

REDUCE

TP: Rs 570 | ▲ 4%

TECH MAHINDRA

| IT Services

| 01 May 2020

Miss on all counts

Tech Mahindra (TECHM) posted a 4.3% QoQ dollar revenue decline and 200bps EBITDA margin contraction to round off a disappointing Q4FY20 performance. The communication vertical had its worst sequential decline since the GFC. The company continues to underperform peers, revealing a subpar revenue portfolio and operational vulnerability. We crop FY21/FY22 EPS by 28%/19% amid Covid-19 volatility, trim our target P/E to 11x (vs. 13x), and move to a new Mar'21 TP of Rs 570 (vs. Rs 840). Reiterate REDUCE.

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Dull quarter: TECHM reported a disappointing Q4 operating performance with a hefty miss on revenue and operating margins. Revenue at US\$ 1.3bn declined 4.3% QoQ – marking the highest sequential contraction since the 2008 crisis. EBITDA margin at 14.2% was down 200bps QoQ, erasing all recovery progress made after the Mar'17 quarter (when margins had dropped to 12%). We highlight that margin contraction is despite a ~290bps QoQ tailwind from subcontract expense reduction.

Worst communication business performance since GFC: Revenue from the communication vertical contracted 8.4% QoQ – the highest sequential decline post-GFC. BFSI revenue growth at 10.9% QoQ was the only pocket of strength, supported by ramp-up of the Jackson Life Insurance contract won in the Dec'19 quarter. Top 5 client revenue contracted 8.2% QoQ, reflecting communication vertical weakness.

Subdued deal wins: Q4FY20 TCV stood at US\$ 505mn. Deal wins normalised after two quarters of record US\$ 1bn+ figures. Management expects delays in deal ramp-ups and more pronounced operational weakness in the Jun'20 quarter.

Ticker/Price	TECHM IN/Rs 546
Market cap	US\$ 6.3bn
Shares o/s	873mn
3M ADV	US\$ 31.0mn
52wk high/low	Rs 847/Rs 471
Promoter/FPI/DII	36%/39%/25%

Source: NSE

STOCK PERFORMANCE

Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
Total revenue (Rs mn)	3,07,729	3,47,421	3,68,677	3,68,578	4,04,408
EBITDA (Rs mn)	47,169	63,368	57,261	58,237	71,811
Adj. net profit (Rs mn)	38,001	42,975	42,505	35,646	45,614
Adj. EPS (Rs)	42.7	47.7	48.3	40.5	51.9
Adj. EPS growth (%)	33.6	11.9	1.2	(16.1)	28.0
Adj. ROAE (%)	21.0	21.4	19.8	15.4	18.0
Adj. P/E (x)	12.8	11.4	11.3	13.5	10.5
EV/EBITDA (x)	9.7	7.4	8.2	8.1	6.4

Source: Company, BOBCAPS Research

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Earnings call highlights

- **Goodwill write-off:** Besides a disappointing Q4 operating performance (EBIT at Rs 9.5bn, down 31% YoY and 19% QoQ), reported net profit declined by 29% YoY and 30% QoQ to Rs 8bn, hit by a Rs 2.2bn goodwill impairment charge. This charge was puzzling given the absence of any such write-downs in past years when a few of TECHM's acquired entities had faced turbulent times (for instance, LCC in FY17).

Management indicated that a part of the charge was attributable to existing contract ramp-down at BIO Agency (acquired in FY17). The company sees a low possibility of reoccurrence of goodwill impairment in the near term; however, we stay apprehensive over the medium-to-long term risk.

- **FY20 sees little improvement over FY19:** TECHM rounded off FY20 with 4.3% YoY dollar revenue growth (or 5.6% YoY CC growth), showing no growth improvement over FY19 (4.2% YoY dollar revenue growth or 5.8% YoY CC growth). Segmental performance contrasted with FY19 as the communication vertical reported 5.3% YoY growth (-0.7% in FY19) and enterprise business increased by 3.5% YoY (+7.9% YoY in FY19) (in dollar terms). FY20 EBIT margin at 11.6% contracted 340bps YoY, marking a year of margin struggles.
- **Other highlights**
 - **AT&T deal:** Management indicated that the AT&T deal has transitioned to a steady-state, leading to sequential revenue weakness in Q4 (due to the absence of transition revenue).
 - **Operating margins:** EBITDA margin declined 200bps QoQ impacted by (1) provision for doubtful debt (100bps), (2) transition cost, and (3) Covid-led delivery migration costs. Currency-led gains of 30bps offered partial tailwinds to mitigate margin pressure. Cost optimisation focus led to subcontractor costs (13.4% of revenue) declining by 290bps QoQ.

