

MAY 27, 2010

#### RESULT

Coverage view: **Attractive**

Price (Rs): **599**

Target price (Rs): **550**

BSE-30: **16,666**

**Earnings call confirms negative outlook on margins; reiterate REDUCE.** Mphasis management indicated that the company has had another round of pricing review with HP (after one only a couple of quarters back) and indicated downward bias on pricing. In addition, reported 2QFY11 (year-ending Oct 2010) margins gained from one-off reversal of certain provisions. We expect MPHL's margins to remain under pressure over the coming quarters. We reduce our estimates to reflect the same and reiterate our REDUCE rating on the stock with a revised target price of Rs550/share (570 earlier).

#### Company data and valuation summary

Mphasis BFL

##### Stock data

52-week range (Rs) (high,low) 797-283

Market Cap. (Rs bn) 124.9

##### Shareholding pattern (%)

Promoters 60.6

FIs 16.8

MFs 5.2

##### Price performance (%)

Absolute (9.3) (9.7) 83.1

Rel. to BSE-30 (3.7) (10.9) 55.0

##### Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	43.6	49.0	45.6
EPS growth (%)	207.5	12.5	(7.0)
P/E (X)	13.7	12.2	13.1
Sales (Rs bn)	42.6	50.4	59.4
Net profits (Rs bn)	9.1	10.2	9.5
EBITDA (Rs bn)	11.3	12.3	13.0
EV/EBITDA (X)	10.9	9.7	8.8
ROE (%)	48.1	36.4	25.8
Div. Yield (%)	0.6	0.7	0.8

#### Another round of pricing review with HP – impact will show up July 2010 quarter onwards

Mphasis indicated another round of pricing review with HP, in less than two quarters after the last review happened in early 1QFY11. Without commenting on the quantum of pricing change, the management stated that –

- ▶ Mphasis had signed a 3-year MSA with HP beginning Nov 1, 2009; pricing review to happen every 6 months. Also, MSA provides for structured reduction in pricing over the 3 years.
- ▶ Pricing mechanism for HP-internal and migration work changed from cost+ to rate-card; this essentially transfers any cost escalation risk to Mphasis – a clear negative, at least in the near term in the increasing attrition and wage inflation environment in the industry. Of course, Mphasis stands to benefit if it manages costs well but with pricing reviews now happening every 6 months, we do not rule out HP taking away any margin benefits through a price cut.
- ▶ Pricing mechanism for joint go-to-market projects remains 'market-minus', where HP contracts pricing with the customer, keeps a certain percentage itself and passes the rest to Mphasis. However, the management commentary suggested a downward revision in pricing on this channel as well.
- ▶ Pricing review applicable across the three business segments – application services, ITO, and BPO. We note that the last round of pricing review led to a sharp 18% qoq decline in ITO and 12.5% decline in BPO pricing in the Jan 2010 quarter.
- ▶ New pricing terms to be applicable from May 1, 2010.

We have long highlighted potential risk to pricing in what is essentially a captive set-up (72% of revenues from the HP channel). The risk has finally come to the fore; with a pricing review scheduled every 6 months, we believe pricing pressure can be a structural margin risk for MPHL – any productivity gains will be passed on to HP while cost escalation risks remain with MPHL.

Kawaljeet Saluja  
kawaljeet.saluja@kotak.com  
Mumbai: +91-22-6634-1243

Rohit Chordia  
rohit.chordia@kotak.com  
Mumbai: +91-22-6634-1397

Vineet Thodge  
vineet.thodge@kotak.com  
Mumbai: +91-22-6634-1225

Kotak Institutional Equities Research  
kotak.research@kotak.com  
Mumbai: +91-22-6634-1100

