Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

L&T Technology Services

Robust Q2; on steady growth path

IT & ITES	Sharekhan code: LTTS	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. 5,123**	
Price Target: **Rs. 5,900**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

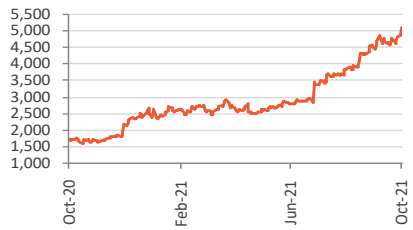
Company details

Market cap:	Rs. 53,887 cr
52-week high/low:	Rs. 5,469 / 1,602
NSE volume: (No of shares)	4.0 lakh
BSE code:	540115
NSE code:	LTTS
Free float: (No of shares)	2.7 cr

Shareholding (%)

Promoters	74.2
FII	10.1
DII	6.9
Others	8.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	15.1	50.6	90.6	192.7
Relative to Sensex	9.6	32.4	61.9	140.0

Sharekhan Research, Bloomberg

Summary

- Q2 saw an all-round beat; EBIT margins improved for fifth consecutive quarter to 18.4%; Q2 witnessed healthy improvement in client additions, offshoring revenue mix and free cash flow (FCF). Deal wins remained strong.
- LTTS raised annual USD revenue growth guidance to 19-20% from 15-17% earlier and 13-15% at the beginning of the year, beating our expectations. The revision in guidance reflects strong demand for digital engineering and market share gains.
- We expect USD revenue and earnings to clock a CAGR of 18% and 23%, respectively, over FY2022-24E. Management expects improvement in margin profile of telecom & hi-tech vertical going ahead as its investments started yielding results.
- We maintain a Buy on L&T Technology Services (LTTS) with a revised PT of Rs. 5,900, given strong revenue growth potential, consistent deal wins and higher spends on digital engineering across verticals.

L&T Technology Services (LTTS) delivered yet another strong quarter beating estimates on all fronts, with healthy improvement in EBIT margins, client additions, offshoring revenue mix and free cash flows (FCF). The company reported CC revenue growth of 6% q-o-q and 22.3% y-o-y, led by strong growth in medical devices, industrial products and transportation verticals. EBIT margins improved for the fifth consecutive quarter to 18.4% despite wage hikes for mid and senior management along with lower utilisation, aided by productivity improvement and cost optimisation. The management increased its annual USD revenue growth guidance to 19-20% from 15-17% earlier and 13-15% at the beginning of the year, ahead of our expectations. The revision in guidance is very impressive and reflects strong demand for digital engineering and market share gains. The management cited that the company is progressing well in terms of transaction, deal wins, deal pipeline and solutions across its six big bets within ERD space.

Key positives

- Revenue growth guidance raised to 19-20%, higher than our expectations
- Margin of transportation, telecom & industrial product vertical expanded for the fifth consecutive quarter

Key negatives

- Attrition rated increased 200 bps q-o-q to 16.5%
- Softness in media sub-segment due to delays in project renewals

Management commentary

- Management saw strong demand environment in the US and Europe
- Getting positive signal on CY2022 budget based on its conversation with customers
- Plans to add another 2,000 freshers in H2FY2022, of which a large portion will be added in Q3

Revision in estimates - We revised our earnings estimates upward for FY22E/FY23E/FY24E by 3-7%

Our Call

Valuation – Strong growth prospects: LTTS is one of the best plays in the faster growing ERD space for its multi-industry expertise, deep engineering capabilities, end-to-end offerings, and long standing relationships with large enterprises worldwide. LTTS is well-placed to gain market share among global competitors because of being the preferred engineering partner among clients, strong customer-centric approach and a full-service model. We expect LTTS' USD revenue and earnings to post a CAGR of 18% and 23% over FY2022-FY2024E. At CMP, the stock trades at 44x/37x its FY2023E/FY2024E earnings estimates, which justifies premium valuations, given strong deal wins, presence in the fast-growing ERD segment, and consistent dividend pay-outs. Hence, we retain a Buy on LTTS with a revised PT of Rs. 5,900.

