ABN·AMRO

Wednesday 27 September 2006

Initiation of coverage

Tech Mahindra

Riding the tailwinds

TML is India's eighth-largest IT services company with strong domain expertise and execution experience in the telecom space owing to its erstwhile parent BT. We expect TML to be a key beneficiary of the rising IT spend by global telecom players.

Key forecasts

	FY05A	FY06A	FY07F	FY08F	FY09F
Revenue (Rsm)	9456.4	12426.7	24630.7	32774.2	43503.1
EBITDA (Rsm)	1350.3	2678.7	5194.4	6332.0	7588.6
Reported net profit (Rsm)	1023.9	2353.8	4243.1	5175.5	6268.7
Normalised net profit (Rsm)[1]	1023.9	2353.8	4243.1	5175.5	6268.7
Normalised EPS (Rs)	8.97	18.3	32.6	39.5	47.9
Dividend per share (Rs)	2.20	10.0	3.00	4.00	5.00
Dividend yield (%)	0.37	1.68	0.51	0.67	0.84
Normalised PE (x)	66.2	32.4	18.2	15.0	12.4
EV/EBITDA (x)	48.7	24.6	12.0	9.36	7.37
Price/book value (x)	13.9	12.4	7.72	5.30	3.83
ROIC (%)	29.3	83.1	105.8	116.5	101.8

1. Post-goodwill amortisation and pre-exceptional items
Source: Company data, ABN AMRO forecasts
Accounting Standard: Indian GAAP

year to Mar, fully diluted

Strong macro environment favours TML
IT spend by the global telecom industry is on an upswing as service providers introduce networks and billing/enterprise systems for converged services. IDC forecasts a global IT services spending CAGR of 6.7% for telecom vs 5.4% for the overall IT services market. The growth of offshoring is likely to become more rapid as time to market for the delivery of services (for service providers) and keeping support costs low for existing products (for equipment manufacturers) become critical. Tech Mahindra (TML) should be a key beneficiary, given its strong domain and execution expertise in this vertical.

Growth prospects in key accounts provide high near-term visibility
We see strong near-term growth in TML's top three accounts. BT is spending £8bn over FY05-09 on a major technology migration programme, according to Gartner, and TML is a key service partner. The US$350m five-year contract with AT&T continues to ramp up, and business from Alcatel is stable despite concerns related to its impending merger with Lucent. We estimate these clients contributed 72% to 1Q07 revenue and forecast a 35% CAGR over FY06-09. TML's attempts to diversify revenue streams continue, the latest being the JV with Motorola.

However, concentrated business mix could put pressure on margins
Management's focus is currently on demand fulfilment and hence margins may remain under pressure. We estimate the offshore effort share at 78%, versus 68-72% for a typical Indian IT company, and see limited upside potential. However, SG&A could provide leverage in the medium term as the AT&T contract ramp-ups and as the company moves to owned premises (currently over 40% of delivery capacity is at leased premises). Furthermore, the employee pyramid is bulging in the middle, so a greater intake of fresh hires could provide additional leverage.

Buy recommended, however, post-listing gains restrict potential upside
We forecast a front-ended 51.8% CAGR in revenues and 34.1% CAGR in EPS over FY06-09, building on a 284bp decline in EBIT margin. Our DCF-based target price of Rs700 values TML at 15.5x FY08F EPS. The stock has enjoyed a stable post-listing premium and we expect this to continue given near-term growth visibility. However, high client concentration is a key risk, as it could lead to financial volatility.

Priced at close of business 26 September 2006. Use of ▲▼ indicates that the line item has changed by at least 5%.

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Buy

Absolute performance
n/a
Short term
Underweight
Market relative to region

Software & Services
India

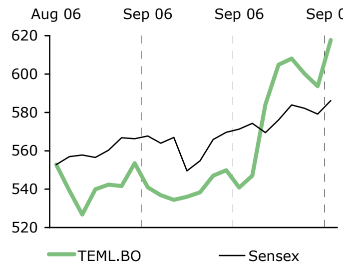
Price
Rs617.80
Target price
Rs700.00
Market capitalisation
Rs68.21bn (US$1.49bn)
Avg (12mth) daily turnover
Rs626.24m (US$13.53m)

Reuters	Bloomberg
TEML.BO	TECHM IN

Asset allocation

Equities	Underweight
Cash	Overweight
Bonds	Overweight

Price performance	(1M)	(3M)	(12M)
Price (Rs)	n/a	n/a	n/a
Absolute %	n/a	n/a	n/a
Rel market %	n/a	n/a	n/a
Rel sector %	n/a	n/a	n/a



Stock borrowing: Impossible
Volatility (30-day): 36.08%
Volatility (6-month trend): →
52-week range: 626.80-520.60
Sensex: 12321.19
BBG AP Software: 284.15

Source: ABN AMRO, Bloomberg

Researched by
ABN AMRO Institutional Equities Team
www.abnamrobroking.co.in

The Basics

Key assumptions

We assume total headcount additions of 4,885 in FY07 (including the 1,873 added in 1QFY07), 5,7180 in FY08 and 6,540 in FY09. We forecast average utilisation (including trainees) will be 73% for FY06, but will fall to 72.4% in FY08 and FY09 as the share of fresh hires rises. We expect the BT account to reach a stable growth phase and its share in total billed effort to decline steadily to 59% in FY07, 49.5% in FY08 and 41.6% in FY09. On a consolidated basis, we forecast the onsite share of total billed effort will rise to 22% in FY07, 22.9% in FY08 and 23.6% in FY09. We assume average billing rates will remain largely flat.

Our exchange-rate assumptions are Rs46.68:US$1 for FY07, Rs44.87:US$1 for FY08 and Rs44.50:US$1 for FY09, in line with the latest view of our regional strategists.

Versus consensus

No consensus data available

How we differ from consensus

No consensus data is available given the company's short listing history (just over a month).

Key events

Date	Event
3rd week Oct '06	2Q06 results

Source: Company

Valuation and target price

Our target price is based on a three-stage DCF model, where we forecast a 36% CAGR in FCF over FY06-09. In stage II (12 years), we assume 24% growth in invested capital with average capital turnover of 5.8x and operating margin of 12%. For stage III (12 years), we assume capital investment growth will decline from 15.6% to 0% and ROIC from 33.2% to 15.5% (equaling WACC). We discount the FCF in three stages, assuming a WACC of 15.5% to derive the NPV and then add the terminal book value. This produces a DCF value of Rs700 per share, which is also our target price.

Forced ranking*

Company	Rec	Upside/ Downside
TCS	Buy	17%
Satyam	Buy	14%
Tech Mahindra	Buy	13%
Wipro	Buy	10%
Infosys	Buy	3%

** by difference to target price as at time of publication. Recommendations may lie outside the structure outlined in the disclosure page*
Source: ABN AMRO forecasts

Catalysts for share price performance

We believe consistent performance in the next few quarters will be key to driving the share price towards our target over the next six to 12 months. Any announcements of inorganic moves – acquisitions or joint ventures – that could add a revenue stream should be catalysts.

Risks to central scenario

High dependence on a few clients exposes TML to the business risks of its clients and could lead to volatility in quarterly financial performance. In addition, higher-than-assumed rupee appreciation, a slowdown in the US economy and a major breach of data security by an Indian company resulting in strong regulatory action against outsourcing are also risks to our estimates and target price for TML.

Key assumptions and forecasts

Table 1 : Key assumptions and forecasts

(Rs m)	FY05A	FY06A	1Q07A	2Q07F	3Q07F	4Q07F	FY07F	FY08F	FY09F
Exchange rate (Rs/US$)	44.94	44.36	45.28	46.42	45.68	45.08	46.68	44.87	44.50
Operating metrics									
Total employees	5,617	10,493	12,366	13,696	14,544	15,378	15,378	21,096	27,636
Delivery employees	5,232	9,875	11,721	12,921	13,721	14,521	14,521	19,921	26,121
Billed person-months	13,488	61,548	23,810	26,798	29,173	30,925	110,706	154,142	204,520
Change (YoY/QoQ) (%)	*15.9%*	*47.8%*	*15.5%*	*12.6%*	*8.9%*	*6.0%*	*79.9%*	*39.2%*	*32.7%*
Non-BT effort share (%)	17.7%	29.3%	35.0%	40.0%	43.0%	45.0%	41.1%	50.5%	58.4%
Total - offshore effort share (%)	64.7%	78.9%	78.0%	78.4%	78.0%	77.7%	78.0%	77.1%	76.4%
Average realization (US$/hr)	26.0	25.9	27.97	27.25	26.84	26.48	27.08	26.92	27.16
Change (YoY/QoQ) (%)	*-0.7%*	*-9.9%*	*7.4%*	*-2.6%*	*-1.5%*	*-1.4%*	*4.7%*	*-0.6%*	*0.9%*
Key financials									
Revenue	9,456	12,427	5,871	5,966	6,296	6,497	24,631	32,774	43,503
Growth (%)	*27.5%*	*31.4%*	*39.4%*	*1.6%*	*5.5%*	*3.2%*	*98.2%*	*33.1%*	*32.7%*
Gross margin (%)	36.8%	40.5%	36.6%	39.8%	38.5%	37.4%	38.1%	35.8%	33.4%
EBITDA margin (%)	14.3%	21.6%	21.8%	21.8%	21.0%	19.9%	21.1%	19.3%	17.4%
Change	-	*728bp*	*21bp*	*4bp*	*-78bp*	*-113bp*	*-47bp*	*-177bp*	*-188bp*
PAT	1,024	2,354	1,066	1,055	1,075	1,048	4,243	5,175	6,269
Growth (%)	*60.8%*	*129.9%*	*19.6%*	*-1.0%*	*1.9%*	*-2.5%*	*80.3%*	*22.0%*	*21.1%*
EPS - Basic (Rs)	10.09	22.75	9.54	9.18	9.36	9.12	37.19	45.05	54.56
EPS - Fully Diluted (Rs)	9.49	18.81	8.35	8.06	8.21	8.00	32.62	39.54	47.90
Shares outstanding - basic (m)	101.5	103.5	111.7	114.9	114.9	114.9	114.1	114.9	114.9
Shares outstanding - fully diluted (m)	107.9	125.1	127.7	130.9	130.9	130.9	130.1	130.9	130.9

Sources: Company data, ABN AMRO forecasts

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Riding the tailwinds

Tech Mahindra has strong domain expertise and execution experience in the telecom space, owing to its erstwhile parent BT. We expect the company to be a key beneficiary of the rising IT spend by global telecom players.

