Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Tech Mahindra Limited

Feet on many accelerators

IT & ITeS	Sharekhan code: TECHM	Company 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. 793**	
Price Target: **Rs. 910**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

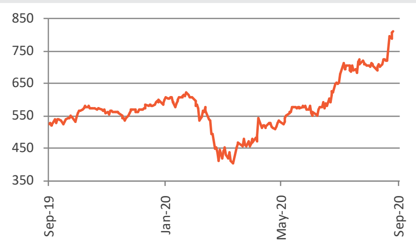
Company details

Market cap:	Rs. 76,616 cr
52-week high/low:	Rs. 845/470
NSE volume: (No of shares)	52.9 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62 cr

Shareholding (%)

Promoters	35.8
FII	40.5
DII	14.0
Others	9.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	12.3	41.7	79.4	51.4
Relative to Sensex	15.2	33.7	38.2	55.0

Sharekhan Research, Bloomberg

Summary

- We maintain our Buy rating on Tech Mahindra (TechM) with a revised PT of Rs. 910, given it is trading at a sharp discount to its large peers.
- Revenue growth in Q2 would be driven by strong recovery in BPO business, stability around network services revenue and growth in BFSI, healthcare, and technology verticals.
- We expect margin improvement going ahead, led by higher offshoring, reduction in subcontractor expenses, improvement in margin profile of two large deals, and better profitability of acquired entities.
- Tech M is well placed to benefit from the expansion of 5G value chain across networks and IT services, when there is pick up in investments by CSPs and higher 5G adoption by enterprise would happen.

Tech Mahindra (TechM) would return to sequential revenue growth with margin improvement in Q2FY2021. Revenue growth would be driven by strong recovery in BPO business, stability around network services revenue (~30% of communication revenue), and growth in the BFSI, healthcare and technology verticals. However, weakness in manufacturing (auto and aero contribute 60% of its revenue) and the retail vertical is expected to continue in Q2FY2021. EBIT margin expansion in subsequent quarters of FY2021 would be led by higher offshore component in revenue, reduction in subcontractor expenses, and improvement of margin profile of two large deals that it won in H2FY2020. Further, management is focusing on restructuring its acquired entities, particularly Pininfarina and Brazilian operations in the next 12-18 months, which would further help margin expansion. We believe capex on 5G would start in the first half of CY2021 as CSPs are committed to invest and strengthen the network. Given TechM's end-to-end solutions in network services, operations support system (OSS), and business support systems (BSS), we believe the company will be the key beneficiary from the acceleration of investments in 5G infrastructure by operators and adoption of 5G technologies by enterprises.

Our Call

Valuation – Attractive on favourable risk-reward perspective: We have upgraded our earnings estimates for FY2021E because of anticipated better-than-earlier margin expansion in Q2FY2020 due to continued lower travel and admin expenses, while we broadly maintain our earnings estimates for FY2022E and FY2023E. Tech M is well placed to benefit from the expansion of 5G value chain across networks and IT services, when pick up in investments by CSPs and higher 5G adoption by enterprise would happen. At the CMP, the stock is trading at a reasonable valuation of 16x/13x its FY2022E/FY2023E earnings at 15-45% discount to its large peers. Hence, we maintain our Buy rating on the stock with a revised price target (PT) of Rs. 910.

Key Risks

Any hostile development with respect to the current visa regime would affect employee expenses as lower proportion of local resources are deployed onsite. Further, a delay in pick-up of 5G-related spends would affect revenue estimates.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	34,742.1	36,867.7	37,341.4	40,941.4	44,808.0
OPM (%)	18.2	15.5	15.4	16.6	17.4
Adjusted PAT	4,297.6	4,250.5	3,738.0	4,513.3	5,387.5
% YoY growth	13.1	-1.1	-12.1	20.7	19.4
Adjusted EPS (Rs.)	47.7	45.9	42.5	51.3	61.2
P/E (x)	16.6	17.3	18.7	15.5	12.9
P/B (x)	3.5	3.2	2.9	2.6	2.3
EV/EBITDA (x)	10.8	12.2	11.8	9.6	7.9
RoNW (%)	22.0	19.2	16.3	17.9	19.1
RoCE (%)	24.0	20.5	17.2	19.1	21.1

