

**SELL**  
 TP: Rs 670 | ▼ 11%

**MINDTREE**

| IT Services

| 18 July 2019

## Painful transition begins; downgrade to SELL

**Mindtree’s (MTCL) Q1FY20 reported EBIT missed estimates by 46% as both revenue and operating margins fell short. Distractions and uncertainty from L&T’s unsolicited takeover translated into flattish sequential topline growth, though deal wins at US\$ 324mn grew 6% YoY. We cut FY20/FY21 EPS by 31%/18% and reduce our target P/E multiple from 17x to 13.6x to factor in transition risks, which lowers our TP from Rs 990 to Rs 670. Downgrade from REDUCE to SELL on risks of further operational slippage.**

**Dull operating performance:** MTCL’s sequential dollar revenue growth of 0.8% was below our/consensus estimates of 1.7%/2.2%. Reported EBIT margins at 6.4% contracted 650bps QoQ due to employee compensation revision, adverse currency movements, visa costs and a one-time charge from additional rewards to employees to commemorate the company’s 20<sup>th</sup> anniversary. Excluding the 260bps impact from one-off employee rewards, adjusted EBIT margins at 9% were also below our estimate of 11.6%. Reported EBIT was 46% short of estimates led by both the revenue and margin miss.

**Loss of business momentum:** A slow start to the year and derailed profitability in the Jun’19 quarter mark a loss of business momentum for MTCL. We cut our FY20/FY21 EPS estimates by 31%/18% and build in lower dollar revenue growth of 8.5%/10.8% and 13.9%/15.5% EBITDA margins.

**Downgrade to SELL:** We value MTCL at a one-year forward P/E of 13.6x, a 20% discount to our earlier multiple of 17x to factor in transition risks in the wake of L&T’s hostile takeover of the company. On rolling valuations forward, we have a revised Jun’20 TP of Rs 670 (vs. Rs 990), and downgrade the stock to SELL. The speed and efficacy with which L&T (which now has a 60%+ stake in MTCL) is able to execute a leadership overhaul will be a key monitorable.

### KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Adj. net profit (Rs mn)	5,701	7,542	5,742	7,812	9,354
Adj. EPS (Rs)	34.7	45.8	34.9	47.4	56.8
Adj. EPS growth (%)	39.5	32.1	(23.9)	36.0	19.7
Adj. ROAE (%)	21.4	24.9	16.5	20.2	21.4
Adj. P/E (x)	21.7	16.4	21.5	15.8	13.2
EV/EBITDA (x)	16.5	11.6	11.6	8.9	7.4

Source: Company, BOBCAPS Research

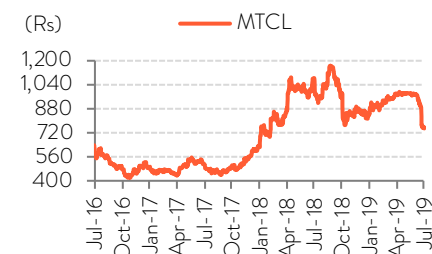
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Ticker/Price	MTCL IN/Rs 751
Market cap	US\$ 1.8bn
Shares o/s	164mn
3M ADV	US\$ 12.7mn
52wk high/low	Rs 1,184/Rs 735
Promoter/FPI/DII	13%/42%/45%

Source: NSE

### STOCK PERFORMANCE



Source: NSE



## Earnings call highlights

- Outlook:** MTCL's management is optimistic about achieving industry-leading growth on the back of strong deal wins and a healthy deal pipeline. Management expects a modest increase in FY20 operating margins excluding one-off charges. This marks a moderation in margin outlook compared to previous quarter commentary where management had outlined 100-120bps margin expansion (excluding any impact from Ind-AS 116).

