Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Tata Elxsi Limited

Designing the digital future

IT & ITeS	Sharekhan code: TATAELXSI	Annual Report Review

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. 3,767**	
Price Target: **Rs. 4,500**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

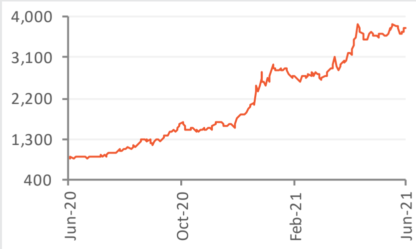
Company details

Market cap:	Rs. 23,457 cr
52-week high/low:	Rs. 4,089/864
NSE volume: (No of shares)	6.2 lakh
BSE code:	500408
NSE code:	TATAELXSI
Free float: (No of shares)	3.5 cr

Shareholding (%)

Promoters	45
DII	7
FII	14
Others	35

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	5.9	44.6	114.2	333.9
Relative to Sensex	2.1	35.4	101.5	282.0

Sharekhan Research, Bloomberg

Summary

- We retain a Buy on Tata Elxsi Limited with a revised PT of Rs. 4,500, led by shift of ER&D budgets towards digital engineering, superior margins and differentiated technological capabilities.
- Company stated that increased hyper-digitisation and technology adoption across industries would open up growth avenues as it is well-placed to leverage given its strong capabilities.
- Reports estimate global ER&D spends to grow at CAGR of 11% over 2020-2023 to $ 1.9 trillion. Digital engineering to ER&D spend is likely to reach at 47% in 2023 from 36% in 2020.
- TEL's USD revenue and earnings are set to post a CAGR of 26% and 29%, respectively, over FY2021-FY2023E. We prefer TEL, given its strong balance sheet, improving cash generation and consistent dividends.

Tata Elxsi Limited's (TEL) FY2021 annual report highlighted that increased hyper-digitisation and technology adoption across industries would open up growth avenues for TEL, as it is well placed to leverage given its strong relevant digital capabilities. Further, the annual report highlighted - (1) strong digital capabilities help clients to re-imagine their products and services, (2) higher digital adoption across industries, (3) strategic diversification to de-risk revenue dependency from customer, segment, and geography, (4) preferred partner for leading car manufacturers, original equipment manufacturers (OEMs), and suppliers, and (5) partnerships to propel growth. As rising digital initiatives have opened up opportunities to reshape the technology stack of large enterprises, TEL positions itself as a strategic design digital partner that can help enterprises to re-imagine their products and services - from strategy, insights, service design, interaction design to technology implementation, and integration. Among the pure-play Indian engineering and R&D companies, TEL reported industry-leading USD revenue growth of 8.8% y-o-y in FY2021, which was severely hit by COVID-19 pandemic. Further, TEL ended FY2021 with a 730 bps improvement in EBITDA margin, 44% net profit growth, 29% growth in cash balance, and 71% growth in free cash flow (FCF). During FY2021, the company opened Global Engineering Center (GEC) with Schaeffler Technologies AG and Aesculap AG in transportation and healthcare and medical devices verticals and entered partnerships with INVIDI, Google Widevine and Syntiant Corp to drive its growth going forward. Management also highlighted that it has been investing equally across its verticals to create solutions and products and platforms for its customers. Management expects the value of proposed aggregate transactions with the top account to be around Rs. 250 crores per year during FY2022 and FY2023. Enterprises are diverting their capex budgets to technology and prioritising digitisation in the face of a pandemic. According to Zinnov, global ER&D is expected to post a CAGR of 11% to $1.9 trillion by 2023 from $1.4 trillion in 2020. Given strong adoption of digital technologies, partnerships, strong deal wins, and a healthy deal pipeline, TEL is expected to deliver revenue growth with a stable operating margin in FY2022. Management believes operating profitability in FY2022 could be similar to last fiscal year despite reversal of COVID-19 related savings, wage revision, higher variable components, and supply-side issues, led by higher offshoring, better realisation in complex projects, and longer-term projects.

Our Call

Valuation – Strong growth outlook going ahead: We expect TEL's revenue growth momentum to remain strong in the medium term because of shift of ER&D budgets towards digital engineering, presence in high-growth verticals, strong deal wins, traction for its offerings and developing partnerships in new areas. Though management expects gradual recovery in the automotive segments in 2021, it expects increased hyper-digitisation and technology adoption across industries including media and communication and healthcare and medical devices vertical. TEL's USD revenue and earnings are likely to post a CAGR of 26% and 29%, respectively, over FY2021-FY2023E. We continue to prefer TEL, given its differentiated technological capabilities, investments in right capabilities, improving sales and marketing, long-standing relationships with clients, and a strong parentage. At the CMP, the stock is trading at 45x/39x/34x its FY2022E/FY2023E/FY2024E earnings. Given a strong balance sheet, improving cash generation, and consistent dividend payout, we maintain our Buy rating on TEL with a revised a price target (PT) of Rs. 4,500.

Key risk

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US and a stringent visa regime would have an adverse impact on its earnings.

Valuation Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	1,826.2	2,430.3	2,965.2	3,439.9
OPM (%)	28.6	28.8	28.0	27.5
Adjusted PAT	368.1	516.3	610.1	692.0
% YoY growth	*43.7*	*40.2*	*18.2*	*13.4*
Adjusted EPS (Rs.)	59.1	82.9	98.0	111.1
P/E (x)	63.7	45.4	38.5	33.9
P/B (x)	17.3	13.7	10.8	8.7
EV/EBITDA (x)	43.9	32.8	27.6	24.2
RoNW (%)	27.2	30.1	28.2	25.6
RoCE (%)	30.8	33.7	31.7	28.7

Source: Company; Sharekhan estimates

Key takeaway

TEL's FY2021 annual report highlighted the following points – (1) its design digital capability to re-imagine enterprises' products and services, (2) investments in strengthening offerings and improving sales and marketing, (3) presence in growth verticals with low overlap, (4) strategic diversification to de-risk revenue dependency from customer, segment, and geography, (5) long-standing relationships with large customers, (6) preferred partner for leading car manufacturers, OEMs, and suppliers, (7) recognised from industry experts as a leader in advanced technologies, (8) acquisition of new logos, and (9) strong dividend payout. With demand tailwinds, strong traction for its offerings, long-standing relationship with clients, and recent deal wins, we expect TEL's USD revenue and earnings to post strong CAGR of 26% and 29%, respectively, over FY2021-FY2023E.

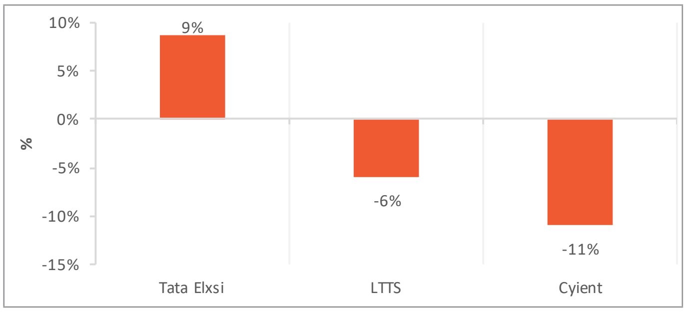
Accelerated digital adoption to dive growth

Digital technologies such as mobility, IoTs, AI, and cloud-based applications are being integrated into consumer contexts, services, and products. The pandemic has accelerated the adoption of digital technologies as these technologies are creating huge opportunities to drive operational efficiency, reduce costs, deliver new services to consumers, and generate new revenue sources. However, digital initiatives increase the technological complexity to develop new products and services. As this has opened up opportunities to re-model the technology stack of large enterprises, TEL positions itself as a design digital partner that can help enterprises re-imagine their products and services – from strategy, insights, service design, interaction design to technology implementation, and integration.

