Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Infosys

Eyeing a large chunk of digital pie

IT & ITES	Sharekhan code: INFY	Company Update

Stock Update

Summary

- Management indicated demand would stay strong for 2-4 years led by clients' high spends on cloud and digital transformation, urgency for core modernisation and greater offshoring.
- Q2FY2022 revenue growth to remain strong aided by ramp-up of Daimler deal. Infosys is well-placed to deliver industry-leading revenue growth in FY2022 given broad-based demand, robust deal wins and a healthy deal pipeline.
- Strategic investments in digital capabilities make Infosys well-placed to participate in clients' digital transformation journey. We expect USD revenue and net profit to clock a 16% and 17% CAGR respectively, over FY2021-2023E.
- We maintain a Buy on Infosys with a revised PT of Rs. 1,950 given strong growth potential, healthy deal wins and broad-based demand.

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 1,693**	
Price Target: **Rs. 1,950**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 718,148 cr
52-week high/low:	Rs. 1,755/925
NSE volume: (No of shares)	66.9 lakh
BSE code:	500209
NSE code:	INFY
Free float: (No of shares)	370.7 cr

Shareholding (%)

Promoters	13.0
FII	51.4
DII	22.9
Others	12.7

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	1.8	19.7	25.8	80.1
Relative to Sensex	-5.3	7.5	11.6	28.3

Sharekhan Research, Bloomberg

We recently interacted with Infosys' management to understand the demand, deal momentum, supply pressures and margin outlook. Infosys reiterated demand acceleration would sustain for the next 2-4 years due to accelerated spending on cloud and digital-transformation initiatives, core modernisation and increased offshoring. The company's strategic investments in digital capabilities places it well to participate in clients' digital-transformation journey.

- **Expect industry-leading growth in FY2022:** Infosys' management remains confident of sustaining strong revenue growth momentum in its BFSI vertical, given strong tech spends by BFS firms and other key verticals as well. Q2FY2022 revenue growth would remain strong because of ramp-up of Daimler deal. Infosys is well placed to deliver industry-leading revenue growth in FY2022, given broad-based demand, robust deal wins and a healthy deal pipeline.
- **Infosys Cobalt gaining traction:** Infosys Cobalt has been gaining traction among customers as it helps enterprises to redesign the core and build new cloud-first capabilities. Growth in its cloud business would continue to remain strong over the next few years, given strong clientele, inclusion of Infosys Cobalt in each new deals, and strong partner ecosystem.
- **Reiterated its EBIT margin guidance of 22-24%:** Management cited that the impact of transition costs of Daimler deal would be less in Q2FY2022 as a substantial portion of it was recognised in Q1FY2022. Margin headwinds in subsequent quarters are wage revision (in Q2FY2022), some reversal of COVID-19 related savings, impact of large deals' transition costs, and possibilities of higher subcontracting expenses. Margin levers including revenue growth, scaling up digital services, higher offshore revenue, and pyramid rationalisation are expected to offset margin headwinds. Management has maintained its EBIT margin guidance at 22-24% for FY2022.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 1,950: Infosys will be at the forefront in driving the digital transformation journey of its customers. We expect Infosys to deliver leading revenue growth among tier-I IT services companies in FY2022, given strong demand across industries, ramp up of large deals, and market share gains. We assume Infosys to report USD revenue and earnings growth of 16% and 17%, respectively, over FY2021-FY2023E. At the CMP, the stock trades at 27x/24x its FY2023E/FY2024E earnings, which is justified given strong growth potential and robust deal wins. We continue to prefer Infosys, given its healthy balance sheet, robust free cash flow (FCF) generation capability, and a strong capital allocation policy. Hence, we maintain a Buy rating on the stock with a revised price target (PT) of Rs. 1,950.

Key Risks

Rupee appreciation and/or adverse cross-currency movements, slackening pace in deal closures, and/or constraints in local talent supply in the US would affect earnings.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	1,00,473.0	1,19,624.3	1,37,675.3	1,54,176.8
OPM (%)	27.8	26.4	26.3	26.4
Adjusted PAT	19,423.0	22,366.0	26,359.4	29,665.8
% YoY growth	17.0	15.2	17.9	12.5
Adjusted EPS (Rs.)	45.6	52.7	62.1	69.9
P/E (x)	37.1	32.1	27.3	24.2
P/B (x)	5.0	4.8	4.4	4.0
EV/EBITDA (x)	25.1	22.1	19.1	16.9
RoNW (%)	25.3	27.6	30.2	30.6
RoCE (%)	31.9	32.7	35.5	36.7

Source: Company; Sharekhan estimates

Indian IT services industry to benefit from higher digital adoption and increasing outsourcing

