Quick Take

Tech Mahindra - REDUCE

IT Services | 24 September 2009

No recovery in sight

Profitability of deals for which Tech Mahindra paid BT US$230m upfront could deteriorate significantly with the likely scope and price changes. Even after accounting for currency hedges, depreciation of the GBP vs INR (12% since 4QFY07) is likely to have knocked off ~250bps of margins over the life of the deal. Our calculations suggest that the NPV on these deals could even be negative after the re-negotiation. Also, the mainstay BT-core business will likely ramp down for lack of new development. Meanwhile, Satyam continues to face headwinds of client and senior management attrition.

- **Negative NPV deals?** Concerns are intensifying on the BTGS deals for which Tech Mahindra paid upfront. Given the falling revenues from legacy BT business, the new BTGS contracts were expected to fill in. However, the spectre of re-pricing and re-scoping on those contracts could drag down their profitability. Our scenario analysis shows that the Barcelona deal's NPV would be negative if its scope is reduced by 25%. The Andes deal, given the higher upfront payment (US$110m for a US$700m deal vs Barcelona's US$120m for a US$1bn deal), would turn into a negative NPV deal at a 15% reduction in its scope. Worse, if the scope of the Andes deal is reduced by 30%, Tech Mahindra may not even recover the upfront payment.
- **These arguments will help Tech Mahindra negotiate and limit the damage. However, these issues do** highlight the concentration risks due to BT (52% of revenues) where Tech Mahindra may not be in a position to enforce the contractual obligations in entirety.
- **Concerns at Satyam to cause de-rating:** Client attrition continues to be a worry at Satyam. Also, we believe senior management attrition could intensify client attrition with a lag. Given Tech Mahindra's poor track record of client additions, we believe it could add little value to Satyam in that respect. On our FY11ii/12ii scenario, Satyam is expensive at 16x-19x PERs. We recommend SELL on Satyam.

CMP	**Rs905**
12-mth Target price (Rs)	***880***
Market cap (US$ m)	**2279**
Bloomberg	**TECHM IN**
52Wk High/Low (Rs)	1022/204
Diluted o/s shares (m)	122
Daily volume (US$ m)	35
Dividend yield FY10ii (%)	0.5
Free float (%)	16.8

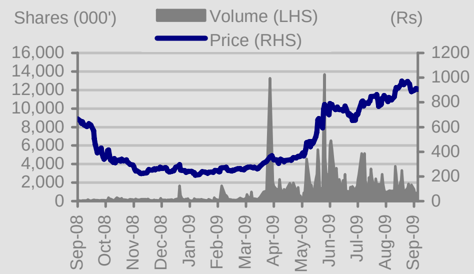
Shareholding pattern (%)

M&M	44.1
BT	31.0
MBTM	8.2
FII	1.6

Price performance (%)

	1M	3M	1Y
Tech M	7.7	15.4	42.8
Rel. to Sensex	-3.7	-1.9	17.0
HCLT	31.7	79.5	59.4
Infosys	19.8	37.0	55.0
Wipro	13.7	51.1	43.2

Stock Performance



Financial summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	**37,661**	**44,647**	**42,216**	**42,431**	**46,733**
EBITDA Margins (%)	21.9	26.7	23.9	23.0	23.0
Pre-Exceptional PAT (Rs m)	3,300	10,146	7,424	8,210	8,850
Reported PAT (Rs m)	3,300	10,146	7,424	8,210	8,850
EPS (Rs)	27.2	83.6	61.2	67.6	72.9
Growth (%)	171.2	207.5	-26.8	10.6	7.8
PER (x)	**33.3**	**10.8**	**14.8**	**13.4**	**12.4**
ROE (%)	30.0	59.1	31.1	29.1	27.1
Debt/Equity (x)	0.0	0.0	0.8	0.7	0.6
EV/EBITDA (x)	**13.9**	**9.1**	**13.0**	**13.0**	**11.4**
Price/Book (x)	8.7	5.1	4.2	3.6	3.2

