

Company

19 July 2010 | 7 pages

MindTree (MINT.BO)

Equity

Buy: Visibility on Products Holds the Key

- Slow quarter** — Revenues at ~\$77m were up 3.4% QoQ vs. our expectations of ~\$78m. EBITDA margins declined more than 600bps due to salary hikes covering three-fourths of the employees (impact of -3.7%), INR appreciation (-1.0%), increase in travel costs (-1.3%), increase in other people-related costs (-1.2%) and investments in the wireless business (-1.0%). Due to the dissolution of a subsidiary, there was additional tax burden leading to a profit fall of ~70% QoQ.
- Update on the products business** — (1) Company is developing 4G wireless IP. MindTree has done independent third-party validations with the first launch expected in H2FY11. (2) MindTree is also designing a 3G-GSM handset based on the Android OS. Company is looking at US/Europe in the first phase, with the first launch expected in H2FY11.
- The positives** — (1) Good volume growth of ~7% QoQ. (2) Net hiring of more than 700 employees (~9% QoQ). (3) Sharp rebound in manufacturing.
- The negatives** — (1) Salary hikes of one-fourth of employees will impact margins in Q2. (2) Discretionary services like package implementation and application development were either flattish QoQ or had declines. (3) Attrition spiked by 370bps on a trailing twelve-months basis.
- Visibility on products holds the key** — The investment in the product business in Q1 was ~\$1m vs. the guidance of ~\$10-11m over Q1 to Q3 of FY11. Management plans to make the investments closer to the launch of the phone (with the quantum unchanged). We continue to believe that until there is greater clarity on the investments/revenues in the products business, the stock may continue to trade sideways. Our estimates do not incorporate the same.

| | |
|------------------------------|-----------------------|
| Buy/Medium Risk | 1M |
| Price (19 Jul 10) | Rs568.40 |
| Target price | Rs665.00 |
| Expected share price return | 17.0% |
| Expected dividend yield | 0.7% |
| Expected total return | 17.7% |
| Market Cap | Rs22,546M US\$483M |

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) | (%) | (%) |
| 2008A | 1,033 | 26.52 | -1.8 | 21.4 | 4.0 | 21.3 | 0.4 |
| 2009A | 523 | 13.49 | -49.1 | 42.1 | 3.7 | 9.4 | 0.2 |
| 2010E | 2,033 | 50.45 | 274.0 | 11.3 | 3.4 | 32.9 | 0.5 |
| 2011E | 2,081 | 51.27 | 1.6 | 11.1 | 2.7 | 27.8 | 0.7 |
| 2012E | 2,155 | 53.09 | 3.5 | 10.7 | 2.2 | 23.0 | 0.9 |

Source: Powered by dataCentral

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Result Tables

Figure 1. Key Financials

| Rs m | 1Q10 | 4Q10 | 1Q11 | QoQ | YoY |
|--------------------------|--------------|--------------|--------------|---------------|---------------|
| Revenues (\$) | 62.1 | 74.5 | 77.0 | 3.4% | 24.0% |
| Revenues | 3,048 | 3,444 | 3,487 | 1.3% | 14.4% |
| Direct costs | 1,934 | 2,167 | 2,266 | 4.6% | 17.2% |
| Gross profit | 1,114 | 1,277 | 1,221 | -4.3% | 9.6% |
| <i>Gross margin</i> | <i>36.5%</i> | <i>37.1%</i> | <i>35.0%</i> | <i>-205bp</i> | <i>-153bp</i> |
| SG&A | 607 | 644 | 798 | 23.9% | 31.4% |
| EBITDA | 507 | 632 | 423 | -33.1% | -16.5% |
| <i>EBITDA margin</i> | <i>16.6%</i> | <i>18.4%</i> | <i>12.1%</i> | <i>-623bp</i> | <i>-450bp</i> |
| Depreciation | 161 | 164 | 145 | -11.4% | -9.9% |
| EBIT | 346 | 469 | 278 | -40.7% | -19.6% |
| <i>EBIT margin</i> | <i>11.3%</i> | <i>13.6%</i> | <i>8.0%</i> | <i>-564bp</i> | <i>-337bp</i> |
| Interest charges | 24 | 1 | 0 | -100.0% | -100.0% |
| Other income | 332 | 197 | 21 | -89.3% | -93.7% |
| PBT | 654 | 665 | 299 | -55.0% | -54.3% |
| Taxes | 87 | 120 | 140 | 16.7% | 61.1% |
| PAT | 567 | 545 | 159 | -70.8% | -72.0% |
| Basic EPS | 14.51 | 13.82 | 4.00 | -71.1% | -72.4% |
| Fully diluted EPS | 14.26 | 13.29 | 3.86 | -71.0% | -72.9% |

Source: Company Reports

Figure 2. Revenue Mix

| | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 |
|----------------------|-------|-------|-------|-------|-------|
| Geography | | | | | |
| America | 66.8% | 66.2% | 64.4% | 64.2% | 64.6% |
| Europe | 21.0% | 21.0% | 18.4% | 17.3% | 16.9% |
| India | 5.8% | 5.3% | 6.4% | 7.0% | 8.0% |
| APAC/Rest of World | 6.4% | 7.5% | 10.8% | 11.5% | 10.5% |
| Service Lines | | | | | |
| AD | 46.9% | 48.6% | 51.8% | 52.7% | 51.2% |
| AM | 23.6% | 22.0% | 20.8% | 18.9% | 19.6% |
| Consulting | 2.9% | 2.9% | 2.5% | 2.5% | 3.1% |
| PI | 4.1% | 4.3% | 4.2% | 4.8% | 4.1% |
| Testing - IVS | 18.1% | 18.2% | 17.0% | 17.0% | 17.0% |
| IMS | 4.4% | 4.0% | 3.7% | 4.1% | 5.0% |

