

Company Focus

12 October 2007 | 28 pages

MindTree Consulting (MINT.BO)

Initiation of coverage

Initiating With Sell: Cheaper but Not Cheap

- Read between the lines** — Despite a strong revenue CAGR of 38% (US\$ terms) in FY07-10E, MindTree's EPS CAGR will be restricted to 10%, on our estimates, due to OPM declines, higher taxes, and IPO- and ESOP-related equity dilution. Finding the stock fairly valued at current levels, we initiate coverage of MindTree with Sell/High Risk and a target price of Rs487.
- Large exposure to application development work a risk** — Around 65% of MindTree's revenue comes from application development, which would be most vulnerable if the US economy slowed.
- What we like about MindTree?** — (1) Experienced and reputed management team, (2) focus on processes and systems to facilitate growth, (3) scope to improve revenue per client through account management, (4) and a strong portfolio of services.
- Small size = Superior revenue growth** — MindTree posted revenues of US\$130m in FY07, making it one of the latest entrants to the US\$100m club. Strong offshoring demand, coupled with the company's focus on processes, should drive MindTree's revenue growth.
- Upside risks to our call** — INR depreciation, M&A activity, and better-than-expected pricing and margins.

| | |
|------------------------------|-----------------------|
| Sell/High Risk | 3H |
| Price (11 Oct 07) | Rs498.60 |
| Target price | Rs487.00 |
| Expected share price return | -2.3% |
| Expected dividend yield | 0.5% |
| Expected total return | -1.8% |
| Market Cap | Rs18,823M US\$481M |

Price Performance (RIC: MINT.BO, BB: MTCL IN)



Statistical Abstract

| Year to | Net Profit | Diluted EPS | EPS growth | P/E | P/B | ROE | Yield |
|---------|------------|-------------|------------|------|------|------|-------|
| 31 Mar | (RsM) | (Rs) | (%) | (x) | (x) | (%) | (%) |
| 2006A | 538 | 17.20 | 190.6 | 29.0 | 11.4 | 69.1 | 0.0 |
| 2007A | 878 | 27.00 | 57.0 | 18.5 | 4.3 | 31.1 | 0.4 |
| 2008E | 967 | 24.70 | -8.5 | 20.2 | 3.6 | 20.2 | 0.5 |
| 2009E | 1,271 | 32.47 | 31.4 | 15.4 | 3.0 | 22.0 | 0.6 |
| 2010E | 1,404 | 35.85 | 10.4 | 13.9 | 2.5 | 20.1 | 0.8 |

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|------------------------------------------|--------------|---------------|---------------|--------------|---------------|
| Valuation Ratios | | | | | |
| P/E adjusted (x) | 29.0 | 18.5 | 20.2 | 15.4 | 13.9 |
| EV/EBITDA adjusted (x) | 24.6 | 16.1 | 13.1 | 10.6 | 8.5 |
| P/BV (x) | 11.4 | 4.3 | 3.6 | 3.0 | 2.5 |
| Dividend yield (%) | 0.0 | 0.4 | 0.5 | 0.6 | 0.8 |
| Per Share Data (Rs) | | | | | |
| EPS adjusted | 17.20 | 27.00 | 24.70 | 32.47 | 35.85 |
| EPS reported | 17.20 | 27.00 | 24.70 | 32.47 | 35.85 |
| BVPS | 43.86 | 115.35 | 138.27 | 168.47 | 201.03 |
| DPS | 0.00 | 2.00 | 2.50 | 3.00 | 4.00 |
| Profit & Loss (RsM) | | | | | |
| Net sales | 4,488 | 5,904 | 7,286 | 9,510 | 12,249 |
| Operating expenses | -3,944 | -5,063 | -6,364 | -8,347 | -10,814 |
| EBIT | 545 | 841 | 922 | 1,162 | 1,435 |
| Net interest expense | 13 | 52 | 132 | 301 | 318 |
| Non-operating/exceptionals | 0 | 0 | 0 | 0 | 0 |
| Pre-tax profit | 558 | 893 | 1,054 | 1,464 | 1,753 |
| Tax | -15 | -15 | -87 | -192 | -349 |
| Extraord./Min.Int./Pref.div. | -4 | 0 | 0 | 0 | 0 |
| Reported net income | 538 | 878 | 967 | 1,271 | 1,404 |
| Adjusted earnings | 538 | 878 | 967 | 1,271 | 1,404 |
| Adjusted EBITDA | 776 | 1,085 | 1,246 | 1,552 | 1,916 |
| Growth Rates (%) | | | | | |
| Sales | 82.1 | 31.5 | 23.4 | 30.5 | 28.8 |
| EBIT adjusted | 281.0 | 54.5 | 9.7 | 26.0 | 23.4 |
| EBITDA adjusted | 206.6 | 39.8 | 14.8 | 24.5 | 23.5 |
| EPS adjusted | 190.6 | 57.0 | -8.5 | 31.4 | 10.4 |
| Cash Flow (RsM) | | | | | |
| Operating cash flow | 378 | 902 | 985 | 1,073 | 1,142 |
| Depreciation/amortization | 232 | 244 | 324 | 389 | 481 |
| Net working capital | -378 | -123 | -173 | -286 | -425 |
| Investing cash flow | -443 | -2,107 | -1,089 | -644 | -848 |
| Capital expenditure | -257 | -555 | -1,446 | -945 | -1,166 |
| Acquisitions/disposals | 0 | 0 | 0 | 0 | 0 |
| Financing cash flow | 57 | 1,711 | 635 | -131 | -175 |
| Borrowings | -424 | -478 | 737 | 0 | 0 |
| Dividends paid | 0 | -78 | -109 | -131 | -175 |
| Change in cash | -7 | 506 | 532 | 298 | 119 |
| Balance Sheet (RsM) | | | | | |
| Total assets | 2,844 | 5,656 | 7,505 | 9,045 | 10,744 |
| Cash & cash equivalent | 262 | 768 | 1,300 | 1,598 | 1,716 |
| Accounts receivable | 1,098 | 1,172 | 1,437 | 1,824 | 2,349 |
| Net fixed assets | 389 | 699 | 1,822 | 2,377 | 3,062 |
| Total liabilities | 1,556 | 1,301 | 2,285 | 2,685 | 3,155 |
| Accounts payable | 0 | 0 | 0 | 0 | 0 |
| Total Debt | 742 | 264 | 1,001 | 1,001 | 1,001 |
| Shareholders' funds | 1,288 | 4,355 | 5,220 | 6,360 | 7,589 |
| Profitability/Solvency Ratios (%) | | | | | |
| EBITDA margin adjusted | 17.3 | 18.4 | 17.1 | 16.3 | 15.6 |
| ROE adjusted | 69.1 | 31.1 | 20.2 | 22.0 | 20.1 |
| ROIC adjusted | 51.5 | 57.1 | 36.1 | 28.7 | 24.9 |
| Net debt to equity | 37.3 | -11.6 | -5.7 | -9.4 | -9.4 |
| Total debt to capital | 36.6 | 5.7 | 16.1 | 13.6 | 11.7 |

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Investment Strategy

We initiate coverage of MindTree with a Sell/High Risk rating. Although the stock has underperformed sharply after its listing (it jumped to ~Rs950 from its IPO price of Rs425), its current valuations still look fairly valued against the 10% EPS CAGR we forecast for FY07-10. Strong offshoring demand and MindTree's process orientation will lead to a revenue CAGR of 38% (in US\$ terms) in FY07-10, based on our estimates. But declining margins, higher tax rates, and ESOP- and IPO-related dilution will curtail the EPS CAGR. Large exposure to application development work (~65% of revenues) would expose MindTree to greater risk if demand from the US slowed. MindTree's exposure to newer services is relatively small.

