



## Tech Mahindra

### 5G to forge growth path

IT &amp; ITes

Sharekhan code: TECHM

Result 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. 848	
Price Target: 1,000	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

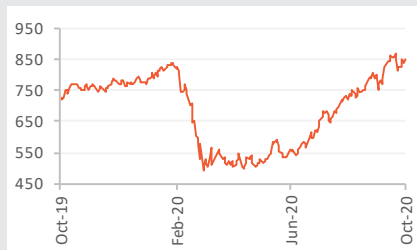
## Company details

Market cap:	Rs. 81,996 cr
52-week high/low:	Rs. 887 / 470
NSE volume: (No of shares)	55.5 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62 cr

## Shareholding (%)

Promoters	35.8
FII	38.9
DII	15.1
Others	10.2

## Price chart



## Price performance

(%)	1m	3m	6m	12m
Absolute	7.0	29.9	62.0	16.8
Relative to Sensex	(1.0)	23.2	34.3	12.6

Sharekhan Research, Bloomberg

## Summary

- We maintain our Buy rating on Tech Mahindra (TechM) with a revised PT of Rs. 1000.
- Performance was better than expected on all parameters. TechM impressed with strong margin expansion, healthy FCF generation and pickup in deal TCVs.
- Management expects double digit growth over next couple of years on the back of anticipated growth in enterprise segment, potential 5G opportunities and strong deal wins.
- TechM is well placed to benefit from the expansion of 5G value chain across networks and IT services; expect TechM's USD revenue/earnings to clock a CAGR of 10.5%/15.5% over FY2021-FY23E.

Tech Mahindra (TechM) impressed with significant expansion in margins, strong FCF generation and decent deal wins. Constant currency (CC) revenue grew 2.9% q-o-q, ahead of our estimates, led by 4.3% growth in enterprise segment and normalisation of supply-side challenges. Reported US Dollar revenues grew by 4.8% q-o-q to \$1,265.4 million. EBIT margin expanded by 410bps q-o-q to 14.2%, led by a recovery in demand side, absence of supply-side constraints, cost management and normalization of seasonality in mobility business. Net profit came in at Rs. 1,065 crore which was 9% above our estimates, led by both revenue and margin beat, partially offset by lower other income. Post a material impact in the wake of pandemic, revenue of BPS business in dollar terms grew 31% q-o-q and margin improved sharply to 21.9% from 6.8% in Q1FY2021. TCVs of large deals bounced back to \$421 million, in-line with expectations, led by strong deal wins in its communication vertical. During Q3FY2021, revenue growth in manufacturing and retail vertical are expected accelerate, while technology and is expected to maintain its growth momentum. Management sees traction in digital, network, customers experience and cloud areas. Capex on 5G is expected to start in FY2022 as it was delayed owing to COVID-19. Management expects double digit growth over next couple of years on the back of anticipated growth in enterprise segment, potential 5G opportunities and strong deal wins. On the margin front, the management maintained its earlier FY2021 EBITDA margin guidance of 15% with an upward bias, despite strong EBITDA margin of 16.2% in 1HFY2021. We expect TechM's USD revenue/earnings to clock a CAGR of 10.5%/15.5% over FY2021-FY23E.

## Key positives

- EBITDA margin at 18.2%, above our estimates
- FCF generation of \$236 million (FCF to net profit conversion at 164%)
- Net new deal wins in communication vertical grew 98% q-o-q

## Key negatives

- Revenue declined 3% y-o-y in CC compared to a decline of 1.8% q-o-q in Q1FY2021

## Our Call

**Valuation – Expect margin likely to improve going ahead:** We have revised our earnings estimates upward for FY2021E/FY2022E/FY2023E factoring in impressive margin performance in Q2FY2021 and decent deal wins. 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 CMP, the stock is trading at reasonable valuation of 16x/14x of its FY2022E/FY2023E earnings, trading at significant discount to large peers despite anticipated strong revenue growth momentum in enterprise business and 5G opportunities. Hence, we maintain our Buy rating on the stock with a revised price target (PT) of Rs. 1,000.

