MPHASIS BFL LTD.

CMP: Rs. 270 Price Target: Rs. 330

BUY

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Please refer to the Disclaimer Section on page 12 for further important disclosures.

MPHASIS BFL LTD.

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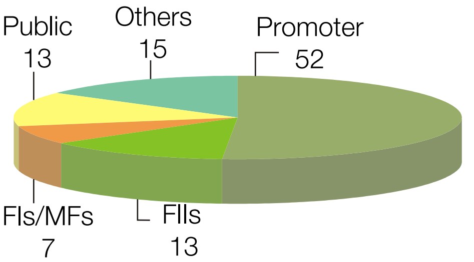
Initiating Coverage : BUY

Price	**270**
Target Price, Upside	330, 22%
52 Week H/L	291/121
Shares o/s	162mn
Market Cap (Rs)	44bn
Market Cap ($)	979mn
Avg daily trading vol.(3m)	1.2mn
BSE Sensex	13,703
Nifty	3,951

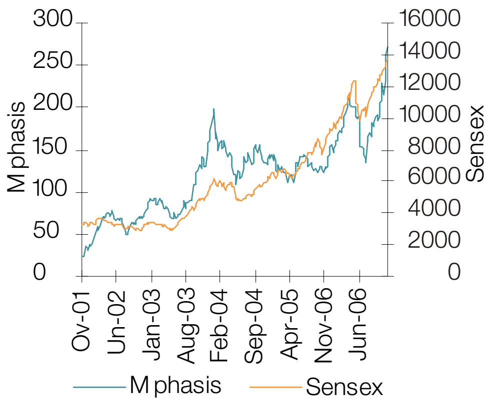
(Source: Bloomberg)

Shareholding Pattern (%)



(Source: BSE)

Price Performance



(Source: Capitaline)

Performance (%)

	1M	3M	12M	YTD
Absolute	19.2	48.5	96.9	80.9
Relative	9.8	25.0	25.6	24.1

(Source: Bloomberg)

Financial Summary

Rs mn (yr end-March)	**FY07E**	**FY08E**	**FY09E**
Sales	16413	26446	38893
% change	74.6	61.1	47.1
EBIDTA	2661	5291	8167
EBIDTA margin (%)	16.2	20.0	21.0
Net profit	1722	4014	6394
EPS(diluted), Rs	8.3	19.2	30.4
% change	(9.7)	131.6	58.7
RoE (%)	19.1	32.3	36.2
Net D/E (%)	(22.6)	(22.5)	(31.4)
P/E (x)	32.6	14.1	8.9
P/BV (x)	6.2	4.5	3.2
EV/EBIDTA (x)	15.5	7.7	4.6
Div payout (%)	28.9	12.5	11.1

(Source: Ambit Capital Research)

MPHASIS BFL LTD.

(REUTERS: MBFL.BO BLOOMBERG: BFL IN)

Consequent to the acquisition of Mphasis by EDS and subsequent merger of Mphasis with EDS(India) subsidiary, we see the company posting better than tier I IT companies revenue growth in the years to come. We believe Mphasis would be retained as a profit center by EDS and expects margin to improve from FY08 onwards. The transition of work from EDS offshore is inevitable and Mphasis presents a proxy play on the MNC outsourcing story. We are positive on the prospects of the company and initiate coverage on the stock with an 18-month target price of Rs. 330

Key Positives

- **Work from EDS a surety:** Mphasis on its own in the period FY02-FY06 has grown at revenue CAGR of 31.6%, though the revenue growth is on a progressive decline. Consequent to its merger with EDS India and acquisition by EDS, we expect it to post stronger revenue growth at 60.5% CAGR over the FY06-FY09E. This would be contributed by the greater offshoring by EDS clientele and EDS shared services work. We expect the muted growth in BPO to be augmented by outsourcing of shared services work and expansion of offerings post EDS acquisition.
- **Strong Parental Backing:** Mphasis would be the prime beneficiary of EDS Best shore strategy of perking up offshore headcount to 30000 by CY06 and 45000 by CY08 and on account of rationalization of people at the current 27 Best Shore locations, India is expected to be the biggest beneficiary. We anticipate Mphasis would end FY07E at greater than 19,000 people and to end FY09E at ~35,000 people.
- **Drawing Parallels:** IBM had India revenues of $350mn in 2002, which touched $937mn in 2004 and greater than $1bn in 2005. It took them 3 years to touch a billion. Mphasis would be $365mn in FY07E, two years hence our estimates are $864mn in FY09E, which looks possible in comparison. IBM's people strength perked up from 9,000 in 2003 to 36,000 in 2006 to current 43,000, in comparison our projection of ~19,000 in FY07E to ~ 35,000 in FY09E looks highly achievable.
- **Expansion of service offerings:** EDS is a leader in the IT Outsourcing or Infrastructure Management space and Mphasis has a limited presence in this area. We see the Mphasis service offerings to mirror EDS over the medium term and expect expansion of service offerings to benefit Mphasis, further. The company expects to add Government, healthcare and manufacturing verticals and domain led services to BPO.

