



## Tech Mahindra

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,170	TECHM IN
	REUTERS CODE
S&P CNX: 3,065	TEML.BO

22 October 2008

Neutral

Previous Recommendation: Neutral

Rs418

Equity Shares (m)	121.7
52-Week Range (Rs)	1,305/336
1,6,12 Rel. Perf. (%)	-10/-13/-22
M.Cap. (Rs b)	50.9
M.Cap. (US\$ b)	1.0

YEAR	NET SALES	PAT	EPS*	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/07A	29,290	6,124	46.4	105.2	9.0	5.5	66.7	65.5	1.7	6.8
3/08A	37,661	7,693	58.3	25.6	7.2	4.0	55.9	54.5	1.3	6.1
3/09E	47,852	10,336	78.4	34.3	5.3	1.9	37.5	37.3	0.8	3.1
3/10E	54,219	10,837	82.2	4.9	5.1	1.2	34.5	34.4	1.2	2.1

\* Diluted EPS (before Ex-ord Item)

- US\$ Revenues decline 1%; margins up 230bp QoQ:** Tech Mahindra 2QFY09 revenue at Rs11.6b (v/s est. of Rs12.1b) registered QoQ growth of 4.3% (-0.8% in US\$ terms, 2.3% in constant currency terms). EBIDTA margin improved to 28% in 2QFY09 (our estimate 23.9%) v/s 25.7% in 1QFY09 on account of rupee depreciation and reduction in transition costs. EBIDTA at Rs3.3b was above our estimate of Rs2.9b. Net profit before extraordinary items was Rs2.35b (v/s est. of Rs2.53b), a degrowth of 9% QoQ and growth of 30% YoY. Net profit was lower on account of US\$9m forex losses v/s forex gains of US\$4m in 1QFY09.
- Business outlook for FY09:** Management mentioned that its long term order book (contracts signed for 5-year periods) remained at US\$2b. The company had won a large deal in 4QFY08 worth US\$700m against which it had made an upfront payment of Rs4.4b (US\$110m) to the customer. As per management, this deal can grow to US\$1b. However, management did not comment on details of reimbursement of the upfront payment by consortium members.
- Valuation and view:** We are downgrading our FY10 US\$ revenue growth estimates by 500bp from 18% to ~13%, on account of renewed concerns about demand visibility, cross currency volatility and global slowdown. Our FY09 EPS stands revised to Rs78.4 from Rs76.8 while our FY10 EPS is lowered to Rs82.2 from Rs89.9. We are assuming an average rate of Rs43.6/US\$ for FY09 and Rs43.7/US\$ for FY10 against our earlier estimate of Rs43/US\$ for FY09 and Rs42/US\$ for FY10. The stock is trading at 5.3x FY09E and 5.1x FY10E earnings (before extraordinary items). We expect FY09 EPS to grow by 34% to Rs78.4 from Rs58.3 (before EO) in FY08. Maintain **Neutral**.

### QUARTERLY PERFORMANCE (I GAAP)

(RS MILLION)

