

## MindTree Consulting

 BSE code: 532819  
 NSE code: MINDTREE

**CMP: Rs 589**
**Target: Rs 556**
**SELL**

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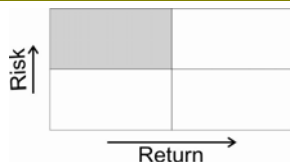
### Company data

Particulars	
Market cap (Rs bn / US\$ mn)	22.2 / 542
Outstanding equity shares (mn)	37.8
52-week high/low (Rs)	1,022 / 525
2-month average daily volume	71,074

### Financial snapshot

Particulars	FY07	FY08E	FY09E
Sales (Rs mn)	5,903.5	7,323.8	9,437.4
Growth (%)	31.5	24.1	28.9
Adj net profit (Rs mn)	900.5	972.4	1,258.1
Growth (%)	67.5	8.0	29.4
FDEPS (Rs)	27.7	25.6	32.4
Growth (%)	59.7	(7.6)	26.8
P/E (x)	21.3	23.0	18.2
ROE (%)	20.7	18.4	19.2

### Risk-return profile



### Shareholding pattern

(%)	Jun-07	Mar-07
Promoters	35.5	35.5
FIs	3.5	4.8
Banks & FIs	1.6	0.2
Public*	59.4	59.5

*\*includes 34.5% locked-in shares of foreign venture funds*

### Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
MindTree	589	(2.5)	(23.5)	NA
Sensex	15,465	2.2	6.7	20.0
BSE IT	4,626	(1.7)	(4.6)	(6.6)

 Company website: [www.mindtree.com](http://www.mindtree.com)

## Richly valued

Operational risks raise concerns and valuations are expensive: Sell

### Exit rationale

- ❖ MindTree has been one of the fastest growing mid-tier Indian IT services companies. However, growth has slowed down significantly in FY07 and is further expected to decline in FY08 due to rupee appreciation.
- ❖ Risks to growth are significant as more than 65% of revenues come from development projects which are highly dependent on the discretionary IT spending of clients. In the event of an economic slowdown in the US, discretionary IT spends would be curtailed.
- ❖ With limited scope for improvement in margin levers like pricing, utilisation and offshoring, profit margins would remain under pressure.
- ❖ Current valuations are already stretched when compared to industry leaders and peers, leaving limited room for further price appreciation.

### Risks to our call

- ❖ Inorganic initiatives to further de-risk the business model would provide a further upside to the stock price.
- ❖ Our estimates do not factor in any large deals that the company might win, which could fuel higher-than-expected earnings growth.

### Valuation

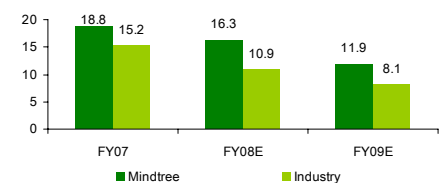
- ❖ We are valuing the company at 22x P/E and 15x EV/EBITDA on FY08E. This is at ~10% premium to our target valuation for mid-tier IT companies, which we believe is justified due to its strong management capabilities and larger scale.
- ❖ At these valuations, our one-year target price for the stock is Rs 556. We recommend that investors Sell the stock.

### P/E multiple (x)



Source: Religare Research

### EV/EBITDA multiple (x)



Source: Religare Research

## Company overview

Established in 1999, MindTree Consulting (MTCL) is a mid-sized Bangalore-based company focused on providing IT and R&D services. In IT services MTCL provides strategic consulting services and also develops and maintains enterprise solutions for business-to-business and business-to-consumer applications. The company's customer base in this segment includes reputed names like AIG, Volvo, Unilever and the Avis Budget group. In R&D services the company is primarily focused on solutions for the storage, automotive and telecom industries, with clients like Symantec and LSI Logic.

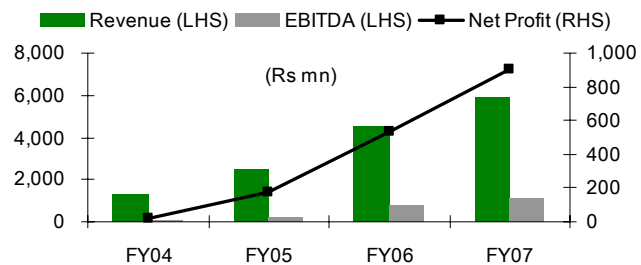
### Strong managerial capabilities...

