

26 October 2023

India | Equity Research | Q2FY24 Results Review

Tech Mahindra

Technology

System reboot and turnaround story may start reflecting from FY25; recommend BUY

Tech Mahindra's (TechM) Q2FY24 result, as expected, was weak on all fronts, including revenue growth and margins. Sequential revenue decline was further exacerbated by weakness in communication vertical globally (where TechM has still very high reliance and which may prove as Achilles heel in Mohit Joshi's (MD & CEO designate) turnaround efforts at TechM, in our view) and TechM's conscious efforts to deliberately move out of non-core geographies, clients and service lines. Business rationalisation may continue in Q3FY24E as well, given certain projects need regulatory approvals before closure/divestiture. This, along with weak macro outlook for discretionary tech spend, implies that signs of demand revival for TechM may only reflect from FY25E.

Q2 result has three positive takeaways: 1) Sequential increase in headcount (1.6%, largely in BPO) and deal wins (78% QoQ), key leading demand indicators; 2) improvement in operating levers like offshoring and sub-contracting expense; and 3) **appointment of senior leadership including BFSI head for the Americas and the EU (Mr. Pankaj Kulkarni and Mr. Roshan Shetty, both have spent >15 years at Infosys in the past)**. TechM will also be appointing new CMO and CHRO shortly.

New CEO, apart from making senior level hires and recent portfolio restructuring, has also decided to divide TechM into six business units in order to bring more accountability, customer centricity, focus on top accounts and large deals. KPIs and incentive policies for senior leaders/ broader employee pool will be effective from Jan 1, '24. **Impact of these initiatives on medium-to long-term revenue growth and margins for TechM will be shared in Apr'25, post testing internally for 1-2 quarters.**

What to do with the stock

We clearly see more headwinds for TechM in the near term on two fronts: a) Broader IT sector demand weakness around discretionary spend coupled with delay in decision making around large deal closures and b) TechM-specific issues like 5G spends getting pushed out, key telecom clients facing profitability challenges and business rationalisation. Even on margin front, despite showing certain improvement in levers like offshoring and sub-contracting, significant margin improvement may only be seen starting FY25E.

Financial Summary

Y/E March (INR mn)	FY23A	FY24E	FY25E	FY26E
Net Revenue	5,32,902	5,18,071	5,55,285	6,23,200
EBITDA	80,288	49,981	81,959	1,12,737
EBITDA Margin (%)	15.1	9.6	14.8	18.1
Net Profit	48,569	29,547	49,557	71,568
EPS (Rs)	55.3	33.4	56.0	80.8
EPS % Chg YoY	(13.6)	(39.6)	67.6	44.4
P/E (x)	20.6	34.2	20.4	14.1
EV/EBITDA (x)	11.9	19.7	12.1	8.7
RoCE (%)	15.5	8.6	17.0	24.0
RoE (%)	17.3	10.8	19.0	26.4

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Market Data

Market Cap (INR)	1,114bn
Market Cap (USD)	13,398mn
Bloomberg Code	TECHM IN
Reuters Code	TEML.BO
52-week Range (INR)	1,320 /981
Free Float (%)	64.0
ADTV-3M (mn) (USD)	40.2

Price Performance (%)	3m	6m	12m
Absolute	(1.2)	17.6	10.2
Relative to Sensex	1.9	10.0	1.2

ESG Disclosure	2021	2022	Change
ESG score	68.7	68.9	0.2
Environment	68.7	70.8	2.1
Social	50.1	48.5	(1.6)
Governance	87.4	87.4	-

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

Source: Bloomberg, I-sec research

Earnings Revisions (%)	FY24E	FY25E
USD Revenue	(3)	(5)
EBIT	(31)	(23)
EPS	(26)	(18)

Previous Reports

21-09-2023: [Company update](#)

27-07-2023: [Q1FY24 results review](#)

Given the above backdrop, we cut our FY24-26E EPS estimates by 26%/19%/8%, led by both lower revenues and EBIT margins. We expect TechM's EBIT margins to move up from 6.1% in FY24E to 11.4%/14.8% in FY25E/26E on the back of various levers (refer EBIT margin walk in Exhibits 3 & 4). Our revised 12-month target price now stands at INR 1,372 (vs prior INR 1,590), implying 20% potential upside, and we reiterate our BUY rating on the stock. We believe the stock may consolidate over the next 1-2 quarters pending clarity on medium-to-longer term revenue growth and margin targets by TechM management.

