

7 February 2020

## Mphasis

### Order wins cover potential uncertainty from DXC; Buy

At 4.4% q/q (4% CC) to \$318m (up 12.5% y/y, 12.6% CC), Mphasis reported its best q/q growth in the last two years, aided by the Direct International business (73% of revenue, up 6% q/q). DXC/HP's \$84.5m revenue grew 1% q/q (flat CC), 3% y/y. The EBIT margin was 16%, up 34bps q/q. The OB (Direct International) was a robust \$189m (up 9% q/q). We retain our FY20e/21e, with Direct offsetting weakness in DXC, and introduce FY22e, raising our target to ₹1,130 (₹1,000 earlier) valuing it at 16x FY22e EPS. The dividend yield is an attractive 5%.

**Robust deal pipeline to drive better growth in the Direct channel.** Deal wins in Direct International were a strong \$189m (up 55% y/y and 9M FY20 TCV of \$514m) suggesting persistent growth in Direct. While DXC, considering the seasonally soft Q3, is not yet in a declining trend, its business growth should be able to negate the DXC slowdown. We agree about an event risk but our sensitivity suggests that a 6% change in DXC revenue will impact Mphasis' consolidated growth by just 1.5%.

**EBIT margin beats expectation.** Bolstered by currency, SG&A leverage on high revenue growth and higher FPP, the 16% EBIT margin (up 34bps q/q, down 116bps y/y) beat expectations. Q3 utilisation was 83.5%, up 23bps q/q, while net hiring was a restrained 326 (2,805 net adds in 9MFY20). Receivables were stable q/q; hence, cash generation was strong, with a ₹22,094m net cash balance in Q3, heightening expectations of a good payout in FY20.

**Maintaining a Buy; raising TP to ₹1,130.** While the slowing DXC is a concern, we are building in a 3.5% CAGR over the next two years on expectations of DXC turning cost-competitive (DXCs Q3 FY20 results were stable) to the benefit of Mphasis. And, if growth persists for the Direct channel, as suggested by deal wins, Mphasis can maintain its growth rates in double digits. Persistent is also in a similar situation and is trading at 13.5x FY22e PE, similar to that of Mphasis. We find the latter better on its higher growth (1.5x Persistent's) and better client metrics. **Risk:** DXC volatility.

Key financials (YE Mar)	FY18	FY19	FY20e	FY21e	FY22e
Sales (₹ m)	63,776	78,194	88,017	99,059	1,08,790
Net profit (₹ m)	8,376	10,734	11,281	12,133	13,130
EPS (₹)	42.6	56.1	60.7	65.3	70.6
PE (x)	22.1	16.8	15.5	14.4	13.4
EV / EBITDA (x)	18.2	11.5	10.1	9.2	8.5
PBV (x)	3.3	3.4	3.3	3.1	3.0
RoE (%)	14.4	20.0	21.0	21.5	22.2
RoCE (%)	9.8	17.1	16.6	17.0	17.9
Dividend yield (%)	2.1	2.9	4.1	4.5	4.8
Net debt / equity (x)	-0.4	-0.3	-0.3	-0.3	-0.3

Source: Company, Anand Rathi Research

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Rating: **Buy**

Target Price: ₹1,130

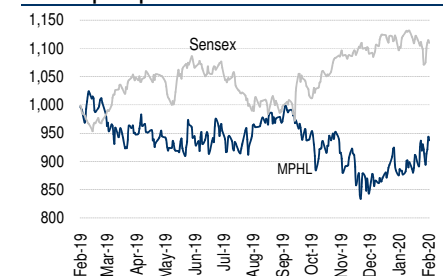
Share Price: ₹933

Key data	MPHL IN / MBFL.BO
52-week high / low	₹1063 / 828
Sensex / Nifty	41142 / 12098
3-m average volume	\$2.7m
Market cap	₹175bn / \$2447.8m
Shares outstanding	186m

Shareholding pattern (%)	Dec'19	Sep'19	Mar'19
Promoters	52.2	52.2	52.3
- of which, Pledged	-	-	-
Free float	47.8	47.8	47.7
- Foreign institutions	28.5	28.8	29.7
- Domestic institutions	13.9	13.7	8.0
- Public	5.3	5.3	10.0

