, with half the year over. Factors driving the company's positive outlook are three-fold:

- HEXW's top 10-20 clients are expected to have a good year as far as CY12 is concerned; while they may have flat to marginally positive budgets next year, it should still translate into healthy growth for the company.
- Deal pipeline remains strong. The company is chasing four deals with a TCV of over USD25m+ each, and is in advanced stages in one of them. A couple of them are new clients, as compared to large deals earlier coming from existing clients. Also, the nature of growth will be broadbased like CY11, with every geography, vertical and horizontal expected to kick in.
- Continued expectation of 6-8% revenue contribution from new business, ramp-up in large deals signed earlier (USD177m and USD250m) over the next 3-4 quarters and a strong current pipeline lend confidence to growth expectations.

Change in revenue growth trajectory reflects the company positioning in a much stronger footing than before

Strong revenue visibility lent by large deal signings

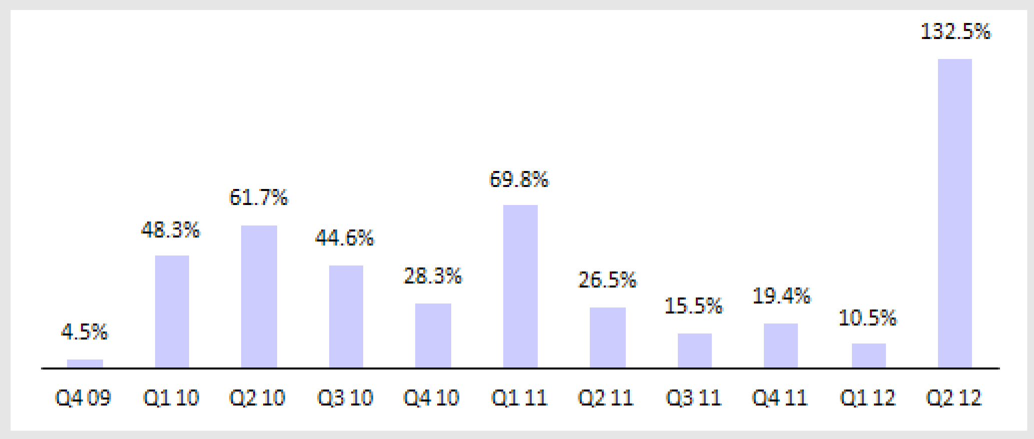


Source: Company, MOSL

PeopleSoft continues to drive EAS; new version could spell more opportunity

PeopleSoft, which contributes ~75% of HEXW's EAS revenue, has been chiefly instrumental in the meteoric growth of the segment over the past four quarters. EAS has contributed 42% of the company's overall incremental revenue over the past 8 quarters, during which period its contribution to total revenue increased from 23.4% to 29%. EAS revenue grew at a CQGR of 10.6% over the last 8 quarters. This was largely owing to the upgradation of clients' PeopleSoft applications to the new 9.1 version.

PeopleSoft's contribution to incremental revenues



Source: Company, MOSL

High contribution to incremental revenues from EAS is attributed to healthy growth in PeopleSoft

Post the release of the latest version in the beginning of CY10, PeopleSoft saw a gradual ramp-up that year, followed by significant growth in CY11. This has largely contributed to the 10.6% CQGR in HEXW's EAS revenue over the last 8 quarters.

Despite the growth, its current penetration stands at 40-50% of the potential clients. We were uncertain on the pace of further implementation in the last couple of quarters due to two factors: [1] possible deferral of upgrading to the 9.1 version, given the macro environment and the discretionary nature of the spend, and [2] expectation of rollout of PeopleSoft 9.2 sometime in CY13.

Revenues from EAS have softened in the last 4 quarters, but release of new PeopleSoft version by Oracle could spell further opportunity

Over the last four quarters, the CQGR declined to 3.5%, much in line with our expectations. The new version of PeopleSoft is currently undergoing testing. Given that HEXW too has a part to play in this, it gives it an early advantage in terms of getting to know the functionalities and the features. We believe HEXW is well placed to tap the next wave of growth opportunity through PeopleSoft.

Even outside PeopleSoft, HEXW is diversifying into other Enterprise Applications as well, especially into Oracle implementation and even SAP in certain instances. Couple of recent large deals had an Oracle implementation component built in as well, and one of which had SAP too, which has helped the company to create a strong reference point for garnering future wins. The company sees particular opportunities in the Asia Pacific region. This diversification should aid growth in EAS, as well.

PeopleSoft helps provide a foot-in-the-door to offer more services

Apart from the direct opportunity from PeopleSoft through implementation, there is an indirect opportunity in the form of potential cross-selling of more services to the customer. In that regard, HEXW's PeopleSoft advantage gives it a competitive edge, triggering a relationship with the client. This is substantiated by the fact that all the large deals won by HEXW came from existing clients, and many of them would have been accessed through PeopleSoft.

Focus on pure services reduces risks around revenue quality and margins

HEXW's pure services nature of deals lend more comfort in terms of execution and margin risks

We understand that for a company of HEXW's size and scale, it is imperative that the company shows substantial aggression in its bid strategies when pursuing deals larger than its current portfolio. The management, too, has not shied away from admitting the fact. While this may be margin dilutive for the near-to-medium term, we remain sanguine on the margin prospects over the long term, as benefits start to kick-in from: [1] scale of operations, now that much larger-sized deals are driving growth, [2] incrementally greater offshoring in such deals over the tenure, and [3] option to improve the pyramid over time.

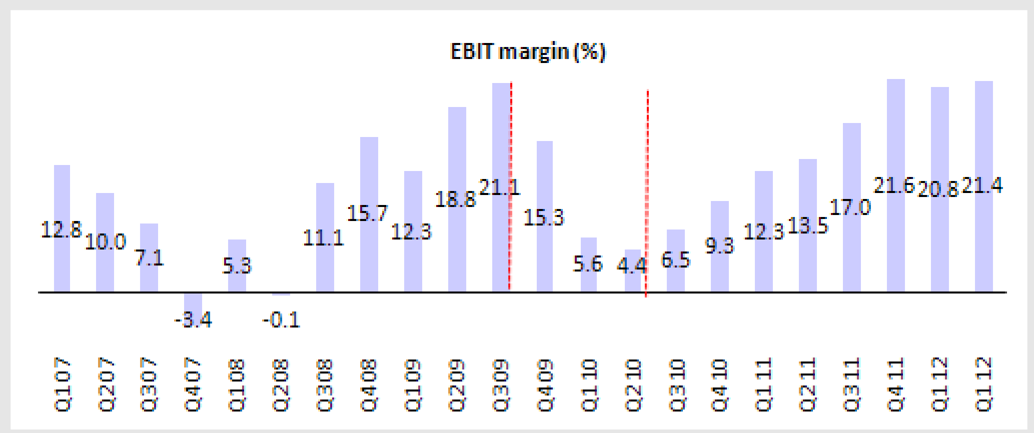
Another important aspect of these contracts is the pure services nature of the work won by the company. This is unlike many large deals announced in the recent few quarters by some peers, a large part of which was hardware. Deals involving hardware yield negligible margins and though they boost revenue growth, they act as a dampener on the profitability front. It also suggests that HEXW's strategy has begun to pay dividends and it has not had to take the 'deal-at-any-cost' route to deliver growth.

Expect stable margins going forward

Over the 8 quarters between 3QCY07 and 3QCY09, HEXW saw wild margin fluctuations, with its EBIT margin ranging from -3% to +21%. A myriad of factors such as currency movements, economic slowdown and salary cuts played on the margins. Even out of the downturn, restoration of wage hikes, INR appreciation and transition costs on large deals meant that there was little respite on margin volatility - EBIT margin plunged to 4.4% in 2QCY10. As the transition phase subsided, HEXW again saw six consecutive quarters of margin improvement - back to 20.8% in 1QCY12.

Volatile margins have made way for gradual margin recovery in the last few quarters, thanks to growth, offshoring and currency

Surge in margins aided by growth, offshoring and currency; expect stability going forward



Source: Company, MOSL

Ramp-ups in large deals over the next couple of quarters may imply higher onsite efforts towards these deals. Despite that, on a full-year basis, HEXW expects to improve the proportion of offshore revenue. It has already seen a surge in its offshore mix by ~700bp over the last six quarters.

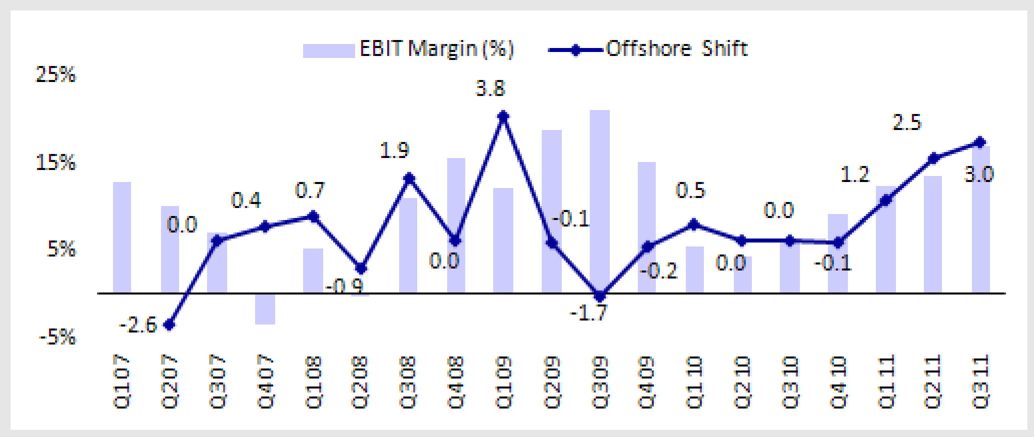
We share management's confidence on stable margins close to the range of current high levels

Apart from offshoring, other margin levers at the company's disposal include:

1. Scale benefits from growth
2. Improvement of the employee pyramid - HEXW added 600 freshers in CY11 and has guided addition of another 650 freshers in CY12
3. Improvement in utilization - while utilization may not change materially in the near term, HEXW will look to increase the same, as growth rates moderate from the current 20%+ levels.

We expect HEXW to deliver better margins in CY12 despite 9.9pp improvement in CY11 to 16.5%. Aided by favorable currency movement, we estimate CY12E EBIT margin at 21.1%, up 460bp.

Offshore shift has been a factor in margin growth



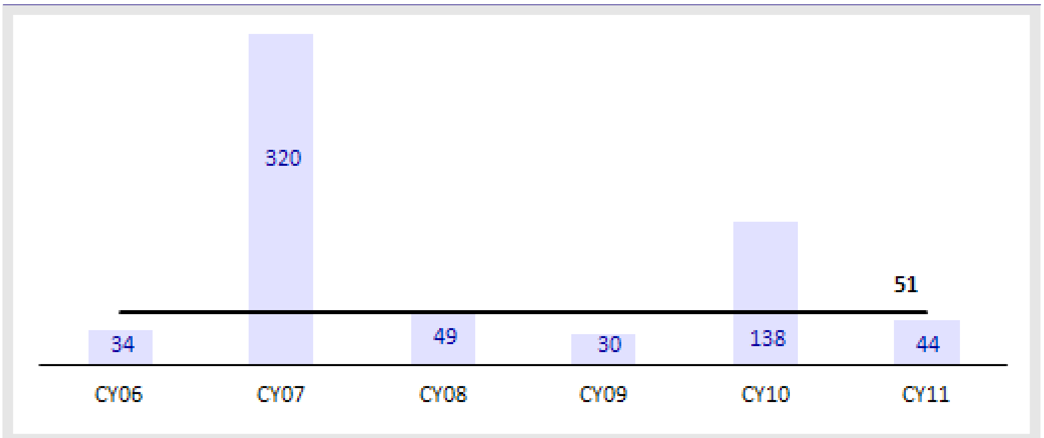
Source: Company, MOSL

Payout ratio among the best in the industry

High payout ratio compared to peers makes a case of better multiple

Hexaware has maintained a policy of paying out nearly half its reported PAT, a ratio that is expected to continue into the future. Over CY06-11, the company has paid out 51% of its aggregated profits as dividends to investors. The company's payout ratio is among the best in the industry, and makes a case for higher multiple to peers like KPIT, where organic growth is similar, margins lower and cash flows stressed.

Aggregate payout over CY06-CY11 is 51%(Payout ratio %)



Source: Company, MOSL

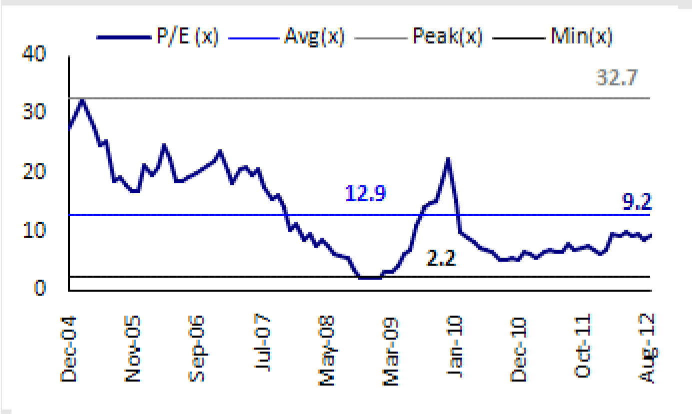
The company continues to scale efficiently, Buy

Scalability, stable margins, healthy payout - Buy

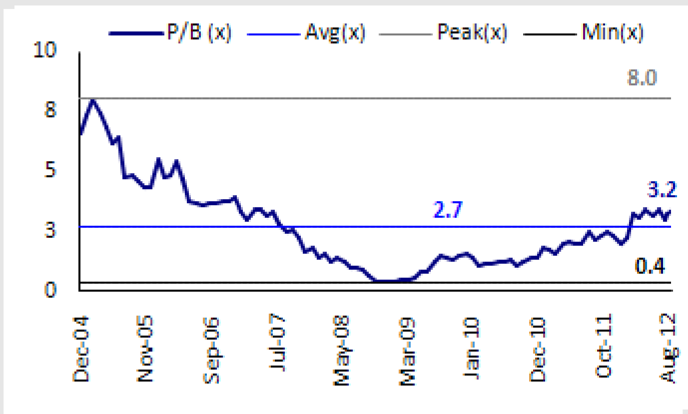
We believe HEXW is one of the very few tier-2 IT companies with the ability to scale up and operate at healthy profit margins. In USD terms, we estimate revenue CAGR of 18.6% and EPS CAGR of 15% over CY11-13. The stock trades at 8.9x CY13E earnings. Our EBIT margin estimate is 21% for CY12 and 20.7% for CY13. We value HEXW at 12x CY13E earnings, at a premium its mid-cap peers, given cleaner revenues, stable margin expectation and a healthy payout ratio. We initiate coverage with a **Buy** rating and a target price of INR167 (34% upside), which discounts our CY13E EPS by 12x.

The key risk to our argument remains the threat to financials from aggressive deal structuring, which could go wrong. While recent deal wins augur well, in a slowing growth environment and fast commoditizing space, we see increasing competition from even the larger players for smaller ticket work. This will require companies like HEXW to stretch themselves further in their quest to gain share, risking a situation of winner's curse.

Hexaware PE Chart



Hexaware PB Chart



Financials and Valuation

Income statement (INR Million)

Y/E December	2009	2010	2011	2012E	2013E
Sales	**10,386**	**10,545**	**14,505**	**19,812**	**23,173**
Change (%)	(9.8)	1.5	37.6	36.6	17.0
Cost of Services	5,643	6,915	8,939	11,843	14,155
SG&A Expenses	2,720	2,692	2,920	3,511	3,903
EBITDA	**2,023**	**938**	**2,646**	**4,458**	**5,115**
% of Net Sales	19.5	8.9	18.2	22.5	22.1
Depreciation	270	242	248	306	313
Other Income	927	745	181	448	528
PBT	**2,680**	**1,441**	**2,579**	**4,601**	**5,331**
Tax	103	92	407	929	1,173
Rate (%)	3.8	6.4	15.8	20.2	22.0
PAT	**2,577**	**1,349**	**2,172**	**3,672**	**4,158**
Extraordinary	-	224	-	-	-
Net Income	**2,577**	**1,125**	**2,172**	**3,672**	**4,158**
Change (%)	91.3	(56.3)	93.1	69.0	13.2

Balance Sheet (INR Million)

Y/E December	2009	2010	2011	2012E	2013E
Share Capital	290	291	587	593	592
Reserves	8,208	9,601	9,575	10,249	12,176
Net Worth	**8,498**	**9,892**	**10,162**	**10,842**	**12,768**
Loan and other long term liab.	163	112	-	-	-
Capital Employed	**8,661**	**10,004**	**10,162**	**10,842**	**12,768**
Gross Block	5,762	5,598	6,482	6,534	7,454
Less : Depreciation	1,404	1,519	1,697	1,737	2,058
Net Block	**4,358**	**4,079**	**4,785**	**4,797**	**5,396**
Curr. Assets	6,901	8,092	9,545	9,963	12,668
Debtors	1,526	1,919	2,993	2,539	3,308
Cash & Bank Balance	4,262	4,753	4,606	4,906	6,352
Loans & Advances					
Other Current Assets	1,113	1,420	1,946	2,518	3,007
Current Liab. & Prov	**2,709**	**2,336**	**4,331**	**4,061**	**5,365**
Current Liabilities	444	(213)	881	349	1,155
Other liabilites	2,265	2,549	3,450	3,712	4,210
Net Current Assets	**4,192**	**5,756**	**5,214**	**5,902**	**7,302**
Deferred Tax	110	169	162	143	70
Application of Funds	**8,660**	**10,004**	**10,161**	**10,842**	**12,768**

E: MOSL Estimates

Financials and Valuation

Ratios

Y/E December	2009	2010	2011	2012E	2013E
Basic (INR)					
EPS	**4.5**	**2.1**	**8.9**	**12.1**	**13.9**
Cash EPS	5.5	2.9	9.9	13.1	15.0
Book Value	28.8	33.5	34.4	36.3	42.7
DPS	1.4	3.0	4.0	6.0	6.0
Payout %	30.1	137.9	43.9	48.7	42.3
Valuation (x)					
P/E			13.9	10.3	8.9
Cash P/E			12.6	9.5	8.3
EV/EBITDA			11.8	7.1	5.9
EV/Sales			2.2	1.6	1.3
Price/Book Value			3.6	3.4	2.9
Dividend Yield (%)			3.2	4.8	4.8
Profitability Ratios (%)					
RoE	17.8	6.8	26.6	34.4	35.2
RoCE	25.3	11.8	24.0	34.7	35.2
Turnover Ratios					
Debtors (Days)	54	66	75	47	52
Fixed Asset Turnover (x)	2.4	2.6	3.4	4.2	4.7

Cash Flow Statement (INR Million)

Y/E December	2009	2010	2011	2012E	2013E
CF from Operations	1,309	685	1,991	3,529	3,942
Cash for Working Capital	201	(563)	(578)	(248)	(317)
Net Operating CF	**1,511**	**122**	**1,413**	**3,281**	**3,625**
Net Purchase of FA	(82)	542	(629)	(448)	(800)
Net Purchase of Invest.	(1,140)	1,140	454	419	528
Net Cash from Invest.	**(1,222)**	**1,682**	**(175)**	**(29)**	**(272)**
Proc. from equity issues	2	32	37	5	-
Proceeds from LTB/STB	(42)	(74)	(234)	-	-
Dividend Payments	(183)	(233)	(1,243)	(2,072)	(2,076)
Cash Flow from Fin.	(223)	(275)	(1,439)	(2,067)	(2,076)
Net Cash Flow	**66**	**1,529**	**(201)**	**1,186**	**1,278**
Opening Cash Bal.	**2,849**	**4,262**	**4,753**	**4,606**	**4,906**
Add: Net Cash	66	1,529	(201)	1,186	1,278
Closing Cash Bal.	**4,262**	**4,753**	**4,606**	**4,906**	**6,352**

E: MOSL Estimates

KPIT Cummins

BSE SENSEX	S&P CNX
18,673	5,670

Bloomberg	KPIT IN
Equity Shares (m)	182.5
52-Week Range (INR)	142/68
1,6,12 Rel. Perf. (%)	-6/53/54
M.Cap. (INR b)	23.4
M.Cap. (USD b)	0.4

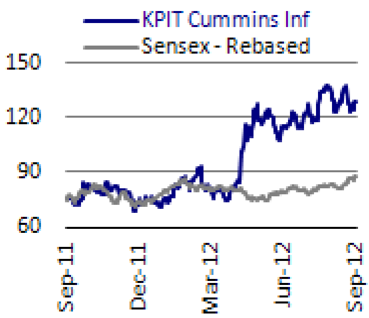
Valuation summary (INR b)

Y/E March	2012	2013E	2014E
Sales	14.9	22.6	26.3
PAT	1.2	2.3	2.6
EPS (INR)	8.0	12.5	14.2
EPS Gr. (%)	41.4	56.0	13.6
P/E (x)	16.0	10.2	9.0
P/BV (x)	3.3	2.6	2.0
RoE (%)	22.4	28.7	25.4
RoCE (%)	20.6	32.6	29.8
EV/Sales (x)	1.5	1.1	0.9
EV/EBITDA (x)	10.9	6.6	5.4

Shareholding pattern (%)

As on	Jun-12	Mar-12	Jun-11
Promoter	26.3	26.4	26.9
Dom. Inst	16.3	16.5	17.2
Foreign	33.1	31.0	30.8
Others	24.4	26.1	25.1

Stock performance (1 year)



CMP: INR128	TP: INR156	Buy

A bet on clear differentiation

Niche player; successful integration of acquisitions

- **KPIT Cummins (KPIT) has carved out a niche for itself, with special focus on the Automotive, Energy and Utilities, and Industrial Equipment industries.**
- **Not only is it a rare example in Indian IT of successfully integrating multiple acquisitions, its organic growth was equally impressive - 39.5% in FY11 and 37% in FY12 (and 21-24% guidance in FY13).**
- **Acquisitions have impacted profitability and free cash flows. Large deals' execution will help offset margin pressures.**
- **The stock trades at 10.2x FY13E and 9x FY14E earnings. We initiate coverage with a Buy rating and a target price of INR156 (11x FY14E earnings).**

Differentiation with select vertical focus - a prudent strategy

KPIT has carved out a niche for itself, with special focus on the Automotive, Energy and Utilities, and Industrial Equipment industries. Building upon its strong domain knowledge, it has broadened its offerings by acquiring capabilities in enterprise services through acquisitions of Sparta, Systime and CPG. KPIT's USD revenue has grown at a CAGR of 41% over FY10-12. Organic growth was 39.5% in FY11 and 37% in FY12.

Vision of billion dollar revenue by 2017, no diversification of focus

According to Deloitte's Auto Transformation Report, by 2020, electric vehicles and other green cars will represent up to a third of total global sales in developed markets and up to 20% in urban areas of emerging markets. Considering the huge growth opportunity, KPIT has stated its vision to achieve revenue of USD1b by 2017, by continuing to operate in focus areas.

Acquisitions have marred profitability, free cash flows

KPIT's EBITDA margin has contracted from 22% in FY10 to 14% in FY12, driven by [1] onsite presence of acquired entities (onsite revenue proportion increased from 40% in FY10 to 48% in FY12), and [2] wage hikes out of the downturn to a lateral employee base. Management's guided EBITDA band is 15-18%, which should sustain given [1] improving acquisition profitability, and [2] large deals execution. Aggregate free cash flow (FCF) over the last 6 years has struggled, understandably given that cash payback will have to wait for a few years.

A bet on Differentiation, option value from Revolo - Buy

We expect KPIT's USD revenue to grow at a CAGR of 27% and EPS to grow at a CAGR of 33% over FY12-14. Success in chasing large deals along with greater offshoring will drive profitability and cash flow improvement, though FCF will continue to remain stressed in the near-medium term on USD45m impending payouts. We initiate coverage with a **Buy**, with a Price target of INR156 (22% upside), which discounts our FY14E EPS by 11x. The company's hybrid engine foray through Revolo remains an option value for the stock.

KPIT Cummins

MID Score|Discount: **68.5|31.5%** FY14 P/E: **11x**

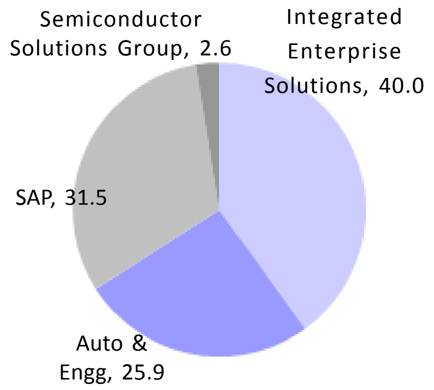
M : 4/5 Management focus and Strategy

- KPIT is a leading technology solutions partner for global Manufacturing corporations with special focus on Automotive, E&U, Industrial Equipments, and Semiconductor industries. The company has a 7,700+ strong team, and it has has 38 patents in Automotive and Semiconductor domains. Its familiarity and deep focus in chosen areas enables it to be specialized providers for its customers.
- Ravi Pandit is the Chairman & Group CEO at KPIT. Ravi is a gold medalist and fellow member of the Institute of Chartered Accountants of India. Holding a Masters from Sloan school of Management, he has extensive experience of over 3 decades in the fields of Information Technology. From his accounting roots, Mr. Pandit, along with his team, has built the global IT, engineering & BPO services company KPIT Cummins, with leadership in sharply defined focus areas

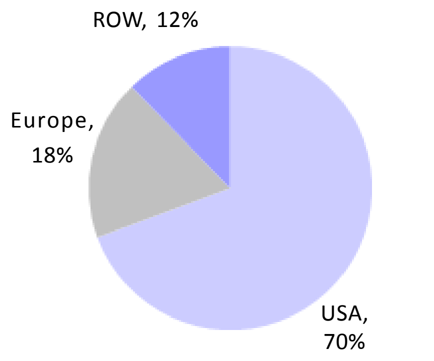
I : 10.5/15 IT Mix

- **Industry Mix (3.5/5):** Automotive, transportation and manufacturing contribute 72.5% to revenues and E&U contributes ~14%.
- **Services Mix (3.5/5):** Skewed in favor of EAS (76%) after multiple acquisitions in SAP (32% of revenues) and Oracle (44% from Oracle and J D Edwards).
- **Geography mix (3.5/5):** Acquisitions have increased the dependence US to 76% of revenues.

LOB-wise revenues - %



Geo-wise revenues - %



D : 8 / 10 Deal signing prowess

After attaining capabilities in various service lines that cater to its focus verticals (organically and inoragnically), KPIT's focus has now shifted to bagging large deals.

FY12 Substantiation:

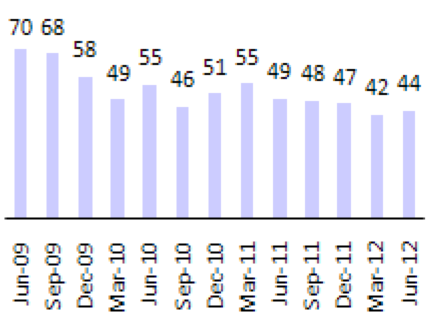
- 3 USD20m+ deals in 2HFY12
- USD60m deal bookings in IES
- USD50m+ orders won in Automotive & Engineering
- USD100m+ orders won in SAP

"Strong vertical focus and expertise has helped us to really increase large deals, so earlier where we were winning $5 million and now we are winning $10 million deals and as we can see last year we have won three $20 million plus deals and we believe that is how we will be in a position to win $10 million plus deal on ongoing basis and a few $20 million plus deal in next year."

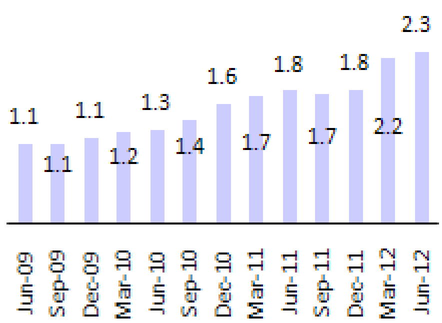
C : 7 / 10 Client Concentration

- Revenue proportion from Cummins reduced from 40%+ in 1QFY10 to 21% in 1QFY13. Multiple acquisitions have helped reduce dependency on the account
- The dependency is set to decline further as the company guided for 32-25% USD revenue growth in FY13, while Growth in Cummins account is expected to be ~12%.

