

FEBRUARY 26, 2010

UPDATE

Coverage view: **Attractive**

Price (Rs): **663**

Target price (Rs): **570**

BSE-30: **16,430**

**Quarterly net profit may have peaked; reiterate REDUCE.** Mphasis' 1QFY11 (year-end Oct '10) bore testimony to the high risk to the company's earnings from a sharp and sudden change in pricing of the HP channel revenue base. Strong volume growth made up for the sharp drop in ITO/BPO pricing in the Jan 2010 quarter, nevertheless, the company's performance will always run the risk of sharp deterioration in any quarter if volume or pricing from the HP channel drops. The stock appears expensive against this backdrop; we reiterate our REDUCE rating. Lower disclosures do not help.

#### Company data and valuation summary

Mphasis BFL

##### Stock data

52-week range (Rs) (high,low) 797-158

Market Cap. (Rs bn) 138.2

##### Shareholding pattern (%)

Promoters 60.6

FIs 17.2

MFs 6.1

##### Price performance (%)

Absolute (2.2) (1.4) 286.4

Rel. to BSE-30 (0.1) 1.1 110.6

##### Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	43.6	48.7	47.9
EPS growth (%)	207.5	11.7	(1.5)
P/E (X)	15.2	13.6	13.8
Sales (Rs bn)	42.6	49.7	56.4
Net profits (Rs bn)	9.1	10.1	10.0
EBITDA (Rs bn)	11.3	12.3	13.4
EV/EBITDA (X)	12.1	10.7	9.3
ROE (%)	48.1	36.2	26.9
Div. Yield (%)	0.5	0.6	0.7

#### 1QFY11 underlying operating performance highlights the risk inherent in the earnings profile

Seemingly robust reported headline revenues/EBITDA/PAT for 1QFY11 (quarter ending Jan 2010) were driven by (1) large forex gains (both in the revenue as well as other income line), and (2) sharp 22% qoq decline in G&A expenses. A close look at the underlying operating performance validates our concerns on the risks inherent in Mphasis' 'essentially captive' business model. The company saw a sharp decline in revenue and profitability in two of its three business segments—ITO (revenues down 8% qoq, and segment profits down 21% qoq) and BPO (revenues down 5% qoq, and segment profits down 29% qoq). Deterioration in the performance of these two segments was driven by a sharp decline in pricing from the HP channel (ITO offshore rates down to US\$18/hr from 22 in 4QFY10; BPO rates down to US\$7/hr from 8 in 4QFY10). We do not rule out a pricing correction in the Applications services business (68% of revenues) as well.

#### Little headroom on operating levers – margins face cost challenges as well

In addition to the potential margin risk from any further pricing decline, we believe the company could face cost pressures on account of potential wage inflation and increasing attrition in the coming quarters. Attrition has increased across the industry over the past two quarters, and we expect higher pressure on the mid-size companies in the coming quarters. Mphasis' margin challenges are compounded by its already-well-optimized cost levers – (1) utilization rates across segments are at optimal levels, (2) SG&A expenses at 8.6% of revenues are the lowest in the industry and even lower than some of the captive centers in the country, and (3) offshore proportion of revenues (70%) is difficult to improve upon. We also highlight that Mphasis' reported EBITDA margins for 1QFY11 (26.3%) were aided by forex gains in the revenue line, which may not recur in the coming quarters.

#### Revise estimates; retain REDUCE

We raise our FY2011E and FY2012E EPS estimates for MPHL to Rs48.7 and Rs47.9 from Rs47.6 and Rs47.3 earlier, to factor in better-than-expected 1QFY11 earnings report. We retain our REDUCE rating on the stock with an unchanged target price of Rs570/share (12X FY2012E EPS).

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## Key changes to FY2011-12E estimates

Rs mn	New		Old		Change (%)	
	FY2011E	FY2012E	FY2011E	FY2012E	FY2011E	FY2012E
<b>Revenues (US\$ mn)</b>	<b>1,064</b>	<b>1,227</b>	<b>1,038</b>	<b>1,196</b>	<b>2.5</b>	<b>2.6</b>
<b>Revenues</b>	<b>49,688</b>	<b>56,434</b>	<b>48,805</b>	<b>54,980</b>	<b>1.8</b>	<b>2.6</b>
EBITDA	12,262	13,382	12,243	13,277	0.2	0.8
Depreciation	(1,874)	(2,192)	(1,963)	(2,271)	(4.5)	(3.5)
EBIT	10,388	11,190	10,280	11,006	1.0	1.7
<b>Net Profit</b>	<b>10,145</b>	<b>9,988</b>	<b>9,926</b>	<b>9,851</b>	<b>2.2</b>	<b>1.4</b>
<b>EPS (Rs/ share)</b>	<b>48.7</b>	<b>47.9</b>	<b>47.6</b>	<b>47.3</b>	<b>2.2</b>	<b>1.4</b>
<b>Margins (%)</b>						
EBITDA	24.7	23.7	25.1	24.1		
EBIT	20.9	19.8	21.1	20.0		
Re/US\$ rate	46.7	46.0	47.0	46.0	<b>(0.7)</b>	<b>0.1</b>

