MphasiS

INR 325

Benefits from EDS handsomely flowing in

BUY

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MphasiS' Q4FY07 results were positive and ahead of our expectations. Revenues grew 10.2% Q-o-Q to INR 3.4 bn, while net profits surged 27.4% Q-o-Q to INR 456 mn (29.6% Y-o-Y). Operating profits before depreciation (EBITDA) at INR 647 mn also registered good sequential growth of 9.9% Q-o-Q. Revenue Y-o-Y growth (34.6%) is the highest in the last four quarters, while Y-o-Y growth of 29.6% in net profit reverses three quarters of Y-o-Y profit decline over the corresponding quarters last fiscal. Additionally, net profit margin, at 13.5% for Q4FY07, has been significantly higher than profitability (as a percentage of revenues) in the earlier three quarters of FY07. SG&A expenses at 16.2% of sales showed a flattish trend over Q3FY07, though S&M expenses sequentially shot up 24%, offset by G&A that grew only 3% Q-o-Q. Net profit growth was also aided by the lower tax provision (effective tax rate of 4.5%), though we expect effective tax rates in the range of 12-15% in FY08.

We are positive on the buoyant revenues of USD 9 mn for the quarter (~ 12%), derived by MphasiS from EDS' internal work. Revenues from this channel, which were non-existent in Q1FY07, have been doubling every quarter through Q4FY07. We are particularly pleased about the quality of pipeline that MphasiS has established and is building with EDS. We believe the pipeline of such deals is strong and is likely to yield more revenues of this kind in the coming quarters.

MphasiS' results do not include the EDS (India) numbers, as the approval for the legal merger is still pending in the high court. But operationally, the merger has already taken effect and synergy benefits have started to accrue in an encouraging fashion.

We estimate MphasiS' EPS on a consolidated basis to grow at a CAGR of 30.4% over FY07-09E. At INR 325, the stock trades at a P/E of 23.5x and 18.6x on our FY08E and FY09E earnings, respectively. We maintain our 'BUY' recommendation.

Key Highlights

- Revenues were reported at INR 3.4 bn, up 10.2% Q-o-Q and 34.6% Y-o-Y and net profit at INR 456 mn was up 27.4% Q-o-Q and 29.6% Y-o-Y.
- IT services witnessed strong volume growth of 9.7%, but the rupee appreciation restricted the growth to 4.8% Q-o-Q. On the BPO side, the revenue growth was impressive at 23.6% (driven by higher volumes and better pricing).

Reuters	:	BFLS.BO
Bloomberg	:	BFL IN

Market Data

52-week range (INR)	:	340 / 121
Share in issue (mn)	:	164.1
M cap (INR bn/USD mn)	:	53.4 / 1,306.8
Avg. Daily Vol. BSE/NSE ('000)	:	1,111.8

Share Holding Pattern (%)

Promoters	:	50.6
MFs, FIs & Banks	:	9.9
FIIs	:	11..5
Others	:	28.1

Financials

Year to March	Q4FY07	Q3FY07	*Growth %*	Q4FY06	*Growth %*	FY08E	FY09E
Revenue (INR mn)	3,372	3,060	*10.2*	2,505	*34.6*	15,367	19,034
Gross profit (INR mn)	1,193	1,077	*10.8*	885	*34.8*	5,394	6,762
EBITDA (INR mn)	647	588	*9.9*	513	*26.1*	2,950	3,728
Net profit (INR mn)	456	358	*27.4*	352	*29.6*	1,953	2,348
Adj. EPS basic (INR)	2.8	2.2	*26.7*	2.2	*27.9*	11.9	14.1
P/E (x) *						27.4	23.1
P/E (x) **						23.5	18.6
EV/EBITDA (x)						17.4	13.6
Market cap / Revenue (x)						3.5	2.8

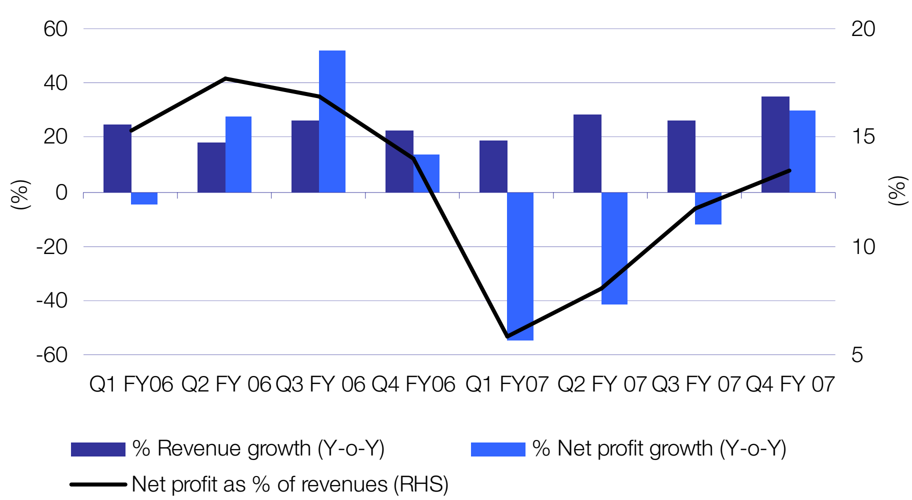
** MphasiS consolidated* *** MphasiS including EDS (India)*

