Company report

Telecoms, Media & Technology
IT Services
Equity – India

HSBC Global Research

MindTree (MTCL)

Initiate OW(V): Well positioned for a cyclical recovery

- **Key attributes: high exposure to cyclical segments, strong client base and experienced management**
- **Forecast robust revenue and EBITDA CAGR of c20% over FY10-12e vs 13% for peer group**
- **Attractive valuation: we initiate with Overweight (V), TP of INR750 at a PE of 14x FY11e EPS**

Revenue drivers. We like Mindtree due to its favourable positioning in high growth segments such as the R&D offshore market (45% of company revenues) and cyclical IT services market (c49% from Application Development). With its strong client references, experienced workforce and robust service mix, MindTree is well positioned to gain market share in these markets and outperform its peers.

Growth opportunity. 1) We estimate the R&D offshore market will grow at a strong 23% CAGR from 2009-12, due to increase in R&D offshoring and growing preference for third-party vendors over 'captives'. 2) The IT services market is likely to pick up in 2010 and cyclical services should lead this recovery: MindTree has high exposure to high-end cyclical services and is likely to benefit most among mid-tier peers.

EBITDA margin cushion is noteworthy. We expect utilisation to be c69% in FY11 (+5% y-o-y), which provides EBITDA margin cushion of c320bps and offsets margin pressures due to potential wage increments in 2010.

Initiate at OW(V). We value MindTree at a PE of 14x our FY11e EPS, at a 10% discount to DCF and c35% discount to Infosys (in line with the historic range). Our target price is INR750 (27.5% return). Our FY11e EPS is in line with consensus and we expect stock outperformance driven by earnings growth-led re-rating of the stock. Risks: forex fluctuation (INR/USD) is the biggest risk to our estimates.

MindTree: Key financials

	Revenues (USDm)	y-o-y	Revenues (INRm)	EBITDA margin	Net margin	EPS (INR)	P/E
FY10e	271	0.7%	12,980	18.6%	15.0%	48.2	12.2x
FY11e	326	20.2%	15,300	19.2%	14.0%	53.4	11.0x
FY12e	391	20.2%	18,398	19.2%	12.7%	58.2	10.1x

Source: Company reports, HSBC estimates

Index^	BOMBAY SE IDX
Index level	15,405
RIC	MINT.BO
Bloomberg	MTCL IN

Source: HSBC

Enterprise value (INRm)	21,719
Free float (%)	67
Market cap (USDm)	489
Market cap (INRm)	23,165

Source: HSBC

Overweight (V)

Target price (INR)	750.00
Share price (INR)	588.30
Potential total return (%)	27.5

Mar	2009a	2010e	2011e
HSBC EPS	14.04	48.23	53.40
HSBC PE	41.9	12.2	11.0

Performance	1M	3M	12M
Absolute (%)	-4.2	29.3	120.3
Relative^ (%)	6.5	33.6	47.8

Note: (V) = volatile (please see disclosure appendix)

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Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	12,375	12,980	15,300	18,398
EBITDA	3,309	2,412	2,935	3,528
Depreciation & amortisation	-570	-626	-664	-828
Operating profit/EBIT	2,740	1,786	2,270	2,700
Net interest	-162	-27	-3	-2
PBT	603	2,226	2,559	3,003
HSBC PBT	603	2,226	2,559	3,003
Taxation	-67	-285	-409	-661
Net profit	536	1,941	2,149	2,343
HSBC net profit	536	1,941	2,149	2,343
Cash flow summary (INRm)				
Cash flow from operations	1,797	2,240	2,722	3,035
Capex	-435	-250	-536	-644
Cash flow from investment	-2,224	-58	-536	-644
Dividends	0	0	0	0
Change in net debt	522	-1,856	-2,184	-2,389
FCF equity	1,691	957	1,483	1,422
Balance sheet summary (INRm)				
Intangible fixed assets	1,460	0	0	0
Tangible fixed assets	2,962	2,829	2,700	2,516
Current assets	4,691	5,420	8,113	11,138
Cash & others	488	968	3,152	5,541
Total assets	10,316	8,934	11,498	14,340
Operating liabilities	3,100	2,521	2,937	3,435
Gross debt	1,376	0	0	0
Net debt	888	-968	-3,152	-5,541
Shareholders funds	5,513	6,413	8,562	10,904
Invested capital	5,525	4,759	4,725	4,679

Ratio, growth and per share analysis

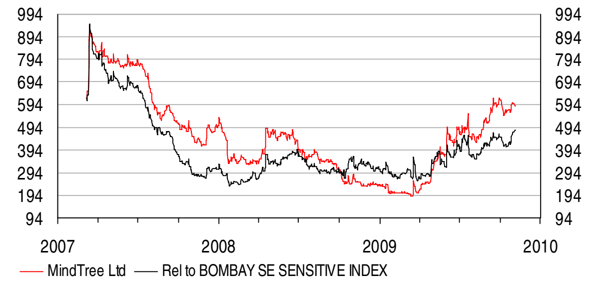
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	67.3	4.9	17.9	20.2
EBITDA	163.9	-27.1	21.7	20.2
Operating profit	205.2	-34.8	27.1	18.9
PBT	-46.1	269.0	14.9	17.4
HSBC EPS	-47.0	243.5	10.7	9.0
Ratios (%)				
Revenue/IC (x)	2.5	2.5	3.2	3.9
ROIC	50.0	30.3	40.2	44.8
ROE	9.9	32.6	28.7	24.1
ROA	7.6	20.4	21.1	18.1
EBITDA margin	26.7	18.6	19.2	19.2
Operating profit margin	22.1	13.8	14.8	14.7
EBITDA/net interest (x)	20.4	90.8	1068.0	1444.5
Net debt/equity	15.2	-15.1	-36.8	-50.8
Net debt/EBITDA (x)	0.3	-0.4	-1.1	-1.6
Per share data (INR)				
EPS reported (fully diluted)	14.04	48.23	53.40	58.20
HSBC EPS (fully diluted)	14.04	48.23	53.40	58.20
DPS	0.00	0.00	0.00	0.00
Book value	145.90	163.88	218.80	278.67

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	1.9	1.7	1.3	0.9
EV/EBITDA	7.0	9.0	6.7	4.9
EV/IC	4.2	4.6	4.1	3.7
PE*	41.9	12.2	11.0	10.1
P/Book value	4.0	3.6	2.7	2.1
FCF yield (%)	7.6	4.2	6.5	6.3
Dividend yield (%)	0.0	0.0	0.0	0.0

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 03 Nov 2009

HSBC

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Investment summary

- Key attributes: high exposure to cyclical segments, strong client base and experienced management
- Well positioned to leverage structural growth in the R&D offshore market and cyclical recovery in the IT services market
- Forecast robust revenue and EBITDA CAGR of c20% over FY10-12e vs 13% for peer group. Initiate coverage with Overweight (V) rating (27.5% potential total return). Currency fluctuation a key risk

MindTree derives around two-thirds of its revenue from cyclical services and was hit hard by macro weakness in the last few quarters. On a revenue base of cUSD270m in FY10e (2.6% y-o-y decline organic), we expect a strong bounce, with USD-based revenue growth of c20% CAGR in FY10-12. The growth should be led by 1) R&D offshore services (45% of revenue in 2QFY10), and 2) a strong pick-up in cyclical services, which should lead the broader IT services market recovery.

Business opportunity

- **R&D offshore market in India** (USD9.4bn in 2008) – this is expected to grow at a strong 23% CAGR in 2009-12, led by stable global R&D spend, greater 'offshoring' of R&D services and increasing preference of third-party vendors over 'captives' (clients' offshore centres). R&D offshoring is currently c2% of the total market of USD530bn. We expect this to grow as clients continue to offshore, driven by cost-arbitrage and higher flexibility offered by offshore vendors. Additionally, growing technical and domain expertise of Indian engineers and long-standing customer relationships between clients and Indian vendors should drive client confidence, enabling further offshoring.
- **IT services market in India** should record c12% revenue CAGR 2009-20e, in our view, post an era of strong c30% CAGR over 2000-08. Post a weak FY10 (down 0-5% y-o-y), we expect demand to recover robustly in FY11 for the sector. With growth in IT budgets, new projects and IT initiatives by clients should trigger strong growth in cyclical services (such as consulting, system integration, application development), which were laggards in the downturn.

Multiple growth drivers for MindTree

MindTree, due to its impressive client references (such as MSFT, Oracle, TI, HP, to name a few), experienced workforce and robust R&D and IT service blend is well positioned to leverage these markets. Noteworthy attributes of MindTree are:

- MindTree's high exposure to cyclical services (c2/3rd of the total revenue), particularly at this point of the business cycle. After a weak FY10, cyclical services such as application development should grow faster than the recurring maintenance revenues.

- MindTree has an impressive client base, which we believe is critical in IT services. Client references are key differentiators for any vendor when bidding for new deals. Additionally, the company has minimum client concentration risk compared to its mid-tier peers, with the top10 clients contributing c40% to revenue in 2Q10.
- Top management includes industry veterans (like Ashok Soota and Krishna Kumar), who have industry experience and long-standing relationships with clients. The average employee experience in MindTree is c5 years; it is c3 years for larger peers such as Infosys.
- High exposure to software product development (SPD is c70% of total R&D exposure), which in our view is an advantage. Compared to other R&D segments such as engineering services, SPD is resilient to macro weakness and should continue to grow strongly.
- Progressive improvement in EBITDA margin: EBITDA margin declined c14% sequentially in the last six months due to volume decline and project overruns. In our view, margin could potentially improve by c320bps in FY11 due to improving utilisation, which is close to historic lows. We expect utilisation of c69% (average) in FY11 vs. c64% in FY10.

Valuation and risks

We value the stock at a PE of 14x our FY11e EPS, at a c35% discount to Infosys (in line with the historic range). Investors, in our view, are still discounting the guidance cut (by the company in 1Q) in the current valuation. Guidance cut was driven by one-off events, which we believe are unlikely to recur. We believe, as the company executes well in the coming quarters, the stock should witness re-rating.

On our target price of INR750, we see total upside of 27.5% from the current market price. The target multiple is at a 10% discount to DCF, which we use as a valuation cross-check. We expect the discount to go down further as the company diversifies into annuity services, resulting in reduced volatility in the top line.

- Forex fluctuation (INR/USD) is the biggest risk to our estimates. We have assumed INR47/USD in our forecasts, but every 1% appreciation from these levels could knock 4-5% off EBITDA. The impact on EPS should be limited due to outstanding hedges of cUSD185m. These hedges cover c35% of our estimated revenue in the next eight quarters.
- Weaker-than-estimated recovery in IT spending is a risk to our volume growth and margin assumptions. Continued vendor consolidation in the IT services industry could result in loss of clients to larger peers.

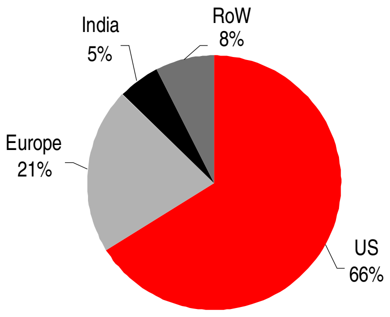
MindTree: Peer valuation comparison

	Price	Mcap	Mcap	EV/Sales			EV/EBIT			P/E			CAGR 10-12E		EBIT Margin		
		(USDm)	(INRm)	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12	Sales	EPS	FY10	FY11	FY12
MINDTREE LTD.	589	493	23,173	1.7x	1.5x	1.2x	12.4x	9.8x	8.2x	12.2x	11.0x	10.1x	19.1%	9.9%	13.8%	14.8%	14.7%
HEXAWARE.	70	214	10,063	0.9x	0.9x	0.8x	6.0x	6.7x	6.3x	8.0x	7.7x	6.6x	6.3%	10.0%	15.8%	13.5%	13.4%
INFOTECH ENTS.	226	266	12,499	1.3x	1.2x	1.0x	8.0x	7.5x	6.4x	8.8x	8.5x	7.6x	14.4%	7.2%	16.6%	15.6%	15.9%
POLARIS	144	302	14,181	1.1x	1.0x	NA	8.7x	6.3x	NA	9.8x	8.1x	NA	2.8%	16.0%	12.1%	15.4%	NA
PATNI.	436	493	23,173	0.7x	0.7x	NA	4.7x	4.4x	4.2x	13.1x	11.8x	11.7x	6.5%	-2.4%	15.7%	15.9%	NA
ROLTA	150	514	24,161	1.5x	1.4x	1.0x	7.8x	6.3x	5.1x	9.4x	7.9x	6.4x	27.1%	21.0%	19.7%	21.9%	18.7%

Source: MT is HSBC estimates, others are consensus from Datastream, Polaris sales & EPS CAGR is FY09-11e. Hexaware year end is Dec end. Prices as on November 3, 2009.

