

ADD

TP: Rs 1,050 | ▲ 11%

MPHASIS

| IT Services

| 07 February 2020

Cloudy DXC/HP visibility overshadows strong operating beat

Mphasis (MPHL) reported a beat on both revenue and margins in Q3FY20. Upbeat Digital Risk revenues (+14% QoQ CC) aided a strong showing in the Direct core business. However, DXC/HP channel revenue growth was soft at 0.1% QoQ CC. Management continues to target above-industry growth in the direct core business and industry-level growth in DXC/HP for FY20. We tweak FY21/FY22 earnings by +1%/–1% and roll over to a revised Mar'21 TP of Rs 1,050 (vs. Rs 1,020 earlier). Retain ADD.

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Digital Risk uplifts Q3 performance: MPHL reported an operational beat in Q3 as revenue grew 4% QoQ CC (~2% est.), aided by 4.5% QoQ CC growth in the direct core business. The Digital Risk business grew 14% QoQ CC (partly led by favourable dynamics for the US mortgage market in the Dec'19 quarter), supporting the strong showing in the direct core business. In contrast, DXC/HP channel performance was subdued, with 0.1% QoQ CC revenue growth.

Ticker/Price MPHL IN/Rs 943

Market cap US\$ 2.5bn

Shares o/s 186mn

3M ADV US\$ 2.6mn

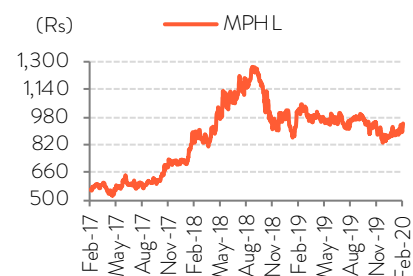
52wk high/low Rs 1,063/Rs 828

Promoter/FPI/DII 52%/29%/14%

Source: NSE

Resilient operating margins: EBIT margin at 16.2% (15.6% est.) was up 10bps QoQ despite annual wage hike headwinds. Annual wage revision will continue to have a lower impact than historical trends as the company has moved to a new deferred wage revision policy in FY20 (aligned with reskilling).

STOCK PERFORMANCE



Source: NSE

Cloudy DXC/HP business visibility: The DXC/HP channel (26.6% of Q3 revenue) has posted tepid growth over the last two quarters, largely due to a sequential decline in non-DXC business (refer Fig 2 & 3). The change of guard at DXC in Sep'19 and subsequent strategy refresh further raises risks for MPHL, given that DXC accounts for a large portion of channel revenue (62% in Q3). MPHL's management sees little impact, citing a status quo on the relationship, and has maintained guidance of above-industry growth in direct core business, industry-level growth in DXC/HP and 15.5-17% EBIT margins for FY20.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	65,459	77,311	88,042	99,612	1,10,610
EBITDA (Rs mn)	10,626	13,240	16,268	18,810	20,761
Adj. net profit (Rs mn)	8,507	10,734	11,225	12,414	13,982
Adj. EPS (Rs)	44.1	57.7	60.3	66.7	75.1
Adj. EPS growth (%)	14.9	30.9	4.6	10.6	12.6
Adj. ROAE (%)	14.6	20.0	20.4	20.5	21.0
Adj. P/E (x)	21.4	16.4	15.6	14.1	12.6
EV/EBITDA (x)	16.2	13.1	10.7	9.3	8.4

