Change in ☑ Estimates ☐Rating ☑ Target

KPIT Cummins

IIFL INDIA PRIVATE CLIENTS

Decent Visibility

KPIT Cummins' impressive performance over last couple of years can be credited to the sustained demand from its key verticals supported by its deep expertise as well as synergistic acquisitions. Recent conversations with the management suggest that decent demand traction should continue. Headroom for margin expansion on the back of various levers should result in a better FY14 OPM performance (versus our earlier expectation of 100bps correction). Though slower decision making and softness in top client account could be near-term headwinds, we continue to remain positive.

Stable demand across SBUs to help sustain decent revenue traction

Our interactions with the company suggest decent demand visibility across major areas of focus viz. Auto engineering, SAP and IES (Oracle practice). Led by automotive and utilities verticals as well as sustained demand from US and APAC, we expect KPIT's revenue growth to continue to be in the top quartile of its peer set. Also, on the back of the recent approval of capital infusion, further inorganic expansion can provide added upsides.

OPM to expand 200bps over FY12-14E on the back of variety of levers

Integration of lower margin acquisitions, greater onsite contribution and continued investments in business were the key reasons for subdued OPM over FY10-11. More recently though, the OPM performance has shown marked improvement supported by utilization, fixed cost leverage, weaker rupee and improving subsidiary profitability. Going forward, possible improvement in SAP SBU profitability, higher shift towards offshore and improving age pyramid should help margin to expand ~200bps over FY12-14E.

KPIT's performance to remain in top quartile amongst peer set; BUY

Buoyed by sustained demand for its niche services and strong ramp up in acquired businesses, KPIT has been one of the best performing mid-cap IT companies. We expect the company to continue to be in the top quartile of its peer set with an expected dollar revenue CAGR of 24% over FY12-14E. We also mark up our OPM estimates and resultantly expect a PAT CAGR of 33% over FY12-14E. Though the near term sluggishness in decision making and soft top client account could be probable headwinds, we continue to be positive and maintain BUY.

Financial summary

Y/e 31 Mar (Rs m)	FY11	FY12	FY13E	FY14E
Revenues	10,065	15,000	22,439	25,198
yoy growth (%)	37.6	49.0	49.6	12.3
OPM (%)	15.1	14.5	16.4	16.5
Reported PAT	948	1,453	2,004	2,582
yoy growth (%)	10.6	53.3	37.9	28.9
EPS (Rs)	5.4	8.2	10.5	13.5
P/E (x)	23.2	15.3	11.9	9.2
EV/EBITDA (x)	13.7	10.6	6.2	5.2
RoE (%)	19.2	20.6	21.1	21.0
RoCE (%)	18.9	22.4	24.3	24.9

Source: Company, India Infoline Research

December 05, 2012

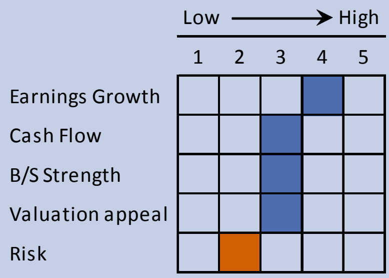
Rating: BUY

Target (9-12 months):	**Rs145**
CMP:	**Rs125**
Upside:	**16%**

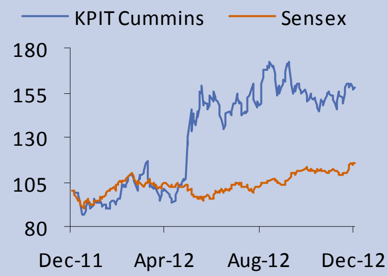
Sector:	**IT**
Sector view:	**Neutral**
Sensex:	19,334
52 Week h/l (Rs):	142/68
Market cap (Rscr) :	2,257
6m Avg vol ('000Nos):	581
Bloomberg code:	KPIT IS
BSE code:	532400
NSE code:	KPIT
FV (Rs):	2

