Sharekhan by BNP PARIBAS

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L&T Technology Services

Weak quarter, deal wins stay strong

IT & ITES	Sharekhan code: LTTS	Result Update

Stock Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		⇔	
RQ		⇔	
RV		⇔	

Reco/View	Change
Reco: **Buy**	⇔
CMP: **Rs. 1,439**	
Price Target: **Rs. 1,600**	⇔

↑ Upgrade ⇔ Maintain ↓ Downgrade

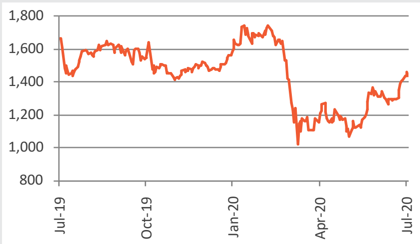
Company details

Market cap:	Rs. 15,045 cr
52-week high/low:	Rs. 1,780/995
NSE volume: (No of shares)	1.3 lakh
BSE code:	540115
NSE code:	LTTS
Free float: (No of shares)	2.6 cr

Shareholding (%)

Promoters	74.6
FII	9.4
DII	6.0
Others	10.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	9.8	17.5	-10.0	-13.5
Relative to Sensex	0.9	2.0	3.0	-7.2

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy on L&T Technology Services (LTTS) with an unchanged PT of Rs. 1,600.
- Q1 revenue met our modest expectations, while margins missed mark; revenue affected by scrapping of aerospace project and softness in plant engineering vertical.
- Management expects USD revenue to fall 9-10%, as anticipated for FY2021 that translates into a 2.3-3% q-o-q growth for remaining quarters.
- We expect growth to normalise in FY2022E on account of catch-up effects and strong demand for digital engineering.

L&T Technology Services (LTTS') revenue declined by 12.7% q-o-q on constant currency (CC) terms owing to scrapping of projects in aerospace sub-segment and weakness in the plant engineering vertical. On a reported basis, US Dollar revenue declined by 12.5% q-o-q to $171 million, meeting our expectations. EBIT margins declined by 309 bps q-o-q to 12.1% in Q1FY2020, significantly below our expectations, as utilisation rates fell. The management expects USD revenue to fall by 9-10% for FY2021, implies a 2.3-3% q-o-q growth for the remaining quarters. The management indicated improvement in the deal closures during the last month of this quarter, though the client decision making cycle has not improved to the pre-COVID level. We model normalisation of growth in FY2022E on account of catch-up effects and continued strong traction in certain segments.

Key positives

- Strong deal wins; deal pipeline was better than Q4FY2020
- Robust growth momentum continued in medical devices vertical (41% y-o-y)

Key negatives

- Transportation vertical revenue declined 23% q-o-q
- Industrial products revenue growth to remain under pressure in the near term

Our Call

Valuation – Maintain Buy with a PT of Rs. 1,600: We have fine-tuned our earnings estimates for FY2021E/FY2022E factoring in the lag in operating margins and growth guidance for FY2021E. We believe that LTTS is well-placed to gain market share among global competitors on account of being the preferred engineering partner among clients, multi-domain expertise, strong account mining activities and leadership depth. We expect growth to normalise in FY2022E on account of catch-up effects and an anticipated demand recovery in major markets. The stock is currently trading at 17x/15x FY2021E/FY2022E earnings. Hence, we retain our Buy rating on LTTS with an unchanged PT of Rs. 1,600.

Key Risks

Macroeconomic uncertainties could affect earnings. Further, loss of key customers and/or lower ERD spends/R&D budgets may impact the growth trajectory.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	5,078.3	5,619.1	5,394.6	6,049.6	6,775.4
OPM (%)	18.0	19.8	18.2	19.8	19.8
Adjusted PAT	765.6	818.6	719.5	891.0	1,034.7
% y-o-y growth	51.3	6.9	-12.1	23.8	16.1
Adjusted EPS (Rs.)	72.9	77.7	68.2	84.4	98.0
P/E (x)	19.7	18.5	21.1	17.0	14.7
P/B (x)	6.0	5.4	4.6	3.9	3.3
EV/EBITDA (x)	15.6	12.7	14.2	11.4	10.0
RoNW (%)	34.7	31.2	24.0	25.3	24.9
RoCE (%)	35.4	31.3	21.8	24.2	23.7

