

Tech Mahindra

 BSE SENSEX 19,008
 S&P CNX 5,697

Rs689
Neutral

 Bloomberg TECHMIN
 Equity Shares (m) 130.7
 52-Week Range (Rs) 1,158/600
 1,6,12 Rel. Perf. (%) 4/-13/-49
 M.Cap. (Rs b) 90.1
 M.Cap. (US\$ b) 2.0

YEAR	NET SALES	PAT#	EPS*	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GR. (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/10A	46,254	7,546	45.0	-42.0	15.3	2.9	31.6	31.5	2.9	5.8
3/11E	48,151	8,844	55.0	22.2	12.5	2.3	25.3	20.9	2.3	6.3
3/12E	51,936	8,664	54.4	-1.0	12.7	1.9	21.2	19.3	1.9	5.8
3/13E	55,344	10,021	64.9	19.2	10.6	1.6	20.3	19.3	1.6	5.3

* EPS incl. profits from Satyam and adjusted for restructuring charge, # reported PAT incl. Satyam

Tech Mahindra's 3QFY11 revenue growth of 1.6% (excluding pass-throughs in 2QFY11, against our estimate of 6.2%) was below estimate and PAT was higher due to US\$8m in forex gains. The company is faced with challenges of sluggish recovery in the Telecom vertical and high attrition. Key highlights:

- Revenue growth of 1.6% to US\$269.8m (excluding 2QFY11 pass-throughs worth US\$63.5m) was below our estimate of 6.2% growth, with volumes staying sequentially flat. Revenues from the BT account were static for the third consecutive quarter at 74m pounds.
- Sluggish recovery of the Telecom vertical and missing discretionary spend impeded growth. The management outlook that the recovery within the segment may not meaningfully materialize over the next two quarters suggests tepid volumes in the near term. However growth may come from key clients like Airtel, were its subscriber base in Africa to ramp up in line with the plans.
- EBITDA margins declined 110bp QoQ after outperforming with a 230bp sequential increase in 2QFY11, largely driven by 3% salary hikes onsite. Recovery of margins to FY10 levels (over 24%) will be challenging given: (1) high attrition rates, which may necessitate out-of-turn wage hikes, (2) expectations of lower utilization as utilization in 3QFY11 was at the higher end of the targeted band, amid ~30% quarterly annualized attrition.
- Given that pick-up in discretionary traction may be a few quarters away, growth in the near term is likely to come from lower end business, which will be potentially margin dilutive for the company.

Downbeat performance on volumes, guidance of delay in telecom revival and unrelenting attrition pressures are expected to weigh on the stock in the near term. Owing to the prevailing challenges going forward, we have revised our estimates downwards. We expect Tech Mahindra to post revenue CAGR of 9% over FY11-13 (against 12.7% earlier). Including profits from Mahindra Satyam, we expect EPS CAGR of 10% (against 18% earlier) over FY11-13. **Neutral.**

Tech Mahindra Quarterly Performance (Indian GAAP)

(Rs Million)

Y/E MARCH	FY10				FY11				FY10	FY11E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenues	11,130	11,418	11,873	11,833	11,337	12,350	12,111	12,353	46,254	48,151
Q-o-Q Change (%)	5.9	2.6	4.0	-0.3	-4.2	8.9	-1.9	2.0	3.6	4.1
Direct Cost	6,838	6,986	7,514	7,373	7,458	7,850	7,882	7,983	28,711	31,173
Other Operating Exps	1,487	1,507	1,552	1,672	1,752	1,820	1,731	1,767	6,218	7,070
Operating Profit	2,805	2,925	2,807	2,788	2,127	2,680	2,498	2,603	11,325	9,908
Margins (%)	25.2	25.6	23.6	23.6	18.8	21.7	20.6	21.1	24.5	20.6
Other Income	-261	270	6	739	253	83	521	271	754	1,128
Interest	571	843	459	311	264	270	252	230	2,184	1,016
Depreciation	296	312	331	399	354	347	347	346	1,338	1,394
PBT bef. Extra-ordinary	1,677	2,040	2,023	2,817	1,762	2,146	2,420	2,299	8,557	8,627
Provision for Tax	268	345	285	542	312	418	359	391	1,440	1,480
Rate (%)	16.0	16.9	14.1	19.2	17.7	19.5	14.8	17.0	16.8	17.2
Net Income aft. Extra-ordinary	1,317	1,690	1,729	2,269	1,456	1,735	2,570	1,902	7,005	7,134
Q-o-Q Change (%)	-42.9	28.3	2.3	31.2	-35.8	19.2	48.1	-26.0	-31.0	1.8
Effect of restructuring fees	420	415	430	404	411	403	426	415	1,669	1,655
Adj. Net Inc. (excl prior period items)	897	1,275	1,299	1,865	1,045	1,332	1,629	1,487	5,336	5,479
Q-o-Q Change (%)	-61.1	42.2	2.0	43.5	-44.0	27.6	22.3	-8.7	-47.4	2.7
Diluted EPS (Rs)	10.7	12.9	13.2	17.4	11.1	13.2	19.7	14.6	54.2	58.5
US\$ Revenues	228	237	254	259	251	265	269	274	977	1,059
Q-o-Q Change (%)	7.7	3.9	7.3	1.9	-2.9	5.4	1.6	2.0	-0.9	8.4

