Equity Research
August 26, 2008
BSE Sensex: 14482

INDIA

Allied Digital Services — BUY

Pure play on RIM — Rs695

Reason for report: Initiating coverage

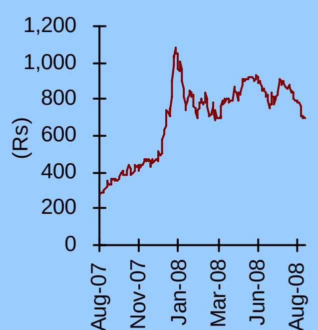
Technology

Shareholding pattern

	Dec '07	Mar '08	Jun '08
Promoters	64.8	64.8	64.6
Institutional investors	21.0	22.0	21.8
MFs and UTI	11.6	11.9	11.9
Insurance Cos.	0.0	0.0	0.0
FIIs	9.4	10.1	9.9
Others	14.2	13.2	13.6

Source: www.nseindia.com

Price chart



Allied Digital Services (ADSL) is riding on high-growth domestic markets of system integration (SI), IT infrastructure management services (IMS) and remote infrastructure management (RIM). Recent acquisition of EnPointe Global Services (EGS), the US-based IMS provider, marks ADSL's foray into international markets. Direct support model in SI versus franchisee model used by competitors, marquee and large client base, strategic alliances with global technology companies, vendor neutral technology adoption, pan-India presence and two decades of execution track record are key differentiators. We expect ADSL's business mix to change to high-margin services, especially RIM, from 21% of revenues to 51% by FY11E resulting in 450bps improvement in EBITDA margin. We estimate revenue (including EGS) and EPS CAGR at 62% and 70% respectively over FY08-11E. With strong revenue visibility, changing business mix, improving margins and higher return ratio, we initiate coverage on ADSL with BUY rating. Our EV/EBITDA based sum-of-the-parts 12-month target price is Rs1,050 with 50% upside. At our target price, ADSL would be valued at FY10E P/E of 11.9x and EV/EBITDA of 7.2x.

- **IMS & RIM to witness exponential growth.** RIM is expected to be US$13-15bn opportunity for the Indian IT industry by '13 from the current US$3.6bn, as per the latest Nasscom and McKinsey report. The report suggests 70-75% offshoring of IMS roles with expected 25-30% savings in operational cost. We believe ADSL, with increased focus on RIM, geographical expansion via recent acquisitions and existing large client base will be a key beneficiary.
- **Domestic SI growth strong.** We believe the use of direct support model and track record of seamless execution with large clients will benefit ADSL in the high-growth domestic SI business. The company intends to leverage SI skills by venturing into integrated solutions for security, smartcards and RFID comprising hardware, software and embedded technology products.
- **Key risks** are: i) lumpiness in project-based SI revenues, ii) execution risk, iii) supply-side issues, iv) increased competition and v) integration of acquisitions.
- **Attractive valuations.** Since the traditional low-margin lumpy SI differs from new initiatives such as high-margin IMS, we value ADSL's both businesses separately on EV/EBITDA and arrive at sum-of-the-parts value of Rs1,050/share. At our target price, ADSL would be valued at FY10E P/E of 11.9x and EV/EBITDA of 7.2x. Given 70% EPS CAGR over FY08-11E, the current FY10E P/E of 7.9x is attractive.

Market Cap	Rs12.6bn/US$287mn
Reuters/Bloomberg	ADIS.BO/ALDS IN
Shares Outstanding (mn)	18.04
52-week Range (Rs)	1129/283
Free Float (%)	35.4
FII (%)	9.9
Daily Volume (US$'000)	300
Absolute Return 3m (%)	(23.6)
Absolute Return 12m (%)	138.7
Sensex Return 3m (%)	(11.4)
Sensex Return 12m (%)	(2.4)

Year to March	FY08	FY09E	FY10E	FY11E
Revenue (Rs mn)	2,973	6,290	9,356	12,550
Net Income (Rs mn)	429	1,019	1,597	2,199
EPS (Rs)	24.8	56.5	88.6	121.9
% Chg YoY	38.3	127.5	56.8	37.7
P/E (x)	28.2	12.4	7.9	5.7
CEPS (Rs)	27.4	62.7	98.2	135.0
EV/E (x)	18.6	8.4	4.7	2.7
Dividend Yield	0.2	0.2	0.2	0.2
RoCE (%)	34.1	35.2	33.9	33.8
RoE (%)	35.8	40.1	39.3	37.3

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IMS & RIM – Dominant growth drivers

High growth in IMS & RIM

IMS is viewed as the next big wave of offshoring opportunity after ADM and BPO. At present, the IMS industry is estimated at ~US$524bn, nearly one-fourth of the overall IT spends at US$2.3trn, according to Gartner. The addressable market for RIM, as per the latest Nasscom and McKinsey report, is estimated to be in the range of US$96bn-US$104bn, the size of which is comparable to the size of the addressable market for offshore ADM and BPO opportunities. At present, less than 7% of the addressable market i.e. US$6-7bn is serviced by offshore vendors and this is expected to post 30-36% CAGR to US$26-28bn by ’13.

RIM in India growing above the industry average

RIM in India has grown more than threefold from US$1bn to US$3.6bn during FY05-08 at 53% CAGR, significantly higher than the overall industry average of ~32%. RIM is expected to be US$13-15bn opportunity for the Indian IT industry by ’13, as per the latest Nasscom and McKinsey report. The report also suggests that IMS could generate 325,000-375,000 jobs in India by ’13 as 70-75% of the roles in IMS can be moved offshore.

Table 1: Huge opportunity in IMS

(US$bn)

	2008	2013E	CAGR (%)
All offshore destinations	6- 7	26-28	30-36
India	3.6	13-15	29-33

Source: Nasscom and Mckinsey report

Table 2: BIG-5 registered 59% CAGR in IMS revenues over FY04–08

	FY04	FY05	FY06	FY07	FY08
Total Revenues (US$mn)					
Infosys	1,063	1,592	2,152	3,090	4,176
Satyam Standalone	556	773	1,051	1,390	2,053
HCL Tech	568	764	979	1,389	1,878
TCS	1,555	2,162	2,971	4,158	5,700
Wipro Global IT Services #	943	1,354	1,815	2,459	3,393
IMS Contribution (%)					
Infosys	2.1	3.0	3.6	4.4	4.9
Satyam Standalone	4.5	4.1	3.9	4.6	4.3
HCL Tech	9.7	9.1	11.5	14.1	15.1
TCS	4.5	5.0	5.5	6.0	6.5
Wipro Global IT Services #	6.0	7.0	8.2	10.6	15.2
IMS Revenues (US$mn)					
Infosys	22	48	77	136	205
Satyam Standalone	25	32	41	63	88
HCL Tech	55	69	112	196	283
TCS*	70	108	163	249	371
Wipro Global IT Services #	57	95	149	261	517
Total - Big 5	**22**	**48**	**77**	**136**	**205**
IMS Revenues YoY growth (%)					
Infosys		114.1	62.2	75.5	50.5
Satyam Standalone		26.7	29.8	52.7	39.9
HCL Tech		25.2	61.9	74.5	44.7
TCS		54.5	51.1	52.7	48.5
Wipro Global IT Services #		67.4	57.1	75.2	98.2
Total - Big 5		**53.3**	**54.4**	**66.6**	**61.7**

Infocrossing for FY08 included as 100% IMS, * assumed for FY04 - FY06

Source: Company data, I-Sec Research

Rationale for high growth in IMS/RIM

We believe IMS/RIM would witness high growth on the back of: i) change in customer behaviour for increasing cost rationalisation and better value, ii) growing need for technology standardisation, iii) evolution in core technologies and IT architecture iv) improvement in offshore capabilities and v) increasing pressure for regulatory compliance.

