

Tech Mahindra (TECHM)

HOLD

Margin to take precedence over growth

Summary

We attended the analyst meet of Tech Mahindra. The key highlight was that the company expects growth to be driven by account expansion, products & platform, large deals and expansion in new growth areas. The company expects margins to improve in long run led by lower sub con, lower transition cost in large deals, SG&A improvement and divestment of low margin acquisitions. However, in the near term we expect growth to be moderated due to challenges in top telecom client, macro uncertainty and seasonality in comviva. In terms of margins, we expect the company to improve margins to 16.6% and 16.9% in FY24E and FY25E but remain below FY22 margins. This coupled with recent run up in price prompt us to maintain HOLD rating on the stock with a revised target price of Rs 1,200 (15x PE on FY25E EPS).

Key Highlights and Investment Rationale

- Key Highlights:** The company will focus on client expansion, large deals, portfolio synergies and business transformation to drive growth. The company expects 5G, Products & Platforms and automation as key drivers. The key strategy is to drive organic growth, margin expansion, portfolio synergy and maintain healthy payout (FCF net of M&A is up from 54% in FY16-FY20 to 75% in FY21-FY22).
- Subdued near term performance:** While the company aims to double its P&P revenues from US\$450 mn to US\$ 1 bn in next 2-3 years and continue to win large deals, we believe near term top client issues and macro uncertainty will lead to industry underperformance. In addition, despite margin levers like lower subcon & offshoring we expect margins to remain below FY22 levels. **The only key trigger is change in management in the near term.**

TP	Rs1,200			Key Stock Data	
CMP	Rs1,085				
Potential upside/downside	11%				
Previous Rating	HOLD				
Price Performance (%)					
	-1m	-3m	-12m		
Absolute	7.3	(2.6)	(24.0)		
Rel to Sensex	9.0	2.3	(32.5)		
V/s Consensus				Shareholding Pattern (%)	
EPS (Rs)	FY23E	FY24E	FY25E	Promoters	35.2
IDBI Capital	58	71	79	FII	28.0
Consensus	58	68	77	DII	22.5
% difference	(0.6)	4.4	2.5	Public	14.3

Year	FY21	FY22	FY23E	FY24E	FY25E	(Rs mn)
Revenue	378,551	446,460	534,089	575,855	620,170	
Change (yoy, %)	3	18	20	8	8	
EBITDA	68,471	80,201	82,443	95,493	104,785	
Change (yoy, %)	20	17	3	16	10	
EBITDA Margin(%)	18.1	18.0	15.4	16.6	16.9	
Adj.PAT	44,788	55,661	50,803	62,674	69,613	
EPS (Rs)	51	63	58	71	79	
Change (yoy, %)	5	24	-9	23	11	
PE(x)	21	17	19	15	14	
Dividend Yield (%)	4	4	4	5	5	
EV/EBITDA (x)	12	11	11	9	8	
RoE (%)	19.2	21.5	18.4	21.6	22.7	
RoCE (%)	19	22	20	23	24	

Source: IDBI Capital Research;

