

Technology

Swap ratio is at par for MTCL's investors

One-month average price of LTI (A)	5,320
One-month average price of MTCL (B)	3,806
Number of shares of MTCL (in b) (C)	0.165
MTCL's valuation (INR b) (B)*(C)	627.9
Swap ratio	73/100
New number of shares of LTI (b) (E)	0.120
MTCL post-merger (INR b) (E)*(A)	638.4
Premium/(discount) for MTCL	2%

LTI-Mindtree merger: Long-term synergies offset by near-term risks

Top management stability at LTI remains key

L&T announced the merger of L&T Infotech (LTI) and Mindtree (MTCL), its two IT Services subsidiaries, on 6th May'22. The combined entity will be known as 'LTIMindtree' and will be led by Mr. Debashis Chatterjee, MTCL's current CEO. LTI's CEO Mr. Sanjay Jalona has resigned, and his last working day will be decided mutually. With L&T having majority holding in both companies (74%/61% in LTI/MTCL), we expect the shareholder approval process to be smooth. Key takeaways from the merger are as follows:

Complimentary verticals position the combined entity well

- We see the complementary vertical presence at LTI and MTCL as one of the key long-term benefits for the combined entity. While LTI generates 47% revenue from BFSI (18% of MTCL's revenue), Technology (including Communications and Media) dominates (43%) at MTCL (12% of LTI's revenue). This concentration will moderate after the merger, as BFSI/Technology will fall down to 35%/25%.
- The merger will reduce MTCL's exposure to its top client to 10% from 25%, significantly lowering the top client's concentration risk at the combined entity.
- Complementary strengths also lower the risk of friction at the vertical leadership level and makes it easier to merge the two different organizations.

Scale brings access to larger deals

- LTIMindtree will be the sixth largest Indian IT Services company by revenue (USD3.5b) and fifth in terms of market capitalization (USD17.7b on a current combined m-cap). This should improve its ability to be invited to bid for deals sized more than USD100m as compared to one-off cases at present.
- But with the deal environment is currently dominated by smaller deals, the larger entity will need to be careful about reassuring clients on maintaining its current level of focus. Any change in focus away from smaller deals can impact the near-term growth of the entity.

Leadership attrition at LTI the key risk

- We view the departure of Mr. Jalona as a key concern for LTI as he has been the key architect of its growth over the last seven years since he joined as CEO. Given his long tenure, he has built a leadership team and has a reputation of close coordination.
- While Mr. Chatterjee has done exceptionally well in retaining and rebuilding MTCL after its founding team exited the company, we will watch out for any exits at LTI, which can have a bearing in the near term.

Strong demand environment to cushion near-term distractions

- We see the timing of the merger as opportune as the demand environment remains supportive. LTIMindtree should be able to absorb any near-term volatility due to the leadership's focus on integration or departure in any vertical.

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Swap ratio neutral for both companies

- The deal involves the merger of MTCL into LTI and the issue of new LTI shares to MTCL's shareholders. The swap ratio of 73 LTI shares for every 100 MTCL shares is Neutral to both companies at the current share price (Exhibit 1).
- This will result in the issuance of 120m new LTI shares (allocated to MTCL's shareholders) and a 41% dilution for LTI's shareholders.
- The expected timeline for deal closure, post shareholder and regulatory approvals, is nine-to-twelve months. During this period, both companies will operate as independent entities and will have limited coordination with each other. Hence, we are not changing our estimates for either company.

View

- We retain our Neutral rating on both stocks as we see near-term risks offsetting the long-term opportunity accruing from the larger entity. We see the share prices fairly factoring in a supportive demand environment. Hence, we are not changing our TP on LTI (INR5,710) and MTCL (INR4,230).

Key highlights from the management commentary

- The merger will usher the necessary scale and capabilities required to mine larger clients and win larger deals.
- With this merger, the combined entity will become the fifth most valuable IT Services company in India.
- The merger benefits include: 1) complementary service offerings and an expanded services portfolio, 2) edge while bidding for large deals, 3) improved pricing, 4) cross-selling opportunities, 5) higher cash pool for acquiring IPs and pursuing M&A opportunities, 6) a bigger and diversified headcount pool, and 7) geographic exposure.
- The management feels attrition should not be an issue as the combined entity will provide bigger opportunities to employees.
- It expects cost synergies on account of lower SG&A and infrastructure expenses.
- There are significant revenue synergies as there is a minimum overlap in clients and there will be a good amount of cross-sell and up-sell opportunities. The combined entity will be in a better place to win large contracts.
- There is huge demand for Cloud adoption, and the merger will provide the required capabilities to tap multi-year demand.
- There is a huge opportunity for innovative deal structuring.
- The two entities already work together on some deals and are very much aware about each others style of functioning, so there should not be any integration issues. A cultural fit is also not a problem.
- On Mr. Jalona's departure, it said there is enough leadership bandwidth to deliver the targets set by the company.
- The timeline to close the transaction is nine-to-twelve months.

