

Mphasis



BSE SENSEX	S&P CNX	CMP: INR384	TP: INR350	Sell						
17,542	5,315									
Bloomberg	MPHL IN									
Equity Shares (m)	210.0									
52-Week Range (INR)	439/277									
1,6,12 Rel. Perf. (%)	-5/-11/3									
M.Cap. (INR b)	80.6									
M.Cap. (USD b)	1.4									
Year End	Net Sales (INR m)	PAT (INR m)	EPS (INR)	EPS Gr. (%)	P/E Ratio	P/BV (x)	RoE (%)	RoCE (%)	EV/Sales	EV/EBITDA
10/10A	50,366	10,269	48.6	12.5	-	-	36.4	36.4	-	-
10/11A	50,980	8,308	39.3	-19.1	9.8	2.1	23.1	22.2	1.2	6.3
10/12E	53,936	7,866	37.3	-5.3	10.3	1.8	18.6	19.2	1.1	5.6
10/13E	55,411	8,155	38.6	3.7	9.9	1.5	16.6	17.4	1.0	4.9

- Mphasis' 3QFY12 (quarter ending July; October year-end) re-emphasized the company's continued focus on profitability and limited growth visibility as it continued to increase utilization by cutting headcount in Applications, and to rationalize costs.
- Revenue was INR13.55b, +2% QoQ, marginally below our estimate of INR13.88b. HP channel declined 6.2% QoQ in constant currency while Direct channel revenue grew 5.8% QoQ in constant currency. Despite wage hikes, EBITDA margin at 19.7% was flat QoQ (in line) on continued cost control measures. PAT was INR2.09b, higher than our estimate of INR1.99b due to lower tax rate (22.7% v/s est 23.5%) and higher other income (INR393m v/s est INR329m).
- Management commentary indicated little respite over the near term from the challenges in the HP channel, as the ramp-down pressures may persist over the next few quarters. On the other hand, it expects to outgrow the industry in the Direct Channel, amid troubled deal velocity. Thrust on utilization of cash implies chances of a buyback in case there are no large acquisitions on the anvil over the foreseeable future.
- Our estimates are little changed after the results. Mphasis' focus on profitability by running a tight ship not only highlight poor growth visibility in the near term, but also concerns us as far as the long term prospects go. This is mainly because even when the environment improves; the company may have to grapple with high attrition rates and wage hikes to lateral employee base - a headwind to margins; let alone sacrifice some growth due to high utilization.
- Healthy cash pile and buyback expectations may support valuations, but mitigation of structural growth concerns is imperative before we draw more comfort in the stock. Maintain **Sell**.

