Tech Mahindra Ltd
Miss on all fronts, Downgrade to Reduce

IT & ItES

Sharekhan code: TECHM

Reco/View: Reduce

CMP: Rs. 1,144

Price Target: Rs. 1,050

Summary
- Constant currency revenue declined 4.1% q-o-q, missing our estimates of 1.9% decline q-o-q, due to weak revenues from CME and BFSI vertical, down 9.4%/3.2% q-o-q.
- EBIT margin contracted sharply by ~440 bps q-o-q to 6.8%, below our estimates of 10.8% due to revenue drop impacting margin, persisting macro overhang.
- Net new deal win (TCV) for the quarter stood at $359 million, down 39% q-o-q/55% y-o-y. The number of active clients declined by 42 to 1255.Net headcount declined by 4,103 taking the total headcount to 1,48,297.
- Tech Mahindra reported the weakest performance among Tier 1 IT service companies with declining trajectory of Net new deal wins which places its earnings outlook at risk. Hence, we downgrade Tech Mahindra to Reduce with revised PT of Rs 1050. At CMP, the stock trades at 21.2/15.5x FY24E/FY25E EPS.

Tech Mahindra reported weak performance for Q1FY24 missing on all fronts. Constant currency revenue declined 4.1% q-o-q, missing our estimates of 1.9% decline q-o-q, due to weak revenues from CME and BFSI vertical, down 9.4%/3.2% q-o-q. USD revenue declined 4.0% q-o-q to $1600.7 million versus our estimate of $1640.8 million. IT services revenues declined 5% q-o-q while BPO segment revenues grew 1.3% q-o-q. EBIT margin contracted sharply by ~440 bps q-o-q to 6.8%, below our estimates of 10.8% due to revenue drop impacting margin, q-o-q. Company had to take a one-time provisioning the quarter, mainly driven by certain customers declaring bankruptcy and the seasonality. Net profit came at Rs. crore 692.5 crore, down 47.9% q-o-q missing our estimates of Rs 1194.4 crore. Net new TCV for the quarter stood at $359 million, down 39% q-o-q/55% y-o-y. The number of active clients declined by 42 to 1255. Net headcount declined by 4,103 taking the total headcount to 1,48,297. LTM attrition improved 200 bps q-o-q to 13% while Utilisation improved 100 bps q-o-q to 87%. Tech Mahindra has delivered the weakest set of numbers among its peers, with disappointing performance from its key CME vertical, declining net new TCV, and sharp loss in headcount for the quarter. Tech Mahindra reported the weakest performance among Tier 1 IT service companies with declining trajectory of Net new deal wins which places its earnings outlook at risk. Hence, we downgrade Tech Mahindra to Reduce with revised PT of Rs 1050. At CMP, the stock trades at 21.2/15.5x FY24E/FY25E EPS.

Key positives
- LTM Attrition moderated to 13% in Q1FY24 down 200 bps q-o-q.
- IT Utilisation improved to 87%, up 100 bps q-o-q.

Key negatives
- Net new deal wins (TCV) for the quarter stood at $359 million, down 39% q-o-q/55% y-o-y.
- Net headcount declined by 4,103 taking the total headcount to 1,48,297.
- Number of active clients declined by 42 to 1255 from 1297 in Q4FY23.
- DSO days rose to 98 days in Q1FY24 from 96 days in Q4FY2023.
- Net headcount declined by 4,103 taking the total headcount to 1,48,297.
- LTM attrition improved 200 bps q-o-q to 13% while Utilisation improved 100 bps q-o-q to 87%.

Management Commentary
- The management indicated levers for margin improvement such as lowering subcon, increasing offshore mix, generalization, pyramid rationalization and divestment of some non-profitable businesses. Management expects recovery to be gradual with good progress this quarter and recovery in H2FY24.
- Reprioritisation is happening as clients have pushed the decisions. 5G is going to take longer than anticipated. However, the company does not think their investments are in jeopardy. Devices, network, software platform continue to do well.

Revision in estimates – We have revised our estimates for FY24/25 to factor weak Q1FY24 performance and persisting macro overhang.

