Information Technology Sector

13 September 2019

Sector Update

Global BFSI malaise beyond capital markets; To pressure growth in FY21

The second and third round of CY2019 revenue downgrades that one has witnessed through recent company commentary – see Exhibit 2 – from large US banks like JP Morgan, Citi and Wells Fargo, in our view is symptomatic of the overall malaise that has gripped the global BFSI companies which will only accentuate going forward in 2020. When we went back to being cautious on the sector in December 2018 (Sector report) after being 'Tactically positive' for a brief while in 2018 (Tactically Positive) it was our view that among many other things, the flatter/inverted yield curve developing in various parts of developed world would have a negative impact on large financial institutions and in turn adversely impact their spending/outsourcing plans. BFSI typically forms about 25%-40% of most large IT service organizations. Studying aggregate BFSI revenues of a basket of companies (Accenture, TCS, Capgemini, Cognizant, Infosys, Wipro and HCLT) over the last 12 quarters indicates that the momentum has been waning if not outright negative until June Quarter 2019 (Exhibit 1). Commentary on BFSI has been mixed across IT services companies over these quarters and has changed over time for the same company in some cases. Some of this may be because of the waxing and waning of individual large customer relationships. The negative news flow from the BFSI vertical thus far has been on capital market oriented financial institutions which seem to have been adversely impacted by likely lower trading volumes, market volatility, etc. However, we believe that the malaise is spreading to the lending and insurance sides of the business. On the lending side, net interest income/margin estimates have been pared by various banks. A slowing economy (from a ~3% real GDP growth in 2018 to a likely 0-1.5% in 2020 for the US and a near recession in Europe) could also likely lead to increase in credit costs. A study of the recent commentary and the consensus estimates of large banks in both US and Europe as well as some of the insurance companies indicate that 2019 has seen downward reset of revenue and profits and there is likely more to come in 2020 (Exhibit 2,3). Many insurance companies are grappling with lower and increasingly negative yields on their bond investments in Europe (Exhibit 6) which puts pressure on their profitability due to return-guaranteed products in their product portfolio. With yields falling precipitously, re-investment risk has aggravated for insurance companies. Insurance segment has been fairly robust for a number of Indian companies like TCS and Infosys and we believe that negative yield scenario that has developed will have an impact on spending decisions/ramp up plans, etc in this sub-vertical. We reiterate our cautious view on the Indian IT services sector. We believe that the reasonably robust growth expected in FY20 is already factored into valuations. We believe that market is being optimistic about growth prospects of the industry in FY21 – which we strongly disagree with. We believe that macro conditions will deteriorate going into 2020 which will lead to no-growth-scenario for the industry in FY21. This is in sharp contrast to acceleration in growth to high-single-digit to low-double-digit levels that most of our competitors seem to be factoring into their estimates. While INR depreciation will help in earnings, we see P/E multiple contraction, driven by consensus revenue numbers going through a significant downward revision over the next 6-12 months on FY21. We reiterate our underweight stance on the sector.

Conversion of TCV will have to be watched: While TCV growth in FY19 and 1QFY20 has been fairly strong these have not really translated into adequate organic revenue growth pick up in 1QFY20 (see our TCS and Infosys 1QFY20 notes). One of the key things to watch out for would be management commentary on ramp up of the large deals won. In the past stressed macro situations, customers had pulled back on execution of large contracts as they saw an impending pressure on their financials. Thus, having a healthy order book is good but a non-executable one is not helpful for vendors. So, one should not draw a straight forward conclusion that a large TCV inflow will mean revenue growth pick up. In FY19, we understand that the conversion rate was likely among the best in many years but the initial signs in FY20 are not too encouraging.