Prices as on Dec 04, 2012

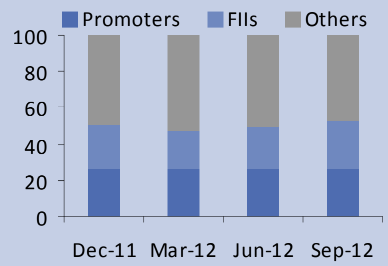
Company rating grid



Share price trend



Share holding pattern



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Company Update

Stable demand across key SBUs to help sustain decent traction; Deal pipeline strong but conversion slower

Continued demand in focus area of automotive engineering as well as decent traction for its enterprise solutions (both areas being bolstered by meaningful acquisitions) has held KPIT Cummins in good stead. This is evident in the superlative CAGR of 40%+ over FY10-12 (organic revenues growth was robust too with CAGR of 28%) validating KPIT's strong expertise. Its knack to acquire strategically important companies, integrate and scale them up continues to be one of the key strengths of the company. As a case in point, its last acquisition – Systime has shown strong quarterly revenue improvement from ~US$13mn at time of acquisition (Q1 FY12) to US$17mn currently. Its margin too has expanded from 5% to 14% in past four quarters. Our conversation with the management suggests that decent demand traction across its businesses should continue.

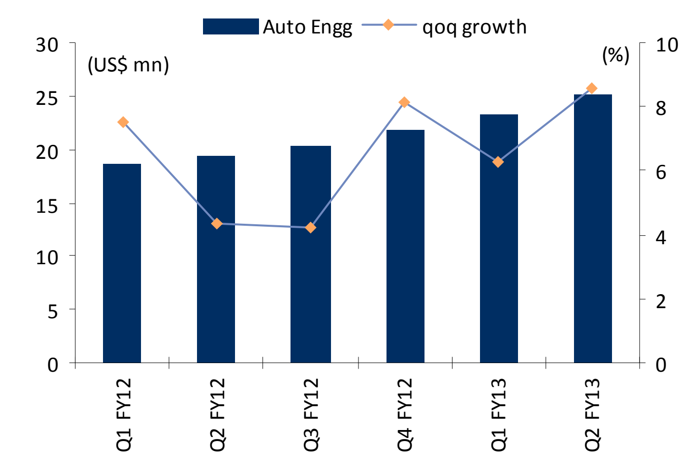
Buoyed by sustained demand in focus verticals, KPIT revenue growth has been one of the highest witnessing 28% organic CAGR over FY10-12 (40% CAGR including inorganic growth)

Decent demand visibility across key SBUs

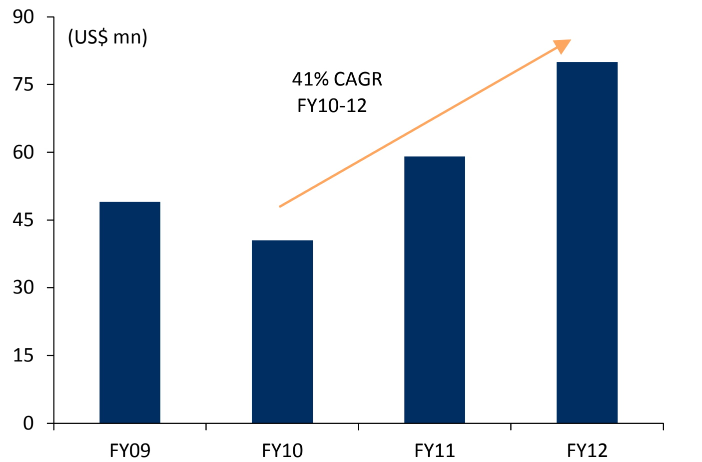
Automotive & engineering SBU (A&E) – The A&E SBU , one of key focus areas at KPIT (~25% of the revenues) continues to grow well with sustained demand in both US and APAC. These spends continue to be driven by rapid technological changes, increased use of car electronics and expansion of global Auto OEMs in emerging markets. Continued spend by global Auto OEMs is further substantiated by the largely stable sales volumes posted by top global OEMS, which form part of the key clientele for the company. With technology being one of the keys of product differentiation and innovation, we believe the demand for KPIT's specialized services (viz. powertrain, infotainment etc) will continue to see stable demand.

