

## Mindtree reloaded

In recent meetings with investors organised by IIFL, Mindtree's management highlighted the company's focus on specialisation in select verticals, client mining and multiple margin levers. A marquee client base and good reference projects have been its forte; however, client mining has been historically poor. Over the past 1.5 years, the company has considerably boosted its client-mining ability by recruiting account managers from tier-1 vendors. Also, the new incentive structure forces more cross-selling. Finally, newer service lines like infra. mgmt. and testing increase the annuity component. Its EBITDA margins have multiple levers as well. Valuations are cheap at less than 12x FY12ii P/E. We reiterate BUY.

**New incentive structure and recruitments improve client mining:** Traditionally, delivery managers performed the role of account managers at Mindtree. Over the past 1.5 years, it has changed, as the company recruited specialists from tier-1 vendors. Now, ~35-40 people of its 80-member sales team are focused on account mining. The company has roped in a leading consultant to improve the incentive structure; its new incentive structure for engagement managers forces greater cross-selling. Also, fast-growing service lines (such as infrastructure management, testing and application maintenance) increase client retention.

**Leveraging expertise:** Mindtree intends to leverage its expertise and references in select verticals/service lines to drive growth. As a result, it is even ramping down many of its legacy projects in healthcare, energy, etc. This is also reflected in the newer vertical-based organisation structure.

**Multiple margin levers and cheap valuations:** We expect improving utilisation on high-cost resources (related to Kyocera) and higher fresher intake (only 20% below 5 years of experience) to improve EBITDA margins by 200bps during FY12. We expect a turnaround in Mindtree and see an EPS CAGR of 25%+ over the next three years. At 12x FY12ii P/E, valuations are cheap. Reiterate BUY.

## Company update

<b>CMP</b>	<b>Rs424</b>
<b>12-mth TP (Rs)</b>	<b>528 (25%)</b>
<b>Market cap (US\$ m)</b>	<b>379</b>
<b>Bloomberg</b>	<b>MTCL IN</b>
<b>Sector</b>	<b>IT Services</b>

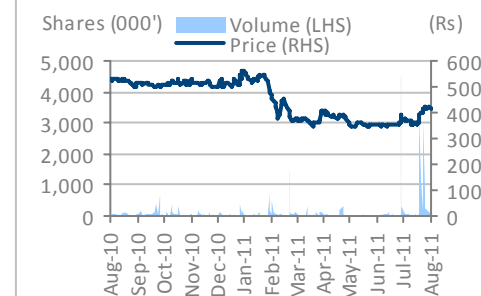
### Shareholding pattern (%)

Promoters	26.4
FIIIs	19.9
DIIIs	6.8
Public	46.9
52Wk High/Low (Rs)	571/342
Shares o/s (m)	40
Daily volume (US\$ m)	2
Dividend yield FY12ii (%)	0.0
Free float (%)	63.6

### Price performance (%)

	1M	3M	1Y
Mindtree	13.7	20.9	-20.8
<b>Rel. to Sensex</b>	<b>23.6</b>	<b>29.2</b>	<b>-14.4</b>
Patni Comp	-10.6	-21.9	-23.6
Wipro	-17.1	-19.1	-17.3
TCS	-14.2	-12.5	16.3

### Stock performance



### Financial summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
<b>Revenues (Rs m)</b>	<b>12,960</b>	<b>15,091</b>	<b>18,026</b>	<b>21,236</b>	<b>24,722</b>
EBITDA Margins (%)	19.1	11.8	12.7	13.4	13.5
Pre-Exceptional PAT (Rs m)	2,136	1,013	1,417	1,778	2,125
Reported PAT (Rs m)	2,136	1,013	1,417	1,778	2,125
EPS (Rs)	52.5	24.7	35.0	44.0	52.5
Growth (%)	454.9	-52.8	41.5	25.5	19.5
IIFL vs consensus (%)			-4.1	0.8	2.9
<b>PER (x)</b>	<b>8.0</b>	<b>16.9</b>	<b>11.9</b>	<b>9.5</b>	<b>8.0</b>
ROE (%)	34.0	14.0	16.9	18.1	18.4
<b>EV/EBITDA (x)</b>	<b>6.2</b>	<b>8.8</b>	<b>6.6</b>	<b>5.1</b>	<b>4.0</b>
Price/Book (x)	2.5	2.2	1.9	1.6	1.4

