IT SERVICES | Q2FY21 Review | 13 November 2020

V-shaped recovery in Q2

Q2FY21 has been a much-awaited recovery quarter for Indian IT, exhibiting a V-shaped rebound marked by growth and margin outperformance across the sector. Traction in cloud and digital business fueled order pipeline revival and higher TCV. We expect the momentum to continue over the near-to-midterm, barring seasonality in Q3, with most of our coverage headed for positive growth in FY21. Coforge has shown agility in handling the pandemic – we upgrade the stock to BUY from ADD and raise our Sep'21 TP to Rs 2,690 (vs. Rs 2,630).

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V-shaped recovery: Contrary to the street's expectations of a muted U-shaped turnaround for Indian IT, tier-I companies have swiftly recouped losses by growing 6.1% QoQ in Q2FY21 (post 6.1% contraction in Q1) and tier-II stocks also saw a similar V-shaped recovery pattern. Growth momentum has been expedited by a boom in cloud demand. Supply-side issues also stand resolved.

Rebound in key verticals: Demand has rebounded across BFS, life-sciences, hi-tech and retail-CPG. BFS saw a pickup in mortgage and lending services as well as digital transformation programmes, while insurance had a mixed showing. Manufacturing and travel saw some recovery but will take longer to normalise. Vendor consolidation post Covid-19 has helped companies in our coverage gain market share (e.g. Coforge in the airlines segment). Emerging areas of demand include cloud partnerships with hyperscalers, data-driven products, cybersecurity, customer experience, cost optimisation, automation and supply chain revamp.

Margins climb higher: Indian IT companies reported operating margin expansion in the range of 80-400bps QoQ in Q2, backed by higher utilisation, increased offshoring, SG&A reduction, and lower travel and branding costs. Players are also winding up the timebound Covid discount offered to clients during Q4F20 and Q1FY21, besides undertaking pyramid optimisation. We expect margins to be slightly impacted in Q3 due to salary hikes and rising marketing and travel spend.

FY22 to see growth acceleration: Most IT companies are headed for positive growth in FY21 post Q2 (vs. earlier expectations of a decline). TCV has largely recovered to pre-pandemic levels, even hitting peaks for some (Infosys, Coforge, Mphasis). Growing cloud pipeline and digital transformation demand in BFSI and retail-CPG should fuel stellar growth in FY22, on a lower base of FY21.

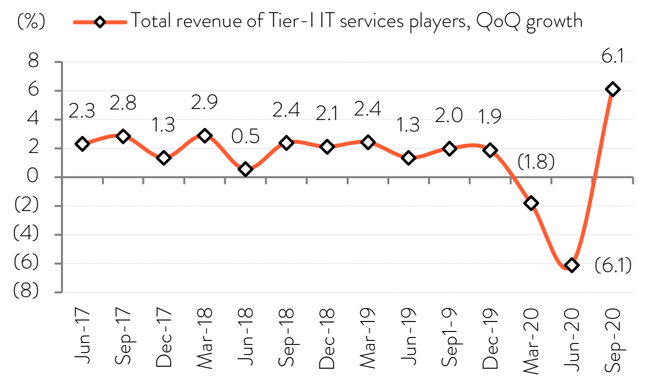
RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
TCS IN	2,657	3,180	BUY
INFO IN	1,124	1,210	ADD
WPRO IN	344	290	SELL
HCLT IN	828	980	BUY
TECHM IN	839	980	BUY
LTI IN	3,022	3,590	BUY
MPHL IN	1,317	1,410	REDUCE
MTCL IN	1,348	1,540	ADD
PSYS IN	1,142	840	SELL
COFORGE IN	2,304	2,690	BUY
ECLX IN	715	600	SELL

