



BSE SENSEX 17,839 S&P CNX 5,365

Rs384

Neutral

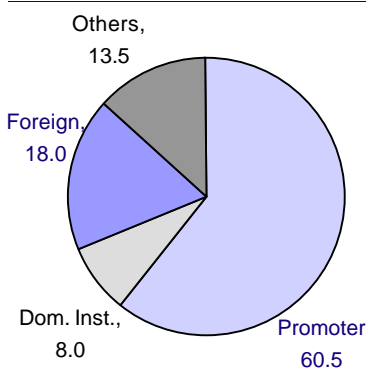


Bloomberg MPHL.IN
Equity Shares (m) 210.0
52-Week Range (Rs) 712/355
1,6,12 Rel. Perf. (%) -39/-32/-45
M.Cap. (Rs b) 80.7
M.Cap. (US\$ b) 1.8

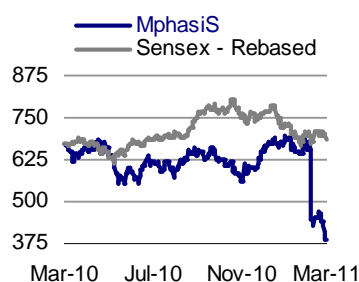
Y/E	October 2010	2011E	2012E
Sales (Rs b)	50.4	51.4	56.9
EBITDA (Rs b)	12.0	9.7	10.9
NP (Rs b)	10.3	8.4	8.6
EPS (Rs)	48.6	40.0	40.8
EPS Gr. (%)	12.5	-17.9	2.1
BV/Sh. (Rs)	157.2	187.9	224.5
P/E (x)	7.9	9.6	9.4
P/BV (x)	2.4	2.0	1.7
EV/EBITDA (x)	5.4	6.2	5.0
EV/Sales (x)	1.3	1.2	1.0
RoE (%)	36.4	23.3	19.9
RoCE (%)	36.4	22.4	21.6

Price as on 18 March 2011

Shareholding pattern % (Dec-10)



Stock performance (1 year)



Setting a low expectations bar or bracing for new reality?

Downgrading earnings, target price; maintain Neutral

Lower growth guidance for the HP channel and muted margin expansion have led us to downgrade Mphasis' earnings and target price. It is possible that the company has set a low bar of expectations for now. However, we believe, it will take Mphasis multiple quarters of good execution to rebuild credibility.

Growth slowing in the HP channel

On the back of a poor 1QFY11, management expectation of a mere 1-2% sequential growth from the HP channel (68% of revenues) for the next few quarters puts to rest any hopes of an imminent turnaround and revival in fundamentals. Though the mantle of growth now shifts to the direct channel (32% of revenues), which is expected to post 3-5% sequential growth, it is not enough to prevent a significant downgrade to our EPS expectations for FY12 (revised from Rs47.7 earlier to Rs40.8 now).

