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India Research - InfoTech

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Paradyne InfoTech Ltd

Initiating Coverage

Paradyne Infotech Ltd is a rapidly growing company in the space of software products & services and technology infrastructure management. It is set to capitalise on strong growth opportunity in HR & Banking software products, offshore & domestic software services, e-governance projects, and IT infrastructure management services through both organic and inorganic initiatives in domestic as well as global markets. This is, however, contingent on the company managing the challenges of attracting & retaining IT professionals.

DCF Value Rs.165

Price Rs.66

+150%

The stock currently trades at 5.9 times and 4.1 times the estimated EPS for FY07 and FY08 respectively. We expect the EPS to grow 62% and 45% in FY07 & FY08. We estimate one-year out DCF value at around Rs.165 (CoE & WACC at 18%). Its high ROCE and ROE of over 30% are expected to be maintained going forward.

Key Data

Market Cap	Rs.718mn US\$16mn
Shares Outstanding	10.9 mn
52 week High-Low	Rs.94 / Rs.42
BSE+NSE 3 months	No. of shares
Avg Trading Volume	47,000
Avg Delivery Volume	24,000
BSE Scrip Code	532672
BSE Group	B1

Shareholding % **30 Sep 05**

Promoters	67.93
Institutions	0.02
Others	32.04

Multiple Valuation **YE Mar-08E**

EV/EBITDA	3.3x
EV/ EBIT	3.8x
Market Cap/Sales	0.45x
P/E	4.1x

Products & Services

Software Products	A human resource management product and a centralised banking product
Software Services	Offshore & domestic customised software development
Technology Infrastructure Management Services	Facility Management, Maintenance upkeep of hardware / system software / database software / networking products.
Technology Integration	Resale & Integration of hardware, system software, database software and/or networking products.

Key Investment Points

- We expect Paradyne, which was rated by Deloitte among fastest growing tech companies in 2005, to see 43% annualised growth in EPS till FY2010.
- It has two software products – HRM product and Core banking product. Both these products hold immense potential for scale up.
- Software services to see strong growth from domestic as well as offshore clients – both organically & inorganically.
- Integrated model of IT infrastructure management & software helps it pre-sell, cross sell and up sell its offerings.
- Technology infrastructure management, especially remote management, has immense potential in both domestic and global market.
- As currently over half of its profits come from domestic clients, it is relatively insulated from US slowdown, if it takes place, and FX fluctuations.

Value Kickers

- Acquisition is part of company's growth plan. It's looking at synergistic acquisitions abroad. One such acquisition may happen within the current fiscal. We have not built-in any acquisitions in our financial & valuation model.
- Extension of 10B IT exemption beyond FY09

Points of Concern

- Attracting & Retaining IT Professionals by managing rise in salaries & attrition rates is a challenge for all IT companies.
- Inadequate disclosures in financial statements
- Issue of significantly higher number of ESOPs vis-à-vis equity base.



Introduction

Paradyne Infotech Ltd (Paradyne) was set up in end 1997 as a small company to cater to domestic customers in system integration space by first generation entrepreneurs – Annand Sarnaik and Divvyani Sarnaik. It has since been moving up value chain and has been growing at a fast clip. It has also moved into managed services and development of packaged and customized software. In Oct2005 it came out with IPO to raise Rs.139n (3.3mn shares at Rs.42 each) to fund further development of its software products, and expand software development and infrastructure management business. The company currently has over 200 employees.

“It’s important to continuously move up customers’ value chain by leveraging proficiencies in emerging technologies” – Annand Sarnaik, MD, Paradyne Infotech Ltd

Technology Infrastructure Management Services (TIMS) segment contributed 79.5% to FY06 revenues. TIMS comprises of technology/system integration and managed services. Software product and services segment contributed 20.5% to FY06 Revenues. TIMS, however, contributed only 36% to FY06 EBIT as it involves resale of buyout components and therefore has lower margins. Software services segment, on the other hand, contributed 64% to FY06 EBIT. Software services segment comprises of two packaged products and customized application development services.

In TIMS, it caters to clients in the domains of banking & finance, education & research, e-governance, manufacturing & retail, healthcare, and telecom. TIMS work is carried out from its centre at Bandra (E), Mumbai.

