SURGE CAPITAL

25 February 2022

INTELLECT DESIGN ARENA

Rating: Conviction Rating:

BUY ★★★

Price: Rs645

intellect® Design for Digital

Surge Capital is focused on Six Key Attributes of Long-Term Earnings Growth

- Strong Business Model ✓
- Innovation & Pivot
- Change & External Trend ✓
- Optionalities ✓
- Leadership & Edge
- Stellar Management Execution

Industry:	Software
Market Cap:	Rs 8675 Crores
Revenues:	Rs 1750 Crores
Net Profits:	Rs 335 Crores
Net Debt:	-

✓ *Indicates attributes present in the stock*

Brief Thesis

Intellect Design Arena is a software products company providing core enterprise software to companies in the BFSI vertical. It has a product portfolio of over 12 products.

A software is an intangible that does not require much incremental cost to replicate and thus any additional sale is extremely high margin business. Each additional sale of software also builds up annuity income of AMC (annual maintenance contract) which continues to add up; making a software products business like Intellect one that gets better overtime as scale of operations increases.

SaaS (software as a service) model is further strengthening a software products business in terms of increased profitability, higher LTV of customers and lower volatility in business.

Plus, the business requires little to no capital investments and thus is a growing free cashflow business, wherein cashflows can be used to further increase growth through inorganic opportunities or buybacks.

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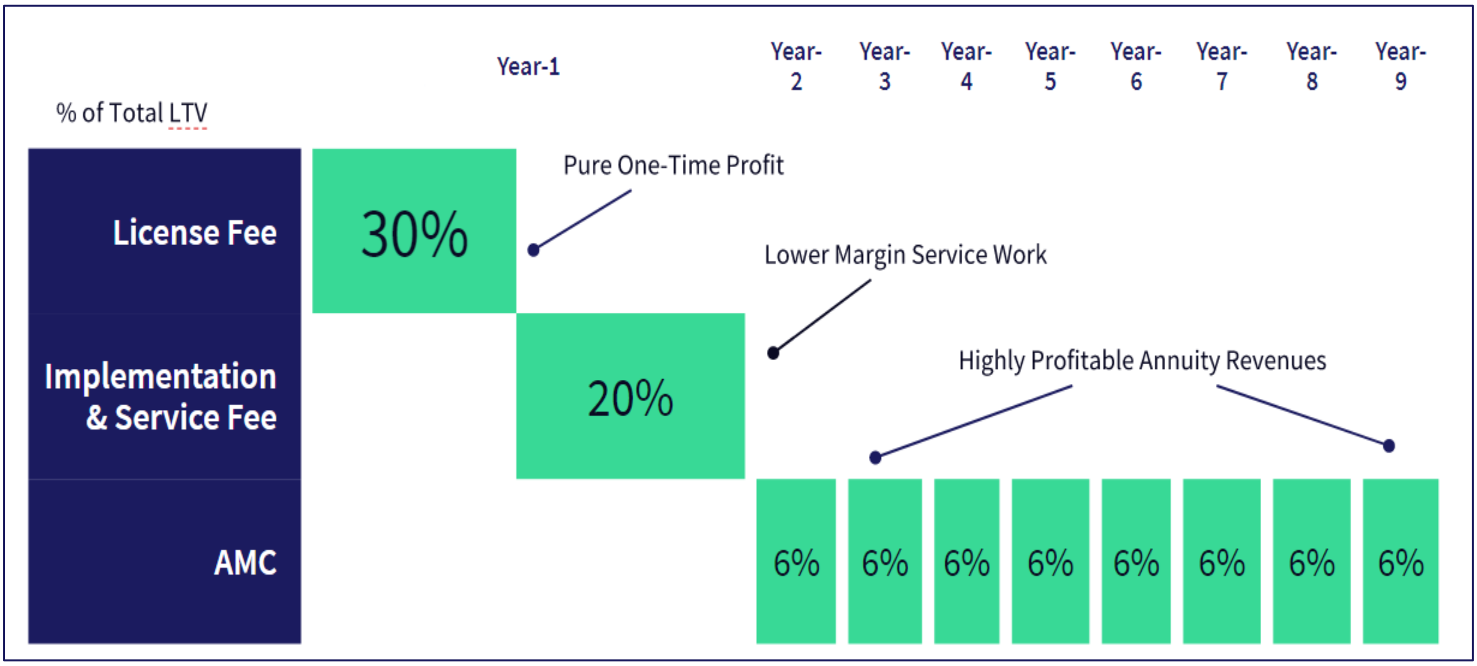
Software Products Business

Crux of a software products business lies in the fact that a software is an intangible and intangibles requires very less costs & efforts to replicate or create additional units of. Which means that once you have created a software, selling additional units of the same software generates very high profitability.

In an enterprise software business (which is what Intellect does business in), a business transaction has three elements-

Software License	Software Implementation	Annual Maintenance (AMC)
-This is providing the actual software IP to the customer to use. -One-time revenue unless the license term is not perpetual -High margin business as no incremental efforts is required -Revenue is realized upfront	-Implementing the software IP at customer's end including integrations with other IT systems of customer and carrying out modifications as per customer's need. -One-time service revenues -Low margins business given that manpower is needed every time to carry out the implementation -Delayed realization based on certain milestones	-Providing technical support, maintenance, problem resolution and upgrades for the licensed products. -Recurring annuity revenues as long as customer is using the software -High margin business -Advance Realization

Timeline and Split of LTV (life time value) of a Software Product Deal-



Sell License > Implement the Same for Customer > Generate AMC Over The Deal Term (5-10 Years)

Primary reason why a software product business gets better overtime is because-

01. Every time a license is sold it creates a future stream of AMCs. And since AMC are recurring in nature it continues to build-up, increasing the share of AMC and decreasing share of Implementation as a % of overall revenue.	**Increases Secularity Of Revenues**
02. License and AMC (together called license linked revenues) are extremely high (70-80%) gross margin business given that they require very less implementation effort. *(For License, you are basically providing a copy of software that you have already developed)*	**Increases Overall Margins**
03. License Linked Revenues (License and AMC) are typically paid upfront by the customers.	**Lowers DSOs (days of sales outstanding/debtor days) and improves cashflows**

Apart of this, there are other cost levers that helps improves overall margins of a software product's business as it scales-

1. R&D Costs

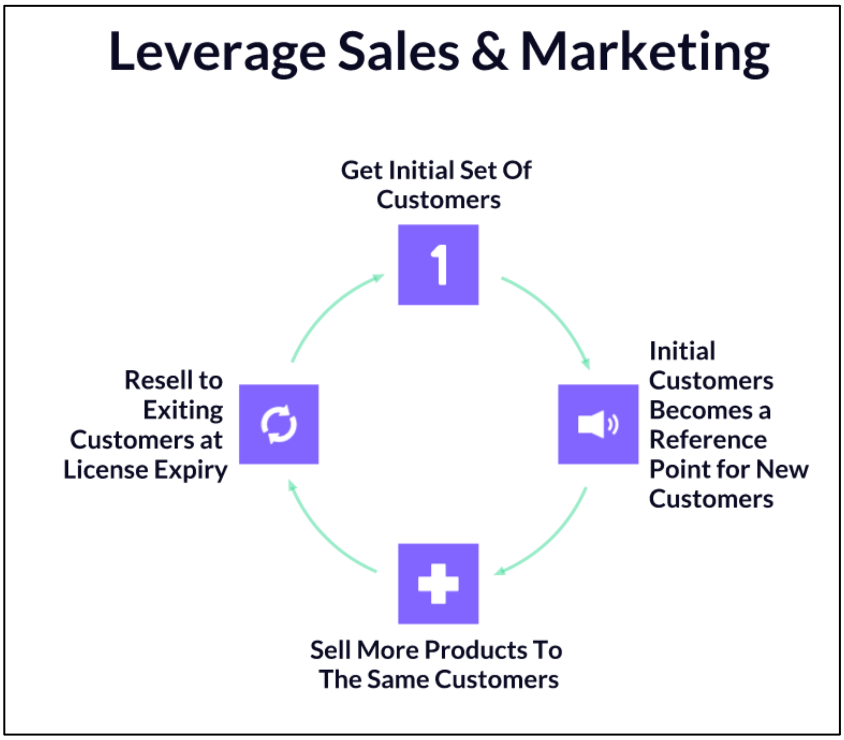
Developing an enterprise software requires a lot of investments in Research & Development. Plus, continuous R&D is involved in upgrading and keeping the products relevant in fast changing businesses like technology. But R&D costs are not linked to how many licenses you sell ie. it is not linked to the size of business.

Thus, as the software product business grows, it can leverage its R&D expenses on a larger base of installed license or revenue base.

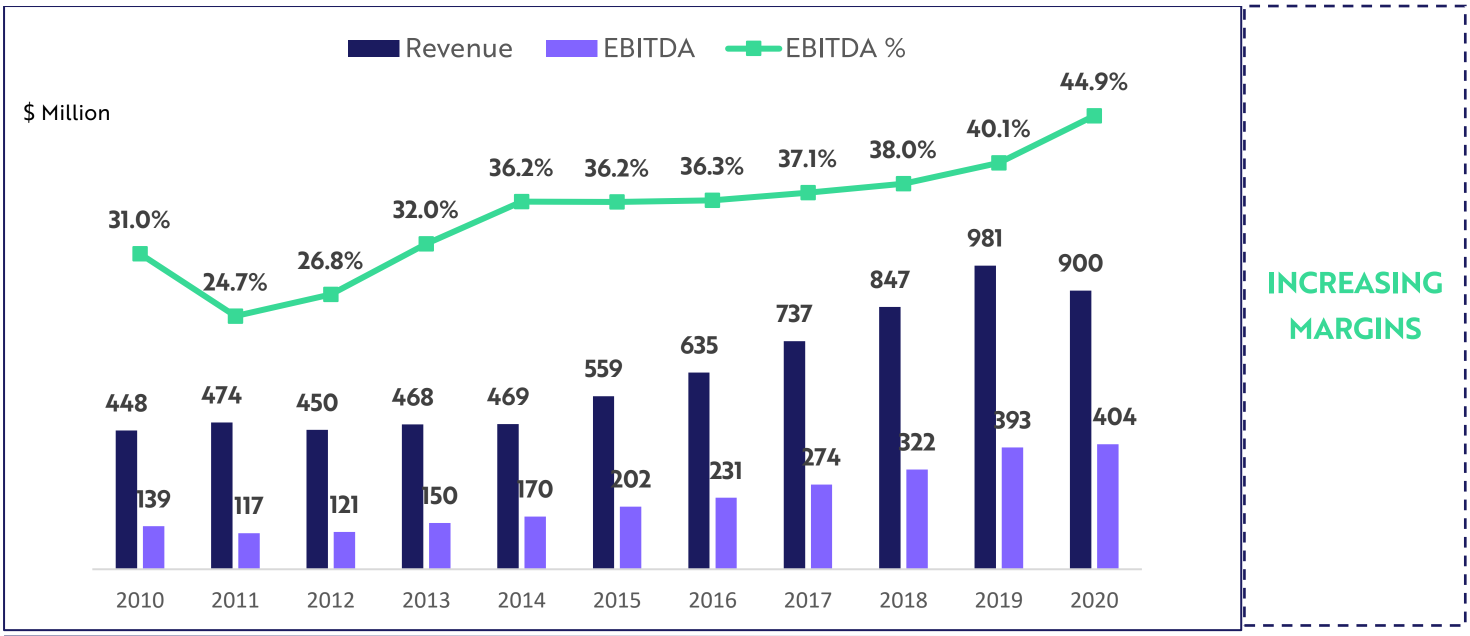
For example, Rs100 of R&D expense spread over 100 Licensed Customer is Rs10 per customer, whereas same R&D cost spread over 200 licensed customers is Rs5 per customer.

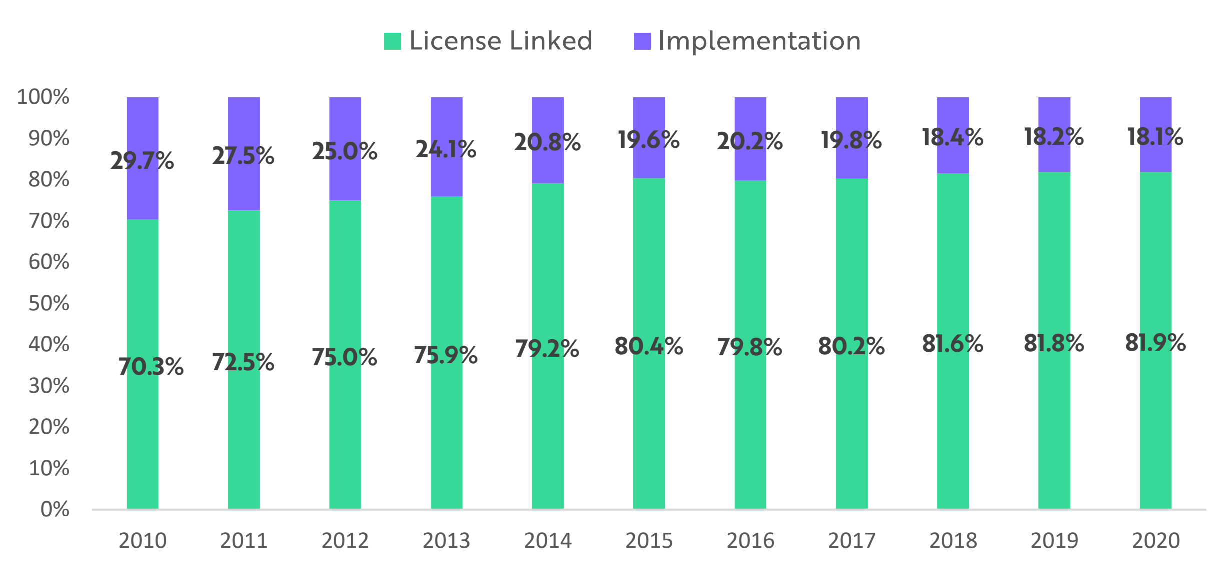
2. Sales & Marketing Costs

Sales & Marketing is the 2nd largest cost for a software product business after the implementation cost. If a new product has to compete with an existing product in the market, then it would require tremendous brand & awareness creation. But post the initial phase wherein you get some traction on your product with some customers, it becomes relatively easier to sell incrementally as now you can demonstrate the success of your previous customer in using your software. And this compounds overtime as your existing customers becomes a reference point. Also, most product companies have multiple products, so if you have a customer who is using one product, selling more products to the same customer requires less efforts.

