KRChoksey | Institutional

Q3FY21 IT Services Preview

7th January, 2021

IT Services

Set for growth recovery in 2QFY21, deal flow, margin outlook, 2HFY21 commentary to be watched

MARKET DATA

	Close	1D (%)	1M (%)	YTD (%)
Nifty	14137	-0.06	5.85	16.18
Sensex	48093	-0.17	5.87	16.58
Nifty IT	25251	-0.01	13.30	61.32
USD / INR	73	0.00	-0.01	0.03

COVERAGE STOCKS

Company	Current Price (INR)	Target Price (INR)*		Upside (%)	Market Cap. (INR mn)	Fwd PE FY2023E (x)	Reco.*	
		New	Old				New	Old
TCS	3,053	3,170	3,170	3.8%	11,4855,843	26.8	ACCUMULATE	ACCUMULATE
Infosys	1,282	1,305	1,305	1.8%	5,459,088	22.8	ACCUMULATE	ACCUMULATE
HCL Technologies	978	1,015	1,015	3.8%	2,653,286	17.4	ACCUMULATE	ACCUMULATE
Wipro	407	420	420	3.2%	2,323,571	19.3	ACCUMULATE	ACCUMULATE
Tech Mahindra	997	975	975	(2.2%)	964,037	14.8	HOLD	ACCUMULATE
Mindtree	1,693	N.A.	1,520	-	278,821	22.8	U.R.	ACCUMULATE
Persistent Systems	1,542	N.A.	1,415	-	117,832	20.6	U.R.	ACCUMULATE
Tata Elxsi	1,995	1,785	1,600	(10.5%)	124,254	29.0	REDUCE	ACCUMULATE
Sonata Software	401	393	393	(1.9%)	42,132	12.2	HOLD	ACCUMULATE
Sterlite Technologies	192	N.A.	186	-	75,984	17.0	U.R.	BUY
Infibeam Avenues	83	105	105	26.8%	54,740	21.4	BUY	BUY

**Source: Bloomberg, Data as of January 6, 2021; U.R. = Under Review*

SECTOR OVERVIEW

- **Deal wins, continuing digital investments to drive revenue in 3QFY21, margin outlook, CY21 IT budget outlook and impact of second COVID-19 strain on verticals to be watched:** We expect IT stocks under our coverage to report a combined 3.4% QoQ USD revenue growth (ex-Tata Elxsi, which does not give out USD revenue numbers) despite normally weak seasonality owing to furloughs and the holiday season, as the sector continues to enjoy a growth recovery, with ramp up of recent deal wins and digital transformation investments to drive revenue. We expect HCL Technologies to out-perform among the top-tier IT pack, with 3.0% QoQ constant currency (CC) revenue growth, aided by deal wins across key verticals, followed by Infosys (2.9% CC growth), TCS (2.7%), Tech Mahindra (2.6%) and Wipro (2.5%). Among mid-tier IT, we expect Tata Elxsi to out-perform, with the company likely to achieve CC revenue growth in excess of 5-5.5% QoQ (6% QoQ INR growth), aided by healthy growth in its Broadcast & Communications and Healthcare & Medical Devices verticals. On the other hand, the other 3 firms under our coverage (Mindtree, Persistent Systems and Sonata Software) are expected to achieve CC revenue growth of 2.5-3.5% QoQ, led by key verticals including Retail & CPG, BFSI, Healthcare, Hi-tech and Manufacturing. This quarter, owing to the weakness of the USD against cross-currencies including the EUR, GBP and AUD, top-tier Indian IT firms are likely to see a benefit of 40-80bps on reported USD revenue growth, with TCS to see maximum impact (nearly 80bps) owing to the highest proportion of revenue coming from these currencies. INR appreciation will lead to INR growth coming in lower than USD revenue growth. We would watch deal flows, sustainable margin outlook in light of WFH becoming a more permanent feature, likely capex impact of WFH, impact of 2nd round of Europe lockdowns and CY21 IT budget outlook.

- **Wage hike, INR appreciation to impact EBIT margin sequentially:** Even as revenue growth is likely to be healthy, we expect EBIT margin to decline sequentially for most of the IT firms under our coverage, mainly owing to the impact of wage hikes undertaken by most IT firms. Revenue growth leverage, continuing cost savings owing to WFH becoming mainstream, along with higher offshore component are key cost levers to offset impact of wage hikes and a potential partial cost return as employee return to work in a staggered manner. TCS, Infosys, Wipro and HCL Technologies are all likely to report 50-80bps QoQ margin declines. We expect Tech Mahindra to report 22bps QoQ expansion, aided by revenue growth and cost optimisation, with the IT major continuing to focus on key margin levers including offshoring and cost synergies between its subsidiaries. Among the mid-sized IT firms, Persistent Systems and Tata Elxsi are likely to report 60-80bos QoQ margin declines. We expect Sonata to post a slight margin improvement on a consolidated basis owing to improving growth of its IITS business, which has higher margins than the DPS business. We expect Mindtree to report 33bps QoQ margin decline.