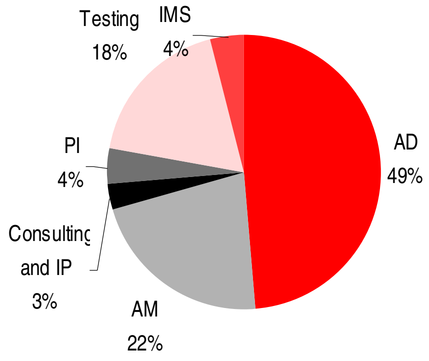
MindTree at a glance

Geographic revenue mix (2Q10 - Consolidated)



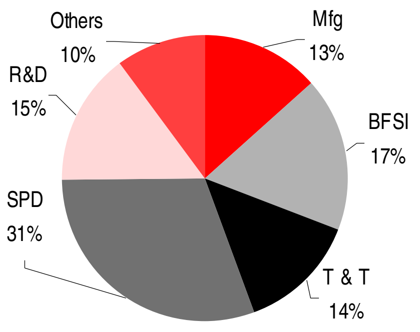
Source: MindTree

Services revenue mix (2Q10 - Consolidated)



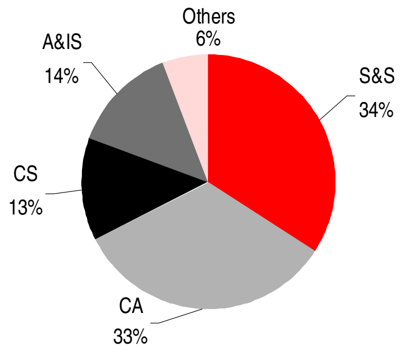
AM = Application maintenance, AD= Application Development, PI = Package Implementation, IT= Independent Testing, C &IP = Consulting & IP licensing
Source: MindTree

Vertical revenue mix (2Q10 - Consolidated)



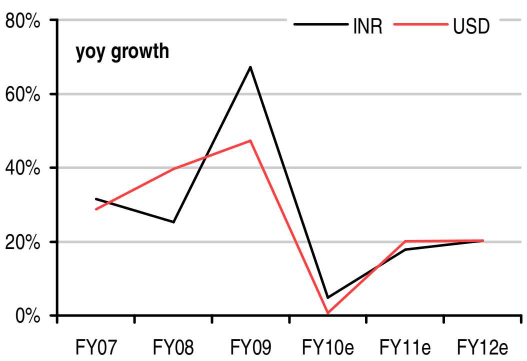
R& D = R&D services, SPD= Software Product Development, T&T = Travel and Transportation, Mfg= Manufacturing; BFSI – Banking and Financial Services and Insurance
Source: MindTree

R&D revenue mix (FY09 - Standalone)



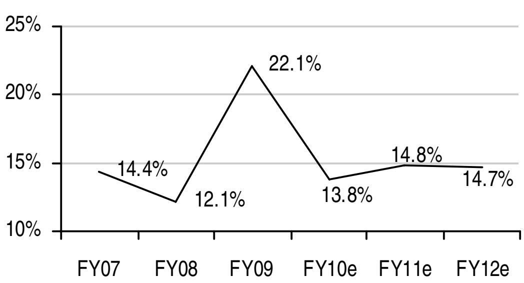
S&S - Storage and Servers; CA - Consumer Appliances; CS - Communication Systems; A& IS - Automotive & Industrial Systems
Source: MindTree

Revenue growth trends (annual)



Source: MindTree, HSBC estimates; FY09 includes the Aztecsoft acquisition

EBIT margin trends



Source: MindTree, HSBC estimates

Focus on growth markets

- R&D offshore market to grow to USD17.5bn by 2012e (2009-12e CAGR: 23%) as R&D spending stabilises and offshoring increases
- Third-party vendors like MindTree to get share from 'captives' too
- Cyclical IT services to bounce back strongly from FY11 as IT spending recovers on a weak FY10 base

Indian IT services market

The Indian IT sector has grown at c30% CAGR 2000-08, led by strong traction in services such as application development and maintenance. Currently, Indian vendors have 41% and 18% market shares in these two services globally. We believe growth should moderate in these mature segments, and increase in new services such as infrastructure management services (IMS), system integration (SI) and package implementation (PI). We expect Indian IT services exports to grow at a c12% CAGR 2009-20, led by these new services.

FY11 outlook for IT services

Over the last few quarters, there were steeper cuts in discretionary components of IT spending compared to recurring services such as application maintenance (AM). Discretionary services, such as consulting, PI and SI are linked to new initiatives and projects and have been deferred in the last few months by the clients. On the other hand, recurring services are run-the-business services, and are relatively resilient to any economic weakness and corresponding IT budget cuts by the clients. Moreover, run-the-business services are typically long-term annuity contracts and provide high visibility to vendors' top lines.

As the business cycle turns and IT spending recovers – presumably in 2010 - we expect a reversal of this trend, wherein cyclical components will grow faster. Recurring services will remain stable in our view, and recover at a slower rate than discretionary components.

We therefore prefer companies that have higher exposure to cyclical services at this point of the business cycle. MindTree gets c2/3rd of its revenue from these discretionary services and is therefore expected to enjoy more robust growth in FY11.

Key lead indicators stabilising

We expect IT demand to improve in 2010 based on our analysis of key indicators such as staffing demand, sub-contracting rates, and enterprise hardware and software spending.

IT staffing and sub-contracting rates in developed markets are improving

We believe local IT staffing demand and sub-contracting rates are key indicators of overall spending in IT services. Based on data provided by major staffing agencies (such as Monster.com, Robert Half, and TechServe Alliance), we perceive IT sector staffing demand has bottomed out and is now improving gradually.

Market size of Indian IT services

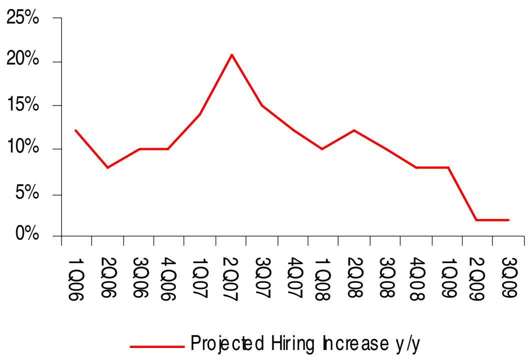
	Total market 2009* (USDbn) - Globally	Total market 2020e	CAGR FY09-20e Total market	Indian exports (FY09)**	Market share (penetration %)	Indian exports (FY19)e	CAGR FY09-20e Indian exports	Indian market share in 2020e
Application Development	28.0	45.6	5.0%	11.4	40.9%	29.7	10%	65.1%
Application Maintenance	27.3	44.5	5.0%	5.1	18.5%	13.1	10%	29.5%
Consulting and SI/PI	159.4	236.0	4.0%	5.8	3.6%	23.4	15%	9.9%
Infrastructure Mgmt Services (IMS)	174.1	283.6	5.0%	6.7	3.9%	27.1	15%	9.6%
Support and Training	157.2	256.1	5.0%	2.2	1.4%	3.6	5%	1.4%
Total IT Services	546.1	865.8	4.7%	31.2	5.7%	96.9	12%	11.2%

*assuming 5% growth in 2008 and 2009 on the 2007 data provided by IDC; **assuming 10% growth for the sector in FY09
Source: IDC, HSBC estimates

Hardware and software spending seems to be bottoming out

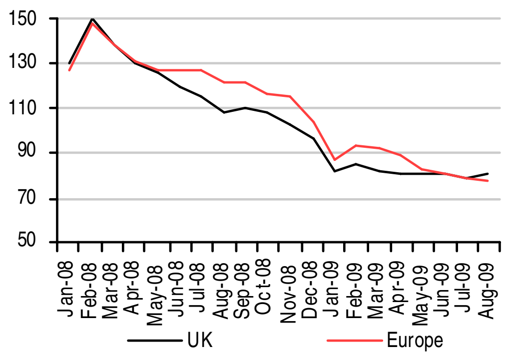
- SAP license sales are expected to grow by c6.5% in 2010 (according to Vara Research) after c28% decline in 2009. Recent quarterly performance of SAP was decent as well. Excluding one-offs and currency impact, license revenues were up 0-3% q-o-q, which we believe is encouraging. While SAP has revised downwards its guidance for 4Q, SAP license revenues are still expected to grow 65-98% q-o-q in constant currency, which is better than historic averages. Furthermore, c25% of new deals this quarter were mega deals.
- 2010 looks promising: SAP license revenues are highly correlated to manufacturing sector growth in the developed markets. ISM and PMI manufacturing indices, which are lead indicators of manufacturing activity, are all trending upwards and we extrapolate these trends positively for SAP license sales in the coming quarters. Upgrades will also kick in from 2H10, as c3,000 SAP customers are still running a two decade old SAP version, and higher maintenance costs and increase in IT budgets would trigger upgrades.
- HP expects a major hardware upgrade cycle in 2010, led by its ageing existing hardware (the last upgrade cycle was in 2004-05). Hardware sales (servers, storage and networking equipment) have been under stress over the last few quarters. While the decline is bottoming y-o-y, we see signs of stability on a q-o-q basis, and expect recovery in 2010.

US hiring outlook



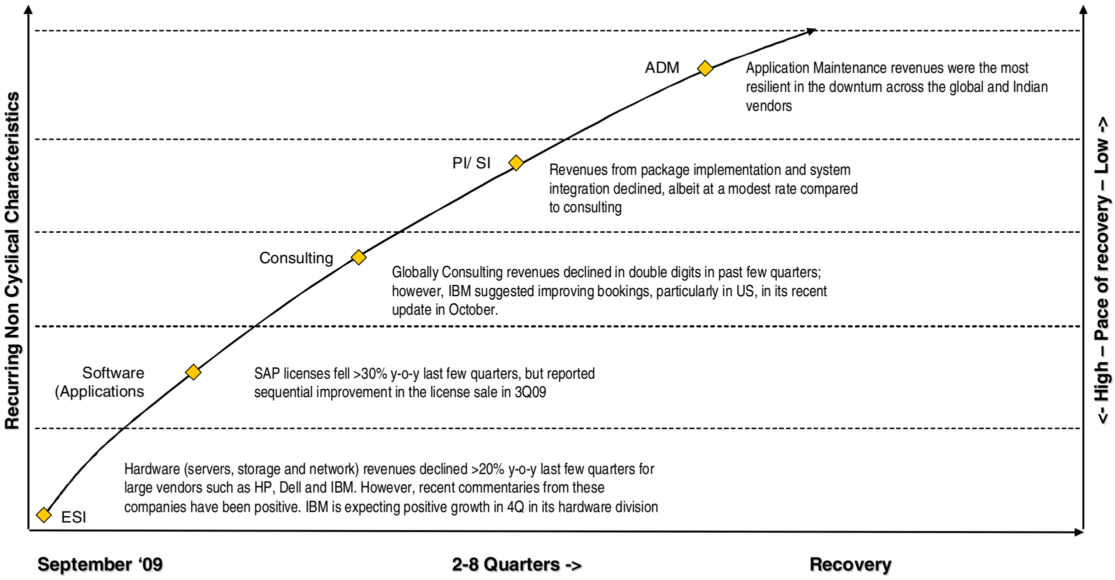
Note: The IT Hiring Index and Skills Report is based on telephone interviews with more than 1,400 CIOs from companies across the United States with 100 or more employees.
Source: Robert Half Technology

Hiring trends in Europe



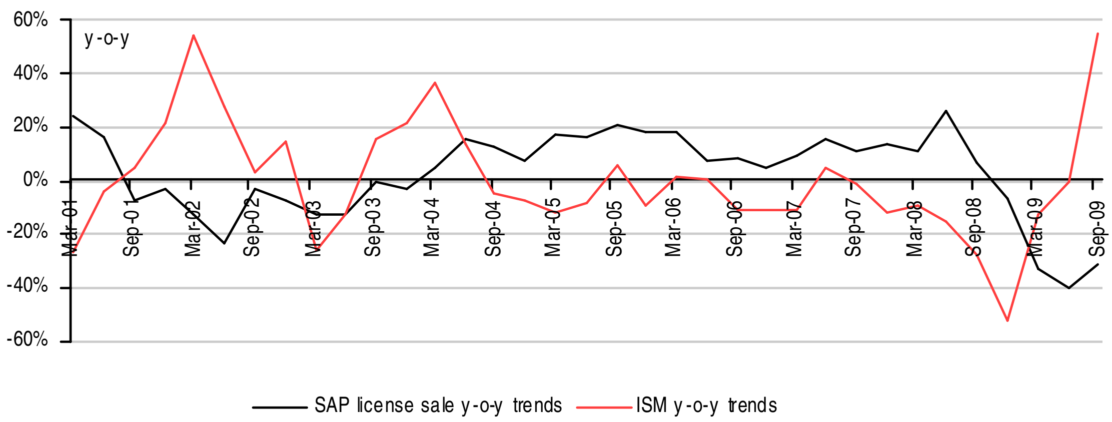
Source: Monster, HSBC

Business cycle – Hardware is the most discretionary component of IT spending, followed by software, and was consequently the most hit in the recent downturn. Among IT services, consulting, system integration and package implementation are relatively discretionary and cyclical. Not surprisingly, these services declined more than the run-the-business services such as application maintenance. As the business cycle turns, presumably in 2010, and IT budgets grow, we expect the cyclical services to bounce back strongly and outgrow the defensive run-the-business services



Source: HSBC

SAP application license sale relationship with ISM data in the US is noteworthy



Source: HSBC

- IBM's hardware sales decline also moderated in 3Q09, with IBM expecting positive growth in 4Q. The banking, financial services and insurance (BFSI) sector led the recovery with 3.3% growth, while the US market was flat overall.

