India Equity Institutional Research | Information Technology | Result Update

Mphasis Ltd. ₹433

KRChoksey
wealth enhancement solutions

Disappointment continues at multiple front — REDUCE

Price target ₹423

Market Data	February 28, 2011
Shares outs (Cr)	20.99
Equity Cap (₹. Cr)	209.9
Mkt Cap (₹. Cr)	9,089
52 Wk H/L (₹)	752/433
Avg Vol (1yr avg)	555,964
Face Value (₹)	10
Bloomberg Code	MPHL IN

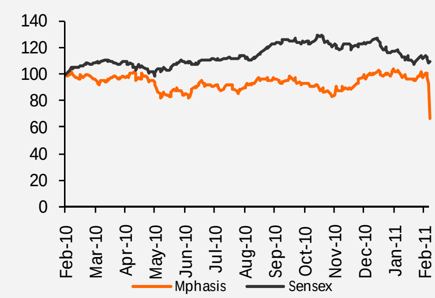
Year end closure by HP and some of the other clients plus undisclosed one time revenue in Q4FY10 led significantly higher than expected decline in revenue:- Mphasis's revenue fell by 7.7% QoQ to ₹ 1,216.4 crore in Q1FY11 led by 9.8% and 3.4% QoQ decline in business from HP and direct channel, respectively. The lower number of working days and year end closure by HP (HP contributed 68% of the total revenue) and some of the other clients resulted in 3.5% QoQ dip in revenue. Further, one time revenue of around USD 9 mn (the same was not disclosed by the management in previous quarter result concall or at analyst day held recently) in Q4FY10 impacted revenue by around 3% in Q1FY11 QoQ. Moreover, the hangover of billing rate discount to HP (in the current quarter billing rate discount of around 5%-10% was offered by HP channel to few clients as productivity improvement pass-on w.e.f. December 1st 2010) continued in Q1FY11 impacting revenue by around 1% QoQ. The full of same will be felt in Q2FY11 adversely impacting billing rate by 50 bps QoQ in Q2FY11.

Will continue to underperform industry due to slower growth in HP and uphill task in expanding business from direct channel:- The management has indicated that rate at which HP is offshoring to India will come down in coming years, as HP is scaling up its delivery centre in other emerging markets. Further, we believe the company faces challenging task in significantly expanding its revenue from direct channel. The primary reason for our belief is its high dependence on traditional service lines (application development and maintenance contributes 64% of the total revenue) which is highly commoditized and expected to grow at around half the times of Indian IT industry growth rate, going forward. Moreover, the company's focus on building business around HP till date and hence lack of investment in building industry centric solutions (except payment solutions) or platforms will impact its ability to participate and win deals through direct channels in coming quarters.

Market Info:

SENSEX	17,824
NIFTY	5,333

Price Performance



The management revises downward its margin expectation for FY11E due to significant pressure on margin in the current quarter:- The EBTIDA margin came down by 431 bps QoQ to 16.2% (excluding reversal of provision of ₹43.4 crore made in the quarters) primarily led by dip in utilization rate and billing rate discount. Higher than anticipated slowdown in business led decline in blended utilization rate of application and BPO segment by 300 bps (to 72%) and 500 bps (to 69%) QoQ, respectively. Moreover, the management has revised its margin expectation to 18% (+ve or -ve 1%) from its previous target range of 18%-20% in FY11E.

Share Holding pattern (%)

Particulars	Dec-10	Sep-10	Chg (%)
Promoters	60.5	60.6	-0.1
Institutions	8.0	7.7	0.3
FIIs	18.0	18.3	-0.3
Public & Others	13.5	13.4	0.1
Total	100	100	

Source: BSE

The reversal of management bonus provision indicates they are not able to achieve set targets:- The company has reversed provision of ₹17.6 crore in Q1FY11 (as compared to ₹20.6 crore in Q1FY10) made for management bonus in FY10. This indicates that the management has been underperforming in terms of target set out to them by the company's board for the second consecutive year. In case there is overhaul in the top management due to underperformance as has been the case in the parent company HP as well as peers such as Wipro; it might disrupt recent efforts to drive business from direct channel and might prolong recovery in revenue growth rate in line with the industry.

