Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Infosys

Staying ahead in the race

IT & ITES	Sharekhan code: INFY	Company Update

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. 1,344**	
Price Target: **Rs. 1,650**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

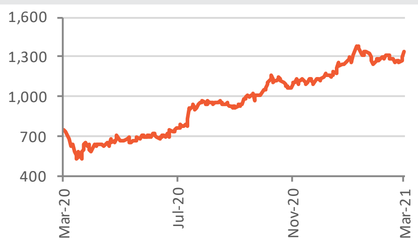
Company details

Market cap:	Rs. 5,72,359 cr
52-week high/low:	Rs. 1,392 / 511
NSE volume: (No of shares)	102.2 lakh
BSE code:	500209
NSE code:	INFY
Free float: (No of shares)	369.8 cr

Shareholding (%)

Promoters	13.0
FII	50.2
DII	24.7
Others	12.2

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6.5	17.8	47.0	77.1
Relative to Sensex	0.7	2.5	14.7	43.2

Sharekhan Research, Bloomberg

Summary

- We retain our Buy rating on Infosys with a price target to Rs. 1,650, given higher demand for digital and Cloud transformation initiatives and strong deal pipeline.
- Infosys' strategic investments in Cloud, data, and experience have been yielding results, which are being reflected from digital revenue growth of 7.6% CQGR since Q1FY2018.
- Revenue growth in FY2022E would be driven by 1) higher demand for digital transformation initiatives, 2) increasing core transformation, 3) continued strong deal wins, 4) better pricing for the digital portfolio, and 5) robust deal pipeline.
- Margin headwinds would be offset to some extent because of higher offshore mix, automation, improving onsite employee pyramid, lower sub-contractor expenses, and better pricing in digital offering.

We recently interacted with Infosys' management to understand the demand environment, traction for its Cloud offering, pricing strategies for digital offering, deal pipeline, and margin outlook. Management highlighted that its strategic investment priorities in areas such as 1) Cloud, 2) data, 3) experience and 4) cyber security have been yielding good results, which was reflected from its strong performance in its digital business during COVID-19. The company's digital revenue has reported a 7.6% CQGR since Q1FY2018, and its contribution stood at 50.1% in Q3FY2021. As COVID-19 has acted as a catalyst in accelerating the demand for digital and cloud transformation across industries, Infosys launched Infosys Cobalt to help clients in building capabilities using the features across leading SaaS, IaaS, and PaaS platforms. Management believes Infosys Cobalt has been a real differentiator for the company, with a first-mover advantage. Infosys is well positioned to play as a prime orchestrator of the Cloud journey for enterprises with partnerships of hyper-scalers and SaaS platforms. Management indicated that FY2022E growth would be driven by 1) higher spending on Cloud-related technologies by clients (to tap opportunities it launched Infosys Cobalt in August 2020), 2) strong demand for cyber security, data analytics and enhancement of customer experience, 3) rising demand for core transformation, 4) continued strong deal wins ($12 billion in YTD FY2021 versus $9 billion in FY2020), 5) higher pricing for certain new-age technologies (which negates pricing pressure in the legacy business), and 6) stronger deal pipeline even after large deal wins over the last couple of quarters. We believe the pace of deal signings would remain strong (given strong participation in RFPs) in the coming quarters, as it has been reaping benefits from accelerated investments on enhancing capabilities, sales transformation initiatives, and increased focus on large deals over the past three years. During the quarter, Infosys has won a nearly $500 million deal from Google to provide customer experience and engineering support for its products. Management indicated that the company has better pricing for its digital portfolio, given its sharpening focus on value-based pricing. Though margins would be impacted from the increase in travel and facility expenses and higher selling and marketing in the coming quarters, these expenses may not return to pre-COVID level even after normalcy. We believe these margin headwinds coupled with increasing competitive intensity and higher expenses owing to the initial period of ramp-up of large deals would be offset to some extent because of higher offshore mix, automation, improving onsite employee pyramid, lower sub-contractor expenses, and better pricing in digital offering.