Hardware sales trends improving sequentially

	3Q08	4Q08	1Q09	2Q09
y-o-y				
IBM hardware	-9.5%	-20.2%	-23.5%	-26.0%
HP storage and servers	-1.8%	-18.1%	-27.7%	-22.8%
Dell servers and networking	-3.5%	-10.5%	-22.2%	-17.6%
q-o-q				
IBM hardware	-4.1%	-3.9%	-6.6%	-1.3%
HP storage and servers	6.7%	-22.0%	-12.5%	5.9%
Dell servers and networking	-4.2%	-12.2%	-10.1%	9.1%

Source: Company reports, HSBC YE: IBM Sept, HP & Dell Oct

R&D market

While IT services has been a high growth market for Indian IT vendors, as suggested earlier, we believe new offshoring avenues such as R&D offshoring should get increasing focus and traction. R&D offshore is relatively a much smaller market than IT services, but the scope of growth is comparatively higher. R&D offshore market in India is expected to grow at a CAGR of 23% from FY09-12, from USD9.4bn in 2008 to USD17.5bn in 2012, according to the industry experts such as Zinnov.

What is the R&D offshore market?

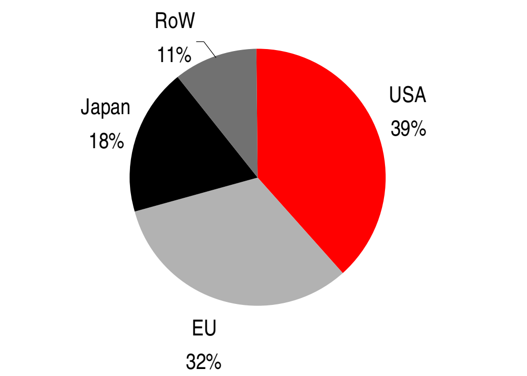
This includes engineering services, embedded services and offshore software product development (SPD). Globally, companies spend a significant proportion of their revenues on R&D to remain competitive. To do similar work at a much lower cost and with greater flexibility without compromising on expertise, companies are increasingly sending a portion of this work to offshore locations such as India – this constitutes the R&D offshore market. This offshored work could be done in 'captives' in low-cost regions such as India (for instance, Microsoft, Oracle and SAP have their own development centres in India), or could be outsourced to third-party vendors such as Wipro, HCL Tech, Infotech Enterprise or MindTree.

Outlook for the offshore R&D market depends on the outlook for global R&D spend, percentage of offshoring in this work and relative market share between 'captives' and third-party vendors

Global R&D spending outlook

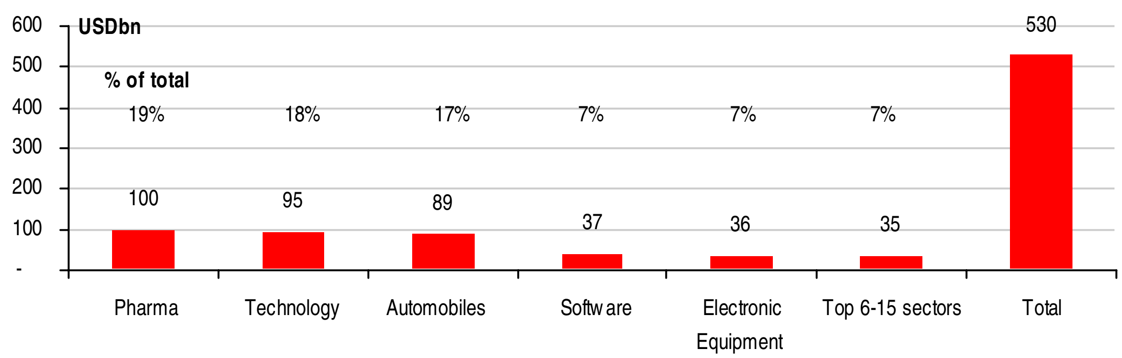
Globally, the total spend on R&D in 2007-08 (top 1,400 spenders on R&D) was cUSD530bn, growing at a stable rate over the past few years. While the US dominates spending in computer software, Europe is ahead in pharmaceutical, telecom and automotive sectors.

Geographic breakdown of global R&D spend (2008)



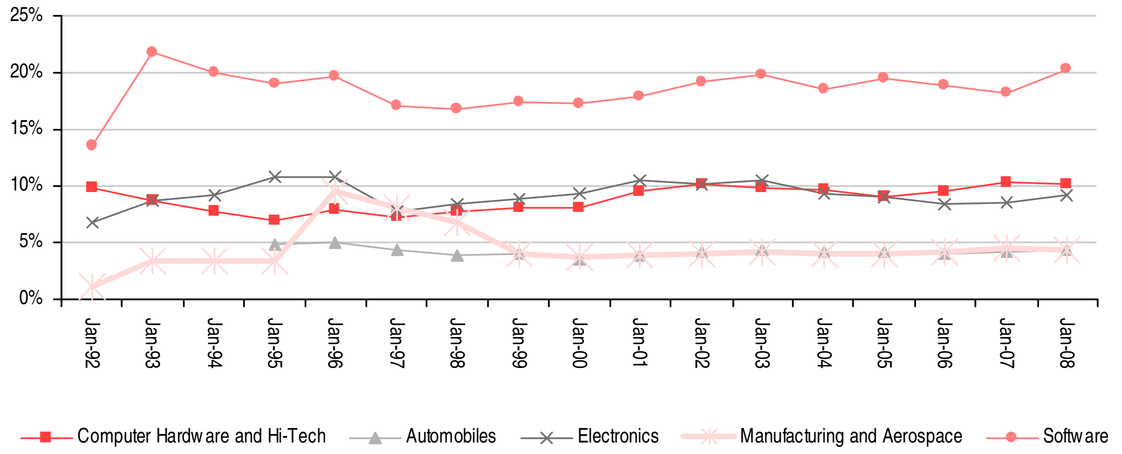
Source: 2008 EU industrial R&D investment scoreboard, HSBC

Global R&D spend by markets (2008)



Source: 2008 EU industrial R&D investment scoreboard, HSBC

R&D intensity, or R&D spend as a percentage of sales (2008)



Companies considered for the analysis - Computer Hardware and Hi-Tech (Nokia, Intel, IBM, HP); Automobiles (Toyota, Daimler, Ford, BMW, Volkswagen, Peugeot); Electronics (Toshiba, Sony, Cisco, Siemens, Samsung, Motorola, Ericsson); Aerospace (Boeing, EADS, Thales); Software (Microsoft, Oracle, SAP, Dassault Systems, Adobe, Cadence, Autodesk, Sage).
Source: HSBC, Factset

To predict R&D services demand in the near term, we analysed the top line growth and R&D spend of the top 30 IT spending companies across sectors. R&D spend by companies is influenced by 1) R&D intensity (R&D as proportion of sales), and 2) overall sales growth.

- **R&D intensity:** As seen in the chart above, R&D intensity varies across sectors. Software companies spend the highest proportion of their revenues on R&D (18-20%), followed by computer hardware and high-tech industries (c10%). However, R&D intensity across industries has either stabilised or is on an upswing. With increasing competitive intensity, and consequently, shorter shelf-life of new products, quick and customised go-to-market strategies and products, we do not expect companies to compromise on R&D spend; hence the intensity should remain flat, at worst.

- **Cyclicality:** There is strong correlation between R&D spending and sales growth. Sales growth for most companies that are big R&D spenders should revive by 2010, as suggested by the Bloomberg consensus estimates. As we find a high correlation between sales and R&D spend, we expect R&D spend to revive soon, as well. Among large R&D spenders, Aerospace is the only market where companies are still likely to see revenues decline next year, according to Bloomberg consensus estimates.

Sales and R&D spend correlation

1992-2008	Correlation
Computer Hardware and Hi-Tech	0.78
Automobiles	0.87
Electronics	0.85
Manufacturing and Aerospace	0.77
Software	0.95
Overall average	0.86

Source: Company, HSBC

R&D offshore market

To take advantage of the cost arbitrage, companies across the globe have been offshoring their R&D work to locations such as India. However, the offshore penetration (offshore/total spend on R&D) is still at a modest c2%. Zinnov Consulting, an independent consulting firm, expects the R&D offshore market in India to grow by 23% CAGR over 2009-12. We expect the R&D offshoring/outsourcing market in India to stay on a structural growth trajectory due to:

Top-line growth estimates

	2008	2009	2010	2011
Computer Hardware & Hi-Tech				
Nokia	-0.7%	-20.6%	2.8%	4.5%
Intel	-2.0%	-8.0%	11.4%	4.9%
IBM	4.9%	-7.8%	3.2%	3.6%
HP	13.5%	-4.2%	4.1%	5.1%
Automobiles				
Toyota	-21.9%	-13.8%	7.1%	8.9%
Daimler	-3.5%	-18.5%	5.1%	7.9%
Ford	-15.2%	-27.6%	5.0%	10.4%
BMW	-5.0%	-10.5%	5.3%	6.2%
Volkswagen	4.5%	-9.1%	-0.6%	5.8%
Peugeot	-7.4%	-14.0%	0.2%	6.0%
Electronics				
Toshiba	-13.2%	0.8%	5.6%	4.6%
Sony	-12.8%	-5.3%	0.8%	0.7%
Cisco	-8.7%	0.9%	9.9%	11.7%
Siemens	6.7%	22.1%	11.7%	10.4%
Samsung	23.1%	11.8%	9.5%	NA
Motorola	-17.7%	-24.7%	8.8%	12.3%
Ericsson	11.3%	0.0%	2.8%	5.3%
Aerospace				
Boeing	-8.3%	11.7%	-3.3%	2.9%
EADS	10.6%	-0.8%	-4.0%	0.0%
Thales	3.0%	2.4%	2.9%	3.5%
Software				
Microsoft	-3.3%	2.2%	7.6%	8.1%
Oracle	3.7%	1.7%	6.7%	5.8%
SAP	13.0%	-6.6%	5.0%	8.1%
Dassault Systems	6.0%	-4.7%	4.9%	8.3%
Adobe	13.4%	-18.7%	6.5%	12.3%
Cadence	-35.7%	-18.0%	7.9%	14.2%
Autodesk	6.6%	-27.0%	5.2%	14.5%
Sage	11.9%	11.2%	-0.3%	4.6%

Source: Factset, Datastream, Bloomberg

- Structural resilience in global R&D spend over the long term. R&D intensity has been stable over the past few years, across sectors.
- Increase in offshoring of R&D services as clients continue to benefit from the cost arbitrage. Just for illustration, an engineer in Infosys is paid cUSD10,500/annum in India, which is just 13% of the average onsite salary of cUSD82,500/annum.
- R&D offshoring will also be driven by the improvement in the range and quality of services offered by Indian vendors. As Indian engineers gain technical and domain expertise and experience of client's processes, they are moving up the value chain.
- Furthermore, with maturing relationships, clients get more comfortable with vendors and are willing to offshore newer services, which were earlier closely held.
- Increase in market share of third-party vendors from 'captives'.

