

November 26, 2010

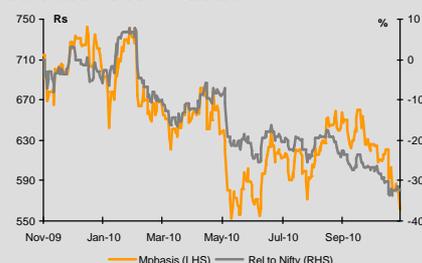
Reco	Previous Reco
Hold	Hold
CMP	Target Price
Rs 599	Rs 600
EPS change FY11E/12E (%)	(5)/(1)
Target Price change (%)	(5)
Sensex	19,585
Nifty	5,890

Price Performance

(%)	1M	3M	6M	12M
Absolute	(9)	(5)	(12)	(22)
Rel. to Nifty	(8)	(11)	(26)	(34)

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	IT Services
Bloomberg	MPLH@IN
Equity Capital (Rs mn)	2099
Face Value(Rs)	10
No of shares o/s (mn)	210
52 Week H/L	752/545
Market Cap (Rs bn/USD mn)	118/2,604
Daily Avg Volume (No of sh)	488496
Daily Avg Turnover (US\$m)	6.8

Shareholding Pattern (%)

	S'10	J'10	M'10
Promoters	60.6	60.6	60.6
FII/NRI	18.3	18.3	16.8
Institutions	7.7	7.7	7.0
Private Corp	7.8	7.7	8.6
Public	5.6	5.8	7.0

Source: Capitaline

Manik Taneja

manik.taneja@emkayglobal.com
+91 22 6612 1253

Priya Gajwani

priya.gajwani@emkayglobal.com
+91 22 6612 1385

- **Post the expected bounce back in Mphasis's stock price after 'no negative surprises' in Oct'10, we find little reason to turn more constructive on the stock**
- **Op mgns should head further lower driven by supply side pressures, US\$/INR appreciation and need to increase S&M investments as co increases focus on non HP business**
- **Cut our Oct'11/Oct'12E EPS by 5%/0.5% to Rs 49.8/54.7 (primarily on reset in US\$/INR at Rs 44/\$) despite building in higher revenues (22%/21%YoY)**
- **Valuations appear inexpensive at 12/11x FY12/13E EPS, however need to be weighed against ~2.8% EPS CAGR over F11-13E with downside risks to revenue, mgn assumptions**

Business Challenges persist

Mphasis's stock price had been under pressure in the run up to Oct'10 results given expectations of extremely weak results by certain sections of the street and thereby we expected a positive reaction to a 'not so negative Oct'10 results'. Although Oct'10 results were not disappointing in our view, we note that the net profit beat on our expectations was driven by higher forex gains and lower taxes. Further co's revenue growth during the quarter was primarily led by recovery in revenues from an Asia Pac telco account. We see **the trend of declining margins continuing for Mphasis** (despite the fact that Mphasis's margins have been on a downtrend for nearly 6 quarters now) on several counts namely (1) higher impact of supply side pressures for Mphasis (given higher offshore proportion of business at ~66% V/s ~50% for Tier 1 peers), (2) possible reduction in pricing from HP (decision on the biannual Nov'10 round of pricing renegotiations to emerge by Dec'10 end), and (3) increased investments both on sales/marketing as well as delivery as company focuses on growing non HP business more aggressively going ahead. **Mphasis management has already indicated that it would find it difficult to maintain EBIT margins between its guided range of 20-22% and expects to achieve operating margins of ~18-21% for FY12. We note that we build in EBIT margins of 20.2%/19.5% for FY12/13 respectively.**

Earnings growth muted going forward

We have tweaked our earnings model for (1) higher revenues (we now model in revenue growth ex hedging gains of 25%/21% for FY ending Oct'11/Oct'12, which by no means is conservative), (2) lower EBITDA margins (we build in EBITDA margins at 22.9%/22.2% for FY ending Oct'11/Oct'12 respectively V/s 24.5%/23.2% earlier, as we reset our US\$ /INR assumptions to Rs 44/\$ V/s Rs 46/45 earlier for Oct'11/Oct'12) driving a 5%/0.5% cut in our earnings estimates to Rs 49.8/54.7 respectively. We note that our earnings estimates build in forex gains of ~Rs 3/share for Oct'11 as compared to ~Rs 8.5 in FY ended Oct'10.