Our Call

Valuation – Maintain Buy with a PT of Rs. 1,650: Enhancement of digital capabilities, engaging with clients for their large transformation initiatives, and reskilling of talents are key drivers for the accelerated growth trajectory and addition of large accounts. Management highlighted that the deal pipeline remains strong even after large deal wins during the past two quarters. We expect Infosys to continue to beat the growth rate of TCS, led by continued large deal wins, investments in digital capabilities (aided by organic investments, acquisitions, and partnerships), and robust deal pipeline. Further, given its strong execution and end-to-end capabilities, the company is well placed to remain at the forefront for capturing the opportunities in the areas of 1) cost take-out initiatives and 2) spends on new-age technologies. We continue to prefer Infosys, given its strong balance sheet, healthy free cash flow (FCF) generation capability, and disciplined capital allocation. At the CMP, the stock is trading at a 26x/23x its FY2022E/FY2023E EPS, at a ~11% discount to TCS. We expect Infosys' valuation gap with TCS to reduce further, given the anticipated outperformance in revenue growth with stable margin performance. Hence, we maintain our Buy rating on the stock with an unchanged PT of Rs. 1,650.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and slackening pace in deal closures would have an adverse impact on its earnings.

Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	82,675.0	90,791.0	1,00,943.9	1,17,107.4	1,32,694.6
OPM (%)	25.3	24.5	27.7	26.9	26.8
Adjusted PAT	15,856.0	16,594.0	19,487.7	22,201.4	25,110.0
% YoY growth	*8.6*	*4.7*	*17.4*	*13.9*	*13.1*
Adjusted EPS (Rs.)	35.4	39.0	45.8	52.3	59.2
P/E (x)	37.9	34.5	29.4	25.7	22.7
P/B (x)	4.7	4.7	4.1	3.7	3.3
EV/EBITDA (x)	26.1	24.8	19.5	17.0	14.7
RoNW (%)	23.7	25.4	27.8	28.0	28.2
RoCE (%)	32.2	32.3	35.6	36.1	36.5