Valuation and view: Considering, lack of proper communication from the management and slower revenue growth expectation than the industry average in coming years, we expect the company to trade at lower end of valuation range (i.e. 10 to 12 times FY12E EPS) at which peer sets trade. We arrive at a target price of ₹423 per share by assigning multiple of 10 times to its FY12E core business EPS of ₹34 and considering cash per share of ₹83. We downgrade our recommendation to "REDUCE" from "HOLD" rating on the stock.

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Exhibit 1 : Key Financials (₹ In Crore)

Particulars	FY09	FY10	FY11E	FY12E
Sales	4,283.4	4,918.9	5,101.9	5,752.8
EPS (₹)	43.4	52.0	34.0	38.3
Core business EPS (₹)	42.0	42.2	29.3	34.0
EBITDA margin	26.8%	22.4%	17.0%	19.5%
NPM	21.2%	22.2%	14.0%	14.0%
P/E	9.8	8.2	12.5	11.1
EV/EBITDA	6.9	6.6	7.6	5.3

Source: Company Data, KRChoksey Research

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Exhibit 2 : Q1FY11 Result (₹ In Crore)

Particulars	Q1FY11	Q4FY10	Q-o-Q	Q1FY10	Y-o-Y	Comment
Revenues	1,216.4	1,318.2	-7.7%	1,155.9	5.2%	One time revenue in Q4FY10, relatively lower number of working days in Q1FY11 and billing rate discount adversely impacted revenue
Cost of revenues	902.7	928.1	-2.7%	779.5	15.8%	Significant decline in blended utilization rate of application and BPO segment and decline in billing rate adversely impacted overall gross margin
Other operating expenses	116.8	119.9	-2.6%	118.9	-1.8%	Significant decline in rental cost and travel expenses led decline in overall operating expenses
EBITDA	196.9	270.20	-27.1%	257.50	-23.5%	
EBITDA margin	16.2%	20.5%	-4.3%	22.3%	-6.1%	
Provision for expenses (net)	(43.4)	(23.0)	88.7%	(20.3)	113.8%	Reversal of provision made for managemet bonus and telecom charges
Foreign exchange gain (incl. adjustment for hedging reserve)	37.3	40.2	-7.2%	59.7	-37.5%	
Other income, net	14.5	18.0	-19.4%	9.0	61.1%	
Depreciation	35.9	37.4	-4.0%	45.7	-21.4%	Consolidation of facilities across India led decline in depreciation cost
Profit before tax	256.2	314.0	-18.4%	300.8	-14.8%	
Taxes	29.5	30.0	-1.7%	32.5	-9.2%	
Net profit	226.7	284.0	-20.2%	268.3	-15.5%	
Net profit margin	18.6%	21.5%	-2.9%	23.2%	-4.6%	

Source : Company data, KRChoksey Research

Exhibit 3: Income Statement

₹ Crore	FY09	FY10	FY11E	FY12E	Comment
Revenues	4,283.4	4,918.9	5,101.9	5,752.8	Due to slowdown in revenue from HP and direct channel and billing rate discount we reduce our FY11E and FY12E forecast
Cost of revenues	2,690.1	3,375.1	3,768.0	4,160.7	
Gross profit	**1,593.3**	**1,543.8**	**1,333.9**	**1,592.0**	
Selling expenses	179.1	220.1	255.5	257.3	
General and administrative expenses	266.4	219.9	210.8	212.3	
EBITDA	**1,147.9**	**1,103.8**	**867.6**	**1,122.4**	Due to higher than expected billing rate discount and pressure on utilization rate we are reducing our margin assumption
Provision for expenses (net)	0.8	(43.3)	(43.4)	-	
Foreign exchange gain (includes adjustment from hedging reserve)	9.9	175.8	46.8	12.7	
Other income, net	18.3	50.8	74.6	109.1	
Depreciation	202.3	163.7	151.0	170.9	
Profit before taxation	**972.9**	**1,210.0**	**881.4**	**1,073.3**	
Income taxes	64.1	119.2	168.5	268.3	
Net profit	**908.9**	**1,090.8**	**712.9**	**805.0**	

