

TECH MAHINDRA

Stellar performance

India Equity Research | IT



Tech Mahindra (TECHM) reported a stellar performance for Q2FY13 as revenue of USD299mn (QoQ growth of 6.4%) was ahead of our estimates. Even on an organic basis, growth of 1.6% was ahead of our estimate of 0.6%. EBITDA margin at 20.7% QoQ dipped by just 70bps despite wage hike surpassing our estimate of 19.3%. Though the decline in BT continued, non-BT (excl. Hutchison) reported a robust growth of 4%. We are revising our revenue growth for the merged entity to 11%/14% from 7%/9% for FY13/FY14 respectively to factor in revenues from acquired businesses (Hutchison and Comviva) and higher growth from the organic non-BT segment. We maintain 'BUY' with a revised target price of INR1,100, implying 12x our FY14E EPS estimate (for the merged entity) of INR91.7.

Robust revenue, profitability performance

TECHM's Q2FY13 revenue of USD299mn with a QoQ growth of 6.4% (incl. Hutchison) surpassed our and Street estimates of USD293mn. On an organic basis, revenue growth of 1.6% was driven by non-BT (organic) which grew 4% QoQ. EBITDA margin dipped 70bps QoQ to 20.7% (ahead of our and Street estimate) despite wage hikes effected during the quarter. The only blip during the quarter was the 2.5% sequential decline in BT revenue. It also won two new clients in Europe during the quarter.

Non-BT, consolidation of acquired businesses to foster growth

We believe the increased traction in non-BT (organic) segment and consolidation of Hutchison Global Services (USD170mn) and Comviva (USD70mn for FY11) will not only offset the decline in BT but also drive growth for FY13/FY14. Hence we are revising our revenue growth assumption for the merged entity to 11%/14% from earlier 7%/9% for FY13/14 respectively. Also, we are revising downwards our BT growth from earlier decline of 2% to decline of 8% for FY13.

Outlook and valuations: Gathering pace; maintain 'BUY'

Post our initiating coverage report on TECHM (*Tech Mahindra - The big league beckons, dated August 30, 2012*), the stock has given 21% returns. However, a strong Q2FY13 by both Mahindra Satyam and TECHM, both on revenue and profitability front besides an improved visibility on non-BT segment keep us bullish on the future growth prospects. Hence we maintain **BUY** and value the company at 12x, FY14E earnings (merged entity) of INR91.7 with a target price of INR1,100.

Financials

Year to March	Q213	Q113	Growth %	Q212	Growth %	FY12	FY13E*	FY14E*
Revenue (INR mn)	16,314	15,434	5.7	13,333	22.4	46,254	146,143	161,396
EBITDA (INR mn)	3,377	3,302	2.3	2,042	65.4	11,325	30,001	32,225
Net profit (INR mn)	2,962	3,384	(12.5)	2,404	23.2	7,005	18,717	21,192
Diluted EPS (INR)	22.3	25.5	(12.4)	18.2	22.6	53.9	81.0	91.7
Diluted P/E (x)						NA	11.8	10.4

*Financials for merged entity

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA (R: TEML.BO, B: TECHM IN)

CMP	: INR 955
Target Price	: INR 1,100
52-week range (INR)	: 1,043 / 528
Share in issue (mn)	: 127.6
M cap (INR bn/USD mn)	: 122 / 2,236
Avg. Daily Vol.BSE/NSE('000)	: 405.3

SHARE HOLDING PATTERN (%)

	Current	Q1FY13	Q4FY12
Promoters*	56.7	70.8	70.8
MF's, FI's & BK's	18.7	14.8	14.8
FII's	15.1	5.9	5.7
Others	9.5	8.5	8.7
* Promoters pledged shares (% of share in issue)	:		NIL

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	0.9	(0.9)	(4.0)
3 months	25.5	9.1	3.9
12 months	53.0	6.8	23.9

