

TECH MAHINDRA

Embarking on a turnaround journey

India Equity Research | IT

Tech Mahindra's (TECHM) Q1FY18 revenue at USD1,138mn (up 0.6% QoQ, down 0.6% CC) and margin at 12.7% were ahead of Street's estimates on account of improvement in efficiency and LCC. Key quarter highlights were: 1) flat organic growth in enterprise business; 2) 70bps QoQ margin improvement in spite of currency & visa headwinds; and 3) strong pipeline in digital business—up 30% YoY—and 2.5x increase in deal sizes. Management reiterated confidence in its telecom/enterprise businesses as well as margin improvement going forward with LCC stabilising, digital business gaining traction and improvement in margin aided by higher utilisation, automation & non-recurrence of LCC-related expenses. Maintain 'BUY' with revised TP of INR546 (INR563 earlier).

LCC stabilising; digital gaining momentum

With LCC stabilising and traction in digital business, management sounded confident on all business verticals. It also highlighted that while deal size in digital business has jumped 2.5x versus Q1FY17, the pipeline has catapulted 30% YoY. We believe, LCC, after almost 50% dip, will stabilise now, although it is likely to impact FY18 growth.

Margin: Green shoots visible

EBITDA margin expanded 70bps QoQ to 12.7% led by efficiency improvement (headcount down 1.5% QoQ and sub-contracting costs down 6.3% QoQ) and some recovery in LCC's margin. Management believes, utilisation gains will reflect from Q2FY18, while other margin levers (including LCC' margins) have further upsides. This implies that the margin trajectory will be on the upmove given that cost headwinds are largely behind.

Outlook & valuations: Revenue, margin on rise; maintain 'BUY'

TECHM's margin surprise and positive commentary are in line with our expectations, and we expect them to reflect in coming quarters' numbers. We believe, on account of restructuring, LCC's revenue has halved (since acquisition), implying that the worst revenue and margin has been factored in current numbers. While we prune FY18/19E EPS 1.5/2.9% due to change in USD/INR assumption, reasonable valuation of 9.9x FY19E factors in near-term pain and leaves substantial medium-term upside. Hence, we maintain 'BUY/SP' with revised TP of INR546 (14.0x FY19E EPS). The stock is trading at 9.9x FY19E EPS.

Financials

(INR mn)

Year to March	Q1FY18	Q4FY17	% Chg	Q1FY17	% Chg	FY17	FY18E	FY19E
Net revenues	73,361	74,950	(2.1)	69,209	6.0	291,408	311,932	343,806
EBITDA	9,347	8,987	4.0	10,290	(9.2)	41,843	45,335	53,204
Adjusted Profit	7,985	5,880	35.8	7,500	6.5	28,400	30,481	34,724
Diluted EPS (INR)	9.0	6.6	35.9	8.4	6.4	31.9	34.3	39.0
Diluted P/E (x)						12.1	11.3	9.9
EV/EBITDA (x)						8.4	7.3	5.8
EV/Revenues (x)						1.2	1.1	0.9

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

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

CMP	: INR 386
Target Price	: INR 546
52-week range (INR)	: 515 / 357
Share in issue (mn)	: 975.7
M cap (INR bn/USD mn)	: 376 / 5,854
Avg. Daily Vol.BSE/NSE('000)	: 2,886.4

SHARE HOLDING PATTERN (%)

	Current	Q4FY17	Q3FY17
Promoters *	36.2	36.2	36.2
MF's, FI's & BK's	14.6	13.3	15.4
FII's	35.2	36.7	34.5
Others	14.1	13.8	13.8
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	1.0	5.8	6.1
3 months	(7.5)	8.3	8.5
12 months	(20.9)	16.7	(3.5)

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LCC drag waning; digital on robust footing

TECHM posted in line revenue growth inspite of seasonal drag from Comviva and some leakage from LCC business, implying the inherent strength in ROB (Rest of business). Management cited almost 30% increase in digital pipeline (YoY) and 2.5x jump in deal size (YoY) as key reasons for its optimism in revenue growth. While newer acquisitions poses risk to the optimism, we believe the hugely diversified (geographic) acquisition of LCC led to much higher-than-expected disappointment. In our view, if things stabilise at current levels for acquired businesses and given the current strength of the enterprise business, revenue trajectory will be on an upmove going forward.

Margin: Green shoots visible

TECHM's margin expanded 70bps QoQ in Q1FY18, which was marginally positive. However, we believe the bigger positive is multiple margin levers going forward. Moreover, benefits of headcount rationalisation and LCC will start reflecting in coming quarters. This implies that if INR does not appreciate significantly, the margin trajectory will be on an upmove as well.

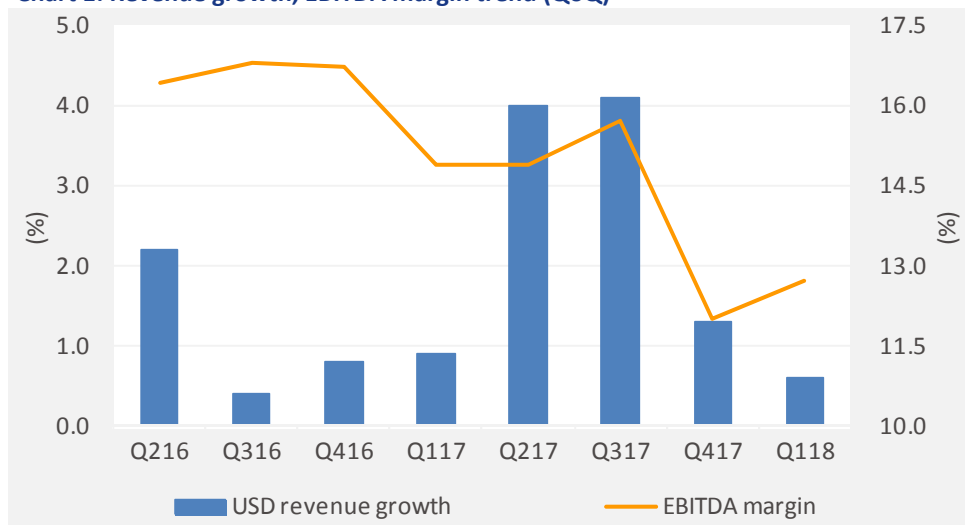
Outlook and valuations: Revenue, margin on the rise; maintain 'BUY'

We believe, negative revenue & margin surprises are largely behind, and given significant margin levers TECHM entails the potential to post 10.6% EPS CAGR over FY17-19E. The key positive is that growth in the entire business, excluding LCC, has recovered, in line with the company's guidance. While management believes bottoming out of LCC business is a quarter or 2 away, in our view, a significant slippage from here is unlikely. While the above earnings growth is not significant, we believe undemanding valuation of 9.9x FY19E implies modest upside from current levels. We maintain 'BUY/SP' with TP of INR 546.

Key highlights

- **Revenue beats estimate:** Consolidated revenue, at USD1,138mn, rose 0.6% QoQ, surpassing Street's 0.6% decline estimate. In INR terms, revenue stood at INR73.4bn, down 2.1% QoQ.

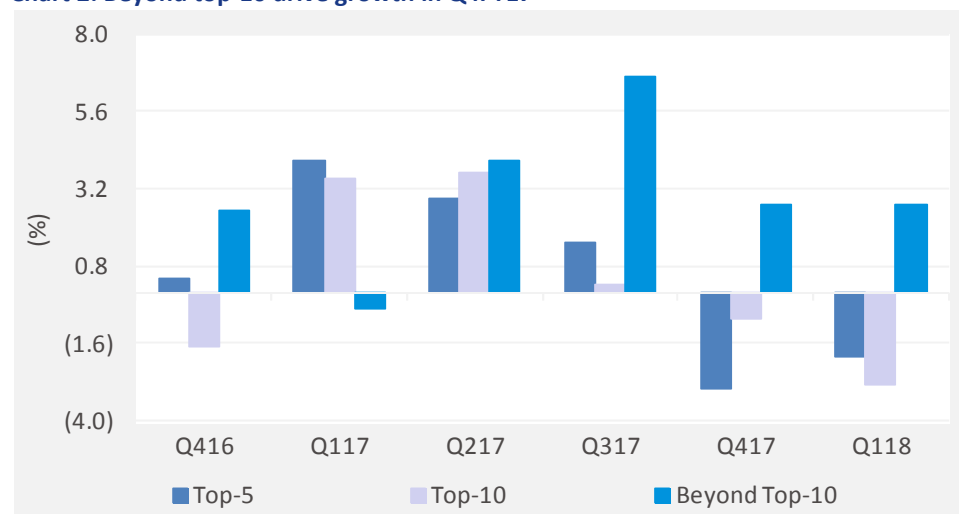
Chart 1: Revenue growth, EBITDA margin trend (QoQ)



Source: Company, Edelweiss research

- **While EBITDA** stood at INR9.3bn, up 4.0% QoQ, **EBITDA margin** rose 70bps QoQ to 12.7%, 50bps above Street's 12.2% estimate.
- **PAT**, at INR8.0bn, was much above Street's INR6.1bn estimate. Net margin stood at 10.9% (up 300bps QoQ).
- **Client data:** Active clientele stood at 864 versus 843 in Q4FY17. The number of less than USD1mn clients stood at 377 from 354 in previous quarter, while the number of USD5mn clients rose 5 QoQ to 139. The number of USD10mn clients jumped by 3 to 74, while the USD20mn bucket rose by 5 to 41. USD50mn plus client count was flat at 14.
- **Employee metrics:** Net decrease of 1,713, with total headcount of 115,980. LTM attrition was flat QoQ at 17%. Utilisation (excluding trainees) stood at 81%, flat QoQ.
- **Broad revenue growth:** Top-5 and top-10 clients declined 2.0% and 2.9% QoQ, respectively, while beyond top-10 clients grew 2.7% QoQ.
- **Industry verticals:** While enterprise segment posted revenue growth of 2.7% QoQ, telecom business declined 1.8% QoQ. In the enterprise segment, revenue growth was boosted by HCI acquisition (USD17mn), whereas retail, transport & logistics, BFSI and manufacturing grew 5.3%, 2.8% and 1.1% QoQ, respectively.

Chart 2: Beyond top-10 drive growth in Q4FY17



Source: Company, Edelweiss research

- **Capex** was INR1,447mn versus INR2,844mn in Q4FY17.
- **Hedging details:** TECHM has outstanding hedges worth USD878mn at an average rate of INR72.6, EUR165mn at an average rate of INR81.6 and GBP247mn at an average rate of INR97.0.
- **Cash and cash equivalents:** Stood at INR60.2bn.

Financial snapshot

(INR mn)

Year to March	Q1FY18	Q4FY17	% Change	Q1FY17	% Change	FY17	FY18E	FY19E
Net revenues	73,361	74,950	(2.1)	69,209	6.0	291,408	311,932	343,806
Cost of revenue	52,818	54,785	(3.6)	48,807	8.2	205,661	219,616	239,614
Gross profit	20,543	20,165	1.9	20,402	0.7	85,747	92,316	104,192
SG&A	11,196	11,178	0.2	10,112	10.7	43,904	46,982	50,988
EBITDA	9,347	8,987	4.0	10,290	(9.2)	41,843	45,335	53,204
Depreciation	2,468	2,835	(12.9)	2,019	22.2	9,781	11,057	12,033
EBIT	6,879	6,152	11.8	8,271	(16.8)	32,062	34,278	41,171
Other income	1,380	762	81.1	1,979	(30.3)	3,900	3,255	3,850
Forex Loss/ (Gain)	2,726	1,617	68.6	479	469.1	3,876	5,066	3,220
Interest	370	318	16.4	274	35.0	1,286	1,480	1,480
Profit before tax	10,615	8,213	29.2	10,455	1.5	38,552	41,119	46,760
Tax	2,698	2,316	16.5	2,468	9.3	9,785	10,385	11,784
Minority interest	(68)	17	NA	464	NA	367	253	253
Exceptionals								
Reported net profit	7,985	5,880	35.8	7,500	6.5	28,400	30,481	34,724
Adjusted Profit	7,985	5,880	35.8	7,500	6.5	28,400	30,481	34,724
Diluted EPS (INR)	9.0	6.6	35.9	8.4	6.4	31.9	34.3	39.0
Diluted P/E (x)	-	-		-		12.1	11.3	9.9
EV/EBITDA (x)	-	-		-		8.4	7.3	5.8
EV/Revenues (x)	-	-		-		1.2	1.1	0.9
Gross profit	28.0	26.9		29.5		29.4	29.6	30.3
SG&A	15.3	14.9		14.6		15.1	15.1	14.8
EBITDA	12.7	12.0		14.9		14.4	14.5	15.5
Reported net profit	10.9	7.8		10.8		9.7	9.8	10.1
Tax rate	25.4	28.2		23.6		25.4	25.3	25.2

Company Description

TECHM has been one of the leaders in providing end to end solution to the IT needs of the telecom vertical and its merger with Mahindra Satyam (MSAT) makes it the fifth largest Indian IT player. It derives ~47% of its revenue from the telecom vertical. 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. TECHM has over 115,980 employees. The company's revenues for the past twelve months stood at INR295.6bn (USD4.46bn).

Investment Theme

The merger of MSAT with TECHM has created a formidable player 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 has led to a better integration of functions and both the entities function as a cohesive unit now. The merger has enabled TECHM to diversify its portfolio vertically as well as geographically. 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 can impact estimates meaningfully
- High exposure to Europe may impact growth
- Currency appreciation can impact estimate

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.2	6.5	7.1	7.7
Inflation (Avg)	4.9	4.5	4.0	4.5
Repo rate (exit rate)	6.8	6.3	5.8	5.8
USD/INR (Avg)	65.0	67.5	66.0	66.0
Company				
Telecom revenue (USD mn)	2,097	2,078	2,073	2,181
Other verticals revenue (USD mn)	1,940	2,273	2,629	2,938
Other vertical growth(%)	10.1	17.2	15.7	11.8
Other Cost (% of rev.)				
Cost of rev. (% of rev.)	69.2	70.6	70.4	69.7
SGA cost (% of revenue)	14.7	15.1	15.1	14.8
Financial assumptions				
Depreciation (% of rev.)	2.9	3.4	3.5	3.5
Capex (INR mn)	8,570	7,603	10,475	11,146
Debtor days	76	70	65	65
Payable days	43	41	39	38
Cash conversion cycle	32	29	26	27

Income statement

(INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Net revenue	264,941	291,408	311,932	343,806
Cost of revenues	183,276	205,661	219,616	239,614
Gross profit	81,665	85,747	92,316	104,192
Total SG&A expenses	38,948	43,904	46,982	50,988
EBITDA	42,717	41,843	45,335	53,204
Depreciation	7,590	9,781	11,057	12,033
EBIT	35,127	32,062	34,278	41,171
Add: Other income	5,056.00	7,776.00	8,320.7	7,069.55
Less: Interest Expense	974	1,286	1,480	1,480
Profit Before Tax	39,209	38,552	41,119	46,760
Less: Provision for Tax	8,182	9,785	10,385	11,784
Less: Minority Interest	352	367	253	253
Reported Profit	30,701	28,400	30,481	34,724
Adjusted Profit	30,701	28,400	30,481	34,724
Shares o /s (mn)	872	974	974	974
Adjusted Basic EPS	35.2	29.2	31.3	35.6
Diluted shares o/s (mn)	892	890	890	890
Adjusted Diluted EPS	34.4	31.9	34.3	39.0
Adjusted Cash EPS	43.9	39.2	42.6	48.0
Dividend per share (DPS)	12.0	9.0	10.0	12.0
Dividend Payout Ratio(%)	39.9	36.1	37.4	39.4

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Cost of revenues	69.2	70.6	70.4	69.7
Gross margin	30.8	29.4	29.6	30.3
SG&A expenses	14.7	15.1	15.1	14.8
EBITDA margins	16.1	14.4	14.5	15.5
EBIT margins	13.3	11.0	11.0	12.0
Net Profit margins	11.7	9.9	9.9	10.2

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	17.1	10.0	7.0	10.2
EBITDA	2.9	(2.0)	8.3	17.4
PBT	8.4	(1.7)	6.7	13.7
Adjusted Profit	16.8	(7.5)	7.3	13.9
EPS	16.8	(7.2)	7.3	13.9

Balance sheet		(INR mn)			
As on 31st March	FY16	FY17	FY18E	FY19E	
Share capital	4,355	4,388	4,388	4,388	
Reserves & Surplus	141,554	159,984	179,068	200,115	
Shareholders' funds	145,909	164,372	183,456	204,503	
Minority Interest	1,927	4,641	4,894	5,147	
Short term borrowings	8,055	8,342	7,508	6,757	
Long term borrowings	1,966	3,853	4,007	4,167	
Total Borrowings	10,021	12,195	11,515	10,924	
Long Term Liabilities	19,088	23,870	23,107	22,639	
Def. Tax Liability (net)	(5,322)	(2,674)	(2,674)	(2,674)	
Sources of funds	171,623	202,404	220,298	240,540	
Net Block	24,341	31,728	30,400	28,842	
Capital work in progress	6,294	3,729	4,475	5,146	
Intangible Assets	19,298	32,873	32,873	32,873	
Total Fixed Assets	49,933	68,330	67,748	66,861	
Non current investments	1,177	2,308	2,770	3,324	
Cash and Equivalents	35,226	41,660	62,089	83,965	
Inventories	403	611	672	739	
Sundry Debtors	57,705	53,377	58,113	64,052	
Loans & Advances	75,481	91,705	87,352	83,916	
Current Assets (ex cash)	133,589	145,693	146,138	148,707	
Trade payable	22,758	23,117	24,068	26,259	
Other Current Liab	25,544	32,470	34,380	36,058	
Total Current Liab	48,302	55,587	58,447	62,317	
Net Curr Assets-ex cash	85,287	90,106	87,691	86,390	
Uses of funds	171,623	202,404	220,298	240,540	
BVPS (INR)	163.5	184.8	206.2	229.9	

Free cash flow		(INR mn)			
Year to March	FY16	FY17	FY18E	FY19E	
Reported Profit	30,701	28,400	30,481	34,724	
Add: Depreciation	7,590	9,781	11,057	12,033	
Interest (Net of Tax)	(19,351)	(31,354)	(35,899)	(35,816)	
Others	45,782	38,706	28,548	30,012	
Less: Changes in WC	32,590	4,819	(2,415)	(1,300)	
Operating cash flow	32,132	40,714	36,602	42,253	
Less: Capex	8,570	7,603	10,475	11,146	
Free Cash Flow	23,562	33,111	26,127	31,107	

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
Tech Mahindra	5,854	11.3	9.9	7.3	5.8	17.2	17.6
ECLERX SERVICES	807	14.5	12.8	8.5	7.3	27.8	27.8
HCL Technologies	19,845	13.9	12.7	10.9	9.7	25.2	24.3
Infosys	36,175	15.3	14.0	9.9	8.8	21.8	22.8
Persistent Systems	803	14.7	12.5	8.5	6.8	17.4	18.0
Tata Consultancy Services	76,471	18.6	17.2	13.5	12.2	30.0	30.5
Wipro	21,863	15.9	13.9	12.5	10.8	16.9	17.2
Median	-	14.7	12.8	9.9	8.8	21.8	22.8
AVERAGE	-	14.9	13.3	10.1	8.8	22.3	22.6

Source: Edelweiss research

Cash flow metrics		FY16	FY17	FY18E	FY19E
Year to March					
Operating cash flow		32,132	40,714	36,602	42,253
Investing cash flow		(14,667)	(30,508)	(11,275)	(16,753)
Financing cash flow		(5,653)	(14,096)	(13,557)	(15,747)
Net cash Flow		11,812	(3,890)	11,771	9,754
Capex		(8,570)	(7,603)	(10,475)	(11,146)
Dividend paid		(6,245)	(12,392)	(11,397)	(13,676)

Profitability and efficiency ratios

Year to March	FY16	FY17	FY18E	FY19E
ROAE (%)	22.8	18.2	17.2	17.6
ROACE (%)	27.8	23.5	22.4	22.9
Debtors Days	76	70	65	65
Payable Days	43	41	39	38
Cash Conversion Cycle	33	30	27	28
Current Ratio	3.5	3.4	3.6	3.7

Operating ratios

Year to March	FY16	FY17	FY18E	FY19E
Total Asset Turnover	1.7	1.6	1.5	1.5
Fixed Asset Turnover	6.3	5.4	4.9	5.5
Equity Turnover	1.9	1.8	1.7	1.7

Valuation parameters

Year to March	FY16	FY17	FY18E	FY19E
Adj. Diluted EPS (INR)	34.4	31.9	34.3	39.0
Y-o-Y growth (%)	16.8	(7.2)	7.3	13.9
Adjusted Cash EPS (INR)	43.9	39.2	42.6	48.0
Diluted P/E (x)	11.2	12.1	11.3	9.9
P/B (x)	2.4	2.1	1.9	1.7
EV / Sales (x)	1.2	1.2	1.1	0.9
EV / EBITDA (x)	7.3	8.4	7.3	5.8
Dividend Yield (%)	3.1	2.3	2.6	3.1

Additional Data

Directors Data

Mr. Anand G. Mahindra	Chairman	Mr. Vineet Nayyar	Executive Vice Chairman
Mr. C. P. Gurnani	Managing Director & CEO	Mr. Anupam Puri	Director
Mr. M. Damodaran	Director	Mr. Ravindra Kulkarni	Director
Mr. Ulhas N. Yargop	Director	Mrs. M. Rajyalakshmi Rao	Director
Mr. T. N. Manoharan	Director	V S PARTHASARATHY	Director

Auditors - Deloitte Haskins and Sells, Chartered Accountants

**as per last annual report*

Holding - Top10

	Perc. Holding		Perc. Holding
First State Investments	13.86	Life Insurance Corp	3.62
Prudential ICICI Asset Management	3.05	Blackrock	1.92
Norges Bank	1.87	Vanguard Group	1.65
Birla Sunlife	1.52	Templeton Asset Management	1.12
UTI Asset Mgmt	0.97	Skagen Funds	0.90

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
03 Apr 2017	VINEET NAYYAR	Sell	3770268.00
03 Apr 2017	Chander Prakash Gurnani	Sell	300000.00
22 Mar 2017	Chander Prakash Gurnani	Sell	100000.00
21 Mar 2017	Chander Prakash Gurnani	Sell	100000.00
16 Feb 2017	Venkata S. K Rao Paturi	Sell	27000.00

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Cyient	BUY	SP	H	ECLERX SERVICES	HOLD	SP	M
HCL Technologies	BUY	SP	H	Hexaware Technologies	HOLD	SP	M
Info Edge	BUY	SP	M	Infosys	BUY	SO	L
Just Dial	REDUCE	SU	M	Persistent Systems	BUY	SP	L
Tata Consultancy Services	HOLD	SP	L	Tech Mahindra	BUY	SP	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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Aditya Narain

Head of Research

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

Cyient, ECLERX SERVICES, HCL Technologies, Hexaware Technologies, Infosys, Info Edge, Just Dial, Persistent Systems, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
31-Jul-17	Hexaware Technologies	Guidance upgrade brightens outlook; <i>Result Update</i>	262	Hold
27-Jul-17	HCL Technologies	Maintaining guidance bolsters confidence; <i>Result Update</i>	890	Buy
25-Jul-17	Just Dial	Good show, long haul ahead; <i>Result Update</i>	383	Reduce

Distribution of Ratings / Market Cap

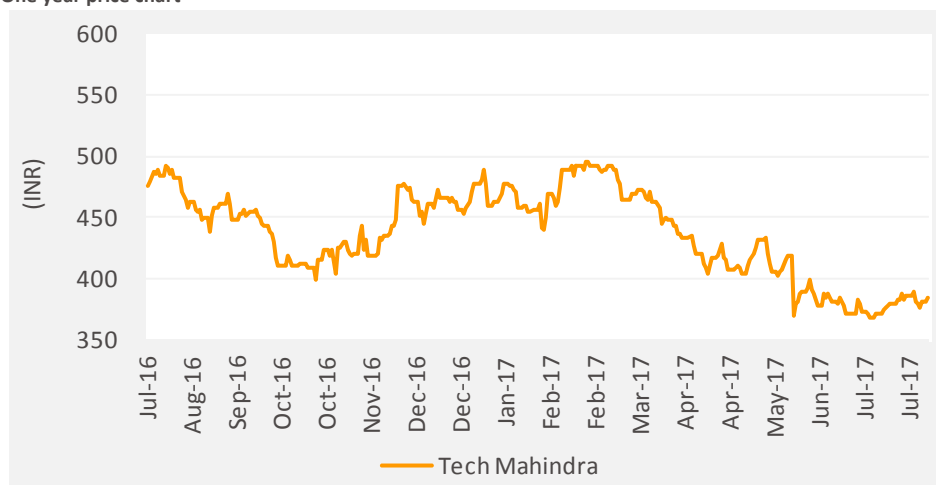
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

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

One year price chart



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