

INDIA RESEARCH
IT SERVICES
BSE SENSEX: 18359
MARCH 16, 2011

Mindtree

NEUTRAL
MANAGEMENT MEETING NOTE
Rs372
Mkt Cap: Rs15bn; US\$331m

We recently had a discussion with Mindtree's management for an update on the business. The management indicated slowing revenue growth in the core IT services business. Sequential USD revenue growth in the IT business is expected to decelerate to a low-to-mid single-digit rate in Q4FY11 from ~9% CQGR in the past four quarters. Mindtree expects the decline to be a quarterly aberration and hopes for 30% growth in FY12; but we expect a lower rate of ~25%. Driven by client-specific issues at Kyocera, R&D revenue growth is also expected to remain muted. The company expects ex-Kyocera R&D and OPD services to witness revenue growth in FY12. In the backdrop of reduced top-line visibility, we have lowered our FY12 and FY13 revenue expectations by ~4% and ~8% respectively. We have also reduced our operating margin expectation by 100-200bp to account for wage inflation (in line with industry levels). Overall, we have reduced our FY11, FY12 and FY13 earnings estimates by ~6%, ~19% and ~14% respectively. We have lowered our 12-month price target to Rs415, based on 11x FY12E EPS estimates, and have downgraded the stock to Neutral (from Outperformer). We expect the stock price to remain close to current levels over a 12-month horizon, though it could potentially decline by 5-10% in the near term.

Key financials

As on 31 March	FY09	FY10	FY11E	FY12E	FY13E
Net sales (Rs m)	12,375	12,960	15,105	17,123	19,622
Adj. net profit (Rs m)	523	2,148	1,119	1,543	1,936
Shares in issue (m)	38	39	40	40	40
Adj. EPS (Rs)	13.7	52.8	27.4	37.7	47.4
% change	(48.3)	285.2	(48.2)	37.9	25.4
PE (x)	27.1	7.0	13.6	9.9	7.9
Price/ Book (x)	2.4	2.3	2.0	1.7	1.4
EV/ EBITDA (x)	4.7	6.0	7.4	5.7	4.5
RoE (%)	9.4	34.2	15.5	18.3	19.3
RoCE (%)	40.6	25.8	17.1	20.4	21.3

Source: IDFC Securities Research
Lower visibility on IT services business

USD revenues of Mindtree's core IT services business grew by ~9% CQGR in the past four quarters and ~30% yoy in 9MFY11. In Q4FY11, the management expects the growth momentum to decline to a low-to-mid single-digit rate. The decline in revenue growth is largely due to slower decision-making at the client's end and delays in a few project renewals. The company sees the revenue dip as a quarterly aberration and hopes for 30% yoy revenue growth in FY12. We, however, believe that the revenue decline in Q4, especially amid improving industry demand, is an early sign of reducing revenue visibility and, so, expect the segment's USD revenues to grow at a lower rate of ~25% in FY12.

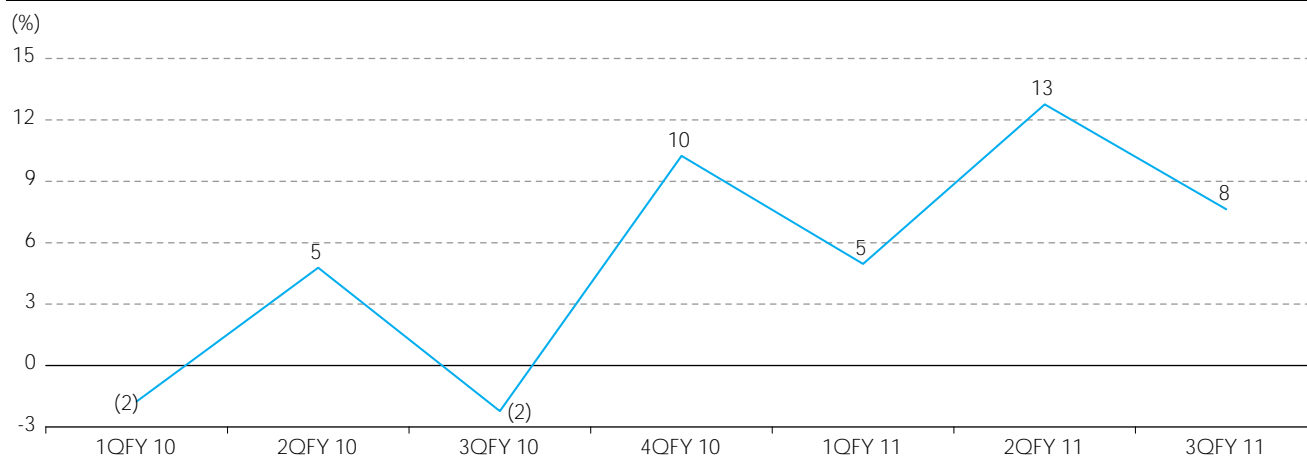
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Exhibit 1: Mindtree – IT services sequential USD revenue growth

