

Mahindra Satyam – BUY

12 September 2012



Dealonomics

With increasing participation in the US, traction continues to improve for Mahindra Satyam (M Sat). Further, we understand that M Sat's internal margin thresholds for new deals are higher now, indicating a high focus on profitability. Tech Mahindra, on the other hand, is benefiting from many large deal wins. Moreover, while the perception is that of Tech Mahindra having 'bought revenue', our analysis shows that the company's cash generation has been on par with larger vendors. Even its recent acquisition of a captive is cheaper than other captive acquisitions over the past two years. Consequently, we continue to be positive on M Sat/Tech Mahindra.

Incremental positives at M Sat: Our channel checks indicate that M Sat's internal margin thresholds for new deals have increased in the recent past. This, along with steady renewals and increasing participation in US-related deals, gives us comfort over sustainability of margins and revenue growth.

Tech Mahindra has not 'bought revenue': Tech Mahindra's large deal wins have been strong over the past year. Moreover, our analysis shows that in deals where Tech Mahindra had paid upfront, its cash generation has been on par with larger vendors. Further, for its recent acquisition of a captive, implied valuations were cheaper than other captive acquisitions over the past two years.

Cheap valuations: We believe stable renewals, improving traction in the US, and margin levers will continue to result in robust Ebitda growth for M Sat. Tech Mahindra is benefiting from an improving market for telecom IT services and a buoyant and large deal pipeline. Almost all uncertainties related to M Sat's legal liabilities have been addressed. Valuations of the combined entity continue to be cheaper than even some of the mid-tier IT companies at ~11x FY13ii PER. We are increasing our target price to Rs122. Re-iterate BUY.

Company update

		Price performance (%)		
		1M	3M	1Y
CMP	Rs103			
12-mth TP (Rs)	122 (19%)			
Market cap (US\$m)	2,186	Absolute (Rs)	11.4	35.5
Enterprise value(US\$m)	1,587	Absolute (US\$)	11.4	36.4
Bloomberg	SCS IN	Rel. to Sensex	9.7	28.4
Sector	Technology	Cagr (%)	3 yrs	5 yrs
		EPS	NA	NA

Shareholding pattern (%)	
Promoter	42.6
FII	22.3
DII	7.0
Others	28.0

52Wk High/Low (Rs)	104/58
Shares o/s (m)	1177
Daily volume (US\$ m)	7.2
Dividend yield FY13ii (%)	0.0
Free float (%)	57.0

Financial summary (Rs m)

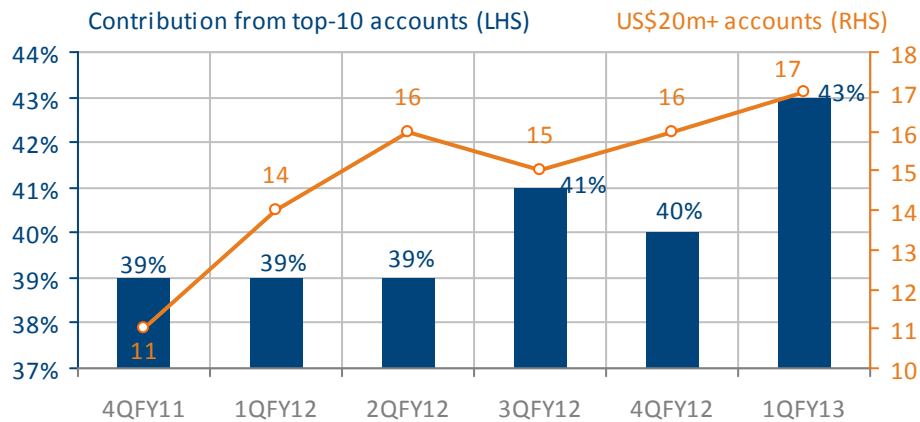
Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues (Rs m)	51,450	63,956	77,897	86,356	96,714
Ebitda margins (%)	8.8	16.0	19.5	19.0	19.0
Pre-exceptional PAT (Rs m)	4,841	9,772	11,917	12,472	14,193
Reported PAT (Rs m)	(1,570)	12,943	11,917	12,472	14,193
Pre-exceptional EPS (Rs)	4.1	8.3	10.1	10.6	12.1
Growth (%)	33.6	101.8	22.0	4.7	13.8
IIFL vs consensus (%)			7.4	3.1	8.4
PER (x)	25.0	12.4	10.2	9.7	8.5
ROE (%)	26.9	41.5	33.3	26.0	23.1
Net debt/equity (x)	(1.8)	(1.1)	(0.8)	(0.8)	(0.8)
EV/Ebitda (x)	19.8	8.6	5.9	4.8	3.8
Price/book (x)	7.0	4.1	2.9	2.2	1.8

