



Mphasis

STOCK INFO.	BLOOMBERG
BSE Sensx: 19,784	MPHL IN
	REUTERS CODE
S&P CNX: 5,869	MBFL.BO

30 October 2007

Buy

Rs301

Previous Recommendation: Buy

Equity Shares (m)	164.1
52-Week Range	340/210
1,6,12 Rel. Perf. (%)	-7/-47/-22
M.Cap. (Rs b)	49.5
M.Cap. (US\$ b)	1.3

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	RATIO	(X)	(%)	(%)	SALES	EBITDA
3/07A	11,958	1,199	7.3	-21.5	41.2	10.1	27.4	30.3	4.0	23.7
3/08E	24,408	2,695	12.9	76.8	23.3	5.5	33.2	36.0	2.5	13.5
3/09E	31,044	3,349	16.0	24.2	18.8	4.6	26.6	30.1	1.8	10.3

Does not include financials of EDS India

- ✍ **Mphasis 2Q beats expectations; revenue up 13.2%, profits up 29.2%:** Mphasis reported revenue of Rs6b, up 13.2% QoQ, higher than our expectation of Rs5.6b. Software services and ITO business grew 15.2% and 17.1% QoQ respectively. BPO grew slower at 5.6% QoQ. EBITDA margin declined 50bp on lower utilization rates and higher than expected rupee appreciation. Other income was negative Rs15m v/s estimate of positive Rs10m. Net profit grew up 29.2% to Rs645m v/s our estimate of 25.7%.
- ✍ **US\$1b order book to feed revenue growth post December 2007:** Revenue from EDS continues to ramp up strongly, with over 49% revenue contribution (including EDS India), up from 45% in 1QFY08. The outstanding order book stands at over US\$1b for a period of five years. We expected continued deal flows to boost volume growth over the next few quarters. The management expects strong ramp ups in volume growth post the October-December budgeting season.
- ✍ **Employee costs to remain high, expect marginal relief in FY08:** The company is ramping up resources in order to service deals starting from January 2008, which would also keep utilization rates subdued in 2HFY08. We expect increasing employee costs and rupee appreciation to keep margins range bound over FY08-FY09. We have reduced our margin estimates for FY08 and FY09 by 30bp and 60bp respectively to reflect the increased pressure on margins.
- ✍ **Outlook and view:** Following strong revenue traction in 2QFY08 and management indications of continued volume growth momentum, we have upgraded our EPS estimates by 3.8% and 5.7% to Rs12.9 and Rs16 for FY08 and FY09 respectively. The stock trades at a P/E of 23.3x FY08E and 18.8x FY09E. Maintain **Buy**.

QUARTERLY PERFORMANCE									(Rs Million)	
Y/E MARCH	FY07				FY08*				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Revenues</b>	<b>2,607</b>	<b>2,919</b>	<b>3,060</b>	<b>3,373</b>	<b>5,316</b>	<b>6,017</b>	<b>6,378</b>	<b>6,697</b>	<b>11,958</b>	<b>24,408</b>
Q-o-Q Change (%)	4.1	12.0	4.8	10.2	57.6	13.2	6.0	5.0	27.2	104.1
Direct Expenses	1,858	1,935	1,982	2,179	3,713	4,290	4,528	4,738	7,954	17,269
Sales, General & Admin. Expenses	434	499	489	547	626	648	684	712	1,969	2,670
<b>Operating Profit</b>	<b>315</b>	<b>485</b>	<b>588</b>	<b>647</b>	<b>978</b>	<b>1,079</b>	<b>1,165</b>	<b>1,247</b>	<b>2,035</b>	<b>4,469</b>
Margins (%)	12.1	16.6	19.2	19.2	18.4	17.9	18.3	18.6	17.0	18.3
Other Income	42	-56	-50	-6	-147	-15	10	10	-69	-141
Depreciation	150	157	161	163	305	340	364	382	631	1,390
<b>PBT bef. Extra-ordinary</b>	<b>207</b>	<b>273</b>	<b>378</b>	<b>478</b>	<b>526</b>	<b>724</b>	<b>812</b>	<b>875</b>	<b>1,335</b>	<b>2,936</b>
Provision for Tax	55	39	20	22	13	61	81	88	136	242
Rate (%)	26.7	14.2	5.3	4.6	2.4	8.4	10.0	10.0	10.2	8.3
<b>PAT bef. Extra-ordinary</b>	<b>152</b>	<b>234</b>	<b>358</b>	<b>456</b>	<b>513</b>	<b>663</b>	<b>730</b>	<b>788</b>	<b>1,199</b>	<b>2,694</b>
Q-o-Q Change (%)	-56.8	54.0	52.9	27.4	12.7	29.2	10.1	7.8	-20.0	124.7

