

Tech Mahindra

Estimate change	↔
TP change	↔
Rating change	↔

CMP: INR1,036 TP: INR1,020 (-2%) Neutral

Margin focus to hinder FY24 topline growth

Await greater comfort on margins; maintain Neutral

- TECHM reported revenue of USD1.67b in 3QFY23, up 0.2% QoQ in CC terms (in line). Reported growth was 1.8% QoQ, led by Retail (+6.0 QoQ) and Technology (+3.3% QoQ). BFSI (-0.5% QoQ) and Manufacturing (flat QoQ) were soft. EBIT margin rose 60bp QoQ to 12% (vs our estimate of 11.6%).
- Q3 revenue softness was anticipated due to extended furloughs and the ongoing account pruning exercise to weed out low-margin and non-strategic accounts. Management indicated a total annualized impact of USD100-120m in FY23 from the exercise, which is now half completed. Additionally, top-5 accounts also remained soft due to internal restructuring at a key client, leading to slow ramp-ups and slow deal closure activities in Q3.
- We expect TECHM to deliver USD revenue growth of 10.6% in FY23 (including ~400bp inorganic impact) followed by ~8% growth in FY24E, which is among the weakest in our coverage universe. TECHM should see pressure in FY24 on account of sacrificing growth over margins, softness in its top accounts and a long revenue conversion cycle amid pressure on small deals.
- On the margin front, TECHM beat our estimate by 40bp QoQ and delivered EBIT margin of 12% in Q3FY23. The margin improvement was led by restructuring in low-margin assets, increased offshoring and rigorous focus on improving quality revenues. We slightly raise our FY23 margin estimate by 30bp to 11.8% due to a beat in Q3 margins. We see FY24E/FY25E margins at 12.8%/13.7%. Our margin estimates remain behind the earlier ramp-up expected by the company as we see fewer gains from operating leverage due to modest topline growth.
- We remain on the sidelines on TECHM as we feel the current valuations fairly factor in uncertainties around growth and margin. We marginally tweak our FY23/FY24/FY25 estimates. Our TP implies 15x FY24E EPS. We **remain Neutral** on the stock with TP of INR 1,020.

In-line performance, but sharp decline in headcount

- Revenue grew 0.2% QoQ CC to USD1.67b (in line; up 1.8% in USD terms).
- For 9MFY23, USD revenue grew 13% YoY, while INR EBIT and INR PAT declined 7% and 8%, respectively.
- The FCF to PAT conversion was weak at 19.9% in 3QFY23 due to a strong conversion in 2QFY23. PAT conversion for 9MFY23 was at 80%.
- Adjusted EBIT margin grew 60bp QoQ, but fell 280bp YoY, to 12% (vs estimate of 11.6%).
- Adjusted PAT rose 1% QoQ to INR13.1b, in line with our estimates.

Key highlights from the management commentary

- The macro environment remains weak; TECHM is seeing slower decision-making for projects, cuts in discretionary spending and shrinking budgets for short-term tactical deals.

Bloomberg	TECHM IN
Equity Shares (m)	919
M.Cap.(INRb)/(USD\$)	1009.1 / 12.4
52-Week Range (INR)	1525 / 914
1, 6, 12 Rel. Per (%)	4/-4/-30
12M Avg Val (INR M)	3479

Financials & Valuations (INR b)

Y/E Mar	2023E	2024E	2025E
Sales	536	591	647
EBIT Margin (%)	11.8	12.8	13.7
PAT	51	60	71
EPS (INR)	58.4	68.2	79.7
EPS Gr. (%)	(6.7)	16.7	16.9
BV/Sh. (INR)	321.4	340.0	361.5

Ratios

RoE (%)	18.8	20.8	22.9
RoCE (%)	19.0	21.4	23.7
Payout (%)	75.0	75.0	75.0

Valuations

P/E (x)	17.6	15.1	12.9
P/BV (x)	3.2	3.0	2.9
EV/EBITDA (x)	10.8	9.3	8.0
Div Yield (%)	4.2	4.9	5.8

Shareholding pattern (%)

As On	Dec-22	Sep-22	Dec-21
Promoter	35.2	35.2	35.7
DII	24.1	24.0	17.4
FII	28.0	28.2	35.4
Others	12.7	12.6	11.6

FII Includes depository receipts

- As a result, TECHM is planning to be more agile while aligning the business with client needs by reviewing on a monthly basis (previously on quarterly).
- TECHM expects the account pruning exercise (similar to 2Q or more) to continue in 4QFY23 and beyond in FY24.
- Extended furloughs, the impact from Top clients, slow decision-making and the focus on costs remain headwinds for 4QFY23.

