

# Earnings rebound, but priced in

## Margins improve sharply

MphasiS BFL reported robust 2Q with revenue growth of 12% QoQ, ahead of MLe, and margin led profit growth. PAT grew by 54% QoQ to Rs234mn, ahead of MLe of 38% QoQ growth.

## Offshoring, utilization drive margins

EBITDA margins improved 455 bps to 17%, reversing the trend witnessed during the past two quarters wherein margins had declined by 1111bps. Margin expansion was driven by 300bps improvement in offshore utilization to 71%, increase in offshore revenues, and breakeven in its domestic BPO business.

## Recruitments, client ramp-up were key highlights

Management indicated that existing clients have ramped up post clarity on the acquisition front and sounded bullish on business flows. It also increased its employee strength through additions of 418 employees in IT services and 883 employees in its BPO business.

## Retaining Neutral on valuations

While profit growth is likely to improve QoQ, we expect a lag of at least two quarters before profits recover to 3QFY06 levels. We believe recent stock appreciation prices in potential re-rating and business upside post its acquisition by EDS. Valuations, at 19x FY08e, are rich when compared to its peers like Hexaware (16x CY07e) and Infotech Enterprises (12x FY08e).

## Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009
Net Income (Adjusted - mn)	1,246	1,499	1,574	2,510	NA
EPS	7.92	9.31	7.64	12.18	NA
EPS Change (YoY)	-11.7%	17.5%	-17.9%	59.5%	NA
Dividend / Share	2.20	2.50	2.00	3.20	NA
Free Cash Flow / Share	6.68	5.71	3.28	11.14	NA

## Valuation (Mar)

	2005A	2006A	2007E	2008E	2009
P/E	29.20x	24.85x	30.27x	18.98x	NA
Dividend Yield	0.951%	1.08%	0.865%	1.38%	NA
EV / EBITDA*	25.10x	18.07x	13.62x	9.23x	NA
Free Cash Flow Yield*	2.72%	2.38%	1.75%	5.95%	NA

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 10.



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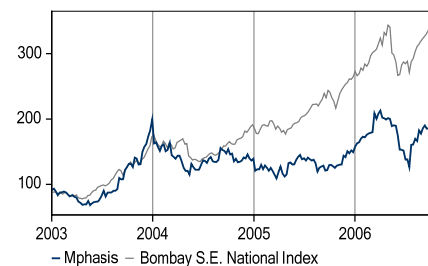
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## Stock Data

Price	Rs231.30
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	Rs121.00-Rs238.30
Mrkt Val / Shares Out (mn)	US\$1,055 / 206.0
Average Daily Volume	243,434
ML Symbol / Exchange	MPSSF / BSE
Bloomberg / Reuters	BFL IN / MBFL.BO
ROE (2007E)	20.6%
Net Dbt to Eqty (Mar-2006A)	-14.4%
Est. 5-Yr EPS / DPS Growth	22.0% / 22.0%
Free Float	60.0%



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Refer to important disclosures on page 11 to 12. Analyst Certification on page 9.

*iQprofile*<sup>SM</sup> **Mphasis-BFL Ltd.**

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009
<b>(Rs Millions)</b>					
Sales	7,657	9,401	16,071	20,764	NA
Gross Profit	2,702	3,345	5,105	7,004	NA
Sell General & Admin Expense	(1,291)	(1,384)	(2,503)	(3,168)	NA
Operating Profit	1,016	1,442	1,823	2,833	NA
Net Interest & Other Income	113	94	11	60	NA
Associates	NA	NA	NA	NA	NA
Pretax Income	1,129	1,536	1,833	2,893	NA
Tax (expense) / Benefit	117	(38)	(259)	(383)	NA
Net Income (Adjusted)	1,246	1,499	1,574	2,510	NA
Average Fully Diluted Shares Outstanding	157	161	206	206	NA

**Key Cash Flow Statement Data**

Net Income (Reported)	1,246	1,499	1,574	2,510	NA
Depreciation & Amortization	396	519	779	1,003	NA
Change in Working Capital	143	(242)	(712)	(584)	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(178)	(55)	(133)	308	NA
Cash Flow from Operations	1,607	1,721	1,508	3,237	NA
Capital Expenditure	(557)	(802)	(833)	(941)	NA
(Acquisition) / Disposal of Investments	(1,318)	(808)	0	0	NA
Other Cash Inflow / (Outflow)	62	(6)	49	60	NA
Cash Flow from Investing	(1,812)	(1,616)	(784)	(881)	NA
Shares Issue / (Repurchase)	197	196	0	0	NA
Cost of Dividends Paid	(260)	(273)	(467)	(747)	NA
Cash Flow from Financing	(28)	(63)	(453)	(747)	NA
Free Cash Flow	1,050	919	675	2,296	NA
Net Debt	(908)	(950)	(2,323)	(3,932)	NA
Change in Net Debt	269	(28)	(1,358)	(1,609)	NA

