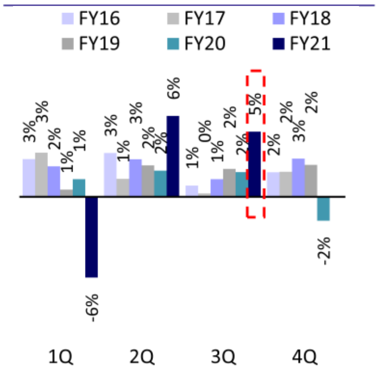
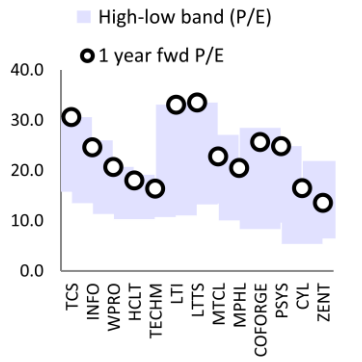
Technology

USD revenue growth for largecap IT (QoQ)



Source: Company, MOFSL

High-low v/s current P/E



Source: Bloomberg, MOFSL

IT services rearview mirror: 3QFY21 earnings review

Strongest third quarter in the past five years

- The Indian IT services industry reported one of its strongest third quarters in FY21, delivering USD revenue growth of 4.9% QoQ, helped by increased technology spends across all key industries (despite adverse seasonality), pick up in deal sizes, and faster conversion from pipeline to orders.
- The outlook for CY21 continue to improve, with an increase in deal TCV (median book-to-bill at 1.2x v/s 0.9x in 3QFY20, Exhibit 6) and pipeline across companies. Managements (Exhibit 16, 17) further highlighted that clients are rolling out multi-year Digital and Cloud transformation projects, further improving long-term visibility in this space.

Robust headcount addition on back of record high utilization…

- Total headcount addition for 3QFY21 stood at 39k as against a net decline of 3k employees in the past nine months. This came in on the back of the highest ever utilization reported by IT Services companies.
- Attrition for 3QFY21 was the lowest ever at 11.3% (average for our IT coverage universe) v/s 16.2% in 3QFY20. This is expected to rise over the next few quarters, despite wage hikes in 4QFY21/1QFY22. This remains a key worry for margin performance as a rapid rise in attrition may require intervention.
- With utilization levers at a historical high (Exhibit 11), margin improvement will be driven more by operating leverage going forward.

…with continuously increasing offshore mix

- The COVID-19 lockdown continues to act as a tailwind on margin in 3QFY21, with higher offshore mix and lower travel expense (Exhibit 10) aiding operating margin. Our largecap coverage has also seen a ~150bp YoY drop (Exhibit 8) in sub-contracting expense, partially helped by higher share of offshore effort.
- Recent acquisitions (TCS – Postbank and Pramerica, Infosys – Rolls Royce and Daimler, and Wipro – Metro AG) suggests higher offshoring intensity and cost take out, indicating higher comfort with offshore delivery at large clients.
- Tier I margin for 3QFY21 (Exhibit 7), on the back of high utilization and offshore mix, stood at 24.1%, an increase of 90bp QoQ and 270bp YoY.

Expect mid-teen growth and rangebound margin for FY22E

- We continue to see Cloud migration, Digital transformation, and user experience as multi-year opportunities for Indian IT companies. These will be complimented by cost takeout deals as clients normalize their budgets to increase spending on Digital transformation. Led by robust order book and decent deal conversion, we expect mid-teens growth for the sector in FY22E.
- We expect margins to be rangebound as some cost pertaining to travel, normalization of utilizations, and wage hikes will now gradually return. However, this impact should be mostly offset by operating leverage due to higher growth and ongoing pyramid rationalization.
- Despite valuations running at the upper end of the historical range (Exhibit 14), we retain our attractive stance on the sector and continue to prefer INFO and HCLT as our preferred picks among Tier I and PSYS, LTTS, and MPHL among Tier II IT companies.

