

Mphasis Ltd

Fundamentally positive, but near-term upside limited; Hold

We initiate coverage on Mphasis with a Hold rating and a December '10 price target of Rs 750/share (14% upside). Mphasis offers a good play on the captive-expansion theme – higher movement of work offshore from HP-EDS should help it deliver consistent growth over the next 12–24 months. However, our fundamentally positive view on Mphasis is tempered by – 1) Recent sharp price reductions by HP in ITO that leave the door open for further cuts, especially given high EBITDA margins at Mphasis, 2) Rising attrition that could lead to salary hikes (not currently planned by the management), 3) Non-operating factors (lower forex gains, higher tax) that would reduce EPS growth over the next two years. Despite these factors, we emphasise that Mphasis has potential to grow rapidly depending on HP's offshore push – we model a revenue/EPS CAGR of 17%/13% over FY09-FY11 with risks to the upside. We thus view Mphasis as a good defensive stock with limited downside but would recommend aggressive buying only on declines.

Sustainable growth from HP-EDS: HP-EDS is the largest customer driving ~71% of revenues for Mphasis and growing steadily. This includes revenues from 1) Internal work of HP, 2) Customers of HP-EDS where Mphasis bills to HP-EDS, and 3) Joint bids with HP-EDS on deals. Besides Mphasis, HP also has its own 100%-owned subsidiary, HP-GDIC. However, we believe that there is segmentation of work along business lines between Mphasis and HP-GDIC, resulting in minimal overlap and conflict of interest. We believe that HP-EDS would continually need to push more work offshore, helping Mphasis. While the initial big ramp-up might be over (seen in H1FY09), we expect sustainable growth of 15–20% over the next 2–3 years. It is worth noting that Mphasis had 2,500+ open positions for hiring in the Applications business, highlighting significant demand traction for the company.

Volumes less of a concern, pricing the worry: Recently Mphasis took a sharp ~15% rate cut in the ITO space from HP-EDS. We believe this was driven by Mphasis' high profitability (40%+ gross margins – ahead of industry). With margins now in the low 30s, we believe the rationale for further rate cuts is limited. Also, the management has pointed to annual renegotiations and hence the next review would only be in October '10. We believe pricing pressure would depend upon the health of the macro environment – with our positive view on IT spends, we do not expect rate pressures in the next 12–24 months. Having said that, we would like more clarity on this from the management and would do so over coming weeks.

Near-term upside limited: Overall, we forecast modest revenue CAGR of 17% over FY09-FY11. We expect traction in the Applications and ITO businesses to continue, though BPO is likely to remain soft near-term. While EBITDA margins should remain intact, lower forex gains and higher tax rates would limit EPS CAGR to 13%. We value Mphasis at a forward P/E of 13x – a discount to top-tier names due to its smaller size and lower level of expertise. However, we expect Mphasis to trade at a premium to mid caps due to its larger size and better business visibility.

Financial highlights

(Rs mn)	FY09	FY10E	FY11E	FY12E
Revenue	42,639	49,957	58,635	69,299
Growth (%)	76.0	17.2	17.4	18.2
Adj net income	9,171	10,679	11,681	13,538
Growth (%)	259.2	16.4	9.4	15.9
FDEPS (Rs)	43.8	51.0	55.7	64.6
Growth (%)	257.0	16.3	9.3	15.9

Profitability and return ratios

(%)	FY09	FY10E	FY11E	FY12E
EBITDA margin	26.3	25.7	26.2	26.5
EBIT margin	21.9	22.0	22.7	23.1
Adj PAT margin	21.5	21.4	19.9	19.5
ROE	48.5	37.7	30.3	27.0
ROIC	57.9	59.9	61.9	66.0
ROCE	46.8	35.4	40.5	74.0

CMP	TARGET	RATING	RISK
Rs 659	Rs 750	HOLD	MEDIUM

BSE	NSE	BLOOMBERG
526299	MPHASIS	MPHL IN

Company data

Market cap (Rs mn / US\$ mn)	138,307 / 3,083
Outstanding equity shares (mn)	210
Free float (%)	39.3
Dividend yield (%)	0.6
52-week high/low (Rs)	797 / 231
2-month average daily volume	703,354

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Mphasis	659	2.7	(8.3)	(10.4)
CNX IT	5,891	(1.0)	5.7	16.3
Sensex	17,331	(3.4)	8.8	5.4

