

# “Tech Mahindra Call on Acquisition of Target Group Conference Call”

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**Moderator:**

Ladies and Gentlemen, Good Day and Welcome to Tech Mahindra Call on acquisition of Target Group. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing '\*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I now hand the conference over to Mr. Vivek Agarwal. Thank you and over to you, sir.

**Vivek Agarwal:**

Thanks, Zaid. Good evening and Good morning, wherever you are. And appreciate you all for joining the call at a short notice and we recognize it is Friday evening. On the call along with me is Manoj Bhat, who a lot of you will know well, our Deputy CFO and Vikas Jadhav who is the head of Investor Relations for us. I will quickly do a preamble of the deal and then take any questions which you may have.

So, earlier today we have announced the acquisition of 100% stake in Target Group. Target Group is a leading processing platform provider to the UK BFSI organizations. Target provides the services and solutions to over 50 financial institutions across the globe. The fintech platform from Target manages assets in excess of £24 billion enabling clients to automate complex and critical processing, servicing and administration of financial and insurance products. The company typically enters into multi-year long-term contracts with their customers ranging from 3 to 10 years. We have TechM have, as we have articulated in our strategy in the past about expanding our fintech and BFSI capabilities by adding IT and platform to our capability set and our capability portfolio. Target's proprietary platform helps deliver high quality services and compliance in a high complex and regulated environment. The acquisition will enhance our capability to capture a larger share of the approximately GBP50 billion annual spend by the BFSI sector in the UK. We do believe that Target's IP and capabilities will play a critical role in the evolving fintech ecosystem where unbundling of conventional banking institutions places Target's platform and capabilities at the heart of this aggregation.

A little bit about the business from Target. Target has had an impressive 20% + CAGR revenue growth in the past three years and has an overall profitability which is comparable to Tech Mahindra. Our expectation is that Target will continue to deliver its growth rate which is above our organic growth rate targets and objectives. And given the business model, it's a business process as a service (BPaaS) based on a platform we do expect non-linear leverage as we get more clients and more volumes on to the platform.

We do expect synergies over and above Target's growth trajectory, we are fairly confident of leveraging Target's platform capabilities across markets outside of the UK within continental Europe and other emerging economies. We also see a potential of taking the capabilities to existing and potential customers of Tech Mahindra. We also do see significant cross-selling opportunities of the wider TechM portfolio of services into the Target existing customer base.

Along with the company, we have an absolutely brilliant and accomplished management team which currently runs the company which will continue with the organization and we look forward to them joining the wider leadership of the organization.

Just moving on to a little bit of the deal dynamics and the deal details on the transaction. The transaction is based on an enterprise value of GBP 112 million, plus surplus cash adjustments. Tech Mahindra is acquiring 100% of the equity in Target and the way the deal is structured is, there is an upfront payment of approximately GBP 82 million out of the GBP 112 million, there are some debt-like items on the books which takes the upfront consideration to about GBP 91 million. There is a deferred payout of up GBP 16.3 million which is linked to the actual performance for fiscal 2016, which is the calendar year 2016. And additionally, on top of it, the management team which will stay with the business and be operationally be responsible for the business, have rolled in 7.6% of their equity stake in the company which essentially means that they have demonstrated their commitment to the business and the future growth potentials of the business by rolling over 7.6% of their equity stake in the company which will be paid in 2020 and linked to the performance of the company over the periods 2017 to 2019.

The deal is subject to regulatory approvals, the Target business is governed by FCA regulations in the UK, so we would have to go through a process of a change of control and a change of controller application to consummate the deal.

With this, I will open the floor for any questions you may have.

**Moderator:** Thank you very much, sir. Ladies and Gentlemen, we will now begin with the question-and-answer session. Our first question is from the line of Sagar Rastogi from Ambit Capital. Please proceed.

**Sagar Rastogi:** Who are the competitors that you typically encounter in this business?

**Vivek Agarwal:** So the typical competitors in this business would be specialized firms, who handle asset books for either banks or large financial institutions. They would be niche services companies in all markets, since it is a regulated offering these are typically smaller companies among the larger players in the UK, Capita would be a competitor for this business, there would be parts of organizations like Computer Shares which would do their specialized servicing, but largely it will be niche small players which constitute this market. And a lot of the servicing in this space is still significantly in-house and especially large institutions.

**Sagar Rastogi:** And sorry for my ignorance, but is TCS's Diligenta operations sort of similar to this or that is different? I mean they pick up closed book for insurance companies.