E: MIOSL Estimates

Result Highlights

- US dollar revenue increased 1.6% QoQ to US\$268.9m (against our estimate of a 6.2% QoQ increase to US\$281m).
- Rupee revenues of Rs12.1b were down 1.9% (against our estimate of Rs12.5b, up 1.3% QoQ).
- Reported BT revenues of US\$118m were up by 3% QoQ, mainly due to the appreciation of the British pound.
- Reported EBITDA margins declined 110bp to 20.6% (against our estimate of a 160bp decline to 20.1%) due to a 3% onsite salary hike; partially offset by a 140bp sequential improvement in utilization to 76.3%.
- Other income was Rs521m (against our estimate of Rs153m), led by forex gains of US\$8m.
- The effective tax rate was 14.8% (against our estimate of 17%).
- PAT (after prior period items and excluding Mahindra Satyam profits) was Rs1.6b (against our estimate of 1.3b), up 22.3% QoQ.

Tech Mahindra 3QFY11: Key parameters

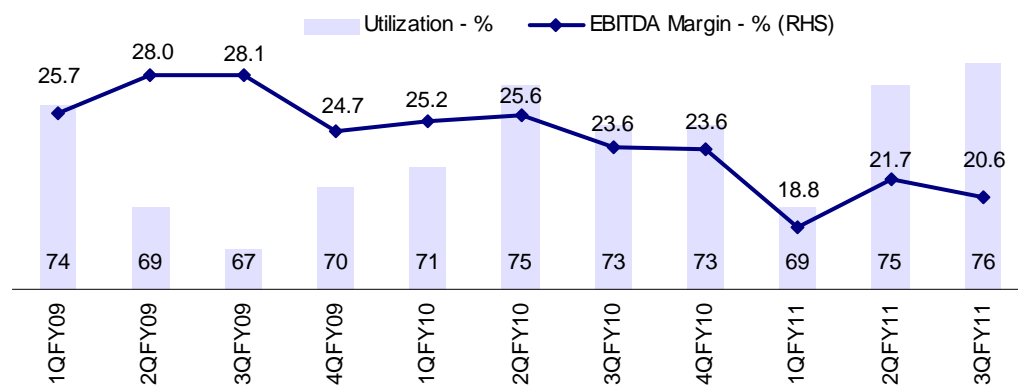
	3QFY11		2QFY11	QoQ (%)	3QFY10	YoY (%)
	Actual	Estimate				
Revenues (Rs m)	12,111	12,506	12,350	-1.9	11,873	2.0
EBITDA (Rs m)	2,498	2,515	2,680	-6.8	2,807	-11.0
EBITDA (%)	20.6	20.1	21.7	-108bp	23.6	-302bp
Adj. PAT (Rs m)	1,629	1,301	1,721	49.3	1,729	48.6
Revenues (US\$)	269	281	265	1.6	254	5.9