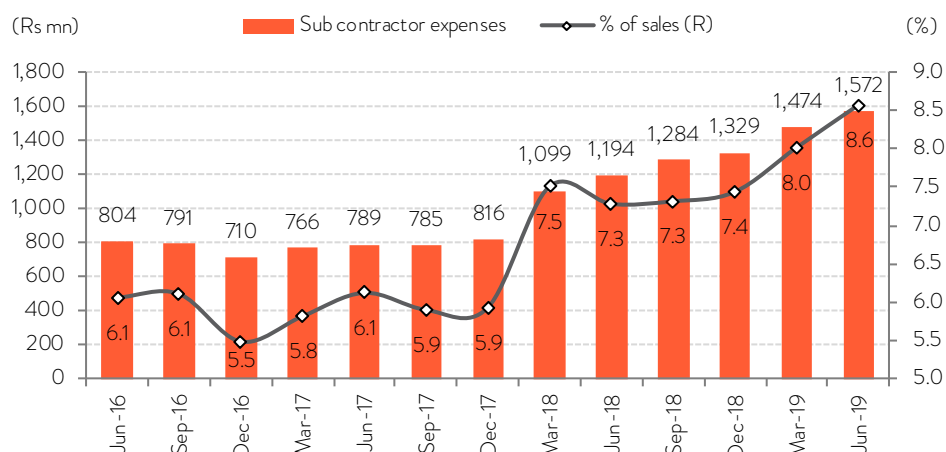
Besides this, management is hopeful that the loss of business momentum in Q1FY20 will be recouped as uncertainty over the L&T takeover bid has been put to rest. Further, the board is expected to finalise a leadership transition plan in a few days.

- BFSI:** Slower offtake of the company's digital offering in this vertical coupled with lower profitability pose challenges. However, management is sanguine about growth on the back of deal wins.
- Compensation:** MTCL announced one-time special rewards to all employees in proportion to their tenure with the company to commemorate its 20<sup>th</sup> anniversary. This one-time reward dented operating margins by 260bps QoQ. Going ahead, a compensation increase for senior executives is guided to impact Sep'19 quarter operating margins by ~100bps. However, management expects sequential margin improvement.

**FIG 1 – IMPACT OF IND-AS 116 ADOPTION ON INCOME STATEMENT**

Particulars	Amount (Rs mn)	Comment
Lease expenses	52	Sequential EBITDA margin tailwind of 180bps
Depreciation of right-of-use assets	233	1.3% of revenues, implying net EBIT margin gain of 50bps QoQ
Interest on lease liabilities	130	0.6% of revenues, translating into sequential net margin headwind of 10bps QoQ
Deferred tax credit	(11)	

Source: Company, BOBCAPS Research

**FIG 2 – SUBCONTRACTING EXPENSES CONTINUE TO INCH UP**

Source: Company, BOBCAPS Research

**FIG 3 – JUN'19 QUARTER PERFORMANCE**

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	YoY (%)	QoQ (%)
<b>Revenues (US\$ mn)</b>	<b>241.5</b>	<b>246.4</b>	<b>251.5</b>	<b>262.0</b>	<b>264.2</b>	<b>9.4</b>	<b>0.8</b>
<b>Revenue</b>	<b>16,395</b>	<b>17,554</b>	<b>17,872</b>	<b>18,394</b>	<b>18,342</b>	<b>11.9</b>	<b>(0.3)</b>
<b>Operating Expenditure</b>	<b>14,085</b>	<b>14,855</b>	<b>15,039</b>	<b>15,591</b>	<b>16,501</b>	<b>17.2</b>	<b>5.8</b>
Cost of revenues	10,395	11,171	11,142	11,504	12,532	20.6	8.9
as % of sales	63.4	63.6	62.3	62.5	68.3	-	-
SG&A expenses	3,690	3,684	3,897	4,087	3,969	7.6	(2.9)
as % of sales	22.5	21.0	21.8	22.2	21.6	-	-
<b>EBITDA</b>	<b>2,310</b>	<b>2,699</b>	<b>2,833</b>	<b>2,803</b>	<b>1,841</b>	<b>(20.3)</b>	<b>(34.3)</b>
Depreciation	400	403	410	428	669	67.3	56.3
<b>EBIT</b>	<b>1,910</b>	<b>2,296</b>	<b>2,423</b>	<b>2,375</b>	<b>1,172</b>	<b>(38.6)</b>	<b>(50.7)</b>
Other Income	252	523	(200)	290	90	-	-
<b>PBT</b>	<b>2,162</b>	<b>2,819</b>	<b>2,223</b>	<b>2,665</b>	<b>1,262</b>	<b>(41.6)</b>	<b>(52.6)</b>
Total Tax	579	756	311	681	335	(42.1)	(50.8)
<b>Adjusted PAT</b>	<b>1,583</b>	<b>2,063</b>	<b>1,912</b>	<b>1,984</b>	<b>927</b>	<b>(41.4)</b>	<b>(53.3)</b>
(Profit)/loss from JV's/Ass/MI	0	0	0	0	0	-	-
<b>APAT after MI</b>	<b>1,583</b>	<b>2,063</b>	<b>1,912</b>	<b>1,984</b>	<b>927</b>	<b>(41.4)</b>	<b>(53.3)</b>
<b>Extra ordinary items</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>-</b>	<b>-</b>
<b>Reported PAT</b>	<b>1,583</b>	<b>2,063</b>	<b>1,912</b>	<b>1,984</b>	<b>927</b>	<b>(41.4)</b>	<b>(53.3)</b>
<b>Reported EPS</b>	<b>9.6</b>	<b>12.6</b>	<b>11.6</b>	<b>12.1</b>	<b>5.6</b>	<b>(41.5)</b>	<b>(53.3)</b>
<b>Margins (%)</b>						<b>(bps)</b>	<b>(bps)</b>
EBITDA	14.1	15.4	15.9	15.2	10.0	(405)	(520)
EBIT	11.6	13.1	13.6	12.9	6.4	(526)	(652)
EBT	13.2	16.1	12.4	14.5	6.9	(631)	(761)
PAT	9.7	11.8	10.7	10.8	5.1	(460)	(573)
Effective Tax rate	26.8	26.8	14.0	25.6	26.5	(23.6)	99.2

