IT-Midcaps - Neutral

Road to US$1bn gets tougher

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IT-Midcaps

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Initiating Coverage

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Road to US$1bn gets tougher

Post the slowdown in 2009, tier-II IT vendors have grown faster than their larger peers, with growth rates being ~1.5-2x higher than the industry growth. Niche offerings in growth verticals/sub-verticals, large deal signings and client mining have been major reasons for the growth. In the last eight quarters, while tier-I vendors have grown at a CQGR of 3.4%, tier-II vendors' growth has been 4.2%.

However, their quest of attaining US$1bn revenues has hit a speed bump, with FY14 revenue growth expected to be in line with the industry growth. Lack of large deal signings and an uncertain macroeconomic environment have resulted in tier-II IT companies reporting a revenue CQGR of 2.2% in 9MFY13, as against 3.1% for the tier-I vendors.

Moreover, unlike the last few quarters where the companies' reported margin expansion was driven primarily by INR depreciation and operational improvement, we expect the margins to decline or remain stable in FY14.

While we remain cautious on tier-II vendors due to the slowing growth, we initiate our coverage on Hexaware with a **Buy** rating on account of cheap valuations and strong dividend yield. However, given expensive valuations, we initiate our coverage on Mindtree and Persistent Systems with a **Hold** rating. Among the other tier-II companies, we have a **Buy** rating on KPIT and NIIT Tech.

Recommendation

		Target Price	M-cap (US$mn)	Upside/ Downside (%)
KPIT	BUY	129	356	25
NIIT Tech	BUY	334	294	24
Mindtree	HOLD	888	665	0
Hexaware	BUY	106	475	21
Persistent	HOLD	549	380	6

*Prices as on 21 Mar'13

IT services - Tier II - Financial Summary

	Sales			PAT			EPS (Rs)			EPS CAGR (%)		EBITDA CAGR (%)		RoE (%)			RoCE (%)		
(Rs mn)	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E	FY11-13E	FY13-15E	FY11-13E	FY13-15E	FY13E	FY14E	FY15E	FY13E	FY14E	FY15E
KPIT Cummins	22,463	25,220	28,693	2,064	2,516	2,911	10.9	13.2	15.3	36.9	18.8	53.4	12.3	23.3	21.4	20.4	19.5	17.2	17.3
NIIT Tech	20,393	23,308	26,043	2,233	2,490	2,727	37.4	41.8	45.7	9.8	10.5	19.5	10.8	22.2	21.0	19.5	21.4	21.1	19.6
Mindtree	23,615	26,485	30,072	3,448	3,553	4,067	83.7	86.2	98.7	82.4	8.6	67.7	6.1	30.4	24.2	22.4	30.2	23.4	20.6
Hexaware	19,482	21,395	24,039	3,242	3,006	3,498	10.9	10.1	11.8	71.9	3.9	108.3	6.0	27.1	22.9	24.0	27.3	22.1	23.3
Persistent	13,003	14,698	16,526	1,839	2,006	2,312	46.0	50.1	57.8	14.7	12.1	45.2	7.6	20.2	18.9	18.9	20.1	17.5	16.9

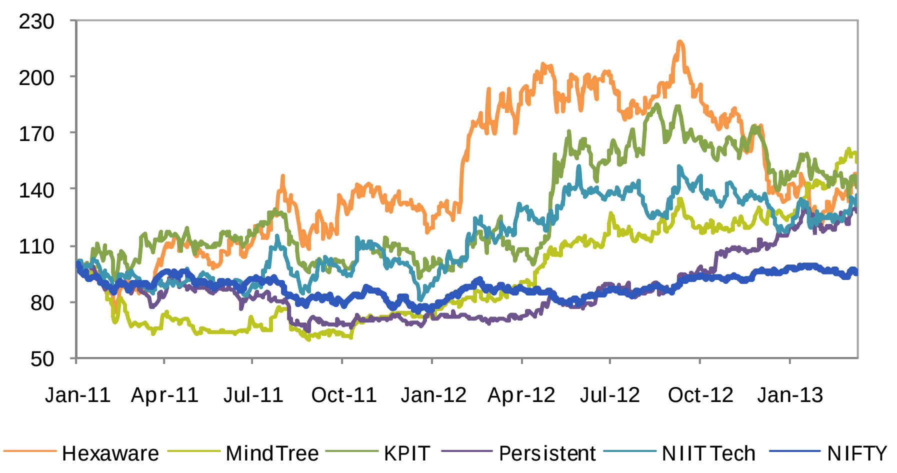
Valuation summary

Company	Blmg ticker	M-Cap (Rs bn)	Rating	Price (Rs) CMP	Tgt Price	P/E (x) FY13E	FY14E	FY15E	EV/EBITDA (x) FY13E	FY14E	FY15E	Dividend Yield (%) FY13E	FY14E	FY15E
KPIT Cummins	KPIT IN	20	BUY	103	129	9.5	7.8	6.7	5.1	4.5	3.5	1.0	1.0	1.0
NIIT Tech	NITEC IN	16	BUY	270	334	7.2	6.5	5.9	4.0	3.4	2.7	3.1	3.3	3.3
Mindtree	MTCL IN	36	HOLD	884	888	10.6	10.3	9.0	6.5	6.2	5.6	0.7	0.9	1.1
Hexaware	HEXW IN	26	BUY	88	106	8.0	8.7	7.4	5.2	5.2	4.3	6.2	6.2	6.8
Persistent	PSYS IN	21	HOLD	520	549	11.3	10.4	9.0	4.9	4.3	3.3	1.7	1.9	2.1
Coverage Group average						**9.3**	**8.8**	**7.7**	**5.3**	**4.8**	**4.0**	**2.4**	**2.6**	**2.8**

Rewarding growth: Select tier-II vendors outperform indices

Notwithstanding recent underperformance, select tier-II IT vendors have outperformed the indices as well as their larger peers in the last two years. While some companies such as Hexaware, NIIT Tech, Persistent and KPIT have outperformed on account of their strong revenue and margin growth, Mindtree and Infotech have benefitted from the margin expansion due to INR depreciation and operational improvements.

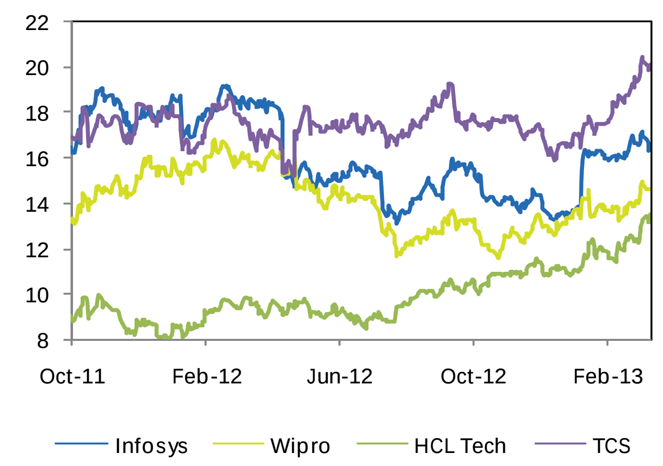
Tier-II vendors stock performance



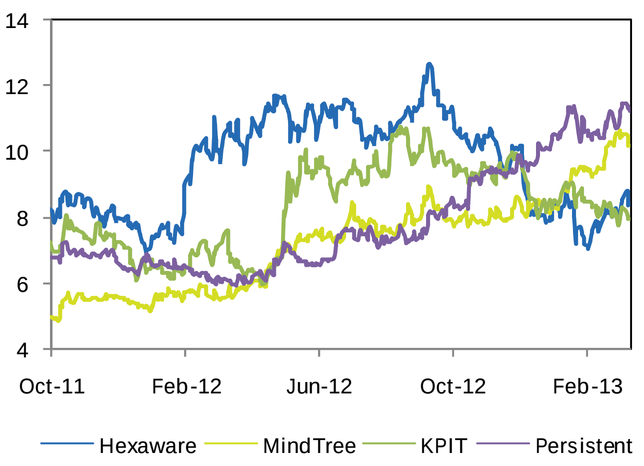
Source: Bloomberg, Tata Securities Research

Strong growth and margin expansion have resulted in a re-rating of these select stocks in the last four-six quarters. This is unlike some of their larger peers, where lower growth and margin contraction despite INR depreciation resulted in a PER de-rating of Infosys and Wipro.

1 yr fwd PER Charts- Tier-I vendors



1 yr fwd PER Charts-Tier-II vendors



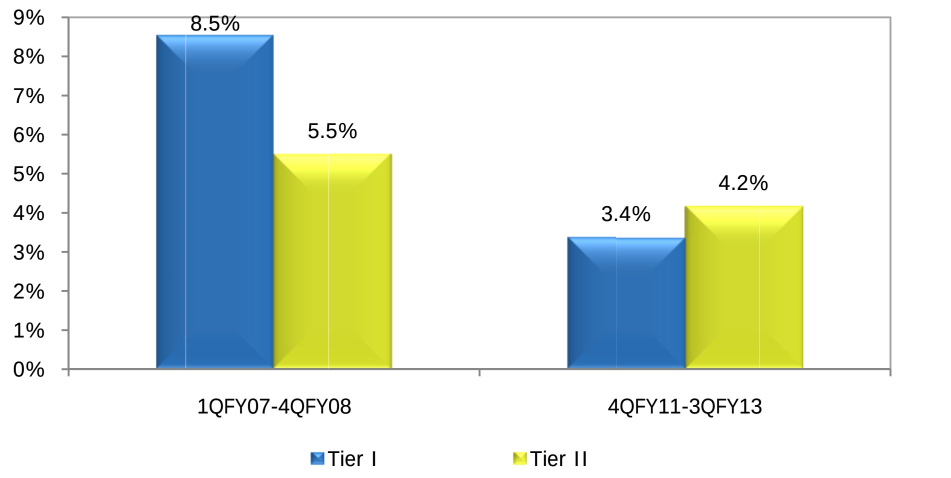
Source: Companies data, Tata Securities Research

Large deals and client mining drive revenue growth

Contrary to expectations of tier-II IT vendors struggling to survive post the slowdown in FY09 due to vendor consolidation, select tier-II companies have grown faster. These companies not only have reported a faster revenue growth, but have also reported a superior profitability growth, compared to their larger tier-I peers. The faster growth has been on account of large deal wins and strong client mining.

While these vendors grew at a CQGR of 4.2% in the last eight quarters, tier-I vendors grew 3.4% during the same period. Though one may argue that the larger size of tier-I vendors was the reason for lower growth, we highlight that prior to the economic slowdown in FY09, tier-II vendors grew slower than tier-I vendors despite lower base. Tier-II vendors' revenues grew at a CQGR of 5.5% between 1QFY07 and 4QFY08, as against a CQGR of 8.5% reported by their larger peers.

Revenue CQGR- Tier-I vs Tier-II



Source: Companies data, Tata Securities Research
Note: Tier-I includes US$ revenues from Infosys, Wipro (IT Services), TCS, HCLT and Cognizant
Tier-II vendors include US$ revenues from Hexaware, Geometric, NIIT Tech, MindTree, Infotech and KPIT

Though the reasons for stronger growth vary among the companies, strong domain capabilities, large deal signings and client mining are the common threads. We also believe that strong presence in some of the growth verticals such as BFSI, manufacturing and retail and low telecom vertical exposure have helped the companies grow faster.

A) Strong domain knowledge

The strong domain knowledge has helped tier-II companies to report a strong growth. The domain experience has not only helped these companies garner marquee clients, but also sign large deals. Despite vendor consolidation post the slowdown, some of the tier-II vendors were able to grow with large accounts due to their strength in chosen verticals. Strong domain knowledge and increased service portfolio have helped the companies penetrate deeper into the clients and become strategic.

