

BUY

TP: Rs 980 | ▲ 16%

TECH MAHINDRA

| IT Services

| 23 October 2020

Communication vertical recovers; TCV robust

Tech Mahindra (TECHM) posted 2.9% QoQ CC revenue growth and stellar 390bps EBITDA margin expansion, bettering our estimates for Q2FY21. The telecom vertical has finally started recovering (+3% QoQ USD). Traction in the TME, BFSI and retail segments led QoQ recovery for the enterprise segment. TCV was robust at US\$ 421mn. We raise FY21-FY23 EPS by 7-10% to bake in the Q2 beat and roll over to a revised Sep'21 TP of Rs 980 (Rs 910 earlier), based on an unchanged target P/E of 15.7x. Reiterate BUY.

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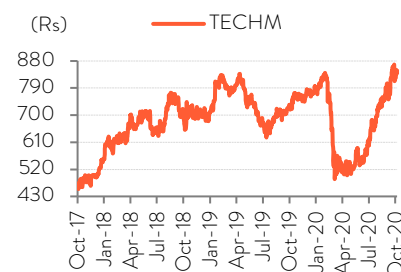
Strong growth momentum: Revenue growth of 2.9% QoQ CC exceeded our estimate of 1.3%, backed equally by growth in supply and demand. The enterprise segment grew 4.3% QoQ CC and communication was up 0.8% after two quarters of decline. Within enterprise, technology, media and entertainment (TME), BFSI and retail revived the most. Alliances with cloud hyperscalers have also seen increased focus. EBIT margin at 14.2% surged 410bps QoQ on lower SG&A and employee cost. Margin tailwinds arose from the supply and demand side (+160bps each), increased cost efficiency (+160bps); offset by normalisation from seasonality (-70bps).

Ticker/Price	TECHM IN/Rs 848
Market cap	US\$ 10.1bn
Shares o/s	873mn
3M ADV	US\$ 63.0mn
52wk high/low	Rs 888/Rs 471
Promoter/FPI/DII	36%/39%/25%

Source: NSE

Deal win recovery: With numerous multiyear wins across the software engineering services, communication, healthcare, ENU and BFSI verticals, net new TCV stood at US\$ 421mn (+45% QoQ, -72% YoY). Q2 TCV was a mix of large- and medium-sized deals. Communication segment wins totaled US\$ 208mn and enterprise US\$ 214mn. The deal funnel is also at an all-time high.

STOCK PERFORMANCE



Source: NSE

Positive outlook: The communication vertical recovered as a few deal reversals from Q1 were recouped. The 5G space is expected to see increased activity in coming quarters, especially in services and core digital transformation. TECHM expects retail and manufacturing to recover from Q3.

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	347,421	368,677	385,822	448,388	501,377
EBITDA (Rs mn)	63,368	57,261	66,649	81,088	90,275
Adj. net profit (Rs mn)	42,975	42,505	45,483	51,911	57,976
Adj. EPS (Rs)	47.7	48.3	51.7	59.0	65.9
Adj. EPS growth (%)	11.9	1.2	7.0	14.1	11.7
Adj. ROAE (%)	21.4	19.8	19.4	19.8	19.9
Adj. P/E (x)	17.8	17.6	16.4	14.4	12.9
EV/EBITDA (x)	11.6	12.9	11.0	8.9	7.6

Source: Company, BOBCAPS Research

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Other highlights

- TECHM's strategy in the wake of Covid-19 has been 'Repair, Rally and Rise'. Management's short-term goals constitute: AI first, cloud first and 5G first. The company is trying to revive the manufacturing vertical in particular and sees weakness here bottoming out in Q2. Retail is being seen as an opportunity for growth in the areas of omnichannel and e-commerce. In communication, network services revival has been slower post Covid, but other ancillary areas pertaining to 5G (data, customer experience, digital and process transformation) should see increased demand from telecom service providers.
- Management expects demand recovery to lead margin recovery going forward. Increased synergy from portfolio subsidiaries is expected to flow through in H2FY21. Travel cost resumption will likely be offset by increased automation and demand recovery. Management sees increased furloughs in Q3FY21 and will plan wage hikes from CY21 onwards in a phased manner.
- DSO has improved from 107 days in Q1FY21 to 97 days in Q2 – the lowest in the last 15 quarters, led by decreased working capital needs and a rebound on the client side.
- TECHM has proposed a special dividend of Rs 15/sh.

FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Revenues (US\$ mn)	1,265	1,287	(1.7)	1,207	4.8
Revenue	93,718	90,699	3.3	91,063	2.9
Operating Expenditure	76,688	75,690	1.3	78,058	(1.8)
Cost of revenues	64,245	63,893	0.6	65,105	(1.3)
as % of sales	68.6	70.4	-	71.5	-
SG&A expenses	12,443	11,797	5.5	12,953	(3.9)
as % of sales	13.3	13.0	-	14.2	-
EBITDA	17,030	15,009	13.5	13,005	30.9
Depreciation	3,717	3,415	-	3,832	-
EBIT	13,313	11,594	14.8	9,173	45.1
Other Income	780	1,783	-	3,659	-
PBT	14,093	13,377	5.4	12,832	9.8
Total Tax	3,462	2,265	-	3,276	-
Adjusted PAT	10,631	11,112	(4.3)	9,556	11.2
(Profit)/loss from JV's/Ass/MI	15	127	-	167	-
APAT after MI	10,646	11,239	(5.3)	9,723	9.5
Extra ordinary items	0	0	-	0	-
Reported PAT	10,646	11,239	(5.3)	9,723	9.5
Reported EPS	12.1	12.8	(5.2)	11.1	9.5

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Margins (%)			(bps)		(bps)
EBITDA	18.2	16.5	160	14.3	390
EBIT	14.2	12.8	140	10.1	410
EBT	15.0	14.7	30	14.1	90
PAT	11.4	12.4	(100)	10.7	70
Effective Tax rate	24.6	16.9	760	25.5	(100)

Source: BOBCAPS Research

FIG 2 – OPERATING METRICS

(in US\$ terms)	Q2FY21 (% Contr. to Revenue)	Growth (%)		
		QoQ	YoY	
Revenue by Geography				
North America	48.4	2.9	(1.9)	
Europe	25.2	2.4	(7.2)	
Rest of the World	26.4	11.2	4.2	
Client Concentration				
Top 5	22.0	4.8	0.1	
Top 10	30.0	1.5	(6.4)	
Top 20	43.0	4.8	(3.0)	
Non-Top 10 client revenues	70.0	6.4	0.5	
Revenue by Vertical				
Telecom	39.3	3.0	(6.0)	
Manufacturing	16.1	0.5	(12.1)	
Technology, Media and Entertainment	9.8	14.2	18.9	
BFSI	16.4	9.5	24.0	
Retail, Transport and Logistics	7.5	7.7	5.3	
Others	10.9	2.0	(16.3)	
Revenue by Delivery				
Onsite	63.0	3.2	(5.3)	
Offshore	37.0	7.8	5.1	

(%)	Q2FY21	QoQ (bps)	YoY (bps)
Utilisation (including trainees)	85	300	300
Attrition	14	(300)	(700)
Headcount (nos)	124,258	842	(1,515)

	Q2FY21	Q1FY21	Q2FY20
No. of Million \$ Clients			
≥ \$1mn clients	460	451	437
≥ \$5mn clients	165	161	155
≥ \$10mn clients	82	81	80
≥ \$20mn clients	50	48	49
≥ \$50mn clients	21	21	22
DSO	97	107	114

Source: BOBCAPS Research

Valuation methodology

We believe that telecom is a relatively resilient industry in the current environment (see our report [Deep Dive 2: Telecom tech spends resilient – upgrade TECHM](#)). While we do expect TECHM to experience near-term weakness related to the pandemic (supply-side issues in BPO, slowdown in manufacturing/retail and delays in new deal execution), we believe 5G-driven traction will boost the communications vertical which forms nearly 40% of the company's revenues. With the onset of Covid-19, 5G adoption timelines have shifted to FY22 onwards but demand remains unaffected.

