

**REDUCE**

TP: Rs 660 | ▼ 2%

**TECH MAHINDRA**

| IT Services

| 09 August 2019

## Subsidiary troubles afresh; cut to REDUCE

Tech Mahindra (TECHM) subsidiary Pininfarina (PINF) was a harbinger of growth for the company over the past two years, bringing in 16% of incremental FY19 revenue. PINF now expects revenue to shrink ~10% in CY19 with operating losses from the suspension of some auto deals amid global weakness. In our view, this will add to TECHM's struggles in the enterprise business and sharpen downside risks to growth. We move from ADD to REDUCE and cut our Jun'20 TP to Rs 660 (vs. Rs 710) on a lower target P/E of 12x (vs. 13x).

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**Pininfarina – the erstwhile growth engine...** Acquired in Dec'15, PINF has been a lynchpin of growth for TECHM over the last two years as its revenues increased at a 30.9% CAGR in dollar terms over FY17-FY19 vs. 6.9% for the company. Despite a relatively low revenue share (2.6% in FY19), we note that PINF accounted for ~16% of TECHM's incremental revenue in FY19 and more than a third of incremental revenue for the manufacturing vertical.

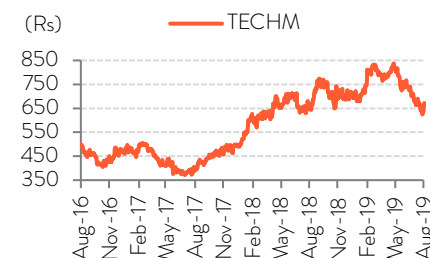
**...now losing steam:** While PINF started the year with a strong outlook, the suspension of some orders dented its H1CY19 performance – euro revenues declined 16% YoY accompanied by operational losses (EBIT margins of -4.09%). Consequently, it has cut its CY19 outlook and now expects a 10% revenue decline for the year with operational losses, against its earlier guidance of “consolidating the CY18 performance” (when euro revenues rose 21% YoY).

**Slower enterprise growth recovery:** The absence of growth traction in the manufacturing vertical (a third of enterprise business) raises the risk of laggardly recovery in the enterprise vertical (58.8% of FY19 revenues; down 2.2% YoY in Q1FY20, marking a second quarter of YoY decline). Considering the downside risks to growth as well as operating margins, we pare our target one-year forward P/E multiple to 12x (vs. 13x) and downgrade the stock to REDUCE.

Ticker/Price	TECHM IN/Rs 674
Market cap	US\$ 8.3bn
Shares o/s	873mn
3M ADV	US\$ 29.6mn
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
Adj. net profit (Rs mn)	38,001	42,975	40,882	46,456	53,065
Adj. EPS (Rs)	42.7	47.7	46.4	52.8	60.3
Adj. EPS growth (%)	33.6	11.9	(2.7)	13.6	14.2
Adj. ROAE (%)	21.0	21.4	18.6	19.0	19.4
Adj. P/E (x)	15.8	14.1	14.5	12.8	11.2
EV/EBITDA (x)	12.3	9.3	9.7	7.9	6.5

Source: Company, BOBCAPS Research

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**FIG 1 – PININFARINA CONTRIBUTED ~16% OF INCREMENTAL FY19 REVENUE**

Pininfarina	FY18	FY19
Revenue (Rs mn)	6,401	9,159
Revenue (US\$ mn)*	99	131
YoY growth (%)	29.8	32.1
% of Revenue	2.1	2.6
% of Manufacturing revenues	10.8	13.0
% Contribution to incremental revenues	5.4	15.9