MTCL was established by a group of ten industry professionals who came from Wipro, Lucent Technologies and Cambridge Technology Partners. In its initial years, the company went through a rough patch with the dotcom bubble going bust and the future of offshoring remaining uncertain. However, the management's strong execution capabilities and domain skills enabled the company to realign itself to market needs and deliver industry leading growth rates. Since then MTCL has been able to carve a niche for itself in the industry with strong customer engagements and a preferred-employer status among IT recruits.

### ...driving rapid growth

During FY03-FY07 MTCL's revenues grew at a 64% CAGR, outpacing other mid-tier Indian IT services players. The net profit in FY07 stood at Rs 901mn as against Rs 65mn of net loss in FY03 due to a significant improvement in operational performance. In a period of four years, the management was able to achieve industry-leading margins.

### FY04-FY07 growth profile



Source: Company

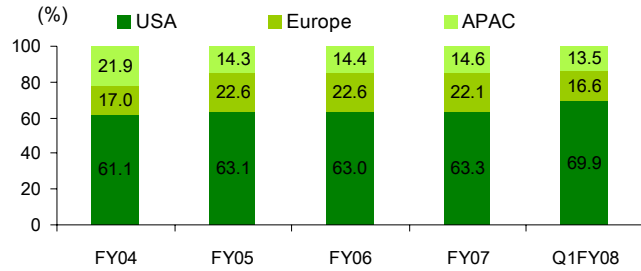
### Well diversified business

Taking advantage of the offshoring trend, MTCL has diversified its business across various verticals, geographies and clients. Unlike certain other mid-tier IT companies it is not exclusively dependent on any vertical or client for a significant amount of its revenues, thus decreasing the level of non-systematic risk in the company.

**Geographies:** MTCL gets a majority of its revenues (~63%) from the US geography, though the contribution has remained stable over the years. Europe contributes approximately 22-23% of the company's revenue with the rest coming from the Asia-Pacific (APAC) region. During Q1FY08, the revenue share of the European geography declined to ~17% due to client rationalisation.

**Revenues well distributed among verticals and clients, reducing concentration risk**

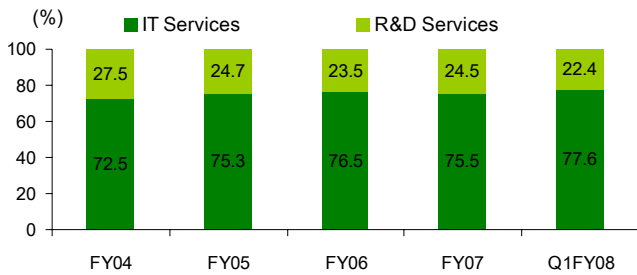
Geographical distribution of revenues



Source: Company

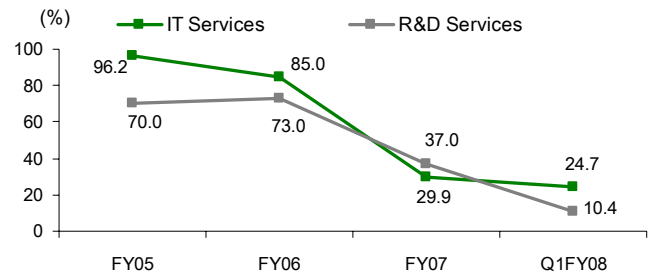
**Verticals:** The company has divided its services into two major verticals: 1) IT Services, and 2) R&D Services. IT Services primarily caters to industries like BFSI, manufacturing and travel & transportation, and contributes ~76% of the revenues. On the other hand, R&D Services focuses on outsourced engineering services catering largely to the storage, consumer appliance, automotive and telecom industries. The contribution from R&D Services has decreased in Q1FY08 from close to ~25% earlier to ~22% due to the slowdown witnessed in R&D offshoring.

