

Equities

6 April 2011 | 9 pages

Tech Mahindra (TEML.BO)

Sell: Core Business Sluggish; Are Valuations Really Cheap?

- Company Update
- Target Price Change
- Estimate Change

- **Core business sluggish** — Tech Mahindra (TechM) continues to face challenges on the business side; management maintains that BT (~44% of revenues in 3QFY11) is likely to be stable (no growth) over the near term. The past few quarter results from Indian IT majors suggest that Telecom remains a challenging vertical for most.
- **Are margins sustainable?** — TechM's reported margins are inflated due to the accounting treatment of the refund from BT. Assuming Rs2b per year of refunds, it is ~18% of FY12E EBITDA. This was announced with quarterly results in Jan'10 and started retrospectively from 1QFY10 (TechM had received ~Rs9.7b as restructuring fees from BT as the large contracts were restructured).
- **Are valuations cheap?** — Excluding Satyam's implied EV (based on current market price and no holding company discount), TechM trades at ~7.5x FY12E EV/EBITDA, ~20% discount to HCLT, which is fully justified in our view, given domain/client risk and sluggish business outlook. More importantly, excluding the refund, TechM trades in line with HCLT on FY12E EV/EBITDA – meaningful relative overvaluation, in our view.
- **What does Satyam currently trade at?** — Assuming 15% yoy growth in FY12 and 11% EBITDA margins (~7.3% in 9MFY11), Satyam trades at ~16x FY12E EPS, which is in line with much larger players like HCLT. Satyam has benefited from recent newsflow (settling of Class action suits etc.) but we find it difficult to see much upside given the current valuations.
- **TechM stock has outperformed; Maintain Sell** — TechM has outperformed the BSEIT index (and the Indian market) by ~10% YTD partly due to chatter on ownership change and some positives on Satyam. We have tweaked our estimates – our FY12/13 operating profits largely remain unchanged; profits go up due to lower tax rate assumptions. Our new target price is Rs700 based on 7x Jun'12E EBITDA of TechM (previously 7x Dec'11E) and the current market price of Satyam. We remain Sellers.

Sell/Medium Risk	3M
Price (06 Apr 11)	Rs737.00
Target price	Rs700.00
	<i>from Rs710.00</i>
Expected share price return	-5.0%
Expected dividend yield	0.8%
Expected total return	-4.2%
Market Cap	Rs92,829M US\$2,094M

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



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	10,146	78.14	210.2	9.4	4.6	63.4	0.5
2010A	7,032	53.90	-31.0	13.7	3.1	29.1	0.5
2011E	7,918	60.78	12.8	12.1	2.5	24.3	0.5
2012E	7,547	57.94	-4.7	12.7	2.1	19.1	0.8
2013E	8,445	64.83	11.9	11.4	1.8	18.1	0.8