We discuss in detail these growth drivers in the following sections.

Market size and growth estimates

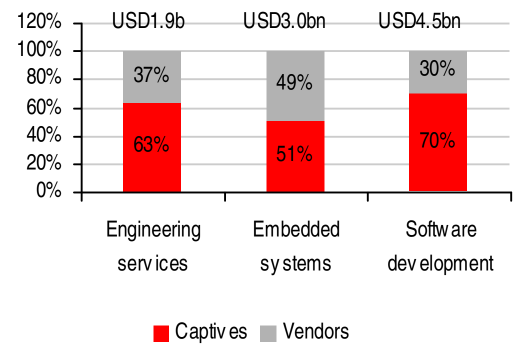
The R&D offshore market can be further categorised into embedded systems, engineering services, and software product development.

- **Embedded services** include chip designing, testing and embedded software development and support for embedded systems. Clients include high-tech companies and consumer durable companies.
- **Engineering services** include design support for CAD/CAM designing and 2D/3D modelling, engineering analysis and modelling including FEMA analysis, stress analysis, crash simulation and re-engineering. Clients typically include automobile companies, aerospace companies and other equipment manufacturers.
- **Software product development** (SPD) includes design support, testing and enhancement support for software applications. Clients include software companies such as MSFT, Oracle and SAP.

According to NASSCOM and Zinnov Analysis, the R&D export (offshore) market was cUSD9.35bn in 2008 and expected to grow at a CAGR of 23% until 2012. The R&D offshore market is dominated by 'captives', which have c60-70% market share in both engineering and SPD.

At USD9.4bn, the current offshore penetration is less than 2% of the total R&D addressable market. Growth for third-party vendors (such as MindTree) should be driven by the increased proportion of

R&D offshore market (2008)



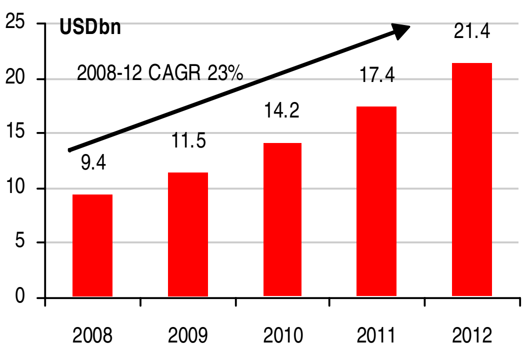
Source: NASSCOM, Secondary Research and Zinnov Consulting, HSBC

offshore in global R&D spending, and by gaining further market share from 'captives' in India.

Size and share of pie to increase for third-party vendors

Although the R&D market is expected to grow at a healthy 23% CAGR 2008-2012, for outsourcing vendors, the growth could be even stronger as they eat into the market share of 'captives'.

Expected growth in R&D offshore market



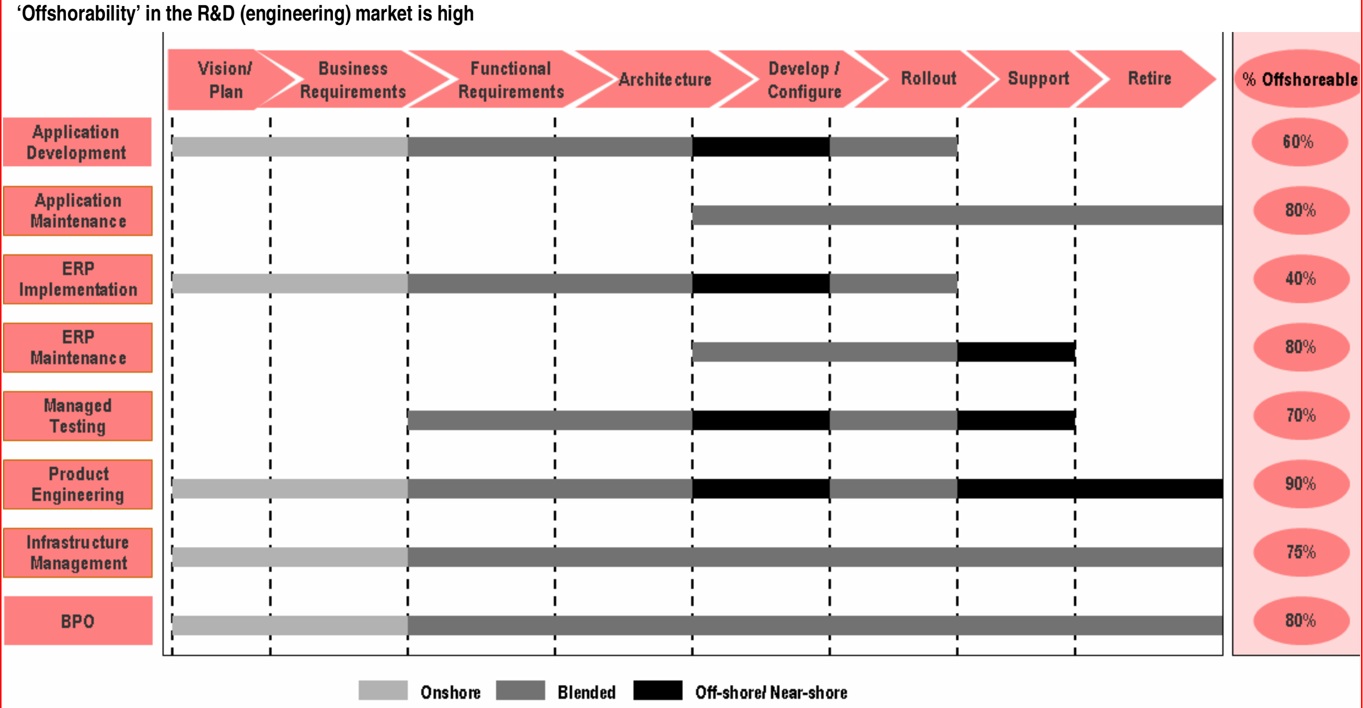
Source: Zinnov Analysis, HSBC

There are c600 R&D centres in India ('captives'), but according to Zinnov Analysis, there are productivity concerns, lack of offshoring vision and other issues such as inefficient knowledge transfer. Clients therefore are likely to increasingly prefer to transition from 'captives' to third-party vendors, in our view.

Level of engagement increasing, opens doors for offshoring in other services

Design support and technical publication have

'Offshorability' in the R&D (engineering) market is high



Source: Logica, HSBC

been the primary offshored activities in engineering (clients in Aerospace, Automobiles etc). Similarly, testing and application software have been the primary activities in the embedded software market (clients in the hi-tech vertical space). However, the level of engagement between clients and vendors has improved over the last few years. Services such as engineering analysis and modelling, which were earlier closely held by clients, are increasingly being offshored. We believe the traction will likely continue as the experience of Indian engineers increases, and as clients are pressured to cut costs. Further, clients' increasing confidence in vendors, with maturing long-term relationships, should also help.

Growing maturity of R&D market to result in innovative business models

Vendors are also exploring various engagement models, rather than remaining pure offshore service providers or assisting in development or testing. This increases their addressable markets and cements relationships with clients.

According to Zinnov, three engagement models are gaining prominence in R&D offshoring:

- **Revenue share,** where vendors partner with clients in conceptualising, designing, manufacturing and maintaining products on a revenue share basis rather than time and material basis.
- **IP-led solutions,** where vendors invest in developing their own IP and products, which are cross-sold to clients.
- **Go-to-market partners,** where vendors go hand-in-hand with the clients to sell products and services across the globe. HCL's relationship with Misys and Nokia is a good example of this business model.

SPD to be most resilient of the pack

Software product development, in our view, is the most resilient of the R&D offshore sectors. Compared to other sectors such as Automobiles and Aerospace, the R&D cycle is much shorter among software companies. Software companies have to spend continuously on R&D to compete with the newer products in the market and introduce upgrades/updates for their existing products. Average spend of large software companies is c18% of sales, much higher than the 4-5% for automobiles and manufacturing.

Evolution of offshore traction in engineering services

Design Support	Complex Design Support	Engineering Analysis	Reengineering	Product Design
1997-1999	**2000-2002**	**2003-2005**	**2006-2007**	**2008-Future**
Design support - CAD/Cam designing - 2D, 3D modeling - Designing of low complex parts such as doors, roofs, windows	**Design support** - 2D, 3D modeling and design conversion of complex parts such as axles, breaks - CAD/CAM designing - Designing of low complex parts **Embedded SW/HW** - Low complex testing - Application software for embedded systems	**Engineering Analysis/modeling** - FMEA analysis , CFD - Stress Analysis, Crash simulation etc. **Design Support** - 2D, 3D modeling and design conversion of complex parts such as axles, breaks **Embedded SW/HW** - Testing - Application software for embedded systems	**Re-engineering** - Proposals for design changes - Design modification of low complex parts - Design modification of complex parts **Engineering Analysis/modeling** - FMEA analysis , CFD - Stress Analysis, Crash simulation etc. **Design Support** - 2D, 3D modeling and design conversion etc. **Embedded SW/HW**	**Prod design and development** - New product development - Proposals for design changes - CAD/Cam designing - Conceptual Design & Drawings **Engineering Analysis/modeling** - Stress Analysis, Crash simulation etc. **Design Support** - 2D, 3D modeling and design conversion etc. **Embedded SW/HW**

Note: FMEA: (Failure Mode and effect analysis); Computational fluid dynamics (CFD)
Source: Zinnov Analysis

Winning attributes

- MindTree's recovery in FY11 to outperform mid-tier peers
- Strong link to R&D market growth and IT spending recovery, impressive client references and robust services blend to drive top-line growth, expect 19% CAGR 2010-12e
- FY11e EBITDA margin could potentially expand by c320bps, on our utilisation assumption of 69% (+6% y-o-y)

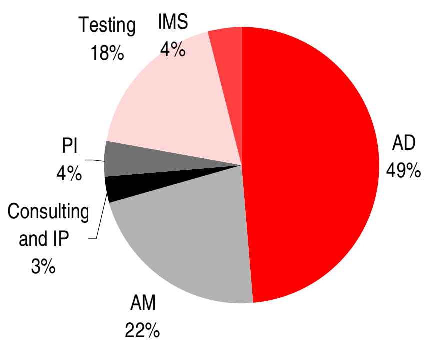
MindTree is one of the better placed mid-tier IT companies in India, which has grown at an industry-leading rate of c57% from FY04-09. The company derives c2/3rd of its revenues from cyclical services and was hit hard by the macro weakness in the last few quarters. On a base of cUSD270m revenues (FY09), in FY10 revenue is likely to remain flat y-o-y; we expect the company to bounce back strongly, with revenue CAGR of c19% in FY10-12. Noteworthy attributes of MindTree, which are likely to drive the growth are:

- At this point of the business cycle, MindTree's high exposure to cyclical services (c2/3rd of the total revenue) is positive. After a weak FY10, cyclical services such as application development should grow faster than the recurring maintenance revenues.
- MindTree boasts an impressive clientele, which we believe is critical in IT services. Client references are key differentiators for any vendor when bidding for new deals. Additionally, the company has minimum client concentration risk compared to its mid-tier peers, with the top10 clients contributing c39% to revenue in 1Q10.
- Top management includes industry veterans (like Ashok Soota and Krishna Kumar), who have industry experience and long-standing relationships with clients. The average employee experience in MindTree is c5 years; it is c3 years for larger peers such as Infosys.
- High exposure to software product development (SPD is c70% of total R&D exposure), which in our view is an advantage. Compared to other R&D segments such as engineering services, SPD is resilient to macro weakness and should continue to grow strongly.
- Progressive improvement in EBITDA margin: EBITDA margin declined c14% sequentially in the last six months due to volume decline and project overruns. In our view, margin could potentially improve by c320bps in FY11 due to improving utilisation, which is close to historic lows. We expect utilisation of c69% (average) in FY11 vs. c64% in FY10.

Poised to leverage IT spend revival…

MindTree derives about two-thirds of its revenue from discretionary services such as application development (AD) and PI/SI. These are cyclical and driven by new initiatives and projects, which had dried up in the last few quarters. Unsurprisingly, revenue from AD declined 14% and 8% y-o-y in 4Q09 and 1Q10, respectively, for MindTree. However, as explained in the previous section, we expect IT spending to pick up in 2010. As new IT budgets are released, we expect these services to bounce back strongly, which should result in a strong comeback for MindTree. We forecast revenue growth of c20% y-o-y from AD in FY11.