## Key risk

A 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

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	34,742.1	36,867.7	38,103.9	42,231.4	46,559.5
OPM (%)	18.2	15.5	17.0	17.5	17.9
Adjusted PAT	4,297.6	4,250.5	4,117.8	4,749.9	5,495.6
% YoY growth	13.1	-1.1	-3.1	15.3	15.7
Adjusted EPS (Rs.)	47.7	45.9	46.8	54.0	62.5
P/E (x)	17.8	18.5	18.1	15.7	13.6
P/B (x)	3.7	3.4	3.0	2.7	2.4
EV/EBITDA (x)	11.6	13.2	11.3	9.5	8.0
RoNW (%)	22.0	19.2	17.9	18.6	19.3
RoCE (%)	24.0	20.5	18.8	20.1	21.2

Source: Company; Sharekhan estimates

### Strong quarter, margin surprised positively, strong FCF generation

TechM reported a strong set of numbers, beating our estimates in revenue, margin and net profit. The company impressed with significant expansion in margin, strong FCF generation and return of its deal TCVs to its historical average quarterly run-rate. Constant currency (CC) revenue grew 2.9% q-o-q, ahead of our estimates, led by 4.3% growth in enterprise segment, improvement in demand environment and absence of supply-side constraints. Communication segment grew 0.8% q-o-q in CC in Q2FY2021. Reported US Dollar revenues grew by 4.8% q-o-q to \$1,265.4 million. EBIT margin surprised positively and was expanded by 410bps q-o-q to 14.2%. The tailwinds for margin improvement were (1) 160 bps from recovery in demand side and absence of supply-side constraints, (2) cost management of 160bps in terms of utilisation, offshoring and reduction of subcontractor expenses and (3) 70 bps from normalization of seasonality (Q1FY2021 is usually a seasonally weak quarter for Comviva business and includes H1-B visa costs). The company incurred forex loss of \$5 million during the quarter versus a gain of \$11 million in Q1FY2021, mainly due to weak dollar. Further, other income was down 71.8% q-o-q during the quarter owing to absence of non-recurring items including interest on income tax refund (\$12 million) and earn-out from sale of a portfolio company. Net profit came in at Rs. 1,065 crore which was 9% above our estimates, led by both revenue and margin beat, partially offset by lower other income. Free cash flow (FCF) generation remained strong at \$236 million (second highest in the company's history) during the quarter, translating into a FCF-net profit conversion ratio of 164%.

### Expect momentum of revenue growth to continue going ahead

The management expects double digit growth over next couple of years on the back of anticipated growth in enterprise segment, potential 5G opportunities and strong deal wins. Enterprise business, accounting for 61% of its total revenue, registered a growth of 6% q-o-q during Q2FY2021, led by BFSI, technology and retail. The management indicated that revenue growth in manufacturing and retail vertical would accelerate from Q3FY2021. During the quarter, TCVs of large deals bounced back to \$421 million, in-line with expectations, led by strong deal wins in communication vertical. Further, capex on 5G is expected to start in FY2022 as its clients are committed to strengthen the network. Management sees traction in digital, network, customer experience and cloud areas. With higher spends on digital transformation by customers, we believe TechM is well positioned to report strong revenue growth over the next couple of years.

### Management expects margin improvement to continue in subsequent quarters

Management indicated that its cost-optimisation measures along with focus on structural changes, higher offshoring, and reduction in subcontractor expenses would drive margin improvement in the subsequent quarters. Further, the improvement in margins would be aided by the normalisation of large deals that were won in FY2020. There would be no wage hike in Q3FY2021. The management guided FY2021 EBITDA margin would be 15% with upward bias.

