

India IT Services

Institutional Equity Research

Results Preview | 07 January 2022

Strong Performance in Seasonally Weak Quarter

In 3QFY22, the Nifty IT Index outperformed by 12% (CY2021 outperformance of 30%) to Nifty. We expect a continued strong revenue momentum on the back of deal ramp-ups, IT transformational spends and sustained deal closure activity across our IT coverage universe. We expect rising pressure on EBIT margin due to higher incentives for employees, wage hike to retain talent amid the high attrition, lower utilization due to aggressive fresh hiring, and stable SG&A cost. Recently, Accenture reported 21% YoY USD revenue growth in its outsourcing services business, which we believe is a key positive 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 companies under our IT sector coverage universe. Despite December being a lean month in general, we expect healthy deal flows to drive the revenue growth.

Robust Demand Outlook and Digitalization 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 due to a strong demand seen for transformation and digitalization. We expect 3-4% and 4-5.3% sequential growth in CC revenue for the large cap and mid-cap companies, respectively. Further, revenue growth is likely to be broad-based across geographies and verticals. We expect deal bookings to remain strong, given the ongoing digital transformation trend.

Higher Attrition & SG&A to Impact Profitability...but Operating Leverage to Benefit; Stable Margins

We expect the companies under our IT sector coverage universe to report 10-40bps QoQ decline in EBIT margin due to: (1) accelerated hiring (both freshers and laterals) amid the high attrition; (2) marginal step-up in investment in sales and capabilities and (3) lower utilization due to hiring freshers. We highlight the margin pressure in 3QFY22, owing to higher employee incentives amid the rising attrition, while operating leverage and cross currency would nullify the impact to a greater extent. Thus, we expect a more or less stable operating margin. Though attrition would remain elevated, we believe that it has already peaked out now. 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 the accelerated attrition is likely to be a medium-term phenomenon, as we expect the demand environment to remain strong over FY21-FY24. Going ahead, we believe margin expansion 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 IT companies to raise their revenue guidance for FY22 on the back of a solid deal backlog and buoyant deal environment. We also believe a broad-based consensus exists among

the large cap and mid-cap IT companies regarding acceleration in technology demand. We expect Infosys to raise FY22 revenue growth guidance to 17-17.5% (vs. the earlier 16.5-17.5%) and reiterate FY22 EBIT margin in the range of 22-25%. We expect HCLT to retain the CC double-digit revenue growth for FY22E and an EBIT margin range of 19-21%. We expect LTI to target to remain in the leader's quadrant in terms of revenue growth in FY22. We expect Wipro to guide 4QFY22 CC revenue growth of 2.5-3.5% (QoQ). We also expect accelerated disclosures/commentary on the progress of cloud business. We expect a decline in the utilization rate due to the fresher hiring and a rise in discretionary cost.

Key Focus Points

(1) Revenue guidance, (2) large deal pipeline/bookings, (3) WFH status due to increasing Covid cases, (4) IT budget of clients for the next year, (5) hiring intensity, and (6) attrition trend.

Our View

The IT sector (coverage universe) is set to post another quarter of strong growth with high CC growth and stable margins despite cost pressure, based on (1) increasing speed of digital transformation/shift to cloud, (2) improving deal pipeline, and (3) investment in the hyperscalers/SaaS ecosystem. We expect the IT companies to invest the margin gains 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 the progress of cloud business. Majority of global enterprises are still at an 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 >45% premium to Nifty on a 1-year forward earnings basis vs. the 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) and strong revenue growth visibility over FY21-FY24, which warrant a premium valuation. The stellar performance of Accenture has further strengthened our positive view on the sector.

