Event Update

Tech Mahindra

September 5, 2012

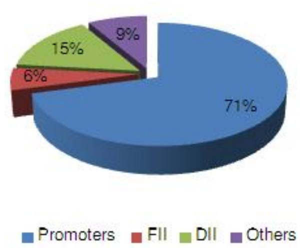
NEUTRAL

CMP*	Rs821
Target Price	-
Stock Info	
Sector	IT
Market Cap (Rs cr)	10,479
52 Week High/Low	886/528
Avg. Daily Volume (3m, '000)	366.6
Avg. Daily Value (3m, cr)	28.7
Dividend Yield (%)	0.5
Sensex	17,441
Nifty	5,274
BSE Code	532755
NSE Code	TECHM

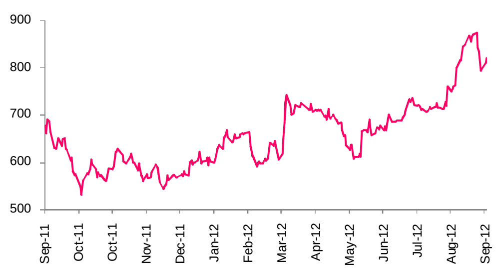
Stock Performance

(%)	TECHM	NIFTY
1-week	(2.6)	(1.1)
1-month	7.8	1.1
1-year	29.2	4.6

Shareholding Pattern (%)



Stock Price Chart



*Note: *CMP as on September 4, 2012*

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Acquisition to enhance growth outlook

- **Tech Mahindra acquires Hutch's BPO business:** Tech Mahindra has acquired 100% shareholding of Hutchison Global Services Pvt Ltd (a wholly owned subsidiary of Hutchison 3 Global Services Holding Ltd) for ~US$87.1mn, which is payable upfront. The company was in the race to acquire this BPO business since last couple of months. London-listed Serco, which acquired Intelenet last year, was also in the race.
- **Background of Hutch BPO:** Mumbai-based Hutchison Global Services Pvt Ltd (HGS) does captive back office technology work and customer service support for the group's mobile telephony services in UK, Ireland and Australia. The BPO business provides services to its clients from its five locations in Pune and Mumbai and has an employee base of ~11,500 employees.
- **Impact:** Tech Mahindra has been struggling on top-line front with revenues from its top client declining quarter over quarter. Recently, British Telecom (accounting for 36% of the company's revenues) sold ~14% stake in the company, which sparked further concerns regarding top-line growth for the company. Thus, this acquisition comes in as a huge positive for the company. As part of the deal, the clients of HGS have committed to procure services worth US$845mn over a 5 year period. Hence, the acquisition would add ~10-11% to Tech Mahindra's FY2014E top-line. On a combined revenue base of Tech Mahindra and Mahindra Satyam, the acquisition would add ~4-5% to the FY2014E top-line.
- **Management gearing up to double revenues:** Management has set a target to double combined revenues of Tech Mahindra and Mahindra Satyam from ~US$2.4bn in FY2012 to ~US$5bn by FY2015. Company has designed a strategy to achieve this target, which also includes inorganic growth. Management is confident of achieving this target in the next three years having successfully completed three year journey of reviving Mahindra Satyam.

Outlook and Valuation

We believe that the acquisition would provide steady revenue base for the company. Considering the acquisition, we have revised our top-line estimates by ~10% for FY2014E to factor in the revenues from HGS. However, assuming that the company will use debt to fund the acquisition, our bottom-line estimates are revised marginally upwards by ~4% for FY2014E. Based on our pro-forma EPS of ~Rs93 for the combined entity, we arrive at a target price of Rs840 for Tech Mahindra (on a post merger basis). **Given the current stock price, we maintain our Neutral rating on the stock with a fair value of Rs840.**

