Tech Mahindra

9 September 2019

Reuters: TEML.BO; Bloomberg: TECHM IN

Event Update

AT&T deal; A showcase deal for the 5G Telco world?

Tech Mahindra (TML) and AT&T recently reached an agreement that would significantly expand the relationship between the two (details inside). Our understanding of the deal is that it involves modernization and migration of hundreds of applications in the Operations Support Systems (OSS) and Business Support Systems (BSS) areas (non-network reated) on to the cloud (likely Azure, Microsoft and AT&T did a US$2bn deal in July 2019). This is expected to make AT&T a more flexible organization and generate savings that can be re-invested in the US 5G network roll out that it is planning in 1H2020. Why did it go to TML? (1) TML has likely been the largest India origin ITES vendor for AT&T in the last 15 years and understands its IT landscape well. Other players like TCS, Infosys, Wipro and Cognizant too work with AT&T, possibly in smaller roles. We believe AT&T also has a very large and possibly decades old relationship with IBM (2) Possibly put in a very competitive bid – we do not think such a large deal would be sole sourced. This deal in our view would have been 'priced to win' and would require TML to bring all of its best automation and technical capabilities to the table. While TML is claiming that this deal will deliver margins in line with that of the company average over its life, we would be skeptical. We see this deal as an investment that TML is likely making to get a large referenceable project top market to the global Telco universe that is at the cusp of pivoting to the 5G era and is looking for a vendor to squeeze out savings from its existing IT investments. We suspect the Verizon-Infosys deal announced a year back likely falls in this category too as Verizon pivots to 5G. Media (mainstream and social) indicates this deal could lead to rebadging of 1000-1500 of AT&T employees/subcontractors who are currently located at Dallas, Texas. Our guess is that this is more of internal spend being outsourced rather than a big vendor consolidation exercise. This business will come on top of the already existing book of business of AT&T with TML. With fine pricing and onsite heavy workforce to begin with, we expect EBIT margins to be in the low single digits if not worse. Margins are likely to rise in the long term through offshore shift, automation, employee pyramid etc. 2HFY18 and FY19 were the periods of strong margin improvement (surprising the street on the speed and extent), which led to strong growth in EPS and also a P/E multiple expansion. This was while TML was more deliberate about the business it wanted to pursue and shed revenues which were low margin. Delivering on both growth and margins in our view is going to be a challenge for TML, something it could not do in FY19 as enterprise business suffered a deceleration, while most peers saw acceleration. While finer deal related details are not yet available, based on media statements made, we are increasing our revenue estimates for FY20 and FY21 while paring margins. We maintain our Sell rating on TML with a reduced target price (TP) of Rs544 based on a target multiple of 9.9x March 2021E EPS. The target multiple is at a 40% discount to TCS and reflects TML's structural weakness because of its less diversified revenue mix, slower organic growth, lower margins, lower RoIC and behind-the-curve investments in automation and digital. Our Sell rating is driven by the view that industry will witness P/E de-rating in a no-growth year we expect in FY21.

5G pick-up by FY21: TML is of the view that the contribution of 5G will be fairly small in FY20. Apparently, 5G spectrum licensing has not picked up with only China and Korea starting the 5G implementation as of now. There have been small trials in the US. In FY21, when TML expects an uptick, the contribution to total revenue would likely be in the mid-to-high-single-digits based on current understanding. The 5G opportunity for TML is going to first play out on the network services side, with TML implementing network expansion (likely through sub contracts) through OEMs like Ericsson, Huawei, Nokia, ZTE, Samsung, etc. The 5G technology business has three branches: deployment, enablement and displacement and TML feels that it is well placed to leverage its capabilities in all these areas. The 5G pick-up is important for TML as the Communication vertical has been TML's forte. With financials stretched across most global Telcos there is going to be a squeeze in legacy investments to pay for the 5G investments and we think that could put some pressure on the business of TML – which has been a strong incumbent in this space for a while. As seen in the deal that it has done with AT&T above, it could also be a big opportunity on the RTB side as many of its Telco customers would want to move to the cloud and transform their IT landscape very aggressively and move their internal spend to vendors.

