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IT SERVICES | Q2FY21 Preview | 05 October 2020

A positive growth quarter after Q1 slump

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We expect Q2FY21 to be the growth recovery quarter with most companies in our coverage universe showing low-mid single digit QoQ growth, barring few exceptions. Growth pick-up is expected to be driven by receding supply side issues and accelerated demand for cloud and digital. BFSI, healthcare-life sciences and hi-tech will be the verticals with steady demand. Pipelines will be healthier across the board. Operating margins will remain strong QoQ. We will be watchful of management's commentary regarding troubled verticals.

A growth recovery quarter: For most of the IT companies, Q2FY21 will be a positive growth quarter after sharp contraction in Q4FY20 and Q1FY21. HCLT's guidance update of at least 3.5% growth echoes the same. Despite the uncertainty regarding a covid-19 second wave, businesses are ramping up their tech spend to remain operational. Supply side issues have abated completely, even for BPS businesses. Verticals driving growth are: BFSI, Healthcare, Hi-Tech and technology. Communications and Manufacturing have not gone back to pre-covid levels but are improving m-o-m. Retail and Travel and hospitality will take longer to recover. We have factored in a sharp 7% QoQ cc growth for NIIT Tech and low single digit growth for the rest.

Deal wins to recover as well: Deal wins had got postponed as clients took time to assess their own budgets and reassess their tech spending in the light of covid-19. Post two quarters of delayed decision making, deal pipelines are returning to pre-covid levels. Most deals focus on cost reduction, digital transformation, vendor consolidation and captive takeover. Client requests for pricing discounts have also thinned down significantly since March. Most new deals are from BFSI, Healthcare, Hi-Tech and Retail-CPG.

Green shoots: Within Hi-Tech, demand for cloud adoption has picked up the most with most companies upping their investment in cloud. Apart from all pervasive increased demand for cloud, Infosys' newly launched 'Cobalt'-a set of solutions and platforms to accelerate cloud transformation journey of enterprises is a testament to that. Mortgage part of BFSI is seeing better traction because of lower interest rates. IMS and run-the-business will see demand for higher productivity. E-commerce adjacent investments in retail are also seeing increased demand. Greater demand for automation will be seen from BPO segment.

RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
TCS IN	2,523	2,620	BUY
INFO IN	1,018	1,020	ADD
WPRO IN	313	246	SELL
HCLT IN	813	920	BUY
TECHM IN	823	910	BUY
LTI IN	2,527	3,290	BUY
MPHL IN	1,357	950	SELL
MTCL IN	1,336	1,220	ADD
PSYS IN	1,304	840	SELL
NITEC IN	2,336	2,110	ADD
ECLX IN	697	580	SELL

Price & Target in Rupees

Company -wise updates

- There is a considerable amount of currency tailwind at play in Q2. We estimate the growth to be roughly sub 5% QoQ USD across the board except for exception of 8.7% QoQ growth for NIIT Tech. The traction is expected to come from reduced exposure to airline, gain in travel tech market share and increased focus on other verticals, after 9.8% decline in Q1. We do not expect any new provisioning for travel clients.
- Infosys' estimated growth of 3.7% will be driven by US$1.74bn TCV in Q1 and US$1.5-2bn Vanguard deal. TCS is expected to see 2.8% growth driven by stable BFSI revenues and growing demand in Life-Sciences, Healthcare, Products and Platforms.
- We have factored in HCLT's mid-quarter updated guidance. Consequently, we have factored in 5.2% QoQ growth due to broad-based growth in pipeline and have raised its EBIT margin by 30bps QoQ to 20.8%.
- We expect the 2.8% growth to be driven by both enterprise and telecom for TechM. TCV is expected to bounce back to pre-covid US$500+ levels.
- Mphasis' DXC segment is expected to underperform and the recovery will be driven by Direct core segment. Digital risk's growth will be fueled by traction in the mortgage business driving 2.1% QoQ growth for Mphasis.
- Mindtree will show a muted positive growth of 2.3% impacted by weakness in travel vertical. Hi-Tech and communication will drive the recovery in Q2FY21. Some portion of deal ramp-up from Q1FY21 will happen in Q3.
- For LTI, we have assumed a growth of 1.7% led by receding supply side issues and marginal recovery in manufacturing, BFS and Insurance. EBIT margin estimate stands at 17.8% with 40bps QoQ improvement.
- Persistent's IP growth is expected to be flat. Services segment will drive the 3.1% QoQ growth. For Wipro and eClerx we estimate modest 2.4% and 1.4% QoQ growth.

FIG 1 – SEP'20 ESTIMATES

Company	Revenues (US$ mn)	US$ Revenue growth (%) QoQ	US$ Revenue growth (%) YoY	CC growth QoQ (%)	EBIT margins (%)	EBIT (Rs mn)	EBIT growth (%) QoQ	EBIT growth (%) YoY	EBIT margins (bps) QoQ	EBIT margins (bps) YoY	PAT (Rs mn)	PAT growth (%) QoQ	PAT growth (%) YoY
TCS	5,201	2.8	(5.7)	1.0	24.3	94,161	4.1	0.6	70	30	74,627	6.5	(7.2)
INFO	3,236	3.7	0.8	2.2	21.8	52,466	(2.4)	6.8	(92)	8	41,184	(2.3)	1.0
WPRO*	1,968	2.4	(3.9)	1.0	19.6	28,700	3.0	8.0	50	150	24,619	3.0	(4.0)
HCLT	2,479	5.2	(0.3)	3.5	20.8	38,484	5.1	10.0	30	90	30,388	4.0	14.6
TECHM	1,241	2.8	(3.6)	1.3	11.6	10,665	16.3	(8.0)	150	(120)	12,403	27.6	10.4
LTI	397	1.7	9.1	1.4	17.8	5,264	2.4	4.6	37	109	4,179	0.3	(2.2)
MPHL	310	2.1	1.1	1.6	15.7	3,612	0.8	4.1	0	(40)	2,791	1.5	2.1
MTCL	259	2.3	(4.5)	1.1	14.3	2756	5.1	51.4	60	480	2003	(5.9)	43.6
PSYS	135	3.1	7.6	2.6	11.1	1,111	8.0	40.4	68	211	902	0.2	4.8
NITEC	152	8.7	2.1	7.0	13.5	1,521	24.7	4.9	193	(50)	1,220	24.7	2.1
ECLX	45	1.4	(9.3)	0.8	20.1	681	3.0	12.9	50	320	577	1.6	19.2

Source: BOBCAPS Research | *EBIT margins refers to IT Services business | CC – Constant Currency

FIG 2 – CURRENCY MOVEMENT

Exchange rate	Sep'19	Jun'20	Sep'20	QoQ (%)	YoY (%)
USD/INR					
Average	70.4	75.4	74.0	(1.8)	5.1
Close	70.7	75.5	73.7	(2.3)	4.3
Euro/USD					
Average	1.10	1.11	1.18	6.9	7.0
Close	1.09	1.12	1.17	4.1	6.7
GBP/USD					
Average	1.22	1.24	1.31	5.4	7.0
Close	1.23	1.24	1.28	2.7	3.7

Source: BOBCAPS Research

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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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