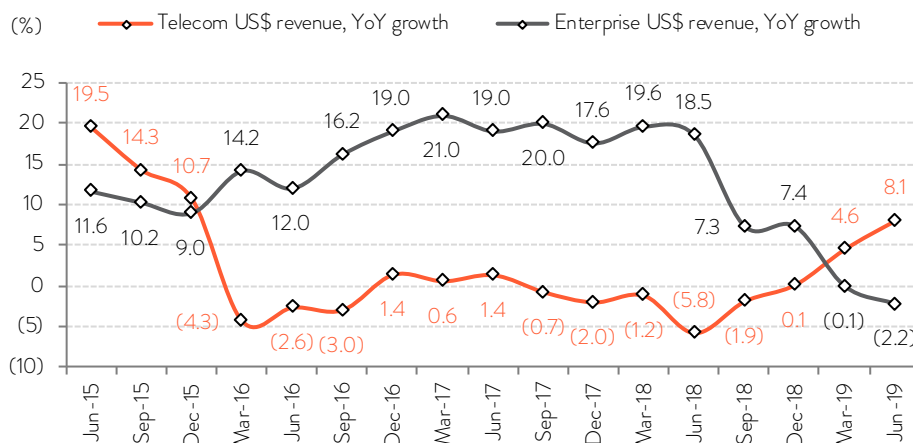
Source: Company, BOBCAPS Research | \*Calculated using average INR/USD realisation rate for TECHM

**FIG 2 – SUSPENSION OF SOME ORDERS LED TO 16% YOY EURO REVENUE DECLINE AND OPERATIONAL LOSSES IN H1CY19**

Pininfarina (Euro mn)	CY16	CY17	CY18	H1CY18	H1CY19
Revenue	68.9	87.1	105.3	55.3	46.4
YoY growth (%)	(16.8)	26.5	20.9	-	(16.1)
EBITDA	0.9	7.6	12.6	7.0	0.9
EBITDA margin (%)	1.3	8.7	12.0	12.7	1.9
EBIT	(2.9)	4.2	3.8	5.1	(1.9)
EBIT margin (%)	(4.2)	4.9	3.6	9.2	(4.1)
Net Loss	20.5	1.3	2.2	3.1	(2.6)

