HOLD (Downgrade from ADD)

CMP: **INR 924** Target Price: **INR 929 (INR 1,001)** ▲ 1%

ICICI Securities

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10 August 2023

India | Equity research | Q1FY24 result review

Happiest Minds Technologies

Technology

Growth better than domestic peers despite tough macro; downgrade to HOLD on balanced risk-reward

Happiestminds (HM) reported 3.6% QoQ USD, 3.5% QoQ CC, revenue growth, slightly lower than our estimate of 4% QoQ CC. On a YoY basis, growth was 12.7% YoY USD (7% organic). EBIT margin came in at 19.2% (-175bps QoQ), below our estimate of 21.1% due to higher employee costs attributable to slight increase in onsite employee mix and campus joinee related costs. Margins will likely be impacted in Q2FY24E by wage hike rollout from 1st Jul'23. Forward-looking demand indicators point towards healthy demand ahead: 1) strong headcount addition (2.7% QoQ and 21% YoY), and 2) strong deal pipeline. However, management mentioned that they may revise the guidance of 25% YoY CC growth for FY24 after Q2FY24 depending on potential M&A closures. EBITDA margin guidance has been retained at 22-24%.

What to do with the stock

HM's 3.5% QoQ growth in CC terms was largely in line with, or better than, its domestic peers like Persistent (2.9%) and Coforge (2.7%) amid the backdrop of a tough macro wherein larger-sized companies indicated drying-up of smaller deals, vendor consolidation and postponement of discretionary spend. Also, strong growth by HM in its product engineering services (PES) segment at 7% QoQ and edutech vertical at 12% QoQ – addresses two important investor concerns about HM's business scalability: 1) PES is largely discretionary in nature and vulnerable under the current macro-environment of tech budget cuts, and 2) clients in the edutech vertical could be under threat from impact of generative AI on content creation and subscriber base. Having said that, we see two key negatives from HM's Q1FY24 results: 1) EBITDA margin was soft at 22.9% (down 260bps YoY, though still in the HM's guidance band of 22-24%) largely due to lower gross margin due to increase in onsite effort mix; and 2) no clarity is provided on FY24 revenue growth given lack of visibility on closure timing and size of potential M&As, and focus on shorter-term time & material based projects. As a result of these two factors, we have cut our revenue forecasts over FY24E-FY26E by 2-3% and EBIT by 6-8%. We are now forecasting 17% (13% organic) revenue growth for HM in FY24E with expectation of demand recovery in the remaining months of 9MFY24E and 5-7% QoQ growth in each of the remaining three quarters. We also incorporate the impact of recent QIP raise of INR 5bn in our model leading to higher interest income and share count forecasts.

Financial summary

Y/E March (INR mn)	FY22A	FY23A	FY24E	FY25E
Net Revenue	10,937	14,293	16,999	21,318
EBITDA	2,576	3,561	4,015	5,147
EBITDA Margin (%)	23.6	24.9	23.6	24.1
Net Profit	1,812	2,310	2,826	3,470
EPS (INR)	12.9	16.4	18.9	23.1
EPS % Chg YoY	12.0	27.0	15.6	21.9
P/E (x)	71.7	56.4	48.8	40.1
EV/EBITDA (x)	50.9	38.8	33.8	26.3
RoCE (%)	21.6	21.8	16.0	17.4
RoE (%)	29.9	30.7	24.0	21.4

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Market Data

Market Cap (INR)	141bn
Market Cap (USD)	1,698mn
Bloomberg Code	HAPPSTMN IN
Reuters Code	HAPP BO
52-week Range (INR)	1,136 /763
Free Float (%)	43.0
ADTV-3M (mn) (USD)	5.3

Price Performance (%)	3m	6m	12m
Absolute	8.5	10.2	(4.1)
Relative to Sensex	7.8	9.6	13.6

ESG Disclosure	2021	2022	Change
ESG score	**34.5**	**45.1**	**10.6**
Environment	15.9	33.9	18.0
Social	24.6	35.3	10.8
Governance	63.0	66.1	3.1

Note - Score ranges from 0 - 100 with a higher score indicating higher ESG disclosures.

Source: Bloomberg, I-sec research

Earnings Revisions (%)	FY24E	FY25E	FY26E
Revenue	(1.9)	(2.6)	(2.7)
EBIT	(6.2)	(6.4)	(8.2)
EPS	1.2	(3.8)	(8.0)

Previous Reports

30-05-2023: Company update

16-05-2023: Re-initiating coverage

As a result, our FY24E / FY25E / FY26E EPS estimates change by +1.2% / -3.8% / -8.0% and our 12-month target price gets reduced to INR 929 (from prior INR 1,001) implying 1% potential upside. Hence we downgrade our rating from ***Add*** to **HOLD**, and see a balanced risk-reward for HM's shares given that it is trading at 40x FY25E for FY23-FY26E EPS CAGR of 19% implying 2x PEG, higher than the average of 1.8x for our Indian IT sector coverage universe.