Stellar performance in a pandemic year

After a sharp decline in sequential revenue growth (down 12.8% q-o-q) in Q1FY2021 owing to COVID-19 related disruptions, TEL reported stellar revenue growth for the remaining quarters of FY2021 because of strong volume growth and its presence in high-growth verticals. Among the pure-play Indian engineering and R&D companies, TEL reported industry-leading USD revenue growth of 8.8% y-o-y in FY2021, which was severely hit by COVID-19 pandemic. Further, TEL ended FY2021 with a 730 bps improvement in EBITDA margin, 44% net profit growth, 29% growth in cash balance, and 71% growth in FCF. The company's strategic diversification, seamless continuity of delivery and operations, and investments in improving offerings, sales, and marketing enabled it to report strong operating revenue where the global economy was contracting. With increased hyper-digitisation and technology adoption across industries, growth verticals such as healthcare, pharma, medical devices, software and internet, and consumer electronics are expected to accelerate in 2021. Over the past few years, TEL has been investing in advanced technologies to build relevant capabilities in growth in industry verticals with low overlap, such as transportation, media, broadcast and communications, and healthcare. During FY2021, the company opened Global Engineering Center (GEC) with Schaeffler Technologies AG and Aesculap AG in transportation and healthcare and medical devices verticals and entered partnerships with INVIDI and Google Widevine and Syntiant Corp to drive its growth going forward. Given strong adoption of digital technologies, partnerships, strong 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.

USD revenue growth of ERD companies in FY2021



Source: Company, Sharekhan Research

Tata Elxsi – USD revenue growth of segments in FY21

q-o-q (%)	Q1FY21	Q2FY21	Q3FY21	Q4FY21
EPD	-10%	9%	10%	6%
IDV	-35%	17%	28%	42%
SIS	-13%	-3%	17%	24%

Source: Company; Sharekhan Research

Embedded Product Design (EPD); Industrial Design & Visualization (IDV); System Integration & Support (SIS)

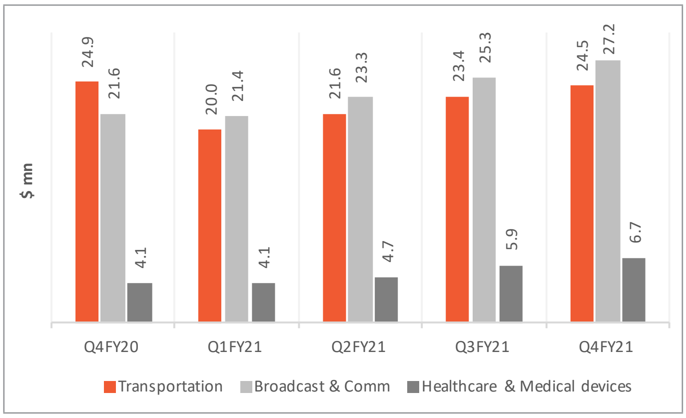
Creating platforms across verticals

Management highlighted that it has been investing equally across its verticals to create solutions and products for its customers. The company has successfully licensed its advanced autonomous vehicle middleware platform i.e., Autonomai to an automotive OEM for their driverless car R&D, while it has deployed its Flacon Eye solution in the media and broadcast sector. Management indicated that it has been working on a new platform i.e., TE-PLAY for enabling the rapid launch of new OTT services. The company has filled eight or nine patents over the past couple of years in the healthcare and medical devices vertical. The company indicated that it is currently working on cloud-based platforms in the healthcare space that consolidates and provides valuable data for analytics on the digital side. It is also developing software accelerator platforms in regulatory intelligence and clinical workflow automation to improve operational efficiencies for the end-users significantly. Moreover, TEL indicated that it has developed a multi-disease diagnostic platform for thalassemia, COVID-19, sickle cell disease, and malaria.

Diversification strategy playing out well

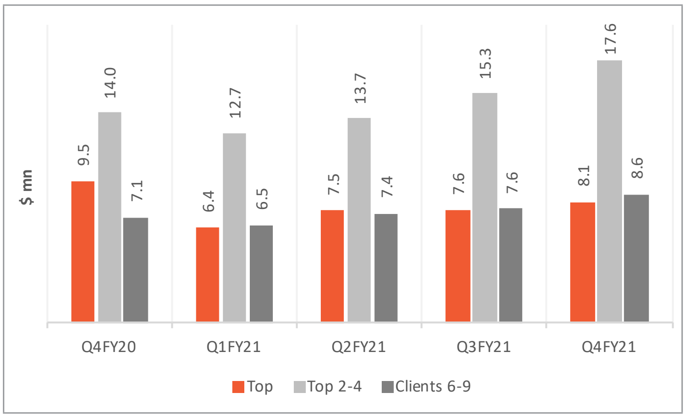
The company's diversification strategy resulted in reduction of exposure in top customer, investments in adjacencies of its focused industries, and redeployment of resources. Further, the company has expanded its offerings across verticals and strengthened its position in major markets. Post its conscious strategy to focus on verticals in 2011, the company has diversified its business into broadcast and communication, transportation, and healthcare and medical devices. During Q1FY2021, the broadcast and communication vertical overtook the transportation vertical and became the largest in terms of revenue to embedded product design (EPD) business, taking its contribution to EPD revenue to 44.7% in Q4FY2021. Whereas, transportation vertical's revenue contribution to EPD revenue stood at 40.3%. The company incubated the medical devices business six years ago, which grew strongly at 49.4% y-o-y in FY2021. Further, management is looking at adjacencies in the transportation vertical such as rail, off-road, and commercial as the skillsets are similar and skillsets can be fungible. Management expects these adjacencies revenue contribution to the transportation vertical's revenue would be 15-20% in the next three years. Over the next 3-5 years, management expects contribution of transportation, broadcast, and medical devices vertical would be 40:40:20. Similarly, the company has successfully reduced the overall exposure from the top account from 25.7% in Q1FY2019 to 11.4% in Q4FY2021. Revenue of top-5 and top-10 clients reduced by 320 bps and 370 bps on a y-o-y basis, respectively, in FY2021. We believe the company's diversification strategy is yielding results with reducing contribution of the automotive segment to total EPD revenue, de-risking revenue dependency from a particular customer, and expanding its footprint in major markets.

Top verticals' revenue ($ mn) trend



Source: Company, Sharekhan Research

Top accounts' revenue ($ mn) trend



Source: Company, Sharekhan Research

Leveraging long-standing relationships

Management indicated that it has long-standing relationships with some of its top customers. The company's top account is one of the oldest customers of its automotive division and has been engaged with the top account prior to the acquisition of this top client by Tata Group. TEL acts as an R&D centre for top clients' various new vehicle programmes and provides niche product design expertise and engineering services in the areas of mechanical, electronics, and software development and complete vehicle programme management. Top account contributed Rs. 216 crore (11.8% of total revenue) in FY2021. Management expects the value of proposed aggregate transactions with the top account to be around Rs. 250 crore per year during FY2022 and FY2023. Further, the top client in the broadcast and communications vertical is a large US-based multi-services operator. TEL has been engaged with this customer over the past 12 years and provides services, including new broadband space and OTT space.