70-75% of IMS roles can be offshored

As per IDC, more than 85% of infrastructure components (such as servers, networks, security, databases, applications and e-business) can be managed from a central remote location. By doing this, the companies can cut down on their cost of infrastructure operations and management by 40-60%, while getting expert service on 24x7 basis. Even the latest Nasscom and McKinsey report suggests 70-75% offshoring of IMS roles with expected savings of 25-30% in operational cost.

Chart 1: 70-75% of IMS roles can be offshored

	Total FTEs	% of offshoreable
End user computing		
Desktop engineering	32	70-80
Desktop support	128	30-50
Management	2	0
Wintel		
Application support	27	60-90
Direct operations and technical server	61	70-80
Operations support	26	70-80
Security	9	60-70
DB engineers	6	70-100
Management	3	0-50
Helpdesk		
Level 1	48	60-80
Level 2	12	50-70
Level 3	13	40-60
Management	2	0
Other support	9	50-75
Mid-range		
Application support	28	60-90
Direct operations and technical support	26	0-80
Operations support	23	70-80
DB engineers	18	70-100
Management	2	0-50

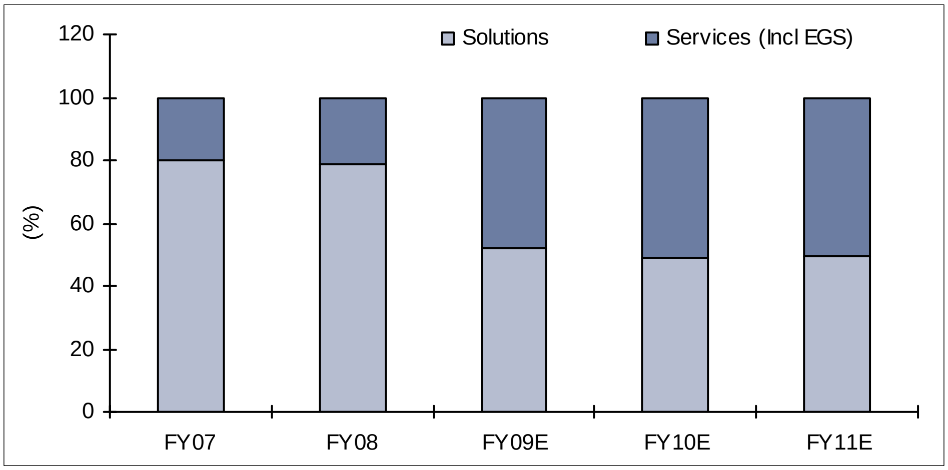
	Total FTEs	% of offshoreable
Mainframe		
Console operation	11	80-100
DB engineers	6	100
Tape management	7	50
Problem mangement	5	67
Production management	47	50
Security	5	100
Systems software engineering	20	70-80
Storage management	3	40-50
Network-Data		
WAN management	39	70-90
LAN management	15	70-90
VPN, EDT, other	15	20-50
Management	2	0
Network-Voice		
Call centre systems support (CMS/CTI/VR)	31	70-80
Voice management	36	0-50
Management	3	0
Cross-Tower		
Finance and procurement	22	0-80
Print	9	0-50
Project management	11	0
Relationship management	11	0
Security	7	40-60
Problem management	14	0
Tools and application support	27	50-70
Other	15	0

(Illustration for team of ~700-1000 FTEs)
Source: NASSCOM RIM Report

ADSL best placed to ride the high-growth IMS/RIM

With more than two decades of execution track record and large-scale implementation in SI for many marquee clients, we believe ADSL is best placed to take advantage of the huge opportunity in IMS/RIM. We believe RIM, including EGS, will contribute 36% to FY11E revenues versus mere 4% in FY08. We expect EBITDA margin to expand 430bps from 22.3% in FY08 to 26.6% in FY11E and estimate RIM including EGS to contribute 52% to EBITDA from the current 12%.

Chart 2: Increasing share of higher margin services revenues



Source: Company data, I-Sec Research

IMS to witness growth across all sectors

Though BFSI was the early adopter of IMS, other sectors such as telecom, IT/ITES are major markets for IMS. Similarly, healthcare and pharma, manufacturing, retail and e-governance are expected to witness a quantum jump in IMS. Even SME has started using IMS to increase focus on core areas and maximise RoIs. Though IMS and RIM are newer areas for ADSL, it has a large number of marquee client bases in SI – ADSL can cross-sell its IMS/RIM offerings to these clients.

Table 3: Marquee clients across sectors

Business Verticals	Name of the client
Manufacturing	Reliance Industries, Bajaj Auto, Gujarat Ambuja, Mahindra & Mahindra
BFSI	ICICI Group, HDFC Bank, NSE, Deutsche Bank, State Bank of India, RBI
Aviation	Jet Airways, Kingfisher, Emirates
ITES/BPO	TCS, NIIT Technologies, Aptech, Syntel
Energy/Power	Tata Power, BPCL, HPCL, GAIL

Source: Company data, I-Sec Research

Non-linear business model

Interestingly, IMS and RIM provide the much needed non-linearity to ADSL's business model. Pricing, in many cases, are based on per component basis. ADSL is witnessing greater demand for offshoring delivered using shared services models and service level agreement (SLA) driven metrics. Hence, there is a clear shift from the full time employment (FTE) model, predominantly adopted by large IT services company, wherein the pricing is based on per hour basis.

NOC/SOC – Early mover advantage

NOC for proactive management of infrastructure

ADSL launched RIM comprising network operating centres (NOC)/information security operating centres (SOC) in Q3FY08 to leverage its current offerings so as to address international markets and expand the revenue base in the Indian market. NOCs are an important part of RIM services as they monitor critical functionalities of infrastructure on 24x7 basis and provide faster solutions to commonly known problems. NOC proactively tracks the infrastructure usage of clients and predicts possible errors to prevent them from occurring. These services augment ADSL's network support portfolio and improves profitability as the same specialist employee can target multiple clients using NOC. ADSL currently serves 20+ clients and intends to leverage its huge existing client base for NOC. Similarly, it plans to expand this into international markets as well (via acquisitions) and improve profitability by taking advantage of the low-cost talent pool in India.