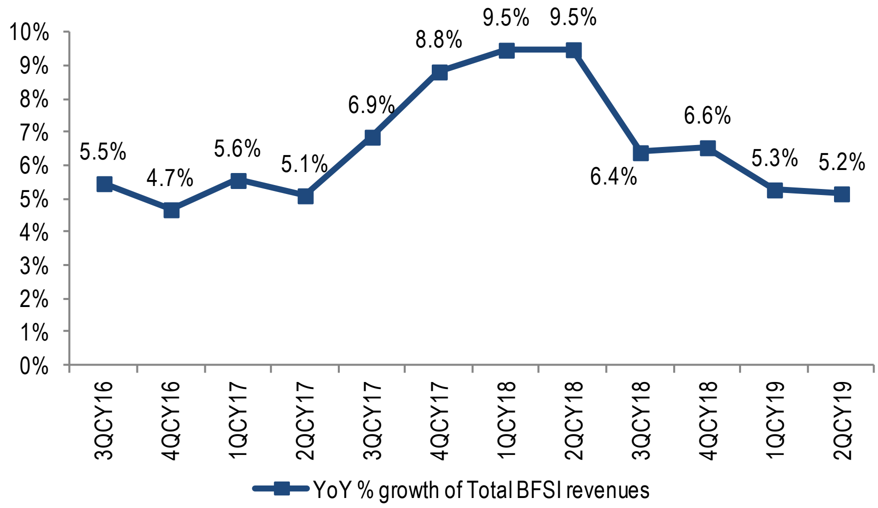
Software becoming strategic for BFSI sector is double edged: While most applications that were built 10-15 years back were merely systems of records, software has become critical for survival of organisations as customer acquisition, transactions, etc go online and increasingly on to the mobile. The pivot to Digital is something most global financial institutions have taken up aggressively. There is also a realization in boardrooms that 'Software' is core to their existence and competitive advantage. That has led to greater in-sourcing of work than was happening in the past. In-sourcing is also likely driven by the desire to move on automation in a far faster manner and to retain the significant gains generated from it rather than share it with the vendors. Robotic Process Automation (RPA) activity has significantly picked up steam in recent years among the captives.

Compression in legacy contracts - largely not discussed by the street – will have a bearing on growth: Large banks typically spend 8-14% of their revenues on Technology (Exhibit 7). While a large part of it has to do with Run-The-Bank spend (currently 60%-70%), increasingly Change-The-Bank spend portion has been rising steeply within the mix. However, with revenues not growing in a meaningful way and budgets on IT being either flat to seeing only modest growth, BFSI organisations have been forced to squeeze their RTB spends and repurpose them to the CTB side. Thus, while in the IT services industry there is a lot of emphasis on order inflow (TCV), the existing book of business is seeing attrition because of productivity gains in-built into contracts. These are required to be delivered by the vendor to the customers. On top of that, we have seen instances of vendors themselves cannibalising their revenue streams to keep a hold on their customers as new automation tools lead to significant efficiency gains. This is especially so in case of maintenance contracts in BPS, IMS, Testing and Application Maintenance. Growth for any particular year is a combination of growth of the existing book of business and addition of new business. The extent of compression in the existing book (which tends to be a larger component of revenues) would be a bigger determinant of growth than just TCV addition.

Girish Pai
Head of Research
girish.pai@nirmalbang.com
+91-22-6273 8017

Seema Nayak
Research Associate
seema.nayak@nirmalbang.com
+91-22-6273 8179

Exhibit 1: Aggregate YoY BFSI revenue growth trend for our basket of vendors over last 12 quarters



Source: Nirmal Bang Institutional Equities Research

Exhibit 2: Shift in consensus estimates of large US lenders for 2020 over the last 12 months

	Revenue		change	Operating profit		change
(in USD bn)	**Sep-18**	**Sep-19**	**%**	**Sep-18**	**Sep-19**	**%**
JP Morgan	115.9	114.2	*(1.4)*	45.9	44.9	*(2.2)*
Citi Group	76.9	73.8	*(4.0)*	24.9	23.8	*(4.3)*
Bank of America	95.7	91.6	*(4.3)*	38.4	33.8	*(12.0)*
Wells Fargo	84.5	83.8	*(0.9)*	31.9	25.0	*(21.8)*
Barclays	22.3	21.3	*(4.7)*	8.6	6.1	*(29.3)*
Credit Suisse	23.7	22.0	*(7.3)*	7.1	5.5	*(22.2)*