Y/E MARCH	FY08				FY09				FY08	FY09E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Revenues</b>	<b>8,763</b>	<b>8,976</b>	<b>9,704</b>	<b>10,218</b>	<b>11,164</b>	<b>11,648</b>	<b>12,335</b>	<b>12,705</b>	<b>37,661</b>	<b>47,852</b>
Q-o-Q Change (%)	0.2	2.4	8.1	5.3	9.3	4.3	5.9	3.0	28.6	27.1
Direct Cost	5,492	5,658	6,144	6,560	6,825	6,867	7,627	7,871	23,854	29,190
Other Operating Exps	1,338	1,346	1,431	1,434	1,470	1,520	1,604	1,715	5,549	6,309
<b>Operating Profit</b>	<b>1,934</b>	<b>1,972</b>	<b>2,129</b>	<b>2,224</b>	<b>2,869</b>	<b>3,261</b>	<b>3,105</b>	<b>3,119</b>	<b>8,259</b>	<b>12,353</b>
Margins (%)	22.1	22.0	21.9	21.8	25.7	28.0	25.2	24.5	21.9	25.8
Other Income	131	249	300	364	261	-320	247	254	1,044	442
Interest	15	26	16	5	2	0	0	0	62	2
Depreciation	168	193	206	229	258	267	284	292	796	1,101
<b>PBT bef. Extra-ordinary</b>	<b>1,882</b>	<b>2,002</b>	<b>2,207</b>	<b>2,354</b>	<b>2,870</b>	<b>2,674</b>	<b>3,068</b>	<b>3,081</b>	<b>8,445</b>	<b>11,692</b>
Provision for Tax	183	187	213	165	282	321	368	385	748	1,356
Rate (%)	9.7	9.3	9.7	7.0	9.8	12.0	12.0	12.5	8.9	11.6
Minority Interest	3	0	1	-1	2	-1	0	0	3	1
<b>Net Income bef. Extra-ordinary</b>	<b>1,696</b>	<b>1,815</b>	<b>1,993</b>	<b>2,190</b>	<b>2,586</b>	<b>2,354</b>	<b>2,700</b>	<b>2,695</b>	<b>7,693</b>	<b>10,335</b>
Q-o-Q Change (%)	-13.5	7.0	9.8	9.9	18.1	-9.0	14.7	-0.2	25.7	34.3
Extra-ordinary items	0	2	0	-4,401	0	673	0	0	-4,399	673
<b>Net Income aft. Extra-ordinary</b>	<b>1,696</b>	<b>1,817</b>	<b>1,993</b>	<b>-2,211</b>	<b>2,586</b>	<b>3,027</b>	<b>2,700</b>	<b>2,695</b>	<b>3,294</b>	<b>11,008</b>
Q-o-Q Change (%)	-151.6	7.2	9.7	-210.9	-217.0	17.0	-10.8	-0.2	171.9	234.1

E: MOST Estimates

**US\$ revenues decline 1%; margins up 230bp QoQ**

Tech Mahindra 2QFY09 revenue at Rs11.6b (v/s est. of Rs12.1b) registered a QoQ growth of 4.3% (-0.8% in US\$ terms, 2.3% in constant currency terms).

EBIDTA margin improved to 28% in 2QFY09 (our estimate 23.9%) v/s 25.7% in 1QFY09 on account of rupee depreciation and reduction in transition costs. EBIDTA at Rs3.3b was above our estimate of Rs2.9b.

Net profit before extraordinary items was at Rs2.35b (v/s est. of Rs2.53b), a degrowth of 9% QoQ and growth of 30% YoY. Net profit was lower on account of US\$9m forex losses v/s forex gains of US\$4m in 1QFY09. The 2QFY09 direct cost included a UK payee tax writeback amounting to Rs673m (US\$15.3m) which we have charged as an extraordinary item. PAT after extraordinary items was Rs3b v/s Rs2.6b in 1QFY09, a growth of 17% QoQ.

The US\$1b British Telecom (BTGS) contract (over a 5-year period) signed seven quarters ago accounted for revenues of US\$32m in 2QFY09. This account is yet to reach a steady state revenue run rate of US\$200m p.a. The billing for the contract began in January 2008 after a delay of a couple of quarters. The corresponding revenue flow was US\$25m in 1QFY09 and US\$19m in 4QFY08. BT contributed ~US\$161m, i.e. 60% to total revenues in 2QFY09, the growth for which was flat, in constant currency.

Revenue from large long term deals contributed 25% to revenues, contributing ~US\$65m in 2QFY09.

**Business outlook for FY09**

Management mentioned that its long term order book (contracts signed for 5-year periods) remained at US\$2b, Tech Mahindra has maintained its target offer of 5,500 campus hires with 800 of them joining in 2QFY09 (500 had already joined in 1QFY09). The company had won a large deal in 4QFY08 worth US\$700m against which it had made an upfront payment of Rs4.4b (US\$110m) to the customer. As per management, this deal can grow to US\$1b. However, management did not comment on details of reimbursement of the upfront payment by consortium members.

