

Tech Mahindra Ltd

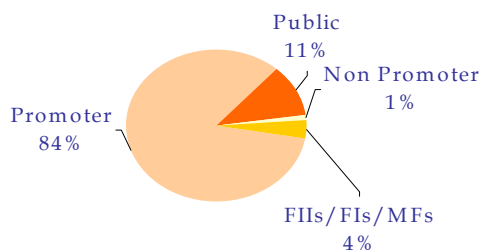
CMP Rs.1395

Target Rs: 1675

STOCK DATA

Sensex	14651
Nifty	4318
Bse Code	532755
Nse Code	TECHM
Bloomberg Code	TML@IN
Reuters Code	TEML.BO
Equity Cap	1212.50Mn
Mkt Cap	169774.30Mn
52 wk Hi / Low	Rs.2049/521
Avg Daily Vol(Wkly)	105213
Face Value	Rs10.00

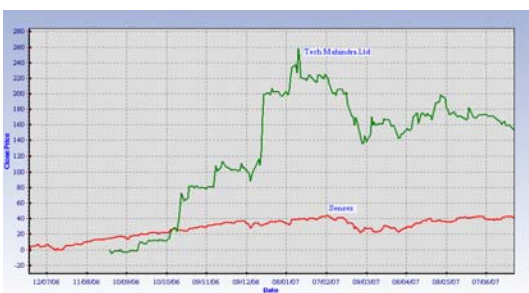
SHARE HOLDING PATTERN



Stock Performance (%)

	3Mths	6Mths	10Mths
Absolute	-2	-18	152
Relative	-16	-24	126

Price Movements Vs Sensex



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Tech Mahindra Ltd, a global leader in providing IT services and solutions to the Telecom Industry, is one of the largest offshore vendor in the Telecom Service Provider (TSP) segment TML's deep domain expertise in Operation Support System (OSS) & Business Support System (BSS), Intellectual leadership and a global workforce gives it an edge to serve the leading players in the telecom ecosystem. TML provides a wide variety of services ranging from IT strategy & consulting to system integration, design, application development, implementation, maintenance and product engineering. TML has built long-term sustainable relationships with its telecom clients.

Investment Highlights

Positive Industry Environment

TML is exclusively focused on the Telecom sector, one of the fastest growing verticals in the offshore IT services space. Reports indicate, that significant increases in the IT spend in the Telecom space is anticipated.

Deep client relationship with equity stake

The top two clients, BT and AT&T have stakes in TML that attractively positions it to sustain business growth from these customers. While delivery expertise is obviously required, client's stake in the company turns out to be a benefiting factor for TML for sustaining the flow of work from them.

Deep domain expertise in Telecom vertical

TML has strong expertise & execution experience in the telecom space owing to its erstwhile parent BT. Close relationship with BT has helped TML, build expertise across all service lines in the TSP segment.

Unique Business model

TML is penetrating its services into BT's client. After having bagged end to end operations of a virtual bank, the company is looking at other financial services, healthcare, retail & Government sectors

High Growth potential in Key Clients

AT&T, second largest client of TML, offers significant potential for growth, given recent spat of mergers it has undergone with. AT&T is approximately 3times the size of BT. BT accounts for over 63% of TML's revenue, while AT&T contributes only 10% of TML's revenue, thereby indicating a huge growth potential. To drive cost synergies, AT&T is expected to consolidate IT systems across all the merged entities, representing good opportunities for TML.

Revenue Visibility

The billion \$ deal with BTGS has enhanced, TML's revenue visibility. Revenue commitment from strong global brands reaffirms TML's "Strong Player" image.