Key downside risks: 1) Weak execution, 2) delay in revival of telecom, 3) high attrition at senior management level because of organisational changes, 4) company is not able to build capabilities organically and therefore may have to pay higher for acquisitions

Actual performance vs estimates

Revenue declined 2.4% QoQ CC (vs ISEC est: -1%, Cons est: -2%). In USD terms, it declined 2.8% QoQ and 5.1% YoY. The decline was led by rationalisation of non-core portfolio and cut in discretionary spends by clients. EBIT margin came in at 4.7%, down 210bps QoQ (vs ISEC est: 5.5%, Cons est: 7.7%). Margins had one-time impact of 260bps on account of rationalisation of non-core portfolio. There was sequential improvement in large deal TCV at USD 640mn, which was up 78% QoQ, but down 10.6% YoY.

Earnings call

- **New organisation structure:** New CEO designate (Mohit Joshi) has structured TechM's business in six strategic go-to-market business units – 1) it has divided Americas into three broad industry verticals – a) communication headed by Abhishek Shankar, b) tech and media led by Harshul Asnani, c) diverse industry group led by CTL, 2) EMEA business unit led by Vikram Nair, 3) APJ (Asia-Pacific and Japan) headed by Harshvendra Soin and 4) India business unit. In EMEA and APJ, the company has consolidated telecom and non-telecom businesses. Delivery will be vertical focused and the company has total eight service lines. New delivery structure is likely to bring more accountability, customer centricity, focus on top accounts and large deals.
- **Demand headwinds in communication vertical continue** led by discretionary spend cuts by clients and pull back in 5G investments. In Q2FY24, there was one-time impact of USD 15mn on revenue due to rationalisation of non-core pass through business in one of the top customers. Management does not expect communication vertical to revive in H2. 5G use cases in manufacturing and travel industry may come up over medium term.
- **BFSI:** TechM has deep presence in insurance segment in EMEA and US. Its presence in banking is limited with capabilities in digital engineering of financial products and targeted BPS capabilities. Management will target to increase presence in banking segment.
- **EBIT margin:** In Q2FY24, there was one-time impact of 260bps QoQ with EBIT margin at 4.7%. Excluding this one-time impact, margin stands at 7.3%, down 130bps QoQ vs 8.6% in Q1FY24 led by wage hikes given to senior employees, reinstatement of variable pay and decline in revenue.
- Sub-contracting expenses decreased 160bps QoQ to 12.4%. Offshore headcount is up 30bps QoQ. LTM attrition is down 200bps to 11%.
- Management highlighted key margin levers for medium term include: 1) Improvement in average resource cost led by change in employee pyramid, 2)

improvement in service line mix, 3) productivity improvement in fixed price portfolio, 4) bringing efficiency in span of control, 5) reduction in sub-contracting costs and 6) rationalisation of non-core businesses.

Exhibit 1: Q2FY24 actuals vs estimates

(INR bn)	Q2FY24	Q1FY24	QoQ	Q2FY23	YoY	Q2FY24E-ISEC	vs our estimates	Cons	vs Cons
CC growth	-2.4%	-4.2%		2.9%		-1.0%	-142 bps		
Sales (\$ m)	82.7	82.2	0.6%	80.0	3.3%	82.6	0.1%	82.7	
USD/INR	1,555	1,601	-2.8%	1,638	-5.1%	1,584	-1.8%	1,603	-3.0%
Sales (Rs mn)	1,28,639	1,31,590	-2.2%	1,31,295	-2.0%	1,30,843	-1.7%	1,32,542	-3%
EBIT	6,066	8,914	-31.9%	14,924	-59.4%	7,160	-15.3%	10,143	-40%
EBIT Margin	4.7%	6.8%	-206 bps	11.4%	-665 bps	5.5%	-76 bps	7.7%	-294 bps
Reported PAT	5,941	6,925	-14.2%	12,854	-53.8%	5,670	4.8%	8,042	-26%
EPS	6.7	7.8	-14.2%	14.5	-53.8%	6.4	4.8%	9.1	-26%

