



Tech Mahindra

STOCK INFO.	BLOOMBERG
BSE Sensex: 16,860	TECHM IN
	REUTERS CODE
S&P CNX: 5,036	TEML.BO

23 January 2010

Neutral

Previous Recommendation: Neutral

Rs1,135

Equity Shares (m)	130.7
52-Week Range (Rs)	1,158/204
1,6,12 Rel. Perf. (%)	15/33/305
M.Cap. (Rs b)	148.3
M.Cap. (US\$ b)	3.2

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
3/09A	44,647	10,147	77.6	31.9	14.6	7.1	57.6	56.9	2.9	10.8
3/10E*	46,446	8,097	49.1	-36.8	23.1	5.2	35.4	35.2	5.2	10.0
3/11E*	50,836	10,119	64.7	31.9	17.5	3.8	32.3	26.1	3.8	10.0
3/12E*	55,645	10,849	71.4	10.3	15.9	3.0	26.5	23.5	3.0	9.3

* Includes profits from Satyam and effect of restructuring fees

Tech Mahindra's adjusted 3QFY10 results were below our expectations (adjusting for one-off restructuring fees of Rs1.5b added to its 9MFY10 revenues). The key highlights were:

- Aggressive policy of amortizing Rs9.7b (received as restructuring fees on its BT contracts) as revenues over 5 year duration.
- Strong headcount addition with 3,889 employees during the quarter taking headcount to 30,404
- Growth largely contributed by North America and RoW

We consider restructuring fees of Rs9.7b as a one-off item and hence use adjusted EPS, (excluding post tax impact of revenue accrued on this account) for valuation. Post the adjustments we estimate consolidated EPS (incl. Satyam's earnings) of Rs65 in FY11 and Rs71 in FY12. Our adjusted core EPS estimate for Tech Mahindra (excl. Satyam earnings) stands at Rs44 in FY11 and Rs47 in FY12. Based on our adjusted EPS (incl Satyam contribution), the stock trades at a P/E of 17.5x FY11 and 15.9x FY12. We maintain **Neutral** on the stock, keeping our target price unchanged at Rs925 (downside 19%), based on 13x FY12 earnings. We continue to maintain a negative view on the stock on account of [1] Slower than industry growth on sluggishness in BT account (46% of its business) [2] Uncertainty on Satyam financials and legal liabilities and [3] Limited scope for an upside on adjusted valuations

QUARTERLY PERFORMANCE (INDIAN GAAP)

(RS MILLION)

Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenues	11,164	11,648	11,322	10,513	11,130	11,418	11,873	12,025	44,647	46,446
Q-o-Q Change (%)	9.3	4.3	-2.8	-7.1	5.9	2.6	4.0	1.3	18.5	4.0
Direct Cost	6,825	6,867	6,572	6,364	6,838	6,986	7,514	7,734	26,628	29,072
Other Operating Exps	1,470	1,520	1,570	1,557	1,487	1,507	1,552	1,563	6,117	6,109
Operating Profit	2,869	3,261	3,180	2,592	2,805	2,925	2,807	2,727	11,902	11,265
Margins (%)	25.7	28.0	28.1	24.7	25.2	25.6	23.6	22.7	26.7	24.3
Other Income	261	-320	-397	78	-261	270	6	79	-378	94
Interest	2	0	0	23	571	843	459	278	25	2,151
Depreciation	258	267	286	286	296	312	331	337	1,097	1,276
PBT bef. Extra-ordinary	2,870	2,674	2,497	2,361	1,677	2,040	2,023	2,191	10,402	7,932
Provision for Tax	282	321	269	306	268	345	285	351	1,178	1,248
Rate (%)	9.8	12.0	10.8	13.0	16.0	16.9	14.1	16.0	11.3	15.7
Net Income aft. Extra-ordinary	2,586	3,027	2,229	2,305	1,317	1,690	1,729	1,832	10,147	6,567
Effect of restructuring fees	0	0	0	0	420	415	430	420	0	1,685
Adjusted Net Income	2,586	3,027	2,229	2,305	897	1,275	1,299	1,412	10,147	4,882
Q-o-Q Change (%)	-217.0	17.0	-26.4	3.4	-61.1	42.2	2.0	8.6	208.0	-51.9