Source: IIFL Research. Priced as on 23 September 2009

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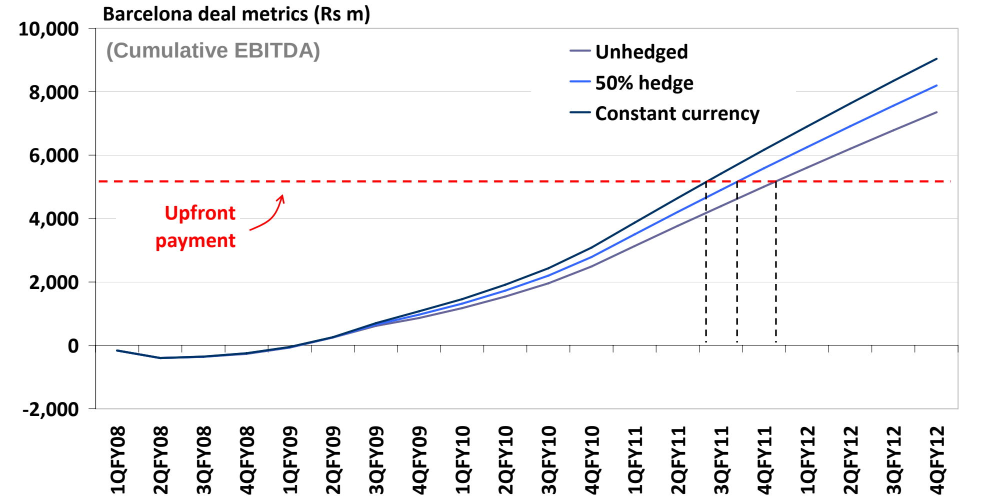
In FY07, Tech Mahindra secured a 5-year US$1bn deal from BT, for an upfront payment of US$120m. Because of concerns at BTGS, revenues from this deal have been falling short of the expected quarterly run rate. After ramping up to GBP22m in 3QFY09, they had fallen to GBP19m in 4QFY09.

Also, depreciation of the GBP has been dragging down the deal's profitability. Since 4QFY07, when the deal was signed, the GBP has depreciated by 12% vs the INR. Were the contract unhedged, this depreciation would have taken ~300bps off deal's EBITDA margin. Assuming an optimistic scenario of a 50% hedge, EBITDA margin would fall by ~100bps.

Figure 1: Depreciation of the GBP vs INR impacted profitability on the deal.

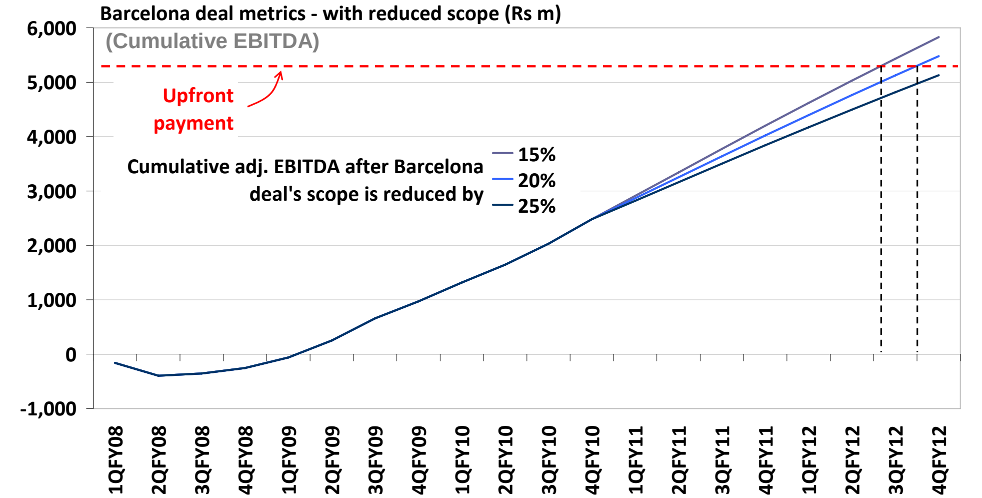


Source: IIFL Research

BT is likely to renegotiate both pricing and the scope of the deal. While this is unlikely to hit 2QFY10 financials (discussions are still in progress), we believe it would materially reduce the profitability of the overall deal. Given the high dependence of Tech Mahindra on BT (52% of revenues), we believe it would be unlikely to enforce contractual obligations in their entirety.

For our scenario analysis of the Barcelona deal, we had assumed a margin erosion of 250-500bps over the remaining life of the deal. In such a case, if the scope is reduced by 20%, it would barely make a positive NPV. If the scope is reduced by 25%, the deal would no longer make a positive NPV.

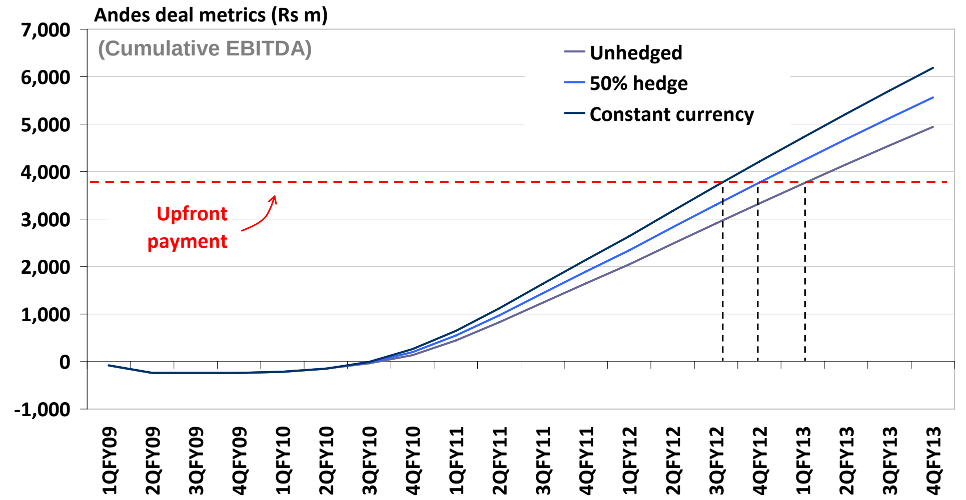
Figure 2: Barcelona deal would make a negative NPV if the scope is reduced by 25%