Source: I-Sec research, Company data

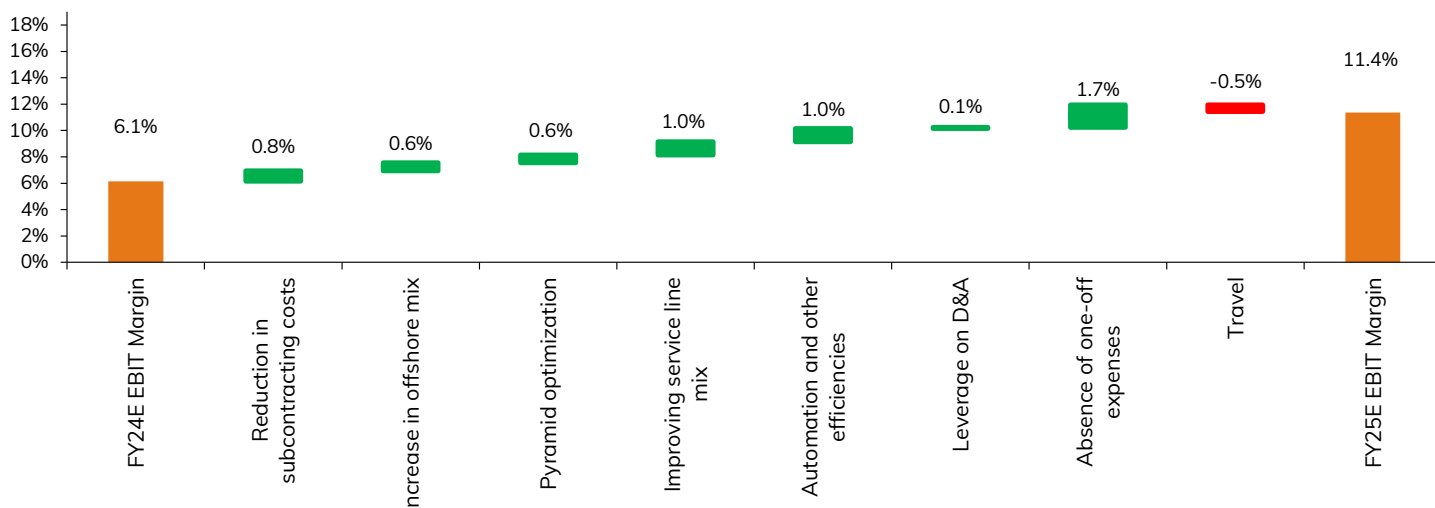
Exhibit 2: TechM – change in estimates

	New			Old			New vs Old		
	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Revenues (USD mn)	6,265	6,695	7,514	6,448	7,077	8,018	-3%	-5%	-6%
Revenue growth YoY CC	-4.6%	7.4%	12.2%	-2.1%	10.2%	13.3%	-250bps	-280bps	-110bps
Revenue growth YoY US\$	-5.2%	6.9%	12.2%	-2.4%	9.8%	13.3%	-280bps	-290bps	-110bps
INR mn									
Revenues	5,18,071	5,55,285	6,23,200	5,33,088	5,86,959	6,65,000	-3%	-5%	-6%
EBIT	31,834	63,079	92,484	46,072	81,453	1,05,339	-31%	-23%	-12%
EBIT margin	6.1	11.4	14.8	8.6	13.9	15.8	-250bps	-250bps	-100bps
EPS (Rs/share)	29.5	55.4	80.3	40.0	68.0	87.4	-26%	-18%	-8%

