Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 12.08

Updated Oct 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. 1,04,298 cr
52-week high/low:	Rs. 1,838 / 944
NSE volume: (No of shares)	32.0 lakh
BSE code:	532755
NSE code:	TECHM
Free float: (No of shares)	63.05 cr

Shareholding (%)

Promoters	35.2
FII	28.2
DII	23.6
Others	13.0

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	6.3	3.8	-13.0	-28.1
Relative to Sensex	-0.1	-1.3	-20.2	-29.9

Sharekhan Research, Bloomberg

Stock Update

Result Update

Tech Mahindra Ltd

Q2 meets expectations, Maintain Buy

IT & ITeS	Sharekhan code: TECHM	
Reco/View: Buy ↔	CMP: Rs. 1,072	Price Target: Rs. 1,220 ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Tech Mahindra (TechM) reported revenues for Q2FY23 at $1,638 million up 2.9% q-o-q in constant currency which was in line with our estimates led by strong performance by the Manufacturing, Technology and Retail verticals. EBIT margin at 11.4% for Q2FY23 was up 32 Bps q-o-q owing to lower SG&A expenses and lower subcontracting costs which was partially offset by higher employee benefits costs and higher depreciation.
- Deal momentum continued to be healthy with deal TCV at $716 million but has moderated from $802 million TCV seen in Q1FY23.
- Management expects to achieve 14% EBIT margin by Q4FY2023 and stated that margin benefits would flow in the next two quarters due to portfolio pruning especially on low margin business.
- We maintain a Buy on TechM with an unchanged PT of Rs. 1,220, given healthy deal wins and reasonable valuation.

Tech Mahindra (TechM) reported revenue for Q2FY23 at $1,638 million; up 0.3% q-o-q and up 11.2% YoY (2.9% q-o-q in constant currency terms) which was in-line with our estimates led by strong performance by the Manufacturing, Technology and Retail verticals. This was offset by weak performance from BFSI and CME verticals. EBITDA margins at 15.1 % up 32Bps q-o-q was also in-line with our estimates. EBIT margin at 11.4%, was up 32 Bps q-o-q owing lower SG&A expenses and lower subcontracting cost partially offset by higher employee benefit costs and higher depreciation. Deal TCVs moderated by 11% q-o-q to $716mn while LTM deal TCVs increased 6% y-o-y to $3.2 billion which provides strong growth visibility. The Management believes that Technology vertical would be one of the key growth drivers as they have built capabilities and are seeing better deal wins and momentum. The management indicated that the margin headwinds from wage hike would be offset by levers such as better geographical mix, large deals and portfolio pruning.

Key positives

- Company added three clients sequentially in $20 million + revenue brackets
- LTM Attrition fell to 20% in Q2FY23 from 22% in Q1FY23
- FCF to PAT improved to 159.1% in Q2FY23 from 50.2% in Q1FY23

Key negatives

- Revenue from top-5/top-10/top-20 accounts declined by 7.5%/6%/3.1% on q-o-q, respectively.

Management Commentary

- Management cited that they are seeing decisions on deal closures getting delayed on account of macro-overhang and indicated that budgets may get reprioritized but believe that tech spends may continue to be high.
- Management expects to achieve 14% EBIT margin by Q4FY2023 and stated that margins improvement for FY24 would be based on levers of Geographic mix – more US, large deals and streamlining of Portfolios.
- Management stated that margin benefits would flow in the next two quarters due to portfolio pruning especially the low margin business.

Revision in estimates – We have fine-tuned our estimates for FY23/24/25 owing to macro-overhang and INR-USD reset

Our Call

Valuation – In-line Q2, Maintain Buy: At CMP, the stock is trading at a reasonable valuation of 18.1x/16.2x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given healthy deal wins and reasonable valuation. We maintain a Buy rating on the stock with an unchanged price target (PT) of Rs. 1,220.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US would affect earnings. Further, macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	44,646.0	53,433.8	56,984.6	63,027.9
OPM (%)	18.0	15.5	16.4	17.0
Adjusted PAT	5,566.1	5,196.4	5,825.9	6,825.5
% YoY growth	24.3	-6.6	12.1	17.2
Adjusted EPS (Rs.)	62.8	59.1	66.2	77.6
P/E (x)	17.1	18.1	16.2	13.8
P/B (x)	3.5	3.2	2.9	2.6
EV/EBITDA (x)	12.0	10.9	9.3	7.7
RoNW (%)	21.5	18.4	18.8	20.0
RoCE (%)	23.3	19.8	20.8	22.3