Source : Company data, KRChoksey Research

Exhibit 4: Balance sheet

₹ Crore	FY09	FY10	FY11E	FY12E
Share capital	209.6	209.9	209.9	209.9
Reserves and surplus	2,135.8	3,089.2	3,720.8	4,444.4
Networth	**2,345.3**	**3,299.1**	**3,930.7**	**4,654.4**
Secured loans	3.3	45.4	34.0	25.5
Total Sources of Funds	**2,348.7**	**3,344.5**	**3,964.7**	**4,679.9**
Gross block	1,004.4	1,025.8	1,150.7	1,294.7
Accumulated depreciation	(688.0)	(783.6)	(934.6)	(1,105.5)
Net block	**316.4**	**242.3**	**216.1**	**189.2**
Capital work-in-progress	12.7	8.9	9.8	10.8
Goodwill	294.6	388.6	388.6	388.6
Deferred tax assets	69.4	75.1	75.1	75.1
Cash & cash equivalents	761.2	1,460.0	1,960.0	2,460.0
Net current assets	894.4	1,169.6	1,315.1	1,556.1
Total Application of Funds	**2,348.7**	**3,344.5**	**3,964.7**	**4,679.9**

Source : Company data, KRChoksey Research

Exhibit 5: Ratios

	FY09	FY10	FY11E	FY12E
Profitability Ratios				
Operating profit margin (%)	26.8%	22.4%	17.0%	19.5%
PAT Margin (%)	21.2%	22.2%	14.0%	14.0%
RONW (%)	38.7%	33.1%	18.1%	17.3%
Per Share				
EPS (₹)	43.4	52.0	34.0	38.3
Core business EPS (₹)	42.0	42.2	29.3	34.0
Book Value (₹)	111.9	157.2	187.2	221.7
Growth Ratios				
Revenue	*	14.8%	3.7%	12.8%
Operating profit	*	0.0%	-20.6%	23.2%
Net profit	*	20.0%	-34.6%	12.9%

Source: Company data, KRChoksey Research. Note: - * FY08 was only of 7 months hence like to like basis comparison not possible.

Exhibit 6: Cash flow statement

₹ Crore	FY09	FY10	FY11E	FY12E
Profit before taxation	972.8	1209.9	881.4	1073.3
Net cash provided by operating activities	1051.7	840.6	873.5	751.0
Net cash used in investing activities	-905.9	-792.3	-551.1	-535.9
Net cash used in financing activities	-42.7	-40.2	-92.7	-89.9
Changes in cash and cash equivalents	**103.1**	**8.1**	**229.7**	**125.3**
Effect of exchange rate changes	2.3	-8.3	0.0	0.0
Cash at beginning of the period	73.1	178.6	178.4	408.1
Cash at end of the year	**178.6**	**178.4**	**408.1**	**533.4**

Source: Company data, KRChoksey Research.

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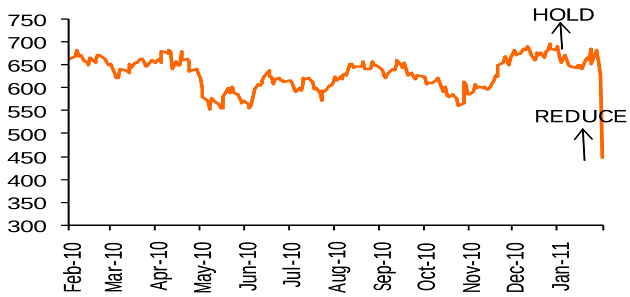
Mphasis Ltd



Rating Legend

Our Rating	Upside
Buy	More than 15%
Hold	5% - 15%
Reduce	Nil – 5%
Sell	Less than 0%

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