### Other highlights

- 1] Top client (BT) contributed 60% (v/s 63% in 1Q), Top 5 accounted for 82% (v/s 84%) and Top 10 contributed 89% (v/s 90% in 1Q). BT reported flat revenue growth in the quarter, in constant currency.
- 2] The US contributed 23% in 2QFY09 (v/s 22% in 1Q), Europe 69% (v/s 72% in 1Q), while RoW contributed 8% in 2QFY09 (v/s 6% in 1Q)
- 3] The company has forex hedges of US\$800m denominated in INR/USD, while US\$300m worth hedges are denominated in GBP/USD.
- 4] Utilization rate (including trainees) went down by 500bp at 69% in 2QFY09 v/s 74% in 1QFY09.
- 5] Added 766 employees (net) in 2QFY09 taking total employee strength to 25,135. BPO headcount saw degrowth of 148 employees in 2Q, which is attributed to operational efficiency as per management.

### Valuation and view

Valuations at 5x FY10 estimates appear attractive with limited downside. But we are maintaining our **Neutral** rating given:

- a) Over 60% revenues derived from a single client, BT and ~90% revenues from top 10 clients, 100% exposure to Telecom vertical. The company carries a higher degree of risk to revenue due to the nature of client and industry concentration, which does not bode well, given the global slowdown.
- b) Tech Mahindra's strategy of making upfront payments (~10% of total deal size) in a few orders to secure large long-term deals, would require it to generate higher EBITDA margins over the life of these large deals in order to make average ROIC.
- c) The US\$1b BT deal is yet to pick up the desired pace even after almost 2 years of signing the contract. This calls for better execution.

We are downgrading our FY10 US\$ revenue growth estimates by 500bp from 18% to ~13%, on account of renewed concerns about demand visibility, cross currency volatility and global slowdown. Our FY09 EPS stands revised to Rs78.4 from Rs76.8 while our FY10 EPS is lowered to Rs82.2 from Rs89.9. We are assuming an average rate of Rs43.6/US\$ for FY09 and Rs43.7/US\$ for FY10 against our earlier estimate of Rs43/US\$ for FY09 and Rs42/US\$ for FY10.

The stock is trading at 5.3x FY09E and 5.1x FY10E earnings (before EO). We expect FY09 EPS to grow by 34% to Rs78.4 from Rs58.3 (before EO) in FY08. Maintain **Neutral**.

## Tech Mahindra: an investment profile

### Company description

Tech Mahindra is India's sixth largest software exporter, and serves telecom service providers, equipment manufacturers, software vendors and systems integrators. It employs over 25,135 people, including over 3,800 in BPO services. Its key clients include British Telecom and AT&T

### Key investment arguments

- ☞ Credible Tier I Indian IT services vendor with specialized offerings in telecom vertical
- ☞ Largest Indian IT vendor in telecom services after the recently announced BT deal

### Key investment risks

- ☞ Significant high dependence on single verticals viz. telecom and clients – BT (approx. 61%)
- ☞ Reduced global IT spend due to economic slowdown in the US and currency risk
- ☞ Margins on large deals and ability of timely execution of same.

### Recent developments

- ☞ Mr. M. Damodaran, ex-SEBI chairman joins the Tech Mahindra board
- ☞ The company has made an exclusivity payment of Rs4.4b to a key customer for a new US\$700m deal

### Valuation and view

- ☞ Revenue CAGR of 20% and earnings CAGR of 18.7% over FY08-FY10E
- ☞ Valuations at 5.3x FY09E and 5.1x FY10E earnings (ex-EO), fairly valued
- ☞ Maintain **Neutral**

### Sector view

- ☞ Indian offshoring has been vindicated with the global clients and service providers making India their base for IT-enabled solutions. India still has less than 5% share in the global IT market.
- ☞ Economic slowdown in the US, sub prime crises and sharper currency appreciation remain key concerns.
- ☞ We believe frontline Indian IT companies would be better placed to sail through the near term adversities mentioned above.

