L&T Technology Services

Weak Q3, Maintain Hold

IT & ITES	Sharekhan code: LTTS
Reco/View: Hold ↔	CMP: Rs. 3,232 / Price Target: Rs. 3,535 ↓

↑ 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	Positive	↓	Neutral
RQ	Positive	↔	Positive
RV	Neutral	↔	Neutral

ESG Disclosure Score NEW

ESG RISK RATING 18.86
Updated Dec 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. 34,128 cr
52-week high/low:	Rs. 5,295 / 2,923
NSE volume: (No of shares)	3.2 lakh
BSE code:	540115
NSE code:	LTTS
Free float: (No of shares)	2.8 cr

Shareholding (%)

Promoters	73.9
FII	7.2
DII	7.7
Others	11.2

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-18.2	-8.5	-5.1	-36.9
Relative to Sensex	-16.5	-10.9	-14.5	-38.8

Sharekhan Research, Bloomberg

Summary

- For Q3FY23 LTTS reported revenue at $248mn, up 2.7% q-o-q .Revenue growth in constant currency was flat, missing our estimates by 140bps, impacted by higher-than-expected furloughs and seasonality. EBIT margin at 18.7% improved by ~60 bps which was ~25 bps above our estimates. In Q3FY23, LTTS won five USD 10 million plus TCV deals and a significant empanelment with Airbus in digital manufacturing.
- Only Transportation vertical grew at a healthy pace, aided by the ramp-up of large deals, while Plant engineering, Hitech and Medical devices verticals declined q-o-q. The Telecom & Hi-tech segment witnessed a challenging quarter due to the weakness in ISV consumer electronics and semi-conductors while Plant engineering was impacted by higher furloughs.
- LTTS cut its revenue growth guidance to 15% from 15.5-16.5% in CC terms for FY2023E. On the recent acquisition of SWC, the company expects the margin to decline by 180-200 bps q-o-q due to integration in Q1FY24.
- We expect FY24 outlook to be uncertain on account of global headwinds and any recovery is most likely to be gradual. The recent SWC acquisition will be margin dilutive for FY24 and may provide only marginal synergies in the near-term. Hence, we maintain Hold rating on LTTS with revised PT of 3535 given strong deal wins in the diversified vertical mix. At the CMP, the stock trades at 28.5x / 23.2x its FY24E / FY25E EPS respectively.

For Q3FY2023, LTTS reported revenue at $248mn, up 2.7% q-o-q. Revenue growth in constant currency was flat, missing our estimates by 140bps, impacted by seasonality and higher-than-expected furloughs, especially in plant engineering. The company reported healthy EBIT margin of 18.7%, which was ~25 bps above our estimate led by offshore mix, higher productivity, rupee depreciation offset by higher SG&A. The company reported a net profit at Rs. 303.6 crore, up 22% y-o-y. LTTS won five USD 10 million plus TCV deals and a significant empanelment with Airbus in digital manufacturing. Revenue growth at 0.4% q-o-q and 10.2% y-o-y was primarily led by 4.4% q-o-q growth in Transportation vertical and 1.1% q-o-q in Industrial Products while Plant Engineering, Telecom & Hi-tech and Medical Devices saw a sequential de-growth of 4.1%, 2.8% and 1.1%, respectively. The Management stated that the Telecom & Hi-tech verticals witnessed a challenging quarter due to weakness in ISV consumer electronics and semi-conductors, as consumers were spending less and the same was partially offset by better 5G spends. The company has cut revenue growth guidance to 15% from 15.5-16.5% in CC terms for FY2023E. We expect FY24 outlook to be uncertain on account of global headwinds and any recovery is most likely to be gradual. The recent SWC acquisition will be margin dilutive for FY24 and may provide only marginal synergies in the near-term. Hence, we maintain Hold rating on LTTS with revised PT of 3535 given strong deal wins in the diversified vertical mix. At the CMP, the stock trades at 28.5x / 23.2x its FY24E / FY25E EPS respectively. We are not including the SWC acquisition to our estimate as we await the completion of the acquisition by late Q4FY23.