Key takeaways from earnings call

- Revenue growth was led by edutech (12.4% QoQ USD) and BFSI (5.5% QoQ USD) verticals, product engineering service line (7% QoQ USD) and analytics COE. Full-quarter impact of SMI acquisition was reflected in Q4FY23, hence the company's sequential revenue growth in Q1FY24 is entirely organic.

- **Revenue growth guidance of 25% YoY CC factors-in potential inorganic acquisitions.** Management mentioned that the M&A pipeline is strong, but there has been no closure of any acquisition so far. Hence, depending on the timeline of potential closure of future acquisitions, company is likely to revise its guidance of FY24 revenue growth after Q2FY24.

- **Demand pipeline remains strong** and the company is chasing several large opportunities. HM has not seen any cancellation of contracts, but there is delay in deal signings.

- **Vertical commentary:** 1) In the edutech vertical, HM benefitted from vendor consolidation activity by a client – leader in the KPO business; 2) company is seeing good traction in the healthcare vertical; it won a deal on cloud-based product lifecycle solution from a global leader and innovator in biosciences industry in Q1FY24; acquisition of SMI is also adding to revenue growth in this vertical. 3) travel, media and entertainment vertical was impacted because one of the largest customers (large movie and park company) is undergoing internal restructuring, causing delay in decision-making by this client.

- A few areas where customers continue to invest: 1) modernisation converting existing applications to cloud, 2) analytics, data science and AI, 3) low code no code, 4) process automation, 5) cybersecurity, 6) optimisation of spends on cloud and multi-cloud management.

- HM is bullish about generative AI led demand opportunities. It has partnered with Microsoft for developing generative AI capabilities.

- EBIT margin came at 19.2% (-175 bps QoQ) below our estimate of 21.1% driven by higher employee costs due to slight increase in onsite employee mix and campus joinee related costs. Margins in FY24 will be impacted by wage hike rollout from 1st Jul'23. HM is focussing on improving utilisation.

- Headcount addition was strong in Q1FY24 at 2.7% QoQ and 21% YoY. Company has a target to hire ~1,300 employees in FY24 (+20% YoY), of which ~450 are expected to be freshers and rest will be laterals and employee additions as a result of M&As, as per management.

- HM opened new centres in Pune and Noida and expanded centres in Bhubaneshwar and Madurai. Management mentioned that substantial number of people are working from office.

- Company's closing cash balance is INR 12,000mn post QIP of INR 5,000mn and NCD raise of INR 450mn.

- **Healthy new logo addition:** HM added 17 new logos in Q1FY24 vs 18 in Q4FY23. New logos are driving growth in new businesses. It added 2 new logos in the category of clients having USD 1bn+ revenue, taking the total to 57. HM's first customer (8 years+ relationship) crossed USD 20mn in annual revenue run-rate.

Key upside risks: 1) global macro concerns around high interest rates and inflation subsiding sooner than expected, 2) stronger than expected demand

Key downside risks: 1) Longer than expected current global macro downcycle extending beyond CY23E, 2) inability to scale revenue in verticals other than Edutech

Exhibit 1: Q1FY24 actuals vs estimates

	Q1FY24	Q4FY23	QoQ (%)	Q1FY23	YoY (%)	Q1FY24 I-Sec estimates	vs our estimates
Revenue QoQ CC	3.5%	1.3%		6.9%		4.0%	
Revenues (USD mn)	48	46	3.6%	42	12.7%	48	-0.7%
USD/INR	82.2	82.3	-0.2%	77.9	5.5%	82.2	0.0%
Revenues (INR mn)							
EBIT (INR mn)	3,909	3,780	3.4%	3,289	18.8%	3,938	-0.7%
EBIT margin (%)	751	792	-5.2%	746	0.7%	830	-9.5%
Adjusted net profit (INR mn)	19.2%	21.0%	-175 bps	22.7%	-347 bps	21.1%	-187 bps
EPS (INR/share)	583	577	1.2%	563	3.5%	623	-6.4%

