

Initiating Coverage
December 14, 2010

Mphasis Ltd.



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Mphasis Ltd.

Mphasising on sustainability

December 14, 2010

Key Stock Data	
Sector	Information Technology
CMP	₹617.4
52-wk High / Low:	₹780.0 / 543.2
Market Cap	₹129.95bn (\$2888.0mn)
Avg 6m daily vol.	429754
NSE Nifty	5907.7
Reco	Buy
TP	₹710

Mphasis, being the 6th Indian IT company to clock \$1bn revenues, is a leading provider of applications (Apps), infrastructure (ITO) and BPO services. The company was initially acquired by Electronic Data Systems (EDS) in 2006, which later merged with HP in 2008, qualifying Mphasis as HP's subsidiary.

The company employs 38000+ professionals, serving 190 clients in BFSI, technology, manufacturing and telecom industries, across the globe.

Restructuring efforts for sustaining growth

Mphasis' dependence on the HP channel is significant, but the management is actively pursuing growth through the direct channel. In this regard, Mphasis has already engaged Boston Consulting Group (BCG) to help pilot the company through restructuring efforts aimed at capturing higher than market growth rates.

Value unlocking through meaningful M&A activity

The company enjoys a strong cash position with negligible debt on books. Management has expressed eagerness in closing service offerings gaps through acquisitions that may contribute to the firm's domain expertise in select verticals, going forward.

Improved HP-margins on rate card negotiations

With increased confidence in direct channel, Mphasis has been able to renegotiate HP-business terms, from "cost+margins" to "rate-card scenario", enabling the company to appropriate cost-optimisations. Thus, unlocking significant value linked to ~30% of its topline.

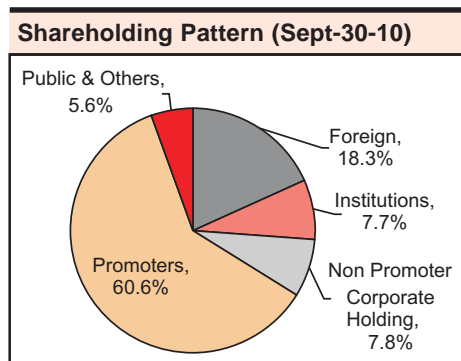
Affiliation with HP affords brand-projection on a global-scale

Co-branding Mphasis as an HP affiliate is a significant intangible for the company, giving it an instant global recognition, a major determinant for direct-channel success.

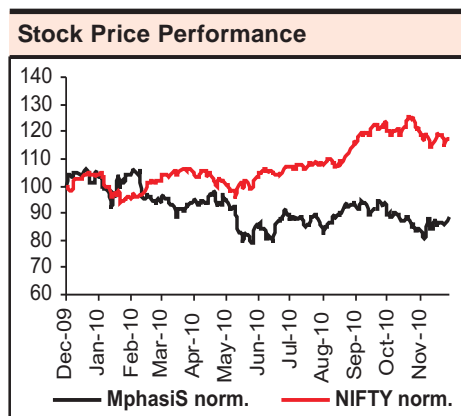
Valuation

At CMP of ₹617.4, the stock is trading at 12.8x FY12E earnings. Considering the growth opportunities and robust economic scenario, we initiate coverage with 'buy' recommendation on the stock, arriving at a target price of ₹710 for one year period, subject to change.

Stock Codes	
Bloomberg Code	MPHL.IN
Reuters Code	MBFL.BO
BSE Code	526299
NSE Code	MPHASIS
Face Value	₹10 per share



Price Performance	(%)			
	1 Mth	3 Mths	6 Mths	1 Yr
	5.4%	-3.7%	8.2%	-14.7%



Key financials

(₹Cr)

For y.e. 31 Oct	2008*	2009	2010	2011E	2012E
Net operating income	1906.52	4263.88	5036.56	5924.63	7067.33
EBITDA	388.41	1127.45	1264.57	1174.35	1367.43
PAT	295.44	908.68	1090.75	894.75	1015.20
EBITDA margin	20.4%	26.4%	25.1%	19.8%	19.3%
EPS (₹)	13.74	43.21	51.82	42.43	48.15
BV (₹)	66.81	111.54	156.75	194.67	238.01
PAT margin	15.5%	21.3%	21.7%	15.1%	14.4%
ROANW	41.1%	48.1%	38.3%	24.0%	22.3%

Source: Company, E: Keynote Capitals Institutional Research Estimates
*7mth ended 31 Oct 2008

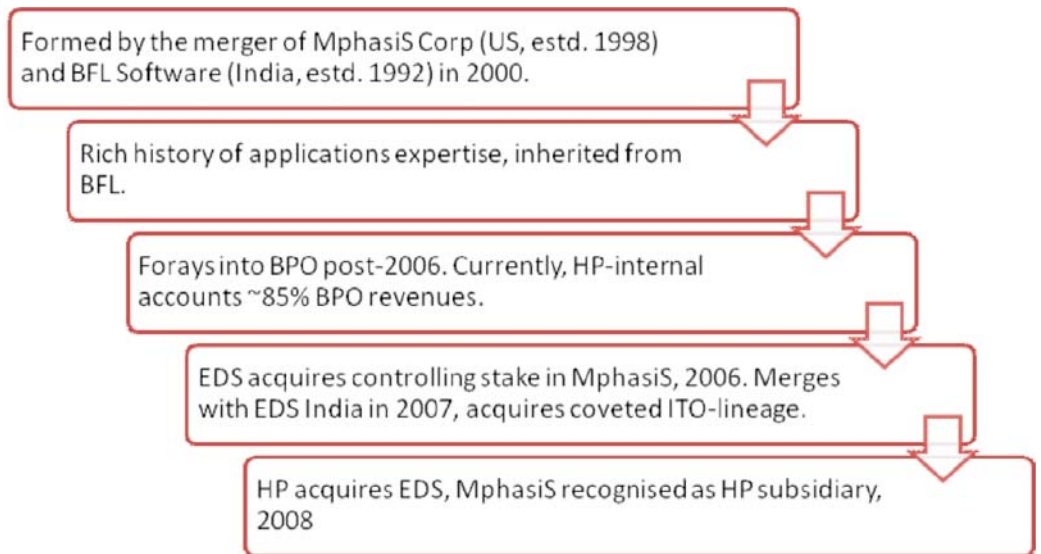
Company background

Established in 2000 by the merger of Mphasis Corp. (US) and BFL Software Ltd (India), Mphasis Ltd has seen gradual movement from an apps-centric firm to BPO and other businesses. Post-merger with EDS India in 2007, the company has bred unparalleled competency in infrastructure outsourcing (ITO).

