

Mindtree

04 December 2020

Reuters: MINT.BO; Bloomberg: MTCL IN

Steadying the ship: higher pipeline conversion to drive growth

Mindtree (MTCL) management at the analyst meet held yesterday exuded quiet confidence in pick-up in growth and sustenance of the sharp recovery in margins seen in the last few quarters. With many in the current top management coming from significantly larger companies like Cognizant (predominantly), Accenture, etc, we believe that the focus will be on scale up. L&T, the promoter, indicated that Mindtree and LTI will continue to be run separately, at least for the foreseeable future, though they do work together in some customer situations. The 4x4x4 strategy of MTCL is quite simple in its approach. This involves focus on 4 verticals, 4 service lines and 4 geographies (see Exhibit 2). Healthcare (no Life Sciences but more of payers, providers, medical device players and pharma retail) is one vertical that is seeing incubation. There is a sharper focus on 4 services lines (customer success, data & intelligence, cloud and enterprise IT) and a new focus on expanding beyond North America. We are comforted by MTCL's reiteration that EBIT margin (which recovered significantly on SGA compression) will be broadly maintained at 2QFY21 levels. The deal flow, which has been a bit tepid recently, is expected to recover as the large deal pipeline starts converting. The large deal team has done greater investments in building better solutions besides expanding beyond the North American market. MTCL indicated that it has been invited to many more large deal conversations than in the past, putting it in competition with some of the Tier-1 players, leading to expansion of the pipeline. In the European market, MTCL indicated that it is open to rebadging customer employees if deals require that. In terms of client concentration, there is stress on growing other top 10 accounts besides Microsoft (its largest client at ~29% revenue in 2QFY21 and source of some investor discomfort). This is largely driven by sales of multiple service lines into these clients. On broader demand conditions, the management was of the view that budgets are unlikely to see material expansion and that the focus would be on repurposing. Also, it sees customer focus on both vendor consolidation as well as best-of-the-breed solutions. The latter is where MTCL capabilities come into play. Some of the cost rationalizations on the SGA side have come from significant restructuring of its go-to-market strategy. From a near term perspective, MTCL believes that 3Q and 4Q could see growth similar to that seen in 2Q (QoQ basis) despite seasonal weakness. It indicated that its strategy to transform from a project-based business to an annuity-based one is still underway. Post the analyst meet, we retain our 'Accumulate' rating and a target price (TP) of Rs1,544 (20x Sept 2022 EPS). We continue to keep discount to TCS' target PE multiple constant at 20%.

Healthcare vertical incubation: It is a synergistic opportunity - there is no Lifesciences element in this. MTCL is focusing on customers trying to extend themselves into the healthcare space. Some Retail-CPG customers are foraying into pharmacy business or some customers (likely high tech) are foraying into wearables. MTCL's strategy is to use its existing capabilities to expand into the new vertical. There are no big investments involved and this foray will not be margin dilutive.

Reduction in costs is largely permanent: The significant SGA cut done in 1HFY21 has been due to cost optimization. MTCL reiterated that this by no means indicates reduction of investments in the organization and in the go-to-market capabilities. MTCL has strengthened its team in each geography where it operates and it is making further investments. Some reduction in SG&A can be attributed to the Covid impact, which will return in some form or shape going forward. MTCL has been running some operational efficiency programs to reduce its cost of delivery by bringing in automation and productivity levers. It is also looking at reducing other overheads. MTCL says that it has reached a comfortable stage as far as margin expansion is concerned and it will not shy away from making investments.

Delivery of the future: MTCL has been investing in people, processes and systems to create this 'delivery organization of the future'. On the people front, the focus is on retraining delivery leadership to handle new technologies, hiring and retraining of the work force to make them 'full stack' engineers. On the systems front, it is focused on digitalization, process simplification, tools standardization, on demand provisioning and metrics automation.

Investments made in large deal team to bear fruit in the near future: MTCL management stated that due to the concerted effort of the large deals team in 1HFY21, the pipeline has increased significantly and the conversion of this pipeline into deals should happen in the next few quarters.

