IT Midcap Picks " Zensar, a better bet at CMP, Mindtree good on dips" July 12, 2012

Zensar Technologies Ltd. (ZTL)

HDFC Sec Scrip code	Industry	CMP (Rs.)	Recommended Action	Avg. Price Band (Rs.)	Price Target (Rs.)	Time Horizon
ZENTECEQNR	IT	260.5	Buy at CMP and add on dips	233-244	297	1-2 quarters

Mindtree Ltd. (MTL)

HDFC Sec Scrip code	Industry	CMP (Rs.)	Recommended Action	Price Band (Rs.)	Price Target (Rs.)	Time Horizon
MINDTREQNR	IT	653.2	Buy on dips	590-619	708	1-2 quarters

ZTL's valuations look attractive - Buy at CMP and on dips in the price band of Rs. 233-244 for price target of Rs. 297

We expect ZTL's revenues & PAT to grow by 16.0% each in FY13. IM, BFSI, Manufacturing / Retail / Distribution and Government / Healthcare / Utilities are likely to be key focus areas and major growth catalysts. Akibia is expected to do well. The consolidated service offerings along with Akibia are getting increased acceptance from company's clients. ZTL has an opportunity to scale up its Remote Infrastructure Management Services business using Akibia's large datacenter customer base. Cross selling opportunities of own and Akibia products across globe is likely to increase the client mining going forward. Vendor rationalization exercise by CISCO is likely to benefit ZTL in generating additional revenues from CISCO. The company is confident of strong growth from CISCO going ahead

We have assumed FY13 revenue growth to be purely organic. ZTL is also pursuing inorganic opportunities in US & Europe over the next 12-18 months in the infrastructure management (in compliance space) & manufacturing (in SAP), which it considers big areas of growth going forward. If these acquisitions materialize, then it could boost the consolidated revenues of ZTL significantly going forward.

We expect ZTL's operating margins to improve in FY13 on the back of rationalization of low-margin business, cost optimization and expected turnaround in Akibia's profitability. The company has benefited due to vendor consolidation by 2 of the Top 10 clients. ZTL stated that it is likely to rationalize some more accounts, which are yielding low margins. This is likely to improve the company's margins. Further, despite the lower other income expected in FY13 (assuming there would be no forex gains in FY13), PAT margins are likely to remain stable at FY12 levels mainly on the back of expected increase in revenues from SEZs.

At CMP, ZTL is trading at 6.1xFY13E EPS, which is at a discount to MTL. In terms of financial parameters like Revenue & PAT per employee, return ratios like ROCE & RONW, P / BV and dividend payouts (19.1% in FY12 vs 7.4% in case of MTL), ZTL is better placed compared to MTL. Despite this, ZTL trades at a discount, largely due higher onsite revenue proportion (70.7% compared to MTL's 33.6%), higher dependence on IMS (commoditised services), client concentration risk (Top client Cisco accounts for 22% of the total turnover) and higher dependence on US (71% of total revenues). However, if ZTL is able to steadily improve its margins, revenue growth profile remains stable, acquisitions that it plans are successfully integrated, then it could get much better valuations going forward. We feel ZTL deserves to trade at 7xFY13E EPS, which gives a price target of Rs. 297. We feel investors can buy this stock at current levels in small quantities and add on dips in the price band of Rs. 233-244 (5.5-5.75xFY13E EPS) for the mentioned price target over the next one to two quarters.

MTL's valuations look slightly stretched - buy on dips in the price band of Rs. 590-619 for a price target of Rs. 708

We expect MTL's revenue & PAT to grow by 14.5% & 9.3% respectively in FY13. The revenue growth is likely to be driven by ITS business. The company expects growth ahead of industry growth of 11-14% projected by Nasscom for FY13. The growth is likely to be largely back ended. Early exit of failed smartphone business is viewed as a positive and the focus now is back on core IT services business. The company has made investment in building client facing team in IT services. This could start yielding benefits in the coming quarters and enable the company to grow its revenues above the industry rates. However, due to underperformance expected for a few more quarters in PES, we don't expect a significant outperformance from MTL in terms of overall revenue growth. Any turnaround in the PES space could result in better than estimated revenue growth.

Among the verticals, BFSI and Manufacturing are likely to remain key focus areas for MTL. Maintenance, IMTS and Testing services are likely to provide MTL immense opportunities going forward. MTL has already started to yield benefits in terms of improvement in the client metrics from its strategy of focusing on select verticals and leveraging domain expertise. Going

forward, MTL is likely to continue with this strategy, which could further improve client mining and drive the company's revenues and profits going forward.

Rationalization of employee pyramid & improvement in utilization rate could result in OPM expansion. We expect MTL's OPM to improve by 90 bps to 16.2% in FY13. While wage inflation could continue to put pressure on the margins, this is likely to be more than offset by tailwinds from factors such as continuation of rationalization of the employee pyramid, improving utilization level, effort to shift offshore and lowering SG&A from current levels. The company has given offers to ~3,000 campus graduates for FY13. The joining ratio is expected to be 70-75% and most of these are expected to join in H1FY13. This would help MTL rationalize its employee pyramid and cushion its margins. However, the company is likely to witness pressure on the absolute PAT and PAT margins due to higher effective tax rate expected in FY13 (as two of the company's SEZ facilities complete their 100% tax holiday period & get into the 50% tax bracket in FY13) and lower other income expected over FY12.

At CMP, MTL trades at 11.1xFY13E EPS, which is at a premium to ZTL, despite ZTL being better placed in terms of most of the financial parameters like return ratios (ROCE & RONW), Revenue & PAT per employee, P / BV and higher dividend payouts. We feel this premium could be because of MTL's more reputed management, higher operating & PAT margins, low client concentration (MTL's top client accounts for 7.5% of total turnover, while ZTL's top client share stands at 22%), no presence in IMS (commoditised service), focus on niche areas like travel & transportation and services like product engineering, which are better than low margin IMS (where ZTL has a strong presence). Moreover MTL's well-diversified revenue stream geographically, high offshore presence (66.4% of total revenues, compared to 29.3% in case of ZTL), larger institutional holding compared to ZTL and higher number of Fortune 500 clients also supports the stock's premium valuations.

MTL has historically traded at 13x+ 1 year forward EPS (except during the 2008-09 global crisis and later after the exit of Mr. Ashok Soota, the key promoter/co-founder of MTL). However, its valuation has started to claw back upwards as the street is more confident that Mr. Soota's exit may not have any major impact on the future of the company. Further, the concerns relating to the smart phone business have ended since the company has already exited the business. MTL could also keep witnessing buying from the secondary markets by V G Siddhartha (Coffee Day Group's chairman) whose stake has reached 21.87%. One expects that he could raise the stake to close to 25% i.e. the threshold of making open offer.

We feel MTL is capable of trading at 12xFY13E EPS, which gives a price target of Rs. 708. For better returns and margin of safety, we recommend investors to buy this stock only on dips in the price band of Rs. 590-619 (10-10.5xFY13E EPS) for the mentioned price target over the next one to two quarters.

IT Industry Outlook

In the face of the volatility in the economic environment and currency, 2011 recorded steady growth for technology and related services sector, with worldwide spending surpassing USD 1.7 trillion, a growth of 5.4% over 2010. Software products, IT and BPO services continued to lead, accounting for over USD 1 trillion - 63% of the total spend. IT-hardware spend of USD 645 billion, accounted for the balance 38% of the worldwide technology spend in 2011. The year saw renewed demand for overall global sourcing, which grew by 12% over 2010, nearly twice the global technology spend growth.

India's share in global sourcing stood at 58% in 2011, up from 55% in 2010. Indian IT-BPO exports continued on the growth path in FY12, as it is estimated to have grown by 16.3%. IT services has been exhibiting the robust growth at 19%, BPO growing by 13% & ER&D by 15%. Transformation, new business models are driving organization wide efficiencies

While the growth in IT-BPO spend is expected to be gradual over the next three years, global sourcing spend is seen to outpace this growth. **IT outsourcing market** is set to grow at a CAGR of about 8% over 2011 to 2013, while BPO off shoring is expected to grow at a little over 7% during the same period. Costs still remain essential for global sourcing, industry expertise and innovation is expected to drive future sourcing requirement. In addition, rate of introduction of new technology is much faster now and is expected to continue to be even faster in future. There is a strong correlation between technology adoption rate and investment rate. The year 2011 was the year of mobile adoption, where tablets and smartphones sales growth, by volume and by percentage, outpaced the shipment of desktop and laptop market. This mobile revolution witnessed spending by organizations in developing both consumer apps and enterprise apps.

From IT industry perspective - the **market for enterprise mobility solutions** alone is expected to grow to USD 17 bn by 2015, presenting a huge opportunity to increase revenue from this segment at a pace of triple-digit growth. Clearly, the future of technology services industry is beyond services - it will be a combination of services, solutions and platforms. Indian IT organizations are investing in building platforms to drive future growth opportunities. These domain solutions and technology platforms will offer improved revenue leverage versus talent employed in the industry and will also significantly increase the intellectual property base of the Indian IT industry. The industry can take a clue from the fact that public cloud services spending is expected to outpace growth of the overall IT spend by about four times between 2012 and 2015.

Diversification and transformation, the key themes for the industry for the last two years, and the untapped opportunities in the new services are expected to drive the next phase of growth for the IT-BPO sector. The **domestic IT-BPO market** is expected to grow in parallel with the growth of the Indian economy. The domestic IT-BPO (excluding hardware) spending trend will be decent in FY13 as the industry is expected to grow at 13-16%. As per Nasscom, **IT-BPO exports** is expected to grow 11-14%

in FY13, driven by proliferation of as-a-service model around enterprise mobility, cloud and platform solutions, analytics offerings and social media.

The **domestic IT market** saw improved performance in 2011, growing by almost 17% driven by the emergence of cloud computing that has led to increasing consumerisation of IT, rapid advancement in technology infrastructure, increasingly competitive Indian organisations, enhanced focus by the government and emergence of business models that help provide IT to new customer segments such as SMBs and consumers. Key global megatrends around macroeconomics, demographics, social, environmental, technology and business will shape the future of the Indian IT-BPO industry. These megatrends will present a new set of opportunities in the form of largely untapped markets and customer segments, which can substantially propel industry revenues.

Key Growth Drivers of the IT sector

- Easy availability of talent pool & cost advantage. Indians considered having better mathematical skills required for writing software.
- Presence of entrepreneurial spirit.
- Indian software companies take CMM (Capability Maturity Model) certification, which is the benchmark of quality management.
- Supportive Government Policies framed in a way, which ensures maximum benefit out of IT outsourcing to India.
- Unique geographic location. US is the major consumer of IT products.

Key Threats to the IT sector

- Threat of new emerging service economies like Israel & Ireland. Software sector of Korea, Taiwan & Philippine posing a challenge to India.
- Development of hardware sector in India lagging.
- Poor communication facilities, power scarcity, poor transport & travel infrastructure as compared to developed countries.
- High dependence on few developed economies like US & Europe and prolonged problem in Europe
- More reliance on external demand & low domestic demand.
- High volatility in exchange rate (mainly INR / USD)
- Rising wage bills & need for retraining fresh recruits.
- Move towards reducing outsourcing of jobs by developed economies.

Infosys Q1FY13 results reflects subdued IT Industry scenario, however, the issues could be company specific

After reviewing the recent Q1FY13 results of Infosys, it appears that the IT Industry still continues to witness slowdown. Infosys revenue growth was just in line with the street estimates, while its PAT growth was below estimates. Also, the company cut its FY13 USD revenue growth guidance significantly to 5%, sharply lower than its earlier guidance of 8-10%. In another surprise move, it has not provided guidance for the second quarter, citing an unclear client spend environment.