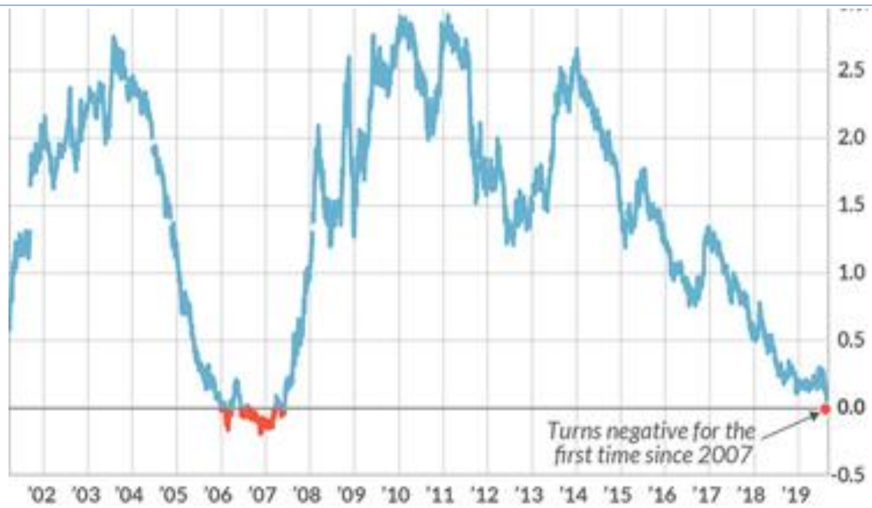
Source: Bloomberg, Credit Suisse numbers in CHF

Exhibit 3: Comments by BFSI companies in the last 6 months on their business prospects

BFSI company	When it said it	What did it say	Our comments
Bank of America	July 2019	Expects net interest income to increase 2% in 2019 down from the 3% guidance provided with first-quarter results.	Works with multiple Indian vendors. Has a large captive unit in India
Citi	September 2019	Forecasts 3-4% interest income growth vs. July's 4% guidance in local currency.	Citi works with multiple Indian vendors both large and small. Already LTI has been adversely impacted. Consensus has shaved off about US$4Bn from its revenue number in the last 12 months for 2020. There will have to be an appropriate cut in cost too.
JP Morgan	September 2019	Cut its outlook for 2019 net interest income to US$57bn versus US$57.5bn given in July 2019 and US$58bn it estimated in February 2019	JPM works with multiple vendors. But has been insourcing a lot more in recent years. Board driven decision to pull back a lot of IT work in house. Non-strategic work to be outsourced. Doing a significant amount of RPA related work in its captives in India to help cut costs
Wells Fargo	September 2019	Lowered expectations for 2019 net interest income (NII) to a 6% decrease from 2018. This follows a reduction to the lower-end of a 2-5% range in June, in turn down from the more bullish plus-or-minus 2% before April	Wells Fargo cited assets re-pricing lower and trailing deposit costs as drivers. Has a decent sized captive in India.
Deutsche Bank	September 2019	Indicated the bank could struggle to meet its mid-term revenue target as its turnaround plan faces challenges from slowing economies and lower interest rates	DB has been outsourcing to a number of Indian players – including we believe TCS and HCL Technologies.

Source: Media articles, Nirmal Bang Institutional Equities Research

Exhibit 4: Flattening and Inversion of Yield Curve: Spread between 10 year yield and US 2 year yield

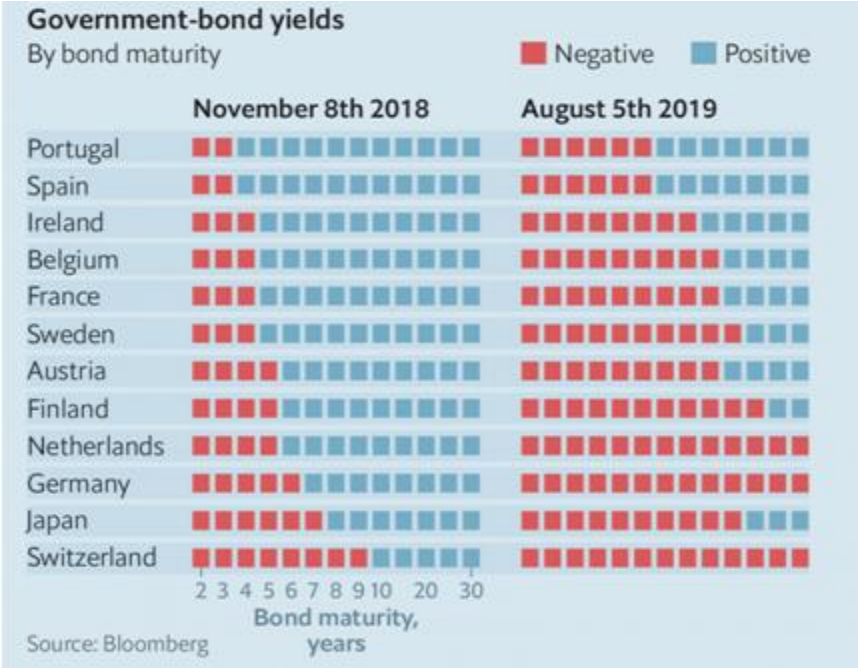


Source: Federal Reserve Bank of St. Louis

Exhibit 5: Negative Yielding Debt has increased significantly in 12 months and tops US$16trn