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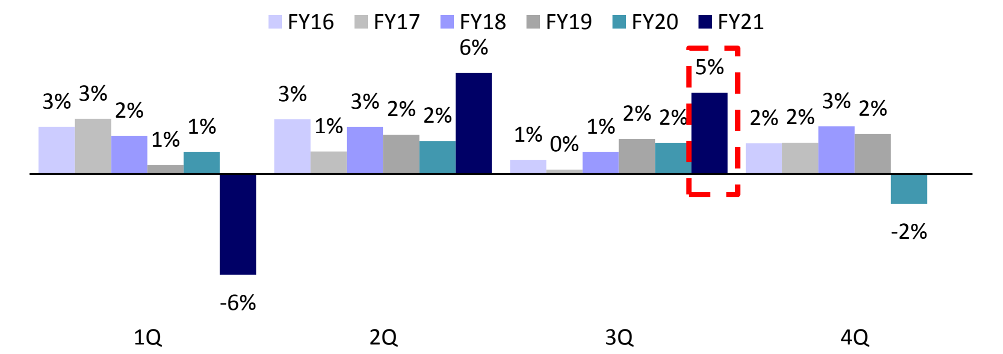
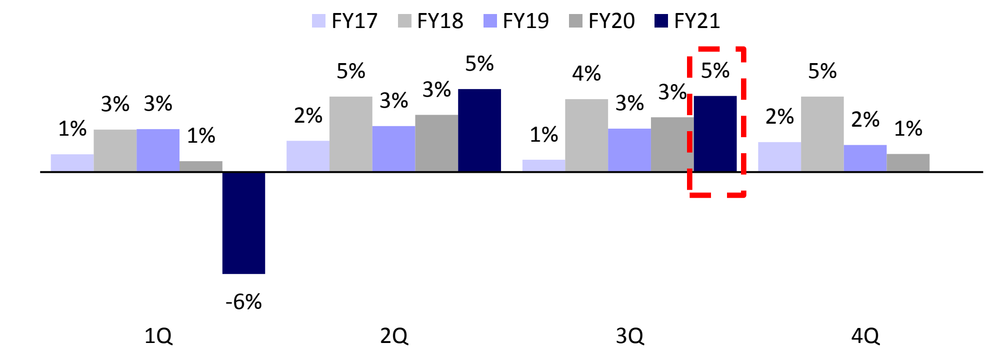
Exhibit 1: USD revenue growth for largecap IT (QoQ)



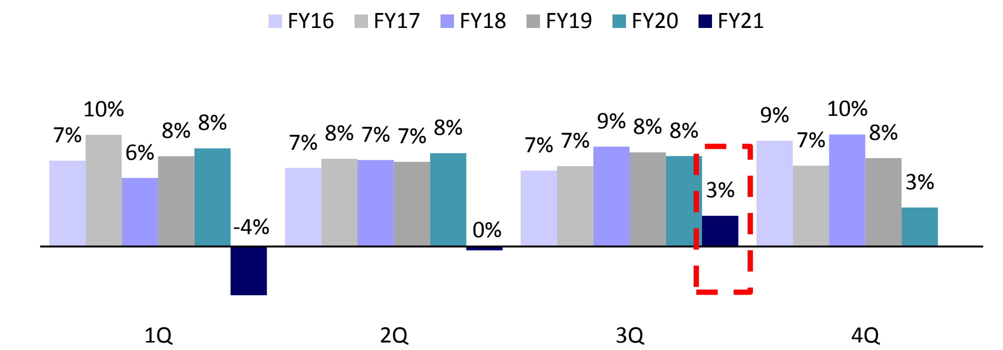
Source: Company, MOFSL

Exhibit 2: USD revenue growth for midcap IT (QoQ)



