

CMP	Rs. 355	Absolute	SELL
Target	Rs. 350	Relative	Underperform

## Another lacklustre quarter – where to from here? Reiterate Sell

Mphasis posted poor 3QFY11 results with revenues ~1% below estimates and EBIT margins 60bps above forecasts – similar to last quarter, this would have been even worse but for one-offs totalling Rs 931mn in the form of credit note write back, provision write-backs in cost of sales and S&M. Considering their operating profit of Rs 1931mn, the absence of these writebacks and reversals would have meant dismal underlying operating margins of 8% vs 15.2% actual. We note that this lacklustre performance is despite any significant pricing cuts from HP – indeed, pricing remained broadly stable expect for apps onsite pricing decreasing to US\$70/hr (from \$72 last qtr). This being the case, we believe Mphasis stock is beset by what one might describe as a “confluence of uncertainties”: around HP-led pricing, sagging business momentum and also the worries about HP’s overall strategic direction and resultant impact on Mphasis. Retain SELL with a Rs 350 target price.

**Provision write-backs yet again; margins a cause for worry:** Mphasis had the following provision write-backs/reversals in 3Q: Rs 665 mn in credit note reversals (2Q: Nil); provision reversal in cost of sales of Rs 110mn (Rs 323mn in 2Q); Rs 156mn in S&M provision reversals (Rs 135mn in 2Q). Underlying margins at 8% are a worry now, and compare unfavourably with ~20% average margins over the last 5 years. Management flagged that their medium term range is ~15%-18%, but that this would “take time”. We believe that management’s levers to achieve this are limited, with their largest client HP unlikely in our view to give them significant leeway on the pricing front.

**Management commentary and metrics:** Management expects the Wyde acquisition to close in a matter of 2 weeks. Recall that Wyde should add ~2.7% to Mphasis’ annual revenues and is expected to be slightly EPS-accretive in Year 1 of consolidation. However, this provides scant consolation at a time when Mphasis’ underlying business momentum shows few signs of material improvement. Utilisation trends were broadly stable and so were billing rates, with the exception of apps onsite which saw a 2.7% qoq reduction. Other noteworthy trends were the headcount reductions qoq in ITO and BPO – we would highlight that ITO+BPO combined headcount stands at 23,756 vs 24,490 last qtr, a 3% cut qoq mainly on account of the ramp-down in Santander-related work, in our view. We also remain surprised by their decision to cut down on sales personnel (315 in 3Q vs 325 last qtr) when management’s stated intention is to enhance their Direct business.

**Reiterate SELL:** We continue to be wary of Mphasis notwithstanding the stock’s steep 44% correction in the last 12 months. We reiterate our SELL rating with a Rs 350 target price.

Financial summary						
Year	Revenues (Rs.mn)	EBITDA (Rs. mn)	PAT (Rs. mn)	EPS (Rs.)	P/E(x)	EV/EBITDA(x)
FY10	49,190	8,659	8,555	51.7	6.9	5.5
FY11E	50,743	6,387	6,526	30.9	11.5	6.9
FY12E	59,399	7,432	7,251	34.4	10.3	5.9

### 3QFY11 Update

Date	Aug 26, 2011
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Market Data	
SENSEX	16047
Nifty	4789
Bloomberg	MPHL IN
Shares o/s	210mn
Market Cap	Rs 74.5bn
52-wk High-Low	Rs 712-308
3m Avg. Daily Vol	Rs 412mn
Index member	BSE200

Latest shareholding (%)	
Promoters	60.6
Institutions	26.0
Public	13.4

Stock performance			
	1m	3m	12m
MPHL	-20	-23	-44
CNXIT	-20	-20	-16
Nifty	-14	-11	-12

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### Quarterly financial results

Rs. mn\Period	31-Jul-11	31-Jul-10	yoy Growth	30-Apr-11	qoq Growth	FY10	FY11E	yoy Growth
Revenues	12,936	12,791	1.1%	12,571	2.9%	49,190	50,743	3.2%
Cost of revenues	9,816	8,967	9.5%	9,501	3.3%	35,007	38,699	10.5%
Gross profit	2,995	3,614	-17.1%	2,960	1.2%	15,358	12,044	-21.6%
Selling expenses	506	594	-14.8%	516	-1.9%	2,215	2,237	1.0%
General and administrative	538	475	13.3%	485	10.9%	2,129	1,915	-10.1%
EBITDA	1,951	2,949	-33.8%	2,296	-15.0%	12,194	7,914	-35.1%
<i>EBITDA margin (%)</i>	<i>15%</i>	<i>23%</i>		<i>18%</i>		<i>25%</i>	<i>16%</i>	
Operating profit	2,076	2,755	-24.6%	2,069	0.3%	11,014	6,444	-41.5%
<i>EBIT margin (%)</i>	<i>16%</i>	<i>22%</i>		<i>16%</i>		<i>22%</i>	<i>13%</i>	
Foreign exchange gain, net	139	54		124	12.1%	581	701	
Other income / (expense),	305	122		14		499	464	
Interest income / (expense),	-15	-2		359		8	750	
Profit before taxation	2,505	2,929	-14.5%	2,566	-2.4%	12,101	8,361	-30.9%
Income taxes	557	217		393		1,191	1,790	
Net profit	1,948	2,712	-28.2%	2,173	-10.4%	10,910	6,571	-39.8%
<i>Net profit margin (%)</i>	<i>15%</i>	<i>21%</i>		<i>17%</i>		<i>22%</i>	<i>13%</i>	
Basic EPS (Rs)	9.3	12.9	-28.2%	10.3	-10.4%	52.0	31.3	-39.8%
Diluted EPS (Rs)	9.2	12.8	-28.2%	10.3	-10.4%	51.7	31.1	-39.8%
Cash and bank balances	2,863	1,443	98.4%	2,044	40.1%	1,784	5,712	

