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Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Tata Elxsi Ltd

Taking a breather, Downgrade to REDUCE

IT & ITES	Sharekhan code: TATAELXSI
Reco/View: Reduce ↓	CMP: **Rs. 8,456**	Price Target: **Rs. 7,500** ↓

↑ 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 19.56

Updated Jul 08, 2022

Low Risk

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

Source: Morningstar

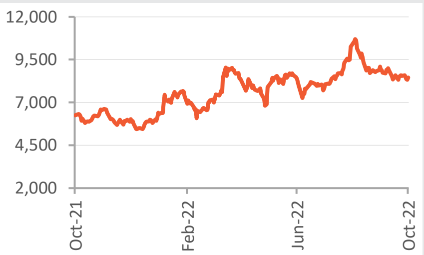
Company details

Market cap:	Rs. 52,660 cr
52-week high/low:	Rs. 10,760/5,264
NSE volume: (No of shares)	5.2 lakh
BSE code:	500408
NSE code:	TATAELXSI
Free float: (No of shares)	3.5 cr

Shareholding (%)

Promoters	44
FII	4
DII	15
Others	37

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-5.2	5.0	0.9	35.2
Relative to Sensex	-1.1	-2.8	-0.4	40.7

Sharekhan Research, Bloomberg

Summary

- Tata Elxsi Limited's (TEL) Q2FY2023 performance missed the mark – both on the revenue and margins front. Revenue increased by 4.7% qoq in CC term and EBITDA margin dropped by 312 bps to 29.7%.
- Margin was impacted by strong addition in headcount in Q2, opening of centres in three locations, back-to-office costs, and increased discretionary spends such as travel and training.
- Management cited softness in Media and Communications on account of macro-uncertainties, though it remains fairly confident on other verticals.
- At the current juncture with macro uncertainties and earnings growth trajectory tapering off, we downgrade our rating on the stock to Reduce from Buy. We also revise our PT to Rs. 7,500. We advise advisors to wait for a better entry point for long-term investment.

Tata Elxsi Limited (TEL) reported weak revenue growth during Q2FY2023, with sharp drop in margin due to strong headcount addition, back-to-office costs, opening of new facilities, and increased discretionary spends related to travel and training. TEL registered constant currency (CC) revenue growth of 4.7% q-o-q during the quarter, below our and street estimates and notably missed the six consecutive quarters of 6% CC growth.

The company reported revenue growth of 5.1% q-o-q and 28.2% y-o-y to Rs. 763.2 crore, but lagged our growth estimates. EBITDA margin declined by 312bps q-o-q to 29.7%, while net profit stood at Rs. 174.3 crore, down 5.7% q-o-q but up 39.1% y-o-y. Transportation grew 3.8% q-o-q and 30.4% y-o-y, aided by large deals in EV, ADAS, and adjacencies in rail and offroad vehicles. Healthcare continued to witness strong growth of 8.2% q-o-q and 55.9% y-o-y, driven by new product engineering and regulatory services.

Media and Communications reported 2.1% q-o-q and 22.2% y-o-y growth, aided by platform-led deals and entry into new operator accounts. However, management highlighted that Media and Communication has seen some deferment and slowdown. Management expects this to continue for one or more quarters as customers are cautious, majorly in US and Europe, owing to the inflationary environment. Management also indicated that deal closures are taking longer in the US and Europe due to the macro environment. For others business, management does not see any major deferment and continues to see deal flows. Management indicated that none of the European clients is stalling the committed projects. However, there is slowness in new opportunities. Customers are a bit more cautions and closure time is going up in Europe. There was a strong net headcount addition of 1,532 during the quarter with the following break-up – freshers at 1050-1100 and laterals at 350. Hiring in 2HFY2023 would be slower than 1HFY2023. Management cited that utilisation has dropped to 78.9% from ~83% and its first focus would be to get back utilisation levels to 80%. The macro overhang, especially in the key markets of Europe and US, and extension of slowness in deal closures spreading to other verticals other than Media and Communication could impact deal wins and revenues. The supply-side pressure, back-to-office costs, and facilities-related costs are expected to increase in the near term and are likely to keep margins under pressure.

