

Company

26 July 2010 | 8 pages

Tech Mahindra (TEML.BO)

Equity

Below Expectations

- Q1 below expectations** — Revenues at \$251m were down ~3% qoq (CIRA exp: \$260m) while EBITDA margins at 18.8% were down ~480bps qoq (CIRA exp: 21.5%). This led to profits of Rs1.5b, a drop of ~35% qoq, much below our expectations of Rs2.1b (fall of ~8% qoq). Revenues were flattish qoq on a constant currency basis with volume growth of 2.5%.
- What impacted the quarter?** — Revenues were impacted by: (1) prolonged decision making cycles at some of the key customers; and (2) adverse currency movements. The margins were impacted by forex volatility (~230bps impact), employee additions (company has reinitiated campus hiring in the last two quarters) and additional investments in SG&A. The company will take salary hikes in Q2 – margins may continue to remain under pressure.
- Other highlights of the quarter** — (1) North America revenues grew ~4% qoq while Europe was down ~6% (on a reported basis). (2) Top client was down ~5% qoq while top-5 clients were flattish qoq. (3) The company added ~1,750 employees on a net basis. (4) Cash balance at the end of the quarter was \$40m while Debt was Rs14.6b. (5) Attrition stood at 27% in IT Services (quarterly annualized; Q4: 22%). (6) Hedge book: £240m (against \$) and \$670m (against INR). (7) BT (the top client) was at ~£75m in Q1 vs. ~£78m in Q4 – the normalized levels are expected to be ~£70-72m. (8) Forex gain was \$5m.
- Maintain Sell** — TechM's business has high domain/client concentration. Further, Satyam will face significant supply-side challenges in the near term given the recent history and the buoyant demand environment. Uncertainties (on both businesses) remain too high to get constructive on the stock.

Sell/Medium Risk	3M
Price (26 Jul 10)	Rs737.50
Target price	Rs900.00
Expected share price return	22.0%
Expected dividend yield	0.5%
Expected total return	22.6%
Market Cap	Rs91,500M
	US\$1,950M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	3,300	25.19	156.6	29.3	7.1	30.3	0.7
2009A	10,146	78.14	210.2	9.4	4.6	63.4	0.5
2010E	6,596	50.52	-35.3	14.6	3.5	29.0	0.0
2011E	7,640	58.29	15.4	12.7	2.7	25.9	0.5
2012E	8,110	61.88	6.2	11.9	2.2	22.1	0.8

Source: Powered by dataCentral

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Result Tables

Figure 1. Key Financials

Rs m	1Q10	4Q10	1Q11	QoQ	YoY
Revenue (\$ m)	228	259	251	-2.9%	10.3%
Revenue	11,130	11,833	11,337	-4.2%	1.9%
Cost of revenue	6,838	7,373	7,458	1.2%	9.1%
Gross profit	4,292	4,460	3,879	-13.0%	-9.6%
Gross margin	38.6%	37.7%	34.2%	-348bp	-435bp
Operating expenses	1,487	1,672	1,752	4.8%	17.8%
EBITDA	2,805	2,788	2,127	-23.7%	-24.2%
EBITDA margin	25.2%	23.6%	18.8%	-480bp	-644bp
Dep. & amortization	296	399	354	-11.3%	19.6%
EBIT	2,509	2,389	1,773	-25.8%	-29.3%
EBIT margin	22.5%	20.2%	15.6%	-455bp	-690bp
Profit before tax	1,677	2,817	1,762	-37.5%	5.1%
Income tax expense	268	542	312	-42.4%	16.4%
Income from operations	1,409	2,275	1,450	-36.3%	2.9%
EO income/(loss)	-85	0	0	NA	NA
Net profit	1,324	2,275	1,450	-36.3%	9.5%
Recurring EPS - basic	11.51	18.60	11.71	-37.0%	1.7%
Recurring EPS - fully diluted	10.84	17.41	11.07	-36.4%	2.1%

Source: Company Reports

Figure 2. Client Metrics

	1Q10	2Q10	3Q10	4Q10	1Q11
No. of active clients	110	110	110	113	117
Client relationship size					
> US\$ 1m	47	47	49	48	52
> US\$ 2m	29	29	30	33	36
> US\$ 5m	15	17	18	18	20
> US\$ 10m	8	9	9	11	13
> US\$ 15m	8	7	8	8	8
> US\$ 20m	4	5	5	5	6
> US\$ 25m	4	4	4	4	4
> US\$ 50m	2	2	2	2	2
Client concentration					
Top client	52%	50%	46%	46%	45%
Top 5	78%	75%	75%	72%	74%
Top 10	86%	84%	82%	81%	82%

Source: Company Reports

Figure 3. Revenue Mix

	1Q10	2Q10	3Q10	4Q10	1Q11
Geography wise					
North America	29%	28%	30%	30%	32%
Europe	61%	61%	56%	57%	55%
Rest of World	10%	11%	14%	13%	13%
Delivery location wise					
Onsite	38%	38%	39%	38%	37%
Offshore	62%	62%	61%	62%	63%

