MphasiS

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,091	BFL IN
	REUTERS CODE
S&P CNX: 4,083	BFLS.BO

Equity Shares (m)	162.4
52-Week Range	319/121
1,6,12 Rel. Perf. (%)	-9/50/19
M.Cap. (Rs b)	45.4
M.Cap. (US$ b)	1.0

31 January 2007

Buy

Previous Recommendation: Neutral

Rs279

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E RATIO	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A	9,401	1,499	9.3	13.5	30.0	11.2	43.8	45.0	4.7	22.2
3/07E	11,813	1,175	7.2	-22.2	38.6	9.3	26.9	30.7	3.8	21.7
3/08E	14,965	1,886	11.6	60.5	24.1	7.3	34.3	39.4	2.9	14.9

**Does not include financials of EDS India*

- **Operational performance exceeds expectations; forex losses dampen net profit growth:** Mphasis reported revenue of Rs3b, up 4.8%QoQ. IT services were up 6.2%QoQ; BPO grew slower at 1.4%QoQ Price realizations were up during the quarter; onsite rates were up 1.5%, while offshore rates were up 4.8%QoQ. BPO rates were up to US$9/hr. EBITDA margins improved 260bp to 19.2% due to improvement in price realization and utilization rates (in IT services). Net profit was up 53% to Rs358m.
- **Expect EDS driven revenue to lead to strong growth post FY07:** MphasiS has started getting traction in several large deals along with EDS, which are likely to add to revenue from FY08 onwards. Shared services (BPO) to EDS are expected to ramp up over the next few quarters. With the management targeting US$1b in revenue over the next 3 years, we believe that EDS would contribute significantly towards the achievement of the same.
- **EDS parentage to keep high realizations, bring economies of scale:** We expect realizations to remain high in IT services through a mix of higher billing rates service offerings through EDS. With greater revenue traction expected through EDS post FY07, we expect SG&A as a percentage of revenue to come off the present levels.
- **Outlook and view:** With higher than expected billing rates in 3QFY07 as well as its sustainability in future, higher EBIDTA margins in 3QFY07 and management's confidence of robust volume traction in IT services going forward, we have significantly revised our diluted FY08E EPS (after considering EDS(I) and upside through EDS Global) upward by 9% to Rs14.7. We have also introduced our FY09 diluted EPS at Rs18.1. At CMP stock is trading at 19xFY08E and 15.4xFY09E diluted EPS. We are upgrading our recommendation from Neutral to **Buy** for a target price of Rs330.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenues	**2,197**	**2,274**	**2,425**	**2,505**	**2,607**	**2,919**	**3,060**	**3,228**	**9,401**	**11,814**
Q-o-Q Change (%)	*7.1*	*3.5*	*6.6*	*3.3*	*4.1*	*12.0*	*4.8*	*5.5*	*22.8*	*25.7*
Direct Expenses	1,468	1,439	1,529	1,620	1,858	1,935	1,982	2,066	6,043	7,842
Sales, General & Admin. Expenses	338	340	333	372	434	499	489	505	1,378	1,927
Operating Profit	**391**	**495**	**562**	**513**	**315**	**485**	**588**	**656**	**1,981**	**2,044**
Margins (%)	*17.8*	*21.8*	*23.2*	*20.5*	*12.1*	*16.6*	*19.2*	*20.3*	*21.1*	*17.3*
Other Income	58	30	-16	22	42	-56	-50	13	94	-50
Depreciation	118	123	139	140	150	157	161	171	518	639
Provisions	0	0	0	0	0	0	0	0	0	0
PBT bef. Extra-ordinary	**332**	**402**	**408**	**394**	**207**	**273**	**378**	**497**	**1,557**	**1,355**
Provision for Tax	-5	1	-1	43	55	39	20	65	58	179
Rate (%)	*-1.6*	*0.3*	*-0.2*	*10.8*	*26.7*	*14.2*	*5.3*	*13.0*	*3.7*	*13.2*
PAT bef. Extra-ordinary	**337**	**401**	**408**	**352**	**152**	**234**	**358**	**433**	**1,499**	**1,176**
Q-o-Q Change (%)	*9.2*	*19.1*	*1.8*	*-13.9*	*-56.8*	*54.0*	*52.9*	*21.0*	*20.4*	*-21.5*