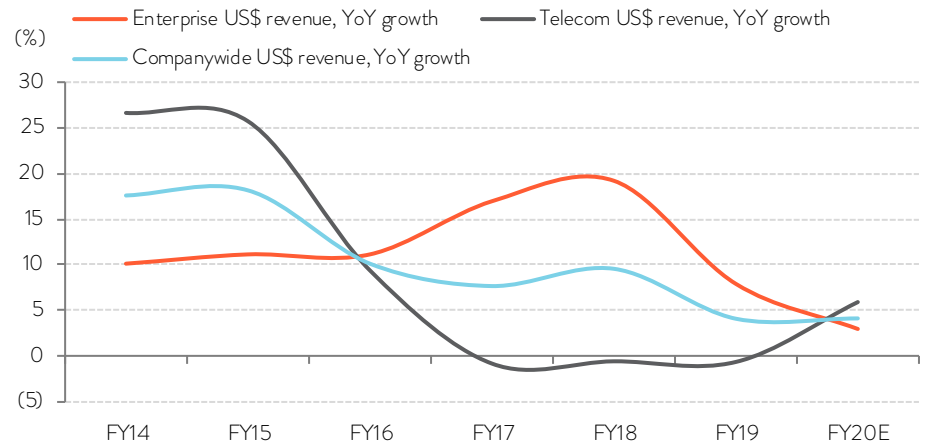
Source: Company, BOBCAPS Research

**FIG 3 – ENTERPRISE BUSINESS GROWTH TRACTION HAS FIZZLED OUT IN RECENT QUARTERS**



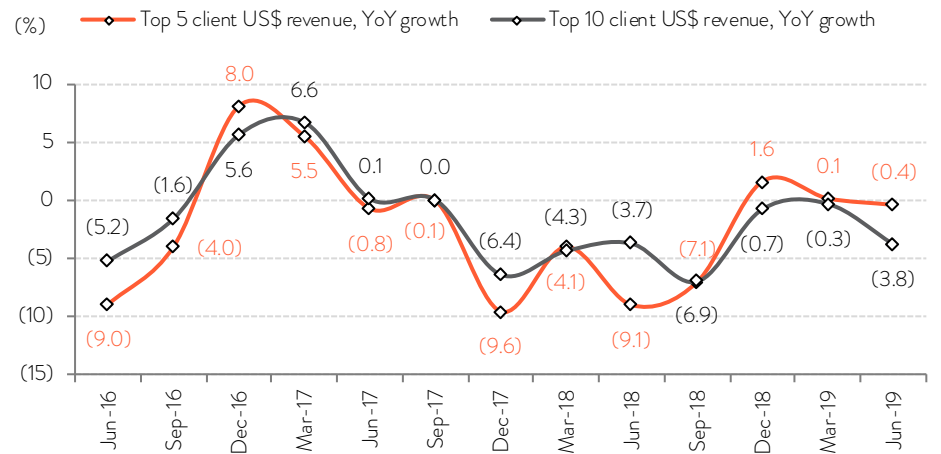
Source: Company, BOBCAPS Research

**FIG 4 – FY20 WILL BE ANOTHER CHALLENGING YEAR FOR TECHM**



Source: Company, BOBCAPS Research

**FIG 5 – REVENUE FROM TOP 10 CLIENTS HAS DECLINED ON ANNUAL BASIS FOR LAST 7 QUARTERS**



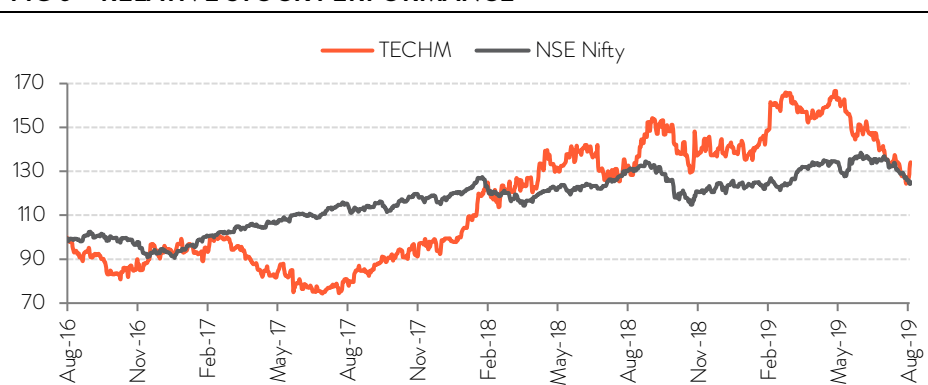
Source: Company, BOBCAPS Research

## Valuation methodology

Loss of growth traction in the enterprise vertical (58.8% of FY19 revenues) which slipped 2.2% YoY in Q1FY20, the second quarter of annual decline, together with operating margin contraction is forecast to result in a 10.7% YoY EBIT decline in FY20. Moreover, the US-Huawei feud casts uncertainty over the timing of 5G rollout, rendering the 5G opportunity a more distant catalyst for the company than earlier envisaged by the market (see our report [US-Huawei feud casts uncertainty over 5G opportunity](#)).

Section of street argue higher valuation in wake of 5G led growth upcycle for TECHM; however absence of overall growth uplift (dragged down by soft Enterprise business) demerit such case in our view. We pare our target one-year forward P/E multiple to 12x (vs. 13x on downside risks to growth), leading to a lower Jun'20 target price of Rs 660 (vs. Rs 710), and downgrade the stock from ADD to REDUCE.

**FIG 6 – RELATIVE STOCK PERFORMANCE**



Source: NSE

## Key risks

Upside risks to our estimates include:

- sharp uptick in the enterprise vertical,
- swift resolution of the US/Huawei dispute and thus uncertainty around 5G, and
- significant favourable currency movement.