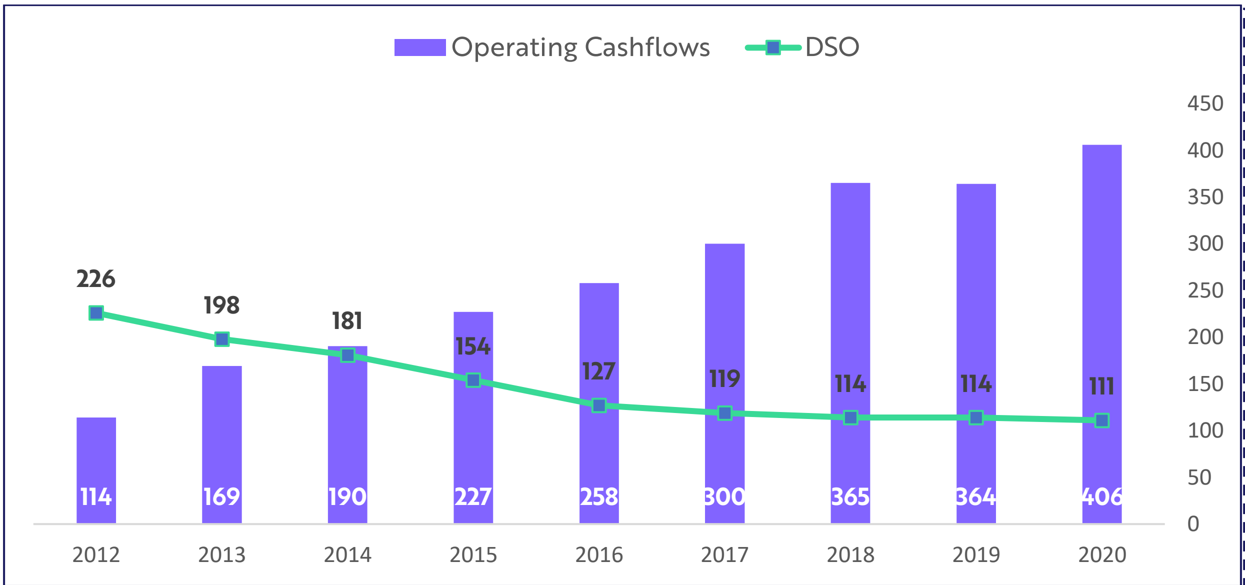


A good example of how a software products business gets better overtime can be seen from how Temenos (competitor of Intellect) as done over last decade-





REDUCING SHARE OF IMPLEMENT- -ATION REVENUE



REDUCING DSO AND IMPROVING CASHFLOWS

In Summary this is how a Software Product Business Evolve-

INCUBATION

- Heavy Investments in Product Development
- Heavy Investments in Sales & Marketing to enable Product discovery
- Very Low Revenues
- Heavy Losses

GO TO MARKET

- Heavy Product Development costs are behind
- Sales & Marketing Costs are still elevated
- Revenues starts building up as products gain traction
- Breakeven or Slight Losses

ACCEPTANCE

- Products gains market acceptance
- Revenues Picks up Strongly
- Sales & Marketing Costs are moderated as products have gain acceptance
- Non-Linear growth in profits as operating leverage plays out

MATURITY

- Products have been in the market for long and thus large AMC buildup has happened
- Company is basically Cash Cow throwing up large amounts of Free Cash
- Company starts looking at additional growth avenues by investing in new products primarily in the form of Acquisitions

SaaS (Software as a Service)

SaaS is the new business model that is increasingly gaining acceptance in an enterprise software product business. Against the traditional model of License-Implementation-AMC, SaaS business model involves selling the software as a service wherein customer can use the product (typically hosted on a cloud) by paying a subscription fee on a recurring basis say monthly or quarterly.

SaaS vs Traditional Business Model

	Traditional Model	SaaS Model
License Fee	✓	✗
Implementation Fee	✓	✓
AMC	✓	✗
Recurring Subscription Fee	✗	✓
Life Time Value of Deal	-	2X

SaaS as a delivery model improves the business in two areas-

1. Increases the LTV of a customer

The whole premise of SaaS is that instead of a customer investing upfront by buying License which costs large sums of money, the customer would be happy paying small sums of money on a regular basis for the same software.

Consider this as buying a car by paying cash upfront (traditional model) vs buying a car on EMI basis (SaaS). And we all know that that total cost of Car would end up being higher in case of EMI vs paying upfront. Similar thing is being played out in SaaS, wherein the LTV of a customer has almost doubled over a 10-year period.

Further, SaaS model also allows for upside possibility in the sense that in some cloud deals the pricing is set not as a fixed fee but is based on some metrics like say in case of a banking software- number of accounts, number of transactions etc. This allows for upside possibility from the growth of your customer's business.

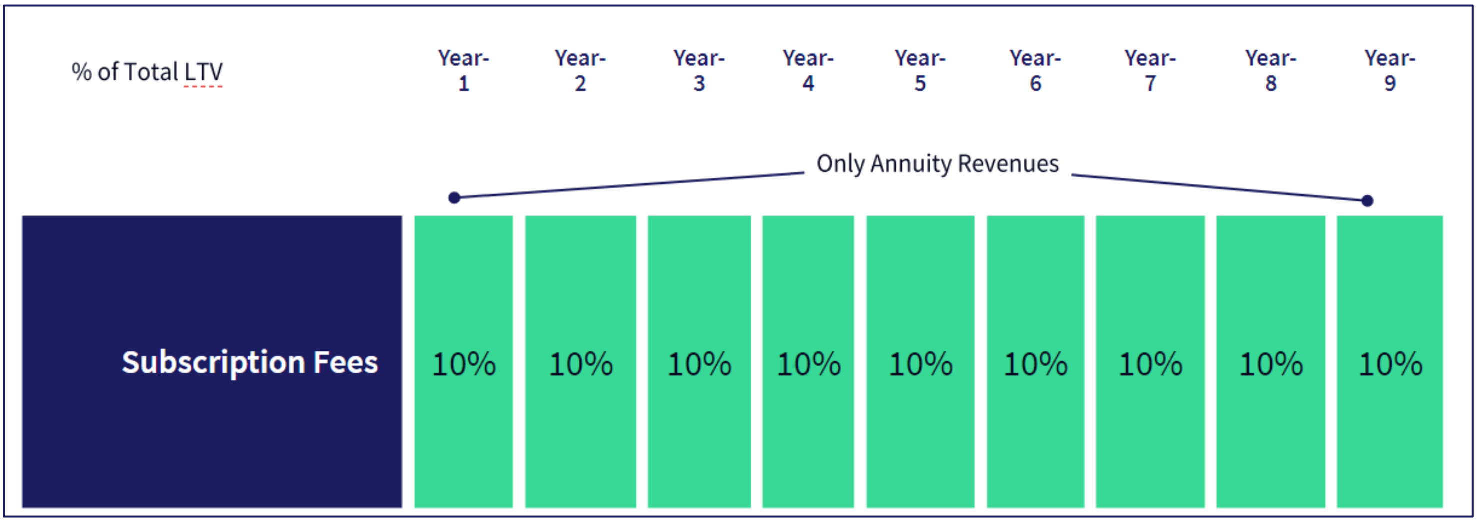
Intellect explaining the increase in LTV-

	Enterprise Model	Cloud Model
Fees	One time $1M + 20% AMC p.a	Zero License upfront, annual subscription $0.35M
Growth Drivers	• Change requests – small value and require new sell and delivery cycle each time • New releases full sales and implementation cycle, often 5 – 7 years between major upgrades	1. Transaction based pricing in growing banks (@$0.49 per account per month = $900K to $1.8 million p.a) 2. New functionality / modules charged as additional subscription with low friction sales 3. Revenue per customer increases with adoption, while cost per customer decreases
10 year Customer LTV	• License + AMC : 1000 + 200X9= $2,800 K • Implementation + CR = $1M • Total = $3.8M	• Entry level subscription = 0.4x10 = $4M • Initial Implementation = $0.5M • Upsell 1 = 0.15K x 8 yrs = 1.2M • Upsell 2 = 0.2 x 6 yrs = 1.2 M • Volume Increase = 0.25x 6 yrs = 1.5M • Total = $8.4M

2. Reduced Volatility and DSOs

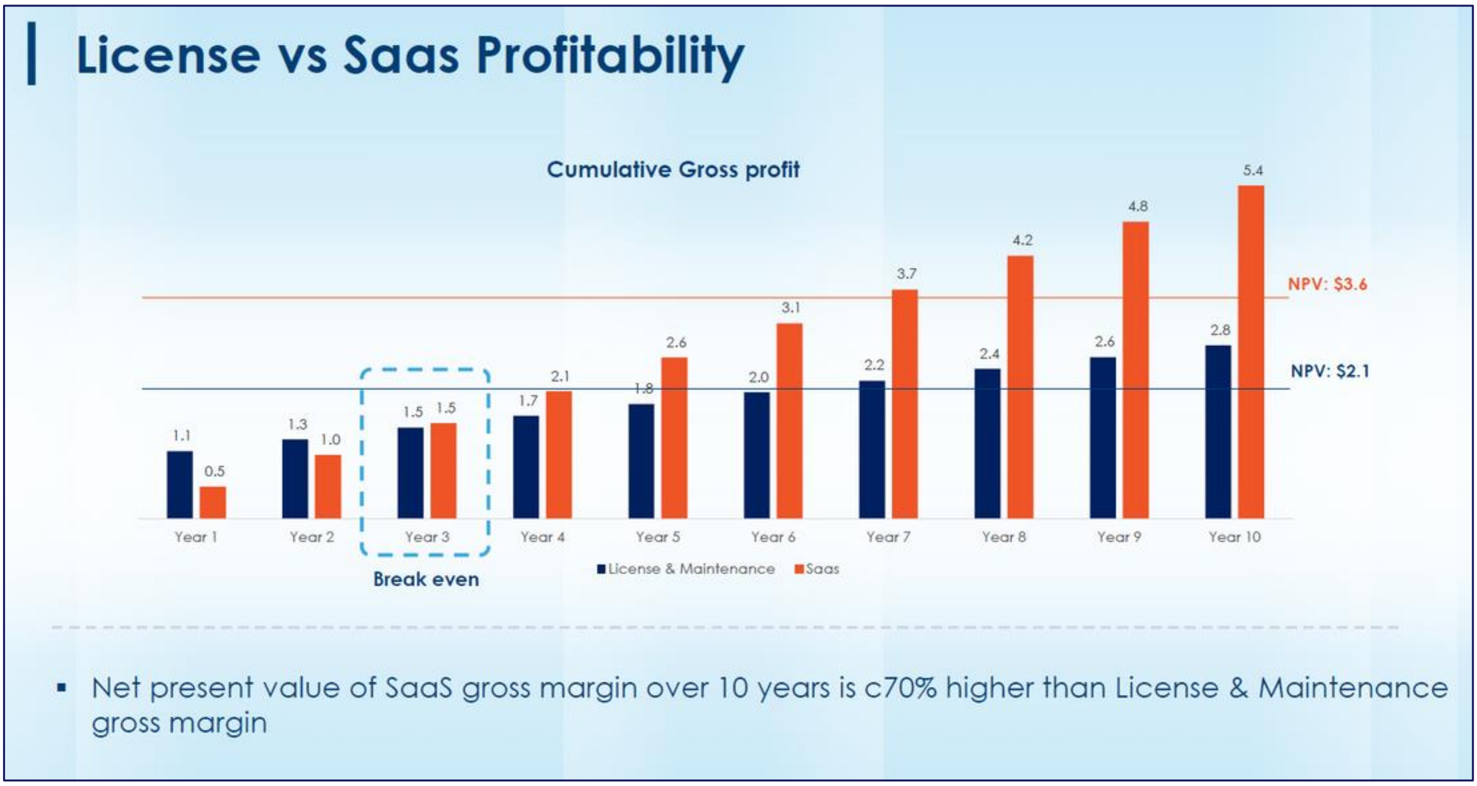
We have discussed earlier that growing share of AMC helps reduce volatility and DSOs in a software product business. SaaS actually accelerates this by basically removing one-time and upfront revenues of License entirely and converting the entire revenue stream of a deal into a recurring annuity, like what we have in case of AMC.

Timeline and Split of LTV (life time value) of a SaaS Deal-



However, one of the drawbacks of SaaS is that initially during the transition phase of License to SaaS model, there is pressure on revenues and margins given that unlike the traditional model, SaaS mode does not have an upfront License Fee which is typically pure profit, but the implementation costs are the same and thus initial profitability is low.