Financial Snapshot

(Rs in Millions)

Particulars	FY2006	FY2007	FY2008E	FY2009E
Revenue from Services	12399	29290	44147	67598
EBIDTA	2651	7366	10569	14606
EBIDTA (%)	21.38%	25.15%	23.94%	21.61%
PAT	2354	6126	8707	12148
PAT(%)	18.98%	20.92%	19.72%	17.97%
Diluted EPS	18.11	47.12	66.98	93.44
ROCE (%)	43.38%	73.72%	67.33%	65.24%
ROE (%)	38.25%	66.70%	59.42%	57.53%
P/E x	77	30	21	15
EV/EBIDTA x	63.50	22.89	15.73	11.05

Source: company, Niche Research

BTGS “Barcelona” deal (\$ 1 billion)

TML signed a strategic five-year deal to provide sourcing services to BT Global Services (BTGS). The deal involves servicing the global external client base of BTGS in the area of managed network services. With this deal, TML has become the preferred vendor for BTGS, presenting immense opportunity for it to penetrate. Until this deal TML was serving BT's internal requirement and now has moved ahead to serve BT's external customers as well. The contract is expected to create new revenues for TML, in excess of \$1 billion over the period and is also the single largest deal ever won by an Indian company. Both companies will work together on creating and operating a global delivery organization, by leveraging and augmenting TML's existing delivery centers, to achieve greater flexibility and efficiencies in addressing BTGS's client requirements.

Key Clients

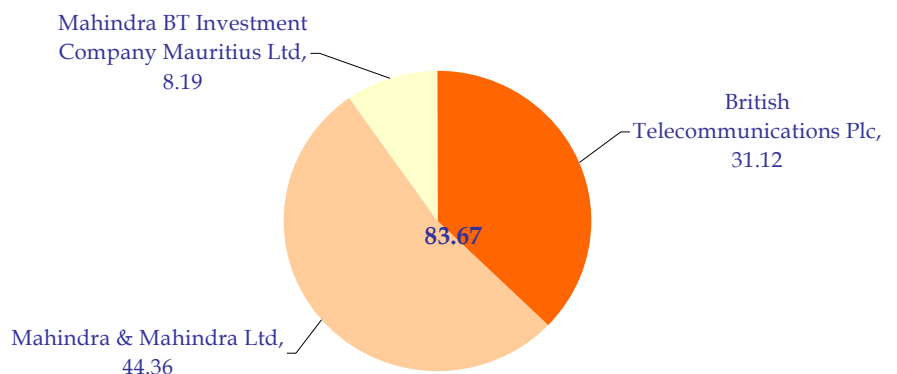
British Telecom (BT)

BT, TML's largest client accounted for 64% of its revenue in FY07. The association of BT & TML goes as long as 20 years. Over the years TML has transformed from BT's offshore supplier of IT services to its strategic partner. TML is the key technology partner to various BT programs like 21CN, 21C Global Venture, Openreach & COTS. TML handles around 50% of the total outsourced services of BT. TML is a strategic partner in BT's 21CN initiative providing OSS solution & testing services. BT holds 31.12% stake in TML, thereby further cementing their relationship.

AT&T

AT&T, second largest client of TML, makes up for approximately 10% of TML's revenue. Engagement with AT&T is in the area of development, testing, maintenance, support, operations & consultancy services. TML is engaged with AT&T in its organization wide initiatives through TML's offshore delivery model. The contract with AT&T is effective until December 2009. AT&T has been granted options of approximately 9.9 million shares, which would be materialized if TML achieves its targeted revenue from AT&T, after which AT&T would have approximately 8% stake in TML. These shares are currently held by TML's promoter group company based in Mauritius.

Holding Structure of Promoter Group



Source:Capitalline

Business Overview

TML's services are focused on clients in the Telecommunication Industry. It provides a wide variety of services ranging from IT strategy, Managed Services and Consulting to System Integration, Application Development & Maintenance, and Product Engineering & Lifecycle Management. TML's clients can be broadly classified into the following segments:-Telecommunication Service Provider (TSP), Telecommunication Equipment Manufacturer (TEM) & Independent Service Vendor (ISV). TSP accounts for over 90% of TML's business. Some of its Telecom specific offerings are

Operating Support System (OSS)

TML offers solutions related to actual operations of the network. It includes systems & process design, development, integration, performance management & fault management.

