

Sharp drop in margins and weak outlook at BT Fear of sharp cuts in BT revenues plays out earlier than anticipated

November 15, 2011

Rating Remains	Reduce
Target price Reduced from 620	INR 580
Closing price November 15, 2011	INR 618
Potential downside	-6.1%

Action: 5% q-q decline in BT & more likely to come; maintain Reduce

- Revenue from BT declined by 5% q-q in 2QFY12 on account of project closures. There appears to be severe pricing pressure in the BT business, as management has indicated that both revenue and margin would be impacted in the near-term despite Tech Mahindra having retained large portions of its business and gaining market share in the re-tendering process. We were earlier anticipating a ~10% decline in BT revenues in FY13F – which we now expect will occur in FY12F.
- 2Q results were disappointing operationally as the margin decline of 340bps q-q was sharper than our expectation. We maintain our Reduce on Tech Mahindra on account of 1) a weak near-term revenue and margin outlook; 2) the absence of a pickup in discretionary spending in Telecom; and 3) increasing skew in TechM's business mix towards the low-margin BPO/emerging markets business.

Valuation: Cutting multiple to 10x; TP reduced to INR580

We cut our TechM standalone EPS estimates by 21%/5% in FY12F/13F on account of an earlier-than-anticipated drop in BT revenues. Our FY13F EPS estimates are marginally higher on increased Satyam contribution stemming from the 2Q outperformance and a better margin outlook. We reduce our valuation multiple to 10x FY13F (from 11x) on 1) balance sheet deterioration; and 2) the likelihood of sustained margin pressure due to skew in the business mix. Our TP declines to INR580 (from INR620).

Catalyst: Sharper declines in BT business and no pickup in discretionary demand

31 Mar	FY11		FY12F		FY13F		FY14F	
	Actual	Old	New	Old	New	Old	New	
Currency (INR)								
Revenue (mn)	51,402	53,594	54,888	53,955	59,102	59,022	65,094	
Reported net profit (mn)	4,741	8,195	7,851	7,384	7,610	7,590	8,572	
Normalised net profit (mn)	4,741	8,195	7,851	7,384	7,610	7,590	8,572	
Normalised EPS	38.21	66.06	62.03	59.51	60.08	61.17	67.68	
Norm. EPS growth (%)	-13.9	72.9	62.3	-9.9	-3.1	2.8	12.6	
Norm. P/E (x)	17.0	N/A	10.4	N/A	10.7	N/A	9.5	
EV/EBITDA (x)	8.7	10.3	9.7	11.0	9.4	11.0	9.0	
Price/book (x)	2.3	N/A	1.9	N/A	1.6	N/A	1.3	
Dividend yield (%)	0.8	N/A	1.1	N/A	1.1	N/A	1.2	
ROE (%)	15.2	21.6	20.9	15.9	16.7	13.9	15.8	
Net debt/equity (%)	28.5	17.4	27.2	10.4	12.8	7.4	9.1	

Source: Nomura estimates

Key company data: See page 2 for company data and detailed price/index chart.

Anchor themes

Participate in sector through companies focussed on market share gains, having low client concentration and better operating scope to tide over current uncertain economic environment.

Nomura vs consensus

Our FY13F earnings estimates are 16% lower than Bloomberg consensus; we believe consensus estimates will be downgraded post the 2Q result.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Tech Mahindra

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	46,254	51,402	54,888	59,102	65,094
Cost of goods sold	-29,915	-35,320	-38,495	-42,741	-47,983
Gross profit	16,339	16,082	16,393	16,361	17,111
SG&A	-6,352	-7,485	-8,789	-9,025	-9,614
Employee share expense					
Operating profit	9,987	8,598	7,604	7,336	7,496
EBITDA	11,325	10,033	9,218	8,931	9,254
Depreciation	-1,338	-1,436	-1,614	-1,596	-1,758
Amortisation					
EBIT	9,987	8,598	7,604	7,336	7,496
Net interest expense	-2,184	-999	-1,436	-911	-809
Associates & JCEs					
Other income	754	1,175	1,040	761	851
Earnings before tax	8,557	8,773	7,208	7,185	7,539
Income tax	-1,440	-1,315	-1,615	-1,653	-1,658
Net profit after tax	7,118	7,458	5,593	5,533	5,880
Minority interests	-28	-21	-22	-20	-20
Other items	-1,663	-2,696	2,280	2,097	2,712
Preferred dividends					
Normalised NPAT	5,426	4,741	7,851	7,610	8,572
Extraordinary items	-85	0	0	0	0
Reported NPAT	5,341	4,741	7,851	7,610	8,572
Dividends	-501	-581	-880	-856	-925
Transfer to reserves	4,840	4,161	6,971	6,754	7,647

