Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

L&T Technology Services

Picking the right growth signals

IT & ITES	Sharekhan code: LTTS	Company Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 2,550**	
Price Target: **Rs. 3,100**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

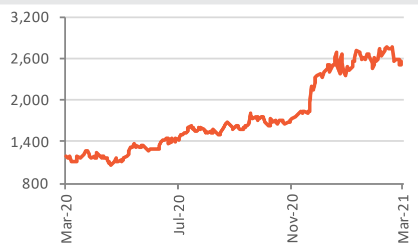
Company details

Market cap:	Rs. 26,788 cr
52-week high/low:	Rs. 2,858 / 1,064
NSE volume: (No of shares)	3.0 lakh
BSE code:	540115
NSE code:	LTTS
Free float: (No of shares)	2.6 cr

Shareholding (%)

Promoters	74.3
FII	9.3
DII	7.8
Others	8.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.1	6.6	59.8	116.1
Relative to Sensex	5.6	3.1	25.8	51.8

Sharekhan Research, Bloomberg

Summary

- We maintain Buy on L&T Technology Services (LTTS) with a PT of Rs. 3,100, given its strong position in the fast-growing ERD space and anticipated market share gains in the auto & Truck & off-highway sub-vertical.
- Management is confident of delivering strong revenue growth going ahead, given rising spends on digital engineering, prudent client mining strategy, large deal wins, and increased outsourcing activities.
- LTTS has been focusing on scaling its revenue from its top-30 customers by (1) expanding its engagement from a project to program level, (2) focusing on adjacencies, (3) penetrating into different distant divisions, and (4) expanding services to other regions.
- We expect LTTS to report margin improvement in FY2022E despite near-term headwinds such as initial expenses relating to ramp-up of large deals, return of certain expenses post normalcy and increased local hires in the US.

L&T Technology Services' (LTTS) management is confident of delivering strong revenue growth going ahead, given rising spends on digital engineering, prudent client mining strategy, broader vertical mix, internal change in portfolio mix, aggressive strategy to participate in customers' cost take-out initiatives, and increased outsourcing activities. LTTS has been strengthening its capabilities in digital technologies across all its verticals to capture the opportunities. Management witnesses strong demand trends such as (1) electric vehicle/connected vehicle - software development services are expected to post a 9%-10% CAGR, aided by increasing usage of software in vehicles, (2) 5G – Orchestra acquisition has strengthened its capabilities to capture opportunities in network equipment, consumer electronic devices, industrial automation, etc., (3) artificial intelligence, which is expected to make its way in every application in the engineering space, (4) medical technology given development of new products using technologies of AI and 5G, and (5) sustainability – enterprises across industries have been started moving towards clean energy. LTTS has been doing consulting work in sustainability area and executing projects on small scale as well. LTTS plans to invest in this space to strengthen its capabilities to capture the opportunities going ahead. With strong digital engineering capabilities across verticals, LTTS will be considered one of the preferred transformation partners for the world's leading companies. Management indicated its top-30 customers (which contribute 55% to its total revenue), each spend $1 billion+ on R&D annually, which provides lot of headroom for the company for scalability. LTTS has been focusing on scaling its revenue from its existing large customers by (1) expanding its existing engagement from a vanilla project to programme level of engagement, (2) moving to other areas of same engagement or focusing on adjacencies of same customer, (3) penetrating into different distant divisions/segments of same customer, and (4) extending the relationship into different regions. Management aspires to cross Q4FY2020 revenue and adjusted EBIT margin levels (16.5%, excluding one-time expenses) in Q4FY2021. Despite highly impacted commercial aero sub-vertical, management expects to deliver sequential revenue growth across its five verticals in Q4FY2021. We expect EBIT margin to improve by 40bps q-o-q to 15.6% in Q4FY2021 (lower to its aspiration level of 16.5%) despite currency headwinds and initial expenses relating to ramp-up of large deals, led by (1) continued lower travel and admin expenses, (2) better revenue mix, (3) improvement of utilisation, and (4) operational efficiencies. We also expect LTTS to report margin improvement in FY2022E despite near-term headwinds such as (1) initial expenses relating to ramp-up of large deals, (2) possible negative impact from new wage code, and (3) increased local hires in the US.

