Equitymaster Agora Research Private Limited
Independent Investment Research
15 May, 2009

KPIT Cummins Infosystems Ltd.

Buy **Target price: Rs 145**

Market data

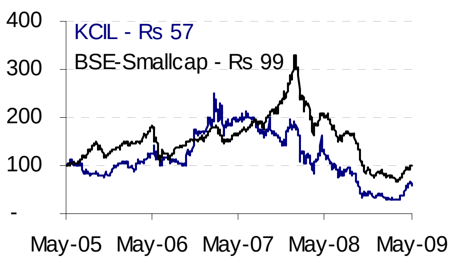
Current price	Rs 42 (BSE)
Market cap	Rs 3,258 m
Face value	Rs 2.0
FY09 div./share	Rs 0.6
NSE symbol	KPIT
No of shares	78.0
Avg. 52-w liquidity	104,500
Free float	72.6%
52 week H/L	Rs 85 / 20

Stock Price Performance

	KCIL	Index*
1-Yr	-52.7%	-50.2%
2-Yr	-45.3%	-22.6%
3-Yr	-23.2%	-18.5%

Returns over one year are on a CAGR basis * BSE Smallcap Index

Rs 100 invested is worth



Shareholding (March-09)

Category	(%)
Promoters	27.4
Banks, FIs & MFs	17.2
FIIs	4.1
Cummins (Inc+India)	14.7
Others	36.6
Total	100.0

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Among the world's best

- Have you ever wondered what benefits you are served when you use the technologies incorporated into your vehicle? From the electronic displays on the dashboard to power steering and power windows, to electric ignition – technology has come to play a very important role in providing you, the vehicle user, with benefits like safety and fuel efficiency.

  Vehicle differentiation these days is largely about electronics and the problems that it solves for the users. In 2000, for instance, a car had 1 million lines of software code. By 2010, the estimate is that this will go to 50-100 million lines of code. An estimate by a German auto magazine claims that electronics in vehicles are growing at a compounded annual rate of 8.1% and are expected to form around 40-45% of a car's cost over the next few years, from around 15-20% currently. As such, companies involved in developing and providing such electric technologies will be in high demand.

  Our Hidden Treasure for this month – **KPIT Cummins Infosystems Ltd. (KCIL)** – is one such technology company that is working wonders in the space of automotive electronics. The company, headquartered in the IT city of Pune, currently earns around 28% of its revenues from this segment, which forms a majority chunk of the manufacturing vertical where the company's key focus lies.

  Over the past five years, KCIL has benefited from the surge in demand for technology solutions from manufacturing and automotive companies. This can be seen from the fact that during this period, the company has multiplied its sales and profits by 6 times and 5 times respectively.

  While the company's stock has lost around 75% of its value since its highs, it currently trades at a very attractive valuation of just around 3.3 times our estimated FY12 earnings. And not to forget the Rs 21 per share of cash (50% of stock price) that the company has on it books, which make the valuations even more attractive. Overall, we are of the belief that the stock, riding on the company's bright prospects, has the potential to become almost a 4-bagger in a span of next 4 to 5 years. Investors, who have the wherewithal to face short-term market fluctuations but believe in the long term story that this company is, can buy into the same at the current levels.

Investment Rationale

- **A 'specialty' solutions provider:** KCIL's business focus is predominantly on two verticals—manufacturing and BFSI (banking, financial services, insurance) – with a large part of revenues (around 87%) coming from the manufacturing vertical. While a large dependence on a single vertical holds its risks, the fact is that KCIL has gained critical competencies in this domain over the past few years that can help it in growing its business strongly in this very niche over the next many years. After all, the use of technology is getting a greater mindshare as manufacturers seek educated workers and a business-friendly environment at a reasonable cost. Moreover, the need for integration in the manufacturing sector – integration of internal functions and supply chain – will also aid the usage of IT in this space and therefore KCIL's business going forward.

Within the manufacturing vertical, KCIL has identified auto electronics, semiconductors, and embedded software as high-growth niche segments. Auto electronics, in fact, is one of the company's key competitive strengths and the management expects it to be a key revenue driver in the future. As a matter of fact, KPIT provides services to five of the top 10 global auto original equipment manufacturers and also to their vendors and has some prestigious affiliations that speak highly of its capabilities in this space.