**Vivek Agarwal:** Similar, I there is a little bit difference around capabilities of the platform but similar is probably an appropriate description. And so this was different asset classes largely in lending products, structured investment products, but from a functionality perspective yes it would be similar. From a

strategy perspective, this business does a very judicious mix of open book and closed book, so this is not only a closed book business. You do get parts of the business are in the origination space which is typically a growth business because closed books have a tendency to run off over a period of time. So this has a mix of the two.

**Sagar Rastogi:** One last thing, sorry I did not hear this part clearly, you talked about a 7.6% stake being rolled over till 2020, could you just repeat that?

**Vivek Agarwal:** So the management team which was saying that the business, they had equity in the company and the company was private equity owned but they had stake in the company, a part of it is being cashed out upfront and through the first deferred payout and linked to the current year performance. But on top of it, they are rolling over 7.6% of their equity in to the company to be paid out in 2020 linked to the performance of the company. So that is their commitment towards the future of the business.

**Sagar Rastogi:** And so right now you have effectively acquired 92.4% of the company for the GBP112 million, is that correct?

**Vivek Agarwal:** No, the equity value is less than GBP 112 million, so 7.6% of that is not being paid so it is equity value which is about GBP 7 million for the 7.6%, that is not being paid to the management team right now, it will only get paid linked to the performance of the value. We have acquired 100% of the shares of the company, we have converted that 7.6% share as a deferred consideration instrument for them to be cashed out in 2020.

**Moderator:** Thank you very much. Our next question is from the line of Ankur Rudra from CLSA. Please proceed.

**Ankur Rudra:** Could you clarify the growth in the business appears to being a bit volatile, it grew at about 12% in CY13 and every sharply in 2014 and then slowed down to 11% last year, so is that due to any particular nature of customer on-boarding, and also what do you feel is the long-term growth potential from here in the existing business?

**Vivek Agarwal:** So you are correct Ankur, the nature of business is that it tends to be lumpy, is when you land a big contract at a big book which you end up managing you would see a certain spike in revenue, and hence the lumpiness. But as you would have noticed, the last three year CAGR has been 22% and from going forward perspective given the pipeline, given the books and the business and the contracts the business has currently, our view is it would grow above what we would call the Indian IT industry growth rate, it would grow about 5% to 7% above Indian IT industry growth rates. So we would be looking at between 18% and 20% growth rates.

**Ankur Rudra:** And in terms of margins it has improved dramatically in the last two or three years, is this a function of scale and do you think as it scales up in the region you mentioned 18% to 20% we will see further operating leverage in the business?

- Vivek Agarwal:** So I think maybe a little bit of history, would explain how the business has performed over the last three, four years. The improvement has been on two or three counts, one is just good operational management, secondly the business has moved to being a platform business process as a service provider which probably gives it a greater share of the profit pool. And sorry, you had a third question, do I expect leverage going forward?
- Ankur Rudra:** Yes.
- Vivek Agarwal:** So I think from a size of scale of the company, that company is GBP 51 million in revenue clearly has a very good and strong management team. We clearly see leverage both from the management team being able to grow the business as well as there has been significant platform investments which have already been made. So every time we do get incremental work on the platform we do see that opportunity, yes.
- Ankur Rudra:** The question is more in terms of, given it is a platform, and maybe you can help us understand what proportion is pure BPaaS versus services which is linear. So with a non-linear platform and with growth of the region you mentioned around 18% - 20%, one would expect profitability to increase. Is that a fair expectation?
- Manoj Bhat:** Ankur, clearly when the internal goals and the internals are announced, are based on the margin improvement, exactly on that logic it is a platform as the scale up happens we do believe the margins will go up and the management team's earn-outs are based on that. So clearly that logic works what you said, yes.
- Ankur Rudra:** And the split of BPaaS nature of the work was a services because it seems like it is a relatively old company.
- Vivek Agarwal:** So it is relatively old company but clearly the business is pivoted about three to four years ago, so that has been the significant change in the business in the last three, four years. So, about half the revenues of the business come from a pure BPaaS offering.
- Ankur Rudra:** Just last question, you mentioned GBP 112 million and then GBP 8 million cash, so the adjusted EV is GBP 114 million or is it GBP 112 million adjusted for the cash on books you mentioned?
- Vivek Agarwal:** No, it is GBP 112 million plus GBP 8 million for the cash adjustments.
- Ankur Rudra:** So then effective EV would be GBP 104 million?
- Manoj Bhat:** No Ankur, zero debt zero cash EV is GBP 112 million that is what we are saying.
- Ankur Rudra:** So GBP 8 million you just mentioned, effectively it is GBP 112 million, that is the number we should go with?

