Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Tech Mahindra Ltd

Mixed bag Q4; multiple growth drivers

IT & ITeS	Sharekhan code: TECHM
Reco/View: Buy ↔	CMP: **Rs. 1,202** / Price Target: **Rs. 1,650** ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 12.73

Updated Apr 08, 2021

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

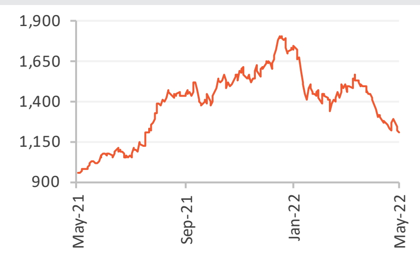
Company details

Market cap:	Rs. 116,857 cr
52-week high/low:	Rs. 1,837 / 941
NSE volume: (No of shares)	28.1 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	62.3 cr

Shareholding (%)

Promoters	35.3
FII	35.2
DII	19.0
Others	10.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-14.8	-15.6	-21.1	26.3
Relative to Sensex	-5.5	-6.6	-9.4	17.7

Sharekhan Research, Bloomberg

Summary

- Q4FY22 revenues were in-line, but EBIT margin lagged our estimates; Q4 saw strong deal intake, healthy deal pipeline, good client mining and logo additions. Net new order intake grew by 44% q-o-q to $1.01 billion.
- Company is well-placed to deliver strong revenue growth in the next few years given strong deal wins, active participation in the transformation activities within telecom ecosystem and strong demand for its both BPS and XDS practices.
- Strong revenue growth, pricing leverage, higher utilisation, increased offshoring and reduced subcontractor expenses would negate the margin headwinds in FY2023E. USD revenue/earnings would clock a CAGR of 13.7%/14.3%, respectively, over FY22-FY24E.
- We maintain a Buy on TechM with a revised PT of Rs. 1,650, given robust deal wins, picking up of 5G spends and reasonable valuation. The stock trades at 15x FY2024E EPS.

Tech Mahindra (TechM) clocked strong in-line revenue growth performance led by communication, media & entertainment (CME) segment, technology and BFSI vertical, while EBIT margins missed our estimates owing to higher depreciation and amortisation expenses. The company reported sequential constant currency revenue growth of 5.1% and USD revenue growth of 4.9% to $1,608.1 million, in-line with our estimates. EBIT margin contracted by 159 bps q-o-q to 13.2%, below our estimates. The company reported strong net new deal TCVs of $1,011 million (up by 44% q-o-q), led by a 2.9x growth in deal TCVs of CME ($645 million). The strong growth in the CME segment would be driven by transformation activity within the telecom ecosystem (digital transformation driven by 5G and readiness of the enterprises for 5G related revenue growth), and adoption of Cloud to transform the existing stack. We expect strong revenue growth in communication vertical for next 2-3 years. Margin levers such as pricing leverage, higher utilisation, increased offshoring and reduced subcontractor expenses would mitigate margin headwinds in FY2023E.

Key positives

- CME segment reported strong CC revenue growth of 23.7% y-o-y
- Net new deal TCVs grew by 48% to $3.3 billion in FY2022
- Added one and four clients sequentially in $50 million + and $20 million + revenue brackets

Key negatives

- FCF declined 41% y-o-y, hence, FCF/net profit ratio fell to 56% versus 127% in Q4FY21
- EBITDA margin of BPO business contracted by 150 bps q-o-q

Management Commentary

- Technology and BFS are expected to grow strongly in FY2023 on the back strong demand
- Management plans to add incremental $1 billion revenue in FY2023E, led by CME, BFSI and h-tech verticals
- Investments in digital engineering positions it to provide engineering capabilities in metaverse ecosystem.
- Company will focus on integration of acquired entities in FY2023; less focus on acquisition spree

Revision in estimates – We have slashed our earnings estimates for FY23E/FY24E by around 3-4% factoring in miss in EBIT margin, and supply side challenges.

Our Call

Valuation – Strong outlook intact: TechM's strong capabilities in 5G space to win more 5G opportunity across telecom service providers, ecosystem and enterprises, BPO space and experience design services (XDS) practice position it to deliver strong revenue growth over next few years. The company's investments in building capabilities in enterprise segments through organic and inorganic routes would help it gain market share in BFSI, and hi-tech verticals. At CMP, the stock is trading at a reasonable valuation of 17x/15x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving 5G deals in telecom space, continued growth in the BPS and XDS businesses, good deal wins and scope for margin improvement. We maintain a Buy rating on the stock with a revised price target (PT) of Rs. 1,650.