- **Prestigious industry affiliations:** KCIL is the only Indian IT company, apart from Infosys, to be a part of AUTOSAR (Automotive Open System Architecture). AUTOSAR, in simple terms, is a consortium of automobile manufacturers, suppliers and tool vendors whose objective is to create and establish open standards to bring about compatibility in different automotive electronics architectures. The aim of AUTOSAR is to contribute to development of global standards, and to evolve and enable standardisation of communication in the areas of auto and electronic software.

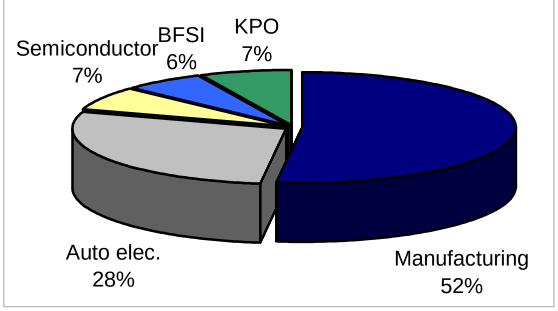
  Core members of AUTOSAR include marquee automobile names like Peugeot, Toyota, Volkswagen, BMW, Daimler AG, Ford Motor, Opel, and automotive suppliers like Bosch and Continental AG. KCIL is one of the premium members of this consortium and this affiliation helps the company to associate itself with these major automobile manufacturers and suppliers across the world and understand and cater to their technology requirements.

  Another affiliation in similar lines that KCIL boasts of is JASPAR, which is like the Japanese version of AUTOSAR. KCIL is in fact the first and the only Indian company to become a part of this consortium, which was originally formed by leading Japanese automotive companies like Honda, Nissan Toyota, and Denso.

  Furthermore, in 2007, KCIL was also awarded the Automotive Spice Maturity Level 5 certification for the quality of its service offerings to automotive manufacturers as also its process competencies. The award came from a consortium called the Automotive Spice User Group, which has members like Audi, BMW, DaimlerChrysler, Fiat, Ford, Jaguar, Land Rover, Porsche, Volkswagen, and Volvo. With the membership of AUTOSAR, JASPAR and the Automotive Spice Maturity Level 5 certification, In fact, KCIL is the only company in the world to be recognised by all the three organisations – AUTOSAR, JASPAR, and Automotive Spice User Group.

  Given that such memberships and certifications are granted after the candidate company has met stringent qualification criteria and has sought endorsement from the core group members, KCIL's recognition by all these groups speaks highly of the company's capabilities. As a matter of fact, auto electronics formed 28% of the company's consolidated revenues in FY09 (23% in FY08) and was the lead sales growth driver during the fiscal (segment sales grew by 60% YoY in FY09).

Segment-wise revenue share (FY09)



Source: Company

- **Growth aided by acquisitions:** Apart from an aggressive growth of its organic business, KCIL has also benefited from some timely and profitable acquisitions over the past few years. Since the year 2002, not only has KCIL acquired six companies across various domains to fill in the gap in its service lines, it has also been able to successfully integrate the operations of the acquired entities to exploit synergies. For instance, the acquisition of Panex Consulting in 2004 brought KCIL domain expertise in the SAP consulting and implementation space and has already earned it several million dollars in revenues. Then, the acquisition of the Bangalore based CG Smith in 2006 brought with itself competencies in the automotive embedded solutions while helping KCIL expand its customer base straight from 39 to 72.

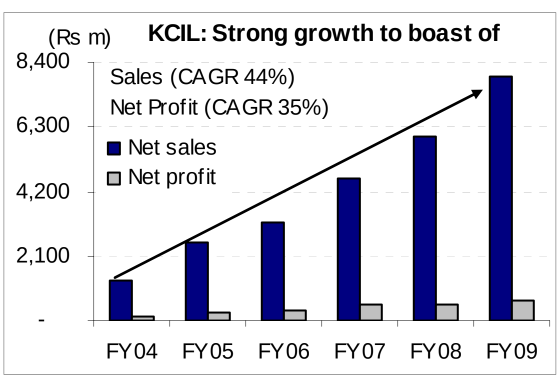
KCIL's inorganic growth acts

Acquisition	Year	Competencies
Cummins Infotech	2002	Manufacturing & embedded solutions
Panex Consulting	2004	SAP consulting and implementation
Pivolis	2005	Offshore consulting; Foothold in French market
SolvCentral	2005	Business intelligence solutions
CG Smith	2006	Automotive embedded solutions
Harita TVS	2008	Mechanical design services