**Vivek Agarwal:**

Yes.

**Moderator:**

Thank you very much. Our next question is from the line of Ananta Narayan from Credit Suisse. Please proceed.

**Ananta Narayan:**

Just wanted to clarify one thing, I think in the opening comments you mentioned that the profitability of this company is similar to that of Tech Mahindra, at least based on some public data the profitability seems to be fairly much lower at least in 2014. So did the things turnaround in 2015?

**Vivek Agarwal:**

So Ananta, that is correct, as I said the company has been on a pivot mode for the last three years and there has been a reasonable growth, it was early teens in 2015 on adjusted basis and we are saying high teens for the current year, that is where we are currently. And then as we discussed previously, we do see operating leverage from the platform.

**Ananta Narayan:**

And the reference to the high teens is EBIT margins I guess, right?

**Vivek Agarwal:**

EBITDA.

**Ananta Narayan:**

And just one final question, when can we expect this to get consolidated?

**Vivek Agarwal:**

So we are filing for FCA approval for change of control, the FCA process in the UK is typically 60 working days so I would assume some time in Q2 of our fiscal year, so in the July to September quarter is where I think we would expect to close the deal.

**Moderator:**

Thank you very much. Our next question is from the line of Sandeep Agarwal from Edelweiss Securities. Please proceed.

**Sandeep Agarwal:**

Manoj, I have two, three question for you. One, if you go by our past experience of acquiring, we generally do not pay this kind of valuation, if I am not wrong it is almost more than two times of the current revenues. Also, when we do some acquisition, not always 100% of the business fits us. So is there some indication of how much of this business will perfectly fit us and how much may have a chance that we have to chop off in future? Also, if you work out the current numbers then it looks like a much, much expensive acquisition at 18 times, 19 times, although it is very-very small in our scheme of things. So are you seeing great opportunity in next two years or you are seeing some strategic fit or what is the kind of rationale you have gone behind this deal which makes this expensive acquisition also very important for us?

**Vivek Agarwal:**

So can I answer the second question, strategic fit and then Manoj can answer the first part of the question?

**Sandeep Agarwal:**

Yes, sure please.

**Vivek Agarwal:** I think from a strategic fit perspective, I think all of this, the entire revenue line of the business is a very good fit into our portfolio, so I do not see that as being a challenge at all.

**Manoj Bhat:** So Sandeep, just adding on to what Vivek mentioned, clearly if I look at how we are approaching, so let me backup a bit. If you look at the M&A strategy we said BFSI and healthcare, two top priorities. From our perspective, in BFSI I do not think we are looking that much at direct ADMS competing with some of the larger players. We are going to go through with offerings which are not directly what would be mainstream kind of offerings and then hoping to enter through that and then build through that, that has been our broad strategy. Now your question on valuation, so as I see it the run rate of the business this year, I think the way we are looking at it will be sub 10x acquisition this year and that is I grant you a bit more expensive, so for example in some of other acquisitions we have typically paid about 7x. So in this case it is probably closer to 9x to 10x. So that is the kind of metrics

**Vivek Agarwal:** I think I can try and conclude the response from Manoj, because I think Manoj is travelling, apologies. So I think Sandeep, the deferred payout for 2016 performance on way the business performs, the EV to EBITDA multiple on current year which is calendar year 2016 will be between 8.5 and 10. So not sure, and we can have an offline conversation along with Vikas about 19, 20 times. But that is the number change we are looking at on 2016 performance for the business.

**Moderator:** Thank you very much. Our next question is from the line of Sandeep Shah from CIMB. Please proceed.

**Sandeep Shah:** Just wanted to understand more than 50 clients, so largely the Tier-I logos, how is this split here?

**Vivek Agarwal:** So I think Sandeep you have had a chance to see the press release which we have done, so there is a mix of clients which like any other business of this size. There are some very large marquee names which are large asset managers where Target helps provide solutions and services for them. There are a set of clients where Target does have smaller license based agreements around the technology and the platform, they would typically be smaller in revenue but there would be about eight or 10 key clients which give the company a substantial part of its revenue and these are big marquee asset managers.