E: MOSt Estimates; Standalone without EDS (I) and upside through EDS Global

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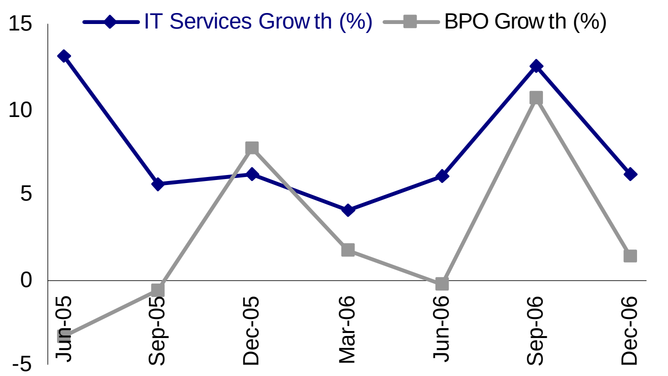
Operational performance exceeds expectations; forex losses dampen net profit growth

Mphasis reported revenue of Rs3b, up 4.8%QoQ, marginally below our expectation of 5.8%QoQ. Lower growth was on account of lower than expected growth in BPO revenues and higher than expected rupee appreciation. IT services were up 6.2%QoQ (dollar growth 8.6%) vs. our expectation of 5.6%QoQ (dollar growth of 7.5%), while BPO at 1.4%QoQ grew slower than our expectation of 6.3%QoQ. Within IT services, BFSI and Technology grew strongly at 8.4% and 8.7%QoQ, while Retail declined 5.4%QoQ. In BPO, inbound voice services (68% of revenue) declined 5%QoQ; outbound voice remained flat, while non voice grew 19.6%QoQ to 30.7% of total revenue (future focus to be on Non Vice). Non voice revenue increased to 30.7% from 26% in the previous quarter.

IT SERVICES FARES WELL, BPO LAGS BEHIND DUE TO DECLINE IN VOICE



Source: Company/ Motilal Oswal Securities

Top client performance during the quarter was uneven in both IT services and BPO. In IT services, growth amongst top clients was propped up by the bottom half of the top 10, while in BPO the top client supported growth.

CLIENT RATIONALIZATION LEADING TO VOLATILE GROWTH (%)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
IT Services					
Top client	6.1	16.3	-10.7	-8.6	-1.9
Top 2-5	6.1	11.5	13.1	16.0	3.0
Top 6-10	12.8	-8.2	6.0	5.0	13.8
BPO					
Top Client	-11.3	16.2	-6.5	18.0	7.7
Top 2-3 clients	23.1	-2.5	8.4	15.1	-10.3
Top 4-5 clients	7.7	1.7	5.3	4.8	1.4

Source: Company/ Motilal Oswal Securities

EBIDTA margin much higher than expected

Price realizations were up during the quarter, both in IT services and BPO. Onsite rates were up 1.5%, while offshore rates were up 4.8%QoQ (based on rounded off billing rates). BPO rates were up to $9/hr after several quarters of decline.

Gross margins improved 150bp despite 380bp impact of rupee appreciation during the quarter due to improvement in billing rates and improved utilization in IT services. SG&A declined by 90bp due to absence of one time selling expenses that were incurred during the previous quarter. (however G&A cost is also lower by 40bp). EBITDA margins improved 260bp to 19.2% due to the above reasons (versus our estimate of 17.8%).

Forex losses dampen net profit growth

Forex losses to the tune of Rs60m resulted in negative other income of Rs50m against our expectation of Rs38m positive other income. Tax rate for the quarter was lower at 5.3% of PBT (vs. 14.2% in 2QFY07) due to deferred tax credits of Rs8m during the quarter. Net profit was up 53% to Rs358m, slightly lower than our estimate of Rs364m (despite better than expected operating profit), primarily due to the negative other income during the quarter.

