

TECH MAHINDRA

IT - SERVICES

08 NOV 2017

Quarterly Update

BUY

Target Price: Rs 550

Strong operational performance

TechM reported revenue growth of 3.6% QoQ (Organic: +2.4%, CJS: ~USD 14 mn, CC: 2.3% QoQ) to USD 1,179 mn (AxisCapE/Cons.: USD 1,165 mn/USD 1,172 mn). EBITDA margin up 180 bps QoQ at 14.5% led by utilization uptick, lower headcount, and absorption of visa costs. Reported EPS grew 4.7% QoQ to Rs 9.4 (AxisCapE/Cons.: Rs 7.02/ Rs 8.27), led by higher EBITDA. TCV win of USD 340 mn+ in Q2FY18 led by 1 large deal win in each Telecom and Enterprise.

Enterprise momentum steady, Telecom outlook for H2 stronger: Enterprise segment (~56% rev) grew ~6% QoQ (Organic: 4.2%) led by strong growth in Retail/Manufacturing/Others (healthcare). Outlook for H2 is steady excluding seasonality. Telecom flattish in Q2, but H2FY18 is likely to be stronger led by VAS revenue and deal ramp-up. We expect growth in Telecom to offset overall seasonality in H2FY18.

CMP : Rs 489
Potential Upside : 12%

MARKET DATA

No. of Shares : 976 mn
Free Float : 64%
Market Cap : Rs 477 bn
52-week High / Low : Rs 515 / Rs 358
Avg. Daily vol. (6mth) : 2.5 mn shares
Bloomberg Code : TECHM IB Equity
Promoters Holding : 36%
FII / DII : 37% / 13%

Key highlights

- ♦ **IP deal – to strengthen cloud presence:** TechM has signed an IP deal with technology majors in virtualization and cloud management software domain. The company will pay USD 140 mn/ 3 years (Q2FY18: USD 35 mn), which will be amortized over next 10 years. Revenue accrual from the same will begin from Q3FY18. Management expects the deal to strengthen its cloud offerings including system integration deals and cloud migration. Details of deal contour would be provided with Q3FY18 financial performance.
- ♦ **Margin trajectory likely to retain:** The company has recouped ~280 bps margin, largely led by utilization improvement (400 bps) in H1FY18 after EBIT margin bottoming out in Q4FY17. Management has undertaken a six quarter initiative to improve margin (i) utilization: nearing peak level, (ii) pyramid rationalization: slow and steady improvement over next few quarters, (iii) automation: much benefits would be realized in FY19-20, (iv) margin improvement of portfolio company: LCC to breakeven in H2, Comviva to be profitable in H2; (v) offshoring and yield management. We expect EBITDA margin to witness improvement to mid-teens by Q4FY19.

Financial summary (Consolidated)

Y/E March	FY16	FY17	FY18E	FY19E
Sales (Rs mn)	264,941	291,408	307,544	339,575
Adj PAT (Rs mn)	30,633	28,411	32,242	34,921
Con. EPS* (Rs)	-	-	34	37
EPS (Rs)	35	32	36	39
Change YOY (%)	16.5	(7.3)	13.3	8.3
P/E (x)	14.2	15.3	13.5	12.5
RoE (%)	22.8	18.3	18.4	17.6
RoCE (%)	24.8	20.9	20.8	20.3
EV/E (x)	10.2	10.4	9.2	7.3
DPS (Rs)	12	9	10	10

Source: *Consensus broker estimates, Company, Axis Capital

Key drivers (USD mn)

	FY16	FY17	FY18E	FY19E
Sales	4,037	4,351	4,740	5,106
% change YoY	10%	8%	9%	8%

Price performance

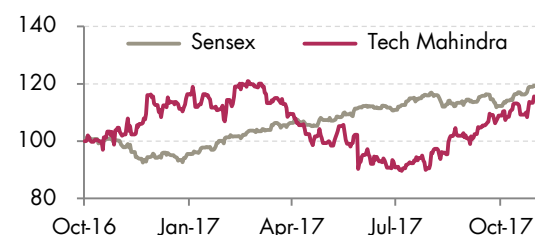


Exhibit 1: Results update (Rs mn)

	Quarter ended					12 months ended		
	Sep-17	Sep-16	% Chg	Jun-17	% Chg	FY18E	FY17	% Chg
Net Sales	76,064	71,674	6.1	73,361	3.7	307,544	291,408	5.5
EBIDTA	11,057	10,701	3.3	9,347	18.3	45,134	41,844	7.9
Depreciation	2,653	2,447	-	2,468	-	10,536	9,781	-
Interest	386	345	-	370	-	1,556	1,286	-
PBT	11,240	9,296	20.9	10,616	5.9	43,371	38,553	12.5
Tax	2,847	2,860	-	2,698	-	11,016	9,785	-
Minority Interest	31	-13	-	-69	-	112	357	-
Adjusted PAT	8,362	6,447	29.7	7,987	4.7	32,242	28,388	13.6
No. of shares (mn)	890	889	-	889	-	890	889	-
EBIDTA margin (%)	14.5	14.9	-	12.7	-	14.7	14.4	-
EPS	9.4	7.3	-	9.0	-	36.2	31.9	-

Source: Company, Axis Capital

- ♦ **Telecom – Challenges bottomed-out, but recovery likely to be gradual:** Telecom vertical (~44% of revs) reported growth of 0.2% QoQ. Outlook for discretionary spend and top 4 clients in the vertical continues to look soft. However, TechM has expanded its service portfolio in VAS and network services to de-risk revenue portfolio. We expect deal win (1 large deal in the vertical), improving outlook in VAS (tracking ahead of planned schedule) and improving fundamental of LCC. We expect flattish revenue growth in the vertical in FY18 despite recovery in H2FY18. However, the momentum would improve in FY19 yielding growth of ~6% YoY.
- ♦ **Enterprise – continues to deliver industry leading growth:** TechM reported strong revenue growth of 6.4% QoQ (Organic: 4.2% QoQ) led by strong performance in Retail/ Manufacturing/ Other (largely led by Healthcare HCI acquisition). Management expects retail momentum to continue in Q3FY18 (unlike industry trend of likely weaker revenue growth in the vertical due to festive seasons). TechM would deliver mid-teen revenue growth in Enterprise vertical (Organic: low-teens) in FY18 ahead of peers. The deal win during the quarter (USD 340 mn), revenue contribution from IP deal, and deal pipeline would help sustain low-teen revenue growth in FY19.

Estimates and valuations

Tech Mahindra reported another quarter of steady beat to the expectation. We believe the financial performance bottomed out in Q4FY17. Nevertheless, we expect revenue trajectory to witness slow and steady recovery (due to weaker momentum in Telecom vertical). However, the margin improvement would drive earnings momentum over next four quarters. We are factoring in ~8% USD revenue and ~11% earnings CAGR (FY17-19E). We believe low running expectation for revenue growth and margin improvement leaves room for positive surprise. We have a BUY rating and target price of Rs 550 (14x FY19E EPS). At the CMP of Rs 489, the stock trades at 13x/ 12x FY18E/FY19E.

Exhibit 2: Performance vs. Expectation

(Rs mn)	2Q18	1Q18	QoQ	2Q17	YoY	Cons	AxisCapE	IDFCe vs. Act
Sales (USD mn)	1,179.2	1,138.1	3.6%	1,072.4	10.0%	1,171.7	1,164.7	1.2%
Sales	76,064	73,361	3.7%	71,674	6.1%	75,339	74,893	1.6%
EBITDA	11,057	9,347	18.3%	10,701	3.3%	10,429	10,092	9.6%
EBITDA Margin	14.5%	12.7%	180 bps	14.9%	-39 bps	13.8%	13.5%	106 bps
PAT	8,362	7,987	4.7%	6,447	29.7%	7,357	6,243	33.9%
EPS (diluted)	9.40	8.98	4.7%	7.25	29.7%	8.27	7.02	33.9%

Source: Company, Axis Capital

Exhibit 3: Geography performance

(USD m)	2Q18	1Q18	QoQ	2Q17	YoY
North America	534.2	532.6	0.3%	518.0	3.1%
Europe	353.8	339.2	4.3%	318.5	11.1%
RoW	291.3	266.3	9.4%	235.9	23.5%
% of Total					
North America	45.3%	46.8%	-150 bps	48.3%	-300 bps
Europe	30.0%	29.8%	20 bps	29.7%	30 bps
RoW	24.7%	23.4%	130 bps	22.0%	270 bps

Source: Company, Axis Capital

Exhibit 4: Vertical performance

(USD mn)	2Q18	1Q18	QoQ	2Q17	YoY
Telecom	515.3	514.4	0.2%	519.0	-0.7%
Enterprise	663.9	623.7	6.4%	553.4	20.0%
- Manufacturing	224.0	219.7	2.0%	205.9	8.8%
- Technology, media & entertainment	69.6	68.3	1.9%	75.1	-7.3%
- BFSI	166.3	163.9	1.5%	125.5	32.5%
- Retail, Transport & Logistics	84.9	77.4	9.7%	72.9	16.4%
- Others	119.1	94.5	26.1%	74.0	61.0%
% of Total					
Telecom	43.7%	45.2%	-150 bps	48.4%	-470 bps
Enterprise	56.3%	54.8%	150 bps	51.6%	470 bps
- Manufacturing	19.0%	19.3%	-30 bps	19.2%	-20 bps
- Technology, media & entertainment	5.9%	6.0%	-10 bps	7.0%	-110 bps
- BFSI	14.1%	14.4%	-30 bps	11.7%	240 bps
- Retail, Transport & Logistics	7.2%	6.8%	40 bps	6.8%	40 bps
- Others	10.1%	8.3%	180 bps	6.9%	320 bps

Source: Company, Axis Capital

Exhibit 5: Client metrics

	2Q18	1Q18	QoQ	2Q17	YoY
≥ \$1 million clients	390	377	3.4%	341	14.4%
≥ \$5 million clients	147	139	5.8%	120	22.5%
≥ \$10 million clients	81	74	9.5%	66	22.7%
≥ \$20 million clients	40	41	-2.4%	40	0.0%
≥ \$50 million clients	14	14	0.0%	14	0.0%
Number Of active clients	885	864	2.4%	825	7.3%

Source: Company, Axis Capital

Exhibit 6: Client mining

(USD mn)	2Q18	1Q18	QoQ	2Q17	YoY
Top 5 Client	292	295	-0.8%	306	-4.3%
Top 6-10 Clients	121	118	2.6%	122	-0.7%
Top 10 Clients	414	413	0.2%	428	-3.3%
Top 10-20 Clients	131	139	-5.7%	127	3.4%
Top 20 Clients	545	552	-1.3%	554	-1.7%
Non Top 20 Clients	634	586	8.2%	518	22.5%

% of Total					
Top 5 Clients	24.8%	25.9%	-110 bps	28.5%	-370 bps
Top 10 Clients	35.1%	36.3%	-120 bps	39.9%	-480 bps
Top 20 Clients	46.2%	48.5%	-230 bps	51.7%	-550 bps
Non Top 20 Clients	53.8%	51.5%	230 bps	48.3%	550 bps

Source: Company, Axis Capital

Exhibit 7: Onsite offshore mix

(USD mn)	2Q18	1Q18	QoQ	2Q17	YoY
Onsite	756	725	4.3%	681	11.0%
Offshore	423	413	2.5%	391	8.2%

% of Total					
Onsite	64.1%	63.7%	40 bps	63.5%	60 bps
Offshore	35.9%	36.3%	-40 bps	36.5%	-60 bps

Source: Company, Axis Capital

Exhibit 8: Employee metrics

	2Q18	1Q18	QoQ	2Q17	YoY
Software Professional	75,587	78,996	-4.3%	78,404	-3.6%
BPO Professionals	35,287	30,322	16.4%	27,669	27.5%
Sales & Support	6,351	6,662	-4.7%	6,813	-6.8%
Total Employees	117,225	115,980	1.1%	112,886	3.8%

Attrition					
IT Utilization(excl. trainees)	81.0%	81.0%	0 bps	82.0%	-1.2%
IT Utilization(incl. trainees)	81.0%	77.0%	400 bps	78.0%	3.8%

Source: Company, Axis Capital

Financial summary (Consolidated)

Profit & loss (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Net sales	264,941	291,408	307,544	339,575
Other operating income	-	-	-	-
Total operating income	264,941	291,408	307,544	339,575
Cost of goods sold	(183,288)	(205,661)	(216,278)	(234,709)
Gross profit	81,653	85,747	91,266	104,865
<i>Gross margin (%)</i>	<i>31</i>	<i>29</i>	<i>30</i>	<i>31</i>
Total operating expenses	(38,945)	(43,903)	(46,132)	(50,597)
EBITDA	42,708	41,844	45,134	54,269
<i>EBITDA margin (%)</i>	<i>16</i>	<i>14</i>	<i>15</i>	<i>16</i>
Depreciation	(7,590)	(9,781)	(10,536)	(11,332)
EBIT	35,118	32,063	34,598	42,937
Net interest	(972)	(1,286)	(1,556)	(1,500)
Other income	5,015	7,776	10,329	5,419
Profit before tax	39,161	38,553	43,371	46,856
Total taxation	(8,182)	(9,785)	(11,016)	(11,615)
<i>Tax rate (%)</i>	<i>21</i>	<i>25</i>	<i>25</i>	<i>25</i>
Profit after tax	30,979	28,768	32,354	35,241
Minorities	(346)	(357)	(112)	(320)
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	30,633	28,411	32,242	34,921
<i>Adj. PAT margin (%)</i>	<i>12</i>	<i>10</i>	<i>10</i>	<i>10</i>
Net non-recurring items	-	-	-	-
Reported net profit	30,633	28,411	32,242	34,921

Balance sheet (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Paid-up capital	4,355	4,388	4,388	4,388
Reserves & surplus	141,590	159,984	181,819	206,312
Net worth	145,945	164,372	186,206	210,700
Borrowing	10,020	12,195	10,695	9,195
Other non-current liabilities	20,127	28,512	29,359	30,960
Total liabilities	176,092	205,078	226,260	250,855
Gross fixed assets	30,089	35,457	38,443	42,447
Less: Depreciation	-	-	-	-
Net fixed assets	30,089	35,457	38,443	42,447
Add: Capital WIP	-	-	-	-
Total fixed assets	30,089	35,457	38,443	42,447
Total Investment	-	-	-	-
Debtors	-	-	-	-
Cash & bank	51,428	53,833	72,970	88,323
Loans & advances	-	-	-	-
Current liabilities	47,955	55,587	65,507	72,329
Net current assets	101,561	107,678	124,262	143,260
Other non-current assets	44,442	61,943	63,555	65,148
Total assets	176,092	205,078	226,260	250,855

Source: Company, Axis Capital

Cash flow (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Profit before tax	39,161	38,553	43,371	46,856
Depreciation & Amortisation	7,590	9,781	10,536	11,332
<i>Chg in working capital</i>	<i>(21,860)</i>	<i>(3,712)</i>	<i>1,053</i>	<i>(5,144)</i>
Cash flow from operations	7,566	19,230	43,943	41,409
<i>Capital expenditure</i>	<i>52,380</i>	<i>(5,368)</i>	<i>(15,112)</i>	<i>(16,926)</i>
Cash flow from investing	70,688	2,408	(15,134)	(16,929)
<i>Equity raised/ (repaid)</i>	<i>5,282</i>	<i>33</i>	-	-
<i>Debt raised/ (repaid)</i>	<i>3,274</i>	<i>2,175</i>	-	-
<i>Dividend paid</i>	<i>(12,459)</i>	<i>(9,367)</i>	<i>(10,408)</i>	<i>(10,408)</i>
Cash flow from financing	(4,875)	(8,446)	(9,673)	(9,127)
Net chg in cash	73,379	13,193	19,137	15,354

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	35	32	36	39
CEPS (Rs)	43	43	48	52
DPS (Rs)	12	9	10	10
Dividend payout ratio (%)	35	28	28	25
GROWTH				
Net sales (%)	18	10	6	10
EBITDA (%)	4	(2)	8	20
Adj net profit (%)	17	(7)	13	8
FDEPS (%)	16.5	(7.3)	13.3	8.3
PERFORMANCE				
RoE (%)	22.8	18.3	18.4	17.6
RoCE (%)	24.8	20.9	20.8	20.3
EFFICIENCY				
Asset turnover (x)	2.5	2.6	2.5	2.7
Sales/ total assets (x)	1.3	1.2	1.1	1.1
Receivable days	-	-	-	-
Payable days	79	81	91	93
FINANCIAL STABILITY				
Total debt/ equity (x)	0.1	0.1	0.1	-
Net debt/ equity (x)	(0.3)	(0.3)	(0.4)	(0.4)
Current ratio (x)	3.1	2.9	2.9	3.0
VALUATION				
PE (x)	14.2	15.3	13.5	12.5
EV/ EBITDA (x)	10.2	10.4	9.2	7.3
EV/ Net sales (x)	1.6	1.5	1.3	1.2
PB (x)	3.0	2.6	2.3	2.1

Source: Company, Axis Capital

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