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Independent Research - Equities

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Important disclosure on the last page

RS Software (India) Ltd

RS Software is an IT services & solutions company specialised in electronic payments vertical with multi-year client relationship with the world's largest payment network. With $15bn opportunity space in electronic payment vertical and FY12 revenues of mere $50mn, this niche company has a huge & growing opportunity space to create wealth from.

DCF Value Rs.400 | **Current Price Rs.102** | **Potential 4x**

At current price, stock trades at 3.3 times FY13 estimated EPS with expected annual EPS growth of 20% over next two years. Our fair value estimate of Rs.400 implies P/E of 11x FY14E EPS. We estimate its RoCE and RoE to be maintained at over 30%. The company has no debt and has Rs.55cr cash. A company, with FY12 EBITDA of 39cr and expected FY13 & FY14 EBITDA of 54cr & 69cr, is available at an enterprise value of only Rs.62cr.

Key Data

Market Cap	Rs.117 Cr US$21mn
Shares Outstanding	1.15cr
52 wk Hi-Lo	103 – 38
Avg Trading Vol	No. of shares
1 month	296,000
3 months	144,000
1 year	67,000
BSE Scrip Code	517447
BSE Group	B
NSE Scrip Id	RSSOFTWARE
Shareholding%	**31 Mar 12**
Promoters	32.19
FIIs	2.81
DIIs	.16
Others	64.84
Valuation	**FY12**
EV/ EBIT	1.7x
Market Cap/Sales	0.4x
P/E	4.1x

Products

IT Services & Solutions for global Electronic payments industry

Key Investment Points

- Niche focus on high-growth vertical of electronic payments with huge opportunity space
- The world's largest payment network is its largest client and providing increased business
- Geographical de-risking with share of US revenues going down and RoW rising
- Rapidly rising share of digital currency over paper currency in total payments
- Rising complexity of payment systems driving growth
- Change in government regulation of payments is a major growth driver
- Mobile and contact-less payments are emerging opportunity with huge potential given the omnipresence of mobile phones
- Company is moving towards high value-added work
- Data Analytics, a future focus area, has immense growth potential in high-value-added space
- Promoters raising stake via open market purchases and through warrants
- High quality balance sheet with huge surplus cash and no capitalized software or other intangibles

Points of Concern

- Client, geographic & vertical concentration
- Appreciation of rupee vis-a-vis USD to impact rupee margins
- Rising effective rate of income tax
- Dilution via issue of share warrants to the promoter

Introduction

RS Software (RSS), a company with annual revenues of Rs.288cr, is a software services firm that mainly caters to a niche vertical of global electronic payments industry comprising of payment networks like Visa and MasterCard, acquiring processors, issuing processors, credit union data processors, banks, financial software product vendors and emerging players in e-commerce and mobile payments. It has over 20 years' experience in this vertical starting with American Express (AXP) as its first client from the vertical. It started in 1991 by offering software services across sectors including electronic payments. However, over the years, it found its niche in the electronic payments (EP) space and currently all but one client is from the EP space.

RSS strength lies in its core execution engine for payment industry around which it does application development work. It works on software for authorization, clearing and settlement. It develops and manages payment-related applications. Payment solutions include gifts & loyalty, fraud management, residual payment management, and payment gateways.

RSS currently has about 900 employees and it has a development centre at Kolkata. In FY12, it derived 88% of revenues from the USA and balance from rest of the world (RoW).

Investment Arguments

Niche focus on high-growth vertical of electronic payments

Global Electronic payments industry is huge with about $300bn in annual revenues derived from processing of about $41 trillion worth of electronic payments. If a mere 5% of this is spent towards IT infrastructure and services, this gives us an annual opportunity space of $15bn and growing. As against this, RSS's revenues are miniscule $50mn. A small player with specialist and niche focus on such a large opportunity space, RSS has multi-year growth opportunity here. RSS has vision of becoming a full service technology service provider in the space covering all players and all kind of work in this space. As it covers the full spectrum in EP space, it will have multiple dimensions to grow its business.

It competes with large software companies with multi-vertical presence like TCS, Cognizant, and IBM; who are top players in this space. Mahindra Satyam and Wipro cater to MasterCard. Other domain-focused companies are very small in this space.

