

Mixed quarter;- Volumes and Attrition rate disappoint; Margins surprise

MindTree reported a mixed results, with an unflattering revenue growth and a positive margin performance. Management commented that they would continue to grow faster than market and margins would expand on the back of revenue growth. We remain skeptical on the revenue growth beating benchmark set by tier-1 companies as R&D and SPE services (41% of revenues) continues to be weak. Margin expansion of ~300bps in FY12 is already factored in the price, and any positive surprise on earnings are hard to come by. **Retain UPF**

- **Muted revenue growth:** Revenue growth was led purely by pricing increase with volumes staying flat. However IT services recorded impressive sequential growth of 7.6%, whereas R&D services declined 2.1% qoq. Realisation increased 1.6% and 5.2% for onsite and offshore respectively. Adjusting for one-off license sale realisation would have increased by 4%.

- **R&D business a drag on performance:** R&D services (41% of revenues) has been flat for 4 quarters in a row and has been a drag on growth. Competitors in R&D services have had good growth in the SPE business, with especially Persistent reporting good growth. Moreover, management commentary indicates softness to continue in the near-term in R&D business and R&D services could continue to hamper performance in the near-term in our opinion.

- **Margins improved by one-off IP sale:** EBITDA margins at 11.7% were 90bps ahead of estimates driven by sale of IP. Wireless business restructuring cost amounted to US\$ 3.7mn, adjusting for one-off's core business margins stands at 15.2%. Lower revenue growth, high attrition and rupee appreciation would continue to hurt MindTree's margin profile. We see limited upside to our FY12 margin expectation of 15.6%. We do not rule-out another wage hike to stem attrition or increased lateral hiring to offset attrition, a potential headwind in our view.

- **Trim estimates:** We trim our FY12 revenue estimates marginally, and steeper cut to our profitability expectation on the back of poor core-business margins

- **Expensive valuation - retain UPF:** MindTree has underperformed most of its peers even on revenue growth over last 6 months and on stock performance over last 18 months. We see no trigger for stock performance as margin expansion of ~300bps in FY12 is already baked in current prices. Moreover, the attempt at diversifying into unrelated business continues to act as hangover. At 540 stock trades at 12.2x FY12E EPS, much higher than other mid-caps. **Retain Underperform and Reduce with a price target of Rs. 500.**

3QFY11 Update

Date Jan 27, 2010

Market Data

SENSEX	18684
Nifty	5604
Bloomberg	MTCL IN
Shares o/s	39.2mn
Market Cap (Rs.)	21.8bn
52-wk High-Low	725-482
3m Avg. Daily Vol	Rs. 33mn
Index member	BSE Midcap

Latest shareholding (%)

Promoters	32
Institutions	26
Public	42

Stock performance (%)

	1m	3m	12m
MindTree	5	3	-5
CNXIT	-3	6	23
Nifty	-6	-7	13

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Financial summary

Year	Revenues (Rs. mn)	EBITDA (Rs. mn)	PAT (Rs. mn)	EPS (Rs.)	P/E(x)	EV/EBITDA(x)
FY10	12,960	2,449	1,666	40.6	13.3	8.6
FY11E	15,215	1,947	1,033	25.3	21.4	10.9
FY12E	18,239	2,851	1,805	44.2	12.2	7.4

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Quarterly Financial Results

CMP	Rs. 540	Absolute	Reduce
Target	Rs. 500	Relative	Underperform

Quarterly financial results								
Rs. mn\Period	31-Dec-10	30-Dec-09	yoy Growth	30-Sep-10	qoq Growth	FY10	FY11E	yoy Growth
Revenue	3,848	3,318	16.0%	3,844	0.1%	12,960	15,215	17.4%
Software development expenses	2,586	2,012	28.5%	2,559	1.1%	7,983	10,016	25.5%
Admin and other expenses	813	649	25.3%	821	-1.0%	2,528	3,252	28.6%
Provision for bad and doubtful	813	649	25.3%	821	-1.0%	2,528	3,252	28.6%
EBITDA	449	657	-31.7%	464	-3.2%	2,449	1,947	-20.5%
EBITDA margin	11.7%	19.8%		12.1%		18.9%	12.8%	
Interest expense	1	1	nm	2	-53.2%	27	3	-87.5%
Depreciation	206	168	22.8%	177	16.4%	652	710	9.0%
Forex Loss	0	-174	nm	0	nm	-673	0	
Other Income	95	28	nm	25	280.0%	96	160	66.1%
Profit Before Tax	337	691	nm	310	8.8%	2,540	1,393	-45.1%
Provision for taxation including FBT	30	171	nm	80	-62.6%	371	336	-9.7%
Reported Profit After Tax	307.1	537.7	-42.9%	229.9	33.6%	2142.2	1062.8	-50.4%
Actual cash loss on FX	0	0	nm	34		0	34	
Spark PAT	307.1	519.4	-40.9%	204.6	50.1%	1666.0	1032.6	-38.0%
Spark PAT margin	8.0%	15.7%		5.3%		12.9%	6.8%	
Reported EPS - diluted	7.5	13.4	-43.7%	5.6	33.8%	52.3	26.0	-50.2%
Spark EPS	7.5	12.9	-41.7%	5.0	50.3%	40.6	25.3	-37.8%
Volume growth qoq - Onshore	-2.1%	-0.4%		8.0%				
Volume growth qoq - Offshore	0.2%	15.3%		8.3%				