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 (Consolidated) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	44,646.0	53,164.7	59,668.5	66,523.9
OPM (%)	18.0	18.2	18.3	18.2
Adjusted PAT	5,566.1	6,305.2	7,267.2	8,151.1
% YoY growth	24.3	13.3	15.3	12.2
Adjusted EPS (Rs.)	62.8	71.7	82.6	92.6
P/E (x)	19.1	16.8	14.6	13.0
P/B (x)	3.9	3.5	3.1	2.8
EV/EBITDA (x)	13.6	10.6	9.0	7.7
RoNW (%)	21.5	22.2	22.8	22.8
RoCE (%)	23.3	24.5	25.5	25.8

Source: Company; Sharekhan estimates

Strong revenue growth, but margin below estimate

TechM reported strong CC revenue growth of 5.4% q-o-q, led by strong sequential 4.8% growth in communication, media & entertainment (CME) and incremental revenue contribution from multiple small acquisitions. Reported US Dollar revenues grew by 4.9% q-o-q and 22.6% y-o-y to $1,608.1 million, in-line with our estimate of $1,608.2 million. BPS business reported revenue growth moderated to 4.4% q-o-q. EBIT margins contracted by 159 bps q-o-q to 13.2%, below our estimates, owing to rising expenses to backfill higher attrition, salary and retention related impact, lower utilisation and 80bps impact due to depreciation and amortisation. Net profit came in at Rs. 1,505.6 crore (up 10% q-o-q) and was 6.2% ahead of our estimate despite miss in margins, owing to higher-than-expected other income (up 43.3% q-o-q, led by $27 million forex gains) and lower tax provision (17.6% versus 26.9% in Q3FY2022, led by one time reversal of tax benefit related to SEZ benefit). FCF declined by 10% q-o-q (and down 41% y-o-y) to $111 million during the quarter, translating into an FCF to net profit conversion ratio of 56% versus 67% in Q3FY2022.

Growth outlook remains intact

The management remains confident of delivering of strong growth in both enterprise and CME segments in the medium term, given strong deal wins, strong spending on 5G by telecom operators and strong demand across enterprise verticals. The CME segment is expected to continue its growth momentum (up 17.2% y-o-y) in FY2023, led by strong net new order intake (up 58% y-o-y), healthy deal pipeline and 5G opportunity. Within enterprise segment, technology and BFS are expected to grow strongly in FY2023 on the back strong demand. The company's strong capability in the XDS business helps the company to win large deals. With healthy deal wins, strong hiring and broad-based demand across verticals, we expect strong growth momentum in enterprise segment in FY2023E. 5G activity is picking up among telecom companies, which would augur well for the company. Hence, we expect strong revenue growth in communication vertical for next 2-3 years.

Margin expansion to sustain

EBIT margin declined 159 bps q-o-q to 13.2% in Q4FY2022 owing to higher depreciation and amortisation expenses. However, EBIT margin stood at 14.6% for FY2022. Higher wage revisions, return of discretionary expenses (including facility cost) and supply-side concerns will keep margins under pressure in the medium-term. Margin levers such as pricing leverage, higher utilisation, increased offshoring and reduced subcontractor expenses would mitigate the above margins in FY2023. Further, the company will move out from the geographies that are low margin for the company. We expect margins to remain stable with an upward bias over FY2022-24E. We forecast the company is likely to report EBIT margin of 14.3% and 14.7% in FY2023E and FY2024E respectively.

Key Conference call takeaways

- **FY2022: A round-up:** The company reported strong 17.3% y-o-y revenue growth in USD terms to $5,998 million. Strong revenue growth was led by a 17.2% y-o-y growth in CME segment, 22.2% y-o-y growth in technology and 19.4% y-o-y growth in BFSI verticals. EBIT margin improved 40bps y-o-y to 14.6% in FY2022. Net profit came at Rs. 5566.1 crore and grew by 26% y-o-y. Net new deal wins remained strong at $3.28 billion, up 48% y-o-y. Further, net deal win TCVs for CME and enterprise segment grew by 58% y-o-y and 41% y-o-y respectively. Free cash flows (FCF) declined by 38% y-oy to $595 million in FY2022.
- **Margins lagged our expectations:** The company's gross margin declined 70bps q-o-q to 29.3% in Q4FY2022. EBITDA margins declined 75bps q-o-q to 17.2%, below our expectations, owing to supply side challenges, salary hike to retain employees, absence of one time benefits and lower utilisation (investment in juniorisation). EBIT margins declined 159 bps on q-o-q to 13.2%, owing to 80bps impact due to higher depreciation and amortisation expenses. Higher depreciation was due to additional investments in software and hardware, while higher amortisation was due to many small acquisitions during Q4FY2022.

