IT SERVICES | Q3FY21 Review | 15 February 2021

Indian IT shows sustained growth resurgence

Q3FY21 sequential revenue growth and margins for the IT services sector have been robust, surpassing our already-optimistic estimates. Cloud and automation remained the key demand drivers alongside cost takeout. BFSI held steady and manufacturing saw a sector-wide pickup. Most companies are confident of double-digit growth in FY22 on the back of robust deal pipelines. Operating margins also ticked up in Q3 despite seasonal headwinds. We remain positive on TCS, HCLT & TECHM among large-caps and LTI & Coforge among mid-caps.

Ruchi Burde | Seema Nayak
research@bobcaps.in

Gainers and losers: In the wake of Covid-19, enterprises are increasingly focused on cost efficiency and vendor consolidation. The scales have shifted in favour of larger players and those with robust digital capabilities. Cognizant, Capgemini and DXC are some of the global IT majors that have lost market share to their Indian counterparts. TCS, Infosys (INFO) and HCL Tech (HCLT) have emerged as the top gainers among large-caps.

Coforge has gained considerable market share in the travel technology space. HCLT with its large five-year Airbus deal is also emerging as a key player in the travel space. L&T Infotech (LTI) has been able to maintain its edge in competing with bigger rivals, bagging large contracts in the ~US$ 50mn-200mn range. Tech Mahindra (TECHM) has also started gaining traction in the communications space with its US$ 455mn TCV during Q3FY21.

Strong margin expansion: EBIT margin expanded 85bps QoQ on average for our IT services universe in Q3 despite headwinds of salary hikes, rupee appreciation, seasonality and higher costs, to name a few. Apart from INFO and Coforge, all our coverage companies had QoQ margin gains. Mindtree (MTCL) and LTI reported record-high margins. Much of the expansion can be attributed to good growth, high utilisation, lower travel & marketing costs, and higher offshoring. Offshoring, lower facilities cost (as companies adopt hybrid work model for long term) and growth will continue to be margin tailwinds in near future.

Bright growth outlook: HCLT and INFO have upgraded their guidance. Coforge expects FY21 growth to be at least 6% CC and LTI foresees strong traction in Q4FY21. TECHM's management expects large deal wins to accelerate in coming quarters and has one of its best deal pipelines yet. HCLT is confident of a further upswing in bookings. Reiterate BUY on TCS, HCLT & TECHM among large-caps and LTI & Coforge among mid-caps.

RECOMMENDATION SNAPSHOT

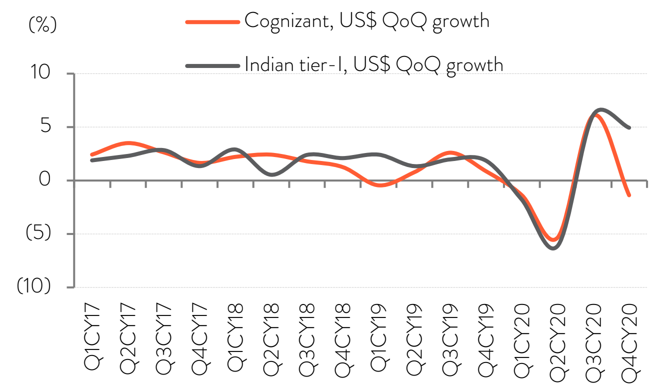
Ticker	Price	Target	Rating
TCS IN	3,190	3,710	BUY
INFO IN	1,310	1,500	ADD
WPRO IN	442	350	SELL
HCLT IN	960	1,150	BUY
TECHM IN	991	1,130	BUY
LTI IN	4,040	4,740	BUY
MPHL IN	1,646	1,550	REDUCE
MTCL IN	1,724	1,850	ADD
PSYS IN	1,795	1,260	SELL
COFORGE IN	2,612	2,800	BUY
ECLX IN	965	950	REDUCE