Tech companies have been recently (over the last few months) hit hard due to delay in the clients' decision making and cut in the budget spends amid the global economic uncertainties led by the Eurozone debt crisis. The volatile currency movements have also hurt IT firms. Due to ongoing slowdown in Europe and not much improvement being witnessed in US, the two major IT markets, pressure on the IT volumes is likely to remain in near term. However, this could be a temporary phase and we could see an improvement in the industry scenario in H2FY13. Also the slowdown could also be due to company specific issues. Infosys is going through transformational and structural issues and would take a few quarters to recoup. Results from other top IT players like TCS, Wipro, Cognizant & HCL Tech would give us better clarity about the current state of IT Industry.

Comparative analysis of Mindtree & Zensar

At CMP, MTL trades at 11.1xFY13E EPS, while ZTL trades at a discount to MTL at 6.1xFY13E. In terms of financial parameters like Revenue & PAT per employee, return ratios like ROCE & RONW and P / BV, ZTL is better placed compared to MTL. Further, ZTL's dividend payout & dividend yield is higher then MTL. Despite this, MTL trades at a premium to ZTL. We feel this premium could be because of MTL's more reputed management, higher operating & PAT margins, low client concentration (top client of MTL accounts for 7.5% of the total turnover, while ZTL's top client contribution stands at 22%), no presence in IMS (which is commoditised service), focus on niche areas like travel & transportation and services like product engineering, which are better than low margin IMS in which ZTL has a sizable presence. Moreover MTL's well-diversified

revenue stream geographically, its high offshore presence (66.4% of total revenues, compared to 29.3% in case of ZTL), larger institutional holding compared to ZTL and higher number of Fortune 500 clients also supports the stock's premium valuations. One more thing to notice is that the recent exit of key promoter/co-founder of MTL, Mr. Ashok Soota has not had any material impact in terms of company operations, client exits and key management attrition. Also we feel that the concerns relating to the smart phone business have been over since the company has already exited the business. With focus back on its core ITS business; investors' confidence in the company has increased.

While we expect MTL to continue to trade at a premium to ZTL on the back of its more reputed management, ZTL's discount to MTL could narrow down going forward, if ZTL is able to steadily improve its margins, revenue growth profile remains stable, acquisitions that it plans are successfully integrated. Higher dividend payouts could also support the valuations. At the current levels, ZTL looks more attractive than MTL.

Particulars	FY12		FY13E	
	MTL	ZTL	MTL	ZTL
Revenue per Employee (Rs. in Mn)	1.74	2.50	1.78	2.64
PAT per Employee (Rs. In Mn)	0.20	0.22	0.19	0.24
OPM (%)	15.30	13.30	16.20	13.75
NPM (%)	11.41	8.90	10.89	8.91
EPS (Rs.)	53.95	36.54	58.97	42.44
PE (x)	12.11	7.13	11.08	6.14
Market Cap / Sales (x)	1.38	0.63	1.21	0.55
Price / Book Value (x)	2.76	1.96	2.26	1.58
ROCE (%)	27.17	31.09	25.51	30.63
RONW (%)	22.83	27.56	20.37	25.70

(Source: Company, HDFC Sec Estimates)

Comparison with other Midcap IT peers

ZTL & MTL face competition from other Mid-Cap IT peers like NIIT Technologies, Tech Mahindra and KPIT Cummins. While MTL trades at a premium to its peers, ZTL trades at a discount.

Company Name	FY13E						
	OPM (%)	NPM (%)	EPS (Rs.)	PE (x)	Net Sales (Rs. in Mn)	Mkt. Cap/Sales (x)	P / BV (x)
MTL	16.2	10.9	59.0	11.1	21929.0	1.2	2.3
ZTL	13.8	8.9	42.4	6.1	20676.8	0.5	1.6
NIIT Tech	17.5	11.9	36.7	7.8	18500.0	0.9	1.6
Tech Mahindra	17.3	14.6	68.2	10.5	59500.0	1.5	1.8
KPIT Cummins	15.9	9.3	11.2	10.6	21500	1.0	2.3

Zensar Technologies Ltd. (ZTL)

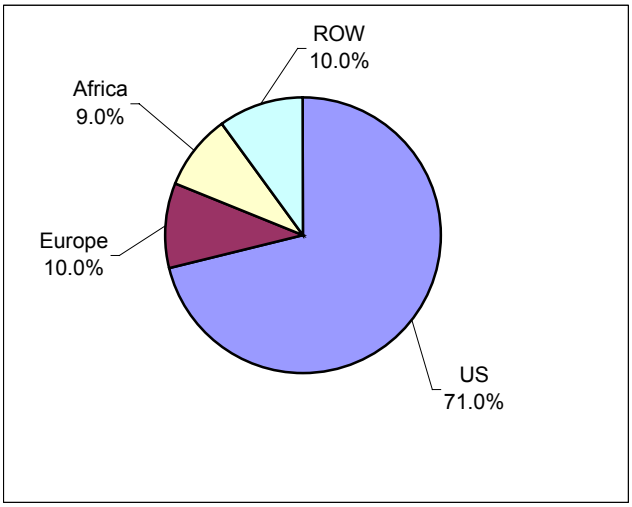
Business Profile

Zensar Technologies Ltd. (ZTL) is among the top 20 software services providers from India. ZTL is the world's first enterprise-wide SEI CMM Level 5 Company and was also later certified as a CMMI Level 5 Company with industry expertise that spans Retail, Manufacturing, Banking, Insurance, Utilities, Healthcare and Life Sciences. An RPG Group company, ZTL has around 7121 employees with sales and operations presence across US, UK, Germany, Sweden, Middle East, South Africa, Singapore, Australia, China and Japan. The Company delivers comprehensive services in mission-critical applications, enterprise applications, e-business, BPO and Knowledge Services. The Company has developed tools and methodologies, including the proprietary Solution BluePrint (SBP), which enables its clients with innovative business solutions and a rapid 'go-to-market' capability. The Company supports Fortune 500 clients with software business solutions that help them compete in the digital economy. With over 7000+ associates and 400+ customers, ZTL helps transform global corporations. ZTL is ranked amongst India's top 20 software companies by NASSCOM and is seen today as a valuable change partner by enterprises keen on driving transformation through innovative technology solutions.

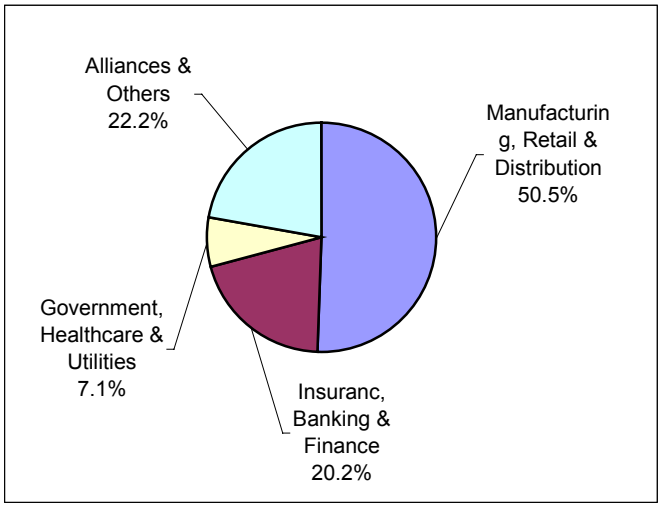
ZTL has evolved from an implementation partner of enterprise business solutions to a Platinum Partner in the Oracle Partner Network providing customized solutions to meet industry demands better. The company enjoys enduring relationships with global leaders like Cisco, Assurant, Danaher Corporation, Electronics Arts and Logitech, among several others. ZTL's customers are spread across various industry segments like Manufacturing, Retail, Banking and Insurance, and Healthcare. The top ten customers of ZTL contribute 40% to the total revenues. Dr. Ganesh Natarajan, Vice Chairman & CEO of ZTL, has been one of the most successful and dynamic professionals in the Indian Information Technology Industry and has been leading ZTL as the CEO for over seven years now, making ZTL one of the most successful IT companies in the country and amongst Fortune's Top 10 global offshore outsourcing companies from India.

Geographically North America continues to be ZTL's major source of revenues, which generates over 71% of total revenues. Europe, Africa & Rest of the World (ROW) contribute the balance 10%, 9% & 10% respectively. Amongst the verticals, around 50% of the revenues comes from Manufacturing, Retail & Distribution. Insurance, Banking & finance, Alliances & Others contribute 20% & 22% respectively, while Government, Healthcare & Utilities account for 7%. Among the service offerings, 62% revenue is generated from Application Management Service (AMS), while Infrastructure Management service (IMS) contributes the balance 38%. Location-wise, ZTL's onsite revenues account for 70.7% of the total revenues.

FY12 Geographical Revenue Breakup



FY12 Vertical-wise revenue breakup



ZTL has nine wholly owned subsidiaries (overseas) in the US, UK, Singapore, Germany, Japan and China (5 Direct subsidiaries). With the acquisition of Akibia Inc (Akibia) in Nov 2010, ZTL has more than doubled its onsite strength to over 800 associates and services spread over 38 states.

The details of ZTL's subsidiaries are given below:

(Rs. In Mn)

Particulars	Country of Incorporation	FY12 Turnover	FY12 PAT
Direct Subsidiaries			
Zensar Technologies Inc	USA	7166.9	284.1
Zensar Technologies (Singapore) Pte. Ltd.	Singapore	517.5	59.5
Zensar Information Technologies (Shanghai) Co. Ltd.	China	15.6	-18.8
Zensar Technologies (UK) Ltd.	UK	1740.8	75.8
Zensar Advanced Technology Ltd.	Japan	59.1	-16.0
Subsidiaries of Zensar Technologies Inc			
PSI Holding Group Inc	USA	82.2	12.8
Subsidiaries of PSI Holding Inc			
Akibia Inc	USA	4886.8	222.9
Aquila Technology Corp.	USA	35.0	10.5
Akibia, B.V.	Netherlands	620.8	-1.7

Shareholding Pattern: (As on March 31, 2012)

Particulars	No of Shares (In Mn)	% Holding
Foreign	3.6	8.2
Institution	1.2	2.8
Promoters	20.9	48.1
Corporate	1.1	2.5
Public & Others	16.6	38.4
Total	**43.4**	**100.0**

(Source: Company)

Investment Rationale

Expansion of services, geographies and significant projects

ZTL's expansion into Cloud Computing, Mobility and Social Media Consulting Services and Analytics has provided significant opportunities for revenue growth. Further developments are being made in its core services ranging from Applications Development & Maintenance, Enterprise Services including Package Implementations and Business Intelligence, Transaction Processing, Testing and Infrastructure Management. These Services have not only brought about end-to-end process improvements and business benefits for clients ranging from the Fortune 100 and FTSE 100 in US, UK and Asia to small start-ups in South Africa and the Middle East but have also helped in creating deep intellectual capital.

ZTL continues to do well in its core Oracle Business by adding more than 16 new accounts in FY12, winning four new deals in R12 Implementations in the US in Q4 including for one of the largest specialty retailer selling high-quality apparel and accessories for children. ZTL is also a Gold Certified and Strategic Value Added Reseller (SVAR) Partner for SAP in the US, and has won a key project by the use of 'Zenlife' a proprietary accelerator tool, in Life Sciences which has resulted in significant cost savings and increased capabilities and efficiency for sales and distribution of this customer.

Penetrating the Cloud, Social Media and Mobility Market

ZTL today is a key global service integrator and has dedicated centers of excellence built to design and implement solutions that employ a broad portfolio of technologies. This capability lends additional focus on creating next-generation solutions that enable new thresholds of business performance by leveraging **cloud delivery models** and technologies. ZTL is helping customers create optimized levels of business performance, through assessment, advisory services as well as application integration and migration services through platforms such as force.com, Google Apps Engine (GAE) and Microsoft Azure. The Cloud Services Charter in the organization would enable its customers redefine the way they deliver value to their customers.

ZTL entered into a **strategic alliance with Google** earlier to address the emerging market demand for next generation collaboration solution for the benefit of all its Indian and global customers. This partnership is expected to not only enhance collaboration but will also empower ZTL's associates in providing more choice and flexibility in where, when and how they choose to do their work. In Cloud, the partnership with Google has already brought in 2-3 clients and ZTL will be providing cloud platforms to them.

