

27 July 2023

India | Equity research | Q1FY24 result review

Tech Mahindra

Technology

Weak execution on all fronts – orderbook, revenue growth and margins – warrants derating; reiterate SELL

TechM reported a weak set of numbers on all fronts. Revenue at USD 1,061mn was down 4% QoQ (I-Sec: -2.3%, consensus: -1.2%) due to sharp decline of 9.4% QoQ USD in communications (38% of revenue) and 3.2% QoQ USD decline in BFS (16.1% of revenue). EBIT margin also contracted by a sharp 440bps QoQ to 6.8% due to drop in revenue, wage hikes, one-time provision related to client bankruptcy, and seasonal weakness in Comviva business. Leading demand indicators were also muted: 1) orderbook at USD 359mn (-39.4% QoQ and -55.2% YoY) and headcount down by 2.7% QoQ (-6.2% YoY). Management expects gradual recovery in the communications vertical, which is being impacted by discretionary and 5G spend cuts.

What to do with the stock

In our IT sector coverage universe, TechM reported the weakest set of numbers for Q1FY24 with: a) orderbook at USD 359mn being down 40% QoQ / 55% YoY, b) USD revenue decline of 4% QoQ and 2% YoY due to 9% QoQ decline in its largest vertical (communications), and c) lowest EBIT margin (since Dec'04) at 6.8% (8.2% after adjusting for a one-time provision of USD 23mn related to client bankruptcy). With no near-term visibility of sharp demand recovery, soft orderbook and bleak demand outlook for the communications vertical due to discretionary/5G spend cuts, we are now forecasting 0.1% CC YoY growth for TechM in FY24E. Due to the significant miss in Q1, we cut our FY24E EPS estimate by 12%, but largely maintain our FY25E/FY26E EPS factoring-in double-digit revenue growth during the two years with EBIT margin recovering to 12.8% from 11% in FY24E. Despite weak earnings fundamentals with its largest vertical (communications) facing multiple headwinds, TechM saw valuation rerating in anticipation of change in top management, which would eventually help turn around the business from both margin and revenue growth perspectives. We believe it could take significant amount of time and effort for the new CEO to turn around the business, which is predicated on: a) his strategy, b) steps to improve TechM's digital capability and higher acceptance of its offerings among its clients, and c) aligning the entire top management with his vision for TechM and managing attrition. TechM shares are currently trading at 17.4x FY25E, much higher than last 5-year average of 16x and despite weak growth outlook in the near to medium term. We reiterate our **SELL** rating on the stock with a revised 12-month target price of INR 910, implying 20% potential downside. We are 8-10% below Bloomberg consensus estimates on FY25/FY26 EPS due to our lower margin assumptions.

Financial summary

Y/E (INR mn)	FY23A	FY24E	FY25E	FY26E
Net Revenue	5,32,902	5,44,263	6,09,708	6,71,259
EBITDA	80,288	78,722	99,673	1,09,405
EBITDA Margin (%)	15.1	14.5	16.3	16.3
Net Profit	48,569	46,180	58,996	63,596
EPS (INR)	54.6	51.6	66.1	71.3
EPS % Chg YoY	(13.6)	(5.9)	27.9	7.8
P/E (x)	20.7	21.9	17.2	15.9
EV/EBITDA (x)	11.9	12.4	10.0	9.2
RoCE (%)	15.5	14.8	19.7	22.0
RoE (%)	17.3	16.2	21.0	23.0

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Market Data

Market Cap (INR)	1,114bn
Market Cap (USD)	13,587mn
Bloomberg Code	TECHM IN
Reuters Code	TEML.BO
52-week Range (INR)	1,271 /968
Free Float (%)	64.0
ADTV-3M (mn) (USD)	35

Price Performance (%)	3m	6m	12m
Absolute	17.8	11.7	19.5
Relative to Sensex	11.4	11.8	22.2

ESG Disclosure	2021	2022	Change
ESG score	68.7	68.9	0.2
Environment	68.7	70.8	2.1
Social	50.1	48.5	(1.6)
Governance	87.4	87.4	0.0