Key positives

- Healthcare continues to grow strongly with new product engineering and regulatory services reporting 8.2% q-o-q and 55.9% y-o-y revenue growth.
- The Design business (IDV) continues to grow strongly, fueled by strategic design-led digital deals reporting 13.5% q-o-q revenue growth.
- Record headcount addition of 1532 in Q2 comprising 1050-1100 freshers and 350 laterals. Attrition rate declined for the second consecutive quarter, down 30 bps q-o-q to 18.7%.

Key negatives

- Revenue growth was below estimates and notably missed the six consecutive quarters of 6% CC growth.
- EBITDA margin fell sharply for the quarter to 29.7%, down 310 bps q-o-q.
- Utilisation rate dropped to 78.9% from 83%.

Management Commentary

- Management admitted to facing crunch at mid-level staff such as delivery managers due to supply-side challenges.
- Management cited that it is regularly meeting the company's top clients. None of the top customers is stalling on committed orders but new opportunities customers are a bit cautious with increasing deal closure time.
- Utilisation rate had dropped to 78.9% and management's immediate focus would be to get it back to 80%.

Revision in estimates – We have fine-tuned our estimates for FY2023/FY2024/FY2025 owing to macro overhang and INR-USD reset.

Our Call

Valuation – Downgrade to Reduce, wait for a better entry point: TEL has consistently proven its expertise and aims to capture market opportunities across key verticals and adjacencies, given its unique capabilities in design-led engineering, low-cost execution, and high offshore mix. However, macro uncertainties have led to management's caution on near-term outlook, primarily led by softness in the media and communication vertical and expects some margin headwinds owing to higher hiring and back-to-office cost. Hence, we believe tapering of superior growth and lack of positive surprise levers would weigh on the premium valuation. The stock trades at 72.2x/71.2x/58.9 its FY2023E/FY2024E /FY2025E earnings. Over the years, despite the expensive valuation, we have kept our conviction intact on TEL, which turned out to be quite right. The stock has delivered multifold returns from our initiation level. However, at the current juncture with macro uncertainties and earnings growth trajectory tapering off, we downgrade our rating on the stock to Reduce from Buy. We have also revised our price target (PT) to Rs. 7,500, as we believe material weakness in the stock would be a good investment opportunity for long-term investors.

Key Risks

Continued Rupee depreciation and quicker turnaround in its Media and Communication vertical are key upside risks. Further, faster than expected moderation of macro headwinds could led to better IT spending.

Valuation Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Total Revenue	2,470.8	3,113.8	3,521.4	4,232.4
EBITDA margin %	31.0	29.9	28.0	28.2
Adjusted Net Profit	549.7	694.4	704.6	851.3
% YoY growth	49.3	26.3	1.5	20.8
EPS (Rs.)	88.3	111.5	113.1	136.7
PER (x)	91.3	72.2	71.2	58.9
P/BV (x)	31.3	24.9	20.6	16.7
EV/EBITDA	64.3	52.5	49.1	40.2
ROE (%)	34.3	34.5	28.9	28.3
ROCE (%)	38.2	40.1	33.4	33.1