ACCUMULATE

Sector: Information Technology

CMP: Rs1,442

Target Price: Rs1,544

Upside: 7%

Girish Pai

Head of Research

girish.pai@nirmalbang.com

+91-22-6273 8017

Key Data

Current Shares O/S (mn)	164.7
Mkt Cap (Rsbn/US\$bn)	237.5/3.2
52 Wk H / L (Rs)	1,606/692
Daily Vol. (3M NSE Avg.)	1,710,206

Price Performance (%)

	1 M	6 M	1 Yr
Mindtree	8.0	54.1	93.1
Nifty Index	10.3	31.0	9.1

Source: Bloomberg

Exhibit 1: Key financials

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Revenue (Rsmn)	70,215	77,643	78,667	88,993	98,545
YoY Growth (%)	28.5	10.6	1.3	13.1	10.7
EBIT (Rsmn)	9,004	7,869	12,641	15,332	16,865
as % of sales	12.8	10.1	16.1	17.2	17.1
Adj. PAT (Rsmn)	7,541	6,309	10,083	12,032	13,401
YoY Growth (%)	32.3	-16.3	59.8	19.3	11.4
FDEPS (Rs)	45.8	38.3	61.2	73.1	81.4
RoE (%)	24.9	19.5	28.6	28.4	27.1
RoCE (%)	31.5	23.8	32.9	34.7	33.2
Pre Tax ROIC (%)	45.5	33.2	54.6	65.7	66.6
P/E(x)	31.5	37.6	23.5	19.7	17.7
P/BV (x)	7.2	7.5	6.1	5.2	4.5

Source: Company, Nirmal Bang Institutional Equities Research

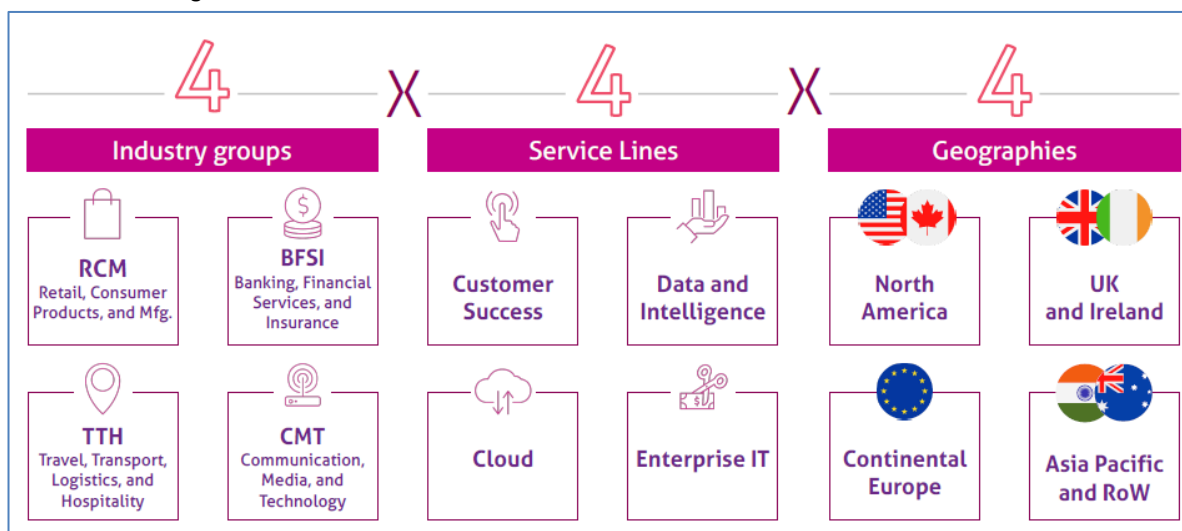
Our view on the Indian IT services sector: In our sector updates of 6th September 2020 ([Rising monetary and digital tides lifting most boats](#)) and of 28th September 2020 ([Medium term commentary turning more positive](#)), we upgraded our view to 'neutral' on the sector from a 'cautious' one held for the last many years on the back of both, higher earnings and higher target PE multiples. The earnings uplift is coming from expectation of margin expansion over the next 2-4 years along with a 300-400bps pick-up in organic revenue growth over FY21-FY23. The changed view on margins has been driven by business model changes that the pandemic has induced, which we think are structurally positive. Higher PE multiples are driven by a combination of valuation exuberance (irrational!?) in the enterprise technology space in the US and constrained domestic investment choices. The demand uplift is more widespread and is a 'rising-tide-lifting-all-boats' kind of situation. Reasons for change in customer behavior, in our view are: (1) quick and unprecedented 'whatever-it-takes' monetary and fiscal actions in the US and Europe that likely eliminated tail risks to economic recovery and reduced risk aversion among corporates. While customer P&Ls and cash flows saw pain, credit market conditions significantly eased up with investment grade and junk bond yields more than halving from their pandemic peak as the US Federal Reserve stepped into the credit markets directly. Corporate America binged on cheap debt. These monetary conditions could last, we believe, for at least 24 months if not longer. (2) Strong need for digital transformation, not only to structurally cut costs, but also to deliver contact-less consumer and employee experiences, driven by the nature of the pandemic. Based on the commentary from customers, software companies and IT services vendors, we believe that digital demand has been pulled forward from the future. While there could be a growth spike in FY22 after a modest dip in FY21 (lower than anticipated), we see organic revenue growth over FY20-FY23 largely at par with that seen over FY17-FY20 as Digital upsurge will be met with a legacy drag.