Exhibit 1: Swap ratio is at par for MTCL's investors

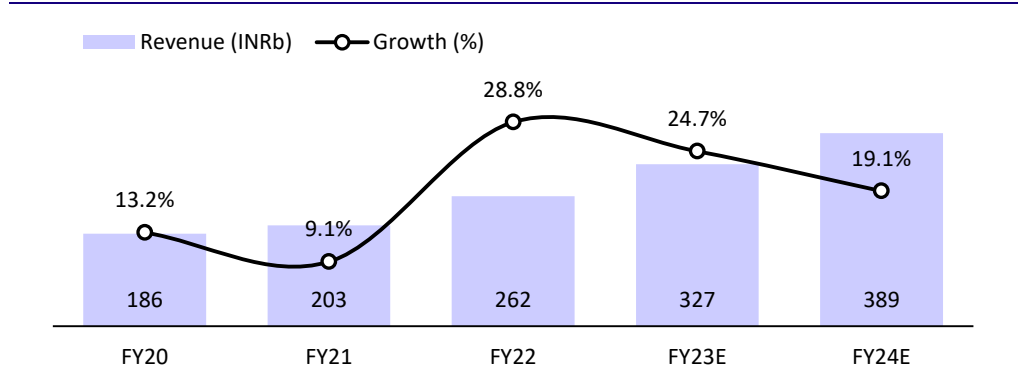
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Source: MOFSL, Company

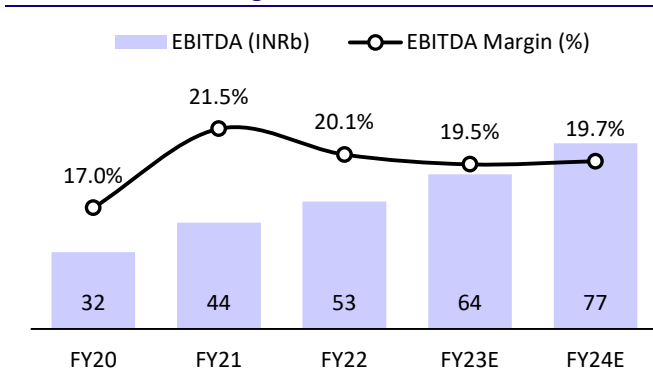
Exhibit 2: LTIMindtree's combined income statement (INR b)

Y/E March	FY19	FY20	FY21	FY22	FY23E	FY24E
Sales	164.7	186.4	203.4	261.9	326.6	388.8
Cost of Services	109.6	129.3	139.1	182.6	229.0	271.5
SG&A Expenses	25.5	25.5	20.5	26.8	33.9	40.8
EBITDA	29.5	31.7	43.8	52.5	63.7	76.5
As a percentage of Net Sales	17.9	17.0	21.5	20.1	19.5	19.7
Depreciation and Amortization	3.2	5.5	5.9	6.0	7.3	8.6
Other Income	3.8	2.1	2.4	6.5	7.3	8.7
PBT	30.1	28.3	40.3	53.1	63.7	76.6
Tax	7.4	6.8	10.4	13.6	16.5	19.8
Rate (%)	24.7	24.0	25.8	25.6	25.9	25.9
PAT	22.7	21.5	29.9	39.5	47.2	56.7
As a percentage of Net Sales	13.8	11.5	14.7	15.1	14.5	14.6