Expect EDS to lead to strong growth post FY07

The impact of the EDS parentage has started resulting in better performance for Mphasis standalone during 3QFY07 itself. Revenue from the EDS channel (excluding EDS (India)) has increased to US$5m (from US$2.5m in the previous quarter), and is expected to ramp up further. EDS parentage could help gain access to hitherto reclusive customer base with expectation of higher contract sizes per client. Mphasis has also started tapping top 17 customers of EDS global and expects good ramp up in future. The company has already started getting traction in large deals along with EDS, which are likely to add to revenue from FY08 onwards. Management has also started tapping infrastructure services, which we believe will be a key to win large deals and expects Infrastructure services to contribute around 20% of revenues in next three years (EDS global derives around 56% of its revenues from IT

Outsourcing). Overall Mphasis expects robust volume growth from FY08 basis on a consolidated basis to be largely driven by IT services (reiterated target of US$1b revenues in next three years - including EDS (I)).

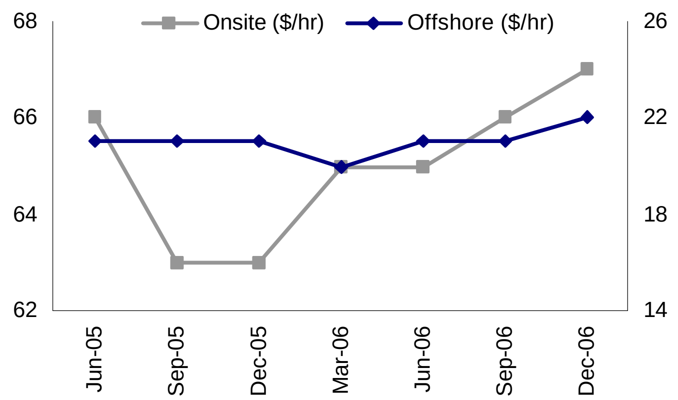
Within BPO, management is looking restructure its services portfolio to include Non Voice services like back office processing work. Within Voice also, company is diversifying more towards CRM related services. BPO India operations have also tuned into black. Mphasis has also started doing business for EDS Global for its HR/Accounts/Sales support work. With ongoing restructuring, management is expecting muted growth in BPO going forward.

With the management targeting US$1b in revenue over the next 3 years, we believe that EDS would contribute significantly towards the achievement of the same. Post FY07, we expect that revenue driven by EDS would help Mphasis (along with EDS (I)) to achieve outperforming growth rates.

EDS parentage to boosts realizations, bring economies of scale

While revenue through the EDS channel has doubled over the previous quarter, the business pipeline for Mphasis standalone is also expected to improve given the EDS parentage.

EXPECT FURTHER INCREASE IN REALIZATIONS IN IT SERVICES

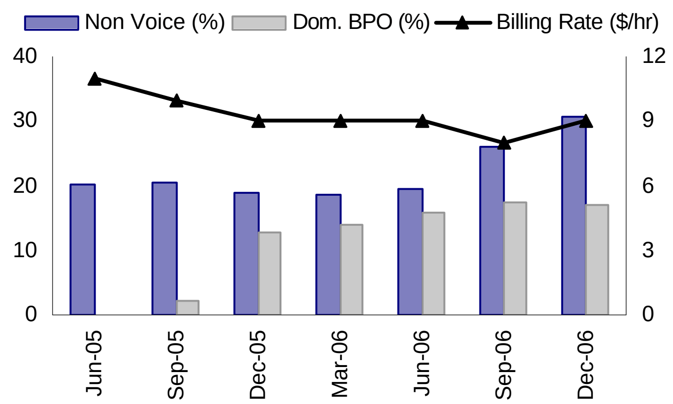


Source: Company/ Motilal Oswal Securities

The company's perception amongst clients, which had taken a beating post the BPO fraud in FY05, would be dramatically improved due to the EDS parentage. We expect realizations to remain high in IT services through a mix of higher billing rates service offerings through EDS (Infrastructure services, consulting, etc.)

In BPO, we expect higher improvement in non voice BPO with anticipated ramp ups in shared services in BPO. Non voice services are currently at 30.7% of BPO revenue and we expect any increase in the same could result in improvement in realizations as well as profitability in the BPO business. In addition, EDS revenue would result in higher contribution from international BPO operations (currently at 83%), which would also help improve realizations.