Competition is going to be stiff. IBM with Red-Hat would be a formidable: We believe competition in the Telco space, both on the 5G implementation and the preparatory part of 5G (when costs would be squeezed out) would be fairly high. While TML works with almost all large Telcos globally, it will find stiff competition from IBM, Accenture, TCS, Infosys and Wipro. All of these entities have initiatives on the 5G front. We believe the multi cloud capability acquired through Red-Hat might likely be a strong point for IBM, especially as 5G is expected to be more a B2B play rather than a B2C one and most corporate customers would want to play in a multi-cloud and hybrid environment rather than be locked into one cloud partner.

SELL

Sector: Information Technology

CMP: Rs684

Target price: Rs544

Downside: 21%

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Key Data

Current Shares O/S (mn)	964.6
Mkt Cap (Rsbn/US$bn)	696.2/9.7
52 Wk H / L (Rs)	847/607
Daily Vol. (3M NSE Avg.)	3,266,426

Price Performance (%)

	1 M	6 M	1 Yr
Tech Mahindra	8.8	(11.0)	(6.5)
Nifty Index	(1.5)	(0.8)	(5.5)

Source: Bloomberg

Exhibit 1: Key financials

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Revenues	291,408	307,730	347,421	382,558	409,124
YoY (%)	*10.0*	*5.6*	*12.9*	*10.1*	*6.9*
Gross Profit	*85,747*	*92,431*	*113,831*	*114,665*	*120,804*
% of sales	*29.4*	*30.0*	*32.8*	*30.0*	*29.5*
EBIT	32,062	36,321	52,076	52,009	56,585
% of sales	*11.0*	*11.8*	*15.0*	*13.6*	*13.8*
PAT	28,136	38,001	42,735	44,283	48,751
YoY (%)	*(9.7)*	*35.1*	*12.5*	*3.6*	*10.1*
FDEPS	31.7	42.8	48.1	49.9	54.9
RoE (%)	*18.3*	*21.5*	*21.9*	*20.3*	*19.5*
RoCE (%)	*17.3*	*17.2*	*22.8*	*21.0*	*20.3*
RoIC (%)	*26.2*	*25.8*	*37.9*	*36.3*	*37.2*
P/E (x)	20.9	15.5	13.8	13.3	12.1
P/BV (x)	3.6	3.1	2.9	2.5	2.2

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Change in our estimates

	New		Old		*Change (%)*	
	FY20E	FY21E	FY20E	FY21E	*FY20E*	*FY21E*
INR/USD	71.9	74.6	71.5	74.5	*0.6*	*0.1*
USD Revenues (USD mn)	5,313	5,488	5,207	5,278	*2.0*	*4.0*
Revenues (Rsmn)	382,558	409,124	372,342	393,108	*2.7*	*4.1*
EBIT (Rsmn)	52,009	56,585	53,007	55,328	*(1.9)*	*2.3*
EBIT Margin (%)	*13.6*	*13.8*	*14.2*	*14.1*	-	-
PAT (Rsmn)	43,961	48,295	44,779	47,519	*(1.8)*	*1.6*
EPS (Rs)	49.9	54.9	50.8	54.0	*(1.8)*	*1.7*