Source: Company reports

We believe, as supported by the company's past financial performance, strategic acquisitions like the ones mentioned above have helped KCIL widen its service offerings and penetrate existing client accounts through cross-selling of services. The management has indicated its intentions of being on a constant lookout for acquisitions to fill in more service gaps in the future as well. The management has indicated that since the company is already into the automotive electronics business, aerospace and defense are the next best domains it is eyeing in terms of acquisitions.

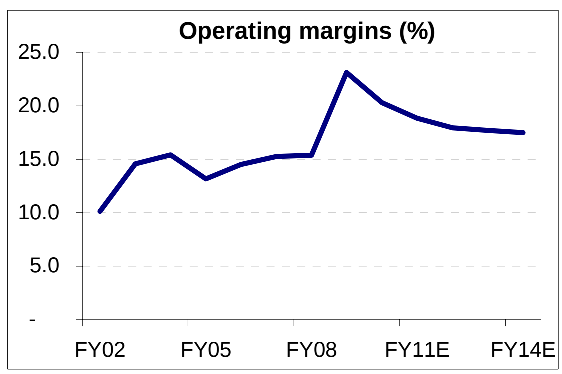
- **Stellar past performance:** KCIL has grown strongly over the past few years. While sales have multiplied 6 times over the past five years,



Source: Company

net profit has multiplied almost 5 times. Furthermore, the company has managed average operating margins of 16% during this period, and its average return on equity has been 30%. Notwithstanding the current weak business environment, we believe that KCIL's niche presence in industries that are expected to spend big sums on technology implementation going forward, as also its domain expertise, makes it a credible investment candidate for long term investors.

- **Focus on profitability:** The manufacturing and automobile industries have witnessed unprecedented uncertainty over the past three quarters. However, despite that, the company recorded a sharp improvement in its profitability during FY09. Operating margins, for instance, jumped from 15.4% in FY08 to 23.1% in FY09. The company's timely initiatives towards increasing employee utilisation, increasing the share of offshore revenues and optimising the overall cost structure led to this spike in margins during FY09. While the coming quarters will be challenging for the company, a fact that has also been accepted by the management, the company is expected to continue doing the good work on the margins front. We expect operating margins to average around 18.5% over the next five years owing to the company's focus on profitability improvement factors as mentioned above.

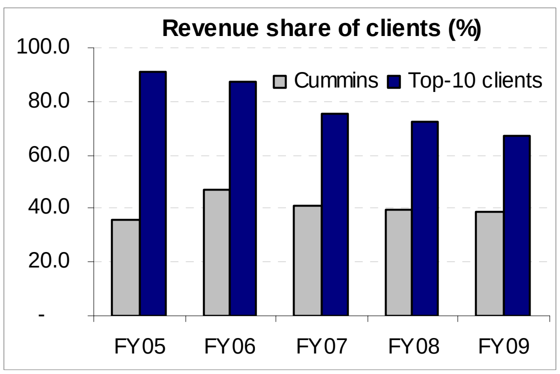


Source: Company, Equitymaster Research

Investment Concerns

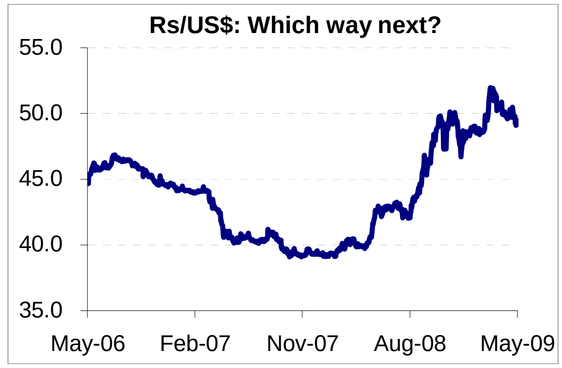
- **Niche has its risks:** Given that KCIL has a niche presence and its revenues are largely dependent on the manufacturing vertical, the company faces the risk of concentration. While this vertical is less prone to slowdown as compared to, say the BFSI (banking, financial services, and insurance) vertical given that manufacturing industries worldwide have a clear cut focus on improving productivity through technology implementation, the fact remains that the company has lesser maneuverability as compared to the bigger firms if the slowdown becomes all encompassing. We understand this risk and have duly factored in the same in our forward estimates for the company.