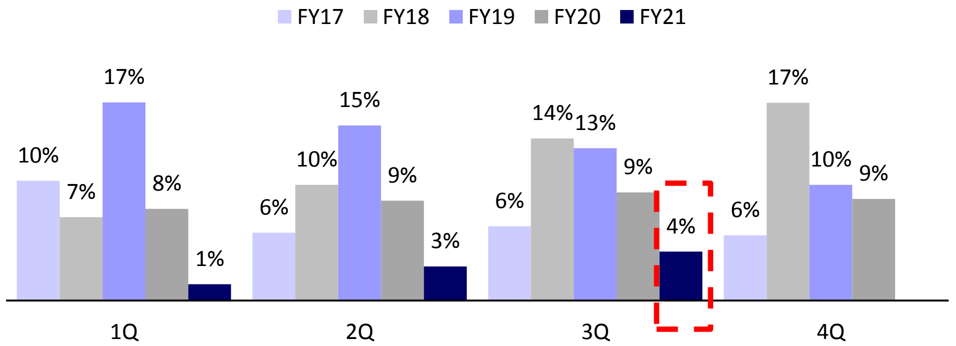
Note: Does not include ZENT. Source: Company, MOFSL

Exhibit 3: USD revenue growth for largecap IT (YoY)



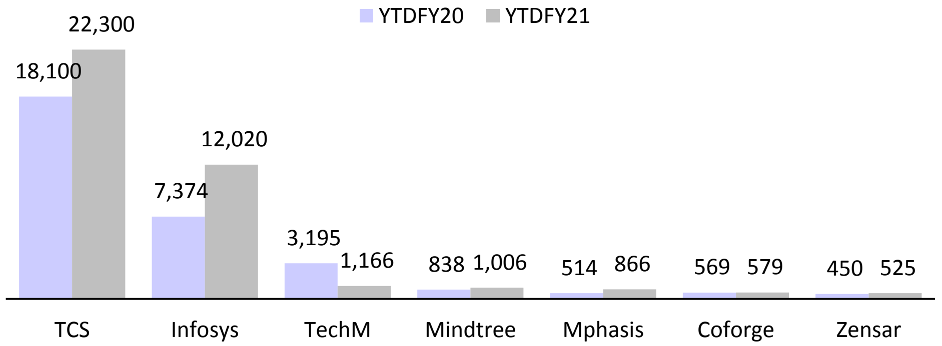
Source: Company, MOFSL

Exhibit 4: USD revenue growth midcap IT (YoY)



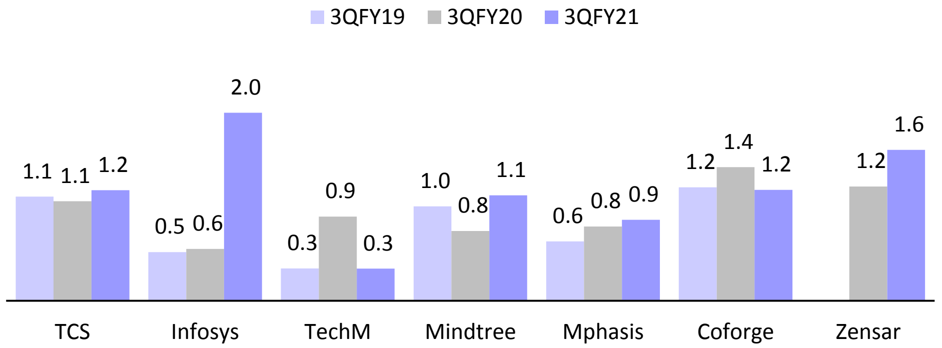
Note: Does not include ZENT. Source: Company, MOFSL

Exhibit 5: Deal wins (USD m) are higher than last year due to increased technology spends



