

MindTree

HOLD
Maintained
Rs559

Product woes continue

Reason for report: Management meet

Post our meeting with MindTree's CFO, we continue to believe that lack of clarity on product revenues and ensuing higher risk will likely take a toll on medium-to-short term valuations. Despite ~15% correction post Q4FY10 results and our downgrade, the market will likely ignore any inexpensive valuations (on FY12 basis) till some clarity emerges on the performance of the product business. Also, regardless of MindTree's core business showing signs of revival, investors are likely to be cautious on diversification in product business considering MindTree's lack of track record in the brand-conscious and highly competitive mobile phone market. We strongly believe that acceptance of mobile phone by clients is not the only important entry criterion, but the ensuing consistent investment to compete against giants (so as to ensure recurring business) is equally important as this would lead to successful diversification. Maintain HOLD.

- ▶ **Products – Uncertainty persists.** i) Of the guided product expenses of US\$10-11mn in H1FY11, Q1FY11 is likely to witness US\$5-6mn expenses (~7% of Q1FY11 revenues); ii) Expenses would be deferred if there are delays in product launch beyond Q3FY11; iii) Expenses of 60-70% would be employee-related, indicating a dedicated team of at least 600-800 (7-10% of FY10 employee base); iv) At present, product development is on track with expected launch in Q3FY11; v) Currently working on only one design and vi) Kyocera Global has sold ~45mn CDMA phones to clients in India (Tata Teleservices) and the US (Sprint and Verizon) using IP developed by Kyocera India (company acquired by MindTree) that MindTree management wants to leverage post buy-out.
- ▶ **Core services – MindTree confident of revival** with: i) manufacturing showing signs of revival (in key client accounts) versus muted management tone during Q4FY10 results call, ii) discretionary spend revival continuing to provide fillip to revenue growth, given higher demand for custom application versus package implementation; also, BFSI continues to lead in discretionary spend revival and iii) management confidence being high on billing rate improvement hereon. We estimate 19.7% dollar revenue growth in FY11 in core business (excluding products), including 3-4% growth driven by Kyocera and 7Strata.
- ▶ **Other details** are: i) high confidence on maintaining margins in core business, excluding products, in line with our estimates, ii) attrition is likely to be high in the short term, not only due to demand revival in the industry but also as wage inflation in Q1FY11 is covering only 60-70% of MindTree's employees.

Market Cap	Rs22.1bn/US\$473mn
Reuters/Bloomberg	MINT.BO/MTCL.IN
Shares Outstanding (mn)	39.5
52-week Range (Rs)	747/405
Free Float (%)	67.5
FII (%)	15.8
Daily Volume (US\$'000)	2,990
Absolute Return 3m (%)	3.7
Absolute Return 12m (%)	13.6
Sensex Return 3m (%)	0.2
Sensex Return 12m (%)	13.4

Year to March	FY09	FY10	FY11E	FY12E
Revenue (Rs mn)	12,375	12,960	14,880	17,723
Net Income (Rs mn)	523	2,148	1,624	2,338
EPS (Rs)	13.8	54.4	40.8	58.5
% Chg YoY	(49.4)	295.0	(25.0)	43.4
P/E (x)	40.6	10.3	13.7	9.6
CEPS (Rs)	29.1	72.2	60.0	79.0
EV/E (x)	6.6	8.3	8.6	5.4
Dividend Yield (%)	0.2	0.5	0.4	0.6
RoCE (%)	36.1	21.8	17.6	22.9
RoE (%)	9.6	35.2	21.8	25.2

Technology

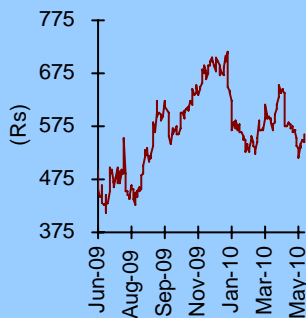
Target price Rs610

Shareholding pattern

	Sep '09	Dec '09	Mar '10
Promoters	33.1	32.7	32.5
Institutional investors	26.1	31.4	28.6
MFs and UTI	10.4	11.8	11.6
Insurance Cos.	1.2	1.1	1.2
FIs	14.5	18.5	15.8
Others	40.8	35.9	38.9