ZTL's **Mobility Consulting Services** helps organizations improve business visibility and employee productivity and assists in porting critical applications onto mobile devices. From receiving information on current status of customer deliveries to allowing boundary-free access to corporate information, ZTL's enterprise mobility applications create new competitive advantages for

businesses. ZTL has also added **Social Media Consulting** as a practice to enable firms in reaching their end user segments faster and to tailor products/services to address end user demands.

IMS, BFSI, Healthcare and Manufacturing / Retail / Distribution - key pillars for future growth

ZTL has a target to take its revenues to an aspirational level of $1bn by FY16. To achieve this, ZTL is likely to focus more on its key areas like IMS, BFSI, Government / Healthcare / Utilities and Manufacturing / Retail / Distribution.

IMS currently contributes 38% to ZTL's total revenues (by service offerings). In this space, the company has a strong presence in Telecom, BFSI and Manufacturing / Retail / Distribution. ZTL has plans to grow its IM space aggressively though strengthening of its existing relationships and partnerships in US and by growing its business in ROW – UK, Germany & Benelux. ZTL is bringing vertical flavor to IM Services. Akibia acquisition has consolidated ZTL's presence in this rapidly growing business. It furthers ZTL's mission to strengthen its position in the critical and fast growing Infrastructure Management and Information Security space by combining ZTL's Remote Infrastructure Management offshore services for global clients with Akibia's US and European Data Center practice.

ZTL is confident that infrastructure management would do well despite all the talks of the European crisis and the impact it could have on clients' IT budgets. The company is looking to strengthen its global customer base of IM through a European acquisition over the next 12-18 months. With organic & inorganic initiatives, we expect the IMS business to do well going forward. Zensar Global IM projections for FY16 include $175 mn from Akibia Core Services, $50 mn from Akibia Offshore / RIMS, $75 mn from Non-Akibia US / Europe, $50 mn from Non-Akibia R-o-W and $50 mn from acquisition. We feel ZTL is capable of achieving its target.

Vertical-wise**, Manufacturing / Retail / Distribution** currently accounts for 50% of ZTL's total revenues with 75% revenues from Fortune 500. Currently 25% of the company's revenues and nearly 50% of the MRD revenues come from the hi-tech companies. The company has a target to make Manufacturing / Retail / Distribution a $500 mn business vertical by FY16. Within manufacturing, focus is likely to in Hi-Tech & Automotive. Oracle & SAP dominance would lead the growth. IT & System Integration capability is likely to drive the revenues. ZTL is looking at SMEs as an area of growth and will target these through solutions and platforms. Within retail, the focus will be on sub-segments like apparel retail and e-tailing. The oracle and SAP capability would lead the new customer engagements.

BFSI currently accounts for 20% of ZTL's revenues (67% of revenues from Fortune 1000). By FY16, ZTL has a target to generate $100 mn revenues from this business. The growth is likely to be driven by leveraging relationship in US, UK, SA and Singapore, growing managed services business & partnerships with products including AWPL, Misys, R-Systems, etc. In BFSI, ZTL's focus would mainly be on Insurance, where it will likely use more platform-based services.

Government / Healthcare / Utilities is a relatively new vertical for ZTL. It is currently focused on the ICD-10 business and has an order book of about $8mn in ICD. Some of the recent wins in this vertical include contracts from municipal corporations in India & from Utility companies in Europe. ZTL's has targeted around $100 mn from this business by FY16. Target market is likely to be large and mid sized healthcare providers, government deals in India & Utilities in US/ EU. The growth would be driven by end-to-end IT & BPO services.

Strengthening position in Infra Management and Information Security space through Akibia acquisition.

ZTL has made 4 acquisitions in the last 10 years to increase its capabilities in SAP, Oracle implementation, high-end technology solutions and infrastructure management. ZTL made a significant acquisition of PSI Holdings Group Inc. a limited liability company incorporated in Massachusetts, US and its wholly owned subsidiaries namely (i) Akibia Inc, (ii) Aquila Technology Corp; and (iii) Akibia B.V, which are collectively referred to as Akibia Group, in Q3 of FY11 to strengthen its position in critical and fast growing Infrastructure management space. The acquisition cost was Rs. 3.05 bn.

Akibia Group is a conglomerate in the IT services space providing Data Center Management and Network Security Solutions. The company has presence in more than 20 countries and more than 800 customers and has some marquee customers like Federal Reserve Bank, JP Morgan Chase etc. The acquisition significantly expands ZTL's accessible market and growth potential, broadening solutions it provides to the rapidly growing Infrastructure markets. It would also expand ZTL's offering of mission-critical solutions to the enterprise customer. The acquisition furthers ZTL's mission to strengthen its position in the critical and fast growing Infrastructure Management and Information Security space by combining ZTL's Remote Infrastructure Management offshore services for global clients with Akibia's US and European Data Center practice. By adding the capabilities of Akibia, ZTL would be able to enhance its customer base for Datacenter services. There is also an opportunity for ZTL to scale up Remote Infrastructure Management Services business using Akibia's large datacenter customer base. This enhanced capability will allow bidding for projects that involve multiple service lines. The acquisition of Akibia also diversifies Zensar's Information Security business by adding Akibia's system integration and consulting expertise in the fast growing network security, compliance and risk management markets.

In FY12, Akibia's revenues stood at $117mn, a growth of 10.2% over FY11. Post the acquisition of Akibia, ZTL is in a position to cross sell services to the mutually exclusive set of clients and this is expected to help growth rates going forward. Around

$20 mn of incremental business is expected from cross selling in FY13. This is also expected to increase the client mining - for instance Nomura is ZTL's client in Asia Pacific and Akibia's client in USA. Order booking for combined services stands at about $14mn. In IM, the company has already won $10mn worth of orders through the joint value proposition. At the time of acquisition, Akibia had PBT margin of 5.5%. ZTL has managed it well to improve it to 8% in Q4FY12 on the back of cost reduction. ZTL has a target to improve it further to 13% by FY14 by rationalization the cost and through better level of dual shore business and infrastructure management. ZTL Global IM revenue projections for FY16 include $175 mn from Akibia Core Services, $50 mn from Akibia Offshore / RIMS.

Pursuing further inorganic opportunities in the Infrastructure Management & Manufacturing space

After a successful acquisition of Akibia, ZTL is pursuing further inorganic opportunities for future growth. Over the next 12-18 months, the company is targeting acquisitions in the range of around $35-40 mn. The company sees infrastructure management as one big area of growth and then in the vertical side, it is looking at manufacturing as the most significant focused area. The management is targeting acquisitions in US in the manufacturing space, particularly SAP area, of revenues ranging from $20-40 mn. SAP is the business that ZTL has grown extremely strongly last year and the company is very bullish about the prospects in the SAP business going forward.

In the infrastructure management side, the company is looking out at a small acquisition in US in the compliance space because there is a lot of focus as companies move their servers to the cloud to make sure that the information security and compliance is really managed. Further, the company is also targeting a follow-on acquisition in Europe in the IM space ranging from €10-€15 mn. This would give ZTL a larger footprint in Europe.

The company has given 15-18% organic revenue growth guidance for FY13. If the targeted acquisitions materialize and are profitable, then it could boost ZTL's consolidated revenues & profits significantly going forward.

Confident of strong growth from CISCO going ahead

Though, post the acquisition of Akibia, ZTL's revenue dependence on CISCO has reduced from 36-37% (six quarters ago) to ~22% in Q4FY12, CISCO still continues to remain the largest client of ZTL. Over the past few quarters (especially till Q3FY11), It had been facing scale up issues because of internal restructuring within the client. However, the company reported decent Q-o-Q growth of 11% in Q4FY12. ZTL expects CISCO's revenues to scale up in FY13, since CISCO has recently conducted vendor rationalization exercise. As per the management, Cisco has rationalized its vendor base to cut the costs. In this process, Cisco has discontinued work with one of the large Indian vendors. This is likely to benefit ZTL in terms of generating additional revenues going forward. ZTL expects CISCO to get back on its robust growth track in FY13 onwards. This is likely to boost ZTL's revenues going forward.

Deal pipeline continues to remain healthy

The deal pipeline continues to remain healthy. In the US, ZTL has recently bagged a multi-million dollar contract with the world's leading provider of Conflict Management and Dispute Resolution Services, to develop and integrate its Case Management System and related business process to various end systems using Fusion Middleware technology. The Company has also bagged the Fusion Middleware implementation and support contract from the leading global interactive entertainment software company in the US that develops, publishes, and distributes interactive software worldwide for video game systems.

In the UK, the Company has implemented a Fusion Middleware and Business Intelligence Enterprise Edition at a leading High Street and On-Line Fashion Retailer. The solution deployed is one of the first few implementations globally involving Retail Data Model. ZTL has also reported on a number of new wins in the Oracle Retail Practice and Process and Discrete Manufacturing in the UAE and Saudi Arabia. ZTL has also entered into a three-year, multimillion-dollar engagement with UK's leading independent private bank, to provide end-to-end support and maintenance services for the bank's core applications. Under the support and maintenance services agreement, ZTL would support multiple applications - which defines the core banking application. Besides providing application maintenance services support, Zensar will also deliver the mission-critical, IT infrastructure services support to the bank's ever-growing network of branches.

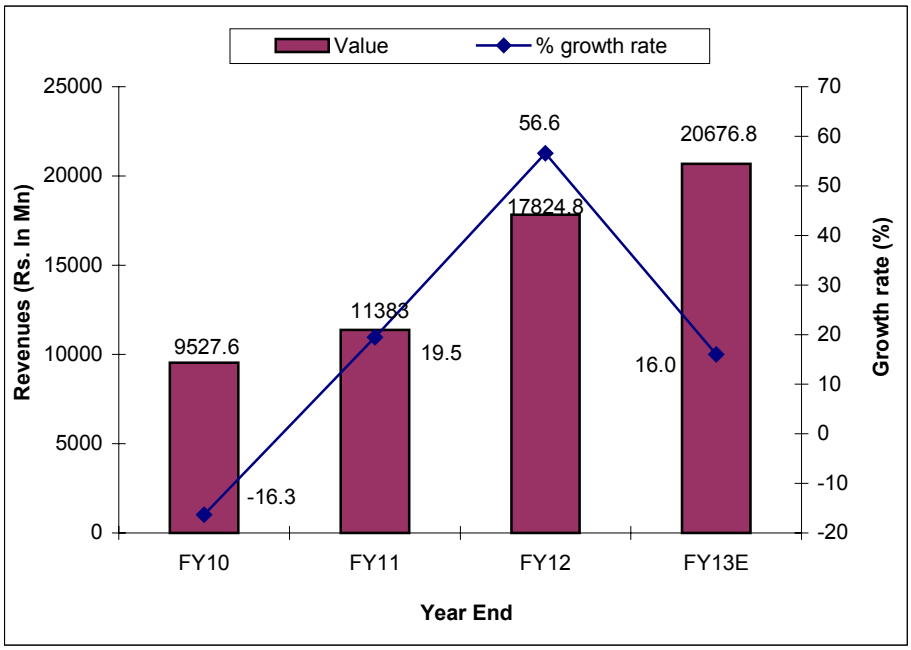
On the order book, there are around $500 mn of contracts for FY13. We expect the deal pipeline to continue to remain healthy going forward.

