11 September 2018

the CornerOffice
Interaction with the CEO

Demand robust; Keep a watch on supply

Upgrading to Neutral

We met with Hexaware's (HEXW) CEO Mr R Srikrishna. Key highlights:

- **The demand environment for services remains robust. Even after closing two large deals within existing accounts last quarter, the pipeline of large deals remains very healthy.**
- **Demand-supply situation in the US local labor market is tight, with unemployment in the technology sector virtually zero – potentially creating a revenue and/or cost issue.**
- **Near-term benefits from a weaker INR will be short-lived. 70-80% will get reinvested into the business, while the remainder may have to be passed on to customers.**
- **HEXW is actively looking to acquire capabilities, especially in the area of customer experiences. These can add 3-4pp to organic revenue growth annually over the next few years.**
- **We are upgrading our price target for HEXW to INR460 (up from INR380), which discounts forward earnings by 18x, in line with peers. Key factors for upgrade in price target are: (1) Bottoming of client ramp downs, (2) Healthy large deal pipeline akin to two wins last quarter and (3) Supportive currency. As a result, we are changing our rating to Neutral from Sell.**

Better win ability and a strong deal pipeline

- HEXW has been able to break into large accounts and expand its pipeline, as: [1] the portfolio of services has grown – HEXW has more to offer to clients, [2] customers are recognizing the improved capabilities, although it took some time for some old customers to acknowledge that, [3] sales communication around the capabilities has also improved materially and [4] clients signing up with HEXW have much bigger wallet shares that can be addressed.
- HEXW had shared two existing-new (EN) deals that it had won, each with a TCV of close to USD100m – one ramping up in 2HCY18 and the other in CY19. The pipeline for such deals remains very strong.

Braced to complement organic momentum with acquired capabilities

- HEXW's growth in the four years under Mr Srikrishna has been entirely organic. The company is now actively looking to acquire niche capabilities, especially in the area of transforming customer experiences.
- Over the next few years, it may end up spending ~USD250-300m in tuck-in acquisitions, which could feed 3-4pp annual revenue growth from the inorganic route, over and above the aspiration of maintaining double-digit organic growth.

Expect benefits from INR depreciation to be reinvested into the business

- Near-term benefits to the operating margin from the depreciation of the INR will be short-lived. HEXW will reinvest the same over the medium term. 70-80% of the benefits will get reinvested into the business toward building capabilities for better growth, while the remaining will be passed on clients as the market resets to newer levels of currency.
- Operating leverage from G&A should continue for a few years, yielding 50-60bp annually. The offshore proportion of revenue is another lever, and then there is a slight room for improvement in utilization which will materialize gradually.

Hexaware Technologies

Mr R Srikrishna
CEO & Executive Director

Mr R Srikrishna (Keech) is CEO of Hexaware Technologies.

Prior to Hexaware, he served in HCL for over 20 years as President of two units – Healthcare and Lifesciences and Infrastructure Services. He was instrumental in growing these units to multibillion dollar businesses.

The year 2014 marked the joining of Keech in Hexaware. Since then, he is dedicated toward delivering world-class services to customers, and ensuring employee satisfaction, thereby creating and sustaining long-term profitable growth.