Source: Company; Sharekhan estimates

Key earnings call highlights

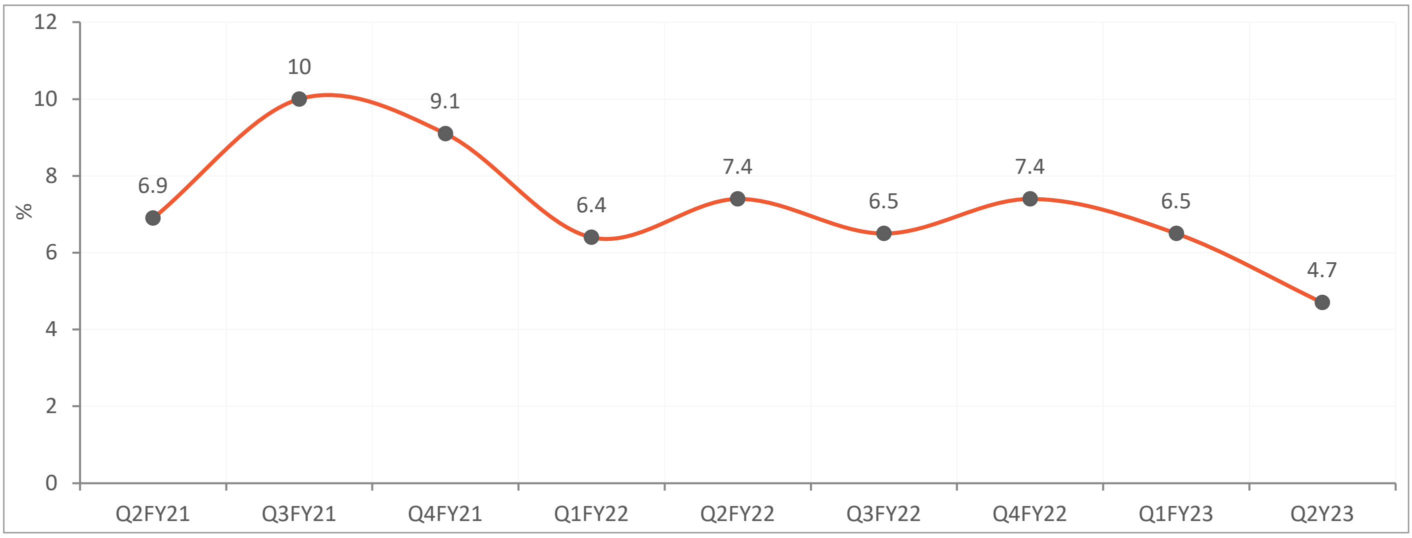
- **Supply-side challenges moderated revenue growth:** Q2FY2023 revenue increased by 4.7% q-o-q/27.8% y-o-y in CC terms and was affected by supply challenges, specially at the mid and senior level. Average sequential CC growth over the past eight quarters is at 7.3%. EPD growth moderated to 3.1% q-o-q in CC terms, whereas SIS and IDV grew strongly by 26% and 15.5%, respectively, q-o-q in CC term. Q-o-Q growth rates in CC terms for all the three verticals in the EPD segment moderated from sequential growth rates in the past quarters.
- **Strong growth in the US and Europe, but decline in India:** Europe and US grew strongly by 9.6% and 6.7%, respectively, q-o-q. India declined by 2.5% q-o-q and there is softness in demand as overseas clients have better realisations and the company is witnessing supply-side challenges.
- **Deal deferment in Media and Communication:** Media and communication vertical is witnessing deal deferments in Europe and US and slowdown from the top five clients in that category. This should continue for 1-2 more quarters as customers are cautious, but this is not a cause of concern as some of the deals deferred will come back because the company has long-term relationships with clients exceeding 15 years. In all other verticals and business segments, the company is not witnessing any deal deferment and is ramping up its customer engagements.
- **Margin headwinds lead to lower EBITDA margin:** EBITDA margin for the quarter declined by 312 bps q-o-q to 29.7%. Campus hiring impacted margins by 120 bps. Other margin headwinds were increased travel and training expense, lateral employees' addition, onsite salary correction, and higher facility expenses as employees return to offices. Margin tailwind was a 30-bps gain from currency.
- **Strong hiring activity:** The company added 1,532 employees in Q2FY2023 (up 15% q-o-q), which was the highest-ever quarterly net addition. Approximately, 1,050 freshers and 350 laterals were hired. Most freshers hired in Q2 are expected to be billed by 4QFY2023/1QFY2024. The strong hiring activity led to a drop in utilisation levels from ~83% to 78.9%. The company will focus on getting it to 80%. The company will slow down its hiring activity in the second half of the fiscal and will add 750-1000 freshers in 2HFY2023. The company has already added 2,000 freshers in 1HFY2023. The company is hiring from a long-term perspective to fulfill growth for the next 4-6 quarters. The company has mandated hybrid work from October 1 and 70% of the staff is coming to office for 1-2 days a week. So, the company could be looking to add office space required to fit in new employees. Attrition rate declined by 30 bps q-o-q to 18.7%. for the second consecutive quarter, which is positive for the company.
- **Positive deal wins, furloughs to not impact Q3 revenue:** The company has won 2-3 large deals and should ramp-up over the next few quarters. The company said it is winning market share from competitors. As of now, the company does not see furloughs to impact Q3 revenue and hopes to have a positive Q3 like last year.
- **Offshore revenue strengthens, while onsite revenue lags:** Offshoring continues to be strong, while the onsite environment has become difficult because of high salaries and increasing attrition rates. Offshoring revenue mix has increased by 30 bps q-o-q to 75.2%.