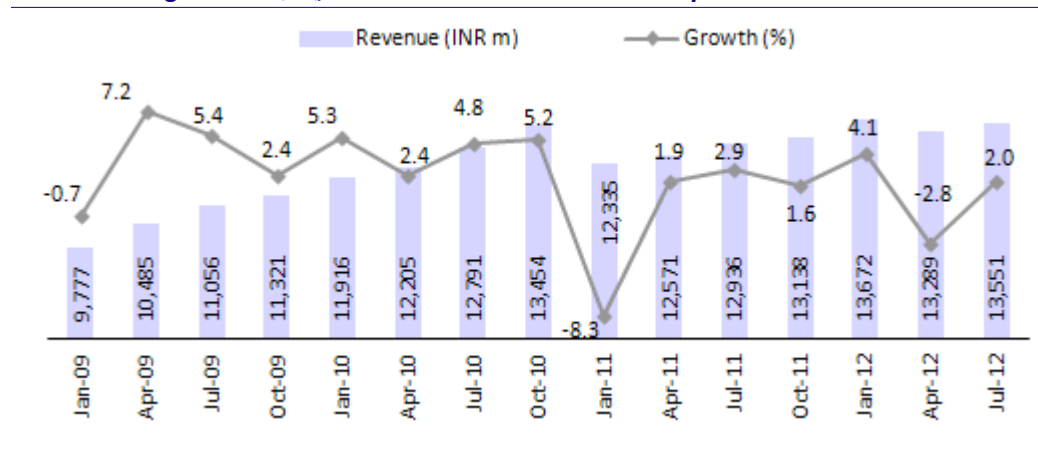
Y/E October	Quarterly Performance								(INR Million)			
	FY11				FY12				FY11	FY12E	FY12	Var.
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE			3QE	(%/bp)
Revenues	12,335	12,571	12,936	13,138	13,672	13,289	13,551	13,424	50,980	53,936	13,882	-2.4
Q-o-Q Change (%)	-8.3	1.9	2.9	1.6	5.7	-2.8	2.0	-0.9	1.2	5.8	4.5	-249bp
Direct Expenses	8,769	8,950	9,396	9,626	9,995	9,454	9,596	9,474	36,741	38,519	9,867	-2.7
Sales, Gen. & Admin. Exp.	1,167	949	1,024	1,165	1,155	1,221	1,280	1,260	4,305	4,916	1,288	-0.6
Operating Profit	2,399	2,672	2,516	2,347	2,522	2,614	2,675	2,691	9,934	10,502	2,728	-1.9
Margins (%)	19.5	21.3	19.4	17.9	18.4	19.7	19.7	20.0	19.5	19.5	19.6	9bp
Other Income	346	497	429	479	338	340	441	386	1,751	1,505	304	44.9
Depreciation	359	337	440	414	468	455	415	415	1,550	1,753	428	-3.1
PBT bef. Extra-ordinary	2,386	2,832	2,505	2,412	2,392	2,499	2,701	2,662	10,135	10,254	2,604	3.7
Provision for Tax	295	393	557	582	544	605	614	626	1,827	2,389	612	0.4
Rate (%)	12.4	13.9	22.2	24.1	22.7	24.2	22.7	23.5	18.0	23.3	23.5	-77bp
PAT bef. Extra-ordinary	2,091	2,439	1,948	1,830	1,848	1,894	2,087	2,037	8,308	7,866	1,992	4.8
Q-o-Q Change (%)	-19.9	16.6	-20.1	-6.1	-5.1	2.5	10.2	-2.4	-19.1	-5.3	5.2	503bp
Diluted EPS (INR)	9.9	11.6	9.3	8.7	8.8	9.0	9.9	9.7	39.4	37.3	9.5	4.8
USD Revs	271	282	290	276	271	266	252	254	1,119	1,042	261	-3.5
Q-o-Q Change (%)	-8.5	3.9	2.9	-4.7	-2.0	-1.8	-5.2	0.7	1.7	-6.8	-1.8	-342bp

E: MOSL Estimates

3QFY12: Revenue and OPM in line while PAT above estimate; cost rationalization continues to aid margin expansion

Revenue was INR13.55b, +2% QoQ, marginally below our estimate of INR13.88b, despite a favorable currency realization of INR55.8/USD (v/s our assumption of INR54.7/USD). This was partly due to higher forex losses in the revenue line (INR502m v/s estimate of INR400m).

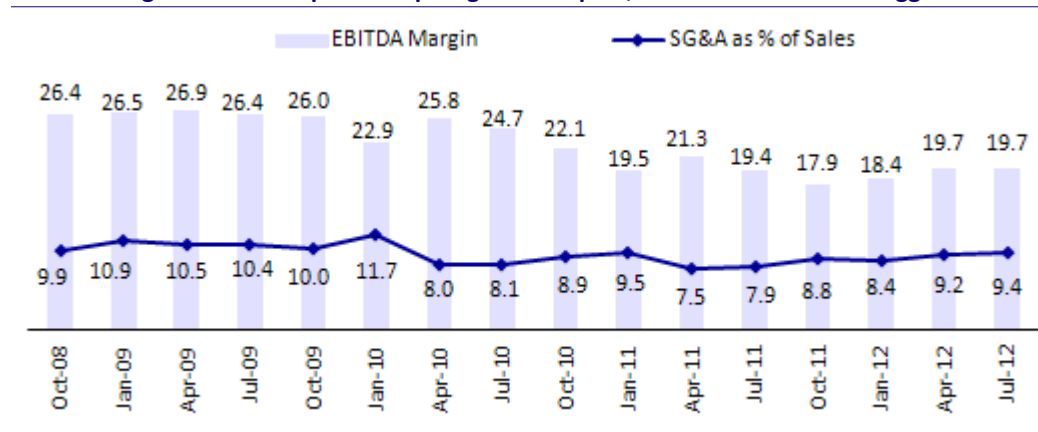
Net revenues grew 2% QoQ, but declined in constant currency



Source: Company, MOSL

EBIT margin expanded 50bp QoQ to 16.7% (in line with our estimate of 16.6%). EBITDA margin at 19.7% was flat QoQ (v/s our estimate of 19.6%). Selling expenses increased 20bp QoQ to 5.4% (v/s estimate of 5.2%) and G&A expense at 4% was flat QoQ and in line with our estimate.