IT Services vs R&D Services



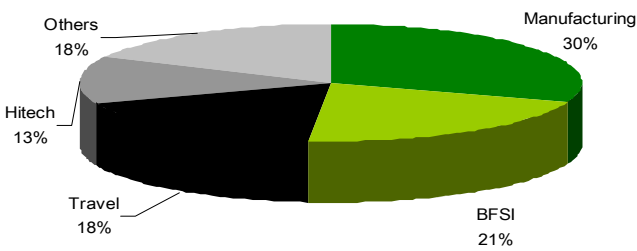
Source: Company

IT and R&D Services growth



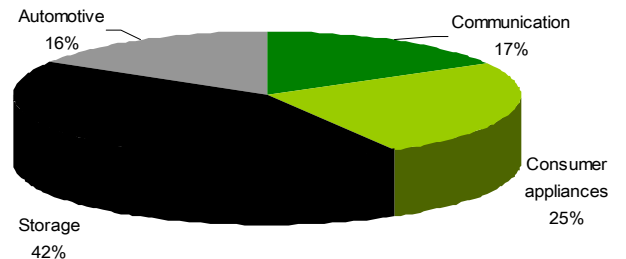
Source: Company

FY07 – IT Services break-up



Source: Company

FY07 – R&D Services break-up



Source: Company

Services large clients like AIG, Volvo, Unilever and the Avis Budget group

Large base of reputed clientele

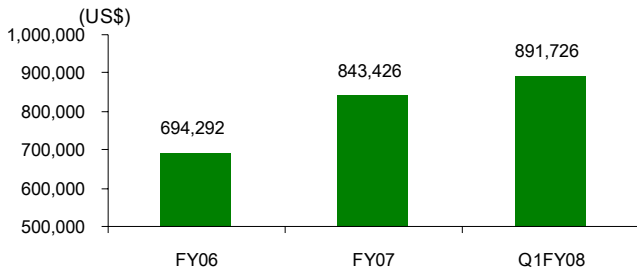
MTCL's client list includes big names like AIG, Volvo, Unilever, the Avis Budget group, Symantec and LSI Logic. The company also has a large base of reputed clients with significant offshoring potential. Going forward, we believe that the management's focus would be on raising the average revenue per client which is much lower than industry peers. One of the main reasons for this could be the significant contribution of development project-related revenues. The company derives ~65% of its revenues from development projects.

**Client metrics**

(Number of clients)	FY07	Q1FY08
US\$ 1mn clients	31	34
US\$ 5mn clients	4	4
US\$ 10mn clients	2	2

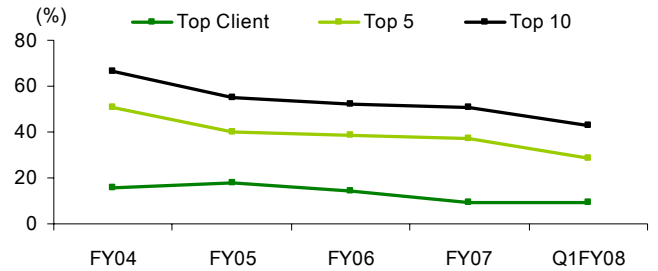
Source: Company

**Average revenue per client**



Source: Company, Religare Research; Q1FY08 numbers are annualised

**Client concentration**



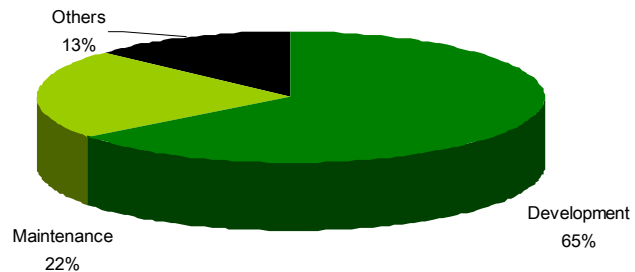
Source: Company, Religare Research

**High exposure to ADM poses a risk...**

In FY07, application development and maintenance (ADM) projects contributed ~87% of the total revenues. This is significantly higher than the industry norm. Generally, ADM projects contribute 50-60% of revenues for large Indian IT services players and ~70% of revenues for mid-tier companies. Within ADM as well, the company is highly dependent on development projects rather than maintenance work, further decreasing annuity revenues.

**High dependence on development projects compresses annuity revenues**

**ADM revenue concentration**



Source: Company, Religare Research

The possibility of a slowdown in the US economy – the source of 65-70% of the company’s revenue – can pose a significant threat to MTCL’s growth prospects. ADM revenues and development projects in particular are directly dependent on the customer’s discretionary spending power. In the event of an economic slowdown, discretionary spending will be curtailed, affecting Indian players who are heavily dependent on ADM projects.