Price & Target in Rupees

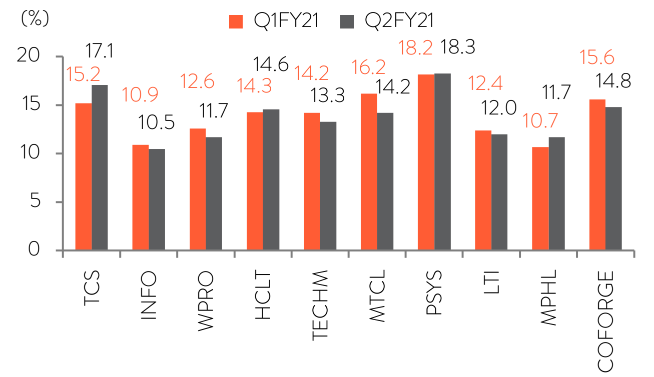
Focus charts

FIG 1 – TIER-I IT PLAYERS SAW V-SHAPED RECOVERY IN Q2FY21



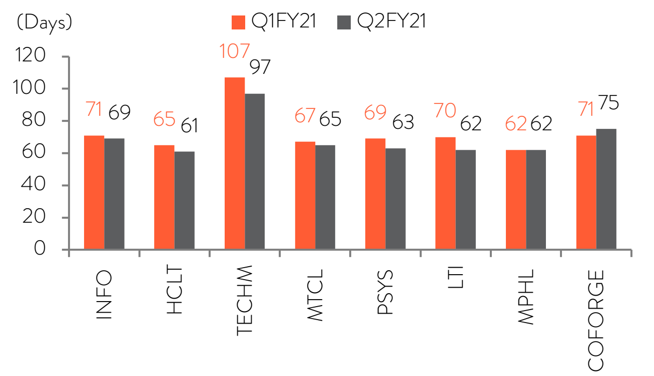
Source: BOBCAPS Research

FIG 2 – SG&A AS A PERCENTAGE OF SALES REDUCED QOQ



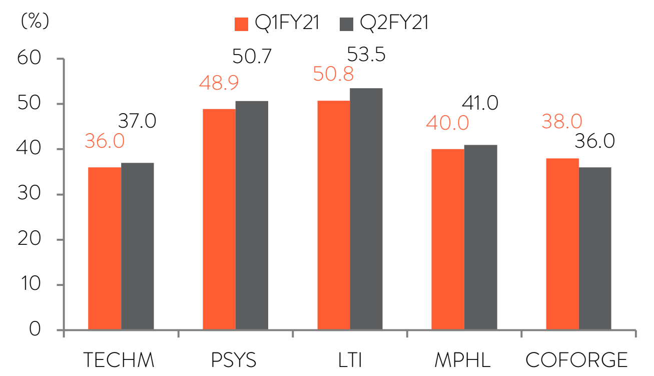
Source: BOBCAPS Research

FIG 3 – DSO (DAYS SALES OUTSTANDING) IMPROVED FOR MOST COMPANIES



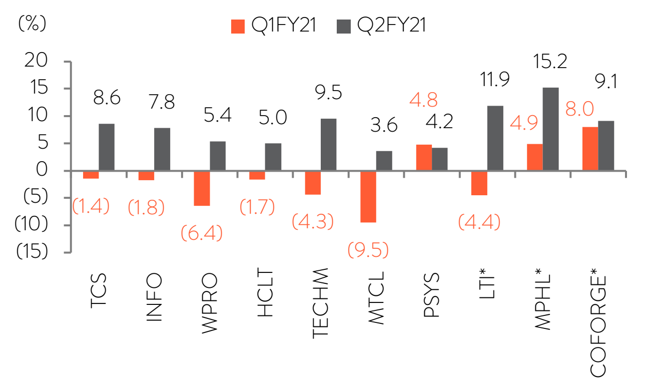
Source: BOBCAPS Research

FIG 4 – PICKUP IN OFFSHORING – A KEY MARGIN LEVER [AS % OF SALES]