Mid-cap with large-cap valuations

Our target price of Rs487 (15x FY09E EPS) is based on a 20% discount to our target multiple for Satyam, which is widely used as a benchmark for mid-tier IT stocks in India. Our discount reflects MindTree's smaller size, lesser diversified revenue mix and higher client concentration. MindTree has a short trading history, hence we have compared it with our India IT coverage. Large-cap Indian IT companies (market cap of more than US\$5bn) trade on 14x-20x FY09E EPS and mid-tier Indian IT companies on 10x-15x FY09E EPS. We believe a P/E-based valuation is appropriate to value MindTree given the company's earnings record and the widespread use of this methodology to value IT services companies.

We forecast a 27% revenue CAGR, 20% EBIT CAGR, 17% net profit CAGR, and 10% EPS CAGR for MindTree over the next 3 years (all in INR terms).

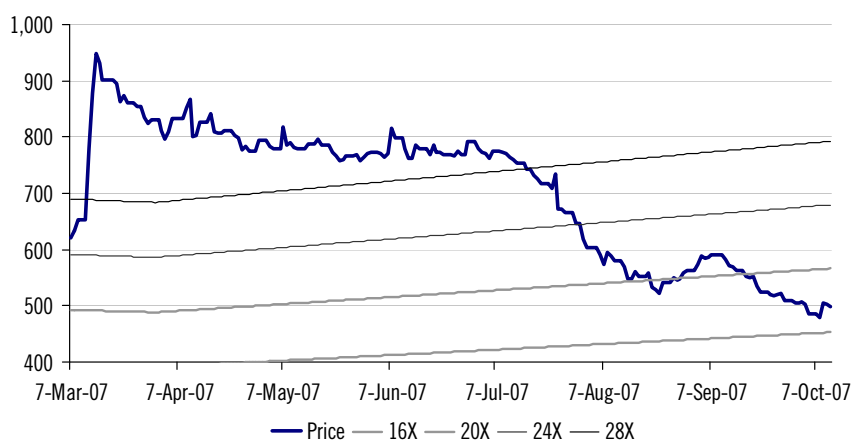
Figure 1. Indian IT Services Coverage Universe: CAGRs vs. Valuations

| Company | FY07-09E CAGR | | | P/E (x) | | EV/EBITDA (x) | |
|-----------------|---------------|------------|------------|-------------|-------------|---------------|-------------|
| | Sales | EBITDA | EPS | FY08E | FY09E | FY08E | FY09E |
| Infosys | 25% | 24% | 20% | 24.6 | 20.1 | 20.5 | 15.8 |
| TCS | 24% | 22% | 23% | 20.8 | 17.1 | 16.7 | 13.5 |
| Wipro | 26% | 21% | 19% | 20.9 | 17.0 | 16.8 | 13.2 |
| Satyam | 27% | 22% | 21% | 18.0 | 14.8 | 14.5 | 11.4 |
| HCL Tech | 23% | 21% | 17% | 17.0 | 14.3 | 12.4 | 10.2 |
| I-Flex | 33% | 50% | 42% | 37.6 | 27.1 | 26.2 | 18.6 |
| Tech Mahindra | 46% | 39% | 212% | 23.9 | 16.6 | 19.6 | 13.8 |
| Patni* | 9% | 11% | 35% | 14.7 | 13.5 | 9.1 | 8.6 |
| Mphasis | 39% | 45% | 49% | 24.3 | 15.6 | 10.5 | 7.3 |
| MindTree | 27% | 20% | 10% | 20.2 | 15.4 | 14.7 | 11.8 |
| Hexaware* | 24% | 14% | 7% | 13.4 | 11.7 | 9.3 | 8.0 |
| Sasken | 29% | 34% | 43% | 16.0 | 9.8 | 10.0 | 5.6 |
| KPIT | 34% | 33% | 37% | 15.8 | 11.2 | 9.7 | 7.4 |

*Using CY07E and CY08E for Dec year-end companies

Source: Company Reports and Citi Investment Research estimates

Figure 2. MindTree — 12-month Forward P/E Trading Band



Source: DataStream, Company Reports and Citi Investment Research

Figure 3. Indian IT Services Sector — Valuation Comparison Table

| Company | RIC Code | Rating | Mkt cap (US\$m) | CMP# (Rs) | TP (Rs) | P/E (x) | | EV/EBITDA (x) | | P/BV (x) | | Div. Yield (%) | |
|-----------------|----------------|-----------|-----------------|------------|------------|-------------|-------------|---------------|-------------|------------|------------|----------------|-------------|
| | | | | | | FY08E | FY09E | FY08E | FY09E | FY08E | FY09E | FY08E | FY09E |
| Infosys | INFY.BO | 1L | 28,838 | 1,976 | 2,440 | 24.6 | 20.1 | 20.5 | 15.8 | 6.3 | 4.9 | 0.8% | 1.0% |
| TCS | TCS.BO | 1L | 26,801 | 1,072 | 1,460 | 20.8 | 17.1 | 16.7 | 13.5 | 4.5 | 3.6 | 1.3% | 1.5% |
| Wipro | WIPR.BO | 1L | 18,193 | 488 | 650 | 20.9 | 17.0 | 16.8 | 13.2 | 3.5 | 2.8 | 2.0% | 2.5% |
| Satyam | SATY.BO | 1M | 7,653 | 448 | 570 | 18.0 | 14.8 | 14.5 | 11.4 | 3.2 | 2.5 | 1.8% | 2.2% |
| HCL Tech | HCLT.BO | 1M | 5,295 | 312 | 400 | 17.0 | 14.3 | 12.4 | 10.2 | 2.5 | 2.0 | 2.6% | 2.6% |
| I-Flex | IFLX.BO | 3M | 3,974 | 1,858 | 2,025 | 37.6 | 27.1 | 26.2 | 18.6 | 5.5 | 4.2 | 0.0% | 0.0% |
| Tech Mahindra | TEML.BO | 1H | 4,704 | 1,518 | 1,920 | 23.9 | 16.6 | 19.6 | 13.8 | 4.2 | 2.9 | 0.1% | 0.2% |
| Patni* | PTNI.BO | 1M | 1,678 | 473 | 525 | 14.7 | 13.5 | 9.1 | 8.6 | 1.9 | 1.6 | 0.7% | 1.1% |
| Mphasis | MBFL.BO | 1M | 1,246 | 297 | 400 | 24.3 | 15.6 | 10.5 | 7.3 | 2.0 | 1.4 | 1.0% | 1.0% |
| MindTree | MINT.BO | 3H | 481 | 499 | 487 | 20.2 | 15.4 | 14.7 | 11.8 | 2.5 | 1.9 | 0.5% | 0.6% |
| Hexaware* | HEXT.BO | 1M | 443 | 121 | 155 | 13.4 | 11.7 | 9.3 | 8.0 | 1.3 | 1.1 | 1.5% | 2.0% |
| Sasken | SKCT.BO | 1M | 233 | 320 | 505 | 16.0 | 9.8 | 10.0 | 5.6 | 1.2 | 0.9 | 1.6% | 3.1% |
| KPIT | KPIT.BO | 1M | 224 | 115 | 154 | 15.8 | 11.2 | 9.7 | 7.4 | 1.5 | 1.1 | 0.4% | 0.7% |

Source: Company Reports and Citi Investment Research estimates *Using CY07E and CY08E for Dec year-ending companies; #Priced as of 11-Oct-07

Business Model and Segments

MindTree is one of the youngest companies to have crossed the US\$100m revenue mark. The company, which started as a consultant focusing on web-based technologies, primarily offers IT and R&D services.