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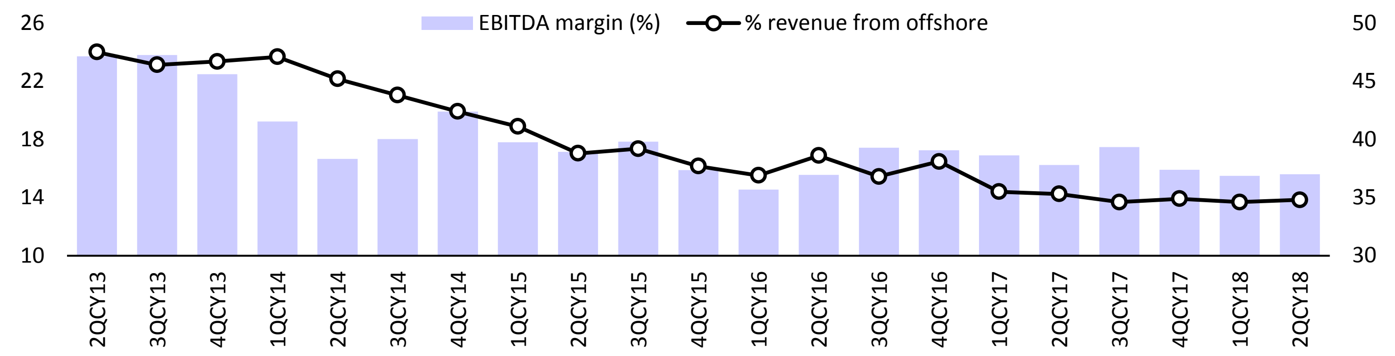
Exhibit 1: Offshore revenue proportion dropped in recent years – may be a lever to margins



US labor market situation poses a key challenge

- Mr Srikrishna cited that the local labor market in the US has tightened considerably, with unemployment in the technology sector virtually non-existent. Combine that with the business compulsions to lower the usage of H-1B visas, this can potentially create pressures on revenue and/or costs. The pressure is not an outcome of Indian vendors hiring locally within the US, but more a function of overall demand-supply dynamics for technology resources.

Churn in top accounts reflective of ability to add to the pool

- While there has been a churn of 5-7 clients into and out of HEXW's top-20 list on a YoY basis, this is more a reflection of the company's ability to keep scaling new accounts into this list than a concern of attrition.
- This is substantiated by the client pyramid, which shows addition of five clients each in the USD1-5m and USD5-10m brackets, three in the USD10-20m bracket, while a client-specific issue led to one client dropping out of the USD20-30m bracket.
- Over the next few years, its mining prowess should further be cemented by taking at least one client to USD100m+ and two more to USD50m+ (HEXW currently has two USD50m+ accounts and no USD100m+ account). While currency too is a tailwind currently, the labor market is a potential headwind. Expect these to set each other off, and margins to remain in a tight band.

Exhibit 2: Client pyramid has been expanding well

Automation will remain the cannibalization agent for a decade

- Cannibalization of legacy IT from Automation is a story that will play out for a decade. That said, it is currently going through a typical hype cycle curve that tends to drive customer disenchantment. Factors that drive customer dissatisfaction are: [1] wrong expectations, [2] client readiness and [3] wrong technology choices.
- That said, the potential for Automation is real, even though it may be overestimated in some areas like App support. A lot of Automation will happen in BPO, IMS and Testing.
- HEXW's 'Automate Everything' is one of its three strategic pillars and it takes the following approach: [1] assess what can be automated, [2] choose the set of technologies, [3] build the business case and establish a pipeline of execution and [4] govern execution.

Valuation view – upgrading to Neutral

- **Automating and cannibalizing:** HEXW's long-term strategic direction of playing a disruptor in Enterprise through technology-led cannibalization can be a rewarding one, but it will need continued investments toward building capabilities in areas like Automation. That said, its traction within its top accounts and strategy to target the top 50-100 accounts of larger peers can help it grab a higher wallet share, if it can achieve the necessary skill sets.
- **Volatility in top accounts…:** Volatility in the performance of top accounts has driven an inconsistent financial performance at HEXW over the past few years. However, strong traction in top-10 accounts has driven robust revenue growth in CY15 and CY16. These accounts contributed 79% of incremental growth in CY15 and 74% in CY16. This cooled off to 28% in CY17 due to a slowdown in two of the top-10 accounts.
- **…mitigated by successful efforts on gaining new accounts:** It has also begun ramping up efforts to win new clients, which gets substantiated by the fact that it won deals worth USD180m in CY17 compared to USD151m in CY16 and USD120m in CY15 from new customers, which was at a fraction of this at end-CY14. The ramp-up of these accounts is evident from the fact that non-top 10 accounts contributed 72% of incremental growth in CY17, a trend opposite of what was seen over the last two years. It is, however, a good sign that HEXW is now able to mitigate top client volatility with traction in non-top customers.
- **Investments yielding results:** Although costs in CY15 increased to a much greater extent than revenue, the same isn't expected, going forward. The company has invested significantly in recent years, substantiated from the doubling of sales & marketing personnel through CY14 and CY15. Although the investment intensity may be lesser than earlier, the ramp-up of new deal wins, onsite-driven growth and continued investments in capability building will cap the upside in margins over the near term.
- **Growth a plus, though payouts are now lower:** HEXW's CMP discounts CY19/20 earnings by 20.3/17.5x. Our CY18-20 USD revenue/earnings CAGR estimate stands at 13/17%. While growth will keep valuations buoyant, we see a re-rating being restricted by the following:

1. The company may not benefit as much as peers in the near term from a depreciating INR, given that it is fairly heavily hedged, and management confirmed the same in its CY18 guidance of EPS growth mirroring revenue growth (in dollar terms) irrespective of currency, and
2. Dividend yield, which was elevated in earlier years, is now below 2% for payout of INR8/share in CY18.

- **Upgrade to Neutral with a TP of INR460:** With top client stress behind, the performance is now back on track, and HEXW is winning large deals, which should drive growth above industry. We are increasing our price target to INR460 (prior: INR380), which discounts forwards earnings by 18x. We, thus, upgrade our rating to **Neutral**.

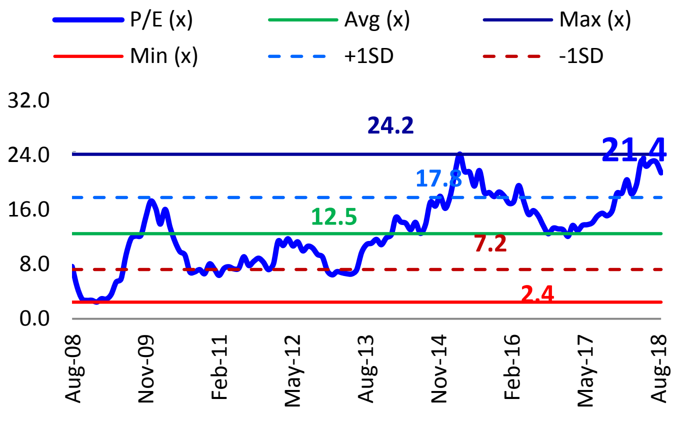
Key triggers

- Large deal wins
- Continued momentum in revenue growth
- Offshore shift lever to margins

Key risk factors

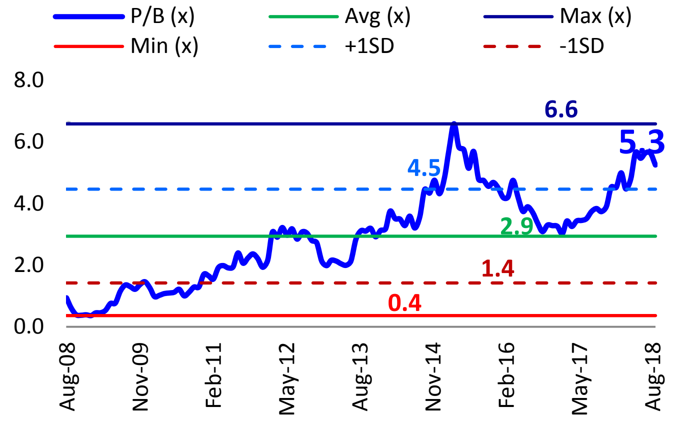
- Lower margins due to investments
- Setback in business from top clients
- Prolonged sluggishness in foot-in-the-door access amid challenging PeopleSoft prospects