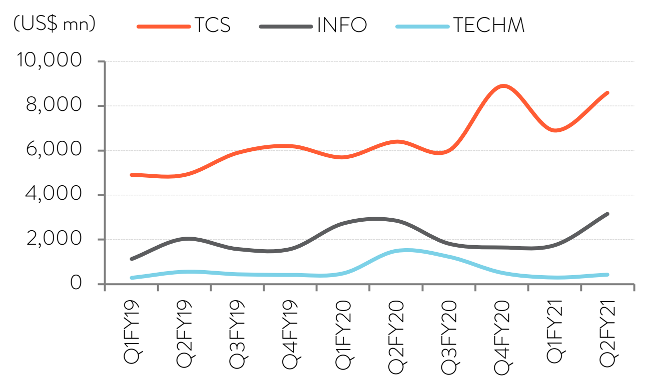
Source: BOBCAPS Research

FIG 5 – SHARP QOQ RECOVERY IN BFSI



Source: BOBCAPS Research | *BFS only

FIG 6 – TCVs BOUNCED BACK QOQ



Source: BOBCAPS Research

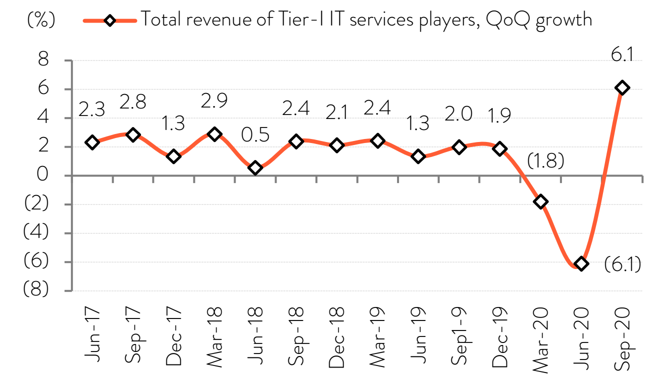
Key Q2FY21 trends

Pickup in cloud demand behind V-shaped recovery

The Covid-19 pandemic has ushered in a multiyear technology upgradation cycle. Cloud and digital demand have accelerated. Overall IT spending has not increased, but clients are funding digital transformation initiatives by cutting costs in their core business through automation. Cloud demand and cost takeout initiatives have enabled contract values and deal pipelines to recover. TCVs for Infosys (INFO), Coforge and Mphasis (MPHL) hit record highs in Q2FY21.

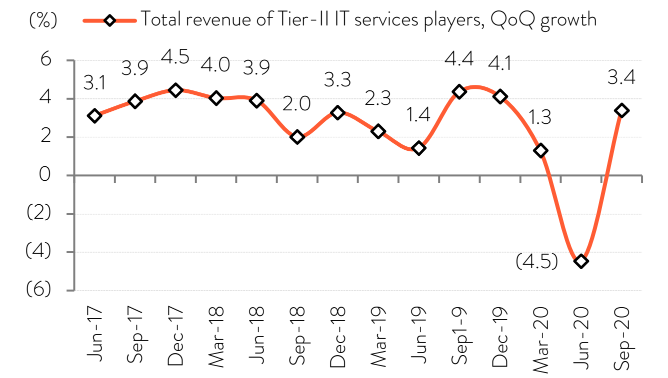
Enterprises are moving from an omnichannel model to 'digital only'. This has led to a V-shaped recovery across the sector. Dollar revenues for tier-I Indian IT services players grew 6.1% QoQ in Q2FY21 vs. a 6.1% contraction in Q1. Tier-II players have rallied as well. The rebound has been aided by resolution of supply-side issues and client budget reallocation toward the digital business.

