

Equity | India | Computer Services  
08 May 2007

# Fundamentals to ride

## Tweaking estimates, Retain Buy

We are tweaking adjusted FY08 and FY 09 estimates by -4% and 1% to factor strong 4Q results and likely impact of rupee appreciation. We retain our Buy on Tech Mahindra Ltd (TML) with a PO of Rs 2125, given strong earnings CAGR of 45% on adjusted EPS basis and robust spend by Telecom service providers.

## Fresher hiring, Capex induces confidence

TML recruited 1,975 employees during the quarter and guided at fresher recruitments of 4,000 and 7,500 for FY08 and FY09. It has outlined capex spend of US\$100mn against ~US\$30mn during FY07, indicating robust growth plans ahead. Strong traction in its new initiatives, mainly infrastructure mgt, given its entry in AT&T account where ramp up opportunities are large.

## Post write-off, focus to shift to fundamentals

Management wrote off Rs5249mn during the quarter to factor in upfront payment to BT Global services. We have adjusted our EPS to factor in five year write-off, as valuations in our view are unlikely to be influenced by full 4Q write-off. However, investor focus could once again shift to fundamentals, which continue to be strong.

## Reasonable valuation, Maintain Buy

Our PO of Rs2125 is at 0.7PEG (FY08PE to FY07-09e) vs our target PEG of ~1 for leading majors like Infosys, implying a target P/E of 21x. We believe this is fair given sharp earnings growth of 45% (FY07-09e), robust IT spends by telecom service providers and increasing trend in offshoring.

## Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	1,055	2,422	6,126	9,894	13,842
EPS	8.11	18.63	47.12	76.10	106.47
EPS Change (YoY)	43.7%	129.6%	152.9%	61.5%	39.9%
Dividend / Share	2.20	10.00	10.06	15.72	21.45
Free Cash Flow / Share	18.26	8.95	36.42	34.20	70.37

## Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	200.22x	87.21x	34.48x	21.35x	15.26x
Dividend Yield	0.135%	0.615%	0.619%	0.967%	1.32%
EV / EBITDA*	143.09x	71.95x	26.83x	16.81x	11.96x
Free Cash Flow Yield*	0.938%	0.470%	2.24%	2.18%	4.59%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.



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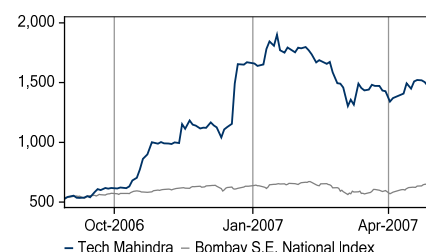
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## Stock Data

Price	Rs1,625
Price Objective	Rs2,125
Date Established	23-Jan-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs365.00-Rs2,050
Mrkt Val / Shares Out (mn)	US\$4,842 / 121.8
Average Daily Volume	294,656
ML Symbol / Exchange	TMHAF / BSE
Bloomberg / Reuters	TECHM IN / TEML.BO
ROE (2007E)	90.5%
Net Dbt to Eqty (Mar-2006A)	-12.3%
Est. 5-Yr EPS / DPS Growth	25.0% / 25.0%
Free Float	12.5%



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Refer to important disclosures on page 9 to 10. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

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# *iQprofile*<sup>SM</sup> Tech Mahindra Ltd.

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
<b>(Rs Millions)</b>					
Sales	9,456	12,427	29,291	46,643	64,203
Gross Profit	5,480	6,803	18,198	27,622	37,325
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	1,060	2,349	6,852	10,969	15,284
Net Interest & Other Income	85	340	15	162	350
Associates	NA	NA	NA	NA	NA
Pretax Income	1,146	2,690	6,867	11,131	15,634
Tax (expense) / Benefit	(91)	(268)	(741)	(1,238)	(1,793)
Net Income (Adjusted)	1,055	2,422	6,126	9,894	13,842
Average Fully Diluted Shares Outstanding	130	130	130	130	130