Valuation

We believe our estimates are realistic considering that EDS globally is expected to post a turnover of $21bn in CY06E. Mphasis and EDS(India) combined would touch revenues of ~$365mn in FY07E. Our revenue estimates for FY07E,FY08E and FY09E are just about 1.7%,2.8%,and 4.1% of EDS CY06E revenues, which we believe is achievable. We also believe that the goals of EDS in improving its margins and outsourcing to Mphasis are aligned synergistically.

We expect the period FY08 onwards, to be a period of accelerated growth at Mphasis and see the challenge in terms of execution, to exploit the excellent opportunity it finds itself in.

Though currently based on FY07E earnings the stock looks expensive at a P/E of 32.6x, we believe the stock holds a lot of value based on its future earnings at a P/E of 14.1x FY08E and 8.9x FY09E earnings. Our estimates include EDS India subsidiary that would be merged with Mphasis and on fully diluted equity of 208mn shares.

We initiate coverage on Mphasis with a 18 month price target of Rs.330 based on DCF, implying a P/E of 17.2x FY08E and 10.9x FY09E earnings.

Financial Summary

Balance Sheet, Rs. mn (year end-March)	FY05A	FY06A	FY07E*	FY08E	FY09E
Cash & equivalents	957	991	2,079	2,821	5,535
Debtors	1,835	2,050	3,377	5,576	8,304
Loans & Advances	806	711	1,503	2,474	3,416
Investments	0	0	0	0	0
Fixed Assets	1,198	1,455	2,027	2,385	2,862
Other assets	3,642	2,843	2,802	2,802	2,802
Total assets	**8,437**	**8,050**	**11,787**	**16,057**	**22,918**
Interest bearing debt	46	37	37	37	37
Other liabilities	1,992	1,407	2,711	3,673	4,846
Total liabilities	**2,039**	**1,444**	**2,748**	**3,709**	**4,883**
Shareholders' equity	786	1,610	2,060	2,060	2,060
Reserves & surpluses	5,612	4,996	6,978	10,287	15,437
Total networth	**6,398**	**6,606**	**9,039**	**12,347**	**17,498**
Net working capital	(648)	(1,354)	(2,168)	(4,377)	(6,874)
Net debt/ (cash)	(910)	(954)	(2,042)	(2,784)	(5,498)

Income statement, Rs mn (year end- March)	FY05A	FY06A	FY07E	FY08E	FY09E
Net sales	7,656	9,401	16,413	26,446	38,893
% growth	31.9	22.8	74.6	61.1	47.1
Cost of Revenue	4,954	6,043	11,135	17,300	25,241
SGA	1,290	1,378	2,617	3,855	5,485
EBITDA	**1,411**	**1,981**	**2,661**	**5,291**	**8,167**
% growth	22.1	40.3	34.3	98.9	54.3
Depreciation/ amortization	396	518	683	742	923
EBIT	1,016	1,463	1,977	4,549	7,244
Other Income(net of interest)	113	94	46	72	112
Pre-tax profit	1,128	1,557	2,023	4,621	7,356
Tax	(117)	58	301	607	963
Net profit	**1,245**	**1,499**	**1,722**	**4,014**	**6,394**
% growth	26.3	20.3	14.9	131.6	58.7

