

May 2, 2007

Stock Rating
Equal-weight

Industry View
Attractive

Mphasis BFL Group

Significant Opportunities From EDS But Lack of Clarity & Rich Valuations

Quick Comment: Mphasis' F4Q results were strong though net income was in line with estimates. IT services volume growth was robust, BPO revenue and margins spiked up and headcount addition was strong. There has not been too much disclosure about consolidated (with EDS India) numbers yet, barring the full year revenue and net income numbers. EDS India's net margins fell in F2007 resulting in net income lower than our estimates.

What's New: Operational highlights of the quarter include a 10% QoQ volume growth in IT services, 24% QoQ revenue growth in BPO and 320 bps expansion in BPO gross margins. Net income was Rs456 mn, up 27% QoQ and in-line with our estimate of Rs458 mn. Mphasis added nearly 2,000 employees to take total headcount to 14,679 - headcount including EDS India has crossed 20,000. The combined entity plans to add 8,000 to 10,000 employees in C2007. EDS India's revenue rose 77% in F2007 but net margins dropped from 13% in F2006 to about 10% in F2007.

Implications: Mphasis undoubtedly can benefit from the volumes that EDS can pass along. However, there is not much clarity yet on the transfer pricing mechanism. Valuations seem rich as well, in our view, at 36x consolidated F2007 actual earnings. The richness of the stock's valuations is accentuated by the fact that 65% of the stand-alone headcount and 25% of gross profits accrues from the relatively lower-end BPO business which had 70% of its F2007 revenue from voice processes.

We maintain an Equal-weight rating. Any attempt by EDS to increase its stake in the company at a price higher than the current market price poses upside risk.

Key Ratios and Statistics

Reuters: MBFL.BO Bloomberg: BFLS IN

India Software

Price target	Rs275.00
Shr price, close (Apr 30, 2007)	Rs313.65
Mkt cap, curr (mn)	Rs50,941
52-Week Range	Rs329.45-121.00
Sh out, basic, curr (mn)	161.0

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Good F4Q07 Numbers, In-Line Net Income

MphasiS reported a strong set of standalone numbers, key highlights being:

- IT services revenue rose 5% QoQ though volume growth was impressive at nearly 10%. Gross margins dropped by about 30 bps and the rupee appreciation during the quarter would have been a key reason.
- BPO revenue spiked up to 24% QoQ in F4Q07 and gross margins rose 320 bps to the highest level in the past two years. The revenue mix appears to be improving as well. While voice-based processes still constituted a high 61% of revenue in F4Q07, it has come down from 69% in F3Q07 and from 82% 12 months ago.
- Net income rose 27% QoQ, although net income has dropped 20% YoY in F2007.

- The company added 23% to its IT services headcount and 12% to BPO headcount during the quarter.

Significant Volumes Possible From EDS

We believe that MphasiS can benefit significantly from work passed on by EDS. In a way, the recent headcount addition could reflect such opportunity. The company has also indicated that the combined entity will add at least another 6,000 employees in the next nine months, representing approximately 30% addition to the headcount.

Not Enough Disclosure Yet Related to EDS India

EDS India's detailed financials are not yet available. The company has released only its annual revenue and net income numbers. F07 revenue rose 77% but net margins declined from 13% to slightly over 10%. Exact details of the likely transfer pricing between EDS and MphasiS are also not clear. The merger formalities between EDS India and MphasiS are likely to be completed by July, as against an earlier expectation of March 2007.

Company Description

MphasiS Group designs and builds information technology architecture and applications for Fortune 500 companies in the financial services, logistics and technology industries. The company's services range from IT architecture to application development and integration; maintenance, enhancement, testing and transformation of legacy systems; contact centers; and business processes outsourcing.

India Software

Industry View: Attractive

MSCI Country: India

Asia Strategist's Recommended Weight: 1.9%
MSCI Asia/Pac All Country Ex Jp Weight: 6.6%

Exhibit 1

Consolidated Quarterly Financials (Rs Mn)