Industry overview: Accelerated digital adoption across its verticals

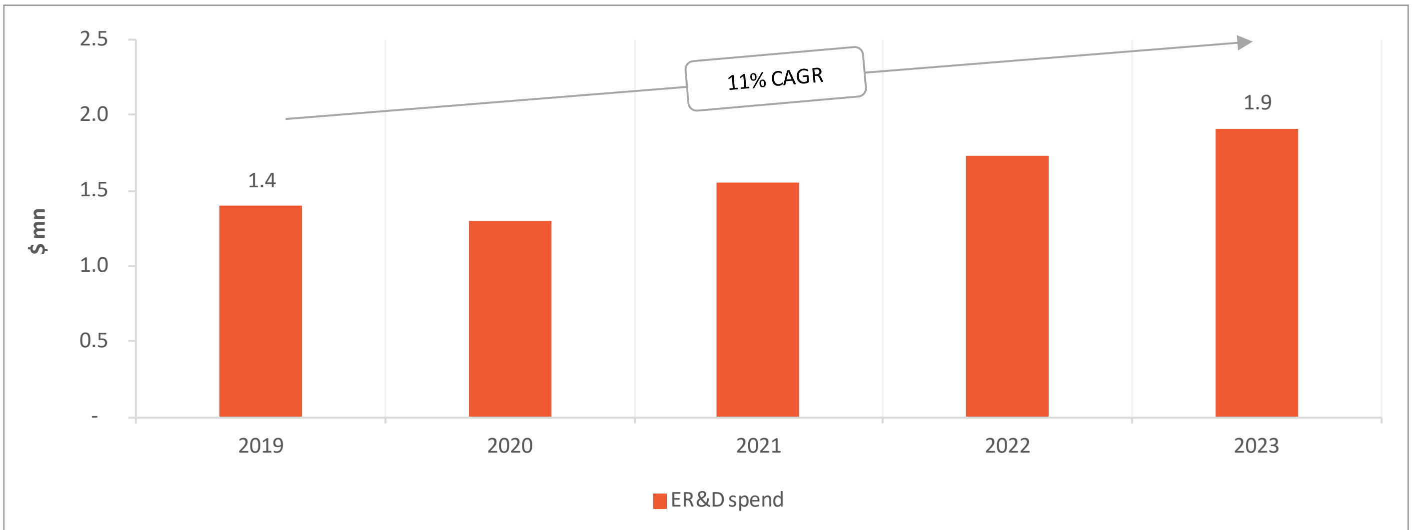
The ongoing COVID-19 pandemic, stagnant economic performance, foreign exchange rate fluctuations, and a downturn in some sectors pose challenges to economic growth. However, management expects advanced economies will recover faster, supported by fiscal stimulus and vaccination mechanisms.

Given manufacturing verticals, including aerospace, automotive, and industrial were badly impacted due to the pandemic, these sectors witnessed a change in ER&D priorities, 5G, digital thread, and sustainable engineering. Further, there is rapid adoption of intelligent, connected, and smart initiatives such as Tele X, intelligent workplaces, contactless commerce, leveraging new-age technologies such as AI, AR/VR, IoT to make enterprises anti-fragile. Hence, we believe the rapid adoption of digital technologies will drive digital engineering spend going forward.

When the global economy contracted by 3.3% y-o-y in 2020 (as per IMF), India's IT & ITeS sector grew by 2.3% y-o-y (as per Nasscom) because of faster digital technology adoption by clients. According to Nasscom, India's technology sector contributed 8% of national GDP and 52% of services exports.

The rate of digital technology adoption has increased across industries, resulting in rapid revenue growth for technology service providers. Enterprises are diverting their capex budgets to technology and prioritising digitisation in the face of a pandemic. According to Zinnov, the global ER&D is expected to post a CAGR of 11% to $1.9 trillion by 2023 from $1.4 trillion in 2019.

ER&D spend likely to grow by 11% to $1.9 trillion over next 3 years



Source: Zinnov; Sharekhan Research

- **Automotive:** COVID-19 triggered significant disturbances in the automotive industry. Lockdowns resulted in a substantial drop in car sales in 1HFY2021. The selling of LV/passenger cars declined sharply in developed/larger economies such as the United States, the United Kingdom, China, and major EU economies such as Germany, France, Italy, Spain, and others. The second half of FY2021 saw a modest rebound, but total car and SUV sales fell by 16% to 76.5 million in 2020. Management expects auto demand to improve in 2021, but at a slower pace, which is expected to report mid-to-high single-digit sales growth in 2022. China is expected to see 2.5% y-o-y growth in auto unit sales in 2021.

- **Media and communications:** Media and communication sector was positively affected by the pandemic. With a surge in data and telecom services due to global lockdowns, the media and communications sector is expected to post a CAGR of 4% during 2020-2023. Further, investments are expected to increase in OTT, 5G, SDN/NFV, and AI.

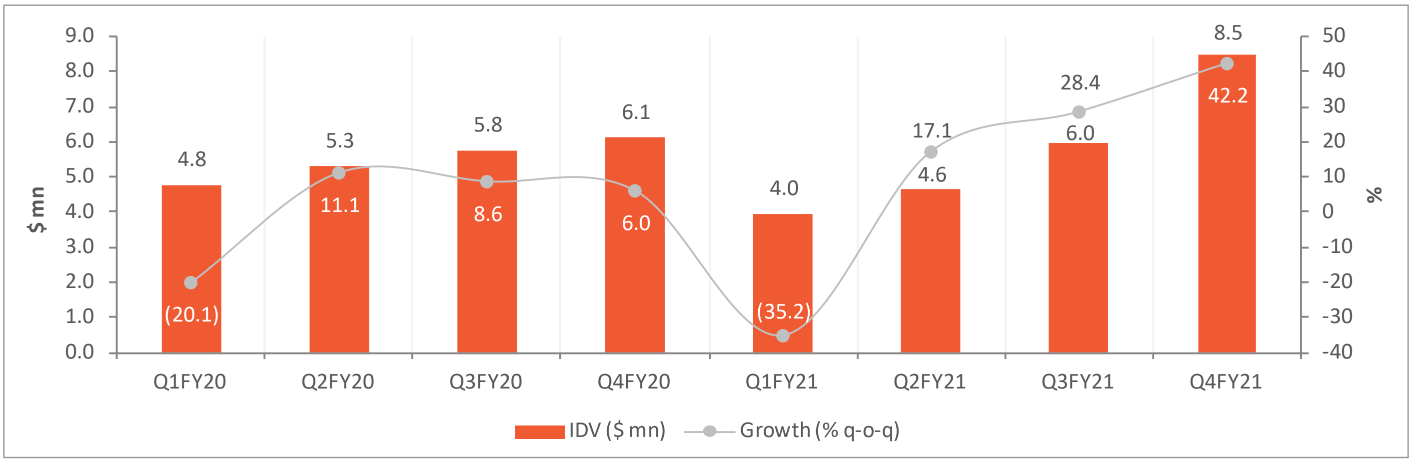
- **Healthcare and medical devices:** COVID-19 has served as an inflection point for digital transformation across the healthcare ecosystem. Transforming the patient experience value chain is top priority for providers. The uberisation of patient care is the biggest COVID-led disruption. Healthcare payers are accelerating digital investments to automate the trifecta of sales, operations, and services. Global health spending is expected to rise at a 3.9% CAGR during 2020-2024, led by Asia and Australia (5.3%) and the economies of Central and Eastern Europe (5.2%). A new trend has emerged during this pandemic phase – creating digitally enabled, on-demand, and seamlessly connected consumer experiences that drive doctor and patient interactions. Consumers are increasingly turning to technology to track their well-being, fitness, and order medicines.

Business overview

Industrial design and visualisation (IDV): TEL works with customers to develop innovative products, services, and experiences that help them establish brands and grow their businesses. It assists clients worldwide in bringing new concepts and goods to market by combining design and technology. During FY2021, this business registered a turnover of Rs. 170 crore and growth of 9% y-o-y.

