FinancialServices*Views*

Target Group—driving Tech Mahindra forward in UK FS

Analyst: Peter Roe June 2016

Indian Pure Play Tech Mahindra has announced that it is acquiring Target Group, a privately-owned specialist provider of Business Process as a Service (BPaaS) in the management of loans, investments and insurance. Over the past five years, this company has grown quickly to exploit its proprietary IP, central processing platform and customer relationships in this complex but growing niche. Target already has a growing pipeline from its business supporting mainstream lenders and from the expanding alternative lending market. Additional potential is being opened up in the management of loan portfolios. The company's acquisition by the much larger Tech Mahindra should enable it to accelerate its progress, expand geographically and drive higher long-term profitability.

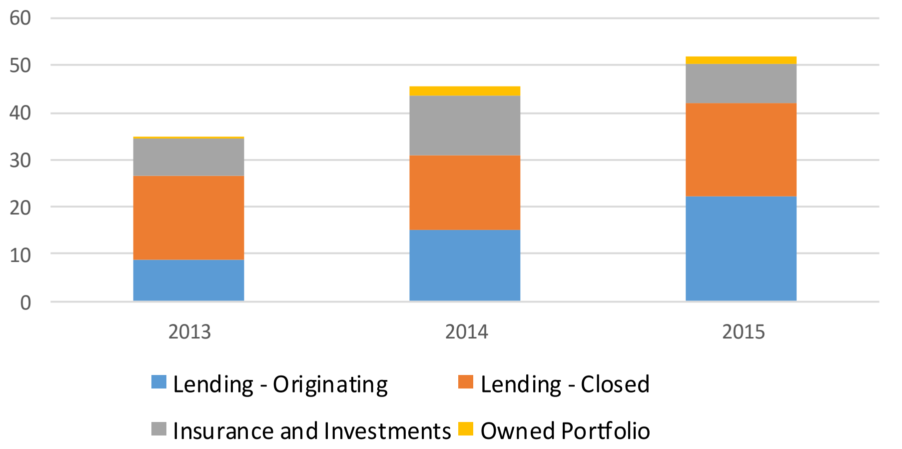
Target Group Overview

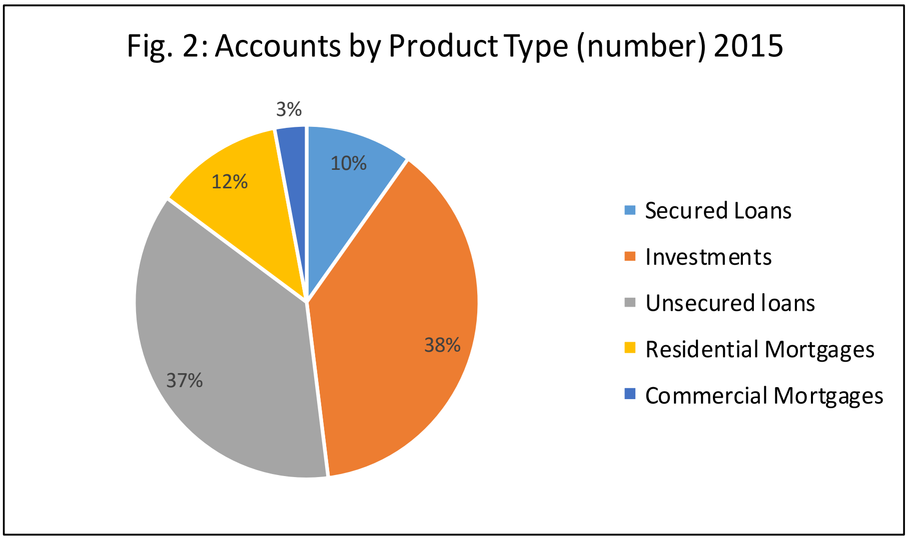
Target Group is a 36-year-old company, HQ'd in Wales, that has the objective of becoming the "software driven service provider of choice for loans, investments and insurance". In these target markets the company offers a portfolio of BPO, managed services and software.

Over the past five years, since the appointment of a new leadership team, the company has moved quickly to revamp its portfolio and build its customer list, now handling over 18 million end customer accounts, almost 4 times the level of 2011. The new management team was quick to bring in several key appointments with many yeara experience in what is a specialist subsector of the financial services industry. For example, co-group CEO Ian Larkin brought with him experience with Lloyds Banking Group, Virgin Money, McKinsey and Accenture, while the other co-group CEO, Bill Alley had worked at Xchanging Dun & Bradstreet, ING Barings and KPMG.