Valuation and view

- Although its current performance remains muted, TECHM's high exposure to the Communications vertical offers a potential opportunity, as a broader 5G rollout can result in a new spending cycle in this space.
- Near-term growth remains weak and we await greater comfort on margins. We value the stock at 15x FY24E EPS. **We maintain our Neutral rating.**

Quarterly performance

Y/E March	FY22				FY23				FY22	FY23E	FY23E 3QE	(INR b) Var. (%/bp)
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE				
Revenue (USD m)	1,384	1,473	1,534	1,608	1,633	1,638	1,668	1,697	5,998	6,636	1,641	1.6
QoQ (%)	4.1	6.4	4.1	4.9	1.5	0.3	1.8	1.7	17.4	10.6	0.2	164bp
Revenue (INR b)	102	109	115	121	127	131	137	140	446	536	135	1.8
YoY (%)	12.0	16.1	18.7	24.5	24.6	20.7	19.9	15.5	17.9	20.0	17.8	211bp
GPM (%)	31.7	31.7	30.1	29.3	28.3	27.9	28.7	29.5	30.6	28.6	28.2	49bp
SGA (%)	13.3	13.3	12.1	12.1	13.5	12.8	13.1	13.0	12.7	13.1	12.9	18bp
EBITDA	19	20	21	21	19	20	21	23	80	83	21	3.9
EBITDA Margin (%)	18.4	18.3	18.0	17.2	14.8	15.1	15.6	16.5	18.0	15.5	15.3	31bp
EBIT	15	17	17	16	14	15	16	18	65	63	16	5.2
EBIT Margin (%)	15.2	15.2	14.8	13.2	11.0	11.4	12.0	12.9	14.6	11.8	11.6	38bp
Other income	2	2	2	3	1	2	1	2	10	6	2	-33.6
ETR (%)	23.9	29.4	26.9	17.5	22.8	21.4	27.3	26.5	24.4	24.7	26.5	79bp
Adj. PAT	14	13	14	15	11	13	13	14	56	52	13	1.7
QoQ (%)	11.7	-1.1	2.2	10.0	-24.9	15.8	-1.0	10.5			-2.7	169bp
YoY (%)	39.2	25.7	4.5	24.3	-16.4	-2.2	-5.3	-4.8	22.1	-7.1	-6.9	162bp
Extra-Ordinary Item	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	-0.2	0.0	0.0
Reported PAT	14	13	14	15	11	13	13	14	56	51	13	1.7
EPS (INR)	15.3	15.1	15.5	16.9	12.8	14.8	14.7	16.2	62.6	58.4	14.4	1.8

E: MOFSL estimates

Key performance indicators

Y/E March	FY22				FY23				FY22	FY23E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenue (QoQ CC %)	3.9	7.2	4.7	5.4	3.5	2.9	0.2			
Margins (%)										
Gross Margin	31.7	31.7	30.1	29.3	28.3	27.9	28.7	29.5	30.6	28.6
EBITDA margin	18.4	18.3	18.0	17.2	14.8	15.1	15.6	16.5	18.0	15.5
EBIT Margin	15.2	15.2	14.8	13.2	11.0	11.4	12.0	12.9	14.6	11.8
Net Margin	13.3	12.3	12.0	12.4	8.9	10.0	9.4	10.2	12.5	9.7
Operating Metrics										
Headcount (k)	126	141	145	151	158	164	157		151	
Utilization excl. trainees (%)	89.0	89.0	86.0	84.0	83.0	85.0	86.0		87.0	
Attrition (%)	17.0	21.0	24.0	24.0	22.0	20.0	17.0		24.0	
Deal TCV (USD m)	815	750	704	1011	802	716	795		3,280	
Key Verticals (QoQ %)										
Communication	3.1	6.7	6.2	4.1	1.0	-1.4	2.1		17.2	
Enterprise	4.7	6.3	2.7	5.4	1.8	1.5	1.7		17.5	
Key Geographies (QoQ %)										
North America	6.8	8.9	6.5	3.6	4.2	2.8	-0.4		18.6	
Europe	6.8	1.3	2.5	8.6	-2.0	-3.6	1.4		18.5	



