Jardine Fleming Research | INDIA
SMALL CAP JIFI NOTE
2 June 1997

BFL Software

RISK/REWARD RATING: UFO

We feel that the company deserves a rating of UFO—this means high risk with high returns in the short-to-medium term.

	Risk: Low	Risk: High
Reward High	Star	UFO
Reward Low	Safe	Dog

Rs m	3/95	3/96	3/97	% CAGR
Sales	126.24	183.64	307.25	56
PBIDT	53.09	60.41	81.71	24
Net	48.96	63.16	60.12	11
EPS (Rs)	8.18	10.54	10.05	11
PER (x)	–	–	8.60	–

Jardine Fleming
India Broking Limited
MUMBAI

It is ...

A developer of software for export, mainly focusing on systems, client servers, networking and Year 2000 re-engineering.

It is interesting because ...

- BFL Software has been one of the fastest-growing software exporters, with over 300% compounded revenue growth during 1994–1996 versus industry growth of about 50%.

- Around 80% of BFL's business comes from offshore services, which are low-risk as billing is on a man-hour basis. Offshore service margins are higher than for on-site services, as employee costs are in rupees. Of late there has been a shift to offshore services due to improving telecom facilities, which allow programmers to work on clients' computers abroad.

- Strong order book with Compaq contributing 20% to total revenue. Contracts with two other large clients expire in December 1999, while a fourth is renewable on a two-yearly basis.

- We feel that with strong growth in software services, the share offers low to medium risk, with high returns in the short to medium term.

Key external drivers

- Government policy towards 100% EOU: In the recent budget, export income has been exempted from MAT (minimum alternate tax). Hence 100% EOUs will stand to benefit in FY98.

- US visa policy: About 60% of Indian software exports have traditionally been in the form of on-site services at client locations. Recently, however, there has been a shift towards offshore project and package development, with the establishment of software technology parks, better communication facilities and visa restrictions imposed by the US and other western countries.

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MARKET CAP
Rs 519 m (US$14 m)

12-MONTH HIGH/LOW
Rs 110/Rs 30

SHARE PRICE
Rs 86.45

TRADED SHARES/ PAST 6 MONTHS
12%

TRADED VALUE/ PAST 6 MONTHS
Rs 59 m (US$1.6 m)

REUTERS
BFLS.BO

Business analysis

Overall	Small			Big	
Market growth				x	Software exports are growing by more than 30% annually.
Market size			x		Exports in FY96 were US$734 m; expected to grow by more than 40% in FY98.

Comment: Traditionally, overseas development has been done on-site. However with stricter visa regulations in the US, which accounts for around 65% of revenue, software exporters are moving to offshore developments .

Market	Low			High	
Customers			x		Four major offshore clients, with Compaq accounting for 20% of revenues.
Consumers			x		Corporations, banks and financial institutions.
Marketing approach			x		Remote login facilities, point-to-multipoint communication, dedicated links, 24-hour global network services.
Repeat business			x		Orders up to 1999 for the second- and third-largest customers, while the fourth-largest contract is renewed on a two-yearly basis.
Cyclicality	x				Frequent upgrading leads to higher growth with less volatility in the overall software demand cycle.
Price sensitivity		x			Offshore business is mainly time- rather than price-sensitive, but cost escalation cannot be ruled out.
Product portfolio			x		Systems, networking, Year 2000, server and emerging technologies.
Geographical distribution				x	Software development in India, but mainly exported to 10 countries.
Growth prospects				x	Strong order book for major international customers coupled with tax exemption under MAT and strong demand growth.
Order book				x	Contracts up to FY99 for the second- and third-largest customers and renewal every two years for the fourth-largest.
Expansion			x		Rs 600 m expansion planned but nothing finalised due to change in management.
Margins			x		Margins are expected to grow as major offshore projects are time based and any cost escalation is passed on.

Comment: High demand growth, strong order book, low cyclicality and tax exemption under MAT will see margins grow in FY98.

Competition	Low			High	
Competitive edge			x		International clientele with growing margins.
Cost competitiveness				x	80% of BFL's business is offshore services where margins are 20%–30%, while on site service margins are lower at 15%–20%.
Differentiation		x			100% export-oriented, with focus on five major areas.
Uniqueness		x			Compaq's first software partner.
Critical success factors			x		Training (5% of engineers' available time)and retaining a steadily rising number of 530 software developers, including maintenance.
Competitors					TCS, Wipro, Tata Unisys, Satyam Computers, Infosys.
Barriers to entry			x		Technological back-up.
New entrants			x		Many small-scale operations, but these have yet to prove their competitiveness.
Substitute products			x		Probably a shift back to paper from computers.
New technology		x			Software development township planned near Bangalore.

Comment: Good margins, manageable competition through tie-ups, technological backup will see growth in bottom line.

