

Buy	CMP: 602.85	Target: 740.0
Mphasis Ltd.	Upside: 22.8 %	Horizon: 12M

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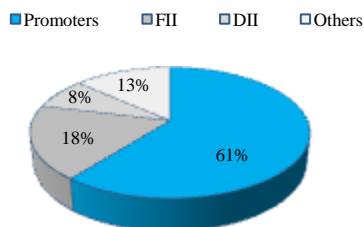
Key Data

Sector	IT Software
Face value (Rs.)	10
52-week high/low (Rs.)	780 / 543.2
Market cap (Rs. cr.)	12658.0
Book value (Rs.)	157.1
Price / book value	3.8
PE ratio (TTM)	11.6
Market cap / sales	2.6
Dividend (%)	40
Average daily volume (1 Y)	557870

About the Company

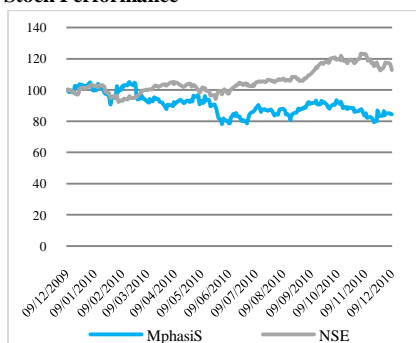
Mphasis Ltd. is a service company engaged in providing information technology solutions and related services. The company specializes in providing a suite of application development and maintenance services, infrastructure outsourcing (ITO) services and business process outsourcing (BPO) solutions to clients around the world. Its application development services cover consulting, application development, testing and application maintenance services. ITO services cover a range of infrastructure management services and service/technical help desks. BPO services provide voice, transaction based services and knowledge based processes. The company's subsidiaries include Mphasis Corporation, Mphasis Deutschland GmbH, BFL Software Asia Pacific, Mphasis Australia, Mphasis (Shanghai) Software and Mphasis Consulting. Mphasis has 29 offices in 14 countries with delivery centers in India, Sri Lanka, China, North America and Europe. The company employs over 38,000 people and is headquartered in Bangalore. Mphasis was formed in June 2000 after the merger of US-based IT consulting company Mphasis Corporation and the Indian IT services company BFL Software Ltd. In June 2006 Electronic Data Systems (EDS) purchased a controlling stake of in Mphasis. On May 13, 2008, Hewlett-Packard confirmed that it had reached a deal with Electronic Data Systems to acquire the company for \$13.9 billion.

Shareholding Pattern



Source: BSE. As on Sep 30, 2010

Stock Performance



Investment Rationale

Robust Q4FY10 and FY10-full year results (standalone)

Q4FY10: Mphasis has performed well in Q4FY10. The net sales increased 9.7% to Rs. 979.2 cr. in the last quarter of FY10 from Rs. 893.0 cr. in Q4FY09. PBIDT went up by 9.0% to Rs. 309.3 cr. from Rs. 283.8 cr. and APAT shot northwards by 15.9% to Rs. 266.8 cr. from Rs. 230.1 cr. During the quarter ended 31 October 2010, Mphasis added 22 new clients. They include a bank, a large health care provider and clients from the manufacturing vertical.

FY2010: FY10 overall has also been good for Mphasis. The net sales increased 10.7% to Rs. 3770.1 cr. from Rs. 3405.0 cr. in FY09. PBIDT shot up by 19.6% to Rs. 1207.6 cr. from Rs. 1010.1 cr. and APAT swung upwards by 19.1% to Rs. 996.9 cr. from Rs. 836.9 cr. PBIDT margins for the same period jumped 230 bps to 32.0% from 29.7%. APAT margins went up by 180 bps to 26.4% from 24.6%. EPS jumped 18.8% to Rs. 47.5 from Rs. 40.0.

HP relationship is a tremendous asset

Mphasis is benefiting from its relationship with its parent, HP. Going ahead, Mphasis looks well positioned to take advantage of existing growth avenues and also to find new ones. For, even though its majority revenue comes from the HP channel, the amount is insignificant considering the size of HP's enterprise pie. Mphasis generated close to \$630 million (Rs 3,027 cr.) through HP in FY09, while HP alone earned close to \$24 billion (Rs 115,200 cr.). This leaves a wide scope to grow the HP link further. Mphasis has shown tremendous growth after becoming part of HP stable. Its topline doubled, on back of large project base from HP, as well as HP rerouting its clients to Mphasis. Presently, Mphasis is deriving ~70% of business through the HP channel, which is prospering a lot on back of strong business growth of HP. The parent company remains the largest client with 10% of Mphasis business on consolidated basis coming from internal HP projects, 20% from HP migration work and balance 40% from joint go-to-market.