Estimates revision (%)	FY20e	FY21e
Sales(\$)	1.0	1.4
EBIT	2.2	2.6
PAT	4.1	0.7

### Relative price performance



Source: Bloomberg

**Princy Bhansali**  
Research Associate

**Mohit Jain**  
Research Analyst

## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (₹ m)**

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
<b>Revenues (\$ m)</b>	<b>989</b>	<b>1,118</b>	<b>1,246</b>	<b>1,389</b>	<b>1,525</b>
<b>Growth (%)</b>	<b>11</b>	<b>13</b>	<b>11</b>	<b>11</b>	<b>10</b>
Net revenues	63,776	78,194	88,017	99,059	1,08,790
Employee & direct costs	49,341	57,840	65,390	73,952	81,896
Gross profit	14,435	20,354	22,628	25,108	26,894
Gross margins %	22.63	26.03	25.71	25.35	24.72
SG&A	5,492	6,231	6,430	7,344	7,707
<b>EBITDA</b>	<b>8,943</b>	<b>14,123</b>	<b>16,197</b>	<b>17,764</b>	<b>19,187</b>
<b>EBITDA margins (%)</b>	<b>14.0</b>	<b>18.1</b>	<b>18.4</b>	<b>17.9</b>	<b>17.6</b>
- Depreciation	709	759	2,282	2,323	2,323
Other income	3,172	864	1,788	1,291	1,179
Interest expenses	130	155	796	760	760
PBT	11,276	14,073	14,907	15,971	17,283
Effective tax rate (%)	26	24	24	24	24
+ Associates / (Minorities)	-	-	-	-	-
<b>Net income</b>	<b>8,376</b>	<b>10,734</b>	<b>11,281</b>	<b>12,133</b>	<b>13,130</b>
WANS	197	191	186	186	186
<b>FDEPS (₹ / sh)</b>	<b>42.6</b>	<b>56.1</b>	<b>60.7</b>	<b>65.3</b>	<b>70.6</b>

**Fig 3 – Cash-flow statement (₹ m)**

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
PBT	11,276	14,073	14,907	15,971	17,283
+ Non-cash items	339	272	1,423	1,904	1,904
Oper. prof. before WC	11,615	14,345	16,330	17,876	19,187
- Incr. / (decr.) in WC	1,502	1,421	-419	4,266	3,866
Others incl. taxes	-2,783	-3,427	-3,672	-3,603	-3,941
<b>Operating cash-flow</b>	<b>7,330</b>	<b>9,497</b>	<b>13,078</b>	<b>10,007</b>	<b>11,380</b>
- Capex (tang. + intang.)	327	849	1,220	1,373	1,507
<b>Free cash-flow</b>	<b>7,003</b>	<b>8,648</b>	<b>11,858</b>	<b>8,634</b>	<b>9,872</b>
Acquisitions	-	-1,696	-	-	-
- Div. (incl. buyback & taxes)	14,979	14,604	8,737	9,397	10,169
+ Equity raised	29	104	-	-	-
+ Debt raised	1,281	1,246	-	-543	-488
- Fin investments	-5,061	-5,099	-1,329	-2,393	-1,914
- Misc. (CFI + CFF)	-2,529	-552	-155	-419	-419
Net cash-flow	923	-651	4,606	1,506	1,548

Source: Company, Anand Rathi Research

**Fig 5 – Price movement**



Source: Bloomberg

**Fig 2 – Balance sheet (₹ m)**

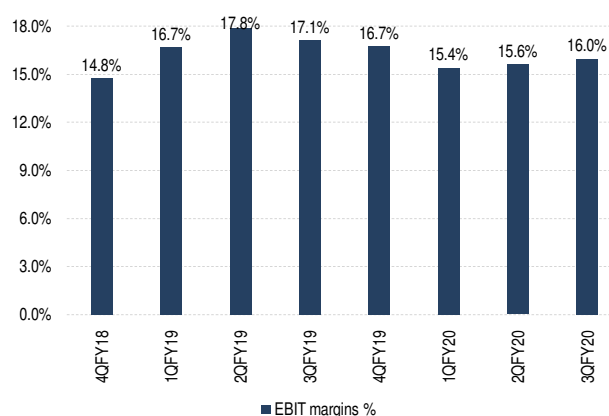
Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
Share capital	1,933	1,862	1,862	1,862	1,862
Net worth	54,818	52,498	55,043	57,779	60,740
Debt	3,899	5,426	5,426	4,883	4,395
Minority interest	-	-	-	-	-
DTL / (Assets)	-5,266	-5,718	-2,695	-2,695	-2,695
<b>Capital employed</b>	<b>53,450</b>	<b>52,206</b>	<b>57,773</b>	<b>59,967</b>	<b>62,440</b>
Net tangible assets	875	1,202	7,087	6,136	5,321
Net intangible assets	17,969	20,509	20,509	20,509	20,509
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	19	16	16	16	16
Investments (strategic)	-	-	-	-	-
<b>Investments (financial)</b>	<b>17,821</b>	<b>13,292</b>	<b>11,963</b>	<b>9,570</b>	<b>7,656</b>
Current assets (ex cash)	20,475	26,231	29,042	32,155	34,894
<b>Cash</b>	<b>7,067</b>	<b>6,416</b>	<b>11,022</b>	<b>12,527</b>	<b>14,076</b>
Current liabilities	10,776	15,460	21,864	20,946	20,030
Working capital	9,699	10,771	7,177	11,209	14,863
<b>Capital deployed</b>	<b>53,450</b>	<b>52,206</b>	<b>57,773</b>	<b>59,967</b>	<b>62,440</b>
Contingent liabilities	17,015	-	-	-	-