### Other conference call highlights

- ▶ Positive on demand environment – MPHL management indicated strong pipeline of deals, acceleration in decision-making process at clients, and broad-based recovery in demand. The company signed 22 new clients during the quarter (8 direct and 14 HP channel). The company also indicated a large deal with TD Ameritrade.
- ▶ The company expects BPO segment to stabilize after seeing a sharp decline over the past two quarters. MPHL's BPO business has been impacted on account of vendor rationalization at HP.
- ▶ Mphasis has effected a wage hike for its employees from May 1, 2010. Management indicated that this would not impact margins substantially as a reduction in variable compensation would make up for increase in fixed salaries. However, with attrition levels at 25% for Mphasis amid a rising trend in the industry, we do not concur with the management on no impact on employee costs (as % of revenues).
- ▶ Hedging – Mphasis continues to be well hedged for the next few quarters with forward covers of US\$598 mn (USD/INR at an average rate of 47.8), GBP53 mn (GBP/INR at 78.4) and AUD19 mn (at 40.7). We note that Mphasis' reported revenues and margins have benefited for each of the past two quarters on account of cash-flow hedging gains booked at the revenue line.
- ▶ Mphasis attributed the sharp 13% sequential decline in G&A expenses to one-off provision reversals and sees 1QFY11 absolute G&A levels (Rs575 mn) as normalized, sustainable levels over the coming quarters. We continue to find Mphasis' SG&A as % of revenues (8.3% in April 2010 quarter) low and see margin risks from SG&A expense normalization.

### Revise estimates, cut target price, reiterate REDUCE

We have cut out FY2012E (year-ending Oct 2011) EPS for Mphasis to Rs45.6 (down 4.8% from earlier estimate of Rs47.9). Our EPS estimate for FY2011E (year-ending Oct 2010) increases marginally to Rs49 (from Rs48.7) to factor in higher forex gains and lower depreciation.

We note that our estimates build in sustenance of robust revenue growth – 24% and 19% yoy growth for FY2011E and FY2012E, respectively. We also build in the benefits of aggressive hedging in our numbers as reflected in the higher Re/US\$ assumptions used for the company (46.5 and 46 for FY2011E/12E for Mphasis versus 45.3/45 for others in the sector).

However, as discussed earlier, we build in sustained weakness in margins (on pricing/ non-pricing factors) and take our EBITDA margin estimates down 30 bps for FY2011E (to 24.4%) and 180 bps for FY2012E (to 21.9%). EPS growth for FY2012E also gets impacted by a sharp increase in tax rates (to 18.9% from 11.6%) on account of STPI tax exemption phase out from April 1, 2011.

We reiterate our REDUCE rating on the stock with a revised target price of Rs550/share (Rs570 earlier), implying 12X FY2012E P/E.

### Potential delisting the key risk to our call

We note that Mphasis, with 72% of its revenues coming from the parent HP channel, is essentially a captive. HP may choose to delist the company at some point in time. Recent ABB example suggests that a stock can run up on an open offer (or even on news flow of an open offer) despite subdued financial performance.

## Key changes to FY2011-12E estimates

Rs mn	New		Old		Change (%)	
	FY2011E	FY2012E	FY2011E	FY2012E	FY2011E	FY2012E
<b>Revenues (US\$ mn)</b>	<b>1,083</b>	<b>1,291</b>	<b>1,064</b>	<b>1,227</b>	<b>1.8</b>	<b>5.2</b>
<b>Revenues</b>	<b>50,359</b>	<b>59,421</b>	<b>49,688</b>	<b>56,434</b>	<b>1.3</b>	<b>5.3</b>
EBITDA	12,296	12,984	12,262	13,382	0.3	(3.0)
Depreciation	(1,817)	(2,168)	(1,874)	(2,192)	(3.1)	(1.1)
EBIT	10,479	10,816	10,388	11,190	0.9	(3.3)
<b>Net Profit</b>	<b>10,222</b>	<b>9,508</b>	<b>10,145</b>	<b>9,988</b>	<b>0.8</b>	<b>(4.8)</b>
<b>EPS (Rs/ share)</b>	<b>49.0</b>	<b>45.6</b>	<b>48.7</b>	<b>47.9</b>	<b>0.8</b>	<b>(4.8)</b>
<b>Margins (%)</b>						
EBITDA	24.4	21.9	24.7	23.7		
EBIT	20.8	18.2	20.9	19.8		
Re/US\$ rate	46.5	46.0	46.7	46.0	<b>(0.4)</b>	<b>0.1</b>