MphasiS' direct channel business grew 8% QoQ, constituting 30% of total revenues in 4QFY10 v/s 29% in 3QFY10.

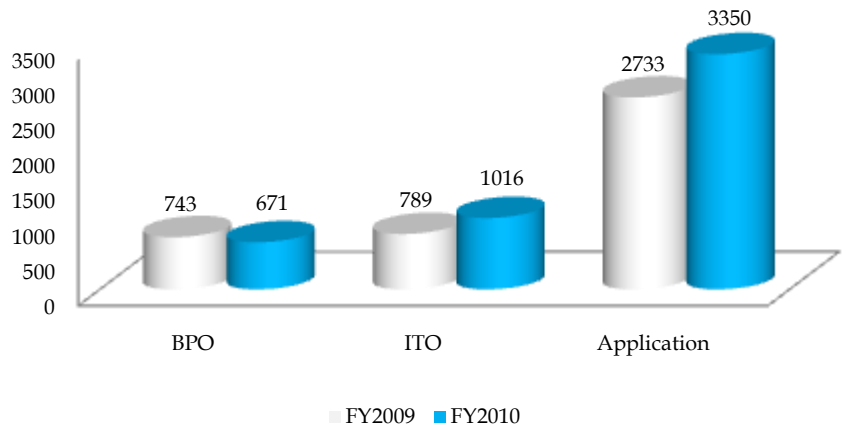
Increased focus on direct sales

The company has started differentiating between HP business and the direct sales business, increasing its focus on the latter. To achieve this, MphasiS has changed its organizational structure, making it more flat. Earlier, the sales team was not bifurcated between direct sales business and HP business. The company has now appointed one head who would handle the entire HP business. In the direct sales business the company has appointed heads for five segments namely banking & capital markets (matured markets), insurance (matured markets), enterprise business (matured markets), infrastructure services and emerging markets (all verticals). MphasiS' direct channel business grew 8% QoQ, constituting 30% of total revenues in 4QFY10 v/s 29% in 3QFY10. Direct channel revenues are expected to expand due to the thrust given to it, by the company.

ITO, Application services segments growing; BPO business turns the corner

While Application and ITO services revenues and profits have surged ahead in FY2010 compared to the previous fiscal, BPO revenues continued to remain impacted as business from HP scaled down. BPO segment recovered in 4QFY10 by arresting three quarters of sequential decline, registering a 2.1% QoQ growth.

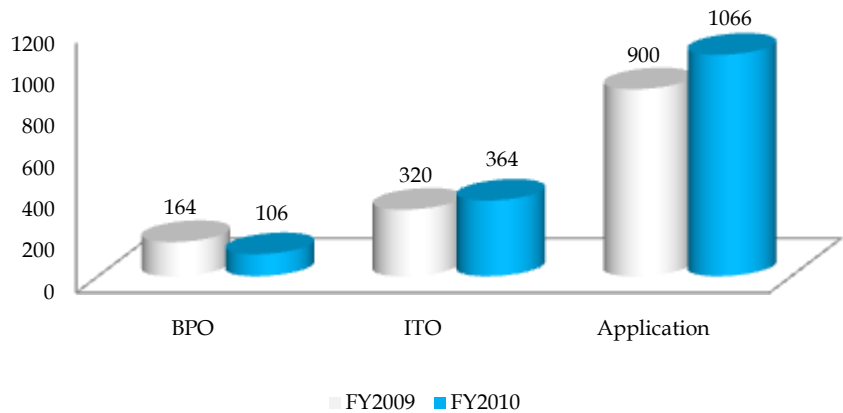
Segment revenues (Rs cr.)



Source: Company

While Application and ITO services revenues and profits have surged ahead in FY2010 compared to the previous fiscal, BPO business is showing signs of turning the corner.

Segment profits (Rs cr.)



Source: Company

MphasiS, now in a select group of Indian software firms to achieve a billion-dollar in revenues, is targeting revenues of \$2 billion in the next few years.

