

India IT Services - Select Midcap Names to Maintain Growth Leadership

Key Sectoral Tailwinds:

- ☞ Pandemic-led Accelerated Adoption of Technology
- ☞ Digital IT Services Expected to Clock 15-20% CAGR over FY21-25E
- ☞ Potential Acquisition Opportunities of Captive Units/Vendor Consolidation to Increase Market Share
- ☞ Supply Side Constraints to Remain a Medium-term Phenomenon; Make a Case for Better Pricing
- ☞ Healthy Deal Wins & Robust FY22 Guidance
- ☞ Double-Digit Growth Deserves Premium Valuation

We released our initiation report on [Mid-cap IT names in Jul'20](#) amid uncertainty over the sectoral outlook led by COVID-led disruptions. Pandemic has accelerated enterprise IT transformation cycle with large enterprises stepping up focus on cloud migration, customer experience, data analytics and cyber security. Indian IT names witnessed strong deal wins and margin recovery in FY21 driven by increased offshoring and higher utilization. Our interpretation of the current scenario, post series of interactions with the companies, sectoral experts and channel check suggests strong sustainable recovery and better earnings visibility. We increase our earnings estimates of the mid-cap companies under our coverage universe by 14.8-45.6% and 10.7-48.8% for FY22E and FY23E, respectively. We initiated [large-cap IT](#) names in Mar'21 with FY24E estimates and currently we introduce the same for the mid-cap IT names. We also increase our valuation multiple by 33-103% and upwardly revise the Target Price of the stocks under our mid-cap IT coverage universe by 59-235%.

Key Highlights:

1. We continue our positive stance on Indian IT sector, as we envisage the current technology spending up-cycle as a multi-year trend. We expect the IT names in our coverage universe to clock low to mid-teen revenue CAGR over FY21-FY24E.
2. Additionally, most Indian IT companies have guided for double-digit revenue growth in FY22E led by strong deal wins and robust deal pipeline.
3. Notably, whilst 2 IT names out of 8 exceeded our EBIT margin estimate in 1QFY22, we expect EBIT margin to witness marginal moderation, going ahead considering optimum utilization, higher talent cost and return of travel cost. On the other side, we expect TechM & Mphasis to report 140-30bps increase in their respective FY22E EBIT margin.
4. While hiring trends remained robust in 1QFY22, employee addition remained higher than revenue growth in FY21 as well, which suggests the robust demand scenario.
5. IT names (specifically Infosys and Cognizant) have highlighted rise in attrition. As their current attrition level is well below the high of FY19-FY20, we do not expect any significant impact on demand fulfilment.
6. Second wave of COVID in India (Apr-May'21) did not have any substantial impact on the execution front for Midcap IT names.

Outlook & Valuation

Currently, Nifty IT 1-year forward PE multiple stands at 27.5x, which is 25% premium to the broader market. Additionally, Nifty IT is trading at 20% discount to NASDAQ, which witnessed substantial multiple rerating (~47% premium) compared to S&P-500 owing to disruptions by the large technology firms. Further, Nifty IT traded at 10-30% premium to broader market over FY10-FY14, when the IT names were reporting double-digit growth. Looking ahead, we expect Nifty IT to trade at premium to broader index driven by: (1) likelihood of double-digit revenue growth over FY21-FY24E and medium-term growth resiliency due to increasing technology adoption; (2) increasing collaboration with the large hyperscalers and SaaS companies; and (3) peer set companies (with ~20% revenue growth) are trading at higher multiple.

Our Top Picks: L&T infotech, TechM & Mphasis

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Presentation ☞



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Coverage Summary

Company	Rating	CMP (Rs)	2 Yr TP (Rs)	Upside (%)
LTI	BUY	4,879	6,000	23.0
Mindtree	SELL	2,926	3,020	3.2
Mphasis	BUY	2,767	3,470	25.4
TechM	BUY	1,387	1,750	26.2

Source: RSec Research; Note: CMP as on 12 August 2021

Price Performance

Company	Mkt. Cap. (Rs bn)	Absolute Performance		
		1 M	3 M	12 M
LTI	856	20.9	34.9	95.5
Mindtree	482	17.2	33.0	158.3
Mphasis	525	24.9	49.7	138.1
TechM	1,225	31.3	42.0	100.4

Source: RSec Research; Note: CMP as on 12 August 2021

Table of Contents

Content	Page No.
Sector At a Glance	
▶ India IT Services - (Select Midcap Names to Maintain Growth Leadership).....	1
▶ Investment Decision Matrix (IDM).....	3
▶ Environmental, Social & Governance Matrix (ESGM)	4
▶ Channel Check Takeaways	5-6
▶ Change in Estimates, Rating & Target Price	8
▶ Key Sectoral Updates.....	10
• Pandemic-led Accelerated Adoption of Technology.....	10
• Digital IT Services Expected to Clock 15-20% CAGR over FY21-25E.....	10
• Potential Acquisition Opportunities of Captive Units/Vendor Consolidation to Increase Market Share...	12
• Supply Side Constraints to Remain a Medium-term Phenomenon; Make a Case for Better Pricing.....	12
• Healthy Deal Wins & Robust FY22 Guidance.....	13
• Expected Growth Justifies Premium Valuation.....	15
Company Section	16
▶ L&T Infotech	17
▶ Mindtree	29
▶ Mphasis	41
▶ Tech Mahindra	54

Investment Decision Matrix (IDM)

Parameters	L&T Infotech		Mindtree		Mphasis		TechM	
	Score	Risk	Score	Risk	Score	Risk	Score	Risk
Management Quality	9	Low	7	Low	8	Low	6	Low
Promoter's Holding Pledge	10	Low	10	Low	10	Low	8	Low
Board of Directors Profile	9	Low	10	Low	8	Low	8	Low
Industry Growth	8	Low	8	Low	8	Low	8	Low
Regulatory Environment / Risk	8	Low	8	Low	7	Low	7	Low
Entry Barriers / Competition	5	Medium	5	Medium	5	Medium	6	Low
New Business/Client Potential	9	Low	7	Low	7	Low	8	Low
Business Diversification	6	Low	2	High	5	Medium	6	Low
Market Share Potential	8	Low	8	Low	7	Low	7	Low
Margin Expansion Potential	8	Low	6	Low	8	Low	7	Low
Earnings Growth	8	Low	8	Low	9	Low	8	Low
Balance Sheet Strength	9	Low	10	Low	8	Low	8	Low
Debt Profile	10	Low	10	Low	8	Low	8	Low
FCF Generation	9	Low	9	Low	9	Low	9	Low
Dividend Policy	5	Medium	5	Medium	9	Low	7	Low
Total Score Out of 150	121		113		116		111	
Total Score (%)	80.7%	Low	75.3%	Low	77.3%	Low	74%	Low

Environmental, Social & Governance Matrix (ESGM)

Parameters	L&T Infotech		Mindtree		Mphasis		TechM	
	Score	Risk	Score	Risk	Score	Risk	Score	Risk
Environment								
Climate Change and Carbon Emissions	10	Low	10	Low	10	Low	9	Low
Air & Water Pollution	10	Low	10	Low	8	Low	10	Low
Biodiversity	9	Low	7	Low	8	Low	8	Low
Deforestation	10	Low	7	Low	8	Low	8	Low
Energy Efficiency	9	Low	10	Low	8	Low	7	Low
Waste Management	7	Low	10	Low	8	Low	7	Low
Defence / Arms / Ammunition Exposure	6	Low	8	Low	8	Low	6	Low
Social								
Customer Satisfaction	8	Low	9	Low	8	Low	8	Low
Data Protection & Privacy	8	Low	8	Low	8	Low	8	Low
Gender & Diversity	7	Low	7	Low	7	Low	8	Low
Employee Engagement	5	Medium	5	Medium	5	Medium	5	Medium
Community Relations / Service	7	Low	8	Low	7	Low	7	Low
Human Rights	7	Low	7	Low	6	Low	7	Low
Labor Standard	8	Low	8	Low	5	Medium	6	Low
Governance								
Audit Committee Structure	8	Low	8	Low	8	Low	7	Low
Bribery & Corruption	8	Low	8	Low	7	Low	8	Low
Executive Compensation	7	Low	6	Low	6	Low	4	High
Lobbying	7	Low	7	Low	8	Low	8	Low
Political Contribution	6	Low	8	Low	10	Low	6	Low
Whistleblower Schemes	8	Low	8	Low	8	Low	9	Low
Total Score Out of 200	155	Low	159	Low	151	Low	146	Low
Total Score (%)	77.5%		79.5%		75.5%		73%	

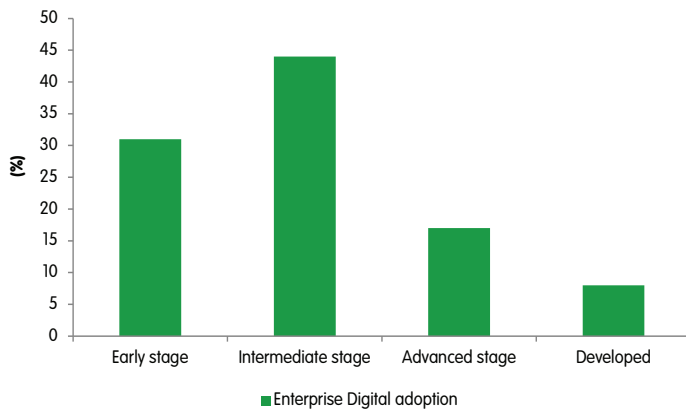
Channel Check Takeaways

We had a detailed discussion with Mr. Dinesh Goel (Partner, Siana Capital and former MD of ISG) to get some insights/trends of the Indian IT services industry. The key takeaways of our discussions are enumerated hereunder.

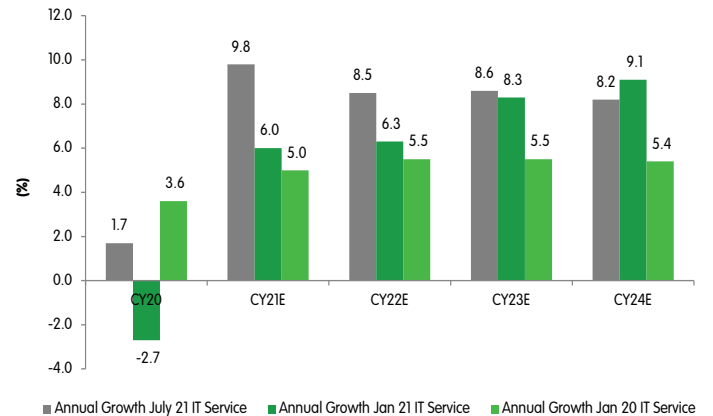
- 1. Deal Environment Remains Strong; COVID Accelerated Transformation Demand:** Currently, the demand environment remains quite strong. While trends such as automation, cloud migration and digital transformation were underway, COVID has accelerated technology adoption, as the enterprises now require engaging both the consumers and employees remotely. Typically, financial services, telecom and retail verticals were early adopters of digital technology. Now, the other industries are also aggressively adopting newer contactless technologies. Mr. Goel highlighted that technology intensity across industries/world will rise, going forward. It means the enterprises will have to spend more on technology and the very definition of 'technology spend' will get broader. Technology budgets will not only comprise of software applications and hardware, but also it will include launch of new service lines, consolidation of activities and cost optimization projects. Basically, technology will become front-end of all business verticals and the IT industry is likely to be the key beneficiary of this transformation.
- 2. Expect Strong Demand for Cloud Related Services:** Mr. Goel envisages strong demand specially across cloud related services such as consulting, migration, re-architecture and integration of application to cloud. Entire cloud ecosystem is likely to witness strong demand. Large number of enterprises are still sitting on the fence with on-premise data centers, which will migrate to cloud in the coming years. There will be greater demand for automation, cyber security and data analytics services. According to Mr. Goel, the Indian IT industry has the potential to grow in the range of 10-15% over next few years. The leaders can grow at upper range of the industry growth, as they will benefit from market share gain.
- 3. Current Attrition Spike is Manageable:** Mr. Goel attributed the current attrition spike to robust demand environment. Skilled workforce around cloud, cyber, full stack services and data science is in demand and the employers are trying to retain/attract new talent. This is not a new phenomenon, as the industry witnessed this even earlier. Ruling out any cause of concern for the large players, Mr. Goel expects the IT industry can handle it ably.
- 4. Impact of Second COVID Wave on Execution:** Industry is well-prepared in terms of business continuity. Even last year, the metros were under lockdown and the people continued to work from home even after lockdown was lifted. Captives also operate in a similar environment, but some captives have transferred work onsite, which is critical for business operations as the western world is currently in a better pandemic situation with significant population have been vaccinated. Sub-contractors have gone up for most companies, which is more due to nature of demand and talent scarcity as opposed to travel restrictions.
- 5. Greater Acceptance of Remote Working Model:** Lockdown forced the enterprises to adopt work from home model. Surprisingly, in post lockdown era also, several enterprises continued with 80-85% of workforce working remotely. Enterprises have highlighted increased productivity in remote working model. Mr. Goel highlighted greater acceptance of remote working model by the IT names and their end customers.
- 6. ER&D Spend is Underexploited – Offers Huge Opportunity:** ER&D services is less matured compared to offshoring. Mr. Goel believes ER&D as segment is underexploited and has a huge growth potential. Despite lagging behind by few years, it witnesses growth trajectory like that of the IT industry. There is a great talent pool available in India and the independent companies and divisions of large companies are also present in this segment. ER&D services is much more technical and it helps the company with vertical focus; for example, KPIT - a smaller ER&D firm, which is totally focused on automotive vertical.

7. **Global Competitive Landscape: (1) Captives:** Mr. Goel believes the captives are not a threat to IT industry, as they are the partners. Large enterprises should have both captives and third-party vendors in their IT ecosystem. Captives are here to stay. There is a room for both third-party vendors and captives to grow. **(2) Hyperscalers:** Their business model is different. They are not interested in competing with service providers. It might be possible that the hyperscalers are in some adjacent services because of their core offerings, which may have some competition with traditional system integrators (SI). Mr. Goel does not expect any overlap between SI and hyperscalers, as the focus of hyperscalers is different. They do not want to be the likes of TCS and Infosys. **(3) Global Vendors:** Other than large known global vendors, rest of the global vendors are losing ground to Indian IT names. **(4) Consultants:** They have limited capacity to compete with the Indian IT names in other than legacy consulting business. In a nutshell, other than Accenture, Capgemini and few others, there is limited global competition for the Indian IT names.
8. **Technology Related Consultancy Business Makes Sense:** Mr. Goel highlighted that since 2001, the Indian IT names have made 2-3 attempts to enter into consulting business. They acquired subsidiaries and hired people from consulting firm but that did not work out. The situation is bit different this time. In every US\$50mn+ IT deal, the client generally expects some help on 'what to do?' than mere 'how to do?'. Therefore, it makes sense for the IT names to acquire consulting firms, which are into technology-related consultancy.
9. **Other Comments:**
- Mr. Goel believes that no other country can challenge India in terms of engineering talent pool. Thus, India will continue to dominate the global IT industry.
 - Though there is a decline in legacy IT spend, overall technology budgets are on the rise. Mr. Goel believes that this generational shift to newer technology occurs after few years. He does not see any concern, provided the IT names can manage to modernize their service offerings and maintain their market share.
 - Mr. Goel believes that DNA of product company is not same as services company. He believes that the Indian IT companies are good in stitching solutions, which are combination of both products and services. While the Indian IT companies have developed some products relating to IT services, they do not directly compete with the product companies. Rather, the IT names will need to partner with the product companies to stay relevant.
 - Overall, HCLT's portfolio remains strong even though some products may not perform well for 1-2 quarters.
 - Wipro's new CEO has made multiple changes such as new acquisitions and appointment of regional leaders etc. As there were many people at same place for long time in Wipro, shakeout was needed to change cultural complacency of people and time will tell whether it will work.

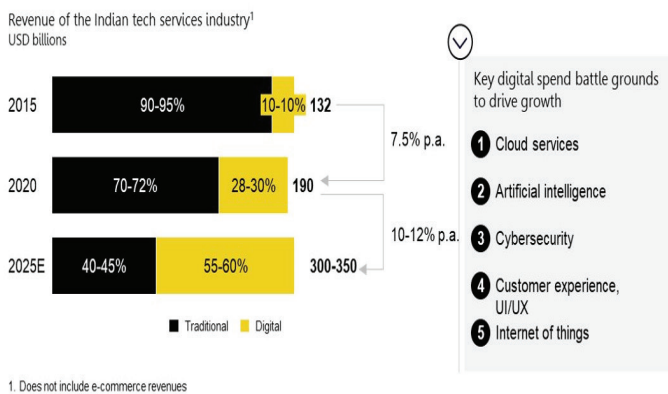
Key Charts

Exhibit 1: Digital adoption by the enterprises


Source: IT Consultant, RSec Research

Exhibit 2: Industry experts expect medium term technology uptrend


Source: RSec Research, Gartner

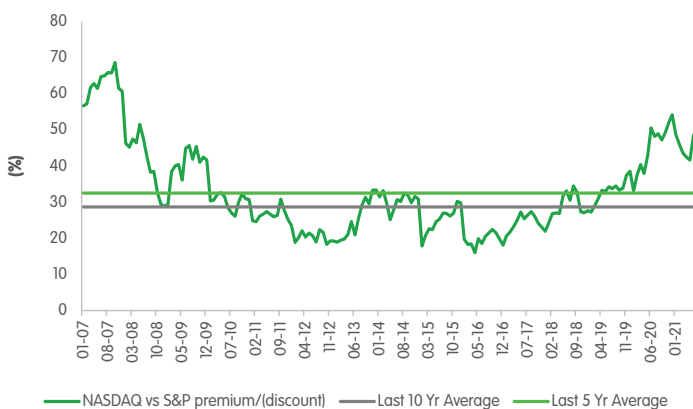
Exhibit 3: Indian IT industry can reach US\$300-350bn by 2025


1. Does not include e-commerce revenues

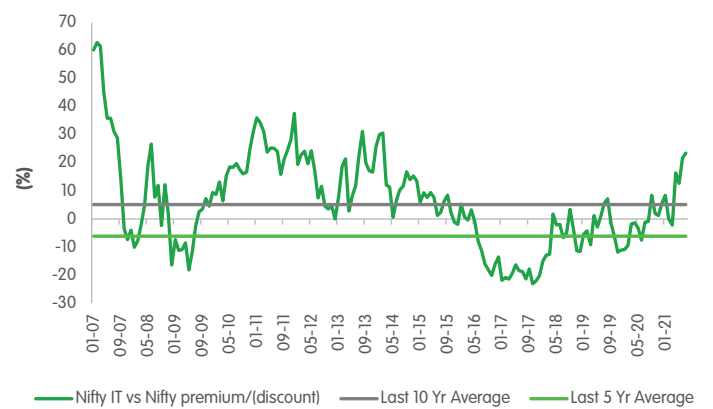
Source: NASSCOM

Exhibit 4: Attrition is still below last 5-year average range of 10.4%-17.6%


Source: Company, RSec Research

Exhibit 5: NASDAQ (US Technology Index) 12M forward PE trades at 47% premium to S&P500


Source: RSec Research, Bloomberg

Exhibit 6: Currently, Nifty IT 12M forward PE trades at 22% premium to Nifty vs. historical peak premium of 40-60%


Source: RSec Research, Bloomberg

Change in Estimates, Rating & Target Price

Propensity among the enterprises to adopt newer business models and digital technologies have gone up especially in the wake of pandemic. In the medium-term technology landscape, digital technologies (Cloud, Data, Customer Experience and DevOps) were already present but pandemic proved to be a material stimulant in driving the global enterprises to adopt them. The sector witnessed robust deal activity and revenue recovery over the last two quarters. Additionally, most names under our IT sector coverage universe have guided for double-digit constant currency revenue growth in FY22. The management commentaries on deal pipeline are encouraging as well. We believe COVID-19 has accelerated overall revenue growth trajectory of the industry to high single digit to low double-digit over FY21-FY24E vs. our earlier expectation of mid to high single digit growth. The mid-cap IT names under our coverage reported low to high single digit revenue growth in FY21 vs. our expectation of high single digit revenue decline. Additionally, on profitability front, they reported ~200-400bps higher EBIT margin in FY21 driven by improved utilization and cost control measures. Overall, revenue and EBIT margin performance was significantly ahead of our expectation in the previous fiscal.

Our channel check suggests no significant impact of second COVID wave on deal execution front. With 90-95% employees working remotely, Indian IT names were well-placed during the second COVID wave compared to the first. Further, the mid-cap IT names have been consistently upgrading partnerships with the hyperscalers, which we believe increases their outreach. We increase our earnings estimates of the mid-cap companies under our coverage universe by 14.8-45.6% and 10.7-48.8% for FY22E and FY23E, respectively driven by improved deal environment, rising share of digital revenue and recovery in the COVID-affected verticals. **Rolling over our estimates to FY24E, we expect the revenue and earnings of mid-cap companies under our coverage universe to grow by 10.5-14% and 11.1-17.6%, respectively.**

Revision in Estimates

Exhibit 7: Change in Estimates - LTI

Y/E March (Rs mn)	New			Old		% Change	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	2,004	2,319	2,644	1,782	1,974	12.5	17.5
Revenue	1,48,128	1,73,894	2,00,939	1,29,582	1,43,035	14.3	21.6
EBIT	25,611	31,157	36,079	21,023	23,400	21.8	33.2
EBIT Margin (%)	17.3	17.9	18.0	16.2	16.4	109 bps	152 bps
EPS (Rs)	121.7	147.2	171.3	104.1	117.3	16.9	25.5

Source: Rsec Research

Exhibit 8: Change in Estimates - Mindtree

Y/E March (Rs mn)	New			Old		% Change	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	1306	1471	1636	1,123	1,214	16.3	21.3
Revenue	96,602	1,10,360	1,24,338	84,210	91,016	14.7	21.3
EBIT	16,328	19,021	21,530	11,831	13,135	38.0	44.8
EBIT Margin (%)	16.9	17.2	17.3	14	14.4	290 bps	284 bps
EPS (Rs)	80.7	92.4	104.2	55.4	62.1	45.6	48.8

Source: Rsec Research

Exhibit 9: Change in Estimates - Mphasis

Y/E March (Rs mn)	New			Old		% Change	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	1,546	1782	2,022	1,328	1,434	16.4	24.3
Revenue	1,14,452	1,33,621	1,53,696	99,582	107,516	14.9	24.3
EBIT	18,753	22,306	25,644	15,436	16,749	21.5	33.2
EBIT Margin (%)	16.4	16.7	16.7	15.5	15.6	88 bps	109 bps
EPS (Rs)	78.5	92.2	108.4	68.4	75.7	14.8	21.8

Source: Rsec Research

Exhibit 10: Change in Estimates - TechM

Y/E March (Rs mn)	New			Old		% Change	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	5,806	6,480	7,163	5,534	6,074	4.9	6.7
Revenue	4,29,255	4,85,971	5,44,395	4,15,061	4,61,591	3.4	5.3
EBIT	67,027	76,996	86,919	56,747	69,407	18.1	10.9
EBIT Margin (%)	15.6	15.8	16.0	13.7	15.0	191 bps	84 bps
EPS (Rs)	63.9	71.5	79.5	54.1	64.6	18.1	10.7

Source: Rsec Research

Exhibit 11: Changes in Rating and Target Price

Company	M Cap (Rs bn)	Rating		Target Price		
		Old	New	Old	New	Change (%)
LTI	856	BUY	BUY	2,550	6,000	135.3
Mindtree	482	SELL	SELL	900	3,020	235.6
Mphasis	525	BUY	BUY	1,250	3,470	177.6
Tech Mahindra	1,225	BUY	BUY	1,100	1,750	59.1

Source: Rsec Research

Exhibit 12: Indian IT - Valuations

Stocks	Price (Rs/ US\$)	Revenue Growth (US\$) (%)			EBIT Margin (%)			PE (X)			RoE (%)		
		FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
TCS	3347	15.8	11.2	10.9	25.8	26.1	26.1	31.7	27.4	24.0	45.8	44.1	41.8
Infosys	1,685	17.4	12.3	10.5	24.4	24.3	24.6	30.4	26.7	23.6	31.5	31.7	31.5
HCLT	1,093	14.0	11.2	10.1	20.4	20.2	20.2	20.9	18.6	16.5	22.5	22.3	22.1
Wipro	606	17.7	11.0	8.5	17.8	18.5	19.0	31.1	26.8	23.6	14.2	14.6	15.7
Tech Mahindra	1,375	13.5	12.2	10.0	18.9	19.1	19.2	21.5	19.1	17.3	21.7	22.5	22.9
Mindtree	2,926	21.3	12.6	11.2	16.9	17.2	17.3	36.2	31.6	28.1	23.6	23.9	25.9
Mphasis	2,767	17.7	16.7	15.0	16.4	16.7	16.7	35.2	30.0	25.5	23.9	26.1	28.5
LTI	4,879	20.0	15.7	14.0	17.3	17.9	18.0	40.1	33.1	28.5	26.6	27.2	26.7
Average of Top-8 Indian IT names		17.2	12.9	11.3	19.7	20.0	20.1	30.9	26.7	23.4	26.2	26.6	26.9
Accenture*	321	9.8	7.6	8.2	15.4	15.6	16.3	32.4	29.6	24.8	30.5	29.3	32.3
Cognizant*	76	10.1	6.6	8.1	15.2	14.9	14.8	18.6	16.8	15.5	18.4	18.2	17.1
EPAM*	605	30.8	22.8	29.9	17.1	17.5	18.6	73.8	59.2	47.3	19.9	21.3	21.1
Average of US based IT names		16.9	12.4	15.4	15.9	16.0	16.6	41.6	35.2	29.2	22.9	22.9	23.5
Global IT Average		17.1	12.7	12.4	18.7	18.9	19.2	33.8	29.0	25.0	25.3	25.6	26.0

Source: RSec Research, Note: *denotes Bloomberg consensus estimates over FY21-FY24E. In case of Cognizant and EPAM, we have taken calendar year as financial year.