Results Rs cr

Particulars	Q2FY23	Q2FY22	Q1FY23	YoY (%)	QoQ (%)
Revenue in USD (mn)	**95.2**	**80.4**	**93.1**	**18.4**	**2.2**
Net sales	**763.2**	**595.3**	**725.9**	**28.2**	**5.1**
Employee expenses	392.2	310.9	365.7	26.1	7.2
Total purchases	41.6	30.3	39.7	37.1	4.6
Other expenses	102.9	70.4	82.3	46.1	25.0
EBITDA	**226.5**	**183.6**	**238.2**	**23.4**	**-4.9**
Depreciation	21.8	13.5	17.1	61.4	27.5
EBIT	**204.8**	**170.1**	**221.1**	**20.3**	**-7.4**
Other income	18.7	2.4	10.3	667.7	80.9
Finance cost	4.3	1.6	3.4	168.2	26.8
PBT	**219.2**	**171.0**	**228.0**	**28.2**	**-3.9**
Total tax	44.9	45.7	43.3	-1.7	3.7
Net profit	**174.3**	**125.3**	**184.7**	**39.1**	**-5.7**
EPS (Rs.)	28.0	20.1	29.7	39.0	-5.7
Margin (%)			**BPS**		**BPS**
EBITDA	29.7	30.8	32.8	-116	-312
EBIT	26.8	28.6	30.5	-175	-362
NPM	22.8	21.1	25.4	178	-261
Tax rate	20.5	26.7	19.0	-622	149

