

India Ratings Upgrades MindTree to 'IND AA+'; Outlook Positive; Off RWE

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By Priyanka Bansal

India Ratings and Research (Ind-Ra) has upgraded MindTree Limited's (MindTree) Long-Term Issuer Rating to 'IND AA+' from 'IND AA', while resolving the Rating Watch Evolving (RWE). The Outlook is Positive. The instrument-wise rating actions are as follows:

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating	Rating Action
Fund-based working capital limits	-	-	-	INR5,600 (reduced from 7,900)	IND A1+	Affirmed; off RWE
Non-fund-based limits	-	-	-	INR450*	IND A1+	Affirmed; off RWE

*Sub limit of fund-based limits

Analytical Approach: Ind-Ra continues to take a consolidated view of MindTree and its 100% subsidiaries MindTree Software (Shanghai) Co. Limited and Bluefin Solutions Sdn Bhd to arrive at the ratings. This is due to operational and strategic linkages among them, driven by similar business lines and common promoters.

The RWE resolution reflects the receipt of adequate clarity on MindTree's business and financial profile after the acquisition of 60.55% of its equity stake by Larsen & Toubro (L&T). The upgrade and Positive Outlook reflect the incorporation of the likely financial and/or operational support that MindTree could receive from L&T, if required.

KEY RATING DRIVERS

Acquisition of Majority Stake by L&T Complete: Effective 2 July 2019, L&T has become the parent of MindTree. Post the acquisition, there has been a churn in the top management team, and a part of the key leadership team is yet to be fully appointed. However, MindTree's management as well as L&T have indicated to Ind-Ra that there are no change in the policies, strategic direction and the long-term vision of the entity. Ind-Ra derives comfort from MindTree's robust operational and financial performance in 9MFY20, no major change in its customer base and the confirmation from its management that MindTree will continue to operate as a separate legal entity and will continue to deliver services to its clients.

Strong Linkages with Parent: L&T is a leading player in India's engineering and construction segment with presence in various sectors such as infrastructure, power, heavy engineering, electrical & automation, hydrocarbons, infrastructure development projects, information technology (IT) and technology services, financial services, etc. The contribution of IT & technology services in L&T's overall revenue and profitability has been increasing since the last few years. The strategic, operational and legal linkages between MindTree & L&T are detailed below:

- **Strategic Importance of MindTree to L&T:** L&T intends to increase the share of services business (including IT, technology services & financial services) in medium to long term as part of its value-creation strategy. Additionally, L&T's latest initiative L&T Nxt is intended to act as a bridge between its core engineering business and the new gen IT business. Moreover, L&T spent about INR100 billion in acquiring the 60.55% stake in MindTree, which represents around 4% of its total assets.
- **Strong Operational Linkage:** Both the companies have a common chairman and some common board of directors. L&T has also overhauled MindTree's treasury operations in line with the L&T Group's treasury philosophy. Additionally, the operational support for MindTree could also flow in the form of synergies with Larsen & Toubro Infotech Limited (LTI) – another IT subsidiary of L&T having minimal client overlap with MindTree – by joint bidding for projects. The operational support shall further strengthen if the L&T Group assists MindTree in terms of securing large deals.
- **Weak Legal Linkages:** L&T has not provided any explicit support to MindTree in terms of corporate guarantees and/or cross-default clauses with regards to the latter's debt (even though there was no bank debt outstanding at end-9MFY20). However, Ind-Ra derives comfort from the fact that L&T will fully consolidate MindTree in its financial statements, effective FY20, implying significant reputation risk, and MindTree can now leverage the superior financial flexibility and strong balance sheet of L&T, in case of any contingency. The legal linkages between the two entities will strengthen if L&T's shareholding in MindTree converges towards L&T's shareholding in LTI and the extension of any guarantee (financial or performance) by L&T to MindTree. Ind-Ra believes this will strengthen L&T's strategic intent to support MindTree.

Established Market Position Supported by Strong Digital Presence: MindTree's revenue growth rate from digital technology, which encompass cloud computing, artificial intelligence, machine learning and productised end-to-end solutions, is likely to pick up momentum in the next two-to-three years and will grow at a much faster pace than revenue from traditional offerings. The contribution of digital technology to MindTree's total revenue increased to 49% in FY19 from 43.5% in FY18; it stands at much higher proportion than the industry average of around 30%. This supports MindTree's strong market position in the sector.

Strong Revenue and Margin Growth in FY19; Margins Dipped in 9MFY20: MindTree's revenue grew 28.5% yoy to INR70.2 billion in FY19, supported by an uptick across all the segments and major geographies. However, revenue growth was softer (grew by around 10%) in 9MFY20 owing to a slowdown in banking, financial services and insurance (BFSI) and retail, consumer packaged goods (CPG), and manufacturing segments. EBITDA margins increased to 15.2% FY19 from 13.6% in FY18 owing to improved utilisations and currency depreciation. However, two rounds of compensation revisions and special compensation granted on the completion of MindTree's 20th anniversary took a toll on margins in 9MFY20 with them dropping to 12.9%. That said, margins have shown an improvement on a quarter-on-quarter basis in 2QFY20 and 3QFY20. The agency expects the momentum of revenue growth to continue in the next few quarters and believes the company will be able to generate revenue growth of 10%-12% yoy in FY20. Ind-Ra also expects the margins to recover from 3QFY20 levels, owing to the management's consistent cost efficiency efforts.