- Gross profits stood at INR 1,193 mn (up 10.8% Q-o-Q), with a 20bps improvement in gross margin. EBITDA stood at INR 647 mn, up 9.9% Q-o-Q and 26.1% Y-o-Y. EBITDA margins remained stable at 19.2%.
- Lower forex loss of INR 26 mn (INR 60 mn loss in Q3) also aided growth in net profits.
- During the quarter, MphasiS added 1,808 employees, the highest addition till date, taking the company's total headcount to 14,679 (5,191 in IT services and 9,485 in BPO).
- The total headcount including EDS (India) stood at 20,249. Further, the management intends to add another 8,000-10,000 employees in CY07, which is indicative of the strong momentum that the company is witnessing.
- Seven new clients were added during the quarter (six in IT and one in BPO). The total number of active clients the company serves stands at 350+, with 60 clients in the BO space.
- Number of clients in the IT services, contributing revenues in excess of USD 1 mn and USD 10 mn stood at 36 and 5 respectively. In BPO, the company has 17 clients with USD 1 mn plus of revenue contribution and 4 clients with USD 10 mn plus revenues.
- The strong growth in the BPO business is particularly on account of the internal work of EDS that is being transitioned offshore. The revenue contribution on this account stood at USD 9 mn for the quarter (grown from USD 4 mn in Q3 and USD 2 mn in Q2).
- Other factors contributing to better performance in the BPO business are: a) turnaround in the domestic BPO, which is ~18-20% of BPO revenues, b) change in the revenue mix – more of back office services like F&A and HR.

A good Q4FY07 rounds off a difficult FY07, marking the end of integration throes

Chart 1, shows that MphasiS' financial performance suffered during most of FY07, but picked up in the last quarter of the fiscal. Quarterly net profits have been particularly volatile through this period, partly explained by the costs of consummating the integration. We believe that Q4FY07 quarter marks the end of a difficult period of transition for MphasiS, as it works through the integration with EDS.

Chart 1: MphasiS' quarterly profit performance through FY07 has been volatile and lags behind the corresponding quarters in FY06



Source: Company, Edelweiss research

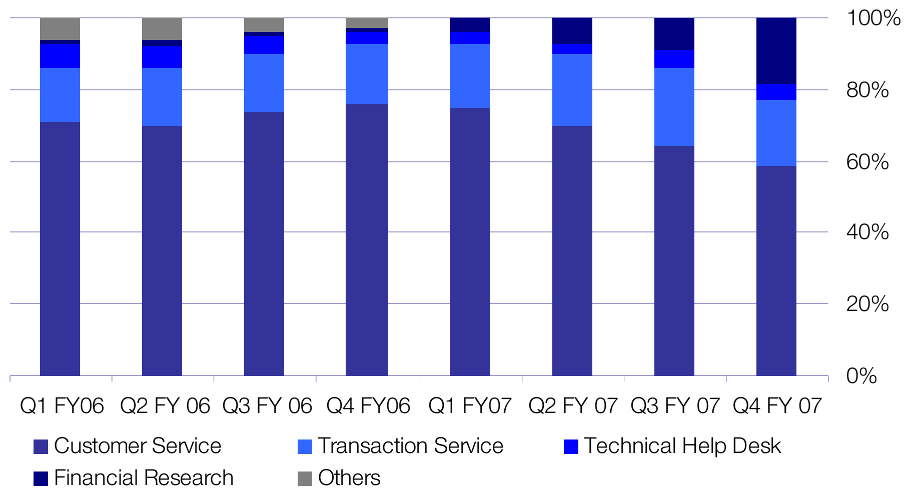
For FY07, MphasiS reported revenues and net profits of INR 12.0 bn and INR 1.2 bn, up 27% and down 20% from FY06, respectively. Profitability, as a percentage of revenues, in FY07 significantly declined to 10% of revenues versus 15.9% in FY06. However, we note that profitability surged to 13.5% of revenues in Q4FY07. Even if MphasiS merely maintains Q4FY07 levels of net profits through FY08 at no further sequential growth, it will have already posted 53% earnings growth in FY08. Hence, we believe that MphasiS without EDS (India) is on course for a well-above 50% earnings growth in FY08 over FY07, admittedly, off a depressed base in FY07.