**Sandeep Shah:** So is it possible to give us the number for the top 10 client contribution?

**Vivek Agarwal:** I do not have it, can we just get back to you, I can take a quick guess but it may not be...

**Manoj Bhat:** Sandeep, my suggestion is, I think let's wait till we finish the deal and we will give some of it in detail. I think this call was more to give you a flavor of the strategy and what are the high level terms. As we go in, because I think there are some steps here in terms of trying to close the deal in the next three four months and after that we will disclose in more detail.

**Sandeep Shah:** And second, I think we said that cross selling of these services would be more towards continental Europe and the emerging markets. So I do agree that the regulations in the US could be slightly different than what is here, but is it fair to say that these services have to be modified significantly, platform has to be modified significantly to bring it to US?

**Vivek Agarwal:** So the good thing about the platform is that it complies to FCA requirements which all of you on this call will know is one of the benchmarks on regulation. But US, I think the industry works in a different way, the structure of the industry is different and in other jurisdictions it will need modifications, we completely agree with you. But given that, this caters to an FCA regulated environment, we see the onus or requirements being typically lower but at the same time they may be different and so it will need some modifications etc. Continental Europe is just because it has geographical proximity and we see that as a definitive market. The product or the technology from the company already works in some parts of the continent, just because the company has gone with their existing clients to help them and support them on the continent and hence that is a natural growth opportunity for the company.

**Sandeep Shah:** And Vivek, you said that there are eight to ten large marquee accounts, so is there any overlap with TechM or largely these are uncommon clients?

**Vivek Agarwal:** There would be overlap, yes, but that would be very different parts of the business, there is some overlap, I think of three of four large ones where there is overlap, but very different parts of the business I would say. The solutions, especially in the BPAS service from Target is typically sold to the business and it is not sold to IT or technology teams which is where we would typically be selling our services. A lot of our overlap will be in technology services to these clients in the US for the large asset managers and the big bulge investment banks whereas Target solutions will be on the business side in primarily the UK.

**Moderator:** Thank you very much. Our next question is from the line of Viju George from JP Morgan. Please proceed.

**Viju George:** I have three questions, one is that, looking at some of the offerings, are these piece meal offerings just add-ons or are these platforms are for end to end nature because I would think that the latter is trickier, that is question number one. Question number two us, when you mention your growth as 22%, is this entirely GBP growth, I am assuming the company's entire revenue base is GBP denominated? And third, when you take this product to the other markets assuming for a moment if you see potential, is it an easy thing to do because TCS has been probably not as successful in taking its platforms to other market given the regulatory constraints are so different across markets. Thank you.

**Vivek Agarwal:** So Viju, I will try and answer one by one your questions. So whether the product or the product suit supports end to end, and I think the product is fairly modulus, the BPaaS offerings on a number of



asset classes supports the entire process end to end right from origination to full lifecycle servicing and support and the company does this for large institutions, asset managers as well as new age fintech companies which essentially focus on online origination, but they need support and help to manage the asset books and technology support and operations support for that. At the same time there are customers in the company's portfolio which only do buy parts of the value chain, and I totally agree with you, the more breadth it is more stickier. But on the question of stickiness, most of the clients, even if they are buying part of the service as BPaaS, are fairly long-term contracts.

To your second question that it is all GBP growth, yes 98% of the revenue of the company comes from the UK, so it is GBP growth.

And the last part of your question was around product going to other markets, so I think we do recognize that there will be needs to change and modify and in our assumption and our plans we have clearly looked at providing for some bit of it. And the other thing which we do see is that Target as standalone entity did not have the resources or the scale to be able to reengineer and custom fit this product for different markets. So we have done some early assessments with some of our customers and there has been definitely interest in the service offering, but it will take some doing to reengineer the product for different markets.

**Viju George:**

I have one more question, when you look at system integration around this, is there any dominant system integrator, typically what might be the ratio, if you are saying GBP 51 million of contracts, how much would be system integration in this and there will be other system integrators feeding of the core platform, I would imagine. So is there a chance for you down the road to displace those system integrators who may be actually implementing this across so where the part of your math going forward, could you just share some light on that?

**Vivek Agarwal:**

So system integration per say, when the company does BPaaS offerings there is a thumb rule which I have learnt in this business, about one year of revenue is spent on onboarding a customer which involves system changes, data migration and stuff like that which is what a typical SI would do. Now on top of it, there is more surround activities, so things like when you start looking at integration and portals and things like that, I would imagine it will vary on the type of customer but between 0.5 to 2 times is what I would think. And 0.5 would be the asset managers who do not really want to do anything but run their book and do minimal stuff around it. But if it is a full service bank, it will need far more system integration around it if this forms a core part of their offering.

