Information Technology Sector

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Sector Update

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Company meetings: No update on demand but margin pressure evident

During the course of this month we had interactions with the managements of TCS, Infosys, HCL Tech and Tech Mahindra. Over the last three months the global macro set-up has incrementally deteriorated with PMIs weakening across developed markets, Trump administration ratcheting up its tariff war with China, softening of bond yields across developed markets – partly on dovish Fed and ECB commentary - with quite a few going into negative territory (especially in Europe), confusion around Brexit, etc. However, the commentary on demand from key industry players TCS and Infosys remained unchanged from that given during 4QFY19. This lack of intra-quarter color on demand is a matter of investor communication policy. We think a change in commentary - if any – will have to wait for 1QFY20 results. TCS indicated that 'double digit' growth momentum would continue into FY20 based on strong exit rate in 4QFY19 (see our 4QFY19 note here). Infosys reiterated its guidance of 7.5%-9.5% constant currency (CC) revenue growth (which is a step down from its 4QFY19 exit rate. See our note here). While HCL Tech did not give any incremental information on services part of its revenues for the quarter, the acquisition of the IP from IBM (see our note here) which should have reflected in revenue in June'19 will now be recorded in 2QFY20. Commentary of Tech Mahindra has turned a bit softer on the enterprise side (see our note here) while it improved a tad on Communication vertical. We believe the market is building in a 2.5%-3% QoQ CC organic revenue growth for both Infosys and TCS and a likely sedate -1% to +1% for Wipro, HCL Tech and Tech Mahindra. Both TCS and Infosys have been guiding for a stronger 1H while the other three have been indicating a back-ended pick-up in growth. Any material surprises to these expectations would see the market react accordingly. We could get a bit more color on the margin picture in our interactions. We believe there could be 100-200bps QoQ margin compression across companies that are likely to report salary increases in 1QFY20 (TCS, Infosys and Tech Mahindra). The fact that INR has appreciated a tad vis-à-vis 4QFY19 is not going to help matters. In the case of Infosys, we think it might potentially start FY20 with a possible sub-20% EBIT margin before things improve to deliver its FY20 EBIT margin guidance of 21%-23% (mostly likely at lower end in our view). While 1QFY20 will see some residual impact of investments that Infosys made in sales and localisation in 4QFY19, we understand Infosys, after a gap of two years has applied for a fair number of H1-B visas. In our view, this would likely result in 25-50bps additional pressure over and above that of salary – 100-150bps. The exit EBIT margin in 4QFY19 was 21.4%. While it might tighten up operations, a sub-20% start seems quite likely. HCL Tech may face greater than expected pressure on margins in 1QFY20 as it has been investing ahead of its acquisition of the IP. One month's IP revenue of ~USD50mn at ~50% EBITDA margin was built in by the market. This will now flow through in 2QFY20. We continue to have an underweight stance on the IT sector vis-à-vis benchmark weight. Within the sector we prefer TCS, Infosys and HCL Tech in that order.

Higher H1-B visa move by Infosys may be to hold on to high performer talent: While across the industry companies are reducing their H1-visa application numbers, the sudden reversal of policy by Infosys seems tactical and could mean a few things: (1) That it has been able to successfully shift the local:visa related employee mix in the US to 50:50. This is likely through both local recruitment and also through rebadging on some of the deals it has won in the US (especially the Verizon deal). (2) While high attrition has become an industry wide problem (except for TCS), this had spread to its high-performer group as admitted by the management. This would have forced Infosys to use the H1-B visa route as a carrot to hold on to some of this talent.

No incremental commentary on impact of US-China tariff war and reasonable part of bond market having negative yields in Europe: Companies indicated that it was too early to discuss impact of the move by the Trump administration to raise US tariffs from 10% to 25% on a broad swathe of goods being imported from China. We had highlighted (see our sector view inside) that a wide variety of companies had indicated build up in costs because of the 10% levy. We suspect the pain would have likely got aggravated as the 10% moved up to 25% (despite a modest Yuan depreciation). Many Global 2000 corporations not only have manufacturing bases in China but also are dependent to an extent on Chinese demand.