Source: Company, IIFL Research. Priced as on 08 August 2011

**Client mining to improve:**

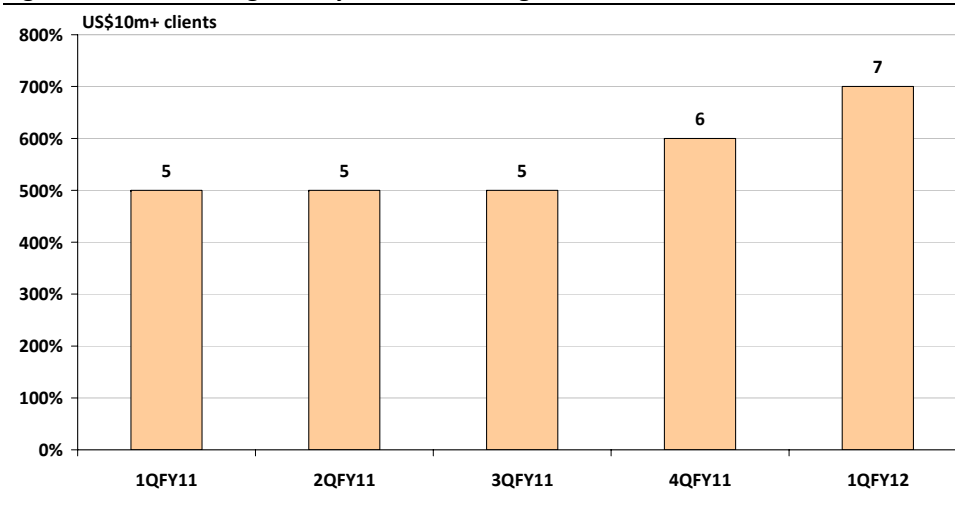
Mindtree significantly enhanced its account management by recruiting specialists from tier-1 vendors over the past 1.5 years. They already account for ~35 of the 80-member sales team at Mindtree. Also, management indicated that most of the additions to its sales team will be ‘farmers’.

Earlier, account management was being done by delivery managers themselves. The newer incentive structure for delivery managers forces more cross-selling. Furthermore, the company is consulting with a leading entity to further improve mining and sales effectiveness.

These measures are already paying dividends. Average revenue per client (ex India) is up from US\$1.5m two quarters ago to US\$1.92m at present; the company’s target is to increase this to US\$2.5m by 4QFY12. Also, productivity of sales people is being targeted. Productivity has increased from US\$3.5m per person to US\$4.2m per person.

In addition, the company has set client mining targets for the next six quarters; two of the four US\$10m+ accounts are targeted to deliver an ACV of US\$50m+. Also, six of the fourteen US\$5m+ accounts are targeted to ramp up to US\$10m+.

**Figure 1: Client mining is a key focus for management**



Source: Company, IIFL Research

**Leveraging expertise:**

Mindtree is focusing on four verticals for its growth—manufacturing, travel & transportation, BFSI, and media/retail. Even within these, Mindtree will focus on certain niches or sub-verticals to leverage its expertise.

**Manufacturing:** While Mindtree has little presence in sub-verticals such as process manufacturing or heavy equipment, it has a marquee set of clients and reference projects in the CPG and automotive industries. For instance, it works with six of the top-10 CPG vendors. A pick up in revenue from one of its top client and many key strategic projects at its CPG clients bodes well for the company.

**Travel and transportation:** Scalability in this vertical is relatively less, but competition is scant. Mindtree’s significant expertise in building travel management systems gives it an edge. ERP-related work is the mainstay of the company. Lately e-commerce has been gaining traction.

**BFSI:** Mindtree makes up for its relatively weaker positioning in BFSI by targeting first-time outsourcers and mid-tier banks. That said, it has recently won a deal with a potentially large BFSI client.