**Fig 4 – Ratio analysis**

Year-end: Mar	FY18	FY19	FY20e	FY21e	FY22e
P/E (x)	22.1	16.8	15.5	14.4	13.4
<b>EV / EBITDA (x)</b>	<b>18.2</b>	<b>11.5</b>	<b>10.1</b>	<b>9.2</b>	<b>8.5</b>
EV / Sales (x)	2.5	2.1	1.9	1.6	1.5
P/B (x)	3.3	3.4	3.3	3.1	3.0
<b>RoE (%)</b>	<b>14.4</b>	<b>20.0</b>	<b>21.0</b>	<b>21.5</b>	<b>22.2</b>
RoCE (%) - after tax	9.8	17.1	16.6	17.0	17.9
RoIC (%) - after tax	17.6	27.4	24.9	25.2	25.9
<b>DPS (₹ / sh)</b>	<b>20.0</b>	<b>27.0</b>	<b>39.1</b>	<b>42.0</b>	<b>45.5</b>
Dividend yield (%)	2.1	2.9	4.1	4.5	4.8
Dividend payout (%) - incl. DDT	187.3	148.5	75.0	75.0	75.0
Net debt / equity (x)	-0.4	-0.3	-0.3	-0.3	-0.3
<b>Receivables (days)</b>	<b>78</b>	<b>86</b>	<b>85</b>	<b>85</b>	<b>85</b>
Inventory (days)	-	-	-	-	-
Payables (days)	33	45	37	34	30
<b>CFO : PAT %</b>	<b>87.5</b>	<b>88.5</b>	<b>115.9</b>	<b>82.5</b>	<b>86.7</b>