Later in 2008, the firm's operations were impacted by the impending credit crisis and, Mphasis which otherwise concentrated on the BFSI sector, diversified its activities to other verticals like Manufacturing, Retail etc. (see charts 1,2).

Chart 1

Evolution chart



Source: Company

The company operations are spread across the Apps, BPO and ITO LoBs, catering to the BFSI, Technology & OEMs, Manufacturing & Retail, Healthcare, Telecom and TTHL industries (see charts 3,4).

Chart 2



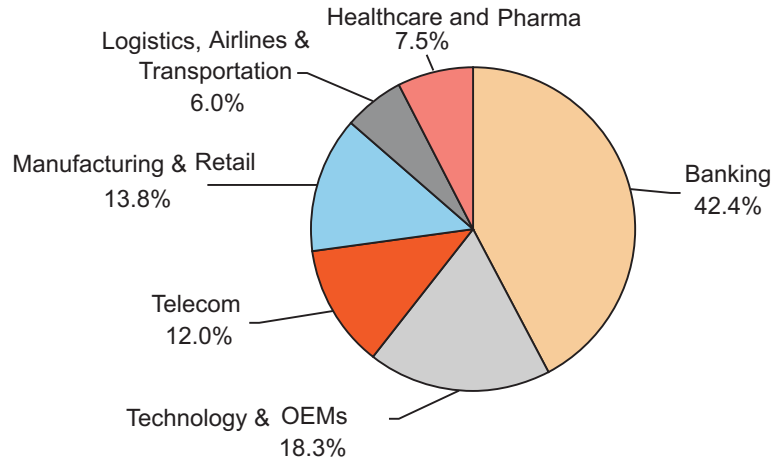
Source: Company

Sales & marketing strategy

Currently, MphasiS serves a well diversified industry-base across different geographies. However, the company is looking to create a differentiated and unique presence in the BFSI space.

Chart 3

Diversified industry presence (FY10)

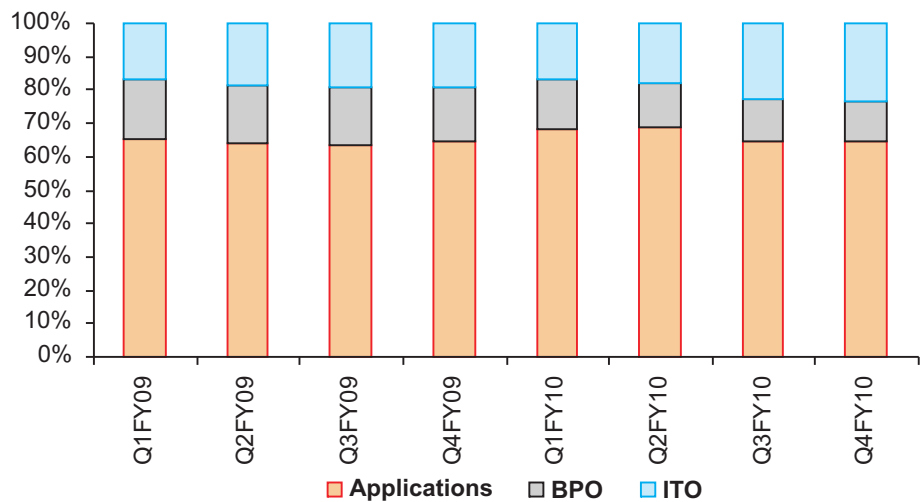


Source: Company

On the revenue front, the company has identified ITO as a high-growth contributor, significantly altering business-mix over the years (see chart 4).

Chart 4

Revenue contribution by horizontals



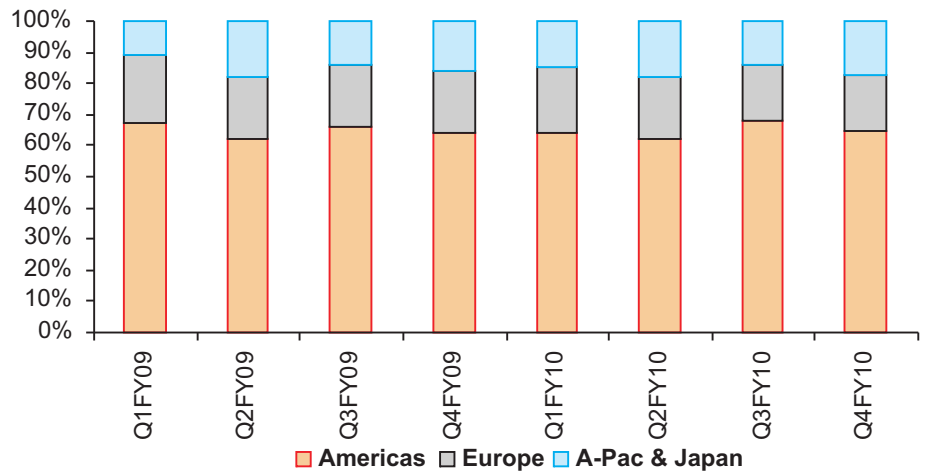
Source: Company

Geographical allocation of revenues

The company has most of its operation concentrated in Americas (see chart 5). However, Europe and A-Pac are emerging as growth markets, especially considering MphasiS' focus on direct-channel. The management has hinted at phenomenal growth rates in emerging markets, going forward.