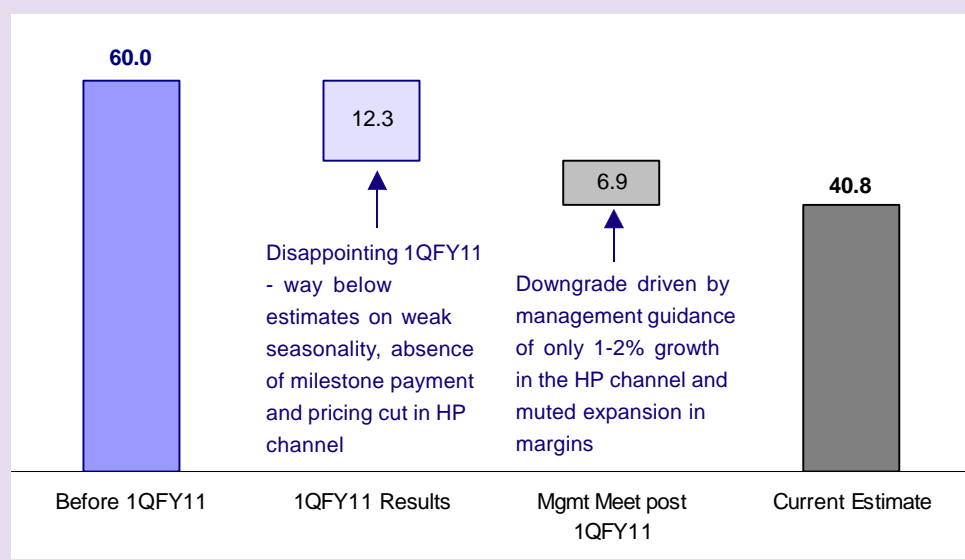
Margins expected to be range-bound

Margins are expected to remain in a range of 16-18%, with increase in utilization and some leverage on SGA to offset the impact of wage inflation. SGA spends are unlikely to increase in absolute dollars despite a higher focus on the direct channel on account of reallocation of the sales spend from the HP channel. On the positive side, bulk of the price reductions are behind the company barring select cases in the direct channel where aggressive pricing may be used to pursue new logos.

Lowering target price, maintain Neutral

It is possible that the company has set a low bar in terms of expectations for now. However, we believe, it will take Mphasis multiple quarters of good execution to rebuild credibility with the street. We retain our **Neutral** rating, but lower the target price to Rs450 (11x FY12E EPS).

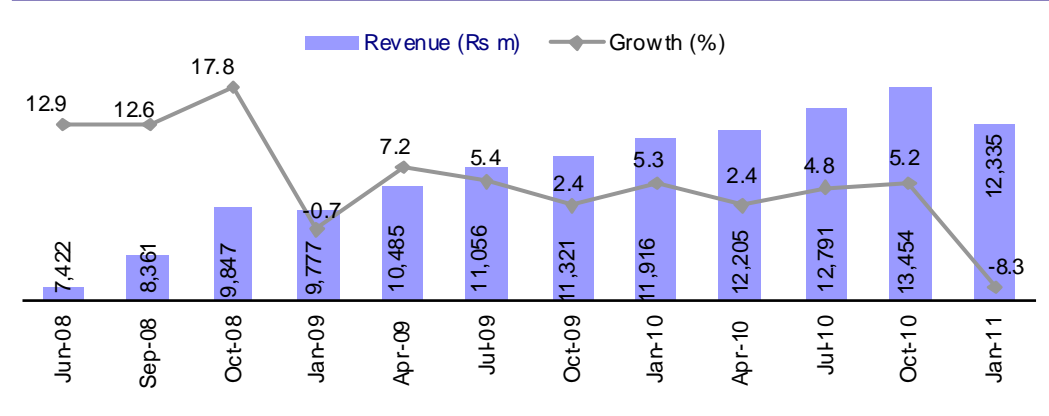
Significant downgrade in Mphasis' FY12 earnings estimate (Rs)



Expect sluggish volumes from the HP account

Mphasis' management now expects revenue from HPES, which constitutes 68% of its revenue, to grow at just 1-2% for several quarters. We find it difficult to reconcile that growth in HPES will be closely tied to HP services revenue growth and not be significantly higher, as we expect HP to continue aggressively pursuing offshoring to protect its market share in new engagements and contract renewals (even assuming part of the opportunity goes to other geographies).

QoQ revenue decline attributed to seasonality and sluggish HP channel



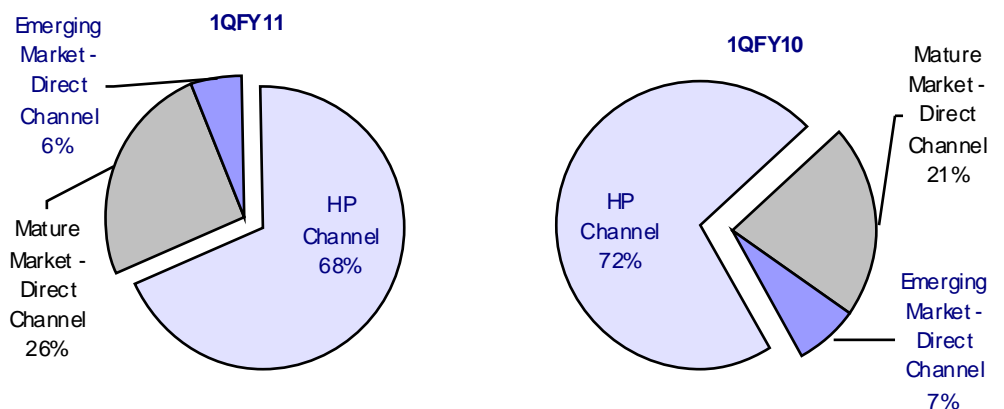
Source: Company/MOSL

Direct channel to drive bulk of the growth

Direct channel is expected to grow at 3-5% QoQ, visibility strengthened by healthy new clients additions (13 in 1QFY11)

Direct channel revenue (32% of total revenue) is likely to grow at 3-5% QoQ over the next few quarters, with likely outperformance relative to the market post that in FY12. Mphasis has had a number of deal wins recently, which aid visibility. The UID bid in India, for instance, is likely to contribute Rs840m over the next two years. The IMS deal from a US financial services company could contribute aggregate revenue of US\$30m over the next five years.

