Tech Mahindra (TECMAH)

ICICI direct Research

CMP: ₹ 1071 | Target: ₹ 1240 (16%) | Target Period: 12 months | BUY

November 2, 2022

Result Update

ICICI Securities – Retail Equity Research

Portfolio restructuring to boost margins…

About the stock: Tech Mahindra (TechM) has over 1.2 lakh employees across 90 countries serving 1000+ clients with higher exposure to telecom (40% of revenues).

- Apart from telecom, the company caters to BFSI, manufacturing & retail
- TechM has grown organically & inorganically (dollar revenue CAGR of 6.6% over the past five years)

Q2FY23 Results: TechM reported steady numbers in Q2FY23.

- Revenue grew 2.9% QoQ in CC terms (3.4% QoQ CC growth, adjusted for exit of low margin portfolio)
- EBIT margins increased ~40 bps QoQ at 11.4%
- New deal TCV of US$716 mn, in the guided range

What should investors do? TechM's share price has grown by ~2.6x over the past five years (from ~₹ 489 in November 2017 to ~₹ 1,071 levels in November 2022).

- We maintain our **BUY** rating on the stock

Target Price and Valuation: We value TechM at ₹ 1240 i.e. 14x P/E on FY25E EPS

Key triggers for future price performance:

- Healthy deal wins, traction in communication segment led by legacy modernisation, 5G, customer care, automation, network and cloud to drive revenues
- Restructuring of low margin portfolios, acceleration in Europe and improving demand from lift & shift deals to drive 11.6% CAGR in FY22-25E
- Margins are expected to recover on pricing, exit of low margin business, lower subcontractor costs and utilisation improvement

Alternate Stock Idea: Apart from TechM, in our IT coverage we also like Infosys.

- Key beneficiary of improved digital demand, industry leading revenue growth and healthy capital allocation prompt us to be positive
- BUY with a target price of ₹ 1,670

Tech Mahindra

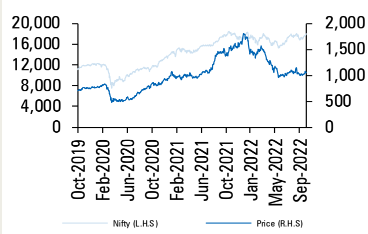
Particulars

Particular	Amount
Market Cap (₹ Crore)	1,03,491
Total Debt (₹ Crore)	1,582
Cash and Invest (₹ Crore)	8,949
EV (₹ Crore)	95,947
52 week H/L	1838 / 944
Equity capital	439
Face value	₹ 5

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoters	36	35	35	35
FII	35	34	30	28
DII	17	18	21	24
Public	12	13	14	13

Price Chart



Recent event & key risks

- Board approves special dividend of ₹ 18 per share
- **Key Risk:** (i) Deceleration in deal pipeline, (ii) Lower than expected margins.

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Key Financial Summary

Key Financials	FY21	FY22	5 Year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 years CAGR (FY22-25E)
Net sales	37,855	44,646	8.9	52,007	57,544	62,007	11.6
EBITDA	6,847	8,020	13.9	8,425	9,725	10,789	10.4
EBITDA Margin (%)	18.1	18.0		16.2	16.9	17.4	
Net Profit	4,428	5,566	14.6	5,752	7,056	7,850	12.1
EPS (₹)	50.2	63.1		65.2	80.0	88.7	
P/E	21.3	17.0		16.4	13.4	12.1	
RoNW (%)	17.8	20.7		19.1	20.8	20.5	
RoCE (%)	19.8	22.5		21.5	23.2	23.3	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- The company reported 0.3% QoQ growth in revenues at US$1,638 mn. In CC terms, revenue grew 2.9% QoQ implying cross currency impact of 260 bps. In rupee terms, revenue grew 3.3% QoQ to ₹ 13,129 crore. In CC terms CME segment grew 3.1% QoQ while Enterprise, IT, BPS segment grew 2.8%, 2.4%, 7.9% QoQ, respectively

- Vertical wise, revenue growth was led by Manufacturing & Technology reporting revenue growth of 4.9% & 4.5% QoQ, respectively, while communications (39.7% of mix) & BFSI (16.3% of mix) were laggards declining 1.4% & 2.1% QoQ, respectively. In CC terms, geography wise, US (50.8% of mix) grew 2.4% while Europe & RoW grew 3.6% & 3.4% QoQ, respectively. The revenue from Europe & RoW region was impacted by currency headwinds reporting a decline of 3.6% & 0.5% QoQ, respectively, in reported dollar terms