Key Sectoral Updates

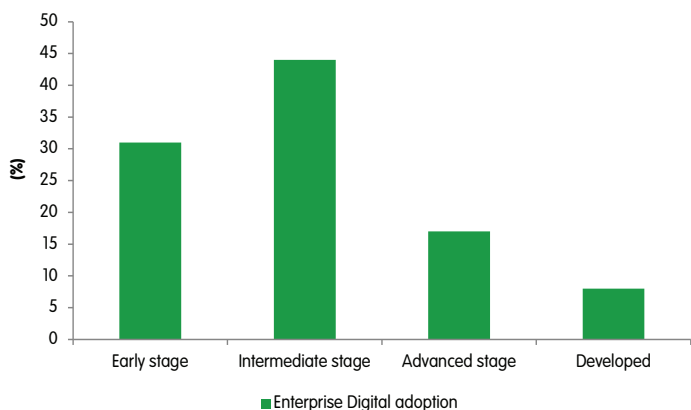
We are optimistic on the IT industry on the back of the following premises.

- Pandemic-led Accelerated Adoption of Technology
- Digital IT Services Expected to Clock 15-20% CAGR over FY21-25E
- Potential Acquisition Opportunities of Captive Units/Vendor Consolidation to Increase Market Share
- Supply Side Constraints to Remain a Medium-term Phenomenon; Make a Case for Better Pricing
- Healthy Deal Wins & Robust FY22 Guidance
- Expected Growth Justifies Premium Valuation

I. Pandemic-led Accelerated Adoption of Technology

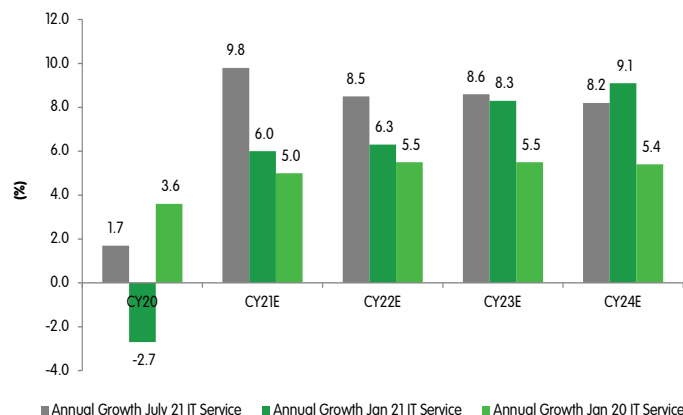
In the early period of the pandemic, though the level of economic activity remained subdued, there was a higher propensity among the enterprises to adopt newer business models and digital technologies. In the medium-term technology landscape, digital technologies (Cloud, Data, Customer Experience and DevOps) were already present but pandemic proved to be a material stimulant in driving the global enterprises to adopt them. While the digital adoption journey of the enterprises was much calibrated, the pandemic warranted a case for faster adoption of new age technologies. The pandemic highlighted the downsides of carrying a technology debt and the need for greater resilience, which resulted in accelerated initiative. The enterprises, which were already ahead in digital transformation journey, have managed to respond to pandemic-led challenges better than their peers. Going forward, as the enterprises have committed for medium-term technology transformation programme, we expect accelerated timelines and faster digital transformation for global enterprises. Large Indian IT names are likely to be key beneficiaries of enterprise-wide adoption of new age technology. We expect USD revenue of TechM, LTI, MPHL and MTCL to clock 11.9%, 16.5%, 15.6% and 15.0% CAGR, respectively over FY21-24E.

Exhibit 13: Digital adoption by the enterprises



Source: IT Consultant, RSec Reserach

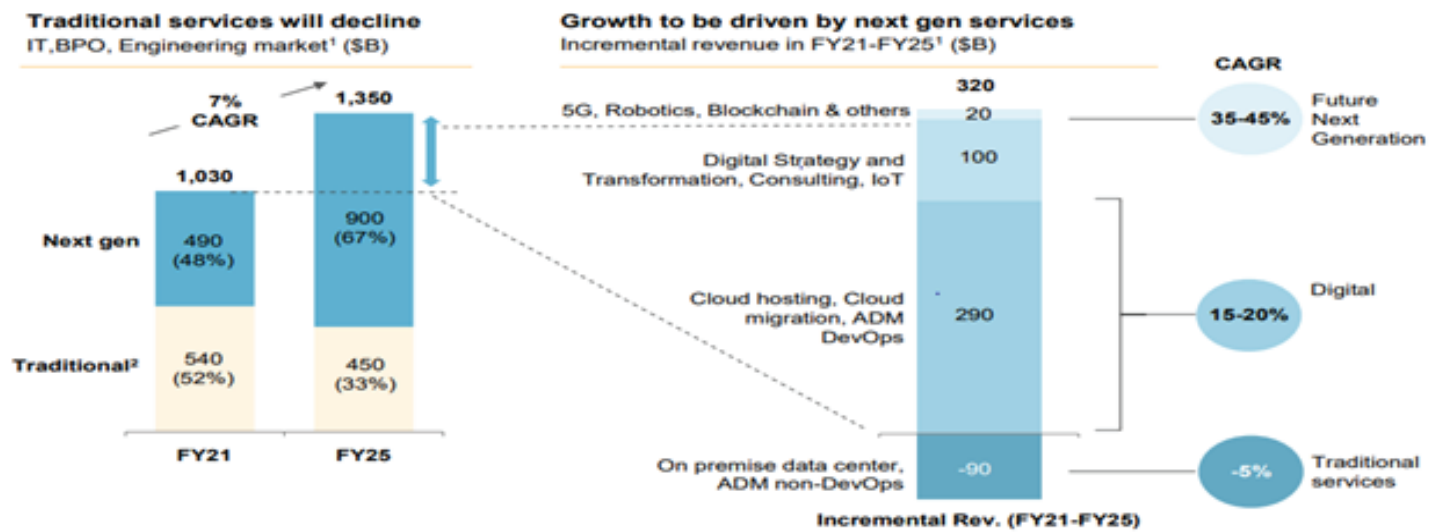
Exhibit 14: Industry experts expect medium term technology uptrend



Source: RSec Research, Gartner

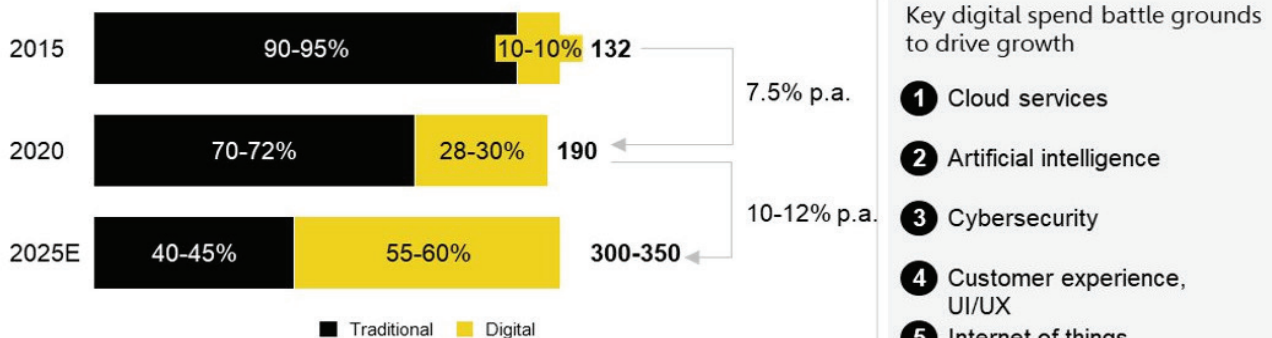
II. Digital IT Services Expected to Clock 15-20% CAGR over FY21-25E

Global IT spend is likely to clock 7% CAGR over FY21-FY25E. While the traditional components (52%) of spend (on-premise data centre and non DevOP ADMs) are expected to witness a negative CAGR of 5%, digital components are expected to register 15-20% CAGR over the same period. Digital IT services primary comprise of Cloud hosting, Cloud migration, DevOps, Consulting, transformation projects and IoT. New growth areas i.e. 5G, robotics and blockchain are likely to witness 30% CAGR over the same period. The key differentiators for digital solutions are: (1) transformation DNA; (2) industry-specific solutions; (3) automation capabilities; and (4) availability of digital talent. Digital services are likely to become the core component (67%) of IT services budget in FY25E.

Exhibit 15: Digital IT Services Expected to clock 15%-20% CAGR over FY20-FY25E


Source: Wipro

Exhibit 16: Indian IT industry can reach US\$300-350bn by 2025

Revenue of the Indian tech services industry¹
USD billions


1. Does not include e-commerce revenues

Source: NASSCOM

Exhibit 17: Top-4 IT Names Enjoy Strong Ecosystem Relationship with Large Cloud Hyperscalers

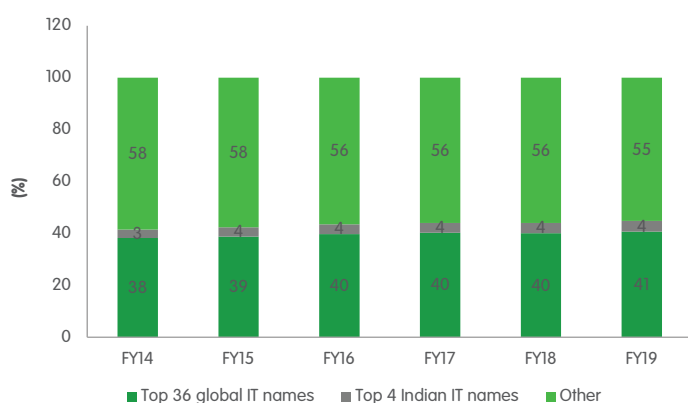
	Accenture	TCS	Infosys	Cognizant	Capgemini	Wipro	HCLT	TechM	LTI	Mphasis	Mindtree
Cloud											
System Integrator Capabilities on Google Cloud Platform	Leader	Leader	Leader	Contender	Contender	Leader	Leader			Contender	
System Integrator Capabilities on Microsoft Azure	Leader	Leader	Leader	Leader	Leader	Leader	Leader	Contender	Contender	Contender	Contender
System Integrator Capabilities on Amazon WEB Services.	Leader	Leader	Leader	Leader	Leader	Leader	Leader	Contender	Contender	Contender	

Source: RSec Research, Everest

III. Potential Acquisition Opportunities of Captive Units/Vendor Consolidation to Increase Market Share

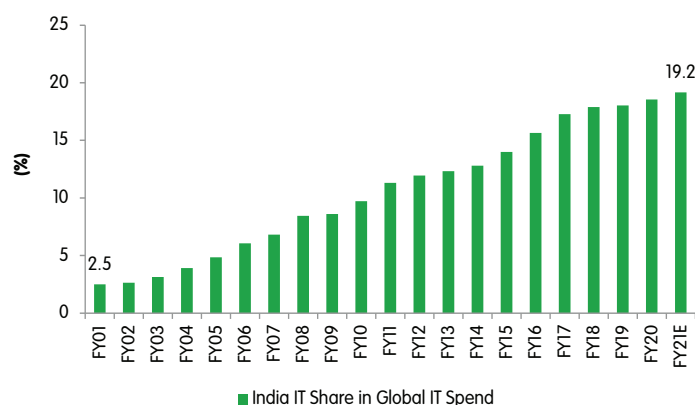
The Indian IT companies are likely to benefit from potential captive monetization efforts by the global enterprises in the medium-term. Currently, India has >1,400 captive units, out of which ~40% has <500 employees. The IT services industry is fragmented with the Top-40 names contributing only 45% to total market. Most enterprises have internal tech teams and they have set up multiple offshore units as well. Additionally, the large enterprises generally deploy multiple vendors across different technology sub-verticals and different geographies. We expect the Indian IT names to witness accelerated market share gain driven by: (1) consistent stable performance during the pandemic period and in the aftermath; (2) monetization of captive/internal IT teams (cost take out) and variable cost operating model; and (3) consolidation of distributed vendors ecosystem (flight to safety/quality). Historically, the Indian IT industry has been consistently gaining market share, which currently stands at 19.4% compared to 9.7% in 2010. Looking ahead, we expect the recent surge in large employee rebadging IT deals to benefit the mid-cap IT names in terms of market share gain.

Exhibit 18: Top-40 IT Firms Contribute Only 45% to Global IT Services Industry



Source: RSec Research, Bloomberg

Exhibit 19: Indian IT Industry Contributes 19.2% to Global IT Spend

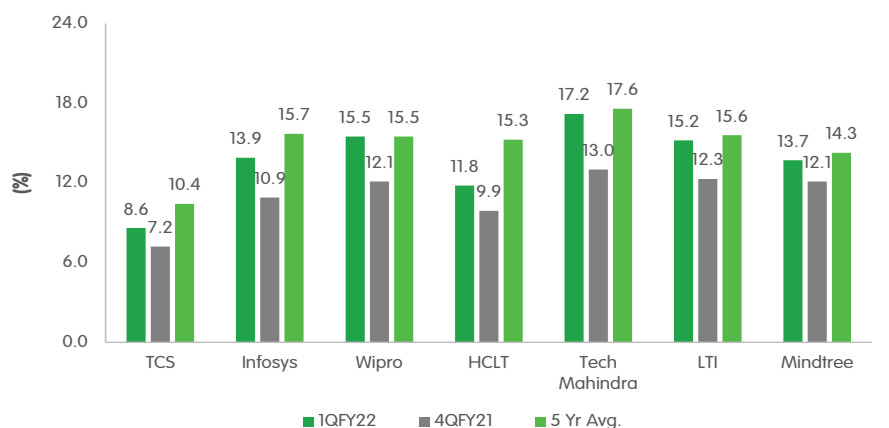


Source: RSec Research, Nasscom

IV. Supply Side Constraints to Remain a Medium-term Phenomenon; Make a Case for Better Pricing

Looking ahead, we expect supply side concerns to remain aggravated in the medium-term, as the top Indian IT companies are likely to report strong double-digit revenue growth over FY21-FY24E. Historically, we have seen demand side chasing supply, which has led to higher attrition. Recent rise in attrition also led by broad-based surge in demand, which has prompted accelerated lateral hiring (3-7 years experienced workforce specifically) by the IT services names, captive firms and software companies. Whilst the companies under our coverage have witnessed accelerated attrition which are in the range of 8.6%-17.2% during the last quarter, it is still below last 5-year average range of 10.4%-17.6%

Indian midcap IT companies are stepping up hiring with employee addition of ~220bps ahead of YoY 1QFY21 revenue growth. Broad-based stepped-up hiring suggests buoyant demand and creating buffer for likely higher attrition, going forward. Additionally, the IT names have also set up special programme to hire junior talent. We also highlight relatively higher salary increment in COVID-affected FY21 vs. historical average. We expect inflationary pressure to continue throughout the demand upcycle due to talent retention. In the US also, technology unemployment remains well below the national average. We believe the IT names also have margin tailwinds such as: (1) rising share of high-margin digital business; and (2) outcome-based pricing and cost+ pricing. However, we believe the current demand supply mismatch makes a strong case for pricing improvement in the upcoming quarters. While the large Indian IT names reiterated stable pricing environment, the mid-cap names such as Mphasis and other are comparatively positive on pricing scenario, going ahead.

Exhibit 20: Attrition is still below last 5-year average range of 10.4%-17.6%


Source: Company, RSec Research

V. Healthy Deal Wins & Robust FY22 Guidance

An analysis of 1QFY22 earnings performance of our IT coverage universe suggests a mixed bag. Notably, 6 out of 8 companies under our coverage universe exceeded our revenue estimates. TCS, HCLT and LTI reported marginal impact on execution due to second COVID wave in India, which we believe to be a one-time blip and expect a strong revenue recovery in 2QFY22E. Importantly, while deal wins data remained robust for the IT names in 1QFY22, the management commentary with regard to deal pipeline was encouraging. Strong order book and accelerated deal pipeline are core attributes for our double-digit revenue growth estimates over FY21-FY24E. All 3 mid-cap IT names under our coverage universe look forward to the industry-leading growth in FY22E, which is encouraging in our view. Moreover, TechM has also reiterated its double-digit organic revenue growth guidance (with further upside potential) in FY22E, led by recovery in both enterprise and telecom verticals. Employee addition specifically in mid-cap domain remained in the range of 20.3%-24.1% YoY in 1QFY22 (150-390bps ahead of revenue growth), which we believe indicates growing confidence of the companies on deal conversion. While the large IT names (specifically Infosys and Cognizant) have highlighted rise in attrition, we do not expect any significant impact on demand fulfilment, as their current attrition level is well below the high of FY19-FY20. Notably, whilst 2 IT names out of 8 exceeded our EBIT margin estimate in 1QFY22, we expect EBIT margin to witness marginal moderation, going ahead considering optimal utilization, higher talent cost and return of travel cost. On the other hand, we expect TechM and Mphasis to report 140bps-30bps increase in FY22E EBIT margin (over comparatively softer comps than peers), driven by consistent cost optimization measures.

Exhibit 21: Large Indian IT companies target robust revenue growth in FY22E

Names	FY22 revenue guidance	FY22 EBIT margin guidance
TCS	Double digit revenue growth	Aspirational range 26%-28%
Infosys	14%-16% (vs prior 12-14% CC growth)	22-24%
Wipro IT Services	2QFY22 revenue guidance growth of 5% to 7% QoQ	
HCLT	Double digits constant currency growth	19% - 21%
TechM	Double digit organic growth	Upward of 15%
LTI	Leader's quadrant of growth	Net income margin range of 14-15%
Mphasis	Industry leading growth in direct business	15.5-17% ,Upward bias on EBIT margin front in the medium-term.
Mindtree	Double digit industry leading growth	EBITDA over 20%

Source: Company, RSec Research

Exhibit 22: 1QFY22 Result Analysis

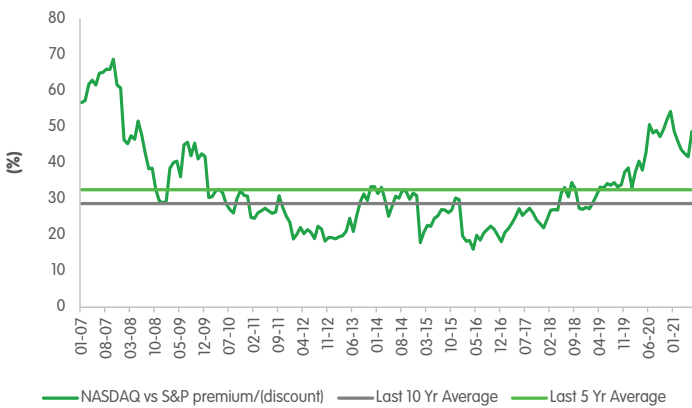
	Orderbook					Revenue					Employees				EBIT Margin					1QFY22 vs. Expectations	
	1QFY22 US\$mn	QoQ (%)	YoY (%)	FY21 US\$mn	YoY (%)	1QFY22 US\$mn	QoQ CC (%)	YoY CC (%)	FY21 US\$mn	YoY CC (%)	1QFY22	YoY%	FY21	YoY%	1QFY22 (%)	QoQ (bps)	YoY (bps)	FY21 (%)	YoY (bps)	Revenue	EBIT Margin
TCS	8,200	(10.9)	18.8	31,500	16.7	6,154	2.4	16.4	22,174	(0.8)	5,09,058	14.7	4,88,649	9.0	25.5	(133)	191	25.9	129	Miss	Inline
Infosys	2,570	21.7	47.7	14,125	57.8	3,782	4.8	16.9	13,562	5.0	2,67,953	12.0	2,59,619	7.1	23.7	(81)	100	24.5	317	Beat	Miss
Wipro IT Services	714	(49.0)				2,415	12.2	25.7	8,137	(2.3)	2,09,890	15.4	1,97,712	8.1	19.0	(200)	(4)	20.3	225	Beat	Miss
HCLT	1,664	(46.3)	37	7,300	18.0	2,720	0.7	11.7	10,174	1.1	176,499	17.4	1,68,977	12.3	19.6	(76)	(93)	21.4	178	Miss	Miss
TechM	815	(21.9)	181.0	2,209	(40.5)	1,384	3.9	10.8	5,111	(2.5)	1,26,263	4.3	1,21,054	(3.3)	15.2	(133)	508	14.2	263	Beat	Beat
ITI		NA	NA	404	21.7	470	4.8	17.8	1,670	8.8	38,298	21.7	35,991	14.5	16.4	(295)	(101)	19.3	320	Beat	Beat
Mphasis	505	106.1	95.0	1,111	55.4	363	6.0	18.8	1,309	4.9	31,454	20.3	29,473	11.6	15.9	(19)	21	16.1	1	Beat	Miss
Mindtree	504	34.4	28.9	1,231	50.3	311	7.7	22.6	1,077	(1.1)	27,256	24.1	23,814	8.3	17.7	(82)	264	17.5	705	Beat	Miss

Source: Company, RSec Research

VI. Expected Growth Justifies Premium Valuation

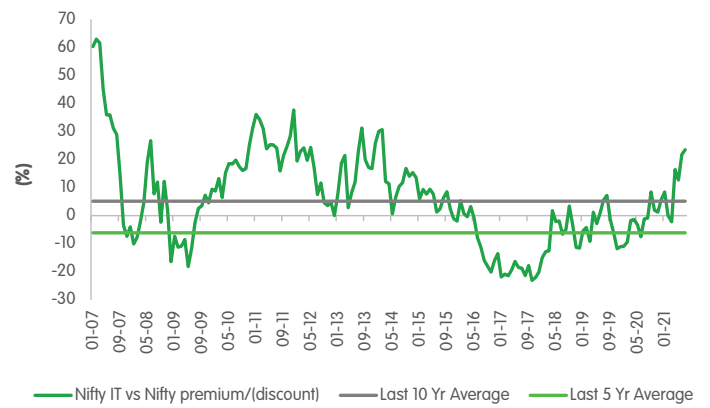
Currently, Nifty IT 1-year forward PE multiple stands at 27.5x, which is 25% premium to the broader market. Additionally, Nifty IT is trading at 20% discount to NASDAQ, which witnessed substantial multiple rerating (~47% premium) compared to S&P-500 owing to disruption by the large technology firms. Further, Nifty IT traded at 10-30% premium over broader market during FY10-FY14, when the IT names were reporting double-digit growth. Looking ahead, we expect Nifty IT to trade at premium to broader index driven by: (1) expected double-digit revenue growth over FY21-FY24E and medium-term growth resiliency due to increasing technology adoption; (2) increasing collaboration with the large hyperscalers and SaaS companies; and (3) peer set companies (with ~20% revenue growth) are trading at higher multiple. We believe the IT industry is embracing more consumer industry like features i.e. growth resiliency, consistency in business cycle, stable EBIT margin and strong cash flow generation. Currently, the Nifty Consumer Index trades at 50% premium to Nifty IT and Nifty. We expect Nifty IT to deserve premium multiple on the back of strong EPS expectation over FY21-FY24E.

Exhibit 23: NASDAQ (US Technology Index) 12M forward PE trades at 47% premium to S&P500



Source: RSec Research, Bloomberg

Exhibit 24: Currently, Nifty IT 12M forward PE trades at 22% premium to Nifty vs. historical peak premium of 40-60%



Source: RSec Research, Bloomberg

COMPANY SECTION

Institutional Equity Research

L&T Infotech

IT | India

Company Update | 13 August 2021

CMP* (Rs)	4,879
Upside/(Downside) (%)	23
Bloomberg Ticker	LTI IN
Market Cap. (Rs bn)	856
Free Float (%)	26
Shares O/S (mn)	176

BUY 
2 Year Target Price: Rs.6,000

Growth Revival Justifies Rerating

Key Triggers:

- Consistent industry-leading revenue growth led by digital acceleration
- Best-in-class clientele base across verticals and geographies
- Improving ecosystem outreach through newer businesses and partnerships
- Stable margin and prudent capital allocation policy

- Over last five years, its revenue clocked 13.5% CAGR (>1.5x of the industry average) driven by consistent new client addition and wallet share gain.
- LTI enjoys diversified customer base across geographies and verticals. Additionally, dedicated cloud teams and product division helps the company in improving its ecosystem outreach.
- Strong leadership team along with stable revenue growth and margin supported by solid RoE make the stock a compelling investment proposition.
- We forecast FY24E EPS of Rs171.2 (6% ahead of the consensus estimate) and free cash flow (FCF) of Rs26.5bn.

