Company Focus

22 October 2007 | 11 pages

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

Tech Mahindra (TEML.BO)

Downgrade to Sell: Disappointing 2Q; Expectations Remain High

- **Disappointing 2Q; second quarter in a row** — Tech Mahindra reported another disappointing quarter with revenues growing only 4.7% qoq. Growth was led by BT, while non-BT business remained flattish. Margins fell ~30bp qoq. Net profit of Rs.1.8b was up 7% qoq due to higher other income and lower taxes.
- **BT/AT&T (top clients) restructuring; could delay recovery** — Tech Mahindra indicated that its two top clients (BT and AT&T) are undergoing restructuring. We believe this could delay recovery in Tech Mahindra's business.
- **BT Global Services (BTGS) ramp-up slow** — Management indicated that currently ~500 positions are being transitioned, with additional visibility on ~500 positions. Management maintained that the contract would ramp up in a "J-Curve" manner; however, there seems to be a delay, in our view.
- **Headcount does not reflect strong pipeline** — Tech Mahindra has hired ~1700 employees in IT Services in H1FY08 compared to ~4,500 employees in H1FY07. On a higher base, it does not reflect confidence in the pipeline.
- **Revised FY09E 13% below consensus; Sell (3H)** — We have revised our FY08E – FY10E estimates downwards by 7-17%. Our revised FY09E estimates are ~13% below consensus and downgrades could follow post disappointing 2Q. The stock trades at 17x FY09E EPS. Our new target price of Rs.1330 is based on 17x FY09E EPS.

Sell/High Risk	3H
from Buy/High Risk	
Price (19 Oct 07)	Rs1,329.45
Target price	Rs1,330.00
from Rs1,920.00	
Expected share price return	0.0%
Expected dividend yield	0.2%
Expected total return	**0.2%**
Market Cap	Rs161,250M
	US$4,080M

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 (%)
2006A	2,354	18.32	104.2	72.6	22.5	42.7	0.8
2007A	1,213	9.82	-46.4	135.4	15.8	15.8	0.1
2008E	7,725	58.97	500.7	22.5	9.7	59.9	0.2
2009E	10,254	78.36	32.9	17.0	6.1	47.7	0.2
2010E	11,918	91.08	16.2	14.6	4.3	37.2	0.3

Source: Powered by dataCentral

Surendra Goyal, CFA[1]
+91-22-6631-9870
surendra.goyal@citi.com

Hitesh Shah, CFA[1]
+91-22-6631-9872
hitesh.b.shah@citi.com

Vishal Agarwal[1]
vishal1.agarwal@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	72.6	135.4	22.5	17.0	14.6
EV/EBITDA adjusted (x)	69.7	23.3	19.6	13.3	10.0
P/BV (x)	22.5	15.8	9.7	6.1	4.3
Dividend yield (%)	0.8	0.1	0.2	0.2	0.3
Per Share Data (Rs)					
EPS adjusted	18.32	9.82	58.97	78.36	91.08
EPS reported	18.32	9.82	58.97	78.36	91.08
BVPS	59.16	84.26	137.24	218.20	311.72
DPS	10.00	1.50	2.00	3.00	4.00
Profit & Loss (RsM)					
Net sales	12,426	29,290	37,953	50,400	62,627
Operating expenses	-10,146	-22,440	-29,996	-39,216	-48,594
EBIT	**2,280**	**6,850**	**7,957**	**11,184**	**14,033**
Net interest expense	341	15	632	620	620
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**2,621**	**6,865**	**8,590**	**11,804**	**14,652**
Tax	-267	-741	-869	-1,550	-2,734
Extraord./Min.Int./Pref.div.	0	-4,911	5	0	0
Reported net income	**2,354**	**1,213**	**7,725**	**10,254**	**11,918**
Adjusted earnings	2,354	1,213	7,725	10,254	11,918
Adjusted EBITDA	2,280	6,850	7,957	11,184	14,033
Growth Rates (%)					
Sales	31.4	135.7	29.6	32.8	24.3
EBIT adjusted	121.8	200.4	16.2	40.6	25.5
EBITDA adjusted	121.8	200.4	16.2	40.6	25.5
EPS adjusted	104.2	-46.4	500.7	32.9	16.2
Cash Flow (RsM)					
Operating cash flow	**1,704**	**-1,274**	**8,332**	**8,962**	**10,639**
Depreciation/amortization	0	0	0	0	0
Net working capital	-331	-2,448	1,280	-672	-660
Investing cash flow	**-1,174**	**-1,963**	**-1,414**	**-1,843**	**-1,877**
Capital expenditure	-1,515	-2,039	-2,087	-2,463	-2,497
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-1,061**	**2,103**	**-468**	**-446**	**-595**
Borrowings	0	170	-170	0	0
Dividends paid	-1,185	-223	-298	-446	-595
Change in cash	**-531**	**-1,133**	**6,451**	**6,672**	**8,166**
Balance Sheet (RsM)					
Total assets	**10,092**	**15,926**	**26,217**	**39,136**	**53,516**
Cash & cash equivalent	2,265	1,647	8,853	16,432	25,567
Accounts receivable	4,377	8,216	10,398	13,808	17,158
Net fixed assets	2,031	3,412	4,744	6,300	7,828
Total liabilities	**3,938**	**6,625**	**9,488**	**12,600**	**15,657**
Accounts payable	0	0	0	0	0
Total Debt	0	170	0	0	0
Shareholders' funds	**6,155**	**9,301**	**16,728**	**26,536**	**37,859**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.3	23.4	21.0	22.2	22.4
ROE adjusted	42.7	15.8	59.9	47.7	37.2
ROIC adjusted	63.4	104.3	90.3	107.2	100.9
Net debt to equity	-36.8	-15.9	-52.9	-61.9	-67.5
Total debt to capital	0.0	1.8	0.0	0.0	0.0