Why not a sell: (1) We see earnings acceleration over FY20-FY23 due to a better margin trajectory on lower talent and SGA expenses. We see a structural reshaping of the employee pyramid, both onsite and offshore, driven by shorter shelf life of digital skills, need to be multiskilled and visa restrictions. Work from home/anywhere (WFH/WFA) and crowdsourcing platforms would open up talent pools hitherto untapped to keep costs in check. We could also see an offshore delivery shift, which may improve margins but could deflate revenues. Also, broader and deeper automation and vertical/horizontal platforms will likely offset compression in legacy services. (2) better relative earnings picture of IT services sector in the Indian equity market over the next 24 months vis-à-vis erstwhile favorite 'financials' sector, which is seeing uncertainty due to likely rise in bad assets. Worst is likely behind for Indian IT services but that can't be said about the Indian lenders and other domestic plays. (3) Current exuberance (irrational!?) in enterprise tech valuations in the US likely rubbing off on Indian IT services.

Why not a buy: (1) rising Covid-19 cases in the US and Europe that could lead to slower than V shaped FY22 recovery, which is currently priced in. Delay in a medical solution will call into question this recovery. (2) Adverse impact on US corporate profits in 2021 and beyond (leading to cut back in spending) due to higher taxation if new US President Joe Biden is able to push them through. (3) BFSI becoming a problem area in the medium term due to lower for longer (and possibly negative) interest rates (4) Likely slower organic growth in the medium term as spends are pulled forward. Growth could settle into mid-single digit territory in USD terms. (5) A likely deflation in enterprise tech valuations in the US.

Valuation and stock calls: TCS continues to be our sector benchmark as it has the strongest position in the industry. With enterprise tech sector in the US going through a bout of exuberance currently, an overshoot on the upside is not entirely ruled out. We back our higher PE multiples with (1) expectation of earnings acceleration over FY21-FY23 against FY17-FY20 on margin expansion (2) lower for longer interest rates globally and likely in India too that could keep PE multiples elevated (3) stress in earnings in many domestic sectors in the next 12-24 months, especially for lenders (4) potential for good return of capital to investors due to strong cash flows. We have benchmarked all other companies with respect to TCS. While historically we have not liked mid-tier companies due to their significant client, geographic and vertical concentration risks and weaker capabilities, we believe they could be beneficiaries in the next 24 months of robust demand. We believe vendor consolidation risks are lower due to this. We also think that some of them are undergoing a structural change for the better under new managements, which could set them up for better growth, margins and PE multiples.

