ZENSAR TECHNOLOGIES IS A STRONG OPERATOR WITH A STRONG GROWTH OUTLOOK, A HEALTHY BALANCE SHEET, A CHEAP VALUATION AND INSIDER BUYING

Zensar Technologies Limited
Ticker: BSE: 504067 | NSE: ZENSARTECH
Rating: Buy
FY2015 No Growth Price Target: ₹424.34

6/6/2014
Price: ₹373.50
Position Size: 5%
FY2015 5% Growth Price Target: ₹584.75

INVESTMENT THESIS

Zensar Technologies is an Indian IT services company generating a strong ROIC relative to its cost of capital (franchise value ≈ 2) with a net cash position (13% of Enterprise Value and 61% of operating profit). Despite Zensar's business strength and financial strength, the company is trading at a significant discount to intrinsic value and peers, due to unfounded concerns over corporate governance, and weakness in its Infrastructure Management Services division after an acquisition doubled the business' size causing integration pains.

Assuming no growth and mid-cycle operating margins (12%), there is still double digit upside. Management expects mid to high teens revenue growth over the next few years and operating margins expansion from FY2014 13.7% to 15.0%. Despite the strong growth outlook and the potential for margin expansion, Zensar Technologies offers 21.5% pre-tax FY2014 operating profit twice the current local AAA yield.

Zensar warrants a 5% initial position, which is a smaller position than PC Jeweller due to an industry average ROIC rather than a industry leading ROIC, smaller upside to no growth/mid-cycle margin target price, and weaker capital allocation.

KEYS TO EVALUATING A BUSINESS

1. The certainty with which the long-term economic characteristics of the business can be evaluated

Zensar's industry and business show high ROIC and low variability of ROIC. Continued growth in the industry subdues competitive pressures and high switching cost among customers locking in client relationships creating an environment for high profitability. The growth in the industry is expected to continue as small and medium size business start taking advantage of labor arbitrage, increase digitalization require IT services solutions, and Emerging Markets companies and governments increase the usage of IT services to increase efficiencies.

Zensar's management expects mid to high teen revenue growth and a few percentage points of margin expansion over the next few years, which should lead to higher earnings power eliminating concerns of business risk.

2. The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows

Over the past 10 years, management grew Zensar's revenue by 24% per year and operating profit grew by 37% per year, due to an additional 1% per year of margin expansion.

Rs mn	FY2005	FY2014	CAGR	Comments
Revenues	3,449	23,350	24%	
Operating Profit	184	3,199	37%	
Operating Margin	*5.3%*	*13.7%*	*0.9%*	pp inc per year
Invested Capital	972	8,319	27%	
Book Value + Dividends Paid	1,530	10,775	24%	
Enterprise Value + Dividend Paid	1,751	15,897	28%	

Source: Company data

Zensar has carved a niche as a company known for creating strong relationships with employees and customers. CEO Ganesh Natarajan is known for being available to employees and customers at any time of the day or any day of the week. Zensar's HR department wins awards on an annual basis and is one of the best in the industry. Clients cited the flexibility in service and product as a key to working with Zensar over tier 1 IT consulting firms.

3. The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself;

Management's salary is high at 4.4% of operating profit, which is on par with similar size companies within the industry. Management's strong operating performance and the CEO adding value as a brand ambassador probably warrant high salaries. As management continues to grow the company, salaries will decrease as a percentage of operating profit.

5 Year Average	Zensar	TCS	Infosys	Wipro	Tech Mahindra	HCL	Hexaware	Mindtree	Sonata
Total Management Salaries	110	144	500	224	59	155	180	72	4
Management Salaries % of Operating Profit	5.3%	0.1%	0.5%	0.3%	0.6%	0.6%	7.8%	3.7%	3.5%
Most Recent Annual Report	**Zensar**	**TCS**	**Infosys**	**Wipro**	**Tech Mahindra**	**HCL**	**Hexaware**	**Mindtree**	**Sonata**
Total Management Salaries	134	201	720	264	91	229	208	96	4
Management Salaries % of Operating Profit	4.4%	0.1%	0.6%	0.3%	0.7%	0.4%	4.4%	2.5%	4.4%

Source: Company data

Zensar's capital allocation has been decent but not spectacular. 29% of cash inflows since FY2005 have been invested back into the business, 24% have been repaid to shareholders in the form of dividends and share buybacks and 45% were used for acquisitions. These acquisitions were close to fair value with strategic merit, but relative to the cost of building the capabilities in-house, it was very expensive.

Zensar Capital Allocation (Rs mn)	Cumulative FY2005-FY2013	% of Cumulative Cash Inflows	% of Cumulative Sales
Sales	**90,846**	**772%**	**100%**
Operating Profit	10,834	92%	12%
Cash Flow from Operations	**10,270**	**87%**	**11%**
Debt Issuance (Repayments)	1,504	13%	2%
Total Cash Inflows	**11,773**	**100%**	**13%**
Working Capital Investments	(1,914)	-16%	-2.1%
Capex	(1,474)	-13%	-1.6%
Other Investing Cash Flows	(5,274)	-45%	-6%
Dividends Paid	(1,353)	-11%	-1%
Share Issuance (Repaid)	(364)	-3%	0%
Other Financing Cash Flows	(274)	-2%	0%
Excess Cash	**1,121**	**10%**	**1%**

Source: Company data

Zensar's management maintains a very healthy balance sheet with a consistent net cash position, the industry requires very little capital investment, ensuring no risk of the business going bankrupt and there is potential for buybacks or strategic acquisitions.

Management does not own a large percentage of shares but has two performance-oriented shareholders in the form of Chairman Harsh Goenka, Chairman of RPG Enterprises and Electra Partners, a London listed private equity firm with extremely strong performance over the past ten years.

4. The purchase price of the business

Zensar current operating profit yield is 21.5% and a mid-cycle margin operating profit yield of 18.8% despite management expectations of double-digit sales growth, margin expansion and low capital requirements.