Source: Company/MOSL

Result reflects pressures on demand and supply

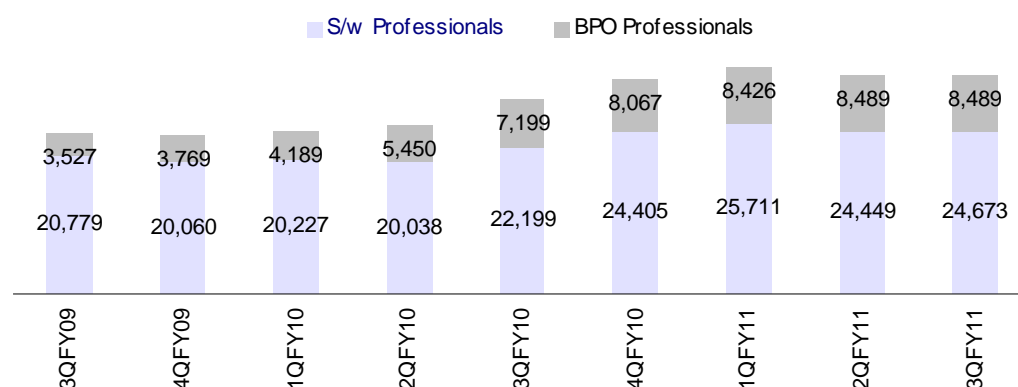
Tech Mahindra's volume was sequentially flat, and the management cited persisting challenges in the Telecom vertical, as the key factor. With BT revenues static, growth for Tech Mahindra is expected to emanate from non-BT accounts and in emerging geographies. However, revenue from the systems integration business in emerging markets was down 9.7% sequentially, given its lumpy nature. Given a general consensus now that the vertical is not expected to recover meaningfully soon, the impact on the company's top-line growth will be more severe than at its peers.

A decline in EBITDA margins after outperformance in 2QFY11 (230bp sequential increase) was on expected lines, largely driven by a 3% salary hike onsite. Quarterly annualized attrition rate of 30% was a repeat of the last quarter, implying no improvement on the supply side. We believe the recovery of margins to FY10 levels (over 24%) will be challenging given: (1) high attrition rates, which may necessitate out-of-turn wage hikes and (2) the expectation of lower utilization as utilization in 3QFY11 was at the higher end of the targeted band, amid ~30% quarterly annualized attrition rate for the past two quarters.

Little room for upside on utilization; margins to be under stress

Source: Company/MOSL

Muted growth in volumes and a large number of exits have meant the growth in employee numbers was unexciting over the past three quarters (up 2% from 4QFY10), especially in a high demand environment witnessed by offshoring players.

2% growth in employees over the past three quarters due to sluggish demand, high attrition

Source: Company/MOSL

Other highlights

- Headcount increased by 201 people to 34,208;
- Added two clients in 3QFY11, taking client count to 126;
- Outstanding US dollar-rupee hedges of US\$780m at Rs48.1/US\$ and British pound-US dollar hedges of 270m pounds at US\$1.71/pound;
- Offshore contribution stable at 63%;
- Outstanding debt decreased to Rs13.5b, from Rs14.3b in 2QFY11;
- Cash and cash equivalents increased to Rs5.2b from Rs2.3b in 2QFY11.

Valuation and view

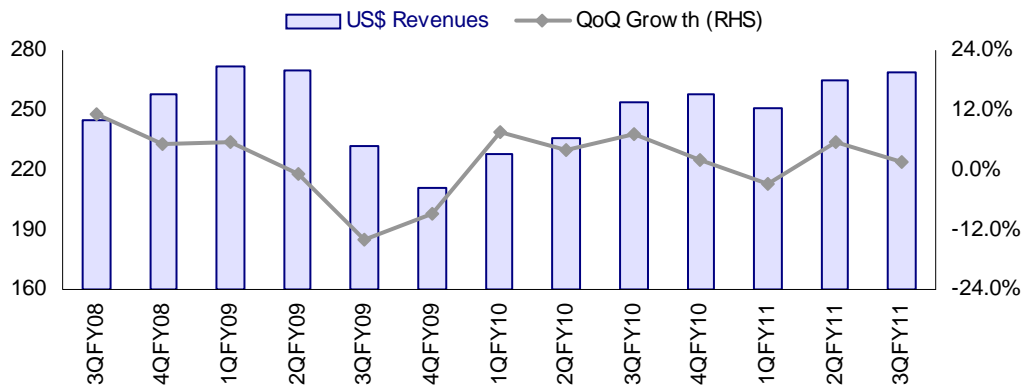
Downbeat performance on volumes, guidance of delay in revival in the Telecom vertical and attrition pressures are expected to weigh on the stock in the near term.