Temenos Highlighting this and also the increase in LTV-



In summary, with scale a Software Product Business gets better and benefits from

- improving margins

- reducing volatility

- improving cashflows

And SaaS Model Is Further Improving The Business On All These Fronts

Intellect Design Arena

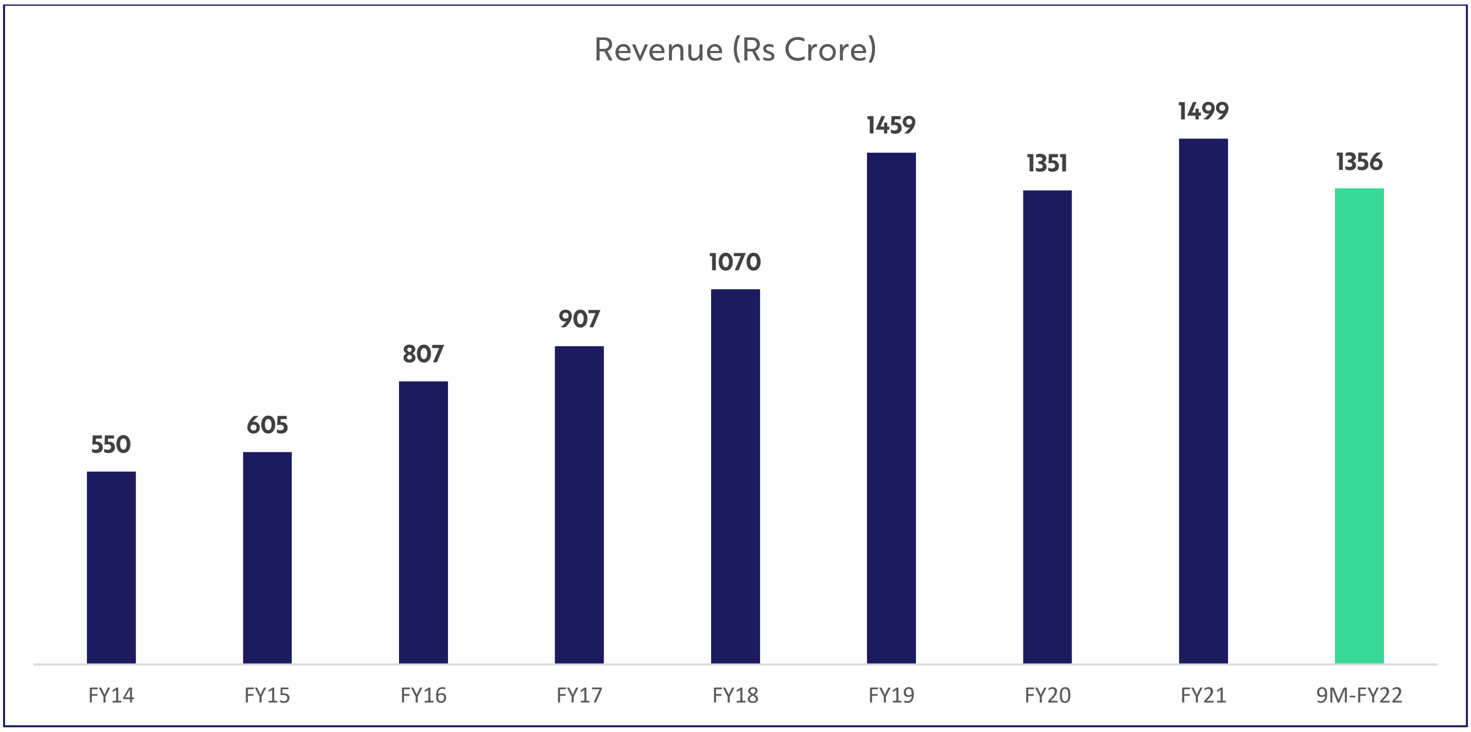
Intellect provides core enterprise software to companies in the BFSI vertical. Intellect traces its history as the products division of BFSI focused IT Services company- Polaris Consulting & Services.

In 2014-2015, Polaris went through major changes wherein the products business was demerged into a separate company- Intellect Design Arena and then Polaris (IT Services Business) was sold to Virtusa (US based IT service firm)

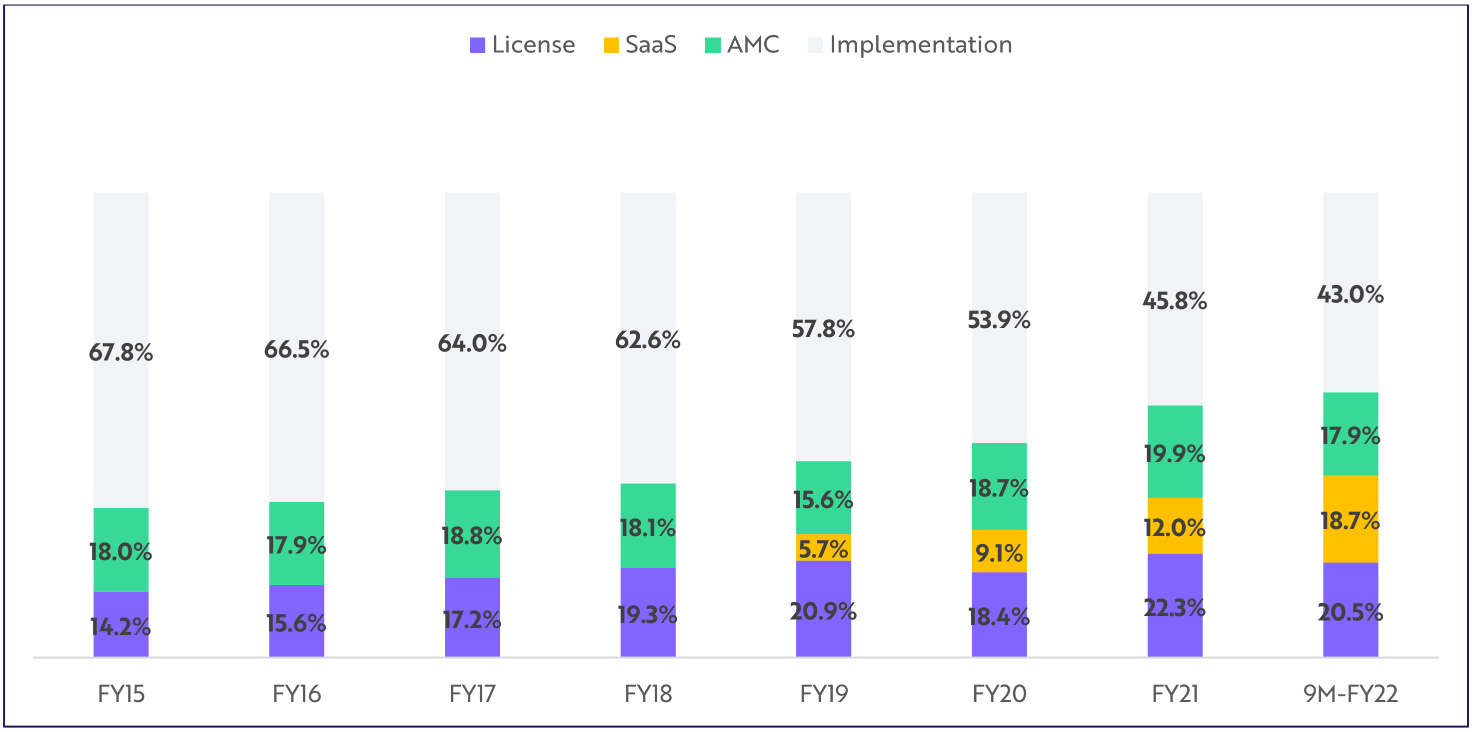
> **"The reason for this entire restructuring is because I always wanted to create a global products company out of India and it would need a dedicated focus to make it happen. Also, Polaris being an IT services company focused on providing services to IP led BFSI players was resulting in a conflict as Intellect itself was an IP led company competing in BFSI space"**
>
> **- Arun Jain, Founder- Polaris & Intellect (at the time of demerger)**

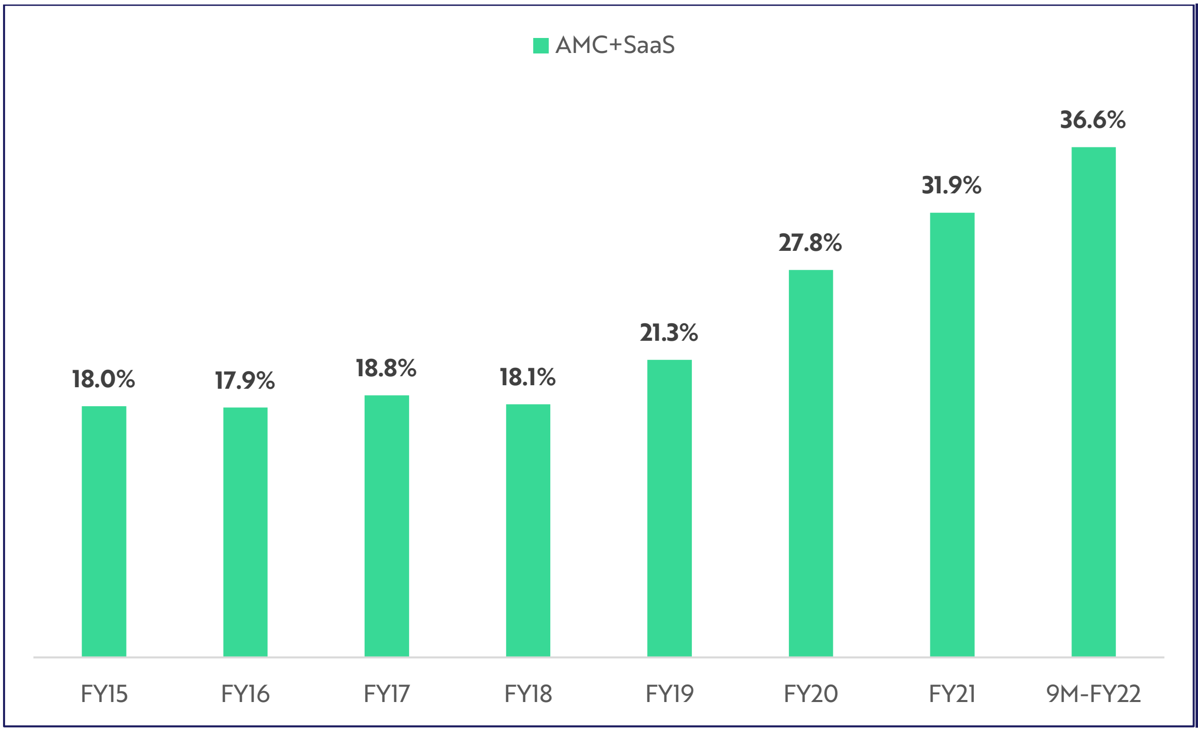
Intellect has witness good scale-up in business post its demerger in 2015; this was on the back of strong investments in bringing its products to market.

> **"Our competition invests between 30-50% on Sales & Marketing. We invest 15% in Sales & Marketing. To be globally competitive, we propose to increase these investments in a focused and planned manner"**
>
> **- Arun Jain, Intellect's Demerger Document**



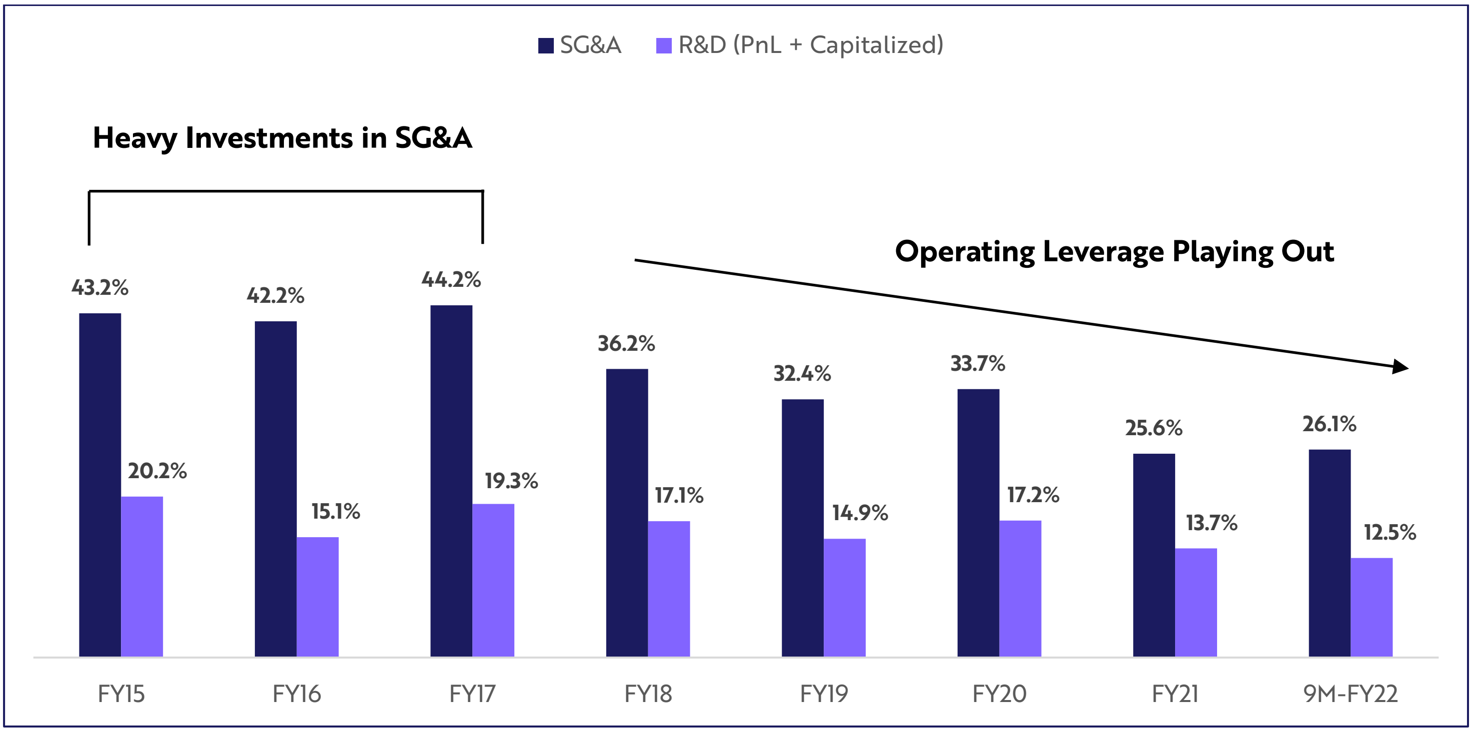
With increasing scale of operations; share of high margin License linked revenues of License+AMC+SaaS have also increased.