Contribution from HP channel down by 4 percentage points YoY



Source: Company

Pricing cuts are largely behind, SGA investments in direct channel may not dent margins as company has reallocated portfolios without increasing investments

Pricing headwinds mostly behind; marginal cuts in some areas may yet come

On the positive side, it seems that bulk of the price reductions are behind the company. Mphasis had agreed to rate reductions with HP for 25 customers, where pricing and margins were ahead of the company average. With that out of the way, further significant price concessions are unlikely and likely restricted to selective cases in the direct channel, where Mphasis may engage in aggressive pricing to get into new logos.

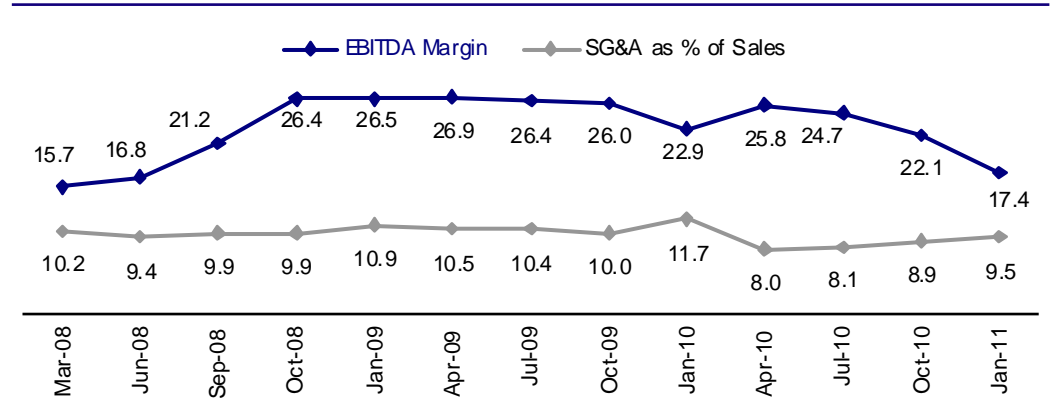
Margins expected to be range-bound

Margin should improve from 1QFY11 level of 14.4% (ex one-offs) on the back of (1) negligible SG&A growth, and (2) higher utilization. However it will be capped at 16-18% given expected wage hike of 10% to offshore employees in April.

Negligible SG&A growth, higher utilization to drive operating leverage

Despite more emphasis on the direct channel business, SG&A spends are unlikely to increase materially for Mphasis in absolute dollars. The company has reallocated the portfolios of its sales teams to ensure more focus on the direct channel without having to increase investments in the same. Just 1/3rd of sales professionals will look after the HP channel, with the remaining 2/3rd driving the direct business.

Volume decline impacted EBITDA margin (%)

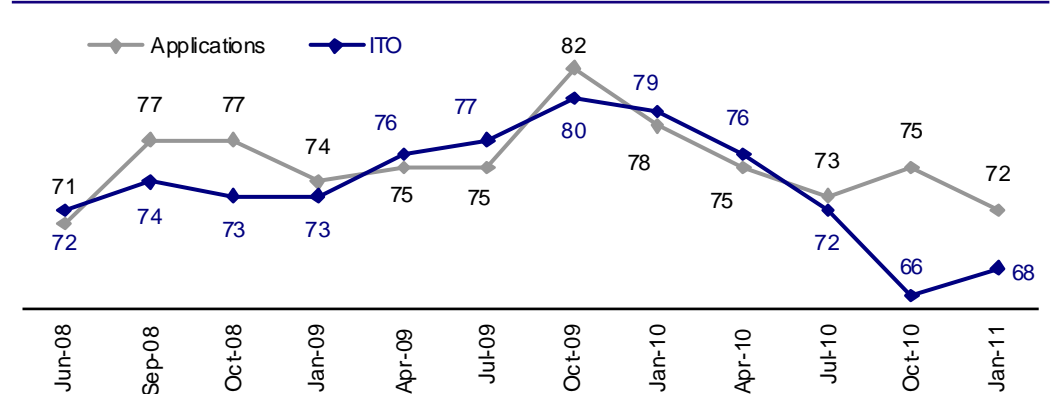


Source: Company

Utilization is a key lever for margin improvement, with the company targeting a four percentage point increase in both Applications and ITO to 75%