Business Support System (BSS)

BSS offering of TML covers general business functions of the Telecom operator such as CRM, customer billing, order management, mediation, revenue assurance, settlement solutions, fraud management & business intelligence. TML provides integrated software that covers several of the above services.

Next Generation Network (NGN)

TML provides solutions to mobile operators to upgrade their network to data intensive 3G network. The service is quite intensive involving designing & executing solutions for functions such as network management, provisioning billing & other CRM elements.

Security

TML offers solutions to assess the position of TSP's information security in comparison with global standards. They also develop Information Management System to maintain confidentiality of the data carried by the operator's network.

Embedded solutions

TML provides solutions that is embedded in mobile handsets & set top boxes.

Product engineering solutions

TML provides product engineering solutions across the entire technology spectrum for Telecom network. It also provides product lifecycle management for switching & signaling network elements.

Network Designing & Engineering

TML offers solutions relating to issues on efficiency, reliability, sensitivity etc owing to design related problems. It also tests whether the implementation of a particular application would have a negative impact on other installed implementations

Mobility Solutions

It provides Value- Added Services (VAS) to the telecom operators. It's a leading supplier of content delivery servers to the operators. TML works with TSPs to identify attractive VAS opportunities that are delivered via multiple service delivery platforms.

BPO

TML provides operation services to TSPs. It covers areas like billing, order provisioning, first line application support, network digitization, technical help desk solutions, etc

BPM

TML through its BPM provides business process management to TSP. It offers services like process mapping, modeling & simulation etc.

Macro Environment

Global Telecommunications Industry is currently driven by an increasing demand for modernizing legacy networks with next generation products and services. Offshore outsourcing has shown significant growth over the last several years and India has emerged as the leading destination for global corporations, delivering quality services and cost advantages. The list of companies outsourcing their IT requirements to offshore locations in India continues to increase, & so does their outsourcing budgets. India, given its implied advantages as an offshore destination, would continue to be the dominant player in the foreseeable future.

Telecom Service Provider (TSP)

Mobile Virtual Network Operators (MVNO)

The steps taken by the government have infused healthy competition in the telecom market. In the mobile services space too, the entry of MVNO's has changed the dynamics of the business. These operators lease their spectrum & network requirement from other operators. They enhance their cost efficiency by outsourcing their IT requirements. The traditional Telecom companies are also facing increasing competition from these MVNO's and the only way out for them is to give more efficient services by increasing their IT spend.

Network Upgradation (NGN)

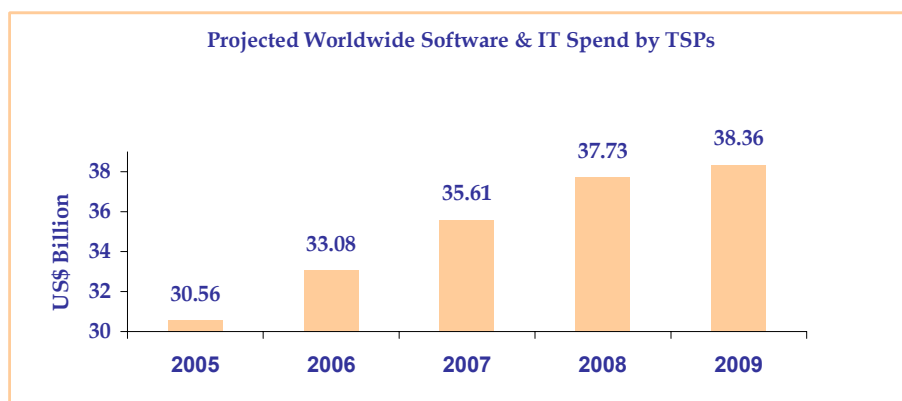
With the competition intensifying & fall in the ARPU (average revenue per user), the main priority of the TSP is to develop Value Added Services (VAS) which would differentiate their service from others, to retain existing clients along with attracting new ones. Major telecom companies are investing in the next generation converged networks that would offer voice, data and video over a single network. The mobile service providers are also upgrading their network to support next generation services. Further the high cost of maintenance of legacy network, also drives investment in NGN.