Source: Company, BOBCAPS Research

## Valuation methodology

A slow start to the year and derailed profitability in the Jun'19 quarter mark a loss of business momentum for MTCL. We cut our FY20/FY21 EPS estimates by 31%/18% and build in reduced dollar revenue growth of 8.5%/10.8% with lower 13.9%/15.5% EBITDA margins. We also introduce FY22 EPS at Rs 56.8 which bakes in 12.3% dollar revenue growth with 16% EBITDA margins.

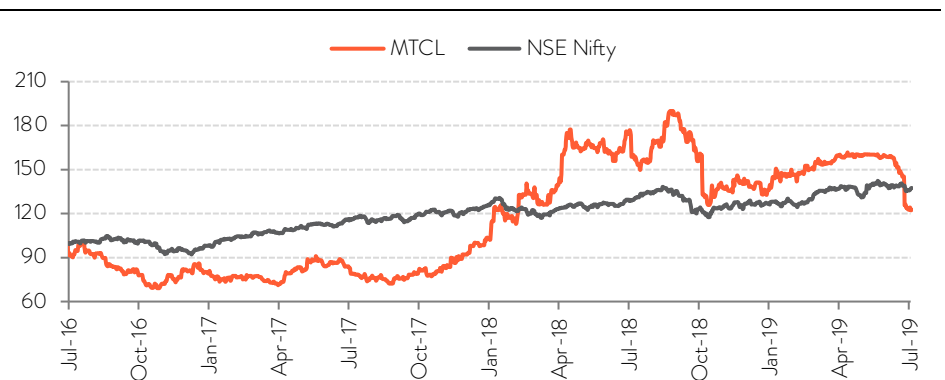
We now value MTCL at a one-year forward P/E of 13.6x, a 20% discount to our earlier multiple of 17x to factor in transition risks in the wake of L&T's hostile takeover of the company. On rolling valuations forward, we have a revised Jun'20 target price of Rs 670 (vs. Rs 990 earlier); downgrade from REDUCE to SELL on risk of operational slippages amidst ownership transition. The speed and efficacy with which L&T (which now has a 60%+ stake in MTCL) is able to execute a leadership overhaul will be a key monitorable.

**FIG 4 – REVISED ESTIMATES**

(Rs mn)	FY20E			FY21E			FY22E
	Old	New	Change (%)	Old	New	Change (%)	New
Overall revenues (US\$ mn)	1,134	1,087	(4.2)	1,283	1,204	(6.2)	1,353
YoY growth (%)	13.2	8.5	-	13.2	10.8	-	12.3
Revenues	79,384	75,098	(5.4)	89,837	84,306	(6.2)	94,680
EBITDA	12,714	10,421	(18.0)	14,415	13,062	(9.4)	15,193
EBITDA margins (%)	16.0	13.9	-	16.0	15.5	-	16.0
Net profits	8,276	5,742	(30.6)	9,569	7,812	(18.4)	9,354
EPS (Rs)	50.3	34.9	(30.6)	58.1	47.4	(18.4)	56.8

Source: BOBCAPS Research

**FIG 5 – RELATIVE STOCK PERFORMANCE**



Source: NSE

## Key risks

Upside risks to our estimates include:

- sharp rupee depreciation,
- above-expected uptick in demand especially from large clients,
- quick and frictionless leadership overhaul, and
- earlier-than-expected operational stability.