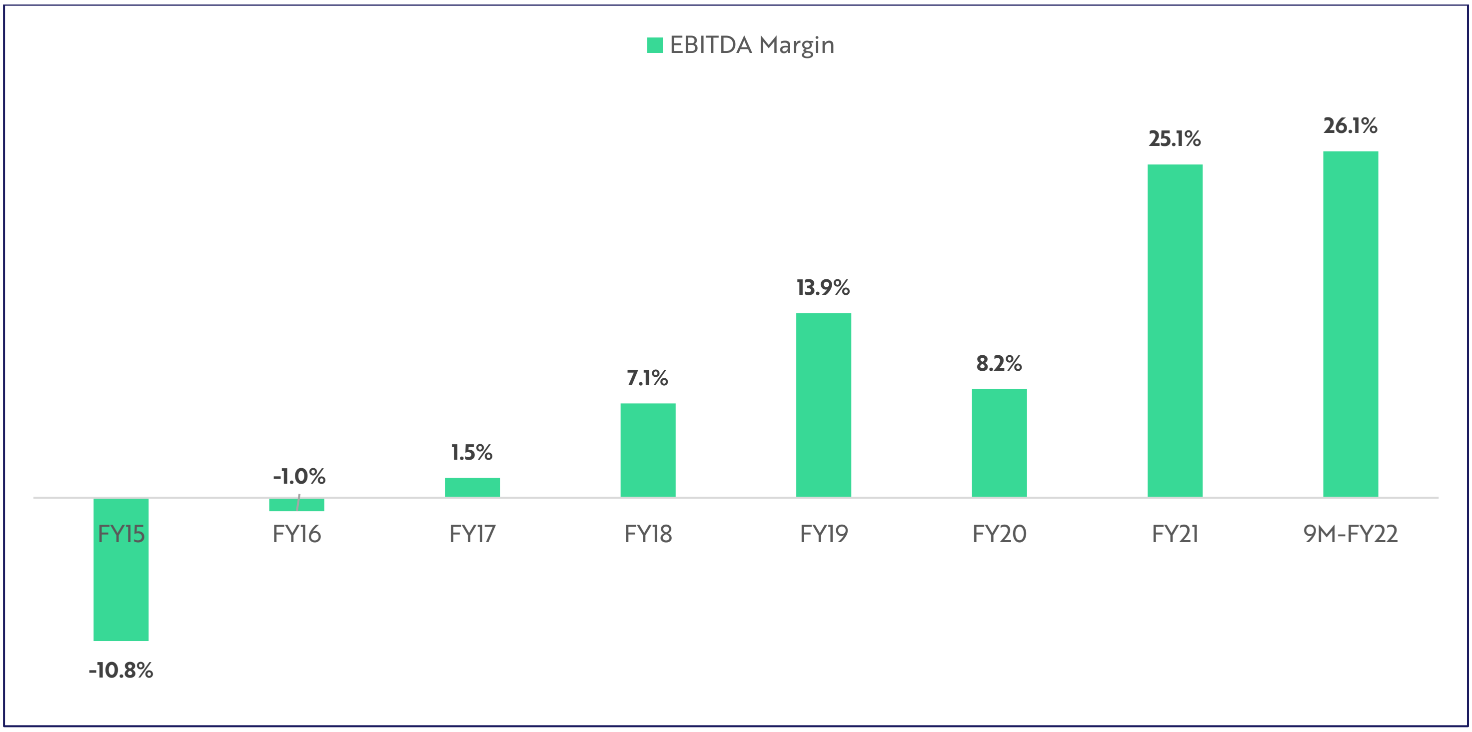




Share of Recurring Revenues (AMC+SaaS) Have Doubled

Increasing scale of business and growing share of high margin license linked revenues has had positive impact on Intellect's margins as well as DSOs.

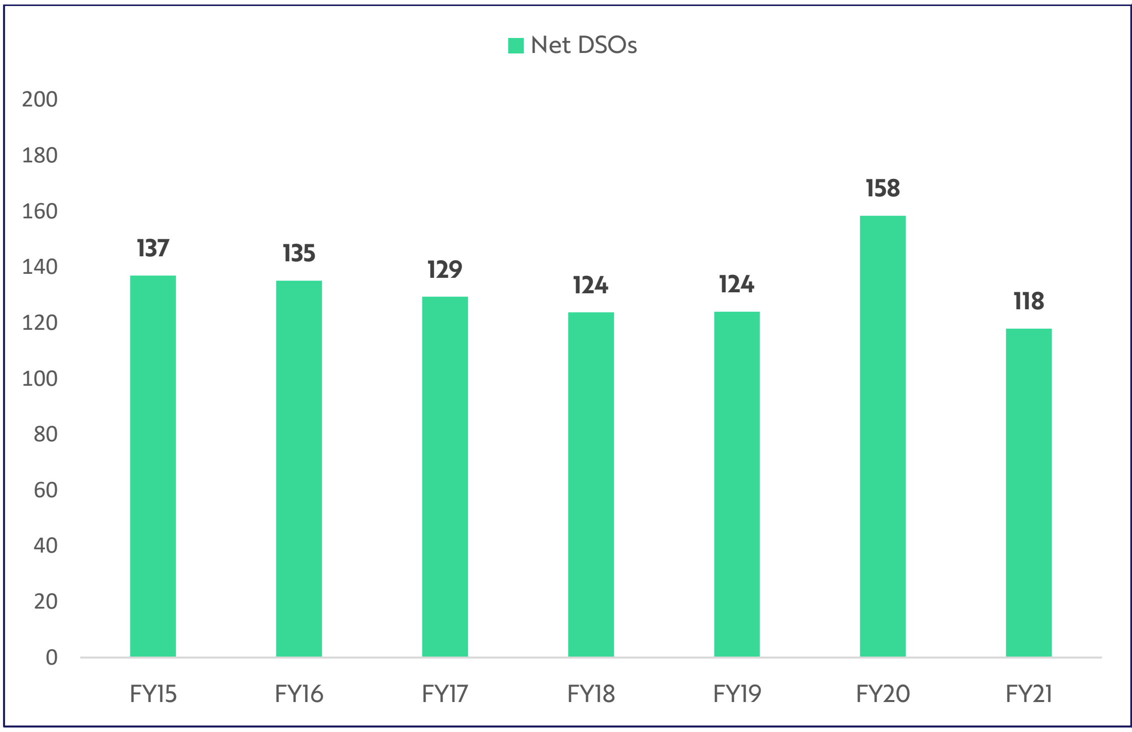




Note-

1. Intellect started capitalizing some part of R&D costs from Q4FY16 onwards and that improved Intellect's EBITDA margin permanently. However, as we can see from chart above, Total R&D costs (PnL+Capitalized) continues to reduce as a % of total revenues, indicating operating leveraging on R&D costs.

2. Margins saw massive improvement in FY21. Was this because of Covid related costs savings, and will the come back and reduce margins? We don't think so, and have covered this in detail in a later section.



Reducing Share of Implementation Revenues Leading To Lower DSOs

(Note: Net DSOs= Trade Receivables + Unbilled Revenues – Customer Advances)

So, Intellect's business has become better with scale with-

A. Increasing Margins

B. Increasing Recurring Revenues

C. Reducing DSOs

We believe that Intellect has opportunity to scale its business multifold from here and that it would see its business metrics improve further.

Intellect currently has a product portfolio of over 12 products across four business divisions-

iGTB THE WORLD'S FIRST COMPLETE GLOBAL TRANSACTION BANKING PLATFORM

intellect SEEC WE INNOVATE TO SIMPLIFY INSURANCE

iGCB SUPERIOR DIGITAL ARCHITECTURE, TOTAL CUSTOMER 360

iRTM INTEGRATED RISK, TREASURY & MARKETS PLATFORM RUNNING THE LARGEST TREASURY OPERATIONS IN THE WORLD

Global Transaction Banking

Products targeted towards a bank's needs around wholesale & corporate banking services like trade finance, liquidity management, payments etc.

Largest & most matured product division of Intellect.

Insurance & Data

Solutions targeted towards Insurance companies around distribution, underwriting and claims. Also extends to other areas of BFSI space for data solutions.

Products under this segment are pure SaaS offerings.

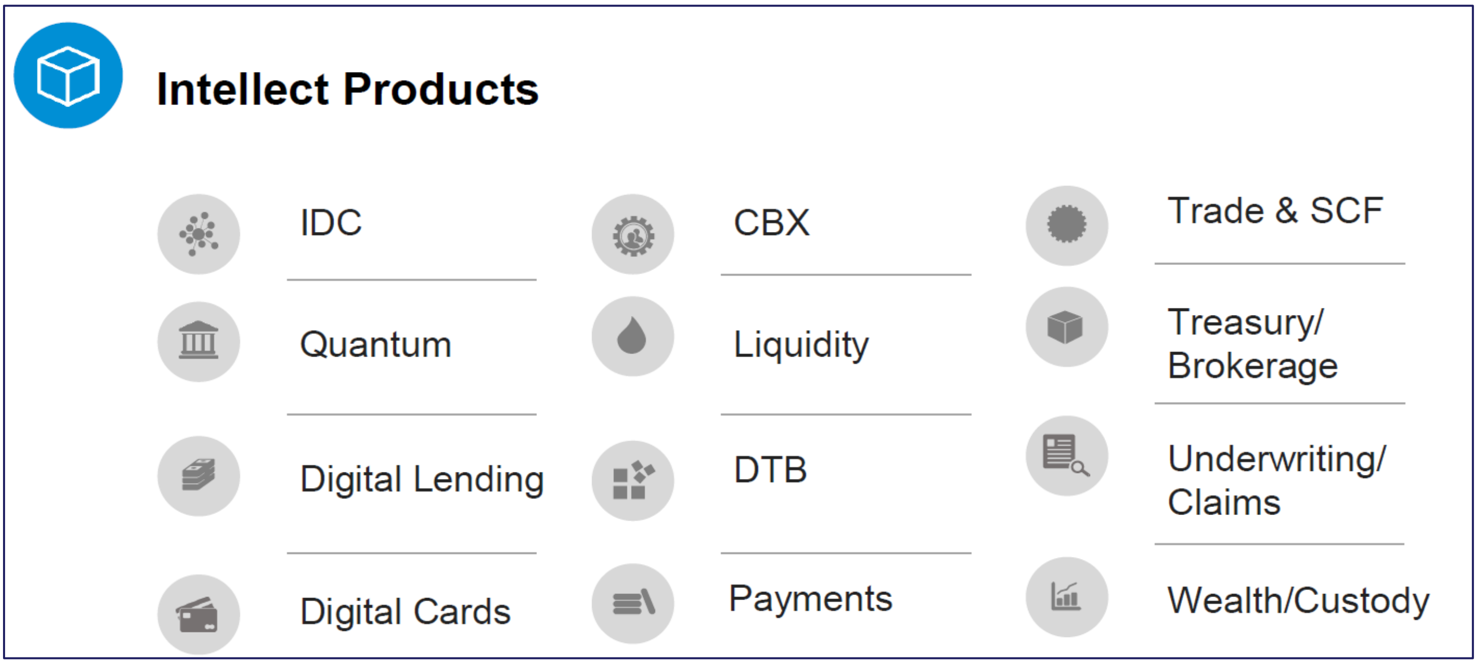
Global Consumer Banking

Products targeted towards a bank's needs around Retail banking, private banking and Central Banking; like core banking software, cards, lending etc.