Increase in offshore trend

TSP on one count needs to drive up the stagnating ARPU and on the other, reduce cost to maintain profitability. The focus on NGN services also calls for TSPs to rationalize their legacy systems so that they can reduce the maintenance costs and open up investments in other profitable ventures. All these, makes a strong case for off shoring and TSPs are increasingly adopting it as the preferred route

Increase in IT expenditure

According to Ovum research, the IT Expenditure by TSPs was estimated to be around US\$30.6 billion in 2005 and is further expected to grow at a CAGR of 5.8% to US\$38.4 billion in 2009.



Source: Company RHP

Telecom Equipment Manufacturer (TEM)

TEM's are facing severe competition, with the embedded software, being the only differentiating element amongst various players. TEM's also plays a important role in deployment of NGN as they provide network equipment such as switches and advanced handsets, which can support these services. TEM prefers off shoring their IT needs to reduce costs & to maintain margins.

TEM's spends around 10 -15% of their revenue on R&D and a sizable proportion is attributable to software & IT services. According to Datamonitor research the revenue of TEM's are expected to grow from US\$299 billion in FY05 to US\$348 billion in FY09 implying a CAGR of 3%. However the future growth rate in TEM segment is expected to be lower than the growth rate in the TSP segment.

Investment Concerns

Client concentration

Despite client diversification, growth in BT and AT&T is the key for sustaining TML's growth momentum. Revenue from BT accounts for over 64% of TML's, revenue. Top 5 clients & Top 10 clients constitute over 83% & 89% of its revenue, respectively. If these clients are negatively impacted by developments in Telecom market or if it faces decline in customer demand for its services it would be forced to reduce it's spending on IT services. Downward shift in the demand from its top clients will impact company's performance adversely. Hence TML's growth remains critically dependent on its key clients. High dependence on few clients exposes TML to business risks of those clients

Single vertical focus

TML's services are exclusively for the Telecom Industry & hence it is highly exposed to the ups & downs of the telecom cycle. Any negative developments in this industry will hit the company's performance directly. It must be viewed that the growth story would continue as long as the IT spends by global telecom sector remains strong.

Retention of Management Team

The new management team has transformed TML in terms of growth & margins. However the long term commitment of the management team post vesting their ESOP is a matter of concern.

Salary Hike

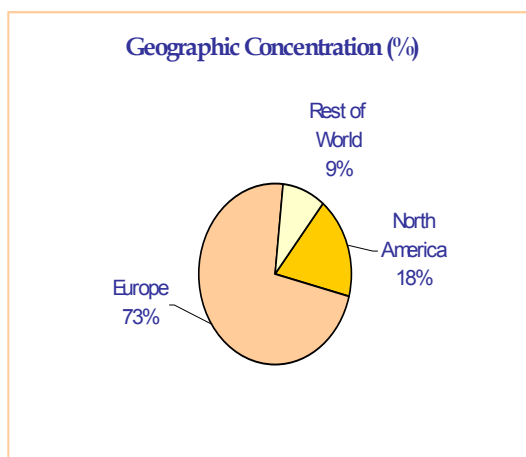
Average salary for the Indian IT sector is on a rise. TML faces sector wide risks of margin pressure from higher than expected salary hike. Industry expectations for the hike in salary for FY08 are around 15%.

High Geographic Concentration

High client concentration has led to high geographic concentration. Around 73% of TML's revenue arises out of Europe. Any economic slowdown in Europe will have a more than proportionate, adverse impact on TML's business

Increase in Competition

TML is likely to face heightened competition from domestic frontline peers or global players such as Accenture, HP and IBM. In the domestic market although it has a very small presence but it competes with the likes of Infosys, TCS, Wipro etc.

