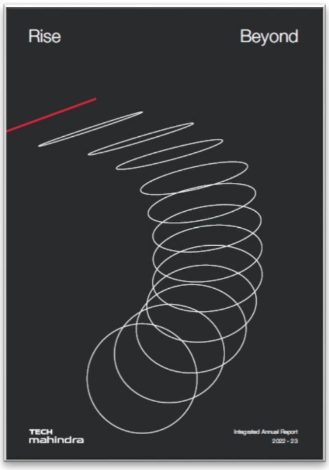
MOTILAL OSWAL
FINANCIAL SERVICES

10 July 2023
Annual Report Update | Sector: Technology

Tech Mahindra

BSE SENSEX	S&P CNX
65,280	19,332



Stock Info

Bloomberg	TECHM IN
Equity Shares (m)	919
M.Cap.(INRb)/(USDb)	1126 / 13.6
52-Week Range (INR)	1185 / 935
1, 6, 12 Rel. Per (%)	2/9/-7
12M Avg Val (INR M)	2988
Free float (%)	64.8

Financials Snapshot (INR b)

Y/E Mar	2023	2024E	2025E
Sales	533	552	608
EBIT Margin (%)	11.4	11.5	12.9
Adj. PAT	50.7	50.0	61.4
Adj. EPS (INR)	57.3	56.5	69.4
PAT	48.3	50.0	61.4
EPS (INR)	54.6	56.5	69.4
EPS Gr. (%)	(12.8)	3.5	22.8
BV/Sh. (INR)	317.3	326.7	338.0
Ratios			
RoE (%)	18.5	17.7	21.0
RoCE (%)	18.6	19.0	22.8
Payout (%)	87.3	85.0	85.0
Valuations			
P/E (x)	20.1	20.4	16.6
P/BV (x)	3.6	3.5	3.4
EV/EBITDA (x)	12.4	12.1	10.1
Div Yield (%)	4.3	4.1	5.1

CMP: INR1,158 TP: INR1,110 (-4%) Neutral

Balacing growth but at the cost of margins

- Tech Mahindra's (TECHM) FY23 annual report highlights that the inflationary environment has led to a massive shift in tech spending by enterprises. The spending is now finding its way through conserving resources and optimizing costs.
- Enterprises continue to accelerate the adoption of new-age technologies to drive innovation and enable a new operating model for making it consumer-centric and agile.
- For 5G technology, which is still emerging and relatively new, TECHM has established a leadership team in the space, and its 5G-related revenue crossed USD1b in FY23.
- In FY23, TECHM reported new deal TCV of USD2.9b (book-to-bill of 0.4x), with a major proportion of digital transformation projects. Given a delay in decision-making amid adverse macros, the conversion remains a challenge in the near-to-medium term.

FY23 growth aided by BPO

- In FY23, USD revenue grew 10.1% YoY, driven by the Enterprise business (+10.9% YoY). Within enterprise, growth was aided by Technology (+25.3%) and Retail (+11.9%).
- Revenue growth in the Communication, Media and Entertainment (CME) vertical (~40% of revenue) at 9% YoY was below consolidated revenue growth, due to structural weakness in the segment and deferral in 5G spending.
- In service lines, IT Services growth (~87% of revenue) was relatively weak at 8.6% YoY, while the BPO business (~13% of revenue) posted 22% YoY growth vs. 43% in FY22.
- Geography-wise, the Americas (~50% of revenue) outpaced other regions with 14.6% YoY growth, while Europe and ROW reported 4.7% and 7.4% YoY, respectively, in FY23.

Margins declined for both service lines

- TECHM reported adj. operating margin of 11.3% in FY23, down 320bp YoY. The margin contraction was mainly due to: 1) robust hiring in H1, added 12.7k employees, 2) intense compensation revision, and 3) elevated subcon % of revenue at 15%.
- Among segments, IT Services EBITDA margin stood at 14.7% in FY23 vs. 17.7% in FY22. Margin in the BPO segment stood at 17.5% in FY23 vs. 19.9% in FY22.
- Subcontractors' percentage of revenue was 15% (down 60bp YoY). Subcontract expenses are expected to moderate gradually as more employees become part of the billing cycle.

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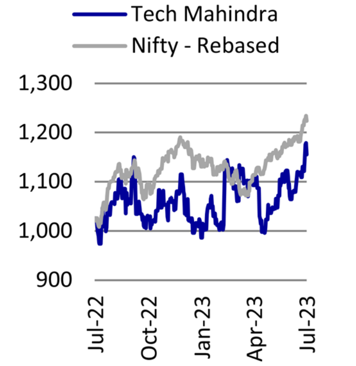
Shareholding pattern (%)

As On	Mar-23	Dec-22	Mar-22
Promoter	35.2	35.2	35.3
DII	26.0	24.1	18.2
FII	26.9	28.0	34.3
Others	11.9	12.7	12.3

FII Includes depository receipts

Stock Performance (1-year)



Cash conversion was strong, although profitability took a hit

- TECHM's cash conversion remained strong, while pre-tax OCF/EBITDA came in at 89% and FCF/PAT stood at 95% in FY23.
- The company generated ROE/ROCE of 18.5%/18.6% in FY23 vs. 21.5%/21% in FY22.
- The payout ratio stood at 87% in FY23, in line with its capital allocation policy.
- FY23 net cash & cash equivalents stood at INR61b, translating into 6% of market cap.

