Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Tata Elxsi Ltd

Mixed Quarter, Upgrade to hold

IT & ITeS	Sharekhan code: TATAELXSI

Reco/View: Hold ↑	CMP: **Rs. 7,002**	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 Updated Mar 08, 2023	19.56

Low Risk

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

Source: Morningstar

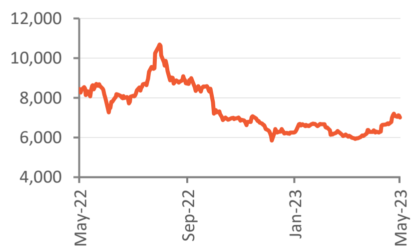
Company details

Market cap:	Rs. 43,605 cr
52-week high/low:	Rs. 10,760 / 5,708
NSE volume: (No of shares)	1.6 lakh
BSE code:	500408
NSE code:	TATAELXSI
Free float: (No of shares)	3.5 cr

Shareholding (%)

Promoters	44
FII	14
DII	4
Others	39

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	10.0	5.1	1.6	-17.0
Relative to Sensex	7.2	4.4	2.0	-30.3

Sharekhan Research, Bloomberg

Summary

- The company reported constant currency revenue growth of 1.6% q-o-q and 17.9% y-o-y, missing our estimates of 2.5% cc revenue growth due to muted sequential growth in Embedded Product Design (EPD) and Industrial Design & Visualization (IDV).
- EBITDA margin fell by ~40bps q-o-q to 29.8%, missing our estimates of 30.7% due to higher employee expenses. Net profit of Rs. 201.5 crore (up 3.5% q-o-q and 25.9% y-o-y) was 3.7% ahead of our estimates aided by higher other income.
- The company believes that growth in the transportation vertical over the years will continue in FY24. In the Media and Healthcare verticals, there are positive signs of growth returning, although it is still in the early stages. The emergence of 5G opportunities and deals further strengthens the management's belief that growth will pick up in the latter half of Q1 and Q2.
- We upgrade Tata Elxsi to Hold (from Reduce)with a revised PT of Rs7500 (increase in PT reflects rollover of PE multiple to FY25E EPS) as the upcoming IPO of group company Tata Technologies and healthy deal wins would support valuation. At the CMP the stock trades at 54.7/45.1x its FY24/25 E Eps.

Tata Elxsi reported constant currency revenue growth of 1.6% q-o-q and 17.9% y-o-y, missing our estimates of 2.5% cc revenue growth due to muted sequential growth in EDP and IDV. US Dollar revenue grew by 2.5% q-o-q/22.9% y-o-y to $101.9 million, which was below our estimates, despite cross-currency tailwinds. Among verticals, Transportation and Media & Communication clocked 1.7% q-o-q in cc terms while Healthcare & Medical devices grew 1.0% q-o-q in cc terms. Transportation growth at 27.4% y-o-y was aided by large deals and growth across customers in EV, Software Defined Vehicles (SDV) and adjacencies. EBITDA margin fell by ~40bps q-o-q to 29.8% missing our estimates of 30.7% due to higher employee expenses. Net profit of Rs. 201.5 crore (up 3.5% q-o-q and 25.9% y-o-y) was 3.7% ahead of our estimates aided by higher other income and lower finance cost. The company added 257 employees on a net basis in the quarter while attrition fell to 17.3%, down 110 bps q-o-q. The company believes that the growth demonstrated in the transportation vertical over the years will continue in the coming financial year. In the Media and Healthcare verticals, there are positive signs of growth returning, although it is still in the early stages. The emergence of 5G opportunities and deals further strengthens the management's belief that growth will pick up in the latter half of Q1 and Q2.We upgrade Tata Elxsi to Hold (from Reduce) with a revised PT of Rs. 7500 (increase in PT reflects rollover of PE multiple to FY25E EPS) as the upcoming IPO of group company Tata Technologies and healthy deal wins would support valuation. At the CMP the stock trades at 54.7/45.1x its FY24/25 E Eps.

Key positives

- Attrition rate eased by 110 bps q-o-q to 17.3% from 18.4%
- Net additions improved by 257 taking the total headcount to 11864.
- System Integration & Support (SIS) witnessed recorded strong growth of 7.8% q-o-q in cc

Key negatives

- EBITDA margins fell by ~40bps q-o-q to 29.8%, missing our estimates of 30.7%
- Industrial Design & Visualization witnessed muted growth of 0.5% q-o-q in cc

Management Commentary

- The company believes that the growth demonstrated in the transportation vertical over the years will continue in the coming financial year. In the Media and Healthcare verticals, there are positive signs of growth returning, although it is still in the early stages. The emergence of 5G opportunities and deals further strengthens the management's belief that growth will pick up in the latter half of Q1 and Q2.
- The company is focused on building a strong deal pipeline and anticipates an increase in large deal conversions in the current quarter and beyond. They have experienced significant growth in their key accounts, increasing their wallet share compared to competitors.