Key Risks

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

Valuation — Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenues	5,449.7	6,624.5	8,048.3	9,583.7
OPM (%)	18.5	21.2	20.8	20.6
Adjusted PAT	663.3	977.2	1,221.4	1,480.9
% y-o-y growth	-19.0	47.3	25.0	21.3
Adjusted EPS (Rs.)	62.9	92.5	115.6	140.2
P/E (x)	81.5	55.4	44.3	36.6
P/B (x)	15.3	12.8	10.6	8.8
EV/EBITDA (x)	51.1	36.6	30.5	25.5
RoNW (%)	21.3	25.6	26.5	26.6
RoCE (%)	21.3	26.9	27.7	28.2

Source: Company; Sharekhan estimates

Excellent quarter; cash conversion stayed strong

LTTS reported strong revenue growth (slightly ahead of our estimates) led by higher spends on digital engineering across all its verticals, while operating margins beat our expectations significantly (by 160 bps) aided by a significant margin expansion in industrial products vertical. Q2 saw a healthy improvement across all parameters - revenue growth, EBIT margins, client additions, net headcount addition and free cash flows. The company reported CC revenue growth of 6% q-o-q and 22.3% y-o-y, marginally ahead of our estimates, led by strong growth in medical devices, industrial products and transportation verticals. Three out of five verticals grew better than the company's growth rate, while medical devices vertical reported strong sequential revenue growth of 9.6% (on USD terms). On reported basis, USD revenue increased 5.7%/22.1% q-o-q/y-o-y to $217.4 million, marginally ahead of our expectations of $215.8 million. EBIT margin improved 116 bps q-o-q to 18.4% (fifth consecutive quarter of operating margin improvement) despite wage hike for mid and senior management, which is 160 bps above our expectations, aided by a gradual portfolio shift towards more digital engineering, operational efficiency initiatives, productivity improvement and cost optimisation. Net profit came at Rs. 230 crore (up 6.4% q-o-q and 39% y-o-y) and was 1% ahead of our estimates, aided by a beat in operating profitability, partially offset by lower other income (reversal of SEIS incentives). The FCF to net profit ratio stood at 154% in Q2FY2022 versus 32% in Q1FY2022.

Key result highlights

- **Beat on all fronts:** Except the medical devices vertical (up 13% y-o-y), the company reported a 20% y-o-y growth across all its verticals in Q2FY2022. However, the medical devices vertical recovered strongly on q-o-q basis in Q2FY2022, registered 10.2% q-o-q growth and crossed $100 million on quarterly annualized revenue. The company's revenue growth accelerated to 22.1% y-o-y (20.3% y-o-y in Q1FY2022) and reported a record-high EBITDA margin of 21.7% since Q1FY2016. During 1HFY2022, the company' USD revenue grew by 21.2% y-o-y, led by industrial products and plant engineering verticals. The industrial products vertical has been growing at around 8% on a sequential basis for last two consecutive quarters. During Q2FY2022, growth was broad-based with four of its five segments grew in the range of 4-10%, led by medical devices.
- **Raised revenue growth guidance for FY2022E, exceeding our estimates:** The management increased its annual USD revenue growth guidance to 19-20% from 15-17% earlier and 13-15% at the beginning of the year, beating our expectations. The revision in guidance is very impressive and reflects strong demand for digital engineering and market share gains. The guidance implies a revenue CQGR of 3.6 -4.5% for the remaining two quarters of FY2022E, which looks healthy. Further, the company has won 5 deals with TCV of over $10 million, which included two $25 million+ deals. Management highlighted that the company is progressing well in terms of transaction, deal wins, deal pipeline and solutions across its six big bets such as EACV (Electric autonomous and connected vehicles), MedTech, 5G, AI and digital products, Digital manufacturing and Sustainability within the ERD space. The management remains confident of its growth trajectory in FY2022 on the back of broad-based growth across its verticals, large deal wins, a healthy deal pipeline and higher spend on digital engineering across the verticals. The management highlighted that it sees strong demand in the US and Europe, while the decision-making has been recovering in Japan and India. Digital and leading-edge technologies' revenue share in total revenue remained at 55% versus 54% in Q1FY2022, rising 8% q-o-q and 37% y-o-y. The management expects that growth would be driven by 1) cost optimisation initiatives in legacy engineering and 2) higher demand for digital and leading-edge technologies. Further, the management expects higher spend on digital engineering would continue in CY2022 based on its conversations with customers. However, supply-side challenges, talent crunch and wage inflation remains key risk to demand. Management indicated that the growth momentum would continue in Q3FY2022 despite weak seasonality.