ESG Analysis: While analyzing 20 key criteria (10 points each) under ESG Matrix, we have assigned an overall score of 78% to LTI. Under **"Environmental Head"**, we have assigned 87% score, as the company mulls becoming carbon neutral by 2030 and plans to reduce water consumption as well. Under **"Social Head"**, we have assigned 71% score, as the company scores high on customer satisfaction and data protection front, despite scoring low on employee engagement front. Under **"Governance Head"**, we have assigned 73%, as the company scores high on audit committee, despite scoring low on political contribution and executive compensation front (please refer to page no. 19 for detailed ESG analysis).

Outlook & Valuation

LTI seems to be well-placed to cash in on the multi-year technology uptrend. Over last five years (FY16-FY21), its revenue clocked 13.5% CAGR, which is 1.5x of the industry average. We believe LTI should continue to warrant premium valuation vs. peers on the back of expected industry-leading growth of 16.5% over FY21-FY24E on the back of execution-focused stable management, diversified client base, robust new logo addition and client mining efforts. Given improved deal pipeline, we increase our USD revenue estimate by 12.5% and 17.5% for FY22E and FY23E, respectively. Considering cost optimization measures and portfolio synergy, we increase our EBIT and EPS estimate by 21.8%/33.2% and 16.9%/25.5%, respectively for FY22E/FY23E. Introducing our estimates for FY24E, we expect LTI's USD revenue to witness 14% growth and see EBIT margin at 18%. At CMP, the stock trades at 21x and 9x premium to TCS and peer mid-cap names (Mphasis and Mindtree). **Valuing the stock at 35x of FY24E earnings (from 20.5x of FY23E earlier), we maintain BUY on LTI with an upwardly revised 2-Year Target Price of Rs6,000 (from Rs2,550 earlier), which implies 23% upside from the current level.**

Key Financials

Y/E Mar (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Sales	94,458	1,08,786	1,23,698	1,48,128	1,73,894	2,00,939
EBIT	17,363	17,563	23,926	25,611	31,157	36,079
PAT	15,156	15,384	19,381	21,121	25,557	29,735
Diluted EPS (Rs)	86.4	87.6	110.6	121.7	147.2	171.3
P/E (x)	56.5	55.7	44.1	40.1	33.1	28.5
EV / EBITDA (x)	36.5	34.1	24.7	22.4	18.1	15.3
RoE (%)	34.6	29.9	30.5	26.6	27.2	26.7
Dividend Yield (%)	0.7	0.7	0.9	1.2	1.3	1.5

Source: Company, RSec Research

Research Analyst:
Suyog Kulkarni, CFA

Contact : (022) 4303 4000 / 9890966735

Email : suyog.kulkarni@relianceada.com

Research Associate:
Chaitanya Panchmatia

Contact : (022) 4303 4000 / 8080782900

Email : chaitanya.panchmatia@relianceada.com

Share price (%)	1 mth	3 mth	12 mth
Absolute performance	20.9	34.9	95.5
Relative to Nifty	17.2	25.2	51.5

Shareholding Pattern (%)	Mar'21	Jun'21
Promoter	74.3	74.3
Public	25.7	25.8

1 Year Stock Price Performance



Note: * CMP as on 12 August 2021

Investment Decision Matrix (IDM)

Key Criteria	Score	Risk	Comments
Management Quality	9	Low	LTI has one of the strongest management teams in mid-cap IT space in terms of deal wins and execution; stability at the top managerial level is appreciable; LTI has consistently maintained its margin in guided range
Promoter's Holding Pledge	10	Low	No share pledging by the promoter as of June 30, 2021. Promoter group (L&T) holds 74% stake in LTI
Board of Directors Profile	9	Low	Its board comprises of members from diverse background i.e. technology, engineering and finance; out of 11 directors, 5 are independent
Industry Growth	8	Low	Indian IT industry is likely to grow by high single-digit in the medium-term; the industry continues to clock 9.7% CAGR since FY08 (pre-GFC level); its share in global IT spends more than doubled from 8.4% in FY08 to 19% in FY21
Regulatory Environment / Risk	8	Low	As IT companies are not regulated by government/regulators, there is limited regulatory risk; but the key regulatory risks for Indian IT are: global immigration policies, privacy and intellectual property rights and Indian SEZ acts etc.
Entry Barriers / Competition	5	Medium	Intense competition is seen between large-cap and mid-cap IT companies; as IT services is a fragmented industry, there is a large pool of capability-specific and geography-specific vendors
New Business/Client Potential	9	Low	LTI added 223 new logos since 1QFY18; it has also amplified capabilities in Cloud, AI, Machine Learning and Data Analytics by way of 6 acquisitions in last few quarters
Business Diversification	6	Low	LTI seems to be relatively diversified, as it generates ~43% revenue from BFSI vertical and a high single-digit revenue from the top client, which is albeit substantially lower than Mphasis (15%: DXC) and Mindtree (29%: Microsoft) in FY21; LTI also generates ~20% revenue from manufacturing vertical, which stands at 5-15% for mid-cap peers
Market Share Potential	8	Low	Revenue is expected to clock 16.5% CAGR over FY21-FY24E vs. high single-digit to low double-digit growth that the industry is expected to clock
Margin Expansion Potential	8	Low	The company targets to maintain net profit margin in the range of 14-15% in FY22E; we expect EBIT margin to fall back to 18-19% range in FY22E from the record 19%+ level seen in FY21
Earnings Growth	8	Low	LTI's EPS CAGR is above the industry average; EPS is expected to clock 15.7% CAGR over FY21-FY24E .
Balance Sheet Strength	9	Low	As it incurs low capex, it has limited working capital requirement; it has a strong balance sheet with cash and cash equivalents and investments to the tune of US\$1bn as of FY21
Debt Profile	10	Low	Its net debt stood at US\$5mn as of FY21-end, while net cash position stood at US\$1bn
FCF Generation/NWC	9	Low	FCF conversation is seen at 80%+ over FY21-FY24E led by limited capex requirement and strong collection
Dividend Policy	5	Medium	Dividend yield of ~2% (FY24E) is lower than the peers largely due to focus on inorganic growth
Total Score Out of 150	121		
Average Score (%)	80.7%	Low	

Score For < 5 **Red** High Risk For 5 **Blue** Medium Risk For > 5 **Green** Low Risk

Total Score (%) For < 50 **Red** High Risk For 50 **Blue** Medium Risk For > 50 **Green** Low Risk

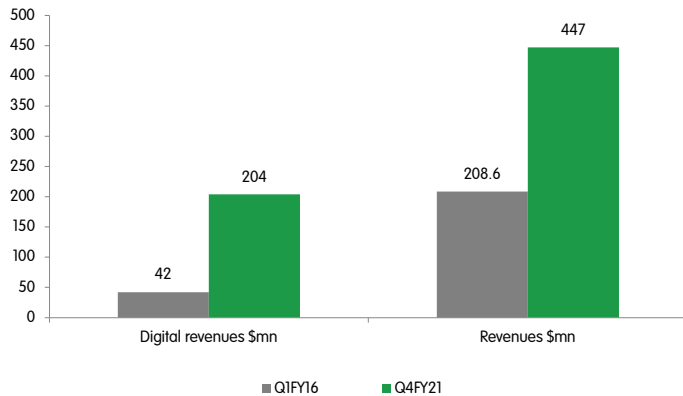
Environmental, Social & Governance Matrix (ESGM)

Key Criteria	Score	Risk	Comments
Environmental			
Climate Change & Carbon Emission	10	Low	LTI is committed to reduce direct environmental impact to “zero” by going carbon neutral before 2030; generally, the IT companies emit limited carbon
Air & Water Pollution	10	Low	There is limited air and water pollution, as no manufacturing activity is involved; LTI is committed to reduce water consumption; it is an ISO 14001 certified company; the company has undertaken initiatives like water recycling and reduction in paper consumption; it plans to reduce water consumption by 40% on full-time equivalent (FTE) basis
Biodiversity	9	Low	LTI has helped to develop Miyawaki forests (artificial forests), which mimics the natural environment
Deforestation	10	Low	It planted >1.5 lakh trees in FY21; it set up two solar energy plants – a 10 kWp plant piloted at a leased location in Mumbai and a 100 kWp plant in our Bengaluru campus; nearly 2,000 acre of land have been irrigated through water conservation programmes; IT sector companies generally have compact offices having the least impact on forest compared to manufacturing industries
Energy Efficiency	9	Low	Energy conservation has been the major pillar of LTI's sustainability strategy; it targets to supplement 50% of conventional energy with renewable energy by 2030; LTI was able to reduce specific energy consumption by 40% in FY21 compared to FY20; currently, company has a renewable energy level of 26.4% in total energy-mix
Waste Management	7	Low	Emission and waste generated by the company are within the limits, as prescribed by central/state pollution control boards
Defence / Arms / Ammunition Exposure	6	Low	It has limited exposure to defence space with no major customer in defence/arms segment; however, defence engineering is a business segment of its parent company (L&T)
Social			
Customer Satisfaction	8	Low	LTI received ~95.9% revenue from the existing clients in FY21; there are ‘Nil’ pending client complaints as on the end of financial year
Data Protection & Privacy	8	Low	LTI is compliant with General Data Protection Regulation (GDPR) and Health Insurance Portability and Accountability Act (HIPAA) data privacy regulations for US-based clients, and data privacy norms for European and Nordic clients; it has also registered for European Union data protection with the Information Commissioner's Office (ICO) of the UK; there is no instance of any cases or penalty for breach of customer privacy/data in FY21
Gender & Diversity	7	Low	Female employees account for ~30.2% of total workforce with 27% of new hires are women
Employee Engagement	5	Medium	Attrition level stands at around 12.3%
Community Relations / Service	7	Low	In FY21, 4,420 LTIes were a part of the 1Step initiatives, including donation drives, walking for a cause and various awareness sessions conducted virtually; LTI had higher CSR expenses in FY20, as it had contributed Rs180mn to PM Cares Fund for COVID-19 relief; as the contribution towards PM Cares Fund exceeded CSR obligation for FY20, it has been offset against CSR obligation for FY21
Human Rights	7	Low	Its code of conduct is fortified and supplemented by the ‘Employee Workplace Behaviour Guideline’, which outlines behaviour in resonance with the company's reputation; it is committed to provide and maintain a work environment that is free of harassment and any kind of discrimination based on caste, creed, race, religion, national origin, age, gender, sexual orientation, region, appearance or any professional atmosphere that promotes equal employment opportunities
Labour Standard	8	Low	LTI's commitment towards creating a safe and secure work environment is reflected through its policies on anti-harassment, prevention of sexual harassment, safety of women employees, anti-slavery and human trafficking; through its supplier code of conduct, it expects the suppliers to comply with the applicable regulatory requirements including labour practices and human rights, health, safety and environment etc.

Audit Committee Structure	8	Low	The audit committee comprises of 4 members, out of whom 3 are independent directors; the committee met 5 times in FY21
Bribery & Corruption	8	Low	No such case has been filed in last five years; no such case is pending against the company as on date
Executive Compensation	7	Low	Average annual pay hike for the employees was ~6%; managerial remuneration increased in the range of 19.8% to 63.0% in FY21; the CEO's salary is 109.5x of median salary of the employees On the other hand, Mindtree and Mphasis paid key managerial remuneration in the range of 25x-122x and 10x-180x of median salary respectively
Lobbying	7	Low	LTI does lobbying through industry bodies i.e. NASSCOM, Bombay Chambers of Commerce & Industry, Swedish Chamber of Commerce (India) etc; it actively participates in various industry associations' forums and provides relevant insights, which help in framing technology related and other policies; the company has also shared its inputs on 'Make-in-India' and 'Digital India' policies of the government; it is also actively working in projects like 'SMART Cities', which ultimately results in larger public good
Political Contribution	6	Low	L&T (parent) company contributed Rs50 crore through electoral bonds (FY19)
Whistleblower Scheme	8	Low	The company has formulated a whistleblower policy and has established a vigil mechanism for directors and employees to report concerns over unethical behaviour and any actual or suspected fraud etc; it formed a committee to address the concerns; the company affirms that no personnel has been denied access to audit committee under vigil mechanism
Total Score Out of 200	155	Low	
Total Score (%)	77.5%		

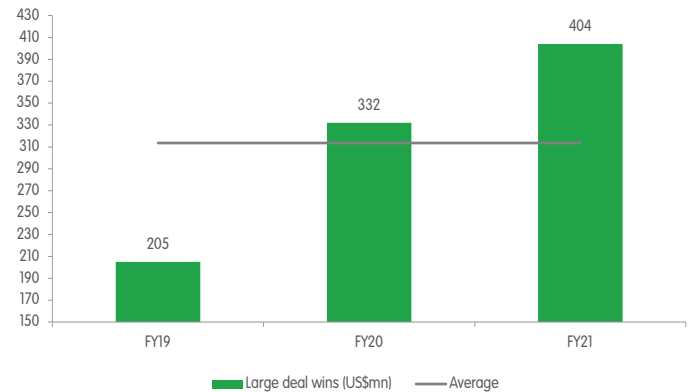
Key Charts

LTI reported strong revenue growth over FY16-FY21 backed by digital acceleration



Source: Company, RSec Research

Improving large deal win trajectory

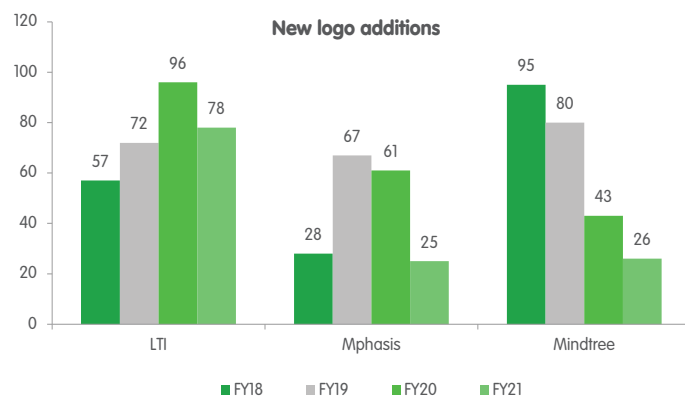


LTI outperformed its Indian mid-cap/large-cap peers in terms of consistent USD revenue growth (%)

	FY17	FY18	FY19	FY20	FY21	FY17-FY21 CAGR
LTI	9.3	16.7	19.1	13.0	9.5	13.5
Mindtree	9.0	8.6	18.3	8.7	(1.1)	8.5
Infosys	7.4	7.2	7.9	8.3	6.1	7.4
Mphasis	(3.3)	10.5	13.0	10.9	5.8	7.2
TCS	6.2	8.6	9.6	5.3	0.6	6.0

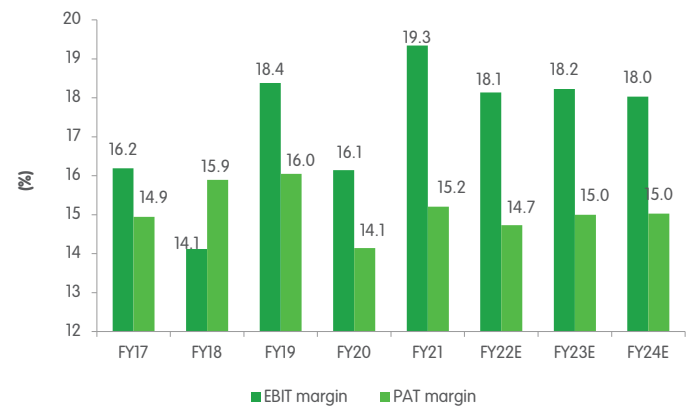
Source: Company, RSec Research

LTI's focused group such as 'must have accounts' specifically focuses on exploring new logos



Source: Company, RSec Research

EBIT margin is likely to remain within comfort zone in FY22E-FY24E



Source: Company, RSec Research

Earnings Revision & Recommendation

Pandemic-led accelerated cloud migration and multi-year transformation projects by the enterprises are beneficial for the IT names. LTI has also highlighted strong deal pipeline and recorded decent net new TCV wins as well. Thus, we increase our USD revenue estimate by 12.5% and 17.5% for FY22E and FY23E, respectively. Considering cost optimization of projects and portfolio synergy, we increase our EBIT and EPS estimate by 21.8%/33.2% and 16.9%/25.5%, respectively for FY22E/FY23E. We have also introduced FY24E and expect LTI's USD revenue to witness 14% growth and see EBIT margin at 18%. In the light of improved business scenario, we forecast LTI's EPS to clock 15.7% CAGR over FY21-FY24E. We believe LTI should continue to warrant premium valuation vis-à-vis peers on the back of its consistent industry-leading growth of 16.5% over FY21-FY24E backed by execution-focused stable management, diversified client base, robust new logo addition and client mining efforts. **Valuing the stock at 35x (from 20.5x earlier) on FY24E earnings, we maintain BUY on LTI with an upwardly revised 2-Year Target Price of Rs6,000 (from Rs2,550 earlier), which implies 23% upside from the current level.**

Change in Estimates

Y/E March (Rs bn)	New			Old		Change (%)	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	2,004	2,319	2,644	1,782	1,974	12.5	17.5
Revenue	1,48,128	1,73,894	2,00,939	1,29,582	1,43,035	14.3	21.6
EBIT	25,611	31,157	36,079	21,023	23,400	21.8	33.2
EBIT Margin (%)	17.3	17.9	18.0	16.2	16.4	109 bps	152 bps
EPS (Rs)	121.7	147.2	171.3	104.1	117.3	16.9	25.5

Source: RSec Research

EPS & Target Price



Source: RSec Research, Bloomberg

Price Sensitivity Analysis

	EPS (Rs)	Growth (%)	FWD P/E	Target P/E multiple (x)					
				30	31	32	33	34	35
FY17 (-3)	55.8		87.4x	1,674	1,730	1,786	1,841	1,897	1,953
FY18 (-2)	66.20	18.6	73.7x	1,986	2,052	2,118	2,185	2,251	2,317
FY19 (-1)	86.43	30.6	56.5x	2,593	2,679	2,766	2,852	2,939	3,025
FY20 (Base Year)	86.61	0.2	56.3x	2,598	2,685	2,772	2,858	2,945	3,031
FY21 (Year 1)	110.62	27.7	44.1x	3,319	3,429	3,540	3,650	3,761	3,872
FY22E (Year 2)	121.67	10.0	40.1x	3,650	3,772	3,893	4,015	4,137	4,258
FY23E (Year 3)	147.22	21.0	33.1x	4,417	4,564	4,711	4,858	4,998	5,153
FY24E (Year 4)	171.28	16.3	28.5x	5,138	5,310	5,481	5,652	5,817	6,000

Source: Company, RSec Research

1QFY22 – Key Highlights

1. Revenue stood at US\$470.2mn in 1QFY22, which is 1.2% higher than our estimate of US\$464.4mn. Its CC revenue grew by 4.8% QoQ vs. our estimate of 3.6% QoQ, driven by strong growth in BFS, Insurance and High-Tech, Media & Entertainment verticals.
2. EBIT margin came in at 16.4% (down 300bps QoQ) vs. our estimate of 16.1%
3. Adjusted net income stood at Rs4,969mn (down 9% QoQ) vs. our estimate of Rs4,661mn. Net income margin stood at 14.3% vs. our estimate of 13.6%
4. The company announced a special dividend of Rs10/share to commemorate completion of 5 years of listing on the stock exchanges in India.
5. LTM attrition stood at 15.2% in 1QFY22 vs. 12.3% in 4QFY21.

Exhibit 1: 1QFY22 Result Summary

Y/E March (Rs mn)	1QFY22E	4QFY21	QoQ (%)	1QFY21	YoY (%)
Revenue US\$ mn	470.2	447.4	5.1	390.3	20.5
Revenue	34,625	32,694	5.9	29,492	17.4
EBIT	5,683	6,329	(10.2)	5,139	10.6
Net Income	4,969	5,457	(8.9)	4,164	19.3
Diluted EPS (Rs)	28.27	31.44	(10.1)	23.74	19.1
Margin (%)					
EBIT	16.4	19.4	(295) bps	17.4	(101) bps
Net Income	14.4	16.7	(234) bps	14.1	23 bps

Source: RSec Research

Key Conference Call Takeaways

Industry Specific Takeaways:

1. Digital adoption has picked up during the pandemic. The company sees continued growth in technology spending by the enterprises.
2. LTI has highlighted acceleration in discretionary spends with shorter deal duration. Additionally, work packages, which were performed onsite earlier, are performed offshore now, as everyone is working remotely.

Company Specific Takeaways:

1. LTI highlighted strong deal pipeline in all sizes across verticals and geographies. The company remains confident of large deal closures.
2. Its largest vertical, BFSI grew by 39.4% YoY, while High Tech, Media & Entertainment and Others grew by >30% YoY. The company also moved on right direction in Insurance and Energy & Utility verticals.
3. LTI added ~2,300 employees in 1QFY22 and plans to hire 4,500 freshers in FY22. As LTI reported ~300bps acceleration in LTM attrition, it has stepped up hiring of freshers and professionals with 1-3 years of experience. On vaccination front, the company has vaccinated ~14,500 employees and their families.
4. The company targets to remain in the leader's quadrant of growth in FY22 on the back of large deal pipeline. It also targets to maintain net income margin in the range of 14-15% in FY22E.
5. EBIT margin declined by 300bps QoQ led by wage hike (340bps), absence of write-back provision (120bps) and investment in business development (60bps) offset by efficiency gain (140bps), forex gain and others (80bps). SG&A expenses were back to 12% of revenue in line with the guidance.

Investment Rationale

Our investment thesis is based on the following premises:

- ▶ Sustained Industry-leading Revenue Growth led by Digital Acceleration
- ▶ Proactive Efforts to Strengthen Offerings via M&A and Ecosystem Partnerships
- ▶ Scores Well on Vertical Diversification/Client Concentration Front
- ▶ Strong Engineering Heritage & Synergy Opportunities with Subsidiaries
- ▶ Stable Margin & Prudent Capital Allocation Policy

I. Sustained Industry-leading Revenue Growth led by Digital Acceleration

LTI's revenue clocked ~13.5% CAGR over the last five years driven by: (1) large deal wins (21 large deal wins across verticals and net new large deal TCV crossing US\$941mn+ in last 3 years); (2) strong new account openings (on an average LTI opened 83 new client accounts in last 3 years, while 78 new logos added in FY21); and (3) focus on client mining efforts (ramping up US\$20mn/US\$50mn client bucket from 10/3 in FY16 to 18/5 in FY21). Additionally, LTI reported constant currency growth of 8.8% in FY21, which is much ahead of most of the large-cap and mid-cap peers. The company also targets to remain in the leadership quadrant of growth in FY22E. LTI seems to be well-placed to cash in on multi-year technology uptrend fuelled by adoption of new business models by global enterprises. We expect LTI to continue its outperformance on the back of execution-focused stable management, impressive sales and marketing team and expanding digital offerings. We expect LTI to report USD revenue growth of 20%/15.7%/14% in FY22E/FY23E/FY24E.

II. Proactive Efforts to Strengthen Offerings via M&A and Ecosystem Partnerships

LTI continues to strengthen its partnership and alliances ecosystem by upgrading existing relationships and entering into new ecosystem partnerships. It has partnership with all three large public cloud vendors namely: AWS, Google and Microsoft Azure. The company achieved SAP competency on AWS in 3QFY20. Notably, LTI is one of the 16 global strategic service partners, which have attained this competency certification on AWS. Further, LTI announced elite global services partnership with Snowflake (Cloud data company) in Jan'21. It has also become the maiden partner for a programme that Snowflake is launching to accelerate cloud data transformation journey of enterprises. LTI has also amplified capabilities in Cloud, AI, Machine Learning and Data Analytics via inorganic route. While Syncordis and Neilesen+Partner provide edge to LTI in expanding outreach to Temenos' customers in Europe and the US, Powerupcloud, Lymbyc, Ruletronics and AugmentIQ fit well in LTI's Mosaic platform. As per our channel check, Syncordis' total workforce grew by >40% in last one year.

III. Scores Well on Vertical Diversification/Client Concentration Front

Indian mid-cap companies in general are more prone to client concentration risk vs. their large-cap peers. However, LTI seems to be well-placed on client concentration front, as it has reduced client concentration levels of Top-5/Top-10 customers by 810/1,040bps since FY16. Our analysis of H1B visa applications suggests strong upsurge in new logo addition and wallet share gain in non-Top-20 accounts. Further, LTI's revenue growth in manufacturing vertical is attributable to diversified client portfolio compared to other US\$1bn+ annual run rate IT companies like Mphasis (financial and insurance vertical) and Mindtree (technology vertical). Notably, LTI's primarily operating verticals have also changed dramatically since FY16. Revenue from Application Development & Maintenance and Testing has declined by 1,600bps along with a strong acceleration in revenue from Enterprise Solutions (software implementation work-through alliances and partnerships), Analytics and AI & Cognitive (digital work).

