

India Research

Tech Mahindra

INITIATION REPORT

Bloomberg: TECHM IN
Reuters: TEML.BO

BUY

Best-In-Class Growth, Strong Differentiators

We like TM's industry-leading revenue and EPS growth profile among the top-tier IT firms. We forecast 22% USD revenue CAGR/25% EPS CAGR over FY15E-FY17E, led by the telecom and manufacturing verticals, aided by large deals and strategic acquisitions. TM's expertise in manufacturing, a result of Satyam should drive new client addition and large deal wins, reflected in its 5.2% USD revenue CQGR over the past 8 quarters. Strategic acquisitions like Lightbridge Communications Corporation (LCC) aid expansion of the addressable market for TM. We like TM's business structurally and the stock gives a flavor of both a top-tier IT firm (industry-leading telecom revenue) as well as a mid-sized IT firm (incremental deal wins through manufacturing differentiation). We initiate coverage on TM with a Buy rating and TP of Rs3,200, implying 17x FY17E EPS.

Highest revenue, earnings growth among top-tier IT pack: We expect TM to record a healthy 21.9% USD revenue CAGR over FY15E-FY17E, led by the telecom and manufacturing verticals. This is the highest revenue growth rate compared with top-tier IT peers (14% USD revenue CAGR for HCLT, 13% for TCS and 12% each for Infosys and Wipro). Led by strong revenue growth, we forecast 24% EBITDA CAGR and an impressive 25% EPS CAGR over the period, the highest forecast among the top-tier IT pack (TCS 14% CAGR, Infosys 11% CAGR, Wipro 12% CAGR and HCLT 14% CAGR).

Manufacturing key niche strength, large deals to drive growth: We expect TM's future revenue growth to be led by the manufacturing vertical, TM's largest outside telecom. Its manufacturing expertise as a result of the Satyam acquisition, and strength in ERP is likely to boost growth going forward. Manufacturing clocked 5.2% USD revenue CQGR over the past 8 quarters and this segment has seen strong client and large deal wins, which drives confidence on sustenance of strong growth going forward.

Acquisitions to expand market: TM's strategic acquisitions such as Hutchison Global, Complex IT and LCC have enabled it to expand its addressable market to newer avenues like Brazilian IT and network services.

Initiate coverage with Buy rating: We like TM's business structurally and like its industry-leading revenue and EPS growth. **We initiate coverage on TM with a Buy rating and TP of Rs3,200, implying 17x FY17E EPS.**

Key Financials

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Revenue	143,320	188,314	222,565	284,506	325,193
EBITDA	30,632	41,838	43,261	57,498	66,704
EBITDA margin (%)	21.4	22.2	19.4	20.2	20.5
Net profit	19,556	30,288	29,690	39,678	46,206
EPS (Rs)	79.6	123.2	120.8	161.4	188.0
RoE (%)	33.5	37.8	28.0	28.6	25.8
RoCE (%)	30.0	33.8	25.3	26.8	24.2
P/E (x)	35.0	22.6	23.0	17.2	14.8

Source: Company, Karvy Stock Broking

Recommendation

CMP:	Rs2,779
Target Price:	Rs3,200
Upside (%)	15%

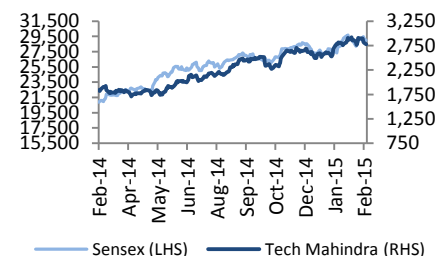
Stock Information

Market Cap. (Rs bn / US\$ mn)	667/10,713
52-week High/Low (Rs)	2,998/1,676
3m ADV (Rs mn /US\$ mn)	1,544/24.8
Beta	0.4
Sensex/ Nifty	28,975/8,755
Share outstanding (mn)	240

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(0.1)	3.8	50.3	7.1
Rel. to Sensex	1.0	1.5	7.4	1.7

Performance



Source: Bloomberg

Analysts Contact

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Company Financial Snapshot

Profit & loss

Rsmn	FY14	FY15E	FY16E
Net sales	188,314	222,565	284,506
EBITDA	41,838	43,261	57,498
Depreciation	5,222	5,851	6,485
Interest Expense	799	176	157
PBT	36,947	39,922	53,255
Tax	7,523	10,348	13,452
Adj. PAT	30,288	29,690	39,678
EPS (Rs)	123.2	120.8	161.4
DPS (Rs)	2.2	5.0	6.0

Profit and Loss Ratios

EBITDA Margin (%)	22.2	19.4	20.2
Adj. Net Margin (%)	16.1	13.3	13.9

Valuation Multiples

P/E (x)	22.6	23.0	17.2
EV/EBITDA (x)	15.6	15.0	11.0

Balance Sheet

Rsmn	FY14	FY15E	FY16E
Total Assets	159,396	189,606	230,027
Net Fixed Assets	19,459	36,643	41,539
Current Assets	105,472	118,497	154,024
Other Assets	34,465	34,465	34,465
Total Liabilities	159,396	189,606	230,027
Net Worth	91,820	119,907	157,284
Debt	190	190	190
Current Liabilities	45,749	47,872	50,916
Other Liabilities	21,637	21,637	21,637