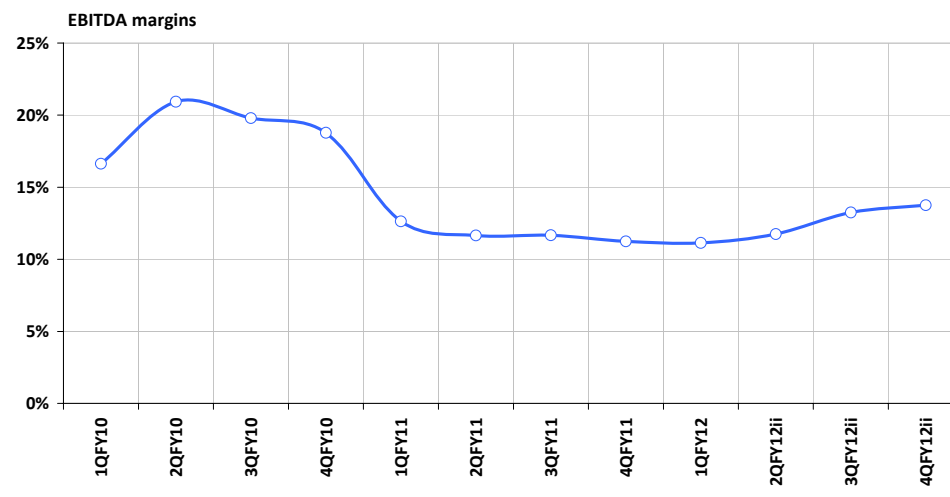
**De-focusing on healthcare/energy/defense:** Mindtree is aggressively pursuing an aggressively focused growth strategy and is defocusing on many of its legacy projects in Healthcare/Defence/Energy/Utilities. Consequently, it is ramping down business at 28-30 clients (~1% of revenues), five of which are F500 accounts. This is a marked change from before when Mindtree had made unrelated diversifications. We believe a repeat of its ill-fated Android handset initiative is unlikely to happen.

**Multiple margin levers:**

Over the past two years, Mindtree’s EBITDA margins fell by ~10pps. These were primarily due to:

- Dual wage hikes in 2010, bad contractual practices (shadow resources) and price cuts.
- High attrition and the consequent recruitment of high-cost laterals.
- Rampdowns at Kyocera and low utilisation at high-cost ex-Kyocera employees.

**Figure 2: EBITDA margins have bottomed out. We expect them to improve by 200bps by 4QFY12**



Source: Company, IIFL Research

We believe EBITDA margins have bottomed out. During 1QFY12 for instance, even after the wage hikes, EBITDA margins remained flat QoQ. Following are some of the margin levers for Mindtree:

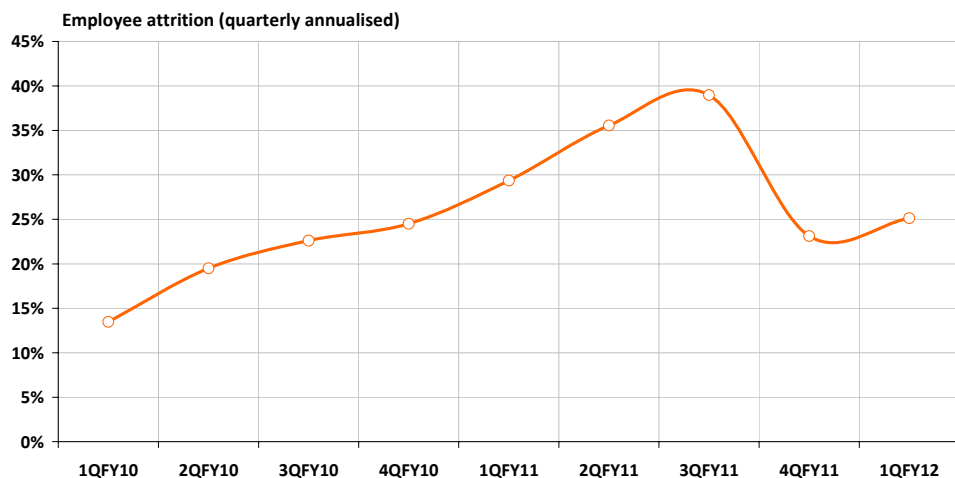
- Ramp-downs at Kyocera led to many of the high-cost employees being unemployed. These employees are being re-deployed and are expected to be utilised by end-FY12.
- Age pyramid is being targeted as a key lever. For instance, management indicated that Mindtree's average salary/person is 15-20% higher than industry standards. The high fresher recruitment (900 in 2QFY12) in FY12 is likely to improve its age pyramid.
- Non-linear revenues are being targeted to increase from the current 3-4% to 9-10% in 1-2 years. IP-based revenue and the infrastructure platform will be beachheads.
- Pricing is also a key focus area. It has received price increases from 20+ customers in 1QFY12 and management is targeting price increases from at least 30 customers/quarter, going forward.

- Over the next three quarters, EBITDA margins are likely to increase by ~300bps.

