

Tech Mahindra Ltd (Q3 FY08)

January 23, 2008

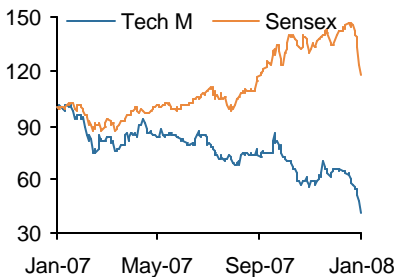
Stock data

Sensex:	17,594
CMP (Rs):	716
Target price (Rs):	-
Upside (%):	-
52 Week h/l (Rs):	1,842/615
Market cap (Rs cr)	8,664
6m Avg vol BSE&NSE ('000 nos):	232
No of o/s shares (mn):	121
FV (Rs):	10
Bloomberg code:	TECHM IN
Reuters code:	TEML.BO
BSE code:	532755
NSE code	TECHM

Shareholding pattern

December 2007	(%)
Promoters	83.0
FIs	1.0
Indian institutions	5.0
Public & others	11.0

Share price trend



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- Revenue growth in Q3 FY08 was strong but outlook remains hazy in key accounts.
- Employee matrix also indicates low near-term growth visibility.
- Company has clearly managed to keep EBITDA margin stable.
- Tech Mahindra is in an awkward position of uncertain near-term growth and declining profitability – Maintain SELL.

Result table

Period to	Q1 FY08	Q2 FY08	QoQ	YoY
(Rs mn)	(3)	(3)	(%)	(%)
Net sales	8,976	9,704	8.1	26.1
Total Expenditure	(7,004)	(7,575)	8.2	34.6
EBITDA	1,972	2,129	8.0	2.8
<i>EBITDA margin (%)</i>	22.0	21.9	-	-
Depreciation	(193)	(206)	6.7	50.4
Interest	(26)	(16)	-	-
Other income	249	300	20.5	(1037.5)
PBT	2,002	2,207	10.2	16.7
Tax	(187)	(213)	13.9	(4.9)
Income from Equity Affiliates	-	-	-	-
Minority Interest	2	1	(50.0)	-
PAT	1,817	1,995	9.8	19.7
Number of shares (Mn)	121.0	121.0	-	-
EPS (Rs)	15.0	16.5	9.8	19.7

Source: Company, India Infoline Research

Revenue growth in Q3 was strong but outlook remains hazy in key accounts

Tech Mahindra reported a strong dollar revenue growth of 11.4% qoq. However, the rupee growth was reduced to 8.1% qoq with sharp appreciation of rupee against the GBP and dollar. Revenues during the quarter included a one-time system integration business of US\$6mn. As forecasted in our earlier SELL note on the company dated 6th December 2007, the revenue growth in company's Top two accounts (BT and AT&T) was sluggish. Robust growth of 43% qoq was witnessed in non-Top 5 customers. Revenue growth of 17% qoq in the US was surprising.

The revenues from BT comprising two components, viz traditional business and the BTGS deal, grew at 4.5% qoq in dollar terms. Growth in the traditional business continued to be flat for third quarter in a row as re-organization within BT continues. Good traction was reported in the BTGS deal with the number of people involved increasing from about 500 to 700 since early December. The deal has a near term visibility of another 500 people.

Employee matrix also indicates low near-term growth visibility

The employee addition stood at a negligible 50 people for the company in the quarter. More importantly, there was a reduction of 440 people in software services indicating management's uncertainty about near term growth. Further, software manpower addition at 1,262 in 9m FY08 is lower by astonishing 78% yoy. Despite the above, company denied commenting on Q4 FY08 manpower additions thus failing to give any re-assurance about growth visibility. BPO had a healthy addition of 513 people in the quarter. Tech Mahindra continues to run at high attrition of 20-21%, which is another negative.

Company has clearly managed to keep EBITDA margin stable

EBITDA margin at 21.9% was stable qoq. The negative impact of sharp rupee appreciation was offset by significant jump in utilization driven by management's efforts. Company chose for lower employee addition for increasing utilization so as to maintain profitability. It intends to continue with this strategy in the near term but has expressed difficulty in maintaining EBITDA margin in future.

It has to be noted that Tech Mahindra has been relatively ineffective in defending cost pressures as indicated by the significant dip of 310 bps yoy in EBITDA margin in 9m FY08, which is worst amongst peers. Going ahead, with no significant pricing improvement recorded, slow growth momentum, attrition above 20% and near-exhaustion of key levers like utilization, Tech Mahindra would continue to struggle in maintaining EBITDA margin. Further, with company relatively laidback in creating SEZ infrastructure (no revenues from SEZ currently unlike peers), it would end paying higher taxes in FY10 further dampening profitability.

Tech Mahindra in an awkward position of uncertain near-term growth and declining profitability – Maintain SELL

Despite a sharp stock price correction of 36% since our SELL recommendation on 6th December 2007, we maintain a negative stance on the company and significantly downgrade earnings estimates of FY09 and FY10 by 8.3% and 18.9% respectively. We believe that material downgrade in street's estimates would follow along with a de-rating in valuation. Though after considerable drubbing (60% in last 12 months) a bounce-back in stock price is not ruled out, it should be used as an opportunity to exit.

Projected financials

y/e March (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
Revenues	12,427	29,290	37,729	48,286	61,359
yoy growth (%)	31.4	135.7	28.8	28.0	27.1
EBITDA	2,679	7,365	8,307	9,836	11,702
EBITDA margin (%)	21.6	25.1	22.0	20.4	19.1
Pre-exceptional PAT	2,354	6,125	7,498	8,439	8,272
yoy growth (%)	129.9	160.2	22.4	12.6	(2.0)
EPS (Rs)	22.6	50.5	61.9	69.6	68.2
P/E (x)	31.8	14.2	11.6	10.3	10.6
P/BV (x)	12.2	9.2	5.4	3.7	2.8
EV/EBITDA (x)	27.1	11.6	9.8	7.8	6.0
ROE (%)	42.7	79.3	59.2	42.5	30.2
ROCE (%)	47.6	88.7	65.1	47.4	40.5

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