Consulting-led IT services

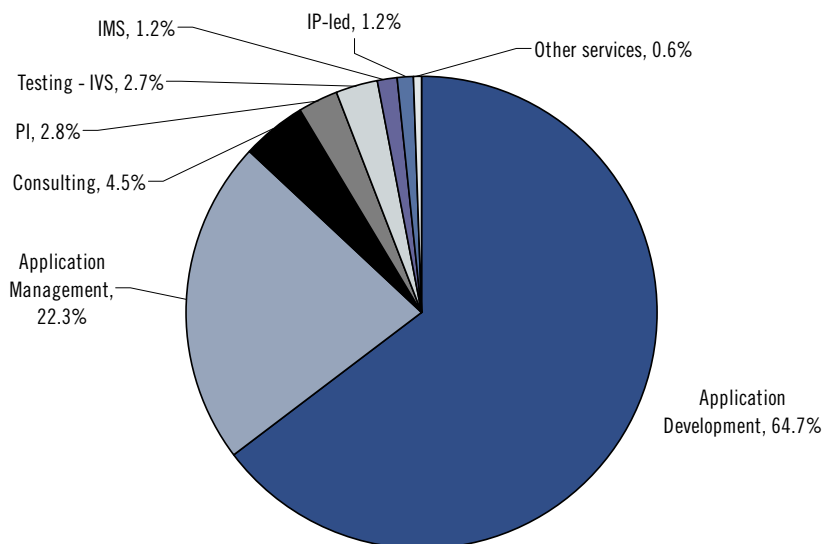
Little differentiation from consulting

MindTree's IT services with a consulting front-end differentiates the company from its mid-tier peers but not the top 5-6 offshore players. This business still makes up only a small part of MindTree's revenues (~4.5% of FY07 revenue).

Strong portfolio of services

The company's services include application development and maintenance (ADM), package implementation, consulting, testing, and infrastructure management. ADM accounts for a large share of revenue (87% in FY07). With a broader services offering, MindTree can mine its existing marquee client list for stronger revenue growth.

Figure 4. MindTree — Revenue Mix by Service Line, FY07



Source: Company Reports

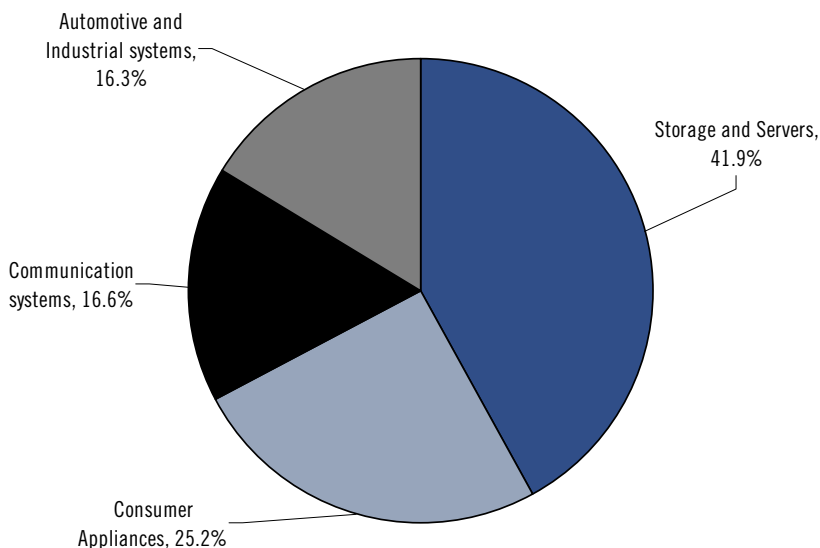
Marquee client list

MindTree has a marquee client list, including the likes of AIG, Volvo, Avis, Unilever, Franklin Templeton, HP, and ABB. IT services account for ~75% of MindTree's revenues, with clients spanning such verticals as manufacturing, BFSI, and travel and logistics.

IP-led R&D services

IP-led R&D services account for ~25% of MindTree's revenue. The company has broad offerings across communications systems, storage applications, and industrial and consumer applications.

Figure 5. R&D Services Revenue Mix by Vertical, FY07



Source: Company Reports

MindTree has on its client list the likes of Alcatel, Lucent, Texas Instrument, Qualcomm, and Broadcom in communications systems. It works with UTC, Volvo, LSI Logic, Kyocera, and Toshiba in industrial and consumer applications, and with Symantec, EMC and LSI Storage, among others, in the storage systems.

Intellectual properties in Bluetooth space

MindTree has its own licensable IP (intellectual property) suite in the short-range wireless communication (Bluetooth) space. The company has a Bluetooth communication protocol stack, which it has licensed to more than 25 clients. This IP suite offering shortens product design cycles, and the company licenses it as individual re-usable components or as part of turnkey product design solutions. The company has an IP suite that supports ultra-wide-band technology. In FY07 IP-led revenues were 1.2% of MindTree’s revenues.

Growth strategies

With a broad range of service offerings (except BPO services, from which MindTree has consciously stayed away), MindTree’s positions itself as an alternative to larger offshore vendors, with more focus from top management, better flexibility and agility. The company typically targets companies in the Fortune 1000 list and aspires to become a major offshore vendor. MindTree boasts a client list that includes AIG, Volvo, Avis, Unilever, Franklin Templeton, HP and ABB for IT services, and Alacatel, Lucent, Texas Instrument, UTC, Volvo, Symantec, EMC, LSI Logic, and LSI Storage in R&D services. The company has a broad range of service offerings in IT and R&D services to help better mine existing client relationships. The company has also resorted to smaller acquisitions to add capabilities to its service offerings.

Inorganic growth is a focus area of the company, and the idea is to acquire small to medium-sized companies that provide access to new markets and/or add specific competencies. So far the company has made two small acquisitions: In Oct 2004, it acquired ASAP Solutions Private Limited (ASAP), Noida-based small company with 200 employees and capabilities in SAP implementation, maintenance and application integration; and in May 2005, the company acquired Bangalore-based Linc Software Services, which had 220 employees and capabilities in IBM mid-range systems.