Key positives

- LTTS won five USD10 million plus TCV deals and a significant empanelment with Airbus in digital manufacturing.
- Attrition at 21.3% moderated by 80 bps q-o-q from 24.1% in Q2FY23.

Key negatives

- Revenue growth guidance cut to 15% from 15.5-16.5% in CC terms for FY23E.
- Plant Engineering, Telecom & Hi-tech and Medical Devices saw a sequential de-growth of 4.1%, 2.8% and 1.1%, respectively.

Management Commentary

- Management stated that the Telecom & Hi-tech verticals witnessed a challenging quarter due to the weakness in ISV consumer electronics and semi-conductors as the consumers were spending less and the same was partially offset by better 5G spends.
- Management cited that despite the recovery in Plant & Engineering in Q4FY23, the weak H2FY23 performance is likely to have an impact on FY23 revenue growth.
- On the recent acquisition of SWC, the company expects the margin to decline by 180-200 bps q-o-q due to integration in Q1FY24. The low-margin business of SWC would keep LTTS's margin depressed for an extended period. However, management has stated that it would aim to reach 18% level again by FY26.

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

Our Call

Valuation – Weak Q3, maintain Hold: We expect FY24 outlook to be uncertain on account of global headwinds and any recovery is most likely to be gradual. The recent SWC acquisition will be margin dilutive for FY24 and may provide only marginal synergies in the near-term. Hence, we maintain Hold rating on LTTS with revised PT of 3535 given strong deal wins in the diversified vertical mix. At the CMP, the stock trades at 28.5x / 23.2x its FY24E / FY25E EPS respectively.

Key Risks

Rupee appreciation and/or adverse cross-currency movements, slackening pace in deal closures, and/or constraints in local talent supply in the US would affect earnings.

Valuation Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	6,569.7	7,984.6	8,479.6	9,967.3
OPM (%)	21.5	21.2	21.5	21.3
Adjusted PAT	957.0	1,142.9	1,197.4	1,471.8
% y-o-y growth	44.3	19.4	4.8	22.9
Adjusted EPS (Rs.)	90.7	108.1	113.3	139.2
P/E (x)	35.6	29.9	28.5	23.2
P/B (x)	8.1	6.9	5.9	5.1
EV/EBITDA (x)	22.3	18.3	16.8	14.3
RoNW (%)	25.1	25.2	22.6	23.9
RoCE (%)	27.2	28.0	25.9	26.5

Source: Company; Sharekhan estimates
Note : We are not including the SWC acquisition to our estimate as we await the completion of the acquisition by late Q4FY23