We expect challenges on the demand and supply side to continue, with little chances of a turnaround in the Telecom space in the short term. Consequently we have revised our estimates downwards. We expect Tech Mahindra to post revenue CAGR of 9% over FY11-13 (against 12.7% earlier). Including profits from Mahindra Satyam, we expect an EPS CAGR of 10% (v/s 18% earlier) over FY11-13.

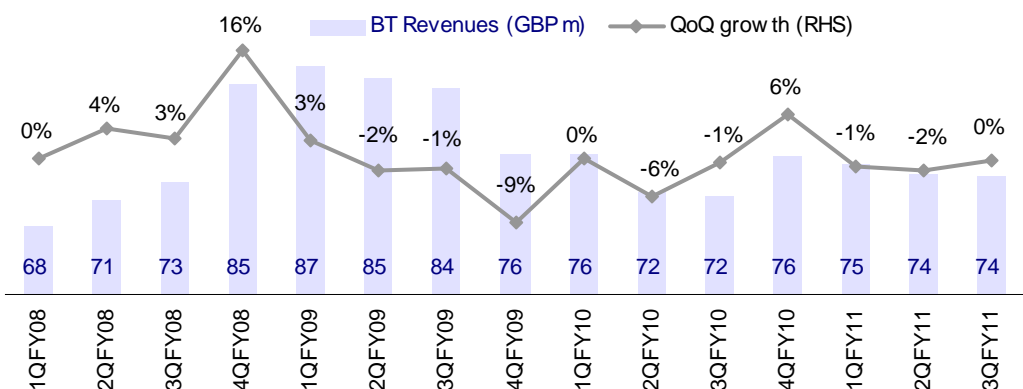
We maintain a cautious view on the stock due to (1) slower than industry growth due to sluggishness in the BT account (44% of revenue) and the Telecom vertical in general, (2) growth skewed towards lower margin segments (domestic BPO and new mobile operators in emerging markets), (3) margin headwinds on elevated attrition and (4) uncertainty over a turnaround at Mahindra Satyam and its legal liabilities.

The stock trades at 12.7x FY12E and 10.6x FY13E earnings. Maintain **Neutral**, with a price target of Rs714, based on 11x FY13E.

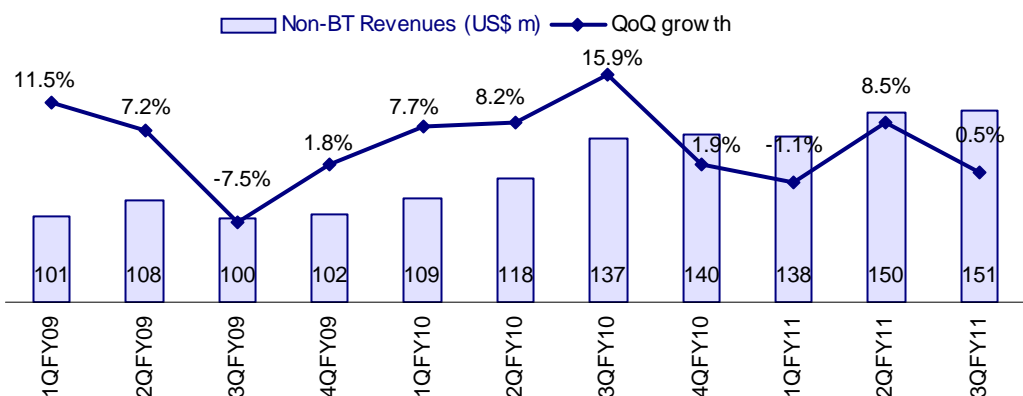
US dollar revenue growth muted on sequentially flat volumes



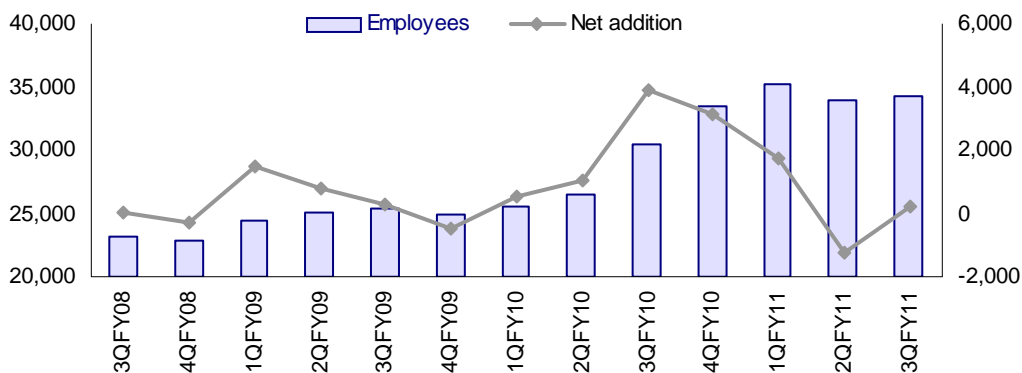
Revenue from BT at 74m pounds, static for the past three quarters