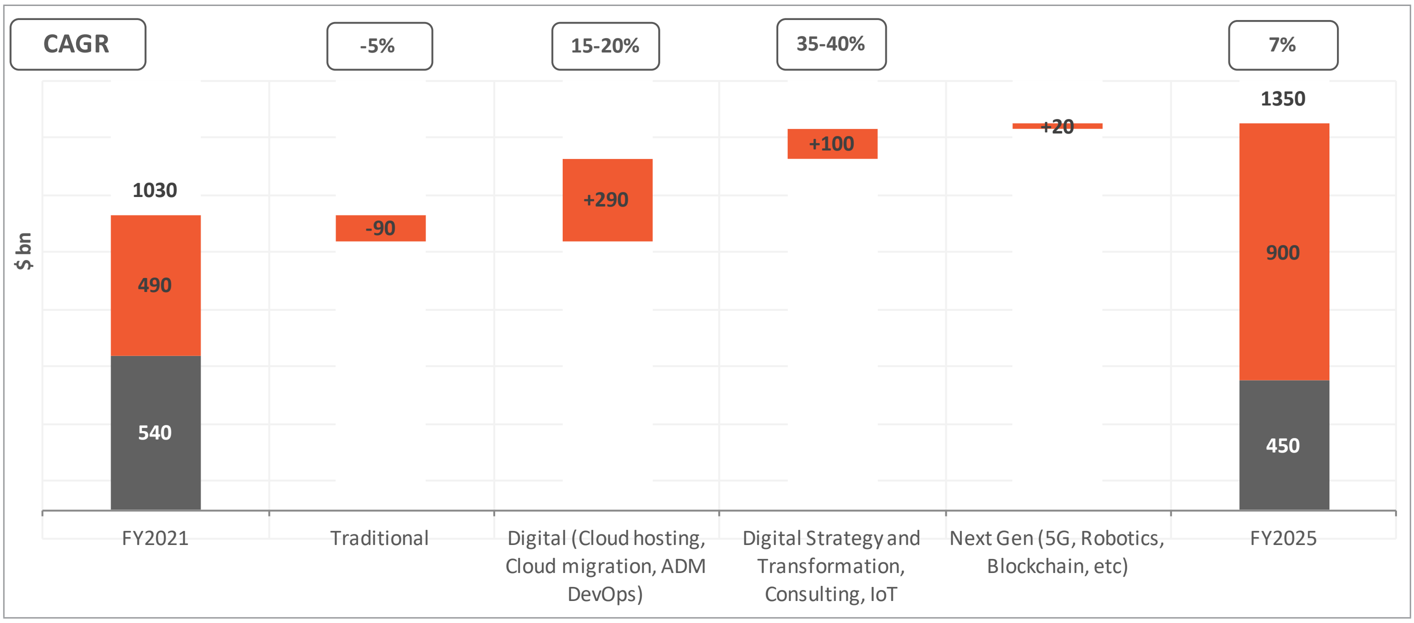
Source: Company; Sharekhan estimates

Higher Cloud migration will be the key growth driver

Indian IT service providers generate revenue by helping enterprises in the Cloud migration roadmap, including services such as data management, processes and applications transformation, digital transformation, creating multi-cloud environment, and offering products and platforms. COVID-19 has acted as a catalyst for accelerating the digital transformation of clients enabled by higher demand for Cloud transformation among enterprises.

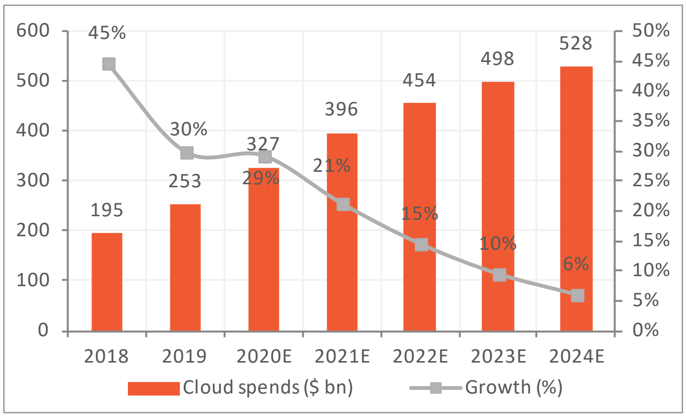
Digital and Cloud transformation related spending has been accelerated by enterprises across industries and will likely continue over the next 3-5 years. Enterprises have been allocating funds for digital transformation as the technology would provide an edge over competition and help them to smoothly transition to the emerging business model. Digital technology (cloud hosting, cloud migration, ADM DevOps, consulting, IoT, etc.) is expected to report a 16.4% CAGR to $900 billion by FY2025, which would help worldwide IT spending to grow at a 7% CAGR over FY2021-FY2025. Cloud is one of the transformational pillars in the digital journeys of enterprises and half of total transformational spends of clients comes from cloud-related technologies. Cloud adoption is high for few industries such as technology, communications, media, and internet-enabled companies. However, BFSI, healthcare, and retail have started adopting the cloud technology to stay relevant to customers. Global cloud service provider market is estimated to report a 15.9% CAGR to $528 billion in 2024 from $253 billion in 2019. Infosys' management highlighted that around $500 billion would be spent on cloud-related technologies over the next three years.

Digital and next-gen technologies will drive incremental growth



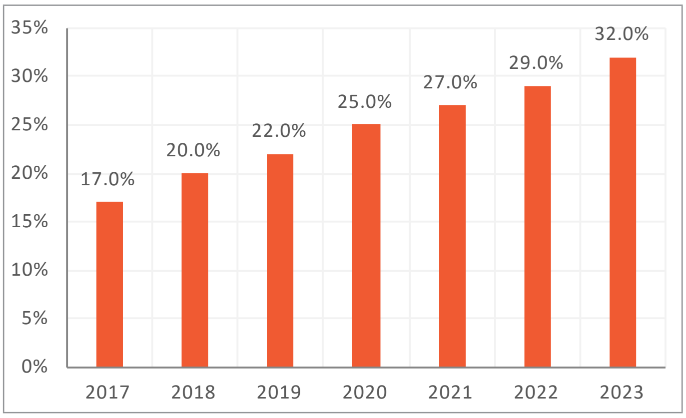
Source: Gartner; Sharekhan Research

Cloud Service Provider Market ($bn) & growth (%)