Source: I-Sec research, Company data

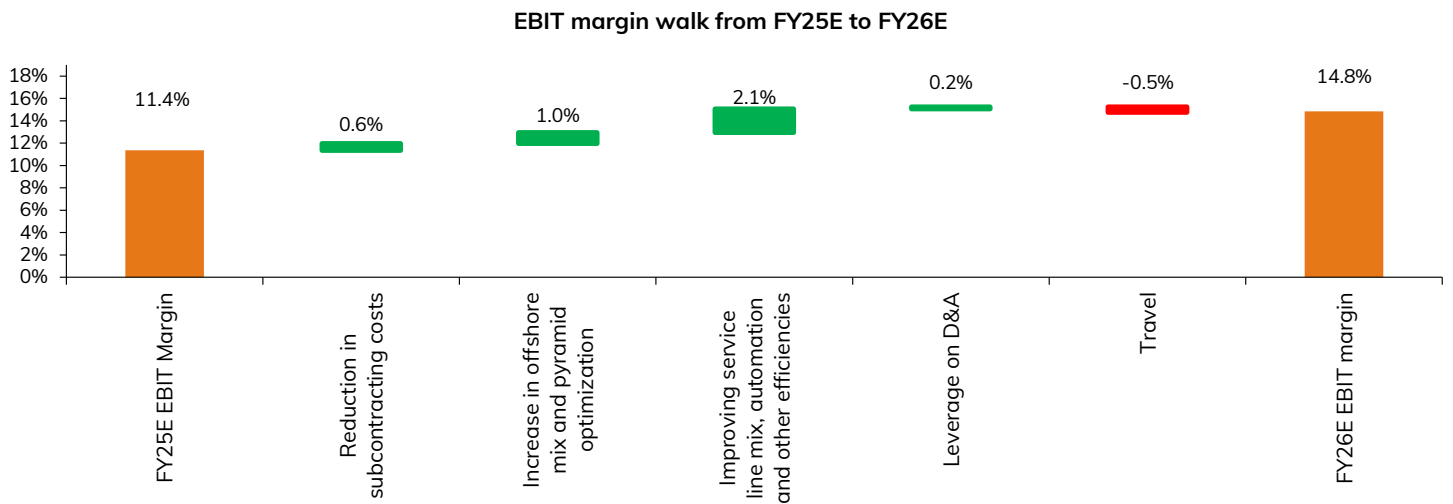
Exhibit 3: EBIT margin to improve 520bps YoY to 11.4% in FY25E

EBIT margin walk between FY24E to FY25E



Source: I-Sec research, Company data

Exhibit 4: EBIT margin to improve 350bps YoY to 14.8% in FY26E



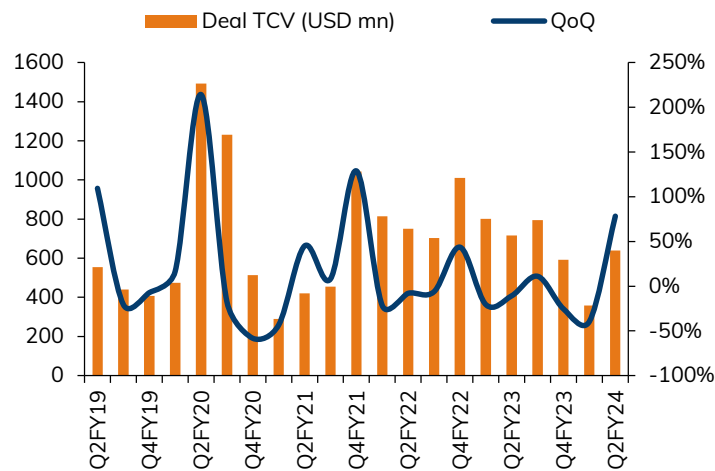
Source: : I-Sec research, Company data

Exhibit 5: TechM has scope to improve employee pyramid with less than or equal to 30 years of age employees accounting to ~48% of total employee mix vs ~60% for Infosys

	FY18	FY19	FY20	FY21	FY22	FY23
Infosys Employee mix						
Less than or equal to 30 years	60%	59%	58%	55%	60%	60%
31-50 years	38%	40%	41%	42%	38%	38%
Greater than 50 years	1%	2%	2%	2%	2%	3%
TechM Employee mix						
Less than or equal to 30 years				50%	51%	48%
31-50 years				47%	45%	48%
Greater than 50 years				2%	3%	3%

