Indra

TMTs

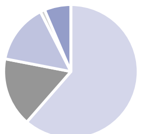
Outperform

Target Price: EUR16.50
Closing price as of 5 September 2011: EUR11.98

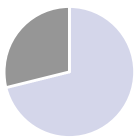
Basic data	
Closing price as of 05/09/2011 (EUR/sh.)	11.98
Recommendation	Outperform
Market cap (EUR mn)	1,929
Target price (EUR/share)	16.50
Total enterprise value (EUR mn)	2,246
Number of shares (million)	161
Average daily volume (EUR mn)	12.2
Free-float (%)	65.0

Main shareholders (%)	
Caja Madrid	20.0
Corp. F. Alba	10.0
Caja Astur	5.0

Sales Geographical



Revenues Divisional



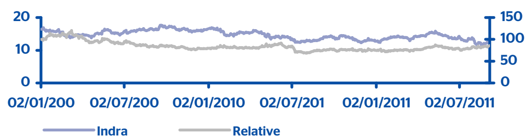
Per share data	2010	2011e	2012e
EPS (EUR)	1.17	1.24	1.34
EPS growth (%)	-3.6%	6.1%	7.9%
Ord. EPS (EUR)	1.34	1.24	1.34
Ord. EPS growth (%)	10.1%	-7.1%	7.9%
DPS (EUR)	0.66	0.68	0.73
CFPS (EUR)	-0.21	0.23	0.80

Valuation ratios (x)	2010	2011e	2012e
P/E	10.9	9.6	8.9
Ord. P/E	9.6	9.6	8.9
P/CF	-62.0	57.4	16.3
P/BV	2.1	1.8	1.6
EV/EBIT	9.2	8.0	7.1
EV/EBITDA	7.8	6.9	6.2
EV/sales	0.9	0.8	0.8
FCF yield (%)	-1.6%	1.9%	6.7%
Dividend yield (%)	5.2%	5.7%	6.1%
Pay-out (%)	56.4%	54.8%	54.2%

Financial and others (x)	2010	2011e	2012e
Net debt/EBITDA	0.9	1.1	0.9
Interest coverage	13.2	11.4	10.2
Net debt/equity	27.7%	31.8%	27.4%
ROE (%)	19.6%	19.3%	19.0%
ROCE (%)	14.3%	13.5%	13.7%
EV/CE	1.5	1.3	1.3
Capex/sales	5.3%	4.9%	3.7%
Working capital/sales	24.9%	26.7%	25.7%

Source: company data and BBVA Research estimates

Stock market performance (-3y until last close)



Source: Bloomberg

Rating record (-3y or since initiating coverage)

(23/09/2008) O

Investor concerns remain overstated

Domestic exposure (60% of 2010 revenues) is seen as a big risk, but we think that the business is resilient

Security & Defence and Transport & Traffic are the most challenging vertical markets at the domestic level as they are closely tied to public spending. Transport & Traffic (19%e of domestic revenues) may suffer in 2011-12e from the impact of political standstill. Defence (18%e of domestic revenues; -9%e YoY in 2010) although likely to see further cuts this year, shows some signs of stabilisation. In its other vertical markets, Indra is benefiting from supplier concentration and market share gains. We expect Indra's domestic business to decline by 1%e in 2011e, in line with our view of the business troughing in Spain in 2011e.

We expect margins to gradually recover, in spite of some dilution coming from Politec integration

We think that Indra has done a good job managing its production capacity so far and we remain confident that a return to a more favourable business mix is just around the corner, providing some breathing space for margins. We have, however, adjusted EBIT margins slightly downwards to reflect the Politec integration (2011e EBIT margin now 10.5%e).

Politec acquisition reinforces the international profile, with a clear LatAm accent

Politec Tecnologia is a Brazilian IT specialist (2010 sales EUR180mn) with strong competitive positions in Energy and Industry, Financial Services and P.A. We consider this acquisition a good strategic deal as it reinforces Indra's critical mass in Latin American IT Services, a position that can also be leveraged in technology-oriented markets such as Security & Defence and Transport & Traffic.