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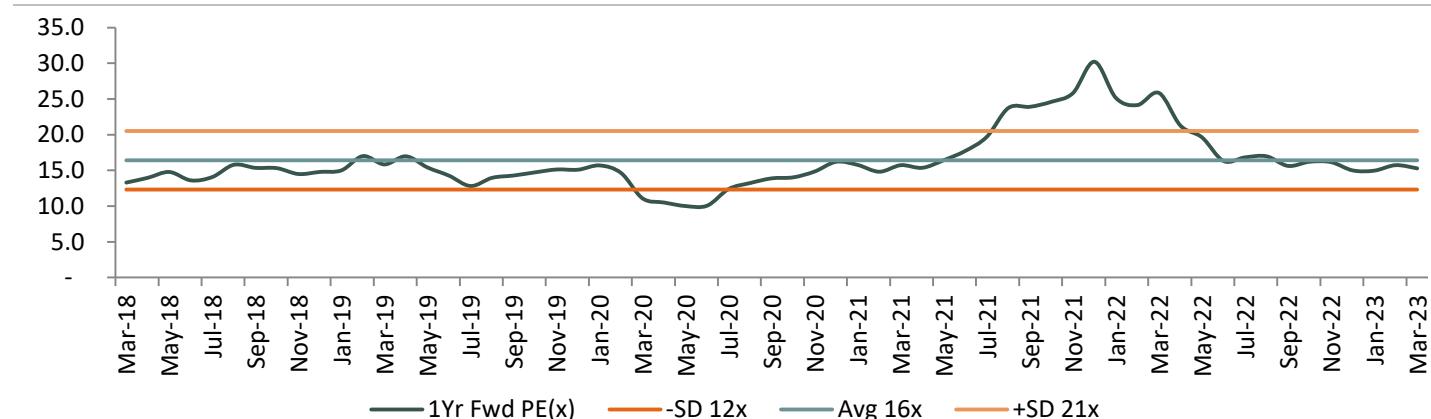
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Analyst meet Highlights

- Company has listed down 5 key areas of focus which are - maintain growth, improve productivity efficiency and margins, Improve product and platform, value creation from M&A, continue a performance led approach
- TechM mentioned that growth will be driven by organic expansion led by client mining and uptick in products business. Management also highlighted that though the deal size is getting smaller there is an uptick in the number of deals. In addition, company is not looking for any inorganic growth opportunities as it remains focused on integrating the acquisitions previously made.
- Company is focused on '4+1' strategy to grow its 5 verticals. Amongst the verticals, healthcare has recorded good growth and continues to see traction. Hi Tech continues to be the leading growth driver.
- TechM stated that cloud, emerging tech, enterprise tech, business transformation and partnership are the key trends that are shaping the demand for IT services.
- **CME** – Company remains positive on this vertical led by increased traction in 5G for enterprises and telecom players. Investments in 5G by clients are being driven by focus on reducing cost, modernizing tech stack and monetization of investments already made in 5G. Company aims to build repeatable solution through platforms. Going forward, TechM will adopt a platform based approach to further drive growth and remains highly optimistic of demand outlook.
- **BFSI** – Modernization contributed more than 50% of revenues in this vertical. Management is focused on offering differentiated solution for digitalizing the core and remains positive of further growth.
- **Hi-Tech** – This vertical remains a key growth driver as emerging technologies remain a key area of focus for clients. TechM is investing on building joint solutions with partners and believes it can benefit from client mining by capitalizing on strong customer relationship.
- **Manufacturing** – More than 40% of the revenue in this vertical came from digital and cloud. Company has shortlisted 3 areas (EV & electrification, Industry 4.0 and Sustainability) where it aims to grow based on understanding customers' requirements.

- **BPS** – BPS business has seen robust demand in the recent past. This segment added more revenue in the last 8 quarters than what it did in the last 8 years and the YTD deal win stands at \$700 mn which is highest ever. Company informed that 3 sub-segments in this segment have crossed \$100 mn revenue mark and 2 sub-segments are near that mark. Company has built end to end capabilities in CX. This has led to CX driving 50% of the revenues of this segment. Going forward, Generative AI would be one of the growth drivers and TechM has already developed platforms to capitalise on these opportunities and will continue to provide client centric solutions.
- **ESG** – Management stated that climate change has now become a part of board room discussions of many corporations as organizations have become aware of the financial consequences of bad ESG practices. ESG focused services were launched by TechM on 22nd September 2022 which has seen a few deal wins, and currently a platform for sustainable financing is under development. Company believes that in the next 2-3 years, ESG will become as big a growth driver as digital is today and hence is developing capabilities on both platform and services front.
- **Products & Platform** – Management believes product business is not an option. It is mandatory and hence will continue to invest. Company expects a non-linear growth opportunity from this business segment as products/platforms create customer stickiness with repeat business. In addition, this business also helps in improving EBIT margin. TechM has laid out its platforms strategy based on innovation hubs which focus on solving 3 problems faced by clients – 1) cost cutting and improving operational efficiency, 2) building new stack much quicker which leads to faster time to market and 3) monetizing products built on TechM's platforms. Company aims to grow its Products business from current level of \$450 mn in revenue to \$1 bn in next 2-3 years and will hence continue to invest in this business.
- **Digital Engineering Services** – TechM had inaugurated a metaverse centre and designed a fleet management software. Currently it is designing the first cognitive city of the world. Going forward, investments will be made in phygital experience (5G, automobile design, etc) and will focus on expanding partnerships.
- Given the challenging macro conditions, demand is expected to be impacted in the near to medium term. However, TechM aims to increase margin on the back of levers like operational efficiency, large deals and changes in business mix. However, increased SG&A & wage hike are expected to act as margin headwinds.