BFL Software

Operations	Bad	Poor	Good	Great	
Quality of plant			x		Dust-free office is the main focus as computers are sensitive to dust.
Capacity			x		Servicing Compaq, contributing 20% of total revenue.
Research and development		x			only 5% of engineers' available time is spent on training.
Suppliers			x		Programs developed in-house .
Production time					Turnaround time about six months for OS/2 under emerging technologies group.
Bottlenecks			x		Problems at telecom facilities (64 Kbps link via IntelSat to customers.
Inventory control			x		Programs written in-house and then transmitted through CES/STP/VSNL route.
Distribution method			x		Central earth stations/STP/VSNL and then through 64 Kbps link which connects to IntelSat at 63 degrees.

Comment: There is one workstation for each employee at each development centre. Programs written at this development centre are then transmitted through 64 K bps link via IntelSat to customers.

Management	Bad	Poor	Good	Great	
Management style			x		
Layers of management			x		There are five layers between CEO and system engineers.
Key people			x		B.V. Venkatesh, Balakrishna BG, A. Koppar and 10 other technical professionals. Engineers have from two to eight years' experience, with bachelor's or master's degrees.
Management (% of equity)			x		Bangurs hold their 25%.
Family members					No family member on the payroll.

Comment: Existing managers will continue to play their role in day-to-day management despite Bangurs being in the process of selling their stake.

Financial control	Low			High	
Subsidiary information					NA
Consolidation					NA
Timeliness			x		Reports half-yearly results in November and yearly results in late May or early June.

Drivers	--	–	+	++	
Political			x		[illegible] policy changes expected.
Technological	x				Changes in the technological field are easy to adopt.
Social					–
Environmental					–

Inputs	Low	Medium	High	V High	Value added by inputs
Labour				x	Labour costs represent 34% of total operating cost and 23% of income.

Comment: The industry's highest costs are for personnel and communications, as software is not a tangible asset.

Classification	Dog	Safe	Star	UFO	Comment
Beta box			x		High beta and strong two-year EPS growth.
Cash box		x			RoCE over 25% and modest dividend yield.
Sentiment	x				Many brokers' visits and a steep 200% above its 12-month low.
Valuation	x				High price-to-cash flow and premium to SCI PER.

Comment: We think the company deserves a rating of UFO, which means high risk and high returns in the short-to-medium term.

Economic effects	US	Japan	China	HK	Indon	Mal	Phil	Sing	Taiwan	Thai	S Korea	India	Pak	Sri L
Foreign exchange	x													
Consumption	x											x		
Investment (government)														
Political change	x											x		
Interest rates														

Comment: The US alone provides 65% of India's software export revenues. Hence any change in visa policy will affect on-site programming work.

Financial data

Rs m	3/94	3/95	3/96	% CAGR	Comment
Profit and loss					
Sales	10	126	184	334	One of the fastest-growing software exporters in India.
EBIT	1	51	76	659	Mainly internal efficiencies.
Net interest	0	–3	–18	–	Mainly for expansion.
Tax	0	0	5	–	
Net earnings	1	49	63	590	Spectacular.
EPS (Rs)	0.24	8.18	10.54	557	Best increase in the sector over two years.
DPS (Rs)	0.00	3.50	3.75	–	
Cash flow					
EBIT	1	51	76	659	
Depreciation	2	5	9	124	
Working capital	–19	–74	–116	146	
Operating cash flow	–16	–23	–89	135	
Capex and other investments	–31	–12	–34	4	Office equipment to be paid for.
Free cash flow	–47	–36	–122	61	
Financing	53	95	77	20	
Change in cash	6	59	–46	–	
Balance sheet					
Cash and equivalents	6	66	20	76	
Receivables	7	96	90	252	Internal efficiencies.
Investments	0	0	0	–	
Inventory	0	4	10	522	Not a worry.
Non-current assets	32	44	77	57	Office equipment, space.
Others	9	26	160	331	
Total assets	54	236	357	157	
Short-term debts	0	8	0	–	
Payables	4	32	29	188	
Long-term debts	0	89	166	–	
Miscellaneous	0	22	36	–	
Shareholders' equity	51	85	126	58	
Total liabilities	54	236	357	157	
Interest rates (%)	15.00	16.50	14.50	–2	
Operating margin (%)	20.46	42.05	32.90	27	Decline in margins in FY96 and FY97. FY98 should look up.
Non-current assets/sales (%)	323.92	34.69	42.10	–64	
RoCE (%)	3.95	30.55	20.71	129	Volatile returns. Value investors at management level should help.
Net income/sales (x)	0.14	0.38	0.32	52	
Sales/assets (x)	0.18	0.54	0.51	69	Time lag between acquiring space and sales pick-up, due to telecom bottlenecks.
Assets/equity (x)	1.07	2.79	2.84	63	
RoE, pre-tax (%)	2.62	57.28	46.06	319	Volatile.
Total debt/equity (%)	0.00	114.85	131.96	–	Capitalising on growing industry.
Net debt/equity (%)	–12.68	37.35	116.11	–	
RoE/RoA, both after-tax (x)	1.07	2.79	2.84	63	
Dividend/FCF (x)	NA	0.00	–0.17	–	
FCF per share (Rs)	NA	–5.95	–20.42	–	Poor due to cash outflow for space.
P/FCF per share (x)	NA	–14.54	–4.23	–	
NAV/share(fully diluted)	9.32	14.13	21.00	50	