

MindTree Ltd

Services business picking up; worries on product investment overdone. Initiate with a BUY

We are initiating coverage on MindTree with a Buy and a December '10 P/E-based price target of Rs 675/share, a 17% upside from the current level. MindTree remains one of the better managed companies in the Indian mid cap space, and will benefit from the uptick in technology spending in our view. We expect the IT services business to grow ahead of larger peers due to the low base, with steady margins. In terms of the concerns over product investments, we believe that one should view the investment as a write-off in the worst case – even assuming double the size of investment planned by the management, we estimate a per-share negative impact of just Rs 25/share (built into our target price). We would be buyers at current levels and would expect the stock to move up slowly as the services business surprises on the upside. Any revenues on the product business remain a further upside trigger in H2FY11.

IT services business remains on track: With the overall improvement in macro environment and recovery in technology spending, we expect a broad-based recovery across the Indian IT services space. MindTree reported a good Q4FY10 with a 5.7% dollar revenue growth and we expect the growth momentum to continue. With its smaller size and established client base, we expect MindTree to grow ahead of larger peers and estimate a 23%/18% dollar/rupee revenue CAGR over FY10-FY12.

Expected to maintain margins in IT services: Although margins were down in Q4FY10, we expect operational efficiencies to help the company maintain its margins in the IT services business. While overall margins would take a dip over the next couple of quarters due to investments being made in the product business, we expect margins to return to steady-state levels in H2FY11 and FY12. We estimate EBITDA margins of 13.4%/19.6% in FY11/FY12.

Smartphone investment a short term drag: MindTree has decided to invest US\$ 10mn–11mn over the next two quarters to develop a ready-to-brand 3G smartphone (android-based) and intellectual property in telecom. The move into the new business is going to depress margins in the subsequent two quarters. While we do agree that the commercial success of such a product is uncertain, we believe that the extent of investment is within reasonable limits to explore a new business proposition.

Valuations: We are positive on the core business and value MindTree on a 1-year forward P/E of 13x – a 35% discount to large cap players on our December '11 EPS. This translates to a fair value of Rs 700/share. We reduce US\$ 20mn (2x the value invested in the product business) from our implied market cap to arrive at our target price of Rs 675/share.

Financial highlights

| (Rs mn) | FY09 | FY10 | FY11E | FY12E |
|----------------|--------|--------|--------|--------|
| Revenue | 10,126 | 12,960 | 14,758 | 18,141 |
| Growth (%) | 36.9 | 28.0 | 13.9 | 22.9 |
| Adj net income | 300 | 2,149 | 1,119 | 2,248 |
| Growth (%) | -71.0 | 616.1 | -47.9 | 100.8 |
| EPS (Rs) | 7.9 | 55.1 | 28.7 | 56.2 |
| Growth (%) | -71.2 | 601.1 | -47.9 | 95.7 |

Profitability and return ratios

| (%) | FY09 | FY10 | FY11E | FY12E |
|----------------|------|------|-------|-------|
| EBITDA margin | 26.1 | 18.9 | 13.4 | 19.6 |
| EBIT margin | 21.5 | 13.9 | 8.7 | 15.1 |
| Adj PAT margin | 3.0 | 16.6 | 7.6 | 12.4 |
| ROE | 5.6 | 35.8 | 15.7 | 26.3 |
| ROIC | 34.9 | 34.4 | 17.8 | 30.7 |
| ROCE | 33.5 | 34.4 | 17.8 | 29.1 |

| CMP | TARGET | RATING | RISK |
|--------|--------|--------|------|
| Rs 575 | Rs 675 | BUY | HIGH |

| BSE | NSE | BLOOMBERG |
|--------|----------|-----------|
| 532819 | MINDTREE | MTCL IN |

Company data

| | |
|--------------------------------|--------------|
| Market cap (Rs mn / US\$ mn) | 23,132 / 520 |
| Outstanding equity shares (mn) | 40 |
| Free float (%) | 42.4 |
| Dividend yield (%) | 0.9 |
| 52-week high/low (Rs) | 747 / 305 |
| 2-month average daily volume | 281,037 |