- **Investments to yield results going ahead:** The management indicated the company's investments in the areas of 5G, design customer experience (XDS), data analytics, AI, IoT, and Cloud through organic or inorganic routes (multiple small acquisitions) over the past few quarters have started yielding results in terms of higher deal TCVs and strong revenue growth.
- **Eyeing $1-billion annual revenue run-rate in four verticals:** The management indicated that its four key verticals (BFSI, manufacturing, hi-tech and healthcare) in the enterprise space are on the path to cross the $1 billion revenue run-rate given its strong digital competencies.
- **CME segment to continue growing strongly in FY2023:** The company remains positive on 5G opportunity given its continued investments in building capability over last 3-4 years. Over last 3-4 years, the company has been investing in the digital part of the network, people, software and IP to capture opportunities in 5G space. The company's strategy is to win more deals in the areas of system integration, design, automation, network integration with Cloud and software architecture, which would help in improving its margin profile. The strong growth in the CME segment would be driven by (1) transformation activity within the telecom ecosystem because of digital transformation driven by 5G and readiness for 5G revenue growth by the enterprises, and (2) adoption of cloud to transform the existing stack and adopt new software development and transformation. TechM's investments in digital engineering positions it to provide engineering capabilities in metaverse ecosystem (from network to devices to applications to use cases) and offering software product development. The company is expected to remain at the forefront in participating in opportunities in 5G areas from the enterprise side, given its early investments.
- **Commentary on enterprise segment:** The BFSI vertical continues to grow due to the robust demand environment despite the rise in inflation. Manufacturing and hi-tech are progressing well to get their respective $1 billion annual revenue run rate in the medium term and are expected to grow at double digit in FY2023. Given large deal wins, the company plans to add incremental $1 billion revenue in FY2023E.
- **BPS services growth moderated:** The BPS business growth moderated to 4.5% in US Dollar terms. The company's BPS business' margins declined by 150 bps q-o-q to 19.3% in Q4FY2022 from 20.8% in Q3FY2022.
- **Healthy deal win momentum to continue:** The company signed deals with a total TCVs of $1,011 million versus $704 million/$1043 million in Q3FY2022/Q4FY2021. Net new deal TCVs remained significantly higher than the average deal wins for the last eight consecutive quarters. Deal win TCVs grew by 44% q-o-q to $1011 million, led by 2.9x growth in net new deal wins of CME ($645 million). Net new deal wins in the enterprise segment declined by 23% q-o-q during Q4FY2022. The company won large deals in the CME and BFSI segment during the quarter. Its investments in capability building in the 5G space for telecom service providers, ecosystem and enterprises have been helping the company to reap benefits in terms of higher qualified deal pipeline in the 5G space.
- **DSO days increased:** DSO days improved by four days to 97 days in Q4FY2022 after increase of 9 days in Q3FY2022.
- **Weak cash generation:** TechM generated a quarterly FCF of $111 million, down 10% q-o-q. FCF to PAT conversion ratio stood at 59% (versus 67% in Q3FY2022). Cash & cash equivalents declined to $1,141 million in Q4FY2022 compared to $1,346 million in Q3FY2022, owing to cash outflow towards acquisitions.
- **Dividend payout:** The board recommended final dividend of Rs. 15 per share and special dividend of Rs. 15 per share during the quarter, taking total dividend to Rs. 45 per share. The payout ratio for FY2022 stood at 79% of net profit and 100% of FCF.
- **Strong net headcount additions, attrition remained stable:** Total headcount stood at 1,51,173 during Q4FY22, with net addition of 6,106 employees q-o-q, owing to headcount addition in IT services businesses. The BPO segment also saw net headcount addition of 1,018 in Q4FY2022. The company' utilisation

rate declined 83.1% from 84% in Q3FY2022. Attrition rate remained stable at 23.5% in Q4FY2022. The company hired more than 10,000 fresher during FY2022. The management cited that fresher hiring would increase substantially in FY2023E given strong underlying demand environment and focus on pyramid improvement.

- **Effective tax rate:** Management expects effective tax rate to be at 26% for FY2023, though the ETR was 24.5% in FY2022.