Balance Sheet Ratios

RoE (%)	37.8	28.0	28.6
RoCE (%)	33.8	25.3	26.8
Net Debt/Equity (x)	(0.3)	(0.3)	(0.3)
Equity/Total Assets (x)	0.6	0.6	0.7
P/BV (x)	7.4	5.7	4.3

Company Background

Tech Mahindra (TM) is an IT service company with revenue of US\$3,098mn in FY14. The company focuses on two key verticals – telecommunications and manufacturing – that account for over 70% of its revenue base. TM also serves other verticals like BFSI, technology, media, retail and logistics. TM's legacy strength lies in telecommunications, where it provides ADM, BSS/OSS, BPO, testing, systems integration, cloud, mobility, security, product engineering and network services to its clients. On the enterprise side, TM's largest vertical is manufacturing, with a focus on aerospace and automotive sub-segments. Geographically, TM derives a major portion of its revenue from the Americas region (48.8% in 3QFY15), with Europe forming the second-largest chunk (31.4%). The company has grown consolidated revenue, EBITDA and net profit at CAGRs of 33.4%, 26.7% and 24.5%, respectively, over FY09-FY14 and had a total of 98,009 employees on its rolls as of 31 December 2014.

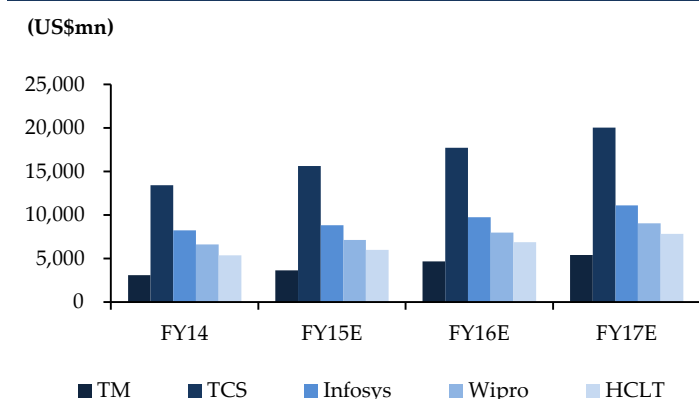
Cash Flow

Rsmn	FY14	FY15E	FY16E
PBT	36,947	39,922	53,255
Depreciation	5,222	5,851	6,485
Tax	(7,523)	(10,348)	(13,452)
Change in working cap.	(17,139)	(7,735)	(14,558)
CF from Operations	17,507	27,690	31,729
Capex	(7,484)	(23,035)	(11,380)
Investments	(11,836)	0	0
CF from Investing	(19,320)	(23,035)	(11,380)
Change in Equity	19	123	0
Change in Debt	(3,025)	0	0
Dividends & Others	(1,359)	(1,726)	(2,301)
CF from Financing	(4,365)	(1,602)	(2,301)
Others	4,751	116	(124)
Change in Cash	(1,427)	3,168	17,924

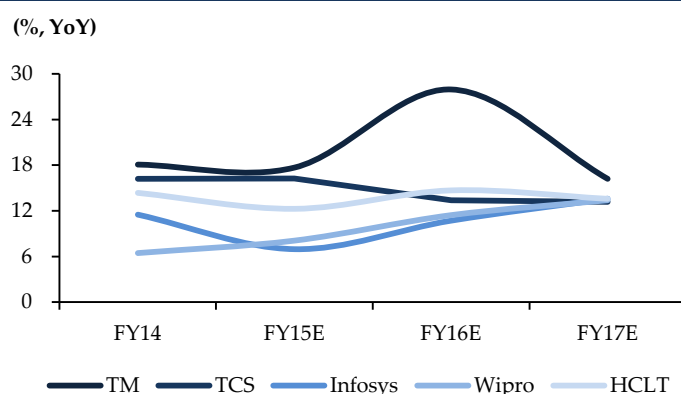
Investment Rationale

Best-in-class revenue, earnings growth profile among top-tier IT pack

We expect TM to record a healthy 21.9% USD revenue CAGR over FY15E-FY17E, led by the key telecom and manufacturing verticals. Even adjusting for acquisitions of LCC and SOFGEN, which we factor in from FY16, we forecast organic USD revenue CAGR of 16% over the period. This is the highest revenue growth rate compared with top-tier IT peers. We forecast 14% USD revenue CAGR for HCLT, 13% for TCS and 12% each for Infosys and Wipro over the period FY15E-FY17E.