Near-term strategic priorities

- **Identify new growth drivers**
  - Encourage digital transformation within established verticals such as BPS and operate them in a machine-first way
  - Focusing on collaborations and partnerships with Hyperscalers, data services, and 5G enablement, especially to integrate human-centric experiences
- **Driving operational excellence**
  - Developing platforms and designing processes to drive better cohesion of ideas, input and collaboration within the team for execution
  - Enhancing our talent retention and fulfillment through up-skilling
- **Big bets on technology**
  - Investing key resources in R&D of advanced technologies such as Blockchain, IoT, Metaverse, and Quantum
  - TECHM has integrated analytics with its top 600 accounts to get a better understanding of their immediate requirements and execute faster
- **Enhancement of organizational culture**
  - Creating avenues for employees to put in meaningful work, backed by personalized career paths
- **Mergers & acquisitions:**
  - Prioritized the creation of synergistic work environments and aligning organizational culture internally
  - Pressing pause on new M&A given the volatility in the market.

ESG metrics

- Recycled and reused 200m litres of water
- Installed 5,600 water restrictors to reduce the flow of water, leading to a reduction of 30% in water consumption
- Total energy consumption: 411,239.80 GJ
- INR1,237m spending on CSR and 57,515 hours of volunteering by 6,538 employees.

Valuation and view: Growing in double digits but margins disappoint

- IT Services business growth was impaired by softness in discretionary spending and structural weakness in the CME vertical. However, TECHM's high exposure to the CME vertical (~40% of revenue) offers a significant opportunity for a broader 5G rollout and a new spending cycle in this space.
- Considering the near-term weakness, we await greater comfort on sustainable and profitable growth. We value the stock at 16x FY25E EPS. **We maintain our Neutral rating.**

Courtesy enterprise business, CME yet to playout

TECHM reported USD revenue growth of 10.1% YoY in FY23. Its IT Services business clocked weak growth (+8.6% YoY), while BPO business grew 21.6% YoY in FY23. The Enterprise business (10.9% YoY) contributed ~60% to total revenue, outpacing CME growth (9.0% YoY) in FY23. Enterprise growth was majorly aided by Technology and Retail verticals, while BFSI growth was weak at 8.9% YoY in FY23. In 5G (part of CME), the company has made early investments in forging partnerships with CSP, Telcos and Hyperscalers; however, the current environment is impairing growth and making it difficult to capitalize on earlier investments. FY23 new deal TCV remained strong at USD2.9b (0.44x BTB), with a healthy mix of digital transformation projects, but the conversion remains a challenge in the near term. On the margin front, the company reported a sharp 320bp YoY contraction in adj. operating margin to 11.3%, due to robust H1 hiring and intensive wage hikes. Overall, the near-term revenue outlook remains weak, but it aspires to reclaim the 14% mark in operating margin.

"Growing enthusiasm among enterprises to invest in innovation and future-ready solutions. We are better positioned than ever before to serve these enterprises with a range of holistic offerings such as generative AI, Metaverse, 5G and Cloud."

- C.P. Gurnani
CEO and MD

Going forward, enterprises would continue to spend and adopt new technologies to reshape their value proposition and gain competitive edge. The company believes that for enterprises to stay relevant in the next decade, it will require massive investments in secure AI technologies.

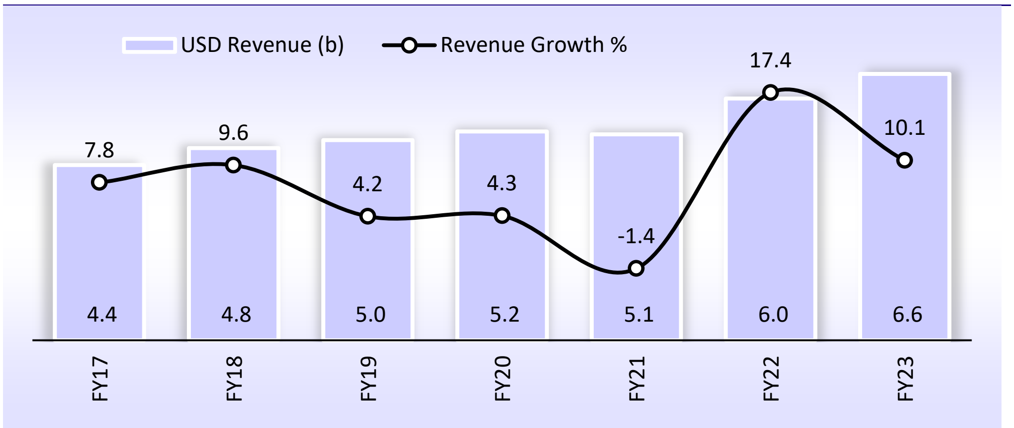
With its NXT.NOW framework, the company is leveraging next-gen technologies to deliver disruptive solutions and enable digital transformation in key technologies like 5G, Cloud, AI, Web3.0, Digital Engineering, Customer Experience (CX) and Sustainability.

"Our people initiatives stressed on unleashing the potential of 152,000+ associates, growing their skill quotient and building a workplace where they truly belong."