- **Margins to remain under pressure in H2:** Key margin levers include strong revenue growth, higher offshoring, pyramid rationalization, potential improvement in margin profile of telecom & hi-tech vertical and productivity improvement. We expect margins to remain under pressure in the near-term owing to gradual reversal of savings related to travel and facility expenses, supply-side concerns and skill-based premium. Management is scouting for M&A to fill the gaps in capabilities, which could impact on margins. Management aspires a sustainable 18% EBIT margin level by FY2025, though the EBIT margin remained at 18.4% during the quarter.
- **Expect growth momentum to remain strong in transportation vertical:** The transportation vertical's revenue grew by 6.2% q-o-q (versus +4.2% in Q1FY2022), led by strong growth in auto, aero and trucks & off-highway. The management sees traction in auto and trucks & off-highway both in new areas like electric vehicles (EVs), autonomous, connected vehicles, advanced driver-assistance systems (ADAS), etc. The company has been partnering with its customers in the areas of electrification and connected vehicles. The company is ramping up projects with traditional OEMs, while it is deepening its engagements with new-age companies on the EV side. Customers continue to focus on optimising R&D costs and invest heavily in the digital engineering given its transition to electric technology, autonomous driving and among others. In trucks & off-highway, the company has been wining deals in electrification programs across product categories. During Q2FY2022, the company won a $25 million+ deal to expand its customers design center in India and create a dedicated technology hub to work on EV space (it had won two $25 million+ deals in the EV space during Q1FY2022). Management expects growth momentum would continue across all three segments of transport.
- **Good wins in plant engineering vertical:** Revenue grew by 4.1% q-o-q (versus a 4.2 % q-o-q growth in Q1FY2022) in Q2FY2022, led by growth in O&G and FMCG, followed by chemical. The company won new engagements with major O&G customers in digital engineering area. In FMCG, customers are leveraging its capabilities to open new plants, automation and sustainability. The management sees increasing opportunities in chemical segment as capex outlook across the industry improves. The growth momentum is expected to continue in its pant engineering vertical going ahead.
- **Growth outlook in industrial products vertical:** Revenue grew by 8.6% q-o-q versus a growth of 7.5% q-o-q in Q1FY2022, led by broad-based growth across all three sub-segments (electrical, machinery and building automation). Demand remains strong in both digital and traditional areas of product development and cost optimisation. Customers are investing in software platforms to improve products and enhance their customer experience. Management expects industrial products vertical would be the fastest-growing vertical in FY2022E.
- **Outlook for telecom & hi-tech:** The telecom and hi-tech verticals' growth moderated to 1.4% q-o-q versus 3.7% q-o-q in Q1FY2022, attributed to softness in media due to delays in project renewals and ramp-ups. The management indicated strong demand for chip design services for end industries like automotive, consumer electronics, data centers and telecom. The company won a $25 million+ deal to build a software platform for a new customer in the media space. The management expects improvement in growth momentum in this vertical going ahead.
- **Strong recovery in medical devices vertical:** The medical devices vertical's revenue grew by 9.6% q-o-q (versus a decline of 0.9% q-o-q in Q1FY2022) and crossed $100 million mark in quarterly annualised revenue growth. Given its deep domain knowledge, differentiated solutions and strong leadership, the company has gained market share in this space and become strategic partners to customers. Demand for digital products, platforms and optimization of manufacturing processes are key growth drivers for this segment. LTTS has been participating in building software platform with digital health, robotic surgery and patient monitoring. LTTS remains optimistic on the demand environment given opportunities in digital product design, digital manufacturing and regulatory compliance. The management sees strong traction in the areas, given a strong deal pipeline.

