Prabhudas Lilladher

Mphasis

Positive catalyst on the horizon

December 22, 2009

Rating	Accumulate
Price	Rs720
Target Price	Rs840
Implied Upside	16.7%
Sensex	16,061

(Prices as on December 21, 2009)

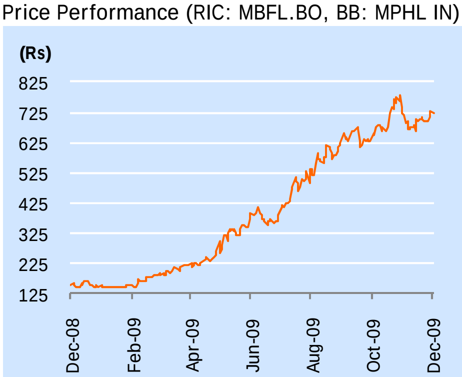
Trading Data	
Market Cap. (Rs bn)	150.9
Shares o/s (m)	209.6
Free Float	39.9%
3M Avg. Daily Vol ('000)	1,349.6
3M Avg. Daily Value (Rs m)	923.2

Major Shareholders	
Promoters	60.1%
Foreign	16.8%
Domestic Inst.	7.9%
Public & Others	15.2%

Stock Performance

(%)	1M	6M	12M
Absolute	0.8	83.8	363.5
Relative	3.2	69.5	299.1

Price Performance (RIC: MBFL.BO, BB: MPHL IN)



Source: Bloomberg

Visit Update

We met the management of Mphasis on Friday. The management sounded confident about the improved demand environment. We expect Mphasis to derive the benefit from joint go-to-market strategy with HP. We reiterate our **'Accumulate'** rating, with increased target price of Rs840.

- **Growth momentum to continue:** The management was optimistic about the growth momentum of HP Migration, Market Facing and Direct channel. The growth would be in line with its peers if not better for these three business mix. There is a ramp-down in the BPO business of HP Internal that contributes about 3% of total revenue which is expected to come down to 1% of total revenue. But the other two verticals of HP Internal are in the steady state and are not anticipating any ramp-down. We believe that improved demand environment and favourable order book of HP would help Mphasis grow in line with its peers if not faster.
- **Multiple levers to help maintain margins:** The management was confident about maintaining the gross margin at current level (31.5-33.0%). The management may use multiple levers to maintain the margins at this level: 1)The company has got hedge position of about 70% of FY10 receivables hedged at Rs49.50. 2)The company has pegged variable pay from 5-25% of the fixed salary that will be paid based on the company performance. 3)The company is increasing the seat utilization and hence, bringing the overall cost down. We believe that these levers would help the company maintain its margins in the narrow range of current gross margins, despite pricing pressure.
- **Revising our FY10 and FY11 estimates upward:** We revise our revenue estimate for FY10 and FY11 by 4.0% and 5.8%, respectively. We believe that multiple margin levers of Mphasis would help maintain its margins and would translate into better bottom-line growth. We also revise our EPS estimate for FY10 and FY11 by 3% and 0.3%, respectively.
- **Valuation and Recommendation:** We believe that the there would be a continuous growth momentum for the company. We also remain optimistic about the improved demand environment and increased earnings visibility for the company. We reiterate **'Accumulate'** rating, with target price of Rs840, a target multiple of 17.5x and 17.0x FY10 and FY11 earnings estimates, respectively.

Key financials (Y/e Oct)	FY08	FY09	FY10E	FY11E
Revenues (Rs m)	29,773	42,639	49,211	57,375
Growth (%)	*69.1*	*43.2*	*15.4*	*16.6*
EBITDA (Rs m)	6,672	11,750	13,345	15,080
PAT (Rs m)	4,923	9,087	9,990	10,366
EPS (Rs)	19.4	43.2	47.4	49.2
Growth (%)	*124.7*	*123.2*	*9.7*	*3.8*
Net DPS (Rs)	3.5	6.0	2.5	2.8

Source: Company Data; PL Research

Profitability & valuation	FY08	FY09	FY10E	FY11E
EBITDA margin (%)	*22.4*	*27.6*	*27.1*	*26.3*
RoE (%)	*34.3*	*38.7*	*30.3*	*24.3*
RoCE (%)	*34.2*	*60.9*	*44.0*	*36.1*
EV / sales (x)	5.1	3.5	3.1	2.6
EV / EBITDA (x)	22.6	12.8	11.3	10.0
PE (x)	36.9	16.6	15.1	14.6
P / BV (x)	10.5	6.4	4.6	3.6
Net dividend yield (%)	*0.5*	*0.8*	*0.3*	*0.4*

Source: Company Data; PL Research

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Growth momentum to continue

We expect Mphasis to derive strong benefits from its alliance with parent company HP. All the business mix is expected to grow, except HP internal. We are factoring in growth in all the verticals, with a slightly negative growth in the HP internal vertical. The company is witnessing good demand in BFSI and healthcare in North America in line with its larger peers.