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Disappointing 2Q; No Recovery in Sight

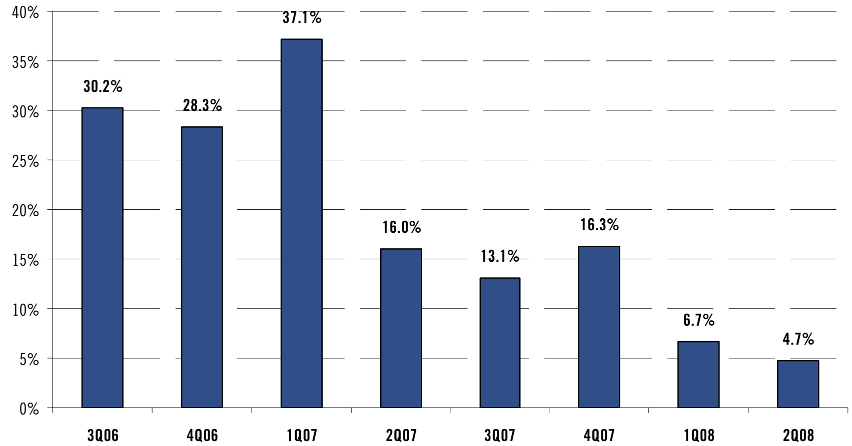
Tech Mahindra reported a disappointing 2Q with revenue growth of 4.7% qoq in $ terms. Operating margins declined again; net income was helped by higher than expected other income and lower tax rates. Restructuring at top two clients, BT and AT&T, has resulted in uncertainty over growth outlook, and there does not seem to be recovery in sight. While the BTGS ramp-up should provide some growth in the coming quarters, we don't think it is enough to support current valuations. We are reducing our FY09E estimates to 13% below consensus estimates. With our CAGR reduced from 32% to 22% over FY07E-FY10E, we now expect the stock to trade at a discount to much diversified players like Satyam. Our target price of Rs.1330 is based on 17x FY09E EPS. We downgrade our recommendation to Sell/High Risk. Further delays in client restructuring could delay the recovery even more and increase risk to our estimates.

What has changed?

Second disappointing quarter in a row

After a CAGR of 23% over 2QFY06-4QFY07, Tech Mahindra's growth has slowed down considerably to 4-7% qoq over the last couple of quarters. This is driven by sluggishness in revenues from the top two clients, BT and AT&T. Both major clients are undergoing some kind of restructuring and a recovery for Tech Mahindra could take longer than anticipated.