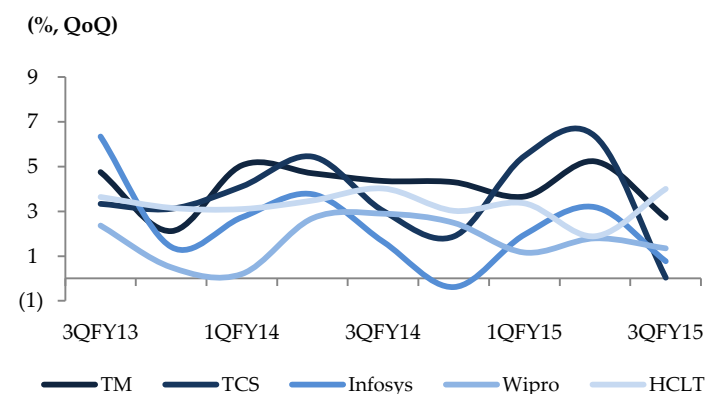
Exhibit 1: Top-tier IT firm revenue


Source: Respective companies, Karvy Stock Broking

Exhibit 2: Top-tier IT firm revenue growth – TM leads


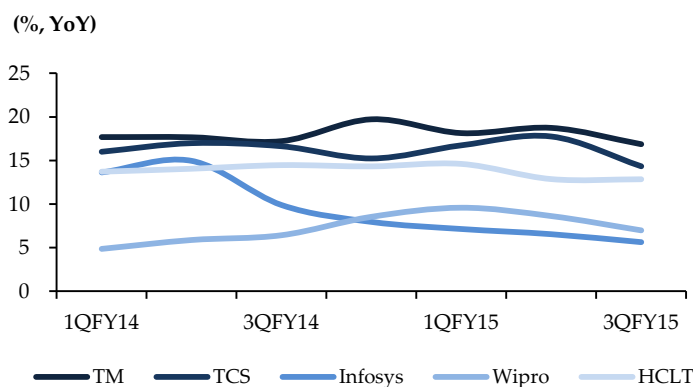
Source: Respective companies, Karvy Stock Broking

From a quarterly revenue growth perspective also, TM's USD revenue growth has been consistently among the fastest compared with its top-tier peers. Over the period 3QFY13-3QFY15, a 9-quarter time-frame, TM's sequential revenue growth has been the fastest in 3 quarters and the second-fastest in 5 quarters, with its growth being the third-fastest in one quarter. **TM's CQGR has been a healthy 4% over the period, the fastest compared with 3.7% for TCS, 3.2% for HCLT, 1.9% for Infosys and 1.6% for Wipro. On a YoY basis, TM's USD revenue growth has been the fastest in all 7 quarters from 1QFY14-3QFY15.** We have not taken 3QFY13 and 4QFY13 for comparison, as YoY growth for TM is inflated owing to FY13 being the first year of quarterly data disclosure post the Satyam merger.

Exhibit 3: Sequential USD revenue growth


Source: Respective companies, Karvy Stock Broking;

Note: HCLT has a June-ending fiscal year. Thus, 3QFY13=2QFY13 and 3QFY15=2QFY15.

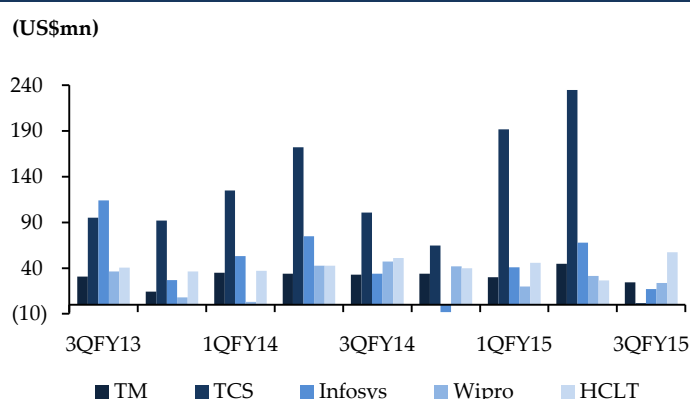
Exhibit 4: YoY USD revenue growth – TM leads all the way


Source: Respective companies, Karvy Stock Broking;

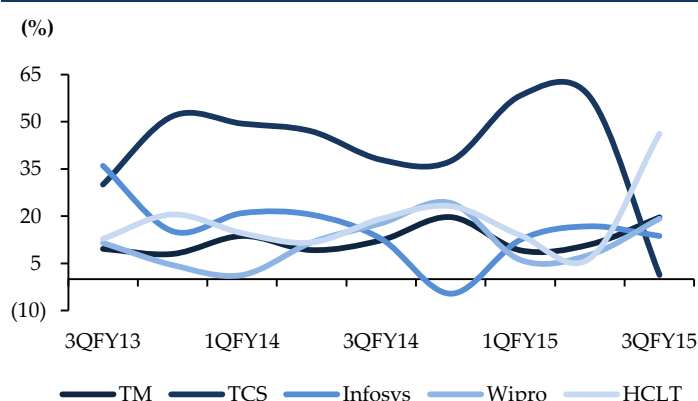
Note: HCLT has a June-ending fiscal year. Thus, 1QFY14=4QFY13 and 3QFY15=2QFY15.