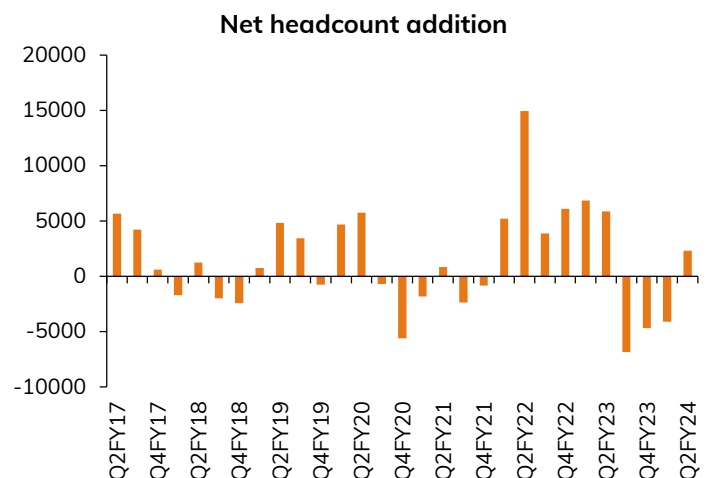
Source: I-Sec research, Company data

Exhibit 6: Uptick in deal TCV on QoQ basis



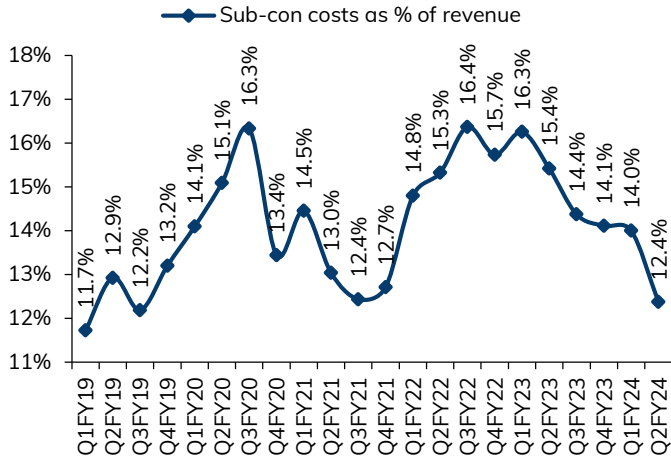
Source: I-Sec research, Company data

Exhibit 7: Sequential uptick in headcount addition



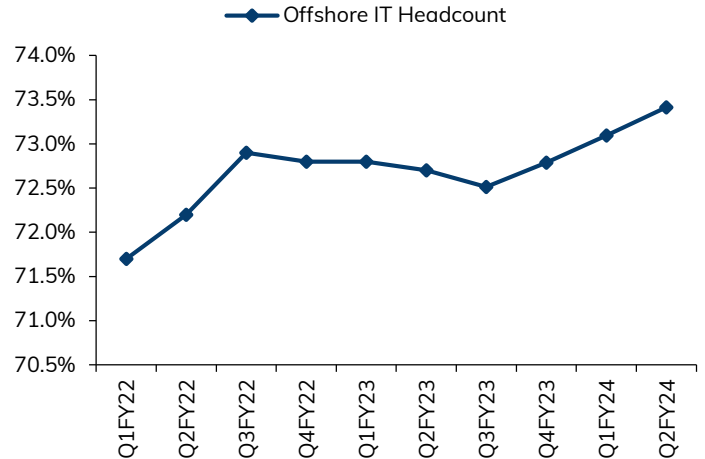
Source: I-Sec research, Company data

Exhibit 8: Sub-con expenses reduce considerably, down 160bps QoQ



Source: I-Sec research, Company data

Exhibit 9: Offshore IT headcount up 30bps QoQ



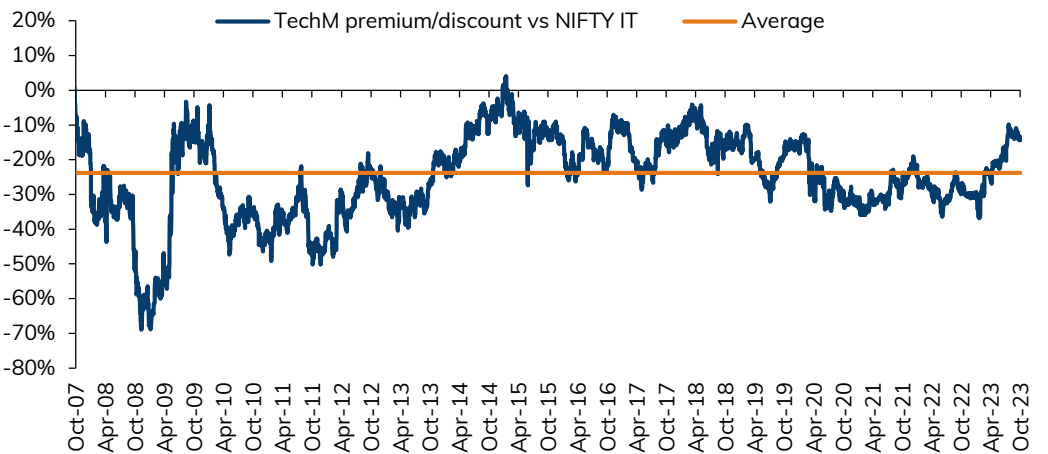
Source: I-Sec research, Company data

Exhibit 10: TechM (1yr forward P/E) is trading at 20x, closer to average+2SD of ~22x



Source: I-Sec research, Company data, Bloomberg

Exhibit 11: TechM is trading at ~14% discount to NIFTY IT vs long term average discount of ~24%



Source: I-Sec research, Company data, Bloomberg

Exhibit 12: Shareholding pattern

%	Mar'23	Jun'23	Sep'23
Promoters	35.2	35.2	35.1
Institutional investors	52.7	52.7	52.8
MFs and others	12.9	12.8	13.6
Insurance Cos	11.9	12.6	13.0
FIIIs	27.9	27.3	26.2
Others	12.1	12.1	12.1

Source: Bloomberg, I-Sec research

Exhibit 13: Price chart



Source: Bloomberg, I-Sec research

Financial Summary

Exhibit 14: Profit & Loss

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
Net Sales (US\$ mn)	6,606	6,265	6,695	7,514
Net Sales (INR mn)	5,32,902	5,18,071	5,55,285	6,23,200
Operating Expense	4,52,614	4,68,090	4,73,326	5,10,462
EBITDA	80,288	49,981	81,959	1,12,737
EBITDA Margin (%)	15.1	9.6	14.8	18.1
Depreciation & Amortization	19,567	18,147	18,880	20,254
EBIT	60,720	31,834	63,079	92,484