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

Source: Bloomberg, I-sec research

Earnings Revisions (%)	FY24E	FY25E	FY26E
Revenue	(1.6)	(1.3)	(1.2)
EBITDA	(12.2)	0.1	2.0
EPS	(12.4)	(1.1)	0.7

Previous Reports

28-04-2023: [Q4FY23 results review](#)

12-03-2023: [Company Update](#)

Key takeaways from earnings call

- **Sharp decline in communications vertical** (-10% QoQ USD) was due to: 1) seasonal weakness in Comviva business; 2) completion of a project for a client in RoW, which is among the top 11-20 accounts in the network services domain; 3) discretionary spend cuts with reprioritization of discretionary projects and focus on cost reductions by tier-1 network operators; and 4) demand for enterprise 5G use cases taking longer to pickup. Weakness in the communications vertical was spread across US, Europe and RoW. Management mentioned there is pressure on both network services and digital services in the communications space. Company expects growth to pick up gradually in this vertical in the coming quarters.
- In Q1FY24, there was a ~USD 6mn-7mn sequential impact on revenue due to bankruptcy filing by a client. The entire impact of loss of revenue due to the bankruptcy filing has been captured in Q1FY24 revenue.
- **Muted performance in enterprise vertical** was driven by decline in BFS (-3.2% QoQ USD). Manufacturing vertical has grown well for industry peers as well as TechM in past 2-3 quarters despite macro slowdown. Within manufacturing, TechM has exposure to automotive, aero and defence, and industrial which are growing well.
- Deal TCV was muted at USD 359mn, -39.4% QoQ and -55.2% YoY. TTM deal TCV was down 24.6% YoY and provides very weak visibility for recovery in the remaining three quarters of FY24.
- **Sharp decline in margin:** EBIT margin declined by a sharp 440bps QoQ to 6.8%, much lower than our and consensus expectations (I-Sec: 11.1%, consolidated: 10.6%) due to the following headwinds: 1) 200bps impact from revenue decline and wage hikes, 2) 200bps impact from one-time provision of bankruptcy filing by a client, and 3) ~50bps impact due to seasonal weakness in Comviva business. Company had majority of wage hike impact of 130bps QoQ in Q1FY24 and wage hikes for senior employees will be rolled out in Q2FY24.
- There was net reduction of 4,103 of software professionals. Overall headcount is down 2.7% QoQ and down 6.2% YoY. Despite muted growth, there was increase in sales and support headcount (2.2% QoQ) due to annual management campus recruits joining in Q1FY24.
- **Operating levers to improve margins over 1-2 years:** TechM management outlined key operating levers to improve margins: 1) scope for reduction in subcontractor costs from current ~14% to below 10% of revenue, 2) scope to grow offshore mix by 300-400bps, 3) pyramid optimisation, 4) rationalisation and divestment of certain businesses.
- **Efforts around generative-AI:** TechM has set up a generative-AI studio and is working on >30 AI use cases. It has trained 8k employees in new AI platforms and generative-AI. It is also investing in new allied areas such as quantum computing and cybersecurity.

Upside risks: 1) INR depreciation against the USD, 2) faster than expected 5G rollouts, 3) global macro concerns around high interest rates and inflation subsiding sooner than expected, 4) stronger than expected demand, 5) successful M&As, 6) various margin levers helping TechM to reach its stated goal of 14-15% EBIT margin in the medium to longer term

Exhibit 1: Q1FY24 actuals vs estimates: PAT ~40% below our and consensus estimates due to big miss on margins