Source: Omdia; Sharekhan Research

Overall cloud spending as % of IT spending



Source: Gartner, Sharekhan Research

The outbreak of COVID-19 has forced most enterprises across the globe to embrace cloud to improve time to value, increase agility, and reduce costs. Among the strategic agendas that were laid out in 2018, Infosys has progressed well on its strategic priorities, including scale agile digital. The company's investments in areas such as 1) Cloud, 2) data, 3) experience, and 4) cyber security have been reaping benefits, which were reflected from strong performance in its digital business during COVID-19. The company's digital revenue has reported a 7.6% CQGR since Q1FY2018 and its contribution stood at 50.1% in Q3FY2021. Management highlighted the company generates around 50% of its digital revenue from cloud.

Infosys has launched Infosys Cobalt in August 2020, a large set of solutions, tools, and accelerators to speed up the cloud journey of enterprises. Infosys Cobalt helps clients in building capabilities using features across leading SaaS, IaaS, and PaaS platforms. The company has over 35,000 people working on cloud-related projects, and it has created 17,000 assets and 200-plus industry templates under its Infosys Cobalt. Management believes Infosys Cobalt has been a real differentiator with a first-mover advantage. Given its scale and end-to-end capabilities, the company would participate in both 1) cost take-out initiatives and 2) spends on new-age technologies. Hence, we believe Infosys is well positioned to play as a prime orchestrator of the cloud journey for enterprises with the partnerships of hyper-scalers and SaaS platforms.

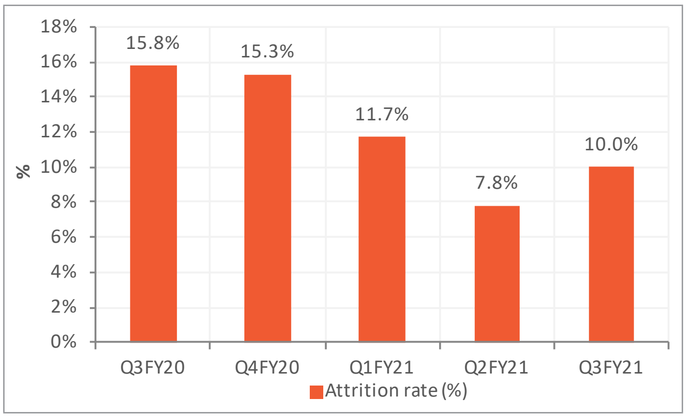
Growth to accelerate in FY2022E; Strong deal pipeline continues even after large deal wins

Management reiterated its earlier commentary on the outlook as it has not witnessed any incremental changes in demand so far during the quarter. Enterprises across the globe have been redirecting their respective technology budget to digital transformations to enhance customer experience. Management increased its revenue growth guidance to 4.5%-5% in constant currency (CC) terms for FY2021, implying 0.5%-2.5% q-o-q growth in Q4FY2021. Management indicated growth in FY2022E would be driven by 1) higher spending on cloud-related technologies by clients and its Cobalt is gaining momentum among enterprises, 2) strong demand for cyber security, data analytics, and enhancement of customer experience, 3) rising demand for core transformation, 4) continued strong deal wins ($12 billion in YTD FY2021 versus $9 billion in FY2020), 5) higher pricing for certain new-age technologies (which negates the pricing pressure in legacy business), and 6) stronger deal pipeline even after large deal wins over the last couple of quarters. Management stated that it continues to see strong demand for its services and Finacle platform in the BFSI vertical, despite slowdown in card and processing sub-segment. Though the retail business reported strong performance in Q3FY2021, management has maintained its cautious stance on recovery of the retail vertical due to continued challenges in brick and mortar business. We believe the pace of deal signings would remain strong (given strong participation in RFPs) in the coming quarters, as it has been reaping benefits from accelerated investments on enhancing capabilities, sales transformation initiatives, and increased focus on large deals over the last three years.