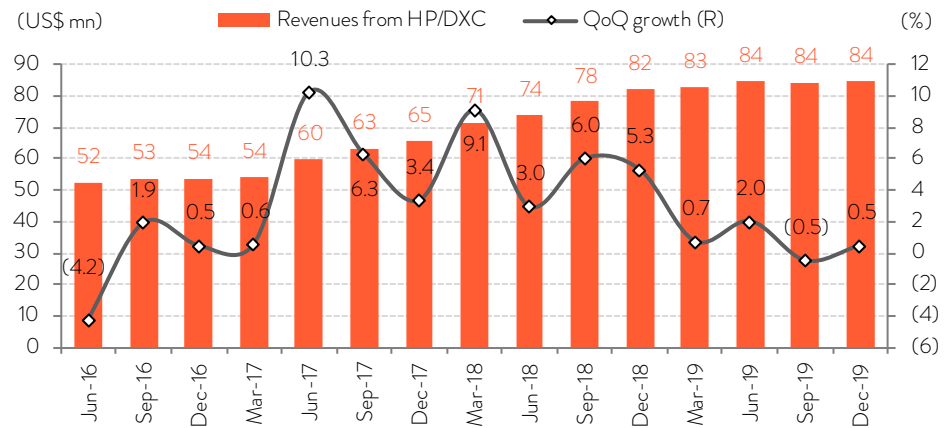
Source: Company, BOBCAPS Research

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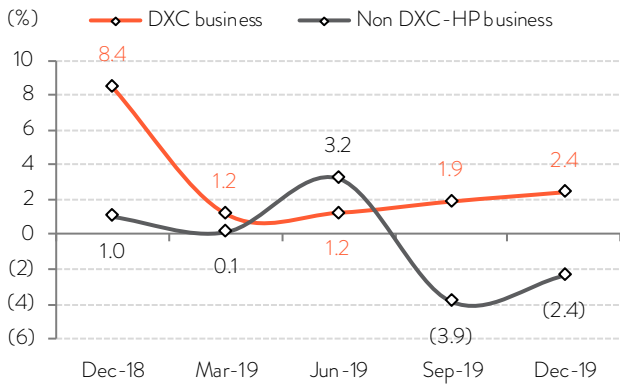


FIG 1 – DXC/HP BUSINESS PERFORMANCE HAS BEEN SOFT...