There is a recurring requirement for software service providers in this space due to:

- Changing policies, processes, procedures, regulations and mandates.
- To keep core data processing systems up and running round the clock
- To migrate to different technology platforms of convenience
- Business continuity support
- To adapt to new security and safety technologies
- Changes in Reward programs
- To accommodate newer robust architecture enabling merchants to sell their products through new channels
- New payment products implementation with emerging technologies

The global leader in electronic payments is its largest client

For reasons best known to RSS, the company does not disclose name of its largest client in any of its publications (website, annual reports, etc). We understand from its past & present employees that Visa Inc, world's largest card payment network, is its largest client accounting for a major portion of its revenues. A multi-year association with such a formidable & growing player in the EP space augurs well for RSS' growth. Cognizant (CTS) and IBM also cater to Visa.

Other major players in the EP space are payment processors like MasterCard International, American Express Company (AXP), and Discover Financial Services (DFS). Then there are transaction processors like American Data Processors (payroll), Global Payments, Heartland Payment Systems, Paychex (payroll) Total System Services, Western Union, EFT Systems, and JCB International.

Geographical de-risking with RoW growth significantly outpacing US growth

The US contributed 87.6% to RSS' revenues in FY12 down from 91.9% in FY11. The dependence on the US revenues has been falling and is expected to fall to 73% in FY14 with revenues from RoW growing significantly faster than that from the US. RoW revenues grew 92% in FY12 and 164% in Q1FY13 on low-base. We expect RoW revenues to grow 100% in FY13 and 65% in FY14. We expect US revenue growth to be 12% and 15% in constant currency in FY13 and FY14.

Rapidly rising share of digital currency over paper currency

Share of digital currency (card payments at merchants, on phone, on internet; mobile payments) has been rising in the total payments. Share of paper currency (currency and cheques) has been falling but is still 85% of all payments. In the US market, cheque volume has been falling at 5-10% per annum. As digital currency snatches market share from paper currency, there will be growth in requirements of software services from EP space in tandem with growth in digital currency. Global e-commerce is rising rapidly and is expected to keep growing at about 20% cagr going forward. The volume and value of electronic payment transactions are expected to grow multiple times over next several years driven by technological advancements and cultural changes that accepts and facilitates the move from paper currency to digital currency. There is a high degree of direct correlation between volume and value of electronic payments and software & IT spend by the industry.

Mobile and contact-less payments is an emerging opportunity

Mobile and contact-less payments have just started to scratch the surface but holds immense potential for growth, as mobile is a ubiquitous medium available with everyone. Despite being around for many years, penetration of cards and internet is still nowhere near that of mobile phones. Mobile phones have the potential to be predominant payment medium in years to come. This throws open a vast avenue for growth for companies like RSS.

Rising complexity of electronic payments drives growth

With rise in number of issuers, merchants, channels with peculiar requirements and kind of cards; electronic payments are becoming complex. The continuously rising complexity requires more software work on a regular basis. Some examples of merchants with peculiar requirements are restaurants (tips payment processing without card); hotels & travels (pre-authorization for card payments). Proliferating channels include point of sales, online, mobile, contactless, phone, pin debit, signature debit, and remittances.

The rapid growth in the electronic payments space across all the segments keep forcing its target customers to constantly rethink their offerings strategy, shorten their time to market, and create the need for a full service provider who can address all the pain points in an integrated manner.

Changing government regulations is a major growth driver

Governments world over has different and changing regulations regarding electronic payments. The industry has to keep adapting its systems and softwares to be in sync with ever changing regulations. Moreover, there are differences in many aspects of regulations in different countries. This requires country-specific customizations. As per RSS, government regulations have been a major growth driver for EP industry and the company.

Moving towards higher value-added work

RSS has been moving up the value-pyramid by increasingly providing high-value-added work to its clients. Recently, it won its first strategic consulting project for card networks. This kind of work is the highest value-added work. The company is also creating intellectual property around its work. Last year, it initiated the process towards creating IP by filing for a patent for a customer acquisition process in the loyalty space as well as for its mobile payment initiative.

Data Analytics presents huge opportunity in high-value-added work

RSS's clients are in possession of valuable data on spending along with spenders' profiles. The data analytics work uses this goldmine of data to slice the data in thousands of different ways to get insights into spending pattern, consumer behavior, spending and consumer trends, etc. RSS has stated that business intelligence & data monetization is one of the focus areas for the company for future growth.