Revenue proportion from top-10 customers (%)



Annualized revenue per client - USD m

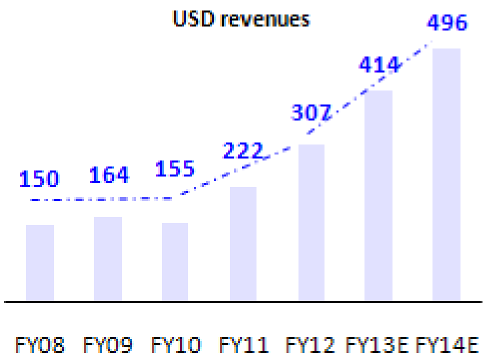


KPIT Cummins

A: 14/20 Ability to scale and Attrition

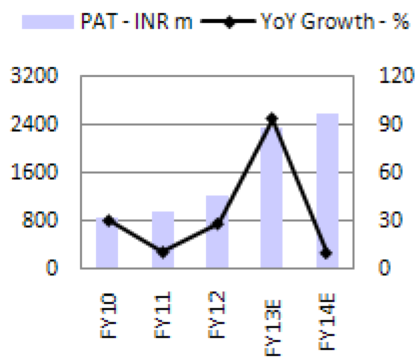
- **Ability to scale (12/15):** Acquisitions have equipped KPIT with wider array of services to offer its client in focus verticals; large deals in which will facilitate scalability.
- **Attrition (2/5):** LTM attrition in 4QFY12 was 18.2% and 17% in 1QFY13, on the higher side in the current environment.

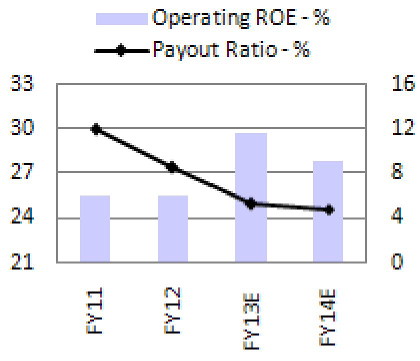
Acquisitions	
Sparta	USD 26m revenues
In2Soft	EUR3m top-line in CY10
CPG	USD8.33m revenues
Systime	USD53m revenues



P : 26/40 P: Profit and Payout

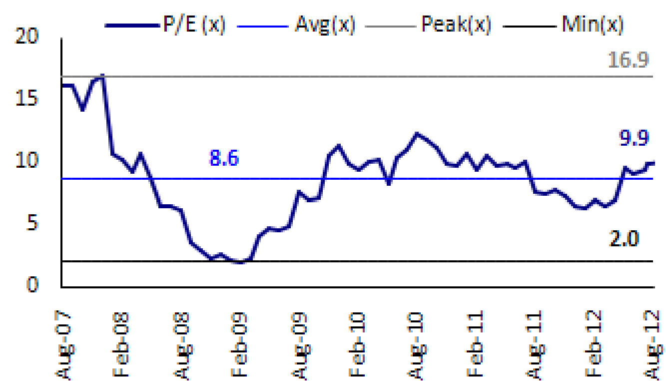
- We expect KPIT to lead EPS growth among the midcap pack with a CAGR of 33% over FY12-14.
- Also, FCF has been negative over the past 6 years and with impending payouts totaling USD45-50m over the next 2 years, near term may not throw any positive surprises.





MID Score : 69.5 / 100 | P/E 11x

Hexaware	Benchmark	
M Management	5	4.0
I IT Mix	15	10.5
D Deals	10	7.0
C Client Concentration	10	7.0
A Ability to scale & Attrition	20	14.0
P Profit & Payout	40	26.0
TOTAL MID SCORE	**100**	**68.5**
Discount - %		31.5
Tier I average target P/E		16.0
Stock target P/E		11.0
FY14E EPS - INR		14.2
Target Price - INR		156
Upside - %		22
Rating		**Buy**



Differentiation with select vertical focus - a prudent strategy

KPIT stands out on two fronts among Tier-II IT - differentiated proposition carving out a niche in Automotives and successful integration of multiple acquisitions

KPIT is one of the few tier-II IT companies in India, with a clearly differentiated strategy. It has carved out a niche for itself, with special focus on the Automotive, Energy and Utilities, and Industrial Equipment industries. Having built strong domain knowledge in its chosen verticals, KPIT broadened its offerings by acquiring enterprise services capabilities that were missing. It acquired Sparta to offer solutions around SAP, CPG to implement Oracle solutions, and Systime to implement JD Edwards solutions.

Despite its multiple acquisitions, KPIT has not been faced with pre or post acquisition hurdles. We attribute this to the management's ability to consistently find the right fit. The management's superior abilities are also substantiated by industry-leading organic growth in the past couple of years.

Armed with a gamut of offerings, the company is now attempting to improve client mining and bag large deals. KPIT won three large deals, each with a total contract value (TCV) of USD20m+ in 2HFY12. It closed deals worth USD210m in FY12 - USD60m in Integrated Enterprise Solutions, USD50m in Automotive and Engineering, and USD100m in SAP.

Acquisition details

Acquisition	Rationale	Cost	Financials
Sparta	KPIT's revenues are mainly based in manufacturing sector, where SAP is choice of many customers. The promoters have been able to build a revenue base of USD26m in 18months; established SEZ in Delhi; established strong presence in North America and acquired 25 new clients. Can now leverage Sparta's presence in North America and KPIT's presence in Europe	30% of the payment upfront and 70% based on milestone based targets spread over the next 3 years Milestone payments based on revenue and EBIDTA targets; USD 30m payable on achieving 150% revenue growth milestone Total compensation of USD38m; includes USD4m for key employees who may not be share holders Initially paid USD 8m; remaining payable after three years	USD 26m revenues Breakeven in terms of profits Payback in under 3 years 125 people in US and 100 in India Onsite billing rates between USD125-200per hour Offshore billing rates between USD25-35 per hour
In2Soft	There are only a handful players in the diagnostic's market globally (3-4 players). Estimated the market size at EUR500m. The largest player would be EUR30m	Upfront cash payment of INR107.5m (Source: Annual Report) Valuation upside on fulfilling certain EBIT and offshoring targets over the next three years is EUR1m	EUR3m top-line in CY10. Grew from EUR70k to EUR3m over the last 10 years EBIT margin of 12%. EBIT margin grew from 6-6.5% a decade ago.
CPG	KPIT wants to build a USD100m Oracle practice over the next three years The acquisition builds a strong base in all relavant practice areas be it e-biz, supply chains, PLM's, CRM, business intelligence and implementations	USD6m upfront The USD1.2m upside would be payable if the actual EBIT is 40% higher than the target Earnouts over three years of USD 12m with potential upside of another USD1.2m; So total deal valuation could be USD13.2m	Revenue was USD8.33m. Expected to reach USD20m in three years time EBITDA is USD2m More than 90% of revenues are project based 80% of revenues are from top-5 clients Expected ETR is 35-36% for the entity
Systime	SYSTIME is a very highly respected name in the world of JD Edwards which is a part of Oracle Corporation's portfolio. There are 25-30 automotive clients who use JD Edwards. JD Edwards widely used by the energy and mfg sectors in US and Europe	Made upfront payment of INR1.03b for 50% stake Total deal value could be ~INR2.5-3b for 100% stake	Revenue of USD53m expect to grow by 20% in FY12 Profitability in mid-single digits 30% SGA Debt free

Healthy growth opportunity in Automotive space

Hybrid cars are expected to serve as a transition technology in the future, the use of electronics in cars continues to increase gradually

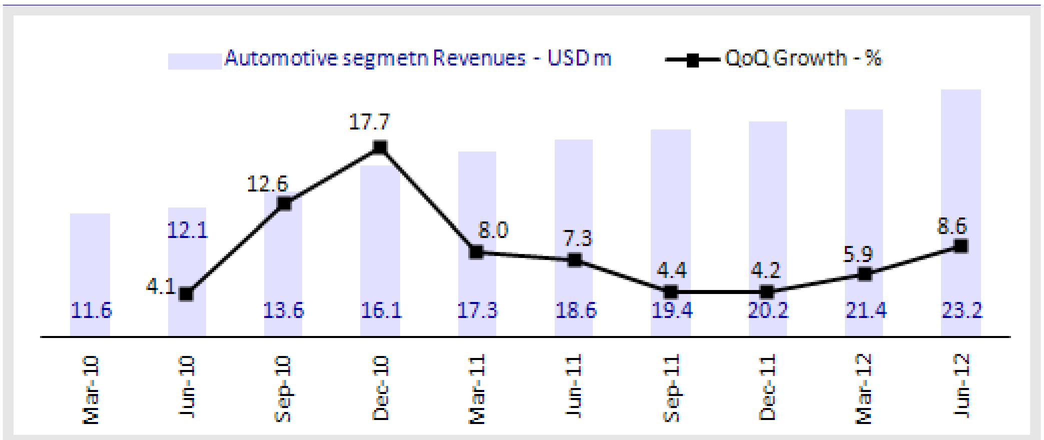
According to Deloitte's Auto Transformation Report, by 2020, electric vehicles and other green cars will represent up to a third of total global sales in developed markets and up to 20% in urban areas of emerging markets. The industry will need to take advantage of emerging trends like the ones mentioned below to make the most of the opportunity:

Powertrain technology and electric vehicles: While hybrid and electric vehicles (EVs) represent only a tiny fraction of the total cars on the road today, growing environmental concerns, volatility of gas prices and depletion of oil reserves will translate into more demand for EVs by 2020. While multiple challenges such as high costs, lack of government incentives and limited range of EVs have impeded speedy adoption, hybrid vehicles are expected to serve as a transition technology, which feature low carbon emissions and higher fuel efficiency.

Shift from mechanics to electronics: The move to greater electronic content in cars has been underway for many years, and OEMs have been steadily inserting more electronic components into each vehicle. Regulations too seem to be doing their bit towards the same, with EU's directive on mandatory use of lane departure warning system (LDWS) for commercial vehicles from 2013 being a case in point. Growing use of electronics in vehicles presents a direct opportunity for players like KPIT, which derived ~26% of its FY12 revenue from the Auto and Engineering industries.

KPIT has the requisite expertise in the Automotive segment to tap onto the opportunities in the space

Auto and Engineering segment has grown at a CQGR of 8% over the last 9 quarters



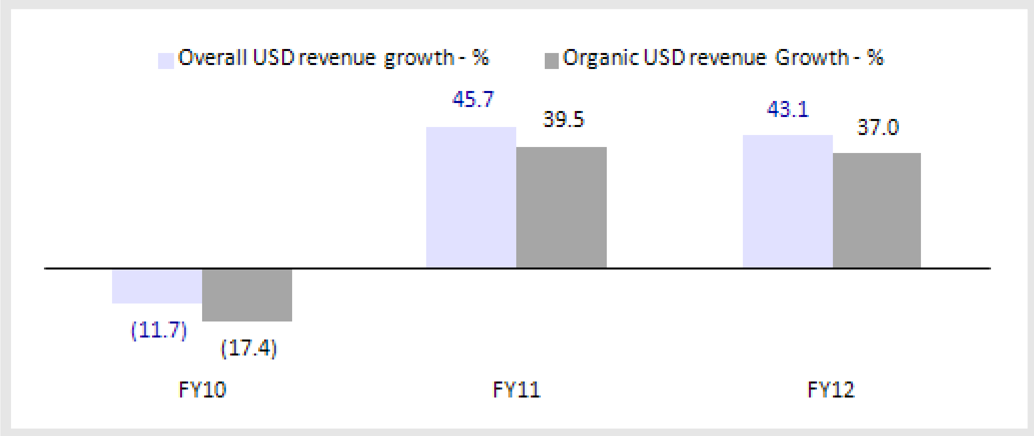
Source: Company, MOSL

Commendable performance on acquisitions; organic growth no less impressive

Not only have acquisitions been integrated successfully, the company's organic revenue growth has been equally impressive

KPIT's USD revenue has grown at a CAGR of 41% over FY10-12, nearly doubling from the FY10 base of USD155m. This does include the impact from acquisitions like Systime, In2Soft, CPG and Sparta. The company's organic growth has been no less impressive post the FY10 downturn, when USD revenue declined 11.7%, whereas organic revenue decline was 17.4%. FY11 revenue growth was 54.7%, 39.5% of which was organic. Even in FY12, while overall USD revenue growth was 43%, organic revenue growth was 37%. The guidance of 32-35% revenue growth in FY13 models 21-24% organic growth.

Organic revenue growth has been impressive over the last two years



Source: Company, MOSL

Even in FY13, when overall revenue growth guidance is 32-35%, 21-24% of it is organic

Vision of billion dollar revenue by 2017 implies continued inorganic forays

Current market price embeds a miss on the company's guidance on both revenues (by 20%) and margins (by 3pp)

KPIT has a vision to grow its revenue to USD1b by 2017. The company had earlier stated its objective of reaching USD500m revenue by FY13. However, revenue guidance at the upper end in FY13 is USD418m. Yet, the management guided an exit run rate of USD500m for FY13. Even if we assume that USD1b will be the exit run rate in FY17 and not the aggregate full-year revenue, it still implies a CQGR of 5% from 2QFY13. We believe that sustaining such a high CQGR will require continued inorganic forays by the company in a slowing growth environment and on an expanding base. FCF generation may be delayed as a result, taking into the account the payback periods of the acquisitions (KPIT's objective is cash payback in 3 years).

Also, we assess what the valuations could look like on our projections in line with the management targets. Assuming KPIT attains the run rate implies a revenue base of USD930m in FY17. Also, KPIT's slated EBITDA margin target at USD1b revenue is 18%. Assuming a PAT margin of 12% and a valuation multiple of 11x implies market cap of INR63b in FY17. If we discount this by 15% per annum to the present, we arrive at an implied market cap of INR36b v/s the prevailing INR23b.

To arrive at the current market cap of INR 23b, we moderate assumptions to USD800m revenue exit rate in FY17 (USD200m revenue in 4QFY17) and 15% EBITDA margin. Thus, these are perhaps the expectations built into the current price. This also implies 16% CAGR over FY13-17 (assuming the company meets the top end of its revenue guidance in FY13).

Analyzing KPIt's financial targets

FY17	Management guidance	Implied in current valuation
4QFY17 Revenue - USD m	250	200
Implied CQGR from 2QFY13 (%)	**5.1**	**3.8**
Implies revenue in FY17 - USD m	**930**	**757**
Currency assumption (INR/USD)	52	52
Revenue - INR b	48	39
EBITDA margin (%)	**18.0**	**15.0**
Depreciation + Interest (as a % of sales)	3.0	3.0
Other income as a % of sales	1.0	1.0
PBT margin (%)	16.0	13.0
Tax rate assumed (%)	26.0	26.0
PAT margin	11.8	9.6
PAT - INR b	5.7	3.8
Valuation multiple - x	11.0	11.0
Valuation - INR b	63.0	41.6
Discounting back to the present at 15%	36.0	23.8
Current Marketcap - INR b	22.8	22.8
Upside (%)	**58.1**	**4.5**

Source: Company, MOSL

As we note in the exhibit above, upside is significant, were we to assume numbers in line with the management guidance. However, the current market cap would imply a miss both on the revenue and profitability guidance.

Acquisitions have impacted profitability; margins to remain range-bound

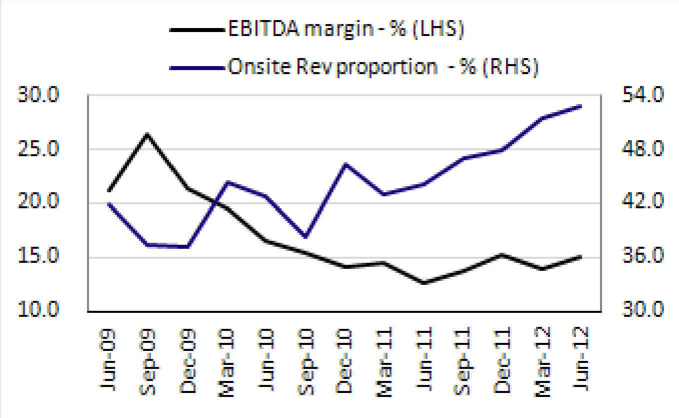
Profit margins at acquired companies have been lower, impacting OPM; and ~3-year cash payback period has hurt FCF

KPIT's EBITDA margin declined from 22% in FY10 to 14% in FY12. One of the key factors contributing to the margin drop was overseas acquisitions, which were operating at lower margins due to mainly onsite presence. This is reflected in the contribution of onsite business increasing from 40% of KPIT's revenue in FY10 to 48% in FY12. The other factor that contributed to the decline was wage hikes amid sudden demand recovery just out of the downturn, to a largely lateral employee base.

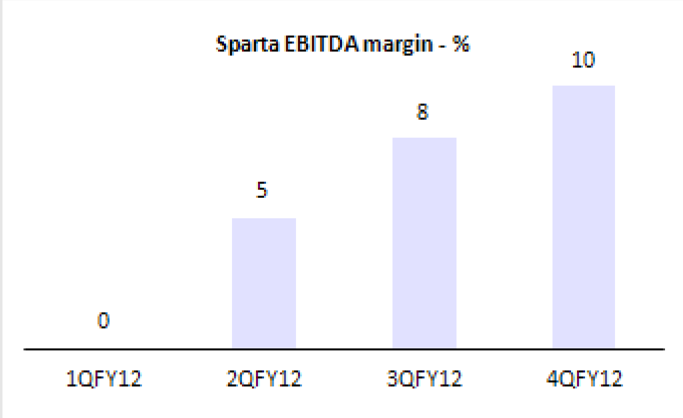
In the near term, the management expects to operate within an EBITDA margin band of 15-18%, driven by improving profitability of its onsite acquisitions. The company has delivered such performance in the case of Sparta and Systime, thus far. Margins at the SAP SBU grew from near-breakeven in 1QFY12 to 10%+ in 4QFY12. KPIT achieved double-digit EBITDA margins in Systime in 4QFY12.

There remains slack to expand margins through efficiency improvements and further expansion in margin of acquired entities. These should help ward off headwinds from factors like wage hikes in the near term. Also, the company's focus on large deals yielded impressive results, substantiated with 3 deals bagged in FY12, and it augurs well for profitability in the future.

Increasing onsite proportion from acquisitions has been a drag on profitability



KPIT has successfully improved profitability of acquisitions



Source: Company/MOSL

We expect EBITDA margin of 16.7% in FY13 and 16.3% in FY14, at midpoint of guided band given levers combined with KPIT's continued growth aggression.

With USD45-50m payouts towards acquisitions over the next two years, FCF generation may remain subdued in the near term

Negative aggregate FCF on acquisition, but OCF conversion impressive

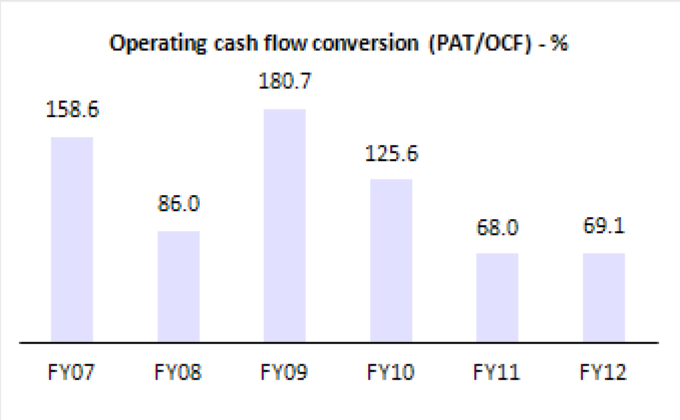
KPIT's revenue growth has been far ahead of the industry, partly driven by acquisitions and partly by healthy synergies that drove organic growth post the acquisitions. However, the company's aggregate FCF over the last six years has been negative. This is understandable, given that KPIT has been aggressively scouting for acquisitions and has invested heavily in inorganic activity in the last couple of years. Cash payback will have to wait for a few years. We note that OCF conversion (OCF/PAT) was much healthier during FY07-12, at an aggregate of 106% during this period. As capability gaps narrow, the capex intensity (including acquisitions) will come off, and drive a turnaround in Free Cash generation.

KPIT Cash generation performance

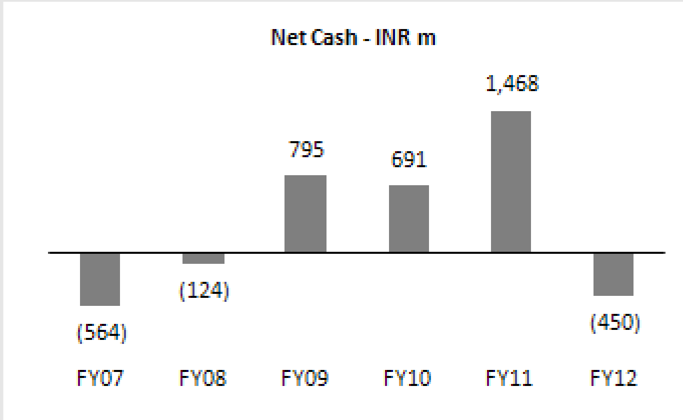
Cash Metrics	FY07	FY08	FY09	FY10	FY11	FY12
Sales	4,637	6,005	7,932	7,316	10,230	14,854
PAT	505	527	659	857	948	1,215
CF - Operations	801	441	1,191	1,076	643	1,005
Capex	918	360	493	806	932	3,073
FCF	(117)	81	698	270	(289)	(2,069)
OCF/PAT (%)	158.6	86.0	180.7	125.6	68.0	83.0
FCF/PAT (%)	-23.2	15.8	105.9	31.5	-30.5	-142.4
EV/FCF	(157)	231	25	67	(67)	(10)
EV/OCF	23	42	15	17	30	21
Capex Intensity (%)	20	6	6	11	9	21

Source: Company, MOSL

Operating cash flow conversion has been lower in the last couple of years



Net debt of INR450m as at the end of FY12



Source: Company, MOSL

The company has pending payouts to the tune of USD45-50m towards acquisitions of Sparta, CPG and taking its stake in Systime from 57.5% to 100%. These are to be paid in over the next two years. The payouts are expected to be equally distributed across the two years. This, added to the continued thrust on inorganic revenues, is expected to keep FCF generation low in the near term.

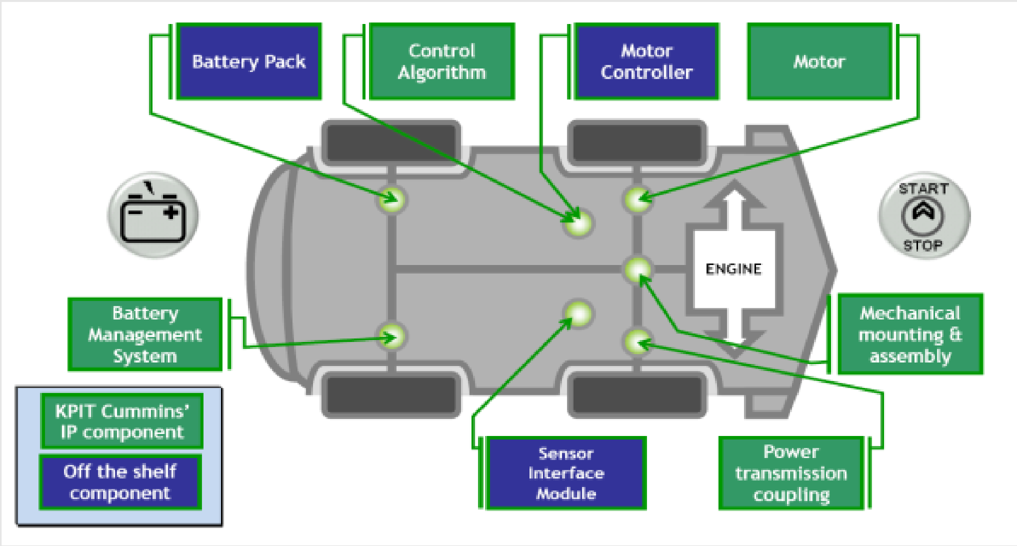
Revolo's success could be an option value for the stock

FY13 was earlier envisaged as the first full year of revenues from Revolo, but now, revenues may only start kicking in from FY14

To tap the hybrid engine opportunity, KPIT has been working towards a plug-in parallel hybrid solution, including a clever battery management system, proprietary software, and mechanical assembly. It is developing the solution through a JV with Bharat Forge. According to KPIT, the solution provides fuel efficiency improvement of over 50% and is capable of reducing CHG emissions by over 30%. KPIT's initial target was to make FY13 the first full year of Revolo sales, but issues with battery life and other niggles have led to delays, and commencement of revenue from the product may have to wait till FY14.

The company is almost through with the product engineering phase for Revolo. It has initiated trials of 200 vehicle conversions of up to four different fleets. It is on track to achieve the launch of 200 vehicles on a mass trial basis by the end of 2012.

Revolo Schematic

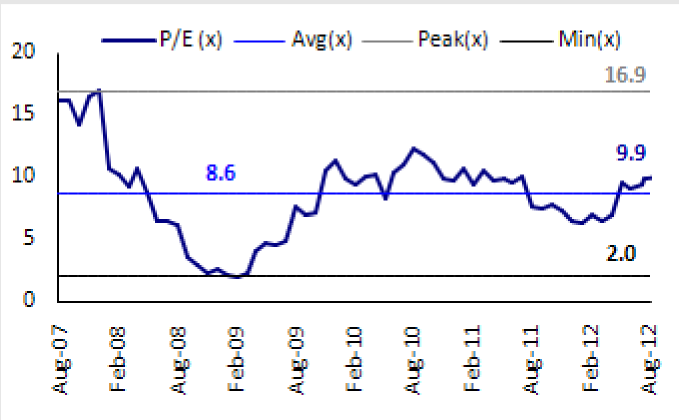


Source: Company, MOSL

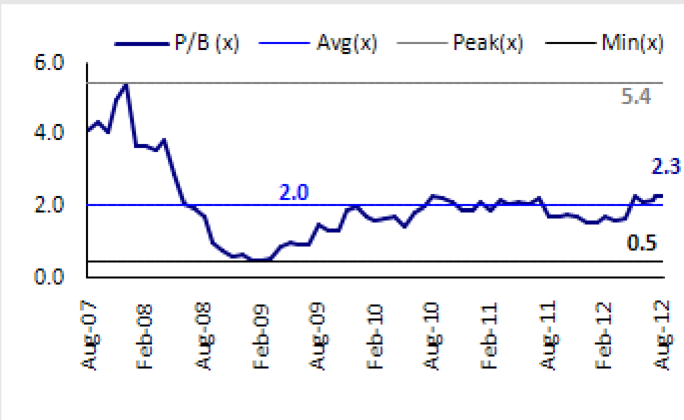
A bet on Differentiation, option value from Revolo - Buy

We expect KPIT's USD revenue to grow at a CAGR of 27% and EPS to grow at a CAGR of 33% over FY12-14. The stock trades at 10.2x FY13E and 9x FY14E earnings. Despite the high growth rate and stable margin expectation, we see near-term cash crunch warranting some discount in valuation multiple to peers like HEXW, which have a debt free Balance Sheet and a healthy payout ratio. Our estimates do not factor any numbers from Revolo, the swift market launch of which could spring in a positive surprise. We value KPIT at 11x FY14E EPS. Our target price of INR156 implies 22% upside. We initiate coverage, with a **Buy** rating.