The company is cheap due to corporate governance concerns, US dollar revenue growth concerns, and weakness in the company's Infrastructure Management business. Concerns are not warranted, as Zensar has not had a related party transaction over the past six years, the largest shareholder (RPG Enterprise aka Swallow Associates) is focused on improving corporate governance structures, and a London listed private equity firm (Electra Partners) with strong performance over the past ten years continues to hold a large percentage of the firm. It is on par with the rest of the industry in returning cash to shareholders and it holds the least excess cash and most operating assets in the industry.

A recent acquisition (FY2011) has subdued performance in its Infrastructure Management Services division, US dollar growth has stagnated and management is continually over optimistic. These issues may or may not work themselves out but at an 18.8% mid-cycle margin operating profit yield, almost twice the local AAA Corporate Bond yield; you are compensated for these risks. If the company is able to meet management's expectations of mid teen revenues growth and expected margin expansion, intrinsic value is 154% higher than Zensar's closing price on June 6, 2014.

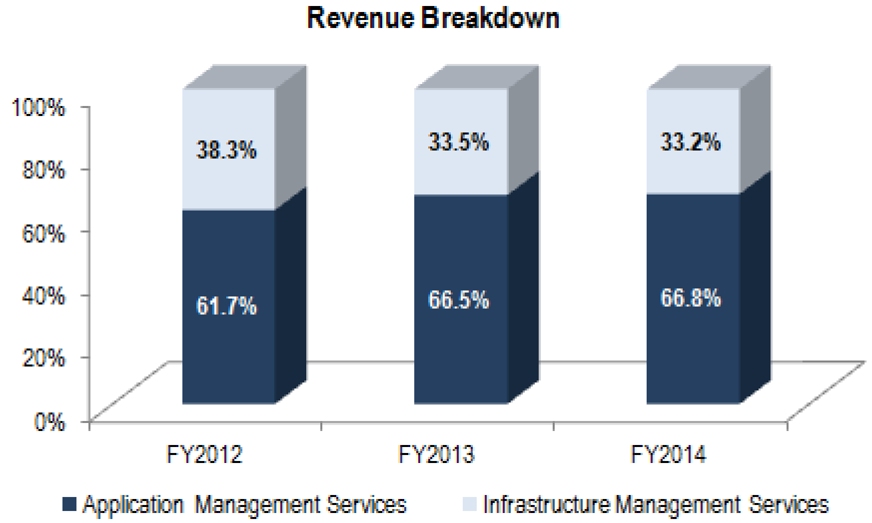
COMPANY DESCRIPTION

HISTORY

Based in Pune, Zensar Technologies Limited is among top 20 software service providers in India. Zensar was established in 2001 as a joint venture between RPG Enterprises and Fujitsu. With employees around the globe, the company's 6500+ associates help 400+ customers solve strategic issues. Zensar is the world's first enterprise-wide SEI CMM Level 5 Company.

Zensar's service portfolio ranges from the traditional to the transformational spreading across service lines of Management Consulting, Business Application Services, Enterprise Solutions, Enterprise Collaboration Services, Testing and Assurance Services, BPM and Infrastructure Management Services.

Zensar operates two segments: Application Management Services and Integrated Management Services.



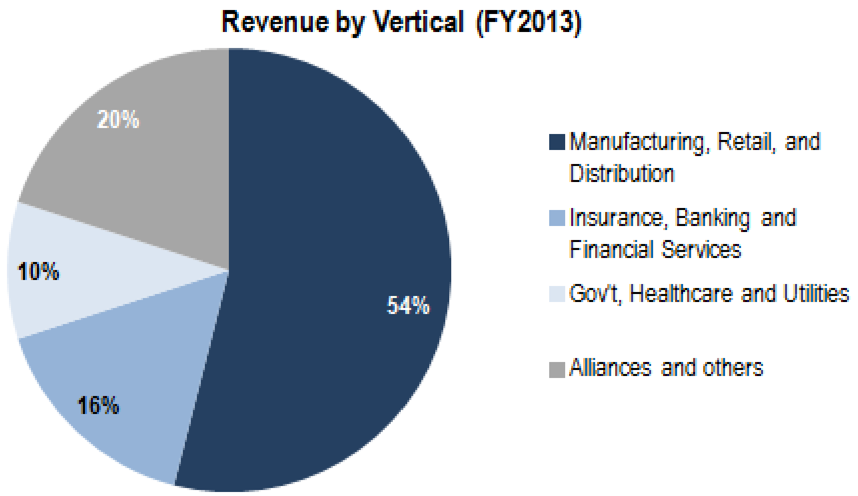
Source: Company data

Application Management Services accounted for 66.8% of revenues in FY2014. Zensar's Application Management Services unit offers total outsourcing, application development and integration, application support and maintenance, and application migration and modernization.

Zensar's Infrastructure Management Services deliver solutions that improving the availability, reliability and performance of data center, network and security infrastructure including data centers, end user computing, remote infrastructure management and security and compliance. In FY2011, Zensar acquired Akibia for $66 million improving the depth of the company's infrastructure management services solutions.

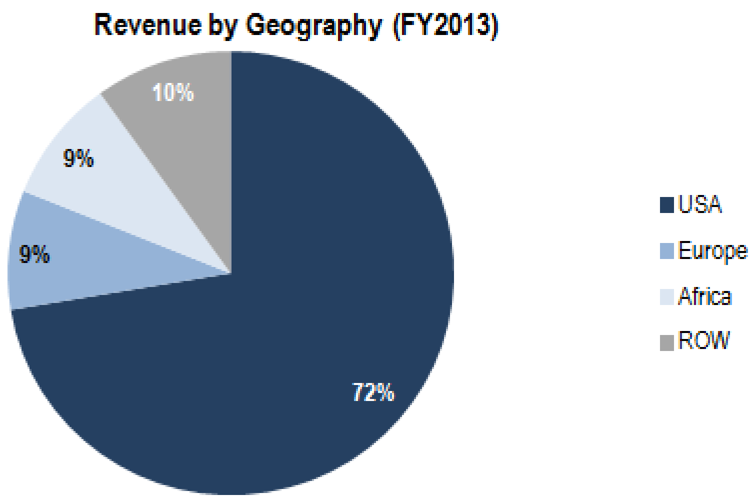
Zensar has strong partnerships with OEMs like SAP, SFDC, Oracle and Microsoft providing the company with the capabilities to meet all the technology needs of an enterprise. Zensar is an Oracle Platinum Partner and a SAP Gold Partner.