MphasiS breaks \$1 billion revenue mark, aims for \$2 billion

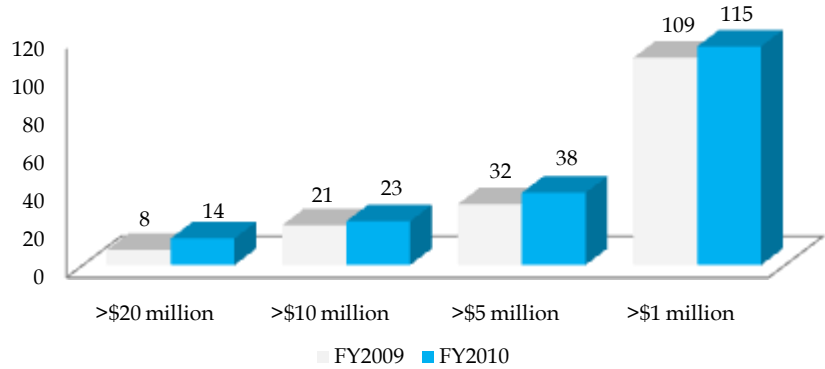
MphasiS, now in a select group only 6 Indian software firms to achieve a billion-dollars in revenues, is targeting sales of \$2 billion in the next few years on the back of higher expected volumes from the owner HP, direct sales and from acquisition of smaller firms.

There was an increase in large accounts with clients contributing more than \$20 million in revenues increasing from 8 in FY09 to 14 in FY10.

Client concentration

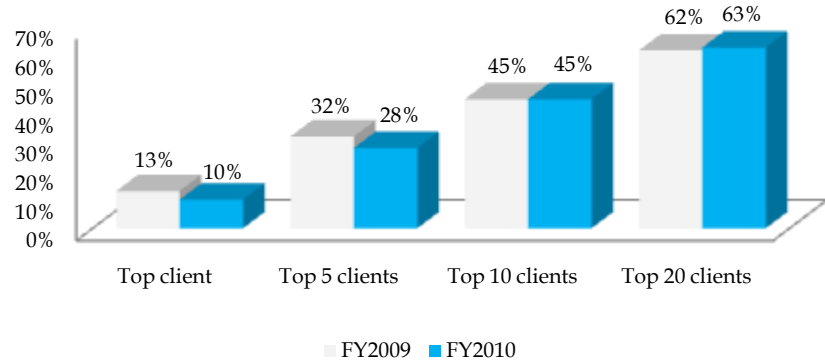
During Q4FY10, the company signed up 22 new accounts of which, 14 came from the HP channel and 8 from independent efforts of MphasiS. Out of these 22, 18 accounts were in IT applications with the remaining 4 in ITO.

Increase in large clients (revenues)



Source: Company

Revenue contribution of top clients: reduced dependency



Source: Company

There was reduced dependency on the top clients with the revenue contribution of top 5 clients coming down to 28% in FY10 from 32% in FY09.

Aggressively pursuing brown-field growth

The company has aggressively pursued inorganic growth in recent times. In the last one year, it has acquired two companies - AIG Systems Solutions Pvt. Ltd. in September 2009 and remote IT solutions provider - Fortify Infrastructure Services in February 2010. MphasiS is expected to do well considering the potential of its acquired businesses. Going forward also, the company plans to pursue its inorganic growth strategy. The size of acquisitions could vary between \$100-200 million. There could also be smaller acquisitions in the emerging markets.

MphasiS to focus on emerging markets

Currently, about 88% of the revenues of the company are derived from matured markets namely the US, the UK, Australia and New Zealand. Going forward, the company has outlined its strategy of focusing on emerging markets. For a start the company would focus on India, the Middle East and Indonesia. The company is deciding on a fourth country as well. MphasiS would grow in these markets through the organic as well as the in-organic route.