Source: Kotak Institutional Equities estimates

## Mphasis consolidated quarterly performance - 1QFY11, fiscal year-ends October (Rs mn)

	1QFY10	4QFY10	1QFY11	qoq (%)	yoy (%)	1QFY11E	Deviation (%)
<b>Revenues</b>	<b>9,777</b>	<b>11,322</b>	<b>11,916</b>	<b>5.2</b>	<b>21.9</b>	<b>11,505</b>	<b>3.6</b>
Cost of revenues	(6,579)	(7,672)	(8,209)	7.0	24.8	(7,859)	4.5
<b>Gross profits</b>	<b>3,198</b>	<b>3,650</b>	<b>3,706</b>	<b>1.5</b>	<b>15.9</b>	<b>3,646</b>	<b>1.6</b>
S&M expenses	(419)	(438)	(451)	2.9	7.6	(440)	2.5
G&A expenses	(673)	(737)	(575)	(22.0)	(14.6)	(753)	(23.7)
Provision for doubtful debts	—	—	(3)			—	
<b>EBIT</b>	<b>2,106</b>	<b>2,475</b>	<b>2,678</b>	<b>8.2</b>	<b>27.2</b>	<b>2,453</b>	<b>9.2</b>
Forex gain/(loss), net	31	153	240			305	
Other income/(loss)	16	72	81			97	
Interest income	18	1	9			-	
<b>PBT</b>	<b>2,170</b>	<b>2,701</b>	<b>3,008</b>	<b>11.3</b>	<b>38.6</b>	<b>2,855</b>	<b>5.4</b>
Provision for tax	(70)	(251)	(325)			(247)	31.5
<b>PAT</b>	<b>2,100</b>	<b>2,450</b>	<b>2,683</b>	<b>9.5</b>	<b>27.7</b>	<b>2,608</b>	<b>2.9</b>
<b>Margins (%)</b>							
Gross margin	32.7	32.2	31.1			31.7	
EBITDA margin	26.5	26.0	26.4			25.4	
EBIT margin	21.5	21.9	22.5			21.3	
PAT margin	21.5	21.6	22.5			22.7	
SG&A expenses (% of revenues)	11.2	10.4	8.6			10.4	
Tax rate (as % of PBT)	3.2	9.3	10.8			8.7	

## Segmental performance

## Application Services

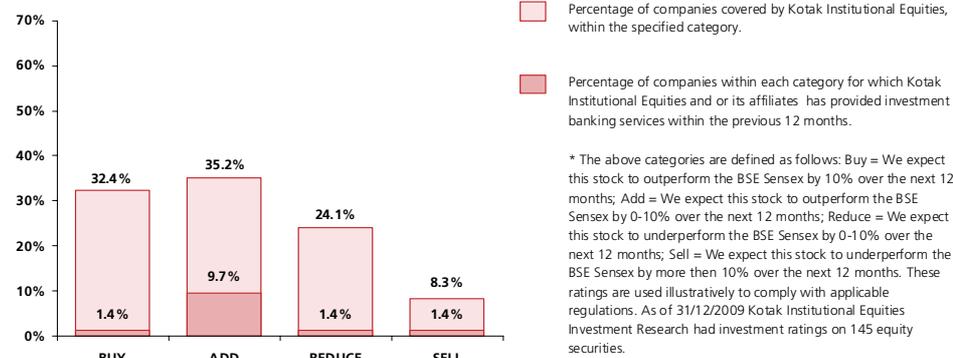
Revenues (Rs mn)	6,361	7,234	8,096	11.9	27.3		
Segment profits (Rs mn)	2,163	2,362	2,721	15.2	25.8		
Segment profit margin (%)	34.0	32.7	33.6				
Offshore pricing (US\$/hr)	22.0	22.0	23.0	4.5	4.5		
<b>ITO</b>							
Revenues (Rs mn)	1,650	2,139	1,970	<b>(7.9)</b>	19.4		
Segment profits (Rs mn)	635	822	653	<b>(20.6)</b>	2.8		
Segment profit margin (%)	38.5	38.4	33.1				
Offshore pricing (US\$/hr)	21.0	22.0	18.0	<b>(18.2)</b>	(14.3)		
<b>BPO</b>							
Revenues (Rs mn)	1,765	1,949	1,849	<b>(5.1)</b>	4.8		
Segment profits (Rs mn)	399	466	332	<b>(28.8)</b>	(16.8)		
Segment profit margin (%)	22.6	23.9	18.0				
Offshore pricing (US\$/hr)	10.0	8.0	7.0	<b>(12.5)</b>	(30.0)		

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of December 31, 2009

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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.

**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.

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