SOC for proactive enterprise information security

Similarly, SOC provides proactive protection and risk management for enterprise security on 24x7 basis. SOC facility has state-of-the-art physical security systems ranging from biometric access control, closed circuit TV, fire detection to suppression systems. ADSL has tied-up with one of the leading commercial SOC player, e-Cop from Singapore, and is exploring exclusive go-to-market strategy with e-Cop. At present, ADSL pays 8% royalty to e-Cop for product licences.

ADSL intends to target its large client base in BFSI, pharma and healthcare, manufacturing and hospitality that are more exposed to security threats and need to mitigate risks in a cost-efficient manner. ADSL intends to tie-up with 'Big 4' consulting firms (PwC, E&Y, KPMG and Deloitte) to target their end clients as a part of information security audits. Besides, ADSL has business alliance with I-Flex Solutions to offer SOC offerings to its client.

ADSL is believed to be charging US$700-800 per device per month to its clients for SOC services. It is currently managing 2,000+ devices and expects additional 1,500-1,700 devices in the next three months – the company's order pipeline is healthy. At present, ADSL has capacity for 25 seaters for its NOC/SOC facility, which would be expanded to 150 seaters in the next 3-6 months. The company would be investing Rs300-350mn in its global delivery centre, from where it would offer NOC/SOC offerings. ADSL expects 60-65% utilisation in FY09E. We believe the company will enjoy the early mover advantage for its SOC offering and hence would be able to effectively compete against competitors. We expect RIM to be the key growth driver for ADSL.

Industry checks indicate ADSL's rate competitiveness

Our industry checks reveal that ADSL's pricing for SOC services are competitive. The revenue potential from an SME organisation (consisting of ~150 users, 1 firewall, 5 servers and an IDS/IPS), is expected to be in the range of US$60,000–80,000 per annum. Extrapolating the same to larger organisations, we believe there is a huge opportunity for ADSL's SOC offerings.

Table 4: Industry – Rate card estimates for SOC

(US$)

Service offered	Per device pricing p.m.
Monitoring & log retention of a Large Firewall	600-700
Monitoring of a large server	700-800
Monitoring of an appliance IDS/IPS	1400-1600
Log file filtering and report transmission	600-700
Web portal access fees	50-100

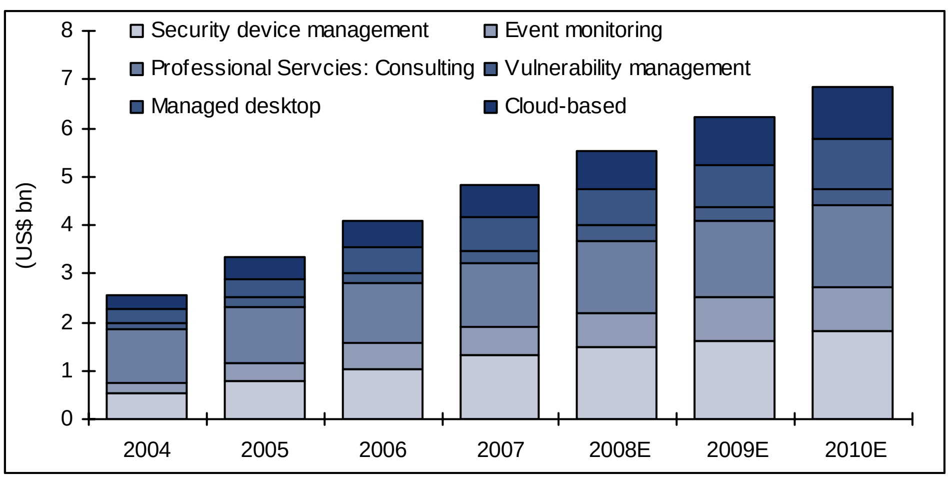
Source: Industry, I-Sec Research

SOC poised to grow rapidly

Increased information/data security threat in a vast and complex information access environment has necessitated organisations to adopt various data security tools. In fact, there is an increased compliance requirement, which has been mandated by various regulations and laws such as Health Insurance Portability and Accounting Act (HIPPA) in US and Basel-II globally. Even the Sarbanes Oxley Act in the US requires reporting of information security compliance for all the companies.

Main drivers for rapid growth of SOC are: i) increased distribution of IT assets across geographically dispersed operations, ii) increased sophistication and proliferation of security threats, iii) lack of adequate training to tackle the problem internally and iv) continuous monitoring and updation required. As per Yankee report on security compliance, the market size is estimated to be of US$6.5bn, growing at 14% CAGR. Thus, information security compliance is gaining importance, providing significant growth opportunities to early movers such as ADSL.

Chart 3: Huge opportunity in managed security services



Source: Yankee Group, I-Sec Research

Table 5: Robust growth in NOC/SOC

(Rs. m)

NOC + SOC	FY08E	FY09E	FY10E	FY11E
Organic revenues (Rs mn)	134	810	1,464	2,276
YoY growth (%)		505.6	80.8	55.4
% of total revenue	4.5	12.8	15.5	17.9

Source: Company data, I-Sec Research

Acquisitions to supplement strong organic growth

ADSL had raised Rs850mn through IPO in July ’07, most of which it intends to use for acquisitions. Similarly, the company has passed enabling resolutions to raise US$100mn, which would be utilised for acquisition. ADSL intends to make acquisitions in NOC/SOC in the international market to gain access to a global client base.

Acquisition of Digicomp to leverage T-BPO delivery

ADSL acquired 51% stake in the Bangalore-based Digicomp for an equity valuation of Rs100mn. Digicomp has a large chip level testing and repair centre in Bangalore with employee strength of 200. It manages repair and RMA services for vendors such as ECS, Asus, USI, IBM, MSI and Foxconn. Recently, it has bagged large order from Dell as well. ADSL intends to leverage T-BPO delivery via the acquisition of Digicomp.

Strategic acquisition of EGS for global expansion of RIM

Recently, ADSL acquired 80.5% stake in IT IMS/RIM provider EnPointe Global Services Llc (EGS) for an equity value of US$23.3mn. EGS is a carved out subsidiary of EnPointe Technologies Inc (ENPT), which is a NASDAQ-listed company with revenues of over US$340mn. The transaction is a combination of cash & equity swap, entailing upfront cash payment of US$10mn and issuance of 745,000 equity shares of ADSL (dilution of 4%) to ENPT, with an additional cash infusion of US$4mn in EGS.

EGS would receive ongoing marketing & business support from ENPT, which enjoys strong sales team, reach and credibility established in the past 15 years in the US market and an established presence across 44 states with client base including several Fortune-1000 corporates across BFSI, healthcare, retail, manufacturing, aviation and transportation. ADSL’s expertise in RIM would enhance EGS’s ability to upsell high-end enterprise and data centre management service offerings to ENPT’s wide customer base across the US by offering cost-effective RIM, managed security, compliance monitoring and reporting services.