Strong Credit Profile: The company repaid INR3,000 million of its commercial paper during FY19 leading to debt at near zero level. Gross adjusted leverage (gross adjusted debt/EBITDAR) improved to 0.7x in FY19 from 1.2x in FY18. Due to no major capex plans in the near term, the gross adjusted leverage is likely to be at 0.8x or below in FY20, primarily due to operating lease rent capitalisation. While the agency has not factored in any major debt-funded acquisition in its assumptions, the company's head room to borrow remains comfortable.

Liquidity Indicator - Adequate: MindTree recorded cash and cash equivalent of INR10.6 billion at end-9MFY20 (end-FY19: INR9.4 billion) against nearly zero debt levels (other than lease obligations). The company's cash flow generation has been healthy and more than sufficient to meet capex and dividend payment requirements in the four years ended FY19. The company has always been generous in declaring dividends and engaging share buybacks. That said, despite declaring three rounds of interim dividends and one special dividend, Ind-Ra believes this will be funded through internal accruals in FY20. MindTree generated positive free cash flow (FCF) of INR2.2 billion on an average over FY16-FY19. In FY20, the agency expects the FCF to remain positive, even after factoring in an annual capex of INR2 billion. Furthermore, all the fund-based limits of the company remain unutilised, which can be used in case of any contingency.

Increasing Customer and Geographical Concentration: MindTree's top 10 customers contributed around 45.6% to revenues in 3QFY20 (3QFY19: 44.1%). Also, revenue contribution from the top client increased over the last few quarters and stood at 23.1% (nearly USD230 million annually) of the total revenue in 3QFY20. This is despite the company continuously adding new clients (seven new clients added in 3QFY20). Its geographic concentration has also increased, with revenue from the US increasing to 73% in FY19 from 69% in FY18. Although the company has a hedging policy in place and there is no increase in debtor days, Ind-Ra believes any major disruption at its top client or negative change in regulatory guidance could impact the overall performance.

Change in Hedging Policy: MindTree earns around 89.8% of its revenue from the US and Europe and incurs about 65% operating expenses in foreign currency. The company earlier had a hedging policy that enabled it to hedge 50% of its net cash accruals on a rolling three months basis. However, after the acquisition by L&T, MindTree has aligned its hedging policy with that of the parent and the company now enters into 36 months long-term contracts. No major foreign currency losses have been reported in the past four years by the company.

RATING SENSITIVITIES

Positive: Developments that could, individually or collectively, lead to a positive rating action include:

- the strengthening of linkages with L&T demonstrated by MindTree becoming an integral part of the overall IT segment of L&T such that all the three IT entities of L&T (Mindtree, LTI and L&T Technology Services Limited) operate in synergies with each other
- sustained revenue diversification and/or a substantial improvement in the scale and profitability supported by the continued demonstration of synergies between the other two IT entities of L&T

Negative: Developments that could, individually or collectively, lead to a negative rating action include:

- the weakening of MindTree's linkages with L&T and/or any weakness in L&T's credit profile
- a substantial reduction in the revenue and/or a meaningful decline in EBITDA margin; all on sustainable basis.
- any significant debt-funded acquisitions and/or higher-than-expected dividend payouts

COMPANY PROFILE

Incorporated in 1999, MindTree is a technology solution provider engaged in providing digital transformation and technology services to its clients globally. The company classifies its business into four verticals wherein the majority of the revenue is being contributed by Hi-tech and Media (FY19: 39% of the consolidated revenue) followed by retail, CPG and manufacturing (22%), BFSI (22%) and travel and hospitality (16%) contributing the remaining. The company's service offerings include digital, test engineering, package solutions, infrastructure management & tech support, application development & maintenance and product engineering. In FY19, MindTree derived 73% of its revenue from the US followed by Europe (19%), India (3%) and the rest of world (4%).

FINANCIAL SUMMARY

Parameters	FY19	FY18
Revenue (INR million)	70,215	54,628
EBITDA (INR million)	10,645	7,405
EBITDAR (INR million)	11,868	8,370
Interest expense (INR million)	29	169
Debt (INR million)	10	3,014
Cash & equivalents (INR million)	9,398	10,495
Adjusted leverage (x)	0.7	1.2
Source: MindTree, Ind-Ra		

RATING HISTORY

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (million)	Rating/Outlook	29 March 2019	16 October 2017	1 February 2017
Issuer rating	Long-term	-	IND AA+/Positive	IND AA/RWE	IND AA/Stable	IND AA/Stable
Fund-based limits	Short term	INR5,600	IND A1+	IND A1+/RWE	IND A1+	IND A1+
Non-fund-based limits	Short term	INR450	IND A1+	IND A1+/RWE	IND A1+	IND A1+

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Applicable Criteria

[Corporate Rating Methodology](#)

Analyst Names

Primary Analyst

Priyanka Bansal

Senior Analyst

India Ratings and Research Pvt Ltd Wockhardt Towers, 4th floor, West Wing Plot C-2, G
Block. Bandra Kurla Complex Bandra (East), Mumbai 400051
+91 22 40356148

Secondary Analyst

Aashman Sharma

Analyst

+91 22 40001783

Committee Chairperson

Abhishek Bhattacharya

Director and Co Head Corporates

+91 22 40001786

Media Relation

Namita Sharma

Manager – Corporate Communication

+91 22 40356121