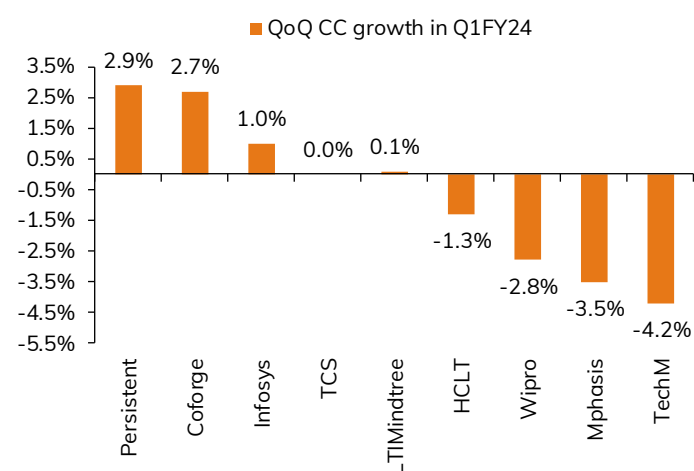
	Q1FY24	Q4FY23	QoQ	Q1FY23	YoY	Q1FY24 I-Sec estimates	vs our estimates	Bloomberg	vs Bloomberg estimates
Revenue QoQ CC	-4.2%	0.3%		3.5%		-2.4%	-180 bps		
Revenues (USD mn)	1,601	1,668	-4.0%	1,633	-1.9%	1,632	-1.9%	1,648	-2.8%
USD/INR	82.2	82.3	-0.1%	77.7	5.8%	82.2	0.0%	82.2	
Revenues (INR mn)	1,31,590	1,37,182	-4.1%	1,27,079	3.5%	1,34,214	-2.0%	1,35,436	-3%
EBIT (INR mn)	8,914	15,303	-41.8%	14,034	-36.5%	14,859	-40.0%	14,408	-38%
EBIT margin (%)	6.8%	11.2%	-438 bps	11.0%	-427 bps	11.1%	-430 bps	10.6%	-386 bps
Adjusted net profit (INR mn)	6,925	12,601	-45.0%	11,316	-38.8%	11,414	-39.3%	11,443	-39%
EPS (INR/share)	7.8	14.2	-45.1%	12.8	-38.8%	12.9	-39.3%	12.9	-40%

Source: Company data, I-Sec research, Bloomberg

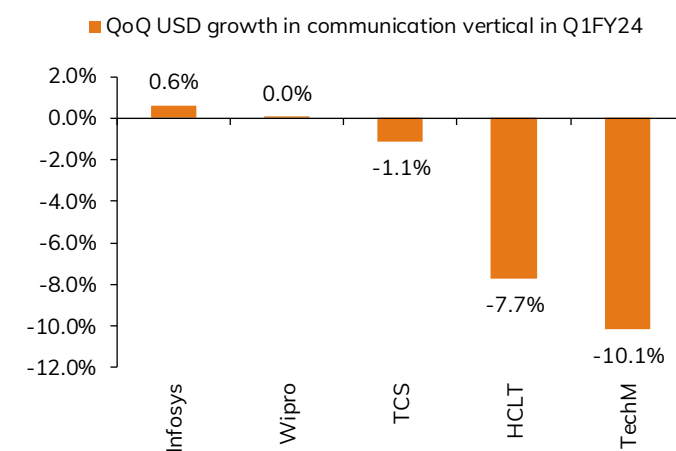
Exhibit 2: Change in estimates; we cut our FY24E estimates due to the significant miss in Q1FY24

	Revised			Old			Change		
	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E	FY24E	FY25E	FY26E
Revenues (USD mn)	6,635	7,439	8,189	6,746	7,535	8,292	(1.6)	(1.3)	(1.2)
Revenue growth YoY CC	0.1%	12.0%	10.1%	1.7%	11.6%	10.0%	-160bps	40bps	10bps
Revenue growth YoY USD	0.4%	12.1%	10.1%	2.1%	11.7%	10.0%	-170bps	40bps	10bps
INR mn									
Revenues	5,44,262	6,09,707	6,71,259	5,53,314	6,17,616	6,79,629	(1.6)	(1.3)	(1.2)
EBIT	59,812	78,333	85,911	68,100	78,256	84,211	(12.2)	0.1	2.0
EBIT margin	11.0	12.8	12.8	12.3	12.7	12.4	-130bps	20bps	40bps
EPS (INR/share)	51.6	66.1	71.3	58.9	66.8	70.8	(12.4)	(1.1)	0.7