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Total revenue</b>	<b>54,628</b>	<b>70,215</b>	<b>75,098</b>	<b>84,306</b>	<b>94,680</b>
EBITDA	7,405	10,645	10,421	13,062	15,193
EBIT	5,690	9,004	7,768	10,227	12,134
Net interest income/(expenses)	(169)	(29)	(520)	(600)	(680)
Other income/(expenses)	1,902	894	609	1,074	1,360
Exceptional items	0	0	0	0	0
EBT	7,423	9,869	7,858	10,701	12,814
Income taxes	1,722	2,327	2,116	2,889	3,460
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>5,701</b>	<b>7,542</b>	<b>5,742</b>	<b>7,812</b>	<b>9,354</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>5,701</b>	<b>7,542</b>	<b>5,742</b>	<b>7,812</b>	<b>9,354</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	5,733	7,330	7,818	8,777	9,857
Provisions	1,218	1,399	1,646	1,848	2,075
Debt funds	3,000	0	0	0	0
Other liabilities	0	0	0	0	0
Equity capital	1,639	1,642	1,642	1,642	1,642
Reserves & surplus	25,775	31,419	34,742	39,264	44,678
Shareholders' fund	27,414	33,061	36,384	40,906	46,320
<b>Total liabilities and equities</b>	<b>37,365</b>	<b>41,790</b>	<b>45,849</b>	<b>51,531</b>	<b>58,252</b>
Cash and cash eq.	3,289	2,562	6,647	11,039	16,349
Accounts receivables	10,155	13,356	13,991	15,706	17,639
Inventories	0	0	0	0	0
Other current assets	3,888	6,634	7,201	8,084	9,079
Investments	7,264	8,036	8,036	8,036	8,036
Net fixed assets	9,660	9,966	8,557	7,122	5,464
CWIP	92	297	297	297	297
Intangible assets	4,539	4,732	4,732	4,732	4,732
Deferred tax assets, net	318	388	388	388	388
Other assets	2,791	848	1,029	1,155	1,297
<b>Total assets</b>	<b>37,365</b>	<b>41,790</b>	<b>45,849</b>	<b>51,531</b>	<b>58,252</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	5,784	6,927	8,395	10,647	12,413
Interest expenses	59	(117)	(89)	(474)	(680)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(833)	(2,360)	(647)	(1,564)	(1,762)
Other operating cash flows	634	1,855	0	0	0
<b>Cash flow from operations</b>	<b>5,644</b>	<b>6,305</b>	<b>7,658</b>	<b>8,608</b>	<b>9,971</b>
Capital expenditures	(1,011)	(1,708)	(1,244)	(1,400)	(1,400)
Change in investments	(877)	(301)	0	0	0
Other investing cash flows	(114)	209	89	474	680
<b>Cash flow from investing</b>	<b>(2,002)</b>	<b>(1,800)</b>	<b>(1,154)</b>	<b>(926)</b>	<b>(720)</b>
Equities issued/Others	1	3	0	0	0
Debt raised/repaid	1,960	(3,004)	0	0	0
Interest expenses	(2,694)	(37)	0	0	0
Dividends paid	(2,142)	(2,180)	(2,419)	(3,291)	(3,940)
Other financing cash flows	0	0	0	0	0
<b>Cash flow from financing</b>	<b>(2,875)</b>	<b>(5,218)</b>	<b>(2,419)</b>	<b>(3,291)</b>	<b>(3,940)</b>
<b>Changes in cash and cash eq.</b>	<b>767</b>	<b>(713)</b>	<b>4,085</b>	<b>4,392</b>	<b>5,310</b>
<b>Closing cash and cash eq.</b>	<b>3,289</b>	<b>2,562</b>	<b>6,647</b>	<b>11,039</b>	<b>16,349</b>