## Key Cash Flow Statement Data

Net Income (Reported)	1,055	2,422	6,126	9,894	13,842
Depreciation & Amortization	321	397	516	790	1,235
Change in Working Capital	1,082	(1,495)	(1,260)	(2,358)	(2,186)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(51)	2	0	0	0
Cash Flow from Operations	2,407	1,326	5,382	8,325	12,891
Capital Expenditure	(549)	(395)	(945)	(4,019)	(3,807)
(Acquisition) / Disposal of Investments	(662)	(1,598)	0	0	0
Other Cash Inflow / (Outflow)	48	128	0	0	0
Cash Flow from Investing	(1,164)	(1,865)	(945)	(4,019)	(3,807)
Shares Issue / (Repurchase)	16	134	1,730	0	0
Cost of Dividends Paid	(412)	(142)	(1,403)	(2,266)	(3,170)
Cash Flow from Financing	(396)	(7)	327	(2,266)	(3,170)
Free Cash Flow	1,857	931	4,437	4,306	9,084
Net Debt	(1,285)	(760)	(275)	(2,496)	(8,410)
Change in Net Debt	(847)	546	(4,765)	(2,041)	(5,914)

## Key Balance Sheet Data

Property, Plant & Equipment	1,710	2,700	3,158	6,295	8,702
Other Non-Current Assets	1,183	1,703	1,703	1,703	1,703
Trade Receivables	2,212	4,377	7,463	11,884	16,359
Cash & Equivalents	1,285	760	455	2,496	8,410
Other Current Assets	377	552	552	602	652
Total Assets	6,767	10,092	13,332	22,981	35,826
Long-Term Debt	0	0	180	0	0
Other Non-Current Liabilities	NA	NA	NA	NA	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	1,906	3,938	5,776	7,976	10,150
Total Liabilities	1,906	3,938	5,956	7,976	10,150
Total Equity	4,861	6,154	7,377	15,004	25,676
Total Equity & Liabilities	6,767	10,092	13,332	22,981	35,827

## *iQmethod*<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	23.1%	43.9%	90.2%	87.8%	68.0%
Return On Equity	23.6%	44.0%	90.5%	88.4%	68.0%
Operating Margin	11.2%	18.9%	23.4%	23.5%	23.8%
EBITDA Margin	14.6%	22.1%	25.2%	25.2%	25.7%

## *iQmethod*<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	2.3x	0.5x	0.9x	0.8x	0.9x
Asset Replacement Ratio	1.7x	1.0x	1.8x	5.1x	3.1x
Tax Rate (Reported)	7.9%	9.9%	10.8%	11.1%	11.5%
Net Debt-to-Equity Ratio	-26.4%	-12.3%	-3.7%	-16.6%	-32.8%
Interest Cover	NA	NA	NM	NM	NA

## Key Metrics

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.

## Company Description

Set up as JV between M&M and British Telecom, Tech Mahindra is a leading offshore player with a focus on the telecom sector. It derives more than 60% of revenues from its top client, BT, and now is a strategic partner in BT's 21CN initiative. It was ranked 8th in terms of exports by Nasscom and derives more than 60% of revenues from offshoring.

## Stock Data

Price to Book Value 26.8x

## Retain Buy on Adjusted EPS basis

We have revised our adjusted EPS estimates for FY08 and FY09 by -4% and 1% to factor strong 4Q results and likely impact of appreciating rupee. We retain our Buy on the stock given strong earnings CAGR of 45% and robust fresher intake guidance for FY08 and FY09E.

Management wrote off Rs5249mn as an extraordinary item during 4Q FY07 results as against our expectation of a five year write-off. While upfront payment will not impact FY08 numbers, we believe valuations are unlikely to be influenced by the change in accounting of upfront payment.

**Accordingly, for valuation purposes** we have adjusted EPS estimates to factor in a five year write-off, given revenues from the deal are likely to flow in over the next five years.

Table 1: Estimate Revisions

	FY 08 old	FY 08new	Change (%) yoy	FY 09old	FY 09 new	Change (%) yoy
Sales	49,894.2	46,643	-7%	65,661	64,203	-2%
EBITDA	11,296.0	11,759	4%	15,407	16,519	7%
PAT	9,393.5	9,894	5%	12,850	13,842	8%
EPS	72.3	76.1	5%	98.9	106.5	8%
Adjusted ML						
EPS*	72.3	69.1	-4%	99.0	99.5	1%

Source: Merrill Lynch Research

Note : Adjusted EPS for valuation purpose to factor in five year expensing of BTGS payment