Revenue for the year to end December 2015 totalled £51m, the company having sustained a 20% average growth rate over the recent past. The recent history of revenue and split by product type is shown in Figure 1. EBITDA margin has now reached the high teens and remains on an upward path. In 2015, 40% of group revenue was derived from lending portfolios, with a further 32% from lending origination. This revenue mix provides good visibility of revenue going forward and establishes a good platform for further growth and diversification.

Fig. 1: Revenue by Product Type (£m)





Figurea 2 shows the split of customer accounts (by number) by product type.

Operating structure

At the centre of Target Group's business is an industrial scale transaction engine which executes all the company's loan processing on the same platform. The platform provides an end-to-end capability for loans, offering the automation of origination, processing and the management of account holders as the loans move through to maturity. The platform also provides integrated reporting and data analytics capabilities, accounting and compliance services within the industry's tightly regulated environment. A significant proportion of the company's work load is executed via "straight through processing".

Although this platform caters for the individual requirements of customers, the Target management team are meticulous in ensuring standardisation and thus to benefit from economies of scale in what is a complex market area. The central platform, run in–house, is backed up by a shared service/utility model for the delivery of support services. Services are provided to its customer base through BPO, Managed Service and Software-only models with a private cloud offering to its clients, with the option of dedicated or shared deployments. Amazon Web Services is the predominant cloud services provider.

The company's long experience with multiple customers and the intricacies of the arcane lending markets in our view provides a competitive differentiation over the larger, more general players in the BPO sector and banking software markets. This experience, coupled with the scale of the operation, also provides a major selling point when compared with systems developed in-house by lenders, insurers and investment administrators.

Customer base

Target Group has over 15 major financial institutions in its 50-plus customer base, with the great majority of its revenue derived in the UK. In terms of incumbent financial services providers, Target provides support for **Barclays Bank** in its point-of-sale finance business, also providing **Morgan Stanley** with servicing for their structured retail products in the Investment division. In the challenger banks, Target has a long relationship with **Shawbrook,** a specialist lender, where it provides all the servicing and administration functions for a very diverse product portfolio. Target has also secured a major deal with the **DVLA**, providing 24/7 payments processing of direct debits for vehicle tax.

An important recent customer win is **Goldman Sachs**, where Target is taking over the management of a large number of individual customer accounts as the investment bank purchased a £1.4bn loan portfolio from a major UK retail bank. This type of deal is likely to be replicated several times in the current year and is made possible by Target Group having achieved regulatory permissions to act as a loan servicing company, being able, when required, to take principal risk on its balance sheet. This status gives Target Group significant flexibility in its business model and further opportunities to generate margin in its processing business.

Strong pipeline leads to significant recruitment

As illustrated by the Goldman Sachs deal, Target Group appears to have discovered a rich vein of opportunity in the management of loan portfolios. In order to support the anticipated contract wins and to deliver the Goldman Sachs commitment, Target Group has announced that it will create over 250 new jobs, largely in the Cardiff and Newport area. This will supplement the 90+ people added at the end of 2015 and will result in the group employing over 900 people in England and Wales.

Increasing scale underwrites profitable growth

As mentioned above, Target Group has been able to generate increased EBITDA margins in the recent past as volumes processed over its central platform have increased. The additional scale generated by recent contract wins and anticipated go-lives should provide a further boost to profitability. The underlying platform appears to be able to support further substantial increases in volume but there will be a requirement for additional customer contact staff as well as for technical and business development, programme management and risk and compliance personnel.

Expertise in lending market provides additional opportunities

Target Group has successfully served the diverse and complex market for lending and investment products, and has built a reputation as being a specialist in this area. The lending market is undergoing a period of substantial change with a large number of alternative providers coming forward. This is accelerating the development and introduction of new and more opportunistic products to fit a changing demographic and the new economic environment. As a consequence, lending is moving away from the established banks and into the raft of new start-ups and smaller operations. Each of these operations will require competent and efficient servicing capability and Target Group is an obvious provider of such services. In addition, the product diversity is expected to increase with innovations such as equity release, peer-to-peer lending and new types of retirement planning becoming more important. Target Group plans to continue to develop specialist modules to serve this market niche, adding the capability to their standardised platform and further scaling their BPaaS service.