Domain capability

Company	Domain strength	% of revenues	Key clients
KPIT Cummins	Auto & engineering	24%	Nine of the top 12 OEMs
NIIT Tech	Travel & transportation	41%	BA, Sabre, Virgin Group, DB Systel
	BFSI	33%	SEI, ING, AXA, Thrivent
Mindtree	Manufacturing	18.5%	P&G, Volvo, Unilever, Arcelor Mittal
	BFSI	22.5%	AIG, ANZ, Carlyle Group
Hexaware	Travel & transportation	21%	9 Global Airlines, 3 large Service providers
	BFSI	31%	

Source: Companies data, Tata Securities Research

B) Large deal signings

Large deal signing has been one of the major reasons for robust growth for the tier-II vendors in the last eight-ten quarters. Deals won against large global system integrators as well as large Indian IT vendors, we believe, demonstrate their domain strength and deal structuring capabilities. Large multi-year deals have also helped them to improve their revenue visibility and have higher share of annuity revenues.

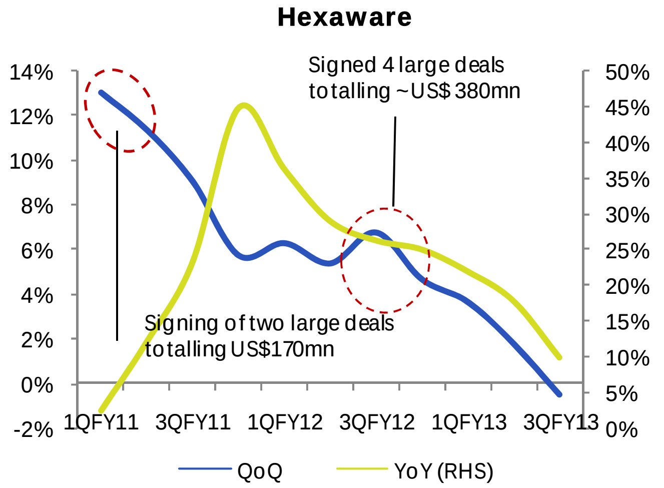
Large deal signings

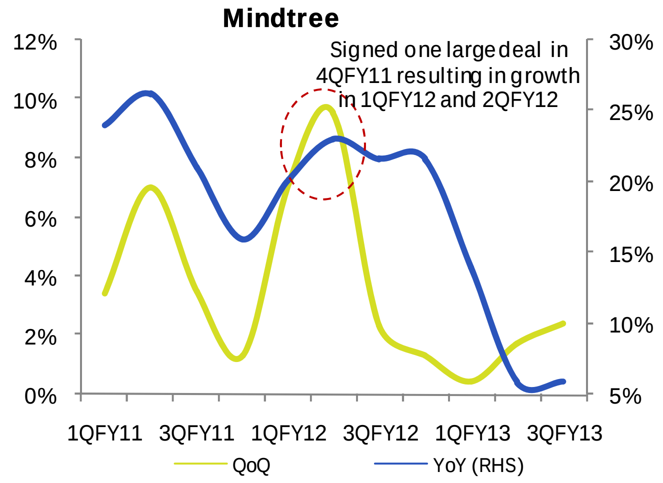
	Deal Size	Quarter	Deal period (yrs)	Services offered	Client
Hexaware	US$110mn	2QCY10	5	ADM,IMS, ERP	Fortune 500 US corporations
	US$60mn	2QCY10	3	Contract Extension encompassing BI, ERP and Testing	Multi-billion dollar enterprise
	US$10-15mn	1QCY11	1	Support clients banking and Invt mgmt business	North American BFSI client
	US$25mn	2QCY11	3	IMS	European client
	US$100mn	2QCY11	5	ERP, BI, Testing,BPO, Application Management	
	US$250mn	4QCY11	5	ERP, Testing, BI, ADM and Remote IMS	
	US$100mn	2QCY12	4	ERP	Multi-billion dollar enterprise
	NA	3QCY12	NA	BA/BI, IMS and Emerging Technologies	BFSI client in Europe
MindTree	2 deals totaling US$70mn	4QFY11	5	Infrastructure management	US based bank and ICT service provider in Europe
	NA	1QFY11	NA	Infrastructure management	Carlyle Group
NIIT Tech	US$85mn	2QFY12	5	IT & BPO Services	Morris Communications
	NA	1QFY12	NA	Managed Services	Eurostar
	NA	4QFY12	NA	Managed Services	Caesar's Palace
	US$20mn	2QFY13	4	Develop digital platform and manage content distribution	Morris Communications

Source: Companies data, Tata Securities Research

Though ramp up in these large deals resulted in a superior growth for tier-II vendors, lack of these deals, post the ramp ups, led to a tepid performance. In our opinion, the growth will continue to be dependent on large deals, till the macro environment improves.

Revenue growth aided by large deal signings





Source: Companies data, Tata Securities Research

C) Client mining improves, but still miles to go

Expanded service portfolio has helped these companies mine the clients, which apart from helping in growth, also aid margins. Some of the large deals signed have been from the existing clients in the last few quarters, demonstrating service quality and domain strength.

Client mining

	1QFY11-3QFY13 CQGR			
	Revenue	Rev/Client	Top 10 clients	Increase in US$10mn+(x)
Hexaware	5.3%	2.1%	5.9%	2.0
MindTree	3.6%	4.7%	5.3%	1.8
NIIT Tech	5.6%	NA	5.4%	2.3
Infotech	4.7%	NA	3.3%	NA
KPIT	8.7%	7.1%	6.4%	NA
Persistent	4.4%	0.4%	4.4%	NA
Geometric	4.6%	5.3%	4.4%	1.5

Source: Companies data, Tata Securities Research

Despite the success of tier-II companies in mining clients, we believe that there is still scope to increase revenues from the existing clients. The US$1mn above clients, as proportion of their total clients' base, is still low as compared to their larger peers. We believe that tier-II vendors would have to further mine the existing clients in order to grow faster. Maturing of newer services such as IMS, BPO and increased aggression could help the companies mine clients. Moreover, client mining helps on the margin front, as sales and marketing effort needed to mine the account is much lower compared to winning a new one.

US$1mn+ clients

US$1mn+ clients are still low for tier-II vendors

	Total clients	US$1mn+	US$1mn+ as % of total
Tier-II			
Mindtree	245	70	28.6%
Hexaware	218	55	25.2%
Geometric	101	24	23.8%
KPIT	178	72	40.4%
Mahindra Satyam	327	135	41.3%
Polaris	265	43	16.2%
iGate	304	120	39.5%
Tier-I			
Infosys	776	419	54.0%
Wipro	966	462	47.8%
TCS	1,051	551	52.4%
HCL Tech	544	418	76.8%

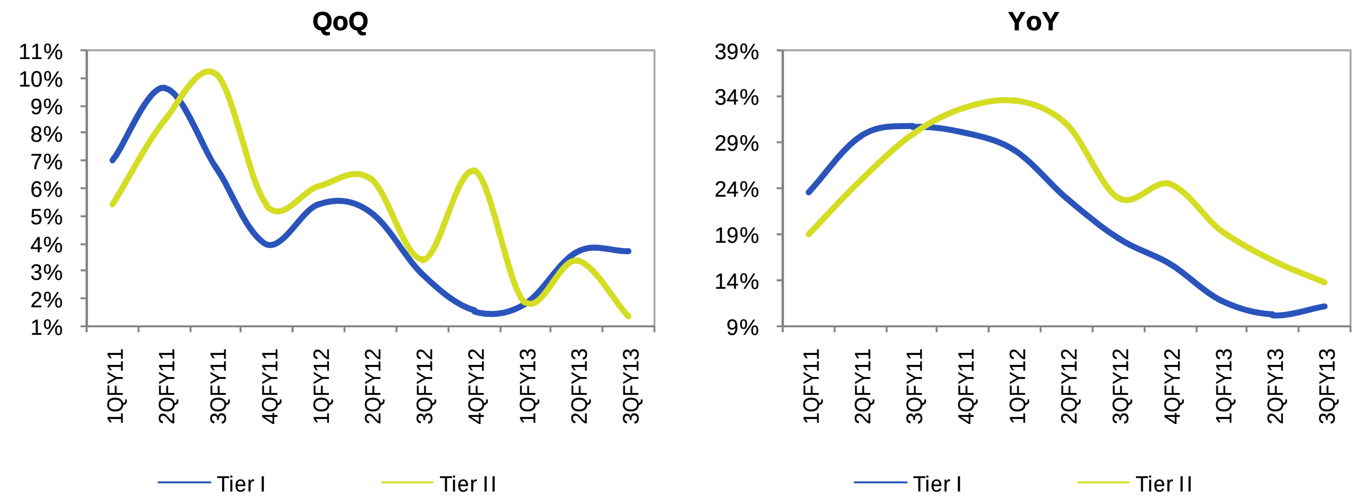
Source: Companies data, Tata Securities Research

Growth is starting to taper off

The growth for tier-II vendors has started to taper off in the last couple of quarters. Lack of large deal signings and an uncertain macroeconomic environment have resulted in a weaker growth. We believe that increased aggression to win deals from their larger peers could also be the reason for lower growth. The growth rate of tier-II vendors has started to converge with that of tier-I vendors. The guidance/commentary of the tier-II vendors also indicates that their growth rate would be similar to larger peers in FY14.

Though pick up in discretionary spending and increased client spending in CY13 are expected to improve growth for the IT sector, in our opinion, it has already been factored in the consensus estimates.

Revenue Growth- Tier-I and Tier-II



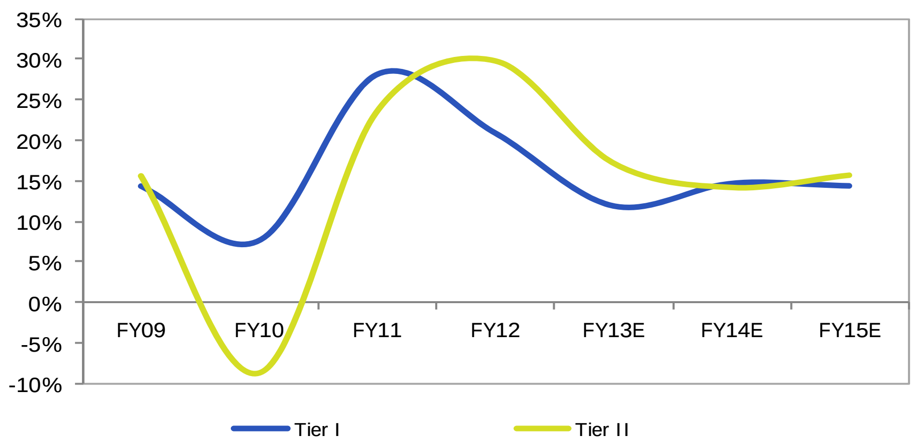
Source: Companies data, Tata Securities Research

Note: Tier-I includes Infosys, Wipro, HCL Tech, TCS and Cognizant. Tier-II includes Mindtree, Persistent, KPIT, NIIT Tech, Hexaware, Geomertic and Infotech Enterprises

We estimate a revenue growth of 14.6% and 15.5% in tier-II companies in FY14 and FY15 respectively, as against a growth of 14.7% and 14.4% in tier-I players during the same period.

Tier-I and tier-II growth rates are expected to converge.