Exhibit 2: Strategic focus areas



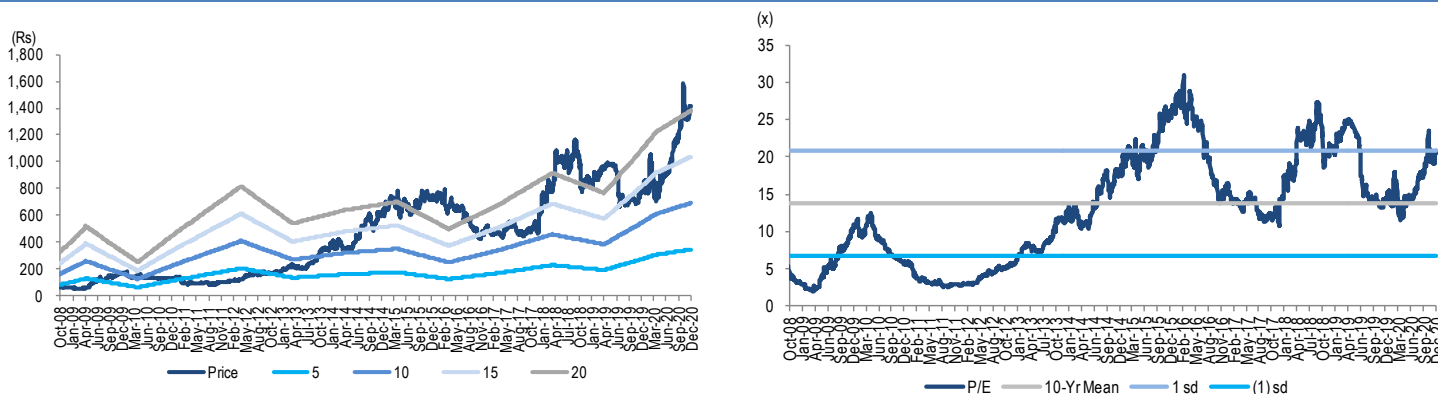
Source: Company

Exhibit 3: The partnership and IP ecosystem



Source: Company

Exhibit 4: P/E charts



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 5: P/E (discount)/premium of Mindtree to TCS



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Financials

Exhibit 6: Income statement

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Average INR/USD	69.9	70.9	74.0	75.2	76.8
Net Sales (USD mn)	1,001	1,089	1,063	1,183	1,284
YoY Growth (%)	18.3	8.7	-2.4	11.3	8.5
Net Sales	70,215	77,643	78,667	88,993	98,545
YoY Growth (%)	28.5	10.6	1.3	13.1	10.7
Employee benefits expense	44,212	50,647	52,140	58,438	65,016
% of sales	63.0	65.2	66.3	65.7	66.0
Gross Margin	26,003	26,996	26,527	30,555	33,528
% of sales	37.0	34.8	33.7	34.3	34.0
Other expenses	15,358	16,373	11,572	12,904	14,289
% of sales	21.9	21.1	14.7	14.5	14.5
EBITDA	10,645	10,623	14,955	17,651	19,239
% of sales	15.2	13.7	19.0	19.8	19.5
Depreciation & Amortisation	1,641	2,754	2,314	2,319	2,375
EBIT	9,004	7,869	12,641	15,332	16,865
% of sales	12.8	10.1	16.1	17.2	17.1
Interest expenses	29	529	527	528	528
Other income (net)	893	948	1,220	1,226	1,530
PBT	9,868	8,288	13,334	16,030	17,866
-PBT margin (%)	14.1	10.7	17.0	18.0	18.1
Provision for tax	2,327	1,979	3,251	3,998	4,466
Effective tax rate (%)	23.6	23.9	24.4	24.9	25.0
Net profit	7,541	6,309	10,083	12,032	13,401
-Growth (%)	32.3	-16.3	59.8	19.3	11.4
-Net profit margin (%)	10.7	8.1	12.8	13.5	13.6

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Balance sheet

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
Equity capital	1,642	1,646	1,647	1,647	1,647
Reserves & surplus	31,423	29,926	37,407	44,103	51,346
Net worth	33,065	31,572	39,054	45,750	52,993
Other liabilities	174	54	7	7	7
Total loans	5	1,744	-	-	-
Lease Liabilities		4,964	4,834	4,834	4,834
Total liabilities	33,244	38,334	43,895	50,591	57,834
Net block	5,234	4,295	3,324	2,524	2,070
Goodwill	4,732	4,732	4,732	4,732	4,732
Investments	8,036	7,748	20,576	24,576	28,576
Deferred tax asset - net	388	1,835	600	600	600
Other non-current assets	2,564	2,150	2,337	2,337	2,337
Unbilled revenue	2,991	3,148	3,242	3,707	4,025
Other current assets	1,927	2,198	1,630	1,862	2,022
Debtors	13,356	14,389	13,981	17,375	18,869
Cash & bank balance	2,562	5,870	1,717	952	3,673
Right-of-use Assets		5,201	5,184	5,184	5,184
Total current assets	20,836	30,806	25,754	29,080	33,773
Total current liabilities	8,546	13,232	13,427	13,258	14,254
Net current assets	12,290	17,574	12,327	15,821	19,519
Total assets	33,244	38,334	43,895	50,591	57,834