Revision in estimates – We have fine-tuned our estimates for FY2024/FY2025 owing to macro overhang.

Our Call

Valuation – Mixed Quarter, Upgrade to Hold: Tata Elxsi is well-positioned to capture opportunities in Automotive and other verticals on account of their deep domain knowledge, scale, and expertise in software development and digital technologies like AI and IoT. We expect a ~18%/13% Sales and PAT CAGR respectively over FY23- 25E. We upgrade Tata Elxsi to Hold (from Reduce)with a revised PT of Rs. 7500 (increase in PT reflects rollover of PE multiple to FY25E EPS) as the upcoming IPO of group company Tata Technologies and healthy deal wins would support valuation. At CMP, the stock trades at 54.7/45.1x its FY24/25 E Eps.

Key Risks

Rupee appreciation and/or adverse cross-currency movements. Contagion impact of banking crisis, macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

Valuation Rs cr

Particulars	FY22	FY23	FY24E	FY25E
Total Revenue	2,470.8	3,144.7	3,607.5	4,390.9
EBITDA margin %	31.0	30.6	30.0	30.0
Adjusted Net Profit	549.7	755.3	797.4	966.9
% YoY growth	49.3	37.4	5.6	21.3
EPS (Rs.)	88.3	121.3	128.0	155.3
PER (x)	79.3	57.7	54.7	45.1
P/BV (x)	27.2	20.9	16.8	13.3
EV/EBITDA	55.7	44.2	38.6	31.3
ROE (%)	34.3	36.2	30.6	29.4
ROCE (%)	38.2	42.0	35.3	34.2