- **Client concentration concerns:** KCIL derives around 39% of its revenues from Cummins, which is also an investor in the company (holds an 8.2% direct stake in the company). This high share of revenues from a single client is a risk, especially considering that Cummins' share in KCIL's revenues has not really come down over the past 5 years. While the company is doing well to reduce its concentration from the top 10 clients (Cummins included – see graph below), a large dependence on one particular client will continue to weigh heavy on KCIL's prospects, especially in these trying times when Cummins itself has seen some cutback in its technology spending (as indicated by KCIL's management).



Source: Company

- **Currency fluctuation risk:** KCIL derives majority of its revenues in foreign currency. Thus, changes in the average exchange rate in a particular currency can have significant affect on its revenues and operating income denominated in that currency. Generally, appreciation of the rupee relative to another currency has an adverse effect on revenues and operating income, while depreciation of the rupee has a positive effect on revenues and operating income denominated in the non-rupee currency. The Indian rupee has been very volatile against the US dollar over the past few years. In 2007, rupee touched a high of nearly 38.5 against the dollar but after that is started depreciating and now it is trading at around 49.6 against the dollar. This kind of movement of the rupee has added to volatility in IT services companies' revenues, and KCIL has been no exception. In FY09, for instance, the company had to write off forex losses worth Rs 574 m from its profits.



Source: Trend

- **Impact of cutback in tech spending:** The crisis that has impacted the entire global financial system is bound to affect the Indian technology industry. There already are talks of US corporations cutting back on their discretionary technology spending during the remainder of 2008 and 2009. While the value proposition offered by offshore outsourcing will be maintained, the fact that fresh contracts are coming in at a much slower pace will most likely impact the volumes of Indian IT players. Mid and small-size companies like KCIL that lack the scale and breadth of offerings of a larger company are likely to suffer more from this slowdown in global tech spending.

Gartner Inc., the world's biggest technology research company, has in fact sharply lowered its projections for global IT spending (on hardware, software and technology services) in 2009. It now estimates that technology spending could rise by only 2.3% in 2009 (as against the earlier estimates of 5.8%) as businesses cut back on budgets following the spreading of economic crisis. Gartner expects the US and Western European countries to be the worst affected from the slowdown in technology spending. Considering that these two regions contribute around 75% to the total global technology spend (see above graph), a deep slowdown there can severely impact the fortunes of the technology industry worldwide as also in India.

Taking a conservative view on the back of the expected slowdown in technology spending, we expect KCIL's revenues to grow at a compounded annual rate of 10% over the next four years. However considering that KCIL derives just around 6% from the banking and financial services space where a majority of the cutback is expected to happen, the company will still be better off as compared to its mid and small size peers who depend a lot on these industries.

Key management personnel

- **Ravi Pandit, Chairman and Group CEO,** is a gold medalist and fellow member of the Institute of Chartered Accountants of India and an associate member of the Institute of Cost and Works Accountants of India. A graduate of Pune University, Mr. Pandit has a Masters from Sloan School of Management, MIT, Cambridge, US. He has an extensive experience of over three decades in the fields of IT, corporate strategy and management consulting. He also serves on the board of Finolex.

- **Kishor Patil, CEO & Managing Director,** is in charge of the overall management of KCIL. He is specifically responsible for all day-to-day operational issues like planning and executing business, reviewing and guiding the country offices, customer delivery units and support functions, and ensuring efficient and effective functioning of the organization as a whole. As a promoter of KCIL, Mr. Patil has been responsible for providing the strategic direction and has spearheaded the company's forays into international markets, especially Europe. He is a fellow member of the Institute of Chartered Accountants of India and a member of the Institute of Cost and Works Accountants of India.