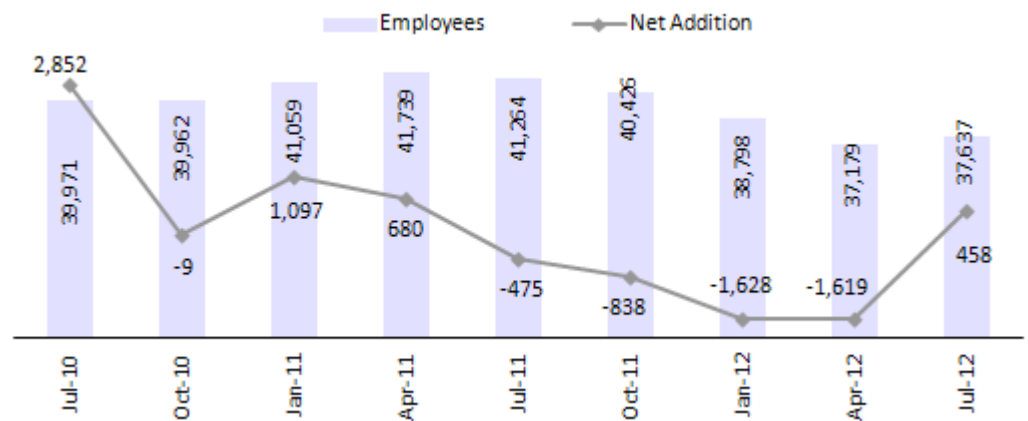
EBITDA margin was flat despite 200bp wage hike impact, due to continued cost aggression



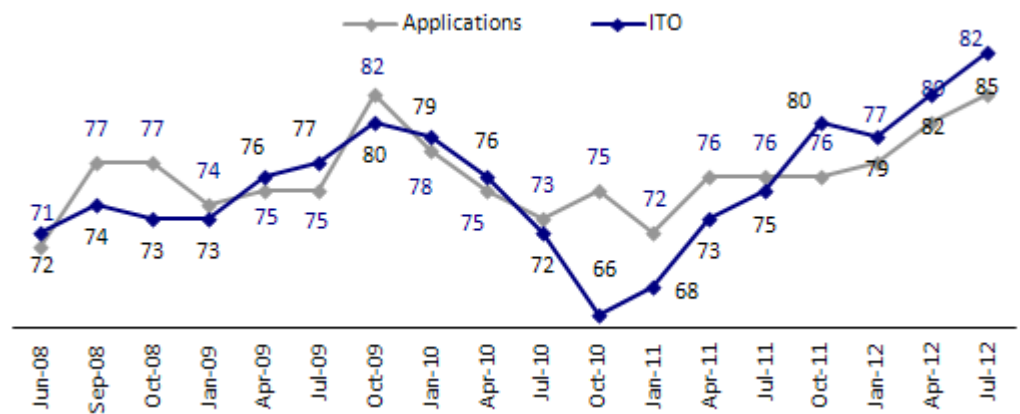
Source: Company, MOSL

Wage hikes of 3% onsite and 8% offshore impacted margins negatively by 200bp. However, continued cost rationalization through lower headcount in Applications (i.e. higher utilization) and facilities' consolidation helped stem the margin decline. With ~37% of the revenue bookings in INR currency and 70% of the next 4 quarters' net foreign currency inflows hedged, MPHL's OPM sensitivity to currency changes is minimal (5-10bp for 1% move in currency).

Net employee increase was primarily due to 1,409 additions to offshore BPO headcount



Blended utilization near all-time high (including trainees)



Source: Company, MOSL

PAT was INR2.09b v/s estimate of INR1.99b, led by lower tax rate (22.7% v/s est 23.5%) and higher other income (INR393m v/s est INR329m).