MindTree: Services revenue mix (2QFY10)

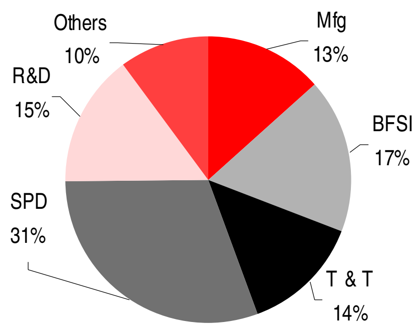


Note: AD – application development, AM – application maintenance, PI – package implementation
Source: Mindtree

…and structural growth in R&D market

As we said earlier, we believe R&D should remain a growth market, driven by stable global R&D spend, increase in offshoring of R&D and increasing preference for third-party vendors over captive. MindTree, with c45% of (2Q10) revenue from this market, is poised to capture the growth potential. With its strong client references, experienced management, quality workforce and robust services mix, the company is well positioned to leverage this growth market in the long term.

R&D* contributed c46% to revenue in 2QFY10



Source: * R&D is Software Product Engineering and Engineering Services

Greater exposure to SPD is desirable

Of the 46% revenue from R&D services, the company derives two-thirds (31% of the total) from software product development (SPD). We believe this market segment is less volatile and non-discretionary compared to engineering services. Software companies such as SAP, Oracle and Microsoft need to keep investing in research and development to remain ahead of the competition and continuously upgrade/update their existing products in the market. R&D spend as proportion of sales is also high for software companies at 18-20% compared to 4-5% for manufacturing and automobile companies.

Increasing focus on recurring services should reduce top line volatility

The company has also increased focus on annuity-based (signed under long-term contracts) services to provide stability to the top line amidst weak IT spending. MindTree recently structured its business into five divisions – 1) IT services; 2) product engineering services, which include research and development (R&D) and outsourced product development (OPD); 3) testing; 4) infrastructure management and technical support (IMTS); and 5) knowledge services.

MindTree intends to focus only on the high-end IMTS services and refrain from services such as desktop management. IMTS currently contributes c4.5% to revenue; it should reach 10% by FY12e.

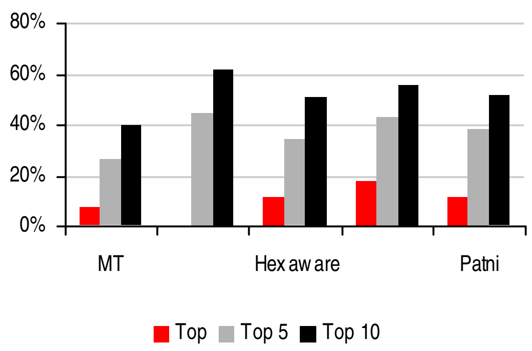
In September this year, with the acquisition of Kyocera Wireless in India, the company has also forayed into Wireless and Mobility product space. The acquisition would contribute USD9m in 2HFY10. The acquired team of 600 has engineered 45m wireless phones till date and has extensive experience in 4G technologies such as WiMAX and LTE (long-term evolution).

Impressive client list and low client concentration risk is noteworthy

In our view, client references are an important enabling factor for any outsourcing company to win new clients and deals. The company boasts of marquee clients such as Microsoft, Texas Instruments, Symantec and HP for providing R&D services. Such client references strengthen MindTree's positioning while bidding for new deals.

Additionally, client concentration risk is low compared to peers. The top client contributes 7% and top 10 clients contribute 39% to revenue. This is better than mid-tier peers such as Patni, Polaris or Hexaware.

MindTree: client concentration (2QFY10)



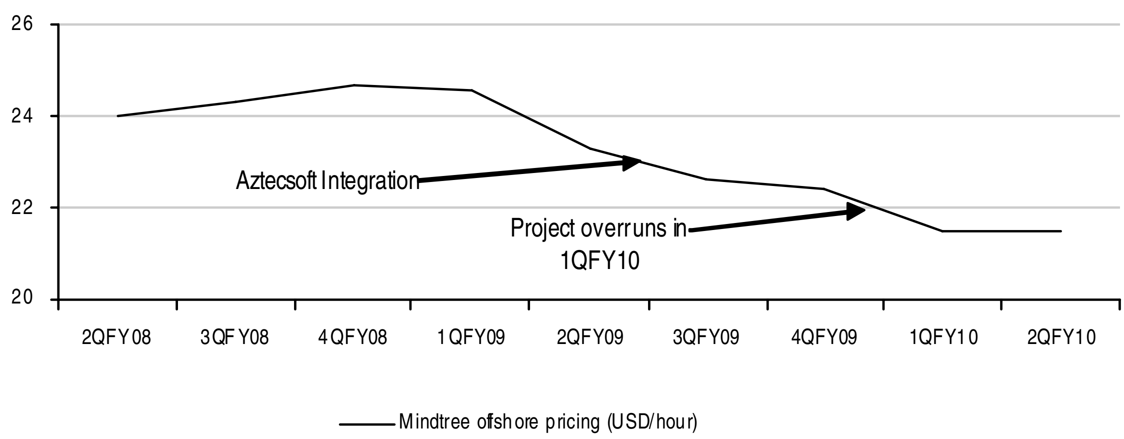
Source: Company reports, HSBC

A valued mid-tier company

Given its strong client reference list, experienced top management, motivated and quality workforce and robust service mix, we expect MindTree to remain a preferred mid-tier partner for its clients. Introduction of newer services and offerings would help the company continue to improve client mining and increase the share of wallet of its clients.

We believe, as the new annuity-based services, such as Infrastructure Management services and Knowledge services, gain traction, client's wallet share should improve. The importance of client-mining in the IT Services industry is evident from the fact that larger peers such as Infosys and TCS derive greater than 98% of their revenues from existing clients.

Offshore pricing trends



Source: Company Reports

Billing rates of MindTree, while at a discount to Infosys, have remained stable, if we ignore one-offs such as the AztecSoft acquisition in FY09 and project overruns in 1QFY10. We expect billing rates to remain stable in the next few quarters (see the Forecast section for details).

Client mining: scope for further improvement

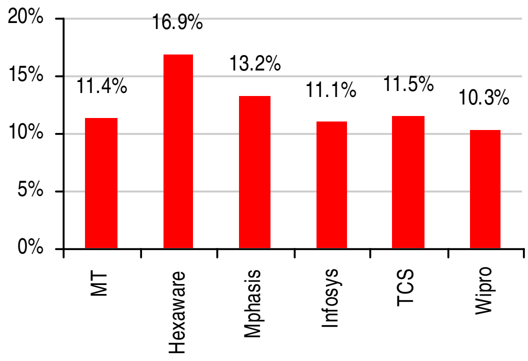
	Number of clients	Revenues/ client (USD '000)	Billed employees per client
MindTree	239	260	20
Patni	294	551	35
Infosys	569	1,972	113
Wipro	830	1,244	83

Source: Company Reports, HSBC

Experience and employee satisfaction matters in IT services

The average experience of a MindTree employee is greater than 5 years, which is higher than Infosys or any other larger IT company in India. The average age of a MindTree employee is 28 years vs. 26 years in Infosys. Attrition rates are also lower compared to its mid-tier peers, suggesting high morale and job satisfaction.

Attrition rate (1QFY10)



Source: Company Reports, HSBC

HSBC

Financials and valuation

- We forecast volume growth of c18% and stable pricing…
- …resulting in EBITDA growth of c21% CAGR FY10-12e
- We value the stock at 14x on our FY11e EPS of INR53, with a TP of INR750 and Overweight (V) rating

Outperformed peers

With its diversified revenue profile and strong execution record, MindTree has outperformed its mid-tier peers in the last few years, growing at a 45% CAGR over FY07-09. Going forward, the company should continue to outperform its peers, as is evident from consensus growth forecasts for the mid-tier IT sector. Our earnings forecasts for FY11e are in line with Datastream consensus.

Top line estimates

MindTree: Top line estimates

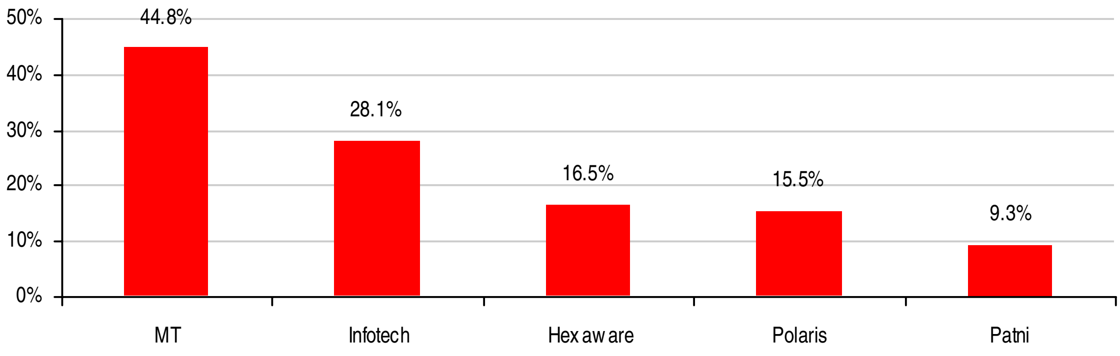
CAGRs	FY04-09	FY10-12	FY10
Revenues (USD)	n/a	20.2%	0.7%
Revenue (INR)	56.8%	19.1%	4.9%

Source: Company reports, HSBC estimates

- We expect revenue CAGR of c20% in FY10-12 in USD terms and c19% in INR terms. We forecast our INR top line on an average INR/USD rate of 47 in FY11. We expect FY10 revenues will remain flat at USD271m, registering 0.7% y-o-y growth
- **Volume growth estimates:** we expect revenue growth in FY11 to be driven primarily by volume growth. We expect both the ADM and R&D services to grow in FY11 and contribute to the volume growth.
- **Pricing (realisation per head):** we expect offshore pricing to improve marginally by the end of FY11 and remain flat for a large part of the year. According to the historic evidence, it takes a while for vendors to convince clients to reverse pricing discounts after a downturn.

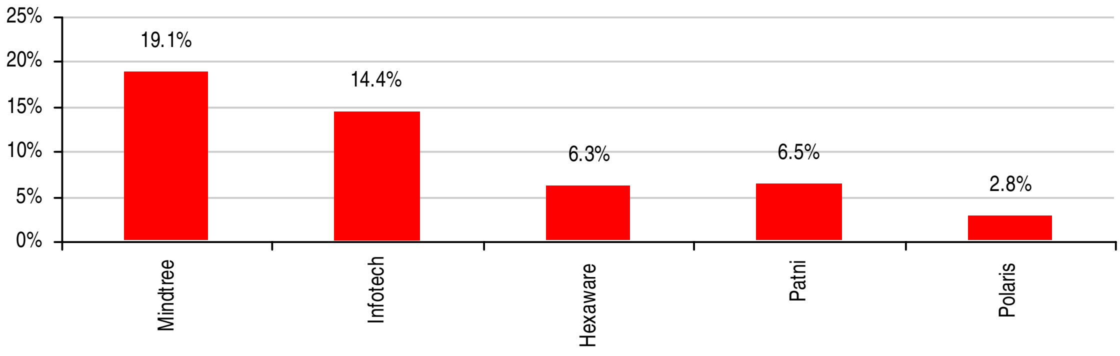
  We also do not expect material change in the onshore/offshore mix. Higher volume growth in offshore could negatively impact realisation per head as offshore billing rates are close to one-third of offshore billing rates. Even though onshore volume growth would lag offshore growth for a few quarters, the difference in growth would not be significant enough to impact the onshore/offshore revenue mix.
- **Segmental break-up:** We expect R&D and SPD to grow at a strong 38% and 23% respectively in FY11 and contribute c50% of the total revenues compared to 47% in FY10. In IT services, we expect BFSI to grow stronger than Manufacturing and Telecom at 17% y-o-y in FY11. Please refer the tables in the following pages for detailed forecasts.