Quarter Ending	Jun-06	QoQ	YoY	Sep-06	QoQ	YoY	Dec-06	QoQ	YoY	Mar-07	QoQ	YoY
IT Services	1,828	6%	24%	2,057	12.5%	32%	2,185	6.2%	32%	2,291	4.8%	33%
ITES	779	0%	8%	862	10.7%	21%	874	1.4%	14%	1,081	23.7%	39%
Revenues	2,607	4%	19%	2,919	12.0%	28%	3,060	4.8%	26%	3,373	10.2%	35%
Cost of revenues	1,987	14%	27%	2,070	4%	35%	2,124	3%	29%	2,324	9%	34%
IT Services	489	-18%	5%	653	33%	18%	721	11%	21%	748	4%	25%
<i>Gross margin - IT services</i>	<i>26.8%</i>	<i>-780 bps</i>	<i>-467 bps</i>	<i>31.7%</i>	<i>496 bps</i>	<i>-367 bps</i>	<i>33.0%</i>	<i>128 bps</i>	<i>-289 bps</i>	<i>32.7%</i>	<i>-35 bps</i>	<i>-192 bps</i>
ITES	131	-22%	-22%	196	50%	7%	215	9%	15%	300	40%	79%
<i>Gross margin - ITES</i>	<i>16.8%</i>	<i>-477 bps</i>	<i>-663 bps</i>	<i>22.8%</i>	<i>596 bps</i>	<i>-297 bps</i>	<i>24.6%</i>	<i>180 bps</i>	<i>28 bps</i>	<i>27.8%</i>	<i>322 bps</i>	<i>621 bps</i>
Gross Profit	620	-19%	-2%	849	37%	15%	936	10%	20%	1,049	12%	37%
<i>Gross Margin</i>	<i>23.8%</i>	<i>-675 bps</i>	<i>-503 bps</i>	<i>29.1%</i>	<i>529 bps</i>	<i>-329 bps</i>	<i>30.6%</i>	<i>152 bps</i>	<i>-163 bps</i>	<i>31.1%</i>	<i>50 bps</i>	<i>55 bps</i>
Selling expenses	197	24%	29%	237	21%	74%	217	-9%	59%	267	23%	68%
<i>% of revenue</i>	<i>7.6%</i>	<i>120 bps</i>	<i>58 bps</i>	<i>8.1%</i>	<i>58 bps</i>	<i>215 bps</i>	<i>7.1%</i>	<i>-104 bps</i>	<i>147 bps</i>	<i>7.9%</i>	<i>83 bps</i>	<i>157 bps</i>
General and admin exp	254	9%	31%	278	9%	27%	288	4%	37%	297	3%	28%
<i>% of revenue</i>	<i>9.7%</i>	<i>46 bps</i>	<i>94 bps</i>	<i>9.5%</i>	<i>-23 bps</i>	<i>-7 bps</i>	<i>9.4%</i>	<i>-9 bps</i>	<i>75 bps</i>	<i>8.8%</i>	<i>-60 bps</i>	<i>-47 bps</i>
Provision for doubtful debts	5	502%	-32%	6	20%	259%	4	-31%	-17%	1	-86%	-32%
Operating Profit	165	-56%	-41%	328	99%	-14%	427	30%	-1%	483	13%	30%
<i>Operating Margin</i>	<i>6.3%</i>	<i>-855 bps</i>	<i>-642 bps</i>	<i>11.2%</i>	<i>493 bps</i>	<i>-548 bps</i>	<i>14.0%</i>	<i>271 bps</i>	<i>-378 bps</i>	<i>14.3%</i>	<i>37 bps</i>	<i>-54 bps</i>
Foreign exchange gain, net	30	148%	-50%	-69	-333%	-273%	-60	-13%	132%	-26	-57%	-313%
Other income	0	-117%	-104%	1	533%	-106%	-2	-404%	-131%	0	-115%	-149%
Interest, net	12	21%	587%	13	3%	438%	12	-3%	320%	19	56%	89%
Profit before taxation	207	-48%	-39%	273	32%	-34%	378	39%	-9%	478	26%	21%
Income taxes	55	30%	5559%	39	-30%	330%	20	-49%	249%	22	10%	-49%
<i>Tax rate</i>	<i>26.7%</i>	<i>1591 bps</i>	<i>2643 bps</i>	<i>14.2%</i>	<i>-1252 bps</i>	<i>1201 bps</i>	<i>5.3%</i>	<i>-893 bps</i>	<i>389 bps</i>	<i>4.6%</i>	<i>-68 bps</i>	<i>-621 bps</i>
Net Profit	152	-57%	-55%	234	54%	-42%	358	53%	-12%	456	27%	30%