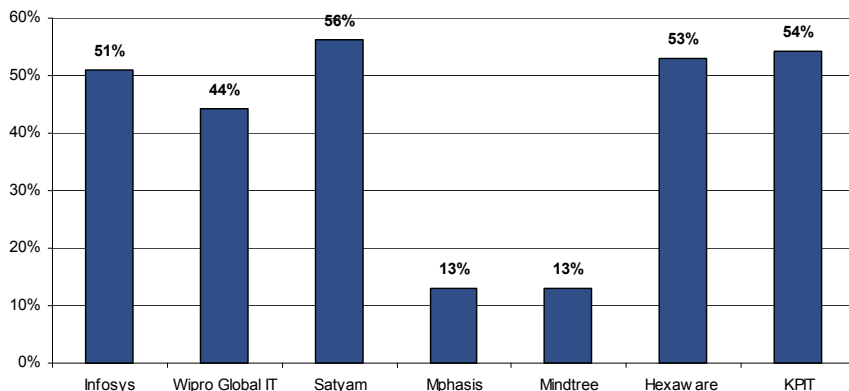
Comparing MindTree with Peers

We have compared MindTree with Indian IT companies on various parameters. Infosys, Wipro and Satyam represent the large-cap names, and Mphasis, Hexaware and KPIT Cummins the mid-tier companies.

High dependence on ADM and relatively low exposure to newer services (growth driver for offshore IT) could hurt growth prospects

New service offerings (share of non-ADM services)

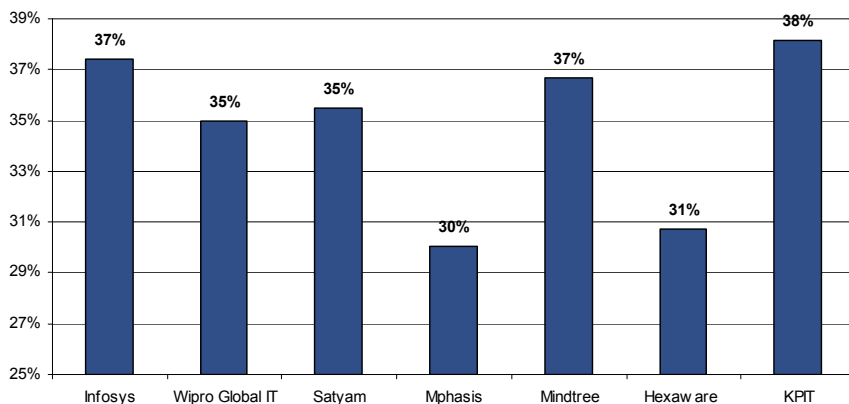
Figure 6. Share of non-ADM Revenue for Selected Indian IT Companies in Previous Financial Year



Source: Company Reports

Geographic diversification (share of non-US revenue)

Figure 7. Share of non-US Revenue for Selected Indian IT Companies in Previous Financial Year

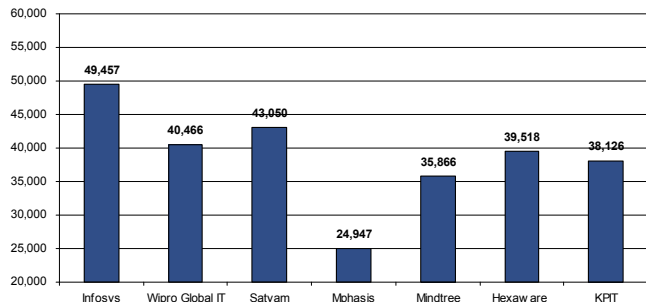


Source: Company Reports

Per-capita revenue and EBIT

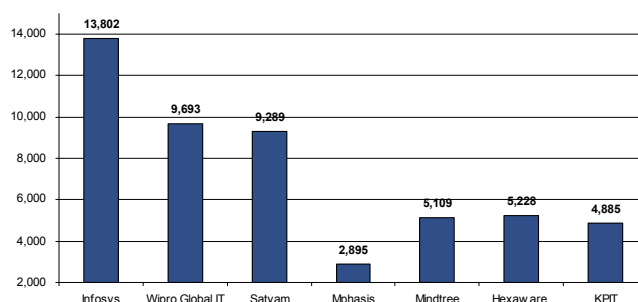
MindTree has one of the lowest revenues per employee and EBIT per employee in its peer group. Low revenue productivity is primarily because of a higher share of offshore revenue (also due to a high share of R&D services, which are primarily offshore). Low EBIT productivity is due to lower revenue productivity, and EBIT margins are lower due to higher SG&A and the lack of scale.

Figure 8. Revenue per Employee (US\$/emp)



Source: Company Reports and Citi Investment Research

Figure 9. EBIT per Employee (US\$/emp)



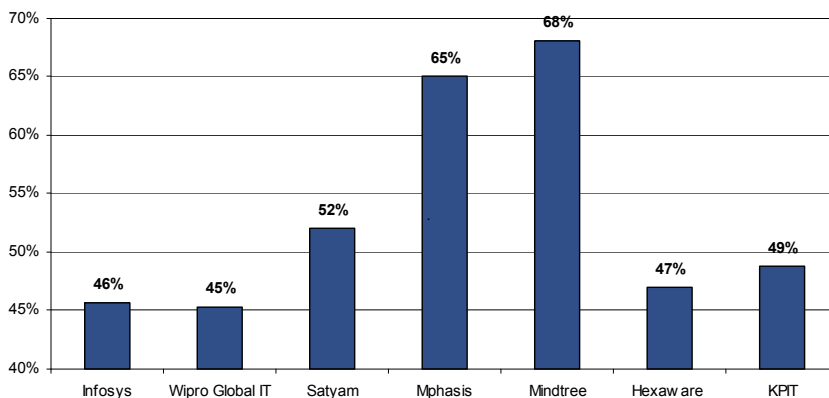
Source: Company Reports and Citi Investment Research

Share of offshore revenue

MindTree has the highest offshore revenue share due to its R&D service offering and higher offshorization for IT services

Despite this, MindTree's margins are lower than those of its peers

Figure 10. Share of Offshore Revenue



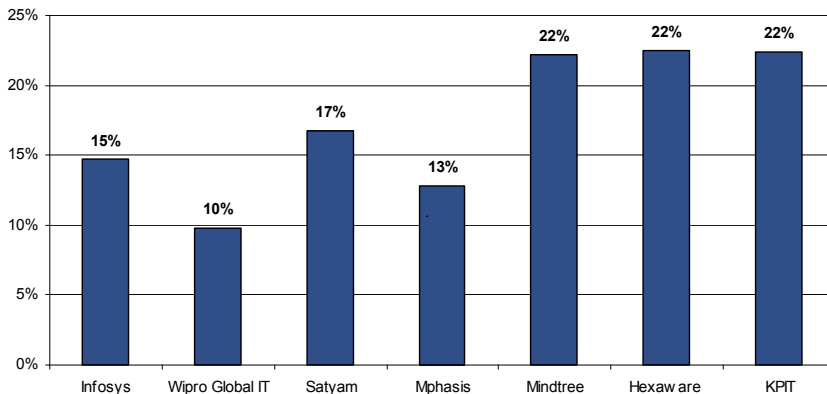
Source: Company Reports and Citi Investment Research

MindTree's SG&A expense is in line with those of mid-tier Indian IT companies but higher compared with larger players due to the lack of scale and dependence on leased premises for development centers

