

REDUCE

TP: Rs 740 | ▼ 5%

TECH MAHINDRA

| IT Services

| 18 December 2019

Analyst meet takeaways

Key takeaways from Tech Mahindra's (TECHM) analyst meet: (1) Management's fresh growth strategy brings little new to the table. Outcome-based solutions and large deals remain in focus, albeit with a shift toward the enterprise business (where large deal pipeline has doubled in FY20YTD). (2) Management is pinning hopes of EBIT margin recovery (-210bps in H1) on recouping contract transition costs. In our view, the path to margin revival looks difficult; valuations at 12.7x FY22E P/E leave limited upside given a telecom-heavy portfolio and operational volatility.

Ruchi Burde

research@bobcaps.in

Static strategic narrative: In our view, TECHM's '3-4-3 Next' strategy unveiled at its recent analyst meet (see page 2 for details) sticks to the roadmap set two years ago, with a continued focus on delivering outcome-based solutions to clients. Management reiterated its emphasis on large deal signings, higher growth visibility and margin improvement.

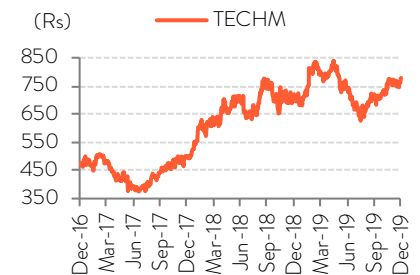
Higher communications deal wins but trend likely to change: Over the last six quarters, deal wins were buoyed by the communications vertical which contributed ~55% of signings. Management hinted that the trend may shift in favour of the enterprise business, which has seen a 20% YoY increase in deal pipeline in Dec'19, including a 100% jump in large contracts versus at the start of FY20. We note that three out of four US\$ 100mn+ TCv deal signings over the last six quarters were from the enterprise vertical.

Path to margin improvement hazy: Management attributed EBIT margin contraction in H1FY20 (down 210bps YoY) to a "shift caused by large deal transition costs" and is counting on recouping these costs in FY21 as a lever for margin improvement (besides refining delivery capabilities). In our view TECHM's path to mitigating these transition costs is still not concrete, clouding the outlook on margins.

Ticker/Price	TECHM IN/Rs 777
Market cap	US\$ 9.6bn
Shares o/s	873mn
3M ADV	US\$ 26.4mn
52wk high/low	Rs 847/Rs 607
Promoter/FPI/DII	36%/39%/25%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	3,07,729	3,47,421	3,64,534	3,99,099	4,37,307
EBITDA (Rs mn)	47,169	63,368	60,937	70,631	81,078
Adj. net profit (Rs mn)	38,001	42,975	43,015	48,285	53,659
Adj. EPS (Rs)	42.7	47.7	48.9	54.8	60.9
Adj. EPS growth (%)	33.6	11.9	2.3	12.2	11.1
Adj. ROAE (%)	21.0	21.4	19.6	19.6	19.5
Adj. P/E (x)	18.2	16.3	15.9	14.2	12.8
EV/EBITDA (x)	14.0	10.6	11.1	9.3	7.7

Source: Company, BOBCAPS Research

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Other analyst meet highlights

- **'3-4-3 Next' strategy:** Following its '3-4-3' strategy rolled out two years ago, TECHM unveiled a '3-4-3 Next' roadmap that retains the vision of having 3 main trends, 4 big bets and 3 objectives, as follows:
 - 3 Trends – (i) Explosion of intelligent devices, (ii) Power of new technologies, (iii) Exponentiality of content consumption
 - 4 Big Bets – (i) Infra, (ii) Business, (iii) Experience, (iv) Platforms
 - 3 Objectives – (i) Run Better, (ii) Change Faster, (iii) Grow Greater
- **Communications vertical:** Preparatory work to be 5G ready is driving deal activity in the communications vertical. The phasing out of old technologies (stacks) and investments in upcoming 5G technology will shape revenues in this space. Nonetheless, management acknowledged that the business may not remain immune to ongoing volatility in the global telecom industry.
- **Enterprise vertical:** TECHM continues to chase synergy-enabled growth in the enterprise business, especially leveraging its leadership in communications services. Management believes that solutions focused on business outcomes, portfolio synergy and agile delivery will aid growth.
- **Capital allocation:** The company aims to retain cash in the range of US\$ 600mn to US\$ 900mn and return the excess cash to shareholders, in line with its capital allocation philosophy.
- **Client mining:** Management indicated that despite a diverse product and service portfolio, TECHM has recall value with only 10% of its clients for multiservice offerings. The company has thus enhanced focus on mining the top 200 clients (out of 900) and aligned marketing/branding efforts to this end.
- **Portfolio company synergies:** Growth synergies and margin expansion at portfolio companies (acquired entities) is another focus area. Management highlighted its initial success with US\$ 120mn TCV synergy deal wins over the last 12 months, a four-fold increase YoY, and a similar 4x rise in deal pipeline.