Source: Company Data, Morgan Stanley Research

Exhibit 2

Mphasis (IT Services) Operating Metrics

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07
Revenue Breakdown by Geography								
USA	69%	73%	73%	76%	76%	77%	76%	76%
Europe	23%	18%	19%	15%	16%	15%	15%	15%
Asia Pacific	2%	3%	2%	3%	3%	3%	3%	3%
Japan	2%	2%	2%	2%	1%	1%	2%	2%
India & Middle East	4%	4%	4%	4%	4%	4%	4%	4%
Revenue Breakdown by Domain								
Financial Services	52%	53%	55%	58%	57%	59%	58%	57%
Retail, Logistics and Transportation	20%	18%	18%	17%	17%	14%	15%	15%
Technology	28%	29%	27%	25%	26%	27%	27%	28%
Size of Clients								
\$1 Million Customers	25	27	28	27	29	35	35	36
\$5 Million Customers	9	9	9	8	7	7	8	9
\$10 Million Customers	3	3	3	4	5	5	5	5
Client Concentration								
Top Client	16%	17%	17%	19%	16%	13%	12%	12%
Top 5	45%	45%	45%	49%	48%	46%	44%	43%
Top 10	61%	61%	62%	64%	63%	60%	59%	60%
Billing Rates (US\$/Person-Hour)								
Onsite	66	63	63	65	65	66	67	67
Offshore	21	21	21	20	21	21	22	22
Headcount	2854	2971	3467	3533	3670	3966	4237	5194
Utilization	76%	77%	75%	73%	73%	74%	78%	NA
Revenue Breakdown by Delivery								
Onsite	60%	58%	57%	60%	57%	55%	55%	52%
Offshore	40%	42%	43%	40%	43%	45%	45%	48%
Revenue Breakdown by Project Type								
Time & Material	85%	81%	83%	81%	86%	90%	90%	91%
Fixed Price	15%	19%	17%	19%	14%	10%	10%	9%
DSO	55	63	62	65	61	60	58	60


Source: Company Data, Morgan Stanley Research

Exhibit 3

MsourceE (BPO) Operating Metrics

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07
Revenue Breakdown by Geography								
USA	49%	49%	43%	42%	41%	43%	43%	53%
Europe	49%	47%	43%	42%	42%	38%	38%	31%
Asia/Pacific	2%	2%	2%	2%	2%	2%	2%	1%
India & Middle East	0%	2%	12%	14%	15%	17%	17%	15%
Revenue Breakdown by Domain								
Financial Services	69%	65%	57%	57%	55%	58%	54%	47%
Insurance	10%	10%	10%	11%	12%	12%	13%	14%
Retail, Logistics and Technology	21%	25%	33%	31%	33%	30%	33%	39%
Size of Clients								
\$1 Million Customers	13	13	12	13	14	15	17	17
\$5 Million Customers	7	5	6	7	7	6	6	6
\$10 Million Customers	1	1	1	1	1	1	2	4
Client Concentration								
Top Client	20%	17%	14%	16%	15%	16%	17%	15%
Top 3	40%	38%	38%	39%	40%	42%	40%	40%
Top 5	58%	56%	56%	57%	59%	60%	58%	60%
Billing Rates (US\$/Person-Hour)	11	10	9	9	9	8	9	10
Staff	5319	6541	7404	7881	7564	8447	8482	9485
Utilization								
Process Utilization	71%	72%	66%	71%	69%	69%	65%	66%
DSO	61	63	51	48	58	60	55	50

Source: Company Data, Morgan Stanley Research

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Industry Coverage: India Software

Company (Ticker)	Rating (as of)	Price (04/30/2007)
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Hexaware Technologies Limited (HEXT.BO)	O (06/22/2006)	Rs169.7
Infosys Technologies (INFY.BO)	O (04/17/2006)	Rs2,049.35
MindTree Consulting Limited (MINT.BO)	U-V (04/10/2007)	Rs793.9
MphasiS BFL Group (MBFL.BO)	E (03/15/2004)	Rs313.65
Patni Computer Systems (PTNI.BO)	O (08/08/2005)	Rs474.35
Polaris Software Lab Ltd. (POLS.BO)	E (02/20/2007)	Rs171.65
Satyam Computer Services (SATY.BO)	O (03/18/2002)	Rs473.1
Tata Consultancy Services (TCS.BO)	O (09/29/2004)	Rs1,265.7
Wipro Ltd. (WIPR.BO)	E (03/22/2002)	Rs571.25
i-flex Solutions Ltd. (IFLX.BO)	E (10/31/2005)	Rs2,519.15

Stock Ratings are subject to change. Please see latest research for each company.