Tech Mahindra

Weak FY24 margin limits the ability to accelerate in FY25

Internal restructuring pressure to add to the macro headwinds

- Tech Mahindra (TECHM) reported another quarter of weak performance, with revenue declining 2.4% QoQ in constant currency (CC) to USD1.6b, which missed our estimate of a 1.1% decline. The weakness was primarily caused by a continued slowdown in CME, which was down 4.9% QoQ and BFSI, which was down 2.8% QoQ. However, Manufacturing showed continued strength with 2.3% QoQ growth. EBIT margin (adjusted for organizational restructuring) contracted 150bp QoQ to 7.3% in 2QFY24, below our estimate of 8.7%. TCV of USD640m (+78% QoQ/-10.6% YoY) improved in 2QFY24 after reporting two consecutive quarters of decline.

- Weakness in the key Communications vertical, along with an internal restructuring exercise (deprioritizing a few business lines and non-strategic accounts), led to another notable decline in TECHM’s revenue performance (-5.9% YoY in CC). Management expects this pain to continue in the Communications vertical, especially in relation to 5G-related investments. With weakness in the BFSI sector and the need to rationalize low-margin accounts, we anticipate that the company will experience a decline in FY24 (MOFSle at -4.6% YoY), before returning to growth in the following year. Moreover, while realigning the vertical and horizontal service lines should benefit the company in streamlining its execution, we expect the process to take most of FY25 before starting to yield results for the company. Our estimates indicate a flat FY23-25 USD revenue CAGR of 1.0%.

- Due to the ongoing challenges in revenue growth and restructuring efforts, TECHM witnessed a significant decline in profitability. This decline was further worsened by a 110bp contraction due to a one-off (vs. 200bp one-time impact caused by a client's bankruptcy). We expect the company's profitability to improve from 3Q onward, partially through the reversal of one-off expenses and progress made in organizational restructuring. We expect FY24 (adj)/FY25 EBIT margins to be 8.7%/10.7%, which will lead to a slight decrease in INR PAT from FY23 to FY25E, despite a low base in FY23 (PAT -8.9% YoY).

- While we expect a potential benefit to come from the overhaul exercise, we believe that it will take time due to macro headwinds and limited opportunities to participate in the transformation initiatives.

- We are staying on the sidelines because we believe that the current valuation adequately accounts for the uncertainties surrounding growth and margin. We reduce our FY24/FY25 EPS estimates by 2-10% due to sluggish growth and a subdued outlook. **Reiterate Neutral with a TP of INR1,040 (premised on 19x FY25E EPS).**

Big miss on revenue and PAT

- Revenue stood at USD1.6b, down 2.4% QoQ CC (est. -1.1% QoQ CC) in 2Q.
- IT Service decelerated 4.1% QoQ, while BPO was muted (-0.7% QoQ).

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CME witnessed a further decline of 4.9% QoQ (vs. -9.4% in 1Q), followed by BFSI (-3.0% QoQ). Retail and Technology were flat QoQ. Manufacturing was up 2.2% QoQ though.

- EBIT margin contracted 150bp QoQ/410bp YoY to 7.3% (est. 8.7%).
- Net employee additions improved by 2,300, after three consecutive quarters of more than 15,000 (collectively) headcount reduction. Utilization (ex. trainees) was up by 120bp QoQ at 86%, LTM attrition improved 140bp QoQ to 11.4%
- NN Deal TCV was strong at USD640m, up 78.3% QoQ/ down 10.6% YoY.
- Adj. PAT stood at INR9.8b (up 2.3% QoQ), above our estimate of INR9.0b, due to lower ETR at 10% vs. 22% in 1Q.
- FCF conversion to PAT stood at 357.6% vs. 126.3% in 1QFY24.