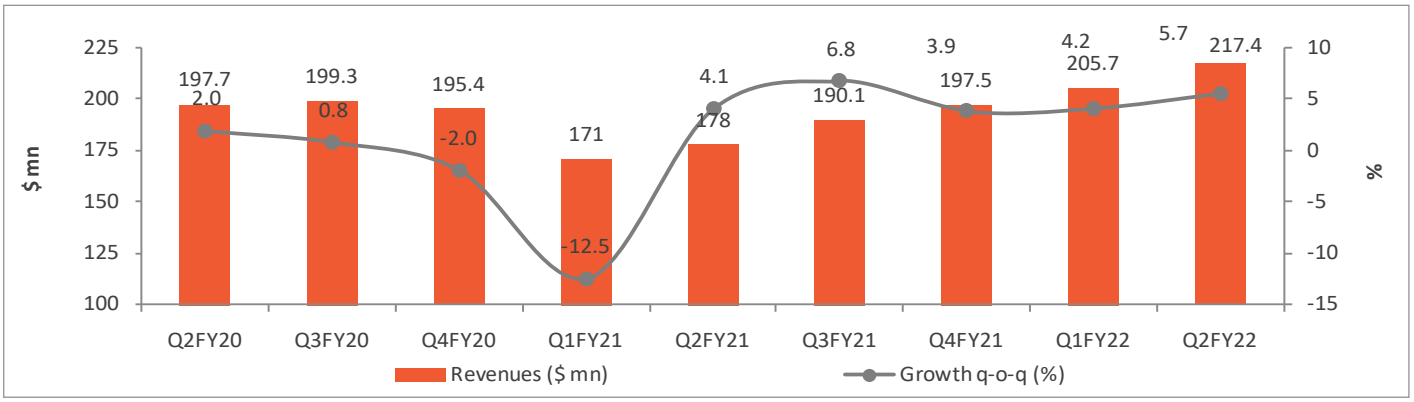
- **Strong headcount addition, higher fresher intake, but attrition rate inched up:** The company added 1,011 net headcounts on a sequential basis during the quarter. The company on-boarded 1,200 freshers over last two quarters. Further, it plans to add another 2,000 freshers in H2FY2022. Attrition rate increased 200 bps sequentially to 16.5% on a TTM basis.
- **Strong deal wins and deal pipeline as well:** LTTS won nine multi-million dollar deals (versus eleven deals in Q1FY2022) across all verticals, which includes two large deal having a TCV of over $25 million and five deals having a TCV of over $10 million. The pipeline is strong across all segments as customers are turning more optimistic about investing in new technologies.
- **Client additions continued to improve on q-o-q:** LTTS added one client on q-o-q basis under $30 million+ category, while it added one client each under the $20 million+ and $10 million+ client buckets. The number of clients under its $5 million+ bucket increased by two on a q-o-q.
- **Reversal of SEIS incentives:** Other income declined 34% q-o-q due to reversal of SEIS accrued income taken in FY2021. The Government of India has capped SEIS incentives at Rs. 5 crore. The management indicated that income from SEIS incentives will not be material for LTTS going forward.
- **Healthy free cash flows:** Free cash flow (FCF) generation was healthy at Rs. 354 crore (versus Rs. 68.7 crore in Q1FY2022) during the quarter. The FCF to net profit ratio stood at 154% in Q2FY2022 versus 32% in Q1FY2022. DSO days remained flat on q-o-q basis in Q2FY2022. DSO (including unbilled days) improved to 15 days q-o-q to 100 days in Q2FY2022. Management expects further improvement in DSO days going ahead. Cash & cash equivalents increased to Rs. 1,958 crore during the quarter from Rs. 1,777 crore in Q1FY2022.
- **Dividend payout:** Board recommended a special dividend of Rs. 10 per share during Q2FY2022.

Results (Consolidated) — Rs cr

Particulars	Q2FY22	Q2FY21	Q1FY22	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**217.4**	**178.0**	**205.7**	**22.1**	**5.7**
Revenue in INR (cr)	**1,607.7**	**1,313.8**	**1,518.4**	**22.4**	**5.9**
Employee benefit expenses	903.8	816.1	875.8	10.7	3.2
Operating expenses	354.6	264.9	324.9	33.9	9.1
EBITDA	**349.3**	**232.8**	**317.7**	**50.0**	**9.9**
Depreciation	52.9	52.7	55.4	0.4	-4.5
EBIT	**296.4**	**180.1**	**262.3**	**64.6**	**13.0**
Other income	29.3	56.6	44.2	-48.2	-33.7
Finance cost	11.3	10.9	10.8	3.7	4.6
PBT	314.4	225.8	295.7	39.2	6.3
Tax provision	83.6	59.5	78.7	40.5	6.2
Minority interest	-0.8	-0.8	-0.8		
Net profit	**230.0**	**165.5**	**216.2**	**39.0**	**6.4**
EPS (Rs.)	**21.8**	**15.7**	**20.4**	**38.8**	**6.5**
Margin (%)				**bps**	**bps**
EBITDA	21.7	17.7	20.9	401	80
EBIT	18.4	13.7	17.3	473	116
NPM	14.3	12.6	14.2	171	7
Tax rate	26.6	26.4	26.6	24	-2