Our Top Results Picks: HCLT, TechM and Infosys

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Exhibit 1: 3QFY22 Preview Table

	CC Revenue Growth (QoQ %)	EBIT Margin (%)
TCS	4.0	25.6
Infosys	4.5	23.7
Wipro	4.0	17.5
HCLT	4.6	19.0
TechM	4.8	15.3
LTI	4.0	17.5
Mindtree	5.3	17.8
Mphasis	4.0	15.2

Source: RSec Research

Exhibit 2: 3QFY22 Average Currency Rates

Currencies	2QFY22- Average rate	3QFY22- Average rate	Delta (%)
AUD USD	0.75	0.73	(2.9)
EUR USD	1.19	1.14	(3.9)
GBP USD	1.39	1.35	(2.9)
USD INR	74.00	74.96	1.3

Source: RSec Research

Exhibit 3: India IT Sector - 3QFY22 Result Preview

Company (Rs mn)	3QFY22E	2QFY22	QoQ (%)	3QFY21	YoY (%)	Comments
TCS						
Revenue \$mn	6,555	6,333	3.5	5,702	15.0	<ul style="list-style-type: none"> ▶ We expect constant currency revenue growth of 4% QoQ. We expect book to bill ratio is likely to be higher than 1.0x. ▶ We expect EBIT margin to be stable by cross currency headwind due to appreciation of dollar against the pound, the euro and the Australian Dollar (~50bps) ▶ TCS expects top-line to grow by double-digit in FY22. ▶ Key things to watch: 1) Deal commentary, 2) Outlook of BFSI, Retail and Healthcare vertical 3) Pricing trends
Revenue	4,91,599	4,68,670	4.9	4,20,150	17.0	
EBIT	1,25,849	1,20,000	4.9	1,11,840	12.5	
Net income	99,906	96,240	3.8	87,010	14.8	
Diluted EPS (Rs)	27.0	26.0	3.8	23.2	16.5	
Margin (%)			Change in bps		Change in bps	
EBIT	25.6	25.6	-	26.6	(102)	
Net Income	20.3	20.5	(21)	20.7	(39)	
Infosys						
Revenue \$mn	4,166	3,998	4.2	3,516	18.5	<ul style="list-style-type: none"> ▶ Expect sequential constant currency revenue growth of 4.5% . We expect strong order bookings. ▶ We expect QoQ increase in EBIT margin of 10bps due to operating efficiency. ▶ We expect Infosys to raise FY22 revenue growth guidance to 17-17.5% (vs earlier 16.5-17.5%) and reiterate FY22 EBIT margin in the range of 22-25% ▶ Key points to watch: 1) Large deal activity, 2) Outlook of BFSI vertical, 3) Attrition trend and 4) Capital allocation policy
Revenue	3,12,444	2,96,020	5.5	2,59,270	20.5	
EBIT	73,981	69,720	6.1	65,890	12.3	
Net income	61,439	54,210	13.3	51,970	18.2	
Diluted EPS (Rs)	14.59	12.88	13.3	12.25	19.1	
Margin (%)			Change in bps		Change in bps	
EBIT	23.7	23.6	13	25.4	(174)	
Net Income	19.7	18.3	135	20.0	(38)	

Continued...

