Equity Research
May 19, 2021
BSE Sensex: 50193

ICICI Securities Limited is the author and distributor of this report

Sector update

Reco Snapshot

	Reco	TP (Rs)	Upside
TCS	HOLD	3,230	5%
Infosys	BUY	1,600	19%
Wipro	SELL	365	-28%
HCLT	ADD	1,050	13%
TechM	HOLD	1,000	3%
Mphasis	ADD	1,910	8%
Persistent	REDUCE	2,050	-12%
LTI	BUY	4,705	29%
Mindtree	HOLD	2,173	4%
Coforge	REDUCE	2,950	-14%
LTTS	SELL	2,000	-24%
Cyient	BUY	925	15%

RV Snapshot

	EPS (x)		P/E (x)	
	FY22E	FY22E	FY22E	FY23E
TCS	105	109	29	28
Infosys	52	58	26	23
Wipro	20	22	26	23
HCLT	49	55	19	17
TechM	61	65	16	15
Mphasis	75	83	23	21
Persistent	83	94	28	25
LTI	119	145	31	25
Mindtree	73	86	29	24
Coforge	101	110	34	31
LTTS	75	88	35	30
Cyient	47	55	17	15

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INDIA

ICICI Securities

Technology

A wake up call against unrealistic expectations!

Our anti-consensus sector stance that steady state growth/margins are unlikely to be higher vs pre-covid (Link, Link, Link) echoed in Q4FY21 performance/outlook. As consensus rationalised lofty expectations to an extent, sector witnessed downgrades - notwithstanding the sharp INR depreciation. Despite the continued euphoria, incremental cloud sales at hyper-scalars remained range bound. The sector continued reporting strong deal wins. However, this metric per se is noticed to be incomplete with no strong causal relationship on future growth. In FY21, BFS / Healthcare witnessed 'reactive' (to covid crisis) spends. (1) Rebalancing of these spends in FY22 and (2) geographic de-risking by clients pose key risks to outlook. (1) Resumption of office/marketing events onsite, (2) increase in onsite effort, (3) employee absenteeism in India, (4) catch-up investments and (5) acquisitions should translate into largely pre-covid (or lower) margins. Multiples remain significantly higher (NIFTY IT: +41%, vs pre-covid averages) on absolute and even relative basis (NIFTY: +19%, BANK NIFTY: -8%, NIFTY FMCG: +3% and NIFTY Pharma: +24%). More overheated in case of mid-cap IT. Valuation premia are still banking on 'post covid growth acceleration (g)' expectations implying further scope for disappointments. Rising rates (r) should pose additional risk to multiples as (r-g) spreads widen. We maintain our anti-consensus cautious stance on sector.

- **Mar-21 a wake-up call against unrealistic expectations.** Robust 'recovery' over H2CY20 from the covid dip has often been extrapolated as long-term 'growth' by the street. In absence of proportionate strength in the lead indicators, we have been cautioning against such extrapolation (**Link**, **Link**, **Link**).

  Mar-21 results are a wake-up call in this regard. Adjusted for a bit of a base shift, organic growth of most companies reverted to their long-term March averages (See 'Narrative in Charts'). Aggregate revenue of tier-I IT in most verticals (e.g. retail, manufacturing) is more or less at pre-covid levels (Dec-19). Notable exceptions being BFSI (+11%) and Healthcare (+17%) – which can be largely attributed to ad-hoc covid reactive spends (e.g. contact tracing apps, pay check apps etc.).

- **Softer-than-expected outlook in most cases.** In FY21, majority of companies either reported revenue decline or low growth. Given the favourable base, good deal booking and captive takeovers many companies reported through FY21, double digit / mid-teen growth for FY22 became a base case expectation. Even with this anticipation, it should be noted, the normalised CAGR over FY20-22E would be in mid / high single digits – lower or at par with pre-covid growth rates.

  Explicitly or subtly, the sector toned down the growth outlook (vs a quarter ago) with the exception of a few firms (e.g. WPRO, LTI, Mindtree, Coforge). In addition, a disappointing March growth run-rate further reinforces our argument that steady state growth (FY23 and beyond) is unlikely to be higher than pre-covid levels. As consensus rationalised lofty expectations to some extent, the sector witnessed earnings downgrades despite a strong tailwind from the exchange rate reset (from 73 to 76).

  Optimists on the sector seem to be taking comfort from the strong deal wins reported during Mar-20. However, going by the previous trends (See 'Narrative in Charts'), this headline metric in itself doesn't appear to be a very credible lead indicator for revenue growth. Without further granularity on the (1) mix of new – renewals – restructured deals, (2) duration of execution and (3) extent of roll off in the portfolio of deals under execution, this metric is incomplete, in our view. Knowledge of large deal ramp up can, at best, help in predicting a potential near-term spike in revenue.

Rebalancing of the ad-hoc covid reactive budgets in verticals like BFSI (e.g. pay check protection apps) and Healthcare (e.g. contact tracing apps) pose a key risk to FY22 growth outlook. Mar-21 tech spends and commentary of global banks (See 'Narrative in Charts') hint at stabilisation pattern (in $ budgets) implying an overhang on % growth.

Secondly, the outlook of many IT companies came out before covid 2nd wave became a wide-scale humanitarian crisis in India. The disturbing magnitude of the pandemic can translate into non-negligible employee absenteeism. While the rapidly evolving nature of the pandemic makes it difficult to quantify, any geographic de-risking by clients to other offshore delivery destinations (e.g. Philippines, Poland) may pose risks to the current outlook. Prima facie, companies with higher T&M share may see bigger impact.

Barring companies which gave very weak / conservative guidance (HCLT/ Infosys), we see limited scope for guidance upgrades through FY22.

- **Margins likely to revert to pre covid (or lower) level.** Sustainably higher profitability on the back of covid-led tailwinds (e.g. WFH, offshorisation etc.) has been a key expectation of the street for some time. We have always argued (Link) these tailwinds are transient in nature and are unlikely to outlive the pandemic. Even if they do, we expected, their impact will be more or less blunted as clients renegotiate aspects like pricing / quality of deliverables etc. in the new normal. Margin outlook of most companies for FY22 corroborated our arguments on industry profitability.

  In some cases (e.g. HCLT, LTI), margin outlook was a bigger disappointment as it was lower than even pre-covid levels. Given the covid situation in India, resumption of office and overseas travel may at least be a couple of quarters away. However, in core markets like US/UK which are progressing well on vaccination front, the situation is relatively rosy. For fully vaccinated people, it should be noted that US CDC recently dropped the advisory related to wearing masks/social distancing.

  Hence, it is not unreasonable to expect resumption of office/marketing events in these geographies in the near term. Secondly, over the previous ~16 months, new project ramp ups have been happening virtually and largely offshore. This is a deviation from the standard practice of higher onsite effort demanded by the clients in the ramp-up phase. This trend can now reverse with developed economies completely opening up. Consequent rise in share of onsite effort, employee absenteeism in India, catch-up investments and acquisitions will likely translate into pre-covid (or lower) margins.

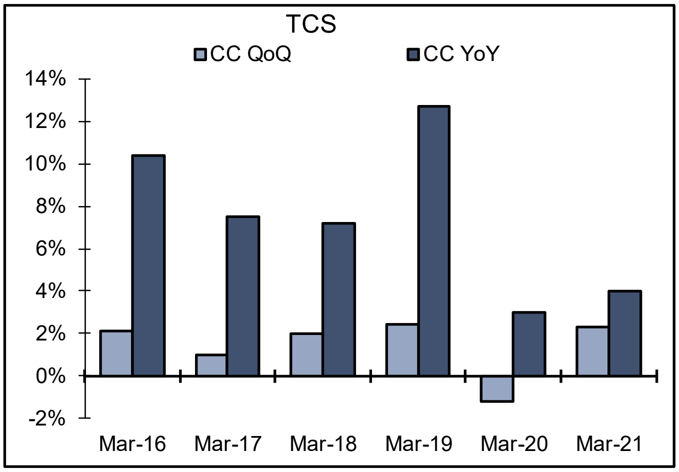
- **Valuation premia for what?!** While valuations have come off the peaks, multiples still remain significantly higher vs long term averages. Across the mainstream sectors, IT witnessed the highest re-rating post Covid. For instance, NIFTY, NIFTY FMCG and NIFTY Pharma are now trading at 19%/3%/24% premium to pre Covid averages, while BANK NIFTY is trading at 8% discount. On the other hand, NIFTY IT is trading at 41% premium without any change in growth / profitability profiles of the sector. At stock level, some large caps / mid-caps are trading up to 65%/130% higher than pre Covid levels.

  The euphoria is more pronounced in multiples of mid-caps. As per many credible indicators, mid-cap IT valuations look overheated and ripe for a correction. Mid-cap IT universe is now trading at 20% premium to NIFTY IT and on par with TCS which is unsustainable going by historical precedent (See 'Narrative in Charts' section).

  Valuation premia still seems to be banking on 'post covid long term growth acceleration (g)' expectations implying further scope for disappointments. Rising rates (r) should pose additional risk to multiples as (r-g) spreads widen. In this context, we maintain our anti-consensus cautious stance on the sector.

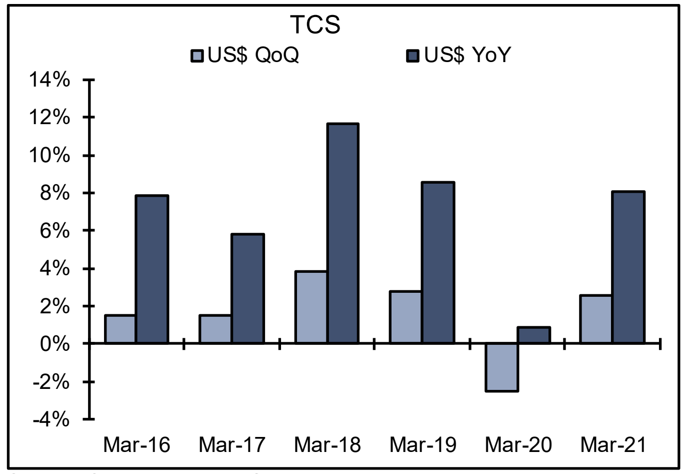
Narrative in Charts

Chart 1: Mar-21 organic growth of TCS was largely



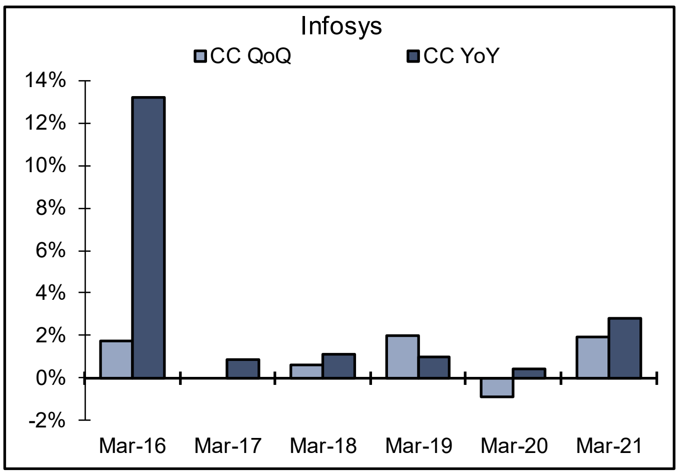
Source: Company data, I-Sec research.

Chart 2: …in line with a typical March quarter



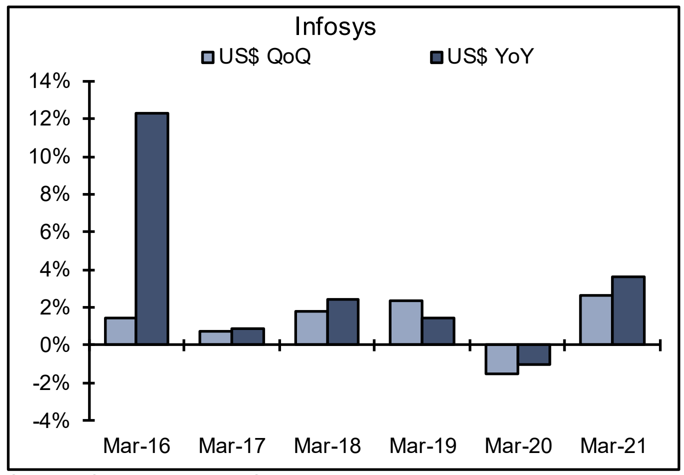
Source: Company data, I-Sec research.