Source: Company, IIFL Research. Priced as on 11 September 2012

Incremental positives at M Sat

M Sat has won more than 125 new clients over the past 18 months. However, its traction in the US had been poor. We understand that the stigma in the US of the delisting of ADRs and that class action law suits had impacted the company's participation in deals. However, this has been changing over the past two quarters as the company is increasingly being invited to deals in the US.

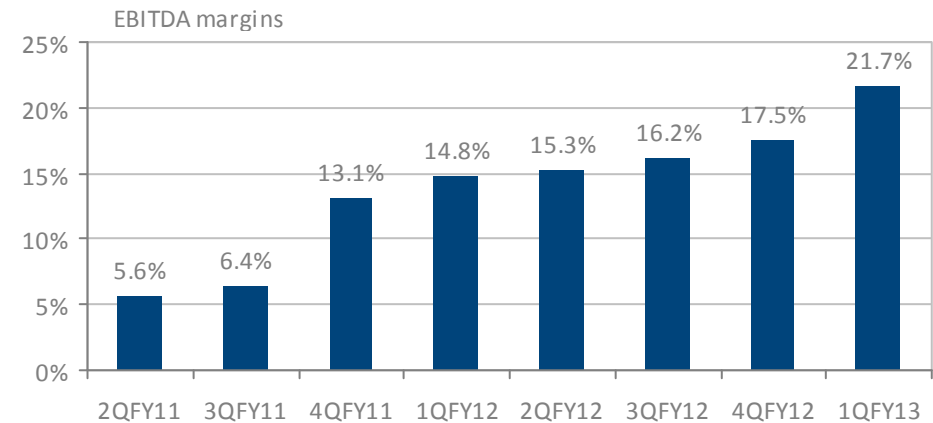
Figure 1: Client mining has been improving at M Sat



Source: Company, IIFL Research

The focus on profitability has also been high. As of 1QFY13, for M Sat, it has been the seventh consecutive quarter of margin expansion. Although salary increases are a near-term headwind, improving age pyramid, SG&A leverage and delivery-related efficiencies are key margin tailwinds. Furthermore, our recent interactions indicate that the internal margin thresholds on new deal wins have increased over the past two quarters.

Figure 2: Consistent improvement in profitability at M Sat



Source: Company, IIFL Research

Large deal wins at Tech Mahindra:

Tech Mahindra is benefiting from an improving demand for telecom-related IT services and a robust large deal pipeline. Our channel checks indicate that Tech Mahindra has won two large deals in the past two months. This is in addition to the ~US\$845m of contracted revenue from the captive acquisition.

Moreover, our analysis of other captive acquisitions shows that Tech Mahindra's acquisition price has not been expensive compared with others. After the deals with BT for which Tech Mahindra had to pay upfront, an acquisition of captives has raised concerns of whether the company is 'buying revenue'. However, contrary to that perception, even during a six-year period when such payouts were made, Tech Mahindra's cash generation was not inferior to larger vendors.