Key highlights from the management commentary

- The company has taken definitive actions in 2QFY24 to prioritize its core business and functions, while deprioritizing certain service lines. It has terminated/closed down a few projects for realignment purpose, leading to a drag in the 2Q revenue growth.
- For large deals, the company is building capabilities in each SBU with deal advisory relationships to pursue significant deals in the areas of Digitization, Transformation, GenAI, and Cloud migration. The company has also set margin aspiration and it would continue to evaluate every large deal wins.
- The sector is undergoing significant challenges, while major telcos remain under stress as they have invested heavily in 5G infrastructure and are awaiting outcomes from those projects.
- The adjusted EBIT margin in 2Q was 7.3% (down 150bp QoQ). Apart from restructuring, the additional costs incurred in 2Q were related to multiple stakeholder dependencies, which are leading to a drag in operating margin.

Valuation and view

- Although its 2QFY24 performance was weak, TECHM’s high exposure to the Communications vertical offers a potential opportunity, since a broader 5G rollout is likely to result in a new spending cycle in this space.
- Near-term growth remains weak and we await greater comfort on margins. We value the stock at 19x FY25E EPS. **We maintain our Neutral rating on the stock.**
## Key Performance Indicators

### Quarterly performance

<table>
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<tr>
<th>Y/E March</th>
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<th>FY24</th>
<th>FY23</th>
<th>FY24</th>
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<td></td>
<td>1Q</td>
<td>2Q</td>
<td>3Q</td>
<td>4Q</td>
</tr>
<tr>
<td>Revenue (USD m)</td>
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<td>1,638</td>
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<td>QoQ (%)</td>
<td>1.5</td>
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<td>0.0</td>
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<td>YOY (%)</td>
<td>575bp</td>
<td>788bp</td>
<td>188bp</td>
<td>163bp</td>
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<tr>
<td>Adj. Net Margin (%)</td>
<td>11.0</td>
<td>11.4</td>
<td>12.0</td>
<td>11.2</td>
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<td>Adj. EBIT Margin (%)</td>
<td>14.8</td>
<td>15.1</td>
<td>15.6</td>
<td>14.7</td>
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<tr>
<td>Adj. PAT</td>
<td>11</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>ETR (%)</td>
<td>22.8</td>
<td>21.4</td>
<td>27.3</td>
<td>22.9</td>
</tr>
</tbody>
</table>

#### Operating Metrics

- **Headcount (k):** 158
- **Util excl. trainees (%):** 83.3
- **Attrition (%):** 22.2
- **Deal TCV (USD m):** 802

#### Key Verticals (QoQ %)

- **Communication:** 1.0
- **Enterprise:** 1.8

#### Key Geographies (QoQ %)

- **North America:** 4.2
- **Europe:** -2.0

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### Highlights from the management commentary

**Organizational restructuring**

- TECHM is undergoing a rigorous organizational restructuring exercise at present. As a result, there is a temporary decrease in revenue from certain regions, business lines, and clients that are not meeting the established standards set during the restructuring activities. The new structure will be effective in Jan’24.

- Management is confident that the new structure will improve efficiency, enhance the customer experience, promote innovation, and drive modernization on a large scale. Additionally, the new structure would: 1) be doubling down focus on top accounts; and 2) augment the sector as it has tremendous rights to win (Communications and Manufacturing), and then gradually build upon other sectors (BFSI and Consumer).

- The company has taken definitive actions in 2QFY24 to prioritize its core business and functions, while deprioritizing certain service lines. It has...
terminated/closed down a few projects for realignment purpose, leading to a
drag in the 2Q revenue growth.

- As a part of the restructuring exercise, TECHM is utilizing its inherent strength in
  Communication (core) and Manufacturing (through its Parent), which will
  continue to be the key focus areas of its new structure.
- For large deals, the company is building capabilities in each SBU with deal
  advisory relationships to pursue significant deals in the areas of Digitization,
  Transformation, GenAI, and Cloud migration. The company has also set margin
  aspiration and it would continue to evaluate every large deal wins.

