

# HEXAWARE TECHNOLOGIES

## Good show continues

India Equity Research | IT



The Q2CY12 results of Hexaware Technologies (Hexaware) were in line with estimates as revenues stood at USD91.2mn, up 3.6% QoQ (4.2% volume growth) vs our and Street estimate of USD92mn. EBITDA margin expanded 50bps to 22.9%, ahead of our estimate of 22.5%. The company seems to be reaping benefits of investments made over the past two years as the decent guidance for Q3CY12 (1.4%-3.0%) in an uncertain environment bears testimony to the same. We believe its continuous investments in strengthening front-end sales team and focus on improvement in operational parameters would drive growth from hereon. Maintain 'BUY' with target price of INR140.

### Inline quarter on revenue, margin front

Hexaware's Q2CY12 revenues at USD91.2mn were marginally lower than our and Street estimate of USD92mn. The sequential growth of 3.6% (4.4% in CC) was driven by a volume growth of 4.2%. The beat on PAT (INR890mn versus estimate of INR834mn) was due to lower forex losses. It has won a large deal of USD100mn spread over four years; revenues from this deal are expected to accrue from early CY13. Further, it is actively chasing four more large deals.

### Growth to be driven by investments, operational focus

The company has reiterated that it will continue to make investments, particularly in new technology areas in order to drive growth. Further, Hexaware plans to continue to invest in S&M for gaining higher wallet share within clients, particularly beyond its top 20 clients (thus strengthened sales team by 11 in H1CY12). We believe this, coupled with its continued focus on improving operational parameters, will enable it to drive growth and maintain operating margin.

### Outlook and valuations: Momentum continues; maintain 'BUY'

While the Q2CY12 results were in line with estimates but lacked any positive surprise, we believe the momentum remains intact for the company, led by a strong order book build up, besides its continuous investments in the front-end. We forecast 20% USD revenue growth with EBITDA margin of 21%. Higher tax rate of 22% (20% earlier) leads to 4% cut in our CY13 EPS to INR12.7. We maintain 'BUY /SO' with TP of INR140 (11x CY13E earnings).

#### Financials

Year to December	Q2CY12	Q1CY12	Growth %	Q2CY11	Growth %	CY11	CY12E	CY13E
Revenue (INR mn)	5,001	4,383	14.1	3,341	49.7	14,505	19,586	22,552
EBITDA (INR mn)	1,147	982	16.8	511	124.4	2,646	4,393	4,741
Net profit (INR mn)	890	884	0.7	603	47.6	2,668	3,458	3,815
Diluted EPS (INR)	3.0	2.9	0.7	2.0	47.3	8.9	11.5	12.7
Diluted P/E (x)						12.8	9.9	9.0
EV/EBITDA (x)						10.9	6.3	5.4
EV/Revenues (x)						2.0	1.4	1.1

#### EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

#### MARKET DATA (R: HEXT.BO, B: HEXW IN)

CMP	: INR 114
Target Price	: INR 140
52-week range (INR)	: 134 / 68
Share in issue (mn)	: 296.1
M cap (INR bn/USD mn)	: 34/ 608
Avg. Daily Vol.BSE/NSE('000)	: 1,861.2

#### SHARE HOLDING PATTERN (%)

	Current	Q4FY12	Q3FY12
Promoters %	27.9	28.0	28.2
MF's, FI's & BK's	8.7	9.5	9.4
FII's	43.4	42.1	41.4
others	20.0	20.4	21.0
* Promoters pledged share (% of share in issue)			NIL

#### PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	(10.7)	(0.9)	(3.7)
3 months	(11.9)	(0.4)	2.0
12 months	30.1	(4.6)	9.9

#### Sandip Agarwal

+91 22 6623 3474  
sandip.agarwal@edelcap.com

#### Omkar Hadkar

+91 22 6620 3147  
omkar.hadkar@edelcap.com

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## Key highlights

- **Revenue marginally lower than estimate:** Revenue at USD91.2mn was marginally lower than our and Street estimate (USD92mn), up 3.6% QoQ, driven by strong volume growth of 4.2% QoQ. Revenue growth in constant currency stood at 4.4% QoQ. INR terms, revenue stood at INR5.0bn, up 14.1% sequentially.