The company's strategy focuses on providing application management and infrastructure management services to clients by vertical meaning consultants and salespeople are experts within each vertical. This gives the company a strong understanding of clients' processes and pain points.



Source: Company data

Zensar's strongest and fastest growing vertical is Manufacturing, Retail and Distribution at 54% of revenues in FY2013 up from 49% in FY2012. Manufacturing and retail are driven by enterprise applications such as Oracle and SAP.



Source: Company data

Zensar generates the majority of its revenues in the US (72% in FY2013 & FY2012). The company's fastest growing region is Africa where Zensar is the one of the three largest IT company's in South Africa and the company received recognition for the largest SAP revenue generation in the MENA region.

SHAREHOLDERS

Promoters	Current Holding (%)
Swallow Associates Ltd & subisidaries	**48.28**
Non-promoters	**Current Holding (%)**
Electra Partners Mauritius Ltd	23.54
Fidelity Mangement & Research Company	8.00
Ganesh Natarajan	1.43
Total	**32.97**

Source: Company filings

On March 28, 2012, Swallow Associates purchased shares from RPG Enterprises. There was no change in control as Swallow Associates and subsidiaries have the same chairman as RPG Enterprises, Harsh Goenka. Via RPG Enterprises, Mr. Goenka was an initial investor in Zensar in 2001 with Fujitsu and Electra Partners. In 2007, RPG bought out Fujitsu's stake in 2007 for an undisclosed amount. Electra Partners increased its stake by over 2% since its original purchase.

Rama Prasad Goenka, father of Harsh Goenka started RPG Enterprises in 1979. He grew the group through acquisitions from Rs600 million in revenues in 1979 to RS60 billion in 1995, when he retired. At retirement, Mr. Rama Goenka handed the Chairmanship to his eldest son Harsh Goenka. When Mr. Harsh Goenka took over the group he and his brother, Sanjiv Goenka, consolidated group businesses across sectors. In the late 1990s, the group had financial problems due to a combination of liberalization leading to higher competition and acquisition of companies with leveraged balance sheets leading to high interest costs. Due to these problems, RPG Enterprises went through a period of restructuring and realignment. In 2011, Rama Prasad Goenka split RPG Enterprises into two groups with Harsh Goenka running the tire, infrastructure, technology and pharmaceutical businesses, while Sanjiv Goenka runs the Power, Carbon Black, Retail and Entertainment businesses.

Zensar is an important part of RPG's conglomerate. As illustrated below, Zensar accounts for 13% of RPG's FY2014 revenue and 35% of RPG's FY2014 profit before tax.

Company	Industry	RPG Ownership	FY2014 Sales (Rs mn)	FY2014 PBT (Rs mn)	% of RPG Sales	% of RPG PBT	Current Market Cap (Rs mn)
Zensar Technologies	**IT**	**48.3%**	**23,350**	**3,399**	**13%**	**35%**	**16,755**
CEAT	Tires	57.1%	55,540	4,032	37%	49%	15,127
KEC International	Infrastructure	49.4%	79,018	1,551	46%	16%	30,956
RPG Life Sciences	Pharmaceutical	61.4%	2,216	5	2%	0%	1,313
Harrisons Malayalam Ltd	Agriculture	50.3%	3,499	35	2%	0%	1,140

Source: Company data

In addition to being an important asset for RPG, RPG continues to increase its stake in Zensar with seven different share purchases over the past year.

Date	Shareholder	Action	Shares	Price	Amount (Rs mn)
23-Mar-14	Swallow Associates (Instant Holdings)	Buy	2,451	397.39	0.97
14-Mar-14	Swallow Associates	Buy	12,400	385.89	4.79
10-Mar-14	Swallow Associates (Instant Holdings)	Buy	6,866	382.61	2.63
5-Mar-14	Swallow Associates	Buy	8,791	398.59	3.50
24-Dec-13	Swallow Associates (Instant Holdings)	Buy	1,500	345.33	0.52
3-Dec-13	Swallow Associates (Instant Holdings)	Buy	5,402	333.58	1.80
20-Jun-13	Swallow Associates (Summit Securities)	Buy	5,500	256.73	1.41

Source: Company filings

The next largest shareholder is Electra Partners Mauritius with a 23.54% ownership stake in Zensar. Electra is a private equity firm in the UK listed on the London Stock Exchange. The company has over 25 years of experience investing over £4.1 billion in over 200 deals. Over the 10 years ending 31 March 2014, Electra's dilute NAV per share has increased 260% and its share price has increased 268%.

IT SERVICES INDUSTRY

MARKET SIZE AND OUTLOOK

The National Association of Software and Services Companies (NASSCOM), the Indian business process outsourcing and software services industry association, estimates Indian IT-BPM industry is reached $118 billion in FY2014 employing over 3 million workers making the Indian IT-BPM industry the largest private employer. The industry generated $86 billion outside of India.