In software services, it has two products. One of the products is complete HR management software (HrWorQ) and another is a core banking solution (FinWorQs) aimed primarily at co-operative banks. In application development, its focus areas are business process management (BPM) and customer relationship management (CRM). It has an STPI unit at Millenium Business Park, Mahape, Navi Mumbai for Software Services work.

It has alliances and partnerships with global technology companies like Oracle, Sun, IBM, Cisco, Acer, and Microsoft. These partnerships help Paradyne in both software services and TIMS.

Some of its key clients are:

Banking & Financial	JM Morgan, IDBI Bank, SIDBI, BoI, Corp Bank, PNB, BoB, NABARD
E-Governance	Income Tax Mumbai, Indian Navy, HUDCO, MHADA, Western Railways
Software	Geometric Software, KPIT Cummins
Education & Research	Symbiosis Institute of Mgmt, Lala Lajpatrai College, Jai Hind College
Telecom	Reliance Infocomm, Idea, IOL Broadband, MTNL, Hathway Cable, Satyam Infoway
Manufacturing, Retail, etc	Globus Stores, ONGC, Nimbus Comm, UTV, Mercator Lines, National Insurance



Key Investment Arguments

Excellent Performance in FY06 and H1FY07

Paradyne was named among top 50 Indian and top 500 Asia Pacific fastest growing technology companies by Deloitte in 2005.

Rs.mn	FY06	YoY Gr %	H1FY07	
Revenue	868	26.7	569	The growth was driven by all segments. Software services segment was the fastest growing segment. Revenues, EBIT, and PAT grew quarter to quarter in each of the last three quarters.
EBIT	91	37.7	76	
PAT	75	45.4	62	

This year, Paradyne has achieved 83% of FY06 profit in the first half itself. We estimate growth rates to accelerate going forward.

"We Expect FY07 to be founding stone for exponential growth of the company in the years to come." – Annand Sarnaik, MD, Paradyne Infotech Ltd (Oct-2006)

Software products hold promise of scale up

Paradyne has two software products – an HRM product and a core banking solution product. Both these products have been further developed and strengthened over the last year. One of the objectives of funds raised through IPO in Oct05 was to develop these products further. With the planned development work on these products now over, both these products hold significant potential to scale up client and installation base. As products sales scale up, margins can shoot up. The company, however, does not have plans to develop any other new product.

HrWorQ – Human Resource Management Product

This is a complete human resource management product developed completely in-house. This encompasses recruitment management to performance appraisal to training management to payroll & taxation to work flow management. The product is available on multiple platforms – Windows, Linux and Solaris.

Its clients include Globus, UTV, and Avenues. Revenue from this product comprises of license fee for base product, license fee for additional modules, and service revenues for customization.

Low penetration of HRM software products (estimated penetration 25% in India) and outsourcing of HR activities will drive growth of this product. The company claims that this product competes with Polaris Software's HRM Product Adrenalin.

FinWorQs – Centralised banking solution

This centralized banking product was acquired by Paradyne in a raw development stage in 2002. It was fully developed and brought to commercialization by Paradyne. The product is aimed at small and medium sized banks – particularly co-operative banks. It covers centralized banking, retail banking, treasury, forex, CRM, HRM, mobile banking, tele-banking, ATM management and MIS reporting.

SME banks are becoming IT savvy partly by the demonstrated benefits of IT and partly by necessity to remain competitive and survive. More and more SME banks are computerizing and networking



their branches and banking functions. There are about 22,000 urban co-operative banks. Only about 5% of these banks are currently using a centralized banking solution. This indicates the huge potential that exists. Though there is no competition from the biggies like I-flex and Infosys in the SME segment, there are many local players making the space intensely competitive. Some of the aggressive competitors in this space are Nucleus Software, Infracore, and Lasersoft. Onward Technologies, which acquired the product from Kale Consultant, too has a competing product. Onward, however, is reportedly not aggressive in market place.

Revenue comprises of license fee for base product and additional MIS reports, and service revenues for customization. Some of its clients include co-operative banks like Mandvi, Vishwas, Jagson, and Amravati. This product too is available on multiple platforms.

Software Services business -- organic and inorganic growth ahead

Software services business comprise of development of customized applications for both domestic and overseas clients. In FY06, 43% of revenue in this segment came from overseas clients and balance from domestic clients. We expect this ratio to improve in favor of overseas clients going forward.