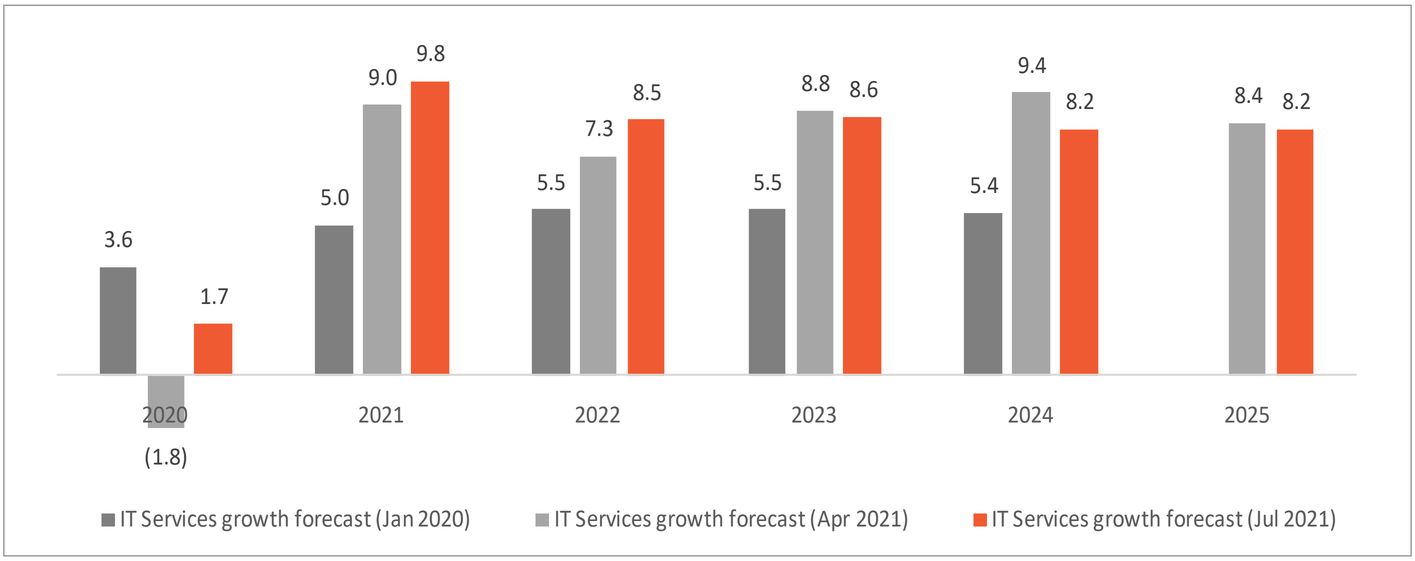
Enterprises are rapidly adopting digital and cloud technologies to re-imagine business model, increased business resilience and agility, optimise cost structure, catching up with digitally mature and cloud-native competitors, and personalising experiences for customers and employees. Infosys' management cited that it sees strong demand acceleration for cloud and digital technologies over the next 2-4 years.

Industry demand is being driven by two big trends – (1) investment in both front-end and back-end transformation to enhance experience in digital transactions and (2) higher tech spending around cloud migration, application modernisation, and data modernisation for greater resilience and agility within enterprises. With reduction in pressures from captives, tight labour market conditions and rising outsourcing because of urgency of transformation initiatives, tier-I IT companies including Infosys will derive maximum benefit, given their strong global service delivery experience, competitive cost structure, strong execution, availability of talent pool, and innovation.

According to the latest forecast, Gartner expects worldwide IT spending to rise by 8.6% y-o-y to $4.2 trillion in 2021. Of this, Gartner forecasts IT services spend would grow by 9.8% in FY2021. Further, IT services spending is likely to report an 8.7% CAGR over FY2021-FY2025, led by strong growth in digital technology. Digital technologies (such as cloud hosting, cloud migration, ADM DevOps, consulting, IoT, etc.) would report a 15-20% CAGR over FY2021-FY2025, while next-generation technologies (5G, robotics, and Blockchain) are expected to report a CAGR of 35-45% over the same period.

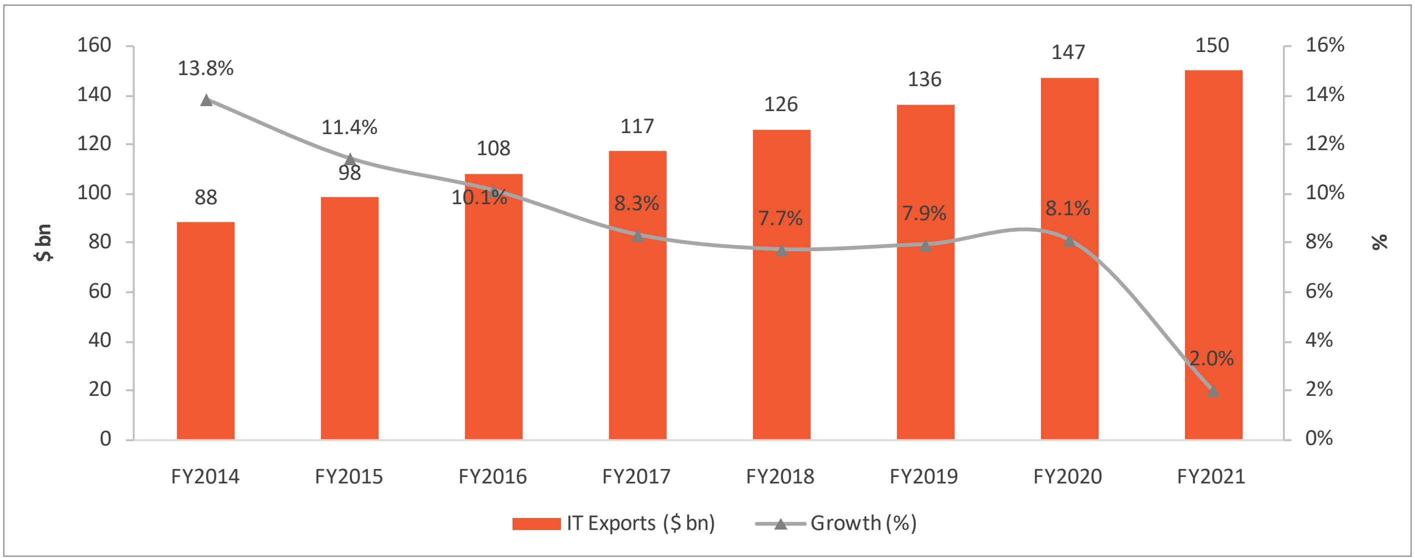
According to NASSCOM, the Indian IT industry reached a size of $194 billion in FY2021, rise of 2.3% y-o-y. Exports from the Indian IT industry grew by 2.0% y-o-y to reach $150 billion in FY2021 and domestic revenue of the IT industry grew by 3.4% y-o-y to ~$45 billion. Growth is driven by increased demand for digital transformation and infrastructure modernisation. Digital revenue accounted for 28-30% of total industry revenue in FY2021, growing at a rapid pace. The Indian IT services industry is expected to touch $300 billion-350 billion in annual revenue in the next five years, led by higher demand in emerging technology areas such as cloud, artificial intelligence (AI), and cyber security.