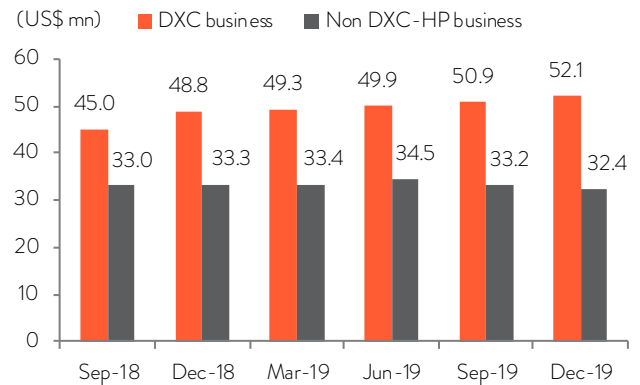
Source: Company, BOBCAPS Research

FIG 2 – ...LED BY CONTINUED WEAKNESS IN NON-DXC REVENUE WITHIN DXC/HP CHANNEL REVENUE



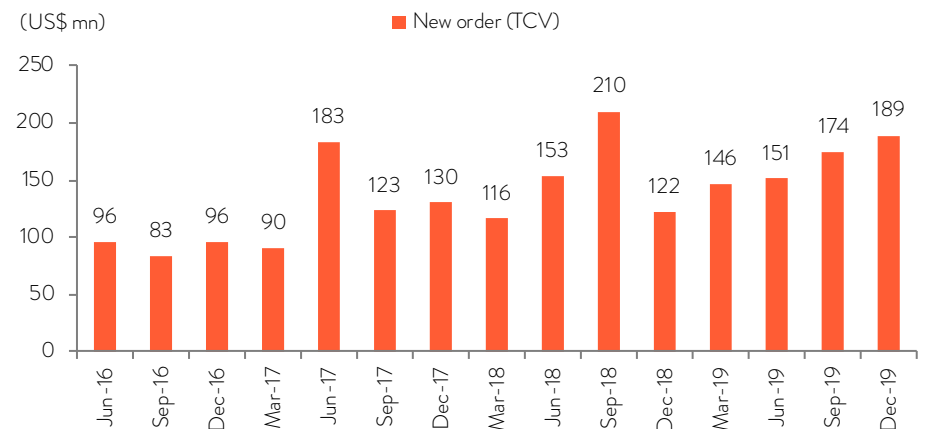
Source: Company, BOBCAPS Research

FIG 3 – DXC REVENUE ACCOUNTED FOR 62% OF DXC/HP CHANNEL REVENUE IN Q3FY20

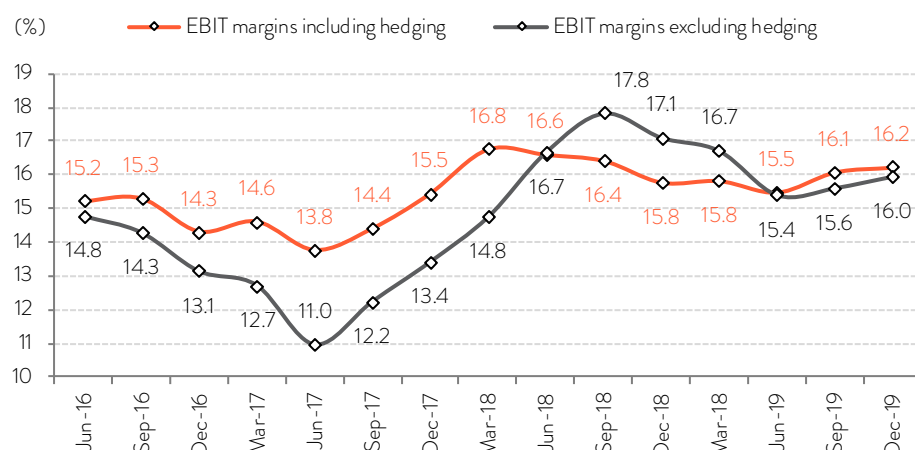


Source: Company, BOBCAPS Research

FIG 4 – HEALTHY DEAL WINS



Source: Company, BOBCAPS Research

FIG 5 – RESILIENT OPERATING MARGINS

Source: Company, BOBCAPS Research

FIG 6 – DEC'19 QUARTER PERFORMANCE

(Rs mn)	Dec'19	Dec'18	YoY (%)	Sep'19	QoQ (%)	9MFY20	9MFY19	YoY (%)
Revenue (US\$ mn)	319	278	14.6	306	4.1	922	818	12.8
Revenue excluding hedging gains/losses (US\$ mn)	318	283	12.4	305	4.3	920	827	11.2
Revenue	22,767	19,710	15.5	21,581	5.5	64,974	57,061	13.9
Revenue excluding hedging gains/losses	22,694	20,028	13.3	21,462	5.7	64,763	57,725	12.2
Operating Expenditure	18,498	16,404	12.8	17,529	5.5	52,910	47,225	12.0
Cost of revenues	16,228	14,204	14.2	15,361	5.6	46,360	40,919	13.3
as % of sales	71.3	72.1	-	71.2	-	71.4	71.7	-
SG&A expenses	2,270	2,200	3.2	2,168	4.7	6,550	6,306	3.9
as % of sales	10.0	11.2	-	10.0	-	10.1	11.1	-
EBITDA	4,269	3,306	29.1	4,052	5.4	12,064	9,836	22.7
Depreciation	575	196	193.4	582	(1.2)	1,707	559	205.4
EBIT	3,694	3,110	18.8	3,470	6.5	10,357	9,277	11.6
Other Income	172	471	(63.5)	134	28.4	648	1,319	(50.9)
PBT	3,866	3,581	8.0	3,604	7.3	11,005	10,596	3.9
Total Tax	929	801	16.0	871	6.7	2,688	2,524	6.5
Adjusted PAT	2,937	2,780	5.7	2,733	7.5	8,317	8,072	3.0
APAT after MI	2,937	2,780	5.7	2,733	7.5	8,317	8,072	3.0
Extra ordinary items	-	-	-	-	-	-	-	-
Reported PAT	2,937	2,780	5.7	2,733	7.5	8,317	8,072	3.0
Reported EPS	14.7	14.4	2.1	14.7	-	44	42	4.3
Margins (%)			(bps)		(bps)			(bps)
EBITDA	18.8	16.8	200	18.8	-	18.6	17.2	130
EBIT	16.2	15.8	40	16.1	10	15.9	16.3	(30)
EBT	17.0	18.2	(120)	16.7	30	16.9	18.6	(160)
PAT	12.9	14.1	(120)	12.7	20	12.8	14.1	(130)
Effective Tax rate	24.0	22.4	170	24.2	(10)	24.4	23.8	60