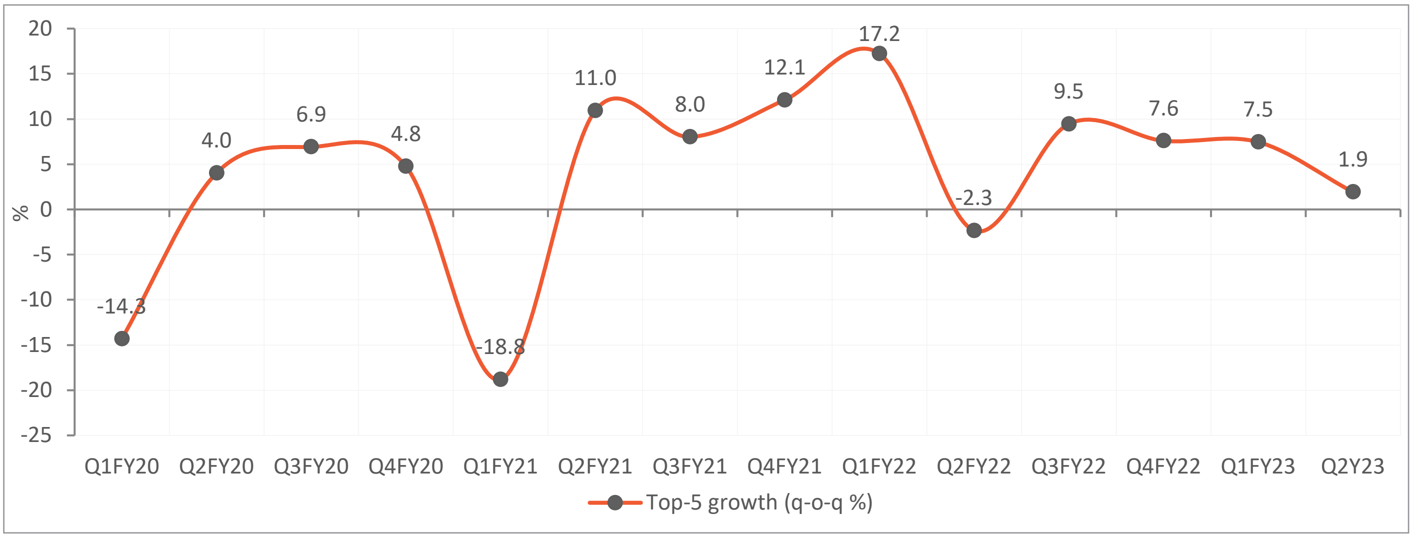
Source: Company, Sharekhan Research

CC revenue growth trend (q-o-q)



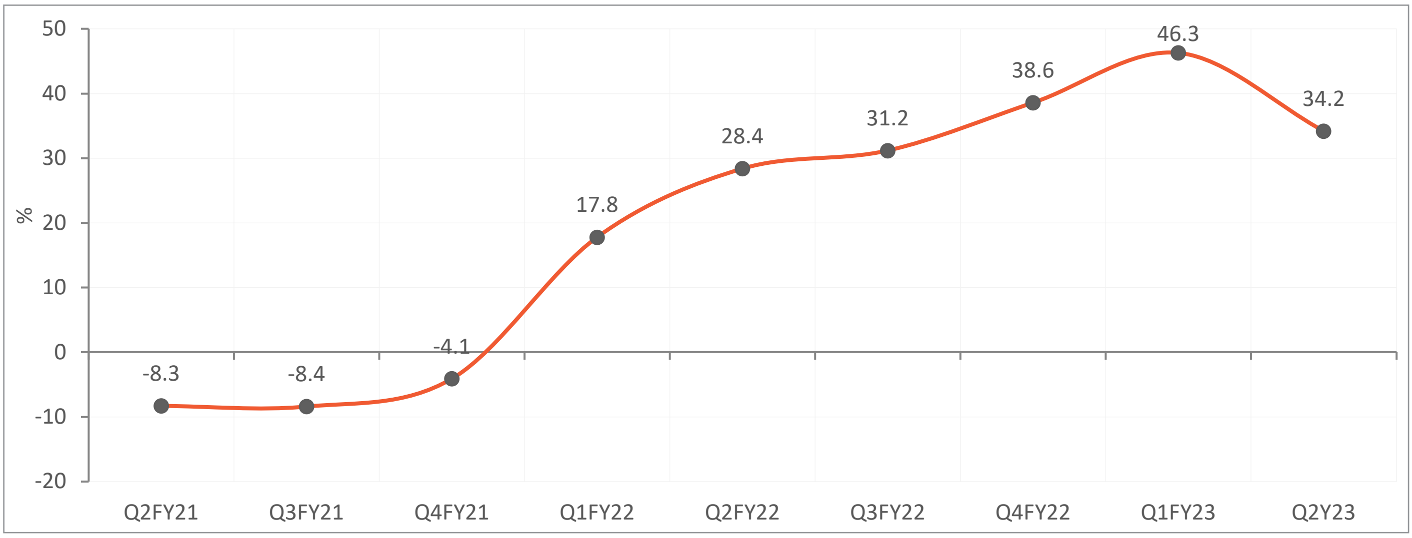
Source: Company, Sharekhan Research

Top five accounts growth trend (q-o-q)