Leading telecom-focused Indian player

Tech Mahindra (TML) is India's eighth-largest IT services company in terms of revenue, with a focus on the telecom vertical. The company was started in 1986 as a 60:40 JV between Mahindra & Mahindra and BT Plc, previously Mahindra British Telecom. Post the recent public offering, Mahindra & Mahindra's holding has fallen to 45% and BT's stake is down to 34%, while 8.6% is held by MBT Mauritius (a special purpose vehicle, or SPV, that will transfer the stake to AT&T over five years).

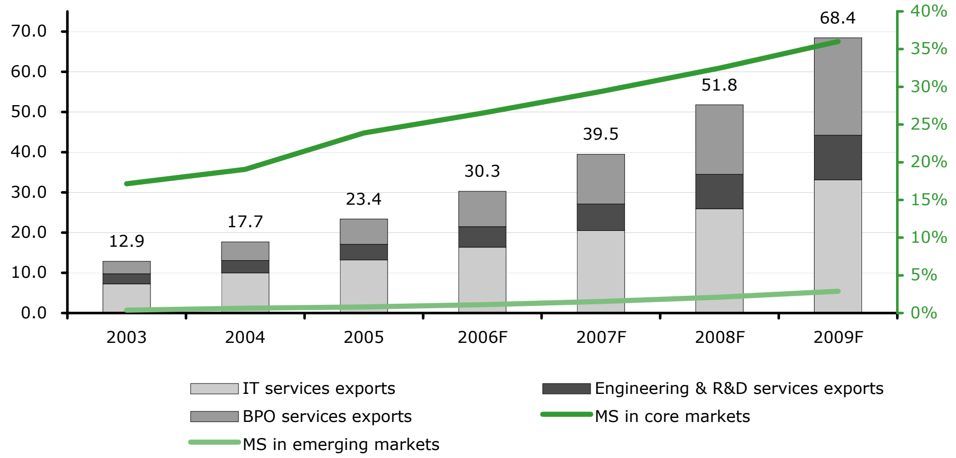
TML's main client is BT, which accounted for around 58% of 1Q07 revenues. The company has been diversifying its client base and currently has 64 non-BT clients. The main focus is the telecom vertical. TML diversified into the telecom equipment manufacturers (TEMs) market from its earlier focus on telecom services providers (TSPs) following the acquisition of Axes Technologies in 2005. TML has 12,366 employees (including sub-contracted manpower) across nine development centres in India and one each in the UK and Singapore.

Demand for offshoring remains strong

We estimate a 30% CAGR for Indian IT services over FY06-09

Offshoring seems to be gaining a permanent and growing place in the IT budgets of global majors. IDC estimates the worldwide offshore IT services spend at US$12bn for 2005 and projects a 14% CAGR to US$20bn through 2009, vs 5.4% for overall IT services. We estimate Indian IT services will grow by more than 30% in the next three years, compared with 32% growth achieved in 2001-05, as players expand into areas that have seen little offshoring traditionally (such as consulting, IT infrastructure management, testing and IT outsourcing).

Chart 1 : Indian IT and BPO exports forecasts – 2003-09F (US$bn)



Source: IDC, Nasscom, ABN AMRO forecasts

Evolving industry dynamics make telecom a key IT spending vertical

The telecom, financial and manufacturing sectors are the key users of external IT services. IDC estimates IT services spending by the telecom vertical (communication and media) was around US$35.6bn in 2005, accounting for 8.1% of worldwide IT services spend. The market comprises two sub verticals: 1) Telecom Service Providers, or TSPs, which include providers of wired/wireless telephony, eg AT&T, Verizon, BT and Deutsche Telecom; and, 2) Telecom Equipment Manufacturers, or TEMs, such as Nokia, Cisco, Nortel, Alcatel and Ericsson.

Global telecom industry capex is on an upswing, driven by the convergence of services such as voice telephony, data communication, media and entertainment. For instance, total capex by North American TSPs increased 12.3% yoy to US$48.3bn in 2005, according to Ovum Research. The trend continued in 2006, with 1QCY06 capital spending by North American wireline operators up 22% yoy and by mobile operators up 15% yoy. The increased capex is aimed at enabling the IT infrastructure to distribute and charge for a diverse bouquet of services across evolving technology platforms.

TSPs are looking to offer 'quadruple-play' services (ie, video, voice, data and wireless) on a single delivery platform, thus driving investments in the enabling infrastructure, such as routing systems from wireless to fixed line or IP-based network. From a business perspective, this is driving consolidation among the telecom, media and entertainment players. It is also forcing players to take a holistic view of aggregated services. From an IT perspective, this means improvements in front-office applications (such as consolidated billing platforms) as well as investments into robust business-analytics tools to identify customer behavioural patterns and develop innovative pricing.

IDC estimates global telecom IT services spend will see a 6.7% CAGR over 2005-09, ahead of a 5.4% CAGR for the overall IT services market. Gartner research also indicates a slight increase in IT budget spending for 2006 and a decline in hardware spending with a slight increase in software and services spending. We believe the offshored IT services market will grow faster (than the overall market) as time to market for the delivery of services (for TSPs) and keeping support costs low for existing product lines (for TEMs) become critical.

Table 2 : Worldwide communication services providers - IT services spend

(US$ m)	2005	2006F	2007F	2008F	2009F	CAGR - 2005-09F
By sub-segment						
Wireline	39,465	40,212	41,475	42,770	44,190	2.9%
Wireless	17,090	17,655	18,488	19,374	20,276	4.4%
Cable and Broadcasting	10,234	10,590	11,131	11,764	12,341	4.8%
Satellite	1,372	1,425	1,497	1,573	1,649	4.7%
Total	**68,161**	**69,883**	**72,591**	**75,481**	**78,456**	**3.6%**
By budget component						
Consulting	5,156	5,313	5,511	5,726	5,948	3.6%
Development and Integration	21,119	21,652	22,462	23,292	24,108	3.4%
H/w maintenance & Support	11,379	11,296	11,437	11,620	11,828	1.0%
IT Management	15,755	16,137	16,748	17,367	17,976	3.4%
Process Management	9,468	10,127	10,911	11,770	12,670	7.6%
Software Support	5,284	5,357	5,522	5,706	5,926	2.9%
Total	**68,161**	**69,883**	**72,591**	**75,481**	**78,456**	**3.6%**

Source: Gartner Dataquest (October 2005)

TML likely to be a key beneficiary of a strong macro environment

TML ranks among the top four offshore IT services vendors in the telecom vertical in terms of revenue. It is the largest offshore vendor within the telecom service provider segment, though a significant portion of its revenue comes from a single client, BT. We believe TML will be a key beneficiary of the current growth in telecom IT spend, given its strong domain expertise and execution experience in this vertical. It is one of the leading players in the system integration space for business support systems/ operation support systems (BSS/OSS) for TSPs worldwide. Gartner ranks TML among the top 10 system integrators and the only offshore player in this space.

Table 3 : Telecom revenue for major Indian IT services companies

								CAGR/CQGR	
US$ m	**FY05**	**1Q06**	**2Q06**	**3Q06**	**4Q06**	**FY06**	**1Q07**	**FY06/05**	**1Q07/2Q06**
TCS	306.5	87.1	92.8	101.9	103.5	385.4	129.1	25.7%	11.6%
Wipro	269.3	78.0	89.1	101.6	110.8	379.5	112.6	40.9%	8.1%
Infosys	294.8	81.9	87.5	88.3	96.7	354.4	116.8	20.2%	10.1%
Tech Mahindra	210.4	55.3	56.6	73.7	94.5	280.1	117.2	33.1%	27.5%
Satyam	135.7	46.0	48.8	49.9	51.9	196.6	57.8	44.9%	5.8%
Patni	21.9	16.2	17.6	21.6	24.5	79.9	28.6	264.6%	17.5%

Notes: 1. Satyam's revenues are inclusive of revenues from infrastructure, media, entertainment and semiconductor sectors
2. Tech Mahindra's revenues for 1Q07 are exclusive of one-time pass-through revenue of US$12.5m towards software purchase
Source: Company data

High visibility for healthy near-term growth

BT relationship provides high visibility for healthy near-term growth

Long-term master service agreements (MSAs) signed with key clients BT, AT&T and Alcatel give TML high revenue visibility for the near and medium term.

TML is a key service partner to its erstwhile parent BT across various business processes. BT has been undertaking several strategic initiatives – 21st Century Network (21CN), OpenReach and NetCentricity – to evolve its technological infrastructure for growing services requirements (from customers). For instance, 21CN is a major initiative by BT to move from public-switched telephone and other traditional networks, which use technologies such as asynchronous transfer mode (ATM) and plesiochronous digital hierarchy (PDH), to a converged system based on internet protocol/multiprotocol label switching (IP/MPLS) in the core and broadband access networks. This involves a total capex of £8bn over the next five years, according to Gartner. The objective is two-fold. First, it will enable BT to deliver cost-effective IP multimedia services over broadband connections to residential and enterprise customers. Second, BT expects 21CN to generate cost savings of around £1bn by 2009, according to Gartner. We expect Tech Mahindra to benefit from the IT investments flowing from these strategic initiatives of BT. Also, as other TSPs will likely follow BT's lead in overhauling its backbone to IP, implementation partnership with BT should provide TML with a strong entry point into this market, in our view.

TML has also signed a long-term master services agreement with Alcatel USA and AT&T, giving it high revenue visibility from these clients. AT&T entered into a strategic tie-up with Tech Mahindra in July 2005, committing outsourcing works worth US$350m over five years in return for options to buy shares up to 9.93m. TML generated revenues of US$22m in FY06 and US$11m in 1Q07 from this relationship. We believe the ramp-up in this account remains strong and TML is already among the largest offshore players at AT&T (Infosys, TCS and Patni are other key offshore vendors to AT&T). Post the recently concluded merger with Cingular, the combined entity is to see accelerated technology evolution as Cingular's wireless networks and AT&T's wireline networks are both being moved to IP-based technologies. We believe TML will benefit from this transition.