Stock performance

| Returns (%) | CMP | 1-mth | 3-mth | 6-mth |
|-------------|--------|-------|-------|-------|
| MindTree | 575 | (2.2) | (0.1) | (2.7) |
| CNX IT | 5,984 | 2.2 | 7.0 | 18.5 |
| Sensex | 17,600 | 0.4 | 7.6 | 10.7 |

Valuation matrix

| (x) | FY09 | FY10 | FY11E | FY12E |
|-----------------|------|------|-------|-------|
| P/E @ CMP | 73.2 | 10.4 | 20.0 | 10.2 |
| P/E @ Target | 85.9 | 12.2 | 23.5 | 12.0 |
| EV/EBITDA @ CMP | 8.6 | 9.2 | 11.4 | 6.4 |

RCML vs consensus

| Parameter | FY11E | | FY12E | |
|---------------|--------|--------|--------|--------|
| | RCML | Cons | RCML | Cons |
| Sales (Rs mn) | 14,758 | 14,816 | 18,141 | 17,583 |
| EPS (Rs) | 28.7 | 44.9 | 56.2 | 53.7 |



Fig 1 - MindTree – Quarterly model

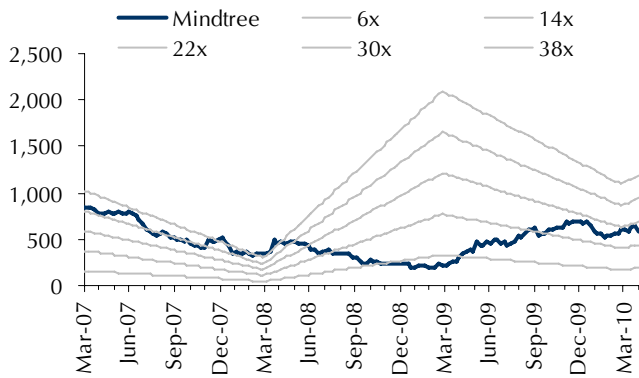
| (Rs in m , year-end Mar) | 2010 | | | | 2011E | | | | 2012E | | | | FY09 | FY10 | FY11E | FY12E | FY13E |
|------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|---------------|---------------|---------------|
| | Q1 | Q2 | Q3 | Q4 | Q1E | Q2E | Q3E | Q4E | Q1E | Q2E | Q3E | Q4E | | | | | |
| Revenue | 3,048 | 3,150 | 3,318 | 3,444 | 3,395 | 3,542 | 3,791 | 4,030 | 4,255 | 4,442 | 4,628 | 4,815 | 10,126 | 12,960 | 14,758 | 18,141 | 21,592 |
| Gross Profit | 953 | 1,121 | 1,138 | 1,113 | 738 | 793 | 1,165 | 1,281 | 1,345 | 1,412 | 1,472 | 1,532 | 3,963 | 4,326 | 3,977 | 5,762 | 6,822 |
| EBIT | 346 | 500 | 489 | 469 | 93 | 138 | 483 | 576 | 621 | 679 | 709 | 738 | 2,173 | 1,804 | 1,289 | 2,747 | 3,259 |
| EBITDA | 507 | 659 | 657 | 633 | 262 | 307 | 658 | 758 | 817 | 874 | 911 | 947 | 2,641 | 2,456 | 1,985 | 3,549 | 4,175 |
| Net Other Income | 308 | 38 | 202 | 195 | 9 | 9 | 6 | 4 | 6 | 12 | 18 | 26 | -1,847 | 743 | 28 | 62 | 184 |
| Pre Tax Profit | 654 | 537 | 691 | 664 | 101 | 147 | 488 | 580 | 627 | 692 | 726 | 764 | 325 | 2,547 | 1,317 | 2,809 | 3,443 |
| Net Profit | 567 | 499 | 538 | 544 | 86 | 125 | 415 | 493 | 502 | 553 | 581 | 611 | 300 | 2,149 | 1,119 | 2,248 | 2,754 |
| EPS (Rs.) | 14.6 | 12.8 | 13.8 | 14.0 | 2.2 | 3.2 | 10.7 | 12.7 | 12.6 | 13.8 | 14.5 | 15.3 | 7.9 | 55.1 | 28.7 | 56.2 | 67.2 |