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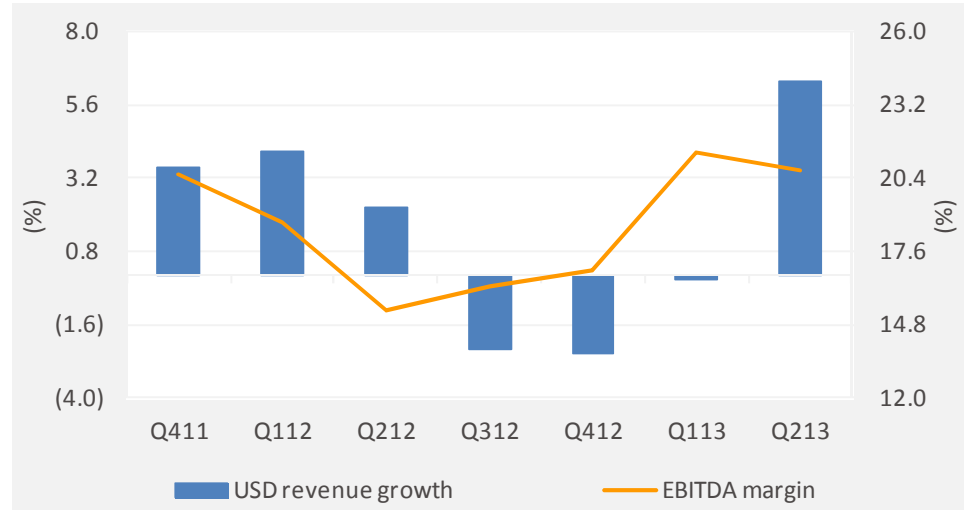
November 5, 2012

Key highlights

- Revenue ahead of estimates:** Revenue at USD299.2mn (including USD13.3mn from Hutchison) was ahead of our estimate (USD293mn), up 6.4% QoQ. In INR terms, revenue stood at INR16.3bn, up 5.7% sequentially. On an organic basis, revenue growth stood at 1.6% QoQ vs our estimate of 0.6%.

EBITDA stood at INR3.4bn, up 2.3% QoQ while EBITDA margin at 20.7% was above our estimate of 19.3% but down 70bps QoQ mainly due to wage hikes which were partially offset by employee rationalisation in the BPO business.

Chart 1: Revenue growth jumps aided by non- BT and Hutchison



Source: Company, Edelweiss research

- Net profit** at INR3.0bn was down 12.5% QoQ, but above our estimate of INR2.6bn mainly due to higher operating profits and lower tax rate of 12.4% (23.7% in previous quarter). Net margin for the quarter stood at 18.2% against 21.9% in Q1FY13.
- Segmental performance:** Revenue from telecom service providers declined 320bps from 80.4% to 77.2% while revenue from telecom equipment provider declined from 6.8% to 6.2%. Contribution from BPO jumped from 10.1% to 13.7%.

Table 1: Segment wise revenue contribution trend

Vertical / Segment wise	Q111	Q211	Q311	Q411	Q112	Q212	Q312	Q412	Q113	Q213
Telecom service provider	87.3	89.3	87.2	83.8	82.4	81.5	78.6	80.5	80.4	77.2
Telecom equipment provider	5.1	4.5	4.8	6.2	6.4	6.0	7.3	6.4	6.8	6.2
BPO	5.9	5.0	6.3	8.0	9.4	9.3	9.6	10.4	10.1	13.7
Others	1.7	1.3	1.6	2.1	1.8	3.2	4.5	2.7	2.8	2.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

