

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

FII's 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
Revenues (US\$ mn)	1,083	1,291	1,064	1,227	1.8	5.2
Revenues	50,359	59,421	49,688	56,434	1.3	5.3
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)
Net Profit	10,222	9,508	10,145	9,988	0.8	(4.8)
EPS (Rs/ share)	49.0	45.6	48.7	47.9	0.8	(4.8)
Margins (%)						
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	(0.4)	0.1

Source: Kotak Institutional Equities estimates

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

	2QFY10	1QFY11	2QFY11	qoq (%)	yoy (%)	2QFY11E	Deviation (%)
Revenues (US\$ mn)	212	249	263	5.8	24.1	262	0.6
Revenues	10,485	11,916	12,205	2.4	16.4	12,225	(0.2)
Cost of revenues	(7,074)	(8,209)	(8,443)	2.8	19.4	(8,506)	(0.7)
Gross profits	3,411	3,706	3,762	1.5	10.3	3,718	1.2
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)	-			-	
EBIT	2,266	2,678	2,748	2.6	21.3	2,667	3.1
Forex gain/(loss), net	124	240	157			205	
Other income/(loss)	20	81	117			126	
Interest income	9	9	1			-	
PBT	2,419	3,008	3,023	0.5	25.0	2,998	0.8
Provision for tax	(175)	(325)	(350)			(281)	24.4
PAT	2,245	2,683	2,673	(0.4)	19.1	2,716	(1.6)
Margins (%)							
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	
Segmental performance							
Application Services							
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		
ITO							
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)		
BPO							
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
Profit model			
Revenues	42,639	50,359	59,421
EBITDA	11,274	12,296	12,984
Depreciation (incl amortization of intangibles)	(2,022)	(1,817)	(2,168)
Other income	475	1,090	914
Pretax profits	9,727	11,570	11,731
Tax	(641)	(1,348)	(2,223)
Profit after tax	9,086	10,222	9,508
Diluted earnings per share (Rs)	43.6	49.0	45.6
Balance sheet			
Total equity	23,453	32,699	41,110
Total borrowings	33	—	—
Current liabilities	9,147	11,447	12,360
Total liabilities and equity	32,634	44,146	53,470
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
Total assets	32,634	44,146	53,470
Free cash flow			
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)	—
Free cash flow	8,959	3,917	5,302
Ratios (%)			
EBITDA margin	26.4	24.4	21.9
EBIT margin	21.7	20.8	18.2

Note:

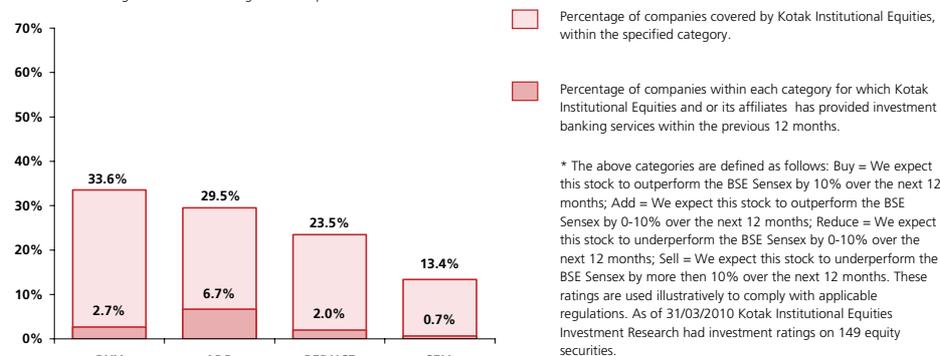
(1) FY2010 corresponds to fiscal year ending October 2009.

Source: Company, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of March 31, 2010

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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.

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

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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

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