Also, we believe that the contractual revenues from the captive perse will seldom justify the purchase consideration for the captive. Better/deeper relationship with the client and likely cross-selling of the captive's services for other accounts are the key reasons. For instance, when TCS acquired CGSL (Citigroup's captive), the

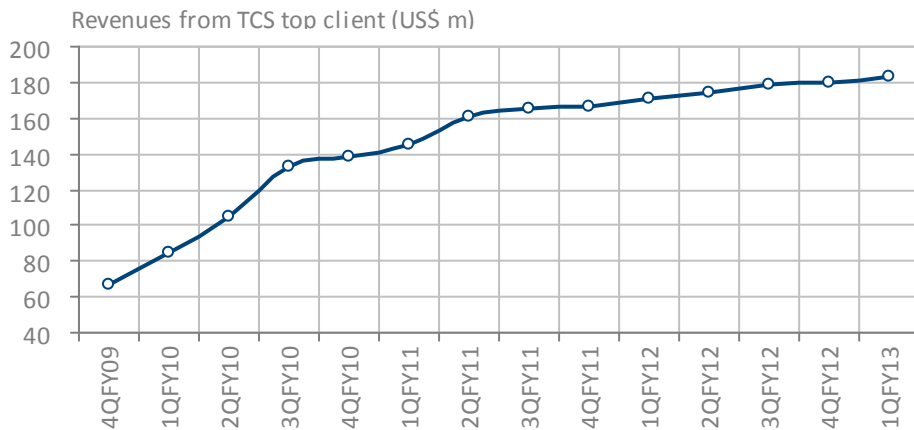
company might not have recovered the purchase consideration even over a 10 year period. However, it has growing rapidly within that account since the acquisition. This likely justifies the price paid for captives.

Figure 3: Tech Mahindra's captive acquisition has been cheaper than similar acquisitions made by other vendors

Deal (US\$ m)	Purchase consideration	Cumulative PAT (10% net margins for Tech Mahindra; 15% net margins for others)	NPV (discount rate of 8%)	Comments
Tech Mahindra - Hutchison deal	87	85	(19.6)	5 year deal
Cognizant - UBS	75	66	(22.1)	5 year deal
TCS - CGSL	510	375	(258.4)	10 year deal
Wipro - Citos	127	75	(69.2)	6 year deal
WNS - Aviva	228	150	(120.3)	8 year deal

Source: Company, IIFL Research

Figure 4: TCS' top client witnessed a robust growth

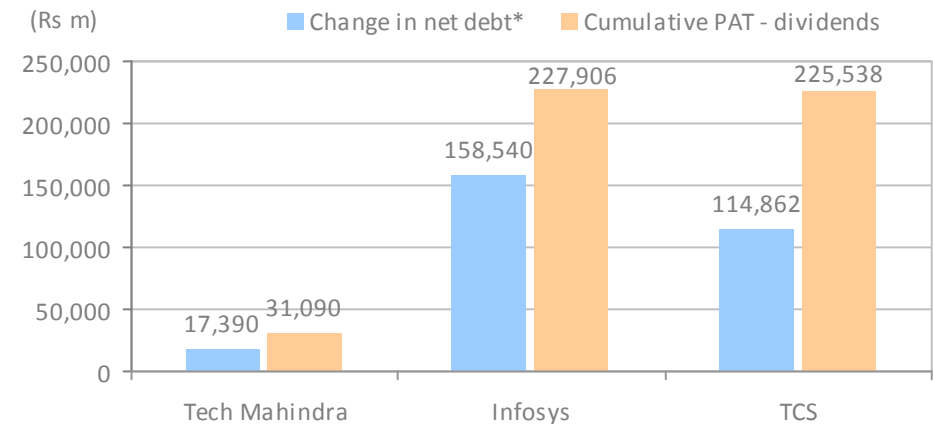


Source: Company, IIFL Research

Our analysis of cash flows at Tech Mahindra during FY07 to FY12 includes the period when it had paid the cost benefits upfront to BT