Utilization, which was at the lower end of the historical band (down to 71% in both Application Services and ITO in 3QFY11), is another key lever for margins. Also, the company's expectation of slowdown in growth going forward naturally calls for rationalization in this metric. Mphasis targets to push its utilization up to 75%.

Utilization dropped on low volumes, company aims to increase it to 75%



Source: Company

Wage hikes in April to put a cap on margins; margins likely to be in 16-18% range

The company is likely to give wage hikes of around 10% to offshore employees in April, with the full impact on margins likely to be felt in the July 2011 quarter. As a result, margins are unlikely to expand significantly from the January 2011 level of 14.4% (ex one-offs). We would expect margins to be towards the lower end of the targeted range of 16-18% over the next 2-3 quarters, despite tailwinds from higher utilization and the benefits of SGA leverage.

Only gradual increase in margins expected, given pressure of wage inflation, though impact of dishing out RSUs to employees will be negligible

RSU impact to be negligible

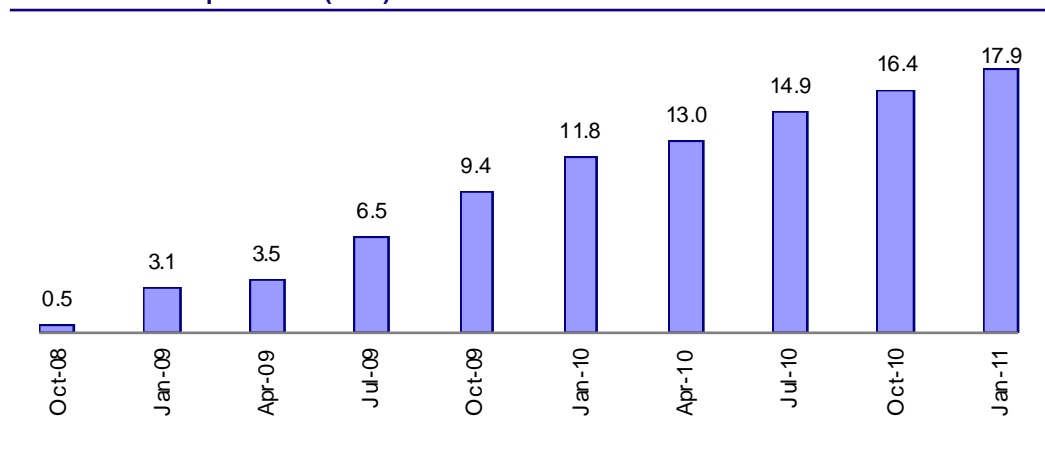
Mphasis had given 150k RSUs to the top management in February 2011, which will vest over a period of two years. In addition, every employee will get 10 shares in April 2011, which will vest over one year. We estimate the aggregate annual impact on pre-tax profit at Rs160m-200m.

Actively looking at EPS accretive acquisitions; can eat up most of the cash

The company has US\$390m of cash on its balance sheet as on January 2011, with average yields on cash likely to be in the range of 8-9%. The management is actively looking to deploy cash primarily through acquisitions. It has zeroed in on three targets and is in advanced stages of talks with one of the candidates. It is a US-based company in the BCM/Insurance space with aggregate revenue of US\$200m. If the deal goes through, we would expect the same to eat up most of the cash on the balance sheet. However, the deal is likely to be EPS accretive, in effect implying an EBIT margin profile of 15%+ for the target. The acquisition will further help in lowering Mphasis' reliance on HP, as it will increase the proportion of revenue from the direct channel to 40%+ from the current 32%. Post merger integration would be a challenge, but we would expect Mphasis HP parentage to help retain resources at the target end.

