

ADD

TP: Rs 1,020 | ▲ 14%

MPHASIS

| IT Services

| 15 November 2019

Cut to ADD on HP/DXC channel uncertainty

Mphasis' (MPHL) Q2FY20 revenue at US\$ 306mn met estimates, marked by strong traction in the direct channel business. HP/DXC channel revenues fell QoQ after 12 consecutive growth quarters. Management is targeting above-industry growth in the direct core business and industry-level growth in DXC/HP for FY20. Amid an uncertain outlook on HP/DXC post the latter's change of guard, we reset our target P/E from 15x to 14x, yielding a new Sep'20 TP of Rs 1,020 (vs. Rs 1,150), and trim our rating a notch to ADD (vs. BUY).

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In-line operating performance: MPHL reported 3.1% QoQ CC revenue growth, largely in line with our estimate of 2.9%, on the back of strong traction in the direct channel business. Direct channel dollar revenue increased by 3.9% QoQ while HP/DXC dollar revenue declined sequentially by 0.5%. We highlight that this marks the first quarter of sequential revenue decline in the HP/DXC business post the MSA (master service agreement) with MPHL in Q1FY17. EBIT margin came in at 16.1% (+60bps QoQ) vs. our estimate of 16.6%.

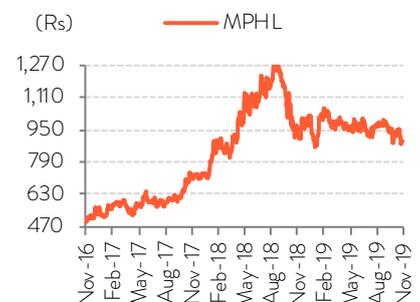
Guidance intact: Management maintained its guidance of above-industry growth in the direct core business, industry-level growth in DXC/HP and 15.5-17% EBIT margins for FY20.

Change of guard and strategy at DXC Tech: In mid-Sep'19, DXC Technology announced the appointment of a new CEO who last week set out a bold strategy that includes the divestment of three business units (a fourth of revenues). This change of guard and strategy raises risks for MPHL considering that the HP/DXC business accounts for 27.6% in Q2FY20 of its revenue. MPHL's management sees little impact, citing a status quo on the relationship and insignificant exposure to the business identified for divestment.

Ticker/Price	MPHL IN/Rs 893
Market cap	US\$ 2.3bn
Shares o/s	186mn
3M ADV	US\$ 2.0mn
52wk high/low	Rs 1,063/Rs 858
Promoter/FPI/DII	52%/29%/14%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	65,459	77,311	86,518	97,186	1,08,185
EBITDA (Rs mn)	10,626	13,240	15,700	18,712	20,860
Adj. net profit (Rs mn)	8,507	10,734	10,877	12,355	14,078
Adj. EPS (Rs)	44.1	57.7	58.4	66.4	75.6
Adj. EPS growth (%)	14.9	30.9	1.3	13.6	13.9
Adj. ROAE (%)	14.6	20.0	19.8	20.5	21.2
Adj. P/E (x)	20.3	15.5	15.3	13.5	11.8
EV/EBITDA (x)	15.3	12.5	10.5	9.0	7.8

Source: Company, BOBCAPS Research

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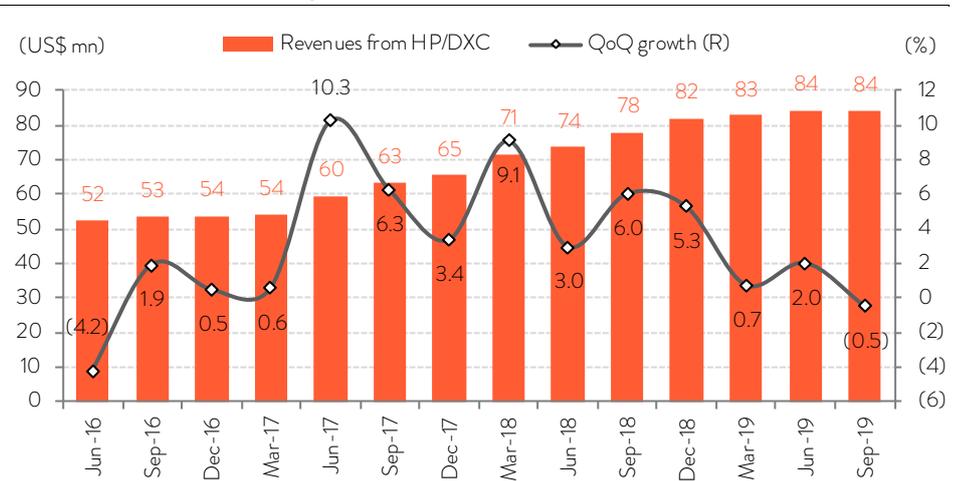
Important disclosures, including any required research certifications, are provided at the end of this report.