Source: Company, Anand Rathi Research

**Fig 6 – EBIT margins**



Source: Company

# Result Highlights

## Q3 FY20 Results at a Glance

**Fig 7 – Segment-wise results**

(₹ m)	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q/Q %	Y/Y %
Revenue (\$ m)	283	291	297	305	318	4.4	12.5
<b>Growth Y/Y %</b>	<b>12</b>	<b>10</b>	<b>11</b>	<b>11</b>	<b>13</b>	<b>196 bps</b>	<b>21 bps</b>
Volume growth % est.	6.7	1.4	-0.1	2.6	4.4	181 bps	-227 bps
<b>Revenues (₹ m)</b>	<b>20,028</b>	<b>20,469</b>	<b>20,607</b>	<b>21,462</b>	<b>22,694</b>	<b>5.7</b>	<b>13.3</b>
Eff. exchange rate	70.8	70.2	69.4	70.4	71.3	1.3	0.7
Employees (EoP)	24,215	24,484	25,499	26,963	27,289		
Revenue Productivity (\$ '000/employee)	12.04	12.03	12.13	11.95	11.80	-1.3	-2.0
Gross Utilization % (IT Services)	85.3	84.7	83.7	83.3	83.5	23 bps	-179 bps
CoR (excluding D&A)	(14,789)	(15,280)	(15,340)	(15,956)	(16,893)	5.9	14.2
As % of revenues	-74	-75	-74	-74	-74	-9 bps	-60 bps
SG&A	(1,615)	(1,566)	(1,543)	(1,573)	(1,605)	2.1	-0.6
As % of revenues	-8	-8	-7	-7	-7	25 bps	99 bps
<b>EBITDA</b>	<b>3,624</b>	<b>3,623</b>	<b>3,724</b>	<b>3,933</b>	<b>4,196</b>	<b>6.7</b>	<b>15.8</b>
<b>EBITDA margins %</b>	<b>18.1</b>	<b>17.7</b>	<b>18.1</b>	<b>18.3</b>	<b>18.5</b>	<b>16 bps</b>	<b>39 bps</b>
EBIT	3,428	3,423	3,174	3,351	3,621	8.1	5.6
<b>EBIT margins %</b>	<b>17.1</b>	<b>16.7</b>	<b>15.4</b>	<b>15.6</b>	<b>16.0</b>	<b>34 bps</b>	<b>-116 bps</b>
Other Income	105	114	518	421	421	0.0	301.0
Forex gain / loss	76	(1)	42	49	14	-71.4	-81.6
PBT	3,581	3,477	3,535	3,604	3,866	7.3	8.0
PBT margins %	17.9	17.0	17.2	16.8	17.0	24 bps	-84 bps
Taxes	(801)	(815)	(888)	(871)	(929)	6.7	16.0
ETR %	-22	-23	-25	-24	-24	14 bps	-166 bps
<b>PAT</b>	<b>2,780</b>	<b>2,662</b>	<b>2,647</b>	<b>2,733</b>	<b>2,937</b>	<b>7.5</b>	<b>5.6</b>
<b>PAT margins %</b>	<b>13.9</b>	<b>13.0</b>	<b>12.8</b>	<b>12.7</b>	<b>12.9</b>	<b>21 bps</b>	<b>-94 bps</b>

Source: Company Reports, Anand Rathi Research

**Fig 8 – Quarterly result(₹m)**

Year-end: Mar	Q3 FY20	% Q/Q	% Y/Y	9M FY20	As % of FY20	% Y/Y
Sales (\$ m)	318	4.4	12.5	920	74	11.2
Sales	22,694	5.7	13.3	64,763	74	12.2
EBITDA	4,196	6.7	15.8	11,853	73	12.9
EBITDA margins (%)	18.5	16 bps	39 bps	18.3	99	11 bps
EBIT	3,621	8.1	5.6	10,146	73	2.1
EBIT margins (%)	16.0	34 bps	-116 bps	15.7	99	-155 bps
PBT	3,866	7.3	8.0	11,005	74	3.9
Tax	(929)	6.7	16.0	(2,688)	74	6.5
Tax rate (%)	(24.0)	14 bps	-166 bps	(24.4)	100	-60 bps
Net income	2,937	7.5	5.6	8,317	74	3.0

Source: Company, Anand Rathi Research

## Conference Call Highlights

- The budget commentary from clients suggests that budgets are flat, and moving away from core IT to modernising the old platforms. This is an area of strength for Mphasis.
- It is seeing broad-based growth in BFSI with growth in insurance stemming from the strong deal wins reported last quarter.
- With uncertainty in the UK and Europe now shrinking, the company saw some deal closures that were earlier halted, and is now well set for growth in that region. This is being reported by many other IT companies.
- Digital Risk to see cyclical tailwinds on interest rate-cut cycle in the US and management is positive about sustainably clocking \$28-30m revenue quarterly (as was the case in Q3 ). The growth is likely to persist for at least the next two quarters.
- The company has planned to increase investing in sales and marketing expenses but revenue growth will be able to absorb the increase when measured as percent of revenue and, therefore, not much of an impact on margins.
- Margins in the BFSI segment declined as the top clients went through furloughs but no structural slowdown was seen in the account. Therefore, management expects steady growth in the top accounts.
- Two clients from the Blackstone portfolio have scaled up to the Top-20 bucket.
- DXC is seeking to rationalise its clients in FY21 (highlighted ramp-down in two clients). However, Mphasis believes that of this portfolio that DXC is looking to de-grow, it has limited exposure and, hence, should not greatly impact revenues of Mphasis.
- The workforce is allocated at a centralized level and, hence, if needed, reallocation to direct business can be done quickly.
- No change in payout policy for changes in tax laws. Capital allocation remains the same and cash will be returned to shareholders if not deployed in M&A.

### Outlook

- DXC to clock growth at industry level in FY20 (our est. 7%). Hence, this guidance has little meaning as marginal growth in Q4 would help meet guidance.
- Direct channel to clock above-industry growth rates.
- Margins to be maintained in the 15.5% to 17% band. Any further gains would be re-invested.

