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IT SERVICES

09 April 2020

ISG Index: Covid-19 to forestall deal activity in Q2CY20

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Deal momentum plummets in March: Data from the ISG Index, which measures global commercial outsourcing contracts with annual contract value (ACV) of US$ 5mn or more, shows Q1CY20 ACV increased by 6.9% YoY to US$ 14.8bn (+6.7% YoY in Q4CY19), supported by a growth rebound in America. America ACV rose 8.7% YoY (–3.1% in Q4CY19), backed by broad-based growth across managed services and as-a-service deals. Q4 and Q1 America trends read together suggest deal activity surged in the BFSI and healthcare & pharma verticals, while slackening in retail/CPG and manufacturing.

As per ISG, Q1CY20 managed services deals – a more relevant indicator for Indian IT services players – were on track for 9-10% YoY growth pre-Covid-19. But deal momentum fizzled out in March, closing Q1CY20 at 2.2% YoY growth.

Q2CY20 to register historic decline in deal activity: ISG expects a record 17% QoQ (and 21% YoY) drop in managed services deal activity for Q2CY20. The travel/transport/hospitality and retail/CPG verticals are likely to bear the brunt (–45% and –28% respectively), while telecom/media and healthcare/pharma should see the least impact (–3% and –8% respectively). ISG has slashed its CY20 expectations to a 7% decline in managed services deals (vs. growth of 3.2% earlier) and 12% growth for as-a-service deals (vs. 23.5% earlier).

Other call highlights: (1) About 60% of clients are demanding concessions, discounts (25-30%) and relaxed payment terms to ease short-term business disruptions. Lower productivity (~80% of normal) will exacerbate short-term challenges for IT vendors. (2) Roughly 60% of clients are evaluating a 15-25% cut in discretionary technology spends, which accounts for ~30% of the global outsourcing spend. A fifth of deals in the pipeline are also likely to be delayed.

Our view: We advocate that the ISG Index be taken with a pinch of salt considering its frequent revisions to base data. Nonetheless, we expect protracted Covid-19-led challenges for Indian IT services players to dent FY21 growth and profit momentum. In such a scenario, tier-I companies should be relatively resilient – TCS and HCL Tech are our preferred picks in this category. With the March quarter results relatively shielded from the lockdown impact, we recommend realigning portfolios in favour of tier-I and trimming exposure to midcap names.

RECOMMENDATION SNAPSHOT

Ticker	Rating
TCS IN	ADD
INFO IN	ADD
WPRO IN	SELL
HCLT IN	BUY
TECHM IN	REDUCE
LTI IN	BUY
MPHL IN	ADD
MTCL IN	SELL
HEXW IN	BUY
PSYS IN	REDUCE
NITEC IN	SELL
ECLX IN	SELL

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

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