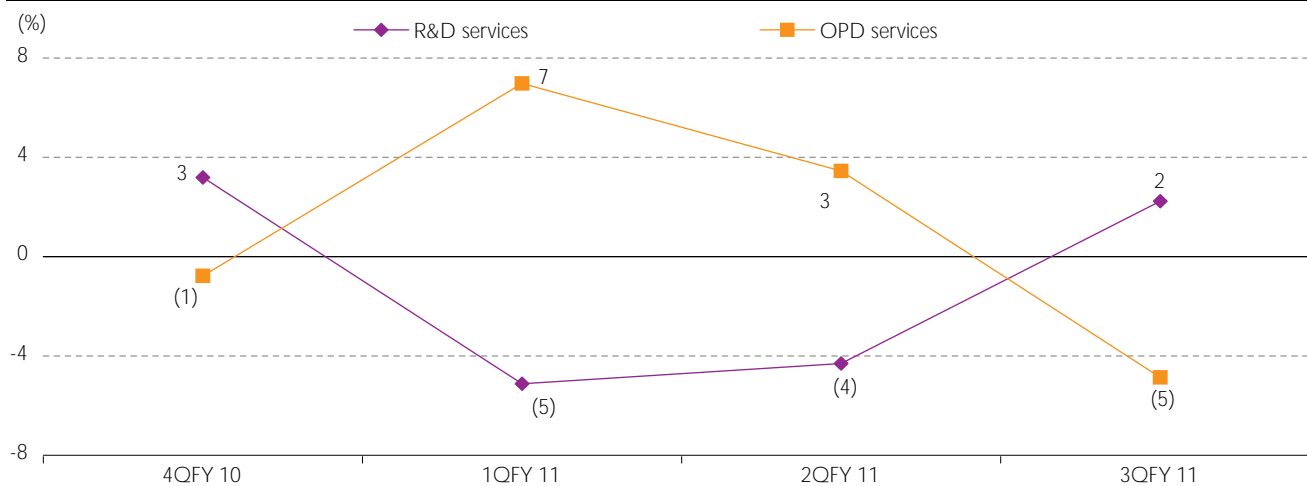


Source: Company, IDFC Securities Research

OPD services to show positive trend; Kyocera to weigh on R&D services

USD revenues of the OPD business grew ~9% yoy in 9M FY11 and management expects it to post healthy growth in FY12. USD revenues of R&D services grew ~5% yoy in 9MFY11 organically. Including Kyocera acquisition, they showed ~32% yoy growth. During the last earnings call, the management highlighted that Kyocera had lost one of its major customers and hence revenues are expected to decline. Ex-Kyocera, the management still expects R&D services' revenues to grow in FY12. We expect these business segments to together clock ~9% yoy growth in FY12.

Exhibit 2: Mindtree – OPD and R&D services' sequential USD revenue growth



Source: Company, IDFC Securities Research

Reducing estimates for lower revenue growth

We have reduced our volume assumptions to factor in lower visibility in the IT services business and client-specific issues in R&D services. We have also reduced our margin estimates from ~16% to 14-15% in FY12 and FY13 to account for wage inflation in line with industry-wide supply pressures. Our INR assumptions remain unchanged at Rs45.5/ USD for FY11, Rs43.7/ USD for FY12 and Rs41.7/ USD for FY13. Also, our tax forecast is largely unchanged at ~22% for FY11, ~21% for FY12 and ~19% for FY13. Overall, we lower our FY11, FY12 and FY13 EPS estimates by ~6%, ~19% and ~14% respectively. Our revised FY11, FY12 and FY13 EPS estimates are ~2%, ~15% and ~9% below Bloomberg consensus estimates.