Source: www.nseindia.com

Price chart



Sandeep Shah

sandeep.shah@icicisecurities.com
+9122 6637 7114

Krupal Maniar, CFA

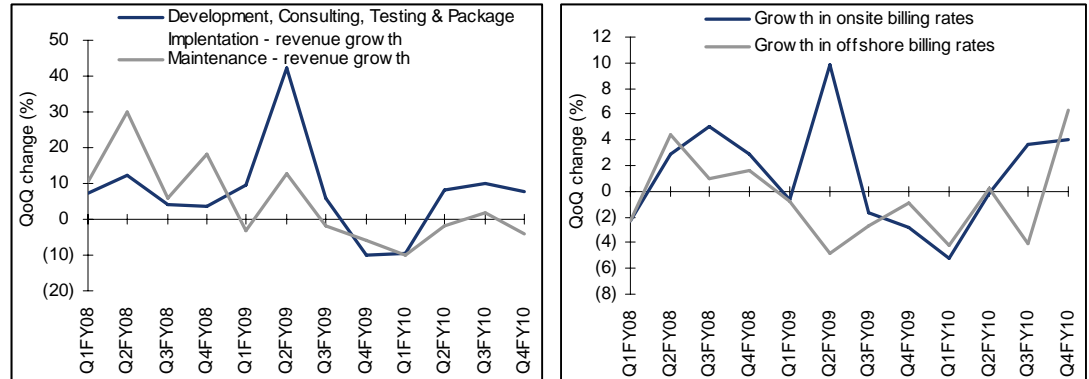
krupal.maniar@icicisecurities.com
+9122 6637 7254

Varun Sharma

varun.sharma@icicisecurities.com
+91 22 6637 7180

Chart 1: Discretionary spend seems to be in revival mode

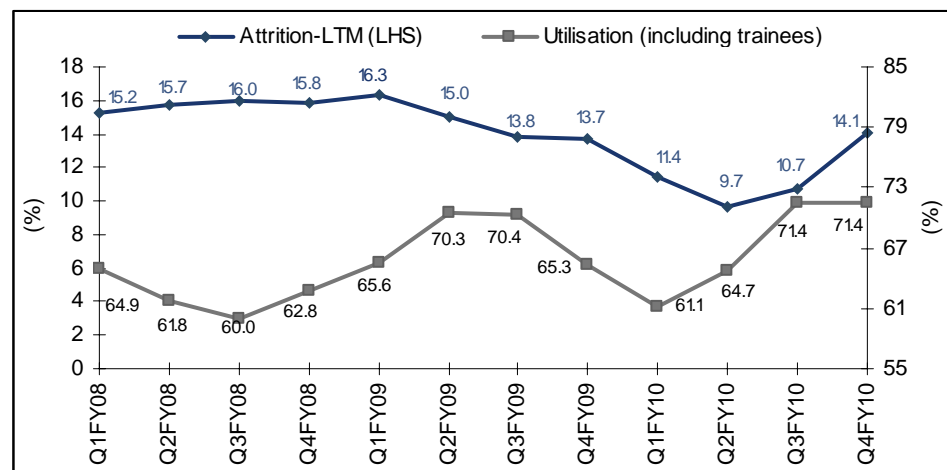
We remain positive on overall discretionary spend revival with QoQ growth in MindTree's discretionary revenues clearly outpacing maintenance revenues (Chart 1 - LHS), and resulting uptick in billing rates (Chart 1 – RHS)



Source: Company data, I-Sec Research

Chart 2: Margin levers dependent on growth revival

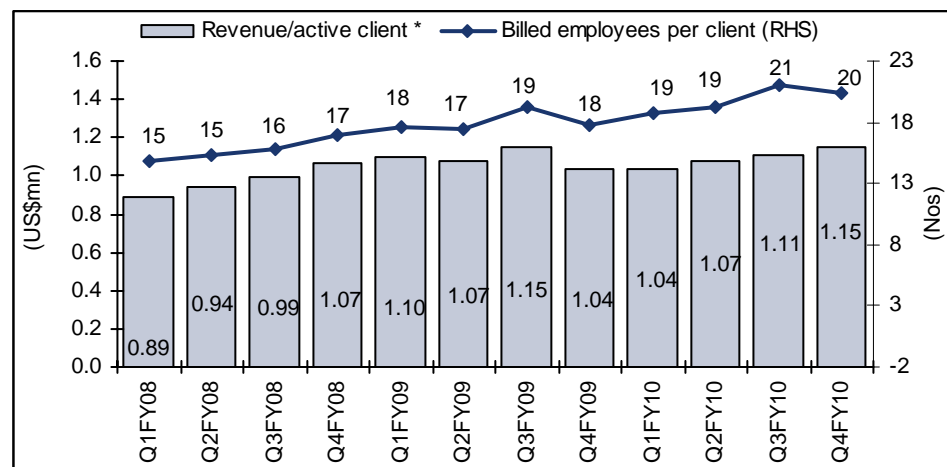
We believe that utilisation rate for MindTree is unlikely to increase significantly hereon, given higher discretionary- & project-based nature of company revenues, which are likely to grow faster going forward. Even attrition is likely to remain high in foreseeable future. However, growth revival and resulting uptick in billing rates and SG&A leverage is likely to drive margins hereon