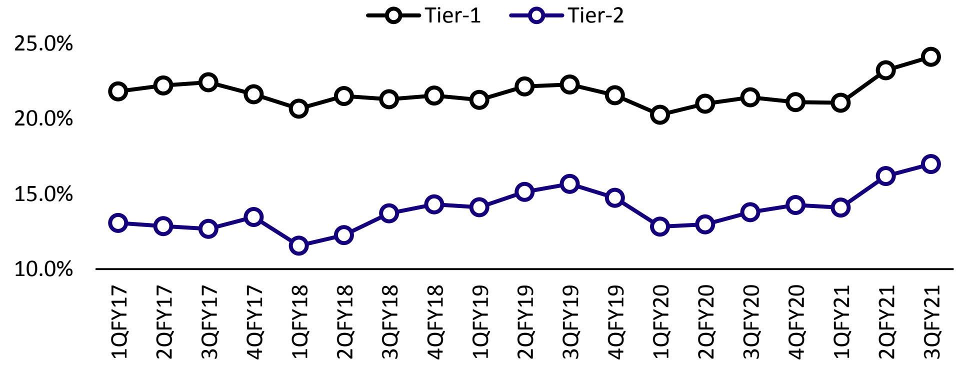
Source: Company, MOFSL

Exhibit 6: Book-to-bill ratio



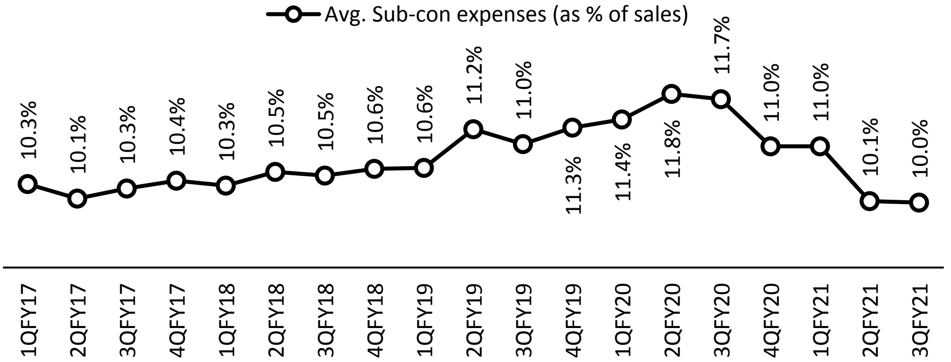
Note: FY19 not available for ZENT due to reclassification. Source: Company, MOFSL

Exhibit 7: EBIT margin expands on increased operational efficiencies and reduced costs



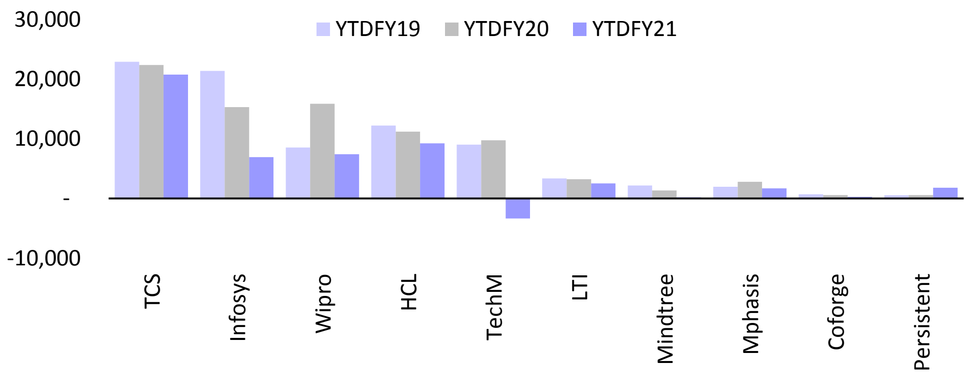
Source: Company, MOFSL

Exhibit 8: Subcontracting expenses fall as companies replace them with own employees…



