

Subdued growth ahead; Retain Underperform

We met up with Mphasis management recently. We believe revenue growth remains challenging & margins likely to be under pressure. Key takeaways

Revenue growth likely to be challenging

Growth from HP channel (69% of revenues) likely to remain subdued (range of 1-2% QoQ likely). As per management scope for offshore migration with existing HP clients is limited and new client wins through joint go to market strategy is slower than anticipated. Pricing pressure from HP remains, though clarified that management stance is to maintain pricing from HP at current levels. During 1Q Mphasis took pricing cut for a few accounts through HP channel.

Margins under pressure

Margins likely to remain under pressure. Expect EBIT margins to be in the range of 16-18% down ~500bps yoy. 1Q EBIT stood at ~15%. May price aggressively for new client wins. We have factored in EBIT margins of around 18% in our estimates.

Likely to focus on inorganic growth

Keen on growing through acquisition to improve share of Non HP business in banking, finance & insurance verticals. Cash & cash equivalents stood at US\$396mn end of 1Q.

Revenue visibility remains a concern

Growth likely to be challenging in our view. Number of open billable positions in applications segment declined from 1,600 (4Q) to 1,000 during the quarter and in Infra management (ITO) from 800 to 470 indicating lower revenue visibility on two key segments. Retain Underperform rating with a PO of Rs490.

Estimates (Oct)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	9,086	10,911	8,567	9,571	11,334
EPS	43.29	51.98	40.81	45.60	54.00
EPS Change (YoY)	207.5%	20.1%	-21.5%	11.7%	18.4%
Dividend / Share	4.10	5.00	5.00	5.00	5.00
Free Cash Flow / Share	42.96	35.67	40.06	33.83	41.21

Valuation (Oct)

	2009A	2010A	2011E	2012E	2013E
P/E	10.80x	8.99x	11.45x	10.25x	8.66x
Dividend Yield	0.876%	1.07%	1.07%	1.07%	1.07%
EV / EBITDA*	7.53x	6.71x	7.95x	6.53x	5.46x
Free Cash Flow Yield*	9.19%	7.63%	8.57%	7.24%	8.82%

* For full definitions of *iQmethod*SM measures, see page 4.

Bank of America Merrill Lynch

Pratish Krishnan >>	+91 22 6632 8679
Research Analyst DSP Merrill Lynch (India) pratish.krishnan@baml.com	
Mitali Ghosh >>	+91 22 6632 8661
Research Analyst DSP Merrill Lynch (India) mitali.b.ghosh@baml.com	
Kunal Tayal >>	+91 22 6632 8663
Research Analyst DSP Merrill Lynch (India) kunal.tayal@baml.com	

Stock Data

Price	Rs467.50
Price Objective	Rs490.00
Date Established	27-Feb-2011
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs355.00-Rs711.90
Mrkt Val / Shares Out (mn)	US\$2,180 / 209.9
Average Daily Volume	1,422,226
BofAML Ticker / Exchange	MPSSF / BSE
Bloomberg / Reuters	MPHL IN / MBFL.BO
ROE (2011E)	23.3%
Net Dbt to Eqty (Mar-2010A)	-4.0%
Est. 5-Yr EPS / DPS Growth	12.0% / 12.0%
Free Float	39.0%

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Refer to important disclosures on page 5 to 7. Analyst Certification on Page 3. Price Objective Basis/Risk on page 3. Link to Definitions on page 3. 11028369

iQprofileSM Mphasis Ltd.

Key Income Statement Data (Oct)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Sales	42,639	50,365	52,202	61,257	72,274
Gross Profit	15,738	16,846	15,499	18,556	22,056
Sell General & Admin Expense	(4,463)	(4,194)	(4,825)	(5,561)	(6,497)
Operating Profit	9,252	11,014	9,116	11,187	13,457
Net Interest & Other Income	476	1,088	1,214	1,407	1,456
Associates	NA	NA	NA	NA	NA
Pretax Income	9,728	12,102	10,331	12,593	14,914
Tax (expense) / Benefit	(642)	(1,191)	(1,764)	(3,022)	(3,579)
Net Income (Adjusted)	9,086	10,911	8,567	9,571	11,334
Average Fully Diluted Shares Outstanding	210	210	210	210	210