Margins likely to be sustained; Headwinds can be negated with margin levers

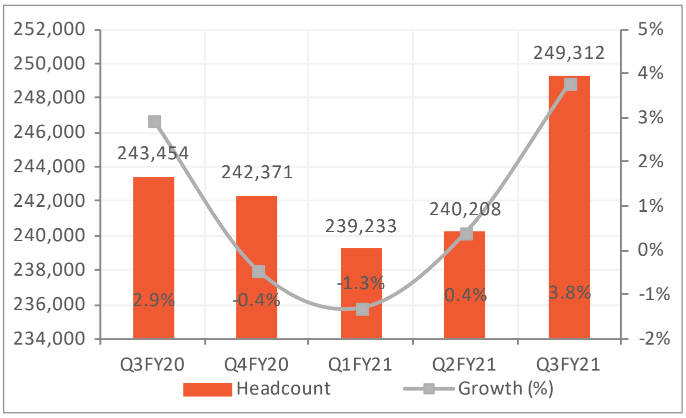
Infosys has surprised positively with a strong beat in margin performance in the last three consecutive quarters because of cost deferrals in terms of wage hike and recruitment freeze, lower travel expenses, reduced facility expenses, and rising offshore revenue mix. Management has raised EBIT margin to 24%-24.5% for FY2021 (versus 24.5% in 9MFY2021) despite a planned wage hike (effective January 1, 2021) and marginal increase in travel and facility expenses. Management indicated that it has higher pricing for certain digital offerings to offset the pricing pressure in the legacy business, which is encouraging in the ongoing recessionary environment. Benefits from cost savings in travel, facility expenses, lower selling and marketing, and higher offshoring revenue are expected to fade away to a certain extent in FY2022, though it may not return to pre-COVID level even after normalcy. Further, there would be a negative impact on margins at the initial period of ramp-up of large deals (Daimler deal is expected to contribute to Q2FY2022E revenue) and higher competitive environment. We expect a stable margin performance with narrow band due to higher offshore mix, automation, improving onsite employee pyramid, lower sub-contractor expenses, and better pricing in digital offering.

Voluntary attrition (%)



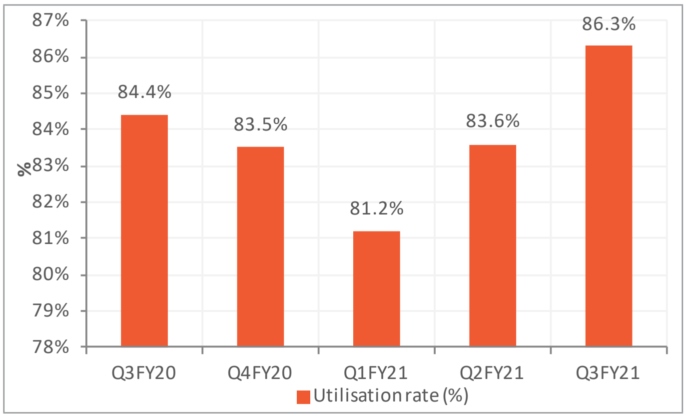
Source: Company, Sharekhan Research

Headcount



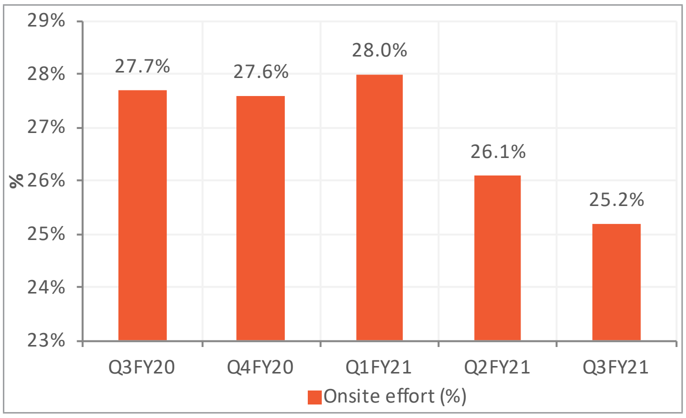
Source: Company, Sharekhan Research

Utilisation (%)



