

EQUITY RESEARCH

March 12, 2009

RESULTS REVIEW

Mphasis Limited

Hold

Share Data

| | |
|-----------------------|---------------------|
| Market Cap | Rs. 38.2 bn |
| Price | Rs. 182.95 |
| BSE Sensex | 8,343.75 |
| Reuters | MBFL.BO |
| Bloomberg | MPHL IN |
| Avg. Volume (52 Week) | 0.11mn |
| 52-Week High/Low | Rs. 256.00 / 119.40 |
| Shares Outstanding | 208.9 mn |

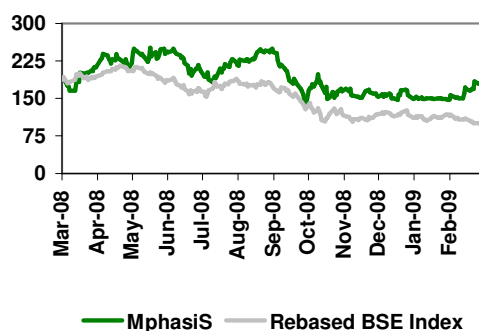
Valuation Ratios (Consolidated)

| Year to 31 October | 2009E | 2010E |
|--------------------|-------|---------|
| EPS (Rs.) | 20.9 | 9.6 |
| +/- (%) | 6.8% | (53.9%) |
| PER (x) | 8.8x | 19.0x |
| EV/ Sales (x) | 1.1x | 1.4x |
| EV/ EBITDA (x) | 6.0x | 10.1x |

Shareholding Pattern (%)

| | |
|-----------------|----|
| Promoters | 61 |
| FII's | 15 |
| Institutions | 5 |
| Public & Others | 19 |

Relative Performance



Parentage driven growth

For Q1'09, Mphasis Limited (Mphasis) reported a stable operating performance despite the deteriorating business conditions. On a sequential basis, the Company's top line grew robustly by 9.3% to Rs. 9.8 bn, owing to a sharp depreciation of the rupee against the dollar, and a marginal improvement in the onsite billing rates. However, declining volume growth remains a key concern. Meanwhile, improved operating performance and cost containment boosted the EBITDA margin by 290 bps qoq to 26.5%.

HP-EDS relation to drive growth: Currently, HP-EDS contribute 45% (~USD 90 mn in Q1'09) to overall revenues, up from 40% in quarter-ended Oct 2008, which is only 1% of HP's total services revenue (USD 8.75 bn in Q1'09). In our view, HP may increase outsourcing of their work to Mphasis to cut costs, which may help support the falling sales volume. Besides, HP's strong brand equity and global presence will improve Mphasis's bargaining power for renegotiating existing contracts and winning new deals.

Margins expected to decline: We believe that the EBITDA margin might remain under pressure and decline from ~17% (in March 2008) to ~13.5% in 2010, owing to an increasing pricing pressure and falling utilisation levels. However, cost containment, expected cut in the variable pay/bonuses, efforts to convert fixed cost into variable costs, and improved offshore contribution might help improve the EBITDA margin beyond 2010.

Key Figures (Consolidated)

| Quarterly Data | Q1'08 | Q4'08 | Q1'09 | YoY% | QoQ% |
|----------------|-------|-------|-------|------|------|
|----------------|-------|-------|-------|------|------|

(Figures in Rs mn, except per share data)

| | | | | | |
|------------|-------|-------|-------|--------|-------|
| Net Sales | 6,183 | 8,947 | 9,777 | 58.1% | 9.3% |
| EBITDA | 994 | 2,112 | 2,592 | 160.8% | 22.7% |
| Net Profit | 567 | 1,830 | 2,100 | 270.3% | 14.8% |

Margins(%)

| | | | |
|--------|-------|-------|-------|
| EBITDA | 16.1% | 23.6% | 26.5% |
| NPM | 9.2% | 20.5% | 21.5% |

Per Share Data (Rs.)

| | | | | | |
|-----|-----|-----|------|--------|-------|
| EPS | 2.7 | 8.7 | 10.0 | 271.8% | 14.8% |
|-----|-----|-----|------|--------|-------|

ITO business poised for long-term growth: Mphasis's ITO segment has shown resilience amid a deteriorating demand scenario as its revenue grew more than double on a yearly basis. Besides, headcount for the business segment went up by 571 during the quarter. Moreover, the segment is moving into high-end virtualisation services with the launch of Enterprise Labs. Subsequently, we believe the segment may become a strong growth driver once the market upturns in the next 12–15 months.