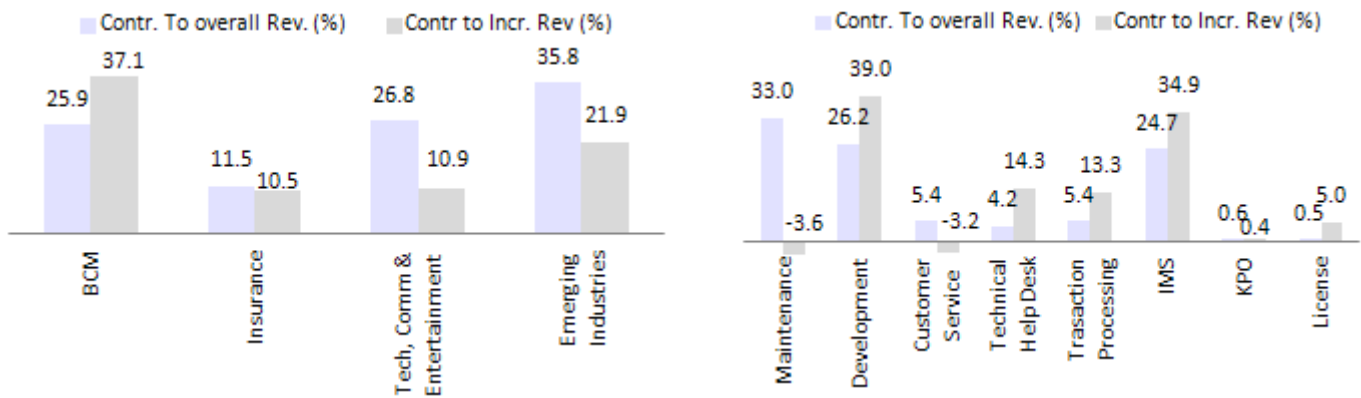
HP Enterprise Services channel declines on ramp-downs while growth rebounds in the Direct Channel

Revenue from HP channel declined 6.2% QoQ in constant currency and 2.3% QoQ in reported currency to INR7.7b. Ramp-downs in few projects led the decline. Clients in the HP channel contributing USD20m+ to Mphasis' revenue came down to 5 in 3QFY12 from 7 in the previous quarter. Within the HP channel, non-HPES segment grew 16% QoQ to INR688m. Over 9MFY12, Mphasis has amassed ~USD34m from HP's non-enterprises segment, while the company guided for USD50-60m revenues from the segment over the full year.

Direct channel revenue grew 5.8% QoQ in constant currency and 12.6% in reported currency to INR6.3b. The company added 24 clients during the quarter, 20 of which were in the Direct Channel.

Among verticals, Banking & Capital Markets (BCM) was the key driver of revenues (+5.7% QoQ), while among Services, growth was driven by Development (+5.9% QoQ) and IMS (+5.6% QoQ).

BCM was the key needle mover of growth, while among Services Development and IMS were the key growth contributors

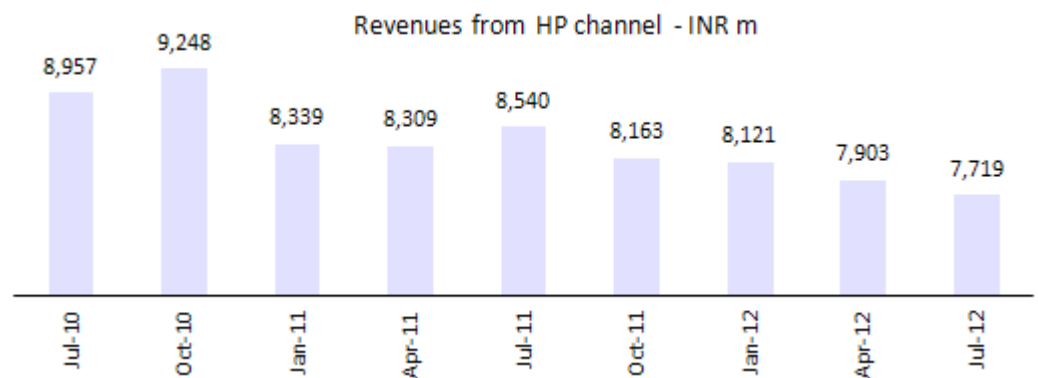


Source: Company, MOSL

Commentary unchanged, indicating continued ramp-down pressures in the HP channel and focus on profitability

Mphasis' commentary indicated little respite over the near term from the challenges in the HP channel, as the ramp-down pressures may last over the next few quarters. Revenues from HP Channel have declined to INR7.7b in 3QFY12 from INR9.2b in 4QFY10.