Higher exposure to AD services is a deterrent

SG&A expense share

Figure 11. SG&A Cost as % of Revenue

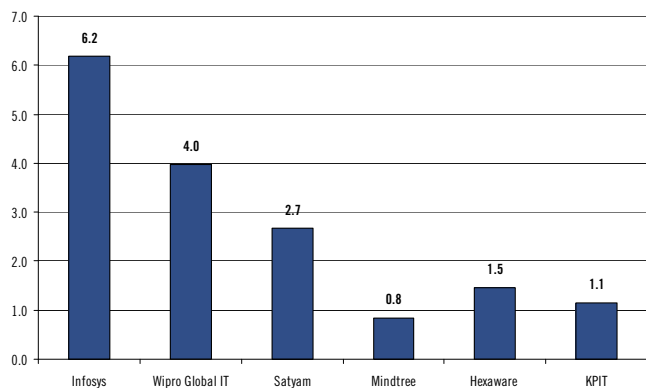


Source: Company Reports and Citi Investment Research

Client mining

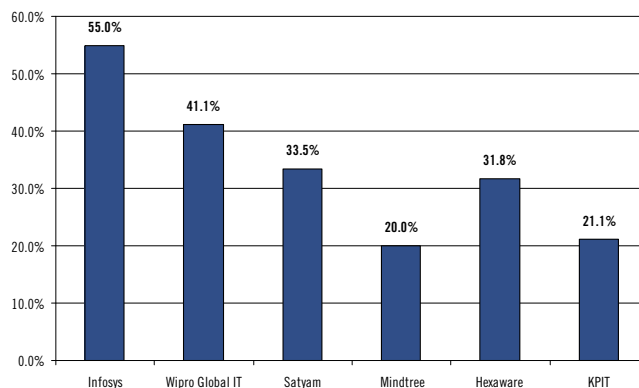
The company has focused on new client acquisitions. It has one of the lowest revenues per client in its peer group. Also, the share of US\$1m clients among active clients is low.

Figure 12. Revenue per Active Client (US\$m/client)



Source: Company Reports and Citi Investment Research

Figure 13. Share of US\$1m Clients Among Active Clients

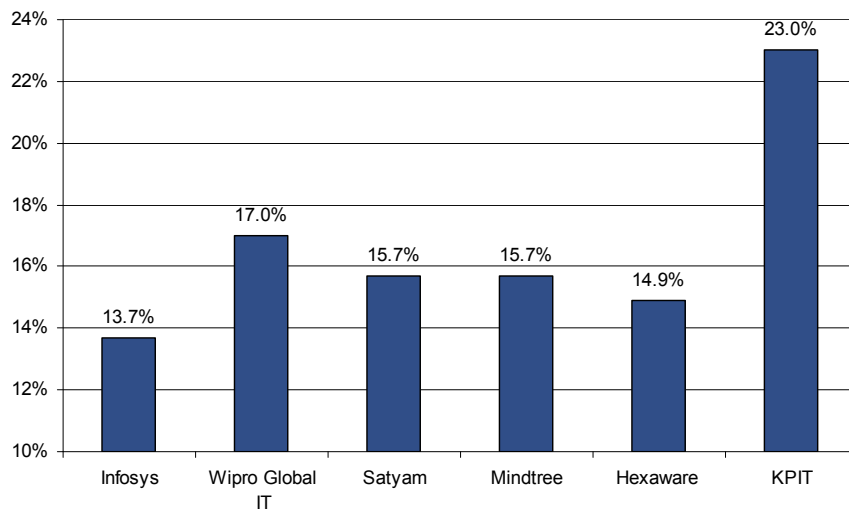


Source: Company Reports and Citi Investment Research

Attrition for MindTree is lower due to its relatively good HR systems and processes. Also ESOP policy covering 100% employee historically has helped MindTree attract and retain talent

Attrition rates

Figure 14. Attrition Rates



Source: Company Reports and Citi Investment Research

Company's Positives

Experienced management team

MindTree was incorporated by 10 industry professionals (with industry experience of 20 years, on average) who came from diverse backgrounds, geographies and specialization. These founding members were from organizations such as Wipro, Lucent Technologies and Cambridge Technology Partners. All the members of the team are still with the organization.

Focus on processes/systems

The company has invested in strong systems/processes since its formative years. It has been assessed at Level 5 CMMi (Capability Maturity Model Integration) and P-CMM (People Capability Maturity Model) within five years of its inception. MindTree has internal processes to survey its clients on a periodic basis, helping the company improve account management.

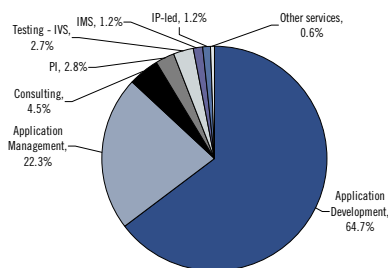
Consulting-led IT services and IP-led R&D services

MindTree has focused on differentiating its service offerings by building a consulting front end to its IT services and IP-led offering in R&D services. In our view, R&D services differentiate MindTree; but in IT services MindTree does not stand out compared with larger offshore IT services. MindTree has had reasonable success in new client acquisitions.

Marquee client list

MindTree's client list includes the likes of AIG, Volvo, Avis, Unilever, Franklin Templeton, HP, and ABB for IT services; and Alcatel, Lucent, Texas Instrument, UTC, Volvo, Symantec, EMC, LSI Logic, and LSI Storage in R&D services. The company has a broad range of service offerings in IT and R&D services to help better mine existing client relationships.

Figure 15. Service Offerings, FY07



Source: Company reports and Citi Investment Research

Strong portfolio of services (ex BPO services)

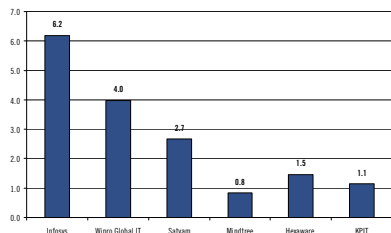
The company's offerings include package implementation, consulting, testing and infrastructure management apart from the 'bread and butter' ADM services. MindTree has a broad range of service offerings. Except for BPO services, the company's service offerings match the services offered by larger IT services companies, in our view. The company has in the past resorted to small acquisitions to add capabilities to its service offering.

Beneficiary of vendor diversification

MindTree is positioned as an alternative to larger offshore vendors, offering more focus from top management, better flexibility and agility. It has a wide range of service offerings, matching most of the services offered by larger IT services companies. Many MindTree clients value this proposition. We view

MindTree as a good alternative for clients looking beyond the top few offshore vendors for prioritization.

