

Viewpoint

Beat the street, upgrade stance to Positive

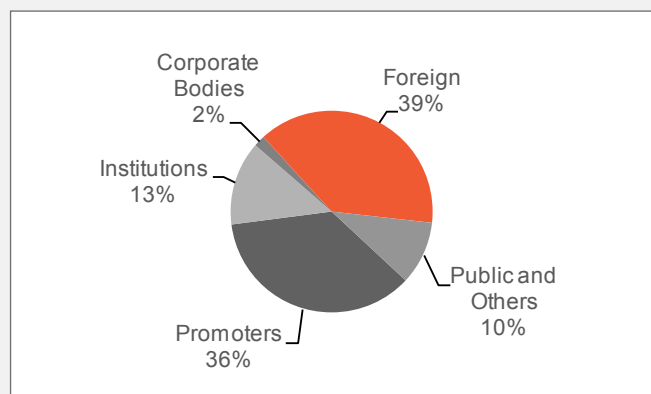
Tech Mahindra

View: Positive | CMP: Rs605

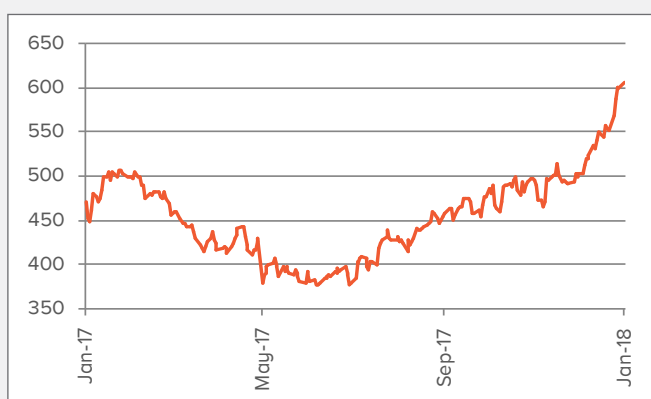
Company details

Market cap:	Rs59,294 cr
52-week high/low:	Rs613 / 357
NSE volume: (No of shares)	1.6 lakh
BSE code:	532755
NSE code:	TECHM
Sharekhan code:	TECHM
Free float: (No of shares)	62.7 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	21.3	27.8	56.7	31.6
Relative to Sensex	14.2	17.0	39.6	-0.2

Key points

- Impressive all round performance:** Tech Mahindra (TechM) delivered solid quarterly performance with 2.4% sequential revenues growth on cc term, ahead of our estimates and 2.5% on reported basis to \$1209 mn. The growth was continued to be driven by enterprise vertical (up 4.2% qoq), while the communication vertical remained weak. The EBIT margins performance surprised positively, improved by 170bps q-o-q to 12.7% (340bps improvement over Q1FY2018). The improvement was led by contribution from IPs deal signed in Q2FY2018 coupled with continued benefits from a reduction in headcounts (software services headcounts declined 9% YoY) and improved utilization (83% vs 81% in Q2). Further, higher than expected other income and lower tax provisioning owing to write backs (21.8% vs 25.3% in Q2) led to strong beat in net income, that was up by 12.8% q-o-q to Rs943 crore.
- Margins trajectory shaping up well, room for further improvement:** TechM has delivered solid margin execution over the last three quarters with an improvement of 340bps in EBIT margins over Q1FY18. The execution was led by a turnaround in loss making LCC (network business), which has reported low single digit margin in Q3 vs loss in H1FY2018. Further, improvement in utilization levels and reduction in IT headcounts has resulted in impressive margin performance. The management believes that there is further room for margin expansion in the coming quarters led by further improvement in the profitability of portfolio companies (LCC and Comviva) coupled with operational efficiency. We have built in around a modest 125bps improvement in EBIT margins over FY18-20E.
- Positive set up for communication vertical revival in FY2019E, Enterprise business to accelerate further:** The telecom vertical, which is languishing on the back of headwinds in portfolio companies business, is expected to witness a revival in FY19E on the back to improving order book coupled with bottoming out of headwinds in LCC. Further, the roll out of 5G, IOT and software transformation related spend will incrementally drive the revival over FY19/20E. On the enterprise side of business, the management expects the momentum to continue with an increasing number of deal wins.