Source: Kotak Institutional Equities estimates

## Mphasis consolidated quarterly performance - 2QFY11, fiscal year-ends October (Rs mn)

	2QFY10	1QFY11	2QFY11	qoq (%)	yoy (%)	2QFY11E	Deviation (%)
<b>Revenues (US\$ mn)</b>	<b>212</b>	<b>249</b>	<b>263</b>	<b>5.8</b>	<b>24.1</b>	<b>262</b>	<b>0.6</b>
<b>Revenues</b>	<b>10,485</b>	<b>11,916</b>	<b>12,205</b>	<b>2.4</b>	<b>16.4</b>	<b>12,225</b>	<b>(0.2)</b>
Cost of revenues	(7,074)	(8,209)	(8,443)	2.8	19.4	(8,506)	(0.7)
<b>Gross profits</b>	<b>3,411</b>	<b>3,706</b>	<b>3,762</b>	<b>1.5</b>	<b>10.3</b>	<b>3,718</b>	<b>1.2</b>
S&M expenses	(468)	(451)	(516)	14.5	10.3	(460)	12.1
G&A expenses	(669)	(575)	(498)	(13.3)	(25.6)	(591)	(15.8)
Provision for doubtful debts	(8)	(3)	-			—	
<b>EBIT</b>	<b>2,266</b>	<b>2,678</b>	<b>2,748</b>	<b>2.6</b>	<b>21.3</b>	<b>2,667</b>	<b>3.1</b>
Forex gain/(loss), net	124	240	157			205	
Other income/(loss)	20	81	117			126	
Interest income	9	9	1			-	
<b>PBT</b>	<b>2,419</b>	<b>3,008</b>	<b>3,023</b>	<b>0.5</b>	<b>25.0</b>	<b>2,998</b>	<b>0.8</b>
Provision for tax	(175)	(325)	(350)			(281)	24.4
<b>PAT</b>	<b>2,245</b>	<b>2,683</b>	<b>2,673</b>	<b>(0.4)</b>	<b>19.1</b>	<b>2,716</b>	<b>(1.6)</b>

<b>Margins (%)</b>							
Gross margin	32.5	31.1	30.8			30.4	
EBITDA margin	26.9	26.3	26.3			25.6	
EBIT margin	21.6	22.5	22.5			21.8	
PAT margin	21.4	22.5	21.9			22.2	
SG&A expenses (% of revenues)	10.8	8.6	8.3			8.6	
Tax rate (as % of PBT)	7.2	10.8	11.6			9.4	

<b>Segmental performance</b>							
<b>Application Services</b>							
Revenues (Rs mn)	6,691	8,096	8,402	3.8	25.6		
Segment profits (Rs mn)	2,225	2,721	2,795	2.7	25.6		
Segment profit margin (%)	33.3	33.6	33.3				
Offshore pricing (US\$/hr)	22.0	23.0	23.0	-	4.5		
<b>ITO</b>							
Revenues (Rs mn)	1,961	1,970	2,177	10.5	11.0		
Segment profits (Rs mn)	803	653	757	15.9	(5.7)		
Segment profit margin (%)	40.9	33.1	34.8				
Offshore pricing (US\$/hr)	21.0	18.0	18.0	-	(14.3)		
<b>BPO</b>							
Revenues (Rs mn)	1,832	1,849	1,625	(12.1)	(11.3)		
Segment profits (Rs mn)	383	332	210	(36.7)	(45.2)		
Segment profit margin (%)	20.9	18.0	12.9				
Offshore pricing (US\$/hr)	10.0	7.0	7.0	-	(30.0)		