Our Call

Valuation – Maintain Buy with a PT of Rs. 3,100: Given an improvement in overall R&D spends in both digital engineering and legacy engineering and possibilities of higher outsourcing, we believe LTTS is well placed to gain market share among global competitors because of being the preferred engineering partner among clients, multi-domain expertise, and leadership depth. Management is also confident of gaining market share in auto and truck and off-highway sub-segment. We expect LTTS' USD revenue and earnings to report CAGR of 19% and 31%, respectively, over FY2021-FY2023E. The stock is currently trading at 29x/23x its FY2022E/FY2023E earnings, which justifies the premium valuation given its long runway for growth. Given the large addressable market and presence in the fast-growing ERD segment, we retain Buy on LTTS with a PT of Rs. 3,100.

Key Risks

Macroeconomic uncertainties could affect earnings. Further, loss of key customers and/or lower ERD spends/R&D budgets may impact growth trajectory.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	5,078.3	5,619.1	5,475.5	6,524.6	7,809.3
OPM (%)	18.0	19.8	18.4	20.2	20.2
Adjusted PAT	765.6	818.6	674.4	916.8	1,160.8
% y-o-y growth	*51.3*	*6.9*	*-17.6*	*35.9*	*26.6*
Adjusted EPS (Rs.)	72.9	77.7	63.9	86.9	110.0
P/E (x)	35.0	32.8	39.9	29.4	23.2
P/B (x)	10.7	9.6	8.3	7.0	5.8
EV/EBITDA (x)	28.2	23.1	25.3	19.2	15.9
RoNW (%)	34.7	31.2	22.6	26.2	27.8
RoCE (%)	35.4	31.3	21.7	25.6	27.2

Source: Company; Sharekhan estimates

LTTS is well placed to benefit from ongoing technology refresh

Higher engineering spends on digital and new technologies are expected to create a large opportunity for LTTS. The company has been strengthening its capabilities in digital technologies (artificial intelligence (AI) and analytics, IoT, and automation), hardware, software products and services across all its verticals to capture the opportunities. Management witnesses strong demand trends (1) **electric vehicle (EV), advanced driver-assistance systems (ADAS), connected vehicle** as autonomous, connected, electric, and shared mobility (ACES), which remain the dominant trends in the automotive market. This is a huge opportunity in the next few years, as global auto ER&D spend of ~$158 billion is one of the largest contributors to total global ER&D spends (i.e. around 12%). As per McKinsey, software development and verification and validation services are expected to post a 9%-10% CAGR, aided by increasing usage of software in vehicles, (2) **5G** – Orchestra acquisition has strengthened its capabilities in the areas of network engineering and operations (for 5G, IoT, RAN, and core networks) and enterprise mobility. Management remains confident to capture opportunities not only in the semiconductor space, but also in areas of network equipment, consumer electronic devices, industrial automation, (3) **artificial intelligence** is expected to make its way in every application in the engineering space, (4) **medical technology**, given development of new products using technologies of AI and 5G. This is a huge opportunity in the coming years, given $48 billion R&D spend, and (5) **sustainability** – enterprises in most industries have been started moving towards clean energy, non-fossil fuels, and renewable energy, among others. Companies have been committed to reducing CO2 emissions in line with the Paris Agreement. LTTS has been doing consulting work and executing projects on a small scale in this space. LTTS plans to invest in this space to strengthen its capabilities to capture the opportunities going ahead. We believe LTTS has strong capabilities in disruptive technologies such as 5G, AI, collaborative robots, digital factories, and autonomous vehicles. With strong digital engineering capabilities, LTTS will be considered one of the preferred transformation partners for the world's leading companies.