**Per Share**

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	34.7	45.8	34.9	47.4	56.8
Adjusted EPS	34.7	45.8	34.9	47.4	56.8
Dividend per share	11.0	33.0	12.2	16.6	19.9
Book value per share	166.7	200.8	221.0	248.4	281.3

**Valuations Ratios**

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.2	1.8	1.6	1.4	1.2
EV/EBITDA	16.5	11.6	11.6	8.9	7.4
Adjusted P/E	21.7	16.4	21.5	15.8	13.2
P/BV	4.5	3.7	3.4	3.0	2.7

**DuPont Analysis**

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	76.8	76.4	73.1	73.0	73.0
Interest burden (PBT/EBIT)	130.5	109.6	101.2	104.6	105.6
EBIT margin (EBIT/Revenue)	10.4	12.8	10.3	12.1	12.8
Asset turnover (Revenue/Avg TA)	155.4	177.4	171.4	173.1	172.5
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.3	1.3	1.3
Adjusted ROAE	21.4	24.9	16.5	20.2	21.4

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

**Ratio Analysis**

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
<b>YoY growth (%)</b>					
Revenue	4.3	28.5	7.0	12.3	12.3
EBITDA	3.1	43.8	(2.1)	25.3	16.3
Adjusted EPS	39.5	32.1	(23.9)	36.0	19.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	13.6	15.2	13.9	15.5	16.0
EBIT margin	10.4	12.8	10.3	12.1	12.8
Adjusted profit margin	10.4	10.7	7.6	9.3	9.9
Adjusted ROAE	21.4	24.9	16.5	20.2	21.4
ROCE	22.1	31.2	25.7	34.2	40.4
<b>Working capital days (days)</b>					
Receivables	64	61	66	64	64
Inventory	0	0	0	0	0
Payables	42	40	43	43	43
<b>Ratios (x)</b>					
Gross asset turnover	5.4	7.2	8.1	10.8	15.0
Current ratio	2.9	2.7	3.1	3.4	3.7
Net interest coverage ratio	(33.7)	NA	NA	NA	NA
Adjusted debt/equity	0.0	(0.1)	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

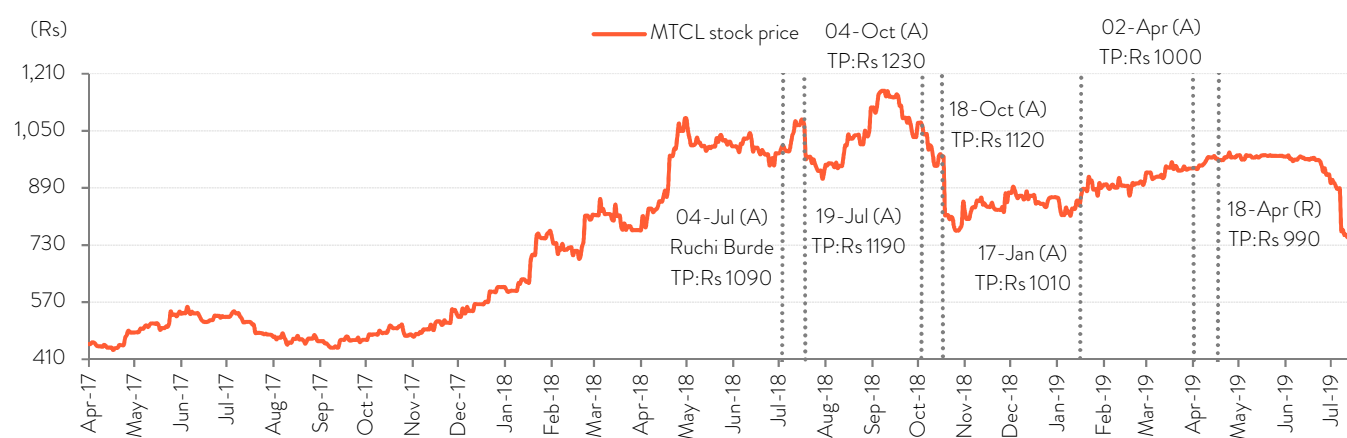
**ADD** – Expected return from >+5% to +15%

**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: MINDTREE (MTCL IN)



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

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