HP Channel sluggishness expected to continue in the coming quarters

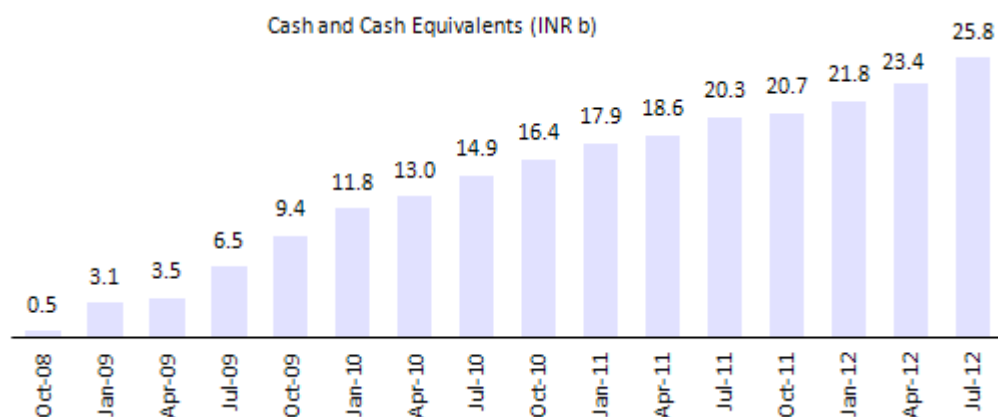


Source: Company, MOSL

As far as the Direct Channel is concerned, Mphasis expects to outgrow the industry. However, the outlook on the environment remained cautious, as deal closures continue to take long.

As visibility on revenue growth over the near term appears weak, the company continues to focus on profitability, which has resulted in EBIT margin expansion from 14.7% in 4QFY11 to 16.7% in 3QFY12. Utilization excluding trainees in Applications increased from 71% in 1QFY11 to 83% in 3QFY12. Applications Headcount was 15,547 in 3QFY11, down to 12,727 in 3QFY12.

Application of cash remains a priority for Mphasis, implying chances of a buyback if there are no large acquisitions on the anvil over the foreseeable future.

Cash continues to pile up, mulling over a share buyback

Source: Company, MOSL

Estimates largely unchanged; running a tight ship introduces additional risk of failure to capitalize when environment improves

Our estimates are little changed after the results. 1.5%/2.1% downward revisions in Mphasis' USD revenue estimates for FY12/FY13 are a function of our 1.1%/2.9% revision in INR assumptions, considering ~37% of the company's revenues are booked in that currency. Also, the depreciated currency assumptions do not have any significant impact on the company's OPM given its low sensitivity, due to INR contracts and hedging of net inflows which is reported in the topline.

Mphasis trades at 10.3x FY12E and 9.9x FY13E earnings. While near-term challenges prevail, the company's focus on driving profitability through headcount cuts and higher utilization concerns us on prospects over a longer time frame. In our opinion, even when the environment improves, the company may have to grapple with high attrition rates and wage hikes to lateral employee base, impacting margins. Besides, it may even have to give up some growth due to the high utilization levels. Healthy cash pile and buyback expectations may support valuations, but mitigation of structural growth concerns is imperative before we draw more comfort in the stock. Maintain Sell.

Revised estimates

	Revised		Earlier		Change (%)	
	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E
INR/USD	53.1	52.2	52.5	50.8	1.1	2.9
USD Revenue (m)	1,042	1,075	1,058	1,097	-1.5	-2.1
EBIT Margin (%)	16.2	16.4	16.0	16.6	18bp	-17bp
EPS (INR)	37.3	38.6	36.1	38.1	3.1	1.4

Source: MOSL

Other result highlights

- Overall headcount increased by 458 QoQ to 37,637
- Cash and cash equivalents increased by INR2.37b during the quarter to INR25.75b
- Revenue proportion from offshore reduced by 1% QoQ to 68%
- Outstanding hedge book at the end of the quarter stands at ~USD440m
- OCI losses on the Balance Sheet stand at INR1.76b
- Revenue proportion from Fixed Price contracts remained stable QoQ at 14%.

