Cognizant Technology Solutions

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Bloomberg: CTSH US

Investor Day Update

Are Street Expectations On Medium-term Industry Growth Too High?

Cognizant Technology Solutions' (CTS) organised its first-ever Investor Day (in 25 years!) recently. Unlike the maintenance-oriented investor days of its Indian peers, this was a 'live' one as it was expected to give medium-term roadmap post exit of Elliott Capital management (Elliott). Over the past three years, point-to-point, CTS has underperformed both TCS and Accenture on stock returns and one of the reasons could be regression to at-par-with industry growth after two decades of outperformance. This slowdown is in the midst of one of the best demand environments seen post Global Financial Crisis of 2008-09. The slow growth stems from CTS' focus on higher margins (in our view, CTS has a different take on this as given inside the note). Ever since Elliot forced CTS's hand to increase its non-GAAP EBIT margin to 22% by 2019 (from 19%-20% in CY16), CTS has been walking away from low-margin business including possibly renewals of legacy IT services work. When Elliott dropped CTS from its holdings in the March 2018 quarter, the expectation was that CTS would possibly go back to its old focus on growth. The Investor Day gave a rather mixed picture on this. CTS gave guidance of: (1) 7%-11% constant currency (CC) revenue growth over the medium term (three to five years) with faster growth back ended. 100bps-200bps of which is expected to be inorganic. (2) 19% adjusted EBIT margin in 2019 with 10bps increase thereafter- this is equivalent to 22% non-GAAP EBIT margin that CTS was talking about previously. (3) A capital allocation policy with 50% return of global FCF to shareholders on an annual basis and 25% being spent on M&A. Overall, this means a guidance of 7.5% organic CC growth (mid-point) in the medium term at EBIT margin which is 600bps-800bps lower than that of its key Indian peers like TCS and Infosys. This implies that the street's expectation of high single-digit growth (we are not in that camp) for key Indian players is probably on the higher side, or CTS is being too conservative, or CTS is bad at execution. We believe it is the first. CTS, in the past, when it had margins lower than its key Indian peers, was growing significantly ahead of them. This new growth guidance of CTS belies our expectation of a material acceleration with a lower focus on margins. This is despite: (1) Based on our understanding of CTS and its key peers, a better capability in digital (the fastest-growing revenue stream). (2) A revenue mix which is slightly less balanced than that of TCS and Infosys (which gives it greater headroom to grow). Unlike both TCS and Infosys, we believe CTS is more BFSI and healthcare heavy from a vertical perspective and North America heavy from a geography perspective. We also believe that CTS has probably invested more in sales, consulting, acquisitions, domain-specific solutions and platforms and hence is in a position to grow faster.

Where we are different from consensus expectations on industry growth: (1) We do not believe that underlying revenue growth is witnessing a robust pick-up, despite being in the best macro environment for IT services ever since the Global Financial Crisis of 2008-09. For instance, for the very first time in 10 years – in our view - there is selective management commentary indicating that pricing is firm/stable. This coming at the last leg of a positive economic cycle means that industry will face significant pricing pressure - both in digital and legacy services - should economic/revenue/capex growth soften. (2) While our USD revenue growth assumptions are lower than that of the street, our assumptions on INR/USD are probably the highest, driven by the view taken by our economist Ms.Teresa John in her latest report: Are India's FX Reserves Sufficient?. (3) We are probably the only Sell side firm which is calling for a decline in the industry in FY21 driven by the view that the US economy will probably slow down from current red-hot level to near-stall level (see Exhibit 1 inside). Consensus, through robust growth assumptions for FY21, implicitly assumes that the US will continue to chug along at a good clip. (4) While we admit that we missed the monstrous mid-cap upside, we continue to remain sceptical in the long run on their prospects, especially with the view we have on the US economy in 2020. See our latest view on them (Onsite Supply Bottleneck H1-B Related, Unlikely A One-Off, Mid-Caps At Risk).

