

SELL

TP: Rs 780 | ▼ 10%

MINDTREE

| IT Services

| 14 January 2020

Impressive margin show but growth grounds weak ahead

Mindtree's (MTCL) Q3FY20 operating performance was buoyed by operating margin beat as revenue fell short on expectations. Soft deal wins, subpar digital business growth, top client dominated growth mix and moderation of quarterly annualized attrition characterized Q3FY20 operating metrics. Management is hopeful of sustaining growth momentum and operating margin improvement. We largely retain FY21/22 EPS estimates and reiterate SELL, rolling over to Dec'20 TP of Rs 780 (V/s Rs690 earlier).

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Operating margin beat: MTCL reported 1% QoQ cc growth in Dec'19 quarter falling short on our estimate of 1.8% QoQ cc growth. However, operating margin beat rounded better than expected operating performance. EBIT margin at 12%, up 280bps QoQ, was ahead of our/consensus estimate of 130/150bps QoQ improvement. Higher other income and lower taxes further aided net profits resulting into ~31% beat on our estimate V/s ~13.5% beat on EBIT.

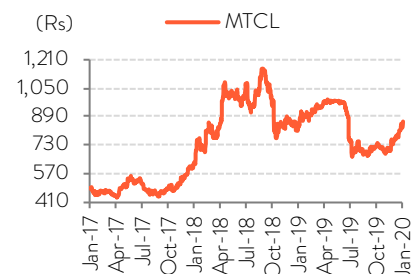
Weak deal wins and subpar Digital business growth: Deal wins for the quarter were soft at US\$ 207mn (-33% QoQ and -19% YoY) led by delay in client decision making. We highlight that deal win expiring in 1 year stood lowest since Sep'16 quarter impairing near-term growth visibility. Digital revenue contributed 38.2% revenues with mere 2.1% QoQ/13.6% YoY growth.

Top client skewed growth for yet another quarter: MTCL's top client continued to dominate growth with 13.9% QoQ dollar revenue growth. We highlight that over last 2 years MTCL's top client revenue concentration has inched up 650bps to 23.1%.

Ticker/Price	MTCL IN/Rs 864
Market cap	US\$ 2.0bn
Shares o/s	165mn
3M ADV	US\$ 8.2mn
52wk high/low	Rs 995/Rs 652
Promoter/FPI/DII	74%/11%/15%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	54,628	70,215	76,826	84,822	95,259
EBITDA (Rs mn)	7,405	10,645	10,615	13,142	15,286
Adj. net profit (Rs mn)	5,701	7,542	6,067	7,690	9,268
Adj. EPS (Rs)	34.7	45.8	36.8	46.7	56.3
Adj. EPS growth (%)	39.5	32.1	(19.6)	26.8	20.5
Adj. ROAE (%)	21.4	24.9	17.4	19.8	21.2
Adj. P/E (x)	24.9	18.9	23.5	18.5	15.4
EV/EBITDA (x)	19.1	13.3	13.3	10.5	8.7

Source: Company, BOBCAPS Research

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Earning call highlights:

- Operating margin:** Management expect operating margin expansion to continue in coming quarters on back of employee pyramid optimization, offshoring and pricing corrections.

 Dec'19 quarter EBITDA margins at 15.6% increased 260bps QoQ led by (1) 70bps gains on completion of project transitions (2) 140bps operational efficiency gains and (3) 50bps tailwinds from favorable currency movements.
- Managed services/strategic deals:** Management indicated its focus on increasing mix of annuity-based revenue with enhanced focus on large managed services/strategic deals going ahead.
- Client rationalization:** Company is curtailing long tail of client to enhance focus and investments in select strategy clients. Consequently, dollar revenue from non-top 10 clients decreased by 2.9% QoQ in Q3FY20. Management hinted that this client rationalization will continue for couple of quarters.
- Management attributed weak deal wins (US\$ 207mn, -33% QoQ and -19% YoY) to weak seasonality and delay in client decision making and dismissed any implications on account of leadership/people change.