E: MOSL Estimates

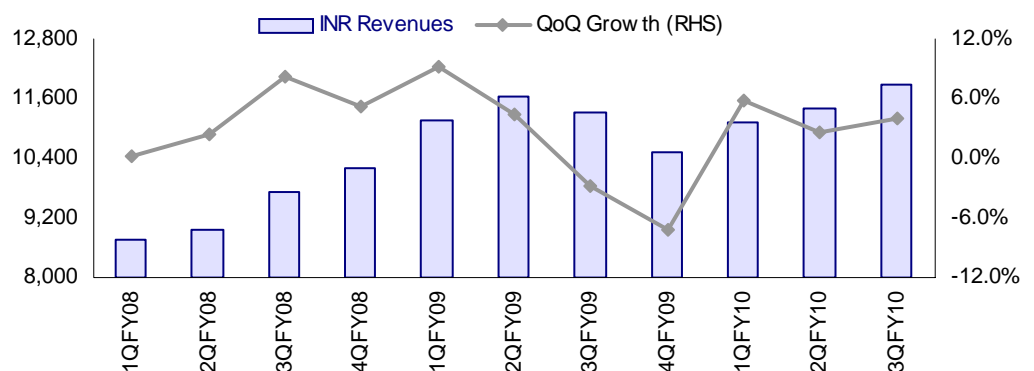
Rs9.7b received as restructuring fees from BT, including same in future revenues would overstate profits

Tech Mahindra received Rs9.7b from BT as ‘restructuring fees’ as a fallout of contract amendments. BT has restructured long term contracts such as Barcelona, Strada and Andes with changes in agreed contract terms including the billing rates. The services under the restructured contracts would be rendered over the life of the contract. Tech Mahindra would be recognizing the payment from BT as revenues at a run rate of ~Rs500m/quarter over the next 16 quarters. The company has disclosed that Rs1.5b has been recognized as revenue for 9MFY10. Management maintains that booking revenues in the future would be the best accounting treatment given the terms of the contracts. However, we believe this payment is a one-off item and should not be accorded multiples, hence we use earnings adjusted for revenues to be accrued (post tax) for valuation. We note that the company had earlier expensed out aggregate payments worth Rs9.7b in FY07 and FY08, thereby have the same effect on earnings.

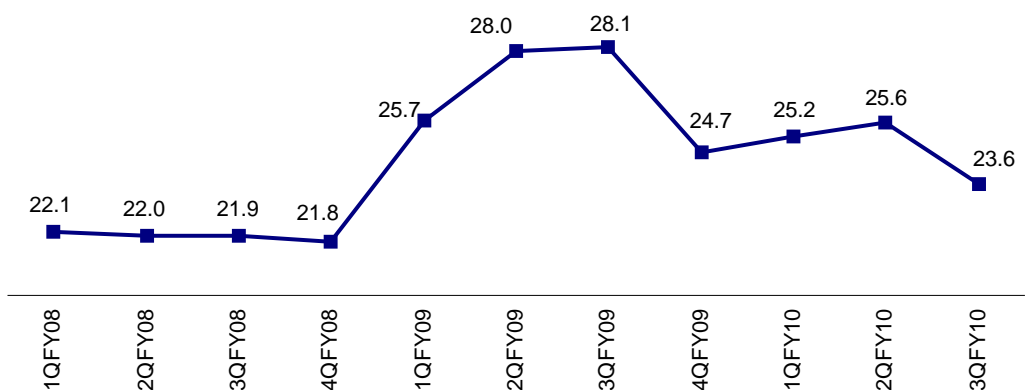
Reported revenues grow 4% QoQ, margins decline by 200bp

Tech Mahindra’s reported basis revenues were up 4% to Rs11.9b. Reported EBITDA margins were down 200bp QoQ to 23.6%. On a reported basis, PAT at Rs1.7b grew by 2.3%. The company indicated Rs1.5b of revenues from Rs9.7b of restructuring fees received has been incorporated in current quarter. Including the impact of the same adjusted EBITDA margins over 9MFY10 would be at 21.4% (lower by 340bp compared to reported EBITDA margins)