**Attrition to moderate:**

Employee attrition, in general, increased for Indian IT vendors once demand started picking up. To add to that, Mindtree’s ill-fated Android handset business and ramp-downs at one of its largest client, Kyocera created redundancies. As a result, employee attrition increased to ~40% in 3QFY11; it has now moderated to ~25%. We understand that most of it is due to higher attrition at its product engineering services (PES) business. Attrition at IT services remains low at ~15%. Going forward, we expect attrition at its PES business to moderate, as new deal wins ramp up and utilisation of skilled resources increases

**Figure 3: Employee attrition is moderating**



Source: Company, IIFL Research

**Assumptions**

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenue growth (US\$, yoy)	0.7%	21.5%	21.4%	17.6%	16.4%
Exchange rate (US\$/INR)	47.6	45.6	44.9	45.0	45.0
Effective tax rate	15.6%	22.1%	22.6%	22.0%	21.0%

Source: Company data, IIFL Research

## Financial summary

### Income statement summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
<b>Revenue</b>	<b>12,960</b>	<b>15,091</b>	<b>18,026</b>	<b>21,236</b>	<b>24,722</b>
<b>EBITDA</b>	<b>2,470</b>	<b>1,777</b>	<b>2,293</b>	<b>2,849</b>	<b>3,347</b>
EBIT	1,818	1,066	1,490	1,965	2,375
Others items	743	239	347	320	320
Profit before tax	2,534	1,301	1,832	2,281	2,691
Tax expense	-398	-288	-416	-503	-566
<b>Net Profit</b>	<b>2,136</b>	<b>1,013</b>	<b>1,417</b>	<b>1,778</b>	<b>2,125</b>

### Cash flow summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
<b>EBIT</b>	<b>1,818</b>	<b>1,066</b>	<b>1,490</b>	<b>1,965</b>	<b>2,375</b>
Depreciation & Amortization	652	712	803	884	972
Tax paid	-398	-288	-416	-503	-566
Working capital change	-981	-1,192	-990	-932	-712
Operating Cash-flow	2,007	597	1,265	1,802	2,471
Capital expenditure	-549	-887	-1,000	-1,000	-1,000
<b>Free cash flow</b>	<b>3,005</b>	<b>107</b>	<b>265</b>	<b>802</b>	<b>1,471</b>
<b>Net change in Cash &amp; cash equivalents</b>	<b>199</b>	<b>-103</b>	<b>171</b>	<b>639</b>	<b>1,262</b>

Source: Company data, IIFL Research

### Balance sheet summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Cash & cash equivalents	1,676	1,571	1,742	2,381	3,643
Sundry debtors	2,370	2,825	3,680	4,465	5,017
Other current assets	2,068	2,506	2,994	3,526	4,105
<b>Fixed assets</b>	<b>2,859</b>	<b>3,034</b>	<b>3,231</b>	<b>3,347</b>	<b>3,375</b>
<b>Total assets</b>	<b>9,340</b>	<b>10,152</b>	<b>11,863</b>	<b>13,935</b>	<b>16,357</b>
Sundry creditors	2,114	1,814	2,167	2,553	2,972
Other current liabilities	490	530	633	746	868
<b>Networth</b>	<b>6,706</b>	<b>7,762</b>	<b>9,017</b>	<b>10,591</b>	<b>12,471</b>
<b>Total liabilities &amp; equity</b>	<b>9,341</b>	<b>10,152</b>	<b>11,863</b>	<b>13,935</b>	<b>16,357</b>

### Ratio analysis

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Sales growth (%)	4.7	16.4	19.5	17.8	16.4
Core EBITDA growth (%)	-25.4	-28.0	29.0	24.2	17.5
Core EBIT growth (%)	-33.6	-41.4	39.8	31.9	20.8
Core EBITDA margin (%)	19.1	11.8	12.7	13.4	13.5
Core EBIT margin (%)	14.0	7.1	8.3	9.3	9.6
Net profit margin (%)	16.5	6.7	7.9	8.4	8.6
Dividend payout ratio (%)	5.5	9.9	10.0	10.0	10.0
Tax rate (%)	15.7	22.1	22.7	22.0	21.0
Net Debt/Equity (%)	25.4	20.8	19.8	22.9	29.6
<b>Return on Equity (%)</b>	<b>34.0</b>	<b>14.0</b>	<b>16.9</b>	<b>18.1</b>	<b>18.4</b>
Return on Assets (%)	21.7	10.4	12.9	13.8	14.0

Source: Company data, IIFL Research

#### Key to our recommendation structure

**BUY** - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

**SELL** - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

**Add** - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

**Reduce** - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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