Highlights from the management commentary

Demand and industry outlook

- TECHM posted a muted revenue growth of 0.2% QoQ in CC terms in 3QFY23 due to the impact of furloughs.
- RoW saw strong growth as the Middle East continued to perform well. The company is seeing good opportunities there, especially in Digital. The US and Europe have a higher risk of a macro slowdown compared to other regions.
- The deal pipeline remains strong. TECHM saw net new deal wins of USD795m (TCV) in 3QFY23, with a large deal in Americas in Telecom.
- There is no change in the average deal size. Clients remain cautious and are taking longer time to sign new deals.
- The macro environment remains weak; TECHM is seeing slower decision-making for projects, cuts in discretionary spending and shrinking budgets for short-term tactical deals.
- As a result, TECHM is planning to be more agile while aligning the business with client needs by reviewing on a monthly basis (previously on quarterly).
- Customer experience in the BPS business had a record quarter and was ahead of the industry in 3QFY23 (seasonally strong). The outlook for BPO remains strong.
- The Communications vertical continues to benefit from 5G. There are good opportunities. There is a change in the delivery model, and the company expects to see good cost take-out deals in 6-7 months. Retail, Manufacturing and BFSI continue to do well, while there is softness in Hi-Tech.
- TECHM expects the account pruning exercise (similar to 2Q or more) to continue in 4QFY23 and beyond in FY24.
- The performance of Top-5 accounts remained muted due to internal restructuring initiatives for some clients. This should bottom out in 4QFY23 before growing in FY24.
- It is witnessing extended furloughs in few markets, which have been extended to Jan'23.
- Extended furloughs, the impact from Top clients, slow decision-making and the focus on costs remain headwinds for 4QFY23.
- Despite near-term weakness, the medium to long-term demand for Communications remains strong, with deals expected to come back in 2-3 quarters and good vendor consolidation opportunities.

Margin performance

- Margin expanded by 60bp in 3QFY23. Utilization, discontinuing of the low-margin business, and favorable forex aided margin during the quarter, partially offset by higher SG&A expenses.
- Margin levers include normalizing sub-contractor expenses, offshoring, divesting non-strategic assets, automation and delivery optimization, along with realizing synergies from portfolio companies.
- The management sees a good utilization buffer. Sub-contractor expenses and offshoring have good headroom to improve margins.

Others

- DSO remained flat at 98 days in 3QFY23.
- Cash and investments stood at USD780m in 3QFY23.
- The FCF to PAT conversion was muted at 19.9% due to higher conversion in 2Q at 159%. For 9MFY23, the conversion stood at ~80%.

Exhibit 1: Retail led the growth in 3QFY23

Verticals	Contribution to revenue (%)	Growth (QoQ %)
Comm., Media, and Ent.	39.8	2.1
Manufacturing	15.7	-0.1
Technology	10.3	3.9
BFSI	15.9	-0.7
Retail, Transport, and Logistics	8.5	6.9
Others	9.8	1.8

Exhibit 2: Americas remained soft in 3QFY23

Geographies	Contribution to revenue (%)	Growth (QoQ %)
Americas	49.7	-0.4
Europe	24.4	1.4
Rest of the World	25.9	6.8

Valuation and view

- Although its current performance remains muted, TECHM's high exposure to the Communications vertical offers a potential opportunity, as a broader 5G rollout can result in a new spending cycle in this space.
- Near-term growth remains weak, and we await greater comfort on margins. We value the stock at 15x FY24E EPS. **We maintain our Neutral rating.**