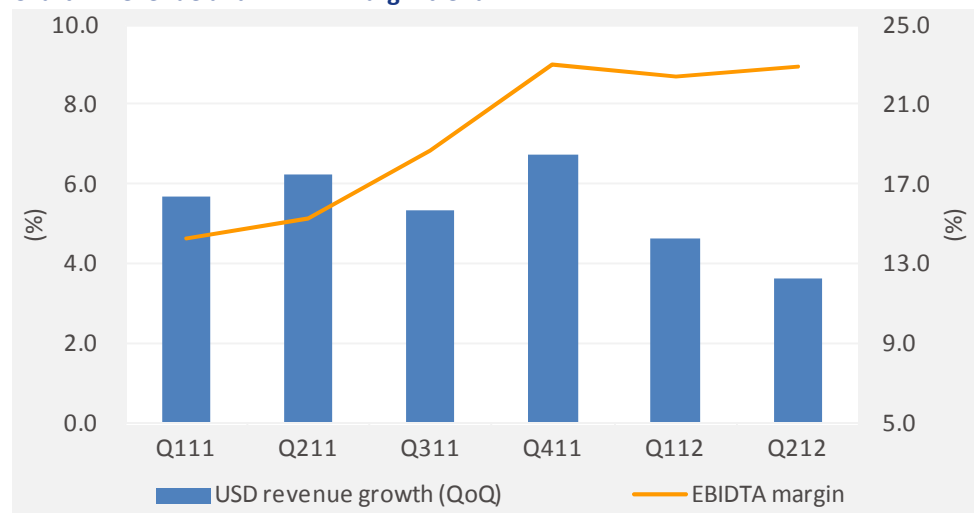
**Table 1: Split of revenue growth in USD terms for Q2CY12**

Revenue growth break-up	(%)
Volumes	4.2
Realisation (in CC)	0.2
Cross currency	(0.8)
<b>Q-o-Q impact</b>	<b>3.6</b>

Source: Company

- Gross profit at INR2.0bn rose 10.9% QoQ. However, gross margin dipped 120bps QoQ to 40.1% due to wage hikes effected during the quarter. EBITDA, at INR1,147mn, jumped 16.8% sequentially, primarily on account of lower SG&A spending. EBITDA margin rose 50bps to 22.9% QoQ.

**Chart 1: Revenue and EBITDA margin trend**



Source: Company, Edelweiss research

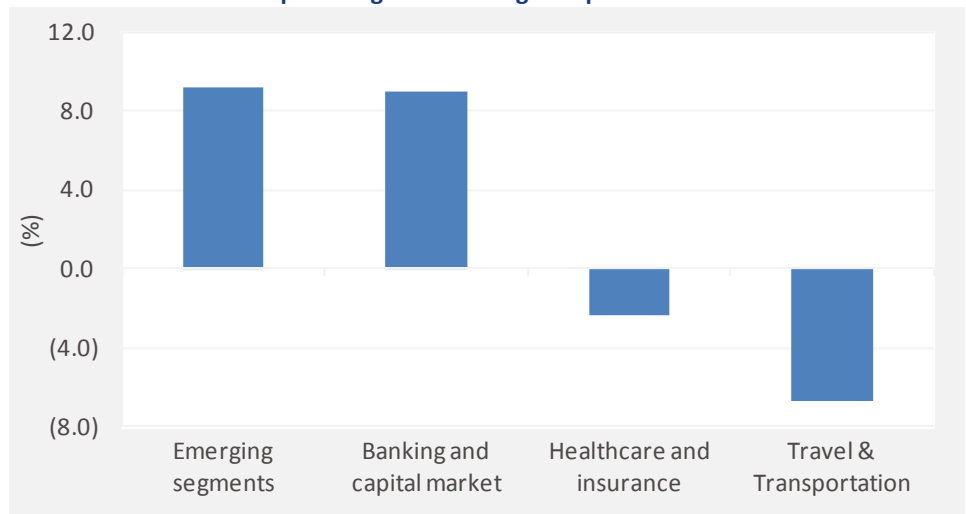
- Net profit at INR890mn was above our INR834mn estimate due to lower-than-expected forex loss. Net profit margin plunged 240bps to 17.8% (20.2% in previous quarter) due to higher tax rate.
- **Q3CY12 guidance:** Revenue for Q3CY12 is likely to be in the USD92.5-94.0mn range (implying 1.4-3.0% QoQ growth). Management expects demand momentum to continue in CY12 and has maintained its revenue guidance of at least USD370mn, implying growth of 20% over CY11. The company requires a CQGR of 2% in the next quarter to achieve its stated annual guidance