Tech Mahindra

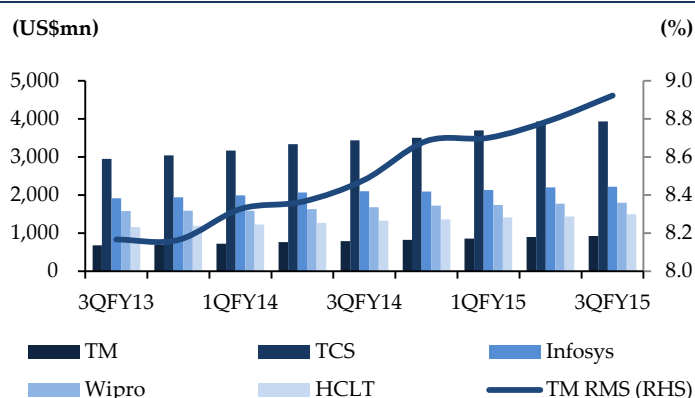
From a revenue market share (RMS) perspective, over the past 8 quarters, TM has consistently gained share due to its better-than-peer growth rates. **In 2QFY13, TM's RMS among itself, TCS, Infosys, Wipro and HCLT stood at 8.2%, which rose to nearly 9% in 3QFY15, the latest quarter.** Given its higher growth, the company's incremental RMS has been consistently better than its total RMS over the past 9 quarters; **in only one quarter out of nine was TM's incremental RMS lower than its total RMS (4QFY13).** From an incremental revenue perspective, while TM's total revenue is the lowest among the top-5 IT firms, **its incremental revenue has ranked above either one or more of its peers in as many as 6 out of the 9 quarters under consideration. In 3QFY15, the company's incremental revenue was the second-highest after HCLT.**

Exhibit 5: Incremental revenue


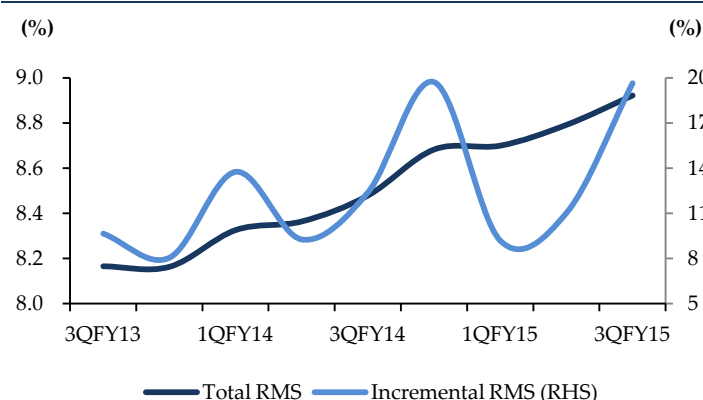
Source: Respective companies, Karvy Stock Broking;
Note: HCLT has a June-ending fiscal year. Thus, 3QFY13=2QFY13 and 3QFY15=2QFY15.

Exhibit 6: Incremental RMS


Source: Respective companies, Karvy Stock Broking;
Note: HCLT has a June-ending fiscal year. Thus, 3QFY13=2QFY13 and 3QFY15=2QFY15.

Exhibit 7: Total revenue, RMS – On the upswing


Source: Respective companies, Karvy Stock Broking;
Note: HCLT has a June-ending fiscal year. Thus, 3QFY13=2QFY13 and 3QFY15=2QFY15.

Exhibit 8: Total vs incremental RMS


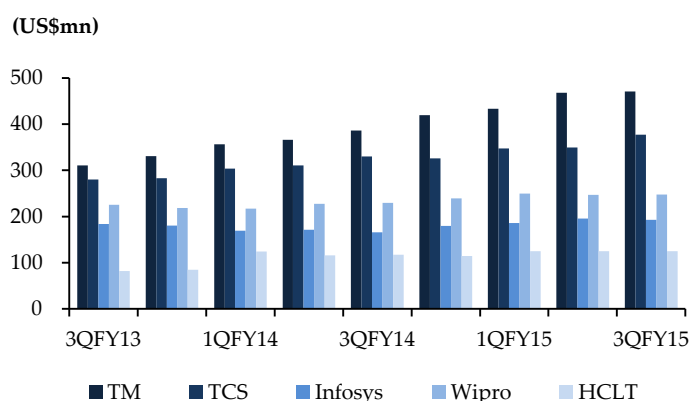
Source: Respective companies, Karvy Stock Broking;
Note: We have taken the top-5 Indian IT firms for calculation of RMS and incremental RMS.

Led by strong revenue growth, we forecast a solid 24% EBITDA CAGR for the IT major over FY15E-FY17E, which we expect will drive an impressive 25% EPS CAGR over the period. This is the highest earnings growth forecast among the top-tier IT pack (TCS 14% CAGR, Infosys 11% CAGR, Wipro 12% CAGR and HCLT 14% CAGR).

