

SELL

TP: Rs 690 | ▼ 7%

MINDTREE

| IT Services

| 16 October 2019

High attrition, hazy outlook worrying – reiterate SELL

Mindtree’s (MTCL) Q2FY20 operating performance was in line (3.2% QoQ CC revenue growth), with a broad-based uptick across verticals. But attrition, a key monitorable post L&T takeover, hit a 19-quarter high of 20.2%. Further, management did not proffer concrete growth guidance for FY20 and cautioned that Q4 exit margins would be softer than in the year-ago period. We trim FY20/FY21 EPS by 5%/2% and stay cautious given transition risks post ownership change. Reiterate SELL, rolling to a revised Sep’20 TP of Rs 690 (vs. Rs 670).

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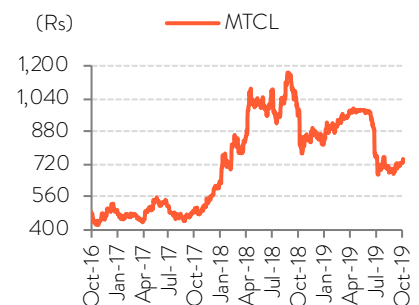
Operating metrics in line; attrition a concern: MTCL reported 3.2% QoQ CC revenue growth and 290bps QoQ EBIT margin improvement to 9.3% in the Sep’19 quarter. Broad-based growth across verticals and healthy top client performance (+5.1% QoQ in dollar terms) were key positives. But revenues from the top 2-5 clients declined 4.3% QoQ. Also, quarterly annualised attrition hit a 19-quarter high of 20.2%, rising 170bps QoQ.

Ticker/Price	MTCL IN/Rs 743
Market cap	US\$ 1.7bn
Shares o/s	165mn
3M ADV	US\$ 11.2mn
52wk high/low	Rs 1,000/Rs 652
Promoter/FPI/DII	74%/11%/15%

Source: NSE

Modest deal signings; digital mix shrinks: Deal wins for the quarter were modest at US\$ 307mn (-5.2% QoQ, +13% YoY). We highlight that digital deal wins at US\$ 140mn were lacklustre and their share in overall signings came down to 44% in H1FY20 vs. 52% in H1FY19.

STOCK PERFORMANCE



Source: NSE

Retain SELL: Management did not put out any specific growth guidance vs. its prior indication of updating the FY20 outlook along with Q2 results (MTCL had indicated double-digit growth at the start of the financial year). We trim FY20/FY21 EPS estimates by 5%/2% as we moderate operating margin assumptions following management’s indication of weaker FY20 exit margins (vs. FY19). Retain SELL (revised TP of Rs 690) as we remain wary of operational risks amidst the unfolding leadership transition.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	54,628	70,215	76,418	84,780	95,212
EBITDA (Rs mn)	7,405	10,645	10,132	13,135	15,278
Adj. net profit (Rs mn)	5,701	7,542	5,444	7,673	9,247
Adj. EPS (Rs)	34.7	45.8	33.1	46.6	56.2
Adj. EPS growth (%)	39.5	32.1	(27.8)	41.0	20.5
Adj. ROAE (%)	21.4	24.9	15.7	20.0	21.3
Adj. P/E (x)	21.4	16.2	22.5	16.0	13.2
EV/EBITDA (x)	16.3	11.5	11.8	8.8	7.3

Source: Company, BOBCAPS Research

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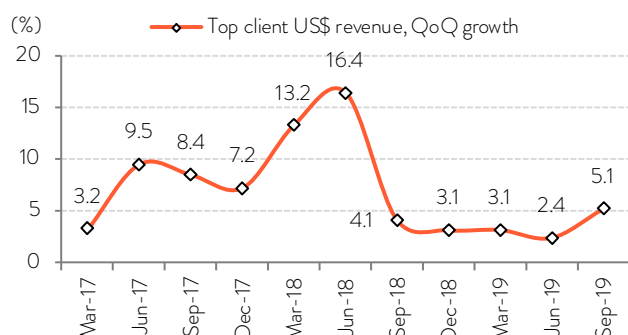
Earnings call highlights