**Client addition continues to impress:** Hexaware added 12 new clients during the quarter (same as in Q1CY12), of which six are from North America, three from Europe and three from APAC. In terms of verticals, three are in banking and capital market (BCM), one in travel & transportation. Total active clientele is now at 210 against 201 in the previous quarter.

During the quarter, the company won a large deal which will generate revenue of USD100mn spread over four years. Revenue from this deal are expected to accrue beginning early 2013.

- **BFSI & emerging segments drive growth:** BFSI and emerging segments led growth during the quarter with a sequential growth of 9.0% and 9.2% QoQ, respectively. However, travel & transportation and healthcare & insurance declined 6.7% and 2.4% QoQ, respectively.

**Chart 2: Vertical wise sequential growth during the quarter**



Source: Company, Edelweiss research

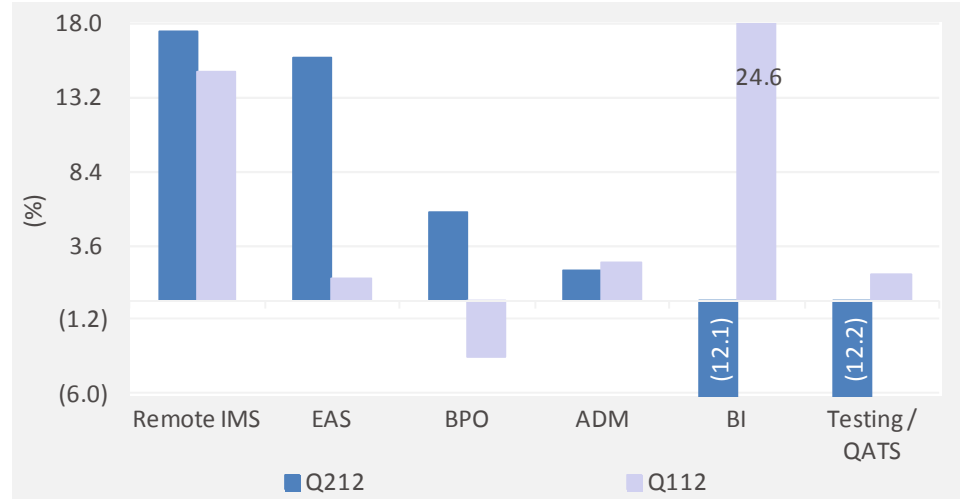
- **Client metric:** Revenue growth of 3.6% was driven by continued traction from its top client who grew 3.6% QoQ (11.4% in Q1CY12) and beyond top 10 clients which reported sequential growth of 5.8% (4.4% in Q1CY12). Its top 5 and 10 clients grew sequentially by 0.7% and 1.7%, respectively.