EDS brings to MphasiS both enhanced quantity and quality of growth in BPO

EDS has already significantly started contributing to MphasiS in two ways: (a) contracts bagged through joint efforts, where customer lead-in may have been provided by EDS and (b) contracts awarded directly to MphasiS by EDS as a client. Notably, the surge in MphasiS' revenues and profitability in its BPO division in Q4FY07 is largely on account of significant traction from EDS, with over 550 personnel engaged in higher-value services such as F&A, HR, back-end processing, and credit card processing. EDS is helping MphasiS manage the shift away from customer interaction-based processes towards knowledge services. This is set to continue with transaction and knowledge-based services expected to account for an increasing share of the BPO pie (39% in Q4FY07).

Chart 2 shows how MphasiS has consistently managed its revenue mix away from customer service.

Chart 2: Increasing contribution from financial research and transaction services



Source: Company, Edelweiss research

The domestic BPO business during the quarter registered an increase in margins, contributing to the profitability. However, the company indicated that profitability in the BPO division in Q1FY08 could be relatively soft, given the likely ramp down of two accounts and salary revisions to be effective during the coming quarter.

Enhanced profile with EDS to aid bidding for significantly larger deals and building good quality pipeline in IT Services

MphasiS is able to leverage its newly acquired EDS parentage for:

- Better pricing of services realised because of EDS' superior brand.

- Gaining better momentum in chasing larger deals with multi-year and multi-service offerings with a good bias towards annuity-based revenues. Till date, MphasiS was almost completely absent from credibly addressing this space owing to its project-oriented execution, as opposed to large-scale application outsourcing.
- Accelerating the progress towards a multi-service shop. RelQ, acquired by EDS, is a specialist testing company and EDS is driving synergies between RelQ's IPs in testing with MphasiS' nascent presence here to bolster the latter's strength. Notably, MphasiS indicated its intention of almost doubling its investment in testing, taking it over 1,300 professionals by FY08 versus 700 as of today. Also, EDS will help drive traction in infrastructure management through addressing areas such as remote desktop management, data centre management, and remote data management. This practice currently has about 600 professionals but MphasiS will invest to grow this practice with over 1,000 professionals by FY08.

EDS is now substantially better-positioned to address the large-deal space, entailing a significant offshore component post the acquisition of its majority stake in MphasiS. MphasiS has already won a large-deal client in the retail vertical this quarter, which follows its one large-deal win in the telecom vertical last quarter.

We see MphasiS-EDS collectively making a better attempt at a portfolio of deals, including the large multi-year ones as well as the high-end project-oriented types such as solution architecting (MphasiS' mainstay).

Robust people addition plans, further provide comfort

MphasiS and EDS together hired over 2,300 professionals in Q4FY07, ahead of their earlier upper-end indications of about 2,000. Notably, they together intend to hire about 8,000-10,000 professionals in FY08, a 40%-50% addition to the existing manpower base. We believe that these combined people addition plans for FY08 are amongst the most aggressive in percentage terms within the sector.

This provides additional comfort and room for conservatism to our revenue growth estimates of near 30% in FY08 for MphasiS.

A developed fresher training program, but entry-level intake still low compared to peers

We believe relative absence of a sound training and orientation program for fresher's or entry-level professionals at MphasiS restrained its ability to lower or optimise its delivery costs. This was a significant problem, given a major proportion of MphasiS' professional base comprises mid-level professionals.

However, with the establishment of MphasiS' fresher training institute in Mangalore and more long-term application outsourcing work in prospect, we believe that MphasiS' can now include a greater proportion of entry-level professionals in its recruitment mix. This should help control incremental cost of delivery over the medium-to-long term.

The company has indicated that it can absorb an entry-level professional intake of about 20% in FY08. We note that this proportion is significantly higher compared with its peers such as Hexaware that is targeting a 50:50 mix of 'entry-level to experienced intake' in FY08. Hence, we believe that MphasiS has still significant progress to make towards broadening its employee pyramid.

Expanding offerings for broad basing revenues

At 60% of revenues, BFSI segment accounts for a major portion of the company's revenues. We understand, much of this comes from application development and maintenance/ support services (ADM). ADM services account for most of the IT services revenues (90% in current quarter), which the company is now looking at diversifying. We have noted that the company is currently making investments in developing high growth practices such as infrastructure management, testing, and business intelligence. We see the broad basing of the revenues as these services grow. Developing these practices will involve its own investments as well as time, before they start yielding the desired results. In our view, the pressure created by investments in developing these services will however be eased by consistent improvement in the billing rates and the lower cost of delivery.