### Key Conference call takeaways

- ♦ **Revenue beat estimates:** TecM indicated that the growth in revenue was supported by absence of supply-side constraints and recovery in demand-side environment. Company reported positive across all its verticals during the quarter. Sequential revenue growth was primarily driven by strong growth in technology (+13.8% q-o-q), BFSI (+7.4% q-o-q) and retail (+7.4% q-o-q). Management indicated that digital business grew in the range of 10-15% q-o-q during the quarter.
- ♦ **Margin walkthrough:** EBIT margin increased 410bps q-o-q to 14.2%. Management highlighted that recovery in demand environment and absence of supply-side constraints provided a benefit of 160bps sequentially. In addition, cost management in terms of higher utilisation, increased offshore revenue mix and reduction in subcontractor expenses helped another 160bps q-o-q improvement in margins. Another 70bps q-o-q improvement in margins came from normalisation of seasonality because Q1 is usually a seasonally weak quarter in terms of mobility business and absence of visa costs.
- ♦ **Margin outlook:** Management believes that there are still operating levers which can help for further improvement in margins. Management provided FY2021E EBITDA margin guidance at 15% with upward bias. In H1FY2021, EBITDA margin was at 16.2%. Given the strong margin performance, company would comfortably beat this guidance.

- ♦ **Strong growth in technology, BFSI and retail:** Management highlighted it would focus on FCF generation, improvement of margins and revenue growth. BFSI, retail and technology, together contributed 34% of its total revenues, reported strong growth of 9.3%, 7.4% and 13.8% respectively. Manufacturing growth remained flat during the quarter, while others vertical grew 2% q-o-q during the quarter. Communication vertical reported revenue growth of 3% q-o-q during the quarter.
- ♦ **Business update:** Management stated that the supply-side constraints have been normalized during the quarter. 99% of its total staffs in IT business are in WFH mode, while 95% of total BPO employees are in WFH mode. Management highlighted that customers are willing to spend on transformation deals. Among new-age technologies, Cloud, Analytics, Customer Experience, Engineering Services, BPS showing positive momentum. Company sees demand revival across multiple segments, as customers have accelerated their pace of digital transformation.
- ♦ **Commentary on communication vertical:** Though service providers rolled out networks and focused on customer experience during the quarter, some of the discretionary spends were pulled back. The company was able to increase the TCVs of new deals in this space by 98% q-o-q to \$208 million. In addition, management also mentioned that deal pipeline in this space remains decent. Management expects acceleration of spends in both network and digital transformation in this communication space would be in next 3-9 months. Out of 5G related spends, systems integration oriented spends constitute of 30-40%.
- ♦ **Commentary on enterprise segment:** Management highlighted that manufacturing vertical recovered during the quarter on the expected lines. Management expects growth in this vertical going ahead, led by auto sub segment. Further, it expects spends relating to autonomous and EV section of auto segment would return going ahead. Management indicated that manufacturing is expected to perform well in both US and Europe in Q3FY2021. In retail, the pandemic has opened up a lot of opportunities in digital, omnichannel, omnicommerce solutions and among others. CPG is expected report strong growth in coming quarters. Management stated that growth momentum in manufacturing and retail verticals are expected to accelerate in Q3FY2021.
- ♦ **Commentary on BPS services:** Post a material impact on BPS business in Q1FY2021 owing to COVID-19, BPS business in dollar terms grew 31% q-o-q during the quarter. Its margin improved to 21.9% from 6.8% in Q1FY2021.
- ♦ **Deal TCVs bounced back:** The company signed deals with a total contract value (TCV) of worth \$421 million versus \$290 million in Q1FY2020. TCVs of large deals bounced back during the quarter as compared to the average quarterly deal wins of \$400-500 million. Management highlighted deal wins consist of large number of medium-sized deals during the quarter. Deal wins grew 97% q-o-q and 16% q-o-q to \$208 mn and \$214 mn for telecom and enterprise respectively
- ♦ **Revenue grew across regions:** The Europe and US business reported revenue growth of 2.4% and 2.9% q-o-q, while revenue in the rest of the world (RoW) business grew 11.1% q-o-q.
- ♦ **DSO days improved:** DSO further declined to 97 days from 107 days in Q1FY2021, led by reduced working capital requirements. This the lowest in last 15 quarters.
- ♦ **Strong cash generation:** TechM generated second highest quarterly FCF of \$236 million, aided by strong collections, versus \$317 million in Q1FY2021. Free cash flow to PAT conversion stood at 164% (versus 246% in Q1FY2021). FCF stood at \$552.4 million in H1FY2021, compared to \$522.6 million in FY2020, aided by improved collections. Cash & cash equivalents increased to \$1,564 million compared to \$1,378.4 million in Q1FY2021.
- ♦ **Capital allocation:** The company has declared annual special dividend of Rs. 15 per share during the quarter. Over last 3 years, TechM has returned back cumulative cash of over \$1 billion through dividends and buyback.
- ♦ **Acquisitions:** TechM announced the acquisition of 100% stake in Auckland, New Zealand headquartered Tenzing and Melbourne, Australia headquartered Momenton. These acquisitions would strengthen its digital capabilities, and offer its clients end-to-end transformation services. This will significantly enhance its local presence in the ANZ markets, and the combination will create significant synergies in bringing next generation solutions to customers.
- ♦ **Headcount added:** Total headcount stood at 124,258 during the quarter, with a net addition of 842 employees q-o-q, owing to headcount addition in BPO business and lower attrition. The BPO segment saw a headcount addition of 2,908 compared to a reduction of 1,262 in Q1FY2021. Attrition rate improved to 13.5% versus 16.6% in Q1FY2021.