Cash flow, Rs. mn (Year end- March)	FY05A	FY06A	FY07E	FY08E	FY09E
EBIT	1,016	1,463	1,977	4,549	7,244
Other Income	113	94	46	72	112
Depreciation/ amortization	396	518	683	742	923
Tax paid	117	(58)	(301)	(607)	(963)
Other Adjustments	(132)	(16)	41	0	0
Net working capital	792	(706)	(814)	(2,209)	(2,497)
Operating cash flow	**2,301**	**1,294**	**1,633**	**2,547**	**4,819**
Capital expenditure	(569)	(775)	(630)	(1,100)	(1,400)
Change in Goodwill	(3,400)	815	0	0	0
Sale/(Purchase) of Assets			(625)		
Investing cash flows	**(3,969)**	**40**	**(1,255)**	**(1,100)**	**(1,400)**
Increase/ (decrease) in borrowings	(355)	(9)	0	0	0
Issuance of equity	2070	(739)	450	0	0
Adjustment to Reserves(merger)			966	0	0
Dividend paid	(423)	(551)	(705)	(705)	(705)
Financing cash flow	**1,292**	**(1,300)**	**711**	**(705)**	**(705)**
Net change in cash	(376)	34	1,089	742	2,714
Closing cash balance	**957**	**991**	**2,079**	**2,821**	**5,535**

Ratio analysis (%)	FY05A	FY06A	FY07E	FY08E	FY09E
EBIDTA margin	18.4	21.1	16.2	20.0	21.0
Net profit margin	16.3	15.9	10.5	15.2	16.4
Return on equity	19.5	22.7	19.1	32.3	36.2
Return on capital employed	15.8	22.0	21.8	36.7	41.3
Net debt to equity	(14.2)	(14.4)	(22.6)	(22.5)	(31.4)
Current ratio (x)	1.8	2.7	2.6	3.0	3.6

Valuation parameters	FY05A	FY06A	FY07E	FY08E	FY09E
EPS (Rs.)	8.0	9.3	8.4	19.4	30.7
Diluted EPS (Rs.)	7.8	9.2	8.3	19.2	30.4
P/E (x)	34.7	29.5	32.6	14.1	8.9
P/BV (x)	6.8	6.7	6.2	4.5	3.2
EV/ EBIDTA (x)	30.1	21.4	15.5	7.7	4.6
EV/Sales(x)	5.5	4.5	2.5	1.5	1.0
Dividend Payout Ratio(%)	20.8	22.9	28.9	12.5	11.1

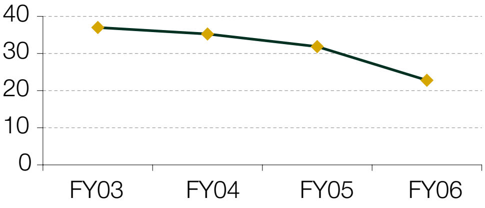
*(Source: Company, Ambit Capital Research. *Estimates for FY07E onwards include EDS India Estimates.)*

Historical Perspective

Mphasis BFL is tier II IT Company with a predominant focus on the following service lines:
- IT Services
- BPO Services

In terms of operating performance the company has been showing a declining trend in revenue growth over the last 4 years, with an inconsistent performance on a year on year basis between IT services and BPO, with tapering growth in BPO, which posted just a 4.7% growth in FY06. IT has been relatively a better performer progressively with 33.5% growth in FY06.

Declining Revenue Growth(%)



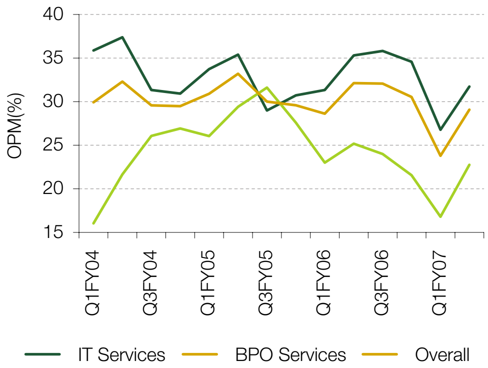
(Source: Company)

Revenue Growth Across Service Lines (%)

	FY03	FY04	FY05	FY06
IT	15.8	15.8	23.9	33.5
BPO	299.1	104.9	48.1	4.7
Overall	37.0	35.2	31.9	22.8

(Source: Company)

Operating Margins Performance



(Source: Company)

In terms of margins, IT services was typically operating at segmental profit margins between 31%-35% whereas BPO Services were at lower margins between 20-25%. In terms of realizations too, the BPO realizations were of the order of $9 per hour whereas IT services offshore realizations were of the order of $21 per hour. Overall margins were dragged by lower margins in the BPO business.