Exhibit 1: One-year forward PER trend



Financial Summary

Profit & Loss Account

(Rs mn)

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net sales	368,677	378,551	446,460	534,089	575,855	620,170
<i>Change (yoY, %)</i>	6	3	18	20	8	8
Operating expenses	(311,416)	(310,080)	(366,260)	(451,646)	(480,361)	(515,385)
EBITDA	57,261	68,471	80,201	82,443	95,493	104,785
<i>Change (yoY, %)</i>	-10	20	17	3	16	10
<i>Margin (%)</i>	15.5	18.1	18.0	15.4	16.6	16.9
Depreciation	(14,458)	(14,577)	(15,204)	(19,903)	(20,708)	(20,708)
EBIT	42,803	53,894	64,997	62,540	74,786	84,077
Interest paid	(1,919)	(1,740)	(1,626)	(3,451)	(1,538)	(1,514)
Other income	11,924	7,871	11,123	8,816	10,835	10,835
Pre-tax profit	52,808	60,025	74,494	67,905	84,083	93,398
Tax	(11,604)	(15,999)	(18,221)	(16,685)	(21,441)	(23,816)
<i>Effective tax rate (%)</i>	22.0	26.7	24.5	24.6	25.5	25.5
Minority Interest	(874.0)	255.0	(612.0)	(416.0)	32.0	32.0
Net profit	40,330	44,281	55,661	50,803	62,674	69,613
Exceptional items	(2,175)	(507)	-	-	-	-
Adjusted net profit	42,505	44,788	55,661	50,803	62,674	69,613
<i>Change (yoY, %)</i>	(1)	5	24	(9)	23	11
EPS	49	51	63	58	71	79
Dividend per sh	15.0	45.0	45.0	43.0	53.0	59.0
<i>Dividend Payout %</i>	37	88	71	74	74	74

Balance Sheet							(Rs mn)
Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E	
Shareholders' funds	218,131	248,650	268,857	281,924	298,084	315,919	
Share capital	4,359	4,370	4,388	4,388	4,388	4,388	
Reserves & surplus	213,772	244,280	264,469	277,536	293,696	311,531	
Total Debt	24,282	16,928	15,817	13,817	11,817	9,817	
Other liabilities	21,076	19,027	22,761	22,761	22,761	22,761	
Curr Liab & prov	105,757	107,619	131,766	159,004	171,190	184,121	
Current liabilities	72,193	71,051	93,494	107,790	115,971	124,652	
Provisions	33,564	36,568	38,272	51,214	55,219	59,468	
Total liabilities	151,115	143,574	170,344	195,582	205,768	216,699	
Total equity & liabilities	373,179	396,019	444,155	482,875	509,191	537,924	
Net fixed assets	76,047	80,405	139,318	132,415	126,707	121,000	
Investments	3,804	6,648	5,276	5,276	5,276	5,276	
Other non-curr assets	61,605	56,367	55,004	55,004	55,004	55,004	
Current assets	231,723	252,599	244,557	290,180	322,203	356,644	
Inventories	358	242	405	484	522	563	
Sundry Debtors	75,772	90,317	119,334	143,399	154,613	166,511	
Cash and Bank	87,606	124,971	84,104	97,251	114,187	132,619	
Loans and advances	30,632	29,331	33,964	40,971	44,175	47,575	
Total assets	373,179	396,019	444,155	482,875	509,191	537,924	