Figure 1. QoQ revenue growth momentum has slowed considerably in FY08



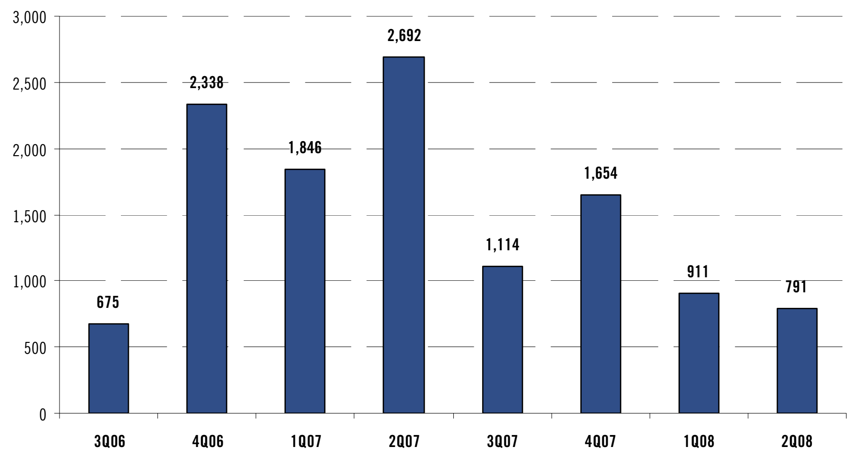
Source: Company Reports

Hiring does not inspire confidence on pipeline

Hiring in H1FY08 has been ~1700 employees in IT Services compared to ~4500 employees H1FY07. On a higher base and factoring in incremental business from BTGS, the hiring data does not seem to indicate a lot of confidence in the growth outlook.

The company had in the past indicated 7500 campus hires for FY08. In 2Q earnings call, it indicated 5000 campus hires for FY09. Management has also talked about focusing efforts on reducing cost per employee using higher proportion of campus hires. Putting all this together, the hiring plan does not inspire confidence on the outlook.

Figure 2. Hiring in IT services has clearly slowed over last two quarters



Source: Company Reports

BTGS deal seems to be behind schedule

The BTGS deal was announced in December 2006. After ~10 months, management indicated in its 2Q earnings call that ~500 positions are now being transitioned, with an additional visibility of ~500 positions. Our rough calculations indicate that for an annualized $200m run rate offshore, Tech Mahindra should be deploying ~4000-5000 resources on the deal. Clearly, the BTGS ramp up seems to be behind schedule, in our view.

Data points suggest weakness in TSP/Telecom OEM space

Data points also suggest some weakness in the TSP space:

1. Ovum data indicates that North American wireline capital spending in the first half of 2007 was down nearly 7 percent compared to last year, largely due to AT&T spending cuts resulting from its merger with BellSouth.

2. Alcatel Lucent recently issued a profit warning.

3. Ericsson recently issued a profit warning attributing it to a shortfall in sales in mobile network upgrades and expansion.

4. Tech Mahindra indicated in the earnings call that BT was in the process of reorganizing and vendors must expect to grow more through end to end engagements rather than project-based business.

5. Recently, Subex Azure, another Indian company in the telecom software space, revised guidance downwards due to a key customer in North America slowing down capex spend, impacting some contracts for Subex.

Figure 3. Earnings Revision

FYE 31 Mar	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
2008E	7,725	58.97	-7.2	2.00
Prev	8,291	63.55		2.00
2009E	10,254	78.36	-14.1	3.00
Prev	11,903	91.23		3.00
2010E	11,918	91.08	-17.1	4.00
Prev	14,330	109.83		4.00

Source: Citi Investment Research estimates

Cutting estimates

Post two quarters of disappointment on earnings and little visibility of recovery, we have cut our earnings estimates by 7-17%. Management commented about re-structuring at a few of its top clients (both in Telecom Equipment and Telecom Service Provider space) leading to slower revenue growth.

With negative sector data points and little visibility on near-term possibility of growth rebounding, we have cut our revenue forecast. We have also incorporated our economics team's new INR/USD exchange rate forecasts into our model.

Valuations to get de-rated

With revenue and earnings slowing down, we believe Tech Mahindra would no longer trade at a premium to more diversified peers like Satyam.