Price & Target in Rupees

Contents

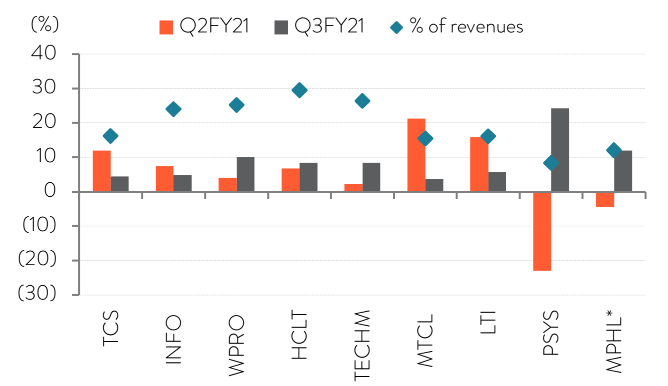
Focus charts

FIG 1 – INDIAN PLAYERS GAINING MARKET SHARE



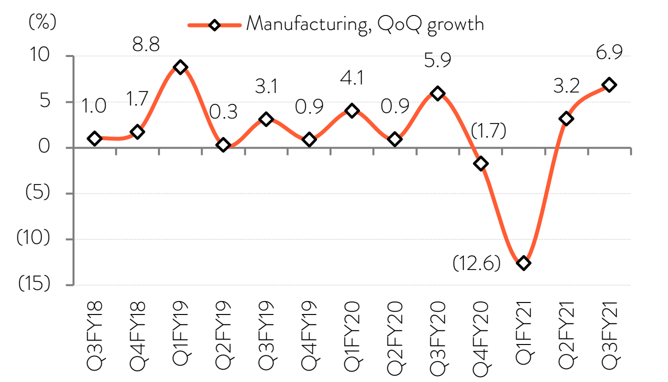
Source: BOBCAPS Research

FIG 2 – INCREASING FOCUS ON EUROPE



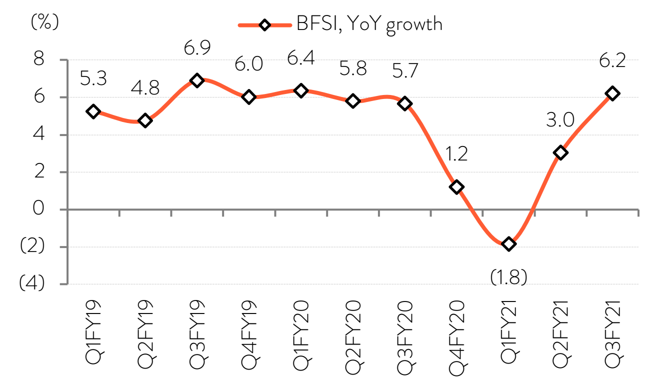
Source: BOBCAPS Research | *INR terms

FIG 3 – MANUFACTURING VERTICAL HAS PICKED UP



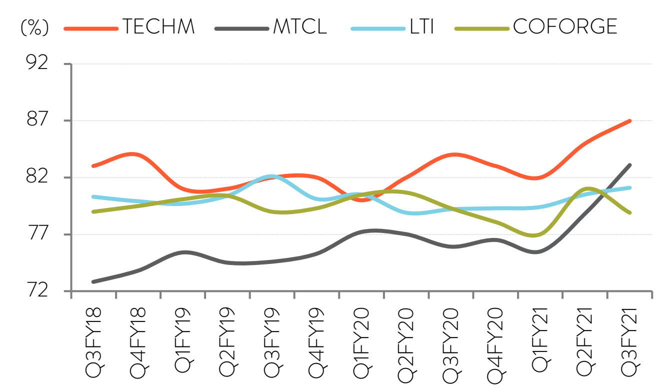
Source: BOBCAPS Research

FIG 4 – BFSI PERFORMANCE STEADY YOY



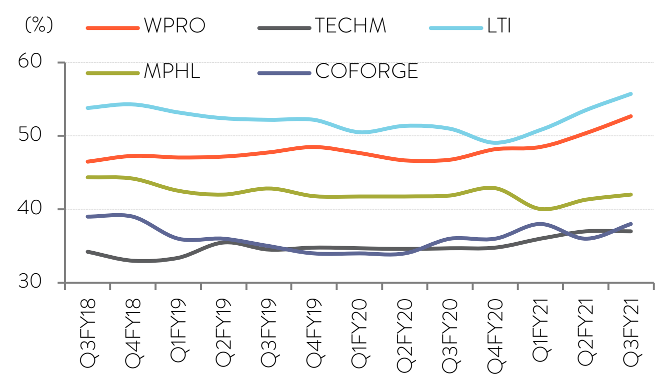
Source: BOBCAPS Research

FIG 5 – Q3FY21 EBIT MARGIN UPTREND LED BY PEAK UTILISATION…



Source: BOBCAPS Research

FIG 6 – …AND HIGHER OFFSHORING



Source: BOBCAPS Research

Q3FY21 highlights

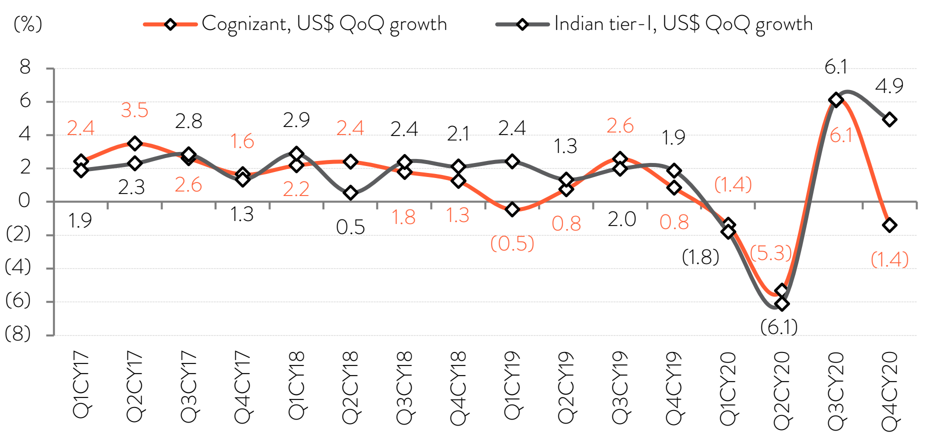
Key surprises

- TCS bagged 200 clients from its dedicated business unit for cloud hyperscalers in Q3FY21 itself.
- Persistent Systems' (PSYS) strong IP growth of 20.7% QoQ resulted in 7.4% QoQ USD growth vs. 5% estimated. The company also started announcing TCV which stood at US$ 302mn in Q3.