Source: Company, Sharekhan Research

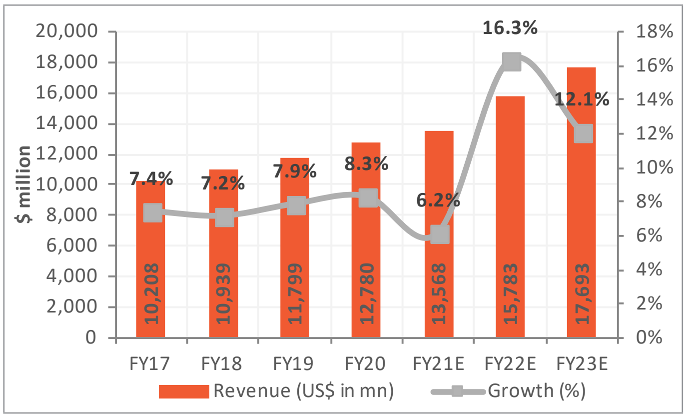
Onsite Effort (%)



Source: Company, Sharekhan Research

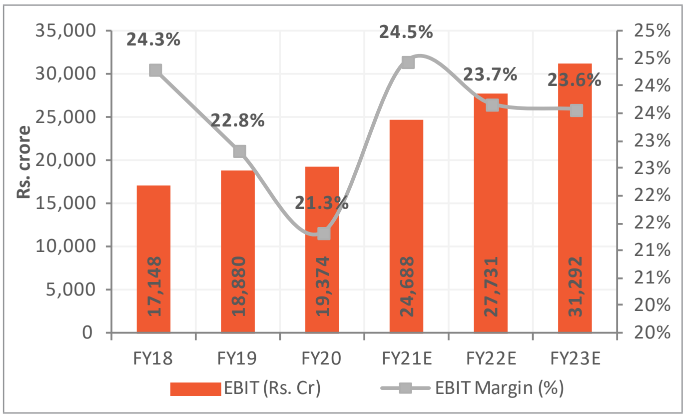
Financials in charts

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



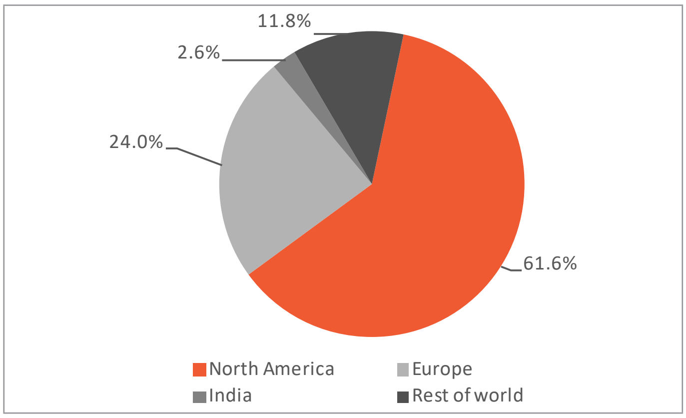
Source: Company, Sharekhan Research

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



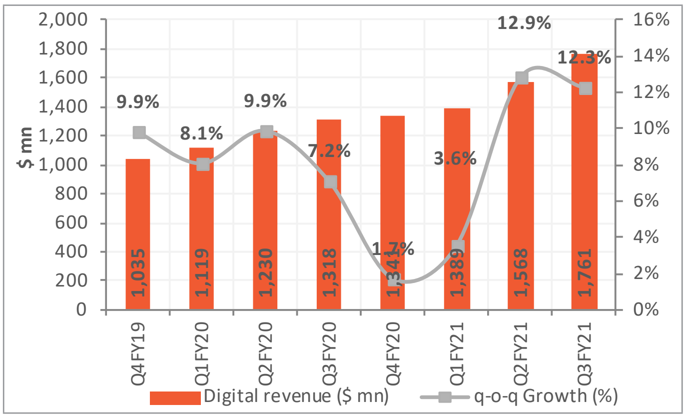
Source: Company, Sharekhan Research

Geograpghy break-up (%)