Valuation and ratio analysis

FD normalised P/E (x)	14.9	17.0	10.4	10.7	9.5
FD normalised P/E at price target (x)	14.9	17.1	10.4	10.7	9.5
Reported P/E (x)	14.1	16.2	10.0	10.3	9.1
Dividend yield (%)	0.7	0.8	1.1	1.1	1.2
Price/cashflow (x)	6.7	27.7	29.1	18.3	18.7
Price/book (x)	2.6	2.3	1.9	1.6	1.3
EV/EBITDA (x)	7.9	8.7	9.7	9.4	9.0
EV/EBIT (x)	8.9	10.2	11.7	11.5	11.1
Gross margin (%)	35.3	31.3	29.9	27.7	26.3
EBITDA margin (%)	24.5	19.5	16.8	15.1	14.2
EBIT margin (%)	21.6	16.7	13.9	12.4	11.5
Net margin (%)	11.5	9.2	14.3	12.9	13.2
Effective tax rate (%)	16.8	15.0	22.4	23.0	22.0
Dividend payout (%)	9.4	12.2	11.2	11.3	10.8
Capex to sales (%)	8.8	-1.1	4.9	4.2	3.8
Capex to depreciation (x)	3.0	-0.4	1.7	1.6	1.4
ROE (%)	22.1	15.2	20.9	16.7	15.8
ROA (pretax %)	25.0	15.0	12.2	10.8	10.3

Growth (%)

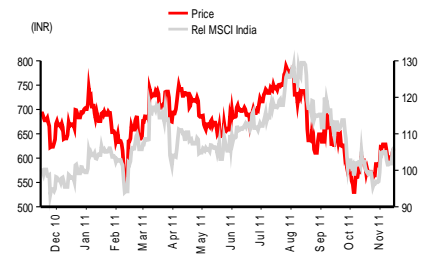
Revenue	3.6	11.1	6.8	7.7	10.1
EBITDA	-4.8	-11.4	-8.1	-3.1	3.6
EBIT	-7.6	-13.9	-11.6	-3.5	2.2
Normalised EPS	-41.5	-13.9	62.3	-3.1	12.6
Normalised FDEPS	-41.2	-12.6	64.0	-3.1	12.6

Per share

Reported EPS (INR)	43.67	38.21	62.03	60.08	67.68
Norm EPS (INR)	44.36	38.21	62.03	60.08	67.68
Fully diluted norm EPS (INR)	41.52	36.28	59.50	57.68	64.97
Book value per share (INR)	235.98	270.12	327.97	393.23	463.95
DPS (INR)	4.10	4.68	6.95	6.76	7.30

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	3.9	-16.3	-14.6
Absolute (USD)	0.5	-25.1	-23.8
Relative to index	3.5	-18.5	3.1
Market cap (USDmn)	1,535.9		
Estimated free float (%)	16.0		
52-week range (INR)	798/476.85		
3-mth avg daily turnover (USDmn)	3.30		
Major shareholders (%)			
Mahindra & Mahindra	47.8		
British Telecommunications	23.3		

Source: Thomson Reuters, Nomura research

Notes

Revenue growth expected to falter in FY12F on decline in BT volumes and pricing.

Other items include 1) share of profit from associate company Mahindra Satyam (proportionate to Tech M's 42.7% stake); and 2) adjustment of post-tax impact of one-time restructuring fee paid by BT which is amortized in the revenue (INR2bn per annum).

