

Mphasis Ltd.

Industry IT
Bloomberg MPHL:IN
BSE CODE 526299

Traction intact in HP/DXC channel; Margin to be in higher end of guidance

RATING	BUY
CMP	920
Price Target	1325
Potential Upside	44%

Rating Change	↔
Estimate Change	↔
Target Change	↔

Stock Info

52wk Range H/L	1278/798
Mkt Capital (Rs Cr)	17130
Free float (%)	40%
Avg. Vol 1M (,000)	320
No. of Shares (Cr)	19
Promoters Pledged (Cr)	0

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3Q FY19 Result Update

- Company's 3QFY19 performance was a mixed set of numbers where revenue were below our estimates (grew 3.1% QoQ in constant currency term and 2.6%QoQ in USD term) whereas margin remained in line (16.8% vs. our estimates of 16.8%) led by better performance in G&A and pyramid optimization despite wage hike.
- In Direct International business, Direct core (~84% of the direct international) revenue posted a strong growth of 5.9% QoQ whereas Digital risk (~7% of sales) declined 20% QoQ mainly led by delay in closure of new projects and well as continued pressure on volumes due to macro challenges.
- HP/DXC continued to show its strong relationship and grew 5.6%QoQ in 3QFY19. The management expects to grow above market growth in this channel going ahead
- Direct international business won new deal of TCv USD122 million during the quarter, out of which 81% came from new gen services. Total YTD now stands for USD484 million (12% growth YoY).
- The management has clearly stated of no impact of acquisition by DXC (Luxoft) in near terms and expects positive outlook for long term.
- Mphasis has acquired Virginia-based cloud technology services company Stelligent Systems LLC (amount to USD 25million) during the quarter to provide access to strategic proposition in Cloud DevOps and DevSecOps within AWS Ecosystem.

View and Valuation

Going forward, we expect Mphasis to report healthy growth for FY20 led by continued traction from core services (HP and direct channel), robust deal momentum (USD122 mn in 3QFY19) and strong growth in new client addition through Blackstone Portfolio.

Direct core business (~ 84% of total direct channel) is expected to grow in mid teens on account of strong growth momentum based across strategic account and continued growth opportunity in new avenues (Blackstone Portfolio). 3QFY19 witnessed 3 new client additions through Blackstone Portfolio and it is expected to continue to expand and grow going ahead. HP/DXC which was soft for last few year bounced back in FY18/FY19 and is expected to performance above market growth in FY20. Though some concern was seen related to recent acquisition by DXC (luxoft), but the management has clearly stated of no impact of acquisition in near terms and expects positive outlook for long term.

However some concern still lies with the digital Risk which was facing challenges, and is expected to be soft as the headwinds have not fully subsided. On the margins, we expected the company to be in the higher end of the guidance for FY20 (15% to 17%) led by continued improvement in operational parameter and improved margin of HP/DXC business. We expect Mphasis to post PAT growth of 20% CAGR over FY18 to FY20. **We largely maintain our target price of Rs1325 (20x FY20EPS) and recommend Buy.**

Key Risks to our rating and target

- Delay in new client addition in Blackstone portfolio.
- Failure to grow Direct International channel faster than industry growth

KEY FINANCIAL/VALUATIONS	FY16	FY17	FY18	FY19E	FY20E
Net Sales	6088	6076	6546	7773	8908
EBITDA	896	969	1062	1335	1544
EBIT	822	890	992	1263	1463
PAT	669	792	837	1088	1229
EPS (Rs)	32	38	43	58	66
EPS growth (%)	-1%	18%	15%	35%	13%
ROE (%)	11%	13%	15%	21%	21%
ROCE (%)	13%	14%	18%	25%	25%
BV	299	292	284	276	318
P/B (X)	1.6	2.0	3.0	3.3	2.9
P/E (x)	15.4	15.4	19.5	15.7	13.9

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3QFY19 Results

PAT Beat estimates....