IV. Strong Engineering Heritage & Synergy Opportunities with Subsidiaries

LTI enjoys rich engineering heritage of parent i.e. Larsen & Toubro (L&T), which has been helping the company in integrating both Operational Hardware Technology (OT) and Information Technology (IT). Manufacturing sector lags in IT transformation vs. other sectors owing to lack of communication between both OT and IT teams. However, we expect distinction between IT and OT to gradually diminish, going forward. We believe engineering DNA of L&T puts LTI in an advantageous position vs. pure play IT players. LTI is also likely to benefit from synergy in offerings with fellow subsidiaries i.e. L&T Technology Services (LTSS) and Mindtree (acquired).

V. Stable Margin & Prudent Capital Allocation Policy

Since FY16, LTI's operating margin expanded by 140bps on the back of higher utilization, productivity benefits and cost optimization measures (specifically at sales). The company has been maintaining net profit margin in the range of 14-15% (and at times also overshoots the range as well) driven by consistent hedging policy. Going ahead, LTI expects to maintain net profit margin in the stated range of 14-15%. The company has also highlighted that consistent investment in sales/marketing, product and cloud business. Strong revenue growth, focus on margin execution and working capital management have aided LTI to witness robust cash flow conversion. LTI's average FCF conversion stands at 88% for last 5 years and we believe the company is likely to sustain the trend over FY21-FY24E as well driven by strong EBIT margin, stable credit quality of top customers and low capex requirement (2-3% of sales). Our analysis FCF distribution over FY16-FY21 suggests that LTI has invested ~25% of FCF back into business/capability building by the way of capex/acquisitions.

Outlook & Valuation

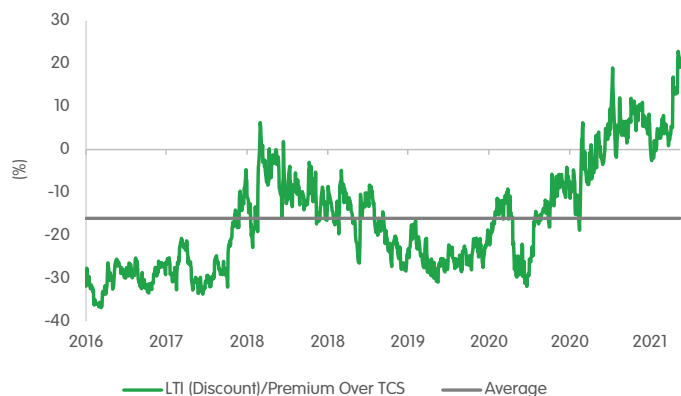
LTI seems to be well-placed to cash in on the multi-year technology uptrend. Over last five years (FY16-FY21), its revenue clocked 13.5% CAGR, which is 1.5x of the industry average. We believe LTI should continue to warrant premium valuation vs. peers on the back of expected industry-leading growth of 16.5% over FY21-FY24E on the back of execution-focused stable management, diversified client base, robust new logo addition and client mining efforts. Given improved deal pipeline, we increase our USD revenue estimate by 12.5% and 17.5% for FY22E and FY23E, respectively. Considering cost optimization measures and portfolio synergy, we increase our EBIT and EPS estimate by 21.8%/33.2% and 16.9%/25.5%, respectively for FY22E/FY23E. Introducing our estimates for FY24E, we expect LTI's USD revenue to witness 14% growth and see EBIT margin at 18%. At CMP, the stock trades at 21% and 9% premium to TCS and peer mid-cap names (Mphasis and Mindtree). **Valuing the stock at 35x of FY24E earnings (from 20.5x of FY23E earlier), we maintain BUY on LTI with an upwardly revised 2-Year Target Price of Rs6,000 (from Rs2,550 earlier), which implies 23% upside from the current level.**

Exhibit 2: LTI Valuation Chart



Source: RSec Research, Bloomberg

Exhibit 3: LTI Discount/Premium over TCS



Source: RSec Research

Exhibit 4: LTI Discount/Premium over Mindtree & Mphasis



Source: RSec Research, Gartner

Key Risks

- ▶ Slower-than-expected rebound in technology budget
- ▶ Possibilities of ban on US H-1B visas for longer-term
- ▶ Lower-than-expected success of continued cost efficiency programmes
- ▶ Unfavourable currency movement

Key Financials

Profit & Loss Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues (US\$ mn)	1,349	1,525	1,670	2,004	2,319	2,644
Growth (%)	19.1	13.0	9.5	20.0	15.7	14.0
Net Revenues	94,458	1,08,786	1,23,698	1,48,128	1,73,894	2,00,939
Growth (%)	29.3	15.2	13.7	19.7	17.4	15.6
Employee Costs & Other expenses	(61,643)	(73,589)	(82,193)	(1,00,594)	(1,17,348)	(1,35,121)
SG&A and Other Operating Expenses	(13,980)	(14,904)	(14,254)	(18,178)	(20,867)	(24,515)
EBITDA	18,835	20,293	27,251	29,357	35,679	41,303
EBITDA (%)	19.9	18.7	22.0	19.8	20.5	20.6
EBITDA Growth (%)	58.6	7.7	34.3	7.7	21.5	15.8
D&A	(1,472)	(2,730)	(3,325)	(3,746)	(4,521)	(5,224)
EBIT	17,363	17,563	23,926	25,611	31,157	36,079
EBIT (%)	18.4	16.1	19.3	17.3	17.9	18.0
EBIT Growth (%)	68.3	1.2	36.2	7.0	21.7	15.8
Other Income	2,915	2,465	1,955	2,648	2,918	3,568
PBT	20,278	20,028	25,881	28,258	34,076	39,646
Tax (incl deferred)	(5,122)	(4,824)	(6,500)	(7,137)	(8,519)	(9,912)
PAT	15,156	15,204	19,381	21,121	25,557	29,735
PAT Growth (%)	37.9	0.3	27.5	9.0	21.0	16.3
EPS (Rs)	86.4	86.6	110.6	121.7	147.2	171.3
EPS Growth (%)	30.6	0.2	27.7	10.0	21.0	16.3

Balance Sheet

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
SOURCES OF FUNDS						
Share Capital - Equity	174	174	175	175	175	175
Reserves & other	48,772	53,877	72,896	85,792	1,01,899	1,20,784
Total Shareholders' Funds	48,946	54,051	73,071	85,967	1,02,074	1,20,959
Debt	-	320	414	414	414	414
Lease liabilities	-	8,799	7,569	7,569	7,569	7,569
Total Debt	-	9,119	7,983	7,983	7,983	7,983
Current Liabilities	14,355	19,176	21,173	22,145	23,170	24,246
Provisions & other liabilities	3,391	5,903	4,864	6,448	6,801	7,172
TOTAL SOURCES OF FUNDS	66,692	88,249	1,07,091	1,22,543	1,40,028	1,60,359
APPLICATION OF FUNDS						
Goodwill	4,947	6,368	6,574	6,574	6,574	6,574
Net Block	4,467	5,728	6,927	6,143	5,100	3,894
Right to use assets	-	7,692	6,221	6,221	6,221	6,221
Investments	17,402	22,186	36,282	36,282	36,282	36,282
Deferred Tax Assets	2,386	3,039	1,476	1,476	1,476	1,476
LT Loans & Advances, Others	9,495	10,442	15,111	15,111	15,111	15,111
Total Non Current Assets	38,697	55,455	72,591	71,807	70,764	69,558
Debtors & Unbilled Revenues	23,845	27,541	26,906	34,901	41,449	47,344
Cash & Bank	4,150	5,252	7,594	15,833	27,814	43,455
Total Current Assets	27,995	32,793	34,500	50,735	69,263	90,800
TOTAL APPLICATION OF FUNDS	66,692	88,248	1,07,091	1,22,542	1,40,027	1,60,358

Cash Flow Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
PBT	15,155	15,205	19,382	21,121	25,557	29,735
Non-operating & EO items	5,135	4,930	4,985	7,137	8,519	9,912
Depreciation	1,472	2,730	3,325	3,746	4,521	5,224
Working Capital Change	(3,061)	(2,313)	2,704	(5,439)	(5,169)	(4,449)
Income Tax paid	(4,751)	(4,118)	(6,400)	(7,137)	(8,519)	(9,912)
Cash Flow from Operations (a)	13,950	16,434	23,996	19,428	24,909	30,510
Capex	(1,530)	(2,426)	(2,665)	(2,963)	(3,478)	(4,019)
Acquisitions	(2,157)	(591)	(408)	0	0	0
Change in Investments	(3,751)	(3,503)	(13,487)	0	0	0
Cash Flow from Investing (b)	(7,438)	(6,520)	(16,560)	(2,963)	(3,478)	(4,019)
Debt Issuance/(Repaid)	(605)	(3,221)	230	0	0	0
Share capital Issuance/(buyback)	3	0	1	0	0	0
Dividend	(5,341)	(5,679)	(5,319)	(8,225)	(9,450)	(10,850)
Cash Flow from Financing (c)	(5,943)	(8,900)	(5,088)	(8,225)	(9,450)	(10,850)
NET CASH FLOW (a+b+c)	569	1,014	2,348	8,240	11,981	15,641
Fx/other	(53)	87	(6)	0	0	0
Opening Cash Balance	3,633	4,150	5,251	7,593	15,833	27,814
Closing Cash Balance	4,149	5,251	7,593	15,833	27,814	43,455
Free Cash Flow	12,420	14,008	21,331	16,465	21,431	26,491

Key Ratios

Y/E March	FY19	FY20	FY21	FY22E	FY23E	FY24E
Profitability (%)						
EBITDA Margin	19.9	18.7	22.0	19.8	20.5	20.6
APAT Margin	16.0	14.0	15.7	14.3	14.7	14.8
RoE	34.6	29.9	30.5	26.6	27.2	26.7
RoCE	25.2	19.9	19.8	18.4	19.5	19.8
ROA	3.1	2.6	5.3	6.7	8.7	11.4
Efficiency						
Tax Rate (%)	(25.3)	(24.1)	(25.1)	(25.3)	(25.0)	(25.0)
Debtors and Un-billed Receivables (days)	92	92	79	86	87	86
Other Liabilities (days)	0	4	4	3	3	2
FCF/NII (%)	81.9	92.1	110.1	78.0	83.9	89.1
Net Debt/EBITDA (x)	(1.1)	(0.9)	(1.3)	(1.5)	(1.6)	(1.7)
Net Debt/Equity (x)	(0.4)	(0.3)	(0.5)	(0.5)	(0.5)	(0.6)
Per Share Data (Rs)						
EPS	86.4	86.6	110.6	121.7	147.2	171.3
DPS	28.0	28.0	38.0	47.0	54.0	62.0
BV	279.1	307.9	417.1	495.2	588.0	696.8
FCF	70.8	79.8	121.7	94.8	123.5	152.6
Valuation (x)						
P/E	46.8	46.1	36.5	33.2	27.5	23.6
P/BV	14.5	13.1	9.7	8.2	6.9	5.8
EV/EBITDA	36.5	34.1	24.7	22.4	18.1	15.3
FCF/EV (%)	1.8	2.0	3.2	2.5	3.3	4.2
FCF/mkt cap (%)	1.8	2.0	3.0	2.3	3.1	3.8
Dividend Yield (%)	0.7	0.7	0.9	1.2	1.3	1.5

Institutional Equity Research

Mindtree

IT | India

Company Update | 13 August 2021

CMP* (Rs)	2,926
Upside/(Downside) (%)	3
Bloomberg Ticker	MTCL IN
Market Cap. (Rs bn)	482
Free Float (%)	39
Shares O/S (mn)	165

SELL 

2 Year Target Price: Rs.3,020

Unfavourable Risk-reward; Valuation Captures Growth Potential

Key Setbacks:

- Client concentration persists despite increasing focus on new growth areas
- Uncertain pace of recovery in Travel & Hospitality (T&H) vertical
- Lower new client addition compared to peers
- Valuation priced-in

- Revenue share of the top clients has grown from 22% in FY20 to 29% in FY21. We believe Mindtree's dependence on top client for growth is unhealthy, as it increases the client concentration risk.
- Mindtree has highlighted increased focus on new areas such as: Health, Security & Enterprise Application, IoT and expansion into APAC, Middle East & Japan, which is encouraging in our view. We expect Mindtree's USD revenue to clock 15% CAGR over FY21-FY24E compared to 8.3% CAGR over FY18-FY21.
- T&H vertical – which is the hardest hit during the current pandemic – accounted for 8.8% of its total revenue in FY21 (17% in FY20). Further, the pace of recovery in T&H vertical remains uncertain, which we believe caps revenue recovery trajectory.
- The company's EBIT margin – which witnessed a strong rebound of 700bps YoY to 17.5% in FY21 – is expected to remain in the range of 16.9%-17.3% over FY22E-FY24E.

ESG Analysis: While analyzing 20 key criteria (10 points each) under ESG Matrix, we have assigned an overall score of 80% to Mindtree. Under **"Environmental Head"**, we have assigned 87% score, as the company scores high in climate change and energy efficiency. Under **"Social Head"**, we have assigned 76% score, as the company scores high on customer satisfaction, despite scoring low on employee engagement. Under **"Governance Head"**, we have assigned 75% score due to high score on audit committee structure front and low score on executive compensation front (please refer to page no. 31 for detailed ESG analysis).

Outlook & Valuation

Going ahead, we expect its USD revenue to clock 15% CAGR over FY21-FY24E (150bps lower than LTI) on the back of improved demand scenario. Additionally, we believe higher dependence on top clients compared to peers is unhealthy and it increases client concentration risk. At CMP, the stock trades at 2% premium to LTI and Mphasis. We increase our USD revenue estimate by 16.3% and 21.3% for FY22E and FY23E, respectively. Considering cost saving measures and strong operating leverage, we increase our EBIT/EPS estimate by 38%/44.8% and 45.6%/48.8%, respectively for FY22E and FY23E. **Rolling over our valuations to FY24E and valuing the stock at 29x of FY24E earnings (from 14.5x of FY23E earlier), we maintain SELL on Mindtree with an upwardly revised 2-Year Target Price of Rs3,020 (from Rs900 earlier), which implies 3% upside from the current level.**

Key Financials

Y/E Mar (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Sales	70,215	77,643	79,678	92,389	1,05,904	1,18,093
EBIT	9,004	8,144	13,971	11,855	13,229	15,244
PAT	7,541	6,309	11,106	13,288	15,221	17,164
Diluted EPS (Rs)	46.3	41.7	67.4	80.7	92.4	104.2
P/E (x)	63.2	70.1	43.4	36.3	31.7	28.1
EV / EBITDA (x)	39.0	38.3	24.3	27.5	24.7	21.4
RoE (%)	27.5	19.1	35.2	22.3	23.7	24.4
Dividend Yield (%)	1.2	0.5	1.1	1.7	1.3	1.4

Source: Company, RSec Research

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Share price (%)	1 mth	3 mth	12 mth
Absolute performance	17.2	33.0	158.3
Relative to Nifty	13.4	23.4	114.3

Shareholding Pattern (%)	Mar'21	Jun'21
Promoter	61.0	61.0
Public	39.0	39.0

1 Year Stock Price Performance



Note: * CMP as on 12 August 2021

Investment Decision Matrix (IDM)

Key Criteria	Score	Risk	Comments						
Management Quality	7	Low	L&T bought majority stake in Mindtree in 2019, which led to new management at the helm; the current management team has come from reputed background; additionally Mindtree has also strengthened leadership roles across verticals; the management has maintained its EBIT margin guidance over the last 2-3 quarters						
Promoter's Holding Pledge	10	Low	Zero share pledging by the promoter as of June 30, 2021; currently, L&T owns 61% of Mindtree and there is no risk of hostile takeover; additionally, strong promoter at the helm aids execution						
Board of Directors Profile	10	Low	Its board comprises of 12 directors from diverse background of technology, engineering and finance, out of whom 6 are independent directors						
Industry Growth	8	Low	Indian IT industry is likely to grow by high single-low double digit in the medium-term; the industry continues to clock 9.7% CAGR since FY08 (pre-GFC level); its share in global IT spends more than doubled from 8.4% in FY08 to 19% in FY21						
Regulatory Environment / Risk	8	Low	As the IT companies are not regulated by government/regulators, there is limited regulatory risk; but the key regulatory risks for the Indian IT companies are: global immigration policies, privacy and intellectual property rights and Indian SEZ acts etc.						
Entry Barriers / Competition	5	Medium	Intense competition is seen between large-cap and mid-cap IT companies; as IT services is a fragmented industry, there is a large pool of capability-specific and geography-specific vendors						
New Business/Client Potential	7	Low	It has identified 4 key white space areas such as: Health, Security and Enterprise Application, IoT and expansion into APAC, Middle East & Japan; historically, LTI and Mphasis have outpaced Mindtree in terms of new client addition						
Business Diversification	2	High	Its top client i.e. Microsoft contributed ~29% to its FY21 top-line; it is less diversified from vertical perspective, as Hi Tech & Media vertical continues to contribute ~50% to its total revenue; we believe Mindtree needs to increase revenue contribution from non-Hi Tech and Media customers to reduce industry concentration						
Market Share Potential	8	Low	Revenue is expected to clock 15% CAGR over FY21-FY24E ahead of the industry's growth rate in the range of high single-digit to low double-digit						
Margin Expansion Potential	6	Low	Mindtree targets EBITDA margin of >20% in FY22E from 20.7% in FY21						
Earnings Growth	8	Low	EPS CAGR is above the industry growth rate; EPS is expected to clock 15.8% CAGR over FY21-FY24E compared to 25.3% CAGR over FY18-FY21						
Balance Sheet Strength	10	Low	With low capex and limited working capital requirement, surplus is generally invested in government bonds						
Debt Profile	10	Low	Cash and bank balance stood at >US\$380mn as of FY21; the company has negligible debt on balance sheet and likely to retain its net cash position, going forward						
FCF Generation/NWC	9	Low	FCF conversation has been consistent in the excess of 80% over the period; FCF is seen at ~US\$186mn in FY24E						
Dividend Policy	5	Medium	Dividend yield stands at ~2.5% (FY24E); clarity on capital allocation policy from the new management is awaited						
Total Score Out of 150	113								
Average Score (%)	75.3%	Low							
Score	For < 5	Red	High Risk	For 5	Blue	Medium Risk	For > 5	Green	Low Risk
Total Score (%)	For < 50	Red	High Risk	For 50	Blue	Medium Risk	For > 50	Green	Low Risk

Environmental, Social & Governance Matrix (ESGM)

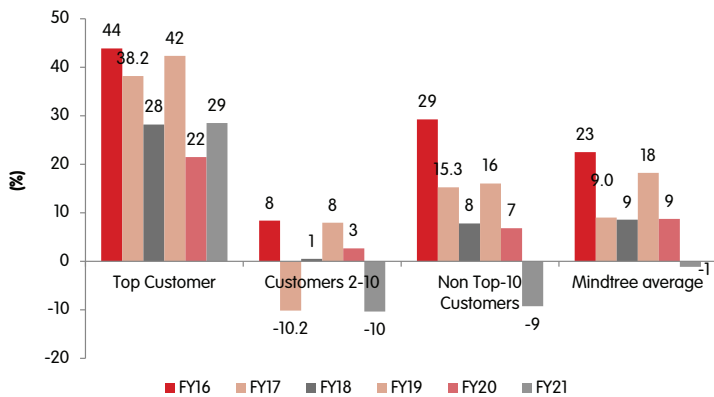
Key Criteria	Score	Risk	Comments
Environmental			
Climate Change & Carbon Emission	10	Low	Mindtree has adopted efficient compressors, which led to in an average annual reduction of 540,000 units of power consumption (equivalent to 490 tonne of CO2 emission and cost saving of Rs4mn); on per capital basis, it reduced 1% GHG (green house gas) emission, 3% energy, 2% water, while waste recycling was increased by 1%; Mindtree has deployed IOT solutions for resource conservation
Air & Water Pollution	10	Low	The company follows all prescribed norms on pollution; generally, IT services companies emit limited water and air pollutants; 100% of outlet water from company's facilities is treated and reused
Biodiversity	7	Low	The IT companies owing to their compact offices and lower emission of pollutants have minimal impact on biodiversity
Deforestation	7	Low	It spends on various environment causes through CSR activities
Energy Efficiency	10	Low	It has undertaken several initiatives like installation of LED fixtures, UPS optimization, AC retrofit activity, shift rationalization through automatic application and common bus system etc. during last five years, which resulted in energy saving to the tune of 29.76 lakh units amounting Rs20.8mn and 2,708 tonne reduction in carbon emission; out of total energy consumption, 75% comes from renewable sources
Waste Management	10	Low	In order to reduce freshwater consumption at Pune facility and to make zero discharge facility in the city, Mindtree upgraded its sewage treatment plant with newer technology and modified plumbing line; it has launched dustbin drive to reduce usage of plastics by removing dustbins from workstations and keeping one common dustbin on the floor; recycling of waste has increased from 80.6% in FY15 to 95% in FY21
Defence / Arms / Ammunition Exposure	8	Low	It has limited exposure to defence space with no major customer in defense/arms segment
Social			
Customer Satisfaction	9	Low	Mindtree conducts regular customer satisfaction survey on several parameters i.e. satisfaction, loyalty, advocacy and value for money etc; It has reported consistent growth in customer satisfaction in last 5 years
Data Protection & Privacy	8	Low	Mindtree respects privacy of data subjects; safeguarding personal data is treated as a basic right of an individual; it is committed to comply with the applicable data privacy laws and legislations (including but not limited to EU General Data Protection Regulation 2016/679, California Consumer Privacy Act, The Privacy Act 1988 (Australia) including the Australian Privacy Principles (APP), Data Protection Act 2018 (UK), Indian IT act and Personal Data Protection Act 2012 (Singapore) and other applicable privacy laws to the extent that they apply to Mindtree's data processing and business operations
Gender & Diversity	7	Low	Gender diversity improved from 45% in FY19 to 47% in FY20 through campus hiring; the company achieved gender diversity ratio of 32% in FY21, which it targets to increase to 35% in next two years; the company was recognized in the Business World HR Excellence Awards for Excellence in Diversity & Inclusion in March 2020
Employee Engagement	5	Medium	The company provides learning environment that is totally in virtual mode; more than 98% employees went through skilling/up-skilling in FY21; however, attrition (12.1%-FY21) continues to remain a concern
Community Relations / Service	8	Low	It spent Rs80mn on CSR activities in FY20; with generous contributions amid COVID-19 crisis, CSR spend crossed well above the mandatory 2% of PAT in FY21
Human Rights	7	Low	It is committed to protect human rights; all its affiliated companies are committed to ensure that its employees/suppliers take appropriate steps to mitigate the risk of forced/child labour and human trafficking
Labour Standard	8	Low	Mindtree upholds the freedom of association and recognizes the right to collective bargaining; it advocates elimination of all forms of forced/compulsory labour and discrimination in respect of employment and occupation

Governance

Audit Committee Structure	8	Low	Two members of the audit committee out of three are independent directors; the audit committee met 7 times in FY21
Bribery & Corruption	8	Low	Mindtree endorses ethics and has stringent 'zero tolerance' stance towards lack of integrity; suppliers, business partners and the NGO are also bound by its code of conduct
Executive Compensation	6	Low	Remuneration of key managerial personnel is in the range of 25x-122x of median salary of the employees; On the other hand, Mphasis and LTI paid key managerial remuneration in the range of 10x-180x and 109x of median salary respectively
Lobbying	7	Low	The company is member of CII, NASSCOM and ASSOCHAM, which advocate sustainable business principles, inclusive development policies, governance and administration, economic reforms, products and technology etc.
Political Contribution	8	Low	While Mindtree has not made any political contribution, L&T (parent) made political contribution in FY18-FY19
Whistleblower Scheme	8	Low	The company has a whistleblower policy to provide appropriate platform to report instances of any actual or suspected incidents of unethical practices, violation of applicable laws and regulations including integrity code, code of conduct for prevention of insider trading and code of fair practices and disclosure etc.
Total Score Out of 200	159	Low	
Total Score (%)	79.5%		

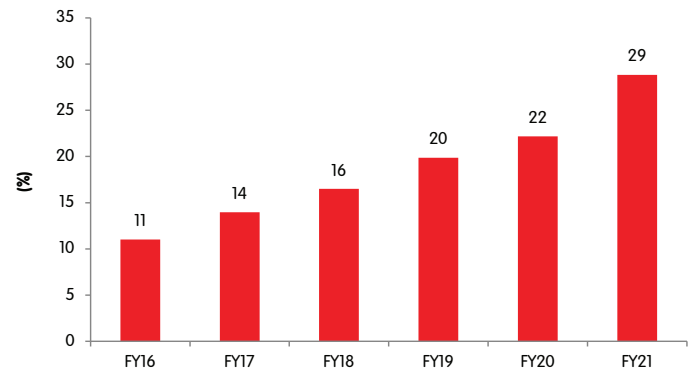
Key Charts

Top client dominated incremental growth...