Earnings call highlights

- HP/DXC channel:** Management indicated that the business relationship remains unchanged despite the change of guard at DXC Tech.
- BFSI:** We highlight the steady traction in BFSI (+3.9% QoQ in dollar terms in Q2) and absence of client-specific concerns, which contrasts with the growth challenges and soft BFSI commentary from peers. Management credits this to its differentiated capabilities in designing unique solutions for clients and lack of exposure to cyclical subsegments of the BFSI industry.
- Deal wins:** MPHL won deal TCV of US\$ 174mn in Q2, up 15.2% QoQ, rounding off H1FY20 at US\$ 325mn (-10% YoY). Management indicated that 80% of the signings in H1 were proactive deals.
- Digital Risk:** Falling interest rates in the US position Digital Risk, the company’s mortgage services business, favourably. Management expects quarterly revenues in the range of US\$ 28mn-30mn, continued sequential growth and a sustainable turnaround beyond the near term.
- Wage revision:** MPHL indicated that the impact of annual wage revisions due in Q3FY20 will be lower as the company had launched skill-linked wage revisions at the start of FY20.

FIG 1 – HP/DXC REVENUE CONTRACTED SEQUENTIALLY – FIRST QOQ DECLINE POST MSA IN Q1FY17



Source: Company, BOBCAPS Research

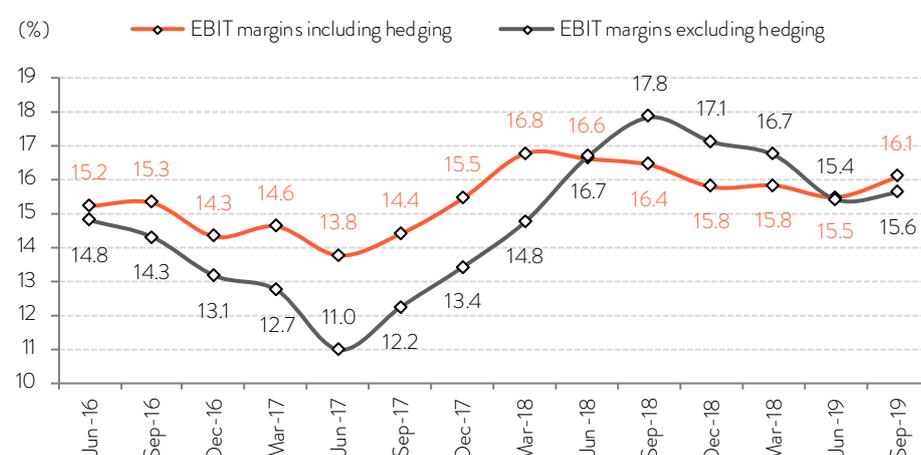
FIG 2 – ASSUMING NIL HP/DXC CHANNEL BUSINESS GROWTH, MPHIL WILL REQUIRE 18-26% DIRECT CHANNEL GROWTH TO ACHIEVE RUN-RATE ABOVE 10%

Scenario analysis	FY19
% of revenue from HP/DXC	28.3
% of revenue from Direct channel	71.7

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Assumption – No growth in HP/DXC channel business				
Company revenue growth rate (%)	10	13	16	19
Required Direct channel growth rate (%)	14	18	22	26