Cash Flow Statement							(Rs mn)
Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E	
Pre-tax profit	52,808	60,025	74,494	67,905	84,083	93,398	
Depreciation	9,343	14,577	15,204	19,903	20,708	20,708	
Tax paid	(13,611)	(16,284)	(13,488)	(16,685)	(21,441)	(23,816)	
Chg in working capital	(13,353)	(11,266)	(9,666)	(3,914)	(2,269)	(2,408)	
Other operating activities	(50,579)	58,648	5,372	(1,185)	(543)	(652)	
Cash flow from operations (a)	(15,392)	105,700	71,916	66,023	80,537	87,229	
Capital expenditure	(13,723)	(18,935)	(74,117)	(13,000)	(15,000)	(15,000)	
Chg in investments	5,424	(2,844)	1,372	-	-	-	
Other investing activities	-	-	-	-	-	-	
Cash flow from investing (b)	(8,299)	(21,779)	(72,745)	(13,000)	(15,000)	(15,000)	
Equity raised/(repaid)	(78)	11	18	-	-	-	
Debt raised/(repaid)	10,235	(7,354)	(1,111)	(2,000)	(2,000)	(2,000)	
Dividend (incl. tax)	(15,692)	(39,330)	(39,492)	(37,737)	(46,513)	(51,778)	
Chg in minorities	(1,718)	117	547	-	-	-	
Other financing activities	-	-	-	-	-	-	
Cash flow from financing (c)	(7,253)	(46,556)	(40,038)	(39,737)	(48,513)	(53,778)	
Net chg in cash (a+b+c)	(30,944)	37,365	(40,867)	13,287	17,024	18,451	

Financial Ratios

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Book Value (Rs)	250	284	306	321	340	360
<i>Adj EPS (Rs)</i>	49	51	63	58	71	79
<i>Adj EPS growth (%)</i>	1	5	24	-9	23	11
<i>EBITDA margin (%)</i>	16	18	18	15	17	17
<i>Pre-tax margin (%)</i>	14	16	17	13	15	15
<i>Net Debt/Equity (x)</i>	0	0	0	0	0	0
<i>ROCE (%)</i>	17	19	22	20	23	24
<i>ROE (%)</i>	20.2	19.2	21.5	18.4	21.6	22.7
DuPont Analysis						
Asset turnover (x)	1.0	1.0	1.1	1.2	1.2	1.2
Leverage factor (x)	1.7	1.6	1.6	1.7	1.7	1.7
<i>Net margin (%)</i>	11.5	11.8	12.5	9.5	10.9	11.2
Working Capital & Liquidity ratio						
Inventory days	0	0	0	0	0	0
Receivable days	75	87	98	98	98	98
Payable days	38	33	41	40	40	40

Valuations

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
PER (x)	22.3	21.2	17.1	18.7	15.2	13.7
Price/Book value (x)	4.3	3.8	3.5	3.4	3.2	3.0
EV/Net sales (x)	2.4	2.2	2.0	1.6	1.5	1.3
EV/EBITDA (x)	15	12	11	11	9	8
<i>Dividend Yield (%)</i>	1	4	4	4	5	5

Source: Company; IDBI Capital Research



Notes

Dealing

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Key to Ratings Stocks:

BUY: 15%+; **HOLD:** -5% to 15%; **SELL:** -5% and below.

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SEBI Registration: BSE & NSE (Cash & FO) – INZ000007237, NSDL – IN-DP-NSDL-12-96, Research – INH000002459, CIN – U65990MH1993GOI075578

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