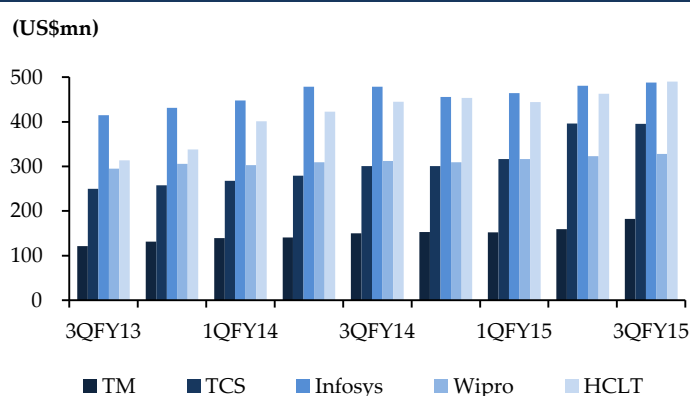
Manufacturing key niche strength, large deals to further drive growth

We expect TM's future revenue growth to be led by the manufacturing vertical, even as the telecom vertical continues to grow at a steady pace. This is TM's largest vertical outside of telecom and came as a result of the Satyam acquisition. Satyam's key strength areas were in the manufacturing vertical, particularly aerospace and automotive sub-verticals, with strong expertise in ERP. **Telecom and manufacturing together accounted for over 70% of revenue in 3QFY15.**

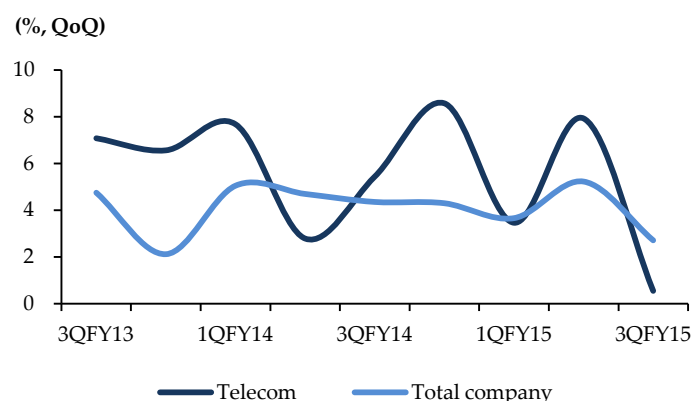
We believe TM can be classified as a top-tier cum mid-sized IT firm. The top-tier portion is reflected by its industry-leading telecom revenue, a result of its historical evolution as a telecom-focused IT firm and strong long term client relationships with marquee names like British Telecommunications (BT) and AT&T. On the other hand, its mid-tier characteristics can be reflected in its attempt to win deals in the enterprise space through manufacturing as a differentiator.

Exhibit 9: TM telecom revenue vs peers – The leader


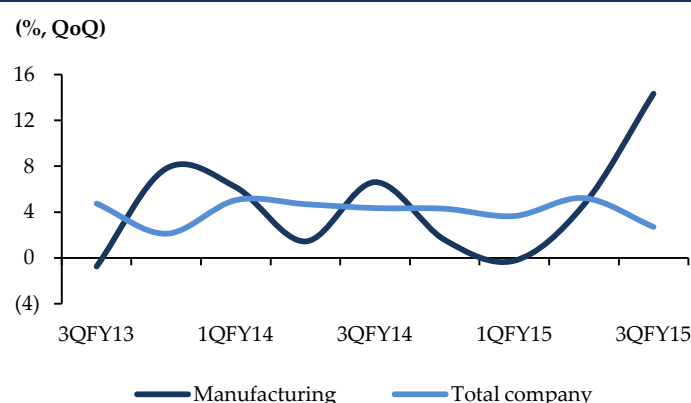
Source: Respective companies, Karvy Stock Broking

Exhibit 11: TM manufacturing revenue vs peers


Source: Respective companies, Karvy Stock Broking

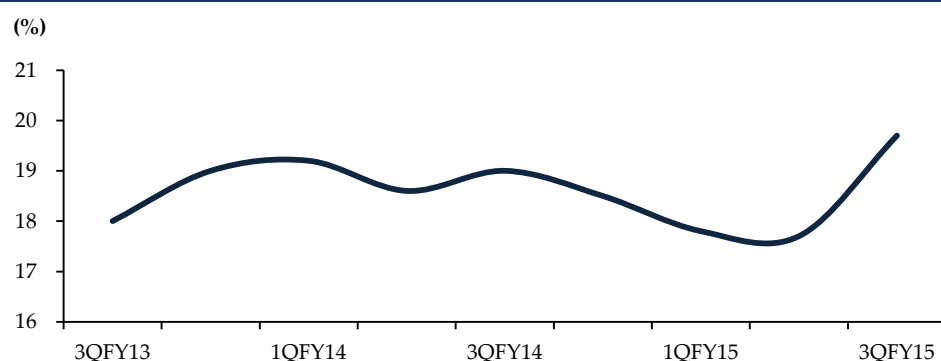
Exhibit 10: TM telecom vs total company growth