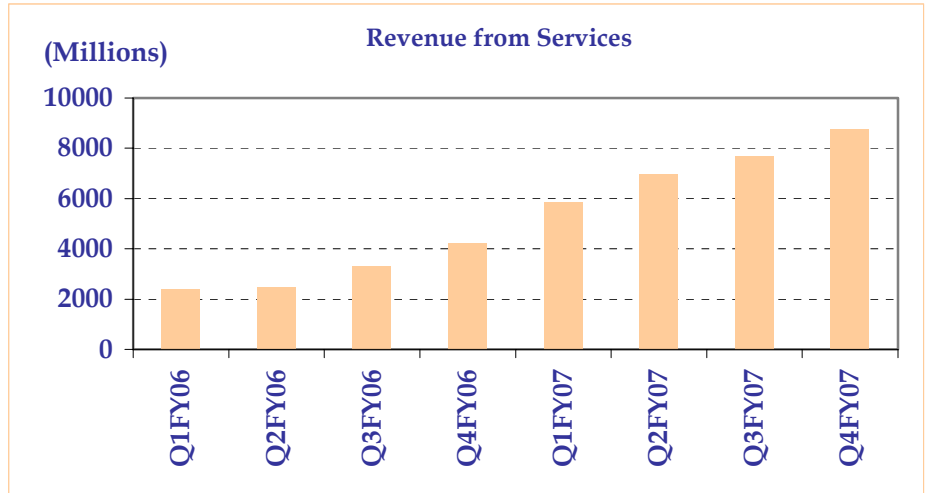


Source: Company

Performance Overview

Sharp rise in revenue

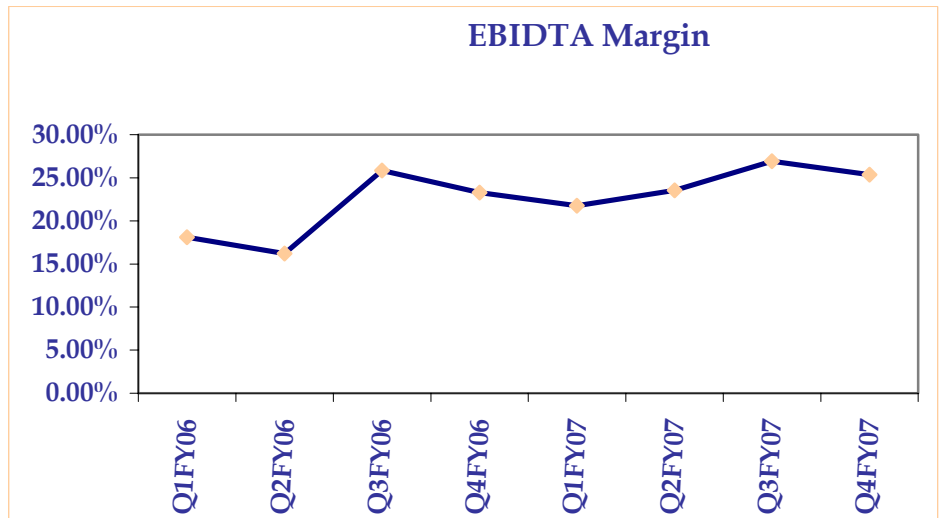
TML witnessed a huge surge in revenue wherein it increased from 2419m in Q1FY06 to 8745m in Q4FY07. Increase in revenue can be attributed to strong revenue commitments from TML's key clients & enhancement in TML's service portfolio.