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	9.4	13.7	12.1	12.7	11.4
EV/EBITDA adjusted (x)	7.9	8.3	9.1	7.5	6.4
P/BV (x)	4.6	3.1	2.5	2.1	1.8
Dividend yield (%)	0.5	0.5	0.5	0.8	0.8
Per Share Data (Rs)					
EPS adjusted	78.14	53.90	60.78	57.94	64.83
EPS reported	78.14	53.90	60.78	57.94	64.83
BVPS	159.84	236.05	291.88	344.29	405.01
DPS	4.00	3.50	4.00	6.00	6.00
Profit & Loss (RsM)					
Net sales	44,647	46,254	51,325	52,788	58,560
Operating expenses	-33,592	-36,267	-42,676	-43,146	-48,215
EBIT	11,055	9,987	8,649	9,642	10,345
Net interest expense	-403	-1,430	264	-206	276
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	10,652	8,557	8,913	9,436	10,622
Tax	-1,179	-1,440	-1,394	-1,889	-2,177
Extraord./Min.Int./Pref.div.	673	-85	399	0	0
Reported net income	10,146	7,032	7,918	7,547	8,445
Adjusted earnings	10,146	7,032	7,918	7,547	8,445
Adjusted EBITDA	11,055	9,987	8,649	9,642	10,345
Growth Rates (%)					
Sales	18.5	3.6	11.0	2.9	10.9
EBIT adjusted	48.2	-9.7	-13.4	11.5	7.3
EBITDA adjusted	48.2	-9.7	-13.4	11.5	7.3
EPS adjusted	210.2	-31.0	12.8	-4.7	11.9
Cash Flow (RsM)					
Operating cash flow	12,606	804	-23,769	7,261	7,019
Depreciation/amortization	0	0	0	0	0
Net working capital	2,218	-5,394	-30,459	28	-998
Investing cash flow	-1,999	-3,315	-265	-1,483	-2,261
Capital expenditure	-1,621	-4,069	-1,492	-1,797	-2,689
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-3,585	23,777	-5,784	-5,889	-4,369
Borrowings	-300	13,672	-5,192	-5,000	-3,480
Dividends paid	-592	-520	-592	-889	-889
Change in cash	7,022	21,266	-29,818	-110	389
Balance Sheet (RsM)					
Total assets	28,432	59,018	62,752	64,703	69,934
Cash & cash equivalent	9,728	32,332	3,926	5,347	7,376
Accounts receivable	9,022	10,420	12,234	12,293	13,637
Net fixed assets	6,520	9,251	9,332	9,598	10,647
Total liabilities	8,888	22,337	18,745	14,038	11,712
Accounts payable	0	0	0	0	0
Total Debt	0	13,672	8,480	3,480	0
Shareholders' funds	19,544	36,681	44,007	50,665	58,222
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	24.8	21.6	16.9	18.3	17.7
ROE adjusted	63.4	29.1	24.3	19.1	18.1
ROIC adjusted	93.2	61.4	39.4	41.1	40.8
Net debt to equity	-49.8	-50.9	10.3	-3.7	-12.7
Total debt to capital	0.0	27.2	16.2	6.4	0.0

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Change in estimates

The sharp increase in estimates for FY11 is attributable to Satyam's profits being consolidated below the line (profits from associates). For FY12-13E, operational estimates are largely unchanged; however, profits have increased slightly due to the assumption of lower tax rates (in line with management commentary). Please note, that we do not explicitly forecast Satyam's numbers in our financials, i.e. our FY12-13E do not have Satyam's numbers built in.

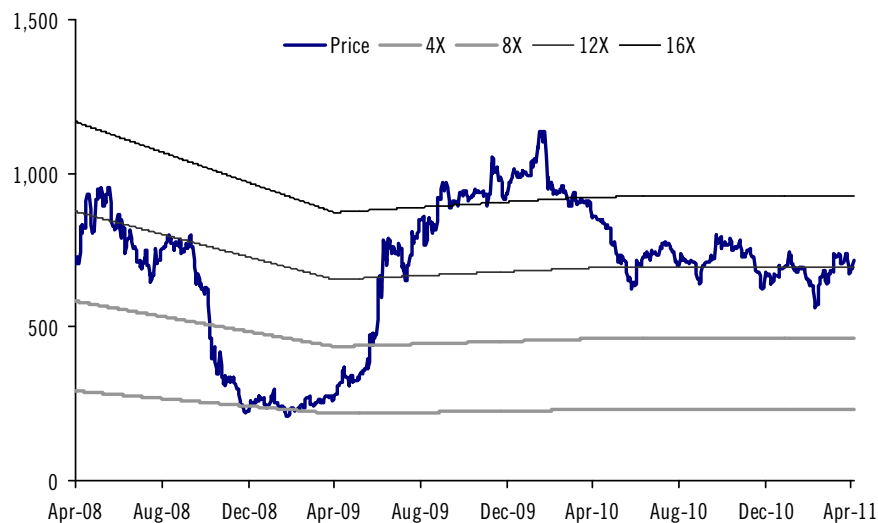
Figure 1. Estimates revisions

FYE	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
31 Mar				
2011E	7,918	60.78	22.5	4.00
Prev	6,499	49.62		4.00
2012E	7,547	57.94	2.3	6.00
Prev	7,416	56.62		6.00
2013E	8,445	64.83	3.5	6.00
Prev	8,207	62.65		6.00