Source: Company; Sharekhan estimates

Key result highlights from earnings call

- **Strong growth in Manufacturing, Technology and Retail Vertical:** The company reported CC revenue growth of 2.9% q-o-q, slightly ahead of our estimates of 2.5% cc growth, led by strong growth in the Manufacturing, Technology and Retail verticals. Manufacturing, technology, retail, verticals grew by 4.9%, 4.5%, 2.9% sequentially, while BFSI and CME contracted 2.1% and 1.4% sequentially
- **Deal closure decisions elongated:** Management cited that they are seeing some decision on deal closure getting delayed on account of macroeconomic concerns and indicated that budgets may get reprioritized but believe that tech spends may continue to be high.
- **SGA expense and subcontracting Costs:** SGA expenses in Q2FY23 contracted by 1.6% sequentially to Rs. 1,684 Cr. Subcontracting costs moderated to Rs. 2,025 crore at 15.4% of its revenue in Q2FY2023.
- **Healthy deal wins:** In Q2FY23, the company won deal TCVs of $716 million compared to deal TCV of $802 million in Q1FY23.
- **Margin levers:** Management stated that margins improvement for FY24 would be based on levers of geographic mix – more US, large deals and streamlining of Portfolios.
- **Headcount addition moderated; attrition rate declined:** Total headcount stood at 1,63,912 during Q2FY2023, with net addition of 5877 employees q-o-q, owing to headcount addition across BPO businesses and sales & support. The company's utilisation rate improved sequentially to 85%. Attrition rate declined to 20% in Q2FY23 from 22% in Q1FY2023.
- **Weak growth in top accounts:** Revenue from top-5, top-10 and top-20 accounts declined by 7.5% q-o-q, 6% q-o-q and 3.1% q-o-q, respectively.
- **Effective tax rate:** The management expects effective tax rate to be at 25-26% for FY2023, though the ETR was 21.4% in Q2FY23.
- **Strong cash generation:** TechM generated a quarterly FCF of $253 million, up 253% q-o-q. FCF to PAT conversion ratio stood at 159% (versus 50% in Q1FY2023). Cash & cash equivalents declined to $947 million in Q2FY2023 compared to $1,114 million in Q1FY2023.
- **DSO days decreased:** DSO days decreased by two days sequentially to 98 days in Q2FY2023.

Results (Consolidated) — **Rs cr**

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	q-o-q (%)
Revenues In USD (mn)	**1,638.0**	**1,472.6**	**11.2**	**1,632.5**	**0.3**
Revenues In INR	**13,129.5**	**10,881.3**	**20.7**	**12,707.9**	**3.3**
Cost of Services	9,461.4	7,434.6	27.3	9,116.2	3.8
Gross profit	**3,668.1**	**3,446.7**	**6.4**	**3,591.8**	**2.1**
SG&A	1,684.0	1,451.5	16.0	1,711.6	-1.6
EBITDA	**1,984.1**	**1,995.2**	**-0.6**	**1,880.1**	**5.5**
Depreciation	491.7	343.0	43.4	476.7	3.1
EBIT	**1,492.4**	**1,652.3**	**-9.7**	**1,403.4**	**6.3**
Other Income	290.2	282.1	2.9	122.1	137.7
PBT	**1,703.6**	**1,899.0**	**-10.3**	**1,485.2**	**14.7**
Provision for taxes	364.7	557.2	-34.5	338.0	7.9
Adjusted net profit	**1,309.8**	**1,338.8**	**-2.2**	**1,131.6**	**15.7**
Reported net profit	**1,334.2**	**1,338.8**	**-0.3**	**1,131.6**	**17.9**
EPS (Rs) Excl Treasury Shares	14.5	15.1	-4.1	12.8	13.6
Margin (%)			**BPS**		**BPS**
EBITDA Margins	15.1	18.3	-322	14.8	32
EBIT Margin	11.4	15.2	-382	11.0	32
PAT Margin	10.2	12.3	-214	8.9	126
Tax rate	21.4	29.3	-793	22.8	-135