Source: Company; Sharekhan estimates

In-line revenue, margins missed mark

Revenue declined 12.7% q-o-q and 10.9% y-o-y in constant currency (CC) terms as many industries operating at limited capacity on account of the pandemic. Revenue was impacted by a sharp 22.8% q-o-q and 24.5% q-o-q fall in revenues in transportation (Japanese customer in aerospace vertical scrapped the projects) and plant engineering vertical (reduction of capex plan by customers in oil & gas segment). However, the medical devices vertical continued to grow strongly, rising of 8.8% q-o-q. On a reported basis, US Dollar revenue declined by 12.5% q-o-q and 11.8% y-o-y to $171 million, in-line with our expectations and management's guidance of low double-digit drop in revenues as well. EBIT margin declined 309bps q-o-q to 12.1% in Q1FY2020, significantly below our expectations, owing to a drop in utilisation because of the furloughs and temporary cut in spending by customers. The adjusted EBIT margin (Excluding one-time expenses in Q4FY2020) contracted by 440 bps q-o-q in Q1FY2021. Net profit came at Rs. 117.3 crore (down 42.7% q-o-q), below our estimates, owing to a fall in profitability and lower other income.

Reinstated guidance; Deal wins stay strong still

The management resumed annual revenue growth guidance for FY2021 and expects USD revenue to fall by 9-10% for FY2021, which is on our expected line. This translates 2.3-3% q-o-q growth for the remaining quarters of FY2021. Management remains optimistic that the company would report positive growth on sequential basis from Q2FY2021 onward. Despite weakness in aerospace sub-segment, the company expects transportation vertical to grow from Q2FY2021. Barring the industrial products vertical, the remaining verticals are expected to report growth on a q-o-q basis from Q2FY2021. Management indicated that it witnessed improvement in the deal closures during the last month of this quarter, though the client decision making cycle has not improved to the pre-COVID level. We model normalisation of growth in FY2022E on account of catch-up effects and continued strong traction in certain segments.

Key result highlights

- **Reinstated growth outlook:** The management has reinstated its annual revenue growth guidance, expecting a decline of 9-10% in USD revenues for FY2021E. Management expects margin improvement from Q2FY2021 led by cost rationalisation measures and recovery in revenue growth.
- **Transportation vertical:** Transportation vertical revenue declined significantly by 22.8% q-o-q owing to weakness in the aero sub-segment (Japanese aerospace customer scrapped project). Further, furloughs and lower cat sales worldwide impacted the revenue of this vertical. The fall in aerospace vertical revenue would bottom out in Q2FY2021. The company sees strong demand in the like electric vehicle (EV), advanced driver-assistance systems (ADAS), connected vehicles, etc. The company closed two new deals (in the design and new-age platform segments) during the quarter. However, management sees good opportunities in the defence side. The management remains optimistic that the growth in this vertical would come back from Q2FY2021 onwards.
- **Telecom and hi-Tech:** The telecom & hi-tech verticals turned to positive sequential growth of 4.8% during the quarter, after five quarters of a consecutive sequential decline in revenues. The growth was driven by ramp-up of deals in both media and entertainment and semiconductor sub-segment. The management remains optimistic that positive revenue growth in this vertical would continue in coming quarter as the deal pipeline is healthy.
- **Industrial products vertical:** Here, revenue declined by 12.5% q-o-q versus a fall of -0.9% q-o-q in Q4FY2020, owing to low demand in oil & gas machinery side. The company won a 15 million+ deal in the machinery side during the quarter. Overall, the company closed three deals in this segment in Q1FY2020. The management expects growth to be muted in the medium term.
- **Plant engineering vertical:** Revenue declined by 24.5% q-o-q owing to weakness in oil and gas segment and subsequent budget cut by the clients owing to a fall in crude oil prices. Management sees some stability in the oil and gas vertical as few large deal proposals are in the pipeline. In CPG, the company sees increasing traction in digital for improving efficiencies. The company closed three deals in this segment – one in oil & gas and two in CPG sub-segments. From Q2FY2021, management expects sequential growth in plant engineering vertical led by CPG and the chemical sub-vertical.

- **Way ahead for medical devices vertical:** Medical devices continued its growth momentum, registered a growth of 8.8% q-o-q and 42% y-o-y during the quarter. Growth was driven by ramp up deal ramp-up. Company closed three of four deals that it pursued during the quarter. The management expects growth momentum would continue in this segment on the back of good deal pipeline and new product development.
- **Strong deal wins:** LTTS won nine multi-million dollar deals across all major industry segments, which includes one deal having a TCV of over $30 million and two deals with a TCV of more than $15 million. The management is getting a positive response to its newer set of offerings like Frugal Manufacturing, Telehealth solution and i-BEMS Shield. The company had strong deal booking compared to Q4FY2020.
- **Client additions:** The company reported a drop of one client and four clients on q-o-q basis under $30 million+ and $20 million+ client buckets. The company has added one client under its $20 million+ bucket.
- **Strong free cash flow:** Free cash flow (FCF) generation was strong during the quarter as the company recouped the shortfall of $25 million in Q4FY2020. FCF to net profit increased to 271% in Q1FY2021 versus 59% in FY2020. Net cash balance stood above Rs. 1,000 crore.
- **Acquisition of Orchestra:** LTTS announced the acquisition of Orchestra, which will enhance its offerings in the areas of Network Engineering & Enterprise Mobility and provide the company strategic access to Telecom service providers who are investing in next generation digital systems for 5G and Internet of Things (IoT) networks.