Our Call
Valuation – Weak Q1, Downgrade to Reduce: The weak Q1 performance on all fronts reflects the severity of persisting headwinds. Further, Tech Mahindra’s Net new deal win (TCV) trajectory has been trending downward since past few quarters unlike its peers who have shown greater resilience despite a muted quarter. Hence, we downgrade Tech Mahindra to Reduce with revised PT of Rs 1050 as earnings outlook remains at risk given weak performance. At CMP, the stock trades at 21.2/15.5x FY24E/FY25E EPS.

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

Valuation (Consolidated) Rs cr

<table>
<thead>
<tr>
<th>Particulars</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24E</th>
<th>FY25E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>44,646.0</td>
<td>53,290.2</td>
<td>55,080.0</td>
<td>62,335.7</td>
</tr>
<tr>
<td>OPM (%)</td>
<td>18.0</td>
<td>15.1</td>
<td>14.3</td>
<td>16.9</td>
</tr>
<tr>
<td>Adjusted PAT</td>
<td>5,566.1</td>
<td>5,249.3</td>
<td>4,738.4</td>
<td>6,516.1</td>
</tr>
<tr>
<td>% YoY growth</td>
<td>24.3</td>
<td>-5.7</td>
<td>-9.7</td>
<td>37.5</td>
</tr>
<tr>
<td>Adjusted EPS (Rs.)</td>
<td>62.8</td>
<td>59.7</td>
<td>53.8</td>
<td>74.0</td>
</tr>
<tr>
<td>P/E (x)</td>
<td>18.2</td>
<td>19.2</td>
<td>21.2</td>
<td>15.5</td>
</tr>
<tr>
<td>P/B (x)</td>
<td>3.7</td>
<td>3.6</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>EV/EBITDA (x)</td>
<td>12.9</td>
<td>13.0</td>
<td>12.4</td>
<td>8.9</td>
</tr>
<tr>
<td>RoNW (%)</td>
<td>21.5</td>
<td>19.2</td>
<td>16.3</td>
<td>20.4</td>
</tr>
<tr>
<td>RoCE (%)</td>
<td>23.3</td>
<td>20.5</td>
<td>18.3</td>
<td>23.0</td>
</tr>
</tbody>
</table>

Source: Company, Sharekhan estimates
Key result highlights from earnings call

- **Weak Revenue growth**: Tech Mahindra sharply missed revenue estimates on account of weak revenues from CME and BFSI verticals. Constant currency revenue declined 4.1% q-o-q, missing our estimates of 1.9% decline q-o-q, on account of weak revenues from CME and BFSI vertical, down 9.4%/3.2% q-o-q. Manufacturing grew 1.8% q-o-q while Technology, Retail and Others declined marginally q-o-q. USD revenue declined 4.0% q-o-q to $1600.7 million versus our estimate of $1640.8 million. IT services revenue declined 5% q-o-q while BPO segment revenues grew 1.3% q-o-q. In terms of geographies, Europe and ROW fell 6.7%/8.2% q-o-q while North Americas was down 0.5% q-o-q.

- **SG&A expenses and subcontracting costs**: SG&A expenses rose by 4.7% sequentially to Rs. 2040.5 crore. Sub-contracting costs moderated to 1842.5 crore at 14.0% of its revenue in Q1FY2023. The management aspires to get subcontracting costs to less than 10%.

- **Deal wins**: Net new deal wins (TCV) for the quarter stood at $359 million, down 39% q-o-q/ 55% y-o-y. Number of active clients declined by 42 to 1255.

- **EBIT margin**: EBIT margin contracted sharply by ~440 bps q-o-q to 6.8 %, below our estimates of 10.8%. due to revenue drop impacting margin, q-o-q. Company had to take a one-time provisioning during the quarter, mainly driven by certain customers declaring bankruptcy Seasonality also impacted the Ebit margin during the quarter

- **Net additions fell while LTM attrition rate moderated**: Net headcount declined by 4,103 taking the total headcount to 1,48,297. LTM attrition fell 200 bps q-o-q to 13% while IT Utilisation improved 100 bps q-o-q to 87%

- **Top accounts**: Revenue from top-5/top-10 and Top-20 declined by 4.0%/0.3% and 6.4% respectively.

- **Cash generation**: Free Cash Flow (FCF) stood at $106 million, down 25% q-o-q with FCF to net income ratio at 126.3%. Net Cash stood at $ 939 million versus $ 905 million in Q4FY23.

