

India IT Services

Institutional Equity Research

Results Preview | 06 October 2021

Demand Resiliency to Continue Amidst Rising Margin Pressure

In 2QFY22, the NIFTY IT Index outperformed by 11% (YTD outperformance of 14%) to NIFTY. We expect continued strong revenue momentum on the back of deal ramp-ups and sustained deal closure activity across our IT coverage universe. We expect rising pressure on EBIT margin due to higher incentives for employees, step-up in employee onboarding and increased SG&A cost. Recently, Accenture reported 18.6% YoY USD revenue growth in its outsourcing services business, which we believe bodes well for the Indian IT names. Looking ahead, we expect the deal environment to remain robust backed by consistent technology spend on digital services by the global enterprises. We expect strong end-market commentary from the Top-8 IT companies under our IT sector coverage universe.

Deal Ramp-up to Accelerate Revenue Growth

We expect the IT companies under our coverage universe to report strong deal momentum (strong book-to-bill ratio and solid deal pipeline) across most verticals. We expect 3.8-6.6% and 5.4-6.3% sequential growth in CC revenue of the large-cap and mid-cap companies, respectively. We expect deal bookings to remain strong given higher demand for digital services. Further, revenue growth is likely to be broad-based across geographies and verticals.

Accelerated Hiring & Higher SG&A to Weigh on Profitability

We expect the companies under our IT sector coverage universe to report 0-170bps QoQ decline (Except TCS & LTI) in EBIT margin due to: (1) annual salary increment cycle; (2) accelerated hiring (both freshers and laterals); and (3) marginal step-up in investment in sales and capabilities. Notably, TCS, LTI and TechM underwent regular increment cycle in 1QFY22 and the rest are likely to follow in 2QFY22. We highlight higher margin pressure in 2QFY22E, owing to higher employee incentives amidst rising attrition. Additionally, we believe the large-cap IT names are in a better position to address supply side concerns compared to their mid-cap peers. We believe accelerated attrition is likely to be a medium-term phenomenon, as we expect the demand environment to remain strong over FY21-FY24E. Going ahead, we believe margin acceleration would depend on: (1) improved pricing; (2) operating leverage (double-digit revenue growth); and (3) USD appreciation.

IT Names to Raise FY22 Revenue Growth Guidance & Maintain Margin Outlook

We expect the companies to raise their strong revenue guidance for FY22E on the back of solid deal backlog and buoyant deal environment. We also believe broad-based consensus among the large-cap and mid-cap IT companies regarding acceleration in technology demand. We expect Infosys to raise its revenue growth guidance range to 16-18% vs. earlier guided range of 14-16%. Additionally,

we expect HCLT to introduce numerical revenue guidance in the range of 12-14% vs. earlier guidance of double-digit revenue growth. We expect the IT names to maintain EBIT margin outlook amidst rising headwinds. We expect the IT names to invest margin gain that they witnessed in FY21 for capability addition and talent retention, which will aid their market share gain in the medium-term. We also expect accelerated disclosures/commentary on progress of Cloud business.

Key Focus Points – Vertical Outlook, Deal Pipeline & Investment Areas

(1) Management commentary on demand outlook in Manufacturing, Energy, Retail and Travel and Hospitality verticals; (2) Any change in tech spending behaviour by the large US banks and insurers; (3) Progress on large deal closure front and read-across for the mid-cap names from mega employee rebadging deals; (4) Long-term target and current progress on Work from Home model; (5) Any plan for expansion of ecosystem partnership and change in capital allocation policies; (6) Focus areas for investment and capability development; (7) Attrition trend and hiring trends; and (8) Pricing trends.

Our View

Majority of global enterprises are still at early stage of digital adoption, which is a huge opportunity for the Indian IT companies. Digital services business is likely to clock 15-20% CAGR in the medium-term, led by increased Cloud adoption by the global enterprises. We expect the IT players to benefit from potential acquisition opportunities of captive units and vendor consolidation efforts. Currently, NIFTY IT trades at >30% premium to NIFTY on 1-Yr Fwd earnings basis vs. historical average premium of 7%. We expect multiple re-rating for select IT names given their resilient operating model (low capex and high variable cost structure) strong revenue growth visibility over FY21-FY24E, which warrant premium valuation.