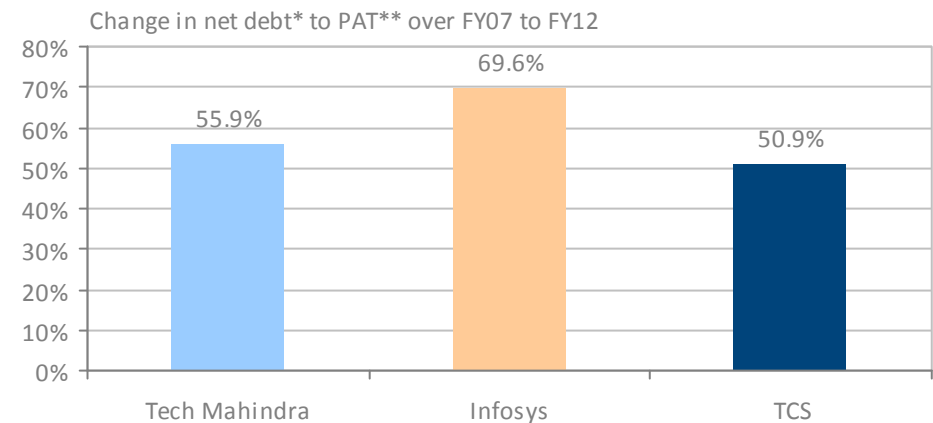
of about Rs10bn. When deals did not ramp up to initial expectations, BT had paid back the entire amount. An analysis of cash flows over a six-year period shows that they are on par with larger vendors. Hence the perception of cash flows being inferior is unfounded.

Figure 5: Tech Mahindra's cash generation has not been inferior to other larger vendors



Source: Company, IIFL Research, * - excluding acquisitions

Figure 6: Tech Mahindra's cash generation hasn't been inferior to other larger vendors



Source: Company, IIFL Research, * - excluding acquisitions, ** - after subtracting dividends

Figure 7: Pro-forma income statement of the combined entity

Item (Rs m)	FY11	FY12	FY13ii	FY14ii	FY15ii
Revenue (US\$ m)	2,140	2,449	2,653	2,993	3,314
Mahindra Satyam	1,124	1,335	1,437	1,599	1,791
Tech Mahindra	1,016	1,115	1,216	1,394	1,523
YoY %	1.4%	14.5%	8.3%	12.8%	10.7%
Revenue (Rs m)	97,858	116,848	144,037	161,609	178,968
Mahindra Satyam	51,450	63,956	77,897	86,356	96,714
Tech Mahindra	46,408	52,892	66,140	75,252	82,254
YoY %	-1.2%	19.4%	23.3%	12.2%	10.7%
EBITDA	12,558	17,429	26,554	28,634	31,950
Mahindra Satyam	4,529	10,240	15,207	16,409	18,377
Tech Mahindra	8,028	7,189	11,347	12,225	13,573
YoY %	71.5%	38.8%	52.4%	7.8%	11.6%
EBITDA margins	12.8%	14.9%	18.4%	17.7%	17.9%
Mahindra Satyam	8.8%	16.0%	19.5%	19.0%	19.0%
Tech Mahindra	17.3%	13.6%	17.2%	16.2%	16.5%
Effective tax rate (%)	23.9%	19.2%	26.2%	25.9%	25.7%
PAT	5,967	18,444	18,664	19,813	21,287
PAT margins	6.1%	15.8%	13.0%	12.3%	11.9%
YoY %	164.5%	209.1%	1.2%	6.2%	7.4%
Pre-exceptional PAT	10,373	13,948	16,659	17,808	21,287
Pre-exceptional PAT margins	10.6%	11.9%	11.6%	11.0%	11.9%
YoY %	999.6%	34.5%	19.4%	6.9%	19.5%
Diluted EPS (Rs)	25.9	79.9	80.9	85.8	92.2
Diluted EPS (Rs) - pre-exceptional	44.9	60.4	72.2	77.2	92.2
YoY % (pre-exceptional profits)	999.6%	34.5%	19.4%	6.9%	19.5%
Diluted EPS (Rs) - pre-exceptional; adjusted for treasury shares	50.2	67.4	80.6	86.1	102.9
YoY % (pre-exceptional profits)	999.6%	34.5%	19.4%	6.9%	19.5%

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Exchange rate	45.8	48.7	54.2	54.0	54.0
Income tax rate (%)	(60.3)	18.5	27.0	27.0	27.0
EBITDA margins (%)	8.8	16.0	19.5	19.0	19.0
Revenue growth (US\$)	(2.7)	16.7	9.5	11.3	12.0