- **Vertical trends, sustainable margin outlook, TCV wins, Europe lockdown impact and IT budget trends likely to be in focus:** We would keep a close eye on vertical trends, with the key BFSI and Retail outlook critical in light of most top-tier IT firms' exposure to these verticals. Trends in positively impacted sectors such as Hi-tech, Communications, Media and Healthcare will also be critical in light of their growth contribution, with Mindtree, Sonata, Tata Elxsi and Persistent all earning a revenue from these verticals. With the 2nd round of lockdowns in Europe, we would also watch for the likely impact on verticals such as Travel and Hospitality, with Sonata and Mindtree having reasonable exposure to this vertical. Sustainable margin outlook, TCV data and IT budget trends for CY21 will also be keenly awaited by the street, as will likely change in guidance by Infosys and HCLT.

- **Sector outlook and view:** While 3QY21 will confirm continuation of growth and deal wins for the sector – with Accenture numbers in December providing a glimpse - stock prices have rallied significantly on the back of a solid 2Q performance and healthy liquidity driving the broader market, raising expectations. We believe stock performance is unlikely to be tolerant of any misses on expectations, with current valuations providing little scope for rerating. After a growth bump-up in FY22 on a low FY21 base aided by pent up demand, we believe FY23 will reflect a more 'normalised' sector growth outlook, and we expect the industry to revert to high single digit growth in that fiscal after double digit growth in FY22. **We would maintain a largely 'equal weight' position on Indian IT, and our preferences remain HCLT, Infosys and Tech Mahindra among the top-tier pack, while we remain positive on the medium-term business prospects of Tata Elxsi and Persistent, even as their stock prices have risen substantially, and we downgrade the former to REDUCE on valuation, while putting the latter along with Mindtree under review.**

IT Services

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Exhibit 1: Quarterly result expectation for companies under coverage

INR Mn	Q3Y21E	Q3FY20A	YoY %	Q2FY21A	QoQ %	Remarks
Tata Consultancy Services (TCS)						
Sales (USD Mn)	5,614	5,586	0.5	5,424	3.5	USD revenue growth is likely to come in at 3.5% QoQ, with CC growth likely at 2.7% QoQ. Cross-currency tailwinds to aid reported USD growth by nearly 80bps. We expect EBIT margin to decline 69bps QoQ on wage hike impact, with revenue growth and cost efficiencies to offset this to an extent, with adjusted PAT likely to be flattish sequentially. Key Parameters: (1) Order book/TCV growth, (2) Vertical impact of 2nd round of lockdowns in Europe, (3) Sustainable margin profile in light of wage hikes, WFH trend along with potential return of some cost going forward, (4) Key vertical performance, mainly BFSI and Retail, (5) Commentary on likely impact of tax hikes on IT spend under a Biden presidency.
Net Sales	414,156	398,540	3.9	401,350	3.2	
EBIT	105,643	99,740	5.9	105,150	0.5	
Adj. Net Profit	86,625	81,180	6.7	86,930	(0.4)	
OPM (%)	25.5	25.0	48bps	26.2	(69bps)	
NPM (%)	20.9	20.4	55bps	21.7	(74bps)	
Infosys						
Sales (USD Mn)	3,428	3,243	5.7	3,312	3.5	USD revenue is likely to rise 3.5% QoQ, while CC revenue growth is likely at 2.9% QoQ with favourable cross-currency tailwinds to boost reported USD revenue growth by nearly 60bps. EBIT margin is likely to decline 51bps QoQ on INR appreciation and slight rise in SG&A cost, while APAT is likely to rise 8.3% QoQ aided by higher other income and lower tax rate. Key Parameters: (1) Change in CC revenue growth guidance (currently 2-3%), (2) Sustainable margin outlook, (3) New deal wins, (4) Commentary on key verticals including BFSI and Retail, (5) Digital revenue proportion.
Net Sales	252,892	230,920	9.5	245,700	2.9	
EBIT	62,813	50,640	24.0	62,280	0.9	
Net Profit	52,493	44,570	17.8	48,450	8.3	
OPM (%)	24.8	21.9	291bps	25.3	(51bps)	
NPM (%)	20.8	19.3	146bps	19.7	104bps	
HCL Technologies						
Sales (USD Mn)	2,598	2,543	2.1	2,507	3.6	USD revenue growth is likely to come in at 3.6% QoQ (3.0% QoQ in CC terms), aided by growth recovery in the ITBS and ER&D businesses, deal wins across verticals. EBIT margin is likely to decline 75bps QoQ on wage hikes and INR appreciation, even as higher other income and lower tax rate will boost PAT growth. Key Parameters: (1) FY21 guidance change, currently at 2.5% CC revenue CQGR over 2Q-4QFY21, (2) Margin outlook, (3) Digital growth through Mode 2, (4) Vertical impact of European lockdowns, (5) P&P business seasonality impact.
Net Sales	191,665	181,350	5.7	185,940	3.1	
EBIT	39,960	36,700	8.9	40,160	(0.5)	
Net Profit	32,654	30,370	7.5	31,420	3.9	
OPM (%)	20.8	20.2	61bps	21.6	(75bps)	
NPM (%)	17.0	16.7	29bps	16.9	14bps	
Wipro						
ITS Sales (USD Mn)	2,036	2,095	(2.8)	1,976	3.1	USD revenue for the Combined IT Services business is likely to rise 3.1% QoQ in USD terms and 2.5% QoQ in CC terms, at the mid-point of guidance. IT EBIT margin should decline 100bps QoQ on wage hike and INR appreciation. Consolidated EBIT margin is likely to fall 66bps QoQ, even as higher other income and lower tax rate boosts PAT growth. Key Parameters: (1) 4QFY21 CC revenue growth guidance, (2) Vertical commentary, (3) Progress on the 5 key growth pillars as outlined in its recent analyst meet.
Cons. Sales (INR Mn)	155,594	154,705	0.6	150,967	3.1	
Cons. EBIT	27,628	26,506	4.2	27,797	(0.6)	
Net Profit	25,284	24,558	3.0	24,656	2.5	
OPM (%)	17.8	17.1	62bps	18.4	(66bps)	
NPM (%)	16.2	15.9	38bps	16.3	(8bps)	