Source: Company data, I-Sec research, Bloomberg

Exhibit 2: Change in estimates

	Revised			Old			Change		
	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Revenues (USD mn)	207	260	322	211	267	331	-1.9%	-2.6%	-2.7%
Revenue growth YoY CC	16.8%	25.4%	24.0%	18.9%	26.3%	24.1%	-210bps	-80bps	-10bps
Revenue growth YoY USD	16.6%	25.5%	24.0%	18.9%	26.3%	24.1%	-230bps	-80bps	-10bps
INR mn									
Revenues	16,999	21,318	26,433	17,338	21,886	27,154	-2.0%	-2.6%	-2.7%
EBIT	3,372	4,370	5,317	3,593	4,669	5,793	-6.2%	-6.4%	-8.2%
EBIT margin	19.8%	20.5%	20.1%	20.7%	21.3%	21.3%	-90bps	-80bps	-120bps
EPS (INR/share)	18.8	23.1	27.2	18.6	24.0	29.5	1.2%	-3.8%	-8.0%

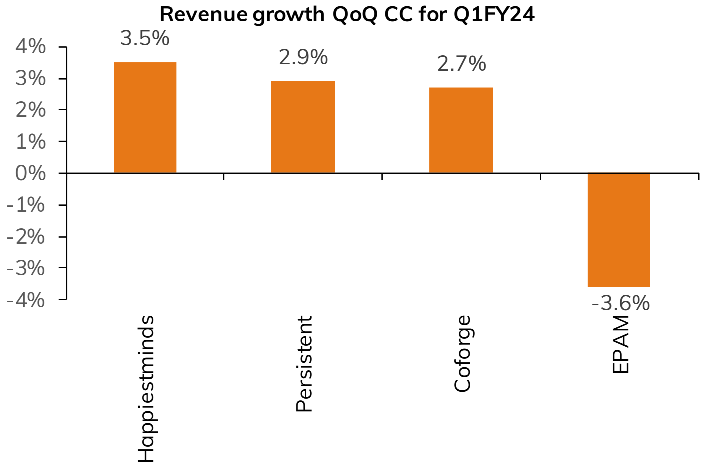
Source: Company data, I-Sec research

Exhibit 3: Valuation methodology

Weightage to P/E valuation	50%
Weightage to DCF valuation	50%
P/E multiple based TP	909
DCF based TP	948
TP	929
CMP	924
Potential Upside	1%

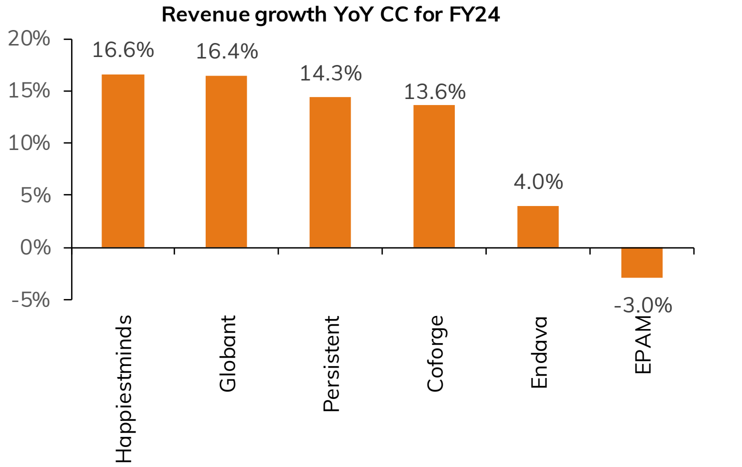
Source: Company data, I-Sec research

Exhibit 4: HM reported highest revenue growth among peers in Q1FY24



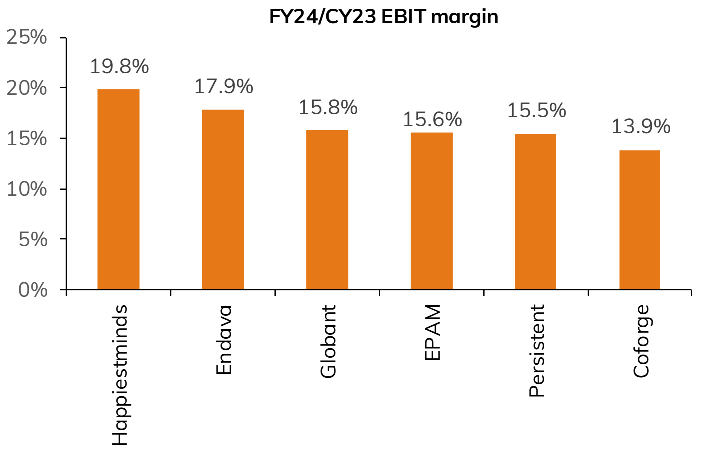
Source: Company data

Exhibit 5: HM expected to report highest revenue growth among peers in FY24.