Non-BT revenues flat due to a slow quarter for SI business in emerging markets

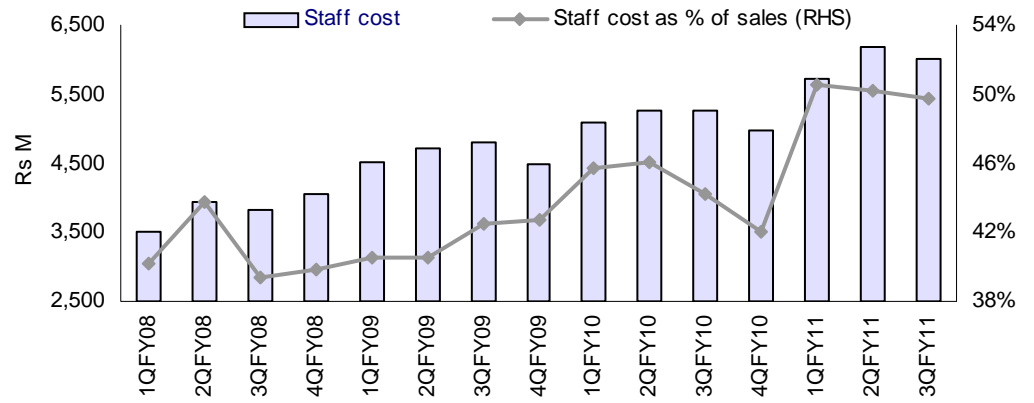


Net addition of 201 employees in 3QFY11, employee count 34,208 (nos)

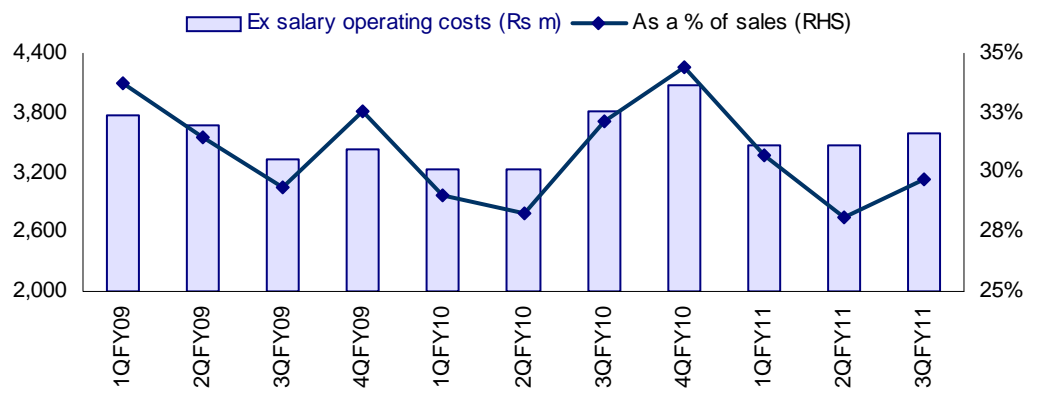


Source: Company/MOSL

Staff costs as a percentage of sales high on 3% onsite salary hike



Ex-salary operating costs up due to higher travel expenses



Source: Company/MOSL

Tech Mahindra: an investment profile

Company description

Tech Mahindra is one of India's largest software exporters and serves telecom service providers, equipment manufacturers, software vendors and systems integrators. It employs over 34,000 people and its key clients include British Telecom and AT&T.

Key investment arguments

- Satyam's acquisition will help Tech Mahindra to diversify its client base and industry focus.
- Large deals like those of Bharti and a gradual revival in the Telecom vertical will help volume growth. Emerging market telco rollouts and domestic BPO deals are expected to be key growth contributors.