- The company indicated growth for the quarter was impacted (reported CC growth of 2.9%, adjusted for portfolio exits it was 3.4% in CC QoQ) as it exited some low margin projects during the quarter. The company indicated that it has taken a call on the basis of i) scaling issues with those accounts ii) not able to raise pricing, iii) low margin, iv) not fitting into strategic objective of growth. The company mentioned that it has US$15 mn impact for the quarter (exits from BFSI vertical and RoW as geography). This portfolio re-alignment will continue for Q3 and Q4 where the company has already identified the verticals and geographies. The total impact of the same (including Q2 exits) would be in the range of US$100-120 mn on revenues. However, margins are expected to benefit in the range of 20-40 bps each in the next couple of quarters

- EBIT margins for the quarter increased ~40 bps QoQ to 11.4% despite implementation of wage hike. It also indicated that the EBIT margin in CC terms was 11.7% for Q2. The company indicated the following factors helped to improve the margins: i) improved utilisation +60 bps, ii) discontinuance of low margin business +20 bps, iii) lower SG&A expenses +60 bps & iv) pricing benefits +50 bps mitigated by headwinds of wage hike & inflation -120 bps and currency headwinds – 30 bps

- The company mentioned following short term levers for margin expansion: i) Pricing: the company did get +50bps QoQ help (second consecutive quarter of +50bps) on margin ii) Utilisation: The company utilisation improved for the quarter and it did mention that it has further scope of taking it to historical trend of 88%, iii) operating efficiency, iv) continued focus on offshoring (though a couple of deals may require onsite presence), v) moderation of subcontractor costs (it has come down to 15.4% of sales vs. 16.3% in Q1). It mentioned that long term margin levers are as follows: i) geographical mix: The company indicated that they are looking to scale up US and Europe regions so that geography mix of RoW is expected to come down, going forward, which indicates that the region may be heavy on low margin projects ii) ramp up of large deals where margin profile is lower for first 12-18 months and then increases steadily, iii) focus on digital engineering projects, which command better margin

- As far as top client's muted performance is concerned (top five reported decline of 7.7% on a QoQ basis), the company indicated that there was a temporary transitionary impact on couple of programs, which were completed and new programs did not start as per expectations. The company expects this to recover from Q3 onwards

- TechM had earlier guided for TCV in the range of US$700 mn to US$ 1 billion. Q2 TCV of US$715 mn was in the guided range

- The company indicated that the demand environment is expected to be strong for them, which is reflected in new deal TCV, which continued to be in the guided range. It mentioned that Q3 is expected to have little higher furlough impact on revenues compared to historical trends. The company indicated that they have a cautious outlook on Europe as a region due to geopolitical issues as well as currency movements. The company did mention that geopolitical issues so far do not percolate into decision making but they cannot rule out softer numbers for two to three quarters from Q4 onwards for this region. The company also mentioned that the impact of geopolitical risks would not be linear across regions in Europe

- As far as the demand environment in communication vertical is concerned, it indicated that the company would get much more clarity on tech spending closer to annual budgeting of clients (i.e. in Q3). The company mentioned that as far as its discussion with client is concerned, it expects some slowdown in decision making as well as re-prioritisation of the tech spend. TechM indicated that customer experience and platform building could be sub-areas where it is expecting re-prioritisation of tech spending. Core tech spending in network modernisation, network integration, operations will continue to be strong. while clarified that network hardware is not their forte. The company indicated that it continues to work with one of the largest network operators in India for its enterprise business expansion ambition

- As far as the manufacturing vertical is concerned, the company mentioned that it continues to be one of the growth drivers for them. TechM has invested into both organic and inorganic opportunities in this vertical and Cloud competency helping the growth. It indicated that it is gaining wallet share in this vertical and is helping to win better deals here. The company mentioned that growth momentum is expected to continue with more and more penetration with existing customers and new client additions another leg of growth, which will play out later. The company also mentioned that strong relationship with hyperscalers is also creating lot of opportunities for it, which is expected to keep growth momentum strong, going forward

- LTM attrition during the quarter declined 260 bps QoQ to 19.6%. This is the third straight quarter of attrition moderating from the peak of 23.5% in Q3FY22. Utilisation improved by 210 bps QoQ to 84.9% and the company indicated that it will work to improve it further

- The company, during the quarter, added 5,877 net new employees taking the total headcount to 163,912. However, net additions were high due to elevated hiring of BPO employees whereas software employee count declined by 1,254 employees during the quarter. TechM mentioned that BPO headcount was higher in this quarter due to seasonality. It further indicated that BPO business is reporting better performance in the last six to eight quarters (i.e. more than 5% QoQ growth) and also mentioned that it was also aided by recently integrated inorganic opportunities. It mentioned that hiring trend in software business is in line with demand expectations in H2

- The company reported FCF of US$253 mn in Q2 due to the spillover from Q1 wherein it reported FCF of US$72 mn in the previous quarter