Management is counting on margin levers such as (1) further reduction in third-party/subcontracting costs, (2) rationalisation of some facilities, and (3) tighter synergy from portfolio companies. TECHM indicated that the Covid-19 crisis has pushed forward margin recovery efforts by almost a year.

- **Covid-19 impact**
 - **BPO supply constraint:** The BPO segment saw a 13.3% QoQ decline (vs. 10.5% growth in Q3FY20) due to delays in 'work-from-home' approvals and supply-side issues. BPO EBITDA margin slipped 190bps. Management refrained from quantifying the extent of BPO delivery enabled for work-from-home but hinted at the possibility of improving these levels to 85% going ahead.
 - **Offshore IT:** A total of 93% of offshore IT associates are now working from home, in line with the industry trend. Virtual call centres (from home) have been established.
- **Q1FY21 demand outlook:** Going into Q1FY21, the ramp-down will be skewed towards the demand side. Network, communication and BPO ramp-down is expected to continue into Q1FY21. Among verticals, manufacturing and retail are likely to be impacted the most. Going forward, demand in digital, cloud, AI and automation will improve. Despite a temporary setback due to the lockdown, management expects 5G focus to continue as before.
- **Miscellaneous**
 - America/Europe revenues declined 5.7%/6.1% QoQ.
 - Digital business posted continued growth (2% QoQ), now forming 44% of revenues.
 - Discretionary spend is slowing and the focus on 'change and grow' has been affected.
 - Middle and senior management have taken pay cuts in the variable component.
 - TECHM announced final dividend of Rs 5/sh in addition to the interim dividend of Rs 10/sh declared earlier.
 - Headcount declined by 5,600 QoQ, especially from the BPO segment (down 4,280 people QoQ).
 - DSO remained steady at 112, the highest in the industry.

FIG 1 – MAR'20 QUARTER PERFORMANCE

(Rs mn)	Q4FY20	Q4FY19	YoY (%)	Q3FY20	QoQ (%)	FY20	FY19	YoY (%)
Revenues (US\$ mn)	1,295	1,268	2.1	1,353	(4.3)	5,182	4,971	4.3
Revenue	94,902	88,923	6.7	96,546	(1.7)	3,68,677	3,47,421	6.1
Operating Expenditure	81,424	72,536	12.3	80,913	0.6	3,11,416	2,84,053	9.6
Cost of revenues	66,896	59,482	12.5	67,312	(0.6)	2,59,743	2,33,590	11.2
as % of sales	70.5	66.9	-	69.7	-	70.5	67.2	-
SG&A expenses	14,528	13,054	11.3	13,601	6.8	51,673	50,463	2.4
as % of sales	15.3	14.7	-	14.1	-	14.0	14.5	-
EBITDA	13,478	16,387	(17.8)	15,633	(13.8)	57,261	63,368	(9.6)
Depreciation	3,982	2,704	-	3,848	-	14,458	11,292	28.0
EBIT	9,496	13,683	(30.6)	11,785	(19.4)	42,803	52,076	(17.8)
Other Income	2,335	1,117	-	2,951	-	9,946	3,357	196.3
PBT	11,831	14,800	(20.1)	14,736	(19.7)	52,749	55,433	(4.8)
Total Tax	2,392	3,535	-	3,629	-	11,604	12,544	-
Adjusted PAT	9,439	11,265	(16.2)	11,107	(15.0)	41,145	42,889	(4.1)
(Profit)/loss from JV's/Ass/MI	775	59	-	352	-	1,356	88	-
APAT after MI	10,214	11,324	(9.8)	11,459	(10.9)	42,501	42,977	(1.1)
Extra ordinary items	(2175)	0	-	0	-	(2,175)	0	-
Reported PAT	8,039	11,324	(29.0)	11,459	(29.8)	40,326	42,977	(6.2)
Reported EPS	9.1	12.6	(27.3)	13.0	(29.8)	46	48	(4.6)
Margins (%)			(bps)		(bps)			(bps)
EBITDA	14.2	18.4	(420)	16.2	(200)	15.5	18.2	(270)
EBIT	10.0	15.4	(540)	12.2	(220)	11.6	15.0	(340)
EBT	12.5	16.6	(420)	15.3	(280)	14.3	16.0	(160)
PAT	8.5	12.7	(430)	11.9	(340)	10.9	12.4	(140)
Effective Tax rate	20.2	23.9	(370)	24.6	(440)	22.0	22.6	(60)