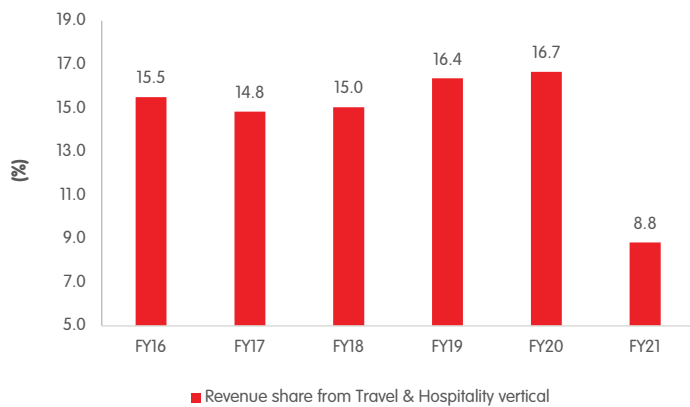
Source: Company, RSec Research

...which led to consistent rise in top client contribution



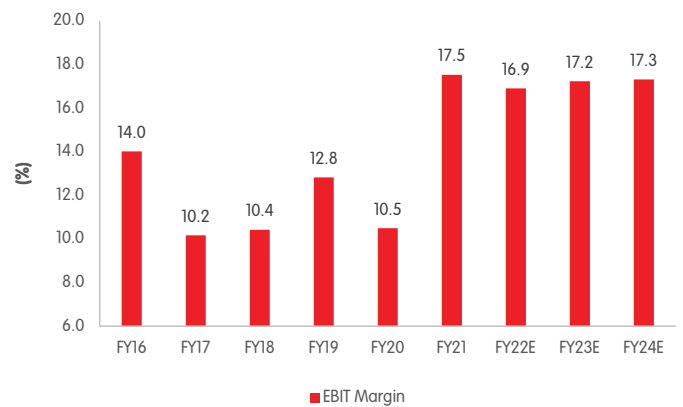
Source: Company, RSec Research

Revenue from Travel & Hospitality vertical declined substantially due to restrictions on mobility



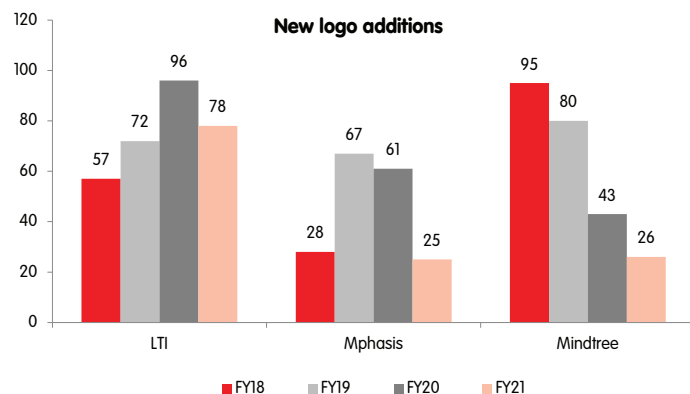
Source: Company, RSec Research

Expect stable EBIT margins over FY22E-24E



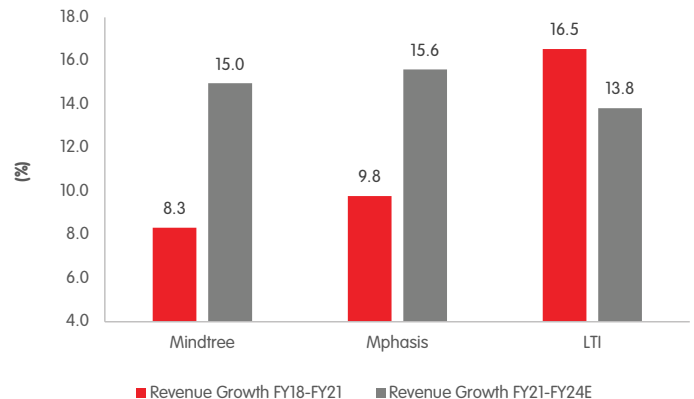
Source: Company, RSec Research

Softer new client addition compared to peers



Source: RSec Research, Bloomberg

Revenue growth comparison



Source: Company, RSec Research

Earnings Revision & Recommendation

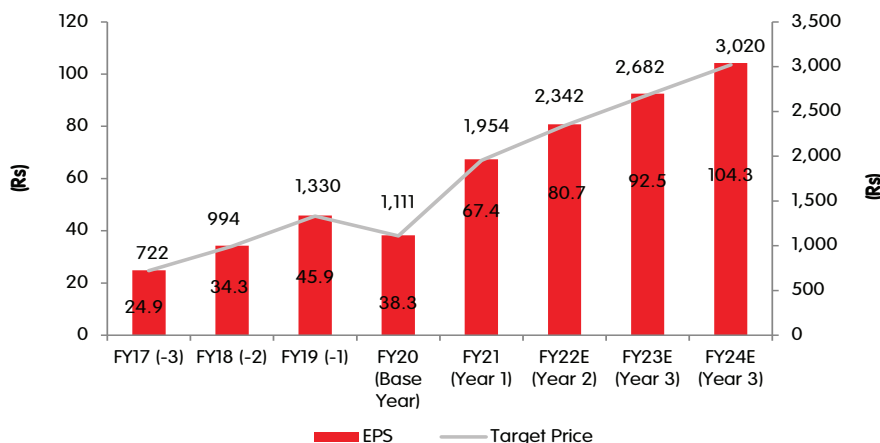
Pandemic-led accelerated cloud migration and multi-year transformation projects by the enterprises are beneficial for the IT names. Mindtree has also highlighted strong deal pipeline and recorded healthy TCV wins. Thus, we increase our USD revenue estimate by 16.3% and 21.2% for FY22E and FY23E, respectively. Considering cost saving measures and strong operating leverage, we increase our EBIT/EPS estimate by 38%/44.8% and 45.6%/48.8%, respectively for FY22E and FY23E. Introducing our estimate for FY24E, we expect Mindtree's USD revenue to witness 11.2% growth, while its EBIT margin is seen at 17.3%. In the light of improved business scenario, we forecast Mindtree's EPS to clock 15.6% CAGR over FY21-24E. At CMP, the stock trades at 2% premium to 1-year forward PE of LTI/Mphasis. We believe risk-reward fully captures EPS CAGR of 15.6% over FY21-FY24E. Additionally, we believe higher dependence on the top clients compared to peers exposes Mindtree to client concentration risk. **Valuing the stock at 29x (from 14.5x earlier) on FY24E earnings, we maintain SELL on Mindtree with an upwardly revised 2-Year Target Price of Rs3,020 (from Rs900 earlier), which implies 3% upside from the current level.**

Change in Estimates

Y/E March (Rs bn)	New			Old		Change (%)	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	1,306	1,471	1,636	1,123	1,214	16.3	21.3
Revenue	96,602	1,10,360	1,24,338	84,210	91,016	14.7	21.3
EBIT	16,328	19,021	21,530	11,831	13,135	38.0	44.8
EBIT Margin (%)	16.9	17.2	17.3	14.0	14.4	290 bps	284 bps
EPS (Rs)	80.7	92.4	104.2	55.4	62.1	45.6	48.8

Source: RSec Research

EPS & Target Price



Source: RSec Research, Bloomberg

Price Sensitivity Analysis

	EPS (Rs)	Growth (%)	FWD P/E	Target P/E multiple (x)					
				24	25	26	27	28	29
FY17 (-3)	24.9		117.6x	597	622	647	672	697	722
FY18 (-2)	34.3	37.7	85.4x	823	857	891	926	960	994
FY19 (-1)	45.9	33.8	63.8x	1,100	1,146	1,192	1,238	1,284	1,330
FY20 (Base Year)	38.3	(16.5)	76.4x	919	957	996	1,034	1,072	1,111
FY21 (Year 1)	67.4	76.0	43.4x	1,617	1,685	1,752	1,820	1,887	1,954
FY22E (Year 2)	80.7	19.8	36.2x	1,938	2,019	2,099	2,180	2,261	2,342
FY23E (Year 3)	92.5	14.6	31.6x	2,220	2,312	2,405	2,497	2,620	2,682
FY24E (Year 3)	104.29	12.76	28.1x	2,503	2,607	2,712	2,816	2,920	3,020

Source: Company, RSec Research

1QFY22 – Key Highlights

1. Revenue stood at US\$310.5mn (up 7.7% QoQ and up 22.6% YoY) in 1QFY22 vs. our estimate of US\$304mn, led by strong growth in Travel, Transportation & Hospitality (TTH) and Retail, CPG & Manufacturing verticals.
2. EBIT margin came in at 17.7% marginally lower than our estimate of 18.2% (excluding wage inflation).
3. Net income grew by 8.2% QoQ to Rs3,434mn in 1QFY22 from Rs3,174mn in 4QFY21.
4. The company added overall TCV of US\$504mn in 1QFY22 vs. US\$375mn in 4QFY21.
5. Top client contributed 27.4% to its total revenue in 1QFY22 vs. 28% in 4QFY21.

Exhibit 1: 1QFY22 Result Review

Y/E March (Rs mn)	1QFY22E	4QFY21	QoQ (%)	1QFY21	YoY (%)
Revenue \$mn	311	288	7.7	278	11.5
EBIT	4,063	3,913	3.8	2,833	43.4
Net Income	3,434	3,174	8.2	2,062	66.5
Diluted EPS (Rs)	20.9	19.3	8.3	12.5	66.5
Margin (%)					
EBIT	17.7	18.6	(82) bps	13.8	391 bps
Net Income	15.0	15.0	(6) bps	10.1	493 bps

Source: RSec Research

Key Conference Call Takeaways

Industry Specific Takeaways:

1. Enterprises across the verticals are leveraging efforts to adopt data, cloud and disruptive technology to thrive in post pandemic new normal environment.

Company Specific Takeaways:

1. Sequential revenue growth of 7.7% was broad-based across the verticals. While CMT revenue grew by 6.9% QoQ, Retail, CPG & Manufacturing, TTH and BFSI revenue grew by 7.7% QoQ, 13.1% QoQ and 7.4% QoQ, respectively. Newly set up healthcare vertical recorded revenue of US\$3mn. As per the management, the pricing environment remained stable and the company is gaining market share.
2. Among geographies, revenue from North America, Continental Europe and APAC & ME grew by 7.7%, 30.4% and 0.7% QoQ, respectively while revenue from the UK & Ireland declined by 4.7% QoQ. Continental Europe witnessed benefit of recent investments in Europe. Lower growth in APAC region is attributable to seasonality. There was no impact of second COVID wave in India on execution front.
3. Total Contract Value (TCV) rose by 34% QoQ to the record level of US\$504mn. Deal wins comprised of both new wins and renewals. Deal wins were broad-based and comprised of both 3-5 years annuity and transformation deals. On an average, tenure of deal is rising compared to the previous quarters. The management expects deal wins to witness YoY rise in FY22.
4. The company added 3,329 employees on net basis in 1QFY22. During the quarter, learning hours increased by 86% QoQ. The company plans salary increment for junior and mid-level employees in 2QFY22. The management expects hiring momentum to remain strong in FY22.
5. Revenue run rate of TTH vertical stood at ~US\$40mn/quarter (back to previous levels). However, as per the management, demand is yet to witness complete recovery, as business travel is yet to resume. Thus, it continues to remain cautious on vertical.
6. The management continues to target industry-leading revenue growth and EBITDA margin in the excess of 20% in the coming years.

Rationale for SELL Recommendation

Our “SELL” recommendation is based on the following premises:

- ▶ Higher Dependency on Top Clients Increases Concentration Risk
- ▶ Uncertain Pace of Recovery in T&H Vertical
- ▶ Softer New Client Addition compared to Peers
- ▶ Limited Focus on Capability-based Inorganic Opportunities

I. Higher Dependency on Top Clients Increases Concentration Risk

Revenue from top client (Microsoft) clocked 30% CAGR over FY16-FY21, which was almost 3.5x of the company's average of >8.5%. Revenue share of top client increased to 22% in FY20 (from 12% in FY16), which increased to 29% in FY21. Mindtree, which has been working with Microsoft since a decade, has >4,000 professionals working on Microsoft's projects currently. However, revenue exposure within the top client is diversified and has decent mix of annuity/short-term projects and service lines i.e. Analytics, Marketing Operations, Networking and Customer Support. Mindtree has highlighted increased focus on new areas such as Health, Security & Enterprise Application and IoT along with expansion into APAC, Middle East and Japan, which is encouraging, in our view. Whilst we also expect acceleration in top 2-20 customers in the coming quarters, we do not expect any substantial reduction in top client concentration, as new orders from top client continue to remain robust. Owing to decent revenue contribution from the top client in the near-term, we believe excessive dependency on top client increases risk from client-specific events in the medium-to-long-term. However, Mindtree has formed dedicated hyperscaler GTM unit for Salesforce, ServiceNow, Google and AWS to expand its footprint into non-Microsoft accounts to reduce client concentration.

Mindtree underperformed vis-à-vis its mid-cap peers i.e. LTI and Mphasis by 750bps YoY and 350bps YoY on revenue growth front in FY21. We expect Mindtree's USD revenue to clock 15% CAGR over FY21-FY24E.

II. Uncertain Pace of Recovery in T&H Vertical

T&H vertical is the hardest hit due to the current COVID-19 pandemic. Mindtree received 8.8% of FY21 revenue (16.7% of FY20 revenue) from this vertical, which is one of the highest compared to peers. The company provides IT solutions to large US airlines and global hospitality chains. Revenue from Top 2-10 customers declined by 10% in FY21, which stood at 28% excluding two large travel accounts. The management has highlighted that even though growth has come back in some areas, it is significantly lower than pre-COVID levels. Additionally, while the larger peers have been consistently highlighting continued weakness in T&H vertical, other peer such as Coforge expects strong recovery in T&H vertical. In our view, pace of recovery in T&H business continues to remain uncertain, which may cap quantum of overall revenue recovery in FY22E.

III. Softer New Client Addition Compared to Peers

Under the new management, Mindtree has undergone multiple strategy upgradation such as: (1) focused efforts on service group and industry lines; (2) accelerated efforts on expansion of partnership with hyperscalers; (3) building dedicated sales teams for large deal; and (4) investing in white space opportunities. Mindtree's order book recorded healthy growth of 12.3% YoY to US\$1,382mn in FY21. Further, it added 69 new customers in last 24 month, which is comparatively softer than its peers namely: Mphasis, LTI and Coforge, which added 86, 174 and 86 customers, respectively during the same period. Additionally, Mindtree's active customer base has also declined by 79 to 270 over the last two years, as the company was working on tail account reduction and improvement in EBIT margin. We believe consistent new client addition along with wallet share gain from the existing accounts is imperative to sustain industry-leading growth, going forward.

IV. Limited Focus on Capability-based Inorganic Opportunities

During 2015-16, Mindtree acquired four companies namely: (1) Magnet 360 (in the field of cloud-based sales and marketing services); (2) Relational Solutions (CPG-focused IT services firm); (3) Bluefin (SAP consulting); and (4) Discoverture Solutions (property and casualty insurance). Out of these, Bluefin and Magnet 360 took longer time to stabilize as cross selling benefits did not materialize on the expected lines. Recently, Mindtree acquired L&T's IoT and AI subsidiary, NxT. It can provide solutions across industries such as Engineering & Construction, Manufacturing, Energy & Utilities and Transportation & Logistics. We estimate NxT business has workforce in the range of 150-200. This acquisition is going to enhance Mindtree's cloud-based IoT and AI capabilities for Industry 4.0. On the other hand, Mindtree's peers were on an acquisition spree over the last three years. While LTI acquired six companies in the field of Cloud, Data Analytics, DevOps and Temenos banking suit, Mphasis has acquired DevOps automation services provider Stelligent, whereas Hexaware acquired Mobiquity, a customer experience firm.

We believe constant renewal and up-gradation of services is essential for IT services firm to maintain client relevance in the medium-term. In that context, limited focus of Mindtree on inorganic capability front may impact depth and breadth of its product offerings, which can directly impact client relevance in the medium-term. We strongly believe that Mindtree needs to accelerate focus on capability-based acquisition in new generation growth areas such as Data Analytics and Cloud for improved experience.

Outlook & Valuation

Going ahead, we expect its USD revenue to clock 15% CAGR over FY21-FY24E (150bps lower than LTI) on the back of improved demand scenario. Additionally, we believe higher dependence on top clients compared to peers is unhealthy and it increases client concentration risk. At CMP, the stock trades at 2% premium to LTI and Mphasis. We increase our USD revenue estimate by 16.3% and 21.3% for FY22E and FY23E, respectively. Considering cost saving measures and strong operating leverage, we increase our EBIT/EPS estimate by 38%/44.8% and 45.6%/48.8%, respectively for FY22E and FY23E. **Rolling over our valuations to FY24E and valuing the stock at 29x of FY24E earnings (from 14.5x of FY23E earlier), we maintain SELL on Mindtree with an upwardly revised 2-Year Target Price of Rs3,020 (from Rs900 earlier), which implies 3% upside from the current level.**

Exhibit 2: Valuation Chart



Source: RSec Research

Exhibit 3: Mindtree Discount/Premium over peers



Source: RSec Research, Gartner

Key Risks

- ▶ Earlier-than-expected rebound in T&H vertical
- ▶ Higher-than-expected margin owing to aggressive cost saving
- ▶ Favourable currency movement

Key Financials

Profit & Loss Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues (US\$ mn)	1,001.4	1,088.8	1,076.5	1,306.2	1,471.5	1,636.0
Growth (%)	18.3	8.7	(1.1)	21.3	12.6	11.2
Net Revenues	70,215	77,643	79,678	96,602	1,10,360	1,24,338
Growth (%)	28.5	10.6	2.6	21.2	14.2	12.7
Employee Costs	44,212	50,647	51,132	58,489	65,658	73,977
SG&A and Other Operating Expenses	15,358	16,098	11,979	18,968	22,624	25,489
EBITDA	10,645	10,898	16,567	19,145	22,078	24,873
EBITDA (%)	15.2	14.0	20.8	19.8	20.0	20.0
EBITDA Growth (%)	43.8	2.4	52.0	15.6	15.3	12.7
Depreciation	1,641	2,754	2,596	2,818	3,057	3,342
EBIT	9,004	8,144	13,971	16,328	19,021	21,530
EBIT (%)	12.8	10.5	17.5	16.9	17.2	17.3
EBIT Growth (%)	58.2	(9.6)	71.5	16.9	16.5	13.2
Other Income	893	673	1,517	1,970	1,790	1,871
Interest	29	529	503	516	516	516
PBT	9,868	8,288	14,985	17,782	20,295	22,885
Tax (incl deferred)	2,327	1,979	3,879	4,494	5,074	5,721
PAT	7,541	6,309	11,106	13,288	15,221	17,164
PAT Growth (%)	32.3	(16.3)	76.0	19.6	14.6	12.8
EPS (Rs) Adj.	46.3	41.7	67.4	80.7	92.4	104.2
EPS Growth (%) Adj.	35.1	(9.9)	61.6	19.6	14.6	12.8

Balance Sheet

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
SOURCES OF FUNDS						
Share Capital - Equity	1,642	1,646	1,647	1,647	1,647	1,647
Reserves	31,419	29,922	41,543	47,507	56,310	65,246
Total Shareholders' Funds	33,061	31,568	43,190	49,154	57,957	66,893
Total Debt including lease oblogation	5	4,964	4,492	4,492	4,492	4,492
Long Term Provisions & Others	-	1,798	6	6	6	6
Creditors	2,131	2,554	2,676	3,284	3,743	4,218
Other Current Liabilities & Provns	1,573	3,522	2,384	3,851	3,376	4,326
Total Current Liabilities	5,020	8,958	10,872	13,142	14,855	16,625
TOTAL SOURCES OF FUNDS	41,790	51,566	63,614	73,924	84,424	96,553
APPLICATION OF FUNDS						
Goodwill	5,912	5,491	4,946	4,946	4,946	4,946
Net Block	3,757	3,400	3,039	3,767	4,476	5,123
CWIP	297	136	224	224	224	224
Investments	1,200	804	1,161	1,161	1,161	1,161
Deferred Tax Assets	388	1,835	351	351	351	351
LT Loans & Advances, Others	2,564	7,351	8,139	9,285	10,836	12,841
Total Non Current Assets	14,118	19,017	17,860	19,734	21,994	24,646
Debtors	13,356	14,389	12,742	18,526	21,165	23,846
Cash & Bank	2,562	5,870	7,597	8,960	13,513	19,246
Liquid Investments	6,836	6,944	19,307	19,307	19,307	19,307
Other Current Assets	4,918	5,346	6,108	7,397	8,444	9,509
Total Current Assets	27,672	32,549	45,754	54,190	62,429	71,907
TOTAL APPLICATION OF FUNDS	41,790	51,566	63,614	73,924	84,424	96,553

Cash Flow Statement

Y/E March (Rs mn)		FY19	FY20	FY21	FY22E	FY23E	FY24E
PAT		7,541	6,309	11,106	13,288	15,221	17,164
Non-operating & EO items		1,738	1,367	6,139	0	0	0
Depreciation		1,692	1,795	1,515	2,818	3,057	3,342
Working Capital Change		(2,360)	420	3,915	(2,728)	(1,989)	(551)
Cash taxes		(2,255)	(1,640)	(2,715)	(3,146)	(3,552)	(4,005)
Cash Flow from Operations	(a)	6,356	8,251	19,960	10,232	12,737	15,951
Capex		(1,759)	(1,220)	(614)	(1,546)	(1,766)	(1,989)
Investments		(225)	991	(11,219)	0	0	0
Cash Flow from Investing	(b)	(1,984)	(229)	(11,833)	(1,546)	(1,766)	(1,989)
Debt Issuance/(Repaid)		(4)	(5)	0	0	0	0
Share capital Issuance		3	4	1	0	0	0
Dividend		(5,912)	(5,940)	(2,880)	(7,324)	(6,418)	(8,229)
Other		814	1,227	(3,521)	0	0	0
Cash Flow from Financing	(c)	(5,099)	(4,714)	(6,400)	(7,324)	(6,418)	(8,229)
NET CASH FLOW (a+b+c)		(727)	3,308	1,727	1,363	4,553	5,733
Opening Cash Balance		3,289	2,562	5,870	7,597	8,960	13,513
Closing Cash Balance		2,562	5,870	7,597	8,960	13,513	19,246
Free Cash Flow		4,597	7,031	19,346	8,686	10,972	13,961

Key Ratios

Y/E March		FY19	FY20	FY21	FY22E	FY23E	FY24E
Profitability (%)							
EBITDA Margin		15.2	14.0	20.8	19.8	20.0	20.0
APAT Margin		10.7	8.1	13.9	13.8	13.8	13.8
RoE		27.5	19.1	35.2	30.8	31.0	29.6
RoCE		24.9	18.1	26.4	26.2	26.2	25.6
Efficiency							
Tax Rate (%)		23.6	23.9	25.9	25.3	25.0	25.0
Fixed Asset Turnover (x)		7.0	5.5	6.1	7.0	7.7	8.3
Debtors (days)		69	68	58	70	70	70
Payables (days)		12	13	12	14	13	13
Net Debt/EBITDA (x)		(0.9)	(0.7)	(1.4)	(1.2)	(1.3)	(1.4)
Net Debt/Equity (x)		(0.3)	(0.2)	(0.5)	(0.5)	(0.5)	(0.5)
Per Share Data (Rs)							
EPS		46.3	41.7	67.4	80.7	92.4	104.2
DPS		30.0	13.0	27.5	44.5	39.0	49.9
BV		201.0	191.6	262.2	298.4	351.8	406.1
Valuation (x)							
P/E		55.7	61.8	38.3	44.2	39.3	34.3
P/BV		12.8	13.5	9.8	9.3	8.4	7.4
EV/EBITDA		39.0	38.3	24.3	27.5	24.7	21.4
FCF/mkt cap (%)		1.1	1.7	4.6	1.6	1.8	2.3
Dividend Yield (%)		1.2	0.5	1.1	1.7	1.3	1.4

Institutional Equity Research

Mphasis

IT | India

Company Update | 13 August 2021

CMP* (Rs)	2,767
Upside/ (Downside) (%)	25
Bloomberg Ticker	MPHL IN
Market Cap. (Rs bn)	525
Free Float (%)	44
Shares O/S (mn)	190

BUY

2 Year Target Price: Rs.3,470

Risk Reward Remains Favourable as Core Business Remains Healthy

Key Triggers

- ☞ **Healthy direct business (83% of FY21 revenue) to drive USD revenue growth**
- ☞ **Receding contribution of volatile business; DXC contributed 12% to total revenue in 4QFY21 vs. 23% 4QFY20**
- ☞ **Continued patronage of Blackstone suggests stability at promoter level**
- ☞ **Co-investment by marquee investors to expand end-market opportunity**
- ☞ **Favourable risk reward against peer group; dividend yield is seen at 4% in FY24E**

1. **Direct business (83% of FY21 revenue) – which clocked a strong 15% CAGR over FY18-21 driven by new client addition and market share gain – is expected to clock 20% CAGR over FY21-24E on the back of strong deal win in FY21 (+51% YoY)**
2. **DXC business continued to witness slump and contributed just 9% to Mphasis' total revenue in 1QFY22 vs. 23% in 4QFY20. Substantial reduction in volatile part of business is encouraging for consistent growth, in our view. .**
3. **Stable top leadership, successful track record in executing legacy and next generation projects along with long-term relationship with the customers are the strong positives.**
4. **Blackstone recommitted 7-10-year investment horizon for Mphasis, which suggests continued patronage. Further, co-investment by Abu Dhabi Investment Authority (ADIA), UC Investments and others would aid in expanding end-market opportunity.**
5. **We expect EBIT margin to expand by 30-50bps to 16.4-16.7% over FY22E-FY24E driven by rising share of direct business, G&A cost control, and payout from recent investments.**

ESG Analysis: While analyzing 20 key criteria (10 points each) under ESG Matrix, we have assigned an overall score of 75.5% to Mphasis. Under **"Environmental Head"**, we have assigned 83% score, as the company scores high in climate change and carbon emission. Under **"Social Head"**, we have assigned 70% score, as the company scores high on customer satisfaction, despite scoring low on employee engagement and human rights front. Under **"Governance Head"**, we have assigned 80% score due to high score in audit committee structure and political contribution and low score on executive compensation front (please refer to page no 43 for detailed ESG analysis).

