Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

| 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. 2,732** | |
| Price Target: **Rs. 3,100** | ↑ |

↑ Upgrade ↔ Maintain ↓ Downgrade

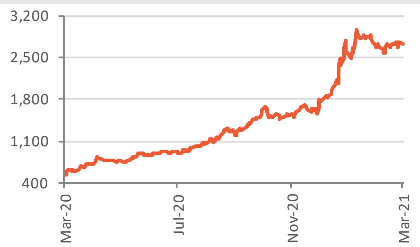
**Company details**

| | |
|---|---|
| Market cap: | Rs. 17,014 cr |
| 52-week high/low: | Rs. 3,050 / 501 |
| NSE volume: (No of shares) | 7.6 lakh |
| BSE code: | 500408 |
| NSE code: | TATAELXSI |
| Free float: (No of shares) | 3.5 cr |

**Shareholding (%)**

| | |
|---|---|
| Promoters | 45 |
| FII | 7 |
| DII | 14 |
| Others | 35 |

**Price chart**




**Price performance**

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 2.4 | 65.4 | 112.7 | 400.6 |
| Relative to Sensex | 1.8 | 56.6 | 81.1 | 308.0 |

*Sharekhan Research, Bloomberg*

# Tata Elxsi Limited

## Connecting all the right dots

IT & ITeS | Sharekhan code: TATAELXSI | Company Update

Stock Update


## Summary

- We stick to our Buy rating on Tata Elxsi Limited (TEL) with a revised PT of Rs. 3,100, given industry tailwinds, strong growth potential, and superior margin profile.
- TEL is well placed to capture increasing R&D spends in automotive (one of the largest spenders on R&D), broadcasting and communication (smart, connected homes, and OTT), and medical devices (remote healthcare).
- Given improving demand environment, ramp-up of recent deal wins, and healthy deal pipeline, TEL is expected to deliver revenue growth in the top quartile of industry-level growth in the coming years.
- TEL has successfully reduced its revenue concentration by increasing revenue contribution from non-automotive verticals and adjacencies. With investments on sales and marketing, delivery, and capabilities, the company has sharpened its focus on large multi-year deals against project-based engagements earlier.


**Tata Elxsi Limited (TEL), a niche engineering, research, and development (ERD) services company, is confident of strong growth and is well placed to capture increasing R&D spends in automotive (one of the largest spenders on R&D), broadcasting and communication (smart, connected homes, and OTT), and medical devices (remote healthcare and leverage of patient data). TEL's unique capability of integrated design and technology teams across verticals help the company to enhance its service portfolio and innovate new products and services for its customers. The company is continuing to invest in strengthening capabilities, which include (1) electric vehicle as autonomous, connected, Electric, and Shared Mobility (ACES), which remain the dominant trend in the automotive market. This is a huge opportunity in the next few years as global auto R&D spends on software development are expected to post a 9%-10% CAGR and (2) new media segment such as smart, connected homes and OTT for operators and broadcasters. TEL's partnership with Google Widevine, Syntiant, and INVIDI Technologies would help in large deal wins and is likely to propel growth; (3) medical technology driven by market human factor engineering, regulatory standards, and telemed. Management indicated that it is confident of growth momentum in Q4 and expect to end FY2021 with a higher exit rate on account of gradual recovery in the automotive sub-segment and continued growth momentum in media and medical devices verticals. We expect EBIT margin to remain stable in Q4FY2021, led by (1) continued lower travel and admin expenses, (2) scope of improvement in utilisation, (3) higher revenue growth, (4) higher offshoring, and (5) operational efficiencies. Management believes that its investments in sales and marketing, delivery, and capabilities would reap benefits in terms of large multi-year deal wins in the coming years. The company has changed its strategies to large multi-year deals compared to project-based engagements earlier. Given improving demand environment, ramp-up of recent deal wins, and a healthy deal pipeline, TEL is expected to deliver revenue growth in the top quartile of industry-level growth rates in FY2022.**

## Our Call

**Valuation – Bright times ahead:** We have revised our earnings estimates upward for FY2022E/FY2023E, factoring in pickup in R&D spends in the automotive industry, and continued growth in the non-automotive segment. With faster-than-expected demand recovery in the auto segment, strong traction in other verticals, recent deal wins, and a healthy deal pipeline, we expect TEL to report industry-leading growth over the next few years, with a stable a margin profile. We continue to prefer TEL, given its advanced technological capabilities, strong execution, long-term relationships with clients, diversification strategy by focusing on adjacencies, and a strong parentage. We expect TEL's revenue and earnings to report a CAGR of 23% and 27%, respectively, over FY2021-FY2023E. At the current market price (CMP), the stock is trading at 36x/29x its FY2022E/FY2023E earnings. A strong balance sheet, improving cash generation, and consistent dividend payout provide comfort on the stock. Hence, we recommend a Buy rating on TEL with a revised price target (PT) of Rs. 3,100.