Chart 3: Mar-21 growth of Infosys was largely…



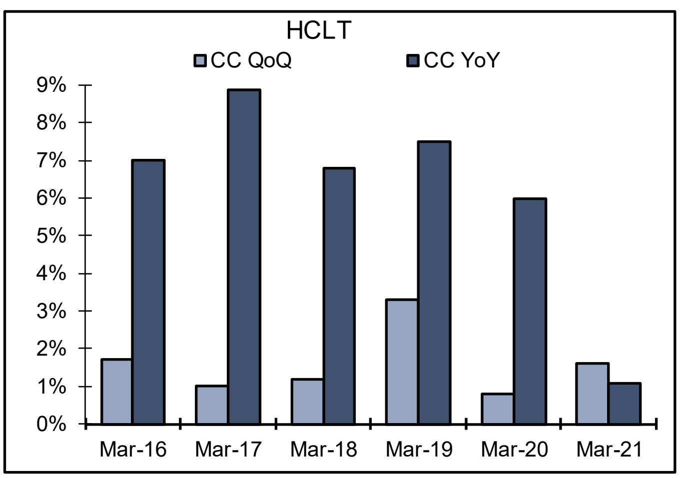
Source: Company data, I-Sec research

Chart 4: …in line with a typical March quarter



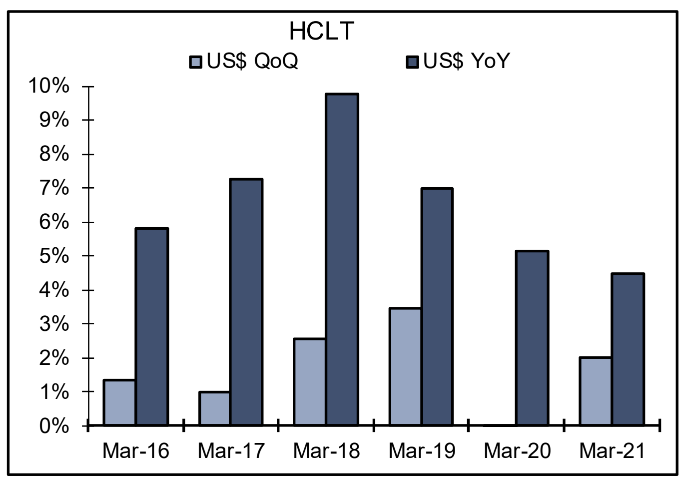
Source: Company data, I-Sec research

Chart 5: Mar-21 organic growth of HCLT was…



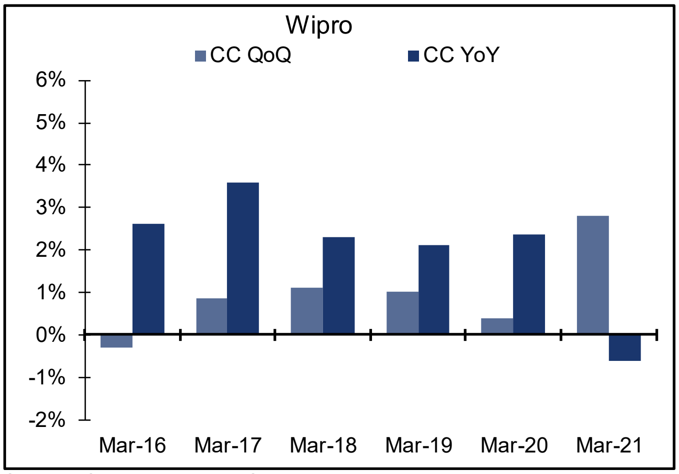
Source: Company data, I-Sec research

Chart 6: …weaker than in previous march quarters



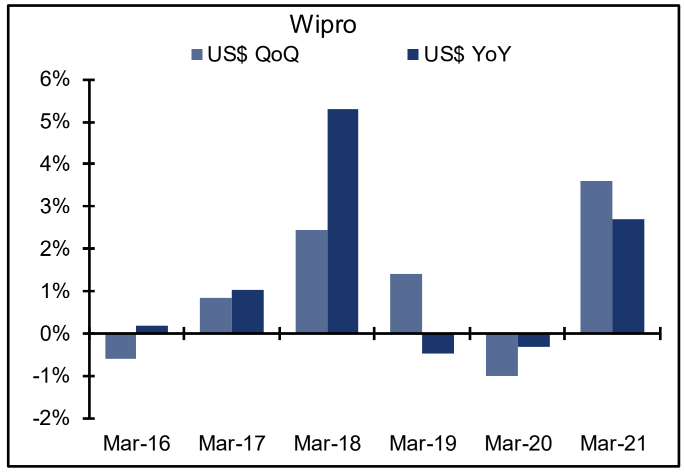
Source: Company data, I-Sec research

Chart 7: Mar-21 organic growth (YoY) of Wipro was



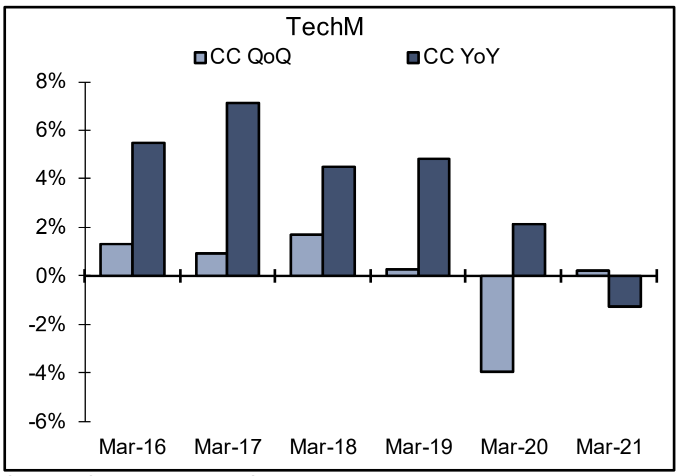
Source: Company data, I-Sec research

Chart 8: …weaker than in previous march quarters



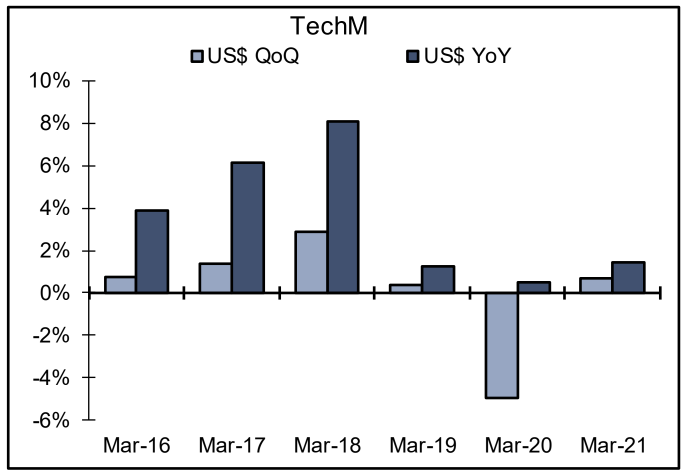
Source: Company data, I-Sec research

Chart 9: Mar-21 organic growth of TechM was…



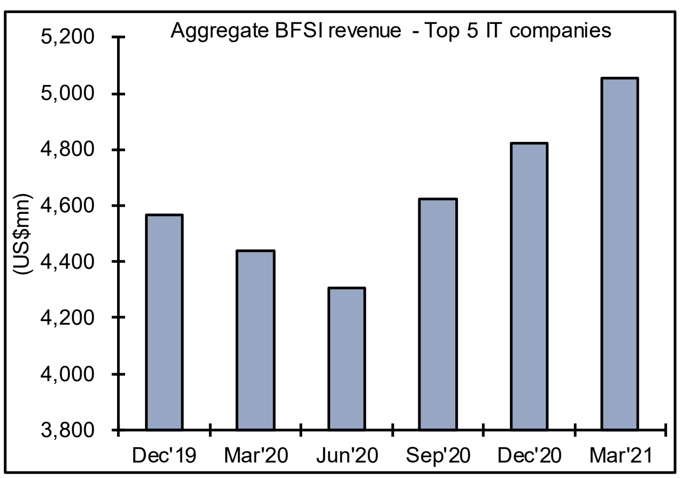
Source: Company data, I-Sec research

Chart 10: weaker than in previous March quarters



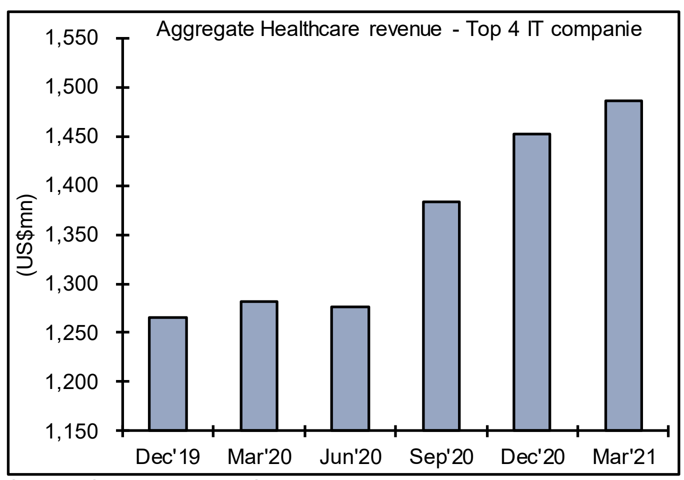
Source: Company data, I-Sec research

Chart 11: Only in BFSI and Healthcare, revenue



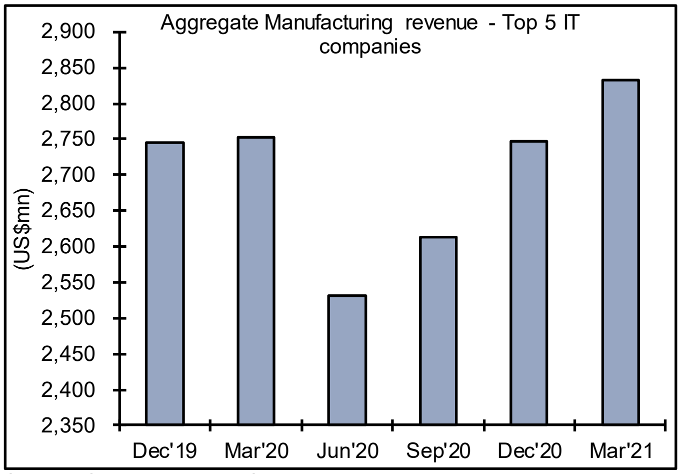
Source: Company data, I-Sec research.

Chart 12: run-rate was higher v/s pre Covid levels



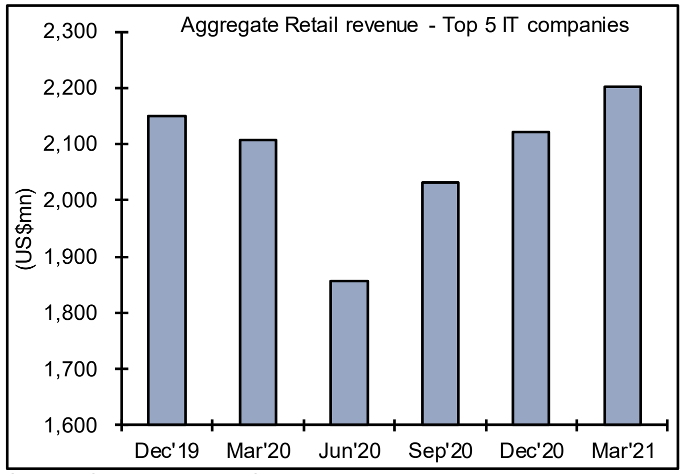
Source: Company data, I-Sec research.

Chart 13: In other verticals, revenue run-rate is…



Source: Company data, I-Sec research.

Chart 14: still close to pre Covid levels



Source: Company data, I-Sec research.