Valuation matrix

(x)	FY09	FY10E	FY11E	FY12E
P/E @ CMP	15.0	12.9	11.8	10.2
P/E @ Target	17.1	14.7	13.5	11.6
EV/EBITDA @ CMP	11.5	10.0	8.4	7.0

RCML vs consensus

Parameter	FY10E		FY11E	
	RCML	Cons	RCML	Cons
Sales (Rs mn)	49,957	49,625	58,635	58,050
EPS (Rs)	51	49	56	53



Fig 1 - Mphasis – Quarterly model

	2009				2010E				2011E				2009	2010E	2011E	2012E
(Rs mn, Year end Oct)	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE	1QE	2QE	3QE	4QE				
Revenue	9,777	10,485	11,056	11,322	11,916	12,390	12,527	13,124	13,713	14,330	14,975	15,617	42,639	49,957	58,635	69,299
Depreciation	461	518	482	430	457	456	469	487	477	498	520	541	1,892	1,869	2,036	2,331
COGS (Excl. dep)	6,042	6,555	6,986	7,242	7,753	8,058	8,262	8,571	8,993	9,328	9,675	10,026	26,825	32,643	38,023	44,689
Gross Profit	3,274	3,411	3,587	3,650	3,706	3,876	3,796	4,067	4,243	4,503	4,780	5,050	13,922	15,444	18,576	22,280
EBIT	2,182	2,274	2,406	2,475	2,678	2,761	2,669	2,885	3,009	3,214	3,432	3,645	9,336	10,993	13,299	16,043
EBITDA	2,643	2,792	2,888	2,905	3,135	3,217	3,138	3,373	3,486	3,712	3,952	4,185	11,228	12,862	15,335	18,373
Net Other Income	64	153	32	225	330	218	223	228	210	219	245	273	475	1,000	946	1,314
Pre Tax Profit	2,246	2,427	2,438	2,700	3,008	2,979	2,892	3,113	3,218	3,432	3,677	3,918	9,812	11,992	14,245	17,357
Net Profit	2,176	2,253	2,292	2,450	2,683	2,651	2,574	2,771	2,639	2,814	3,015	3,212	9,171	10,679	11,681	13,538
EPS (Rs)	10.4	10.8	11.0	11.7	12.8	12.6	12.3	13.2	12.6	13.4	14.4	15.3	43.8	51.0	55.7	64.6
Margins (%)																
Gross Margin	33.5	32.5	32.4	32.2	31.1	31.3	30.3	31.0	30.9	31.4	31.9	32.3	32.7	30.9	31.7	32.1
Operating Margin	22.3	21.7	21.8	21.9	22.5	22.3	21.3	22.0	21.9	22.4	22.9	23.3	21.9	22.0	22.7	23.1
EBITDA Margin	27.0	26.6	26.1	25.7	26.3	26.0	25.0	25.7	25.4	25.9	26.4	26.8	26.3	25.7	26.2	26.5
Net Margin	22.3	21.5	20.7	21.6	22.5	21.4	20.5	21.1	19.2	19.6	20.1	20.6	21.5	21.4	19.9	19.5
Sequential Growth (%)																
Revenue	16.9	7.2	5.4	2.4	5.2	4.0	1.1	4.8	4.5	4.5	4.5	4.3	123.6	17.2	17.4	18.2
Gross Profit	9.6	4.2	5.2	1.8	1.5	4.6	(2.1)	7.1	4.3	6.1	6.1	5.7	189.4	10.9	20.3	19.9
EBIT	5.0	4.2	5.8	2.9	8.2	3.1	(3.3)	8.1	4.3	6.8	6.8	6.2	224.3	17.7	21.0	20.6
EBITDA	49.8	5.6	3.4	0.6	7.9	2.6	(2.5)	7.5	3.4	6.5	6.5	5.9	194.1	14.5	19.2	19.8
PBT	26.7	8.0	0.4	10.8	11.4	(1.0)	(2.9)	7.7	3.4	6.6	7.1	6.5	216.8	22.2	18.8	21.8
Net Profit	64.9	3.5	1.8	6.9	9.5	(1.2)	(2.9)	7.7	(4.8)	6.6	7.1	6.5	210.4	16.4	9.4	15.9
EPS	51.5	3.5	1.6	6.7	9.5	(1.2)	(2.9)	7.7	(4.8)	6.6	7.1	6.5	223.3	16.3	9.3	15.9
Y/Y Growth (%)																
Revenue	54.6	59.4	49.0	35.4	21.9	18.2	13.3	15.9	15.1	15.7	19.5	19.0				
Gross Profit	37.7	46.6	27.1	2.2	13.2	13.6	5.8	11.4	14.5	16.2	25.9	24.2				
EBIT	30.9	34.8	27.7	25.8	22.7	21.4	10.9	16.6	12.3	16.4	28.6	26.3				
EBITDA	138.8	150.7	128.4	67.0	18.6	15.2	8.6	16.1	11.2	15.4	25.9	24.1				
Net Profit	70.3	60.2	60.6	36.4	23.3	17.7	12.3	13.1	(1.6)	6.2	17.1	15.9				
EPS	198.9	249.4	188.1	87.0	22.9	17.3	12.1	13.1	(1.6)	6.2	17.1	15.9				

