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# Tech Mahindra

## IPO Fact Sheet

| Issue details | |
|---|---|
| Issue opens: | August 1, 2006 |
| Issue closes: | August 4, 2006 |
| Offer price: | Rs315 to Rs365 |
| Route | 100% book building |
| Issue size: | 127.5 lakh equity shares (Rs401-465 crore) |
| Retail portion: | 34.76 lakh shares |
| Equity pre-issue: | Rs112.7 crore |
| Equity post-issue: | Rs115.9 crore |

### Objects of the issue

The issue size of 127.5 lakh shares consists of an offer for sale by the promoters (95.6 lakh shares; 57.36 lakh shares by British Telecommunications Plc [BT] and 38.24 lakh shares by Mahindra & Mahindra [M&M]) and a fresh issue of 31.9 lakh shares. The company proposes to utilise the proceeds from the fresh issue of shares (in the range of Rs100-116.4 crore) to set up a development facility in Pune.

The stake held by the promoters and the promoter group would decline from 98.5% of the pre-issue equity to 87.5% of the post-issue diluted equity base.

**Shareholding pattern**

| | Pre-issue | | Post-issue | |
|---|---|---|---|---|
| | No of shares | % | No of shares | % |
| **Promoters** | | | | |
| M&M | 57600060 | 51.1 | 53776252 | 46.4 |
| BT | 43452635 | 38.6 | 37716923 | 32.6 |
| **Promoter group** | | | | |
| MBTM | 9931638 | 8.8 | 9931638 | 8.6 |
| **Others** | | | | |
| Public and employees | 1701240 | 1.5 | 1701240 | 1.5 |
| Public issues | 0 | 0.0 | 12746000 | 11.0 |
| Total | 112685573 | 100.0 | 115872053 | 100.0 |

### Company background

Tech Mahindra Ltd (TML), earlier known as Mahindra British Telecom, was incorporated in 1986 as a joint venture between M&M and BT, one of the world's leading telecommunication companies. TML is focused on providing information technology (IT) services and solutions to the telecommunication companies globally.

Traditionally, as a result of the association with BT, the company was primarily focused on providing IT services to telecommunication service providers (TSPs) and its geographical presence was limited to Europe and the Asia Pacific region. However, TML has considerably expanded its client base and geographical presence over the past couple of years. The change was driven by the acquisition of Axes Technologies that was involved in providing services to leading telecom equipment manufacturers (TEMs) like Alcatel, Nortel and Motorola. This enabled the company to establish itself in the TEM space and also gain a foothold with some of the leading independent software vendors (ISVs). In terms of geographical reach, TML has made progress in penetrating the US markets and has acquired business from AT&T, the largest TSP in the USA.

### Key positives

#### On a growth path

TML has reported an impressive performance in the past couple of years. Its revenues have shown a compounded annual growth rate (CAGR) of 29.4% during FY2004-06, in spite of the fact that the company shifted substantial portion of the business offshore (where billing rates are lower but profitability is higher) in the same period. Over the past eight quarters, the contribution of the offshore revenues has smartly increased from 37% in Q1FY2005 to 68% in Q4FY2006.

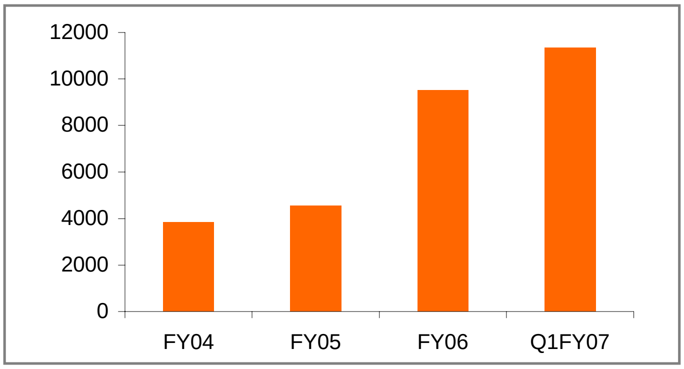
**Revenue mix**

| | FY2005 | | | | FY2006 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Offshore (%) | 37 | 35 | 59 | 63 | 62 | 64 | 69 | 68 |
| Onsite (%) | 63 | 65 | 41 | 37 | 38 | 36 | 31 | 32 |

Given the shift towards the offshore business and the continued efforts to curtail selling, general and administration (SG&A) expenses as a percentage of sales, the operating profit margin has more than doubled from 10.8% in FY2004 to 21.6% in FY2006. Consequently, the earnings showed a CAGR of 92.2% in the two-year period FY2004-06, up from Rs63.7 crore to Rs235.4 crore in FY2006.