Figure 16. Peer Comp: Revenue / client. US\$ m



Source: Company Reports and Citi Investment Research

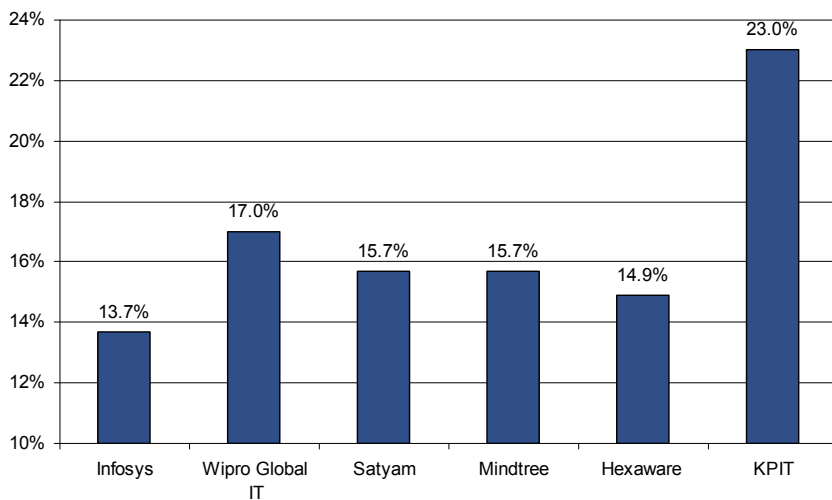
Room for client mining

The company has acquired several clients over the past few years. Of the selected set of Indian companies we used for benchmarking, MindTree has the lowest score on client mining — both in terms of revenue per active client and US\$1m+ clients as a share of active clients.

Preferred employer and low attrition

The company is perceived as a preferred employer in the supply-side market. It has won several accolades in this area. Also, MindTree was an early adopter of strong HR processes, which has helped it attract and retain talent. Its policy of covering 100% of its employee (pre-IPO) for ESOP has been a key differentiator in the supply-side market.

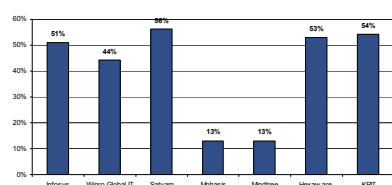
Figure 17. Annual Attrition in the Previous Financial Year



Source: Company Reports

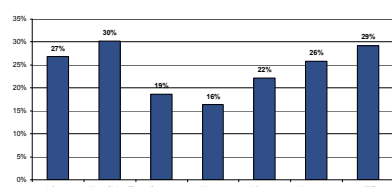
Company's Negatives

Figure 18. Peer Comp: Non-ADM Revenue



Source: Company Reports and Citi Investment Research

Figure 19. Peer Comp: Share of Europe Revenue



Source: Company Reports and Citi Investment Research

High proportion of application development revenues

About 87% MindTree's revenues come from application development and maintenance services — among the highest in the sector (see chart). With its small size and high exposure to development services (~65% of revenues and which have a higher likelihood of coming from the non-discretionary part of IT budgets), MindTree's quarterly volatility could be high and business risk could be higher vs. peers if the US economic growth slowed.

Lower exposure to high-growth areas

Geography

In terms of geographical spread, MindTree's exposure to Europe is now at ~22%, which is lower than that of peers. With European revenues growing at a much faster pace than US revenues for the industry, lower exposure to Europe is a negative.

New service lines

MindTree has ~87% of its revenues coming from application development and maintenance. A large part of incremental growth over the last few years in the Indian IT industry has been contributed by new service lines such as package implementation, BPO, infrastructure services, engineering services, testing, and consulting. Most of the larger companies have ~40-45% of their revenues coming from new service lines. With lower exposure to new services, MindTree will have two challenges: (1) Strong growth is relatively difficult in application development and maintenance as its Indian market share in this space is high; and (2) Profitability in application development and maintenance may be difficult to maintain/improve due to keener competition.

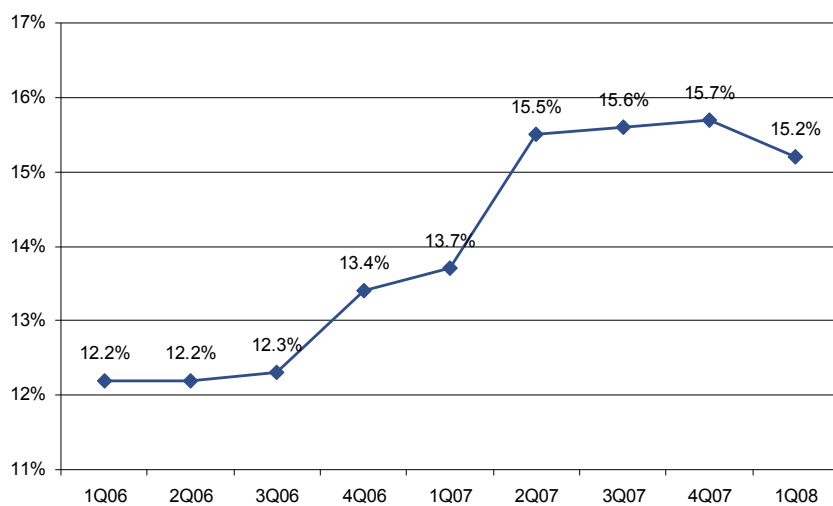
Tier I players have advantages in the longer term

With the evolution of the Indian IT industry, scale has emerged as one of the key differentiators in the industry. Large companies have advantages from a demand perspective as many deals are large in size and oriented toward multiple services. On the supply side, larger players have the brand to attract and retain talent, and the ability to make investments. These advantages enable them to hire engineers from campuses and train them. Over the past few years, the tier-one players have outpaced the mid-cap players.

Attrition on the increase

MindTree had low attrition rates in the past. However, one needs to keep in mind that the attrition figure is on a trailing 12-month basis and does not include involuntary attrition and attrition of employees with less than 6 months work experience in the company. But over the past few quarters, MindTree's attrition has been inching up. Though still under control, it could lead to execution challenges if the rate keeps increasing.

Figure 20. MindTree Employee Attrition (LTM)



Source: Company reports

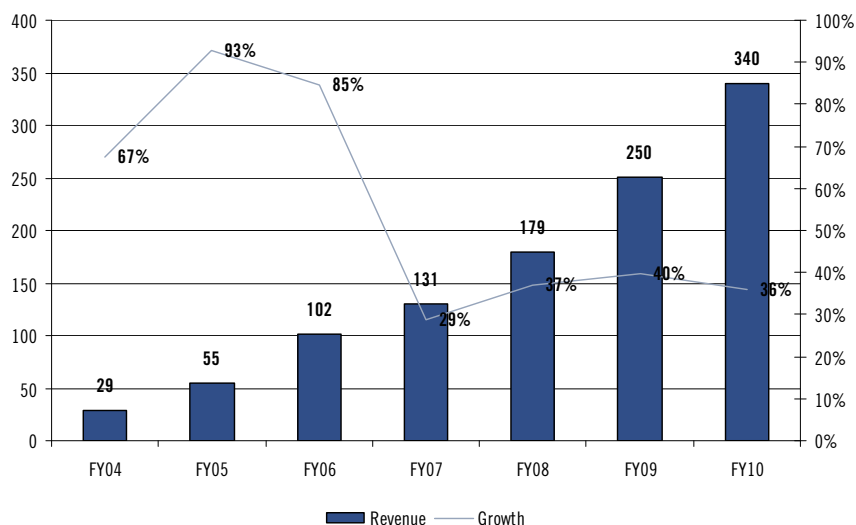
Financials

Revenue growth likely to remain decent

We expect a revenue CAGR of 38% over FY07-10E in US\$ terms, much lower than its historical growth rates (as the base effect catches up) but better than the pace of some of the names in our large-cap coverage universe. Revenue CAGR in INR terms will be 27% over FY07-10, we estimate, on the back of the appreciation of the INR.