Source: Company; Sharekhan estimates

Acceleration in digital transformation likely to benefit Indian IT industry

Implications from the COVID-19 outbreak have accelerated digital activities among large global enterprises, leading to a rise in spending on workplace transformation and collaboration tools, cybersecurity, and higher cloud migration. As technology is seen as a source of competitive differentiation in every industry, we believe technology spend is expected to increase once the situation normalises.

Industry analysts have estimated IT services spending growth to decline by 2-10% for CY2020 and subsequent recovery in CY2021. Despite a recessionary environment, most managements of IT companies also indicated higher spending on transformational works to improve business resiliency, emergence of new business models, and cost-takeout initiatives. The Indian IT services sector is expected to enter into high-growth phases because of (1) higher core modernisation to build business resiliency, (2) higher cloud adoption, and (3) increased online activities considering social distancing measures.

Telecom spending is expected to be less impacted overall, as demand for broadband remains extremely strong due to remote working, virtual team meetings, and isolation measures. Gartner expects flat growth in spending in the communication services segment for CY2020. Rising need for rapid access to data and automation will enhance focus on network equipment and communications, speeding up deployment of 5G networks and adoption of 5G equipment. The communications industry is one of the largest spenders on IT and network services, with evolving nature of spends as new technology is introduced.

Slow 5G capex spend in CY2020, expect bounce back in CY2021

Though the company has been executing projects related to 5G for ecosystem, management highlighted that 5G spends by communication service providers (CSP) and enterprises have been deferred by few months due to delay in decision making, geopolitical war, and continuous postponement in spectrum allocation. Due to uncertainties in the wake of COVID-19 pandemic and deferment of spectrum action across markets, CSPs have pushed the 5G roll-out related spends, and it is expected to rebound in CY2021. We believe capex on 5G would start in the first half of next year, as CSPs are committed to invest and strengthen the network, and they see strong traction in digital, network, customer experience, and cloud areas.

The roll-out of 5G in developed markets would be a huge opportunity for TechM. 5G is driving a new wave of digitalisation of the Telco and other industries that include IT, network and emergence of new-age delivery model. The company is well placed to capture 5G spends such as new-age network infrastructure services, 5G labs for innovation, research and collaboration among technologies, intelligent operations solutions, and 5G service offerings to enterprise clients in collaboration with CSPs. TechM has partnered with Rakuten in most spend areas relating to 5G and has recently partnered with Rakuten for global go-to-market opportunities for the Rakuten Communications Platform (RCP). As a preferred partner, TechM will provide its leading technologies and software capabilities to support the development and deployment of mobile networks for global customers of RCP.

TechM has transformed itself to end-to-end solutions in network services, operations support system (OSS), and business support system (BSS) even through acquisitions and partnerships from just a vanilla system integrator. Hence, we believe the company will be key beneficiary from 5G opportunities from the acceleration of investments in 5G infrastructure by operators and adoptions of 5G by enterprises.

Expect revenue growth and margin expansion on q-o-q in Q2; Healthy deal pipeline to continue

COVID-19 had a material impact on BPS business and network services during Q1FY2021. Note that TechM's front-office processes (includes voice, email, chat and instant messaging channels) account for 75% of its total BPO revenue compared to around 20% of large peers, which are more focused on mid and back office BPO (around 80% of BPO revenue). Management expects strong recovery in its BPO segment in Q2FY2021 because of lower supply constraints, easing of demand impact, approvals from clients for WFH, and lower base. Though network usage has increased across the globe, the business did not take off as anticipated and the recovery in network business is expected to remain slow in Q2FY2021 owing to continued labour issues. Management indicated better deal pipeline during Q2FY2021 compared to the previous year. Though management indicated small deal pipeline started converting faster, we believe total deal TCVs during the quarter could remain flat or lower compared to its average quarterly deal TCVs of $400 million-$500 million. We expect USD revenue to grow by 1.4% q-o-q to $1,225 million in Q2FY2021, while EBIT margin is expected to improve around 100 bps on a sequential basis.