**Key Balance Sheet Data**

Property, Plant & Equipment	1,198	1,455	1,709	1,647	NA
Other Non-Current Assets	3,641	2,843	2,843	2,843	NA
Trade Receivables	1,835	2,050	3,206	3,830	NA
Cash & Equivalents	955	989	2,360	3,969	NA
Other Current Assets	808	713	834	914	NA
Total Assets	8,436	8,050	10,952	13,203	NA
Long-Term Debt	46	38	37	37	NA
Other Non-Current Liabilities	NA	NA	NA	NA	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	1,992	1,407	2,201	2,688	NA
Total Liabilities	2,039	1,446	2,238	2,726	NA
Total Equity	6,397	6,605	8,714	10,477	NA
Total Equity & Liabilities	8,436	8,051	10,952	13,203	NA

**iQmethod<sup>SM</sup> - Bus Performance\***

Return On Capital Employed	18.4%	20.1%	20.9%	26.1%	NA
Return On Equity	25.2%	23.1%	20.6%	26.2%	NA
Operating Margin	13.3%	15.3%	11.3%	13.6%	NA
EBITDA Margin	18.4%	20.9%	16.2%	18.5%	NA

**iQmethod<sup>SM</sup> - Quality of Earnings\***

Cash Realization Ratio	1.3x	1.1x	1.0x	1.3x	NA
Asset Replacement Ratio	1.4x	1.5x	1.1x	0.9x	NA
Tax Rate (Reported)	NM	2.5%	14.1%	13.2%	NA
Net Debt-to-Equity Ratio	-14.2%	-14.4%	-26.7%	-37.5%	NA
Interest Cover	NA	NA	NA	NA	NA

**Key Metrics**

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 10.

**Company Description**

Mphasis BFL is a mid-tier offshore IT services company formed by the acquisition of Mphasis by BFL in 1999. Mphasis follows an integrated IT Services and BPO (largely voice) strategy and is among the leading third-party call centres in India. In IT Services, focus verticals are financial services, technology and logistics. EDS recently acquired majority stake and will hold 62% post EDS India merger. Jerry Rao continues to be the CEO of the firm.

**Stock Data**

Price to Book Value 4.4x

## Robust numbers, but priced in

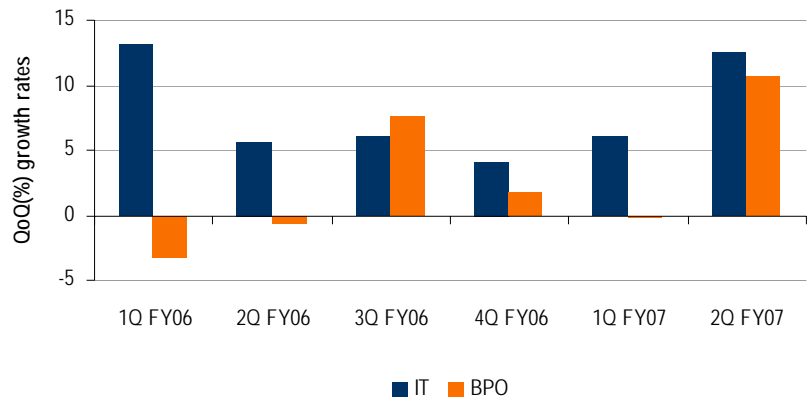
Mphasis BFL reported robust 2Q results, ahead of MLE estimates. Sales grew by 12% QoQ to Rs2919mn as against our expectation of 3.4% QoQ growth. Profits grew by 54% QoQ, to Rs234mn, ahead of our estimates of 38% growth. While profit growth was strong and likely to improve further, we expect a lag of at least two quarters before profits recover to 3QFY06 levels.

We believe recent stock appreciation prices in potential re-rating and business upside post its acquisition by EDS. Valuations, at 19x FY08e, are rich when compared to its peers like Hexaware (16x CY07e) and Infotech Enterprises (12x FY08e).

## Driven by growth in IT and BPO

Contrary to earlier quarters, growth during the quarter was driven by both IT and BPO business. While IT revenues grew by 13% QoQ, BPO revenues grew by 11% QoQ. Management attributed growth to ramp-up by existing clients, post clarity on EDS acquisition.