**...but efforts are underway to diversify the business**

The management is placing a greater emphasis on ramping up annuity revenues as a de-risking initiative. Annuity revenues rose from 28% of revenues in FY07 to 33% in Q1FY08. The contribution of maintenance projects to revenues increased from 22.3% to 25.6% over the same period. Apart from this, the management is also focusing on raising the contribution from new services like package implementation, testing and infrastructure management to further de-risk the business model.

### Client rationalisation and a slowdown in offshored R&D have moderated growth

#### Growth momentum slowing, but still expected to beat industry growth

After growing at a CAGR of 76% over FY03-FY06, the growth in revenues slowed down to 31.5% in FY07. The slowdown can be attributed primarily to: a) higher offshore volumes, b) lower volumes from GE due to a ramp down in the account, and c) the rationalisation of certain client accounts. The YoY growth has further moderated in Q1FY08 to 21% in revenues and a decline of 15% in net profits due to pressure from rupee appreciation and a slowdown in offshored R&D services.

#### We expect revenues to grow at a 26% CAGR over FY07-FY09

The management has given a dollar revenue growth guidance of 36-38% accompanied by net profit growth of 26% for FY08. In rupee terms the growth translates down to 24-25% in revenues and ~14% in net profit. The EBITDA margin is expected to contract by ~130bps due to the strong rupee environment and wage pressures, leading to profit growth lagging behind revenues. Our estimates are based on an average exchange rate of Rs 41/US\$ and Rs 40.5/US\$ for FY08 and FY09 respectively.

We expect the company's revenues and net profit to grow at a CAGR of 26% and 18% respectively over FY07-FY09. In a stable rupee scenario, we expect the growth to get back on track in FY09 with revenues and profits growing at 29%. However, in our opinion, the risks attached to growth are high. Besides cost pressures due to wage inflation and a stronger rupee, a decline in project volumes in the event of a US slowdown poses a significant risk to growth.

### Margins constraints from a strong rupee, high reliance on ADM and rising attrition rates

#### Limited scope for further margin expansion

Since FY04, MTCL's profit margins have witnessed a consistent uptrend. The EBITDA margins have improved from 3.9% in FY04 to 18.6% in FY07. However, we believe that the room for margins to expand further is limited due to the following:

**Strong rupee:** This would impact both growth and profit margins adversely. The impact on margins would be higher than larger peers in the industry due to higher offshore contribution to effort, which limits the natural hedge available.

**Higher contribution of ADM in revenues:** Over the past few years the company has witnessed an uptrend in billing rates due to strong execution capabilities. However, in the event of a slowdown in the US economy, billing rates could stagnate thus limiting the resultant margin cushion.

**Supply side constraints:** MTCL has been one of the preferred employers in the industry with strong brand equity. However, due to systematic reasons its attrition rate and wage pressures are on the rise, putting further pressure on margins.

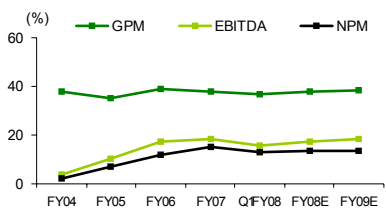
**Little room for further offshoring:** In a continuous bid to increase margins, MTCL's offshoring has risen to 86% of effort and 71% of revenue in Q1FY08. We believe that there is limited room for further offshoring from these levels.

**Utilisation rates:** MTCL's gross utilisation levels are lower than some of its industry peers. We attribute this factor to the higher reliance on development projects. Due to this we do not expect the utilisation levels to improve drastically from the current levels of 65% in the short term. In a strong rupee scenario, we expect the company to increase gross utilisation to close to 68% in FY09, thus increasing the EBITDA margin to 18.3% as against our 17.3% expectation for FY08.

#### Return ratios lower due to higher cash and investment component

The return ratios are expected to decline in FY08 and FY09 due to higher cash and cash equivalents in the balance sheet. Cash and liquid investments are expected to account for ~40% of the total assets as compared to ~10% in FY06.

#### Profit margin movement



Source: Company, Religare Research

## Upside risks to our estimates

### Inorganic initiatives

Any acquisition made by the company to de-risk its services lines would have a positive impact. Acquisition would bring in domain skills apart from client-specific synergies and thus boost growth beyond our expectations.