Key result highlights

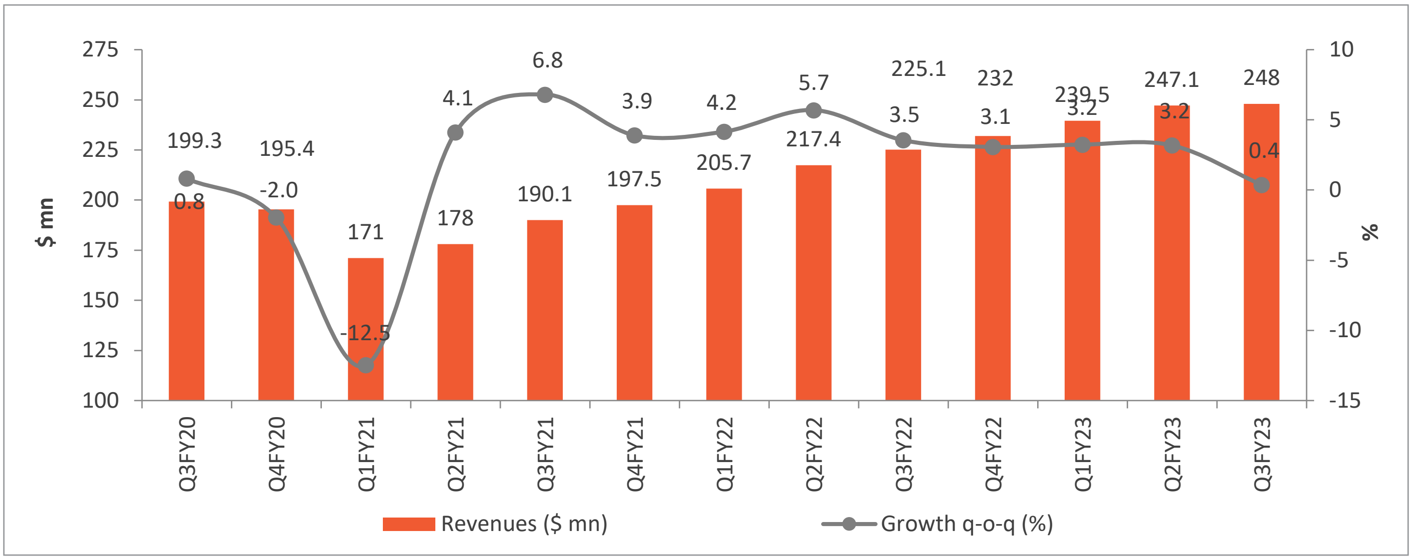
- **Revenue misses estimates:** The company reported revenue at $248mn, up 0.4% q-o-q, broadly in line with street's estimates (missed our estimates by 140 bps), which was impacted by seasonality and furloughs. EBIT margin at 18.7% improved by ~60 bps, which was ~25 bps above our estimates. Revenue growth at 0.4% q-o-q and 10.2% y-o-y was primarily led by 4.4% q-o-q growth in Transportation vertical and 1.1% q-o-q in Industrial Products while plant Engineering, Telecom & Hi-tech and Medical Devices saw a sequential decline of 4.1%, 2.8%, and 1.1%, respectively. The company has cut its revenue growth guidance to 15% from 15.5-16.5% in CC terms for FY2023E.
- **EBIT margin improves:** The company reported a healthy EBIT margin of 18.7%, which was ~25 bps above our estimate, led by the offshore mix, higher productivity, and rupee depreciation offset by higher SG&A. This was the sixth consecutive quarter of 18% plus EBIT margin.
- **Deal wins and deal pipeline:** LTTS won five USD10 million plus TCV deals and a significant empanelment with Airbus in digital manufacturing. Three of the five USD10 million plus deal wins in Q3FY23 were from Industrial Products on the back of their differentiated capabilities such as digital twin and sustainability driven product development.
- **Onsite-Offshore Mix:** The onsite and offshore revenue mix during the quarter was 43% and 57%, respectively. Offshore revenue mix increased by 210 bps q-o-q.
- **Good client trend:** LTTS added one client each on q-o-q basis under the 5 million+ and USD10 million+ category, while it added eight clients under the USD1 million+ client bucket. Clients in the USD30 million+ category, however, declined by one sequentially. \
- **Poor headcount metrics:** Total headcount increased by only 175 people q-o-q to 21,649.
- **Decline in DSO days:** DSO days declined to 77days from 78 days in Q2FY23.
- **Robust FCF generation in Q3:** Free cash flow (FCF) generation was at Rs. 374.5 crore (versus Rs. 360.1 crore in Q2FY2023). OCF/PAT was at 134.8% and FCF/PAT was healthy at 123.4%.

Results (Consolidated) — **Rs cr**

Particulars	Q3FY23	Q3FY22	Q2FY23	y-o-y (%)	q-o-q (%)
Revenues in USD (mn)	**248.0**	**225.1**	**247.1**	**10.2**	**0.4**
Revenues In INR	**2,048.6**	**1,687.5**	**1,995.1**	**21.4**	**2.7**
Employee benefit expenses	1,176.3	922.4	1,152.8	27.5	2.0
Operating expenses	431.1	397.7	423.0	8.4	1.9
EBITDA	**441.2**	**367.4**	**419.3**	**20.1**	**5.2**
Depreciation	58.3	53.0	59.1	10.0	-1.4
EBIT	**382.9**	**314.4**	**360.2**	**21.8**	**6.3**
Other income	74.2	37.0	41.8	100.5	77.5
Finance cost	11.5	11.1	13.1	3.6	-12.2
PBT	**445.6**	**340.3**	**388.9**	**30.9**	**14.6**
Provision for taxation	140.6	90.7	105.7	55.0	33.0
Minority interest	-1.4	-0.8	-0.8		
Net profit	**303.6**	**248.8**	**282.4**	**22.0**	**7.5**
EPS (Rs)	28.7	23.6	26.7	21.6	7.4
Margin (%)					
EBITDA	21.5	21.8	21.0	-24	52
EBIT	18.7	18.6	18.1	6	64
NPM	14.8	14.7	14.2	8	67
Tax rate	31.6	26.7	27.2	490	437