Alcatel has made significant investments in TML's facilities and has a contractual commitment to give 50% of product engineering work from its North American operations to TML. The contract with Alcatel, originally with Axes Technologies up to March 2007, has been extended until October 2008 post Axes' acquisition by TML.

Thus, we expect these relationships to be the key drivers for near to medium-term top-line growth for TML. We estimate the business from these three clients will show a 35% CAGR over FY06-09.

Table 4 : Key accounts – ramp-up forecasts (FY05-09)

	FY05 A	FY06 A	1Q07 A	FY07 F	FY08 F	FY0 9F	CAGR FY07F/06	CAGR FY09F/06
Revenues (US$ m)								
BT	169.5	191.2	77.3	312.1	354.0	395.9	63.2%	27%
Share (%)	*81%*	*68%*	*60%*	*59%*	*48%*	*41%*	*-9.1%*	*-28%*
Non BT - Total	40.9	89.0	52.4	215.6	376.5	581.7	142.3%	87%
- AT&T	0	22.0	11.0	60.0	80.0	110.0	172.7%	71%
Share (%)	*0%*	*8%*	*8%*	*11%*	*11%*	*11%*	*3.5%*	*3%*
- Alcatel	0	5.9	4.7	21.7	26.1	31.3	268.4%	74%
- Others	40.9	61.1	36.7	69.4	116.6	213.2	13.7%	52%
TOTAL	**210.4**	**280.1**	**129.7**	**527.6**	**730.4**	**977.6**	**88.4%**	**52%**
Share (%)								
BT + AT&T + Alcatel	81%	78%	72%	75%	63%	55%	-	-
BT + AT&T	81%	76%	68%	71%	59%	52%	-	-

Source: Company data, ABN AMRO forecasts

Inorganic activism to drive client diversification

TML continues to build new service lines (such as BPO services) organically for better mining of its existing clients, but the focus remains on inorganic revenue diversification. It acquired Axes Technologies in 2005 in order to move into product engineering services to TEMs, where growth has recovered after the 2001-03 slump. According to Datamonitor, the TEM market will show a CAGR of 3.06% from 2004-09 to reach US$347.7bn in 2009. The leading TEMs typically spend 10-15% of their revenues on research and development, as shown in the table below. TML acquired key clients such as Alcatel and Motorola through this acquisition.

Table 5 : Leading TEM: FY05 revenue and R&D expenses

Company	Revenues in FY05 (US$bn)	R&D expenses in FY05 (US$bn)	R&D expenses in FY05 (% of net sales)
Siemens*	91.90	6.28	6.80%
Motorola	36.84	3.68	10.00%
Nokia*	32.00	4.55	14.20%
Alcatel + Lucent	25.00	2.90	11.60%
Cisco Systems	24.80	3.32	13.40%
Ericsson*	19.89	3.20	16.10%

**Revenue and R&D expenses shown above are based on an exchange rate of 1 euro = US$1.2181*
Source: Company data, corporate presentation on Alcatel and Lucent merger

Similarly, CanvasM, the recently formed 80:20 joint venture with Motorola, is focused on developing applications for the provision of content-based services by TSPs. However, the joint venture is still in a formative stage and we expect it to contribute to revenues only by FY08.

Client concentration and high barriers to winning new clients are the key risks

High barriers to winning new clients - in both the TSP and TEM space - could limit diversification

The vertical is characterised by high entry barriers, especially in the TEM segment. Therefore, high dependence on a few clients exposes TML to the business risks of its clients and could lead to quarterly volatility in financial performance.

Furthermore, IT spend by the telecom vertical could be highly cyclical, as the sector is exposed to movements in both technology and economic cycles. For instance, the hype around 3G technologies and the high licence fees paid to get 3G licences across geographies had led to financial duress for most carriers and a slowdown in capex during 2001-03, thus translating into lower IT spending.

However, we do not see a repeat of 2001-03, when Indian IT services exports to the telecom vertical were flat, even if the current uptick in capex by global telecom players reverses. The current spend focuses more on non-discretionary areas (supporting and maintaining existing product lines) relative to the product development-led capex of 2001-03. For TML, a significant share of revenues from BT and AT&T comes from maintenance of existing applications, which are typically among the last to be affected by any slowdown in IT spend. However, work flowing from long-term strategic initiatives could be affected.

TSPs in non-US geographies are growing faster than those in the US. Also, emerging geographies have less competition, providing an entry point to TML. We foresee gains in European and Apac (including India) markets in the medium term, but quarterly variation in business flow from key clients remains a key risk.

Table 6 : Geography-wise projected software and IT services spend by TSPs

(US$ bn)	2005	2006	2007	2008	2009	CAGR
North America	9.02	9.44	9.94	10.35	10.52	3.9%
Latin America	2.32	2.57	2.83	3.04	3.08	7.3%
Western Europe	9.71	10.25	10.76	11.15	11.29	3.8%
Eastern Europe	1.18	1.36	1.53	1.68	1.70	9.6%
China-India	2.40	2.84	3.31	3.73	3.82	12.3%
Asia-Pacific	4.53	4.95	5.34	5.67	5.80	6.4%
Middle East and Africa	1.40	1.66	1.91	2.12	2.15	11.3%
Total	**30.56**	**33.08**	**35.61**	**37.73**	**38.36**	**5.8%**

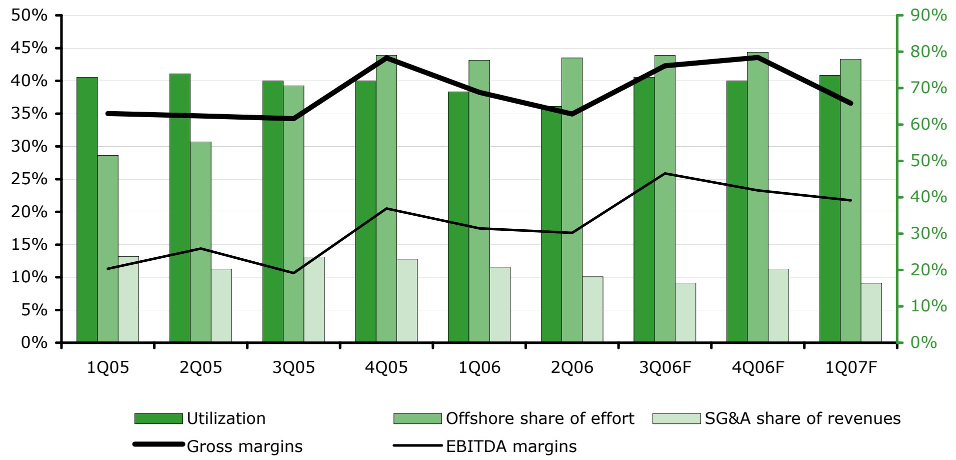
Source: Ovum Research

Continued business concentration could put pressure on margins

High dependence on select clients limits TML's pricing flexibility

Over the last nine quarters, TML's EBITDA margins have doubled on the back of an increased share of offshore business (from 52% in 1Q05 to 78% in 1Q07, as per our estimates) and decline in the share of SG&A expenses (from 23.7% to 16.4% of revenue).

Chart 2 : Key margin drivers – last nine quarters



Sources: Company data, ABN AMRO estimates

Going forward, we believe margins could come under pressure, given that management focus is currently on demand fulfilment due to the strong ramp-up in key accounts, especially AT&T. We estimate TML already has a high offshore business share of 78% vs 68-72% for a typical Indian IT company. As new accounts ramp up, there could actually be an increase in the onsite share. We also expect utilisation to come under pressure as the company increases the share of fresh engineers. Management indicates that it has doubled its on-campus offers, to 3,100 so far for trainees joining in FY08 from FY07. While this should help lower the average manpower costs, overall the effect should be margin dilutive in the near term until the resources become billable.

However, any near-term margin decline can be cushioned by SG&A leverage, as the recently won AT&T and BT contracts are still in ramp-up mode, which should help reduce the SG&A share of revenue by 100-200bp. TML also stands to gain from the planned shift to owned facilities across three Special Economic Zones (SEZs) over the next two years, as this would reduce lease rental costs (currently over 40% of manpower is located in leased spaces).

Our valuation model is built on front-ended growth

Given the company's high dependence on BT and our estimates of different levels of growth and operational metrics in the BT and non-BT businesses, we have made various assumptions in terms of key operational parameters, such as billed effort, onsite-offshore effort mix and changes in onsite and offshore realisation.

We assume total headcount additions of 4,885 in FY07 (including the 1,873 added in 1Q07), 5,718 in FY08 and 6,540 in FY09. We forecast average utilisation (including trainees) will be 73% for FY06 but will fall to 72.4% in FY08 and FY09 as the share of fresh hires rises. However, the visibility on manpower requirements and transition of recently-acquired businesses from BT and AT&T should restrict the downside. We also expect onsite utilisation to improve by 300bp over FY06-09 from the current 85%, among the lowest in the industry, as AT&T and BT businesses mature.

We expect the share of BT business in TLM's total billed effort to decline to 59% in FY07, 49.5% in FY08 and 41.6% in FY09. We expect average realisation to remain stable for like-to-like services and the offshore share to remain at around 16% of the total billed effort. For the non-BT business, we expect the offshore share to remain range-bound, while average realisation could improve in FY08 as the share of lower-rates business from Apac declines. Our growth assumption for the non-BT business is built on expectations that the AT&T business will steadily scale up to a US$100m annual run rate by FY09 (based on a revenue commitment of US$350m over a five-year period as part of the MSA signed in February 2005).

We expect margins to come under pressure from increasing costs. We forecast effective wage hikes of 3% in FY08 and 7% in FY09, in line with our view on salary hikes at mid-tier IT companies. However, operating leverage implies that, at the EBITDA level, margins will decline 47bp in FY07, 177bp in FY08 and 188bp in FY09.

We expect TLM's capex plans to pick up from FY08 when such investments would be critical for enjoying tax benefits under the SEZ scheme.

For the Rs/US$ exchange rate, we assume the rate forecast by our regional economist for the next six quarters (2Q07–3Q08). For the subsequent five quarters, we assume a flat Rs/US$ rate at the 3Q08 level of Rs44.50.