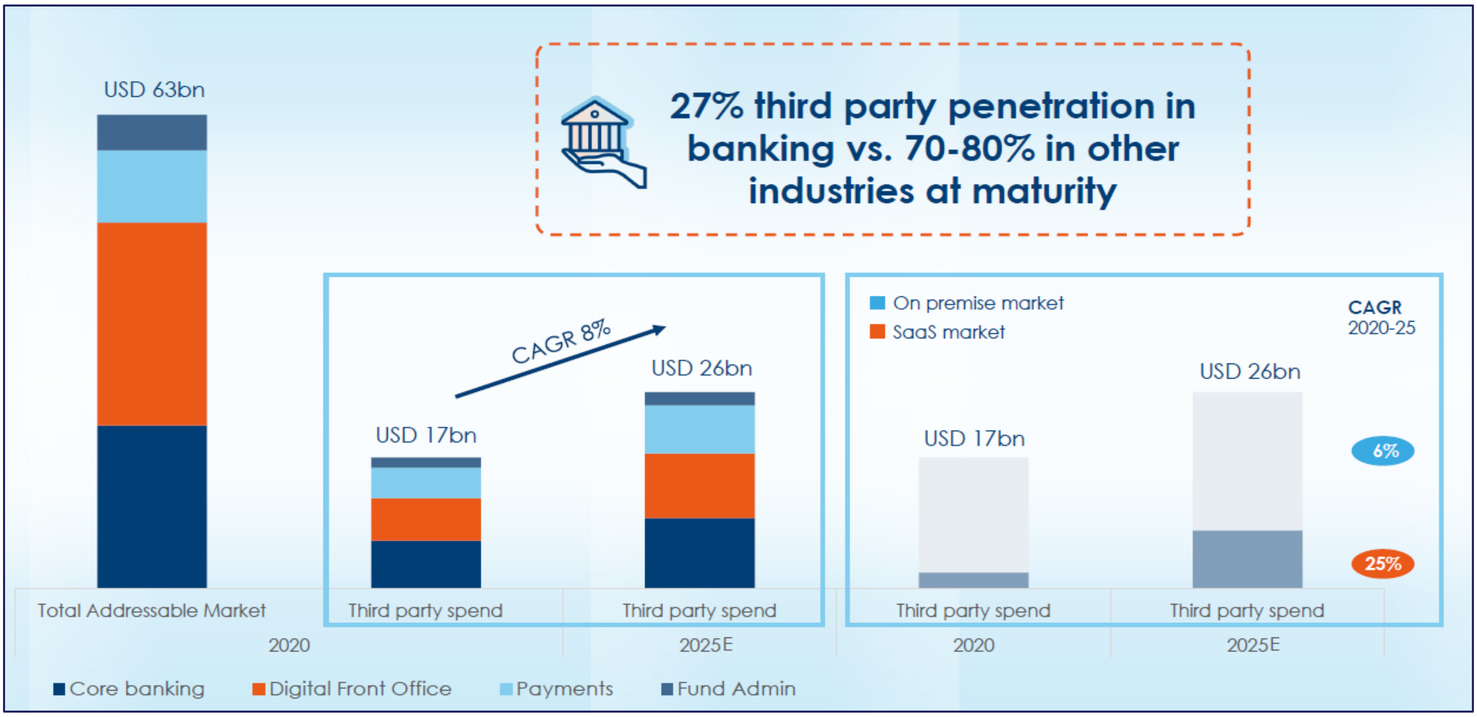
Risk, Treasury & Wealth Management

Solutions for a bank's need around treasury, risk management and asset management.

Youngest & Smallest product line currently.



This wide basket of products across multiple verticals of BFSI space provides a large addressable opportunity for Intellect; addressable opportunity within the banking space itself is ~$26 billion. Temenos has a business of ~$1 billion just on the back of core banking software (iGCB Segment of Intellect)



(Source: Temenos)

In this large addressable market, Intellect is a tier-1 player competing with global leading players across all its segments. It is among the very few companies to feature on reports of leading global market intelligence firms like Gartner and Forrester.

Segment	Competitors
iGTB	Finastra, ACI Worldwide, CGI and Bottomline
iGCB	Temenos, TCS, Finacle (Infosys), Oracle, Mambu and Thought Machine
iRTM	Sungard, Finastra and Calypso
SEEC	Palantir, Carpe Data, Planch and Duck Creek

(Gartner Magic Quadrant: Global Core Banking 2020)

Some of Intellect product are among the top selling products in their respective category based on IBS Sales League.

5.2.2 Lending | Retail | Sales League Table

Table 8: IBSI Sales League Table 2021 – Lending | Retail

#	Product	Supplier	# Deals (Previous years in bracket)
1	Finacle Digital Banking Solution Suite	Infosys Finacle	16+
2	Intellect Digital Lending	Intellect Design Arena	15+
3	Lend.Ezee	EpikInDiFi	11+
4	Kastle Universal Lending Solution	Azentio Software (3i Infotech)	6 (5+)
5	Mortgage plus	EgabiFSI	4
6	BX PF	Bankware Global	3
7	ConsumerPlus	EgabiFSI	3
8	Loxon Collection System	Loxon	3 (3, 0, 2)
9	Sopra Banking Platform	Sopra Banking Software	3
10	EbixCash Debt Collections	EbixCash Financial Technologies	2+
11	EbixCash Lending Management	EbixCash Financial Technologies	2
12	EbixCash Lending Origination	EbixCash Financial Technologies	2+
13	Finairo Loan Origination Solution	Infrasoft Technologies	2+
14	FinnOne Neo	Nucleus Software	2+ (8+, 6+, 7+, 5, 3 ,8, 7, 14, 27, 13, 17, 16, 17, 11, 9)
15	Sopra Financing Platform	Sopra Banking Software	2
16	Bantotal Core	Bantotal	1
17	Blenderpay TM	Blender	1
18	Finairo Loan Management Solution	Infrasoft Technologies	1
19	FinnOne	Nucleus Software	1

6.4.2 Wholesale Banking | Transaction Banking | Sales League Table

Table 14: IBSI Sales League Table 2021 – Wholesale Banking | Transaction Banking

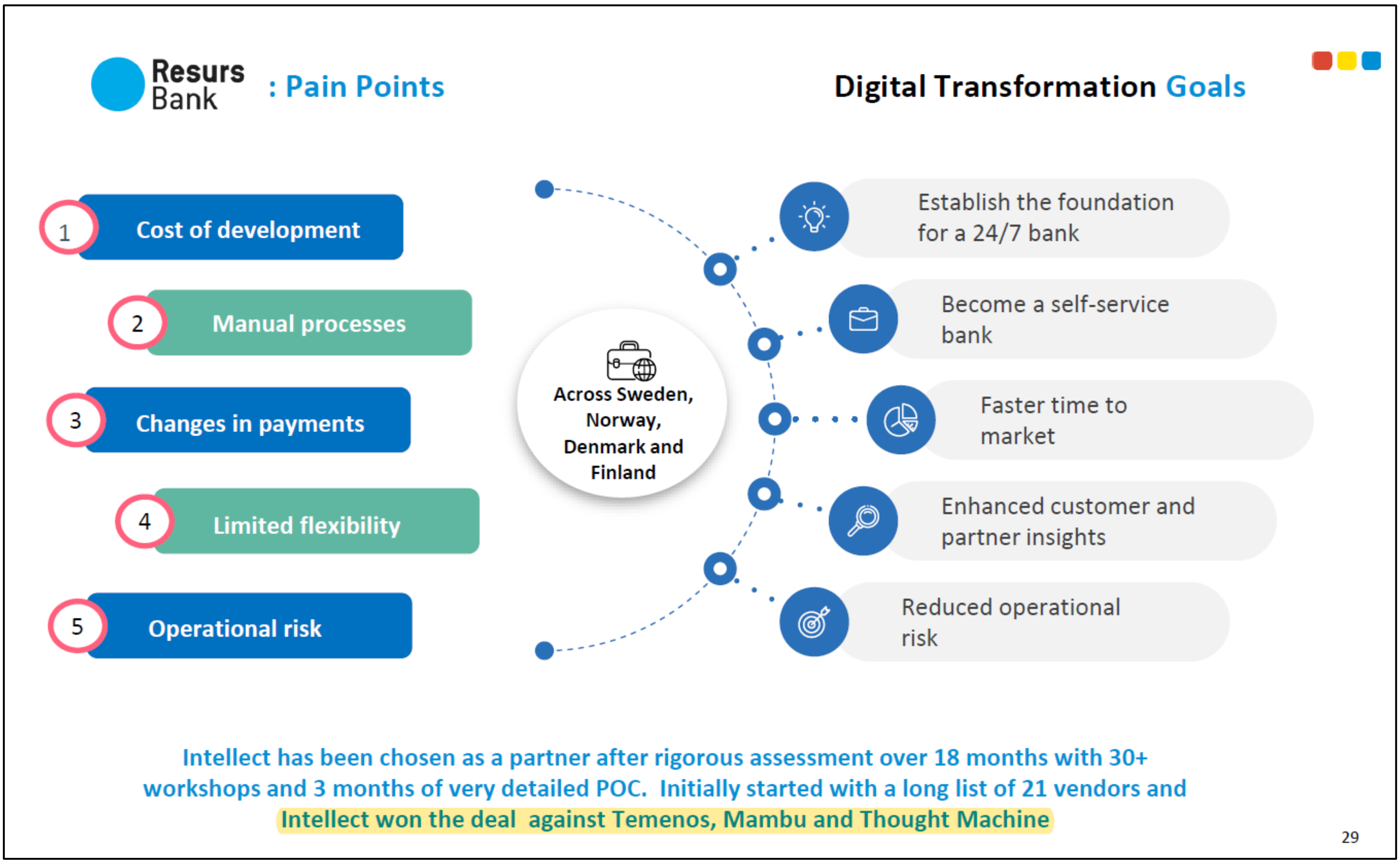
#	Product	Supplier	# Deals (Previous years in bracket)
1	Intellect iGTB	Intellect Design Arena	12 (8)
2	Finacle Corporate Banking Solution Suite	Infosys Finacle	12
3	Cyberbank Digital	Technisys	2
4	OLYMPIC Banking System	ERI Bancaire	1 (1)
5	Fusion Cash Management	Finastra	1
6	Fusion Trade Innovation	Finastra	0 (7, 3,0,4)
7	FinnAxia	Nucleus Software	0 (2, 2, 1)
8	Finacle Cash Management Suite	Infosys Finacle	0 (2)
9	Vtransact Ecollect	MindGate Solutions	0 (2)
10	iCashpro+	Aurion Pro	0 (1, 2)
11	Bantotal Core	Bantotal	0 (1)
12	Aquarius	TAS Group	0* (1)

5.1.2 Retail Banking | Core | Sales League Table

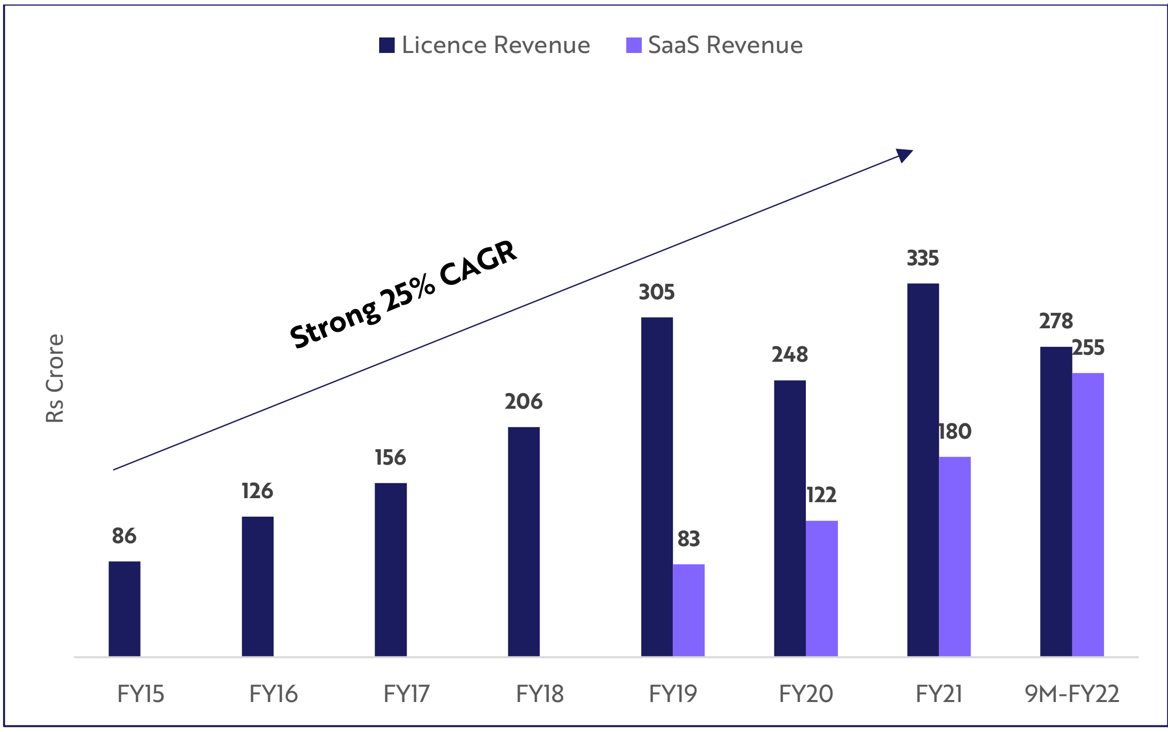
Table 7: IBSI Sales League Table 2021 – Retail Banking | Core

#	Product	Supplier	# Deals (Previous years in bracket)
1	Intellect iGCB	Intellect Design Arena	18+ (14+, 7+)
2	Sopra Banking Platform	Sopra Banking Software	13
3	Vault	Thought Machine	6 (1)
4	BX CBP	Bankware Global	3 (1, 1, 2)
5	Core Banking - International	FIS	3+
6	Cyberbank Core	Technisys	3
7	Bantotal Core	Bantotal	2 (2, 5, 3, 2, 5, 3 ,5, 3, 5)
8	TCS BaNCS	TCS Financial Solutions	2
9	Avaloq Banking Software	Avaloq	1 (0, 0, 1)
10	BankPLus	EgabiFSI	1
11	Bantotal Internet Banking	Bantotal	1
12	CapitalBanker	Capital Banking Solutions	1
13	Cyberbank Core + Digital	Technisys	1
14	Cyberbank Digital	Technisys	1 (1)
15	Fusion Phoenix	Finastra	1+
16	LFI - Latam	FIS	1
17	Systematics	FIS	0 (7+, 3, 0+, 1+, 0, 0 ,0, 0, 0, 0, 1, 1, 0+, 0, 2, 1, 8, 7, 7, 0*)
18	Finairo Microfinance Solution	Infrasoft Technologies	0 (2)
19	Finairo Core Banking Solution	Infrasoft Technologies	0 (2+, 0*, 0, 1)
20	FinCraft Core Banking Solution	Nelito Systems	0 (2, 1, 1)

Intellect recently won a large multi-year digital transformation deal for Resurs Bank against heavyweights like Temenos, indicating its ability to compete with leading players.