Client mining strategy along with multi-vertical expertise to enable scalability

LTTS is one of India's leading pure-play engineering services providers with a clientele of 69 Fortune 500 companies. Management indicated that a significant portion of the company's growth is being driven by its top-80 customers, who contribute 85% to its total revenue. These large customers spend a significant portion of their capital on R&D and development of new engineering products. Management indicated its top-30 customers (which contribute 55% of its total revenue) each spend $1 billion+ on R&D annually, which provides lot of headroom for the company for scalability. Unlike IT services, a customer in the ERD space does not usually outsource end-to-end programmes from a vendor from the beginning of the engagement. LTTS has been focusing on scaling its revenue from its existing large customers by (1) expanding its existing engagement from a project to programme level of engagement, (2) moving to other areas of same engagement or focusing on adjacencies of the same customer, (3) penetrating into different distant divisions/segments (other business units) of the same customer if it is a conglomerate, and (4) extending the relationship into different regions of the same customer. Further, the company's domain expertise in multiple verticals complement its account mining strategy very well.

Remains confident to drive its growth in the medium term

Management continues to maintain its earlier stance that it aspires to cross Q4FY2020 revenue and cross adjusted EBIT margin levels (16.5%, excluding one-time expenses relating to Rs. 18.3 crore contributions to the PM CARES fund) in Q4FY2021. We believe the company would supress Q4FY2020 revenue level in Q4FY2021; however, it seems a challenging task for the company to achieve 16.5% EBIT margin (15.2% in Q3FY2021) in Q4FY2021.

Management believes that the worst is behind now, given initial signs of recovery in spends in certain affected verticals, rising spends on digital engineering, and cost-optimisation initiatives in legacy engineering. The transportation vertical would continue to grow in Q4FY2021 because of continued growth in auto and trucks and off-highway sub-segments and strong growth in the defense aero sub-segment. Management believes that commercial aero recovery would be delayed by three quarters due to rise in COVID-19 cases across the globe. Increasing budget in the US defence space is expected to continue the sequential growth momentum in the aero sub-segment of the transport vertical. Although its record-high $100-million large deal in the plant engineering space would ramp-up in March 2021, management remains confident of delivering positive growth in the plant engineering vertical, led by growth in FMCG and the specialty chemical sub-segment. Growth of the industrial products vertical (5.7% q-o-q in Q3FY2021) would continue in Q4FY2021 due to ramp-up of recent deal wins. Growth momentum in this vertical would continue in the coming quarters because of (1) rising customer spending on digital initiatives and (2) strong capabilities in this space. Growth momentum in medical devices is expected to accelerate due to gradual resumption of spending on new product developments in the device space. Telecom and hi-tech (up 14.3% q-o-q in Q3FY2021) verticals would continue their growth momentum, as management has changed its portfolio internally.

Aspires EBIT margin at 17%; Expect margins to improve despite near-term headwinds

Management expects to achieve EBIT margin of 17% (15.2% in Q3FY2021) because of improvement in utilisation, operational efficiencies, productivity, margin improvement in telecom and hi-tech verticals, better growth in medical devices, plant engineering, and industrial products. Margins have improved sharply by 310 bps over the past three quarters despite reinstatement of variable pay, increased subcontractor expenses, and higher amortisation owing to Orchestra acquisition, led by a combination of higher utilisation, improvement in offshore revenue, and better operational efficiency. We expect EBIT margin to improve by 40bps q-o-q to 15.6% in Q4FY2021 despite currency headwinds, led by (1) continued lower travel and admin expenses, (2) better revenue mix, (3) improvement of utilisation, and (4) operational efficiencies. We expect LTTS to report margin improvement in FY2022E despite near-term headwinds such as (1) initial expenses relating to ramp-up of large deals, (2) possible impact from new wage code starting from April 1, 2021, (3) return of some expenses post normalcy and (3) increased local hires in the US.