Electronic transactions are creating massive amounts of data stored in data warehouses. Companies do not have the resource-bandwidth to analyze this data and arrive at monetizable business intelligence - and that is where they may go for outsourcing. Analytics however requires a strong combination of technology talent, availability of sophisticated tools as well as good business acumen. So such value-added outsourcing will not be the typical 'grunt-work' or 'data-crunching' work. If RSS can prove its capabilities here, this has the potential to take RSS to a new orbit of probably the highest value-added work in EP space with huge recurring business potential.

Promoters have been raising stake

Promoters have been raising stake in the company via warrants issue and open market purchases. Promoters' stake has been gradually rising from under 20% at the end of Dec-2008 to 32.2% at the end of Mar-12. With conversion of pending 11.6 lac warrants, promoters' stake will go up to 38.4%.

High quality balance sheet with huge surplus cash & no capitalized software

RSS has 61.6% of its capital employed in cash & equivalents as on 31-03-12. Excluding cash balances required for operations, surplus cash & equivalents are 47.5% of the capital employed. It had Rs.55 crores of cash & equivalents on 31-3-12 as against total capital employed of Rs.89cr and market cap of Rs.117cr. This implies enterprise value of Rs.62cr. This compares very favorably with FY12 EBITDA of 39cr, and expected FY13 & FY14 EBITDA of 54cr & 69cr.

We expect the surplus cash to grow to Rs.61cr by 31-03-14 despite building-in expected dividend payout of Rs.5 and Rs.7.50 for next two years (implying dividend yields of 5% and 7.5%). This surplus position is after building-in an expected capex of Rs.35 crore over the next two years on creating facilities to house increasing number of personnel. The actual amount of capex will depend on order inflows.

Unlike many other software companies, there is no capitalized software or other intangibles on the balance sheet except for a minor amount of Rs. 0.7cr.

Risks / Concerns

Client, vertical & geographic concentration

RSS gets bulk of its revenues from a single client and percentage of revenues from this client grew by five percentage points in FY12. Almost entire revenues are from the electronic payment industry and 88% of Revenues are from the US. Top five clients contribute 85% of revenues. This kind of concentration comes with risk in case of any problem with client, in the industry and/or in the geography. RSS is trying to broad-base its client base and reduce concentration. The geographic broad-basing is already visible. The company added two new clients last year with long term contracts and YoY price escalation clause. RSS has been doing business with its largest client for many years with repeat and growing business. The vertical concentration is likely to remain. It currently has 12-15 active clients.

Rupee appreciation vis-à-vis USD

Appreciation of rupee vis-à-vis USD will have an adverse impact on it. On the other hand, depreciation of rupee will have a positive impact. As most of its revenues (~99%) and costs (~72%) are in USD, the impact will be restricted to net forex earnings, which is about 40% of revenues. There is a trend of forex costs to total costs coming down over the last two years. We expect this trend to continue. With this, RSS' susceptibility to forex fluctuations will rise. The company does not do any forex hedging.

For the last three quarters, a good part of its growth is being contributed by growth in INR/USD. Though, with forex expenses at 61% of its revenues, the impact on profits is only to the extent of 40% of revenues.

Quarter Ended	201206	201106	Change	201203	201103	Change	201112	201012	Change	201109	201009	Change
No. of months	3	3	%	3	3	%	3	3	%	3	3	%
Revenues $mn	14.8	12.6	17.3%	14.0	11.7	19.5%	14.1	11.4	23.6%	14.2	11.1	28.0%
INR/USD avg	54.56	44.85	21.6%	50.46	45.38	11.2%	51.18	44.95	13.9%	45.66	45.14	1.2%
Gross Revenues Rs.cr	81	57	42.7%	70	53	32.9%	72	51	40.8%	65	50	29.5%

RSS added to its team in the first quarter resulting in 15% sequential rise in employee cost. The utilization will, however, improve as the year progresses and this will provide cushion against fall in INR/USD in the short-term. We expect and hence have built-in an INR/USD average rate of 53 for FY13 and FY14.

Rising tax rate

RSS' effective average income tax rate is going to rise in FY13 and FY14. It exhausted benefit of accumulated losses in FY12. The tax rate was ~18% in FY11 & FY2. This is going to rise to 26% in FY13. The lower than full rate in FY13 is due to availability of Rs.3.5 cr of MAT credit. From FY14, we expect the company to pay full tax at around 32.5% unless its future seat additions happen in an SEZ.