Market Facing (43% of revenue)

This is a direct market channel along with the partnership with HP. Mphasis will bid jointly with HP for the projects and most likely deliver the offshore component. According to the management, the company is exposed to the pricing risk along with HP. Mphasis is witnessing the demand in line with the market condition.

Direct (29% of revenue)

This business line is a direct channel of Mphasis and has nothing to do with HP. The company is witnessing the demand environment in line with the market. The company is ramping up its sales and marketing effort. The decline in the last quarter was due to reversal of the surplus reserves created by the company. The company is also witnessing strong growth in North America and Asia Pacific.

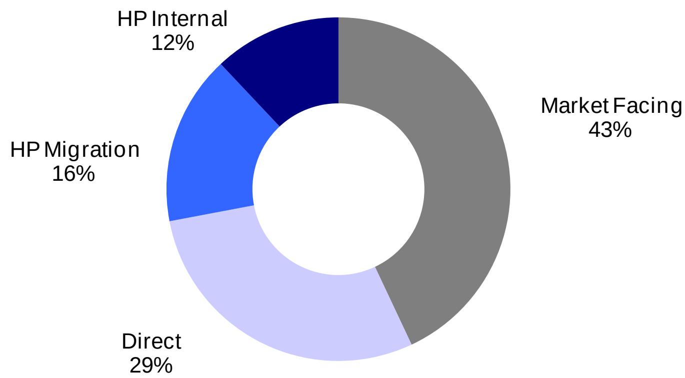
HP Migration (16% of revenue)

This segment revenue is based on the offshore strategy of HP for its existing customers. The revenue of this segment is exposed to the discretion of HP. Mphasis does not put its sales and marketing effort for this segment. The work given by HP is based on cost plus basis, with a fixed margin for Mphasis. We believe that a strong performance by HP in the last quarter in the services business would help Mphasis get more business from the parent company.

HP Internal (12% of revenue)

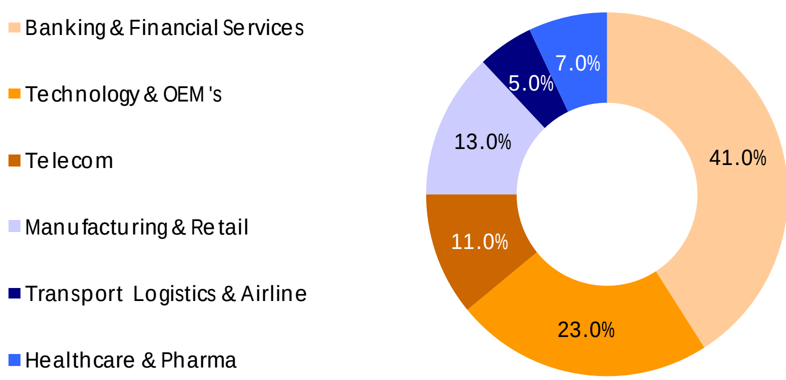
This segment of Mphasis derives its revenue from HP as a client. This segment contains 5% of revenue from ITO, 4% from Application and 3% from BPO. ITO and Application are steady and not witnessing any fluctuation, whereas BPO vertical is witnessing a ramp-down. The ramp-down is largely due to EDS consolidation with HP which is nearing its completion. We are expecting the ramp-down to continue for 2-3 quarters. We expect BPO revenues from HP internal to come down to 1% of revenue in the steady state.

Market Facing and Direct channel to lead the growth chart



Source: Company Data; PL Research

Witnessing good demand in BFSI and Healthcare & Pharma



Source: Company Data; PL Research

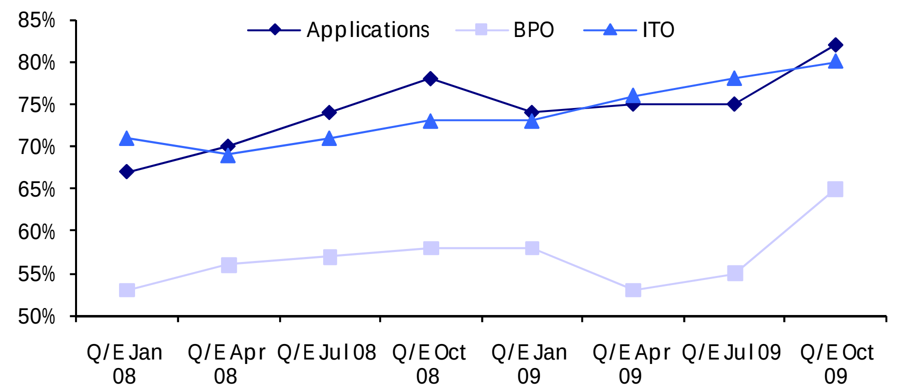
Ramp-up in hiring - filling up 3k open positions