| Margins (%) | | | | | | | | | | | | | | | | | |
| Gross Margin | 31.3 | 35.6 | 34.3 | 32.3 | 21.7 | 22.4 | 30.7 | 31.8 | 31.6 | 31.8 | 31.8 | 31.8 | 39.1 | 33.4 | 27.0 | 31.8 | 31.6 |
| Operating Margin | 11.3 | 15.9 | 14.7 | 13.6 | 2.7 | 3.9 | 12.7 | 14.3 | 14.6 | 15.3 | 15.3 | 15.3 | 21.5 | 13.9 | 8.7 | 15.1 | 15.1 |
| EBITDA Margin | 16.6 | 20.9 | 19.8 | 18.4 | 7.7 | 8.7 | 17.4 | 18.8 | 19.2 | 19.7 | 19.7 | 19.7 | 26.1 | 18.9 | 13.4 | 19.6 | 19.3 |
| Net Margin | 18.6 | 15.8 | 16.2 | 15.8 | 2.5 | 3.5 | 11.0 | 12.2 | 11.8 | 12.5 | 12.6 | 12.7 | 3.0 | 16.6 | 7.6 | 12.4 | 12.8 |
| Sequential Growth (%) | | | | | | | | | | | | | | | | | |
| Revenue | 17.1 | 3.3 | 5.4 | 3.8 | -1.4 | 4.3 | 7.0 | 6.3 | 5.6 | 4.4 | 4.2 | 4.0 | 36.9 | 28.0 | 13.9 | 22.9 | 19.0 |
| Gross Profit | 2.2 | 17.7 | 1.5 | -2.2 | -33.7 | 7.6 | 46.8 | 10.0 | 5.0 | 5.0 | 4.3 | 4.1 | 71.0 | 9.2 | -8.0 | 44.9 | 18.4 |
| EBIT | -29.4 | 44.5 | -2.1 | -4.2 | -80.3 | 49.3 | 249.4 | 19.4 | 7.9 | 9.3 | 4.3 | 4.1 | 142.0 | -17.0 | -28.5 | 113.0 | 18.6 |
| EBITDA | -19.3 | 30.1 | -0.3 | -3.7 | -58.6 | 17.4 | 114.2 | 15.2 | 7.8 | 7.1 | 4.2 | 4.0 | 110.6 | -7.0 | -19.2 | 78.8 | 17.6 |
| EPS | 966.5 | -12.1 | 7.9 | 1.1 | -84.2 | 45.2 | 232.1 | 18.8 | -0.8 | 10.2 | 5.0 | 5.3 | -71.2 | 601.1 | -47.9 | 95.7 | 19.6 |
| Y/Y Growth (%) | | | | | | | | | | | | | | | | | |
| Revenue | 37.2 | 23.7 | 20.4 | 32.3 | 11.4 | 12.5 | 14.2 | 17.0 | 25.3 | 25.4 | 22.1 | 19.5 | 36.9 | 28.0 | 13.9 | 22.9 | 19.0 |
| Gross Profit | 23.7 | 5.8 | -5.2 | 19.4 | -22.6 | -29.2 | 2.4 | 15.1 | 82.3 | 78.0 | 26.4 | 19.6 | 71.0 | 9.2 | -8.0 | 44.9 | 18.4 |
| EBIT | -4.0 | -16.4 | -32.5 | -4.3 | -73.2 | -72.4 | -1.4 | 22.9 | 571.8 | 391.7 | 46.8 | 28.1 | 142.0 | -17.0 | -28.5 | 113.0 | 18.6 |
| EBITDA | 9.5 | -7.1 | -21.8 | 0.7 | -48.4 | -53.4 | 0.2 | 19.8 | 212.2 | 184.6 | 38.4 | 25.0 | 110.6 | -7.0 | -19.2 | 78.8 | 17.6 |
| Net Profit | -537.7 | 35.8 | 5730.8 | 922.9 | -84.8 | -74.9 | -22.9 | -9.4 | 483.0 | 342.6 | 39.9 | 24.0 | -71.0 | 616.1 | -47.9 | 100.8 | 22.5 |
| EPS | -526.2 | 32.3 | 5579.6 | 922.9 | -84.8 | -74.9 | -22.9 | -9.4 | 468.4 | 331.5 | 36.4 | 20.9 | -71.2 | 601.1 | -47.9 | 95.7 | 19.6 |