Order backlog remains healthy and valuation attractive

Indra's trading range has fallen in the last few years (12M Fwd P/E 9-12x, down from 13-16x) on investor concerns. However the market appears to be overlooking that order backlog remains healthy (1.27x LTM sales at the end of 1H11), providing good visibility over estimates. Valuation (P/E 9.7x 11e) remains attractive in our view. We maintain our Outperform rating with a TP of EUR16.5/share.

Strengths	Weaknesses
• International leadership in selected solution niches • Visibility via the backlog • Know-how generation through R&D investment	• Critical mass in some regions • Dependence on public spending in Spain (~27%e) • Perception of unstable shareholding structure

Opportunities	Threats
• Expansion in growth markets • Strategic acquisitions • Railway signalling	• Domestic slowdown • Budgetary austerity in Spain • Pricing pressure

Indra - TMTs

Closing price as of 5 September 2011: EUR11.98 - **Outperform**

Company description

An increasingly international company

Indra is a leading Spanish IT multinational which generates 39% of its revenues internationally (17% in Europe, 15% in LatAm, 8% in RoW). With the recent acquisition of Politec in Brazil, Indra has increased its exposure to growth markets (LatAm 22% of pro-forma 2010 revenues, total growth markets 26% of pro-forma 2010 revenues) and reduces its dependence on the domestic market (53% of pro-forma 2010 revenues). Indra's activity is divided into two segments: Solutions (higher value-added and margins), 71% of revenues, and Services (counter-cyclical activity with a high level of recurrence), 29% of revenues.

International expansion continues to be the main growth driver

International revenues have been growing in double digits for the last few years (2007-10 CAGR +12%) and are expected to continue to be the main growth driver. However, regional differences are starting to show: while growth markets (LatAm, APAC, Middle East, Africa) continue to be very strong (+17% YoY in 1H11), Europe (-6% YoY in 1H11) is negatively affected by its high exposure to the Eurofighter project (experiencing short-term budget cuts).

Technology-oriented vertical markets are the most international

Security & Defence (23% of 2010 revenues) and Transport & Traffic (22% of 2010 revenues) are the technology-oriented (as opposed to IT Services-oriented) vertical markets, where the Solutions content is very high. They are also the most international vertical markets: international sales represented 53% of Security & Defence and 46% of Transport and Traffic in 2010.

Operating outlook

We see business bottoming-out in Spain in 2011e

We are beginning to see some signs of business bottoming out in Spain (flat sales in 1H11), which the company claims is related to the process of supplier concentration that is taking place in the Spanish corporate IT Services market, favouring the larger industry players. We forecast that the domestic recovery will be volume-driven, which might put some temporary strain on margins. We expect Indra's domestic business to decline by 1% in 2011e, in line with our view of business troughing in Spain in 2011e.

Order intake very strong in Services, still weak in Solutions

Order intake has been strong during the bearish cycle (+5% YoY in 2009, +7% YoY in 2010), driven by a very strong performance from Services (+13% in 2009, +33% in 2010), as the Services activity tends to be counter-cyclical and involves multi-year deals. As a result the order delivery cycle (from intake to billing) has lenghtened a little and so has the visibility of future revenues. Solutions order intake tends to be more volatile QoQ as projects tend to be lumpy and back-end loaded. However, this has shown signs of stabilisation in the first half of the year (0% in 1H11), and we expect to see a flattish YoY performance by the end of the year. Total order backlog remains at a healthy 1.27x LTM sales at the end of 1H11.

Margins should prove to be resilient...

Indra's EBIT margins, historically double-digit and significanty above the typical range of 3-7% for an IT Services company, are the result of a blended best-in-class performance both in IT Services related markets (c.54% of total sales, with a lower than average Solutions component) and technology-oriented vertical markets (c.46% of total sales with a higher than average Solutions component). We expect these to support the underlying best-in-class margin performance thanks to i) active management of production capacity (nearshoring in Spain, increasing LatAm production capacity, etc.); ii) increasing utilisation rates by swapping subcontractors for own personnel; and iii) tight control of indirect costs and overheads. We also remain confident that a return to a more favourable business mix (i.e. higher Solutions content) is just around the corner, providing some breathing space for margins. Excluding the effect of the Politec integration we would expect 2011e EBIT margins to be in line with guidance (10.7%) before slight expansion in 2012e (11.2%).