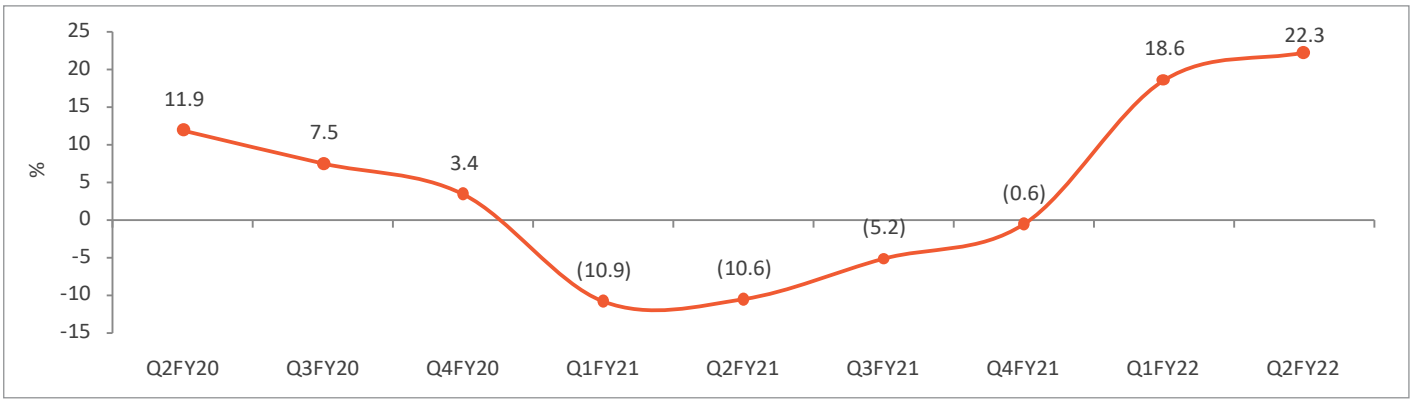
Source: Company; Sharekhan Research

Revenue ($ mn) and growth (% q-o-q)