Key operating metrics

	Jul-10	Oct-10	Jan-11	Apr-11	Jul-11	Oct-11	Jan-12	Apr-12	Jul-12
IT Services Revenue									
Service Type									
Application Maintenance & Other Services	4,697	4,867	4,552	4,433	4,726	4,371	4,451	4,662	4,643
As % of Sales	37	36	37	36	37	33	32	34	33
Application Development	3,392	3,651	3,212	3,224	3,354	3,725	3,897	3,473	3,678
As % of Sales	27	28	26	26	26	28	28	26	26
Customer Service	660	614	629	771	731	787	761	778	761
As % of Sales	5	5	5	6	6	6	5	6	5
Service/Technical Help Desk	692	741	465	693	575	623	523	509	584
As % of Sales	6	6	4	6	4	5	4	4	4
Transaction Processing Service	685	790	740	726	641	630	704	686	756
As % of Sales	5	6	6	6	5	5	5	5	5
Infrastructure Management Services	2,255	2,356	2,446	2,534	2,705	2,990	3,346	3,292	3,475
As % of Sales	18	18	20	20	21	23	24	24	25
Knowledge Processes	197	163	117	80	79	78	84	81	83
As % of Sales	2	1	1	1	1	1	1	1	1
License Income	3	0	3	0	0	38	163	47	73
As % of Sales	0	0	0	0	0	0	1	0	1
Total	12,581	13,182	12,164	12,461	12,811	13,242	13,929	13,528	14,053
Group - Revenues by delivery location									
Onsite	4,108	4,460	4,051	4,014	3,537	4,198	4,450	4,150	4,523
As % of Sales	33	34	33	32	28	32	32	31	32
Offshore	8,473	8,722	8,113	8,447	9,274	9,044	9,479	9,378	9,530
As % of Sales	67	66	67	68	72	68	68	69	68
Total	12,581	13,182	12,164	12,461	12,811	13,242	13,929	13,528	14,053
Project Type									
Time and Material	11,196	11,492	10,630	10,855	11,187	11,560	12,259	11,649	12,095
As % of Sales	89	87	87	87	87	87	88	86	86
Fixed Price	1,385	1,690	1,534	1,606	1,624	1,682	1,670	1,879	1,958
As % of Sales	11	13	13	13	13	13	12	14	14
Total	12,581	13,182	12,164	12,461	12,811	13,242	13,929	13,528	14,053
Client Concentration									
Revenues from Top Client	11	10	10	10	10	10	10	10	9
Revenues from Top 5 Clients	29	28	29	28	30	30	31	31	31
Revenues from Top 10 Clients	45	45	44	44	44	44	44	44	44
Clients Contributing more than:									
US\$1 million Revenues	109	115	119	119	120	120	122	126	129
US\$5 million Revenues	39	38	38	39	41	43	41	42	41
US\$10 million Revenues	22	23	22	25	24	24	25	24	24
US\$20 million Revenues	13	14	14	14	12	12	12	12	10
Receivables Days	78	83	94	89	91	88	88	80	85
Number of Employees									
Onsite									
Applications	2,613	2,751	2,675	2,761	2,748	2,692	2,716	2,496	2,441
BPO	167	210	478	378	315	314	308	312	307
ITO	326	459	192	153	149	141	121	116	101
Total Onsite	3,106	3,420	3,345	3,292	3,212	3,147	3,145	2,924	2,849
Offshore									
Applications	13,031	13,189	12,657	12,459	12,799	12,682	11,820	10,966	10,286
BPO	16,367	15,183	15,469	16,246	15,693	15,132	14,830	14,844	16,253
ITO	7,467	8,170	8,126	8,244	8,063	7,950	7,503	7,010	6,844
Total offshore	36,865	36,542	36,252	36,949	36,555	35,764	34,153	32,820	33,383
Total People (Including SGA)	39,971	39,962	41,059	41,739	41,264	40,426	38,798	37,179	37,637

