Stock Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Tata Elxsi Limited

Another stellar quarter, promising outlook

IT & ITeS	Sharekhan code: TATAELXSI	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. 2,376**	
Price Target: **Rs. 2,850**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

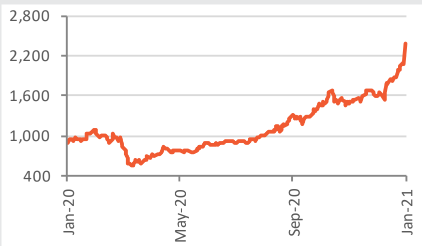
Company details

Market cap:	Rs. 14,799 cr
52-week high/low:	Rs. 2,474 / 501
NSE volume: (No of shares)	5.7 lakh
BSE code:	500408
NSE code:	TATAELXSI
Free float: (No of shares)	3.5 cr

Shareholding (%)

Promoters	45
FII	6
DII	13
Others	36

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	48.6	63.1	166.7	161.9
Relative to Sensex	41.6	41.8	129.4	143.9

Sharekhan Research, Bloomberg

Summary

- We retain our Buy rating on Tata Elxsi Limited (TEL) with a revised PT of Rs. 2,850, given sustained recovery in the auto segment and rising spends in the digital engineering space.
- Beat on all fronts; Constant currency revenue grew by 10% q-o-q, led by strong growth in its key business segments; EBITDA margin improved by 266bps q-o-q despite wage revision, led by higher utilisation and increasing offshore mix.
- The company's continued investments in sales and marketing, delivery and building new-age capabilities would help it to win large long-term deals going ahead. Focus on cross selling of design-related services likely to drive growth.
- We expect margin to sustain in the medium term, given 1) continued reduced travel and administration expenses, 2) WFH efficiencies, 3) higher offshoring, and 4) better cost control. The company's offshore revenue contribution may not come back to pre-COVID level.

Tata Elxsi Limited (TEL) impressed once again with all-round growth, led by strong recovery in the automotive market, accelerated growth in other verticals, and ramp up of deals. The company reported constant currency (CC) revenue growth of 10% q-o-q and 7.5% y-o-y, ahead of our estimates, led by strong 8.5% q-o-q/9.1% y-o-y and 25.3% q-o-q/2.5% y-o-y growth in embedded product design (EPD) and industrial design and visualisation (IDV) businesses. USD revenue grew by 11.7% q-o-q to $64.7 million versus our estimate of $62 million. EBITDA margin improved by 266bps q-o-q to 30.1% despite wage revision, exceeding our estimates, led by revenue growth, absence of one-time visa expenses, and higher offshore revenue. Net profit of Rs. 105.2 crore (up 33.4% q-o-q and 39.5% y-o-y) was ahead of our estimate, aided by strong beat in revenue and margin and higher-than-expected other income (up 3.4x q-o-q). Management indicated that some OEMs started reinitiating key R&D programmes, which would lead to resumption of projects as well as deals with tier-1 suppliers. The company has added new automotive customers and closed some large deals in vehicle electronics and software and the autonomous driving space during the quarter. Management remains optimistic that growth momentum would continue in Q4FY2021 because of 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. Further, management believes that its investments in sales and marketing, delivery, and capabilities would reap benefits in terms of large long-term deal wins in the coming years. Management believes it can be sustainable in the medium term, given 1) continued reduced travel and administration expenses, (2) WFH efficiencies, and (3) higher offshoring.

Key positives

- Revenue grew by 10% q-o-q on CC terms, beating our estimates.
- EBITDA margin improved to 30.1% despite wage revision, exceeding our estimates
- Offshore revenue mix improved by 250bps q-o-q to 67.8%.

Key negatives

- System integration and support reported revenue decline of 19% y-o-y on CC basis.
- Revenue growth in the top account remained at 0.5% q-o-q.