- This division was impacted (down 35% q-o-q) in Q1FY2021 due to COVID-19 as lot of work requires people to go out and interact with people in the market. However, there was a sharp recovery in Q2FY2021 and growth was accelerated for Q3FY2021 and Q4FY2021.
- There was a leadership change in this vertical in Q1FY2021.
- Further, the company is working on the VR for education and training. Management expects strong growth in this area.
- During FY2021, Dish TV selected TEL to develop Orbit, the new user interface (UI), for both its brands Dish TV and d2h. This enables subscribers with a seamless TV and online viewing experience. The new interface will leverage artificial intelligence and machine learning to make it easier to find content on TV where users are restricted to traditional remotes.

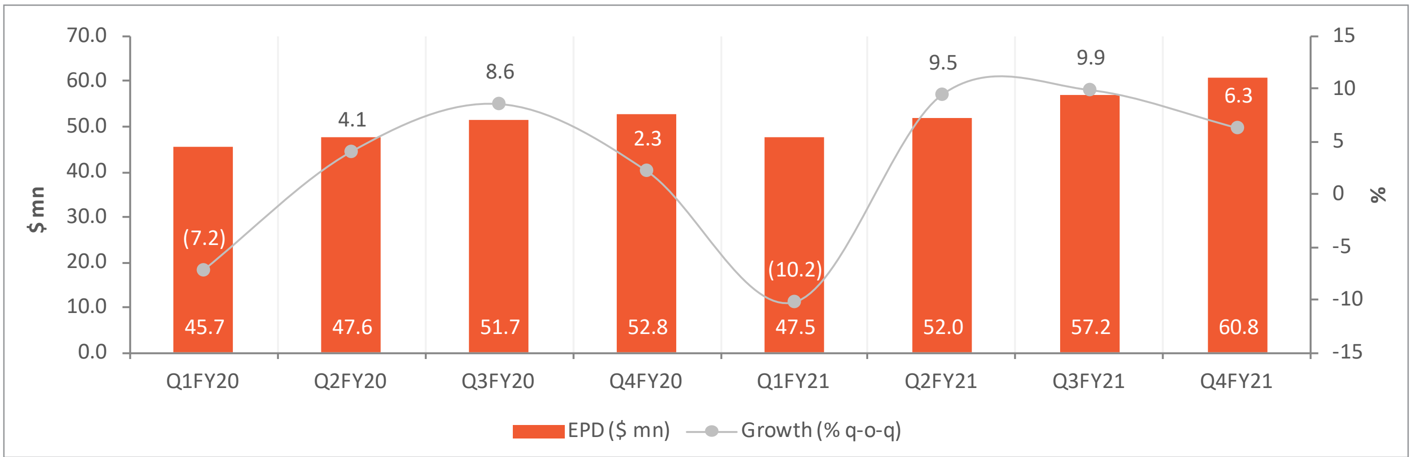
IDV business growth trend



Source: Company; Sharekhan Research

Embedded Product Design (EPD): EPD division provides technology consulting, new product design, development, and testing services for the transportation, media, broadcast and communication, and healthcare and medical devices vertical. During FY2021, this division's revenue grew by 14.8% y-o-y to Rs. 1,611 crore.

EPD business growth trend

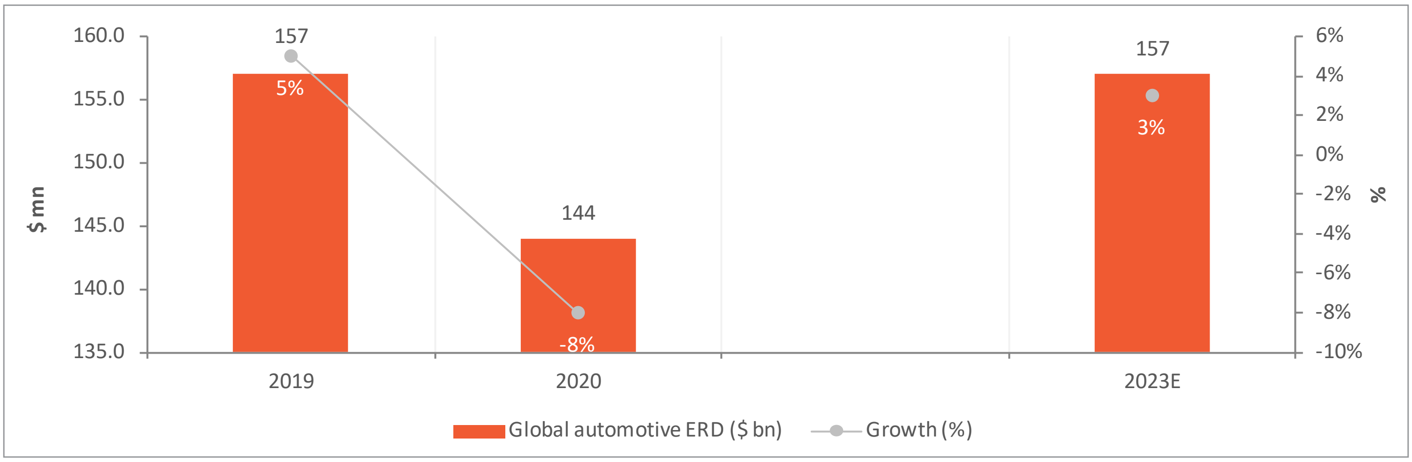


Source: Company; Sharekhan Research

Transportation: TEL is a preferred partner for leading car manufacturers, OEMs, and suppliers to develop electronics and software for power train, infotainment, connectivity, active safety, and comfort. TEL provides R&D, design, and product engineering services to leading global automotive and transportation industry players. This business segment contributed to 41.2% of EPD revenue in FY2021.

As per Zinnov, global automotive ER&D spending is expected to grow at 5% to $157 billion by 2023, led by investments in digital engineering, given increasing focus on new-age technologies. Automotive OEMs and component manufacturers are growing their R&D expenditures on digital innovation initiatives to develop autonomous, ADAS, and industry 4.0 capabilities. Digital ER&D ($133.5 billion) constitutes a significant part of global automotive ER&D spend.

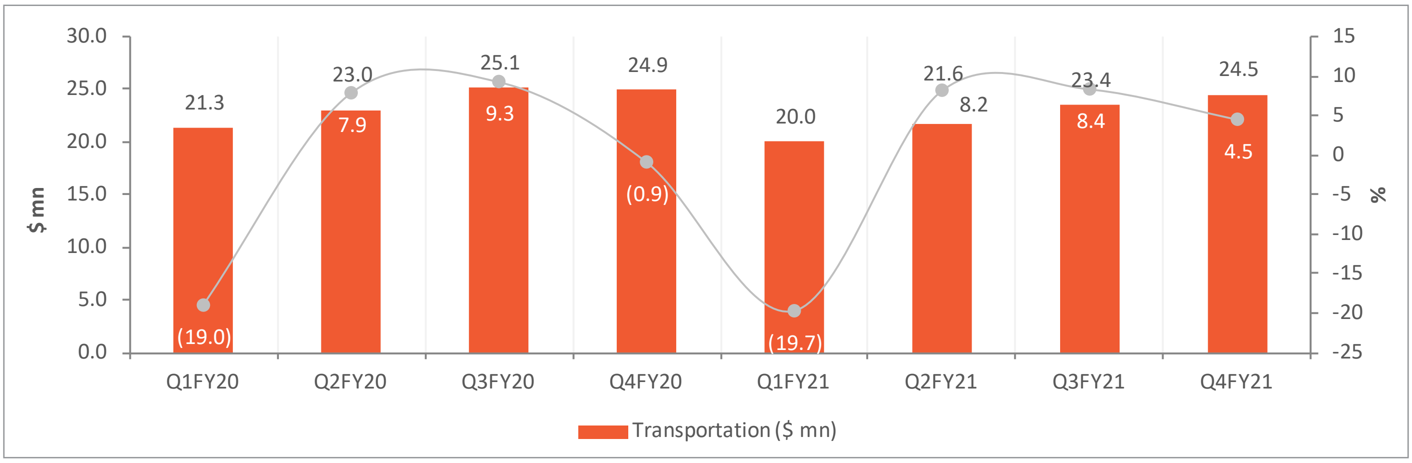
Global automotive ER&D ($bn)