- INFO's deal win acceleration – including the biggest contract in the history of Indian IT (Daimler) – led to its industry-leading topline growth of 5.3% CC/6.2% USD. TCV of US$ 7.1bn was a record high for the company and the sector in Q3.
- TCS surprised by achieving a 26.6% EBIT margin – the highest in the last five years – despite salary hikes, staying within its target band of 26-28%.

Market share gains

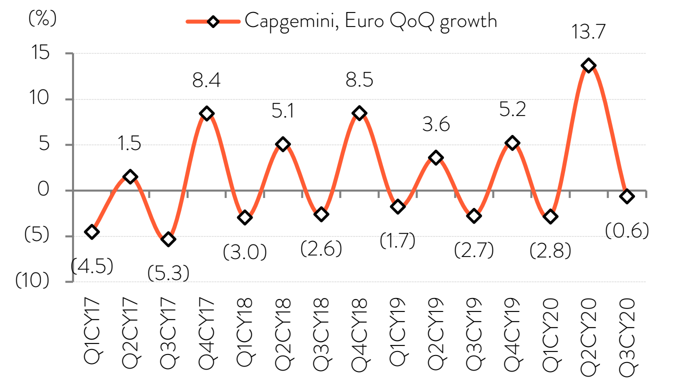
Indian players have managed to emerge from the crisis stronger than their overseas counterparts. Whereas all Indian firms including midcaps reported robust sequential dollar revenue growth in the Dec'20 quarter, Cognizant's revenue declined by 1.4% QoQ USD and Capgemini's by 0.6% QoQ EUR while DXC's revenue contracted 5.8% QoQ USD. Indian IT companies have managed to post steady sequential growth, capturing the value migration away from global majors.

FIG 7 – INDIAN PLAYERS GAINING MARKET SHARE



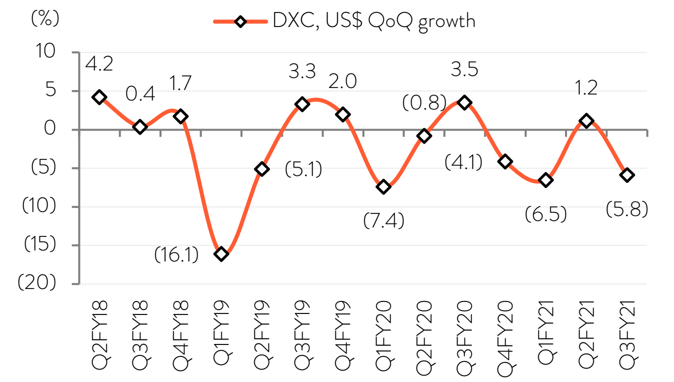
Source: Company, BOBCAPS Research | Tier-I: TCS, INFO, HCLT, WPRO, TECHM