Financials	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19	YoY %	QoQ%	FY17	FY18	YoY %
Net Sales	1,661	1,744	1,820	1,915	1,971	18.7%	2.9%	6,076	6,546	7.7%
Other Income	35	42	45	48	51	43%	7%	239	162	-32.1%
Employee Exp	963	1,012	1,037	1,060	1,089	13.0%	2.7%	3,710	3,818	2.9%
Other Expenses	423	423	463	522	552	30.4%	5.8%	1,394	1,666	19.5%
EBITDA	274	309	320	333	331	20.6%	-0.7%	969	1,062	9.7%
Depreciation	18	17	18	18	20	11.6%	7.1%	79	71	-10.5%
EBIT	257	292	302	315	311	21.2%	-1.2%	890	992	11.5%
Interest	3	4	4	4	3	19.9%	-1.3%	14	13	-6.3%
PBT	289	330	343	359	358	23.9%	-0.1%	1,114	1,141	2.4%
Tax	74	80	85	88	80	8.1%	-8.6%	308	290	-5.7%
Exceptional	-	13	-	-	-			15	13	-13.8%
PAT	215	238	258	271	278	29.4%	2.6%	792	837	5.8%

Revenue growth contributed to by both HP and Direct Core despite seasonality

Mphasis 3QFY19 revenue grew 2.9% QoQ and 18.7%YoY, below our estimates. Overall revenue in constant currency term grew 3.1%QoQ .TCV for the quarter stood at USD 122 million as compared to highest TCV in last quarter (USD 210 million). 81% of the deal wins in the quarter and year were in the focus areas of Digital and Next-Gen Services.

Segmental performance

Secondary Segment(in USD mn)	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19	QoQ%	YoY %
Direct International	170	177	182	186	187	190	1.7%	7.7%
DXC / HP Business	63	65	71	74	78	82	5.3%	25.4%
Others	9	9	10	9	10	10	-1.5%	8.8%

Traction continued in direct core/HP channel however volatility seen in direct risk business

Mphasis growth was mainly driven by HP channel which grew 5.3% QoQ and Direct International grew 1.7%QoQ, However some expected headwinds were witnessed in the Digital Risk business which led to decline of 20%QoQ (mainly on account of decline in mortgage originations in US). Direct Core revenues (84% of Direct International) grew 5.6% QoQ.

Transportation,logistics & healthcare led strong growth in Emerging segment

Segments(in crore)	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19	QoQ%	YoY %
Banking and Capital Market	760	773	805	857	896	883	-1.6%	14.1%
Insurance	202	208	198	205	220	237	7.7%	13.9%
IT, Comm & Entertainment	221	233	288	314	332	337	1.6%	44.4%
Emerging Industries	382	407	412	446	500	546	9.3%	34.2%

In terms of Verticals, in rupee terms, Banking saw a decline of 1.6%QoQ due to furlough, Insurance continued to strong and grew 7.7% QoQ, IT, Communications & Entertainment grew by 1.6% QoQ, while Emerging Technologies grew by 9.3% QoQ.

Despite wage hike, margin remained in guided range (15% to 17%)

EBITDA for the quarter stood at Rs 331 crore , a decline of 0.7%QoQ. Margin stood at 16.8% in line with our estimates of 16.8%, a decline of 60 bps as compared to previous quarter mainly on account of wage hike, decline in digital risk and lower working days. However some impact of wage revision by mitigated by the operational parameter like better G&A and pyramid optimization. PAT for the quarter stood at Rs278 a growth of 2.6% QoQ led by higher other income and lower tax.

Upward biases for the margin guidance for FY20 (15% TO 17%)

Mphasis has indicated of upward biases in EBIT margin for FY20 led by lower hedging loss (if rupee remain at current level) and continued improvement in cost optimization(better G&A and automation benefit) .

No concern to be seen from acquisition of luxoft by DXC

Mphasis will continue to be creditable long term partner to DXC by supporting its partner in application transformation progress for core IT operations. However with Recent Luxoft acquisition there was some concern raised related to issues that the company would face due to acquisition and which would impact the relationship and revenue growth of the company. But the company in its concall has clearly stated that they are seeing no impact on DXC relationship in near term due to acquisition and sees positive impact on medium to long term for the company as combined.