Chart 5

Revenue spread by geography



Source: Company

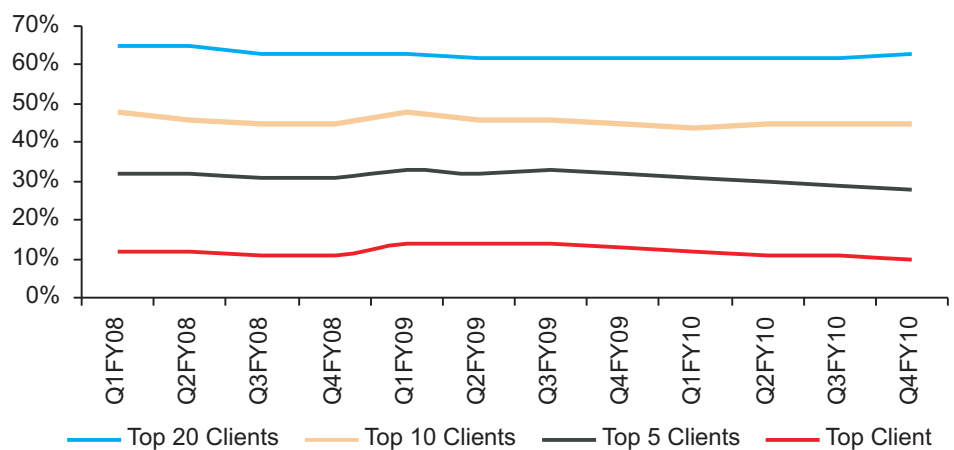
Well diversified client-mix

MphasiS enjoys a comfortable business-mix in terms of client concentration, with the largest client accounting for 11% of total revenues while top 10 clients accounting for less than 45% of total revenues (see chart 6).

Over the years, the client-structure has remained relatively stable with little change witnessed in the revenue contribution. However, the top-client contribution is bound to reduce, on concerns related to consolidation (top client being HP).

Chart 6

Client concentration (TTM basis)



Source: Company

Restructure plan

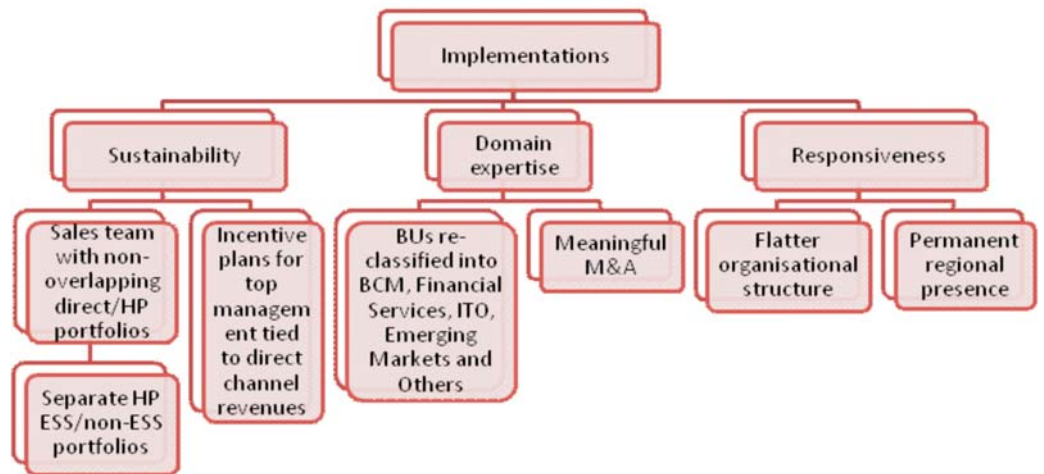
Broadly, the restructuring efforts have been directed towards maintaining sustainable growth in future. The management’s rationale can be briefly summarised as; predictable performance through:

- Direct channel growth while sustaining HP-channel business (ESS and non-ESS).
- Sustainable emerging markets exposure.
- Vendor consolidation through differentiated end-to-end BFSI offerings.
- All this, while maintaining the responsiveness of a small firm.

Given hereunder are the restructure implementations adopted by the company in consultation with BCG.

Chart 7

Restructure implementations

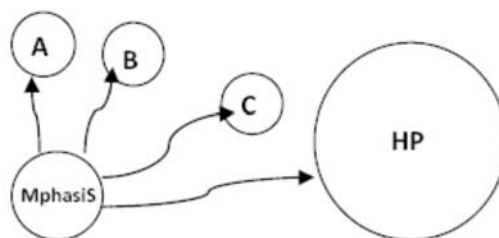


Source: Company

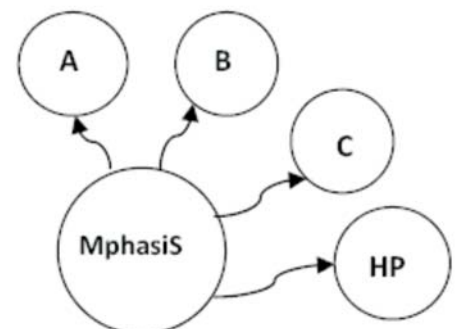
The firm has also instituted incubation processes, of which one has blossomed into a commercially viable product, Javelina, voted as the highest-potential healthcare product in the Healthcare IT Summit, US, 2010. The product has already seen some implementations, with good results and favorable customer testimonies.