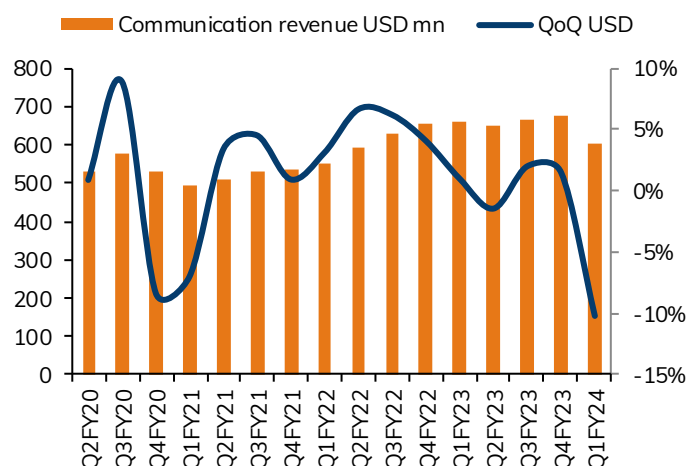
Source: Company data, I-Sec research

Exhibit 3: TechM reported weakest growth among peers


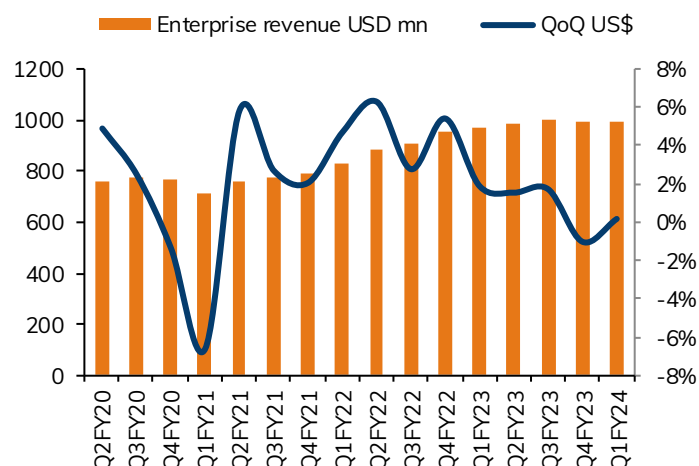
Source: Company data, I-Sec research

Exhibit 4: Sharpest decline in communications vertical for TechM among peers


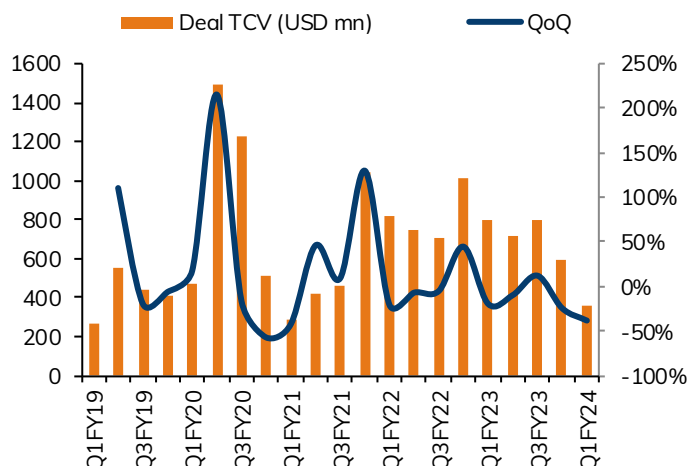
Source: Company data, I-Sec research

Exhibit 5: Major decline in communications vertical was due to slowdown in discretionary and 5G spends