Source: BOBCAPS Research

FIG 3 – ANNUAL WAGE REVISION TO HIT OPERATING MARGINS IN Q3FY20



Source: Company, BOBCAPS Research

FIG 4 – SEP'19 QUARTER PERFORMANCE

(Rs mn)	Jun'18	Sep'18	Dec'18	Mar'19	Jun'19	Sep'19	YoY (%)	QoQ (%)	H1FY19	H1FY20	YoY (%)
Revenue (US\$ mn)	268	271	278	289	297	306	13.1	3.1	539	604	11.9
Revenue excluding hedging gains/losses (US\$ mn)	269	276	283	292	297	305	10.6	2.6	544	602	10.5
Revenue	18,202	19,149	19,710	20,250	20,626	21,581	12.7	4.6	37,351	42,207	13.0
Revenue excluding hedging gains/losses	18,218	19,479	20,028	20,469	20,607	21,462	10.2	4.1	37,697	42,069	11.6
Operating Expenditure	15,001	15,820	16,404	16,846	16,883	17,529	10.8	3.8	30,821	34,412	11.7
Cost of revenues	12,945	13,770	14,204	14,815	14,771	15,361	11.6	4.0	26,715	30,132	12.8
as % of sales	71.1	71.9	72.1	73.2	71.6	71.2	-	-	71.5	71.4	-
SG&A expenses	2,056	2,050	2,200	2,031	2,112	2,168	5.8	2.7	4,106	4,280	4.2
as % of sales	11.3	10.7	11.2	10.0	10.2	10.0	-	-	11.0	10.1	-
EBITDA	3,201	3,329	3,306	3,404	3,743	4,052	21.7	8.3	6,530	7,795	19.4
Depreciation	179	184	196	200	550	582	216.3	5.8	363	1,132	211.8
EBIT	3,022	3,145	3,110	3,204	3,193	3,470	10.3	8.7	6,167	6,663	8.0
Other Income	407	441	471	273	342	134	(69.6)	(60.8)	848	476	(43.9)
PBT	3,429	3,586	3,581	3,477	3,535	3,604	0.5	2.0	7,015	7,139	1.8
Total Tax	846	877	801	815	888	871	(0.7)	(1.9)	1,723	1,759	2.1

(Rs mn)	Jun'18	Sep'18	Dec'18	Mar'19	Jun'19	Sep'19	YoY (%)	QoQ (%)	H1FY19	H1FY20	YoY (%)
Adjusted PAT	2,583	2,709	2,780	2,662	2,647	2,733	0.9	3.3	5,292	5,380	1.7
APAT after MI	2,583	2,709	2,780	2,662	2,647	2,733	0.9	3.3	5,292	5,380	1.7
Extraordinary items	-	-	-	-	-	-	-	-	-	-	-
Reported PAT	2,583	2,709	2,780	2,662	2,647	2,733	0.9	3.3	5,292	5,380	1.7
Reported EPS	13.4	14.0	14.4	14.3	14.2	14.7	5.0	3.5	27	29	5.5
Margins (%)							(bps)	(bps)			(bps)
EBITDA	17.6	17.4	16.8	16.8	18.1	18.8	140	60	17.5	18.5	100
EBIT	16.6	16.4	15.8	15.8	15.5	16.1	(30)	60	16.5	15.8	(70)
EBT	18.8	18.7	18.2	17.2	17.1	16.7	(200)	(40)	18.8	16.9	(190)
PAT	14.2	14.1	14.1	13.1	12.8	12.7	(150)	(20)	14.2	12.7	(140)
Effective Tax rate	24.7	24.5	22.4	23.4	25.1	24.2	(30)	(100)	24.6	24.6	10

Source: Company, BOBCAPS Research

FIG 5 – SEP'19 QUARTER OPERATING METRICS

	Q2FY20 (% Contr. to Revenue)	(Growth %)	
		QoQ	YoY
Revenue by Business Segment (US\$ terms)			
HP Channel	28	(0.5)	7.7
Digital Risk	7	(1.2)	(20.0)
Direct Channel (ex-Digital Risk)	66	4.4	16.4
Revenue by Vertical (Rs terms)			
Banking and Capital Markets	46	6.8	10
Insurance	11	0.3	10
Information Technology, communication & Entertainment	16	1.3	4
Emerging Industries	27	3.1	15
Revenue by Service Type (Rs terms)			
App Maintenance & Other services	30	(2)	(3)
App Development	33	5	33
Customer Service	1	(3)	15
Service/Tech Helpdesk	9	19	46
Transaction Processing service	7	9	17
Infra Mgmt services	13	7	(2)
Knowledge Process	7	0	(19)
IT Services Client Concentration (Rs terms)			
Top client contribution to revenues	15	5	21
Top 5 client contribution to revenues	49	7	28
Top 10 client contribution to revenues	60	3	17
Total employees (nos)	26,963	5.7	14.8
Revenue by Project Type		(bps)	(bps)
T & M	74	(200)	(100)
Fixed price	26	200	100