Chart 15: Post Covid incremental sales don't hint

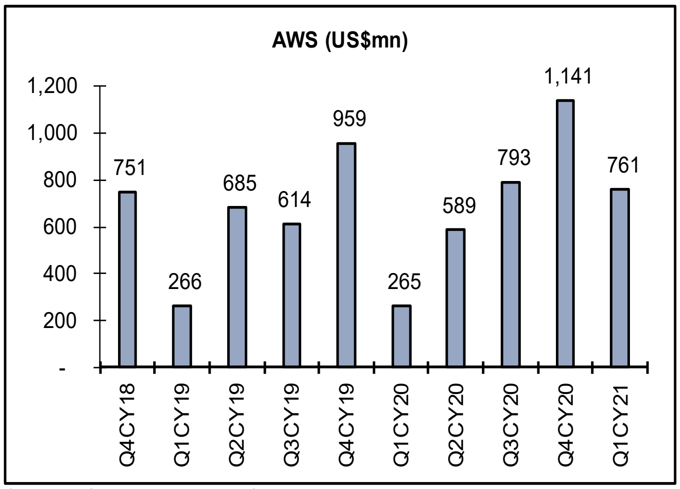
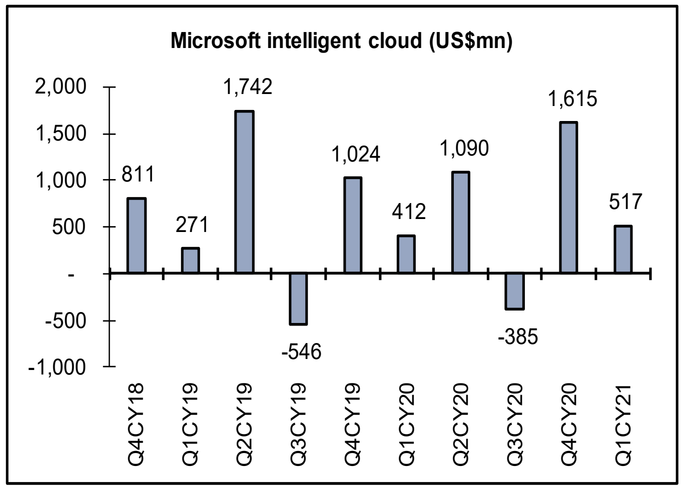
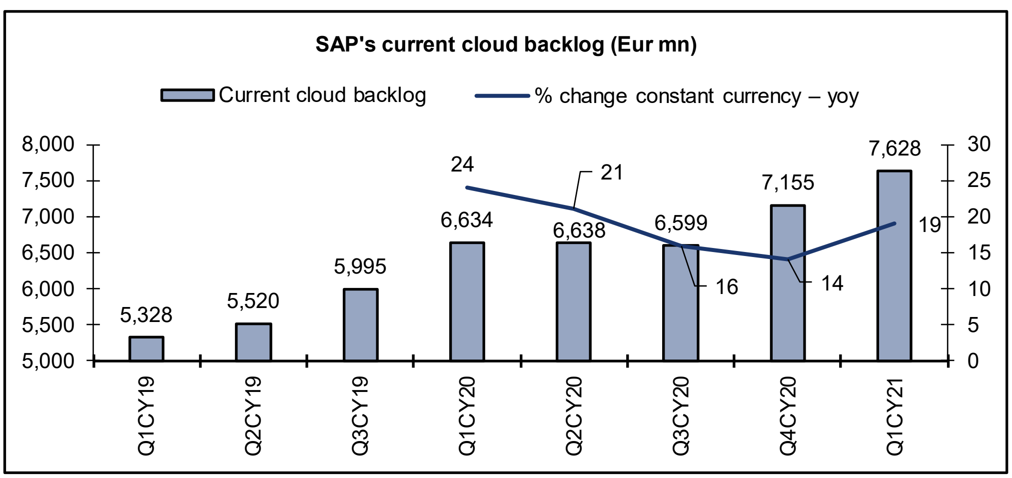


Chart 16: ..at major acceleration in cloud adoption



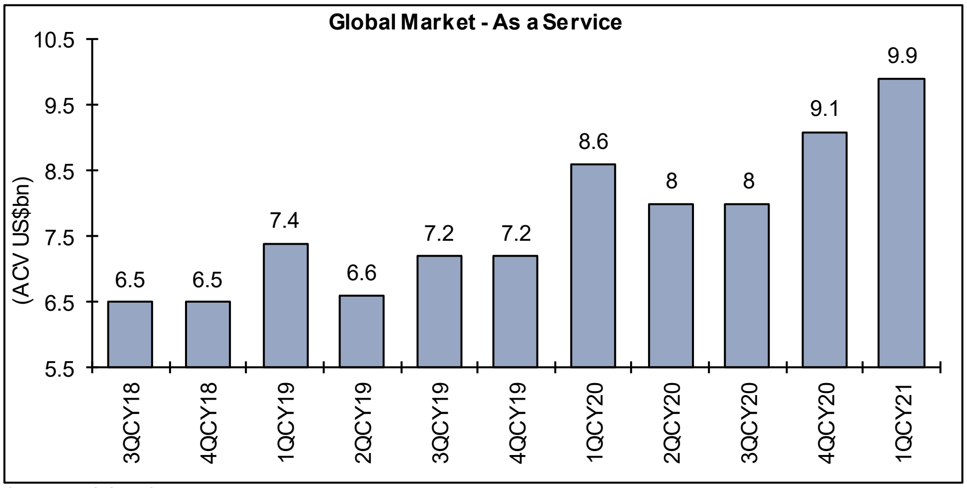
Source: Company data, I-Sec Research

Chart 17: On a low base, SAP cloud backlog too is range bound



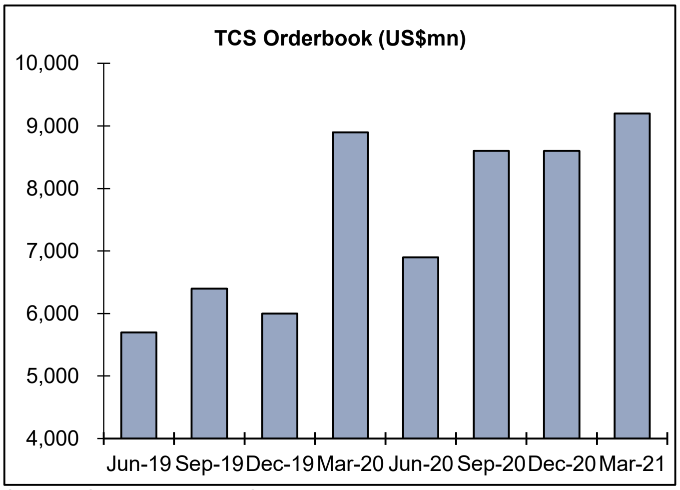
Source: Company Data, I-Sec research

Chart 18: As-a-service ACV too did not show any major spurt post covid



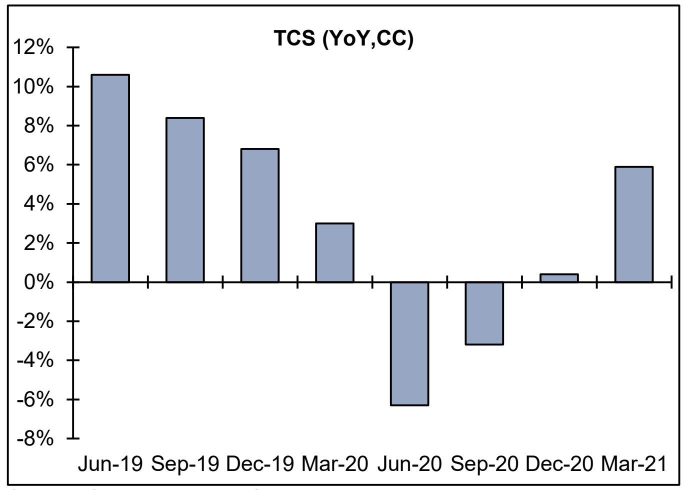
Source: ISG, I-Sec research

Chart 19: Causality between order booking and



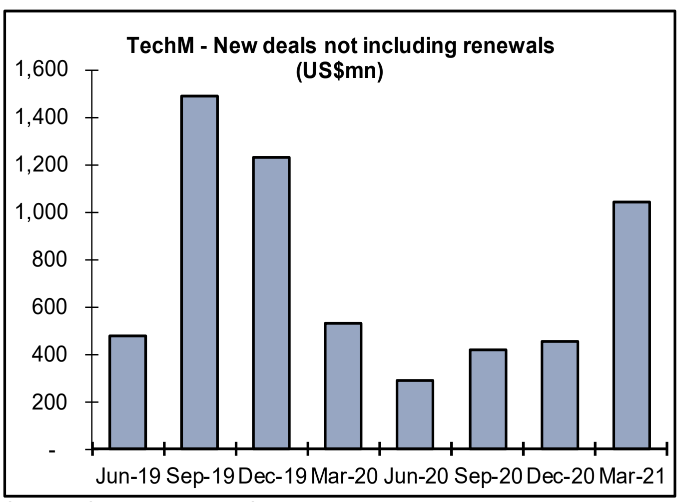
Source: Company data, I-Sec research.

Chart 20: …subsequent period growth is limited



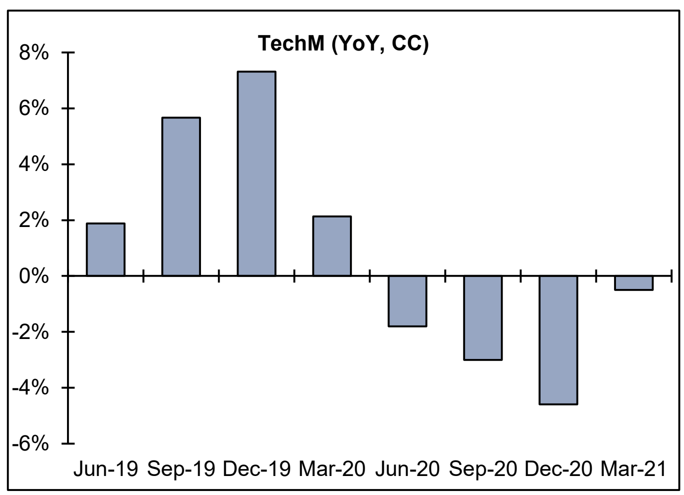
Source: Company data, I-Sec research.

Chart 21: Causality between order booking and…



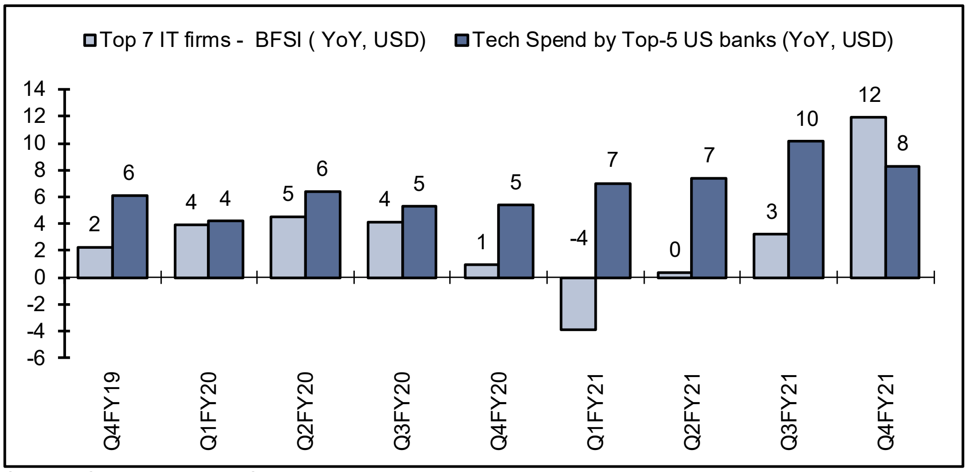
Source: Company data, I-Sec research

Chart 22: subsequent period growth is limited



Source: Company data, I-Sec research

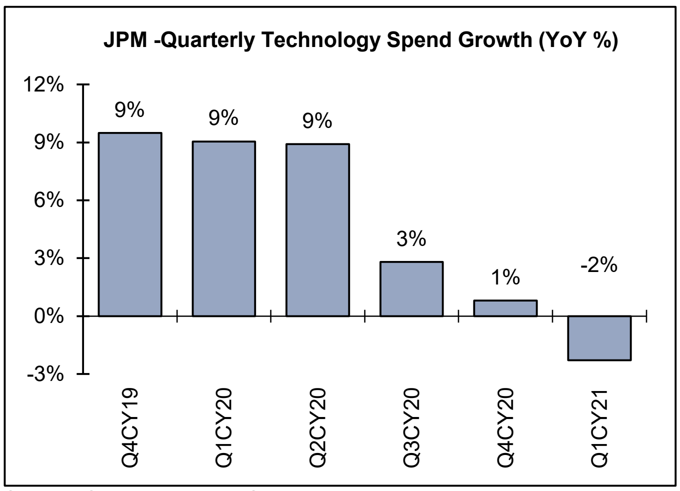
Chart 23: Tech spends at Top-5 US banks is on a stabilizing trend