Exhibit 3: HEXW one-year forward P/E



Source: Company, MOSL

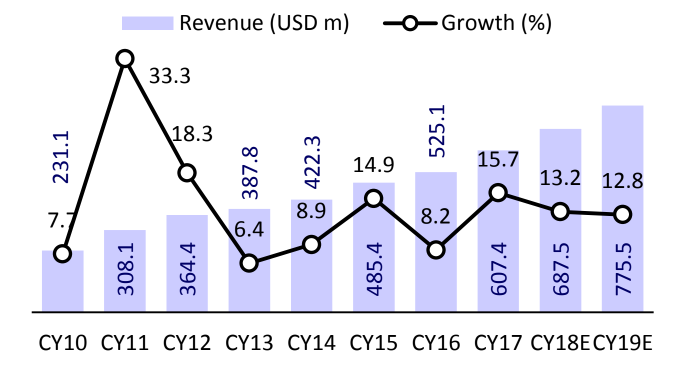
Exhibit 4: HEXW one-year forward P/B



Source: Company, MOSL

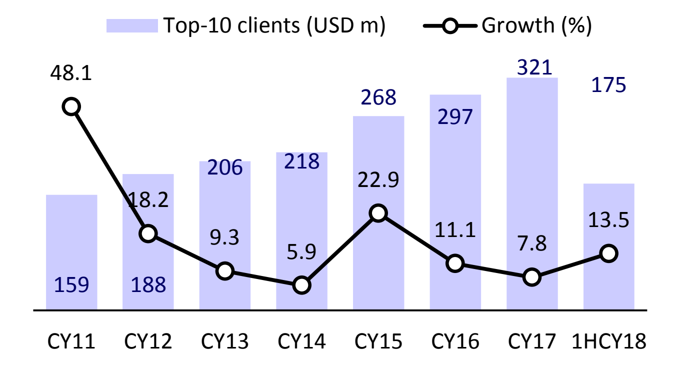
Story in charts

Exhibit 5: Strong visibility of double-digit growth in CY18



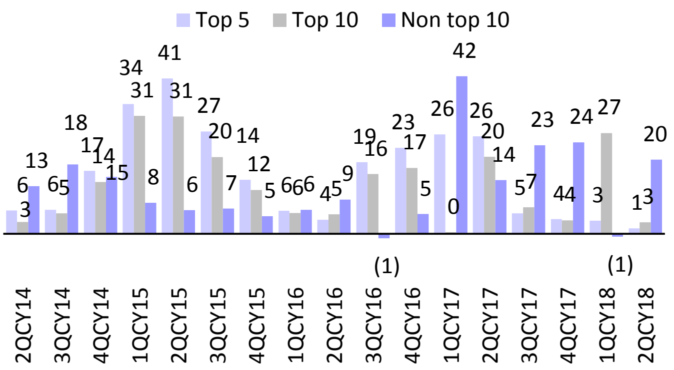
Source: Company, MOSL

Exhibit 6: Performance in top 10 clients has been volatile lately



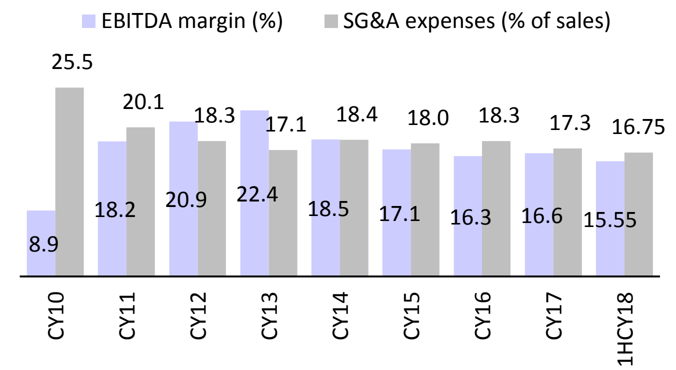
Source: Company, MOSL

Exhibit 7: Lumpy growth in top accounts



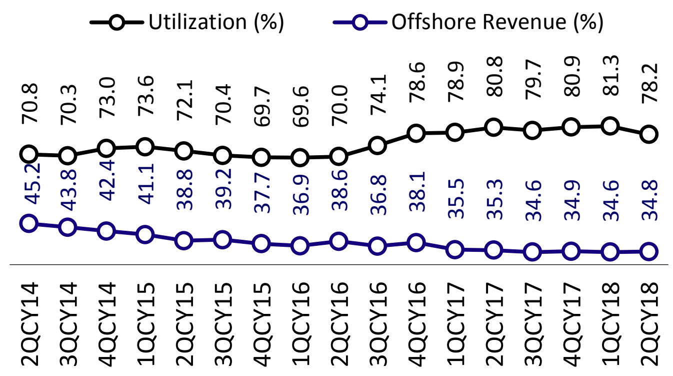
Source: Company, MOSL

Exhibit 8: Investments to drive revenue growth have been a priority over margin growth so far