EGS had contracted US$40mn revenues at the time of the acquisition, which according to the management has currently increased to US$49mn. EBITDA margin is expected to be in the range of 14-15% in FY09E, which is expected to match the company average in the next 1-2 years. We believe this acquisition would be revenue- and earnings-accretive to ADSL and would strengthen the opportunity pipeline in the US market for its remote service offering (NOC+SOC). Predominantly, domestic-focussed ADSL would have substantial exposure to dollar-denominated revenue through this acquisition and hence will be exposed to foreign currency fluctuations. Also, we believe the company will be new to integration-related risks.

Besides the above acquisitions, ADSL intends to make further acquisitions in Europe, Australia and the Middle East in order to establish global presence in RIM. We believe future acquisitions would supplement the company’s strong organic growth initiatives.

Table 6: Acquisition history

Company	Services	Date of acquisition	Acquisition cost	Acquisitions rationale	Result post acquisition
Digicomp	Testing services & Repair Centre	11/4/2008	Rs100mn for 51% stake	ADSL intends to leverage Digicomp's delivery centre for its T-BPO services	Acquired recently
EGS	IT Infrastructure Management/Remote management services	9/7/2008	US$23.3mn for 80.5% stake	EGS' acquisition would enhance the ADSL' opportunity pipeline for NOC + SOC services in US	Acquired recently

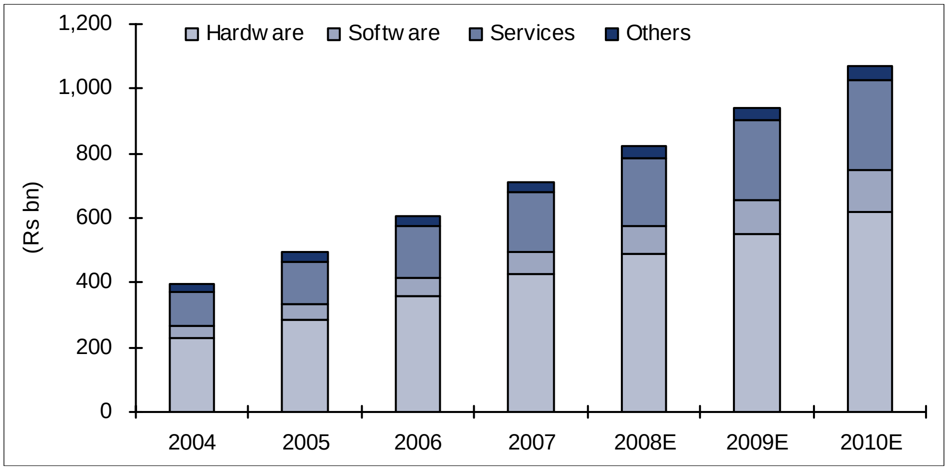
Source: Company data, I-Sec Research

Domestic SI growth strong

Leading player in domestic SI

Traditionally, ADSL has been a leading player in the domestic SI market with expertise spanning more than two decades. ADSL provides SI solutions to its large client base for: i) networking and communications, ii) hardware and enterprise computing, iii) storage and security and iv) package implementation services (CRM, SCM, HRM etc).

Chart 4: Domestic IT services growth



Source: IDC

Given strong domestic economic growth, the Indian domestic IT services market is expected to post 20%+ CAGR in the next three years. With domestic revenues contributing 95%, direct support model acting as a key differentiator and track record of seamless execution with large clients, ADSL is all set to benefit, in our view.

Differentiated business model

Direct support model

ADSL provides support to its customer through direct support model as against competitors who have adopted the franchise model. ADSL has presence in more than 132 locations in India. This enhances convenience and prompt delivery, and support at customers end.

Common resource pool

ADSL maintains common pool of resources and depending on the requirement resources are rotated within the solutions space. Hence, there is optimum utilisation of resources without the need for creating a bench.

Strategic and technology alliances

ADSL has entered into technology and strategic alliances with leading companies such as Cisco, Intel, HP, IBM, Unisys, Microsoft etc to built advanced technology capabilities, address broader market, leverage combined base of clients and deliver comprehensive vendor independent technology solutions to clients in a cost effective manner.

Integrated solution – Niche offerings

ADSL also intends to leverage SI skills by venturing into integrated solutions (IS) for security, smartcards and RFID comprising hardware, software and embedded technology products. IS includes providing safety and security systems (computerised time and attendance, access controls, digital CCTV systems, ATM surveillance and remote monitoring systems and fire detection systems), video conferencing systems, standalone or networked kiosks, RFID, intelligent building management systems (IBMS) and energy management systems (EMS).

IBMS and EMS include providing and monitoring lighting systems, HVAC, access control and security systems using Echelon solutions. EMS aids in saving energy for building premises, hotels etc resulting in 30-40% saving of energy cost. We believe within solutions offerings, IS would be a niche and unique offering by ADSL, which would differentiate ADSL from peers. Also, margins in these offerings are better than the margins in other solutions offerings. We expect revenue and EBITDA CAGR of 51% and 55% respectively over FY08-11E.

Strong earnings CAGR through FY08-11E

Table 7: Revenue CAGR at 62% through FY08-11E, including acquisitions

(Rs mn, year ending March 31)