Source: Company, RCML Research



Valuation

We value Mphasis at a forward P/E of 13x – a discount to top-tier players due to its smaller size and lower level of expertise. However, we expect Mphasis to trade at a premium to the mid cap pack due to its larger size and higher visibility of business. On a DCF basis, the December '10 fair value is Rs 788, assuming a 10-year revenue CAGR of 10%, a long-term EBIT margin of 23%, average ROIC of 61% and a WACC of 11%. We have assumed terminal growth of 4%.



Consolidated financials

Profit and Loss statement

Y/E Oct (Rs mn)	FY09	FY10E	FY11E	FY12E
Revenues	42,639	49,957	58,635	69,299
<i>Growth (%)</i>	76.0	17.2	17.4	18.2
EBITDA	11,228	12,862	15,335	18,373
<i>Growth (%)</i>	177.4	14.5	19.2	19.8
Depreciation & amortisation	1,892	1,869	2,036	2,331
EBIT	9,336	10,993	13,299	16,043
<i>Growth (%)</i>	234.4	17.7	21.0	20.6
Interest	28	439	891	1,314
Other income	447	561	55	-
EBT	9,812	11,992	14,245	17,357
Income taxes	641	1,313	2,564	3,818
Effective tax rate (%)	6.5	11.0	18.0	22.0
Extraordinary items	-	-	-	-
Min into / inc from associates	-	-	-	-
Reported net income	9,171	10,679	11,681	13,538
Adjustments	-	-	-	-
Adjusted net income	9,171	10,679	11,681	13,538
<i>Growth (%)</i>	259.2	16.4	9.4	15.9
Shares outstanding (mn)	209.6	209.7	209.7	209.7
FDEPS (Rs) (adj)	43.8	51.0	55.7	64.6
<i>Growth (%)</i>	257.0	16.3	9.3	15.9
DPS (Rs)	-	4.0	4.0	4.0

Cash flow statement

Y/E Oct (Rs mn)	FY09	FY10E	FY11E	FY12E
Net income + Depreciation	11,063	12,549	13,717	15,869
Non-cash adjustments	0	0	0	0
Changes in working capital	(726)	(1,232)	(816)	(817)
Cash flow from operations	10,336	11,317	12,901	15,051
Capital expenditure	(1,047)	(1,365)	(2,000)	(2,400)
Change in investments	(349)	(24)	0	0
Other investing cash flow	14	57	0	0
Cash flow from investing	(1,383)	(1,332)	(2,000)	(2,400)
Issue of equity	(81)	67	(0)	0
Issue/repay debt	(21)	(9)	0	0
Dividends paid	0	(981)	(981)	(981)
Other financing cash flow	0	0	0	0
Change in cash & cash eq	8,852	9,062	9,920	11,670
Closing cash & cash eq	9,398	18,460	28,381	40,051

Economic Value Added (EVA) analysis

Y/E Oct	FY09	FY10E	FY11E	FY12E
WACC (%)	10.9	10.9	10.9	10.9
ROIC (%)	57.9	59.9	61.9	66.0
Invested capital (Rs mn)	16,220	17,281	18,494	19,914
EVA (Rs mn)	7,609	8,456	9,418	10,974
EVA spread (%)	46.9	48.9	50.9	55.1