Source: Company, Nirmal Bang Institutional Equities Research

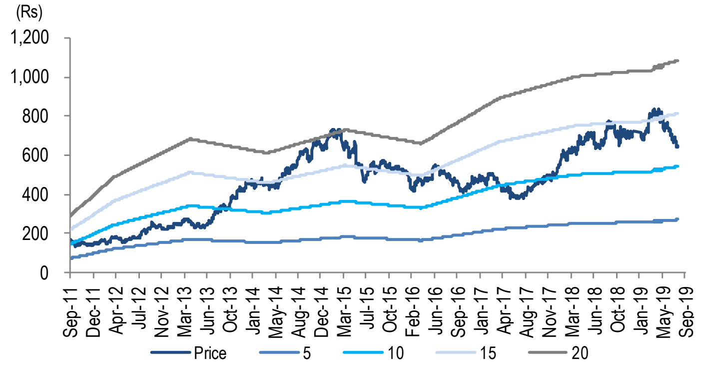
The deal details: TML will assume management of many of the applications which support AT&T's network and shared systems. This would help AT&T to focus on building an advanced software defined 5G network, and migrate the majority of its non-network workloads to the public cloud by 2024. Based on comments by management in the media and other sources, we believe the deal size will likely be US$800mn-US$1bn spread over 6.5 years. With this deal, we believe AT&T, which is likely TML's second largest customer in Communications vertical (behind BT), will become the largest by 3QFY20 when we believe revenue from the deal would start kicking in. We believe this deal would involve rebadging of AT&T employees and subcontractors. TML has indicated that the deal would be margin dilutive for 2-3 quarters and would deliver corporate level margins over the life of the contract.

AT&T's relationship with TML: This started in 2004 with the outsourcing from AT&T rising strongly over the years. The agreement that got signed at that time gave AT&T call options to acquire 8% of the company in 2010 at a predetermined exercise price. This was linked to the quantum of outsourcing done by AT&T to TML. The options were exercised by AT&T in 2010 only for the shares to be divested by AT&T almost immediately. Just as the share of BT in the revenue mix continued to dip over the years the share of AT&T continued to rise. But, we believe it remained the second largest communication services customer behind BT.

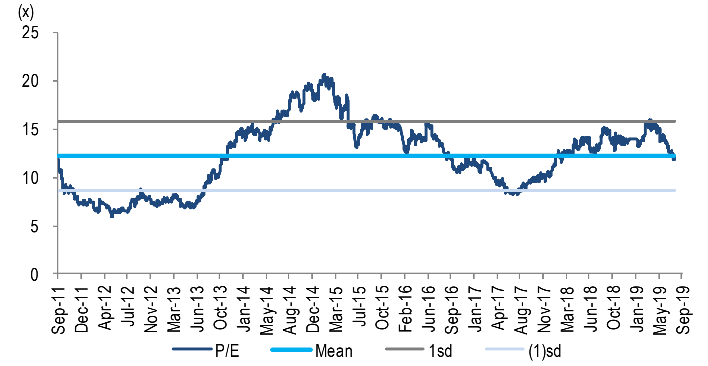
AT&T has struck multiple deals in recent months: These have been with IBM, Microsoft and Dell. Applications which are part of the AT&T Business – division that caters to enterprise customers of AT&T – will be shifted to IBM cloud. This deal also likely revolves around the capability of handling multi-cloud and hybrid clouds acquired through the Red-Hat acquisition. AT&T seems to have also hedged its bets by a tie-up with Microsoft to use its Azure platform. It seems to be working with Dell with help connected with the edge part of its likely 5G network. On 5G itself, AT&T seems to have spread its risks by involving three partners on the equipment side – Ericsson, Nokia and Samsung. Indian companies can aspire to strike subcontracting relationships with these players as the 5G networks get rolled out globally over the next 5 years.