Source: Company Reports

Figure 4. Key Execution Metrics

	1Q10	2Q10	3Q10	4Q10	1Q11
Total headcount	25,482	26,515	30,404	33,524	35,267
- IT delivery	20,227	20,038	22,199	24,405	25,711
- net add	167	-189	2,161	2,206	1,306
- BPO delivery	4,189	5,450	7,199	8,067	8,426
- net add	420	1,261	1,749	868	359
- Sales & Support	1,066	1,027	1,006	1,052	1,130
Utilization	71.0%	75.0%	73.0%	73.0%	69.0%

Source: Company Reports

Tech Mahindra

Company description

One of India's top 10 IT Services providers focusing on the telecom space, Tech Mahindra (TechM) services Telecom Service Providers (TSPs), Telecom Equipment Manufacturers (TEMs), Independent Software Vendors (ISVs) and Systems Integrators (SIs). It was formed in 1986 as a JV between M&M and British Telecom (BT). Key clients include BT, AT&T, Alcatel, Alltel, Convergys, Motorola, O2 and Vodafone. TechM is headquartered at Pune with development centers across India and a few centers in the UK. TechM is the only Indian player among the top 10 BSS vendors worldwide, as ranked by Gartner Dataquest.

Investment strategy

We rate TechM Sell/Medium Risk (3M) based on a fundamental 12-month view. With high exposure to the telecom domain, TechM is likely to be affected by deteriorating fundamental trends in the telecom vertical. We expect revenue and EPS CAGRs of ~8% and ~-5% respectively over FY09-12E. Satyam acquisition will help in diversifying vertical exposure and add size; however, we still await Satyam's financials (expected in Jun'10). After the recent run-up, TechM is not really cheap on valuations, considering its muted growth prospects, based on our analysis.

Valuation

Tech Mahindra's organic business still carries higher domain (telecom) and client concentration (BT) risk. Given the risks and challenges at BT, Tech Mahindra will continue to struggle in the near term, in our view. The standalone business is valued at 8x Sep'11E EV/EBITDA, which is at a ~15% discount to more diversified players like HCL Tech. For Satyam, we use TechM's share of Satyam's Enterprise value based on the current market price of Satyam, given Satyam's financials are still awaited. Our target price of Rs900 is based on 8x Sep'11E EV/EBITDA and considering TechM's share of Satyam's current EV. We believe that this valuation measure is most appropriate as there are only limited disclosures for Satyam.

Risks

Although our quantitative risk-rating system suggests High Risk, we rate TechM Medium Risk, in line with other mid-cap stocks. Key upside risks that could cause the stock to exceed our target price are: 1) any significant depreciation

of the rupee against the USD/EUR/GBP; 2) a sharp upturn in IT spending among TSPs; 3) sharp ramp-ups in BTGS deal; 4) hiring rebounding in the next few quarters; 5) a large deal announcement; and 6) inorganic activity due to a stake sale or change in ownership.

Appendix A-1

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Analyst: Surendra Goyal, CFA

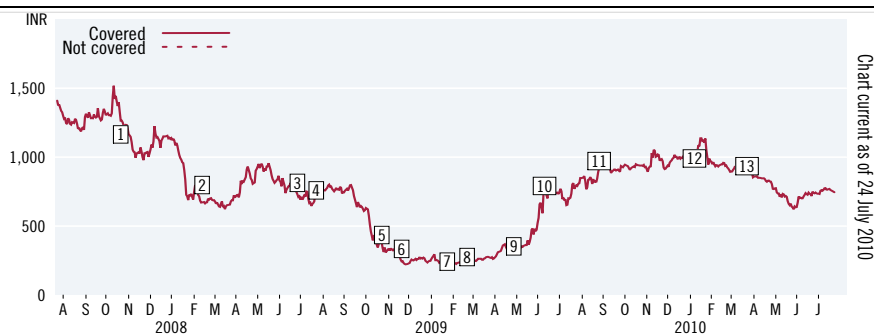


Chart current as of 24 July 2010

	Date	Rating	Target Price	Closing Price
1	21-Oct-07	*3H	*1,330.00	1,329.45
2	13-Feb-08	3H	*730.00	672.10
3	26-Jun-08	3H	*815.00	730.10
4	23-Jul-08	3H	*820.00	753.35
5	23-Oct-08	*2H	*500.00	376.10

	Date	Rating	Target Price	Closing Price
6	20-Nov-08	2H	*310.00	243.50
7	23-Jan-09	2H	*245.00	210.15
8	20-Feb-09	*3H	245.00	269.65
9	28-Apr-09	3H	*300.00	318.20
10	10-Jun-09	3H	*640.00	784.85

	Date	Rating	Target Price	Closing Price
11	26-Aug-09	*3M	*825.00	921.10
12	7-Jan-10	3M	*910.00	1,018.10
13	23-Mar-10	3M	*900.00	910.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2010

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