KPIT Cummins PE Chart



KPIT Cummins PB Chart



Financials and valuation

Income statement (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Sales	**7,316**	**10,120**	**14,897**	**22,580**	**26,324**
Change (%)	-7.8	38.3	47.2	51.6	16.6
Cost of Services	4,091	6,492	9,934	14,483	16,993
SG&A Expenses	1,611	2,106	2,885	4,418	5,036
EBITDA	**1,614**	**1,522**	**2,078**	**3,679**	**4,295**
% of Net Sales	22.1	15.0	13.9	16.3	16.3
Depreciation	308.0	411.3	444.9	525.2	727.9
Interest	27.4	25.9	78.1	166.7	175.0
Other Income	(252.5)	17.6	128.0	97.6	112.7
PBT	**1,026**	**1,103**	**1,683**	**3,085**	**3,505**
Tax	169	155	437	807	911
Rate (%)	16.5	14.0	25.9	26.1	26.0
Minority Interest	-	-	(31.5)	(12.3)	-
PAT	**857**	**948**	**1,215**	**2,266**	**2,594**
Net Income	**857**	**948**	**1,215**	**2,266**	**2,594**
Change (%)	30.2	10.5	28.2	86.5	14.4

Balance Sheet (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Share Capital	312	340	356	356	356
Reserves	3,559	5,692	6,769	8,799	11,393
Net Worth	**3,871**	**6,032**	**7,125**	**9,155**	**11,749**
Minority Interest	51.2	63.7	333.7	(898.8)	(898.8)
Loan and other long term liab.	1,108	1,105	1,189	2,431	2,431
Capital Employed	**5,030**	**7,201**	**8,649**	**10,687**	**13,281**
Fixed Assets	**1,522**	**1,581**	**1,853**	**3,071**	**4,218**
Other LT assets	950	1,300	4,527	4,798	4,798
Curr. Assets	**3,117**	**5,719**	**6,983**	**8,314**	**10,685**
Debtors	1,388	2,525	4,380	5,496	6,420
Cash & Bank Balance	1,052	2,096	1,838	1,525	2,754
Loans & Advances	677	1,097	766	1,293	1,511
Current Liab. & Prov	**1,306**	**1,875**	**4,714**	**5,496**	**6,420**
Current Liabilities	1,306	1,875	4,714	5,496	6,420
Net Current Assets	**1,811**	**3,844**	**2,269**	**2,818**	**4,265**
Application of Funds	**5,030**	**7,201**	**8,649**	**10,687**	**13,281**

E: MOSL Estimates

Financials and Valuation

Ratios

Y/E March	2010	2011	2012	2013E	2014E
Basic (INR)					
EPS	**5.5**	**5.9**	**8.2**	**12.8**	**14.6**
Cash EPS	7.4	7.7	9.1	15.3	18.2
Book Value	24.5	34.4	39.0	50.2	64.4
DPS	0.7	0.7	0.7	0.7	0.7
Payout %	12.8	11.9	8.5	5.5	4.8
Valuation (x)					
P/E			16.0	10.2	9.0
Cash P/E			14.1	8.4	7.0
EV/EBITDA			10.7	6.4	5.2
EV/Sales			1.5	1.0	0.9
Price/Book Value			3.3	2.6	2.0
Dividend Yield (%)			0.5	0.5	0.5
Profitability Ratios (%)					
RoE	30.9	19.1	18.5	27.8	24.8
RoCE	22.2	15.9	16.7	25.3	23.1
Turnover Ratios					
Debtors (Days)	69	91	107	89	89
Fixed Asset Turnover (x)	4.3	6.5	8.8	9.2	7.3

Cash Flow Statement (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
CF from Operations	1,245	1,217	1,874	2,422	3,497
Cash for Working Capital	-169	-574	-870	-862	-217
Net Operating CF	**1,076**	**643**	**1,005**	**1,560**	**3,279**
Net Purchase of FA	-905	-882	-3,002	-1,743	-1,875
Net Purchase of Invest.	-530	207	174	28	0
Net Cash from Invest.	**-1,435**	**-675**	**-2,828**	**-1,715**	**-1,875**
Proc. from equity issues	27	1,203	65	0	0
Proceeds from LTB/STB	-104	-96	1,091	-158	-175
Dividend Payments	-55	-64	-72	0	0
Cash Flow from Fin.	-132	1,043	1,084	-158	-175
Net Cash Flow	**-491**	**1,011**	**-739**	**-313**	**1,229**
Opening Cash Bal.	**1,671**	**1,052**	**2,096**	**1,838**	**1,525**
Add: Net Cash	-491	1,011	-739	-313	1,229
Closing Cash Bal.	**1,052**	**2,096**	**1,838**	**1,525**	**2,754**

E: MOSL Estimates

MindTree

BSE SENSEX	S&P CNX
18,673	5,670

CMP: INR686 TP: INR882 Buy

Bloomberg	MTCL IN
Equity Shares (m)	40.6
52-Week Range (INR)	770/331
1,6,12 Rel. Perf. (%)	-7/32/79
M.Cap. (INR b)	27.9
M.Cap. (USD b)	0.5

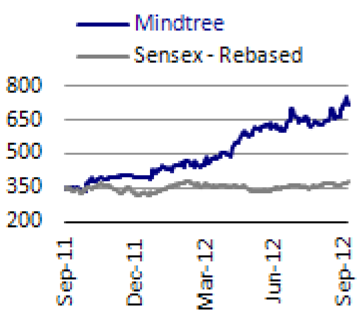
Valuation summary (INR b)

Y/E March	2012	2013E	2014E
Sales	19.2	24.2	27.2
PAT	2.2	3.5	3.6
EPS (INR)	53.7	84.0	88.2
EPS Gr. (%)	116.5	56.4	5.0
P/E (x)	12.8	8.2	7.8
P/BV (x)	3.9	3.8	3.6
RoE (%)	22.8	27.1	22.1
RoCE (%)	25.2	27.1	24.9
EV/Sales (x)	1.3	0.9	0.7
EV/EBITDA (x)	8.2	4.7	4.0

Shareholding pattern %

As on	Jun-12	Mar-12	Jun-11
Promoter	19.8	20.2	26.4
Dom. Inst	10.8	9.6	6.8
Foreign	23.3	30.9	31.2
Others	46.1	39.3	35.7

Stock performance (1 year)



Back to Basics

Valuations still favorable despite PES concerns; Buy

- **Revised strategy articulated by MindTree (MTCL) over a year ago was followed by industry-leading revenue growth in IT Services (ITS) and EBITDA margin expansion.**
- **In FY13, MTCL expects to post revenue growth in line with the Nasscom band of 11-14%, implying ~6% CQGR in ITS - again ahead of peers in the current environment.**
- **Its focus on select customers has helped MTCL to improve profitability in the Product Engineering Services (PES) segment.**
- **At 7.8x FY14E, valuations remain attractive. Our target price of INR882 discounts FY14E EPS by 10x. We initiate coverage with a Buy rating.**

Restructuring - so far so good

After MTCL rolled out its revised strategy of focusing on fewer segments and clients over a year ago, it has posted industry-leading revenue growth in ITS (37% in FY12), improved its client mining metrics and expanded its EBITDA margin by 330bp in the last four quarters (partly facilitated by currency). Focus on select customers has helped MTCL to improve profitability within the PES segment, which closed the gap with the ITS to zero from 6.4pp in the last 4 quarters.

Outlook of another year of leading ITS growth

After soft revenue growth in 1QFY13 (0.4% QoQ), MTCL now expects to meet the Nasscom band of 11-14%, implying that ITS is likely to grow at ~6% CQGR considering PES softness. This remains an industry-beating growth rate in the current environment. The company's confidence stems from deal wins over last few quarters, both in existing and new accounts, which continue to ramp up.

Service mix more diversified, but commoditized areas dominate share

The contribution of ADM (Application Development and Maintenance) and testing services declined from ~90% of MTCL's revenue about three years ago (in 4QFY09) to 81%. During this period, the contribution of IMS increased from 3.3% to 11.2%. Increasing contribution from more services will help MTCL to bid for large multi-services deals. Its presence in highly competitive spaces is allayed somewhat by instance of differentiation in IMS brought about by automation. More such differentiated solutions will be the key growth outperformance imperatives for the company.

Remains a play on valuations; Initiating coverage with a Buy

We expect MTCL to grow its revenue at a CAGR of 13% and EPS at a CAGR of 28% over FY12-14. The company's back-to-basics approach has so far yielded refreshing results, though we would prefer more instances of differentiated services in its business. At 7.8x FY14E EPS, the valuations still offer an upside. Our target price for MTCL is INR882 (29% upside), which discounts our FY14E EPS by 10x. We initiate coverage with a **Buy** rating.

MindTree

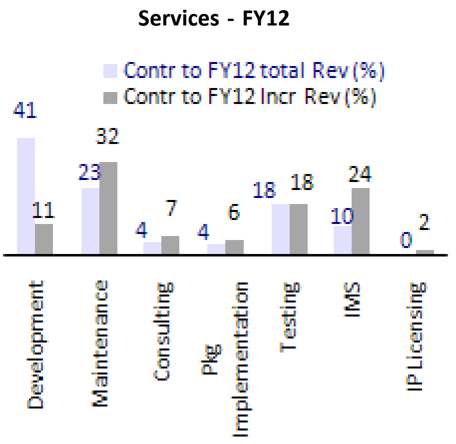
MID Score|Discount: **62.5|37.5%** FY14 P/E: **10x**

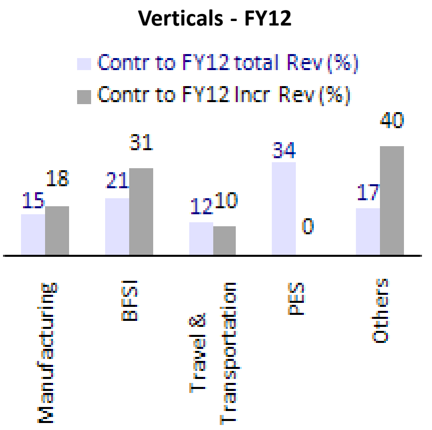
M : 3.5/5 Management focus and Strategy

- MindTree is a global IT and Product Engineering Services Company with deep knowledge in specific domains. MindTree was ranked No. 2 among the Most Admired Knowledge Enterprise (MAKE) India Award winners in 2011
- Krishnakumar Natarajan - CEO & MD: he has the overall responsibility of both the IT Services and the Product Engineering Services businesses of the organization. Until recently, KK served as President and CEO – IT Services for MindTree. Prior to co-founding MindTree, KK worked with Wipro from 1982 to 1999

I : 7.5/15 IT Mix

- **Industry Mix (2.5/5):** Outside of PES (31% of revenues), the contribution is evenly spread across Manufacturing (18.5%), BFSI (22%) and Travel & Transportation (21%)
- **Services Mix (2/5):** 81% of revenues from ADM, Engineering and Testing in 1QFY13, although down from 90% in 4QFY09, still remains high
- **Geography mix (3/5):** Revenues from India and APAC have declined from 18.5% in 4QFY10 to 13% in 1QFY13.





D : 8/15 Deal signing prowess

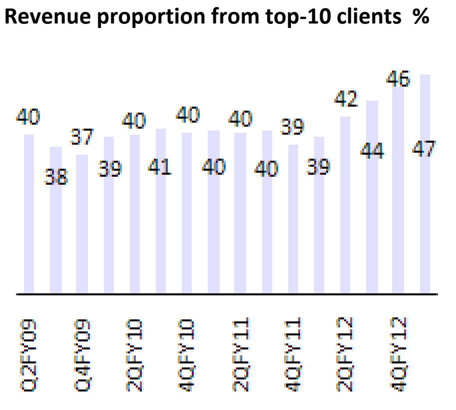
- Top-10 accounts have grown at a CQGR of 6% over the last 12 quarters.
- Investments in the front-end have yielded encouraging results thus far.

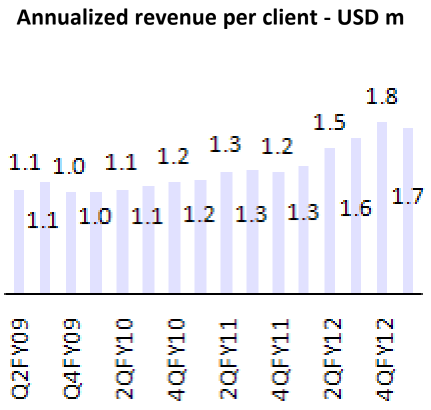
"During the year, to achieve growth, the leadership team embarked upon a new strategy-'Back to Basics'. This approach has helped MindTree Minds to focus on building specialization in chosen verticals, deep account mining and getting prepared for larger deals"

"Growth rate will be in line with industry estimates. The confidence for our growth comes predominantly from the deal wins that we have had over the last few quarters that give us the confidence that over the next two, three quarters growth momentum will be sustained"

C : 7 / 10 Client Concentration

- Revenues from top accounts have been the key growth driver in IT Services
- Nearly half the revenues from top-10 customers imply that client concentration is a risk, especially in the environment where clients budgets are being diligently scrutinized.

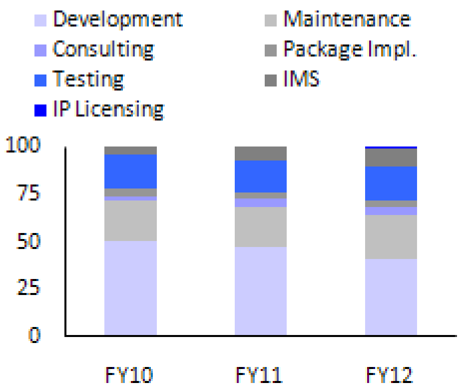


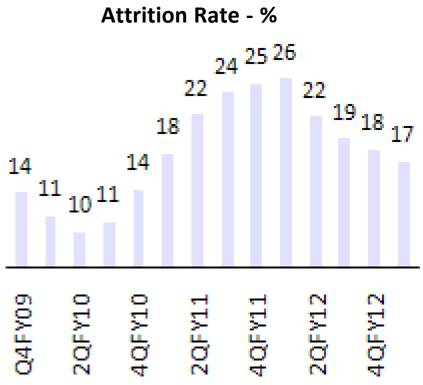


MindTree

A: 12.5/20 Ability to scale and Attrition

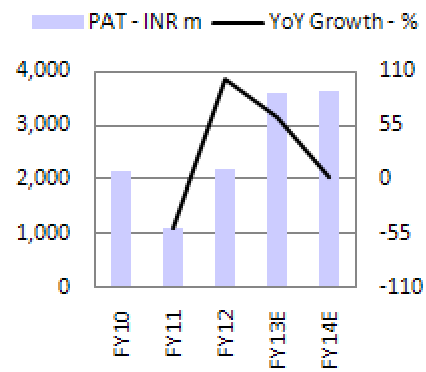
- Ability to Scale (10.5/15): Like in the case of IMS (differentiation through automation), the company will continuous need differentiation in its offerings in order to sustain growth.
- Attrition (2/5): Quarterly annualized attrition in 1QFY13 was 17%, on the higher side considering the environment.

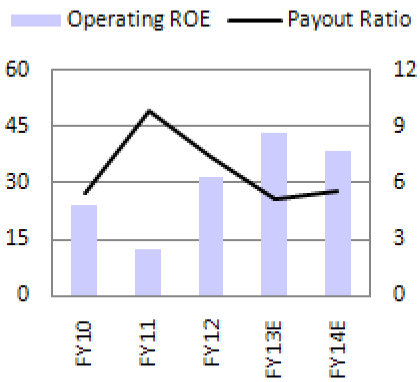




P : 24/40 P: Profit and Payout

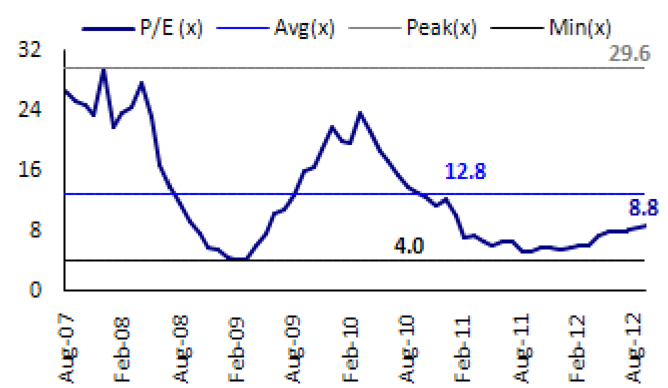
- **Profit Growth (12/15):** We expect an EPS CAGR of 25.3% over FY12-14.
- **Profit Quality (10/15):** Operating RoE of ~30% is at the higher end of the tier-II peer set.
- **Payout ratio (2/10):** Has been poor thus far, improvement in which could be a fillip to the stock's valuation multiple.





MID Score : 62.5 / 100 | P/E 10x

Hexaware		Benchmark	
M	Management	5	3.5
I	IT Mix	15	7.5
D	Deals	10	8.0
C	Client Concentration	10	7.0
A	Ability to scale & Attrition	20	12.5
P	Profit & Payout	40	24.0
	TOTAL MID SCORE	**100**	**62.5**
	Discount - %		37.5
	Tier I average target P/E		16.0
	Stock target P/E		10.0
	FY14E EPS - INR		88.2
	Target Price - INR		882
	Upside - %		22.6
	Rating		**Buy**



MindTree's restructuring has yielded all the right results - growth in ITS, top accounts, margins.

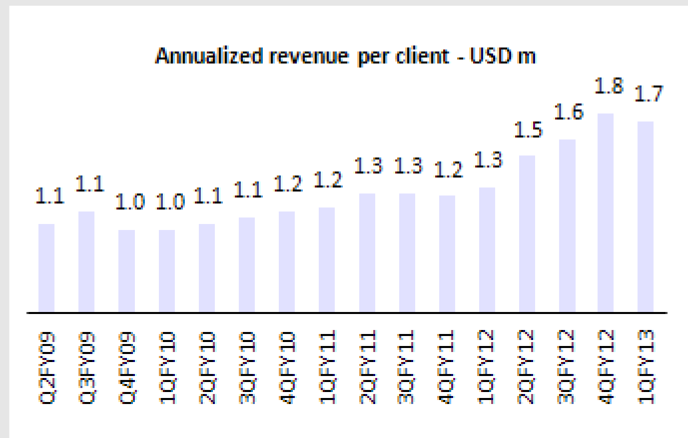
Assessing restructuring after a year - impressive execution

A little over a year ago, MTCL rolled out its revised strategy to scale its business, the key aspects of which were: [1] focusing on fewer segments and not expanding in any new verticals, seeking to deliver significantly higher value and go deeper into the sub-segments of the chosen verticals, [2] improving the quality of customer additions, which entailed reduction of few clients, [3] pursuing large deals, and [4] strong focus on improving client mining metrics. This was along with a significant shake-up in the top-management of the organization.

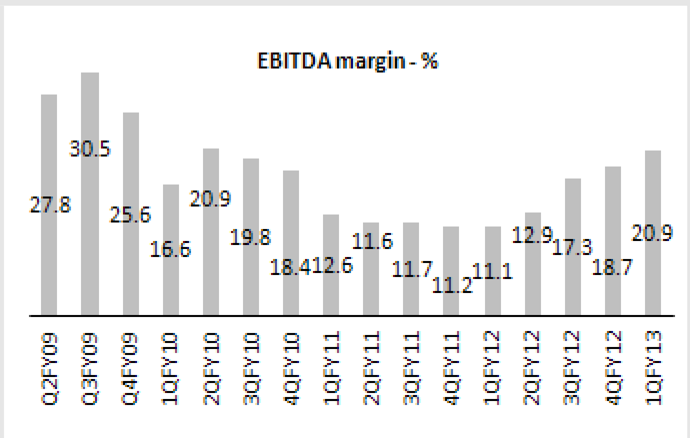
Post the implementation of the revised strategy: [1] USD revenue grew 21.7% in FY12, driven by industry-leading 37% growth in ITS, [2] EBITDA margin expanded 330bp YoY in 4QFY12 in constant currency, [3] account mining metrics improved significantly, with the number of USD20m+ accounts increasing from 1 to 4 and USD5m+ accounts increasing from 14 to 17. Annualized revenue per client increased to USD1.7m in 1QFY13 from USD1m ~4 years ago.

The focus on select customers has also helped MTCL to improve profitability within the PES segment, which closed the gap with the ITS segment to zero from 6.4pp in the last four quarters.

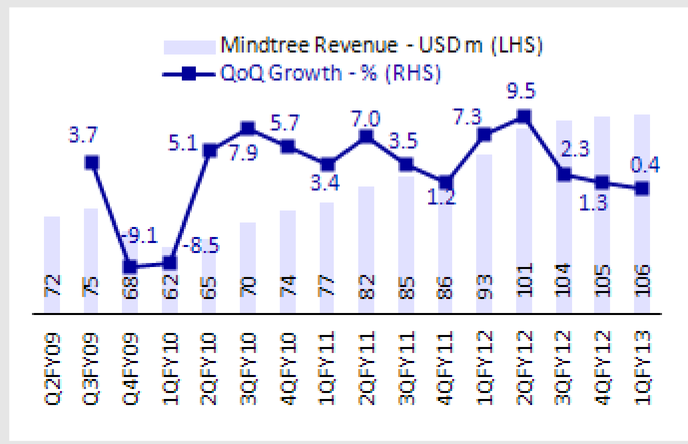
Impressive improvement in client mining over the past few quarters



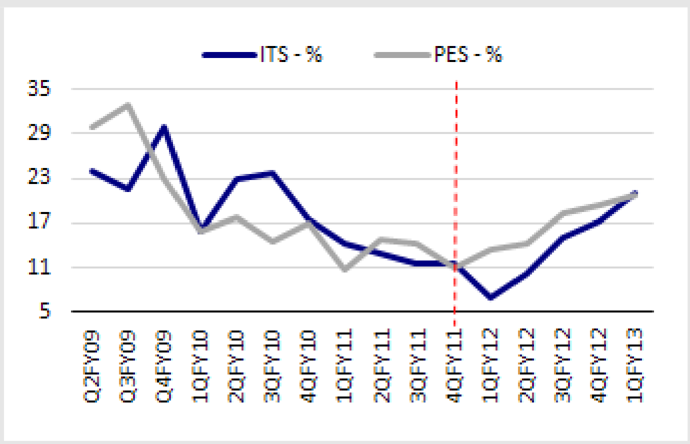
Growth has helped improve profitability (other than tailwind from currency)



Revenue growth subdued over the past couple of quarters, weighed down by weakness in PES



Focus on quality accounts has helped close PES' margin gap with ITS



Source: Company, MOSL

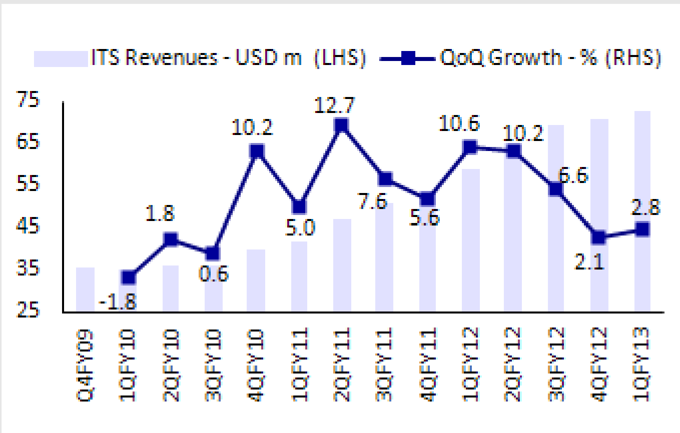
Guidance builds in another year of strong growth for ITS - deals lend visibility

FY13 guidance moderated on sluggish 1Q, dragged by ramp-downs in PES. Guidance still implies industry-leading growth in ITS in FY13

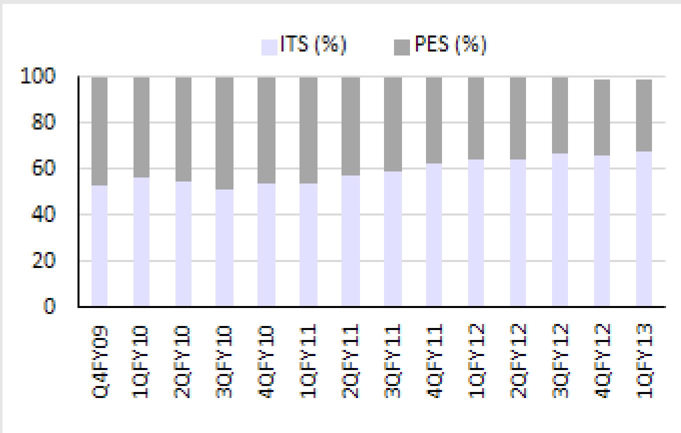
After just 0.4% QoQ revenue growth in 1QFY13, MTCL toned down its USD revenue growth guidance for FY13 to meeting the Nasscom band of 11-14%. In the previous quarter, it had guided revenue growth higher than the Nasscom band. Couple of ramp-downs in key PES customers drove the weakness in 1QFY13 and the ensuing downward revision. Current guidance still entails 4.8% CQGR in overall revenue. Considering that a couple of recent deal wins will help drive some growth in PES (assuming 2% CQGR), it implies ~6% CQGR in ITS over 2Q-4QFY13. This remains an industry-beating growth rate in a challenging environment. MTCL's confidence comes predominantly from deal wins over the last few quarters, both in existing accounts as well as some new wins, which continue to ramp up. Also, discussions around large deals the company is currently working on, gives additional support for the sanguine outlook.

Achieving the Nasscom growth band would imply 20%+ YoY growth in ITS in a challenging environment, which can be attributed to the management's adopted strategy of focusing on potential growth channels. We have arrived at the 20%+ growth in ITS by assuming 2% CQGR in PES from 2Q.

ITS revenue continues to outperform industry



Proportion of revenue from PES has been declining



Source: Company, MOSL

Revenue profile getting more diversified from services perspective - positive for large multi-service deals

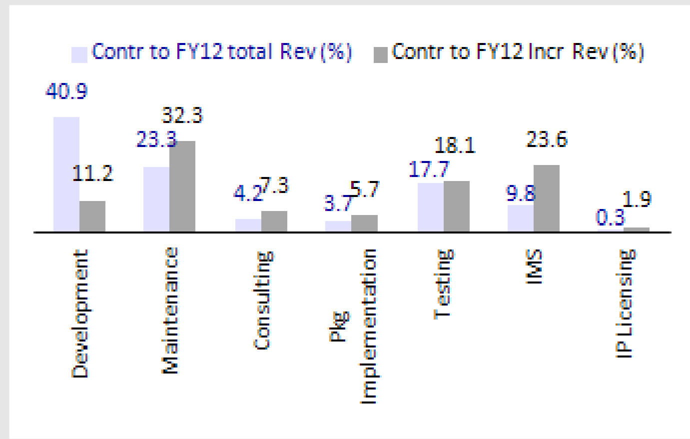
More diversified revenue profile a function of strong execution in IMS; bodes well from large multi-service deal bids perspective

The contribution of ADM and testing services declined from ~90% of MTCL's revenue about three years ago (in 4QFY09) to 81%. During this period, the contribution of IMS increased from 3.3% to 11.2%. IMS, which contributed 6.9% to MTCL's revenue in FY11, contributed 23.6% of the company's incremental revenue in FY12.

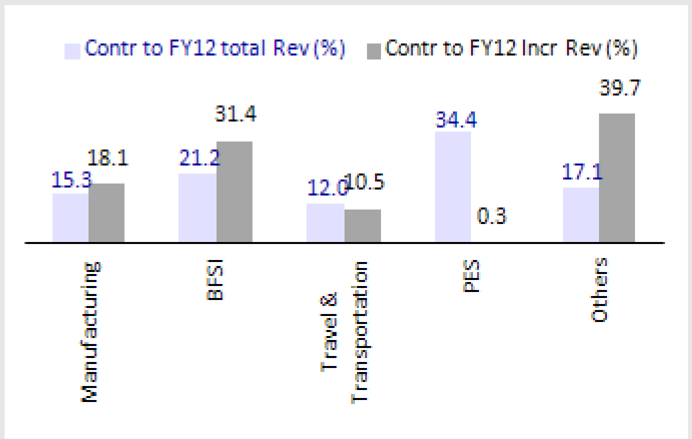
One of the strategic decisions taken by MTCL in driving its IMS services was to build its own automated platform and significantly improve productivity, helping it to gain traction through a differentiated offering. Also, it is seeing good activity even in Cloud infrastructure. The company has guided continued traction within IMS in the coming quarters.

Increasing contribution from more services is a healthy sign, as it improves MTCL's ability to qualify for more large deals which are multi-services in nature. Also, most the larger sized deals contain a significant portion of IMS work. Hence, the surge in this segment is particularly welcome.