Turnover to grow by 16% in FY13, cost optimization, lower effective tax rate to boost profits

ZTL's revenues have grown at a CAGR of 16.1% over FY09-12. We expect ZTL's revenues to grow by 16% in FY13 (assumed to be only organic). IM, BFSI, Manufacturing / Retail / Distribution and Government / Healthcare / Utilities are likely to be key growth pillars for ZTL going forward. Akibia is expected to do well, while vendor rationalization exercise by CISCO is likely to benefit ZTL in generating additional revenues from CISCO going forward. In case ZTL undertakes any acquisition in FY13, then it would boost the consolidated revenues further. The management expects FY13 consolidated revenue growth of

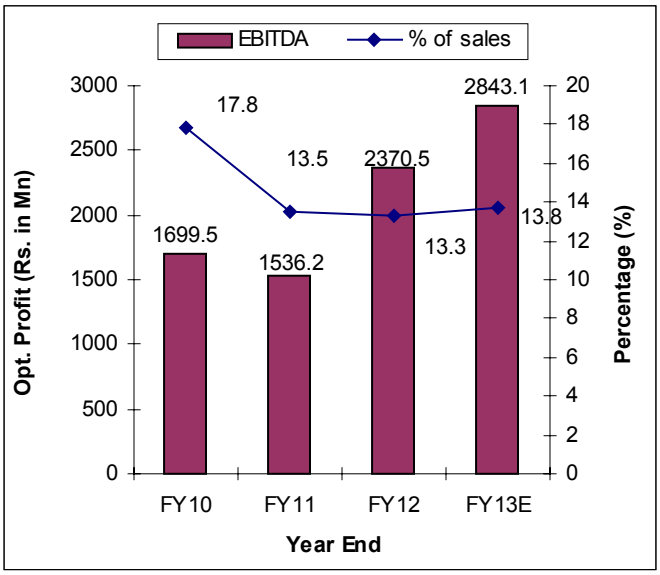
15-18% on top of currency/acquisition impact. It expects FY13 volume growth to be 15%. ZTL has kept an ambitious target of becoming a $1 bn company by FY16.

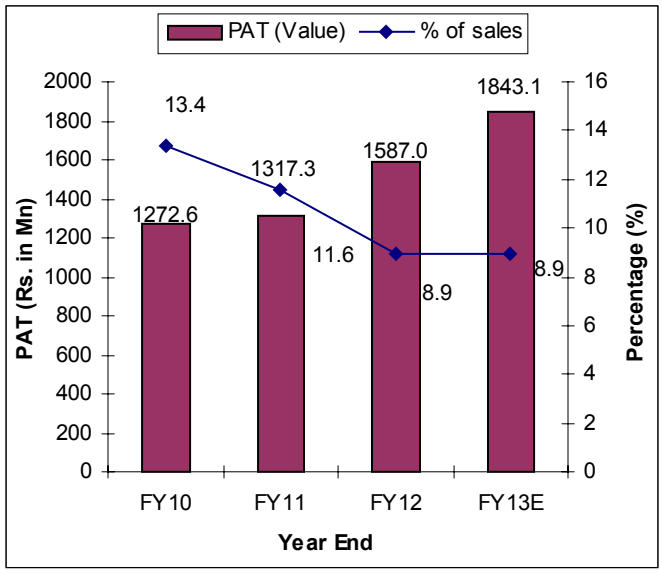
The chart below gives an overview of ZTL's consolidated revenues since FY10 along with our projections for FY13:



We expect ZTL's operating profit & PAT to grow by 19.9% and 16.1% respectively in FY13. Rationalization of low-margin business, cost optimization and turnaround in Akibia's profitability could result in margin expansion. The company has benefited due to vendor consolidation by 2 of the Top 10 clients. ZTL stated that it is likely to rationalize some more accounts, which are yielding low margins. This is likely to improve the company's margins. We expect ZTL's OPM to increase by 45 bps to 13.8% in FY13. However, PAT margins are likely to stay flat at 8.9% in FY13. While we have projected lower other income in FY13 (in FY12, ZTL had earned an exchange gain of Rs. 290 mn), effective tax rate on PBT is likely to be lower (estimated to be 31.5% in FY13 compared to 32.9% in FY12) due to expected increase in revenues from SEZs. This is likely to protect the downside in the PAT margins.

The chart below gives an overview of ZTL's operating profit & PAT since FY10 along with our projections for FY13:





Consistant Dividend Payment

ZTL has a good track record of enriching its shareholders' wealth with consistent dividend payments. The dividend payment has increased consistently from Rs. 35 mn in FY02 to Rs. 304 mn in FY12. The dividend payout ratio in FY12 was the highest in last 3 years at 19.1%. Looking at strong growth prospects, we expect the dividend payout ratio to increase going forward.

Risks and concerns

- Providing service in the USA & Europe is becoming tough and expensive due to adverse regulatory changes. US is a major revenue contributor for ZTL, as the region accounts for 71% of the total revenues of ZTL. Protectionist measures in the US could lead to greater scrutiny of visa applications and potentially higher costs owing to the need to hire a greater number of more expensive onsite resources.
- High currency fluctuations, especially in INR / USD, could lead to forex losses and adversely impact profitability. The company normally benefits in terms of forex gains when the rupee depreciates, since a large amount of ZTL's operations are on a branch mode and therefore the debtors get converted. The company's receivables stood at Rs. 3.4 bn in FY12. Hence sharp rupee appreciation could impact both company's revenue & profit growth. However, ZTL has a policy of hedging the receivables (plain vanilla hedge) and has hedged about 52% of its receivables for the next three months.
- If the Eurozone problems are stretched for a longer period, it could lead to a global slowdown and could impact the company's financial performance (especially the volumes & pricing) going forward. ZTL derives around 10% revenues from Europe.
- Higher-than-expected wage-cost inflation could put pressure on margins going forward.
- ZTL has stated that it has not witnessed any major delays in project ramp-ups or start of new projects, both discretionary and non-discretionary. However, any delay on that front could impact the sales & profit growth of ZTL.
- The dependence of ZTL on Cisco, the largest client for ZTL, currently stands at 22%. Though it has reduced from 36-37% six quarters ago, it is still large enough to impact ZTL's revenues in case CISCO witnesses a slowdown. Cisco revenues had not scaled up for around three quarters (till Q3FY12) because of internal restructuring within the client. While ZTL expects CISCO's revenues to scale up in FY13, any disappointment on that front could hamper ZTL's growth prospects.
- ZTL expects its consolidated margins to improve as it expects Akibia margins to improve by 1-2% besides organic business improvement. Any delay in turnaround in Akibia's profitability growth could restrict the overall margin expansion of ZTL.
- ZTL has made 4 acquisitions in the last 10 years and is targeting some more acquisitions in US & Europe in the range of around $35-40 mn over the next 12-18 months. This could expose the company to more integration risks and risk of overpayment for the company, which in turn could have an adverse impact on the financials if not executed well.

Conclusion & Recommendation:

We expect ZTL's revenues & PAT to grow by 16.0% each in FY13. IM, BFSI, Manufacturing / Retail / Distribution and Government / Healthcare / Utilities are likely to be key focus areas and major growth catalysts. Akibia is expected to do well. The consolidated service offerings along with Akibia are getting increased acceptance from company's clients. ZTL has an opportunity to scale up its Remote Infrastructure Management Services business using Akibia's large datacenter customer base. Cross selling opportunities of own and Akibia products across globe is likely to increase the client mining going forward. Vendor rationalization exercise by CISCO is likely to benefit ZTL in generating additional revenues from CISCO. The company is confident of strong growth from CISCO going ahead

We have assumed FY13 revenue growth to be purely organic. ZTL is also pursuing inorganic opportunities in US & Europe over the next 12-18 months in the infrastructure management (in compliance space) & manufacturing (in SAP), which it considers big areas of growth going forward. If these acquisitions materialize, then it could boost the consolidated revenues of ZTL significantly going forward.

We expect ZTL's operating margins to improve in FY13 on the back of rationalization of low-margin business, cost optimization and expected turnaround in Akibia's profitability. The company has benefited due to vendor consolidation by 2 of the Top 10 clients. ZTL stated that it is likely to rationalize some more accounts, which are yielding low margins. This is likely to improve the company's margins. Further, despite the lower other income expected in FY13 (assuming there would be no forex gains in FY13), PAT margins are likely to remain stable at FY12 levels mainly on the back of expected increase in revenues from SEZs.

At CMP, ZTL is trading at 6.1xFY13E EPS, which is at a discount to MTL. In terms of financial parameters like Revenue & PAT per employee, return ratios like ROCE & RONW, P / BV and dividend payouts (19.1% in FY12 vs 7.4% in case of MTL), ZTL is better placed compared to MTL. Despite this, ZTL trades at a discount, largely due higher onsite revenue proportion (70.7% compared to MTL's 33.6%), higher dependence on IMS (commoditised services), client concentration risk (Top client Cisco accounts for 22% of the total turnover) and higher dependence on US (71% of total revenues). However, if ZTL is able to steadily improve its margins, revenue growth profile remains stable, acquisitions that it plans are successfully integrated, then it could get much better valuations going forward. We feel ZTL deserves to trade at 7xFY13E EPS, which gives a price target of Rs. 297. We feel investors can buy this stock at current levels in small quantities and add on dips in the price band of Rs. 233-244 (5.5-5.75xFY13E EPS) for the mentioned price target over the next one to two quarters.

Quarterly Financial Performance: (Consolidated)

(Rs. In Million)

Particulars	Q4FY12	Q4FY11	VAR [%]	Q3FY12	VAR [%]	Q2FY12	Q1FY12
Revenue from operations	4939.1	3742.6	32.0	4808.3	2.7	4089.6	3987.8
Purchase of traded goods / Change in Inventories	601.1	400.7	50.0	566.7	6.1	298.9	530
Employee Benefit Expenses	2913.6	2307.7	26.3	2622.7	11.1	2425	2230.9
Other Expenditure	814.0	664.4	22.5	920.0	-11.5	842.4	796.2
EBITDA	610.4	369.8	65.1	698.9	-12.7	523.3	430.7
Finance Cost	25.7	23.3	10.3	23.8	8.0	22.5	21.4
Depreciation	92.6	90.3	2.5	78.2	18.4	81.4	81.2
Other Income	77.7	95.6	-18.7	201.1	-61.4	191.1	57.1
PBT	569.8	351.8	62.0	798	-28.6	610.5	385.2
Tax (DT & FBT)	176.9	-26.4	-	275.1	-35.7	210	114.5
PAT	392.9	378.2	3.9	522.9	-24.9	400.5	270.7
Minority Interest	0	0	-	0	-	0	0
PAT (Net of minority interest)	392.9	378.2	3.9	522.9	-24.9	400.5	270.7
EPS (Rs.)	9.1	8.7	3.6	12.0	-24.9	9.2	6.2
Equity	434.1	433	0.3	434	0.0	433.9	433.8
FV	10	10	0.0	10	0.0	10	10
EBITDA (%)	12.4	9.9	25.1	14.5	-15.0	12.8	10.8
PATM (%)	8.0	10.1	-21.3	10.9	-26.9	9.8	6.8

(Source: Company, HDFC Sec)

Financial Estimations: (Consolidated)

Profit & Loss A/c

(Rs. In Million)

YE March	FY11	FY12	FY13E
Revenue from operation	**11383.0**	**17824.8**	**20676.8**
Purchase of Traded Goods / Change in Inventories	476.3	1996.7	2584.6
Employee Benefit Expense	7379.7	10192.2	11940.8
Other Expenses	1990.8	3265.4	3308.3
EBITDA	**1536.2**	**2370.5**	**2843.1**
Finance Costs	38.6	93.4	108.7
Depreciation & Amortisation	288.5	333.4	379.6
Other Income	292.1	419.8	335.8
PBT	1501.2	2363.5	2690.6
Provision for Tax	183.9	776.5	847.5
PAT	1317.3	1587.0	1843.1
Earnings in Affiliates	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0
Adjusted PAT	**1317.3**	**1587.0**	**1843.1**

(Source: Company, HDFC Sec Estimates)

Balance Sheet

(Rs. In Million)