FIG 7 – V-SHAPED RECOVERY FOR TIER-I…



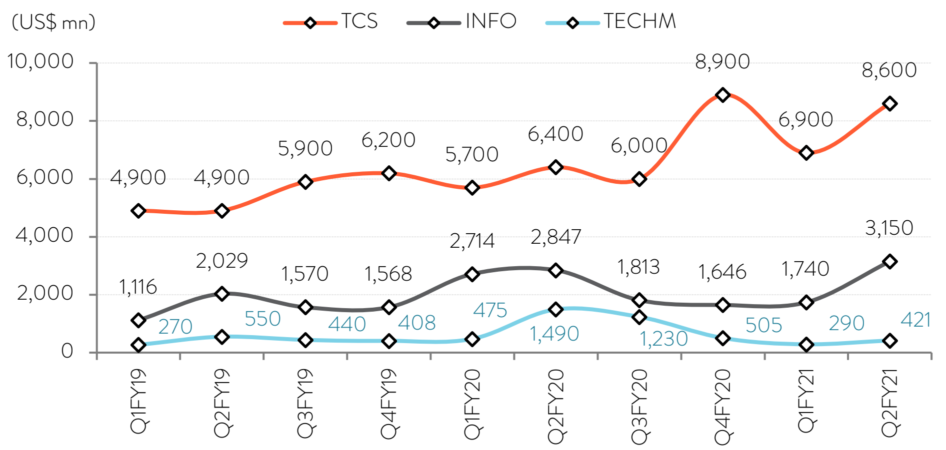
Source: BOBCAPS Research

FIG 8 – …AND TIER-II PLAYERS



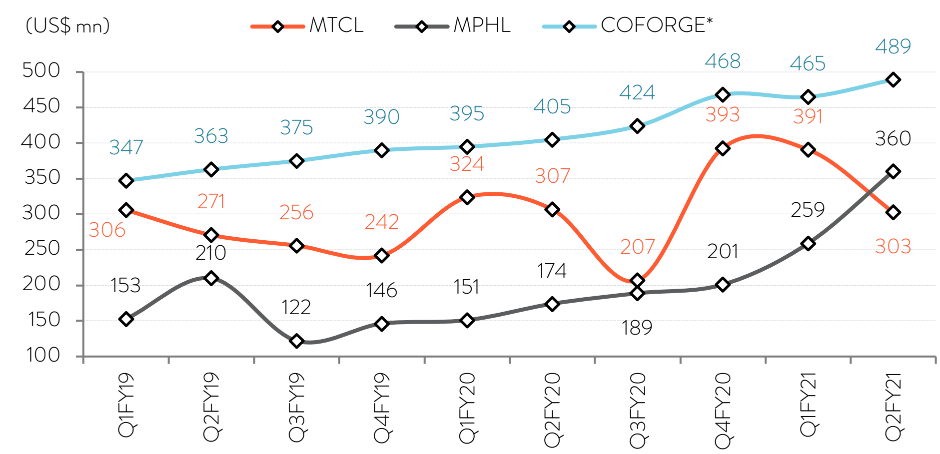
Source: BOBCAPS Research | * Includes Hexaware revenues

FIG 9 – STRONG QOQ TCV PICKUP



Source: BOBCAPS Research

FIG 10 – MID-CAP TCV ALSO RECOVERING



Source: BOBCAPS Research | *Executable order book for next 12 months

Companies are launching their own cloud frameworks. TCS is streamlining its cloud services into five strategic units, each with their own P&L. TCS's private cloud arm, Amazon Web Services (AWS), Microsoft Azure, Google Cloud Platform (GCP) and a cloud consulting arm would benefit from the recent cloud wave. INFO has launched 'Cobalt', which is a set of services, solutions and platforms to help enterprises migrate to the cloud.

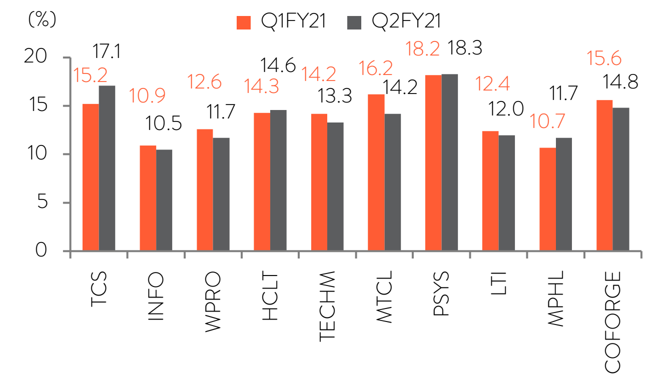
Similarly, L&T Infotech (LTI) has rolled out Canvas PolarSled – an automated cloud migration and modernisation framework. The company is also creating a dedicated sales unit to focus on cloud hyperscalers – AWS, GCP and Azure. Apart from cloud migration, demand for application development and modernisation has also picked up.

Robust margin expansion helped by offshoring

IT players across our coverage posted operating margin expansion in the range of 80-400bps QoQ in Q2FY21. This has materialised due to higher utilisation, reduction in SG&A and employee costs, as well as increased offshoring. Work from home has led to a larger portion of work being done offshore, with clients becoming more amenable to global delivery. Currently, companies are able to pitch up to 90-95% offshoring in deals, thereby making then sustainable.