Source: Company, Kotak Institutional Equities estimates

## Condensed consolidated financials for Mphasis, 2010-2012E, October fiscal year-ends (Rs mn)

	2010	2011E	2012E
<b>Profit model</b>			
Revenues	42,639	50,359	59,421
<b>EBITDA</b>	<b>11,274</b>	<b>12,296</b>	<b>12,984</b>
Depreciation (incl amortization of intangibles)	(2,022)	(1,817)	(2,168)
Other income	475	1,090	914
<b>Pretax profits</b>	<b>9,727</b>	<b>11,570</b>	<b>11,731</b>
Tax	(641)	(1,348)	(2,223)
<b>Profit after tax</b>	<b>9,086</b>	<b>10,222</b>	<b>9,508</b>
<b>Diluted earnings per share (Rs)</b>	<b>43.6</b>	<b>49.0</b>	<b>45.6</b>
<b>Balance sheet</b>			
Total equity	23,453	32,699	41,110
Total borrowings	33	—	—
Current liabilities	9,147	11,447	12,360
<b>Total liabilities and equity</b>	<b>32,634</b>	<b>44,146</b>	<b>53,470</b>
Cash and investments	9,398	12,780	17,680
Other current assets	16,305	21,224	24,697
Goodwill	2,946	3,643	3,643
Tangible fixed assets	3,291	5,805	6,756
Deferred tax assets	694	694	694
<b>Total assets</b>	<b>32,634</b>	<b>44,146</b>	<b>53,470</b>
<b>Free cash flow</b>			
Operating cash flow, excl. working capital	9,896	11,565	10,981
Working capital changes	816	(2,620)	(2,559)
Capital expenditure	(1,500)	(4,331)	(3,119)
Investment changes/acquisition)	(253)	(698)	—
<b>Free cash flow</b>	<b>8,959</b>	<b>3,917</b>	<b>5,302</b>
<b>Ratios (%)</b>			
EBITDA margin	26.4	24.4	21.9
EBIT margin	21.7	20.8	18.2

Note:

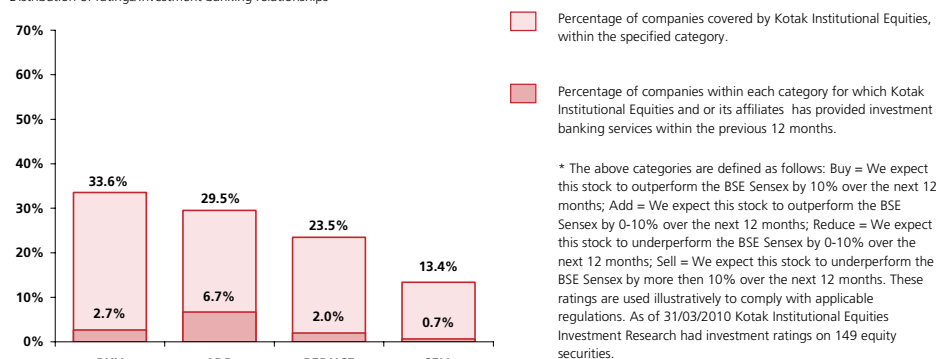
(1) FY2010 corresponds to fiscal year ending October 2009.

Source: Company, Kotak Institutional Equities estimates

"I, Kawaljeet Saluja, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

## Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2010

## Ratings and other definitions/identifiers

### Definitions of ratings

**BUY.** We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

### Other definitions

**Coverage view.** The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

### Other ratings/identifiers

**NR = Not Rated.** The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

**CS = Coverage Suspended.** Kotak Securities has suspended coverage of this company.

**NC = Not Covered.** Kotak Securities does not cover this company.

**RS = Rating Suspended.** Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.

**NA = Not Available or Not Applicable.** The information is not available for display or is not applicable.

**NM = Not Meaningful.** The information is not meaningful and is therefore excluded.

#### Corporate Office

Kotak Securities Ltd.  
Bakhtawar, 1st Floor  
229, Nariman Point  
Mumbai 400 021, India  
Tel: +91-22-6634-1100

#### Overseas Offices

Kotak Mahindra (UK) Ltd  
6th Floor, Portsoken House  
155-157 The Minories  
London EC 3N 1 LS  
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc  
50 Main Street, Suite No.310  
Westchester Financial Centre  
White Plains, New York 10606  
Tel: +1-914-997-6120

Copyright 2010 Kotak Institutional Equities (Kotak Securities Limited). All rights reserved.

1. Note that the research analysts contributing to this report may not be registered/qualified as research analysts with FINRA; and
2. Such research analysts may not be associated persons of Kotak Mahindra Inc and therefore, may not be subject to NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund. Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMLnc). However KMLnc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.