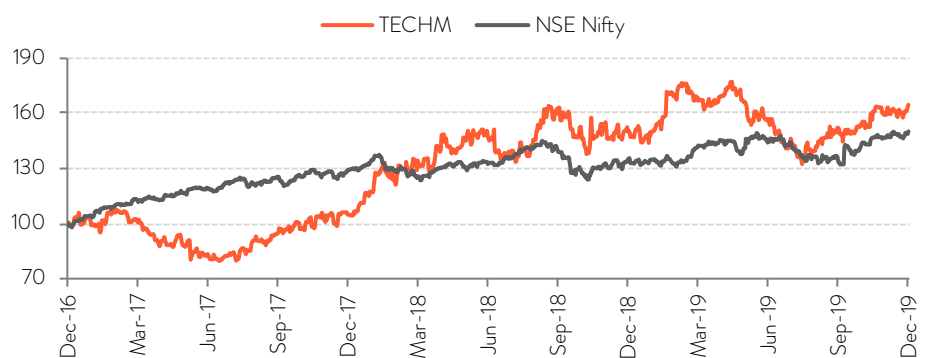
Management acknowledged weakness at select portfolio companies, namely Pininfarina (as we highlighted in our Aug'19 report, **'TECHM: Subsidiary troubles afresh'**) and Complex IT (Brazil-based entity acquired in 2013).

- **Attrition:** TECHM showcased a slew of initiatives aimed at reskilling employees and enhancing their work experience. As per the company, attrition has shown early signs of easing in the last four months, though it is too early to call this a trend. Management also pointed out that in comparison to peers, TECHM's attrition will be structurally higher due to its BPS segment.

Valuation methodology

We believe that valuations at 14.1x/12.7x FY21E/FY22E P/E leave limited upside considering TECHM's communications-heavy portfolio and operational volatility. Retain REDUCE with an unchanged Sep'20 target price of Rs 740 based on a target one-year forward P/E of 12.5x.

FIG 1 – 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	FY20E	FY21E	FY22E
Total revenue	3,07,729	3,47,421	3,64,534	3,99,099	4,37,307
EBITDA	47,169	63,368	60,937	70,631	81,078
Depreciation	10,849	11,292	13,558	14,767	16,180
EBIT	36,320	52,076	47,379	55,864	64,898
Net interest income/(expenses)	(1,624)	(1,332)	(1,462)	(1,250)	(1,550)
Other income/(expenses)	14,093	5,342	10,214	10,136	8,616
Exceptional items	0	0	0	0	0
EBT	48,789	55,431	55,895	64,651	71,864
Income taxes	10,925	12,544	13,159	16,486	18,325
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	137	(567)	44	20	20
Reported net profit	38,001	42,975	43,015	48,285	53,659
Adjustments	0	0	0	0	0
Adjusted net profit	38,001	42,975	43,015	48,285	53,659

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	71,708	90,744	94,879	1,03,875	1,13,820
Provisions	9,581	9,753	9,987	10,934	11,981
Debt funds	17,260	14,047	14,047	14,047	14,047
Other liabilities	12,304	12,304	12,304	12,304	12,304
Equity capital	4,417	4,437	4,437	4,437	4,437
Reserves & surplus	1,89,102	2,03,184	2,27,896	2,55,713	2,86,640
Shareholders' fund	1,93,519	2,07,621	2,32,333	2,60,150	2,91,077
Total liabilities and equities	3,04,372	3,34,469	3,63,550	4,01,310	4,43,229
Cash and cash eq.	19,661	20,427	48,544	81,435	1,17,923
Accounts receivables	65,117	69,586	71,908	78,726	86,263
Inventories	659	752	752	752	752
Other current assets	76,857	88,020	91,005	93,846	96,986
Investments	59,595	77,926	77,926	77,926	77,926
Net fixed assets	76,717	71,667	67,222	62,433	57,185
CWIP	2,399	2,763	2,763	2,763	2,763
Intangible assets	27,727	28,163	28,163	28,163	28,163
Deferred tax assets, net	5,766	6,091	6,091	6,091	6,091
Other assets	0	0	0	0	0
Total assets	3,04,372	3,34,469	3,63,448	4,01,208	4,43,127

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	44,374	50,112	56,295	62,931	69,719
Interest expenses	169	(745)	(11,676)	(11,386)	(10,166)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(7,832)	(10,574)	(938)	284	314
Other operating cash flows	(1,176)	5,527	0	0	0
Cash flow from operations	35,535	44,320	43,681	51,829	59,867
Capital expenditures	(7,902)	(7,793)	(9,113)	(9,977)	(10,933)
Change in investments	(20,701)	(23,216)	0	0	0
Other investing cash flows	(4,590)	9,967	11,676	11,386	10,166
Cash flow from investing	(33,193)	(21,042)	2,562	1,409	(766)
Equities issued/Others	251	359	0	0	0
Debt raised/repaid	7,486	(4,504)	0	0	0
Interest expenses	(993)	(3,460)	0	0	0
Dividends paid	(9,438)	(14,907)	(18,127)	(20,347)	(22,612)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(2,694)	(22,512)	(18,127)	(20,347)	(22,612)
Changes in cash and cash eq.	(352)	766	28,117	32,891	36,489
Closing cash and cash eq.	19,661	20,427	48,544	81,435	1,17,923