Revenues growth rates



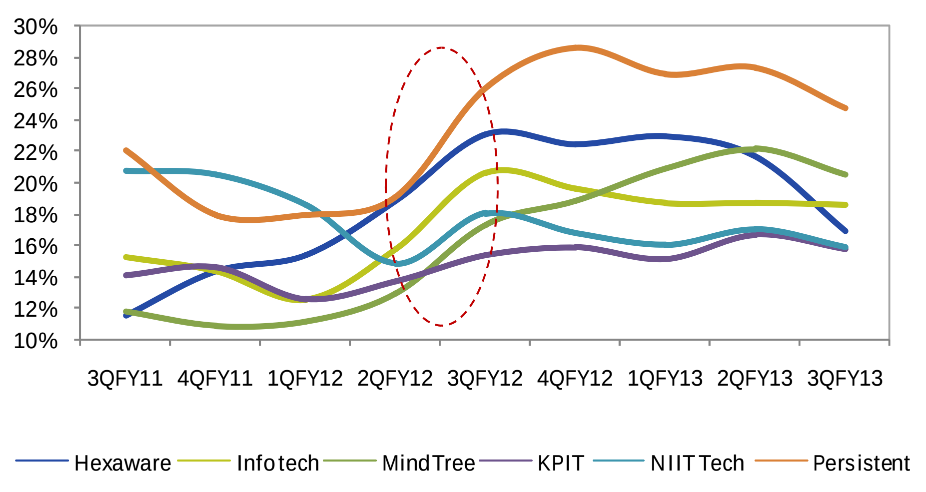
Source: Companies data, Tata Securities Research
Note: Tier-I includes US$ revenues from Infosys, Wipro (IT Services), TCS, HCLT and Cognizant
Tier-II vendors include US$ revenues from Hexaware, NIIT Tech, MindTree, Infotech and KPIT
TCS and Cognizant growth rates for FY13, CY13/FY14 and CY14/FY15 are Bloomberg Consensus estimates

Margin expansion: Growth remains the only lever

Over the past five-six quarters, unlike their larger peers, INR depreciation of over 15% and operational improvements have helped tier-II vendors to report margin expansion. The strong growth and margin expansion led to EBITDA and net profit CQGR of 9.1% and 7.4% over the last eight quarters.

Margin increase mainly on account of INR depreciation

EBITDA margin- Quarterly trend

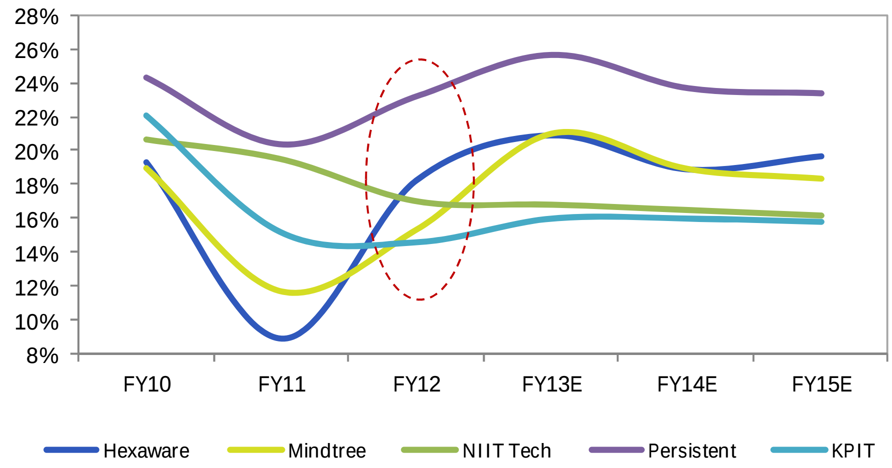


Source: Companies data, Tata Securities Research

However, going forward, we expect the margins to trend downwards from FY12 and FY13 levels. Focus on higher growth, salary costs and higher visa & sub-contractor cost are likely to be major headwinds for the margins. We believe that future margin expansion will be dependent on growth; higher-than-expected revenue growth could be the only margin lever.

EBITDA margin

Margins are likely to decline or remain flat going forward



Source: Companies data, Tata Securities Research

Further upgrades unlikely

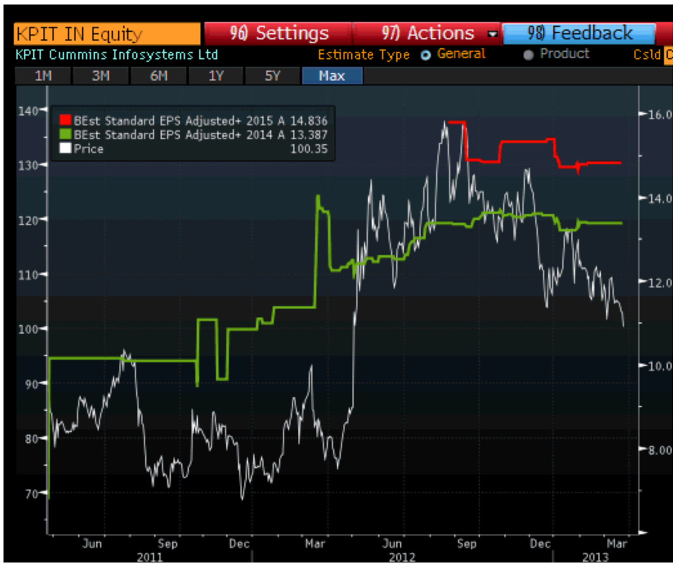
Pace of consensus upgrades have slowed down for FY14 and FY15

Higher-than-expected revenue and margin growth, coupled with INR depreciation in the last few quarters, have resulted in significant EPS upgrades for tier-II vendors. However, with the revenue growth tapering off and limited margin levers, the pace of the upgrades have slowed down. Though next fiscal year is likely to be better than FY13, we believe that FY14 estimates already factor that in.

We expect tier-II vendors (under our coverage) to report a revenue CQGR of ~3.6% in FY14, as against ~2.7% in FY13. We also expect the companies to report an EBITDA CQGR of 3.5% in FY14, as against 3.6% in FY13.

Hexaware

KPIT



Source: Bloomberg, Tata Securities Research

Mindtree | **NIIT Tech**

Source: Bloomberg, Tata Securities Research

Road to US$1bn: Differentiation is the key

The recovery, post the slowdown in 2009, has helped some of the tier-II vendors to move from an annual revenue run-rate of ~US$0.2bn to US$0.4-0.45bn, implying revenue CAGR of ~20%. Assuming revenue growth rate of 15%, these companies would become US$1bn companies in the next six-seven years. However, we believe that they would need to differentiate to grow faster.

While they are investing to grow their service portfolio, commoditisation of traditional services such as ADM/IMS/Testing is a challenge. Moreover, we believe that parts of BPO and ERP (maintenance) are also getting commoditised, reducing the attractiveness further.

The margins, in the commoditised services, have been declining over the years and were negated only by higher margins in newer service areas such as package implementation. However, with some segments in these services also getting commoditised, we believe it has become essential for the IT companies to invest in newer growth areas of cloud, enterprise mobility and big data. Though tier-I companies have already indicated their plans to focus on investing and growing new technologies practice, tier-II vendors (excluding Persistent) have still to show that commitment.

According to Nucleus Research, organisations can earn incremental RoI of 241% by using Big Data capabilities. Similarly, consumerisation of IT, led by abundance of smart devices making real time access to enterprise systems possible to employees and customers, becomes imperative for enterprises to invest.

According to NASSCOM, enterprise mobility market opportunity is expected to be US$140bn, while IDC expects the big data technology and services to expand at a CAGR of ~32% between 2012 and 2016, with revenues from Big Data sector approaching ~US$24bn by 2016.

We believe that investing in these technologies would help the companies to move up the value chain within their client base and become increasingly strategic.

While these technologies increase the target market of the vendors, they can also be a good entry strategy in larger clients' group. We also believe that margins in these technologies would be higher and the companies would be able to negate the impact of lower margins in the commoditised services.

Currently, there are four-five tier-II vendors with an annual revenue run rate of US$0.4-0.5bn. Assuming a conservative revenue growth rate of 15%, they would become US$1bn companies in the next six-seven years. Although we believe this is doable, achieving the target in the next three-four years looks an uphill task. In our opinion, in order to grow faster, these companies would have to invest and strengthen their vertical and horizontal portfolio.

Valuations attractive post recent fall

We don't expect the stocks to get re-rated due to lower revenue and profitability growth going forward. Moreover, tier-I vendors' revenues and net profit are expected to grow at a faster or similar pace, as compared to tier-II vendors in FY14, thus further reducing the attractiveness of the stocks.

Therefore, we remain selective and recommend stocks where we believe that the current valuations are attractive. While we maintain our **Buy** rating on NIIT Tech and KPIT, we initiate our coverage on Hexaware with a **Buy** rating and on Mindtree and Persistent Systems with a **Hold** rating.

Valuations

Company	Price	EPS		EPS CAGR	PER		EV/EBITDA		ROE	
		FY14E	FY15E	FY13-15E	FY14E	FY15E	FY14E	FY15E	FY14E	FY15E
Tier I										
TCS*	1,567	79.2	89.2	11.9%	19.8	17.6	14.9	13.4	33.8%	30.6%
Infosys	2,875	176.6	202.0	11.5%	16.3	14.2	10.1	8.5	23.3%	22.8%
Wipro	436	30.2	32.8	9.4%	14.4	13.3	10.9	9.9	20.4%	19.0%
HCL Tech	774	58.8	65.7	8.4%	13.2	11.8	8.3	7.0	26.4%	24.0%
Average					**17.4**	**15.5**	**12.4**	**11.0**	**25.8%**	**24.2%**
Tier II										
KPIT	103	13.2	15.3	18.8%	7.8	6.7	4.5	3.5	21.4%	20.4%
NIIT Tech	270	41.8	45.7	10.5%	6.5	5.9	3.4	2.7	21.0%	19.5%
Mindtree	884	86.2	98.7	8.6%	10.3	9.0	6.2	5.6	23.4%	20.6%
Hexaware	88	10.1	11.8	3.9%	8.7	7.4	5.2	4.3	22.9%	24.0%
Persistent	520	50.1	57.8	12.1%	10.4	9.0	4.3	3.3	18.9%	18.9%
Infotech Ent*	171	22.6	25.9	12.4%	7.6	6.6	3.3	2.7	16.7%	16.9%
Polaris*	115	24.4	25.2	5.4%	4.7	4.6	2.0	1.5	15.4%	14.9%
Average					**8.5**	**7.4**	**4.5**	**3.8**	**19.9%**	**19.5%**

Source: Companies data, Tata Securities Research
* Estimates are Bloomberg consensus estimates

Mindtree

Hold

CMP: Rs 884

Target Price: Rs 888

Potential Upside: 0%

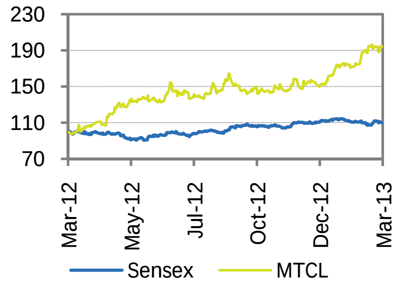
Key Statistics

M cap (INR bn/USD mn)	: 36.4/665
Avg 3m daily volume	: 80,108
Avg 3m daily value	: US$1.2mn
Shares O/S (mn)	: 42
Reuters	: MINT.BO
Bloomberg	: MTCL IN
Sensex	: 18,793
Nifty	: 5,659
52-Wk High/Low	: 925/465

Shareholding Pattern (Dec12) (%)

Promoter	*19.3*
FII's	*25.9*
MFs, FIs & Banks	*8.8*
Others	*46.0*

Relative Performance



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Initiating Coverage

Drab growth justifies current valuations

Mindtree has witnessed a multi-fold jump in its financial performance in the last two years. Its EBITDA and net profit have increased 2.7x and 3.2x over the last eight quarters as it benefitted from large deal signings, client mining and INR depreciation. The growth was despite revenues from product engineering business seeing a CQGR of -0.7% and its share in overall revenues declining from ~41% in 3QFY11 to ~30% in 3QFY13.

