

Company Report

Key Data

CMP	513
Target Price	544
Bloomberg Code	MTCL In
Reuters Code	MINT.BO
BSE Code	532819
NSE Code	Mindtree
Face Value	10
Market Cap	208,669 Lacs
52 Week High/Low	729/491

Share Holding	%
Promoters	32.3
Banks / FI's / MF	5.6
FII's/ NRI's	30.1
Corporates	17.4
Public & Others	14.8

We initiate coverage on MindTree Ltd. (MTL) with "Hold" recommendation and price target of Rs. 544 per share. We are valuing the business at Rs. 544 per share by assigning 12 P/E multiple to its FY12E EPS of Rs.45.35. We expect, MTL's IT service business will underperform tier I Indian IT companies (in terms of revenue growth) over the span of next two years i.e. from FY10 to FY12E because of its relatively higher dependence on traditional service lines and significant dependence on USA as its major market of revenues. We have assumed MTL will capture 1-2% market of android-based phones in US and India.

Forayed into Smart Phone Business

MTL has entered into smart-phone space after acquiring Kyocera Wireless (India) Pvt. Ltd. (KWIL) in October 2009. Phone will be sold on fixed margin basis to telecom service provider or mobile phone vendor. At present it's working on one model and plans to spend around USD11 million on building the product. We expect, smart-phone business will drag overall return ratio of the company, as this business being competitive and products have low-shelf life.

Pressure building on operating margin

MTL has one of the highest offshore effort mixes among its peer and hence it will be the most impacted in the scenario of double-digit wage inflation for offshore based employees. Further, the company is currently operating at near peak utilization rate (including trainees) and employees under training are close to the bottom level. Whereas, employee attrition rate is expected to be around 20% (on annualized basis) in 1Q FY11. Taking into account, double digit wage inflation (for offshore based employees) and dip in utilization rate, going forward, operating margin will be under pressure.

Company Background

MindTree Ltd. (MTL), incorporated in 1999 by ten IT professionals, provides end-to end IT services. The company has a team of 8300 professionals serving 258 clients across geographies and industries. It is a global IT Solutions company specializing in IT Services, Independent Testing, Infrastructure Management and Technical Support (IMTS), Knowledge Services and Product Engineering, which comprises of R&D Services, Software Product Engineering and Next In Wireless.

MindTree is a one of the best-diversified player in mid-cap IT space, similar to large cap peers. Revenues are well diversified in terms of a) Verticals contribution, b) Service lines and c) Client contribution.

The company has recently forayed into knowledge process outsourcing (KPO), however so far it has been unable to make any significant headway in this space.

MINDTREE'S VISION

MindTree has set up an ambitious target of becoming a \$1-billion (around Rs 4,600-crore) company by 2014. The company achieved revenue of \$269 million (Rs 1,237 crore) for the FY09. The rate required to achieve \$1-billion revenue is over 35% as against, the IT sector is expected to grow only 12-13% for FY11E. Similar kind of ambitious target (\$200 million (around Rs. 960 cr) in five years) was set by Mindtree when it was just three years old with an \$18 mn revenue. But, they nearly reached the target of it with the growth of 11 times. MindTree has identified Middle East IT services market, as one of its fastest growing regions, which is expected to hit US\$ 3.5 billion by 2011, according to recent reports from the Economist Intelligence Unit (EIU). MindTree sees the Middle East region to play a key role in its plan to become a US\$ 1 billion organization

Relatively higher exposure to traditional service lines

MTL has relatively higher exposure to traditional service lines (i.e. ADM) among its peer sets. These service lines are highly commoditized leading to stiff competition and resultant adverse impact on billing rate and margin. Further, Indian IT service Industry has captured nearly 1/3rd global market in these service lines and in coming years growth opportunity for Indian IT companies in ADM is expected to be almost half of that in emerging IT service lines (Source-IDC). MTL dependence on ADM has taken toll on its growth rate compared to Indian IT industry (excluding hardware) over the span of last three financial years. Going forward, because of the relatively higher dependence on slower growth areas (i.e. ADM) we expect the company's growth rate will continue to lag Tier I Indian IT companies.