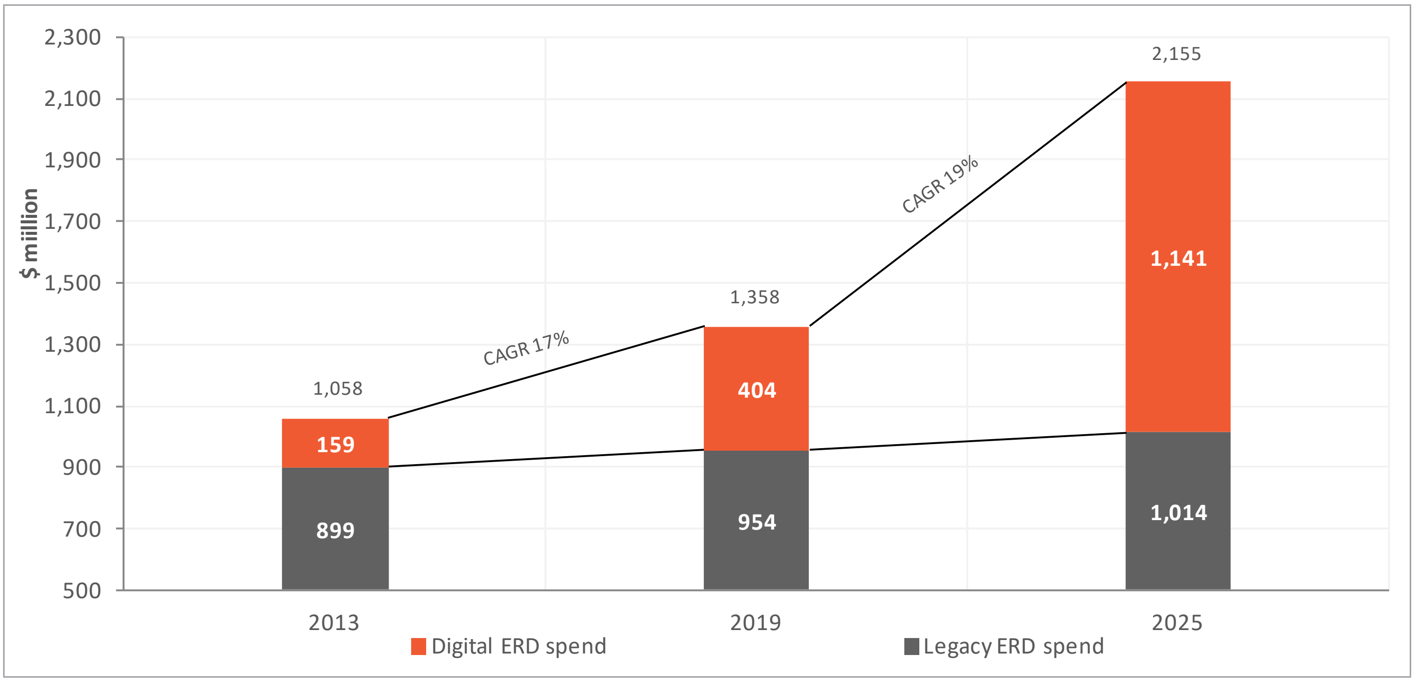
Strong demand for digital ERD services would drive growth

According to NASSCOM, India's ERD services sector (comprising embedded systems, ERD, and product engineering services) is the fastest growing sector within the Indian technology space. Over the past 5-6 years, India's ERD services sector has been growing in double digits, driven by higher adoption of new technologies (including IOT, Edge, AR/VR, and robotics), rising spends on digital manufacturing, increasing platformisation, cloudification, data monetisation, and rising outsourcing supported by talent and cost. However, global ERD spend is expected to decline by 6% y-o-y to $1.3 trillion in CY2020, as enterprises across affected verticals such as aerospace, auto, and manufacturing tighten purse-strings. Global ERD spend is expected to report an 8% CAGR over CY2019-CY2025, reaching $2.2 trillion. Growth drivers for the ERD industry are 5G ($250 billion), IoT ($756 billion), EV/autonomous ($83 billion), smart building ($32 billion), and edge computing ($7 billion).

Enterprises have started allocating their budgets towards new-age technologies such as 5G, AI, machine-to-machine communication, IoT, and advanced robotics to shift themselves from a physical to digital framework. As the ERD industry is shifting its focus from only mechanical and structural engineering to entire product ecosystem across engineering, manufacturing, supply chain, and software services around products, enterprises have been investing on connected resilient systems, optimisation of manufacturing process, new product development, and cost takeout initiatives through digital engineering.