Mphasis was slow on hiring last quarter to accommodate about 300 employees of AIGSS on the bench. The acquisition of AIGSS added 700 employees, out of which 300 were on bench when the AIG unit was acquired. The company froze hiring to accommodate the employees on bench. The management is not comfortable with the current level of utilization rate and expects to bring it down to 80% across the segment.

The company currently has ~3k open positions, which includes ~1.2k open positions in Application, ~600 in ITO and ~1k in BPO. We expect these positions to be filled over the next 2-3 quarters. The growth in the employee base is in line with our expectation of topline growth.

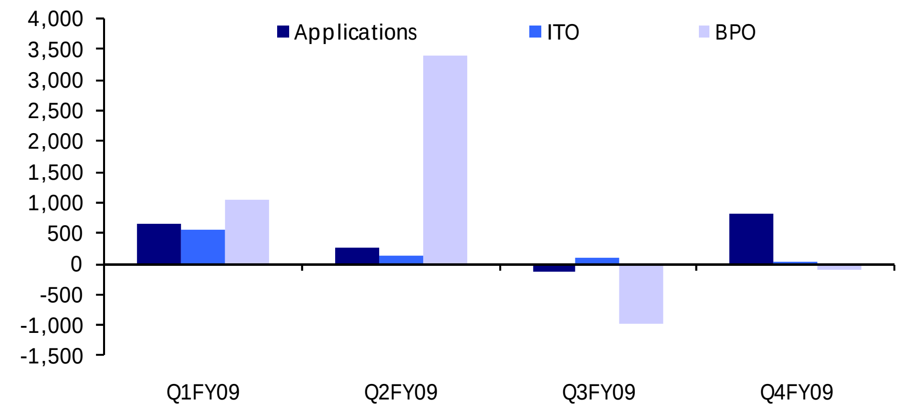
New offshore centre in Sri Lanka: The company is setting up a new offshore development centre in Sri Lanka, which is expected to grow to 500 employees by October 2010. According to the management, the centre would expected to be ramped up to 2k in the next three years

Efforts to bring utilization level down to ~80%, hiring on the cards



Source: Company Data; PL Research

Muted employee growth in Q4FY09 to utilize 300 bench staffs of AIGSS



Source: Company Data; PL Research

Multiple levers to help maintain margin

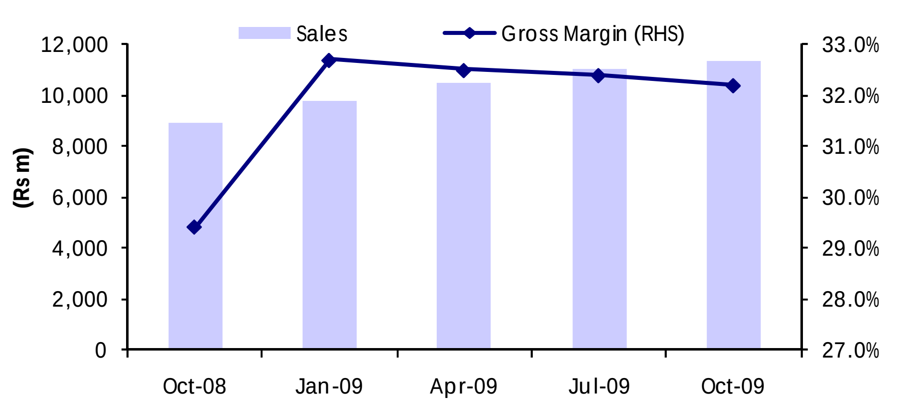
The management is confident about maintaining its gross margin at the current level of 32%. We believe that multiple margin levers would help the company maintain its margin at the current level despite currency and pricing headwinds.