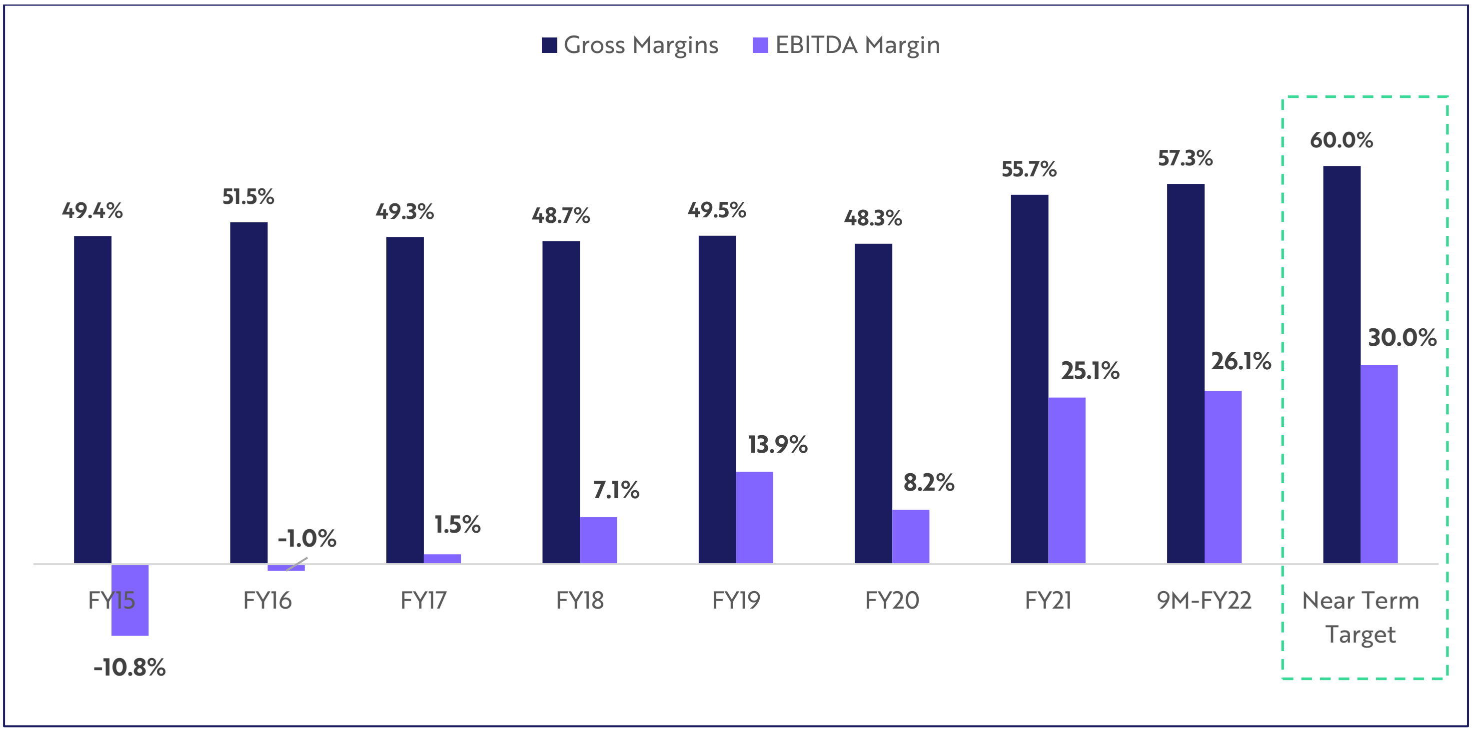
A good indicator to judge how well a software product company's products are doing is to check growth in License value. Since license are one-time revenues, strong growth in license value means that the company is able to sell its software to an increasingly large number of customers.



Strong growth in-spite of getting a large number of recent deals as SaaS deals which does not have a License component

A glimpse into how increasing scale can improve Intellect's profitability comes from the gross margins that its matured products command. Intellect has a large basket of products and some of its segments like SEEC and iRTM are fairly young with low gross margins. As these products mature, Intellect's will see positive impact on its profitability.

Management has guided that the business can achieve 60% Gross Margins and 30% EBITDA Margins in near term.

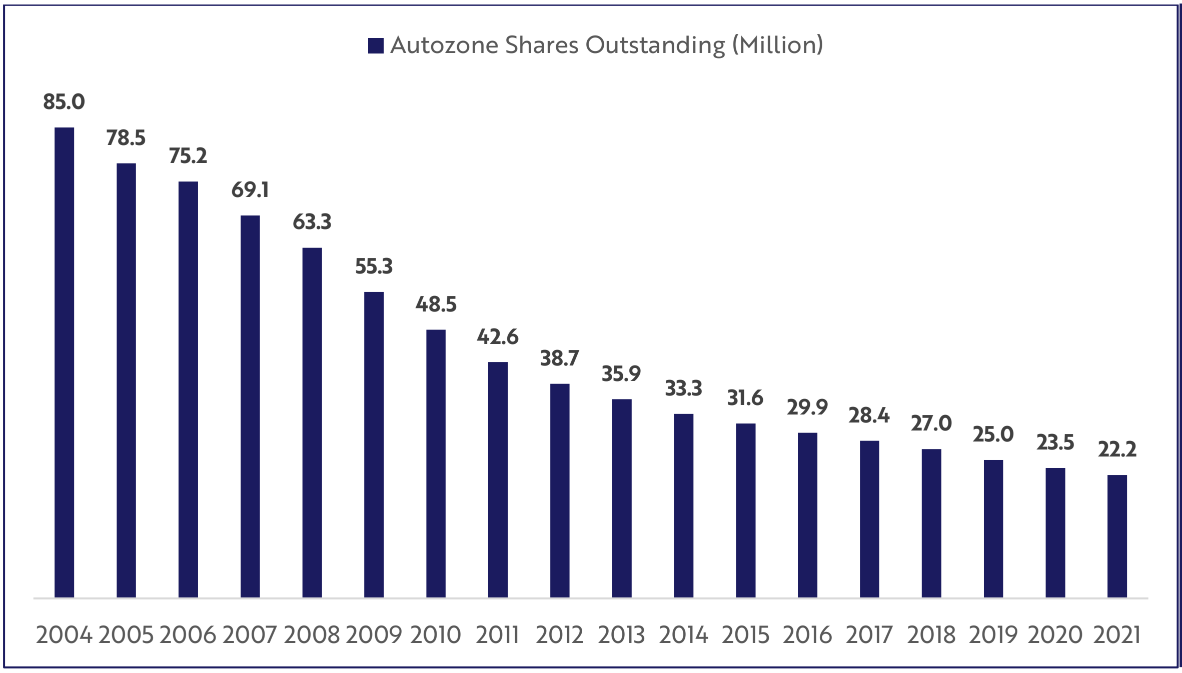


Optionality of Free Cashflows

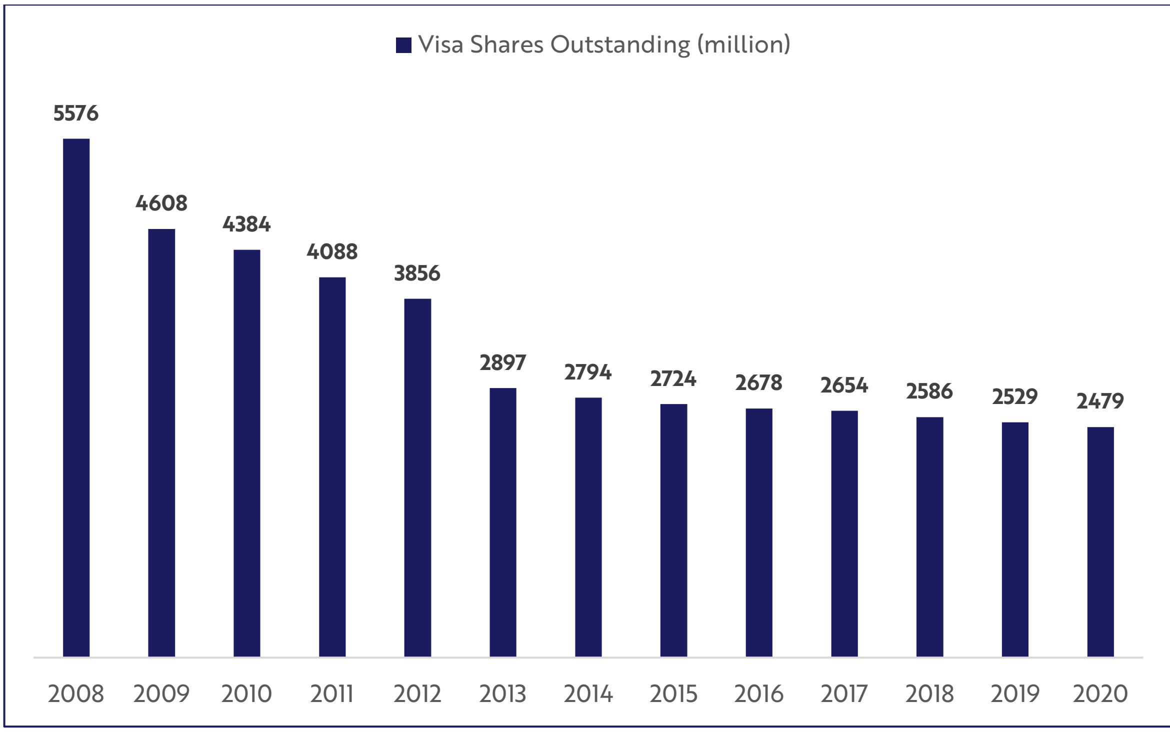
A software product's business like Intellect generates high free cashflows given that there is no major investments required in fixed assets and most of the costs except for some R&D costs are expensed in the profit & loss statement itself. These free cashflows are then used for various initiatives like Buybacks and Inorganic growth opportunities.

Regular buybacks are something which we believe could a big optionality for Intellect. In the western markets, there are so many examples of companies using buybacks to turbocharge returns for their shareholders.

Autozone (US based autoparts retailer) has reduced its outstanding shares by 75% in last 16 odd years-

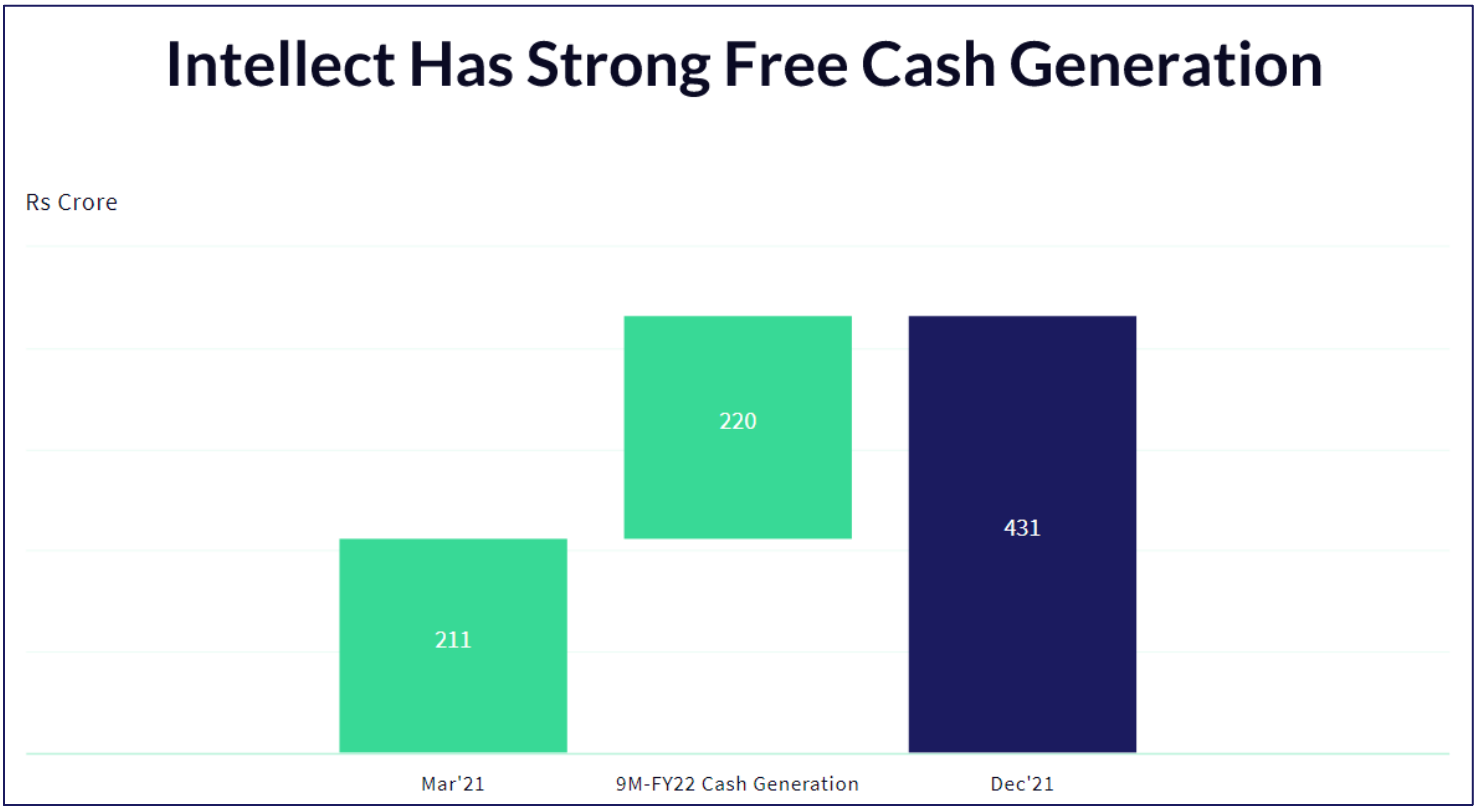


Over Same Period, Profits are up by ~4x, but EPS (Earnings Per Share) is up by ~15x due to reduction in no. of shares.



