

A welcome return to the basics: Upgrade to BUY/OPF

Investor concerns over strategic direction and worries over the seemingly abrupt resignation of Mr Ashok Soota from the Chairman role have weighed on MindTree, with the stock having corrected 27% over the last 12 months and 4% over the last month. While strategy-related concerns were the primary reason for our cautious stance on MindTree thus far, we believe that management has now re-embarked on a welcome return to the basics, with focus being limited to improving execution on existing operations.

We upgrade MindTree to BUY/OPF with a revised TP of Rs 478, based on 10x (reduced from 11x earlier) our revised Jun-12 EPS (slight tweaks in cash yield, hedges etc). MindTree currently trades at 8.3x FY12E earnings vs 12.5x historical average, and we believe the key concerns on the stock are priced into this low multiple. Our core thesis is that the results of their execution focus will bear fruit over the next 4-5 quarters and that the stock will revert back towards its historical multiple, as the market begins to look beyond their recent strategic mis-steps (specifically their smartphone-related foray). Further, we believe there is room for upside to our earnings estimates - from billing rate uptick and improvement in utilization levels.

Expect IT services, rather than RDS to drive growth: In the last few quarters, IT services (~60% of revenues) has shown robust revenue growth (8.9% TTM CQGR) while RDS (~40% of revenues) has remained lacklustre (flat TTM CQGR) – this is because RDS as a sub-sector tends to be late-cyclical and has lagged IT services into recovery. Within RDS, we believe SPE (~25% of overall revenues) is likely to recover faster than product engineering services. Overall, we still think IT services should be the growth driver for MindTree in the next 4-5 quarters as well, just as it has been for the preceding few quarters. We expect a 5.1% US\$ revenue CQGR for Dec '10 through Mar '12, with INR revenues for FY12E expected to increase ~20% yoy.

Improved visibility post recent deal wins: MindTree's recent deal wins (cumulative US\$ 70mn over five years) in the Infrastructure Management (IMTS) space increase revenue visibility and also enhance MindTree's credibility in the fast-growing IMTS space. With these deals expected to be largely offshore-driven, we believe margins should also benefit. Interestingly, MindTree flagged that their RIM platform (acquired via the 7Strata acquisition for Rs 72mn in April '10) was one of the key factors in MindTree winning these deals.

Financial summary

Year	Revenues (Rs. mn)	EBITDA (Rs. mn)	PAT (Rs. mn)	EPS (Rs.)	P/E(x)	EV/EBITDA(x)
FY10	12,960	2,449	1,666	40.6	9.3	6.1
FY11E	15,215	1,947	1,056	25.8	14.7	7.6
FY12E	18,239	2,851	1,856	45.5	8.3	5.2

Company Update

Date: Mar 9, 2011

Market Data

SENSEX	18487
Nifty	5534
Bloomberg	MTCL IN
Shares o/s	39.2mn
Market Cap (Rs.)	14.8bn
52-wk High-Low	Rs 664-358
3m Avg. Daily Vol	Rs 33mn
Index member	BSE Midcap

Latest shareholding (%)

Promoters	32
Institutions	26
Public	42

Stock performance (%)

	1m	3m	12m
MindTree	-4	-24	-27
CNXIT	1	0	16
Nifty	5	-4	8

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Expect 280bps margin improvement yoy in FY12E: We expect a 280bps yoy EBITDA margin increase in FY12E; of this, 240bps comes from the non-recurrence of ~Rs 370mn spent in the smartphone venture, while 40bps comes from the traditional margin levers (~1% pricing uptick, SG&A leverage etc). We believe these margin estimates are conservative, with room for upside from: 1. Pricing uptick – we estimate ~1% yoy, but optimistic commentary from peers suggests this could be closer to 1.5-2% 2. Utilization improving from 69% (including trainees) to ~71-72% levels. Management commentary suggests that their longer-term margin goal is at ~18% levels (historical levels being in the 18-20% range), which is encouraging in our view.

A return in execution focus on the cards: Investors have been concerned about MindTree's strategic direction ever since its foray into the smartphone products space – and these concerns have not abated fully even after their retreat from the products space after 2QFY11 results. The seemingly abrupt resignation of their Chairman Mr Ashok Soota has also intensified investor worries. **We, however, believe that these concerns are overplayed and that repercussions from the strategic mis-steps that plagued MindTree throughout CY10 are largely behind us now. More importantly, management commentary suggests a “back to the basics” approach with execution being the key focus.** We are inclined to view this renewal of focus favourably. Also, we note that Mr Ashok Soota at the time of his resignation was largely involved in the strategy area rather than in day-to-day operations, the primary responsibility for which vested with the CEO. With the CEO Mr N Krishnakumar now taking over Mr Soota's earlier role, we see a smooth transition ahead.