Results (Consolidated) Rs cr

Particulars	Q4FY22	Q4FY21	y-o-y (%)	Q3FY22	q-o-q (%)
Revenue in USD (mn)	**1,608.1**	**1,329.6**	**21.0**	**1,533.5**	**4.9**
Revenue	**12,116.3**	**9,729.9**	**24.5**	**11,450.8**	**5.8**
Cost of Services	8,560.3	6,449.7	32.7	8,008.8	6.9
Gross profit	**3,555.9**	**3,280.3**	**8.4**	**3,442.0**	**3.3**
SG&A	1,467.6	1,332.1	10.2	1,381.9	6.2
EBITDA	**2,088.4**	**1,948.2**	**7.2**	**2,060.0**	**1.4**
Depreciation	484.2	344.4	40.6	362.1	33.7
EBIT	**1,604.1**	**1,603.8**	**0.0**	**1,697.9**	**-5.5**
Other Income	319.8	32.6	881.0	223.1	43.3
PBT	**1,868.7**	**1,594.7**	**17.2**	**1,887.1**	**-1.0**
Provision for taxes	328.0	499.8	-34.4	508.2	-35.5
Reported net profit	**1,505.6**	**1,132.2**	**33.0**	**1,368.5**	**10.0**
EPS (Rs.)	16.9	13.0	30.8	15.5	9.6
Margin (%)			**BPS**		**BPS**
EBITDA	17.2	20.0	-279	18.0	-75
EBIT	13.2	16.5	-324	14.8	-159
NPM	12.4	11.6	79	12.0	48
Tax rate	17.6	31.3	-1,379	26.9	-938

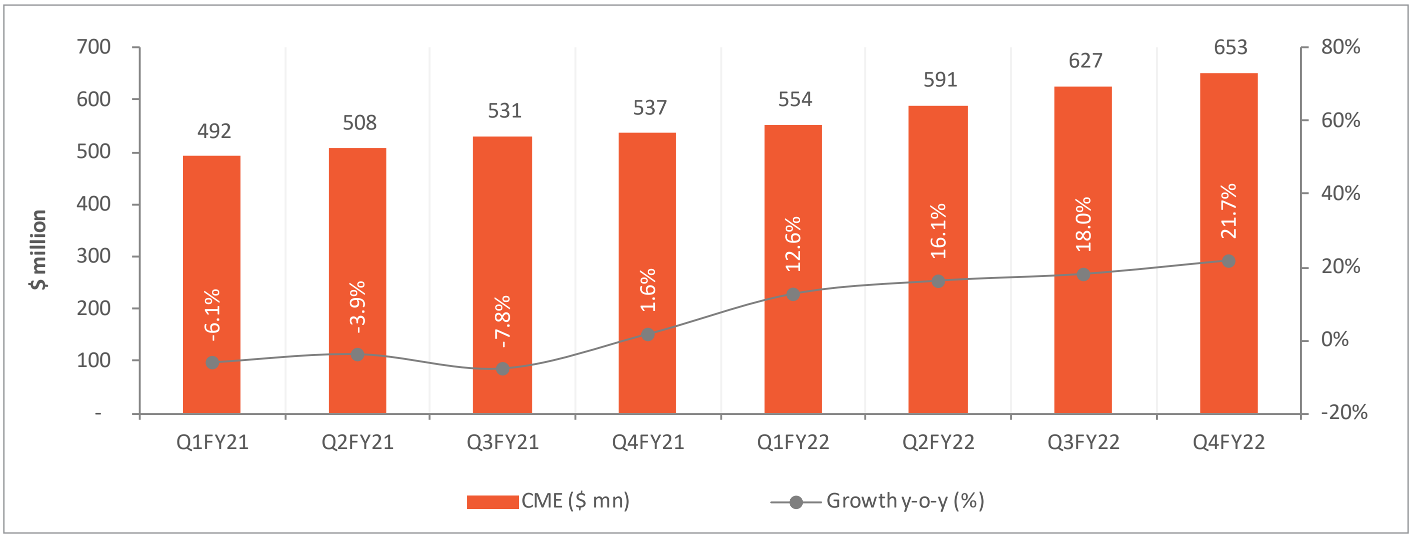
Source: Company; Sharekhan Research

Revenue mix: Geographies, industry verticals, and other operating metrics

Particulars	Revenue	Contribution	$ Growth (%)	
	($ mn)	(%)	q-o-q	y-o-y
Revenue ($ mn)	1,608	100	4.9	21.0
Geographic mix				
America	777	48.3	3.6	28.4
Europe	425	26.4	8.4	20.5
RoW	407	25.3	3.7	9.2
Industry verticals				
CME	653	40.6	4.1	21.7
Manufacturing	240	14.9	-1.2	9.6
Technology	150	9.3	15.6	32.9
BFSI	280	17.4	18.2	28.0
Retail, transport and logistics	122	7.6	-6.5	18.8
Others	164	10.2	-1.8	16.5
Clients contribution				
Top 5	355	22.1	2.3	20.1
Top 10	502	31.2	4.1	21.7
Top 20	687	42.7	5.7	19.5
Revenue by services				
IT	1,407	87.4	5.2	18.7
BPO	202	12.6	4.4	40.1