Interest expenditure	3,256	4,143	3,942	3,942
Other Non-operating Income	7,280	10,722	7,831	8,171
Recurring PBT	64,744	38,413	66,969	96,714
Profit / (Loss) from Associates	(290)	(7)	-	-
Less: Taxes	15,885	8,859	17,412	25,146
PAT	48,859	29,554	49,557	71,568
Less: Minority Interest	(257)	(453)	(456)	(456)
Net Income (Reported)	48,569	29,547	49,557	71,568
Extraordinaries (Net)	-	-	-	-
Recurring Net Income	48,312	29,087	49,101	71,112

Source Company data, I-Sec research

Exhibit 15: Balance sheet

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
Total Current Assets	2,16,495	1,94,476	2,03,227	2,28,213
of which cash & cash eqv.	40,563	19,268	14,552	22,523
Total Current Liabilities & Provisions	1,14,999	1,11,804	1,16,709	1,22,907
Net Current Assets	1,01,496	82,673	86,517	1,05,306
Investments	33,881	27,486	27,486	27,486
Net Fixed Assets	28,622	27,224	27,424	27,624
ROU Assets	11,720	10,739	10,739	10,739
Capital Work-in-Progress	836	1,244	1,244	1,244
Goodwill	76,657	75,808	75,808	75,808
Other assets	47,631	41,896	41,896	41,896
Deferred Tax assets	12,965	14,966	14,966	14,966
Total Assets	3,34,230	3,00,008	3,04,052	3,23,041
Liabilities				
Borrowings	15,782	15,509	15,509	15,509
Deferred Tax Liability	3,261	3,003	3,003	3,003
provisions	9,288	11,074	11,074	11,074
other Liabilities	10,332	3,478	3,478	3,478
Minority Interest	4,702	4,462	4,462	4,462
Equity Share Capital	4,400	4,407	4,407	4,407
Reserves & Surplus*	2,74,845	2,47,443	2,51,487	2,70,476
Total Net Worth	2,79,245	2,51,850	2,55,894	2,74,883
Total Liabilities	3,34,230	3,00,008	3,04,052	3,23,041