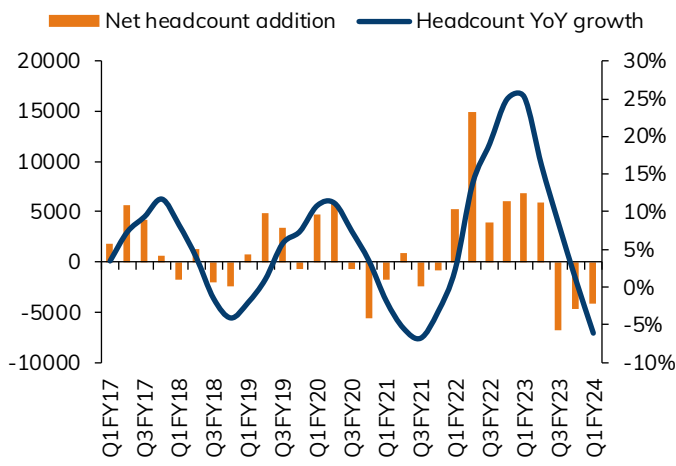
Source: Company data, I-Sec research

Exhibit 6: Flattish growth in enterprise vertical was due to weakness in BFS segment


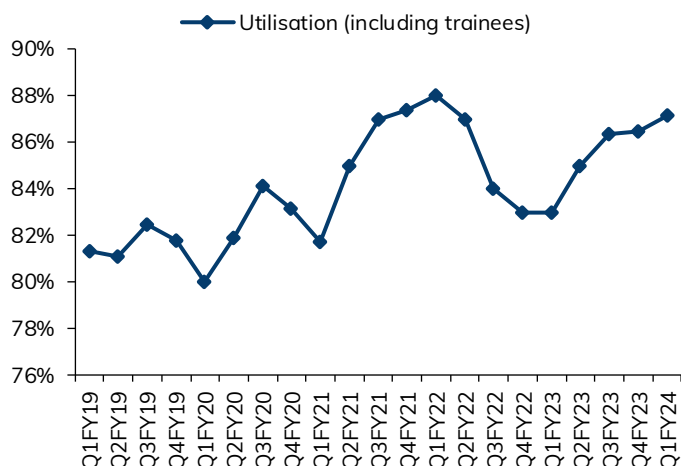
Source: Company data, I-Sec research

Exhibit 7: Muted large-deal TCV was due to elongated deal cycles, especially in communications


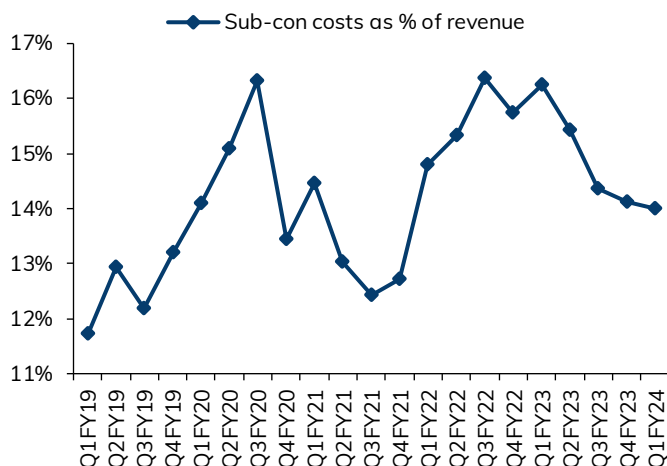
Source: Company data, I-Sec research

Exhibit 8: Net headcount declined further on muted growth prospects in the near term