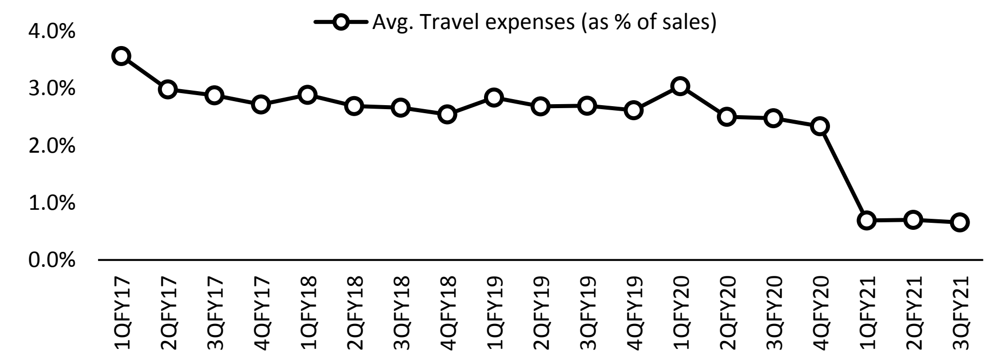
Note: Average of TCS, INFO, WPRO and TECHM. Source: Company, MOFSL

Exhibit 9: …leading to strong net additions despite the COVID-19 pandemic in most cases



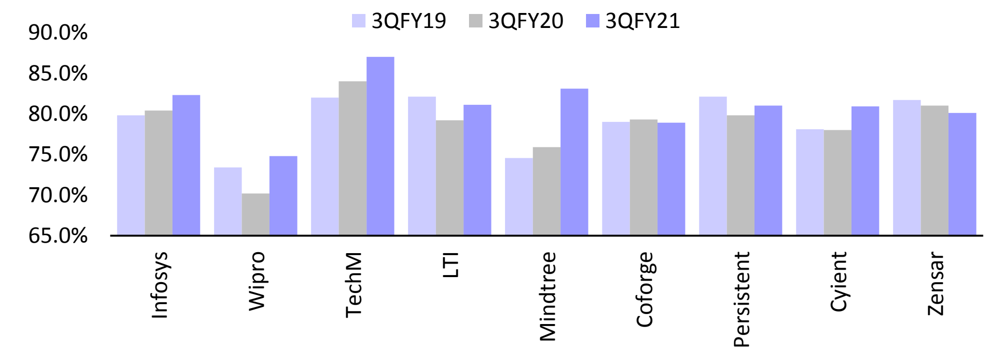
Source: Company, MOFSL

Exhibit 10: After a steep dip in travel expenses in 1QFY21, the levels stay largely the same



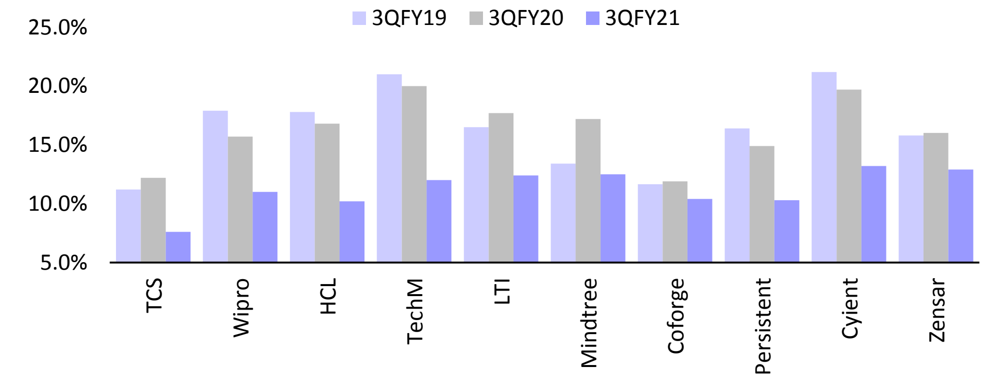
Note: Average of TCS, INFO and WPRO. Source: Company, MOFSL