Industry experts revised in IT services spending



Source: Gartner, Sharekhan Research

Indian IT Industry export growth trajectory

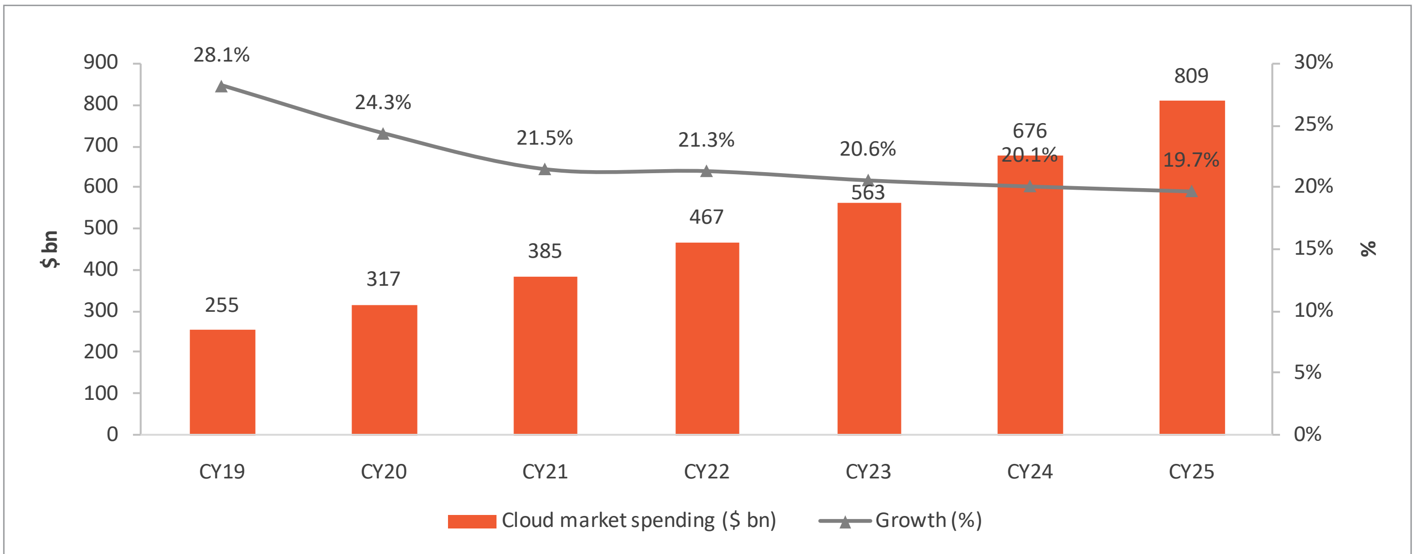


Source: Nasscom, Sharekhan Research

Cloud adoption is still in the early phase; Infosys Cobalt gaining traction among customers

The future of enterprise cloud strategy has been shaped by business agility, scaled innovation, and security of the ecosystem. The pandemic precipitated structural changes across industries, given higher adoption of online digital channels. Hence, Cloud and advanced analytics remain the prime focus areas of enterprises worldwide, as these technologies help in business scalability, reducing risk, increasing efficiencies, and improving customer experiences. Enterprises have sped up cloud investments by migrating workloads to public cloud and data modernisation. Public cloud adoption is in the early stages as only 15-20% of workloads have moved to public cloud and it is expected that 60-70% of workloads would be shifted in 3-4 years. Total public cloud spending in 2020 was $317 billion, implied around 20% of total enterprise technology spending ($1.5 trillion). Given strong adaption of cloud post COVID-19 crisis, it is estimated that spending on cloud-related technologies would grow at 21% over 2020-2025.

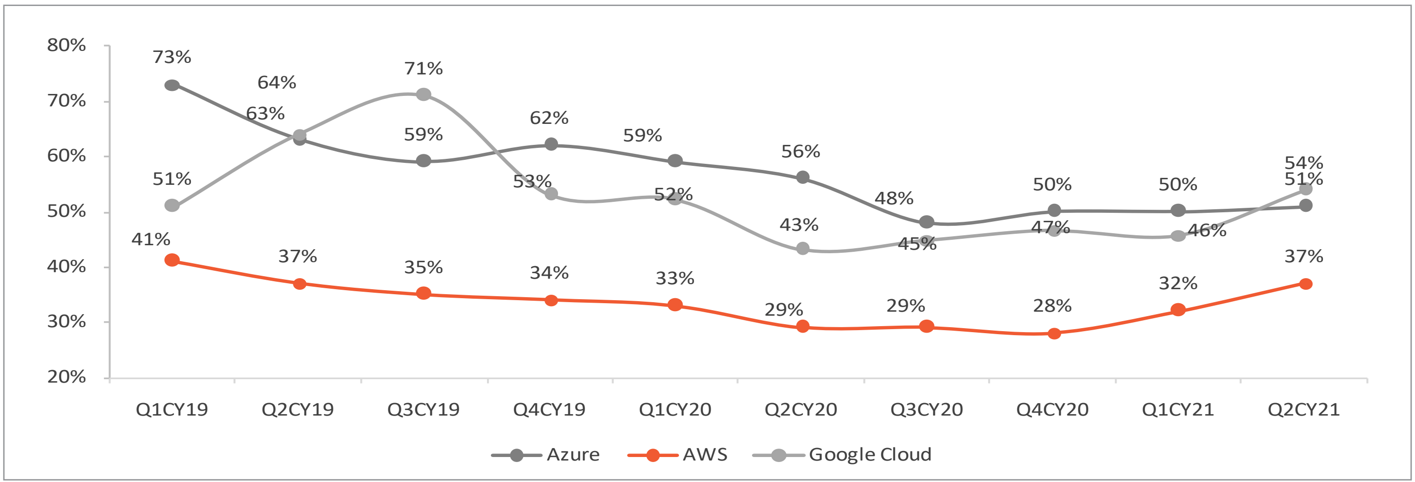
Cloud market spending is expected to grow at a 21% over 2020-2025



Source: IDC; Sharekhan Research

Strong growth in revenue of cloud providers offers confidence for strong growth of Indian IT services companies. Higher spend on Cloud would have an upside risk from data, analytics, and AI spend. Cloud technology is driving revenue growth and cost savings across enterprises as it provides on-demand access to IT resources and tools. It is estimated that average net return on investment of up to $3 for every $1 invested in cloud services.