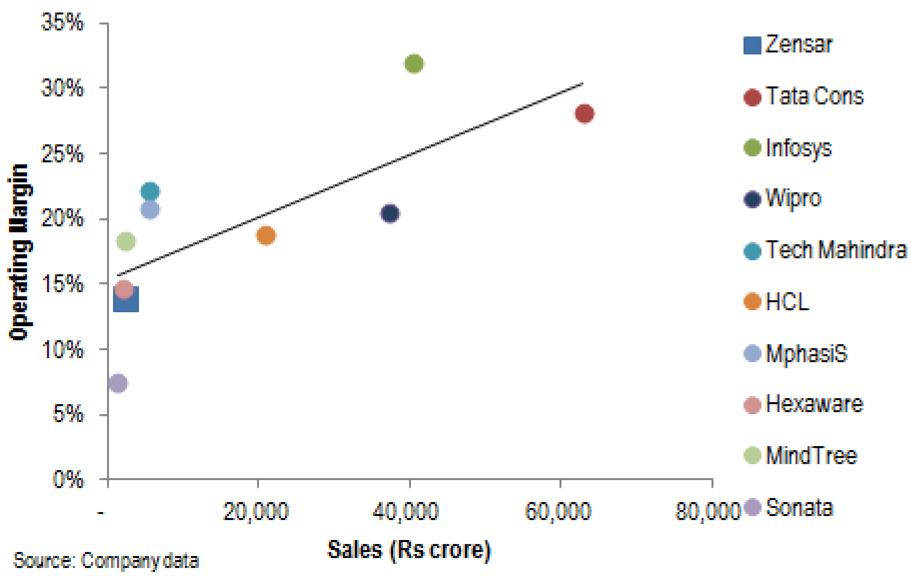
NASSCOM believes industry revenues will reach $300 billion by 2020, representing a 17% compound annual growth rate over the next six years. NASSCOM believes 80% of the growth will come from outside of current core markets in new customer verticals (small and medium size businesses), new geographies (BRIC), and new verticals (media, public sector and healthcare).

COMPETITION

According to NASSCOM, there are 16,000 firms in the Indian IT services industry creating significant amounts of competition with the largest competitor is Tata Consultancy generate Rs629.89 billion in revenues. According to NASSCOM's 2013 industry rankings, Zensar was the 19th largest IT Services firm.

BARRIERS TO ENTRY

Zensar is a smaller IT services company at a disadvantage as the large Indian IT companies have pricing premium due to brand differentiation and switching costs. As illustrated below, operating margin seems to be related to the size of the firm evidence of economies of scale or brand associated with size.



Source: Company data

With 16,000 firms in the Indian IT industry economies of scale is not a significant driver in the industry. If economies of scale were present, the number of firms within the industry would be significantly lower as high fixed costs would create a high minimum efficient scale and drive many of these firms out of business. The cost structure of the industry would also point to low levels of fixed costs within the industry as an employee expense and other variable costs make up almost 100% of costs.

A more reasonable explanation for the size and margin relationship is the brand value of the larger players allows for a pricing premium. The product offering is an experience good and is crucial to the performance of the customers' business leading to brand and the perception of the product being crucial to success within the industry. The larger IT services firms have worked with some of the largest companies in the world providing a signal quality of a product. The larger companies can also hire the best talent. Both lead to higher margins for larger companies as these companies do not compete on price. Tata Consultancy believes its brand is valued at $8.2 billion, the highest in the industry.

Economies of learning and switching costs also allow firms to generate excess profits.

OTHER FOUR FORCES

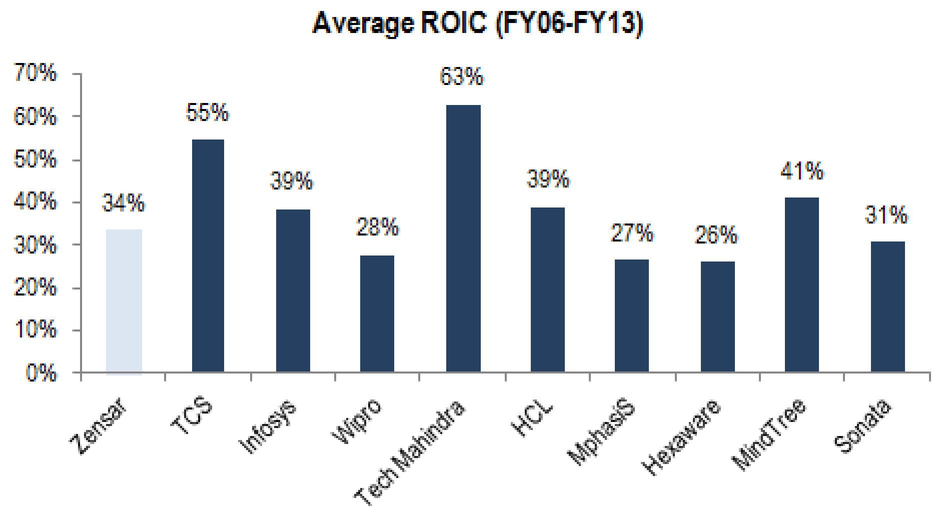
Intensity of rivalry is medium. The traditional labor cost arbitrage is commoditized and there are a diverse set of competitors. The projected growth in the industry, the presence of switching costs, the low level of fixed costs, and the ease of exit all lower competitive rivalry.

Bargaining power of suppliers or potential employees is low. Employees are fragmented and there pool of talent available is large.

Bargaining power of customers is medium. There are a large number of competitors to choose from and competitors outside of the top tier are willing to compete on price. The importance of the product to a customer, presence of strong brands and switching costs decrease customer bargaining power among top tier firms.

Threat of substitutes is low. The infrastructure to compete with Indian IT services firms is not existent in any other countries. The only credible threat is backward integration to an internal strategy department but the economies of learning and existing infrastructure means Indian IT services firms offer a strong value proposition. In 2008 alone, NASSCOM estimated the Indian IT services industry saved customers $25 billion.

Overall, the industry is very attractive. Between FY2006-FY2013, the average return on invested capital of tier 1 and tier 2 firms was 38%.



Source: Company data, Reperio Capital estimates

KEY INDUSTRY TRENDS

There are a few key trends within the industry

1. Shift from labor cost arbitrage to more value added service
2. Increase in demand for Social Media/Digitalization solutions
3. Shift in contract pricing from fixed pricing to outcome based pricing
4. Increasing demand for IT Services from the untapped Small and Medium sized businesses

ZENSAR'S STRATEGY

Given the disadvantages of smaller IT firms, Zensar understands it cannot adopt "me too" strategy and generate industry average returns, therefore the company differentiates itself by the strength of employee relationships and customer relationships.