- **FY20 outlook:** Management chose not to quantify or share any growth milestones as against its prior indication of updating the FY20 outlook along with the Sep'19 results (MTCL had indicated double-digit growth for FY20 at the start of the financial year).
- **Top client outlook:** MTCL remains optimistic about growth prospects for its top client. Conclusion of deal renewal with the top client cements visibility till mid of next calendar year, per management.
- **Other top accounts:** The company sees no client-specific challenges and is confident of stable engagement with its top accounts. Nonetheless, project completions and seasonality will also shape quarterly revenue performance.
- **Attrition:** Quarterly annualised attrition rose 170bps QoQ and 540bps YoY to 20.2% due to the confluence of seasonality and change of ownership at MTCL, followed by the exit of its founding promoters. Management acknowledged some senior leadership exits post ownership change.
- **Operating margin:** EBIT margins at 9.3% improved by 290bps QoQ on reported basis and by ~40bps QoQ excluding the impact of a one-off compensation award in Q1FY20. Currency gains (~50bps QoQ) and operational efficiencies supported Q2 margin improvement, partially offset by headwinds from compensation revision for senior leaders (~150bps QoQ).

Management has guided for continued operating margin improvement in H2FY20, led by employee pyramid optimisation and offshoring, but cautioned that Q4FY20 exit margins will be lower than that in Q4FY19 (12.9%).

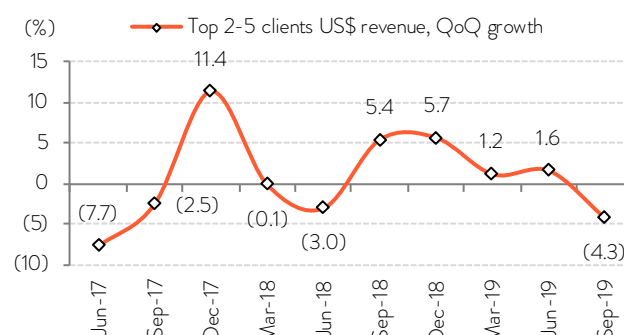
- **Key verticals:** Unlike larger peers, MTCL did not share any specific commentary on the BFSI and retail segments. Management highlighted that growth in its BFSI segment (+2.6% QoQ in dollar terms) was led by insurance and tier-II banks; also, that CPG contributes a relatively higher proportion of revenues compared to retail.
- **Tax cut impact:** Management sees no impact from the recently announced tax cuts for at least two years owing to the company's tax concessions.

FIG 1 – HEALTHY TRACTION IN TOP ACCOUNT...



Source: Company, BOBCAPS Research

FIG 2 – ...BUT REVENUES FROM TOP 2-5 CLIENTS DECLINED



Source: Company, BOBCAPS Research

FIG 3 – DIGITAL DEAL MIX SHRANK IN H1FY20

(US\$ mn)	Jun'18	Sep'18	Dec'18	Mar'19	Jun'19	Sep'19	H1FY19	H1FY20
Total Deal wins	306	271	256	242	324	307	577	631
QoQ growth (%)	2.7	(11.4)	(5.5)	(5.5)	33.9	(5.2)	-	-
YoY growth (%)	17	31	5	(19)	6	13	23.0	9.4
Digital Deal wins	139	162	136	126	137	140	301	277
Digital Deal wins % of total	45.4	59.8	53.1	52.1	42.3	45.6	52	44
QoQ growth (%)	36.3	16.5	(16.0)	(7.4)	8.7	2.2	-	-
YoY growth (%)	29	93	3	24	(1)	(14)	56.8	(8.0)

Source: Company, BOBCAPS Research.