REPORTED REVENUES GROW BY 4% QOQ



REPORTED EBITDA MARGIN DECLINES BY 200BP

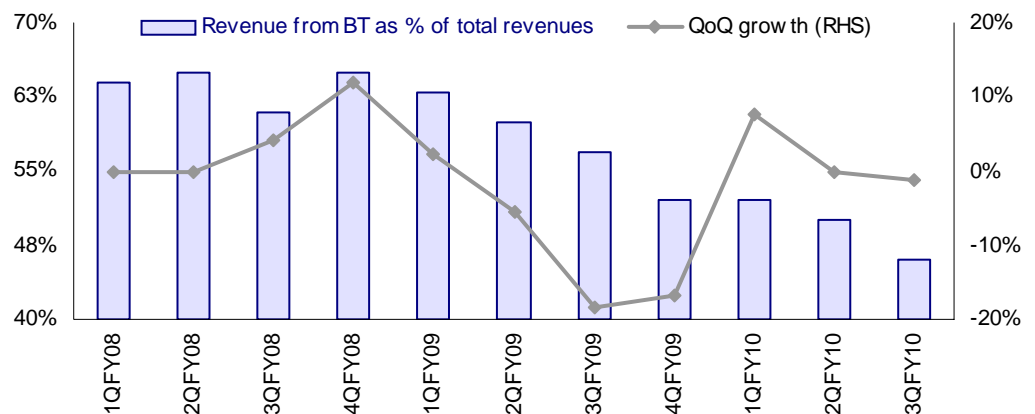


Source: Company/MOSL

Large BT deals renegotiated with pricing discounts, common rate card across deals

Barcelona and Strada, large deals from BT, have already been negotiated during the quarter. However, negotiations on the Andes deal is still going on and is expected to be finalized in the near future. The restructuring fees received by Tech Mahindra is for contract renegotiations of all these contracts. The management has indicated that the large deal structures with BT have been simplified with the introduction of one rate card across the deals. Under the new deal structure, billing rates appear to have been lowered with volume commitments on some of the deals. The company expect BT volumes including restructuring fees component to be maintained.

UNADJUSTED BT REVENUES FLAT QOQ

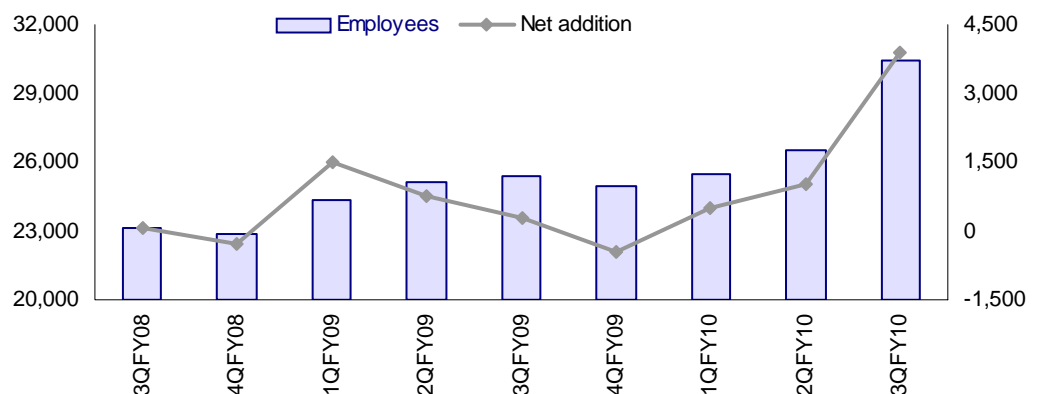


Source: Company/MOSL

Reduced leverage, headcount increase indicates higher volume visibility

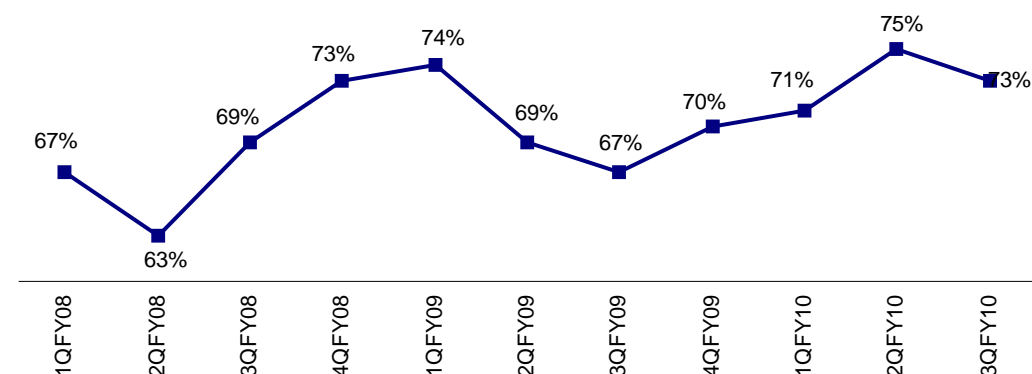
Tech Mahindra used part of the proceeds from restructuring fees to retire a portion of the debt taken for Satyam acquisition. The company has used Rs4.5b to repay debt during the quarter bringing down debt levels to Rs17.4b as of Dec '09. Additionally, the company has repaid debt worth Rs3.5b in Jan '10 further reducing debt levels to Rs13.9b. Cash and equivalents on the books as of Dec '09 was at US\$140m. The company has added 3,889 employees during the quarter taking headcount to 30,404. Headcount addition is at historical high and is in response to confirmed business visibility as per the management.