Valuations appear inexpensive, however are fair in our view

After a nearly 35% underperformance post our downgrade in Nov'09, valuations no doubt appear inexpensive at 12x/11x Oct'11/Oct'12E earnings however we believe they are fair given an anemic 2.8% EPS CAGR over FY11-13E (albeit sharp increase in tax rates a major factor here) and the downside risks to revenue/margin assumptions. Retain HOLD with a revised target price of Rs 600 (V/s Rs 630 earlier)

Y/E Oct	Net Sales	EBITDA	EBITDA %	PAT	EPS (Rs)	ROE %	P/E(x)	EV/ EBITDA	P/B (x)
FY10	42,639	11,275	26.4	9,087	43.3	48.1	13.5	10.1	5.2
FY11	50,366	12,652	25.1	10,911	52.0	38.7	11.3	8.5	3.7
FY12E	59,669	13,692	22.9	10,489	49.9	31.6	11.7	7.3	2.9
FY13E	71,172	15,777	22.2	11,540	55.0	29.0	10.7	5.8	2.3

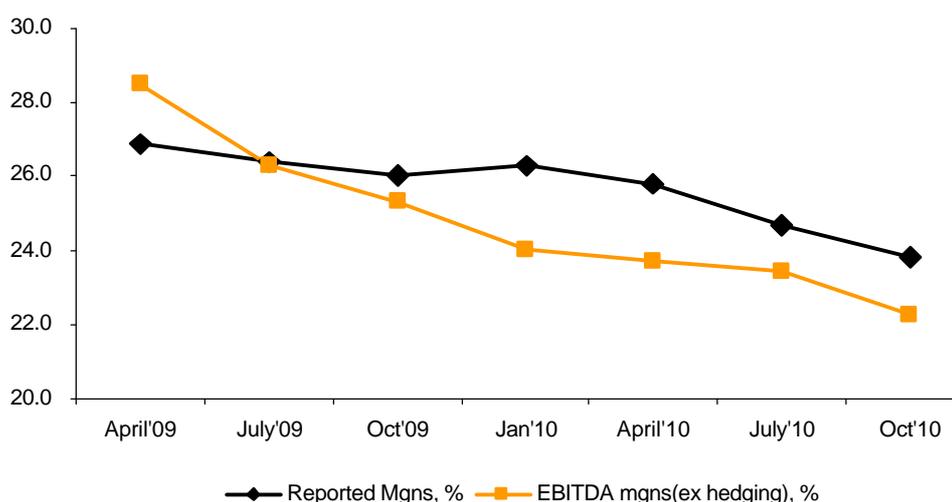
Mphasis wants to focus on growing non HP business aggressively

Mphasis management highlighted its strategy for growing its business beyond the current revenue size of US\$ 1.1 bn. Co intends to increase its focus on growing non HP business more aggressively going forward. Mphasis wants to focus on (1) the already competitive verticals of Banking and Capital Markets (BCM) and Insurance in the mature markets and (2) emerging geographies (India, Middle East and Indonesia). Although a welcome move in the medium to long term as it reduces dependence on HP driven business, we believe this would require significant investments on (1) sales and marketing and (2) building domain and delivery capabilities. **Our interactions with the top management indicated that they would not be averse to pricing aggressively to gain traction and establish credibility as an independence services vendor.**

We see no respite to margin headwinds for Mphasis

Some sections of the street believe that the margin pressures for Mphasis may have been abated; however we do not think so. To begin we note that Mphasis's operating margins have been on a downwards trend through FY10 despite significant help from forex hedging gains (refer chart below, note that co recorded forex hedging gains of ~Rs 1180 mn in the revenue line which boosted EBITDA margins by ~233 bps primarily on account of lower pricing resets from parent HP (HP has renegotiated lower pricing with Mphasis for both applications business as well as ITO business during the Year)

We see Mphasis's operating margins trending down further despite ~600 bps decline in EBITDA margins (ex hedging) over the past 7 quarters



Source: Company, Emkay Research

We believe that Mphasis's operating margins should trend down further going forward and thereby build in EBITDA margins at 22.9%/22.2% for Oct'11/Oct'12 respectively (EBIT margins of 20.2%/19.5% for Oct'11/Oct'12) with our thesis based on the following counts