## Key Risks

(1) Slowdown in the global economy especially in the automotive industry might affect growth momentum; (2) currency risks; and (3) slower growth in automotive and broadcast sectors.

**Valuation** Rs cr

| Particulars | FY19 | FY20 | FY21E | FY22E | FY23E |
|---|---|---|---|---|---|
| Revenue | 1,596.9 | 1,609.9 | 1,808.2 | 2,274.0 | 2,757.9 |
| OPM (%) | 26.0 | 21.3 | 27.7 | 28.3 | 28.0 |
| Adjusted PAT | 290.0 | 256.1 | 363.0 | 477.9 | 582.6 |
| *% YoY growth* | *20.8* | *-11.7* | *41.7* | *31.6* | *21.9* |
| Adjusted EPS (Rs.) | 46.6 | 41.1 | 58.3 | 76.7 | 93.6 |
| P/E (x) | 58.7 | 66.4 | 46.9 | 35.6 | 29.2 |
| P/B (x) | 18.0 | 15.6 | 12.7 | 10.0 | 7.8 |
| EV/EBITDA (x) | 39.7 | 48.1 | 32.9 | 25.6 | 21.4 |
| RoNW (%) | 30.8 | 23.5 | 27.1 | 28.0 | 26.8 |
| RoCE (%) | 33.0 | 24.5 | 29.8 | 30.9 | 29.0 |