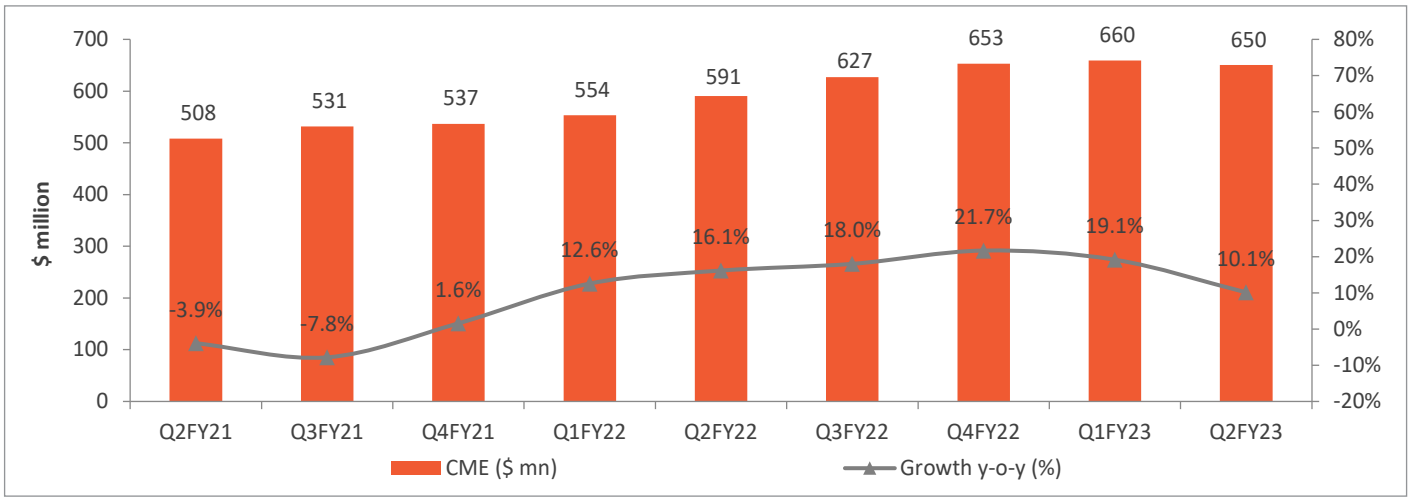
Source: Company, Sharekhan Research

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

Particulars	Revenues ($ mn)	Contribution (%)	$ Growth (%) q-o-q	$ Growth (%) y-o-y
Revenues ($ mn)	1,638	100	0.3	11.2
Geographic mix				
America	832	50.8	2.8	18.2
Europe	401	24.5	-3.6	5.2
RoW	405	24.7	-0.5	4.5
Industry verticals				
CME	650	39.7	-1.4	10.1
Manufacturing	262	16.0	4.9	11.2
Technology	165	10.1	4.5	24.8
BFSI	267	16.3	-2.1	11.2
Retail, transpost and logistics	133	8.1	2.9	15.5
Others	161	9.8	-1.7	0.9
Clients' contribution				
Top 5	310	18.9	-7.5	-6.3
Top 10	459	28.0	-6.0	-0.7
Top 20	654	39.9	-3.1	3.8
Revenue by services				
IT	1,424	86.8	-0.3	9.9
BPO	216	13.2	4.6	22.4