Concall Highlights

- ❑ **Direct Core:** Direct core continued to strong and posted highest ever in 3QFY19. The three primary vectors of growth were **Strategic account:** continued to see double digit growth aided by differentiated service offering, superior client management and wallet share in most competitive segment. The differentiated offering makes management confident of strong growth to continue for remainder of the business. **Blackstone channel** continued to growth by aiding client, now having 10 portfolio companies as client out of which 5 came in FTY19YTD and 3 won during the quarter. The management expects Blackstone to contribute 5% to overall revenue in FY19. the managements sees continues opportunity in channel as they continue to expand their relationship and focus on new client addition in the channel. **Investment in sales** is now beginning to pay off. Growth in 3QFY19 was 100% YoY and has become creditable engine for direct core which will also good for company strong in coming quarter.
- ❑ **Large deal wins continues:** 80% is net wins now coming from next gen services. Strong pipeline continues to be building around new gen services. Direct international business won new deal of TCV USD112 million during the quarter, out of which 81% came from new gen services. Total YTD now stands for USD484 million(12%groth YoY). Moreover, Mphasis is seeing an increase in the average deal size.
- ❑ **To boost cloud automation acquired stelligent:** Mphasis has acquired Virginia-based cloud technology services company Stelligent Systems LLC in an all-cash deal valued at \$25 million. The acquisition is expected to provide access to strategic proposition in Cloud DevOps and DevSecOps within AWS Ecosystem.
- ❑ **HP/DXC:** Mphasis will continue to invest in client engagement and partnership as the company expands growth with them. Mphasis will continue to be creditable long term partner to DXC for application transformation opportunities as client for core IT operations. Luxoft acquisition will expected to further expand relationship, thus seeing no impact on DXC relationship in near term due to acquisition and sees positive impact on medium to long term for the company as combined.
- ❑ **DXC subcontracting concern:** DXC spend approximately 3.5 billion in labor cost and key focus is to reduce these vectors cost by using automation, consultant suppliers and increasing low cost mix delivery. Mphasis is closely involved with DXC to execute all this vectors. There is no impact on subcontracting.
- ❑ **Digital risk:** Continued softness seen in digital risk due to delay in closure of new projects and well as continued pressure on volumes due to macro challenges. The management expects digital risk to recover in 4QFY19 and get back to normal run rate in FY20.
- ❑ **Margin for 3QFY19:** Wage hike impacted the margins for 3QFY19 however operational efficiency mitigated some impact. The company is confident of EBIT margin within the guided range of 15to 17% for FY19. As hedge gains will be seen in FY20 (condition if rupees states at current level), the management has upward biasness to EBIT margin for FY20.
- ❑ **Outlook for FY20:** Managment stated that one should not expect more than 20% YoY growth in FY20 after growing20% is seeing the two year of consistent growth however expect to be at power or market above growth for FY20.

Exhibit: Revenue trend

Continued uptick in revenue growth led by strong growth in strategic account and client addition in Blackstone portfolio.

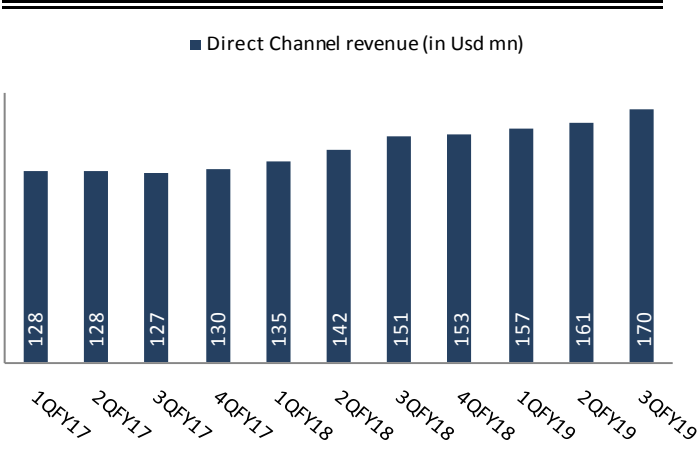


Exhibit:HP/DXC Revenue

Situation at HP improving every quarter.