Enterprise segment to recover in FY2022E

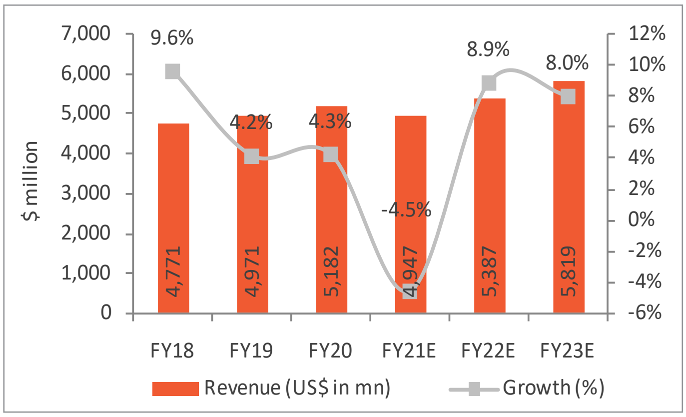
Enterprise business, accounting for 60% of its total revenue, registered a decline of 5.1% q-o-q during Q1FY2021. The decline in revenue can be attributed to sharp revenue drop in manufacturing and retail verticals. The healthcare vertical was impacted due to lower elective surgeries in hospitals. Management expects strong growth in healthcare (excluding hospitals) and technology to continue in Q2FY2021, while revenue growth in BFSI would be decent due to lower exposure to capital market. However, weakness in manufacturing and retail is expected to continue given its higher exposure to aero and auto sub-segment (around 60% of manufacturing revenue). We expect muted revenue performance in the enterprise segment in FY2021E and strong revenue growth of around high single digit in FY2022E/FY2023E.

Expect margin improvement in subsequent quarters, led by higher offshoring

Management indicated that its cost-optimisation measures along with focus on structural changes (around Pininfarina and Brazilian operations), higher offshoring, and lower subcontractor expenses would improve margin trajectory in subsequent quarters. Pininfarina and Brazilian operations are currently pain-points for the company in terms of margin profile. Hence, the company has been actively strategising restructuring activities around these businesses, which would aid TechM's overall margin performance. Further, lower travel costs, rationalisation of facilities, and improvement of margin profile of two large deals would support the company's margin improvement in Q2FY2021.

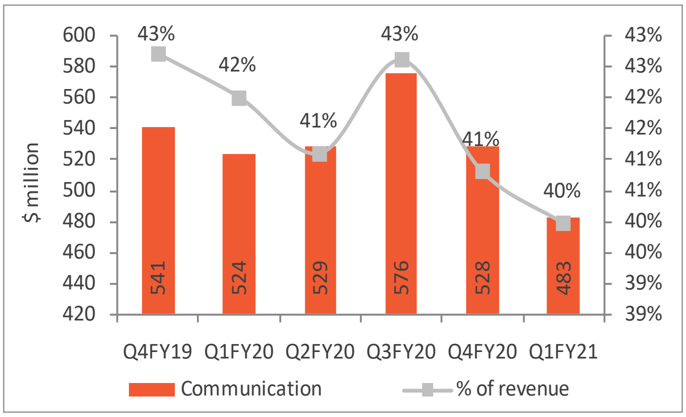
Financials in charts

Revenue ($ mn) and growth (%)