Balance sheet

Y/E Oct (Rs mn)	FY09	FY10E	FY11E	FY12E
Cash and cash eq	9,398	18,460	28,381	40,051
Accounts receivable	9,064	10,936	13,014	15,331
Inventories	0	0	0	0
Other current assets	7,241	8,308	9,108	9,908
Investments	0	0	0	0
Gross fixed assets	10,044	11,226	13,226	15,626
Net fixed assets	3,291	2,787	2,751	2,820
CWIP	0	0	0	0
Intangible assets	2,946	2,888	2,888	2,888
Deferred tax assets, net	0	0	0	0
Other assets	694	718	718	718
Total assets	32,634	44,097	56,859	71,716
Accounts payable	0	0	0	0
Other current liabilities	9,147	10,854	12,916	15,216
Provisions	0	0	0	0
Debt funds	33	25	25	25
Other liabilities	0	0	0	0
Equity capital	2,096	2,097	2,097	2,097
Reserves & surplus	21,358	31,122	41,822	54,379
Shareholder's funds	23,453	33,219	43,919	56,476
Total liabilities	32,634	44,097	56,859	71,716
BVPS (Rs)	112	158	209	269

Financial ratios

Y/E Oct	FY09	FY10E	FY11E	FY12E
Profitability & Return ratios (%)				
EBITDA margin	26.3	25.7	26.2	26.5
EBIT margin	21.9	22.0	22.7	23.1
Net profit margin	21.5	21.4	19.9	19.5
ROE	48.5	37.7	30.3	27.0
ROCE	46.8	35.4	40.5	74.0
Working Capital & Liquidity ratios				
Receivables (days)	77.6	79.9	81.0	80.7
Inventory (days)	n.m	n.m	n.m	n.m
Payables (days)	n.m	n.m	n.m	n.m
Current ratio (x)	2.8	3.5	3.9	4.3
Quick ratio (x)	2.0	2.7	3.2	3.6
Turnover & Leverage ratios (x)				
Gross asset turnover	4.4	4.7	4.8	4.8
Total asset turnover	1.6	1.3	1.2	1.1
Interest coverage ratio	n.m	n.m	n.m	n.m
Adjusted debt/equity	0.0	0.0	0.0	0.0
Valuation ratios (x)				
EV/Sales	3.0	2.6	2.2	1.9
EV/EBITDA	11.5	10.0	8.4	7.0
P/E	15.0	12.9	11.8	10.2
P/BV	5.9	4.2	3.1	2.4



Quarterly trend

Particulars	Q3FY09	Q4FY09	Q1FY10	Q2FY10E	Q3FY10E
Revenue (Rs mn)	11,056	11,322	11,916	12,390	12,527
YoY growth (%)			21.9	18.2	13.3
QoQ growth (%)	5.4	2.4	5.2	4.0	1.1
EBITDA (Rs mn)	2,406	2,475	2,678	2,761	2,669
EBITDA margin (%)	21.8	21.9	22.5	22.3	21.3
Adj net income (Rs mn)	2,292	2,450	2,683	2,651	2,574
YoY growth (%)	204.2	53,929.6	23.3	17.7	12.3
QoQ growth (%)	1.8	6.9	9.5	(1.2)	(2.9)

DuPont analysis

(%)	FY09	FY10E	FY11E	FY12E
Tax burden (Net income/PBT)	93.5	89.0	82.0	78.0
Interest burden (PBT/EBIT)	105.1	109.1	107.1	108.2
EBIT margin (EBIT/Revenues)	21.9	22.0	22.7	23.1
Asset turnover (Revenues/Avg TA)	1.6	1.3	1.2	1.1
Leverage (Avg TA/Avg equitiy)	1.4	1.4	1.3	1.3
Return on equity	48.5	37.7	30.3	27.0

Company profile

Mphasis is an integrated software services vendor in India which provides IT services, BPO and infrastructure management services mainly in the BFSI segment. Its BPO practice includes voice-and transaction-based services. EDS holds ~61% stake in Mphasis and EDS in-turn is acquired by HP.