Intended channel position

Now



Post-restructure

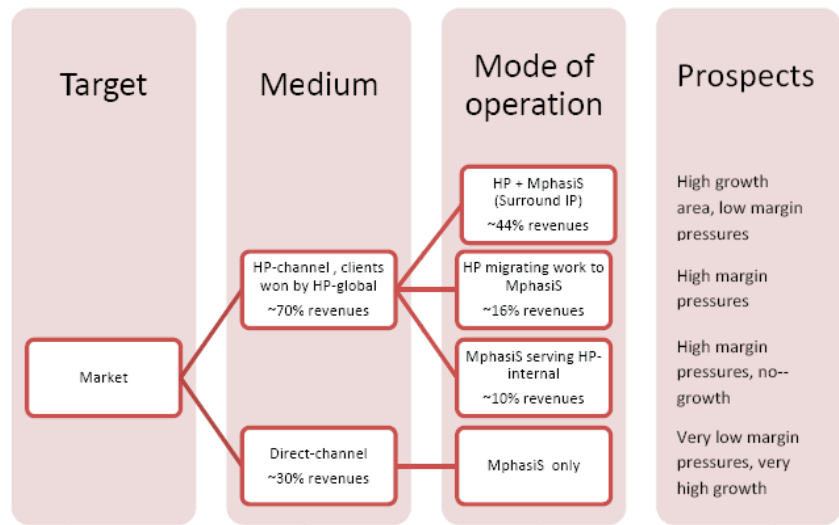


Source: Keynote Capitals Institutional Research

Channel segmentation

Chart 8

Channel operations

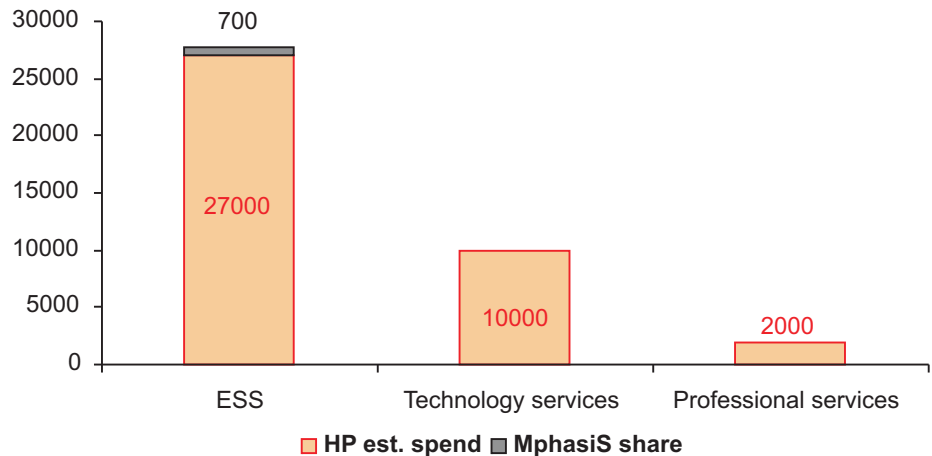


Source: Company

On the HP-side, a large portion of revenues flow from Enterprise Shares Services (ESS). The management is looking to tap non-ESS prospects (see chart 9), an avenue that has been left largely untouched.

Chart 9

HP spend targeted by MphasiS (\$mn)



Source: Company

We believe that, the direct-channel offers immense growth-potential, with management energies being directed to exploit the same.

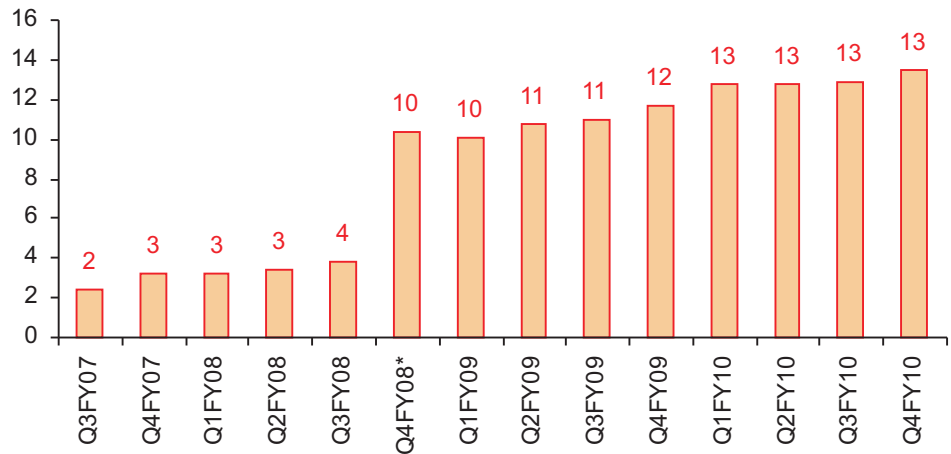
Margin levers

MphasiS has been actively involved in shifting the revenue-mix from HP-channel to open market, allowing the company to gain higher margins as a result of competitive negotiations devoid of intermediary layers. This will further reduce MphasiS' dependence on HP-revenues and, depolarise the negotiation-equation w.r.t. HP.

As a direct consequence, the firm has been able to migrate almost 30% of its revenues (HP-related transactions) from fixed margins to fixed price, delivering consistent and predictable EPS performance (see chart 10).