Source: MOSL

Key operating metrics

	Jul-10	Oct-10	Jan-11	Apr-11	Jul-11	Oct-11	Jan-12	Apr-12	Jul-12
Utilization Rates									
Applications									
Excluding Trainees									
Onsite	90	90	87	89	87	92	91	93	94
Offshore	72	74	71	76	76	78	80	82	83
Blended	75	77	74	78	78	80	82	84	85
Including Trainees									
Onsite	90	90	87	89	87	92	91	93	94
Offshore	70	72	69	73	73	72	74	77	79
Blended	73	75	72	76	76	76	77	80	82
BPO - Process Utilization									
Excluding Trainees									
	79	82	80	78	76	78	79	80	80
Including Trainees									
	71	74	69	68	66	70	71	71	70
ITO									
Excluding Trainees									
	90	81	71	75	76	84	82	86	86
Including Trainees									
	72	66	68	73	75	80	79	82	85
Onsite									
	79	81	77	78	76	91	79	82	82

Source: MOSL

Mphasis: an investment profile

Company description

Mphasis, an HP-EDS company is amongst the top IT service providers from India. It has a balanced mix of Application and BPO businesses, with good growth in ITO business, and support of its US-based parent, HP-EDS. Mphasis employs over 37,000 people.

Key investment arguments

- Credible tier-II Indian IT services vendor, with balanced offerings in Applications, BPO and ITO.
- Subsidiary of HP, the second largest IT service provider in the world.
- Focus and efforts towards growing the Direct Channel reducing the HP concentration risk.
- Net cash per share of INR123 suggest ample leeway to deploy cash in new opportunities.

Key investment risks

- Slower than expected ramp up in Direct channel.
- Continued sluggishness and pricing risk in the HP business.
- Pressure on margins on high attrition.

Recent developments

- The company added 24 new clients in 3QFY12, 20 in the Direct channel.

- First license sale of the Wynsure insurance platform after the acquisition of Wyde for a TCV of USD2.4m.

Valuation and view

- We expect Revenue CAGR of -1.9% and EPS CAGR of -1% over FY11-13.
- Stock trades at a P/E of 10.3x FY12E and 9.9x FY13E.
- Maintain **Sell**, with a target price of INR350, based on 9x FY13E earnings.

Sector view

- In the last few months, increasingly weak macro economic data have been emanating from both the US and Europe, which implies deceleration in growth for Indian IT services.
- Commentary on CY12 budget spends indicate a moderation in growth across the sector, resulting flat to marginally lower budgets.
- We reckon frontline Indian IT companies would be better placed to sail through the near-term challenges mentioned above. Niche IT/ITeS services companies with strong business models are also likely to be better placed to face uncertainties in the near term.

Comparative valuations

		Mphasis*	Tech Mahindra	HCLT#
P/E (x)	FY13E	10.3	9.3	12.5
	FY14E	9.9	8.9	11.8
P/BV (x)	FY13E	1.8	1.9	2.9
	FY14E	1.5	1.4	2.5
EV/Sales (x)	FY13E	1.1	1.9	1.5
	FY14E	1.0	1.4	1.2
EV/EBITDA (x)	FY13E	5.6	7.6	7.9
	FY14E	4.9	7.2	7.2

* YE October; # YE June

Shareholding pattern (%)

	Jun-12	Mar-12	Jun-11
Promoter	60.5	60.5	60.5
Domestic Inst	6.1	6.3	6.3
Foreign	22.0	21.6	20.4
Others	11.4	11.7	12.9

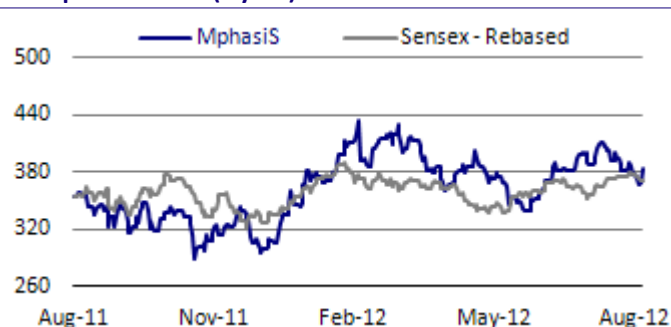
EPS: MOSL forecast v/s consensus (INR)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY12	37.3	37.3	0.1
FY13	38.6	38.9	-0.7

Target price and recommendation

Current Price (INR)	Target Price (INR)	Upside (%)	Reco.
384	350	-8.9	Sell

Stock performance (1 year)