Source: Zinnov; Sharekhan Research

- During FY2021, TEL announced the opening of the GEC with Schaeffler Technologies AG & Co. KG, a world leader in providing mechatronics solutions for the transportation industry. This relationship strengthens the company's automotive presence in Europe and reinforces strategic investments as a design-led engineering solutions provider over the years.
- TEL is investing in strengthening electric vehicles' development capabilities, including control software development, battery management systems, and validation. It continues to invest in developing IP in select areas, creating new monetisation opportunities, and demonstrating expertise in specific areas of future growth.
- The company is investing in building capabilities in the rail industry, working with leading operators, metro and rail authorities, rolling stock and systems suppliers to deliver design and technology services that enhance safety, convenience, quality, and overall customer experience, while accelerating product and service development and deployment.

Transportation vertical growth trend

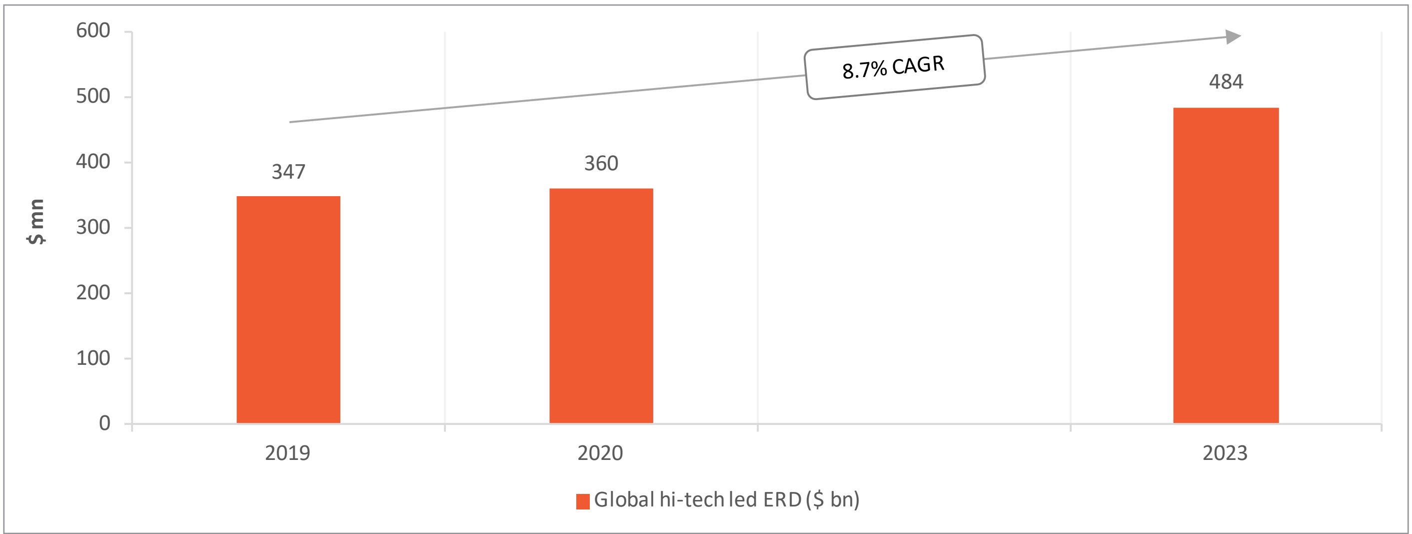


Source: Company; Sharekhan Research

Media, broadcast and communications: TEL addresses the complete product development lifecycle from R&D, new product development, and testing to maintenance engineering for broadcast, consumer electronics, and communications. It works with leading broadcasters and operators to develop and deliver new connected services and superior customer experience. This division contributed 44.7% to EPD revenue in FY2021.

As per Zinnov, global hi-tech-led verticals consisting of software and internet, semiconductor, and telecom are expected to reach $484 billion by 2023, registering a CAGR of 14% during 2019-2023.

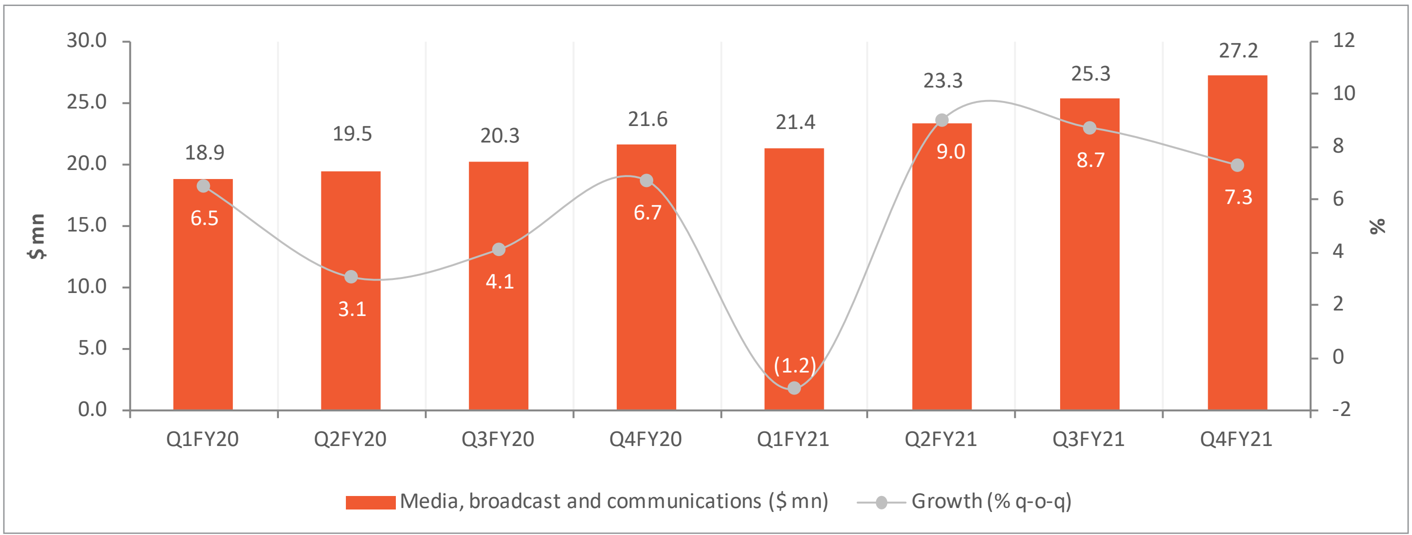
Global hi-tech led ER&D ($bn)



Source: Zinnov; Sharekhan Research

- TEL offers better customer engagement through the user-centric design and AI-based video analytics for hyper-personalisation for rich interaction with users. Its FalconEye solution enables a superior quality experience, thereby helping content providers increase customer loyalty, retention, and extend their customer base.
- In FY2021, TEL expanded its RDK offerings by developing an end-to-end, full-stack, intuitive user interface solution for RDK Video Accelerator set-top boxes. This solution offers faster application development cycles for operators adopting RDK for their video and broadband services.
- TEL teamed up with Syntiant Corp., a deep learning chip technology company, to assist manufacturers in designing and developing low-power always-on voice applications for various product categories, including smart home devices and consumer electronics, as well as industrial and transportation use cases.
- TEL announced an expansion of its relationship with INVIDI Technologies to bring addressable television capabilities to pay-TV operators in India, Asia-Pacific, and MEA.
- TEL was selected as a 3PL certification partner for Google Widevine to deliver secure premium content protection for broadcast, media, consumer electronics, and automotive applications. This certification partnership further expands TEL's offerings and leadership in the broadcast, media, consumer devices, and transportation domains and enables leading brands, content distributors, OTT providers, and operators with a seamless development, integration, and certification service for Widevine solutions, ensuring faster time-to market for their revenue-generating services.