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	42.7	47.7	48.9	54.8	60.9
Adjusted EPS	42.7	47.7	48.9	54.8	60.9
Dividend per share	14.0	14.0	17.1	19.2	21.3
Book value per share	217.3	230.6	263.9	295.4	330.6

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	2.1	1.9	1.9	1.6	1.4
EV/EBITDA	14.0	10.6	11.1	9.3	7.7
Adjusted P/E	18.2	16.3	15.9	14.2	12.8
P/BV	3.6	3.4	2.9	2.6	2.4

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	77.9	77.5	77.0	74.7	74.7
Interest burden (PBT/EBIT)	134.3	106.4	118.0	115.7	110.7
EBIT margin (EBIT/Revenue)	11.8	15.0	13.0	14.0	14.8
Asset turnover (Revenue/Avg TA)	108.9	108.8	104.5	104.4	103.6
Leverage (Avg TA/Avg Equity)	1.6	1.6	1.6	1.6	1.5
Adjusted ROAE	21.0	21.4	19.6	19.6	19.5

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

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	5.6	12.9	4.9	9.5	9.6
EBITDA	12.7	34.3	(3.8)	15.9	14.8
Adjusted EPS	33.6	11.9	2.3	12.2	11.1
Profitability & Return ratios (%)					
EBITDA margin	15.3	18.2	16.7	17.7	18.5
EBIT margin	11.8	15.0	13.0	14.0	14.8
Adjusted profit margin	12.3	12.4	11.8	12.1	12.3
Adjusted ROAE	21.0	21.4	19.6	19.6	19.5
ROCE	15.0	19.3	17.1	20.0	23.9
Working capital days (days)					
Receivables	70	71	71	69	69
Inventory	1	1	1	1	1
Payables	90	104	112	110	112
Ratios (x)					
Gross asset turnover	4.3	4.7	5.2	6.2	7.3
Current ratio	2.0	1.8	2.0	2.2	2.4
Net interest coverage ratio	(22.4)	(39.1)	(32.4)	(44.7)	(41.9)
Adjusted debt/equity	0.0	0.0	(0.1)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

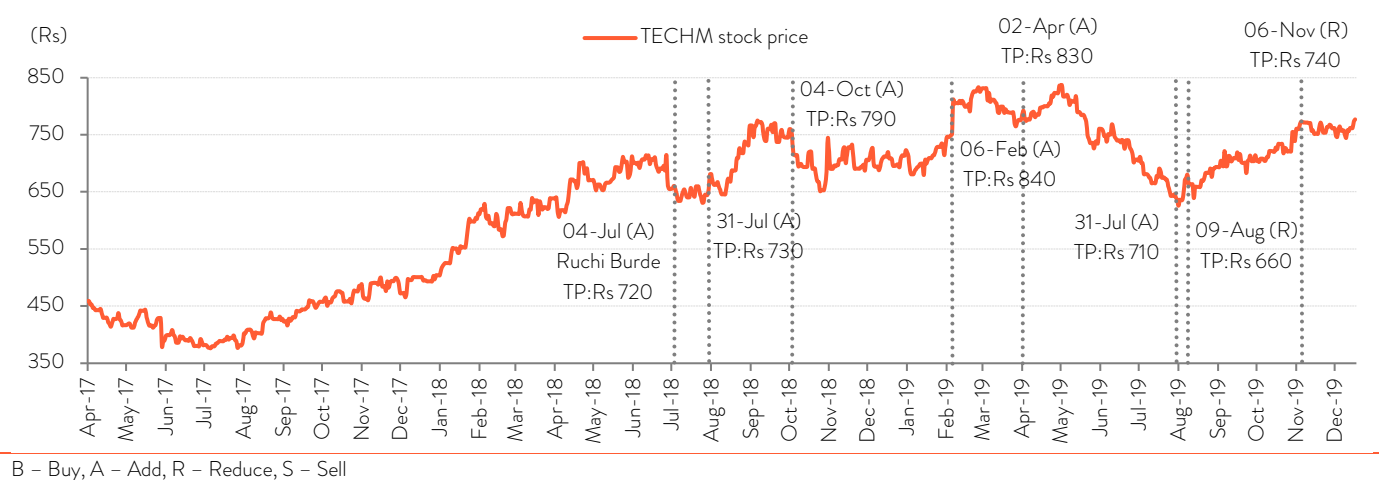
ADD – Expected return from >+5% to +15%

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: TECH MAHINDRA (TECHM IN)



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