Background

KCIL is a niche player in the manufacturing vertical and within manufacturing, the company's focus is on three sub-verticals – automotive and transportation, industrial and farm equipment, and high-tech and semiconductors. The company derives around 55% of its revenues from the US market, while another 36% comes from Europe. Over the past five years, KCIL has multiplied its sales and profits by 6 times and 5 times respectively, thereby showing a compounded annual growth of 44% and 35% respectively. At the end of March 2009, the company had around 4,500 employees on its rolls serving 128 clients worldwide. The US based Cummins Inc., which holds an 8.2% direct stake in KCIL, is also its largest client and contributes around 39% of the total revenues (as per FY09 data).

Industry Prospects

The current macroeconomic environment poses significant short & medium-term challenges to growth of IT companies worldwide and in India. Gartner Inc., the world's biggest technology research company, has in fact sharply lowered its projections for global IT spending (on hardware, software and technology services) in 2009. It now estimates that technology spending could rise only 2.3% in 2009 (as against the earlier estimates of 5.8%) as businesses cut back on budgets following the spreading of economic crisis.

Gartner expects the US and Western European countries to be the worst affected from the slowdown in technology spending. In such an environment, growth for Indian IT companies will be impacted as well. However the key for survival will be to offer innovative service offerings, and having a deep understanding of customer needs. In the long run, factors like the growing impact of technology-led innovation will continue to lead the increasing demand for global sourcing. Considering that global sourcing (offshoring) is just around 5% to 6% of the total worldwide technology spend, and that there will be an intense need for corporations to cut costs, the technology offshoring market is expected to outpace growth in total spends.

Risk Analysis

Please refer to the Risk Matrix on page 8 of this report

Sector: KCIL operates in the IT industry, which is dependent to a great extent on the offshoring work from companies in the US and Europe. The sector is facing a rough patch amidst financial crisis and economic slowdown in these regions as governments talk about protectionism as a way to keep jobs at home. As per managements of several leading IT services companies, the next two quarters are going to be tough for the industry. However, there is nothing to take away from the value proposition that offshore outsourcing possesses. Nevertheless, we have assigned a 'high risk' rating to the sector.

Company standing: KCIL has a strong operational history. The founder members of the company have vast entrepreneurial experience. The company is well entrenched in the IT industry in general and the manufacturing vertical in particular, and has been growing at an astounding rate. However, given its small size and dependence on a single industry vertical, we have assigned a 'medium' rating to the company.

Sales: KCIL, being a small company, has generated average annual sales of just around US$ 100 m over the past five years. The growth in sales has however been very strong given the low base effect. We assign a rating of 8 to the stock.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. KCIL's average operating margins for the past five years have been over 16%, which is reasonably good. We assign a medium risk rating of 5 to the stock on this parameter.

Long term EPS growth: KCIL has been able to grow its earnings at an average rate 35% over the past five years. Going forward, we believe that the company has the potential to achieve around 17% growth over the next five years and hence, the rating assigned is 5.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering KCIL's last five years' average ROIC of over 30%, we have assigned a low-risk rating of 7 to the stock on this parameter.

Dividend history: A stable dividend payout history inspires confidence in the management's intentions of rewarding shareholders. KCIL's last five years; average dividend payout has been less than 10%, and we expect the company to maintain the same in the future as well. As such, the rating assigned is 2.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 30% promoter holding indicates safety for retail investors. At the end of March 2009, KCIL's promoters held around 27% stake in the company. The rating assigned is 3.

FII holding: We believe that FII holding of greater than 20% can lead to high volatility in the stock price. At the end of March 2009, FII holding in KCIL stood at just around 4%. We consider this safe from a retail investor's perspective. Rating assigned is 7.

Liquidity: The average daily volumes in KCIL's shares over the past 52-weeks stand around 105,000 shares, which we believe is comfortable liquidity for a small cap company. The rating assigned on this parameter is 7, which indicates low risk.