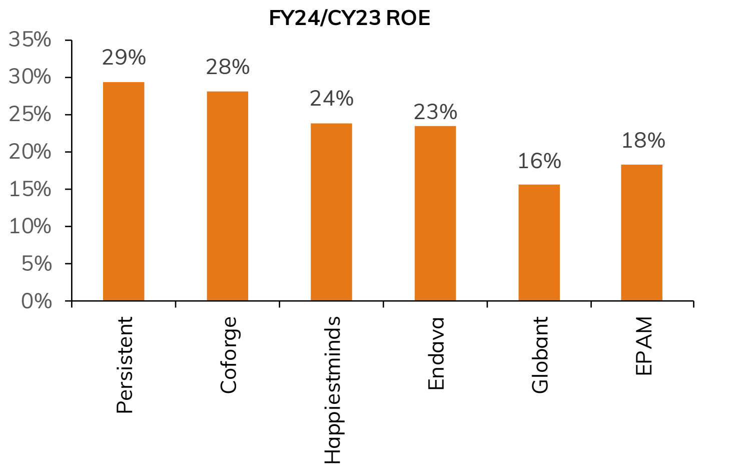
Source: Company data, Happiestminds and Persistent are our estimate and rest are bloomberg estimates

Exhibit 6: HM has highest EBIT margins peers



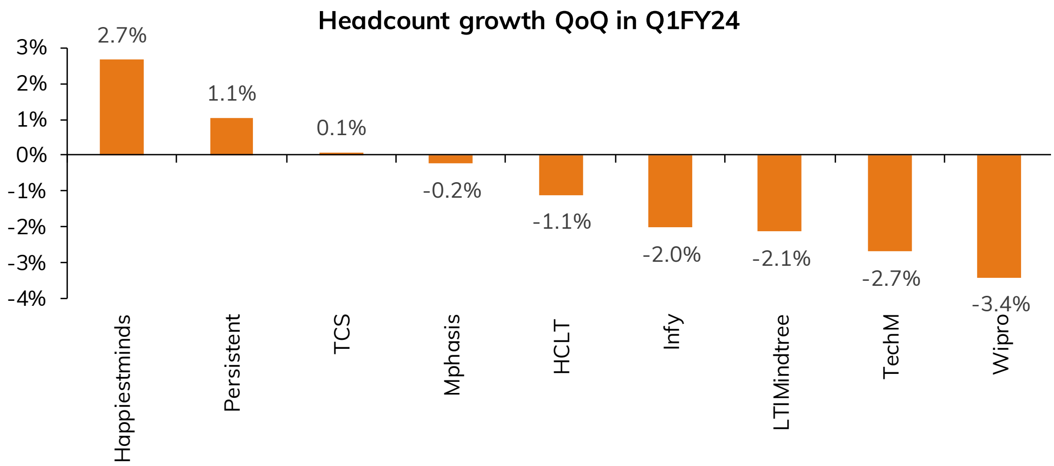
Source: Company data

Exhibit 7: HM's RoE lower vs Persistent and Coforge because of recent QIP of INR 5,000mn