## In-line 4Q results

Table 2: Quarterly Analysis

Rs m	Q4 FY07	Q3FY07	QoQ	Q4 FY06	YoY	MLe	Var%
Net Sales	8745	7698	13.6%	4212	107.6%	8,391	4.2%
Personnel Cost	3091	2908	6.3%	1740	77.6%	3,173	-2.6%
Traveling Exps	1061	921	15.2%	579	83.2%	1,007	5.4%
Operating and Other Exps	2375	1796	32.2%	818	190.3%	2,014	17.9%
Cost of goods sold excld dep	6,527	5,625	16.0%	3,137	108.1%	6,194	5.4%
EBITDA	2,218	2,073	7.0%	1,075	106.3%	2,197	1.0%
Depreciation	158	137	15.3%	111	42.3%	141	11.9%
EBIT	2,060	1,936	6.4%	964	113.7%	2,056	0.2%
Other Income	154	-32	-581.3%	127	21.3%	35	340.0%
Interest	49	12	308.3%	1	-	51	-3.2%
PBT	2,165	1,892	14.4%	1,090	98.6%	2,040	6.1%
Tax	204	224	-8.9%	106	92.5%	231	-11.5%
PAT	1,961	1,668	17.6%	984	99.3%	1,810	8.4%
Profit before minority int./equity in earnings of affiliates	1,961	1,668	17.6%	984	99.3%	1,810	8.4%
Extraordinary Item- payment to BT GS	(5,250)	0		0		0	-
Reported profit	(3289)	1,668	-297.2%	984	-434.2%	1,810	-281.7%
Recurring Profit	1,961	1,668	17.6%	984	99.3%	1,810	8.4%
			bps		bps		bps
EBITDA margin	25.4%	26.9%	-157	25.5%	-16	26.2%	-82
EBIT margin	23.6%	25.1%	-159	22.9%	67	24.5%	-94
PAT margin	22.4%	21.7%	76	23.4%	-94	21.6%	86

Source: Company, Merrill Lynch Research

- Revenues grew by 14% qoq, ahead of MLe by 4%. Revenue growth was driven by both BT (17% qoq) and Non BT (7% qoq). Share of BT revenues stood at 67% vs 65% in the previous quarter.
- EBITDA margins declined by 157 bps, largely driven by increase in SG&A spend. SG&A spend increased by 165bps to 16% due to incurrence of a few one-time charges. Management expects SG&A to remain near 15% levels.
- Profits grew by 18% QoQ, largely driven by forex gains. Excluding Forex gains profit growth would have been in line with MLe.

## Financials

**Table 3: Profit & Loss Statement**

<b>Profit &amp; Loss Statement (Rs.mn)</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Revenues	9,456	12,427	29,291	46,643	64,203
Other income	85	340	76	170	350
Total Income	9,542	12,767	29,367	46,813	64,553
Personnel costs	3,976	5,624	11,093	19,020	26,878
Gross Profit	5,480	6,803	18,198	27,622	37,325
Operating and other exps	2,023	2,240	7,336	10,550	13,744
traveling exps	2,076	1,816	3,494	5,313	7,062
Total Expenditure	8,075	9,680	21,923	34,884	47,684
Operating profit	1,381	2,747	7,368	11,759	16,519
Depreciation	321	397	516	790	1,235
EBIT	1,060	2,349	6,852	10,969	15,284
Less Interest	0	0	61	8	0
EBT	1,060	2,349	6,791	10,961	15,284
PBT	1,146	2,690	6,867	11,131	15,634
Taxation	91	268	741	1,238	1,793
Net profits (adj)	1,055	2,422	6,126	9,894	13,842
Tax Write Back	0	0	339	0	0
Extra Ordinary	0	0	-5,249	0	0
Profit Reported	1,055	2,422	1,216	9,894	13,842
ML Adjusted Profit	1,055	2,422	6,126	8,987	12,935

Source: Company, Merrill Lynch Research

**Table 4: Balance Sheet**

<b>Sources of Funds : (Rs.mn)</b>	<b>FY05</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Share Capital	203	208	1,159	1,159	1,159
Reserves & Surplus	4,658	5,946	6,218	13,846	24,518
Total Shareholders Funds	4,861	6,154	7,377	15,004	25,676
Debt	0	0	180	0	0
Total Liabilities	4,861	6,154	7,557	15,004	25,676
Applications of funds					
Gross Block	2,867	4,580	5,525	9,543	13,350
Less: Accumulated Depreciation	1,156	1,880	2,366	3,248	4,648
Net Block	1,710	2,700	3,158	6,295	8,702
Capital Work in Progress	70	198	198	198	198
Investments (Liquid Mutual funds)	1,113	1,505	1,505	1,505	1,505
Current Assets, Loans & Advances					
Sundry Debtors	2,212	4,377	7,463	11,884	16,359
Cash and Bank	1,285	760	455	2,496	8,410
Loans and Advances	243	441	441	491	541
Total Current Assets	3,740	5,578	8,359	14,871	25,309
Less: Current Liabilities and Provisions					
Current Liabilities	1,290	1,836	3,604	5,734	7,838
Provisions	615	2,102	2,172	2,242	2,312
Total Current Liabilities & Provn	1,906	3,938	5,776	7,976	10,150
Net Current Assets	1,834	1,640	2,584	6,895	15,159
Deferred Tax Assets	134	112	112	112	112
Total Assets	4,861	6,155	7,557	15,005	25,676