NON VOICE, INTERNATIONAL BUSINESS TO IMPROVE RATES IN BPO



Source: Company/ Motilal Oswal Securities

Mphasis is currently seeing increases in billing rates for new deals and believes that rate increases in existing deals would be a challenge. However, we expect to see some improvement in existing deals going forward, given that Mphasis would be able to offer a wider range of service offerings in addition to its position as a leading IT services vendor due to EDS parentage.

In addition to improvement in realizations, we expect significant economies of scale to kick in once the merger with EDS (I) is complete and the company begins to receive the full benefits of greater offshoring from the parent company. SG&A, which is currently at 16.1% (16.6% in 9m FY07), has scope for further improvement. With greater revenue traction expected through EDS post FY07, we expect SG&A as a percentage of revenue to come off the present levels.

Employee Ramp up to remain challenge

The company plans to recruit around 9,000-10,000 (Net) employees in CY07 on a current base of 17600 (including EDS(I)). We believe this is a steep target as management has to pull up its recruitment resources significantly. However management has started investing in creating training infrastructure (plan to announce a training centre in Mangalore in coming months with capacity to train 500 employees on an ongoing basis). We also believe that if management is successful in ramping up its team by another 9,000-10,000 employees in CY2007, then there may be upside to our estimates.

Outlook and view – Upgrade to Buy

With higher than expected billing rates in 3QFY07 as well as its sustainability in future, higher EBIDTA margins in 3QFY07 and management's confidence of robust volume traction in IT services going forward, we have significantly revised our diluted FY08E EPS (after considering EDS(I) and upside through EDS Global) upward by 9% to Rs14.7. We have also introduced our FY09 diluted EPS at Rs18.1. At CMP stock is trading at 19xFY08E and 15.4xFY09E diluted EPS. Considering robust visibility in earnings through EDS global, we are upgrading our recommendation from Neutral to **Buy** for a target price of Rs330 (based 18x diluted FY09 EPS), upside of 18.3%. We also believe that if management is successful in ramping up its team by another 9,000-10,000 employees in CY07, then there may be upside to our estimates.

SCENARIO ANALYSIS – FINANCIAL UPSIDE OF EDS PARENTAGE AND EDS (I) MERGER (RS M)

	CURRENT ESTIMATES			UPSIDE IN ESTIMATES SCENARIO 1			UPSIDE IN ESTIMATES SCENARIO 2		
	FY07E	FY08E	FY09E	FY07E	FY08E	FY09E	FY07E	FY08E	FY09E
IT Services	**8,385**	**11,022**	**13,814**	**8,385**	**11,022**	**13,814**	**8,385**	**11,022**	**13,814**
Additional business from/thru EDS				0	1,750	2,363	0	2,625	3,806
EDS India				3,929	5,305	7,161	3,929	5,501	7,702
Total IT services	**8,385**	**11,022**	**13,814**	**12,315**	**18,076**	**23,338**	**12,315**	**19,148**	**25,322**
% Change	*30.6*	*31.4*	*25.3*	*91.8*	*46.8*	*29.1*	*91.8*	*55.5*	*32.2*
BPO Services	**3,427**	**3,943**	**4,791**	**3,427**	**3,943**	**4,791**	**3,427**	**3,943**	**4,791**
Additional business from/thru EDS				0	656	820	0	1,094	1,422
EDS India				587	792	1030	587	822	1,109
Total BPO services	**3,427**	**3,943**	**4,791**	**4,014**	**5,392**	**6,641**	**4,014**	**5,858**	**7,322**
% Change	*15.0*	*15.0*	*21.5*	*34.7*	*34.3*	*23.2*	*34.7*	*45.9*	*25.0*
Total Revenues - Rs in mn	**11,813**	**14,965**	**18,605**	**16,329**	**23,468**	**29,979**	**16,329**	**25,006**	**32,644**
% Change	*25.7*	*26.7*	*24.3*	*73.7*	*43.7*	*27.7*	*73.7*	*53.1*	*30.5*
PAT	**1,175**	**1,886**	**2,199**	**1,758**	**2,940**	**3,573**	**1,758**	**3,157**	**3,928**
% Change	*(21.6)*	*60.5*	*16.6*	*17.3*	*67.2*	*21.5*	*17.3*	*79.6*	*24.4*
EPS @ 27% equity dilution				8.5	14.2	17.3	8.5	15.2	19.0
P/E (x)				32.9	19.7	16.2	32.9	18.3	14.7

Notes:

- We expect Mphasis to register diluted EPS of Rs14.7 and Rs18.1 in FY08 and FY09 respectively (average of Scenario 1 and 2), at CMP P/E based diluted earnings works out to 19xFY08E and 15.4xFY09E.