Historic revenue CAGR FY07-09



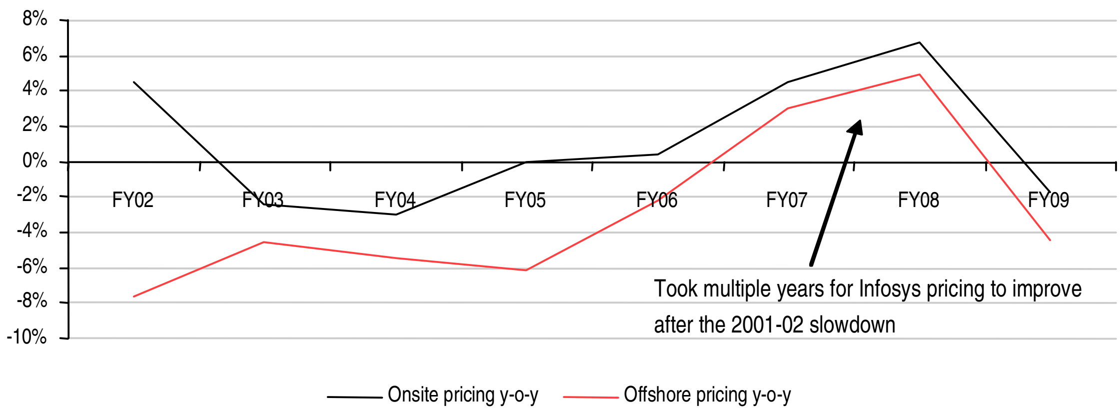
Source: Company reports, HSBC , Hexaware & Patni Dec end, all others Mar end

Forecasts* for revenue CAGR FY10-12



Source: MindTree HSBC estimate, all others Datastream, Hexaware & Patni Dec end, all others Mar end, Patni estimates are for 09-11e

Pricing (Revenue realisation per head) trends of Infosys



Source: Company reports, HSBC

HSBC

Top-line forecasts

Volumes	1Q10	2Q10	3Q10e	4Q10e	FY10E	FY11E	FY12E
Billed hours, m							
Onsite	286	295	301	309	1,190	1,333	1,533
Offshore	2,006	2,096	2,284	2,376	8,762	10,571	12,474
Total	2,292	2,391	2,585	2,684	9,952	11,904	14,007
Volume Growth (q-o-q)					y-o-y	y-o-y	y-o-y
Onsite	0.0%	3.3%	2.0%	2.5%	0.0%	12.0%	15.0%
Offshore	-4.0%	4.5%	9.0%	4.0%	0.0%	20.7%	18.0%
Total	-3.5%	4.3%	8.1%	3.8%	9.5%	19.6%	17.7%
Pricing (USD/hour)	**1Q10**	**2Q10**	**3Q10e**	**4Q10e**	**FY10E**	**FY11E**	**FY12E**
Onsite	62	62	62	62	62	62	64
Offshore	22	22	22	22	22	22	23
Blended	27	27	26	26	26	27	27
Pricing	q-o-q				**y-o-y**	**y-o-y**	**y-o-y**
Onsite	-5.4%	-0.3%	0.0%	0.0%	-6.5%	0.2%	2.0%
Offshore	-4.2%	0.2%	1.0%	0.0%	-6.4%	2.1%	3.0%
Blended	-3.9%	-0.1%	-0.4%	-0.2%	-7.3%	0.4%	2.3%
Fee Revenues (USDm)	**1Q10**	**2Q10**	**3Q10e**	**4Q10e**	**FY10E**	**FY11E**	**FY12E**
Onsite	18	18	19	19	74	83	97
Offshore	43	45	50	52	190	234	284
Total Revenues (incl. non fee revenues)	62	65	70	73	271	326	391
Fee Revenues	q-o-q				y-o-y	y-o-y	y-o-y
Onsite	-5.4%	3.0%	2.0%	2.5%	0.0%	12.2%	17.3%
Offshore	-8.0%	4.7%	10.1%	4.0%	0.0%	23.2%	21.5%
Total Revenues (incl. non fee revenues)	-8.5%	5.1%	7.9%	3.8%	0.7%	20.2%	20.2%

Source: MindTree, HSBC estimates

Top-line estimates

Vertical wise (USDm)	1Q10	2Q10	3Q10e	4Q10e	FY10E	FY11E	FY12E
Manufacturing	8	9	9	9	34	38	41
BFSI	11	11	12	12	46	54	63
T & T	9	9	9	9	36	38	40
R&D	9	10	14	15	47	66	90
SPD	18	20	20	22	80	98	121
Others	7	7	7	7	27	32	36
Total	62	65	70	73	271	326	391
	q-o-q				y-o-y		
Manufacturing	-12.6%	8.4%	0.0%	2.0%	NA	10.1%	9.5%
BFSI	-4.2%	2.8%	2.0%	4.0%	NA	17.3%	16.0%
T & T	23.3%	-3.9%	0.0%	0.0%	NA	4.6%	5.0%
R&D	-27.1%	11.1%	45.0%	5.0%	NA	38.3%	38.0%
SPD	-9.4%	8.7%	3.0%	6.0%	NA	23.2%	23.2%
Total	-8.5%	5.1%	7.9%	3.8%	0.7%	20.2%	20.2%
Service wise	**1Q10**	**2Q10**	**3Q10e**	**4Q10e**	**FY10E**	**FY11E**	**FY12E**
IT Services	35	36	36	37	144	162	180
Product Engineering Services*	27	30	34	36	127	164	212
Total Revenues	62	65	70	73	271	326	391
	q-o-q				y-o-y		
IT Services	NA	1.6%	0.6%	2.0%	NA	12.5%	11.2%
Product Engineering Services	NA	9.8%	16.6%	5.6%	NA	28.8%	29.1%
Total	NA	5.1%	7.9%	3.8%	NA	20.2%	20.2%

Source: MindTree, HSBC estimates; * includes R&D services and Software Product Development

Structurally, a better margin business

Historically, along with strong top-line growth, the company has reported strong profitability, with the highest operating margins among mid-tier peers. We believe profitability was driven by the high offshore effort mix (87.5% offshore in 1QFY10) and resulted in a high offshore proportion of revenues – c71%, as reported in 1QFY10. As discussed in our R&D market section, R&D services are highly ‘offshorable’. We believe the current offshore revenue mix is sustainable at current levels at the very least, as MindTree achieves further scale with existing clients.

Recent margin dilution likely to reverse

Profitability has been volatile in the last few quarters. EBITDA margin improved from c18% in 4Q08 to c30% in 3Q09, primarily due to INR weakness. The average INR/USD rate was c40 in 4Q08 and c49 in 3Q09. However, after this expansion, margins collapsed in just six months, to c17% in 1Q10. The decline of c14% since 3QFY09 was due to:

- **Lower revenue growth:** USD revenue declined 9% in 4Q09 and 7% in 1Q10, resulting in utilisation declining to 61%, which is the lower end of the historic range. With volumes recovering by c4% in 2QFY10, utilisation improved to 65% including trainees.
- **Pricing decline after AztecSoft integration,** as it had lower offshore billing rates due to higher exposure to testing practice.

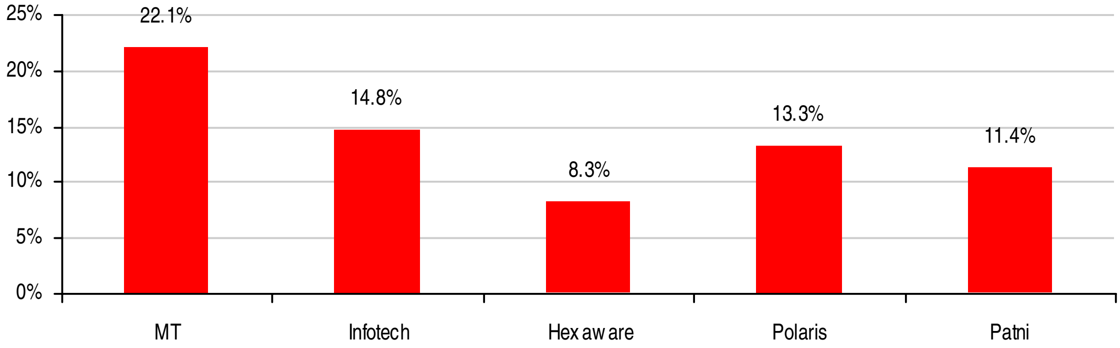
We believe margin pressures have bottomed out, and profitability should improve. According to our synthetic cost model, EBITDA margin could potentially expand c320bps in FY11e due to improving utilisation (all else unchanged on our top-line growth forecasts). We expect utilisation to improve to 69% in FY11.

Our synthetic cost model suggests margin expansion of 320bps for MindTree in FY11e

	1Q10	2Q10	3Q10E	4Q10E	FY10E	1Q11E	2Q11E	3Q11E	4Q11E	FY11E
q-o-q	-9.1%	7.3%	8.3%	4.0%	5.3%	3.8%	3.8%	4.6%	4.7%	20.2%
Revenue Per employee (INR'000s)	2,767	2,717	2,668	2,631	2,692	2,627	2,623	2,654	2,696	2,651
q-o-q	-5.0%	-1.8%	-1.8%	-1.4%	0.0%	-0.1%	-0.1%	1.2%	1.6%	0.0%
Utilisation	61.1%	64.7%	65.0%	65.0%	64.0%	67.0%	68.0%	70.0%	70.0%	68.8%
Billable employees	7,073	7,167	7,724	8,033	7,499	8,088	8,270	8,404	8,800	8,390
q-o-q	-2.9%	1.3%	7.8%	4.0%	12.0%	0.7%	2.3%	1.6%	4.7%	11.9%
Cost per employee (INR'000s)	204	195	191	191		191	191	191	191	
q-o-q	5.4%	-4.6%	-2.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Employee Costs - billable	1,446	1,398	1,477	1,536	5,856	1,546	1,581	1,606	1,682	6,416
q-o-q	2.4%	-3.3%	5.6%	4.0%	20.6%	0.7%	2.3%	1.6%	4.7%	9.6%
cost as % of revenues	47.4%	44.4%	44.1%	44.7%	45.1%	43.4%	42.9%	41.2%	40.5%	41.9%
Margin expansion y-o-y					-588 bp					318 bp

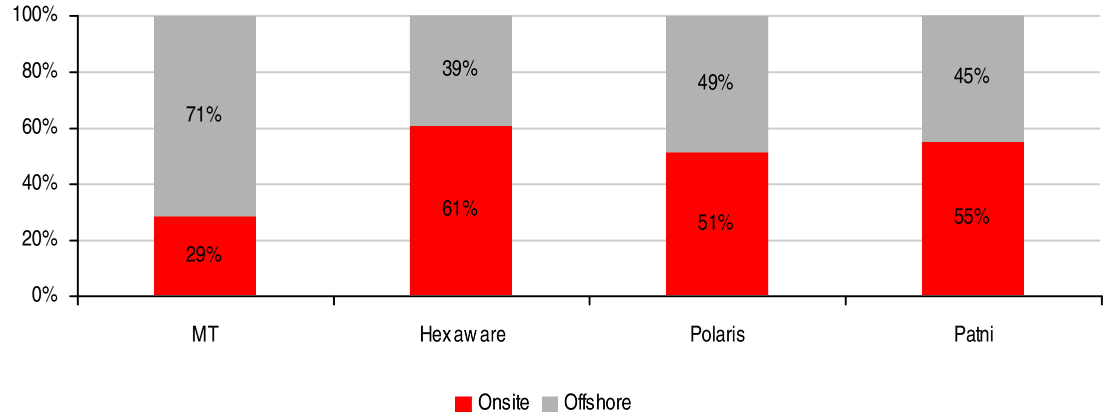
Source: HSBC estimates

EBIT margin comparison for mid-tier companies (FY09)



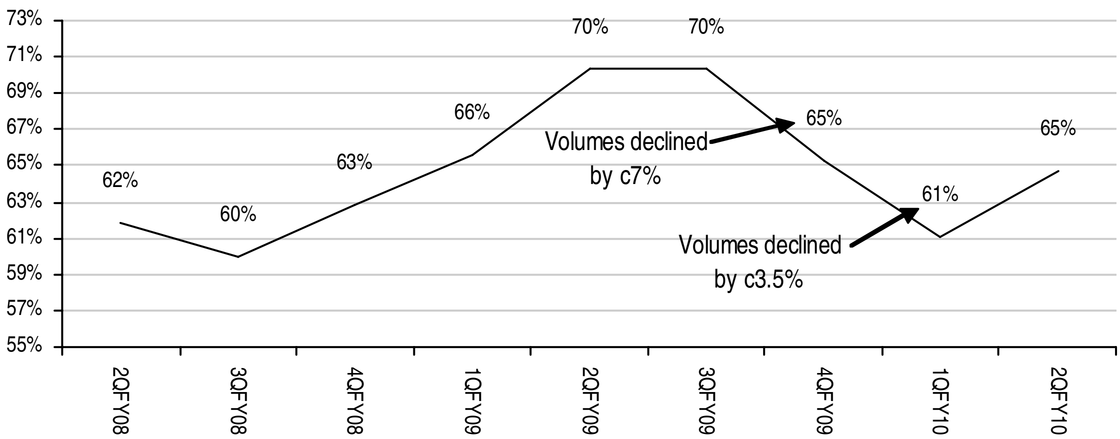
Source: Company reports, HSBC , Hexaware & Patni Dec end, all others Mar end, EBIT is before other income and FX gains & losses