FIG 1 – DEC'20 QUARTER RESULT SUMMARY

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	YoY (%)	QoQ (%)	9mFY19	9mFY20	YoY (%)
Revenues (US\$ mn)	241.5	246.4	251.5	262.0	264.2	271.0	275.2	9.4	1.5	739.4	810.4	9.6
Revenue	16,395	17,554	17,872	18,394	18,342	19,143	19,653	10.0	2.7	51,821	57,138	10.3
Operating Expenditure	14,085	14,855	15,039	15,591	16,501	16,661	16,590	10.3	(0.4)	43,979	49,752	13.1
Cost of revenues	10,395	11,171	11,142	11,504	12,532	12,647	12,535	12.5	(0.9)	32,708	37,714	15.3
as % of sales	63.4	63.6	62.3	62.5	68.3	66.1	63.8	-	-	63.1	66.0	-
SG&A expenses	3,690	3,684	3,897	4,087	3,969	4,014	4,055	4.1	1.0	11,271	12,038	6.8
as % of sales	22.5	21.0	21.8	22.2	21.6	21.0	20.6	-	-	21.7	21.1	-
EBITDA	2,310	2,699	2,833	2,803	1,841	2,482	3,063	8.1	23.4	7,842	7,386	(5.8)
Depreciation	400	403	410	428	669	707	699	70.5	(1.1)	1,213	2,075	71.1
EBIT	1,910	2,296	2,423	2,375	1,172	1,775	2,364	(2.4)	33.2	6,629	5,311	(19.9)
Other Income	252	523	(200)	290	90	59	215	-	-	575	364	(36.7)
PBT	2,162	2,819	2,223	2,665	1,262	1,834	2,579	16.0	40.6	7,204	5,675	(21.2)
Total Tax	579	756	311	681	335	484	609	95.8	25.8	1,646	1,428	(13.2)
Adjusted PAT	1,583	2,063	1,912	1,984	927	1,350	1,970	3.0	45.9	5,558	4,247	(23.6)
(Profit)/loss from JV's/Ass/MI	0	0	0	0	0	0	0	-	-	0	0	-
APAT after MI	1,583	2,063	1,912	1,984	927	1,350	1,970	3.0	45.9	5,558	4,247	(23.6)
Extra ordinary items	0	0	0	0	0	0	0	-	-	0	0	-
Reported PAT	1,583	2,063	1,912	1,984	927	1,350	1,970	3.0	45.9	5,558	4,247	(23.6)
Reported EPS	9.6	12.6	11.6	12.1	5.6	8.2	12.0	3.0	45.9	34	26	(23.7)
Margins (%)								(bps)	(bps)			(bps)
EBITDA	14.1	15.4	15.9	15.2	10.0	13.0	15.6	(30)	260	15.1	12.9	(220)

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	YoY (%)	QoQ (%)	9mFY19	9mFY20	YoY (%)
EBIT	11.6	13.1	13.6	12.9	6.4	9.3	12.0	(150)	280	12.8	9.3	(350)
EBT	13.2	16.1	12.4	14.5	6.9	9.6	13.1	70	350	13.9	9.9	(400)
PAT	9.7	11.8	10.7	10.8	5.1	7.1	10.0	(70)	300	10.7	7.4	(330)
Effective Tax rate	26.8	26.8	14.0	25.6	26.5	26.4	23.6	960.0	(280.0)	22.8	25.2	230

Source: Company, BOBCAPS Research

FIG 2 – DEC'20 QUARTER OPERATING METRICS

	Q3FY20 (% Contr. to Revenue)	QoQ (%)	YoY (%)
Deal wins (US\$ mn)	207	(32.6)	(19.1)
Digital Revenues	38.2	2.1	13.6
Revenue breakup-Geography			
North America	74.6	2.8	11.2
Europe	17.0	(1.9)	(0.5)
India	4.0	(3.3)	21.6
APAC	4.4	(0.7)	14.6
Revenue breakup-Verticals			
Hi-Tech	50.6	5.9	15.3
BFSI (US\$ mn)	21.3	0.1	7.4
Manufacturing & Retail (US\$ mn)	20.6	(3.6)	1.1
Travel, Media and Services (US\$ mn)	16.6	(0.3)	8.8
Client concentration			
Top Client	23.1	13.9	26.4
Top 5 Clients	36.1	10.4	16.9
Top 10 Clients	45.6	7.4	13.1
Non Top 10 Clients	54.4	(2.9)	6.5

Source: Company, BOBCAPS Research

Valuation methodology

We stay cautious on MTCL on risk of operational slippages as the transition post L&T Ltd's takeover unfolds. In our view, soft deal wins and subpar digital business growth lay weak growth grounds at MTCL. In addition, management's strategy to chase large managed services deals with innate longer deal conversion cycle may keep deal closures soft in near term.