Digital engineering spend of enterprises is projected to report a 19% CAGR in 2019-2025E, reaching $1.1 trillion by 2025. Digital engineering is going to be the focus area for enterprises with growing requirements for better user experience and personalisation, greater adoption of platforms and cloud, and consolidation to build full-stack capabilities. Digital engineering spends are accelerating across verticals, and this is expected to contribute to 53% of ERD spending by 2025 as compared to 30% in 2019. Verticals such as manufacturing (digital infrastructure), media and communication (OTT), technology (new engineering products), retail, medical devices (remote healthcare), BFSI, and travel and hospitality have been investing on building new products and services for the emergence of a new business model. Digital engineering witnessed significant traction (~20% growth) with digital thread and higher adoption of cloud engineering. Digital engineering experiences higher adoption of cloud (platformisation), softwarisation, servitisation (As-a-Service models), product-as-a-service, sensorisation, and data monetisation opportunities.

Digital engineering spend to post a 19% CAGR over 2019-2025E



Source: Zinnov, Sharekhan Research

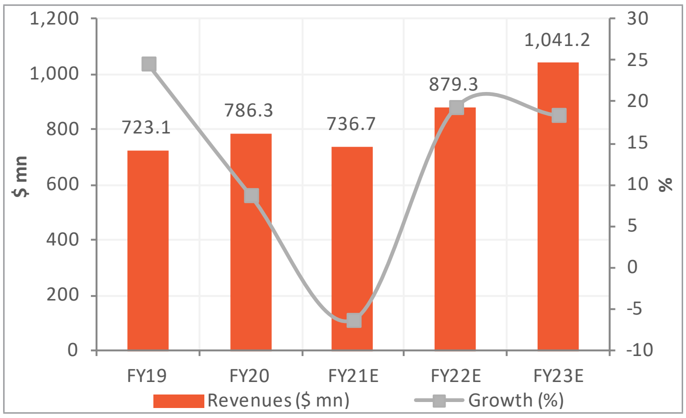
The global outsourced ERD addressable market stood at $90 billion, of which India outsources $33 billion. Offshore ERD demand is addressed by global in-house centres (GICs) and third-party ESPs from global locations. Of $33 billion, GICs export around $19 billion exports and the remaining $14 billion by third party ESPs. We expect the ERD outsourcing market in India to post a CAGR of 14% over 2019-2025E.

Looking for M&A activities to fill gaps in niche areas

The management indicated that it has been looking for M&A activities in autonomous vehicles/electric vehicles, medical devices (especially hospital segment) and product software engineering segment to strengthen its capabilities. LTTS acquired Thales Software (in 2014), Esencia Technologies (in FY18), Graphene Semiconductor Services (in FY19) and Orchestra (in 2020). These acquisitions have significantly strengthened LTTS' capabilities in areas like embedded avionics in the transportation vertical, application-specific integrated circuit (ASIC) design, embedded software and network engineering and operations.

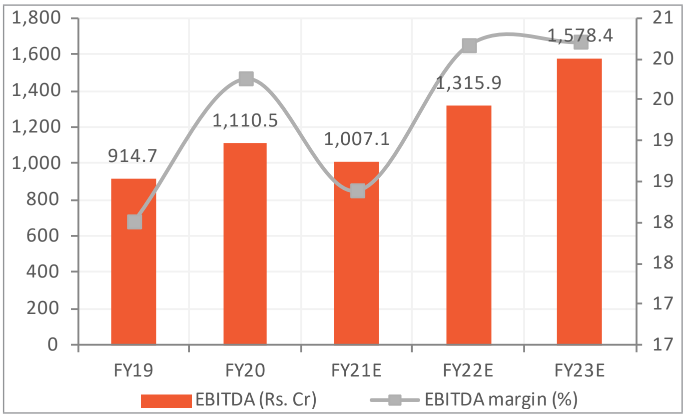
Financials in charts

Revenue ($ mn) and growth (%)