### Results (Consolidated) Rs cr

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Q1FY24</th>
<th>Q1FY23</th>
<th>Y-o-Y %</th>
<th>Q4FY23</th>
<th>Q-o-Q %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues In USD (mn)</td>
<td>1,600.7</td>
<td>1,632.5</td>
<td>-1.9</td>
<td>1,667.6</td>
<td>-4.0</td>
</tr>
<tr>
<td>Revenues In INR</td>
<td>13,159.0</td>
<td>12,707.9</td>
<td>3.5</td>
<td>13,718.2</td>
<td>-4.1</td>
</tr>
<tr>
<td>Cost of Services</td>
<td>9,780.5</td>
<td>9,116.2</td>
<td>6.3</td>
<td>9,748.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Gross profit</td>
<td>3,378.5</td>
<td>3,591.8</td>
<td>-5.9</td>
<td>3,970.0</td>
<td>-14.9</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>2,040.5</td>
<td>1,711.6</td>
<td>19.2</td>
<td>1,949.3</td>
<td>4.7</td>
</tr>
<tr>
<td>EBITDA</td>
<td>1,338.0</td>
<td>1,880.1</td>
<td>-28.8</td>
<td>2,020.7</td>
<td>-33.8</td>
</tr>
<tr>
<td>Depreciation</td>
<td>446.6</td>
<td>476.7</td>
<td>-6.3</td>
<td>490.2</td>
<td>-8.9</td>
</tr>
<tr>
<td>EBIT</td>
<td>891.4</td>
<td>1,403.4</td>
<td>-36.5</td>
<td>1,530.5</td>
<td>-41.8</td>
</tr>
<tr>
<td>Other Income</td>
<td>191.7</td>
<td>122.1</td>
<td>57.0</td>
<td>305.5</td>
<td>-37.3</td>
</tr>
<tr>
<td>PBT</td>
<td>963.4</td>
<td>1,485.2</td>
<td>-35.1</td>
<td>1,742.6</td>
<td>-44.7</td>
</tr>
<tr>
<td>Provision for taxes</td>
<td>267.6</td>
<td>338.0</td>
<td>-20.8</td>
<td>399.9</td>
<td>-33.1</td>
</tr>
<tr>
<td>Adjusted net profit</td>
<td>692.5</td>
<td>1,131.6</td>
<td>-38.8</td>
<td>1,330.4</td>
<td>-47.9</td>
</tr>
<tr>
<td>Non Recurring / Exceptional Items</td>
<td>0.0</td>
<td>0.0</td>
<td>-</td>
<td>212.6</td>
<td>-</td>
</tr>
<tr>
<td>Reported net profit</td>
<td>692.5</td>
<td>1,131.6</td>
<td>-38.8</td>
<td>1,117.8</td>
<td>-38.0</td>
</tr>
<tr>
<td>EPS (Rs) Excl Treasury Shares</td>
<td>7.8</td>
<td>12.8</td>
<td>-38.8</td>
<td>12.6</td>
<td>-38.0</td>
</tr>
<tr>
<td>Margin (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA Margins</td>
<td>10.2</td>
<td>14.8</td>
<td>-463</td>
<td>14.7</td>
<td>-456</td>
</tr>
<tr>
<td>EBIT Margin</td>
<td>6.8</td>
<td>11.0</td>
<td>-427</td>
<td>11.2</td>
<td>-438</td>
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<tr>
<td>PAT Margin</td>
<td>5.3</td>
<td>8.9</td>
<td>-364</td>
<td>9.7</td>
<td>-444</td>
</tr>
<tr>
<td>Tax rate</td>
<td>27.8</td>
<td>22.8</td>
<td>502</td>
<td>22.9</td>
<td>483</td>
</tr>
</tbody>
</table>

Source: Company; Sharekhan Research
Revenue mix: Geographies, industry verticals, and other operating metrics