- The board of directors of the company approved a special dividend of ₹ 18 per share

Exhibit 1: Variance Analysis

	Q2FY23	Q2FY23E	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	Comments
Revenue	13,129	13,092	10,881	20.7	12,708	3.3	Revenue grew by 2.9% QoQ CC growth while dollar growth was 0.3%
Employee expenses	9,461	9,413	7,435	27.3	9,116	3.8	
Gross Margin	3,668	3,679	3,447	6.4	3,592	2.1	
Gross margin (%)	27.9	28.1	31.7	-374 bps	28.3	-33 bps	
SG&A expenses	1,684	1,702	1,452	16.0	1,712	(1.6)	
EBITDA	1,984	1,977	1,995	(0.6)	1,880	5.5	
EBITDA Margin (%)	15.1	15.1	18	-321 bps	15	32 bps	
Depreciation & amortisation	491.7	524	343.0	43.4	476.7	3.1	
EBIT	1,492	1,453	1,652	(9.7)	1,403	6.3	
EBIT Margin (%)	11.4	11.1	15	-382 bps	11.0	32 bps	EBIT margins tailwind : i) improved utilisation +60 bps, ii) discontinuance of low margin business +20 bps, iii) lower SG&A expenses +60 bps & iv) pricing benefits +50 bps. Margin headwinds were wage hike -120 bps and currency impact – 30 bps
Other income (less interest)	211	80	247	(14.4)	82	158.2	
PBT	1,704	1,533	1,899	(10.3)	1,485	14.7	
Tax paid	365	337	557	(34.5)	338	7.9	
PAT	1,285	1,181	1,339	(4.0)	1,132	13.6	PAT was higher due to higher other income & low tax rate due to one off item
Adjusted PAT	1,285	1,181	1,339	(4.0)	1,132	13.6	

Source: Company, ICICI Direct Research

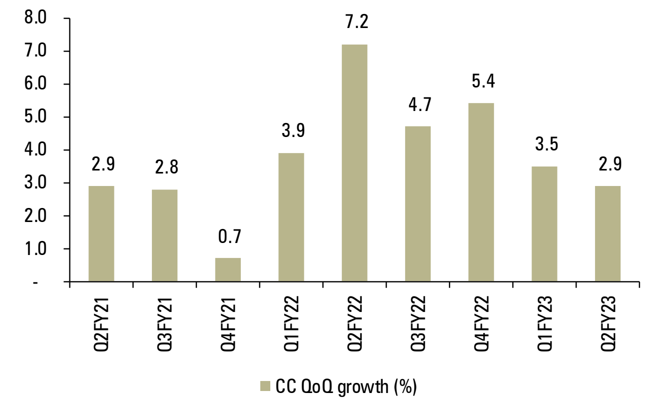
Exhibit 2: Change in estimates

	FY23E			FY24E			FY25E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	51,357	52,007	1.3	55,803	57,544	3.1	62,007	tweaking numbers on H1 performance
EBIT	6,622	6,501	-1.8	7,645	7,883	3.1	8,929	
EBIT Margin (%)	12.9	12.5	-39 bps	13.7	13.7	0 bps	14.4	we are building in margin improvement in FY25 on pricing benefit, moderation of sub con costs, better utilisation
PAT	5,842	5,752	-1.5	6,875	7,056	2.6	7,850	
EPS (₹)	66.2	65.2	-1.5	77.9	80.0	2.6	88.7	