HIGH EMPLOYEE ADDITION ON CONFIRMED DEMAND...



Source: Company/MOSL

UTILIZATION DIPS ON HIGH EMPLOYEE ADDITION



Source: Company/MOSL

Other result highlights

- Forex hedges at US\$735m in US\$/INR at a rate of INR46.3/US\$ and GBP280m in GBP/US\$ at a rate of US\$1.8/GBP
- Utilization declined by 200bp QoQ to 73% on high employee addition
- Including the restructuring fees business from BT was flat QoQ, while non-BT business grew by 16% QoQ
- Interest expenses at Rs459m vs Rs843m in 2QFY10

Valuation and view

Tech Mahindra's decision to amortize the restructuring fees and book them as revenues would overstate future margins and earnings in our view. We have adjusted our earnings estimates, excluding the after tax impact of these future revenue bookings (run rate of Rs500m per quarter). We have also revised our revenue growth assumptions upwards given the demand improvement in Telecom vertical. Post the adjustments we estimate consolidated (incl. Satyam's earnings) EPS of Rs65 in FY11 and Rs71 in FY12. Our adjusted core EPS estimate for Tech Mahindra (excl. Satyam earnings) stands at Rs44 in FY11 and Rs47 in FY12. On a consolidated basis, the stock trades at 17.5x FY11 and 15.9x FY12 adjusted earnings. Maintain **Neutral**, with a target price of Rs925, based on 13x FY12 earnings. We continue to maintain a negative view on the stock on account of [1] Expected slower than industry growth on sluggishness in BT account (46% of its business) [2] Uncertainty on Satyam financials and legal liabilities and [3] Limited scope for an upside on adjusted valuations.

Tech Mahindra: an investment profile

Company description

Tech Mahindra is one of India's largest software exporter, and serves telecom service providers, equipment manufacturers, software vendors and systems integrators. It employs over 30,000 people. Its key clients include British Telecom and AT&T.

Key investment arguments

- Revival in Telecom vertical to help volume growth.
- Satyam acquisition would help Tech Mahindra diversify its client base and industry focus

Key investment risks

- Significant dependence on single vertical viz telecom and clients – BT (46% of revenues)
- Slowdown in telecom spends and pricing pressure from BT
- Profitability on large deals and ability of timely execution of same.

Recent developments

- Selected as a preferred partner for a multi year migration program by a large telecom operator in Europe.
- Chosen by an emerging telecom operator in India for managing its customer desk service.

Valuation and view

- Valuations at 17.5x FY11E and 15.9x FY12E earnings, fairly valued
- Maintain **Neutral** with a target price of Rs925.

Sector view

- Indian IT services sector has been vindicated with the Global Clients and Service providers making India as their base for IT Enabled solutions. India still has less than 5% of Global IT markets. We are positive on sector from long term perspective
- Delay in demand recovery and sharper currency appreciation remains key concerns
- We reckon frontline Indian IT companies would be better placed to sail through the near term uncertainty on the demand front. Niche IT/ITeS services companies with strong business models are also likely to do well.

COMPARATIVE VALUATIONS

		TECH MAHINDRA	HCLT	MPHASIS
P/E (x)	FY11E	17.5	15.2	14.6
	FY12E	15.9	13.3	13.9
P/BV (x)	FY11E	3.8	3.2	4.6
	FY12E	3.0	2.6	3.5
EV/Sales (x)	FY11E	3.8	1.8	2.7
	FY12E	3.0	1.5	2.1
EV/EBITDA (x)	FY11E	10.0	8.9	10.3
	FY12E	9.3	7.5	8.7

SHAREHOLDING PATTERN (%)

	DEC-09	SEP-09	DEC-08
Promoter	83.0	85.9	85.0
Domestic Inst	7.0	2.3	1.7
Foreign	1.3	1.6	1.8
Others	8.7	10.2	11.5

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY10	49.1	53.1	-7.5
FY11	64.7	62.9	2.8