- Anand G. Mahindra
Chairman

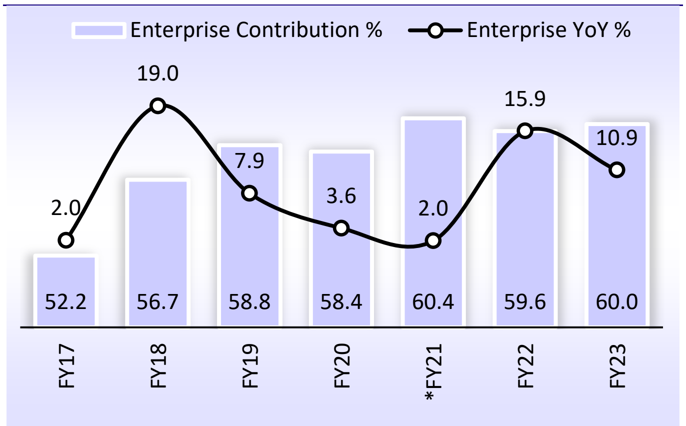
IT Service business growth was weak at 8.6% YoY, BPO business continued its growth momentum in FY23 with 21.6% growth

Exhibit 1: USD revenue and growth %



Source: MOSL, Company

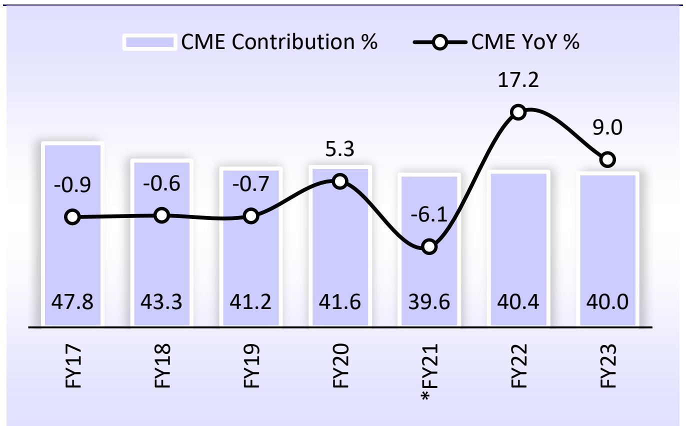
Exhibit 2: Enterprise growth (USD) moderated a bit



***Reclassification post FY21**

Source: MOSL, Company

Exhibit 3: CME growth (USD) decelerated sharply



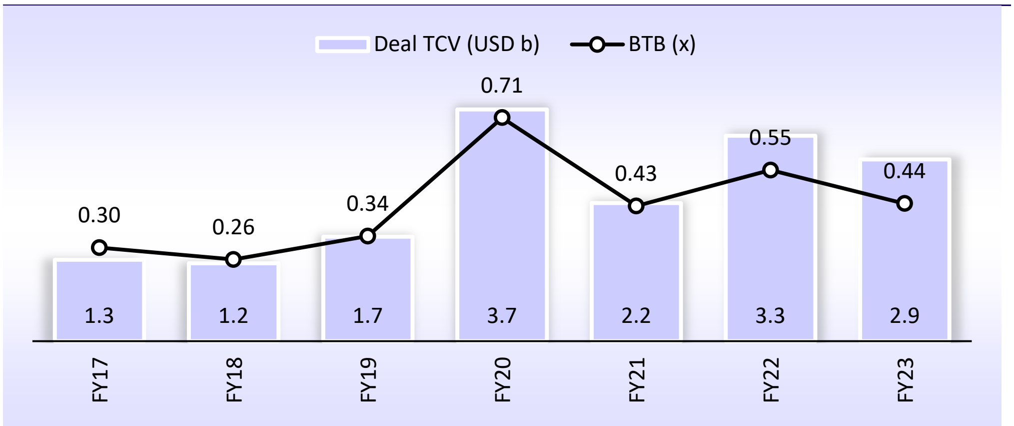
***Reclassification post FY21**

Source: MOSL, Company

Managed to expand deal sizes and acquire new and elite clientele; TECHM has 1,297 active clients

New deal TCV has major component of digital transformation projects

Exhibit 4: Impressive large deal TCV, but conversion remains a challenge



Source: MOFSL, Company

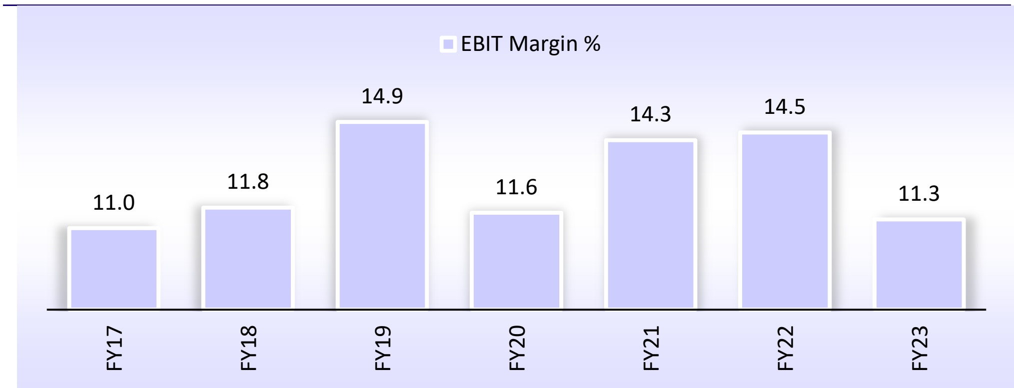
Disappointed on margins

EBITDA margin in BPO business declined by 240bp YoY despite revenue growth of 21.6% YoY