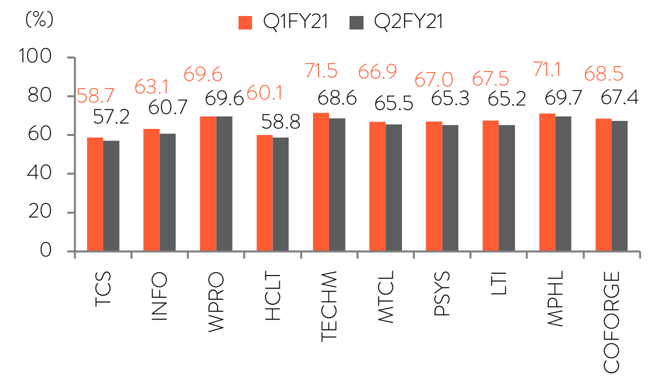
We do expect some negative impact in Q3FY21 due to salary hikes announced across the board, but management commentary suggests confidence in maintaining better margins vis-à-vis FY20 – albeit not as high as current levels – by using various efficiency levers.

FIG 11 – SG&A AS PERCENTAGE OF SALES HAS REDUCED QOQ



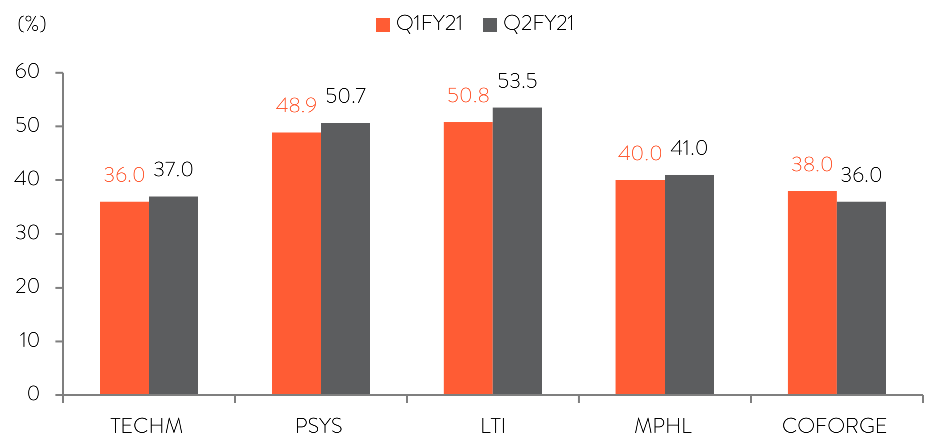
Source: BOBCAPS Research

FIG 12 – EMPLOYEE COST AS PERCENTAGE OF SALES ALSO REDUCED QOQ



Source: BOBCAPS Research

FIG 13 – OFFSHORING A MAJOR MARGIN LEVER (% OF REVENUE)