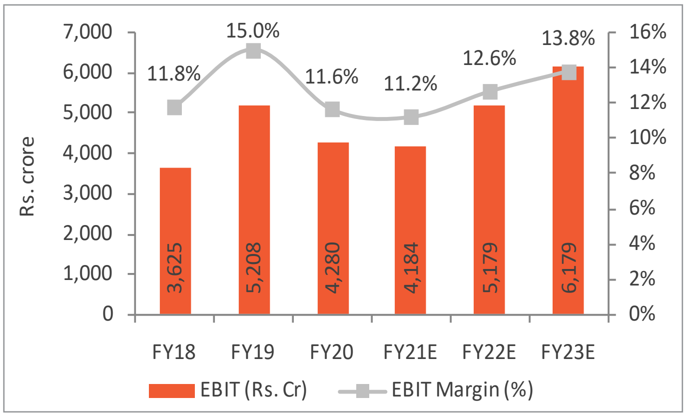
Source: Company, Sharekhan Research

Communication ($ mn)& % of total revenue



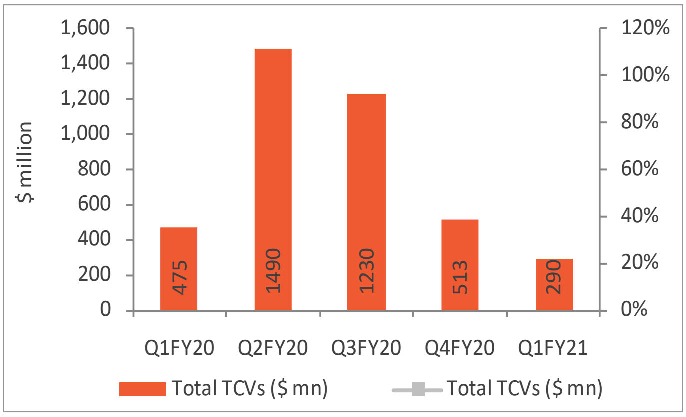
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



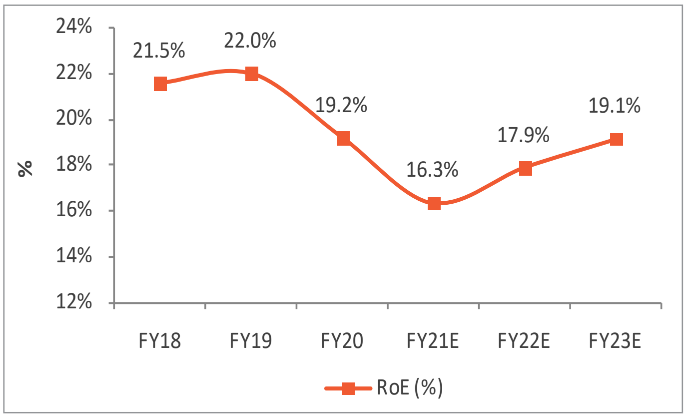
Source: Company, Sharekhan Research

Order book ($ million)



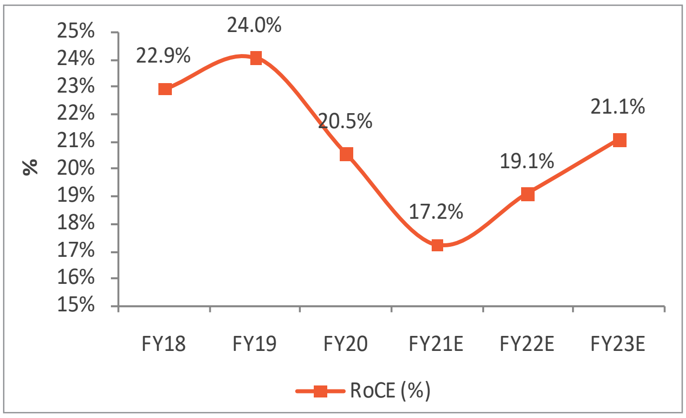
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate IT services spending would grow by 5-8% over CY2021-CY2024E compared to average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Implications from the outbreak of the pandemic have accelerated digital activities among large global enterprises, leading to increased spending on workplace transformation and collaboration tools, cyber-security, and higher cloud migration. Further, the increasing need for rapid access to data and automation will enhance focus on network equipment and communications, speeding up 5G network deployments, and adoption of 5G equipment.