IMS was one of the key revenue growth drivers in FY12 despite a low base



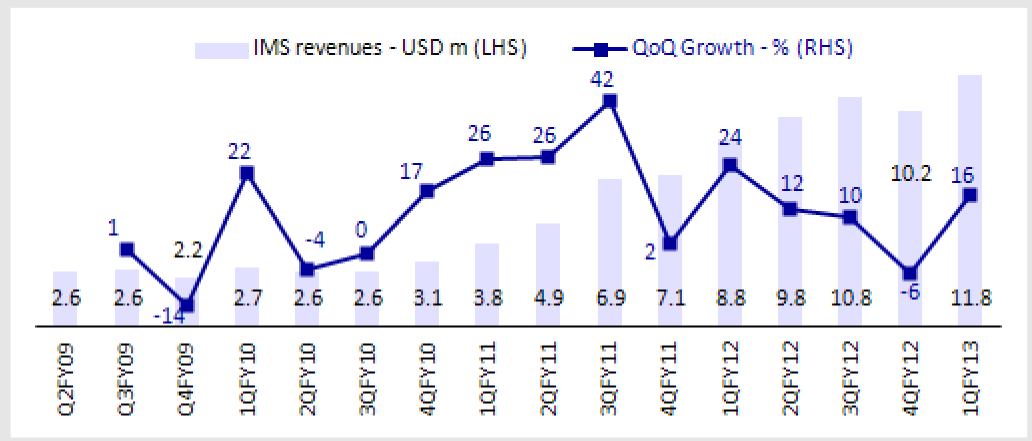
Among verticals, growth was driven by "others" and BFSI



Source: Company, MOSL

IMS comprised of 6.9% revenues in FY11, and contributed 23.6% of FY12 incremental revenues

IMS has grown at a CQGR of 10.6% over the past four years



Source: Company, MOSL

Significant mix shift towards onsite unlikely; growth to keep margins stable

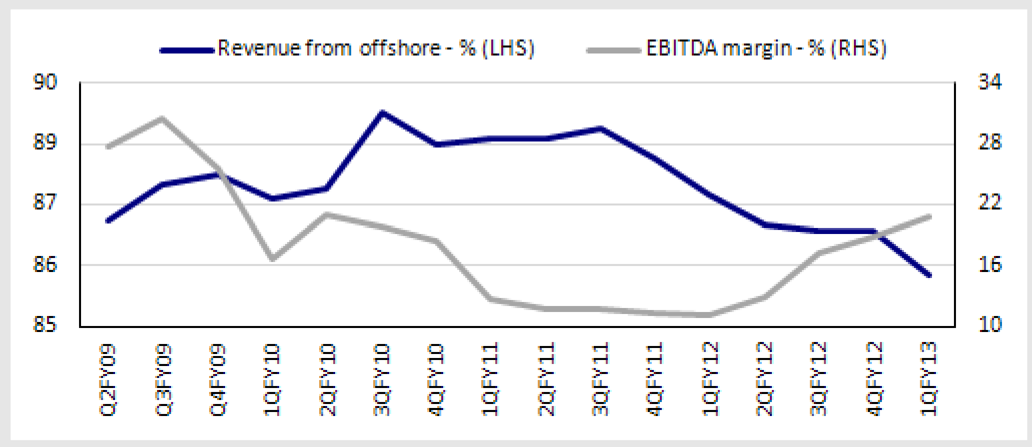
Onsite : offshore mix is not expected to see significant shift in either direction from current levels

MTCL has been traditionally operating a more 'heavily offshored' model than most of its peers. Offshore business had been contributing more than 70% of the company's sales till a few quarters ago. However, that has begun to change and the recent quarters have seen a swift move in revenue mix towards onsite. Revenue from onsite business was only 27.5% of total revenue in 3QFY10, which increased to 37.8% in 1QFY13. The company attributed this to its focus on being closer to its customers and to have a better understanding of the customers' businesses. Significant mix shift towards onsite is unlikely from the current levels, and the current mix should sustain within a tight band.

While greater efforts on onsite business will impact margins, we agree with the company's choice since offshoring as a differentiator is no longer as relevant in an increasingly competitive environment. Relationships are the single-most important factor that will help drive future growth, given that most players derive 95%+ of their revenue in any year from their existing customer base.

Onsite shift could also partly be a function of reduced PES contribution to overall revenues, which is more heavily offshored

Revenue mix shift towards onsite has not impacted margins thus far, with growth and currency coming to the rescue



Source: Company, MOSL

The changing mix has not impacted MTCL's margins, as it had multiple levers simultaneously working for its margins (like employee pyramid), facilitated by healthy volume growth. Some scope for savings in selling, general and administrative (SGA) expenses and pyramid remain levers for the company, which will help cushion the impact of wage hikes in FY13.

Also, with unpredictable revenue from PES, the company chose to shift its focus to margins rather than on volumes. However, we maintain that growth is imperative for margin sustenance.

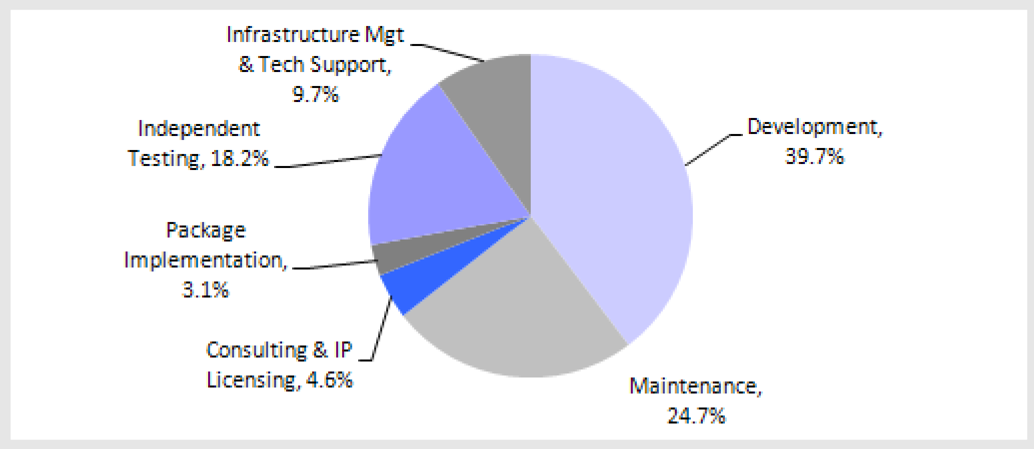
Services remain highly commoditized; intensifying competition our key concern

More instances of differentiation like automation in IMS are imperative in commoditized services, high competition

While MTCL's revenue profile has diversified from the services point of view, ADM, testing and IMS constitute 76% of its revenue. Also, majority of the revenue outside these services comes from Engineering, given MTCL's presence in PES. MTCL's focus on growing select clients and few offerings have driven growth, but given its presence in the highly competitive spaces where scope for differentiation is little, there will be concerns on the sustainability of growth and profitability.

Our fears are somewhat allayed by instances like differentiation in IMS brought about by automation. We would like to see more such innovation by MTCL to continue carving out niches for itself.

Business IT Services constitute major proportion of revenue - FY12



Source: Company, MOSL

Application Development and Project-based work constitute a large part of MTCL's portfolio (Development: 40%; PES: 36%), where nature of work is more project based and hence, unpredictability is higher. In the current challenging environment, mired with slowdown in decision making, MTCL faces higher risk. We are reminded of the period between 4QFY09 and 2QFY10, when it had lost 17% of its revenue in two quarters (USD75m in 4QFY09 and USD62m in 2QFY10).

Wrong bets - hedges looking at five years of cash flows, Kyocera, Android - now behind

Wrong bets behind the company, fresh start has thus far yielded encouraging results

MTCL's problems in PES are not limited to the demand environment alone. The company had to write off USD8m at the net income level on account of the product investments it had made in Android phones based on IP acquired from Kyocera. Likewise, Kyocera itself as a customer contributed ~USD14m to PES revenue (or nearly 10% of PES revenue) in FY11, which ramped down to zero in FY12.

Also, during the steadily appreciating INR days, the company resorted to an aggressive hedging stance, extending covers over the next 60 months. It wasn't too long before MTCL started to feel the heat, as the currency movement took a U-turn and the INR started to weaken. The last bunch of hedges booked back then will expire in FY13, though the management has changed its hedging policy to not extending any cover beyond 12 months.

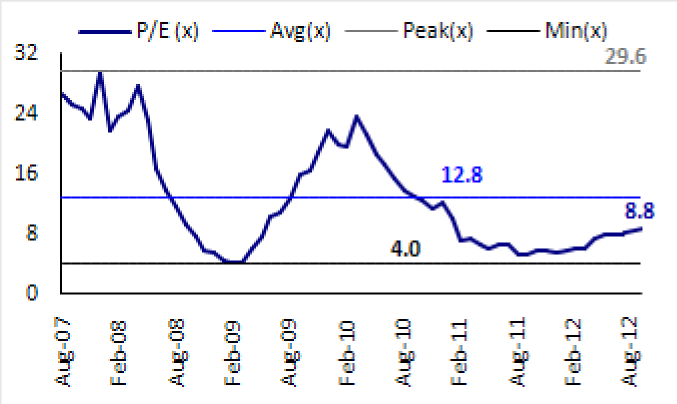
The Android fiasco and Kyocera ramp-down are now behind the company, and MTCL's start from ground zero has thus far been encouraging. Multiple deal wins in IMS have been driving the ITS business and the company's growth outlook in that segment remains very strong. However, the PES part of the business remains challenging, with little having worked in terms of the big steps that that the company took towards growing the business. We do not expect the PES business to turnaround soon, as the company grapples to put in place a definitive strategy before focusing on execution.

Stock remains a play on valuations; Initiating coverage with Buy

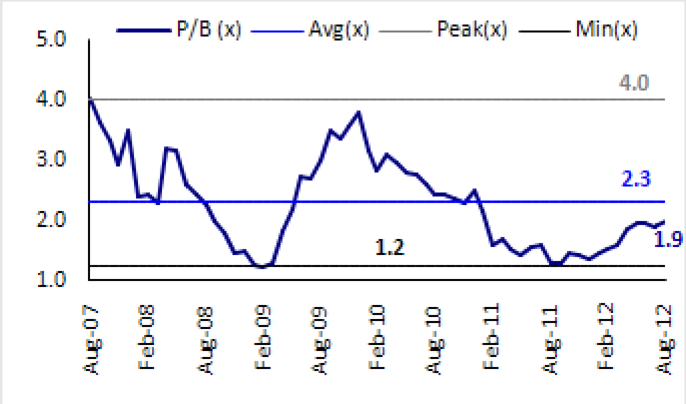
Despite factoring in PES challenges, stock valuation is attractive. Key risk is ramp-down similar to last downturn

Mindtree's execution in ITS has matched that of Hexaware's, but overall company performance has been marred by sluggish PES segment. This is likely to continue to play out in the near-term. We expect MTCL to grow its revenue at a CAGR of 13% and EPS at a CAGR of 28% over FY12-14. The company's back-to-basics approach has so far yielded refreshing results, though we would prefer more instances of differentiated services in its business. At 7.8x FY14E EPS, the valuations still offer an upside. Our EPS estimate for FY14 is INR88. Our target price for MTCL is INR882, (29% upside), which discounts our FY14E EPS by 10x. We initiate coverage with a **Buy** rating.

Mindtree PE chart



Mindtree PB Chart



Financials and Valuation

Income statement (INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Sales	**12,375**	**12,960**	**15,091**	**19,152**	**24,198**	**27,239**
Change (%)	67.3	4.7	16.4	26.9	26.3	12.6
Cost of Services	6,968	7,982	10,145	12,261	14,878	17,197
SG&A Expenses	2,097	2,522	3,164	3,961	4,542	5,018
Provisions	81	-	-	-	-	-
EBITDA	**3,229**	**2,456**	**1,781**	**2,930**	**4,778**	**5,023**
% of Net Sales	26.1	18.9	11.8	15.3	19.7	18.4
Depreciation	570	652	712	695	685	790
Interest	162	27	4	5	3	-
Other Income	115	96	86	188	248	393
Forex	(2,089)	673	155	197	86	-
PBT	**523**	**2,547**	**1,307**	**2,615**	**4,424**	**4,627**
Tax	67	398	222	430	964	995
Rate (%)	12.8	15.6	17.0	16.4	21.8	21.5
Eq. in earnings of affiliates	27	-	-	1	-	-
Minority Interest	41	-	-	-	-	-
PAT	**443**	**2,149**	**1,085**	**2,186**	**3,460**	**3,632**
Net Income	**443**	**2,149**	**1,085**	**2,186**	**3,460**	**3,632**
Change (%)	-	385.6	(49.5)	101.5	58.3	5.0

Balance Sheet (INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Share Capital	380	395	400	405	407	407
Reserves	5,133	6,311	7,362	9,167	12,365	15,997
Net Worth	**5,513**	**6,706**	**7,762**	**9,572**	**12,772**	**16,404**
Minority Interest	328	-	-	-	-	-
Loan and other long term liab.	1,394	31	46	37	32	32
Capital Employed	**7,234**	**6,737**	**7,808**	**9,609**	**12,804**	**16,436**
Gross Block	4,941	5,145	5,624	5,820	6,762	8,162
Less : Depreciation	2,110	(2,533)	(2,618)	(3,229)	(3,914)	(4,704)
Net Block	**2,831**	**7,678**	**8,242**	**9,049**	**10,676**	**12,866**
CWIP	130	247	28	85	215	215
Other LT Assets	1,460	154	-	-	-	-
Investments	1,013	1,272	1,112	7	30	30
Curr. Assets	**4,691**	**4,841**	**5,790**	**9,541**	**13,558**	**17,070**
Current Investments	-	-	-	3,075	-	-
Debtors	2,792	2,370	2,825	4,078	4,529	5,060
Cash & Bank Balance	488	523	459	602	5,196	7,728
Loans & Advances	1,411	1,948	2,506	1,786	3,832	4,281
Current Liab. & Prov	**3,082**	**7,670**	**7,580**	**9,394**	**12,086**	**14,024**
Current Liabilities	2,860	2,114	1,814	2,979	-	-
Other liabilites		5,066	5,236	5,691	12,086	14,024
Provisions	222	490	530	724	-	-
Net Current Assets	**1,609**	**(2,828)**	**(1,790)**	**147**	**1,472**	**3,046**
Deferred Tax	190	214	216	321	334	334
Application of Funds	**7,234**	**6,737**	**7,808**	**9,609**	**12,727**	**16,491**

E: MOSL Estimates

Financials and Valuation

Ratios *

Y/E March	2009	2010	2011	2012	2013E	2014E
Basic (INR)						
EPS	**13.8**	**54.8**	**25.5**	**54.2**	**85.2**	**89.4**
Cash EPS	28.6	68.8	43.9	70.3	100.6	107.4
Book Value	144.4	164.8	189.4	233.5	310.1	398.3
DPS	1.0	3.0	2.5	4.0	4.5	5.0
Payout %	7.2	5.5	9.8	7.4	5.3	5.6
Valuation (x)						
P/E				12.8	8.2	7.8
Cash P/E				9.8	6.8	6.4
EV/EBITDA				8.2	4.7	4.0
EV/Sales				1.3	0.9	0.7
Price/Book Value				2.9	2.2	1.7
Dividend Yield (%)				0.6	0.7	0.7
Profitability Ratios (%)						
RoE	9.6	35.2	15.0	25.2	27.1	24.9
RoCE	39.9	26.8	15.8	27.7	38.7	31.6
Turnover Ratios						
Debtors (Days)	82	67	68	78	68	68
Fixed Asset Turnover (x)	4.4	5.0	5.0	7.4	8.5	7.9

* 1:1 bonus in FY07, accordingly ratios are adjusted

Cash Flow Statement (INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
CF from Operations	-	-	1,277	2,459	3,833	4,067
Cash for Working Capital	-	-	(389)	2,079	(1,569)	41
Net Operating CF	**-**	**-**	**1,277**	**2,459**	**3,833**	**4,067**
Net Purchase of FA	-	-	(836)	(253)	(1,072)	(1,400)
Net Purchase of Invest.	-	-	453	1,293	225	393
Net Cash from Invest.	**-**	**-**	**(383)**	**1,040**	**(847)**	**(1,007)**
Proc. from equity issues	-	-	139	5	2	-
Proceeds from LTB/STB	-	-	13	(9)	(5)	-
Dividend Payments	-	-	(150)	-	-	-
Cash Flow from Fin.	-	-	2	(4)	(3)	-
Net Cash Flow	**-**	**-**	**896**	**3,495**	**2,983**	**3,060**
Opening Cash Bal.	**553**	**488**	**523**	**459**	**602**	**5,196**
Add: Net Cash	-	-	896	3,495	2,983	3,060
Closing Cash Bal.	**488**	**523**	**459**	**602**	**5,196**	**7,728**

E: MOSL Estimates

NIIT Technologies

BSE SENSEX	S&P CNX
18,673	5,670

Bloomberg	NITEC IN
Equity Shares (m)	60.0
52-Week Range (INR)	325/164
1,6,12 Rel.Perf.(%)	7/13/27
M.Cap. (INR b)	17.5
M.Cap. (USD b)	0.3

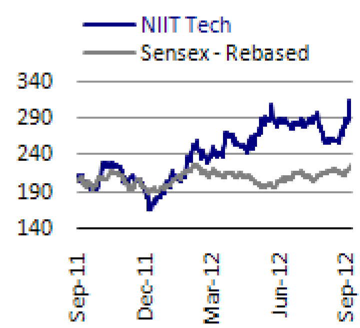
Valuation summary (INR b)

Y/E March	2012	2013E	2014E
Sales	15.8	20.4	23.3
PAT	2.0	2.5	2.4
EPS (INR)	33.0	41.2	39.6
EPS Gr. (%)	7.5	24.8	-3.9
P/E (x)	8.8	7.1	7.4
P/BV (x)	1.9	1.6	1.4
RoE (%)	23.7	24.5	19.8
RoCE (%)	26.7	29.0	24.8
EV/Sales (x)	1.0	0.8	0.5
EV/EBITDA (x)	5.6	4.3	3.4

Shareholding pattern (%)

As on	Jun-12	Mar-12	Jun-11
Promoter	38.9	39.1	39.3
Dom. Inst	14.1	13.1	10.1
Foreign	23.4	24.9	24.5
Others	23.6	23.0	26.2

Stock performance (1 year)



CMP: INR292 | **TP: INR317** | **Neutral**

Focus on strengthening order book

Margin pressures keep us Neutral low valuations

- **NIIT Technologies (NITEC) strategy is driven towards being the first choice vendor in verticals like BFSI, and Travel and Transport (T&T).**
- **Its aggressive deal pursuits and synergies from JVs/acquisitions lend healthy growth visibility, but we remain cautious on the margins going forward.**
- **We expect NITEC's USD revenue to grow at a CAGR of 15.1% and EPS to grow at a CAGR of 9.5% over FY12-14.**
- **Our target price of INR317 discounts its FY14E EPS by 9x. We initiate coverage with a Neutral rating.**

Balanced geographic portfolio; select vertical focus

NITEC has strived to grow by being the first choice vendor in select verticals - BFSI: 34% of FY12 revenue, and Travel and Transport: 39% of revenue. Acquisition of ROOM Solutions provided the company with a platform solution for the Insurance industry. Even within T&T, acquisitions like Projecta have facilitated scale. The company has a balanced geography mix. It derives ~24% of its revenue from non-linear services: ~12% each from IP Licensing and Managed Services.

Focus on building order book ensures revenue visibility...

In a tough environment, NITEC's priority has been to secure healthy orders and ensure revenue visibility. It has beefed up its front end and is also not shying away from innovative deal structures to grab share. This is reflected in healthy order bookings - NITEC signed deals worth USD453m in FY12, as compared to USD210m-310m per year in the past.

... but raises concerns on margins, revenue quality

Amidst the high growth, NITEC's EBITDA margin declined from 20.7% in 3QFY11 to 16% in 1QFY13, primarily due to (a) transition costs pertaining to large deals, (b) increasing share of revenue from lower margin government business - CCTNS (Crime and Criminal Tracking Network and Systems) deals won in four states, and (c) wage hikes in 1QFY13. 25.7% margin at ROOM and assuming GIS (Geographic Information System) margin at 20% imply EBITDA margin for the remaining business at ~14% - lower than its peers in the Services segment.

Margin concerns keep us Neutral

We like NITEC's [1] focus on select offerings, [2] its early thrust on driving non-linear initiatives and [3] diversified portfolio of business. We expect USD revenue CAGR of 15% and EPS CAGR of 9.5% over FY12-14E. While we believe that the engine put in place by the company to drive growth will yield results in the medium term, we remain cautious on the company's long term scalability and margin profile. The stock trades at 7.1x FY13E and 7.4x FY14E EPS. We value NITEC's business at 8x FY14E earnings, to arrive at our target price of INR317. We initiate our coverage with a Neutral rating on the stock.

NIIT Technologies

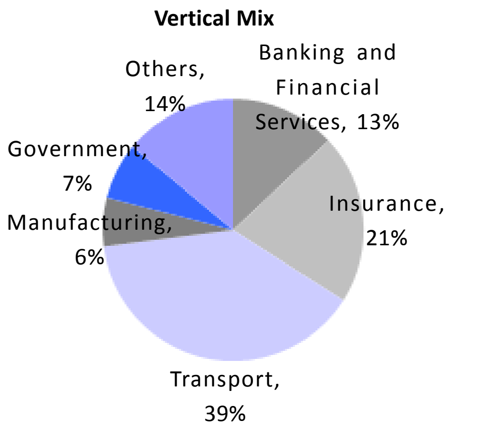
MID Score|Discount: **53|47%** FY14 P/E: **8x**

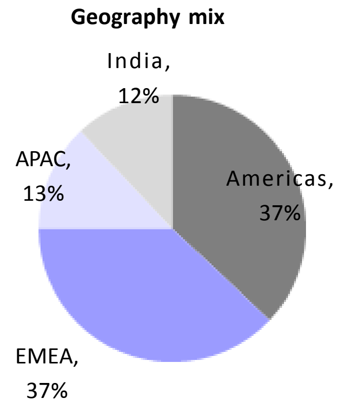
M : 3/5 Management focus and Strategy

- NIIT Technologies is offers end-to-end software solutions and services in ADM, Managed Services, Cloud Computing and BPO to organisations in the BFSI, Travel & Transportation, Manufacturing & Distribution, and Government sectors. NITEC's vision is to be “First Choice” vendor of services in focused verticals.
- Mr. Arvind Thakur is the CEO of NITEC's, and serves as the Joint MDon its board. He graduated in engineering from IIT. Thereafter he pursued post graduation in Industrial Engineering from NITIE. He started his career as an Industrial Engineer with BHEL, before joining NIIT Ltd. in 1985 as a member of the core team

I : 10.5/15 IT Mix

- **Industry Mix (3.5/5):** NITEC's revenues are dominated by Travel & Transport (40%) and BFSI (34%)
- **Services Mix (3/5):** ~24%+ of the company's revenues are non-linear, from IP (ROOM platform) and Managed Services.
- **Geography mix (4/5):** Has a well balanced geographic mix, with 25% revenues from APAC and India, 39% from EMEA and 36% from Americas.



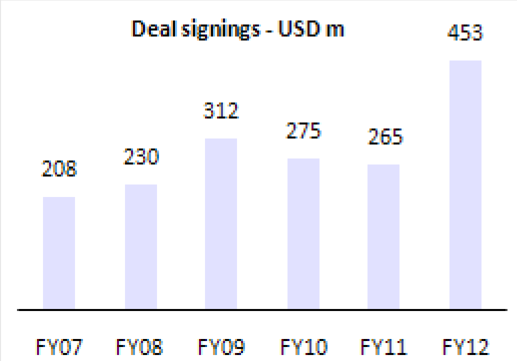


D : 7 / 10 Deal signing prowess

- JV with Morris Communication, Eurostar, BSF order from GOI and CCTNS orders won in multiple states have been testimony to the company's ability to win large deals. Some pose risks around revenue quality.

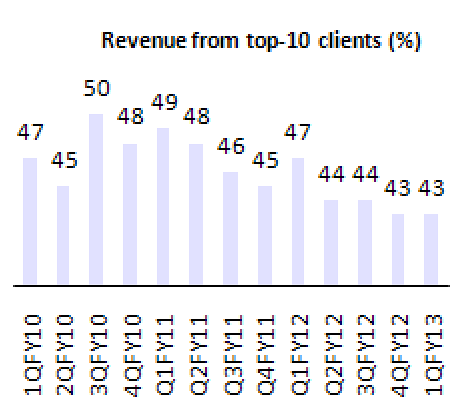
Some Large orders announced

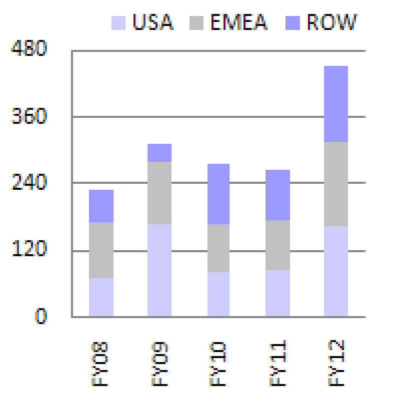
Morris JV	USD85m
CCTNS - 4 States	~USD75m
Eurostar	est. USD40m
BSF	USD50m



C : 7 / 10 Client Concentration

- Revenue from top-10 clients have stayed within the band of 45-50% over the past 3 years, this despite the company bagging multiple large deals in the last two years.
- NITEC' growth has been broad-based in most respects, which goes to the company's credit.



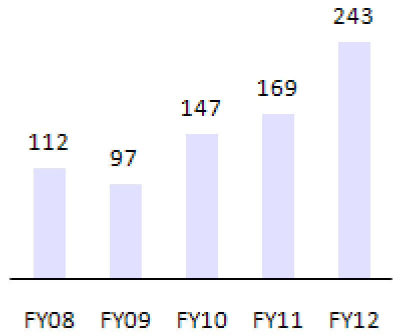


NIIT Technologies

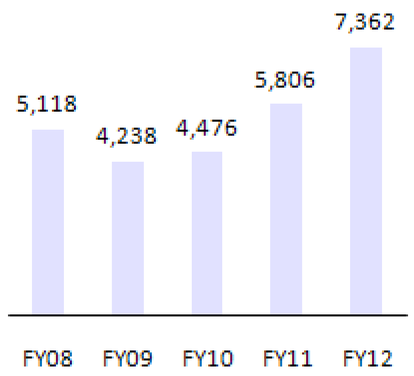
A: 9/20 Ability to scale and Attrition

- **Ability to Scale (6/10):** NITEC's revenue profile varies in terms of quality. Sustainable growth and scalability will be a function of large deals in higher-margin profile work, and in pure services with lesser hardware component
- **Attrition (3/5):** Attrition rate at the company is at the lower end of the industry average, which is a positive for its execution of large order book.

Executable order book over next 12 months - USD m

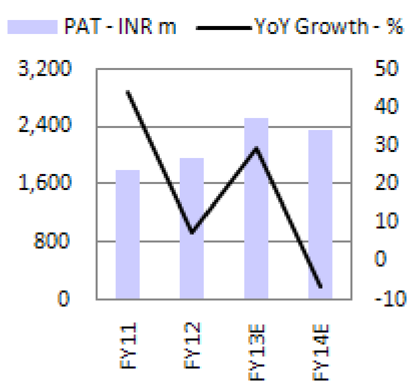


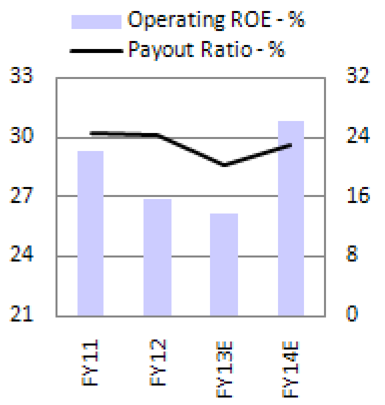
Employee headcount



P : 20.0/40 P: Profit and Payout

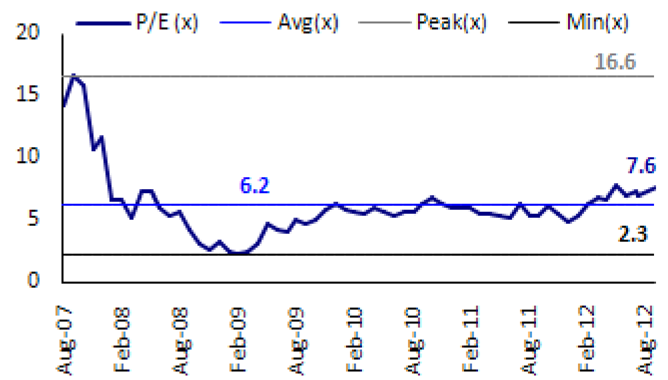
- **Profit Growth (4/15):** We expect NITEC to grow its EPS at a CAGR of 9.5% over FY12-14, lower than peers on account of margin contraction we model in our estimates
- **Profit Quality (9/15):** We expect Operating ROE average at 26%.
- **Payout Ratio (7/10):** Payout ratio has been 20%+, and is one of the higher dividend paying companies among IT midcaps.