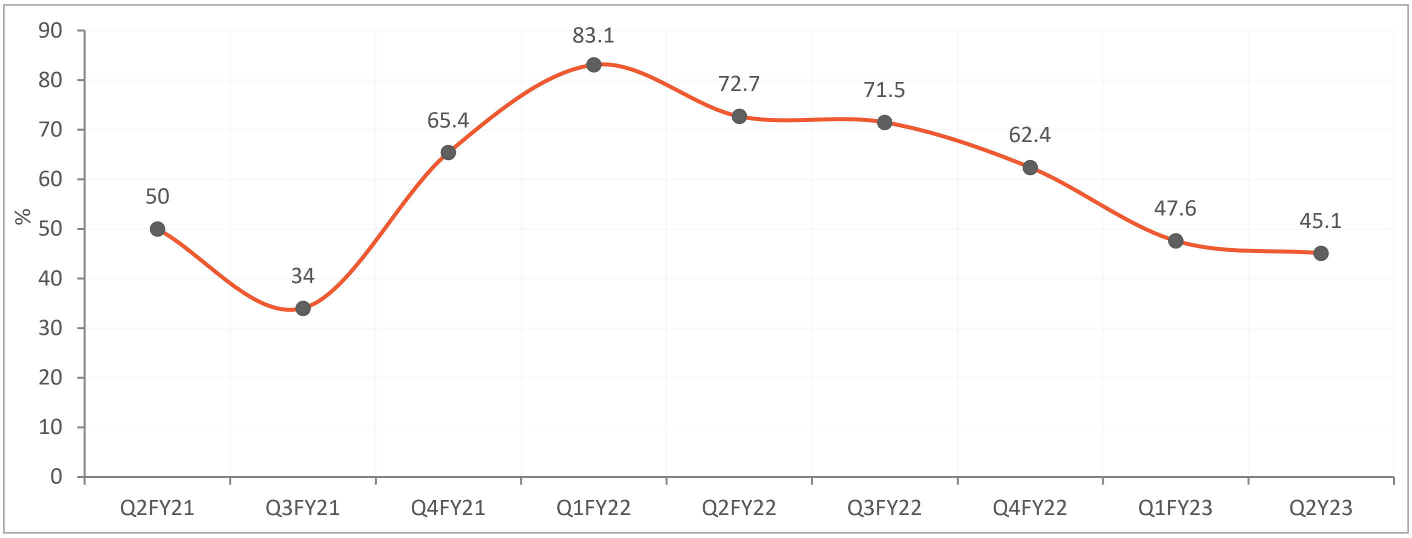
Source: Company, Sharekhan Research

Transportation vertical growth trend (q-o-q)