# Mphasis

## Business Overview

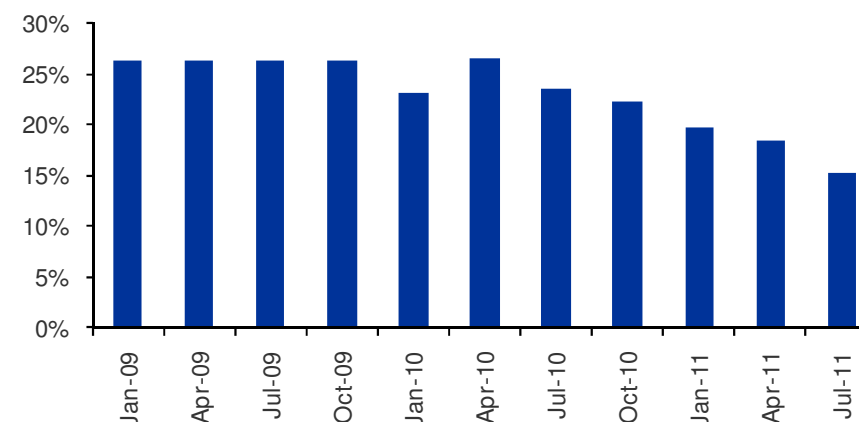
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### Key estimate revision

	FY11E			FY12E		
	Old	New	Change	Old	New	Change
US\$ revenue	1,146	1,130	-1%	1,381	1,350	-2%
INR revenue	51,454	50,743	-1%	60,754	59,399	-2%
EBITDA	8,580	7,914	-24%	11,054	9,475	-28%
EBITDA margin	16.7%	15.6%	-393bps	18.2%	15.8%	-442bps
EPS	35	31	-28%	41	35	-28%

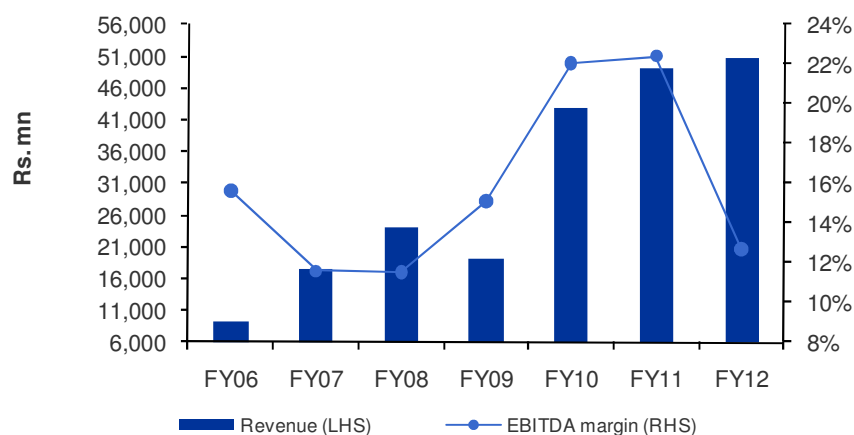
All figures in Rs. mn, except EPS, which is in Rs.