Source: Company data, I-Sec Research

Chart 3: Improvement in client mining

MindTree's effort in terms of introducing new services, including infrastructure management, technical helpdesk and SAP implementation etc., coupled with investment in account relationship management is driving growth within existing clients. However, we believe that MindTree is a long way from achieving scalability amongst most big clients



*Annualised

Source: Company data, I-Sec Research

Financial Summary

Table 1: Profit and Loss statement

(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Operating Revenues (Sales)	12,375	12,960	14,880	17,723
Operating Expenses	9,065	10,504	12,608	14,309
EBITDA	3,310	2,456	2,273	3,415
% margins	26.7	18.9	15.3	19.3
Depreciation & Amortisation	570	652	718	842
Interest & Finance Chgs	162	27	2	2
Other Income	(1,974)	770	369	247
Recurring PBT	604	2,547	1,922	2,817
Add: Extraordinary exps / (Inc)	0	0	0	0
Less: Taxes	67	398	298	479
- Current tax	139	380	279	535
- Deferred tax / MAT Credit	(71)	19	19	(56)
Less: Minority Int / Add: Associates	14	0	0	0
Net Income (Reported)	523	2,148	1,624	2,338
Recurring Net Income	523	2,148	1,624	2,338

Source: Company data, I-Sec Research

Table 2: Balance sheet

(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Assets				
Total Current Assets	4,691	4,841	5,901	7,633
of which cash and deposits	488	523	787	806
Total Current Liabilities & Provisions	3,082	2,604	3,076	4,183
Net Current Assets	1,609	2,238	2,825	3,450
Investments	1,013	1,272	1,772	3,022
of which Strategic/Group	7	7	7	7
of which Other Marketable	1,007	1,266	1,766	3,016
Net Fixed Assets	4,292	2,766	3,109	3,367
Tangible assets	2,831	2,612	2,819	3,077
Intangible assets	1,460	154	290	290
Capital Work-in-Progress	130	247	300	325
Total Assets	7,044	6,523	8,007	10,164
of which cash and equivalents	1,494	1,789	2,552	3,822
Liabilities				
Borrowings	1,394	31	31	31
Deferred Tax Liability	(190)	(214)	(194)	(251)
Minority Interest	328	0	0	0
Equity Share Capital	380	395	398	400
Face Value per share (Rs)	10	10	10	10
Preference Share Capital	0	0	0	0
Reserves & Surplus*	5,133	6,311	7,772	9,984
Net Worth	5,513	6,706	8,170	10,384
Total Liabilities	7,044	6,523	8,007	10,164

Source: Company data, I-Sec Research

Table 5: Quarterly trend

(Rs mn, year ending March 31)

	Jun-09	Sep-09	Dec-09	Mar-10
Net sales	3,048	3,150	3,319	3,444
% growth (YoY)	36.3	0.9	(8.8)	1.9
Recurring EBITDA	507	659	657	632
Margin (%)	16.6	20.9	19.8	18.4
Other income	332	38	202	197
Extraordinary Inc / (Loss)	0	0	0	0
Recurring Net Income	567	499	538	545

Source: Company data, I-Sec Research

Table 3: Cashflow statement

(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Operating Cash flow before W Cap changes	2,757	2,057	2,283	2,960
Working Capital Inflow / (Outflow)	(955)	208	(438)	(699)
Capex	(369)	(473)	(978)	(1,125)
Free Cash flow	1,433	1,791	867	1,137
Cash Flow from other Invst Act (Ex Capex)	(1,854)	(491)	(526)	(1,050)
Proceeds from Issue of Share Capital	6	94	62	40
Inc/(Dec) in Borrowings / Deferred Liabilities	310	(1,390)	(2)	(2)
Dividend paid	(90)	(46)	(138)	(105)
Increase/(Decrease) in Cash	(196)	(41)	263	20

Source: Company data, I-Sec Research

Table 4: Key ratios

(Year ending March 31)

