Company In-Depth

9 July 2007 | 20 pages

# Tech Mahindra (TEML.BO)

## Initiate With Buy: In a Sweet Spot

- **Target price of Rs1,920 (21x FY09E)**— With outsourcing by telecom service providers (TSPs) on an upswing, we expect Tech Mahindra (TechM) to deliver industry-leading CAGRs of 40% in revenue and 32% in recurring EPS over FY07-FY10E.
- **Beneficiary of IT spend in TSP space** – TechM is the largest Indian IT services player in the TSP space. IT spend by TSPs is expected to remain robust – and TechM should be a prime beneficiary given its strong relationships with the likes of BT (which owns 31% of the company) and AT&T.
- **Management change has fuelled growth** — Various initiatives by new management (joined in 2004) have resulted in faster growth and improved profitability over the past two years. TechM continues to leverage its domain capabilities and to use its JVs/acquisitions/equity partnerships to take advantage of a buoyant telecom outsourcing market.
- **Buy for 31% upside** — Our target FY09E P/E multiple of 21x represents a 10% premium to our fair-value multiple for Satyam – which we believe is justified by TechM's 32% recurring EPS CAGR over FY07-FY10E (vs. 20% for Satyam).
- **High domain/client concentration is key risk** — Our High Risk rating reflects TechM's client/domain concentration. Almost all revenues are derived from the telecom segment, ~64% of them from British Telecom. Also, quarterly performances could be volatile. Sector risks include supply-side challenges, currency risk (though TechM is relatively less exposed to US$) and visa issues.

| | |
|---|---|
| **Buy/High Risk** | **1H** |
| Price (06 Jul 07) | Rs1,463.55 |
| Target price | Rs1,920.00 |
| Expected share price return | 31.2% |
| Expected dividend yield | 0.1% |
| **Expected total return** | **31.3%** |
| Market Cap | Rs177,457M<br>US$4,415M |

**Price Performance (RIC: TEML.BO, BB: TECHM IN)**


See Appendix A-1 for Analyst Certification and important disclosures.

**Statistical Abstract**

| Year to 31 Mar | Net Profit (RsM) | Diluted EPS (Rs) | EPS growth (%) | P/E (x) | P/B (x) | ROE (%) | Yield (%) |
|---|---|---|---|---|---|---|---|
| 2006A | 2,354 | 18.32 | 104.2 | 79.9 | 24.7 | 42.7 | 0.7 |
| 2007A | 1,213 | 9.39 | -48.7 | 155.8 | 17.9 | 15.7 | 0.1 |
| 2008E | 8,291 | 63.55 | 576.5 | 23.0 | 10.2 | 62.3 | 0.1 |
| 2009E | 11,903 | 91.23 | 43.6 | 16.0 | 6.2 | 51.7 | 0.2 |
| 2010E | 14,330 | 109.83 | 20.4 | 13.3 | 4.2 | 40.2 | 0.3 |

Source: Powered by dataCentral

**Surendra Goyal, CFA**[2]
+91-22-6631-9870
surendra.goyal@citi.com

**Hitesh Shah**[1]
+91-22-6631-9872
hitesh.b.shah@citi.com


[1]Citigroup Global Markets India Private Limited

| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| **Valuation Ratios** | | | | | |
| P/E adjusted (x) | 79.9 | 155.8 | 23.0 | 16.0 | 13.3 |
| EV/EBITDA adjusted (x) | 76.8 | 25.6 | 18.5 | 12.5 | 9.2 |
| P/BV (x) | 24.7 | 17.9 | 10.2 | 6.2 | 4.2 |
| Dividend yield (%) | 0.7 | 0.1 | 0.1 | 0.2 | 0.3 |
| **Per Share Data (Rs)** | | | | | |
| EPS adjusted | 18.32 | 9.39 | 63.55 | 91.23 | 109.83 |
| EPS reported | 18.32 | 9.39 | 63.55 | 91.23 | 109.83 |
| BVPS | 59.16 | 81.95 | 142.93 | 237.62 | 351.15 |
| DPS | 10.00 | 1.50 | 2.00 | 3.00 | 4.00 |
| **Profit & Loss (RsM)** | | | | | |
| Net sales | 12,426 | 29,290 | 43,948 | 62,337 | 80,711 |
| Operating expenses | -10,146 | -22,440 | -34,649 | -49,096 | -63,782 |
| **EBIT** | **2,280** | **6,850** | **9,299** | **13,242** | **16,928** |
| Net interest expense | 341 | 15 | 232 | 676 | 676 |
| Non-operating/exceptionals | 0 | 0 | 0 | 0 | 0 |
| **Pre-tax profit** | **2,621** | **6,865** | **9,531** | **13,918** | **17,605** |
| Tax | -267 | -741 | -1,240 | -2,015 | -3,274 |
| Extraord./Min.Int./Pref.div. | 0 | -4,911 | 0 | 0 | 0 |
| **Reported net income** | **2,354** | **1,213** | **8,291** | **11,903** | **14,330** |
| Adjusted earnings | 2,354 | 1,213 | 8,291 | 11,903 | 14,330 |
| Adjusted EBITDA | 2,280 | 6,850 | 9,299 | 13,242 | 16,928 |
| **Growth Rates (%)** | | | | | |
| Sales | 31.4 | 135.7 | 50.0 | 41.8 | 29.5 |
| EBIT adjusted | 121.8 | 200.4 | 35.8 | 42.4 | 27.8 |
| EBITDA adjusted | 121.8 | 200.4 | 35.8 | 42.4 | 27.8 |
| EPS adjusted | 104.2 | -48.7 | 576.5 | 43.6 | 20.4 |
| **Cash Flow (RsM)** | | | | | |
| **Operating cash flow** | **1,704** | **-1,416** | **9,121** | **10,234** | **12,663** |
| Depreciation/amortization | 0 | 0 | 0 | 0 | 0 |
| Net working capital | -331 | -2,553 | 1,062 | -993 | -992 |
| **Investing cash flow** | **-1,174** | **-1,820** | **-2,561** | **-2,558** | **-2,710** |
| Capital expenditure | -1,515 | -1,896 | -2,793 | -3,234 | -3,386 |
| Acquisitions/disposals | 0 | 0 | 0 | 0 | 0 |
| **Financing cash flow** | **-1,061** | **2,103** | **-467** | **-445** | **-593** |
| Borrowings | 0 | 170 | -170 | 0 | 0 |
| Dividends paid | -1,185 | -223 | -297 | -445 | -593 |
| **Change in cash** | **-531** | **-1,133** | **6,093** | **7,232** | **9,359** |
| **Balance Sheet (RsM)** | | | | | |
| **Total assets** | **10,092** | **15,132** | **28,282** | **44,337** | **62,667** |
| Cash & cash equivalent | 2,265 | 1,647 | 8,451 | 16,618 | 27,066 |
| Accounts receivable | 4,377 | 8,216 | 12,041 | 17,079 | 22,113 |
| Net fixed assets | 2,031 | 3,411 | 5,494 | 7,792 | 10,089 |
| **Total liabilities** | **3,938** | **5,831** | **10,987** | **15,584** | **20,178** |
| Accounts payable | 0 | 0 | 0 | 0 | 0 |
| Total Debt | 0 | 170 | 0 | 0 | 0 |
| **Shareholders' funds** | **6,155** | **9,301** | **17,295** | **28,753** | **42,490** |
| **Profitability/Solvency Ratios (%)** | | | | | |
| EBITDA margin adjusted | 18.3 | 23.4 | 21.2 | 21.2 | 21.0 |
| ROE adjusted | 42.7 | 15.7 | 62.3 | 51.7 | 40.2 |
| ROIC adjusted | 63.4 | 104.3 | 96.7 | 107.0 | 99.1 |
| Net debt to equity | -36.8 | -15.9 | -48.9 | -57.8 | -63.7 |
| Total debt to capital | 0.0 | 1.8 | 0.0 | 0.0 | 0.0 |

