

MPHASIS

No respite in the medium term

March 10, 2011

Reuters: MBFL.BO Bloomberg: MPHL IN

EDELWEISS 4D RATINGS

Absolute Rating	REDUCE
Rating Relative to Sector	Underperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 461
52-week range (INR)	:	712 / 355
Share in issue (mn)	:	210.0
M cap (INR bn/USD mn)	:	97 / 2,145
Avg. Daily Vol. BSE/NSE ('000)	:	663.2

SHARE HOLDING PATTERN (%)

Promoters*	:	60.5
MFs, FIs & Banks	:	8.0
FIIIs	:	18.0
Others	:	13.5
* Promoters pledged shares (% of share in issue)	:	NIL

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	(26.9)	5.3	1.9
3 months	(21.3)	(4.1)	2.7
12 months	(28.4)	8.4	26.2

Mphasis' recently declared results for quarter ending January 2011, came in as a shocker with actual results differing significantly against expectations, despite anticipated concerns. We met with Mr. Ganesh Murthy, CFO, Mphasis to understand business outlook going forward from direct and HP channel. We summarize the takeaways below:

- Expect moderate growth through HP channel (1-2% Q-o-Q)

Driven by decline in HP's services revenues, management has indicated sluggish revenue growth (meager 1-2%) from the HP channel for the next few quarters. Factors such as volatility in HP's services revenues, short-term signings or project based revenues lower than expected and migration work losing traction are resulting in overall bleak growth outlook from the HP channel.

- Revenues from direct channel to grow faster than HP channel

With a view of increasing direct channel's contribution (currently 32% of revenues), Mphasis is hiring talent to develop industry specific solutions in the banking and capital markets (BCM) and insurance verticals. Also, two-third of its sales force is dedicated to direct channel. Management expects these initiatives to be fruitful and believes it to grow 3-5% Q-o-Q for the next three quarters.

- Operating margins to drift down further

Management expects EBIT margins in the range of 16-18% for the next three quarters. We believe persisting price pressure and wage hikes (~10% offshore and 2-3% onsite) effective May 2011 - are key reasons for margin detractors.

- Acquisition to reduce HP dependence and add new logos

Mphasis is actively looking for an acquisition to utilise part of its accumulated USD 380 mn cash pile. However, we will be cautious on the same, given its primary rationale is to add new logos and revenues to reduce dependence on HP.

- Outlook and valuations: No respite; maintain 'REDUCE'

Mphasis' business continues to have structural issues, with HP determining the growth trajectory. Muted revenue growth and margin decline trend is expected to continue. We, thus, maintain our 'REDUCE/ Sector Underperformer' recommendation/rating on the stock. At CMP of INR 461, the stock is trading at P/E of 11.9x and 11.5x our FY12E and FY13E estimates, respectively.

Financials

Year to October	FY10	FY11	FY12E	FY13E
Revenues (INR mn)	42,639	50,365	52,321	59,164
Revenue growth (%)	30.5	18.1	3.9	13.1
EBITDA (INR mn)	11,275	12,648	10,402	11,955
Net profit (INR mn)	9,087	10,907	8,154	8,487
Shares outstanding (mn)	211	211	211	211
Diluted EPS (INR)	43.1	51.8	38.7	40.2
EPS growth (%)	79.3	20.0	(25.3)	4.1
Diluted P/E (x)	10.7	8.9	11.9	11.5
EV/EBITDA (x)	7.7	6.4	7.1	6.0
ROAE (%)	48.1	38.6	22.3	19.4