Source: Company Reports

Figure 3. Key Client Metrics

| | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 |
|----------------------|-------|-------|-------|-------|-------|
| Top Customer | 7.0% | 7.8% | 7.2% | 7.2% | 7.0% |
| Top 5 Customers | 26.4% | 26.9% | 28.4% | 27.9% | 26.9% |
| Top 10 Customers | 39.4% | 39.7% | 40.5% | 40.0% | 40.2% |
| Repeat business | 99.1% | 98.8% | 98.2% | 99.1% | 98.9% |
| US\$1m+ | 60 | 59 | 58 | 60 | 62 |
| US\$5m+ | 12 | 11 | 13 | 13 | 13 |
| US\$10m+ | 3 | 4 | 5 | 5 | 5 |
| Total active clients | 239 | 243 | 253 | 258 | 261 |
| New clients added | 18 | 24 | 35 | 27 | 31 |

Source: Company Reports

Figure 4. Key Execution Metrics

| | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 |
|----------------------|-------|-------|-------|-------|-------|
| Employee base | | | | | |
| Total | 7,693 | 7,450 | 8,127 | 8,297 | 9,012 |
| Delivery | 7,073 | 6,832 | 7,460 | 7,651 | 8,353 |
| Non-Delivery | 620 | 618 | 667 | 646 | 659 |
| Utilization | | | | | |
| - inc trainees | 61.1% | 64.7% | 71.4% | 71.4% | 70.5% |
| - ex trainees | 63.7% | 65.6% | 72.9% | 72.6% | 71.9% |
| Attrition rate - LTM | 11.4% | 9.7% | 10.7% | 14.1% | 17.8% |
| DSO | 86 | 70 | 65 | 68 | 68 |

Source: Company Reports

MindTree

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. It 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. The company has consciously stayed away from BPO services. In R&D services, it offers product design, re-engineering, optimization and support.

Investment strategy

We rate MindTree shares Buy/Medium Risk (1M). The business environment for IT services has been challenging given the global slowdown; however, things are starting to look up. Mindtree has a higher proportion of application development work (~49% of revenues) - so risks are higher, in our view. In IT Services, the tier-one players have done better than the industry, and we expect this to continue. Tier-two players could face pressure from vendor consolidation. We expect revenue (\$ terms) and EPS CAGRs of ~13% and ~58% over FY09-12E. A high-quality management team lends credibility to future plans for MindTree.

Valuation

Our target price of Rs665 is derived from 13x FY11E EPS, towards the lower end of the trading band of 4-36x one-year forward earnings since listing because challenges remain for the group. We believe a PE-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.

Risks

Although our quantitative risk-rating system suggests High Risk, we rate MindTree shares Medium Risk given its strong branding and management credibility. Downside risks to our target price are: (1) slower than expected recovery in the global economy; (2) pricing cuts/discounts; (3) INR appreciation; and (4) value destructive acquisition.

Appendix A-1

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Analyst: Vishal Agarwal

Covered since June 18 2010

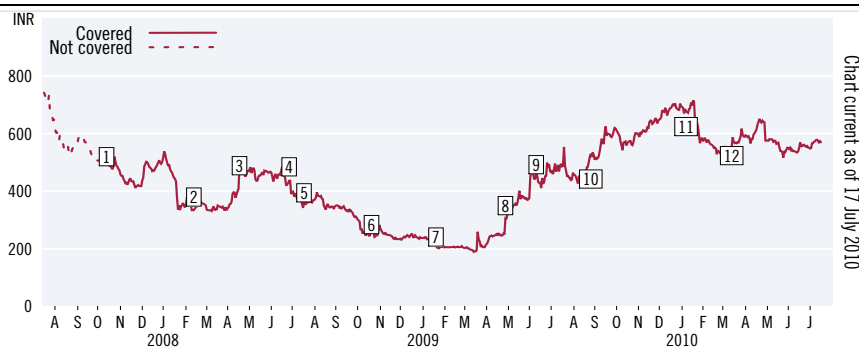


Chart current as of 17 July 2010

| | Date | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 1 | 12-Oct-07 | *3H | *487.00 | 492.20 |
| 2 | 13-Feb-08 | 3H | *380.00 | 333.95 |
| 3 | 17-Apr-08 | 3H | *465.00 | 488.40 |
| 4 | 26-Jun-08 | 3H | *485.00 | 436.05 |

| | Date | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 5 | 17-Jul-08 | 3H | *390.00 | 366.05 |
| 6 | 21-Oct-08 | *1H | *367.00 | 283.85 |
| 7 | 20-Jan-09 | *3H | *190.00 | 216.55 |
| 8 | 28-Apr-09 | 3H | *240.00 | 306.90 |

| | Date | Rating | Target Price | Closing Price |
|----|-----------|--------|--------------|---------------|
| 9 | 10-Jun-09 | 3H | *415.00 | 462.45 |
| 10 | 26-Aug-09 | *3M | *485.00 | 529.65 |
| 11 | 7-Jan-10 | 3M | *665.00 | 676.80 |
| 12 | 12-Mar-10 | *1M | 665.00 | 554.25 |

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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|--|-----|------|------|
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