Financials and valuation

Income Statement		(INR Million)			
Y/E October	2010	2011	2012E	2013E	
Revenues	50,366	50,980	53,936	55,411	
Change (%)	18.1	1.2	5.8	2.7	
Cost Of Goods Sold	33,749	36,741	38,519	39,745	
SG&A Expenses	4,607	4,305	4,916	4,880	
EBITDA	12,010	9,934	10,502	10,787	
% of Net Sales	23.8	19.5	19.5	19.5	
Depreciation	1,638	1,550	1,753	1,684	
Other Income	1,089	1,751	1,505	1,558	
PBT	11,461	10,135	10,254	10,660	
Tax	1,192	1,827	2,389	2,505	
Rate (%)	10.4	18.0	23.3	23.5	
PAT	10,269	8,308	7,866	8,155	
Net Income	10,269	8,308	7,866	8,155	
Change (%)	13.0	-19.1	-5.3	3.7	

Balance Sheet		(INR Million)			
Y/E October	2010	2011	2012E	2013E	
Share Capital	2,099	2,100	2,101	2,101	
Reserves	30,892	36,898	43,593	50,178	
Net Worth	32,991	38,998	45,694	52,279	
Loans	454	2,946	3,414	3,289	
Capital Employed	33,445	41,944	49,108	55,568	
Gross Block	10,258	11,339	12,619	15,419	
Less : Depreciation	7,836	8,495	9,682	11,366	
Net Block	2,423	2,844	2,937	4,053	
CWIP	89	102	177	177	
Goodwill	3,886	8,698	9,929	9,929	
Investments	14,600	17,765	22,017	22,017	
Deferred tax assets	754	975	1,010	1,010	
Curr. Assets	23,286	25,610	23,367	30,428	
Debtors	12,054	13,072	12,541	13,430	
Cash & Bank Balance	1,786	2,897	3,524	9,177	
Loans & Advances	9,446	9,641	7,302	7,820	
Current Liab. & Prov	11,590	14,050	10,329	12,045	
Net Current Assets	11,696	11,560	13,038	18,382	
Application of Funds	33,445	41,944	49,108	55,568	

Ratios		2010	2011	2012E	2013E
Y/E October					
Basic (INR)					
EPS		48.6	39.3	37.3	38.6
Cash EPS		56.7	46.9	45.8	46.8
Book Value		157.2	185.7	217.5	248.8
DPS		3.5	6.5	7.0	3.5
Payout %		7.2	16.5	18.8	9.1
Valuation (x)					
P/E			9.8	10.3	9.9
Cash P/E			8.2	8.4	8.2
EV/EBITDA			6.3	5.6	4.9
EV/Sales			1.2	1.1	1.0
Price/Book Value			2.1	1.8	1.5
Dividend Yield (%)			1.7	1.8	0.9
Profitability Ratios (%)					
RoE		36.4	23.1	18.6	16.6
RoCE		36.4	22.2	19.2	17.4
Turnover Ratios					
Debtors (Days)		77	90	87	86
Asset Turnover (x)		18.0	19.4	18.7	15.9
Leverage Ratio					
Debt/Equity Ratio(x)		0.0	0.1	0.1	0.1

Cash Flow Statement		(INR Million)			
Y/E October	2010	2011	2012E	2013E	
CF from Operations	11,848	9,637	9,583	9,839	
Chg. in Wkg. Capital	-2,757	1,247	-851	310	
Net Operating CF	9,091	10,884	8,732	10,149	
Net Purchase of FA	-858	-1,985	-1,921	-2,800	
Net Purchase of Invest.	-7,929	-7,976	-5,483	0	
Net Cash from Invest.	-8,787	-9,961	-7,404	-2,800	
Proceeds from issue of cap	127	-704	550	-710	
Proceeds from LTB/STB	421	2,492	468	-125	
Dividend Payments	-858	-1,598	-1,719	-860	
Net CF from Financing	-311	191	-701	-1,695	
Free Cash Flow	8,233	8,899	6,811	7,349	
Net Cash Flow	-7	1,114	627	5,654	
Opening Cash Balance	1,790	1,783	2,897	3,524	
Add: Net Cash	-7	1,114	627	5,654	
Closing Cash Balance	1,783	2,897	3,524	9,177	

E: MOSL Estimates

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Motilal Oswal Securities Ltd

Motilal Oswal Tower, Level 9, Sayani Road, Prabhadevi, Mumbai 400 025
Phone: +91 22 3982 5500 E-mail: reports@motilaloswal.com