

14 September 2017

Tech Mahindra—BUY

CMP :441
Target Price :536
Upside : 21%+
Stop Loss :391(closingbasis)

Investment Thesis

Recently, the stock price of Tech Mahindra Ltd. (Tech Mahindra) corrected by ~15% from 52-week high of Rs.515 as it has reported lower revenue growth in the recent quarters due to slower-than-expected growth in the enterprise segment, flatdeal TCV and consistent weakness in communication vertical.

Post integration with Satyam, Tech Mahindra has transformed itself into a full range IT service provider, with presence in all verticals across multiple geographies. It has a fairly distributed market in US, Europe and emerging markets such as Australia, Middle East and LATAM. The company has developed more than 25 platforms and products to support its 818 active clients. Tech Mahindra has been one of the most active Indian IT vendor in the European region, with over 29% of its revenues coming from EU. Its growth over the last 8-10 quarters too, has been much ahead of peers. We expect the trend to continue, and the company to benefit immensely from more companies opening up to outsourcing, on the back of cost pressures and regulatory changes.

Merger of MSAT with Tech Mahindra has created a formidable player making it the fifth-largest player in the Indian IT services sector (ex-Cognizant). This will enable Tech Mahindra to compete with biggies of the industry and vie for larger deals which could lead to improved traction for the merged entity. Generally, clients are more comfortable with larger organizations having a good track record. The close relationship between Tech Mahindra and MSAT since past three years has led to a better integration of functions and both the entities function as a cohesive unit now. The merger has enabled Tech Mahindra to diversify its portfolio vertically as well as geographically. This although, higher than tier-1 players, will come down going ahead as the merged entity cross sells and up sells its services to an expanded client base.

Financials

- During the past 5 years, revenue of Tech Mahindra grew at CAGR of 39.6 while PAT grew at CAGR of 20.8% in the same period.

Consol. (Rs.Mn.)	FY15	FY16	FY17	FY18E	FY19E
Revenue	2,26,213	2,64,942	2,91,408	3,35,119	3,85,387
EBITDA	41,529	43,184	41,844	48,121	55,339
% growth	-0.7	4.0	-3.1	15.0	15.0
PAT	26,277	31,180	28,129	32,123	36,685
EPS (INR)	27.3	32.2	28.9	33.0	37.6
P/E (x)	15.8	13.4	15.0	13.1	11.5
RoE (%)	21.5%	21.7%	17.1%	17.8%	18.5%

- Tech Mahindra has reported 0.6% QoQ growth in its dollar revenues to \$1,138mn aided by two months consolidation (\$17mn) of acquired US-based healthcare CJS Solutions, LLC (The HCI Group).

Stock Data

Market Cap (INR MN)	430,759
Market Cap (\$ MN)	6,714.8
Shares O/S (in MN)	974.9
Avg. Volume (3 month)	3,282,000
52-Week Range (Rs.)	515 / 356

Shareholding Pattern

Promoters	36.23%
FIIIs	31.75%
Institutions	18.32%
Others (incl. body corporate)	13.70%

Performance (%)	1M	6M	1Yr
Absolute	12.2%	-14.5%	-4.9%
BSE IT	-2.1%	-2.2%	-1.5%

Key Ratios

Div Yield	2.1%
TTM PE	14.7x
ROE	17.3%
TTM EPS (INR)	29.4/-

- Enterprise solution (54.8% of revenues) led the quarterly growth for the ninth straight quarter and grew 2.7% QoQ while communication segment declined 1.8% QoQ owing to restructuring in LCC business.
- EBITDA margin of Tech Mahindra witnessed an up-tick of 70 bps QoQ to 12.7% despite seasonal headwinds of visa cost and Comviva seasonality, however, offset by lower cost of services (down 3.6% QoQ), lower LCC losses and aided by operational efficiency.