Table 7 : Key operational assumptions

	FY05A	FY06A	1Q07A	2Q07F	3Q07F	4Q07F	FY07F	FY08F	FY09F
Exchange rate (Rs/US$)	44.94	44.36	45.28	46.42	45.68	45.08	46.68	44.87	44.50
Net addition - delivery staff	1,082	4,643	1,846	1,200	800	800	4,646	5,400	6,200
Utilisation (inc. trainees)	72.8%	69.8%	73.5%	72.5%	73.0%	73.0%	73.0%	72.4%	72.4%
Offshore effort share (%)									
Total	64.7%	78.9%	78.0%	78.4%	78.0%	77.7%	78.0%	77.1%	76.4%
- BT	67.1%	84.2%	83.1%	84.0%	84.0%	84.0%	83.8%	84.0%	84.0%
- Non BT	53.6%	66.0%	68.5%	70.0%	70.0%	70.0%	69.7%	70.3%	71.0%
Sequential change in average realization ((YoY/QoQ) - BT business									
Onsite (%)	-	-4.7%	6.5%	-4.0%	-4.0%	-4.0%	-4.0%	1.0%	0.0%
Offshore (%)	-	0.5%	5.0%	-2.0%	-2.0%	-2.0%	-2.0%	0.0%	0.0%
Sequential change in average realization ((YoY/QoQ) - Non-BT business									
Onsite (%)	-	-9.8%	1.0%	0.0%	0.0%	0.0%	0.0%	1.0%	0.0%
Offshore (%)	-	25.1%	11.5%	0.0%	0.0%	0.0%	0.0%	1.0%	0.0%

Sources: Company data, ABN AMRO forecasts

Recommend Buy; DCF-based target price of Rs700

We forecast 51.8% CAGR in revenues and 38.6% CAGR in profit after tax over FY06-09. However, this builds in 98% growth in revenues and 80% growth in PAT in FY07. Our estimates for FY08 and FY09 are therefore more modest. Our DCF model, based on the above assumptions, indicates a fair value and target price of Rs700, which implies 15.5x FY08F EPS and represents 13% upside potential from current levels.

Valuations could be sustained at higher end of peer range due to near-term visibility

TML's stock was listed at 15x FY07F basic EPS and is trading at 13.6x FY08F basic EPS or 15.8x 12-month forward EPS, at today's closing price. This is at the higher end of the typical valuation range for mid-tier IT companies. However, we expect these levels to be sustained, given TML's high growth visibility, which should translate into strong quarterly performance in the near term.

Table 8 : Select IT services companies – Comparative valuations

	EPS (Rs)		EPS CAGR		CMP (Rs)	P/E	
	FY07F	FY08F	FY07F/06	FY08F/07	26/09/06	FY07F	FY08F
Infosys	65.8	82.8	46%	26%	1,842	28.0x	22.2x
TCS	40.9	52.3	38%	28%	1,049	25.6x	20.1x
Wipro	19.8	24.9	37%	26%	526	26.5x	21.1x
Average	-	-	-	-	-	**26.7x**	**21.1x**
Satyam	41.7	48.2	37%	16%	837	20.1x	17.4x
HCL Technologies	30.3	37.2	27%	23%	559	18.4x	15.0x
Patni	25.8	33.3	30%	29%	389	14.8x	11.4x
Average	-	-	-	-	-	**17.8x**	**14.6x**
KPIT	30.2	30.2	38%	37%	363	12.0x	12.0x
Mphasis BFL	9.0	12.6	-4%	39%	184	20.4x	14.6x
Sasken	14.1	27.1	29%	92%	378	26.9x	14.0x
Infotech Enterprises	14.8	17.7	33%	20%	207	14.0x	11.7x
Hexaware	11.3	14.2	24%	25%	155	13.7x	10.9x
Average	-	-	-	-	-	**17.7x**	**12.7x**
Tech Mahindra	**37.2**	**45.1**	**64%**	**21%**	**614**	**16.5x**	**13.6x**

Note: Year-end for Patni and Hexaware is Dec.
Sources: Company data, ABN AMRO estimates, IBES estimates (for Mphasis BFL, Sasken, Infotech Enterprises and Hexaware)

Strong franchise in telecom vertical

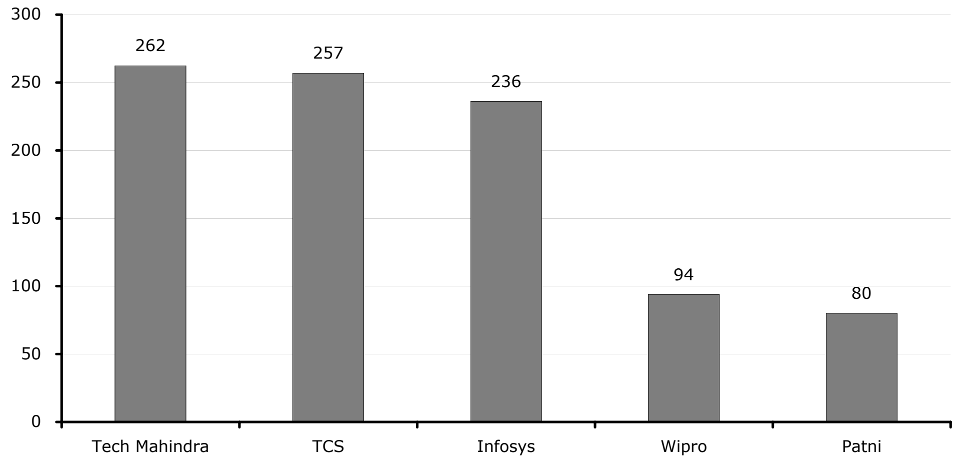
TML is India's eighth-largest IT services company, with strong domain expertise and execution experience in the telecom space due to its erstwhile parent, BT.

Leadership position in the telecom vertical

TML ranks among the top four Indian offshore vendors in the telecom vertical, with a quarterly revenue run rate of US$89m vs US$90m-110m for the top three Indian IT players, namely TCS, Infosys, and Wipro. Importantly, TML has been growing faster than its peers, with a revenue CQGR of over 27% in the past four quarters vs around 7% for the top four players. We believe it is the biggest player in the TSP segment, given its strong relationships with BT and AT&T.

Tech Mahindra is the only offshore player rated among the top 10 system integrators in the BSS/OSS space by Gartner

Chart 3 : Select Indian players - revenues from TSPs (FY06, US$m)



Source: Company data, ABN AMRO estimates (forecasts for Patni which has Dec year-end)

TML has strong domain expertise and execution experience in the TSP market, thanks to its legacy of serving BT as a semi-captive operation. It is now diversifying into the TEM market following the Axes Technologies' acquisition in 2005. Axes provides R&D, product engineering and life-cycle support services to major players in the TEM space, such as Alcatel and Motorola.

End-to-end services portfolio

TML's service portfolio covers a wide spectrum of IT services within its focus area of telecom. Among traditional IT services, the company's service portfolio includes system integration, consulting and managed services, besides the core application development and maintenance services. TML is one of the leading players in system integration in the BSS/OSS space for TSPs. The company has been rated among the top 10 system integrators – and the only offshore player – in the telecom vertical by Gartner.

R&D and product engineering services

TML provides outsourced R&D and product engineering services to independent telecom software vendors (ISVs) and TEMs. We believe its leadership position in system integration (SI) has given it a head-start in product development services. The company leverages its relationships to offer outsourced product engineering to its ISV partners (in system-integration services). Additionally, TML has worked on building some of its partner products (from Product Engineering relationship), which ensured a better understanding of these products and helped it in the SI area.

TML has added product engineering/R&D services for its TEM customers following the Axes acquisition. We see this as a fast-growing service offering for offshore vendors and TML has a good headstart here. For example, Alcatel is one of its major clients in this space (acquired through Axes acquisition). Alcatel has made significant investments in setting up state-of-art development labs at TML's facilities and has given contractual commitment to outsource at least 50% of its product engineering work from its North American operations to TML.

BPO offering – still in infancy

TML offers BPO services as part of its overall solutions offering. However, this still constitutes only a small share of revenue. Its offerings in this space include network management, support functions, billing, customer interactions and analytics. Currently, TML is running a few processes for BT in the UK and a TSP in India from its facilities in Mumbai and Pune. We expect this service to pick up following changes in senior management at the division.

Client diversification strategy is on track

BT business grew 13% in FY06, while non-BT business increased 117%

Tech Mahindra continued to work primarily for BT until 2000. Since then it has been proactively diversifying its client base: TML currently has 64 non-BT active clients, which together accounted for 42% of revenue in 1Q07. As a comparison, the non-BT client base was 29 in FY04 and accounted for only 21% of revenue.

Mining on non-BT clients has improved. Revenue per non-BT active client grew 56% to US$1.5m pa in FY06. (However, this is still lower than the revenue run-rate of US$2m-3.5m pa for the top four Indian players). TML's BT business grew 12.8% in FY06, while non-BT business increased 116%. Excluding Axes, growth was 94%.