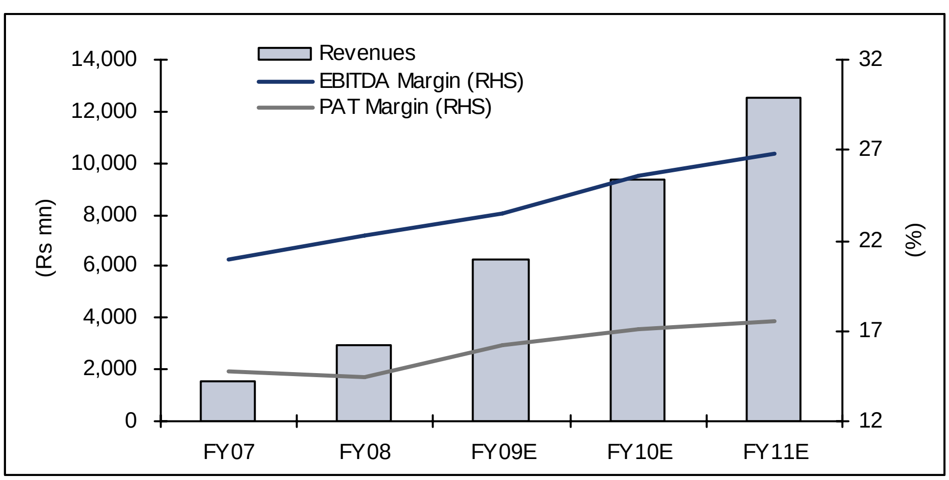
	FY06	FY07	FY08E	FY09E	FY10E	FY11E
Revenues (Rs mn)						
Solutions	**704**	**1,243**	**2,343**	**3,263**	**4,522**	**6,109**
- Enterprise Solutions		1,119	2,013	2,741	3,717	4,973
- Integrated Solutions		125	330	522	805	1,136
Services	**170**	**313**	**630**	**1,616**	**2,642**	**3,887**
-T-BPO + IMS	170	313	496	806	1,177	1,611
-NOC + SOC			134	810	1,464	2,276
Digicomp				**163**	**202**	**244**
EnPointe				**1,248**	**1,990**	**2,309**
Total	**873**	**1,557**	**2,973**	**6,290**	**9,356**	**12,550**
Growth Rate (%)						
Solutions			**88.5**	**39.3**	**38.6**	**35.1**
- Enterprise Solutions			80.0	36.2	35.6	33.8
- Integrated Solutions			165.0	58.3	54.1	41.1
Services			**100.9**	**156.7**	**63.5**	**47.2**
-T-BPO + IMS			58.2	62.5	46.2	36.8
-NOC + SOC				505.6	80.8	55.4
Digicomp					**23.8**	**20.9**
EnPointe					**59.5**	**16.1**
Total	**73.7**	**78.2**	**91.0**	**111.6**	**48.7**	**34.1**
Revenue breakup (%)						
Solutions	***80.6***	***79.9***	***78.8***	***51.9***	***48.3***	***48.7***
- Enterprise Solutions	*0.0*	*71.9*	*67.7*	*43.6*	*39.7*	*39.6*
- Integrated Solutions	*0.0*	*8.0*	*11.1*	*8.3*	*8.6*	*9.0*
Services	***19.4***	***20.1***	***21.2***	***25.7***	***28.2***	***31.0***
-T-BPO + IMS	*19.4*	*20.1*	*16.7*	*12.8*	*12.6*	*12.8*
-NOC + SOC	*0.0*	*0.0*	*4.5*	*12.9*	*15.7*	*18.1*
Digicomp	***0.0***	***0.0***	***0.0***	***2.6***	***2.2***	***1.9***
EnPointe	***0.0***	***0.0***	***0.0***	***19.8***	***21.3***	***18.4***
Total	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***	***100.0***

Source: Company data, I-Sec Research

EBITDA and PAT CAGR at 72% and 70% respectively over FY08-11E

We expect RIM, including EGS, to contribute 36.5% to FY11E revenues from a mere 4.5% in FY08. This is expected to improve EBITDA margin 450bps to 26.8% by FY11E. We expect EBITDA and PAT CAGR of 72% and 70% respectively through FY08-11E.

Chart 5: Improving EBITDA and PAT margins



Source: Company data, I-Sec Research

Risks

Project-based SI revenues

Still ~79% of FY08 revenues were from enterprise consulting and networking solutions (SI), which are project-based requiring ongoing replacement of revenue post 90-120 days of such implementation. This leads to lumpiness to existing revenue stream (also a low-margin stream). Slowdown of the Indian economy, if any, may be detrimental to the growth of SI revenues.

Execution risk, particularly in newer areas of NOC/SOC

Though ADSL has more than two decades of experience for SI offerings, NOC/SOC are relatively new offerings and hence execution has to be observed in the short term.

Supply-side issues

ADSL requires experts (Microsoft/Cisco certified and Certified Ethical Hackers etc) for NOC/SOC offerings and their non availability can restrict growth.

Increased competition

ADSL may face stiff competition from bigger and traditional SI players such as Wipro, HCL Tech and Tata Consultancy Services, thus affecting its growth. However, ADSL enjoys the early-mover advantage in NOC/SOC, which is expected to grow faster than the company's average. Also, the direct support model used by ADSL versus the franchisee model used by competitors will act as a differentiator for the company.

Integration of acquisitions

ADSL may embark on faster growth track through acquisitions going forward. This may pose an integration risk for ADSL and may lead to dilution of equity. Also, future acquisitions could be margin/EPS-dilutive.

Higher debtor days

SI, by nature of its business, leads to higher debtor days of 120-130, thus pressurising working capital. However, as the contribution of services increases, debtor days are expected to come down.

Attractive valuations

We expect ADSL's business mix to change to high-margin services, especially RIM, from 21% of revenues to 51% by FY11E resulting in 450bps improvement in EBITDA margin. We estimate revenue (including EGS) and EPS CAGR at 62% and 70% respectively over FY08-11E. With strong revenue visibility, changing business mix, improving margins and higher return ratio, we initiate coverage on ADSL with BUY rating.

Since the traditional low-margin lumpy SI differs from new initiatives such as high-margin IMS, we have valued ADSL's both businesses separately on EV/EBITDA and arrived at sum-of-the-parts value of Rs1,050/share. At our target price, ADSL would be valued at FY10E P/E of 11.9x and EV/EBITDA of 7.2x. Given 70% EPS CAGR over FY08-11E, the current FY10E P/E of 7.9x is attractive.

Table 8: Sum-of-the-parts valuations based on FY10E EV/EBITDA

(Rs mn)

Business Segments	EBITDA	% of EBITDA	Target multiple (x)	EV	% to EV
Enterprise Solutions	677	28	5	3,386	20
TPO + IMS + Digicomp	580	24	7	4,063	24
NOC + SOC	753	32	10	7,531	44
EnPointe	378	16	6	2,271	13
Total EV	**2,389**	**100**	**7.2**	**17,251**	**100**
Add Cash				2,315	
Less Debt				564	
Equity Value				**19,002**	
No. of Shares outstanding (mn)				18.04	
Per Share Value (Rs)				**1,050**	

Source: I-Sec Research

Table 9: Comparative valuations

Company	Price (Rs)	EPS (Rs) FY09E	EPS (Rs) FY10E	EPS (Rs) FY11E	EPS CAGR (%) FY08-11E	P/E (x) FY09E	P/E (x) FY10E	P/E (x) FY11E	EV/EBITDA (x) FY09E	EV/EBITDA (x) FY10E	EV/EBITDA (x) FY11E
Large Cap Peers											
HCL Technologies*	225	21.9	24.5	26.2	11.8	10.3	9.2	8.6	8.3	6.7	5.5
Infosys Technologies##	1,705	101.3	115.9	127.3	16.8	16.8	14.7	13.4	12.9	10.7	8.9
Satyam Computer	394	32.1	38.2	40.2	16.8	12.3	10.3	9.8	8.1	6.5	5.3
Tata Consultancy Services	825	58.0	68.8	74.5	13.4	14.2	12.0	11.1	10.6	8.8	7.4
Wipro	425	26.2	32.0	35.0	16.6	16.2	13.3	12.1	11.8	9.5	7.8
Mid Cap Peers											
Patni Computer Systems**	227	29.6	34.4	37.0	3.5	7.7	6.6	6.1	3.9	3.9	3.9
3i Infotech #	110	14.6	18.1	22.0	31.1	7.5	6.1	5.0	6.6	5.1	4.1
Nucleus Software	170	17.7	23.6	27.0	13.5	9.6	7.2	6.3	5.2	3.4	2.3
Infotech Enterprises	205	21.5	25.6	28.6	20.5	9.6	8.0	7.2	6.7	5.0	3.7
MphasiS	225	16.3	20.8	22.2	22.1	13.8	10.8	10.1	8.2	6.2	4.8
ADSL	700	56.5	88.6	121.9	70.0	12.4	7.9	5.7	8.4	4.7	2.7