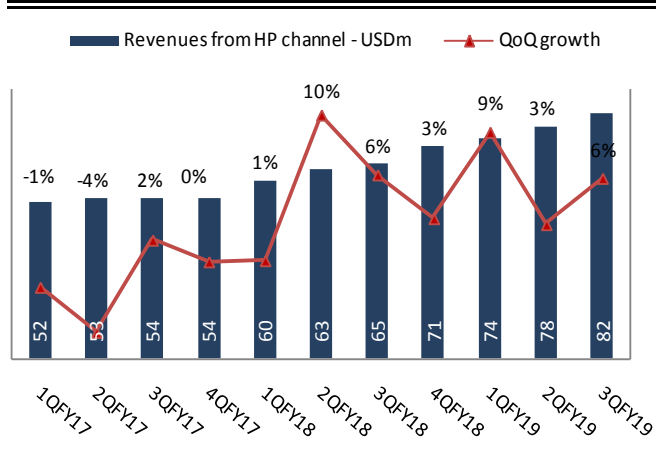


Exhibit:Revenue from Digital Risk

Volatility continued in Digital risk revenue

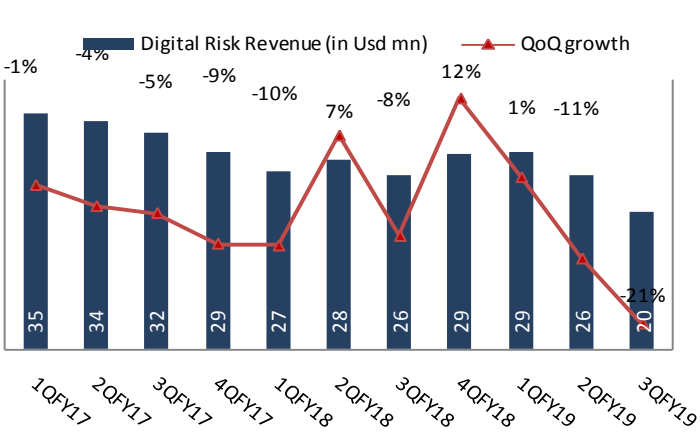


Exhibit:EBIT margin

Despite wage hike, EBIT margin managed to be within guided range of 15% to 17%.

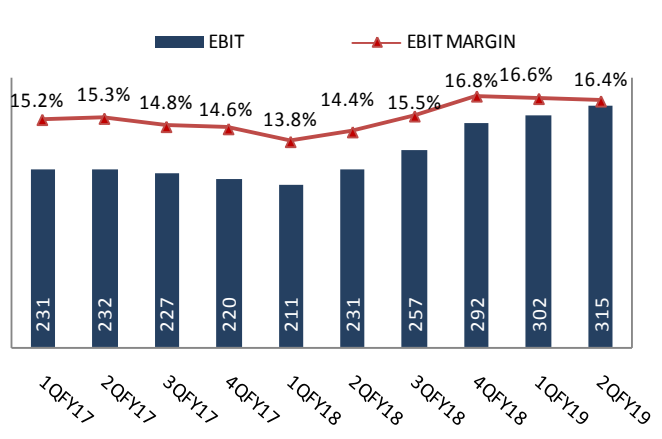
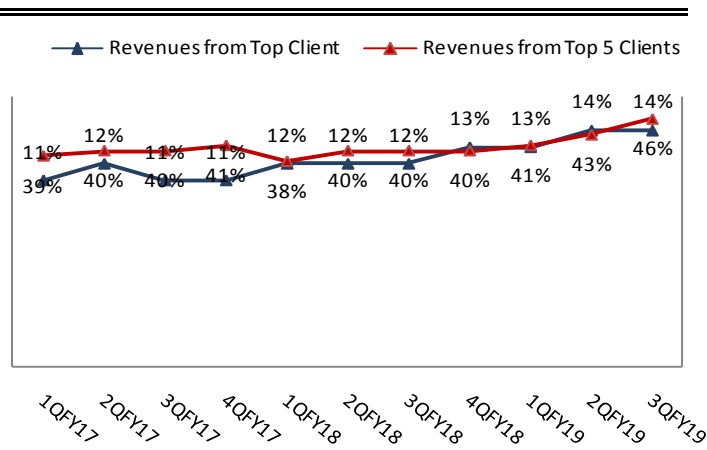


Exhibit: Top client contribution

Strong momentum amongst top clients.