The employee base also more than doubled from 3,838 as on March 2004 to 9,513 employees at the end of March 2006.

**Growing employee base**




During the first quarter ended June 2006, TML reported consolidated revenues of Rs591 crore and earnings of Rs106.6 crore. The employee base has further grown to over 11,000 in the first quarter of FY2007.

### Huge market potential

TML's key target segment of TSPs spend around $35 billion annually on IT services. The IT spending by TSPs has been growing steadily over the year and is expected to touch $40 billion by 2010. What's more, the TSPs globally are under tremendous pressure to increasingly outsource to stay competitive. The tariffs on the voice traffic has been declining continuously and the TSPs are focusing on introducing more value-added services to boost the non-voice revenues, leading to a strong demand environment for IT service companies.

In case of TEMs, the cumulative IT spending just on research & development by the six large TEMs (including Alcatel, Motorola and Nokia) works out to over $19 billion annually and is expected to grow at a steady rate in the coming years. TML with its focused approach (on the telecom vertical) is uniquely positioned to effectively exploit this huge potential.

### Scope to build on the established client relationships

TML has a base of 62 active clients that includes reputed names like BT, Alcatel, AT&T, Motorola and Nortel among others. Some of these engagements have commenced over the past four to six quarters and offer scope to substantially ramp up the business from some of the large clients, especially given the scale of their annual IT budgets. It has already entered into master service agreements (spread over three to four years) with clients like Alcatel and AT&T in the recent past.

With the continued efforts to enhance the range of service offerings, the company has proven its ability to ramp up business even from a mature client like BT. TML has been able to almost double its revenues from BT (client for over a decade) to $77.3 million in Q1FY2007 as compared to the corresponding period last year.

## Key concerns

### High client concentration

Though the non-BT revenue is growing at a rapid pace, the company's largest client (BT) still accounts for close to 68% of its turnover. The top five clients accounted for over 85% of its turnover in FY2006, which is quite high and may increase the risk of a weak performance in case of a slowdown in the business from one of the large clients.

**Client concentration (% of net revenues)**

| | FY2005 | | | | FY2006 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Top client | 83 | 81 | 78 | 80 | 72 | 66 | 68 | 68 |
| Top 5 | 90 | 88 | 85 | 86 | 85 | 85 | 84 | 87 |
| Top 10 | 94 | 93 | 90 | 90 | 88 | 89 | 90 | 92 |

### Pressure on gross margins

The gross margins have declined by 1,220 basis points to 54.7% over the two-year period FY2004-06. The improvement in its operating profit margin is primarily driven by the savings in the SG&A expenses as a percentage of sales. Going forward also, the continued wage inflation, already relatively high employee utilisation rate (74% including trainees) and attrition rate (17% including trainees) is likely to result in further pressure on the gross margins. There is little scope of improvement in the other margin levers like the offshore contribution, as the company already accrues relatively high level (68% of revenues) of offshore revenues.

## Valuation

At the current market price the stock trades at 19.9x FY2006 earnings and 10.9x Q1FY2007 annualised earnings.