Source: Company, RCML Research



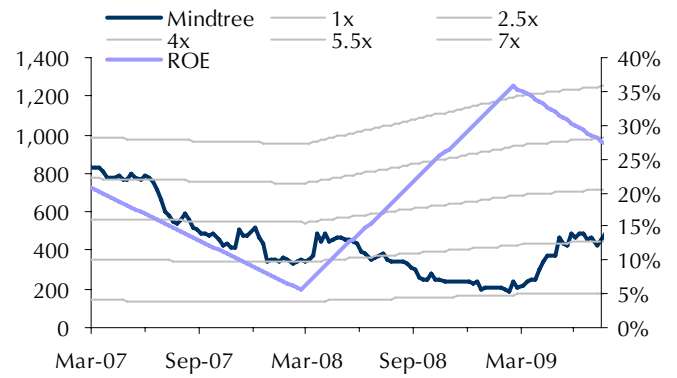
Band charts

Fig 2 - Mindtree – 12m Fwd P/E bands



Source: Company, RCML Research

Fig 3 - Mindtree – 12m Fwd P/B bands



Source: Company, RCML Research



Consolidated financials

Profit and Loss statement

| Y/E March (Rs mn) | FY10 | FY11E | FY12E | FY13E |
|--------------------------------|---------------|---------------|---------------|---------------|
| Revenues | 12,960 | 14,758 | 18,141 | 21,592 |
| Growth (%) | 28.0 | 13.9 | 22.9 | 19.0 |
| EBITDA | 2,456 | 1,985 | 3,549 | 4,175 |
| Growth (%) | (7.0) | (19.2) | 78.8 | 17.6 |
| Depreciation & amortisation | 652 | 695 | 802 | 916 |
| EBIT | 1,804 | 1,289 | 2,747 | 3,259 |
| Growth (%) | (17.0) | (28.5) | 113.0 | 18.6 |
| Interest | 738 | 28 | 62 | 184 |
| Other income | 5 | - | - | - |
| EBT | 2,547 | 1,317 | 2,809 | 3,443 |
| Income taxes | 398 | 198 | 562 | 689 |
| Effective tax rate (%) | 15.6 | 15.0 | 20.0 | 20.0 |
| Extraordinary items | - | - | - | - |
| Min into / inc from associates | - | - | - | - |
| Reported net income | 2,149 | 1,119 | 2,248 | 2,754 |
| Adjustments | - | - | - | - |
| Adjusted net income | 2,149 | 1,119 | 2,248 | 2,754 |
| Growth (%) | 616.1 | (47.9) | 100.8 | 22.5 |
| Shares outstanding (mn) | 39.0 | 39.0 | 40.0 | 41.0 |
| FDEPS (Rs) (adj) | 55.1 | 28.7 | 56.2 | 67.2 |
| Growth (%) | 601.1 | (47.9) | 95.7 | 19.6 |
| DPS (Rs) | 4.0 | 5.5 | 6.5 | 7.5 |

Cash flow statement

| Y/E March (Rs mn) | FY10 | FY11E | FY12E | FY13E |
|----------------------------|---------|---------|-------|-------|
| Net income + Depreciation | 2,800 | 1,815 | 3,050 | 3,671 |
| Non-cash adjustments | - | - | - | - |
| Changes in working capital | (1,322) | (522) | (525) | (601) |
| Cash flow from operations | 1,478 | 1,293 | 2,525 | 3,069 |
| Capital expenditure | (1,073) | (1,184) | (900) | (900) |
| Change in investments | 1,433 | - | - | - |
| Other investing cash flow | (10) | - | - | - |
| Cash flow from investing | 351 | (1,184) | (900) | (900) |
| Issue of equity | (563) | 2 | 2 | 2 |
| Issue/repay debt | (1,363) | - | - | - |
| Dividends paid | (182) | (251) | (304) | (360) |
| Other financing cash flow | - | - | - | - |
| Change in cash & cash eq | 46 | (140) | 1,323 | 1,812 |
| Closing cash & cash eq | 523 | 383 | 1,706 | 3,518 |