Chart 10

EPS performance (₹)



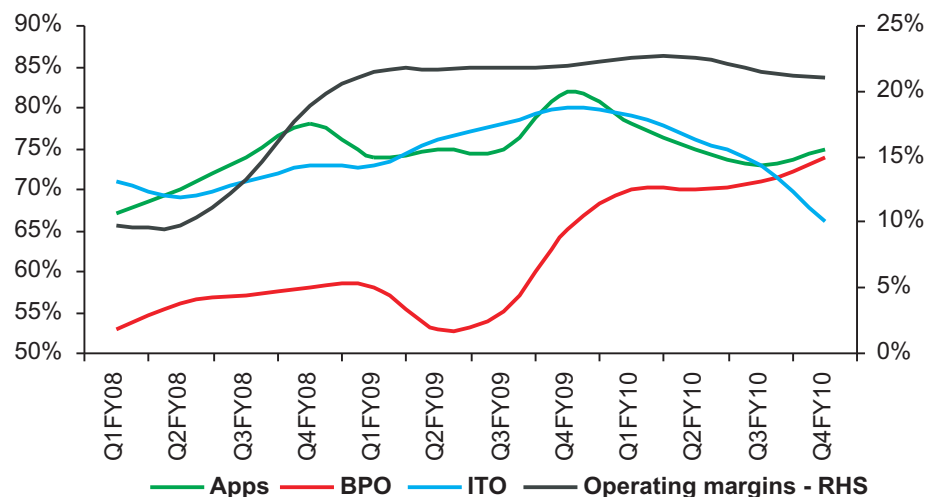
Source: Capitaline, Company
*4mth ended 31 Oct 2008

Further, the management has indicated significant headroom in operational levers (see chart 11), substantiated by the Surround-IP concept and ~75% utilisation targeted for the intermediate term.

Margin control has been impeccable, with consistent 21-22% operating margins. As of FY10, MphasiS witnessed 21.5% operating margin, reflecting fully the impact of "rate card" pricing w.r.t. HP businesses.

Chart 11

Utilisation tweaks to improve margins



Source: Company

We expect some intermediate-term pressure on SG&A and DSO, due to investments in transformational process, as the firm gears for sustaining higher than market growth rates.

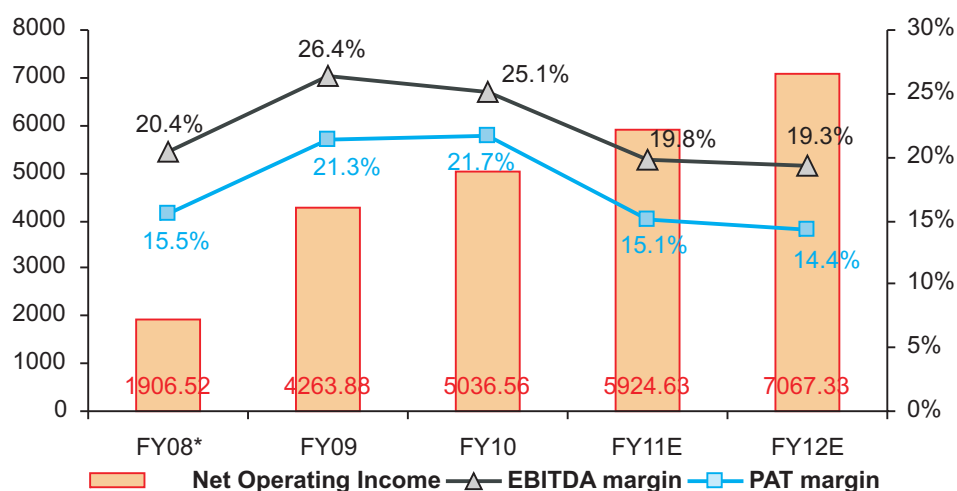
Valuation

We base our valuation on certain assumptions, crystallised post our interaction with the management:

- Sustained growth in the medium term on account of restructuring efforts. The management has hinted at BFSI and emerging market focus for sustaining growth rates.
- Higher utilisation levels, targeted at ~75%.
- Stable pricing regime as reflected in HY2FY10.
- Higher SG&A and possible pressure on DSO due to direct channel focus and, other transformational costs to be incurred in FY11.
- Wage pressure on account of attrition (Apps 30%, BPO 70%, ITO 25%; FY10)
- HP-internal (~10% topline) identified as zero-growth area.

Chart 12

Revenue forecasts



Source: Company, E: Keynote Capitals Institutional Research Estimates
*7mth ending 31 Oct 2008

Key acquisitions

During FY10, MphasiS acquired AIGSS and Fortify, adding significantly to the BFSI and ITO portfolios respectively. The company has consolidated ~₹55Cr Fortify revenues during HY2FY10.

Hedging policy

The company has a well defined hedging policy in place for protecting balance-sheet exposure. The company takes a medium-term view while hedging its ForEx exposure. MphasiS uses only forward contracts as hedging instruments;

Significant hedging position as at 31 Oct 2010

Currency	MTM (\$mn)
USD	536
AUD	43
GBP	37

Source: Company

Valuation ratios

For y.e. 31 Oct	2008*	2009	2010	2011E	2012E
EPS (₹)	13.74	43.21	51.82	42.43	48.15
EBITDA (₹Cr)	388.41	1127.45	1264.57	1174.35	1367.43
P/E (x)	44.9	14.3	11.9	14.5	12.8
EV/EBITDA (x)	31.1	10.7	9.6	10.3	8.8

Source: Company, E: Keynote Capitals Institutional Research Estimates
* 7mth ended 31 Oct 2008