Our Call

Valuation – Bright times ahead: We have revised our earnings estimates upward for FY2021E/FY2022E/FY2023E, factoring in all-round beat in Q3FY2021, sustained recovery in the auto segment, and continued growth in the non-automotive segment. With faster-than-expected demand recovery in the auto segment, strong traction in other verticals, and recent deal wins in the ERD space, we expect TEL's revenue growth to pick up faster than expected over the next few years, with a stable a margin profile. We expect TEL's revenue and earnings to post a CAGR of 20% and 27%, 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 CMP, the stock is trading at 33x/27x its FY2022E/FY2023E earnings. A strong balance sheet, improving cash generation, and consistent dividend payout provide comfort on the stock. Hence, we recommend Buy on TEL with a revised a price target (PT) of Rs. 2,850.

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 the automotive and broadcast sectors.

Valuations Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	1,596.9	1,609.9	1,820.4	2,233.9	2,674.2
OPM (%)	26.0	21.3	26.9	27.8	28.2
Adjusted PAT	290.0	256.1	341.4	444.8	554.6
% YoY growth	*20.8*	*-11.7*	*33.3*	*30.3*	*24.7*
Adjusted EPS (Rs.)	46.6	41.1	54.8	71.4	89.0
P/E (x)	51.0	57.8	43.3	33.3	26.7
P/B (x)	15.7	13.6	11.2	9.0	7.1
EV/EBITDA (x)	34.4	41.6	29.2	23.0	18.9
RoNW (%)	30.8	23.5	25.9	26.9	26.5
RoCE (%)	33.0	24.5	29.3	30.5	29.4

Source: Company; Sharekhan estimates

Another strong all-round performance

Once again, TEL impressed with all-round growth, led by sustained recovery in the automotive market, accelerated growth in other verticals (media and healthcare), and strong growth in other divisions. The company reported CC revenue growth of 10% q-o-q and 7.5% y-o-y, ahead of our estimates. Revenue growth was driven by strong growth in EPD (up 8.5% q-o-q in CC), IDV (up 25.3% q-o-q in CC), and system integration and support (up 16.1% in CC) divisions. USD revenue grew by 11.7% q-o-q to $64.7 million (versus our estimate of $62 million), above our estimates. Top account revenue growth remained flat (0.5% q-o-q) during the quarter after strong recovery in revenue growth (up 17.9% q-o-q) in Q2FY2021. Revenue in rupee terms grew by 10.9% q-o-q and 12.7% y-o-y to Rs. 477.1crore. EBITDA margin improved by 266 bps q-o-q to 30.1%, exceeding our estimates, led by revenue growth, absence of one-time visa expenses, and higher offshore revenue. Net profit of Rs. 105.2 crore (up 33.4% q-o-q and 39.5% y-o-y) was ahead of our estimate, aided by strong beat in revenue and margin and higher-than-expected other income (up 3.4x q-o-q).

Expect strong growth in Q4FY2021; Expect investments to reap benefits going ahead

Management continues to see recovery in the automotive sub-segment, while media and medical devices verticals are expected to continue their growth momentum. Further, some OEMs have started reinitiating key R&D programmes, which would lead to resumption of projects as well as deals with Tier1 suppliers. 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 the growth momentum would continue in Q4FY2021 because of strong deal pipeline across markets and verticals, ramp-up of deals, strong deal wins, green shoots in auto sub-segment, and strong traction in media and medical devices verticals. Further, management believes that its investments in sales and marketing, delivery, and capabilities would reap benefits in terms of strong revenue growth in the coming years. Further, the company focuses on building adjacencies areas under its existing verticals to de-risk its business from any slowdown on any specific business and add more logos for growth going ahead. Moreover, shift from project-based model to multi-year deal (average deal duration increased to more than one year from average 6-8 months) and focus on end-to-end capabilities would drive its growth going ahead. On the margin front, management expects it can be sustainable in the medium term, given 1) continued reduced travel and administration expenses, (2) WFH efficiencies, and (3) higher offshoring.