Risks to the view

- The uncertainties plaguing the US and European economies can lead to volatility in earnings in the short term
- Acquisition of HGS increases company's exposure to telecom vertical, which has been underperforming over last two years due to lack of capital spending
- We have factored in USD/INR rate of Rs53 and Rs52 for FY2013E and FY2014E respectively. Any sharp appreciation in INR will negatively impact our estimates
- Higher than expected decline in revenues from BT can hamper the company's performance

Year End	Net Revenues		EBITDA		Net income (adjusted)		RoaE	RoIC	EPS	Valuations (X)	
	(Rs cr)	% growth	(Rs cr)	% margin	(Rs cr)	% growth	%	%	(Rs)	P/E	EV/EBITDA
FY2011	5,140	3.6	1,003	19.5	1,061	51.5	34.0	59.9	81.3	10.1	8.4
FY2012	5,490	6.8	918	16.7	1,055	(0.6)	28.5	40.4	85.1	9.6	8.4
FY2013E	6,649	21.1	1,237	18.6	1,203	14.0	27.4	43.1	91.4	9.0	6.2
FY2014E	7,341	10.4	1,356	18.5	1,283	6.7	25.3	39.3	97.5	8.4	5.1

Note: PAT includes income from Mahindra Satyam

Acquisition to propel standalone top-line by 12-13% and consolidated top-line (Tech Mahindra and Mahindra Satyam) by ~5%

Acquisition to boost growth prospects

Tech Mahindra has acquired Hutch's BPO business for ~US$87.1mn. The company was in the race to acquire this BPO business since last couple of months. The acquisition will provide significant enhancement to Tech Mahindra's expertise in the customer management space. In addition, the acquisition will enable Tech Mahindra to leverage the acquired company's capabilities and scale for further expanding the scope of their existing services to other parts of the Hutchison group, and also to other customers and verticals. With this acquisition, Tech Mahindra will further strengthen its leadership position in the telecom domain. According to the Management, Hutchison's focused service portfolio combined with Tech Mahindra's domain knowledge, geographic spread and execution excellence will help the company to become the undisputed leader in this space, and extend these services to other verticals and markets. Moreover, the acquisition would strengthen the company's presence in BPO business. Notably, Mahindra Satyam had acquired vCustomer's BPO arm for US$27mn 3-4 quarters back. This indicates that the company is focusing to expand its BPO business. BPO services in the IT industry have seen significant growth over last couple of years (as indicated in our Sector Update ***"Mixed results; growth likely to be subdued"*** dated August 21, 2012).

The acquisition comes as a much needed reprieve for the company as it has been struggling to maintain the growth momentum post ramp down of deals with its top client. As part of the deal, HGS has also made a revenue commitment of US$845mn over the next 5 years to Tech Mahindra. HGS has clocked in revenues of US$160mn in CY2011 with operating profit of ~US$30mn. Given this revenue base, we believe it would not be difficult for the clients of HGS to meet the revenue commitment. Further, Management has indicated that HGS' profitability is comparable to Tech Mahindra's BPO profitability, and thus, the acquisition will be EPS accretive. Notably, Management had recently indicated that company will resort to acquisitions in order to drive top-line growth.

Management aiming to double revenues

Revenue per client needs a significant push up in order to compete with the Top 4 IT companies listed in India

Management has set a target to double the combined revenues of Tech Mahindra and Mahindra Satyam from ~US$2.4bn in FY2012 to ~US$5bn by FY2015. Mr. C. P. Gurnani (managing director of Tech Mahindra) stated that the idea was given shape in April 2012, during a meeting of 120 executives drawn from both the companies along with some key customers. Company has designed a strategy to achieve this target, which also includes inorganic growth. Management is confident of achieving this target in the next three years, having successfully completed three year journey of reviving Mahindra Satyam. To achieve the revenue target of US$5bn by FY2015E, management has divided the company's business into the following four segments:-

1) Run the business

The first segment will focus on maintaining business momentum through existing businesses and customers. In this segment, company will focus on cross-selling, up-selling and bringing more value to its customers. Client mining can present strong growth opportunities, as the company's revenue per account is low as compared to its peers. Tech Mahindra's revenue per client (excluding BT) has been steady. Mahindra Satyam's revenue per client declined in 1QFY2013 due to acquisition of BPO arm of vCustomer. We believe that the merged entity will have to work hard on client mining to improve revenue per client in order to compete with the four big players in the industry.