Proforma consolidated earnings

Table 1 lays out our proforma consolidated financials for EDS-MphasiS based on current and estimated financials of EDS. We note that post consolidation; EDS (India) will likely add INR 1.9 in FY08E and ~ INR 3.4 in FY09E).

Table 1: Proforma consolidation is EPS accretive

	MphasiS consolidated			EDS (India)			Combined		
	FY07	FY08E	FY09E	FY07	FY08E	FY09 E	FY07	FY08E	FY09 E
Revenues (INR mn)	11,958	15,367	19,035	5,700	7,410	9,633	17,658	22,777	28,668
EBITDA (INR mn)	2,035	2,950	3,729	1055*	1,352	1,782	3,090	4,302	5,511
Net profits (INR mn)	1,199	1,953	2,349	590	889	1,252	1,789	2,842	3,601
Shares o/s (mn)	164.1	164.5	166.5				173.4	205.3	205.3
EPS (INR)	7.3	11.9	14.1				10.3	13.8	17.5
PE (x)	44.5	27.4	23.1				31.5	23.5	18.6

** estimated no.*

Source: Edelweiss research

Valuations

We remain positive on the long term prospects of the company, given significant changes in the company's profile post merger with EDS. We see higher proportion of revenues flowing in the coming quarters from the clients pursued through EDS along with improvement in the billing rates. At a CMP of INR 325, the stock trades at a P/E of 23.5x and 18.6x for FY08E and FY09E, respectively. We maintain our 'BUY' recommendation.

Financials snapshot								(INR mn)
Year to March	Q4FY07	Q3FY07	*Growth %*	Q4FY06	*Growth %*	FY07	FY08E	FY09E
Total revenues	3,372	3,060	*10.2*	2,505	*34.6*	11,958	15,367	19,034
Cost of revenues	2,179	1,982	*9.9*	1,620	*34.5*	7,954	9,972	12,272
Gross profit	1,193	1,077	*10.8*	885	*34.8*	4,003	5,394	6,762
General & admin exp	283	276	*2.6*	218	*29.9*	1,067	1,273	1,589
Selling expenses	263	213	*23.7*	154	*70.9*	902	1,171	1,445
EBITDA	647	588	*9.9*	513	*26.1*	2,035	2,950	3,728
Depreciation	163	161	*1.2*	140	*16.3*	631	902	1,170
EBIT	483	427	*13.2*	372	*29.8*	1,403	2,048	2,558
Other income	(6)	(50)	*(88.2)*	22	*(126.9)*	(69)	174	140
Profit before tax	478	378	*26.5*	394	*21.2*	1,335	2,222	2,698
Tax provision	22	20	*10.2*	43	*(48.5)*	136	269	349
Net profit	456	358	*27.4*	352	*29.6*	1,199	1,953	2,348
Adjusted EPS basic (INR)	2.8	2.2	*26.7*	2.2	*27.9*	7.3	11.9	14.1
as % of net revenues								
Gross profit	35.4	35.2		35.3		33.5	35.1	35.5
General & admin exp	8.4	9.0		8.7		8.9	8.3	8.3
Selling expenses	7.8	7.0		6.2		7.5	7.6	7.6
EBITDA	19.2	19.2		20.5		17.0	19.2	19.6
Net profit	13.5	11.7		14.0		10.0	12.7	12.3
Tax rate	4.6	5.3		10.8		10.2	12.1	13.0

Company Description

MphasiS is a tier II and one of top 10 IT integrated software services vendor in India. The company provides IT services, mainly focused on banking, financial services, and insurance segments. It has one of the largest BPO practice in India, providing voice and transaction-based services. In June 2006, Electronic Data Systems (EDS) bought a majority stake in MphasiS and now, the total holding stands at 50.6%. The company's last twelve month revenues stood at INR 11.1 bn (USD 249.8 mn), with employee strength of 4,300 plus in IT services and 8,400 plus in BPO services. Combined with EDS (India), the company's employee strength stands at 20,249.

Investment Theme

We believe, with EDS as the owner, the issues such as size and scale, market access, pricing power, and enhanced capabilities in offshore delivery will add substantial business for MphasiS, going forward. Incremental business for MphasiS is likely to come from – direct working with EDS' clients, serving EDS' clients through sub-contracting arrangement with EDS, and servicing EDS' itself (doing internal work in the HR and F&A area).

Key Risks

Key risks to our investment theme include – a) sustained slowdown in the US, b) supply side constraints such as salary hikes and attrition, and c) appreciation of rupee against US dollar, GBP, and Euro.

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Vishal Goyal, CFA	-	2286 4370	Banking & Finance
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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period