

Mphasis BFL

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Shareholding (%)

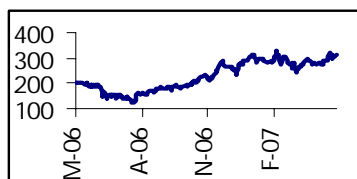
Foreign Promoters	51.1
FII's	13.8
MFs	8.7
Others	26.4

Share price performance

52-week high/low (Rs)	340/123		
	-1m	-3m	-12m
Abs (%)	11.0	12.1	56.8
Rel* (%)	4.0	12.0	43.4

*to Nifty

Stock chart



Stretched valuations, maintain 'Reduce'

During Q4FY07, Mphasis BFL (Mphasis) reported a 10.2% sequential increase in revenue and 27.4% increase in net profit to Rs3,373mn and Rs456mn respectively. Highlight of the results was 23.7% sequential increase in BPO revenue, highest in the last 18 quarters.

Though Mphasis Q4FY07 results were better than expected, we are decreasing our FY08E and FY09E EPS estimates by 4.8% and 7% respectively, to take into account higher tax rate and rupee appreciation. We now expect the company to post an EPS of Rs11.4 and Rs15.0 in FY08E and FY09E respectively, implying a two year EPS CAGR of 42.1%.

Though Mphasis' merger with EDS India is expected to be completed by mid CY07, lack of data on EDS India makes it difficult to estimate EPS of the combined entity (Mphasis and EDS India together). However, we expect the combined entity to post an EPS of Rs13.2 and Rs17.9 in FY08E and FY09E, implying a two year EPS CAGR of 44.2%.

Currently, Mphasis is quoting at FY08E and FY09E PER (based on EPS of the combined entity) of 23.8x and 17.5x respectively; this is at 2.3% and 12.6% discount to Infosys' PER respectively. However, Infosys is about 7x the size of Mphasis and has better margin and better return ratios. Therefore, Mphasis' valuation appears stretched. Though synergies with EDS would help Mphasis increase traction in its business, we believe that this has already been factored in the stock price. We are therefore maintaining 'Reduce' recommendation on the stock.

Key highlights of Q4FY07 are:

- Revenue grew 10.2% sequentially:** Mphasis reported 10.2% sequential increase in revenue, from Rs3.06bn in Q3FY07 to Rs3.37bn in Q4FY07. IT services and BPO business registered a sequential growth of 4.8% and 23.7% respectively. Growth in BPO business was the highest in the last 18 quarters.

Reduce

Rs314

April 30, 2007

Market cap

Rs bn 51

US\$ mn 1,233

Avg 3m daily volume

1,051,200

Avg 3m daily value

USD mn 7

Shares outstanding (mn)

161

Reuters

BFLS.BO

Bloomberg

BFL IN

Sensex

13,872

Nifty

4,088

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- ▲ **KPO business drives BPO business growth:** The 23.7% sequential increase in BPO business to Rs1.08bn was driven by a 189.9% sequential increase in KPO business. This led to non-voice business share in revenue increasing from 30.6% in Q3FY07 to 39.1% in Q4FY07. The company expects this share to increase further to about 50% by the end of FY08E, leading to higher average realisation and improved margin.
- ▲ **EBITDA margin declines by 17bps:** Though Mphasis' gross margin expanded by 19bps, despite a 4% rupee appreciation on account of:
 - b) Higher offshore revenue
 - c) Higher realisations in both BPO and IT services business
 - d) Improvement in the domestic BPO marginEBITDA margin fell by 17bps on account of higher sales and marketing expense, as the company increased its sales force.
The margins are expected to fall further in Q1FY08 on account of:
 - a) Offshore and onsite salary hikes of 12-16% and 5-6% respectively.
 - b) Scaling down of some contracts
 - c) Rupee appreciation
- ▲ **Lower forex loss and lower taxes help net income:** Mphasis reported forex loss of Rs26mn in Q4FY07 as against a loss of Rs60mn in Q3FY07. Further, a lower effective tax rate helped the company post a sequential increase of 27.4% in net profit. However, the effective tax rate is expected to increase going forward to 16-17% on account of imposition of MAT on IT companies.
- ▲ **Employee addition shows good visibility:** Mphasis added a net of about 1,900 employees in Q4FY07, with about 900 in IT services and 1,000 in BPO. This is the highest employee addition by the company in the last 18 quarters. The company further added 500 employees in EDS India, taking the total number of net addition to 2,400 in the combined entity. The company further expects to add about 6,500-7,500 employees in the combined entity in the next three quarters, taking the total number of net addition to 9,000-10,000 in CY07. We believe that this indicates good visibility for the company going forward.
- ▲ **Business from EDS clients flowing in:** Mphasis is witnessing an increased visibility from EDS as a client as well as from EDS clients. The company is expected to benefit from annuity revenue coming from EDS as it off-shores a lot of maintenance work of its clients to Mphasis. Mphasis is also benefiting from EDS as a client. Mphasis is currently doing F&A and HR-shared services work for EDS. Revenue from EDS as a client has doubled in the last three quarters, with EDS contributing US\$9mn to the topline in Q4FY07.
- ▲ **Increasing visibility in Infrastructure management and testing services:** The company is investing and building its capabilities in remote infrastructure