Zensar's HR strategy is highly regarded in the industry winning numerous awards. In FY2013 alone, the Dataquest Best Employer Survey acknowledged Zensar for its exemplary human capital management and AIMA global forum acknowledged Zensar for Human Capital Innovation for participatory management and leadership. The company also won the Asia Pacific HRM Congress Award in the CEO category, and the National Award in Global HR Strategy at the World. Zensar won numerous awards annually for HR management. Zensar sees employees as family members called Zensarians. CEO Ganesh Natarajan gets to know many of the company's employees closely. This creates a family like atmosphere and lower turnover. Zensar's retention ratio target is 5-6% below the industry with FY2012 and FY2013 retention ratio is 87% and 88% respectively.

Tier 2 players, such as Zensar, are known for providing more customized service. Tier 1 players charge for every additional service and try to standardize processes. Tier 2 players are more willing to provide additional services without charging. Customers have highlighted Zensar and Mr. Natarajan for being adaptive and willing to hear customer concerns. Customers stated Mr. Natarajan is always available to them. Tier 2 players make for friendly competition against tier 1 players, accept smaller minimum project sizes allowing smaller companies to generate savings from IT services, and can ramp projects faster.

To illustrate the strength of Zensar's strategy, the company won the Porter Prize for the Best Strategic Management practices in the Information, Media and Telecom Industry 2012. The Porter Prize, named after strategy guru Michael Porter, is awarded by the Institute of Competitiveness in India to the company for "creating a competitive advantage by aligning its strategy to customer centricity and continuous innovation".

MANAGEMENT TEAM

Zensar CEO Ganesh Natarajan was hired in February 2001, when the company was in financial distress after missing the Y2K trend. He was a turnaround expert after growing Aptech Ltd from a small unsuccessful computer company to a profitable leader in the field.

OPERATING PERFORMANCE

Since 2005, Mr. Natarajan helped growth Zensar's revenues from Rs3,449 million to Rs23,350 million at the end of FY2014.

Rs mn	FY2005	FY2014	CAGR	Comments
Revenues	3,449	23,350	24%	
Operating Profit	184	3,199	37%	
Operating Margin	*5.3%*	*13.7%*	*0.9%*	pp inc per year
Invested Capital	972	8,319	27%	
Book Value + Dividends Paid	1,530	10,775	24%	
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Source: Company data

Zensar's CEO and management have done a fantastic job of growing the company's key accounts including revenues, operating profit, and operating margin. Despite, consistent performance and economic profits the company's pre-tax profit yield doubled over the same period.

CAPITAL ALLOCATION

Zensar Capital Allocation (Rs mn)	Cumulative FY2005-FY2013	% of Cumulative Cash Inflows	% of Cumulative Sales
Sales	**90,846**	**772%**	**100%**
Operating Profit	10,834	92%	12%
Cash Flow from Operations	**10,270**	**87%**	**11%**
Debt Issuance (Repayments)	1,504	13%	2%
Total Cash Inflows	**11,773**	**100%**	**13%**
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Other Investing Cash Flows	(5,274)	-45%	-6%
Dividends Paid	(1,353)	-11%	-1%
Share Issuance (Repaid)	(364)	-3%	0%
Other Financing Cash Flows	(274)	-2%	0%
Excess Cash	**1,121**	**10%**	**1%**

Source: Company data

From the beginning of FY2005 to the end of FY2013, Zensar cumulative revenues were Rs90.85 billion, generating Rs10.27 billion in cash flow from operations. The company also raised Rs1.5 billion in debt for cumulative cash inflows of Rs11.77 billion. 29% of cash inflows or 2% of revenues went to capital investment illustrating the business does not require a lot of capital.

Acquisitions

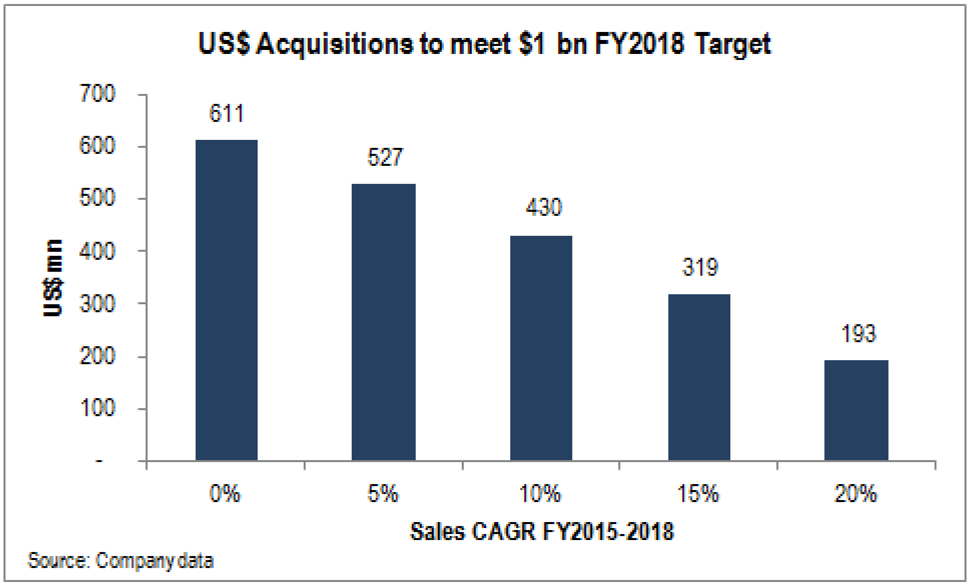
Zensar largest capital allocation was to other investing cash flows, in particular acquisitions, which accounted for 45% of capital inflows. Zensar's largest acquisition came in FY2011. When the company acquired Akibia, Zensar paid $66 million (Rs2.98 billion @ 45.13 USDINR rate) for $100 million in revenues, $7.4 million in EBITDA and over 300 associates. Zensar's depreciation to revenues averaged 2.5% over the last 10 years so EBIT is assumed to be roughly $5 million. The Akibia acquisition strengthened Zensar's Infrastructure Management Services division, which is one of the fastest growing segments in the market. Unfortunately, Zensar slightly overpaid with an acquisition multiple of 0.66x sales, 8.92x EBITDA, 13.2x EBIT, and $220,000 per employee acquired. The acquisition looks particularly expensive when compared to the internal capital investment requirements of $0.31 to generate a $1 of EBIT internally.