Continued technology adoption and increased electronics usage In automobiles continue to give decent revenue visibility

Robust quarterly growth trend – A&E

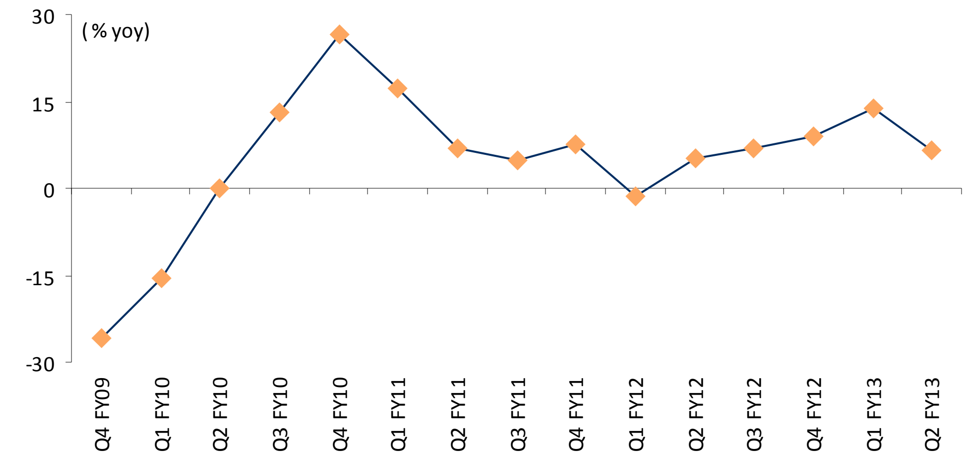


Strong CAGR over FY10-12 –A&E



Source: Company, India Infoline Research

Volume growth of top global auto OEMs* remains largely stable



Source: Company, India Infoline Research
**includes Toyota, GM, Ford, Hyundai, Volkswagen, Honda*

Integrated enterprise solutions(IES) SBU – On the IES front, demand for the Systime business (~35% of IES Revenues) remained strong as validated by the 14%+ dollar revenue CQGR over last two quarters. Management expects the demand for the IES (JD Edwards/Oracle E-biz implementation/support) to continue due to the ongoing upgrade environment. Additionally, focus on front-end investments and solutioning should lead to improved client mining through cross selling of other IES and SAP offerings.

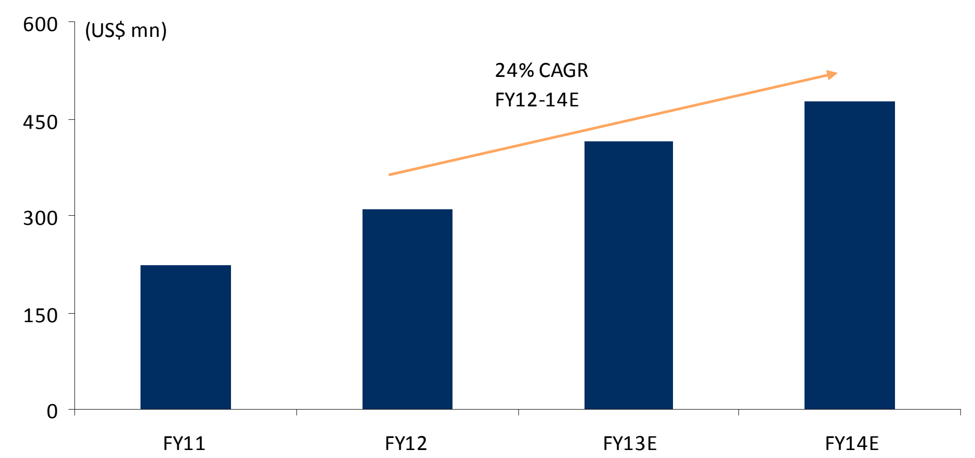
An ongoing upgrade environment for ERP (Oracle Ebiz and JD Edwards) should help sustain revenues for IES SBU

Cross/up selling of other services to clients to help client mining

SAP SBU – SAP SBU has been one of the strongest growing vertical for KPIT driven by mid-segment transformational implementation programs especially in manufacturing and utilities verticals. The demand from utilities vertical in US continues to be strong as validated by pipeline of 4-5 large deals (US$10mn+) in the area of utilities. Traction in Europe is also expected to see up-tick with increased infrastructure upgradation requiring adoption of SAP/Oracle from older legacy systems.