Key Cash Flow Statement Data

Net Income	9,086	10,911	8,567	9,571	11,334
Depreciation & Amortization	2,022	1,638	1,557	1,809	2,102
Change in Working Capital	621	(3,068)	(203)	(2,209)	(2,666)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(1,211)	(1,075)	25	(70)	(119)
Cash Flow from Operations	10,517	8,406	9,947	9,101	10,651
Capital Expenditure	(1,500)	(919)	(1,538)	(2,000)	(2,000)
(Acquisition) / Disposal of Investments	0	0	0	0	0
Other Cash Inflow / (Outflow)	153	45	254	287	336
Cash Flow from Investing	(1,346)	(874)	(1,284)	(1,713)	(1,664)
Shares Issue / (Repurchase)	73	41	0	0	0
Cost of Dividends Paid	(486)	(858)	(1,202)	(1,202)	(1,202)
Cash Flow from Financing	(406)	(822)	(1,202)	(1,201)	(1,201)
Free Cash Flow	9,018	7,487	8,409	7,101	8,651
Net Debt	(1,752)	(1,330)	(2,791)	(4,979)	(8,767)
Change in Net Debt	(8,758)	(6,715)	(7,461)	(6,186)	(7,786)

Key Balance Sheet Data

Property, Plant & Equipment	3,291	2,512	2,493	2,684	2,582
Other Non-Current Assets	11,253	19,240	25,181	29,181	33,181
Trade Receivables	9,064	12,054	12,157	14,265	16,831
Cash & Equivalents	1,786	1,784	3,245	5,433	9,221
Other Current Assets	7,241	9,448	10,448	11,448	12,448
Total Assets	32,635	45,038	53,523	63,011	74,263
Long-Term Debt	33	454	454	454	454
Other Non-Current Liabilities	NA	NA	NA	NA	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	9,147	11,590	12,490	13,390	14,290
Total Liabilities	9,181	12,044	12,944	13,844	14,744
Total Equity	23,454	32,993	40,579	49,167	59,519
Total Equity & Liabilities	32,635	45,037	53,523	63,011	74,263

iQmethodSM - Bus Performance*

Return On Capital Employed	44.1%	34.8%	20.4%	18.9%	18.8%
Return On Equity	48.0%	38.7%	23.3%	21.3%	20.9%
Operating Margin	21.7%	21.9%	17.5%	18.3%	18.6%
EBITDA Margin	26.4%	25.1%	20.4%	21.2%	21.5%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.2x	0.8x	1.2x	1.0x	0.9x
Asset Replacement Ratio	0.7x	0.6x	1.0x	1.1x	1.0x
Tax Rate (Reported)	6.6%	9.8%	17.1%	24.0%	24.0%
Net Debt-to-Equity Ratio	-7.5%	-4.0%	-6.9%	-10.1%	-14.7%
Interest Cover	NA	NA	NA	NA	NA

Key Metrics

* For full definitions of iQmethodSM measures, see page 4.

Company Description

Mphasis 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 acquired majority stake in the company in 2006. Post merger of HP EDS, Mphasis is now a 62pct subsidiary of HP

Investment Thesis

While Mphasis is a strong play on higher offshoring from HP, potential pricing cuts from HP remain a concern. Mphasis recently renegotiated its pricing model with HP. While we have factored in strong revenue growth, earnings likely will be muted due to the decline in margins and higher tax rates.

Stock Data

Price to Book Value 2.4x

Price objective basis & risk

Mphasis Ltd (MPSSF)

Our PO of Rs490 is at 11x FY12E, at discount to mid-tier peers and factors in potential de-rating given the risk to pricing from HP, its largest customer.

Risks: Potential upside to volumes from HP. Industry risks: a worse-than-expected slowdown in the United States, sharper-than-expected INR appreciation and increasing competition.

Link to Definitions

Technology

Click [here](#) for definitions of commonly used terms.