Key result highlights from earnings call

- **Broad-based revenue growth across verticals:** TEL reported broad-based growth across verticals and geographies during the quarter. Revenue in rupee terms grew by 10.9% q-o-q and 12.7% y-o-y. The company's growth was driven by each business divisions – Embedded Product Design (EPD), Industrial Design and Visualisation (IDV), and System Integration and Support (SIS). EPD, the largest contributor to its total revenue, grew by 8.5% q-o-q and 9.1% y-o-y on CC terms. IDV's revenue growth accelerated to 25.3% q-o-q and 2.5% y-o-y on CC basis. SIS's CC revenue grew by 16.1% q-o-q (versus revenue decline of 4.9% q-o-q in Q2FY2021), but it declined by 19% y-o-y (versus revenue decline of 25.4% y-o-y in Q2FY2021).
- **Strong revenue growth across verticals in the EPD business segment:** TEL reported positive revenue growth across verticals on a q-o-q basis under the EPD business. The transportation vertical reported smart recovery with revenue growth of 6.9% q-o-q on CC basis, led by deals and new projects in the automotive sector. The broadcast and communications vertical continued its revenue growth momentum, with CC revenue growth of 7.3% q-o-q. The healthcare and medical devices vertical's revenue growth accelerated to 23.5% q-o-q, led by key deal wins and customer additions.
- **All-round growth across geographies:** The company reported strong growth on a sequential basis across all geographies. America delivered revenue growth of 15.9% q-o-q, while Europe reported revenue growth of 6.2% q-o-q. Growth in Europe was driven by key automotive deal wins. India reported accelerated growth of 19.9% q-o-q in Q3FY2021.
- **IDV business segment's growth to outpace the EPD business:** This business segment has remained volatile in the past few quarters owing to management change, restructuring of sales team, and sharp focus on design kind of projects. Management indicated that this business segment's growth would outpace EPD over the next 2-3 years. However, margin of this business currently remains lower than EPD. Management expects margin would improve once customer acquisitions are largely completed.

- **Outlook on the automotive sub-vertical:** Management sees sustained recovery in the automotive market for the second consecutive quarter. Management indicated that some OEMs reinitiated key R&D programmes, which led to resumption of projects as well as deals with Tier1 suppliers. The company added new automotive customers including a new-age OEM in North America. TEL closed some large deals, including a multi-million dollar deal with a European Tier1 supplier for vehicle electronics and software, and a North American Tier1 supplier for autonomous driving. Most OEMs and Tier-1 supplies are looking for vendor consolidation to bring down overall costs. Connected and infotainment-related spends are expected to accelerate going ahead. Customers are currently more interested in implementing small autonomy features rather than full autonomy kind of features.
- **Broadcast and communication vertical:** The broadcast and communication vertical is the largest in terms of revenue. The vertical's total contribution to overall revenue remained at 44.3%. There are three sub-segments in this vertical i.e. (1) operator segment, (2) broadcasters, and (3) devices segment. The top account in this vertical is a large multi-services operator based out of the US, and the company has a relationship of over 12 years with that customer. Within media, the company highlighted that growth would be driven by (1) OTT, led by higher consumption and (2) broadband and data-led services. A leading US-based OTT technology company has selected Tata Elxsi's FalconEye test automation solution.
- **Commentary on healthcare and medical device business:** Revenue growth in the healthcare and medical device vertical accelerated to 23.5% q-o-q. Management believes the growth trend in this segment would continue in the coming quarters, as the company has been investing on delivery capabilities, sales, and demand creation perspective. Healthcare and medical revenue accounted for 10.4% to its total revenue versus 8.3% in Q3FY2020. Management expects the healthcare and medical vertical to contribute 20% of its total revenue over the next 3-5 years. The medical devices vertical is unaffected due to COVID-19.
- **Change in the business mix:** Management highlighted that its de-risking plan has been progressing well, given its strong growth momentum in the medical devices vertical and improving contribution of revenue from adjacencies segments in the transportation vertical. Over the next 3-5 years, management expects the contribution of transportation, broadcast, and medical devices vertical to be 40:40:20.
- **Promising outlook:** Growth momentum would continue in Q4FY2021 because of strong deal pipeline across markets and verticals and ramp-up of deals won earlier. The company's capabilities in product engineering, design, and digital have helped it to strengthen its market position. Management sees sustained recovery in the automotive market for the second consecutive quarter. Management also indicated that OEMs have started reinitiating key R&D programmes, which would lead to resumption of projects as well as deals with Tier-1 suppliers.
- **Improvement in gross margin:** The company's gross margin continued to improve both on a q-o-q and y-o-y basis in Q3FY2021, with an expansion of 190 bps q-o-q to 40.3%, led by strong revenue growth and better cost control.
- **Top accounts performance:** Contribution of the top account to total revenue declined to 11.7% from 13% in Q2FY2021. USD revenue of the top account remained flat at $7.6 million, up 0.5% q-o-q. Revenue from the top 5 and top 10 accounts grew by 8% q-o-q and 6.9% q-o-q, respectively.
- **Attrition and higher offshore mix:** Attrition rate marginally increased to 6.1% in versus 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. Management expects there would not be any material change in offshore mix even after normalcy. Management highlighted that onsite mix would not move to pre-COVID era.