In terms of EBITDA margins the company has been posting EBITDA margins in the range of 18.4-21.1%, which is at a discount of almost 4% from Satyam. The EBITDA margins in the first half for Mphasis (excluding EDS India) have declined to 14.4%.

In terms of people strength the company had 12535 employees as of Q2FY07. With the employee mix skewed towards BPO with almost 67% of the employees. IT services constituted the remaining 33%.

The verticals that the company focused on were:
- BFSI
- Retail, logistics and transportation
- Technology and Telecom

It was facing the mid life crisis faced by mid tier companies in the IT sector of slower than tier I company growth rates and smaller scale so that cost cannot be optimized efficiently and limited participation possibilities were there in large outsourcing deals.

Expectations for the Future

On account of EDS acquisition and merger of EDS (India) subsidiary with Mphasis. we expect a visible improvement in performance across all operational parameters in the years to come. We expect the following in the future years:

- Revenue growth decline to be arrested and company should post better than tier I IT company revenue growth rates.

- Margins to improve on account of higher growth for higher margin IT services business and return of revenue growth to the BPO business, which was showing a declining revenue trend.

EDS Acquisition Bonanza

EDS acquired 52% of the company stake at Rs.204.5, subsequently they have hiked their stake by merging EDS(India) subsidiary with Mphasis in the ratio of 5 shares of Mphasis for 4 shares of EDS(India). This has increased the stake of EDS to 61.8%.

The EDS (India) subsidiary brings to Mphasis a workforce of 4200 people as of Q2FY07. Taking the combined strength of Mphasis to 1,6735 people. It had last year revenues of Rs.3,223m and PAT of Rs.420mn.

The acquisition is complimentary in terms of bringing legacy mainframe skills and infrastructure management skills, whereas Mphasis till now had been focusing on newer technologies and among service lines on BPO and IT services.

On account of consolidation with EDS (India) and organic growth, Mphasis would be expected to post a revenue growth of 74.6% in FY07E.

The benefits accruing from this acquisition are:

Revenue growth to accelerate

We expect the declining trend in revenue growth at Mphasis to be reversed and expect a stronger than tier I IT company growth CAGR of 60.4% over the period FY06-FY09E.

The increase in revenue growth rate would be on account of the following factors:

- **Offshoring by EDS is not a choice but a compulsion:** EDS has lagged behind its traditional rivals IBM and Accenture in terms of offshoring, with the Mphasis acquisition it is trying to play the catch up game. EDS's commitment to Best Shoring is evident through their self-professed targets for head count in these locations. The prime beneficiary of which would be India.

  It has already committed to improving its operating margins in CY07 to 6.3% from current 4% in Q3CY06, a large portion of which is expected from offshoring.

  The early signs of offshoring are already visible with the company working on 12 engagements currently with EDS.

  The recent outsourcing deal win with Vodafone, was joint pitch by EDS and Mphasis sales people. It is a 7-year deal involving application development and maintenance and is expected to scale up nicely from FY08E onwards.

  Also the management has started to see improved traction on large deals of sizes, even up to the order of $20mn, after the EDS acquisition.

  Based on TPI estimates there are $100bn worth of contract up for renegotiation over the next 2 years. Of EDS and IBM command almost $50bn worth of these, which would increasingly have an offshore component making it imperative for EDS to expand Mphasis operations in India.

- **Shifting of shared services work of EDS,** in the areas of financial accounting (FA) and human resources (HR) to Mphasis BPO over the next 18-month duration.

  To put things in perspective EDS globally has an employee strength of 117,000. Based on ballpark calculation even if 50% of support staff is made redundant, that would amount to at least an addition of 3000 people at Mphasis (Assuming a support staff at 5% of the total staff).

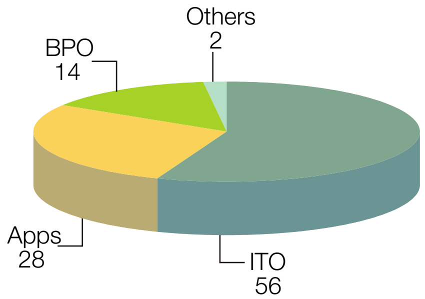
- **Expansion of service offerings:** Mphasis practices and processes are being aligned to mirror EDS globally, so that EDS presents a unified interface to its clientele worldwide. The major alignment in terms of delivery processes/tools/methods is expected by FY07 end.