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Business Overview

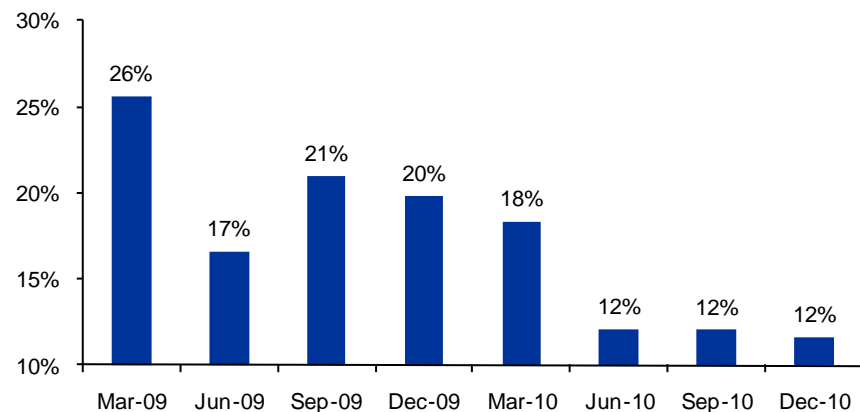
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Key estimate revision

	FY11E			FY12E		
	New	Old	Change	New	Old	Change
Revenues (US\$ Mn)	338	334	-1%	414	405	-2%
US\$ /INR assumption	45.4	45.5		45.0	45.0	
Revenues	15,358	15,215	-1%	18,615	18,239	-2%
EBITDA	2,016	1,947	-3%	3,198	2,851	-11%
EBITDA margin	13%	13%	-33bps	17%	16%	-155bps
EPS (Rs.)	25.6	25.3	-1%	50.0	44.2	-12%

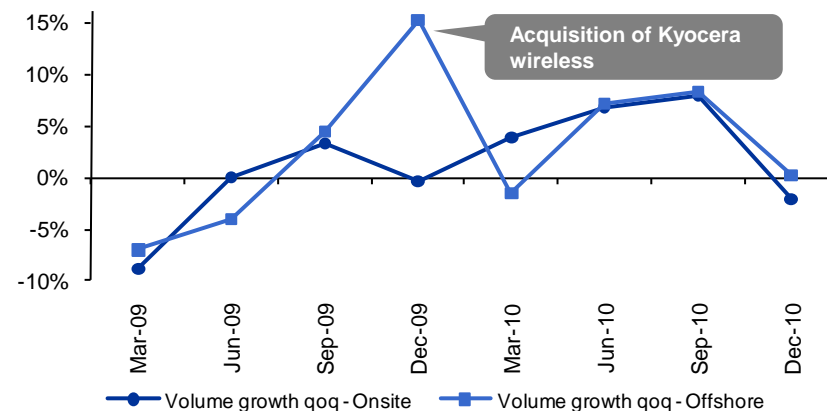
All figures in Rs. mn, except EPS, which is in Rs.