Source: Company, ICICI Direct Research

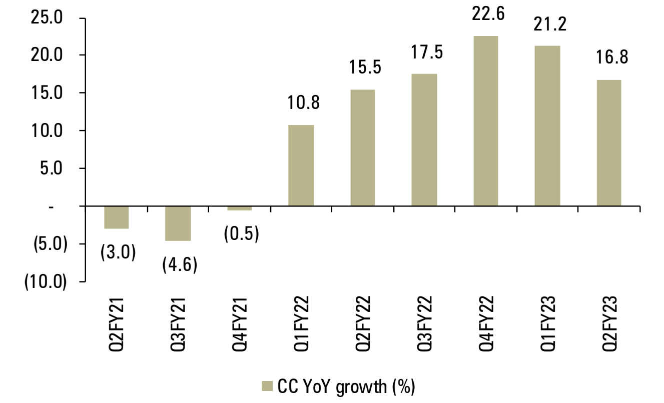
Key Metrics

Exhibit 3: Adjusted for portfolio exit, growth was 3.4% QoQ



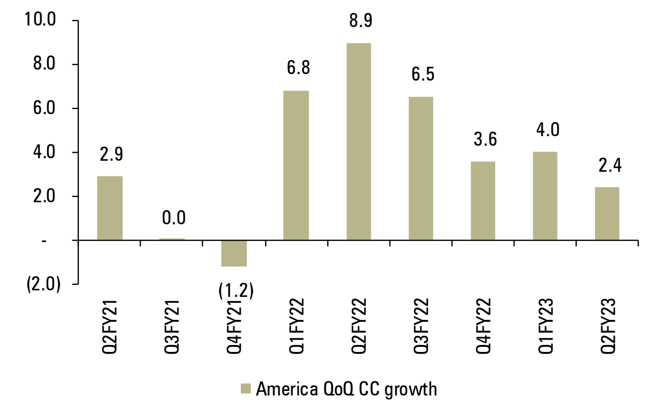
Source: Company, ICICI Direct Research

Exhibit 4: And ~18% on YoY basis



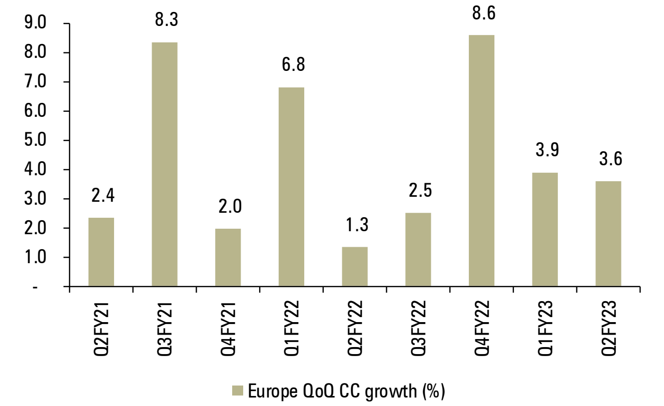
Source: Company, ICICI Direct Research

Exhibit 5: Americas region QoQ growth



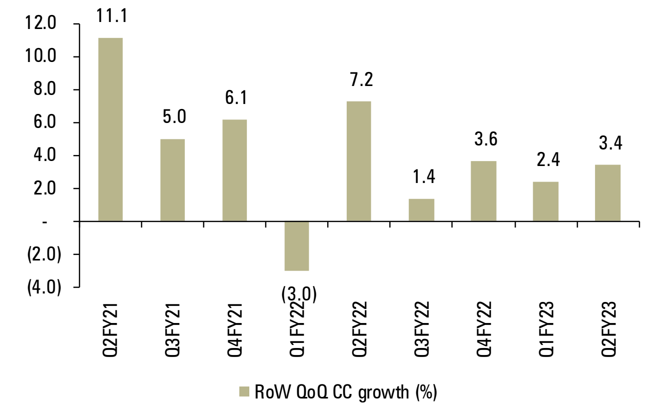
Source: Company, ICICI Direct Research, for Q1FY23 and Q2FY23, growth is in CC while dollar growth for rest of the quarters

Exhibit 6: Europe region QoQ CC growth



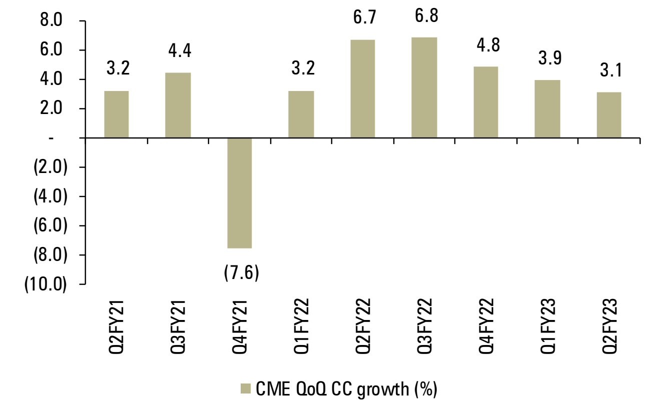
Source: Company, ICICI Direct Research, for Q1FY23 and Q2FY23, growth is in CC while dollar growth for rest of the quarters

Exhibit 7: RoW region QoQ CC growth



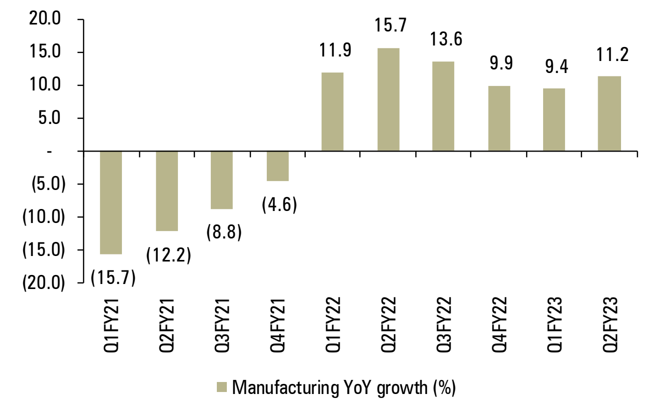
Source: Company, ICICI Direct Research, for Q1FY23 and Q2FY23, growth is in CC while dollar growth for rest of the quarters