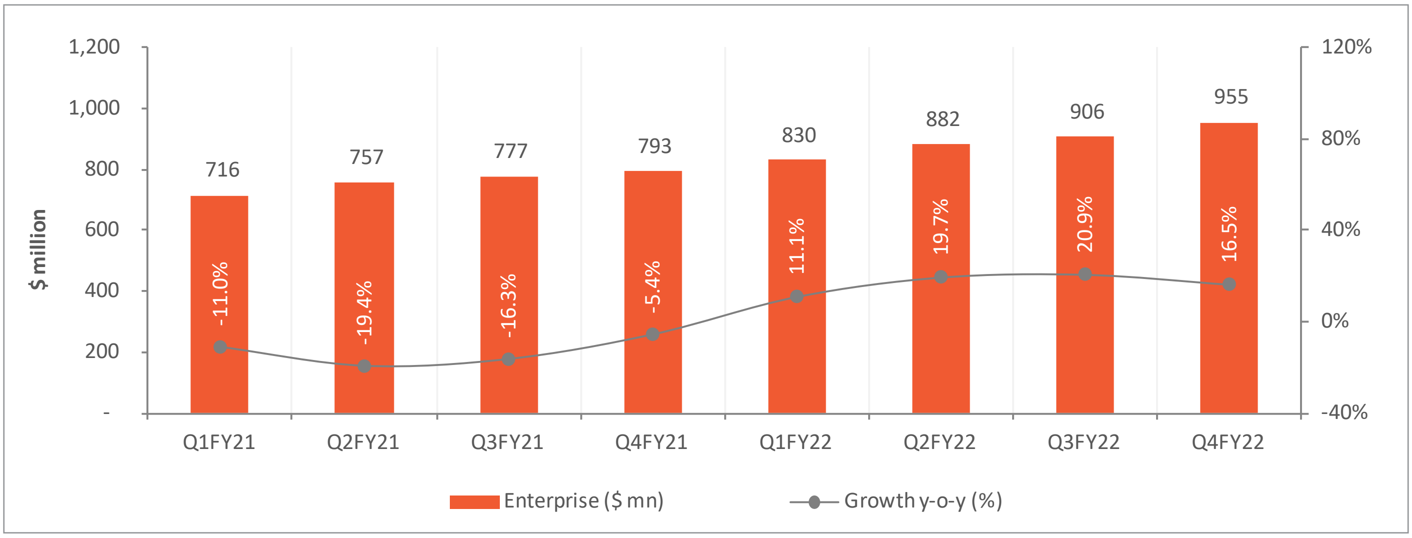
Source: Company; Sharekhan Research

CME vertical revenue growth trend



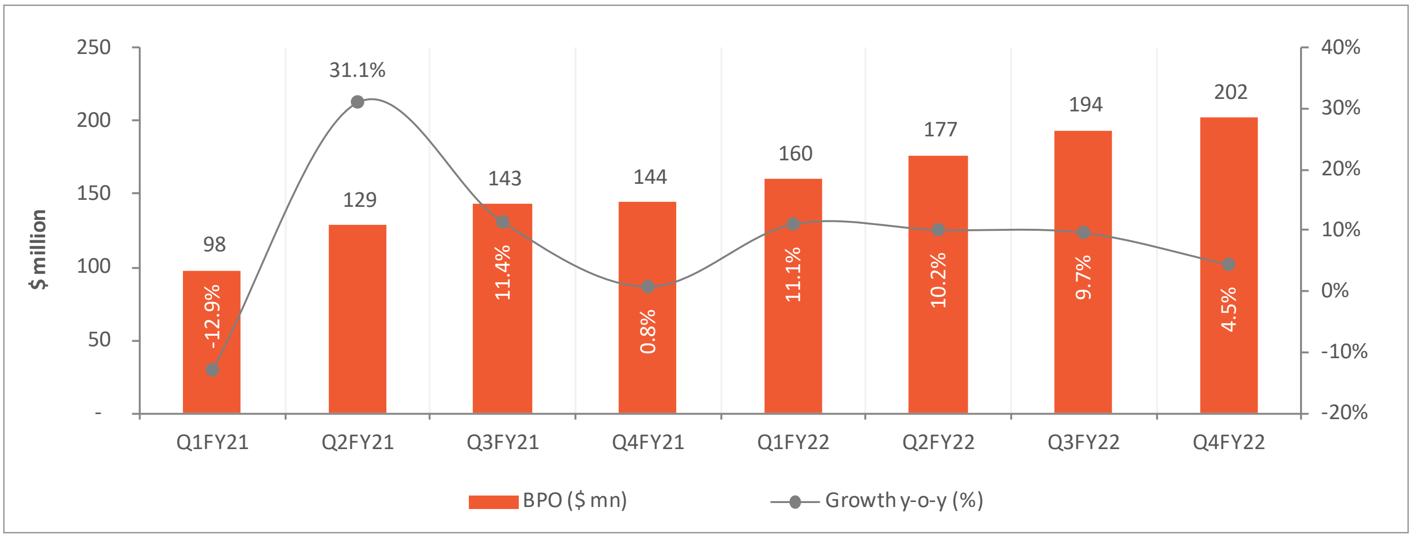
Source: Sharekhan Research

Enterprise vertical revenue growth trend



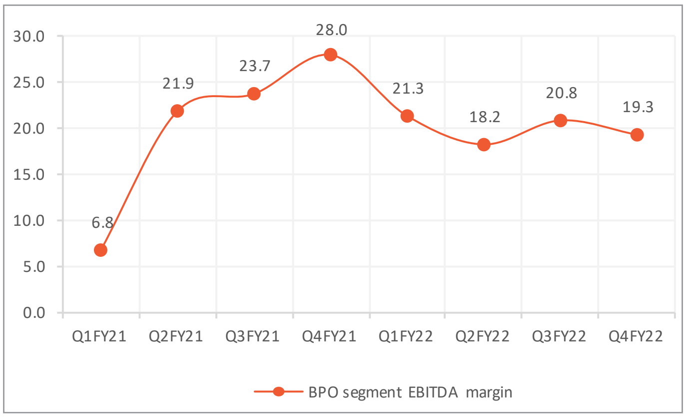
Source: Sharekhan Research

BPO revenue growth trend