When do we get off this gravy train?: From this stage onwards, our positivity on the sector is more a portfolio and a relative call rather than a standalone one. Robust global economic growth combined with tight liquidity globally will help the sector initially as the INR depreciates (probably a bit more than what we had anticipated), but there would come a time when the tightness of financial conditions will adversely impact developed market growth, revenue growth for Global 2000 companies, their spending plans and consequently demand for Indian IT services. We, however, believe that is probably another 12 months away and do not foresee any material negative to develop on the demand front in the next six months. The real risk, in our view, is that elevated revenue growth expectations (in USD terms) for FY20 and FY21 that consensus has are likely to moderate as the capex cools off. May be concerns on slower global growth is what led to the recent underperformance in the December quarter (see Exhibit 3).

Risks to our view: The upside risks to our stock target prices include: (1) An economic cycle upturn than lasts longer than we are currently anticipating. (2) A higher-than-currently expected depreciation of the INR. (3) A sustained flight away from financials as inflation/interest rates move higher and stressed asset cycle elongates. This ties in with the view that Nifty earnings in FY19 and FY20 are likely to show a downward revision while the earnings of IT services sector look up. **Downside risks to our target prices include**: (1) A significant and faster-than-expected slowdown in the US/global economy. The rise in interest rates in the US and trade war with China could be catalysts. (2) Faster-than-expected return to Indian 'financials' as interest rates stabilise and stressed asset provisioning peaks.

NOT RATED

Sector: Information Technology

CMP: US$69.2

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View on Indian IT services sector: We turned 'tactically positive' on Indian IT services sector in March 2018 after having been negative on it for close to three years (see the report here). We also released an update recently (see link: Peaking Global Capex Cycle; 'Relatives' Are The Only Positives)This change in stance has been driven by: (1) Modest growth pick-up because of a peaking developed market economic cycle in 2018 that has also been boosted by US tax reforms. (2) Large underweight institutional positioning in the sector. (3) Near-term negative news flow on 'financials' (a large overweight sector for institutions). (4) Better relative valuation (which is no longer as compelling as it was six months ago). (5) INR depreciation-related benefits. (6) Regular capital return to investors. When we upgraded the sector, 80% of the upward revision in target prices was because of P/E multiple expansion and only 20% came from a revision in earnings. However, after a highly anaemic INR depreciation versus the USD of 1.7% over FY15-FY18 (against a long-term annual depreciation of 5%-6% over the past 70 years), we believe the INR will start depreciating at its long-term rate of 5%-6% (at the least) in the next three years or FY18-FY21E. Thus, while we believe that revenue growth for the sector in USD terms will still be in the mid-single-digit territory in the foreseeable future, earnings growth will likely pick up pace to the mid-teen level over this timeframe from a mid-single digit number over FY15-FY18. The higher P/E multiple will be supported by rebound in earnings growth, return ratios and high return of capital to shareholders. The structural pressure that we have been harping on since April 2015 will continue to constrain USD revenue growth for the industry. These include value compression and cannibalisation from automation (which is reaching enterprise scale, in our view, countering the upside from digital projects which are also scaling up) and movement to cloud, and a weaker but improving competitive position in 'new areas', insourcing, etc. These pressures have led to growth pick-up being pushed back to the last stage of this economic upcycle. We believe that growth will be dispersed in FY19. In our coverage universe, we believe only TCS will witness any material pick-up in organic revenue growth in the Tier-1 space. We prefer large-caps over mid-caps at current valuations. Mid-caps may witness faster growth pick-up on a low base in FY19 (and from bombed-out margins in some cases), but would advise investors to focus on sustainability and not overpay for a riskier business model. Current valuations of mid-cap stocks factor in strong growth over a two to three-year time frame - which we believe is unlikely.

Some other key takeaways from the analyst meet

On why it witnessed slower growth in the past few years: While we attribute this to the 'growth versus margin' debate, CTS framed it as a 'quality versus quantity' debate. CTS also mentioned that it (and the industry) was in a 'stall zone' as it/industry moved from the one 'S' curve (internet technologies) to the new 'S' curve (digital). So this was the time it had to slow down to pivot the organisation to the new wave by reorienting the capability set, sales, its way of approaching business, employees, etc. However, the guidance it has given for the future does not indicate that there is a material acceleration from the 'stall zone' growth to the new normal, especially because it was of the view that its pivot to digital was more or less over.