E: MSt Estimates; \*Consolidated with EDS (I)

### **Mphasis 2Q beats expectations; revenue up 13.2%, profits up 29.2%**

Mphasis reported revenue of Rs6b, up 13.2% QoQ, higher than our expectation of Rs5.6b. This was on account of strong growth in software services and ITO business, which were up 15.2% and 17.1% QoQ respectively. BPO grew slower at 5.6% QoQ. While billing rates remained flat during the quarter, blended price realizations were up 3% QoQ on account of better service mix.

EBITDA margin declined 50bp v/s our estimate of flat margins. This was due to lower utilization rates on account of greater fresher recruitment during the quarter and 40bp impact of rupee appreciation (lowered gross margins by 145bp). SG&A leverage helped neutralize some impact on the margins, with a positive impact of 120bp during the quarter.

Other income was negative at Rs15m v/s estimate of positive Rs10m. However, tax rate was lower at 8.4%, which boosted net profit to Rs645m, up 29.2% v/s our estimate of 25.7%.

### **USUS\$1b order book to feed revenue growth post December 2007**

Revenue from EDS continues to ramp up strongly, with over 49% revenue contribution (including EDS India), up from 45% in 1QFY08. Mphasis is the leading partner for several application deals, wherein it has better positioning, which is expected to add growth in the applications space. In the ITO space, the management plans to leverage EDS' strong presence for larger outsourcing deals. The outstanding order book stands at over USUS\$1b for a period of five years. We expected continued deal flows to add to the large outstanding order book, as well as boost volume growth over the next few quarters. The management expects strong ramp ups in volume growth post the October-December budgeting season.

### **Strong employee ramp up to continue**

We had earlier remarked that the company's plans to recruit around 8,000-10,000 (net) employees in CY07 would tax its recruitment resources significantly. The management has started investing in creating training infrastructure, and has already hired close to 1,900 freshers as part of its recruitment for the year. Management expects to recruit 10,000-11,000 employees in CY08, of which 3,500 are expected to be freshers. Any ramp ups higher than 10,000 employees in CY2008 could result in an upside to our estimates.

### **Employee costs to remain high, expect marginal relief in FY08**

Employee costs have been rising every quarter with average addition of around 800 employees (net) per month. While the company has put in a fresher training programme and has started hiring increased number of freshers (1,900 in FY08; 3,500 planned in FY09), we expect this to reduce utilization rates over the near term. Additionally, the company is ramping up resources in order to service deals starting from January 2008, which would also keep utilization rates subdued in 2H FY08. While SG&A leverage would help improve EBITDA margins over 2H FY08, we expect increasing employee costs and rupee appreciation to keep margins range bound over FY08-FY09. We have reduced our margin estimates for FY08 and FY09 by 30bp and 60bp respectively to reflect the increased pressure on margins.

### **Outlook and view**

Following strong revenue traction in 2QFY08 and management indications of continued volume growth momentum, we have upgraded our EPS estimates by 3.8% and 5.7% to Rs12.9 and Rs16 for FY08 and FY09 respectively. The stock trades at a P/E of 23.3x FY08E and 18.8x FY09E. Maintain **Buy**.

## Mphasis BFL: an investment profile

### Company description

Mphasis BFL is one of the Top 20 integrated software services vendors employing more than 24,000 people, catering to more than 350 clients. It is one of the largest BPO/IT services vendors in India. It is mainly focused on the banking, financial services and insurance segments. Some of its large clients include Citibank, JP Morgan Chase and FedEx.

### Key investment arguments

- Most preferred Tier-2 vendor in the BFSI segment.
- EDS parentage to help Mphasis enter the big league in terms of client wins and larger contract sizes.

### Key investment risks

- Faces intense competition in the BFSI segment from the top 6 players in the industry.
- Lack of differentiation would keep pricing under pressure.