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	11,325	10,033	9,218	8,931	9,254
Change in working capital	2,283	-5,424	-4,708	-2,798	-3,205
Other operating cashflow	-1,633	-1,698	-1,712	-1,673	-1,678
Cashflow from operations	11,976	2,911	2,799	4,461	4,371
Capital expenditure	-4,069	541	-2,693	-2,500	-2,500
Free cashflow	7,907	3,451	105	1,961	1,871
Reduction in investments	-25,799	1,065	-3,901	363	-4,022
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	0	0	0	0	0
Addition in other LT liabilities	0	0	0	0	0
Adjustments	0	-995	3,832	3,637	4,022
Cashflow after investing acts	-17,892	3,521	36	5,961	1,871
Cash dividends	-501	-581	-880	-856	-925
Equity issue	2,956	-1,191	-510	5	5
Debt issue	13,672	-1,445	1,314	-1,425	-1,527
Convertible debt issue	0	0	0	0	0
Others	-1,430	176	-396	-150	42
Cashflow from financial acts	14,697	-3,041	-472	-2,427	-2,405
Net cashflow	-3,195	479	-435	3,534	-534
Beginning cash	5,382	2,187	2,666	2,231	5,765
Ending cash	2,187	2,666	2,231	5,765	5,230
Ending net debt	11,485	9,561	11,310	6,351	5,358

Source: Nomura estimates

Notes

We expect only marginal improvement in cash flow from operations in FY13F on revenue growth and margin moderation.

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	2,187	2,666	2,231	5,765	5,230
Marketable securities	0	0	0	0	0
Accounts receivable	10,420	12,468	15,790	17,002	18,726
Inventories	0	0	0	0	0
Other current assets	6,739	8,321	9,025	9,717	10,702
Total current assets	19,346	23,455	27,045	32,484	34,658
LT investments	30,145	29,080	32,981	32,618	36,641
Fixed assets	9,251	7,275	8,354	9,259	10,001
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	276	638	712	712	712
Total assets	59,018	60,448	69,093	75,074	82,012
Short-term debt	0	0	0	0	0
Accounts payable	13,572	11,488	10,240	9,096	8,230
Other current liabilities	2,770	3,060	3,626	3,876	4,247
Total current liabilities	16,342	14,548	13,866	12,973	12,477
Long-term debt	13,672	12,227	13,541	12,116	10,588
Convertible debt	0	0	0	0	0
Other LT liabilities	0	0	0	0	0
Total liabilities	30,014	26,775	27,406	25,088	23,065
Minority interest	139	159	174	179	184
Preferred stock	0	0	0	0	0
Common stock	1,223	1,260	1,272	1,272	1,272
Retained earnings	27,642	32,254	40,240	48,534	57,491
Proposed dividends	0	0	0	0	0
Other equity and reserves	0	0	0	0	0
Total shareholders' equity	28,865	33,514	41,512	49,806	58,763
Total equity & liabilities	59,018	60,448	69,093	75,074	82,012

Notes

We expect long-term debt to decline over FY11-13F.

Liquidity (x)

Current ratio	1.18	1.61	1.95	2.50	2.78
Interest cover	4.6	8.6	5.3	8.1	9.3

Leverage

Net debt/EBITDA (x)	1.01	0.95	1.23	0.71	0.58
Net debt/equity (%)	39.8	28.5	27.2	12.8	9.1

Activity (days)

Days receivable	76.7	81.3	94.2	101.3	100.2
Days inventory	0.0	0.0	0.0	0.0	0.0
Days payable	123.9	129.5	103.3	82.6	65.9
Cash cycle	-47.2	-48.2	-9.1	18.7	34.3

Source: Nomura estimates

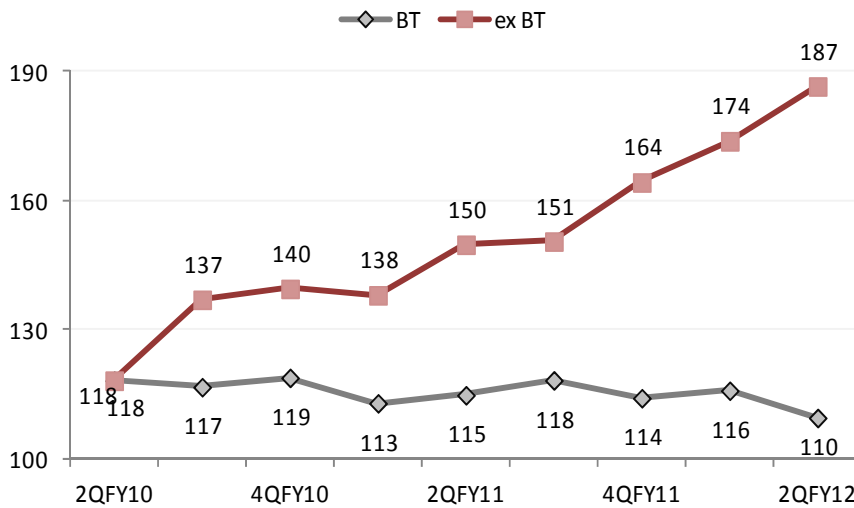
BT business drops sharply; more pain likely in near term