*PAT after ESOP charges, ** Figures for CY08E, CY09E and CY10E,#Fully diluted EPS ,##Excluding Axon
Source: I-Sec Research

Company background

ADSL is a key emerging player in the Indian IT industry, providing a spectrum of technology solutions and services to a diverse client base across verticals. The company is riding on high-growth markets of domestic SI & IMS and RIM. ADSL currently operates in 132 locations with an employee base of ~1,800. The recent acquisition of the US based EGS, an IT infrastructure managed services business and NASDAQ-listed company, enhances ADSL's global presence and provides a step-up growth in complimentary business opportunities. The company has increased its focus towards global marketing initiatives in major geographies such as America, Europe and emerging geographies of Middle East, Far East, Australia for software solutions and RMS (NOC and SOC).

Service offerings

ADSL operates in two segments – Solutions and Services

Solutions

The solutions business is the same as SI, wherein an entire IT infrastructure is set up on a turnkey basis. ADSL has tied up with strategic partners such as HP, IBM and Echelon to provide these solutions. The solutions business is spread across four separate strategic business units (Table 10). Recently, ADSL has shifted its focus from traditional SI to high-margins IS. ADSL's strategic tie-up with Echelon for providing intelligent building management and energy management solutions helped the company win larger deals with increased profitability. The company is also increasingly shifting its focus from low-margin, high working capital intensive traditional SI with high hardware sales to consultancy-based services by setting up a procurement advisory cell, which assists clients in procuring hardware from various vendors. This will lead to lower revenue growth, compensated by better margins and higher profits. Solutions, which contributed 79% to total revenues in FY08, are expected to post 38% CAGR through FY08-11E and contribute 49% in FY11E.

Table 10: Solutions SBUs

Description	SBU1 IT Solutions	SBU2 Networking & Communication Solutions	SBU3 Integrated Solutions	SBU4 Software Solutions
Clients	BPCL ,HPCL, Deloitte	SBI, Gail, RIL, BSNL,	Gujarat Ambuja	Plain burgh, IMAS,
	& Touché	Holcim, Pfizer, Tata	Cipla, MTNL,	Bhawan Group
		Indicom.	Reliance Retail	
Partnership	HP, IBM, Novel	Cisco, Nortel,	GE Securities,	Epicor, IMAS, Redhat
	Microsoft , EMC	Enterasys, Call Up,	Echelon, Cisco,	
		Avaya	Quantum Auto.	
Competition	Wipro, HCL, CMC, Tata	Wipro, Data Craft,	Siemens, Zicom	Wipro, HCL, Mastek,
	Elxsi	HCL,3D Networks,	Honeywell, Johnson	iGATE
		Gemini Comm.	Contr.	
Market Size	US$5.4bn			US$35bn
Solutions offered	Enterprise computing, storage solutions, information security, message & collaboration, enterprise management solutions, convergence, thin-client computing, telecom solutions	Premises distribution system, enterprise switching, wireless & WAN solutions, technology consulting & network planning & implementation	Security & safety, asset tracking devices, video conferencing / communication, intelligent building & energy management solutions	Enterprise management system, enterprise resource planning

Source: Company data

Services

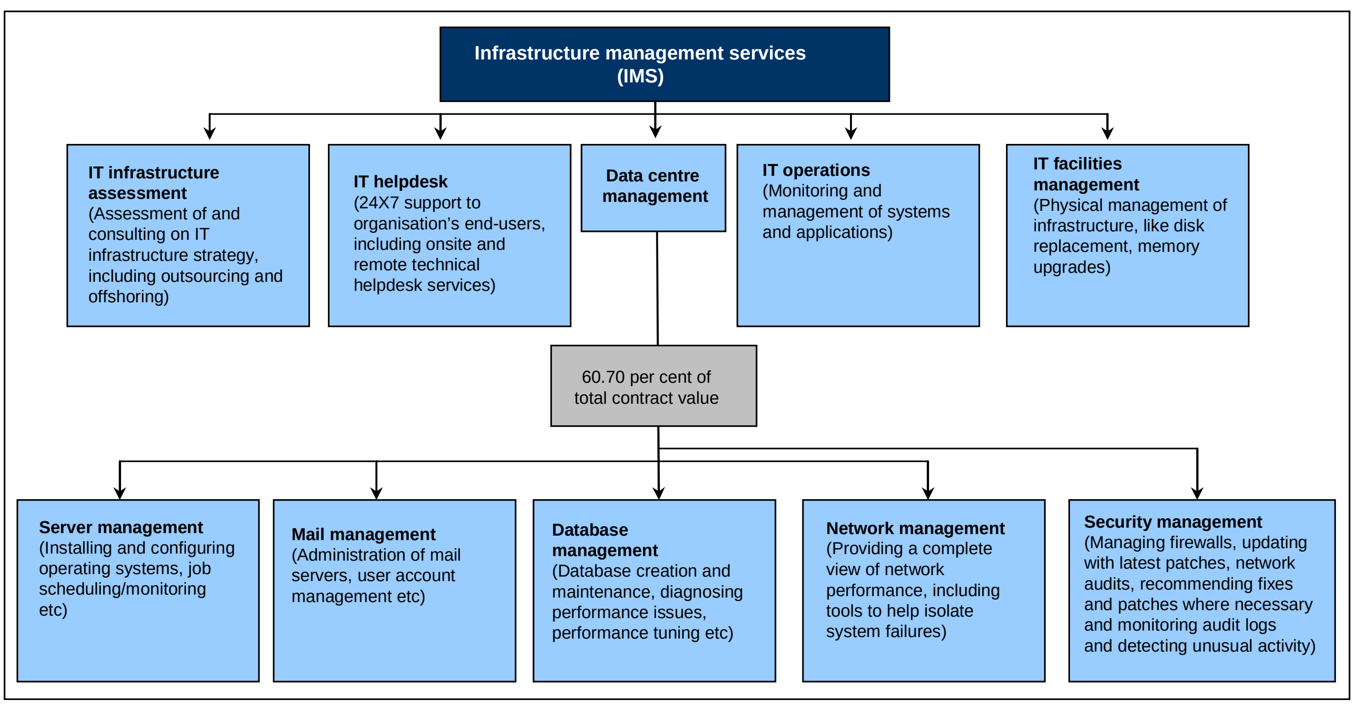
ADSL provides services under two SBUs: i) IT services including technical-BPO (T-BPO) and infrastructure management services and ii) RIM services. The company provides assistance to customers to help them align business with IT and deliver services with speed and quality. With more than two decades of execution track record and large-scale SI implementation for many marquee clients, we believe ADSL is best placed to take advantage of the huge opportunity in IMS/RIM. In the IT services SBU, ADSL provides test & repair/service centre, technical BPO, incident-based support, AMC, facility management services among others with focus on verticals such as telecom, consumer electronics and OEM. Remote management services will be provided via NOC and SOC with focus on BFSI and healthcare.