Outlook & Valuation

We believe Mphasis deserves multiple rerating considering the industry leading FY21-FY24E CAGR of 20% in direct business, expanding EBIT margin and attractive dividend yield of 2.3% (FY24E). In the medium-term, we expect strong growth in direct core business to outweigh the concerns over DXC business. Considering steady increase in the contribution of direct business and optimization of G&A cost, we increase our EBIT and EPS estimates by 21.5%/33.2% and 14.8%/21.8% for FY22E/FY23E, respectively. Introducing our estimate for FY24E, we expect its USD revenue to grow by 13.5% and see EBIT margin at 16.7%. At CMP, the stock trades at 6% discount to its peers (LTI and Mindtree) compared to historical average discount of 13%. **Valuing the stock at 32x of FY24E earnings (vs. 15.8x of FY23E earlier), we maintain BUY on Mphasis with an upwardly revised 2-Year Target Price of Rs3,470 (from Rs1,250), which implies 25% upside from the current level.**

Key Financials

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Sales	77,311	88,436	97,222	1,14,452	1,33,621	1,53,696
EBIT	12,481	14,187	15,609	18,753	22,306	25,644
PAT	10,734	11,424	12,166	14,786	17,395	20,499
Diluted EPS (Rs)	55.5	60.8	64.4	78.5	92.2	108.4
P/E (x)	49.9	45.5	43.0	35.2	30.0	25.5
RoE (%)	18.5	21.3	22.0	23.9	26.1	28.5
Dividend Yield (%)	1.0	1.3	2.3	1.8	2.0	2.3

Source: Company, RSec Research

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Share price (%)	1 mth	3 mth	12 mth
Absolute performance	24.9	49.7	138.1
Relative to Nifty	21.2	40.1	94.1

Shareholding Pattern (%)	Mar'21	June'21
Promoter	56.0	56.0
Public	44.0	44.0

1 Year Stock Price Performance



Note: * CMP as on 12 August 2021

Investment Decision Matrix (IDM)

Key Criteria	Score	Risk	Comments
Management Quality	8	Low	The management team is largely stable with limited attrition; track record on forward looking outlook is good; the management consistently achieves margin on guided lines
Promoter's Holding Pledge	10	Low	Zero share pledging by the promoter as of June 30, 2021; currently, Blackstone (promoter) owns 56% of Mphasis; Blackstone has recommitted 7-10-year investment horizon for Mphasis, which suggests continued patronage
Board of Directors Profile	8	Low	Its board comprises of members from diverse background of technology, engineering and finance; out of total 8 directors, there are 3 independent directors and 1 woman director
Industry Growth	8	Low	Indian IT industry is likely to grow in high single-digit to low double-digit in the medium-term; the industry continues to clock 9.7% CAGR since FY08 (pre-GFC level); its share in global IT spends more than doubled from 8.4% in FY08 to 18.5% in FY20
Regulatory Environment / Risk	7	Low	As the IT companies are not regulated by government/regulators, there is limited regulatory risk; but the key regulatory risks for the Indian IT companies are: global immigration policies, privacy and intellectual property rights and Indian SEZ acts etc.
Entry Barriers / Competition	5	Medium	Intense competition between large-cap and mid-cap IT companies; as IT services is a fragmented industry, there are large number of capability-specific and geography-specific vendors
New Business/Client Potential	7	Low	Mphasis follows proactive sales strategy and has added 88 new clients during last two years; direct business (83% of FY21 revenue) has consistently grown >15% in last 3 years; deal wins increased by 51% YoY in FY21, which suggests new business potential
Business Diversification	5	Medium	Its top client i.e. DXC contributes ~15% to its FY21 top-line; it is less diversified from vertical perspective, as financial services and insurance contributes >50% to its total revenue; we believe Mphasis needs to increase revenue contribution from non-BFSI customers to reduce industry concentration
Market Share Potential	7	Low	We expect Mphasis to clock ~15.6% CAGR over FY21-FY24E, substantially higher than the industry's growth rate of low double-digit; we also highlight Blackstone's patronage at the top and new co investors such as ADIA and University of California could expand incremental growth opportunity for Mphasis
Margin Expansion Potential	8	Low	EBIT is likely to expand by 30-60bps in FY22E-FY24E on the back of improved operating efficiency and recovery in revenue growth
Earnings Growth	9	Low	EPS is expected to clock 18.9% CAGR over FY21-FY24E compared to 13% CAGR over FY18-FY21
Balance Sheet Strength	8	Low	As it incurs low capex, it has limited working capital requirement; it has a strong balance sheet with cash and cash equivalents to the tune of Rs29bn
Debt Profile	8	Low	Its debt stood at Rs5.1bn as of FY21-end, while net cash position stood at Rs24bn
FCF Generation/NWC	9	Low	FCF conversion is seen at >80% over FY21-FY24E, led by limited capex requirement and strong collection
Dividend Policy	9	Low	Dividend yield is seen at ~2.3% (FY24E); the company generally distributes 50% of profit as dividend
Total Score Out of 150	116		
Average Score (%)	77.3%	Low	
Score	For < 5	Red	High Risk
	For 5	Blue	Medium Risk
	For > 5	Green	Low Risk
Total Score (%)	For < 50	Red	High Risk
	For 50	Blue	Medium Risk
	For > 50	Green	Low Risk

Environmental, Social & Governance Matrix (ESGM)

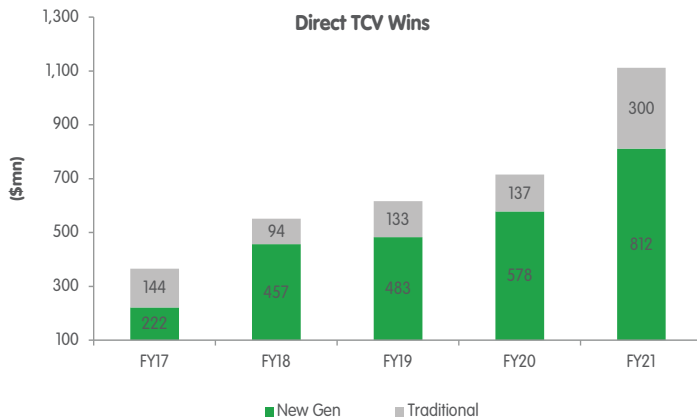
Key Criteria	Score	Risk	Comments
Environmental			
Climate Change & Carbon Emission	10	Low	IT companies have limited carbon emission footprint; Mphasis has been working on lowering carbon emission by enthalpy system and installing sensors in the office premises; carbon footprints are monitored on monthly basis; one of its facilities at Bengaluru has been certified LEED (Leadership in Energy & Environmental Design) Gold by the United States Green Building Council (USGBC)
Air & Water Pollution	8	Low	It follows all prescribed norms on pollution; generally, the services company emit limited water and air pollutants
Biodiversity	8	Low	IT companies owing to their compact offices and lower emission of pollutants have minimal impact on biodiversity
Deforestation	8	Low	The company spends on various environment causes through CSR activities
Energy Efficiency	8	Low	Mphasis is among one of the few IT companies in India to implement captive renewable energy generation units at multiple locations; it has installed 15 and commissioned 10 kW of solar power capacity at Kshema facility in Global Tech Park, Bangalore and Mangalore facility
Waste Management	8	Low	The company has effective waste management programme; it has tied-up with various organizations for disposal of dry paper/products, metal waste, plastic waste, e-waste and food waste; it also runs initiative to reduce plastic usage in the organization
Defence / Arms / Ammunition Exposure	8	Low	It has limited exposure to defence space with no major customer in defense/arms segment
Social			
Customer Satisfaction	8	Low	It conducts weekly status review meeting, monthly governance review meeting, monthly/quarterly senior management governance reviews and quarterly customer satisfaction survey
Data Protection & Privacy	8	Low	Mphasis has implemented reasonable physical, technical and administrative security measures to protect personal information from loss, misuse, alteration or destruction; the service providers and agents are also bound to maintain the confidentiality of personal information and may not use the information for any unauthorized purpose; through formally executed contracts, Mphasis ensures that the service providers are committed to "same level of data protection" as per data protection laws and regulations
Gender & Diversity	7	Low	Total number of employees is 19,313 out of which 13,225 are male and 6,088 are female (32%)
Employee Engagement	5	Medium	The company has multi-disciplinary employee engagement programmes and employee assistance programmes on intranet; its new HR portal provides Facebook like experience to employees; additionally, the company also provides and encourages re-skilling of employees; however, higher attrition continues to remain a concern
Community Relations / Service	7	Low	It spends around Rs208mn on CSR activities, which is generally 2% of profit; the CSR activities carried out in >20 different projects
Human Rights	6	Low	The company emphasizes on human rights, prevention of fraudulent and corrupt practices, avoidance of conflict of interest, prevention of sexual harassment and unyielding integrity at all times
Labour Standard	5	Medium	Mphasis is committed to provide safe working condition to employees; 96.68% employees were paid above the legal minimum wage in the last year

Governance

Audit Committee Structure	8	Low	The audit committee comprises of 4 members out of whom of 3 are independent directors and it is headed by an independent director
Bribery & Corruption	7	Low	Mphasis has organization level rules regarding bribery and corruption, which are applicable to vendors as well
Executive Compensation	6	Low	It awarded 5% average pay hike to employees in FY20, while the remuneration of key managerial personnel increased in the range of 5-6.5%; salary of key managerial personnel is in the range of 10x-180x of median salary of the employees; On the other hand, Mindtree and LTI paid key managerial remuneration in the range of 25x-122x and 109x of median salary respectively
Lobbying	8	Low	Mphasis is member of NASSCOM and CII, which advocate areas of engagement, sustainable business principles, inclusive development policies, governance and administration, economic reforms, products and technology etc.
Political Contribution	10	Low	Mphasis does not make any political contribution
Whistleblower Scheme	8	Low	The company has a whistleblower policy to enable employees, partners and business associates a framework where they can raise unethical practices and/or concerns (whether or not a violation of law) and report it to the whistleblower custodian anonymously; this policy governs reporting/investigation of allegations that are in breach of COBC
Total Score Out of 200	151	Low	
Total Score (%)	75.5%		

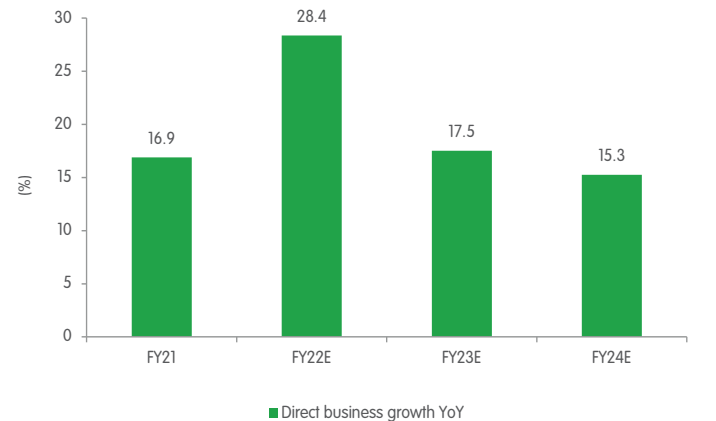
Key Charts

Solid deal momentum to enhance mid-term visibility



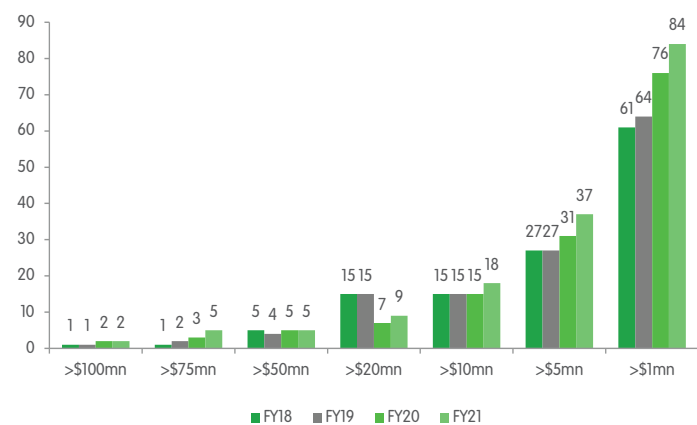
Source: Company, RSec Research

Direct business remains growth engine



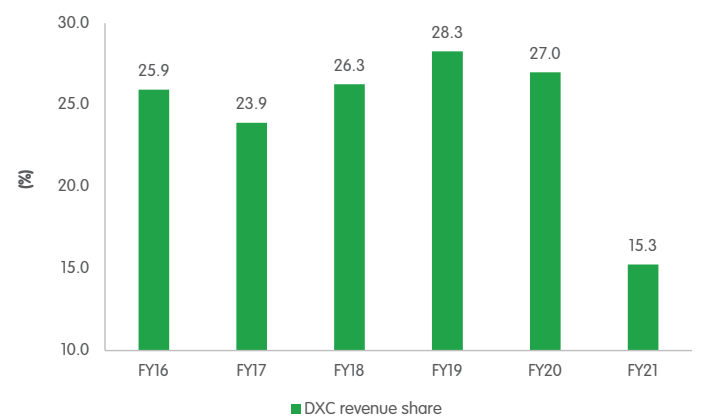
Source: Company, RSec Research

Improved client pyramid suggests client share gain



Source: Company, RSec Research

Steady decline in contribution of volatile DXC Business is encouraging



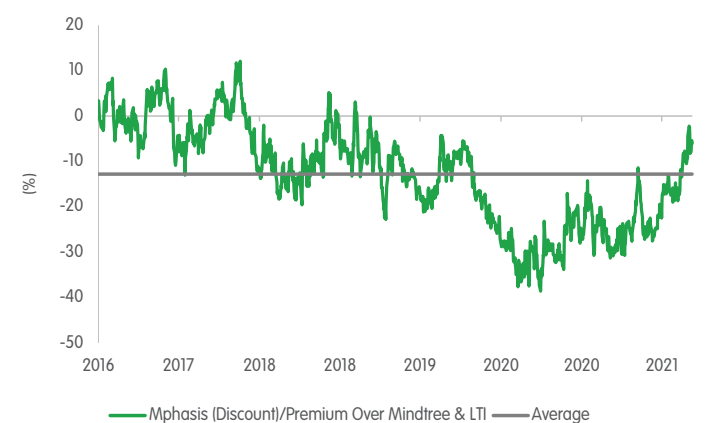
Source: Company, RSec Research; Note: Company has changed DXC business definition during FY21

Stable EBIT margin with upward bias on the cards



Source: Company, RSec Research

At CMP, Mphasis trades discount to it's peers



Source: Company, RSec Research

Earnings Revision & Recommendation

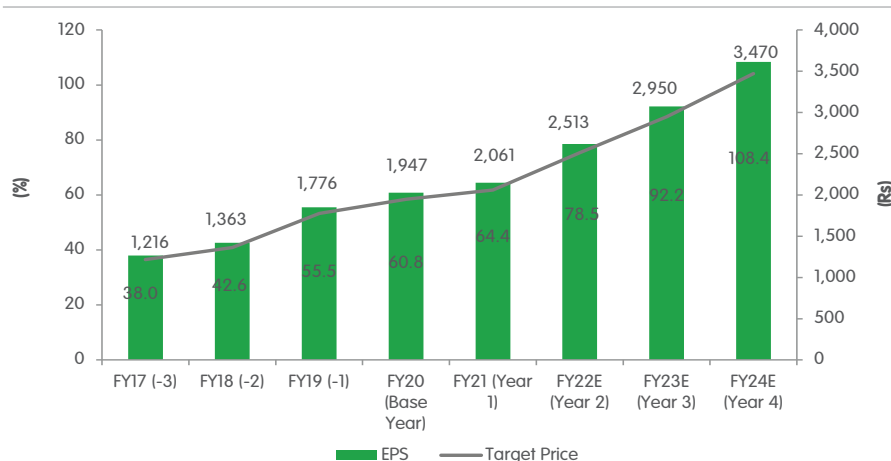
Pandemic-led accelerated cloud migration and multi-year transformation projects by the enterprises are beneficial for the IT names. Mphasis has also highlighted strong deal pipeline and recorded decent net new TCV wins in FY21. Hence, we increase our USD revenue estimate by 16.4% and 24.3% for FY22E and FY23E, respectively. Considering increasing direct business contribution and G&A cost optimization, we increase our EBIT and EPS estimate by 21.5%/33.2% and 14.8%/21.8% for FY22E/FY23E, respectively. We have also introduced our estimate for FY24E and expect USD revenue growth of 13.5% and EBIT margin of 16.7%. In the light of improved business, we forecast Mphasis to witness EPS CAGR of 18.9% over FY21-FY24E. We believe Mphasis should continue to warrant premium valuation vis-à-vis peers on the back of its consistent industry-leading growth of 15.6% over FY21-FY24E backed by execution-focused stable management, diversified client base, robust new logo addition and client mining efforts. **Valuing the stock at 32x (from 15.8x earlier) on FY24E earnings), we maintain BUY on Mphasis with an upwardly revised 2-Year Target Price of Rs3,470 (from Rs.1,250), which implies 25% upside from the current level.**

Change in Estimates

Y/E March (Rs bn)	New			Change (%)		Change (%)	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	1,546	1,782	2,022	1,328	1,434	16.4	24.3
Revenue	1,14,452	1,33,621	1,53,696	99,582	1,07,516	14.9	24.3
EBIT	18,753	22,306	25,644	15,436	16,749	21.5	33.2
EBIT Margin (%)	16.4	16.7	16.7	15.5	15.6	88 bps	109 bps
EPS (Rs)	78.5	92.2	108.4	68.4	75.7	14.8	21.8

Source: RSec Research

EPS & Target Price



Source: RSec Research

Price Sensitivity Analysis

	EPS (Rs)	Growth (%)	FWD P/E	Target P/E multiple (x)				
				21	29	30	31	32
FY17 (-3)	38.0		72.8x	798	1,102	1,140	1,178	1,216
FY18 (-2)	42.6	12.1	65.0x	894	1,235	1,278	1,320	1,363
FY19 (-1)	55.5	30.3	49.9x	1,166	1,610	1,665	1,721	1,776
FY20 (Base Year)	60.8	9.6	45.5x	1,277	1,764	1,825	1,886	1,947
FY21 (Year 1)	64.4	5.9	43.0x	1,353	1,868	1,933	1,997	2,061
FY22E (Year 2)	78.5	21.9	35.2x	1,649	2,278	2,356	2,435	2,513
FY23E (Year 3)	92.2	17.4	30.0x	1,936	2,673	2,765	2,857	2,950
FY24E (Year 4)	108.4	17.6	25.5x	2,276	3,142	3,251	3,359	3,470

Source: RSec Research

1QFY22 - Key Highlights

1. Revenue came in at US\$362.9mn in 1QFY22, which is 2% higher than our estimate of US\$356mn. In CC terms, revenue grew by 5.9% QoQ (up 16.3% YoY) vs. our estimate of 3.7% QoQ.
2. EBIT margin stood at 15.9% (down 20bps QoQ) vs. our estimate of 16%.
3. Net income came in at Rs3,390mn, which is 6% higher than our estimate of Rs3,206mn, driven by higher-than-expected revenue growth and higher other income.
4. New TCV (Total Contract Value) wins in Direct business more than doubled to US\$505mn in 1QFY22 from US\$245mn in 4QFY21.
5. In CC terms, direct business revenue grew by 9.8% QoQ (up 32.5% YoY), while DXC revenue declined by 18.1% QoQ (down 48.7% YoY).

Exhibit 1: 1QFY22 Result Summary

Y/E March (Rs mn)	1QFY22E	4QFY21	QoQ (%)	1QFY22	YoY (%)
Revenue US\$mn	363	342	6.0	305	12.0
Revenue	26,909	25,243	6.6	22,882	10.3
EBIT	4,271	4,054	5.4	3,583	13.1
Net income	3,390	3,169	7.0	2,750	15.2
Diluted EPS (Rs)	17.9	16.9	5.9	14.6	15.2
Margin (%)					
EBIT	15.9	16.1	(19) bps	15.7	21 bps
Net Income	12.6	12.6	4 bps	12.0	58 bps

Source: RSec Research

Key Conference Call Takeaways

Industry Specific Takeaways:

1. The management highlighted key technology megatrends such as: (1) enterprise cloud migration; (2) next-gen data analytics; (3) core modernization; and (4) customer experience.
2. The company highlighted that some pricing leverage is available due to supply side concerns. The management expects value-based pricing and zero cost transformation to aid the industry on pricing front.

Company Specific Takeaways:

1. Revenue from Direct channel grew by 35% YoY on reported basis (up 32.5% YoY in CC terms) in 1QFY22. The company highlighted broad-based growth across geographies, service lines and verticals. The performance of Direct business is one of the best in the industry. In CC terms, Europe region delivered a strong 25.9% YoY growth in 1QFY22.
2. The management expects contribution of DXC to decline, going forward and settle in mid-single digit in the medium-term. Mphasis will provide clarity on Minimum Revenue Commitment (MRC) in next couple of quarters. Net employee addition was lower due to redeployment of resources from DXC channel. DXC channel contributed 9% to the company's topline in 1QFY22.
3. LTM revenue from Top 1-5, Top 6-10 and Top 11-20 clients grew by 17%, 56% and 19% YoY, respectively. All US\$50mn+ accounts witnessed sequential growth in 1QFY22. New customer acquisition witnessed a strong growth rate of 34.3% YoY in 1QFY22.
4. The company recorded its highest ever quarterly TCV win of US\$505mn (85% in new-gen areas) in 1QFY22. Current TCV – which includes a landmark deal of \$250mn in the UK region in BFSI domain – has already reached 45% of FY21 TCV. Deal size is usually bigger in new-gen wins. Deal pipeline remains robust and a large deal of US\$250mn is likely to flow to the topline from 3QFY22 onwards.
5. Revenue from Banking & Capital Market vertical grew by 29.3% YoY in Direct channel. All Top-10 banks in the US are Mphasis' clients today compared to just 5 banks three years ago. The management expects continued growth momentum over FY22E. Revenue from insurance vertical is expected to pick-up, going forward based on deal closures and deal pipeline. While IT, Communication and Entertainment vertical grew by 168% driven by recent large deal wins, Logistics & Transportation vertical recorded a strong 27.7% YoY growth in 1QFY22.
6. The management has highlighted a negative one-time impact of 30bps on gross margin due to the second COVID-19 wave.
7. The management expects Direct business to witness industry-leading growth in FY22E with an EBIT margin in the range of 15.5-17%. However, it expects some upward bias on EBIT margin front in the medium-term.

Investment Rationale

Our investment thesis is based on the following premises:

- ▶ Robust Direct Channel to Aid in Sustaining Revenue Growth
- ▶ Steady Decline in Contribution of Volatile DXC-HP Business
- ▶ Blackstone's Patronage & Co-investment by Marquee Investors Augur Well
- ▶ Stable EBIT Margin with Upward Bias on the Cards

I. Robust Direct Channel to Aid in Sustaining Revenue Growth

Mphasis' direct business (83% of FY21 revenue) comprises of strategically focused client accounts, which are sourced through direct channels (unlike DXC). During FY17-FY21, the company's direct core business witnessed a robust 14% revenue CAGR vs. ~7.5% CAGR witnessed by the industry. We believe Mphasis' outperformance was largely driven by:

- Rapid development and constant renewals of offerings
- Proactive deal sourcing
- Expanding wallet share among the existing accounts
- Continued market share gain in European markets

Mphasis' new generation deal wins almost trebled in FY21 from the FY17 level. Direct business in Europe has grown 25% YoY in CC terms in FY21. As the deal pipeline in Europe remains strong (especially from the new clients), we believe the region would continue to drive growth in FY22E and beyond. It added 88 new clients in FY20-FY21 compared to 45 new clients over FY17-FY18. Additionally, the company continued to increase its wallet share in strategic accounts with growth in US\$100mn/US\$75mn/US\$5mn client buckets by 1/2/4. Notably, the company's direct TCV (Total Contract Value) grew by 55% YoY to US\$1.1bn in FY21.

We expect MPHL's direct businesses to sustain the industry-leading growth in the medium-term on the back of strong deal wins in FY21 and focused client mining efforts. We expect its direct business to clock >20% CAGR over FY21-FY24E.