Exhibit 8: Communications QoQ CC growth



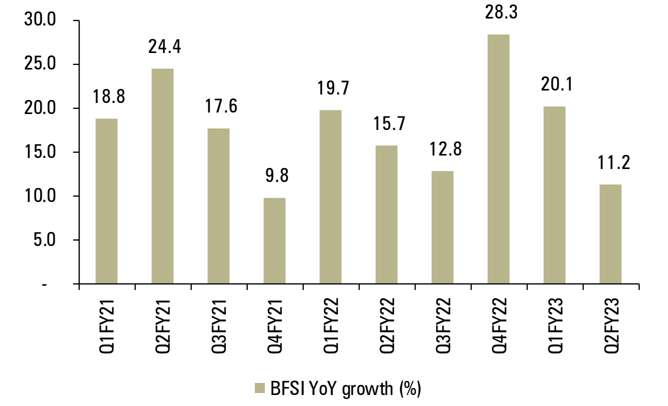
Source: Company, ICICI Direct Research, CC growth from Q3FY22 onwards

Exhibit 9: Manufacturing YoY growth



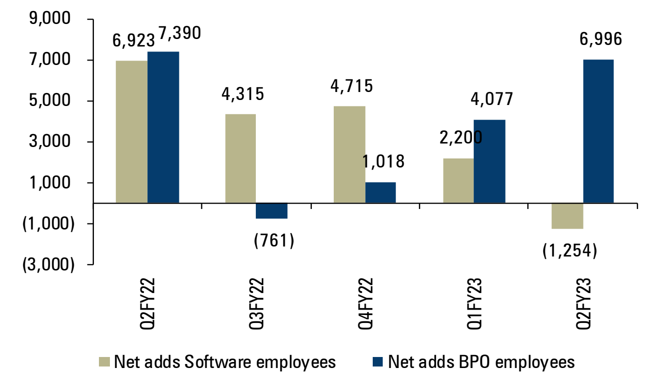
Source: Company, ICICI Direct Research

Exhibit 10: Adjusted for exit, BFSI grew 5% QoQ in CC



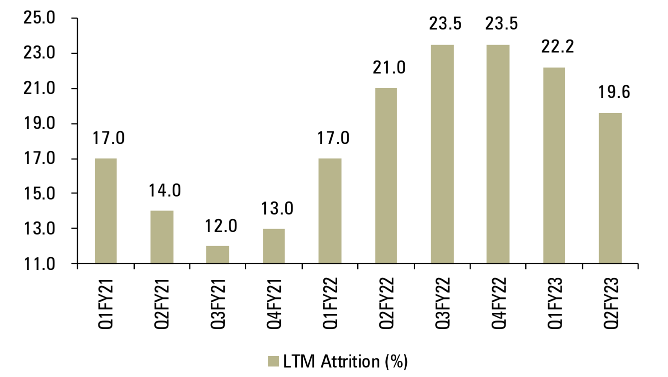
Source: Company, ICICI Direct Research

Exhibit 11: Net decline for IT aligned as per demand



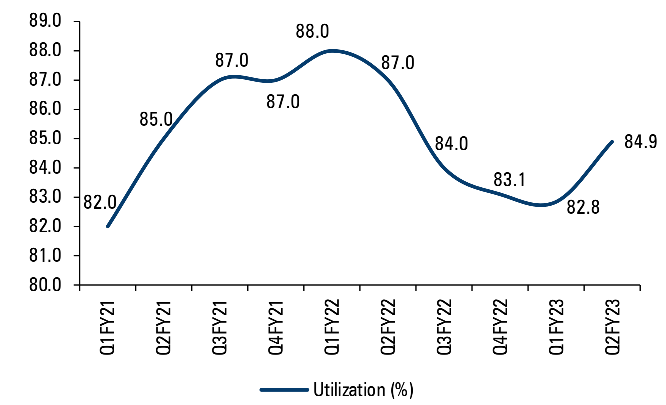
Source: Company, ICICI Direct Research

Exhibit 12: LTM attrition continues to decline



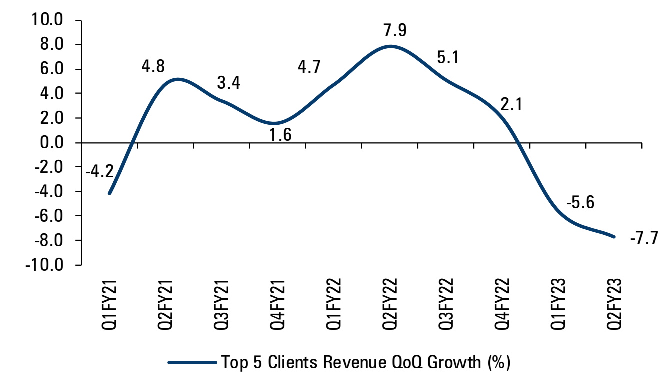
Source: Company, ICICI Direct Research

Exhibit 13: Utilisation improving



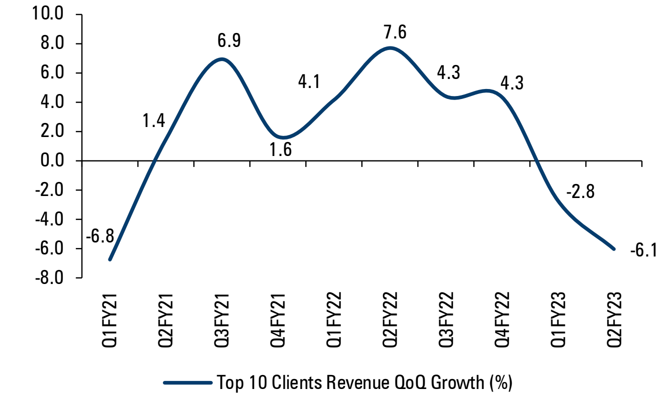
Source: Company, ICICI Direct Research

Exhibit 14: Top five clients QoQ growth declines due to transitions



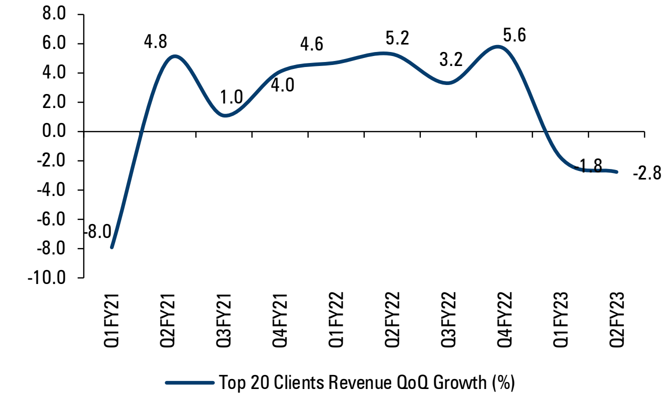
Source: Company, ICICI Direct Research

Exhibit 15: Same reason for top 10



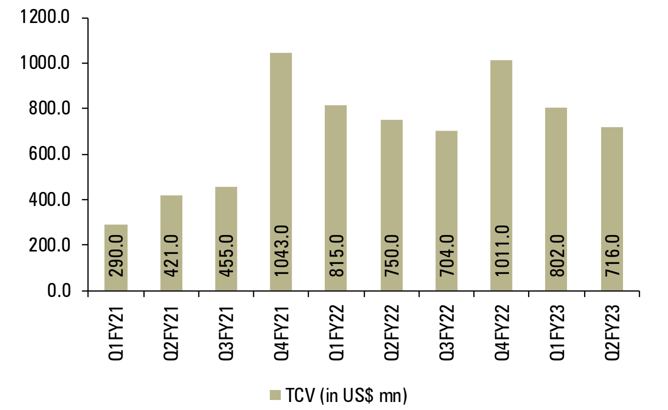
Source: Company, ICICI Direct Research

Exhibit 16: And top 20 clients



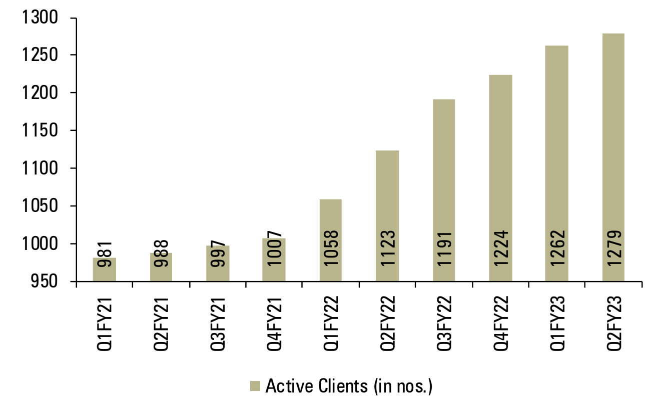