#### COMPARATIVE VALUATIONS

		TECHMAHINDRA	HCLT	WIPRO
P/E (x)	FY09E	5.3	6.1	10.0
	FY10E	5.1	6.4	9.4
P/BV (x)	FY09E	1.9	1.3	2.5
	FY10E	1.2	1.0	2.0
EV/Sales (x)	FY09E	0.8	0.6	1.3
	FY10E	1.2	0.3	1.4
EV/EBITDA (x)	FY09E	3.1	2.6	7.1
	FY10E	2.1	1.2	7.8

#### SHAREHOLDING PATTERN (%)

	SEP-08	JUN-08	SEP-07
Promoter	85.0	85.1	83.6
Domestic Inst	2.0	2.2	3.3
Foreign	2.3	1.9	1.9
Others	10.8	10.9	11.2

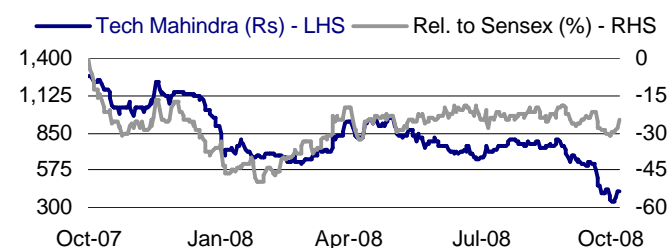
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY09	78.4	75.4	4.0
FY10	82.2	89.0	-7.6

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
418	-	-	Neutral

#### STOCK PERFORMANCE (FROM 28 AUGUST 2006)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
<b>Sales</b>	<b>12,427</b>	<b>29,290</b>	<b>37,661</b>	<b>47,852</b>	<b>54,219</b>
Change (%)	31.4	135.7	28.6	27.1	13.3
Direct Costs	7,396	17,535	23,854	29,190	33,557
Other Operating Expenses	2,352	4,388	5,549	6,309	7,444
Operating Expenses	9,748	21,923	29,403	35,499	41,001
<b>EBITDA</b>	<b>2,679</b>	<b>7,367</b>	<b>8,259</b>	<b>12,353</b>	<b>13,218</b>
% of Net Sales	21.6	25.2	21.9	25.8	24.4
Depreciation	397	516	796	1,101	1,233
Interest	0	61	62	2	0
Other Income	340	76	1,044	442	400
<b>PBT</b>	<b>2,621</b>	<b>6,866</b>	<b>8,445</b>	<b>11,692</b>	<b>12,385</b>
Tax	268	741	748	1,356	1,548
Rate (%)	10.2	10.8	8.9	11.6	12.5
<b>PAT</b>	<b>2,354</b>	<b>6,125</b>	<b>7,697</b>	<b>10,336</b>	<b>10,837</b>
Minority Interest	0	1	3	0	0
<b>PAT before EO</b>	<b>2,354</b>	<b>6,124</b>	<b>7,693</b>	<b>10,336</b>	<b>10,837</b>
Change (%)	130.1	160.2	25.6	34.3	4.8
Extraordinary Items (EO)	0	4,910	4,399	0	0
<b>PAT after EO</b>	<b>2,354</b>	<b>1,214</b>	<b>3,294</b>	<b>10,336</b>	<b>10,837</b>
Change (%)	130.1	-48.4	171.5	213.7	4.8

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
Share Capital	208	1,213	1,214	1,217	1,217
Share Premium	283	2,293	2,303	2,303	2,303
Reserves	5,664	5,679	9,055	23,520	37,652
<b>Net Worth</b>	<b>6,154</b>	<b>9,185</b>	<b>12,572</b>	<b>27,040</b>	<b>41,172</b>
Minority Interest	0	116	111	111	111
Loans	0	133	300	295	620
<b>Capital Employed</b>	<b>6,155</b>	<b>9,434</b>	<b>12,983</b>	<b>27,445</b>	<b>41,903</b>
Gross Block	4,580	6,245	7,457	10,292	12,498
Less : Depreciation	1,880	2,403	3,101	4,369	4,493
<b>Net Block</b>	<b>2,700</b>	<b>3,842</b>	<b>4,356</b>	<b>5,923</b>	<b>8,006</b>
CWIP	198	579	1,640	300	300
Investments	1,505	979	633	2,633	4,633
<b>Curr. Assets</b>	<b>5,578</b>	<b>10,395</b>	<b>15,562</b>	<b>27,271</b>	<b>42,873</b>
Debtors	4,377	8,216	10,965	14,325	16,365
Cash & Bank Balance	760	631	976	12,370	23,863
Loans & Advances	441	1,158	2,121	576	2,645
Other Current Assets	0	390	1,500	0	0
<b>Current Liab. &amp; Prov</b>	<b>3,938</b>	<b>6,435</b>	<b>9,268</b>	<b>8,621</b>	<b>13,701</b>
Creditors	1,836	4,899	6,505	5,871	9,225
Provisions	2,102	1,536	2,763	2,750	4,476
<b>Net Current Assets</b>	<b>1,640</b>	<b>3,960</b>	<b>6,294</b>	<b>18,650</b>	<b>29,172</b>
Deferred tax liability	112	74	60	-60	-207
Misc. Expenses	0	0	0	1	1
<b>Application of Funds</b>	<b>6,155</b>	<b>9,434</b>	<b>12,983</b>	<b>27,445</b>	<b>41,903</b>