View on Indian IT services sector: We downgraded the Indian IT sector (see our report: Street Is Not Factoring Even A Soft Landing; We Downgrade) on 27 December 2018 based on: (1) Consensus not factoring in significantly softer growth in FY21 as the best demand environment since 2008-09 is largely behind us with corporate capex in both the US and Europe likely to have peaked in 2018. (2) The US BFSI space could witness pressure on margins from a flattened/inverted yield curve and probably a more hostile regulatory environment through a split Congress in the US. (3) Pressure on cost structure because of tariffs levied on imports from China impacting US manufacturers. (4) Front-office capabilities in digital still elusive for Indian IT services players, leading to an inability to tap into the marketing budgets of customers in a material way. The focus has been on the technology-intensive back-end of digital where we believe the field is relatively more crowded. (5) 'Automation at scale' in legacy services eating into growth coming in from new services. This is driven by explosive growth in both intelligent and robotic process automation software industry. (6) Factoring in lower Indian rupee or INR depreciation benefits than estimated earlier (Refer: Incorporating New INR Estimate). (7) Capital return to shareholders not being as potent a stock driver as it was earlier as the cash hoard is shrinking after two to three rounds of buyback over the past three years. (8) Talent pressure in the US in new-age services because of a tighter H1-B visa regime. We were planning the downgrade a quarter or two down the road, but the global macro set-up has turned weaker far more quickly than we anticipated, hastening this move. While some of the 'relative' factors like investor positioning, valuation, earnings revision momentum - partly the reasons for turning 'tactically positive in March 2018 - still exist, we believe they are unlikely to carry as much importance with investors as deteriorating fundamentals would over FY19-FY21. While many of our competitors are expecting a better FY20 versus FY19, which we believe is unlikely. We probably had the best macro environment that the industry has seen in the past 10 years in 2018 and incrementally we only see a deterioration which should crimp spending by customers. More importantly, we reiterate our no-industry-growth-in-FY21 call initiated in March 2018. We base this scenario on an explicit expectation of a soft landing in the US (0%-1.5% real GDP growth) in 2020. We believe the consensus is expecting mid-high single-digit revenue growth in FY21 for the industry, implicitly assuming continued robust growth in the US (2%-2.5%). It is our belief that the street will converge with our no-growth expectations over time. Until the market prices in this scenario, we believe technical factors are not likely to hold the sector up. A hard landing (recession) - not our current base case - could lead to single-digit negative growth for the sector. Just as outperformance of the sector in 2018 was driven largely by P/E multiple expansion in the belief that growth is going to accelerate, we believe the downside in 2019 will be driven by P/E multiple deflation as investors begin to re-calibrate growth expectations lower over FY19-FY21. We prefer large-caps over mid-caps. The faster growth shown by select mid-caps is a case of 'rising tide lifting all boats', a smaller base and lower exposure to legacy services. But as digital demand shifts from the front to back, we believe that traditional large Indian companies will be in a better position to capture the market. We would advise investors to focus on sustainability and not overpay for a riskier business model - some companies have seen client concentration rising over the past two years.

Exhibit 3: P/E charts

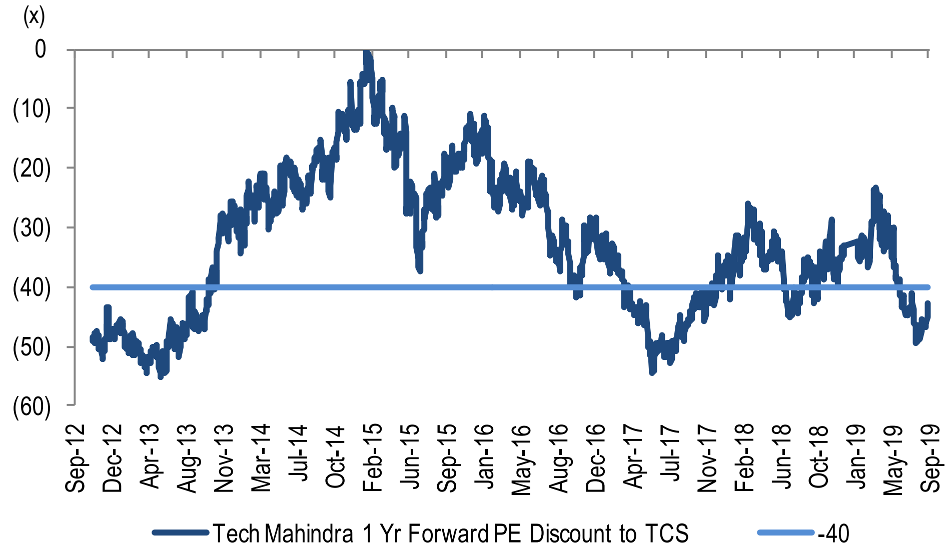


Source: Company, Nirmal Bang Institutional Equities Research



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: P/E premium/ (discount) to TCS