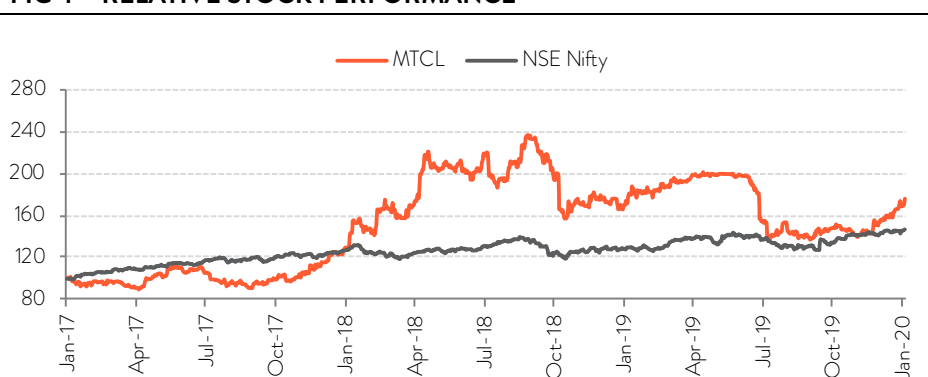
We revise FY20E EPS by 11.5% to bake in Q3FY20 operational beat along with higher other income and lower taxes. We retain FY21/22 EPS estimates largely unchanged. On rolling valuations forward, we have a revised Dec'20 target price of Rs 780 (vs. Rs 690 earlier), based on an one-year forward P/E multiple of 14.5x. Now we factor in 15% discount to 5 year average P/E V/s 20% discount earlier on faster than expected operating margin recovery.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Overall Revenues (US\$ mn)	1,091	1,092	0.0	1,211	1,212	0.0	1,360	1,361	0.0
YoY growth (%)	9.0	9.0	-	11.0	11.0	-	12.3	12.3	-
Revenues	76,418	76,826	0.5	84,780	84,822	0.0	95,212	95,259	0.0
EBITDA	10,132	10,615	4.8	13,135	13,142	0.0	15,278	15,286	0.0
EBITDA margin (%)	13.3	13.8	-	15.5	15.5	-	16.0	16.0	-
Net profits	5,444	6,067	11.5	7,673	7,690	0.2	9,247	9,268	0.2
EPS (Rs)	33.1	36.8	11.5	46.6	46.7	0.2	56.2	56.3	0.2

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- 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	76,826	84,822	95,259
EBITDA	7,405	10,645	10,615	13,142	15,286
Depreciation	1,715	1,641	2,780	3,051	3,292
EBIT	5,690	9,004	7,834	10,090	11,993
Net interest income/(expenses)	(169)	(29)	(531)	(600)	(680)
Other income/(expenses)	1,902	894	865	1,044	1,383
Exceptional items	0	0	0	0	0
EBT	7,423	9,869	8,168	10,535	12,696
Income taxes	1,722	2,327	2,101	2,844	3,428
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	5,701	7,542	6,067	7,690	9,268
Adjustments	0	0	0	0	0
Adjusted net profit	5,701	7,542	6,067	7,690	9,268

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	7,998	8,831	9,917
Provisions	1,218	1,399	1,684	1,859	2,088
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	34,930	39,381	44,746
Shareholders' fund	27,414	33,061	36,572	41,023	46,388
Total liabilities and equities	37,365	41,790	46,255	51,713	58,393
Cash and cash eq.	3,289	2,562	6,646	11,390	16,874
Accounts receivables	10,155	13,356	14,313	15,802	17,747
Inventories	0	0	0	0	0
Other current assets	3,888	6,634	7,367	8,134	9,134
Investments	7,264	8,036	8,036	8,036	8,036
Net fixed assets	9,660	9,966	8,452	6,801	4,909
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	1,052	1,162	1,305
Total assets	37,365	41,790	46,255	51,713	58,393