Source: BOBCAPS Research

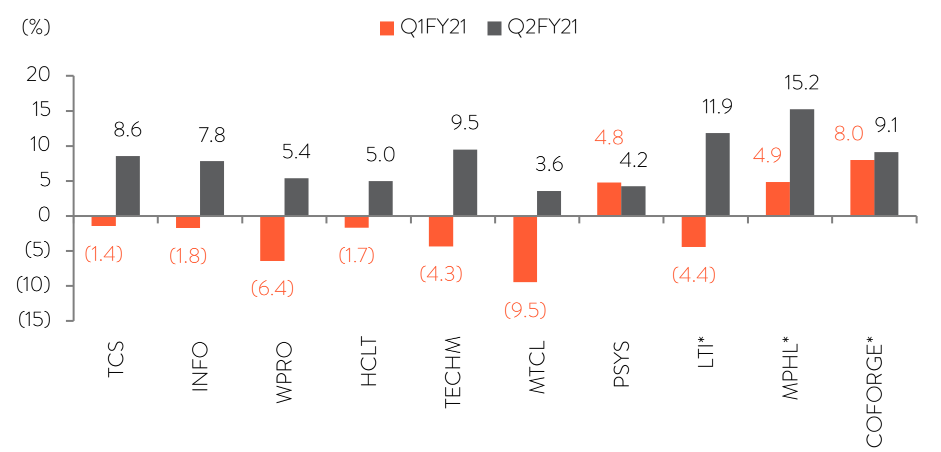
Pickup in BFS business

As expected, the BFS vertical saw an uptick following the Covid outbreak due to increased demand in the digital space. We had anticipated this in our previous sector note: **Deep Dive 3: Swift BFSI recovery ahead – raise TCS to BUY**. Demand has poured in from banks in the US and Europe. Since BFSI forms ~30% of overall IT sector revenues, it propelled QoQ recovery.

The BFSI sector spends heavily on latest technology adoption, customer experience transformation and automation. Technology spending is a matter of competitive advantage in the sector. Following the pandemic outbreak, the use of mobile banking apps, internet banking, blockchain and chatbots has increased while cybersecurity spends have also risen to support the work-from-home model.

Areas that have seen higher demand include cloud migration, call centre technology, customers' digital onboarding, mortgage servicing, and lending services for various government relief programmes and operations. Payments is also seeing a better performance. TCS, INFO, Wipro (WPRO), HCL Tech (HCLT), LTI and Mindtree (MTCL) saw an improved BFS performance in Q2. Both of Coforge's large deals are also from the BFSI vertical.

FIG 14 – UPTICK IN BFSI QOQ



Source: BOBCAPS Research | * BFS only

Pockets of strength

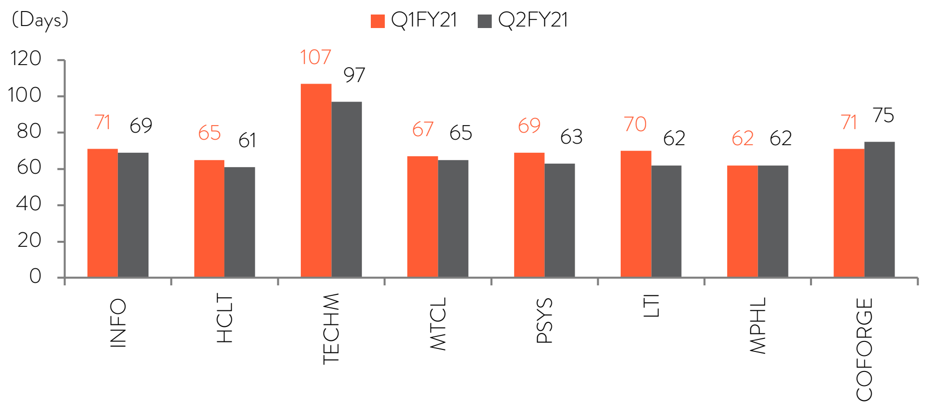
In the retail vertical, consumer packaged goods (CPG), e-commerce and customer experience have picked up. CPG is driving higher spends on digital marketing. Discretionary retail continues to be weak. Travel and manufacturing are also expected to take longer to recover. In travel, the airlines and airport segment continue to be depressed, while travel technology spend is stable. Within manufacturing, engineering services is doing well but auto remains weak. Manufacturing has bottomed out for most and is expected to start reviving by Q3.

Within communication, 5G-related traction will be seen for the next 3-9 months. The opportunity in 5G will range from process to operations systems to network architecture. Network services revival is likely to be slower. The insurance vertical has been mixed because of increased pandemic-led losses and a decline in premium volumes.

High cash conversion

Better cash conversion has resulted in improved DSOs across the sector. Some of this is due to reduced working capital needs. Even Tech Mahindra (TECHM) which usually has one of the highest DSOs, posted its lowest levels in 15 quarters. Coforge saw an increase in DSO due to credit period extensions to a few travel customers.

FIG 15 – DSO IMPROVED QOQ



Source: BOBCAPS Research

Acquisition spree

With the pandemic making it difficult for smaller firms to stay afloat, larger companies are scouting for target acquisitions. The following exhibit highlights key acquisitions made during Q2-Q3FY21 YTD.