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SEBI Regn no. : BSE - INB/INF 011348134 NSE – INB/INF 231348138

Address – Mafatlal Centre, 8th Floor, Nariman Point, Mumbai, India. 400021

Tel : +91 22 6632 8000

10 March 2011

India - Software & IT Services Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	D.B.Corp Ltd	XDDCF	DBCL IN	Pratish Krishnan
	Educomp Solu	EUSOF	EDSL IN	Pratish Krishnan
	Firstsource	FSSOF	FSOL IN	Mitali Ghosh
	HCL	XHCLF	HCLT IN	Mitali Ghosh
	Hexaware Tech	XFTCF	HEXW IN	Pratish Krishnan
	Infosys Tech	INFYF	INFO IN	Mitali Ghosh
	Infosys Tech - A	INFY	INFY US	Mitali Ghosh
	Jagran Prakashan Ltd	JGRPF	JAGP IN	Pratish Krishnan
	Persistent Systems	XPSYF	PSYS IN	Kunal Tayal
	Rollta India	RLTAF	RLTA IN	Pratish Krishnan
	Rollta India-GDR	XLROF	RTI LI	Pratish Krishnan
	Sun TV Network Ltd	SUTVF	SUNTV IN	Pratish Krishnan
	Tata Consultancy	TACSF	TCS IN	Mitali Ghosh
	Zee Entertainment	XZETF	Z IN	Pratish Krishnan
NEUTRAL				
	ExlService Holdi	EXLS	EXLS US	Mitali Ghosh
	Infotech Enterprises Ltd	IFKFF	INFTC IN	Pratish Krishnan
	Tech Mahindra	TMHAF	TECHM IN	Pratish Krishnan
	Wipro	WIPRF	WPRO IN	Mitali Ghosh
	Wipro	WIT	WIT US	Mitali Ghosh
UNDERPERFORM				
	Genpact Ltd	G	G US	Mitali Ghosh
	Mastek	MSKDF	MAST IN	Pratish Krishnan
	Mphasis Ltd	MPSSF	MPHL IN	Pratish Krishnan
	WNS (Holdings) L	WNS	WNS US	Mitali Ghosh

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
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
Quality of Earnings		
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
Valuation Toolkit		
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

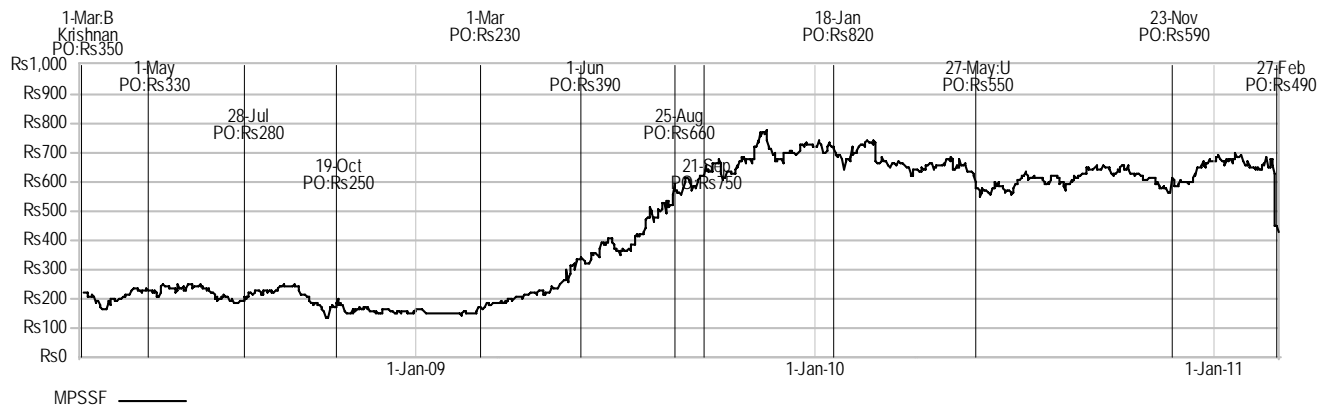
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B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of February 28, 2011 or such later date as indicated.

Investment Rating Distribution: Technology Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	128	54.01%	Buy	53	46.49%
Neutral	48	20.25%	Neutral	21	46.67%
Sell	61	25.74%	Sell	16	27.59%

Investment Rating Distribution: Global Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2011	53.86%	Buy	874	48.31%
Neutral	925	24.77%	Neutral	444	52.30%
Sell	798	21.37%	Sell	276	36.75%

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Buy	≥ 10%	≤ 70%
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Underperform	N/A	≥ 20%

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10 March 2011

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