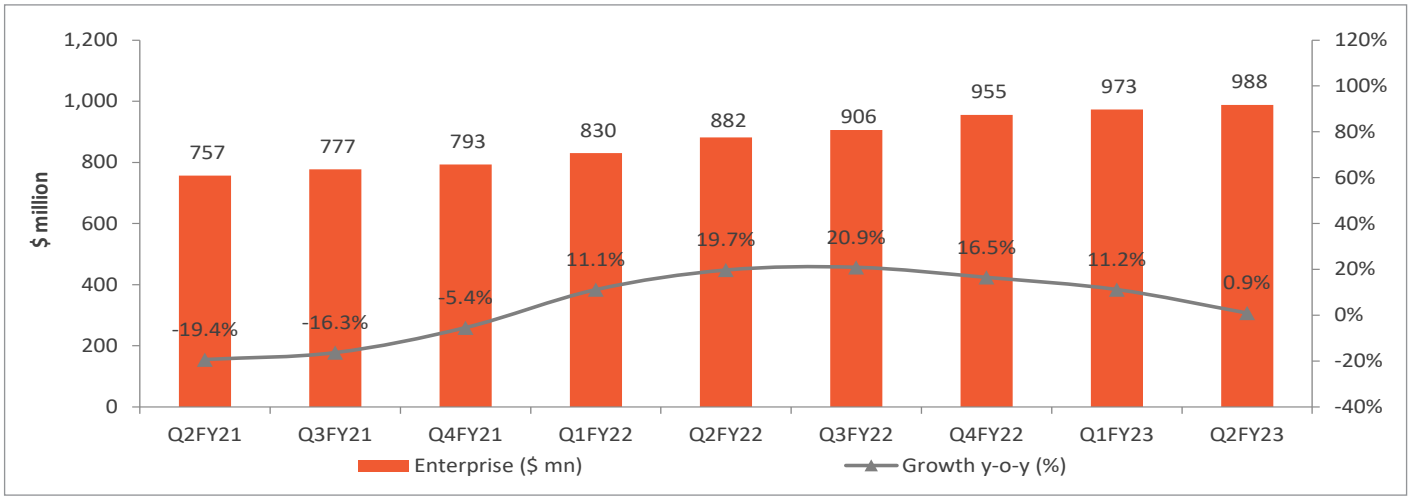
Source: Company, Sharekhan Research

CME vertical revenue growth trend



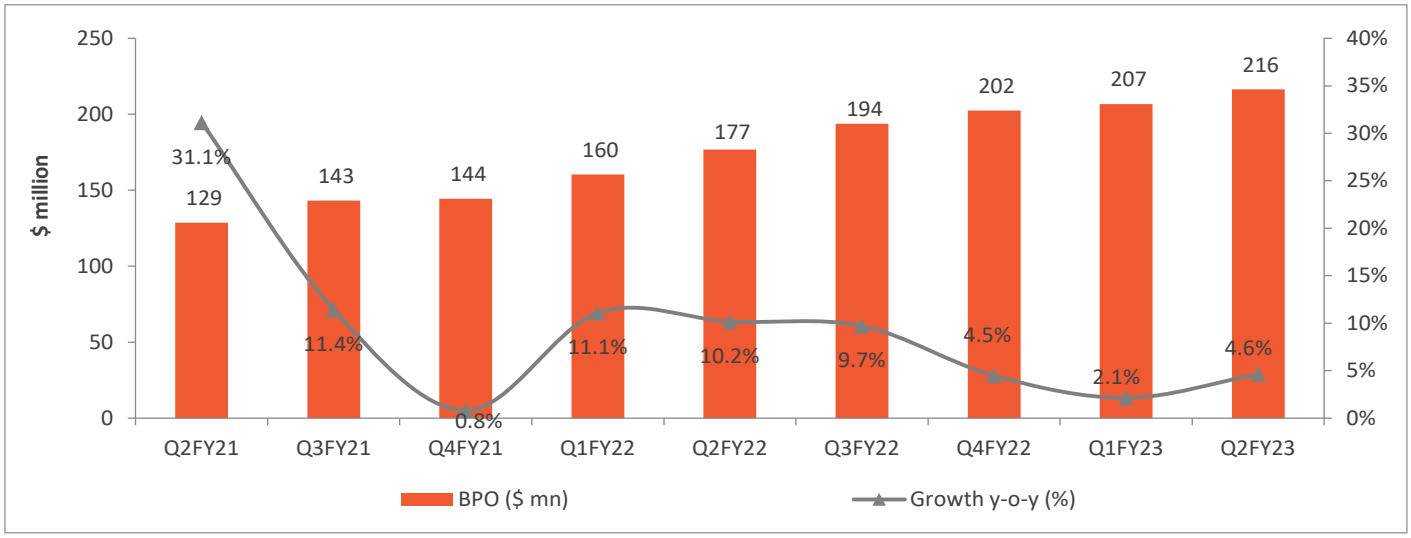
Source: Company; Sharekhan Research

Enterprise vertical revenue growth trend



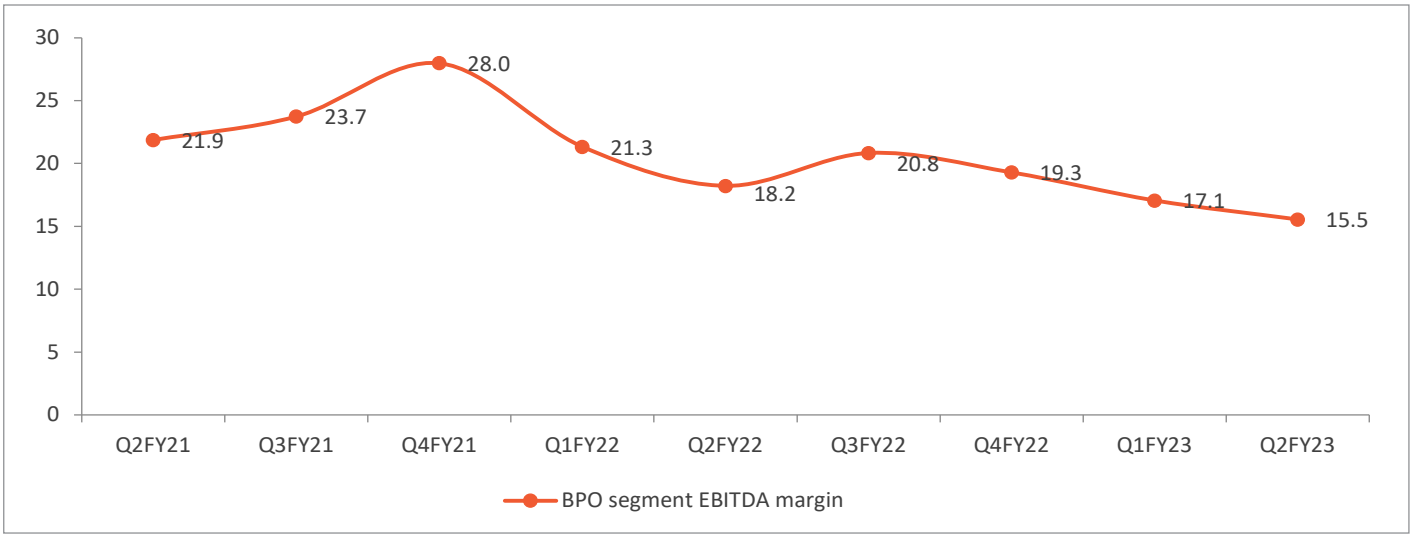
Source: Company; Sharekhan Research

BPO revenue growth trend



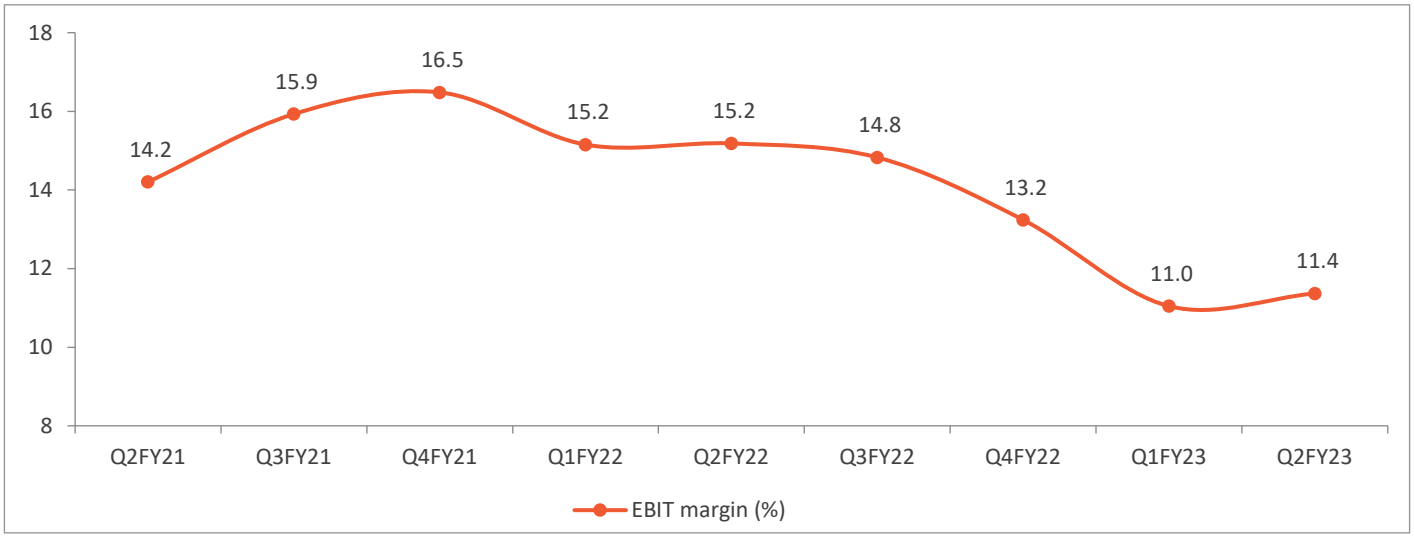
Source: Company; Sharekhan Research

BPO segment's EBITDA margin trend



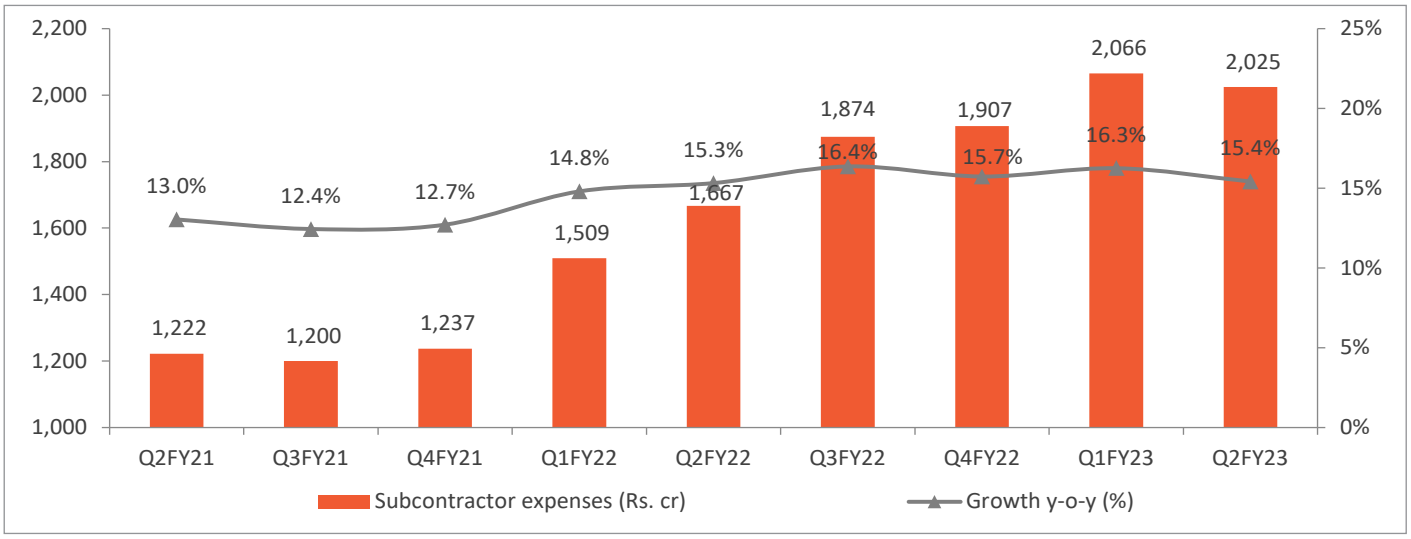