Media, broadcast and communications vertical growth trend

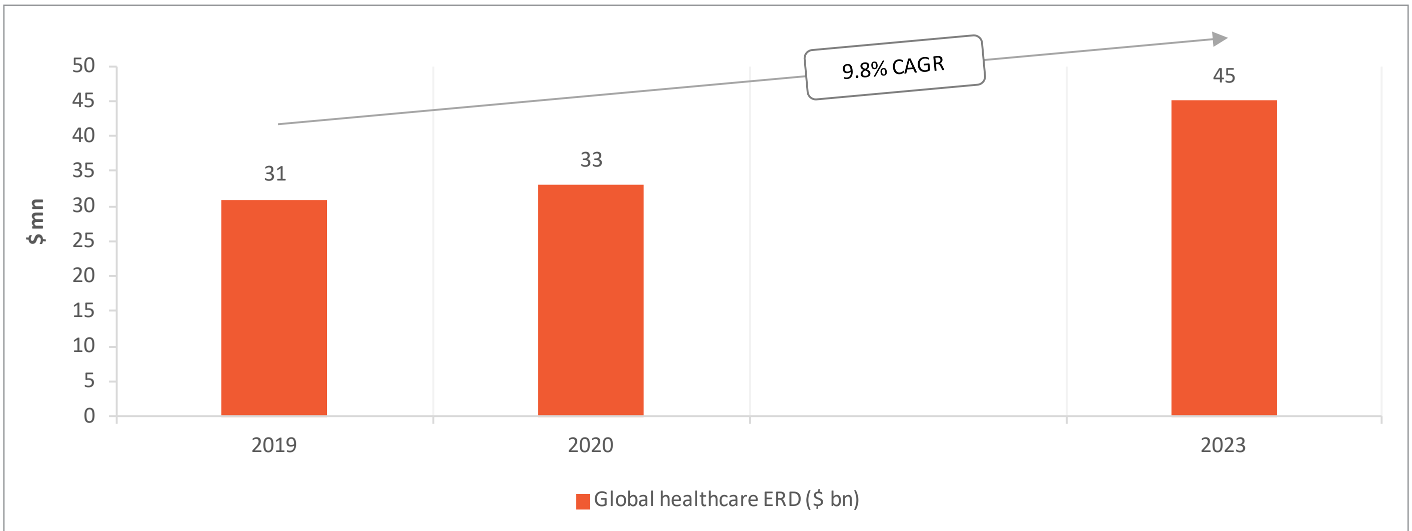


Source: Company; Sharekhan Research

Healthcare and medical devices: TEL supports global medtech, digital health, pharmaceuticals, and biotech businesses. The company helps clients to conceptualise, launch, and sustain products in the world's most regulated industries. The healthcare segment contributed 9.9% to EPD revenue and continues to be fastest-growing segment, registering 49.4% y-o-y revenue growth in FY2021.

As per Zinnov, global healthcare (services led) ER&D is expected to reach $45 billion by 2023, registering a CAGR of 9.8% over 2019-2023. The total global R&D spend in the medical devices industry stands at $48 billion-49 billion in 2019, concentrated on top players. North America is the biggest spender with 59% of the pie, followed by Europe at 34% and APAC at 7%.

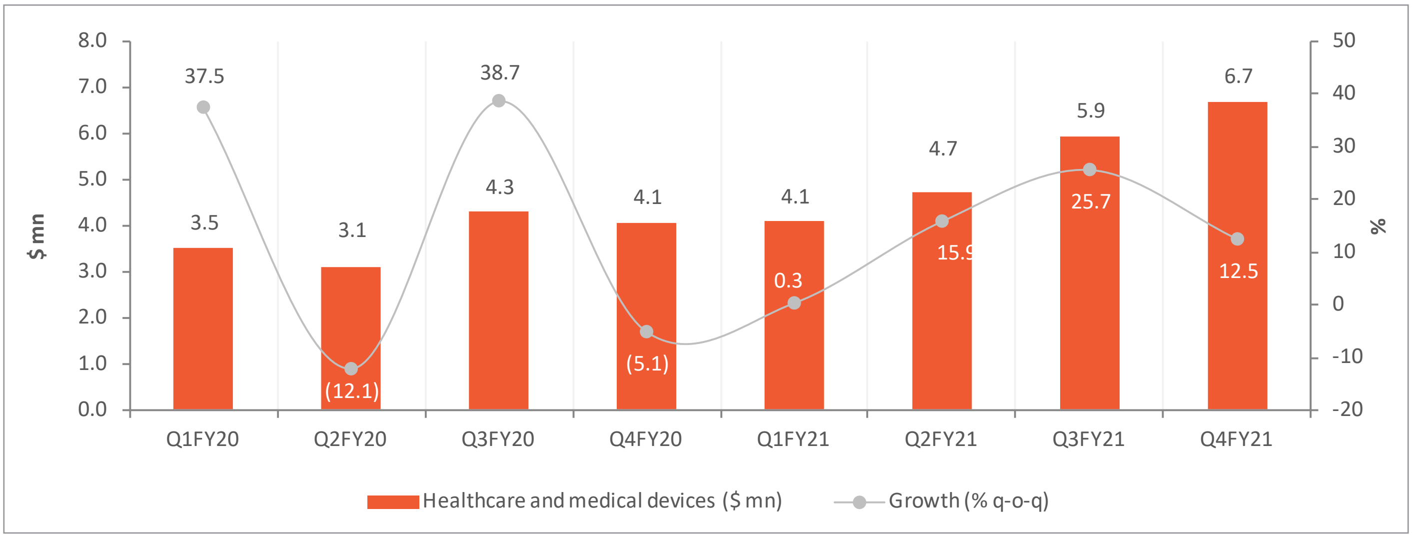
Global healthcare ER&D ($bn)



Source: Zinnov; Sharekhan Research

- TEL engages with its customers to design next-generation products in critical care, patient monitoring, and drug delivery.
- TEL announced the opening of a GEC with Aesculap AG, a subsidiary of B.Braun, one of the world's leading manufacturers of medical devices and pharmaceutical products and services.