FIG 8 – CAPGEMINI EURO REVENUE GROWTH QOQ



Source: Company, BOBCAPS Research

FIG 9 – DXC'S USD REVENUE GROWTH QOQ



Source: Bloomberg, BOBCAPS Research

Cloud adoption – separate business units for hyperscalers

Enterprises across B2B and B2C industries have been investing in digital transformation over the years. But the onset of Covid-19 has led to a sharp acceleration in these investments and a rebalancing of the portfolio spend in favour of digital transformation over traditional business-as-usual IT. Cloud adoption is driving a multiyear technology spending cycle and is emerging as the new-age ERP. It is expected to remain an all-encompassing growth driver for the next three years at least.

Consequently, firms such as TCS, LTI, HCLT, Mphasis (MPHL) and INFO (Cobalt capability) have created multiple separate business units to cater to the various large cloud hyperscalers – gaining an early-mover advantage. PSYS is working to deepen its associations with hyperscalers while LTI has moved beyond the large players via its partnership with Snowflake.

Increase in Europe-based investments

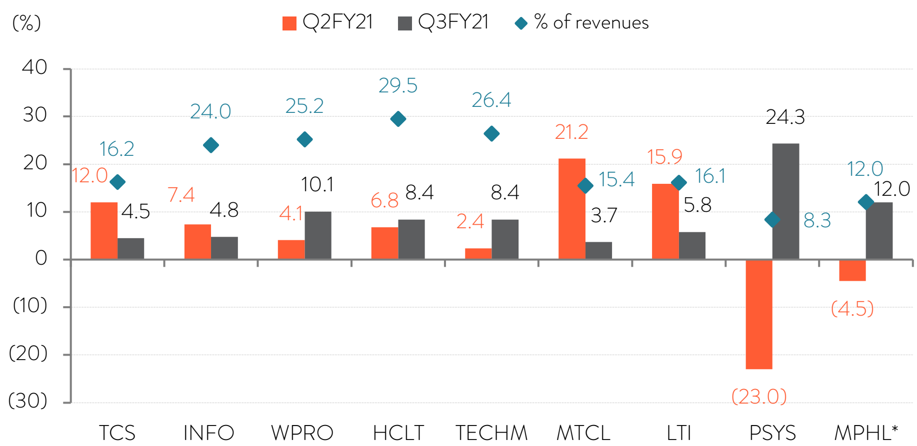
In the wake of the pandemic, companies are looking to mitigate risks from a geographical standpoint. Demand in Europe is particularly strong owing to accelerated cloud adoption, digital transformation and a focus on cost optimisation by driving core efficiencies.

TCS is beginning to invest more in Europe and recently announced the hiring of 1,500 employees in the UK over the next year. Due to various rebadging deals, INFO, HCLT and Wipro (WPRO) will also be taking in more European employees. INFO and WPRO have absorbed 600 and 1,300 employees owing to their Daimler and Metro AG deals respectively. LTI has invested in Nordics SaaS while MPHL expects multiyear growth in Europe and is investing to expand its presence there.

TCS registered healthy growth in the Europe and UK retail vertical in Q3FY21. WPRO posted accelerated 10.1% QoQ growth in Europe due to the Metro-AG deal transition and MPHL saw a 12% QoQ uptick (rupee terms). MPHL's direct business in Europe has grown 13.5% QoQ and 20% YoY in Q3, with the region expected to emerge as its key market in FY21. INFO is also seeing increased cloud adoption in Europe. The Daimler deal – one of INFO's largest contract wins in history – was from Europe.

PSYS saw a strong growth surge from the region and is looking to expand its footprint and raise Europe revenue share to at least 15-18% from 8.8% at present. The company is adding to its leadership team in the region and also scouting for viable acquisitions. TECHM saw 8.4% QoQ growth from Europe in Q3 driven by a 5G network rollout deal.

FIG 10 – EUROPE REVENUE SHARE AND QOQ GROWTH



Source: Company, BOBCAPS Research | *INR terms

Healthy deal pipeline

INFO has bagged some of the biggest deals this season – namely, Daimler and XacBank. HCLT has also signed several cloud and digital deals in Q3FY21 and management is confident of further acceleration of bookings in coming quarters. The company also saw triple-digit growth in new licence bookings for its software business.