Table 9 : Key client metrics

	FY05	FY06	1Q07	Δ FY06/05	Δ 1Q07/4Q06
Total active clients	45	62	65	17	3
Client distribution					
US$1m+	10	14	17	4	3
Share	*22%*	*23%*	*26%*	-	-
US$5m+	2	6	7	4	1
Share	*4%*	*10%*	*11%*	-	-
US$10m+	1	2	5	1	3
Share	*2%*	*3%*	*8%*	-	-
US$25m+	1	1	2	0	1
Share	*2%*	*2%*	*3%*	-	-
Revenue distribution (US$ m)					
BT	169.5	191.2	77.3	13%	21%
Share	*81%*	*68%*	*58%*	-	-
Non-BT	41.1	88.6	54.5	116%	80%
Share	*19%*	*32%*	*42%*	-	-
Top5 clients	183.5	239.3	111.5	30%	36%
Share	*87%*	*85%*	*86%*	-	-
Top10 clients	193.0	252.3	118.0	31%	36%
Share	*92%*	*90%*	*91%*	-	-
Revenue run-rate (US$ m) - annualised					
Cons. (including BT)	4.7	4.5	8.0	-3%	31%
Non BT clients	0.9	1.5	3.4	56%	72%
Top5 clients	36.7	47.9	89.2	30%	36%

Source: Company data, ABN AMRO estimates

Table 10 : Key client metrics (1Q07) – comparison with key peers

	Tech Mahindra	Infosys	Wipro	Satyam	Patni
Total active clients	65	469	565	489	220
Addition over TTM	*16*	*26*	*135*	*79*	*29*
Client distribution					
US$1m+	26%	47%	41%	29%	29%
Change over TTM	*-38bp*	*830bp*	*8bp*	*-364bp*	*291bp*
US$5m+	11%	20%	6%	10%	-
Change over TTM	*669bp*	*356bp*	*-61bp*	*116bp*	-
US$10m+	8%	12%	5%	7%	-
Change over TTM	*565bp*	*223bp*	*-75bp*	*163bp*	-
Revenue profile (US$ m)					
Top client	77	38	18	22	21
Share	*58%*	*6%*	*4%*	*7%*	*15%*
Top 5 clients	112	129	78	69	54
Share	*86%*	*20%*	*16%*	*23%*	*38%*
Revenue run-rate (US$ m) - annualised					
Top5 clients	89.2	103.0	62.4	54.9	43.6
Change over TTM	*137%*	*42%*	*37%*	*6%*	*4%*
Non-Top5 clients	1.2	4.6	3.3	1.9	1.6
Change over TTM	*60%*	*30%*	*3%*	*13%*	*35%*

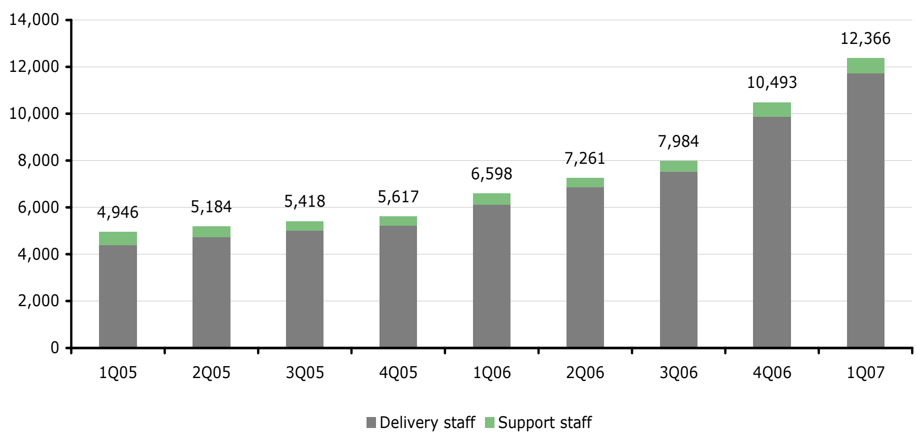
Note: Figures for Patni (Dec year-end) are for corresponding quarterly periods, eg 1Q07 for rest corresponds to 2Q06 for Patni
Source: Company data, ABN AMRO estimates

Recruitment momentum remains strong

Organic manpower addition of 72% in FY06 was higher than for the top four Indian players

TML has 12,366 employees across its nine development centres in India, and one centre each in Singapore and the UK. It added 4,876 employees in FY06 – about 87% of its year-beginning manpower base – including 72% added organically. This is among the highest in the industry in percentage terms; the top four Indian IT services players added 35-45% to their manpower in FY06. Importantly, the momentum has been sustained; the company added 1,873 employees in 1Q07 and expects to add more than 4,000 over the next three quarters.

Chart 4 : Headcount growth - last nine quarters

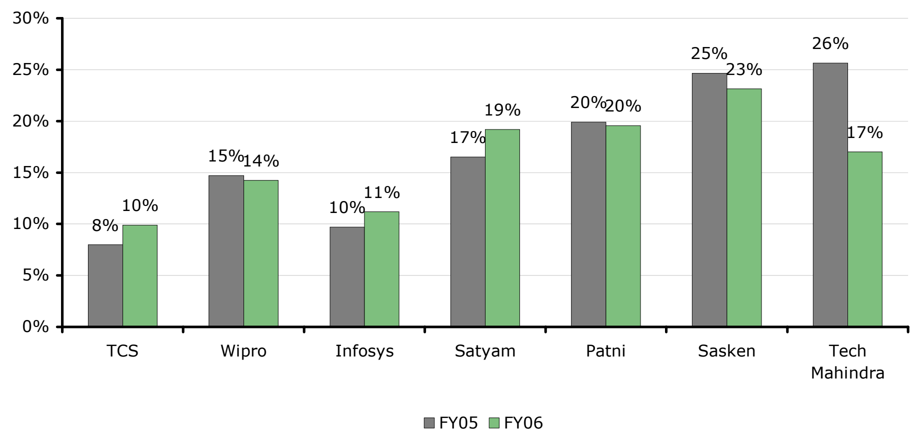


Source: Company data

The manpower profile, in terms of both educational background and years of experience, compares favourably with the larger players.

The attrition rate has declined significantly over the last few quarters and is now comparable to the industry average.

Chart 5 : Manpower attrition – comparison with select Indian IT companies



Note: Figures for Patni (Dec year-end) are for corresponding quarterly periods, eg 1Q07 for rest corresponds to 2Q06 for Patni
Source: Company data

TML's delivery infrastructure currently has total seat capacity for around 15,000 employees, including over 7,000 under leased premises. It is setting up facilities at SEZs across three cities, with a total capacity of 14,000 seats, in phases.

Delivery model – the IDU and CSU structure

TML's delivery model consists of 12 independent delivery units (IDU) supported by competency and solutions units (CSU).

Each IDU has its own resource pool and delivery responsibilities for its client relationships. A single IDU typically consists of 700-1,000 employees serving a particular client or geography. There are eight IDUs serving BT and one each for AT&T, Europe, America and Asia. Resources are fungible across IDUs and are proactively rotated to facilitate knowledge sharing.

CSUs contribute significantly to develop R&D capabilities in certain technological areas like OSS (operation support system), BSS (business support system), network design and engineering. There is a CSU for each technological area with the responsibility to develop technical skills, marketing support and delivery support.

Pick-up in financials with increased offshoring

TML has reported strong top line and net profit growth over FY04-06, with 29% revenue CAGR, 83% EBITDA CAGR and 92% net profit CAGR. The EBITDA margin expanded to 21.6% in FY06, from 10.8% in FY04, driven by increased offshoring and SG&A leverage.

Strong top-line growth even as offshore has been on an upswing

TML's revenue increased at a healthy CAGR of 29% to Rs12.43bn over FY04-06, or 31% in US$ terms to US$280.1m, in line with the growth rate for the industry and the peer group, but lagging the top four players who grew at an average of 37.4% over this period. Growth came despite the strong shift to offshore: offshore revenue share increased from 32% in FY04 to 66% in FY06. In the last four quarters, TML generated a revenue CQGR of 21.7% (20.6% in US$ terms). The growth was primarily volume led; we estimate billed efforts grew at a CQGR of 18% during this period.

The momentum has continued in 1Q07, with revenues up 23.9% qoq to US$117.2m (excluding US$12.5m of software purchase pass-through revenue). BT business grew 21.2% qoq to US$77m while non-BT business grew 29.5% to US$39.5m (including one-time charge).

Table 11 : Revenue growth for major Indian IT services companies

(Rs bn)	FY04 A	FY05 A	FY06 A	1Q07 A	Growth FY06/04	FY06/05	QoQ - 1Q07
TCS	71.2	97.3	132.6	41.4	36.4%	36.3%	11.3%
Infosys	48.5	71.3	95.2	30.2	40.1%	33.5%	14.9%
Wipro	43.5	60.7	80.7	24.5	36.3%	33.0%	7.1%
Satyam	25.6	35.2	47.9	14.4	36.8%	36.1%	9.8%
Top4 players	**189**	**264**	**356**	**111**	**37.4%**	**34.8%**	**11.1%**
Patni	14.1	19.8	25.1	6.6	33.3%	26.6%	13.6%
HCL Technologies	25.7	33.7	44.0	12.5	30.9%	30.6%	11.7%
Tech Mahindra	**7.4**	**9.5**	**12.4**	**5.9**	**29.4%**	**31.4%**	**39.4%**
Mphasis BFL	5.8	7.7	9.4	2.6	27.3%	22.8%	4.1%
KPIT Cummins	1.3	2.5	3.2	1.0	58.3%	26.0%	13.4%
Total Indian IT services exports	**607.4**	**815.3**	**1,057.5**	**n.a.**	**31.9%**	**29.7%**	**n.a.**

Note: Figures for Patni (Dec year-end) are for corresponding quarterly periods, eg 1Q07 for rest corresponds to 2Q06 for Patni
Source: Company data, Nasscom (for Indian IT services exports data)

Increased offshore and operating leverage have driven margins

Tech Mahindra's margin expanded despite wage inflation

TML's gross margin expanded 363bp to 40.5% in FY06 (following a 15bp increase in FY05), while EBITDA margins increased 728bp to 21.6% during the year (after 352bp growth in FY05). Importantly, margin expansion has come despite average wage hikes of 3% onsite and 20% offshore in FY06. Main margin drivers have been: 1) an increase in the offshore effort share to 79% in FY06, from 65% in FY05; and 2) operating leverage, as the share of SG&A expenses declined from 22.6% of revenue in FY05 to 18.9% in FY06.

However, in 1Q07, EBITDA margins declined by 151bp qoq due to a) higher onsite delivery – we estimate onsite billed effort share increased to 22% from 20% in 4Q06; and, b) annual salary hikes effected during the quarter – 16% offshore and 3% onsite. These neutralised the gains on utilisation – up 150bps qoq - and SG&A share – down 3.9% qoq.