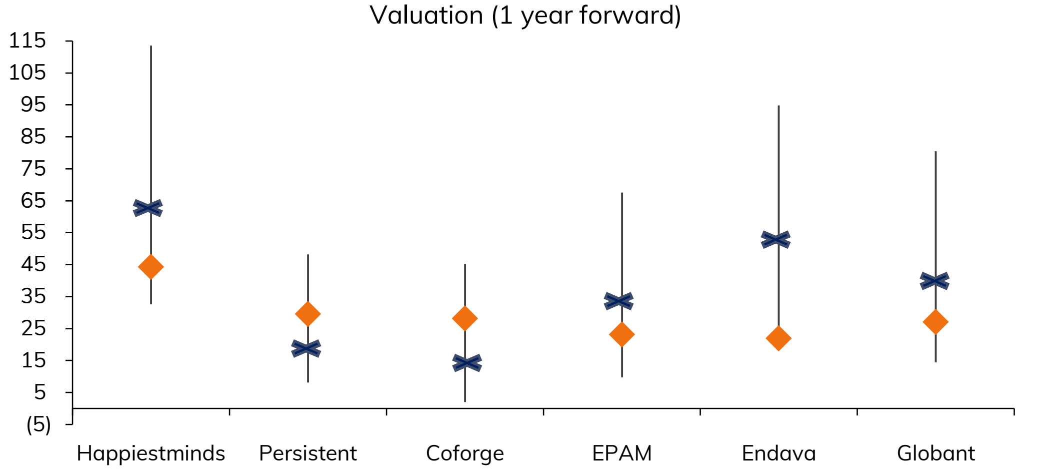
Source: Company data

Exhibit 8: Headcount addition of HM highest in our coverage universe



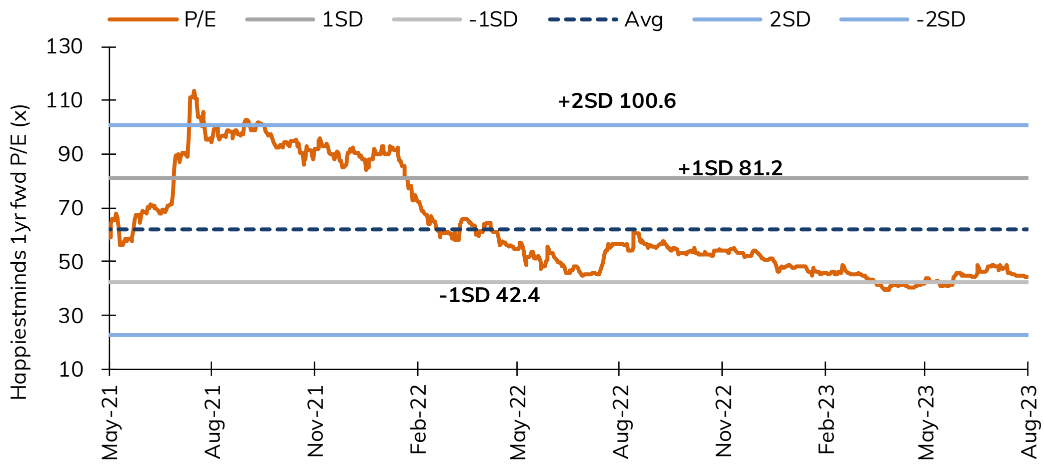
Source: Company data, Bloomberg, I-Sec research, Note: Orange diamonds represent current P/E and blue cross represent Average P/E of the respective stocks

Exhibit 9: Valuation of HM vs peers



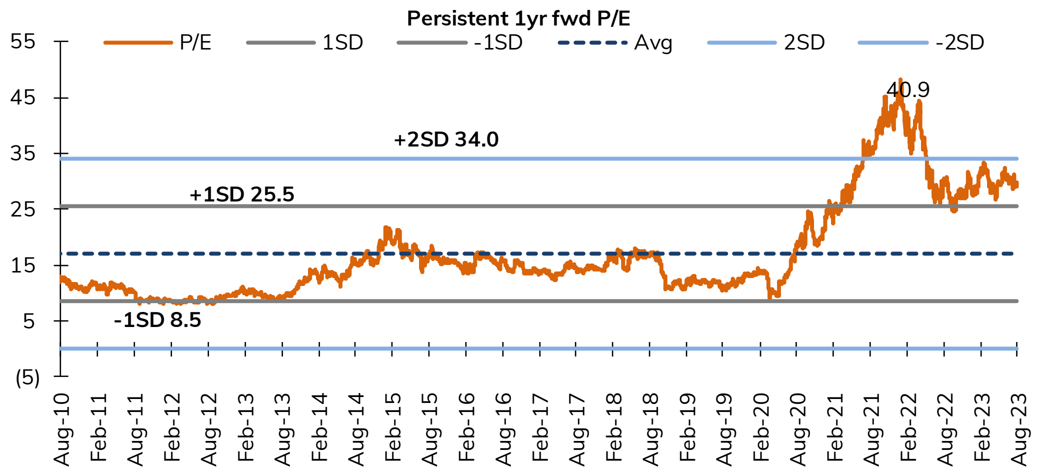
Source: Company data, Bloomberg, I-Sec research, Note: Orange diamonds represent current P/E and blue cross represent Average P/E of the respective stocks

Exhibit 10: HM is currently trading at 44.3x (1-year forward P/E) vs its historical long-term average of 62x