Visa Reduced Number of Shares By

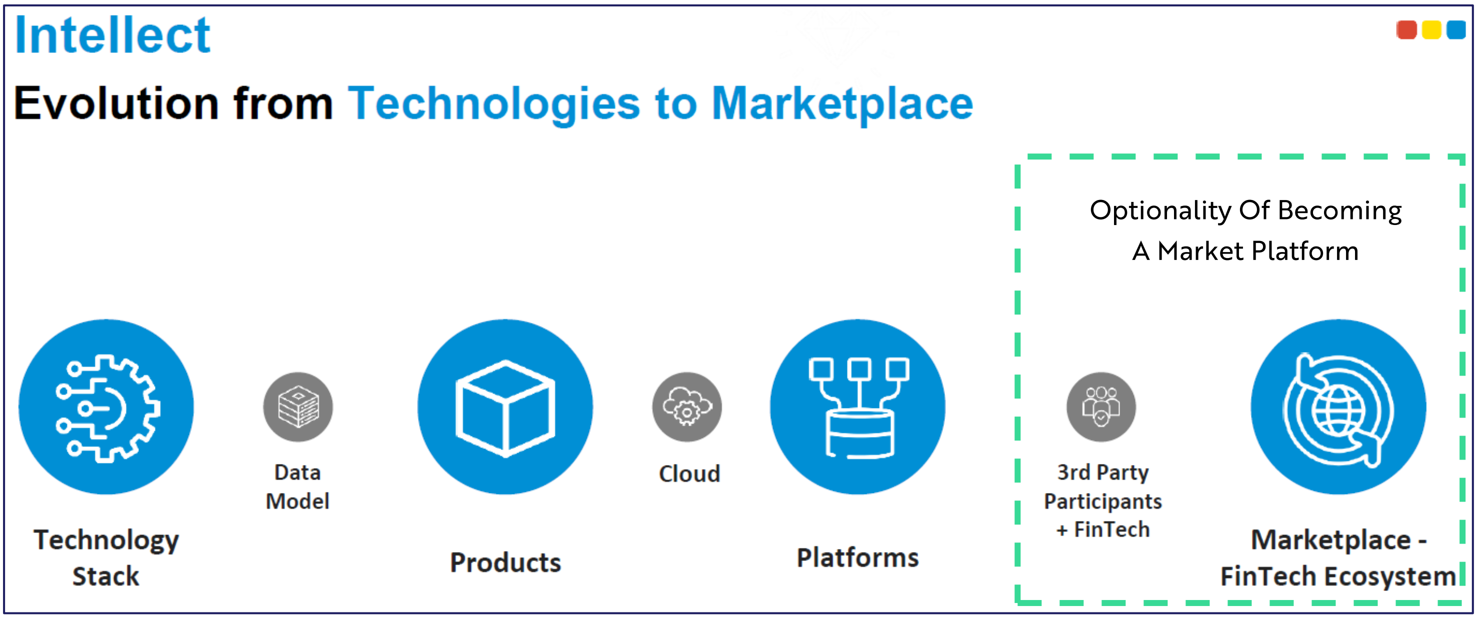
55%



We don't expect Intellect to do some major M&A given that it already has a fairly large basket of products. The company however have announced setting up an AIF with initial corpus of Rs100 crores which it wants to use to acquire minority stakes in other financial technology companies who can then build their products over product platforms of Intellect.

The idea here is to move from a product company to a platform company wherein Intellect will be the provider of core technologies and products, over which other companies can build their software products; something like what Salesforce is.

We currently don't build any expectations on this front at the moment given that it is a long-shot and too distant in the future.



Expectations Ahead

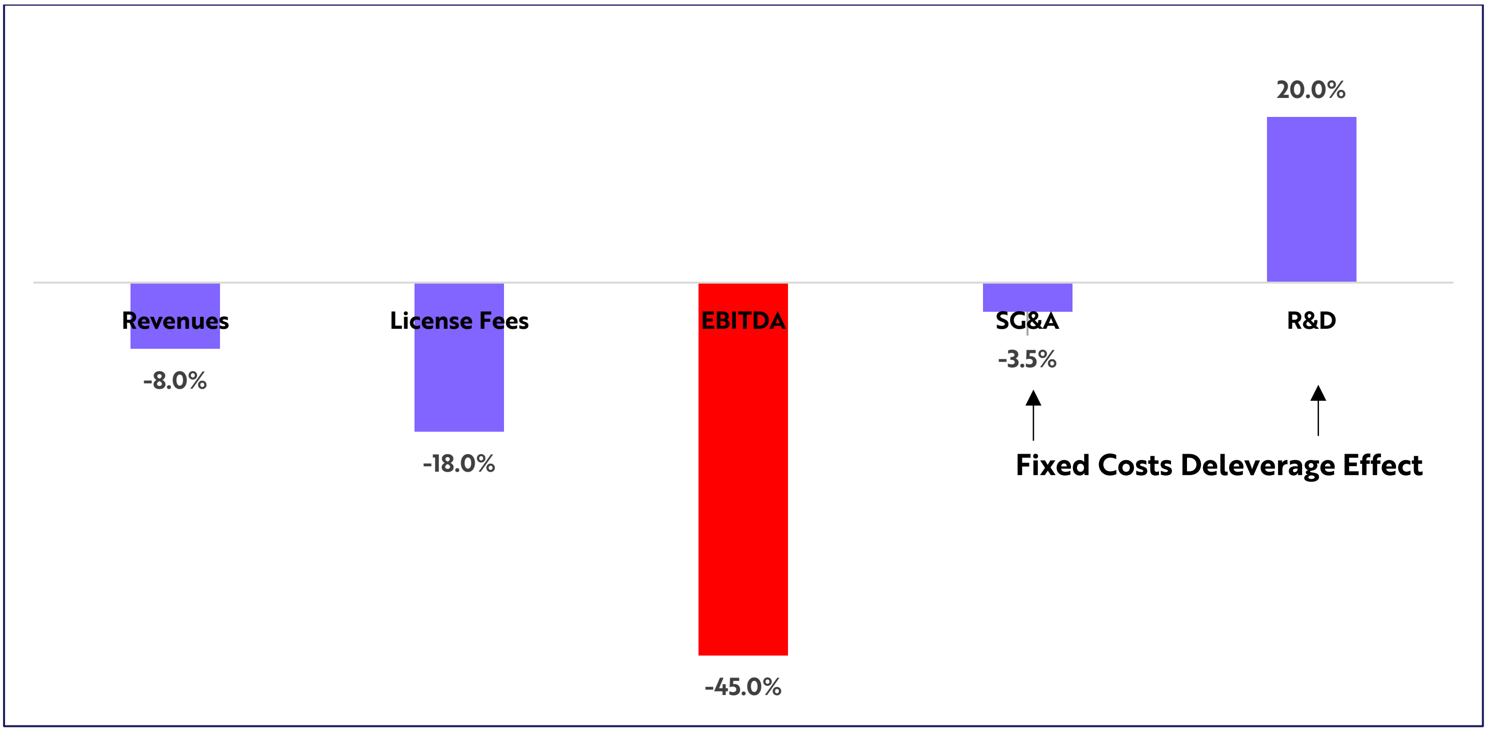
We expect Intellect to grow its topline atleast at high-teens over medium term; this coupled with expansion in margins, we expect that profits will grow at higher rates of ~25%. At current market cap of Rs8675 crores, Intellect is trading at 26x its trailing twelve months profits. We believe that there is a strong case for re-rating here given the growth, expansion in margins, reducing volatility of business and the fact that it's a growing free-cashflow business. A policy of regular buybacks can add another growth lever to EPS growth rate.

Risks

1. Business Volatility and Operating De-leverage

A software product business has inherent volatility because of License fee. License fee are non-recurring in nature and thus every year, a software product company has to find new customers to generate license fee and give that License fee are pure-profit, any degrowth in license fee has a large impact on the profits. This is further extrapolated by the fact that other costs like R&D and SG&A are largely fixed costs in the business and thus there is deleverage effect as well on the profits.

This volatility and de-leverage effect can be seen in FY20 performance of Intellect-



However, with growing share of AMC+SaaS, this volatility will continue to reduce as these revenues have the same high profitability of License fee, but are recurring in nature. AMC+SaaS now contributes nearly 37% of total revenue and should cross 50% in near term.

2. History of Missed Guidance

Ever since the company got listed in 2014, management has been giving strong guidance regularly and have missed this guidance in most cases.

Even though Intellect as a business has done reasonably well in the past and looks well placed to do so in the future as well; such things can dampen market's perception of the company and thus valuations.

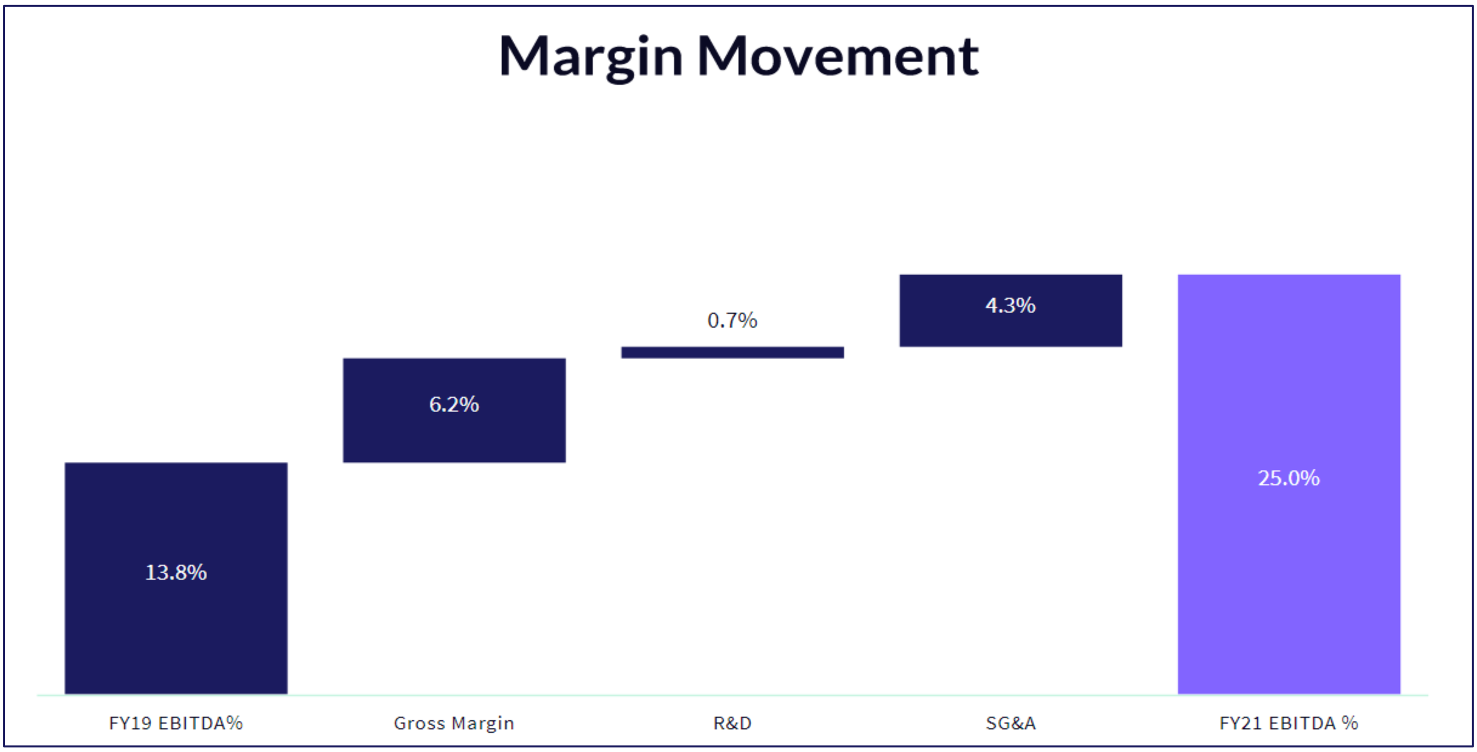
Guidance history

Timeline	Guidance	Status	Remark
Q4FY15	Breakeven or Profitable by Q4FY16	✖	Technically met, but due to change in policy of Capitalizing R&D expense
August'15	60% Gross Margins by FY19	✖	FY19 Gross Margins at 50%.
AR-FY16	Rs1200 crores Revenues by FY18	✖	FY18 Revenues at Rs1000 crores
Q4FY16	22-26% Revenue growth in FY17	✖	FY17 Revenue growth at 13%.
Q1FY20	20% Revenue Growth for FY20	✖	Degrowth of 8% in FY20
Q3FY20	EBITDA Margins of 20% in FY21	✔	Achieved 25% EBITDA Margins in FY21
Q2FY21	30% EBITDA Margins in next four quarters	✖	Guidance later trimmed to 25-30%.
Q4F21	20% Revenue and 30% EPS Growth Over Next 4 Years	?	-