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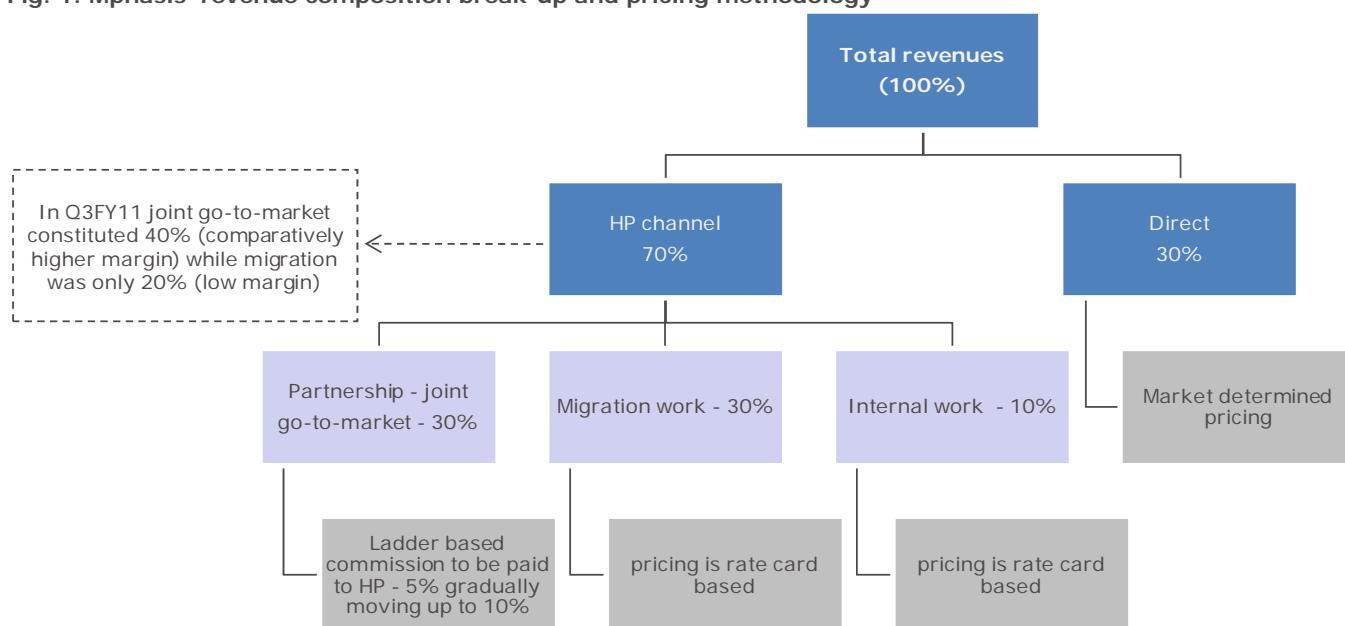
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■ Operating margins to drift down further

Management expects EBIT margins in the range of 16-18% for the next three quarters, from 18% reported for Q1 and 22% last year. We believe persisting price pressure and expected wage hikes (~10% offshore and 2-3% onsite) effective May 2011 - are key reasons for margin detractors.

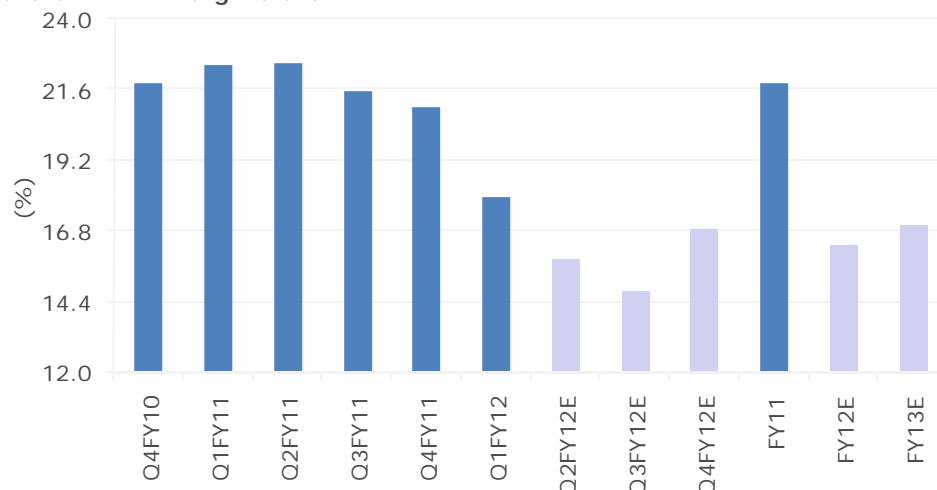
We also note that among the key reasons for the margin collapse in the recent quarter is not only the selective pricing cut given to few clients in the 'go-to-market' segment, but also shift of work from go-to-market to rate-card-driven. **This is expected to have led the contribution of 'joint go-to-market' reducing to 30% from 40% in just a matter of two quarters, apart from lack of growth in the go-to-market business.** With rate-card-based pricing lower (**18-20% gross margin**) than go-to-market, margin impact due to this shift is also expected to have contributed to the margin decline.