Source: Company, BOBCAPS Research

FIG 2 – MAR'20 OPERATING METRICS

(In US\$ terms)	Q4FY20	Growth (%)	
	(% Contr. to Revenue)	QoQ	YoY
Revenue by Geography			
North America	47.7	(5.7)	5.0
Europe	26.5	(6.1)	(5.4)
Rest of the World	25.8	0.4	5.8
Top clients			
Top 5	21.4	(8.2)	(4.1)
Top 10	31.0	(4.3)	(1.1)
Top 20	43.6	(0.9)	(1.3)
Non-Top 10	69.0	(4.3)	3.6
Revenue by Vertical			
Telecom	40.8	(8.4)	(2.4)
Manufacturing	17.7	(2.1)	(10.5)
Technology, Media and Entertainment	7.4	(6.8)	0.8
BFSI	15.3	10.9	19.3
Retail, Transport and Logistics	7.3	(3.0)	16.5
Others	11.5	(9.8)	15.2

(In US\$ terms)	Q4FY20 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by Delivery			
Onsite	65.2	(4.5)	2.1
Offshore	34.8	(4.0)	2.1
		(bps)	(bps)
Utilisation (including trainees)	83	(100)	100
Attrition	19	(100)	(200)
Headcount	1,25,236	(5,603)	4,154

	Q4FY20	Q3FY20	Q4FY19
No. of Million \$ Clients			
≥ \$1mn clients	446	446	425
≥ \$5mn clients	160	164	156
≥ \$10mn clients	85	83	83
≥ \$20mn clients	49	50	50
≥ \$50mn clients	22	22	20
DSO	112	112	102

Source: Company, BOBCAPS Research

Valuation methodology

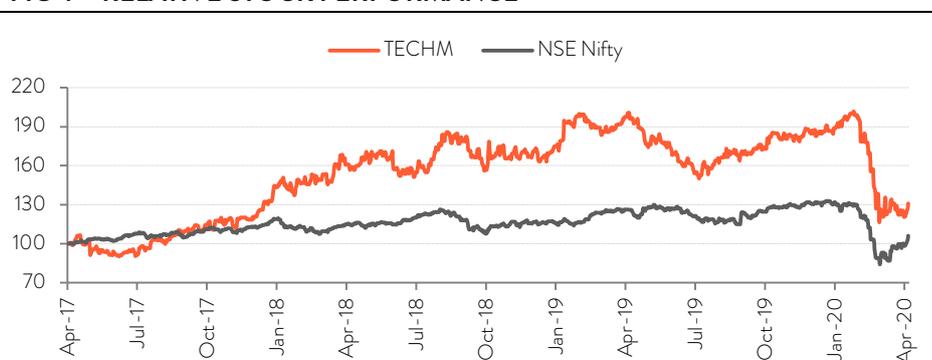
TECHM continues to underperform peers, revealing a subpar revenue portfolio (heavily skewed by the communication business and subscale in the enterprise segment) as well as operational vulnerability. We crop FY21/FY22 EPS by 28%/19% as we reduce revenue growth and margin assumptions amid Covid-19. Reiterate REDUCE with a revised Mar'21 target price of Rs 570 (vs. Rs 840), set at a target FY22E P/E of 11x vs. 13x earlier. After a 28% YTD correction, valuations at 13.5x/10.5x are inexpensive but lack catalysts in our view.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)
US\$ Revenues (US\$ mn)	5,870	4,914	(16.3)	6,496	5,392	(17.0)
YoY growth (%)	1,140.0	(5.2)	-	10.7	9.7	-
Revenues	4,10,889	3,68,578	(10.3)	4,54,685	4,04,408	(11.1)
EBITDA (Rs mn)	72,717	58,237	(19.9)	84,300	71,811	(14.8)
EBITDA margins (%)	17.7	15.8	-	18.5	17.8	-
EBIT margins (%)	14.0	11.7	-	14.8	13.7	-
Net Profits	49,601	35,646	(28.1)	56,318	45,614	(19.0)
EPS (Rs)	56.4	40.5	(28.1)	64.0	51.9	(19.0)