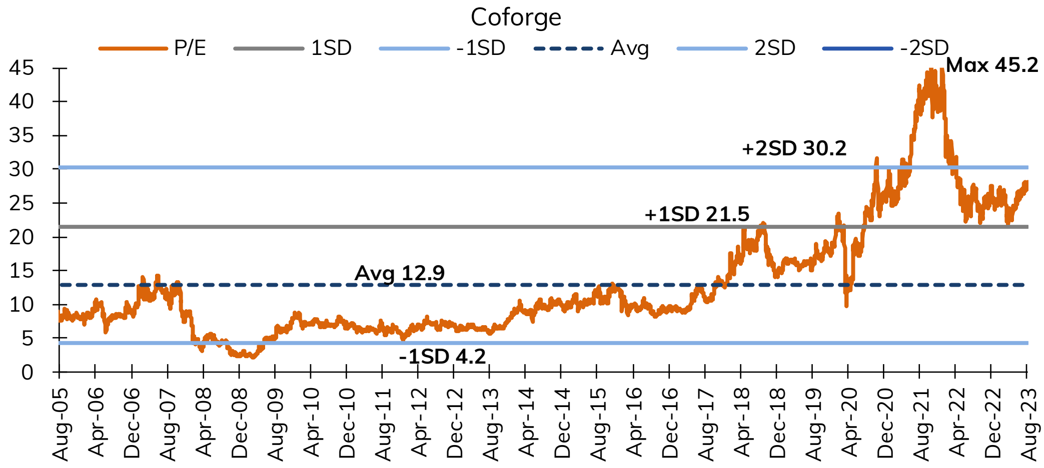
Source: Company data, Bloomberg, I-Sec research

Exhibit 11: Persistent is currently trading at 29.5x (1-year forward P/E) vs its historical long-term average of 17x



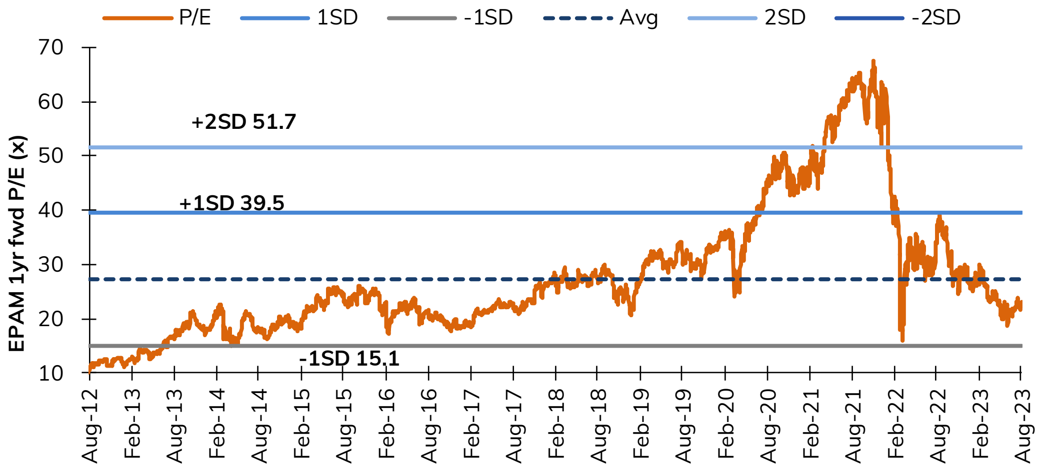
Source: Company data, Bloomberg, I-Sec research

Exhibit 12: Coforge is currently trading at 28.2x (1-year forward P/E) vs its historical long-term average of 13x



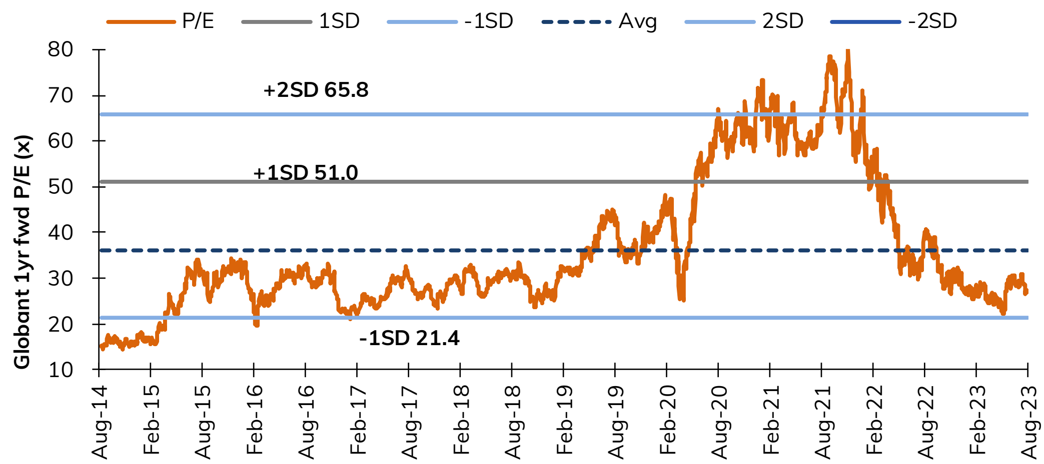
Source: Company data, Bloomberg, I-Sec research