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Cash flow

Y/E March (Rsmn)	FY19	FY20	FY21E	FY22E	FY23E
EBIT	9,004	7,869	12,641	15,332	16,865
(Inc.)/dec. in working capital	(5,045)	3,225	1,077	(4,260)	(976)
Cash flow from operations	3,959	11,094	13,718	11,072	15,889
Other income	893	948	1,220	1,226	1,530
Depreciation & amortisation	1,641	2,754	2,314	2,319	2,375
Financial expenses	(29)	(529)	(527)	(528)	(528)
Tax paid	(2,327)	(1,979)	(3,251)	(3,998)	(4,466)
Dividends paid	(5,342)	(2,572)	(4,516)	(5,337)	(6,158)
Net cash from operations	(1,205)	9,716	8,960	4,754	8,642
Capital expenditure	1,587	147	280	800	1,200
Net cash after capex	(2,792)	9,569	8,680	3,954	7,442
Inc./(dec.) in debt	85	1,619	(1,791)	-	-
(Inc.)/dec. in investments	(1,108)	(745)	(11,780)	(4,000)	(4,000)
Equity issue/(buyback)	3	4	1	-	-
Cash from financial activities	(1,020)	878	(13,570)	(4,000)	(4,000)
Others	3,085	(7,139)	737	(720)	(720)
Opening cash	3,289	2,562	5,870	1,717	952
Closing cash	2,562	5,870	1,717	952	3,673
Change in cash	(727)	3,308	(4,153)	(766)	2,722

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Key ratios

Y/E March	FY19	FY20	FY21E	FY22E	FY23E
Per Share (Rs)					
EPS	45.9	38.4	61.4	73.3	81.6
FDEPS	45.8	38.3	61.2	73.1	81.4
Dividend Per Share	27.0	13.0	27.5	32.5	37.5
Book Value	201	192	237	278	322
Dividend Payout Ratio (incl DDT)	71	41	45	44	46
Return ratios (%)					
RoE	24.9	19.5	28.6	28.4	27.1
RoCE	31.5	23.8	32.9	34.7	33.2
Pre Tax ROIC (%)	45.5	33.2	54.6	65.7	66.6
Turnover Ratios					
Asset Turnover Ratio	1.7	1.5	1.4	1.4	1.4
Debtor Days (incl. unbilled Rev)	85	82	80	86	85
Working Capital Cycle Days	37	38	28	31	38
Valuation ratios (x)					
PER	31.5	37.6	23.5	19.7	17.7
P/BV	7.2	7.5	6.1	5.2	4.5
EV/EBITDA	21.4	21.3	14.4	12.0	10.7
EV/Sales	3.3	2.9	2.7	2.4	2.1
M-cap/Sales	3.4	3.1	3.0	2.7	2.4
Dividend Yield (%)	1.9	0.9	1.9	2.3	2.6

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
7 June 2017	Sell	547	424
21 June 2017	Sell	519	382
20 July 2017	Sell	506	382
22 August 2017	Sell	461	382
28 September 2017	Sell	471	396
26 October 2017	Sell	507	426
26 December 2017	Under Review	600	-
18 January 2018	Under Review	622	-
17 March 2018	Sell	812	574
26 October 2017	Sell	867	-
26 December 2017	Under Review	600	-
18 January 2018	Under Review	622	-
17 March 2018	Sell	812	574
19 April 2018	Sell	867	577
3 July 2018	Sell	986	716
19 July 2018	Sell	1,062	803
4 September 2018	Sell	1,100	803
5 October 2018	Sell	1,063	986
19 October 2018	Sell	978	778
27 December 2018	Sell	855	631
7 January 2019	Sell	815	552
17 January 2019	Sell	835	553
19 March 2019	Sell	963	554
20 March 2019	Sell	943	554
18 April 2019	Sell	972	563
18 July 2019	Sell	751	531
23 September 2019	Sell	711	567
17 October 2019	Sell	744	532
2 January 2020	Under Review	812	-
15 January 2020	Under Review	863	-
31 March 2020	Sell	830	522
27 April 2020	Sell	780	532
9 July 2020	Under Review	988	-
15 July 2020	Under Review	973	-
6 September 2020	Accumulate	1,194	1,222
28 September 2020	Accumulate	1,269	1,310
16 October 2020	Accumulate	1,425	1,544
4 December 2020	Accumulate	1,442	1,544