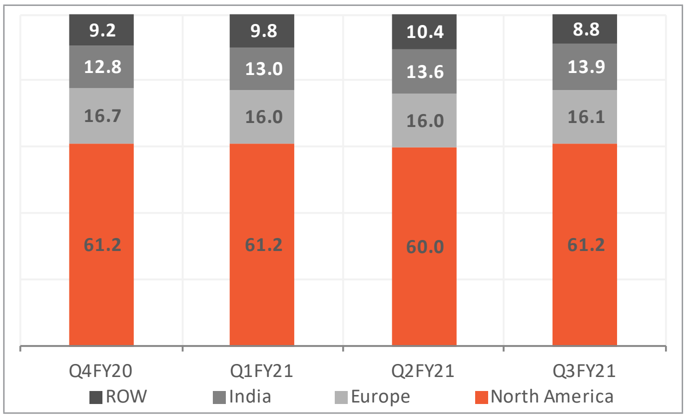
Source: Company, Sharekhan Research

EBITDA and EBITDA margin (%)



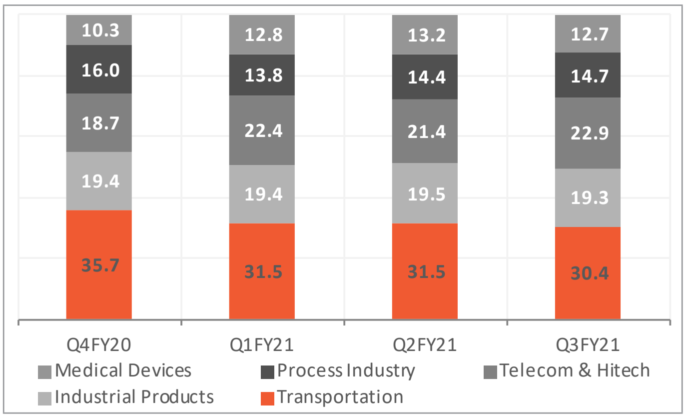
Source: Company, Sharekhan Research

Geography-wise breakdown (%)



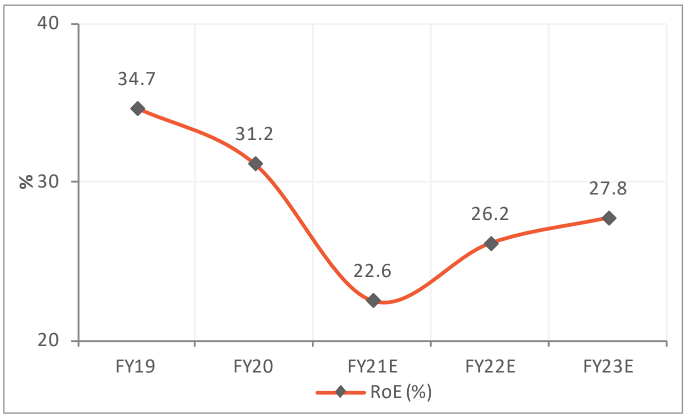
Source: Company, Sharekhan Research

Vertical-wise breakdown (%)



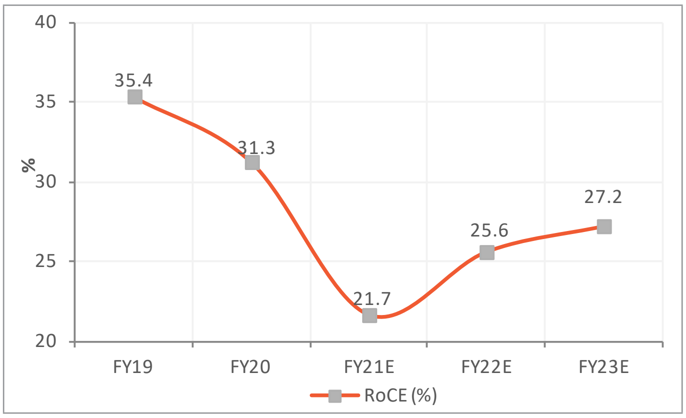
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view – Large addressable market provides sustainable growth opportunities

Total global engineering, research and development (ERD) spends are estimated at $1.4 trillion in 2019, of which the global addressable ERD market is at $345 billion. The share of Indian outsourcing in engineering remained at $33 billion. The share of engineering service providers' (ESPs) outsourcing to India is estimated at $14 billion in 2019 and is expected to reach $63 billion by 2025. Further, the ERD services space is likely to grow faster among technology spends, led by higher adoption of digital engineering. Digital engineering spends of enterprises are projected to report a 19% CAGR in 2019-2025E.