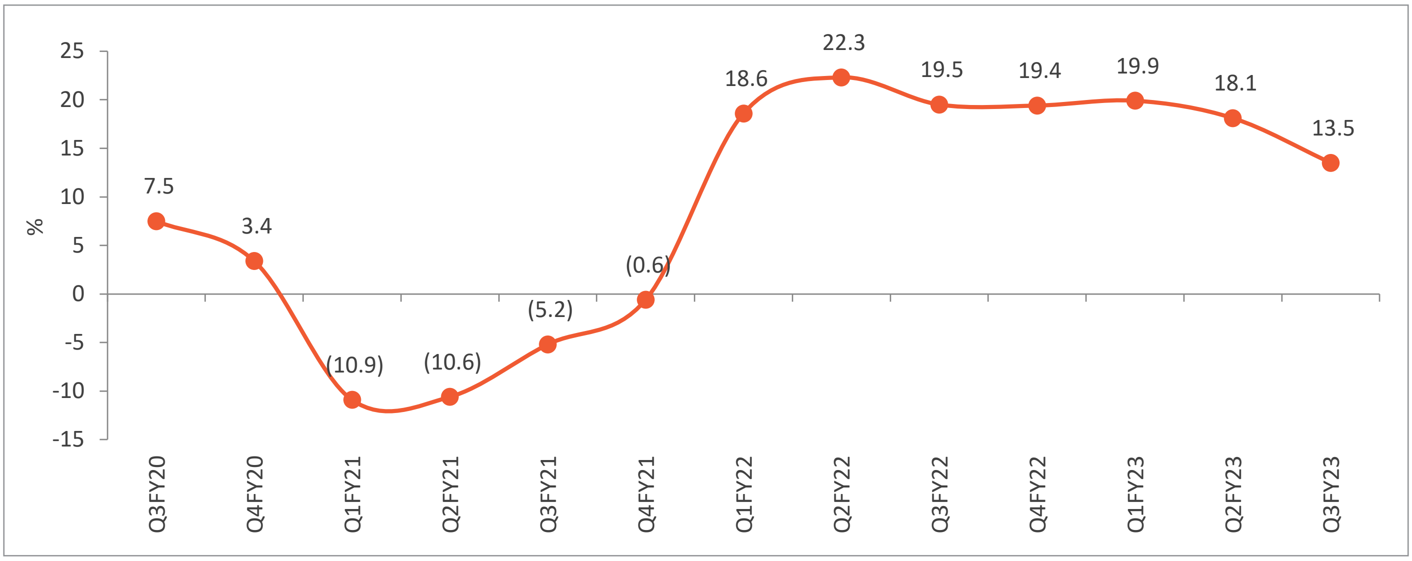
Source: Company, Sharekhan Research

Revenue ($ mn) and growth (% q-o-q)