EDS Best Shore Intentions

Target	All Best Shore Locations	India
CY06	30,000	~20,000
CY08	45,000	Major Beneficiary India

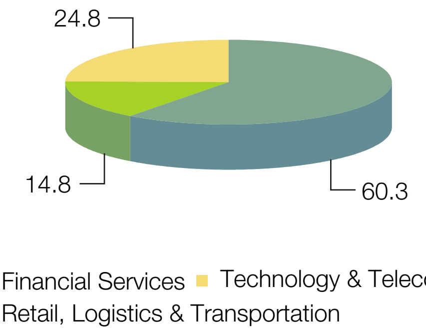
(Source: EDS)

EDS Service Mix(%) -2005



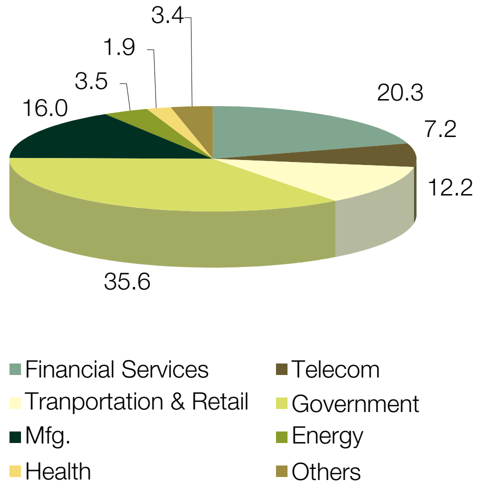
(Source: Company)

Mphasis Vertical Revenue Breakup (%) H1FY07



(Source: Company)

EDS Vertical Revenue Breakup(%) Q3CY06



(Source: EDS)

Further to this the company intends to add to its existing service offerings:

IT Outsourcing/Infrastructure Management: This is the largest proportion of EDS business worldwide, with almost 56% of EDS revenues coming from it in CY05.

Mphasis till now has been predominantly focused on BPO and IT services, the company is expected to perk up its infrastructure management practice, portion of it got through the acquired entity EDS (India).

The focus would be on network centric remote management and no asset-based investments are envisaged.

Expansion of current offerings

IT Services:
Testing: This has till now been part of IT Services at Mphasis, the company is planning to make it a more independent offering.

Legacy modernization and enterprise asset management (EAM) are potential high growth areas, where the company intends to perk up presence.

Domain led BPO Services:
The current BPO offering of Mphasis has a 65-68% voice component, of which 70% is inbound voice and remaining would be outbound voice. The company intends to reduce dependence on voice and introduce domain led services in the area of Human Resources/Financial Accounting/Credit Cards etc.

The company intends to have a 50:50 mix of domain v/s technical helpdesk or embedded sales & service type of work.

This move should have a positive impact on realization and margins. What would also help the company in getting domain led BPO work is a referenceable client in EDS, in the area of FA and HR, something that Mphasis did not have previously.

Verticals:
In addition to its current portfolio of services in the financial services, technology & telecom and transportation & logistics. The newer verticals that the company intends to introduce are:

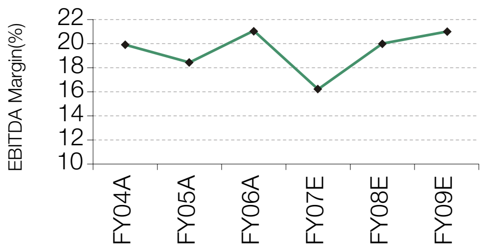
- Government
- Manufacturing
- Healthcare

Incidentally governments is the largest vertical for EDS with almost 35.6% of its revenues coming from it in Q3CY06 and manufacturing contributed 16% of its business in the same period.

Also in terms of the overlap the existing verticals of Mphasis contribute just about 40% of EDS revenues whereas the ones they intend to introduce contribute almost 54% of their revenues. Thus, the possibilities of offshoring from these verticals remain huge.

This is another positive development showing that EDS intends to offshore not just BFSI work but work across other verticals as well to Mphasis.

EBITDA Margin Movement



(Source: Company, Ambit Capital Research)

Positive Margin Outlook

Though in the interim we expect a margin decline of almost 490bps in FY07E over FY06 at 16.2%. This is on account of higher taxation (including one time items), retention expenses, integration expenses and salary hikes. We expect the performance in the second half of FY07E to be better in terms of margins.