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## In a Sweet Spot

TechM, a niche IT services provider in the telecom space, is a key beneficiary of the huge IT spend by British Telecom (one of the owners of TechM) and AT&T and Alcatel (with whom it also has strong relationships). TechM is in a sweet-spot in a buoyant market – resulting in industry-leading CAGRs of 40% for revenue and 32% for EPS over FY07-FY10E. While we are cognizant of the risks of a less diversified, domain-focused model such as TechM's, we believe that significantly higher growth will result in a valuation premium over comparables like Satyam and HCL Tech. Initiate with a Buy rating and Rs1,920 target

### Background

- One of India's top 10 IT Services providers focused on the telecom space, TechM services Telecom Service Providers (TSPs), Telecom Equipment Manufacturers (OEMs), Software Vendors and Systems Integrators (SIs).
- Formed in 1986 – JV between M&M and British Telecom (BT).
- Key clients include BT, Alcatel, AT&T, Alltel, Convergys, Motorola, O2 and Vodafone.
- ~20,500 employees at the end of FY07. Revenue and net profit growth over FY05-FY07 has been 76% and 145% yoy.
- TechM is headquartered at Pune with development centres across India and a couple of centers in the UK.
- 45% of revenues from BSS, 20-25% from OSS, 10-15% from Next generation networks and the remainder from new areas.
- TechM is the only Indian playe in the top 10 BSS vendors worldwide, as ranked by Gartner Dataquest.
- The new management team hired in 2004 made significant changes – resulting in a significant turnaround in growth/profitability.

# Investment positives

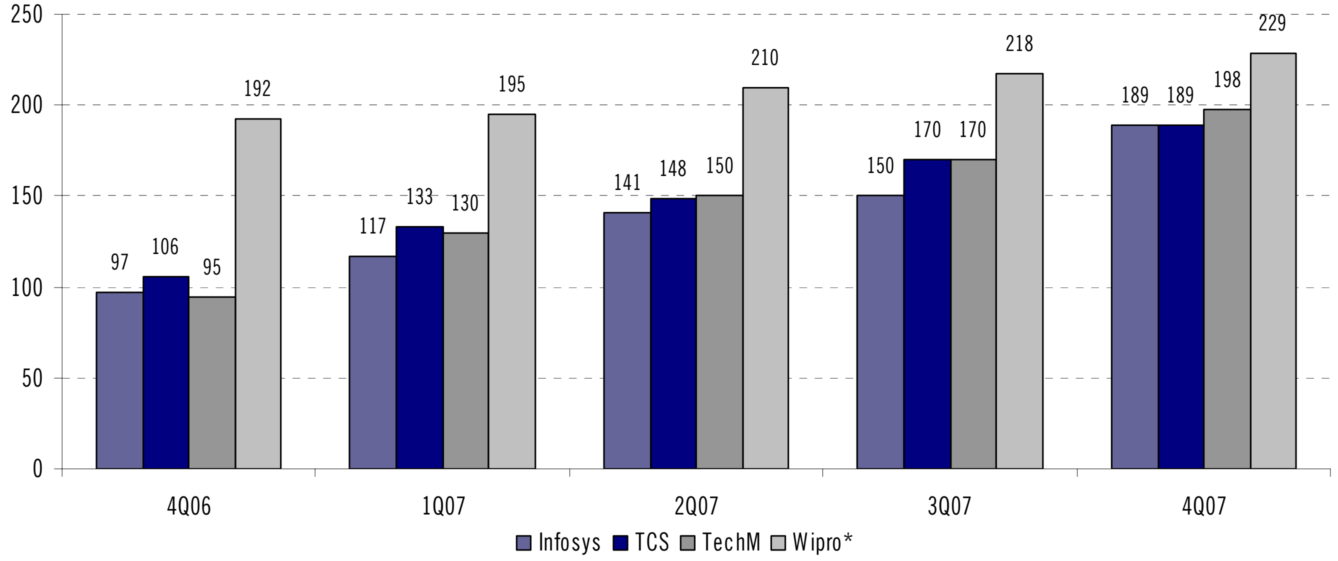
## Strong domain experience

Solid domain experience resulting in leadership in TSP space and increasing presence in OEM space