FIG 16 – MAJOR ACQUISITIONS IN Q2-Q3FY21

Company	Acquired by	Geography	Domain Expertise	Remarks	Estimated value
GuideVision	Infosys	Europe	One of the largest 'Servicenow' partners in Europe	Enhances INFO's Cobalt portfolio of services	€ 30mn
Blue Acorn	Infosys	US	Digital customer experience, commerce and analytics services provider	Strengthens INFO's customer experience offerings	US$ 125mn
Kaleidoscope	Infosys	US	Product design, development and insights	Strengthens INFO's digital offerings	US$ 42mn
DWS	HCL Tech	Australia, New Zealand	Digital transformation, application development and project management and consulting	Gives HCLT access to Australian clients and Australian govt. which is investing in digital in a big way (**details in our report**)	US$ 115.8mn
Tenzing	Tech Mahindra	New Zealand	Technology consulting	Increases TECHM's financial services capabilities	Rs 2.18bn
Momenton	Tech Mahindra	Australia	Cloud and engineering services	Increases TECHM's financial services capabilities	Rs 750mn
Capiot	Persistent Systems	Australia, Singapore	Enterprise integration with expertise in Mulesoft and Redhat	Helps PSYS's ability to provide enterprise integration	US$ 6.34mn

Source: BOBCAPS Research

Investors rewarded

TCS and WPRO approved share buybacks in Q2. More IT companies are expected to follow suite. TCS, MTCL, Coforge, INFO, LTI and TECHM have all announced interim dividends. HCLT has doubled its dividend per share on double the number of shares (1:1 bonus issue in 2019).

Vendor consolidation

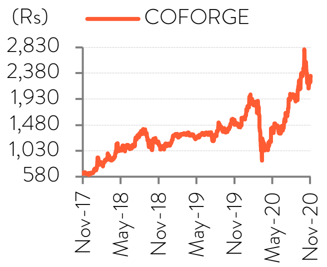
Firms such as TCS, INFO, HCLT, MTCL, MPHL and Coforge have been prime beneficiaries of vendor consolidation exercises, with customers assigning them many small-sized engagements from existing incumbents.

Upgrade Coforge to BUY

Coforge has proven to be remarkably agile during the pandemic. We raise our Sep'21 target price for the stock to Rs 2,690 (Rs 2,630 earlier) based on a higher target P/E of 22x (21.5x earlier), and also upgrade our rating to BUY from ADD which is backed by:

- **Timely revenue diversification:** Despite having one of the highest exposures to the travel (19% of sales in Q1FY21 from 29% in Q3FY20) and airlines (~5%) business, Coforge grew by 8.1% QoQ CC in Q2. The company achieved this by diversifying revenues away from travel towards BFS, insurance and healthcare.
- **Wallet share gains:** Demand in the airline segment continues to be suppressed. Coforge's QoQ growth from airline in Q2 has come on the back of wallet share gains from pre-pandemic customers. Demand weakness in this vertical till Mar'21 has been baked into the guidance.
- **Upbeat outlook:** Coforge's ~6% CC organic revenue growth guidance for FY21 is backed by 21% YoY growth in the executable order book and large deal wins (in insurance and BFS).