The traction from mid-segment SAP implementation from verticals like manufacturing and utilities are expected to support growth

Expect decent revenue traction across SBUs over FY12-14E



Source: Company, India Infoline Research

Cummins account to be soft in near term; Decision making cycles remain status quo

Top client Cummins, post its stellar growth in FY12 (30% yoy versus 12% for Top2-10 clients), is expected to be soft in FY13 with an estimated growth of 10-12% yoy on account of weakness in its core business. Notably, the revenue contribution of Cummins has corrected from 30% in FY10 to ~20% currently. Despite this the company revenues have shown robust organic revenue CAGR of 33% over the same period fueled by the robust growth in rest of the business. We anticipate further correction in this revenue contribution over FY13-14E both due to near term softness in demand of top client and stronger growth in rest of the business. While pipeline remains decent across its key businesses, the management in its quarterly commentary had alluded to slightly slower decision making. On a positive note, our recent interactions with the management suggests no incremental worsening in the decision making cycle.

Driven by slower growth in Cummins account and relatively stronger growth in rest of the business Cummins revenue contribution has been trending down..

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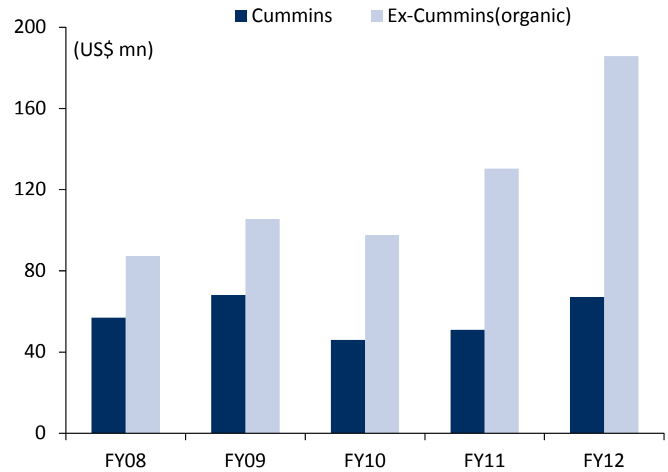
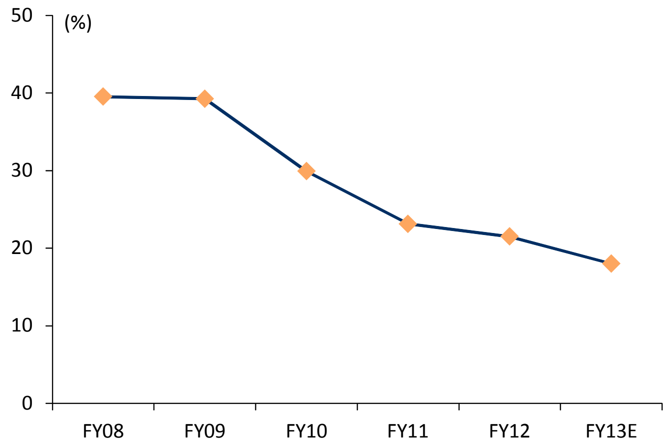
Conversation with the management suggests no incremental weakening of decision making cycles