Source: Company, BOBCAPS Research

FIG 7 – DEC'19 OPERATING METRICS

Particulars	Q3FY20 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by business segments (US\$ terms)			
HP Channel	27	0.5	2.8
Digital Risk*	9	34.2	41.4
Direct Channel (ex-Digital Risk)	65	2.8	13.7
Revenue by Vertical (Rs terms)			
Banking and Capital Markets	45.4	5.0	17.0
Insurance	11.2	5.8	7.8
Information Technology, communication & Entertainment	15.7	3.1	5.8
Emerging Industries	27.4	8.6	14.3
Revenue by Service Type (Rs terms)			
App Maintenance & Other services	28.6	(0.3)	(9.6)
App Development	32.2	2.0	22.3
Customer Service	1.2	18.0	21.2
Service/Tech Helpdesk	9.1	12.7	53.1
Transaction Processing service	7.8	24.2	42.1
Infra Mgmt services	13.0	9.4	16.3
Knowledge Process	9.1	33.7	39.5
IT services-Client Concentration (Rs terms)			
Top client contribution to revenues	14.0	(1.5)	15.5
Top 5 client contribution to revenues	48.0	3.3	20.5
Top 10 client contribution to revenues	60.0	5.5	17.5
Total Employees	27,289	1.2	12.7
Revenue by Project Type		(bps)	(bps)
T & M	73	(100)	(300)
Fixed price	27	100	300

Source: Company, BOBCAPS Research | *Based on BOBCAPS estimates as MPHL does not make separate disclosures for Digital Risk. In its earnings call, management said Digital Risk revenue grew 14%+ QoQ CC in Q3FY20.

Valuation methodology

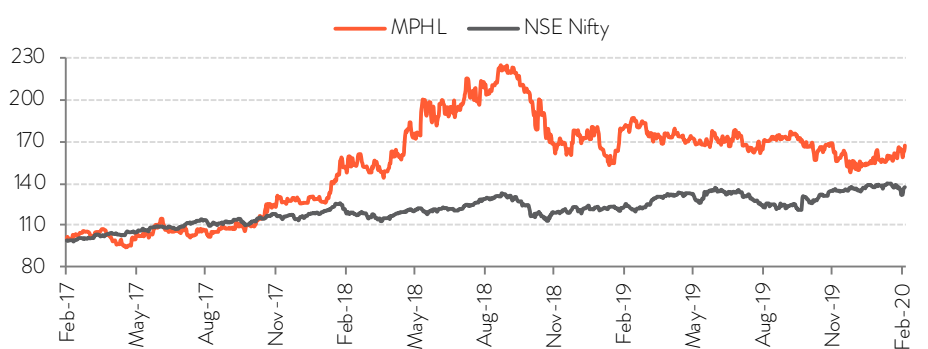
We tweak our FY21/FY22 EPS estimates by +1/-1% as we accommodate the Dec'19 quarter performance. Over FY20-FY22, we build in a dollar revenue/EBIT CAGR of 12.3%/14%. Retain ADD with a revised Mar'21 target price of Rs 1,050 (vs. Rs 1,020 earlier), set at a target one-year forward P/E of 15x, the average multiple under Blackstone ownership.