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	5,784	6,927	8,847	10,742	12,560
Interest expenses	59	(117)	(334)	(444)	(703)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(833)	(2,360)	(941)	(1,358)	(1,773)
Other operating cash flows	634	1,855	0	0	0
Cash flow from operations	5,644	6,305	7,573	8,939	10,085
Capital expenditures	(1,011)	(1,708)	(1,267)	(1,400)	(1,400)
Change in investments	(877)	(301)	0	0	0
Other investing cash flows	(114)	209	334	444	703
Cash flow from investing	(2,002)	(1,800)	(933)	(956)	(697)
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)	(2,556)	(3,239)	(3,904)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(2,875)	(5,218)	(2,556)	(3,239)	(3,904)
Changes in cash and cash eq.	767	(713)	4,084	4,744	5,483
Closing cash and cash eq.	3,289	2,562	6,646	11,390	16,874

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	34.7	45.8	36.8	46.7	56.3
Adjusted EPS	34.7	45.8	36.8	46.7	56.3
Dividend per share	11.0	33.0	12.9	16.3	19.7
Book value per share	166.7	200.8	222.1	249.2	281.7

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.6	2.0	1.8	1.6	1.4
EV/EBITDA	19.1	13.3	13.3	10.5	8.7
Adjusted P/E	24.9	18.9	23.5	18.5	15.4
P/BV	5.2	4.3	3.9	3.5	3.1

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	76.8	76.4	74.3	73.0	73.0
Interest burden (PBT/EBIT)	130.5	109.6	104.3	104.4	105.9
EBIT margin (EBIT/Revenue)	10.4	12.8	10.2	11.9	12.6
Asset turnover (Revenue/Avg TA)	155.4	177.4	174.5	173.2	173.0
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.3	1.3	1.3
Adjusted ROAE	21.4	24.9	17.4	19.8	21.2

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	9.4	10.4	12.3
EBITDA	3.1	43.8	(0.3)	23.8	16.3
Adjusted EPS	39.5	32.1	(19.6)	26.8	20.5
Profitability & Return ratios (%)					
EBITDA margin	13.6	15.2	13.8	15.5	16.0
EBIT margin	10.4	12.8	10.2	11.9	12.6
Adjusted profit margin	10.4	10.7	7.9	9.1	9.7
Adjusted ROAE	21.4	24.9	17.4	19.8	21.2
ROCE	22.1	31.2	25.9	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	3.8
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%

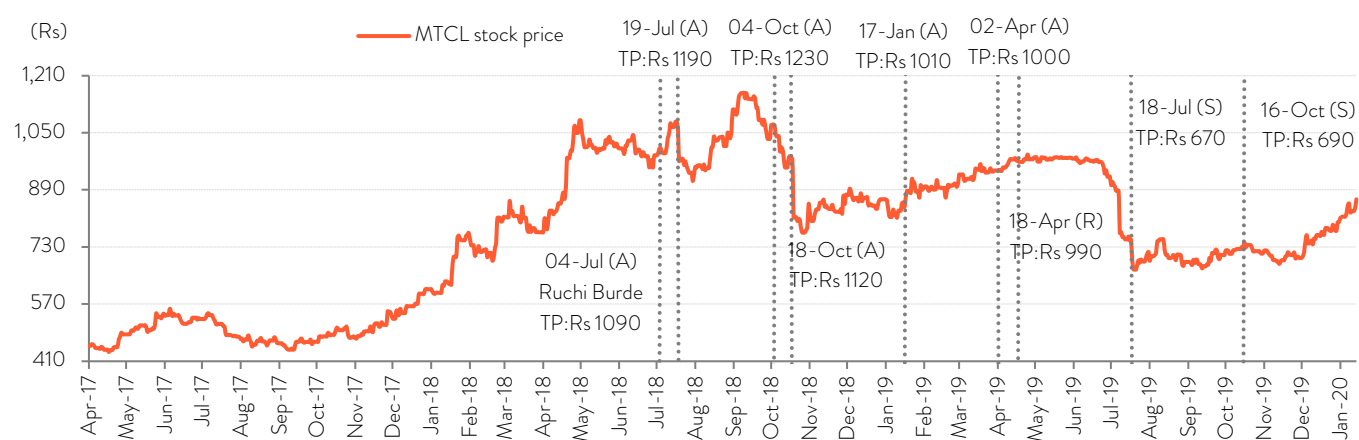
ADD – Expected return from >+5% to +15%

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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