Going forward with the integration related costs/retention costs and period of bringing about uniformity in processes out of the way the margins should look northwards. The main drivers for margin improvement would be increased revenue growth, shift of mix towards better margin IT services and SGA savings on account of increased scale. We expect the company to return to its FY06A EBITDA margin levels of ~21% by FY09E. We expect EBITDA margins of 20% and 21% in FY08E and FY09E.

Currently the company is incurring retention costs for 165 of its key people for duration of 5 quarters from Q2FY07 onwards.

Upside margin risks are possible on account of better realizations on the BPO side of business as the current realizations at $9 per hour are slightly depressed on account of domestic component of business, which would increasingly get marginalized and also as the mix improves towards domain led services from voice heavy BPO business. We have not factored in any pricing improvement in our estimates.

Why is this accelerated growth Achievable?

We would like to draw parallels with the performance of EDS's global peers in terms of their offshoring plans and feel that the plans of EDS are more conservative that what they have actually achieved.

IBM Story

IBM India Revenues	Year	EDS entities India Revenues*	Year
$350 mn	2002	$365 mn	FY07E
$937 mn	2004	$864 mn	FY09E
> 1bn	2005	Management expects to exceed $1bn	FY10E

*(Source: IBM Analyst Meet-Bangalore. * Ambit Cap Research Estimates.)*

IBM India Workforce	Year	EDS entities Workforce *	Year
9000	2003	~19000	FY07E
36000	2006	~35000	FY09E
43000	Current		

*(Source: IBM Analyst Meet- Bangalore, * Ambit Cap Research)*

Other Peers

Company	Plans
Accenture	Workforce expected to touch 35000 by next year
Cap Gemini	Current Strength 12000 after Kanbay acquisition. Plans to touch 35000 by 2010

(Source: Newspaper reports)

If we consider the plans or implementation of the offshoring strategy of its global peers the targets set by EDS for its India operation look achievable.

Also the stated objective of EDS to be among the top 3 IT outsourcers from India in the next 5 years lends credence to the seriousness of EDS offshoring initiative and bodes well for Mphasis. Considering that EDS lags behind its peers in terms of percentage of its workforce in offshore locations, we expect it to be even more aggressive than its peers.

We see our revenue targets for FY07E, FY08E and FY09E at 1.7%, 2.8%, 4.1% respectively of EDS CY06E revenues of ~$21bn. (based on EDS Guidance for CY06).

Possible Risks

Risks
- *Scaling up*
- *Handling more complex and larger executions*

We believe Mphasis finds itself at the outset of a huge opportunity waiting to be capitalized.The only downside impact to this could be on account of the company's ability to scale up and manage the scale that it has not seen before.

The scale is in terms of people, the maximum numbers that Mphasis has recruited in a year has been ~3000 people. That scale is due for a change to more than 3 times of this number to be recruited in a year. This would require an overhaul of the HR function and the company is working towards that in terms of perking up its training capabilities and recruitment.

The scale is in terms of handling large deals that the company because of its size was not into. Execution risk for these deals is another issue the company would face. The company has in this regard started work on bringing about uniformity in its processes/rules/tools with EDS globally and has been put on its "Best Shore Global Delivery Strategy". Further, duplicate practices at Mphasis and EDS (India) are being integrated for them to be able to take up larger engagements.

Possible Investor Concerns

Why wouldn't EDS want to make Mphasis a cost center?

Two main reasons why this would not happen:

Investor Concerns
- *Margin squeeze by EDS*
- *Delisting of Mphasis stock*

It doesn't make economic sense for EDS

- Mphasis is currently a 62% subsidiary of EDS, with an offer for acquiring further 20% in the fray. Mphasis financials are already consolidated with EDS so overall on a consolidated basis EDS does not gain anything by making Mphasis as a cost center.
- Secondly, and most importantly it is more beneficial for EDS to let Mphasis make higher profits because in India Mphasis enjoys tax exempt status on exports under section 10A, whereas EDS tax rate is of the order of 40%. This also fits in well with EDS strategy of improving its margins going in Cy07.

- **Profit contribution of 8.5%**
  Mphasis consolidated profits in FY07E would be almost 8.5% of EDS CY06E guided profitability, even though the revenue proportion is just about 1.7% of EDS CY06E guided revenues. This proportion is expected to improve further as Mphasis grows.Thus it makes much more sense for EDS to let Mphasis make more profits.