Relatively stronger performance Ex-Cummins biz

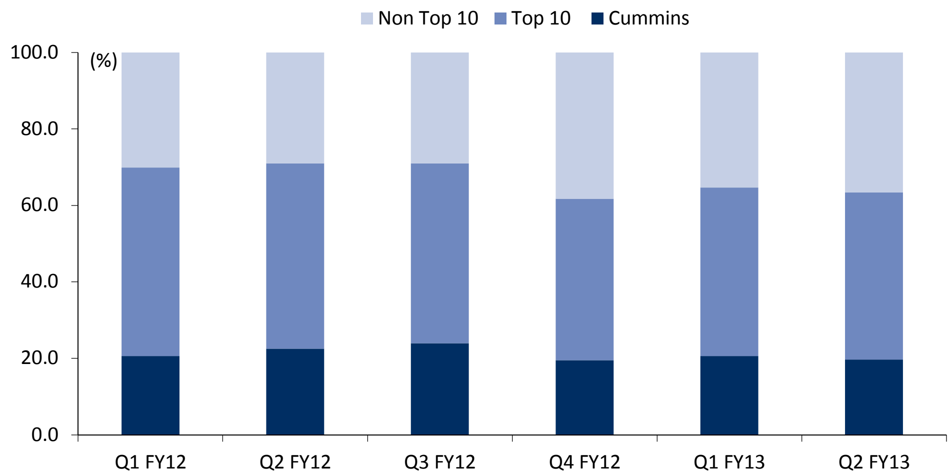


Cummins revenue contribution has been trending down



Source: Company, India Infoline Research

Top clients contribution trend



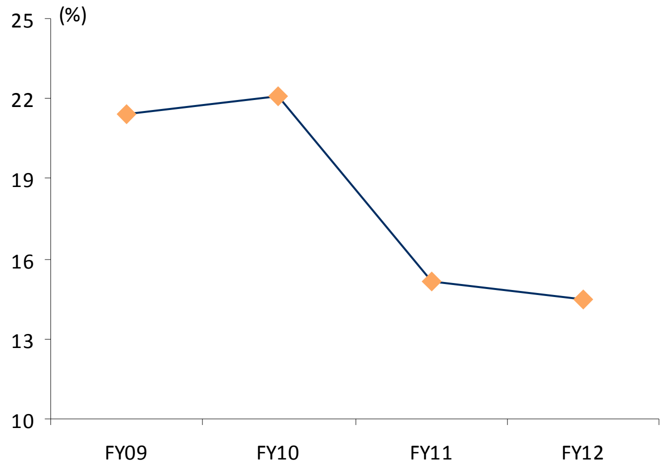
Source: Company, India Infoline Research

OPM to expand 200bps over FY12-14 on the back of variety of levers

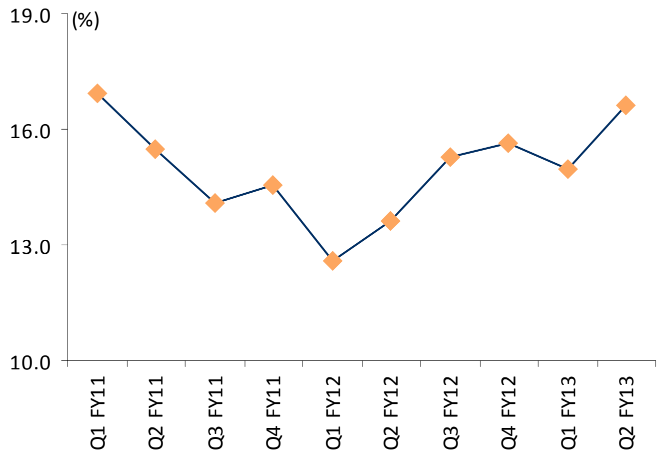
Integration of lower margin acquisitions, greater onsite contribution (due to higher implementation projects) and continued investments in business (IP creation efforts) were the key reasons for subdued OPM over FY10-11. Post FY11, margin has consistently improved over the past six quarters despite one of the highest salary hikes within the industry. This was on the back of weaker rupee, volume driven levers like SG&A leverage, utilization and improving Systime (subsidiary) profitability.

Post tepid performance over FY11, OPM has consistently improved in past six quarters due to improving subsidiary profitability, higher utilization, SG&A leverage & weaker rupee