Table 12 : How the margin drivers have moved

	FY05	1Q06	2Q06	3Q06	4Q06	FY06	1Q07
Exchange rate (Rs/$)	44.94	43.74	43.64	45.13	44.55	44.36	45.28
Cons. revenues (Rs m)	**9,456**	**2,419**	**2,469**	**3,326**	**4,212**	**12,427**	**5,871**
BT revenue (US$ m)	169.5	39.6	37.6	50.2	63.8	191.2	77.3
Non - BT revenue (US$ m)	41.1	15.5	19.2	23.6	30.3	88.6	54.5
Utilization (inc trainees)	72.8%	69.0%	65.0%	73.0%	72.0%	69.8%	73.5%
Blended billing rates ($/hr)	28.7	26.0	25.0	26.2	26.0	25.9	28.0
Billed effort share							
- Onsite	35.3%	22.3%	21.7%	21.0%	20.1%	21.1%	22.0%
- Offshore	64.7%	77.7%	78.3%	79.0%	79.9%	78.9%	78.0%
Cost of revenues	5,972	1,494	1,606	1,919	2,377	7,396	3,203
- Wage costs	4,946	1,239	1,402	1,689	1,972	6,302	2,501
As % of revenues	*52.3%*	*51.2%*	*56.8%*	*50.8%*	*46.8%*	*50.7%*	*42.6%*
Gross profit	**3,484**	**925**	**862**	**1,407**	**1,836**	**5,030**	**2,147**
Gross margin	***36.8%***	***38.2%***	***34.9%***	***42.3%***	***43.6%***	***40.5%***	***36.6%***
SG&A expenses	2,134	502	448	547	855	2,351	870
As % of revenues	*22.6%*	*20.8%*	*18.1%*	*16.4%*	*20.3%*	*18.9%*	*14.8%*
Operating profit (EBITDA)	**1,350**	**423**	**415**	**860**	**980**	**2,679**	**1,278**
Operating margin	***14.3%***	***17.5%***	***16.8%***	***25.9%***	***23.3%***	***21.6%***	***21.8%***

Source: Company data, ABN AMRO

We believe margin decline in the near term can be cushioned by the SG&A leverage, as the AT&T and BT contracts are still in ramp-up mode, which could help reduce the

SG&A share of revenue by 100-200bp. TML should also gain from the shift to owned facilities planned across three SEZs over the next two years, as this would reduce lease rental costs (currently 43% of manpower sits in leased spaces).

Table 13 : SG&A (as % of revenue) – comparison with key IT companies

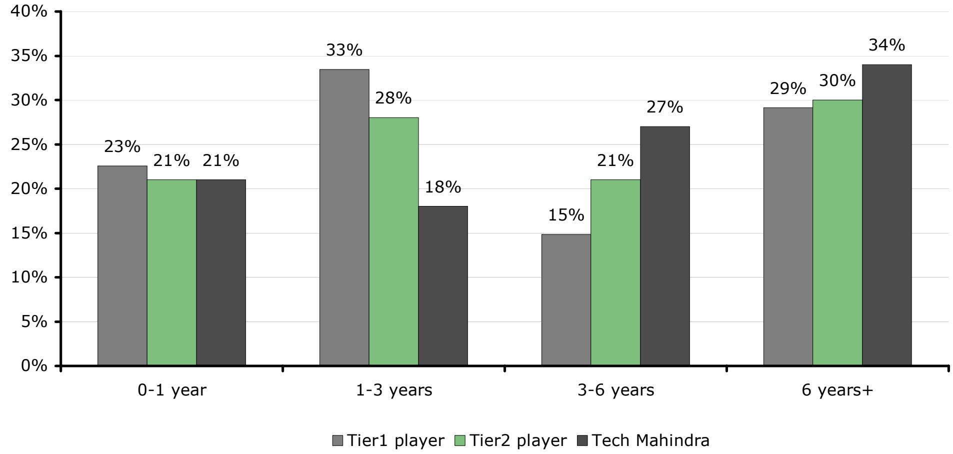
SGA as % of revenue	1Q05 A	2Q05 A	3Q05 A	4Q05 A	1Q06 A	2Q06 A	3Q06 A	4Q06 A	1Q07A
TCS	16.9%	16.4%	18.1%	20.3%	19.7%	18.1%	19.1%	19.9%	19.9%
Infosys	14.7%	15.0%	14.2%	14.1%	14.6%	15.2%	13.6%	14.1%	15.3%
Wipro Technologies	9.7%	9.9%	9.3%	10.1%	10.5%	10.0%	9.4%	9.4%	9.5%
Satyam	18.7%	17.8%	17.3%	17.4%	16.9%	17.4%	16.8%	17.4%	17.7%
Patni	17.7%	17.7%	17.9%	19.5%	19.0%	18.6%	18.5%	20.0%	19.7%
Tech Mahindra	**23.7%**	**20.3%**	**23.6%**	**23.0%**	**20.8%**	**18.1%**	**16.4%**	**20.3%**	**16.4%**
KPIT Cummins	21.4%	20.4%	19.9%	21.6%	21.5%	21.0%	20.9%	20.0%	22.4%

Note: Figures for Patni (Dec year-end) are for corresponding quarterly periods, eg 1Q07 for rest corresponds to 2Q06 for Patni
Source: Company data

Better management of employee pyramid could be an important lever for margins going forward

Furthermore, the employee pyramid is still top heavy – only 42% of its employee base has less than three years of experience, compared with 49% for Patni and 56% for Infosys. We believe the addition of inexperienced staff could provide additional leverage to TML, but could also limit the potential to improve utilisation.

Chart 6 : Manpower profile – comparison with typical tier-one and tier-two players



Source: Company data

We believe the offshore-onsite mix for TML is close to optimal, and so see limited leverage on this front. We expect the levers outlined above to play out in the near term, thus margin movement in the medium to long term should depend on factors such as: 1) improvement in average realisation; 2) dilution in client concentration; 3) effective wage hikes; and 4) the trend in employee attrition.

Table 14 : Offshore revenue share – comparison with key IT companies

Offshore share of revenues	1Q05 A	2Q05 A	3Q05 A	4Q05 A	1Q06 A	2Q06 A	3Q06 A	4Q06 A	1Q07 A
TCS	36.9%	37.5%	40.0%	39.9%	37.1%	37.3%	38.6%	37.3%	38.1%
Infosys	48.1%	50.2%	51.0%	51.9%	52.1%	51.2%	51.4%	50.7%	49.5%
Wipro Technologies	43.0%	44.1%	44.1%	44.8%	45.2%	45.3%	46.9%	47.4%	45.2%
Satyam	42.1%	41.8%	42.4%	43.5%	43.2%	44.2%	45.0%	46.0%	47.2%
Tech Mahindra	**37.0%**	**35.0%**	**59.0%**	**61.0%**	**62.0%**	**64.0%**	**69.0%**	**68.0%**	**66.0%**
KPIT Cummins	31.3%	30.2%	31.1%	34.9%	34.6%	34.8%	42.0%	43.4%	46.8%

Source: Company data

Debt-free balance sheet

TML hada fixed asset/turnover ratio of 6x as of March 2006, in line with its peer group at 5-8x. The company is debt-free and has net cash equivalent of about Rs2.8bn (US$62.6m). The company paid out Rs1.1bn (US$26m) in FY06 as dividend and related taxes, which was around 50% of its net profit for the year. However, DSOs (days of sales outstanding) at 85 days in 1Q07 are at the higher end of the 60-85 days range for peers.

Table 15 : TML – abridged balance sheet

	FY04	FY05	FY06
Cash and equivalent	840	2,398	2,265
Sundry debtors	2,671	2,212	4,377
Loans and advances	306	243	441
Total current assets	**3,816**	**4,853**	**7,083**
Current liabilities and liabilities	1,378	1,906	3,938
Net current assets	**2,438**	**2,947**	**3,145**
Deferred tax assets	85	134	112
Goodwill	0	0	867
Net PPE	1,544	1,781	2,031
Total assets	**4,067**	**4,861**	**6,155**
Share capital	203	203	208
Reserves and surplus	3,865	4,658	5,946
Share holders' funds	**4,067**	**4,861**	**6,154**
Minority interest	0	0	0
Total liabilities and equity	**4,067**	**4,861**	**6,154**

Source: Company data

Natural hedge against dollar movements

Relatively lower share of revenue from the US limits its exposure to depreciation in the US dollar

TML has a natural hedge against any depreciation in the US dollar as its revenue exposure to the US is just 18%, while Europe's share is 67%. The company has a policy of hedging 30-70% of its forex receivables based on the currency view. It hedges its pound sterling receivables through cross-currency hedges of pound sterling vs the US dollar and US dollar vs the Indian rupee. As of June 2006, TML had an outstanding forward cover worth £77m (GBP-INR) and US$16m (USD-INR).

Concentrated business model

TML's concentrated business model, with two clients contributing over 75% of revenue, makes it prone to business risks of its clients. High entry barriers into new clients are a major risk, as TML tries to diversify its business model.

High client dependence

TML's revenues continue to be highly dependent on BT, AT&T and Alcatel. BT is the company's largest customer, accounting for about 60% of revenue. We believe TML will remain dependent on these three clients, making it prone to their business risks. High client dependence generally leads to erratic quarterly fluctuations in revenue, as it is closely linked with the IT spend of a few clients.

High cost of new client acquisition; barriers to entry are high

High barriers to new client acquisition is one of our major concerns

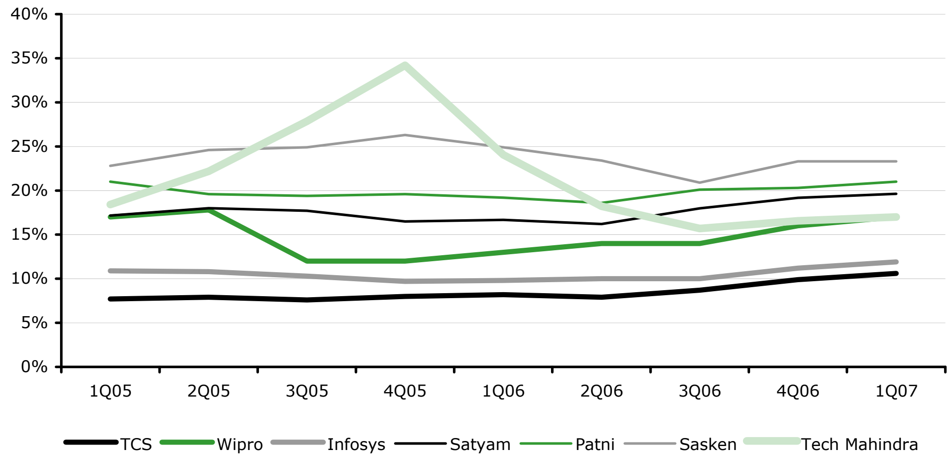
The telecom vertical is a heavy user of IT services, but the lock-in for clients is high, especially as they make significant investments in vendor partners before outsourcing critical work. TML was focused on a single client until a few years back and only started acquiring new clients in the past three years. It is relatively difficult to break into new clients and get significant ramp-ups in the telecom vertical, in our view. TML has been using non-conventional means of inorganic growth, including divesting part of its stake to its clients to get a foothold into a new client base. The issuance of 9.93m options to AT&T in return for a revenue commitment and the acquisition of Axes Technologies are some of the methods TML has used to win new clients.