**Demand and industry outlook**

- Telecom – The sector is undergoing significant challenges, while major telcos
  remain under stress as they have invested heavily in 5G infrastructure and are
  awaiting outcomes from those projects. TECHM has established labs and use-
  cases in 5G and is building close relationships with these OEMs. They are also
  applying their expertise in Enterprise, specifically in the areas of Manufacturing
  and Travel. However, management does not anticipate any immediate recovery
  in the Communications vertical.
- Manufacturing – The momentum continues in 2Q as the segment is under-
  invested in technology. It continues to gain traction in: a) remote engineering
  from developers’ perspective, and b) customer experience from sales
  perspective.
- BFSI – TECHM has a deep presence in Insurance in the US and Europe. The
  company is benefiting from this and is plugging the gap that is being created on
  the Banking vertical. Within banking, selective capabilities such as mortgages
  and asset management continue to do well in Europe. TECHM is actively forming
  partnerships and developing a go-to-market (GTM) strategy to tap into the
  existing accounts and acquire new ones.

**Margin performance**

- TECHM is strategically utilizing various methods to enhance its margins and
  firmly believes that FY25 is poised for significant margin improvement. The
  company is: 1) changing the service mix while leveraging upon high-realization
  horizontal line (digital product engineering vs. service assurance); (2) realigning
  the cost structure of acquired entities; 3) driving Automation; and (4) optimizing
  sub-contractor expenses. However, no meaningful measures have been taken
  on optimizing SG&A costs.
- The adjusted EBIT margin in 2Q was 7.3% (down 150bp QoQ). Apart from
  restructuring, the additional costs incurred in 2Q were related to multiple
  stakeholder dependencies, which are leading to a drag in operating margin.

**Exhibit 1: CME saw a further drag in 2QFY24 vs. 9.4% decline in 1Q**

<table>
<thead>
<tr>
<th>Verticals</th>
<th>Contribution to revenue (%)</th>
<th>Growth (QoQ %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comm., Media, and Ent.</td>
<td>37.0</td>
<td>-4.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>17.8</td>
<td>2.3</td>
</tr>
<tr>
<td>Technology</td>
<td>11.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>BFSI</td>
<td>16.1</td>
<td>-2.8</td>
</tr>
<tr>
<td>Retail, Transport, and Logistics</td>
<td>8.2</td>
<td>0.8</td>
</tr>
<tr>
<td>Others</td>
<td>9.9</td>
<td>-9.3</td>
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</table>
**Exhibit 2: Europe & ROW saw a sharp decline in 2QFY24**

<table>
<thead>
<tr>
<th>Geographies</th>
<th>Contribution to revenue (%)</th>
<th>Growth (QoQ %)</th>
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</thead>
<tbody>
<tr>
<td>Americas</td>
<td>53.3</td>
<td>0.7</td>
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<tr>
<td>Europe</td>
<td>23.6</td>
<td>-6.8</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>23.2</td>
<td>-6.1</td>
</tr>
</tbody>
</table>

**Valuation and view**

- Although its 2QFY24 performance was weak, TECHM’s high exposure to the Communications vertical offers a potential opportunity, since a broader 5G rollout is likely to result in a new spending cycle in this space.
- Near-term growth remains weak and we await greater comfort on margins. We value the stock at 19x FY25E EPS. **We maintain our Neutral rating on the stock.**

**Exhibit 3: Revisions to our estimates**

<table>
<thead>
<tr>
<th></th>
<th>Revised estimate</th>
<th>Earlier estimate</th>
<th>Change</th>
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<td>USD:INR</td>
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<td>83.0</td>
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<tr>
<td>Revenue (USD m)</td>
<td>6,268</td>
<td>6,730</td>
<td>6,401</td>
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<tr>
<td>Growth (%)</td>
<td>(5.1)</td>
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<tr>
<td>EBIT margin (%)</td>
<td>8.7</td>
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<td>PAT (INR b)</td>
<td>39</td>
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<td>40</td>
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<tr>
<td>EPS</td>
<td>44.1</td>
<td>54.7</td>
<td>44.9</td>
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</table>