However, like its peers, the growth has started to taper off in the last few quarters. Lack of large deal signings and a slow growth in the product engineering business have impacted its revenue growth. We expect the company's FY13 revenue growth to be 8.3%, lower than the NASSCOM's estimate for the industry growth. The growth is expected to be ~14% in FY14, in line with NASSCOM's guidance. Moreover, we expect its EBITDA margins to decline going forward. We expect Mindtree's revenues and EBITDA to grow at a CAGR of 12.8% and 6.1% between FY13-15, as compared to a CAGR of 25.1% and 67.7% between FY11-13.

The stock is currently quoting at FY14E and FY15E PER of 10.3x and 9x respectively. The stock got re-rated over the last few quarters on account of string of revenue and profitability growth. However, with the growth expected to taper off to the industry level, we do not expect the re-rating to continue. We, therefore, initiate our coverage on the stock with a **Hold** rating and target price of Rs888/share, 9x FY15 EPS.

Key highlights

Product engineering business drags down growth: Mindtree's revenue growth rate has been impacted by lower growth in its product engineering business due to the challenges faced by the semiconductor and consumer devices business. Compared to revenue CQGR of 6.3% in the IT services business over the last 10 quarters, product engineering business saw a CQGR of -0.7%.

Margin growth could reverse: The margin expanded as the company benefitted from the operational improvement and INR depreciation. However, we don't expect the margins to improve going forward. It could trend downwards as we believe that headwinds like salary hikes and lower utilisation would negate positives from the employee pyramid rationalisation.

Financial summary

Year-end March	Sales (Rs mn)	YoY (%)	EBITDA (Rs mn)	YoY (%)	NP (Rs mn)	YoY (%)	EPS (Rs)	YoY (%)	PE (x)	EV/EBITDA (x)	PSR (x)	PBR (x)	ROE (%)	ROCE (%)	DPS (Rs)	Div Yield (%)
FY2012	19,152	26.9	2,932	66.4	2,185	118.4	53.9	114.5	16.4	11.2	1.9	4.1	25.2	21.2	4.0	0.5
FY2013E	23,615	23.3	4,955	69.0	3,448	57.8	83.7	55.1	10.6	6.5	1.5	3.2	30.4	30.2	6.0	0.7
FY2014E	26,485	12.2	5,116	3.3	3,553	3.0	86.2	3.0	10.3	6.2	1.4	2.5	24.2	23.4	8.0	0.9
FY2015E	30,072	13.5	5,581	9.1	4,067	14.5	98.7	14.5	9.0	5.6	1.2	2.0	22.4	20.6	10.0	1.1

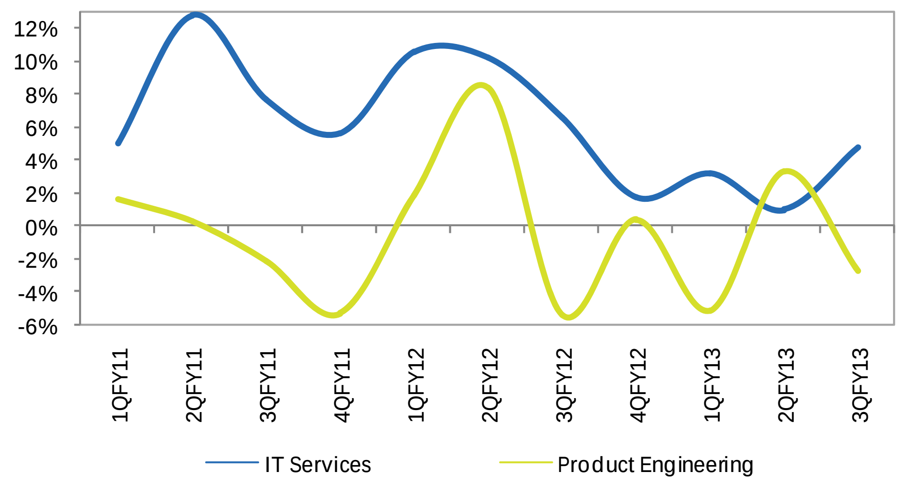
Product engineering business has dragged down the overall growth

Product engineering business dragging overall growth

Mindtree revenues have grown at a CQGR of 3.6% over the last 10 quarters, lower than its peers' growth rate of ~5.7%. Moreover, its expected revenue growth rate of 8.3% in FY13 is likely to be lower than the NASSCOM's industry growth estimate of ~10.2%.

The overall growth rate has been impacted by revenue CQGR of -0.7% in its product engineering business. On the other hand, revenues in IT services business have increased at a CQGR of 6.3% during the same period. The lower growth rate has resulted in revenues from the product engineering business declining from ~46% of the overall revenues in 1QFY11 to ~30% in 3QFY13.

Segmental revenue growth



Source: Company Data, Tata Securities Research

The weak macroeconomic environment has impacted the growth of product engineering business. Delayed decision on product roadmap, ramp downs in certain projects and challenges faced by semiconductor and consumer devices business had an impact on the business. However, the company is seeing some demand momentum in the space with pick up in independent software vendor and semiconductor space.

In the independent software vendor segment, the company is seeing traction in the cloud engineering space. In the semiconductor segment, the company witnessed a build-up of strong sales pipeline in 3QFY13. Consumer electronics and communications segment remain sluggish for the company, which we believe is client specific.

IT services business growth driven by focus on select verticals

Mindtree's revenue growth has been driven by the IT services business, where revenue CQGR of 6.3% is one of the highest among its peers. Strong growth in IT services business and lower growth in the product engineering space have resulted in the former contributing ~70% to the revenues in 3QFY12 as against ~60% eight quarters back. The revenue growth has been driven by Mindtree's focus on select verticals such as manufacturing, CPG/Retail, BFSI and travel & transportation. The company has multi-year relationship with some of the world's largest corporation and has not been impacted by vendor consolidation, indicating strong domain capability.

Client relationships

Client	Age of Relationship (Yr)	Services Offered
Avis Budget Group	12	ADM, testing, BPM
Microsoft	11	Product Dev, Testing, IMS
Unilever	11	ADM
Volvo	10	ADM, Mainframe, SI
KPN	7	ADM, IMS
TI	7	VLSI, Software
SITA	5	Consulting, ADM, SI, BPM

Source: Company Data, Tata Securities Research

Focus on select verticals, strong domain capability and increase in service offerings has helped the company mine the clients, resulting in an increase in revenue/client at a CQGR of 4.7% over the last 10 quarters. US$5mn+ and US$10mn+ customers have also increased 1.5x over the last two years.

Client mining has been strong over the last four years

Client mining

	FY09	FY10	FY11	FY12	3QFY13
US$ 1mn+	52	60	67	77	70
US$ 5mn+	10	13	14	17	21
US$ 10mn+	2	5	6	7	9
US$ 20mn+	-	-	-	4	4

Source: Company Data, Tata Securities Research

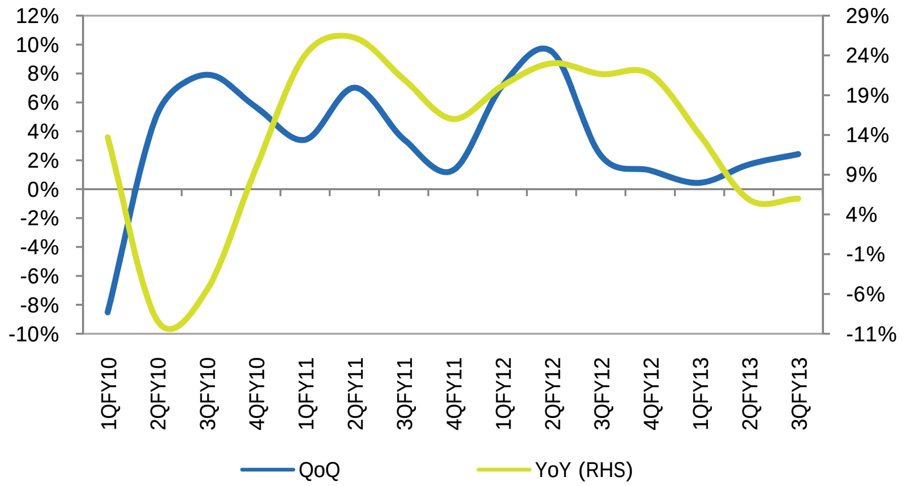
Large deal signings: Still a lot of work to be done

The growth in the IT services business in FY11 and FY12 was driven by ramp ups in certain large deals. However, post these ramp ups, the growth has started to slow down. The IT services' revenues have grown at a CQGR of 2.7% in the last four quarters, as against 8.2% between 3QFY11 and 3QFY12. The lower growth has also been on account of company's inability to sign large deals in the last four quarters despite healthy large deal pipeline. Out of the six large deal in pipeline in 2QFY13, the company lost two or three deals, with the scope of work in couple of deals being reduced.

In our opinion, lack of scale in some of the high growth service areas - IMS and some slow down in the focused verticals such as BFSI and travel & transportation space could be the key reason for no wining. Moreover, increase aggression of larger peers to win these large deals could have impacted the win ratio of the company. We believe that winning of large deals would give an impetus to the growth and would help the company to report an above industry growth.

Revenue growth in FY12 driven by large deal signings towards the end of FY11.

Revenue growth



Source: Company Data, Tata Securities Research

Margins could trend downward going forward

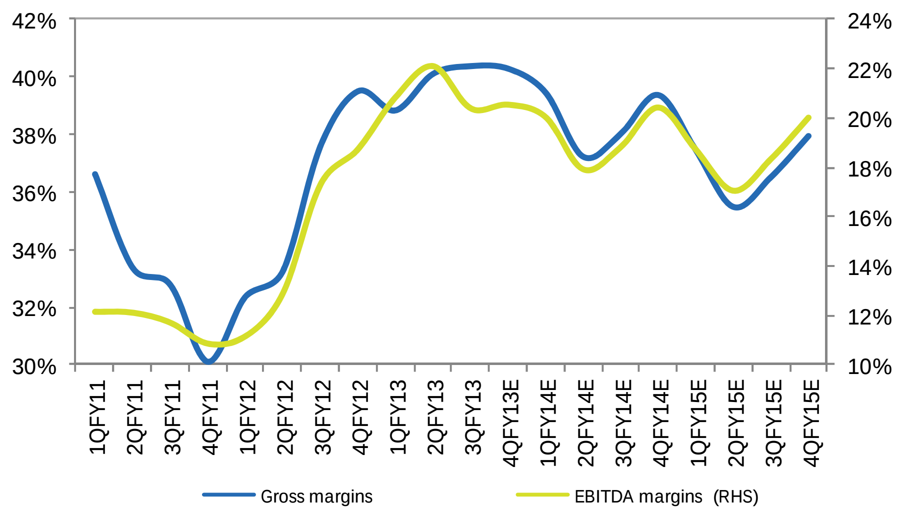
Mindtree's EBITDA margins have seen steady improvement, post 4QFY11, when the company decided to shelve its product strategy. Since 4QFY11, its EBITDA margins have improved 960bps from 10.8% to 20.4% in 3QFY13. The margin increase has been driven by operational improvements such as higher utilisation and lower attrition, besides the scale benefits. INR depreciation of over 15% during the period has also helped the company improve its EBITDA margins by ~600-650bps. We estimate that its 3QFY13 EBITDA margin was at 16-16.5%, as against reported 20.3%, assuming Rs/US$ at Rs48.

Going forward, we expect its EBITDA margins to decline. Though the company has some margin levers such as employee pyramid rationalisation and higher offshore revenues, we expect lower utilisation, salary increases and INR appreciation to negate the impact.