MID Score : 56.5 / 100 | P/E 9x

Hexaware		Benchmark	
M	Management	5	3.0
I	IT Mix	15	9.5
D	Deals	10	6.0
C	Client Concentration	10	7.0
A	Ability to scale & Attrition	20	9.0
P	Profit & Payout	40	18.5
	TOTAL MID SCORE	**100**	**53.0**
	Discount - %		47.0
	Tier I average target P/E		16.0
	Stock target P/E		8.0
	FY14E EPS - INR		39.6
	Target Price - INR		317
	Upside - %		9
	Rating		**Neutral**

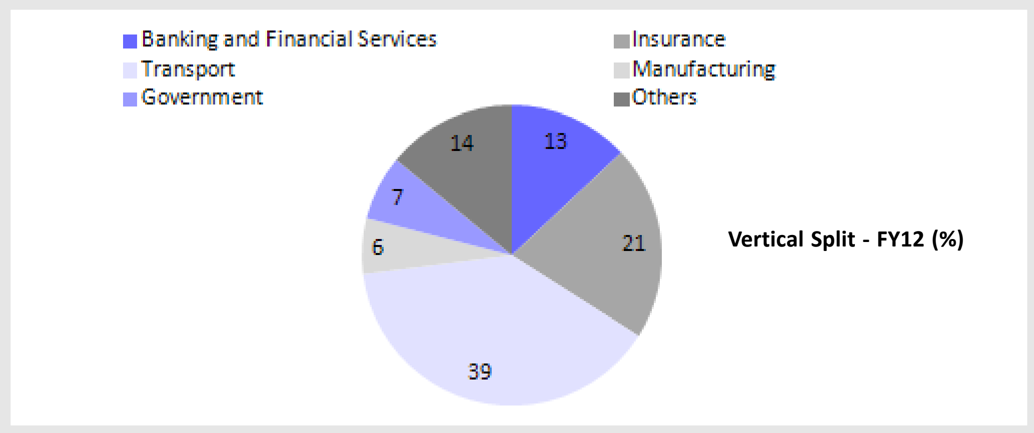


Focus on selected set of offerings, balanced portfolio

Has been focused on select verticals, and managed to spread revenue evenly across the Americas and EMEA

NITEC has done well to maintain its focus on a select set of offerings. It intends to differentiate itself within the chosen spaces, which in our opinion is the right approach for mid-sized IT companies. About 74% of NITEC's revenue comes from two verticals - Banking, Financial Services and Insurance (BFSI) and Travel and Transport (T&T). Apart from these two verticals, NITEC focuses on the domestic government business, the manufacturing vertical in the Asia-Pacific (APAC), and lastly, Healthcare, which it has identified as the new opportunity area.

Transport and BFSI are the key verticals for the company



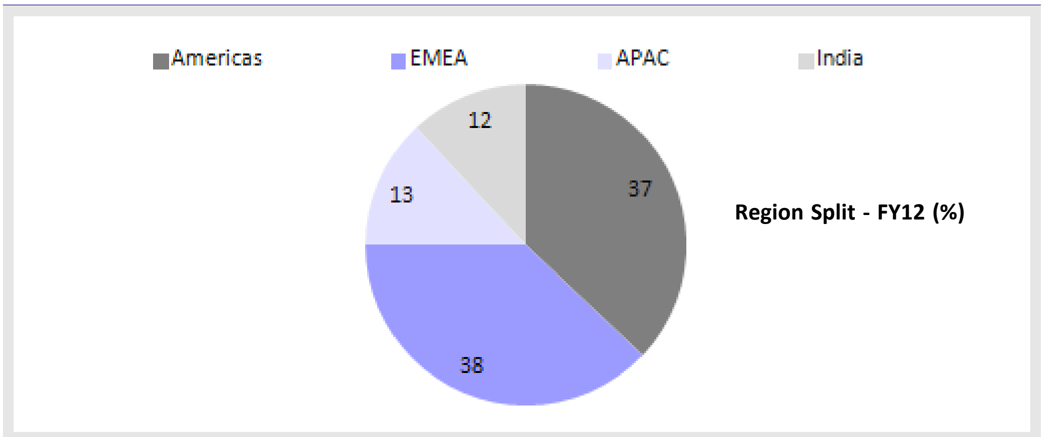
Source: Company, MOSL

NITEC has strong references in the domestic space, with significant experience in GIS projects (6.2% of revenue in FY12) and execution of a large BSF order. Its references are only getting stronger, with CCTNS deals won in four states (total contract value of USD75m) - Tamil Nadu, Jharkhand, Uttar Pradesh and Odisha.

In terms of geographies, NITEC does not have heavy dependency on any one region. The Americas and EMEA contribute almost equally to the company's revenue, India and APAC contribute ~25%.

Revenues spread evenly between Americas and EMEA

Strength in Transport helped EMEA edge Americas



Source: Company, MOSL

Ahead of the curve in driving non-linearity

ROOM and Managed Services are the key non-linear revenue generators. ROOM's OPM has been much better than overall company's

NITEC has been ahead of the curve in driving non-linear initiatives. The impetus on non-linearity is manifested in the company's 4-pronged approach, whereby it obtains revenue from:

[1] Managed Services,

[2] Cloud Services,

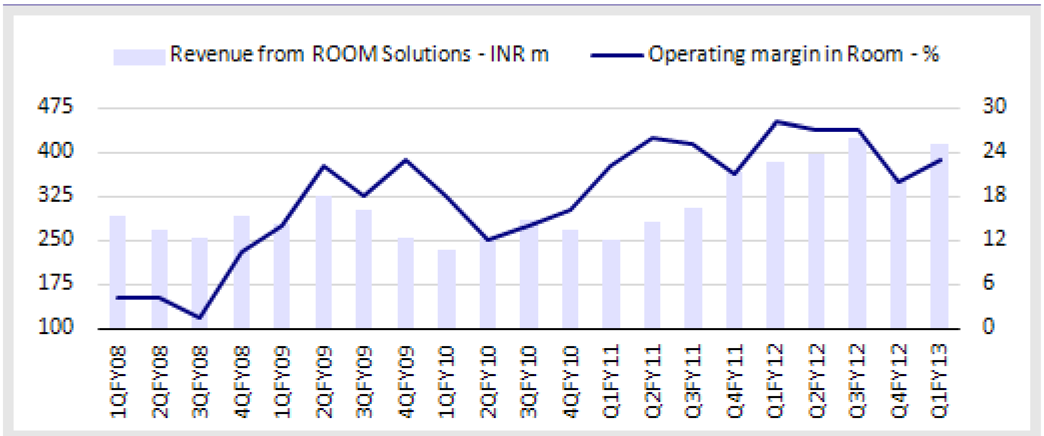
[3] Platform-based Solutions, and

[4] Development of IP Assets.

The company currently derives ~24% of its revenue from non-linear initiatives, the share of which should increase, as Morris JV revenue switches from the existing mode to the transaction-based mode. NITEC currently derives nearly half its non-linear revenue from its Insurance platform (ROOM). Managed Services constitute the major part of its remaining revenue. We note that despite heavy growth in remaining services, the share of non-linear revenue has held its own.

NITEC's acquisition of ROOM in FY07 set a good precedent for identifying, nurturing and leveraging a potentially beneficial non-linear opportunity. ROOM, which had quarterly revenue of INR250m-300m and operating margin of 6-8% at the time of acquisition, reported revenue of ~INR415m and operating margin of 23% in 1QFY13.

Non-linearity in ROOM Solutions reflected in margin expansion with increasing revenue base



Source: Company, MOSL

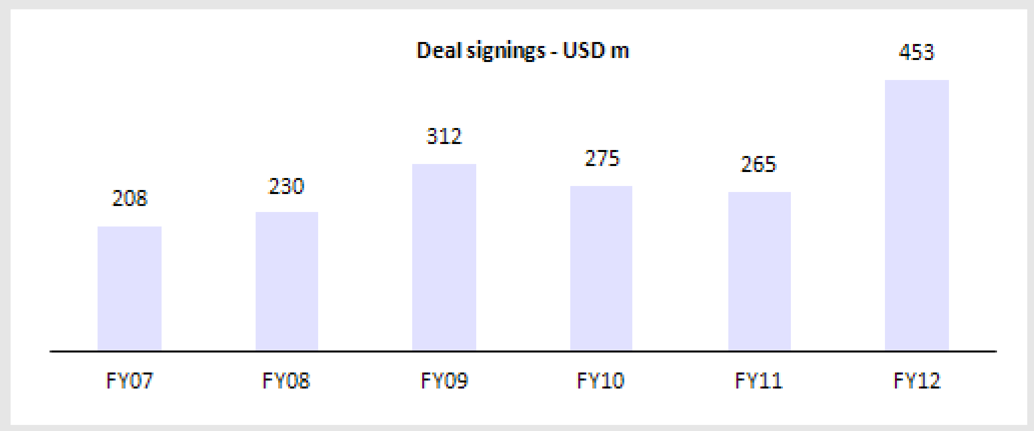
Aggressive pursuit of growth yields healthy order book, revenue growth visibility

Deals signed in FY12 and orders executable in the next 12 months lend healthy visibility on growth

As the macro environment has grown more challenging, NITEC has chosen to pursue growth aggressively, beefing up its front end and also not shying away from innovative deal structures to grab share. This reflects in healthy order booking for the company - it went on to sign deals worth USD453m in FY12 as compared to USD210m-310m per year in the past.

TCV of deals signed in FY12 much higher than the range in the last 5 years

Deal signings in FY12 lend growth visibility for FY13

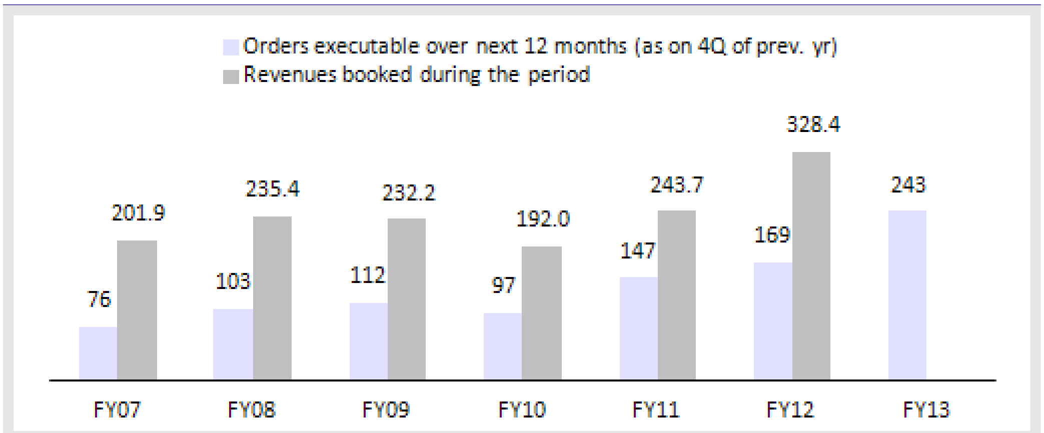


Source: Company, MOSL

Orders executable over the next 12 months as at end-4QFY12 were USD243m, compared with USD169m as at end-4QFY11. Over the last six years, the ratio of revenue realized over the next four quarters book to order booked has ranged from 1.66x to 2.66x. Even if we assume a conversion ratio of 1.6x, lower than the bottom of the range, we obtain revenue growth of 18.4% YoY, much better than expected industry average in FY13. We remain conservative, and estimate FY13 revenue at USD373m, YoY growth of 13.7%, after a weak 1QFY13 made the asking rate high for a significantly higher growth.

Orders executable in the next 12 months indicate 18%+ YoY growth, going by historical precedence

Strong next-12-months executable order book indicates above-industry growth in FY13



Source: Company, MOSL

Synergies from JVs/acquisitions could augment revenue growth

Potential augmenters: [1] Media clients other than Morris on JV, [2] selling ROOM solutions to new regions [3] Projeca to other geographies

NITEC also stands a chance to augment its organic growth by leveraging upon its acquisitions/JV:

- While the Morris JV is currently catering only to Morris Communications, it can sell its services to other media companies, too. The management has indicated that other media companies have evinced interest and it is currently trying to understand how best to price its services.
- ROOM Solutions, which was largely selling in the UK, has begun to see scope in other regions like Belgium and even the US. Acceptance of the product in these geographies can open a huge market for its services.
- Similarly, NITEC has even taken its services from the Projecta acquisition to other parts of the world.

New deals keep us cautious on the margin profile, going forward

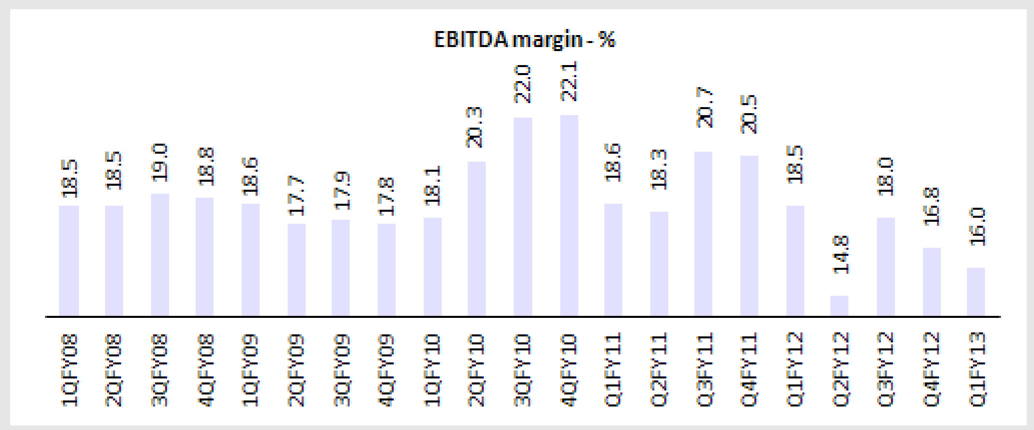
Transition costs on large deals, low margin hardware component in Government orders have dragged margins

NITEC's EBITDA margin declined from 20.7% in 3QFY11 to 16% in 1QFY13. Transition costs incurred towards large deals like Morris Communications and Eurostar contributed to the decline. Besides, increasing revenue from government business (CCTNS deals won in four states) will also adversely impact overall margins, given that hardware constitutes 65-70% of these deals.

NITEC's EBITDA margin for FY12 was 17%, down 250bp, despite favorable currency movement (4.3% INR depreciation on the realized currency rate). Also, ~16% of revenue came from ROOM and GIS, with the EBITDA margin in ROOM Solutions at 25.7%. Even GIS has a margin profile of 20%+. If we assume EBITDA margin at GIS at 20%, this implies EBITDA margin of 13.7% for the remaining business, lower than its peers in the Services segment. Also, the revenue contribution from GIS and ROOM was down 3pp in FY12. We are concerned about NITEC's profitability. While the outlook on ROOM appears sanguine, growth in GIS has been tapering off over the last few quarters.

Additionally, NITEC expects revenue of INR1.1b-1.2b from the CCTNS deals in FY13. On our overall revenue estimate of INR20b in FY13, this implies CCTNS contribution of 5.5-6%, as a result of which we see improvement in margins hard to come by.

Margin profile trended down on transition costs and hardware revenue



Source: Company, MOSL

Margin levers may not reverse, but at best arrest the slide in margins

Margin levers: [1] Offshoring of revenues from Morris, [2] shift of JV's revenue model to transaction-based [3] employee pyramid are margin levers

The management indicated its intention of growing its margins back to high teens (18-19%). NITEC has a few margin levers: [1] offshoring from Morris deal should drive some offshore mix shift, [2] potential transaction-based revenue from Morris JV should drive non-linearity, and hence, margins, [3] broadening of the employee pyramid, with the addition of freshers.

While these levers could stem the margin decline, we do not expect a reversal in the margin trend. Revenue from CCTNS will be a drag on margins. Also, despite no transition costs in 1QFY13, the company did not see any benefits from the transition cost impacted base of the previous quarters. Incrementally, pricing pressures, especially in BFS, could also hurt margins.

Our EBITDA margin estimates are 18.1% for FY13 (v/s 17% in FY12) and 16% for FY14.

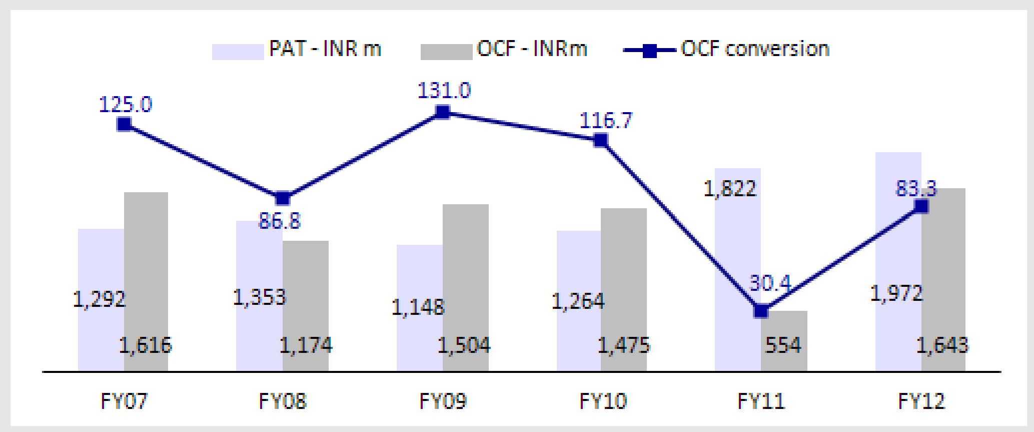
Cash flow metrics took a dent in BSF order, will come under spotlight with CCTNS

Higher proportion of business from Government is reflected in the deteriorating OCF metrics and DSO

NITEC witnessed an impressive OCF conversion (OCF/PAT) over FY07-FY10, in the range of 87%-131%. However, with the increase in receivables in the large BSF order, the ratio fell to 30% in FY11, picking up to 83% in FY12.

Some of the large deals that NITEC has won, in the case of BSF, have significant hardware component (65-70% hardware in ~USD125m BFS and four states' CCTNS deals). Not only are profits from such engagements extremely low, the bigger issue is that 60-65% of the costs will be incurred upfront and the company will accrue revenue to that extent in its P&L. However, the cash payment happens only at a later point of time, hurting the company's debtor profile.

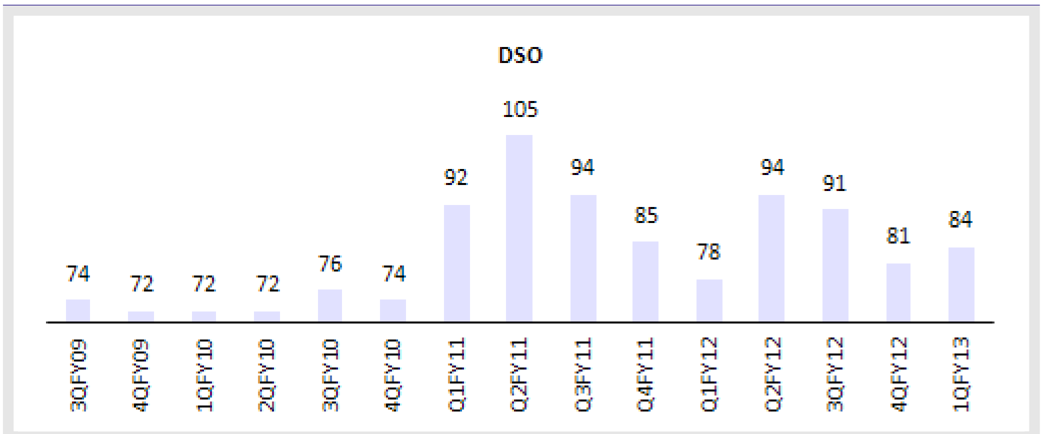
OCF conversion hurt by high DSO days following increase in government orders



Source: Company, MOSL

Also, DSO days have increased to 80-90 as compared to low 70's earlier. DSO days are at risk again, with CCTNS revenue booking adding to debtors. Currently, debtors stand at INR3.4b and USD22m (INR1.1b) revenue is likely to accrue from the CCTNS deals in FY13. This is nearly 30% of the existing debtor number.

Larger proportion of Government orders has impacted DSO metrics



Source: Company, MOSL

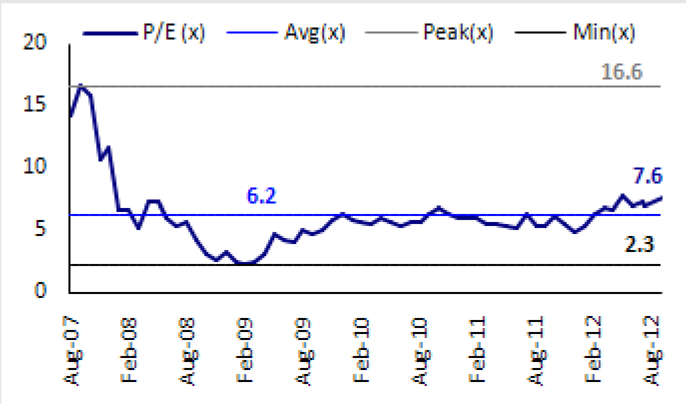
Margin concerns keep us Neutral

Revenue growth healthy but revenue quality and future margins are potential concerns

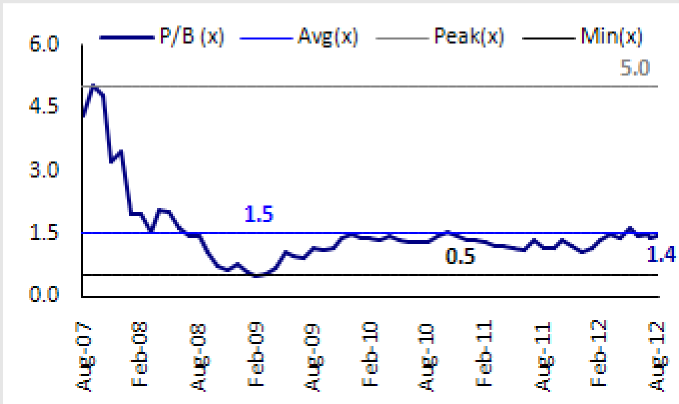
We like NITEC's [1] focus on select offerings, [2] its early thrust on driving non-linear initiatives and [3] diversified portfolio of business. We expect NITEC's USD revenue to grow at a CAGR of 15.1% and EPS to grow at a CAGR of 9.5% over FY12-14. While we believe that the engine put in place by the company to drive growth will yield results in the medium term, we remain cautious on the company's long term scalability and margin profile. On EV/FCF basis, the stock still trades favorably v/s peers, when looked at historical cash generation, but Cash Flow generation going forward remains uncertain with increasing proportion of government contracts in the order book. NITEC has had consistent dividend payout policy, second only to HEXW in our tier-II universe.

The stock trades at 7.1x FY13E and 7.4x FY14E EPS. We value NITEC's business at 8x FY14E earnings, to arrive at our target price of INR317. We initiate our coverage with a **Neutral** rating on the stock.

NIIT Tech PE Chart



NIIT Tech PB Chart



Financials and Valuation

Income statement (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Sales	**9,138**	**12,323**	**15,764**	**20,395**	**23,304**
Change (%)	-6.8	34.9	27.9	29.4	14.3
Software Develop. Exp.	7,249	9,919	13,082	16,753	19,618
EBITDA	**1,889**	**2,404**	**2,682**	**3,642**	**3,686**
% of Net Sales	20.7	19.5	17.0	17.9	15.8
Depreciation	360	315	364	539	577
Other Income	-109	89	282	281	138
PBT	**1,420**	**2,178**	**2,600**	**3,383**	**3,247**
Tax	144	323	637	909	869
Rate (%)	10.1	14.8	24.5	26.9	26.8
Minority Interest	13	33	0	0	0
Adjusted PAT	**1,263**	**1,822**	**1,963**	**2,475**	**2,378**
Reported PAT	**1,263**	**1,822**	**1,963**	**2,475**	**2,378**
Change (%)	9.9	44.3	7.7	26.1	-3.9

Balance Sheet (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Share Capital	588	593	596	599	599
Reserves	5,210	6,885	8,505	10,484	12,293
Net Worth	**5,798**	**7,478**	**9,101**	**11,083**	**12,892**
Minority Interest	28	43	123	131	132
Loans	217	110	506	422	422
Capital Employed	**6,043**	**7,631**	**9,730**	**11,636**	**13,446**
Gross Block	5,241	5,814	8,452	9,825	10,625
Less : Depreciation	3,388	3,857	4,221	4,760	5,337
Net Block	**1,853**	**1,957**	**4,231**	**5,065**	**5,288**
CWIP	1,287	1,437	2	24	24
Deferred tax assets	107	143	207	263	263
Curr. Assets	**4,996**	**6,665**	**8,822**	**9,752**	**13,419**
Debtors	1,851	2,871	3,492	4,767	5,311
Cash & Bank Balance	1,895	1,637	2,871	2,220	5,512
Other Current Assets	1,250	2,157	2,459	2,765	2,596
Current Liab. & Prov	**2,200**	**2,508**	**3,533**	**3,468**	**5,548**
Current Liabilities	1,647	2,508	3,533	3,468	5,548
Provisions	553	0	0	0	0
Net Current Assets	**2,796**	**4,157**	**5,289**	**6,284**	**7,871**
Application of Funds	**6,043**	**7,631**	**9,729**	**11,636**	**13,446**

E: MOSL Estimates

Financials and Valuation

Ratios

Y/E March	2010	2011	2012	2013E	2014E
Basic (INR)					
EPS	**21.4**	**30.7**	**33.0**	**41.2**	**39.6**
Cash EPS	27.5	36.0	39.2	50.2	49.2
Book Value	98.4	126.1	153.2	184.7	214.9
DPS	7.0	7.5	8.0	8.5	9.0
Payout % (excl.div.taxes)	32.7	24.4	24.2	20.6	22.7
Valuation (x)					
P/E			8.8	7.1	7.4
Cash P/E			7.4	5.8	5.9
EV/EBITDA			5.6	4.3	3.4
EV/Sales			1.0	0.8	0.5
Price/Book Value			1.9	1.6	1.4
Dividend Yield (%)			2.7	2.9	3.1
Profitability Ratios (%)					
RoE	26.1	27.4	23.7	24.5	19.8
RoCE	29.7	30.6	26.7	29.0	24.8
Turnover Ratios					
Debtors (Days)	76	70	74	74	79
Fixed Asset Turnover (x)	4.6	6.5	5.1	4.4	4.5
Leverage Ratio (x)					
Debt/Equity Ratio(x)	0.0	0.0	0.1	0.0	0.0

Cash Flow Statement (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
CF from Operations	1,951	2,101	2,263	2,958	2,982
Cash for Working Capital	-1,832	-1,619	102	-1,646	1,705
Net Operating CF	**119**	**482**	**2,365**	**1,312**	**4,687**
Net Purchase of FA	-343	-505	-1,267	-1,395	-800
Net Purchase of Invest.	0	0	0	0	0
Net Cash from Invest.	**-343**	**-505**	**-1,267**	**-1,395**	**-800**
Proceeds from Equity	1,148	393	296	112	64
Proceeds from LTB/STB	-131	-107	396	-84	-27
Dividend Payments	-483	-520	-556	-597	-632
Cash Flow from Fin.	**534**	**-234**	**136**	**-569**	**-595**
Net Cash Flow	**310**	**-257**	**1,234**	**-652**	**3,292**
Opening Cash Bal.	**1,585**	**1,895**	**1,638**	**2,872**	**2,220**
Add: Net Cash	310	-257	1,234	-652	3,292
Closing Cash Bal.	**1,895**	**1,638**	**2,872**	**2,220**	**5,512**

E: MOSL Estimates

Persistent Systems

BSE SENSEX	S&P CNX
18,673	5,670

Bloomberg	PSYS IN
Equity Shares (m)	40.0
52-Week Range (INR)	427/281
1,6,12 Rel.Perf.(%)	-1/27/29
M.Cap. (INR b)	16.5
M.Cap. (USD b)	0.3

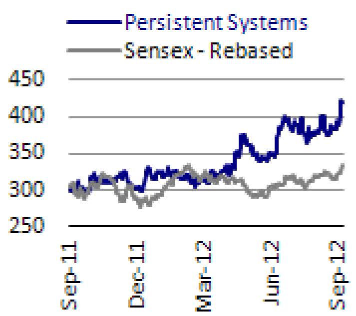
Valuation summary (INR b)

Y/E March	2012	2013E	2014E
Sales	10.0	12.8	14.5
PAT	1.4	2.0	2.2
EPS (INR)	34.6	49.8	52.9
EPS Gr. (%)	1.5	43.9	6.3
P/E (x)	12.0	8.3	7.8
P/BV (x)	2.0	1.6	1.4
RoE (%)	17.7	21.6	19.3
RoCE (%)	14.6	17.7	15.8
EV/Sales (x)	1.5	1.1	0.9
EV/EBITDA (x)	6.6	4.2	3.7

Shareholding pattern %

As on	Jun-12	Mar-12	Jun-11
Promoter	39.0	39.0	38.9
Dom. Inst	12.8	11.9	6.2
Foreign	21.7	22.0	26.4
Others	26.5	27.1	28.5

Stock performance (1 year)



CMP: INR415 | TP: INR476 | Neutral

Impressive capabilities; Await proof of scale

Unpredictability highly; margin sustainability a concern; Neutral

- **Persistent Systems (PSYS) is focusing on new initiatives that are likely to drive the next wave of growth in technology - Cloud, Mobility, Data Analytics and Collaboration.**
- **While its chosen segments are niche, in line with the times and cutting-edge, its multi-pronged efforts to scale are yet to bear fruit.**
- **Profitability is a key concern due to higher proportion of offshoring and the fact that it will be compelled to give frequent wage hikes to curb attrition.**
- **Greater revenue visibility and waning headwinds to margins are the keys to higher confidence in the stock. We initiate coverage with a Neutral rating.**

Clear focus on new technologies offering high growth potential

PSYS is focusing on new initiatives that are witnessing greater demand and will drive the next wave of growth in technology - Cloud, Mobility, Data Analytics and Collaboration. It is an early entrant in these segments and its experience in building platforms as a vendor to marquee customers gives it a competitive edge. The company has been creating new business lines like sell-with and technology consulting to scale up, though the fruition of such efforts will take time.