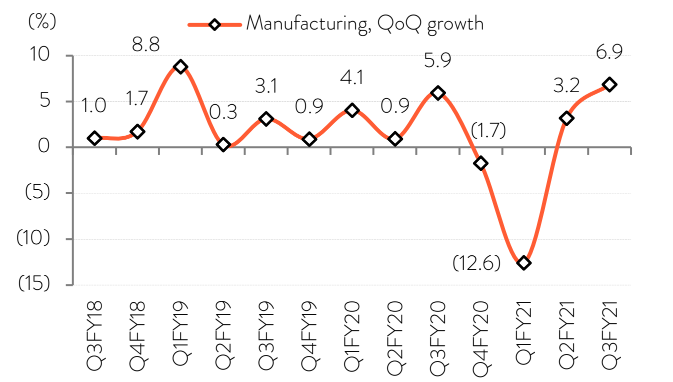
Coforge's executable order book for the next 12 months increased 18% YoY in Q3 and breached the US$ 500mn mark for the first time. The company is currently pursuing four large deals. MTCL's year-to-date order book has crossed the US$ 1bn mark and its pipeline is robust. Similarly, LTI has signed two large multiyear contracts with total TCV of US$ 278mn, of which the US$ 204mn Injezat deal will flow through from Q1FY22.

Manufacturing and BFSI remain at the fore

Manufacturing pickup

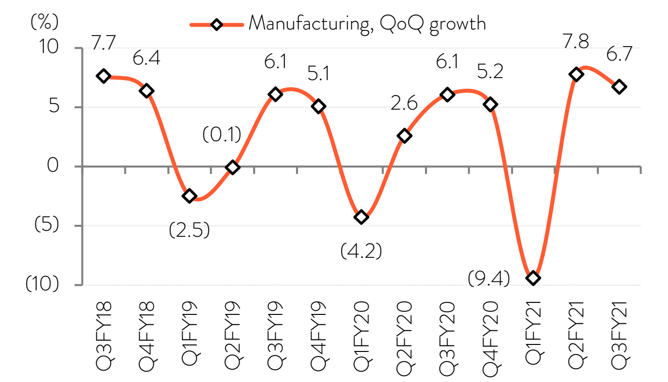
Some of the sectors worst affected by Covid-19 such as manufacturing, travel and retail are seeing traction from pent-up demand. Supply chain optimisation and omnichannel commerce have gained momentum post pandemic. During Q3FY21, INFO, LTI, TCS and HCLT have all registered a significant uptick in manufacturing vertical revenues.

FIG 11 – BROAD-BASED PICKUP IN MANUFACTURING VERTICAL REVENUE: TIER-I…



Source: BOBCAPS Research | Tier-I: TCS, INFO, HCLT, WPRO, TECHM

FIG 12 – …AND TIER-II



Source: BOBCAPS Research | Tier II: LTI, MTCL, Coforge

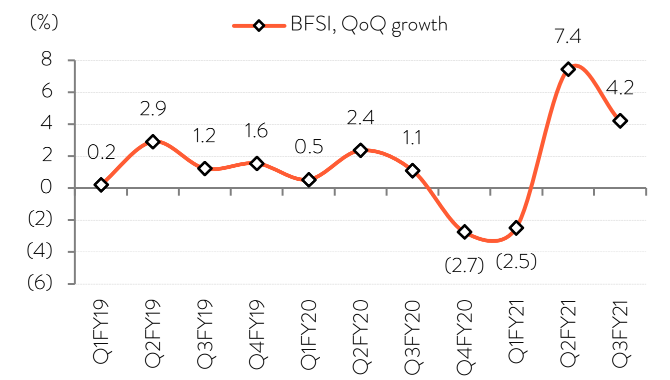
BFSI has stabilised; growth to continue

QoQ growth in the BFSI vertical was subdued in Q3 as compared to the previous quarter but only due to the seasonality impact. BFSI continues to see elevated demand in areas such as cloud adoption, core modernisation, cybersecurity, workspace modernisation, call centre modernisation, digital banking, insights and analytics (see our report: **Deep Dive 3 – Swift BFSI recovery ahead; raise TCS to BUY**). The wealth management subsegment is also seeing good demand traction.

For TCS, BFSI grew 3% QoQ – one of its best third-quarter growth rates in the recent past. Most revenues from the Prudential financial and Postbank systems deals will flow through in Q4FY21. TCS had two new wins for digital banking products, two for wealth management solutions, and one for payments. These include one of the largest contracts ever for TCS BaNCS, its flagship product suite in BFSI. For INFO, BFSI posted stellar YoY growth and management is positive of future traction on the back of large deal wins.