Source: Company/Niche Research

EBIDTA margin

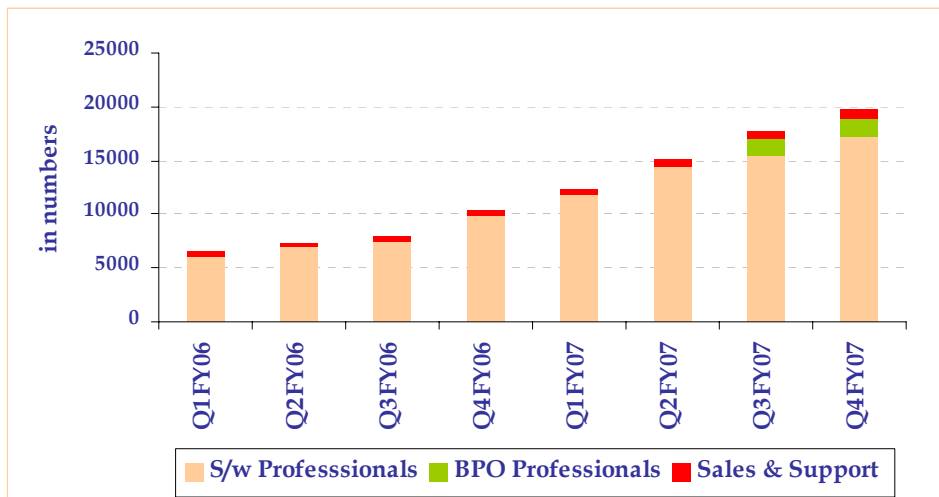
TML's EBIDTA margin has been on a rising trend. It has risen from 18.11% in Q1FY06 to 25.36% in Q4FY07. Efficiency in managing the operational expenditure has been the main contributor to this. During that period Operational cost in terms of sale has come down from 81.89% to 74.64%. However going forward, we see margin pressure for the coming two quarters.



Source: Niche Research

Employee addition

Total Employee count of TML has risen from 6598 in Q1FY06 to 19749 in Q4FY07. The employee ramp up clearly indicates company's growing business. TML's Management has indicated huge employee addition for FY08.



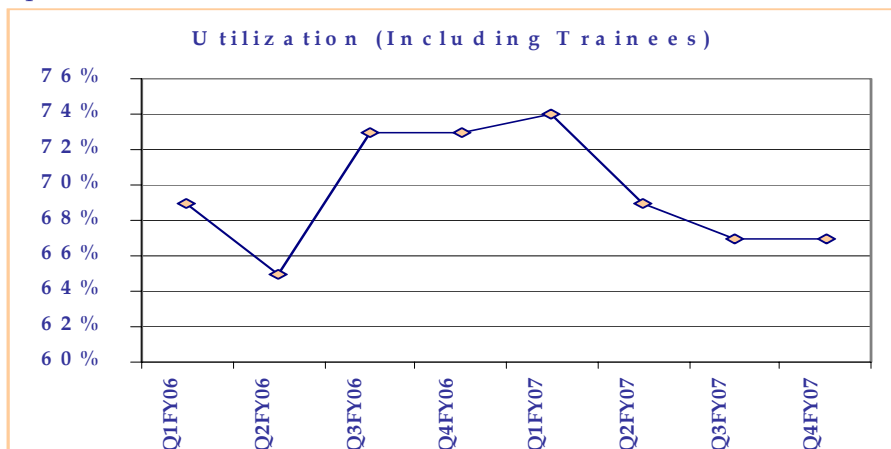
Source: Company

	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07
S/w Professionals	6131	6862	7537	9875	11721	14413	15527	17181
BPO Professionals	0	0	0	0	0	0	1542	1755
Sales & Support	467	399	447	618	645	667	705	813
Total Head Count	6598	7261	7984	10493	12366	15080	17774	19749

Source: Company

Utilization Rate (Including Trainees)

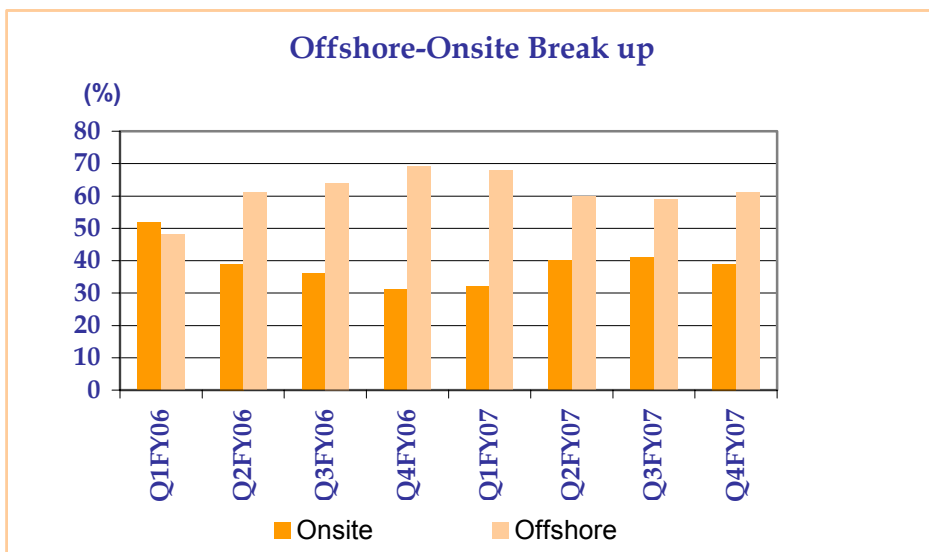
The trend in utilization remains mixed. It improved from 69% in Q1FY06 to 74% in Q1FY07 & gradually came down to 67% in Q4FY07. We believe that this is due to the huge intake of employees, especially freshers. The utilization rate excluding trainees should be higher. TML has also been building up bench strength to handle large deals. Going forward we expect the utilization rate to improve.