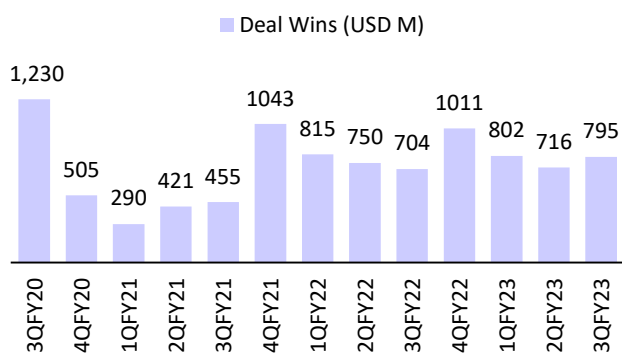
Exhibit 3: Revisions to our estimates

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.6	82.5	82.5	80.7	82.8	82.8	-0.1%	-0.4%	-0.4%
Revenue (USD m)	6,636	7,169	7,847	6,600	7,158	7,760	0.5%	0.2%	1.1%
Growth (%)	10.6	8.0	9.4	10.0	8.4	8.4	60bps	-40bps	100bps
EBIT margin (%)	11.8	12.8	13.7	11.6	12.6	13.5	30bps	20bps	30bps
PAT (INR b)	52	60	71	51	61	70	1.4%	-0.3%	1.3%
EPS	58.4	68.2	79.7	57.6	68.4	78.6	1.5%	-0.2%	1.4%