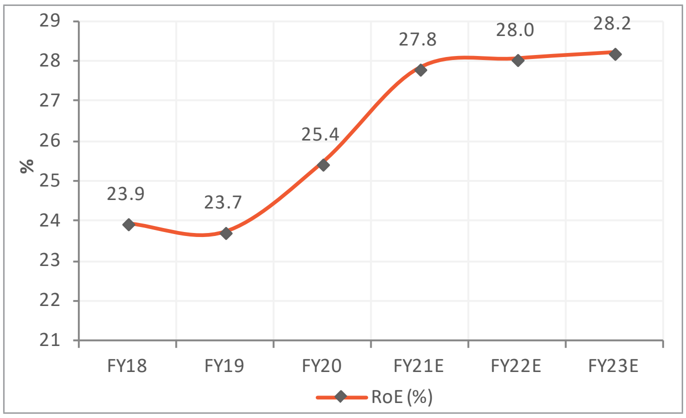
Source: Company, Sharekhan Research

Digital revenue ($ mn) and growth (%)



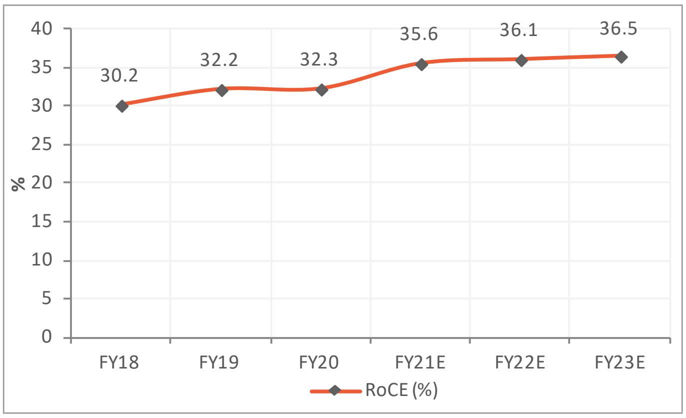
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view – Technology spending to accelerate going forward

Industry analysts such as Gartner estimate that spending on IT services would grow by 5%-8% over CY2021-CY2024E as compared to an average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and an increase in online adoption across verticals. Implications from the outbreak of COVID-19 have accelerated digital activities among large global enterprises, leading to an increase in spending on workplace transformation and collaboration tools, cyber security, and higher cloud migration. We believe the variable cost structure of companies combined with cost-efficiency measures would help IT companies to absorb pricing pressure.