Source: Company, Karvy Stock Broking

Exhibit 12: TM manufacturing vs total company growth


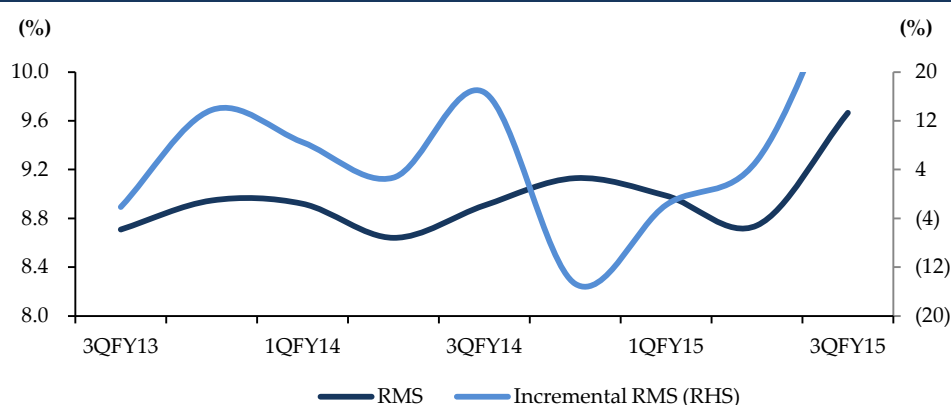
Source: Company, Karvy Stock Broking

TM's manufacturing vertical has grown at a healthy pace of 5.2% CQGR in USD terms over the period 3QFY13-3QFY15, well ahead of the company average of 4% CQGR. While it is still much lower in revenue terms compared with top-tier peers, it is the major vertical where the IT major is able to compete effectively apart from telecom to win large deals (deals with total contract value of US\$50mn and above) and win new clients. This vertical accounted for nearly 20% of TM's revenue in 3QFY15, the highest-ever level.

Exhibit 13: Manufacturing – Steady rise as a % of revenue


Source: Company, Karvy Stock Broking

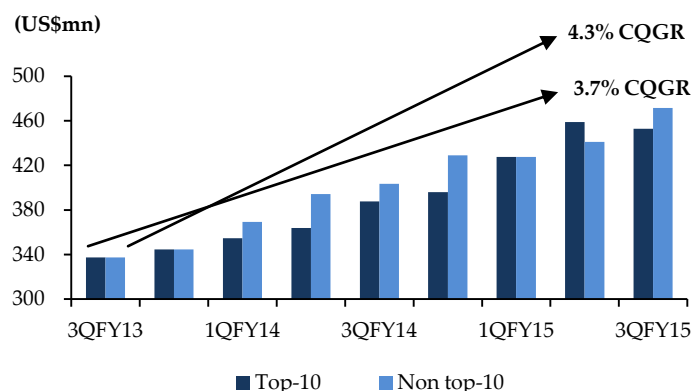
Even from an RMS perspective, TM's share in manufacturing USD revenue among the top-5 IT firms has been on the rise and is up by nearly 100bps in 3QFY15 at close to 10% compared with 8.7% RMS in 3QFY13. In 3 of the 9 quarters under consideration, the IT major's share in manufacturing revenue was in double digits and at close to 40% in 3QFY15, reflecting strong growth and market share gains.

Exhibit 14: Manufacturing RMS – Steady upswing


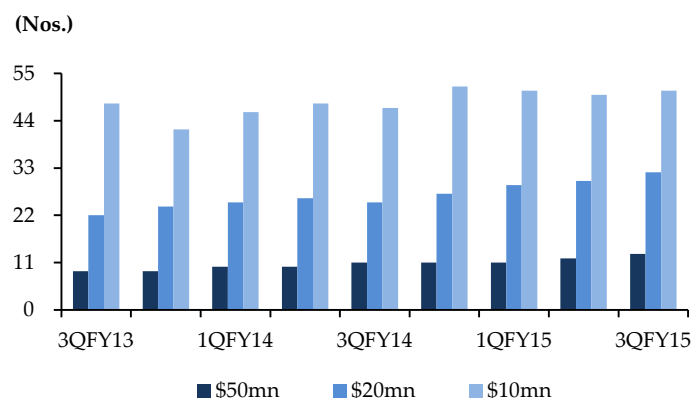
Source: Company, Karvy Stock Broking;

Note: We have taken the top-5 Indian IT firms for calculation of RMS and incremental RMS.

From a client perspective, TM has seen healthy additions over the past several quarters, with the active client base at 674 in 3QFY15 against 475 in 3QFY13. The IT major's imperative of growing its manufacturing revenue and its dual focus on client mining and hunting for the same has driven this. Over the past several quarters, TM's non top-10 client base has grown at a faster pace than the top-10 clients (4.3% USD revenue CQGR against 3.7% CQGR). This, we believe has been a result of new client additions, particularly in the enterprise side of the business, mostly in the manufacturing vertical. Healthy client adds and improving revenue buckets drive confidence in TM's ability to sustain better-than-peer revenue growth over FY16E and FY17E.

Exhibit 15: Non top-10 clients – Strong growth


Source: Company, Karvy Stock Broking

Exhibit 16: Client revenue buckets – Strong additions


Source: Company, Karvy Stock Broking

Strategic acquisitions to expand addressable market

TM has made some strategic acquisitions over the past few years, which have enabled the IT major to expand its services and addressable market for future growth. Examples of such acquisitions include Hutchison Global Services (BPO firm providing call centre services to UK, Irish and Australian customers, acquired in September 2012), Comviva (mobility solutions to mobile service providers, acquired in December 2012), Complex IT (SAP consulting services in the US\$36bn addressable Brazilian IT services market) and Lightbridge Communications Corporation (LCC, one of the world's largest independent global providers of network engineering services to the telecom industry, acquired in November 2014).