OPM performance subdued over FY10-11

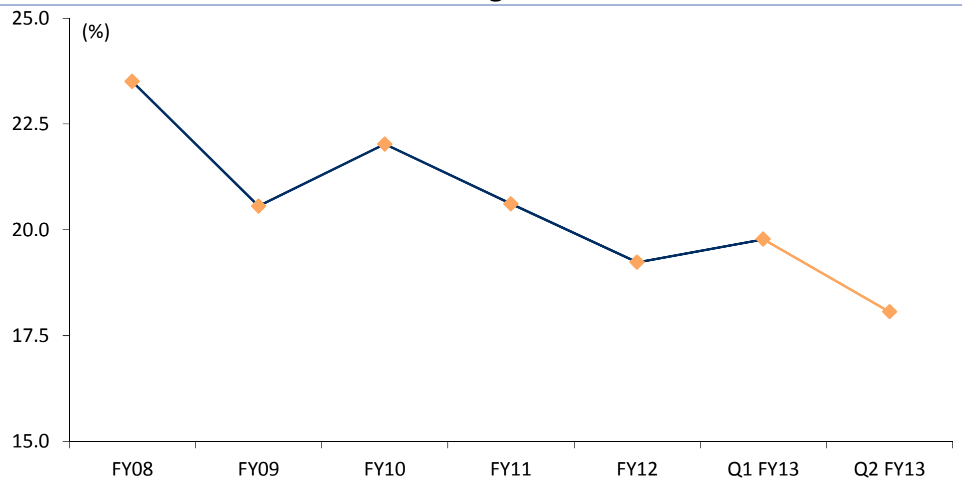


Quarterly OPM performance showing improvement



Source: Company, India Infoline Research

SG&A as % of revenues has been a margin lever



Source: Company, India Infoline Research

Going forward, we believe headroom to improve the OPM in near to medium term exists.

SAP SBU profitability improvement…

In Q2 FY13, due to technology reset (extraneous factor) in the SAP Human capital management business, its growth and hence utilization got impacted resulting in correction of its OPM by nearly 300bps. Cross training and redeployment of ~40 consultants should lead to OPM improvement in near term. Additionally, highly implementation-centric project portfolio (85%+ projects are implementation-based) has resulted in higher onsite efforts and lower annuity business. Inherently lower margin profile of onsite-based

As utilization of the SAP SBU normalizes on the back of better volumes, its OPM are expected to inch up

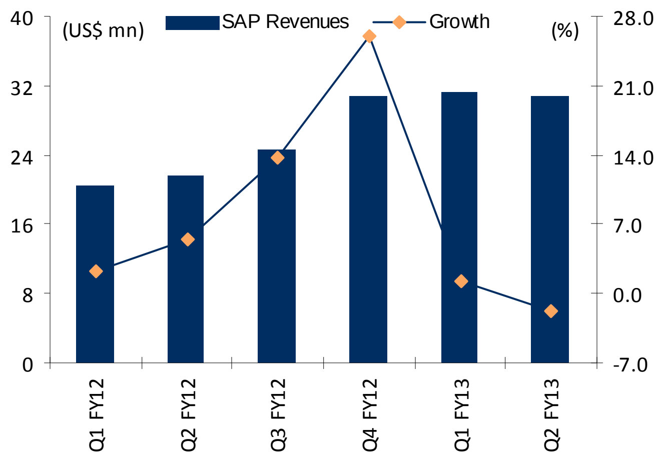
Over medium term, higher maintenance revenues, offshoring should help further improve OPM implementation has led to lower than company average margin for the SAP SBU. Improving maintenance revenue stream from these projects is expected to help offshoring and effectively improving profitability.

...Employee pyramid and SG&A leverage to help improve OPM over FY12-14E

With only ~30% of the employees having up to three years experience (lower cost bracket), we believe employee pyramid broadening continues to be a margin lever. Focus on fresher hiring (50% of the guided employee addition in FY13 would be freshers) is expected to help in the same. Additionally, with large amount of front-end investment as well as integration of acquired companies largely done, we believe there is decent opportunity to leverage the fixed operational (SG&A) costs. This should help buffer the OPM to a certain extent. On the back of the above discussed levers, we have marked up our OPM estimates and now expect the margin to expand 200bps over FY12-14E.