- Supply Side pressures:** We believe Mphasis would not be immune to the industry wide wage pressures that have only intensified in the recent quarters. We note that in the recent quarters while for larger Tier 1 peers like Infosys and TCS , manpower expenses (as % of sales) have largely remained in a close range (<100 bps), in case of Mphasis they have increased by ~430 bps. **Further the wage increases will have higher impact on margins in case of Mphasis given higher offshore proportion of business for Mphasis.** We believe that the sharp jump in attritions at Mphasis only worsens the dynamics on this count (Mphasis's LTM attrition has jumped up to 30%/25% in Oct'10 V/s 19%/20% in July'10 quarter in Applications/IMS business)

While Tier 1 peers like Infy and TCS have been able to hold manpower expenses as % of sales within 100 bps, Mphasis's manpower expenses have jumped up by ~430 bps over the past 5 quarters

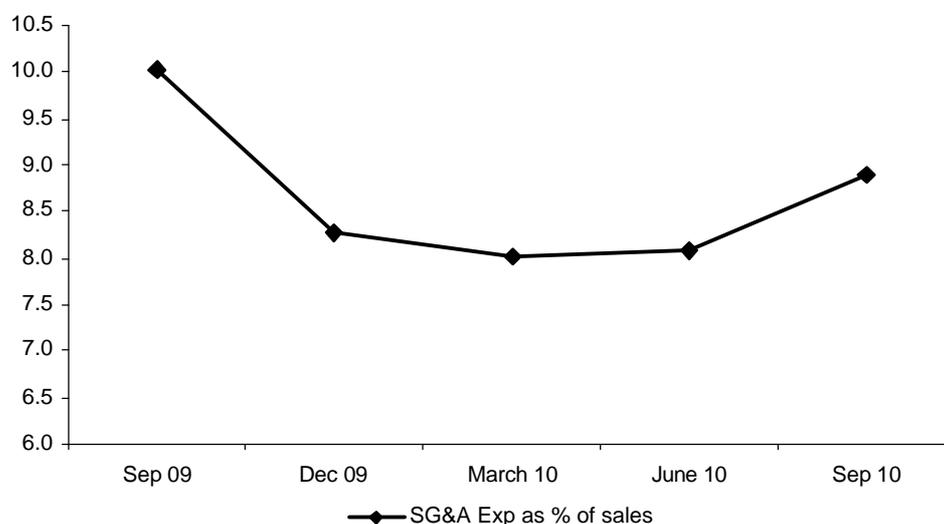
	Sep'09	Dec'09	March'10	June'10	Sep'10
Gross Margins					
Infosys	46.9	47.6	46.4	44.5	46.0
TCS	47.3	47.9	48.4	46.5	46.8
Mphasis*	36.0	34.6	33.8	32.8	32.7
Manpower expenses					
Infosys	47.0	46.1	47.0	47.7	46.1
TCS	45.0	44.1	43.9	45.8	45.4
Mphasis*	47.3	43.5	45.1	50.2	51.6

Source: Companies, Emkay Research

* for Mphasis Sep'09=Oct'09 and so on

- **Possibility of a further rate renegotiation from HP:** Mphasis's pricing has remained largely constant after the cut imposed by HP in April'10 quarter as part of bi-annual pricing negotiation arrangement agreed upon between HP and Mphasis in April'09. Mphasis management has indicated that the final decision on the pricing renegotiations due Nov'10 remains pending. Though it is difficult to put a timeframe to the same, we would expect the downward bias on pricing to continue
- **Increased Sales and marketing investments:** Mphasis management has indicated intention to increase focus on growing non HP business more aggressively going forward. Though a welcome move in the long run as it reduce dependence on HP channel, it would require increase in investments both on sales and marketing as well as build up of delivery capabilities for non HP business, thereby hurting margins in the near to medium term. ***Our interactions with co management indicate that it would not be averse to pricing aggressively to establish credibility for non HP business***

Mphasis' SG&A expenses would see an increase going forward



Source: Company, Emkay Research

Expect an anemic 2.8% EPS CAGR over FY11-13E

We have tweaked our earnings model for

- Higher revenues (we now model in a 25%/21% revenue growth ex hedging gains for FY ended Oct'11/Oct'12 as we expect revenues (ex hedging gains) of US\$ 1,342 /1,618 mn, note that Mphasis reported hedging gains of ~US\$ 25 mn in FY ended Oct'10,
- Lower margin assumptions (as we now factor in a US\$/INR at Rs 44/\$ V/s Rs 46/45 for Oct'11/Oct'12 earlier and higher SG&A expenses),

- Forex gains of ~Rs 3/share in Oct'11 (V/s ~8.5/share in financial year ended Oct'10) thereby driving a 5%/0.5% cut in our Oct'11E/Oct'12E earnings to Rs 49.8/54.7 respectively.