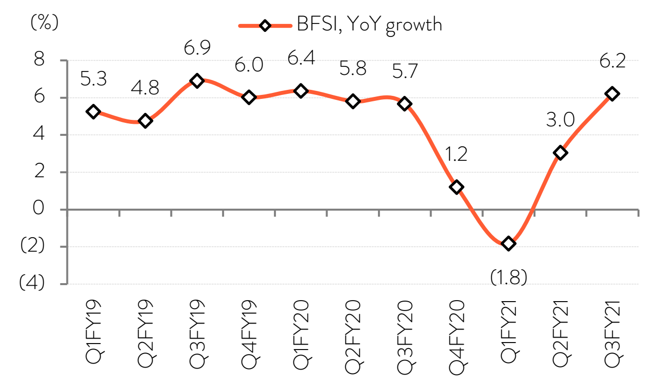
Financial services was a little slow for a couple of mid-caps such as PSYS (down 0.8% QoQ due to some large client ramp-downs) and Coforge (insurance down 2.9% QoQ in INR terms due to a high base). However, the demand outlook remains bright as Coforge has signed a US$ 45mn five-year insurance deal. BFS continues to be a growth driver for the company as two of the world's top 10 banks are in its top 20 and top 30 client mix. LTI's BFS growth streak continued in Q3 with an 8.2% QoQ USD uptick and though insurance was down, it is expected to bounce back as Covid-related commercial concessions wind up.

FIG 13 – BFSI GROWTH UPTICK FOR TIER-I PLAYERS QOQ



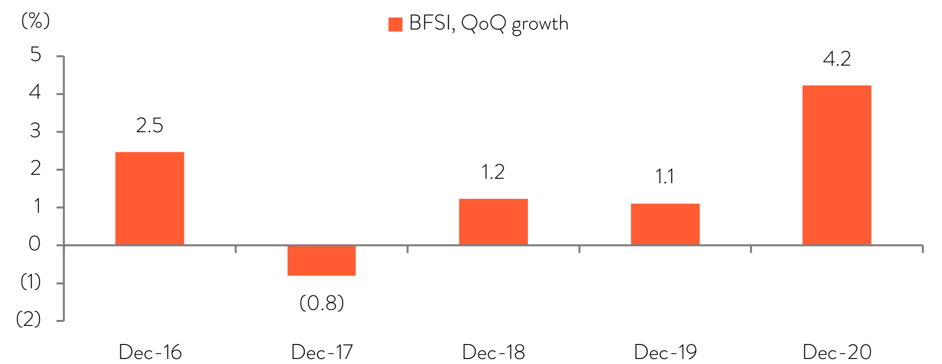
Source: BOBCAPS Research

FIG 14 – BFSI GROWTH UPTICK FOR TIER-I PLAYERS YOY



Source: BOBCAPS Research

FIG 15 – SIGNIFICANT RISE IN DEC'20 QUARTER BFSI GROWTH QOQ



Source: Company, BOBCAPS Research

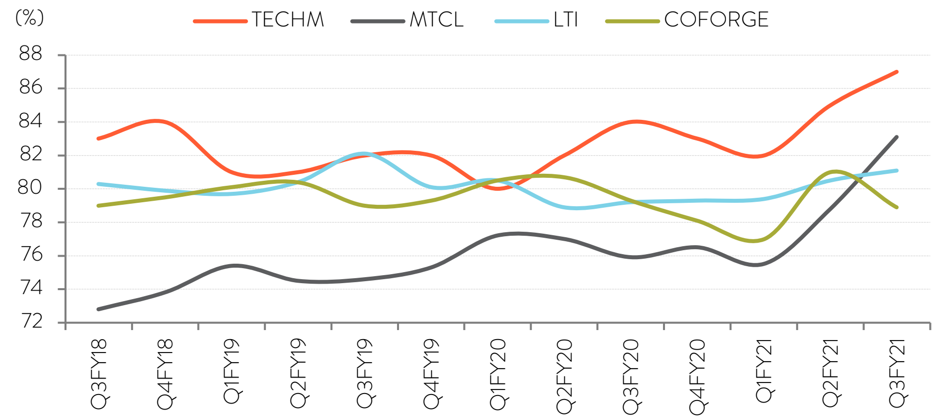
Margin levers in place

Besides good topline growth, the operational efficiencies that drove record EBIT margins for Q3FY21 comprised improved utilisation, control over subcontracting costs, and lower travel and branding costs.