Company is targeting both organic and inorganic growth for this segment. It plans to expand its software development capacity by 200-seats at its STPI SDC at Navi Mumbai. It has set up a 100% subsidiary in the US for tapping business opportunities there.

It is also aggressively looking for synergistic acquisitions particularly in US. The company is looking at offshoring the development work of companies that it may acquire.

We understand from sources that the company is in advanced negotiations for an acquisition in the US. This acquisition may materialize within the current fiscal itself. If this happens, the company's size and growth curve will shift to a different tangent. Revenues can almost double from our projected levels with this one acquisition.

The company has no net debt and is cash positive. It will use the available cash, internal accruals and debt to fund the acquisition. We do not expect any equity dilution for the first acquisition.

Our innovation strategy calls for synergy of internal development, partnerships, and acquisitions. To lead in the technology industry, companies must be able to do all three – Annand Sarnaik, MD, Paradyne Infotech Ltd

Significant opportunities in Tech Infrastructure Management –both domestic and global

Technology Infrastructure Management Services (TIMS) comprises of low margin business of system integration and managed services. In this, the company takes charge of managing the entire IT infrastructure of its clients. It provides design, build and operate solutions to large organizations. As system integration involves resale of IT hardware and software, margins are low. Pure managed services, however, have decent margins wherein the company gets a fee for managing the IT infrastructure. Most contracts, however, involve an element of both.

As per the company's estimates, only about 45% of organizations currently outsource management of tech infrastructure. Rest of the organizations have in-house IT department to manage tech infrastructure. Thus the untapped opportunity in TIMS space in India is greater than the current market size. Increasingly, organizations are moving towards outsourcing. The company claims to have brought in significant cost and operational efficiencies to its clients who moved from in-house management to outsourcing.



A large part of management of IT Infrastructure is gradually moving towards Remote Management (RMS) from on-site management. Paradyne is currently offering RMS to domestic customers. With the experience of TIMS and growing experience of RMS in domestic market, the company aims to target the \$110bn global RMS market. We think this growth driver is still a few years away but is definitely a sizeable market to train sights on. Wipro has lately shown growth of as high as 70% in global RMS business segment.

Though TIMS is currently a high revenue-low profit business for Paradyne, it has a significant strategic value for the company.

Company currently has presence in Mumbai, Pune, Bangalore, and Ranchi. It is now office in Delhi to cater to market in the North. It has plans to expand to more cities. It is also expanding its infrastructure to cater to this segment. Geographic expansion and deeper penetration in existing markets to tap untapped opportunities are going to be growth drivers for TIMS segment.

Paradyne is among top 10 Level I turnkey solution providers to Department of IT, Maharashtra Government. Others in the top 10 are IBM, TCS, Wipro, and CMC. These companies can be approached for any work even without tender, though most of the work is awarded through tenders. Paradyne is working on e-governance projects of Maharashtra government. E-governance projects of central and state governments in India will require thousands of crores of rupees to be spent on IT Infrastructure.

Integrated model of infrastructure & software provides more opportunities

Paradyne management is of the opinion that an integrated play of infrastructure and software is crucial for future success, as technologies evolve.

The integrated model has the advantage of offering a complete solution to customer, who does not have to deal with multiple IT companies for their IT requirements. With rapid evolution of technology and rapid obsolescence, reconciling suggestions and offerings of multiple vendors so that they are compatible with each other is difficult for customers for whom IT is not a core area.

This model also offers the company an opportunity to cross sell and up sell its products & services. Paradyne management credits cross selling and up selling for its growth in recent times.

Predominantly domestic focus insulates it from US slowdown and FX fluctuations

Paradyne derives bulk of its current revenues and profits from clients in India. Overseas revenues contributed only 8.7% to its FY06 revenues. As overseas revenues relate to software services segment alone, the right matrix will be look at proportion of software service revenue generated from overseas. This proportion was 43% in FY06. We expect it to reach 50% in FY08 and over 60% in FY10. These are based on organic growth assumptions. Acquisitions, if and when they happen, may change the picture substantially.

Given that less than half of its software services revenues come from overseas and the fact that company has a growing client base in India, it is relatively insulated from any slowdown in IT spending in the US and FX fluctuations. This benefit will, however, pale as we go forward, as the company has plans to substantially increase the offshoring of US software services work.