E: MOST Estimates

RATIOS					
Y/E MARCH	2006	2007	2008	2009E	2010E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>22.6</b>	<b>50.5</b>	<b>63.4</b>	<b>84.9</b>	<b>89.0</b>
<b>Diluted EPS</b>		<b>46.4</b>	<b>58.3</b>	<b>78.4</b>	<b>82.2</b>
Cash EPS	26.5	54.8	33.7	94.0	99.2
Book Value	59.2	75.8	103.6	222.2	338.3
DPS	9.2	15	2.8	5.7	6.4
Payout %(Incl.Div.Taxes)	50.3	3.4	5.2	7.6	9.2
<b>Valuation (x)</b>					
P/E		8.3	6.6	4.9	4.7
P/E - Diluted		9.0	7.2	5.3	5.1
Cash P/E		7.6	12.4	4.5	4.2
EV/EBITDA		6.8	6.1	3.1	2.1
EV/Sales		1.7	1.3	0.8	0.5
Price/Book Value		5.5	4.0	1.9	1.2
Dividend Yield (%)		0.4	0.7	1.4	1.5
<b>Profitability Ratios (%)</b>					
RoE	38.2	66.7	55.9	37.5	34.5
RoCE	38.2	65.5	54.5	37.3	34.4
<b>Turnover Ratios</b>					
Debtors (Days)	129	102	106	109	110
Fixed Asset Turnover (x)	2.7	4.7	5.1	4.6	4.3
<b>Leverage Ratio</b>					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
CF from Operations	2,822	1,445	3,022	11,742	15,139
Cash for Working Capital	-1,474	-2,294	-1,472	3,037	777
<b>Net Operating CF</b>	<b>1,347</b>	<b>-849</b>	<b>1,550</b>	<b>14,780</b>	<b>15,916</b>
Net Purchase of FA	-1,991	-2,046	-2,273	-820	-2,207
Net Purchase of Invest.	126	602	846	-1,614	-1,496
<b>Net Cash from Invest.</b>	<b>-1,865</b>	<b>-1,444</b>	<b>-1,427</b>	<b>-2,434</b>	<b>-3,702</b>
Inc./(Dec) in Equity & other r	134	3,014	12	3	0
Proceeds from LTB/STB	0	194	210	-188	298
Dividend Payments	-142	-1,044	0	-759	-1,012
<b>Cash Flow from Fin.</b>	<b>-7</b>	<b>2,164</b>	<b>222</b>	<b>-945</b>	<b>-714</b>
Free Cash Flow	-646	-3,011	-723	14,919	12,303
<b>Net Cash Flow</b>	<b>-525</b>	<b>-128</b>	<b>344</b>	<b>11,401</b>	<b>11,500</b>
<b>Opening Cash Balance</b>	<b>1,285</b>	<b>759</b>	<b>631</b>	<b>976</b>	<b>12,377</b>
Add: Net Cash	-525	-128	344	11,401	11,500
<b>Closing Cash Balance</b>	<b>759</b>	<b>631</b>	<b>976</b>	<b>12,377</b>	<b>23,877</b>



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**Tech Mahindra**

- |   |    |
|---|----|
| 1. Analyst ownership of the stock                       | No |
| 2. Group/Directors ownership of the stock               | No |
| 3. Broking relationship with company covered            | No |
| 4. Investment Banking relationship with company covered | No |

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