Lack of predictability due to multiple volatility factors

PSYS' chosen segments are niche, in line with the times and cutting-edge, but predictability of trends in the business are low due to: [1] smaller size of engagements in offshore product development (OPD), [2] more cyclical nature of OPD due to lower annuity revenue and discretionary nature of product development, and [3] increasing thrust on expanding IP-led revenue share.

Concerns on margins due to frequent wage hikes to curb attrition

Despite an impressive surge in EBITDA margin from 17.9% in 4QFY11 to 28.6% in 4QFY12, margin sustainability is a concern due to: [1] high proportion of offshoring (79% of FY12 revenue was from offshore) - implying offshore wage hikes hurt margins more than peers (440bp impact on 10% hike), and [2] high attrition levels, resulting in frequent wage hikes (4 hikes since April 2010).

Impressive capabilities but high uncertainty, margin concerns; Neutral

While PSYS impresses us on its capabilities, we are concerned with: [1] the lack of predictability in a tough environment, [2] margins and [3] concentration risks (82.5% of FY12 revenue from US, revenue from top-10 clients up from 43.8% in FY10 to 48.6% in FY12). We expect PSYS to grow its USD revenue at CAGR of 15% and EPS at a CAGR of 24% over FY12-14. Our target price is INR476 discounts its FY14E EPS by 9x. Greater revenue visibility, confidence on scability and waning headwinds to margins are the keys to higher confidence in the stock. We initiate coverage with a **Neutral** rating.

Persistent Systems

MID Score|Discount: **58|42%**

FY14 P/E: **9x**

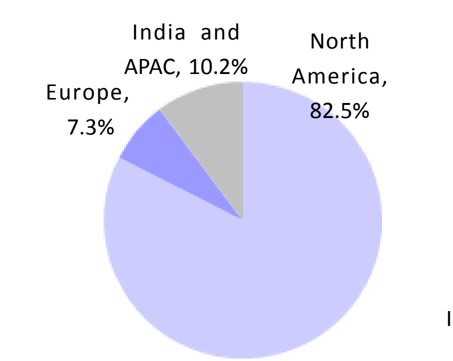
M : 3/5 Management focus and Strategy

- PSYS is focusing on new initiatives that are witnessing greater demand and will drive the next wave of growth in technology – Cloud, Mobility, Data Analytics and Collaboration; and operates in the Offshore Product Development space (OPD) . The company has partnered with pioneering start-ups, innovative enterprises and the world's largest technology brands.
- Mr. Anand Deshpande is the Founder, Chairman and Managing Director of Persistent Systems. Anand has a B. Tech (1984) in Computer Science and Engineering from IIT Kharagpur, a Masters (1986) and a Ph.D. (1989) in Computer Science from Indiana University, Bloomington (USA). Anand worked as MTS at Hewlett-Packard Laboratories in Palo Alto, California from 1989 to 1990, after which, he started Persistent.

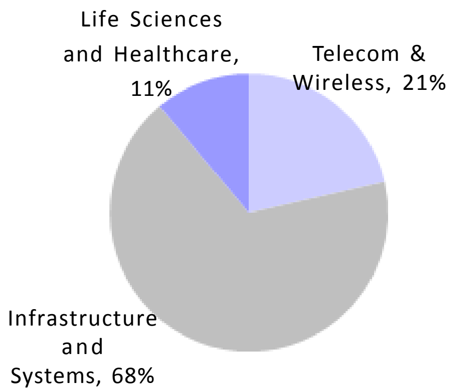
I : 8.5/15 IT Mix

- **Industry Mix (2.5/5):** Nearly two-thirds of PSYS revenues are from Infrastructure and Systems, understandable given its play in the products domain.
- **Services Mix (3.5/5):** 40%+ revenues from the new initiatives imply healthy exposure to cutting edge services.
- **Geography mix (2.5/5):** PSYS has been relying on North America as the sole geography for most of its revenues (80-90%)

FY12 Geographic split - %



FY12 Vertical split - %



D : 5/15 Deal signing prowess

The nature of work in Offshore Product Development (OPD) implies smaller deals, where USD3-5m annual run-rate is considered fairly large. These are only getting smaller as per the management.

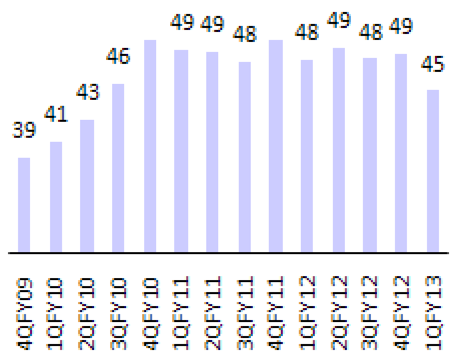
"Deal sizes are becoming more project driven rather than ODC, kind of things when we running a business where it was an offshore development center. This is the nature of the business, we had anticipated this and this is how its going to be."

"The pipeline actually is very large with lots of large deals. The problem is the time it takes to close the deals is pretty large as well. But overall lot of the deals that we are going and adding in these areas, are definitely in millions and not in thousands of dollars."

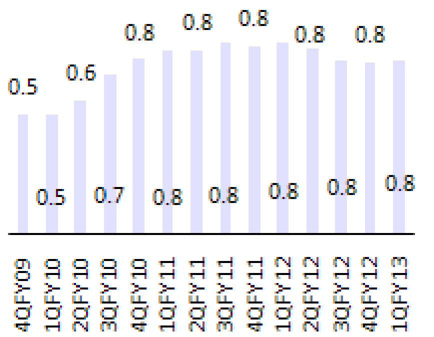
C : 6 / 10 Client Concentration

- Top client contributed 16% of revenues in FY12 and top-10 contributed 49%. Revenue proportion from top client was 11% in FY10.
- Additionally, having bought IP from the clients, the company's revenues are directly linked to the business success of the clients in selling the products

Revenue proportion from top-10 Clients %



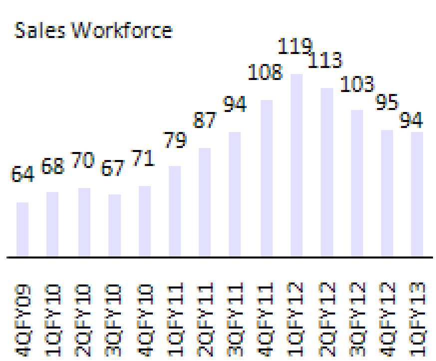
Annualized revenue per client - USD m

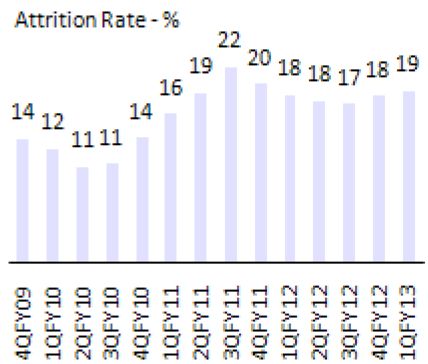


Persistent Systems

A: 8.5/10 Ability to scale and Attrition

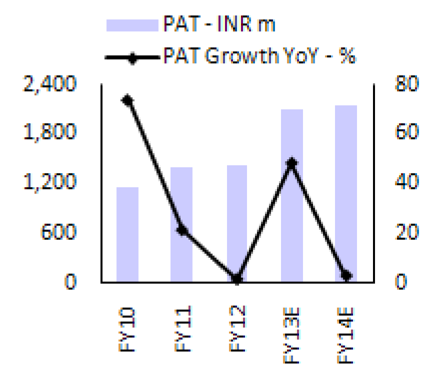
- **Ability to scale (6/15):** Scalability is one of the key questions that PSYS seeks answers to. While it continues to do high end work, it has not managed to grow its deal sizes. Revenue per client has ranged between USD0.7-0.8m since 3QFY10.
- **Attrition (2.5/5):** High-teens attrition have necessitated frequent wage hikes

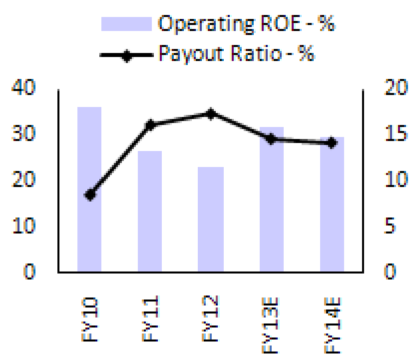




P : 27/40 P: Profit and Payout

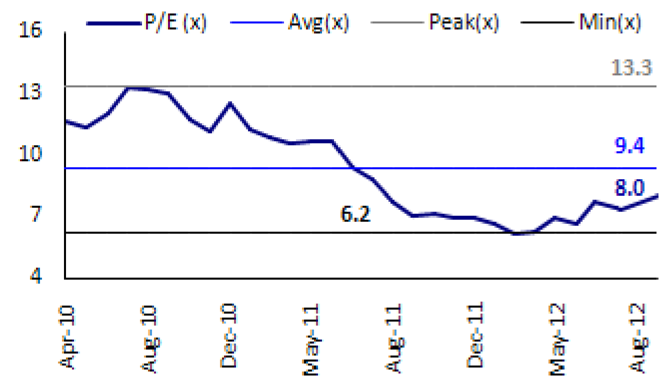
- **Profit Growth (12/15):** We expect PSYS to grow its EPS at a CAGR of 24% over FY12-14.
- **Profit Quality (9/15):** We expect an operating ROE average of 26%
- **Payout Ratio (6/10):** The company's payout ratio has been ~15% in the last couple of years. Healthy cash generation implies scope for more.





MID Score : 58 / 100 | P/E 9x

Hexaware		Benchmark	
M	Management	5	3.0
I	IT Mix	15	8.5
D	Deals	10	5.0
C	Client Concentration	10	6.0
A	Ability to scale & Attrition	20	8.5
P	Profit & Payout	40	27.0
	TOTAL MID SCORE	**100**	**58.0**
	Discount - %		42.0
	Tier I average target P/E		16.0
	Stock target P/E		9.0
	FY14E EPS - INR		52.9
	Target Price - INR		476
	Upside - %		15
	Rating		**Neutral**



Clear focus on new technologies offering high growth potential

Clear focus on new age technologies - Cloud, Analytics, Mobility and Collaboration

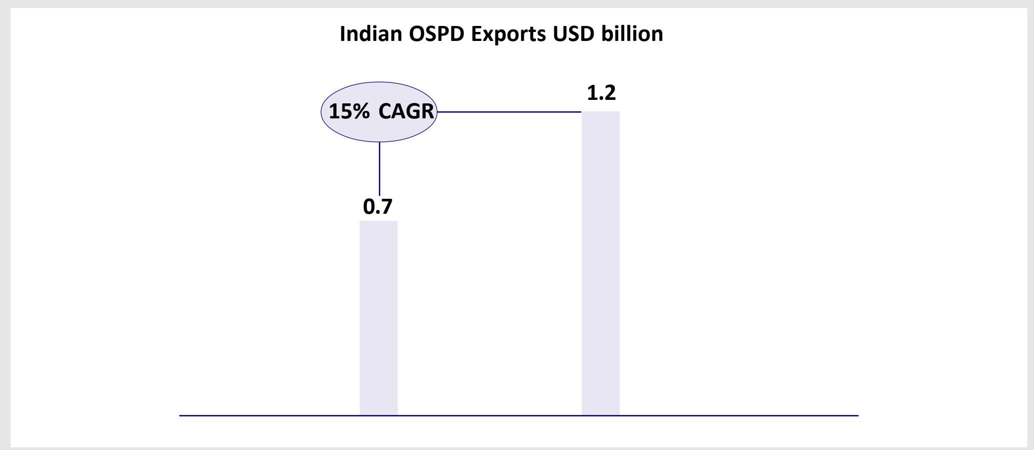
PSYS is focusing on new initiatives that are witnessing greater demand and will drive the next wave of growth in technology - Cloud, Mobility, Data Analytics and Collaboration. Increasingly, enterprises and software providers are extending existing applications onto the mobile environment apart from creating new mobile applications to implement their **mobility** strategy actively. **Cloud** deployment and migration of application software companies to software-as-a-service architecture has only been growing with the passage of time, and penetration is still very low. Enterprises are beginning to leverage social networking and search technologies, resulting in a splurge of product development activities in this space. There is also a need for elaboration of the plethora of data through predictive analytics.

An example of this is work that PSYS is doing with Satyamev Jayate (a television talk show highlighting sensitive social issues prevalent in India) around data analytics on social and media twitter feed, Facebook and other social media to provide them with an impact understanding.

In the light of these opportunities, PSYS has been following a 4*4*4 business strategy, defining its focus on 4 verticals, 4 new initiatives (Cloud, Collaboration, Analytics and Mobility) and 4 models of business. Product Engineering, Sell-with Partnerships, Technology Consulting and IP-led businesses are the modes of revenue generation. In terms of verticals, the company's focus is on Telecom, Life Sciences, Infrastructure Systems, and Banking and Finance.

OPD exports have grown at a 15% CAGR on a low base

OPD exports have grown at 15% CAGR since FY07 on a small base, captives enjoy a fair share of this piece



Source: NASSCOM, MOSL

Enjoys early mover advantage; ability to scale will be key factor to watch

PSYS' foray into new technologies much before peers; and marquee clients gives it competitive edge

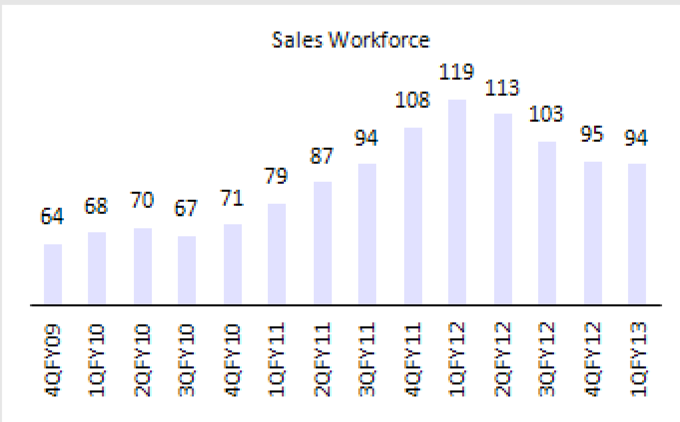
Given the extent of opportunity identified in PSYS' chosen areas, it is not the only company talking of these themes. However, major players at the forefront of providing technologies like infrastructure in cloud computing are its customers and it has been building platforms for them. This has enabled the company to gain an extremely good understanding of what is happening in the cloud infrastructure space. PSYS has developed extremely deep technical capabilities in the cloud computing and mobility area. While it expects competition to intensify, given the opportunity size, it is confident about its ability and positioning in the market. We believe the key factor to watch would be how effectively PSYS manages to scale. The company has been channelizing its efforts aggressively towards that end by creating new business lines like Sell-with and Technology Consulting, in addition to the flagship Product Engineering.

In its attempt to scale, the company tries to reach out directly to the end customer through sell-with model, where it approaches the market jointly with its clients

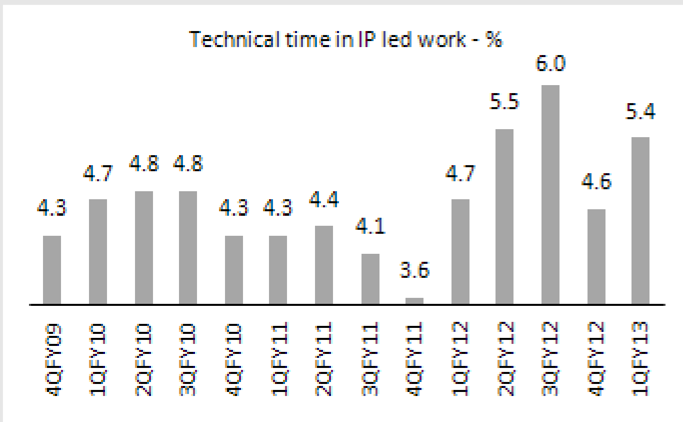
In the Sell-with business, PSYS has identified a key partner in each of its 4 focus areas, and is jointly selling with their sales teams, working with customers directly. Some of its partnerships are:

1. SalesForce.com for migrating client applications to Cloud.
2. Strategic services partnership with Dassault Systems in the Product Lifecycle Management (PLM) space and also in research and other areas.
3. CloudSense for the next-generation development on Force.com.
4. Cisco on Quad.
5. Partnership with Exalead around search and various other areas.

Growth in sales strength impeded by team realignment; expect investments to continue



Gradual increase in time spent on IP-led revenue - to remain at 5%+



Source: Company, MOSL

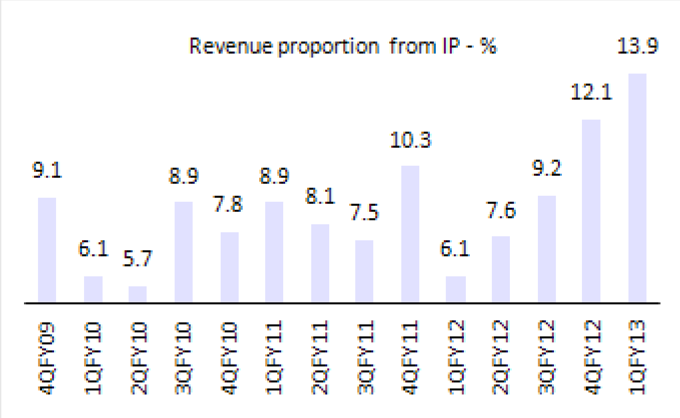
Lack of predictability on multiple volatile factors

Small size of OPD engagements, more discretionary nature of Product development and greater proportion of IP-led revenues increase unpredictability

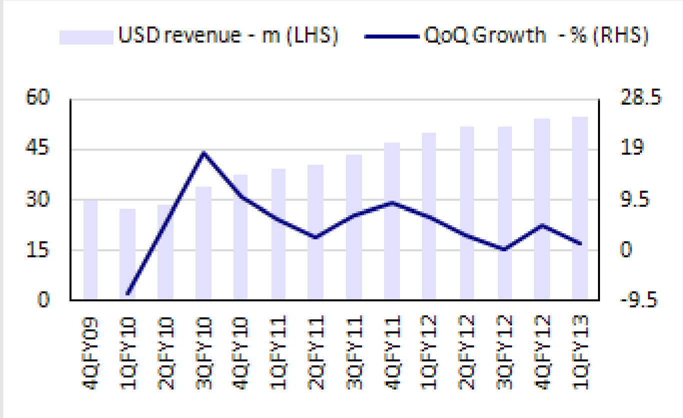
We believe that the areas where PSYS has chosen to grow are niche, in line with the times, and cutting edge. On the flip side, however, the segments are marred with unpredictability. The reasons why we believe volatility will continue to be high are:

1. Size of engagements in the Offshore Product Development (OPD) segment is usually small - an annual run rate of USD3m-5m from any client is considered fairly big ticket. The size of deals has only become smaller in recent times and that is expected to be the new normal.
2. OPD is more cyclical as compared to business IT Services for two reasons - lower annuity revenue and more discretionary nature of the work that is done by OPD vendors.
3. The company's thrust has increasingly been on expanding the share of IP-led revenue. Most of the IP-led revenue was earlier composed of royalty obtained from the connectors developed for its top client. However, association with Life Technologies, acquisition of Agilent, and location business from OpenWave are some examples of PSYS' moves to grow its share of revenue from non-linear IP sales. Revenue from IP-led sales increased from 7.2% in FY10 to 8.8% in FY12 and the reported share in the last two quarters was 12% and 14%, respectively.

Focus on IP-led revenue reflecting in its increasing share of revenue



Revenue growth can be volatile



Source: Company, MOSL

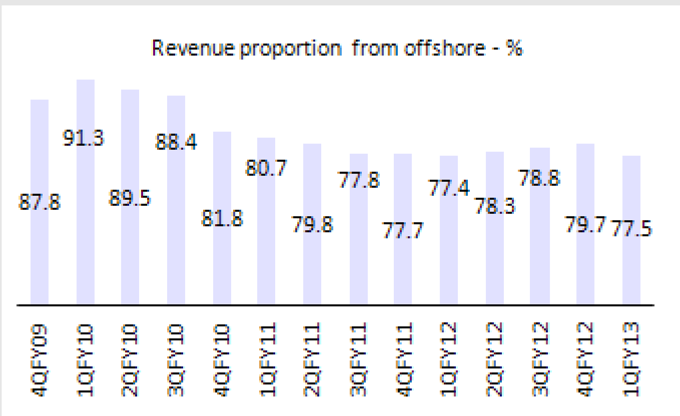
Concerns on margins due to frequent wage hikes to curb attrition

10% offshore wage hike impacts operating margin by ~440bp

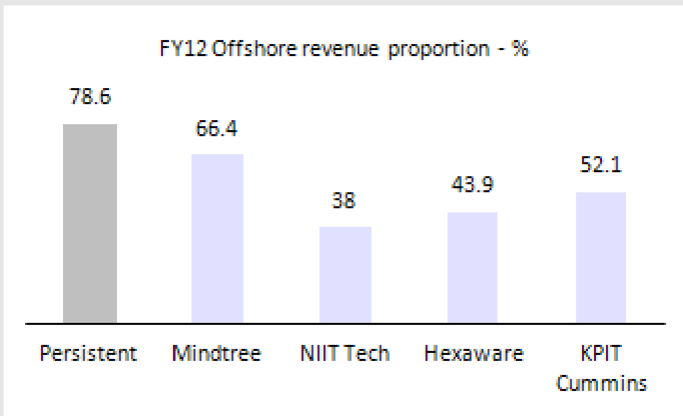
PSYS' EBITDA margin saw an impressive surge from 17.9% in 4QFY11 to 28.6% in 4QFY12, expanding 10.7pp during this period. A large part of the margin upswing was contributed by INR depreciation, sensitivity to which is much higher at PSYS - ~60bp for every 1pp change in currency rate. However, we have concerns on margin sustainability due to:

1. **Higher proportion of offshoring** (79% of FY12 revenue was from offshore): The offshore wage bill as a percentage of revenue is high, at 40%+, and double-digit offshore wage hikes hurt margins significantly. Even if we assume offshore wages at 40% of revenue, 10% offshore wage hike implies 400bp headwind to margins.
2. **High teen attrition levels:** PSYS' attrition has been consistently high, forcing the company to announce frequent wage hikes. It had given out-of-turn wage hikes in 3QFY11, following which it announced a normal wage hike two quarters later. Even in FY13, the company initially spoke of reacting to and following the market as far as wage hikes go, and eventually announced 10% wage hikes offshore and 4.4% onsite, both at the higher end of the peer-set.

Revenue proportion from offshore, though down in recent quarters, remains higher than industry norm



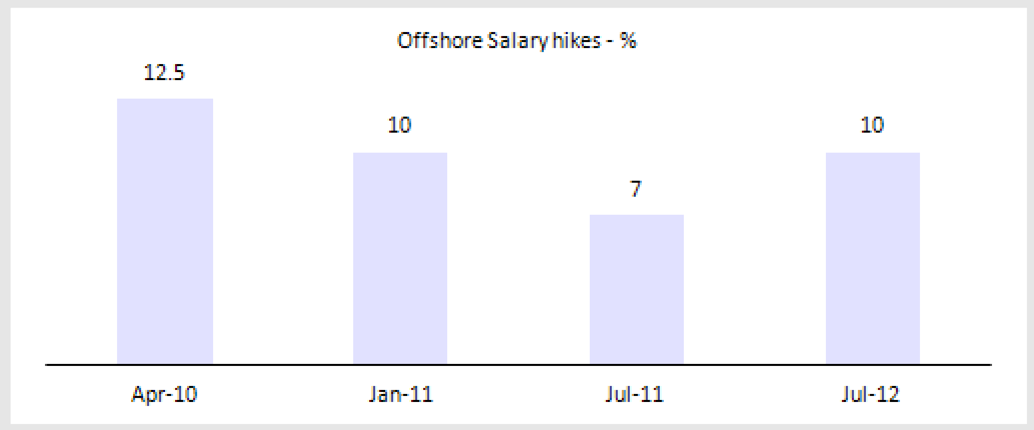
Offshore proportion among the highest in the industry



Source: Company, MOSL

Competition from captives has kept attrition high, offering little relief on wage hikes

Out-of-turn wage hike in January 2011, followed by another hike in July; FY12 wage hike above industry average

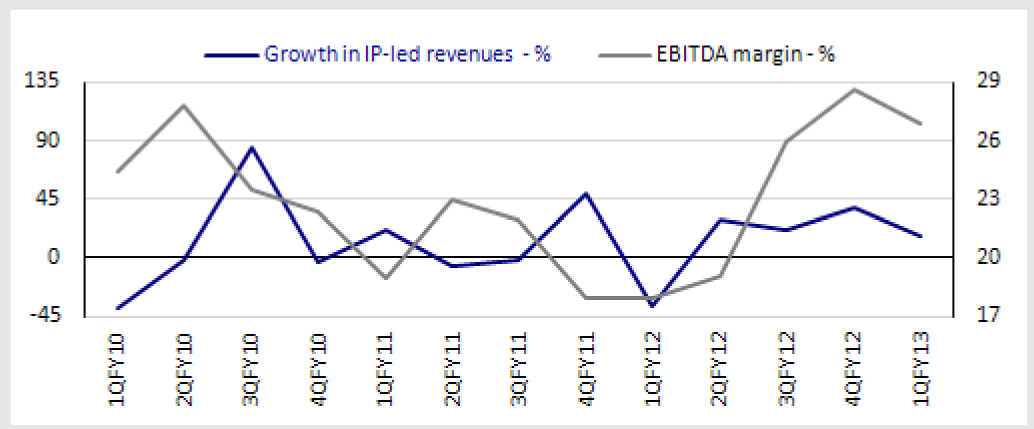


Source: Company, MOSL

Such a model poses challenges to profitability, especially in an environment where price hikes are extremely difficult to come by. This also partly explains the necessity for PSYS to grow its revenue from non-linear IP sources (where OPM range is potentially between 40-60%) and higher value consulting businesses. It intends to grow IP-led sales, which contributed ~14% to 1QFY13 revenue, to 20% of revenue over the next couple of years.