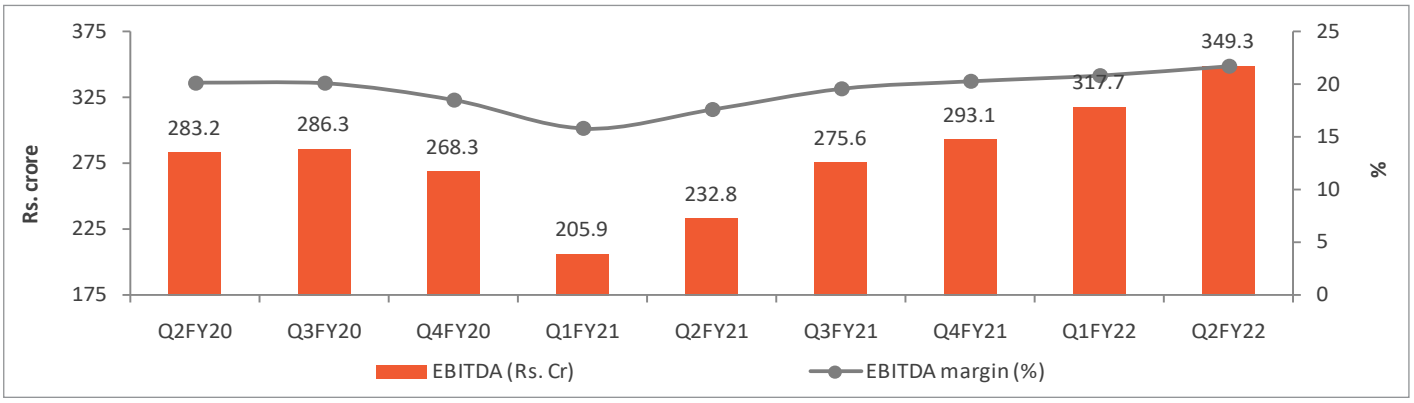
Source: Company, Sharekhan Research

Revenue growth trend (% y-o-y) on CC



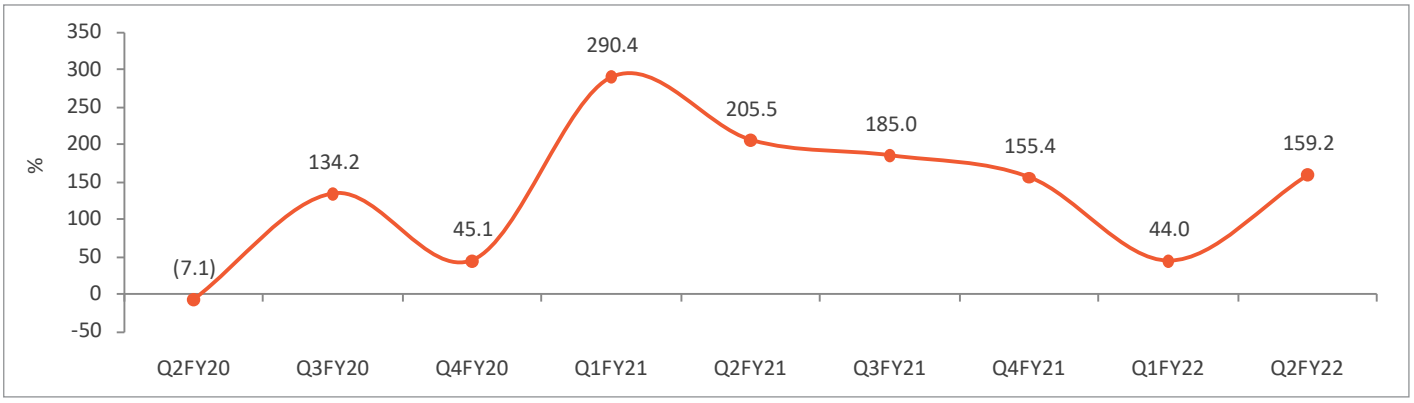
Source: Company, Sharekhan Research

EBITDA margin (%) trend



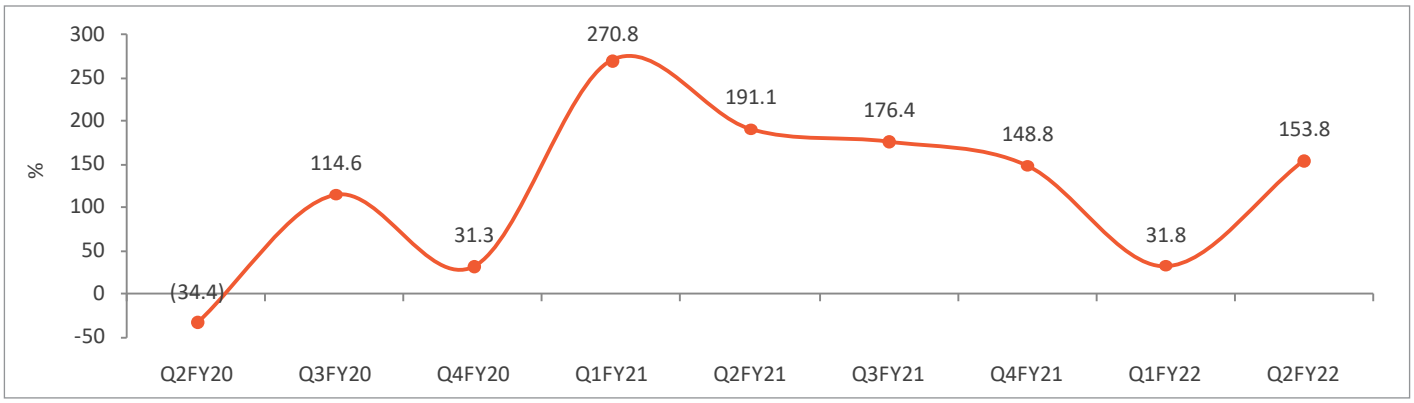
Source: Company, Sharekhan Research

OCF as a % of net profit



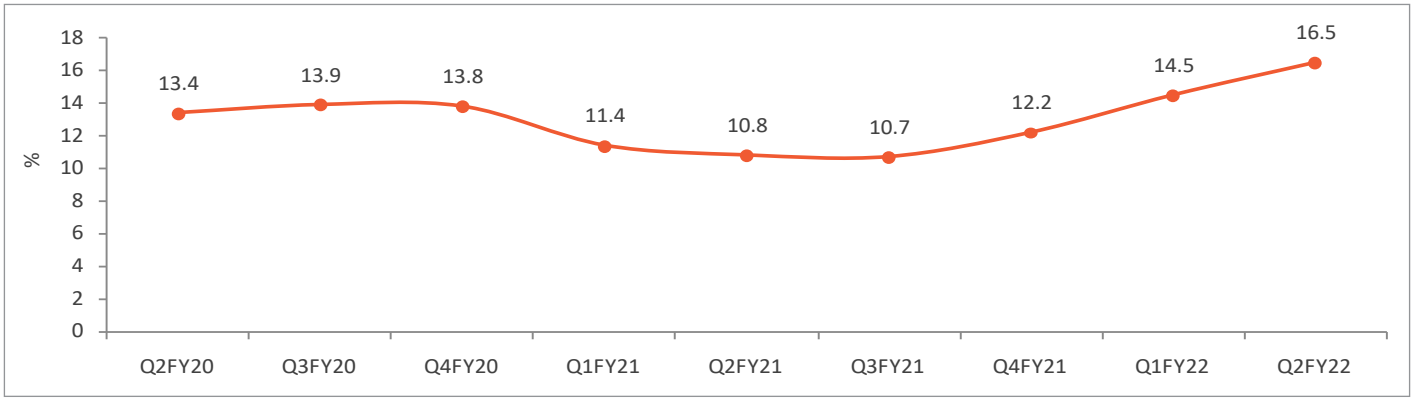
Source: Company, Sharekhan Research

FCF as a % of net profit



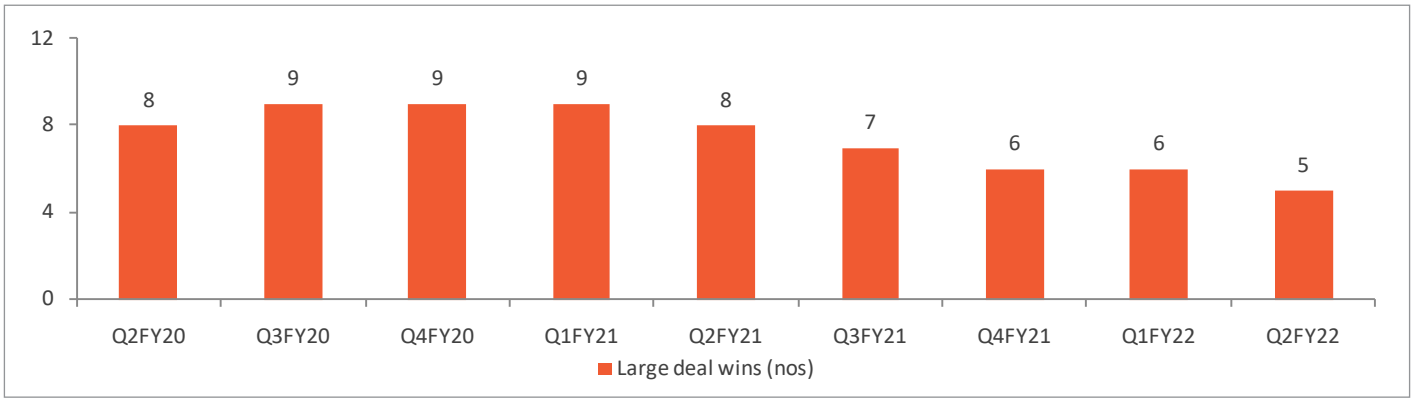
Source: Company, Sharekhan Research

Attrition rate (on LTM basis) trend



Source: Company, Sharekhan Research

Large deal wins (nos) momentum



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Large addressable market provides sustainable growth opportunities

Global ERD spends remained resilient in CY2020 despite the outbreak of COVID-19, though the growth rate moderated to ~3% as manufacturing-led verticals such as aerospace, automobiles and manufacturing tighten purse-strings (declined by 4.6% in CY2020). Total global ERD spends stood at $1.5 trillion in 2020 and are expected to touch $1.9 trillion by 2023.The global outsourced ERD addressable market stood at $90 billion, of which India outsources $33 billion. Of this, GICs export ~$19 billion exports and the remaining $14 billion by third party ESPs. Indian ESPs will grow at a faster rate as compared to global peers owing to their ability to leverage robust digital engineering talent chains. According to Zinnov, the digital engineering market is expected to post a 19% CAGR from $545billion in 2020 to $911billion by 2023. It is estimated that hi-tech and service-led verticals' spending on ERD would outpace growth of ERD spend of manufacturing-led verticals over FY2020-FY2023E. Digital engineering to ERD spend ratio is likely to reach 47% in 2023 from 36% in 2020.