TECHM incurred one-off expense of INR2.1b in Q4 (impairment cost). Reported EBIT margin at 9.6%

- Adjusted EBIT margin sharply declined by 320bp to 11.3% in FY23 due to robust net hiring in H1 (12.7k) and intensive wage hikes, while corresponding revenue growth was missing.
- The majority of the H1 talent hiring was for the BPO business (+11k), which witnessed a sharp decline in net hiring by +8.2k in H2. Meanwhile, the IT business saw a decline in net hiring by 2k+ in FY23.
- Among segments, IT Services EBITDA margin stood at 14.7% in FY23 vs. 17.7% in FY22. BPO segment margin stood at 17.5% in FY23 vs. 19.9% in FY22.
- Subcontractor expenses witnessed a slight moderation from the peak (FY22) by 50bp YoY to 15.0%. Expenses are expected to moderate further as supply-side challenges are easing with attrition cooling off sharply.

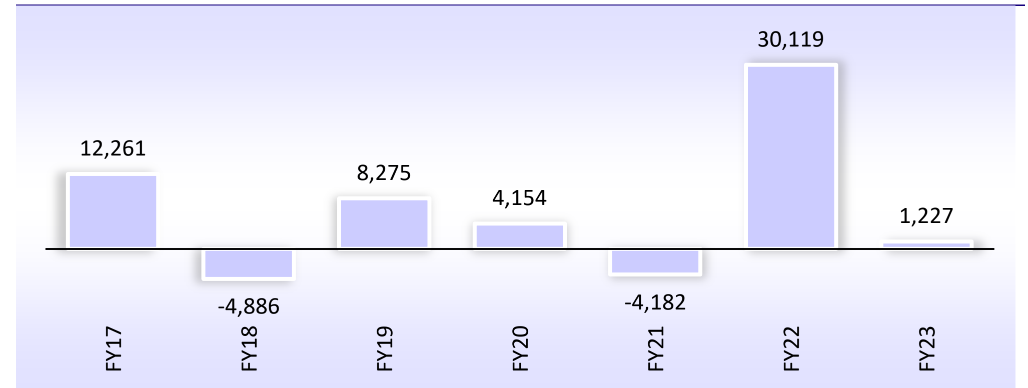
Exhibit 5: Incremental hiring kept EBIT margin under pressure



Source: MOFSL, Company

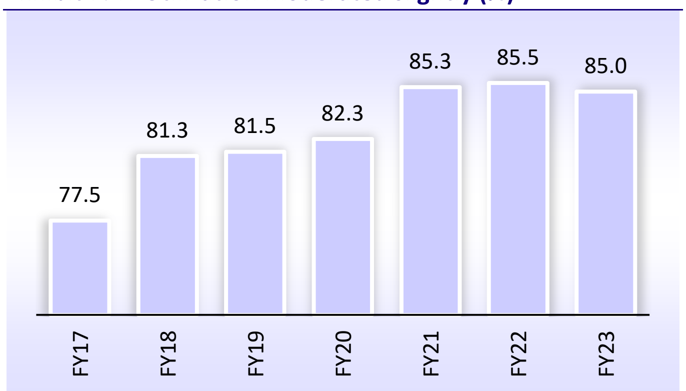
Exhibit 6: Net headcount saw a sharp decline in 2HFY23 by +11k

Net new deal TCV was impressive at USD2.9b; however, the employee headcount in IT services declined by +2k in FY23



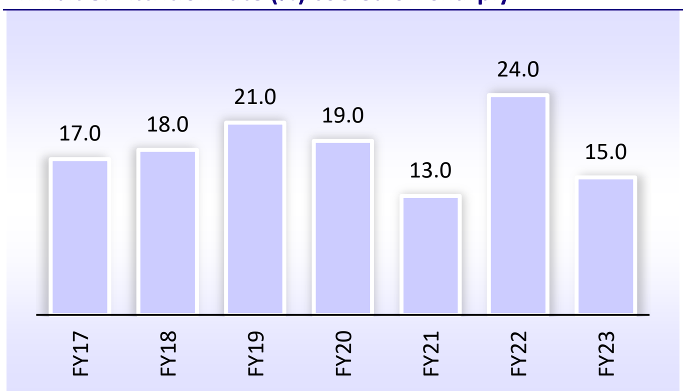
Source: MOFSL, Company

Exhibit 7: IT Utilization moderated slightly (%)