TechM is a differentiated play on the telecom segment of IT Services – particularly the Telecom Service Provider (TSP) space. While the key reason for its success in the telecom space is due to its parentage and history (it started out with BT as the only customer and BT still owns 31% of the company), TechM has done a good job of diversifying its clientele with non-BT business now accounting for 36% of revenues in FY07, up from 19% of revenues in FY05.

TechM is also the largest Indian IT player in the TSP space and is a significant player in the OSS/BSS/Next Generation Network space. New service lines include BPO, ITO and Valued Added Services (where it has a JV with Motorola). Wipro is the only Indian player with a larger telecom practice – however, Wipro's revenues largely come from the Telecom OEM space.

Figure 1. Select Indian IT Vendors: Size of Telecom Vertical, US$m




Source: Company Reports and Citigroup Investment Research; * Wipro revenue is largely from Telecom OEM and also includes product engineering practice

On the Telecom OEM side, Alcatel is the company's flagship customer. TechM entered into a relationship with Alcatel through the Axes acquisition in 2005.

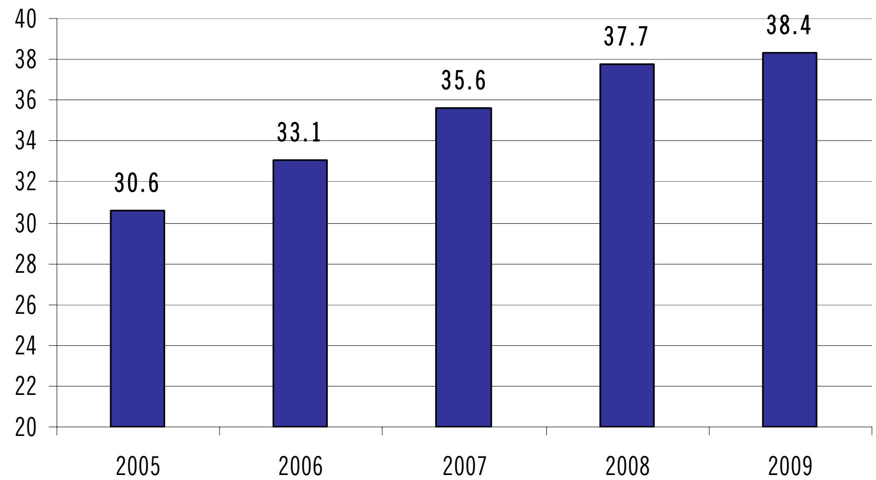
## Telecom-sector IT spend expected to remain robust

Falling voice revenues, growth in mobile and data, consolidation and cost pressures ensure good growth in the IT spend of TSPs

With voice-related revenues under pressure, TSPs are struggling to reduce costs across the organisation and deploy new revenue-generating services without increasing their IT budgets. They are increasingly turning to packaged software, systems integrators and outsourcing companies to help them achieve their goals. According to Ovum Research, global spending on software and IT services by TSPs is expected to grow to US$38.36 billion in 2009, from US$33.08 billion in 2006 (see Figure 2).

TechM will also be a key beneficiary of currently ongoing large initiatives like 21CN (for BT) and AT&T Lightspeed.

Figure 2. TSP Spend on Software and IT Services, US$ billion (Ovum Research)




Source: Company reports, Ovum Research

On the telecom OEM side, all large telecom OEMs spend 10-15% of their revenues on R&D and the total revenues of the top five OEMs are ~$180b, providing a huge opportunity in that space. Increasingly, telecom OEMs are also under cost pressures and are increasingly adopting outsourcing (and offshoring) to generate more value out from their IT spend.

## Capable of building large relationships

TechM has shown its ability to scale relationships through its work with BT, AT&T and Alcatel

TechM has demonstrated an ability to build large relationships – BT, AT&T and Alcatel are examples of the same. With the IT spend among TSPs expected to remain robust, we expect TechM to do well with marquee relationships that support its credentials in the space.

## BT relationship

The relationship with BT started in 1988. In the initial years, TechM started with development and testing work on a time and material basis – primarily onsite. However, today, a large part of the work is end-to-end responsibility and has a significant offshore component. TechM has been involved in various projects such as:

1. Transformation of BT's legacy customer care and billing systems through the development of solutions for incremental improvements in BT's CRM system.

2. Design and optimization of solutions for the planning and operation of BT's network.

3. TechM is a strategic partner in BT's 21st Century Network ("21CN") project, which is BT's largest transformation initiative. TechM has provided

a range of solutions covering CRM, portal-based solutions and OSS solutions as well as the activation, configuration and management of network elements.

On December 1, 2005, TechM entered into a new Master Framework Agreement with BT. Under this agreement, TechM has been granted preferred supplier status by BT for IT services on a non-exclusive basis. The agreement is for an initial term of three years from July 1, 2005, and may be extended for a further period of 12 months, for a maximum period of two years.

TechM will be a key beneficiary of 21CN – BTs large transformation initiative

21CN is BT's next generation network – an advanced communication network for the future. It is designed to give flexibility to end-users — offering communications from anywhere to any device. 21CN is a total IP-based network and will consolidate BT's network and systems infrastructure making it more efficient. Revenues from converged services are becoming increasingly important – particularly in a scenario where voice revenues are coming down sharply due to tremendous price pressure in the industry. BT has earmarked £10 billion for the 21CN programme. BT successfully upgraded the first end-user customers to its 21CN infrastructure in the village of Wick in South Wales on November 28, 2006 as scheduled. The upgrade is part of the first phase of the national roll-out of 21CN.