We value Tech Mahindra at 17x FY09E earnings. Our target P/E multiple of 17x is derived from a 10% discount to our target of 19x FY09E for Satyam. Satyam is widely used as a benchmark for valuing companies in the non-Tier I space; we use Satyam as benchmark for our entire mid-cap IT services universe.

We expect TechM PER to get de-rated from a premium PE multiple to a discount PE multiple over Satyam as revenue and earnings growth slow from high teens to single digits.

Figure 4. Tech Mahindra: 12-month forward PER valuation band chart

Source: DataStream, Company Reports and Citi Investment Research estimates

We believe P/E remains the most appropriate valuation measure given Indian IT companies' profitable track record and earnings visibility.

Upside Risks

Large deal announcement: Announcement of any large deal from BT or any other customer could act as a positive catalyst for the stock price.

Sharp ramp up in BTGS: Better than expected ramp up in BTGS could result in positive earnings surprise.

INR depreciation: INR depreciation could be a positive for the entire IT services sector and would impact Tech Mahindra positively as well.

Inorganic initiatives: Announcement of any inorganic initiatives could be a positive catalyst for the stock price.

2QFY08 Result Tables

Figure 5. Key financials

Rs m	2Q07	1Q08	2Q08	QoQ	YoY
Revenue (US m)	**150**	**211**	**221**	**4.7%**	**46.8%**
Revenue	**6,976**	**8,763**	**8,976**	**2.4%**	**28.7%**
Cost of revenue	4,149	5,492	5,658	3.0%	36.4%
Gross profit	2,827	3,271	3,318	1.4%	17.4%
Gross margin	40.5%	37.3%	37.0%	-36bp	-356bp
Operating expenses	1,058	1,338	1,346	0.6%	27.2%
EBITDA	**1,769**	**1,933**	**1,972**	**2.0%**	**11.5%**
EBITDA margin	***25.4%***	***22.1%***	***22.0%***	***-9bp***	***-339bp***
Depreciation and amortization	113	168	193	14.9%	70.8%
EBIT	**1,656**	**1,765**	**1,779**	**0.8%**	**7.4%**
EBIT margin	***23.7%***	***20.1%***	***19.8%***	***-32bp***	***-392bp***
Profit before tax	1,599	1,881	2,002	6.4%	25.2%
Income tax expense	169	183	187	2.2%	10.7%
Income from operations	1,430	1,698	1,815	6.9%	26.9%
EO income/(loss)	339	3	2	n.a.	n.a.
Net profit	1,769	1,701	1,817	6.8%	2.7%
Recurring EPS - basic	12.67	14.04	14.99	6.8%	18.3%
Recurring EPS - fully diluted	11.14	12.92	13.87	7.4%	24.5%

Source: Company Reports

Figure 6. Revenue mix

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Geography wise						
North America	18%	18%	19%	19%	19%	19%
Europe	67%	73%	73%	76%	74%	75%
Rest of World	15%	9%	8%	5%	7%	6%
Delivery location wise						
Onsite	34%	38%	40%	41%	43%	45%
Offshore	66%	62%	60%	59%	57%	55%

Source: Company Reports

Figure 7. Key HR and execution metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Total headcount	12,366	15,080	17,774	19,749	21,146	23,100
- IT delivery	11,721	14,413	15,527	17,181	18,092	18,883
- net add	1,846	2,692	1,114	1,654	911	791
- BPO delivery	0	0	1,542	1,755	2,019	3,191
- net add	0	0	1,542	213	264	1,172
- Sales & Support	645	667	705	813	1,035	1,026
Utilization	74.0%	69.0%	67.0%	67.0%	67.0%	63.0%

Source: Company Reports

Figure 8. Key client metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
No. of active clients	65	70	78	83	87	96
Client relationship size						
>$ 1m	17	17	22	29	31	32
> $ 2m	10	12	15	18	18	17
> $ 5m	7	8	8	8	9	12
> $ 10m	5	5	5	6	6	6
> $ 15m	3	4	4	4	5	4
> $ 20m	2	3	3	3	3	3
> $ 25m	2	2	2	2	3	3
> $ 50m	1	1	1	2	2	2
Client concentration						
Top client	58%	64%	65%	67%	64%	65%
Top 5	86%	82%	82%	83%	85%	86%
Top 10	91%	90%	90%	89%	90%	89%