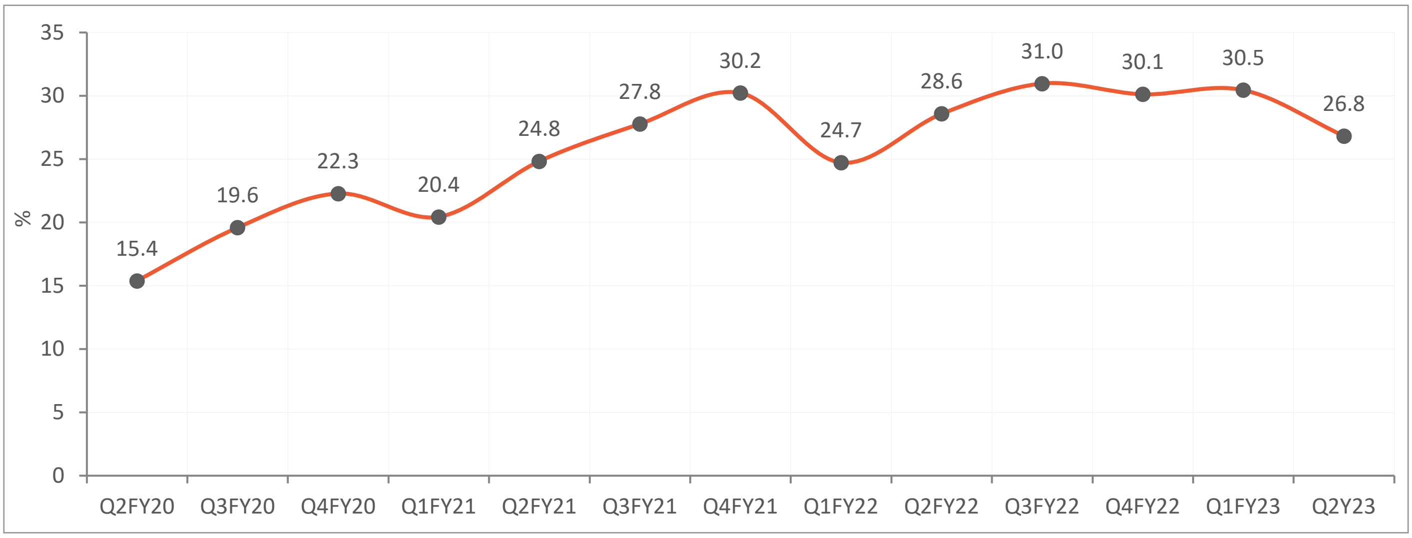
Source: Company, Sharekhan Research

Healthcare and medical devices growth trend (q-o-q)



Source: Company, Sharekhan Research

EBIT margin trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Large addressable market provides sustainable growth opportunities

Total global ERD spends stood at $1.3 trillion in 2021 and are expected to touch $1.6 trillion by 2024. With a 10-15% market share, India is gradually establishing itself as an engineering and design centre for automobiles, aerospace, consumer electronics, machinery, and semiconductors. According to NASSCOM, India's contribution to the global ERD market is likely to increase to $63 billion by CY2025 from $31 billion in CY2019, translating into a CAGR of 12-13%. Indian ESPs will grow at a faster rate as compared to global peers owing to their ability to leverage robust digital engineering talent chains. According to Zinnov, the share of Indian ERD service providers is expected to increase from $ 16 billion in 2020-2021 to $58 billion in 2030-2031, implying a 13%+ CAGR.

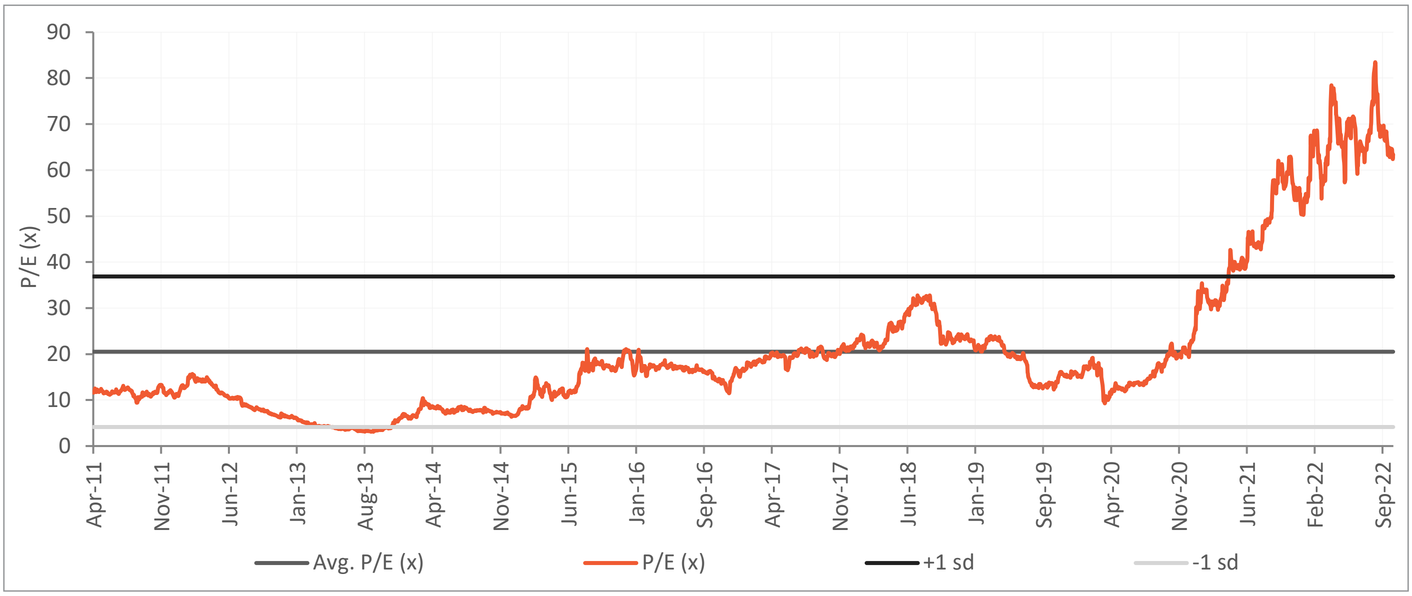
■ Company Outlook – Growth prospects promising