Source: Company data, I-Sec research

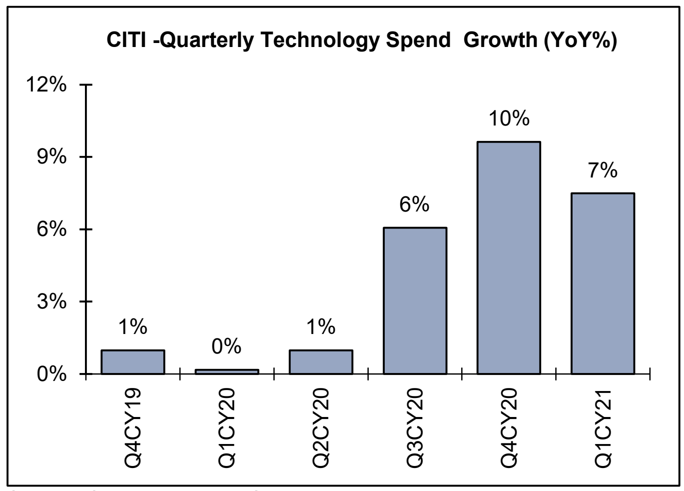
Note: Top-5 US banks' sample = JPM, Citi, BofA, Morgan Stanley and US Bancorp. Top-7 IT companies' sample = Accenture, TCS, Cognizant, Infosys, Wipro, HCL Tech and Tech Mahindra

Chart 24: Tech spends at top BFSI firms is on…



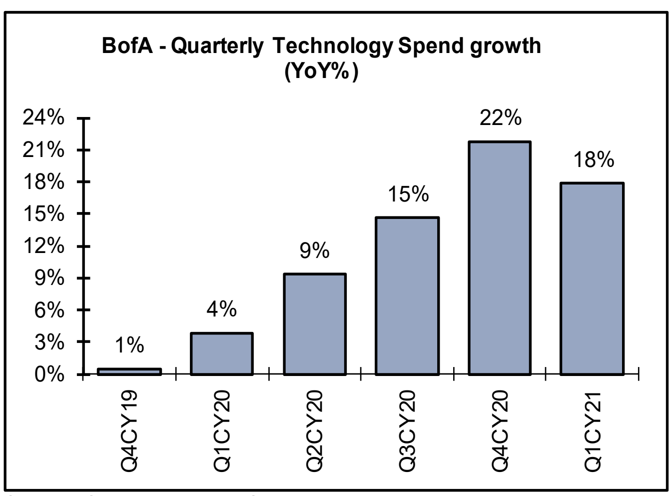
Source: Company data, I-Sec research.

Chart 25: … a stabilizing trend



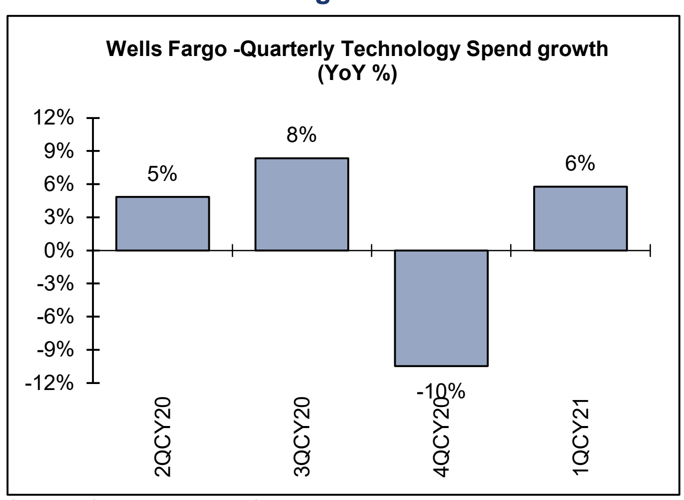
Source: Company data, I-Sec research.

Chart 26: Tech spends at top BFSI firms is on…



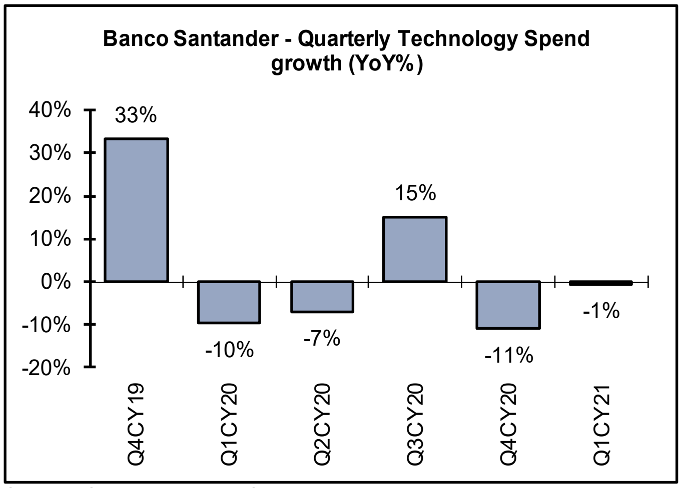
Source: Company data, I-Sec research

Chart 27: … a stabilizing trend



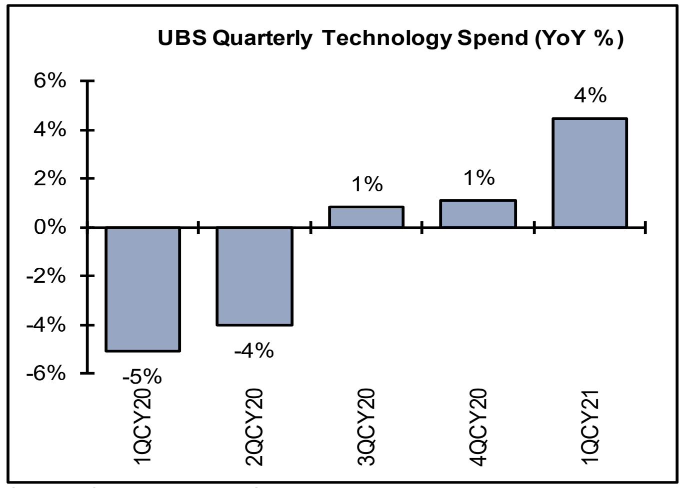
Source: Company data, I-Sec research.

Chart 28: Tech spends at top BFSI firms is on…



Source: Company data, I-Sec research.

Chart 29: …a stabilizing trend



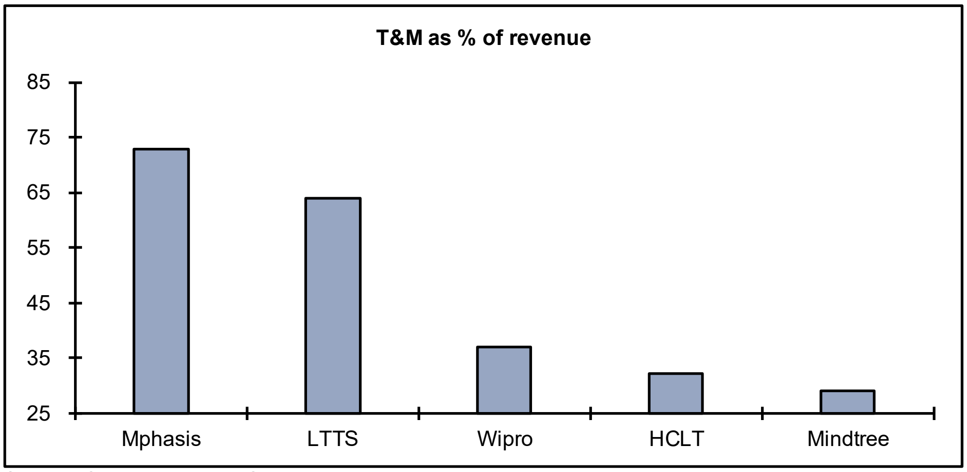
Source: Company data, I-Sec research.

Commentary of global banks is largely stable and does not hint at any major rise in spends

Name	Comments
Wells Fargo	• Technology, telecommunications and equipment expense grew 6% YoY in Q1CY21. On the consumer banking side, the company is accelerating investments in digital with a particular focus on delivering a simple, easy-to-use, best-in-class customer experience for the most-used mobile app features. • On consumer banking and lending, the company's physical presence will continue to be an important asset but digital capabilities will become an ever more important complement in the business model.
Morgan Stanley	• Information processing and communications expenses increased 5% YoY in 1QCY21. • The company is looking at data analytics and scoring models. It is making investments in the engine that will help match the FA to the client based on specific needs.
U.S. Bancorp	• Technology and communications expenses increased 22% YoY in Q1CY21. The strong increase is primarily due to capital expenditures supporting business growth and the impact of increased call center volumes. • Digital transactions now account for nearly 80% of all transactions. More than 60% of loan sales now occur digitally, which compares to less than 40% a year ago. • Continue to adopt new technologies in banking. Invested in the new Akoya Data Access Network and became the first bank to integrate with the company, giving our customers a more secure way to link their data with their favorite third-party apps, as well as more control over their data. In 2020, customers engaged with US Bancorp digitally nine times more than in person. By the end of 2020, more than 77% of transactions and more than half of loan applications were completed digitally. In addition, Paycheck Protection Program digital application was built from an existing all-digital small business lending platform
JP Morgan	• Technology, telecommunications and equipment expenses declined 2% YoY in Q1CY21. On newer business apps, the company is adding a broad set of capabilities across the full spectrum. Personalisation of apps, global wallets within the payment systems are some of the impending changes on the fintech part. • On lending side, the company is building new data centers. It is building new agile. It is going into the cloud. It doesn't really change that much over time. The company's investments will probably go up over time, not go down, since it sees plenty of organic growth opportunities to be invested in. • Banks need to invest in cloud to remain competitive. • Competition coming from fintech and big-tech. Banks already compete against a large and powerful shadow banking system. And they are facing extensive competition from Silicon Valley, both in the form of fintechs and Big Tech companies (Amazon, Apple, Facebook, Google and now Walmart), that is here to stay. • As the importance of cloud, AI and digital platforms grows, this competition will become even more formidable. As a result, banks are playing an increasingly smaller role in the financial system. • AI, cloud and digital are transforming the way banks do business.
Citi	• Tech spend growth healthy at 7% YoY. • Citi continues to make investments to enhance its digital capabilities across the franchise, including digital platforms, mobile and cloud based solutions. • Back in 2012, Citi streamlined consumer business and embraced the shift to digital. The company re-established Citi as a go-to bank for our institutional clients through our global network.
BOFA	• The company's investments in digital client interfaces across client groups allowed it to maintain a close relationship with clients, as they moved seamlessly to digital check deposits, payments, banking and investing. • The company's modern infrastructure and simplified operations underscore the importance of smart investments. BoFA continues to invest approximately USD 3 billion in technology - especially in digital, mobile and online platforms.
DB	• To be able to respond to market developments and client needs faster and more flexibly, the bank has decided to migrate in scope applications to the public Cloud through a strategic partnership with Google Cloud. This partnership with Google is a major milestone in the Banks' digital journey and shows a commitment to embrace new technologies such as Cloud. • On the cost side, digitization offers our divisions an opportunity for significant efficiency gains. By investing in digital applications such as digital client self-boarding, front-to-back processes can be automated and the productivity increased. • Development of strong data capabilities should enhance DB's ability to make accurate predictions about client and market behaviour, reducing fraud and pricing products more efficiently, while complying with regulatory obligations.
Barclays	• Driving technology and digital innovation - Barclays continues to invest in digital capabilities, upgrading its systems, moving to cloud technology and implementing rapid automation of manual processes. This allows Barclays to deliver a more personalized digital experience, reduce cost and create additional capacity to support more clients.
Banco Santander	• IT costs declined by 1% YoY in 1QCY21 respectively The bank continues to invest in digital channels and that is strengthening its value proposition with new products and services. • The banking sector has become highly competitive due to new entrants in the digital sphere (including the so-called Big Techs). The company is certain that swift reactions and the implementation of its action plans will place it at the forefront of change. • The bank is investing in growth opportunities that advance its digitalization, collaborating with or acquiring smaller, highly specialized fintechs. Its investments in Ebury and Mercury, coupled with the acquisition of technology-based assets from Wirecard, will fast track the growth of its world-class payment platform. • Medium-term goal of Banco Santander on technology front is to enable > 50% of its sales in digital channel.
Royal Bank of Canada	• The pandemic has accelerated digital adoption, changing consumer behaviour and how organizations create value • Leveraging data and our trusted brand, RBC will use data analytics and digital platforms to understand and meet clients' needs, and deliver new and differentiated solutions. • RBC's Capital Markets AI-based electronic trading platform, Aiden™, executes trades based on live market data, and dynamically adjusts to new information and learnings from each of its previous actions.