Near the end of FY2007, Zensar acquired ThoughtDigital, a New York based software firm specializing in Oracle applications for $24.9 million (Rs1.1 billion @ 44.01 USDINR rate). Zensar acquired $27 million in revenues, $3 million in operating profit, 120 Oracle consultants, and a company with strong capabilities in the financial services and media verticals. Although the acquisition filled holes in Zensar's portfolio, it seems expensive at $0.92 per $1 of revenues acquired when internal capital investment requirements were $0.037 per $1 of revenues generated. Zensar paid 8.3x operating profit and $207,500 per employee acquired.

In FY2006, Zensar acquired OBT Global, a US-based provider of SAP solutions, for an undisclosed amount. The acquisition provided Zensar with a platform to enter and consolidate the SAP services business and 150 employees.

Zensar's acquisitions plugged holes in the company's portfolio opening the company to new markets and vertical, but the prices were expensive relative to internal capital investment requirement and probably close to or just above fair value for the assets (estimated at 10% operating profit yield).

At the beginning of FY2014, Zensar mentioned a goal of $1 billion in revenues by FY2018. Management expects mid to high teens top line growth over the next few years. Assuming a 20% top line growth rate, management will have to make $193 million in acquisitions to meet its $1 billion revenue target.



To meet its revenues targets, Zensar is open to acquire companies with revenue of $20 million to $50 million.

Dividends/Share Buybacks

Management has steadily increased its dividends. The company is now paying roughly 20% of net income in the form of dividends. Given the low capital intensity of the business, management should return more cash to shareholders. A better form of dividends would be in the form of share buybacks, as the company would generate a pre-tax return of 20% before accounting for growth. The company made a buyback in FY2010. The company bought 2.4 million shares for Rs400 million or Rs166.67 per share when the operating profit yield was over 20%, which was a very good use of excess cash.

Accounting

Zensar's accounting is not too aggressive and in line with industry peers.

Years	Zensar	Tata Consultancy	Infosys	Wipro
Depreciation Method	Straight Line	Straight Line	Straight Line	Straight Line
Buildings	30	50	15	30-60
Plant and Equipment	5	3	5	5
Office Equipment	5	3-20	5	5
Furniture and Fixtures	10	1-16	5	5-6
Data Processing Equipment	4	2-10	2-5	2-7
Vehicles	5	1-16	5	4

Source: Company data

Management Remuneration

5 Year Average	Zensar	TCS	Infosys	Wipro	Tech Mahindra	HCL	Hexaware	Mindtree	Sonata
Total Management Salaries	110	144	500	224	59	155	180	72	4
Management Salaries % of Operating Profit	5.3%	0.1%	0.5%	0.3%	0.6%	0.6%	7.8%	3.7%	3.5%
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Total Management Salaries	134	201	720	264	91	229	208	96	4
Management Salaries % of Operating Profit	4.4%	0.1%	0.6%	0.3%	0.7%	0.4%	4.4%	2.5%	4.4%

Source: Company data

Zensar's management receives roughly 5% of operating profit in the form of salaries. This is well above the amount paid to the larger firms within the peer group and in-line with similar size peers within the industry. Salary as a percentage of operating profit continues to decline. Given management's strength as operators since taking the control of Zensar in 2001, the company's strategy of creating extremely strong internal and external relationships and the continued mention, both internally and externally, of CEO Ganesh Natarajan role in strengthening relationships by always being available, management salaries is high but not excessive. As the company grows, management salaries as a percentage of operating profit should continue to decline.

FINANCIAL STATEMENT ANALYSIS

GUIDANCE

Revenue

As mentioned above, management longer-term target is $1 billion in revenues by the end of FY2018. Management expects mid-double digit organic top line growth over the next few years.

Management target revenue split by FY2016 is 70% Application Management Services and 30% Infrastructure Management Services. Within Infrastructure Management Services, 70% of revenues are non-product margins and 30% are product and licensing revenues. This distinction is important due to the difference in operating margins.

Revenue by Segment	FY2011	FY2012	FY2013	FY2014
Application Management Services	81.5%	61.7%	66.5%	66.8%
Infrastructure Management Services	18.5%	38.3%	33.5%	33.2%
IMS- Non-Product Operating Margin			20.6%	22.8%
IMS- Product and License Operating Margin			12.9%	10.4%

Source: Company data

Management states current Digitalization revenues are 8% of revenues and will grow to 15% of revenues by the end of FY2016

Operating Margins

Application Management Services generates a higher operating margin than the Infrastructure Management Services. Within Infrastructure Management Services, product margins are much lower than non-product margin business.

Operating Margin by Segment	FY2011	FY2012	FY2013	FY2014
AMS Operating Margin	16.2%	15.6%	17.3%	19.2%
IMS- Operating Margin	9.6%	9.6%	9.9%	7.4%
IMS- Non-Product Operating Margin			13.9%	9.9%
IMS- Product and License Operating Margin			3.4%	1.9%
Blended Margin	**15.0%**	**13.3%**	**14.8%**	**15.3%**
Unallocated Costs % Sales	1.9%	1.3%	2.2%	1.6%
Operating Margin	**13.1%**	**12.0%**	**12.6%**	**13.7%**

Source: Company data

Despite low margins, Zensar believes Product and License business is crucial to providing end-to-end solutions and gaining clients, which leads to larger, higher margin deals. Management is expecting operating margins to improve to the 15% region by FY2016. Application Management Services should continue to increase as Zensar's deal size continues to increase.

In the Infrastructure Management Services business, management expects the product operating margin to increase to 5-6% and overall business margins to increase 12.0-12.5%. Overall, weakness in the Infrastructure Management business is a function of integration of Akibia, which nearly doubled the business size in FY2012. Management believes the integration is complete and the business has a stable base for future growth.