- BT Global Services deal enhances visibility

In December 2006, TechM announced a large deal with BT Group (BT Global Services) whereby TechM would also support BT Global's managed services business to its customers. This is in addition to what TechM is already doing for BT's internal processes and platforms. The revenues from this deal are expected to be US$1b over a 5 year period. Management expects the deal to ramp up in a "J-curve" fashion and ramp up fully in 7-8 quarters from the start.

TechM paid an upfront consideration of US$118 million in accordance with the terms of the deal. The same amount was written off by the company in Q4FY07.

Assuming terminal value with BT's ownership in TechM, the deal will generate value

From a financial perspective, the key debate would be whether to treat the deal as a 5-year contract or a recurring revenue stream. Our view is that given TechM's BT parentage, there will be some recurring revenues associated with the deal. Moreover, in most deals, incumbents tend to get at least a portion of the original deal due to exit barriers (related to migrating work from one vendor to other).

1. If the deal is treated as only a 5-year contract…

Looked at purely from a cash flow (DCF) perspective, even in the worst case assumption that the deal does not generate any return at all, the impact is $118m on an EV of ~$4.5b (which the stock price implies) which is around 3% of EV (this does not even assume some value which will be generated from the deal).

If the payment is assumed to be some kind of sales and marketing expense paid upfront and that it is only a 5-year deal, then this could impact EPS for FY09 and FY10E by ~5-7% (depending on how the profitability curve of the deal is modelled) .

2. If some terminal value is assumed (and we believe it should be)…
If it is assumed that the deal has terminal value (in other words, the work could continue beyond the contracted 5 years), then the deal could generate significant value (depending on the deal's duration).

BT's 31% stake in TechM gives some comfort that the deal will have some terminal value. Moreover, our channel checks indicate that BT is adopting this model for incremental work – in that case, this model would become an industry norm going forward.

## AT&T relationship

AT&T relationship is growing well; consolidation there is a big growth opportunity

TechM entered into a software and professional Services Agreement with SBC Services, Inc. on December 28, 2004 to provide services to SBC Services, Inc. and its group companies. In 2005, SBC Communications Inc. acquired AT&T Corp., and the combined company was subsequently renamed AT&T Inc. TechM works with AT&T in the areas of development, testing, maintenance, support, operations and consultancy services across customer care and billing, network software solutions and web based solutions. The contract with AT&T Services, Inc. remains in effect until December 28, 2009, and it is extendable by mutual agreement. A May 10, 2005 agreement grants an AT&T company options over approximately 9.9 million Equity Shares (Equity Shares underlying such options are held by Mauritius-based shareholder, MBT Investment Co. Mauritius Ltd). These options vest over a period ending April 30, 2010 if the company achieves $350m revenues from AT&T over the five years of the contract. As the shares are already held in the Mauritius entity, this will not result in any dilution.

In the recent past, some competition has witnessed a ramp-down from AT&T and TechM has actually been a beneficiary of the same – highlighting AT&T's intent on increasing outsourcing to TechM.

With the AT&T/Cingular/SBC/BellSouth merger, the potential for TechM has gone up significantly. With the cost savings which the merger targets, outsourcing will need to be stepped up – a good opportunity from TechM's point of view.

## Alcatel relationship

Alcatel relationship was the result of Axes acquisition to build up presence in the OEM space

TechM provides IT services to Alcatel as a result of the Axes acquisition in late 2005. Axes's relationship with Alcatel stems from its relationship with DSC Communications Corp., a company that was acquired by Alcatel in 1998. Most of the work done for Alcatel is from Alcatel's operations in the US (Alcatel is a French company, though). Axes's current contract with Alcatel came into force on April 1, 2004 and was initially valid for a period for three years. This contract contained a commitment from Alcatel North America to source at least half of its requirements volume for its US outsourced product engineering development work from Axes. After the acquisition of Axes, the terms of this contract were extended to October 31, 2008.

With the Alcatel Lucent merger process on over the last few quarters, growth in this account would have been impacted, in our view.

## Aggressive growth strategy – JV/Acquisition/equity partnership

Aggressive growth strategy using JV/acquisition/equity partnership/tie-ups

TechM has followed an aggressive growth strategy using JV/acquisition/equity partnerships. The following examples clearly validate the argument:

a. The Telecom OEM practice was started with the Alcatel relationship which came in through the Axes acquisition (details above).

b. JV with Motorola (CanvasM) – TechM has announced a JV with Motorola for Value Added Services on Motorola's Global Applications Management Architecture (GAMA) platform.

c. AT&T relationship – In the AT&T relationship (already detailed above), TechM has used the equity partnership route by giving AT&T an option to own 9.9m shares of TechM if a revenue commitment of $350m is met over a period of 5 years.

d. In January 2007, TechM announced the acquisition of iPolicy Networks Private Limited (iPolicy). iPolicy is a small company with 120 employees and this acquisition would add to TechM's security services capabilities. iPolicy provides next-generation, carrier-grade integrated network security solutions for enterprise and service provider customers.

## Strong parentage and management team

Experienced and highly incentivised management team

TechM was started as a JV between M&M and BT – clearly a strong parentage. At present, M&M and BT own 44% and 31% of the company, respectively. The management team is very experienced and has a track record of managing large client relationships and building new businesses. TechM achieved a spectacular turnaround in revenues and profitability after the new management team joined in 2004. Mr. Vineet Nayyar, CEO, was the founder and CEO of HCL Perot Systems and the Vice-Chairman of HCL Technologies, one of the larger Indian IT Services players. Mr. Sanjay Kalra, President of Strategic Initiatives and Mr. C.P. Gurnani, President of International Operations, also have substantial experience in IT Services and previously were associated with HCL Technologies.