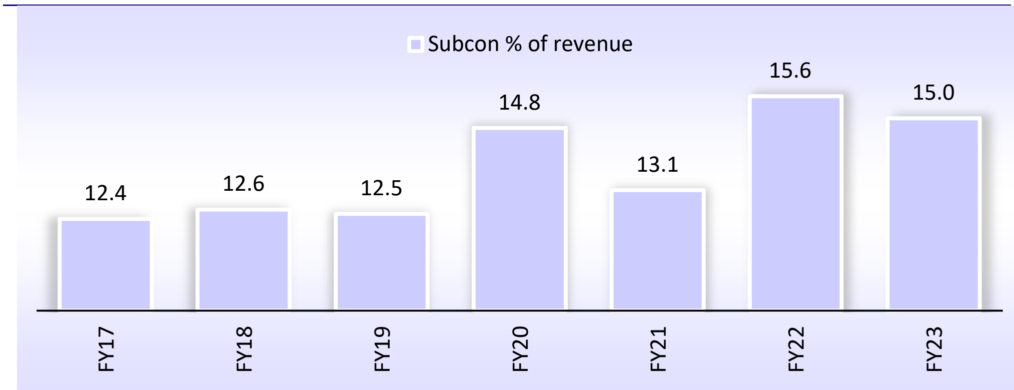
Source: MOFSL, Company

Exhibit 8: Attrition rate (%) cooled off sharply



Source: MOFSL, Company

Exhibit 9: Subcon expenses remain elevated at 15%



Source: MOFSL, Company

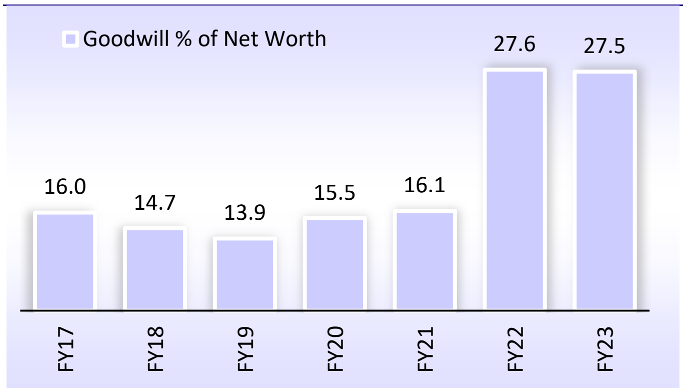
Margin outlook

- With rigorous efforts in hiring talent and optimizing bench, the company has been able to increase its internal fulfillment to 71% from 48% earlier.
- The focus is on growing the high-margin business and pruning low-quality revenue.
- The company aspires to reclaim the 14% mark in operating margin.

Robust return profile

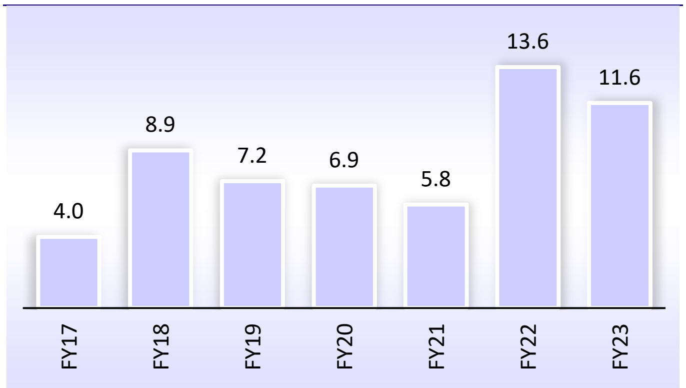
- The payout ratio stood at 87% in FY23, in line with its capital allocation policy.
- However, the return profile has moderated due to a decline in net income (down 13.2% YoY) in FY23. ROE/ROCE stood at 18.5%/18.6% in FY23 vs. 21.5%/21.0% in FY22.
- Goodwill as a % of net worth was stable at 27.5%, while intangible assets % of net worth declined 200bp YoY.

Exhibit 10: Share of Goodwill as a % of net worth



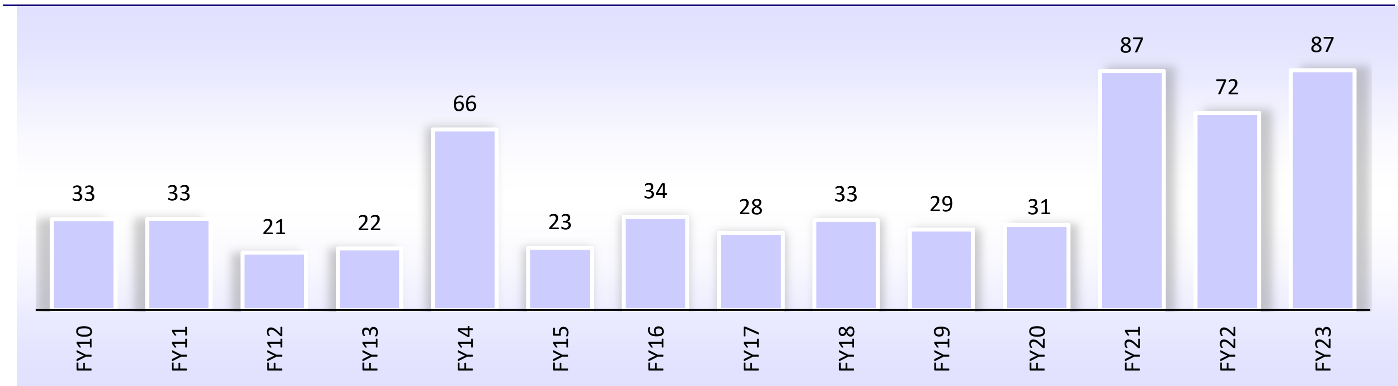
Source: Company, MOFSL

Exhibit 11: Share of intangible assets as a % of net worth



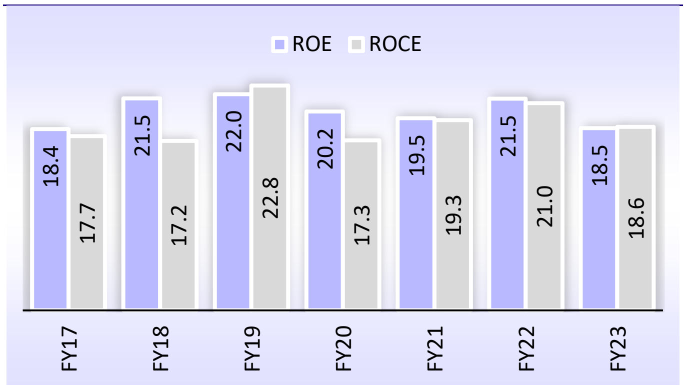
Source: Company, MOFSL

Exhibit 12: Payout (dividend + buyback, %)