...even if affected in the short term by Politec integration

We have, however, adjusted EBIT margins slightly to account for the Politec integration, which combined with Indra's local business in Brazil, would have generated a pro-forma local EBIT margin in 2010 of around 1%. We believe that the Brazilian market has great potential for margin synergies stemming from the ability to leverage an increased resource base, both from a commercial and a production capacity point of view. We also see room for efficiency improvements in the integration process by implementing Indra's best practices in process monitoring and control and project management, much in the same way as Indra did in the past with Azertia and Soluziona. However, at the same time, we expect the margin development process in Brazil towards the local IT peer average of around 9% to be gradual, which would have a negative short-term impact on the consolidated EBIT margin. We have trimmed our margin estimates to 10.5% in 2011e and to 11.0% 2012e.

Cash flow

Working capital requirements continue to rise...

We have seen steady increases in Indra's net working capital from 2007, driven by a sharp drop in pre-payments as a direct consequence of new Defence projects plummeting during the financial crisis (and a general lack of financing for Defence projects). Nevertheless, prepayments started to stabilise in 2010 at 72-73 days of sales, while net working capital went up again (from 80 DoS to 93 DoS) in 2010. According to the company, the reason for this is that within the above-mentioned context of supplier concentration, large corporations have asked for more favourable payment terms. This trend should continue at least in the short term, as implied in Indra's guidance of 100 DoS in net working capital assets by the end of 2011, dragging down cash flow conversion.

...but we do not see this as a sign of weakening earnings quality

In a very fragmented market, we think that the ability to offer more favourable payment terms becomes a competitive advantage for companies with sufficient financial muscle. We think this is one of the main reasons behind the surprising (to some) resiliency of Indra's domestic business and its increasing market share. At the same time, it is important to note that bad debt provisions remained stable in 2007-10, so we do not see that the rise in working capital requirements represents a sign of weakening earnings quality.

We are still keeping an eye on R&D capitalisation

One of the main differences between Indra's business model and that of a pure IT Services company is that Indra generates its own Solutions know-how through R&D investment (Indra invests roughly 7% of revenues in R&D). Capitalised R&D is on the rise, raising some concerns about potential margin overstatement, but we want to highlight that the percentage of R&D financed through third parties has also gone up (from 22% in 2007 to 48% in 2010). This third-party financing comes in the form of government subsidies and soft loans with repayments subject to both the technical and the commercial success of the project. Net capitalised R&D, after third-party financing, has remained stable over the last few years, allaying our concerns about margin overstatement.

Net debt rises on M&A activity, even if the bulk of Politec acquistion price should be paid in 2014

We expect Indra to close 2011e with net debt of EUR338mn after the acquisition of Galyleo in Italy and the initial payment of Politec minority shareholders. This implies 1.1x net debt/EBTITDA. Indra will actually pay for the 93% of Politec in the hands of the majority shareholders (founding partners 84% and Mitsubishi Corp. 9%) in 2014 and this payment is contingent upon the achievement of certain business targets by the merged company in 2013. The base case (assuming 2013 combined sales of BRL1,000mn, EBIT margin of 9% and net debt of BRL90mn) contemplates a cash payment of BRL219.5mn (approximately EUR98mn) and values the integrated company using an implied multiple of 2013 0.9x EV/Sales.

Valuation

We have trimmed our DCF valuation to EUR16.5/share (vs. our previous EUR17/share)

We have trimmed our DCF valuation to reflect more challenging than expected working capital requirements (extended payment terms), setting our new target price at EUR16.5/share, 3% below our previous target price. We maintain our Outperform rating on the stock.