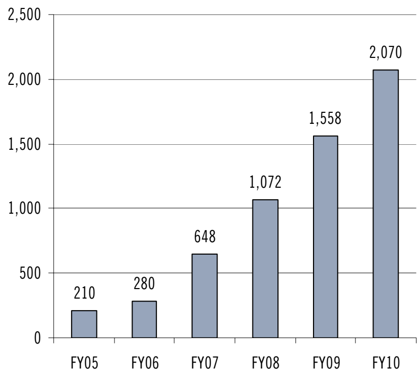
## Hiring plans suggest traction; competition doing well

Hiring plans suggest strong pipeline

In its Q4FY07 earnings call, TechM guided to hiring 4,500 and 7,500 campus hires in FY08 and FY09 respectively. Considering that this will only be a part of the overall hiring plans, the numbers clearly highlight the kind of visibility that the management has on the business going forward.

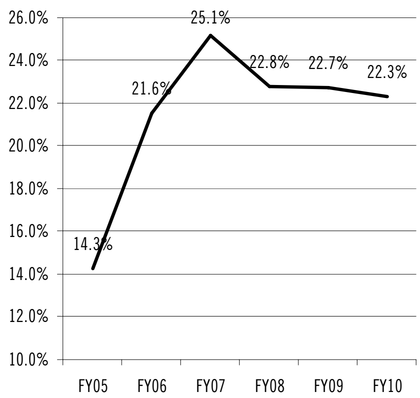
Amdocs, one of Tech Mahindra's competitors, reported growth of 18% yoy in the last reported quarter. Despite its large size, Amdocs' high level of growth is a sign of the sector's strength.

Figure 3. TechM Revenue, US$ mn




Source: Company Reports and CIR Estimates

Figure 4. TechM EBITDA Margins




Source: Company Reports and CIR Estimates

# Financials

- Revenue CAGR of 40% over FY07-FY10E driven by volumes
  We expect a revenue CAGR of 40% over FY07-FY10E driven primarily by volumes as TechM continues to benefit from strong IT spending in the telecom space.

- Margins to fall ~280 bps over FY07-FY10E
  Margins are set to fall ~240bp in FY07 due to wage hikes, currency pressures and investments in the BTGS contract (which will ramp up significantly in FY08). However, as the BTGS business ramps up, we expect margins to be more or less stable in FY09. Positive margin levers will be marginal increases in pricing (mainly in non-BT business) and a change in the employee pyramid (at present, 43% of employees in IT services have less than 3 years' experience), which will partially offset the impact of wage hikes.

- Sector-leading EPS growth of 32% CAGR
  We expect sector-leading EPS growth of 32% CAGR over FY07-FY10E. This will be driven by an EBITDA CAGR of 35%. Higher tax rates will impact the EPS growth in FY10E over FY09E.

- Return ratios
  Return ratios are expected to remain robust with ROE at 30%+ despite increasing cash on the books going forward. Excluding cash, ROE is expected to remain upward of 70%+, which is very healthy.

- Quarterly performance could be volatile
  Over the next few quarters, TechM's quarterly performance could be volatile as investments in the BTGS deal are not balanced by commensurate revenues flowing through the P&L. Moreover, with a significant portion of SI revenues, the business model is more volatile than that of traditional IT Services players.

  In 1Q, we expect revenues of Rs8.9b (2.3% qoq growth), with net profit of Rs.1.6b — a decline of ~19% qoq primarily on account of currency pressures, wage hikes and investments in the BTGS deal.

# Valuations

In line with our thesis that the best benchmark for mid-tier Indian IT companies is Satyam, we look at the arguments for and against TechM trading at a premium to Satyam.

## The Case for a Premium

Bulls could argue that valuations in tech are largely a function of growth

- Valuations in the sector are all about growth
  Valuations in tech have largely been a function of growth rates, as most companies have enjoyed high profitability (in terms of return ratios). With superior growth prospects, TechM should continue to trade at a premium to more diversified players like Satyam/HCL Tech (whose growth rates are lower).

- Parentage
  BT's 31% ownership helps TechM directly benefit from BT's spending plans.

## The Case for a Discount/Par

- Less diversified business model
  TechM has high domain and client concentration (as highlighted earlier). Due to its less diversified business model, risks to growth and valuation are clearly higher. Also, TechM is exposed to greater volatility as far as qoq performance is concerned (there could be delays with associated spend by a client). TechM's SI revenues already result in volatility in QoQ performance – this adds further to the volatile nature of revenues.

- Eventually growth will taper off
  Eventually TechM will grow in line with rest of the sector. Why pay a premium?

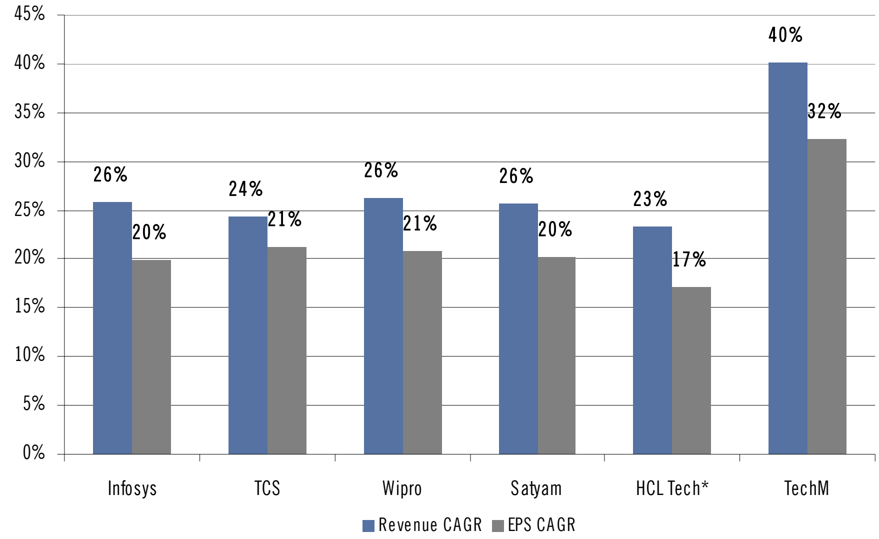
## Our Take

We continue to believe that valuations in the Indian IT Services sector are largely a function of growth rates – primarily because most companies have a decent track record and high return ratios.