Source: Company, Merrill Lynch Research

**Table 5: Cash Flows**

	FY05	FY06	FY07E	FY08E	FY09E
Net Profit Before taxation	1,115	2,621	6,867	11,131	15,634
Depreciation	321	397	516	790	1,235
Operating profit before working capital changes	1,348	2,858	7,383	11,921	16,869
Trade and Other receivables	523	-2,039	-3,086	-4,471	-4,524
Trade and Other Payables	559	543	1,838	2,201	2,174
Cash generated from Operations	2,430	1,362	6,123	9,563	14,683
Direct Taxes	-23	-36	-741	-1,238	-1,793
<b>Net Cash from Operating activities</b>	<b>2,407</b>	<b>1,326</b>	<b>5,382</b>	<b>8,325</b>	<b>12,891</b>
Cash flow from investing activities					
Purchase of Fixed Assets	-549	-395	-945	-4,019	-3,807
Acquisitions	0	-1,602	0	0	0
Others	48	128	-5,249	0	0
Cash used in investing activities	-1,164	-1,865	-6,194	-4,019	-3,807
<b>Cash used in investing activities (excl treasury)</b>	<b>-502</b>	<b>-1,869</b>	<b>-6,194</b>	<b>-4,019</b>	<b>-3,807</b>
Free Cash Flow	1,857	931	4,437	4,306	9,084
Proceeds from issue of shares (including share premium)	16	134	1,730	0	0
Dividend (including dividend tax paid)	-412	-142	-1,403	-2,266	-3,170
<b>Net cash used in financing activities</b>	<b>-396</b>	<b>-7</b>	<b>507</b>	<b>-2,266</b>	<b>-3,170</b>
Net increase in cash	847	-546	-304	2,041	5,914
cash at the beginning of the year	440	1,287	760	455	2,496
cash at the end of the year	1,287	741	455	2,496	8,410

Source: Company, Merrill Lynch Research

**Table 6: RATIOS**

Year Mar 31 (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
P/CEPS	157	78	149	25	18
P/BV (x)	44	36	33	16	10
EV/EBITDA (x)	186	94	35	22	15
EV/ Revenues	27	21	9	5	4
Growth %					
Revenue	27	31	136	59	38
EBITDA	54	99	168	60	40
EBIT	58%	122%	192%	60%	39%
Net Profit	44	130	153	62	40
Profitability %					
EBITDA	15	22	25	25	26
Net Profit	11	19	4	21	22
Return %					
RONW	24	44	91	88	68
ROCE	41	71	163	131	107
Per Share Data (Rs.)					
EPS -diluted	8	19	47	76	106
EPS- ML Adjusted	8	19	47	69	100
CEPS	14	27	14	85	117
BVPS	48	59	64	129	222
DPS	2	10	10	16	21
DSO	94	97	93	93	93

Source: Company, Merrill Lynch Research

## Price Objective Basis & Risk

Our PO of Rs2125 is at 0.7PEG (FY08PE to FY07-09e) vs our target PEG of ~1 for leading majors like Infosys, implying a target P/E of 21x, lower than Infosys' target multiple of 24x FY09e

Risks to our rating are rapid growth-related execution risks, high vertical (telecom) and client concentration (BT- 67% revenue). Industry-wide risks include growing competition, wage and attrition pressures and risk of rupee appreciation.

## Analyst Certification

I, Pratish Krishnan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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08 May 2007

## *iQmethod*<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	$\text{Net Debt} = \text{Total Debt, Less Cash \& Equivalents}$	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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## Important Disclosures

### TMHAF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of April 30, 2007 or such later date as indicated.

### Investment Rating Distribution: Technology Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	114	41.76%	Buy	21	20.39%
Neutral	146	53.48%	Neutral	31	22.79%
Sell	13	4.76%	Sell	1	9.09%

### Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

\* Companies in respect of which MLPS&S or an affiliate has received compensation for investment banking services within the past 12 months.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

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