Source: Company; Sharekhan estimates

Key earnings call highlights

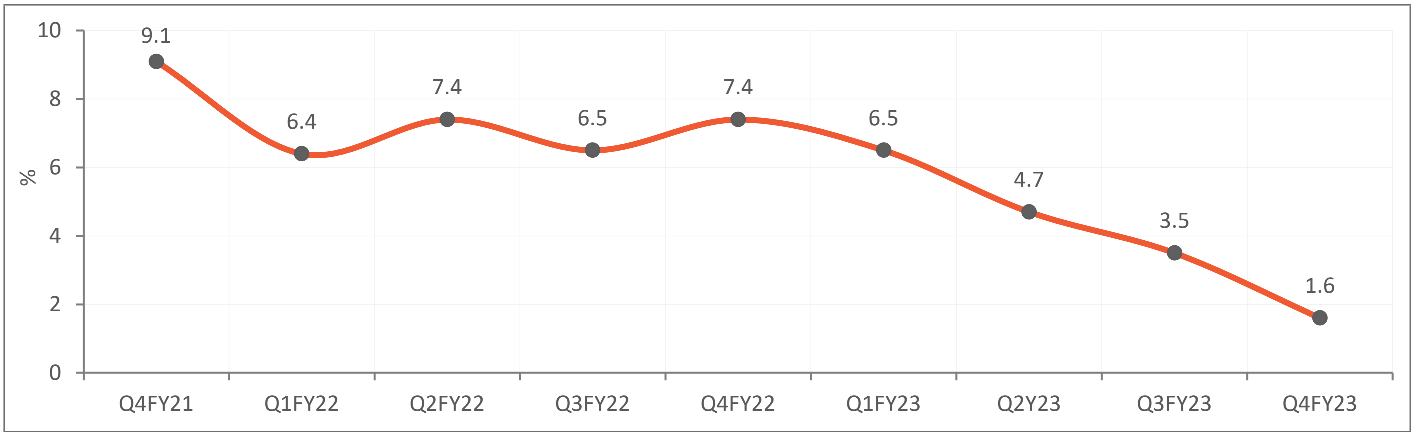
- **Growth across verticals:** Among verticals, Transportation and Media & Communication clocked 1.7% q-o-q in cc terms while Healthcare & Medical devices grew 1.0% q-o-q in cc terms. Transportation growth of 27.4% y-o-y was aided by large deals and growth across customers in EV, Software Defined Vehicles (SDV) and adjacencies while Healthcare growth at 20.5% y-o-y was driven by new product engineering, digital health and regulatory services. Media and Communications grew 9.2% y-o-y in a challenging quarter, aided by platform-led deals and increased wallet share in key accounts.
- **Growth across Geographies and Top clients:** Europe and India grew strongly by 4.6% and 9.2%, q-o-q respectively which was offset by degrowth in US and RoW by 1.1% and 5.9% q-o-q. For Q4FY23, Top 5 and Top 10 clients grew 5.9% and 5.2%, respectively.
- **Growth Strategy:** The company is focused on building a strong deal pipeline and anticipates an increase in large deal conversions in the current quarter and beyond. They have experienced significant growth in their key accounts, increasing their wallet share compared to competitors. The company believes there are many opportunities in the automotive and transportation business and highlighted the need for the industry to undergo a transformative process driven by regulatory sustainability, evolving customer preferences, and changes in business models.
- **Margins:** EBITDA margins fell by ~40bps q-o-q to 29.8%, missing our estimates of 30.7% due to higher employee expenses. This can be attributed to factors such as campus onboarding and ongoing investments in subject matter experts and sales team expansion across locations. Despite the lower EBIT margin, the company achieved a higher profit before tax (PBT) margin of 29% compared to 28.7% in the previous quarter. This improvement was primarily due to higher other income, including interest income, R&D credits, and exchange gains from onsite businesses. Therefore, at the PBT level, the company delivered stronger growth and improved margins.
- **Hiring & attrition:** Company added 257 employees taking the total headcount to 11,864. In this financial year, the company plans to hire approximately 2,000 - 2,200 new employees. The company stated that around 1,800 will be fresh graduates, while the remaining 450 to 500 will be experienced hires. The hiring plan reflects the company's growth goals and expansion objectives.
- **Offshore onsite revenue mix:** Offshore mix further deteriorated to 74.5% from 75.4% in Q3FY23.The management stated the movement of employees between onsite and offshore locations may vary based on project completion in each quarter. However, the level of movement from quarter to quarter is insignificant.
- **Tata Technologies IPO:** Tata Technologies is a group company focusing on areas such as mechanical engineering, PLM, ERP, and specific verticals like automotive, aerospace, and industrial sectors. On the other hand, Tata Elxsi specializes in embedded engineering, hardware and software, and design services. Their service offerings are distinct and orthogonal to each other. The management does not anticipate any impact on their business from Tata Technologies' operations.

Results Rs cr

Particulars	Q4FY23	Q4FY22	Q3FY23	YoY (%)	QoQ (%)
Revenues in USD (mn)	**101.9**	**90.5**	**99.7**	**12.6**	**2.2**
Net sales	**837.9**	**681.7**	**817.7**	**22.9**	**2.5**
Employee expenses	429.2	344.8	410.7	24.5	4.5
Total purchases	55.8	33.9	49.2	64.8	13.6
Other expenses	103.1	81.8	111.0	26.0	-7.1
EBITDA	**249.7**	**221.2**	**246.9**	**12.9**	**1.2**
Depreciation	21.1	15.9	21.4	32.7	-1.6
EBIT	**228.6**	**205.4**	**225.4**	**11.3**	**1.4**
Other income	25.7	18.1	19.1	42.0	34.2
Finance cost	4.1	3.2	4.5	29.2	-7.8
PBT	**250.2**	**220.3**	**240.1**	**13.6**	**4.2**
Total tax	48.7	60.3	45.4	-19.2	7.2
Net profit	**201.5**	**160.0**	**194.7**	**25.9**	**3.5**
EPS (Rs)	32.4	25.7	31.3	26.0	3.5
Margin (%)			**BPS**		**BPS**
EBITDA	29.8	32.5	30.2	-265	-38
EBIT	27.3	30.1	27.6	-284	-28
NPM	24.0	23.5	23.8	58	24
Tax rate	19.5	27.4	18.9	-789	55