With an industry-leading recurring EPS CAGR of 32% over FY07-FY10, we believe TechM will trade at a premium to more diversified but lower growth peers like Satyam. We value TechM at 21x FY09 EPS and initiate coverage with a Buy/High Risk rating and a target price of Rs1,920, which implies upside of 31% from present levels.

Our target P/E multiple of 21x FY09E EPS is derived from a 10% premium to our target of 19x FY09E for Satyam. Satyam is widely used as a benchmark for valuing companies in the non-Tier I space; we use Satyam as benchmark for our entire mid-cap IT services universe. We expect TechM to trade at a premium to Satyam primarily on account of industry leading revenue and EPS growth rates of 40% and 32% over FY07-FY10E. While TechM's business model is less diversified, better growth prospects and superior growth visibility merit a premium to Satyam, in our view. We believe P/E remains the most appropriate valuation measure given TechM's profitable track record and strong earnings visibility.

Figure 5. Select Indian IT Companies: Revenue and EPS CAGRs for FY07-10E




Source: Citigroup Investment Research estimates; *For HCL Tech, forecast is for FY07-09 CAGR

Strong positioning and end-market demand should ensure superior growth; superior growth = higher valuations

To reflect domain/client concentration, among other risks, we assign a High Risk rating to the TechM stock, as against a Medium Risk rating for the likes of Satyam and HCL Tech.

Figure 6. TechM: PER Valuation Band Chart

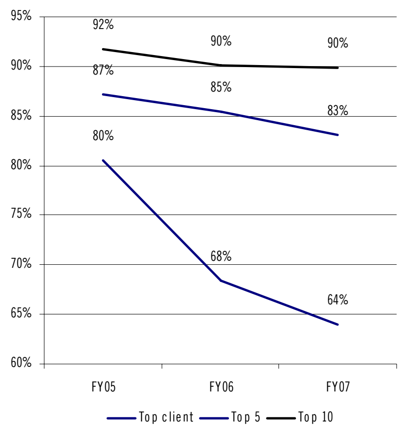

Source: DataStream, Company Reports and CIR Estimates

# Risks and Concerns

We rate Tech Mahindra as High Risk, as opposed to the default Speculative Risk rating for stocks with a trading history of less than one year. We believe a High Risk rating is appropriate as BT and AT&T have ownership/options in TechM and that ensures high visibility on revenues and earnings, while the company also has strong cash flows and a solid balance sheet.

The key downside risks to our target price include:(1) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (2) A sharp slowdown IT spending among telecom service providers; (3) H1B visa quotas; (4) High client and domain concentration; (5) Acquisition-related risks; (6) Consolidation in the industry resulting in client attrition. Below we discuss some of the key risks in details.

Figure 7. Client Concentration




Source: Company Reports

- Client concentration and domain concentration very high
  TechM's client and domain concentration is very high, which makes the company reliant on the spending plans of its top clients and the health of the telecom industry (which can be highly cyclical).

- Amdocs' warning a few months back
  A few months ago, one of TechM's key competitors Amdocs warned of a slowdown, on account of the slow pace of transformation projects in certain clients. TechM has continued to post good growth over the last few quarters (post the warning) but it has exposure to a similar set of clients and thus a similar warning cannot be ruled out going forward. However, in the following quarter, Amdocs talked of stabilisation in terms of demand outlook.

- Fringe Benefit Tax (FBT) on ESOPs
  FBT on ESOPs could have an impact on profits or sentiment (or both). TechM has indicated that it will pass this on to employees and in that case, there would not be much incremental impact on the company's financials. In case of any change here, this could impact profit/sentiment negatively.

- Industry consolidation could pose a risk to revenues
  The telecommunications industry has experienced substantial consolidation over last few years. The mergers of Sprint and Nextel, Cingular and AT&T Wireless, SBC and AT&T, Verizon and MCI, Alcatel and Lucent and the acquisitions of O2 by Telefonica and of BellSouth by AT&T are instances of the same. Consolidation could result in loss of customers and revenues and could impact TechM negatively.

High client and domain concentration remains the key risk; high valuations leave little room for execution error

- Valuations leave little room for error
  TechM trades at ~23xFY08E EPS, which is in line with larger and more diversified players like Infosys and Wipro. We believe that the better multiples are due to the high growth trajectory of TechM despite the company's high client and domain concentration. Clearly, the valuations leave little room for error – any disappointment could impact valuations negatively.