Exhibit 3: Earnings downgraded by ~6% for FY11E, ~19% for FY12E and ~14% for FY13E

	FY11E	FY12E	FY13E
Net Income (Rs m)			
- New	1,119	1,543	1,936
- Old	1,184	1,903	2,248
Revision (%)	(5.5)	(18.9)	(13.9)
Fully diluted EPS (Rs)			
- New	27.4	37.7	47.4
- Old	29.0	46.5	55.0
Revision (%)	(5.5)	(18.9)	(13.9)

Source: IDFC Securities Research

Exhibit 4: IDFC vs Bloomberg consensus estimates

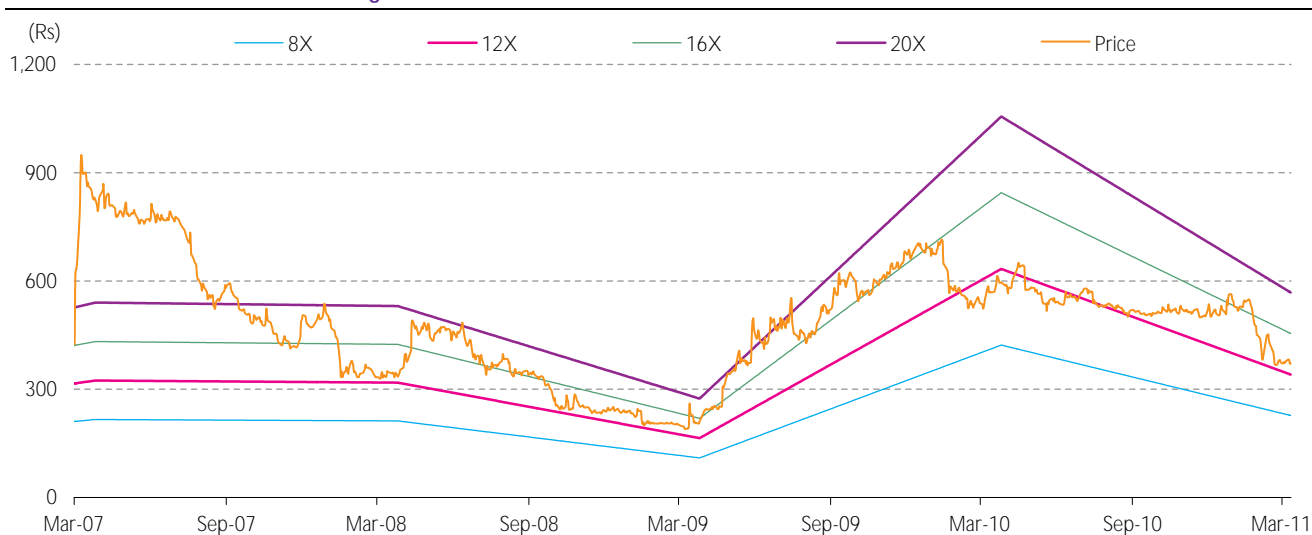
Fully diluted EPS (Rs)	FY11E	FY12E	FY13E
IDFC	27.4	37.7	47.4
Bloomberg Consensus	27.8	44.3	51.9
Difference (%)	(1.6)	(14.7)	(8.8)

Source: Bloomberg, IDFC Securities Research

Downgrade to Neutral; price target reduced to Rs415

We have reduced our 12-month price target to Rs415/ share (based on 11x FY12E EPS) from Rs650/ share (based on 14x FY12E EPS). Our target multiple has been lowered to factor in reduced revenue visibility. We have also downgraded our recommendation to Neutral. We believe stock returns hereon will largely be driven by improvement in revenue visibility in the IT services business and/or revenue growth in R&D/OPD services. We expect the stock price to remain close to current levels over a 12-month horizon, though it could potentially decline by 5-10% in the near term.

Exhibit 5: Mindtree – 12-month rolling PER band chart



Source: Company, Bloomberg, IDFC Securities Research

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2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: More than 5% downside to Index

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