Mphasis profits in FY07E is almost 8.5% of EDS CY06E Profits.

Regulatory Mechanisms would prevent it

Transfer pricing norms would prevent EDS from giving lower than market prices for the services that Mphasis provides. We believe Mphasis operates at either comparable or lower than comparable prices to vendors that EDS has traditionally outsourced business in India and see this as minimal risk.

So we believe Mphasis would continue to remain a profit center for EDS and expect price realizations of Mphasis to improve rather than deteriorate from here on.

Why would Mphasis remain a listed entity?

Management has indicated that there are no plans of delisting Mphasis and EDS has also stated its intent of keeping the company an independent listed entity.

Secondly, EDS is not looking for Mphasis just as an outsourcing hub but on its own merit as an asset to get incremental business. So there is a commitment to maintaining two separate brands.Thirdly, Mphasis is being seen as a vehicle for EDS to expand on its applications practice, which is currently the second largest practice after ITO at EDS.

We believe the stock would continue to be a listed entity, as EDS current focus would be bringing about operational efficiencies across its global locations. But we do not rule out a possibility of the stock getting delisted but believe even if it happens the investors stand to gain.

Investment Argument

Mphasis on its own has posted revenue CAGR of 31.6% over the period FY02-FY06. We expect the company to post a much healthier revenue growth CAGR of 60.5% over the period FY06-FY09E. This coupled with improvement in EBITDA margins to FY06A levels of ~21%, lead us to believe that the stock holds value from a long-term perspective. The company should show a healthy EPS CAGR of 48.5% over the period FY06-FY09E, which should translate in stock price appreciation from current levels. We initiate coverage on Mphasis with a buy rating with a target price of Rs. 330 over a 12-18month period, based on DCF valuation.

DCF Valuation

Stock provides a 22% appreciation possibility based on DCF valuation.

We initiate coverage with a Buy with an 18-month target price of Rs. 330

On an explicit growth period of 3 years, transition growth period of 7 years with declining growth having an implied FCFF CAGR of 24.5% and a terminal growth of 4%. Assuming a WACC of 13.5% our DCF analysis gives us a value of Rs.330 over an 18-month period.

DCF Table

	FY05	FY06	FY07E	FY08E	FY09E
PAT + Interest (1-tax rate)	1,245	1,499	1,722	3,988	6,327
Dep	396	518	683	742	923
Capex	(569)	(775)	(630)	(1,100)	(1,400)
NWC Change	792	(706)	(814)	(2,209)	(2,497)
FCFF	1,865	535	961	1,421	3,353

(Source: Company, Ambit Capital Research)

DCF Calculations (Rs mn)	
Explicit Growth period	3 years
Transition Growth period	7 years
Present Value (explicit growth period)	5589
Present Value(transition period)	36,601
Terminal Value	18,142
Firm Value	60,332
Less: Debt	37
Add: Cash & Equivalents	2,873
Equity Value	63,168
No. of shares outstanding (mn)	208
Target Price (Rs.)	**330**
Current Market Price (Rs.)	270
Appreciation (%)	22

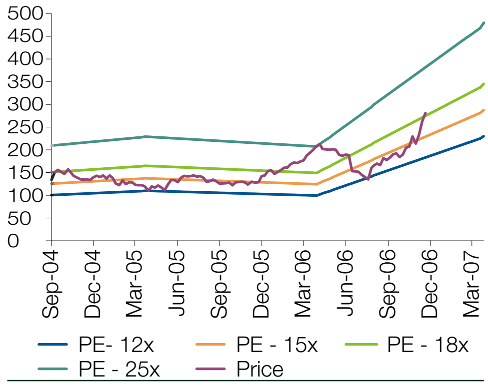
Assumptions	
Beta	0.85
Risk Free Rate (%)	7.5
Risk Premium (%)	7.0
Cost of Equity (%)	13.5
WACC (%)	13.5
Explicit period FCFF CAGR (%)	84.3
Transition period FCFF CAGR (%)	24.6
Perpetual growth (%)	4.0

(Source: Ambit Capital Research)

Sensitivity	WACC (%)			
Terminal Growth Rate (%)		**13.0**	**13.5**	**14.0**
	3	333	320	305
	4	345	330	314
	5	359	342	324

(Source: Ambit Capital Research)

1-year rolling forward PE band



(Source: Ambit Capital Research)

PE Band Analysis

Mphasis historically has traded at 1-year forward P/E multiples in the range of 12-18x. Our target price of Rs. 330 implies a P/E of ~17.2x FY08E earnings, which we think is justified, based on the change in trajectory of revenue growth and associated profitability at Mphasis.