Source: Company

Offshore/ Onsite mix

TM's offshore share ranged from 61% in Q1FY06 to 59% in Q4FY07, correspondingly the onsite share oscillated between 39% to 41%.



Source: Company

Quality Clients

Client distribution of TM has improved considerably. Total Active clients have increased from 49 in Q1FY06 to 83 in Q4FY07. FY07 witnessed increase in Active clients by 18.

	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07
No of Active Clients	49	49	57	62	65	70	78	83
≥ \$1 million client	13	14	14	14	17	17	22	29
≥ \$2 million client	7	7	7	9	10	12	15	18
≥ \$5 million client	2	3	4	6	7	8	8	8
≥ \$10 million client	1	1	2	2	5	5	5	6
≥ \$15 million client	1	1	1	2	3	4	4	4
≥ \$20 million client	1	1	1	2	2	3	3	3
≥ \$25 million client	1	1	1	1	2	2	2	2
≥ \$50 million client	1	1	1	1	1	1	1	2

Source: Company

Valuations

We are overweight on TML, based on our analysis of financial & non financial parameters of the company. At the CMP, TML trades at a P/E multiple of 30 & EV/ EBIDTA of 22.89 on FY07 earnings. The PEG ratio on FY07 earnings stands at 0.71. At the set Target price, the valuation ratios of TML on estimated earnings of FY08 & FY09 looks as follows

	FY08E	FY09E
P/E	25	18
EV/ EBIDTA	18.95	13.37

Source: Niche Research

We set a Price Target of Rs.1675, considering TML's unique business model, enhanced revenue visibility & growth potential in revenue from its key clients.

Consol Income Statement				
(Rs.in Million.) (YE March)	FY2006	FY2007	FY2008E	FY2009E
Revenue from services	12399	29290	44147	67598
Growth (%)	31.11%	136.24%	50.72%	53.12%
Personnel exp	5624	11093	17252	27994
Operating & Other Expenses	4124	10832	16326	24998
Cost of services	9748	21924	33578	52992
EBIDTA	2651	7366	10569	14606
Depreciation	397	515	743	871
Interest	0	61	0	0
Other Income	368	77	69	69
PBT Before Exceptional Items	2621	6866	9894	13804
Margins (%)	21.14%	23.44%	22.41%	20.42%
Provisin For Tax	268	740	1187	1657
PAT	2354	6126	8707	12148
Margins(%)	18.98%	20.92%	19.72%	17.97%
Exceptional Item	0	5249	0.00	0.00
Minority Interest	0	1	0.00	0.00
Adj PAT	2354	876	8707	12148
Margins(%)	18.98%	2.99%	19.72%	17.97%
Before Exceptional Items				
EPS (Basic)	19.42	50.55	71.84	100.23
EPS (Diluted)	18.11	47.12	66.98	93.44
After Exceptional Items				
EPS (Basic)	19.42	7.23	71.84	100.23
EPS (Diluted)	18.11	6.74	66.98	93.44
FV	10	10	10	10
Cons Balance Sheet				
(Rs. In Million YE March)	FY2006	FY2007	FY2008E	FY2009E
Equity Capital	208	1212	1212	1212.00
Share Application Money	0	0	0	0
Reserves and Surplus	5946	7973	13442	19904
Shareholders funds	6154	9185	14654	21116
Secured Loans	0	100	0	0
Unsecured Loans	0	70	0	0
Total Loans	0	170	0	0
Deferred Tax Liability	-112	-74	-74	-74
Minority Interest	0	116	116	116
Capital Employed	6043	9397	14696	21158
Gross Block	4580	6245	8745	10245
Less: Depreciation	1880	2403	3146	4017
Net Block	2700	3842	5598	6228
CWIP	198	579	579	579
Investments	1505	979	979	979
Inventory	0	11	11	11
Receivables	4377	8216	12337	18891
Cash and Bank	760	668	2782	7716
Loans and Advances	539	1557	1557	1557
Current Assets	5676	10451	16687	28174
Payables	1836	4919	7378	11297
Other Liabilities and Prov.	2201	1536	1769	3505
Current Liabilities	4036	6455	9147	14802
Net Current Assets	1640	3997	7540	13372
Misc. Expenses not w/o	0	0	0	0
Capital Deployed	6043	9397	14696	21158

