

Company

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Tech Mahindra (TEML.BO)

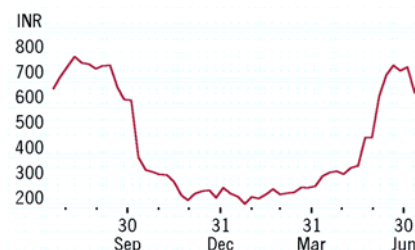
Equity

Sell: Core Challenging; Satyam Holds the Key

- Operationally inline; Profit affected by interest cost** — Revenues at \$228m were up ~8% qoq (~2% in constant currency) while operating margin was down ~180bps (CIRA: \$222m & decline of ~150bps respectively). Profits were affected by interest cost of Rs571m and higher forex loss (swing of Rs339m qoq in other income). Management believes that despite the economic challenges, the first signs of revival in business are visible.
- Challenges in BT continue** — Core BT business continues to remain under pressure as BT is not making new investments. The decline here is also visible in other vendors. However, the two new BTGS contracts started ramping and made up for this decline leading to flattish revenues qoq. There is pricing pressure as well as scope changes happening in these two contracts.
- Satyam update** — After TechM took over, there has not been any significant client attrition. Management believes that: (1) business has bottomed – growth should return, (2) it is possible to further cut costs and (3) pricing is inline with industry and in some cases better due to ERP consulting kind of work.
- Highlights from the earnings call** — (1) Forex hedges of £290m and \$700m. (2) Debt on books Rs23.8b taken for the Satyam acquisition. (3) Cash balance of ~\$40m. (4) Rs85m of exceptional item due to the closure of Servista where TechM had made an investment. (5) OCI loss at ~\$16m.
- Maintain Sell** — Our estimates currently do not factor in the interest cost for the debt – will be updating the same shortly. TechM stock has had a good run in the recent past – future performance will depend on Satyam-related news flow given that the core business is still challenging.

Sell/High Risk	3H
Price (22 Jul 09)	Rs770.15
Target price	Rs640.00
Expected share price return	-16.9%
Expected dividend yield	0.0%
Expected total return	-16.9%
Market Cap	Rs93,856M
	US\$1,946M

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



Statistical Abstract

Year to	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
31 Mar							
2007A	1,213	9.82	-46.4	78.5	9.1	15.8	0.2
2008A	3,300	25.19	156.6	30.6	7.4	30.3	0.7
2009E	10,146	78.14	210.2	9.9	4.2	58.5	0.5
2010E	8,139	63.21	-19.1	12.2	3.1	31.1	0.0
2011E	8,263	64.17	1.5	12.0	2.5	24.2	0.5

Source: Powered by dataCentral

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Result Tables

Figure 1. Key Financials

Rs m	1Q09	4Q09	1Q10	QoQ	YoY
Revenue (US\$ m)	272	212	228	7.7%	-16.3%
Revenue	11,164	10,513	11,130	5.9%	-0.3%
Cost of revenue	6,825	6,114	6,838	11.8%	0.2%
Gross profit	4,339	4,399	4,292	-2.4%	-1.1%
Gross margin	38.9%	41.8%	38.6%	-328bp	-30bp
Operating expenses	1,470	1,557	1,487	-4.5%	1.2%
EBITDA	2,869	2,842	2,805	-1.3%	-2.2%
EBITDA margin	25.7%	27.0%	25.2%	-183bp	-50bp
Dep. & amortization	258	286	296	3.5%	14.7%
EBIT	2,611	2,556	2,509	-1.8%	-3.9%
EBIT margin	23.4%	24.3%	22.5%	-177bp	-84bp
Profit before tax	2,870	2,611	1,677	-35.8%	-41.6%
Income tax expense	283	306	268	-12.4%	-5.3%
Income from operations	2,587	2,305	1,409	-38.9%	-45.5%
EO income/(loss)	0	0	-85	NA	NA
Net profit	2,587	2,305	1,324	-42.6%	-48.8%
Recurring EPS - basic	21.28	18.95	11.51	-39.3%	-45.9%
Recurring EPS - fully diluted	19.83	17.90	10.84	-39.4%	-45.3%

Source: Company Reports

Figure 2. Revenue Mix

	1Q09	2Q09	3Q09	4Q09	1Q10
Geography wise					
North America	22%	23%	26%	30%	29%
Europe	72%	69%	65%	62%	61%
Rest of World	6%	8%	9%	8%	10%
Delivery location wise					
Onsite	40%	40%	40%	39%	38%
Offshore	60%	60%	60%	61%	62%

Source: Company Reports

Figure 3. Client Metrics

	1Q09	2Q09	3Q09	4Q09	1Q10
No. of active clients	110	110	110	108	110
Client relationship size					
> US\$ 1m	44	45	46	44	47
> US\$ 2m	29	30	29	31	29
> US\$ 5m	12	14	14	13	15
> US\$ 10m	7	8	8	8	8
> US\$ 15m	6	7	7	7	8
> US\$ 20m	4	4	4	4	4
> US\$ 25m	3	4	4	4	4
> US\$ 50m	2	2	2	2	2
Client concentration					
Top client	63%	60%	57%	52%	52%
Top 5	84%	82%	79%	78%	78%
Top 10	90%	89%	87%	84%	86%