MphasiS BFL: an investment profile

Company description

MphasiS BFL is one of the Top 20 integrated software services vendors employing more than 17,500 people in both IT services as well as BPO services (including EDS (I)), catering to more than 300 clients. It is one of the largest BPO services vendors in India and in IT services, it is mainly focused on the Banking, Financial Services and Insurance segment. Some of its large clients include Citibank, JP Morgan Chase and FedEx.

Key investment arguments

- Most preferred tier-2 vendor in the BFSI segment.
- EDS parentage to help Mphasis enter the big league in terms of client wins and larger contract sizes.

Key investment risks

- Faces intense competition in the BFSI segment from the top 6 players in the industry.
- Ramping of employees will be a challenge.

Recent developments

- EDS India expected to be merged with Mphasis with effect from 4QFY07 pending court approval.
- Named to the International Association of Outsourcing Professionals (IAOP) 2006 Global Outsourcing 100 List.

Valuation and view

- We expect consolidated revenue (including EDS (I) and upside through EDS Parentage) CAGR of 38.5% and net profit CAGR of 46.1% over FY07-FY09.
- Valuations at 15.4x FY09E diluted earnings offer room for upside.
- Upgrade to **Buy** with a target price of Rs330.

Sector view

- Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- Indian offshore vendors gaining market share in competition with MNCs.
- Prefer large companies, as bulk of volumes going to them while niche players benefit due to lack of offshore competition.

COMPARATIVE VALUATIONS

		MPHASIS*	HEXAWARE	I-FLEX
P/E (x)	FY07E	38.6	17.4	50.6
	FY08E	24.1	14.0	34.5
P/BV (x)	FY07E	9.3	2.9	7.2
	FY08E	7.3	2.5	6.1
EV/Sales (x)	FY07E	3.8	2.1	7.2
	FY08E	2.9	1.6	5.2
EV/EBITDA (x)	FY07E	21.7	13.2	37.7
	FY08E	14.9	10.5	24.5

* *Standalone*

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	8.5	-	-
FY08	14.7	-	-

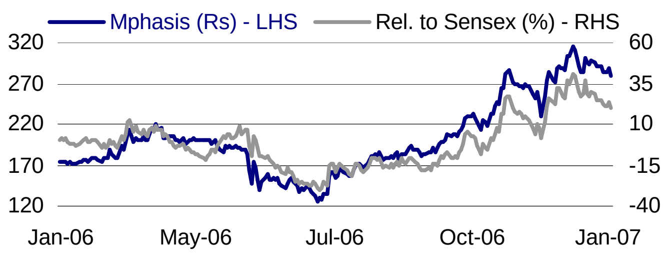
TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
279	330	18.3	Buy

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoters	51.2	51.4	0.0
Domestic Institutions	7.4	4.3	4.5
FIIs/FDIs	13.1	16.3	31.5
Others	28.3	28.0	64.0

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
Revenues	**7,656**	**9,401**	**11,813**	**14,965**	**18,605**
Change (%)	*31.9*	*22.8*	*25.7*	*26.7*	*24.3*
Cost Of Goods Sold	4,956	6,043	7,842	9,966	12,773
SG&A Expenses	1,290	1,378	1,927	2,110	2,386
EBITDA	**1,410**	**1,981**	**2,043**	**2,888**	**3,447**
% of Net Sales	*18.4*	*21.1*	*17.3*	*19.3*	*18.5*
Depreciation	396	518	639	793	977
Interest	-41	-17	-50	-55	-36
Other Income	72	77	-101	30	51
PBT	**1,127**	**1,557**	**1,354**	**2,180**	**2,558**
Tax	-117	58	179	294	358
Rate (%)	*-10.4*	*3.7*	*13.2*	*13.5*	*14.0*
PAT	**1,244**	**1,499**	**1,175**	**1,886**	**2,200**
Extra-ordinary items	0	0	0	0	0
Net Income	**1,244**	**1,499**	**1,175**	**1,886**	**2,200**
Change (%)	*26.2*	*20.4*	*-21.6*	*60.5*	*16.7*