### Success in bagging a large deal

With the strong growth momentum witnessed in the last few years, MTCL is gaining the scale needed to participate in relatively larger deals. The announcement of any large project in the range of US\$ 25mn-30mn would lead to higher-than-expected earnings growth.

## Valuation

### Significant risks to growth; we expect MTCL to underperform the market

At the current price of Rs 573, the company is trading at 22.4x and 17.7x its FY08 and FY09 expected earnings of Rs 25.6 and Rs 32.4 respectively. MTCL's valuations have corrected significantly during the current market downturn. However, we believe valuations still remain expensive when compared to peers and industry leaders. With risks to growth and uncertainty levels on the rise for IT companies in India, we expect the stock to underperform the market and the industry.

### Peer comparison

	Market Cap (US\$ mn)	FY07-FY09 EPS CAGR (%)	P/E (x)		EV/EBITDA (x)		PEG Ratio (x)
			FY08E	FY09E	FY08E	FY09E	
<b>Large-caps</b>							
TCS	25,444	19.6	20.8	17.3	17.2	14.0	1.1
Infosys	26,317	21.5	23.4	18.7	19.6	15.4	1.1
Wipro	16,583	15.0	20.5	17.2	20.3	16.9	1.4
Satyam	7,169	17.9	18.4	15.1	16.7	13.8	1.0
Tech Mahindra	3,836	26.0	20.4	15.3	16.8	12.3	0.8
<b>Mid-caps</b>							
Hexaware Technologies	397	11.1	12.5	10.7	7.9	6.2	1.1
Infotech Enterprises	327	24.3	13.0	10.7	8.5	7.3	0.5
Sasken Technologies	264	34.2	20.7	13.4	11.6	7.6	0.6
KPIT Cummins	226	33.1	14.3	10.1	10.1	7.7	0.4
MindTree Consulting	542	8.2	23.0	18.2	16.3	11.9	2.8

Source: Religare Research

**Despite a premium of 10% to peers, we find MTCL expensive; Sell**

### Sell with a one-year target price of Rs 556

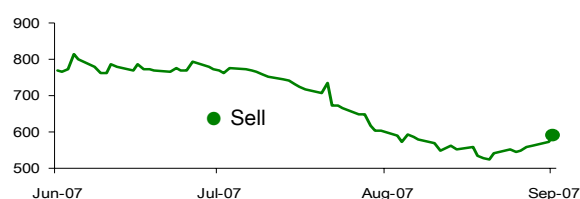
We have valued MTCL at 22x and 17x its FY08 and FY09 expected earnings respectively, which gives us a one-year target price of Rs 556. On EV/EBITDA basis, the target valuations are 15x and 11x on FY08E and FY09E respectively. These valuations are at a ~10% premium to our target valuations of other mid-tier IT services companies and at a discount of 25% and 10% to our respective target multiples for Infosys and Satyam. We recommend that investors Sell the stock.

### Recommendation history

Date	Event	Reco price	Tgt price	Reco
05-Sep-07	Initiating Coverage	589	556	Sell

Source: Religare Research

### Stock performance



Source: Religare Research

## Financials

### Profit and Loss statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Revenues	4,488.0	5,903.5	7,323.8	9,437.4
Growth (%)	82.1	31.5	24.1	28.9
EBITDA	776.2	1,096.4	1,267.3	1,726.7
Growth (%)	206.6	41.2	15.6	36.3
Depreciation	231.8	244.4	364.4	519.6
EBIT	544.4	852.0	902.9	1,207.1
Growth (%)	281.0	56.5	6.0	33.7
Interest	52.6	30.0	59.4	50.7
Other income	65.7	73.6	236.1	260.2
EBT	557.5	895.7	1,079.7	1,416.6
Growth (%)	222.8	60.7	20.5	31.2
Tax	15.5	(4.9)	107.3	158.5
Effective tax rate	2.8	(0.5)	9.9	11.2
Adj net income	537.5	900.5	972.4	1,258.1
Growth (%)	201.0	67.5	8.0	29.4
Shares outstanding (mn)	29.4	37.8	38.4	39.1
FDEPS (Rs)	17.4	27.7	25.6	32.4
DPS (Rs)	2.0	2.0	2.0	2.0
CEPS (Rs)	28.7	36.7	35.2	45.8