### Recent developments

- EDS India to be merged with Mphasis with effect from July 2007 pending court approval.
- Named on the International Association of Outsourcing Professionals (IAOP) 2006 Global Outsourcing 100 List.

### Valuation and view

- We expect revenue CAGR of 61.1% and net profit CAGR of 67.1% (incl EDS (India)) over FY07-FY09E.
- Valuations at 18.8x FY09E (consolidated) earnings offer room for upside.
- Maintain **Buy**.

### Sector view

- Various CIO surveys indicate increasing share of offshore spending in IT budgets. However, CY08 could be cautious due to perceived slowdown in the US economy.
- Sharp rupee appreciation continues to be cause for concern over the near term.
- We prefer large companies, as they are better placed to contain margin erosion due to rising rupee; niche players are likely to benefit due to lack of offshore competition.

#### COMPARATIVE VALUATIONS

		MPHASIS*	HEXAWARE	I-FLEX
P/E (x)	FY08E	23.3	13.7	50.1
	FY09E	18.8	11.0	39.1
P/BV (x)	FY08E	5.5	2.9	8.2
	FY09E	4.6	2.4	6.9
EV/Sales (x)	FY08E	2.5	3.0	7.7
	FY09E	1.8	3.0	6.2
EV/EBITDA (x)	FY08E	13.5	1.6	37.4
	FY09E	10.3	1.2	29.2

\* Standalone

#### SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	60.9	50.5	51.2
Domestic Inst	9.0	11.4	7.4
Foreign	9.6	11.6	13.1
Others	20.5	26.5	28.3

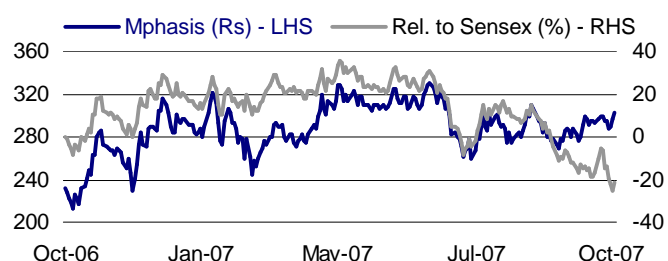
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	12.9	12.8	1.2
FY09	16.0	17.0	-5.3

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
301	330	9.5	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Revenues</b>	<b>7,656</b>	<b>9,401</b>	<b>11,958</b>	<b>24,408</b>	<b>31,044</b>
Change (%)	319	22.8	27.2	104.1	27.2
Cost Of Goods Sold	4,956	6,043	7,954	17,269	22,181
SG&A Expenses	1,290	1,378	1,969	2,670	3,330
<b>EBITDA</b>	<b>1,410</b>	<b>1,981</b>	<b>2,035</b>	<b>4,469</b>	<b>5,534</b>
% of Net Sales	18.4	21.1	17.0	18.3	17.8
Depreciation	396	518	631	1,390	1,770
Interest	-41	-17	-57	0	0
Other Income	72	77	-126	-141	40
<b>PBT</b>	<b>1,127</b>	<b>1,557</b>	<b>1,335</b>	<b>2,937</b>	<b>3,805</b>
Tax	-117	58	136	242	456
Rate (%)	-10.4	3.7	10.2	8.2	12.0
<b>PAT</b>	<b>1,244</b>	<b>1,499</b>	<b>1,199</b>	<b>2,695</b>	<b>3,349</b>
Extra-ordinary items	0	0	0	0	0
<b>Net Income</b>	<b>1,244</b>	<b>1,499</b>	<b>1,199</b>	<b>2,695</b>	<b>3,349</b>
Change (%)	26.2	20.4	-20.0	124.8	24.3