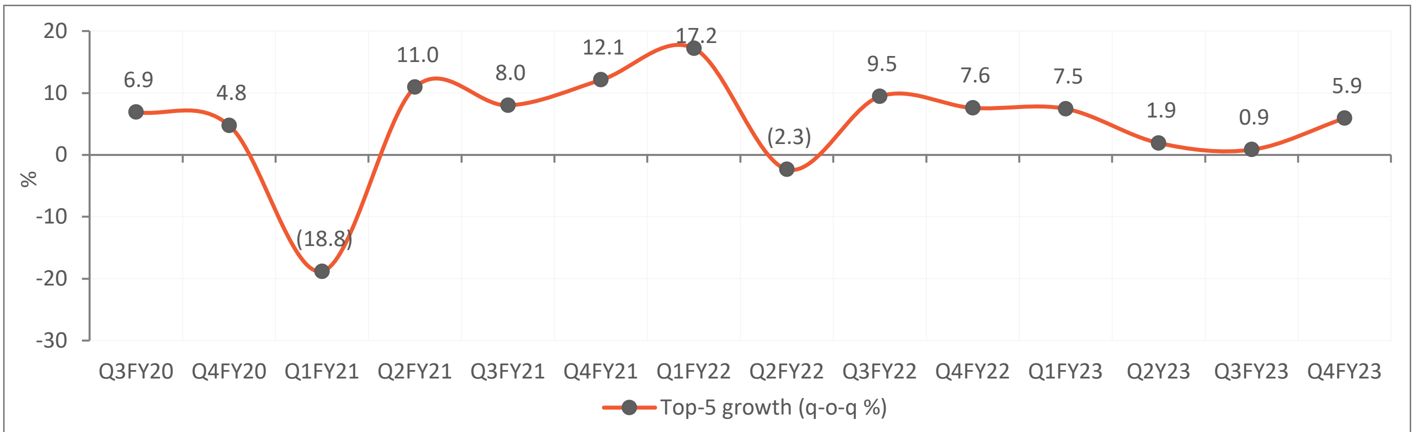
Source: Company; Sharekhan Research

CC revenue growth trend (q-o-q)