We see decent revenue CAGR of 38% in FY07-10 in US\$ terms

Figure 21. MindTree Consulting — Revenue and Growth Trajectory



Source: Company Reports and Citi Investment Research estimates

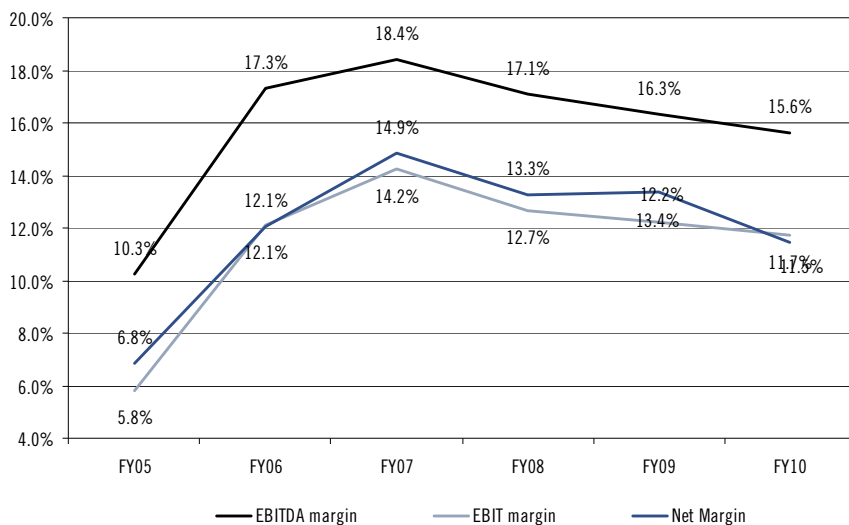
Operating margin to decline by estimated ~250bps

We expect EBITDA and EBIT margins to decline, weighed down by wages and INR appreciation. We believe that operating margins will be a function of margin headwinds such as wage inflation; the appreciating rupee; and leverage from better pricing, a higher offshore proportion, a flatter employee pyramid, and SG&A leverage. While we forecast a revenue CAGR over the next three years of 27% (INR terms), margin declines lead to estimated EBITDA and EBIT CAGRs of 21% and 20%, respectively.

Tax impact; net margins likely to decline

We expect sharp declines in net margins as MindTree starts paying taxes in overseas geographies after overcoming accumulated losses there. Also, taxes would jump in FY10E as the STPI sunset clause raises tax rates for exports. Net profit CAGR in FY07-10E is estimated at 17%, weighed down by operating margin declines and higher tax rates.

Figure 22. MindTree Consulting — Margin Trends

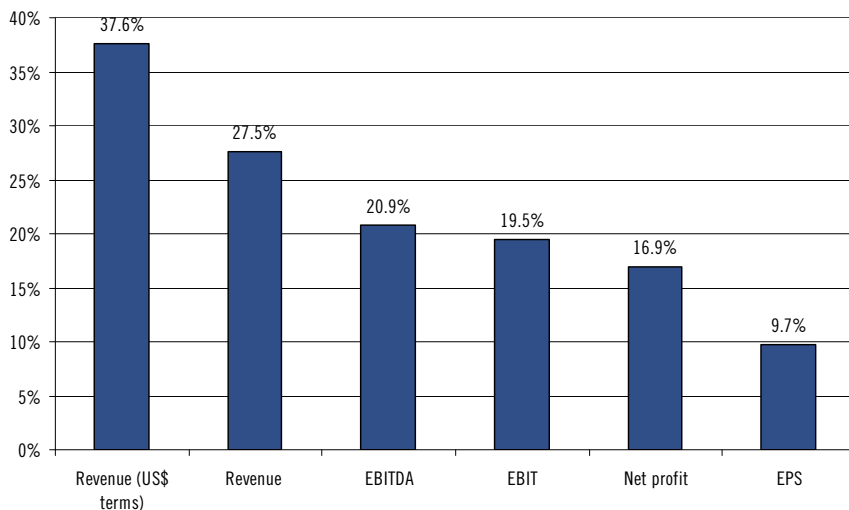


Source: Company Reports and Citi Investment Research estimates

Dilution impact: Earnings growth muted

Despite a 17% net profit CAGR over FY07-10E, EPS CAGR would, on our estimates, be much lower at 10% due to dilutions from an IPO and ESOPs. Pre-IPO the company had a policy of covering 100% employees under the ESOP plan. As of end-FY07, the company's total outstanding ESOPs were ~2.3m (more than 6% of its basic equity base).

Figure 23. MindTree — FY07-10E CAGRs



Source: Citi Investment Research estimates

Forex policy

MindTree hedges receivables beyond the rolling 12-month period, as done by most offshore IT services companies. As of end-June the company had forex hedges worth US\$69m, of which US\$22m is for the rolling 12-month period and the rest for 48 months thereafter. Also, the company has debt of US\$17m, which acts as a natural hedge for its revenue.

Abridged Financial Statements

Figure 24. Income Statement (Rs m)

| Year to Mar 31 | FY05 | FY06 | FY07 | FY08E | FY09E | FY10E |
|----------------------------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Revenues | 2,465 | 4,488 | 5,904 | 7,286 | 9,510 | 12,249 |
| <i>Growth</i> | 89.0% | 82.1% | 31.5% | 23.4% | 30.5% | 28.8% |
| Cost of revenues | 1,600 | 2,735 | 3,509 | 4,564 | 6,199 | 8,190 |
| Gross profit | 865 | 1,753 | 2,395 | 2,722 | 3,311 | 4,059 |
| <i>Gross margin</i> | 35.1% | 39.1% | 40.6% | 37.4% | 34.8% | 33.1% |
| Operating expenses | 612 | 977 | 1,309 | 1,476 | 1,759 | 2,144 |
| Operating profit (EBITDA) | 253 | 776 | 1,085 | 1,246 | 1,552 | 1,916 |
| <i>Operating margin</i> | 10.3% | 17.3% | 18.4% | 17.1% | 16.3% | 15.6% |
| Depreciation and Amortization | 110 | 232 | 244 | 324 | 389 | 481 |
| EBIT | 143 | 545 | 841 | 922 | 1,162 | 1,435 |
| <i>EBIT margin</i> | 5.8% | 12.1% | 14.2% | 12.7% | 12.2% | 11.7% |
| Profit before tax | 173 | 558 | 893 | 1,054 | 1,464 | 1,753 |
| Income tax expense | 4 | 15 | 15 | 87 | 192 | 349 |
| Income from operations | 169 | 542 | 878 | 967 | 1,271 | 1,404 |
| Prior period adjustment, others | 10 | -5 | 0 | 0 | 0 | 0 |
| Reported net profit | 179 | 538 | 878 | 967 | 1,271 | 1,404 |
| EPS - Basic | 8.34 | 19.96 | 28.26 | 25.65 | 33.68 | 37.18 |
| <i>Growth</i> | | 139.3% | 45.2% | -11.5% | 31.3% | 10.4% |
| EPS - Fully diluted | 5.92 | 17.20 | 27.00 | 24.70 | 32.47 | 35.85 |
| <i>Growth</i> | | 190.5% | 61.0% | -10.8% | 31.4% | 10.4% |