Source: Company, BOBCAPS Research

Valuation methodology

We lower our FY20/FY21/FY22 EPS estimates by 6%/3%/2% and build in a dollar revenue/EPS CAGR of 11.8%/13.8% over FY20-FY22. We turn cautious on the stock given an uncertain HP/DXC business outlook and its diminishing margin of safety (since Q2FY17, MPHL has already booked US\$ 906mn in revenue from the HP/DXC channel vs. a minimum commitment of US\$ 990mn over five years). Recommend ADD vs. BUY earlier with a revised Sep'20 target price of Rs 1,020 (Rs 1,150 earlier), set at 14x P/E vs. an average of ~15x under Blackstone ownership.

FIG 6 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Reported Revenues (US\$ mn)	1,251	1,237	(1.1)	1,400	1,388	(0.8)	1,562	1,545	(1.0)
YoY (%)	13.1	11.8	--	12.0	12.3	-	11.5	10.4	-
Revenues (ex-hedging, US\$ mn)	1,251	1,237	(1.1)	1,400	1,388	(0.8)	1,562	1,545	(1.0)
Revenues	86,414	86,518	0.1	98,009	97,186	(0.8)	1,09,310	1,08,185	(1.0)
EBIT	14,265	13,486	(5.5)	16,028	16,127	0.6	18,086	18,276	1.1
EBIT margins (%)	16.5	15.6		16.4	16.6	-	16.5	16.9	-
Net Profits	11,521	10,877	(5.6)	12,754	12,355	(3.1)	14,378	14,078	(2.1)
EPS (Rs)	61.9	58.4	(5.6)	68.5	66.4	(3.1)	77.2	75.6	(2.1)

Source: BOBCAPS Research

FIG 7 – 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	86,518	97,186	1,08,185
EBITDA	10,626	13,240	15,700	18,712	20,860
Depreciation	709	759	2,213	2,584	2,584
EBIT	9,917	12,481	13,486	16,127	18,276
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	1,490	1,592	982	346	494
Exceptional items	0	0	0	0	0
EBT	11,407	14,073	14,468	16,473	18,770
Income taxes	2,900	3,339	3,591	4,118	4,693
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	8,507	10,734	10,877	12,355	14,078
Adjustments	0	0	0	0	0
Adjusted net profit	8,507	10,734	10,877	12,355	14,078

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	13,037	14,644	16,302
Provisions	245	3,100	3,556	3,994	4,446
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	55,620	61,281	67,731
Shareholders' fund	54,815	52,498	57,482	63,143	69,593
Total liabilities and equities	69,849	72,741	85,434	93,141	1,01,701
Cash and cash eq.	4,641	6,572	9,629	14,195	19,317
Accounts receivables	8,127	8,620	10,904	12,248	13,634
Inventories	0	0	0	0	0
Other current assets	10,923	21,339	23,704	26,626	29,640
Investments	26,245	13,292	13,292	13,292	13,292
Net fixed assets	1,824	2,113	7,102	5,975	5,014
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	85,434	93,141	1,01,701

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	9,331	11,405	13,090	14,939	16,662
Interest expenses	(96)	(98)	(982)	(346)	(494)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,503)	(1,421)	(2,843)	(2,221)	(2,290)
Other operating cash flows	(404)	(389)	0	0	0
Cash flow from operations	7,330	9,497	9,265	12,372	13,878
Capital expenditures	(313)	(815)	(1,298)	(1,458)	(1,623)
Change in investments	7,366	5,725	0	0	0
Other investing cash flows	(2,076)	(2,111)	982	346	494
Cash flow from investing	4,977	2,798	(316)	(1,112)	(1,128)
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)	(5,893)	(6,694)	(7,627)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(13,797)	(13,418)	(5,893)	(6,694)	(7,627)
Changes in cash and cash eq.	(1,491)	(1,122)	3,056	4,566	5,122
Closing cash and cash eq.	4,642	6,572	9,629	14,195	19,317