Key Business Highlights

- Tech Mahindra is an IT service company having major focus on two key verticals, telecommunications and manufacturing that account for ~70% of its revenue. Tech Mahindra also serves other verticals like BFSI, technology, media, retail and logistics.
- Tech Mahindra'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, its largest vertical is manufacturing, with a focus on aerospace and automotive sub-segments.
- Geographically, Tech Mahindra derives a major portion of its revenue from the America region (51%), with Europe forming the second-largest chunk (29%).

Valuation

- On the back of healthy deal pipeline along with pick up in discretionary spending, primarily in the US, Tech Mahindra is expected to improve its revenue growth. Tech Mahindra is following a two-pronged strategy to expand its enterprise business; like providing end-to-end offerings in leadership areas like manufacturing and following a niche offerings-led entry strategy in areas like BFSI, where it is a challenger. Better cross-sell of services can also help grow marquee accounts. We expect the enterprise segment growth to be led by broader revival in the markets and deepening of existing relationships. During Q1FY18, the company won deals worth TCV of \$325mn leading to LTM TCV of \$1,325mn, up by 12.8% YoY.
- Observing the steady growth in the enterprise segment for the past several quarters, Tech Mahindra expects it to continue its momentum, going ahead. Although restructuring in the LCC business could lead to softness in communication for a quarter or two, the management expects a gradual recovery, going ahead. On the margin front, margins are expected to improve gradually in coming quarters due to the absence of visa cost, better Comviva seasonality and employee pyramid correction. Going ahead, we expect Tech Mahindra to report EBITDA margin of over 14.0% during in FY18-19E.
- With transformed into a full range IT service provider, merger of MSAT with Tech Mahindra has created it fifth-largest player in the Indian IT services sector, healthy deal pipeline along with pick up in discretionary spending, steady growth in the enterprise segment for past several quarters and margin is expected to improve gradually in coming quarters, we value Tech Mahindra at 14.25x FY19E EPS of Rs.37.60 to arrive at target price of Rs.536, an upside of ~21%.

Risk & Concern

- Tech Mahindra derives ~50% of its revenue from top-10 clients, which poses a high risk as change in strategy by any one of top client may adversely affect its business.
- Rupee appreciation against major currency may affect operating margin of the company.
- Attrition rate has decrease from 21% in Q1FY17 to 17% in Q1FY18. Any increase in attrition rate may increase employee cost further and affect margin of the company.

Graphs & Charts

Figure 1: Net Sales Trend



Figure 2: EBITDA & EBITDA Margin Trend

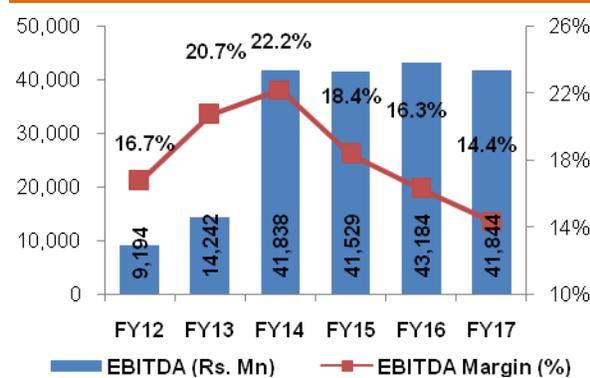
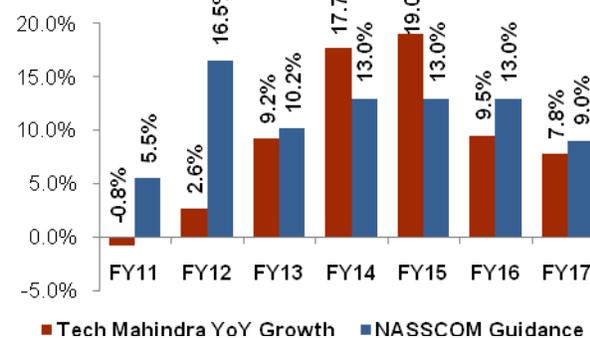


Figure 3: PAT Trend



Figure 4: Tech Mahindra Growth Vs. NASSCOM Guidance



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