Source: Company Reports and Citi Investment Research estimates

Figure 25. Balance Sheet (Rs m)

| As at Mar 31 | FY05 | FY06 | FY07 | FY08E | FY09E | FY10E |
|-------------------------------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Cash and equivalents | 269 | 262 | 768 | 1,300 | 1,598 | 1,716 |
| Other current assets | 1,000 | 1,656 | 2,002 | 2,421 | 3,108 | 4,003 |
| Total current assets | 1,269 | 1,918 | 2,770 | 3,721 | 4,705 | 5,719 |
| Goodwill and Intangibles | 27 | 0 | 0 | 0 | 0 | 0 |
| PPE, net | 336 | 389 | 699 | 1,822 | 2,377 | 3,062 |
| Other assets | 339 | 538 | 2,187 | 1,962 | 1,962 | 1,962 |
| Total Assets | 1,971 | 2,844 | 5,656 | 7,505 | 9,045 | 10,744 |
| Current Liabilities | 536 | 814 | 1,038 | 1,284 | 1,684 | 2,154 |
| Borrowings | 1,166 | 742 | 264 | 1,001 | 1,001 | 1,001 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Liabilities | 1,702 | 1,556 | 1,301 | 2,285 | 2,685 | 3,155 |
| Total Equity | 269 | 1,288 | 4,355 | 5,220 | 6,360 | 7,589 |
| Total Liabilities and Equity | 1,971 | 2,844 | 5,656 | 7,505 | 9,045 | 10,744 |

Source: Company Reports and Citi Investment Research estimates

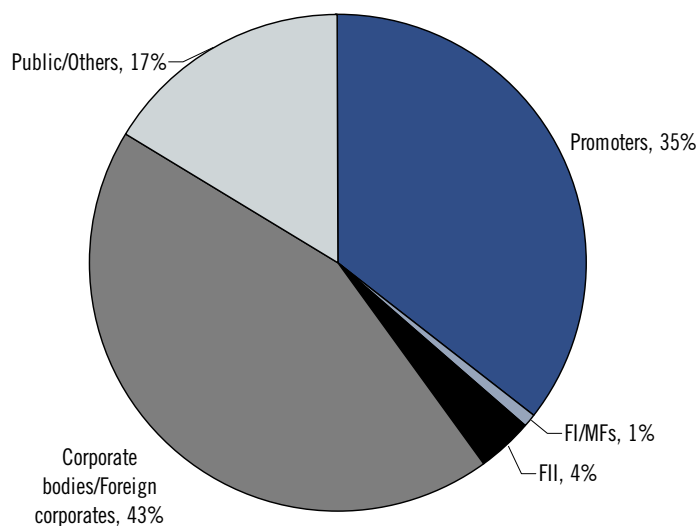
Figure 26. Cash Flow Statement (Rs m)

| Year to Mar 31 | FY05 | FY06 | FY07 | FY08E | FY09E | FY10E |
|----------------------------------|-------------|-------------|---------------|---------------|--------------|--------------|
| Net income | 179 | 538 | 878 | 967 | 1,271 | 1,404 |
| Depreciation | 110 | 232 | 244 | 324 | 389 | 481 |
| Other operating cash flows | -30 | -13 | -98 | -133 | -301 | -318 |
| Working capital changes | -116 | -378 | -123 | -173 | -286 | -425 |
| Cash flow from Operations | 142 | 378 | 902 | 985 | 1,073 | 1,142 |
| CapEx, acquisitions, divestures | -326 | -257 | -555 | -1,446 | -945 | -1,166 |
| Other investing cash flows | -54 | -185 | -1,551 | 357 | 301 | 318 |
| Cash flow from Investing | -380 | -443 | -2,107 | -1,089 | -644 | -848 |
| Borrowings | 258 | -424 | -478 | 737 | 0 | 0 |
| Equity Changes | 3 | 481 | 2,267 | 7 | 0 | 0 |
| Dividends | 0 | 0 | -78 | -109 | -131 | -175 |
| Other financing cash flows | 0 | 0 | 0 | 0 | 0 | 0 |
| Cash flow from Financing | 261 | 57 | 1,711 | 635 | -131 | -175 |
| Net cash flows | 24 | -7 | 506 | 532 | 298 | 119 |

Source: Company Reports and Citi Investment Research estimates

Shareholding pattern

Figure 27. Shareholding Pattern, June 2007



Source: Company Reports

Risks and Concerns

Our quantitative risk-rating system, which tracks 260-day historical share-price volatility, rates MindTree a default Speculative Risk because of the stock's short trading history. But we believe a High Risk is more appropriate as the company has strong cash flows and a solid balance sheet. Upside risks that could test our target price include: (1) large order wins; (2) better than expected pricing improvement; (3) inorganic activity at attractive valuations, (4) rupee depreciation leading to improved profitability for the offshore business; (5) acquisition of MindTree by a large MNC player; and (6) easing of the supply-side situation.

Key Business Metrics

Figure 28. Revenue by Geographic Region

| | 3Q07 | 4Q07 | 1Q08 |
|--------------------------|-------|-------|-------|
| America | 64.7% | 64.7% | 69.9% |
| Europe | 21.7% | 19.9% | 16.6% |
| India | 4.1% | 4.7% | 4.3% |
| APAC / Rest of the World | 9.5% | 10.8% | 9.2% |

Source: Company Reports

Figure 29. Revenue by Service Line

| | 3Q07 | 4Q07 | 1Q08 |
|----------------|-------|-------|-------|
| AD | 64.6% | 61.0% | 60.4% |
| AM | 22.5% | 25.5% | 25.6% |
| Consulting | 4.4% | 4.7% | 4.8% |
| PI | 3.6% | 2.3% | 1.7% |
| Testing - IVS | 2.6% | 3.4% | 3.5% |
| IMS | 1.5% | 1.9% | 3.9% |
| IP-led | 0.2% | 0.8% | 0.1% |
| Other services | 0.6% | 0.4% | 0.0% |

Source: Company Reports

Figure 30. Revenue by Vertical

| | 3Q07 | 4Q07 | 1Q08 |
|-----------------------------------|-------|-------|-------|
| IT services revenue | | | |
| Manufacturing | 30.9% | 26.2% | 25.7% |
| BFSI | 18.5% | 24.6% | 27.3% |
| Travel and Transportation | 15.3% | 17.5% | 17.0% |
| Hi-Tech | 12.5% | 16.0% | 17.0% |
| Others | 22.8% | 15.7% | 13.0% |
| R&D services revenue | | | |
| Storage and Servers | 44.4% | 42.7% | 44.9% |
| Consumer Appliances | 24.4% | 24.8% | 26.4% |
| Communication systems | 15.2% | 15.3% | 10.6% |
| Automotive and Industrial systems | 16.0% | 17.2% | 18.1% |

Source: Company Reports

Company Description

MindTree is a mid-tier Indian IT services company providing offshore-based services to global organizations in BFSI, manufacturing, transportation and hi-tech industries. The company offers a range of services including IT and R&D services. In IT services, its offerings include application development, maintenance, package implementation, testing and infrastructure management services. The company has consciously stayed away from BPO services. In R&D services, the company offers product design, re-engineering, optimization and support.

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