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Revenues ($ mn)</th>
<th>Contribution (%)</th>
<th>$ Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues ($ mn)</td>
<td>1,601</td>
<td>100</td>
<td>-4.0</td>
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<tr>
<td><strong>Geographic mix</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>America</td>
<td>823</td>
<td>51.4</td>
<td>-0.5</td>
</tr>
<tr>
<td>Europe</td>
<td>394</td>
<td>24.6</td>
<td>-6.7</td>
</tr>
<tr>
<td>RoW</td>
<td>384</td>
<td>24.0</td>
<td>-8.2</td>
</tr>
<tr>
<td><strong>Industry verticals</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CME</td>
<td>605</td>
<td>37.8</td>
<td>-9.5</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>271</td>
<td>16.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Technology</td>
<td>171</td>
<td>10.7</td>
<td>-0.3</td>
</tr>
<tr>
<td>BFSI</td>
<td>258</td>
<td>16.1</td>
<td>-2.8</td>
</tr>
<tr>
<td>Retail, transport and logistics</td>
<td>126</td>
<td>7.9</td>
<td>-0.2</td>
</tr>
<tr>
<td>Others</td>
<td>170</td>
<td>10.6</td>
<td>-0.2</td>
</tr>
<tr>
<td><strong>Clients contribution</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top 5</td>
<td>272</td>
<td>17.0</td>
<td>-4.0</td>
</tr>
<tr>
<td>Top 10</td>
<td>432</td>
<td>27.0</td>
<td>-0.3</td>
</tr>
<tr>
<td>Top 20</td>
<td>624</td>
<td>39.0</td>
<td>-6.4</td>
</tr>
<tr>
<td><strong>Revenue by services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IT</td>
<td>1,392</td>
<td>85.2</td>
<td>-3.0</td>
</tr>
<tr>
<td>BPO</td>
<td>242</td>
<td>14.8</td>
<td>3.5</td>
</tr>
</tbody>
</table>

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

![Graph of EBIT margin trend from Q1FY22 to Q1FY24](Source: Company; Sharekhan Research)

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

![Graph of subcontractor expenses and growth y-o-y from Q1FY22 to Q1FY24](Source: Company; Sharekhan Research)

New deal win TCV trend

![Graph of new deal win TCV trend from Q1FY22 to Q1FY24](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 by Indian IT companies.

- 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 – Weak Q1, Downgrade to Reduce

The weak Q1 performance on all fronts reflects the severity of persisting headwinds. Further, Tech Mahindra’s Net new deal win (TCV) trajectory has been trending downward since past few quarters unlike its peers who have shown greater resilience despite a muted quarter. Hence, we downgrade Tech Mahindra to Reduce with revised PT of Rs 1050 as earnings outlook remains at risk given weak performance. At CMP, the stock trades at 21.2/15.5x FY24E/FY25E EPS.

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) 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

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: Company Website

Top 10 shareholders

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Holder Name</th>
<th>Holding (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Life Insurance Corp of India</td>
<td>9.47</td>
</tr>
<tr>
<td>2</td>
<td>SBI Funds Management Ltd</td>
<td>3.95</td>
</tr>
<tr>
<td>3</td>
<td>First State Investments ICVC</td>
<td>2.81</td>
</tr>
<tr>
<td>4</td>
<td>Mitsubishi UFJ Financial Group Inc</td>
<td>2.34</td>
</tr>
<tr>
<td>5</td>
<td>BlackRock Inc</td>
<td>2.15</td>
</tr>
<tr>
<td>6</td>
<td>Vanguard Group Inc/The</td>
<td>2.15</td>
</tr>
<tr>
<td>7</td>
<td>GOVERNMENT PENSION FUND - GLOBAL</td>
<td>2.05</td>
</tr>
<tr>
<td>8</td>
<td>Norges Bank</td>
<td>2.01</td>
</tr>
<tr>
<td>9</td>
<td>ICICI Prudential Asset Management</td>
<td>1.83</td>
</tr>
<tr>
<td>10</td>
<td>HDFC Asset Management Co Ltd</td>
<td>1.30</td>
</tr>
</tbody>
</table>

Source: Bloomberg

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a position in the companies mentioned in the article.
### Understanding the Sharekhan 3R Matrix

<table>
<thead>
<tr>
<th>Right Sector</th>
<th>Positive</th>
<th>Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neutral</td>
<td>Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>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.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Right Quality</th>
<th>Positive</th>
<th>Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neutral</td>
<td>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</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>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 deteriorating balance sheet</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Right Valuation</th>
<th>Positive</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neutral</td>
<td>Trading at par to historical valuations and having limited scope of expansion in valuation multiples.</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>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.</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Sharekhan Research*