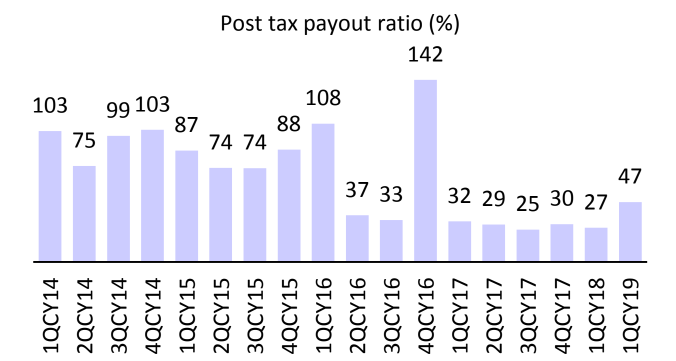
Source: Company, MOSL

Exhibit 9: Utilization is optimal now



Source: Company, MOSL

Exhibit 10: Dividend payout of INR8 per share for CY18E (~40% payout ratio)



Source: Company, MOSL

Operating metrics

Exhibit 11: Operating metrics

	2QCY16	3QCY16	4QCY16	1QCY17	2QCY17	3QCY17	4QCY17	1QCY18	2QCY18
Revenue - Verticals (%)									
Banking and Capital Markets	40.0	41.6	42.1	42.7	43.3	43.4	44.4	43.7	42.8
Travel and Transportation	14.5	14.5	13.2	13.6	13.4	13.2	12.0	13.1	11.1
Healthcare and Insurance	17.1	16.0	16.5	15.7	15.6	16.6	16.7	16.0	17.1
Manufacturing and Consumer				13.6	13.4	13.4	13.9	15.1	16.1
Professional Services				14.4	14.3	13.4	13.0	12.1	12.9
Total	100	100	100	100	100	100	100	100	100
Revenue - Service Lines (%)									
Application Devt & Maint (ADM)	36.9	37.3	36.4	36.1	36.5	36.3	37.2	35.9	36.6
Enterprise Application Services (EAS)	13.2	12.2	12.7	12.1	11.6	11.3	10.8	10.9	10.5
Testing	20.1	20.2	20.9	20.9	19.7	20.0	19.5	19.1	18.4
Business Intelligence & Analytics	15.5	15.2	14.1	13.8	14.0	13.8	13.8	14.2	13.5
BPO	6.5	6.8	6.8	6.4	7.2	7.3	7.0	6.9	7.2
RIMS	7.8	8.3	9.1	10.7	11.0	11.3	11.7	13.0	13.8
Total	100	100	100	100	100	100	100	100	100
Revenue - Geography (%)									
Americas	80.9	82.0	82.5	81.6	80.8	79.1	77.7	75.3	77.0
Europe	12.5	11.6	11.1	11.0	11.2	11.3	12.1	12.5	12.7
RoW	6.6	6.4	6.4	7.4	8.0	9.6	10.2	12.2	10.3
Total	100	100	100	100	100	100	100	100	100
Onsite: Offshore Revenue Mix (%)									
Onsite	63.9	65.6	64.5	66.6	64.7	65.4	65.1	65.4	65.2
Offshore	36.1	34.4	35.5	33.4	35.3	34.6	34.9	34.6	34.8
Client Metrics									
Repeat Business (%)	95.2	95.4	95.4	93.8	93.9	95.3	94.3	94.3	94.3
Clients billed	226	222	220	222	220	218	221	224	226
Clients added	6	7	7	6	9	8	8	5	7
Client Concentration (%)									
Top 1									
Top 5	43.1	47.0	46.3	45.6	46.1	43.5	42.8	42.1	42.4
Top 10	55.2	58.3	57.4	46.7	56.5	54.8	52.9	52.8	52.8
Client Size (Nos)									
More than USD 1 Mn +	76	77	78	81	81	82	88	89	93
Between USD 1 to 5 Mn	62	63	64	67	66	64	71	69	71
Between USD 5 to 10 Mn	6	6	6	6	7	9	7	10	12
Over USD 10 Mn	3	5	3	3	3	4	6	6	6
DSO Days - Billed	46	50	43	46	45	47	49	47	47
DSO Days - Unbilled	74	75	68	74	70	72	71	74	75