Fig. 1: Mphasis' revenue composition break-up and pricing methodology



Source: Company, Edelweiss research

Chart 1: EBIT margin trend

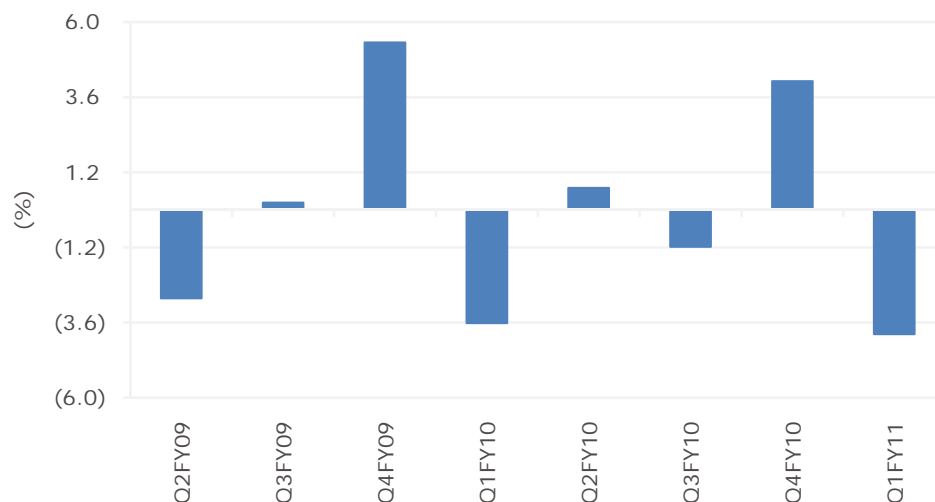


Source: Company, Edelweiss research

■ Growth from HP channel to remain sluggish

Driven by decline in HP's services revenues, management has indicated sluggish revenue growth (meager 1-2%) from the HP channel for the next few quarters. Factors such as volatility in HP's services revenues, short-term signings or project based revenues lower than expected level and migration work losing traction are resulting in overall bleak growth outlook from the HP channel.

Chart 2: HP services' sequential revenue growth



Source: Company, Edelweiss research

■ Direct channel to grow faster than HP

With a view of increasing direct channel's contribution (currently 32% of revenues), Mphasis is hiring talent to develop industry specific solutions in BCM and insurance verticals. Also, two-third of its sales force is dedicated to direct channel. Recent quarter, Q1FY12, saw 13 new direct customer wins; however, we would like to highlight that the average deal size is just USD 3-5 mn, with the largest being implementation of the UID project in some parts of Maharashtra and 13 districts of Andhra Pradesh. Management expects these initiatives to be fruitful and is confident of growth from direct channel at 3-5% Q-o-Q for the next three quarters. While traction is increasing due to the smaller nature of deals and overall contribution of direct business at ~30%, the overall quarterly growth rate for the company is unlikely to cross 3% sequentially.

■ Acquisition to reduce HP dependence and add new logos

Mphasis is actively looking for an acquisition to utilise part of its accumulated USD 380 mn cash pile. It is looking at acquire companies in the BCM and insurance space and has already shortlisted three of them (one under due diligence). However, we would be cautious on the acquisition, given the primary rationale is to add new logos and revenues to reduce dependence on the HP channel. However, management has indicated the option for share buy-back in case it does not succeed in acquiring any company in the next 2-3 quarters.

■ **Outlook and valuations: No respite; maintain 'REDUCE'**

Mphasis' business continues to have structural issues, with HP determining the growth trajectory. Muted revenue growth and margin decline trend is expected to continue. We, thus, maintain our '**REDUCE/ Sector Underperformer**' recommendation/rating on the stock. At CMP of INR 461, the stock is trading at P/E of 11.9x and 11.5x our FY12E and FY13E estimates, respectively.