Improving age pyramid and further SG&A leverage should help support margin

SAP SBU growth slowed post strong FY12 due to technology reset



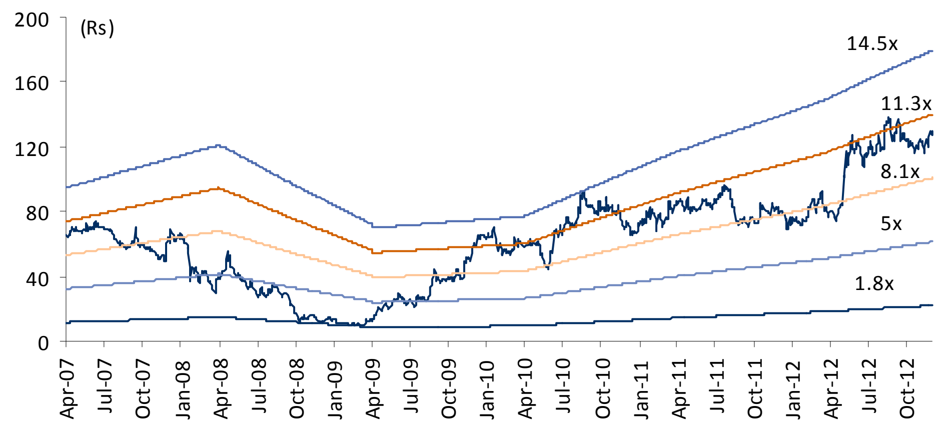
Expect OPM to inch up over FY12-14E

Source: Company, India Infoline Research

Valuation and Recommendation

Sustained demand momentum owing to KPIT's niche positioning and synergistic acquisitions has resulted in the company being one of the best performers amongst its peer set. Going forward, despite the general slowdown in IT decision making/spending, we expect KPIT growth to continue to be in the top quartile amongst its peers. Also, we believe, credible margin levers should help company expand its margin appreciably over FY12-14E resulting in a PAT CAGR of 33% over the same period. With the approval of additional equity infusion, further inorganic expansion will only add to upsides. P/E valuation at 9.2x FY14E earnings still provides decent upside. Maintain BUY .

1 year forward rolling PE band



Source: Company, India Infoline Research

Key risks to our call:

- Significant slowdown in key demand geographies like US.
- Sharp appreciation in rupee can be a risk to our margin estimates.
- Inability to monetize effectively significant expenditure done over years in R&D and IP creation.
- Integration risks associated with the inorganic growth strategy followed by the company.

Financials

Income statement

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Revenue	10,065	15,000	22,439	25,198
Operating profit	**1,522**	**2,171**	**3,670**	**4,151**
Depreciation	(411)	(445)	(474)	(571)
Interest expense	(34)	(79)	(134)	(144)
Other income	26	138	(334)	178
Profit before tax	**1,103**	**1,785**	**2,728**	**3,615**
Taxes	(155)	(437)	(734)	(940)
Minorities and other	-	4	(72)	(93)
Adj. profit	**948**	**1,353**	**1,922**	**2,582**
Exceptional items	-	100	81	-
Net profit	**948**	**1,453**	**2,004**	**2,582**

Balance sheet

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Equity capital	176	356	382	382
				0
Reserves	5,856	6,770	10,718	13,099
Net worth	**6,032**	**7,125**	**11,100**	**13,481**
Minority interest	9	326	209	245
Debt	931	2,222	2,600	2,600
Defer tax liab (net)	55	(27)	(27)	(27)
Total liabilities	**7,027**	**9,646**	**13,881**	**16,298**
Fixed assets	1,580	1,853	2,370	2,734
Intangible assets	1,300	3,623	3,686	3,686
Investments	477	582	1,200	1,800
Net work capital	**3,670**	**3,589**	**6,625**	**8,079**
Sundry debtors	2,538	4,544	6,640	7,318
Cash	2,080	1,473	3,617	4,839
Other current assets	1,111	1,254	1,875	2,106
Sundry creditors	(942)	(1,757)	(2,628)	(2,951)
Other current liab.	(1,116)	(1,925)	(2,879)	(3,233)
Total assets	**7,026**	**9,646**	**13,881**	**16,298**