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Total revenue</b>	<b>3,07,729</b>	<b>3,47,421</b>	<b>3,57,925</b>	<b>3,95,078</b>	<b>4,32,908</b>
EBITDA	47,169	63,368	59,759	69,919	80,263
EBIT	36,320	52,076	46,504	55,301	64,245
Net interest income/(expenses)	(1,624)	(1,332)	(1,392)	(1,250)	(1,550)
Other income/(expenses)	14,093	5,342	9,912	8,245	8,472
Exceptional items	0	0	0	0	0
EBT	48,789	55,431	54,706	62,196	71,067
Income taxes	10,925	12,544	14,002	15,860	18,122
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	137	(567)	(141)	20	20
<b>Reported net profit</b>	<b>38,001</b>	<b>42,975</b>	<b>40,882</b>	<b>46,456</b>	<b>53,065</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>38,001</b>	<b>42,975</b>	<b>40,882</b>	<b>46,456</b>	<b>53,065</b>

### 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	93,159	1,02,828	1,12,675
Provisions	9,581	9,753	9,806	10,824	11,860
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	2,26,661	2,53,421	2,84,004
Shareholders' fund	1,93,519	2,07,621	2,31,098	2,57,858	2,88,441
<b>Total liabilities and equities</b>	<b>3,04,372</b>	<b>3,34,469</b>	<b>3,60,414</b>	<b>3,97,861</b>	<b>4,39,327</b>
Cash and cash eq.	19,661	20,427	47,218	79,024	1,15,114
Accounts receivables	65,117	69,586	70,604	77,933	85,396
Inventories	659	752	752	752	752
Other current assets	76,857	88,020	90,461	93,515	96,624
Investments	59,595	77,926	77,926	77,926	77,926
Net fixed assets	76,717	71,667	67,361	62,620	57,425
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
<b>Total assets</b>	<b>3,04,372</b>	<b>3,34,469</b>	<b>3,60,414</b>	<b>3,97,861</b>	<b>4,39,327</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	44,374	50,112	53,959	60,954	68,962
Interest expenses	169	(745)	(11,303)	(9,495)	(10,022)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(7,832)	(10,574)	(992)	305	311
Other operating cash flows	(1,176)	5,527	0	0	0
<b>Cash flow from operations</b>	<b>35,535</b>	<b>44,320</b>	<b>41,664</b>	<b>51,764</b>	<b>59,252</b>
Capital expenditures	(7,902)	(7,793)	(8,948)	(9,877)	(10,823)
Change in investments	(20,701)	(23,216)	0	0	0
Other investing cash flows	(4,590)	9,967	11,303	9,495	10,022
<b>Cash flow from investing</b>	<b>(33,193)</b>	<b>(21,042)</b>	<b>2,355</b>	<b>(382)</b>	<b>(801)</b>
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)	(17,227)	(19,577)	(22,362)
Other financing cash flows	0	0	0	0	0
<b>Cash flow from financing</b>	<b>(2,694)</b>	<b>(22,512)</b>	<b>(17,227)</b>	<b>(19,577)</b>	<b>(22,362)</b>
<b>Changes in cash and cash eq.</b>	<b>(352)</b>	<b>766</b>	<b>26,791</b>	<b>31,806</b>	<b>36,089</b>
<b>Closing cash and cash eq.</b>	<b>19,661</b>	<b>20,427</b>	<b>47,218</b>	<b>79,024</b>	<b>1,15,114</b>

**Per Share**

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	42.7	47.7	46.4	52.8	60.3
Adjusted EPS	42.7	47.7	46.4	52.8	60.3
Dividend per share	14.0	14.0	16.2	18.5	21.1
Book value per share	217.3	230.6	262.5	292.8	327.6

**Valuations Ratios**

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	1.9	1.7	1.6	1.4	1.2
EV/EBITDA	12.3	9.3	9.7	7.9	6.5
Adjusted P/E	15.8	14.1	14.5	12.8	11.2
P/BV	3.1	2.9	2.6	2.3	2.1