Peer comparison

		Mphasis*	Infosys	TCS	Wipro	HCL Tech	NIIT Tech	Hexaware#	Patni#	Polaris
Revenues (₹Cr)	FY10	5036.56	22742.00	30028.92	27212.90	12136.29	913.71	1038.56	3146.15	1353.76
	FY11E	5924.63	27535.35	37103.76	31316.55	15464.71	1207.68	1245.17	3633.00	1541.39
	FY12E	7067.33	33253.62	44847.07	36903.58	18507.87	1261.05	1480.71	4121.67	1791.62
FY10-12E CAGR		18.5%	20.9%	22.2%	16.5%	23.5%	17.5%	19.4%	14.5%	15.0%
EPS (₹)	FY10	51.82	109.84	35.68	19.07	18.69	21.51	9.34	45.74	15.48
	FY11E	42.43	122.24	42.75	21.94	24.08	28.51	9.39	40.13	20.29
	FY12E	48.15	147.80	49.28	24.60	30.59	29.48	10.21	42.95	21.82
EBITDA (₹Cr)	FY10	1264.57	7911.00	8694.55	6081.10	1992.42	191.07	198.50	666.07	223.43
	FY11E	1174.35	9210.50	10918.74	6661.03	2732.61	235.68	158.74	696.88	228.02
	FY12E	1367.43	11061.71	13056.27	7817.70	3382.18	261.35	192.10	763.97	267.99
EV/EBITDA (x)	FY10	9.0	21.0	23.3	17.5	15.1	5.0	5.7	5.8	5.1
	FY11E	9.7	18.1	18.5	16.0	11.0	4.1	7.1	5.6	5.0
	FY12E	8.3	15.0	15.5	13.6	8.9	3.7	5.9	5.1	4.2
RoAA	FY10	38.3%	25.1%	27.9%	15.3%	10.3%	15.4%	12.2%	14.5%	13.8%
	FY11E	24.0%	23.9%	29.3%	16.2%	11.7%	19.1%	11.1%	12.3%	16.8%
	FY12E	22.3%	24.5%	27.9%	15.9%	13.5%	15.9%	10.8%	11.8%	16.0%
P/E (x)	FY10	11.9	28.6	30.2	23.5	23.4	8.9	11.4	9.9	10.7
	FY11E	14.5	25.7	25.2	20.4	18.2	6.7	11.3	11.3	8.2
	FY12E	12.8	21.3	21.8	18.2	14.3	6.5	10.4	10.6	7.6
EV(₹Cr)		11401.51	166272.22	202316.87	106243.88	30072.37	959.78	1133.67	3875.93	1131.49
MCap (₹Cr)		12994.53	180540.22	210614.29	109886.38	29760.20	1127.55	1543.53	5945.44	1642.42

Chart 13

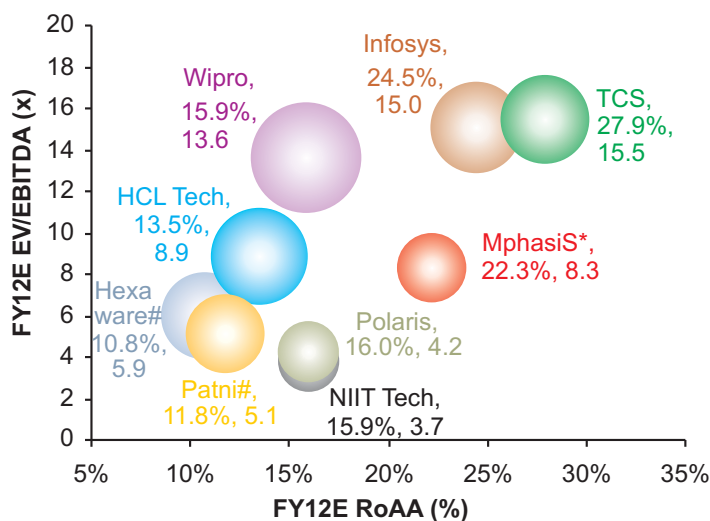
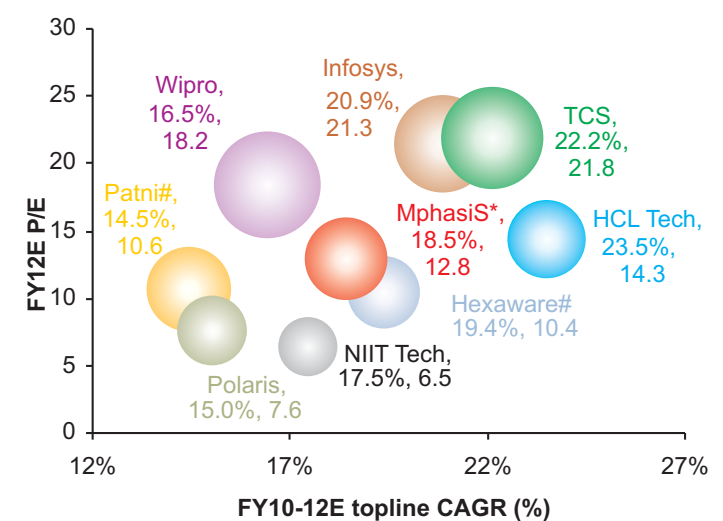


Chart 14



Source: Bloomberg, E: Bloomberg consensus; except *: Keynote Capitals Institutional Research Estimates; smaller bubble is better
#FY ended 31 Dec 2009

Price performance

Chart 15

2yr fwd price bands

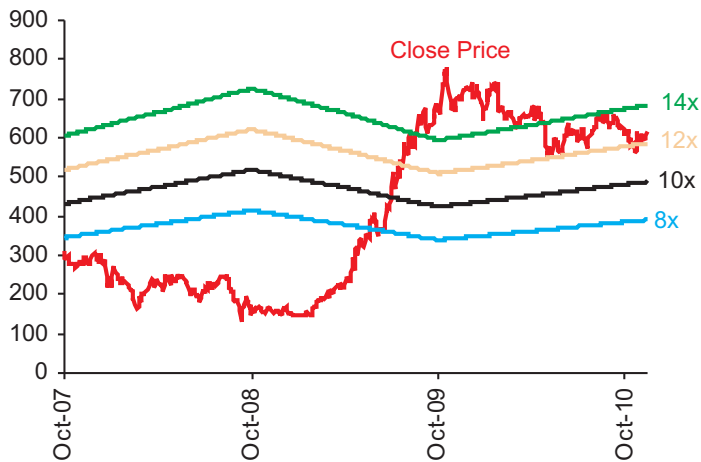
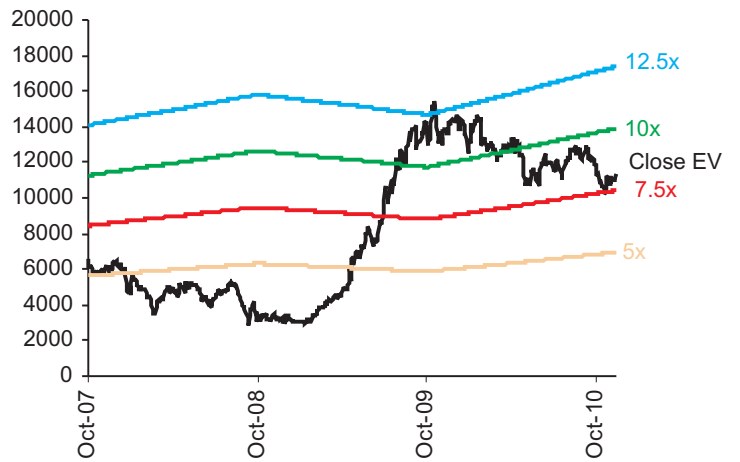