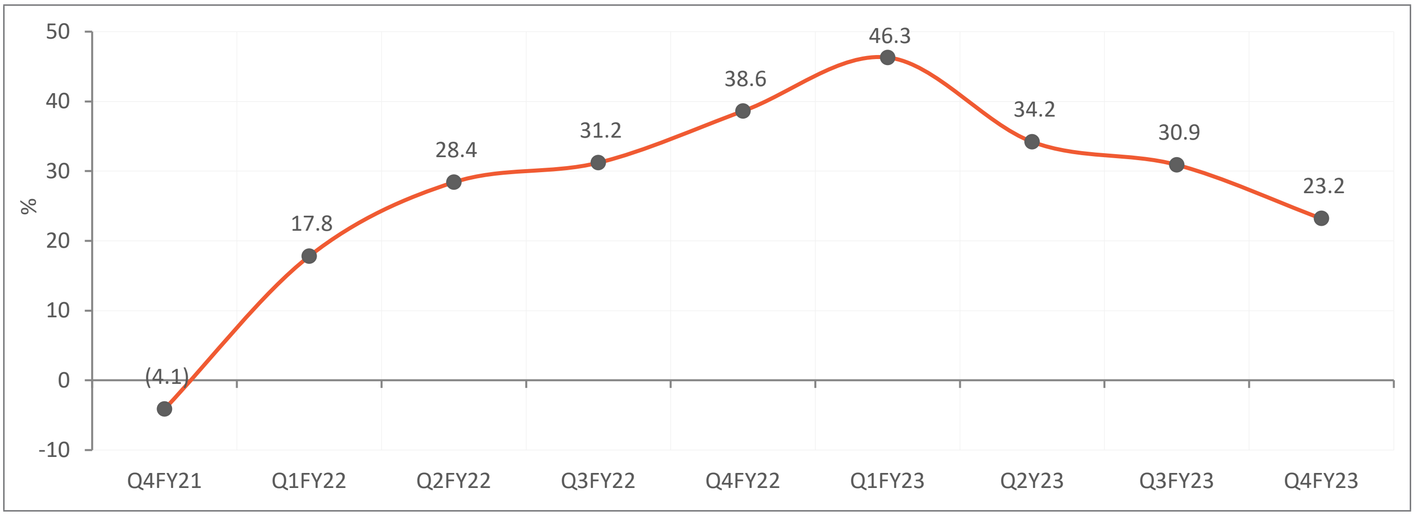
Source: Sharekhan Research

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



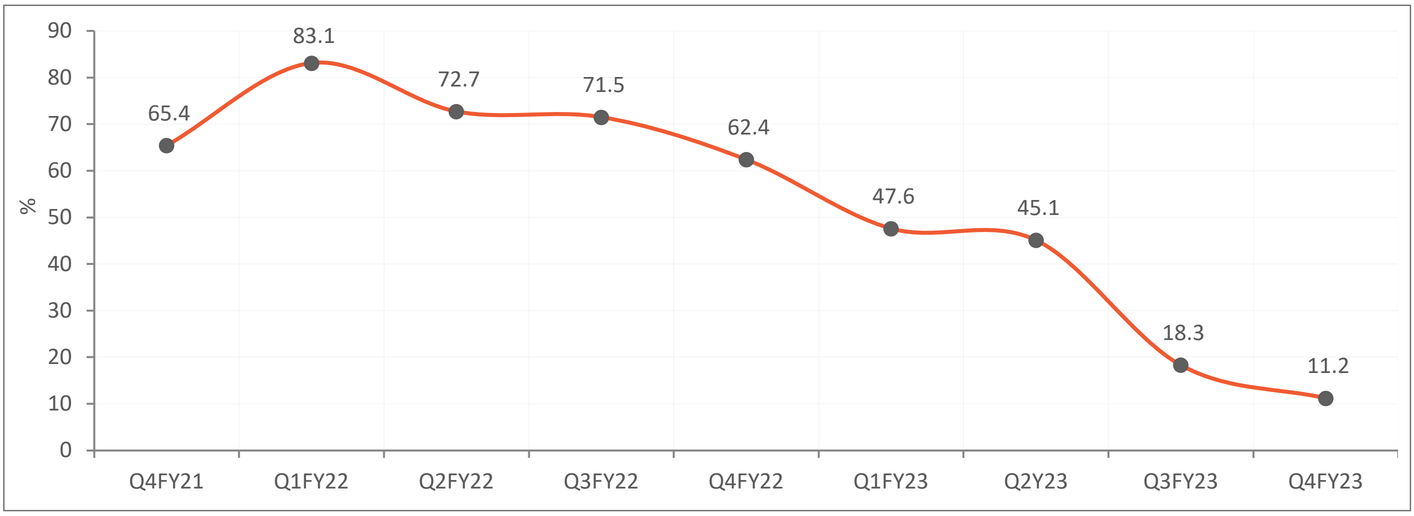
Source: Sharekhan Research

Transportation vertical growth trend (q-o-q)



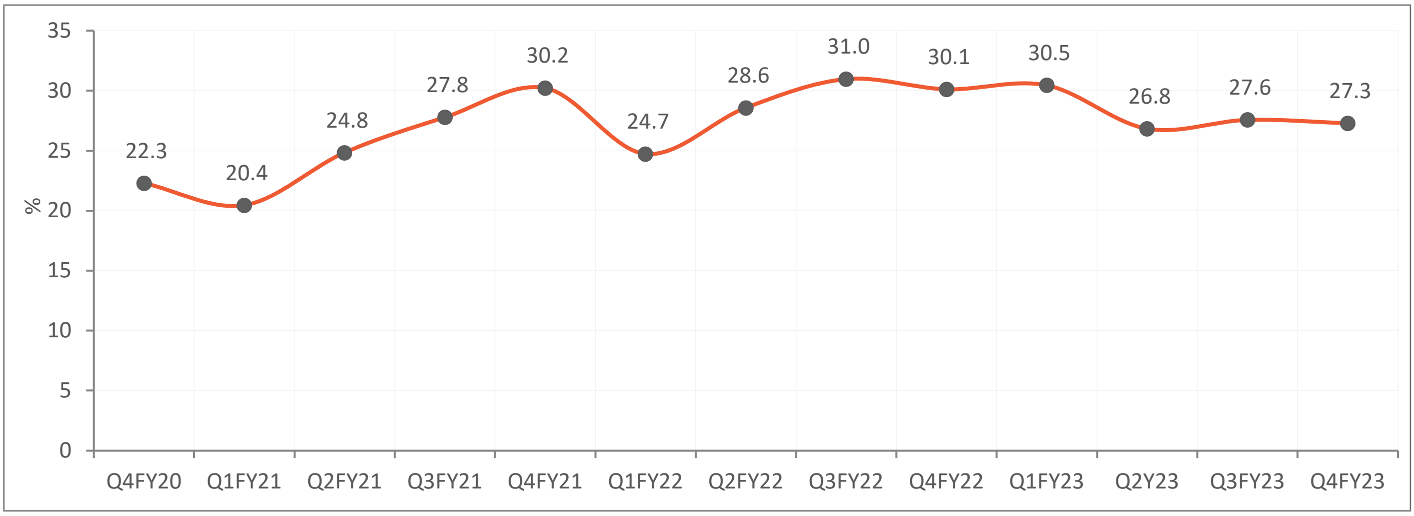
Source: Sharekhan Research

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



Source: Sharekhan Research

EBIT margin trend



Source: 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.