Only two of its top five banking clients are growing currently: One key thing to focus on during the analyst meet was CTS' commentary on large global banks' spending. These form a sizable portion of its and Indian industry's revenues. In 3Q, CTS stated that it saw growth in large US banking clients, especially in digital initiatives. At the investor day, it said that only two out of its five large banking clients actually grew revenues materially during the past few quarters. It stated on YTD basis these five banks in aggregate had a revenue decline of 11% YoY. Which means three of the five banks actually saw high material compression in the work being done with CTS. It said digital work only compensated for value compression in core services- 'Run The Bank' work. During early CY2018, its commentary on non-US large banks was cautious. It had raised the issue of insourcing being an impediment to revenue growth. This is something we touched up on in many of our sector notes. CTS' commentary on BFSI is different from what we heard from TCS and Infosys recently which seemed to be indicating a broad pick-up in large bank spending across various geographies. This variation in commentary across players stems from individual client-specific exposures. Each large bank seems to have its own pace of digital transformation. It is still early to call out a secular upturn in spending in aggregate by large global banks for the industry. CTS indicated that insurance and mid-tier regional banks continue to grow robustly in its client base, a commentary echoed by large Indian peers.

Workforce only 40% localised in North America: It comes as a surprise to us that CTS is only 40% local in the US, despite having its headquarters in the US and being listed only in the US. Some Indian companies like Wipro and HCL Technologies have already moved to localisation band of 50%-60%. To that extent, CTS has some more heavy lifting to do, especially considering its high level of attrition.

Links to our notes on Cognizant Technology Solutions (latest on top)

Cognizant Technology Solutions - A Rather Tame End To What Should Have Been A Great Year

Cognizant Technology Solutions- No Uptick In Spending By Large US Banks

Cognizant Technology Solutions- 6%-8% Organic CC Growth Guidance For 2018; Upside Risks Exist

Cognizant- With Elliott Out, Will Growth Focus Be Back To The Detriment Of Peers

Cognizant Technology Solutions- No Upward Revision To Guidance As It Picks Its Battles

Cognizant Technology Solutions- Likely Revisit Of Its Growth, Margin and Capital Return Strategy

Exhibit 1: Assumptions on macro and companies (as in the 5 October 2018 sector report)

	2018	2019	2020
Real US GDP growth (%)	2.75-3.25	1.5-2.5	0.0-1.5
	FY19E	**FY20E**	**FY21E**
INR/USD	72	77	79.7
USD revenue growth (%)	**FY19E**	**FY20E**	**FY21E**
TCS	9.2	8.0	-
Infosys	6.7	7.9	(0.2)
Wipro (IT services)	2.8	5.4	(3.0)
HCL Technologies	9.4	7.7	0.1
Tech Mahindra	4.7	8.6	(1.8)
Mindtree	18.7	8.1	(1.5)
Persistent Systems	11.2	10.4	0.5