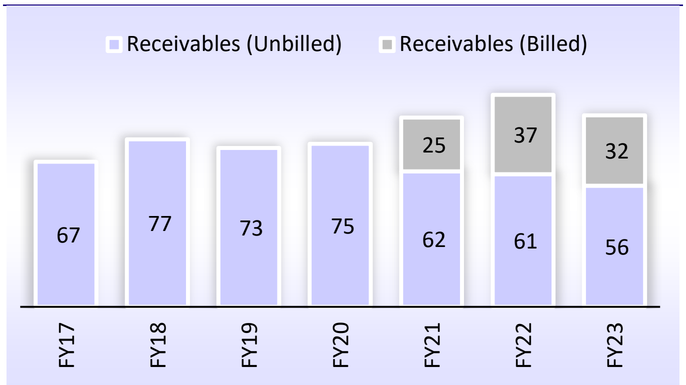
Source: MOFSL, Company

Exhibit 13: Lower profitability (%) due to a decline in PAT



Source: MOFSL, Company

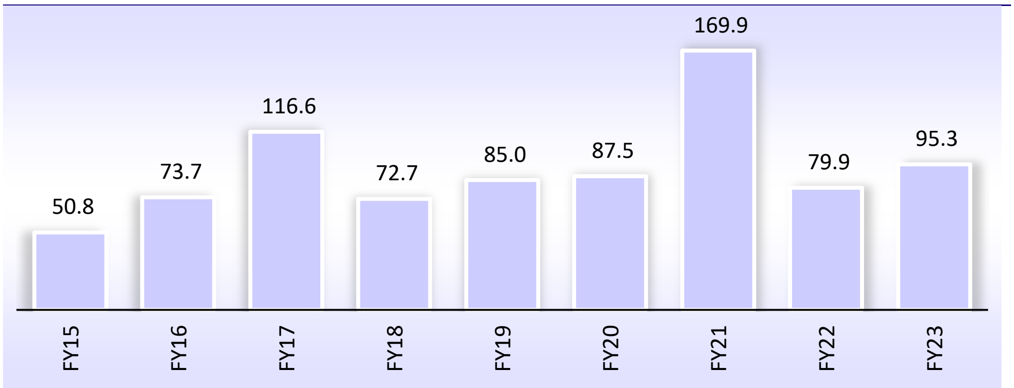
Exhibit 14: Billed & Unbilled days improved in FY23



Source: MOFSL, Company

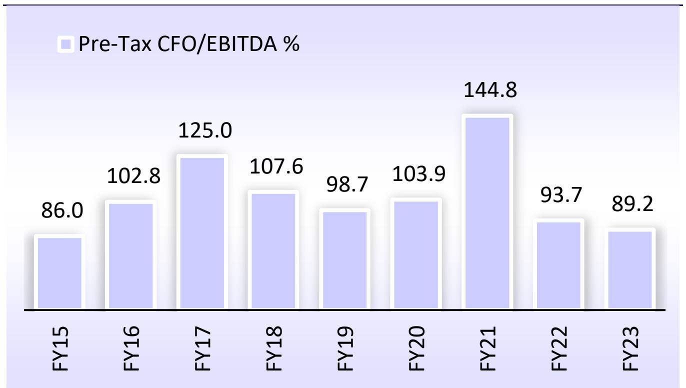
Cash conversion remained stable. Pre-tax OCF/EBITDA came in at 89%, while FCF/PAT improved to 95% in FY23 from 80% in FY22.