Results Rs cr

Particulars	Q1FY21	Q1FY20	Q4FY20	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	171.0	193.9	195.4	-11.8	-12.5
Revenue in INR (cr)	1,294.7	1,347.5	1,446.6	-3.9	-10.5
Employee benefit expenses	840.2	781.5	840.1	7.5	0.0
Operating expenses	248.6	293.3	338.2	-15.2	-26.5
EBITDA	205.9	272.7	268.3	-24.5	-23.3
Depreciation	49.2	42.8	48.5	15.0	1.4
EBIT	156.7	229.9	219.8	-31.8	-28.7
Other income	13.7	56.5	61.4	-75.8	-77.7
Finance cost	10.7	9.1	9.4	17.6	13.8
PBT	159.7	277.3	271.8	-42.4	-41.2
Tax provision	41.6	73.2	65.5	-43.2	-36.5
Minority interest	-0.8	-0.2	-1.5		
Net profit	117.3	203.9	204.8	-42.5	-42.7
EPS (Rs.)	11.1	19.3	19.4	-42.5	-42.8
Margin (%)				**BPS**	**BPS**
EBITDA	15.9	20.2	18.5	-433	-264
EBIT	12.1	17.1	15.2	-496	-309
NPM	9.1	15.1	14.2	-607	-510

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Large addressable market provides sustainable growth opportunities

Total global engineering, research and development (ERD) spends are estimated at $1.4 trillion in 2019, of which the global addressable ERD market is at $345 billion, while the share of Indian outsourcing in engineering remained at $29 billion in 2019. The share of engineering service providers' (ESPs') outsourcing to India is estimated at $14 billion in 2019 and is expected to reach $63 billion by 2025. Further, the ERD services space is likely to grow faster among technology spends, led by higher adoption of digital engineering.

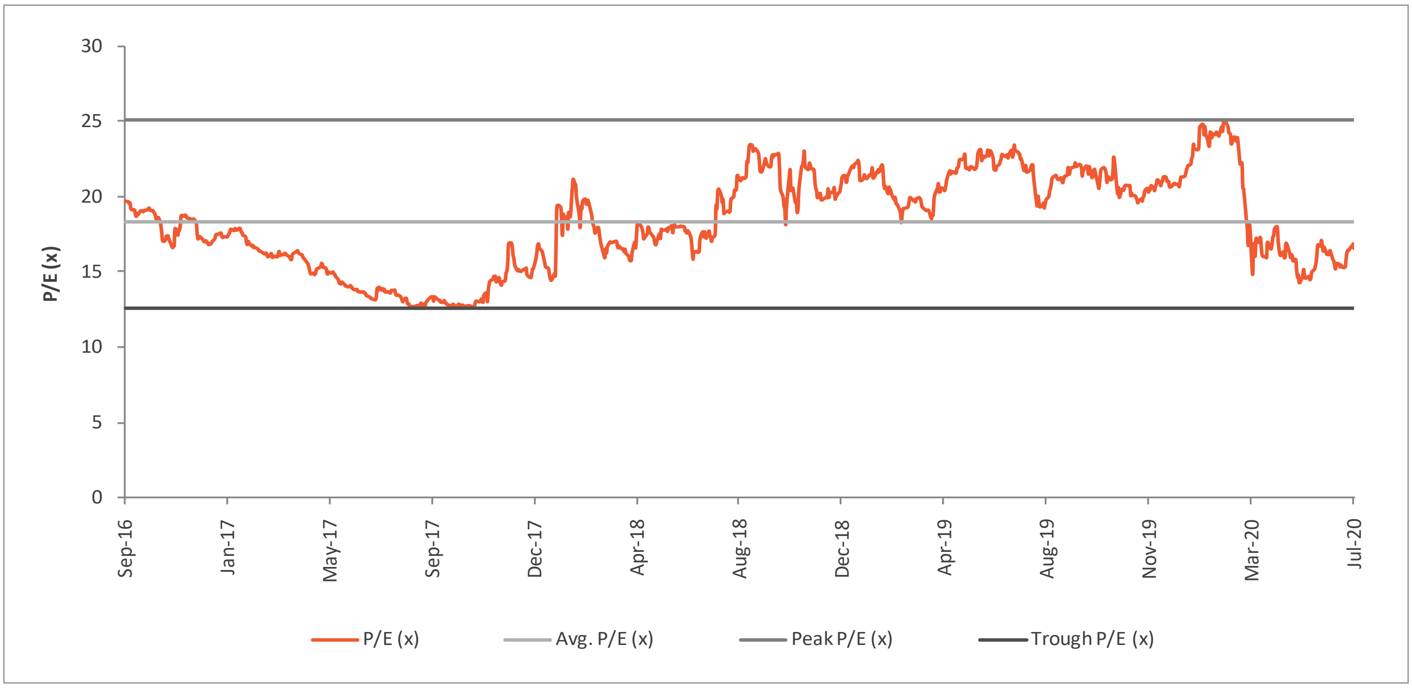
■ Company outlook - Board portfolio to support long runway of growth