3. Cost Savings during Covid Led Margins Spike in FY21?

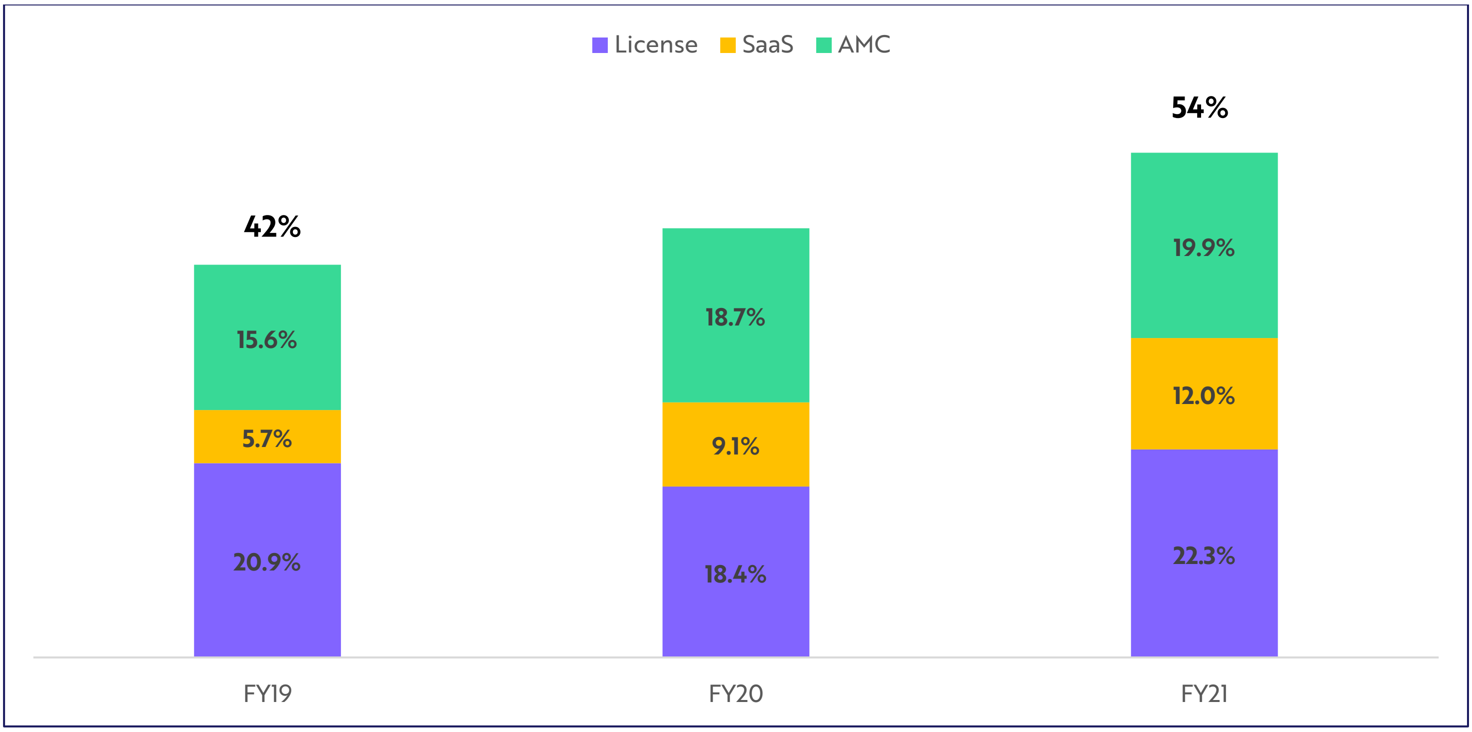
A lot of businesses saw cost savings during Covid, which pose a risk to margins in the future, as costs comes back. Intellect also saw a sharp spike in margins in FY21, but our understanding and research shows that a major part of Intellect margin expansion was organic and not covid related costs savings.

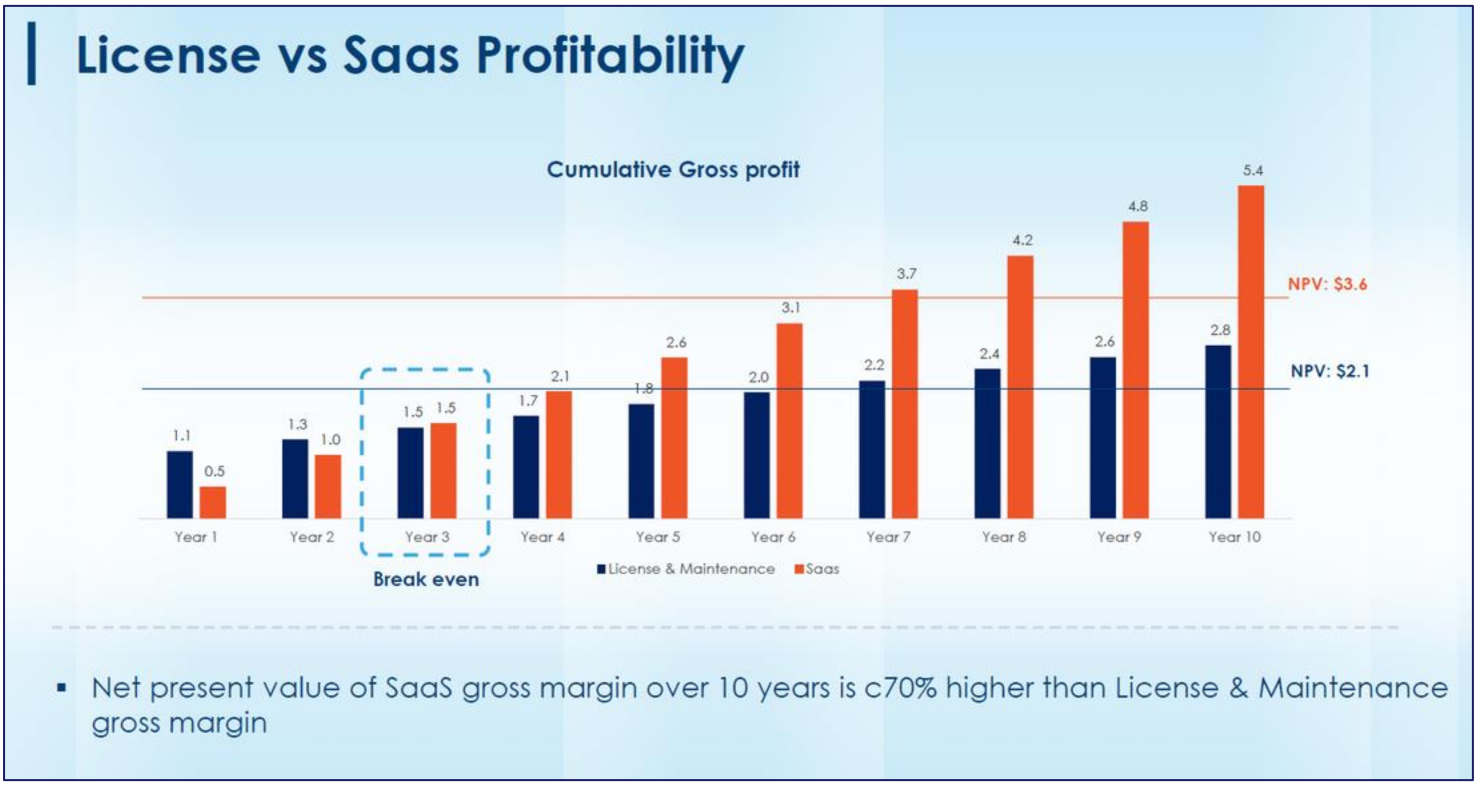
Firstly, we need to compare margins of FY19 vs FY21 and not FY20 to judge increase in margins; because FY20 margins where depressed due to slowdown in license fee and operating deleverage which we talked about above.



As can be seen from above, a large part of margin expansion was led by improvement in Gross Margins. We believe that this sharp improvement in gross margins has been on the back of large increase in the share of high margin License Linked Revenues (License+AMC+SaaS).

Also, FY21 was the 3rd year of Intellect generating SaaS revenues, so the easing out of initial pressure on gross margins from the transition would have also helped.





On SG&A side there would have definitely been cost savings, and those will come back, but max what could happen is that in the coming year Intellect might not see any operating leverage play out on SG&A side. But post that, increase in revenues should help Intellect improve its margins.

Ratings Explanation:

Buy: Expected total return (price appreciation plus dividend yield) of more than 10% over next 12 months.

Hold: Expected total return (price appreciation plus dividend yield) of +/- 10% over next 12 months.

Exit: No Further Coverage/Update on the stock.

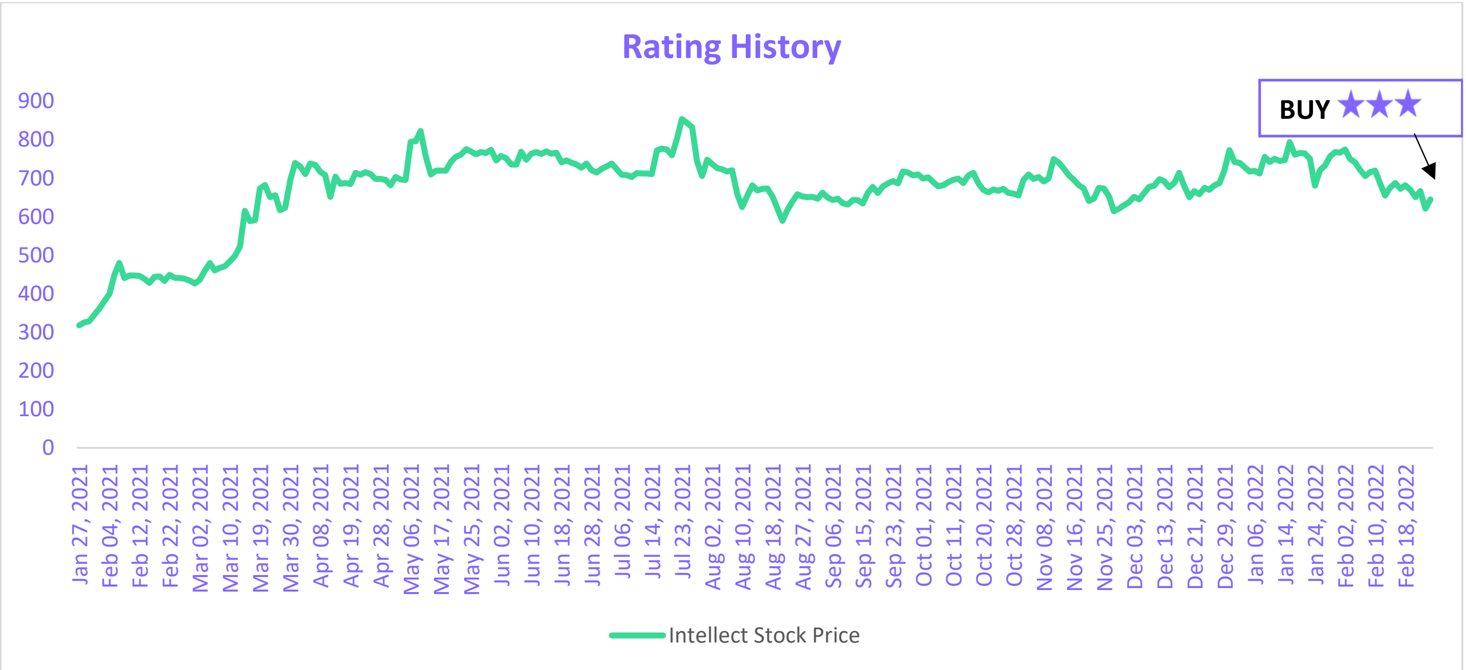
Conviction Rating:

Conviction rating reflects our understanding of return:risk ratio of the underlying stock for next 12 months. The rating is given within a range of 1-5 stars, wherein each higher star reflects a higher return:risk ratio; so, 1 star indicates a low return:risk ratio and 5 star indicates a high return:risk ratio.

The rating is based on our qualitative understanding of how the four factors of- Price Action, Earnings Growth, Valuations & Perception will play out over next 12 months for the stock.

Conviction ratings are to be read along with Buy & Hold ratings and no conviction rating is assigned for stocks with Exit rating.

Note: Ratings are valid till changed.



Note: Above chart indicates ratings assigned (including changes) over the period of coverage of stock.

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