Inorganic growth on the company's radar to achieve its long term targets

Exhibit 1: Revenue per client (US$mn)

	3QFY11	4QFY11	1QFY12	2QFY12	3QFY12	4QFY12	1QFY13
Infosys	2.6	2.3	2.4	2.4	2.4	2.3	2.2
TCS	2.2	2.3	2.5	2.5	2.6	2.6	2.6
HCL Tech	2.0	2.0	2.1	2.1	2.0	2.0	2.0
Wipro	1.5	1.5	1.5	1.6	1.6	1.6	1.6
Tech Mahindra*	1.2	1.3	1.4	1.5	1.5	1.4	1.4
Mahindra Satyam	-	-	1.0	1.1	1.0	1.1	0.9

*Source: Company, RSec Research *Excluding revenues from British Telecom*

Company will also have to focus on pursuing some large deals. At present, the company does not have clients in the US$100mn category. Management has indicated that the company's priority will be on getting a few larger accounts to grow at a faster rate. Despite overcoming the earlier issues (related to the fraud committed by erstwhile promoters), Mahindra Satyam has been unable to get back into the big league (over US$100mn deals) and is only executing deals of up to US$50mn. Mahindra Satyam has 4 clients above US$50mn category, while, Tech Mahindra has just 2 clients in this category.

2) Focus on business solutions and platform

The second business segment (to be headed by a CEO), will focus on new business solutions and platform. This will focus on developing new platform-based solutions, such as mobile apps and setting up new services.

3) Inorganic growth opportunities

The third segment will focus on mergers and acquisitions. Management expects 8-10% of the US$5bn target (by 2015) to come from inorganic growth, which indicates that the company will look for an acquisition with the target company having a revenue base of ~US$400-500mn annually. For this, the company will appoint two senior executives — while one will be involved at the corporate level to look at M&A opportunities, the other will drive the portfolio. Having recently acquired Hutch's BPO business, we do not see the company aggressively pursuing further acquisitions in the near term. Instead we expect that the company will grow recently acquired entities (vCustomer and Hutch BPO) and accumulate some cash before looking for further inorganic growth.

4) Investing in new start-ups

The fourth segment that the company is focusing on is incubating start-ups. In this segment, the company has already announced its tie-up with Soft Bank to set up a US$50mn fund that will invest in promising new technology firms. This will be headed by a Chief Innovation Officer, who will focus on incubating start-ups. However, we believe that this initiative would reap benefits only in the long term.

Profit & Loss Statement

Y/E March (Rs cr)	FY2011	FY2012	FY2013E	FY2014E
Revenues	**5,140**	**5,490**	**6,649**	**7,341**
Personnel expenses	2,412	2,869	3,463	3,887
Services rendered by associates	495	580	674	741
Travelling expenses	349	355	486	498
Other expenses	882	767	789	857
EBITDA	**1,003**	**918**	**1,237**	**1,356**
% chg	*(11.4)*	*(8.5)*	*34.7*	*9.6*
(% of Revenues)	*19.5*	*16.7*	*18.6*	*18.5*
D&A	144	161	182	234
EBIT	**860**	**757**	**1,055**	**1,122**
% chg	*(13.9)*	*(12.0)*	*39.4*	*6.4*
(% of Revenues)	*16.7*	*13.8*	*15.9*	*15.3*
Interest expenses	111	103	121	140
Other Income	129	98	18	60
(% of revenues)	*14.7*	*14.3*	*1.9*	*5.8*
Exceptional Items	0	(68)		
PBT	**877**	**685**	**952**	**1,042**
Tax	132	144	228	250
(% of PBT)	*15.0*	*21.0*	*23.9*	*24.0*
PAT (before inc from asso.)	**746**	**541**	**724**	**792**
Share of profit from associates	315	514	479	491
Exceptional Items	(417)	(47)	0	0
PAT reported	**644**	**1,008**	**1,203**	**1,283**
PAT adjusted	**1,061**	**1,055**	**1,203**	**1,283**
% chg	*51.5*	*(0.6)*	*14.0*	*6.7*
(% of Revenues)	*20.6*	*19.2*	*18.1*	*17.5*
Diluted Adj EPS (Rs)	**81.3**	**85.1**	**91.4**	**97.5**
% chg	*49.5*	*4.7*	*7.3*	*6.7*