## Factsheet

**Fig 9 – Revenue by industry (%)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
BFS	44	44	45	46	46
Insurance	12	12	12	11	11
Information Technology	17	17	17	16	16
Emerging industries	27	26	27	27	28

Source: Company

**Fig 10 – Revenue-split, by service line (%)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
Application Maintenance & Other Services	36	34	33	30	29
Application Development	30	31	33	33	32
Customer Service	1	1	1	1	1
Service / Technical Help Desk	7	7	8	7	8
Transaction Processing Service	6	6	6	7	8
Infrastructure Management Services	13	13	12	13	13
Knowledge Processes	7	8	7	9	9
License Income	-	-	-	-	-

Source: Company

**Fig 11 – Revenue-split, by region (%)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
North America	78	78	78	80	78
India	6	5	5	5	5
APAC (RoW)	5	6	6	5	5
EMEA	11	11	12	10	12

Source: Company

**Fig 12 – Key verticals, horizontals and geographic growth (%)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
<b>Top-five verticals growth (y/y)</b>					
BFS	4	4	5	10	16
Insurance	4	13	15	10	7
Information Technology	31	12	6	5	5
Emerging industries	22	21	22	15	14
<b>Top-five horizontals growth (y/y)</b>					
Application Maintenance & Other Services	23	21	22	-2	-9
Application Development	30	32	30	30	20
Infrastructure Management Services	12	-4	-10	3	13
Knowledge Processes	-29	-26	-30	0	45
Service / Technical Help Desk	-2	-3	11	29	29
Transaction Processing Service					
<b>Y/Y key geographic growth (%)</b>					
North America	10	9	8	11	13
India	12	-8	-8	-8	-6
APAC(ROW)	40	65	121	84	13
EMEA	12	10	21	1	23

Source: Company

**Fig 13 – Revenue-split by delivery type and billing (%)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
Offshore	57.0	58.0	58.0	58.0	58.0
On-site	43.0	42.0	42.0	42.0	42.0

Source: Company

**Fig 14 – Client profiles (LTM)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
<b>Client concentration, %</b>					
Top 1	14.0	14.0	15.0	15.0	14.0
Top 5	46.0	47.0	48.0	49.0	48.0
Top 10	59.0	60.0	61.0	60.0	60.0
Top 20	70.0	70.0	69.0	70.0	69.0
<b>Client bucket growth rates, Q/Q,%</b>					
Top 1	2.6	3.1	9.2	2.6	-2.6
Next 2-5	13.2	6.3	1.9	5.7	4.4
Next 6-10	-11.1	3.1	1.9	-13.2	13.9
Top 20	4.3	4.8	3.6	0.9	4.4
<b>New TCV win(\$ m)</b>	122	146	151	174	189

Source: Company

**Fig 15 – Client profiles (LTM)**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
\$1m+	96	94	96	104	106
\$5m+	33	33	33	35	36
\$10m+	19	17	17	17	17
\$20m+	8	8	8	8	8
<b>Client addition (LTM)</b>					
\$1m+	7	4	3	9	10
\$5m+	-6	-4	-4	-1	3
\$10m+	2	0	-1	-2	-2
\$20m+	0	0	0	0	0

Source: Company

**Fig 16 – Employee movement**

	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20
<b>Number of employees</b>	<b>24,215</b>	<b>24,484</b>	<b>25,499</b>	<b>26,963</b>	<b>27,289</b>
Onsite	5,633	5,421	5,719	5,936	6,095
Offshore	17,365	17,849	18,575	19,820	19,985
S&M	292	293	282	280	280
G&A	925	921	923	927	929
<b>Utilisation % (cum trainees)</b>					
	85.3	84.7	83.7	83.3	83.5

Source: Company

## Valuations

We introduce FY22e and roll forward our target to FY22e EPS. The stock trades at 13x FY22e EPS of ₹70.6. This, we think, is attractive, considering Mphasis' revenue growth is likely to beat that of the industry. While the slowing DXC is a concern, direct business growth should be able to offset the DXC slowdown to a large extent as suggested by strong TCV data and our model sensitivity.

On the other hand, it is unlikely that its EBIT margin will expand from FY19's 17.1% (our estimates: 15.8% for FY20, 15.6% for FY21) but will be maintained largely at FY20 levels. The company is similar to Persistent in how top client exposure is playing out, and both are trading at similar valuations. We, however, believe that Mphasis should trade at a premium as its Direct business is growing much faster than Persistent's and its FCF generation seems to be higher. Consequently, growth at company levels may turn out to be ~1.5 times faster for Mphasis than for Persistent.