FIG 4 – SEP'19 QUARTER PERFORMANCE

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	YoY (%)	QoQ (%)	H1FY19	H1FY20	YoY (%)
Revenues (US\$ mn)	241.5	246.4	251.5	262.0	264.2	271.0	10.0	2.6	487.9	535.2	9.7
Revenue	16,395	17,554	17,872	18,394	18,342	19,143	9.1	4.4	33,949	37,485	10.4
Operating Expenditure	14,085	14,855	15,039	15,591	16,501	16,661	12.2	1.0	28,940	33,162	14.6
Cost of revenues	10,395	11,171	11,142	11,504	12,532	12,647	13.2	0.9	21,566	25,179	16.8
as % of sales	63.4	63.6	62.3	62.5	68.3	66.1	-	-	63.5	67.2	-
SG&A expenses	3,690	3,684	3,897	4,087	3,969	4,014	9.0	1.1	7,374	7,983	8.3
as % of sales	22.5	21.0	21.8	22.2	21.6	21.0	-	-	21.7	21.3	-
EBITDA	2,310	2,699	2,833	2,803	1,841	2,482	(8.0)	34.8	5,009	4,323	(13.7)
Depreciation	400	403	410	428	669	707	75.4	5.7	803	1,376	71.4
EBIT	1,910	2,296	2,423	2,375	1,172	1,775	(22.7)	51.5	4,206	2,947	(29.9)
Other Income	252	523	(200)	290	90	59	-	-	775	149	(80.8)
PBT	2,162	2,819	2,223	2,665	1,262	1,834	(34.9)	45.3	4,981	3,096	(37.8)
Total Tax	579	756	311	681	335	484	(36.0)	44.5	1,335	819	(38.7)
Adjusted PAT	1,583	2,063	1,912	1,984	927	1,350	(34.6)	45.6	3,646	2,277	(37.5)
(Profit)/loss from JV's/Ass/MI	0	0	0	0	0	0	-	-	0	0	-
APAT after MI	1,583	2,063	1,912	1,984	927	1,350	(34.6)	45.6	3,646	2,277	(37.5)
Extra ordinary items	0	0	0	0	0	0	-	-	0	0	-
Reported PAT	1,583	2,063	1,912	1,984	927	1,350	(34.6)	45.6	3,646	2,277	(37.5)
Reported EPS	9.6	12.6	11.6	12.1	5.6	8.2	(34.7)	45.6	22	14	(37.6)
Margins (%)							(bps)	(bps)			(bps)
EBITDA	14.1	15.4	15.9	15.2	10.0	13.0	(240)	290	14.8	11.5	(320)
EBIT	11.6	13.1	13.6	12.9	6.4	9.3	(380)	290	12.4	7.9	(450)
EBT	13.2	16.1	12.4	14.5	6.9	9.6	(650)	270	14.7	8.3	(640)
PAT	9.7	11.8	10.7	10.8	5.1	7.1	(470)	200	10.7	6.1	(470)
Effective Tax Rate	26.8	26.8	14.0	25.6	26.5	26.4	(40.0)	(20.0)	26.8	26.5	(30)

Source: Company, BOBCAPS Research

Valuation methodology

Management's emphasis on 'establishing stability' highlights its ongoing efforts to curtail the perils of a painful transition post the L&T takeover. We stay wary of operational risks as this transition unfolds. Retain SELL.