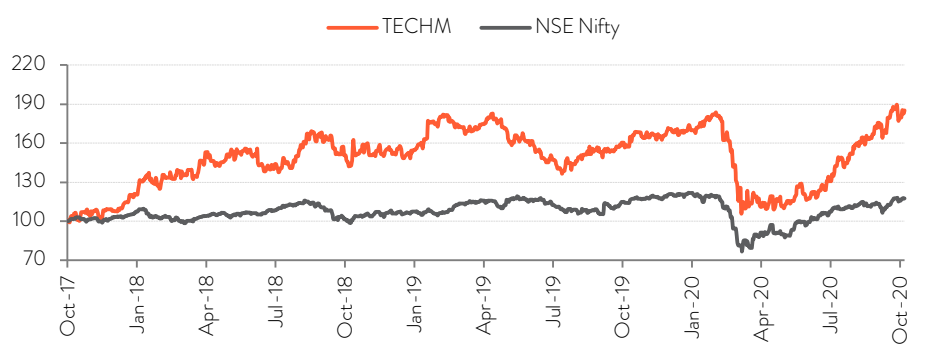
TECHM's Q2FY21 results are better than our as well as consensus estimates on both revenue and margins. We increase FY21/FY22/FY23 EPS estimates by 10%/7%/7%. Rolling valuations forward, we move to a new Sep'21 target price of Rs 980 (vs. Rs 910), set at an unchanged target P/E of 15.7x. Our target multiple is in line with the last five-year average considering the operational beat in these challenging times. Reiterate BUY.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY21E			FY22E			FY23E		
	Old	New	Change (%)	Old	New	Change (%)	New	New	Change (%)
US\$ Revenues (US\$ mn)	4,918	5,126	4.2	5,418	5,749	6.1	6,002	6,428	7.1
YoY growth (%)	(5.0)	(1.1)	-	10.2	12.1	-	10.8	11.8	-
Revenues	374,963	385,822	2.9	422,619	448,388	6.1	468,176	501,377	7.1
EBITDA (Rs mn)	59,255	66,649	12.5	76,422	81,088	6.1	83,954	90,275	7.5
EBITDA margins (%)	15.8	17.3	-	18.1	18.1	-	17.9	18.0	-
EBIT margins (%)	11.6	13.2	-	14.0	14.0	-	13.7	13.8	-
Net Profits	41,294	45,483	10.1	48,444	51,911	7.2	54,083	57,976	7.2
EPS (Rs)	47.0	51.7	10.1	55.1	59.0	7.2	61.5	65.9	7.2

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- Slow growth in communication business
- Lack of synergy among portfolio companies
- Prolonged delay in 5G timeline

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue	347,421	368,677	385,822	448,388	501,377
EBITDA	63,368	57,261	66,649	81,088	90,275
Depreciation	11,292	14,458	15,591	18,395	21,058
EBIT	52,076	42,803	51,059	62,693	69,217
Net interest income/(expenses)	(1,332)	(1,919)	(1,527)	(1,550)	(1,650)
Other income/(expenses)	5,342	11,924	9,787	5,898	8,066
Exceptional items	0	0	0	0	0
EBT	55,431	52,753	59,343	67,081	75,673
Income taxes	12,544	11,604	14,843	16,770	19,297
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	(567)	1,301	1,007	1,640	1,640
Reported net profit	42,975	42,505	45,483	51,911	57,976
Adjustments	0	0	0	0	0
Adjusted net profit	42,975	42,505	45,483	51,911	57,976

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	0	0	0	0	0
Other current liabilities	90,744	103,830	100,419	116,704	130,495
Provisions	9,753	11,055	10,570	12,285	13,736
Debt funds	14,047	24,282	24,282	24,282	24,282
Other liabilities	12,304	12,304	12,304	12,304	12,304
Equity capital	4,437	4,359	4,359	4,359	4,359
Reserves & surplus	203,184	217,705	243,039	271,475	303,420
Shareholders' fund	207,621	222,064	247,398	275,834	307,779
Total liabilities and equities	334,469	373,535	394,974	441,408	488,597
Cash and cash eq.	20,427	30,167	62,975	99,110	140,014
Accounts receivables	69,586	75,772	76,107	88,449	98,902
Inventories	752	358	358	358	358
Other current assets	88,020	121,702	115,943	121,086	125,441
Investments	77,926	61,046	61,046	61,046	61,046
Net fixed assets	71,667	76,047	70,102	62,917	54,394
CWIP	2,763	501	501	501	501
Intangible assets	28,163	33,877	33,877	33,877	33,877
Deferred tax assets, net	6,091	8,443	8,443	8,443	8,443
Other assets	0	0	0	0	0
Total assets	334,469	373,535	394,975	441,409	488,597

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	50,112	55,607	60,091	68,705	77,434
Interest expenses	(745)	(13,843)	(11,314)	(7,448)	(9,716)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(10,574)	(13,356)	1,528	514	436
Other operating cash flows	5,527	17,667	0	0	0
Cash flow from operations	44,320	46,075	50,306	61,772	68,154
Capital expenditures	(7,793)	(15,386)	(9,646)	(11,210)	(12,534)
Change in investments	(23,216)	(16,880)	0	0	0
Other investing cash flows	9,967	13,843	11,314	7,448	9,716
Cash flow from investing	(21,042)	(18,423)	1,668	(3,762)	(2,819)
Equities issued/Others	(1,747)	0	0	0	0
Debt raised/repaid	(4,504)	0	0	0	0
Interest expenses	(1,354)	0	0	0	0
Dividends paid	(14,907)	(17,912)	(19,166)	(21,875)	(24,431)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(22,512)	(17,912)	(19,166)	(21,875)	(24,431)
Changes in cash and cash eq.	766	9,740	32,808	36,135	40,904
Closing cash and cash eq.	20,427	30,167	62,975	99,110	140,014