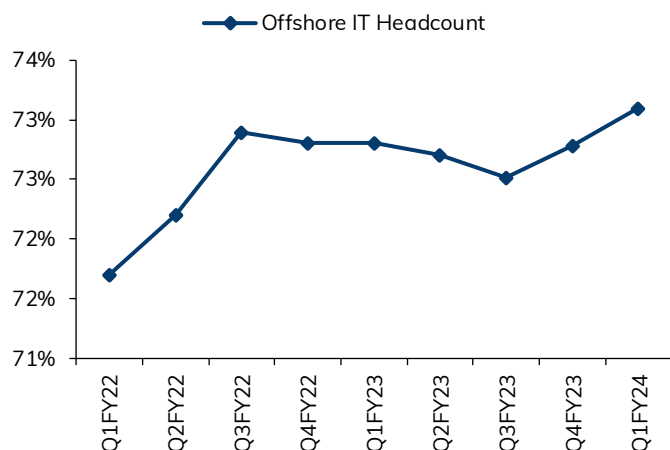
Source: Company data, I-Sec research

Exhibit 9: Utilisation has little scope to improve further


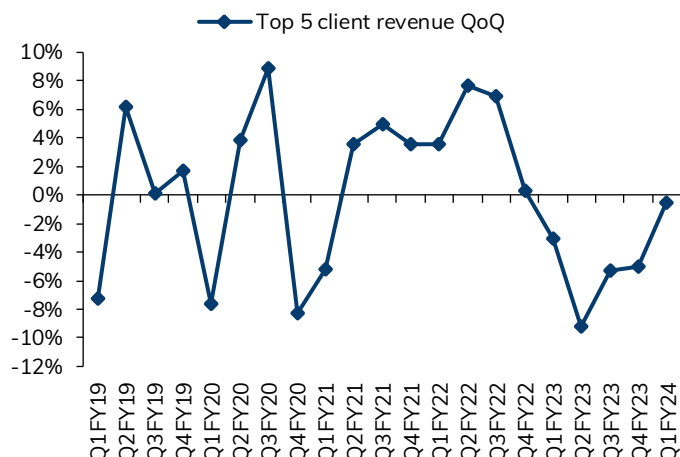
Source: Company data, I-Sec research

Exhibit 10: Company targets to bring down subcontractor expenses to below 10% of revenue


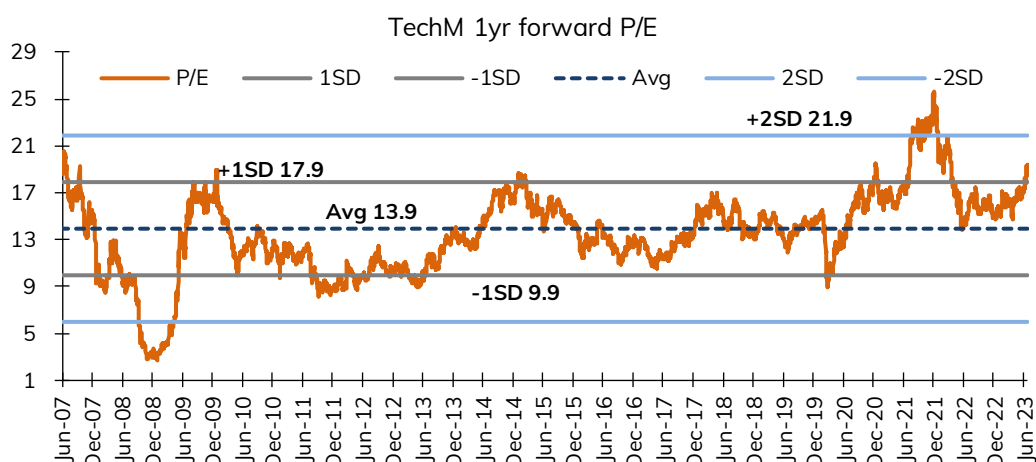
Source: Company data, I-Sec research

Exhibit 11: Offshore headcount has scope to improve by 300-400bps as per management