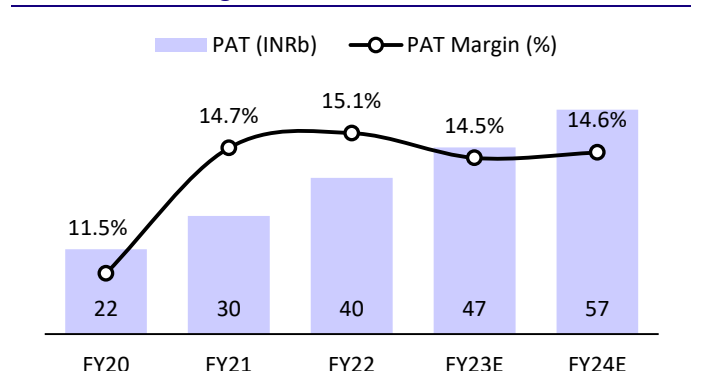
Source: MOFSL, Company

Exhibit 3: Revenue growth for LTIMindtree

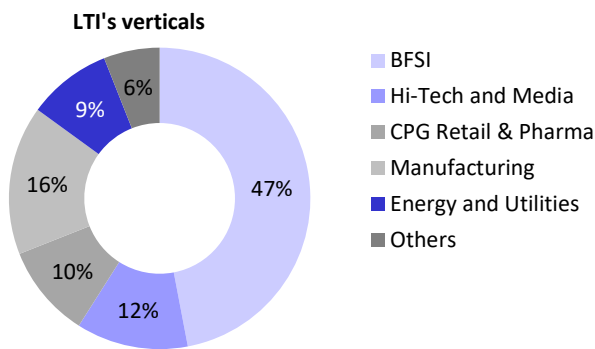
Source: MOFSL, Company

Exhibit 4: EBITDA margin trends for LTIMindtree

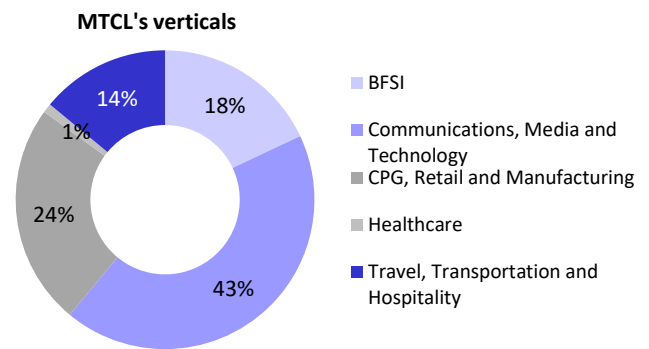
Source: MOFSL, Company

Exhibit 5: PAT margin trends for LTIMindtree

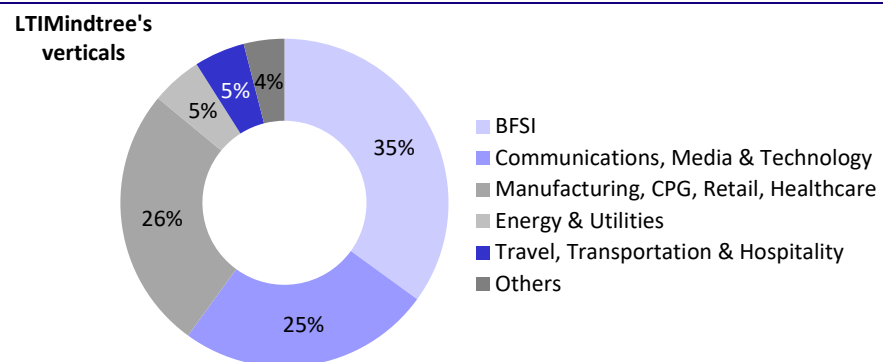
Source: MOFSL, Company

Exhibit 6: Both companies are complementary in vertical offerings

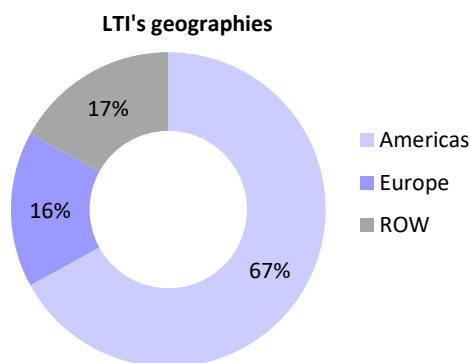
Source: MOFSL, Company



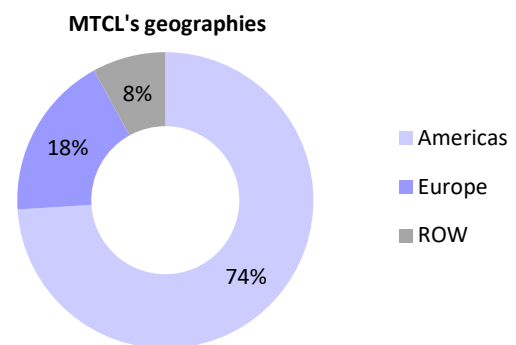
Source: MOFSL, Company

Exhibit 7: Combined entity will be more diversified

Source: MOFSL, Company

Exhibit 8: While regionally, they are broadly similar in nature

Source: MOFSL, Company



Source: MOFSL, Company

Exhibit 9: Promoter shareholding (%)

Promoter holding in LTI	74.1
Promoter holding in MTCL	61.0
Promoter holding in LTIMindtree	68.7

Source: MOFSL, Company

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Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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