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	786	1,610	1,641	2,086	2,086
Share Premium	2,464	1,165	1,476	1,530	1,530
Reserves	-344	1,154	1,700	7,794	10,134
<b>Net Worth</b>	<b>2,906</b>	<b>3,929</b>	<b>4,816</b>	<b>11,410</b>	<b>13,750</b>
Minority Interest	0	0	0	0	0
Loans	46	37	28	46	41
<b>Capital Employed</b>	<b>2,953</b>	<b>3,966</b>	<b>4,844</b>	<b>11,456</b>	<b>13,792</b>
Gross Block	2,557	3,143	3,703	7,203	8,053
Less : Depreciation	1,455	1,802	2,381	3,771	5,541
<b>Net Block</b>	<b>1,102</b>	<b>1,341</b>	<b>1,322</b>	<b>3,431</b>	<b>2,512</b>
CWIP	96	114	242	200	150
<b>Curr. Assets</b>	<b>3,747</b>	<b>3,918</b>	<b>5,065</b>	<b>12,173</b>	<b>16,464</b>
Debtors	1,835	2,050	2,657	6,839	7,280
Cash & Bank Balance	955	989	1,228	2,475	5,920
Loans & Advances	806	711	1,055	2,606	2,981
Other Current Assets	152	169	126	253	283
<b>Current Liab. &amp; Prov</b>	<b>1,992</b>	<b>1,407</b>	<b>1,785</b>	<b>4,349</b>	<b>5,335</b>
Sundry Liabilities	1,602	767	1,078	2,820	3,098
Provisions	390	640	707	1,529	2,237
<b>Net Current Assets</b>	<b>1,755</b>	<b>2,511</b>	<b>3,280</b>	<b>7,824</b>	<b>11,129</b>
<b>Application of Funds</b>	<b>2,953</b>	<b>3,966</b>	<b>4,844</b>	<b>11,456</b>	<b>13,793</b>

E: MOSI Estimates; Standalone

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>8.2</b>	<b>9.3</b>	<b>7.3</b>	<b>12.9</b>	<b>16.0</b>
Cash EPS	10.4	12.5	11.2	19.6	24.5
Book Value	19.0	24.9	29.8	55.0	66.2
DPS	15	3.0	2.2	3.5	4.3
Payout %(Incl.Div.Taxes)	19.0	32.2	30.0	27.0	27.0
<b>Valuation (x)</b>					
P/E		32.4	41.2	23.3	18.8
Cash P/E		24.1	27.0	15.4	12.3
EV/EBITDA		24.0	23.7	13.5	10.3
EV/Sales		5.1	4.0	2.5	1.8
Price/Book Value		12.1	10.1	5.5	4.6
Dividend Yield (%)		10	0.7	12	14
<b>Profitability Ratios (%)</b>					
RoE	39.4	43.8	27.4	33.2	26.6
RoCE	33.3	45.0	30.3	36.0	30.1
<b>Turnover Ratios</b>					
Debtors (Days)	87	80	81	102	86
Asset Turnover (x)	3.0	3.0	3.2	3.4	3.9
<b>Leverage Ratio</b>					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
CF from Operations	1,640	2,017	1,534	4,083	5,113
Cash for Wkg. Capital	-665	723	581	-833	-39
<b>Net Operating CF</b>	<b>2,305</b>	<b>1,294</b>	<b>954</b>	<b>4,916</b>	<b>5,152</b>
Net Purchase of FA	-543	-605	-688	-3,458	-800
Net Purchase of Invest.	-3,568	312	0	0	0
<b>Net Cash from Invest.</b>	<b>-4,110</b>	<b>-293</b>	<b>-688</b>	<b>-3,458</b>	<b>-800</b>
Proceeds from Pvt. placeme	1,651	-475	341	500	0
Proceeds from LTB/STB	19	-9	-8	18	-5
Dividend Payments	-236	-483	-360	-728	-904
<b>Net CF from Financing</b>	<b>1,434</b>	<b>-968</b>	<b>-27</b>	<b>-210</b>	<b>-908</b>
Free Cash Flow	1,762	689	316	-2,670	4,452
<b>Net Cash Flow</b>	<b>-371</b>	<b>34</b>	<b>239</b>	<b>1,248</b>	<b>3,444</b>
<b>Opening Cash Balance</b>	<b>1,326</b>	<b>955</b>	<b>988</b>	<b>1,227</b>	<b>2,475</b>
Add: Net Cash	-371	34	239	1,248	3,444
<b>Closing Cash Balance</b>	<b>955</b>	<b>988</b>	<b>1,227</b>	<b>2,475</b>	<b>5,919</b>

## **N O T E S**



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1. Analyst ownership of the stock
2. Group/Directors ownership of the stock
3. Broking relationship with company covered
4. Investment Banking relationship with company covered

#### MphasiS

No  
No  
No  
No

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