Source: MOSL, Company

Exhibit 12: Operating metrics

	2QCY16	3QCY16	4QCY16	1QCY17	2QCY17	3QCY17	4QCY17	1QCY18	2QCY18
Employee Metrics (%)									
Billable Personnel									
Onsite	17	18	19	18	18	18	18	18	19
Offshore	49	47	46	46	46	45	46	46	47
Total	66	65	65	64	64	63	64	64	65
Marketing (Incl. Sales Support)	4	4	3	3	3	3	3	3	3
Others (Incl. Tech. Support)	5	5	5	5	5	5	5	5	5
BPS (Technical)	25	27	27	28	29	29	29	28	28
Grand Total	100	100	100	100	100	100	100	100	100
Total Headcount	11875	11859	12115	12734	13098	13488	13705	14619	15357
Utilization (%)	70.0	74.1	78.6	78.9	80.8	79.7	80.9	81.3	78.2
Attrition Rate (%)	17	17	16	15	14	14	13	13	14
Period Closing rate	68	67	68	65	65	65	64	65	68
Period average rate	67	67	68	66	64	64	64	65	68
Vertical Growth - QoQ (%)									
Banking and Capital Markets	8.7	8.4	4.0	5.7	6.9	1.1	3.7	2.3	1.6
Travel and Transportation	1.0	4.2	-6.5	7.3	3.9	-0.6	-7.9	13.4	-12.1
Healthcare and Insurance	4.1	-2.5	5.9	-0.9	4.8	7.4	2.0	-0.4	10.9
Manufacturing and Consumer					3.9	0.9	5.1	12.9	10.6
Professional Services					4.7	-5.4	-1.7	-3.3	10.6
Total	6.6	4.2	2.7	4.2	5.5	0.9	1.4	3.9	3.8
Service Line Growth - QoQ (%)									
Application Devt & Maint (ADM)	3.2	2.8	3.9	3.3	6.6	0.4	3.9	0.3	5.8
Enterprise Application Services (EAS)	3.5	1.9	0.4	-0.7	1.1	-1.7	-3.1	4.9	0.0
Testing / BTO	5.5	5.3	5.8	4.2	-0.6	2.4	-1.2	1.8	0.0
Business Intelligence & Analytics	9.4	1.6	-4.7	2.0	7.0	-0.5	1.4	6.9	-1.4
BPO	19.4	9.1	2.7	-2.0	18.6	2.3	-2.8	2.4	8.3
Remote IMS	16.8	13.4	7.5	22.5	8.4	3.7	5.0	15.5	10.1
Total	6.6	4.2	2.7	4.2	5.5	0.9	1.4	3.9	3.8
Geography Growth QoQ (%)									
Americas	5.9	5.7	3.4	3.0	4.4	-1.2	-0.4	0.7	6.1
Europe	11.0	-3.3	-1.7	3.2	7.4	1.8	8.5	7.3	5.4
RoW	6.6	1.1	2.7	20.5	14.0	21.1	7.7	24.3	-12.4
Total	6.6	4.2	2.7	4.2	5.5	0.9	1.4	3.9	3.8
Revenue Growth QoQ (%)									
Top 5	7.1	13.7	1.2	2.6	6.6	-4.8	-0.3	2.2	4.5
Top 10	6.4	10.1	1.2	-15.2	27.6	-2.1	-2.2	3.7	3.8
Non Top 10	6.8	-3.0	5.0	30.3	-13.9	4.9	5.6	4.1	3.8