Exhibit 13: EPAM is trading at 23x (1-year forward P/E) vs its historical long-term average of 27x owing to lowest growth among peers



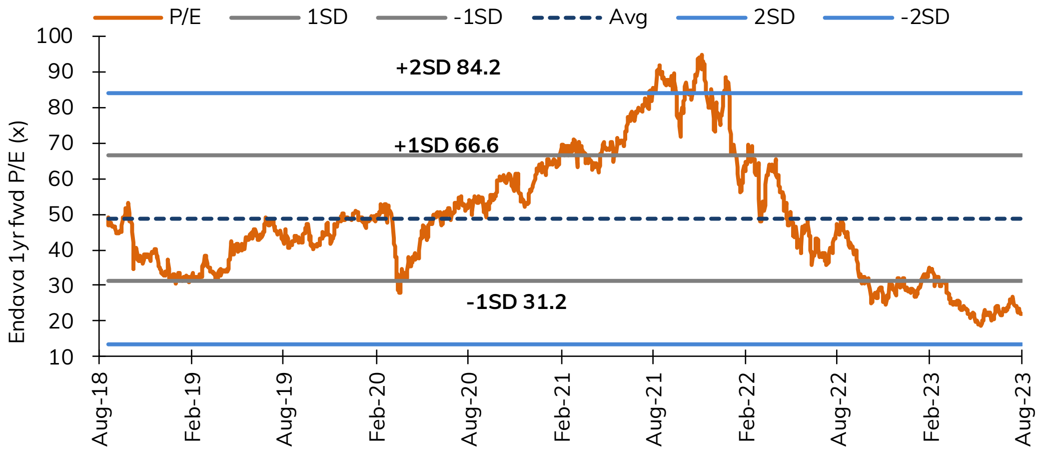
Source: Company data, Bloomberg, I-Sec research

Exhibit 14: Globant is currently trading at 27x (1-year forward P/E) vs its historical long-term average of 36x



Source: Company data, Bloomberg, I-Sec research

Exhibit 15: Endava is currently trading at 22x (1-year forward P/E) vs its historical long-term average of 49x



Source: Company data, Bloomberg, I-Sec research

Exhibit 16: Shareholding pattern

%	Dec'22	Mar'23	Jun'23
Promoters	53.3	53.2	53.2
Institutional investors	5.4	5.4	5.8
MFs and others	0.9	0.8	0.8
FIs/Banks	0.0	0.0	0.0
Insurance	0.4	0.5	0.5
FIIs	4.1	4.1	4.5
Others	41.3	41.4	41.0

Source: Bloomberg

Exhibit 17: Price chart

Source: Bloomberg

Financial Summary

Exhibit 18: Profit & Loss

(Rs mn, year ending March)

	FY22A	FY23A	FY24E	FY25E
Net Sales (USD mn)	**147**	**178**	**207**	**260**
Net Sales (Rs mn)	**10,937**	**14,293**	**16,999**	**21,318**
Operating Expense	8,360	10,732	12,984	16,172
EBITDA	**2,576**	**3,561**	**4,015**	**5,147**
EBITDA Margin (%)	23.6	24.9	23.6	24.1
Depreciation & Amortisation	329	419	619	777
EBIT	2,248	3,142	3,396	4,370
Interest expenditure	99	219	403	403
Other Non-operating Income	371	239	819	714
Recurring PBT	**2,519**	**3,162**	**3,812**	**4,681**
Profit / (Loss) from Associates	**-**	**-**	**-**	**-**
Less: Taxes	647	789	986	1,211
PAT	1,873	2,373	2,826	3,470
Less: Minority Interest	-	-	-	-
Net Income (Reported)	**1,812**	**2,310**	**2,826**	**3,470**
Extraordinaries (Net)	-	-	-	-
Recurring Net Income	**1,812**	**2,310**	**2,826**	**3,470**

Source Company data, I-Sec research

Exhibit 19: Balance sheet

(Rs mn, year ending March)