Source: MOFSL, Company
Story in charts

Exhibit 4: Deal wins improved in 2QFY24

Exhibit 5: Another quarter of revenue decline

Exhibit 6: Adj. EBIT margin saw a further decline of 150bp QoQ in 2QFY24

Exhibit 7: Utilization reduced by 120bp in 2QFY24 (%)

Exhibit 8: Headcount improved in 2QFY24

Source: Company, MOFSL

Source: Company, MOFSL

Source: Company, MOFSL

Source: Company, MOFSL
Exhibit 9: Operating metrics

<table>
<thead>
<tr>
<th></th>
<th>2QFY22</th>
<th>3QFY22</th>
<th>4QFY22</th>
<th>1QFY23</th>
<th>2QFY23</th>
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<th>4QFY23</th>
<th>1QFY24</th>
<th>2QFY24</th>
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<tr>
<td><strong>Revenue by Geography (%)</strong></td>
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<tr>
<td>Americas</td>
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<td>25.3</td>
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<tr>
<td>Rest of World</td>
<td>26.3</td>
<td>25.6</td>
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<td>Telecom</td>
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<td>Manufacturing</td>
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<td>BFSI</td>
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<td>Retail</td>
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<td>Others</td>
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<td><strong>Client Metrics</strong></td>
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<td>No. of active clients</td>
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<td>1,262</td>
<td>1,290</td>
<td>1,297</td>
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<td><strong>Total</strong></td>
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<td>1,45,067</td>
<td>1,51,173</td>
<td>1,58,035</td>
<td>1,63,912</td>
<td>1,57,068</td>
<td>1,52,400</td>
<td>1,48,297</td>
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<td>IT Attrition (LTM %)</td>
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<td>24</td>
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<td>22</td>
<td>20</td>
<td>17</td>
<td>15</td>
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<td>IT Utilization (%)</td>
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<td>IT Utilization (excl. trainees)</td>
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<td>DSO - incl. unbilled</td>
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<td>97</td>
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<td>98</td>
<td>98</td>
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<td>97</td>
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<td>Borrowings (USD m)</td>
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<td>212.0</td>
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<td>187</td>
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<tr>
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Source: Company, MOFSL
## Financials and valuations

### Income Statement

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<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24E</th>
<th>FY25E</th>
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### Balance Sheet

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<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24E</th>
<th>FY25E</th>
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<td>289</td>
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<td>338</td>
<td>343</td>
<td>348</td>
<td>357</td>
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### Applications

| Assets     | 79    | 73    | 89    | 91    | 149   | 149   | 146   | 145   |
| Investments | 15    | 12    | 2     | 6     | 4     | 6     | 6     | 6     |
| Other non-current assets | 30   | 33    | 50    | 47    | 50    | 62    | 60    | 65    |
|Curr. Assets | 181   | 216   | 232   | 253   | 245   | 244   | 250   | 262   |
| Debtors    | 65    | 70    | 76    | 65    | 75    | 81    | 80    | 86    |
| Cash and Bank Balance | 20  | 20    | 30    | 27    | 38    | 41    | 35    | 22    |
| Investments | 75    | 98    | 57    | 98    | 46    | 30    | 55    | 80    |
| Other Current Assets | 22   | 28    | 68    | 63    | 86    | 93    | 80    | 75    |
|Current Liab. and Prov. | 70   | 91    | 87    | 88    | 111   | 119   | 114   | 121   |
| Net Current Assets | 111   | 124   | 145   | 165   | 134   | 126   | 136   | 142   |
| Application of Funds | 235 | 243   | 287   | 309   | 338   | 343   | 348   | 357   |
### Financials and valuations

#### Ratios

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<tr>
<th>Y/E March</th>
<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24E</th>
<th>FY25E</th>
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#### Cash Flow Statement (INR b)

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<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24E</th>
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<td>27</td>
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<td>41</td>
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