■ Company outlook - Well-placed to capture 5G opportunity

With 40% of revenue arising from the telecom segment, Tech M is well-placed to capture 5G-related spending from telecom service providers and OEMs. We believe Tech M is well positioned to be a key beneficiary from 5G roll out, given its early investments in network capabilities through LCC, investments in IPs and platforms and investments/partnerships (Intel, Rakuten, AltioStar and among others) to develop an ecosystem. We remain positive on the company considering a strong demand environment in telecom, strategic focus on digital acquisitions, improving large deal win rate, and continuous focus to diversify business.

■ Valuation - Attractive valuation

We have upgraded our earnings estimates for FY2021E because of anticipated better-than-earlier margin expansion in Q2FY2020 due to continued lower travel and admin expenses, while we broadly maintain our earnings estimates for FY2022E and FY2023E. Tech M is well placed to benefit from the expansion of 5G value chain across networks and IT services, when pick up in investments by CSPs and higher 5G adoption by enterprise would happen. At the CMP, the stock is trading at a reasonable valuation of 16x/13x its FY2022E/FY2023E earnings at 15-45% discount to its large peers. Hence, we maintain our Buy rating on the stock with a revised PT of Rs. 910.

One-year forward P/E (x) band

Source: Sharekhan Research

Peer comparison

Particulars	CMP (Rs /Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
HCL Tech	814	271	220,987	18.5	16.9	5.9	5.5	3.9	3.5	21.9	21.7
Infosys	1,020	426	434,309	25.2	22.4	16.7	15.1	3.5	3.4	26.1	28.8
Wipro	315	570	179,731	18.2	17.3	5.0	4.4	3.1	2.9	15.6	15.5
Tech M	793	97	76,616	18.7	15.5	11.8	9.6	2.9	2.6	16.3	17.9

Source: Company, Sharekhan Research

About company

Incorporated in 1986, Tech M was formed by a joint venture between Mahindra & Mahindra and British Telecom Plc, under the name of Mahindra British Telecom. The company has been providing end-to-end services to telecom OEMs and service providers. Over the years, the company has acquired Comviva Technologies, LCC and Hutchison Global Services to fill gaps in its service offerings in the telecom space. Notably, post the acquisition of Satyam, Tech M entered the enterprise solutions space and became the fifth largest Indian IT player. The company has now diversified its exposure to other verticals such as BFSI and manufacturing. Tech M offers a bouquet of services, which include IT outsourcing services, consulting, next generation solutions, application outsourcing, network services, infrastructure management services, integrated engineering solutions, business process outsourcing, platform solutions, and mobile value-added services.

Investment theme

Tech M is one of the leading players in providing end-to-end services and solutions to telecom OEMs and major global service providers in the communication space (contributes more than 40% to its total revenue). Historically, this has helped the company whenever there is any uptick in technology spends, led by adoption of new technology. As the pace of spending from the roll-out of 5G network is set to accelerate across the globe, Tech M is well-positioned to capitalise on the 5G opportunity across networks and IT services given its investments in network capabilities, IPs, platforms, and partnerships. This has enabled the company to compete with large peers by striving for large deals in the enterprise segment.

Key Risks

- Any hostile development against current visa regime would affect employee expenses due to lower proportion of local resources are deployed onsite.
- Rupee appreciation or/and adverse cross-currency movements might affect earnings.
- Delay/loss of accounts in the enterprise segment.
- Delay in pick-up of 5G-related spends.

Additional Data

Key management personnel

Mr. Anand Mahindra	Chairman
CP Gurnani	Chief Executive Officer
Manoj Bhat	Chief Financial Officer
Jagdish Mitra	Chief Strategy Officer
Manish Vyas	President, Communications, Media & Entertainment Business
Vivek Agarwal	Global Head for Enterprise Verticals

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	TML BENEFIT TRUST	9.75
2	First State Investments ICVC	5.82
3	BlackRock Inc	4.99
4	First State Global Umbrella Fund	4.58
5	SBI Funds Management Pvt Ltd	2.55
6	Republic of Singapore	2.19
7	ICICI Prudential Asset Management	1.88
8	SBI-ETF NIFTY 50	1.76
9	Vanguard Group Inc/The	1.75
10	Government Pension fund	1.60

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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