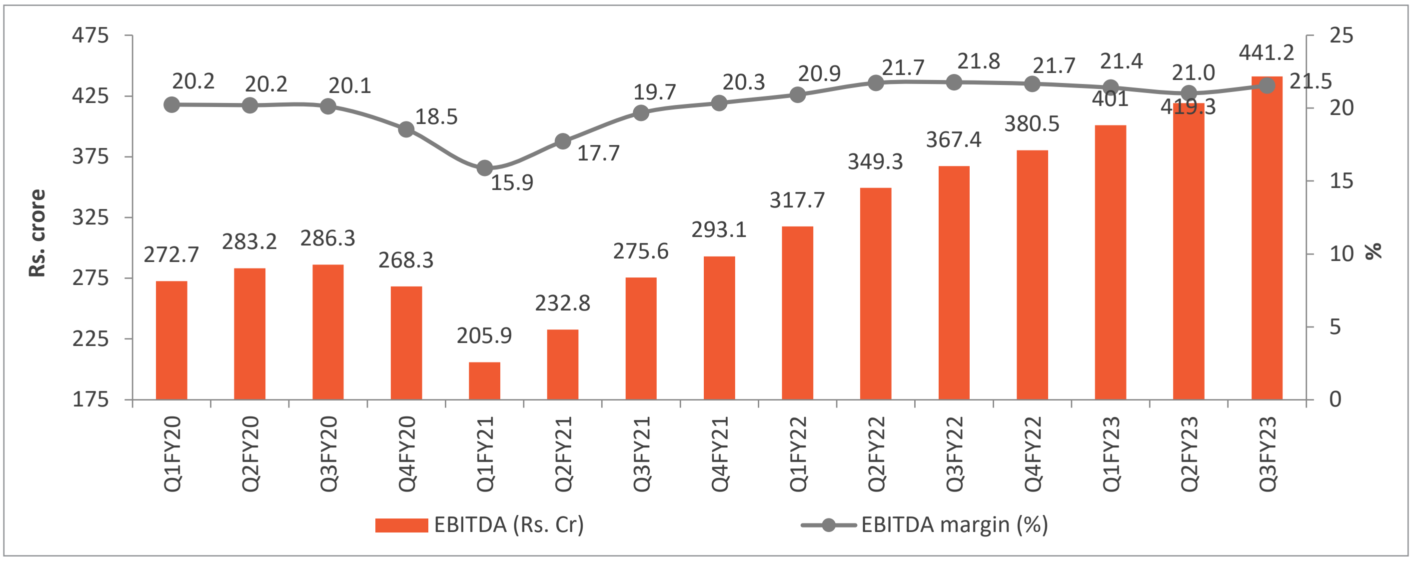
Source: Company, Sharekhan Research

Revenue growth trend (% y-o-y) on CC



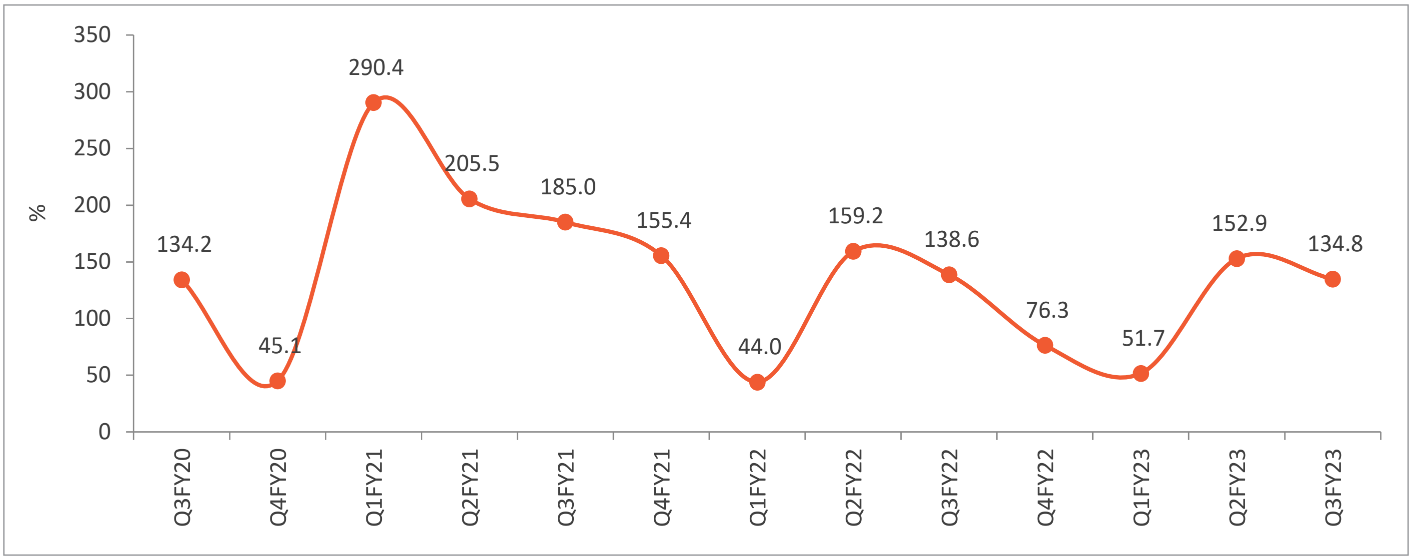
Source: Company, Sharekhan Research

EBITDA margin (%) trend



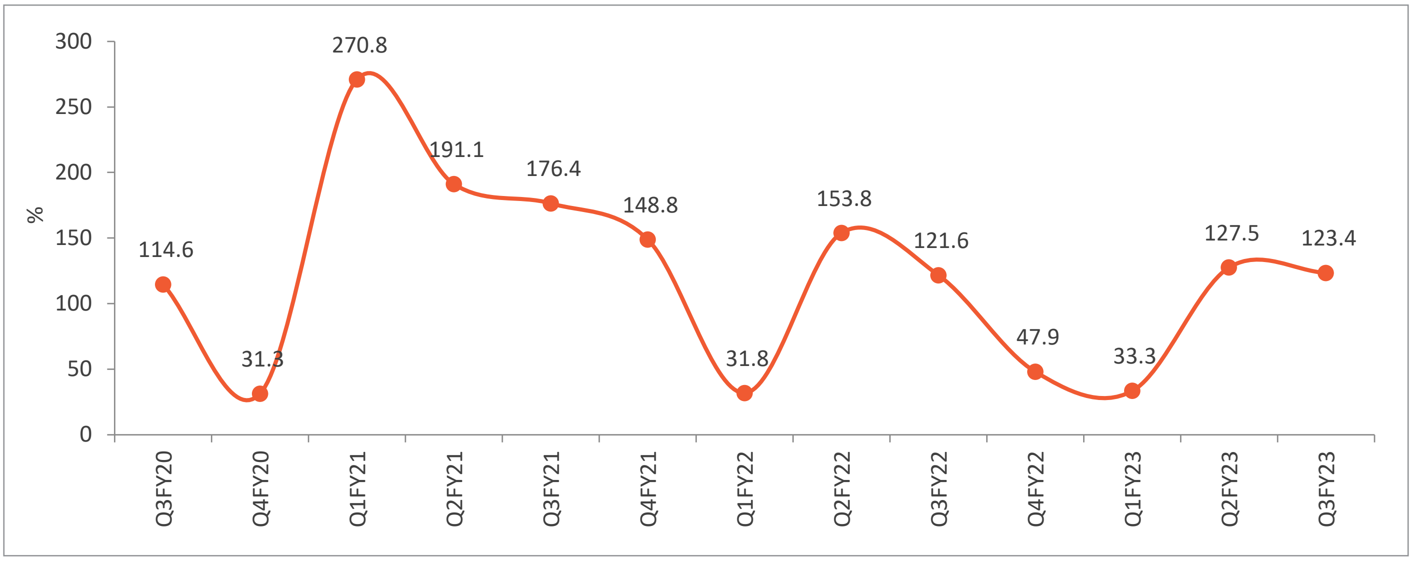
Source: Company, Sharekhan Research

OCF as a % of net profit