FIG 8 – REVISED EARNINGS

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Reported Revenues (US\$ mn)	1,237	1,252	1.2	1,388	1,423	2.5	1,545	1,580	2.2
YoY (%)	11.8	13.2	-	12.3	13.7	-	11.3	13.8	-
Revenues (ex-hedging, US\$ mn)	1,237	1,252	1.2	1,388	1,423	2.5	1,545	1,580	2.2
Revenues	86,518	88,042	1.8	97,186	99,612	2.5	1,08,185	1,10,610	2.2
EBIT	13,486	13,982	3.7	16,127	16,211	0.5	18,276	18,162	(0.6)
EBIT margins (%)	15.6	15.9	-	16.6	16.3	-	16.9	16.4	-
Net Profits	10,761	11,225	4.3	12,353	12,414	0.5	14,076	13,982	(0.7)
EPS (Rs)	57.8	60.3	4.3	66.4	66.7	0.5	75.6	75.1	(0.7)

Source: BOBCAPS Research

FIG 9 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- In the past, MPHL had suffered adversely due to high HP/DXC channel revenue concentration. Unfavourable changes in HP/DXC and Blackstone portfolio company relationships could pose downside risks to our estimates.
- Inability of the company to arrest the sharp decline in Digital Risk revenues, adverse currency movements, and a steep decline in IT spending at other clients could also adversely impact financial performance.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	65,459	77,311	88,042	99,612	1,10,610
EBITDA	10,626	13,240	16,268	18,810	20,761
Depreciation	709	759	2,286	2,599	2,599
EBIT	9,917	12,481	13,982	16,211	18,162
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	1,490	1,592	901	341	480
Exceptional items	0	0	0	0	0
EBT	11,407	14,073	14,883	16,552	18,642
Income taxes	2,900	3,339	3,657	4,138	4,660
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,507	10,734	11,225	12,414	13,982
Adjustments	0	0	0	0	0
Adjusted net profit	8,507	10,734	11,225	12,414	13,982

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	10,842	11,687	13,267	15,010	16,667
Provisions	245	3,100	3,618	4,094	4,546
Debt funds	3,898	5,428	11,332	11,332	11,332
Other liabilities	49	28	28	28	28
Equity capital	1,932	1,862	1,862	1,862	1,862
Reserves & surplus	52,883	50,636	55,780	61,468	67,874
Shareholders' fund	54,815	52,498	57,642	63,330	69,736
Total liabilities and equities	69,849	72,741	85,886	93,793	1,02,309
Cash and cash eq.	4,641	6,572	9,521	13,905	18,960
Accounts receivables	8,127	8,620	11,096	12,554	13,940
Inventories	0	0	0	0	0
Other current assets	10,923	21,339	24,121	27,291	30,304
Investments	26,245	13,292	13,292	13,292	13,292
Net fixed assets	1,824	2,113	7,051	5,947	5,007
CWIP	19	406	406	406	406
Intangible assets	17,014	19,585	19,585	19,585	19,585
Deferred tax assets, net	1,056	814	814	814	814
Other assets	0	0	0	0	0
Total assets	69,849	72,741	85,886	93,793	1,02,309

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	9,331	11,405	13,512	15,013	16,580
Interest expenses	(96)	(98)	(901)	(341)	(480)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,503)	(1,421)	(3,160)	(2,409)	(2,290)
Other operating cash flows	(404)	(389)	0	0	0
Cash flow from operations	7,330	9,497	9,451	12,263	13,810
Capital expenditures	(313)	(815)	(1,321)	(1,494)	(1,659)
Change in investments	7,366	5,725	0	0	0
Other investing cash flows	(2,076)	(2,111)	901	341	480
Cash flow from investing	4,977	2,798	(420)	(1,154)	(1,179)
Equities issued/Others	29	104	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	(9,877)	(8,867)	0	0	0
Dividends paid	(3,949)	(4,655)	(6,082)	(6,726)	(7,575)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(13,797)	(13,418)	(6,082)	(6,726)	(7,575)
Changes in cash and cash eq.	(1,491)	(1,122)	2,949	4,384	5,056
Closing cash and cash eq.	4,642	6,572	9,521	13,905	18,960