High attrition, wage inflation

TML has significantly higher attrition than the top four/six Indian IT companies, at 17-34% against single-digit attrition for tier-one players over the last eight quarters.

Higher attrition can lead to higher wage inflation for TML vs its peers, as seen in the case of Patni (strong demand and a lower salary base resulting in higher-than-average attrition rate).

Chart 7 : Attrition – comparison with select Indian IT companies



Source: Company data

Integration issues with Axes Technologies

The Axes acquisition has been a good strategic fit for TML, in our view, giving it an entry into a large and growing sub-segment of the telecom vertical. However, Axes' cost structure is probably higher than TML's (we estimate a negative impact of 2.1% on 4Q06 EBITDA margin). The difference in salary levels could impact the medium-term profitablity of the consolidated entity before the costs structures are alligned. Also, cultural issues would need to be taken care of before the acquisition is fully digested and synergies are unlocked.

The integration issue is moderate, as Axes operates in a segment where TML has limited presence, though within its focused vertical of telecom. This should make integration relatively less difficult. Also, the payout for the acquisition is staggered over the next few years and is linked to the performance of Axes, which further mitigates integration risks.

Appendix

1. Evolution of the BT relationship

The relationship with BT dates back to the inception of Tech Mahindra – or the erstwhile Mahindra British Telecom, which was started as a 60:40 joint venture between the Mahindra group of India and BT Plc. This relationship can be viewed in four phases:

BT continues to be the largest client for Tech Mahindra, accounting for over two-third of its revenue

Phase I – 1986-96
Started as a captive offshore centre for BT. Until 1995, the company worked on a time and materials basis for BT, onsite and offshore. Tech Mahindra's work was more in the form of staff augmentation to handle small projects, both onsite and offshore.

Phase II – 1996-2002
Tech Mahindra began taking ownership of applications around 1996. It started delivering application development and solution design. Some of BT's applications were completely owned by Tech Mahindra from offshore.

Phase III – 2002-04
The company moved up the value chain, providing complete product lifecycle management for BT's applications. Tech Mahindra took programme responsibility for BT's E2E programme.

Phase IV - 2004 onwards
In 2004, the company started taking ownership of integrated telecom networks and offered business process management as part of the complete ownership of business process. Close to 90% of ADM-related work has been offshored to India. Tech Mahindra now bids for projects competitively against other third-party IT service providers.

Current stage of relationship

TML gets about 60% of its revenue from BT, and eight of TML's 12 business units work exclusively for BT. We estimate about 6,000 employees, 45% of its billable manpower, work for BT, including over 1,000 on BT's Next-Generation initiatives such as 21CN (21 century network), Openreach and NetCentricity.

Besides TML, BT has relationships with other Indian offshore vendors such as TCS, Wipro (for application outsourcing services) and HCL Technologies (for BPO services).

2. AT&T relationship

AT&T and Tech Mahindra have a strategic relationship (since February 2005) wherein AT&T has the option to buy 9.93m shares of Tech Mahindra, based on revenue milestones over five years. AT&T was already among the top five clients of Tech Mahindra in FY06. The nature of engagements is spread across service lines – application development, application maintenance, support of IT systems and IT operations services. Tech Mahindra is one of the preferred vendors for AT&T and most of the projects are long term (duration of about three years). The current MSA, signed at the beginning of the relationship, is for five years.

Among non-BT accounts, AT&T is one of the largest clients for Tech Mahindra

3. Axes Technologies acquisition

Tech Mahindra acquired a 99.9% stake in Axes Technologies, a Texas-based IT services company focused on TEMs, for a total consideration of US$52.25m. Axes Technologies has revenues of US$30m (management estimate for FY06) and 850 employees.

Axes fills a strategic gap in Tech Mahindra's vertical portfolio

Axes Technologies - profile

Founded in 1990, Axes Technologies is focused on the TEM space with about 850 employees based mainly in Bangalore and Chennai in India. It is a profitable company with FY06 (March 2006) revenues at US$30m. The company provides R&D services, product engineering services and lifecycle support services to companies in the TEM space. Its key clients include Alcatel and Motorola.

Strategic fit

The acquisition has helped TML diversify its revenue base to the TEM segment within its focus vertical of telecom. The company's ability to bid for large customers in this segment was limited, given it had no foothold here. The players in the TEM space are one of the biggest consumers of IT services, and the acquisition should help TML expand its client base beyond TSPs. Moreover, scale and expertise in the TSP space should help TML differentiate itself while serving TEM companies, as it should better understand the needs of TSPs (also clients of TEM companies).

On the other hand, Axes had a marquee client list in the TEM space, including Alcatel, Motorola and Coppercom. A few of these relationships have already reached critical size – top three clients account for close to 75% of revenues. Overall, the acquisition should help Tech Mahindra build a new TEM practice and diversify its revenue stream within its focus vertical. Moreover, it should enhance TML's scale of operations in Bangalore and provide a new development centre in Chennai.

Acquisition cost and valuation

Axes had surplus cash and investments of US$6.75m at the time of the acquisition, indicating an enterprise value of US$45.5m, or 1.5x FY06 revenue. Of the acquisition cost of US$52.25m, Tech Mahindra paid US$38.25m up front, while US$14m is to be paid as earn-outs based on meeting performance targets.

DISCLOSURES APPENDIX

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TECH MAHINDRA: KEY FINANCIAL DATA

Income statement

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Revenue	9456.4	12426.7	24630.7	32774.2	43503.1
Cost of sales	-5972.2	-7396.5	-15254	-21034	-28954
Operating costs	-2133.9	-2351.5	-4182.2	-5407.7	-6960.5
EBITDA	**1350.3**	**2678.7**	**5194.4**	**6332.0**	**7588.6**
DDA & Impairment (ex gw)	-321.1	-397.5	-520.0	-732.6	-836.6
EBITA	**1029.1**	**2281.2**	**4674.4**	**5599.4**	**6752.0**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**1029.1**	**2281.2**	**4674.4**	**5599.4**	**6752.0**
Net interest	0.00	0.00	0.00	0.00	0.00
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	21.6	149.9	4.38	0.00	0.00
Exceptionals (pre-tax)	n/a	n/a	n/a	n/a	n/a
Other pre-tax items	63.9	190.2	142.0	349.4	537.2
Reported PTP	**1114.6**	**2621.4**	**4820.8**	**5948.8**	**7289.1**
Taxation	-90.7	-267.6	-577.7	-773.3	-1020.5
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	**1023.9**	**2353.8**	**4243.1**	**5175.5**	**6268.7**
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	**1023.9**	**2353.8**	**4243.1**	**5175.5**	**6268.7**

Source: Company data, ABN AMRO forecasts *year to Mar*

Balance sheet

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Cash & market secs (1)	2397.7	2264.5	5822.9	8953.1	12287.9
Other current assets	2455.0	4818.0	7733.4	9392.3	11871.0
Tangible fixed assets	1780.7	2031.3	2736.7	3855.8	5577.3
Intang assets (incl gw)	0.00	866.8	866.8	866.8	866.8
Oth non-curr assets	133.7	111.7	111.7	111.7	111.7
Total assets	**6767.1**	**10092.4**	**17271.5**	**23179.7**	**30714.7**
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	1905.7	3937.7	7266.0	8521.3	10440.7
Long term debt (3)	0.00	0.00	0.00	0.00	0.00
Oth non-current liab	0.00	0.00	0.00	0.00	0.00
Total liabilities	**1905.7**	**3937.7**	**7266.0**	**8521.3**	**10440.7**
Total equity (incl min)	4861.4	6154.6	10005.5	14658.4	20273.9
Total liab & sh equity	**6767.1**	**10092.4**	**17271.5**	**23179.7**	**30714.7**
Net debt (2+3-1)	-2397.7	-2264.5	-5822.9	-8953.1	-12288

Source: Company data, ABN AMRO forecasts *year ended Mar*

Cash flow statement

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
EBITDA	1350.3	2678.7	5194.4	6332.0	7588.6
Change in working capital	1049.3	-331.0	413.0	-403.7	-559.3
Net interest (pd) / rec	59.1	132.6	135.9	349.4	537.2
Taxes paid	-139.1	-245.5	-577.7	-773.3	-1020.5
Other oper cash items	n/a	n/a	n/a	n/a	n/a
Cash flow from ops (1)	**2319.5**	**2234.7**	**5165.6**	**5504.4**	**6546.0**
Capex (2)	-557.8	-648.1	-1225.4	-1851.7	-2558.1
Disposals/(acquisitions)	0.00	-866.5	-0.36	0.00	0.00
Other investing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from invest (3)	**-557.8**	**-1514.6**	**-1225.8**	**-1851.7**	**-2558.1**
Incr / (decr) in equity	24.6	124.2	0.00	0.00	0.00
Incr / (decr) in debt	0.00	0.00	0.00	0.00	0.00
Ordinary dividend paid	-254.5	-1185.1	-391.9	-522.5	-653.1
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from fin (5)	**-229.9**	**-1060.9**	**-391.9**	**-522.5**	**-653.1**
Forex & disc ops (6)	21.6	149.9	4.38	0.00	0.00
Inc/(decr) cash (1+3+5+6)	**1553.4**	**-190.9**	**3552.3**	**3130.2**	**3334.7**
Equity FCF (1+2+4)	1761.7	1586.6	3940.2	3652.7	3987.9

Lines in bold can be derived from the immediately preceding lines. *year to Mar*
Source: Company data, ABN AMRO forecasts