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Upside risks to our estimates are:

- sharp favourable currency movements,
- a disproportionately higher revenue uptick led by 5G deals, and
- above-expected margin expansion.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Total revenue	3,07,729	3,47,421	3,68,677	3,68,578	4,04,408
EBITDA	47,169	63,368	57,261	58,237	71,811
Depreciation	10,849	11,292	14,458	15,117	16,590
EBIT	36,320	52,076	42,803	43,120	55,221
Net interest income/(expenses)	(1,624)	(1,332)	(1,919)	(1,250)	(1,550)
Other income/(expenses)	14,093	5,342	11,924	3,929	5,508
Exceptional items	0	0	0	0	0
EBT	48,789	55,431	52,753	45,699	59,079
Income taxes	10,925	12,544	11,604	11,653	15,065
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	137	(567)	1,301	1,500	1,500
Reported net profit	38,001	42,975	42,505	35,646	45,614
Adjustments	0	0	0	0	0
Adjusted net profit	38,001	42,975	42,505	35,646	45,614

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	71,708	90,744	1,03,830	95,931	1,05,257
Provisions	9,581	9,753	11,055	10,098	11,080
Debt funds	17,260	14,047	24,282	24,282	24,282
Other liabilities	12,304	12,304	12,304	12,304	12,304
Equity capital	4,417	4,437	4,359	4,359	4,359
Reserves & surplus	1,89,102	2,03,184	2,17,705	2,36,730	2,61,522
Shareholders' fund	1,93,519	2,07,621	2,22,064	2,41,089	2,65,881
Total liabilities and equities	3,04,372	3,34,469	3,73,535	3,83,704	4,18,804
Cash and cash eq.	19,661	20,427	30,167	56,481	88,048
Accounts receivables	65,117	69,586	75,772	72,706	79,774
Inventories	659	752	358	358	358
Other current assets	76,857	88,020	1,21,702	1,14,526	1,17,471
Investments	59,595	77,926	61,046	61,046	61,046
Net fixed assets	76,717	71,667	76,047	70,145	63,665
CWIP	2,399	2,763	501	501	501
Intangible assets	27,727	28,163	33,877	33,877	33,877
Deferred tax assets, net	5,766	6,091	8,443	8,443	8,443
Other assets	0	0	0	0	0
Total assets	3,04,372	3,34,469	3,73,535	3,83,705	4,18,804

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20P	FY21E	FY22E
Net income + Depreciation	44,374	50,112	55,607	49,163	60,604
Interest expenses	169	(745)	(13,843)	(5,179)	(7,058)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(7,832)	(10,574)	(13,356)	1,386	294
Other operating cash flows	(1,176)	5,527	17,667	0	0
Cash flow from operations	35,535	44,320	46,075	45,370	53,840
Capital expenditures	(7,902)	(7,793)	(15,386)	(9,214)	(10,110)
Change in investments	(20,701)	(23,216)	(16,880)	0	0
Other investing cash flows	(4,590)	9,967	13,843	5,179	7,058
Cash flow from investing	(33,193)	(21,042)	(18,423)	(4,035)	(3,052)
Equities issued/Others	251	(1,747)	0	0	0
Debt raised/repaid	7,486	(4,504)	0	0	0
Interest expenses	(993)	(1,354)	0	0	0
Dividends paid	(9,438)	(14,907)	(17,912)	(15,021)	(19,222)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(2,694)	(22,512)	(17,912)	(15,021)	(19,222)
Changes in cash and cash eq.	(352)	766	9,740	26,314	31,567
Closing cash and cash eq.	19,661	20,427	30,167	56,481	88,048

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20P	FY21E	FY22E
Reported EPS	42.7	47.7	48.3	40.5	51.9
Adjusted EPS	42.7	47.7	48.3	40.5	51.9
Dividend per share	14.0	14.0	16.9	14.2	18.2
Book value per share	217.3	230.6	252.5	274.1	302.3