Paradyne has an STPI unit at Millenium Business Park, Mahape at Navi Mumbai where it does the software development work. It's currently operating at full capacity and is looking at acquiring additional space for about 200-300 seats at Navi Mumbai. The company has not yet decided on buy/lease option, we have however built-in the capex for 300 seats in FY07 in our financial model.



Extension of 10B IT exemption beyond FY09 will be value accretive

We have assumed in our financial model that income tax exemption to STPI units u/s 10B will cease to exist as scheduled at the end of FY09. If this exemption is extended as is the demand of IT industry, it will add about 10% to our fair value estimate.

Significantly under priced even on historical earnings

The stock of the company is significantly under priced even on historical earnings. At the current price of Rs.66, the stock trades at mere 7 times trailing four quarters' EPS of Rs.9.27. This price multiple is very low for a company with significant growth track record and better growth prospects going forward.

On FY08 and FY09 expected earnings, the stock trades at 4.1x and 2.8x respectively. We estimate fair value range of Rs.150-180 per share (point estimate: Rs.165) using discounted free cash flow (DCF) methodology. We have assumed that all 1mn shares reserved for ESOPs will be issued by Mar-09.

Risks / Concerns

Inadequate Disclosures in financial statements

Paradyne discloses revenue break up in annual financial statements under two broad heads of TIMS and software services. Earlier, it used to disclose break up of TIMS revenues into Technology Integration and managed services. It, however, discontinued this disclosure from FY06. The kind of break up it provides does not help provide much helpful insights into its business and trends in it. It should provide break up of TIMS into Tech integration and managed services as it used to provide earlier. It should also provide break up of software services into products and services. In the quarterly results, Paradyne does not even give the elementary segment break-up that it gives in annual report.

On the cost side, it clubs 93% of costs under single head of Material costs, software development, contract and service charges. A break up of this head into material cost (bought out hardware, software, etc), software development expenses, and other heads should be provided to give shareholders an insight into costs and trends in costs.

Significantly high number of shares reserved for ESOPs

Paradyne reserved 1mn shares for Employees stock options recently. Current outstanding shares are 10.9mn. ESOPs currently reserved amounts to 8.4% of the post conversion equity. This is significantly higher. Increase in ESOPs going forward to partly compensate employees has the potential of greatly diluting the per share fair value especially when the stock is greatly under priced.

We do not like the indirect route of compensating employees using ESOPs. It's akin to taking out money from existing shareholders' pocket and giving it to employees. It's the company that should pay its employees and not its shareholders.

Though we take into account dilution from the currently reserved 1mn shares, we have not accounted for any further increase in shares reserved for ESOPs.

Attracting & Retaining IT Professionals is a challenge, as is the case with all IT companies

Attracting and retaining IT Professionals is a challenge for all IT companies including top IT companies. Attrition rates and salaries of IT employees have been rising. The problem is more acute in case of smaller companies. The company has so far managed growth well and claims to have attrition rates under control at around 10-12%. There are also indications to the contrary of late. We



learn that in order to corner large number of personnel, IT companies went overboard in recruiting. This has resulted in all time high bench rates at top-tier Indian IT companies.

Ownership and Management

Promoters held 67.93% stake at end Sep-06. Almost the entire promoters' stake was held by Sarnaik family. There was no institutional holding at end Sep-06.

Key Promoters Annand Sarnaik and Divvyani Sarnaik are MD & CEO and ED & COO respectively. Paradyne's sales & marketing head has over two decade's experience with MNCs like Sun, IBM, HCL-HP. Its global delivery head possesses over a decade's experience in the US. In Nov06, Vedprakash Arya, Director & COO of Pantaloon Retail (India) Ltd, joined as an additional director of Paradyne.

Paradyne also has a global advisory board. It consists of Mr. Arvind Pitre, Dr Rajendra Mohanty, et al. Mr. Pitre possesses wide experience in banking software development. After retiring as head of eh IT department of Bank of Baroda, he was consultant to IT companies like TCS, NCR, ALIT, and Zenith Infotech to help them in developing banking products. Dr. Mohanty is ex-VP (Human Resources) of ACC Ltd. He has published a few books including one on TQM in service sector.