Facility consolidation: Mphasis is increasing the seat utilizations of its current centres and is in the process of consolidation of facilities. It is giving up some of the facilities to bring down the operational cost. The company has given-up one centre in Bengaluru and is expected to discontinue another one in Bengaluru and one each in Chennai and Mumbai over the next 2-3 quarters. Each centre had seat capacity of 1-2k. We believe that this will bring down the operational cost of company.

Employee cost – maintaining variable pay structure: Unlike its competitors, the company has not given any raise to its employees. But the company has paid bonus of 14% of the fixed component for FY09; this varies from the range of 5% to 25% of fixed salary in the last quarter. It has also set the target for 5-25% as a variable pay for FY10. The company has set internal target for the revenue for FY10 and pegged the variable pay to that. If the company achieves lower than 85% of the internal target then no variable component will be paid. On the other hand, the company will pay the entire 25% if it achieves 100% of the target.

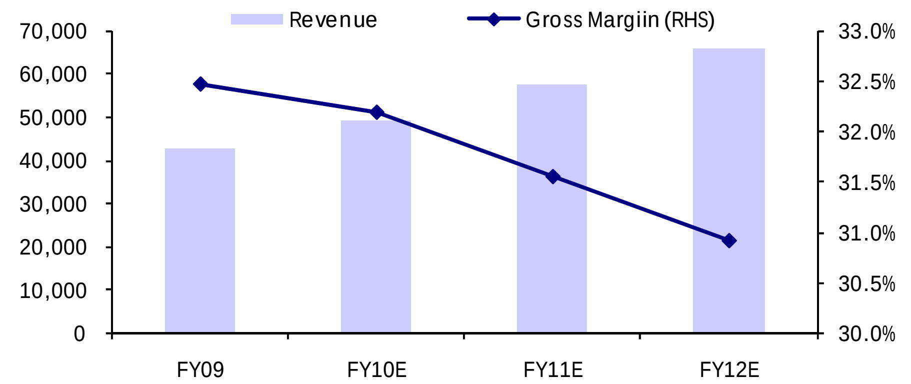
Hedging policy – help withstanding currency fluctuation: The company has total outstanding hedge of US$652m at an average rate of Rs49.15 and £54m at an average rate Rs80.60. 70% of FY10 receivables are hedged. The hedging would help Mphasis to withstand currency headwinds.

Steady margins despite multiple headwinds



Source: Company Data; PL Research

Factoring margin erosion of 40bp and 60bp in FY10 and FY11, respectively



Source: Company Data; PL Research

Revising our FY10 and FY11 estimates upward

We believe that the earnings momentum of the company is likely to be continued with a slight deceleration. We revise our FY10 and FY11 revenue estimates upward by 4.0% and 5.8% to Rs49.2bn and Rs57.4bn, respectively. We are factoring in margin erosion of 40 bps for FY10 and further 60 bps for FY11. Due to steady margin, and improved growth visibility, we revise our EPS estimates for FY10 and FY11 by 3.0% and 0.3% to Rs47.6 and Rs49.2, respectively.

Revising estimates upward: positive catalyst on the horizon

	Old		New		Revision	
	FY10	FY11	FY10	FY11	FY10	FY11
Revenue (Rs m)	47,314	54,205	49,211	57,375	4.0%	5.8%
EPS (Rs)	46.2	49.1	47.6	49.2	3.0%	0.3%

Tax Rate and SEZ

Mphasis is setting up new SEZs at Bengaluru, Pune and Chennai. All the new projects are expected to go to SEZs. Currently, SEZs contributes ~10% of total revenue. The management guided for tax rate of 10% and 18% for FY10 and FY11, respectively.

Valuation and Recommendation

We believe that there would be continuous growth momentum for the company. We remain optimistic about the improved demand environment and increased earning visibility for the company. We reiterate **'Accumulate'** rating, with target price of Rs840, a target multiple of 17.5x and 17.0x FY10 and FY11 earnings estimate, respectively.

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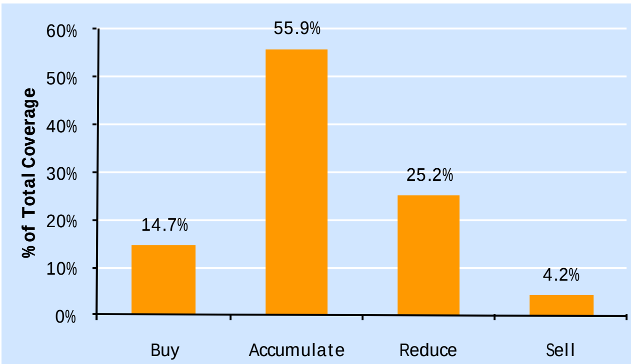
Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly