VISIT NOTE

TECH MAHINDRA

Mission 3-4-3: Replenishing growth ammo

India Equity Research| IT

We recently attended Tech Mahindra's (TECHM) analyst meet, which offered insights into the company's strategy. Key takeaways: 1) unveiled *3-4-3* strategy, wherein the company has identified 3 mega trends, 4 key bets and 3 objectives to accelerate growth; 2) while enterprise business' growth momentum has sustained, leadership in telecom is envisaged to spearhead revival; 3) cost rationalisation will sustain margin revival (up 250bps in 2 quarters); and 4) synergistic benefits from integrated acquisitions kicking in. The analyst meet reinforces our confidence on margin prospects and revenue revival in the telecom vertical. Maintain 'BUY' with target price of INR546.

Entrenched relationships, pole position to fuel telecom revival

While enterprise business has consistently posted robust growth, weakness in telecom vertical has taken a toll on TECHM's overall growth. However, we perceive palpable opportunities on account of communication service providers (CSPs) investing in IoT, enhancing customer experience, digital transformation and network upgrades. We believe, along with TECHM's expertise, its established relationships and leadership in the telecom vertical will lead to positive surprises. The company has also been building platforms to jumpstart CSP client transformation, which is gaining strong traction.

M&A synergies kicking in; eyeing cross-sell opportunities

With the worst of LCC now behind, TECHM has also learned the necessary lessons. Management indicated that recent acquisitions—HCI, Bio, Target and Pininfarina—have been successfully integrated and are leading to synergistic deal wins. The company will continue to fill in capability and geography gaps via acquisitions, but with much more caution.

Outlook and valuations: High growth on horizon; maintain 'BUY'

With sustenance of enterprise business' robust revenue momentum, growth revival in telecom is likely to lead to industry-leading growth. Further, with all headwinds behind and sustained margin improvement, we estimate TECHM to comfortably post EPS CAGR of 10.6% over FY17-19. The stock currently trades at 12.8x FY19E EPS. We retain **'BUY/SP'** with target price of INR546 (14x FY19E EPS).

Financials **(INR mn)**

Year to March	FY16	FY17E	FY18E	FY19E
Net revenue	264,941	291,408	309,707	345,866
EBITDA	42,717	41,843	44,213	52,843
Adjusted profit	30,701	28,400	31,240	34,716
Adjusted diluted EPS (INR)	34.4	31.9	35.1	39.0
EPS growth (%)	*16.8*	*(7.2)*	*10.0*	*11.1*
Diluted P/E (x)	14.6	15.7	14.3	12.8
EV/EBITDA (x)	9.7	11.1	10.1	8.1
ROAE (%)	22.8	18.2	17.5	17.4

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 501
Target Price	: INR 546
52-week range (INR)	: 515 / 357
Share in issue (mn)	: 976.6
M cap (INR bn/USD mn)	: 489 / 7,589
Avg. Daily Vol.BSE/NSE('000)	: 2,731.3

SHARE HOLDING PATTERN (%)

	Current	Q1FY18	Q4FY17
Promoters *	36.1	36.2	36.2
MF's, FI's & BK's	13.0	14.6	13.3
FII's	37.4	35.2	36.7
Others	13.4	14.1	13.8

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	2.0	0.0	1.7
3 months	13.4	2.3	9.7
12 months	6.7	26.3	11.7

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3-4-3: New strategy

TECHM, at the recently organised analyst meet, unveiled its new *3-4-3* strategy. Management has identified **3 mega trends** in the industry and is accordingly planning **4 big bets** in order to achieve its **3 objectives**. It also defined trends and bets in specific industry verticals. Management stated that in the current digital and IoT wave, enhancing customer experience and helping clients in their digital transformation endeavour remain key focus areas.

Fig 1: *3-4-3* strategy

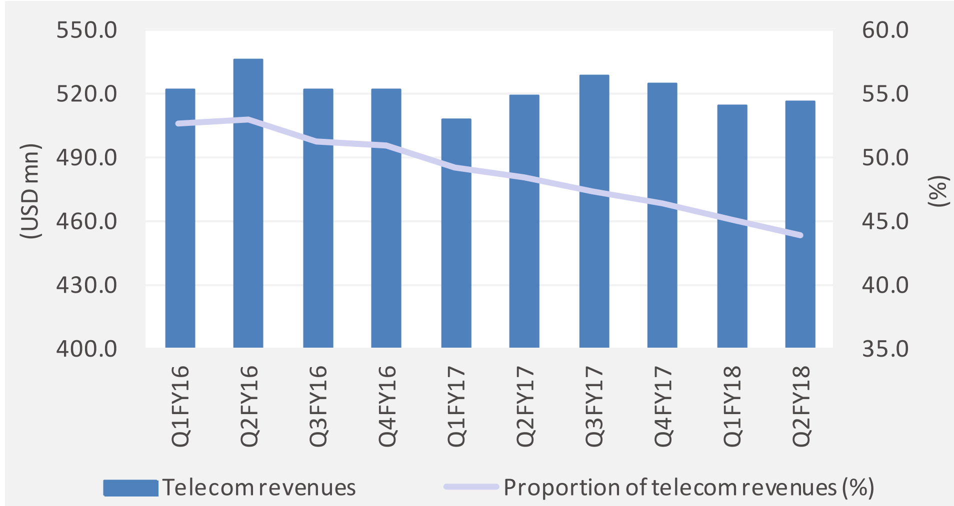
Source: Company

Telecom business: Brightening prospects

While multiple headwinds have taken a toll on the telecom business over the past 2 years, we believe the worst is now behind. TECHM enjoys leadership in the telecom vertical by virtue of its deep domain expertise, well diversified presence across geographies and partnerships with all major CSPs globally.

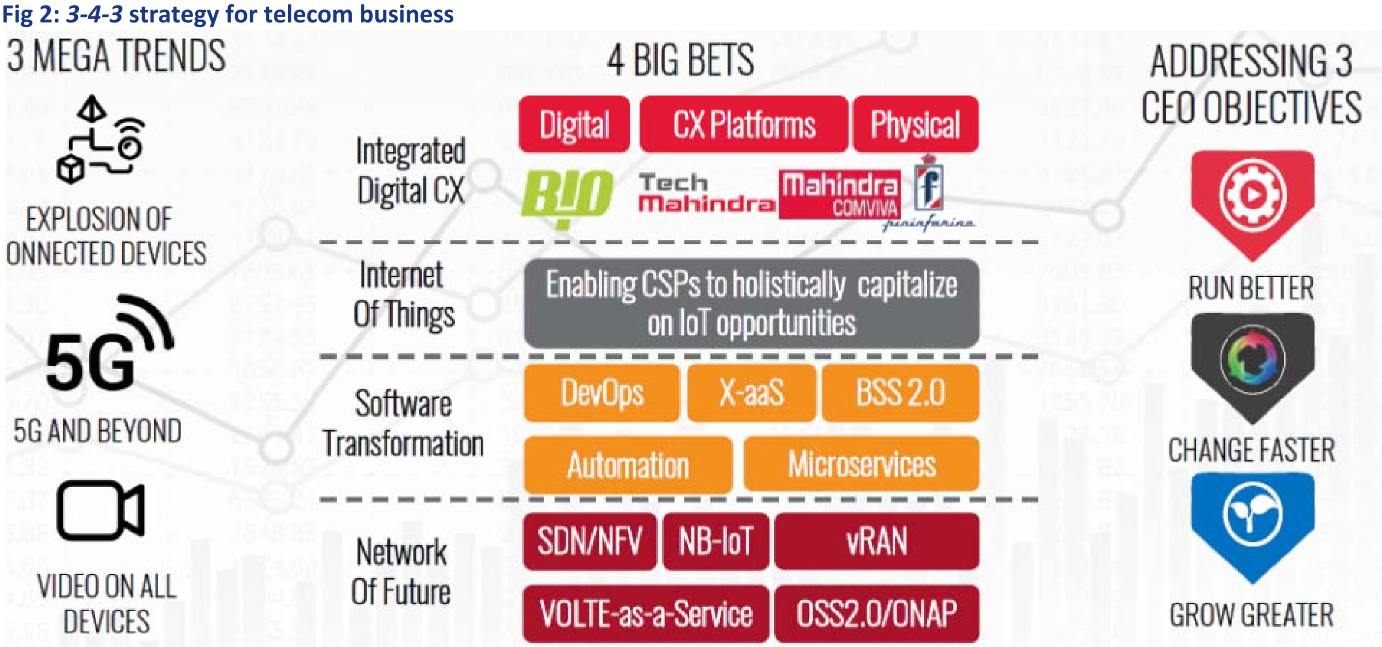
Hence, we believe, the telecom business entails huge upside potential as CSPs are looking to upgrade their networks (5G), invest in connected devices (IoT), enhance customer experience and digitally transform their businesses. Further, the company has also built an end-to-end-digital ecosystem for CSPs and its platform to jump start digital transformation for CSPs is also gaining good traction.

Chart 1: Growth in telecom revenues over past 10 quarters



Source: Company, Edelweiss research

Fig 2: *3-4-3* strategy for telecom business



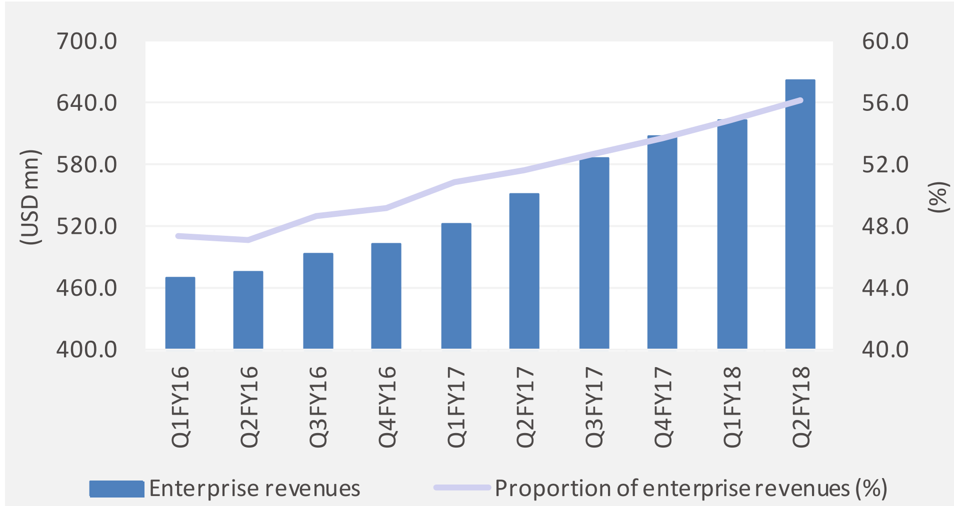
Source: Company

Enterprise business: Revenue momentum to sustain

TECHM has been gaining healthy traction in the enterprise business as clients are increasingly looking to embed digital in order to enhance business efficiencies and drive growth. The company is transforming itself to become clients' partner in their digital journey rather than a plain vanilla IT outsourcer. Management also enumerated how its digital solutions have helped top clients enhance their services.

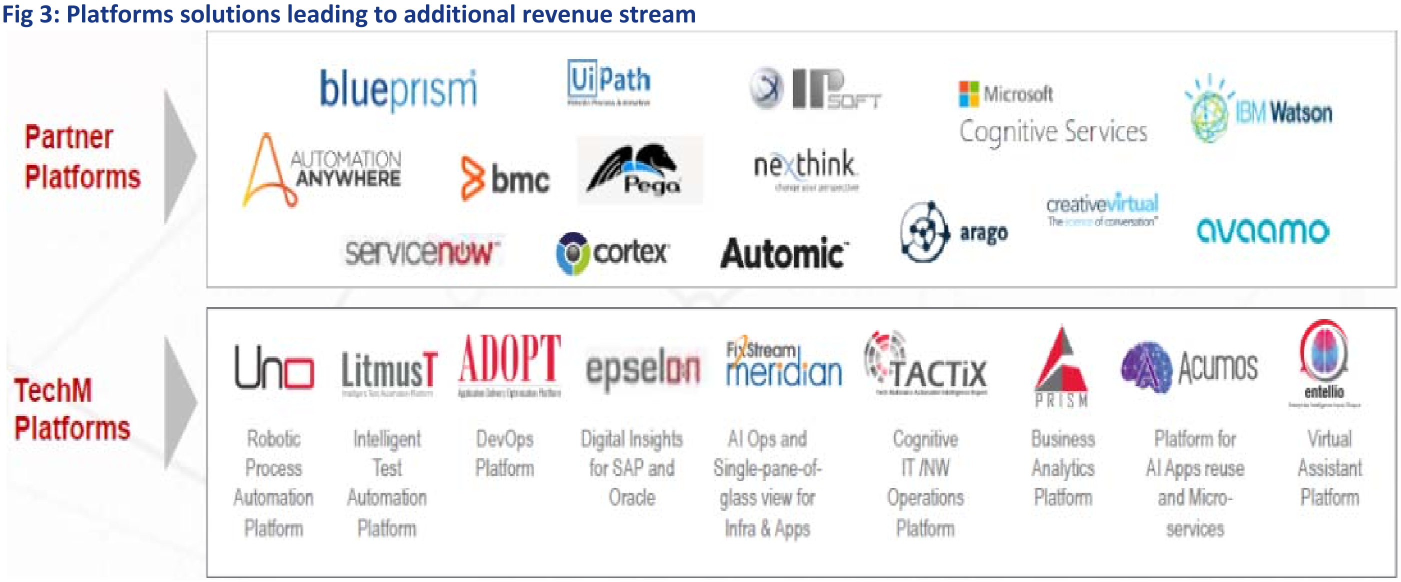
BFS, manufacturing, retail & CPG and healthcare have been driving TECHM's growth. The enterprise business has posted robust CQGR of 3.9% over the past 10 quarters and we remain convinced of sustained revenue momentum in these verticals.

Chart 2: Growth in enterprise revenues over past 10 quarters



Source: Company, Edelweiss research

Fig 3: Platforms solutions leading to additional revenue stream



Source: Company

M&A: Synergies kicking in

Management highlighted that the HCI, Bio, Target and Pininfarina acquisitions have been successfully integrated. TECHM perceives immense cross-selling and up-selling potential and has already won 2 major synergistic contracts with Pininfarina of TCV of EUR65mn & EUR70mn and is about to close a deal with HCI. Management reiterated its strategy of being on the prowl for acquisitions to fill capabilities or geography gaps, but stated that it will now be more cautious and preferably target small sized buys.

Fig 4: TECHM's mergers & acquisitions over the years

Source: Company

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 117,225 employees. The company’s revenues for the past twelve months stood at INR300.0bn (USD4.57bn).

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 enables 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 %)	7.9	6.6	6.8	7.4
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)	65.5	67.1	65.0	66.0
Company				
Telecom revenue (USD mn)	2,097	2,078	2,079	2,190
Other verticals revenue (USD mn)	1,940	2,273	2,683	3,017
Other vertical growth(%)	10.1	17.2	18.0	12.5
Other Cost (% of rev.)				
Cost of rev. (% of rev.)	69.2	70.6	71.0	70.2
SGA cost (% of revenue)	14.7	15.1	14.7	14.5
Financial assumptions				
Depreciation (% of rev.)	2.9	3.4	3.4	3.4
Capex (INR mn)	8,570	7,603	13,887	13,421
Debtor days	76	70	65	64
Payable days	43	41	39	38
Cash conversion cycle	32	29	26	26

Income statement (INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Net revenue	264,941	291,408	309,707	345,866
Cost of revenues	183,276	205,661	219,920	242,872
Gross profit	81,665	85,747	89,787	102,993
Total SG&A expenses	38,948	43,904	45,574	50,150
EBITDA	42,717	41,843	44,213	52,843
Depreciation	7,590	9,781	10,603	11,829
EBIT	35,127	32,062	33,611	41,014
Add: Other income	5,056.00	7,776.00	9,981.95	7,068.14
Less: Interest Expense	974	1,286	1,528	1,544
Profit Before Tax	39,209	38,552	42,065	46,538
Less: Provision for Tax	8,182	9,785	10,799	11,797
Less: Minority Interest	352	367	25	25
Reported Profit	30,701	28,400	31,240	34,716
Adjusted Profit	30,701	28,400	31,240	34,716
Shares o /s (mn)	872	974	974	974
Adjusted Basic EPS	35.2	29.2	32.1	35.6
Diluted shares o/s (mn)	892	890	890	890
Adjusted Diluted EPS	34.4	31.9	35.1	39.0
Adjusted Cash EPS	43.9	39.2	43.0	47.8
Dividend per share (DPS)	12.0	9.0	10.0	12.0
Dividend Payout Ratio(%)	39.9	36.1	36.5	39.4

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Cost of revenues	69.2	70.6	71.0	70.2
Gross margin	30.8	29.4	29.0	29.8
SG&A expenses	14.7	15.1	14.7	14.5
EBITDA margins	16.1	14.4	14.3	15.3
EBIT margins	13.3	11.0	10.9	11.9
Net Profit margins	11.7	9.9	10.1	10.0

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	17.1	10.0	6.3	11.7
EBITDA	2.9	(2.0)	5.7	19.5
PBT	8.4	(1.7)	9.1	10.6
Adjusted Profit	16.8	(7.5)	10.0	11.1
EPS	16.8	(7.2)	10.0	11.1

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	179,827	200,867
Shareholders' funds	145,909	164,372	184,215	205,255
Minority Interest	1,927	4,641	4,666	4,691
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**	**220,829**	**240,836**
Net Block	24,341	31,728	30,854	29,501
Capital work in progress	6,294	3,729	4,475	5,146
Intangible Assets	19,298	32,873	36,286	38,561
Total Fixed Assets	49,933	68,330	71,615	73,207
Non current investments	1,177	2,308	2,770	3,324
Cash and Equivalents	35,226	41,660	59,202	77,889
Inventories	403	611	672	739
Sundry Debtors	57,705	53,377	57,699	64,435
Loans & Advances	75,481	91,705	87,352	83,916
Current Assets (ex cash)	133,589	145,693	145,723	149,091
Trade payable	22,758	23,117	24,101	26,616
Other Current Liab	25,544	32,470	34,380	36,058
Total Current Liab	48,302	55,587	58,480	62,674
Net Curr Assets-ex cash	85,287	90,106	87,243	86,417
Uses of funds	**171,623**	**202,404**	**220,829**	**240,836**
BVPS (INR)	163.5	184.8	207.1	230.7

Free cash flow (INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Reported Profit	30,701	28,400	31,240	34,716
Add: Depreciation	7,590	9,781	10,603	11,829
Interest (Net of Tax)	(19,351)	(31,354)	(37,701)	(37,595)
Others	45,782	38,706	28,509	31,628
Less: Changes in WC	32,590	4,819	(2,863)	(826)
Operating cash flow	32,132	40,714	35,514	41,404
Less: Capex	8,570	7,603	13,887	13,421
Free Cash Flow	**23,562**	**33,111**	**21,627**	**27,983**

Cash flow metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating cash flow	32,132	40,714	35,514	41,404
Investing cash flow	(14,667)	(30,508)	(13,026)	(19,029)
Financing cash flow	(5,653)	(14,096)	(13,605)	(15,811)
Net cash Flow	11,812	(3,890)	8,883	6,564
Capex	(8,570)	(7,603)	(13,887)	(13,421)
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	17.5	17.4
ROACE (%)	27.8	23.5	22.8	22.8
Debtors Days	76	70	65	64
Payable Days	43	41	39	38
Cash Conversion Cycle	33	30	27	27
Current Ratio	3.5	3.4	3.5	3.6

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	4.7	5.1
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	35.1	39.0
Y-o-Y growth (%)	*16.8*	*(7.2)*	*10.0*	*11.1*
Adjusted Cash EPS (INR)	43.9	39.2	43.0	47.8
Diluted P/E (x)	14.6	15.7	14.3	12.8
P/B (x)	3.1	2.7	2.4	2.2
EV / Sales (x)	1.5	1.5	1.4	1.2
EV / EBITDA (x)	9.7	11.1	10.1	8.1
Dividend Yield (%)	2.4	1.8	2.0	2.4

Peer comparison valuation

	Market cap	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
Name	(USD mn)	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
Tech Mahindra	7,589	14.3	12.8	10.1	8.1	17.5	17.4
ECLERX SERVICES	857	16.1	14.6	10.1	8.4	25.6	23.9
HCL Technologies	19,492	14.0	12.7	10.9	9.6	25.7	25.8
Infosys	35,842	15.5	13.9	10.4	8.9	22.5	25.1
Persistent Systems	806	14.8	12.6	8.9	7.0	17.3	17.9
Tata Consultancy Services	79,070	20.2	18.4	14.7	12.9	29.7	30.6
Wipro	21,861	16.1	14.5	13.0	11.6	17.4	18.7
Median	-	15.5	13.9	10.4	8.9	22.5	23.9
AVERAGE	-	15.8	14.2	11.2	9.5	22.2	22.8

Source: Edelweiss research

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	6.35	Life Insurance Corp	3.61
Blackrock	1.99	Prudential ICICI Asset Management	1.97
Norges Bank	1.91	Government Pension Fund - Global	1.86
Vanguard Group	1.71	Hermes Investment	1.45
Birla Sunlife	1.44	Templeton Asset Mgmt	1.11

**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	HOLD	SP	L
Just Dial	REDUCE	SU	M	Persistent Systems	BUY	SP	L
Tata Consultancy Services	HOLD	SP	L	Tech Mahindra	BUY	SP	M
Wipro	HOLD	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

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
01-Dec-17	**Persistent Systems**	Digitally bent; *Visit Note*	654	Buy
30-Nov-17	**Tech Mahindra**	Newer horizons beckon; *Visit Note*	489	Buy
27-Nov-17	**Persistent Systems**	'Persistent' growth ahead; *Visit Note*	654	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240

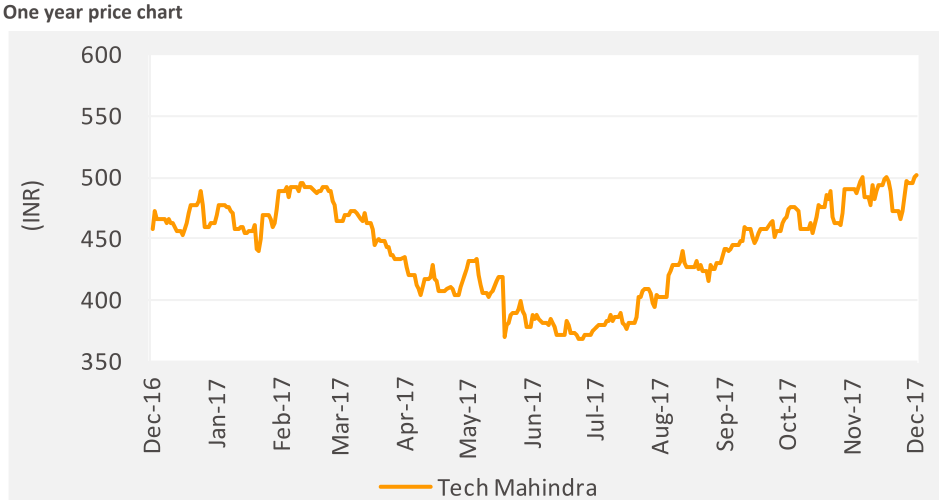
* 1stocks under review

	> 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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