Economic Value Added (EVA) analysis

| Y/E March | FY10 | FY11E | FY12E | FY13E |
|--------------------------|-------|-------|-------|-------|
| WACC (%) | 13.7 | 13.7 | 13.7 | 13.7 |
| ROIC (%) | 34.4 | 17.8 | 30.7 | 32.4 |
| Invested capital (Rs mn) | 5,741 | 6,611 | 7,758 | 8,516 |
| EVA (Rs mn) | 1,189 | 273 | 1,320 | 1,591 |
| EVA spread (%) | 20.7 | 4.1 | 17.0 | 18.7 |

Balance sheet

| Y/E March (Rs mn) | FY10 | FY11E | FY12E | FY13E |
|---------------------------|--------------|---------------|---------------|---------------|
| Cash and cash eq | 523 | 383 | 1,706 | 3,518 |
| Accounts receivable | 2,370 | 2,773 | 3,313 | 3,945 |
| Inventories | - | - | - | - |
| Other current assets | 1,948 | 2,456 | 2,935 | 3,494 |
| Investments | 1,486 | 1,486 | 1,486 | 1,486 |
| Gross fixed assets | 5,145 | 5,945 | 6,845 | 7,745 |
| Net fixed assets | 2,859 | 3,348 | 3,445 | 3,429 |
| CWIP | - | - | - | - |
| Intangible assets | - | - | - | - |
| Deferred tax assets, net | - | - | - | - |
| Other assets | 154 | 154 | 154 | 154 |
| Total assets | 9,340 | 10,600 | 13,040 | 16,026 |
| Accounts payable | 2,114 | 2,503 | 2,997 | 3,587 |
| Other current liabilities | - | - | - | - |
| Provisions | - | - | - | - |
| Debt funds | 31 | 31 | 31 | 31 |
| Other liabilities | 490 | 490 | 490 | 490 |
| Equity capital | 395 | 397 | 399 | 401 |
| Reserves & surplus | 6,311 | 7,180 | 9,123 | 11,518 |
| Shareholder's funds | 6,706 | 7,577 | 9,522 | 11,919 |
| Total liabilities | 9,340 | 10,600 | 13,040 | 16,026 |
| BVPS (Rs) | 172.0 | 189.5 | 232.4 | 283.9 |

Financial ratios

| Y/E March | FY10 | FY11E | FY12E | FY13E |
|---|-------|--------|--------|--------|
| Profitability & Return ratios (%) | | | | |
| EBITDA margin | 18.9 | 13.4 | 19.6 | 19.3 |
| EBIT margin | 13.9 | 8.7 | 15.1 | 15.1 |
| Net profit margin | 16.6 | 7.6 | 12.4 | 12.8 |
| ROE | 35.8 | 15.7 | 26.3 | 25.7 |
| ROCE | 34.4 | 17.8 | 29.1 | 29.0 |
| Working Capital & Liquidity ratios | | | | |
| Receivables (days) | 66.7 | 68.6 | 66.7 | 66.7 |
| Inventory (days) | 0.0 | 0.0 | 0.0 | 0.0 |
| Payables (days) | 59.5 | 61.9 | 60.3 | 60.6 |
| Current ratio (x) | 2.3 | 2.2 | 2.7 | 3.1 |
| Quick ratio (x) | 1.4 | 1.3 | 1.7 | 2.1 |
| Turnover & Leverage ratios (x) | | | | |
| Gross asset turnover | 2.9 | 2.7 | 2.8 | 3.0 |
| Total asset turnover | 1.4 | 1.5 | 1.5 | 1.5 |
| Interest coverage ratio | (2.4) | (46.9) | (44.1) | (17.7) |
| Adjusted debt/equity | 0.0 | 0.0 | 0.0 | 0.0 |
| Valuation ratios (x) | | | | |
| EV/Sales | 1.7 | 1.5 | 1.2 | 1.0 |
| EV/EBITDA | 9.2 | 11.4 | 6.4 | 5.4 |
| P/E | 10.4 | 20.0 | 10.2 | 8.6 |
| P/BV | 3.3 | 3.0 | 2.5 | 2.0 |