IP-led revenues have margins anywhere in the range of 40-60%

Higher growth in non-linear IP-led revenue supports margins



Source: Company, MOSL

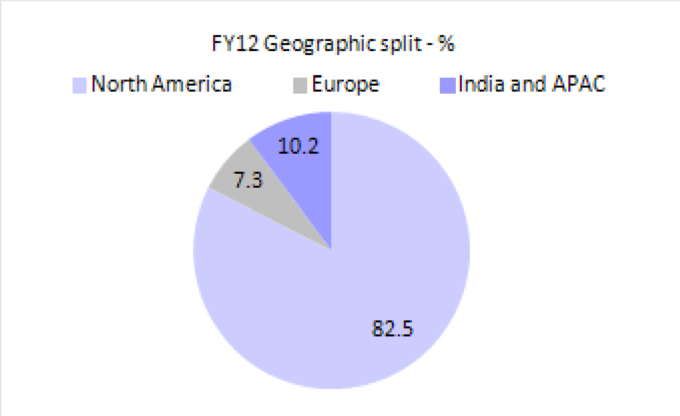
Concentration risk - high dependence on US and top-10 clients

Majority of the revenues are concentrated in the US geography

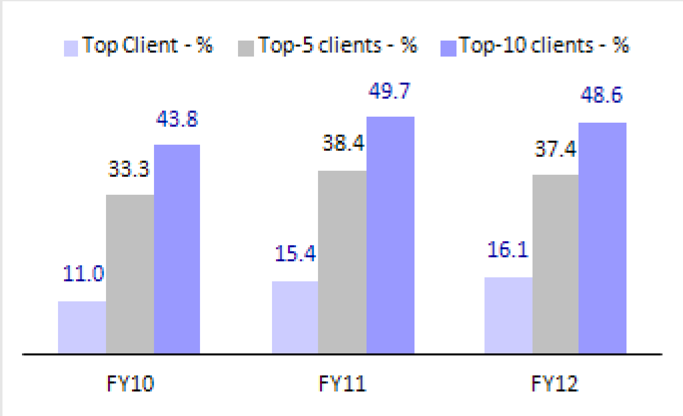
PSYS derived 82.5% of its FY12 revenue from the US. Despite a small ticket acquisition in France and the setting up of an engineering facility in Malaysia, the company expects revenue growth to continue coming from the US. The share of revenue from Europe remains in single digits (7.3% in FY12).

Also, the top-10 customers contributed 48.6% of its revenue in FY12, up from 43.8% in FY10. The proportion of revenue from the top customer increased from 11% in FY10 to 16.1% in FY12, the key factor in the increase in proportion of revenue from top-10 clients. Given that new customers in the segments that PSYS operates are very small in ticket size, this remains a key risk, as ramp-downs in large clients is a greater possibility than winning a new big client.

Heavy dependence on North American geography for revenue

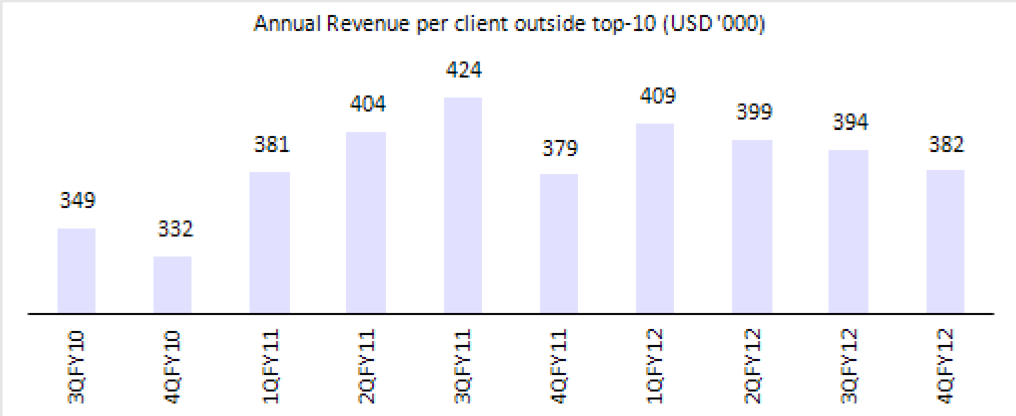


Dependence on top clients has increased over the last couple of years



Source: Company, MOSL

Scope for client mining limited by large number of small projects, which are expected to go up going forward



Source: Company, MOSL

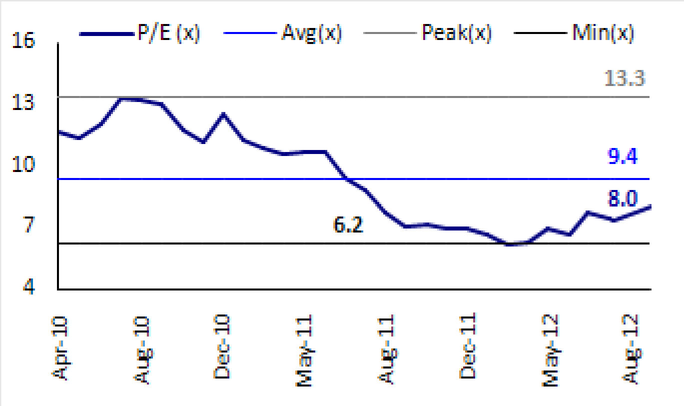
Impressive capabilities but high unpredictability, margin concerns; Neutral

Impressive capabilities but: [1] Unpredictability, [2] margin concerns, [3] concentration risks and [4] uncertainty around scalability - Neutral

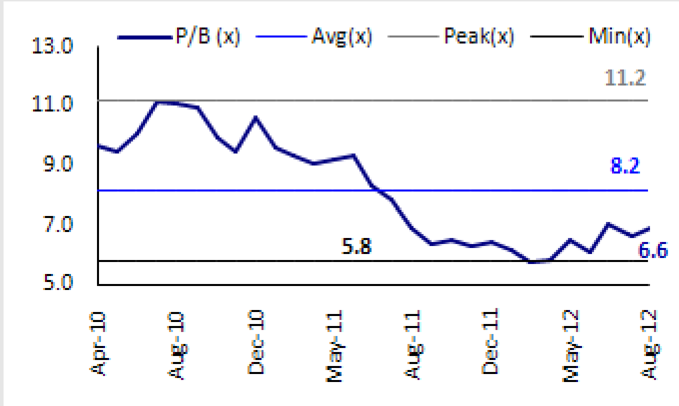
We like PSYS' chosen areas of play and its capabilities in the same. However, lack of predictability in a tough environment, concerns around margins and concentration risks (82.5% of FY12 revenue from US, revenue from top-10 clients up from 43.8% in FY10 to 48.6% in FY12) will constrain valuation multiples, so long as scalability is not clearly visible in the business. The company does not lack potential to scale, given its credentials in areas that are projected to grow multi-fold in years to come; however, larger orders with annuity component have eluded PSYS thus far.

We expect the company to grow its USD revenue at CAGR of 15% and EPS at a CAGR of 24% over FY12-14. Our EBITDA margin estimates are 26.5% for FY13 and 23.5% for FY14 (v/s 23.2% in FY12). Our target price is INR476, which discounts our FY14E EPS by 9x. Greater revenue visibility and waning headwinds to margins are the keys to higher confidence in the stock. We initiate coverage with a **Neutral** rating.

Persistent Systems PE Chart



Persistent Systems PB Chart



Financials and Valuation

Income statement (INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Sales	**5,938**	**6,012**	**7,758**	**10,003**	**12,801**	**14,516**
Change (%)	39.8	1.2	29.1	28.9	28.0	13.4
Cost of Goods Sold	3,324	3,687	4,723	5,922	7,258	8,706
Gross Profit	**2,614**	**2,324**	**3,036**	**4,081**	**5,543**	**5,810**
% of Net Sales	44.0	38.7	39.1	40.8	43.3	40.0
Selling Expenses	1,700	860	1,453	1,757	2,154	2,401
% of Net Sales	28.6	14.3	18.7	17.6	16.8	16.5
EBITDA	**914**	**1,464**	**1,583**	**2,324**	**3,389**	**3,409**
% of Net Sales	15.4	24.3	20.4	23.2	26.5	23.5
% Growth	0.1	60.2	8.2	46.8	45.8	0.6
Depreciation	297	335	424	611	669	659
EBIT	**617**	**1,128**	**1,159**	**1,713**	**2,720**	**2,750**
% of Net Sales	10.4	18.8	14.9	17.1	21.2	18.9
Other Income	68	112	344	256	143	303
PBT	**685**	**1,241**	**1,504**	**1,969**	**2,863**	**3,053**
Tax	10	91	108	551	823	885
Rate (%)	1.4	7.3	7.2	28.0	28.7	29.0
PAT	**676**	**1,150**	**1,396**	**1,418**	**2,040**	**2,168**
Net Income	**676**	**1,150**	**1,396**	**1,418**	**2,040**	**2,168**
% of Net Sales	11.4	19.1	18.0	14.2	15.9	14.9
Change (%)	-22.1	70.2	21.3	1.6	43.9	6.3
Extraordinary Item	-14.7	0.0	0.0	0.0	0.0	0.0
Net Income after EO	**661**	**1,150**	**1,396**	**1,418**	**2,040**	**2,168**

Balance Sheet (INR Million)

Y/E March	2009	2010	2011	2012	2013E	2014E
Share Capital	379	432	435	400	400	400
Other Reserves	3,329	5,990	7,071	8,243	9,772	11,793
Net Worth	**3,709**	**6,422**	**7,506**	**8,643**	**10,172**	**12,193**
Loans	0	0	0	132	132	132
Minority Interest/other LT liab.	0	45	0	0	0	0
Capital Employed	**3,709**	**6,467**	**7,506**	**8,775**	**10,304**	**12,325**
Gross Block	3,372	3,715	4,543	5,628	6,428	7,228
Less : Depreciation	1,573	1,881	2,281	2,846	3,539	4,193
Net Block	**1,800**	**1,834**	**2,261**	**2,782**	**2,889**	**3,035**
CWIP	377	485	605	585	585	585
Investments	880	1,562	2,500	1,787	1,787	1,787
Deferred Tax Assets	20	7	60	78	78	78
Curr. Assets	**1,777**	**4,259**	**3,677**	**5,166**	**7,296**	**9,404**
Debtors	1,043	1,363	1,582	2,410	3,084	3,497
Cash & Bank Balance	165	1,918	1,000	1,294	2,443	3,951
Loans & Advances	438	638	869	1,096	1,403	1,591
Other Current Assets	130	340	226	366	366	366
Current Liab. & Prov	**1,146**	**1,679**	**1,597**	**1,623**	**2,330**	**2,564**
Current Liabilities	997	1,394	1,206	1,370	1,754	1,988
Other Liabilites	-21	-32	-5			
Provisions	170	317	396	253	577	576
Net Current Assets	**631**	**2,580**	**2,080**	**3,543**	**4,965**	**6,840**
Application of Funds	**3,709**	**6,467**	**7,506**	**8,775**	**10,304**	**12,325**

E: MOSL Estimates

Financials and Valuation

Ratios

Y/E March	2009	2010	2011	2012	2013E	2014E
Basic (INR)						
EPS*	**17.4**	**29.5**	**34.1**	**34.6**	**49.8**	**52.9**
Cash EPS	25.2	38.1	44.4	49.5	66.1	69.0
Book Value	103.4	160.5	193.2	222.5	261.9	313.9
DPS	1.0	2.5	5.5	6.0	7.5	7.5
Payout %	5.7	8.5	16.1	17.3	15.1	14.2
Valuation (x)						
P/E after ESOP chg				12.0	8.3	7.8
Cash P/E				8.4	6.3	6.0
EV/EBITDA				5.7	3.5	3.1
EV/Sales				1.3	0.9	0.7
Price/Book Value				1.9	1.6	1.3
Dividend Yield (%)				1.4	1.8	1.8
Profitability Ratios (%)						
RoE	18.9	22.7	20.0	17.6	21.7	19.4
RoCE	23.8	13.0	16.5	17.1	14.9	18.0
Turnover Ratios						
Debtors (Days)	64	83	75	75	75	75
Asset Turnover (x)	3.5	3.3	3.8	4.0	4.5	4.9
Leverage Ratio						
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement (INR Million)

Y/E March	2009	2010	2011	2012E	2013E	2014E
CF from Operations	904	1,533	1,394	1,723	2,394	2,715
Chg. in Working Capital	57	-141	-490	-1,174	-273	-367
Net Operating CF	**961**	**1,392**	**905**	**549**	**2,120**	**2,348**
Net Purchase of FA	-501	-476	-971	-1,112	-776	-805
Net Purchase of Invest.	-188	-682	-939	714	0	0
Net Cash from Inv.	**-689**	**-1,158**	**-1,910**	**-399**	**-776**	**-805**
Issue of shares	-211	1,507	19	74	0	0
Proceeds from LTB/STB	0	0	0	132	0	0
Dividend Payments	-42	-115	-255	-270	-338	-338
Net CF from Finan.	**-253**	**1,392**	**-235**	**-64**	**-338**	**-338**
Free Cash Flow	461	916	-67	-563	1,344	1,543
Net Cash Flow	**19**	**1,626**	**-1,241**	**87**	**1,007**	**1,205**
Opening Cash Balance	**1,029**	**1,505**	**1,249**	**805**	**2,263**	**2,651**
Closing CashBalance	**165**	**1,918**	**1,000**	**1,294**	**2,443**	**3,951**

E: MOSL Estimates

Tech Mahindra

BSE SENSEX	S&P CNX
18,673	5,670

CMP: INR913 **TP: INR1,110** **Upgrade to Buy**

Bloomberg	TECHM IN
Equity Shares (m)	127.5
52-Week Range (INR)	933/524
1,6,12 Rel. Perf. (%)	0/18/31
M.Cap. (INR b)	116.4
M.Cap. (USD b)	2.2

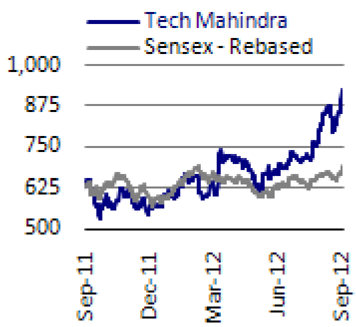
Valuation summary (INR b)

Y/E March	2012	2013E	2014E
Net Sales	54.9	70.9	82.3
PAT	9.3	11.5	13.3
EPS (INR)	70.4	87.2	101.0
EPS Gr. (%)	29.7	23.8	15.9
P/E (x)	13.0	10.5	9.0
P/BV (x)	2.7	2.2	1.6
RoE (%)	30.2	24.4	23.0
RoCE (%)	24.5	24.0	22.1
EV/Sales (x)	2.7	2.2	1.6
EV/EBITDA (x)	13.0	8.3	7.1

Shareholding pattern (%)

As on	Jun-12	Mar-12	Jun-11
Promoter	70.8	70.8	71.1
Dom. Inst	14.8	14.8	15.0
Foreign	6.3	6.1	4.3
Others	8.2	8.3	9.6

Stock performance (1 year)



Commendable performance outside BT

Lowering dependency on uncertain BT keeps us positive

- **We expect growth at least at par with the industry in its business outside BT and at Mahindra Satyam.**
- **EBITDA margin has expanded from ~15% in 2QFY12 to 21.7% in 1QFY13, but face headwinds from wage hikes, transition costs on new deals, and HGS acquisition.**
- **Declining proportion of revenues from BT and steady execution in rest of the business make a case for expansion of valuation multiple. Upgrade to Buy.**

Expect organic growth outside BT to at least match industry growth

TECHM remains confident of delivering growth at least at par with the industry in its business outside BT. Traction in Managed Services is a key contributor to its performance, and Tech Mahindra (TECHM) expects to close two of the 6-7 deals that have been in the pipeline for a while. The outlook on growth at Satyam is no different, on a small base compared to industry leaders. Also, its presence in over 70 of the G-500 accounts implies significant mining opportunity.

Margin concerns in the near term

Margins had plummeted, as revenue mix changed in favor of emerging markets, BPO and non-BT accounts. However, cost optimization, higher utilization and a favorable currency have helped TECHM to expand its EBITDA margin from ~15% in 2QFY12 to 21.7%. Current margins may not sustain due to the following: [1] single-digit wage hikes, effective from July 2012, (~200bp impact), [2] transition costs on deals won in Managed Services, and [3] acquisition of Hutchison Global Services (HGS), which has mid-teen margins and is likely to add ~14% to revenues.

HGS acquisition - success a function of adding new clients

TECHM announced the acquisition of Hutchison Global Services (HGS), a provider of customer lifecycle operations, for a net payout of USD67m (consideration of USD87m and net cash of USD20m at HGS). As part of the deal, HGS' clients have committed to procure services worth USD845m over a 5-year period, and have agreed to HGS being their exclusive provider of certain services. Any potential benefits from the deal will be a function of TECHM's ability to add new clients.

Scaling potential post integration; stable execution ex-BT; Buy

TECHM's performance in its areas of focus outside BT has been commendable, and so has the turnaround at Satyam. However, risks of revenue decline from the top client loom over the near-to-medium term. We estimate the combined entity revenue at USD2.7b for FY13 and at over USD3 for FY14, with PAT of INR19b and INR20b, respectively. The stock trades at 10.5x FY13E and 9x FY14E EPS. Our target price of INR1,110 discounts its FY14E EPS by 11x. We upgrade TECHM to **Buy,** with an upside potential of 22%.

Tech Mahindra

MID Score|Discount: **66|34%**

FY14 P/E: **11x**

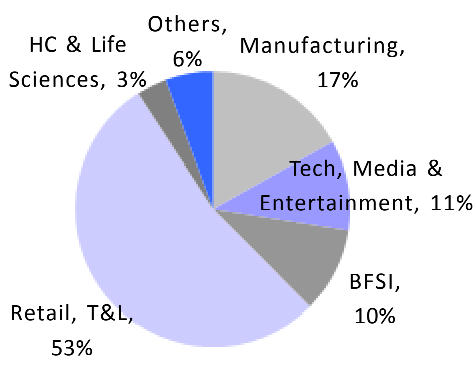
M : 4/5 Management focus and Strategy

- TECHM is a provider of solutions and services to the telecom industry with a majority stake owned by Mahindra & Mahindra Limited, in partnership with British Telecommunications plc. It serves telecom service providers, OEMs, software vendors and systems integrators worldwide. Acquisition of Mahindra Satyam has helped diversify into more verticals and services, and reduce dependency on BT
- Mr. Vineet Nayyar is the Executive Vice Chairman of Tech Mahindra and the Chairman of Mahindra Satyam. In a career spanning over 40 years, he has worked with the Government, international multilateral agencies and the corporate sector (both public and private), having started his career with the Indian Administrative Service.

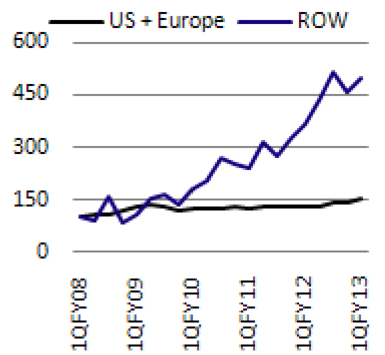
I : 10.5/15 IT Mix

- **Geography (4.5/5):** TECHM managed to increase revenues from Emerging markets to 20% in 1QFY13 from 7% in 1QFY08
- **Verticals (2.5/5):** Telecom will continue to constitute 47% of revenues post integration with Satyam, followed by Manufacturing at 17%

Vertical mix of merged entity



Growth driven by emerging market focus



D : 8 / 10 Deal signing prowess

- Powess in Managed Services deals exhibited in emerging markets is now rubbing of positively in the developed economies.
- Integrated entity will be able to bid for large multi-service deals.

"Deal traction continues to be robust and we are getting invited to large opportunities mainly in Europe. We are seeing some signs of growth momentum in our non-BT business"

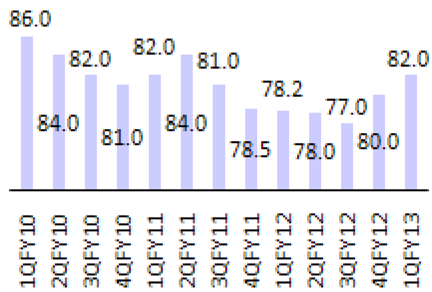
"The funnel buildup is great, the number of deals in the pipeline compared to what we had at the same time last quarter this is much better"

"Decision-making is slower than normal but we do reiterate that from a funnel perspective those deals are still in the funnel and none of the deals have closed"

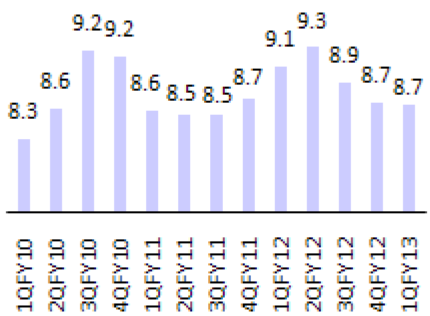
C : 7 / 10 Client Concentration

- Post the acquisition of HGS and the integration with Mahindra Satyam, revenue share from BT will be sub-15%. Also, pressures from BT may be lower than earlier anticipated.

Revenue proportion from top-10 clients - %



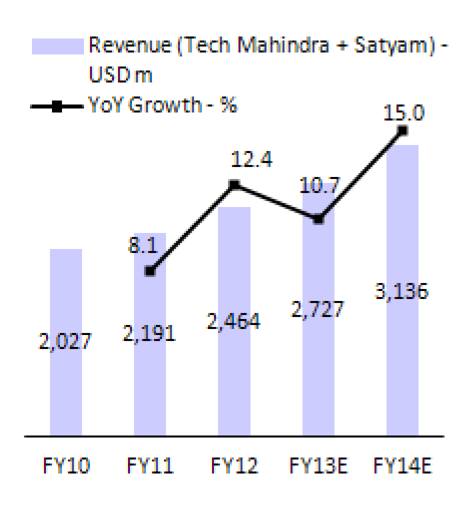
Annualized revenue per client - USD m



Tech Mahindra

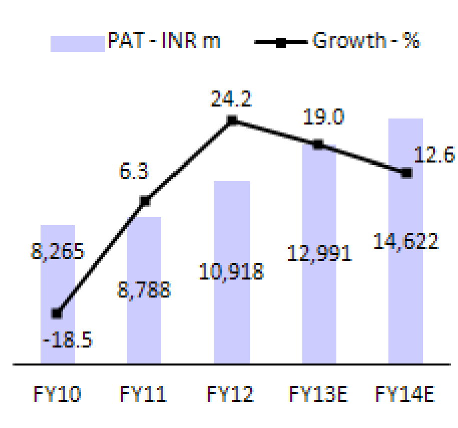
A: 14/20 Ability to scale and Attrition

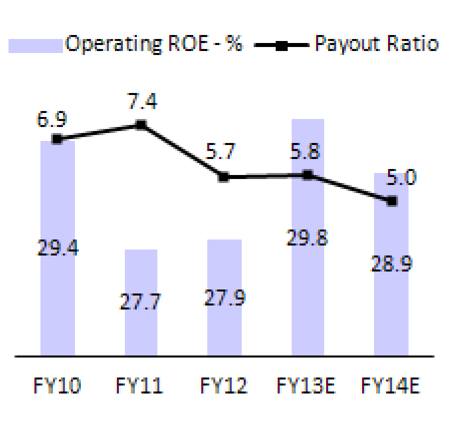
- **Ability to Scale (12/15):** Integrated entity would be among the top-5 India-based IT Services vendors, and the combined entity stands a chance to qualify greater number of large deals.
- **Attrition: (2/5):** Large number of BPO employees implies that attrition will be high. Also, the company's thrust on increasing utilization could prove costly in the event of unexpected growth resurgence.
- Post the amerger, the management plans to:
  (1) Leverage Tech Mahindra's expertise in Mobility, System Integration, and delivery of large transformations
  (2) Better penetrate the opportunity presented by Mahindra Satyam's clients across multiple verticals and
  (3) Enable a more complete value proposition to be delivered to Tech Mahindra clients through Satyam's expertise in Enterprise solutions.



P : 23/40 P: Profit and Payout

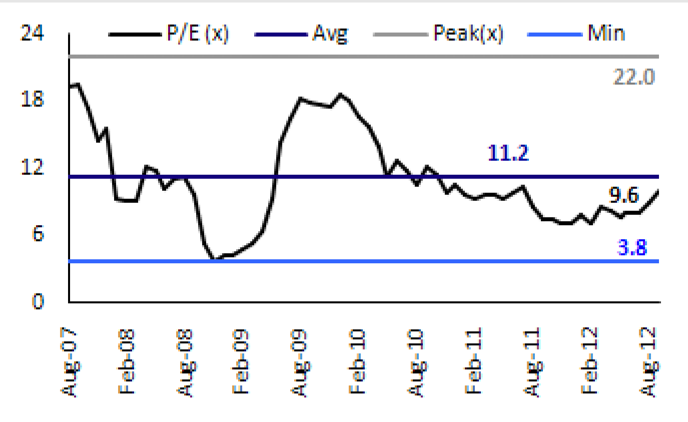
- **Profit Growth (10/15):** We expect an EPS CAGR of 17% over FY12-14E
- **Profit quality (10/15):** Our average Operating RoE going forward is 28%.
- **Payout Ratio (3/10):** Has been in single digits at TECHM.





MID Score : 66.5 / 100 | P/E 11x

Hexaware		Benchmark	
M	Management	5	4.0
I	IT Mix	15	10.5
D	Deals	10	7.5
C	Client Concentration	10	7.0
A	Ability to scale & Attrition	20	14.0
P	Profit & Payout	40	23.0
	TOTAL MID SCORE	**100**	**66.0**
	Discount - %		34.0
	Tier I average target P/E		16.0
	Stock target P/E		11.0
	FY14E EPS - INR		101.0
	Target Price - INR		1,110
	Upside - %		22
	Rating		**Buy**

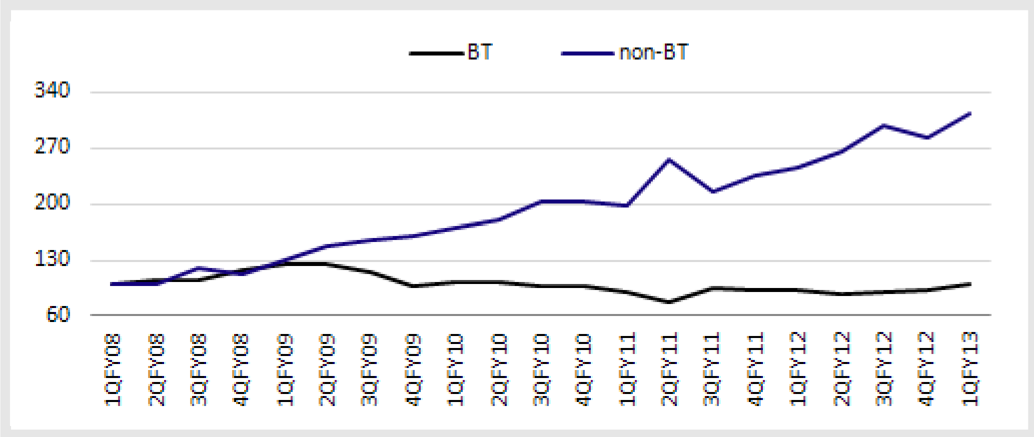


Successfully picked growth pockets as BT pie came under pressure

Focus on Managed services and Emerging markets helped reduced dependency on BT

As sustaining revenue share from BT became increasingly difficult since the last downturn, TECHM was impacted the most. It had a revenue share of 64% from BT in 1QFY08. However, it successfully identified pockets of growth outside BT and managed to grow them handsomely, particularly the emerging geographies and clients outside BT. Over the last 8 quarters, TECHM's INR revenue grew at a CQGR of ~4%. Of this, CQGR at BT was 1.1%, while non-BT revenue grew at a CQGR of ~6%. The contribution from BT is now down to 36% (1QFY13) from 64%.

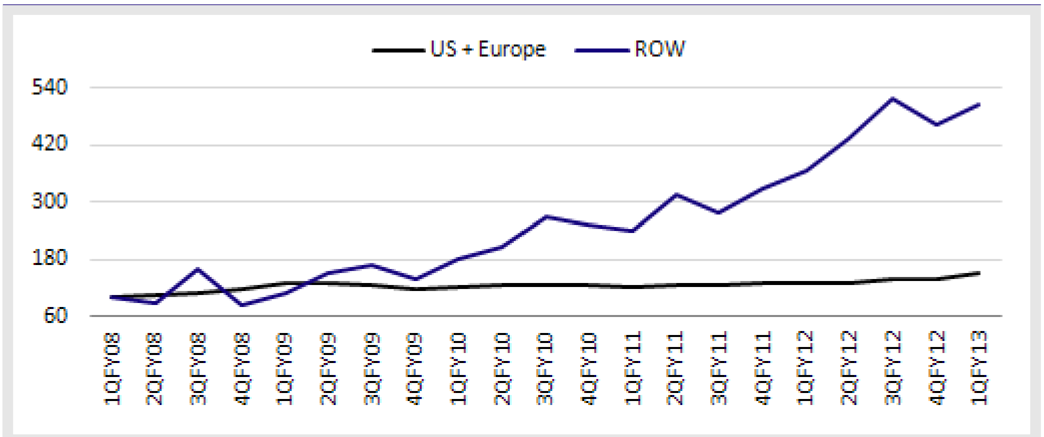
Non-BT revenue grew impressively, as BT revenue declined - Indexed at 100



Source: Company, MOSL

Growth in non-BT accounts was largely facilitated by TECHM's focus on emerging economies, where growth in the wireless space was robust. RoW's contribution to overall revenue increased from a mere 7% in 1QFY08 to 20% in 1QFY13. The RoW segment grew at a CQGR of 10% over the past 8 quarters v/s 3% CQGR in Europe and North America combined.