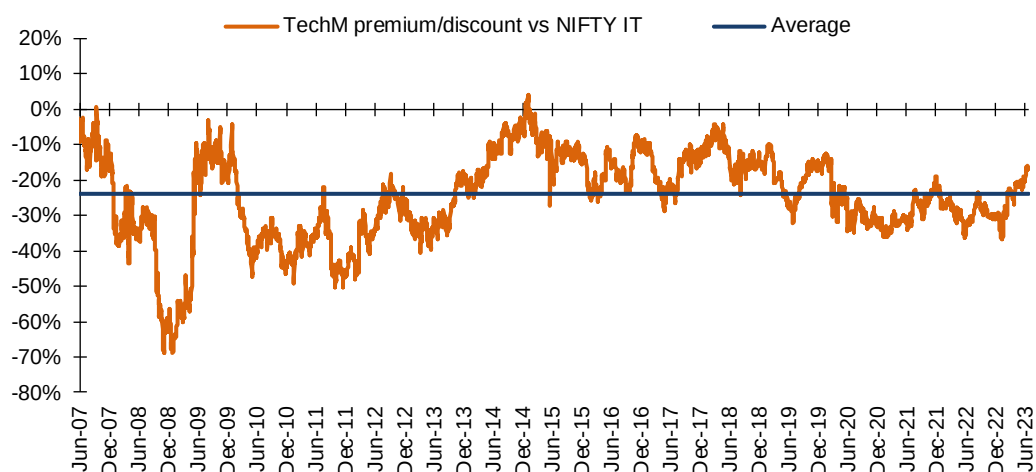
Source: Company data, I-Sec research

Exhibit 12: Revenue from top-5 clients stabilising


Source: Company data, I-Sec research

Exhibit 13: TechM is currently trading at 18.5x (1-year forward P/E) vs its historical long-term average + 1SD of 18x


Source: Company data, I-Sec research, Bloomberg

Exhibit 14: TechM is currently trading at 17% discount to NIFTY IT vs its historical long-term average discount of 24%


Source: Bloomberg, Company data, I-Sec research

Exhibit 15: Shareholding pattern

%	Dec'22	Mar'23	Jun'23
Promoters	35.2	35.2	35.2
Institutional investors	51.9	52.7	52.7
MFs and others	12.0	12.9	12.8
Insurance Cos	10.3	11.9	12.6
FII's	29.6	27.9	27.3
Others	12.9	12.1	12.1

Source: Bloomberg, I-Sec research

Exhibit 16: Price chart

Source: Bloomberg, I-Sec research

Financial Summary

Exhibit 17: Profit & Loss

(INR mn, year ending)

	FY23A	FY24E	FY25E	FY26E
Net Sales (USD mn)	6,606	6,635	7,439	8,189
Net Sales (INR mn)	5,32,902	5,44,263	6,09,708	6,71,259
Operating Expense	4,52,614	4,65,541	5,10,035	5,61,854
EBITDA	80,288	78,722	99,673	1,09,405
EBITDA Margin (%)	15.1	14.5	16.3	16.3
Depreciation & Amortization	19,567	18,910	21,340	23,494
EBIT	60,720	59,812	78,333	85,911
Interest expenditure	3,256	4,718	4,695	4,695
Other Non-operating Income	7,280	7,438	6,087	4,725
Recurring PBT	64,744	62,532	79,725	85,940
Profit / (Loss) from Associates	(290)	78	-	-
Less: Taxes	15,885	16,429	20,728	22,345
PAT	48,859	46,102	58,996	63,596
Less: Minority Interest	(257)	(444)	(444)	(444)
Net Income (Reported)	48,569	46,180	58,996	63,596
Extraordinaries (Net)	-	-	-	-
Recurring Net Income	48,312	45,814	58,552	63,152

Source Company data, I-Sec research

Exhibit 18: Balance sheet

(INR mn, year ending)

	FY23A	FY24E	FY25E	FY26E
Total Current Assets	2,16,495	2,10,350	2,14,379	2,10,872
of which cash & cash eqv.	40,563	19,958	6,043	(8,871)
Total Current Liabilities & Provisions	1,14,999	1,14,787	1,21,421	1,25,638
Net Current Assets	1,01,496	95,563	92,958	85,234
Investments	33,881	34,710	34,710	34,710
Net Fixed Assets	28,622	28,049	28,249	28,449
ROU Assets	11,720	11,341	11,341	11,341
Capital Work-in-Progress	836	1,130	1,130	1,130
Goodwill	76,657	77,038	77,038	77,038
Other assets	47,631	45,952	45,952	45,952
Deferred Tax assets	12,965	13,336	13,336	13,336
Total Assets	3,34,230	3,26,233	3,23,827	3,16,303
Liabilities				
Borrowings	15,782	15,182	15,182	15,182
Deferred Tax Liability	3,261	3,173	3,173	3,173
provisions	9,288	9,534	9,534	9,534
other Liabilities	10,332	6,887	6,887	6,887
Minority Interest	4,702	4,589	4,589	4,589
Equity Share Capital	4,400	4,403	4,403	4,403
Reserves & Surplus*	2,74,845	2,71,420	2,69,014	2,61,490
Total Net Worth	2,79,245	2,75,823	2,73,417	2,65,893
Total Liabilities	3,34,230	3,26,233	3,23,827	3,16,303