Revenue from TechM's BT business declined by 5% q-q in 2Q on account of project closures. Management outlook on BT revenues in the near term continues to be dim even after a sharp drop in revenues in 2Q. There appears to be severe pricing pressure in the BT business as management has indicated that both revenue and margin would be impacted in the near-term despite Tech Mahindra having retained large portions of its business and gaining market share in the re-tendering process. We were earlier anticipating ~10% decline in BT revenues in FY13F – which we now expect will occur in FY12F itself.

Non-BT revenues grew sharply by 7% q-q led by the rest of the world and the US geographies. Management outlook on non-BT business continues to be positive as they expect growth momentum to sustain. However most of the incremental revenues in non-BT have come from low-margin businesses like BPO/emerging markets. Revenue from emerging markets grew by 17% q-q in 2Q and has grown by a 16% CQGR over the past three quarters. Similarly BPO revenues have also increased by a 16% CQGR over the past three quarters compared with a 2% CQGR for the higher margin IT business.

Fig. 1: BT and ex-BT revenue trajectory (USD mn)

Non-BT business shows impressive trajectory, but skew of growth is towards lower-margin BPO/emerging market business



Note: ex-BT revenues for 2QFY11 exclude hardware revenues of USD63.5
 Source: Company, Nomura research

BPO share of total professionals has increased from 17% in 1QFY10 to 37% currently.

Fig. 2: IT and BPO employee growth trend and BPO employee proportion (%)

	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	4QFY11	1QFY12	2QFY12
IT Professionals	20,227	20,038	22,199	24,405	25,711	24,449	24,673	26,282	27,920	26,665
q-q growth in headcount (%)	1	-1	11	10	5	-5	1	7	6	-4
BPO Professionals	4,189	5,450	7,199	8,067	8,426	8,489	8,489	11,011	13,804	15,875
q-q growth in headcount (%)	11	30	32	12	4	1	0	30	25	15
BPO share of total professionals	17	21	24	25	25	26	26	30	33	37

Source: Company data, Nomura research

Expect 440bp decline in EBITDA margins over FY11-13F

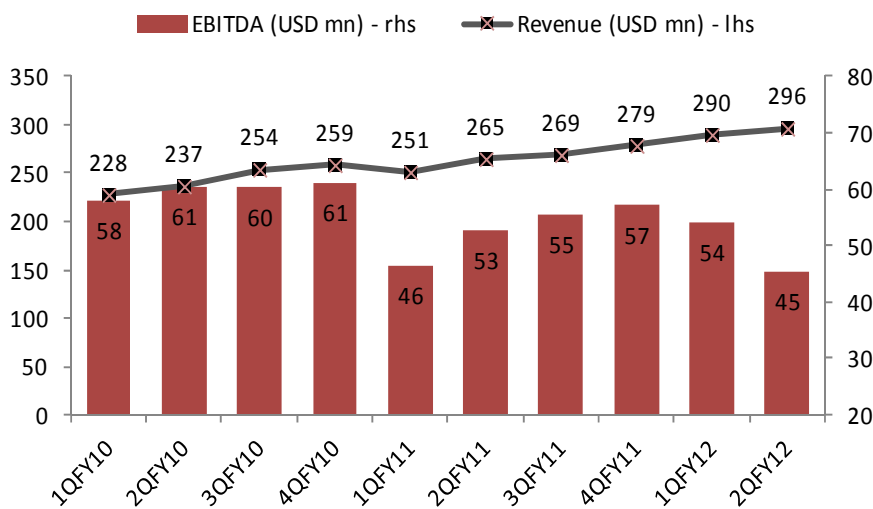
Management expects margins to be impacted over the next quarters due to the BT business re-tendering, the impact of which it expects would be mitigated by 1) rupee depreciation against the USD; and 2) through productivity and optimization initiatives.