Share warrants to promoters

RSS promoters have been raising their stake in the company via issue of warrants, which is not in the interest of minority shareholders. A zero debt company with surplus cash does not require funds via equity dilution. To issue warrants to raise promoters' equity in such situation is not fair. Promoters should raise their stake only from open market in such a situation. The conversion of pending 11.6 lac warrants (~10% of existing outstanding shares) will restrict EPS growth. Any such warrant issue in future will be detrimental for per share value.

Ownership & Management

Rajnit Rai Jain, the founder and CMD, owns 32.2% in RSS. He is an ex-chairman of NASSCOM and currently a member of NASSCOM executive council. An MBA from California, he worked in the US software industry before founding RSS. He is supported by a team of experienced professionals.

Valuation and key underlying assumptions

We estimate fair value per share to be around Rs.400 by discounting free cash flows using conservative assumptions.

At current price of Rs.102, stock trades at 4.1 times FY12 EPS of Rs.25.11 and 3.3x FY13E EPS of Rs.31.06 with expected earnings growth of 37% & 17% in FY13 & FY14. The company has no net debt and is cash positive. Our fair value estimate of Rs.400 implies P/E of 11x FY14E EPS.

Financials

Income Statement

Rs. Cr.	FY12	FY13E	FY14E
Revenues	264	359	449
EBIT	35	49	63
PBT	35	53	68
PAT	29	39	46
EPS Rupees	25.11	31.19	36.47

Ratios

%	FY12	FY13E	FY14E
Revenue Gr%	30.0	22.0	20.0
EPS Growth %	23.2	21.6	22.4
RoE %	27.3	26.3	25.8
D/E x	-	-	-
Core Debtor days	95	95	95
CoreCreditor days	43	43	43
OtherLiab/Rev %	24.0	20.0	18.0

Balance Sheets

Rs. Cr.	31Mar12	31Mar13	31Mar14
Assets			
Net Block	12	27	47
Capital WIP	1	-	-
Net Curr. Assets	35	43	53
Surplus Funds	42	55	61
Liabilities			
Equity Capital	11.5	12.6	12.6
Warrant money	1.5	-	-
Reserves	76	113	148
Debt	-	-	-
Non-Current Liab	-	-	-

Interim Performance

Rs. Cr.	Sep11	Dec11	Mar12	Jun12
Months	**3**	**3**	**3**	**3**
Revenues-Net	65	72	70	81
EBITDA	9	12	11	12
EBIT	8	11	10	11
PBT	8	11	10	12
PAT-Adjusted	6.3	8.0	9.6	9.6
Eq Capital	11.0	11.1	11.5	11.5
EPS Rs.	5.71	7.18	8.37	8.35
EBIT Margin %	12.4	14.9	13.7	14.1
Other income/PBT %	(.5)	2.8	6.3	8.5
Tax/PBT %	20.8	27.7	5.0	21.3

Multiple Valuation

	FY12	FY13E	FY14E
EV/EBITDA x	1.5	1.1	0.9
EV/EBIT x	1.7	1.2	0.9
Mkt. Cap/Sales x	0.4	0.3	0.3
P/E x	4.1	3.3	2.8
Price/Book x	1.3	1.1	0.8

Free Cash Flow

Rs. Cr.	FY12	FY13E	FY14E
NOPLAT	28	36	43
Change in Net Working Capital	-1	13	13
Operating Cash Flows	**29**	**23**	**30**
Net Capex & others	-14	28	33
Free Cash Flow	**42**	**8**	**10**
Non-opr. Cash flow	1	3	3
Cash Flow to Investors	**43**	**11**	**13**

Financing Cash Flow

Rs. Cr.	FY12	FY13E	FY14E
Post-tax Interest	-	-	-
Repayment/ (issue) of Debt	-	-	-
Equity Share Dividend	4	3	7
Equity buyback/(issue)	-4	-5	-
Inc / (Dec) in surplus cash/Investments	42	13	6
Financing Cash Flow	**43**	**11**	**13**

DCF Valuation

Key Assumptions	%
Terminal Growth Rate	2.0
WACC	17.7
Cost of Equity	17.7
Terminal ROIC	19.7
Outcome	**Rs.**
Fair Value Per Share (Rs.)	**400**

Important Disclosure

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