## Results

Particulars	Q2FY21	Q2FY20	y-o-y (%)	Q1FY21	Rs cr q-o-q (%)
Revenues In USD (mn)	1,265.4	1,287.2	-1.7	1,207.5	4.8
Revenues	9,371.8	9,069.9	3.3	9,106.3	2.9
Cost of Services	6,424.5	6,389.3	0.6	6,510.5	-1.3
Gross profit	2,947.3	2,680.6	9.9	2,595.8	13.5
SG&A	1,244.3	1,179.7	5.5	1,295.3	-3.9
EBITDA	1,703.0	1,500.9	13.5	1,300.5	30.9
Depreciation	371.7	341.5	8.8	383.2	-3.0
EBIT	1,331.3	1,159.4	14.8	917.3	45.1
Other Income	117.5	216.3	-45.7	416.1	-71.8
PBT	1,408.9	1,337.4	5.3	1,283.1	9.8
Provision for taxes	346.2	226.5	52.8	327.6	5.7
Reported net profit	1,064.6	1,123.9	-5.3	972.3	9.5
EPS (Rs.)	12.1	12.8	-5.2	11.0	9.6
Margin (%)			BPS		BPS
EBITDA	18.2	16.5	162	14.3	389
EBIT	14.2	12.8	142	10.1	413
NPM	11.4	12.4	-103	10.7	68

Source: Company; Sharekhan Research

## Revenue mix: Geographies, industry verticals, and other operating metrics

Particulars	Revenues	Contribution	\$ Growth (%)	
	(\$ mn)	(%)	q-o-q	y-o-y
Revenues (\$ mn)	1,265	100	4.8	-1.7
Geographic mix				
America	612	48.4	2.9	-1.9
Europe	319	25.2	2.4	-7.2
RoW	334	26.4	11.1	4.2
Industry verticals				
Communication	497	39.3	3.0	-6.0
Manufacturing	204	16.1	0.2	-12.1
Technology, media & entertainment	124	9.8	13.8	18.9
BFSI	208	16.4	9.3	24.0
Retail, transport and logistics	95	7.5	7.4	5.3
Others	138	10.9	2.0	-16.3
Clients contribution				
Top 5	272	21.5	3.4	-2.1
Top 10	385	30.4	2.4	-5.2
Top 20	541	42.7	3.0	-3.6
Revenue by services	(INR in crore)	(%)	q-o-q	y-o-y
IT	84,193	89.8	0.6	2.4
BPO	9,525	10.2	28.8	12.7

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.