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20P	FY21E	FY22E
EV/Sales	1.5	1.4	1.3	1.3	1.1
EV/EBITDA	9.7	7.4	8.2	8.1	6.4
Adjusted P/E	12.8	11.4	11.3	13.5	10.5
P/BV	2.5	2.4	2.2	2.0	1.8

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20P	FY21E	FY22E
Tax burden (Net profit/PBT)	77.9	77.5	80.6	78.0	77.2
Interest burden (PBT/EBIT)	134.3	106.4	123.2	106.0	107.0
EBIT margin (EBIT/Revenue)	11.8	15.0	11.6	11.7	13.7
Asset turnover (Revenue/Avg TA)	108.9	108.8	104.1	97.3	100.8
Leverage (Avg TA/Avg Equity)	1.6	1.6	1.6	1.6	1.6
Adjusted ROAE	21.0	21.4	19.8	15.4	18.0

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20P	FY21E	FY22E
YoY growth (%)					
Revenue	5.6	12.9	6.1	0.0	9.7
EBITDA	12.7	34.3	(9.6)	1.7	23.3
Adjusted EPS	33.6	11.9	1.2	(16.1)	28.0
Profitability & Return ratios (%)					
EBITDA margin	15.3	18.2	15.5	15.8	17.8
EBIT margin	11.8	15.0	11.6	11.7	13.7
Adjusted profit margin	12.3	12.4	11.5	9.7	11.3
Adjusted ROAE	21.0	21.4	19.8	15.4	18.0
ROCE	15.0	19.3	15.1	14.3	18.9
Working capital days (days)					
Receivables	70	71	72	74	69
Inventory	1	1	1	0	0
Payables	90	104	114	117	110
Ratios (x)					
Gross asset turnover	4.3	4.7	5.0	5.0	6.0
Current ratio	2.0	1.8	2.0	2.3	2.5
Net interest coverage ratio	(22.4)	(39.1)	(22.3)	(34.5)	(35.6)
Adjusted debt/equity	0.0	0.0	0.0	(0.1)	(0.2)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

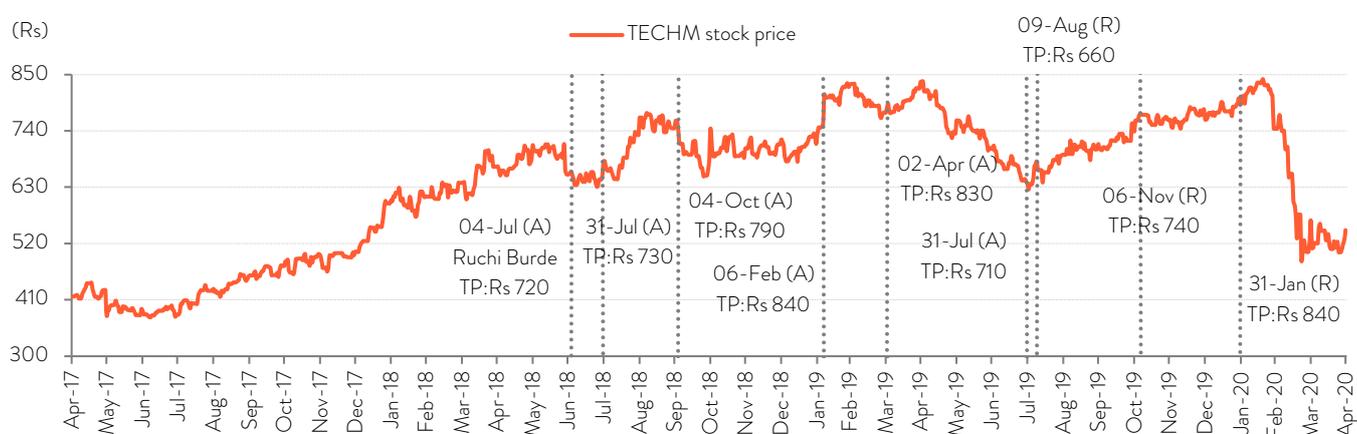
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: TECH MAHINDRA (TECHM IN)



B – Buy, A – Add, R – Reduce, S – Sell

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