EBITDA margin evolution



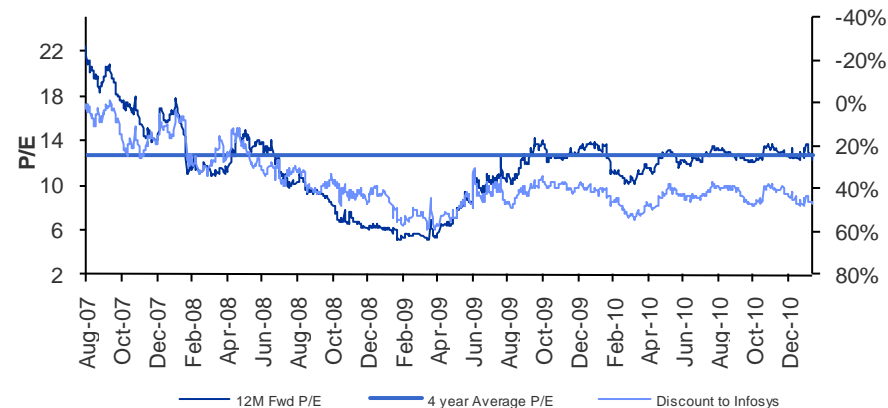
Source: Company data, Spark Capital

Volumes qoq growth



Source: Company data, Spark Capital

MindTree 12-m forward P/E



Source: Bloomberg, Spark Capital

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Financial Summary

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Abridged Financial Statements				
Rs. mn	FY10	FY11E	FY12E	FY13E
Profit & Loss				
Net Sales	12,960	15,215	18,239	21,800
Software development expenses	7,983	10,016	11,732	14,294
SG&A expenses	2,528	3,252	3,657	4,197
EBITDA	2,449	1,947	2,851	3,310
Other income	96	160	172	252
Depreciation/Amortization	652	710	738	752
Interest	27	3	0	0
PBT	1,867	1,393	2,285	2,810
Tax	371	336	480	590
PAT	1,495	1,058	1,805	2,220
Spark Adj PAT	1,666	1,033	1,805	2,220
Reported diluted EPS	36.5	25.9	44.2	54.4
Spark EPS	40.6	25.3	44.2	54.4
Balance Sheet				
Paid up capital	395	399	399	399
Reserves and surplus	6,311	7,366	9,171	11,391
Secured loans	0	0	0	0
Total net worth & liabilities	6,737	7,808	9,613	11,833
Goodwill	154	0	0	0
Net fixed assets	2,612	3,132	3,193	3,252
Capital WIP	247	28	28	28
Investments	1,272	962	962	962
Current assets	4,841	7,289	9,791	12,695
Sundry debtors	2,370	3,538	4,307	5,090
Cash	523	1,733	3,028	4,702
Deferred tax assets	214	224	224	224
Total assets	6,737	7,808	9,613	11,833

Key metrics				
	FY10	FY11E	FY12E	FY13E
Cash flows				
Cash flow from operations	1,294	1,765	1,922	2,232
Cash flow from investments	(1,055)	(392)	(628)	(558)
Cash flow from financing	65	(44)	-	-
Key ratios and metrics				
EBITDA margin (%)	18.9%	12.8%	15.6%	15.2%
PAT margin (%)	11.5%	7.0%	9.9%	10.2%
Revenue per employee p.a (000's)	1,832	1,832	1,832	1,833
EBITDA per employee p.a (000's)	303	211	255	249
Profit per employee p.a (000's)	206	112	162	167
ROE	24.5%	14.6%	20.8%	20.8%
ROCE	21.7%	14.6%	20.7%	20.7%
Valuation metrics				
Shares o/s (mn)	39.4	39.8	39.8	39.8
Fully diluted shares (mn)	40.99	40.83	40.83	40.83
Market cap (Rs. mn)	21,287	21,287	21,287	21,287
EV (Rs.mn)	21,173	21,173	21,173	21,173
EV/Sales (x)	1.6x	1.4x	1.2x	1.0x
EV/EBITDA (x)	8.6x	10.9x	7.4x	6.4x
P/E (x)	13.3x	21.4x	12.2x	9.9x
Price to book (x)	1.4x	1.2x	1.0x	0.8x
EPS(E) / Current market price	6.8%	4.8%	8.2%	10.1%
Per share data (Rs.)				
Book value	170	195	240	296
Cash	13	44	76	118
Operating cash flow	33	44	48	56
Free cash flow	25	21	28	36

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Absolute Rating Interpretation

BUY	Stock expected to provide positive returns of > 15% over a 1-year horizon
ADD	Stock expected to provide positive returns of <=15% over a 1-year horizon
REDUCE	Stock expected to fall <=15% over a 1-year horizon
SELL	Stock expected to fall >15% over a 1-year horizon

Relative Rating Interpretation

OUTPERFORM	Stock expected to outperform sector index /sector peers in our coverage
UNDERPERFORM	Stock expected to underperform sector index/ sector peers in our coverage

Recommendation History

Date	CMP	Target price	Absolute Rating	Relative Rating
28-Dec-10	509	520	ADD	UPF
14-Dec-10	508	520	ADD	UPF
20-Oct-10	520	520	REDUCE	UPF
21-Jul-10	545	520	REDUCE	UPF
6-May-10	581	560	REDUCE	UPF

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