II. Steady Decline in Contribution of Volatile DXC Business

DXC-HP business – which has been volatile historically – contributed 9% to MPHL's revenue in 1QFY22 (down ~1,000bps YoY) vs. 23% in 4FY20. A decade back, as the top client contributed ~40-50% to MPHL's topline, budget drawdowns and soft performance of the top client led to underperformance of Mphasis' revenue growth till FY17. In last 4-6 quarters, DXC has trimmed subcontracting cost under its restructuring efforts. Additionally, Master Service Agreement (MSA) between Mphasis and DXC is due for renewal in Sept'21. In last couple of years, Mphasis has expanded its relationship with DXC as 'Transformation Projects Partner' vs. previously being a mere supplier. We expect sharp decline in Mphasis' DXC to business to continue in FY22E and stabilize thereafter. We expect DXC business to contribute 5% to MPHL's FY24E revenue.

We believe receding contribution of DXC-HP business is encouraging. Looking ahead, we expect incrementally lower contribution of DXC business to boost Mphasis' growth in FY23E and FY24E.

III. Blackstone's Patronage & Co-investment by Marquee Investors Augur Well

In Apr'21, Blackstone recommitted up to US\$2-2.8bn to maintain controlling stake in Mphasis. Additionally, Abu Dhabi Investment Authority (ADIA), UC Investments and other long-term investors have agreed co-invest in the company albeit the quantum of investment is not disclosed. BCP Topco IX Pte. Ltd. (Blackstone fund) will acquire 55.3% from other Blackstone funds (Blackstone Capital Partners Asia and Blackstone Capital Partners (CYM) VIII AIV). Based on open offer subscription, the blended purchase price will vary between Rs1,452 to Rs.1,497/share. The transaction will trigger open offer for acquisition of up to 26% stake at a price of Rs1,677.16/share. It can be recalled that in 2016, Blackstone entered Mphasis with a 10-15-year investment horizon vs. its typical 4-6 years investment horizon. Blackstone funds generally have life span of 10 years, while other Sovereign and Pension funds generally invest for long-term value creation. Blackstone considers cloud migration by the enterprises as a secular growth story, which has been accelerated by the pandemic. Additionally, Mphasis can also tap these investors and their other investments as prospective clients, going forward.

Currently, Mphasis has ~US\$400mn of cash in hand, which can be used for larger acquisitions in IT space. We believe Blackstone's commitment through other funds rests debate over continuity of promoter. We expect continued patronage from the promoters will help the management to take bolder bets in buoyant end-market environment.

IV. Stable EBIT Margin with Upward Bias on the Cards

Mphasis reported 16.1% margin (vs. guided range of 15.5-17%) in FY21 (up 10bps YoY) on the back of strong execution focus, improved operating efficiency led by higher utilization, rising digital share and higher offshoring. Looking ahead, the company expects industry-leading growth in direct business in FY22E with EBIT margin of 15.5-17%. It expects upward bias to EBIT margin in the medium-term. As the company has highlighted comparatively improving pricing scenario, we expect it to report EBIT margin of 16.4%, 16.7% and 16.7% in FY22E, FY23E and FY24E, respectively.

Mphasis fares well on dividend yield front in comparison to other IT companies on the back of higher dividend payout ratio and strong FCF generation. We believe Mphasis is likely to continue with 50%+ payout ratio in the medium-term.

Outlook & Valuation

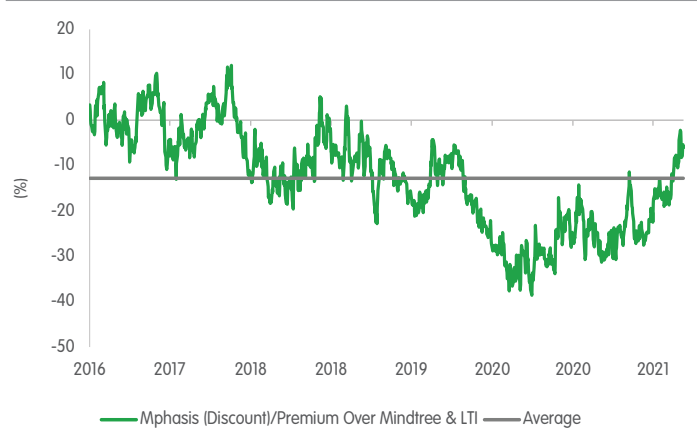
We believe Mphasis deserves multiple rerating considering the industry leading FY21-FY24E revenue CAGR of >20% in direct business, expanding EBIT margin and attractive dividend yield of 2.3% (FY24E). In the medium-term, we expect strong growth in direct core business to outweigh the concerns over DXC business. Considering steady increase in the contribution of direct business and optimization of G&A cost, we increase our EBIT and EPS estimates by 21.5%/33.2% and 14.8%/21.8% for FY22E/FY23E, respectively. Introducing our estimate for FY24E, we expect its USD revenue to grow by 13.5% and see EBIT margin at 16.7%. At CMP, the stock trades at 6% discount to its peers (LTI and Mindtree) compared to historical average discount of 13%. **Valuing the stock at 32x of FY24E earnings (vs. 15.8x of FY23E earlier), we maintain BUY on Mphasis with an upwardly revised 2-Year Target Price of Rs3,470 (from Rs1,250), which implies 25% upside from the current level.**

Exhibit 2: Mphasis Valuation Chart



Source: Bloomberg, RSec Research

Exhibit 3: At CMP, Mphasis trades discount to it's peers



Source: Bloomberg, RSec Research

Key Risks

- ▶ Significant reduction in tech spends by US banks/insurers
- ▶ Extended travel restriction to onsite locations
- ▶ Unfavourable currency movement

Key Financials

Profit & Loss Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues (US\$ mn)	1,118.0	1,239.6	1,308.9	1,545.9	1,781.6	2,022.3
Growth (%)	13.0	10.9	5.6	18.1	15.2	13.5
Net Revenues	77,311	88,436	97,222	1,14,452	1,33,621	1,53,696
Growth (%)	18.1	14.4	9.9	17.7	16.7	15.0
Employee Costs & Other expenses	55,754	62,951	67,723	79,198	91,532	1,05,301
SG&A and Other Operating Expenses	8,317	8,980	11,472	13,730	16,459	18,928
EBITDA	13,240	16,505	18,027	21,523	25,630	29,468
EBITDA (%)	17.1	18.7	18.5	18.8	19.2	19.2
EBITDA Growth (%)	24.6	24.7	9.2	19.4	19.1	15.0
D&A	759	2,318	2,418	2,771	3,323	3,824
EBIT	12,481	14,187	15,609	18,753	22,306	25,644
EBIT (%)	16.1	16.0	16.1	16.4	16.7	16.7
EBIT Growth (%)	25.9	13.7	10.0	20.1	18.9	15.0
Other Income	1,592	967	696	1,012	992	1,815
PBT	14,073	15,154	16,305	19,765	23,298	27,459
Tax (incl deferred)	3,339	3,730	4,139	4,979	5,903	6,960
PAT	10,734	11,424	12,166	14,786	17,395	20,499
PAT Growth (%)	28.2	6.4	6.5	21.5	17.6	17.8
EPS (Rs)	55.5	60.8	64.4	78.5	92.2	108.4
EPS Growth (%)	30.3	9.6	5.9	21.9	17.4	17.6

Balance Sheet

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
SOURCES OF FUNDS						
Share Capital - Equity	1,862	1,865	1,870	1,870	1,870	1,870
Reserves	50,636	56,431	63,398	66,051	74,112	84,334
Total Shareholders' Funds	52,498	58,296	65,268	67,921	75,982	86,204
Debt	5,428	5,714	5,134	5,134	5,134	5,134
Lease liabilities	28	7,378	7,019	7,019	7,019	7,019
Total Debt	5,456	13,092	12,153	12,153	12,153	12,153
Current Liabilities	11,687	12,769	11,927	16,238	19,030	22,041
Provisions	3,100	2,242	3,494	2,900	3,398	3,936
Total Current Liabilities	3,100	2,242	3,494	2,900	3,398	3,936
TOTAL SOURCES OF FUNDS	72,741	86,399	92,842	99,211	1,10,563	1,24,334
APPLICATION OF FUNDS						
Goodwill	19,585	21,405	21,326	21,326	21,326	21,326
Net Block	2,113	2,494	3,193	2,856	2,534	2,163
CWIP & Right to use assets	406	6,789	5,708	4,877	3,880	2,733
Investments	13,292	13,257	18,460	18,460	18,460	18,460
Deferred Tax Assets	814	2,157	1,261	1,261	1,261	1,261
LT Loans & Advances, Others	12,272	11,866	13,563	13,563	13,563	13,563
Total Non Current Assets	48,482	57,968	63,511	62,343	61,023	59,505
Debtors & Unbilled Revenues	17,687	16,947	18,021	23,777	27,866	32,274
Cash & Bank	6,572	11,484	11,310	13,092	21,674	32,555
Total Current Assets	24,259	28,431	29,331	36,869	49,540	64,829
TOTAL APPLICATION OF FUNDS	72,741	86,399	92,842	99,211	1,10,563	1,24,334

Cash Flow Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
PBT	14,073	15,154	16,305	19,765	23,298	27,459
Non-operating & EO items	(486)	(721)	(277)	0	0	0
Depreciation	758	2,316	2,418	2,771	3,323	3,824
Working Capital Change	(1,421)	423	(453)	(2,039)	(798)	(860)
Income Tax paid	(3,427)	(3,960)	(3,448)	(4,979)	(5,903)	(6,960)
Cash Flow from Operations (a)	9,497	13,212	14,544	15,518	19,921	23,463
Capex	(815)	(1,243)	(1,252)	(1,602)	(2,004)	(2,305)
Acquisitions	(1,696)	0	(805)	0	0	0
Change in Investments	5,404	2,651	(6,162)	0	0	0
Cash Flow from Investing (b)	2,893	1,408	-8,219	-1,602	-2,004	-2,305
Debt Issuance/(Repaid)	1,082	(2,333)	(2,356)	0	0	0
Share capital Issuance/(buyback)	(9,845)	151	268	0	0	0
Dividend	(4,653)	(6,065)	(6,527)	(12,134)	(9,334)	(10,277)
Cash Flow from Financing (c)	(13,416)	(8,247)	(8,615)	(12,134)	(9,334)	(10,277)
NET CASH FLOW (a+b+c)	(1,026)	6,373	(2,289)	1,782	8,583	10,881
EO items, others	(97)	(10)	(120)	0	0	0
Opening Cash Balance	4,642	3,519	9,882	7,473	9,255	17,837
Closing Cash Balance	3,519	9,882	7,473	9,255	17,837	28,718
Free Cash Flow	8,682	11,969	13,292	13,915	17,916	21,157

Note: Cash and cash equivalent in balance sheet includes both cash and bank balance

Key Ratios

Y/E March	FY19	FY20	FY21E	FY22E	FY23E	FY24E
Profitability (%)						
EBITDA Margin	17.1	18.7	18.5	18.8	19.2	19.2
EBIT Margin	16.1	16.0	16.1	16.4	16.7	16.7
APAT Margin	13.9	12.9	12.5	12.9	13.0	13.3
RoE	18.5	21.3	22.0	23.9	26.1	28.5
RoCE	18.4	18.3	16.4	18.8	20.7	22.0
ROA	15.0	16.6	15.3	16.5	18.1	19.5
Efficiency						
Tax Rate (%)	23.7	24.6	25.4	25.2	25.3	25.3
Debtors (days)	38	28	28	32	32	35
Unbilled Receivables (days)	40	38	34	38	39	42
Current Liabilities (days)	51	50	41	48	48	52
FCF/Ni (%)	80.9	104.8	109.3	94.1	103.0	103.2
Net Debt/EBITDA (x)	(1.1)	(0.7)	(1.0)	(0.9)	(1.1)	(1.3)
Net Debt/Equity (x)	(0.3)	(0.2)	(0.3)	(0.3)	(0.4)	(0.5)
Per Share Data (Rs)						
EPS	55.5	60.8	64.4	78.5	92.2	108.4
DPS	27.0	35.0	65.0	50.0	55.0	65.0
BV	271.4	310.4	345.6	360.8	402.6	455.7
FCF	35.2	45.3	64.2	71.2	74.5	95.9
Valuation (x)						
P/E	49.9	45.5	43.0	35.2	30.0	25.5
P/BV	10.2	8.9	8.0	7.7	6.9	6.1
EV/EBITDA	38.9	30.8	27.6	23.2	19.4	16.6
FCF/EV (%)	2.1	2.2	2.4	3.0	3.5	4.2
FCF/mkt cap (%)	1.6	2.3	2.6	2.7	3.5	4.1
Dividend Yield (%)	1.0	1.3	2.3	1.8	2.0	2.3

Institutional Equity Research

Tech Mahindra

IT | India

Company Update | 13 August 2021

CMP* (Rs)	1,387
Upside/(Downside) (%)	26
Bloomberg Ticker	TECHM IN
Market Cap. (Rs bn)	1,225
Free Float (%)	64
Shares O/S (mn)	883

BUY 

2 Year Target Price: Rs.1,750

Growth Revival Justifies Rerating

Key Triggers:

- Key beneficiary (40% of revenue) of capex for 5G and network softwarization
- Expanding focus on enterprise business with rising share of digital business
- Cost optimization measures and portfolio synergy to drive EBIT margin
- Attractive valuation; available at 33% discount to peers

- Tech Mahindra's revenue from Communication business (40% of FY21 revenue) is on the cusp of growth trajectory with 12% CAGR over FY21-24E on the back of capex for modernization of 5G network in the telecom space.
- We believe TechM will be the key beneficiary of the medium-term themes such as Software Defined Network (SDN) and Telecom IT modernization.
- Digital services now contributes ~40% of topline. We expect revenue from enterprise segment to clock 11.9% CAGR over FY21-FY24E.
- We expect TechM to report EBIT margin in the range of 15.6-16.0% over FY22E-FY24E driven by improved operating leverage, better subsidiary performance and automaton.
- We see TechM's FY24E EPS at Rs79.5, which is 5% higher than the consensus estimate.

ESG Analysis: While analyzing 20 key criteria (10 points each) under ESG Matrix, we have assigned an overall score of 73% to TechM. Under **"Environmental Head"**, we have assigned 78% score, as the company scores high in carbon emission and air/water pollution front with less exposure to defence space. Under **"Social Head"**, we have assigned 67% score, as the company scores high on customer satisfaction, despite scoring low on employee engagement. Under **"Governance Head"**, we have assigned 70% score due to high score in whistleblower scheme and low score in executive compensation (please refer to page no.56 for detailed ESG analysis).

Outlook & Valuation

Looking ahead, we expect both telecom and enterprise vertical to witness healthy growth on the back of step-up in 5G capex and mid-term resiliency in technology demand. Given improved deal wins in both enterprise and telecom vertical, we increase our USD revenue estimate by 4.9% and 6.7% for FY22E and FY23E, respectively. Considering cost optimization and portfolio synergies, we increase our EBIT and EPS estimate by 18.1%/10.9% and 18.1%/10.7% for FY22E/FY23E, respectively. Introducing our estimates for FY24E, we expect its USD revenue to grow by 10.5% and see EBIT margin at 16%. We forecast TechM to witness EPS CAGR of 17% over FY21-FY24E. At CMP, the stock trades at 33% discount to its peers vs. historical average discount of 23% owing to softness at telecom business. **Valuing the stock at 22x PE of FY24E earnings (vs. 16.5x earlier on FY23E earnings), we maintain BUY on TechM with an upwardly revised 2-Year Target Price of Rs1,750 (from Rs1,100 earlier), which implies 26% upside from the current level.**

Key Financials

Y/E Mar (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Sales	3,47,421	3,68,677	3,78,551	4,29,255	4,85,971	5,44,395
EBIT	52,317	42,803	53,894	67,027	76,996	86,919
PAT	42,976	40,329	44,281	56,415	63,450	70,893
Diluted EPS (Rs)	48.0	45.8	49.6	63.9	71.5	79.5
P/E (x)	28.9	30.3	28.0	21.7	19.4	17.4
EV / EBITDA (x)	21.2	23.6	20.4	17.3	15.4	14.1
RoE (%)	21.2	19.8	18.9	21.4	22.1	22.6
Dividend Yield (%)	1.0	1.1	2.2	2.9	3.2	3.5
P/BV (x)	13.4	13.7	15.1	12.6	10.5	8.7

Source: Company, RSec Research

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Email : chaitanya.panchmatia@relianceada.com

Share price (%)	1 mth	3 mth	12 mth
Absolute performance	31.3	42.0	100.4
Relative to Nifty	27.6	32.3	56.4

Shareholding Pattern (%)	Mar'21	Jun'21
Promoter	35.8	35.7
Public	64.2	64.3

1 Year Stock Price Performance



Note: * CMP as on 12 August 2021

Investment Decision Matrix (IDM)

Key Criteria	Score	Risk	Comments
Management Quality	6	Low	The management is well-experienced in the field of telecom and IT services; but historically in few instances it failed in anticipating high level of volatility in EBIT margin
Promoter's Holding Pledge	8	Low	Zero share pledging by the promoter as of June 30, 2021; promoter group owns 36% stake in Tech Mahindra
Board of Directors Profile	8	Low	Its board comprises of members from diverse background i.e. technology, engineering and finance; every sub-committee within the board has at least 1 independent director; TechM's board comprises of 9 members out of which 6 are independent directors
Industry Growth	8	Low	Indian IT industry is likely to grow at high single digit in the medium-term; it continues to clock 9.7% CAGR since FY08 (pre-GFC level); notably, its share in global IT spends more than doubled from 8.4% in FY08 to 18.5% in FY20
Regulatory Environment / Risk	7	Low	As the IT companies are not regulated by the government/regulators, there is limited regulatory risks; however, key regulatory risks for the Indian IT companies are: worsening of global immigration policies, privacy and intellectual property rights and Indian SEZ acts etc.
Entry Barriers / Competition	6	Low	IT services industry is fragmented with multiple players; large-cap companies enjoy benefits of scale compared to their mid-cap peers
New Business/Client Potential	8	Low	Strong potential to win new clients specifically in telecom space given its full spectrum offerings and imminent 5G roll-out
Business Diversification	6	Low	Though TechM receives 40% of revenue from telecom vertical, its client concentration is lower than its mid-cap peers
Market Share Potential	7	Low	We expect TechM's revenue to clock 11.9% CAGR over FY21-FY24E, which is ahead of the industry's growth rate
Margin Expansion Potential	7	Low	EBIT margin is likely to expand by 120-170bps to 15.6-16.0% level over FY22E-FY24E, largely driven by cost efficiency measures and portfolio synergies
Earnings Growth	8	Low	EPS expected to clock 17% CAGR over FY21-24E led by improved operating leverage
Balance Sheet Strength	8	Low	Low capex and limited working capital requirement; investments are also generally made in government bonds
Debt Profile	8	Low	As of FY21, the company had cash and bank balance in the excess of US\$1bn; with negligible debt on balance sheet, it is likely to sustain net cash position
FCF Generation/NWC	9	Low	TechM reported a consistent FCF conversion of >80% over the period
Dividend Policy	7	Low	Dividend yield stands at ~3% (FY24E); TechM pays 20% of net profit as dividend in normal circumstances; large peers of TechM have much clear and consistent capital allocation policies; we believe the company has scope to improve payout ratios, going forward
Total Score Out of 150	111		
Average Score (%)	74%	Low	

Score	For < 5	Red	High Risk	For 5	Blue	Medium Risk	For > 5	Green	Low Risk
Total Score (%)	For < 50	Red	High Risk	For 50	Blue	Medium Risk	For > 50	Green	Low Risk

Environmental, Social & Governance Matrix (ESGM)

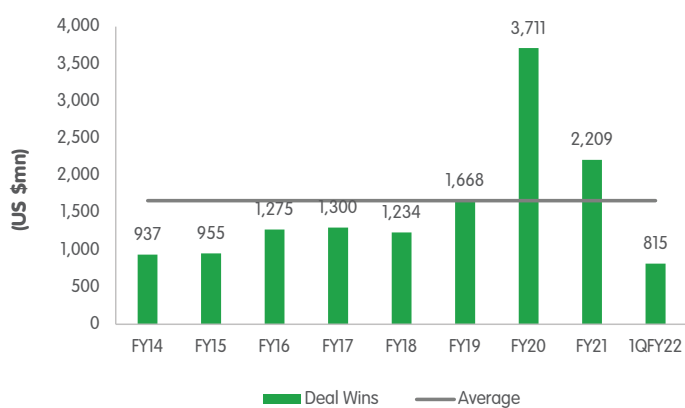
Key Criteria	Score	Risk	Comments
Environmental			
Climate Change & Carbon Emission	9	Low	TechM aligned itself to the Paris agreement by implementing several practices i.e. (1) adoption of low-emission technology; and (2) leveraging green solutions; it implemented carbon price at US\$9/tonne CO ₂ ; renewable energy- mix increased to 21.2% from 1.77% in FY16; teleconferencing and video conferencing systems set up to enable virtual meetings and reduce business travel
Air & Water Pollution	10	Low	Limited air and water pollution, as TechM is an IT service company; it follows pollution norms
Biodiversity	8	Low	Limited impact, as TechM is an IT company
Deforestation	8	Low	During FY21, TechM planted >65,000 trees; it has adopted sustainable, environment-friendly practices through 3-4-3 initiative (every associate to plant 3 trees a month, take 4 carpool rides and volunteer 3 hours a month)
Energy Efficiency	7	Low	Energy consumption was reduced by 34% YoY per associate in FY21 through effective operational controls, renewable energy sourcing and use of innovative technologies; installation of solar rooftop panels resulted in increase in share of renewable energy
Waste Management	7	Low	TechM recycled ~203mn litres of water through sewage treatment plants; paper consumption was reduced by 26% YoY in FY20; single-use plastics banned across campuses
Defence / Arms / Ammunition Exposure	6	Low	It has limited exposure to defence space with no major customer in defense/arms segment; however, defence engineering is a business segment of its parent company
Social			
Customer Satisfaction	8	Low	TechM consistently conducts customer satisfaction survey and majority of its revenue comes from renewal of existing contracts
Data Protection & Privacy	8	Low	TechM's Information Security Group (ISG) policy ensures confidentiality, integrity and availability of required information that is acquired, developed and provided to relevant stakeholders; its Information and Data Security initiatives are in line with ISO/IEC 27001:2005 standard and code of practice ISO 27002; TechM is among the five Indian companies to be certified and the specifications are implemented through the Information Security Management System (ISMS)
Gender & Diversity	8	Low	Female employees account for ~32% of total workforce
Employee Engagement	5	Medium	TechM tries to fulfill new positions/roles internally; attrition level stands at ~17%, which is expected to pick up here on; TechM did not announce any salary increment cycle in FY21 (but announced it in 1QFY22), which we believe is a concern, as all the large and mid- cap IT names announced regular increment during 3Q/4QFY21
Community Relations / Service	7	Low	CSR vision of Tech Mahindra Foundation (TMF) is 'Empowerment through Education', under which, TMF focuses on three key primary areas of intervention: Education, Employability & Disability; the foundation currently runs 179 projects with 139 NGO partners across 11 different locations in India; TMF in FY21, the foundation served 30,820 direct beneficiaries and ; it spent Rs1.2bn towards CSR activities in FY21
Human Rights	7	Low	TechM is committed to be compliant with all applicable laws on employment, labour and human rights to ensure implementation of fair and ethical employment practices
Labour Standard	6	Low	TechM is commitment towards creating a safe and secure work environment is reflected through its policies on anti-harassment, prevention of sexual harassment, safety of women employees, anti-slavery and anti-human trafficking etc; through its supplier code of conduct, it expects its suppliers to comply with the applicable regulatory requirements including labour practices and human rights, health, safety and environment etc.