Mindtree plans to add 2,000 freshers in FY14, as against expectation of 800 additions in FY13. We believe that this would result in a decline in its utilisation (including trainees) as freshers undergo training. We also note that current utilisation is one of the highest; thus, we do not expect it to improve from hereon. We also believe that if and when the company wins large deals, it would have an impact on its EBITDA margins in the first few quarters due to high transition cost.

EBITDA margin growth post 3QFY12 driven primarily by INR depreciation

Margins



Source: Company Data, Tata Securities Research

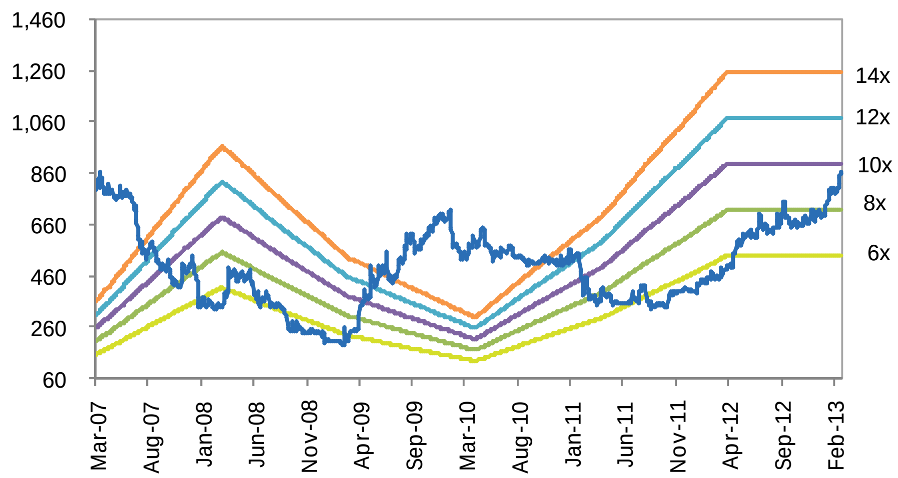
Upside limited, initiate Hold

In line with its tier-II peers, Mindtree got re-rated on account of its strong revenue and profitability growth. However, the growth has started to taper off, in line with larger peers. It growth rate in FY13 will not only be lower than the industry growth rate, but will also be lower than its peers. We also highlight that the company's revenues would have to grow at a CQGR of ~3.8% in FY14 to achieve higher end of NASSCOM guidance (12-14% growth), as against CQGR of 1.9% in FY13.

The stock is currently quoting at FY14 and FY15 PER of 10.3x and 9x respectively. Given lower revenue and profitability growth expected going forward, the stock is unlikely to get re-rated any further. We, therefore, initiate our coverage on the stock with a **Hold** rating and a target price of Rs888/share.

The stock got re-rated due to higher profitability growth

PER Chart



Source: Company Data, Bloomberg, Tata Securities Research

Financials

Profit & Loss (YE March)

(Rs mn)	FY12	FY13E	FY14E	FY15E
Net sales	**19,152**	**23,615**	**26,485**	**30,072**
YoY (%)		***23.3***	***12.2***	***13.5***
Cost of Revenues	12,261	14,182	16,275	18,978
Gross Profit	**6,891**	**9,432**	**10,210**	**11,093**
YoY (%)		***36.9***	***8.2***	***8.7***
Gross Profit %	***36.0***	***39.9***	***38.6***	***36.9***
SG&A	3,959	4,477	5,094	5,512
EBIDTA	**2,932**	**4,955**	**5,116**	**5,581**
YoY (%)		***69.0***	***3.3***	***9.1***
EBIDTA (%)	***15.3***	***21.0***	***19.3***	***18.6***
Depreciation	695	631	692	813
EBIT	**2,237**	**4,324**	**4,424**	**4,768**
Interest	5	13	16	13
Other income	383	11	146	425
PBT	**2,615**	**4,322**	**4,555**	**5,181**
Less: Taxation	430	874	1,002	1,114
Effective tax rate (%)	*16.4*	*20.2*	*22.0*	*21.5*
Recurring PAT	**2,185**	**3,448**	**3,553**	**4,067**
YoY (%)		***57.8***	***3.0***	***14.5***
PAT (%)	***11.4***	***14.6***	***13.4***	***13.5***

Balance Sheet

(Rs mn)	FY12	FY13E	FY14E	FY15E
Equity capital	405	409	409	409
Reserves	9,167	12,672	15,895	19,550
Net worth	**9,572**	**13,081**	**16,304**	**19,959**
Non Current Liabilities	**71**	**97**	**70**	**75**
Long Term Borrowing	37	32	-	-
Other Non-current Liabilities	34	65	70	75
Current Liabilities	**3,703**	**3,581**	**3,797**	**3,567**
Short Term Borrowing	407	400	350	300
Trade Payables	137	131	147	167
Others	3,159	3,050	3,300	3,100
Total liabilities	**13,346**	**16,760**	**20,171**	**23,601**
Tangible Assets	2,548	2,378	2,303	2,152
Intangible Assets	43	32	21	10
CWIP	85	50	50	50
Non Current Investments	7	7	7	7
Non Current Assets	1,122	1,971	2,121	2,271
Current assets	**9,541**	**12,322**	**15,672**	**19,114**
Current Investments	3,075	4,000	4,500	5,000
Debtors	4,078	4,920	5,518	6,265
Cash	602	1,753	3,854	5,899
Loans and advances	219	450	500	550
Other Current Assets	1,567	1,200	1,300	1,400
Total assets	**13,346**	**16,760**	**20,171**	**23,601**

Key Ratios

	FY12	FY13E	FY14E	FY15E
EPS (Rs)	53.9	83.7	86.2	98.7
CEPS (Rs)	71.1	99.0	103.0	118.4
Book value (Rs)	214	275	357	440
Dividend per share (Rs)	4.0	6.0	8.0	10.0
Debt Equity Ratio	0.0	0.0	0.0	0.0
Inventory Days				
Debtor Days	77	75	75	75
ROCE (%)	21.2	30.2	23.4	20.6
ROE (%)	25.2	30.4	24.2	22.4
Dividend Yield (%)	0.5	0.7	0.9	1.1
Valuation Ratios				
PE (x)	16.4	10.6	10.3	9.0
Cash P/E (x)	12.4	8.9	8.6	7.5
Price/book value (x)	4.1	3.2	2.5	2.0
Market cap/sales (x)	1.9	1.5	1.4	1.2
EV/sales (x)	1.7	1.4	1.2	1.0
EV/EBITDA (x)	11.2	6.5	6.2	5.6

Cash Flow

(Rs mn)	FY12	FY13E	FY14E	FY15E
Profit before Tax	2,615	4,322	4,555	5,181
Depn and w/o	524	631	692	813
Tax Paid	(564)	(874)	(1,002)	(1,114)
Change in working cap	(512)	(1,639)	(627)	(1,222)
Operating cash flow	**2,063**	**2,440**	**3,618**	**3,657**
Capex	(484)	(415)	(605)	(650)
Others	(1,822)	(925)	(500)	(500)
Investing cash flow	**(2,306)**	**(1,340)**	**(1,105)**	**(1,150)**
Dividend	(176)	(247)	(330)	(412)
Fresh Equity	144	309	-	-
Debt	397	(12)	(82)	(50)
Financing cash flow	**365**	**50**	**(412)**	**(462)**
Others	21	-	-	-
Net change in cash	143	1,150	2,101	2,045
Opening cash	459	602	1,753	3,854
Closing cash	**602**	**1,753**	**3,854**	**5,899**

Hexaware

Buy

CMP: Rs 88

Target Price: Rs 106

Potential Upside: 21%

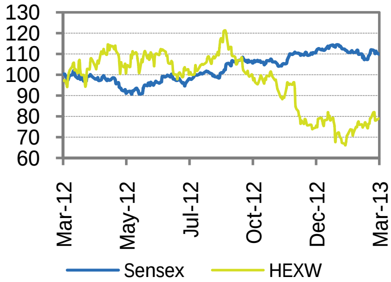
Key Statistics

M cap (INR bn/USD mn)	: 26.0/475
Avg 3m daily volume	: 3,134,397
Avg 3m daily value	: US$5.0mn
Shares O/S (mn)	: 297
Reuters	: HEXT.BO
Bloomberg	: HEXW IN
Sensex	: 18,793
Nifty	: 5,659
52-Wk High/Low	: 141/73

Shareholding Pattern (Dec12) (%)

Promoter	*28.1*
FII's	*39.6*
MFs, FIs & Banks	*6.5*
Others	*25.8*

Relative Performance



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Recent correction makes valuations attractive

Initiating Coverage

For Hexaware, things are not going well for some time now. Not only has the growth slowed down in the last two quarters due to lack of large deal signing and cancellation/deferment of a project by a large client, the EBITDA margin has also declined by over 600bps during the same period. Though CY13/FY14 is likely to be better than CY12/FY13 for IT companies, lower revenue growth in 2HCY12 is likely to result in a below-industry-growth for the company in CY13. We estimate the revenue to grow ~9% in CY13, implying a CQGR of 3.1%. Moreover, we expect it to report a 260bps decline in its EBITDA margins in CY13.

EPS downgrades and PER de-rating due to the above reasons have resulted in a ~30% decline in the stock price in the last couple of quarters. However, we believe that current CY13 and CY14 PER of 8.7x and 7.4x factor in all the negatives. Low valuations, coupled with dividend yield of ~6%, in our opinion, protect the downside. We, therefore, initiate coverage on the stock with a **Buy** rating and a target price of Rs106/share, 9x CY14 PER.

Key highlights

Muted 2HCY12 growth to result in lower than industry CY13 growth: Compared to higher-than-industry-growth in the last two years, Hexaware's CY13 growth rate is expected to be lower on account of muted 2HCY12. As against a revenue growth of 18.3% in CY12, we expect Hexaware to report a revenue growth of 9.3% in CY13, as against NASSCOM industry growth estimate of 12-14%.

Subdued performance to reflect on margins: Muted growth and lower margins in 4QCY12 are expected to result in a 260bps decline in its EBITDA margins in CY13.

High dividend yield makes valuations attractive: At current CY13 and CY14 PER of 8.7x and 7.4x respectively, we believe the stock has limited downside. Moreover, dividend yield of ~6% and return ratios in excess of 22% are likely to give support to the valuations. We, therefore, initiate our coverage on the stock with a **Buy** rating and a target price of Rs106/share.