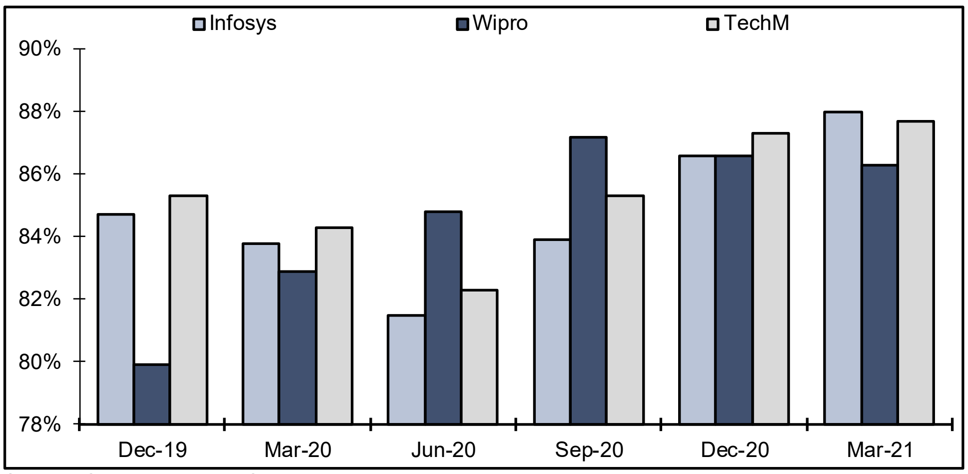
Source: Company Data, I-Sec Research

Chart 30: Employee absenteeism should have higher impact in T&M projects



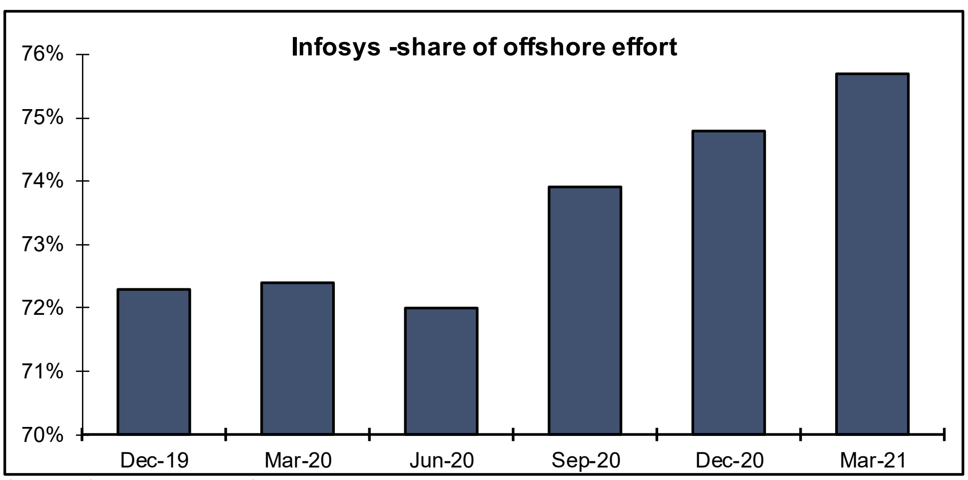
Source: Company data, I-Sec research.

Chart 31: Utilisations are closer to the peak and should mean revert



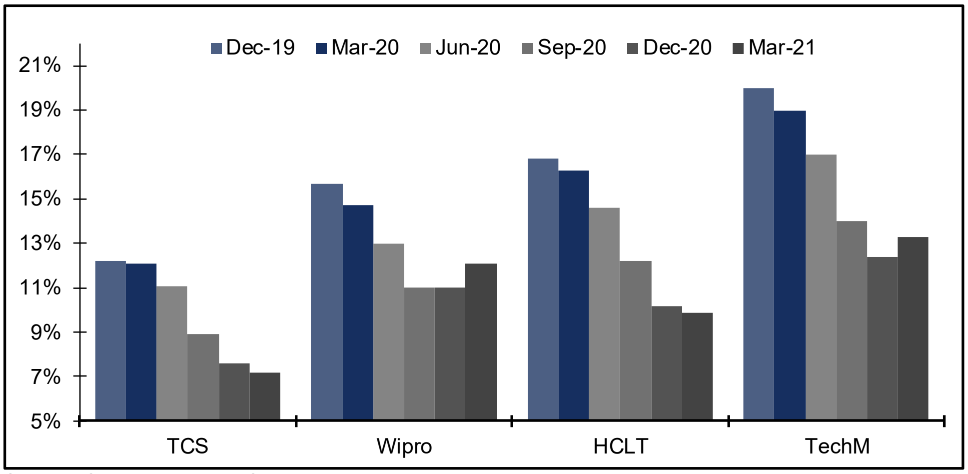
Source: Company data, I-Sec research.

Chart 32: Offshore effort share is closer to the peak and should rebalance



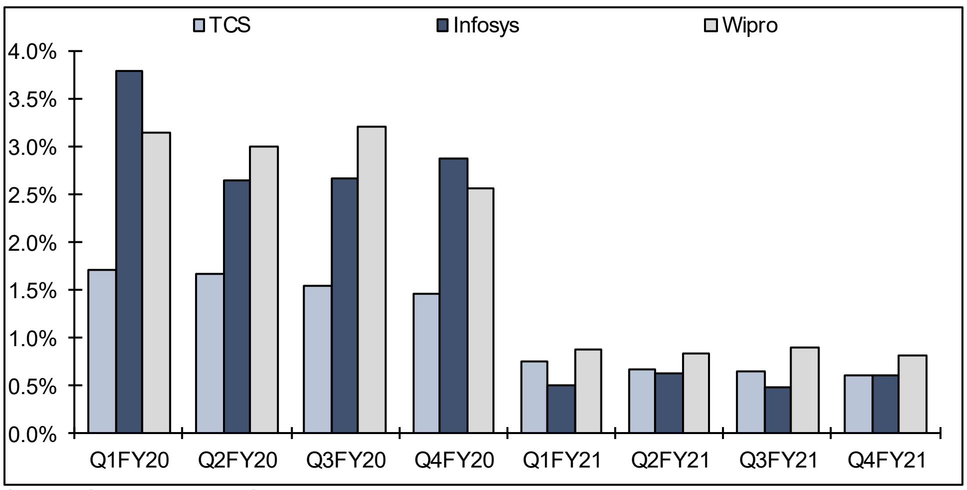
Source: Company data, I-Sec research.

Chart 33: Retention costs / attrition interventions will likely come back



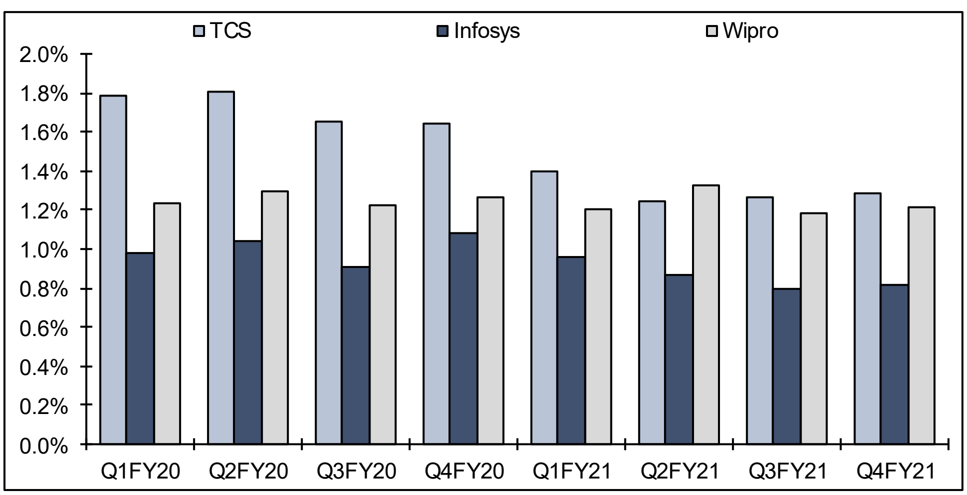
Source: Company data, I-Sec research.

Chart 34: Overseas travel may be at least a couple of quarters away



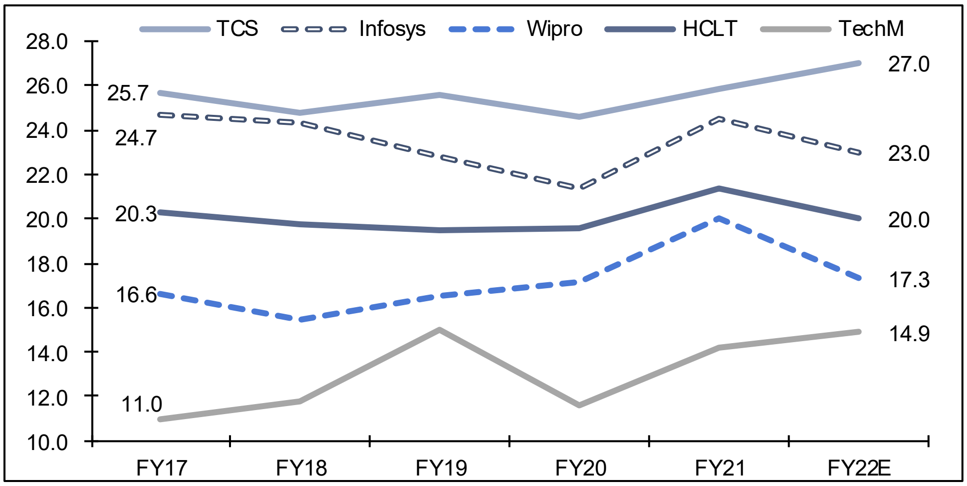
Source: Company data, I-Sec research.

Chart 35: Facility expense savings should continue for a couple of quarters



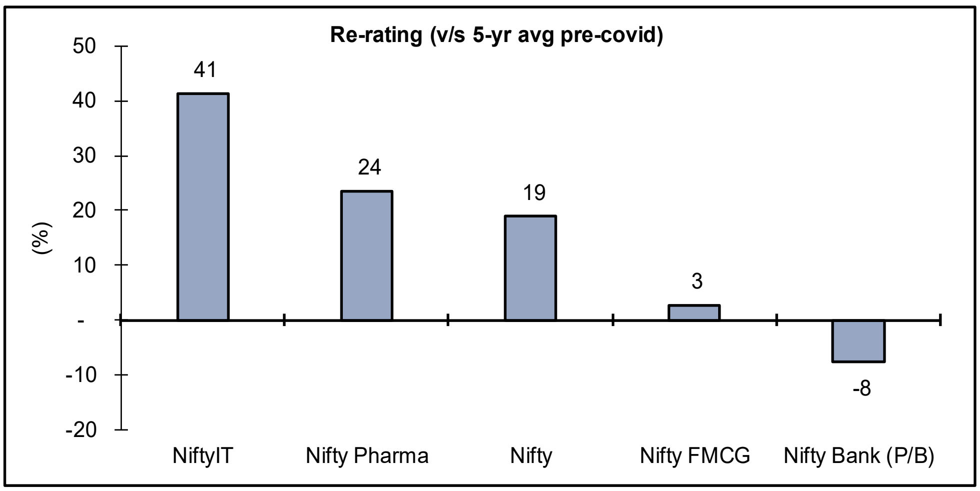
Source: Company data, I-Sec research.