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	44.1	57.7	60.3	66.7	75.1
Adjusted EPS	44.1	57.7	60.3	66.7	75.1
Dividend per share	20.0	0.0	27.1	30.0	33.8
Book value per share	283.9	282.0	309.6	340.2	374.6

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.6	2.2	2.0	1.8	1.6
EV/EBITDA	16.2	13.1	10.7	9.3	8.4
Adjusted P/E	21.4	16.4	15.6	14.1	12.6
P/BV	3.3	3.3	3.0	2.8	2.5

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	74.6	76.3	75.4	75.0	75.0
Interest burden (PBT/EBIT)	115.0	112.8	106.4	102.1	102.6
EBIT margin (EBIT/Revenue)	15.1	16.1	15.9	16.3	16.4
Asset turnover (Revenue/Avg TA)	91.5	108.4	111.0	110.9	112.8
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.4	1.5	1.5
Adjusted ROAE	14.6	20.0	20.4	20.5	21.0

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	7.7	18.1	13.9	13.1	11.0
EBITDA	9.7	24.6	22.9	15.6	10.4
Adjusted EPS	14.9	30.9	4.6	10.6	12.6
Profitability & Return ratios (%)					
EBITDA margin	16.2	17.1	18.5	18.9	18.8
EBIT margin	15.1	16.1	15.9	16.3	16.4
Adjusted profit margin	13.0	13.9	12.8	12.5	12.6
Adjusted ROAE	14.6	20.0	20.4	20.5	21.0
ROCE	13.2	18.0	19.0	20.2	22.2
Working capital days (days)					
Receivables	40	40	41	43	44
Inventory	0	0	0	0	0
Payables	63	75	71	72	72
Ratios (x)					
Gross asset turnover	32.3	39.3	19.2	15.3	20.2
Current ratio	2.1	2.5	2.6	2.8	3.0
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	0.0	0.0	(0.1)

Source: Company, BOBCAPS Research

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

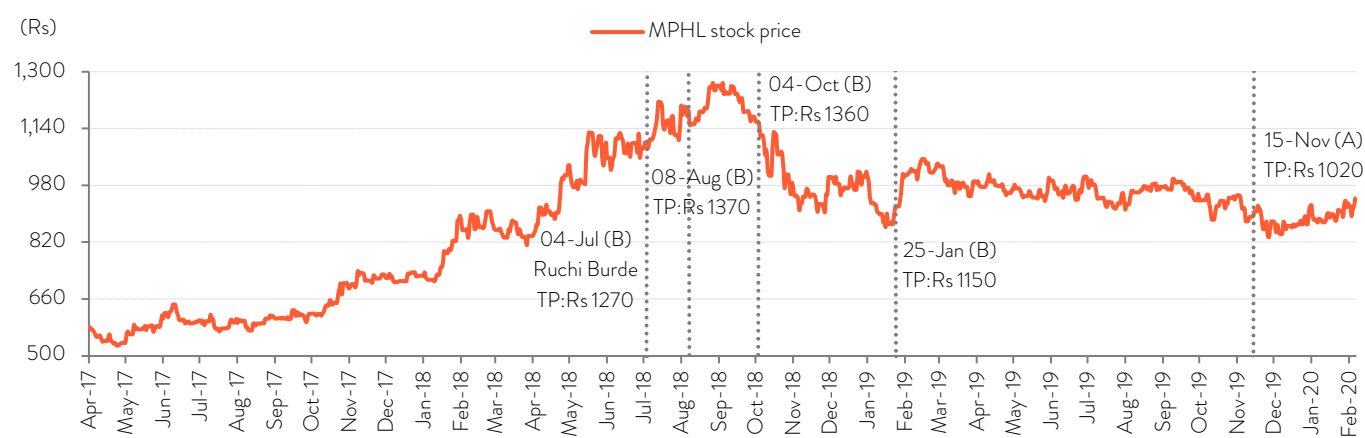
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: MPHASIS (MPHL IN)



B – Buy, A – Add, R – Reduce, S – Sell

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