## RESULTS REVIEW

**Share Data**

| | |
|---|---|
| Market Cap | Rs. 32.51 bn |
| Price | Rs. 267.10 |
| BSE Sensex | 9,042.63 |
| Reuters | TEML.BO |
| Bloomberg | TECHM IN |
| Avg. Volume (52 Week) | 0.06 mn |
| 52-Week High/Low | Rs. 990.00 / 203.70 |
| Shares Outstanding | 121.73 mn |

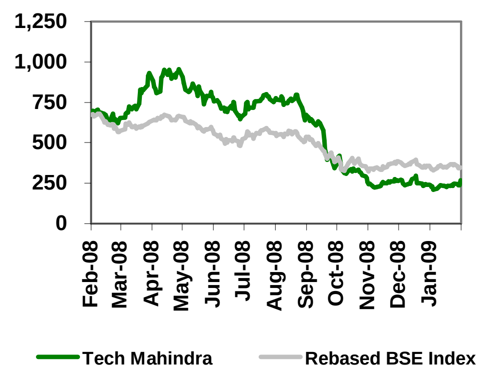
**Valuation Ratios (Consolidated)**

| Year to 31 March | 2009E | 2010E |
|---|---|---|
| EPS (Rs.) | 76.1 | 48.7 |
| +/- (%) | 29.0% | (36.0%) |
| PER (x) | 3.1x | 4.9x |
| EV/ Sales (x) | 0.7x | 0.9x |
| EV/ EBITDA (x) | 2.7x | 4.0x |

**Shareholding Pattern (%)**

| | |
|---|---|
| Promoters | 83 |
| FIIs | 1 |
| Institutions | 3 |
| Public & Others | 12 |

**Relative Performance**




## Tech Mahindra Limited — Buy

***Attractive valuation despite near-term headwinds***

Tech Mahindra (TM) reported a disappointing performance for the quarter ended December 2008 as revenues went down 2.8% qoq to Rs. 11.3 bn, owing to a 3% decline in the sales volume. In USD terms, revenues declined substantially by 14% qoq due to a sharp depreciation in the GBP vis-à-vis the USD. The EBITDA margin improved slightly by 10 bps qoq to 28.1% after adjusting for a one-time tax reversal of Rs. 673 mn in the last quarter. Although we have cut our target price to Rs. 309 because of the deteriorating demand outlook and high revenue concentration, we maintain a Buy rating on the stock. This is attributed largely to TM's large order book and strong balance sheet. Besides, we believe that the current price correction to the stock is overdone.

**Strong revenue visibility:** TM maintains a healthy order book of USD 2.5 bn over the next 3–4 years, including approximately USD 2 bn of deals from British Telecom (BT). This provides strong revenue visibility for the near-to-medium term. However, we remain concerned about the possible delays in the ramp-ups from BT due to the deteriorating performance of its various operating segments. Moreover, the new deals inflow is likely to remain poor, adversely affecting the volume growth.

**Margin-dilutive deals:** In our view, the deals signed with BT will erode margins in the next 6–8 quarters**,** considering the high transition costs, upfront payment made to BT, and any further delays in execution. Besides, the inability to achieve an IRR higher than its WACC (16.2%) on large projects such as the Andes deal (worth USD 700 mn), where the Company has made an upfront payment, will also hurt profitability.

**Key Figures (Consolidated)**

| Quarterly Data | Q3'08 | Q2'09 | Q3'09 | YoY% | QoQ% | 9M'08 | 9M'09 | YoY% |
|---|---|---|---|---|---|---|---|---|
| (Figures in Rs. mn, except per share data) | | | | | | | | |
| Net Sales | 9,704 | 11,648 | 11,322 | 16.7% | (2.8%) | 27,443 | 34,134 | 24.4% |
| EBITDA | 2,129 | 3,261 | 3,180 | 49.4% | (2.5%) | 6,034 | 9,310 | 54.3% |
| Net Profit | 1,995 | 2,354 | 2,229 | 11.7% | (5.3%) | 5,513 | 7,168 | 30.0% |
| **Margins (%)** | | | | | | | | |
| EBITDA | 21.9% | 28.0% | 28.1% | | | 22.0% | 27.3% | |
| NPM | 20.6% | 20.2% | 19.7% | | | 20.1% | 21.0% | |
| **Per Share Data (Rs.)** | | | | | | | | |
| EPS | 15.2 | 23.2 | 17.2 | 12.5% | (26.2%) | 42.0 | 60.2 | 43.3% |

### Valuation

Our DCF valuation suggests a fair price of Rs. 309, assuming a 16.2% of WACC and a 5% terminal growth rate. This provides an upside of 15.6% from the current levels. Amidst the dismal outlook for IT budgets for 2009, the stock trades at its historically low P/E of 3x. However, we believe that the price correction of TM's stock is overdone, considering that the Company has a cash balance of USD 110 mn (cash per share of Rs. 45), high receivables quality, and strong revenue visibility for the next 3–4 years on the back of a robust order book.