	FY09	FY10	FY11E	FY12E
Per Share Data (Rs)				
Earnings per share (Basic Recurring)	13.8	54.4	40.8	58.5
Diluted Earnings per share	13.7	54.0	40.8	58.8
Cash earnings per share	29.1	72.2	60.0	79.0
Dividend per share	1.0	3.0	2.2	3.5
Book Value per share	145.1	169.7	205.1	259.7
Growth Ratios (%)				
Operating Income (Sales)	67.3	4.7	14.8	19.1
EBITDA	163.9	(25.8)	(7.4)	50.2
Recurring Net Income	(49.3)	310.7	(24.4)	43.9
Diluted Recurring EPS	(48.3)	294.2	(24.4)	43.9
Diluted Recurring CEPS	(17.1)	147.8	(16.2)	32.1
Valuation Ratios (x)				
P/E	40.6	10.3	13.7	9.6
P/CEPS	19.2	7.7	9.3	7.1
P/BV	3.9	3.3	2.7	2.2
EV / EBITDA	6.6	8.3	8.6	5.4
EV / Sales	1.8	1.6	1.3	1.0
EV / FCF	(14.8)	13.6	26.8	16.1
Operating Ratio				
Software Development Expenses/Sales (%)	56.3	61.6	65.4	63.2
SG&A/Sales (%)	16.3	19.3	19.1	17.3
Other Income / PBT (%)	(353.7)	29.2	19.1	8.7
Effective Tax Rate (%)	11.1	15.6	15.5	17.0
NWC / Total Assets (%)	15.6	24.0	25.1	23.6
Fixed Asset Turnover (x) on avg.	3.6	3.7	5.1	5.5
Receivables (days) on average	67.1	72.7	64.0	66.0
D/E Ratio (x)	0.3	0.0	0.0	0.0
Return/Profitability Ratio (%)				
Recurring Net Income Margins	4.2	16.6	10.9	13.2
RoIC (Based on Avg)	48.5	28.5	24.8	34.9
RoCE (Based on Avg)	36.1	21.8	17.6	22.9
RoNW (Based on Avg)	9.6	35.2	21.8	25.2
Dividend Payout Ratio	8.5	6.4	6.4	7.0
Dividend Yield	0.2	0.5	0.4	0.6
EBITDA Margins	26.7	18.9	15.3	19.3

Source: Company data, I-Sec Research

I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

BUY: +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

ANALYST CERTIFICATION

We /I, *Sandeep Shah, CA; Krupal Maniar, CA, CFA and Varun Sharma, MBA*, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Analysts aren't registered as research analysts by FINRA and might not be an associated person of the ICICI Securities Inc.

Disclosures:

ICICI Securities Limited (ICICI Securities) and its affiliates are a full-service, integrated investment banking, investment management and brokerage and financing group. We along with affiliates are leading underwriter of securities and participate in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationship with a significant percentage of companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. ICICI Securities generally prohibits its analysts, persons reporting to analysts and their dependent family members from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

The information and opinions in this report have been prepared by ICICI Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of ICICI Securities. While we would endeavour to update the information herein on reasonable basis, ICICI Securities, its subsidiaries and associated companies, their directors and employees ("ICICI Securities and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent ICICI Securities from doing so. Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or ICICI Securities policies, in circumstances where ICICI Securities is acting in an advisory capacity to this company, or in certain other circumstances.

This report is based on information obtained from public sources and sources believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and may not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. ICICI Securities will not treat recipients as customers by virtue of their receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgement by any recipient. The recipient should independently evaluate the investment risks. The value and return of investment may vary because of changes in interest rates, foreign exchange rates or any other reason. ICICI Securities and affiliates accept no liabilities for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

ICICI Securities and its affiliates might have managed or co-managed a public offering for the subject company in the preceding twelve months. ICICI Securities and affiliates might have received compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of public offerings, corporate finance, investment banking or other advisory services in a merger or specific transaction. ICICI Securities and affiliates expect to receive compensation from the companies mentioned in the report within a period of three months following the date of publication of the research report for services in respect of public offerings, corporate finance, investment banking or other advisory services in a merger or specific transaction. It is confirmed that *Sandeep Shah, CA; Krupal Maniar, CA, CFA and Varun Sharma, MBA* research analysts and the authors of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months. Our research professionals are paid in part based on the profitability of ICICI Securities, which include earnings from Investment Banking and other business.

ICICI Securities or its affiliates collectively do not own 1% or more of the equity securities of the Company mentioned in the report as of the last day of the month preceding the publication of the research report.

It is confirmed that *Sandeep Shah, CA; Krupal Maniar, CA, CFA and Varun Sharma, MBA*, research analysts and the authors of this report or any of their family members does not serve as an officer, director or advisory board member of the companies mentioned in the report.

ICICI Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report. ICICI Securities and affiliates may act upon or make use of information contained in the report prior to the publication thereof.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ICICI Securities and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.