The trading range has fallen to 9-12x 12MFwd P/E (from 13-16x), while visibility remains high

Indra's trading range seems to have been downgraded in the last few years on investor concerns, mainly about the resilience of the domestic business and margin compression risk. We would argue that Indra's order backlog provides considerable visibility of future earnings, reducing the risk in 2011 estimates and beyond. While Indra has the largest short position of all Ibex-35 stocks (9% of its market cap), in our view the current valuation (9.7x 11e P/E; 9x 12e P/E) is very attractive.

Valuation not stressed even in a worst-case scenario for 2012e (domestic business -5%e, EBIT margin 10%e)

We acknowledge that there is a correlation between trailing 12M Spanish GDP and Indra's domestic business. As GDP growth prospects for 2011e have come into question recently, we have envisaged a hypothetical scenario with Indra's domestic business declining 5% (which would be the largest drop ever in domestic revenues for Indra) and EBIT margins contracting to 10%. In this scenario, Indra would be trading at 10.6x 12e P/E. According to our stressed model, the upper end of the new trading range, 12x 12e P/E, would not be reached unless the EBIT margin fell to 9% of revenues.

Indra - TMTs

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Balance sheet (EUR mn)	2006	2007	2008	2009	2010	2011e	2012e	2013e
Intangible assets	29.3	62.9	87.3	133.6	219.9	219.9	219.9	219.9
Tangible assets	94.1	131.1	139.2	140.4	148.2	235.9	299.4	363.8
Financial investments	32.3	37.0	42.9	41.4	50.5	51.4	52.3	53.2
Other long-term assets	218.8	459.2	464.2	471.5	506.6	506.6	506.6	506.6
Assets classified for disposal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current assets	1,126.9	1,585.0	1,632.1	1,561.4	1,830.7	1,826.2	1,893.4	1,954.0
Other current assets	28.1	78.3	73.1	74.8	91.0	91.0	91.0	91.0
Cash and cash equivalents	42.3	32.0	23.1	66.5	129.0	129.0	129.0	129.0
Total assets	**1,571.8**	**2,385.5**	**2,461.9**	**2,489.6**	**2,975.9**	**3,060.0**	**3,191.6**	**3,317.5**
Equity	345.8	696.7	781.4	931.8	991.0	1,084.0	1,190.1	1,315.7
Minority interests	26.3	41.8	42.2	45.3	23.0	22.4	21.8	21.2
Prov. and other long-term	58.6	97.4	66.4	94.4	129.6	129.6	129.6	129.6
Liabilities classified for disposal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial debt	101.2	182.4	171.8	201.1	403.8	474.2	454.7	404.8
Accounts payable	895.5	1,153.6	1,133.6	1,013.3	1,176.8	1,098.1	1,143.7	1,194.5
Other current liabilities	144.4	213.6	266.5	203.7	251.7	251.7	251.7	251.7
Total liabilities	**1,571.8**	**2,385.5**	**2,461.9**	**2,489.6**	**2,975.9**	**3,059.9**	**3,191.6**	**3,317.5**
Net debt	58.9	150.4	148.7	134.6	274.8	345.2	325.7	275.8
Capital employed	573.6	1,084.6	1,189.2	1,293.6	1,528.6	1,690.5	1,775.6	1,849.8
Working capital	231.4	431.4	498.5	548.1	653.9	728.1	749.7	759.5