Our Top Results Picks: TechM and HCLT

Research Analyst:

Suyog Kulkarni, CFA

Contact : (022) 41681371 / 9890966735

Email : suyog.kulkarni@relianceada.com

Research Associate:

Chaitanya Panchmatia

Contact : (022) 41681371 / 8080782900

Email : chaitanya.panchmatia@relianceada.com

Exhibit 1: 2QFY22 Preview Table

	CC Revenue Growth (QoQ %)	EBIT Margin (%)
TCS	4.2	25.8
Infosys	5	22.2
Wipro	6.6	17.3
HCLT	3.8	19.6
TechM	4.5	15.1
LTI	5.4	16.9
Mindtree	6.3	16.4
Mphasis	5.7	15.5

Source: RSec Research

Exhibit 2: 2QFY22 Average Currency Rates

Currencies	1QFY22- Average rate	2QFY22- Average rate	Delta (%)
AUD USD	0.77	0.75	(2.4)
EUR USD	1.21	1.19	(1.4)
GBP USD	1.40	1.39	(0.8)
USD INR	73.74	74.00	(0.4)

Source: RSec Research

Exhibit 3: India IT Sector - 2QFY22 Result Preview

Company (Rs mn)	2QFY22E	1QFY22	QoQ (%)	2QFY21	YoY (%)	Comments
TCS						
Revenue \$mn	6,388	6,154	3.8	5,424	17.8	<ul style="list-style-type: none"> ▶ We expect constant currency revenue growth of 4.2% QoQ. We expect book to bill ratio is likely to be higher than 1.0x. ▶ We expect EBIT margin benefit of 30bps driven by operating leverage and marginal currency tailwind (~10bps) ▶ TCS expects top-line to grow by double-digit in FY22. We expect to get more details ▶ Key things to watch: 1)Deal commentarry, 2) Outlook of BFSI, Retail and Helathcare vertical 3) Attrition trends 4) Pricing trends
Revenue	4,72,701	4,54,110	4.1	4,01,350	17.8	
EBIT	1,21,862	1,15,880	5.2	1,05,150	15.9	
Net income	97,439	90,080	8.2	86,930	12.1	
Diluted EPS (Rs)	26.3	24.4	8.2	23.2	13.7	
Margin (%)			Change in BPS		Change in BPS	
EBIT	25.8	25.5	30	26.2	(40)	
Net Income	20.6	19.8	80	21.7	(105)	
Infosys						
Revenue \$mn	3,956	3,782	4.6	3,312	19.4	<ul style="list-style-type: none"> ▶ Expect sequential constant currency revenue growth of 5% (Incl full quarter contribution of Daimler Deal). We expect strong order bookings. ▶ We expect decline in EBIT margin of 150bps (QoQ) primary due to wage hike, stepped up hiring and higher SG&A cost ▶ We expect Infosys to raise FY22 revenue growth guidance to 14-16% (vs earlier 12-14%) and reiterate FY22 EBIT margin in the range of 22-24% ▶ Key points to watch: 1) Large deal activity, 2) Outlook of BFSI vertical, 3) Attrition trend and 4) Capital allocation policy
Revenue	2,92,742	2,78,960	4.9	2,45,700	19.1	
EBIT	64,984	66,030	(1.6)	62,280	4.3	
Net income	52,090	51,950	0.3	48,450	7.5	
Diluted EPS (Rs)	12.27	12.24	0.3	11.42	7.4	
Margin (%)			Change in BPS		Change in BPS	
EBIT	22.2	23.7	(150)	25.3	(310)	
Net Income	17.8	18.6	(80)	19.7	(190)	

Continued...