Commentary on Verticals: The broad commentary on verticals continued to be the same as given in 4QFY20, with a mixed picture on BFSI – weakness in capital market players offset by some growth in select banking players. With a larger amount of developed market bonds trading with negative yields we expect many global insurance firms will likely begin to feel the pain and may re-look at their spending plans. This should get reflected in demand commentary going forward.

Robust TCV is going be critical for FY20 and FY21 growth: In FY19, we saw across the board pick-up in TCV (more so for Infosys, HCL Tech and Tech Mahindra where there were either explicit numbers on a YoY basis or commentary). It remains to be seen in the kind of worsening macro backdrop, how the TCV stacks up both on a QoQ basis and more so on a YoY basis. The news flow from companies in terms of press releases on large deals has been fairly muted - this could be reflective of demand or it could also be because of companies turning cagey for competitive reasons. As we have said in the past while large deal TCV is a good demand indicator, it needs to be taken with a pinch of salt as despite signing large deals customers may hold back on execution. The pace of deal conversion to revenue also needs to be monitored. In FY19, we understand that the conversion rate was likely among the best.

Automation remains the key margin lever: As highlighted by us multiple times, companies in the sector benefited from the sharp INR depreciation in FY19 (~9%-10%), which gave benefit to the tune of 150-200bps for each company. With that missing and a number of operating levers at close to their peak points – utilisation, fixed price, offshore delivery mix, we believe companies will have to extract more from their ability to automate work to claw back some of the pressures coming from salaries. What we hear from companies is that the headroom on this aspect is quite good. We believe subcontractor costs will remain elevated in the next two quarters at the least.

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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 1: Comparative valuation

	TCS	Infosys	Wipro	HCL Tech	TechMahindra	Mindtree	Persistent
Year Ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 26-Jun-19	**2,254**	**739**	**286**	**1,080**	**718**	**936**	**614**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rsbn)	8,628	3,213	1,413	1,465	633	155	49
(US$mn)	119,840	44,625	19,625	20,348	8,794	2,151	682
March 2020 Target Price	1,614	601	219	1,090	562	563	604
Upside/(downside)	-28.4%	-18.7%	-23.5%	0.8%	-21.7%	-39.8%	-1.5%
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
FY19E	83.1	36.0	18.6	73.5	48.1	45.8	44.1
FY20E	93.4	38.9	18.4	83.6	52.6	53.5	54.4
FY21E	97.8	40.4	19.0	88.0	56.8	56.9	56.4
PE (x)							
FY18	33.6	22.7	17.0	17.2	16.8	27.0	15.2
FY19E	27.1	20.5	15.4	14.7	14.9	20.4	13.9
FY20E	24.1	19.0	15.6	12.9	13.7	17.5	11.3
FY21E	23.0	18.3	15.1	12.3	12.6	16.4	10.9
EV/EBITDA (x)							
FY18	23.6	16.1	14.3	12.7	12.8	20.2	10.1
FY19E	19.1	14.6	11.5	10.5	9.0	14.0	7.3
FY20E	18.0	13.5	9.7	9.1	8.2	11.3	6.2
FY21E	17.3	12.9	9.2	8.5	7.5	10.6	5.5
EV/Sales (x)							
FY18	6.2	4.3	2.7	2.9	2.0	2.7	1.6
FY19E	5.2	3.7	2.3	2.4	1.6	2.1	1.3
FY20E	4.7	3.4	2.0	2.2	1.5	1.8	1.1
FY21E	4.5	3.2	1.9	2.0	1.3	1.7	0.9
Pre Tax ROIC (%)							
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19E	61.8	47.5	30.4	36.3	37.9	46.4	44.2
FY20E	59.4	49.4	37.0	32.4	41.1	49.2	52.5
FY21E	58.9	48.2	36.8	29.7	41.6	49.1	54.0

Source: Bloomberg, Nirmal Bang Institutional Equities Research

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