*Source: Company; Sharekhan estimates*

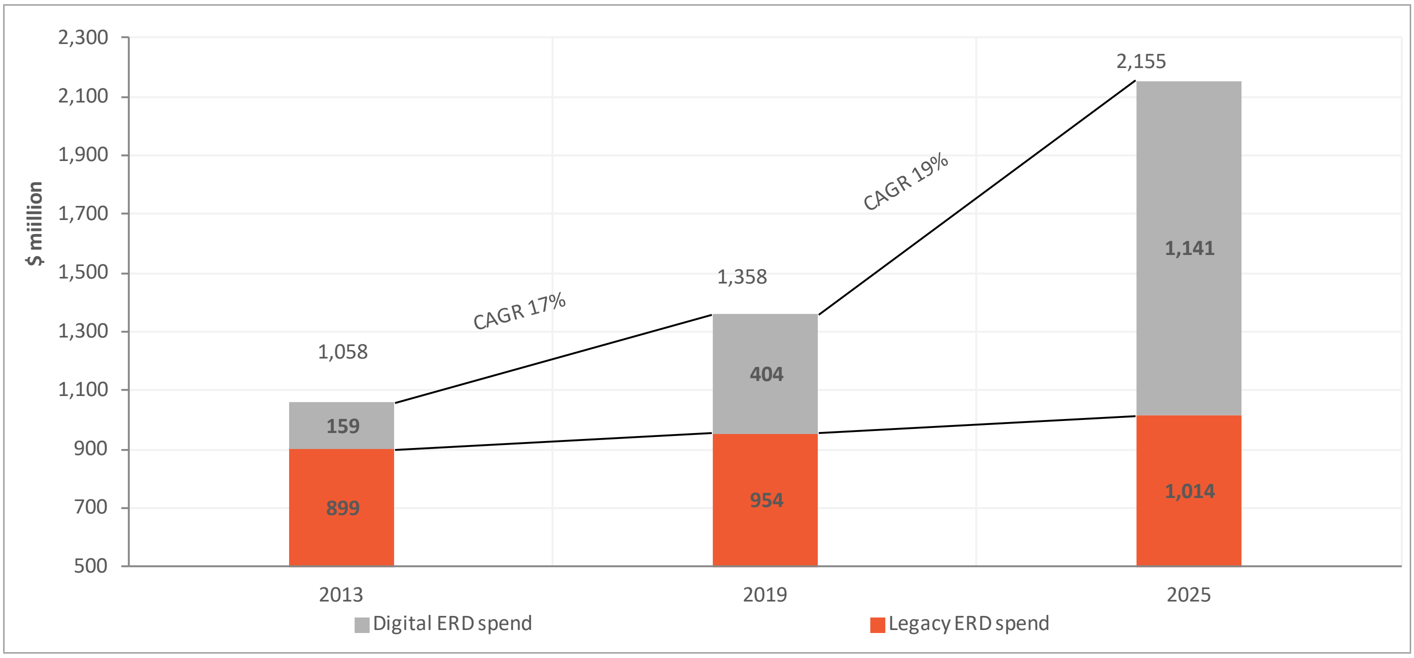
**ERD to grow at a faster rate**

According to NASSCOM, India's ERD services sector (comprising embedded systems, ERD, and product engineering services) is the fastest growing sector within the Indian technology space. Over the past 5-6 years, India's ERD services sector has been growing in double digits, driven by (1) higher adoption of new technologies such as IOT, Edge, AR/VR, and robotics to enhance customer experience, (2) increasing platformisation and cloudification, and (3) rising outsourcing supported by talent and cost. However, global ERD spend is expected to decline by 6% y-o-y to $1.3 trillion in CY2020, as enterprises across affected verticals such as aerospace, auto, and manufacturing tighten purse-strings. Global ERD spend is expected to report an 8% CAGR over CY2019-CY2025, reaching $2.2 trillion. Growth would be led by increasing software-led engineering and digital technologies (like IoT and analytics).

With navigation to a new normal post COVID-19 era, enterprises have started allocating their spends towards new-age technologies such as 5G, artificial intelligence, machine-to-machine communication, Internet of Things (IoT), and advanced robotics to shift themselves from a physical to digital framework. In the aftermath of COVID-19 impact, there are some initial signs of gradual improvement in ERD spending by automotive, telecom, and aerospace companies, who have started investing on connected resilient systems, optimisation of manufacturing process, new product development, and cost takeout initiatives through digital engineering.

There has been a significant shift towards embedded engineering. A large portion of this technology spend is now moving towards digital. The sharpening focus on digital integration would lead to higher share of digital engineering in total ERD spends. Digital engineering spend of enterprises is projected to report a 19% CAGR in 2019-2025E, reaching $1.1 trillion by 2025. Digital engineering is going to be the focus area for enterprises with growing requirements for better user experience and personalisation, greater adoption of platforms and cloud, and consolidation to build full-stack capabilities. Digital engineering spends are accelerating across verticals, and this is expected to contribute to 53% of ERD spending by 2025 as compared to 30% in 2019.

**Digital engineering spend to post 19% CAGR over 2019-2025E**




*Source: Zinnov, Sharekhan Research*

**TEL well-placed to capture increasing spends on digital engineering**

Higher engineering spends on digital and new technologies especially by automotive, broadcast, and healthcare companies create a large opportunity for TEL. The company has been sufficiently investing in digital technologies (artificial intelligence (AI) and analytics, IoT and automation), hardware, IPs and services to benefit from the opportunity. Further, TEL brings together its unique capability of integrated design and technology teams across verticals to enhance its service portfolio and innovate new products and services. The continues to invest in strengthening capabilities in selected verticals, which include (1) electric vehicle (including control software development, battery management systems, and validation), as autonomous, connected, electric, and shared mobility (ACES) remain the dominant trends in the automotive market. TEL works with leading car manufacturers and suppliers in developing electronics and software for powertrain, infotainment, connectivity, active safety, and comfort and convenience. TEL has licensed its AUTOSAR Software and partnered with automobile manufacturers and component suppliers, including OEMs, Tier-1 suppliers, and chip vendors. This is a huge opportunity in the next few years, as global auto ER&D spend of ~$158 billion is one of the largest contributors to total global ER&D spends (i.e. around 12%). As per McKinsey, software development and verification and validation services are expected to post a 9%-10% CAGR, aided by increasing usage of software in vehicles, and (2) new media segments such as smart, connected homes, and OTT for operators and broadcasters. TEL's partnership with Google Widevine (to secure premium content protection for broadcast, media, consumer electronics, and automotive applications), Syntiant (to provide low-power edge AI device development for voice applications and INVIDI Technologies (to bring addressable television capabilities to pay TV operators in India, Asia-Pacific and MEA), (3) medical technology driven by market research and human factor engineering, hardware and software engineering, verification and validation, regulatory standards and compliance requirements along with technologies such as AI, cloud, and IoT. This is a huge opportunity in coming years given $48 billion R&D spend.