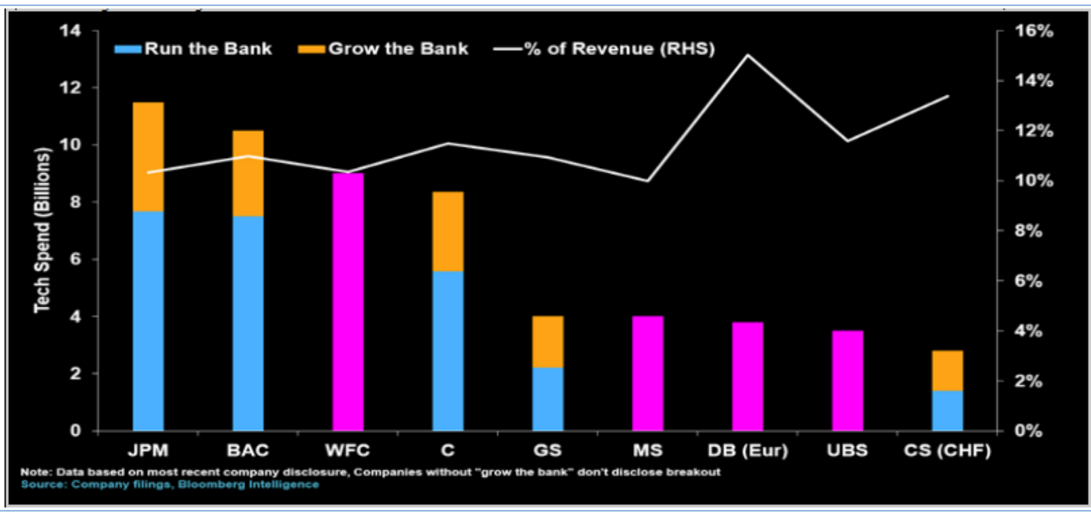
Source: Bloomberg

Exhibit 6: Extent of Negative yield bonds in European countries over the last 12 months



Source: Bloomberg, The Economist

Exhibit 7: Technology Spend by some key Banks in 2019. 'Run the bank' dominates



Source: Bloomberg

View on Indian IT services sector: We downgraded the Indian IT sector (see our report: Street Is Not Factoring Even A Soft Landing; We Downgrade) on 27 December 2018 based on: (1) Consensus not factoring in significantly softer growth in FY21 as the best demand environment since 2008-09 is largely behind us with corporate capex in both the US and Europe likely to have peaked in 2018. (2) The US BFSI space could witness pressure on margins from a flattened/inverted yield curve and probably a more hostile regulatory environment in a split Congress in the US. (3) Pressure on cost structure because of tariffs levied on imports from China impacting US manufacturers. (4) Front-office capabilities in digital still elusive for Indian IT services players, leading to inability to tap into the marketing budgets of customers in a material way. The focus has been on the technology-intensive back-end of digital where we believe the field is relatively more crowded. (5) 'Automation at scale' in legacy services eating into growth coming in from new services. This is driven by explosive growth in both intelligent and robotic process automation software industry. (6) Factoring in lower INR depreciation benefits than estimated earlier (Refer: Incorporating New INR Estimate). (7) Capital return to shareholders not being as potent a stock driver as it was earlier as the cash hoard is shrinking after two to three rounds of buyback over the past three years. (8) Talent pressure in the US in new age services because of a tighter H1-B visa regime. We were planning the downgrade a quarter or two down the road, but the global macro set-up has turned weaker far more quickly than we anticipated, hastening this move. While some of the 'relative' factors like investor positioning, valuation and earnings revision momentum - partly the reasons for turning 'tactically positive in March 2018 - still exist, we believe they are unlikely to carry as much importance with investors as deteriorating fundamentals would over FY19-FY21. While many of our competitors are expecting a better FY20 versus FY19, we believe that is unlikely. We probably had the best macro environment that the industry has seen in the past 10 years in 2018 and incrementally we only see a deterioration which should crimp spending by customers. More importantly, we reiterate our no-industry-growth-in-FY21 call initiated in March 2018. We base this scenario on an explicit expectation of a soft landing in the US (0%-1.5% real GDP growth) in 2020. We believe consensus is expecting mid-high single-digit revenue growth in FY21 for the industry, implicitly assuming continued robust growth in the US (2%-2.5%). It is our belief that the street will converge with our no-growth expectations over time. Until the market prices in this scenario, we believe technical factors are not likely to hold the sector up. A hard landing (recession) - not our current base case - could lead to single-digit negative growth for the sector. Just as outperformance of the sector in 2018 was driven largely by P/E multiple expansion in the belief that growth is going to accelerate, we believe the downside in 2019 will be driven by P/E multiple deflation as investors begin to re-calibrate growth expectations lower over FY19-FY21. We prefer large-caps over mid-caps. The faster growth shown by select mid-caps is a case of 'rising tide lifting all boats', a smaller base and lower exposure to legacy services. But as digital demand shifts from the front to back, we believe that traditional large Indian companies will be in a better position to capture the market. We would advise investors to focus on sustainability and not overpay for a riskier business model - some companies have seen client concentration rising over the past two years.