Chart 1: QoQ growth trends in IT & BPO



Source: Company, ML Research

## EBITDA margins expand

EBITDA margins during the quarter expanded by 455bps, ahead of MLE estimates of 278bps improvement. Margin expansion was driven by increase in offshore utilization, higher offshoring, breakeven in domestic business and robust revenue growth. We have factored in 150bps improvement in margins to 18.5% by FY08 from current levels.

## Other key highlights:

- It added 11 new clients including one in BPO. It added 418 employees in its IT business and 883 employees in its BPO business, additions of 11% and 12% respectively.
- It further diversified its revenue profile in its BPO business. Share of inbound voice decreased further to 73%. Billing rates too fell to US\$8 from US\$9.

## Raising estimates post 2Q results

**Table 1: Estimates Revision**

	FY07E			FY08E		
	Old	Revised	Change (%)	Old	Revised	Change (%)
Sales	14,793	16,071	9	19,752	20,764	5
EBITDA	2,351	2,602	11	3,718	3,837	3
PAT	1,415	1,574	11	2,368	2,510	6
EPS-Diluted	6.9	7.6	10	11.6	12.2	5

Source: Merrill Lynch Research

## Quarterly snapshot

**Table 2: Quarterly Results**

Rs mn	2QFY07	1QFY07	QoQ	2QFY06	YoY	MLe	Var %
<b>IT Services</b>							
Revenues	2057.2	1827.7	12.6%	1561.3	31.8%	1901.8	8.2%
Cost of Revenues	1377.0	1314.3	4.8%	988.9	39.3%	1312.2	4.9%
Gross Margin	680.2	513.4	32.5%	572.4	18.8%	589.6	15.4%
<b>BPO</b>							
Revenues	862.0	779.1	10.6%	713.2	20.9%	794.8	8.5%
Cost of Revenues	558.2	543.8	2.7%	450.1	24.0%	548.4	1.8%
Gross Margin	303.8	235.3	29.1%	263.1	15.5%	246.4	23.3%
<b>Total Revenues</b>	<b>2919.2</b>	<b>2606.8</b>	<b>12.0%</b>	<b>2274.5</b>	<b>28.3%</b>	<b>2696.6</b>	<b>8.3%</b>
Cost of revenues	1935.3	1858.1	4.2%	1439.0	34.5%	1860.6	4.0%
<b>Gross profit</b>	<b>984.0</b>	<b>748.6</b>	<b>31.4%</b>	<b>835.5</b>	<b>17.8%</b>	<b>835.9</b>	<b>17.7%</b>
Selling expenses	233.1	192.2	21.3%	131.7	77.1%	188.8	23.5%
General and admin expenses	260.1	237.2	9.6%	207.0	25.7%	242.7	7.2%
Provision for doubtful debt	5.6	4.7	19.5%	1.6	259.3%	4.0	39.5%
<b>EBITDA</b>	<b>485.2</b>	<b>314.6</b>	<b>54.2%</b>	<b>495.4</b>	<b>-2.1%</b>	<b>400.5</b>	<b>21.1%</b>
Depreciation	156.9	149.9	4.7%	122.8		154.3	1.7%
Other income	-55.7	42.3	-231.7%	30.1	-284.7%	8.0	-796.2%
<b>PBT</b>	<b>272.6</b>	<b>206.9</b>	<b>31.7%</b>	<b>402.7</b>	<b>-32.3%</b>	<b>254.2</b>	<b>7.2%</b>
Income tax	38.7	55.3	-30.0%	1.1		45.8	-15.4%
<b>Profit after tax</b>	<b>233.9</b>	<b>151.6</b>	<b>54.2%</b>	<b>401.7</b>	<b>-41.8%</b>	<b>208.4</b>	<b>12.2%</b>
			bps		bps		bps
<b>Gross Margins</b>	<b>33.7%</b>	<b>28.7%</b>	<b>499</b>	<b>36.7%</b>	<b>(303)</b>	<b>31.0%</b>	<b>270.7</b>
<b>EBITDA Margins</b>	<b>16.6%</b>	<b>12.1%</b>	<b>455</b>	<b>21.8%</b>	<b>(516)</b>	<b>14.9%</b>	<b>177</b>
Effective tax rate	14.2%	26.7%	(1,252)	0.3%	1,394	18.0%	(380)

Source: Company, Merrill Lynch Research

## Key risks

Key risks to our ratings:

- While we have assumed revenue growth in line with leading offshore and global vendors, faster than expected business flow through EDS could increase visibility and influence our ratings positively.
- Any proposal to increase stake by EDS (62% post merger) could improve stock sentiment positively.
- Wage inflation remains a key issue for the company, as for the industry. The company may also have to resort to lateral hiring, in case client wins are ahead of expectation. This could impact margins negatively.
- Other industry-wide risks include appreciation in Rupee and sharper than expected slowdown in the US economy

## Financial Tables

**Table 3: Profit & Loss statement**

	FY04	FY05	FY06	FY07E Consltd	FY08E Consltd
<b>Revenues</b>	<b>5,806</b>	<b>7,657</b>	<b>9,401</b>	<b>16,071</b>	<b>20,764</b>
Cost of revenues	3,801	4,954	6,056	10,965	13,760
<b>Gross profit</b>	<b>2,005</b>	<b>2,702</b>	<b>3,345</b>	<b>5,105</b>	<b>7,004</b>
Selling expenses	353	548	567	1,122	1,390
General and admin expenses	490	740	803	1,363	1,757
Amortization of ESOP	2	1	0	0	0
Provision for doubtful debt	5	2	14	18	20
<b>Operating profit</b>	<b>1,156</b>	<b>1,412</b>	<b>1,961</b>	<b>2,602</b>	<b>3,837</b>
Less Depreciation	287	396	519	779	1,003
<b>EBIT</b>	<b>869</b>	<b>1,016</b>	<b>1,442</b>	<b>1,823</b>	<b>2,833</b>
Less : Interest			0	0	0
<b>EBT</b>	<b>869</b>	<b>1,016</b>	<b>1,442</b>	<b>1,823</b>	<b>2,833</b>
Foreign exchange gain	147	68	85	-39	0
Other income	-1	4	-9	1	0
Interest	39	41	17	49	60
Other income	185	113	94	11	60
<b>PBT</b>	<b>1,055</b>	<b>1,129</b>	<b>1,536</b>	<b>1,833</b>	<b>2,893</b>
Income tax	69	-117	38	259	383
<b>Profit after tax</b>	<b>986</b>	<b>1,246</b>	<b>1,499</b>	<b>1,574</b>	<b>2,510</b>
Minority interest	0	0	0	0	0
<b>PAT post minority</b>	<b>986</b>	<b>1,246</b>	<b>1,499</b>	<b>1,574</b>	<b>2,510</b>

Source: Company, Merrill Lynch Research

**Table 4: Balance Sheet**

	FY04	FY05	FY06	FY07E Consltd	FY08E Consltd
<b>Sources of Funds</b>					
<b>Shareholder's Funds</b>	<b>3,506</b>	<b>6,397</b>	<b>6,605</b>	<b>8,714</b>	<b>10,477</b>
Share Capital	354	786	1,610	2,060	2,060
Reserves and Surplus	3,138	5,526	4,921	6,581	8,344
Others	14	86	74	74	74
<b>Loan Funds</b>	<b>27</b>	<b>46</b>	<b>38</b>	<b>37</b>	<b>37</b>
<b>Total Liabilities</b>	<b>3,907</b>	<b>6,444</b>	<b>6,643</b>	<b>8,752</b>	<b>10,515</b>
<b>Application of Funds</b>					
<b>Fixed Assets</b>					
Cost	2,003	2,557	3,143	3,977	4,918
<b>Net Book value</b>	<b>918</b>	<b>1,102</b>	<b>1,341</b>	<b>1,595</b>	<b>1,533</b>
Capital WIP	107	96	114	114	114
<b>Goodwill arising on Consolidation</b>	<b>92</b>	<b>3,491</b>	<b>2,676</b>	<b>2,676</b>	<b>2,676</b>
<b>Deferred Tax Assets</b>	<b>18</b>	<b>150</b>	<b>167</b>	<b>167</b>	<b>167</b>
<b>Current assets loans and advances</b>	<b>3,453</b>	<b>3,597</b>	<b>3,752</b>	<b>6,400</b>	<b>8,713</b>
Cash and bank balances	1,211	955	989	2,360	3,969
Debtors and unbilled revenues	1,588	1,835	2,050	3,206	3,830
Loans and advances	539	808	713	834	914
<b>Current Liabilities and Provisions</b>	<b>681</b>	<b>1,992</b>	<b>1,407</b>	<b>2,201</b>	<b>2,688</b>
Current Liabilities	507	1,602	767	1,644	1,764
Provisions	174	390	640	556	924
<b>Net Current Assets</b>	<b>2,773</b>	<b>1,605</b>	<b>2,345</b>	<b>4,199</b>	<b>6,025</b>
<b>Total Assets</b>	<b>3,907</b>	<b>6,443</b>	<b>6,643</b>	<b>8,751</b>	<b>10,515</b>

