

23rd January'2008

Tech Mahindra

Result
Update

Amber Signs flashing; Demand concerns arise

BUY

Price	Target Price
Rs725	Rs 975
Sensex	16,730

Price Performance

(%)	1M	3M	6M	12M
Absolute	(37)	(43)	(48)	0
Rel. to Sensex	(28)	(39)	(51)	(65)

Source: Capitaline

Stock Details

Sector	IT Services
Reuters	TEML.BO
Bloomberg	TECHM@IN
Equity Capital(Rs mn)	1213
Face Value(Rs)	10
52 Week H/L	1842/615
Market Cap(Rs bn)	88.2
Daily Avg Volume (No of shares)	165318
Daily Avg Turnover (US\$)	4.7

Shareholding Pattern (%)

(31 st Dec.'07)	
Promoters	83.6
FII/NRI	1.6
Institutions	12.9
Private Corp.	1.3
Public	8.5

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Tech Mahindra reported US\$ term revenues of US\$ 245 mn, up 11% QoQ. Revenues in Indian Rs terms grew by 8.1% sequentially to Rs 9704 mn, slightly lower than expectations. EBITDA margins remained flat QoQ at 22% (V/s expectations of 200 bps improvement, and was a disappointment considering that employee addition was next to negligible during the quarter along with a increase in offshore proportion of revenues). Net profits grew in line with expectations at 9.7% QoQ to Rs 1994 mn, helped by higher than expected other income and lower tax rates. However the concern on the company continue to pick up further (please refer to our Tech Mahindra Q2FY08 Result Update dated 22nd October'07, Downgrade to 'REDUCE) and stem from (1) 4.2% in the top client British Telecom continuing for the 3rd consecutive quarter in a row (and considering that significant ramp up was expected to happen during the quarter in the BTGS deal, top client growth remained disappointing), (2) management admitted that the organic business share in the top client has remained flat within BT over the past few quarters (and the top client continues to go through 'some tough' times) and (3) Employee addition remained below par (with net addition at a mere 55, IT services headcount came down by 435, while BPO count increased by 513). Though the company indicated that the employee addition would pick up in the subsequent quarters as well as it would continue to focus on increasing utilization levels (they were up 600 bps QoQ during the quarter to 69%, with the internal target at 74-75% levels), we would remain wary on the prospects of the company given that the IT spending in the telecom space continues to be under pressure globally.

We are cutting our FY09E estimates further by ~7% and also introduce our FY10E estimates and expect Tech Mahindra to report revenue, EBITDA and net profit CAGR of 24.9%, 19.5% and 19.4% over FY07-10E. Though valuations have already cooled down to reasonable levels at <12 x on FY09 adjusted earnings from the lofty valuations enjoyed by the company a few quarters back, we believe that the stock performance could remain subdued for a while. We reduce our 1 year forward price target on the stock to Rs 975, based on 13.5 x on adjusted FY10E earnings of Rs 72.2.

Top client growth continues to be slack

In Rs mn	Q3FY08	Q2FY08	QoQ(%)	Q3FY07	YoY (%)
Net sales	9704	8976	8.1%	7698	26.1%
Total Income	9,704	8,976		7,698	
Operating expenses	7575	7004		5626	
EBITDA	2,129	1,972	8.0%	2,072	2.8%
Margins (%)	21.9	22.0		26.9	
Depreciation	206	193		137	
EBIT	1,923	1,779	8.1%	1,935	-0.6%
Margins (%)	19.8	19.8		25.1	
Interest Paid	16	25		12	
Other income	300	249		-32	
Pre-tax profit	2,207	2,003		1,891	
Tax provided	213	187		224	
Profit after tax	1,994	1,816		1,667	
Emkay Net profit	1,993	1,817	9.7%	1,667	19.6%
EPS, Rs	15.2	13.9		13.1	

Other result highlights

Revenue growth below par, muted growth from top client worrying

Tech Mahindra reported a 11.1% sequential growth in revenues in US\$ terms to US\$ 245mn. The revenues in Indian Rs terms increased by 8.1% QoQ to Rs 9704 mn, a tad below expectations. However apart from the headline numbers the disappointment in the result stemmed from the top client growth continuing to raise amber signs **(BT grew by only 4.2% QoQ and is the biggest concern given that the company had guided that BTGS deal would ramp up during the quarter, and hence revenue growth would return to the FY07 quarterly run rate.)**

(in US\$ mn)	Q3FY07	Q4FY07	Q1FY08	Q2FY08	Q3FY08
Quarterly Revenues	171	198	211	221	245
QoQ growth, %	16.1%	13.4%	16.0%	6.7%	4.7%
Top client revenues	110.8	132.5	135.0	143.5	149.6
QoQ growth, %	15.2%	19.5%	1.9%	6.3%	4.2%
Top 5 client revenues	139.8	164.1	179.3	189.9	201.1
QoQ growth, %	13.4%	17.4%	9.2%	5.9%	5.9%
Top 10 client revenues	153.5	176.0	189.8	196.5	215.8
QoQ growth, %	13.4%	14.7%	7.9%	3.5%	9.8%

The company affirmed the view that 'it's share within the IT budget of British Telecom has remained stagnant over the past few quarters. Besides the company indicated that the IT budgets in the TSP space continued to be under pressure globally and were thus impacting the company. However we would like to note that the non top client growth was encouraging at 23.7% QoQ and would go as the only key positive from the operating metrics.

Employee count almost flat; Utilization moves up

Tech Mahindra reported a marginal increase in employee headcount by 55 taking the company wide roll count to 23,155. The headcount in the IT services side declined by 435 people while the BPO resource count increased by 513 during the quarter. The utilization level moved up smartly by 600 bps along expected lines to 69%.

Operating margins flat, below expectations

Tech Mahindra reported EBITDA margins of 22% in Q3FY08, which were flat QoQ (V/s expectations of ~200 bps improvement). The management indicated that the margins were hit on account of lower margin system integration business (US\$ 6 mn of contribution during the quarter) apart from the Rs appreciation against the British Pound.

Net profits grow by 9.8%QoQ to Rs 1995 mn

Tech Mahindra reported in line net profits at Rs 1995 mn, helped by higher than expected other income at Rs 300 mn (included US\$ 6.5 mn of forex gains) and lower than expected tax rates (effective tax rate at 9.7% V/s expectation of 11%).

Cut estimates further, Introduce FY10E estimates.

We have been wary of the prospects of Tech Mahindra **(please refer to our Tech Mahindra Q2FY08 Result Update Downgrade to 'REDUCE' dated 22nd October'07)** and believe that though the stock valuations have corrected significantly with the stock now trading at sub 12x multiple of FY09E adjusted earnings, the stock performance may get continue to suffer for a while given that the operating performance continues to be muted.

We have cut our FY09E revenue and net profit estimates by 3.5% and 7% respectively and also introduce our FY10E estimates. We expect Tech Mahindra to report revenue, EBITDA and net profits CAGR of 24.9%, 19.5% and 19.4% over FY07-10E. We reduce our price target on Tech Mahindra to Rs 975 from Rs 1234 earlier.

(in Rs mn, except EPS)	FY09E			FY10E
	Old	New	change	
Revenues	49000	47267	-3.5%	57408
EBITDA	11450	10644	-7.0%	12626
Net Profits	10060	9335	-7.2%	10505
EPS	76.8	71.3	-7.2%	80.2

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