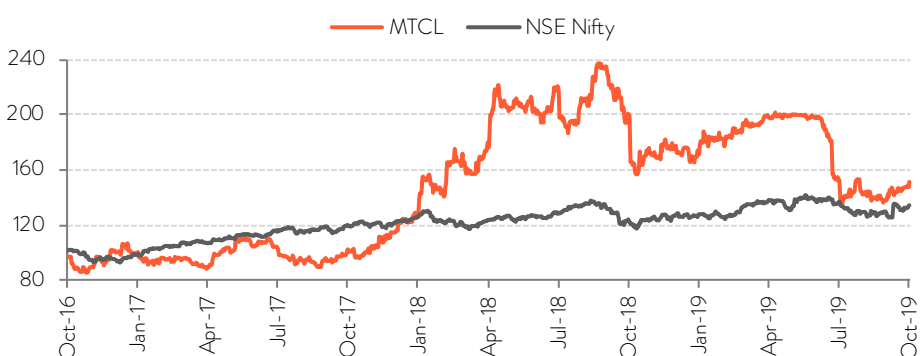
We reset margins lower to align with management's guidance and thus cut our FY20/FY21 EPS estimates by 5%/2%. On rolling valuations forward, we have a revised Sep'20 target price of Rs 690 (vs. Rs 670 earlier), based on an unchanged one-year forward P/E multiple of 13.6x. The speed and efficacy with which L&T (which now owns a 60%+ stake in MTCL) is able to execute a leadership overhaul will be a key monitorable.

FIG 5 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Overall Revenues (US\$ mn)	1,087	1,091	0.4	1,204	1,211	0.6	1,353	1,360	0.6
YoY growth (%)	8.5	9.0	-	10.8	11.0	-	12.3	12.3	-
Revenues	75,098	76,418	1.8	84,306	84,780	0.6	94,680	95,212	0.6
EBITDA	10,421	10,132	(2.8)	13,062	13,135	0.6	15,193	15,278	0.6
EBITDA margin (%)	13.9	13.3	-	15.5	15.5	-	16.0	16.0	-
Net profits	5,742	5,444	(5.2)	7,812	7,673	(1.8)	9,354	9,247	(1.1)
EPS (Rs)	34.9	33.1	(5.2)	47.4	46.6	(1.8)	56.8	56.2	(1.1)

Source: BOBCAPS Research

FIG 6 – 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
Total revenue	54,628	70,215	76,418	84,780	95,212
EBITDA	7,405	10,645	10,132	13,135	15,278
Depreciation	1,715	1,641	2,787	3,050	3,291
EBIT	5,690	9,004	7,345	10,085	11,987
Net interest income/(expenses)	(169)	(29)	(528)	(600)	(680)
Other income/(expenses)	1,902	894	617	1,026	1,360
Exceptional items	0	0	0	0	0
EBT	7,423	9,869	7,434	10,511	12,667
Income taxes	1,722	2,327	1,990	2,838	3,420
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	5,701	7,542	5,444	7,673	9,247
Adjustments	0	0	0	0	0
Adjusted net profit	5,701	7,542	5,444	7,673	9,247

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	7,956	8,826	9,913
Provisions	1,218	1,399	1,675	1,858	2,087
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	34,570	39,011	44,362
Shareholders' fund	27,414	33,061	36,212	40,653	46,004
Total liabilities and equities	37,365	41,790	45,842	51,337	58,004
Cash and cash eq.	3,289	2,562	6,367	11,038	16,509
Accounts receivables	10,155	13,356	14,237	15,795	17,738
Inventories	0	0	0	0	0
Other current assets	3,888	6,634	7,328	8,130	9,130
Investments	7,264	8,036	8,036	8,036	8,036
Net fixed assets	9,660	9,966	8,440	6,790	4,899
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	1,047	1,161	1,304
Total assets	37,365	41,790	45,842	51,337	58,004

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	5,784	6,927	8,230	10,723	12,538
Interest expenses	59	(117)	(89)	(426)	(680)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(833)	(2,360)	(872)	(1,420)	(1,772)
Other operating cash flows	634	1,855	0	0	0
Cash flow from operations	5,644	6,305	7,270	8,877	10,086
Capital expenditures	(1,011)	(1,708)	(1,260)	(1,400)	(1,400)
Change in investments	(877)	(301)	0	0	0
Other investing cash flows	(114)	209	89	426	680
Cash flow from investing	(2,002)	(1,800)	(1,172)	(974)	(720)
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)	(2,293)	(3,232)	(3,895)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(2,875)	(5,218)	(2,293)	(3,232)	(3,895)
Changes in cash and cash eq.	767	(713)	3,805	4,671	5,471
Closing cash and cash eq.	3,289	2,562	6,367	11,038	16,509

