Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Tata Elxsi Limited

Branching out to grow faster

IT & ITeS	Sharekhan code: TATAELXSI	Company Update

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

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	
CMP: **Rs. 1,958**	
Price Target: **Rs. 2,315**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

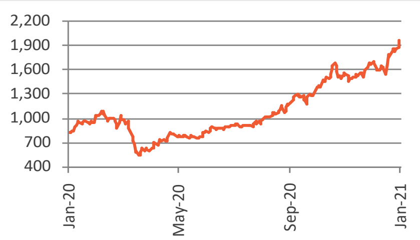
Company details

Market cap:	Rs. 12,192 cr
52-week high/low:	Rs. 1,970/501
NSE volume: (No of shares)	5.6 lakh
BSE code:	500408
NSE code:	TATAELXSI
Free float: (No of shares)	3.5 cr

Shareholding (%)

Promoters	45
DII	6
FII	13
Others	36

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	17.4	40.6	113.7	137.9
Relative to Sensex	9.9	18.2	80.9	118.8

Sharekhan Research, Bloomberg

Summary

- We stick to our Buy rating on Tata Elxsi Limited (TEL) with a revised PT of Rs. 2,315 given material improvement in demand environment in certain segments of ERD space and strong traction for offerings across verticals
- Enterprises' digital engineering spends to clock a 19% CAGR in 2019-2025E, which is expected to create strong growth prospects for TEL given its strong footprint across key markets and excellent operational management.
- Amid better demand and lower-than-expected furloughs, management remains optimistic on delivering strong growth in H2FY2021, which would be better than H1FY2021 but in line with H2FY2020.
- With a demand recovery in auto segment and strong traction in other verticals, we expect TEL's revenue growth to pick up faster than expected in the next few years and boost margins. We expect TEL's revenue/earnings to clock 21/24% CAGR over FY2021-FY2023E

Tata Elxsi Limited (TEL) is expected to be one of the prime beneficiaries from the strong recovery in auto segment, pick-up in deals in the engineering, research, and development (ERD) segment, rising adoption of digital engineering across industries and huge potential for long-term outsourcing business opportunity. The company has been investing in digital technologies over the past few years in areas such as artificial intelligence (AI) and analytics, IoT and automation, which have helped the company to strengthen its relationships with its existing customers and win new customers across markets as well. There are initial signs of a gradual recovery in ERD spending by automotive, telecom, aerospace companies, etc, who have started investing on connected resilient systems, optimisation of manufacturing process, new product development and cost take-out initiatives through digital engineering. Over the last couple of months, the flow of new deals has accelerated for Indian ERD service providers. Digital engineering spends of enterprises is projected to clock a 19% CAGR in 2019-2025E, which is expected to create strong growth prospects for TEL given its offerings across verticals, strong footprint in key markets and excellent operational management. After a sharp decline in sequential revenue growth (down 12.8% q-o-q) in Q1FY2021 owing to COVID-19 related disruptions, company reported a stellar performance in Q2FY2021 given faster-than expected recovery in demand environment. Most of managements of the ERD companies have indicated the improving demand environment in automotive segment. Given pick-up in the demand environment in auto space and closure of a multi-year deal with European Tier-1 supplier, we expect a sustainable growth momentum (up 8.2% q-o-q) in its transportation vertical (37% of its total revenues in Q2FY2021). In addition, strong traction in medical & healthcare and media verticals and new project wins in industrial design and visualisation (IDV) business would aid to the growth of the company. Given improving demand environment and lower-than-expected furloughs, management remains optimistic on delivering strong growth in H2FY2021, which would be better than H1FY2021 but in-line with 2HFY2020. On the margin front, the key levers for margin sustainability in coming quarters are - (1) continued reduced travel and administration expenses, (2) WFH efficiencies, (3) higher offshoring, and (4) better cost control. We expect TEL would deliver strong USD revenue growth of 6.8% q-o-q to $61.9 million in Q3FY2021 with a decline in EBIT margin of 30 bps to 24.6%.