We do not expect EBITDA margins to benefit much from the significant rupee depreciation against the USD (9% quarter-to-date), as the BT business is likely to see ~5% pricing pressure over the next two quarters. From a medium-term perspective, we see further moderation in margins and expect a decline of 440bps to 15.1%, over FY11-13F. The key contributors according to us would be:

- Adverse skew of business towards lower-margin BPO/emerging markets
- Anticipated pricing cuts in the BT business over 3Q-4QFY12F, by which time management expects the process of re-tendering would come to conclusion.

Fig. 3: Tech Mahindra revenue and EBTIDA trend

EBTIDA margins have declined by ~10pp over the last 2 years partly on account of increasing BPO contributions



Note: Revenue and EBITDA adjusted for one-off revenue of USD63.5mn in 2QFY11

Source: Company data, Nomura research

Balance sheet health deteriorates in past 2-3 quarters

TechM's balance sheet has deteriorated over the past three quarters, as net debt position and working capital days have increased.

- **Net debt has increased by INR3bn over the past three quarters** despite cumulative profits of INR5.3bn over the same period.
- **Receivable days have increased by 23 days** to 111 days over the past two quarters. Management attributed this to higher credit periods in some contracts.

The current cash & equivalents position of the company is INR2.8bn and it carries debt of INR14.2bn.

Fig. 4: TechM net debt position

Net debt increased by INR3.1bn over the past 3 quarters

in INR mn	3QFY11	4QFY11	1QFY12	2QFY12
cash	5,190	3,047	1,944	2,780
debt	13,480	12,227	12,822	14,220
net debt	8,290	9,180	10,878	11,440

Source: Company data, Nomura research

Change of estimates

Mahindra Satyam estimates

Tech Mahindra holds a 42.7% stake in Mahindra Satyam (SCS IN, INR70.10, not rated). Our USD revenue growth assumptions are largely unchanged and we look for 19% and 15% USD revenue growth in FY12F and FY13F, respectively. Our margin assumptions of 15.3%/15.5% have gone up (from 13.7%/14.5%) on account of 1) better-than-expected margin performance in 2Q; 2) an increase in the USD/INR rate assumption for FY12/13F; and 3) expectation of lower impact from wage inflation due to rupee depreciation tailwind. Our EPS assumptions are higher at INR7.6/7.2 over FY12/13F (vs INR6.3/6.5) on 1) outperformance in 2Q, and 2) higher margin assumptions. We have not factored any additional cash payouts for the two pending cases yet to be settled (the Central Board of Tax claim and the Aberdeen complaint).

Fig. 5: Mahindra Satyam expectations

	FY12F	FY13F
Revenue (USD mn)	1,339	1,540
Revenue (INR bn)	63.3	70.8
EBITDA margin (%)	15.3	15.5
Tax rate (%)	18.9	24.0
EPS (INR)	7.6	7.2

Source: Nomura estimates

Tech Mahindra estimates

We have reduced our FY12F revenue estimate for Tech Mahindra by 2% on account of an earlier-than-anticipated drop in BT revenues. Our FY13F revenue estimate goes up by 5% as we shift the BT pricing-related revenue decline to FY12F. We now look for USD revenue growth of 4.7%/8.9% in FY12/13F. We have revised our margin estimates lower on 1) a sharper-than-expected margin drop in 2Q; 2) earlier-than-anticipated decline in BT revenues; and 3) increasing skew towards lower-margin businesses (BPO/emerging markets). Over FY11-13F, we model for a 440bp decline in EBITDA margin. Our standalone estimates for Tech Mahindra are down by 21%/5% in FY12/13F based on expectation of sharper margin drop in FY12F. Overall, our consolidated EPS estimates are up by slightly up by 2% in FY13F as the Satyam contribution more than offsets the decline in our TechM standalone business expectations.