Table 11: Services SBU

Description	SBU5 IT Services		SBU6 Remote Management Services
Clients	Dell, BT, Nokia , Reuters (Unisys) etc	Raymond's, Kingfisher, OTIS, Reliance, etc	McDonalds, Emerson
Partnership	Unisys, IBM, Fujitsu-Siemens, EDS	IBM Global Services, Unisys, EDS	e-COP, HP, LANDesk
Competition	Wipro, Slash Support, Sutherland	Wipro, HCL, CMC, etc	Wipro, MindTree, Sify, HCL Comnet
Market Size	US$6bn	US$500mn	US$24bn
Services offered	Test & repair / Service Centre, Technical BPO, Incident Based Support, AMC, Facility Management Services, Enterprise Management Services, Consultancy and Professional Services		***Network Operation Center*** Remote Desktop / Server / Network management, End User Helpdesk ***Security Operations Center*** Information Security Surveillance Services, Managed Detection Service, Managed Microsoft Security Service

Source: Company data

Chart 6: IMS framework



Source: CRISIL Research, I-Sec Research

Impressive management

ADSL's promoters have nearly three decades of experience in technology and enterprise IT infrastructures, successfully implementing, managing and consulting complex IT and business systems for global businesses.

Table 12: Key management

Designation	Name	Educational Qualification & Experience
Promoter, Chairman & Managing Director	Mr. Nitin Shah	BE (Electrical) and a Post Graduate Diploma in Computer Management from JBIMS Previous Employment with CMC, Crompton Greaves & Nelco
Promoter, Whole time Director and CFO	Mr. Prakash Shah	BCom and Diploma in Computers Management With the company since inception
Executive Director and CIO	Mr. Manoj Shah	A science graduate with post graduate diploma in Computer Science With the company since 1990
Chief Executive Officer	Mr. Bimal Raj	B.Com.P.G.DBA, Diploma in Programing Previously with Cyber Comm (P) Ltd, Hundai Byte Systems, Essen Computers, Sonata Ltd, Digital Solutions Pvt. Ltd
Chief Technical Officer	Mr. Sunil Bhatt	Diploma in Computer Technology Previously with Megha Systems, Digitech Computers, Expert Computers

Source: Company data, I-Sec Research

Consolidated financials

Table 13: Profit and loss statement

(Rs mn, year ending March 31)

	FY05	FY06	FY07	FY08E	FY09E	FY10E	FY11E
Revenues							
Solutions	394	704	1,243	2,343	3,263	4,522	6,109
T-BPO + IMS	109	170	313	496	806	1,177	1,611
NOC+SOC	0	0	0	134	810	1,464	2,276
Digicomp	0	0	0	0	163	202	244
EnPointe	0	0	0	0	1,248	1,990	2,309
Total	**503**	**873**	**1,557**	**2,973**	**6,290**	**9,356**	**12,550**
Cost of Sales	382	587	1,031	1,997	2,940	4,108	5,531
% to Sales	76.0	67.2	66.2	67.2	46.7	43.9	44.1
YoY (%)	29.3	53.5	75.6	93.6	47.2	39.7	34.7
Employee Cost	49	86	128	221	1,549	2,404	3,076
% to Sales	9.8	9.9	8.2	7.4	24.6	25.7	24.5
YoY (%)	2.9	75.3	48.3	72.7	602.6	55.2	28.0
SG&A Expenses	33	43	71	93	324	455	582
% to Sales	6.5	4.9	4.6	3.1	5.1	4.9	4.6
YoY (%)	(2.7)	31.2	66.2	30.6	247.5	40.5	28.0
EBITDA	**39**	**157**	**326**	**662**	**1,478**	**2,389**	**3,360**
% to Sales	7.7	18.0	21.0	22.3	23.5	25.5	26.8
YoY (%)	287.0	306.4	107.5	102.9	123.2	61.7	40.7
Depreciation	3	6	9	33	98	152	202
% to Sales	0.6	0.6	0.6	1.1	1.6	1.6	1.6
YoY (%)	23.1	76.3	52.5	282.5	197.7	55.0	33.4
Interest & Finance Charges	8	8	11	14	36	43	32
% to Sales	1.5	0.9	0.7	0.5	0.6	0.5	0.3
YoY (%)	4.1	4.1	37.5	25.1	162.3	20.0	(27.3)
Other Income (including Lease)	15	16	5	30	53	98	163
% to PBT	35.2	10.3	1.7	4.7	3.8	4.3	4.9
YoY (%)	79.8	9.2	(67.7)	470.2	73.4	85.4	66.5
Profit Before Tax	**43**	**160**	**312**	**646**	**1,396**	**2,292**	**3,289**
% to Sales	8.5	18.3	20.1	21.7	22.2	24.5	26.2
YoY (%)	410.7	273.2	94.9	106.9	116.2	64.1	43.5
Total tax	9	40	83	217	349	642	1,020
% to Sales	1.7	4.5	5.3	7.3	5.5	6.9	8.1
% to PBT	19.8	24.7	26.5	33.5	25.0	28.0	31.0
YoY (%)	1,114.3	364.9	109.7	161.3	61.2	83.8	58.9
Profit after tax	**34**	**121**	**229**	**429**	**1,047**	**1,650**	**2,270**
% to Sales	6.8	13.8	14.7	14.4	16.6	17.6	18.1
YoY (%)	346.8	250.6	90.1	87.3	143.9	57.6	37.5
Minority Interest	0.0	0.0	0.0	0.0	28.4	52.6	70.2
Extraordinary Items	(19.9)	0.0	0.0	0.0	0.0	0.0	0.0
Reported Profits	**14**	**121**	**229**	**429**	**1,019**	**1,597**	**2,199**
% to Sales	2.9	13.8	14.7	14.4	16.2	17.1	17.5
YoY (%)	88.3	731.8	90.1	87.3	137.3	56.8	37.7

Source: Company data, I-Sec Research

Table 14: Balance Sheet

(Rs mn, year ending March 31)