Source: Company Reports

Figure 4. HR and Execution Metrics

	1Q09	2Q09	3Q09	4Q09	1Q10
Total headcount	24,369	25,135	25,429	24,972	25,482
- IT delivery	19,386	20,273	20,779	20,060	20,227
- net add	956	887	506	-719	167
- BPO delivery	3,882	3,734	3,527	3,769	4,189
- net add	437	-148	-207	242	420
- Sales & Support	1,101	1,128	1,123	1,143	1,066
Utilization	74.0%	69.0%	67.0%	70.0%	71.0%

Source: Company Reports

Tech Mahindra

Company description

One of India's top 10 IT Services providers focusing on the telecom space, Tech Mahindra (TechM) services Telecom Service Providers (TSPs), Telecom Equipment Manufacturers (OEMs), Software Vendors (ISVs) and Systems Integrators (SIs). It was formed in 1986 as a JV between M&M and British Telecom (BT). Key clients include BT, AT&T, Alcatel, Alltel, Convergys, Motorola, O2 and Vodafone. TechM is headquartered at Pune with development centres across India and a few centers in the UK. TechM is the only Indian player among the top 10 BSS vendors worldwide, as ranked by Gartner Dataquest.

Investment strategy

We rate TechM Sell/High Risk (3H) based on a fundamental 12-month view. With high exposure to the telecom domain, TechM is likely to be affected by deteriorating fundamental trends in the telecom vertical. We expect revenue and EPS CAGRs of ~6% and ~3% respectively over FY08-11E (muted compared to 59% and 87% respectively that it delivered over FY05-08A). The stock remains cheap on valuations but so is the sector given the sharp de-rating over the last year due to concerns about demand visibility.

Valuation

With revenue and earnings slowing, we believe TechM should trade closer to mid-cap multiples. Our target price of Rs640 is based on 10x the average FY10-11E EPS, which is towards the lower end of its historic band of 3x-35x since its listing in Aug'06. We expect TechM's P/E to remain in line with the mid-caps primarily due to high client concentration risk. We believe P/E remains the most appropriate valuation measure given Indian IT companies' profitable track record and earnings visibility.

Risks

We rate TechM High Risk, in line with our quantitative risk-rating system. The key upside risks that could cause shares to exceed our target price are: 1) Any significant depreciation of the rupee against the USD/EUR/GBP; 2) A sharp upturn in IT spending among TSPs; 3) Sharp ramp-ups in BTGS deal; 4) Hiring rebounding in next few quarters; 5) Large deal announcement; and 6) Inorganic activity due to a stake sale or change in ownership.

Appendix A-1

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Analyst: Surendra Goyal, CFA
Covered since July 9 2007

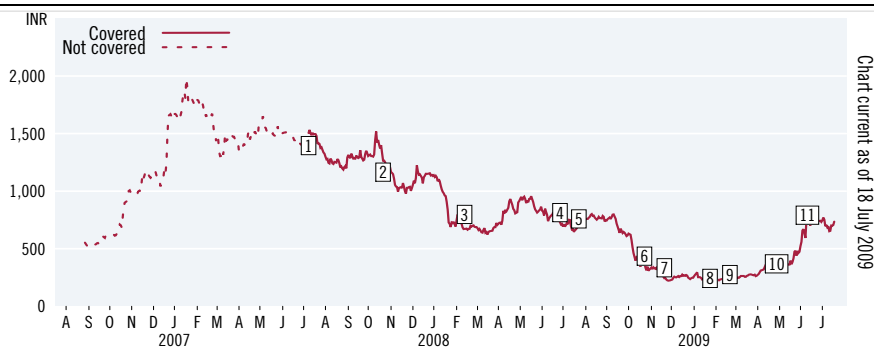


Chart current as of 18 July 2009

	Date	Rating	Target Price	Closing Price
1	9-Jul-07	*1H	*1,920.00	1,504.75
2	21-Oct-07	*3H	*1,330.00	1,329.45
3	13-Feb-08	3H	*730.00	672.10
4	26-Jun-08	3H	*815.00	730.10

	Date	Rating	Target Price	Closing Price
5	23-Jul-08	3H	*820.00	753.35
6	23-Oct-08	*2H	*500.00	376.10
7	20-Nov-08	2H	*310.00	243.50
8	23-Jan-09	2H	*245.00	210.15

	Date	Rating	Target Price	Closing Price
9	20-Feb-09	*3H	245.00	269.65
10	28-Apr-09	3H	*300.00	318.20
11	10-Jun-09	3H	*640.00	784.85

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2009

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