TECH MAHINDRA: PERFORMANCE AND VALUATION

Standard ratios

Performance	Tech Mahindra FY05A	FY06A	FY07F	FY08F	FY09F	HCL Technologies FY07F	FY08F	FY09F	Patni Computer Systems FY06F	FY07F	FY08F
Sales growth (%)	27.5	31.4	98.2	33.1	32.7	28.0	26.0	25.7	26.6	29.2	29.3
EBITDA growth (%)	69.1	98.4	93.9	21.9	19.8	24.7	24.5	24.3	1.96	31.1	30.0
EBIT growth (%)	80.0	121.7	104.9	19.8	20.6	24.1	24.7	24.9	-3.67	31.2	32.7
Normalised EPS growth (%)	45.3	104.3	78.1	21.2	21.1	20.3	21.1	19.7	-6.33	30.3	29.1
EBITDA margin (%)	14.3	21.6	21.1	19.3	17.4	21.9	21.6	21.4	15.3	15.5	15.6
EBIT margin (%)	10.9	18.4	19.0	17.1	15.5	17.3	17.1	17.0	11.9	12.1	12.4
Net profit margin (%)	10.8	18.9	17.2	15.8	14.4	16.6	16.0	15.2	11.0	11.1	11.1
Return on avg assets (%)	16.8	27.9	31.0	25.6	23.3	18.1	19.4	19.9	10.3	11.7	12.9
Return on avg equity (%)	22.9	42.7	52.5	42.0	35.9	22.0	24.1	25.3	12.7	14.8	16.8
ROIC (%)	29.3	83.1	105.8	116.5	101.8	37.1	38.8	40.1	32.4	35.5	37.6
ROIC - WACC (%)	13.8	67.6	90.3	101.0	86.3	23.5	25.2	26.5	18.2	21.3	23.4
					year to Mar			*year to Jun*			*year to Dec*
Valuation											
EV/sales (x)	6.96	5.31	2.53	1.81	1.29	2.93	2.32	1.83	1.51	1.15	0.87
EV/EBITDA (x)	48.7	24.6	12.0	9.36	7.37	13.4	10.7	8.55	9.87	7.38	5.60
EV/EBITDA @ tgt price (x)	57.8	29.2	14.4	11.3	8.98	14.6	11.7	9.34	10.2	7.62	5.78
EV/EBIT (x)	63.9	28.9	13.3	10.6	8.28	16.9	13.6	10.8	12.7	9.49	7.06
EV/invested capital (x)	26.7	17.0	14.9	10.4	7.00	6.02	5.06	4.20	4.30	3.36	2.57
Price/book value (x)	13.9	12.4	7.72	5.30	3.83	4.11	3.66	3.17	2.32	2.05	1.79
Equity FCF yield (%)	2.60	2.08	5.10	4.70	5.13	2.86	3.40	3.98	2.18	2.46	2.58
Normalised PE (x)	66.2	32.4	18.2	15.0	12.4	19.4	16.0	13.4	19.1	14.7	11.4
Norm PE @tgt price (x)	78.1	38.2	21.5	17.7	14.6	21.0	17.4	14.5	19.5	15.0	11.6
Dividend yield (%)	0.37	1.68	0.51	0.67	0.84	2.87	2.87	2.87	0.80	1.06	1.59
					year to Mar			*year to Jun*			*year to Dec*

Per share data	FY05A	FY06A	FY07F	FY08F	FY09F
Tot adj dil sh, ave (m)	114.2	128.5	130.1	130.9	130.9
Reported EPS (INR)	8.97	18.3	32.6	39.5	47.9
Normalised EPS (INR)	8.97	18.3	32.6	39.5	47.9
Dividend per share (INR)	2.20	10.0	3.00	4.00	5.00
Equity FCF per share (INR)	15.4	12.3	30.3	27.9	30.5
Book value per sh (INR)	42.6	47.9	76.9	112.0	154.9
					year to Mar

Solvency	FY05A	FY06A	FY07F	FY08F	FY09F
Net debt to equity (%)	-49.3	-36.8	-58.2	-61.1	-60.6
Net debt to tot ass (%)	-35.4	-22.4	-33.7	-38.6	-40.0
Net debt to EBITDA	-1.78	-0.85	-1.12	-1.41	-1.62
Current ratio (x)	2.55	1.80	1.87	2.15	2.31
Operating CF int cov (x)	-40.6	-17.7	-41.3	-17.0	-13.1
Dividend cover (x)	4.59	2.26	12.3	11.3	10.9
					year to Mar

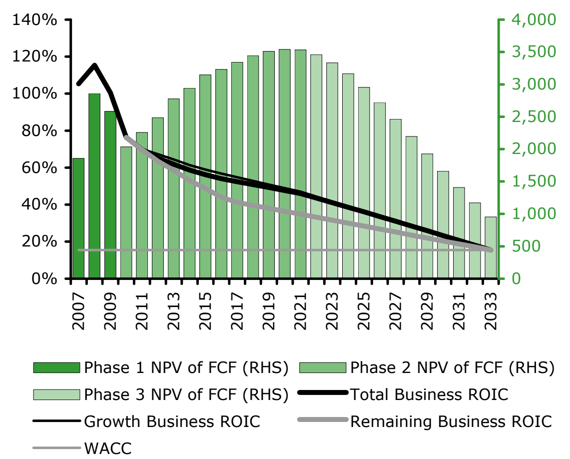
Priced as follows: TEML.BO - Rs617.80; HCLT.BO - Rs557.75; PTNI.BO - Rs380.75
Source: Company data, ABN AMRO forecasts

TECH MAHINDRA: VALUATION METHODOLOGY

Economic Profit Valuation	INR m	%
Adjusted Opening Invested Capital	4,330	5.6
NPV of Economic Profit During Explicit Period	8,949	11.6
NPV of Econ Profit of Remaining Business (1, 2)	13,739	17.8
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	50,090	65.0
Enterprise Value	77,109	100.0
Plus: Other Assets	0	0.0
Less: Minorities	0	0.0
Less: Net Debt (as at 27 Sep 2006)	-2,835	-3.7
Equity Value	79,943	104
No. Shares (millions)	115	
Per Share Equity Value	**700**	
Current Share Price	617.8	**13%**

Discounted Cash Flow Valuation	INR m	%
Value of Phase 1: Explicit (2007 to 2009)	7299.2	9
Value of Phase 2: Value Driver (2010 to 2021)	36244.3	47
Value of Phase 3: Fade (2022 to 2033)	27407.0	36
Terminal Value	6156.4	8
Enterprise Value	77106.8	100
FCF Grth Rate at end of Phs 1 implied by DCF Valuation		11.4
FCF Grth Rate at end of Phs 1 implied by Current Price		55.0

Returns, WACC and NPV of Free Cash Flow



Sensitivity Table		No of Years in Fade Period				
		15	18	20	23	25
WACC	**13.5%**	930	995	1038	1104	1147
	14.5%	826	877	911	961	994
	15.5%	738	778	804	843	868
	16.5%	662	694	715	744	763
	17.5%	597	622	638	661	676

Performance Summary	2007	2008	2009	Phase 2 Avg (2010 - 2021)
Invested Capital Growth (%)	7.5	36.4	40.0	24.3
Operating Margin (%)	19.0	17.1	15.5	12.0
Capital Turnover (x)	6.3	7.8	7.6	5.8

Source: ABN AMRO
1. In periods following the Explicit Period i.e. Phase 2 and Phase 3
2. Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter
3. Net Investment is defined as capex over and above depreciation after Phase 1

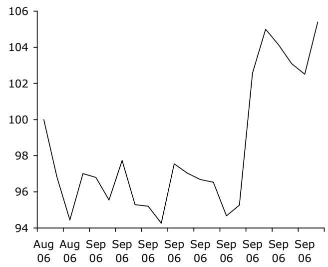
Strategic & competitive overview

Tech Mahindra

Company description — Buy

Tech Mahindra is the eighth-largest Indian IT services vendor, focused on the telecommunications industry. Majority owned by Mahindra & Mahindra, in partnership with BT Group Plc (BT), Tech Mahindra has over 12,300 employees based in 11 development centers across India, Singapore and the UK. Tech Mahindra's global customers include Alcatel, Alltel, BT, BSNL, Convergys, Ericsson, Motorola, O2 and Vodafone.

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 4
Strong execution experience on the back of BT relationship. Marquee client relationships - BT, AT&T, Motorola and Alcatel - provide strong referrals.

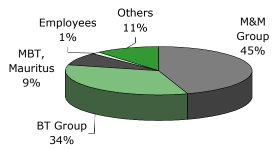
Weaknesses — 3
Concentrated business model with high client dependence. Service and client portfolio diversification strategies are still evolving.

Opportunities — 4
Growing market opportunity for offshore IT services. Telecom vertical is projected to grow ahead of the overall market for IT services.

Threats — 2
Global vendors scaling capacities in India, appreciating rupee and potential demand-supply mismatch could affect profitability; these are the key threats.

Scoring range is 1-5 (high score is good)

Shareholing pattern, Mar'06



Source: Company data

Market data

Headquarters
Sharda Centre, Off karve Road, Erandwane, Pune-411 004

Website
www.techmahindra.com

Shares in issue
114.9m

Freefloat
13%

Majority shareholders
Mahindra and Mahindra Ltd (45%), BT Plc (34%), MBT, Mauritus (9%)

India

Country view — Underweight

We are concerned the Indian market is now significantly overvalued. We see a risk of a reversal in the strong liquidity flows into the market from local and foreign investors and with the earnings cycle becoming less clear due to the broadening of the corporate capex cycle and growing regulatory concerns in the local market. We believe the government is unlikely to engineer a meaningful slowdown in economic growth this fiscal year. We may see some fine-tuning in interest rates, but it should be mild and is unlikely to derail the growth momentum. We downgraded India in May 2006 from Neutral to Underweight.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific

Competitive position — Average competitive score: 3-

Supplier power — 3-
Bargaining power is shifting to employees as demand for manpower, especially those with 3-5 years of experience, is increasing.

Barriers to entry — 3+
Moderate in enterprise applications support services. High in product design and support services.

Customer power — 2-
Moderate to high given limited differentiation among offshore vendors. However, as the relationship matures, client has high exit barriers due to interdependence.

Substitute products — 3+
Other low-cost locations such as Eastern Europe, the Philippines and China. However, none except China offer scale comparable to India.

Rivalry — 3-
Moderate to high in services where players have little differentiation. Low in services such as product design and support that require expertise in specific product lines.

Scoring range 1-5 (high score is good)   Plus = getting better   Minus = getting worse

Broker recommendations

No broker coverage