Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Tech Mahindra Limited

Well-poised for growth

IT & ITeS	Sharekhan code: TECHM	Result Update

Summary

- We maintain our Buy rating on Tech Mahindra (TechM) with an unchanged PT of Rs. 1,100, as it is trading at an attractive valuation.
- Beat our estimates on all fronts; TechM impressed with continued margin expansion, healthy FCF generation, and healthy deal pipeline. The company won a deal of $50 million TCVs in the 5G rollout space in Europe.
- Given robust pipeline in the enterprise segment ($4.5 billion) and conversion of deals in the communication space, net new deal TCVs are expected to accelerate in the coming quarters.
- We prefer TechM because of anticipated improvement in growth in the enterprise segment, 5G opportunity, and scope for margin improvement. We assume TechM would report USD revenue/earnings CAGR of 9%/13%, respectively.

Tech Mahindra (TechM) continues to impress with margin expansion, strong FCF generation, healthy deal pipelines, and decent deal win TCVs. Constant currency (CC) revenue grew by 2.8% q-o-q, ahead of our estimates, led by 4.4% q-o-q growth in the communication segment. The enterprise segment grew by 2.3% in CC terms in Q3FY2021. Reported US Dollar revenue grew by 3.4% q-o-q to $1,308.7 million. EBIT margin expanded by 170 bps q-o-q to 15.9%, above our expectations, aided by better cost management. Net profit came in at Rs. 1,309.8 crore and was ahead of our estimates, led by both revenue and margin beat and higher-than-expected other income. TCVs of large deals bounced back to pre-COVID level at $455 million, in-line with expectations, led by strong deal wins in the enterprise segment. Notably, TechM has signed around a deal of $50 million TCVs in the 5G rollout space during the quarter. Further, management cited that there were a couple of postponements of deals in the communication space during Q3FY2021 and it expects those deals to flow in the coming months. Given robust pipeline ($4.5 billion in the enterprise segment) and expected deals in the communication space, net new deal TCVs are expected to accelerate in the coming quarters. Management cited that it expects revenue growth on a sequential basis in Q4FY2021 and Q1FY2022. With higher spends on digital transformation by enterprises, modernisation of networks by service providers, and 5G in enterprise, we believe TechM is well positioned to report strong revenue growth over the next couple of years. On the margin front, management believes expenses related to travel and facility would come back to some extent post normalcy, which would be partially mitigated by revenue growth and portfolio synergies.

Key positives

- EBITDA margin at 19.6%, exceeding our estimates
- FCF generation of $226 million (FCF to net profit conversion at 127%)
- Management expects deal TCVs to accelerate in the coming quarters

Key negatives

- Revenue declined by 4.6% y-o-y in CC terms compared to a decline of 3% q-o-q in Q2FY2021
- Deal TCVs in the communication space declined by 50% q-o-q

Our Call

Valuation – Expect growth momentum to accelerate: We have revised our earnings estimates upward for FY2021E/FY2022E/FY2023E, factoring in impressive margin performance in Q3FY2021 and acceleration of deal TCVs going ahead. 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 the CMP, the stock is trading at reasonable valuation of 17x/15x of its FY2022E/FY2023E earnings, trading at significant discount to large peers despite anticipated strong revenue growth momentum in the enterprise business, 5G opportunities, and scope for margin improvement. Hence, we maintain our Buy rating on the stock with an unchanged price target (PT) of Rs. 1,100.