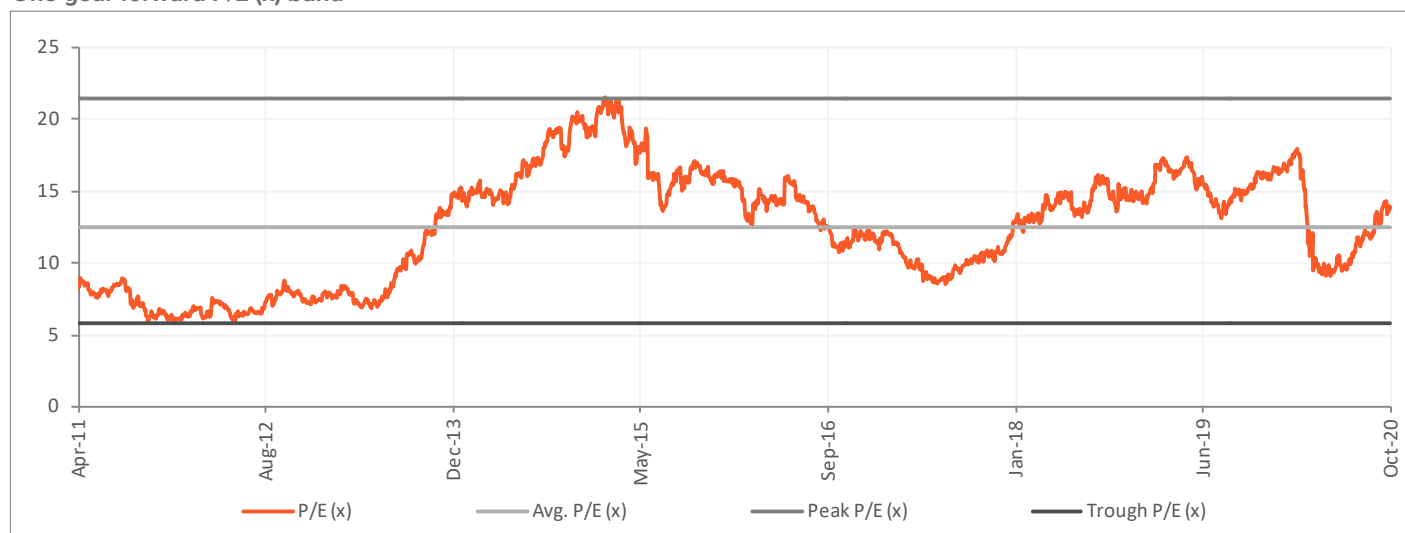
### Company Outlook – Well-placed to capture 5G opportunity

With 39% 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 revised our earnings estimates upward for FY2021E/FY2022E/FY2023E factoring in impressive margin performance in Q2FY2021 and decent deal wins. 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 CMP, the stock is trading at reasonable valuation of 16x/14x of its FY2022E/FY2023E earnings, trading at significant discount to large peers despite anticipated strong revenue growth momentum in enterprise business and 5G opportunities. Hence, we maintain our Buy rating on the stock with a revised price target (PT) of Rs. 1,000.

#### 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	852	271	231,272	18.7	17.2	11.9	11.1	4.0	3.6	22.7	22.1
Infosys	1,122	426	477,906	25.6	23.5	16.7	15.4	3.5	3.2	26.7	26.2
Wipro	342	571	195,680	19.7	18.5	13.4	12.3	3.4	3.1	15.7	15.8
Tech M	848	97	81,996	18.1	15.7	11.3	9.5	3.0	2.7	17.9	18.6

Source: Company, Sharekhan estimates

## About company

Incorporated in 1986, Tech Mahindra was formed with 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 Mahindra entered the enterprise solutions space and became the fifth-largest Indian IT player. The company has now diversified its exposure to other verticals like BFSI and manufacturing. Tech Mahindra offers a bouquet of services 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 Mahindra is one of 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 to accelerate across the globe, Tech Mahindra is well-positioned to capitalize 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 as 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
- ♦ Macro uncertainties could impact earnings
- ♦ 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: Company Website

### Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	TML BENEFIT TRUST	9.75
2	First State Investments ICVC	5.85
3	BlackRock Inc	4.99
4	First State Global Umbrella Fund	4.58
5	SBI Funds Management Pvt Ltd	2.59
6	Republic of Singapore	2.19
7	ICICI Prudential Asset Management	1.80
8	SBI-ETF NIFTY 50	1.75
9	Vanguard Group Inc/The	1.75
10	Government Pension fund	1.60

Source: Bloomberg

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## 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 deteriorating 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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