- ♦ **Valuation: Stance upgrade to Positive, expect 15.5% upside:** At the current levels, the stock is trading at 14.7/13x FY19/20E earnings estimates, which is cheapest among the top 5 IT companies. The return of stability in earnings performance coupled with improved earnings visibility over the next two years, provides us the comfort to upgrade our stance on the company to “Positive” from the Neutral rating earlier. We expect potential return of 15.5% from current level over next 6-8 months.
- ♦ **Risks:** Increase in local hiring in US and longer than anticipated time for revival in profitability of portfolio companies will remain a key margins and earnings risk for the company.

Valuations				Rs cr
Particulars	FY2017	FY2018E	FY2019E	FY2020E
Total revenue	29,140.8	30,627.5	33,599.2	36,523.5
EBITDA margin (%)	14.4	15.1	15.8	16.2
Net profit	2,839.3	3,503.8	3,625.8	4,055.0
EPS (Rs)*	32.8	39.8	41.2	46.1
P/E (x)	18.4	15.2	14.7	13.1
EV/EBITDA	12.0	10.4	8.7	7.3
ROE (%)	18.3	20.1	18.5	18.3
ROCE (%)	20.9	21.9	20.7	21.1

*excluding treasury shares

Results under IFRS					Rs cr
Particulars	Q3FY18	Q3FY17	YoY %	Q2FY18	QoQ %
Revenues (\$ mn)	1,209.1	1,116.1	8.3	1,179.2	2.5
Revenues in INR (Cr)	7,776.0	7,557.5	2.9	7,606.4	2.2
Direct costs	5,380.7	5,235.2	2.8	5,378.9	0.0
Gross profit	2,395.3	2,322.3	3.1	2,227.5	7.5
SG&A	1,130.6	1,135.8	-0.5	1,121.8	0.8
EBITDA	1,264.7	1,186.5	6.6	1,105.7	14.4
Depreciation	274.2	248.0	10.6	265.3	3.4
EBIT	990.5	938.5	5.5	840.4	17.9
Other income	225.0	155.2	45.0	322.2	-30.2
PBT	1,181.4	1,058.8	11.6	1,124.0	5.1
Tax provision	257.0	214.1	20.0	284.7	-9.7
Net profit	943.1	855.0	10.3	836.2	12.8
EPS (Rs)	10.7	9.7	10.3	9.5	12.8
Margin (%)					
EBITDA	16.3	15.7	56	14.5	173
EBIT	12.7	12.4	32	11.0	169
NPM	12.1	11.3	82	11.0	113

Operating metrics

Particulars	Q3FY18	Q3FY17	Q2FY18	YoY (%)	QoQ (%)	Comments
Geographic mix (%)						
North Americas	46.9	46.7	45.3			North America grew by 6.2% qoq led by consolidation of IPs revenues (deal signed in Q2FY18)
in \$ mn	567.1	521.2	534.2	8.8	6.2	
Europe	29.8	29.4	30.0			
in \$ mn	360.3	328.1	353.8	9.8	1.9	
RoW	23.3	23.9	24.7			
in \$ mn	281.7	266.7	291.3	5.6	-3.3	
Industry verticals (%)						
Telecom	42.8	47.3	43.7			Telecom continues to remain weak, expect to witness revival in FY2019E
in \$ mn	517.5	527.9	515.3	-2.0	0.4	
Manufacturing	19.1	18.4	19.0			Enterprise segment continues to see strong momentum , TME vertical growth was led by IPs deal
in \$ mn	230.9	205.4	224.0	12.5	3.1	
Technology, Media	6.5	6.4	5.9			
in \$ mn	78.6	71.4	69.6	10.0	13.0	
BFSI	13.3	13.1	14.1			
in \$ mn	160.8	146.2	166.3	10.0	-3.3	
Retail, transport	7.1	7.6	7.2			
in \$ mn	85.8	84.8	84.9	1.2	1.1	
Others	11.3	7.1	9.9			
in \$ mn	136.6	79.2	116.7	72.4	17.0	
Clients contribution						
Top 5 clients	23.2	27.8	24.8			Weak growth print from top 5 clients
in \$ mn	280.5	310.3	292.4	-9.6	-4.1	
Top 10 clients	33.2	38.4	35.1			
in \$ mn	401.4	428.6	413.9	-6.3	-3.0	
Top 20 clients	45.0	50.5	46.2			
in \$ mn	544.1	563.6	544.8	-3.5	-0.1	

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