Chart 36: In FY22, profitability is expected to revert to pre Covid (or lower) level



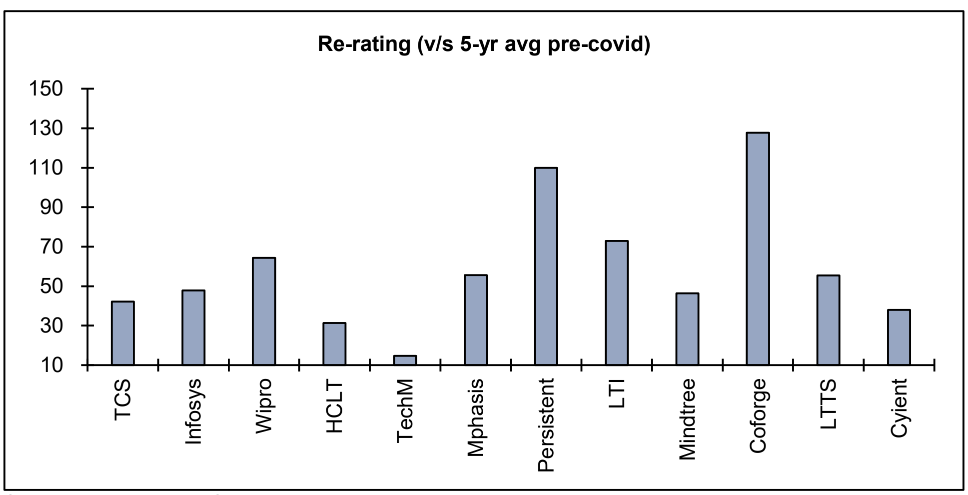
Source: Company data, I-Sec research.

Chart 37: IT Sector witnessed the highest rerating (v/s pre Covid)



Source: Bloomberg, I-Sec research

Chart 38: Multiples of our coverage universe rerated by up to 130% (v/s Pre Covid)



Source: Bloomberg, I-Sec research.

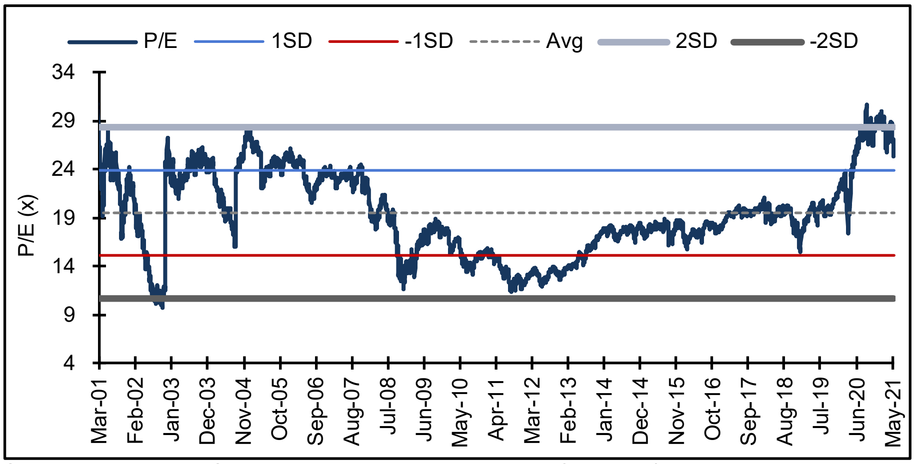
Table 1: Relative valuation table

	P/E (x)				Revenue growth (US$,%)				EBIT (%)			
	FY21E	FY22E	FY23E	FY24E	FY21E	FY22E	FY23E	FY24E	FY21E	FY22E	FY23E	FY24E
TCS	35.7	29.3	28.2	26.1	0.6	14.3	8.0	8.0	25.9	26.1	25.0	25.0
Infosys	29.4	25.8	23.1	21.4	6.1	16.5	10.0	8.0	24.5	23.5	23.5	23.5
Wipro	26.3	25.9	23.0	21.5	-1.4	20.0	8.7	5.5	20.1	17.3	17.8	18.0
HCLT	19.4	19.1	16.9	15.3	2.4	11.0	8.5	8.0	21.4	20.0	20.5	21.0
TechM	19.3	15.8	14.9	14.1	-1.4	11.0	7.5	8.5	14.2	14.9	14.5	14.0
Mphasis	27.4	23.5	21.2	19.0	5.6	9.9	9.5	12.0	16.1	17.0	17.0	17.0
Persistent	39.5	28.0	24.9	20.6	12.9	20.1	11.3	13.0	12.1	14.0	14.0	15.0
LTI	33.0	30.6	25.1	22.2	9.5	19.2	13.5	12.0	19.3	18.0	18.8	19.0
Mindtree	31.0	28.5	24.3	21.9	-1.1	13.5	12.0	11.0	17.5	16.6	16.7	16.7
Coforge	44.3	34.0	31.3	27.5	6.5	29.9	14.8	13.1	13.0	14.0	12.9	12.6
LTTS	42.0	35.2	30.1	26.8	-6.3	11.0	12.0	12.0	14.5	16.5	17.0	17.0
Cyient	23.8	17.3	14.6	13.3	-10.9	13.4	11.0	10.0	10.1	13.5	14.2	14.2

	EPS (Rs)				RoE (%)			
	FY21E	FY22E	FY23E	FY24E	FY21E	FY22E	FY23E	FY24E
TCS	86.5	105.4	109.3	118.4	37.1	41.9	40.7	42.3
Infosys	45.5	51.9	58.0	62.7	25.2	28.2	26.9	25.2
Wipro	19.3	19.6	22.0	23.6	19.7	18.3	18.1	17.4
HCLT	48.0	48.7	55.0	60.8	23.5	20.2	20.6	20.8
TechM	50.3	61.4	64.9	68.8	17.8	19.2	18.2	17.4
Mphasis	64.5	75.2	83.2	93.1	19.7	20.8	20.8	20.9
Persistent	59.0	83.4	93.6	113.2	16.1	19.7	19.4	20.2
LTI	110.3	118.8	144.7	164.0	32.6	29.3	29.9	28.2
Mindtree	67.4	73.3	85.9	95.2	25.7	23.5	22.9	21.3
Coforge	77.4	100.9	109.6	124.7	19.4	22.0	20.8	20.4
LTTS	62.9	75.1	87.6	98.3	21.3	21.6	22.4	22.0
Cyient	33.8	46.6	55.1	60.4	13.5	16.4	17.4	16.9

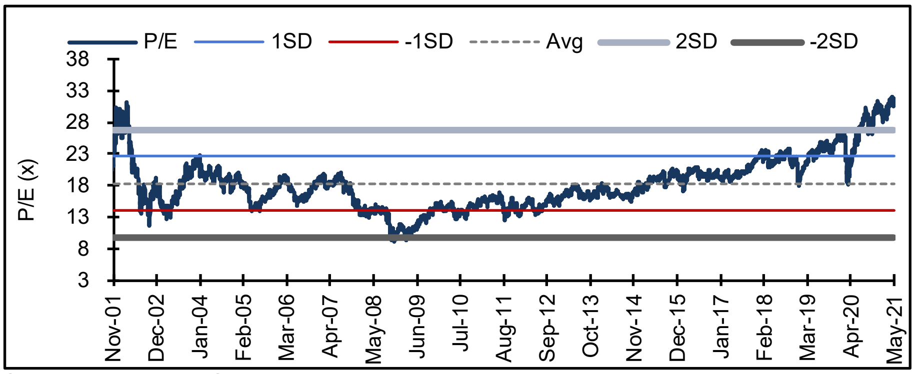
Source: Company data, Bloomberg, I-Sec Research

Chart 39: Nasdaq100 is off the peak and trading close to 1SD above mean



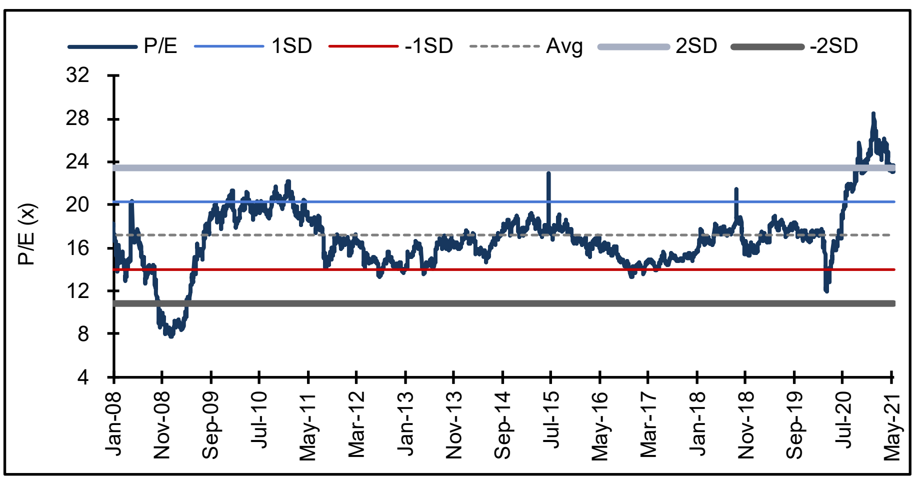
Source: Bloomberg, I-Sec research, Note: 1- year blended forward P/E ratio used.

Chart 40: Accenture is still trading 3SD above long term average



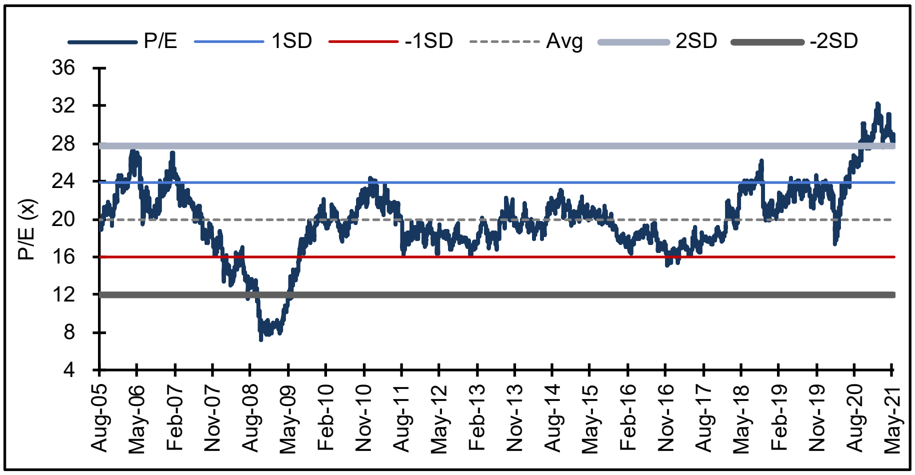
Source: Bloomberg, I-Sec research.

Chart 41: Despite correction from peak, NIFTY IT valuations are still bloated



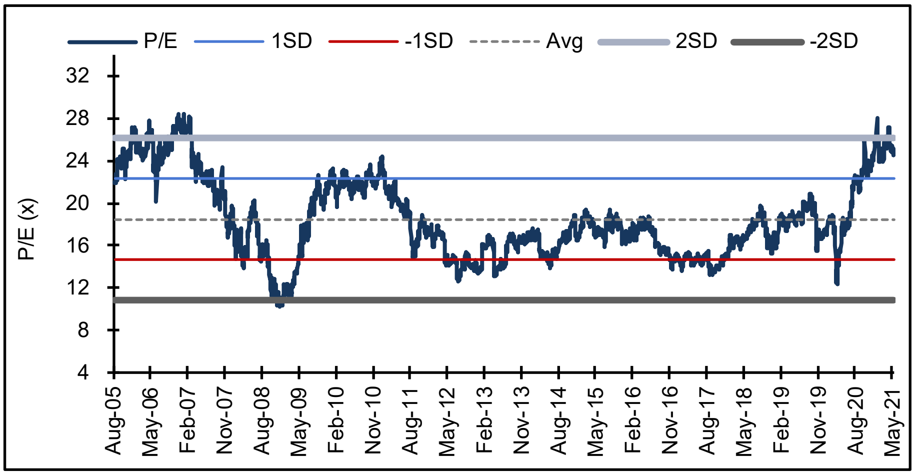
Source: Bloomberg, I-Sec research.