Could adoption continues to touch record-high



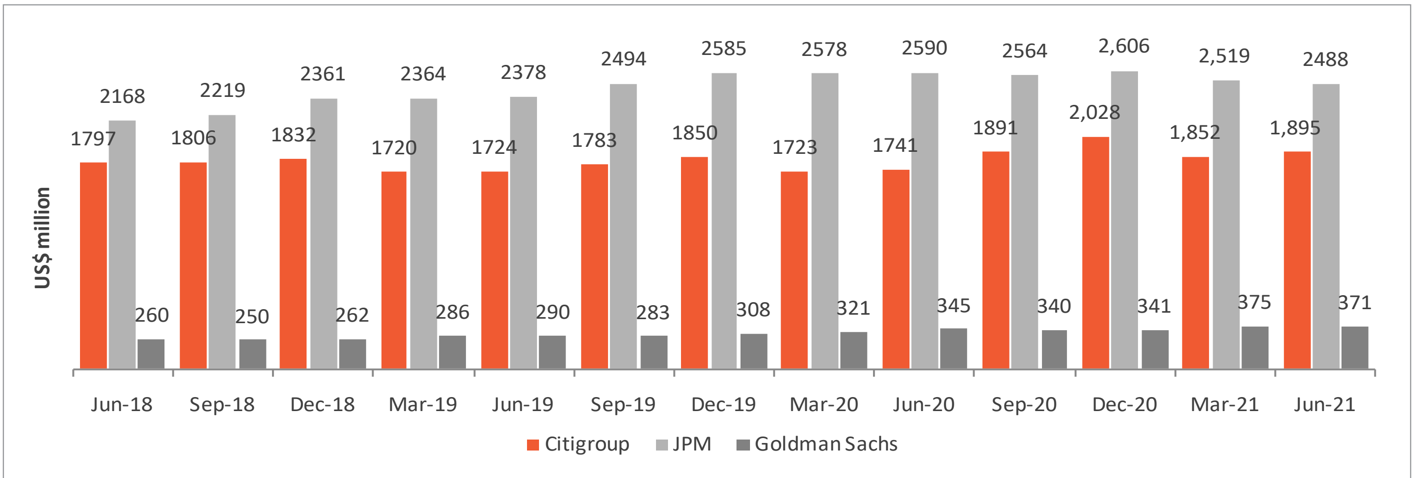
Source: Sharekhan Research

As enterprises find it difficult to evaluate the return of their investments on cloud technologies due to legacy burden and complexity of cloud, Infosys helps enterprises to redesign the core and build new cloud-first capabilities to create seamless experiences in public, private, and hybrid cloud, across PaaS, SaaS, and IaaS landscapes. Last year, Infosys had launched its integrated cloud offering, Infosys Cobalt, which has been gaining traction among customers, as it helps in driving value for clients. Management believes that its cloud business would sustain strong growth momentum in the next 2-4 years, led by strong clienteles, inclusion of Infosys Cobalt in each new deals, and strong partner ecosystem with hyperscalers and downstream players.

BFS spending remains robust; Infosys is well poised to capture opportunities

Higher adoption of online channels and rising competition from fintech companies have accelerated investments in cloud and digital initiatives by BFS firms. Banks are leveraging technology for cost reduction, improving customer experience, and gaining market shares. We believe that tech spending among BFS firms would remain strong in the medium terms as these financial institutions focus on legacy modernisation and digital-transformation initiatives.

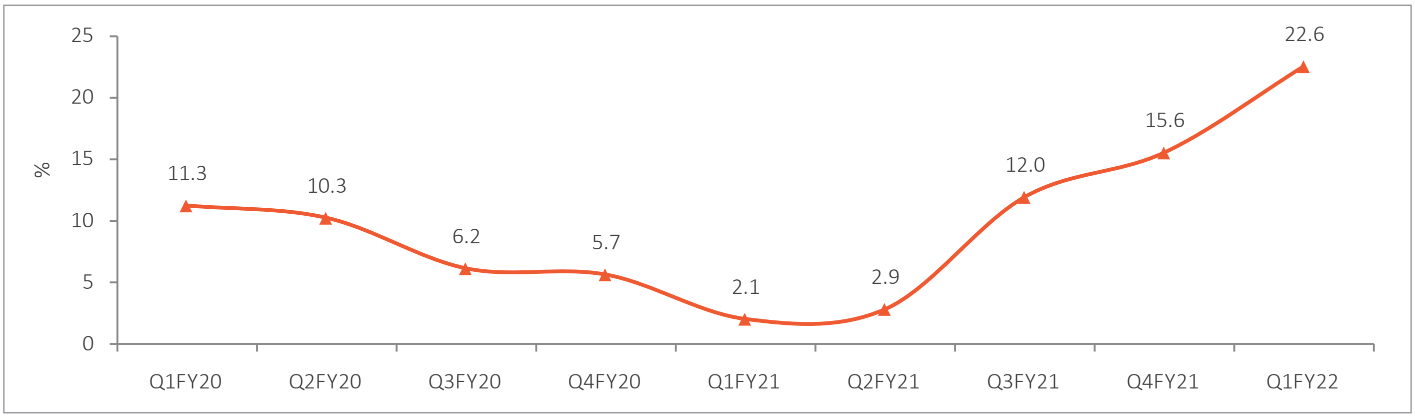
Technology spends by large US banks remained strong