Balance Sheet

Y/E March (Rs cr)	FY2011	FY2012	FY2013E	FY2014E
SOURCES OF FUNDS				
Share Capital	126	127	127	127
Reserves & Surplus	3,225	3,923	4,588	5,306
Total Shareholders Funds	**3,351**	**4,051**	**4,716**	**5,434**
Total Loans	1,183	1,127	1,402	902
Minority Interest	16	0	0	0
Other Long Term Liab.	538	618	649	681
Total Liabilities	**5,088**	**5,796**	**6,766**	**7,017**
APPLICATION OF FUNDS				
Net Block	678	850	1,242	1,110
Investments	2,908	3,588	3,788	3,988
Deferred Tax Assets	64	100	100	100
Other Long Term Assets	415	338	372	409
Current Assets	1,991	2,044	2,562	2,847
Cash	267	242	311	376
Debtors	1,036	1,317	1,639	1,810
Loans & Advances	688	485	612	661
Current Liab. & Prov.	968	1,124	1,298	1,437
Payables	247	365	445	492
Other Curr. Liab.	558	608	669	736
Provisions	162	151	184	209
Net Current Assets	**1,023**	**920**	**1,264**	**1,410**
Total Assets	**5,088**	**5,796**	**6,766**	**7,017**

Cash Flow Statement

Y/E March (Rs cr)	FY2011	FY2012	FY2013E	FY2014E
Net income	877	754	952	1,042
Depreciation	144	161	182	234
Change in Working Capital	(274)	23	(275)	(81)
Others	(283)	(226)	(127)	(175)
Cash Flow from Operations	**464**	**712**	**731**	**1,021**
(Inc.)/ Dec. in Fixed Assets	(151)	(295)	(575)	(101)
Payment for acquisitions	0	(14)	0	0
(Inc.)/ Dec. in Investments	18	(111)	(182)	(140)
Cash Flow from Investing	**(133)**	**(420)**	**(757)**	**(241)**
Issue of Equity	26	12	0	0
Dividend Paid (Incl. Tax)	(51)	(59)	(59)	(74)
Borrowings	(262)	(270)	154	(640)
Cash Flow from Financing	**(287)**	**(317)**	**95**	**(714)**
Inc./(Dec.) in Cash	43	(26)	69	66
Opening Cash balances	**221**	**265**	**242**	**311**
Closing Cash balances	**265**	**239**	**311**	**376**

Key Ratios

Y/E March	FY2011	FY2012	FY2013E	FY2014E
Valuation Ratio (x)				
P/E (on FDEPS)	10.1	9.6	9.0	8.4
P/CEPS	11.4	14.8	11.5	10.1
P/BV	3.0	2.6	2.2	1.9
Dividend yield (%)	0.5	0.5	0.5	0.6
EV/Sales	1.6	1.4	1.2	0.9
EV/EBITDA	8.4	8.4	6.2	5.1
Per Share Data (Rs)				
Diluted EPS	81.3	85.1	91.4	97.5
Cash EPS	71.9	55.4	71.6	81.1
DPS	4.0	4.0	4.0	5.0
Book Value	270.9	319.5	372.8	429.6
Returns (%)				
RoIC	59.9	40.4	43.1	39.3
RoE	34.0	28.5	27.4	25.3