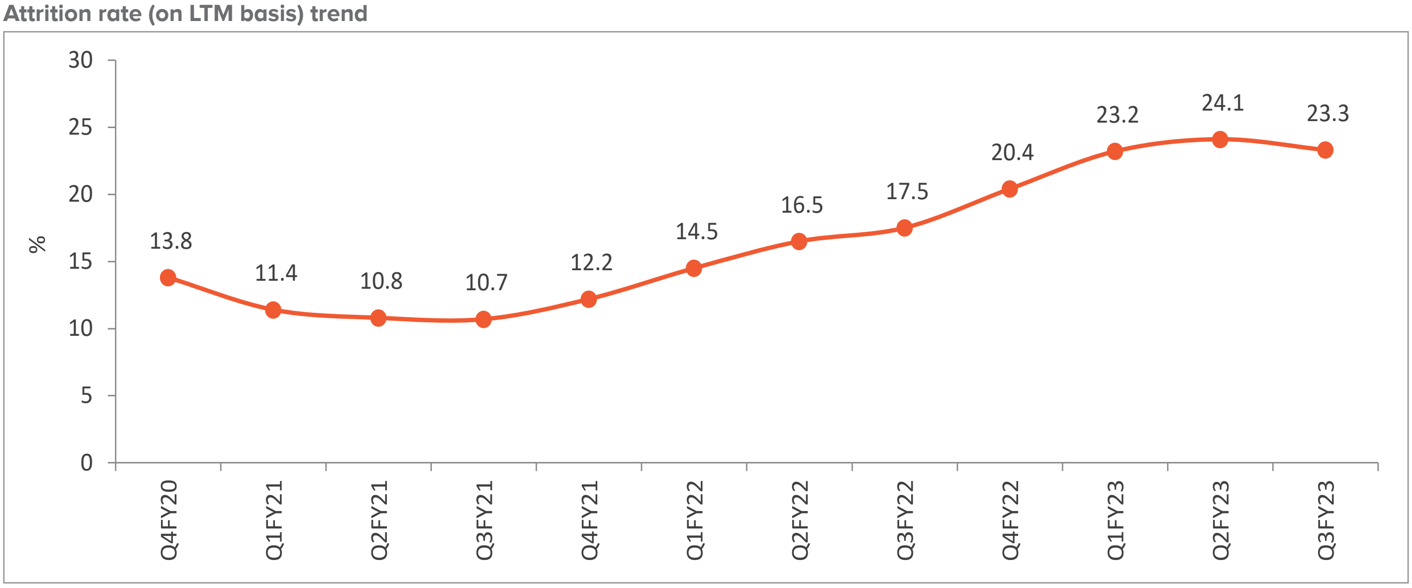
Source: Company, Sharekhan Research

FCF as a % of net profit



Source: Company, Sharekhan Research

Attrition rate (on LTM basis) trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Persisting multiple global headwinds turning outlook for FY24E uncertain