Growth in headcount signals confidence in future outlook

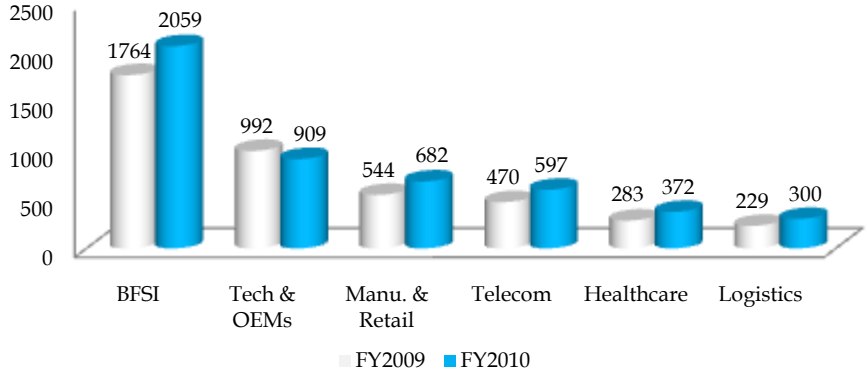
The company added 5,330 employees during FY10. The recruitment increased by 24% in Applications services and 61% in ITO segment during the fiscal 2009-10. Applications headcount increased by 296 and ITO increased by 836 people, sequentially in Q4FY10. But the BPO headcount declined by 1,141 employees QoQ, which was a conscious decision by the management to link its headcount with the 'call-forecast' obtained from clients.

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Most of the verticals have shown a decent growth YoY with Healthcare growing by 31.5%, Logistics by 31%, Telecom grew by 27%, Manufacturing & Retail by 25.4% and BFSI by 16.7%.

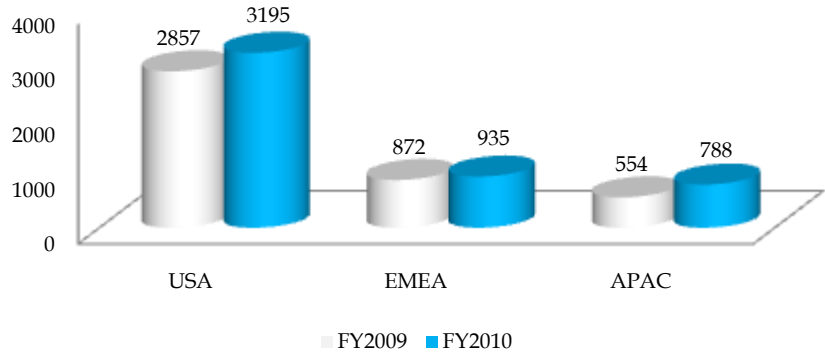
Growth is seen across verticals, geographies & service types

Group revenue by vertical / industry (Rs cr.)



Source: Company

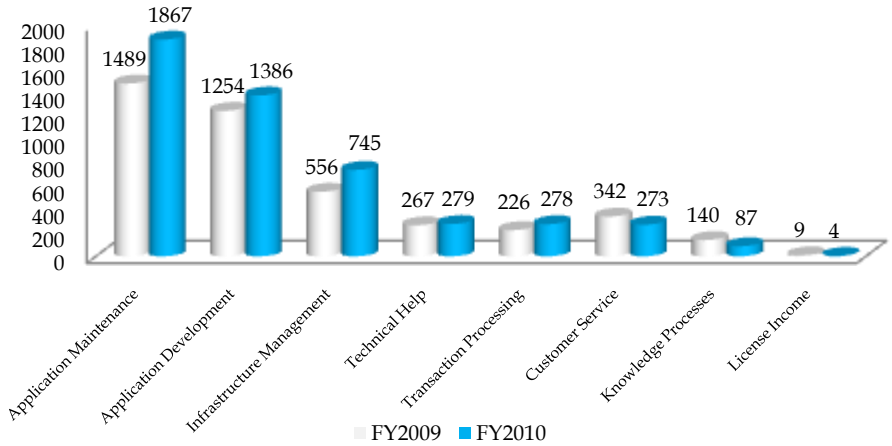
Group revenue by geography (Rs cr.)



EMEA – Europe, Middle East & Africa, APAC – Asia Pacific

Source: Company

Group revenue by service type (Rs cr.)



Infrastructure management services showed the maximum growth at 34%, followed by Application maintenance at 25.4% and Transaction processing at 23%. Application development grew by 10.5% and Technical help by 4.5%.

Source: Company

Peer Analysis

Attractively valued compared to peers

MphasiS compares well with its peers in terms of most parameters. While it has the best RONW (%) after TCS, it looks an undervalued stock in terms of P/E ratio. The company also has decent margins.