Key Risks

Any 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 Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	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

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. 962**	
Price Target: **Rs. 1,100**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

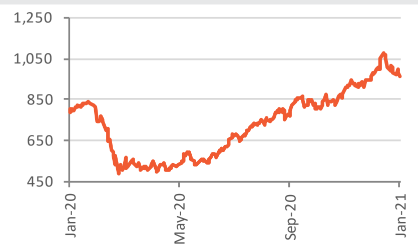
Company details

Market cap:	Rs. 93,048 cr
52-week high/low:	Rs. 1,081 / 470
NSE volume: (No of shares)	52.0 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62 cr

Shareholding (%)

Promoters	35.8
FII	39.9
DII	14.5
Others	9.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-2.2	18.2	42.5	19.6
Relative to Sensex	0.9	1.3	19.8	7.2

Sharekhan Research, Bloomberg

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 margin expansion, strong FCF generation, and decent deal wins. Constant currency (CC) revenue grew by 2.8% q-o-q, ahead of our estimates, led by 4.4% q-o-q growth in the communication segment. The enterprise segment grew by 2.3% q-o-q in CC terms in Q3FY2021. Reported US Dollar revenue grew by 3.4% q-o-q to $1,308.7 million. EBIT margin surprised positively and expanded by 170 bps q-o-q to 15.9%, above our expectations. The tailwinds for margin improvement were (1) 140 bps from higher offshoring and utilisation and (2) cost management. Net profit came in at Rs. 1,309.8 crore, which was 17% above our estimates, led by both revenue and margin beat and higher-than-expected other income. Free cash flow (FCF) generation remained strong at $226 million during the quarter, translating into FCF to net profit conversion ratio of 127%.

Expect momentum of revenue growth to continue going ahead

Management expects double-digit growth over the next couple of years because of anticipated growth in the enterprise segment, potential 5G opportunities, and strong deal wins. During the quarter, TCVs of large deals bounced back to pre-COVID level at $455 million, in-line with expectations, led by strong deal wins in the enterprise segment. Given robust pipeline ($4.5 billion in the enterprise segment), management expects net new deal TCVs to accelerate going ahead. Further, management cited that there were a couple of postponements of deals in the communication space during Q3FY2021 and it expects those deals to flow in the coming months. Further, 5G-related activities have started to scale up across three segments such as 5G ecosystem, 5G in enterprise, and 5G in services providers. Management cited that it expects revenue growth on a sequential basis in Q4FY2021 and Q1FY2022. With higher spends on digital transformation by enterprises and modernisation of networks by service providers, we believe TechM is well positioned to report strong revenue growth over the next couple of years.

Management expects margin improvement to continue in the 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, margin improvement would be aided by higher revenue growth. Management has guided FY2021 EBIT margin would be 14%-15%.

Key result highlights from earnings call

- **Accelerated investments in building capabilities:** Management sees increasing demand in digital transformation, Cloud migration, and work-from-home transformation initiatives. Hence, the company has been making investments in Cloud, AI, cybersecurity, and data and analytics to fill its gap in the capabilities. Management believes investments around R&D in new products and platforms and new service offering would generate better outcomes for the company.
- **Revenue beats estimates:** TechM indicated that revenue growth (3.4% q-o-q) was supported by strong growth in Europe (up 8.3% q-o-q), network services (up 4.5% q-o-q), and manufacturing (up 4.5% q-o-q) during the quarter. Retail reported revenue growth of 8.9% q-o-q, followed by manufacturing and others (up 2.4% q-o-q). BFSI revenue grew by 0.6% q-o-q, while technology, media, and entertainment revenue declined by 1.1% q-o-q post strong growth over the past two consecutive quarters.
- **Margin walkthrough:** EBIT margin increased by 170 bps q-o-q to 15.9% (high over the last 24 quarters). Sequential margin improvement was aided by higher offshoring, improved utilisation (+80 bps), and operating leverage.
- **Margin outlook:** Management believes there are still operating levers that can help for further margin improvement. Management has retained FY2021E EBIT margin guidance at 14%-15%. In 9MFY2021, EBIT margin was at 13.4%. We believe the company would comfortably achieve its EBIT margin guidance target in FY2021. Management also indicated that expenses related to salary, travel, and facility would come back to some extent post normalcy. These margin headwinds would be partially mitigated by revenue growth and portfolio synergies.