Onshore/Offshore revenue mix for mid-tier companies for 2QFY10



Source: Company reports

Utilisation including trainees



Source: Company reports

HSBC

MindTree: Financial statements

P&L, Indian GAAP, INRm	FY07	FY08	FY09	FY10E	FY11E	FY12E
Total Revenues from operations	5,904	7,398	12,375	12,980	15,300	18,398
Operating Expenses	0	0	0	-	-	-
Software development expenses	3,660	4,725	6,968	7,941	9,256	11,076
Administrative and other expenses	1,147	1,419	2,097	2,628	3,110	3,794
Gross Profit	2,244	2,673	5,407	5,040	6,044	7,322
EBITDA (exl OI)	1,096	1,254	3,309	2,412	2,935	3,528
Interest	30	59	162	27	3	2
Depreciation	244	356	570	626	664	828
EBIT (exl OI)	852	898	2,740	1,786	2,270	2,700
PBT (incl other income)	896	1,118	603	2,226	2,559	3,003
Tax	(5)	85	67	285	409	661
PAT	901	1,033	536	1,941	2,149	2,343
Net profit	901	1,033	522	1,941	2,149	2,343
EPS	-	-	-	-	-	-
Basic	29.0	27.5	13.8	49.6	54.9	59.9
Diluted	27.7	26.5	13.7	48.2	53.4	58.2
Gross Margin	38.0%	36.1%	43.7%	38.8%	39.5%	39.8%
EBITDA margin	18.6%	16.9%	26.7%	18.6%	19.2%	19.2%
PAT margin	15.3%	14.0%	4.2%	15.0%	14.0%	12.7%
Tax Rate	-0.5%	7.6%	11.1%	12.8%	16.0%	22.0%

Balance Sheet, Indian GAAP, INRm	FY07	FY08	FY09	FY10E	FY11E	FY12E
Share Capital	378	379	380	392	392	392
Reserves and surplus	3,977	4,952	5,133	6,021	8,170	10,512
Total shareholders equity	4,355	5,331	5,840	6,413	8,562	10,904
Secured Loans	264	919	1,376	-	-	-
Total Assets	4,619	6,250	7,234	6,443	8,592	10,935
Fixed Assets	699	2,625	2,962	2,829	2,700	2,516
Investments	2,141	1,395	1,013	478	478	478
Sundry debtors	1,172	1,756	2,792	2,634	3,144	3,780
Cash and bank balances	768	553	488	968	3,152	5,541
Loans and advances	830	949	1,411	1,817	1,817	1,817
Current liabilities	862	1,162	2,860	2,121	2,536	3,035
Total Liabilities	4,619	6,250	7,234	6,443	8,592	10,935

Cash Flow, Indian GAAP, INRm	FY07	FY08	FY09	FY10E	FY11E	FY12E
Cash Flow From Operating Activities	0	0	0	0	0	0
Profit Before Tax	896	1,118	604	2,042	2,267	2,698
Depreciation	243	356	570	626	664	828
Change in working capital	(314)	(440)	(955)	(893)	(503)	(799)
Increase (decrease) in sundry debtors	(74)	(540)	(335)	158	(509)	(636)
Increase (decrease) in loans & advances	(249)	(39)	(2)	(56)	-	-
Increase (decrease) in current liabilities & provisions	56	326	(330)	(642)	415	499
Income taxes	(48)	(188)	(287)	(352)	(409)	(661)
Net operating cash flow	819	914	1,798	2,240	2,722	3,035
Capital expenditure	(558)	(2,183)	(435)	(250)	(536)	(644)
Net investing cash flow	(2,122)	(1,501)	(2,224)	(58)	(536)	(644)
Net financing cash flow	1,807	373	226	(1,330)	(3)	(2)
Opening cash balance	262	768	683	488	968	3,152
Net increase (decrease) in cash	505	(215)	(196)	480	2,184	2,389
Closing cash balance	768	553	488	968	3,152	5,541
Operating Cash flow	819	914	1,798	2,240	2,722	3,035
FCF	261	(1,270)	1,363	1,990	2,187	2,391
Capex	558	2,183	435	517	536	644

Source: Company reports, HSBC estimates

Valuation

As seen in the following table, the company revised its full year FY10 (in its 1QFY10 results release). Management cited these reasons for the revisions: 1) bankruptcy filing by a client; 2) ramp-down in Getronics business after the sale of the IT division to CapGemini, and 3) contract loss from a European customer.

While this downward revision took many investors by surprise and was a disappointment, the company rebounded strongly in 2Q10, reporting q-o-q growth of 5.1%, higher than any other company in the sector.

Guidance revision

	As of 31 March 2009, for FY10		As of 30 July 2009, for FY10	
	Lower end	Upper end	Lower end	Upper end
Revenue (USDm)	290	300	255	270
y-o-y	7.8%	11.5%	-5.2%	0.4%
CAGR required 2Q-4Q	4%*	5%*	1.5%	6.0%
Revenue (INRm)	14,906	15,420	12,342	13,068
PAT (INRm)	1,938	2,005	1,471	1,781
PAT margin	13.0%	13.0%	11.9%	13.6%
EPS (INR)	49	51	37.4	45.3

* from 1Q to 4QFY10
Source: MindTree, HSBC

The stock trades at a PE of c11x on our FY11e EPS and 12x on our FY10e EPS. On a relative scale, MindTree is trading at c50% discount to Infosys on 12-month forward PE. This is higher than the average c30% and lower than the peak c60% in March 2009. Investors, in our view are still discounting the guidance cut (by the company in 1Q) in the current valuations. The guidance cut was driven by one-off events, which we believe are unlikely to recur. We believe that as the company executes in the coming quarters, the stock should witness a re-rating.

We value the stock at a PE of 14x our FY11e EPS, at a c35% discount to Infosys (in line with the historic range). The valuation seems justified for an EBITDA CAGR from FY10-12e of c20%. We expect a discount to Infosys, as despite the marquee client base and experienced management, the company is prone to vendor consolidation. Furthermore, compared to its mid-tier peers, which are trading at an average of 10x, we think the stock should trade at a premium. Mindtree has a diversified revenue profile and much lower client concentration risks compared to its peer group, justifying this premium.

On our target price of INR750, we see total upside of 27.5% from the current market price. The target multiple is at a 10% discount to DCF, which we use as a valuation cross-check. We expect the discount to go down further as the company diversifies into annuity services.

DCF assumptions

We validate our PE multiple valuation with an underlying fundamental DCF analysis.

MindTree: HSBC estimates vs consensus

	Lower end	Upper end	Consensus	Our estimates	Comments
Revenues (USDm)	265	281	267	271	USD9m contributed by Kyocera, risk remains to the upside
y-o-y	-1.3%	4.5%		0.7%	
Revenues (INRm)	12,624	13,055	12,836	12,980	
PAT (INRm)	1,879	1,934	1,910	1,941	
PAT margin	14.9%	14.8%	14.9%	15.0%	Post adjusting for fresher intake of 300 in 3Q and an average salary hike of 8% in 4Q
EPS (INR)	46.8	46.8	46.8	48.2	More than c3% above consensus

Source: Company reports, HSBC estimates, Bloomberg

HSBC

Relative price performance

	1-Mth	3-Mth	YTD	1-Year	52-wk high	52-wk low
Sensex	-7%	9%	61%	295%	-8%	95%
BSE Tech	-4%	12%	91%	64%	-5%	120%
MindTree	-2%	29%	153%	143%	-4%	218%
KPIT Cummins	2%	49%	181%	199%	-11%	294%
Infotech Enterprise	-12%	3%	131%	67%	-18%	238%
Polaris	6%	29%	247%	272%	-9%	377%
Patni	-2%	23%	234%	212%	-5%	368%
Hexaware	-7%	9%	245%	295%	-16%	297%

Source: Datastream

MindTree: DCF analysis

Assumptions	
CAGR Revenue Growth (FY10-19)	12.5%
Average EBIT Margin (FY10-19)	14.9%
WACC	13.0%
Terminal Growth	5.0%
Terminal EBIT margin	14%
Terminal Working Capital/sales	5%

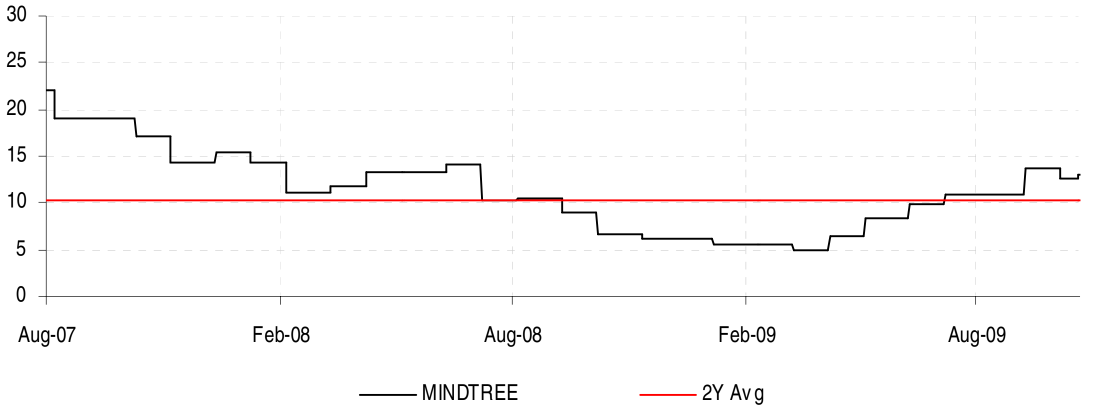
Source: HSBC estimates

Under these assumptions, we derive an intrinsic value for the stock of INR850/share, which is an implied valuation of 15x on our FY11e EPS.

The stock, therefore, is trading at a c30% discount to its intrinsic fair value. Our target price is at a modest c10% discount. As MindTree diversifies further into annuity-based revenues and improves client mining, the discount to DCF would continue to decline.

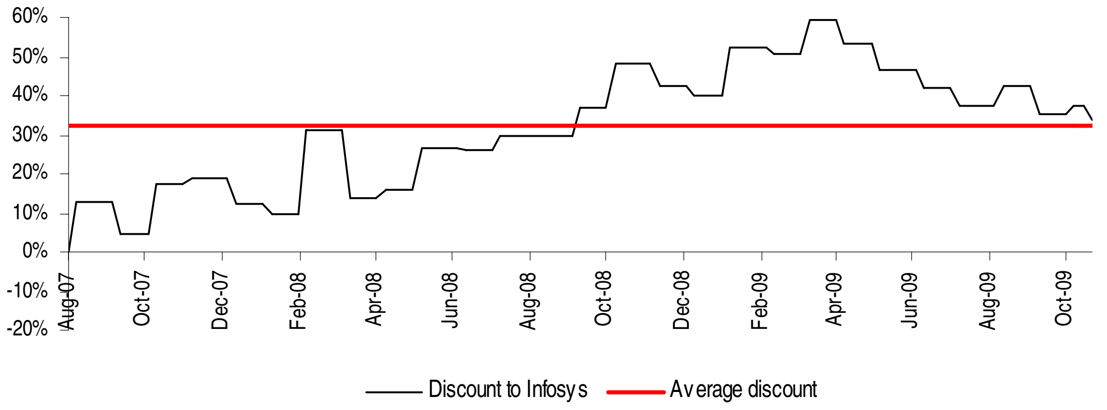
Under our research model, for India stocks with a volatility indicator, the Neutral rating band is 10 percentage points above and below the hurdle rate of 10.5%. This translates into a Neutral band of 0.5-20.5% around the current share price. Our target price implies a potential total return of c27.5% (no dividend expected); thus, we initiate coverage with an Overweight (V) rating.