Exhibit 15: Payout as a % of FCF



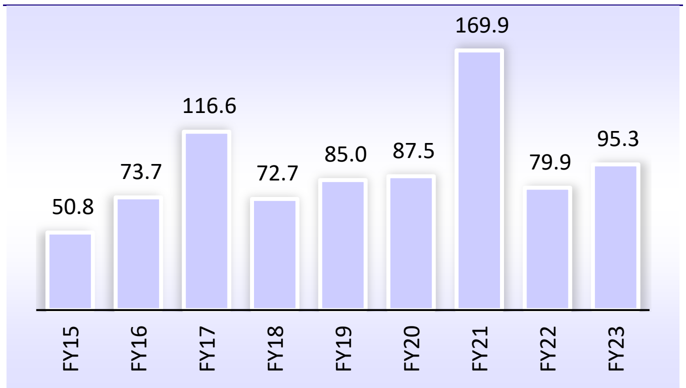
Source: MOFSL, Company

Exhibit 16: Pre-tax OCF/EBITDA (%) and…



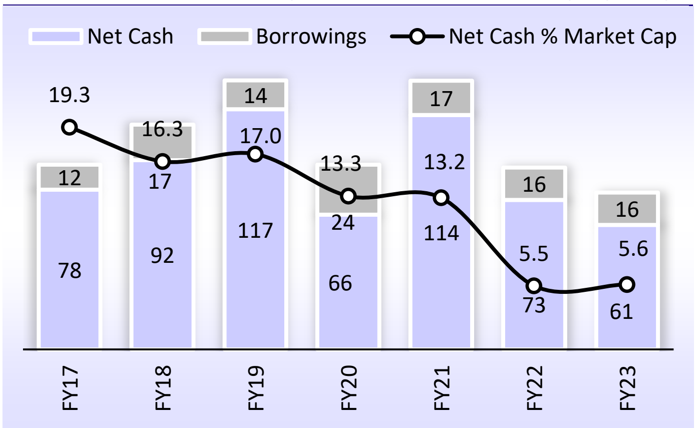
Source: MOFSL, Company

Exhibit 17: …FCF/PAT (%) remained strong



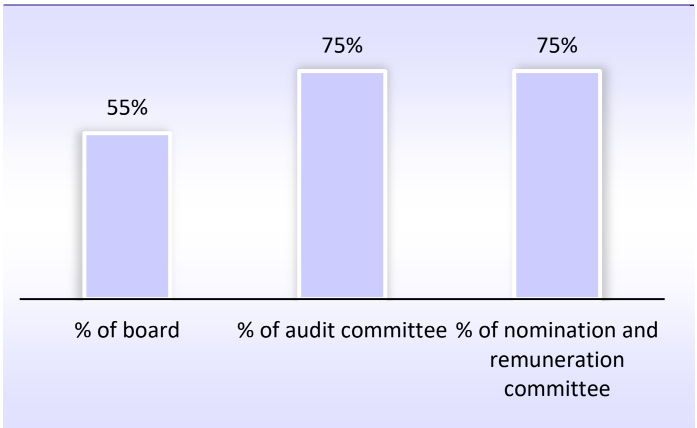
Source: MOFSL, Company

Exhibit 18: Cash & Cash Equivalent (INR b) – healthy liquidity



Source: Company, MOFSL

Exhibit 19: Independent Directors as a % of Board/Audit/Remuneration committees



Source: Company, MOFSL

Exhibit 20: Management remunerations

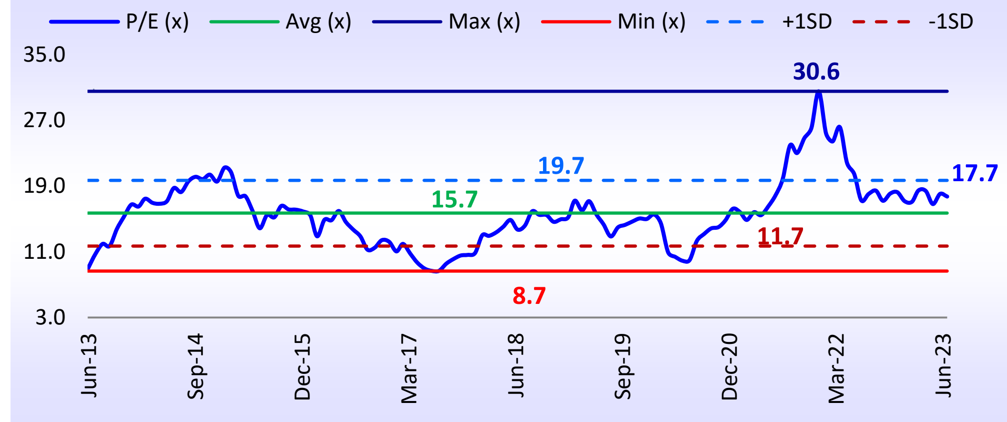
(INR m)	FY17	FY18	FY19	FY20	FY21	FY22	FY23
CEO	181	277	449	332	219	634	320
CFO	18	12	20	44	38	26	33
Total	**199**	**289**	**469**	**376**	**257**	**660**	**353**
Mgmt. remuneration as a % of PAT	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**

Source: Company, MOFSL

Managed to grow double-digit, but disappointed on margins

- Growth in the IT Service business was impaired by softness in discretionary spending and structural weakness in the CME vertical. However, TECHM's high exposure to the CME vertical (~40% of revenue) offers a significant opportunity for a broader 5G rollout and new spending cycle in this space.
- Considering the near-term weakness, we await greater comfort on sustainable and profitable growth. We value the stock at 16x FY25E EPS. **We maintain our Neutral rating.**

Exhibit 21: P/E chart 1-year forward – TECHM



Source: Company, MOFSL

Financials and valuations

Income Statement								(INR b)
Y/E March	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24E**	**FY25E**
Sales	**308**	**347**	**369**	**379**	**446**	**533**	**552**	**608**
Change (%)	5.6	12.9	6.1	2.7	17.9	19.4	3.5	10.2
COGS	215	234	260	259	310	381	391	426
SGA expenses	45	50	52	52	57	71	78	82
Total Expenses	261	284	311	310	366	453	469	508
EBITDA	**47**	**63**	**57**	**68**	**80**	**80**	**83**	**100**
As a percentage of Net Sales	15.3	18.2	15.5	18.1	18.0	15.1	15.1	16.5
Depreciation	11	11	14	15	15	20	20	22
Other Income	12	3	10	6	10	6	6	6
PBT	**49**	**55**	**53**	**60**	**75**	**67**	**69**	**84**
Tax	11	13	12	15	18	16	18	22
Rate (%)	22.4	22.6	22.0	25.3	24.4	23.7	26.5	26.5
PAT	**38**	**43**	**41**	**45**	**56**	**51**	**51**	**62**
Minority interest	0	0	-1	-1	1	1	0	0
Share from associates	0	0	0	0	0	0	0	0
PAT before EO	**38**	**43**	**43**	**46**	**56**	**51**	**50**	**61**
Change (%)	33.9	13.1	-1.1	7.2	22.1	-8.9	-1.3	22.8
Extraordinary Items (EO)	0	0	-2	-1	0	-2	0	0
Reported PAT	**38**	**43**	**40**	**44**	**56**	**48**	**50**	**61**
Change (%)	33.9	13.1	-6.2	9.8	25.7	-13.2	3.5	22.8