Chart 16

2yr fwd EV bands*



Source: Capitaline, Keynote Capitals Institutional Research Estimates
 *EV computed using FY-1 balance sheet numbers

Investment risks

Currency rate fluctuations

Our sensitivity estimates suggest an estimated 70bps reduction in EBITDA margins for every percentage point decrease in USD/INR exchange rates.

Attrition rates

We have witnessed high attrition rates across the IT sector. With high attrition rates constraining the supply side, we cannot rule out margin pressures related to manpower costs.

HP policy risks

We view probable risks related to change in HP's sourcing policy.

Protectionism

With more than 65% revenues flowing from the US, there exists significant risk related to sustainability of growth.

Financials

Income statements (₹Cr)

For y.e. 31 Oct	2008*	2009	2010	2011E	2012E
Net operating income	1906.52	4263.88	5036.56	5924.63	7067.33
EXPENDITURE :					
Direct expenses	1324.98	2677.10	3344.50	4039.32	4887.16
SG&A	193.13	459.33	427.49	710.96	812.74
Total expenditure	1518.11	3136.43	3771.99	4750.28	5699.91
EBITDA	388.41	1127.45	1264.57	1174.35	1367.43
Other income	21.78	47.51	108.83	89.12	118.63
Interest	0.00	0.00	0.00	5.67	0.00
Gross profit	410.20	1174.97	1373.40	1257.80	1486.06
Depreciation & Amortisation	100.49	202.22	163.47	159.95	132.46
PBT	309.71	972.75	1209.93	1097.85	1353.60
Tax	14.27	64.07	119.18	203.10	338.40
PAT	295.44	908.68	1090.75	894.75	1015.20
Cost structure					
Direct expenses	69.5%	62.8%	66.4%	68.2%	69.2%
SG&A	10.1%	10.8%	8.5%	12.0%	11.5%

Source: Company, E: Keynote Capitals Institutional Research Estimates
*7mth ended 31 Oct 2008

Balance Sheets (₹Cr)

As at y.e. 31 Oct	2008	2009	2010	2011E	2012E
SOURCES OF FUNDS :					
Share capital	215.00	210.28	210.47	210.85	210.85
Reserves total	1221.34	2135.06	3088.67	3893.94	4807.62
Total shareholders' funds	1436.34	2345.34	3299.14	4104.80	5018.48
Total debt	5.38	3.32	45.37	0.00	0.00
Total liabilities	1441.72	2348.66	3344.51	4104.80	5018.48
APPLICATION OF FUNDS :					
Gross block	946.32	1004.36	1025.83	1084.72	1284.72
Less: Accumulated depreciation	605.79	687.99	783.57	846.36	905.95
Less: Impairment of assets	0.00	0.00	0.00	0.00	0.00
Net block	340.54	316.37	242.26	238.37	378.77
Lease adjustment	0.00	0.00	0.00	0.00	0.00
CWIP	73.07	12.73	8.90	0.00	0.00
Goodwill	295.93	294.55	388.65	291.49	218.62
Investments	0.00	761.25	1460.03	1533.03	1609.68
Cash and bank	73.12	178.57	178.37	466.51	1212.60
Net current assets	697.73	894.36	1169.58	2041.92	2811.41
Net deferred tax	34.45	69.39	75.11	0.00	0.00
Total assets	1441.72	2348.66	3344.51	4104.80	5018.48

Source: Company, E: Keynote Capitals Institutional Research Estimates

Cash flow statements (₹Cr)

For y.e. 31 Oct	2008*	2009	2010	2011E	2012E
Cash flow from operating activity	178.36	1051.73	840.59	462.16	1005.63
Cash flow investing activity	-120.36	-905.91	-792.25	-123.00	-276.65
Cash flow financing activity	-78.67	-42.70	-40.23	-51.01	17.11
Cash at beginning of period	95.25	73.12	178.57	178.37	466.51
Exchange rate effects	-1.46	2.32	-8.30	0.00	0.00
Cash at end of period	73.12	178.57	178.37	466.51	1212.60

Source: Company, E: Keynote Capitals Institutional Research Estimates
*7mth ended 31 Oct 2008

Financial ratios (for y.e. 31 Oct)

Margin ratios	2008*	2009	2010	2011E	2012E
EBITDA	20.4%	26.4%	25.1%	19.8%	19.3%
PAT	15.5%	21.3%	21.7%	15.1%	14.4%

Efficiency ratios	2008	2009	2010	2011E	2012E
Average asset turnover	2.6	2.2	1.8	1.6	1.5
RoANW	41.1%	48.1%	38.3%	24.0%	22.3%