Governance

Audit Committee Structure	7	Low	The audit committee comprises of 4 members, out of whom 4 are independent directors; the committee met 5 times in FY21
Bribery & Corruption	8	Low	The policy relating to ethics, bribery and corruption extends beyond TechM to its all stakeholders; the company has well-defined policies on anti-corruption and bribery as well as code of conduct, which are also applicable to all stakeholders; TechM also has a separate code of conduct for the suppliers, vendors, and companies, who provide different products and services
Executive Compensation	4	High	An increase of 0.3% was given to the employees in FY21 as against 28% decline in the remuneration of managerial personnel; key managerial remuneration range was is 14x-270x of median salary; On the other hand, Mindtree and LTI paid key managerial remuneration in the range of 25x-122x and 109x of median salary respectively
Lobbying	8	Low	TechM is member of NASSCOM and CII; it is also member of wider trade/commerce bodies through Mahindra group; the company collaborates with trade bodies for sustainability and climate change actions
Political Contribution	6	Low	Its parent company, Mahindra & Mahindra (M&M) made political contribution through electoral bonds during FY19
Whistleblower Scheme	9	Low	The company has formulated a whistleblower policy and has established a vigil mechanism for directors and employees to report concerns over unethical behaviour and any actual or suspected fraud etc; it formed a committee to address the concerns; the company affirms that no personnel has been denied access to audit committee under vigil mechanism
Total Score Out of 200	146	Low	
Total Score (%)	73%		

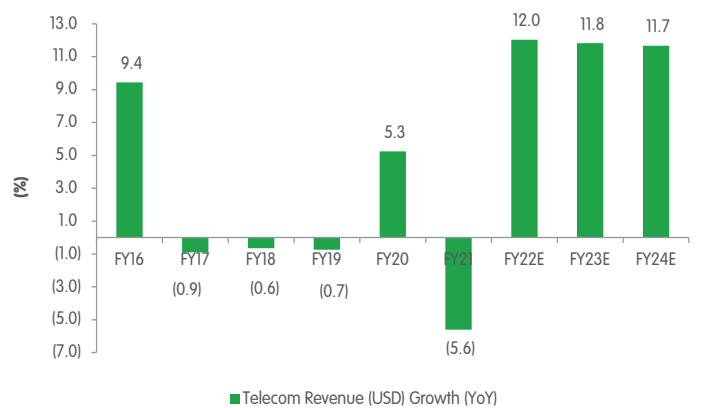
Key Charts

Deal win trend zoomed up in FY20-FY21



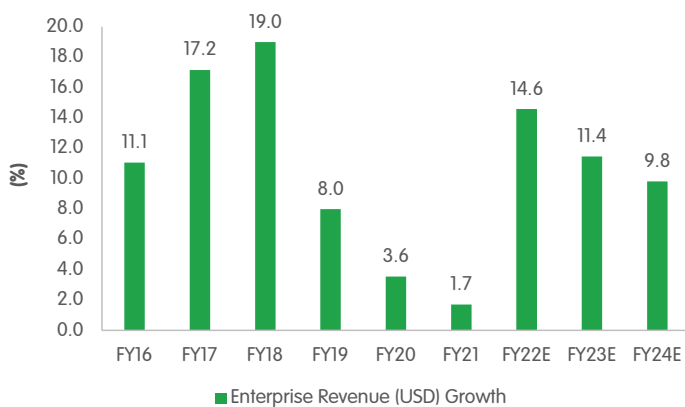
Source: Company, RSec Research

Telecom is likely to pick up in FY22/FY24E driven by step up in 5G capex cycle



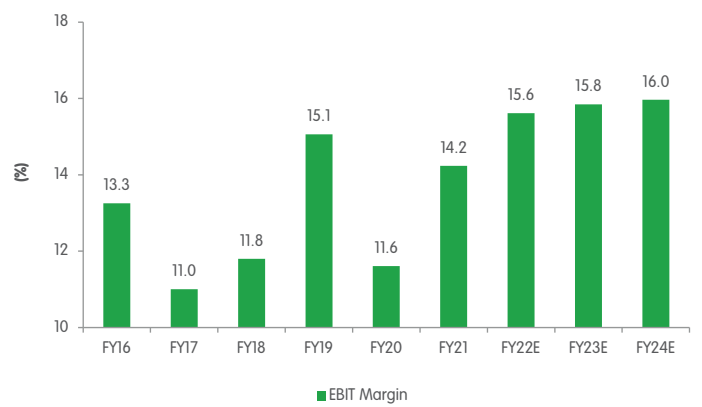
Source: Company, RSec Research

Enterprise revenue growth is ahead of IT industry growth



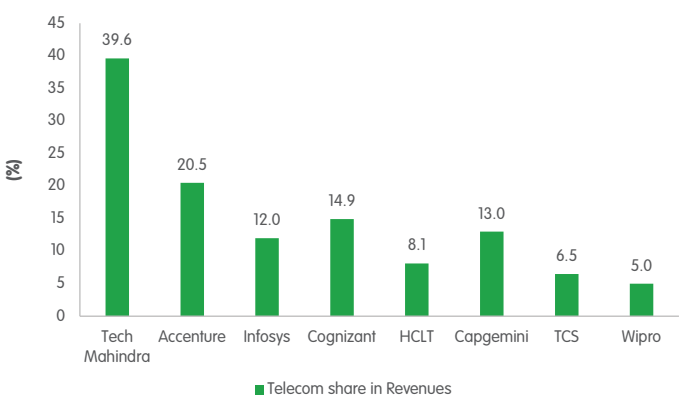
Source: RSec Research, Bloomberg

EBIT Margin is likely to step up in FY22/24 driven by strong operating leverage



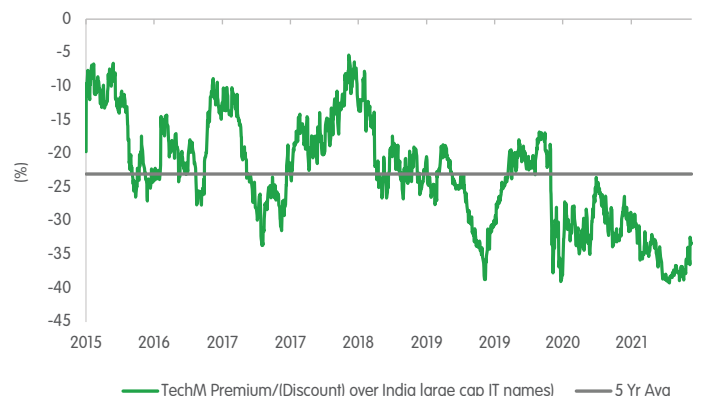
Source: RSec Research, Bloomberg

Revenue share of telecom vertical of leading players



Source: Company, RSec Research

At CMP, TechM trades at ~35% discount over larger peers



Source: RSec Research, Bloomberg

Earnings Revision & Recommendation

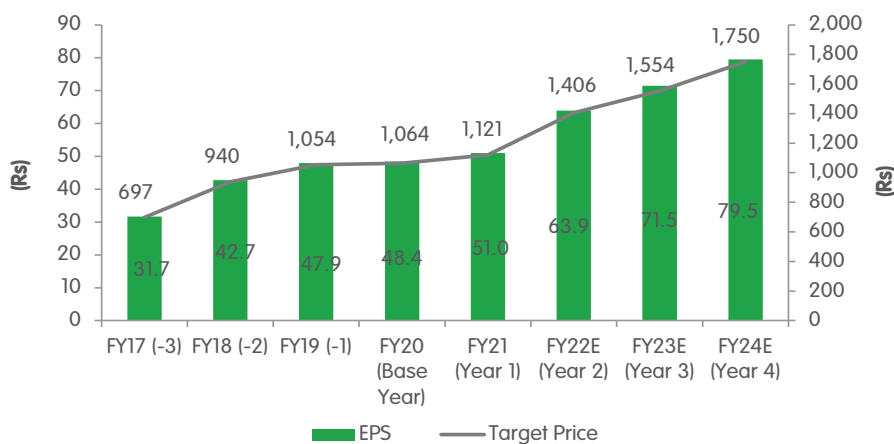
On account of faster-than-expected recovery in FY21 post COVID-led disruptions in 4QFY20-1QFY21, we increase our USD revenue and EBIT margin estimate by 4.9% and 190bps for FY22E, respectively. Pandemic has accelerated cloud migration, while the enterprises are undergoing multi-year transformation projects, which are beneficial to IT names. TechM has also highlighted acceleration in 5G deal, which we believe would lead to higher growth in telecom vertical. Accordingly, we increase our USD revenue estimate by 4.9% and 6.7% for FY22E and FY23E, respectively. Considering cost optimization projects and portfolio synergies, we increase our EBIT and EPS estimate by 18.1%/10.9% and 18.1%/10.7% for FY22E/FY23E, respectively. We have also introduced FY24E and expect USD revenue growth of 10.5% and EBIT margin of 16%. In light of improved business visibility in both enterprise and telecom vertical, we forecast TechM's EPS to clock 17% CAGR over FY21-FY24E. The stock deserves multiple rerating considering double-digit revenue growth, elevated EBIT margin and attractive dividend yield of 3% (FY24E). **We maintain BUY on TechM with an upwardly revised 2-Year Target Price of Rs1,750 (from Rs1,100 earlier) valuing the stock at 22x PE (vs. 16.5x earlier on FY24E earnings), which implies 26% upside from the current level.**

Change in Estimates

Y/E March (Rs bn)	New			Old		Change (%)	
	FY22E	FY23E	FY24E	FY22E	FY23E	FY22E	FY23E
US\$ Revenue	5,806	6,480	7,163	5,534	6,074	4.9	6.7
Revenue	4,29,255	4,85,971	5,44,395	4,15,061	4,61,591	3.4	5.3
EBIT	67,027	76,996	86,919	56,747	69,407	18.1	10.9
EBIT Margin (%)	15.6	15.8	16.0	13.7	15.0	191 bps	84 bps
EPS (Rs)	63.9	71.5	79.5	54.1	64.6	18.1	10.7

Source: RSec Research

EPS & Target Price



Source: Company, RSec Research

Price Sensitivity Analysis

	EPS (Rs)	EPS Growth (%)	FWD P/E	Target P/E multiple (x)					
				17	18	19	20	21	22
FY17 (-3)	31.7		43.8x	539	570	602	634	665	697
FY18 (-2)	42.7	34.8	32.5x	726	769	811	854	897	940
FY19 (-1)	47.9	12.2	28.9x	815	862	910	958	1,006	1,054
FY20 (Base Year)	48.4	1.0	28.7x	822	871	919	968	1,016	1,064
FY21 (Year 1)	51.0	5.3	27.2x	866	917	968	1,019	1,070	1,121
FY22E (Year 2)	63.9	25.4	21.7x	1,086	1,150	1,214	1,278	1,342	1,406
FY23E (Year 3)	71.5	11.9	19.4x	1,216	1,287	1,359	1,430	1,482	1,554
FY24E (Year 4)	79.5	11.2	17.4x	1,351	1,431	1,510	1,590	1,669	1,750

Source: Company, RSec Research

1QFY22 – Key Highlights

1. Revenue stood at US\$1,383.6mn in 1QFY22, which is 1.8% above our estimate of US\$1,360mn. CC revenue grew by 3.9% QoQ (vs. our estimate of 2.1% QoQ), driven by lower seasonality in Communication vertical and strong growth in Manufacturing & Technology verticals.
2. The company won net new deals worth US\$815mn in 1QFY22 compared to US\$1,040mn in 4QFY21.
3. EBIT margin came in at 15.2% ahead of our estimate of 14.4%. However, it declined by 130bps QoQ, driven by salary hike, higher visa cost, seasonal decline in mobility business and higher subcontractor cost, which were partially offset by improved operating leverage and efficiency gains.
4. Net income stood at Rs13.5bn, 9.8% above our estimate of Rs12.4bn, driven by strong operating leverage and absence of tax one-off.
5. CC revenue from Communication and Enterprise verticals grew by 2.9% QoQ and 4.5% QoQ, respectively.

Exhibit 1: 1QFY22 Result Review

Y/E March (Rs mn)	1QFY22E	4QFY21	QoQ (%)	1QFY21	YoY (%)
Revenue U\$mn	1,384	1,330	4.0	1,207	14.6
Revenue	1,01,976	97,299	4.8	91,063	12.0
EBIT	15,453	16,037	-3.6	9,173	68.5
Net income	13,534	10,812	25.2	9,722	39.2
Diluted EPS (Rs)	15.3	12.3	24.5	11.1	38.5
Margin (%)					
EBIT	15.2	16.5	(133) bps	10.1	508 bps
Net Income	13.3	11.1	216 bps	10.7	260 bps

Source: RSec Research

Key Conference Call Takeaways

Industry Specific Takeaways:

1. The operators are getting ready for 5G adoption. Primary deal discussion with them includes modernizing consumer engagement platform, cloud native architecture/ network and system back-end process optimization.
2. Telco capex – as a percentage revenue – will not change much. However, the operators will repurpose their spend on network, cloud and data analytics.

Company Specific Takeaways:

1. Large deal environment remained robust and deal wins were within earlier guided range of US\$800mn to US\$1bn. The company also closed large deals in healthcare (hospital modernization) and BPS vertical. Deal wins in sub-US\$5mn ticket size also remained strong. Additionally, the company has highlighted the highest ever deal pipeline in absolute terms.
2. TechM will continue to work on transformation efforts including both on network and digital side. Currently, 60-70% of deals have 5G integration from scaling-up of cloud and AI to transform it to intelligent network.
3. Net headcount grew by ~5,000. The company highlighted that current trend of hiring is likely to continue in the upcoming quarters.
4. Tax rate stood at 24% in 1QFY22 compared to 32% in 4QFY21. Going ahead, effective tax rate is likely to be in the range of 24-26%.
5. The company targets double-digit organic revenue growth in FY22E. The management also targets EBIT margin of 15% in FY22E, driven by strong operating leverage and improving profitability of portfolio companies. The company indicates upside to FY22 outlook on the back of strong 1QFY22 print.

Investment Rationale

Our investment thesis is based on the following premises:

- ▶ Key Beneficiary of Capex for 5G & Network Softwarization
- ▶ Expanding Focus on Enterprise Biz with Rising Capability of NewGen Services
- ▶ Cost Optimization Measures & Portfolio Synergy to Drive EBIT Margin
- ▶ Prudent Capital Allocation to Unlock Value for the Shareholders

I. Key Beneficiary of Capex for 5G & Network Softwarization

TechM provides network and IT services to top global telecom operators and telecom equipment manufactures. Telecom vertical contributes ~40% to its total top-line. Our analysis of commentary of the key telecom operators suggests step-up in 5G capex, specifically on software virtualization front, where we believe the integrators like TechM will be the key beneficiary. TechM reported strong revenue growth in the range of mid-to-high-teen and EBIT margin in the excess of 15% in 2013-15 during the peak time of 4G capex. We expect 5G spend on technology as significantly higher than 4G and it will be a multi-year trend, as: (a) the telecom companies will spend higher on network modernization and softwarization; and (b) multi-year step-up in consumer/enterprise spend on IoT and smart homes and smart factories. As TechM offers full spectrum services in telecom segment, we expect its telecom vertical to clock 11.9% CAGR over FY21-FY24E.

II. Expanding Focus on Enterprise Biz with Rising Capability of NewGen Services

Over FY16-FY20, TechM's enterprise business grew by 8.7% ahead of India IT sector growth of 7.6%. The company is likely to grow ahead of the industry, going forward led by consistent efforts on capability addition and strengthening the ecosystem partnership. While segmental revenue grew by 2% in FY21, we expect it to grow by 14.6%, 11.4% and 9.8% in FY22E, FY23E and FY24E, respectively. TechM has made multiple acquisitions in AI, cloud, customer experience and DevOps. It has also expanded its partnerships and alliances with cloud providers, software companies and digital players. Currently, digital business contributes 40% to its total revenue. The company has >5,000 professionals certified in AI/Automation. We believe consistent efforts have helped TechM in terms of: (a) expansion of service lines; (b) change in business-mix; (c) new delivery centers; and (d) structure to increase agility.

III. Cost Optimization Measures & Portfolio Synergy to Drive EBIT Margin

TechM's EBIT margin improved by 260bps YoY in FY21 driven by improved cost efficiency, higher utilization, increased offshoring and one-time cost savings (e.g. Travel). We forecast its FY22E, FY23E and FY24E EBIT margin at 15.6%, 15.8% and 16%, respectively driven by continued initiatives around delivery, transformation, cost optimization, portfolio synergy and tailwinds. The management highlighted that the company targets to report >15% EBIT margin in FY22E.

IV. Prudent Capital Allocation to Unlock Value for the Shareholders

During last 3 years, TechM has spent ~20% of FCF on acquisitions. It follows the policy of paying 20% of net income as dividend under normal circumstances. On an average, TechM reported cash conversion of 80% and we expect it to continue to post strong FCF conversion, going forward. TechM is likely to continue its investment towards enterprise side, which will aid it in reducing business concentration risk. We believe value unlocking for the shareholders needs efficient programmes and sustainable capital deployment. Looking ahead, we see a huge scope for meaningful improvement in operating margin and return ratios led by efficient deployment of capital. As TechM's return ratios are lower than the large-cap mid-cap peers, we believe it needs to sharpen cost optimization measures and accelerate automation to match up with peers in the medium-term. We see TechM's RoE in 21.4-22.6% range over FY22E-FY24E as against 18% in FY21.

Outlook & Valuation

Looking ahead, we expect both telecom and enterprise vertical to witness healthy growth on the back of step-up in 5G capex and mid-term resiliency in technology demand.. Given improved deal wins in both enterprise and telecom vertical, we increase our USD revenue estimate by 4.9% and 6.7% for FY22E and FY23E, respectively. Considering cost optimization and portfolio synergies, we increase our EBIT and EPS estimate by 18.1%/10.9% and 18.1%/10.7% for FY22E/FY23E, respectively. Introducing our estimates for FY24E, we expect its USD revenue to grow by 10.5% and see EBIT margin at 16%. We forecast TechM to witness EPS CAGR of 17% over FY21-FY24E. At CMP, the stock trades at 33% discount to its peers vs. historical average discount of 23% owing to softness at telecom business. **Valuing the stock at 22x PE of FY24E earnings (vs. 16.5x earlier on FY23E earnings), we maintain BUY on TechM with an upwardly revised 2-Year Target Price of Rs1,750 (from Rs1,100 earlier), which implies 26% upside from the current level.**

Exhibit 2: TechM Valuation Band



Source: RSec Research, Bloomberg

Key Risks

- ▶ Aggressive acquisition may divert the focus from execution in crucial 5G roll-out period
- ▶ Stricter immigration laws may delay project ramp-up and completion
- ▶ Lower-than-expected success of continued cost efficiency programmes
- ▶ Unfavourable currency movement

Key Financials

Profit & Loss Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues (US\$ mn)	4,970.6	5,181.9	5,111.9	5,806.3	6,479.6	7,163.1
Growth (%)	4.2	4.3	(1.4)	13.6	11.6	10.5
Net Revenues	3,47,421	3,68,677	3,78,551	4,29,255	4,85,971	5,44,395
Growth (%)	12.9	6.1	2.7	13.4	13.2	12.0
Employee Costs & Other expenses	2,18,576	2,42,508	2,42,716	2,78,820	3,14,546	3,51,695
SG&A and Other Operating Expenses	65,236	68,908	67,364	69,471	78,651	88,106
EBITDA	63,609	57,261	68,471	80,964	92,774	1,04,595
EBITDA (%)	18.3	15.5	18.1	18.9	19.1	19.2
EBITDA Growth (%)	34.9	(10.0)	19.6	18.2	14.6	12.7
D&A	11,292	14,458	14,577	13,937	15,779	17,676
EBIT	52,317	42,803	53,894	67,027	76,996	86,919
EBIT (%)	15.1	11.6	14.2	15.6	15.8	16.0
EBIT Growth (%)	44.0	(18.2)	25.9	24.4	14.9	12.9
Other Income	3,770	7,830	6,131	8,604	7,349	7,349
PBT	56,087	50,632	60,025	75,630	84,344	94,268
Tax (incl deferred)	12,544	11,604	15,999	18,707	21,086	23,567
Exceptional	(240)	(2,175)	0	0	0	0
Minorities	(567)	1,300	762	(508)	192	192
PAT	42,459	42,504	44,788	56,415	63,450	70,893
PAT Growth (%)	11.7	0.1	5.4	26.0	12.5	11.7
EPS (Rs)	47.9	48.4	51.0	63.9	71.5	79.5
EPS Growth (%)	12.2	1.0	5.3	25.4	11.9	11.2

Balance Sheet

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
SOURCES OF FUNDS						
Share Capital - Equity	4,437	4,359	4,370	4,370	4,370	4,370
Reserves & other	2,03,184	2,17,705	2,48,075	2,70,538	2,95,140	3,23,689
Total Shareholders' Funds	2,07,621	2,22,064	2,52,445	2,74,908	2,99,510	3,28,059
Debt	14,047	24,282	16,618	16,618	16,618	16,618
Total Debt	14,047	24,282	16,618	16,618	16,618	16,618
Current Liabilities	87,399	82,398	82,504	95,251	1,07,531	1,20,277
Provisions & other liabilities	25,402	44,791	45,213	44,739	45,363	46,010
TOTAL SOURCES OF FUNDS	3,34,469	3,73,535	3,96,780	4,31,516	4,69,023	5,10,964
APPLICATION OF FUNDS						
Tangible assets	26,229	26,609	24,632	24,632	24,632	24,632
Intangible Assets	42,675	60,667	64,662	62,744	60,572	58,140
Capital WIP	2,763	501	1,183	1,183	1,183	1,183
Investments	75,127	59,927	1,03,267	1,03,267	1,03,267	1,03,267
Deferred Tax Assets	6,091	8,443	9,133	9,133	9,133	9,133
LT Loans & Advances, Others	87,659	1,09,775	1,00,580	1,00,580	1,00,580	1,00,580
Total Non Current Assets	2,40,544	2,65,922	3,03,457	3,01,539	2,99,367	2,96,935
Debtors & Unbilled Revenues	70,338	76,130	64,970	89,703	1,01,555	1,13,764
Cash & Bank	23,587	31,483	28,352	40,273	68,098	1,00,266
Total Current Assets	93,925	1,07,613	93,322	1,29,975	1,69,652	2,14,029
TOTAL APPLICATION OF FUNDS	3,34,469	3,73,535	3,96,780	4,31,516	4,69,023	5,10,964

Cash Flow Statement

Y/E March (Rs mn)	FY19	FY20	FY21	FY22E	FY23E	FY24E
PBT	55,432	50,578	59,529	75,630	84,344	94,268
Non-operating & EO items	4,782	(1,106)	5,343	-8,604	-7,349	-7,349
Depreciation	11,292	14,458	14,577	13,937	15,779	17,676
Working Capital Change	(10,574)	(5,218)	15,634	(12,461)	1,051	1,186
Income Tax paid	(16,612)	(15,131)	(14,146)	(18,707)	(21,086)	(23,567)
Cash Flow from Operations (a)	44,320	43,581	80,937	49,796	72,740	82,214
Capex	(8,046)	(8,446)	(6,660)	(12,019)	(13,607)	(15,243)
Change in Investments	(23,216)	18,464	(40,154)	0	0	0
Cash Flow from Investing (b)	(21,164)	10,286	(54,501)	(1,892)	(4,734)	(6,370)
Debt Issuance/(Repaid)	(4,504)	2,114	(7,949)	0	0	0
Share capital Issuance/(buyback)	359	468	569	0	0	0
Dividend	(17,013)	(24,917)	(17,594)	(34,960)	(38,456)	(41,952)
Other	(1,354)	(1,883)	(1,789)	(1,524)	(1,524)	(1,524)
Cash Flow from Financing (c)	(22,512)	(44,656)	(29,869)	(35,984)	(40,180)	(43,676)
NET CASH FLOW (a+b+c)	644	9,211	-3,433	11,920	27,825	32,168
Opening Cash Balance	19,661	20,427	30,166	26,904	38,825	66,650
Closing Cash Balance	20,427	30,166	26,735	38,825	66,650	98,818
Free Cash Flow	36,274	35,135	74,277	37,777	59,132	66,971

Note: Cash and cash equivalent in balance sheet includes both cash and bank balance

Key Ratios

Y/E March	FY19	FY20	FY21	FY22E	FY23E	FY24E
Profitability (%)						
EBITDA Margin	18.3	15.5	18.1	18.9	19.1	19.2
EBIT Margin	15.1	11.6	14.2	15.6	15.8	16.0
APAT Margin	12.6	11.0	11.7	13.1	13.1	13.0
RoE	21.2	19.8	18.9	21.4	22.1	22.6
RoCE	21.9	16.2	18.1	20.9	22.4	23.5
ROA	13.3	12.0	11.6	13.6	14.1	14.5
Efficiency						
Tax Rate (%)	22.4	22.9	26.7	24.7	25.0	25.0
Debtors (days)	72	74	62	75	75	75
Payables (days)	32	38	32	35	35	35
FCF/NII (%)	85.4	82.7	165.8	67.0	93.2	94.5
Net Debt/EBITDA (x)	(1.3)	(1.2)	(1.7)	(1.6)	(1.7)	(1.8)
Net Debt/Equity (x)	(0.4)	(0.3)	(0.5)	(0.5)	(0.5)	(0.6)
Per Share Data (Rs)						
EPS	47.9	48.4	51.0	63.9	71.5	79.5
DPS	14.0	15.0	30.0	40.0	44.0	48.0
BV	227	248	279	306	333	363
FCF	41	40	84	43	67	76
Valuation (x)						
P/E	28.9	28.7	27.2	21.7	19.4	17.4
P/BV	6.1	5.6	5.0	4.5	4.2	3.8
EV/EBITDA	21.2	23.6	20.4	17.3	15.4	14.1
FCF/EV (%)	2.7	2.6	5.3	2.7	4.1	4.6
FCF/mkt cap (%)	2.9	2.9	6.0	3.1	4.8	5.4
Dividend Yield (%)	1.0	1.1	2.2	2.9	3.2	3.5

Change in Ratings

- We have shifted to **BUY & SELL** ratings only and no longer continue with HOLD rating.
- We have also shifted to **2-year Target Price** from 1-year Target Price earlier.

Rating Rationale

Market Cap	BUY	SELL
Large Cap	>15%	<15%
Mid/Small Cap	>20%	<20%

Score	For < 5	Red	High Risk	For 5	Blue	Medium Risk	For > 5	Green	Low Risk
Total Score (%)	For < 50	Red	High Risk	For 50	Blue	Medium Risk	For > 50	Green	Low Risk

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