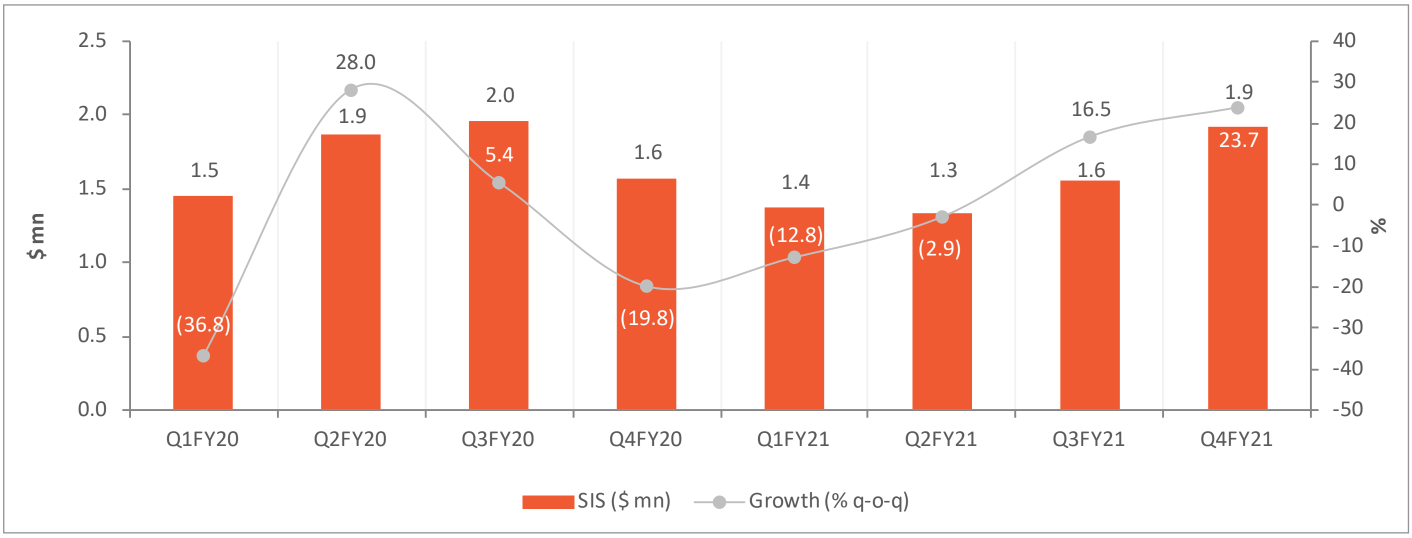
Healthcare and medical devices vertical growth trend



Source: Company; Sharekhan Research

System Integration and Support (SIS): TEL implements and integrates complete systems and solutions for specialised applications such as experience centres, training and safety, and design visualisation. The company helps customers implement complex design solutions across market segments such as automotive, aerospace, entertainment, manufacturing, government, and education. TEL's SIS segment reported a turnover of Rs. 44.5 crore during FY2021, a decline of 5.5% y-o-y. The segment generated a profit of Rs. 3.7 crore during FY2021.

SIS business growth trend



Source: Company; Sharekhan Research

Financial performance

- TEL's revenue in rupee terms grew by 13.4% y-o-y to Rs. 1,826.2 crore in FY2021. This growth was mostly volume-led. The company's revenue grew at 8% y-o-y in constant currency terms and 8.8% y-o-y in USD terms in FY2021.
- EBITDA grew by 52.3% y-o-y to Rs. 522.4 crore. EBITDA margin improved by 730 bps y-o-y to 28.6%. Management indicated that it deferred hiring and lowered administrative expenses and travel expenses during FY2021.

Analysis of overheads

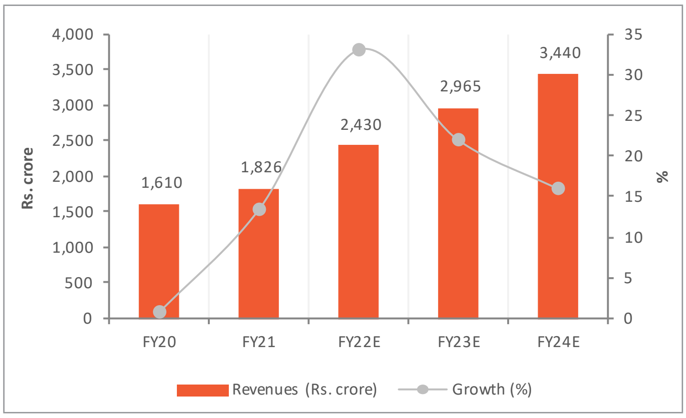
Analysis of Overheads	FY20	FY21	Variance (%)
Communication expenses	7.35	5.9	-19.2%
Inland travel and conveyance	7.9	2.0	-74.4%
Overseas travel	68.02	26.9	-60.4%
Advertisement and Sales Promotion	8.39	6.7	-20.0%
Legal and Professional Expenses	10.04	10.8	8.0%
Consultant fees for software development	70.12	71.5	2.0%
Total	**171.8**	**124.0**	**-27.8%**

Source: Company

- PBT grew by 45.3% y-o-y to Rs. 511.9 crore in FY2021, crossing the Rs. 500 crore mark for the first time in the company's history.
- The company's net profit for the year grew by 43.7% y-o-y to Rs. 368.1 crore.
- The onsite offshore revenue mix has also shifted this year, with offshore share rising by 920 bps to 66.9%.
- The company hired 785 net employees. Its attrition rate dropped by 360 bps to 6.6% for FY2021.
- The company's receivable days declined to 79 days in FY2021 from 85 days in FY2020.
- Cash and cash equivalents increased to Rs. 859.6 crore in FY2021 from Rs. 664.2 crore in FY2020.
- The company's current liability increased by 21% y-o-y to Rs. 291.3 crore in FY2021 from Rs. 240.7 crore in FY2020.
- CFO increased by 71% y-o-y to Rs. 437.4 crore in FY2021 from Rs. 255.8 crore in FY2020.
- FCF to EBITDA ratio improved to 76% in FY2021 from 67% in FY2020.
- The company declared dividend per share of Rs. 48 in FY2021 compared to Rs. 16.5 per share in FY2020. Dividend to net profit increased to 81% in FY2021 from 40% in FY2020.

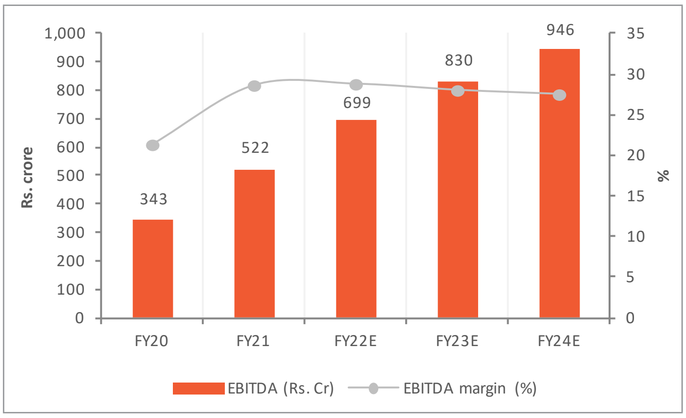
Financials in charts

Revenue (Rs. crore) and growth (%)