Operational ratios	2008	2009	2010	2011E	2012E
Receivable days	161	96	108	125	115
Payable days	78	54	58	58	58
Cash conversion cycle (days)	83	42	50	67	57

Valuation ratios	2008	2009	2010	2011E	2012E
EPS (₹)	13.74	43.21	51.82	42.43	48.15
EBITDA (₹Cr)	388.41	1127.45	1264.57	1174.35	1367.43
P/E (x)	44.9	14.3	11.9	14.5	12.8
EV/EBITDA (x)	31.1	10.7	9.6	10.3	8.8

Other ratio	2008	2009	2010	2011E	2012E
Dividend payout	16.3%	8.9%	7.7%	10.0%	10.0%

Source: Company, E: Keynote Capitals Institutional Research Estimates
 *7mth ended 31 Oct 2008

Annexure

Sector outlook

Global IT spending will increase by 5.3% to \$3.4tn during 2010, according to Gartner, with computer hardware and IT services demonstrating the strongest growth (5.7%). This is in contrast to the 4.5% contraction witnessed last year when hardware sales were badly impacted, slumping by 12.5% and IT services and computer software saw declines of 4% and 2.5%, respectively. Further, software and telecoms will both benefit from increases of approximately 5.1%. (Source: Information Age, 17 May 2010).

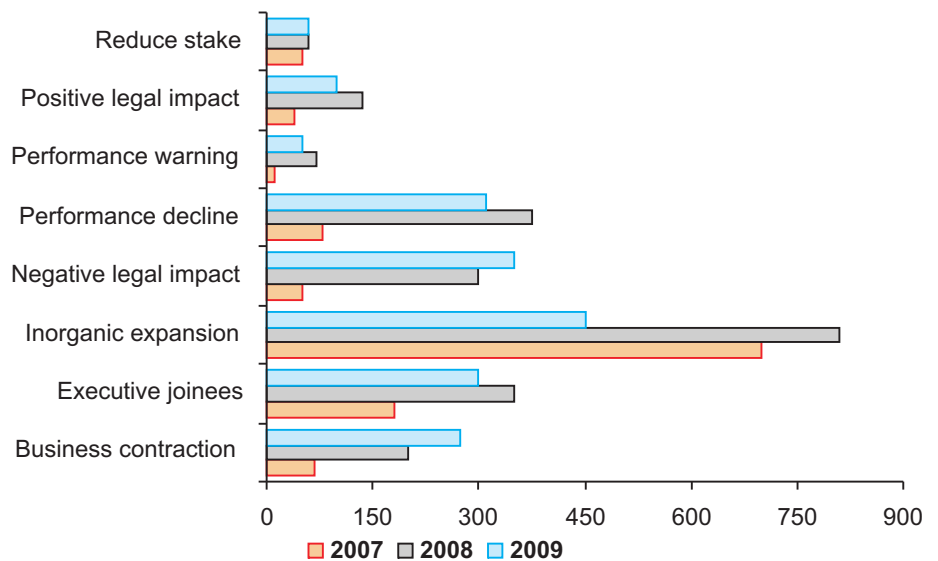
ITO growth still offers sustainable traction

The company has registered 28.6% growth in ITO business during the year, effectively changing the business mix. We believe that, ITO business offers a sustainable passage of growth for Mphasis, going forward. Our view has been further reinforced by Mphasis' willingness to evaluate inorganic alternatives, given the recent acquisition of a US-based ITO firm, Fortify Infrastructure Services.

The environment is particularly ripe for ITO deals in BFSI, with business events snowballing to critical proportions (see chart 15). This has been further aided by technological advances in virtualisation and cloud computing, offering significant cost advantages.

Chart 17

Event frequency for a sample of 100 American BFSI institutions (2007-09)

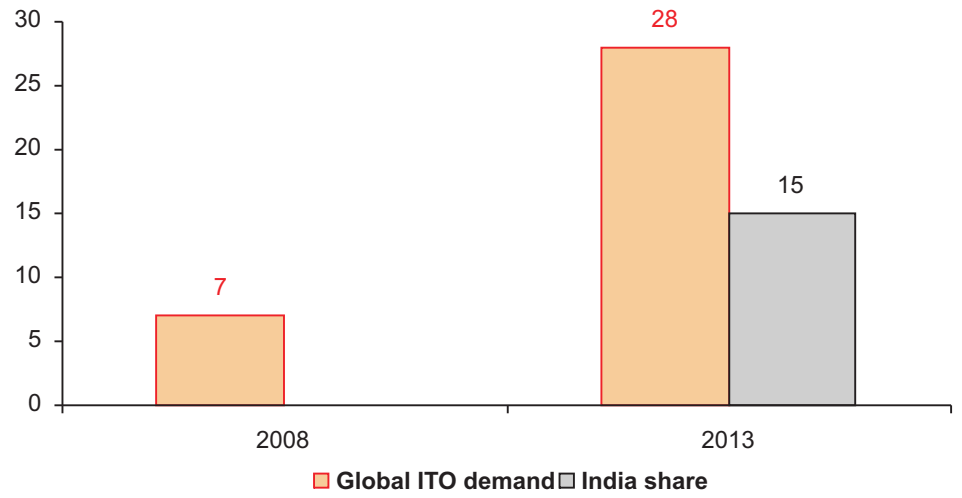


Source: Everest Research

Going forward, IT Infrastructure Management Services offers a market opportunity of around \$500bn. Globally, the ITO industry is expected to achieve a penetration of 25-27% by 2013; \$20-21bn increase over \$6-7bn revenues presently. Further, based on a global CIO survey, India emerges as “primary” offshore destination, the country will capture greater than 50% of the world market i.e. \$13-15bn 2013 revenues (Source: NASSCOM-McKinsey) (see chart 16).

Chart 18

ITO potential w.r.t. Indian IT industry



Source: NASSCOM-McKinsey

Institutional Equity Team

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