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Comparative valuation

	TCS	Infosys	Wipro	HCL Tech	Tech Mahindra	Mindtree	Persistent
Year Ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 06-Sep-19	**2,198**	**840**	**252**	**1,100**	**722**	**686**	**570**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rs Bn)	8,413	3,652	1,244	1,492	636	113	46
(US$mn)	116,851	50,719	17,283	20,727	8,838	1,576	633
March 2020 Target Price	1,601	596	212	1,127	544	531	602
Upside/(downside)	-27.2%	-29.0%	-15.9%	2.4%	-24.7%	-22.5%	5.6%
Recommendation	Sell	Sell	Sell	Accumulate	Sell	Sell	Accumulate
FDEPS (Rs)							
FY18	67.0	32.5	16.8	62.9	42.8	34.6	40.4
FY19	83.1	36.0	18.6	73.5	48.1	45.8	44.1
FY20E	94.8	38.4	17.7	78.5	49.9	45.4	46.8
FY21E	97.0	40.1	18.3	85.4	54.9	53.7	56.1
PE (x)							
FY18	32.8	25.9	15.0	17.5	16.9	19.8	14.1
FY19	26.5	23.3	13.6	15.0	15.0	15.0	12.9
FY20E	23.2	21.9	14.2	14.0	14.5	15.1	12.2
FY21E	22.7	20.9	13.7	12.9	13.1	12.8	10.2
EV/EBITDA (x)							
FY18	24.8	15.6	13.1	12.0	11.3	15.3	9.1
FY19	20.0	14.2	10.4	10.0	7.9	10.6	6.5
FY20E	18.8	13.5	9.4	8.8	7.6	9.6	6.3
FY21E	17.9	12.5	9.0	7.9	6.5	8.2	4.7
EV/Sales (x)							
FY18	6.6	4.2	2.4	2.7	1.7	2.1	1.4
FY19	5.5	3.6	2.0	2.3	1.4	1.6	1.1
FY20E	5.0	3.4	1.8	2.0	1.3	1.4	0.9
FY21E	4.7	3.1	1.7	1.8	1.1	1.3	0.8
Pre Tax ROIC (%)							
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19	61.8	47.5	30.4	36.3	37.9	46.4	44.2
FY20E	60.2	46.8	35.8	33.0	36.3	43.7	41.0
FY21E	61.7	45.3	36.8	31.9	37.2	51.9	52.2

Source: Bloomberg, Nirmal Bang Institutional Equities Research

Financials

Exhibit 6: Income statement

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Average INR/USD	**67.0**	**64.5**	**69.9**	**71.9**	**74.6**
Net Sales (US$m)	**4,351**	**4,771**	**4,971**	**5,313**	**5,488**
-Growth (%)	***7.8***	***9.6***	***4.2***	***6.9***	***3.3***
Net Sales	**291,408**	**307,730**	**347,421**	**382,558**	**409,124**
-Growth (%)	*10.0*	*5.6*	*12.9*	*10.1*	*6.9*
Cost of Sales & Services	205,661	215,299	233,590	267,893	288,321
Gross Profit	85,747	92,431	113,831	114,665	120,804
% of sales	*29.4*	*30.0*	*32.8*	*30.0*	*29.5*
SG& A	43,904	45,261	50,463	49,629	50,588
% of sales	*15.1*	*14.7*	*14.5*	*13.0*	*12.4*
EBITDA	41,843	47,170	63,368	65,036	70,216
% of sales	*14.4*	*15.3*	*18.2*	*17.0*	*17.2*
Depreciation	9,781	10,849	11,292	13,027	13,631
% of sales	*3.4*	*3.5*	*3.3*	*3.4*	*3.3*
EBIT	32,062	36,321	52,076	52,009	56,585
% of sales	***11.0***	***11.8***	***15.0***	***13.6***	***13.8***
Interest expenses	1,286	1,624	1,332	1,688	1,414
Other income (net)	7,776	14,093	5,342	8,853	9,438
PBT	38,552	48,790	56,086	59,174	64,610
-PBT margin (%)	*13.2*	*15.9*	*16.1*	*15.5*	*15.8*
Provision for tax	10,021	10,925	12,544	14,427	15,506
Effective tax rate (%)	*26.0*	*22.4*	*22.4*	*24.4*	*24.0*
Minority Interest	389	-136	120	258	208
Net profit	**28,119**	**38,001**	**42,767**	**43,961**	**48,295**
-Growth (%)	*-9.8*	*35.1*	*12.5*	*2.8*	*9.9*
-Net profit margin (%)	*9.6*	*12.3*	*12.3*	*11.5*	*11.8*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Balance sheet