- **Revenue outlook:** Management cited that it expects revenue growth on a sequential basis in Q4FY2021 and Q1FY2022. Management believes that Q4 would be better compared to Q3 in terms of deal conversion. Management remains positive on the outlook of BPS business in FY2022.
- **Business update:** Management highlighted that customers are willing to spend on transformation deals. Among new-age technologies, Cloud, Analytics, Customer Experience, Engineering Services, and BPS showing positive momentum.
- **Commentary on the communication vertical:** Management highlighted that 5G-related activities have been continued to scale up across three segments such as 5G ecosystem, 5G in enterprise, and 5G in telecom operators. Service providers need to transform and modernise their network for 5G. On 5G in enterprise, the company is engaged with large enterprises across industries such as process industries, oil refinery, retail, aerospace, and defense. The company has signed around a deal of $50 million TCVs in the 5G rollout space with one of the European customers during the quarter. Despite this deal, the company signed TCVs of new deals in this space of $104 million (down 50% q-o-q). Management indicated that there are large deals related to 5G in its pipeline. Management expects strong deal wins in the coming months as there were a couple of postponements of deals during Q3FY2021. Management continues to see strong deal pipeline across the board from network to digital to BPS.
- **Commentary on the enterprise segment:** Management stated that it has a deal pipeline of $4.5 billion in the enterprise segment. Further, the company sees opportunities around 5G in enterprises.
- **Commentary on BPS services:** BPS business continued to grow strongly in dollar terms at 11.4% q-o-q for second consecutive quarter. The company's margin improved to 23.7% from 21.9% in Q2FY2021.
- **Decent deal wins TCVs:** The company signed deals with a total contract value (TCV) of worth $455 million versus $421 million in Q2FY2020. TCVs of large deals remained in the average quarterly deal wins of $400 million-500 million. Deal win TCVs grew by 65% q-o-q to $352 million for the enterprise segment, while deal wins TCVs declined by 50% q-o-q to $104 million for the telecom segment. Given robust pipeline and strong conversion, management expects net new deal TCVs would accelerate going ahead.
- **Revenue grew across regions except US:** Europe business reported revenue growth of 8.3% q-o-q, while revenue in rest of the world (RoW) business grew by 4.9% q-o-q. US business revenue remained flat on a q-o-q basis during the quarter.
- **DSO days improved:** DSO further declined to 95 days in Q3FY2021 from 97 days in Q2FY2021, led by reduced working capital requirements. This the lowest in last 16 quarters.
- **Strong cash generation:** TechM generated quarterly FCF of $226 million, aided by strong collections versus $236 million in Q2FY2021. FCF to PAT conversion stood at 127% (versus 164% in Q2FY2021). FCF stood at $779 million in 9MFY2021 compared to $522.6 million in FY2020, aided by improved collections. Cash and cash equivalents increased to $1,625 million compared to $1,564 million in Q2FY2021.
- **Headcount added:** Total headcount stood at 1,21,901 during the quarter, with net reduction of 2,357 employees q-o-q, owing to headcount decline in the BPO business. The BPO segment saw headcount reduction of 1,630 compared to an addition of 2,908 in Q2FY2021, owing to ramp-down of a project in retail during December 2020. The company is operating at an all-time high utilisation rate of 87%. The company expects to add 5,000 employees over the next two quarters. Attrition rate improved to 12.4% in Q3FY2021 versus 13.5% in Q2FY2021.