Financial summary

Year-end December	Sales (Rs mn)	YoY (%)	EBITDA (Rs mn)	YoY (%)	NP (Rs mn)	YoY (%)	EPS (Rs)	YoY (%)	PE (x)	EV/EBITDA (x)	PSR (x)	PBR (x)	ROE (%)	ROCE (%)	DPS (Rs)	Div Yield (%)
CY2011	14,506	37.6	2,647	182.0	2,669	147.6	9.1	145.6	9.7	8.0	1.7	2.5	26.3	20.8	4.0	4.6
CY2012	19,482	34.3	4,074	53.9	3,242	21.5	10.9	20.2	8.0	5.2	1.3	2.2	27.1	27.3	5.4	6.2
CY2013E	21,395	9.8	3,922	(3.7)	3,006	(7.3)	10.1	(7.3)	8.7	5.2	1.2	2.0	22.9	22.1	5.4	6.2
CY2014E	24,039	12.4	4,576	16.7	3,498	16.3	11.8	16.3	7.4	4.3	1.1	1.8	24.0	23.3	6.0	6.8

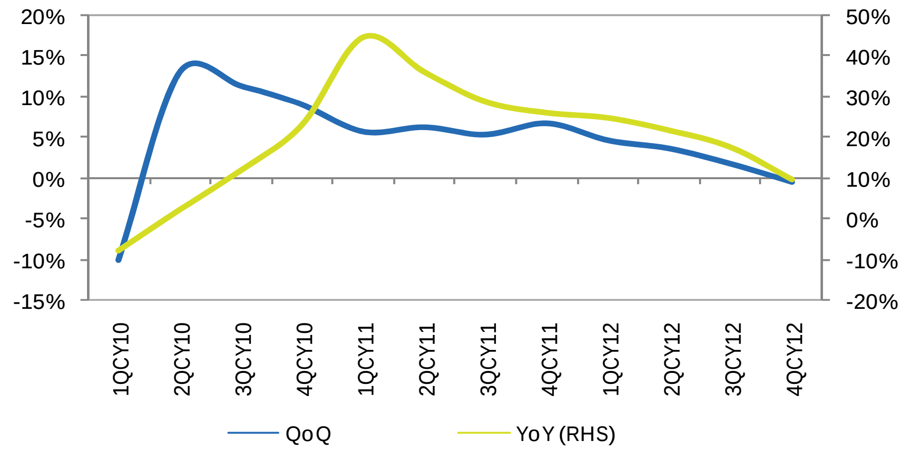
Strong growth starting to taper off

The strong growth in CY11 and 1HCY12 has started to taper off, with the sequential revenue growth in 3QCY12 and 4QCY12 being the lowest since 1QCY10. Post the slowdown in CY09, the growth was driven by large deal signings, increased service offerings and client mining. Increase in discretionary spending, post the slowdown, also helped the company to grow faster as ~20% of its revenues comes from Peoplesoft practice.

However, lack of large deal signings and deferment/cancellation of a project from one of its large client resulted in a below-par-growth in 2HCY12. As against US$ revenue CQGR of 6% and 4.1% in CY11 and 1HCY12, revenue CQGR was only 0.7% in 2HCY12.

Revenue growth has started to taper off

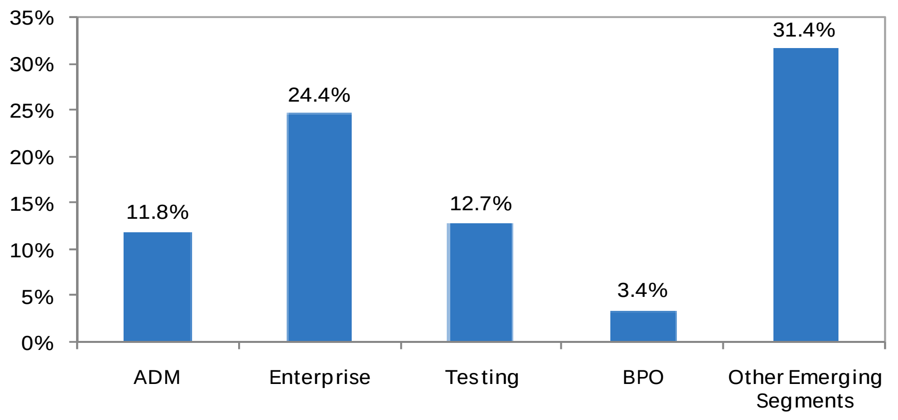
Revenue growth



Source: Company Data, Tata Securities Research

Revenue growth has been driven by enterprise and other emerging segments such as BI/Analytics and IMS

Revenue CAGR (CY09-12) - Horizontals



Source: Company Data, Tata Securities Research

Note: Other emerging segments include services such as IMS, Testing, BI/Analytics

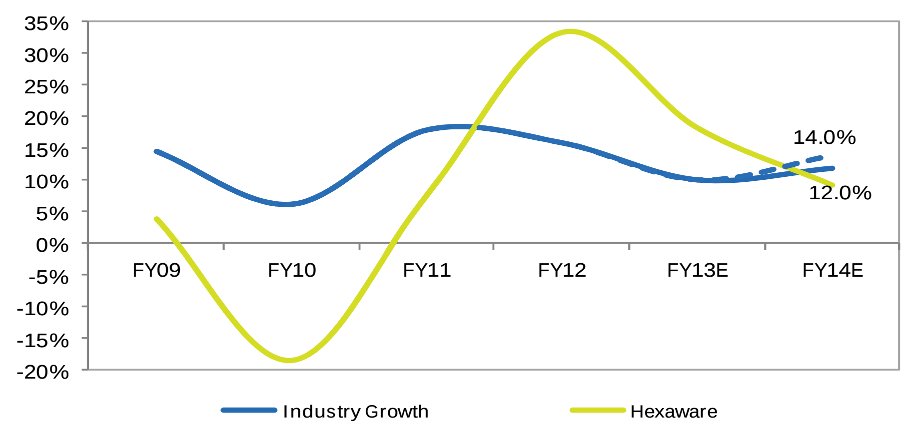
Expect CY13 growth to be lower than the industry

The management commentary of IT companies, post 3QFY13/4QCY12, indicated that FY14/CY13 is likely to be better than CY12/FY13. Stable macroeconomic environment and pent up demand due to underinvestment in IT in the last couple of years are likely to result in an increase in discretionary spending and spending of clients' CY13 IT budgets.

However, poor performance in 2HCY12 and low exit 4QCY12 revenue growth rate are likely to result in a lower growth in CY13. While we expect the company to report a revenue CQGR of 3.1% in CY13 as against 2.4% in CY12, the revenue growth in CY13 is expected to be ~9% as against 18.3% and 33.3% in CY12 and CY11 respectively. The CY13 growth rate is expected to be lower than the FY14 industry growth rate of 12-14% as guided by NASSCOM.

Hexaware is expected to grow slower than the industry in CY13/FY14

Growth rates



Source: NASSCOM, Company Data, Tata Securities Research

Subdued revenue performance to reflect in margins

From a low of 6.8% reported in 2QCY10, Hexaware's EBITDA margin improved to 21.6% in 3QCY12. The margin expansion was on account of a) higher revenue growth b) INR depreciation c) lower attrition as it declined from 22.6% in 2QCY10 to 8.4% in 3QCY12 d) higher offshore revenues and e) benefits from economies of scale as SG&A was reduced from 27% of revenues to 18%.

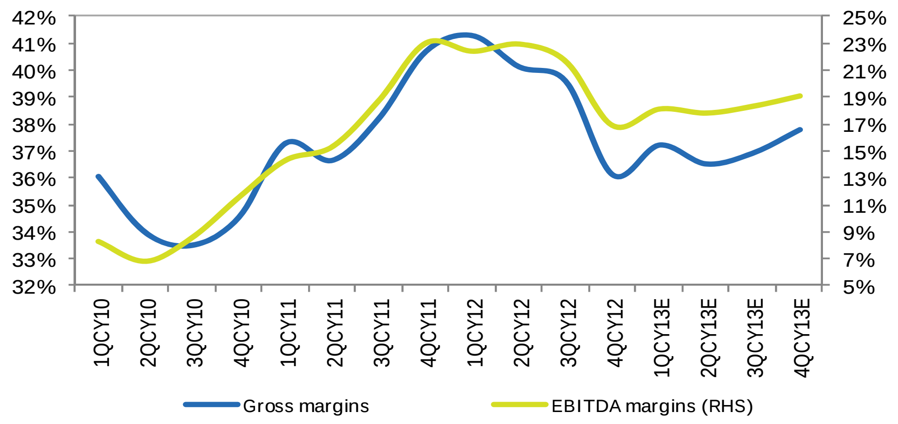
However, project cancellation/deferment from one of its large client in 4QCY12 and working days lost due to Hurricane Sandy resulted in a 470bps decline in its EBITDA margin in 4QCY12. Though we expect the margins to start increasing from 1QCY13 onwards on account of improvement in utilisation, lower growth rates in CY13 and low exit 4QCY12 margins are likely to result in a 260bps decline in its CY13 margins.

It may, however, be noted that our CY13 and CY14 estimates are based on average Rs/US$ rate of Rs53.8 and Rs52.4 respectively as against Rs53.4 in CY12. Any appreciation/depreciation of INR would be downside/upside risk to our margin estimates.

Margins were expanded on account of INR depreciation and operational improvement

Margins are expected to increase post 4QCY12 decline. However, CY13 margins are likely to be lower than CY12

Margins



Source: NASSCOM, Company Data, Tata Securities Research

Growth and margins likely to return in CY14

Though lower exit revenue growth and margins are likely to hit CY13, we expect it to start reporting industry leading growth from CY14 onwards. The growth is likely to be driven by growth in top 20 accounts as well as some large deals signings as the company has two-three large deals in the pipeline.

The company's growth in CY11 and CY12 was driven by its focus on clients mining and growing its top 10 customers. It plans to now focus on growing the next 10 accounts in order to kick-start its second leg of growth. Moreover, we believe that there is still some scope of growth in top 10/20 accounts as only three accounts currently contribute more than US$20mn revenues and eight more than US$10mn. We also note that excluding revenues from top 10 clients, the revenues/clients have only grown at a CAGR of 1% over the past four years, as against 3% including top 10.

Higher growth, increasing utilisation and economies of scale are likely to result in 15% revenue growth and 70bps EBITDA margin expansion in CY14.

Increased service offerings have helped the company mine clients, but still some scope left

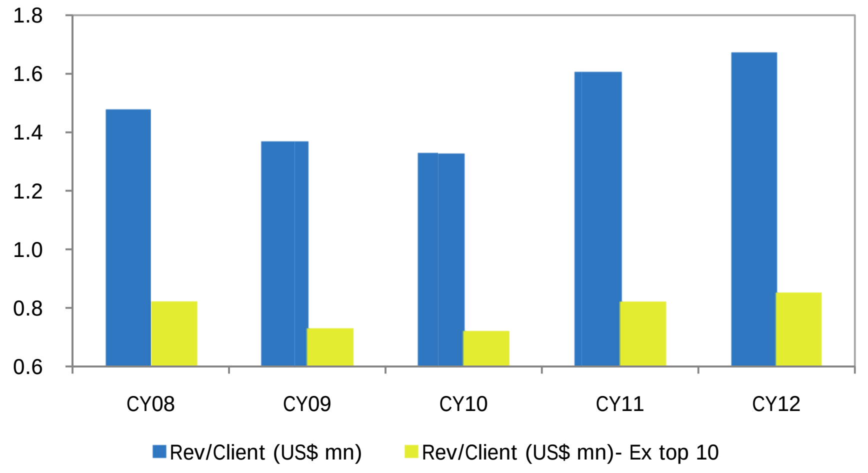
Client Metrics

	CY09	CY10	CY11	CY12
Between US$1-5mn	39	39	40	40
Between US$5-10mn	4	7	7	7
Between US$10-20mn	4	2	2	5
Over US$20mn	1	2	3	3

Source: Company Data, Tata Securities Research

Revenue/Client (US$mn)

Revenue per non top 10 clients is still low



Source: Company Data, Tata Securities Research

High dividend yield to support valuations; initiate coverage with Buy

Post disappointing 2HCY12, the stock has got de-rated due to growth concerns. However, we believe that at CY13 and CY14 PER of 8.7x and 7.4x respectively, the stock factors in lower growth expectations. The company has also indicated that it would distribute ~50% of its net profit as dividends. It gave a dividend of Rs5.4 in CY12, translating into a dividend yield of ~6% at CMP.

We believe that high dividend yield, coupled with RoE/RoCE in excess of 22%, would give support to the valuations. We, therefore, do not expect the stock to get further de-rated. We initiate coverage on the stock with a **Buy** rating and target price of Rs106/share, 9x CY14 EPS.