Exhibit 8: Comparative valuation

	TCS	Infosys	Wipro	HCL Tech	TechMahindra	Mindtree	Persistent
Year Ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 12-Sep-19	**2,134**	**816**	**245**	**1,055**	**706**	**670**	**569**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rs Bn)	8,169	3,549	1,208	1,431	622	111	46
(US$mn)	113,453	49,285	16,772	19,870	8,640	1,541	632
March 2020 Target Price	1,601	596	212	1,127	544	531	602
Upside/(downside)	-25.0%	-27.0%	-13.3%	6.8%	-22.9%	-20.8%	5.8%
Recommendation	Sell	Sell	Sell	Accumulate	Sell	Sell	Accumulate
FDEPS (Rs)							
FY18	67.0	32.5	16.8	62.9	42.8	34.6	40.4
FY19	83.1	36.0	18.6	73.5	48.1	45.8	44.1
FY20E	94.8	38.4	17.7	78.5	49.9	45.4	46.8
FY21E	97.0	40.1	18.3	85.4	54.9	53.7	56.1
PE (x)							
FY18	31.8	25.1	14.5	16.8	16.5	19.4	14.1
FY19	25.7	22.7	13.2	14.3	14.7	14.6	12.9
FY20E	22.5	21.3	13.8	13.4	14.1	14.8	12.2
FY21E	22.0	20.3	13.3	12.4	12.8	12.5	10.1
EV/EBITDA (x)							
FY18	24.8	15.6	13.1	12.0	11.3	15.3	9.1
FY19	20.0	14.2	10.4	10.0	7.9	10.6	6.5
FY20E	18.8	13.5	9.4	8.8	7.6	9.6	6.3
FY21E	17.9	12.5	9.0	7.9	6.5	8.2	4.7
EV/Sales (x)							
FY18	6.6	4.2	2.4	2.7	1.7	2.1	1.4
FY19	5.5	3.6	2.0	2.3	1.4	1.6	1.1
FY20E	5.0	3.4	1.8	2.0	1.3	1.4	0.9
FY21E	4.7	3.1	1.7	1.8	1.1	1.3	0.8
Pre Tax ROIC (%)							
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19	61.8	47.5	30.4	36.3	37.9	46.4	44.2
FY20E	60.2	46.8	35.8	33.0	36.3	43.7	41.0
FY21E	61.7	45.3	36.8	31.9	37.2	51.9	52.2

Source: Bloomberg, Nirmal Bang Institutional Equities Research

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Team Details:

Name		Email Id	Direct Line
Rahul Arora	CEO	rahul.arora@nirmalbang.com	-
Girish Pai	Head of Research	girish.pai@nirmalbang.com	+91 22 6273 8017 / 18
Dealing			
Ravi Jagtiani	Dealing Desk	ravi.jagtiani@nirmalbang.com	+91 22 6273 8230, +91 22 6636 8833
Pradeep Kasat	Dealing Desk	pradeep.kasat@nirmalbang.com	+91 22 6273 8100/8101, +91 22 6636 8831
Michael Pillai	Dealing Desk	michael.pillai@nirmalbang.com	+91 22 6273 8102/8103, +91 22 6636 8830

Nirmal Bang Equities Pvt. Ltd.

Correspondence Address

B-2, 301/302, Marathon Innova,

Nr. Peninsula Corporate Park,

Lower Parel (W), Mumbai-400013.

Board No. : 91 22 6273 8000/1; Fax. : 022 6273 8010