Chart 3: Mphasis' one year rolling forward P/E chart



Source: Company, Edelweiss research

Table 1: Mphasis' absolute and relative stock performance

	Absolute stock performance (%)					Relative to BSE ITINDEX (%)					Relative to Sensex (%)				
	1 mth	2 mth	3 mth	6 mth	1 yr	1 mth	2 mth	3 mth	6 mth	1 yr	1 mth	2 mth	3 mth	6 mth	1 yr
Infosys	1.6	(7.1)	(1.7)	8.2	17	(0.1)	(2.2)	(1.4)	(2.0)	0.6	(1.8)	(2.6)	4.3	10.7	10.7
TCS	1.7	1.1	3.3	27.2	43	0.1	6.0	3.6	17.0	26.6	(1.6)	5.6	9.4	29.7	36.7
Wipro	8.2	(2.3)	1.3	12.0	8	6.5	2.6	1.6	1.8	(8.5)	4.8	2.3	7.4	14.5	1.5
HCLT	(2.7)	(3.5)	6.3	12.5	28	(4.4)	1.4	6.5	2.3	11.6	(6.1)	1.0	12.3	15.0	21.6
Mphasis	(28.2)	(31.2)	(23.0)	(28.1)	(28)	(29.9)	(26.3)	(22.7)	(38.3)	(45.3)	(31.6)	(26.6)	(17.0)	(25.6)	(35.2)
Patni	(1.5)	1.7	0.1	1.0	(0)	(3.2)	6.6	0.4	(9.2)	(17.3)	(4.9)	6.2	6.2	3.5	(7.2)

Source: Company, Edelweiss research

■ Company Description

Mphasis is a tier-II and one of the top 10-IT integrated software services vendors in India. The company provides IT services, mainly focused on banking, financial services, and insurance segments. It has one of the largest BPO practices in India, providing voice- and transaction-based services. In June 2006, Electronic Data Systems (EDS) bought a majority stake in Mphasis and now, its total holding stands at 60.61%. EDS is now acquired by Hewlett Packard (HP). The company has total employee strength of 41,059 (23,936 plus in IT services and around 15,661 in BPO services).

■ Investment Theme

HP as the owner, issues such as size and scale, market access, and enhanced capabilities in offshore delivery are improving at healthy pace. Incremental business for Mphasis is likely to come from direct working with HP clients and that now contributes 68% to its revenues. However, with HP being the major client and shareholder as well, the dependency risk has increased substantially along bill rate pressure that is being witnessed currently. We see inadequate investments to grow non-HP business to impact the growth rates going forward as HP business is also undergoing rationalisation. Further, sharp increase in effective tax rates will restrict the growth rate at net profit level over the next two years.

■ Key Risks

Key risks to our investment theme include: (a) no further bill rate pressure from HP; (b) fast scale-up of non-HP business; and (c) depreciation of rupee against USD, GBP, and EUR.

Financial Statements

Income statement

(INR mn)

Year to October	FY09	FY10	FY11	FY12E	FY13E
Net revenue	19,065	42,639	50,365	52,321	59,164
Cost of revenues	13,316	26,901	33,519	37,063	41,884
Gross profit	5,749	15,738	16,846	15,258	17,280
Total SG&A expenses	1,865	4,463	4,198	4,856	5,325
S&M expenses	721	1,791	2,201	2,812	2,958
G&A expenses	1,144	2,672	1,996	2,044	2,367
EBITDA	3,884	11,275	12,648	10,402	11,955
Depreciation & amortization	1,005	2,022	1,638	1,850	1,900
EBIT	2,879	9,253	11,011	8,552	10,055
Other income	54	183	508	819	1,261
Foreign exchange gain/(loss)	164	292	581	500	-
Profit before tax	3,097	9,728	12,099	9,871	11,316
Provision for tax	143	641	1,192	1,717	2,829
Core profit	2,954	9,087	10,907	8,154	8,487
Profit after tax	2,954	9,087	10,907	8,154	8,487
Profit after minority interest	2,954	9,087	10,907	8,154	8,487
Basic shares outstanding (mn)	209	209	210	210	210
Basic EPS (INR)	14.1	43.4	52.0	38.8	40.4
Diluted equity shares (mn)	210	211	211	211	211
Diluted EPS (INR)	14.0	43.1	51.8	38.7	40.2
CEPS (INR)	18.9	53.1	59.8	47.6	49.4
Dividend per share (INR)	4.5	3.5	4.0	4.8	4.8
Dividend (%)	45.5	35.1	40.0	47.6	47.6
Dividend payout (%)	36.2	9.4	9.0	13.8	13.3