Valuation and key underlying assumptions

We estimate one-year out fair value per share in the range of Rs.150-Rs.180 (point estimate: Rs.165) using the discounted free cash flows methodology. Key assumptions for the valuation are 3% terminal growth rate in NOPLAT, 3% terminal ROIC spread over WACC, Cost of equity at 18.2% based on beta of 1.23 (we chose to build-in scalability risk here), risk free rate of 8.37% and market risk premium of 8%. Fair value range is based on extreme assumptions on key variables like revenue growth in each of its segments, operating margins in each of its segments (taking into account rising cost of personnel). We have assumed that entire 1mn shares reserved for ESOPs will be issued & allotted by Mar-09.

At the current price of Rs.66, the stock trades at mere 5.9 times FY07 expected EPS of Rs.11.20. It trades at just 4.1x and 2.8x expected EPS for FY08 and FY09 respectively. The company, which had D/E of mere 0.2 at end Mar-06, to be complete debt free & cash positive in FY08 in the absence of any acquisition.



Income Statement

Rs. Mn.	Mar-07E	Mar-08P	Mar-09P
Revenues	1194	1589	2045
EBIT	138	206	295
PBT	133	202	305
Adj. PAT	122	185	278
EPS Rupees	11.20	16.29	23.41

Ratios

	Mar-07E	Mar-08P	Mar-09P
Revenue Gr %	37.5	33.1	28.7
EPS Growth %	61.8	45.4	43.7
RoE %	34.0	36.7	37.8
D/E x	0.2	-	-
Receivable days	68	68	68
L&A/Revenues%	3.7	3.7	3.7
Credit days	15	15	15

Balance Sheets

Rs. Mn.	Mar-07E	Mar-08P	Mar-09P
Assets			
Net Block	274	274	274
Net Curr. Assets	220	286	360
Excess Cash	-	25	203
Liabilities			
Equity Capital	109	114	119
Reserves	287	466	720
Debt	87	-	-
Non-Curr. Liab.	11	6	(2)

Interim Performance

Rs. Mn. Months	Dec-05	Mar-06	Jun-06	Sep-06
Revenues	216	230	268	301
EBITDA	19	27	38	46
Depreciation	2	3	3	4
EBIT	17	24	35	42
Interest	2	2	2	3
Other	8	2	1	1
Income				
PBT	23	23	33	40
Tax	4	3	5	6
PAT	19	20	28	34
Eq Capital	109	109	109	109
Ann EPS Rs.	6.83	7.41	10.45	12.37
EBIT Margin	7.8%	10.2%	13.0%	13.8%
Other income/PBT	33.8%	6.9%	2.7%	2.7%
Tax/PBT	17.5%	13.1	15.0%	15.1%
Staff cost/Rev	NA	4.5%	4.1%	4.4%

Multiple Valuation

	Mar-07E	Mar-08P	Mar-09P
EV/EBITDA x	4.7	3.3	2.4
EV/EBIT x	5.6	3.8	2.6
Mkt. Cap/Sales x	0.60	0.45	0.35
P/E x	5.9	4.1	2.8
Price/Book x	1.8	1.3	0.9

Free Cash Flow

Rs. Mn.	Mar-07E	Mar-08P	Mar-09P
NOPLAT	125	188	269
Change in Net Working Capital	63	78	91
Operating Cash Flows	63	110	178
Net Capex & others	153	5	8
Free Cash Flow	(91)	105	171
Non-opr. Cash flow	3	1	9
Cash Flow to Investors	(87)	106	180

Financing Cash Flow

Rs. Mn	Mar-07E	Mar-08P	Mar-09P
Post-tax Interest	7	4	-
Repayment/ (issue) of Debt	(25)	87	-
Equity Share Dividend	12	23	35
Buyback/Redn/ (issue) of equity shares*	-	(33)	(33)
Increase in cash/Investments	(82)	25	178
Financing Cash Flow	(87)	106	180

* Rise in equity due to ESOPs assumed at current price

DCF Valuation

Key Assumptions	Rs. Mn.	%
Terminal Growth Rate		3.0
WACC		17.9
Cost of Equity		18.2
Terminal ROIC		20.9
		WACC+3%
Fair Value Range (Rs.)	150-180	
Per share Value (Rs.)	165	



Important Disclosure

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