Adopted inorganic route for diversifying into emerging service lines

Service Category	Company Acquired	Year of Acquisition	Purchase Price(Rs. Millions)

ERP	ASAP Solutions Pvt. Ltd.	FY05	32
Product engineering	TES-Purple Vision	FY08	259
Testing	Aztec Soft	FY09	3194
Smart-phone business	Kyocera Wireless India Pvt. Ltd.	FY10	436
Infrastructure Management Services (IMS)	7Strata	FY11	72

Despite company's effort to diversify into non-ADM space through acquisition, it has been unable to significantly increase revenue share from non-ADM space except testing service lines.

Aggressive accounting policy

MTL follows the practice of setting off the goodwill arising on amalgamation against the securities premium account. However, prudent accounting treatment requires amortization of goodwill through profit and loss account over the span of five years. In comparison to standard accounting practice of amortization of goodwill, the accounting policy followed by the company has inflated both earnings and return ratios of the company.

Will be the hardest hit among peers by wage inflation

MTL has one of the highest offshore effort mixes among its Indian peer sets. Most of the Indian IT companies have announced double-digit wage hike for offshore based employees and 2%-3% wage hike for onsite-based employees. MTL having relatively higher offshore effort mix will be the most impacted in scenario of double-digit wage inflation for offshore-based employees.

Financials

MTL derives 64-65% of its revenue from US geography, Whereas, Europe revenue share is 20-21%, Domestic sales are at around 5% and remaining from rest of the world.

Pressure building on operating margin

We expect, pressure on margin to continue because of wage hike and investment in development of mobile phone and going forward by Re. appreciation against the USD.

Key Financials

Profit & Loss A/c

	FY 09	FY'10	FY'11	FY'12	FY'13
Revenues	123747	129598	133358	138077	145127
Cost of Revenues	-69678	-79825	-82141	-85047	-89390
Gross Profit	54069	49773	51217	53029	55737
SGA	-20168	-24978	-25703	-26612	-27971
Bad Debts	-806	-239	-263	-273	-287
EBITDA	33095	24556	25251	26145	27480
Interest	-1620	-267	-30	0	0
Depreciation	-5696	-6518	-5685	-5506	-5404
Operating Profit	25779	17771	19536	20639	22075
Forex Gain /(Loss)	-20892	6734	0	0	0
Other Income	1152	962	1051	1051	1051
PBT	6039	25467	20587	21690	23126
Tax Expense	-808	3983	3069	3233	3447
Net Profit	5231	21484	17519	18457	19679

Cash Flow

	FY 09	FY'10	FY'11	FY'12	FY'13
PBT	6039	25468	20587	21690	23126
OPBWC	27525	20649	25302	26196	27531
Net Cash by Operating Activities	17890	23017	23730	22193	27879
Net Cash in Investing Activities	-22235	-10045	-3655	-3821	-4070
Net Cash in Financing Activities	2256	-13415	-1106	-771	-771
Forex Diff	41	-79			
Increase in Cash	-1958	-522	-18969	17601	23038
Cash at end	4876	4033	23002	40603	63641

Balance Sheet

	FY 09	FY'10	FY'11	FY'12	FY'13
Share Capital	3800	3951	3951	3951	3951
Share Application Money	0.03	0	0	0	0
Reserves &	51328	63112	79912	97649	121554

Surplus					
Total Debt	17213	305	0	0	0
	72340	67369	83863	101601	125506
Net Fixed Assets	29616	28587	27609	26975	26692
Goodwill	14605	1543	1543	1543	1543
Investments	10133	12725	12725	12725	12725
Deferred tax assets, net	1897	2136	2136	2136	2136
Net Current Assets	16088	22379	39852	58222	82410
	72340	67369	83863	101601	125506