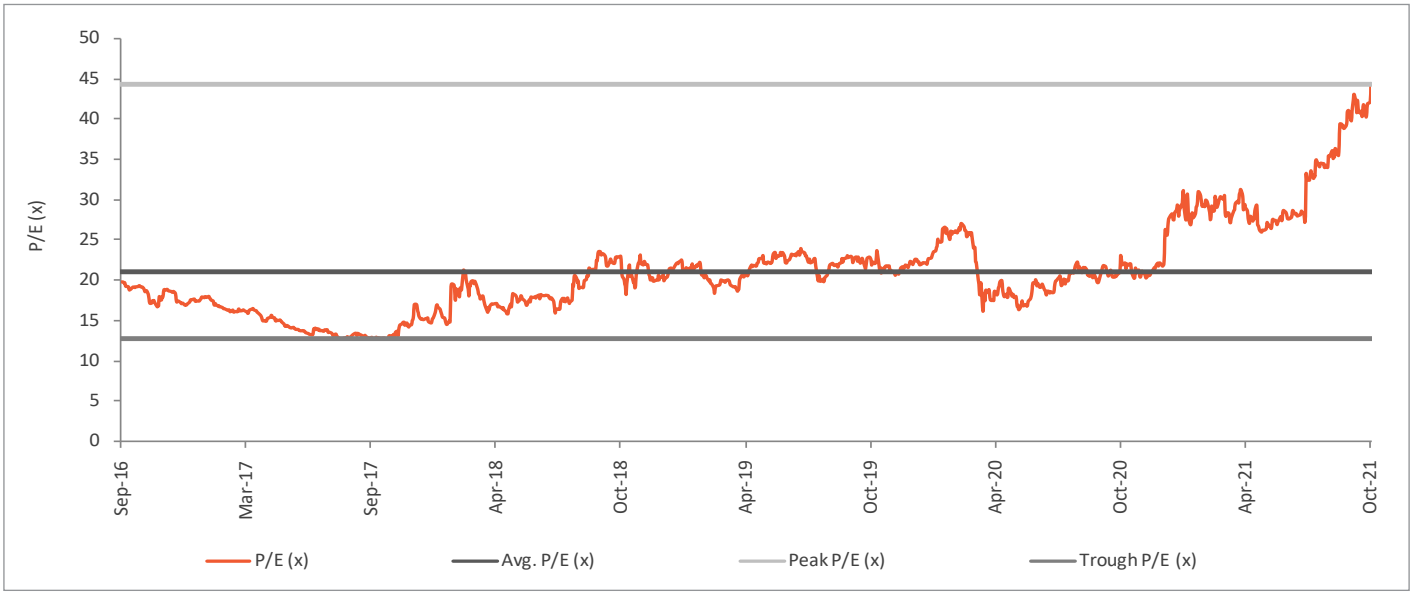
■ Company outlook - Broad portfolio to support long growth runway

LTTS is the third-largest engineering service provider (ESP) in India and is well-diversified across verticals. The large ERD addressable market and a huge scope in deepening relationships with top-30 customers provide multi-year sustainable growth prospects. Technology shifts in verticals are also positive for LTTS as they create huge growth opportunities for ESPs. We expect strong growth from FY2022E on the back of rising spends in both digital engineering and legacy engineering areas.

■ Valuation - Maintain Buy

LTTS is one of the best plays in the faster growing ERD space for its multi-industry expertise, deep engineering capabilities, end-to-end offerings, and long standing relationships with large enterprises worldwide. LTTS is well-placed to gain market share among global competitors because of being the preferred engineering partner among clients, strong customer-centric approach and a full-service model. We expect LTTS' USD revenue and earnings to post a CAGR of 18% and 23% over FY2022-FY2024E. At CMP, the stock trades at 44x/37x its FY2023E/FY2024E earnings estimates, which justifies premium valuations, given strong deal wins, presence in the fast-growing ERD segment, and consistent dividend pay-outs. Hence, we retain a Buy on LTTS with a revised PT of Rs. 5,900.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer comparison

Company	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Cyient	1,231	11	13,563	26.6	24.2	15.9	13.6	4.4	4.0	16.2	17.9
Tata Elxsi	6,283	6	39,130	77.4	63.6	56.7	46.2	23.0	18.1	29.7	28.4
LTTS	5,123	11	53,887	55.4	44.3	36.6	30.5	12.8	10.6	25.6	26.5

Source: Company; Bloomberg

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 62.9% from North America, 16.7% from Europe, 13% from India and .4% from Rest of the World (RoW). The company offers ERD practices to 53 of the top 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
Amit Chadha	Chief Executive Officer
Rajeev Gupta	Chief Financial Officer
Abhishek Sinha	Chief Operating Officer (COO)

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Wasatch Advisors Inc	1.17
2	Nippon Life India Asset Management Ltd	1.05
3	Vanguard Group Inc/The	0.74
4	Invesco Asset Management India Pvt	0.70
5	Axis Asset Management Co Limited	0.64
6	HDFC Asset Management Co Limited	0.51
7	UTI Asset Management Co LTD	0.48
8	Sundaram Asset Management Co Limited	0.41
9	BlackRock Inc	0.40
10	Goldman Sachs Group Inc	0.39

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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