STOCK PERFORMANCE



Source: NSE

Financials – COFORGE

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue	**36,762**	**41,839**	**48,112**	**58,954**	**66,339**
EBITDA	6,453	7,431	8,414	10,641	11,761
Depreciation	1,248	1,730	1,849	2,131	2,291
EBIT	5,205	5,701	6,566	8,510	9,470
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	476	462	413	1,370	1,334
Exceptional items	0	0	0	0	0
EBT	5,681	5,978	6,799	9,880	10,804
Income taxes	1,404	1,203	1,588	2,371	2,593
Extraordinary items	0	185	180	0	0
Min. int./Inc. from associates	188	236	225	360	400
Reported net profit	**4,089**	**4,539**	**4,985**	**7,149**	**7,811**
Adjustments	0	0	0	0	0
Adjusted net profit	**4,089**	**4,539**	**4,985**	**7,149**	**7,811**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	0	0	0	0	0
Other current liabilities	6,345	7,222	8,304	10,176	11,450
Provisions	3,626	4,127	4,745	5,815	6,543
Debt funds	224	224	224	224	224
Other liabilities	455	455	455	455	455
Equity capital	615	615	615	615	615
Reserves & surplus	21,625	25,657	28,887	33,557	38,666
Shareholders' fund	22,240	26,272	29,502	34,172	39,281
Total liabilities and equities	**32,890**	**38,299**	**43,230**	**50,841**	**57,953**
Cash and cash eq.	8,726	13,390	17,349	22,941	29,199
Accounts receivables	7,352	8,368	9,622	11,791	13,268
Inventories	0	0	0	0	0
Other current assets	3,324	3,783	4,350	5,330	5,998
Investments	3,955	3,955	3,955	3,955	3,955
Net fixed assets	8,302	7,572	6,723	5,593	4,302
CWIP	7	7	7	7	7
Intangible assets	0	0	0	0	0
Deferred tax assets, net	1,231	1,231	1,231	1,231	1,231
Other assets	0	0	0	0	0
Total assets	**32,890**	**38,299**	**43,230**	**50,841**	**57,953**

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	5,525	6,505	7,059	9,640	10,501
Interest expenses	(476)	(462)	(413)	(1,370)	(1,334)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(151)	(97)	(120)	(208)	(142)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	**4,898**	**5,946**	**6,526**	**8,062**	**9,026**
Capital expenditures	(750)	(1,000)	(1,000)	(1,000)	(1,000)
Change in investments	0	0	0	0	0
Other investing cash flows	476	462	413	1,370	1,334
Cash flow from investing	**(274)**	**(538)**	**(587)**	**370**	**334**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	0	0	0	0	0
Dividends paid	0	(744)	(1,980)	(2,839)	(3,102)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	**0**	**(744)**	**(1,980)**	**(2,839)**	**(3,102)**
Changes in cash and cash eq.	**4,624**	**4,664**	**3,959**	**5,592**	**6,258**
Closing cash and cash eq.	**8,726**	**13,390**	**17,349**	**22,941**	**29,199**

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	66.2	73.5	80.7	115.7	126.4
Adjusted EPS	66.2	73.5	80.7	115.7	126.4
Dividend per share	0.0	10.0	26.6	38.2	41.7
Book value per share	360.0	425.2	477.5	553.1	635.8

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	3.8	3.3	2.7	2.2	1.8
EV/EBITDA	21.5	18.3	15.6	12.0	10.4
Adjusted P/E	34.8	31.4	28.6	19.9	18.2
P/BV	6.4	5.4	4.8	4.2	3.6

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	72.0	75.9	73.3	72.4	72.3
Interest burden (PBT/EBIT)	109.1	104.9	103.5	116.1	114.1
EBIT margin (EBIT/Revenue)	14.2	13.6	13.6	14.4	14.3
Asset turnover (Revenue/Avg TA)	123.4	117.5	118.0	125.3	122.0
Leverage (Avg TA/Avg Equity)	1.5	1.5	1.5	1.5	1.5
Adjusted ROAE	20.3	18.7	17.9	22.5	21.3

Source: Company, BOBCAPS Research | Note: TA = Total Assets

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Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	22.9	13.8	15.0	22.5	12.5
EBITDA	28.8	15.2	13.2	26.5	10.5
Adjusted EPS	45.9	11.0	9.8	43.4	9.3
Profitability & Return ratios (%)					
EBITDA margin	17.6	17.8	17.5	18.0	17.7
EBIT margin	14.2	13.6	13.6	14.4	14.3
Adjusted profit margin	11.1	10.8	10.4	12.1	11.8
Adjusted ROAE	20.3	18.7	17.9	22.5	21.3
ROCE	18.1	20.5	24.8	34.3	41.7
Working capital days (days)					
Receivables	66	69	68	66	69
Inventory	0	0	0	0	0
Payables	132	128	129	134	128
Ratios (x)					
Gross asset turnover	4.3	5.3	6.7	9.6	13.4
Current ratio	1.9	2.3	2.4	2.5	2.7
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.4)	(0.5)	(0.6)	(0.7)	(0.7)

Source: Company, BOBCAPS Research

Disclaimer

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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