Target also has a growing list of customers among peer-to-peer lending brokers and servicers for whom it provides standby servicing capability, an increasingly important consideration for alternative lenders and challenger banks in a tougher regulatory environment. **Zopa** and **RateSetter** are two such clients.

Ambitions supported by Tech Mahindra acquisition

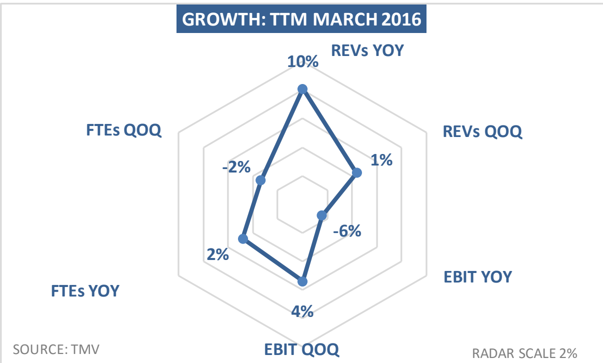
In June, Indian pure play (IPP) **Tech Mahindra** announced that it is to acquire Target Group, paying private equity owners Pollen Street Capital an estimated total of £112m for the company. Final completion will have to wait until the FCA has given approval for the transfer of the regulatory permissions which allow Target Group to act as a servicer of loans. This could take several months, with an indicated completion date of the end of October. In addition to the initial payment of £64m there will be a deferred payment in 2017 and a performance related payment in 2020.

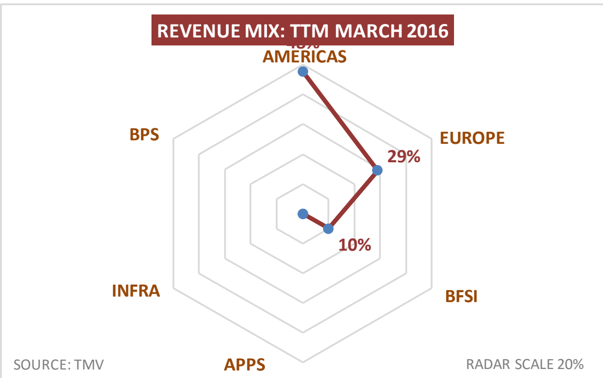
Using TechMarketView’s estimates, Tech Mahindra generated revenue just short of £400m in the UK during the year to March 2015. This represents around 10% of the Group’s total business and half of its European revenue. Over half of Tech Mahindra’s total revenue is still generated within the Telecoms sector and the company is actively seeking new opportunities to lessen this dependence, particularly by growing in Banking, Financial Services and Insurance (BFSI). The BFSI-related portfolio is already diverse (and unfocused) and in our view the business lacks scale to compete with the larger IPPs in some of the bigger opportunities within the sector. Nevertheless, along with the other IPPs, Tech Mahindra has already been enjoying double digit growth in BFSI revenue for several years.

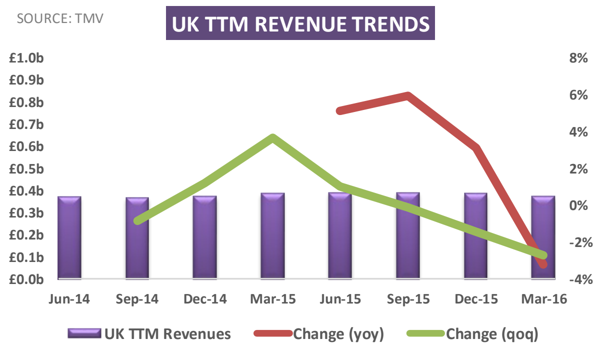
In the UK, the company is already active in market data management inside financial markets companies and in providing infrastructure services to insurance and retail payments companies. Tech Mahindra has been looking for new growth platforms in this sector for some time.