Utilisation at peak levels

Utilisation has peaked for most companies – these levels picked up in Q1 and Q2FY21 due to the work-from-home shift, but in Q3 the uptick was mostly led by the demand surge. INFO has reached 86.3% utilisation. MTCL and TECHM are at 83% (up 7% YoY) and 87% respectively – their highest ever. Most managements are aware that current levels are unsustainable and have started to recruiting ahead of the curve to backfill higher attrition and satisfy future demand.

FIG 16 – UTILISATION AT PEAK LEVELS

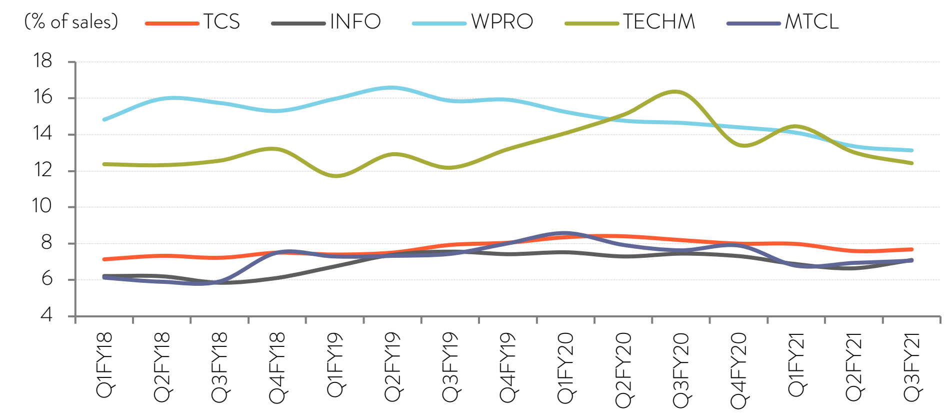


Source: Company, BOBCAPS Research

Subcontracting costs stable

Subcontracting costs as a percentage of sales have either remained stable or declined for most IT services players, signaling tighter cost control.

FIG 17 – SUBCONTRACTING COST AS PERCENTAGE OF SALES REINED IN

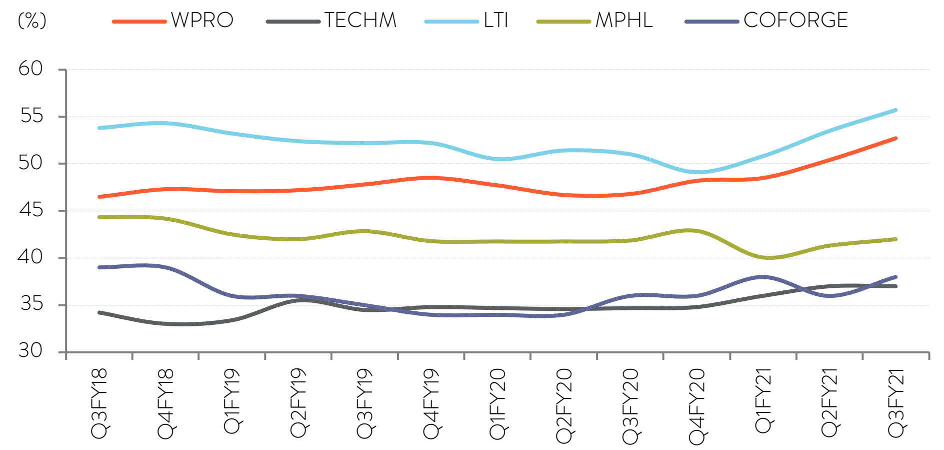


Source: Company, BOBCAPS Research

Increase in offshoring

Offshoring – which lowers facility cost as companies adopt a long-term hybrid work model – and topline growth will remain margin tailwinds in the near future. 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 them sustainable.