Exhibit 11: Utilizations increase for most companies compared to previous years



Source: Company, MOFSL

Exhibit 12: Companies report lowest attrition levels compared to previous years



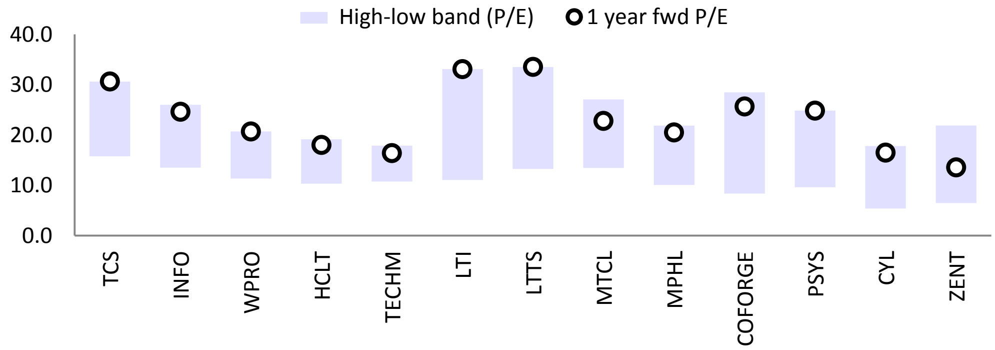
Source: Company, MOFSL

Exhibit 13: Upgrade/downgrade of our EPS estimates show sector's resilience despite COVID-related disruptions

Company	1Q		2Q		3Q	
	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
TCS	1%	NA	6%	NA	4%	6%
INFO	12%	NA	12%	NA	3%	7%
WPRO	6%	NA	2%	NA	15%	16%
HCLT	12%	NA	2%	NA	4%	7%
TECHM	17%	NA	-11%	NA	7%	10%
LTI	3%	NA	11%	NA	1%	2%
MTCL	13%	NA	3%	NA	10%	11%
MPHL	1%	NA	7%	NA	1%	0%
COFORGE	-1%	NA	3%	NA	6%	8%
PSYS	17%	NA	-4%	NA	9%	8%
CYL	25%	NA	8%	NA	14%	7%
ZENT	0%	NA	5%	NA	-2%	1%

Source: MOFSL

Exhibit 14: High-low v/s current P/E



Source: Bloomberg, MOFSL

Exhibit 15: Comparative valuation

Company	Rating	CMP (INR)	M-cap (INR b)	EPS (INR)			EPS CAGR (%)	Dividend yield (%)	P/E (x)			RoE (%)		
				FY21E	FY22E	FY23E	FY20-23E	FY21E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
INFO	Buy	1297	5500	46.3	56.9	67.2	20.4	2.7	28	22.8	19.3	29.6	34.8	39.2
HCLT	Buy	961	2600	48	56.5	65	16.9	1.9	20	17	14.8	23.6	24.6	25.9
MPHL	Buy	1637	305	65.1	79.5	91.8	13.3	2	25.1	20.6	17.8	20.1	22	22.7
LTTS	Buy	2622	275	64.3	91	109	12	0.7	40.7	28.8	24.1	22.7	27.3	27.4
PSYS	Buy	1775	132	56.5	70	81.9	22.5	0.9	31.4	25.4	21.7	17.4	19.4	19.8
CYL	Buy	634	70	33.2	43.7	47.3	11.9	1.5	19.1	14.5	13.4	13.6	16.1	15.6
TCS	Neutral	3216	11870	87.9	111.9	127	13.8	1.1	36.6	28.7	25.3	38.9	47.6	50.8
WPRO	Neutral	440	2400	18.5	21.6	23.9	13.4	4.2	23.8	20.3	18.4	19.5	23.2	25.8
TECHM	Neutral	977	944	52.6	60.4	68.6	12.4	1.9	18.6	16.2	14.2	19.9	20.1	20
LTI	Neutral	4004	699	107.3	128.2	151.1	20.4	0.9	37.3	31.2	26.5	31.3	30.6	29.7
MTCL	Neutral	1725	285	65.9	75.3	84.1	29.9	1.4	26.2	22.9	20.5	31.1	29.3	27.2
COFORGE	Neutral	2620	159	78.9	102.1	116.9	15.7	0.8	33.2	25.7	22.4	18.6	20.9	20.7
ZENT	Neutral	230	52	15.6	17.9	20.3	20.2	1.4	14.7	12.8	11.3	15.8	16.3	16.3