Source: MOSL, Company

Financials and Valuations

Income statement (INR Million)

Y/E December	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18E	CY19E
Sales	**14,505**	**19,482**	**22,854**	**25,817**	**31,235**	**35,349**	**39,420**	**46,631**	**54,549**
Change (%)	37.6	34.3	17.3	13.0	21.0	13.2	11.5	18.3	17.0
Cost of Services	8,939	11,846	13,826	16,278	20,262	23,134	26,049	31,602	36,749
SG&A Expenses	2,920	3,562	3,904	4,763	5,618	6,468	6,817	7,625	8,768
EBITDA	**2,646**	**4,074**	**5,124**	**4,776**	**5,355**	**5,747**	**6,554**	**7,403**	**9,033**
% of Net Sales	18.2	20.9	22.4	18.5	17.1	16.3	16.6	15.9	16.6
Depreciation	248	324	386	440	482	559	633	704	776
Other Income	677	290	58	(90)	173	394	484	660	255
PBT	**3,075**	**4,040**	**4,796**	**4,247**	**5,046**	**5,582**	**6,405**	**7,359**	**8,512**
Tax	407	764	1,004	980	1,114	1,411	1,411	1,491	1,745
Rate (%)	13.2	18.9	20.9	23.1	22.1	25.3	22.0	20.3	20.5
PAT	**2,668**	**3,276**	**3,792**	**3,267**	**3,932**	**4,171**	**4,997**	**5,870**	**6,767**
Extraordinary	-	25	-	(66)	-	-	-	-	-
Net Income	**2,668**	**3,251**	**3,792**	**3,333**	**3,932**	**4,171**	**4,997**	**5,870**	**6,767**
Change (%)	324.2	21.9	16.6	(12.1)	18.0	6.1	19.8	17.5	15.3

Balance Sheet (INR Million)

Y/E December	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18E	CY19E
Share Capital	587	593	601	602	603	604	594	594	594
Reserves	9,575	11,445	11,392	12,304	13,729	16,507	19,510	23,091	26,878
Net Worth	**10,162**	**12,038**	**11,993**	**12,906**	**14,332**	**17,111**	**20,104**	**23,685**	**27,472**
Loan	-	-	205	294	353	475	-	-	-
Capital Employed	**10,162**	**12,038**	**12,198**	**13,200**	**14,685**	**17,586**	**20,104**	**23,685**	**27,472**
Gross Block	6,482	7,192	9,047	9,816	11,648	14,191	12,470	13,563	15,163
Less : Depreciation	1,697	1,993	2,379	2,819	3,301	3,860	4,493	5,197	5,973
Net Block	**4,785**	**5,199**	**6,668**	**6,997**	**8,347**	**10,331**	**7,977**	**8,366**	**9,190**
Curr. Assets	**9,545**	**10,381**	**11,417**	**10,363**	**11,604**	**13,051**	**16,140**	**19,632**	**24,963**
Debtors	2,993	3,649	3,236	3,656	4,406	4,376	7,729	10,314	12,006
Cash & Bank Balance	3,769	1,969	3,011	2,865	3,864	4,126	5,147	6,634	9,833
Other Current Assets	2,783	4,763	5,170	3,842	3,334	4,549	3,264	2,684	3,124
Current Liab. & Prov	**4,331**	**3,616**	**5,839**	**4,336**	**5,520**	**5,798**	**5,349**	**5,956**	**8,324**
Current Liabilities	881	222	53	77	871	364	2,204	2,897	2,897
Other liabilites	3,450	3,394	5,786	4,259	4,649	5,434	3,145	3,059	5,427
Net Current Assets	**5,214**	**6,765**	**5,578**	**6,027**	**6,084**	**7,253**	**10,791**	**13,676**	**16,639**
Deferred Tax	162	73	(48)	175	256	-	1,336	1,643	1,643
Application of Funds	**10,162**	**12,038**	**12,198**	**13,200**	**14,685**	**17,584**	**20,104**	**23,685**	**27,472**