Source: IIFL Research. Adj. EBITDA represented discounted value of future EBIDTA

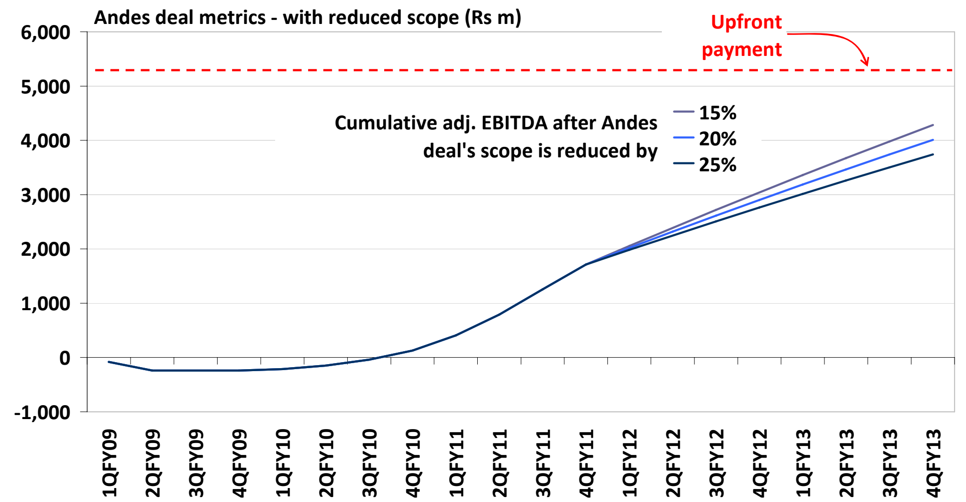
NPV of the Andes deal would be hit even harder, given the higher upfront payment. Against 12% of the total contract value (TCV) in the case of Barcelona, Tech Mahindra paid ~16% of TCV upfront for Andes. As a result, even with an assumption of smaller margin fall (250bps vs 250-500bps in the case of the Barcelona deal), its NPV would turn negative with a 15% reduction (vs 25% of Barcelona) in the project's scope.

Figure 3: Andes deal is likely less profitable than Barcelona (cumulative EBITDA)



Source: Company, IIFL Research

Figure 4: NPV of Andes deal could be negative if the deal is rescoped by ~15%



Source: Company, IIFL Research

De-rating at Satyam

We had upgraded Tech Mahindra soon after its acquisition of Satyam. Though the BT concerns were an overhang on Tech Mahindra, the potential value of Satyam was not fully captured. Since then, Satyam's stock price has increased by 132% and Tech Mahindra's by 105%.

In the subsequent tables, we have attempted to isolate the financials of Tech Mahindra and Satyam, to arrive at the implied valuations for both. For Tech Mahindra, we exclude the profits from Satyam. We are also reducing its market cap by an amount equal to 42.5% stake in Satyam after accounting for the holding company discount (30%).

After these adjustments, Tech Mahindra is trading at an expensive ~15x one-year-forward PER—in line with larger and more diversified peers like HCL Tech. However, when the upfront payments for Barcelona and Andes deals are amortised over the life of the contract, the PER valuations are substantially higher at ~25x.

Figure 5: Financial summary of Tech Mahindra—after adjusting for Satyam's profits and market capitalisation

Tech M - w/o Satyam (Rs m)	FY10ii	FY11ii	FY12ii
Revenues	42,216	42,431	46,733
EBITDA	10,110	9,759	10,749
EBITDA margins	23.9%	23.0%	23.0%
PAT	4,735	4,744	4,804
Amortization of upfront payment	*-1,930*	*-1,930*	*-1,930*
Adj. PAT	2,805	2,814	2,874
EPS (Rs)	38.9	38.9	39.4
Adj. EPS (Rs)	23.0	23.1	23.6
PER (x)	14.5	14.5	14.3
Adj. PER (x)	24.4	24.4	23.9

Source: IIFL Research

On our estimates, Satyam is trading at significantly higher valuations than Tech Mahindra at 16-19x.

Figure 6: Satyam - scenarios

Mahindra – Satyam (Rs m)	FY10	FY11	FY12
Revenues	60,000	66,000	73,920
EBITDA	7,587	9,740	12,506
EBITDA margins	12.6%	14.8%	16.9%
PBT	6,442	8,663	11,500
PBT margins	10.7%	13.1%	15.6%
PAT	5,679	7,577	8,999
EPS (Rs)	4.8	6.5	7.7
PER (x)	24.7	18.5	15.6

Source: Company, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