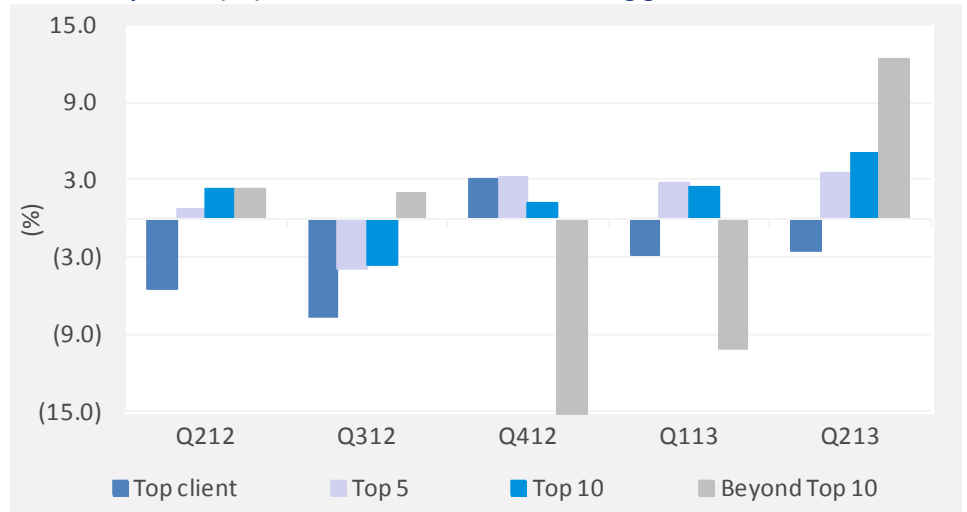
Source: Company, Edelweiss research

- Client Data:** Active clientele stood at 126 versus 130 in the previous quarter. The number of USD1mn clients increased by 1 to 57 and USD2m clients increased by 3 to 41. USD5mn, USD10mn & USD15mn clients declined by one, two and one respectively. USD50mn clients increased by one to 3 (2 in the previous quarter).

- **Geographical split:** Europe and Rest of World led growth with 8.7% and 11.7% QoQ growth in USD terms, respectively. America reported a marginal growth of 0.3% in USD terms.
- **Employee metrics:** Net employee addition stood at 9,849 during the quarter. Total headcount stands at 50,479.

Top 5 and 10 clients drive growth: Top client declined 2.5% QoQ (33% of revenue). Top 5 and 10 clients reported a sequential growth of 3.4% and 5.1% respectively. Growth from beyond top 10 clients came at 12.3% QoQ (10.1% decline in previous quarter).

Chart 2: Top client (BT) decline continues, non-BT driving growth



Source: Company, Edelweiss research

- **Utilisation** including trainees was flat QoQ at 74%.
- **Capex** for the quarter was USD5.3mn versus USD4.9mn in Q1FY13.
- Current cash and equivalents in hand stand at USD67.9mn while debt stands at USD243.4mn.

Financials snapshot

(INR mn)

Year to March	Q213	Q113	Growth %	Q212	Growth %	FY12	FY13E*	FY14E*
Total revenues	16,314	15,434	5.7	13,333	22.4	46,254	146,143	161,396
Software dev expenses	10,336	9,684	6.7	9,069	14.0	28,711	91,822	101,388
Gross profit	5,978	5,750	4.0	4,264	40.2	17,543	54,321	60,008
Selling & General Admin Expenses	2,601	2,448	6.3	2,222	17.1	6,218	24,321	27,783
EBITDA	3,377	3,302	2.3	2,042	65.4	11,325	30,001	32,225
Depreciation	481	421	14.3	507	(5.1)	1,338	4,348	5,039
EBIT	2,896	2,881	0.5	1,535	88.7	9,987	25,652	27,185
Interest Expenses	228	240	(5.0)	721	(68.4)	2,184	0	0
Other income	(640)	(174)	NA	972	NA	754	1,900	3,662
PBT	2,028	2,467	(17.8)	1,786	13.5	8,557	27,552	30,848
Tax	251	585	(57.1)	393	(36.1)	1,440	6,835	7,655
Adjusted net profit	1,777	1,882	(5.6)	1,393	27.6	7,117	20,717	23,192
Exceptional items	0	0	NA	0	NA		(2,000)	(2,000)
Share of profit in associate	1,185	1,502	(21.1)	1,016	16.6	0	0	0
Extra ordinary income	0	0	NA	0	NA	(85)	0	0
Minority interest	0	0	0.0	(5)	NA	(28)	0	0
Reported net profit	2,962	3,384	(12.5)	2,404	23.2	7,005	18,717	21,192
Diluted EPS (INR)	22	26	(12.4)	18	22.6	54	81.0	91.7

as % of net revenues

Gross profit	36.6	37.3		32.0		37.9	37.2	37.2
Selling & General Admin Expenses	15.9	15.9		16.7		13.4	16.6	17.2
EBITDA	20.7	21.4		15.3		24.5	20.5	20.0
Adjusted net profit	10.9	12.2		10.4		15.4	14.2	14.4
Reported net profit	18.2	21.9		18.0		15.1	12.8	13.1
Tax rate	12.4	23.7		22.0		16.8	24.8	24.8

*Financials for merged entity

Changes in estimates

	FY13E			FY14E			Comments
	New	Old	% change	New	Old	% change	
Net revenue	146,143	140,946	3.7	161,396	149,669	7.8	Revising USD revenue growth to 11% and 14% from 7% and 9% fro FY13E and FY14E to factor in the revenues from Hutchison and Comviva and improved visibility for Non- BT (organic) leads to increase in revenue
EBITDA	30,001	27,687	8.4	32,225	29,507	9.2	Revision of revenue growth as stated above and improved margin performance in Q2FY13 by both TECHM and Mahindra Satyam leads to an increase in EBITDA
EBITDA margin (%)	20.5	19.6		20.0	19.7		
PAT	18,717	17,167	9.0	21,192	19,333	9.6	
PAT margin (%)	12.8	12.2		13.1	12.9		

Company Description

TECHM has been one of the leaders in providing end to end solution to the IT needs of the telecom vertical and derives ~96% of its revenue from the telecom vertical. Its top client British Telecom (BT) contributes 37% to revenues. The company was incorporated in 1986 as a joint venture between Mahindra & Mahindra and British Telecommunications (BT). In 2009, Tech Mahindra acquired Satyam Computer Services Limited and plans to merge it into Tech Mahindra in the next few months. TECHM has over 50,479 employees. The company's revenues for the past twelve months stood at INR60.4bn (USD1.1bn).

Investment Theme

The merger of MSAT with TECHM creates a formidable player with combined revenues of USD2.5bn thus making it the fifth-largest player in the Indian IT services sector (ex-Cognizant). This will enable TECHM to compete with biggies of the industry and vie for larger deals which could lead to improved traction for the merged entity. Generally clients are more comfortable with larger organizations having a good track record. The close relationship between TECHM and MSAT since past three years will help better integration of functions and provide synergies to the company going forward. It will enable TECHM to diversify its portfolio vertically as well as geographically. Further the merger leads to reduction in top client dependency for TECHM from 36% to 17% in the combined entity. This although, higher than Tier I players, will come down going ahead as the merged entity cross sells and up sells its services to an expanded client base.

Key Risks

Key risks to our investment theme include –

- Delay in telecom spend raises a concern
- High exposure to BT, Europe may impact growth
- Legal, tax litigations could adversely impact estimates

Financial Statements

Key assumptions

		FY11	FY12	FY13E	FY14E
Macro -	GDP(Y-o-Y %)	8.4	6.5	5.8	6.5
	Inflation (Avg)	9.9	8.8	7.8	6.0
	Repo rate (exit rate)	6.8	8.5	7.5	6.8
	USD/INR (Avg)	45.6	47.9	53.5	52.0
Company -	BT growth (%)			(8.0)	0.0
	Non-BT growth (%)*			24.0	22.0
	Other verticals growth (%)			9.9	12.4

* including revenues from Hutchison and Comviva

Income statement

		FY11	FY12	FY13E*	FY14E*
(INR mn)					
Year to March					
Revenues		102,852	118,852	146,143	161,396
Cost of revenues		69,971	76,371	91,822	101,388
Gross profit		32,881	42,482	54,321	60,008
SG&A expenses		18,297	23,048	24,321	27,783
EBITDA		14,584	19,433	30,001	32,225
Depreciation & amortization		3,282	3,191	4,348	5,039
EBIT		11,302	16,242	25,652	27,185
Interest expense		1,096	1,531	0	0
Other income		3,568	4,918	1,900	3,662
Foreign exchange gain/(loss)		548	665	0	0
Profit before tax		14,322	20,295	27,552	30,848
Tax		1,893	2,290	6,835	7,655
Core profit		12,429	18,005	20,717	23,192
Extraordinary income/(loss)		(6,411)	1,094	(2,000)	(2,000)
Profit after tax		6,018	19,099	18,717	21,192
Diluted shares (mn)		NA	NA	231	231
EPS (INR) diluted		NA	NA	81.0	91.7
Diluted P/E (x)		NA	NA	11.8	10.4

Common size metrics - as % of revenues

Year to March	FY11	FY12	FY13E	FY14E
Cost of revenues	68.0	64.3	62.8	62.8
Gross margin	32.0	35.7	37.2	37.2
SG&A expenses	17.8	19.4	16.6	17.2
EBITDA margin	14.2	16.4	20.5	20.0
EBIT margin	11.0	13.7	17.6	16.8
Net profit margins	5.9	16.1	12.8	13.1

Growth metrics (%)

Year to March	FY11	FY12	FY13E	FY14E
Revenues	1.8	15.6	23.0	10.4
EBITDA	(8.2)	33.3	54.4	7.4
Net profit	23.7	44.9	15.1	11.9
EPS	NA	NA	NA	13.2

*Financials for merged entity

Peer comparison valuation

Company	Absolute	CMP	Mcap	P/E(x)		EV/EBITDA(x)		Mcap/Revenue (x)	
	Reco	(INR)	(INR bn)	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
CMC	BUY	1,145	34.7	14.4	11.0	10.6	8.1	1.9	1.9
eClerx	BUY	666	19.6	11.7	9.1	6.7	5.5	3.0	2.6
HCL Tech	BUY	614	426.2	13.8	12.8	7.9	7.4	1.7	1.5
Hexaware	BUY	113	33.6	9.8	8.5	6.3	5.1	1.7	1.5
Info Edge	REDUCE	354	38.7	29.6	22.9	20.6	14.0	8.9	7.1
Infosys	BUY	2,378	1,365.8	14.7	12.9	9.5	7.9	3.4	3.1
Infotech	BUY	194	21.6	9.7	8.9	4.2	3.8	1.1	1.0
Mphasis	HOLD	392	82	10.9	9.8	5.5	4.7	1.5	1.4
Persistent Systems	BUY	483	19	11.2	10.0	(1.4)	(1.8)	1.5	1.3
TCS	HOLD	1,330	2,602	19.1	17.8	14.0	12.5	4.2	3.7
TECHM*	BUY	955	122	11.8	10.4	NA	NA	0.9	0.8
Wipro#	BUY	363	893	14.3	13.0	10.0	9.2	2.4	2.2

* Merged entity

Source: Company, Edelweiss research

#Estimates excl. non-IT businesses



Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
CMC	BUY	SO	L	ECLERX SERVICES	BUY	SO	M
HCL Technologies	BUY	SO	H	Hexaware Technologies	BUY	SO	M
Info Edge	REDUCE	SU	M	Infosys	BUY	SO	L
Infotech Enterprises	BUY	SO	H	Mphasis	HOLD	SP	M
Persistent Systems	BUY	SO	L	Tata Consultancy Services	HOLD	SP	L
Tech Mahindra	BUY	SO	M	Wipro	BUY	SP	L

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return



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Coverage group(s) of stocks by primary analyst(s): IT

CMC, ECLERX SERVICES, HCL Technologies, Hexaware Technologies, Infosys, Info Edge, Infotech Enterprises, Mphasis, Persistent Systems, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
02-Nov-12	Wipro	Time's ripe now; Result Update	365	Buy
01-Nov-12	Hexaware Technologies	Inline results; Result Update	111	Buy
01-Nov-12	Wipro	Fair demerger; EdelFlash	351	Hold

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	113	53	19	186
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	14	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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