Source Company data, I-Sec research

Exhibit 19: Quarterly trend

(INR mn, year ending)

	Sep-22	Dec-22	Mar-23	Jun-23
Net sales	1,31,295	1,37,346	1,37,182	1,31,590
% growth (QoQ)	3.3	4.6	-0.1	-4.1
Recurring EBITDA	19,841	21,440	20,205	13,380
Margin (%)	15.1	15.6	14.7	10.2
Other income	1,715	1,253	-55	798
Extraordinaries Inc / (Loss)	-	-	-	-
Reported Net Income	12,854	12,966	11,176	6,925

Source Company data, I-Sec research

Exhibit 20: Cashflow statement

(INR mn, year ending)

	FY23A	FY24E	FY25E	FY26E
CFO before WC changes	64,197	62,166	79,281	85,496
CFO after WC changes	75,651	58,360	83,224	97,076
Capital Commitments	(20,824)	(17,432)	(21,540)	(23,694)
Free Cashflow	76,543	59,363	84,035	98,426
Other investing cashflow	18,039	8,744	6,087	4,725
Cashflow from Investing Activities	(2,785)	(8,688)	(15,453)	(18,969)
Issue of Share Capital	442	1,968	0	-
Interest Cost	(2,570)	-	-	-
Inc (Dec) in Borrowings	(6,020)	(4,619)	-	-
Cashflow from Financing Activities	(50,781)	(53,847)	(60,958)	(70,676)
Dividend paid	(42,633)	(51,240)	(60,958)	(70,676)
Others	(1)	44	-	-
Chg. in Cash & Bank balance	2,154	(20,605)	(13,915)	(14,913)
Closing cash & balance	40,563	19,958	6,043	(8,871)

Source Company data, I-Sec research

Exhibit 21: Key ratios

(Year ending)

	FY23A	FY24E	FY25E	FY26E
Per Share Data (INR)				
Reported EPS	55.3	52.1	66.6	71.8
Diluted EPS	54.6	51.6	66.1	71.3
Cash EPS	76.9	73.2	90.3	97.9
Dividend per share (DPS)	59.9	57.9	68.9	79.8
Book Value per share (BV)	316.3	311.7	308.9	300.4
Dividend Payout (%)	109.9	112.2	104.2	112.0
Growth (%)				
Net Sales	19.4	2.1	12.0	10.1
EBITDA	0.1	(2.0)	26.6	9.8
EPS	(13.6)	(5.9)	27.9	7.8
Valuation Ratios (x)				
P/E	20.7	21.9	17.2	15.9
P/CEPS	14.9	15.6	12.7	11.7
P/BV	3.6	3.7	3.7	3.8
EV / EBITDA	11.9	12.4	10.0	9.2
P/S	1.9	1.9	1.7	1.5
Dividend Yield (%)	5.2	5.1	6.0	7.0
Operating Ratios				
EBITDA Margins (%)	15.1	14.5	16.3	16.3
EBIT Margins (%)	11.4	11.0	12.8	12.8
Effective Tax Rate (%)	24.5	26.3	26.0	26.0
Net Profit Margins (%)	9.2	8.5	9.7	9.5
Inventory Turnover Days	0.2	0.2	0.1	0.1
Fixed Asset Turnover (x)	18.4	18.6	20.8	22.8
Receivables Days	53	56	55	55
Payables Days	29	31	31	31
Working Capital Days	40	46	49	49
Net Debt / EBITDA (x)	(2.7)	(1.8)	(0.9)	(0.2)
Profitability Ratios				
RoCE (%)	15.5	14.8	19.7	22.0
RoIC (%)	22.9	20.7	25.8	27.4
RoNW (%)	17.3	16.2	21.0	23.0

Source Company data, I-Sec research

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