LTTS is the third-largest ESP in India and is well-diversified across verticals. The large ERD addressable market and a huge scope in deepening relationships with its top-30 customers provide multi-year sustainable growth prospects to the company going forward. Technology shifts in verticals are also positive for LTTS as any change in technology creates huge growth opportunities for ESPs. Though FY2021E looks to be a weak year due to COVID-19 and US election-related headwinds, we expect normalised growth from FY2022E building on the catch-up effect.

■ Valuation

We have fine-tuned our earnings estimates for FY2021E/FY2022E factoring in the lag in operating margins and growth guidance for FY2021E. We believe that LTTS is well-placed to gain market share among global competitors on account of being the preferred engineering partner among clients, multi-domain expertise, strong account mining activities and leadership depth. We expect growth to normalise in FY2022E on account of catch-up effects and an anticipated demand recovery in major markets. The stock is currently trading at 17x/15x FY2021E/FY2022E earnings. Hence, we retain our Buy rating on LTTS with an unchanged PT of Rs. 1,600.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Tata Elxsi	914	6	5,690	22.3	19.2	15.2	12.9	4.6	4.0	20.7	20.9
KPIT Tech	72	27	1,977	16.0	11.4	6.2	4.6	1.8	1.8	10.5	12.3
LTTS	1,439	10	14,524	21.1	17.0	14.2	11.4	4.6	3.9	24.0	25.3

Source: Company, Sharekhan Research

About company

L&T Technology Services (LTTS) is a leading global ER&D services company, backed by the rich engineering expertise and experience of parent company, Larsen & Toubro. LTTS is a pure-play Engineering Design Services firm with a presence across multiple verticals (transportation, industrial products, telecom & hi-tech, medical devices and process industries). The company derives revenue 61% from North America, 15% from Europe, 13% from India and 11% from Rest of the World (RoW). The company offers ERD practices to 51 of the top 100 R&D spenders worldwide. LTTS also has IP and Platforms which it independently sells to clients.

Investment theme

LTTS currently generates a mere 0.5% of its Top-30 (T-30) customers' R&D spends ($75 billion) as revenue ($376 million), which provides a long runway for growth. We believe the multi-sectoral presence and robust horizontal technology practice would help LTTS to deliver sustainable revenue growth momentum. Additionally, technology shifts in verticals is positive for LTTS as any change in technology creates huge growth opportunities for ESPs. Unlike peers, LTTS has a broader portfolio, which helps the company to mitigate the risk relating to vertical-specific cyclicality. We believe LTTS is well poised to deliver strong multi-year growth going forward, led by leadership depth, broad client portfolio, and multi-domain expertise across verticals and under-penetrated ERD outsourcing market.

Key Risks

1) Rupee appreciation and/or adverse cross-currency movements, 2) any hostile regulatory visa norms could impact employee expenses, 3) macro-uncertainties could adversely affect earnings, 4) loss of key customers and 5) lower ERD spends/R&D budgets

Additional Data

Key management personnel

A.M. Naik	Non-Executive Chairman
S.N. Subrahmanyan	Vice Chairman
Dr. Keshab Panda	Chief Executive Officer
Amit Chadha	Deputy CEO
Mr. Rajeev Gupta	Chief Financial Officer

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Life Insurance Co	1.10
2	Invesco Asset Management India Pvt	0.83
3	Vanguard Group Inc/The	0.76
4	HDFC Asset Management Co Ltd	0.75
5	Reliance Capital Trustee Co Limited	0.74
6	Sundaram Asset Management Co Ltd	0.58
7	FMR LLC	0.54
8	Grandeur Peak Global Advisors LLC	0.54
9	JPMorgan Chase & Co	0.49
10	BMO Investments II Ireland PLC	0.48

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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