Cash flow and balance sheet position remain sound: The company's cash generation remains sound, with ~Rs 2bn in operating cash flow expected for FY12 (vs ~Rs 1.7bn for FY11) representing a CFO:EBITDA of ~72%. Cash and investments balance is at ~Rs 1.27bn (US\$ 31mn), which is comfortable in our view. Also, DSOs are at 68 days (vs 76 days at the end of Sep-10) which is encouraging in our view. Finally, return metrics (ROE, ROCE) are expected to revert back to reasonably healthy 20%+ levels in FY12 vs the ~15% levels expected for FY11E.

Key concerns priced in - upgrade to BUY: At Rs 379, the stock trades at 8.3x FY12E earnings, vs historical levels of 12.5x. We also note that the stock has traded above this multiple on ~85% of trading days.

We upgrade MindTree to a BUY/OPF with a Rs 478 target price based on 10x our 12-months-to-Jun '12 EPS (earlier target multiple: 11x), with the stock having traded above our target multiple on ~77% of its trading days. We also note that our margin assumptions are conservative, and we estimate that a 100bps beat in margins for FY12 could yield an earnings upside of 7-8%. With the stock trading at inexpensive valuations relative to historical, and our earnings estimates underpinned by conservative assumptions, we believe downside risks are limited, and we upgrade the stock to BUY/OPF (vs our earlier REDUCE/UPF).

MindTree

Business Overview

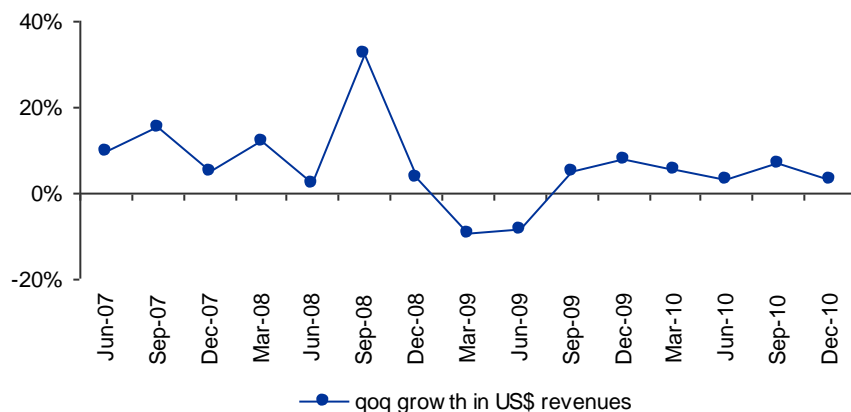
CMP	Rs. 379	Absolute	BUY
Target	Rs. 478	Relative	Outperform

Key estimate revision

	FY11E			FY12E		
	Old	New	Change	Old	New	Change
US\$ revenue	334	334	0%	405	405	0%
Revenue	15,215	15,215	0%	18,239	18,239	0%
EBITDA	1,947	1,947	0%	2,851	2,851	0%
EBITDA margin	12.80%	12.80%	0%	15.63%	15.63%	0%
PAT	1,058	1,065	1%	1,805	1,856	3%
EPS	25.3	25.8	2%	44.2	45.5	3%

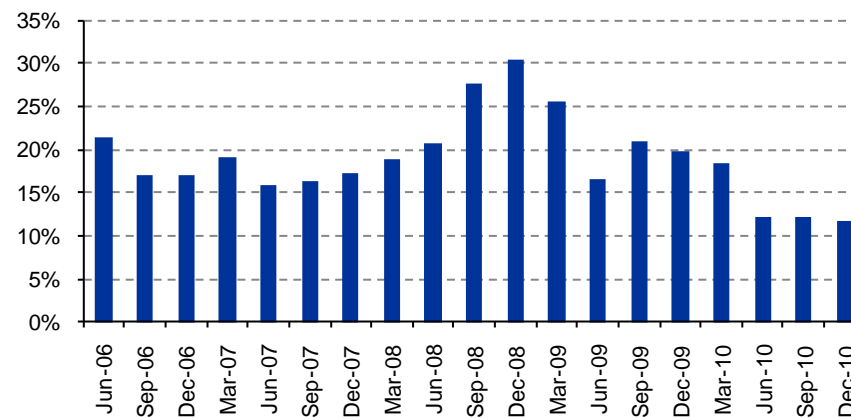
All figures in Rs. mn, except EPS, which is in Rs.

Qoq growth in US\$ revenues



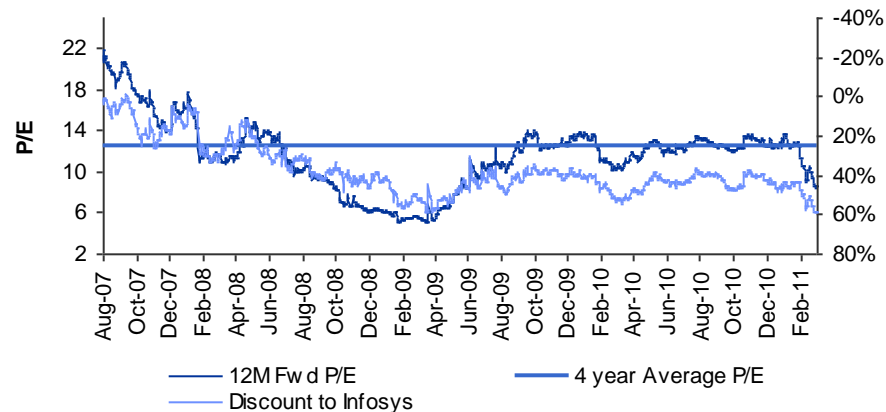
Sep-08 qtr bolstered by revenues from AztecSoft. Source: Company data, Spark Capital.