Source: Sharekhan Research

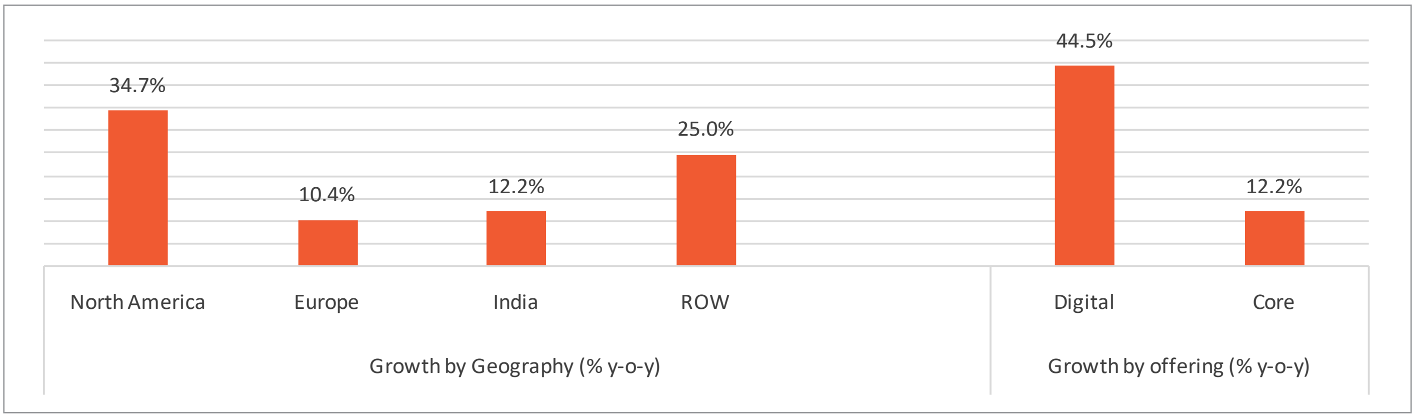
Revenue growth of Infosys' BFSI vertical has been accelerating over the past three quarters. Infosys reported strong USD revenue growth of 4.7% q-o-q and 26.9% y-o-y in its BFSI vertical because of ramp-up of large deal and strong deal wins. On LTM basis, the company's BFSI vertical growth remained at 15.8% y-o-y, which was the highest among top four tier-I IT companies. Stellar growth in its BFSI vertical was led by strong demand in the sub verticals such as banking, mortgages, wealth, and retirement services in the US. Management cited that it expects significant improvement in the payments sector after normalisation of economic activities. Given Infosys' deep domain expertise, robust delivery capabilities, transformation solutions across sub-segments of BFS, and strong tech spends by BFS firms, we believe Infosys would sustain its strong growth momentum in its BFSI vertical.

Infosys' BFSI constant-currency revenue growth trend (% y-o-y)