FIG 18 – OFFSHORING PICKUP POST PANDEMIC



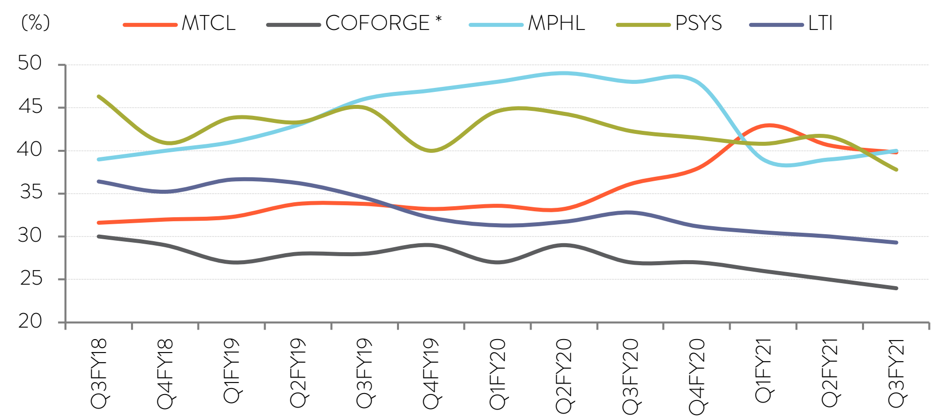
Source: Company, BOBCAPS Research

Improvement in other key metrics

Derisking the client base

Most mid-caps have seen a derisking of revenue. Coforge has been reducing client concentration since Q2FY20. Its top accounts now have fewer travel clients. On the other hand, MTCL's client concentration has risen because of increased work on collaborative tools from its top account in Q1FY21.

FIG 19 – CLIENT CONCENTRATION (TOP-5) COMING DOWN

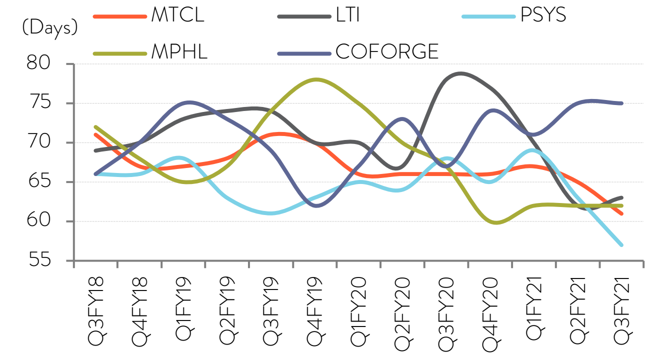


Source: BOBCAPS Research | *INR terms

Better DSO levels

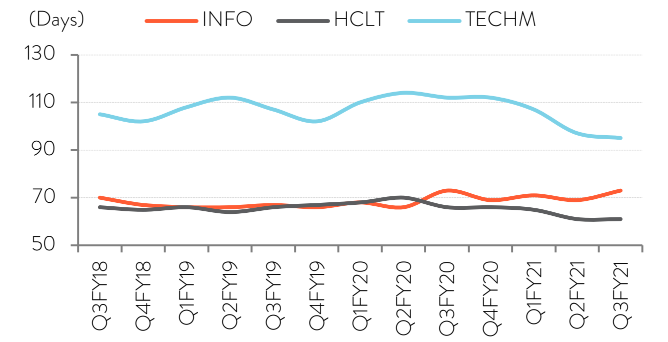
Post Covid-19, better cash conversion has resulted in improved DSOs across the sector. Some of this was due to reduced working capital needs. Even TECHM, which usually has one of the highest DSOs, posted its lowest levels in 16 quarters.

FIG 20 – DSO FOR SMALL-CAPS



Source: BOBCAPS Research

FIG 21 – DSO FOR LARGE-CAPS



Source: BOBCAPS Research

Annexure A

FIG 22 – BOBCAPS IT SERVICES UNIVERSE: MARGIN AND ROE SUMMARY

Company	EBIT Margin (%)				ROE (%)			
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
TCS	24.6	25.8	26.7	26.4	37.0	37.7	43.6	42.1
INFO	21.3	24.4	23.7	23.2	26.5	28.3	29.0	28.6
WPRO	17.1	19.1	18.4	17.3	16.9	18.7	18.0	16.5
HCLT	19.6	21.5	21.6	22.1	23.5	24.2	23.8	24.0
TECHM	11.6	13.8	15.0	15.1	19.8	19.9	21.3	22.4
LTI	16.1	19.2	18.8	18.8	29.5	32.0	33.2	32.5
MTCL	10.1	17.4	18.1	16.8	19.5	31.3	30.8	27.1
PSYS	9.2	11.8	11.6	12.4	14.1	16.1	15.7	16.9
MPHL	16.0	16.2	17.1	17.1	21.4	20.1	22.4	23.8
COFORGE	13.6	13.3	13.9	14.1	18.7	17.3	22.6	22.1

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)

Rating distribution

As of 31 January 2021, out of 88 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 41 have BUY ratings, 13 have ADD ratings, 6 are rated REDUCE and 28 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2025. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities —that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.