YE March	FY11	FY12	FY13E
Equity & Liabilities			
Shareholders Funds	**4460.1**	**5759.2**	**7170.7**
Share Capital	433.0	434.1	434.3
Reserves & Surplus	4027.1	5325.1	6736.4
Non-Current Liabilities	**2391.8**	**2144.6**	**1969.9**
Long Term borrowings	2140.3	1858.9	1673.0
Trade Payables	0.0	2.4	2.8
Other Long Term Liabilities	78.3	59.6	53.6
Long Term Provisions	173.2	223.7	240.5
Current Liabilities	**2972.9**	**4351.9**	**5069.0**
Trade Payables	996.6	1337.0	1550.9
Other Current Liabilities	1682.1	2494.1	2893.2
Short Term Provisions	294.2	520.8	625.0
Total Equity & Liabilities	**9824.8**	**12255.7**	**14209.7**
Assets			
Non-Current Assets	**4267.0**	**4386.5**	**4720.8**
Fixed Assets:	3522.8	3803.4	4103.4
Tangible Assets	1007.5	976.4	1107.9
Intangible Assets (including under development)	2470.0	2827.0	2995.5
Capital work in progress	45.3	0.0	0.0
Non-Current investments	9.7	9.6	10.1
Deferred Tax Assets (net)	209.2	235.7	235.7
Long Term Loans & Advances	525.3	337.8	371.6
Current Assets	**5557.8**	**7869.2**	**9488.9**
Current Investments	246.4	468.2	561.8
Inventories	835.5	949.8	1101.8
Trade Receivables	1875.7	2910.7	3434.6
Cash & Bank Balances	1099.9	1744.8	2307.7
Short Term Loans & Advances	916.1	1141.7	1324.4
Other Current Assets	584.2	654.0	758.64
Total Assets	**9824.8**	**12255.7**	**14209.7**

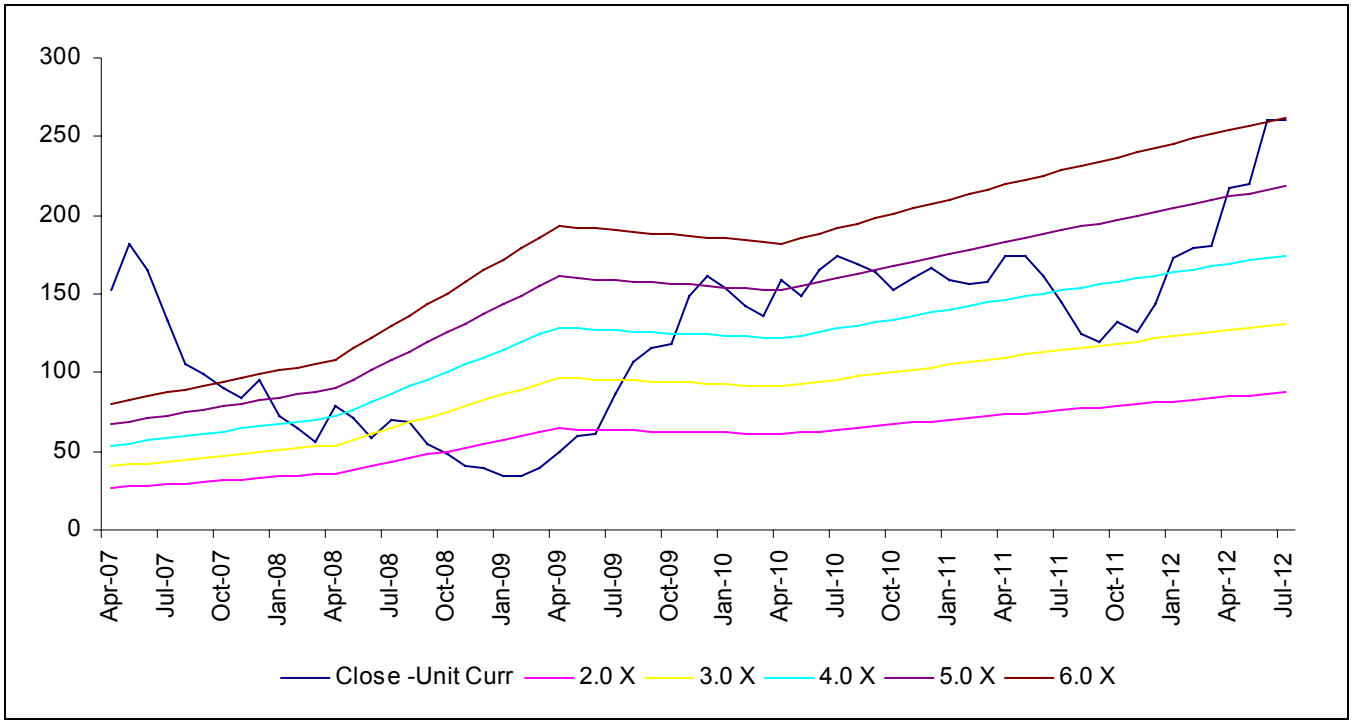
(Source: Company, HDFC Sec Estimates)

Key Ratios

YE March	FY11	FY12	FY13E
FD EPS	**30.3**	**36.5**	**42.4**
PE (x)	**8.6**	**7.1**	**6.1**
Book Value (Rs.)	103.0	132.7	165.1
P/BV (x)	2.5	2.0	1.6
EBITDA (%)	13.5	13.3	13.8
PBT (%)	13.2	13.3	13.0
NPM (%)	11.6	8.9	8.9
ROCE (%)	22.5	31.1	30.6
RONW (%)	29.5	27.6	25.7
Debt-Equity	0.5	0.4	0.3
Current Ratio	1.9	1.8	1.9
Mkt. Cap / Sales (x)	1.0	0.6	0.5
EV/EBITDA	7.9	4.6	3.6

(Source: Company, HDFC Sec Estimates)

ZTL's price chart with 1-year forward PE:



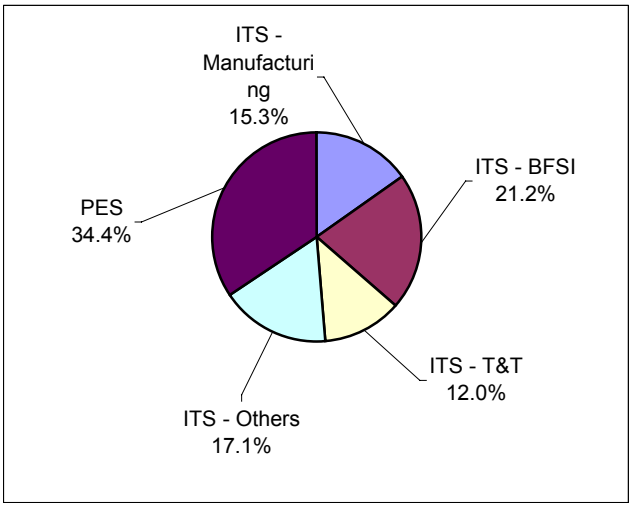
Mindtree Ltd. (MTL)

Business Profile

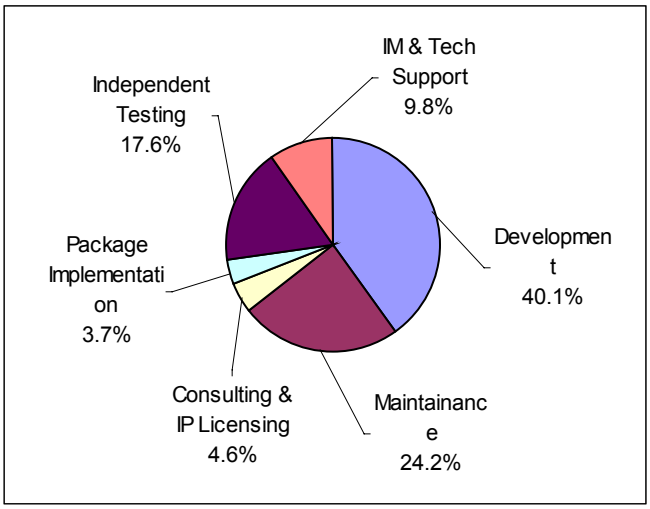
Incorporated in 1999, the Subroto Bagchi promoted MindTree Ltd (MTL) is a global IT and Product Engineering Services Company with deep knowledge in specific domains. MTL is acknowledged as the best mid-size software services company in India for its capability to build, test and deploy solutions. The company got listed in March 2007 and is co-headquartered in Bangalore, India and Warren (New Jersey). MTL has three development centres in India and 15 offices spread across the US, Europe and Asia-Pacific geographies.

MTL offers a range of IT services such as application development and maintenance (ADM), consulting, package implementation, independent testing and infrastructure management services to focused industry verticals like banking, financial services and insurance (BFSI), manufacturing and travel/transportation. From a segment-wise perspective, MTL's business is divided into two segments, IT services (ITS) and product engineering services (PES). In the ITS business, MTL offers solutions like ADM, testing, enterprise services, infrastructure services and consulting. In the PES business, the IT firm works with software product companies like Microsoft to launch new products and support them enabling faster time-to-market.

Industry-wise Revenue breakup (FY12)

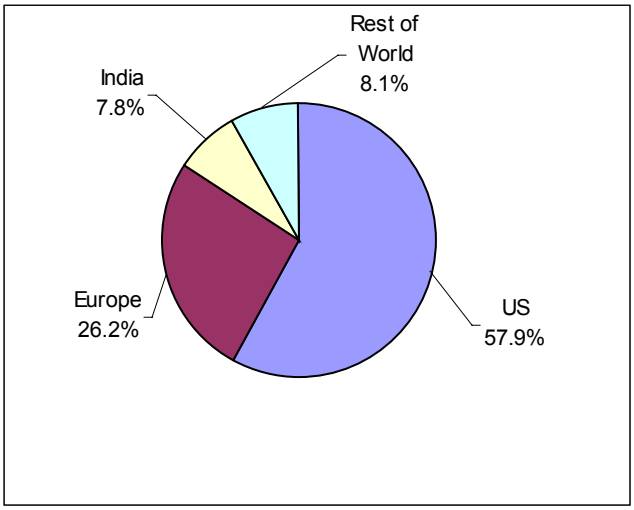


Revenue Share of Service Offerings (FY12)

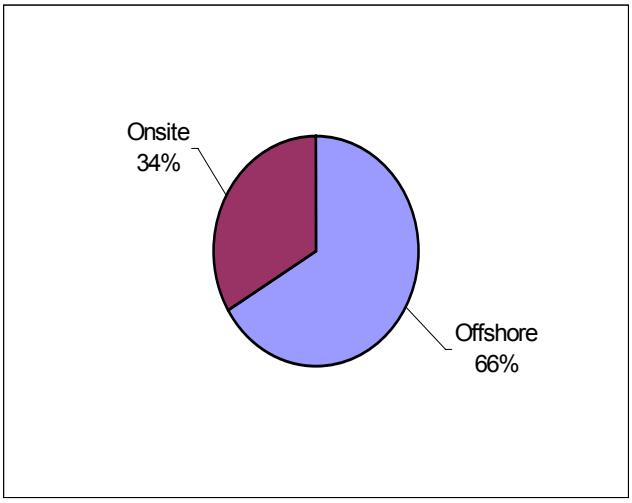


Geographically, US is a major revenue contributor, which accounts for 57.9% of MTL's total revenues. Europe contributes 26.2%, while India & Rest of the World (ROW) account for the balance 7.8% & 8.1% respectively. Location-wise, ZTL's offshore revenues account for 66.4% of the total revenues. The company's total employee strength as on March 31, 2012 stood at 11,000.

Geographical Revenue Breakup (FY12)



Offshore & Onsite Revenue Mix (FY12)



MTL has only two subsidiaries (as on March 31, 2012) viz; MindTree Software (Shenzhen) Co. Ltd. and MindTree Wireless Pte. Ltd., Singapore (dissolved w.e.f April 05, 2011), which are not generating any revenues at present. In FY12, MTL dissolved its two subsidiaries viz., Aztecsoft Disha Inc and Aztec Software Inc.