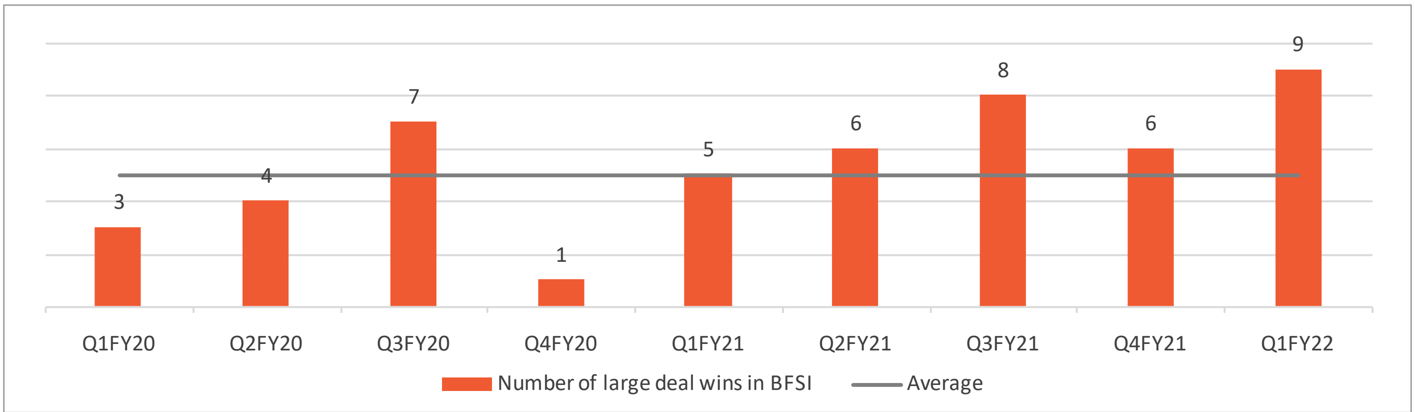
Source: Sharekhan Research

Q1FY2022: BFSI USD revenue growth y-o-y across geographies and offerings



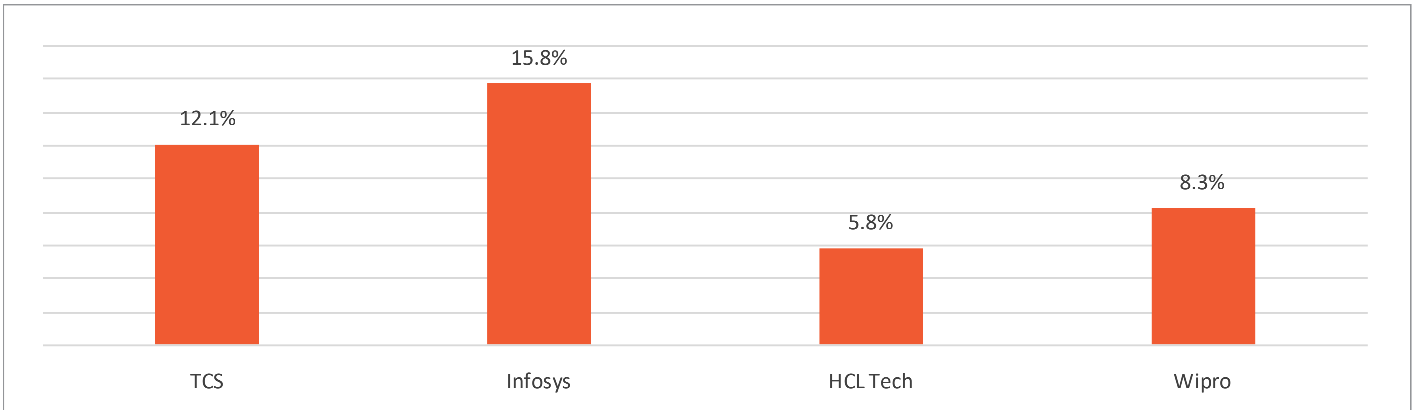
Source: Sharekhan Research

Number of BFSI deal wins by Infosys



Source: Company, Sharekhan Research

Infosys leads in growth in BFSI vertical on LTM basis



*Source: Company, Sharekhan Research * last twelve months y-o-y*

Set to outrun the industry in FY2022; Expect strong Q2 aided by ramping up of Daimler deal

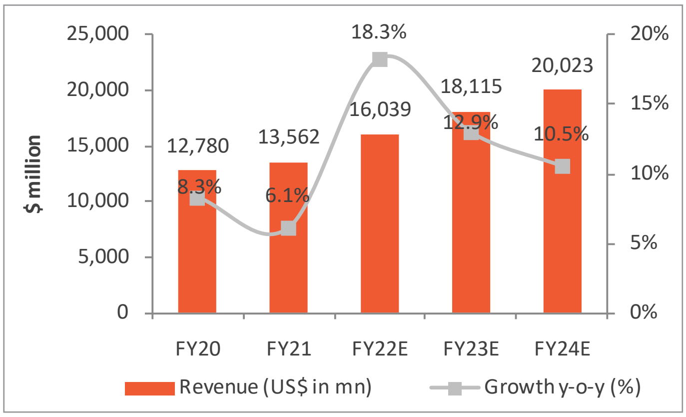
Management has reiterated its earlier commentary on the outlook as it has not witnessed any incremental changes in demand so far during the quarter. Infosys remains confident on achieving its FY2022 revenue growth guidance of 14-16% on CC basis. Infosys indicated growth would be driven by strong adoption of digital and cloud technologies across industries, strong deal wins, and healthy deal pipeline. Infosys won large deal TCVs of $2.6 billion in Q1FY2022, taking total large deal TCVs of $15 billion over the past four quarters. Further, the company won 83 large deals and added 478 new logos during the same period. Management indicated that broad-based growth across verticals and geographies would continue in the remaining quarters of FY2022, as it sees increasing digital spends across BFSI, retail, communication, and lifesciences verticals. Further, demand outlook in the impacted verticals such as energy and utilities, all sub-verticals of manufacturing and travel continues to improve. Infosys plans to hire 35,000 freshers globally in FY2022 (on-boarded 10,000 freshers in 1QFY2022), which is higher than its previous target of 25,000. Increased hiring indicates strong demand environment, measures to deal with supply-side challenges, and lower dependence on subcontractors. As the ramp-up of Daimler deal would contribute in Q2FY2022, we expect revenue growth would be strong in Q2FY2022. Hence, we believe management could again raise its revenue growth guidance for FY2022E due to strong performance in 1HFY2022, though Q3FY2022 performance would be impacted by lower billing days and furloughs. We believe Infosys is well placed to deliver industry-leading revenue growth (18.3% y-o-y) among tier-I companies in FY2022 because of ramp-up of deals, broad-based demand, strong deal intake, and a robust deal pipeline.

Expect margin to stay under pressure in Q2; Management remains comfortable with the guidance

Infosys reported EBIT margin at 23.7% in Q1FY2022, which was impacted due to increased sub-contracting expenses, talent constraint, and large deal transition expenses. Management highlighted that a substantial portion of transition costs relating to Daimler deal was recognised in Q1FY2022. Hence, the impact of transition costs of Daimler deal would be less in Q2FY2022. However, the company's margin is expected to be impacted in subsequent quarters, owing to (1) wage revision, (2) unsustainable utilisation rate (88.5% in Q1FY2022), (3) higher attrition rate, (4) some reversal of COVID-19 related savings, (5) some impact of large deals' transition costs, and (6) anticipated higher subcontracting expenses. Management highlighted that price revision is taking place in some projects where the portion of digital/new-age technologies remains higher and the company has much better negotiation power. Further, the company's efforts on re-skilling of employees has helped it to control subcontracting cost to some extent. In addition, the company has taken some sub-contractors on its payroll to manage subcontracting expenses and meet clients' work commitment. Management highlighted that supply-side pressures are likely to normalise over the next 2-3 quarters as industry-wide freshers hiring would come on stream in the coming quarters. We believe margin levers such as strong revenue growth, scaling up digital services, higher automation, higher offshore revenue mix, some price increases in digital transformation works, and pyramid rationalisation would be able to offset margin headings in the coming quarters. Management has maintained its EBIT margin guidance at 22-24% for FY2022, which is higher compared to pre-COVID level.