Financials

Profit & Loss (YE December)

(Rs mn)	CY11	CY12	CY13E	CY14E
Net sales	**14,506**	**19,482**	**21,395**	**24,039**
YoY (%)		***34.3***	***9.8***	***12.4***
Cost of Revenues	8,939	11,846	13,457	15,060
Gross Profit	**5,567**	**7,636**	**7,938**	**8,979**
YoY (%)		***37.2***	***4.0***	***13.1***
Gross Profit %	***38.4***	***39.2***	***37.1***	***37.4***
SG&A	2,920	3,562	4,016	4,403
EBIDTA	**2,647**	**4,074**	**3,922**	**4,576**
YoY (%)		***53.9***	***(3.7)***	***16.7***
EBIDTA (%)	***18.2***	***20.9***	***18.3***	***19.0***
Depreciation	248	324	399	481
EBIT	**2,399**	**3,750**	**3,523**	**4,095**
Other income	677	256	282	333
PBT	**3,076**	**4,006**	**3,806**	**4,427**
Less: Taxation	407	764	799	930
Effective tax rate (%)	*13.2*	*19.1*	*21.0*	*21.0*
Recurring PAT	**2,669**	**3,242**	**3,006**	**3,498**
YoY (%)		***21.5***	***(7.3)***	***16.3***
PAT (%)	***18.4***	***16.6***	***14.1***	***14.5***

Balance Sheet

(Rs mn)	CY11	CY12E	CY13E	CY14E
Equity capital	587	593	593	593
Reserves	9,575	11,390	12,555	14,007
Net worth	**10,162**	**11,983**	**13,148**	**14,600**
Secured Loans	-	-	-	-
Deferred Tax Liability	32	32	32	32
Total	**10,194**	**12,015**	**13,181**	**14,632**
Gross Fixed Assets	5,669	6,539	7,464	8,389
Less: Depreciation	1,697	2,021	2,420	2,901
Net Fixed Assets	**3,972**	**4,518**	**5,044**	**5,488**
CWIP	813	700	600	500
Investments	229	400	500	600
Current assets	**9,315**	**9,843**	**10,719**	**12,071**
Debtors	2,993	3,247	3,566	4,006
Cash	4,376	4,296	5,079	5,914
Loans and advances	1,272	1,500	1,350	1,400
Other Current Assets	674	800	725	750
Current Liabilities and Prov	4,331	3,640	3,877	4,221
Net Current Assets	**4,985**	**6,203**	**6,842**	**7,850**
Deferred Tax Asset	195	195	195	195
Total assets	**10,194**	**12,015**	**13,181**	**14,632**

Key Ratios

	CY11	CY12	CY13E	CY14E
EPS (Rs)	9.1	10.9	10.1	11.8
CEPS (Rs)	9.9	12.0	11.5	13.4
Book value (Rs)	35	40	44	49
Dividend per share (Rs)	4.0	5.4	5.4	6.0
Debt Equity Ratio	-	-	-	-
Inventory Days				
Debtor Days	74	60	60	60
ROCE (%)	20.8	27.3	22.1	23.3
ROE (%)	26.3	27.1	22.9	24.0
Dividend Yield (%)	4.6	6.2	6.2	6.8
Valuation Ratios				
PE (x)	9.7	8.0	8.7	7.4
Cash P/E (x)	8.8	7.3	7.6	6.5
Price/book value (x)	2.5	2.2	2.0	1.8
Market cap/sales (x)	1.7	1.3	1.2	1.1
EV/sales (x)	1.5	1.1	1.0	0.8
EV/EBITDA (x)	8.0	5.2	5.2	4.3

Cash Flow

(Rs mn)	CY11	CY12E	CY13E	CY14E
Profit before Tax	3,077	4,006	3,806	4,427
Depn and w/o	(451)	324	399	481
Tax Paid	(635)	(764)	(799)	(930)
Change in working cap	(578)	(1,299)	144	(172)
Operating cash flow	**1,413**	**2,267**	**3,549**	**3,807**
Capex	(633)	(757)	(825)	(825)
Others	458	(171)	(100)	(100)
Investing cash flow	**(175)**	**(928)**	**(925)**	**(925)**
Dividend	(1,243)	(1,841)	(1,841)	(2,046)
Fresh Equity	37	421	-	-
Debt	(234)	-	-	-
Financing cash flow	**(1,439)**	**(1,421)**	**(1,841)**	**(2,046)**
Others	215	-	-	-
Net change in cash	15	(81)	783	836
Opening cash	4,361	4,376	4,296	5,079
Closing cash	**4,376**	**4,296**	**5,079**	**5,914**

Persistent Systems

Hold

CMP: Rs 520

Target Price: Rs 549

Potential Upside: 6%

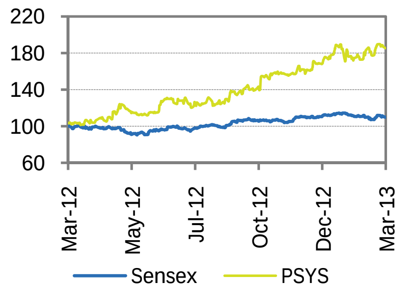
Key Statistics

M cap (INR bn/USD mn)	: 20.8/380
Avg 3m daily volume	: 33,849
Avg 3m daily value	: US$0.3mn
Shares O/S (mn)	: 40
Reuters	: PERS.BO
Bloomberg	: PSYS IN
Sensex	: 18,793
Nifty	: 5,659
52-Wk High/Low	: 591/306

Shareholding Pattern (Dec12) (%)

Promoter	*31.3*
FII's	*26.8*
MFs, FIs & Banks	*17.6*
Others	*24.3*

Relative Performance



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Initiating Coverage

Uniqueness attracting attention; initiate Hold

Unlike its peers, Persistent Systems is a product focused company, providing services as well as solutions to its clients. It has evolved from being an outsourced product development vendor to becoming a strategic partner to its clients. Early investment in newer technologies such as cloud, analytics and enterprise mobility has helped it take advantage of the demand shifts towards these technologies. The company's deep understanding of domain and investment in these technologies are helping it target business heads, which are increasingly becoming decision makers in the enterprises.

The IP strategy has helped the company to report strong revenue and profitability growth in the last few quarters. While its consolidated revenues have grown at a CQGR of 4.4% in the last eight quarters, its margins have improved 690bps. The share of IP-led revenues, in overall revenues, has increased from 6.1% in 1QFY12 to 18.2% in 3QFY13. Its IP strategy also involves acquiring products that are either non-strategic to the sellers or are at the end of their lifecycle, but help it fill white spaces towards its strategic direction. Persistent has also been strengthening its senior management team in order to grow to the next level.

However, the increased contribution of IP-led revenues makes its earnings volatile. Though we remain bullish about the strategic direction that the company has taken, diffcult to estimate IP-led revenues makes us wary. Moreover, we highlight that some of the incremental growth of the company has been driven by acquisition of products/solutions. Therefore, we believe that the earnings are likely to remain volatile going forward. Hence, we initiate our coverage on the stock with a **Hold** rating and a target price of Rs549/share,9.5x FY15 EPS.

Financial summary

Year-end	Sales	YoY	EBITDA	YoY	NP	YoY	EPS	YoY	PE	EV/EBITDA	PSR	PBR	ROE	ROCE	DPS	Div Yield
March	(Rs mn)	(%)	(Rs mn)	(%)	(Rs mn)	(%)	(Rs)	(%)	(x)	(x)	(x)	(x)	(%)	(%)	(Rs)	(%)
FY2012	10,003	28.9	2,324	46.8	1,418	1.5	35.4	1.5	14.7	7.5	2.1	2.6	17.9	15.5	6.0	1.2
FY2013E	13,003	30.0	3,340	43.7	1,839	29.7	46.0	29.7	11.3	4.9	1.6	2.3	20.2	20.1	9.0	1.7
FY2014E	14,698	13.0	3,482	4.3	2,006	9.1	50.1	9.1	10.4	4.3	1.4	2.0	18.9	17.5	10.0	1.9
FY2015E	16,526	12.4	3,867	11.1	2,312	15.2	57.8	15.2	9.0	3.3	1.3	1.7	18.9	16.9	11.0	2.1

Focused strategy yielding results

In order to remain relevant to its client base, in an ever changing demand environment, the company has been investing in newer technologies such as cloud, enterprise mobility and analytics. Investment in these technologies, which are now at the forefront of clients' business needs, is helping it to become strategic partner to its clients. In outsourced product development business, it deals with engineering/product heads, where the goal is to make products at lower costs. However, investment in these technologies, technology buying decisions and a shift from CIOs to business heads are helping its clients to not only reduce costs, but also increase revenues. These new technologies contribute ~45% to the company's total revenues.

New Technology Offerings

Technology	Offerings
Analytics	Persistent analytics offerings include business intelligence services, data management services, analytic services and large data analytics.
Mobility	It has developed portable frameworks such as Skype for connected devices, iPAF for rapid iPhone application development, and J2ME for covering the entire gamut of feature phones and protocol stacks. Apart from IP investments, it has also built over 200 mobile applications for customers, spanning enterprise as well as consumer domains, engagements with top handset OEMs and semi-conductor chipset manufacturers.
Cloud Computing	In cloud computing, Persistent offers cloud consulting, platform building, application development & management services, tool development and application migration
Enterprise collaboration	The company has developed tools and solutions in the areas of social networking, collaborative business processes, social analytics and enterprise search.

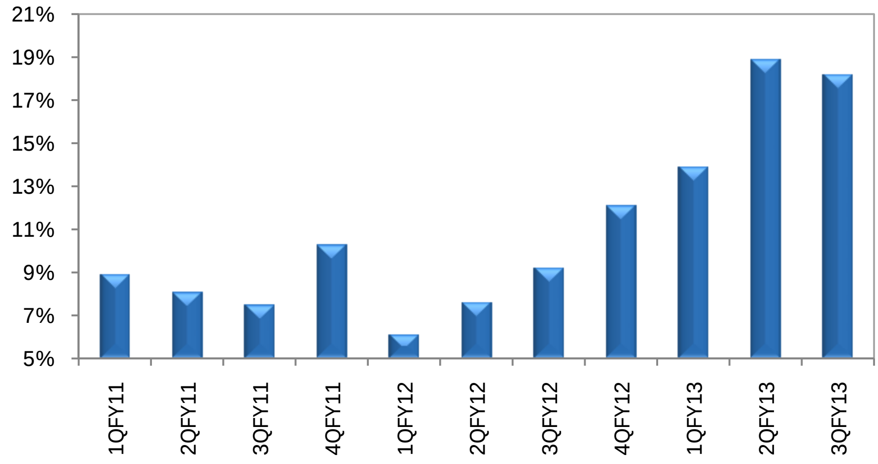
Source: Company Data, Tata Securities Research

Persistent also has a well articulated 4X4X4 strategy, clearly indicating its focus areas around revenue models, service offerings and industry verticals.

IP-led business driving growth

Persistent Systems' growth has been driven by an increase in its IP-led revenues over the last few quarters. The IP-led revenues have increased at a CQGR of 16.6% in the last eight quarters, resulting in share of revenues from IP business increasing from 7.5% in 3QFY11 to 18.2% in 3QFY13.

IP-led revenues as % of total



Source: Company Data, Tata Securities Research

The company's IP strategy revolves around a) filling white spaces for large customers such as connectors b) acquisition of non-strategic assets from customers, for example, the acquisition of location business from Openwave Systems c) acquiring assets around focus areas such as cloud and analytics; recent acquisition of Doyenz, which operates in the cloud space, is an example of that and d) new internal R&D with products such as eMee and Klisma.

Besides selling IPs through its own sales force, it also aligns with ISV (Independent Software Vendors) clients in order to sell them to the enterprise customers. The company also includes revenues from IP that are held by the client, but are sold jointly by Persistent on a revenue share basis. The recent licensing agreement with HP for its Client Automation Software is an example of that. In this, it is not only responsible for the product development, but also recognises revenues (though some part is reimbursed by the client earlier) when the client sells the product as it has a share in the license sales. Though it takes the risks during product development, RoI could be high.