Acquisition and amalgamation of MindTree Wireless Private Limited

In FY10, MTL acquired 412,500 equity shares of MindTree Wireless Private Limited (MWPL) [formerly Kyocera Wireless (India) Pvt Ltd] in the fiscal year 2009-10, representing 100% of equity share capital of MWPL at a consideration of Rs. 437 mn (including a contingent consideration of Rs. 144 mn). Consequently, MWPL became a 100% subsidiary of the Company with effect from Oct 1, 2009. The Company had subsequently reassessed contingent consideration payable based on forecast of estimated future revenue and during FY11, reduced it by Rs. 100 mn. Consequently, the cost of investment was reduced to Rs. 337 million as at March 31, 2011. b) The Company filed a scheme of Amalgamation ("the Scheme") with the Hon'ble High Court of Karnataka for the merger of MWPL with the Company and as per the terms of the Scheme, MWPL was amalgamated with the Company with effect from April 1, 2010.

Shareholding Pattern: (As on March 31, 2012)

Particulars	No of Shares (In Mn)	% Holding
Foreign Institutions	8.05	19.86
Locals Institutions	3.87	9.55
Promoters	8.19	20.20
Corporate	11.21	27.65
Public & Others	9.22	22.74
Total	**40.54**	**100.00**

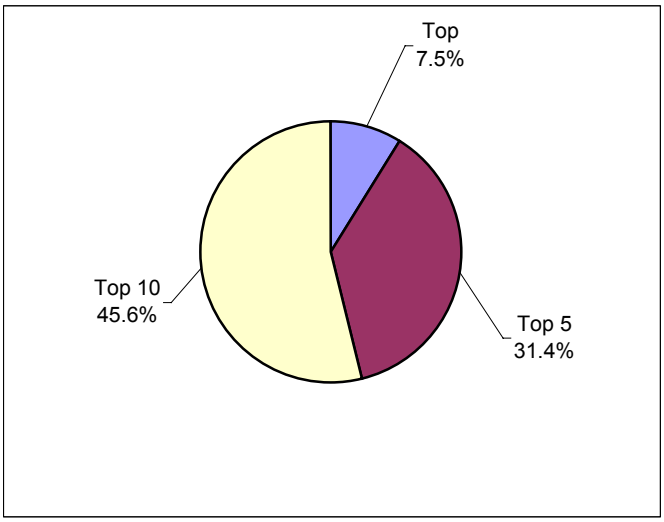
(Source: Company)

Investment Rationale

Diversified clientele with reputed relationship, comprehensive range of service

MTL has a well-diversified client base with top client accounting for only 7.5% of the total revenues. Company has 37 Fortune 500 clients across verticals like auto, consumer goods, software and hi-tech. Client distribution within revenue brackets is also impressive with 4 clients in the $20 mn category, 7 clients in $10 mn category & 17 clients in $5mn category. With time, the company has over the years demonstrated its ability to build and manage large client relationships and outsourcing engagements. The company's marquee client list comprises well-known names such as Unilever, Procter & Gamble (P&G), Microsoft, The Coca-Cola Company, PepsiCo, KPN and Volvo. Around 99.6% of MTL's revenues come from repeat business (existing customers). The company is ranked amongst the top global 100 IT companies in the Global Services (GS100) companies list, instituted by Global Services Media and NeoAdvisory. Besides, it is ranked in the GS100 list in several other categories, including top global mid-tier IT outsourcing vendors; leading mid-tier Application Development and Maintenance vendors; top Engineering Services outsourcing vendors; top Product Engineering vendors and top emerging Infrastructure Management vendors. The company is recognized among the top 20 IT Services Exporters by the National Association of Software and Service Companies (NASSCOM) for 2010-2011.

Revenue share of Top, Top 5 & Top 10 clients



MTL has developed a comprehensive range of services to ensure that it offers end-to-end IT services to its clients. With delivery centers in India and the U.S., the company offers IT strategy consulting, application development and maintenance, data warehousing and business intelligence, package implementation, product architecture, design and engineering, embedded software, technical support, testing, infrastructure management, and knowledge processing services to its customers. The R&D research team creates intellectual property primarily in the short-range wireless communication segment, which are licensed to its clients. This comprehensive portfolio of service offerings helps the company's customers achieve their business objectives.

Niche verticals like BFSI, Manufacturing, etc – key focus areas, maintenance, IMTS and Testing services to provide opportunities

Among the industry verticals, BFSI and Manufacturing are the major revenue contributors, which account for 36.5% of the total revenues (in FY12). Among the other key verticals, Travel & transportation contributes 12% to the total revenues. Within BFSI (21.2% of revenues), MTL focuses on niche segments such as casualty and property insurance, while within manufacturing; focus is on automotives and trade promotion management within consumer durables. In the product engineering business, its focus is on Business intelligence, enterprise products, consumer and communication markets and portal and web companies. This effort of specialization differentiates the company amongst its peers.

BFSI has been a strong growth engine for the company in FY12. The segment has clocked a 35.3% CAGR revenue growth over FY10-12 as compared with the company average of 21.6%. However, over the last few months, the segment has witnessed some slowdown. While the company sees a little bit of a caution and delay on the BFSI side, it considers this to be the temporary phase. The company does not see any closing of budgets. Manufacturing continues to be fairly strong as does travel. Manufacturing has shown a 33.7% CAGR revenue growth over FY10-12. We expect both these segments to continue to drive MTL's revenue growth going forward as the corporates in these segments in the Western world which were struggling for survival have now become leaner and fitter assuring longer sustainability. Travel and transportation is likely to provide buoyant growth since severe cost advantage can be achieved by integration of IT.

Infrastructure Management & Tech Support (IMTS) consists of support and maintenance of IT infrastructure through Implementation of services, managed and consulting services, security services and technical support while testing consists of periodic testing of new technologies with the existing installed ones. The business is expected to scale up going forward as the companies from the western world would aggressively look for cost cutting measures. This is likely to boost MTL's revenues. The maintenance and testing is likely to be off-shored increasing the business pie of the Indian IT service providers and reducing costs for the clients. This would enable MTL to move towards non-linear revenues.

Strategy to focus on select verticals and leveraging domain expertise resulting in improved client metrics

MTL has already started to yield benefits in terms of improvement in the client metrics from its strategy of focusing on select verticals and leveraging domain expertise. This is evident from the fact that the company's revenue per client has increased from $1.2 mn in Q4FY10 to $1.7mn in Q4FY12. This reflects in the 6.1% CQGR rise in revenue share from top 10 clients from 40% in Q4FY10 to 45.6% in Q4FY12. The number of clients across the revenue brackets have also increased steadily, with US$1mn revenue clients increasing from 60 in Q4FY10 to 77 in Q4FY12, US$5mn clients rising to 17 from 13 in Q4FY10) and US$10mn clients increasing from 5 to 7. More interestingly, the clients in the US$20mn+ brackets, which were NIL in Q1FY12, stood at 4 in Q4FY12. This reflects MTL's success in its strategy of focusing on select verticals for growth and expansion of service lines, which has improved the overall client metrics.

Going forward, MTL is likely to continue with this strategy, which would further improve the client mining and drive the company's revenues and profits going forward.

Early exit of failed smartphone business a positive step, focus now back on core IT services business

Lack of client mining as well of management focus due to entry into unrelated business had led to relatively slower revival in revenues in FY11. Eyeing the handsome profits made in the Indian mobile market, MTL had acquired the captive unit of Kyocera wireless corporation in H2FY10 and subsequently had ventured into design and manufacturing of smartphones. The company was infact planning to launch a 3G smartphone based on Google's Android operating system in the US. Leveraging on Kyocera's expertise in wireless phones arena, Wimax & LTE, MTL was targeting to produce mobile handsets and sell them to OEMs/Service providers.

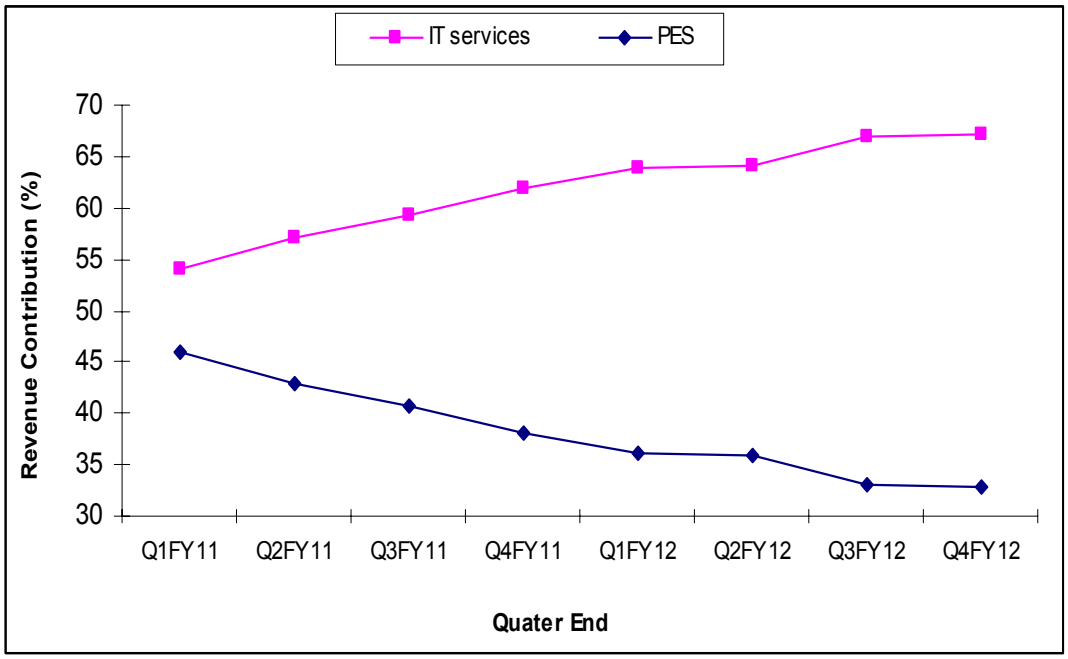
The company had initially made an investment of $4.5 mn into the business in H1FY10. However, the venture became unfeasible, as it required investments of about US$75-80mn against the expectation of US$10-12mn. Hence due to this cost overrun the company decided to exit the business. The company had an overall impact with investments to the tune of US$8-9mn being written off, thus impacting the P&L. While the entry in this business proved to be a mistake, the move of exiting the same proved to be beneficial since the market is over saturated and MTL had already posted a loss of $4.5 mn in the H1FY12.

The restructuring charge was significantly lower at $3.2 mn than what the company earlier estimated (at $12-15 mn). Further, the expertise gained by MTL in developing mobile handsets especially on the Android front is now being successfully utilized in terms of offerings to semiconductor/ communication equipment clients.

IT Services to help achieve growth above industry average, pick up in PES revenues to be gradual

IT services (ITS) consists of Application Development and Maintenance, Consulting, Data and Analytics solutions, Infrastructure Management, Mobility and Testing. The business currently accounts for 65.6% of MTL's revenues (in FY12; 67.2% in Q4FY12). In FY10, the revenue share of the ITS business fell to 53.8% because of MTL's entry in wireless business. However, with the exit of the smartphone business & slowdown in the PES business, ITS revenue contribution increased substantially to 65.6% in FY12. The business has infact witnessed a steady Q-o-Q increase in the revenue share over the last eight quarters from 54.1% in Q1FY11 to 67.2% in Q4FY12. On the other hand the revenue contribution of the PES segment has reduced steadily from 45.9% in Q1FY11 to 32.8%, as the challenging global economic environment led to major corporations slowing the investments in new products. Most of the growth in PES segment over the past five years (FY07-12) was mainly led by acquisitions notably Aztecsoft w.e.f. 2QFY09 and Kyocera Wireless w.e.f. 3QFY10. PES has grown at a CAGR of 5% over FY10-12, while ITS has grown at a CAGR of 34.2%. The PES revenue was also impacted from the ramp down in revenue from Japanese firm Kyocera, a key client, which used to contribute $4mn on a quarterly basis to PES revenue. Post the ramp-down, the contribution has reduced drastically to around $1mn per quarter.