Thus, in our view, TM remains a strong value pick in the ITES sector, and we maintain our Buy rating on the stock.

**Sensitivity of Our Fair Value Estimate**

| | | Cost of Capital (%) | | | | |
|---|---|---|---|---|---|---|
| | | 15.5 | 16.0 | 16.2 | 16.5 | 17.0 |
| Terminal Rate (%) | 4.0 | 317 | 306 | 301 | 295 | 284 |
| | 4.5 | 322 | 309 | 305 | 298 | 287 |
| | 5.0 | 327 | 314 | 309 | 302 | 291 |
| | 5.5 | 332 | 318 | 313 | 306 | 294 |
| | 6.0 | 338 | 323 | 318 | 310 | 298 |

### Result Highlights and Outlook

*Volume and price weakness*

In Q3'09, revenues declined 14% qoq to USD 232 mn, largely impacted by the depreciation of the GBP vis-à-vis the USD. This weak performance also reflects the fall in IT spending by clients, leading to a volume decline (down 3% qoq). Though the Company showed a robust 9% qoq growth in the BTGS deal to GBP 22.2 mn, it reported an 11.9% qoq fall in revenue to GBP 59 mn in its traditional BT deal.

*Ramp-ups in the Andes deal to limit volume contraction; however, the deal involves high transition costs*

In our view, the Company's operating performance will further deteriorate in the next 4–6 quarters, considering the over-dependence on large clients (approximately 60% of revenues comes from BT) and a high focus on the Telecom vertical. This is reflected in our assumption of the low level of net additions for the next couple of quarters (~150 employees in FY10) and increasing pricing pressure. Although we expect volume growth to continue its downward trend in the next 4–6 quarters, the adverse effect of this decline will be partially offset with the ramp-up in the Andes deal (worth USD 700 mn), scheduled to commence in Q1'10. Consequently, we expect revenue to fall ~18% in FY10 (in USD terms).

*EBITDA margin to decline in FY10*

The EBITDA margin improved slightly by 10 bps qoq to 28.1% during the quarter, after adjusting for a one-time tax reversal payment of Rs. 673 mn from the UK in the last quarter. However, we believe the margin will decline by ~2.5% in FY10 (excluding the currency impact), due to the transition cost of the Andes deal signed, falling utilisation levels, and increasing pricing pressure. However, margins may improve in the medium term, excluding the currency impact, as the cost of transition is disproportionate and will fall post FY10. Besides, the Company has a high fixed price project (FPP) contribution from BT (~75% in FPP contracts), which will help in moderating the pricing pressure.

***High FPP contribution and focus on non-BT clients to ease the pressure on margins***

*Focusing on Non-BT clients*

The Company's non-BT revenues have grown by 4.5% qoq, compared with the sequential 7.7% decline in revenues from BT during the quarter. Further, revenue contribution from BT (~57%) has declined by 4% pts on a yoy basis. The trend indicates that the TM is focusing to reduce its dependence on BT, in order to ease the pricing pressure and reduce concentration risk in its business.

**Sensitivity of key variables**

| Variables | Change | Impact on Tp |
|---|---|---|
| Pricing | +1.0% | +2.9% |
| | -1.0% | -2.9% |
| Salary cost/emp | +1.0% | -1.3% |
| | -1.0% | +1.3% |
| Utilization | +1.0% | +1.7% |
| | -1.0% | -1.7% |

## Key Risks

The following factors can pose a threat to our rating:

- Over-dependence on BT and the Telecom vertical
- Currency fluctuations
- A more-than-anticipated hike in wages

**Key Figures (Consolidated)**

| Year to March | FY06 | FY07 | FY08 | FY09E | FY10E | FY11E | CAGR (%) |
|---|---|---|---|---|---|---|---|
| (Figures in Rs. mn, except per share data) | | | | | | | (FY08-11E) |
| Net Sales | 12,427 | 29,290 | 37,661 | 44,631 | 36,030 | 36,652 | (0.9%) |
| EBITDA | 2,680 | 7,382 | 8,257 | 11,905 | 8,086 | 7,089 | (5.0%) |
| Net Profit | 2,355 | 6,125 | 7,700 | 9,228 | 6,331 | 5,490 | (10.7%) |
| **Margins (%)** | | | | | | | |
| EBITDA | 21.6% | 25.2% | 21.9% | 26.7% | 22.4% | 19.3% | |
| NPM | 19.0% | 20.9% | 20.4% | 20.7% | 17.6% | 15.0% | |
| **Per Share Data** | | | | | | | |
| EPS (Rs.) | 18.7 | 47.0 | 58.9 | 76.1 | 48.7 | 42.0 | (10.7%) |
| PER (x) | 28.0x | 30.4x | 12.0x | 3.1x | 4.9x | 5.7x | |

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