### EBITDA margin evolution



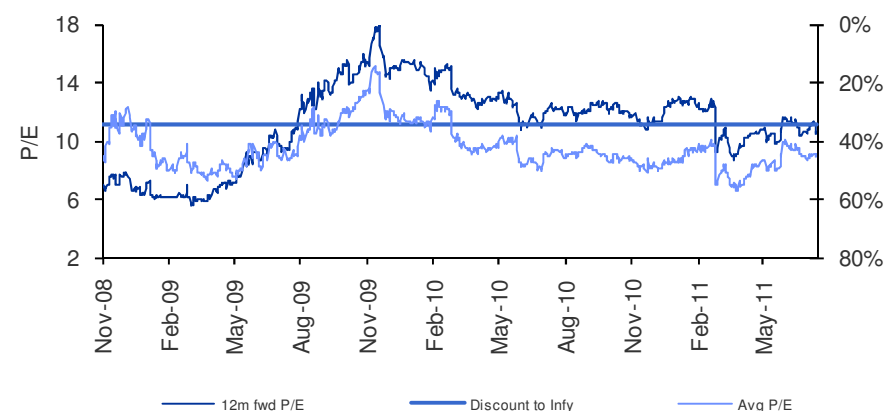
Source: Company data, Spark Capital

### Revenues and margins progression



Source: Company data, Spark Capital

### MPHL 12-m forward P/E



Source: Bloomberg, Spark Capital

# Mphasis

## Financial Summary

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Abridged Financial Statements				
Rs. mn	FY09	FY10	FY11E	FY12E
<b>Profit &amp; Loss</b>				
Revenues	42,834	49,190	50,743	59,399
Cost of revenues	26,901	35,007	38,699	45,342
Gross profit	15,933	15,358	12,044	14,057
Selling expenses	1,791	2,215	2,237	2,473
General and administrative expenses	2,664	2,129	1,950	2,363
EBITDA	11,478	12,194	7,857	9,221
Foreign exchange gain, net	292	581	701	625
Other income / (expense), net	155	499	464	0
Interest income / (expense), net	28	8	750	1,611
Profit before taxation	9,923	12,101	8,302	9,668
Income taxes	641	1,191	1,776	2,417
Net profit	9,282	10,910	6,526	7,251
Basic EPS - Rs	44	52	31	35
Diluted EPS - Rs	44	52	31	34
<b>Balance sheet</b>				
Shareholders' funds	23,453	32,991	40,473	41,628
Secured loans	33	454	445	445
<b>Total Sources of funds</b>	<b>23,488</b>	<b>33,448</b>	<b>40,918</b>	<b>42,073</b>
Total fixed assets	3,291	2,512	3,011	3,309
Goodwill	2,946	3,886	3,897	3,897
Deferred Tax Assets	695	754	847	847
Investments	7,612	14,600	17,430	17,430
Cash and bank balances	1,786	1,784	5,752	6,421
Debtors and unbilled	9,064	12,054	11,435	11,708
Loans and advances	7,240	9,446	9,518	9,705
Net current assets	8,944	11,696	15,733	16,590
<b>Total - Application of funds</b>	<b>23,488</b>	<b>33,448</b>	<b>40,918</b>	<b>42,073</b>

Key metrics				
	FY09	FY10	FY11E	FY12E
<b>Cashflow</b>				
Net cash from operations	10,517	8,406	9,338	7,095
Net cash from investing	-9,059	-7,923	-2,070	-2,970
Net cash from financing	-427	-402	-1,932	-1,932
Free cash flow	<b>9,018</b>	<b>7,487</b>	<b>7,278</b>	<b>4,125</b>
Cash at year-end	1,786	1,784	7,119	9,312
<b>Growth</b>				
Revenues	nm	15%	3%	17%
EBITDA	nm	6%	-36%	17%
PAT	nm	18%	-40%	11%
EPS	nm	17%	-40%	11%
<b>Margins</b>				
EBITDA	27%	25%	15%	16%
PAT	22%	22%	13%	12%
<b>Return</b>				
ROE	49%	30%	18%	18%
ROCE	47%	27%	15%	16%
<b>Valuation</b>				
Fully diluted shares (mn)	209.8	210.4	211.1	211.1
Market cap (Rs. mn)	74,252	74,554	74,554	74,554
EV (Rs.mn)	54,404	54,404	54,404	54,404
EV/Sales (x)	1.3x	1.1x	1.1x	0.9x
EV/EBITDA (x)	4.7x	5.5x	6.9x	5.9x
P/E (x)	8.0x	6.9x	11.5x	10.3x
EPS(E) / Current market p	12%	15%	9%	10%
Revenue per employee (0	1,415	1,348	1,262	1,453
EBITDA per employee (00	379	270	195	225
PAT per employee (000's)	307	234	162	177

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Absolute Rating Interpretation	
<b>BUY</b>	Stock expected to provide positive returns of > 15% over a 1-year horizon
<b>ADD</b>	Stock expected to provide positive returns of <=15% over a 1-year horizon
<b>REDUCE</b>	Stock expected to fall <=15% over a 1-year horizon
<b>SELL</b>	Stock expected to fall >15% over a 1-year horizon
Relative Rating Interpretation	
<b>OUTPERFORM</b>	Stock expected to outperform sector index /sector peers in our coverage
<b>UNDERPERFORM</b>	Stock expected to underperform sector index/ sector peers in our coverage

Recommendation History				
Date	CMP	Target price	Absolute Rating	Relative Rating
30-May-11	473	405	Sell	UPF
8-Mar-11	451	480	Add	UPF
10-Jan-11	683	625	Add	UPF
14-Dec-10	603	625	Add	UPF
11-Oct-10	660	625		Neutral

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