Increasing revenue contribution of ITS, share of PES falling

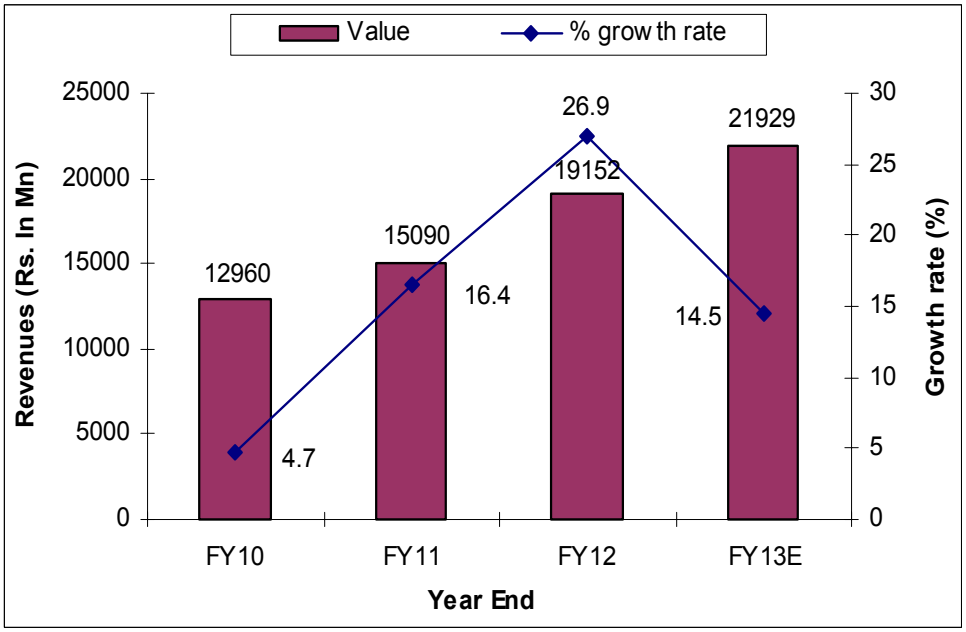


Going forward, we expect the ITS business of MTL to pick up pace and continue to drive growth for MTL. The management expects better growth from this business from H2FY13 onwards. However, with increasing presence of captives, delay in spending & muted outlook for consumer electronic items, we expect PES revenue growth to be lackluster for a few more quarters. Hence we expect the revenue contribution of ITS to increase and PES share could continue to fall over the next few quarters. Any pick-up in PES revenues would depend upon a sustained recovery in the global economy and a rapid solution to the Euro zone crisis. It things improve then along with the ITS business, PES performance could also improve substantially, as the global corporations would start investing more in new product development.

Revenue to grow by 14.5% in FY13, ITS to lead the growth

We expect MTL's revenues to grow by 14.5% in FY13, which would be mainly driven by the ITS business. The company expects growth ahead of industry growth of 11-14% projected by Nasscom for FY13. The growth is likely to be largely back ended. The company has made investment in building client facing team in IT services. This could start yielding benefits in the coming quarters and enable the company to grow its revenues above the industry. However, due to underperformance expected for a few more quarters in PES, we don't expect a significant outperformance from MTL in terms of overall revenue growth. Any turnaround in the PES space could result in better than estimated revenue growth.

The chart below gives an overview of MTL's net sales since FY10 along with our projections for FY13:



Rationalization of employee pyramid & improvement in utilization rate could result in OPM expansion

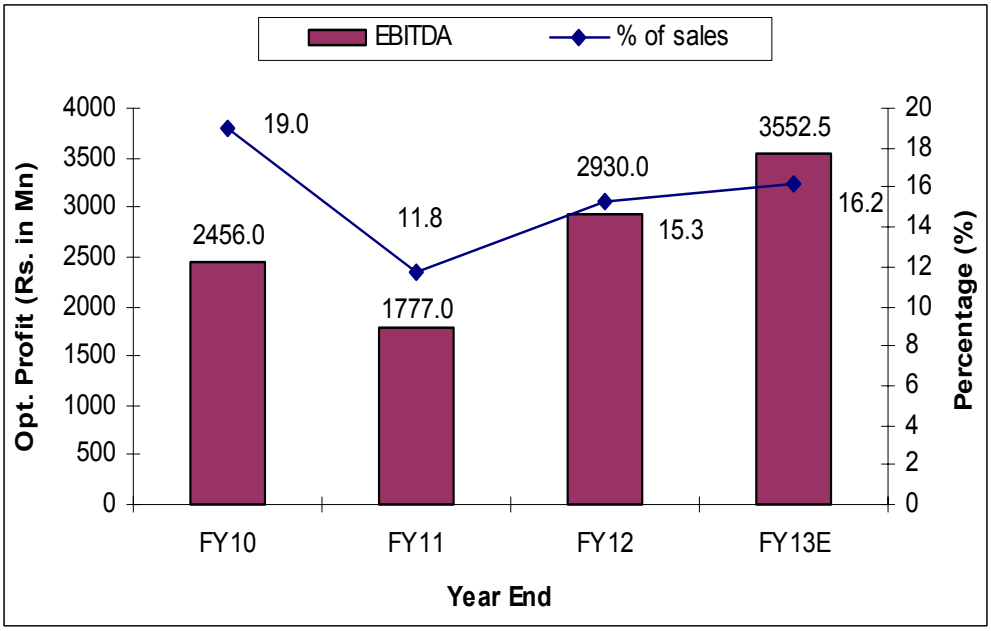
MTL's operating profit has grown at a CAGR of 33.2% over FY09-10. We expect the growth momentum to continue and estimate the operating profit growth at 21.2% for FY13. MTL witnessed a sharp fall of 718 bps in its OPM in FY11 from 19% in FY10 on the back of sharp jump in the employee cost. However, OPM improved to 15.3% in FY12, on the back of rationalization of employee pyramid, cut down on SG&A expenses & INR depreciation.

This move of rationalizing the employee pyramid has helped MTL to shift its employee pyramid significantly, with the employees having less than three years of experience increasing from 30% of the total employee base at the start of FY12 to 36% by the end of FY12. Going forward, the company is targeting further rationalization. For instance, MTL is establishing a training centre during FY13.

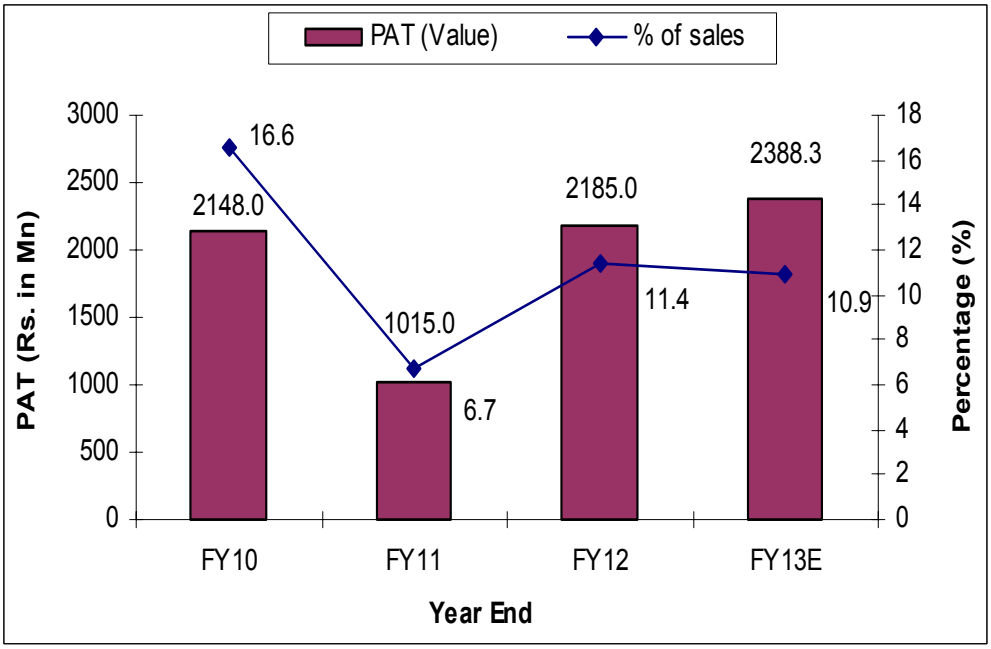
We expect MTL's OPM to improve by 90 bps to 16.2% in FY13. While the wage inflation could continue to put pressure on the margins, this is likely to be more than offset by tailwinds from factors such as continuation of rationalization of the employee pyramid, improving utilization level, efforts to shift offshore and lowering SG&A from current levels. The company has given offers to ~3,000 campus graduates for FY13. The joining ratio is expected to be 70-75% and most of these are expected to join in H1FY13. This would help MTL rationalize its employee pyramid and cushion its margins.

Over the last three quarters, the utilization rate, including & excluding trainees, have steadily fallen from 71.3% & 77.7% in Q2FY12 from 67.8% & 72.1% respectively in Q4FY12 mainly because of strong fresher hiring. However, the company expects the utilization rate to pick up in the coming quarters, as strong fresher hiring done in FY12 would start turning billable. This is expected to improve the operating margins in FY13.

The chart below gives an overview of MTL's operating profit & margins along with our estimations for FY13:



While OPM is set to expand, the company is likely to witness pressure on the absolute PAT and PAT margins on the back of higher effective tax rate expected in FY13 (as two of the company's SEZ facilities complete their 100% tax holiday period and get into the 50% tax bracket in FY13) and lower other income expected over FY12 (in FY12, the other income was substantially higher largely due to reversal of a liability that the company created as contingent consideration payable to Kyocera, which turned out to be much lesser than estimated). We expect the PAT to grow by 9.3% in FY13 and PAT margins are likely to fall by 52 bps to 10.9% in FY13.



Risks and concerns

- Providing service in the USA & Europe is becoming tough and expensive due to adverse regulatory changes. US & Europe are major revenue contributor for MTL, as the regions together account for 84.1% (US: 57.9% & Europe: 26.2%) of the total revenues. Protectionist measures in the US could lead to greater scrutiny of visa applications and potentially higher costs owing to the need to hire a greater number of more expensive onsite resources.
- High currency fluctuations, especially sharp appreciation in the INR / USD, could lead to forex losses and adversely impact the company's profitability & margins.
- If the Eurozone problems are stretched for a longer period, it could lead to global slowdown and could impact the company's financial performance (especially the volumes & pricing) going forward. MTL derives around 26.2% revenues from Europe.
- MTL has high dependence on BFSI segment (20% of the total revenues), which has been witnessing a slowdown since the last few months. The segment is more volatile and generally underperforms the other verticals during the times of slowdown in the IT industry.
- Higher-than-expected wage-cost inflation could put pressure on the margins going forward.
- MTL expects its effective tax rate to go up to about 20-21% in FY13 from 16.4% in FY12, as two of its SEZ facilities complete their 100% tax holiday period and get into the 50% tax bracket in FY13. This is likely to put pressure on the company's bottomline & PAT margins.
- MTL's attrition rate is relatively higher compared to its other mid-cap peers largely due to PES segment. Though it has reduced from a high 25.6% in Q1FY12 to 18.2% in Q4FY12, it still remains on a higher side & poses risk to revenue growth.
- R&D outsourcing services are generally discretionary in nature and their recovery generally lags the IT services. Within RDS, product engineering services (PES) recovers slower than software product engineering. MTL derives 34.4% of its revenues from the PES segment and hence the ongoing macro uncertainties in Europe could result in slower recovery in PES & accordingly slower overall revenue growth for MTL.
- The management expects FY13 USD revenue growth ahead of the industry (11-14% as per NASSCOM estimates). However, we don't expect any significant outperformance in terms of revenue growth over industry growth considering 3,000 campus hires and slower growth expected in PES business.
- MTL's free cash flow has been weak largely due to acquisitions and capital expenditure. This weakness could continue since the company has sizable CAPEX plan of $25-30 mn in FY13. Further, the dividend payout ratio is very less (7.4% in FY12) and dividend yield is modest at 0.8%.