Fig. 6: Tech Mahindra expectations

	New		Old		Change (%)	
	FY12F	FY13F	FY12F	FY13F	FY12F	FY13F
Revenue (US\$ mn)	1,179	1,285	1,204	1,226	-2.0	4.8
Revenue (Rs mn)	54,888	59,102	53,594	53,955	2.4	9.5
EBITDA margin (%)	16.8	15.1	18.1	16.5	-130 bps	-140 bps
Standalone diluted EPS (Rs)	30.5	30.1	38.4	31.6	-20.7	-4.6
Consolidated diluted EPS (Rs)	59.5	57.7	62.7	56.5	-5.1	2.1

Source: Nomura estimates

Maintain Reduce with TP of INR580

We maintain our Reduce on TechM on account of 1) a weak near-term revenue and margin outlook; 2) the absence of a pickup in discretionary spending in Telecom; and 3) an increasing skew in TechM's business mix towards the low-margin BPO/emerging markets business. We reduce valuation multiple to 10x FY13F (from 11x) on 1) deterioration in the balance sheet; and 2) likelihood of sustained margin pressure due to the skew in the business mix. Our TP decreases to INR580 (from INR620).

Our target multiple of 10x is 30% lower than Tech M's average one-year forward multiple of 14.5x on greater revenue and margin uncertainty. We believe a lower multiple is justified as the outlook on business from BT continues to worsen and the skew of growth continues towards lower-margin segments, leading to a likely decline in profitability over FY12-13F, in our view.

Risks to our Tech Mahindra target price

Upside risks include higher-than-anticipated revenue and margin ramp-up in Mahindra Satyam and better-than-anticipated performance in TechM's non-BT segment.

2QFY12: Operationally below expectations

- Tech Mahindra reported USD revenue growth of 2.2% q-q which was in line with our expectations.
- The EBITDA margin declined by 340bps to 15.3% and was below our estimate of a 110bp decline. The drop in the margin was on account of the 5% q-q drop in BT revenues and 140bp q-q increase in SGA spend (as a percentage of revenue).
- PAT excl. Satyam was INR1.4bn, lower than our estimate of 1.5bn largely on account of lower-than-expected margins.
- Employee addition of 807 employees during 2Q (2% q-q), of which 2,071 employees were added in BPO (25% q-q), while IT headcount declined by 1,255 employees q-q.
- Utilization improved to 72% in 1Q (from 71% in 1Q).
- Depreciation increased sharply in 2Q on account of one-time charge of rental facility.
- Interest income surged in 2Q on account of translation loss of INR0.5bn.

Fig. 7: Quarterly performance & estimates

Y/E Mar (Rs mn)	FY11				FY12				FY11	FY12F
	1Q	2Q	3Q	4Q	1Q	2Q	3QF	4QF		
Revenues (US\$ mn)	251	328	269	279	290	296	295	299	1,127	1,179
<i>q-q change (%)</i>	-2.9	30.7	-18.1	3.6	4.1	2.2	-0.6	1.5	15.4	4.7
Revenues	11,337	15,339	12,111	12,615	12,925	13,333	14,432	14,198	51,402	54,888
<i>q-q change (%)</i>	-4.2	35.3	-21.0	4.2	2.5	3.2	8.2	-1.6	11.1	6.8
Direct Cost	7,458	10,701	7,882	7,987	8,540	9,069	9,689	9,744	34,028	37,042
Other Operating Exps	1,752	1,820	1,731	2,038	1,967	2,222	2,309	2,130	7,341	8,628
EBITDA	2,127	2,818	2,498	2,590	2,418	2,042	2,434	2,324	10,033	9,218
<i>EBITDA margin (%)</i>	18.8	18.4	20.6	20.5	18.7	15.3	16.9	16.4	19.5	16.8
Other Income	253	83	522	317	460	972	-60	-331	1,175	1,040
Interest	264	270	252	213	223	721	249	243	999	1,436
Depreciation	354	347	348	387	334	507	390	383	1,436	1,614
PBT	1,762	2,284	2,420	2,307	2,321	1,786	1,735	1,366	8,773	7,208
Provision for Tax	312	418	359	226	509	393	399	314	1,315	1,615
<i>tax rate (%)</i>	17.7	18.3	14.8	9.8	21.9	22.0	23.0	23.0	15.0	22.4
Minority Interest	6	-7	6	16	7	5	5	5	21	22
Standalone PAT	1,444	1,873	2,055	2,065	1,805	1,388	1,331	1,047	7,437	5,571
<i>q-q change (%)</i>	-36.4	29.7	9.7	0.5	-12.6	-23.1	-4.1	-21.3	4.9	-25.1
Share of profit from Satyam	416	99	251	-1,144	960	1,016	899	957	-995	3,832
Effect of restructuring fees	411	408	426	451	390	390	385	385	1,700	1,552
Adjusted Net Income	1,448	1,564	1,880	470	2,375	2,014	1,844	1,619	4,741	7,851
<i>q-q change (%)</i>	-22.3	8.0	20.2	-75.0	405.4	-15.2	-8.4	-12.2	-11.1	65.6