We find it difficult to envisage a scenario for Mphasis's out performance ahead given the downside risks to revenue/margin assumptions as well as anemic 2.8% EPS CAGR over FY11-13E. Retain HOLD with a revised target price of Rs 600 (V/s Rs 630 earlier).

(in Rs mn, except EPS)	Oct'11E			Oct'12E		
	Old	New	change	Old	New	change
Reported Revenues(US\$ mn)	1,295	1,356	4.7%	1,545	1,618	4.7%
Revenues(ex hedging , in US\$ mn)	1,283	1,342	4.6%	1,545	1,618	4.7%
Revenues	59,578	59,669	0.2%	69,534	71,172	2.4%
EBITDA	14,598	13,692	-6.2%	16,164	15,777	-2.4%
Net Profits	10,985	10,489	-4.5%	11,552	11,540	-0.1%
EPS	52.3	49.8	-4.9%	55.0	54.7	-0.5%

Source: Emkay Research

Key Financials

Income Statement

Y/E, Oct (Rs. m)	Oct'09	Oct'10	Oct'11E	Oct'12E
Net Sales	42,639	50,366	59,669	71,172
Growth (%)		18	18	19
Total Expenditure	(31,364)	(37,713)	(45,977)	(55,395)
Growth (%)		20	22	20
EBIDTA	11,275	12,652	13,692	15,777
Growth (%)		12	8	15
EBIDTA %	26.4	25.1	22.9	22.2
Other Income	292	581	-	-
Depreciation	(2,022)	(1,637)	(1,666)	(1,885)
EBIT	9,253	11,015	12,026	13,892
Interest	28	8	798	1,293
EBT	9,728	12,103	12,823	15,185
Tax	(641)	(1,192)	(2,335)	(3,644)
EAT	9,087	10,911	10,489	11,540
Growth (%)		20	(4)	10
EAT (%)	21.3	21.7	17.6	16.2

Cash Flow

Y/E, Oct (Rs. m)	Oct'09	Oct'10	Oct'11E	Oct'12E
Net Profit after Tax	9,087	10,911	10,489	11,540
Add : Depreciation	2,022	1,637	1,666	1,885
Add : Misc exp w/off	-	-	-	-
Net changes in WC	(3,410)	(2,443)	(1,161)	(2,458)
Operational Cash Flows	9,376	9,174	11,768	11,440
Capital expenditure	(1,163)	(1,799)	(3,087)	(2,500)
Investments	(7,612)	(6,988)	-	-
Investing Cash Flows	(8,776)	(8,787)	(3,087)	(2,500)
Borrowings	(20)	421	-	-
dividend paid	(858)	(858)	(980)	(1,227)
Issue of shares	112	(10)	-	-
Share Premium	105	(135)	-	-
Financing Cash Flows	640	(389)	(1,187)	(1,350)
changes in cash	1,240	(2)	7,493	7,590
Opening balance	546	1,786	1,784	9,277
Closing balance	1,786	1,784	9,277	16,867