Key investment risks

- The company is dependent on a single vertical, Telecom, and a single client, BT (44% of revenue). Growth is skewed towards lower margin services like new telco rollouts and domestic BPOs.
- High attrition rates (30% quarterly annualized attrition in 3QFY11).
Uncertainty regarding Satyam's financials and legal liabilities.

Recent developments

- Tech Mahindra's BPO operations in Ghana are set to go live from 1 February 2011. The company will also start operations in five other countries between March and May.
- The company added two clients in 3QFY11, taking the number of its clients to 126.

Valuation and view

- Valuations at 12.7 FY12E and 10.6x FY13E earnings.
- Maintain **Neutral** with a target price of Rs714, based on 11x FY13E.

Sector view

- Indian offshoring has been vindicated with global clients and service providers making India their base for IT-enabled solutions. Still, India has less than 5% of the global IT markets. We are positive on the long-term prospects of the sector.
- A slowdown in the US economy, wage inflation and sharper currency appreciation are key concerns.
- We reckon frontline Indian IT companies will be better placed to sail through near-term adversities. Niche IT/ITeS services companies with strong business models are likely to be better placed to face near-term uncertainty.

Comparative valuations

		Tech Mahindra	HCLT	Mphasis
P/E (x)	FY11E	12.5	21.8	12.8
	FY12E	12.7	15.8	11.4
P/BV (x)	FY11E	2.3	4.1	3.4
	FY12E	1.9	3.3	2.6
EV/Sales (x)	FY11E	1.3	2.2	2.0
	FY12E	1.1	1.7	1.5
EV/EBITDA (x)	FY11E	6.3	13.0	8.7
	FY12E	5.8	9.1	6.6

Shareholding Pattern (%)

	Dec-10	Sep-10	Dec-09
Promoter	72.8	72.8	83.0
Domestic Inst	15.3	15.1	7.0
Foreign	2.1	2.1	1.3
Others	9.9	10.0	8.7

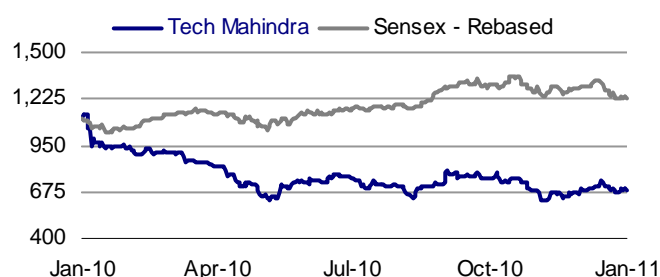
EPS: MOSL forecast v/s Consensus (Rs)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY11	57.2	52.8	8.2
FY12	56.6	58.9	-4.0

Target Price and Recommendation

Current Price (Rs)	Target Price (Rs)	Upside (%)	Reco.
689	714	3.6	Neutral

Stock performance (1 year)