Source: MOFSL, Company

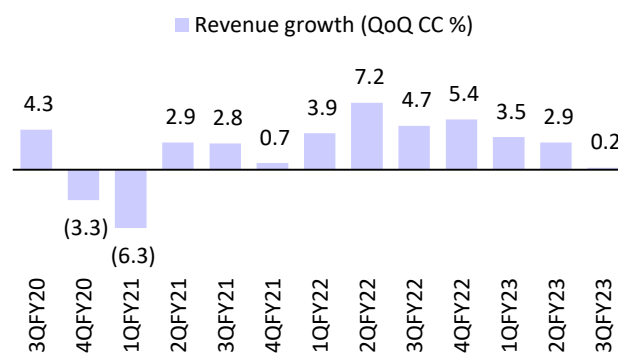
Story in charts

Exhibit 4: Decent deal wins in 3QFY23



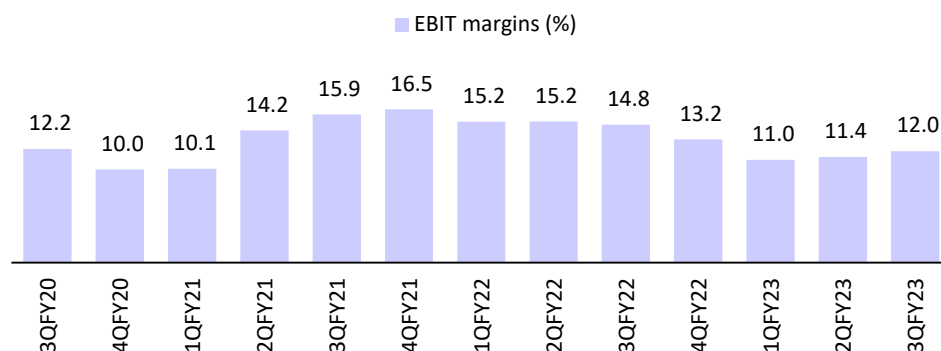
Source: Company, MOFSL

Exhibit 5: Revenue was flat QoQ CC in 3QFY23



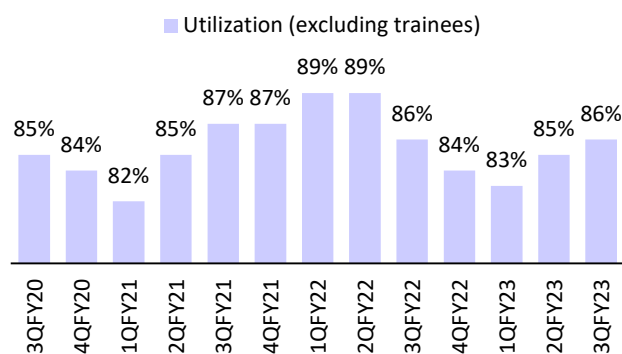
Source: Company, MOFSL

Exhibit 6: EBIT margin saw marginal improvement in 3QFY23



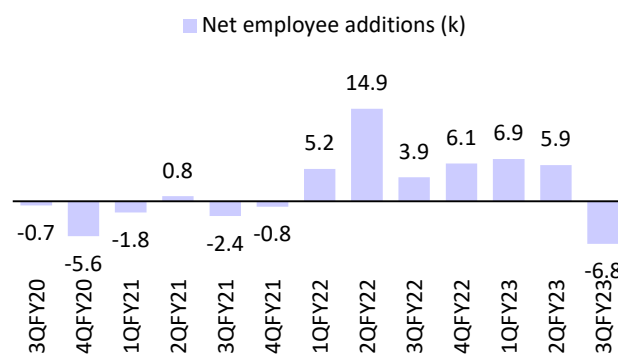
Source: Company, MOFSL

Exhibit 7: Utilization improves by 100bp in 3QFY23



Source: Company, MOFSL

Exhibit 8: Headcount declines meaningfully in 3QFY23



Source: Company, MOFSL

Exhibit 9: Operating metrics

	3QFY21	4QFY21	1QFY22	2QFY22	3QFY22	4QFY22	1QFY23	2QFY23	3QFY23
Revenue by Geography (%)									
Americas	46.8	45.5	46.7	47.8	48.9	48.3	49.6	50.8	49.7
Europe	26.4	26.5	27.2	25.9	25.5	26.4	25.5	24.5	24.4
Rest of the World	26.8	28.0	26.1	26.3	25.6	25.3	24.9	24.7	25.9
Client Metrics									
No. of active clients	997	1,007	1,058	1,123	1,191	1,224	1,262	1,279	1,262
As a percentage of repeat business	94.0	92.0	96.0	93.0	92.0	87.0	98.0	95.0	98.0
Number of clients (USD m)									
Over USD1m	454	451	466	488	502	524	549	562	549
Over USD5m	162	169	168	169	173	174	176	184	176
Over USD10m	83	85	86	90	96	97	104	108	104
Over USD20m	50	50	51	50	50	54	60	63	60
Over USD50m	21	21	22	22	22	23	23	23	23
Client concentration (%)									
Top five Clients	22.0	22.0	22.0	22.0	23.0	22.0	21.0	19.0	18.0
Top six to 10	9.0	9.0	9.0	9.0	8.0	9.0	9.0	9.0	9.0
Top 11-20	11.0	12.0	12.0	12.0	11.0	12.0	11.0	12.0	13.0
Headcount									
Software professionals	68,734	68,427	69,877	76,800	81,115	85,830	88,030	86,776	84,874
BPO	46,832	46,125	49,668	57,058	56,297	57,315	61,392	68,388	63,568
Sales and support	6,335	6,502	6,718	7,335	7,655	8,028	8,613	8,748	8,626
Total	1,21,901	1,21,054	1,26,263	1,41,193	1,45,067	1,51,173	1,58,035	1,63,912	1,57,068
IT Attrition (LTM %)	12	13	17	21	24	24	22	20	17
IT Utilization (%)	87	87	88	87	84	83	83	85	86
IT Utilization (excluding trainees)	87	87	89	89	86	84	83	85	86
DSO including unbilled	95	92	93	92	101	97	101	98	98
Borrowings (USD m)	262.0	232.0	218.0	206.0	210.0	209.0	220.0	207.0	212.0
Cash and Cash Equivalent (USD m)	1,625.0	1,781.0	1,818.0	1,626.0	1,346.0	1,140.7	1,114.0	947.0	780.0
Capital Expenditure (USD m)	16.0	20.0	22.0	23.0	26.0	46.0	20.0	19.0	31.0

Source: Company, MOFSL

Financials and valuations

Income Statement								(INR b)
Y/E March	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
Sales	308	347	369	379	446	536	591	647
Change (%)	5.6	12.9	6.1	2.7	17.9	20.0	10.4	9.4
COGS	215	234	260	259	310	382	418	452
SGA expenses	45	50	52	52	57	70	76	83
Total Expenses	261	284	311	310	366	453	494	535
EBITDA	47	63	57	68	80	83	97	112
As a percentage of Net Sales	15.3	18.2	15.5	18.1	18.0	15.5	16.4	17.3
Depreciation	11	11	14	15	15	20	21	23
Other Income	12	3	10	6	10	6	8	8
PBT	49	55	53	60	75	70	83	97
Tax	11	13	12	15	18	17	22	26
Rate (%)	22.4	22.6	22.0	25.3	24.4	24.7	26.5	26.5
PAT	38	43	41	45	56	52	61	72
Minority interest	0	0	-1	-1	1	1	1	1
Share from associates	0	0	0	0	0	0	0	0
PAT before EO	38	43	43	46	56	52	60	71
Change (%)	33.9	13.1	-1.1	7.2	22.1	-7.1	16.7	16.9
Extraordinary Items (EO)	0	0	-2	-1	0	0	0	0
Reported PAT	38	43	40	44	56	51	60	71
Change (%)	33.9	13.1	-6.2	9.8	25.7	-7.5	17.3	16.9