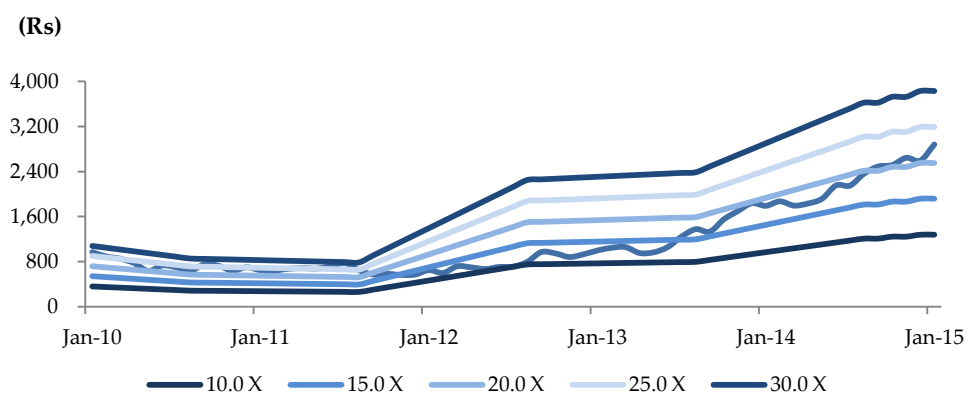
These acquisitions have increased TM's suite of services and expanded its addressable market substantially, most notably LCC, which gives the company a presence in the network engineering services space, which is a US\$41bn market and has minimal competition from any of the Indian IT service majors. The acquisition will add over 10% to FY16E revenue and is earnings-accretive.

Initiate Coverage With A Buy Rating

We have valued TM based on a target price-to-earnings (PE) multiple of 17x FY17E EPS. We are enthused with the IT major's best-in-class USD revenue growth and EPS growth over FY15E-FY17E, increasing large deal wins, scaling up of its manufacturing vertical and strategic acquisitions, enabling expansion of services and addressable market for growth.

We forecast a strong 22% USD revenue CAGR over FY15E-FY17E, aided by the telecom and manufacturing verticals, while we expect a 107bps margin expansion over the period, aided by strong revenue growth, some SG&A leverage and higher utilisation. In absolute terms, we forecast a 24% EBITDA CAGR over the period, which we expect will drive a solid 25% EPS CAGR.

We like TM's business structurally and believe a higher valuation is justified given its evolution as a diversified IT services company post its acquisition of Satyam, from a telecom-focused IT services company earlier. We expect continued growth in the key telecom and manufacturing verticals, even as we do not expect its smaller verticals like BFSI, technology and retail to contribute substantially to growth, given their sub-scale size and likelihood of quarterly volatility in revenue. Strategic acquisitions will contribute to growth through expansion of addressable market. At the CMP, TM's stock trades at 14.8x FY17E EPS. **We initiate coverage on TM with a Buy rating and target price of Rs3,200.**

Exhibit 17: PE chart


Source: C-line, Karvy Stock Broking

Exhibit 18: Karvy vs Bloomberg consensus estimates

Particulars	KSBL estimates	BBG consensus	% difference
FY15E			
Revenue (Rsmn)	222,565	224,487	(0.9)
EBITDA (Rsmn)	43,261	43,767	(1.2)
EBITDA margin (%)	19.4	19.5	(6)bps
EPS (Rs)	120.8	129.1	(6.4)
FY16E			
Revenue (Rsmn)	284,506	279,704	1.7
EBITDA (Rsmn)	57,498	54,501	5.5
EBITDA margin (%)	20.2	19.5	72bps
EPS (Rs)	161.4	162.3	(0.6)
FY17E			
Revenue (Rsmn)	325,193	322,575	0.8
EBITDA (Rsmn)	66,704	63,498	5.0
EBITDA margin (%)	20.5	19.7	83bps
EPS (Rs)	188.0	190.0	(1.1)

Source: Bloomberg, Karvy Stock Broking

Exhibit 19: Profit and Loss Statement

(Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Net Sales	143,320	188,314	222,565	284,506	325,193
<i>% growth</i>	22.5	31.4	18.2	27.8	14.3
Total Expenditure	112,688	146,476	179,304	227,008	258,489
EBITDA	30,632	41,838	43,261	57,498	66,704
<i>% growth</i>	45.0	36.6	3.4	32.9	16.0
<i>EBITDA margin (%)</i>	21.4	22.2	19.4	20.2	20.5
Other income incl. forex gain/(loss)	2,122	1,130	2,688	2,398	3,033
Financial Expenses	921	799	176	157	137
Gross Profit	31,833	42,169	45,773	59,739	69,600
<i>% growth</i>	35.7	32.5	8.5	30.5	16.5
Depn. & Amortisation	3,896	5,222	5,851	6,485	7,196
Profit Before Tax	27,937	36,947	39,922	53,255	62,404
<i>% growth</i>	37.8	32.3	8.1	33.4	17.2
Tax	6,479	7,523	10,348	13,452	16,073
<i>Effective tax rate (%)</i>	23.2	20.4	25.9	25.3	25.8
Profit After Tax	21,458	29,424	29,574	39,802	46,330
<i>% growth</i>	19.4	37.1	0.5	34.6	16.4
Associate Profit and Minority Interest	(301)	(336)	(169)	(124)	(124)
Exceptional Items	(1,601)	1,200	285	0	0
Reported Net Profit	19,556	30,288	29,690	39,678	46,206
<i>% growth</i>	6.1	54.9	(2.0)	33.6	16.5
EPS (Rs)	79.6	123.2	120.8	161.4	188.0