Chart 42: TCS is trading 2SDs above long term average



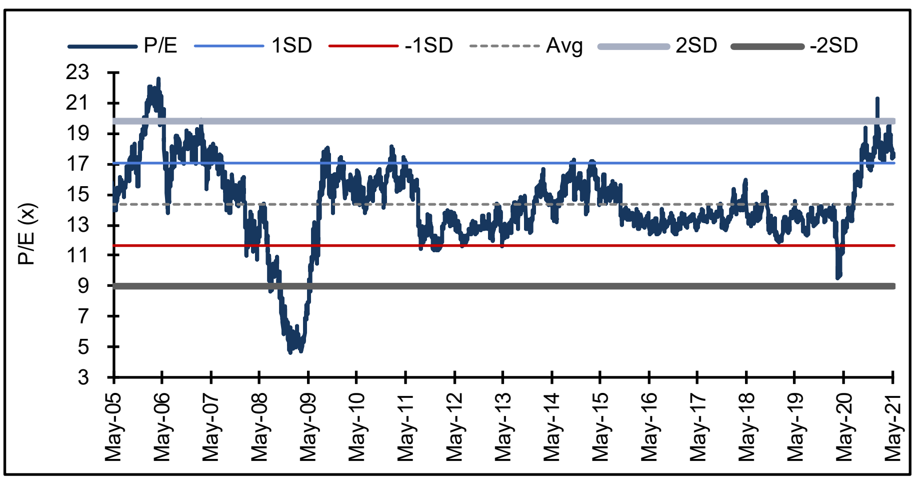
Source: Bloomberg, I-Sec research.

Chart 43: Infosys is trading 1.5 SDs above long term average



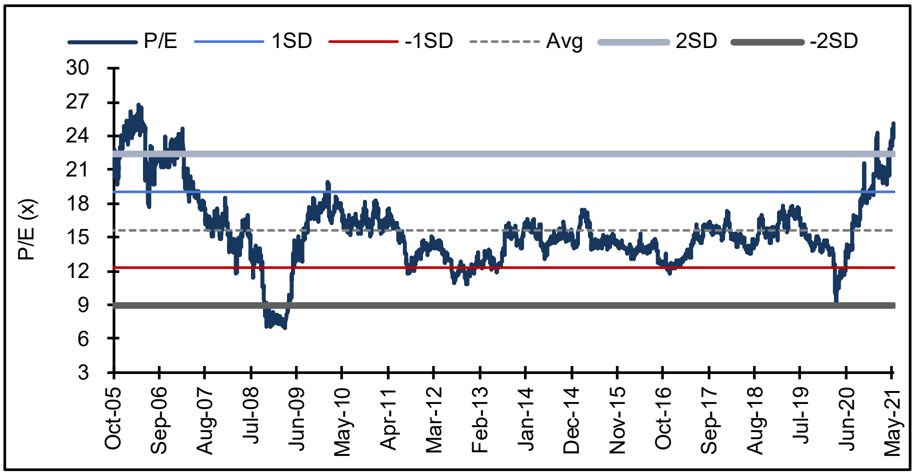
Source: Bloomberg, I-Sec research.

Chart 44: HCLT is trading 1SD above long term average



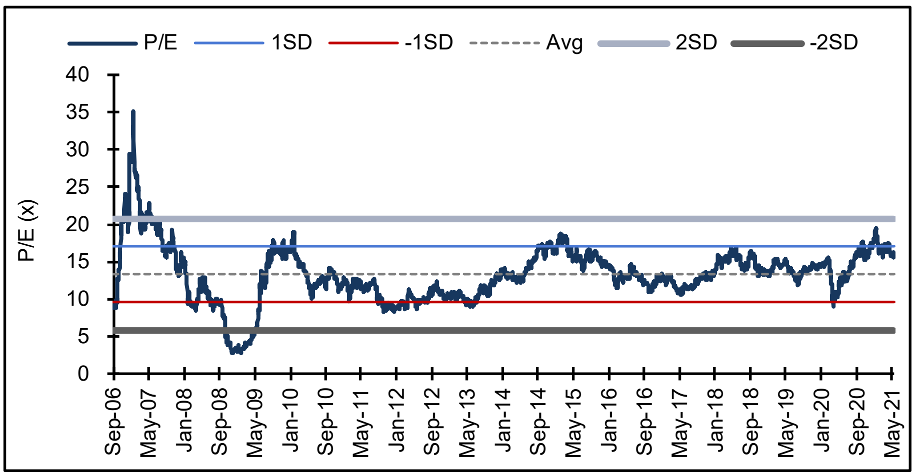
Source: Bloomberg, I-Sec research.

Chart 45: Wipro is trading 2SD above long term average



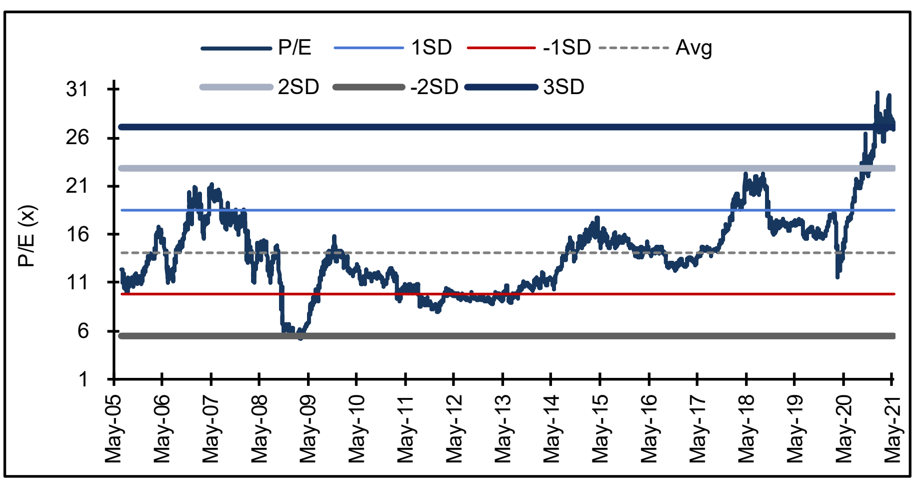
Source: Bloomberg, I-Sec research.

Chart 46: TechM is trading 0.5SD above long term average



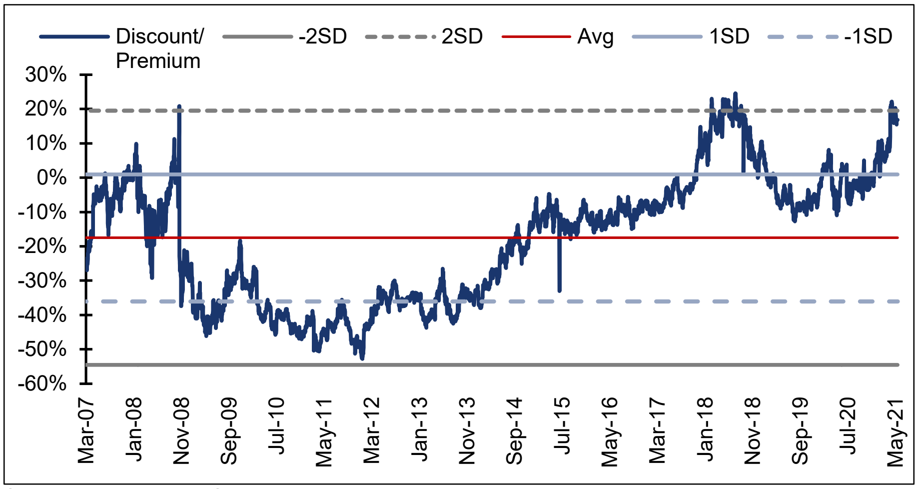
Source: Bloomberg, I-Sec research.

Chart 47: Mid-cap IT is trading 3SD above long term average



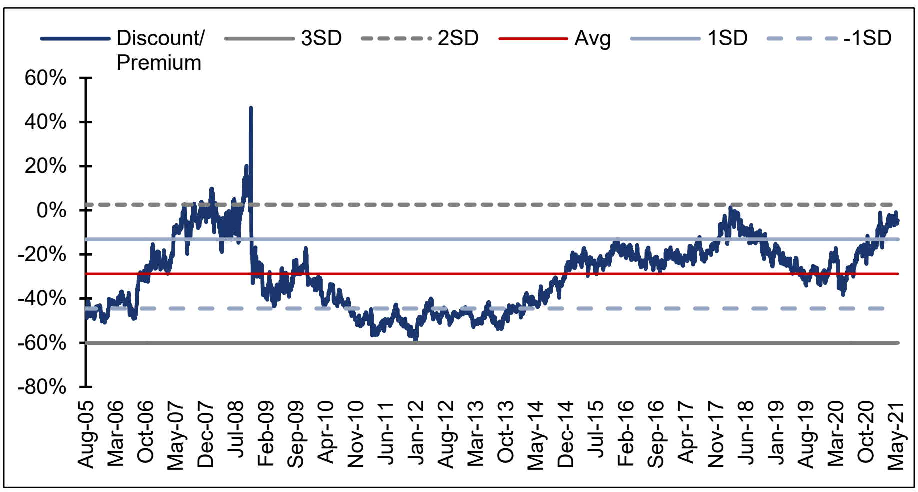
Mid-cap IT = Market cap weighted average of MPHL, Coforge, HEXW, MTCL, PSYS, CYL, LTI, LTTS
Source: Bloomberg, I-Sec research.

Chart 48: Mid-cap IT trading at ~20% premium to NIFTY IT is rare (and unsustainable?)



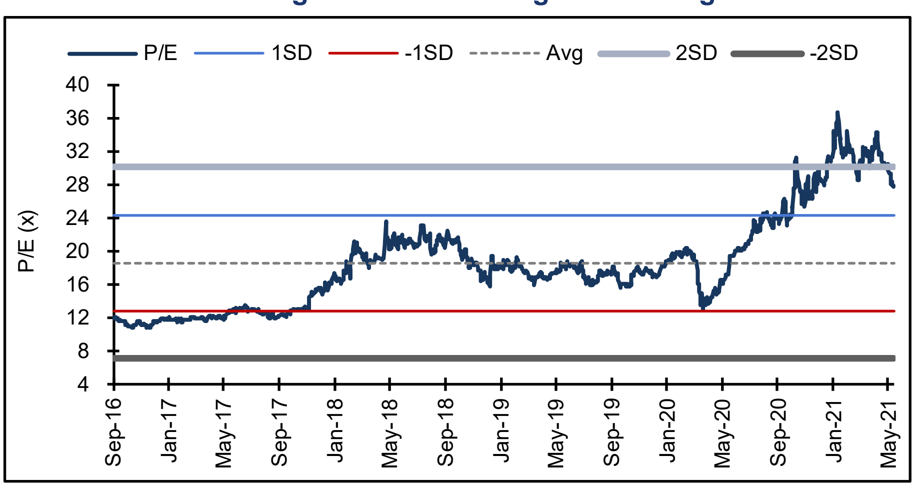
Source: Bloomberg, I-Sec research.

Chart 49: Mid-cap IT trading at par with sector leader (TCS) is rare (and unsustainable?)