Traditional OPD business: Still a long way to go

While the company has been focusing on growing its IP business, its traditional Outsourced Product Development (OPD) business has been growing steadily. The traditional OPD business has grown at a CAGR of 1.8% over the past eight quarters.

Unlike IT services, its OPD business is stickier and more strategic to the clients. Increasing product development cost and reducing time to market have resulted in product companies outsourcing and offshoring their product development. Since the OPD vendor is involved in the product development, incremental work of product upgrade and maintenance generally accrue to the OPD vendors as they understand the product much better.

According to Zinnov Research in FY12, Indian OPD vendors reported revenues of ~US$1.3bn from Independent Software companies. Assuming the growth rate to remain in line with the total growth in product engineering segment (~14%

CAGR), the target market for Persistent in the OPD segment is expected to increase to ~US$4bn by 2020.

We believe that Persistent is well positioned to capitalise on the growth in OPD segment going forward. According to Zinnov, the company is one of the leaders in the OPD segment. With strong client relationship such as IBM, Salesforce and Microsoft, we believe it could improve its market share going forward. We also highlight that its market share, among the Indian service provider in ISV segment, increased from ~13.8% in FY11 to 14.2% in FY12.

Acquisition: Key ingredient for success

In order to strengthen its IP business, the company has been acquiring products/solutions over the past many quarters. These product/solutions are either end of the life cycle products that are non-strategic to its clients (due to lack of management bandwidth) or are in the focus areas of the customers. In 9MFY13, these acquired products/solutions have contributed ~US$16.7mn to the revenues (~10% of the revenues). The company has spent ~Rs400mn to acquire products/solutions in the last three quarters.

The case in point is the company's acquisition of Openwave's location business in early 2012. Openwave divested this business to Persistent as it has limited R&D spend and wanted to move out of the telecom operator business. Moreover, Persistent was the OPD partner for Openwave in this business for six years and was involved in the R&D, customisation and professional services for the product.

Acquisitions

Product/Company	Offering
NovaQuest	Product Lifecycle Management (PLM) and search based technology solutions company, a value added reseller (VAR) and services provider of Dassault Systems 3DEXPERIENCE platform and applications.
rCloud from Doyenz Inc	Provides back-up and disaster recovery for physical and virtual servers on the cloud for SMBs.
Location business of Openwave Systems Inc	Gives an ability to the telecom operator to track mobile number within a range of 50-200mts.
French software business from Agilent Technologies	Focused on supplying data acquisition and control software for scientific instruments to the life sciences, environmental, energy, applied research and other markets.
Infospectrum	Software product development and technology services enterprise that specialises in serving complex manufacturing, asset and service-oriented industries, including aerospace & defense, GIS, telecom, logistics verticals as well as the ISVs that serve them.

Source: Company Data, Tata Securities Research

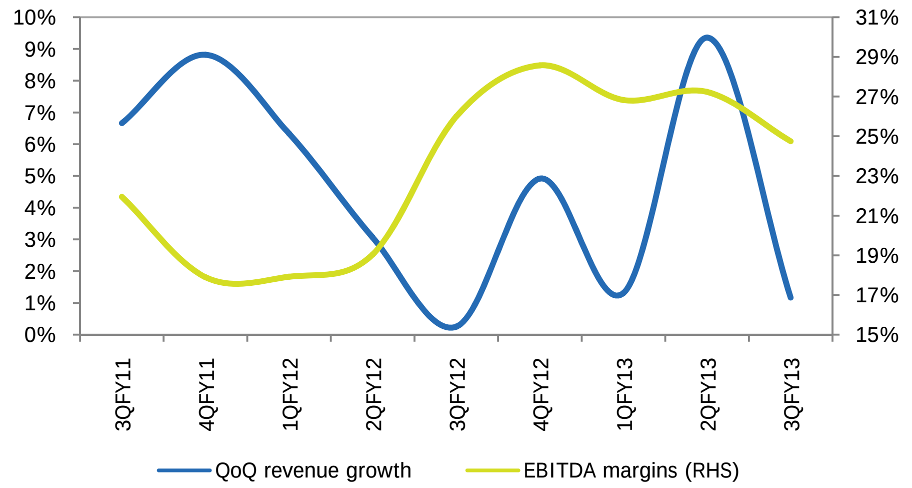
Earnings volatility to stay

Persistent's revenues and margins have been volatile over the last few quarters on account of lumpy nature of its IP-led business. Since the IP-led business has higher margin than the linear OPD business, the strong growth in IP revenues results in a strong margin expansion and profitability growth.

Margin expansion was due to INR depreciation

Growth in revenues was due to an increase in IP-led revenues

Revenue growth and margins



Source: Company Data, Tata Securities Research

We believe that the volatility in earnings will continue, given the nature of the IP-led business. Though it indicated that over a period of time it would like to have enough IP assets, which collectively will not be lumpy (mix of annuity and license revenues), we believe that till it happens, earnings and margins will remain volatile. Moreover, given the nature of product business, the estimation of IP revenues is difficult, increasing the variability between actual revenue & margin estimates and consensus estimates.

Financials

Persistent is expected to report a revenue growth of ~15% in FY13, driven primarily by IP-led revenues. While IP-led revenues are expected to surge 127% in FY13, linear revenues may increase by only 2.5%. The lower growth in linear revenues is on account of ramp down in couple of projects due to their completion and delay in ramp ups in new projects.

However, we expect the linear business to report a revenue growth of 13.3% and 14.7% in FY14 and FY15 respectively. The growth in linear business estimated at 25% and 18% growth in IP-led revenues are expected to result in a ~15.5% growth in its consolidated revenues in FY14 and FY15.

On the margin front, we expect the company to report an EBITDA margin decline of 200bps and 30bps in FY14 and FY15 respectively. The fall would be mainly on account of lower utilization in the linear business. We highlight that the company reported a net reduction of ~180 employees in the last six quarters due to a lower growth in the linear business. However, in case IP-led revenue growth is higher than our estimates, the margins could be higher than our expectations.

We expect the company to report an EPS of Rs50.1and Rs57.8 in FY14 and FY15 respectively, implying a three-year EPS CAGR of ~18%, one of the highest among the tier-II vendors.

Valuations and recommendation

The stock is currently quoting at FY14 and FY15 PER of 10.4x and 9.0x respectively. Though the EPS growth for the company over the next two years is expected to be the strongest, current valuations already factor that in. While we believe that the stock should quote at premium valuations to its tier-II peers, volatile nature of its earnings keeps us cautious. Therefore, we initiate our coverage with a **Hold** rating and a target price of Rs549/share, 9.5x FY15 EPS.

Financials

Profit & Loss (YE March)

(Rs mn)	FY12	FY13E	FY14E	FY15E
Net sales	**10,003**	**13,003**	**14,698**	**16,526**
YoY (%)		***30.0***	***13.0***	***12.4***
Cost of Revenues	5,922	7,341	8,557	9,783
Gross Profit	**4,081**	**5,662**	**6,142**	**6,743**
YoY (%)		***38.7***	***8.5***	***9.8***
Gross Profit %	***40.8***	***43.5***	***41.8***	***40.8***
SG&A	1,757	2,322	2,660	2,876
EBIDTA	**2,324**	**3,340**	**3,482**	**3,867**
YoY (%)		***43.7***	***4.3***	***11.1***
EBIDTA (%)	***23.2***	***25.7***	***23.7***	***23.4***
Depreciation	611	773	900	1,001
EBIT	**1,713**	**2,567**	**2,582**	**2,866**
Interest	-	-	-	-
Other income	256	10	214	322
PBT	**1,969**	**2,577**	**2,796**	**3,189**
Less: Taxation	551	738	790	877
Effective tax rate (%)	*28.0*	*28.6*	*28.2*	*27.5*
Recurring PAT	**1,418**	**1,839**	**2,006**	**2,312**
YoY (%)		***29.7***	***9.1***	***15.2***
PAT (%)	***14.2***	***14.1***	***13.6***	***14.0***

Balance Sheet

(Rs mn)	FY12	FY13E	FY14E	FY15E
Equity capital	400	400	400	400
Reserves	8,005	9,423	10,961	12,758
Net worth	**8,405**	**9,823**	**11,361**	**13,158**
Non Current Liabilities	**77**	**75**	**80**	**85**
Long Term Borrowing	7	-	-	-
Other Non-current Liabilities	71	75	80	85
Current Liabilities	**1,660**	**1,978**	**2,295**	**2,644**
Short Term Borrowing	-	-	-	-
Trade Payables	289	361	408	459
Others	1,371	1,617	1,887	2,185
Total liabilities	**10,143**	**11,876**	**13,736**	**15,887**
Tangible Assets	2,475	2,345	2,365	2,242
Intangible Assets	722	899	703	474
CWIP	528	520	475	430
Non Current Investments	123	123	123	123
Non Current Assets	256	259	264	274
Current assets	**6,040**	**7,730**	**9,805**	**12,341**
Current Investments	1,915	2,000	2,200	2,500
Debtors	2,033	2,709	3,062	3,443
Cash	1,375	2,271	3,743	5,548
Loans and advances	535	550	575	600
Other Current Assets	182	200	225	250
Total assets	**10,143**	**11,876**	**13,736**	**15,887**

Key Ratios

	FY12	FY13E	FY14E	FY15E
EPS (Rs)	35.4	46.0	50.1	57.8
CEPS (Rs)	50.7	65.3	72.6	82.8
Book value (Rs)	198	228	265	306
Dividend per share (Rs)	6.0	9.0	10.0	11.0
Debt Equity Ratio	0.0	-	-	-
Inventory Days				
Debtor Days	73	75	75	75
ROCE (%)	15.5	20.1	17.5	16.9
ROE (%)	17.9	20.2	18.9	18.9
Dividend Yield (%)	1.2	1.7	1.9	2.1
Valuation Ratios				
PE (x)	14.7	11.3	10.4	9.0
Cash P/E (x)	10.3	8.0	7.2	6.3
Price/book value (x)	2.6	2.3	2.0	1.7
Market cap/sales (x)	2.1	1.6	1.4	1.3
EV/sales (x)	1.7	1.3	1.0	0.8
EV/EBITDA (x)	7.5	4.9	4.3	3.3

Cash Flow

(Rs mn)	FY12	FY13E	FY14E	FY15E
Profit before Tax	1,969	2,577	2,796	3,189
Depn and w/o	453	958	1,120	1,249
Tax Paid	(381)	(738)	(790)	(877)
Change in working cap	(604)	(576)	(306)	(335)
Operating cash flow	**1,436**	**2,221**	**2,820**	**3,225**
Capex	(1,507)	(812)	(680)	(605)
Others	516	(85)	(200)	(300)
Investing cash flow	**(992)**	**(897)**	**(880)**	**(905)**
Dividend	(233)	(421)	(468)	(515)
Fresh Equity	-	-	-	-
Debt	(9)	(7)	-	-
Financing cash flow	**(241)**	**(428)**	**(468)**	**(515)**
Others	941	-	-	-
Net change in cash	1,145	896	1,472	1,805
Opening cash	230	1,375	2,271	3,743
Closing cash	**1,375**	**2,271**	**3,743**	**5,548**

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1. Name of the analysts:	Ashish Aggarwal
2. Qualifications of the analysts:	BE (Mechanical), PGPM
3. Analysts' ownership of any stock including the long & short position related to the information contained:	YES (Infosys(2))
4. Ownership of any stock held by the dependent family members of the analyst including the long & short position:	NIL
5. TSL ownership of any stock related to the information contained including the long & short position:	NIL
6. Broking relationship with company covered:	NO
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