Valuation

At the current market price of Rs. 182.95, the stock trades at a forward P/E of 8.8x for 2009E. In our view, the Company stands to gain from its strong brand equity and the global presence of HP, which could provide an upside to our forecasts and the target price (TP). We have valued the stock at Rs. 196, using DCF valuation assuming a 13.8% WACC and a 5% terminal growth rate. This provides an upside of 7.3% from the current levels; thus, we maintain our Hold rating on the stock.

Sensitivity of Our Fair Value Estimates:

| | | Cost of Capital (%) | | | | |
|-------------------|-----|---------------------|------|------|------|------|
| | | 13.0 | 13.5 | 13.8 | 14.0 | 14.5 |
| Terminal Rate (%) | 4.0 | 204 | 192 | 187 | 182 | 173 |
| | 4.5 | 210 | 197 | 191 | 186 | 177 |
| | 5.0 | 216 | 203 | 196 | 191 | 181 |
| | 5.5 | 224 | 209 | 202 | 196 | 185 |
| | 6.0 | 232 | 216 | 209 | 202 | 190 |

Result Highlights and Outlook

Marginal improvement in billing; uncertainty remains

The Company recently changed its reporting period from April-March to November-October. For the quarter ended January 2009, the Company reported an increase of 9.3% qoq in its net sales to Rs. 9.8 bn. This is largely due to the sharp depreciation in the rupee against the dollar and the marginal improvement in the onsite billing rate for the Application business (up 2.9% qoq).

Weak pricing power coupled with deteriorating demand environment

In our view, an improvement in the billing rate is a quarterly aberration, considering the falling demand, and the cut in IT spending across the sector. Besides, the Company has a high degree of dependence on its large clients

(top 10 clients contribute ~50%), which can easily pressurize its pricing. Moreover, the Company has a few fixed-price projects (~6%), which might intensify the pricing pressure. However, we believe that HP's strong brand equity and global presence will help the Company during the renegotiation of its existing contracts.

All said, we expect revenue to fall by 10%–12% in the next two quarters, in INR terms.

ADM and IMS growing strongly

Position for the future

The Company posted strong quarterly results for its mainstay Application Maintenance (AM) and Application Development (AD) businesses, up 11.1% and 11.7% qoq, respectively, which included stable revenue contribution (~65% together by AD & AM). Besides, revenues from Infrastructure Management Services (IMS) jumped 37.6% qoq, and thereby improved contribution by 2% qoq to 10%. This is largely due to the investment made in setting up the high-end service capabilities of Enterprise Labs.

Expected weakness in the operating performance

Despite the weak macroeconomic environment, the Company reported stable operating performance during the quarter. However, we expect a weak operating performance from the Company in the next 4–5 quarters. We also expect the Company to reduce its lateral hires in the coming quarters, as a measure to control the salary cost per employee. Besides, the utilization level is expected to drop by ~2.5% in the next 6–8 quarters. Nonetheless, we expect the offshore contribution to increase as HP might increase the outsourcing of their work to MphasiS with a view to cut costs.

Key Risks

The following factors can pose a threat to our rating:

- Prolonged slowdown in the developed economies
- Currency fluctuations
- More-than-expected hike in wages

Key Figures (Consolidated)

| | FY06 | FY07 | FY08 | 2008* | 2009E | 2010E | CAGR (%) |
|---|-------|--------|--------|--------|--------|--------|------------|
| (Figures in Rs mn, except per share data) | | | | | | | (2008-10E) |
| Net Sales | 9,401 | 17,607 | 24,231 | 29,774 | 33,322 | 26,794 | (5.1%) |
| EBITDA | 1,981 | 3,061 | 4,194 | 5,658 | 6,235 | 3,677 | (19.4%) |
| Net Profit | 1,499 | 1,802 | 2,553 | 4,107 | 4,386 | 2,024 | (29.8%) |
| Margins (%) | | | | | | | |
| EBITDA | 21.1% | 17.4% | 17.3% | 19.0% | 18.7% | 13.7% | |
| NPM | 15.9% | 10.2% | 10.5% | 13.8% | 13.2% | 7.6% | |
| Per Share Data (Rs.) | | | | | | | |
| EPS | 9.3 | 8.6 | 12.2 | 19.6 | 20.9 | 9.6 | (29.8%) |
| PER (x) | 22.5x | 32.8x | 16.4x | 7.8x | 8.8x | 19.0x | |

*The Company has changed its reporting period to Nov-Oct in 2008. Earlier it was following fiscal year as its reporting period. We have calendarised the financials to arrive at 2008 nos.

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