# Key Financials

Figure 8. Income Statement, Rs mn

| Year to Mar 31 | FY05 | FY06 | FY07 | FY08E | FY09E | FY10E |
|---|---|---|---|---|---|---|
| **Revenues** | **9,456** | **12,426** | **29,290** | **43,948** | **62,337** | **80,711** |
| ***Growth*** | ***27.5%*** | ***31.4%*** | ***135.7%*** | **50.0%** | **41.8%** | **29.5%** |
| Cost of revenues | 5,972 | 7,396 | 17,536 | 27,565 | 39,433 | 51,797 |
| Gross profit | 3,484 | 5,030 | 11,754 | 16,383 | 22,904 | 28,914 |
| *Gross margin* | *36.8%* | *40.5%* | *40.1%* | 37.28% | 36.74% | 35.82% |
| Operating expenses | 2,135 | 2,352 | 4,388 | 6,372 | 8,727 | 10,896 |
| **EBITDA** | **1,349** | **2,678** | **7,366** | **10,010** | **14,177** | **18,018** |
| ***EBITDA margin*** | ***14.3%*** | ***21.6%*** | ***25.1%*** | **22.8%** | **22.7%** | **22.3%** |
| Depreciation | 321 | 398 | 516 | 711 | 935 | 1,090 |
| Operating profit (EBIT) | 1,028 | 2,280 | 6,850 | 9,299 | 13,242 | 16,928 |
| *Operating margin* | *10.9%* | *18.3%* | *23.4%* | 21.16% | 21.24% | 20.97% |
| Other income, net | 85 | 341 | 15 | 232 | 676 | 676 |
| Profit before tax | 1,113 | 2,621 | 6,865 | 9,531 | 13,918 | 17,605 |
| Income tax expense | 91 | 267 | 741 | 1,240 | 2,015 | 3,274 |
| Income from operations | 1,022 | 2,354 | 6,124 | 8,291 | 11,903 | 14,330 |
| EO gain/(loss) | 0 | 0 | -4,911 | 0 | 0 | 0 |
| Net income - reported | 1,022 | 2,354 | 1,213 | 8,291 | 11,903 | 14,330 |
| **EPS - Basic** | **10.07** | **22.63** | **10.69** | **68.52** | **98.37** | **118.43** |
| *Growth* | *60.4%* | *124.7%* | *-52.8%* | 541.1% | 43.6% | 20.4% |
| **EPS - Fully diluted** | **8.97** | **18.32** | **9.39** | **63.55** | **91.23** | **109.83** |
| *Growth* | *60.4%* | *104.2%* | *-48.7%* | 576.5% | 43.6% | 20.4% |

Source: Company Reports and Citigroup Investment Research estimates

Figure 9. Balance Sheet, Rs mn

| Year to Mar 31 | FY05 | FY06 | FY07E | FY08E | FY09E | FY10E |
|---|---|---|---|---|---|---|
| Cash and equivalents | 2,398 | 2,265 | 1,647 | 8,451 | 16,618 | 27,066 |
| Other current assets | 2,455 | 4,818 | 9,094 | 13,359 | 18,949 | 24,534 |
| Total current assets | 4,853 | 7,083 | 10,742 | 21,810 | 35,567 | 51,600 |
| PPE, net | 1,781 | 2,031 | 3,411 | 5,494 | 7,792 | 10,089 |
| Other assets | 134 | 979 | 979 | 979 | 979 | 979 |
| **Total Assets** | **6,767** | **10,092** | **15,132** | **28,282** | **44,337** | **62,667** |
| Total Current Liabilities | 1,906 | 3,938 | 5,661 | 10,987 | 15,584 | 20,178 |
| Borrowings | 0 | 0 | 170 | 0 | 0 | 0 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total long term liabilities** | **0** | **0** | **170** | **0** | **0** | **0** |
| Total Equity | 4,861 | 6,154 | 9,301 | 17,295 | 28,753 | 42,489 |
| **Total Liabilities and Equity** | **6,767** | **10,092** | **15,132** | **28,282** | **44,337** | **62,667** |

Source: Company Reports and Citigroup Investment Research estimates

Figure 10. Cash Flow Statement, Rs mn

| Year to Mar 31 | FY05 | FY06 | FY07E | FY08E | FY09E | FY10E |
|---|---|---|---|---|---|---|
| Net income | 1,022 | 2,354 | 1,213 | 8,291 | 11,903 | 14,330 |
| Depreciation | 321 | 398 | 516 | 711 | 935 | 1,090 |
| Other operating cash flows | -133 | -319 | -76 | -232 | -676 | -676 |
| Working capital changes | 1,049 | -331 | -2,553 | 1,062 | -993 | -992 |
| **Cash flow from Operations** | **2,259** | **2,102** | **-900** | **9,832** | **11,169** | **13,752** |
| CapEx, acquisitions, divestures | -558 | -1,515 | -1,896 | -2,793 | -3,234 | -3,386 |
| Other investing cash flows | 85 | 341 | 76 | 232 | 676 | 676 |
| **Cash flow from Investing** | **-473** | **-1,174** | **-1,820** | **-2,561** | **-2,558** | **-2,710** |
| Borrowings | 0 | 0 | 170 | -170 | 0 | 0 |
| Equity Changes | 24 | 124 | 2,156 | 0 | 0 | 0 |
| Dividends | -252 | -1,185 | -223 | -297 | -445 | -593 |
| Other financing cash flows | 0 | 0 | 0 | 0 | 0 | 0 |
| **Cash flow from Financing** | **-228** | **-1,061** | **2,103** | **-467** | **-445** | **-593** |
| Net cash flows | 1,558 | -133 | -617 | 6,804 | 8,167 | 10,449 |

Source: Company Reports and Citigroup Investment Research estimates

## Key Business Metrics

Figure 11. Key HR and Execution Metrics

| | 1Q07 | 2Q07 | 3Q07 | 4Q07 |
|---|---|---|---|---|
| Total headcount | 13,066 | 16,180 | 17,774 | 20,562 |
| - IT delivery | 11,721 | 14,413 | 15,527 | 17,994 |
| - net add | 1,846 | 2,692 | 1,114 | 2,467 |
| - BPO delivery | 700 | 1,100 | 1,542 | 1,755 |
| - net add | 300 | 400 | 442 | 213 |
| - Sales & Support | 645 | 667 | 705 | 813 |
| Utilization | 74.0% | 69.0% | 67.0% | 67.0% |