Operational Details

By Project Type (%)	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Time and Material	79%	80%	79%	23%	75%	74%	73%	75%	76%
Fixed Price	21%	20%	21%	23%	25%	26%	27%	25%	24%
By Geography	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
AMERICAS	78%	79%	80%	80%	80%	79%	80%	80%	78%
EMEA	10%	10%	10%	10%	10%	11%	11%	11%	11%
INDIA	7%	6%	6%	6%	6%	6%	6%	6%	6%
ROW	5%	5%	4%	4%	4%	4%	3%	3%	5%
Service Type	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Application Maintenance &	37%	37%	36%	35%	33%	31%	30%	34%	36%
Application Development	23%	24%	25%	24%	26%	26%	28%	28%	30%
Customer Service	2%	2%	1%	2%	1%	1%	1%	1%	1%
Service / Technical	2%	2%	5%	7%	8%	8%	8%	6%	7%
Transaction Processing	6%	6%	7%	7%	7%	7%	7%	7%	6%
IMS	14%	14%	14%	13%	13%	15%	15%	14%	13%
Knowledge Processes	15%	14%	12%	12%	11%	12%	11%	10%	7%
License Income	1%	1%	0%	0%	1%	0%	0%	0%	0%
Client	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Top Client	11%	11%	12%	12%	12%	13%	13%	14%	14%
Top 5 Clients	40%	41%	38%	40%	12%	40%	41%	43%	46%
Top 10 Clients	55%	55%	54%	54%	55%	56%	56%	58%	59%
Headcount	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Onsite									
Application Services	2299	2353	2373	2363	2392	2456	2550	2703	3539
ITO Services / IS	251	274	277	676	1106	1120	1087	1071	1210
BPO Services	1127	1040	1044	998	981	950	914	914	884
Offshore									
Application Services	8615	8807	8668	8486	8228	8281	8680	8958	9286
ITO Services / IS	3136	3074	3055	3011	3062	3121	3075	2937	2843
BPO Services	5351	5176	5191	5360	5304	5139	5092	5140	5236
Sales and Marketing	315	325	346	330	300	278	270	270	292
General and Administration	940	945	943	932	897	894	898	898	925
New Client wins	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Banking & Capital Market	1	1	4	0	2	1	4	3	11
Insurance	2	1	2	0	1	2	0	0	1
Information Technology	1	1	2	1	0	0	1	0	3
Emerging Industries	2	2	4	4	3	2	7	9	5
	6	5	12	5	6	5	12	12	20
Total client additions	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Direct Channel	4	4	7	3	4	4	7	5	18
HP / DXC Channel	2	1	5	2	2	1	5	7	2
Total client additions	6	5	12	5	6	5	12	12	20

Financial Details
Balance Sheet

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
Share Capital	210	210	210	210	210	193	186	186
Reserves	4,724	4,905	5,270	6,083	5,942	5,289	4,949	5,733
Networth	4,934	5,115	5,480	6,293	6,152	5,482	5,135	5,919
Debt	498	431	434	311	260	390	220	220
Other Non Cur Liab	113	60	111	153	76	102	205	205
Total Capital Employed	5,545	5,606	6,025	6,758	6,489	5,973	5,560	6,343
Net Fixed Assets (incl CWIP)	239	224	176	173	224	185	190	209
Non Cur Investments	742	541	250	375	126	317	317	317
Other Non Cur Asst	16	25	105	104	198	151	90	90
Non Curr Assets	3,969	3,721	3,469	3,733	2,868	3,039	3,293	3,311
Current investment	1,158	1,275	1,193	1,736	2,270	1,465	1,465	1,465
Inventories	-	-	-	4	-	-	-	-
Trade receivables	651	778	625	649	628	812	964	1,105
Other current assets	586	545	558	682	270	280	272	312
Other financial assets	-	-	-	-	597	600	600	600
Short term loans and advances	152	214	251	251	71	82	98	112
Cash & Bank balance	580	458	1,321	855	614	707	301	988
Current assest	3,127	3,269	3,948	4,177	4,449	3,946	3,700	4,581
Trade payables	621	451	406	453	388	502	597	684
Other curr liab & provisions	929	932	985	699	137	169	201	230
employee defined benefit liabilities	-	-	-	-	78	73	73	73
Other financial liabilities	-	-	-	-	160	180	475	475
Income tax liabilities (Net)	-	-	-	-	65	87	87	87
Curr Liabilities	1,550	1,384	1,392	1,152	828	1,012	1,433	1,549
Net Curr Assets	1,576	1,886	2,556	3,025	3,621	2,934	2,267	3,032
Total Assets	7,096	6,990	7,417	7,909	7,317	6,985	6,993	7,893