Company	Net Sales	PAT	PBIDTM (%)	APATM (%)	RONW (%)	P/E	P/BV	Mkt Cap
Polaris	1353.8	153.3	15.9	11.3	18.6	8.8	1.8	1591.0
Oracle	2874.0	773.9	32.8	26.9	19.9	22.9	4.2	17891.6
Patni	3146.2	586.6	23.8	18.7	18.4	9.3	1.7	6080.4
Tech Mahin.	4625.4	703.2	25.9	15.2	29.0	12.0	2.9	8349.9
MphasiS	5036.5	1090.8	27.3	21.7	38.7	11.5	3.8	12526.8
HCL Tech.	12136.3	1259.0	17.3	10.4	22.4	24.5	4.7	29579.5
Infosys	22742.0	6266.0	38.9	27.6	30.3	28.2	7.8	179740.5
Wipro	27297.2	4593.2	23.4	16.8	28.8	21.2	5.9	106783.5
TCS	30029.3	7092.7	29.9	23.6	40.9	26.7	11.5	211211.2

Consolidated figures for December 8, 2010. Net Sales & PAT figures for FY10 are in Rs cr.

Recent Developments

MphasiS enters Australia & Srilanka

MphasiS has opened an integrated development and delivery center in Australia at the University of Wollongong. The strategic location of the center will enable MphasiS to work on a range of initiatives including training, recruitment and research & development in the ICT (Information & Communication Technology) space. The center will focus exclusively on customers in Australia and New Zealand and will offer a specialized resource pool for the telecommunications industry as well as a center of excellence for testing. MphasiS has also recently entered the Sri Lankan market.

SWOT Analysis

<p>STRENGTHS</p> <ul style="list-style-type: none"> - Market access through HP. - Application services & ITO segments are on the growth path while BPO arm is showing signs of turning around. - Has broken the \$1billion revenue mark in FY10. - Reduced revenue dependency on its top clients. 	<p>WEAKNESSES</p> <ul style="list-style-type: none"> - Dependency on HP. - High attrition rate. - Margin pressures going ahead due to increased focus on direct sales.
<p>OPPORTUNITIES</p> <ul style="list-style-type: none"> - Direct sales have a lot of scope to grow. - Aggressively taking the inorganic route. - Increased focus on emerging markets like India, Middle East & Indonesia. 	<p>THREATS</p> <ul style="list-style-type: none"> - Increase in tax rates. - Possibility of further rate negotiation by HP. - US visa fee hike.

The management believes that it has some margin levers like utilization and general & administration expenses leverage which would help negate the adverse impact of higher selling and marketing spend.

Key Concerns

Margin pressures expected in FY11 due to increased focus on direct sales

In FY11, pressure on margins is expected due to increased investments in selling and marketing spend, with the company's increased focus on direct sales business. The management believes that it has some margin levers like utilization and general & administration expenses leverage which would help negate the adverse impact of higher selling and marketing spend.

Increase in tax rate

The effective tax rate for FY11 is expected to increase to 18.5% and for FY12, it is set to reach to 25%. The company is taking steps whereby it would reduce its tax liability. Currently, about 18% of the revenues are derived from SEZ facilities. The company would be undertaking capital expenditure to increase its SEZ share of revenues. MphasiS is in the process of signing up 1 lakh square feet in a Bangalore SEZ.

Possibility of further rate renegotiation by HP

MphasiS and HP have negotiations on pricing every six months. In the last negotiation, the pricing was cut by HP. The next pricing negotiation was in November 2010. The management expects the negotiation to be completed in the next two-three weeks. The pricing negotiations have had a bearing on the performance of the stock on the bourses. However, the management believes that the pricing re-negotiation is in due course of business and the company has the levers whereby it would be able to minimize the adverse impact of price cuts if any.

High attrition

Attrition was at the high end of industry levels at ~25% for Applications and ~30% for ITO services. Company has open positions of 1,600 and 800 in Application and ITO service lines, respectively. MphasiS has announced grant of 10 RSUs (Restricted Stock Units) to each employee with a total of 0.4m RSUs to arrest attrition. The company would buy-back shares from the open market for these RSUs and thus there would be no equity dilution for the same.

US visa fee hike

The recent fee hikes in H1 and L1 visas will have its relative effect, as US is the biggest market for the company

The company would be undertaking capital expenditure to increase its SEZ share of revenues. MphasiS is in the process of signing up 1 lakh square feet in a Bangalore SEZ. Currently, about 18% of the revenues are derived from SEZ facilities.