Source: Company, ICICI Direct Research

Exhibit 17: TCV in guided range of US$700 mn- 1 bn



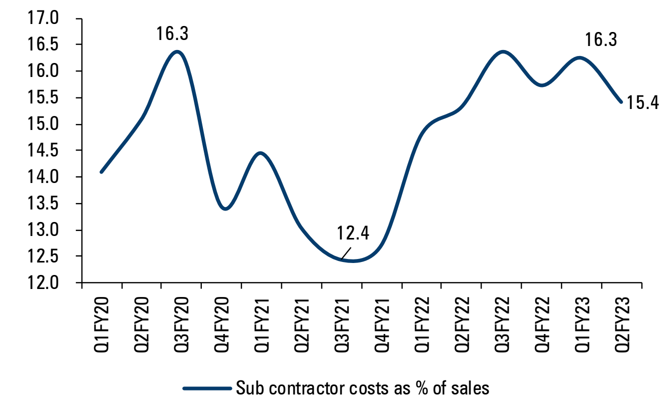
Source: Company, ICICI Direct Research

Exhibit 18: Active clients trend



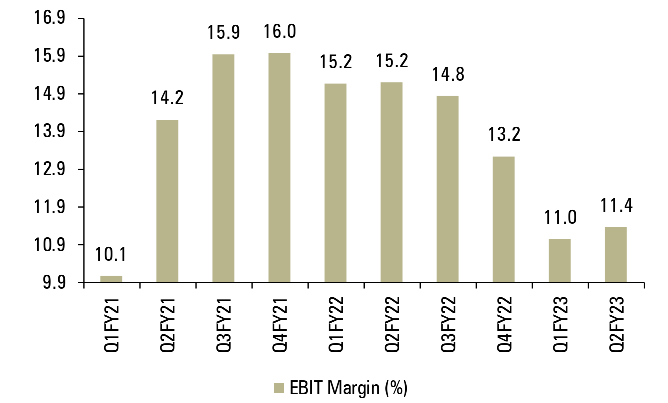
Source: Company, ICICI Direct Research

Exhibit 19: Sub-contractor cost has seen decline



Source: Company, ICICI Direct Research

Exhibit 20: Helping margin improvement



Source: Company, ICICI Direct Research

Financial summary

Exhibit 21: Profit and loss statement ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Net sales	**44,646**	**52,007**	**57,544**	**62,007**
Growth (%)	18	16	11	8
COGS (employee expenses)	30,972	36,873	40,280	43,095
Gross profit	13,674	15,134	17,263	18,912
S,G&A expenses	5,654	6,709	7,538	8,123
Total Operating Expenditure	36,626	43,582	47,819	51,217
EBITDA	**8,020**	**8,425**	**9,725**	**10,789**
Growth (%)	17	5	15	11
Depreciation	1,520	1,924	1,841	1,860
Interest	163	163	163	163
Other Income	1,112	1,465	1,644	1,644
PBT	7,449	7,803	9,364	10,410
Total Tax	1,822	1,990	2,247	2,498
Exceptional item	-	-	-	-
PAT	**5,566**	**5,752**	**7,056**	**7,850**