Source: Company, Merrill Lynch Research

**Table 5: Cashflow Statement**

			FY07E	FY08E	
	FY04	FY05	FY06	Consltd	Consltd
<b>Cash flow statement</b>					
<b>Cash Flow from operations</b>					
Profit before tax	1,055	1,129	1,557	1,833	2,893
<b>Adjustments</b>					
Depreciation	287	396	519	779	1,003
Others	-36	-51	-13	-49	-60
<i>Operating profit before working capital changes</i>	1,305	1,474	2,062	2,564	3,837
Cash from working capital chnages	-395	143	-242	-712	-584
Cash generated from operations	909	1,617	1,821	1,852	3,252
Income taxes paid	-115	-11	-100	-259	-383
<b>Net cash provided by operating activities</b>	<b>794</b>	<b>1,607</b>	<b>1,721</b>	<b>1,508</b>	<b>3,237</b>
<b>Cash flow from investing activities</b>					
Purchase of fixed assets	-591	-557	-802	-833	-941
Acquisition of minority interest of Mphasis India	0	-680	-7	0	0
Purchase consideration for acquisitions	-48	-638	-801	0	0
Others	58	62	-6	49	60
<b>Net cash from investing activities</b>	<b>-581</b>	<b>-1,812</b>	<b>-1,616</b>	<b>-784</b>	<b>-881</b>
<b>Cash flow from financing activities</b>					
Proceeds of premium from issue of share capital	171	181	196	0	0
Proceeds from minority shareholders - preferred stock	45	0	0	0	0
Proceeds from minority shareholders - common stock	19	16	0	0	0
Dividend Paid	-58	-260	-273	-467	-747
Others	8	36	13	14	0
<b>Net Cash provided by financing activities</b>	<b>185</b>	<b>-28</b>	<b>-63</b>	<b>-453</b>	<b>-747</b>
Effect of exchange rate changes	4	-92	-7	0	0
Increase/ decrease in cash and cash equivalents	398	-233	42	272	1,609
Cash + inter corporate deposits beg of the period	924	1,326	955	989	2,360
Others		-46	0	0	0
Cash inflow from EDS India		0	0	1,100	0
<b>Cash + inter corporate deposit end of the period</b>	<b>1,326</b>	<b>955</b>	<b>989</b>	<b>2,360</b>	<b>3,969</b>

Source: Company, Merrill Lynch Research

**Table 6: Ratios**

	FY04	FY05	FY06	FY07E	FY08E
<b>Growth</b>					
Revenue from Operations	35%	32%	23%	71%	29%
EBITDA	22%	22%	39%	33%	47%
EBIT	15%	17%	42%	26%	55%
PAT	47%	26%	20%	5%	59%
<b>Margins</b>					
EBITDA	20%	18%	21%	16%	18%
EBIT	15%	13%	15%	11%	14%
PAT	17%	16%	16%	10%	12%
<b>Return Ratios</b>					
ROE	15%	25.2%	23%	21%	26%
ROA	14%	24%	23%	20%	26%
<b>Others</b>	<b>44%</b>	<b>14%</b>	<b>17%</b>	<b>-18%</b>	<b>59%</b>
EPS (Rs)	7	8	9	8	12
DPS (Rs)	1	2	3	2	3
Dividend Payout Ratio	11	28	32	30	30
BV (Rs)	25	41	41	42	51
CFPS (Rs)	9	10	13	11	17
EV (Rsmn)	31,466	35,411	36,247	45,269	43,660
EV(US\$m)	699	787	805	1006	970
<b>Valuation ratios</b>					
PER	33.2	29.2	24.8	30.2	19.0
EV/EBITDA	27.2	25.1	18.5	17.4	11.4
EV/Sales	5.4	4.6	3.9	2.8	2.1
P/CF	25.8	22.1	18.4	20.2	13.5
FCF/share	1.4	6.7	5.7	3.3	11.1

Source: Company, Merrill Lynch Research



## Analyst Certification

I, Pratish Krishnan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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30 October 2006

***iQmethod*<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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## Important Disclosures

### Investment Rating Distribution: Technology Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	111	45.12%	Buy	21	18.92%
Neutral	126	51.22%	Neutral	21	16.67%
Sell	9	3.66%	Sell	1	11.11%

### Investment Rating Distribution: Global Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
Sell	215	7.26%	Sell	48	22.33%

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