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	34.7	45.8	33.1	46.6	56.2
Adjusted EPS	34.7	45.8	33.1	46.6	56.2
Dividend per share	11.0	33.0	11.6	16.3	19.7
Book value per share	166.7	200.8	219.9	246.9	279.4

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.2	1.7	1.6	1.4	1.2
EV/EBITDA	16.3	11.5	11.8	8.8	7.3
Adjusted P/E	21.4	16.2	22.5	16.0	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	73.2	73.0	73.0
Interest burden (PBT/EBIT)	130.5	109.6	101.2	104.2	105.7
EBIT margin (EBIT/Revenue)	10.4	12.8	9.6	11.9	12.6
Asset turnover (Revenue/Avg TA)	155.4	177.4	174.4	174.5	174.2
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.3	1.3	1.3
Adjusted ROAE	21.4	24.9	15.7	20.0	21.3

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

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	4.3	28.5	8.8	10.9	12.3
EBITDA	3.1	43.8	(4.8)	29.6	16.3
Adjusted EPS	39.5	32.1	(27.8)	41.0	20.5
Profitability & Return ratios (%)					
EBITDA margin	13.6	15.2	13.3	15.5	16.0
EBIT margin	10.4	12.8	9.6	11.9	12.6
Adjusted profit margin	10.4	10.7	7.1	9.1	9.7
Adjusted ROAE	21.4	24.9	15.7	20.0	21.3
ROCE	22.1	31.2	24.3	33.8	40.4
Working capital days (days)					
Receivables	64	61	66	65	64
Inventory	0	0	0	0	0
Payables	42	40	42	43	43
Ratios (x)					
Gross asset turnover	5.4	7.2	8.3	11.1	16.3
Current ratio	2.9	2.7	3.0	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

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

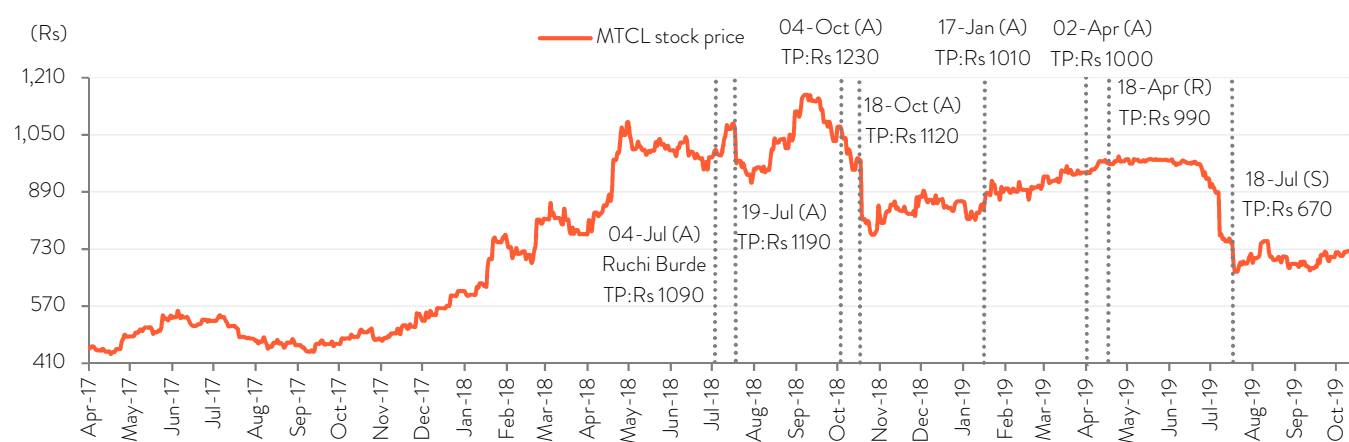
ADD – Expected return from >+5% to +15%

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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