Source: Company data, Nomura estimates

Appendix A-1

Analyst Certification

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Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Tech Mahindra	TECHM IN	INR 618	15-Nov-2011	Reduce	Not rated	

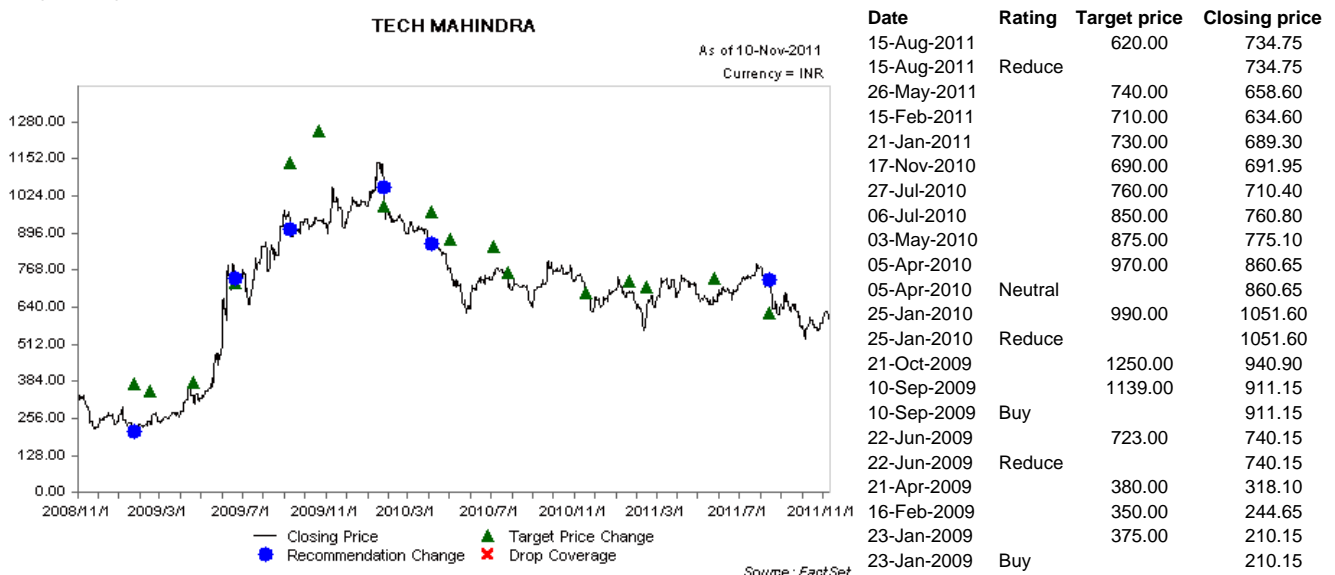
Previous Rating

Issuer name	Previous Rating	Date of change
Tech Mahindra	Neutral	15-Aug-2011

Tech Mahindra (TECHM IN)

INR 618 (15-Nov-2011) Reduce (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price of INR580 is based on 10x FY13F consolidated EPS (INR57.7). The 10x multiple is 30% lower than Tech Mahindra's average one-year forward P/E multiple, on account of greater revenue and margin uncertainty.

Risks that may impede the achievement of the target price Upside risks include higher-than-anticipated revenue ramp-up in Mahindra Satyam and early announcement of a merger with Satyam.

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STOCKS

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SECTORS

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009

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