Source: MOFSL

Exhibit 16: Management commentaries on the demand environment

Company	Commentary
TCS	Due to the COVID-19 pandemic, earlier quarters had seen a large mix of smaller deals. As the recovery commences, the proportion of large deals has returned to previous levels. Enterprises seek to grow and improve efficiency through leveraging technology, which is driving IT spends. The strengthening of investments was observed in 2HCY20. Enterprises are leveraging new-gen technology to enter newer markets, gain new revenue streams, or enhance customer experience. They are using the Cloud to drive efficiency and productivity within the business. The addressable market for Cloud is huge, and a significant shift is expected in coming years.
INFO	The management is seeing demand come in from cost takeout deals. Large enterprises are looking to invest in Digital infrastructure. Its capabilities around Digital, Automation, and efficiency have become key. Going forward, growth should accrue from next generation services like Data, Cloud, and Security, while pressure would remain in legacy services. The health of the pipeline is extremely robust.
HCLT	The strong performance during 3QFY21 was led by Digital, Cloud, and the P&P business. The demand environment remains strong. Going forward, the pipeline remains strong and would accelerate. In the current environment, it is seeing deals around: 1) commerce modernization; 2) customer experience, and 3) supply chain modernization. Application modernization plays a significant role in the market as clients transform them to Cloud. The management sees better growth in the next five years than the preceding five years.
MPHL	The management stated that FY20 had been about the continuation and the resilience of the business, while FY21 is all about Digital transformation. The key industry drivers currently are: 1) Data driven organizations, 2) adoption of Cloud infrastructure, and 3) core business transformation. There is no pricing pressure currently and the management expects the pricing environment to remain stable, with an upward bias. The proactive deal environment is helping in better pricing. The movement in wallet share can be witnessed in the industry, with broad value migration coming in from India-centric providers. This is due to clients wanting an increase in the offshoring mix.
COFORGE	Order book stood at USD501m, an increase of 18% YoY. This offers strong revenue growth visibility for FY22. The company is currently chasing many large deals. Cloud and product engineering comprise three-fourth of all new deals coming to the market.
PSYS	The management sees a 3-5 year technology upcycle. It is confident of PSYS' ability to execute and ride this wave. The company has built strong partnerships, which is supporting its growth trajectory.
CYL	Comparing GFC to the COVID-19 pandemic, the management stated that in this recovery there was a greater focus on newer technologies and an increase in spends is expected going forward.

Source: Company, MOFSL

Exhibit 17: Management commentaries on verticals

Company	Commentary
INFO	Within BFSI, 1) Cloud, 2) Data services, and 3) Digital Banking remain the key growth drivers.
WPRO	While the management foresees a ramp-up in demand in the Oil and Gas sector, Healthcare was driven by seasonality.
HCLT	Deals in verticals like Manufacturing and Retail have returned, and clients in BFSI, Grocery, Telecom, etc. are now making golden bets.
TECHM	The Communications segment saw temporary postponements. However, the management expects strong growth in deals wins and deals to ramp up.
LTI	The BFSI vertical posted a revenue growth of 8.4% QoQ (USD), with continued growth in its top client. This is on the back of investments in core infrastructure to make it data driven. Manufacturing also reported strong growth during 3QFY21. Pass-through revenue in the segment remain similar to those in 2QFY21. Despite a large win in Energy and Utilities, the segment remained flat sequentially, and the management remains cautious on this vertical.
MTCL	Among the verticals, Travel is still some quarters away from a full recovery. It has reached bottom levels and would only grow from here on.
COFORGE	Within Travel, a meaningful pickup is expected post Nov-Dec'21 when volumes for Airlines are expected to pick up. The company has gained a lot of wallet share in Travel, which has diluted the negative impact in the vertical. BFS continues to perform well. The company has a good pipeline in BFS, which should help maintain the growth momentum in this vertical.
PSYS	The BFS segment was soft due to ramp down in large customers, coupled with the seasonality factor. However, the management stated that this was temporary, given that a number of clients are working on modernizations and ample work related to compliance and security is cropping up.
CYL	Aerospace and Defense are still lagging. However, traction has picked up in the sector and spends should start coming in now. The management continues to see momentum in Communications. It stated that Transportation was soft due to end of a project and expects some pain in the vertical over the next few quarters.
ZENT	3QFY21 was good for the Insurance vertical – a couple of deals were closed. Legacy to Cloud is becoming a big theme in this space, and ZENT's capability in Digital foundation is helping with this. It would lead to a growth revival in this vertical.