Owing to multiple global headwinds the outlook for FY24E looks uncertain, and the recovery could be gradual in the coming quarters. Hence concerns relating to macro headwinds are unlikely to abate anytime soon thus restricting any material outperformance for Indian IT companies

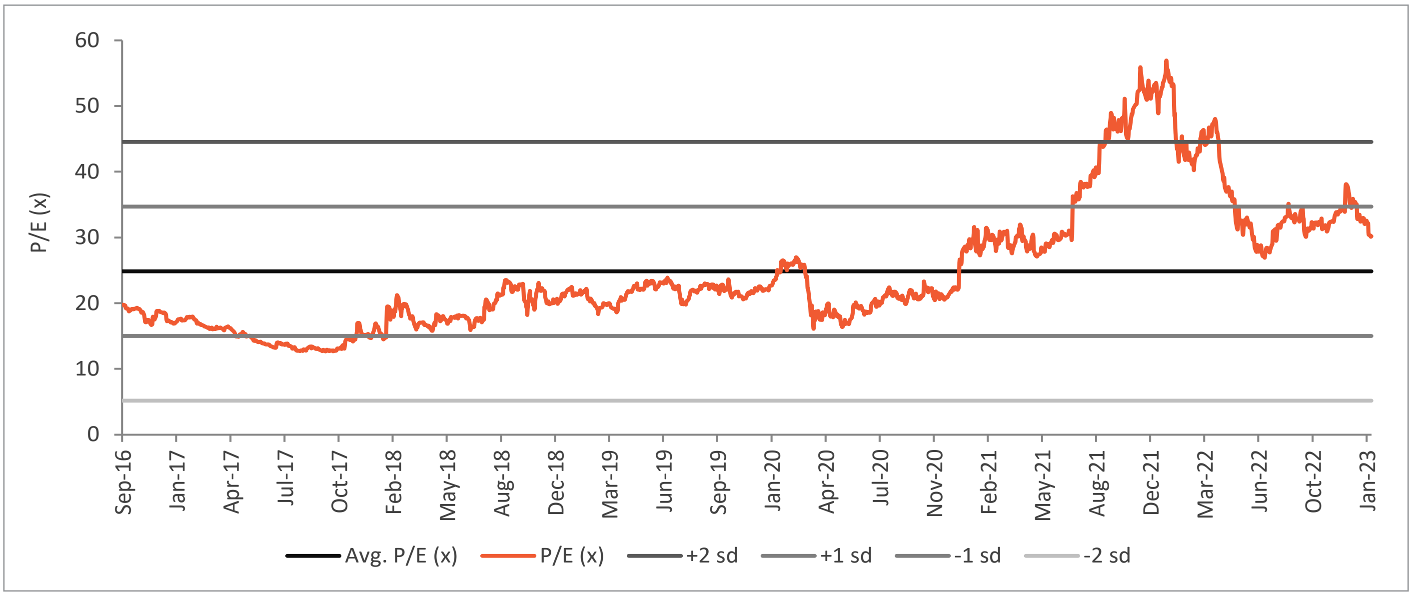
■ Company outlook - Broad portfolio to support long growth runway