**DuPont Analysis**

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	77.9	77.5	74.7	74.7	74.7
Interest burden (PBT/EBIT)	134.3	106.4	117.6	112.5	110.6
EBIT margin (EBIT/Revenue)	11.8	15.0	13.0	14.0	14.8
Asset turnover (Revenue/Avg TA)	108.9	108.8	103.0	104.2	103.4
Leverage (Avg TA/Avg Equity)	1.6	1.6	1.6	1.6	1.5
Adjusted ROAE	21.0	21.4	18.6	19.0	19.4

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

**Ratio Analysis**

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
<b>YoY growth (%)</b>					
Revenue	5.6	12.9	3.0	10.4	9.6
EBITDA	12.7	34.3	(5.7)	17.0	14.8
Adjusted EPS	33.6	11.9	(2.7)	13.6	14.2
<b>Profitability &amp; Return ratios (%)</b>					
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	11.4	11.8	12.3
Adjusted ROAE	21.0	21.4	18.6	19.0	19.4
ROCE	15.0	19.3	16.3	19.8	23.6
<b>Working capital days (days)</b>					
Receivables	70	71	71	69	69
Inventory	1	1	1	1	1
Payables	90	104	113	110	112
<b>Ratios (x)</b>					
Gross asset turnover	4.3	4.7	5.1	6.1	7.2
Current ratio	2.0	1.8	2.0	2.2	2.4
Net interest coverage ratio	(22.4)	(39.1)	(33.4)	(44.2)	(41.4)
Adjusted debt/equity	0.0	0.0	(0.1)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

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

**BUY** – Expected return >+15%

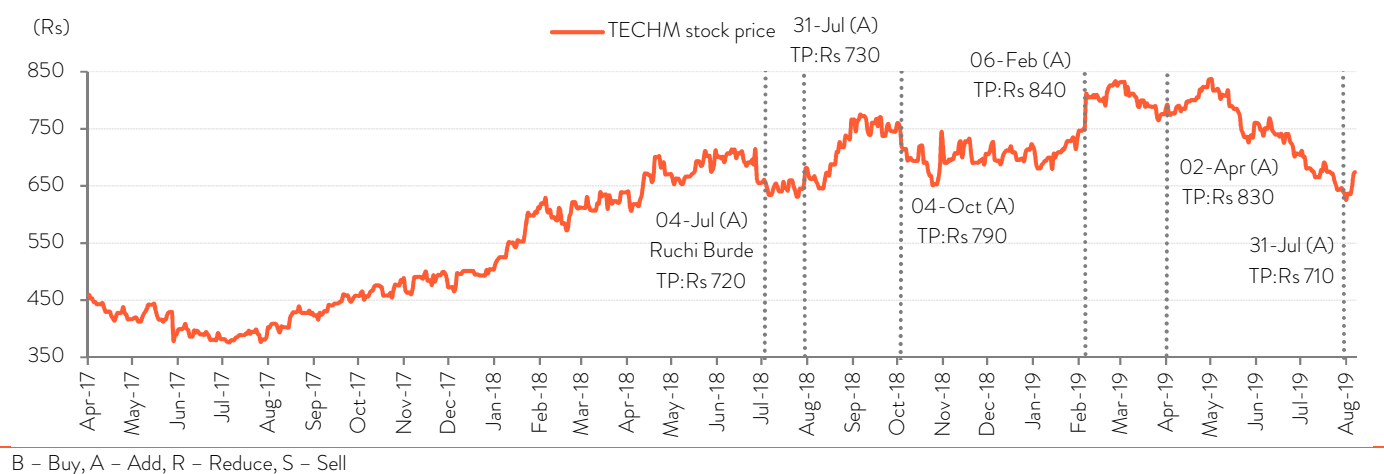
**ADD** – Expected return from >+5% to +15%

**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)

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