Source: Nirmal Bang Institutional Equities Research

Exhibit 2: Comparative valuation table

	TCS	Infosys	Wipro	HCL Tech	TechMahindra	Mindtree	Persistent
Year Ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 19-Nov-18	**1,902.5**	**651.7**	**332.9**	**1,040.1**	**732.6**	**848.7**	**558.8**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market value (Rsbn)	7,284	2,833	1,644	1,429	646	140	45
(US$mn)	112,925	43,917	25,482	22,161	10,014	2,177	693
September 2019E target price	2,120	756	364	1,277	731	778	622
Upside/(downside)	11.5%	15.9%	9.3%	22.8%	(0.2%)	(8.3%)	11.3%
Recommendation	Accumulate	Accumulate	Buy	Buy	Accumulate	Sell	Accumulate
FDEPS (Rs)							
FY16	61.6	31.0	18.0	54.1	35.2	35.1	37.2
FY17	66.7	31.2	17.5	60.5	31.8	24.9	37.7
FY18	67.0	32.5	16.8	62.9	42.9	34.4	40.4
FY19E	86.9	39.0	20.0	77.9	50.4	46.9	49.2
FY20E	100.9	45.0	25.1	87.1	58.5	59.9	60.9
P/E (x)							
FY16	30.9	21.0	18.5	19.2	20.8	24.2	15.0
FY17	28.5	20.9	19.1	17.2	23.1	34.1	14.8
FY18	28.4	20.1	19.8	16.5	17.1	24.7	13.8
FY19E	21.9	16.7	16.6	13.3	14.5	18.1	11.3
FY20E	18.9	14.5	13.3	11.9	12.5	14.2	9.2
EV/EBITDA (x)							
FY16	23.5	14.7	13.3	14.5	14.2	16.5	10.4
FY17	22.4	14.0	13.0	12.7	14.4	18.4	9.5
FY18	22.3	13.9	14.7	11.7	12.6	17.6	9.0
FY19E	17.1	12.4	12.1	9.4	8.9	11.8	6.8
FY20E	14.6	10.3	9.4	8.2	7.6	8.7	5.1
EV/Sales (x)							
FY16	6.6	4.0	2.8	3.2	2.3	2.9	1.9
FY17	6.1	3.8	2.6	2.8	2.1	2.5	1.5
FY18	5.9	3.7	2.7	2.6	1.9	2.4	1.4
FY19E	4.8	3.3	2.3	2.3	1.7	1.8	1.2
FY20E	4.2	2.8	2.0	2.0	1.4	1.5	0.9
RoIC (%)							
FY16	63.1	58.8	32.3	51.3	33.8	40.6	43.5
FY17	60.8	51.1	28.8	46.2	26.2	27.8	31.1
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19E	68.1	49.6	28.4	36.2	35.2	47.7	44.0
FY20E	74.8	54.7	35.0	32.6	36.9	54.9	53.4

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Performance of stocks and indices