LTTS is the third-largest engineering service provider (ESP) in India and is well-diversified across verticals. The large ERD addressable market and a huge scope in deepening relationships with top-30 customers provide multi-year sustainable growth prospects. Technology shifts in verticals are also positive for the company as they create huge growth opportunities for ESPs. We expect strong growth from FY2022E on the back of rising spends in both digital engineering and legacy engineering areas.

■ Valuation - Weak Q3, maintain Hold

We expect FY24 outlook to be uncertain on account of global headwinds and any recovery is most likely to be gradual. The recent SWC acquisition will be margin dilutive for FY24 and may provide only marginal synergies in the near-term. Hence, we maintain Hold rating on LTTS with revised PT of 3535 given strong deal wins in the diversified vertical mix. At the CMP, the stock trades at 28.5x / 23.2x its FY24E / FY25E EPS respectively.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

L&T Technology Services (LTTS) is a leading global ER&D services company, backed by the rich engineering expertise and experience of parent company, Larsen & Toubro. LTTS is a pure-play Engineering Design Services firm with a presence across multiple verticals (transportation, industrial products, telecom & hi-tech, medical devices and process industries). The company derives revenue 62.3% from North America, 16.1% from Europe, 14.5% from India and 7.1% from Rest of the World (RoW). The company offers ERD practices to 57 of the top R&D spenders worldwide. LTTS also has IP and Platforms which it independently sells to clients.

Investment theme

LTTS currently generates a mere 0.5% of its Top-30 (T-30) customers' R&D spends ($75 billion) as revenue ($376 million), which provides a long runway for growth. We believe the multi-sectoral presence and robust horizontal technology practice would help LTTS to deliver sustainable revenue growth momentum. Additionally, technology shifts in verticals is positive for LTTS as any change in technology creates huge growth opportunities for ESPs. Unlike peers, LTTS has a broader portfolio, which helps the company to mitigate the risk relating to vertical-specific cyclicality. We believe LTTS is well poised to deliver strong multi-year growth going forward, led by leadership depth, broad client portfolio, and multi-domain expertise across verticals and under-penetrated ERD outsourcing market.

Key Risks

Regulatory visa norms could have an impact on employee expenses; 2) Any instability in leadership; additional exits at senior management level; 3) Rupee appreciation and/or adverse cross-currency movements; and 4) Increasing attrition rate.

Additional Data

Key management personnel

A.M. Naik	Non-Executive Chairman
S.N. Subrahmanyan	Vice Chairman
Amit Chadha	Chief Executive Officer
Rajeev Gupta	Chief Financial Officer
Abhishek Sinha	Chief Operating Officer (COO)

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	3.42
2	Wasatch Advisors Inc	0.95
3	Vanguard Group Inc/The	0.91
4	Capital group Cos Inc/The	0.41
5	UTI Asset Management Co LTD	0.34
6	Aditya Birla Sun Life Asset Management	0.26
7	SBI Funds Management Ltd	0.25
8	Credit Agricole Group	0.20
9	HDFC Asset Management	0.20
10	Norges Bank	0.17

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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