Financials and Valuation

INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2010	2011E	2012E	2013E	
Sales	46,254	48,151	51,936	55,344	
<i>Change (%)</i>	<i>3.6</i>	<i>4.1</i>	<i>7.9</i>	<i>6.6</i>	
Employee Cost	20,584	24,136	26,557	29,564	
Other Expenses	14,345	14,106	15,321	15,914	
Total Expenses	34,929	38,242	41,878	45,478	
EBITDA	11,325	9,908	10,058	9,866	
<i>% of Net Sales</i>	<i>24.5</i>	<i>20.6</i>	<i>19.4</i>	<i>17.8</i>	
Depreciation	1,338	1,394	1,558	1,550	
Interest	2,184	1,016	881	644	
Other Income	754	1,128	893	970	
PBT	8,557	8,627	8,511	8,642	
Tax	1,440	1,480	1,915	1,988	
<i>Rate (%)</i>	<i>16.8</i>	<i>17.2</i>	<i>22.5</i>	<i>23.0</i>	
PAT	7,118	7,147	6,596	6,654	
Minority Interest & EO items	113	-502	24	24	
Share of associate's profits	541	1,195	2,092	3,391	
PAT before EO	7,546	8,844	8,664	10,021	
<i>Change (%)</i>	<i>-25.6</i>	<i>17.2</i>	<i>-2.0</i>	<i>15.7</i>	
Effect of restructuring fees	-1,663	-1,657	-1,550	-1,540	
PAT after RF before EO	5,882	7,187	7,114	8,481	
<i>Change (%)</i>	<i>-42.0</i>	<i>22.2</i>	<i>-1.0</i>	<i>19.2</i>	
Extraordinary Items (EO)	85	-515	0	0	
PAT after EO	5,967	6,672	7,114	8,481	
<i>Change (%)</i>	<i>-46.1</i>	<i>11.8</i>	<i>6.6</i>	<i>19.2</i>	
BALANCE SHEET		(Rs Million)			
Y/E MARCH	2010	2011E	2012E	2013E	
Share Capital	1,223	1,223	1,223	1,223	
Share Premium	2,374	2,374	2,374	2,374	
Reserves	25,268	33,288	41,146	50,234	
Net Worth	28,865	36,884	44,742	53,830	
Minority Interest	139	144	149	154	
Loans	13,672	9,723	7,232	4,518	
Capital Employed	42,676	46,751	52,124	58,502	
Gross Block	11,312	14,312	16,812	19,312	
Less : Depreciation	5,269	6,663	8,221	9,771	
Net Block	6,043	7,649	8,591	9,541	
C/WIP	3,208	1,500	1,500	1,500	
Investments	30,145	30,145	30,145	30,145	
Deferred Tax Assets	276	276	276	276	
Curr. Assets	19,346	21,803	25,030	29,560	
Debtors	10,420	11,213	12,095	12,888	
Cash & Bank Balance	2,187	3,843	5,512	8,607	
Loans & Advances	6,725	6,596	7,115	7,581	
Other Current Assets	14	151	309	484	
Current Liab. & Prov	16,342	14,621	13,418	12,520	
Creditors	13,572	11,298	9,861	8,562	
Provisions	2,770	3,324	3,556	3,958	
Net Current Assets	3,004	7,181	11,612	17,040	
Application of Funds	42,676	46,751	52,124	58,503	

E: MDSL Estimates

RATIOS					
Y/E MARCH	2010	2011E	2012E	2013E	
Basic (Rs)					
EPS	48.1	57.2	56.6	67.5	
Diluted EPS	45.0	55.0	54.4	64.9	
Cash EPS	55.2	65.7	66.4	76.7	
Book Value	236.0	293.4	355.9	428.2	
DPS	3.5	5.6	5.5	6.4	
Payout %	7.8	10.2	10.1	9.8	
Valuation (x)					
P/E	15.3	12.5	12.7	10.6	
Cash P/E	12.5	10.5	10.4	9.0	
EV/EBITDA	5.8	6.3	5.8	5.3	
EV/Sales	1.4	1.3	1.1	0.9	
Price/Book Value	2.9	2.3	1.9	1.6	
Dividend Yield (%)	0.5	0.8	0.8	0.9	
Profitability Ratios (%)					
RoE	31.6	25.3	21.2	20.3	
RoCE	31.5	20.9	19.3	19.3	
Turnover Ratios					
Debtors (Days)	77	82	82	82	
Fixed Asset Turnover (x)	4.5	3.8	3.3	3.1	
Leverage Ratio					
Debt/Equity Ratio(x)	0.5	0.3	0.2	0.1	

CASH FLOW STATEMENT		(Rs Million)			
Y/E MARCH	2010	2011E	2012E	2013E	
CF from Operations	8,829	10,243	10,227	11,576	
Change in Working Capital	2,283	-2,522	-2,761	-2,334	
Net Operating CF	11,112	7,722	7,466	9,242	
Net Purchase of FA	-4,069	-1,292	-2,500	-2,500	
Net Purchase of Invest.	-25,799	0	0	0	
Net Cash from Invest.	-29,868	-1,292	-2,500	-2,500	
Inc./(Dec) in Equity & other related iter	2,389	3	5	5	
Proceeds from LTB/STB	13,672	-3,949	-2,490	-2,714	
Dividend Payments	-501	-828	-811	-938	
Cash Flow from Fin.	15,560	-4,774	-3,296	-3,647	
Free Cash Flow	7,044	6,430	4,966	6,742	
Net Cash Flow	-3,195	1,656	1,669	3,094	
Opening Cash Balance	5,382	2,187	3,843	5,512	
Add: Net Cash	-3,195	1,656	1,669	3,094	
Closing Cash Balance	2,187	3,843	5,512	8,607	

Earnings estimate includes contribution from Mahindra Satyam

N O T E S



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Tech Mahindra

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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