Growth (%)	26	3	23	11
EPS (₹)	63.1	65.2	80.0	88.7

Source: Company, ICICI Direct Research

Exhibit 22: Cash flow statement ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Profit before Tax	7,452	7,803	9,364	10,410
Add: Depreciation	1,520	1,924	1,841	1,860
(Inc)/dec in Current Assets	(3,362)	(2,632)	(1,986)	(1,601)
Inc/(dec) in CL and Provisions	1,928	1,824	1,372	1,106
Taxes paid	(2,314)	(1,990)	(2,247)	(2,498)
CF from operating activi	**5,285**	**6,192**	**7,428**	**8,361**
(Inc)/dec in Investments	1,188	-	-	-
(Inc)/dec in Fixed Assets	(835)	(1,300)	(1,439)	(1,550)
Others	108	901	1,079	1,079
CF from investing activi	**482**	**(400)**	**(359)**	**(471)**
Issue/(Buy back) of Equity	87	-	-	-
Inc/(dec) in loan funds	(163)	-	-	-
Dividend paid & dividend tax	(3,981)	(2,588)	(3,175)	(3,533)
Inc/(dec) in debentures	-	-	-	-
Finance charges	(123)	(163)	(163)	(163)
CF from financing activi	**(4,667)**	**(3,101)**	**(3,688)**	**(4,045)**
Net Cash flow	1,100	2,692	3,381	3,845
Cash by acquisition	-	-	-	-
Opening Cash	2,835	3,975	6,666	10,047
Cash carried to B/S	**3,975**	**6,666**	**10,047**	**13,892**