Conclusion & Recommendation:

We expect MTL's revenue & PAT to grow by 14.5% & 9.3% respectively in FY13. The revenue growth is likely to be driven by ITS business. The company expects growth ahead of industry growth of 11-14% projected by Nasscom for FY13. The growth is likely to be largely back ended. Early exit of failed smartphone business is viewed as a positive and the focus now is back on core IT services business. The company has made investment in building client facing team in IT services. This could start yielding benefits in the coming quarters and enable the company to grow its revenues above the industry rates. However, due to underperformance expected for a few more quarters in PES, we don't expect a significant outperformance from MTL in terms of overall revenue growth. Any turnaround in the PES space could result in better than estimated revenue growth.

Among the verticals, BFSI and Manufacturing are likely to remain key focus areas for MTL. Maintenance, IMTS and Testing services are likely to provide MTL immense opportunities going forward. MTL has already started to yield benefits in terms of improvement in the client metrics from its strategy of focusing on select verticals and leveraging domain expertise. Going forward, MTL is likely to continue with this strategy, which could further improve client mining and drive the company's revenues and profits going forward.

Rationalization of employee pyramid & improvement in utilization rate could result in OPM expansion. We expect MTL's OPM to improve by 90 bps to 16.2% in FY13. While wage inflation could continue to put pressure on the margins, this is likely to be more than offset by tailwinds from factors such as continuation of rationalization of the employee pyramid, improving utilization level, effort to shift offshore and lowering SG&A from current levels. The company has given offers to ~3,000 campus graduates for FY13. The joining ratio is expected to be 70-75% and most of these are expected to join in H1FY13. This would help MTL rationalize its employee pyramid and cushion its margins. However, the company is likely to witness pressure on the absolute PAT and PAT margins due to higher effective tax rate expected in FY13 (as two of the company's SEZ facilities complete their 100% tax holiday period & get into the 50% tax bracket in FY13) and lower other income expected over FY12.

At CMP, MTL trades at 11.1xFY13E EPS, which is at a premium to ZTL, despite ZTL being better placed in terms of most of the financial parameters like return ratios (ROCE & RONW), Revenue & PAT per employee, P / BV and higher dividend payouts. We feel this premium could be because of MTL's more reputed management, higher operating & PAT margins, low client concentration (MTL's top client accounts for 7.5% of total turnover, while ZTL's top client share stands at 22%), no presence in IMS (commoditised service), focus on niche areas like travel & transportation and services like product engineering, which are better than low margin IMS (where ZTL has a strong presence). Moreover MTL's well-diversified revenue stream geographically, high offshore presence (66.4% of total revenues, compared to 29.3% in case of ZTL), larger institutional holding compared to ZTL and higher number of Fortune 500 clients also supports the stock's premium valuations.

MTL has historically traded at 13x+ 1 year forward EPS (except during the 2008-09 global crisis and later after the exit of Mr. Ashok Soota, the key promoter/co-founder of MTL). However, its valuation has started to claw back upwards as the street is more confident that Mr. Soota's exit may not have any major impact on the future of the company. Further, the concerns relating to the smart phone business have ended since the company has already exited the business. MTL could also keep witnessing buying from the secondary markets by V G Siddhartha (Coffee Day Group's chairman) whose stake has reached 21.87%. One expects that he could raise the stake to close to 25% i.e. the threshold of making open offer.

We feel MTL is capable of trading at 12xFY13E EPS, which gives a price target of Rs. 708. For better returns and margin of safety, we recommend investors to buy this stock only on dips in the price band of Rs. 590-619 (10-10.5xFY13E EPS) for the mentioned price target over the next one to two quarters.

Quarterly Financial Performance: (Consolidated)

(Rs. In Million)

Particulars	Q4FY12	Q4FY11	VAR [%]	Q3FY12	VAR [%]	Q2FY12	Q1FY12
Revenue from operations	5257	3912	34.4	5197	1.2	4567	4131
Employee Benefit Expenses	3179	2613	21.7	3242	-1.9	3047	2793
Other Expenditure	1133	859	31.9	1083	4.6	932	878
EBITDA	945	440	114.8	872	8.4	588	460
Finance Cost	3	2	50.0	1	200.0	1	0
Depreciation	168	184	-8.7	173	-2.9	174	180
Other Income	51	101	-49.5	36	41.7	241	122
PBT	825	355	132.4	734	12.4	654	402
Tax (DT & FBT)	136	35	288.6	128	6.3	109	57
PAT	689	320	115.3	606	13.7	545	345
Minority Interest	0	0	-	0	-	0	0
PAT (Net of minority interest)	689	320	115.3	606	13.7	545	345
EPS (Rs.)	17.0	8.0	112.7	15.0	13.7	13.5	8.6
Equity	405	400	1.3	405	0.0	403	401
FV	10	10	0.0	10	0.0	10	10
EBITDA (%)	18.0	11.2	59.8	16.8	7.1	12.9	11.1
PATM (%)	13.1	8.2	60.2	11.7	12.4	11.9	8.4

(Source: Company, HDFC Sec)

Financial Estimations: (Consolidated)

Profit & Loss A/c

(Rs. In Million)

YE March	FY11	FY12	FY13E
Revenue from operation	**15090.0**	**19152.0**	**21929.0**
Employee Benefit Expense	9853.0	12261.0	13749.5
Other Expenses	3460.0	3961.0	4627.0
EBITDA	**1777.0**	**2930.0**	**3552.5**
Finance Costs	4	5	6
Depreciation & Amortisation	712.0	695.0	792.7
Other Income	242.0	385.0	250.3
PBT	1303.0	2615.0	3004.1
Provision for Tax	288.0	430.0	615.8
PAT	1015.0	2185.0	2388.3
Earnings in Affiliates	0.0	0.0	0.0
Minority Interest	0.0	0.0	0.0
Adjusted PAT	**1015.0**	**2185.0**	**2388.3**

(Source: Company, HDFC Sec Estimates)

Balance Sheet

(Rs. In Million)

YE March	FY11	FY12	FY13E
Equity & Liabilities			
Shareholders Funds	**7762.0**	**9572.0**	**11723.4**
Share Capital	400.0	405.0	405.0
Reserves & Surplus	7362.0	9167.0	11318.4
Non-Current Liabilities	**247.0**	**71.0**	**74.6**
Long Term borrowings	41.0	37.0	38.9
Other long term liabilities	206.0	34.0	35.7
Current Liabilities	**2136.0**	**3703.0**	**4026.9**
Short Term Borrowings	0.0	407.0	203.5
Trade Payables	167.0	137.0	158.9
Other Current Liabilities	1439.0	2435.0	2824.6
Short Term Provisions	530.0	724.0	839.8
Total Equity & Liabilities	**10145.0**	**13346.0**	**15824.8**
Assets			
Non-Current Assets	**3757.0**	**3805.0**	**4856.4**
Fixed Assets:	3007.0	2676.0	3535.0
Tangible Assets	2951.0	2548.0	3373.0
Intangible Assets	55.0	43.0	43.0
Capital work in progress	1.0	85.0	119.0
Non-Current investments	7.0	7.0	7.0
Deferred Tax Assets (net)	216.0	321.0	385.2
Long Term Loans & Advances	416.0	544.0	631.0
Other non-current assets	111.0	257.0	298.1
Current Assets	**6388.0**	**9541.0**	**10968.5**
Current Investments	1105.0	3075.0	3382.5
Trade Receivables	2825.0	4078.0	4689.7
Cash & Bank Balances	459.0	602.0	824.5
Short Term Loans & Advances	335.0	219.0	254.0
Other Current Assets	1664.0	1567.0	1817.7
Total Assets	**10145.0**	**13346.0**	**15824.8**

(Source: Company, HDFC Sec Estimates)

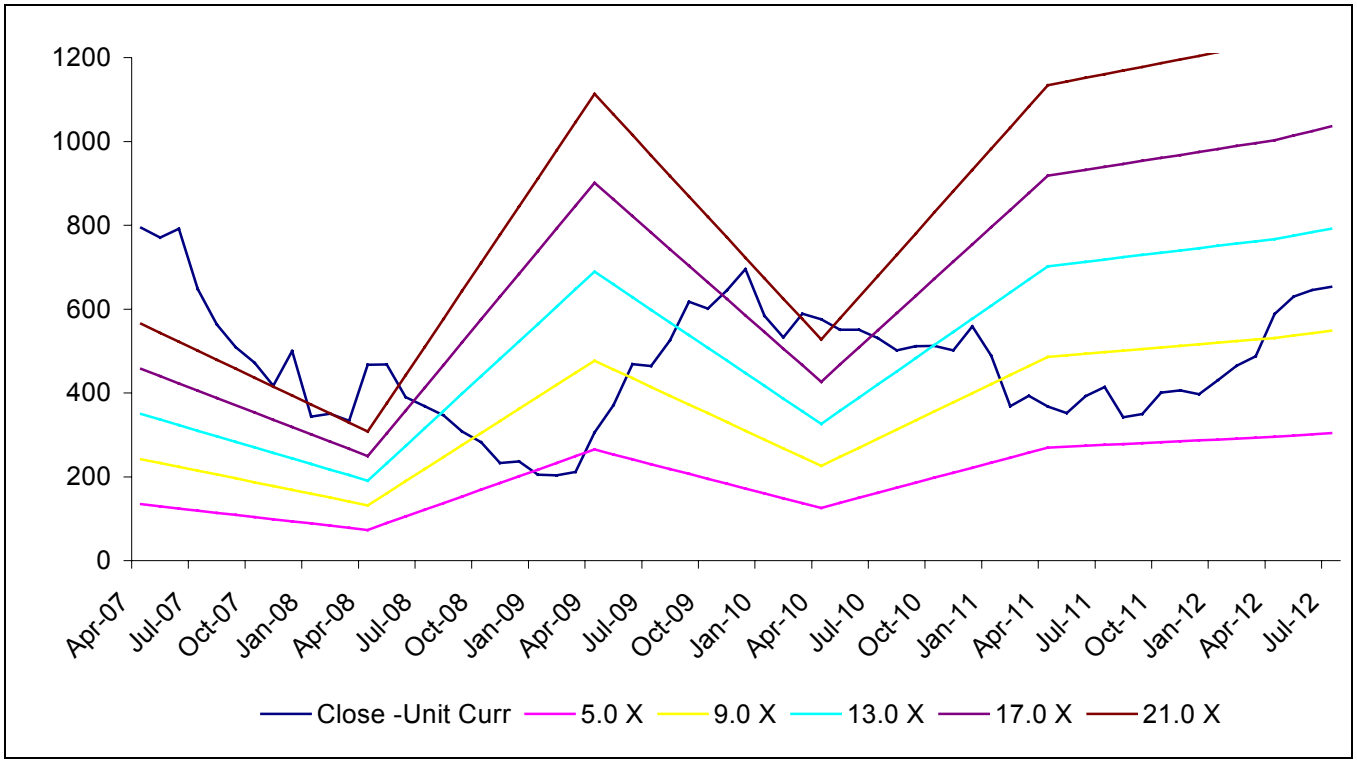
Key Ratios

YE March	FY11	FY12	FY13E
FD EPS	25.1	54.0	59.0
PE (x)	27.9	13.0	11.9
Book Value (Rs.)	194.1	236.3	289.5
P/BV (x)	3.6	3.0	2.4
EBITDA (%)	11.8	15.3	16.2
PBT (%)	8.6	13.7	13.7
NPM (%)	6.7	11.4	10.9
ROCE (%)	16.3	27.2	25.5
RONW (%)	13.1	22.8	20.4

Debt-Equity (x)	0.0	0.0	0.0
Current Ratio (x)	3.0	2.6	2.7
Mkt. Cap / Sales (x)	1.9	1.5	1.3
EV/EBITDA (x)	14.9	8.6	6.9

(Source: Company, HDFC Sec Estimates)

MTL's price chart with 1-year forward PE:



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