Focus on RoW has helped revenue from the geography to grow multifold - Indexed at 100



Source: Company, MOSL

Similarly, TECHM started focusing on bagging deals in Managed Services, which also contributed towards the healthy growth in RoW. Managed Services currently constitutes 10-12% of the company's revenue. After RoW, TECHM is now witnessing healthy pipeline build-up in these deals in the European region. The company had cited 6-7 deals in the pipeline (4 in Europe), which were taking a long time to close due to the challenging environment. It is now likely to close a couple of them.

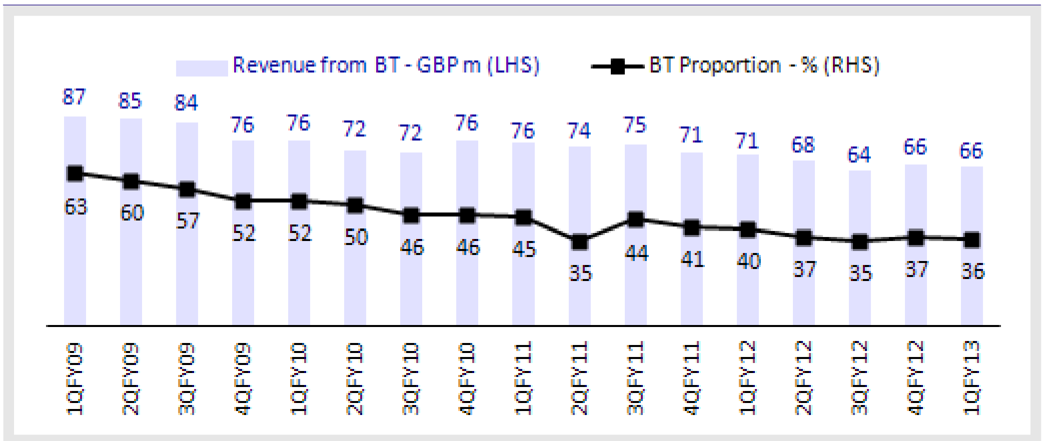
Uncertainty in revenue from BT remains a headwind

Uncertainty in BT remains a headwind, but the cut in pricing may not be as sharp as before

Contracts from the BT account came up for restructuring a couple of quarters ago, and the contracts that got restructured witnessed significant pricing cuts. While Tech Mahindra managed to hold on to its share, the quarterly revenue run rate declined from GBP70m-72m to ~GBP65m. Considering that this was only after a portion of BT restructuring, implications are of a steep double-digit cut in prices.

While restructuring activity at BT has slowed down, TECHM has taken a stand of not withering under pricing pressure, hinting at a volume-margin tradeoff within the account. The management guided stable revenue from BT over the medium term, but remains cautious over the longer term, not ruling out further downward bias in the account. TECHM is the largest vendor for BT, with over 50% of its IT share.

Revenues from BT have stabilized in the last two quarters; may come under pressure again



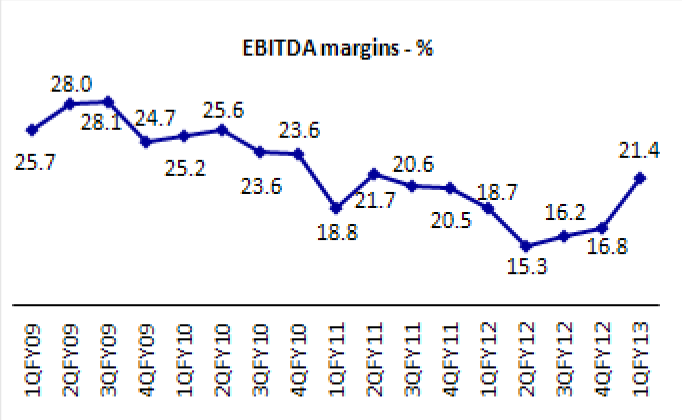
Source: Company, MOSL

Margins to moderate in the near term

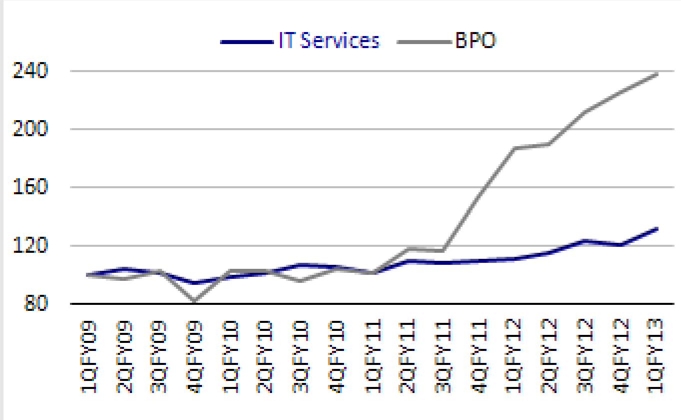
Wage hikes are expected to drive decline in margins in the near term

After touching a high of 28% in FY09, EBITDA margin had plummeted to 15% in 2QFY12, as revenue mix changed in favor of emerging markets, BPO and non-BT accounts. Cost optimization, higher utilization and a favorable currency have helped TECHM to expand its EBITDA margin to 21.7% in 1QFY13. However, current margins may not sustain due to the following: [1] single-digit wage hikes, effective from July 2012, could impact margins by ~200bp, [2] transition costs on deals that TECHM continues to win in Managed Services, and [3] acquisition of Hutchison Global Services (HGS), which has mid-teen margins and is likely to add ~14% to revenues.

EBITDA margin trend



BPO revenue driving growth; trend to strengthen post HGS acquisition - Indexed at 100



Source: Company, MOSL

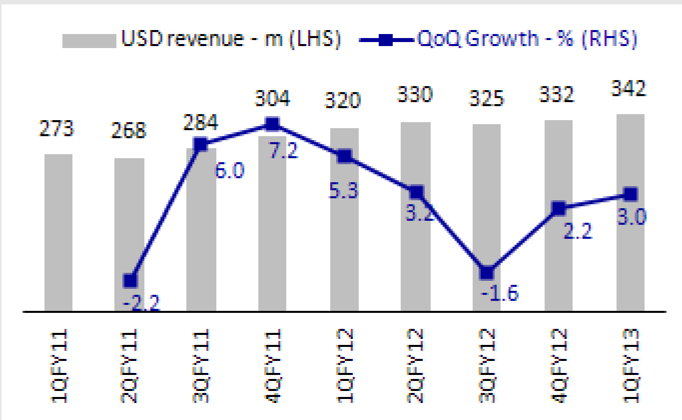
Continued improvement in Mahindra Satyam's execution augurs well

Mahindra Satyam's turnaround is complete, claim from Aberdeen UK is the only major impending litigation

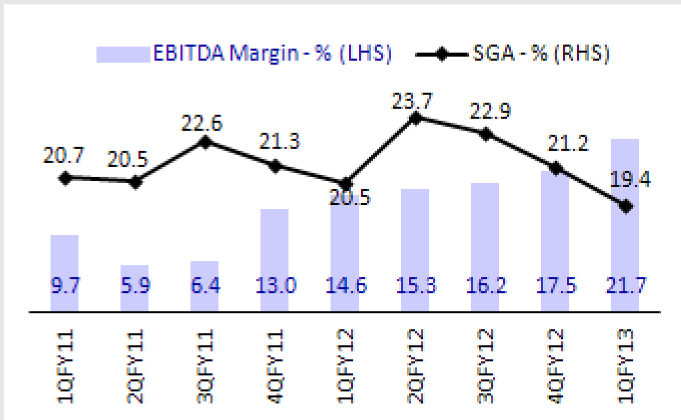
Mahindra Satyam has come a long way in its recovery process, which was focused on addressing concerns around the following:

1. **Customer retention:** Mahindra Satyam's focus on mining existing accounts better has been a key revenue driver over the last couple of years.
2. **Employee retention:** The company's attrition rate declined to 13.5% in 1QFY13 from 25% in 3QFY11. Though this is partly attributed to the environment, we cannot ignore the fact that attrition is now among the lowest in the industry from among the highest, earlier.
3. **Dispute resolution:** Most of the litigation is now behind the company, with the only prominent one being that of Aberdeen UK (claim of USD150m).
4. **Improving profitability:** EBITDA margin has expanded steadily from 5.9% in 2QFY11 to 21.7% in 1QFY13.

Steady revenue growth despite tarnished history

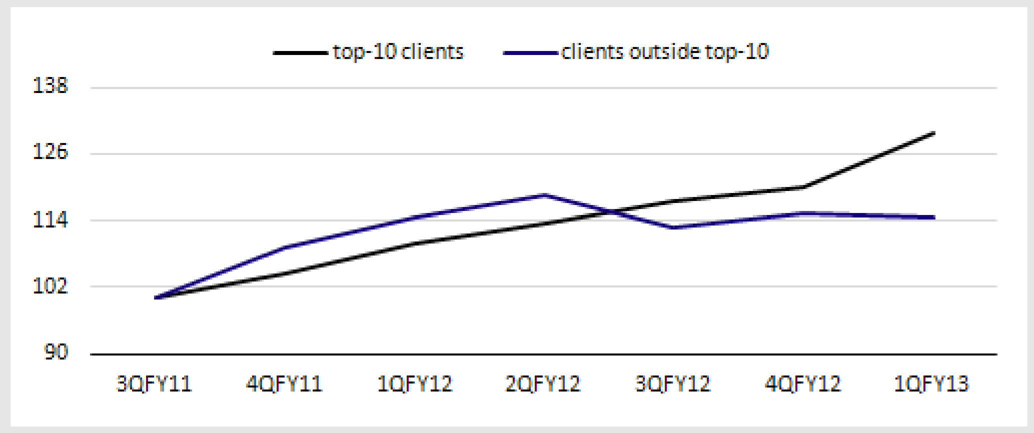


Margins continued to surprise positively



Source: Company, MOSL

Satyam's revenue from top-10 clients outgrew that from remaining clients (indexed at 100)



Source: Company, MOSL

Growth prospects sanguine outside of BT business

Presence in more than 70 of the G-500 implies ample scope to grow from client mining

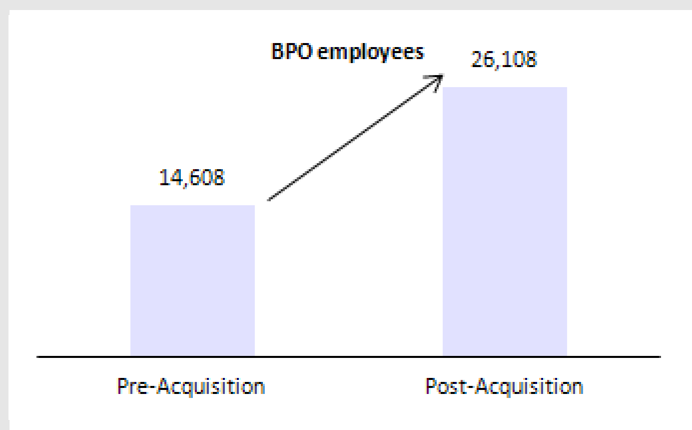
We recently interacted with the TECHM management to get some clarity on the growth that company envisages in the current environment. While the BT account is stable for now, there could be headwinds if the retendering process resumes. However, outside of BT, TECHM remains confident of delivering growth at least in line with the industry, if not better. Even in the case of Satyam, TECHM expects growth to continue, as the base is still smaller than peers. However, Satyam is faced with similar margin headwinds as TECHM, and margins may shrink by 2-3pp in the near term.

HGS acquisition - success a function of adding new clients

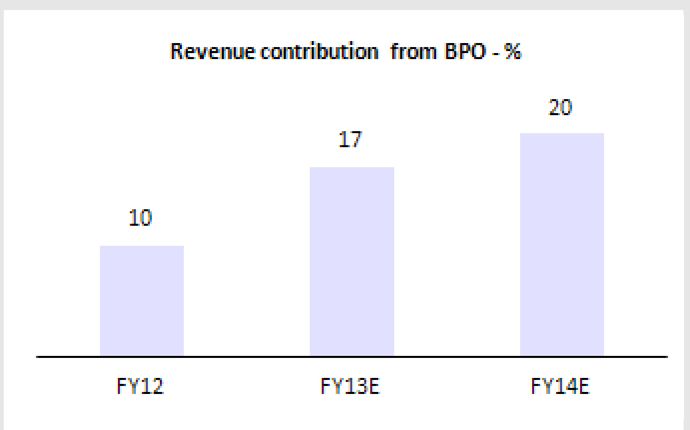
HGS adds end-to-end customer lifecycle capabilities to TECHM's BPO offerings

TECHM announced the acquisition of Hutchison Global Services (HGS), a provider of customer lifecycle operations, for a net payout of USD67m (consideration of USD87m and net cash of USD20m at HGS). The deal will be funded by debt and internal accruals, and will be EPS accretive, with HGS' operating margin comparable to TECHM's international BPO margins (mid-teens). As part of the deal, HGS' clients have committed to procure services worth USD845m over a 5-year period, and have agreed to HGS being their exclusive provider of certain services in India. The integration date with TECHM is 4 September 2012. This implies additional revenue of ~USD12m in 2QFY13 and USD40m per quarter from 3QFY13.

~11,500 employees to join Tech Mahindra's payroll



Revenue contribution from BPO could double by FY14



Source: Company, MOSL

Success of the deal will be a function of TECHM's capability of adding new clients

At a net payout of USD67m, assuming 14% EBITDA margin and 30% tax rate, the deal is valued at a P/E of 6x, which is fair for a non-platform-based BPO business. In FY12, TECHM's BPO revenue was USD112m, which is also the annualized 1QFY13 revenue. Addition of revenue from HGS increases the contribution of BPO from ~10% in FY12 to ~17% in FY13 and ~20% in FY14. Our USD revenue estimates are up by 9%/15% and EBITDA margin estimates are lower by 68bp/46bp for FY13/14. Our EPS estimate for FY14 is up by 8%.

Any benefits from the deal will be a function of the company's ability to add new clients. The acquisition is similar in nature to TCS' acquisition of Citi's BPO operations. TCS had managed to successfully win new clients that helped deliver revenues of USD353m in FY10 and USD413m in FY11 v/s committed revenues of USD263m per annum from Citi.

For TECHM, the acquisition also reduces dependency on BT, further. BT had contributed 36% to TECHM's 1QFY13 revenue; this should come down to ~30% post the integration of HGS. Also, our recent interactions with the management indicate that the company should meet, if not beat, the industry average growth in its business outside BT and so should Mahindra Satyam.

Deal increases our EPS estimate for FY14, reduces dependency on BT to ~30%

Change in estimates

	Revised		Earlier		Change (%)	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
INR/USD	53.8	52.0	53.8	52.0	-0.1	0.0
USD Revenue - m	1,265	1,462	1,163	1,267	8.8	15.4
EBITDA Margin (%)	18.8	17.5	19.5	18.0	-68bp	-46bp
EPS - INR	84.9	96.6	85.6	88.6	-0.9	9.1

Source: Company, MOSL

Scaling potential post integration; stable execution ex-BT; Upgrade to Buy

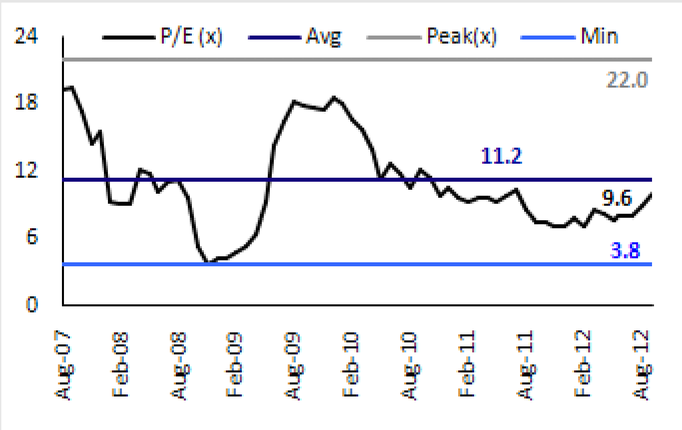
Mahindra Satyam could leverage TECH's abilities in Mobility and SI. Scale benefits imply rerating potential

TECHM's performance in its areas of focus outside BT has been commendable, and so has the turnaround at Satyam. Post the acquisition of HGS and merger with Mahindra Satyam, the share of BT is likely to fall to ~15%. However, risks of revenue decline from the top client loom over the near-to-medium term. Given TECHM's slated stand on pricing cuts demanded by BT, there could be some volume declines, going forward. We estimate the combined entity revenue at USD2.7b for FY13 and at over USD3 for FY14, with PAT of INR19b and INR20b, respectively. The stock trades at 10.5x FY13E and 9x FY14E EPS. Our target price of INR1,110 discounts its FY14E EPS by 11x (22% upside). We upgrade TECHM to **Buy**.

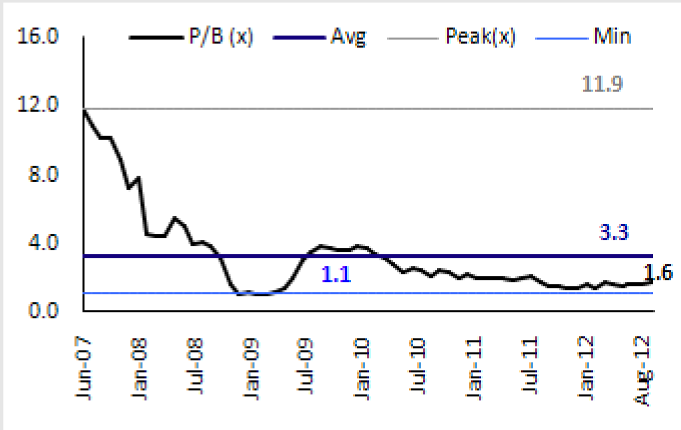
Combined entity snapshot

	FY10	FY11	FY12	FY13E	FY14E
USD Revenue	2,027	2,191	2,464	2,693	3,049
YoY (%)		8.1	12.4	9.3	13.2
Revenue	101,064	99,863	118,853	144,868	158,552
YoY (%)		-1.2	19.0	21.9	9.4
EBITDA	16,881	14,446	19,407	28,315	29,615
Margin (%)	16.7	14.5	16.3	19.5	18.7
PAT	8,372	10,600	17,533	18,167	19,737
YoY(%)		26.6	65.4	3.6	8.6
Margin (%)	8.3	10.6	14.8	12.5	12.4
No. Of shares - m	207	207	207	207	207
EPS - INR	40.5	51.3	84.8	87.8	95.4

Tech Mahindra PE Chart



Tech Mahindra PB Chart



Financials and Valuation

Income statement (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Sales	**46,254**	**48,413**	**54,897**	**70,869**	**82,293**
Change (%)	3.6	4.7	13.4	29.1	16.1
Total Expenses	34,929	38,518	45,703	57,472	67,830
EBITDA	**11,325**	**9,895**	**9,194**	**13,397**	**14,463**
% of Net Sales	24.5	20.4	16.7	18.9	17.6
Depreciation	1,338	1,435	1,614	1,876	2,016
Interest	2,184	999	1,413	1,014	648
Other Income	754	1,174	1,368	-342	256
PBT	**8,557**	**8,635**	**7,535**	**10,165**	**12,056**
Tax	1,440	1,315	1,438	2,355	2,773
Rate (%)	16.8	15.2	19.1	23.2	23.0
PAT	**7,118**	**7,320**	**6,097**	**7,809**	**9,283**
Minority Interest & EO items	113	652	714	110	240
Share of associate's profits	1,260	2,120	5,534	5,350	5,588
PAT before EO	**8,265**	**8,788**	**10,918**	**13,049**	**14,631**
Change (%)	-18.5	6.3	24.2	19.5	12.1
Effect of restructuring fees	-1,663	-1,695	-1,618	-1,537	-1,294
PAT after RF before EO	**6,601**	**7,093**	**9,299**	**11,512**	**13,337**
Change (%)	-34.9	7.4	31.1	23.8	15.9
Extraordinary Items (EO)	85	629	679	0	0
PAT after EO	**6,686**	**7,722**	**9,978**	**11,512**	**13,337**
Change (%)	-39.6	15.5	29.2	15.4	15.9

Balance Sheet (INR Million)

Y/E March	2010	2011	2012	2013E	2014E
Share Capital	1,223	1,260	1,275	1,275	1,275
Share Premium	2,374	2,374	2,374	2,374	2,374
Reserves	25,268	29,881	39,658	49,891	69,993
Net Worth	**28,865**	**33,514**	**43,307**	**53,539**	**73,641**
Minority Interest	139	159	0	0	5
Loans	13,672	12,227	11,266	9,226	1,560
Deferred Revenue	0	5,837	0	0	0
Capital Employed	**42,676**	**51,737**	**54,573**	**62,766**	**75,206**
Gross Block	11,312	12,783	15,095	18,095	20,595
Less : Depreciation	5,269	6,613	8,227	10,103	12,119
Net Block	**6,043**	**6,170**	**6,868**	**7,992**	**8,476**
CWIP	3,208	1,105	1,629	1,629	1,500
Investments	30,145	29,080	35,876	35,876	30,145
Deferred Tax Assets	276	638	998	998	998
Curr. Assets	**19,346**	**23,455**	**20,437**	**33,638**	**50,185**
Debtors	10,420	12,468	13,172	18,485	19,164
Cash & Bank Balance	2,187	2,666	2,418	8,410	15,029
Loans & Advances	6,725	8,315	4,845	6,742	14,134
Other Current Assets	14	6	2	2	1,857
Current Liab. & Prov	**16,342**	**8,711**	**11,235**	**14,570**	**16,098**
Creditors	13,572	5,631	10,377	10,006	9,896
Provisions	2,770	3,080	3,080	3,080	4,068
Net Current Assets	**3,004**	**14,744**	**9,202**	**22,451**	**34,087**
Application of Funds	**42,676**	**51,737**	**54,573**	**62,766**	**75,206**

E: MOSL Estimates

Financials and Valuation

Ratios

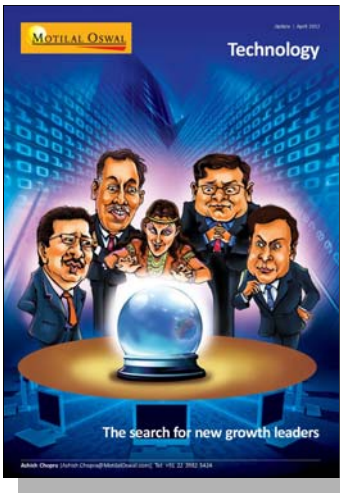
Y/E March	2010	2011	2012	2013E	2014E
Basic (INR)					
EPS	**54.0**	**56.3**	**72.9**	**90.3**	**104.6**
Diluted EPS	**50.5**	**54.3**	**70.4**	**87.2**	**101.0**
Cash EPS	60.7	65.2	82.6	101.4	116.2
Book Value	236.0	266.0	339.7	419.8	577.4
DPS	3.5	4.0	4.0	5.0	5.0
Payout %	6.9	7.4	5.7	5.7	5.0
Valuation (x)					
P/E			13.0	10.5	9.0
Cash P/E			11.1	9.0	7.9
EV/EBITDA			13.0	8.3	7.1
EV/Sales			2.2	1.6	1.2
Price/Book Value			2.7	2.2	1.6
Dividend Yield (%)			0.4	0.5	0.5
Profitability Ratios (%)					
RoE	34.6	30.2	30.2	24.4	23.0
RoCE	33.9	22.1	24.5	24.0	22.1
Turnover Ratios					
Debtors (Days)	77	86	85	82	83
Fixed Asset Turnover (x)	4.5	4.0	3.9	4.3	4.3
Leverage Ratio					
Debt/Equity Ratio(x)	0.5	0.4	0.3	0.2	0.0

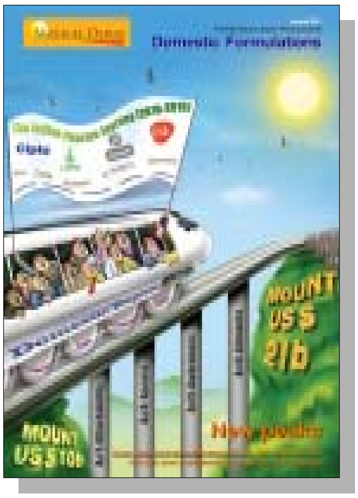
Cash Flow Statement (INR Million)

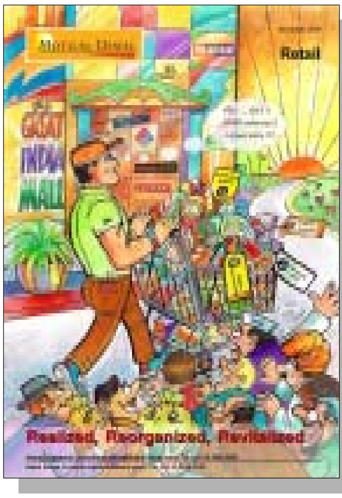
Y/E March	2010	2011	2012	2013E	2014E
CF from Operations	9,549	15,718	3,692	21,004	14,242
Change in Working Capital	2,283	-11,261	7,778	-7,156	-8,787
Net Operating CF	**11,832**	**4,457**	**11,470**	**13,848**	**5,455**
Net Purchase of FA	-4,069	541	-2,836	-3,000	-2,371
Net Purchase of Invest.	-25,799	1,065	-6,796	0	5,731
Net Cash from Invest.	**-29,868**	**1,606**	**-9,632**	**-3,000**	**3,360**
Inc./(Dec) in Eq. &other related	1,670	-3,549	-528	-2,070	6,218
Proceeds from LTB/STB	13,672	-1,445	-961	-2,040	-7,666
Dividend Payments	-501	-590	-597	-746	-746
Cash Flow from Fin.	**14,841**	**-5,584**	**-2,086**	**-4,856**	**-2,195**
Free Cash Flow	7,763	4,998	8,634	10,848	3,084
Net Cash Flow	**-3,195**	**479**	**-248**	**5,992**	**6,620**
Opening Cash Balance	**5,382**	**2,187**	**2,666**	**2,418**	**8,410**
Add: Net Cash	-3,195	479	-248	5,992	6,620
Closing Cash Balance	**2,187**	**2,666**	**2,418**	**8,410**	**15,029**

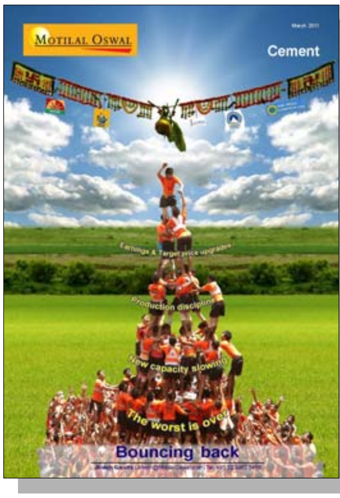
E: MOSL Estimates

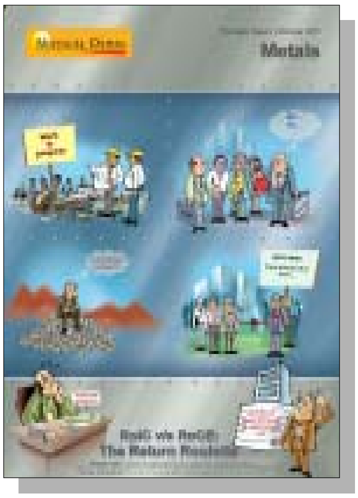
Motilal Oswal Sector Gallery

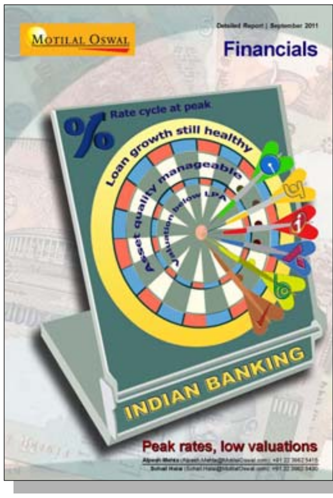












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