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Equity capital	4,388	4,417	4,437	4,350	4,350
Reserves & surplus	159,984	184,011	198,407	226,977	258,666
Net worth	164,372	188,428	202,844	231,327	263,016
Minority Interest	4,641	5,091	4,777	4,708	4,708
Other liabilities	18,905	18,246	18,441	18,810	18,810
Total loans	8,818	13,440	5,095	9,136	8,172
Total liabilities	**196,736**	**225,205**	**231,157**	**263,981**	**294,706**
Goodwill	26,279	27,727	28,163	28,139	28,139
Net block (incl. CWIP)	42,051	50,896	45,212	39,189	31,558
Investments	6,802	15,116	12,050	11,276	11,276
Right of Use Asset				9,441	9,441
Deferred tax asset - net	2,674	5,766	6,091	6,436	6,436
Other non-current assets	19,594	23,797	26,934	31,631	30,553
Other current assets	21,571	19,623	26,770	30,104	29,078
Debtors	53,377	64,979	69,586	83,045	80,215
Loans & Advances	33,608	30,917	29,425	39,446	38,102
Cash & bank balance	54,098	64,892	89,486	95,518	136,366
Inventory	611	659	752	829	829
Total current assets	163,265	181,070	216,019	248,942	284,590
Total current liabilities	63,929	79,167	103,312	111,073	107,287
Net current assets	99,336	101,903	112,707	137,869	177,303
Total assets	**196,736**	**225,205**	**231,157**	**263,981**	**294,706**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Cash flow

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
EBIT	32,062	36,321	52,076	52,009	56,585
(Inc.)/dec. in working capital	(9,120)	8,227	13,790	(19,131)	1,415
Cash flow from operations	22,942	44,548	65,866	32,878	58,000
Other income	7,776	14,093	5,342	8,853	9,438
Depreciation &amortisation	9,781	10,849	11,292	13,027	13,631
Financial expenses	(1,286)	(1,624)	(1,332)	(1,688)	(1,414)
Tax paid	(10,021)	(10,925)	(12,544)	(14,427)	(15,506)
Dividends paid	(9,048)	(14,835)	(14,900)	(18,599)	(20,476)
Net cash from operations	**20,144**	**42,106**	**53,724**	**20,045**	**43,674**
Capital expenditure	(19,449)	(21,142)	(5,608)	(7,004)	(6,000)
Net cash after capex	695	20,964	48,116	13,041	37,674
Inc./(dec.) in debt	(145)	3,963	(8,150)	4,410	(964)
(Inc.)/dec. in investments	18,498	(15,609)	(396)	(4,268)	1,078
Equity issue/(buyback)	(451)	29	(19,560)	(87)	-
Cash from financial activities	**17,903**	**(11,617)**	**(28,106)**	**55**	**114**
Others	(4,637)	1,447	4,584	(7,064)	3,061
Opening cash	40,138	54,098	64,892	89,486	95,518
Closing cash	54,098	64,892	89,486	95,518	136,367
Change in cash	13,960	10,794	24,594	6,032	40,849