US based US\$200m BCM/ Insurance company a key acquisition target, expected to be EPS accretive, which implies an EBIT margin profile of 15%+ for the target

Cash and cash equivalents (Rs b)



Source: Company

Significant downward revision in our revenue and EPS estimates. Target Price revised to Rs450 based on 11x FY12E earnings

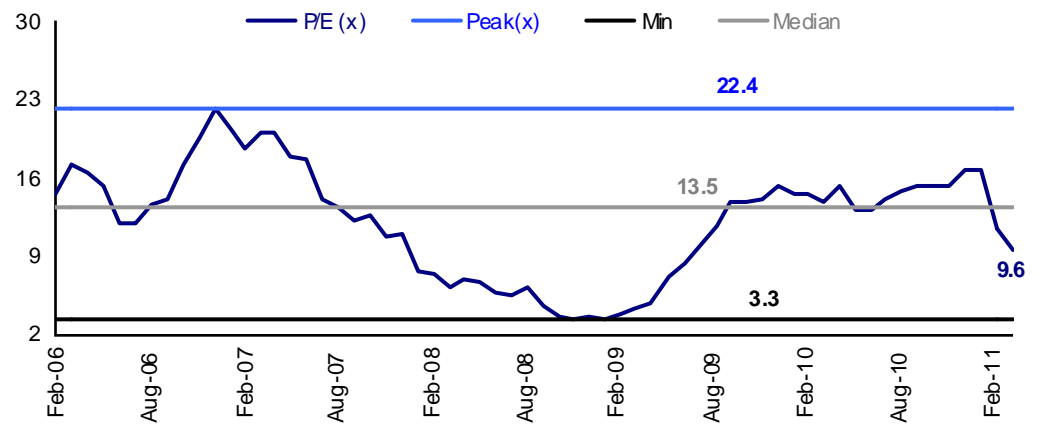
Lowering volume and margin assumptions; sharp downward revision in FY12E EPS

We are lowering our volume growth assumptions, especially on the HP business. We now model revenue growth of 2.1% for FY11 and 10.7% for FY12, significantly lower than our prior assumption of 8.8% and 27%, respectively. We are also tweaking down our

margin assumptions, as new business in the direct channel is expected to come at lower margins than we were modeling earlier. In consonance, our EPS estimate is revised downwards to Rs40.8 for FY12 (v/s Rs47.7 earlier), though our FY11 EPS estimate remains at Rs40, helped by assumptions of increased yields generated on cash and forex gains. The company has recently shifted to making more investments in short dated FMPs, where the yields are higher. Also, given the prevailing currency rates, its hedges appear favorable, due to which the management expressed its confidence of achieving similar forex gains in the remaining quarters as in 1QFY11 (~Rs200m).

It is possible that the company has set a low bar in terms of expectations for now. However, we believe, it will take Mphasis multiple quarters of good execution to rebuild credibility with the street. We retain our Neutral rating, but lower the target price to Rs450 (11x FY12E EPS).

Mphasis: P/E band



Source: MOSL

Mphasis: Financials and Valuation

Income Statement (Rs Million)

Y/E October	2009	2010	2011E	2012E	2013E
Revenues	42,638	50,366	51,403	56,889	69,824
Change (%)	30.5	18.1	2.1	10.7	22.7
Cost Of Goods Sold	26,901	33,749	37,091	41,294	50,543
SG&A Expenses	4,463	4,607	4,650	4,703	6,245
EBITDA	11,274	12,010	9,662	10,892	13,036
% of Net Sales	26.4	23.8	18.8	19.1	18.7
Depreciation	2,022	1,638	1,430	1,457	1,735
Other Income	476	1,089	2,128	2,053	1,269
PBT	9,727	11,461	10,360	11,488	12,570
Tax	641	1,192	1,925	2,872	2,891
Rate (%)	6.6	10.4	18.6	25.0	23.0
PAT	9,086	10,269	8,435	8,616	9,679
Net Income	9,086	10,269	8,435	8,616	9,679
Change (%)	79.4	13.0	-17.9	2.1	12.3

Balance Sheet (Rs Million)