Common size metrics

Year to October	FY09	FY10	FY11	FY12E	FY13E
Cost of revenues	69.8	63.1	66.6	70.8	70.8
Gross margin	30.2	36.9	33.4	29.2	29.2
G&A expenses	6.0	6.3	4.0	3.9	4.0
S&M expenses	3.8	4.2	4.4	5.4	5.0
SG&A expenses	9.8	10.5	8.3	9.3	9.0
EBITDA margins	20.4	26.4	25.1	19.9	20.2
EBIT margins	15.1	21.7	21.9	16.3	17.0
Net profit margins	15.5	21.3	21.7	15.6	14.3

Growth ratios (%)

Year to October	FY09	FY10	FY11	FY12E	FY13E
Revenues	34.9	30.5	18.1	3.9	13.1
EBITDA	58.8	69.3	12.2	(17.8)	14.9
EBIT	76.8	87.5	19.0	(22.3)	17.6
PBT	99.5	83.2	24.4	(18.4)	14.6
Net profit	98.4	79.4	20.0	(25.2)	4.1
EPS	97.9	79.3	20.0	(25.3)	4.1

Balance sheet**(INR mn)**

As on 31st October	FY09	FY10	FY11	FY12E	FY13E
Equity capital	2,089	2,096	2,099	2,099	2,099
Share premium account	1,564	1,669	1,534	1,534	1,534
Reserves & surplus	10,710	19,688	29,358	36,386	43,748
Shareholders funds	14,363	23,453	32,991	40,020	47,381
Borrowings	54	33	454	-	-
Sources of funds	14,417	23,487	33,445	40,020	47,381
Gross block	9,345	10,044	10,258	13,258	16,758
Accumulated depreciation	5,940	6,880	7,836	9,686	11,586
Net block	3,405	3,164	2,423	3,573	5,173
Capital work in progress	731	127	89	150	150
Deferred tax asset	345	694	751	751	751
Goodwill	2,959	2,946	3,886	3,886	3,886
Investments	-	7,612	14,600	20,000	23,000
Sundry debtors	8,810	9,064	12,054	10,751	12,319
Cash and equivalents	731	1,786	1,784	2,839	2,649
Loans and advances	3,359	7,241	9,448	10,863	13,579
Total current assets	12,900	18,091	23,286	24,453	28,547
Sundry creditors and others	1,208	725	440	528	633
Others current liabilities	3,217	5,688	7,654	8,419	9,261
Provisions	1,498	2,734	3,497	3,846	4,231
Total current liabilities & provisions	5,923	9,147	11,590	12,793	14,125
Net current assets	6,977	8,944	11,696	11,659	14,421
Uses of funds	14,417	23,487	33,445	40,020	47,381
Book value per share (INR)	68.2	111.3	156.6	189.7	224.6

Free cash flow**(INR mn)**

Year to October	FY09	FY10	FY11	FY12E	FY13E
Net profit	2,954	9,087	10,907	8,154	8,487
Depreciation	1,005	2,022	1,638	1,850	1,900
Others	(261)	320	(1,385)	(2)	-
Gross cash flow	3,699	11,429	11,160	10,002	10,387
Less: Changes in WC	1,915	912	2,754	(1,092)	2,952
Operating cash flow	1,784	10,517	8,406	11,093	7,435
Less: Capex	1,256	1,375	890	3,061	3,500
Free cash flow	527	9,142	7,515	8,032	3,935

Cash flow metrics

Year to October	FY09	FY10	FY11	FY12E	FY13E
Cash flow from operations	3,769	9,897	11,473	10,004	10,387
Cash for working capital	(1,985)	621	(3,068)	1,090	(2,952)
Operating cash flow	1,784	10,517	8,406	11,093	7,435
Net purchase of fixed assets	(1,256)	(1,375)	(890)	(3,061)	(3,500)
Net purchase of investments	53	(7,684)	(7,032)	(5,400)	(3,000)
Investing cash flow	(1,204)	(9,059)	(7,923)	(8,461)	(6,500)
Dividends	(807)	(486)	(858)	(1,125)	(1,125)
Proceeds from issue of equity	23	80	45	(1)	-
Proceeds from LTB/STB	(3)	(21)	420	(454)	-
Interest paid & other items	-	-	(9)	-	-
Financing cash flow	(787)	(427)	(402)	(1,579)	(1,125)
Exchange rate differences	(14.6)	23.2	(83.0)	-	-
Net cash flow	(221)	1,055	(2)	1,053	(190)