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IT Services

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INR Mn	Q3Y21E	Q3FY20A	YoY %	Q2FY21A	QoQ %	Remarks
Tech Mahindra						
Sales (USD Mn)	1,306	1,353	(3.5)	1,265	1,306	USD revenue is likely to rise 3.2% QoQ (2.6% QoQ in CC terms) aided by growth across Enterprise and Communications. Margin is likely to rise by a healthy 114bps QoQ, aided by revenue growth and continued cost rationalisation, which should drive PAT growth. Key Parameters: (1) TCV deal wins, (2) 5G commentary, (3) Sustainable margin outlook, (4) Commentary on key Enterprise verticals including Manufacturing, Retail, BFSI and Energy.
Net Sales	96,344	96,546	(0.2)	93,718	96,344	
EBIT	13,899	11,785	17.9	13,313	4.4	
Net Profit	12,133	11,459	5.9	10,662	13.8	
OPM (%)	14.4	12.2	222bps	14.2	22bps	
NPM (%)	12.6	11.9	72bps	11.4	122bps	
Mindtree						
Sales (USD Mn)	269	275	(2.3)	261	3.0	USD revenue is expected to rise 3% QoQ, with CC growth likely to come in at 2.6% QoQ, aided by growth in Hi-tech, Retail & CPG and BFSI verticals, while Travel & Hospitality could take a little more time to recover. Margins are likely to decline marginally by 33bps QoQ on INR appreciation, while higher other income should aid PAT growth. Key Parameters: (1) Growth and margin outlook for 4QFY21 in light of wage hikes, (2) Non-Microsoft client growth, (3) Deal TCV, and (4) Impact of Europe lockdowns on Travel & Hospitality vertical.
Net Sales	19,833	19,653	0.9	19,260	3.0	
EBIT	3,368	2,364	42.5	3,334	1.0	
Net Profit	2,646	1,970	34.3	2,537	4.3	
OPM (%)	17.0	12.0	495bps	17.3	(33bps)	
NPM (%)	13.3	10.0	332bps	13.2	17bps	
Persistent Systems						
Sales (USD Mn)	141	129	8.9	136	3.6	USD revenue is likely to grow 3.9% QoQ, aided by deal wins and CAPIOT acquisition, EBIT margin is likely to decline on wage hike impact, though higher other income and lower tax rate should boost PAT. Key Parameters: (1) Progress on cross-sell strategy between TSU and Alliances business, (2) IBM growth in seasonally strong quarter, (3) Deal wins, large deal strategy continuing to reflect.
Net Sales	10,402	9,227	12.7	10,077	3.2	
EBIT	1,195	806	48.3	1,218	(1.9)	
Net Profit	1,098	879	24.9	1,020	7.6	
OPM (%)	11.5	8.7	276bps	12.1	(60bps)	
NPM (%)	10.6	9.5	102bps	10.1	43bps	
Tata Elxsi						
Sales (USD Mn)	N.A.	N.A.	N.A.	N.A.	N.A.	Revenue is likely to rise by 6% QoQ in INR terms, aided by growth in Broadcast & Communications and Healthcare & Medical Devices verticals, as well as Design growth. Margin should see 80bps QoQ expansion partly owing to some cost return and INR appreciation, while higher other income should boost PAT growth. Key Parameters: (1) Growth in Transportation vertical, (2) Progress in verticals adjacent to Transportation such as Rail and Off-highway Eqiuipment, (3) Commentary on any impact of the BREXIT deal and UK lockdowns, and (4) Developments on cash return or M&A activity.
Net Sales	4,559	4,234	7.7	4,302	6.0	
EBIT	1,096	830	32.0	1,068	2.5	
Net Profit	852	754	12.9	789	8.0	
OPM (%)	24.0	19.6	444bps	24.8	(80bps)	
NPM (%)	18.7	17.8	87bps	18.3	35bps	