Ratio Analysis

	FY 09	FY'10	FY'11	FY'12	FY'13
GP Margin	44%	38%	38%	38%	38%
EBITDA	27%	19%	19%	19%	19%
EBIT	22%	14%	15%	15%	15%
PBT	5%	20%	15%	16%	16%
NP Margin	4%	17%	13%	13%	13%
ROE	9.49%	32.04%	20.89%	18.17%	15.68%
Book Value	136	161	202	246	305
Current Ratio	1.5	1.9	2.3	2.9	3.6
EPS (Diluted)	13.7	52.79	43.04	45.35	48.35

Industry Outlook

The global IT spending, which has a positive correlation with GDP of developed economies, is expected to grow in 2010 (by 2.4%) and 2011 (by 4.2%) along with expected momentum in developed economies' GDP over the next two after years after declining in 2009 (Source-NASSCOM).

Indian IT services exports back to recording double-digit growth:

Growth in outsourcing is expected to supersede overall IT spending reaffirming its potential to not only support short-term goal of cost savings but also long term advantages of increased competitiveness and efficiencies. Within outsourcing, offshoring is expected to see increased acceptance as traditional service providers ramp up offshore delivery capabilities and offshore-based providers grow. Even though India has a 51% market share of the offshoring market there is tremendous headroom for growth as current offshoring market is still a small part of the outsourcing industry. For Global Sourcing of IT and Engineering Services, the addressable market is nearly \$280 bn, of which \$54-56 bn has been tapped so far leaving a head room of 5-6x for growth (Source-NASSCOM). For Global Sourcing of BPO Services, the addressable market is nearly \$220 bn, of which \$35-37 bn has been tapped so far (Source-NASSCOM). This means there is still 6-7x headroom for growth available in global sourcing of BPO services. As per 'NASSCOM Perspective 2020: Transform Business, Transform India' report, India's IT/BPO Exports could range from \$65 bn to \$75 bn in FY12. Two potential scenarios were analyzed. In the worst case scenario, factors such as constraints on pricing pressures, global sourcing mix, talent, infrastructure and productivity were considered in addition to falling demand as a result of regulation and policy changes in core markets. In this scenario, export revenues could grow to \$65 bn to \$70 bn with industry growing at a CAGR of 13%- 15% between 2008 and 2012.

In the Best case scenario, export revenues are projected to grow to \$70 bn to \$75 bn with industry growing at a CAGR of 15%-17% between 2008 and 2012. Indian IT industry outlook over the next 10 years NASSCOM-McKinsey outlined in a report likely scenario at the end of the next decade, i.e. FY20. The Indian IT industry will likely maintain its leadership in the offshoring space in the next decade as well despite threats from other locations such as China, Philippines, Brazil, and Argentina. In a worst-case scenario

Indian IT exports are expected to reach US\$125 billion in FY20 from US\$47 billion in FY09; in the most optimistic case (growth would be innovation driven), exports are expected to reach US\$300 billion in FY20. In either case, Indian IT companies have potential to grow at double-digit rates over FY09-FY20E.

The Indian IT industry has played a key role in putting India on the global map. Thanks to the success of the IT industry, India is now a power to consider with. According to the National Association of Software and Service Companies (NASSCOM), the apex body for software services in India, the revenue of the information technology sector has risen from 1.2% of the GDP in FY 1997-98 to an estimated 5.8% in FY 2008-09. The Indian IT sector continues to be one of the sunshine sectors of the Indian economy showing rapid growth and promise.

According to a report prepared by McKinsey for NASSCOM, the exports component of the Indian industry is expected to reach US\$ 175 billion in revenue by 2020. The domestic component will contribute US\$ 50 billion in revenue by 2020. Together, the export and domestic markets are likely to bring in US\$ 225 billion in revenue, as new opportunities emerge in areas such as public sector and healthcare and as geographies including Brazil, Russia, India, China (BRIC) and Japan opt for greater outsourcing.

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