

JUNE 10, 2010
UPDATE

Coverage view: **Attractive**

Price (Rs): **537**

Target price (Rs): **550**

BSE-30: **16,922**

Closer look at products strategy. We have gained further clarity on MindTree's product strategy. While we are impressed with the level of preparedness and ambitious plans, we believe that product diversification is fraught with risk and faces challenges of (1) limited budgets versus established players; (2) product acceptance and success in the high ASP market and (3) increase in capital intensity. We maintain our constructive view on the services business but retain REDUCE rating on high-risk product diversification.

Company data and valuation summary

Mindtree

Stock data

52-week range (Rs) (high,low)	747-405
Market Cap. (Rs bn)	22.1

Shareholding pattern (%)

Promoters	32.5
FIs	15.8
MFs	11.6

Price performance (%)

	1M	3M	12M
Absolute	(7.2)	1.5	16.1
Rel. to BSE-30	(3.5)	4.2	7.8

Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	52.2	38.9	51.6
EPS growth (%)	294.3	(25.5)	32.6
P/E (X)	10.3	13.8	10.4
Sales (Rs bn)	13.0	15.4	18.7
Net profits (Rs bn)	2.1	1.6	2.1
EBITDA (Rs bn)	2.5	2.4	3.3
EV/EBITDA (X)	8.8	8.5	6.0
ROE (%)	35.2	21.4	23.1
Div. Yield (%)	0.4	0.7	1.0

Details on product investments and strategy

We spoke to Jankiraman, Head- R&D Services of MindTree. MindTree had formally announced plans to enter the high-end smart phone market recently. MindTree intends to launch Android-OS smart phone with an ASP of US\$300+ by Nov-Dec 2010, which will be sold on white-labeled basis to telecom service providers globally. Key takeaways from our discussion

- ▶ MindTree's product focus will be on the high-end market on account of (1) large replacement market, (2) shift in customer buying behavior towards high-end smart phones, and (3) increasing 3G adoption across the world.
- ▶ Total investment of US\$10-11 mn primarily comprises (1) people costs across development, user interface/experience and sales, (2) material costs (prototype manufacturing) and royalty towards using certain phone components/IP and (3) marketing costs.
- ▶ MindTree will be responsible for all the facets of the smart phone. MindTree will undertake the industrial design (capability acquired courtesy Kyocera wireless acquisition), integration of chipset, developing of user interface on top of the Android platform, testing of phone of different carrier networks and certifications. Physical manufacturing of the phone will be done by a Chinese ODM. Processing capability of the chipset will be one of the best in industry.
- ▶ MindTree will offer the phone on white-labeled basis to TSPs at defined gross margin that will enable the company to earn reasonable return on investment. The company will try to minimize inventory risk by having back-to-back arrangements on client order to manufacture. MindTree will assume risks of post-sale product warranty.
- ▶ MindTree claims competitive advantage on account of (1) strong R&D capabilities with prior experience on developing various components of mobile phones, (2) Kyocera acquisition providing industrial design capability and understanding of supply-chain, and (3) a young motivated team; time to market will be faster as there is no need to ensure backward compatibility of products.

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- ▶ Product timelines. MindTree is confident of readying the prototype that can be showcased to telecom service providers by July 2010. Phone testing will be completed by Oct-Nov 2010 and MindTree is targeting commercial launch by November 2010.
- ▶ MindTree has also set up a wireless infrastructure unit which will focus on developing IP stacks for LTE and Wimax network infrastructure. MindTree's focus will be on wireless stacks that can deliver business outcome in areas such as bandwidth allocation, ticketing for usage, QoS etc.

Product strategy appears to be a high-risk one

We believe that MindTree's product strategy is high risk on account of

- ▶ Limited R&D budgets. Against the backdrop of heavy R&D budgets of established handset manufacturers, MindTree's budget of US\$10-11 mn appears small. We appreciate that MindTree will not compete directly with established global handset manufacturers, but will face challenge on creating a unique solution.
- ▶ No prior track record. We note that a number of international players' diversification into handset business has met with limited success.
- ▶ We highlight that the market for white-labeled smart phones has reduced after initial success with Windows Mobile OS Smartphone in the early part of the decade. These phones were designed and manufactured by HTC and successfully launched by O2, T-Mobile, AT&T etc. MindTree believes that it can capture an opportunity available in white-labeled handset manufacturing space after HTC vacated that space and started competing with handset manufacturers directly.