Source: Company, Religare Research

### Cash flow statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Net income	537.5	900.5	972.4	1,258.1
Depreciation	231.8	244.4	364.4	519.6
Other adjustments	(32.7)	(68.4)	(186.4)	46.0
Changes in WC	(343.4)	(266.3)	(231.4)	(292.2)
Operating cash flow	393.2	810.2	919.0	1,531.5
Capital expenditure	(203.7)	(549.2)	(1,563.6)	(863.6)
Investments	(175.3)	(1,575.8)	257.1	-
Other investing inc/(exp)	(236.2)	(16.8)	-	-
Investing cash flow	(615.2)	(2,141.8)	(1,306.5)	(863.6)
Free cash flow	(222.0)	(1,331.6)	(387.5)	667.9
Issue of equity	64.6	2,365.3	131.1	119.1
Issue/repay debt	233.4	(472.1)	510.1	(200.0)
Dividends paid	(58.9)	(34.7)	(116.8)	(106.2)
Others	(24.0)	(21.1)	(5.3)	-
Financing cash flow	215.1	1,837.4	519.1	(187.1)
Beg. cash & cash bal	269.0	262.1	767.9	899.6
Chg in cash & cash bal	(6.9)	505.8	131.6	480.8
Closing cash & cash bal	262.1	767.9	899.6	1,380.4

Source: Company, Religare Research

### Balance sheet

(Rs mn)	FY06	FY07	FY08E	FY09E
Cash and cash bal	262.1	768.0	899.6	1,380.4
Accounts receivable	1,097.7	1,171.6	1,440.4	1,807.3
Inventories	-	-	-	-
Others current assets	558.3	830.3	958.8	1,165.4
Current assets	1,918.1	2,769.9	3,298.8	4,353.2
Investments	537.6	2,140.6	1,915.2	1,915.2
Net fixed assets	388.5	699.3	1,922.0	2,266.1
CWIP	-	46.4	50.2	54.2
Total assets	2,844.2	5,656.1	7,186.2	8,588.7
Payables	741.3	861.6	886.4	1,167.8
Others	73.1	176.0	232.0	282.0
Current liabilities	814.4	1,037.6	1,118.4	1,449.8
LT debt	742.0	263.8	776.0	576.0
Other liabilities	-	-	-	-
Equity capital	58.7	377.5	384.2	391.4
Reserves	1,229.1	3,977.2	4,907.6	6,171.5
Net Worth	1,287.8	4,354.8	5,291.8	6,562.8
Total liabilities	2,844.2	5,656.1	7,186.2	8,588.7
BVPS (Rs)	43.9	115.3	137.7	167.7

Source: Company, Religare Research

### Financial ratios

	FY06	FY07	FY08E	FY09E
EBITDA margin (%)	17.3	18.6	17.3	18.3
EBIT margin (%)	12.1	14.4	12.3	12.8
Net profit margin (%)	12.0	15.3	13.3	13.3
FDEPS growth (%)	123.6	59.7	(7.6)	26.8
Receivables (days)	89.3	72.4	71.8	69.9
Inventory (days)	-	-	-	-
Payables (days)	72.9	65.4	53.4	55.3
Current ratio (x)	2.4	2.7	2.9	3.0
Interest coverage (x)	11.2	31.0	17.4	25.8
Debt/equity ratio (x)	0.6	0.1	0.1	0.1
ROE (%)	41.7	20.7	18.4	19.2
ROCE (%)	29.1	20.1	17.0	18.3
ROAE (%)	20.8	16.5	14.4	15.2
EV/Sales (x)	4.6	3.5	2.8	2.2
EV/EBITDA (x)	26.6	18.8	16.3	11.9
P/E (x)	33.9	21.3	23.0	18.2
P/BV (x)	13.4	5.1	4.3	3.5
P/CEPS (x)	20.5	16.0	16.7	12.8

Source: Company, Religare Research



## RELIGARE RESEARCH

### Fundamental Research

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### Recommendation parameters

	Returns	Absolute
<b>Large-caps*</b>	> 10%	< -5%
	BUY	SELL
<b>Mid-caps**</b>	> 25%	< 10%

*\*Market cap over US\$ 1bn    \*\*Market cap less than US\$ 1bn*

### Religare Securities

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