Quarterly trend

| Particulars | Q2FY10 | Q3FY10 | Q4FY10 | Q1FY11E | Q2FY11E |
|------------------------|--------|---------|--------|---------|---------|
| Revenue (Rs mn) | 3,150 | 3,318 | 3,444 | 3,395 | 3,542 |
| YoY growth (%) | 23.7 | 20.4 | 32.3 | 11.4 | 12.5 |
| QoQ growth (%) | 3.3 | 5.4 | 3.8 | (1.4) | 4.3 |
| EBITDA (Rs mn) | 500 | 489 | 469 | 93 | 138 |
| EBITDA margin (%) | 15.9 | 14.7 | 13.6 | 2.7 | 3.9 |
| Adj net income (Rs mn) | 499 | 538 | 544 | 86 | 125 |
| YoY growth (%) | 35.8 | 5,730.8 | 922.9 | (84.8) | (74.9) |
| QoQ growth (%) | (12.1) | 7.9 | 1.1 | (84.2) | 45.2 |

DuPont analysis

| (%) | FY09 | FY10 | FY11E | FY12E | FY13E |
|----------------------------------|------------|-------------|-------------|-------------|-------------|
| Tax burden (Net income/PBT) | 92.2 | 84.4 | 85.0 | 80.0 | 80.0 |
| Interest burden (PBT/EBIT) | 15.0 | 141.2 | 102.1 | 102.3 | 105.6 |
| EBIT margin (EBIT/Revenues) | 21.5 | 13.9 | 8.7 | 15.1 | 15.1 |
| Asset turnover (Revenues/Avg TA) | 1.2 | 1.4 | 1.5 | 1.5 | 1.5 |
| Leverage (Avg TA/Avg equity) | 1.6 | 1.6 | 1.4 | 1.4 | 1.4 |
| Return on equity | 5.6 | 35.8 | 15.7 | 26.3 | 25.7 |

Company profile

Mindtree is an international IT company. The company delivers business and technology solutions through global software development. Mindtree develops applications to help companies enhance their enterprise operations. The company also delivers product-development services and designs reusable building blocks for high-tech companies.

Shareholding pattern

| (%) | Sep-09 | Dec-09 | Mar-10 |
|-------------|--------|--------|--------|
| Promoters | 33.1 | 32.7 | 32.5 |
| FIs | 14.5 | 18.5 | 15.8 |
| Banks & FIs | 11.5 | 12.9 | 13.0 |
| Public | 40.9 | 35.9 | 38.8 |

Recommendation history

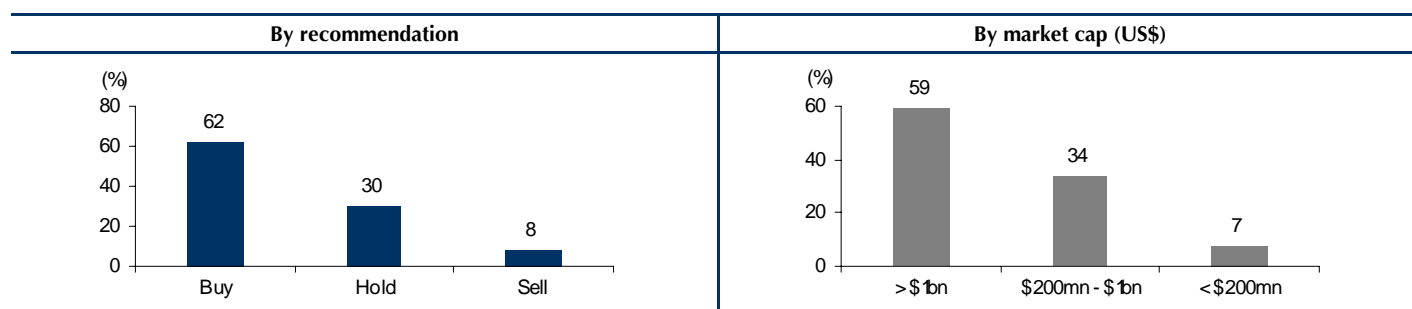
| Date | Event | Reco price | Tgt price | Reco |
|-----------|------------|------------|-----------|------|
| 30-Apr-10 | Initiation | 575 | 675 | BUY |

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.

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