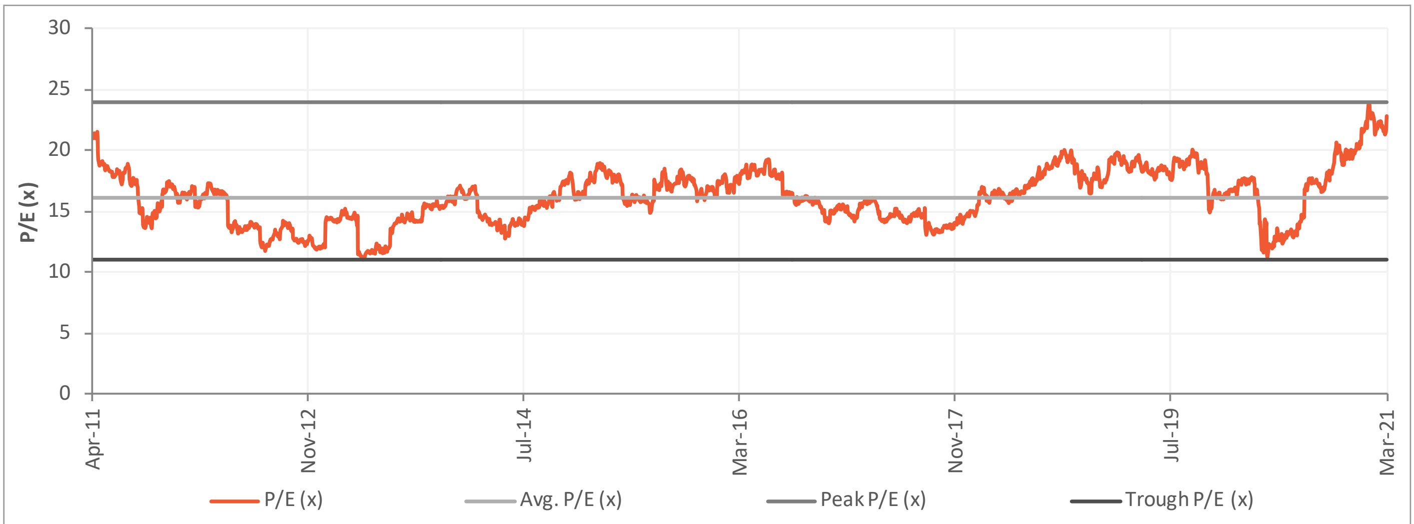
■ Company outlook – Well positioned to capture opportunities

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

■ Valuation - Maintain Buy

Enhancement of digital capabilities, engaging with clients for their large transformation initiatives, and reskilling of talents are the key drivers for the accelerated growth trajectory and addition of large accounts. Management highlighted that the deal pipeline remains strong even after large deal wins during the past two quarters. We expect Infosys to continue to beat the growth rate of TCS, led by continued large deal wins, investments in digital capabilities (aided by organic investments, acquisitions, and partnerships), and robust deal pipeline. Further, given its strong execution and end-to-end capabilities, the company is well placed to remain at the forefront for capturing opportunities in the areas of 1) cost take-out initiatives and 2) spends on new-age technologies. We continue to prefer Infosys given its strong balance sheet, healthy FCF generation capability, and disciplined capital allocation. At the CMP, the stock is trading at 26x/23x its FY2022E/FY2023E EPS, at a ~11% discount to TCS. We expect Infosys' valuation gap with TCS to reduce further, given the anticipated outperformance in revenue growth with stable margin performance. Hence, we maintain our Buy rating on the stock with an unchanged PT of Rs. 1,650.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
HCL Tech	822	271	223,118	18.1	16.6	11.5	10.8	3.9	3.5	22.7	22.1
TCS	3058	375	1,005,320	30.6	27.0	22.3	20.0	11.4	10.5	38.0	40.4
Wipro	351	572	200,323	20.1	18.9	13.8	12.6	3.5	3.2	15.7	15.8
Infosys	1344	426	468,779	25.2	22.7	16.5	15.0	3.4	3.1	26.7	26.6

Source: Company, Sharekhan estimates

About company

Founded in 1981, Infosys is the second largest ($12,780 million in FY2020) IT services company in India in terms of export revenue with 2.49 lakh number of head count. BFSI accounts for the largest chunk of revenue (~31.5% of total revenue), followed by retail, energy and utilities, and manufacturing. Region wise, North America and Europe continue to be the mainstay. Digital revenue continued to have strong growth momentum in the past few quarters and now contributes 50.1% to total revenue.

Investment theme

Infosys has accelerated deal wins 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 has certainly helped the company to drive its digital business. Sharp focus on execution and augmentation of digital capabilities through investments can bring 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 Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Deutsche Bank Trust Co Americas	17.26
2	Life Insurance Corp of India	5.92
3	BlackRock Inc	4.55
4	SBI Funds Management Pvt Ltd	2.69
5	Vanguard Group Inc/The	2.67
6	Republic of Singapore	1.63
7	ICICI Prudential Asset Management	1.55
8	HDFC Asset Management Co Ltd	1.37
9	ICICI Prudential Life Insurance Co	1.32
10	Norges Bank	1.22

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

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