Profitability & efficiency ratios

Year to October	FY09	FY10	FY11	FY12E	FY13E
ROAE (%)	22.8	48.1	38.6	22.3	19.4
ROACE (%)	22.1	61.1	63.4	44.0	45.3
Debtors days	82	77	77	80	71
Payable days	19	8	4	3	4
Cash conversion cycle (days)	63	68	73	77	70
Current ratio	2.2	2.0	2.0	1.9	2.0

Operating ratios

Year to October	FY09	FY10	FY11	FY12E	FY13E
Total asset turnover	0.4	0.6	0.4	0.4	0.3
Fixed asset turnover	6.1	13.0	18.0	17.5	13.5
Equity turnover	1.5	2.3	1.8	1.4	1.4

Valuation parameters

Year to October	FY09	FY10	FY11	FY12E	FY13E
Diluted EPS (INR)	14.0	43.1	51.8	38.7	40.2
<i>Y-o-Y growth (%)</i>	<i>97.9</i>	<i>79.3</i>	<i>20.0</i>	<i>(25.3)</i>	<i>4.1</i>
CEPS (INR)	18.9	53.1	59.8	47.6	49.4
Diluted PE (x)	32.9	10.7	8.9	11.9	11.5
Price/BV (x)	6.8	4.1	2.9	2.4	2.1
EV/Sales (x)	5.0	2.0	1.6	1.4	1.2
EV/EBITDA (x)	24.6	7.7	6.4	7.1	6.0
EV/EBITDA (x) +1 yr forward	8.5	6.9	7.8	6.2	-
Dividend yield (%)	1.0	0.8	0.9	1.0	1.0



RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
ECLERX SERVICES	BUY	SO	M	HCL Technologies	BUY	SO	H
Hexaware Technologies	BUY	SP	M	Info Edge	REDUCE	SU	M
Infosys Technologies	HOLD	SP	L	Infotech Enterprises	BUY	SO	H
Mphasis	REDUCE	SU	M	Patni Computer Systems	HOLD	SU	M
Rolta India	BUY	SO	H	Tata Consultancy Services	BUY	SO	L
Wipro	HOLD	SU	L				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect

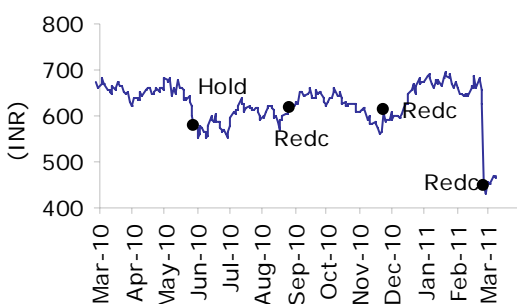
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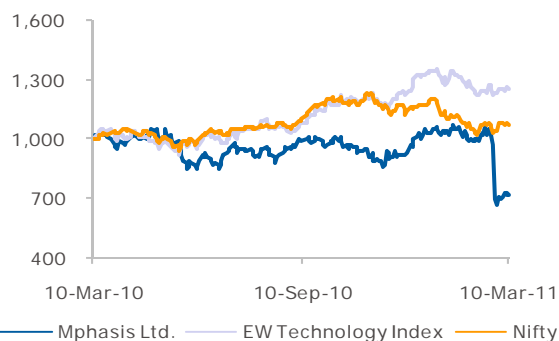
Coverage group(s) of stocks by primary analyst(s): IT

ECLERX SERVICES, HCL Technologies, Hexaware Technologies, Infosys Technologies, Info Edge, Infotech Enterprises, Mphasis, Patni Computer Systems, Rolta India, Tata Consultancy Services, Wipro

Mphasis



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	116	45	12	176
* 3 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	110	53	13	

Recent Research

Date	Company	Title	Price (INR)	Recos
10-Mar-11	Wipro	Course correction to address higher growth mandate; <i>Visit Note</i>	455	Hold
10-Mar-11	Infosys	Changing mindset; <i>Visit Note</i>	3,090	Hold
25-Feb-11	Mphasis	Plumbing new low; our concerns validated; <i>Result Update</i>	449	Reduce

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