**Expect industry-leading revenue growth over FY2021-FY2023E; Strong momentum to continue in Q4FY2021**

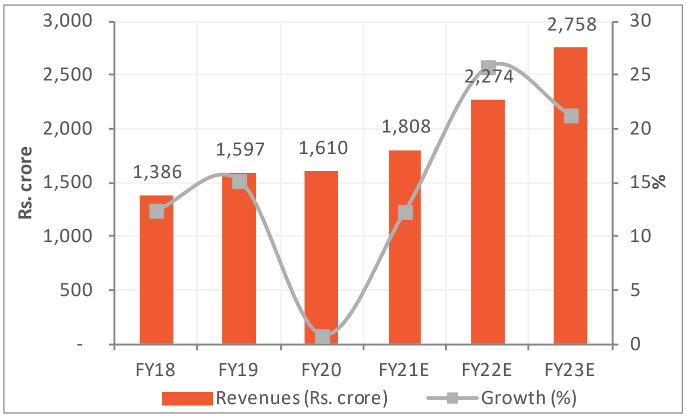
Management indicated that it is confident of growth momentum in Q4 and expects to end FY2021 with higher exit rate because of gradual recovery in the automotive sub-segment and continued growth momentum in media and medical devices verticals. With demand slowdown in the auto industry over the past two years, global auto sales have started recovering. This indicates improvement in capital allocation towards R&D spending, especially in the digital engineering space. In the last quarter, the company has added new automotive customers, including a new-age OEM in North America, and has closed some large deals in the vehicle electronics and software and autonomous driving space. Management remains optimistic that growth momentum would continue in Q4FY2021 because of a strong deal pipeline across markets and verticals, ramp-up of deals, strong deal wins, green shoots in the auto sub-segment, and strong traction in media and medical devices verticals. Management believes that its investments in sales and marketing, delivery, and capabilities would reap benefits in terms of large multi-year deal wins in the coming years. The company has changed its sales incentive structure and its focus is on large multi-year deals compared to its project-based engagements earlier. Given improving demand environment, ramp-up of recent deal wins, and a healthy deal pipeline, TEL is expected to deliver revenue growth in the top quartile of industry-level growth rates in FY2022.

**Expect margins to remain stable in Q4FY2021E**

EBIT margin has been beating our expectations for the past two consecutive quarters because of improving utilisation, improvement in offshore revenue, and higher revenue growth. We expect EBIT margin to remain stable in Q4FY2021, led by (1) continued lower travel and admin expenses, (2) scope of improvement in utilisation, (3) higher revenue growth, (4) higher offshoring, and (5) operational efficiencies. Attrition rate has marginally increased to 6.1% in Q3FY2021versus 6% in Q2FY2021. Net addition of employees stood at 177 on a sequential basis during the quarter. Offshore mix improved to 67.8% from 65.3%/59.7% in Q2FY2021/Q3FY2020.