E: MOSL Estimates

Financials and Valuations

Ratios

Y/E December	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18E	CY19E
Basic (INR)									
EPS	8.9	10.9	12.6	10.6	12.9	13.7	16.6	19.5	22.4
Cash EPS	9.9	12.0	13.9	12.1	14.6	15.6	18.5	21.8	25.0
Book Value	34.4	40.3	39.9	42.9	47.4	56.3	66.0	78.6	91.1
DPS	4.0	5.4	11.1	8.5	8.7	5.5	4.0	8.0	8.0
Payout %	43.9	48.7	85.8	77.4	64.5	38.6	23.5	39.9	34.6
Valuation (x)									
P/E	50.9	41.7	36.0	42.9	35.1	33.2	27.4	23.3	20.3
EV/EBITDA	48.2	32.2	25.4	27.3	24.2	22.5	19.5	17.1	13.6
EV/Sales	8.8	6.7	5.7	5.1	4.1	3.7	3.2	2.7	2.3
Price/Book Value	13.2	11.3	11.4	10.6	9.6	8.1	6.9	5.8	5.0
Dividend Yield (%)	0.9	1.2	2.4	1.9	1.9	1.2	0.9	1.8	1.8
Profitability Ratios (%)									
RoE	26.6	29.3	31.6	25.7	28.9	26.5	26.9	26.8	26.5
RoCE	24.3	30.3	33.3	27.6	27.7	24.2	24.6	24.9	26.1
ROIC	35.7	36.9	38.9	34.2	35.9	31.9	32.5	33.4	37.8
Turnover Ratios									
Debtors (Days)	75	68	52	52	51	45	72	81	80
Fixed Asset T/O (x)	3.4	4.0	3.9	3.8	4.1	3.8	4.3	5.7	6.2

Cash Flow Statement (INR Million)

Y/E December	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18E	CY19E
CF from Operations	2,096	2,989	3,217	4,437	4,686	4,927	5,663	5,912	7,288
Cash for Working Capital	(683)	(791)	140	(309)	(755)	(197)	(901)	(1,398)	236
Net Operating CF	**1,413**	**2,198**	**3,357**	**4,128**	**3,931**	**4,730**	**4,762**	**4,514**	**7,523**
Net Purchase of FA	(629)	(741)	(392)	(603)	(1,364)	(2,223)	(957)	(1,093)	(1,600)
Free Cash Flow	**784**	**1,457**	**2,965**	**3,525**	**2,567**	**2,507**	**3,805**	**3,421**	**5,923**
Net Purchase of Invest.	455	(1,743)	(770)	1,796	1,505	249	11	131	147
Net Cash from Invest.	**(174)**	**(2,484)**	**(1,162)**	**1,193**	**141**	**(1,974)**	**(946)**	**(962)**	**(1,453)**
Proc. from equity issues	38	60	79	48	31	13	12	-	-
Proceeds from LTB/STB	(235)	(2)	(2)	(1)	(1)	(1)	(1,380)	609	2
Dividend Payments	(1,258)	(1,956)	(1,333)	(5,400)	(3,172)	(2,506)	(1,428)	(2,874)	(2,873)
Net Cash Flow	**(579)**	**(2,165)**	**1,059**	**(27)**	**1,003**	**262**	**1,020**	**1,666**	**3,578**
Opening Cash Bal.	**4,349**	**4,132**	**1,950**	**2,891**	**2,860**	**3,864**	**4,126**	**5,147**	**6,435**
Add: Net Cash	(579)	(2,165)	1,059	(27)	1,003	262	1,020	1,666	3,578
Closing Cash Bal.	**3,769**	**1,969**	**3,011**	**2,865**	**3,864**	**4,126**	**5,147**	**6,634**	**9,833**

E: MOSL Estimates

Explanation of Investment Rating	
Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	> - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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