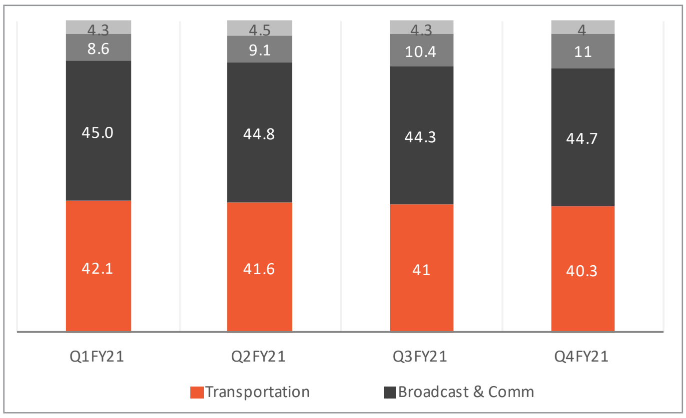
Source: Company, Sharekhan Research

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



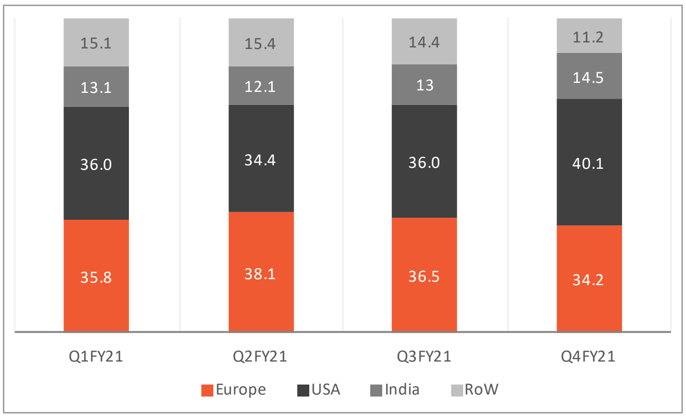
Source: Company, Sharekhan Research

Vertical breakdown (%)



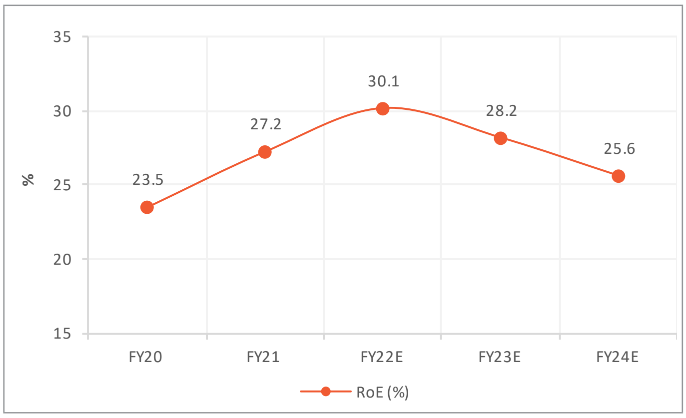
Source: Company, Sharekhan Research

Geography breakdown (%)



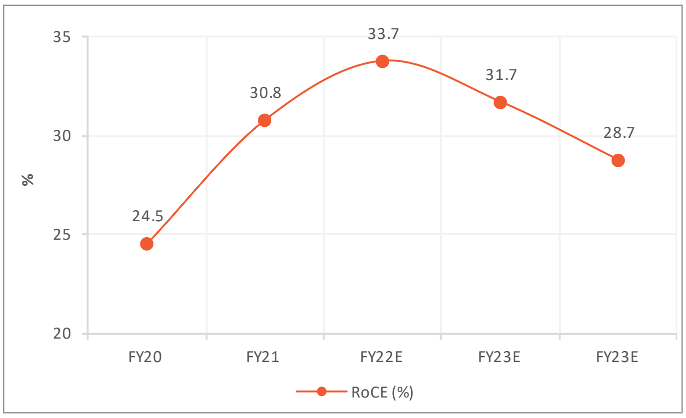
Source: Company, Sharekhan Research

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 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. According to Zinnov, global ER&D is expected to post a CAGR of 11% to $1.9 trillion by 2023 from $1.4 trillion in 2020. Digital engineering to ER&D spend ratio is likely to reach 47% in 2023 from 36% in 2020. Further, digital engineering spend is expected to grow to around $1.1 trillion by 2025 from $404 million in 2019.

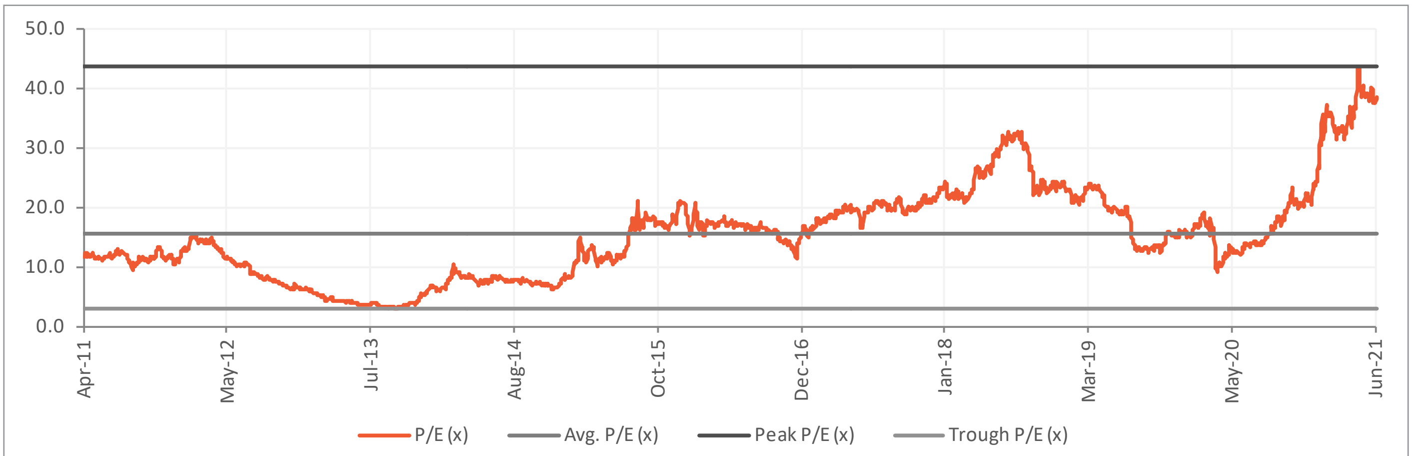
Company Outlook – Promising outlook

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 USD revenue and earnings to register CAGR of 26% and 29%, respectively, over FY2021-FY2023E.

Valuation – Bright times ahead

We expect TEL's revenue growth momentum to remain strong in the medium term because of shift of ER&D budgets towards digital engineering, presence in high-growth verticals, strong deal wins, traction for its offerings, and developing partnerships in new areas. Though management expects gradual recovery in automotive segments in 2021, it expects increased hyper-digitisation and technology adoption across industries, including media and communication and healthcare and medical devices vertical. TEL's USD revenue and earnings are likely to post CAGR of 26% and 29%, respectively, over FY2021-FY2023E. We continue to prefer TEL, given its differentiated technological capabilities, investments in right capabilities, improving sales and marketing, long-standing relationships with clients, and a strong parentage. At the CMP, the stock is trading at 45x/39x/34x its FY2022E/FY2023E/FY2024E earnings. Given a strong balance sheet, improving cash generation, and consistent dividend payout, we maintain our Buy rating on TEL with a revised a PT of Rs. 4,500.

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 (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Cyient	839	11	9,237	20.4	16.9	10.7	9.3	3.1	2.8	15.2	16.7
LTTS	2,926	11	30,738	33.3	27.3	21.9	18.4	7.4	6.2	24.4	24.9
Tata Elxsi	3,767	6	23,457	45.4	38.5	32.8	27.6	13.7	10.8	30.1	28.2

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 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 business mix would help in improving margins and return ratios. TEL has a strong, debt-free balance sheet, and a robust cash balance that provide 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 and Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Axis Asset Management	3.57
2	Axis Equity Advantage Fund	3.16
3	Tata Investment Corp Limited	2.30
4	Vanguard Group Inc.	1.05
5	BlackRock Inc.	0.88
6	JPMorgan Chase & Co	0.59
7	Invesco Ltd	0.59
8	William Blair & Co LLC	0.55
9	Dimensional fund advisors LP	0.42
10	Tata Asset Management Limited.	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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