Source: Company Reports

Figure 12. Revenue Mix

| | 1Q07 | 2Q07 | 3Q07 | 4Q07 |
|---|---|---|---|---|
| **Geography wise** | | | | |
| North America | 18% | 18% | 19% | 19% |
| Europe | 67% | 73% | 73% | 76% |
| Rest of World | 15% | 9% | 8% | 5% |
| **Delivery location wise** | | | | |
| Onsite | 34% | 38% | 40% | 41% |
| Offshore | 66% | 62% | 60% | 59% |

Source: Company Reports

Figure 13. Key Client Metrics

| | 1Q07 | 2Q07 | 3Q07 | 4Q07 |
|---|---|---|---|---|
| No. of active clients | 65 | 70 | 78 | 83 |
| **Client relationship size** | | | | |
| >$ 1m | 17 | 17 | 22 | 29 |
| > $ 2m | 10 | 12 | 15 | 18 |
| > $ 5m | 7 | 8 | 8 | 8 |
| > $ 10m | 5 | 5 | 5 | 6 |
| > $ 15m | 3 | 4 | 4 | 4 |
| > $ 20m | 2 | 3 | 3 | 3 |
| > $ 25m | 2 | 2 | 2 | 2 |
| > $ 50m | 1 | 1 | 1 | 2 |
| **Client concentration** | | | | |
| Top client | 58% | 64% | 65% | 67% |
| Top 5 | 86% | 82% | 82% | 83% |
| Top 10 | 91% | 90% | 90% | 89% |

Source: Company Reports

Figure 14. Indian IT Services : Valuation Comparison Table (Large Cap Universe)

| Company | | | Mkt cap | Current | Target | P/E (x) | | EV/EBITDA (x) | | Div. Yield (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | RIC Code | Rating | (US$m) | Price (Rs) | Price (Rs) | FY08E | FY09E | FY08E | FY09E | FY08E | FY09E |
| Infosys | INFY.BO | 1L | 28,017 | 1,971 | 2,440 | 24.6 | 20.2 | 20.0 | 16.1 | 0.8% | 1.0% |
| TCS | TCS.BO | 1L | 28,222 | 1,159 | 1,460 | 22.7 | 19.0 | 18.2 | 15.1 | 1.2% | 1.4% |
| Wipro | WIPR.BO | 1L | 18,854 | 519 | 650 | 21.6 | 17.6 | 17.6 | 13.9 | 1.9% | 2.3% |
| Satyam | SATY.BO | 1M | 8,127 | 489 | 570 | 19.3 | 16.3 | 16.5 | 13.4 | 1.6% | 2.0% |
| HCL Tech | HCLT.BO | 1M | 5,573 | 337 | 400 | 18.4 | 15.4 | 13.5 | 11.1 | 2.4% | 2.4% |
| Tech Mahindra | TEML.BO | 1H | 4,415 | 1,464 | 1,920 | 23.0 | 16.0 | 18.9 | 13.3 | 0.1% | 0.2% |
| I-Flex | IFLX.BO | 3M | 5,285 | 2,538 | 2,025 | 51.4 | 37.0 | 36.2 | 25.7 | 0.0% | 0.0% |
| Patni* | PTNI.BO | 3M | 1,749 | 507 | 565 | 16.1 | 14.6 | 9.9 | 9.4 | 0.7% | 1.0% |

Source: Company Reports and Citigroup Investment Research estimates

## Satyam Computers Services: Valuation & Risks

(SATY.BO - Rs493.95; 1M)

Valuation: Our 12-month target is Rs570, based on 19x FY09E earnings. We value Satyam on a P/E basis relative to its medium-term growth potential and also on its valuation relative to peer Infosys, which is the industry benchmark. Given that we expect Satyam's earnings to grow at 16% CAGR over the next three years, we believe the stock should trade toward the upper end of its historical three-year trading range of 12-21x 12-month forward earnings. Satyam has traded at a 10-40% discount to Infosys in the past two years due to its lower growth rates. Our forward P/E is based on a ~25% discount to our target multiple of 25x for Infosys.

Risks: Although our quantitative risk-rating system suggests Low Risk for Satyam, we rate Satyam as Medium Risk given the similar risk ratings for other mid-sized IT peer-group companies in our coverage universe. The key downside risks that could impede the shares from reaching our target price include: (1) A slowdown in enterprise software license revenues; (2) The supply side situation becoming more difficult; (3) Risks to earnings from a sharp US slowdown; (4) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (5) A sharp slowdown in the US economy; (6) A slowdown in the banking, financial services and insurance (BFSI) sector; and (7) Limited H1B visa quotas.

# Appendix A-1

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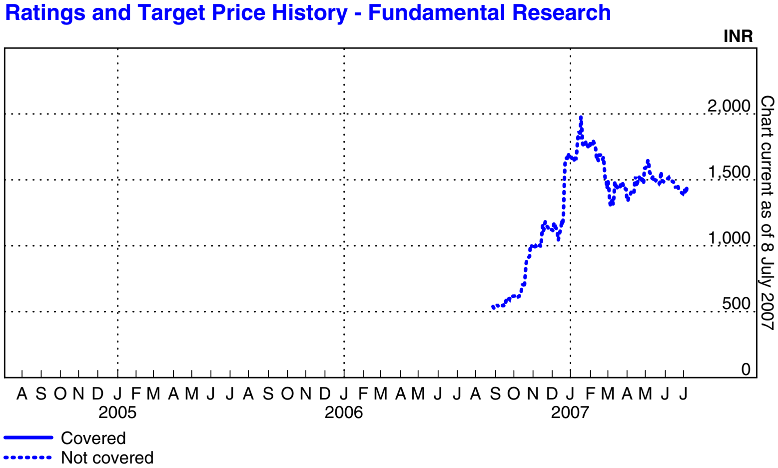


| # | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|

*Indicates change.

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|---|---|---|---|
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