**Table 2: Per client realization in top 10 category has increased significantly**

Realization per customer (USD mn)	Q310	Q410	Q111	Q211	Q311	Q411	Q112	Q212
Top client	6.7	6.5	8.2	9.4	10.7	11.7	13.0	13.5
Top 2-5 clients	4.0	4.7	4.6	4.8	4.9	5.3	5.3	5.2
Top 6-10 clients	1.6	1.6	1.7	2.0	2.2	2.3	2.4	2.5
Beyond 10	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2

Source: Company, Edelweiss research

- **All service lines except Testing and BI post growth:** Growth was led by enterprise solutions (32.3% of revenue), which grew 15.8% QoQ (1.5% in Q1CY12). ADM (38.3% of revenue) and BPO grew 2.0% and 5.8% QoQ, respectively. Business intelligence and testing disappointed as they declined sequentially by 12.1% and 12.2%, respectively.

**Chart 3: Domain-wise QoQ revenue growth**


Source: Company, Edelweiss research

- **Hiring:** The quarter saw a net employee addition of 109 (307 in Q1CY12). Total employee count now stands at 8,733.
- **Utilisation inches up:** Utilisation saw an uptick of 140bps sequentially to 70.0%.
- **Attrition dips:** Annualised attrition dipped for fifth quarter in a row to 9.6% from 11.0% in Q1CY12.
- **Geo split:** APAC posted strong growth of 17.8% albeit on a lower base while Europe (29.2% of revenue) and North America (63.3% of revenue) grew 2.2% and 2.8%, respectively.
- **Hedging:** Hexaware has hedges worth USD219mn (at an average rate of INR50.4) and EUR13mn (at an average rate of INR69.6), maturing over subsequent eight quarters.
- DSO declined by 7 days to 45 from 52 (in Q1CY12).
- Current cash and equivalents position stands at INR4.3bn, translating into INR15 per share (~13% of current market price).

**Financial snapshot**

(INR mn)

Year to December	Q2CY12	Q1CY12	% Change	Q2CY11	% Change	CY11	CY12E	CY13E
Net revenues	5,001	4,383	14.1	3,341	49.7	14,505	19,586	22,552
Direct costs	2,995	2,574	16.4	2,117	41.5	8,939	11,722	13,864
Gross profit	2,006	1,809	10.9	1,224	63.9	5,566	7,864	8,688
SG&A	859	827	3.9	713	20.5	2,920	3,471	3,947
EBITDA	1,147	982	16.8	511	124.4	2,646	4,393	4,741
Depreciation	76	71	7.0	59	28.8	248	303	338
EBIT	1,071	911	17.6	452	136.9	2,398	4,090	4,403
Other income	49	138	(64.5)	267	(81.6)	677	238	488
Profit before tax	1,120	1,049	6.8	719	55.8	3,075	4,328	4,891
Tax	230	165	39.4	116	98.3	407	870	1,076
Reported net profit	890	884	0.7	603	47.6	2,668	3,458	3,815
Diluted EPS (INR)	3.0	2.9	0.7	2.0	47.3	8.9	11.5	12.7

**As % of net revenues**

Direct costs	59.9	58.7		63.4		61.6	59.8	61.5
Gross profit	40.1	41.3		36.6		38.4	40.2	38.5
SG&A	17.2	18.9		21.3		20.1	17.7	17.5
EBITDA	22.9	22.4		15.3		18.2	22.4	21.0
EBIT	21.4	20.8		13.5		16.5	20.9	19.5
Reported net profit	17.8	20.2		18.0		18.4	17.7	16.9
Tax rate	20.5	15.7		16.1		13.2	20.1	22.0

**Change in estimates**

(INR mn)

	CY12E			CY13E			Comments
	New	Old	% change	New	Old	% change	
Net revenue	19,586	18,871	3.8	22,552	22,703	(0.7)	Reduced revenue growth for CY12/13 from earlier 22%/20% to 20%/19%. Revised USD/INR assumption for FY12 to INR53.5/USD from earlier INR51.5/USD
EBITDA	4,393	3,928	11.8	4,741	4,914	(3.5)	Revision of USD/INR assumption for the year leads to an improvement in EBITDA for CY12.
EBITDA margin (%)	22.4	20.8		21.0	21.6		
PAT	3,458	3,306	4.6	3,815	3,988	(4.3)	Tax rate assumption raised from 20% to 22% for CY13
PAT margin (%)	17.7	17.5		16.9	17.6		
Capex	696	675	3.1	503	496	1.3	