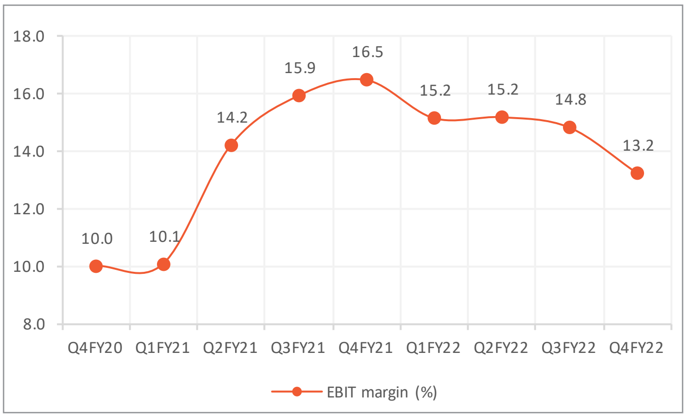
Source: Sharekhan Research

BPO segment's EBITDA margin trend



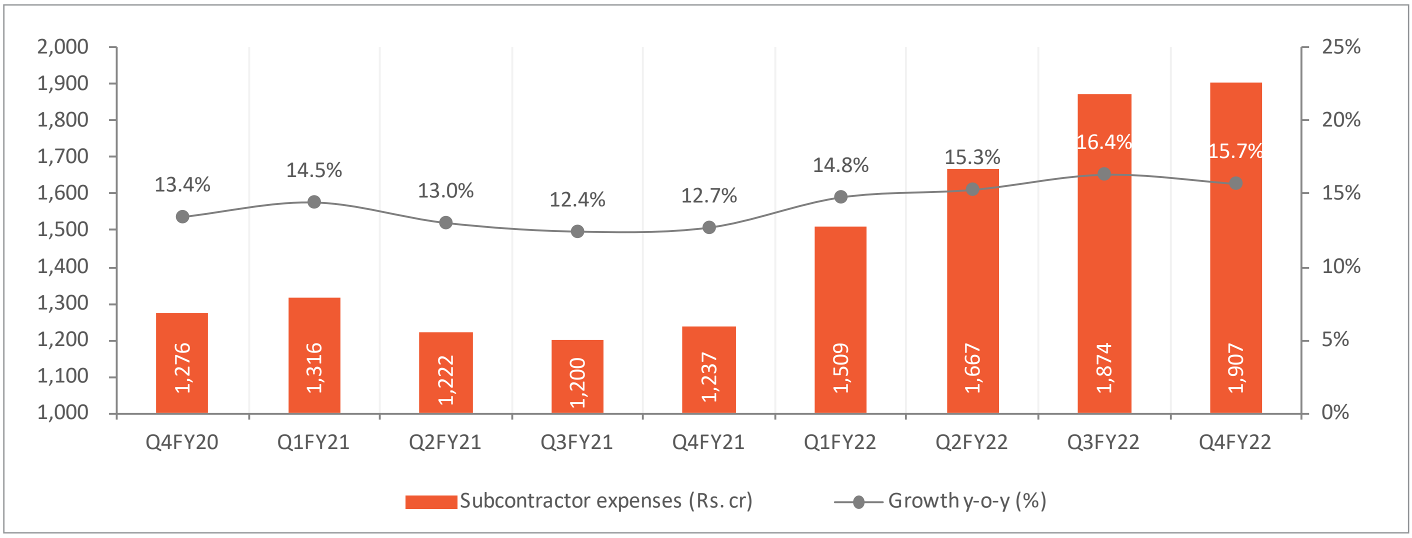
Source: Company, Sharekhan Research

Tech M's EBIT margin trend



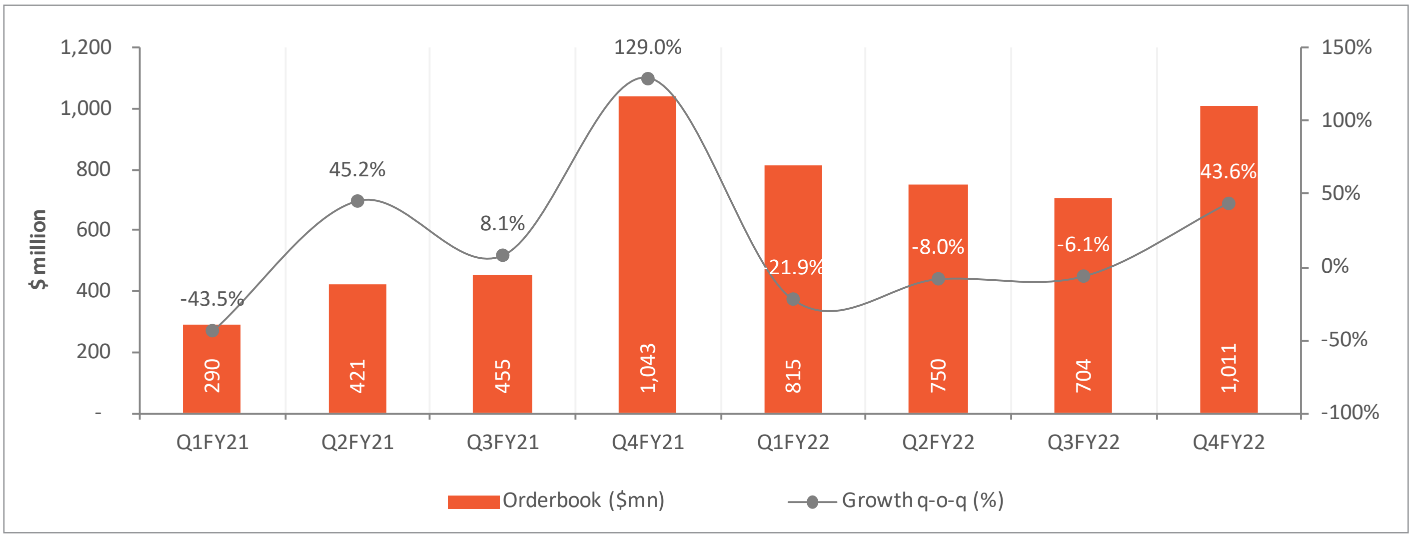
Source: Company, Sharekhan Research

Subcontractor expense (Rs. crore) and as a % of revenues



Source: Sharekhan Research

New deal win TCV trend



Source: Sharekhan Research

Outlook and Valuation

Sector View – Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved in CY2010-CY2020. 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. Further, 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.