■ Company outlook – Board portfolio to support long runway of growth

LTTS is the third-largest ESP in India and is well diversified across verticals. The large ERD addressable market and a huge scope in deepening relationships with its top-30 customers provide multi-year sustainable growth prospects to the company going ahead. Technology shifts in verticals are also positive for LTTS, as any change creates huge growth opportunities. Though FY2021E remains a weak year due to COVID-19, we expect strong revenue growth in FY2022E and beyond.

■ Valuation – Maintain Buy with a PT of Rs. 3,100

Given an improvement in overall R&D spends in both digital engineering and legacy engineering and possibilities of higher outsourcing, we believe LTTS is well placed to gain market share among global competitors because of being the preferred engineering partner among clients, multi-domain expertise, and leadership depth. Management is also confident in gaining market share in auto and truck and off-highway sub-segment. We expect LTTS' USD revenue and earnings to post a CAGR of 19% and 31% over FY2021-FY2023E. The stock is currently trading at 29x/23x its FY2022E/FY2023E earnings, which justifies the premium valuation given its long run-way for growth. Given the large addressable market and presence in the fast-growing ERD segment, we retain Buy on LTTS with a PT of Rs. 3,100.

One-year forward P/E (x) band

Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Cyient	643	11	7,075	19.7	16.4	10.8	8.9	2.6	2.4	13.8	15.4
Tata Elxsi	2,649	6	16,499	45.5	34.5	31.8	24.8	12.3	9.7	27.1	28.0
LTTS	2,550	11	26,788	39.9	29.4	25.3	19.2	8.3	7.0	22.6	26.2

Source: Company, Sharekhan estimates

About company

LTTS is a leading global ER&D services company, backed by the rich engineering expertise and experience of its parent company, Larsen & Toubro. LTTS is a pure-play engineering design services firm present across multiple verticals (transportation, industrial products, telecom and hi-tech, medical devices, and process industries). The company derives 61% revenue from North America, 16% revenue from Europe, 14% revenue from India, and 9% revenue from Rest of the World (RoW). The company offers ERD practices to 53 of the top 100 R&D spenders worldwide. LTTS also has IP and platforms that it independently sells to clients.

Investment theme

LTTS currently generates mere 0.5% of its Top-30 (T-30) customers' R&D spends ($75 billion) as revenue ($376 million), which provides a long runway for growth. We believe the company's multi-sectoral presence and robust horizontal technology practice would help LTTS to deliver sustainable revenue growth momentum. Additionally, technology shifts in verticals are positive for LTTS, as any change in technology creates huge growth opportunities for ESPs. Unlike peers, LTTS has a broader portfolio, which helps the company to mitigate the risk relating to vertical-specific cyclicality. We believe LTTS is well poised to deliver strong multi-year growth going forward, led by leadership depth, broad client portfolio, and multi-domain expertise across verticals and the under-penetrated ERD outsourcing market.

Key Risks

1) Rupee appreciation and/or adverse cross-currency movements, 2) any hostile regulatory visa norms could impact employee expenses, 3) macro-uncertainties could adversely affect earnings, 4) loss of key customers, and 5) lower ERD spends/R&D budgets.

Additional Data

Key management personnel

A.M. Naik	Non-Executive Chairman
S.N. Subrahmanyan	Vice Chairman
Dr. Keshab Panda	Chief Executive Officer
Amit Chadha	Deputy CEO
Mr. Rajeev Gupta	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Invesco India Tax PLA	1.46
2	Nippon Life India Asset Management Ltd	1.28
3	Invesco Asset Management India Pvt	1.20
4	HDFC Trustee	1.19
5	Vanguard Group Inc/The	0.77
6	JPMorgan Chase & Co	0.67
7	HDFC Asset Management	0.67
8	Axis Asset Management	0.65
9	Alliance Bernstein LP	0.64
10	FMR LLC	0.59

Source: Bloomberg