Source: Company; Sharekhan Research

Tech M's EBIT margin trend



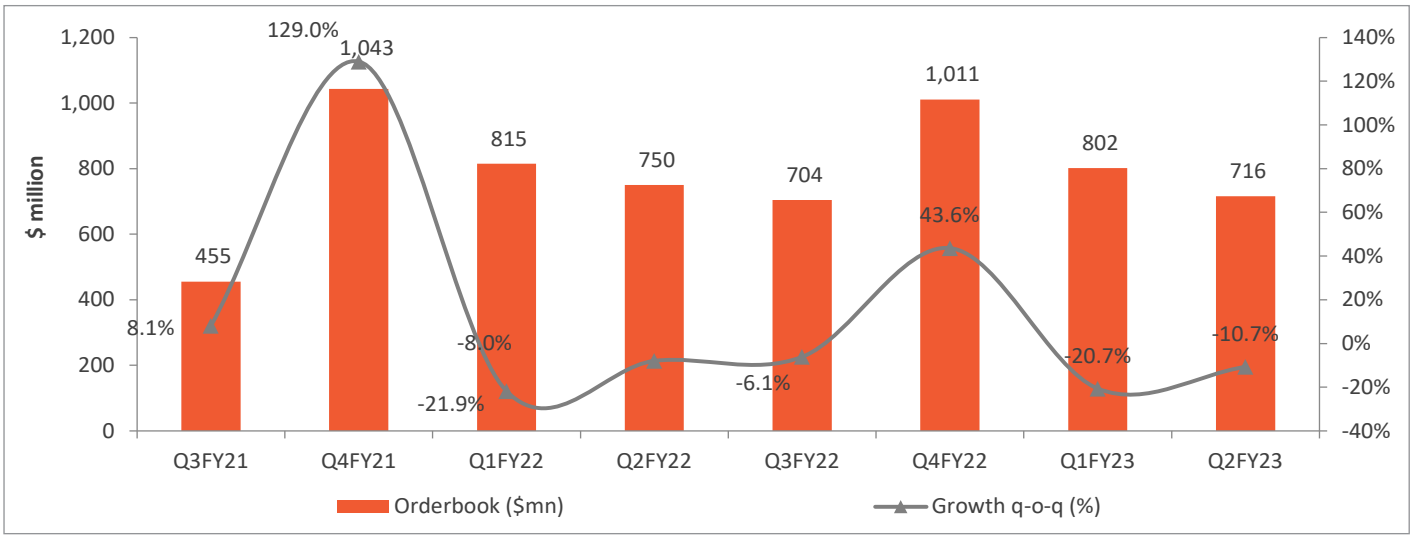
Source: Company; Sharekhan Research

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



Source: Company; Sharekhan Research

New deal win TCV trend



Source: Company; 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 - In-line Q2, Maintain Buy

At CMP, the stock is trading at a reasonable valuation of 18.1x/16.2x its FY2023E/FY2024E earnings estimates. We continue to prefer TechM, given healthy deal wins and reasonable valuation. We maintain a Buy rating on the stock with an unchanged price target (PT) of Rs. 1,220.

One-year forward P/E (x) band

Source: Sharekhan Research

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) Rupee appreciation and/or adverse cross-currency movements, 2) constraint in local talent supply in the US would have an adverse impact on its earnings and 3) macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

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: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp. of India	4.83
2	ICICI Prudential Asset Management	3.24
3	SBI Funds Management Pvt. Ltd.	2.86
4	First State Investments ICVC	2.65
5	BlackRock Inc	2.46
6	Vanguard Group Inc.	2.36
7	First Sentier Investors LLC	2.27
8	Norges Bank	1.44
9	Government Pension Fund	1.43
10	Schroders PLC	1.29

Source: Bloomberg (old data)

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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