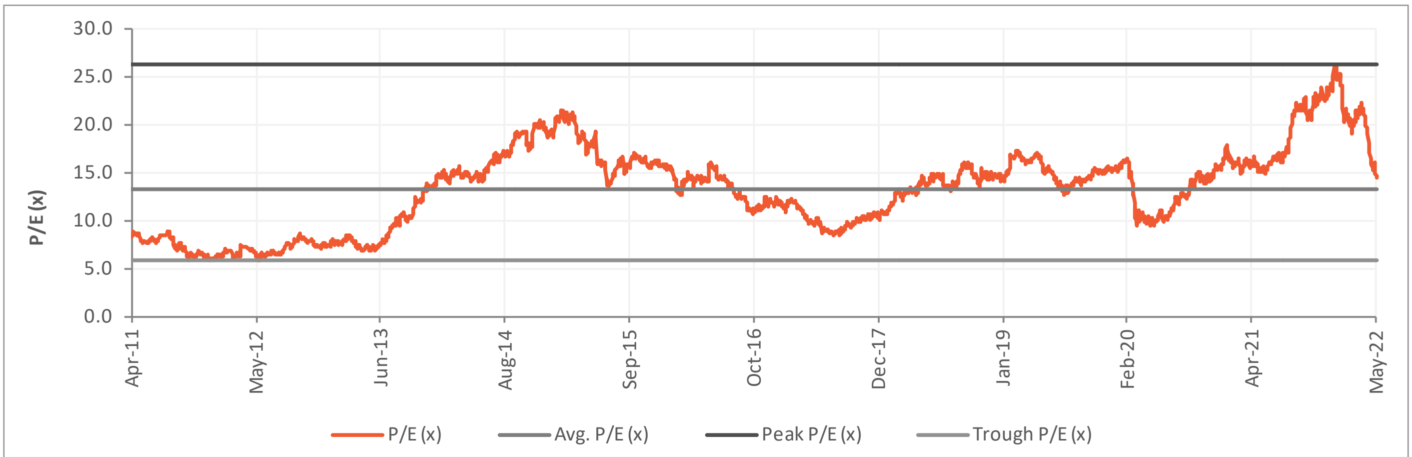
Company Outlook – Well-placed to capture 5G opportunity

TechM is well-placed to capture 5G-related spending from TSPs and OEMs, given its early investments in network capabilities through LCC, investments in IPs, platforms, and investments/partnerships (Intel, Rakuten, and AltioStar, among others) to develop an ecosystem. We remain positive on the company, considering strong demand in the telecom vertical, strategic focus on digital acquisitions, steady pace of deal intake and a continuous focus on diversifying the business. Improvement in execution led by efficient capital allocation is expected to augur well for the company.

Valuation – Improving execution

TechM's strong capabilities in 5G space to win more opportunities across telecom service providers, ecosystem and enterprises, BPO space and experience design services (XDS) practice position it to deliver strong revenue growth over next few years. The company's investments in building capabilities in enterprise segments through organic and inorganic routes would help it in gaining market share in BFSI, and hi-tech verticals. At CMP, the stock is trading at a reasonable valuation of 17x/15x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given improving 5G deals in telecom space, continued growth in the BPS and XDS businesses, good deal wins and scope for margin improvement. We maintain a Buy rating on the stock with a revised price target (PT) of Rs. 1,650.

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 (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
HCL Tech	1,133	271	3,07,350	22.6	19.9	15.0	13.2	4.9	4.6	21.4	23.0
Infosys	1,772	421	7,45,299	33.5	28.7	22.8	19.7	5.0	4.7	27.5	29.9
Tech M	1,507	97	1,46,330	24.0	20.5	16.3	13.8	4.8	4.4	21.2	22.7

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

1. Any hostile development against the current visa regime would affect employee expenses as lower proportion of local resources are deployed onsite.
2. Rupee appreciation or/and adverse cross-currency movements might affect earnings.
3. Delay/loss of accounts in the enterprise segment.
4. Delay in pick-up of 5G-related spends.

Additional Data

Key management personnel

Mr. Anand Mahindra	Chairman
CP Gurnani	Managing Director and Chief Executive Officer
Milind Kulkarni	Chief Financial Officer
Jagdish Mitra	Chief Strategy Officer and Head Of Growth
Manish Vyas	President, Communications, Media &Entertainment Business
Vivek Agarwal	President – BFSI, HLS and Corporate Development

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp. of India	4.31
2	First State Investments ICVC	3.07
3	SBI Funds Management Pvt. Ltd.	2.75
4	BlackRock Inc	2.68
5	The Vanguard Group Inc.	2.29
6	ICICI Prudential Asset Management	1.90
7	Norges Bank	1.74
8	Government Pension Fund	1.48
9	FMR LLC	1.35
10	Schroders PLC	1.30

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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