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management and testing, the two fastest growing services in the offshore space. The company currently has good visibility in these services and is ramping up fast to cater to demand. It currently has 700 people working in remote infrastructure management and another 1,300 in remote desktop management. It further has 700 people in the testing space and expects to add another 600 by the end of FY08E.

- ▲ **Financials:** Though the company reported better than expected Q4FY07, we are reducing FY08E and FY09E EPS estimates by 4.8% and 7% respectively to Rs11.4 and Rs15. The reduction is on account of expectation of higher tax rate and rupee appreciation. Our estimates are based on Rs/USD rate of Rs42.25 in FY08E and Rs42 in FY09E. Though Mphasis' merger with EDS is expected to be completed by mid CY07, it is difficult to estimate EPS of the combined entity (Mphasis and EDS India together) due to the lack of data on EDS India. EDS India posted revenue of Rs5.7bn and net profit of Rs590mn in FY07. Further, it currently has in excess of 5,000 employees. We expect the combined entity to post an EPS of Rs13.2 and Rs17.9 in FY08E and FY09E respectively, implying a two year EPS CAGR of 44.2%.
- ▲ **Valuation:** Synergies with EDS are expected to help Mphasis increase traction in its business. However, we believe that at the current FY08E and FY09E PER of 23.8x and 17.5x respectively, these synergies have already been factored in the stock price. Further, the stock is quoting at 2.3% discount to FY08E PER of Infosys, a company almost 7x the size of Mphasis and having better margin and return ratios. Therefore, Mphasis' valuation appears stretched. We thus maintain 'Reduce' rating on the stock.

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Table 1: Quarterly result table

Rs mn	Q4FY07	Q3FY07	QoQ (%)	Q4FY06	YoY (%)
Revenue	3,373	3,060	10.2%	2,505	34.6%
IT Services	2,291	2,185	4.8%	1,724	32.9%
IT Enabled	1,081	874	23.7%	781	38.5%
Cost of Revenues	2,179	1,982	9.9%	1,620	34.5%
Gross Profit	1,194	1,077	10.8%	885	34.9%
GPM	35.4%	35.2%		35.3%	
SG&A	547	485	12.7%	371	47.2%
EBITDA	647	592	9.3%	514	26.0%
EBITDA Margin	19.2%	19.4%		20.5%	
Depreciation	163	161	1.2%	140	16.3%
EBIT	484	431	12.3%	373	29.6%
EBIT Margin	14.3%	14.1%		14.9%	
Forex gains/Losses	(26)	(60)		12	
Other Income	20	10	90.3%	10	
Provision for doubtful debts	1	4	-86.3%	1	-31.6%
PBT	478	378	26.5%	394	21.2%
Tax	22	20	10.2%	43	-48.5%
Tax rate	4.6%	5.3%		10.8%	
Net Income	456	358	27.4%	352	29.6%
NPM	13.5%	11.7%		14.0%	

Source: IISL Research, Company

Table 2: Estimates

Rs mn	FY06	FY07	FY08E	FY09E
Revenue	9,401	11,958	16,165	20,869
% change	22.8%	27.2%	35.2%	29.1%
EBITDA	1,975	2,049	2,849	3,763
% change	39.8%	3.8%	39.0%	32.1%
Net Profit	1,499	1,199	1,830	2,421
% change	20.2%	-20.0%	52.7%	32.3%
EPS (Rs) (Without EDS India)*	9.3	7.4	11.4	15.0
EPS (Rs) (With EDS India)*	9.3	8.6	13.2	17.9
PE (x) (Without EDS India)	33.7	42.1	27.6	20.9
PE (x) (With EDS India)	33.7	36.5	23.8	17.5
ROCE (%)	30.2%	20.3%	26.3%	29.1%
ROE (%)	23.0%	17.2%	22.9%	25.1%

*EPS with EDS India based on share count of 208mn, EPS without EDS India based on 161mn share count

Source: IISL Research, Company

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