TEL's key verticals have a huge growth opportunity, considering an increase in research and development (R&D) spends in automotive, consumer electronics, and medical devices. TEL is a specialist vendor for top OEMs and tier-I suppliers. This along with recent re-allocation of R&D budgets towards electronics and software, a large addressable market, and differentiated product offerings is expected to drive the company's revenue growth going ahead. The company's strong capabilities in digital engineering, domain expertise, and robust platform portfolio have helped it to strengthen its market position and win wallet share from existing customers.

■ Valuation – Margin headwinds to continue

TEL has consistently proven its expertise and aims to capture market opportunities across key verticals and adjacencies, given its unique capabilities in design-led engineering, low-cost execution, and high offshore mix. However, macro uncertainties have led to management's caution on near-term outlook, primarily led by softness in the media and communication vertical and expects some margin headwinds owing to higher hiring and back-to-office cost. Hence, we believe tapering of superior growth and lack of positive surprise levers would weigh on the premium valuation. The stock trades at 72.2x/71.2x/58.9 its FY2023E/FY2024E /FY2025E earnings. Over the years, despite the expensive valuation, we have kept our conviction intact on TEL, which turned out to be quite right. The stock has delivered multifold returns from our initiation level. However, at the current juncture with macro uncertainties and earnings growth trajectory tapering off, we downgrade our rating on the stock to Reduce from Buy. We have also revised our price target (PT) to Rs. 7,500, as we believe material weakness in the stock would be a good investment opportunity for long-term investors .

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Incorporated in 1989, Bengaluru-based TEL is a global design and technology services company. The company provides digital design and engineering services and systems integration and support services in India, the US, Europe, and RoW. The company 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. TEL also works with leading OEMs and suppliers in the automotive industries for R&D, design, and product engineering services from architecture to launch. The company has been investing in platforms to scale and build efficiencies.

Investment theme

TEL is an integrated engineering services company with strong expertise in the automotive, media, broadcast and communication, and healthcare 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 and talent pool. TEL has a strong debt-free balance sheet with a robust cash balance that provides an inorganic growth opportunity. The company's differentiated technology capabilities, domain expertise, and strong delivery capability enable it to address the emerging opportunities across key verticals.

Key Risks

Continued Rupee depreciation and quicker turnaround in its Media and Communication vertical are key upside risks. Further, faster than expected moderation of macro headwinds could led to better IT spending.

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
Gaurav Bajaj	Chief Financial Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	St James's Place PLC	4.09
2	Vanguard Group Inc.	2.04
3	Axis Asset Management	1.89
4	Tata Investment Corp Limited	1.69
5	BlackRock Inc.	1.63
6	Life Insurance Corp of India	1.04
7	Wasatch Advisors Inc	0.63
8	Dimensional Fund Advisors LP	0.58
9	William Blair & Co LLC	0.55
10	Norges Bank	0.35

Source: Bloomberg

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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

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