P&L (EUR mn)	2006	2007	2008	2009	2010	2011e	2012e	2013e	CAGR 10/13e
Net revenues	1,406.8	2,167.6	2,379.6	2,513.2	2,557.0	2,651.2	2,838.3	3,026.9	5.78%
Other income	6.6	13.6	19.6	60.6	74.4	74.4	74.4	74.4	
Revenues and other income	**1,413.4**	**2,181.2**	**2,399.2**	**2,573.8**	**2,631.4**	**2,725.6**	**2,912.7**	**3,101.3**	5.63%
Growth in sales (%)	n.a	54.1%	9.8%	5.6%	1.7%	3.7%	7.1%	6.6%	
Supplies	-770.1	-1,067.4	-1,133.9	-1,239.5	-1,255.5	-1,239.1	-1,325.1	-1,411.1	
Personnel costs	-458.7	-840.4	-957.2	-1,006.9	-1,048.6	-1,162.4	-1,229.0	-1,294.1	
Other operating expenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recurrent EBITDA	**184.6**	**273.4**	**308.2**	**327.4**	**327.3**	**324.1**	**358.6**	**396.1**	6.57%
Non-recurrent items	0.0	-16.5	0.0	0.0	-33.3	0.0	0.0	0.0	
EBITDA	**184.6**	**256.9**	**308.2**	**327.4**	**294.0**	**324.1**	**358.6**	**396.1**	10.45%
EBITDA growth (%)	n.a	39.2%	20.0%	6.2%	-10.2%	10.2%	10.6%	10.5%	
EBITDA/sales (%)	13.1%	11.9%	13.0%	13.0%	11.5%	12.2%	12.6%	13.1%	
Depreciation and provisions	-20.8	-33.4	-37.7	-42.0	-42.1	-44.8	-45.6	-47.6	
EBIT	**163.8**	**223.5**	**270.5**	**285.4**	**251.9**	**279.3**	**313.0**	**348.5**	11.43%
EBIT growth (%)	n.a	36.5%	21.0%	5.5%	-11.7%	10.9%	12.1%	11.3%	
EBIT/sales (%)	11.6%	10.2%	11.3%	11.1%	9.6%	10.2%	10.7%	11.2%	
EBIT non-recurrent items	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Operating profit	**163.8**	**223.5**	**270.5**	**285.4**	**251.9**	**279.3**	**313.0**	**348.5**	11.43%
Net financial result	-1.4	-12.7	-22.9	-24.9	-19.1	-24.5	-30.8	-29.2	
Equity-accounted earnings	0.0	1.4	3.5	0.2	0.9	0.9	0.9	0.9	
Ordinary income	**162.4**	**212.2**	**251.1**	**260.7**	**233.7**	**255.7**	**283.1**	**320.2**	11.07%
Ordinary income growth (%)	n.a	30.7%	18.3%	3.8%	-10.4%	9.4%	10.7%	13.1%	
Extr. result/discont. activities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Pre-tax profit	**162.4**	**212.2**	**251.1**	**260.7**	**233.7**	**255.7**	**283.1**	**320.2**	11.07%
Tax	-44.2	-57.4	-65.0	-62.7	-45.7	-56.2	-67.9	-76.9	
Minorities	-3.8	-7.0	-3.7	-2.4	0.6	0.6	0.6	0.6	
Net profit	**114.4**	**147.8**	**182.4**	**195.6**	**188.6**	**200.0**	**215.8**	**244.0**	8.96%
Net profit growth (%)	n.a	29.3%	23.4%	7.2%	-3.6%	6.1%	7.9%	13.1%	
Ordinary net profit	**114.4**	**159.8**	**182.4**	**195.6**	**215.4**	**200.0**	**215.8**	**244.0**	4.25%
Effective tax rate (%)	27.2%	27.2%	26.3%	24.1%	19.6%	22.1%	24.1%	24.1%	

Cash flow statement (EUR mn)	2011e	2012e	2013e
EBITDA	324.1	358.6	396.1
Non-cash EBITDA	0.0	0.0	0.0
Working capital variation	-74.2	-21.6	-9.8
Capex	-132.5	-109.1	-112.0
Free operating CF pre-tax	**117.4**	**227.8**	**274.3**
Net financial result	-24.5	-30.8	-29.2
Non-cash financial result	0.0	0.0	0.0
Taxes	-56.2	-67.9	-76.9
Div. from/to assoc./minorities	0.0	0.0	0.0
Cash flow other	0.0	0.0	0.0
FCFE	**36.6**	**129.1**	**168.3**
Dividends	-107.0	-109.7	-118.3
FCFE after dividends	**-70.4**	**19.4**	**50.0**
FX	0.0	0.0	0.0
Change in net debt	**70.4**	**-19.4**	**-50.0**

Source: company data and BBVA Research estimates