	FY05	FY06	FY07	FY08E	FY09E	FY10E	FY11E
Gross Fixed Assets	34	39	98	298	1,630	1,930	2,280
Less :accumulated depreciation	16	22	31	64	161	313	516
Net Fixed Assets	17	17	67	234	1,468	1,617	1,764
Capital WIP	0	0	37	57	72	87	102
Inventories	12	11	13	27	40	56	76
Sundry Debtors	98	291	596	896	1,809	2,563	3,095
Cash & Bank balances	17	27	29	414	960	2,015	4,149
Loans & Advances	0	103	129	329	592	999	1,494
Total Current Assets	127	431	767	1,666	3,402	5,634	8,814
Sundry Creditors		64	95	174	317	481	638
Provisions		48	144	350	698	1,325	2,319
Other Current Liabilities		0	0	30	77	107	131
Total Current Liabilities	40	111	239	553	1,092	1,913	3,087
Net Working Capital	88	319	528	1,114	2,311	3,721	5,727
Investments	2	2	29	501	351	301	251
Miscellaneous Expenditure	0	1	0	0	0	0	0
Deferred tax assets	0	0	5	0	0	0	0
Total Assets	**107**	**339**	**666**	**1,906**	**4,202**	**5,725**	**7,844**
Equity Capital	26	47	128	173	180	180	180
Share Premium	0	58	95	869	1,463	1,463	1,463
Free Reserves	28	148	364	773	1,771	3,347	5,525
Minority Interest	-	-	-	-	78	123	160
Long Term Debt	56	79	73	73	173	153	123
Short Term Debt	9	7	7	7	511	411	311
Deferred Tax Liability	2	1	0	12	26	49	82
Total Liabilities	**121**	**339**	**666**	**1,906**	**4,202**	**5,725**	**7,844**

Source: Company data, I-Sec Research

Table 15: Cash Flow statement

(Rs mn, year ending March 31)

	FY05	FY06	FY07	FY08E	FY09E	FY10E	FY11E
Cash flow from operating activities							
Net profit before tax and extraordinary	23	160	312	646	1,396	2,292	3,289
Adjustment for							
Depreciation	3	6	9	33	98	152	202
Interest Expense	8	8	11	14	36	43	32
Interest Income	0	(2)	(1)	(30)	(53)	(98)	(163)
Dimunition in value of investments	(1)	-	-	-	-	-	-
Op. profit before working cap chgs.	**33**	**172**	**331**	**662**	**1,478**	**2,389**	**3,360**
Adjustments for							
Trade and other receivables	3	(193)	(306)	(300)	(914)	(754)	(531)
Inventories	(0)	1	(2)	(14)	(13)	(16)	(20)
Trade payables	(5)	36	41	79	143	164	157
Loans and advances	(4)	(60)	10	(64)	(133)	(123)	(128)
Other Liabilities	-	-	-	31	61	38	31
Deferred tax	-	-	-	5	0	0	0
Minority Interest	-	-	-	-	(28)	(53)	(70)
Working capital changes	(5)	(215)	(258)	(264)	(884)	(743)	(561)
Direct tax paid	(5)	(34)	(38)	(137)	(130)	(284)	(368)
Net Cash flow from operations (A)	**22**	**(77)**	**35**	**262**	**464**	**1,363**	**2,431**
Cash flow from investing activities							
Purchase of Fixed assets (incl. goodwill)	(8)	(5)	(96)	(220)	(1,347)	(315)	(365)
Purchase/Sale of Investments	(1)	(0)	(27)	(473)	150	50	50
Interest received	1	2	1	30	53	98	163
Net cash from investing activities (B)	**(9)**	**(3)**	**(122)**	**(662)**	**(1,144)**	**(167)**	**(152)**
Cash flow from financing activities							
Issue of equity shares	0	79	106	819	602	0	0
Proceeds from borrowings	(1)	21	(6)	0	682	(76)	(92)
Financing charges	(8)	(8)	(11)	(14)	(36)	(43)	(32)
IPO expenses /Dividend paid		(1)	0	(20)	(21)	(21)	(21)
Net cash from financing activities (C)	**(9)**	**90**	**89**	**785**	**1,227**	**(140)**	**(145)**
Net increase in cash & cash equivalents	4	10	2	385	546	1,055	2,134
Cash & Cash equivalents opening	13	17	27	29	414	960	2,016
Cash & Cash equivalents closing	17	27	29	414	960	2,016	4,149

Source: Company data, I-Sec Research

Table 16: Key ratios

(Year ending March 31)

	FY08E	FY09E	FY10E	FY11E
Per Share Data (Rs)				
Recurring Earning per share (DEPS)	24.8	56.5	88.6	121.9
Recurring Cash Earnings per Share (CEPS)	27.4	62.7	98.2	135.0
Free Cash flow per share (FCPS - post capex)	14.2	(45.0)	64.0	77.6
Book Value (BVPS)	104.9	189.3	276.7	397.5
Dividend Per Share (DPS)	1.2	1.2	1.2	1.2
Valuation Ratios (x)				
Price Earning Ratio	28.2	12.4	7.9	5.7
Recurring Cash Earnings per share	25.5	11.2	7.1	5.2
Price to Book Value	6.7	3.7	2.5	1.8
EV / EBITDA	18.6	8.4	4.7	2.7
EV / Total Operating Income	4.1	2.0	1.2	0.7
EV / Operating Free Cash Flow (Pre-Capex)	347.8	26.5	20.9	6.1
EV / Net Operating Free Cash Flow (Post-Capex)	NA	50.1	NA	7.7
Dividend Yield (%)	0.2	0.2	0.2	0.2
Growth Ratios (% YoY)				
Total Operating Income Growth	91.0	111.6	48.7	34.1
EBITDA Growth	102.9	123.2	61.7	40.7
Recurring Net Income Growth	87.3	143.9	57.6	37.5
Recurring EPS Growth	38.3	127.5	56.8	37.7
Recurring CEPS Growth	50.7	128.7	56.7	37.4
Operating Ratios (%)				
EBITDA Margin (%)	22.3	23.5	25.5	26.8
EBIT Margins	21.2	21.9	23.9	25.2
Recurring Pre-tax Income Margins	21.7	22.2	24.5	26.2
Recurring Net Income Margins (%)	14.4	16.6	17.6	18.1
Raw Material Consumed / Sales	67.2	46.7	43.9	44.1
SGA Expenses / Sales	3.1	5.1	4.9	4.6
Other Income / Pre-tax Income	4.7	3.8	4.3	4.9
Other Operating Income / EBITDA	4.6	3.6	4.1	4.8
Effective Tax Rate	33.5	25.0	28.0	31.0
Debtor days	110.0	105.0	100.0	90.0
Creditor days for goods	30.0	30.0	30.0	30.0
Return / Profitability Ratios (%)				
Return on Capital Employed (RoCE)-Overall	34.1	35.2	33.9	33.8
Return on Invested Capital (RoIC)	78.7	71.1	71.0	92.2
Return on NetWorth (RoNW)	35.8	40.1	39.3	37.3
Dividend Payout Ratio	4.7	2.1	1.3	1.0

Source: Company data, I-Sec Research

Annexure 1: Index of Tables and Charts

Tables

Charts

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