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 9: Key ratios

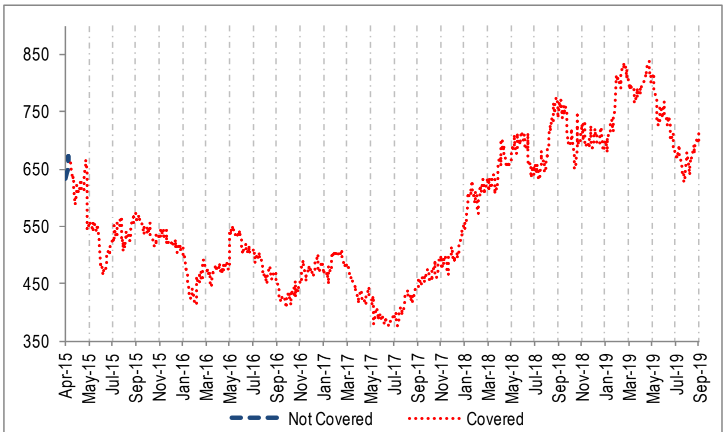
Y/E March	FY17	FY18	FY19	FY20E	FY21E
Per Share (Rs)					
FDEPS	31.7	42.8	48.1	49.9	54.9
Dividend Per Share	8.8	14.5	17.5	18.2	20.0
Dividend Yield (%)	1.3	2.1	2.6	2.7	2.9
Book Value	193	221	238	271	308
Dividend Payout Ratio (%. Incl DDT)	32.2	39.0	34.8	42.3	42.4
Return ratios (%)					
RoE	18.3	21.5	21.9	20.3	19.5
RoCE	17.3	17.2	22.8	21.0	20.3
RoIC	26.2	25.8	37.9	36.3	37.2
Turnover Ratios					
Asset Turnover	1.1	1.0	1.0	1.0	1.0
Debtor Days	67	77	73	79	72
Working Capital Cycle Days	57	44	24	40	37
Valuation ratios (x)					
P/E	20.9	15.5	13.8	13.3	12.1
P/BV	3.6	3.1	2.9	2.5	2.2
EV/EBITDA	12.9	11.3	7.9	7.6	6.5
EV/Sales	1.8	1.7	1.4	1.3	1.1
M-cap/Sales	2.0	1.9	1.7	1.5	1.4

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
13 April 2015	Sell	660	593
28 May 2015	Sell	549	511
19 June 2015	Sell	541	470
28 July 2015	Sell	520	470
28 September 2015	Sell	567	474
4 November 2015	Sell	557	472
15 December 2015	Sell	543	471
8 January 2016	Under Review	522	-
2 February 2016	Under Review	497	-
14 March 2016	Sell	459	395
25 May 2016	Sell	480	409
21 June 2016	Sell	544	421
3 August 2016	Sell	499	400
28 October 2016	Sell	414	385
10 January 2017	Sell	473	368
31 January 2017	Sell	472	383
14 February 2017	Sell	500	388
7 March 2017	Sell	501	408
29 May 2017	Sell	429	403
21 June 2017	Sell	395	367
1 August 2017	Sell	385	360
28 September 2017	Sell	447	358
2 November 2017	Sell	478	387
11 December 2017	Sell	496	426
26 December 2017	Under Review	493	-
30 January 2018	Under Review	605	-
17 March 2018	Accumulate	635	608
28 May 2018	Accumulate	703	721
3 July 2018	Accumulate	655	716
31 July 2018	Accumulate	658	718
5 October 2018	Buy	696	845
31 October 2018	Accumulate	685	731
27 November 2018	Accumulate	695	731
27 December 2018	Sell	695	590
7 January 2019	Sell	681	525
6 February 2019	Sell	751	561
19 March 2019	Sell	789	587
6 June 2019	Sell	750	562
31 July 2019	Sell	641	535
9 September 2019	Sell	684	544

Rating track graph



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Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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