Results Rs cr

Particulars	Q3FY21	Q3FY20	Q2FY21	Y-o-Y (%)	Q-o-Q (%)
Revenue ($ mn)	**64.7**	**59.5**	**58.0**	**8.9**	**11.7**
Net sales	**477.1**	**423.4**	**430.2**	**12.7**	**10.9**
Employee expenses	262.8	242.6	245.9	8.4	6.9
Total purchases	21.8	22.2	19.1	-1.6	14.5
Other expenses	48.8	64.5	47.2	-24.3	3.5
EBITDA	**143.6**	**94.2**	**118.1**	**52.5**	**21.7**
Depreciation and amortisation	11.1	11.2	11.2	-1.5	-1.4
EBIT	**132.6**	**83.0**	**106.8**	**59.8**	**24.1**
Other income	15.1	20.5	4.4	-26.5	242.3
Finance cost	1.3	1.4	1.3	-6.6	3.6
PBT	**146.3**	**102.1**	**110.0**	**43.3**	**33.1**
Tax provision	41.1	26.6	31.1	54.3	32.3
Net profit	**105.2**	**75.4**	**78.9**	**39.5**	**33.4**
EPS (Rs.)	**16.9**	**12.1**	**12.7**	**39.5**	**33.3**
Margin (%)				***BPS***	***BPS***
EBITDA	30.1	22.2	27.4	786	266
EBIT	27.8	19.6	24.8	819	295
NPM	22.1	17.8	18.3	424	371

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. Digital engineering 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 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 26%, respectively, over FY2021-FY2023E.

■ Valuation - Bright times ahead

We have revised our earnings estimates upward for FY2021E/FY2022E/FY2023E, factoring in all-round beat in Q3FY2021, sustained recovery in the auto segment, and continued growth in the non-automotive segment. With faster-than-expected demand recovery in the auto segment, strong traction in other verticals, and recent deal wins in the ERD space, we expect TEL's revenue growth to pick up faster than expected over the next few years, with a stable a margin profile. We expect TEL's revenue and earnings to post a CAGR of 20% and 27%, 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 CMP, the stock is trading at 33x/27x its FY2022E/FY2023E earnings. A strong balance sheet, improving cash generation, and consistent dividend payout provide comfort on the stock. Hence, we recommend Buy on TEL with a revised a price target (PT) of Rs. 2,850.

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	2,600	10	27,303	40.4	31.0	26.9	20.6	8.4	7.1	22.7	25.3
Tata Elxsi	2,376	6	14,799	43.3	33.3	29.2	23.0	11.2	9.0	25.9	26.9

Source: Company, Sharekhan estimates

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, the 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 the 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 andCompliance 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	2.24
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	0.87
9	Tata Asset Management Ltd.	0.60
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

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

---

Registered Office: Sharekhan Limited, 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183;