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Sonata Software						
IITS Sales (USD Mn)	40.6	46.8	(13.3)	39.0	4.0	USD revenue growth is likely at 4% QoQ in the IITS business aided by traction in key verticals including Hi-tech, Retail, Manufacturing and Commodities, even as Travel could remain subdued. Consolidated EBIT margin is likely to rise marginally owing to higher IITS growth, which should boost PAT growth. Key Parameters: (1) Impact of Europe lockdowns on Travel vertical, (2) Microsoft account growth, (3) 4QFY21 revenue growth outlook, (4) Sustainable margins for IITS business.
Cons. Sales (INR Mn)	10,744	12,369	(13.1)	9,524	12.8	
Cons. EBIT	781	1,005	(22.3)	679	15.0	
Net Profit	591	759	(22.1)	499	18.5	
OPM (%)	7.3	8.1	(86bps)	7.1	14bps	
NPM (%)	5.5	6.1	(63bps_	5.2	26bps	
Sterlite Technologies						
Sales (USD Mn)	N.A.	N.A.	N.A.	N.A.	N.A.	For 3QFY21, we expect STL to report revenue of INR 12,500 Mn, up 7.8% QoQ on steadily improving volumes and utilisation of OF and OFC capacity. YoY growth is likely at a subdued 3.9%. Consolidated EBITDA is expected to rise by 17.3% QoQ (fall of 3.9% YoY), as sequentially volumes improve, even as it may take one more quarter to get back to pre-COVID levels fully. EBITDA margin is likely to rise 155bps QoQ, and decline 153bps YoY. Net profit is expected at INR 800 Mn, up 36.8% QoQ but down 12.1% YoY. Key parameters: 1) New order wins 2) Demand outlook 3) Any major deal wins on fibre and service in domestic and international market
Net Sales	12,500	12,030	3.9%	11,595	7.8%	
EBITDA	2,375	2,470	(3.9%)	2,024	17.3%	
APAT	800	910	(12.1%)	585	36.8%	
EBITDAM (%)	19.0%	20.5%	(153bps)	17.5%	155bps	
NPM (%)	6.4%	7.6%	(120bps)	5.0%	140bps	
Infibeam Avenues						
Sales (USD Mn)	23	23	0.6%	21	7.9%	We expect top line to increase 8.9% QoQ / 5.9% YoY mainly on account of commencement of revenue contribution from Reliance Jio contract and improvement in travel and hospitality sector. We have forecasted uptick in margins in Q3FY21 on Q-o-Q basis to the tune of 439bps in Operating margin and 988bps in Net Profit margin, led by incremental profit share from international subsidiaries Key Parameters: (1) Recovery in travel and hospitality segment (2) Performance of corporate credit cards business (Acquired from Cardpay Technologies). (3) Daily volume data from UAE / Saudi Arabia / Oman market (4) Commentary on expansion of business in the US market.
Net Sales	1,676	1,583	5.9%	1,539	8.9%	
EBIT	176	152	15.9%	94	87.3%	
Net Profit	264	259	1.9%	90	192.1%	
OPM (%)	10.5%	9.6%	90bps	6.1%	439bps	
NPM (%)	15.8%	16.4%	-61bps	5.9%	988bps	

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Rating Legend (Expected over a 12-month period)	
Our Rating	**Upside**
Buy	More than 15%
Accumulate	5% – 15%
Hold	0 – 5%
Reduce	-5% – 0
Sell	Less than – 5%

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