EBITDA margin evolution



Source: Company data, Spark Capital

MindTree 12-m forward P/E



Source: Bloomberg, Spark Capital

MindTree

Financial Summary

CMP

Rs. 379

Absolute

BUY

Target

Rs. 478

Relative

Outperform

Abridged Financial Statements				
Rs. mn	FY10	FY11E	FY12E	FY13E
Profit & Loss				
Net Sales	12,960	15,215	18,239	21,800
Software development expenses	7,983	10,016	11,732	14,294
SG&A expenses	2,528	3,252	3,657	4,197
EBITDA	2,449	1,947	2,851	3,310
Other income	96	168	224	300
Depreciation/Amortization	652	710	751	769
Interest	27	3	0	0
PBT	1,867	1,402	2,324	2,840
Tax	371	337	441	568
PAT	1,495	1,065	1,882	2,272
Spark Adj PAT	1,666	1,056	1,856	2,306
Reported diluted EPS	36.5	26.1	46.1	55.6
Spark EPS	40.6	25.8	45.5	56.5
Balance Sheet				
Paid up capital	395	399	399	399
Reserves and surplus	6,311	7,373	9,255	11,528
Secured loans	0	0	0	0
Total networth & liabilities	6,737	7,815	9,697	11,970
Goodwill	154	0	0	0
Net fixed assets	2,612	3,132	3,280	3,321
Capital WIP	247	28	28	28
Investments	1,272	962	962	962
Current assets	4,841	7,225	9,803	12,773
Sundry debtors	2,370	3,538	4,307	5,090
Cash	523	1,669	3,040	4,780
Deferred tax assets	214	224	224	224
Total assets	6,737	7,815	9,697	11,970

Key metrics				
	FY10	FY11E	FY12E	FY13E
Cash flows				
Cash flow from operations	1,294	1,692	2,047	2,250
Cash flow from investments	(1,055)	(384)	(676)	(510)
Cash flow from financing	65	(44)	-	-
Key ratios and metrics				
EBITDA margin (%)	18.9%	12.8%	15.6%	15.2%
PAT margin (%)	11.5%	7.0%	10.3%	10.4%
Revenue per employee p.a (000's)	1,832	1,832	1,832	1,833
EBITDA per employee p.a (000's)	303	211	255	249
Profit per employee p.a (000's)	206	114	166	173
ROE	24.5%	14.7%	21.6%	21.1%
ROCE	21.7%	14.7%	21.5%	21.0%
Valuation metrics				
Shares o/s (mn)	39.4	39.8	39.8	39.8
Fully diluted shares (mn)	40.99	40.83	40.83	40.83
Market cap (Rs. mn)	14,941	14,941	14,941	14,941
EV (Rs.mn)	14,827	14,827	14,827	14,827
EV/Sales (x)	1.1x	1.0x	0.8x	0.7x
EV/EBITDA (x)	6.1x	7.6x	5.2x	4.5x
P/E (x)	9.3x	14.7x	8.3x	6.7x
Price to book (x)	1.4x	1.2x	1.0x	0.8x
EPS(E) / Current market price	9.6%	6.9%	12.2%	14.7%
Per share data (Rs.)				
Book value	170	195	242	299
Cash	13	42	76	120
Operating cash flow	33	42	51	56
Free cash flow	25	19	29	36

CMP	Rs. 379	Absolute	BUY
Target	Rs. 478	Relative	Outperform

Absolute Rating Interpretation

BUY	Stock expected to provide positive returns of > 15% over a 1-year horizon
ADD	Stock expected to provide positive returns of <=15% over a 1-year horizon
REDUCE	Stock expected to fall <=15% over a 1-year horizon
SELL	Stock expected to fall >15% over a 1-year horizon

Relative Rating Interpretation

OUTPERFORM	Stock expected to outperform sector index /sector peers in our coverage
UNDERPERFORM	Stock expected to underperform sector index/ sector peers in our coverage

Recommendation History

Date	CMP	Target price	Absolute Rating	Relative Rating
27-Jan-11	540	500	REDUCE	UPF
28-Dec-10	509	520	ADD	UPF
14-Dec-10	508	520	ADD	UPF
20-Oct-10	520	520	REDUCE	UPF
21-Jul-10	545	520	REDUCE	UPF

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