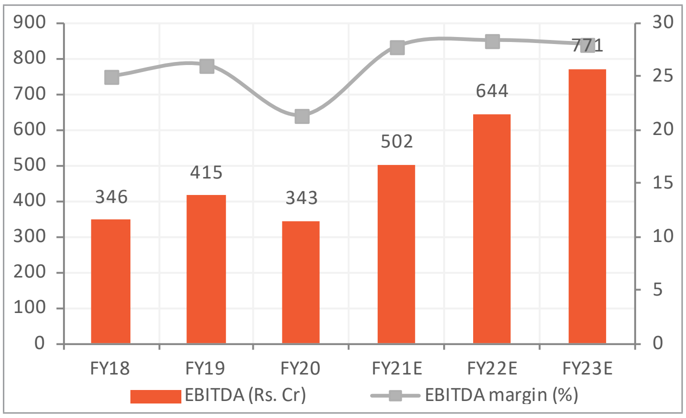
## Financials in charts

**Revenue (Rs. crore) and growth (%)**



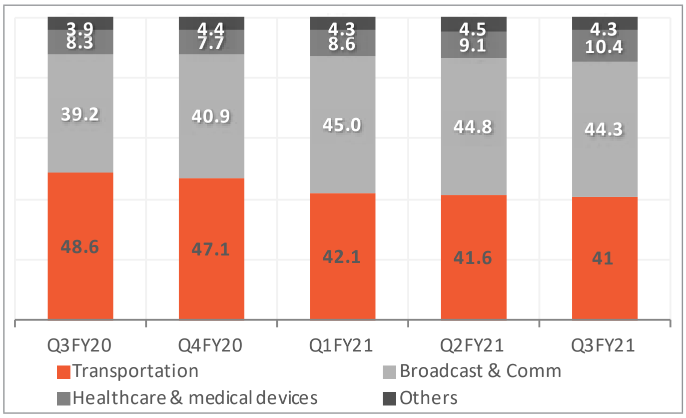

Source: Company, Sharekhan Research

**EBITDA (Rs. cr) and EBITDA margin (%)**



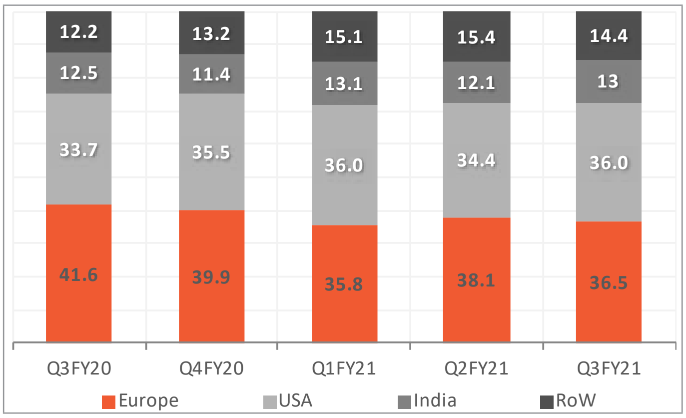

Source: Company, Sharekhan Research

**Vertical breakdown (%)**



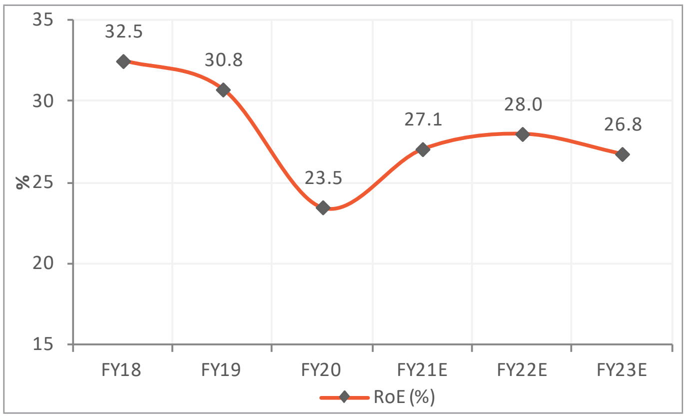

Source: Company, Sharekhan Research

**Geography breakdown (%)**



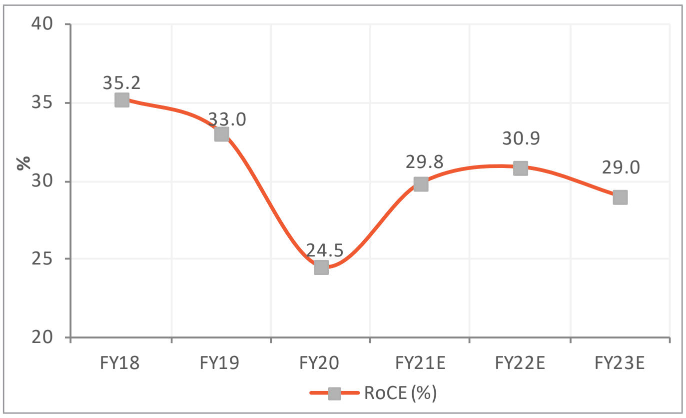

Source: Company, Sharekhan Research

**RoE trend (%)**




Source: Company, Sharekhan Research

**RoCE trend (%)**




Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector view – Large addressable market provides sustainable growth opportunities

Total global 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, for which spends are accelerating across verticals. This is expected to contribute to 53% of ERD spending by 2025 as compared to 30% in 2019, taking digital engineering spends to grow to around $1.1 trillion by 2025 from $404 million in 2019.