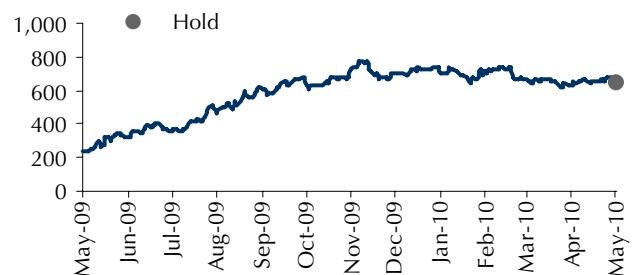
Shareholding pattern

(%)	Sep-09	Dec-09	Mar-10
Promoters	60.7	60.6	60.6
FIs	16.8	17.2	16.8
Banks & FIs	7.4	7.0	7.0
Public	15.2	15.1	15.6

Recommendation history

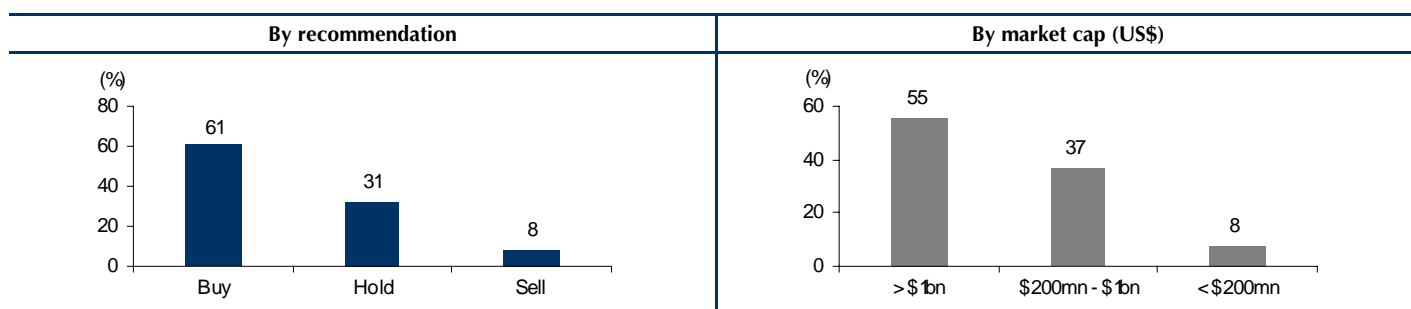
Date	Event	Reco price	Tgt price	Reco
10-May-10	Initiating Coverage	659	750	Hold

Stock performance





Coverage Profile



Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

Religare Capital Markets Ltd

4th Floor, GYS Infinity, Paranjpe 'B' Scheme, Subhash Road, Vile Parle (E), Mumbai 400 057.

Disclaimer

This document is NOT addressed to or intended for distribution to retail clients (as defined by the FSA).

This document is issued by Religare Capital Markets plc ("RCM") in the UK, which is authorised and regulated by the Financial Services Authority in connection with its UK distribution. RCM is a member of the London Stock Exchange.

This material should not be construed as an offer or recommendation to buy or sell or solicitation of any offer to buy any security or other financial instrument, nor shall it, or the fact of its distribution, form the basis of, or be relied upon in connection with, any contract relating to such action or any other matter. The material in this report is based on information that we consider reliable and accurate at, and share prices are given as at close of business on, the date of this report but we do not warrant or represent (expressly or impliedly) that it is accurate, complete, not misleading or as to its fitness for the purpose intended and it should not be relied upon as such. Any opinion expressed (including estimates and forecasts) is given as of the date of this report and may be subject to change without notice.

RCM, and any of its connected or affiliated companies or their directors or employees, may have a position in any of the securities or may have provided corporate finance advice, other investment services in relation to any of the securities or related investments referred to in this document. Our asset management area, our proprietary trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this briefing note.

RCM accepts no liability whatsoever for any direct, indirect or consequential loss or damage of any kind arising out of the use of or reliance upon all or any of this material howsoever arising. Investors should make their own investment decisions based upon their own financial objectives and financial resources and it should be noted that investment involves risk, including the risk of capital loss.

This document is confidential and is supplied to you for information purposes only. It may not (directly or indirectly) be reproduced, further distributed to any person or published, in whole or in part, for any purpose whatsoever. Neither this document, nor any copy of it, may be taken or transmitted into the United States, Canada, Australia, Ireland, South Africa or Japan or into any jurisdiction where it would be unlawful to do so. Any failure to comply with this restriction may constitute a violation of relevant local securities laws. If you have received this document in error please telephone Nicholas Malins-Smith on +44 (0) 20 7382 4479.