Source: Company, Karvy Stock Broking

Exhibit 20: Balance Sheet

(Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Equity Capital	2,316	2,335	2,458	2,458	2,458
Reserves	66,219	89,485	117,449	154,826	198,157
Net Worth	68,535	91,820	119,907	157,284	200,615
Minority Interest	1,344	1,438	1,438	1,438	1,438
Other Liabilities	18,480	20,199	20,199	20,199	20,199
Total Loans	3,215	190	190	190	190
TOTAL LIABILITIES	91,574	113,647	141,735	179,112	222,442
Goodwill and Intangible Assets	5,054	6,485	6,485	6,485	6,485
Gross Block	30,917	38,334	61,369	72,750	84,131
Depreciation	13,653	18,875	24,726	31,211	38,407
Net Block	17,264	19,459	36,643	41,539	45,724
Capital Work in Progress	2,595	2,662	2,662	2,662	2,662
Non Current Investments	358	12,194	12,194	12,194	12,194
Other Assets	23,200	13,124	13,124	13,124	13,124
Total Current Assets	89,634	105,472	118,497	154,024	195,244
Total Current Liabilities	46,531	45,749	47,872	50,916	52,992
Net Current Assets	43,103	59,723	70,626	103,108	142,252
TOTAL ASSETS	91,574	113,647	141,735	179,112	222,442

Source: Company, Karvy Stock Broking

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Exhibit 21: Cash Flow Statement

(Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
EBIT	26,736	36,616	37,410	51,013	59,508
(Inc.)/Dec in working capital	(2,300)	(17,139)	(7,735)	(14,558)	(9,858)
Cash flow from operations	24,436	19,477	29,675	36,455	49,650
Other income	2,122	1,130	2,688	2,398	3,033
Depreciation & Amortisation	3,896	5,222	5,851	6,485	7,196
Financial Expenses	(921)	(799)	(176)	(157)	(137)
Tax paid	(6,479)	(7,523)	(10,348)	(13,452)	(16,073)
Dividends paid	(593)	(1,359)	(1,726)	(2,301)	(2,876)
Net cash from operations	22,461	16,148	25,965	29,428	40,793
Capital expenditure	(5,686)	(7,484)	(23,035)	(11,380)	(11,382)
Net cash after capex	16,775	8,664	2,929	18,048	29,411
Inc./(dec.) in short-term borrowing	(3,019)	(3,025)	0	0	0
Inc./(dec.) in long-term borrowing	0	0	0	0	0
Inc./(dec.) in borrowings	(3,019)	(3,025)	0	0	0
(Inc.)/Dec. in investments	(6)	(11,836)	0	0	0
Equity issue/(Buyback)	7	19	123	0	0
Cash from Financial Activities	(3,018)	(14,842)	123	0	0
Others	(10,088)	4,751	116	(124)	(124)
Opening cash	30,960	34,629	33,202	36,370	54,294
Closing cash	34,629	33,202	36,370	54,294	83,582
Change in cash	3,669	(1,427)	3,168	17,924	29,287

Source: Company, Karvy Stock Broking

Exhibit 22: Key Ratios

Particulars	FY13	FY14	FY15E	FY16E	FY17E
RoE (%)	33.5	37.8	28.0	28.6	25.8
RoCE (%)	30.0	33.8	25.3	26.8	24.2
Operating Ratios					
Revenue growth (%)	22.5	31.4	18.2	27.8	14.3
EBITDA margins (%)	21.4	22.2	19.4	20.2	20.5
EBITDA growth (%)	45.0	36.6	3.4	32.9	16.0
Net Profit growth (%)	6.1	54.9	(2.0)	33.6	16.5
RPEs (Rsmn)	2.31	2.27	2.43	2.74	2.83
RPEs (US\$'000)	42.51	37.39	39.82	44.97	47.13
Valuation Ratios					
PER (x)	35.0	22.6	23.0	17.2	14.8
P/BV (x)	10.0	7.4	5.7	4.3	3.4
Price/sales (x)	4.8	3.6	3.1	2.4	2.1
EV/EBITDA (x)	21.4	15.6	15.0	11.0	9.0

Source: Company, Karvy Stock Broking

Stock Ratings		Absolute Returns
Buy	:	> 15%
Hold	:	5-15%
Sell	:	< 5%

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Disclosures Appendix

Analyst certification

The following analyst(s), who is (are) primarily responsible for this report and whose name(s) is/ are mentioned therein, certify (ies) that the views expressed herein accurately reflect his (their) personal view(s) about the subject security (ies) and issuer(s) and that no part of his (their) compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report.

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