### ■ Company outlook - Promising outlook

TEL's major verticals have a huge growth opportunity considering increased R&D spends in the automotive, consumer electronics, and medical devices. Given that TEL is a specialist vendor for top OEMs and Tier-I suppliers, recent re-allocation of R&D budgets towards electronics and software, a large addressable market, and differentiated product offerings augment growth opportunities for the company. However, we model TEL's revenue and earnings to register CAGR of 23% and 27%, respectively, over FY2021-FY2023E.

### ■ Valuation - Bright times ahead, maintain Buy

We have revised our earnings estimates upward for FY2022E/FY2023E, factoring in pickup in R&D spends in the automotive industry, and continued growth in the non-automotive segment. With faster-than-expected demand recovery in the auto segment, strong traction in other verticals, recent deal wins, and a healthy deal pipeline, we expect TEL to report industry-leading growth over the next few years, with a stable a margin profile. We continue to prefer TEL, given its advanced technological capabilities, strong execution, long-term relationships with clients, diversification strategy by focusing on adjacencies, and a strong parentage. We expect TEL's revenue and earnings to report a CAGR of 23% and 27%, respectively, over FY2021-FY2023E. At the current market price (CMP), the stock is trading at 36x/29x its FY2022E/FY2023E earnings. A strong balance sheet, improving cash generation, and consistent dividend payout provide comfort on the stock. Hence, we recommend a Buy rating on TEL with a revised price target (PT) of Rs. 3,100.

**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 |
| LTTS | 2,580 | 11 | 27,101 | 40.7 | 29.8 | 25.7 | 19.4 | 8.4 | 7.1 | 22.4 | 26.1 |
| Tata Elxsi | 2,732 | 6 | 17,104 | 46.9 | 35.6 | 32.9 | 25.6 | 12.7 | 10.0 | 27.1 | 28.0 |

*Source: Company, Sharekhan estimates*

## About company

The company was incorporated in 1989 as Tata Elxsi (India) Limited. The company provides product design and engineering services and systems integration and support services in India, US, Europe, and Rest of the World. The company also provides solutions and services for emerging technologies such as IoT, big data analytics, cloud, mobility, virtual reality, and AI and brings together domain experience across infotainment, autonomous driving, telematics, powertrain, and body electronics. The company addresses the automotive, broadcast and communications, consumer electronics, and healthcare industries, supported by its worldwide network of design studios, development centres, and offices. The company also works with leading OEMs and suppliers in the automotive and transportation industries for R&D, design and product engineering services from architecture to launch and beyond.

## Investment theme

TEL is an integrated engineering services company with a strong expertise in the automotive and broadcast and communication verticals. The complex innovation requirements for OEMs need to be cost-effective, which makes a good case for offshoring to India due to its capabilities along with cost advantage. A change in the business mix would help in improving margins and return ratios. TEL has a strong, debt-free balance sheet, and a robust cash balance that provides an inorganic growth opportunity, which is crucial in the fast-changing technology landscape. The company has been generating return on equity in excess of 30% since the past three years.

## Key Risks

(1) Slowdown in the global economy, especially in the automotive industry and ongoing US-China global trade might affect growth momentum; (2) currency risks; and (3) slower growth in automotive and broadcast sectors.

## Additional Data

**Key management personnel**

| | |
|---|---|
| NG Subramanian | Non-Executive Chairperson |
| Manoj Raghavan | Managing Director cum Chief Executive Officer |
| Nitin Pai | CMO and Chief Strategy Officer |
| H V Muralidharan | Chief Financial Officer |
| Girja Vaidyanathan | Company Secretary and Compliance Officer |

*Source: Company Website*

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | JPMorgan Chase & Co | 2.39 |
| 2 | Tata Investment Corp Limited | 2.30 |
| 3 | Axis Asset Management | 1.91 |
| 4 | Vanguard Group Inc. | 1.89 |
| 5 | Axis Equity Advantage Fund | 1.36 |
| 6 | Somerset Emerging Market | 1.27 |
| 7 | Avendus Enhanced Return Fund | 1.10 |
| 8 | BlackRock Inc. | 0.83 |
| 9 | Tata Asset Management Limited. | 0.62 |
| 10 | Invesco Limited | 0.59 |

*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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