**Peer comparison**

| | TML @Rs315 | TML @Rs365 | Patni | HCL Tech | Satyam |
|---|---|---|---|---|---|
| EPS (TTM*) | 18.3 | 18.3 | 19.6 | 21.9 | 30.3 |
| PER | 17.2 | 19.9 | 14.7 | 24.6 | 24.5 |
| EV/EBIDTA | 10.1 | 11.8 | 8.5 | 15.4 | 19.5 |
| EV/Sales | 2.5 | 2.9 | 1.6 | 3.5 | 4.9 |
| OPM (%) | 21.6 | 21.6 | 18.3 | 22.4 | 24.3 |
| PAT growth (%) (CAGR two-year period) | 92.2 | 92.2 | 8.3 | 21.1 | 34.6 |

* Trailing four quarter earning from Arpil 05 to March 06

## Financials

**Profit & loss account** Rs (cr)

| Particulars | FY03 | FY04 | FY05 | FY06 | Q1FY07 |
|---|---|---|---|---|---|
| Net sales | 621.4 | 741.7 | 945.6 | 1242.7 | 591.2 |
| Software development cost | 140.0 | 244.9 | 397.6 | 562.4 | 232.4 |
| Gross profit | 481.4 | 496.8 | 548.0 | 680.3 | 358.8 |
| Other expenses | 285.9 | 417.0 | 413.0 | 412.4 | 227.0 |
| Operating profit | 195.6 | 79.8 | 135.0 | 267.9 | 131.8 |
| Other income | 20.5 | 14.8 | 8.5 | 34.0 | 0.0 |
| Interest cost | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Depreciation | 22.8 | 22.7 | 32.1 | 39.7 | 10.8 |
| PBT | 193.2 | 72.0 | 111.5 | 262.1 | 121.0 |
| Tax | 30.1 | 8.3 | 9.1 | 26.8 | 14.4 |
| PAT | 163.1 | 63.7 | 102.4 | 235.4 | 106.6 |

**Balance sheet** Rs (cr)

| Particulars | FY03 | FY04 | FY05 | FY06 | Q1FY07 |
|---|---|---|---|---|---|
| Share capital | 20.2 | 20.3 | 20.3 | 20.8 | 112.7 |
| Reserves and surplus | 362.8 | 386.5 | 465.8 | 594.6 | 657.9 |
| Minority interest | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Capital employed | 383.0 | 406.7 | 486.1 | 615.5 | 770.6 |
| Net fixed assets | 105.1 | 134.6 | 171.0 | 270.0 | 276.7 |
| CWIP | 37.9 | 19.9 | 7.0 | 19.8 | 29.5 |
| Investment | 33.5 | 45.1 | 111.3 | 150.5 | 146.0 |
| Net current assets | 204.5 | 198.7 | 183.4 | 164.0 | 307.4 |
| Deferred tax | 2.0 | 8.5 | 13.4 | 11.2 | 11.0 |
| Capital deployed | 383.0 | 406.7 | 486.1 | 615.5 | 770.6 |

**Key ratios**

| Particulars | FY03 | FY04 | FY05 | FY06 | Q1FY07 |
|---|---|---|---|---|---|
| GPM (%) | 77.5 | 67.0 | 58.0 | 54.7 | 60.7 |
| OPM (%) | 31.5 | 10.8 | 14.3 | 21.6 | 22.3 |
| NPM (%) | 26.2 | 8.6 | 10.8 | 18.9 | 18.0 |
| RoNW (%) | 42.6 | 15.7 | 21.1 | 38.2 | - |
| RoCE (%) | 50.4 | 17.7 | 22.9 | 42.6 | - |

**Valuation ratios (at upper end of price band Rs365)**

| Particulars | FY03 | FY04 | FY05 | FY06 | Q1FY07 |
|---|---|---|---|---|---|
| EPS (diluted) | 15.8 | 6.2 | 9.0 | 18.3 | 33.4 |
| PER | 23.1 | 59.2 | 40.7 | 19.9 | 10.9 |
| Book Value | 37.8 | 40.1 | 47.8 | 59.2 | 54.7 |
| EV/EBIDTA | 16.4 | 38.2 | 24.2 | 11.8 | 7.2 |
| EV/Sales | 5.7 | 4.9 | 3.7 | 2.9 | 1.6 |

Q1FY2007 figures on valuation ratios are on an annualized basis

The views expressed in this report are our views only and have been arrived at after a thorough analysis of the public offering details. The note is advisory in nature, but is not a Recommendation under our "Stock Idea" category. It may/may not be considered as a "Stock Idea" by our analysts at a later date.