	FY22A	FY23A	FY24E	FY25E
Total Current Assets	4,634	10,730	16,241	17,087
of which cash & cash eqv.	673	700	5,677	5,778
Total Current Liabilities & Provisions	1,757	2,030	2,265	2,490
Net Current Assets	**2,877**	**8,699**	**13,976**	**14,597**
Investments	4,640	-	-	-
Net Fixed Assets	8	1,346	1,347	1,348
ROU Assets	539	579	579	579
Capital Work-in-Progress	-	-	-	-
Goodwill	790	1,391	1,391	1,391
Other assets	397	1,336	1,336	1,336
Deferred Tax assets	-	-	-	-
Total Assets	**9,493**	**14,378**	**19,655**	**20,278**
Liabilities				
Borrowings	**1,906**	**4,676**	**3,176**	**1,676**
Deferred Tax Liability	**-**	**-**	**-**	**-**
provisions	162	247	247	247
other Liabilities	176	406	406	406
Minority Interest	-	-	-	-
Equity Share Capital	285	287	5,287	5,287
Reserves & Surplus*	6,373	8,102	9,879	12,001
Total Net Worth	**6,658**	**8,388**	**15,166**	**17,288**
Total Liabilities	**9,493**	**14,378**	**19,655**	**20,278**

Source Company data, I-Sec research

Exhibit 20: Quarterly trend

(INR mn, year ending March)

	Sep-22	Dec-22	Mar-23	Jun-23
Net Sales	3,555	3,669	3,780	3,909
% growth (QoQ)	8.1	3.2	3.0	3.4
EBITDA	905	895	922	893
Margin %	25.5	24.4	24.4	22.9
Other Income	-7	20	-3	36
Extraordinaries				
Adjusted Net Profit	594	576	577	583

Source Company data, I-Sec research

Exhibit 21: Cashflow statement

(Rs mn, year ending March)

	FY22A	FY23A	FY24E	FY25E
CFO before WC changes	2,459	3,099	3,812	4,681
CFO after WC changes	**2,216**	**2,960**	**3,313**	**4,224**
Capital Commitments	(7)	(1,477)	(620)	(778)
Free Cashflow	**1,688**	**3,549**	**2,947**	**3,791**
Other investing cashflow	(954)	(2,033)	819	714
Cashflow from Investing Activities	**(961)**	**(3,510)**	**199**	**(64)**
Issue of Share Capital	2	-	5,000	-
Interest Cost	(82)	(153)	-	-
Inc (Dec) in Borrowings	196	1,634	(1,500)	(1,500)
Cashflow from Financing Activities	**(908)**	**1,147**	**2,451**	**(2,848)**
Dividend paid	-	(572)	(1,049)	(1,348)
Others	(1,024)	238	-	-
Chg. in Cash & Bank balance	**(187)**	**(291)**	**4,977**	**101**
Closing cash & balance	673	414	5,677	5,778

Source Company data, I-Sec research

Exhibit 22: Key ratios

(Year ending March)

	FY22A	FY23A	FY24E	FY25E
Per Share Data (INR)				
Reported EPS	12.9	16.4	18.9	23.1
Diluted EPS	12.9	16.4	18.9	23.1
Cash EPS	14.7	18.8	23.1	28.2
Dividend per share (DPS)	3.7	5.3	7.0	9.0
Book Value per share (BV)	45.8	57.8	101.5	114.9
Dividend Payout (%)	28.4	32.7	37.1	38.8
Growth (%)				
Net Sales	41.4	30.7	18.9	25.4
EBITDA	34.9	38.2	12.8	28.2
EPS	12.0	27.0	15.6	21.9
Valuation Ratios (x)				
P/E	71.7	56.4	48.8	40.1
P/CEPS	62.7	49.1	40.1	32.7
P/BV	20.2	16.0	9.1	8.0
EV / EBITDA	50.9	38.8	33.8	26.3
P/S	12.3	9.4	8.1	6.5
Dividend Yield (%)	0.4	0.6	0.8	1.0
Operating Ratios				
EBITDA Margins (%)	23.6	24.9	23.6	24.1
EBIT Margins (%)	20.6	22.0	20.0	20.5
Effective Tax Rate (%)	25.7	24.9	25.9	25.9
Net Profit Margins (%)	17.1	16.6	16.6	16.3
Inventory Turnover Days	-	-	-	-
Fixed Asset Turnover (x)	1,358.6	21.1	12.6	15.8
Receivables Days	48	49	51	50
Payables Days	17	17	18	18
Working Capital Days	56	130	175	147
Net Debt / EBITDA (x)	(10.4)	9.5	(4.0)	(5.3)
Profitability Ratios				
RoCE (%)	21.6	21.8	16.0	17.4
RoIC (%)	51.1	19.9	20.9	25.7
RoNW (%)	29.9	30.7	24.0	21.4

Source Company data, I-Sec research

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