## Company Description

Hexaware Technologies (Hexaware) is an IT-services company, specialised in offering enterprise solutions, application management, and embedded system. The company provides software services to banking and financial services, insurance, travel & transportation, emerging segments (manufacturing and healthcare) verticals. Hexaware has a dominant PeopleSoft practice and is amongst the Top 20 software and services exporter from India. The company's last twelve month revenues stood at INR17.4bn (USD342mn) and it employees 8,733 people.

## Investment Theme

Over the past one year Hexaware has focused on improving operational efficiencies and re-aligned itself vertically from earlier horizontal sales-based approach. Further, strengthening of the sales force with 16 new recruits and new deal wins reported in the past six months are likely to result in improving revenue traction going forward. In addition, high US and BFSI exposure should aid growth in an improving macro environment. We see Hexaware fundamentally strengthened with the recent initiatives and with a healthy cash position it is well poised to explore inorganic growth opportunities as well.

## Key risks

- Double dip recession in its major market US and prolonged slowdown in Europe.
- Appreciation of INR against USD, EUR, and GBP.
- Inadequate availability of manpower.

## Financial Statements

### Key assumptions

	CY09	CY10	CY11	CY12E	CY13E
<b>Macro -</b> GDP(Y-o-Y %)	8.4	8.4	6.5	6.4	7.0
Inflation (Avg)	3.6	9.9	8.8	7.0	6.0
Repo rate (exit rate)	5.0	6.8	8.5	7.3	6.8
USD/INR (Avg)	47.4	6.8	47.9	53.5	50.0
<b>Company -</b> USD revenue growth (%)	(18.3)	7.7	33.3	20.1	19.8
Net addition (nos.)	(1,285)	1,335	1,845	1,236	1,417

### Income statement

	(INR mn)				
Year to December	CY09	CY10	CY11	CY12E	CY13E
Net revenue	10,386	10,545	14,505	19,586	22,552
Cost of revenues	5,643	6,915	8,939	11,722	13,864
Gross profit	4,743	3,630	5,566	7,864	8,688
Total SG&A expenses	2,720	2,692	2,920	3,471	3,947
G&A expenses	2,720	2,692	2,920	3,471	3,947
EBITDA	2,023	938	2,646	4,393	4,741
Depreciation & Amortization	270	242	248	303	338
EBIT	1,753	696	2,398	4,090	4,403
Other income	(307)	249	677	238	488
Profit before tax	1,446	945	3,075	4,328	4,891
Provision for tax	103	92	407	870	1,076
Net profit	1,343	853	2,668	3,458	3,815
Extraordinary income/ (loss)	-	224	-	-	-
Profit After Tax	1,343	1,077	2,668	3,458	3,815
Profit after minority interest	1,343	1,077	2,668	3,458	3,815
Shares outstanding (mn)	298	297	299	301	301
Diluted EPS (INR)	4.5	3.6	8.9	11.5	12.7
Dividend per share (INR)	0.7	2.0	4.0	4.5	5.0

### Common size metrics - as % of net revenues

Year to December	CY09	CY10	CY11	CY12E	CY13E
Gross margin	45.7	34.4	38.4	40.2	38.5
EBITDA margins	19.5	8.9	18.2	22.4	21.0
EBIT margins	16.9	6.6	16.5	20.9	19.5
Net profit margins	12.9	8.1	18.4	17.7	16.9

### Growth ratios (%)

Year to December	CY09	CY10	CY11	CY12E	CY13E
Rev. growth (%)	(9.8)	1.5	37.6	35.0	15.1
EBITDA	57.0	(53.6)	182.1	66.0	7.9
Net profit	101.6	(36.5)	212.8	29.6	10.3
EPS growth (%)	95.8	(19.6)	145.8	28.9	10.3