Conclusion

MphasiS being an HP company is in a position of advantage, as 70% of its business is sourced directly or indirectly from its parent company. There is also tremendous scope to increase its revenue for HP. But it refuses to rely solely on this revenue stream. So, it has started concentrating on direct sales and has created the required organizational structure for the same. It is also focusing on diversifying its geographical sales that presently come mainly from US & EU. The company is targeting growth by both organic and in-organic routes in the future. It has acquired one company each in FY09 and FY10. It has recently become a \$1billion company by revenue and is eyeing the \$2 billion mark in the next few years. MphasiS has seen healthy growth in its Application development and ITO services business in FY10 and a turnaround was seen in the BPO segment in Q4FY10. While the company is increasingly acquiring big clients, its revenue dependency on the top few clients has come down in FY10, compared to the previous financial year. The company is very confident about facing a few issues of concern like margin pressure due to increase selling and advertising expenses, increase in tax rates and possibility of further rate negotiation by HP.

MphasiS has a market capitalization of Rs 12658.0 cr. and is trading at a share price of Rs.602.85. The consolidated EPS is Rs 52.0 translating into a PE of 11.6. The price to book value stands at 3.8 and market cap/sales ratio is at 2.6. The stock is an attractive buy considering the growth prospects of the industry as well as the company. The company has a high RONW of 38.7%. The low market PE and other valuation parameters ensure that one is not overpaying for the growth.

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We recommend a “BUY” on the stock with an investment horizon of 12 months and target price of Rs. 740.

Financials

Income Statement (Quarterly): Standalone				Rs. Cr.	
Particulars	Q4FY10	Q3FY10	Q4FY09	QoQ (%)	YoY (%)
Net Sales	979.2	857.2	893.0	14.2	9.7
Total Income	1013.6	869.5	922.5	16.6	9.9
Total Expenditure	704.3	585.5	638.8	20.3	10.3
PBIDT	309.3	284.0	283.8	8.9	9.0
PBIDT Margin %	31.6	33.1	31.8		
Interest	-0.8	-0.3	2.5	-175.0	-130.8
PBDT	310.1	284.3	281.3	9.1	10.3
Depreciation	29.0	28.7	33.1	0.9	-12.4
Tax	14.3	23.2	47.6	-38.4	-70.0
APAT	266.8	232.4	230.1	14.8	15.9
APATM (%)	27.2	27.1	25.8		

Financials (Annual):Consolidated							Rs. Cr.	
	201010E	200910	200810	200803	200703	200603	5 yr CAGR %	
Share Capital	210.0	209.6	208.9	208.7	164.1	161.0		
Networth	3298.5	2345.3	1436.3	1150.8	957.7	653.2		
Capital Employed	3344.5	2348.7	1441.7	1156.5	1004.6	656.9		
Debt	45.4	3.3	5.4	5.7	2.8	3.7		
Sundry Debtors	1205.4	906.4	881.0	580.2	421.0	211.7		
Cash & Bank Balance	178.4	178.6	73.1	95.3	189.3	98.9		
Revenues	5036.5	4263.9	1906.5	2423.1	1760.6	940.1	39.9	
Total Income	5144.5	4320.1	1928.3	2432.0	1768.1	955.0	40.0	
Total Expenditure	3771.6	3144.3	1517.5	2024.6	1467.4	746.7	38.3	
PBIDT	1372.9	1175.8	410.8	407.3	300.7	208.3	45.8	
Interest	-0.8	0.8	0.6	1.0	0.7	0.8		
Depreciation	163.8	202.2	100.5	140.2	101.7	51.8		
APAT	1090.8	908.0	295.3	255.0	180.2	149.8	48.7	
Cash Flow from Operating Activities	840.6	1054.1	176.9	201.1	166.8	165.7		
Cash Flow from Investing Activities	-792.3	-905.9	-120.4	-232.0	-53.9	-156.0		
Cash Flow from Financing Activities	-40.2	-42.7	-78.7	-63.1	-22.5	-6.3		
Free Cash Flows	48.3	148.2	56.5	-30.9	112.9	9.7		
Dividend %	40.0	35.0	20.0	33.0	30.0	30.0		
EPS (Rs.)	52.0	42.8	23.7	11.7	10.3	8.9		
Debt-Equity Ratio	0.2	0.0	0.0	0.0	0.0	0.0		
RoNW %	38.7	48.1	39.2	24.2	22.4	23.3		
Total Asset Turnover Ratio	1.3	1.6	1.1	1.7	1.7	1.2		
Fixed Asset Turnover Ratio	-	3.4	2.9	2.6	2.5	1.6		
PBIDT Margin %	27.3	27.6	21.5	16.8	17.1	22.2		
APAT Margin %	21.7	21.3	15.5	10.5	10.2	15.9		

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