Our Call

Valuation – Bright times ahead: We believe the company's diversification strategy is yielding results with reducing contribution of the automotive segment to total revenue, de-risking revenues from a particular customer and expanding footprint of the company in major markets. With faster-than-expected demand recovery in auto segment, strong traction in other verticals and recent deal wins in ERD space, we expect TEL revenue growth will pick up faster than expected over next few years, with a scope of improvement in margins. Hence, we are increasing our EPS estimates by 10%/19% for FY2022E/FY2023E. We expect TEL's revenue and earnings to grow at a CAGR of 20% and 24%, respectively, over FY2021-FY2023E. We continue to prefer TEL, given its advanced technological capabilities, strong execution, long-term relationships with clients, and a strong parentage. At the current market price (CMP), the stock is trading at 31x/25x 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. 2,315.

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

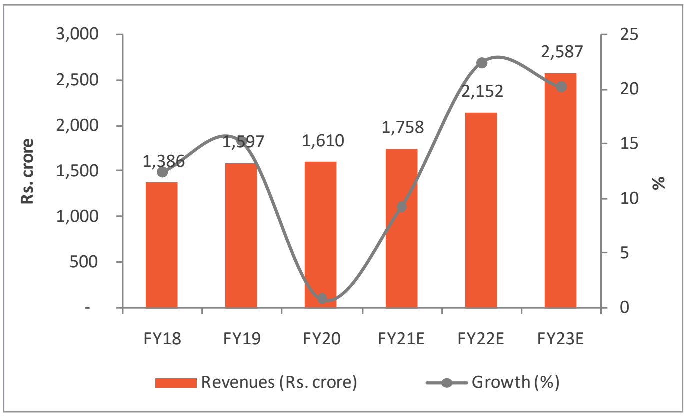
Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	1,596.9	1,609.9	1,758.4	2,152.2	2,587.3
OPM (%)	26.0	21.3	25.5	25.6	25.8
Adjusted PAT	290.0	256.1	313.2	389.6	480.0
% YoY growth	20.8	-11.7	22.3	24.4	23.2
Adjusted EPS (Rs.)	46.6	41.1	50.3	62.6	77.1
P/E (x)	42.0	47.6	38.9	31.3	25.4
P/B (x)	12.9	11.2	9.4	7.8	6.3
EV/EBITDA (x)	28.1	34.0	26.0	21.2	17.4
RoNW (%)	30.8	23.5	24.3	24.9	24.8
RoCE (%)	33.0	24.5	27.3	28.1	27.9

Source: Company; Sharekhan estimates

** We now convert Tata Elxsi into a stock update; it was earlier a 'Viewpoint' under our coverage*

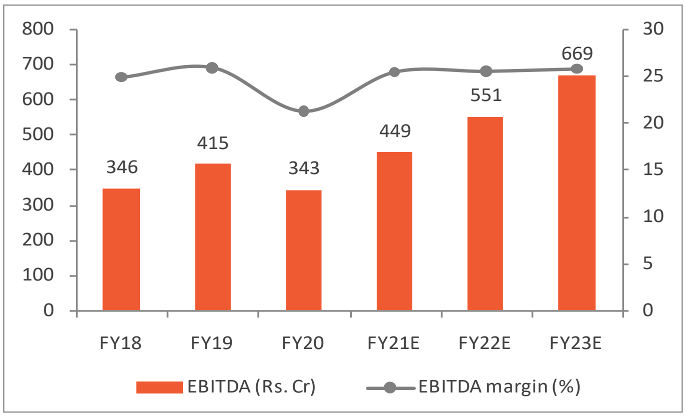
Financials in charts

Revenue (Rs. crore) and growth (%)