India IT Sector - 3QFY22 Results Preview

Company (Rs mn)	3QFY22	2QFY22	QoQ (%)	3QFY21	YoY (%)	Comments
HCLT						
Revenue (\$ mn)	2,888	2,791	3.5	2,507	15.2	▶ We expect constant currency revenue growth of 4.6% QoQ . We expect acceleration in deal activity
Revenue	2,16,628	2,06,550	4.9	1,85,940	16.5	▶ We expect a constant EBIT margin as higher operating leverage offsets by cost increase.
EBIT	41,255	39,160	5.4	40,160	2.7	▶ We expect HCLT to retain CC double digit revenue growth for FY22 and EBIT margin range of 19-21%
Net income	32,899	32,650	0.8	31,393	4.8	▶ 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)	12.15	12.07	0.6	11.63	4.5	
Margin (%)			Change in bps		Change in bps	
EBIT	19.0	19.0	-	21.6	(255)	
Net Income	15.2	15.8	(62)	16.9	(170)	
Wipro						
Wipro IT Services-Revenue \$ mn	2,701	2,580	4.7	1,992	35.6	▶ We expect Wipro to report QoQ constant currency growth of 4%
Wipro IT Services- Revenue	2,02,595	1,93,799	4.5	1,47,681	37.2	▶ We expect QoQ decline of 30bp in EBIT margin due to lower utilisation amid new hiring
Wipro IT Services- EBIT	35,454	34,587	2.5	28,351	25.1	▶ We expect Wipro to guide 4QFY22 revenue growth of 2.5-3.5% (QoQ)
Net income	30,588	29,325	4.3	25,042	22.1	▶ Key points to watch: 1) Large deal win momentum 2) Pricing trends and 3) Outlook of BFSI and retail vertical
Diluted EPS (Rs)	2.02	1.97	2.5	1.80	12.4	
Margin (%)			Change in bps		Change in bps	
EBIT IT Services	17.5	17.8	(35)	19.2	(170)	
Net Income	14.8	14.9	(6)	16.6	(172)	
Tech Mahindra						
Revenue \$mn	1,548	1,473	5.1	1,309	18.3	▶ We expect constant currency revenue growth of 4.8% QoQ. We expect deal wins likely to improve sequentially
Revenue	1,16,100	1,08,813	6.7	96,471	20.3	▶ We expect 10bps improvement in EBIT margin driven by operating efficiencies
EBIT	17,819	16,522	7.8	15,371	15.9	▶ Key things to watch: 1) Updated on 5G deal activity, 2) Update on margin optimization program
Net income	14,352	13,387	7.2	13,098	9.6	
Diluted EPS (Rs)	16.2	15.1	7.2	14.9	8.5	
Margin (%)			Change in bps		Change in bps	
EBIT	15.3	15.2	16	15.9	(60)	
Net Income	12.4	12.3	6	13.6	(122)	

Continued...

India IT Sector - 3QFY22 Results Preview

Company (Rs mn)	3QFY22E	2QFY22	QoQ (%)	3QFY21	YoY (%)	Comments
Larsen & Toubro Infotech						
Revenue USD mn	536.0	509.0	5.3	427.8	25.3	▶ Revenue is expected to grow by 4% QoQ in constant currency
Revenue	40,198	37,670	6.7	31,528	27.5	▶ We expect EBIT margin to increase by 30bps driven by operating leverage.
EBIT	7,018	6,482	8.3	6,501	7.9	▶ LTI targets to remain in leaders quadrant in terms of revenue growth in FY22
Net Income	5,898	5,517	6.9	5,192	13.6	▶ Key Things to Watch: (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)	33.6	31.4	6.9	29.5	13.8	
Margin (%)			Change in bps		Change in bps	
EBIT	17.5	17.2	25	20.6	(316)	
Net Income	14.7	14.6	3	16.5	(179)	
Mindtree						
Revenue \$mn	370	350	5.7	274	35.0	▶ We expect constant currency growth of 5.3%(QoQ)
Revenue	27,754	25,862	7.3	20,237	37.1	▶ We expect 40bps decline in EBIT margin due to lower utilisation.
EBIT	4,941	4,697	5.2	3,962	24.7	▶ 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	4,059	3,989	1.8	3,265	24.3	
Margin (%)			Change in bps		Change in bps	
EBIT	17.8	18.2	(36)	19.6	(178)	
Net Income	14.6	15.4	(80)	16.1	(151)	
Mphasis						
Revenue \$mn	402	385	4.3	334	15.4	▶ We expect constant currency growth rate of 4% QoQ.
Revenue	30,134	28,693	5.0	24,743	16.0	▶ We expect EBIT margin likely to improve by 10bps due to operating efficiencies.
EBIT	4,569	4,320	5.8	4,048	6.7	▶ Key things to watch: 1) Outlook on BFSI spend 2)Update on DXC business and 3) Capital allocation policy
Net income	3,654	3,415	7.0	3,255	4.9	
Diluted EPS (Rs)	19.2	18.0	7.0	17.3	3.6	
Margin (%)			Change in bps		Change in bps	
EBIT	15.2	15.1	10	16.4	(120)	
Net Income	12.1	11.9	22	13.2	(103)	

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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