Balance Sheet								(INR b)
Y/E March	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24E**	**FY25E**
Share Capital	4	4	4	4	4	4	4	4
Reserves	184	198	214	244	264	275	283	293
Net Worth	**188**	**203**	**218**	**249**	**269**	**279**	**287**	**297**
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	31	31	34
Amount pending invest.	12	12	12	12	12	12	12	12
Capital Employed	**235**	**243**	**287**	**309**	**338**	**343**	**352**	**364**
Applications								
Assets	**79**	**73**	**89**	**91**	**149**	**149**	**145**	**143**
Investments	15	12	2	6	4	6	6	6
Other non-current assets	30	33	50	47	50	62	64	70
Curr. Assets	**181**	**216**	**232**	**253**	**245**	**244**	**258**	**276**
Debtors	65	70	76	65	75	81	85	94
Cash and Bank Balance	20	20	30	27	38	41	33	21
Investments	75	98	57	98	46	30	55	80
Other Current Assets	22	28	68	63	86	93	85	81
Current Liab. and Prov.	**70**	**91**	**87**	**88**	**111**	**119**	**121**	**131**
Net Current Assets	**111**	**124**	**145**	**165**	**134**	**126**	**137**	**145**
Application of Funds	**235**	**243**	**287**	**309**	**338**	**343**	**352**	**364**

Financials and valuations

Ratios

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
Basic (INR)								
EPS	**43.0**	**48.5**	**48.7**	**52.1**	**63.2**	**57.6**	**56.8**	**69.8**
Diluted EPS	**42.7**	**47.7**	**48.3**	**51.7**	**62.6**	**57.3**	**56.5**	**69.4**
Cash EPS	54.8	60.3	62.3	66.7	79.7	76.7	79.0	94.1
Book Value	213.4	228.7	249.9	284.4	305.2	317.3	326.7	338.0
DPS	14.0	14.0	15.0	45.0	45.0	50.0	48.0	59.0
Payout (%, Div+Buyback)	32.8	29.3	31.0	87.1	71.9	87.3	85.0	85.0
Valuation (x)								
P/E ratio	26.9	23.9	23.8	22.2	18.3	20.1	20.4	16.6
Cash P/E ratio	21.1	19.2	18.6	17.4	14.5	15.1	14.7	12.3
EV/EBITDA ratio	21.6	16.1	17.6	14.6	12.4	12.4	12.1	10.1
EV/Sales ratio	3.3	2.9	2.7	2.6	2.2	1.9	1.8	1.7
Price/Book Value	5.4	5.1	4.6	4.1	3.8	3.6	3.5	3.4
Dividend Yield (%)	1.2	1.2	1.3	3.9	3.9	4.3	4.1	5.1
Profitability Ratios (%)								
RoE	21.5	22.0	20.2	19.5	21.5	18.5	17.7	21.0
RoCE	17.2	22.8	17.3	19.3	21.0	18.6	19.0	22.8
Turnover Ratios								
Debtors (Days)	77	73	75	62	61	56	56	56
Fixed Asset Turnover (x)	3.9	4.7	4.1	4.1	3.0	3.6	3.8	4.3
Leverage Ratio								
Debt/Equity Ratio (x)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

Cash Flow Statement (INR b)

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
CF from Operations	43	55	49	65	67	74	70	84
Change in Working Capital	-8	-11	-5	16	-14	-18	5	1
Net Operating CF	**36**	**44**	**44**	**81**	**53**	**56**	**75**	**84**
Net Purchase of FA	-8	-8	-8	-6	-8	-10	-15	-19
Free Cash Flow	**28**	**37**	**35**	**75**	**45**	**46**	**60**	**65**
Net Purchase of Invest.	-26	-13	19	-49	13	7	-25	-25
Net Cash from Invest.	**-34**	**-21**	**10**	**-55**	**5**	**-3**	**-40**	**-44**
Inc./(Dec.) in Equity	0	0	0	1	1	0	0	0
Proceeds from LTB/STB	6	-6	-20	-13	-8	-9	0	0
Dividend Payments	-9	-17	-25	-18	-40	-43	-42	-52
Cash Flow from Fin.	**-3**	**-23**	**-45**	**-30**	**-47**	**-51**	**-42**	**-52**
Other adjustments	0	0	1	0	0	1	0	0
Net Cash Flow	**0**	**1**	**10**	**-3**	**11**	**3**	**-7**	**-12**
Opening Cash Balance	**20**	**20**	**20**	**30**	**27**	**38**	**41**	**33**
Add: Net Cash	0	1	10	-3	11	3	-7	-12
Closing Cash Balance	**20**	**20**	**30**	**27**	**38**	**41**	**33**	**21**

N O T E S

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

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