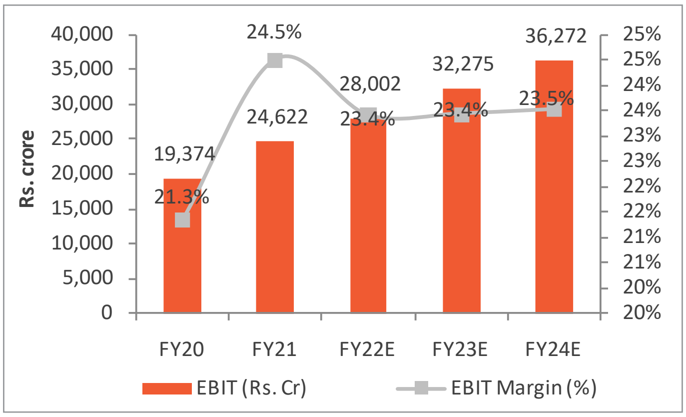
Financials in charts

Revenue in US$ (mn) and growth (%)



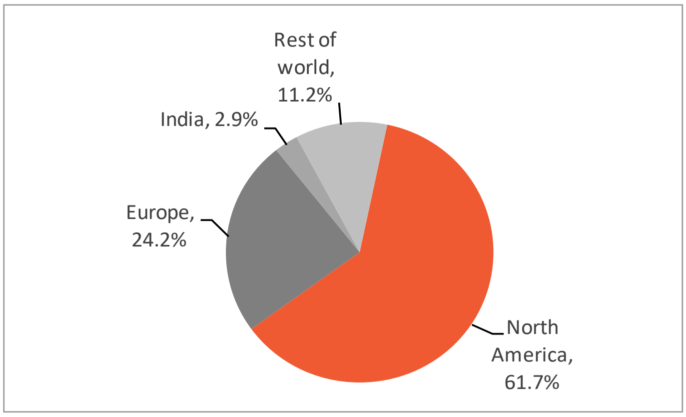
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



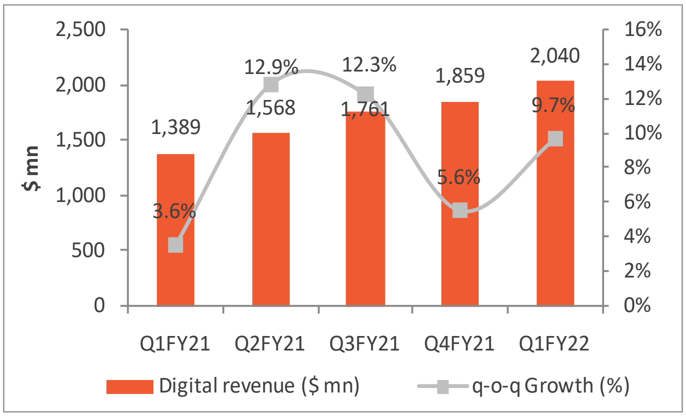
Source: Company, Sharekhan Research

Geography break-up (%)



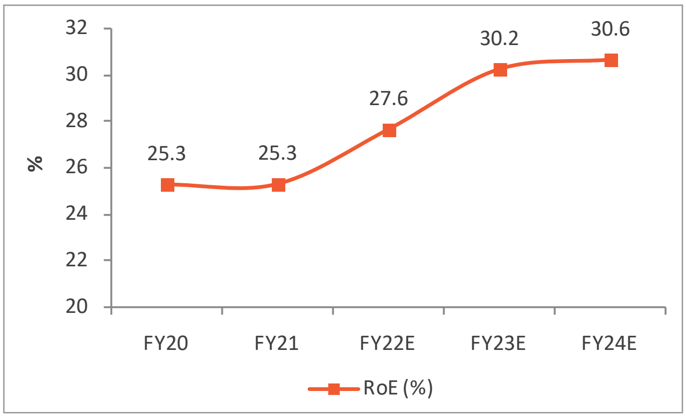
Source: Company, Sharekhan Research

Digital revenue ($ mn) and growth (%)



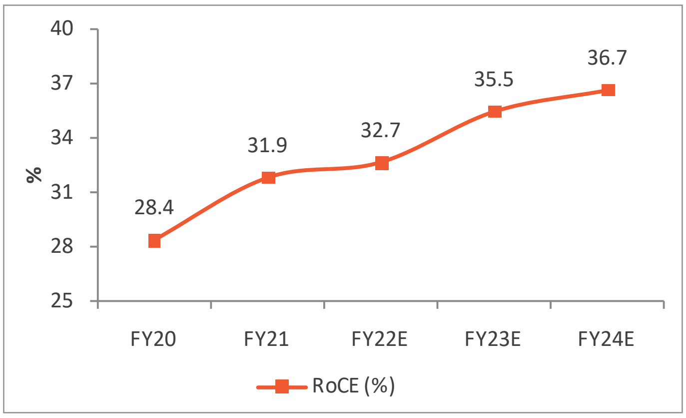
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Technology spending to accelerate going forward

The COVID-19 pandemic is estimated to drag the world output by 3.3% in CY2020, as advanced economies see GDP shrink by 4.7%. As a result, global technology spend is estimated to have declined by 3.2% to $1.4 trillion in 2020. Within that, IT services spending is likely to have declined 3.9%, while business process management spends fell by 2.4%. After the initial dislocations led to contractions, the need for business continuity, operational resilience, and the switch to digital transactions have led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved over CY2010-CY2020. Forecasts indicate higher demand for cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