Source: Citi Investment Research and Analysis estimates

PE band chart

Figure 2. TechM – One year rolling forward PE band chart



Source: Citi Investment Research and Analysis

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 ~6% respectively over FY10-13E. Satyam acquisition will help in diversifying vertical exposure and add size; however, Satyam's reported margins are much below expectations and turnaround will be a challenge, in our view. 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 7x Jun'12E EV/EBITDA, which is at a ~20% discount to more diversified players like HCLT. For Satyam, we use TechM's share of Satyam's Enterprise value based on the current market price of Satyam. Our target price of Rs700 is based on 7x Jun'12E EV/EBITDA and considering TechM's share of Satyam's current EV. We believe that this valuation measure is most appropriate given only limited disclosures for Satyam.

Risks

Although our quantitative risk-rating system suggests Low 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 BT deals; 4) hiring rebounding in the next few quarters; 5) large deal announcements; and 6) inorganic activity due to a stake sale or change in ownership.

Appendix A-1

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Tech Mahindra (TEML.BO) Ratings and Target Price History Fundamental Research

Analyst: Surendra Goyal, CFA



Chart current as of 26 March 2011

	Date	Rating	Target Price	Closing Price
1	26-Jun-08	3H	*815.00	730.10
2	23-Jul-08	3H	*820.00	753.35
3	23-Oct-08	*2H	*500.00	376.10
4	20-Nov-08	2H	*310.00	243.50

* Indicates change

	Date	Rating	Target Price	Closing Price
5	23-Jan-09	2H	*245.00	210.15
6	20-Feb-09	*3H	245.00	269.65
7	28-Apr-09	3H	*300.00	318.20
8	10-Jun-09	3H	*640.00	784.85

	Date	Rating	Target Price	Closing Price
9	26-Aug-09	*3M	*825.00	921.10
10	7-Jan-10	3M	*910.00	1,018.10
11	23-Mar-10	3M	*900.00	910.20
12	24-Aug-10	3M	*710.00	705.80

Rating/target price changes above reflect Eastern Standard Time

Tech Mahindra (TEML.BO) Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Surendra Goyal, CFA

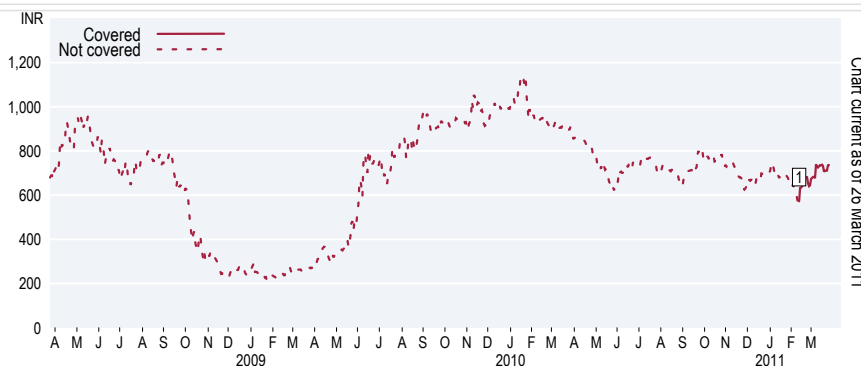


Chart current as of 26 March 2011

	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	571.95

* Indicates change

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<i>% of companies in each rating category that are investment banking clients</i>	43%	41%	41%	51%	41%	45%

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