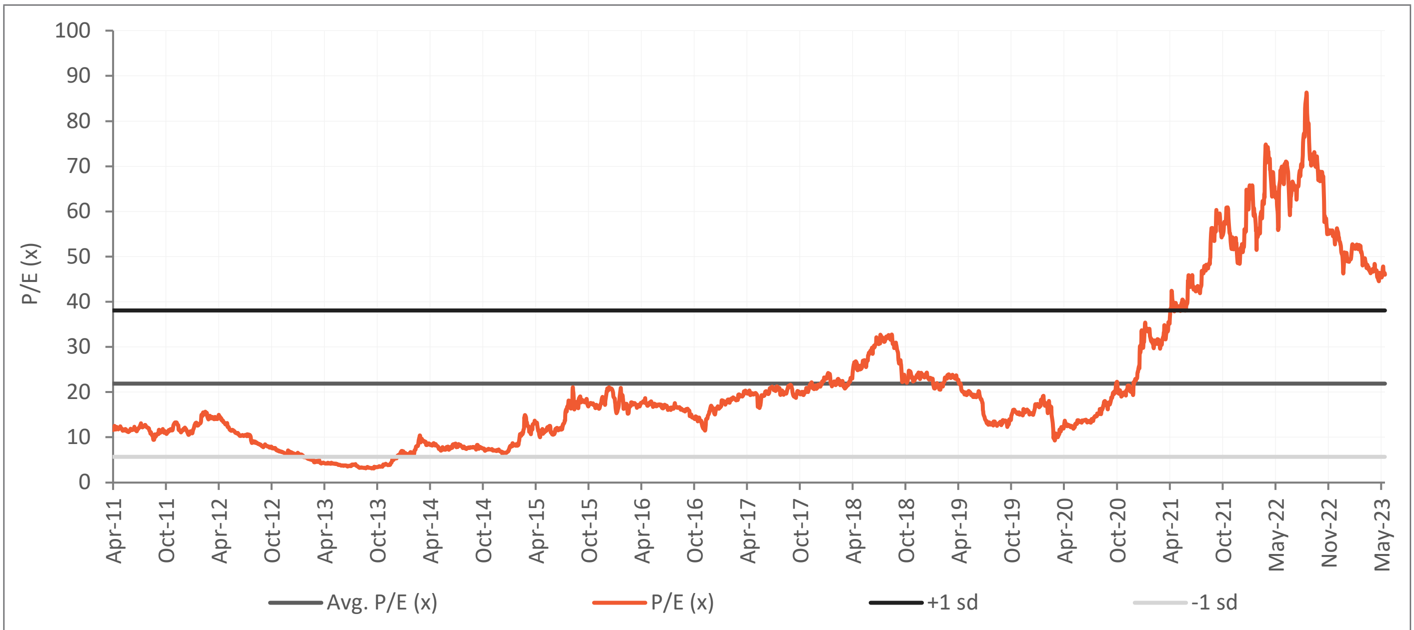
■ Company Outlook – Growth prospects promising

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 – Mixed Quarter, Upgrade to Hold

Tata Elxsi is well-positioned to capture opportunities in Automotive and other verticals on account of their deep domain knowledge, scale, and expertise in software development and digital technologies like AI and IoT. We expect a ~18%/13% Sales and PAT CAGR respectively over FY23- 25E. We upgrade Tata Elxsi to Hold (from Reduce) with a revised PT of Rs. 7500 (increase in PT reflects rollover of PE multiple to FY25E EPS) as the upcoming IPO of group company Tata Technologies and healthy deal wins would support valuation. At CMP, the stock trades at 54.7/45.1x its FY24/25 E Eps.

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

1) Rupee appreciation and/or adverse cross-currency movements, and 3) Contagion effect of banking crisis, macro headwinds and possible recession in the US are likely to moderate the pace of technology 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: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Vanguard Group Inc	2.21
2	BlackRock Inc	1.85
3	Tata Investment Corp Ltd	1.69
4	Axis Asset Management Co Ltd	1.33
5	Norges Bank	0.47
6	Dimensional Fund Advisors LP	0.2
7	FMR LLC	0.2
8	Northern Trust Corp	0.16
9	Credit Agricole Group	0.16
10	UBS AG	0.15

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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