<b>Balance sheet</b>					
	(INR mn)				
<b>As on 31st December</b>	<b>CY09</b>	<b>CY10</b>	<b>CY11</b>	<b>CY12E</b>	<b>CY13E</b>
Equity capital	290	291	587	591	591
Share premium account	4,726	4,774	4,522	4,522	4,522
Reserves & surplus	3,482	4,590	5,053	7,159	9,250
Shareholders funds	8,497	9,655	10,162	12,272	14,363
Borrowings	163	112	-	-	-
Deferred tax liability	10	13	32	32	32
<b>Sources of funds</b>	<b>8,670</b>	<b>9,780</b>	<b>10,194</b>	<b>12,304</b>	<b>14,396</b>
Gross block	3,298	3,469	4,292	5,313	6,059
Accumulated depreciation	1,404	1,519	1,697	2,000	2,338
Net block	1,893	1,950	2,594	3,312	3,721
Capital work in progress	1,258	969	813	488	244
Deferred tax asset	121	182	195	195	195
Goodwill	1,207	1,160	1,377	1,377	1,377
Investments	1,269	397	229	800	1,500
Sundry debtors	1,526	1,919	2,993	3,649	4,078
Cash and equivalents	2,992	4,356	4,377	5,303	6,580
Loans and advances	1,113	1,632	1,946	1,400	1,500
Total current assets	5,632	7,907	9,317	10,352	12,158
Sundry creditors and others	1,998	1,475	2,891	3,240	3,700
Provisions	710	1,309	1,440	980	1,100
Total current liabilities & provisions	2,709	2,785	4,331	4,220	4,800
Net current assets	2,923	5,123	4,986	6,132	7,359
<b>Uses of funds</b>	<b>8,670</b>	<b>9,780</b>	<b>10,194</b>	<b>12,304</b>	<b>14,396</b>
Book value per share (INR)	29.6	33.3	34.7	41.5	48.6

<b>Free cash flow</b>					
	(INR mn)				
<b>Year to December</b>	<b>CY09</b>	<b>CY10</b>	<b>CY11</b>	<b>CY12E</b>	<b>CY13E</b>
Net profit	1,343	1,077	2,668	3,458	3,815
Depreciation	270	242	248	303	338
Others	(304)	(634)	(925)	(238)	(488)
Gross cash flow	1,309	685	1,991	3,523	3,665
Less: Changes in WC	(201)	563	578	21	(50)
Operating cash flow	1,511	122	1,413	3,501	3,715
Less: Capex	82	(542)	629	696	503
<b>Free cash flow</b>	<b>1,429</b>	<b>665</b>	<b>784</b>	<b>2,806</b>	<b>3,213</b>

<b>Cash flow metrics</b>					
<b>Year to December</b>	<b>CY09</b>	<b>CY10</b>	<b>CY11</b>	<b>CY12E</b>	<b>CY13E</b>
Cash flow from operations	1,309	685	1,991	3,523	3,665
Cash for working capital	201	(563)	(578)	(21)	50
Operating cash flow	1,511	122	1,413	3,501	3,715
Net purchase of fixed assets	(82)	542	(629)	(696)	(503)
Net purchase of investments	(1,249)	872	168	(571)	(700)
Investing cash flow	(1,331)	1,414	(461)	(1,267)	(1,203)
Dividends	(183)	(233)	(1,243)	(1,551)	(1,724)
Proceeds from issue of equity	2	32	37	5	-
Proceeds from LTB/STB	(24)	(48)	(212)	-	-
Interest paid & other items	(17)	(26)	(22)	238	488
Financing cash flow	(223)	(275)	(1,439)	(1,308)	(1,236)
Net cash flow	(43)	1,236	(394)	926	1,277



## Profitability & efficiency ratios

Year to December	CY09	CY10	CY11	CY12E	CY13E
ROAE (%)	17.8	9.4	26.9	30.8	28.6
ROACE (%)	24.7	8.3	24.8	38.1	36.1
Debtors days	63	60	62	62	63
Payable days	88	60	55	57	56
Cash conversion cycle (days)	(25)	-	7	5	6
Current ratio	2.1	2.8	2.2	2.5	2.5