India IT Sector - 2QFY22 Results Preview

Company (Rs mn)	2QFY22E	1QFY22	QoQ (%)	2QFY21	YoY (%)	Comments
HCLT						
Revenue (\$ mn)	2,815	2,720	3.5	2,507	12.3	▶ We expect constant currency revenue growth of 3.8% QoQ . We expect acceleration in deal activity
Revenue	2,08,293	2,00,680	3.8	1,85,940	12.0	▶ We expect stable EBIT margin as higher operating leverage offsets stepped up hiring and pick up in SG&A cost
EBIT	40,870	39,310	4.0	40,160	1.8	▶ We expect HCLT to provide revenue growth guidance of 12-14% and company is likely to retain EBIT margin range of 19-21%
Net income	32,267	32,140	0.4	31,393	2.8	▶ Key things to watch: 1) Update on deal activity, 2) Outlook of financial services and manufacturing vertical and 3) Update on outlook and margin from Mode 2 and Mode 3 business
Diluted EPS (Rs)	11.92	11.91	0.1	11.63	2.5	
Margin (%)			Change in BPS		Change in BPS	
EBIT	19.6	19.6	0.0	21.6	(200)	
Net Income	15.5	16.0	(50)	16.9	(140)	
Wipro						
Wipro IT Services-Revenue \$ mn	2,564	2,415	6.2	1,992	28.7	▶ We expect Wipro to report QoQ constant currency growth of 6.6% (guidance range of 5%-7%).Capco to contribute 250bps in sequential revenue growth
Wipro IT Services- Revenue	1,89,751	1,80,481	5.1	1,47,681	28.5	▶ We expect QoQ decline of 170bp in EBIT margin driven by impact from acquisition, accelerated hiring and higher SG&A cost
Wipro IT Services- EBIT	32,827	34,270	(4.2)	28,351	15.8	▶ We expect Wipro to guide 3QFY22 revenue growth of 1.5-3% (QoQ)
Net income	12,849	13,003	(1.2)	11,707	9.8	▶ Key points to watch: 1) Large deal win momentum 2) Capco integration plan 3) Pricing trends and 4) Outlook of BFSI and retail vertical
Diluted EPS (Rs)	1.97	2.00	(1.7)	1.80	9.6	
Margin (%)			Change in BPS		Change in BPS	
EBIT IT Services	17.3	19.0	(170)	19.2	(190)	
Net Income	16.0	17.8	(180)	16.6	(60)	
Tech Mahindra						
Revenue \$mn	1,442	1,384	4.2	1,265	13.9	▶ We expect constant currency revenue growth of 4.6% QoQ. We expect deal wins likely to improve sequentially
Revenue	1,06,687	1,01,976	4.6	93,718	13.8	▶ We expect mere 10bps sequential decline in EBIT margin driven by accelerated hiring
EBIT	16,060	15,453	3.9	13,313	20.6	▶ Key things to watch: 1) Updated on 5G deal activity, 2)Attrition trends 3) Update on margin optimization program
Diluted EPS (Rs)	15.3	15.3	(0.2)	12.1	26.2	
Margin (%)			Change in BPS		Change in BPS	
EBIT	15.1	15.2	(10)	14.2	90	
Net Income	12.7	13.3	(60)	11.4	130	

Continued...

India IT Sector - 2QFY22 Results Preview

Company (Rs mn)	2QFY22E	1QFY22	QoQ (%)	2QFY21	YoY (%)	Comments
Larsen & Toubro Infotech						
Revenue USD mn	494.2	470.2	5.1	404.5	22.2	▶ Revenue is expected to grow by 5.4% QoQ in constant currency
Revenue	36,569	34,625	5.6	29,984	22.0	▶ We expect EBIT margin to increase by 50BPS driven by operating leverage.
EBIT	6,174	5,683	8.6	5,957	3.6	▶ LTI targets to remain leaders quadrant in terms of revenue growth in FY22
Net Income	5,113	4,969	2.9	4,568	11.9	▶ Key Things to Watch Out For: (1) Outlook on BFSI spend and health of manufacturing and energy verticals; (2) key investment areas for growth; (3) update on M&A strategy 4)Hiring Trends
Diluted EPS (Rs)	29.45	28.27	4.2	25.95	13.5	
Margin (%)			Change in BPS		Change in BPS	
EBIT	16.9	16.4	50	19.9	(300)	
Net Income	14.0	14.4	(40)	15.2	(120)	
Mindtree						
Revenue \$mn	329	311	6.0	261	26.1	▶ We expect constant currency revenue growth of 6.3%(QoQ)
Revenue	24,356	22,917	6.3	19,260	26.5	▶ We expect 130bps decline in EBIT margin driven by salary increment cycle and higher M&A amortisation cost.
EBIT	3,986	4,063	(1.9)	3,215	24.0	▶ Key things to watch: 1) Top Client growth outlook, 2) Pace of recovery in travel and hospitality vertical and 3)Update on client diversification efforts
Net Income	3,201	3,434	(6.8)	2,537	26.2	
Margin (%)			Change in BPS		Change in BPS	
EBIT	16.4	17.7	(130)	16.7	(30)	
Net Income	13.1	15.0	(190)	13.2	(10)	
Mphasis						
Revenue \$mn	382	363	5.3	327	10.8	▶ We expect constant currency revenue growth rate of 5.7% QoQ.
Revenue	28,279	26,909	5.1	24,354	10.5	▶ We expect EBIT margin likely to drop driven by cost of accelerated hiring and integration cost of acquisition.
EBIT	4,383	4,271	2.6	3,924	8.8	▶ Key things to watch: 1) Outlook on BFSI spend 2) Key Investment areas 3)Update on DXC business and 4) Capital allocation policy
Net income	3,402	3,390	0.4	2,992	13.3	
Diluted EPS (Rs)	17.9	17.9	0.4	15.9	12.2	
Margin (%)			Change in BPS		Change in BPS	
EBIT	15.5	15.9	(40)	16.1	(60)	
Net Income	12.0	12.6	(60)	12.3	(30)	

Source: Company, RSec Research

Change in Ratings

We have changed our rating system and included **HOLD** recommendation. We have **BUY, HOLD and SELL** recommendation now.

We have also shifted to **1-Year Target Price** from **2-Year Target Price**.

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