Rating track graph



DISCLOSURES

This Report is published by Nirmal Bang Equities Private Limited (hereinafter referred to as “NBEPL”) for private circulation. NBEPL is a registered Research Analyst under SEBI (Research Analyst) Regulations, 2014 having Registration no. INH000001436. NBEPL is also a registered Stock Broker with National Stock Exchange of India Limited and BSE Limited in cash and derivatives segments.

NBEPL has other business divisions with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets.

NBEPL or its associates have not been debarred / suspended by SEBI or any other regulatory authority for accessing / dealing in securities Market. NBEPL, its associates or analyst or his relatives do not hold any financial interest in the subject company. NBEPL or its associates or Analyst do not have any conflict or material conflict of interest at the time of publication of the research report with the subject company. NBEPL or its associates or Analyst or his relatives do not hold beneficial ownership of 1% or more in the subject company at the end of the month immediately preceding the date of publication of this research report.

NBEPL or its associates / analyst has not received any compensation / managed or co-managed public offering of securities of the company covered by Analyst during the past twelve months. NBEPL or its associates have not received any compensation or other benefits from the company covered by Analyst or third party in connection with the research report. Analyst has not served as an officer, director or employee of Subject Company and NBEPL / analyst has not been engaged in market making activity of the subject company.

Analyst Certification: I, Girish Pai, research analyst, the author of this report, hereby certify that the views expressed in this research report accurately reflects my personal views about the subject securities, issuers, products, sectors or industries. It is also certified that no part of the compensation of the analyst was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views in this research. The analyst is principally responsible for the preparation of this research report and has taken reasonable care to achieve and maintain independence and objectivity in making any recommendations.

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. NBEPL is not soliciting any action based upon it. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any such transaction. In preparing this research, we did not take into account the investment objectives, financial situation and particular needs of the reader.

This research has been prepared for the general use of the clients of NBEPL and must not be copied, either in whole or in part, or distributed or redistributed to any other person in any form. If you are not the intended recipient you must not use or disclose the information in this research in any way. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. NBEPL will not treat recipients as customers by virtue of their receiving this report. This report is not directed or intended for distribution to or use by any person or entity resident in a state, country or any jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject NBEPL & its group companies to registration or licensing requirements within such jurisdictions.

The report is based on the information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up-to-date and it should not be relied upon as such. We accept no obligation to correct or update the information or opinions in it. NBEPL or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. NBEPL or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

This information is subject to change without any prior notice. NBEPL reserves its absolute discretion and right to make or refrain from making modifications and alterations to this statement from time to time. Nevertheless, NBEPL is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.

Before making an investment decision on the basis of this research, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. There are risks involved in securities trading. The price of securities can and does fluctuate, and an individual security may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international stock market or economic conditions, which may adversely affect the value of the investment. Opinions expressed are subject to change without any notice. Neither the company nor the director or the employees of NBEPL accept any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. Here it may be noted that neither NBEPL, nor its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profit that may arise from or in connection with the use of the information contained in this report.

Copyright of this document vests exclusively with NBEPL.

Our reports are also available on our website www.nirmalbang.com

Access all our reports on Bloomberg, Thomson Reuters and Factset.

Team Details:			
Name		Email Id	Direct Line
Rahul Arora	CEO	rahul.arora@nirmalbang.com	-
Girish Pai	Head of Research	girish.pai@nirmalbang.com	+91 22 6273 8017 / 18
Dealing			
Ravi Jagtiani	Dealing Desk	ravi.jagtiani@nirmalbang.com	+91 22 6273 8230, +91 22 6636 8833
Michael Pillai	Dealing Desk	michael.pillai@nirmalbang.com	+91 22 6273 8102/8103, +91 22 6636 8830

Nirmal Bang Equities Pvt. Ltd.

Correspondence Address

B-2, 301/302, Marathon Innova,
 Nr. Peninsula Corporate Park,
 Lower Parel (W), Mumbai-400013.
 Board No. : 91 22 6273 8000/1; Fax. : 022 6273 8010