Balance Sheet

Y/E, Oct (Rs. m)	Oct'09	Oct'10	Oct'11E	Oct'12E
Equity share capital	2,096	2,099	2,089	2,089
Reserves & surplus	21,358	30,892	40,203	50,394
Minority Interest	-	-	-	-
Networth	23,453	32,992	42,293	52,484
Secured Loans	-	-	-	-
Unsecured Loans	33	454	454	454
Loan Funds	33	454	454	454
Deferred Tax Liabilities	1	3	3	3
Total Liabilities	23,488	33,449	42,749	52,940
Goodwill	-	-	-	-
Gross Block	12,989	14,145	17,232	19,732
Less: Depreciation	6,880	7,836	9,502	11,387
Net block	6,109	6,309	7,730	8,345
Capital WIP	127	89	89	89
Investment	-	-	-	-
Current Assets	25,703	37,886	46,928	58,961
Inventories	-	-	-	-
Sundry debtors	9,064	12,054	13,242	15,794
Cash & bank balance	1,786	1,784	9,277	16,867
Loans & advances	7,240	9,446	9,809	11,700
Other current assets	1	2	-	-
Current Liab & Prov	9,147	11,590	12,751	15,209
Current liabilities	6,414	8,094	8,664	10,335
Provisions	2,734	3,497	4,087	4,875
Net current assets	16,556	26,296	34,176	43,752
Misc exps	-	-	-	-
Deferred Tax	695	754	754	754
Total Assets	23,488	33,448	42,749	52,940

Key ratios

Y/E, Oct	Oct'09	Oct'10	Oct'11E	Oct'12E
EPS (Rs)	43.3	52.0	49.9	55.0
CEPS (Rs)	52.9	59.8	57.9	63.9
Book Value Per Share (Rs)	111.7	157.1	201.4	249.9
Dividend Per Share (Rs)	3.5	4.0	5.0	5.5
Valuations Ratios (x)				
PER	13.5	11.3	11.7	10.7
P/CEPS	11.3	10.0	10.4	9.4
P/BV	5.2	3.7	2.9	2.3
EV/EBIDTA	10.1	8.5	7.3	5.8
EV/Sales	2.7	2.1	1.7	1.3
M-Cap/sales	2.9	2.4	2.1	1.7
Profitability Ratios (%)				
RoCE	48.8	38.7	31.6	29.0
RoNW	48.1	38.7	27.9	24.4
EBITDA Margin	26.4	25.1	22.9	22.2
EBIT Margins	21.7	21.9	20.2	19.5
Net Profit Margin	21.3	21.7	17.6	16.2

Recommendation History: Mphasis Limited - MPHL IN

Date	Reports	Reco	CMP	Target
23/11/2010	Mphasis Q4FY10 Result Update	Hold	561	630
26/08/2010	Mphasis July'10 Result Update	Hold	626	630
27/05/2010	Mphasis Company Update 270510	Hold	600	560
20/11/2009	Mphasis Co Update 201109	Hold	720	650

Recent Research Reports

Date	Reports	Reco	CMP	Target
19/11/2010	Wipro Company Update	Reduce	418	420
16/11/2010	Mahindra Satyam Q2FY11 Result Update	Reduce	85	70
27/10/2010	Patni Q3CY10 Result Update.pdf	Not Rated	465	NA
27/10/2010	Tech Mahindra Q2FY11 Result Update	Hold	787	810

Emkay Global Financial Services Ltd.

Paragon Center, H -13 -16, 1st Floor, Pandurang Budhkar Marg, Worli, Mumbai – 400 013. Tel No. 6612 1212. Fax: 6624 2410

DISCLAIMER: This document is not for public distribution and has been furnished to you solely for your information and may not be reproduced or redistributed to any other person. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries, including the United States. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions. This material is for the personal information of the authorized recipient, and we are not soliciting any action based upon it. This report is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. No person associated with Emkay Global Financial Services Ltd. is obligated to call or initiate contact with you for the purposes of elaborating or following up on the information contained in this document. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon. Neither Emkay Global Financial Services Ltd., nor any person connected with it, accepts any liability arising from the use of this document. The recipient of this material should rely on their own investigations and take their own professional advice. Opinions expressed are our current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis the information discussed in this material, there may be regulatory, compliance, or other reasons that prevent us from doing so. Prospective investors and others are cautioned that any forward-looking statements are not predictions and may be subject to change without notice. We and our affiliates, officers, directors, and employees world wide, including persons involved in the preparation or issuance of this material may; (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company (ies) mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the company (ies) discussed herein or may perform or seek to perform investment banking services for such company(ies) or act as advisor or lender / borrower to such company(ies) or have other potential conflict of interest with respect to any recommendation and related information and opinions. The same persons may have acted upon the information contained here. No part of this material may be duplicated in any form and/or redistributed without Emkay Global Financial Services Ltd.'s prior written consent. No part of this document may be distributed in Canada or used by private customers in the United Kingdom. In so far as this report includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.