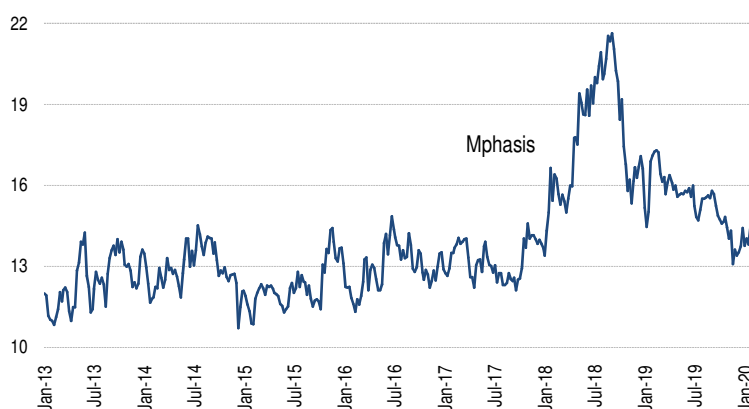
Its FCF-to-PAT conversion had deteriorated in FY19 (65%). This is likely to improve to 105% in FY20, with resultant expectations of a good payout in FY20. Over a longer span, Mphasis generated FCF:NI of ~72%. Considering all these factors, we value it at 16x FY22e (from 15x FY21 earlier), with a revised target price of ₹1,130.

**Fig 17 – Change in estimates**

(Rs. m)	FY20			FY21		
	New	Old	% Change	New	Old	% Change
Revenues (\$m)	1,246	1,234	1.0	1,389	1,369	1.4
Revenues	88,017	86,584	1.7	99,059	96,440	2.7
EBITDA	16,197	15,791	2.6	17,764	17,770	(0.0)
EBITDA margin %	18%	18%	16 bps	18%	18%	-49 bps
EBIT	13,915	13,612	2.2	15,441	15,046	2.6
EBIT margin %	16%	16%	9 bps	16%	16%	-1 bps
PBT	14,907	14,342	3.9	15,971	15,889	0.5
Net Profit	11,281	10,842	4.1	12,133	12,049	0.7

Source: Anand Rathi Research

**Fig 18 – PE band**



Source: Bloomberg, Anand Rathi Research

## Risk

- DXC volatility

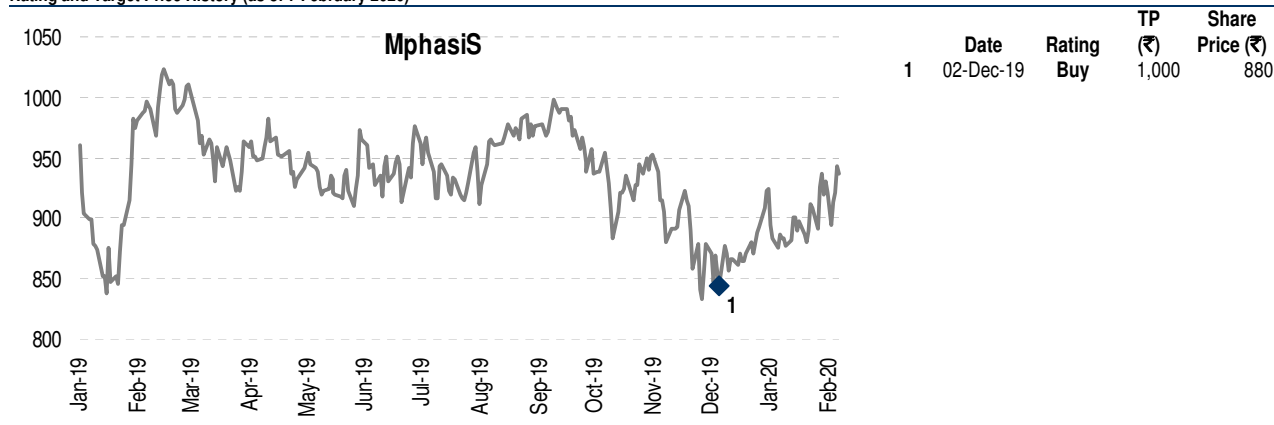
## Appendix

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ARSSBL registered address: Express Zone, A Wing, 9th Floor, Western Express Highway, Diagonally Opposite Oberoi Mall, Malad (E), Mumbai – 400097.  
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