**Viju George:**

So I am just thinking that there might be other system integrators who may be doing this who you would probably be able to displace down the road given your downstream system integrations skills, is that part of the math as well because I would think that is also part of the calculation giving the way other platform, players, consideration values have happened in the sector. So I am just thinking if that is also possibility?

- Vivek Agarwal:** Absolutely, and I think the possibility really lies in not only just around this platform, clearly we see a possibility for us going and offering the entire portfolio of TechM services and offerings into the customer base. So together clearly the number that I was talking about, 18% to 20% growth rate is more or less standalone, but there is a significant synergy opportunity on top of it.
- Moderator:** Thank you. Our next question is from the line of Rishi Jhunjhunwala from Goldman Sachs. Please proceed.
- Rishi Jhunjhunwala:** Just wanted to understand, I guess you guys are keeping the entity separate, right, so there are not exactly any kind of integration issues or anything of that sort that should come up, it is going to be purely a consolidation from an accounting perspective?
- Vivek Agarwal:** So the business will run standalone, that is correct, that is our intention but clearly over the next few months we will work with the management team and the wider leadership at TechM to define a lot of it in detail. The way we are looking to exploit on synergies is put a core team who know TechM, understand the TechM ecosystem offerings and embed them working for and with the management team of Target to bring about the synergies. So that is the early thoughts on how we see this operationally. We clearly see the ability of target to go and chase bigger opportunities with a longer term mindset which as a standalone 50 million business they were not able to bid for the larger opportunities, or opportunity which had extremely large sales cycles etc. So I think that is what we expect to change with this team which will get embedded into the operational team at Target.
- Rishi Jhunjhunwala:** And the other thing is, just wanted to understand the relationships with some of these financial services, banks and companies and banks. You have mentioned some of them in the press release, I am assuming that considering that you said that most of the business is based out of UK and there are a lot of these global banks that you have mentioned, so I am assuming the relationship would be primarily with the regional offices or the businesses rather than having a connect with their global teams on the technology or the business side.
- Vivek Agarwal:** So Rishi, clearly London is a big center, so a lot of the European businesses run out of London, so a lot of the business the company does today is with the business side of it, so it is not with IT, you are correct on that for especially the large asset managers and it is UK and Europe centric currently. And as I said, there are two issues I think we will have to solve, one is, the difference in regulation and different markets as we go out and then second is that we probably need to overcome two challenges and work around them, one is, when we try and go to other markets like the US, we will have to work around regulation and market structure which may be different in different markets. And then secondly, how can we leverage the good work we are doing for these institutions in the UK and European geography and extend it over to different markets and that is an ongoing activity we will definitely need to undertake.

**Rishi Jhunjhunwala:** Because I was more asking it from a perspective of cross selling and are there actually real opportunities and do you have real relationships which are deep enough to actually start having cross selling opportunities with the client base of Target?

**Vivek Agarwal:** So I would try and answer this question in two parts, and I think maybe at a little bit of color on the nature of clients and relationships is also important. So one category is clearly the kind of big banks which you work for and the opportunity there is to be able to do more deals because we only are scratching a part of the surface for banks of those kinds and with a larger footprint, larger franchise, a bigger organization behind it we can try and address bigger portfolio and more opportunities there. Then there is the kind of clients, the second category I would put is which are specialist lenders and banks in the local UK market and we have mentioned Shobrooks and Yorkshire Building Society etc. Now these are core offerings where the company would have essentially a CXO, CEO relationship, because they are critical to the entire business operations of that institution. And those would have a full range of cross selling, upselling opportunities is how I would think about it.

**Moderator:** Thank you very much. Ladies and Gentlemen, that was our last question due to time constraints. I now hand the conference over to Mr. Manoj Bhat for closing comments. Over to you, sir.

**Manoj Bhat:** Thank you. First of all, apologies, I am travelling so I could not participate fully on the call and I was interrupted. But clearly I think we have tried to answer a lot of the questions, I know there might be more questions, please route them through Vikas and then we will try to get them answered as soon as possible. Thank you so much for your interest and Thank you for attending the call so late on a Friday evening. Thank you so much.

**Moderator:** Thank you very much, Mr. Bhat and Mr. Agarwal. Ladies and Gentlemen, on behalf of Tech Mahindra, that concludes today's conference call. Thank you for joining us and you may now disconnect your line.

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