Results

Rs cr

Particulars	Q3FY21	Q3FY20	YoY %	Q2FY21	QoQ %
Revenues In USD (mn)	**1,308.7**	**1,353.0**	**-3.3**	**1,265.4**	**3.4**
Revenues	**9,647.1**	**9,654.6**	**-0.1**	**9,371.8**	**2.9**
Cost of Services	6,470.8	6,731.2	-3.9	6,424.5	0.7
Gross profit	**3,176.3**	**2,923.4**	**8.6**	**2,947.3**	**7.8**
SG&A	1,280.8	1,360.1	-5.8	1,244.3	2.9
EBITDA	**1,895.4**	**1,563.3**	**21.2**	**1,703.0**	**11.3**
Depreciation	358.4	384.8	-6.9	371.7	-3.6
EBIT	**1,537.1**	**1,178.5**	**30.4**	**1,331.3**	**15.5**
Other Income	220.9	349.6	-36.8	117.5	88.0
PBT	**1,715.9**	**1,473.1**	**16.5**	**1,408.9**	**21.8**
Provision for taxes	426.3	362.9	17.5	346.2	23.1
Reported net profit	**1,309.8**	**1,145.9**	**14.3**	**1,064.6**	**23.0**
EPS (Rs.)	14.9	13.0	14.1	12.1	22.8
Margin (%)			**BPS**		**BPS**
EBITDA	19.6	16.2	346	18.2	148
EBIT	15.9	12.2	373	14.2	173
NPM	13.6	11.9	171	11.4	222

Source: Company; Sharekhan Research

Results

Particulars	Revenues	Contribution	$ Growth (%)	
	($ mn)	(%)	q-o-q	y-o-y
Revenues ($ mn)	1,309	100	3.4	-3.3
Geographic mix				
America	613	46.8	0.0	-6.4
Europe	345	26.4	8.3	-5.5
RoW	351	26.8	4.9	5.3
Industry verticals				
Communication	520	39.7	4.5	-9.8
Manufacturing	213	16.3	4.5	-9.1
Technology, media & entertainment	123	9.4	-1.1	19.2
BFSI	209	16.0	0.6	16.9
Retail, transport and logistics	103	7.9	8.9	6.1
Others	141	10.8	2.4	-14.4
Clients contribution				
Top 5	285	21.8	4.8	-5.4
Top 10	400	30.6	4.1	-4.5
Top 20	556	42.5	2.8	-2.4
Revenue by services				
IT	1,165	89.0	2.5	-4.5
BPO	143	11.0	11.4	7.8

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 40% of revenue arising from the telecom segment, TechM is well placed to capture 5G-related spending from telecom service providers and OEMs. We believe TechM 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, and AltioStar, 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 the business.

Valuation - Attractive valuation

We have revised our earnings estimates upward for FY2021E/FY2022E/FY2023E, factoring in impressive margin performance in Q3FY2021 and acceleration of deal TCVs going ahead. TechM 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 the CMP, the stock is trading at reasonable valuation of 17x/15x its FY2022E/FY2023E earnings, trading at significant discount to large peers despite anticipated strong revenue growth momentum in the enterprise business, 5G opportunities, and scope for margin improvement. Hence, we maintain our Buy rating on the stock with an unchanged PT of Rs. 1,100.

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
HCL Tech	915	271	2,48,287	18.6	17.6	12.3	11.0	4.3	3.8	24.5	23.1
Infosys	1,240	426	5,28,040	27.1	23.7	17.9	15.6	3.8	3.4	27.8	28.1
Wipro	418	572	2,38,930	22.1	20.1	15.0	13.6	4.1	3.7	17.2	17.6
Tech M	962	97	93,048	18.4	17.1	12.2	10.5	3.4	3.1	19.9	19.1

Source: Company, Sharekhan estimates

About company

Incorporated in 1986, TechM 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, TechM entered the enterprise solutions space and became the fifth largest Indian IT player. The company has now diversified its exposure to other verticals such as BFSI and manufacturing. TechM offers a bouquet of services including 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

TechM is one of the 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 is likely to accelerate across the globe, TechM is well positioned to capitalise 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 the 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	9.74
2	First State Investments ICVC	5.70
3	BlackRock Inc	4.98
4	First State Global Umbrella Fund	3.75
5	SBI-ETF NIFTY 50	2.55
6	SBI Funds Management Pvt Ltd	2.50
7	Life Insurance Corp of India	2.03
8	Vanguard Group Inc/The	1.91
9	Government Pension Fund	1.75
10	ICICI Prudential Asset Management	1.96

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