IPP SnapShot: TECH MAHINDRA

KPIs TTM MARCH 2016	
HEADLINE REVENUES	$4.0b
EBIT MARGIN	13.4%
AVERAGE FTEs	104.4k
REVENUE/FTE	$38.7k
REVENUE GROWTH YOY	10.2%
FTE GROWTH YOY	2.1%
REVENUE GROWTH QOQ	1.0%
FTE GROWTH QOQ	-1.6%
NET LINEARITY INDEX	8.1%
UK REVENUES	£375m
UK REVENUE GROWTH YOY	-3.2%
UK REVENUE GROWTH QOQ	-2.7%







Quarter in review

Tech Mahindra (TechM) had the weakest quarter (ended 31st March) than all the other India-headquartered top tier players, with headline revenues increasing by just 3.9% to $1.02b, almost flat compared to the prior quarter. This is the fourth consecutive quarter of yoy headline growth decline. Operating profit fell qoq leaving margins well below peers at 13.8%.

TechM just made it through the $4b revenue barrier on the FY ($4.04b to be more precise), representing 10.2% yoy growth (9.5% adjusted), a huge decrease on the prior year's 18.2% growth. Even so, TechM came second only to Cognizant's 18% growth for the trailing 12 months to 31st March. TechM's FY operating margins, at 13.4%, were down a couple of points yoy; they remain the only India-headquartered top-tier player with margins below 20%.

UK revenues declined by 3% yoy to £375m, less than half the size of its next largest rival (Infosys).

TechM's headcount grew by 2% over the year, giving it an impressive Net Linearity Index of 8.1%, second only to Cognizant.

This overview is taken from the latest edition of TechMarketView's

OffshoreViews

The full document is available here.

Although there had been no commercial relationship between Target and Tech Mahindra, the IPP had been tracking the business for a couple of years and when the private equity holders decided to realise their investment, Tech Mahindra felt in a strong position to make a bid. Tech Mahindra has stated that acquiring Target Group will enable them to “broaden its service offerings” within the financial services sector. This deal will give Tech Mahindra access to expertise and market position in a relatively small (but growing) and complex niche, and should therefore provide opportunities for competitive advantage and differentiation.

TechM’s move is the latest by an IPP to acquire BPaaS capability within the BFSI sector, following Wipro’s purchase of US-based Viteos earlier in the year. It shows that the platform BPaaS space is now ripe for consolidation as the IPPs seek to transform their legacy business process services operations.

Tech Mahindra does not report revenues by service line. However, some 27k FTEs work in BPO, about 26% of total headcount. With average offshore BPO billing rates at c. 30-50% of other IT service lines, this suggests that Tech Mahindra derives around $300-500m in revenues from BPO.

The stated intention is to run Target Group as a separate organisation and to provide it with the resources to accelerate its growth and general development. The Target management had already set out a significant development plan for which Tech Mahindra can provide additional support in terms of technology, specifically in areas such as data analytics and automation. £1m had been spent on improved data analytics, benchmarking and dashboarding to enable a larger proportion of self-serve operations and to exploit big data techniques. In addition, Target had initiated several programmes to increase the degree of system intelligence and automation/workflow employed and the link should add impetus to these initiatives. Also, the management had already identified several avenues of development for their lending platform, in terms of meeting new regulatory requirements, meeting the new demands as faster payments, new verification methods and digital signatures become more widely adopted and adding functionality to support diversification into the market areas of P2P lending and standby servicing. Access to Tech Mahindra’s large pool of resource should prove helpful, assuming that the management team remain focused.

In addition, there are substantial potential advantages due to the bigger balance sheet and longer term investment horizons of Target Group’s new parent. We would anticipate that Target Group will be able to grow its market position more quickly, further adding scale to the group’s central platform and providing a greater diversity of business models to its customer base. This should accelerate growth and increase further the potential profitability of the Target Group operation.

Tech Mahindra will be looking to take Target Group’s platform into other geographies. There are certainly many opportunities for the platform in reducing the cost of processing and replacing legacy systems. However, there will be significant and subtle differences in lending practices between national markets and building market positions internationally could take some time. Target Group already has experience and relationships in New Zealand, South Africa, the Netherlands and the Czech Republic which could prove helpful in accelerating international development.

Tech Mahindra’s acquisition of Target Group appears to offer benefits to both the acquirer and the acquired. Target group had been enjoying good success under its PE owners, but access to a bigger balance sheet and a greater pool of resource should accelerate its progress. On the other hand, Tech Mahindra have bought a centre of excellence and a market position in a profitable, growing and differentiated sector of the competitive Financial Services market.