Cash flow statement

Y/e 31 Mar (Rs mn)	FY11	FY12	FY13E	FY14E
Profit before tax	1,103	1,785	2,728	3,615
Depreciation	411	445	474	571
Tax paid	(155)	(437)	(734)	(940)
Working capital Δ	(831)	(526)	(892)	(232)
Other operating items	-	4	(72)	(93)
Operating cashflow	528	1,272	1,505	2,921
Capital expenditure	(819)	(3,040)	(1,055)	(934)
Free cash flow	(292)	(1,769)	450	1,987
Equity raised	1,284	(214)	2,149	-
Investments	270	(106)	(618)	(600)
Debt finan/disposal	(177)	1,291	378	-
Dividends paid	(71)	(146)	(179)	(201)
Other items	13	335	(36)	36
Net Δ in cash	1,028	(607)	2,144	1,222

Key ratios

Y/e 31 Mar	FY11	FY12	FY13E	FY14E
Growth matrix (%)				
Revenue growth	37.6	49.0	49.6	12.3
Op profit growth	(5.7)	42.7	69.0	13.1
EBIT growth	7.9	64.0	53.5	31.3
Net profit growth	10.6	42.7	42.1	34.3
Profitability ratios (%)				
OPM	15.1	14.5	16.4	16.5
EBIT margin	11.3	12.4	12.8	14.9
Net profit margin	9.4	9.0	8.6	10.2
RoCE	18.9	22.4	24.3	24.9
RoNW	19.2	20.6	21.1	21.0
RoA	12.3	12.1	11.8	12.3
Per share ratios				
EPS	5.4	8.2	10.5	13.5
Dividend per share	0.3	0.7	0.8	0.9
Cash EPS	7.7	10.1	12.6	16.5
Book value per share	34.3	40.0	58.1	70.6
Valuation ratios (x)				
P/E	23.2	15.3	11.9	9.2
P/B	3.6	3.1	2.1	1.8
EV/EBIDTA	13.7	10.6	6.2	5.2
Payout (%)				
Dividend payout	7.5	10.8	9.3	7.8
Tax payout	14.0	24.5	26.9	26.0
Liquidity ratios				
Debtor days	92	111	108	106
Creditor days	34	43	43	43
Leverage ratios				
Interest coverage	33.2	23.5	21.4	26.1
Net debt / equity	(0.2)	0.1	(0.1)	(0.2)
Net debt / op. profit	(0.8)	0.3	(0.3)	(0.5)

Du-Pont Analysis

Y/e 31 Mar	FY11	FY12	FY13E	FY14E
Tax burden (x)	0.86	0.76	0.70	0.71
Interest burden (x)	0.97	0.96	0.95	0.96
EBIT margin (x)	0.11	0.12	0.13	0.15
Asset turnover (x)	1.31	1.34	1.37	1.20
Financial leverage (x)	1.56	1.70	1.80	1.70
RoE (%)	**19.2**	**20.6**	**21.1**	**21.0**

After receiving two reputed awards for being the 'Best Broker' in 2011, IIFL has now bagged the Best Broking House with Global Presence in 2012.

'Best Equity Broker of the Year' – Bloomberg UTV, 2011

IIFL was awarded the 'Best Equity Broker of the Year' at the recently held Bloomberg UTV Financial Leadership Award, 2011. The award presented by the Hon'ble Finance Minister of India, Shri Pranab Mukherjee. The Bloomberg UTV Financial Leadership Awards acknowledge the extraordinary contribution of India's financial leaders and visionaries from January 2010 to January 2011.

'Best Broker in India' – Finance Asia, 2011

IIFL has been awarded the 'Best Broker in India' by Finance Asia. The award is the result of Finance Asia's annual quest for the best financial services firms across Asia, which culminated in the Country Awards 2011

Other awards

D&B Decide with Confidence 2012 – BEST BROKING HOUSE WITH GLOBAL PRESENCE

Zee Business 2009 & 2012 – BEST MARKET ANALYST

Euromoney 2012 – BEST COMMODITIES INVESTMENT

D&B Decide with Confidence 2009 – FASTEST GROWING LARGE BROKING HOUSE

Asiamoney Brokers Poll 2009 – BEST BROKERAGE, INDIA

FinanceAsia Country Awards for Achievement 2008 – BEST BROKER, INDIA

Asiamoney Brokers Poll 2008 – MOST IMPROVED, INDIA

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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