* Diluted Equity capital taken as 1300 million

Source : Company, Niche Research

Ratio Analysis				
	FY2006	FY2007	FY2008E	FY2009E
Cost Analysis				
Personnel Exp/Revenue from Services	45.36%	37.87%	39.08%	41.41%
Operating & Other Exp/Revenue from Services	33.26%	36.98%	36.98%	36.98%
Return Ratios (%)				
EBIDTA	21.38%	25.15%	23.94%	21.61%
PBT	21.14%	23.44%	22.41%	20.42%
PAT	18.98%	20.92%	19.72%	17.97%
Adj PAT	18.98%	2.99%	19.72%	17.97%
RoCE	43.38%	73.72%	67.33%	65.24%
RoE	38.25%	66.70%	59.42%	57.53%
Growth Ratios (%)				
Revenue from Services	31.11%	136.24%	50.72%	53.12%
EBIDTA	84.62%	177.91%	43.48%	38.20%
PAT	129.88%	160.27%	42.12%	39.52%
Adj PAT	129.21%	-62.79%	894.01%	39.52%
Per Share data				
EPS	19.42	50.55	71.84	100.23
Diluted EPS	18.11	47.12	66.98	93.44
CEPS	22.70	54.80	77.97	107.41
Cash & Bank	6.27	5.51	22.95	63.66
BV	50.78	75.78	120.91	174.22
DPS	8.58	2.20	28.74	40.09
Valuation Ratios (x)				
PE	77	30	21	15
CPE	61	25	18	13
EV/Market Cap	1.00	1.00	0.98	0.95
EV/Revenue from Services	13.58	5.76	3.77	2.39
EV/EBIDTA	63.50	22.89	15.73	11.05
EV/Adj PAT	71.51	192.45	19.10	13.28
CMP/BV	27.47	18.41	11.54	8.01
Dividend Payout (%)	44.16%	30.38%	40.00%	40.00%
Dividend Yield (%)	0.61%	0.16%	2.06%	2.87%
Turnover Ratios				
Revenue from Services/Total Assets (x)	2.05	3.12	3.00	3.19
Revenue from Services/Net Block (x)	4.59	7.62	7.89	10.85
RoA- Du Pont Analysis	38.95%	9.32%	59.25%	57.41%
Receivables turnover (days)	129	102	102	102
Payable turnover (days)	54	61	61	61
Work. Cap. (excl Cash) (days)	26	41	39	31
Other Key Ratios				
Debt-Equity Ratio	0.00	0.02	0.00	0.00
Debt- Assets Ratio	0.00	0.02	0.00	0.00
Current Ratio (x)	1.41	1.62	1.82	1.90
Quick Ratio (x)	1.41	1.62	1.82	1.90
Interest Cover (x)	0.00	113.25	0.00	0.00

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