We expect the stock to be re rated and to trade near to the top end of its range once the integration issues are through in FY07E and revenue from EDS clientele and shared services starts to flow in.

Relative Valuation

Name	Price	Mkt Cap (Rs bn)	P/E	FY07E P/E	FY08E P/E	FY07E EPS	FY08E EPS	OPM (%)	ROE (%)	Sales Gr(%)	ROCE	NI Growth (%)	P/S	P/B	EV/EBITDA
Infosys	2,234	1,240	49.7	33.0	26.0	67.8	85.8	28.1	40.3	33.5	29.9	40.1	12.8	17.7	29.2
TCS	1,148	1,120	37.8	27.5	21.8	41.8	52.7	26.1	62.6	35.7	50.1	59.8	8.4	18.8	27.1
Wipro	590	835	40.2	30.4	24.1	19.4	24.5	21	34.8	29.9	27	34.4	7.8	12.8	33.6
Satyam	462	303	26.0	23.4	19.5	19.7	23.7	21.5	30.7	36.1	60.4	29.6	6.2	7.1	23.8
HCL Tech	629	204	31.3	19.9	16.5	31.7	38.2	18.7	20.4	30.7	(9.8)	20.5	5.8	5.8	0.0
Iflex	1,647	129	52.4	39.1	29.4	42.1	56.1	18.5	18.8	30.2	2.3	18.8	8.4	9.1	30.4
Patni	405	56	25.6	18.8	13.4	21.5	30.2	16.6	11.2	34.6	(22.9)	11.6	2.6	2.6	18.7
Mphasis	**270**	**44**	**28.7**	**32.5**	**14.1**	**8.3**	**19.2**	**15.6**	**23.1**	**22.8**	**20.3**	**22.9**	**4.6**	**6.6**	**21.8**
Hexaware	186	24	23.9	20.0	15.9	9.3	11.7	14.1	29.8	24.3	44.7	29.5	3.3	6.4	15.4
Infotech Ent.	304	14	27.3	17.5	13.8	17.4	22.1	13.1	27.3	41	83.8	26.8	3.8	6.6	15.9
Sasken	484	13	41.1	32.1	22.9	15.1	21.1	9.9	8.7	27.5	0.6	8.7	4.0	3.5	24.8
Polaris	124	12	57.0	11.7	11.0	10.6	11.2	4	4	4.8	(63.3)	4.1	1.5	2.2	31.1
KPIT Cummins	593	9	26.0	17.6	13.4	33.6	44.2	10.8	26.3	25.1	14.7	19.1	2.7	6.1	18.2
Igate	232	7	124.1	16.7	9.6	13.9	24.2	4.1	1.9	9.6	(74)	1.9	1.1	2.8	29.3
Geometric	115	7	25.2	17.0	12.5	6.8	9.2	14.4	19.6	32.8	(6.2)	23.4	3.0	4.6	17.2

(Source: Infosys, Satyam & Mphasis estimates Ambit Cap Research, Rest Bloomberg consensus estimates)

Though on FY07E earnings Mphasis appears expensive, based on FY08E earnings it is quoting at a P/E of 14.1x, which is at a discount of 14% to HCLT the smallest of the top 5 IT vendors and at a discount of almost 45% to the top tier sector valuations of Infosys and 27% to Satyam.

Our target valuation is at a discount of 13% to our target multiple for Satyam and at a discount of 33% to our target multiple for Infosys.

We believe once the company starts to show the revenue growth and the pipeline improves going into FY08E, its discount to top tier players should reduce.

Conclusion

We believe Mphasis is in a once in a lifetime opportunity situation, which is important for both Mphasis and EDS to grab with both hands. The compulsions of making this a big success is absolutely without question.

We see scaling up as the only risk to making the most of the situation and believe that there are sufficient upside risks to our estimates in terms of possible improvements in utilization and pricing, which have not been taken into consideration in our estimates.

We see Mphasis as a proxy play in terms of participation in the MNC offshoring story, with visible revenue growth possibilities.

Based on these we initiate coverage on Mphasis with an 18-month price target of Rs. 330, representing an upside of 22% from current levels.

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