12-month forward PE



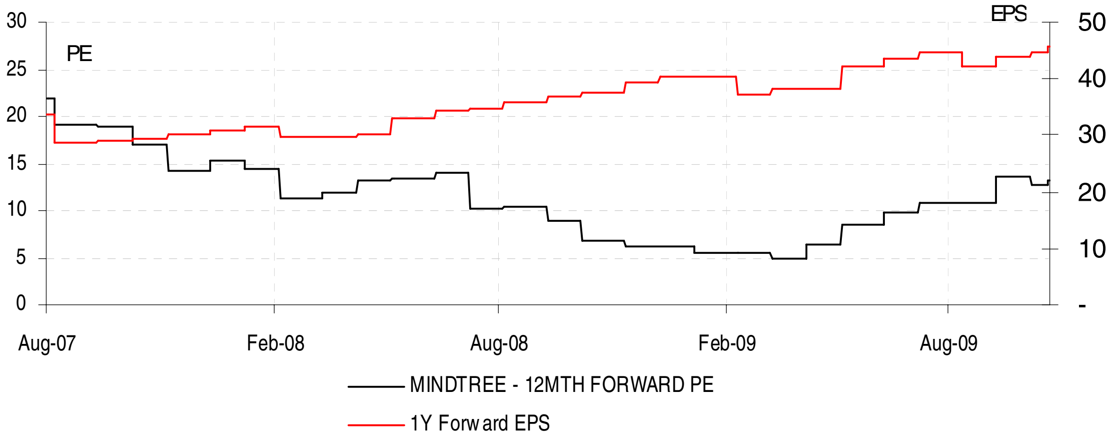
Source: Datastream, HSBC

Valuation discount to Infosys (on 12-month forward PE)



Source: Datastream, HSBC

12-month forward P/E vs. EPS (RHS)



Source: Datastream, HSBC

Risks

- INR/USD: the company drives c70% of its revenue from offshore as c87% of the volume is from offshore locations. Due to this high leverage to offshore, MindTree has high exposure to INR/USD exchange rate fluctuation. In our view, every 1% appreciation in INR affects EBITDA margin by 50-60bps and earnings (EPS) by c5% (assuming there are no hedges). While we do not forecast currency in our assumptions for top-line, further appreciation from the current INR/USD levels could be a risk for the earnings.

  The company has a policy of hedging 50-100% of forward revenues. At the end of September 2009, it had cUSD187m of hedges outstanding. Of these, USD75m are to expire in 2HFY10 and booked at an average rate of INR47.8. The remaining USD112m, due to expire after FY10, are MTM at an average rate of INR47.8. The company follows mark-to-market hedging and has currently booked USD20m provisions in the balance sheet.

  Due to the hedges, FX fluctuations do not pose a significant risk to earnings as the impact on EBITDA is offset by the gains on hedges.

  However, beyond FY10, FX fluctuation remains a risk. According to our basic scenario analysis, at INR45, there is 10% risk to our earnings estimate for FY11.

- Vendor consolidation – the company is vulnerable to vendor consolidation in its IT services and R&D businesses. To simplify vendor management and achieve pricing discounts, clients are increasingly looking to consolidate vendors and prefer large vendors due to their end-to-end service capabilities. While the risk remains real, MindTree has not lost any clients so far to vendor consolidation and we believe its niche offerings should continue to protect its client base.

- IT spending recovery anaemic – our FY11 estimates are based on an underlying prognosis of a recovery in IT spending. As spending recovers, clients should initiate new projects and discretionary spending, which should benefit MindTree more than the vendors who are focused on annuity-based maintenance work. However, if the macro economy does not continue to recover at the current pace, IT spending should become muted – in which case our 16% growth assumption for FY11 would be at downside risk.

Sensitivity to INR/USD

FY11	Scenario 1	Scenario 2	Scenario 3	Scenario 4 (base case)	Scenario 5
INR/USD	44	45	46	47	48
% appreciation from our base case assumption of 47	-6.4%	-4.3%	-2.1%	0.0%	2.1%
Revenues (INRm)	14,324	14,649	14,975	15,300	15,626
PBT margin	11.7%	12.8%	13.8%	14.9%	16.0%
PBT (INRm)	1,677	1,871	2,072	2,280	2,495
Impact on PBT margin	-319 bp	-213 bp	-106 bp	00 bp	106 bp
Impact on PBT INRm	(603)	(409)	(208)	-	215
Hedging gains/(losses) (INRm)	300	200	100	0	-100
Impact on EPS	(7.5)	(5.2)	(2.7)	-	2.9
Downside risk to our base case EPS estimate	-15.5%	-10.7%	-5.5%	0.0%	5.9%

Source: HSBC estimates

Company profile

Background

MindTree is a mid-tier IT company in India, focused on high-end IT services and R&D engineering services. The company was started in 1999 by industry veterans and recorded revenue CAGR of c57% over FY04-09. In contrast to most IT companies in India, MindTree derives two-thirds of its revenue from discretionary services such as application development. It recently acquired AztecSoft to bolster its R&D services, by adding capabilities in software product development and testing.

The company derives 43% of its revenue from R&D services – 29% from software product engineering and 14% from engineering services and embedded systems. The rest of the 57% revenues are IT services – 13% from manufacturing, 18% from BFSI and 15% from transportation.

The group has increased its focus on annuity-based services to provide stability to the top-line in a weaker IT spending environment. The company recently structured its business in five divisions – 1) IT services; 2) Product Engineering services which include research and development (R&D) and outsourced product development (OPD); 3) Testing; 4) Infrastructure Management and Technical Support (IMTS); 5) and a new area called Knowledge Services.

Details of AztecSoft acquisition

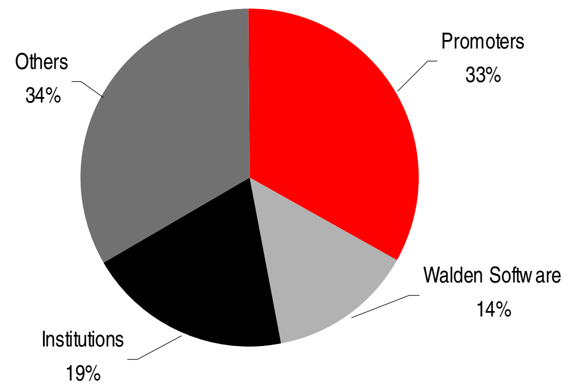
MindTree acquired AztecSoft in May 2008 to bolster its position in the R&D market. While it had a presence in engineering capabilities, through Aztec, MindTree acquired capabilities and clients in offshore product development and independent testing markets. AztecSoft had annual revenue of cUSD80m and PAT margin of c10% when acquired by MindTree.

Management profile

Name	Designation	Experience
Ashok Soota	Executive Chairman	▸ Co-founded the company in August 1999 with nine other industry professionals ▸ President of Wipro Infotech from 1984 to 1999. Under his leadership, the company grew from a USD2m business in 1984 to a run rate of USD500m business in 1999
Subroto Bagchi	Vice Chairman and Gardener	▸ Co-founder, started as the Chief Operating Officer
Krishnakumar Natarajan	CEO and Managing Director	▸ Co-founder ▸ Earlier served as President & CEO – IT Services for MindTree ▸ In the early years of MindTree, he moved to the US to launch its operations in the region and was instrumental in acquiring some of the early customers for the organisation
Rostow Ravanan	Chief Financial Officer	▸ He has been with company since inception ▸ Earlier, worked with Lucent Technologies as Business Value Manager and with KPMG Corporate Finance
S. Janakiraman	President and Group CEO, Product Engineering Services	▸ Heads Product Engineering Services (PES) of MindTree as the President and Group CEO of the business unit ▸ 29 years of experience in building R&D and Product Engineering Services organisations through setting up multiple dedicated development centres for the engineering units for semiconductor, system and application product vendors

Source: Company, HSBC

Shareholding profile



Walden software is a San Francisco based PE fund
Source: Promoters - Ashok Soota 11.3%; Subroto Bagchi 5.5%; N Krishnakumar 5.1%; Others 11.1%, Others include Global Technology Ventures 6.7% & AIG offshore 3.1%

HSBC

History of MindTree

Date	Event
Sep-09	▶ Acquisition of Kyocera Wireless India and foray into Wireless and Mobiles Technology
Jun-09	▶ Becomes Microsoft Service ready partner
May-09	▶ Named among the top 10 global Outsourced Product Development (OPD) service providers for 2009 by Global Services and neoIT in their Global Services 100 study
Mar-09	▶ It has reorganised its businesses into the following five divisions -- IT services, product engineering services, infrastructure management and technical support, independent testing and the newly created knowledge services
Dec-08	▶ MindTree wins the National Award for Excellence in Corporate Governance for 2007-08
Nov-08	▶ Became an SAP channel partner authorized to resell the SAP Business All-in-One solutions to midsize companies in North America
Sep-08	▶ Established a Testing Center of Excellence (CoE) in partnership with Hewlett Packard (HP), for HP's quality and performance testing tools
Sep-08	▶ Announced its intention to open a new development center in Monterrey, Mexico, later this year. Will employ c250 people. Scheduled to open on 1 Nov 2008
Jul-08	▶ Completed the open offer to acquire equity stake (79.9%) in Aztecsoft Limited
Jul-08	▶ Opened its own development center in Chennai. Seating capacity 2,800
May-08	▶ Acquired stake in Aztecsoft ltd (c32.5%) at INR80/sh
Apr-08	▶ Signed a multi-year IT offshoring agreement with ArcelorMittal
Apr-08	▶ MindTree Consulting changed its name to MindTree Limited
Dec-07	▶ Chief Executive Officer Krishnakumar Natarajan will take on the additional responsibility of managing director. Ashok Soota (currently Chairman & MD) appointed as Executive Chairman
Nov-07	▶ Acquired stake (100%) in TES-PV Electronic Solutions in all cash deal of USD6.5m
Mar-07	▶ Launched an Infrastructure Management and Technical Support (IMTS) business
Feb-07	▶ Net issue of c4.9m shares @ INR425/sh aggregating INR2.1bn from IPO
Jun-05	▶ Acquired Linc Software Services (100% stake) for a total consideration of INR306m
	▶ Engaged in the business of application development and maintenance, ERP product support and web development
Sep-04	▶ Acquired software division of ASAP Solutions and Arachno Solutions for a total consideration of INR32m
	▶ Both of these companies are engaged in providing information technology services, specifically SAP implementation and maintenance, data management and customized application development in Asia and USA
Jan-04	▶ Execution of contract with AIG Offshore Systems Services, for supply of IT services
Dec-01	▶ Commencement of IT outsourcing partnership with Volvo Information Technology
Oct-01	▶ Investment by Franklin Templeton Holdings (INR75.5m)
Aug-01	▶ Investment by Global Technology Ventures Limited, Walden Software Investments Limited and Capital International Global Emerging Markets Private Equity Fund LP in second round of funding (INR 590m)
Jan-00	▶ Investment by Walden Software Investments Limited, Amalgamated Holdings Limited and Vaitarna Holdings Private Limited in first round funding (INR169m)
Aug-99	▶ Formation of MindTree with two customers and commitment of funding of USD9.5m at its inception

Source: Company reports

Notes

Notes

Notes

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This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at www.hsbcnet.com/research. Details of these short-term investment opportunities can be found under the Reports section of this website.

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Rating definitions for long-term investment opportunities

Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

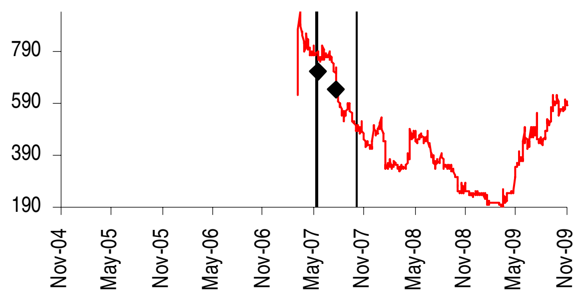
Rating distribution for long-term investment opportunities

As of 04 November 2009, the distribution of all ratings published is as follows:

Overweight (Buy)	40%	(17% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(17% of these provided with Investment Banking Services)
Underweight (Sell)	22%	(15% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

MindTree Consulting (MINT.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Underweight	17 May 2007
Underweight	N/A	04 October 2007
Target Price	**Value**	**Date**
Price 1	715.00	17 May 2007
Price 2	650.00	24 July 2007
Price 3	N/A	04 October 2007

Source: HSBC

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