Stock performance (%)	CY08	CY09	CY10	CY11	CY12	CY13	CY14	CY15	CY16	CY17	1QCY17	2QCY17	3QCY17	4QCY17	1QCY18	2QCY18	3QCY18	QTD	CY18TD
TCS	(55.4)	207.8	57.5	(0.4)	8.7	70.1	17.3	(4.4)	(2.8)	11.7	3.4	(2.9)	3.1	7.8	8.5	29.7	18.2	(12.9)	44.8
Infosys	(37.2)	128.7	33.6	(20.4)	(15.3)	50.8	12.3	10.5	(8.6)	4.1	3.0	(8.5)	(3.8)	14.8	9.5	15.5	11.7	(10.7)	26.1
Wipro	(55.3)	188.8	19.8	(18.7)	(1.6)	57.7	0.2	1.0	(15.4)	30.4	9.2	0.2	8.5	9.9	(8.7)	(7.0)	23.9	2.7	8.1
HCL Tech	(64.6)	219.8	23.6	(15.6)	61.5	99.1	27.5	5.8	(2.5)	7.2	6.8	(2.7)	2.8	0.4	10.3	(4.4)	17.4	(4.4)	18.4
Tech Mahindra	(78.3)	298.9	(29.3)	(17.1)	58.7	100.6	41.4	(19.6)	(8.1)	3.0	(4.9)	(16.8)	19.9	8.6	28.5	2.6	13.7	(1.7)	47.4
Persistent	-	-	-	(24.5)	55.6	91.7	65.8	(20.7)	(3.6)	11.7	(4.6)	14.5	(1.8)	4.1	(0.5)	16.9	(2.8)	(29.1)	(19.9)
Mindtree	(51.8)	195.6	(24.3)	(24.7)	72.2	122.7	59.8	16.4	(26.9)	17.0	(13.5)	16.8	(12.1)	31.9	25.9	27.8	4.7	(17.9)	38.5
Cognizant	(49.3)	157.1	62.4	(13.8)	13.6	38.4	6.2	14.8	(7.9)	27.1	5.9	11.6	9.2	(1.6)	11.6	(0.9)	(2.3)	3.8	12.2
Accenture	(12.1)	28.6	16.1	11.2	22.0	25.0	9.9	17.4	10.5	31.2	2.5	3.2	9.2	13.7	(4.0)	11.0	4.0	(12.5)	(3.1)
Globant SA	-	-	-	-	-	-	-	150.3	(12.9)	39.7	11.3	19.3	(7.8)	14.0	11.1	11.9	3.9	(12.5)	13.0
Epam Systems INC	-	-	-	-	-	83.9	37.2	65.8	(18.9)	67.5	17.5	11.3	4.6	22.5	3.6	11.5	10.8	(17.7)	5.2
Luxoft Holding INC	-	-	-	-	-	-	1.7	105.3	(29.4)	(0.3)	12.0	(2.7)	(21.4)	16.5	(26.4)	(10.1)	28.5	(12.2)	(25.4)
Cap Gemini	(36.5)	17.2	11.3	(32.9)	38.7	48.4	-	44.0	(6.2)	22.5	7.2	4.5	9.6	(0.3)	1.8	14.4	(5.9)	(4.8)	4.4
Hexaware	(76.2)	383.6	22.4	27.7	13.3	56.1	51.2	21.1	(15.1)	65.0	4.7	12.7	11.4	25.5	11.3	21.6	(6.4)	(27.0)	(7.6)
Cyient	(67.2)	193.0	11.0	(33.9)	59.3	88.6	53.3	(8.6)	3.9	18.3	(4.7)	8.6	0.6	13.7	19.7	10.3	(2.8)	(14.8)	9.3
Mphasis	(47.4)	357.0	(6.9)	(56.0)	29.9	12.2	(13.9)	33.9	13.8	27.9	2.3	3.4	3.2	17.1	15.6	29.4	8.2	(19.1)	31.0
NIIT Tech	(71.8)	167.9	10.6	(9.5)	34.8	45.9	(0.1)	63.0	(26.4)	53.1	2.7	32.6	(6.0)	19.7	33.2	26.9	(0.1)	3.3	74.4
LTI	-	-	-	-	-	-	-	-	-	61.2	5.1	10.3	1.3	37.2	22.3	24.7	14.7	(14.4)	49.6
LTTS	-	-	-	-	-	-	-	-	-	30.5	(0.8)	(7.9)	9.1	31.0	20.7	(1.4)	42.5	(11.2)	50.5
Intellect Design	-	-	-	-	-	-	-	258.4	(50.2)	27.9	(17.6)	7.2	3.2	40.3	(1.1)	17.1	4.9	16.8	41.8
OFSS	(69.4)	398.1	(0.6)	(19.7)	77.0	1.0	1.5	11.5	(17.1)	30.6	22.7	(5.4)	0.7	11.7	(7.8)	8.8	(3.9)	(10.9)	(14.1)
Ramco Systems	(75.8)	93.2	17.3	(37.4)	33.6	54.2	219.0	71.7	(57.8)	57.3	14.7	(14.8)	16.8	37.9	(32.6)	(4.1)	(6.1)	(3.1)	(41.2)
Just Dial	-	-	-	-	-	-	(4.9)	(36.0)	(61.5)	57.4	58.6	(29.5)	0.1	40.7	(15.4)	25.3	(14.0)	3.3	(5.8)