Balance Sheet								(INR b)
Y/E March	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
Share Capital	4	4	4	4	4	4	4	4
Reserves	184	198	214	244	264	278	295	314
Net Worth	188	203	218	249	269	283	299	318
Minority Interest	5	5	4	4	5	5	5	5
Loans	17	14	24	17	16	16	16	16
Other long-term liabilities	12	9	28	28	36	43	47	50
Amount pending invest.	12	12	12	12	12	12	12	12
Capital Employed	235	243	287	309	338	359	379	402
Applications								
Assets	79	73	89	91	149	141	137	134
Investments	15	12	2	6	4	4	4	4
Other non-current assets	30	33	50	47	50	60	66	73
Curr. Assets	181	216	232	253	245	283	314	344
Debtors	65	70	76	65	75	90	100	110
Cash and Bank Balance	20	20	30	27	38	30	27	27
Investments	75	98	57	98	46	71	96	121
Other Current Assets	22	28	68	63	86	92	90	86
Current Liab. and Prov.	70	91	87	88	111	131	142	154
Net Current Assets	111	124	145	165	134	153	171	190
Application of Funds	235	243	287	309	338	359	379	402

Financials and valuations

Ratios

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
Basic (INR)								
EPS	43.0	48.5	48.7	52.1	63.2	58.8	68.6	80.2
Diluted EPS	42.7	47.7	48.3	51.7	62.6	58.4	68.2	79.7
Cash EPS	54.8	60.3	62.3	66.7	79.7	80.4	92.3	106.0
Book Value	213.4	228.7	249.9	284.4	305.2	321.4	340.0	361.5
DPS	14.0	14.0	15.0	45.0	45.0	43.8	51.2	59.8
Payout (%)	32.8	29.3	31.0	87.1	71.9	75.0	75.0	75.0
Valuation (x)								
P/E ratio	24.1	21.4	21.3	19.9	16.4	17.6	15.1	12.9
Cash P/E ratio	18.9	17.2	16.6	15.5	13.0	12.9	11.2	9.8
EV/EBITDA ratio	19.3	14.4	15.7	13.1	11.1	10.8	9.3	8.0
EV/Sales ratio	3.0	2.6	2.4	2.4	2.0	1.7	1.5	1.4
Price/Book Value	4.9	4.5	4.1	3.6	3.4	3.2	3.0	2.9
Dividend Yield (%)	1.4	1.4	1.4	4.3	4.3	4.2	4.9	5.8
Profitability Ratios (%)								
RoE	21.5	22.0	20.2	19.5	21.5	18.8	20.8	22.9
RoCE	17.2	22.8	17.3	19.3	21.0	19.0	21.4	23.7
Turnover Ratios								
Debtors (Days)	77	73	75	62	61	61	62	62
Fixed Asset Turnover (x)	3.9	4.7	4.1	4.1	3.0	3.8	4.3	4.8
Leverage Ratio								
Debt/Equity Ratio (x)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0

Cash Flow Statement

(INR b)

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
CF from Operations	43	55	49	65	67	72	83	95
Change in Working Capital	-8	-11	-5	16	-14	-5	1	3
Net Operating CF	36	44	44	81	53	67	84	98
Net Purchase of FA	-8	-8	-8	-6	-8	-11	-17	-21
Free Cash Flow	28	37	35	75	45	56	68	77
Net Purchase of Invest.	-26	-13	19	-49	13	-25	-25	-25
Net Cash from Invest.	-34	-21	10	-55	5	-36	-42	-46
Inc./ (Dec.) in Equity	0	0	0	1	1	0	0	0
Proceeds from LTB/STB	6	-6	-20	-13	-8	0	0	0
Dividend Payments	-9	-17	-25	-18	-40	-39	-45	-53
Cash Flow from Fin.	-3	-23	-45	-30	-47	-39	-45	-53
Other adjustments	0	0	1	0	0	0	0	0
Net Cash Flow	0	1	10	-3	11	-8	-2	0
Opening Cash Balance	20	20	20	30	27	38	30	27
Add: Net Cash	0	1	10	-3	11	-8	-2	0
Closing Cash Balance	20	20	30	27	38	30	27	27

Explanation of Investment Rating	
Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

*In case the recommendation given by the Research Analyst is inconsistent with the investment rating legend for a continuous period of 30 days, the Research Analyst shall be within following 30 days take appropriate measures to make the recommendation consistent with the investment rating legend.

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