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	47.7	48.3	51.7	59.0	65.9
Adjusted EPS	47.7	48.3	51.7	59.0	65.9
Dividend per share	14.0	16.9	18.1	20.7	23.1
Book value per share	230.6	252.5	281.3	313.6	350.0

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	2.1	2.0	1.9	1.6	1.4
EV/EBITDA	11.6	12.9	11.0	8.9	7.6
Adjusted P/E	17.8	17.6	16.4	14.4	12.9
P/BV	3.7	3.4	3.0	2.7	2.4

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	77.5	80.6	76.6	77.4	76.6
Interest burden (PBT/EBIT)	106.4	123.2	116.2	107.0	109.3
EBIT margin (EBIT/Revenue)	15.0	11.6	13.2	14.0	13.8
Asset turnover (Revenue/Avg TA)	108.8	104.1	100.4	107.2	107.8
Leverage (Avg TA/Avg Equity)	1.6	1.6	1.6	1.6	1.6
Adjusted ROAE	21.4	19.8	19.4	19.8	19.9

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

Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	12.9	6.1	4.7	16.2	11.8
EBITDA	34.3	(9.6)	16.4	21.7	11.3
Adjusted EPS	11.9	1.2	7.0	14.1	11.7
Profitability & Return ratios (%)					
EBITDA margin	18.2	15.5	17.3	18.1	18.0
EBIT margin	15.0	11.6	13.2	14.0	13.8
Adjusted profit margin	12.4	11.5	11.8	11.6	11.6
Adjusted ROAE	21.4	19.8	19.4	19.8	19.9
ROCE	19.3	15.1	17.0	21.7	24.7
Working capital days (days)					
Receivables	71	72	72	67	68
Inventory	1	1	0	0	0
Payables	104	114	117	108	110
Ratios (x)					
Gross asset turnover	4.7	5.0	5.3	6.7	8.5
Current ratio	1.8	2.0	2.3	2.4	2.5
Net interest coverage ratio	(39.1)	(22.3)	(33.4)	(40.4)	(41.9)
Adjusted debt/equity	0.0	0.0	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

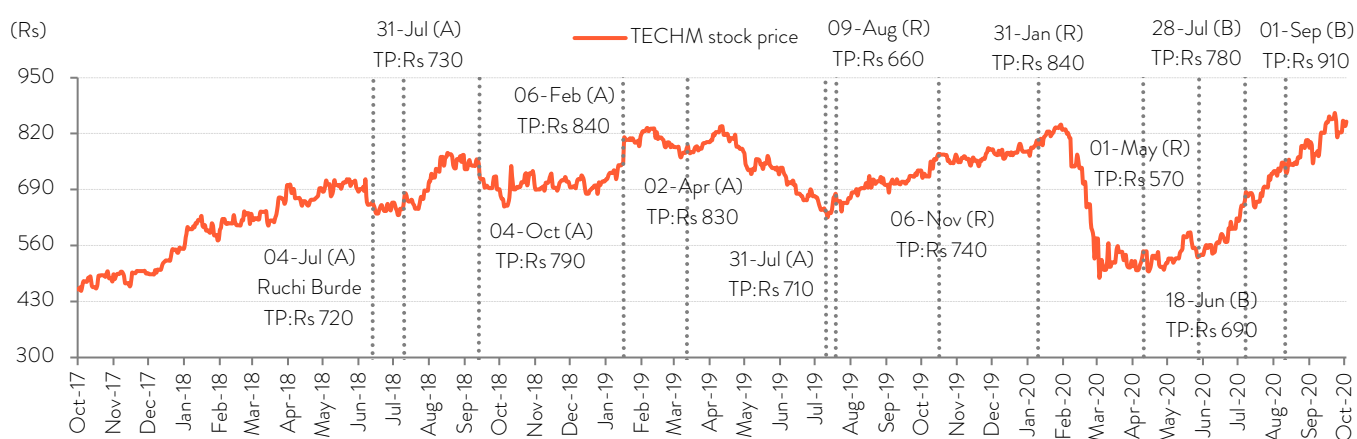
ADD – Expected return from >+5% to +15%

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)

RATINGS AND TARGET PRICE (3-YEAR HISTORY): TECH MAHINDRA (TECHM IN)



B – Buy, A – Add, R – Reduce, S – Sell

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