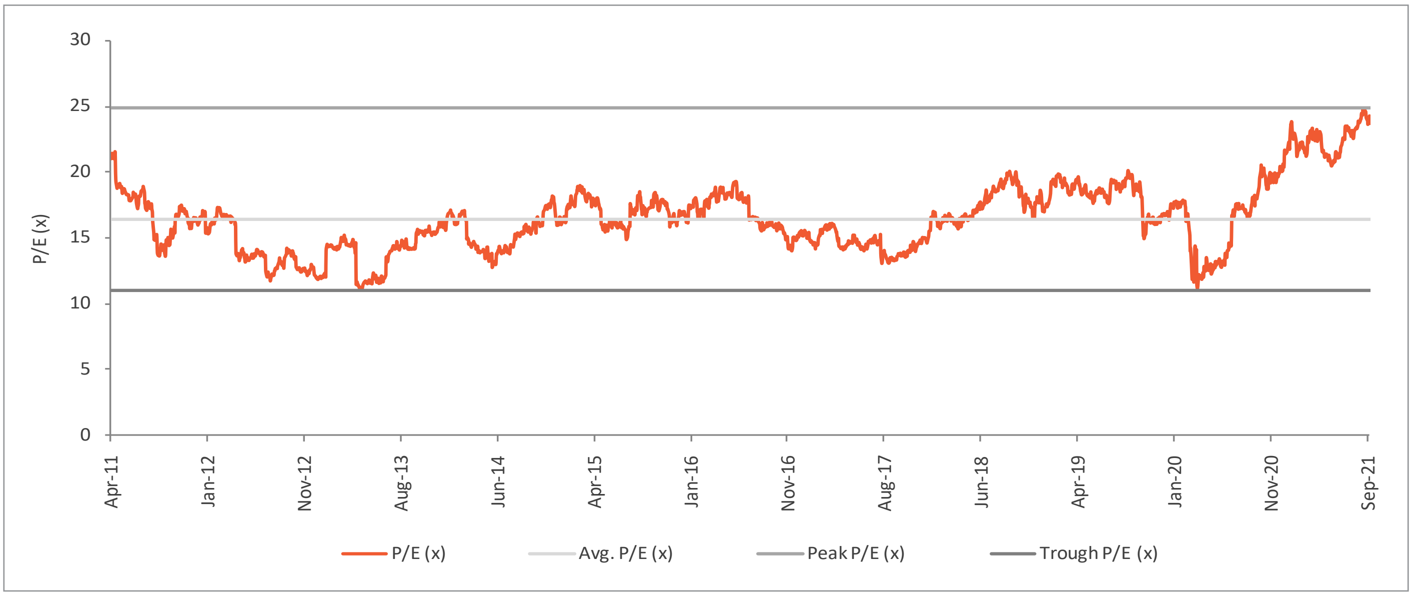
■ Company outlook - Well-positioned to capture opportunities

Infosys services a large number of Fortune 500/Global 500 clients who have a strong balance sheet and are able to hold on better amid the economic downturn. Further, Infosys has aggressively invested in digital technologies in the past couple of years to capture a large portion of upcoming digital spends. Given strong relationships with clients and robust execution capabilities, Infosys is well positioned to capitalise on opportunities from clients' transformation journeys.

■ Valuation - Maintain Buy with a revised PT of Rs. 1,950

Infosys will be at the forefront in driving the digital transformation journey of its customers. We expect Infosys to deliver leading revenue growth among tier-I IT services companies in FY2022, given strong demand across industries, ramp up of large deals, and market share gains. We assume Infosys to report USD revenue and earnings growth of 16% and 17%, respectively, over FY2021-FY2023E. At the CMP, the stock trades at 27x/24x its FY2023E/FY2024E earnings, which is justified given strong growth potential and robust deal wins. We continue to prefer Infosys, given its healthy balance sheet, robust free cash flow (FCF) generation capability, and a strong capital allocation policy. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,950.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Company	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
HCL Tech	1,189	271	3,22,546	23.4	20.4	15.2	13.6	4.8	4.3	21.7	22.4
TCS	3,774	370	13,96,059	35.2	31.1	24.9	22.2	13.7	11.7	41.5	40.6
Wipro	662	548	3,62,949	30.0	26.6	20.2	17.7	6.4	5.7	18.9	20.4
Infosys	1,693	424	7,18,148	32.1	27.3	22.1	19.1	4.8	4.4	27.6	30.2

Source: Company, Sharekhan Research

About company

Founded in 1981, Infosys is the second largest ($13,562 million in FY2021) IT services company in India in terms of export revenue with headcount of 2.7 lakh employees. BFSI accounts for the largest chunk of revenue (~33% of total revenue), followed by retail, energy and utilities, and communication. Region wise, North America and Europe continue to be the mainstay. Digital revenue continued to have a strong growth momentum in the past few quarters and now contributes 53.9% to total revenue.

Investment theme

Infosys has accelerated deal win momentum through engagement with deal advisors, consulting firms, and private equity players. Effectively, the strong large deal trajectory provides better revenue growth visibility. Further, revitalisation of sales and investment in digital competencies have certainly helped the company to drive its digital business. Sharp focus on execution and augmentation of digital capabilities through investments have brought Infosys back on its high-growth trajectory. Given strong deal wins, strengthening relationships with large clients, and continued digital momentum, we believe Infosys is well positioned to report industry-leading revenue growth in the coming years.

Key Risks

1) Regulatory visa norms could have an impact on employee expenses; 2) any instability in leadership; additional exits at senior management level; 3) Rupee appreciation and/or adverse cross-currency movements; and 4) increasing attrition rate.

Additional Data

Key management personnel

Nandan M. Nilekani	Co-founder and Non-Executive Chairman
Salil Parekh	Chief Executive Officer
U.B. Pravin Rao	Chief Operating Officer (COO)
Nilanjan Roy	Chief Financial Officer
Ravi Kumar S	President, Deputy COO
Mohit Joshi	President, Head – BFSI and HCLS

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Deutsche Bank Trust Co Americas	17.35
2	Life Insurance Corp. of India	5.50
3	BlackRock Inc.	4.55
4	SBI Funds Management Pvt. Ltd.	2.79
5	The Vanguard Group Inc.	2.60
6	Republic of Singapore	1.68
7	ICICI Prudential Asset Management	1.39
8	HDFC Asset Management Co. Ltd.	1.21
9	Government Pension Fund Global	1.13
10	ICICI Prudential Life Insurance Co.	1.08

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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