## Operating ratios

Year to December	CY09	CY10	CY11	CY12E	CY13E
Total asset turnover	1.3	1.1	1.5	1.7	1.7
Fixed asset turnover	5.9	5.5	6.4	6.6	6.4
Equity turnover	1.4	1.2	1.5	1.7	1.7

## Valuation parameters

Year to December	CY09	CY10	CY11	CY12E	CY13E
Diluted EPS (INR)	4.5	3.6	8.9	11.5	12.7
Y-o-Y growth (%)	95.8	(19.6)	145.8	28.9	10.3
CEPS (INR)	5.6	3.8	10.0	12.7	14.0
Diluted PE (x)	25.3	31.4	12.8	9.9	9.0
Price/BV (x)	3.9	3.4	3.3	2.8	2.3
EV/Sales (x)	2.8	2.7	2.0	1.4	1.1
EV/EBITDA (x)	14.2	30.4	10.9	6.3	5.4
EV/EBITDA (x)+1 yr forward	30.5	10.8	6.6	5.8	-
Dividend yield (%)	0.6	1.8	3.5	3.9	4.4

## Peer comparison valuation

Company	CMP (INR)	Mcap (INR bn)	P/E (x)		EV/EBITDA(x)		ROAE (%)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
eClerx	680	20	10.5	9.3	6.8	6.1	50.9	46.5
HCL Tech	519	360	13.4	12.4	7.5	7.1	23.9	21.9
Hexaware	114	34	9.9	9.0	6.3	5.4	30.8	28.6
Info Edge	321	35	27.0	20.7	17.4	12.4	22.2	23.3
Infosys	2,227	1,279	13.4	12.0	8.2	7.3	28.1	27.0
Infotech	176	20	8.7	8.6	3.6	3.4	18.1	16.1
Mphasis	398	84	11.2	10.0	5.6	4.7	17.7	17.1
TCS	1,244	2,434	18.1	16.6	12.9	11.8	35.9	30.8
Wipro	340	837	12.5	12.3	8.8	8.6	21.6	19.0

Source: Edelweiss research

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ECLERX SERVICES	BUY	SO	M	HCL Technologies	BUY	SO	H
Hexaware Technologies	BUY	SO	M	Info Edge	REDUCE	SU	M
Infosys	BUY	SO	L	Infotech Enterprises	BUY	SO	H
Mphasis	HOLD	SP	M	Tata Consultancy Services	HOLD	SP	L
Wipro	HOLD	SP	L				

### ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

### RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

### RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

### SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

**Edelweiss Securities Limited**, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.  
Board: (91-22) 4009 4400, Email: [research@edelcap.com](mailto:research@edelcap.com)

Vikas Khemani	Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Nischal Maheshwari	Co-Head Institutional Equities & Head Research	nischal.maheshwari@edelcap.com	+91 22 4063 5476
Nirav Sheth	Head Sales	nirav.sheth@edelcap.com	+91 22 4040 7499

### Coverage group(s) of stocks by primary analyst(s):

ECLERX SERVICES, HCL Technologies, Hexaware Technologies, Infosys, Info Edge, Infotech Enterprises, Mphasis, Tata Consultancy Services, Wipro

### Recent Research

Date	Company	Title	Price (INR)	Recos
25-Jul-12	<b>Info Edge</b>	Moderate hiring impacts growth; <i>Result Update</i>	340	Reduce
25-Jul-12	<b>HCL Technologies</b>	Robust growth with margin comfort....; <i>Result Update</i>	514	Buy
24-Jul-12	<b>eClerx Services</b>	Inorganic contribution, profits surprise positively; <i>Result Update</i>	703	Buy

### Distribution of Ratings / Market Cap

#### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	104	60	18	183
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	11	

### Rating Interpretation

Rating	Expected to
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period

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