BALANCE SHEET					(Rs Million)
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
Share Capital	786	1,610	1,624	1,624	1,624
Share Premium	2,464	1,165	1,269	1,269	1,269
Reserves	-344	1,154	1,926	3,295	4,864
Net Worth	**2,906**	**3,929**	**4,820**	**6,188**	**7,757**
Minority Interest	0	0	0	0	0
Loans	46	37	30	20	20
Capital Employed	**2,953**	**3,966**	**4,850**	**6,208**	**7,777**
Gross Block	2,557	3,143	3,743	4,593	5,543
Less : Depreciation	1,455	1,802	2,441	3,234	4,211
Net Block	**1,102**	**1,341**	**1,302**	**1,359**	**1,332**
CWIP	96	114	225	200	200
Curr. Assets	**3,747**	**3,918**	**5,296**	**7,186**	**9,538**
Debtors	1,835	2,050	2,999	3,397	4,555
Cash & Bank Balance	955	989	1,056	2,296	3,212
Loans & Advances	806	711	1,061	1,334	1,643
Other Current Assets	152	169	180	159	128
Current Liab. & Prov	**1,992**	**1,407**	**1,973**	**2,538**	**3,294**
Sundry Liabilities	1,602	767	1,310	1,353	1,661
Provisions	390	640	663	1,184	1,632
Net Current Assets	**1,755**	**2,511**	**3,323**	**4,648**	**6,244**
Application of Funds	**2,953**	**3,966**	**4,850**	**6,208**	**7,779**

E: MOSt Estimates; Standalone

RATIOS					
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
Basic (Rs)					
EPS	**8.2**	**9.3**	**7.2**	**11.6**	**13.5**
Cash EPS	10.4	12.5	11.2	16.5	19.6
Book Value	19.0	24.9	30.1	38.5	48.1
DPS	1.5	3.0	2.2	3.5	4.1
Payout %(Incl.Div.Taxes)	19.0	32.2	30.0	30.0	30.0
Valuation (x)					
P/E		30.0	38.6	24.1	20.6
Cash P/E		22.3	25.0	16.9	14.3
EV/EBITDA		22.2	21.7	14.9	12.2
EV/Sales		4.7	3.8	2.9	2.3
Price/Book Value		11.2	9.3	7.3	5.8
Dividend Yield (%)		1.1	0.8	1.2	1.5
Profitability Ratios (%)					
RoE	39.4	43.8	26.9	34.3	31.6
RoCE	33.3	45.0	30.7	39.4	36.6
Turnover Ratios					
Debtors (Days)	87	80	93	83	89
Asset Turnover (x)	3.0	3.0	3.2	3.3	3.4
Leverage Ratio					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
CF from Operations	1,640	2,017	1,814	2,679	3,176
Cash for Wkg. Capital	-665	723	795	38	650
Net Operating CF	**2,305**	**1,294**	**1,020**	**2,641**	**2,526**
Net Purchase of FA	-543	-605	-711	-825	-950
Net Purchase of Invest.	-3,568	312	0	0	0
Net Cash from Invest.	**-4,110**	**-293**	**-711**	**-825**	**-950**
Proceeds from Pvt. placeme	1,651	-475	118	0	0
Proceeds from LTB/STB	19	-9	-7	-10	0
Dividend Payments	-236	-483	-353	-566	-660
Net CF from Financing	**1,434**	**-968**	**-241**	**-576**	**-660**
Free Cash Flow	1,762	689	359	1,768	1,546
Net Cash Flow	**-371**	**34**	**67**	**1,240**	**916**
Opening Cash Balance	**1,326**	**955**	**988**	**1,056**	**2,296**
Add: Net Cash	-371	34	67	1,240	916
Closing Cash Balance	**955**	**988**	**1,056**	**2,296**	**3,212**

N O T E S

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Disclosure of Interest Statement	MphasiS
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No