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	44.1	57.7	58.4	66.4	75.6
Adjusted EPS	44.1	57.7	58.4	66.4	75.6
Dividend per share	20.0	0.0	26.3	29.9	34.0
Book value per share	283.9	282.0	308.8	339.2	373.9

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.5	2.1	1.9	1.7	1.5
EV/EBITDA	15.3	12.5	10.5	9.0	7.8
Adjusted P/E	20.3	15.5	15.3	13.5	11.8
P/BV	3.1	3.2	2.9	2.6	2.4

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	74.6	76.3	75.2	75.0	75.0
Interest burden (PBT/EBIT)	115.0	112.8	107.3	102.1	102.7
EBIT margin (EBIT/Revenue)	15.1	16.1	15.6	16.6	16.9
Asset turnover (Revenue/Avg TA)	91.5	108.4	109.4	108.8	111.0
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.4	1.5	1.5
Adjusted ROAE	14.6	20.0	19.8	20.5	21.2

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	11.9	12.3	11.3
EBITDA	9.7	24.6	18.6	19.2	11.5
Adjusted EPS	14.9	30.9	1.3	13.6	13.9
Profitability & Return ratios (%)					
EBITDA margin	16.2	17.1	18.1	19.3	19.3
EBIT margin	15.1	16.1	15.6	16.6	16.9
Adjusted profit margin	13.0	13.9	12.6	12.7	13.0
Adjusted ROAE	14.6	20.0	19.8	20.5	21.2
ROCE	13.2	18.0	18.3	20.2	22.5
Working capital days (days)					
Receivables	40	40	41	43	44
Inventory	0	0	0	0	0
Payables	63	75	70	71	72
Ratios (x)					
Gross asset turnover	32.3	39.3	18.8	14.9	19.7
Current ratio	2.1	2.5	2.7	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

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

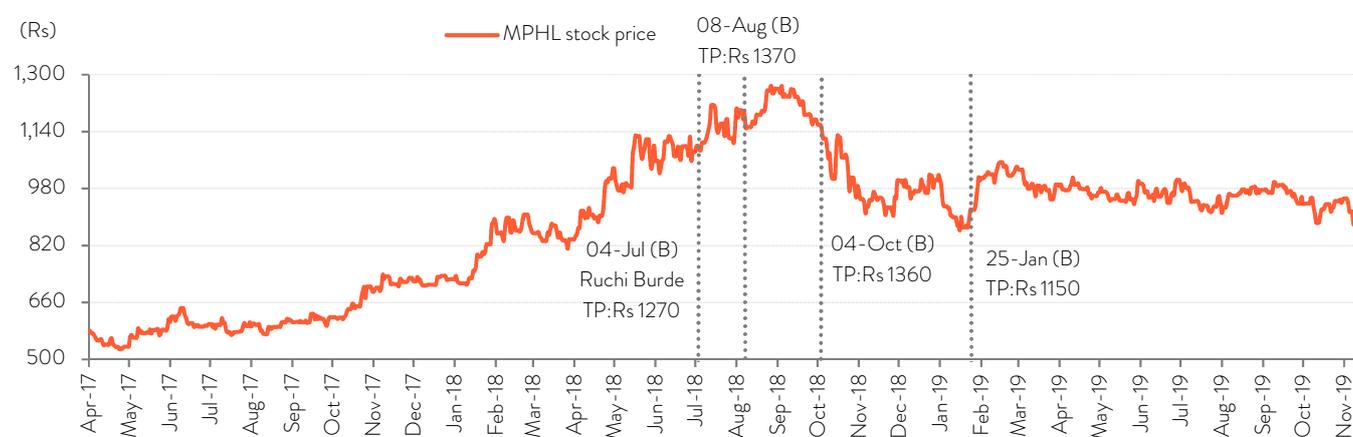
ADD – Expected return from >+5% to +15%

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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