Y/E October	2009	2010	2011E	2012E	2013E
Share Capital	2,097	2,099	2,100	2,100	2,100
Reserves	21,358	30,892	37,344	45,047	53,841
Net Worth	23,454	32,991	39,444	47,147	55,941
Loans	33	454	466	466	466
Capital Employed	23,487	33,445	39,910	47,613	56,407
Gross Block	10,044	10,258	11,524	14,324	17,124
Less : Depreciation	6,880	7,836	9,292	10,749	12,484
Net Block	3,164	2,423	2,232	3,575	4,640
CWIP	127	89	163	163	163
Goodwill	2,946	3,886	4,038	4,038	4,038
Investments	7,612	14,600	15,138	15,138	15,138
Deferred tax assets	695	754	803	803	803
Curr. Assets	18,087	23,286	26,695	34,093	44,135
Debtors	9,060	12,054	13,149	14,510	18,712
Cash & Bank Balance	1,787	1,786	6,109	11,376	14,837
Loans & Advances	7,240	9,446	7,438	8,208	10,585
Current Liab. & Prov	9,147	11,590	9,159	10,197	12,511
Net Current Assets	8,940	11,696	17,536	23,896	31,624
Application of Funds	23,484	33,448	39,910	47,613	56,407

E: MOSL Estimates

Ratios

Y/E October	2009	2010	2011E	2012E	2013E
Basic (Rs)					
EPS	43.2	48.6	40.0	40.8	45.8
Cash EPS	53.0	56.7	47.0	48.0	54.4
Book Value	111.9	157.2	187.9	224.5	266.4
DPS	3.5	3.5	3.5	3.5	3.5
Payout %	8.1	7.2	8.8	8.6	7.6
Valuation (x)					
P/E	8.9	7.9	9.6	9.4	8.4
Cash P/E	7.3	6.8	8.2	8.0	7.1
EV/EBITDA	6.3	5.4	6.2	5.0	3.9
EV/Sales	1.7	1.3	1.2	1.0	0.7
Price/Book Value	3.4	2.4	2.0	1.7	1.4
Dividend Yield (%)	0.9	0.9	0.9	0.9	0.9
Profitability Ratios (%)					
RoE	48.1	36.4	23.3	19.9	18.8
RoCE	48.8	36.4	22.4	21.6	21.7
Turnover Ratios					
Debtors (Days)	76	77	89	89	87
Asset Turnover (x)	13.0	18.0	22.1	19.6	17.0
Leverage Ratio					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement (Rs Million)

Y/E October	2009	2010	2011E	2012E	2013E
CF from Operations	10,758	11,848	9,815	10,072	11,414
Chg. in Wkg. Capital	-724	-2,757	-1,517	-1,093	-4,267
Net Operating CF	10,034	9,091	8,298	8,980	7,147
Net Purchase of FA	-1,177	-858	-1,312	-2,800	-2,800
Net Purchase of Invest.	-7,599	-7,929	-690	0	0
Net Cash from Invest.	-8,776	-8,787	-2,002	-2,800	-2,800
Proceeds from issue of cap.	862	127	-1,123	-53	-26
Proceeds from LTB/STB	-21	421	12	0	0
Dividend Payments	-858	-858	-860	-860	-860
Net CF from Financing	-16	-311	-1,970	-913	-885
Free Cash Flow	8,857	8,233	6,986	6,180	4,347
Net Cash Flow	1,242	-7	4,326	5,267	3,461
Opening Cash Balance	548	1,790	1,783	6,109	11,376
Add: Net Cash	1,242	-7	4,326	5,267	3,461
Closing Cash Balance	1,790	1,783	6,109	11,376	14,837

Motilal Oswal Company Gallery

Motilal Oswal
Bharti Airtel



Out of turbulence

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.


Motilal Oswal
Petronet LNG



Bridging the gap

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.


Motilal Oswal
Shree Renuka Sugars



Sweetening the world

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.

Motilal Oswal
State Bank of India



PLAY FOR GROWTH

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.


Motilal Oswal
Indusind Bank



Polished execution

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.


Motilal Oswal
Strides Arcolab



On target

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.

Motilal Oswal
Coal India



Lord of the mines

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.


Motilal Oswal
Siemens



The right steps

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.

Motilal Oswal
Oberoi Realty



Premium play

Motilal Oswal Securities Pvt. Ltd. is a member of the National Institute of Securities Markets (NISM) and is registered with the Securities and Exchange Board of India (SEBI) as a Merchant Caterer Member.



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: reports@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement	Mphasis
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.