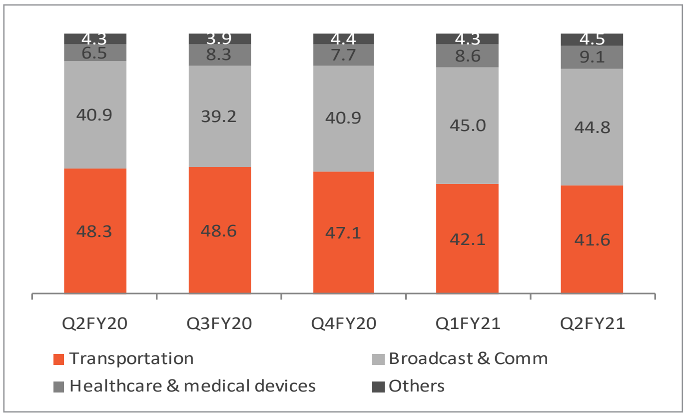
Source: Company, Sharekhan Research

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



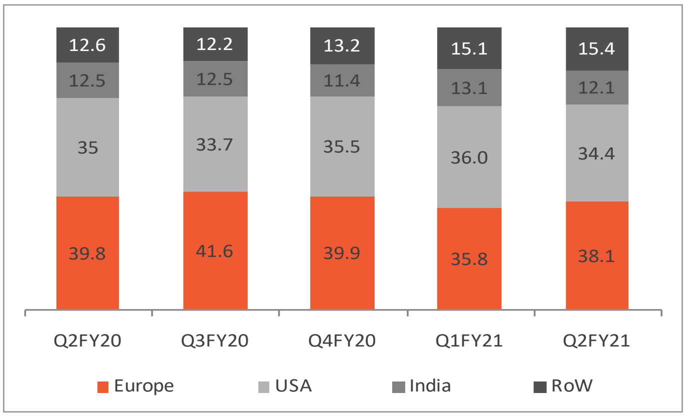
Source: Company, Sharekhan Research

Vertical breakdown (%)



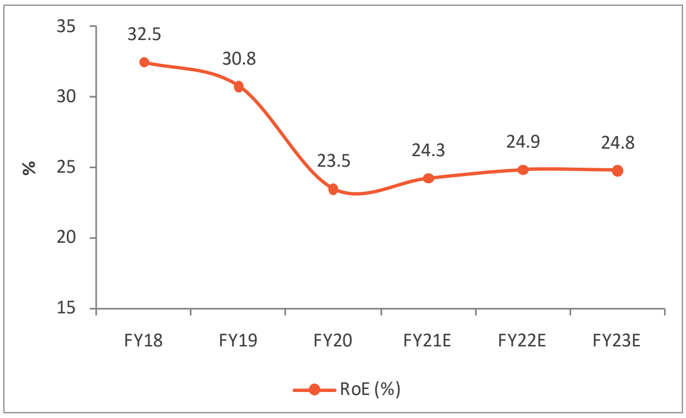
Source: Company, Sharekhan Research

Geography breakdown (%)