Source: Company, ICICI Direct Research

Exhibit 23: Balance sheet ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Liabilities				
Equity Capital	439	439	439	439
Share application money	-	-	-	-
Reserve and Surplus	26,447	29,611	33,491	37,809
Total Shareholders funds	26,886	30,049	33,930	38,248
Minority Interest	495	559	623	687
Total Debt	1,582	1,582	1,582	1,582
Other long term liabilities	4,843	4,843	4,843	4,843
Total Liabilities	**33,806**	**37,033**	**40,978**	**45,360**
Assets				
Net Block	3,620	3,152	3,099	3,139
Capital WIP	165	165	165	165
Investments	4,884	4,887	4,889	4,892
Deferred tax assets	819	819	819	819
Goodwill on consolidation	7,426	7,426	7,426	7,426
Debtors	11,934	13,902	15,382	16,575
Loans and Advances (short	-	-	-	-
Other non-current assets	4,198	4,191	4,192	4,192
Cash	3,975	6,666	10,047	13,892
Other current assets	4,071	4,743	5,248	5,655
Total Current Assets	24,457	29,787	35,153	40,598
Trade payables	4,095	4,770	5,278	5,687
Current liabilities	6,299	7,337	8,118	8,748
Provisions	672	782	866	933
Total Current Liabilities	11,065	12,889	14,262	15,368
Application of Funds	**33,806**	**37,033**	**40,978**	**45,360**

Source: Company, ICICI Direct Research

Exhibit 24: Key ratios ₹ crore

(Year-end March)	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS	63.1	65.2	80.0	88.7
Cash EPS	80.3	87.0	100.8	109.7
BV	304.7	340.6	384.6	432.0
DPS	28.4	29.3	36.0	40.0
Cash Per Share	45.0	75.6	113.9	156.9
Operating Ratios (%)				
EBITDA Margin	18.0	16.2	16.9	17.4
PAT Margin	12.5	11.1	12.3	12.7
Return Ratios (%)				
RoE	20.7	19.1	20.8	20.5
RoCE	22.5	21.5	23.2	23.3
RoIC	25.8	25.4	30.2	33.5
Valuation Ratios (x)				
P/E	17.0	16.4	13.4	12.1
EV / EBITDA	12.1	11.2	9.3	8.0
EV / Net Sales	2.2	1.8	1.6	1.4
Market Cap / Sales	2.3	2.0	1.8	1.7
Price to Book Value	3.5	3.1	2.8	2.5
Solvency Ratios				
Debt/EBITDA	0.2	0.2	0.2	0.1
Debt/Equity	0.1	0.1	0.0	0.0
Current Ratio	1.5	1.4	1.4	1.4
Quick Ratio	1.4	1.4	1.4	1.4

Source: Company, ICICI Direct Research

Exhibit 25: ICICI Direct coverage universe (IT)

					EPS (₹)			P/E			RoCE (x)			RoE(x)		
Company Name	CMP	TP (₹)	Rating	Mcap (₹)	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
HCL Tech (HCLTEC)	1,060	1,115	BUY	2,87,649	49.8	52.8	58.3	21.3	20.1	18.2	24.2	25.8	27.4	21.8	21.9	23.0
Infosys (INFTEC)	1,573	1,670	BUY	6,61,859	52.1	59.7	68.7	30.2	26.3	22.9	36.0	35.8	38.3	29.2	29.7	31.6
TCS (TCS)	3,260	3,630	BUY	11,92,851	104.7	115.7	130.3	31.1	28.2	25.0	51.4	49.3	48.7	43.0	42.0	41.0
Tech M (TECMAH)	1,071	1,240	BUY	1,04,189	63.1	65.2	80.0	17.0	16.4	13.4	22.5	21.5	23.2	20.7	19.1	20.8
Wipro (WIPRO)	392	420	HOLD	2,14,866	23.5	23.1	26.1	16.7	17.0	15.0	18.8	18.7	20.3	19.6	18.5	20.1
LTI (LTINFC)	4,843	5,525	BUY	84,860	130.8	150.5	180.0	37.0	32.2	26.9	32.3	30.8	31.0	26.1	25.6	26.0
Mindtree (MINCON)	3,507	4,000	BUY	57,797	100.3	119.2	142.0	35.0	29.4	24.7	38.0	37.9	37.1	30.2	29.3	28.6
Coforge (NIITEC)	3,845	4,570	BUY	23,418	106.5	147.8	170.8	36.1	26.0	22.5	25.6	31.6	31.2	24.2	28.4	27.8
TeamLease (TEASER)	2,904	4,240	BUY	4,965	22.5	85.6	124.6	129.2	33.9	23.3	15.4	17.6	20.8	(4.7)	17.4	20.4
Infoedge (INFEDG)	4,000	5,230	BUY	50,269	35.8	47.8	54.2	111.8	83.8	73.8	4.2	5.7	6.3	3.2	4.3	4.7

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%

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