Current ratio: KCIL's current ratio has averaged 2.6 times over the last five years. We are comfortable with a ratio greater than 2. We have assigned a rating of 7 to the stock on this parameter.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Given the fact that KCIL has averaged a debt to equity ratio of 0.5 times over the past five years, we have assigned the medium risk rating of 6 to the stock.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. KCIL's interest coverage ratio has averaged a high 18.5 times over the past five years. As such, we have accorded a low risk rating of 8 to the stock on this parameter.

P/E Ratio: The P/E ratio (price-to-earnings ratio) of a stock is a measure of the price paid for a share relative to per share income or profit earned by the company. This is one of the important metrics to judge the attractiveness of a stock, and thus gets the highest weightage in our risk matrix. KCIL's P/E on its earnings of the past four quarters currently stands at around 5 times. We have assigned a low-risk rating of 8 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 73, which on a weighted basis, stands at 6.3. This makes the stock a low-risk investment from a long-term perspective. Investors however need to understand that small-caps as a category is high risk on an overall basis as compared to large and mid-cap stocks.

Valuations

KCIL currently trades at Rs 42, implying a multiple of around 3.3 times our estimated FY12 earnings. This makes the stock a very attractive investment opportunity for long term investors. The company has built up key capabilities over the years, and has a very good quality management and unique business model, which position it well amongst the IT service providers. Given this, we expect the company to clock superior topline and bottomline growth over the next few years, which shall ultimately show in its stock price performance. We thus recommend a 'BUY' on the stock with a target price of Rs 145 from a 4 to 5 years perspective. This will make the stock an almost 4-bagger over this timeframe.

Valuations at a glance

(Rs m)	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
Net sales (Rs m)	7,932	7,490	8,102	9,205	10,932	13,017
Net profit (Rs m)	659	631	776	992	1,191	1,433
No. of shares (m)	78.0	78.0	78.0	78.0	78.0	78.0
Diluted EPS (Rs)	8.4	8.1	9.9	12.7	15.3	18.4
Price to earnings (x)	5.0	5.2	4.2	3.3	2.8	2.3
Price to sales (x)	0.4	0.4	0.4	0.4	0.3	0.3
Price to book value (x)	1.9	1.4	1.1	0.8	0.7	0.5

Risk Matrix

		Ratings accorded	
Rating	**Weightage* (A)**	**Rating# (B)**	**Weighted (A*B)**
Sector risk		High	
Company's standing		Medium	
Performance parameters			
Sales	5.0%	8	0.4
Operating margins	5.0%	5	0.3
Long term EPS growth	10.0%	5	0.5
Return on invested capital	10.0%	7	0.7
Technical parameters			
Dividend payout	5.0%	2	0.1
Promoter holding	10.0%	3	0.3
FII holding	5.0%	7	0.4
Liquidity	10.0%	7	0.7
Safety parameters			
Current ratio	5.0%	7	0.4
Debt to equity ratio	10.0%	6	0.6
Interest coverage ratio	5.0%	8	0.4
P/E ratio	20.0%	8	1.6
Final Rating**		**73**	**6.3**

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk. * 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be one of the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Financials at a Glance

(Rs m)	FY09	FY10E	FY11E	FY12E	FY13E	FY14E
Sales	7,932	7,490	8,102	9,205	10,932	13,017
Sales growth (%)	32.1%	-5.6%	8.2%	13.6%	18.8%	19.1%
Operating profit	1,834	1,521	1,525	1,650	1,936	2,278
Operating profit margin (%)	23.1%	20.3%	18.8%	17.9%	17.7%	17.5%
Net profit	659	631	776	992	1,191	1,433
Net profit margin (%)	8.3%	8.4%	9.6%	10.8%	10.9%	11.0%
Balance Sheet						
Fixed assets	1,795	1,770	1,706	1,650	1,590	1,519
Current assets	4,189	4,435	5,461	6,864	8,684	10,888
Investments	0	0	0	0	0	0
Total assets	**5,984**	**6,206**	**7,168**	**8,514**	**10,274**	**12,407**
Current liabilities	3,052	2,987	3,291	3,780	4,501	5,374
Other liabilities	1,685	2,261	2,964	3,863	4,943	6,242
Net worth	1,185	895	850	808	767	729
Total debt	62	62	62	62	62	62
Total liabilities	**5,984**	**6,206**	**7,168**	**8,514**	**10,274**	**12,407**

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