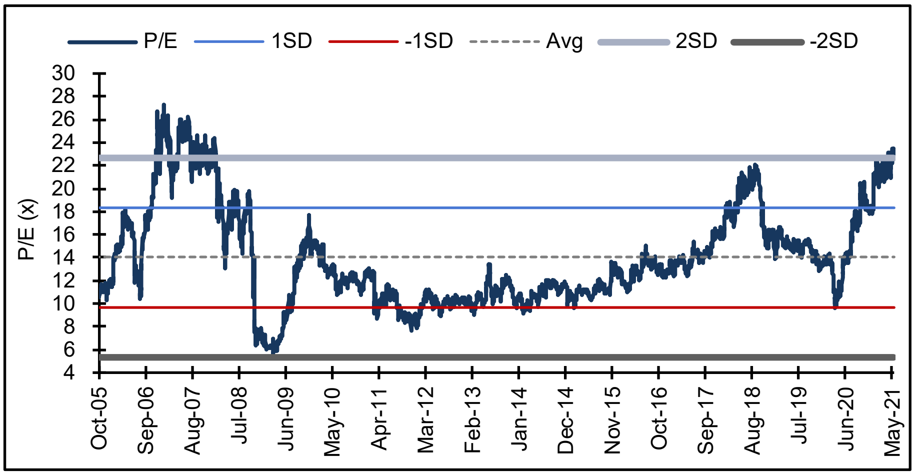
Source: Bloomberg, I-Sec research.

Chart 50: LTI is trading 1.5SD above long term average



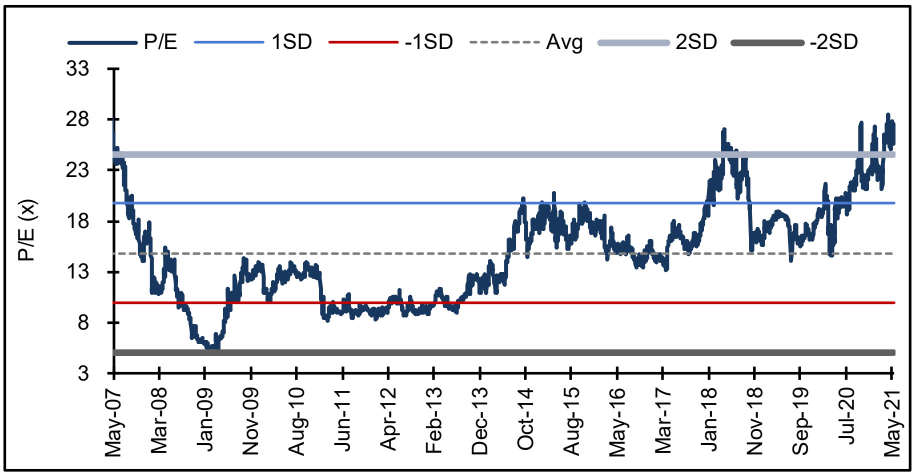
Source: Bloomberg, I-Sec research.

Chart 51: Mphasis is trading 1.5SD above long term average



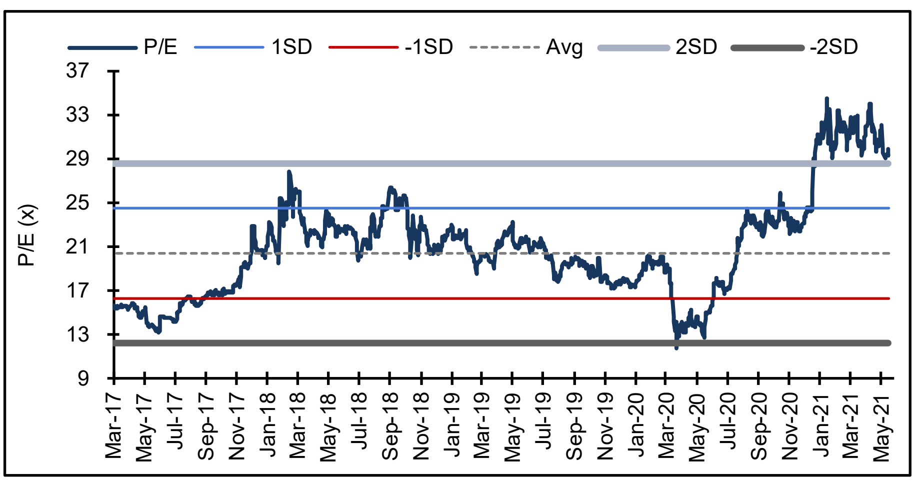
Source: Bloomberg, I-Sec research.

Chart 52: Mindtree is trading 2SD above long term average



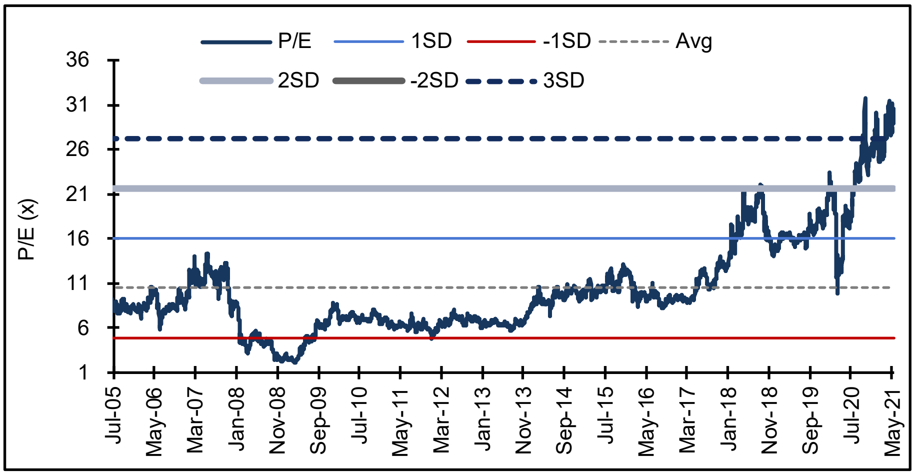
Source: Bloomberg, I-Sec research.

Chart 53: LTTS is trading 2SD above long term average



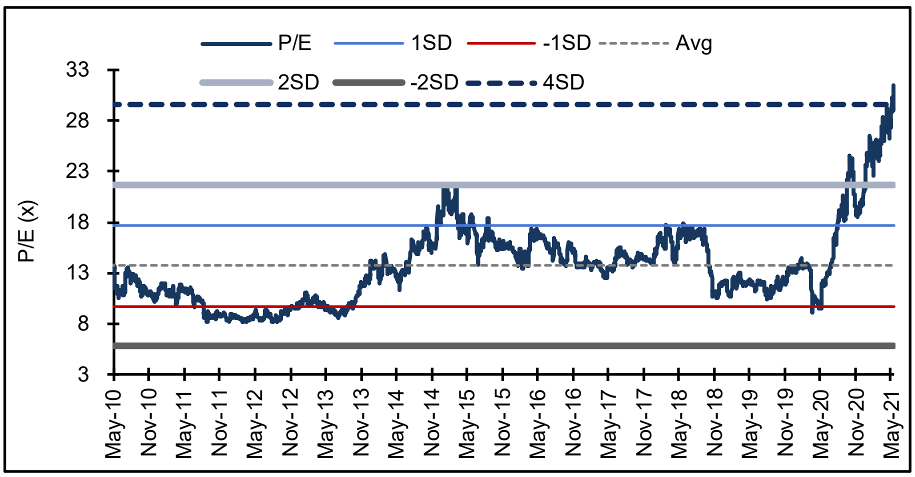
Source: Bloomberg, I-Sec research.

Chart 54: Coforge is trading 3.5SD above long term average



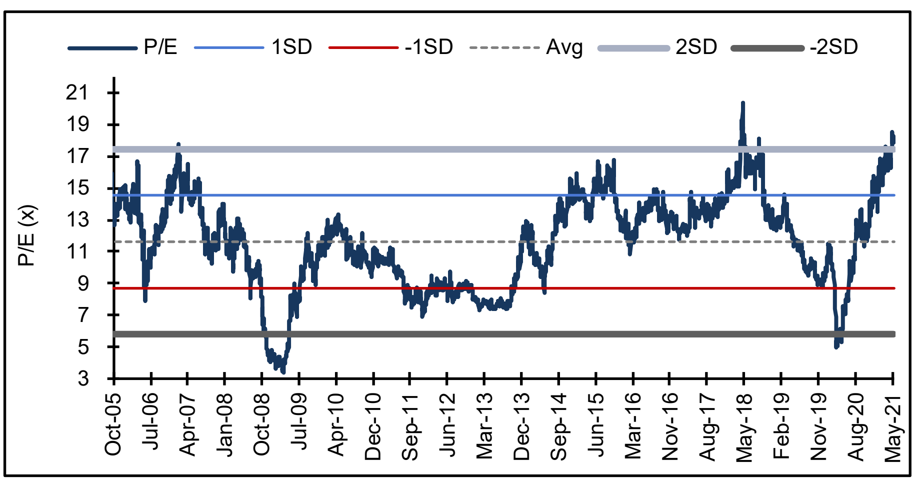
Source: Bloomberg, I-Sec research

Chart 55: Persistent is trading 4SD above long term average



Source: Bloomberg, I-Sec research.

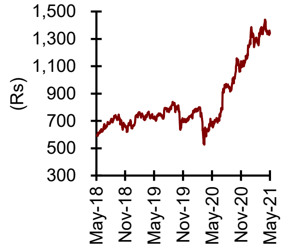
Chart 56: Cyient is trading 2SD above long term average



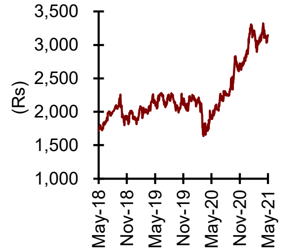
Source: Bloomberg, I-Sec research.

Price charts

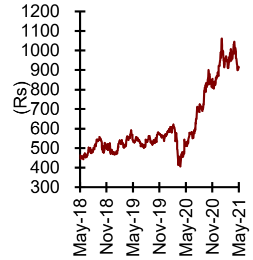
Infosys



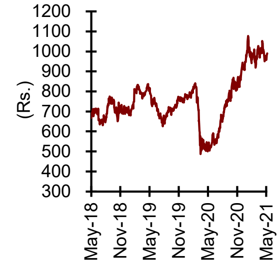
TCS



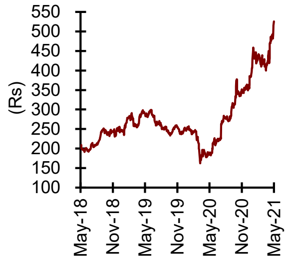
HCL Tech



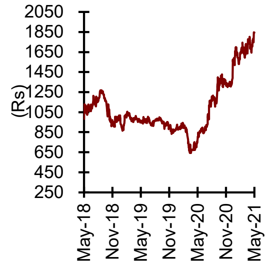
Tech Mahindra



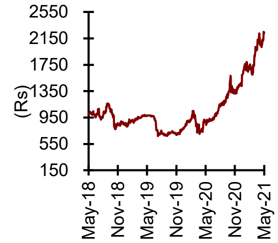
Wipro



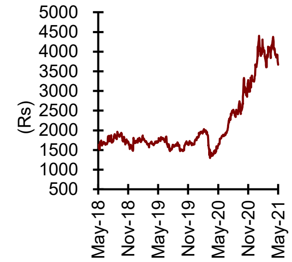
Mphasis



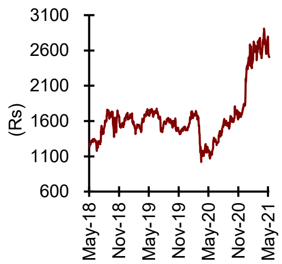
Mindtree



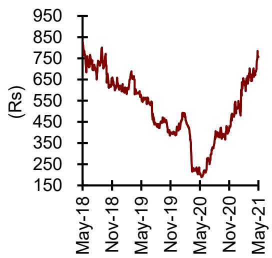
L&T Infotech



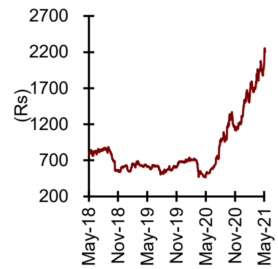
L&T Technology Services



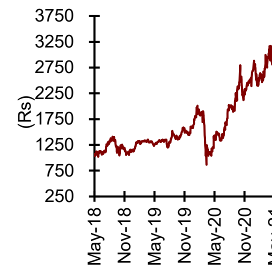
Cyient



Persistent Systems



Coforge



Source: Bloomberg

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