Source Company data, I-Sec research

Exhibit 16: Quarterly trend

(INR mn, year ending March)

	Dec-22	Mar-23	Jun-23	Sep-23
Net Sales	1,37,346	1,37,182	1,31,590	1,28,639
% growth (YOY)	4.6	-0.1	-4.1	-2.2
EBITDA	21,440	20,205	13,380	10,723
Margin %	15.6	14.7	10.2	8.3
Other Income	1,253	-55	798	87
Extraordinaries	-	-	-	-
Adjusted Net Profit	12,966	11,176	6,925	4,939

Source Company data, I-Sec research

Exhibit 17: Cashflow statement

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
CFO before WC changes	64,197	34,963	66,513	96,258
CFO after WC changes	75,651	47,082	69,000	97,523
Capital Commitments	(20,824)	(12,635)	(19,080)	(20,454)
Free Cashflow	76,543	50,858	70,667	92,831
Other investing cashflow	18,039	12,855	7,831	8,171
Cashflow from Investing Activities	(2,785)	220	(11,249)	(12,282)
Issue of Share Capital	442	(16,634)	-	-
Interest Cost	(2,570)	-	-	-
Inc (Dec) in Borrowings	(6,020)	(7,589)	-	-
Cash flow from Financing Activities	(50,781)	(59,737)	(45,056)	(52,124)
Dividend paid	(42,633)	(37,105)	(45,056)	(52,124)
Others	(1)	1,591	-	-
Chg. in Cash & Bank balance	2,154	(21,294)	(4,717)	7,972
Closing cash & balance	40,563	19,268	14,551	22,523

Source Company data, I-Sec research

Exhibit 18: Key ratios

(Year ending March)

	FY23A	FY24E	FY25E	FY26E
Per Share Data (INR)				
Reported EPS	55.3	33.4	56.0	80.8
Diluted EPS	54.6	29.5	55.4	80.3
Cash EPS	76.9	53.4	76.8	103.2
Dividend per share (DPS)	59.9	41.9	50.9	58.9
Book Value per share (BV)	316.3	284.7	289.1	310.5
Dividend Payout (%)	109.9	142.3	91.8	73.3
Growth (%)				
Net Sales	19.4	(2.8)	7.2	12.2
EBITDA	0.1	(37.7)	64.0	37.6
EPS	(13.6)	(39.6)	67.6	44.4
Valuation Ratios (x)				
P/E	20.6	34.2	20.4	14.1
P/CEPS	14.9	21.4	14.9	11.1
P/BV	3.6	4.0	4.0	3.7
EV / EBITDA	11.9	19.7	12.1	8.7
P/S	1.9	2.0	1.8	1.6
Dividend Yield (%)	5.2	3.7	4.5	5.2
Operating Ratios				
EBITDA Margins (%)	15.1	9.6	14.8	18.1
EBIT Margins (%)	11.4	6.1	11.4	14.8
Effective Tax Rate (%)	24.5	23.1	26.0	26.0
Net Profit Margins (%)	9.2	5.7	8.9	11.5
Inventory Turnover Days	0.2	0.2	0.2	0.2
Fixed Asset Turnover (x)	18.4	17.9	19.4	21.7
Receivables Days	53	57	55	55
Payables Days	29	31	31	30
Working Capital Days	40	44	44	45
Net Debt / EBITDA (x)	(2.7)	(1.4)	(1.1)	(1.4)
Profitability Ratios				
RoCE (%)	15.5	8.6	17.0	24.0
RoC (%)	22.9	12.4	22.6	31.4
RoNW (%)	17.3	10.8	19.0	26.4

Source Company data, I-Sec research

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