Source: Company, MOFSL

Exhibit 18: Management commentaries on margin

Company	Commentary
TCS	Going forward, operational efficiency arising from utilization and productivity levels would be closely monitored. Any opportunity for improvement would be worked on to help sustain the current margin levels.
INFO	Efficiencies kicked in as a result of the management deploying strategic cost levers around offshore mix, pyramid rationalization, and automation. Margin guidance to 24-24.5% (v/s 23-24% earlier). The management expects some cost to return as travel resumes and the situation normalizes. A normalization in utilizations can also be expected.
WPRO	Margin momentum was seen on the back of three levers: 1) revenue momentum, 2) significant offshoring, and 3) utilization management within a tight range. The management expects some normalization in margin as the company plans to invest in its sales team. However, some operational efficiency benefits are expected to continue.
HCLT	The management expects margin in 4QFY21 to face a headwind of 80bp on account of salary increments. Going forward, higher offshoring would result in margin tailwinds. However, this would be offset by travel resuming and the company's investments in sales and marketing.
TECHM	The management expects some pressure on margin as costs return, but is confident that operational efficiency would be enough to compensate for this. It is confident of sustaining margin in 4QFY21 and has guided at a 14-15% margin band for FY22.
LTI	As the company doles out wage hikes in 4QFY21 (6-7% for offshore and 2% for on-site), margin is expected to be impacted by 160bp. Decline in utilization is expected to have some impact in 4QFY21. The management said it would continue to invest in the business (sales and marketing) to boost growth. Despite this, it reiterated its PAT margin guidance of 14-15%.
MTCL	The management intends to invest in growth in the coming quarters, which would be a headwind to margin. The company expects wage hikes to impact margin in the next quarter (-250bp). Despite this, the management is confident of sustaining margin over 20% on a sequential basis.
MPHL	The company has increased investments across the board. Investments in sales and marketing and in building competencies have increased. There is an upward bias to margin due to improving offshore mix and utilizations, but these would be offset by increasing investments to drive growth. The management has guided it would be able to maintain its EBIT margin in the current range with an upward bias. For FY22, it would set a new margin band.
COFORGE	Margin is expected to remain range bound as COFORGE needs to hire more people. There is a talent crunch in the market for highly skilled employees, therefore supply would only come at higher salaries.
PSYS	The management alluded that it still has efficiency levers in place to aid further margin expansion going forward. Moreover, the management is constantly working on optimizing the IP months.
CYL	Margin in FY21 is expected to be better than FY20 (50-100bp) and 4Q would see a 100-200bp improvement in margin. Dilution in margin because of DLM is expected to be minimal.
ZENT	The company started with 100 associates for the 'Work from Anywhere' program, which has now increased to 550. This has had a massive positive impact on margin. The company intends to make certain investments. With wage hikes, margin is likely to be pressured. However, they would remain in a narrow range. The management alluded that the current margin profile is not sustainable going forward.

Source: Company, MOFSL

Exhibit 19: Commentary on IT spends by global Banks

Company	Commentary
JP Morgan	Technology represents roughly half of overall investment spends. These tech investments are across the board as the management looks to better meet customer and client needs, improve customers' digital experience, strengthen fraud detection capabilities, as well as modernize and improve its technology infrastructure, Cloud, and Data capabilities.
Goldman Sachs	The management expects its tech budget to continue to grow by several USD100m YoY. It will do so for two reasons: a) continued improvement at the core, and b) focus on particular initiatives, like transaction banking, consumer business, and so forth.
BoFA	The management is investing USD3.5b on technology next year.

Source: Company, MOFSL

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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