VALUATIONS

Blended Valuation

Assumptions	First 5 Years	Terminal Rate	F2005 -FY2014 Average	Peak	Trough	St Dev
WACC	12.5%	12.5%				
Forecast Period Sales Growth	0.0%	0.0%	24.6%	57.6%	4.9%	16.3%
Operating Margin	12.0%	12.0%	12.0%	15.6%	9.0%	2.0%
Tax Rate	35.0%	35.0%	23.8%			
Fixed Capital Investment Rate	2.1%	2.1%	-6.8%	34.8%	-60.1%	26.0%
Working Capital Investment Rate	7.4%	7.4%	7.2%	18.6%	-21.1%	13.7%
Dividend Payout Ratio	20.0%	20.0%	18.1%	42.5%	0.0%	11.7%

Source: Reperio Capital Research estimates

Despite management's mid teen revenues growth expectations and margin improvements, valuations are based on conservative mid-cycle margins, no growth and elevated tax rates, Zensar has 13% upside from June 6, 2014 closing price.

Zensar Technologies Ltd (ZENSARTECH:NSI)	FY2010 FV (INR)	FY2011 FV (INR)	FY2012 FV (INR)	FY2013 FV (INR)	FY2014 FV (INR)	FY2015 FV (INR)	FY2016 FV (INR)	FY2017 FV (INR)	FY2018 FV (INR)	Weight
EVA Total Return	264	299	322	354	394	412	460	493	526	20%
DCF Total Return	349	315	330	352	408	417	466	499	531	20%
Earnings Power Value per share	285	247	274	343	447	424	456	489	522	20%
Earnings Power Value w/ Terminal Growth Rate	285	247	274	343	447	424	456	489	522	20%
Owners Earnings Valuation no growth	200	11	413	150	542					
Owners Earnings Valuation w/ Terminal Growth Rate	319	27	677	238	869					
Target Multiple	194	224	281	352	446	446	465	489	513	20%
Historical Valuation	187	202	176	266	408	380	421	464	516	
Reproduction Value	49	17	40	70	129	104				
Debt Capacity	83	132	171	206	191	141	116	92	67	
NCAV	21	(26)	(6)	22	73	73				
NNWC	13	(49)	(34)	(9)	34	34				
Blended fair price	**275.22**	**266.46**	**296.21**	**349**	**429**	**424**	**461**	**492**	**523**	
Recent price (6/6/2014)	137.50	156.50	180.00	242	376	374	374	374	374	
Upside	**100%**	**70%**	**65%**	**44%**	**14%**	**14%**	**23%**	**32%**	**40%**	100%
Annualized Return	**100%**	**70%**	**65%**	**44%**	**14%**	**19%**	**13%**	**11%**	**9%**	
Intrinsic Value Growth	**-25.4%**	**-3.2%**	**11.2%**	**17.7%**	**22.9%**	**-1.0%**	**8.5%**	**6.7%**	**6.3%**	

Under a conservative scenario with no growth and mid-cycle margins, Zensar's intrinsic value is 14% above the current market price. Under the base case scenario of 5% growth into perpetuity, current margins and no further margin improvement, the company's intrinsic value is 80% above the current share price. Under a more aggressive scenario that assumes 10% growth over the next 5 years, 5% terminal growth rate (well below management's target) and 15% operating margin (management's target), the company's intrinsic value is 119% above the company's current share price. If management is able to hit its targets of 15% top line organic growth with operating margin improvements to 15%, the company's intrinsic value is 151% above current levels. Assuming high-end assumptions of 15% revenue growth, FY2018 revenues reach $680 million assuming a constant exchange rate well below its FY2018 revenue target of $1 billion.

Scenario	Price Target (Rs per share) FY2015	FY2020	Comments
Conservative	424	585	no-growth + mid-cycle margins
Base Case	674	1,039	5% perpetual growth rate + current margins with no improvement
Aggressive	817	1,412	10% forecast period growth rate + 5% terminal growth rate + 15% operating margins
Management Targets	939	1,786	15% forecast period growth rate + 5% terminal growth rate + 15% operating margins

Source: Reperio Capital Research estimates

IRR

Based on FY2014 results, Zensar's current pre-tax operating yield of 21.5% is more than twice the current AAA bond rate in India of 9.50-9.75%, prior to any growth or margin improvements. Given this is not a capital intensive, top line growth comes without any significant investment requirements. Using the conservative case from above of 5% perpetual growth rate, Zensar offers almost 26% pre-tax yield. Given Zensar's strong balance sheet, good growth outlook, and strong ROIC, the company pre-tax yield is very attractive.

KEY ASSUMPTIONS SENSITIVITY TABLES

The sensitivity tables below assume a change to the conservative assumptions illustrated above:

- WACC = 12.5%
- Forecast Period Growth = 0%
- Terminal Growth Rate = 0%
- Operating Margin = 12%
- Tax Rate = 35%
- Incremental Capital Investment Requirements = 9.5%

Target Price Sensitivity- WACC & Terminal Growth Rate

Terminal Growth Rate \ WACC	10.0%	11.0%	12.0%	13.0%	14.0%	15.0%	Δ
0.0%	479	440	408	380	357	336	-6%
1.0%	503	459	423	393	367	345	-6%
2.0%	533	482	441	407	379	355	-7%
3.0%	572	511	463	424	393	366	-7%
4.0%	623	548	491	446	409	379	-8%
5.0%	695	597	526	472	430	395	-9%
Δ	9%	7%	6%	5%	4%	3%	

Source: Reperio Capital Research estimates

Target Price Sensitivity- Operating Margin & Forecast Period Sales Growth							
	Operating Margin						
Forecast Period Sales Growth	12.0%	13.0%	14.0%	15.0%	16.0%	17.0%	Δ
0.0%	393	418	442	466	490	515	6%
2.0%	441	469	497	526	554	582	6%
4.0%	510	544	578	612	646	680	7%
6.0%	620	664	707	750	793	836	7%
8.0%	827	888	948	1,009	1,069	1,130	7%
10.0%	1,363	1,468	1,573	1,679	1,784	1,889	8%
Δ	25%	25%	26%	26%	26%	27%	

Source: Reperio Capital Research estimates

VARIANT PERCEPTION

6/3/2014 Close	EV/Operating Profit	FY06-FY14 Sales Growth	FY06-FY13 Ave ROIC	FY06-FY13 ROIC Variation	Debt/Equity Ratio	Net Debt/Operating Profit
Zensar	4.67	25%	34%	8%	10%	-61%
Tata Consultancy	16.87	27%	55%	7%	1%	-64%
Infosys	11.92	25%	39%	5%	0%	-238%
Wipro	12.23	25%	28%	2%	15%	-138%
Tech Mahindra	10.78	33%	63%	18%	1%	-93%
HCL	12.27	25%	39%	14%	6%	-118%
MphasiS	19.85	32%	27%	8%	8%	-342%
Hexaware	7.67	15%	26%	10%	0%	-131%
MindTree	11.14	27%	41%	11%	0%	-119%
Sonata	15.68	23%	31%	15%	0%	-407%
Average	**12.31**	**26%**	**38%**	**10%**	**4%**	**-171%**

Source: Company data

The table above illustrates Zensar's key operating metrics and valuations alongside its peers. Why is Zensar trading at a cheap valuation? It is not because of any sector issues otherwise the other firms in the industry would be trading at similar valuations.