Infoedge	(69.5)	116.2	47.6	(13.6)	23.2	34.6	81.3	2.4	5.4	44.3	(11.9)	29.1	6.9	18.7	(10.4)	0.9	20.0	(2.7)	5.5
Makemytrip	-	-	-	(15.4)	(47.5)	53.9	33.1	(31.2)	32.5	29.9	49.8	(3.0)	(14.3)	4.3	10.7	8.9	(24.1)	22.0	11.7
Index performance (%)																			
Nasdaq	(43.0)	56.4	18.5	2.7	14.1	37.0	20.0	8.6	5.7	31.0	10.5	3.9	5.9	7.7	0.3	9.0	8.3	(14.4)	1.4
S&P 500	(39.8)	26.5	11.7	0.4	11.0	31.3	13.0	(0.8)	9.0	19.5	5.0	2.6	4.0	6.7	(3.1)	4.4	7.2	(10.3)	(2.8)
Stox 600	(46.0)	28.6	9.4	(12.5)	15.0	17.3	4.2	7.8	(2.0)	8.1	5.8	(0.5)	2.3	0.4	(5.2)	2.9	0.9	(4.1)	(5.6)
DAX	(40.4)	23.8	16.1	(15.4)	30.2	25.5	2.7	9.6	6.6	13.4	7.5	0.1	4.1	1.2	(8.0)	3.1	(0.5)	(2.3)	(7.8)
Nikkei	(42.1)	19.0	(3.0)	(17.9)	23.8	56.7	7.1	9.1	0.6	19.0	(1.2)	5.9	1.6	11.9	(7.7)	6.1	8.1	(2.5)	3.2
MSCI EM	(54.6)	73.3	16.8	(20.2)	15.4	(5.0)	(4.7)	(17.1)	8.5	34.4	11.6	5.5	7.0	6.6	0.8	(8.0)	(2.0)	13.1	2.7
Bovespa	(41.2)	82.7	1.0	(18.1)	7.4	(15.5)	(2.9)	(13.3)	38.9	26.9	7.9	(3.2)	18.1	2.8	9.8	(13.2)	9.0	8.5	2.9
HSCEI	(51.3)	60.9	0.4	(21.0)	14.4	(5.3)	10.0	(18.4)	(3.6)	25.5	10.3	0.9	5.3	7.1	2.7	(7.7)	(0.5)	(3.5)	(9.0)
CNX BANK	(48.5)	77.7	29.3	(31.0)	55.2	(8.7)	63.9	(9.3)	6.6	41.4	18.9	8.2	3.6	6.0	(4.8)	8.7	(4.7)	4.7	3.2
CNX IT	(54.5)	163.5	29.6	(18.6)	(1.1)	57.2	17.4	(0.3)	(7.4)	11.7	4.0	(5.1)	3.2	9.7	8.8	11.8	13.2	(7.8)	27.0
CNX FMCG	(18.6)	41.7	29.5	9.4	48.7	11.7	17.8	0.1	1.7	30.5	15.4	13.6	(8.5)	8.7	(1.8)	10.9	2.7	(0.4)	11.4
CNX AUTO	(54.5)	193.3	35.0	(18.6)	41.2	9.9	57.3	(0.7)	10.5	30.2	8.5	6.7	2.6	9.7	(8.7)	(1.0)	(10.4)	(4.0)	(22.3)
CNX ENERGY	(47.0)	58.6	4.0	(27.5)	12.0	0.1	8.4	(0.7)	19.2	40.8	14.8	(0.4)	10.1	11.9	(7.5)	0.9	17.7	(7.8)	1.2
CNX PHARMA	(25.4)	60.8	34.5	(10.2)	32.7	26.3	42.6	10.3	(15.5)	(5.4)	2.8	(7.7)	(4.5)	4.5	(12.8)	9.8	8.7	(5.7)	(1.9)
CNX METAL	(73.4)	224.0	0.5	(47.1)	16.2	(13.8)	6.2	(31.3)	45.5	49.7	17.1	(3.4)	18.7	11.5	(11.3)	(2.1)	1.3	(2.6)	(14.3)
CNX INFRA	(56.0)	38.0	(4.1)	(38.1)	21.9	(4.7)	22.5	(8.8)	(2.3)	34.1	15.2	3.4	1.4	11.1	(7.7)	(6.1)	(5.1)	5.8	(12.9)
CNX MID-CAP	(59.1)	100.2	18.0	(30.5)	39.3	(5.4)	55.7	7.2	6.5	47.4	20.8	3.1	2.1	15.9	(10.6)	(3.1)	(5.6)	2.6	(16.2)
CNX SMALL-CAP	(70.5)	107.8	16.6	(32.9)	35.6	(8.1)	53.9	7.4	2.2	57.5	22.1	4.7	3.7	18.8	(13.6)	(7.9)	(14.3)	2.1	(30.3)
NIFTY	(51.0)	73.5	18.0	(23.9)	27.2	6.5	31.1	(4.3)	2.6	29.3	13.2	3.8	2.8	7.0	(3.5)	5.9	2.0	(1.5)	2.7
USD/INR	48.80	46.53	44.71	53.07	55.00	61.80	63.04	66.15	67.37	65.14	67.01	64.47	`64.3	64.73	65.18	68.47	70.07	73.28	68.11

Source: Company, Nirmal Bang Institutional Equities Research

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