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,135	925	-	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2009	2010E	2011E	2012E	
Sales	44,647	46,446	50,836	55,645	
Change (%)	18.5	4.0	9.5	9.5	
Employee Cost	18,556	21,423	25,483	28,725	
Other Expenses	14,189	13,759	14,692	16,225	
Total Expenses	32,745	35,182	40,175	44,949	
EBITDA	11,902	11,265	10,662	10,696	
% of Net Sales	26.7	24.3	21.0	19.2	
Depreciation	1,097	1,276	1,462	1,600	
Interest	25	2,151	983	760	
Other Income	-378	94	718	1,745	
PBT	10,402	7,932	8,935	10,081	
Tax	1,178	1,248	1,519	2,420	
Rate (%)	11.3	15.7	17.0	24.0	
PAT	9,224	6,683	7,416	7,662	
Minority Interest & extraordinary items	-923	116	36	36	
Share of associate's profits	0	1,530	2,739	3,223	
Effect of restructuring fees	0	-1,685	-1,660	-1,520	
PAT after RF before EO	10,147	6,412	8,459	9,329	
Change (%)	208.0	-36.8	31.9	10.3	
Extraordinary Items (EO)	923	85	0	0	
PAT after EO	11,070	6,497	8,459	9,329	
Change (%)	43.9	-41.3	30.2	10.3	

BALANCE SHEET		(Rs Million)			
Y/E MARCH	2009	2010E	2011E	2012E	
Share Capital	1,217	1,217	1,217	1,217	
Share Premium	2,330	2,330	2,330	2,330	
Reserves	15,884	23,228	32,405	42,244	
Net Worth	19,431	26,775	35,952	45,791	
Minority Interest	113	118	123	128	
Loans	0	12,245	9,759	7,051	
Capital Employed	19,544	39,138	45,834	52,969	
Gross Block	9,079	11,179	13,279	15,379	
Less : Depreciation	4,100	5,376	6,837	8,438	
Net Block	4,979	5,803	6,442	6,941	
CWIP	1,541	1,200	1,200	1,200	
Investments	4,346	33,149	33,149	33,149	
Deferred Tax Assets	196	196	196	196	
Curr. Assets	17,370	17,489	23,609	29,943	
Debtors	9,022	9,881	11,361	13,033	
Cash & Bank Balance	5,382	4,390	8,584	12,744	
Loans & Advances	1,271	1,322	1,447	1,584	
Other Current Assets	1,695	1,895	2,217	2,582	
Current Liab. & Prov	8,888	18,699	18,761	18,460	
Creditors	6,738	15,576	15,213	14,583	
Provisions	2,150	3,123	3,549	3,877	
Net Current Assets	8,482	-1,211	4,848	11,483	
Application of Funds	19,544	39,138	45,834	52,969	

IE: MOSL Estimates

RATIOS		2009	2010E	2011E	2012E
Y/E MARCH					
Diluted EPS		77.6	49.1	64.7	71.4
Cash EPS		86.0	58.8	75.9	83.6
Book Value		159.7	220.0	295.4	376.3
DPS		6.7	5.3	6.7	7.1
Payout %		8.6	10.8	10.3	10.0
Valuation (x)					
P/E		14.6	23.1	17.5	15.9
Cash P/E		13.2	19.3	15.0	13.6
EV/EBITDA		10.8	10.0	10.0	9.3
EV/Sales		2.9	2.4	2.1	1.8
Price/Book Value		7.1	5.2	3.8	3.0
Dividend Yield (%)		0.6	0.5	0.6	0.6
Profitability Ratios (%)					
RoE		57.6	35.4	32.3	26.5
RoCE		56.9	35.2	26.1	23.5
Turnover Ratios					
Debtors (Days)		82	74	76	80
Fixed Asset Turnover (x)		5.4	4.6	4.2	3.9
Leverage Ratio					
Debt/Equity Ratio (x)		0.0	0.5	0.3	0.2

CASH FLOW STATEMENT		(Rs Million)			
Y/E MARCH	2009	2010E	2011E	2012E	
CF from Operations	11,110	9,378	11,586	12,455	
Change in Working Capital	2,218	8,701	-1,865	-2,475	
Net Operating CF	13,328	18,079	9,721	9,980	
Net Purchase of FA	-1,621	-1,759	-2,100	-2,100	
Net Purchase of Invest.	-3,714	-28,803	0	0	
Net Cash from Invest.	-5,335	-30,562	-2,100	-2,100	
Inc./(Dec) in Equity & other related iter	-2,338	5	5	5	
Proceeds from LTB/STB	-300	12,245	-2,486	-2,709	
Dividend Payments	-950	-758	-947	-1,015	
Cash Flow from Fin.	-3,588	11,492	-3,428	-3,719	
Free Cash Flow	11,707	16,320	7,621	7,880	
Net Cash Flow	4,406	-992	4,194	4,160	
Opening Cash Balance	976	5,382	4,390	8,584	
Add: Net Cash	4,406	-992	4,194	4,160	
Closing Cash Balance	5,382	4,390	8,584	12,744	

N O T E S



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: reports@motiloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement

Tech Mahindra

- | | |
|---|----|
| 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 |

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.