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Revenues	51,450	63,956	77,897	86,356	96,714
Ebitda	4,529	10,240	15,207	16,409	18,377
Depreciation and amortisation	(1,847)	(1,577)	(1,724)	(1,985)	(2,222)
Ebit	2,683	8,663	13,483	14,424	16,156
Non-operating income	2,867	4,071	3,161	2,987	3,645
Financial expense	(97)	(118)	(127)	(132)	(137)
PBT	5,453	12,616	16,518	17,278	19,664
Exceptionals	(6,411)	3,171	0	0	0
Reported PBT	(959)	15,786	16,518	17,278	19,664
Tax expense	(578)	(2,928)	(4,466)	(4,665)	(5,309)
PAT	(1,537)	12,858	12,052	12,613	14,355
Minorities, Associates etc.	(33)	84	(135)	(142)	(161)
Attributable PAT	(1,570)	12,943	11,917	12,472	14,193

Ratio analysis

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Per share data (Rs)					
Pre-exceptional EPS	4.1	8.3	10.1	10.6	12.1
DPS	0.0	0.0	0.0	0.0	0.0
BVPS	14.7	25.4	35.5	46.1	58.2
Growth ratios (%)					
Revenues	(6.1)	24.3	21.8	10.9	12.0
Ebitda	(18.4)	126.1	48.5	7.9	12.0
EPS	33.6	101.8	22.0	4.7	13.8
Profitability ratios (%)					
Ebitda margin	8.8	16.0	19.5	19.0	19.0
Ebit margin	5.2	13.5	17.3	16.7	16.7
Tax rate	(60.3)	18.5	27.0	27.0	27.0
Net profit margin	(3.0)	20.1	15.5	14.6	14.8
Return ratios (%)					
ROE	26.9	41.5	33.3	26.0	23.1
ROCE	17.9	35.0	34.2	28.5	26.6
Solvency ratios (x)					
Net debt-equity	(1.8)	(1.1)	(0.8)	(0.8)	(0.8)
Net debt to Ebitda	(7.0)	(3.3)	(2.1)	(2.6)	(2.8)
Interest coverage	27.7	NM	NM	NM	NM

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Cash & cash equivalents	31,800	33,656	32,472	42,338	51,769
Inventories	592	146	153	161	169
Receivables	14,439	18,056	23,352	24,398	29,028
Other current assets	5,030	5,640	6,958	7,437	8,006
Creditors	6,338	5,984	6,483	6,886	7,352
Other current liabilities	24,595	21,020	17,692	17,618	18,968
Net current assets	20,928	30,494	38,762	49,829	62,652
Fixed assets	8,657	9,668	11,369	12,634	13,912
Intangibles	504	427	1,102	1,102	1,102
Investments	0	350	1,600	1,600	1,600
Other long-term assets	81	1,696	1,854	2,135	2,389
Total net assets	30,170	42,635	54,687	67,300	81,655
Borrowings	315	293	293	293	293
Other long-term liabilities	12,606	12,469	12,604	12,746	12,907
Shareholders equity	17,249	29,873	41,789	54,261	68,454
Total liabilities	30,170	42,635	54,687	67,300	81,655

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Ebit	2,683	8,663	13,483	14,424	16,156
Tax paid	(594)	(2,519)	(4,624)	(4,946)	(5,563)
Depreciation and amortization	1,847	1,577	1,724	1,985	2,222
Net working capital change	(1,302)	(2,077)	(3,938)	(202)	(3,391)
Other operating items	(517)	(4,851)	(5,513)	(1,000)	0
Operating cash flow before interest	2,116	792	1,132	10,260	9,423
Financial expense	0	0	0	0	0
Non-operating income	2,770	3,953	3,035	2,855	3,508
Operating cash flow after interest	4,886	4,745	4,166	13,115	12,932
Capital expenditure	(953)	(2,553)	(2,750)	(3,250)	(3,500)
Long-term investments	0	(350)	(2,600)	0	0
Others	33	0	0	0	0
Free cash flow	3,966	1,842	(1,184)	9,865	9,432
Equity raising	0	0	0	0	0
Borrowings	(202)	14	0	0	0
Dividend	0	0	0	0	0
Net chg in cash and equivalents	3,764	1,856	(1,184)	9,865	9,432

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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