It must be Zensar specific. It is not operating performance, as Zensar is middle of the road across key metrics. It is not financial risk given the strength of Zensar's balance sheet. The company's growth and weakness in the Infrastructure Management business could be the cause of cheap valuations but the discount would not be as large as it is. Management's lack of credibility given their constant optimism about growth and improving operations would lead to a discount but not to the extent of the current discount to peers. The market could be placing an additional discount on Zensar's because of its size and lack of analyst coverage.

Perceived corporate governance risk must be leading to the significant discount. The RPG group companies were notorious for cross-holdings and intra-group loans. RPG management cleaned up intra-group equity and debt-holdings to give it a cleaner structure. Zensar maintains insignificant investment in the RPG companies (less than 3bps of assets). Other than management remuneration, Zensar has not any related party transactions (key personnel and sister companies) over the past 6 fiscal years. Zensar also eliminated minority interest in subsidiaries with the exception of China.

Name of the subsidiary	Country of Incorporation	Extent of holding as on 31st March 2013
Zensar Technologies Inc. [ZTI]	USA	100%
Zensar Technologies (Singapore) Pte Ltd	Singapore	100%
Zensar Technology (Shanghai) Co. Limited	People's Republic of China	100%
Zensar Technologies (UK) Limited[ZT (UK)]	UK	100%
Zensar Advanced Technologies Limited	Japan	100%
Subsidiaries of Zensar Technologies Inc.		
PSI Holding Group, Inc.	USA	100%
Subsidiaries of PSI Holding Group Inc.		
Zensar Technologies IM, Inc (formerly known as Akibia, Inc.)	USA	100%
Aquila Technology Corp.	USA	100%
Akibia, B. V.	Netherlands	100%

Source: Company data

Lack of corporate governance risk is further illustrated by Zensar's balance sheet being the cleanest in the industry (portion of assets in PPE & working capital). As illustrated below, Zensar's 21.9% of assets in investments and loans/advances is the lowest in the industry at almost half the industry average. The amount of cash Zensar returned to shareholders is in line with its peer group average.

5 Year Average	Zensar	TCS	Infosys	Wipro	Tech Mahindra	HCL	MphasiS	Hexaware	Mindtree	Sonata
PP&E + Working Capital % Assets	59.6%	51.8%	32.3%	50.7%	37.1%	61.1%	41.3%	51.2%	56.4%	50.9%
Cash % Assets	15.9%	16.1%	46.4%	18.3%	7.3%	13.4%	5.9%	24.0%	5.1%	16.1%
Investments % Assets	3.6%	6.2%	5.4%	11.4%	42.4%	3.8%	31.1%	9.9%	16.5%	3.4%
Loans and Advance % Assets	21.0%	26.0%	15.9%	19.7%	13.2%	21.7%	21.8%	14.9%	22.0%	29.7%
Dividend and Repayment % Operating Cash Flow	22.5%	46.0%	31.8%	27.5%	5.5%	30.6%	19.4%	77.2%	0.5%	21.9%
Most Recent Annual Report	**Zensar**	**TCS**	**Infosys**	**Wipro**	**Tech Mahindra**	**HCL**	**MphasiS**	**Hexaware**	**Mindtree**	**Sonata**
PP&E + Working Capital % Assets	66.8%	46.1%	31.1%	42.1%	33.3%	53.5%	44.2%	47.0%	45.3%	29.2%
Cash % Assets	11.3%	21.5%	45.6%	19.4%	6.0%	16.0%	8.2%	16.4%	7.4%	24.2%
Investments % Assets	3.4%	5.1%	7.6%	15.5%	45.6%	3.2%	26.8%	18.5%	25.2%	3.9%
Loans and Advance % Assets	18.5%	27.3%	15.8%	23.0%	15.1%	27.4%	20.8%	18.1%	22.1%	42.7%
Dividend and Repayment % Operating Cash Flow	35.8%	49.1%	27.3%	24.2%	5.1%	17.0%	54.9%	37.3%	-4.1%	35.1%

Source: Company data

Electra Partner's shareholding provides further evidence that corporate governance is not an issue. Electra has been a shareholder since Fujitsu and RPG Group established Zensar in 2001. Electra is a London listed Private Equity firm with a long term view and strong long term returns. The length of Electra's ownership in Zensar provides confidence there are no corporate governance issues.

Zensar's auditor is Price Waterhouse India. Price Waterhouse is a large reputable auditor with many clients that will not be influenced by Zensar.

Given the absence of related party transactions, Zensar returning cash to shareholders and the existence of a long standing Private Equity shareholder, the market perception of corporate governance risk is antiquated and over time Zensar should trade on par with peers.

INVESTMENT RISKS

The key risks for the investment thesis includes a decrease in the attractiveness of the industry as service offerings become commoditized or the cloud renders current service offerings obsolete.

Zensar is exposed to FX Risks as the companies top line is in US dollar and expenses are in Indian rupee.

Zensar operates in an industry where employees are the strength of the business. Failure to be able to hire top talent or a change in HR policies may lead to poor operating results.

Zensar's CEO Ganesh Natarajan adds value as brand ambassador. His departure could have an effect on the business and its operations.

Macroeconomic risks could hurt IT spending.

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