Income Statement

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
Revenue from Operation	5,796	5,728	5,795	6,088	6,076	6,546	7,773	8,908
Change (%)	8%	-1%	1%	5%	0%	8%	19%	15%
EBITDA	1,033	992	870	896	969	1,062	1,335	1,544
Change (%)	-2%	-4%	-12%	3%	8%	10%	26%	16%
Margin (%)	18%	17%	15%	15%	16%	16%	17%	17%
Depr & Amor.	145	122	98	74	79	71	72	81
EBIT	888	870	772	822	890	992	1,263	1,463
Int. & other fin. Cost	33	37	28	24	14	13	15	14
Other Income	140	117	197	196	239	162	185	201
EBT	995	950	941	994	1,114	1,141	1,433	1,650
Exp Item	-	6	3	55	15	13	-	-
Tax	251	258	263	270	308	290	346	421
Minority Int & P/L share of Ass.	-	-	-	-	-	-	-	-
Reported PAT	744	686	675	669	792	837	1,088	1,229
Adjusted PAT	744	686	675	669	792	837	1,088	1,229
Change (%)	-6%	-8%	-2%	-1%	18%	6%	30%	13%
Margin(%)	13%	12%	12%	11%	13%	13%	14%	14%

Financial Details

Key Ratios

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
ROE	15%	13%	12%	11%	13%	15%	21%	21%
ROCE	16%	16%	13%	13%	14%	18%	25%	25%
Asset Turnover	24	25	29	35	31	32	41	45
Debtor Days	41	50	39	39	38	45	45	45
Payable Days	39	29	26	27	23	28	28	28
Book Value Per Share	235	243	261	299	292	284	276	318
Earnings Per Share	35	33	32	32	38	43	58	66
EPS Growth	-6%	-8%	-2%	-1%	18%	15%	35%	13%
P/E	11	12	12	15	15	19	16	14
Price / Book Value	2	2	1	2	2	3	3	3
EV/EBITDA	8	9	8	11	12	15	13	11
EV/Sales	1	1	1	2	2	2	2	2
Sales/Working Capital	4	3	2	2	2	2	3	3

Cash Flow Statement

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
PBT	995	428	941	945	1,114	1,141	1,433	1,650
(inc)/Dec in Working Capital	(17)	(121)	(20)	52	(105)	(150)	337	(103)
Non Cash Op Exp	53	21	(22)	(21)	(54)	21	72	81
Int Paid (+)	-	-	-	-	-	-	-	-
Tax Paid	(275)	(130)	(279)	(234)	(290)	(278)	(346)	(421)
others	-	-	(3)	(11)	(1)	-	-	-
CF from Op. Activities	756	198	616	731	664	733	1,385	1,232
(inc)/Dec in FA & CWIP	(74)	(36)	(72)	(127)	(118)	(33)	(77)	(100)
Free Cashflow	681	162	544	603	546	700	1,308	1,132
(Pur)/Sale of Inv	695	115	460	(562)	-126.129	737	-	-
others	(1,164)	141	(755)	531	512.141	(211)	-	-
CF from Inv. Activities	(543)	220	(366)	(158)	268	493	(77)	(100)
inc/(dec) in NW	0	0	0	0	0	0	(7)	-
inc/(dec) in Debt	129	-	8	(146)	(197)	128	(170)	-
Int. Paid	(31)	(11)	(22)	(18)	(7)	(10)	0	0
Div Paid (inc tax)	(415)	(418)	(172)	(404)	(505)	(395)	-446	-446
others	(0)	(0)	(0)	0	(0)	(1,103)	-981	0
CF from Fin. Activities	(318)	(429)	(186)	(568)	(710)	(1,380)	(1,604)	(446)
Inc(Dec) in Cash	(105)	(11)	64	5	222	(154)	(296)	686
Add: Opening Balance	465	364	340	388	391	618	464	168
Closing Balance	360	353	403	393	613	464	168	855

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