Source: Company Reports

Tech Mahindra

Company description

One of India's top 10 IT Services providers focused on the telecom space, TechM services Telecom Service Providers (TSPs), Telecom Equipment Manufacturers (OEMs), Software Vendors and Systems Integrators (SIs). Formed in 1986 – JV between M&M and British Telecom (BT). Key clients include BT, Alcatel, AT&T, Alltel, Convergys, Motorola, O2 and Vodafone. TechM is headquartered at Pune with development centres across India and a couple of centers in the UK. 45% of revenues from BSS, 20-25% from OSS, 10-15% from Next generation networks and the remainder from new areas. TechM is the only Indian player in the top 10 BSS vendors worldwide, as ranked by Gartner Dataquest.

Investment strategy

We rate TechM Sell/High Risk (3H) based on a fundamental 12-month view. With high exposure to the telecom domain, TechM is likely to get affected with deteriorating fundamental trends in telecom vertical. While we expect margins to decline in FY08 on account of currency, wages and investments in the BT Global Services contract, there is downside risk to revenue estimates in case of slower IT spend from telecom service providers. We expect revenue and EPS CAGRs of 29% and 22% respectively over FY07-FY10E. With our FY09 estimates at 13% lower than the consensus, we see risks of consensus downward revisions weighing on the stock performance.

Valuation

With revenue and earnings slowing for Tech Mahindra, we believe it would not trade at a premium to more diversified peers like Satyam. Our target P/E multiple of 17x FY09E EPS is derived from a 10% discount to our target of 19x FY09E for Satyam. Satyam is widely used as a benchmark for valuing companies in the non-Tier I space; we use Satyam as benchmark for our entire mid-cap IT services universe. We expect TechM PER to get de-rated from a premium PE multiple to a discount PE multiple over Satyam as revenue and earnings growth slows from high-teens to single-digit growth. We believe P/E remains the most appropriate valuation measure given Indian IT companies' profitable track record and earnings visibility.

Risks

We rate Tech Mahindra High Risk, in line with our quantitative risk rating system. We believe a High Risk rating is appropriate as BT and AT&T have ownership/options in TechM and that ensures decent visibility on revenues and earnings, while the company also has strong cash flows and a solid balance sheet. However, the top two customers account for >75% of revenues, implying high client concentration risk. The key upside risks to our target price include: 1) Any significant depreciation of the rupee against the US Dollar/Euro/GBP; 2) A sharp upturn in IT spending among telecom service providers; 3) Sharp ramp-ups in BT Global services deal 4) Hiring rebounding in next few quarters; 5) Large deal announcement; and 6) Acquisition-related risks.

Appendix A-1

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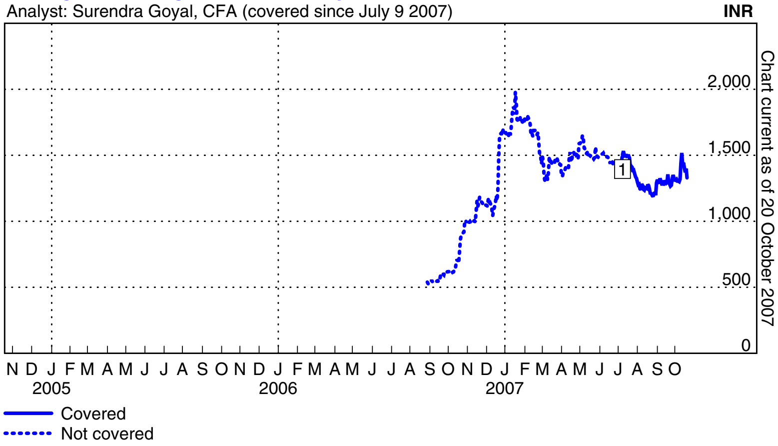
IMPORTANT DISCLOSURES

Tech Mahindra (TEML.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal, CFA (covered since July 9 2007)



#	Date	Rating	Target Price	Closing Price
1:	9 Jul 07	1H	1,920.00	1,504.75

*Indicates change.

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