Core business remains strong; product investment drives our REDUCE rating

We like the core business of MindTree and believe that it is well-positioned to grow core revenues by 20%+ in US\$ terms in FY2011E led by a rebound in discretionary spending and growth from high quality accounts won in FY2010. We also believe that the company may manage margins (despite rupee appreciation). However, we are concerned on product diversification, which drives our REDUCE rating.

We assume US\$10-12 mn as recurring product expenses in our valuation model and do not build any revenue against this investment. Our FY2011E EPS stands as Rs38.9 and FY2012E EPS at Rs51.6. Our DCF-based target price is based on 20% discount to fair value noting uncertainty around quantum of investment (losses) in the product business.

Condensed consolidated financials for MindTree Limited, 2008-2012E, March fiscal year-ends (Rs mn)

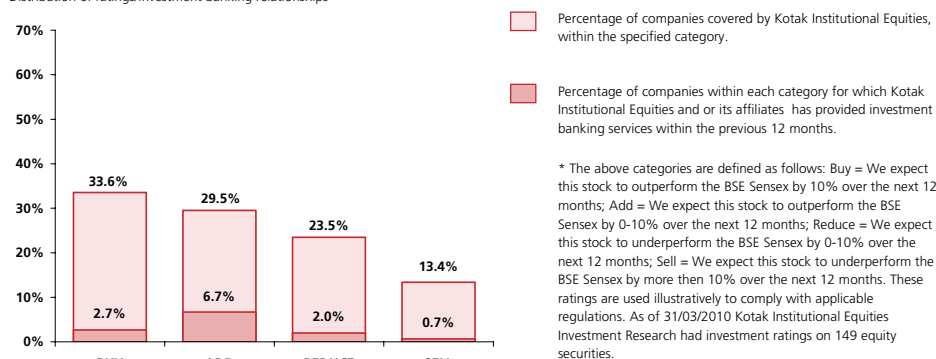
	2008	2009	2010	2011E	2012E
Profit model					
Revenues	7,398	12,375	12,829	15,359	18,398
EBITDA	1,254	3,309	2,461	3,193	3,829
Interest (expense)/income	(59)	(162)	(28)	-	-
Depreciation	(356)	(570)	(663)	(707)	(776)
Other income	279	(1,974)	607	168	287
Pretax profits	1,118	604	2,377	2,654	3,340
Tax	(85)	(67)	(344)	(386)	(737)
Profit after tax	1,033	537	2,033	2,268	2,602
Diluted earnings per share (Rs)	26.1	13.2	49.4	55.1	63.2
Balance sheet					
Total equity	5,331	5,513	7,552	9,680	11,978
Deferred taxation liability	(90)	(190)	(190)	(190)	(190)
Total borrowings	919	1,394	-	—	—
Minority interest	—	328	—	—	—
Current liabilities	1,392	3,082	3,173	3,926	4,676
Total liabilities and equity	7,553	10,126	10,535	13,417	16,466
Cash	553	488	753	2,500	4,081
Other current assets	2,765	4,203	4,617	5,589	6,768
Goodwill	214	1,460	1,753	1,753	1,753
Tangible fixed assets	2,625	2,962	2,599	2,761	3,050
Investments	1,395	1,013	813	813	813
Total assets	7,553	10,126	10,535	13,417	16,465
Free cash flow					
Operating cash flow, excl. working capital	1,398	1,889	2,133	3,193	3,829
Tax paid	(188)	(287)	(344)	(386)	(737)
Working capital changes	(408)	251	(323)	(218)	(429)
Capital expenditure	(2,176)	(369)	(300)	(869)	(1,065)
Investment changes/acquisition	491	(2,538)	(92)	—	—
Free cash flow	(883)	(1,053)	1,074	1,720	1,598
Ratios (%)					
EBITDA margin	16.9	26.7	19.2	20.8	20.8
EBIT margin	12.1	22.1	14.0	16.2	16.6
Debt/equity	0.2	—	—	—	—
Net debt/equity	(0.2)	(0.0)	(0.2)	(0.3)	(0.4)
RoAE	21.3	5.5	31.1	26.3	24.0
RoACE	16.5	32.2	24.3	28.9	28.2

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2010

Ratings and other definitions/identifiers

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BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

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