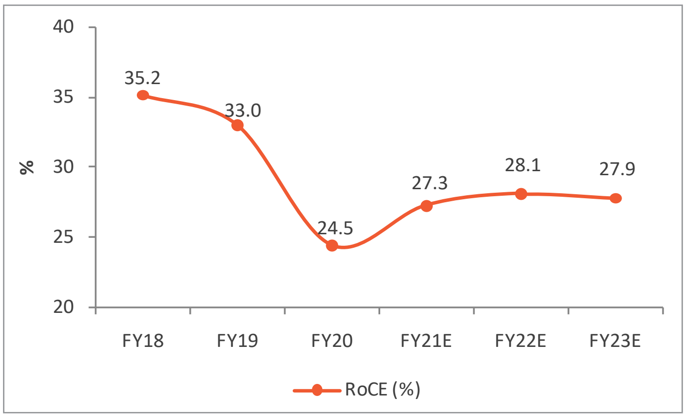
Source: Company, Sharekhan Research

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

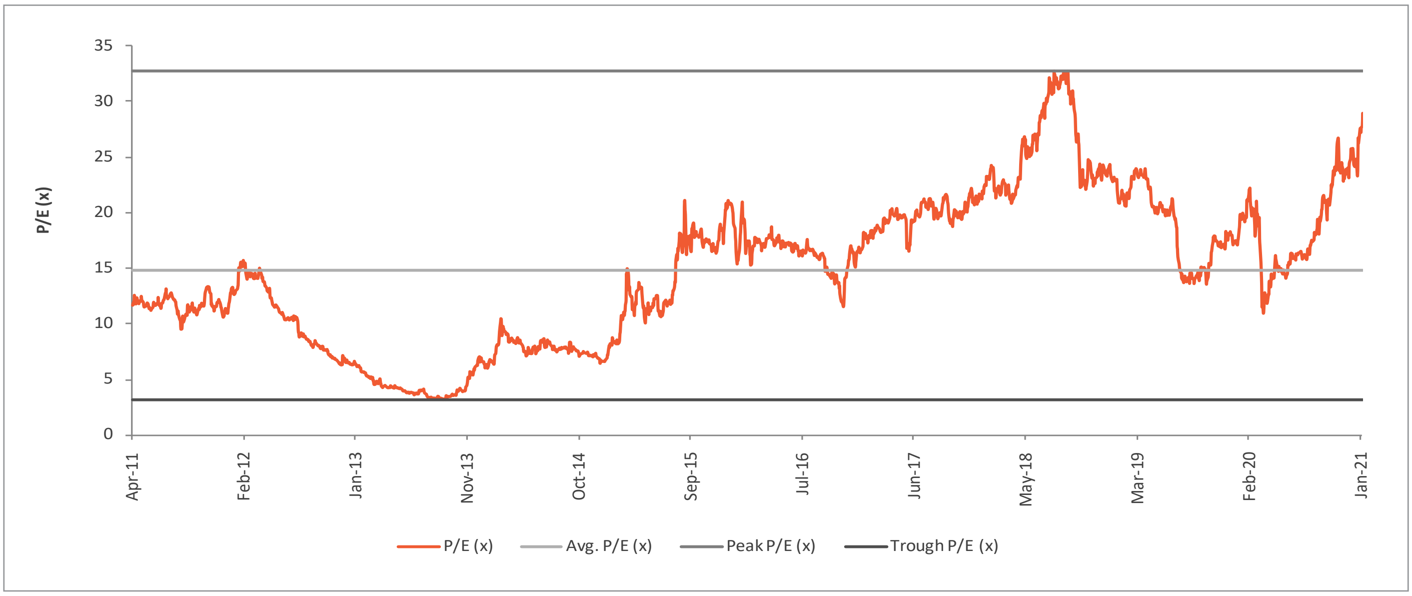
■ Company outlook - Promising outlook

TEL's major verticals have a huge growth opportunity considering an increase in 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 would register a CAGR of 20% and 24%, respectively, over FY2021-FY2023E.

■ Valuation - Bright times ahead, maintain Buy

We believe the company's diversification strategy is yielding results with reducing contribution of the automotive segment to total revenue, de-risking revenues from a particular customer and expanding footprint of the company in major markets. With faster-than-expected demand recovery in auto segment, strong traction in other verticals and recent deal wins in ERD space, we expect TEL revenue growth will pick up faster than expected over next few years, with a scope of improvement in margins. Hence, we are increasing our EPS estimates by 10%/19% for FY2022E/FY2023E. We expect TEL's revenue and earnings to grow at a CAGR of 20% and 24%, respectively, over FY2021-FY2023E. We continue to prefer TEL, given its advanced technological capabilities, strong execution, long-term relationships with clients, and a strong parentage. At the current market price (CMP), the stock is trading at 31x/25x 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. 2,315.

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/EBITDA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
LTTS	2,506	10	26,312	39.0	29.9	25.9	19.8	8.1	6.9	22.7	25.3
Tata Elxsi	1,958	6	12,192	38.9	31.3	26.0	21.2	9.4	7.8	24.3	24.9

Source: Company, Sharekhan Research

About company

Bengaluru-based TEL is a global design and technology services 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 Internet of Things (IoT), big data analytics, cloud, mobility, virtual reality, and artificial intelligence 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% during 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 & Chief Strategy Officer
H V Muralidharan	Chief Financial Officer
Girja Vaidyanathan	Company Secretary & Compliance Officer

Source: Bloomberg

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 Ltd.	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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