

Technology

Outlook 2021: A year of physicalisation of digital?

2021 should present an acid test for the lofty expectations around Covid-led acceleration in cloud / digital adoption and cost savings. Re-rating in Indian IT (~up to ~41%, v/s pre-Covid) hints at much taller expectations vs even global tech (MSFT, Amazon, Alphabet, ~3-17%). More surprisingly, the consensus optimism on Indian IT seems to be 'relatively' pushed out into longer term. These disproportionate / asymmetric expectations should correct in 2021. (1) Weakness in incremental sales / backlog of hyper-scalers ([link](#)), (2) stagnancy in cloud deals ([link](#)) and (3) Gartner's CY21 outlook ([link](#)) underpin our assessment. As inoculation and businesses progress to reestablish human connect, clients should recalibrate IT spends, which appear partly pulled forward (e.g. BFSI). So, rather than pent up, IT spends may turn out to be lower. Resumption in travel / marketing events and weaker US\$ can be the key cost headwinds. In this backdrop, after 3 years of maintaining OW stance, we see high likelihood of NIFTY IT under performance in 2021. Prefer stocks with scope for idiosyncratic surprises & valuation comfort.

- **Multiple positives (many one time) led to strong outperformance in CY20.** Relatively better business resilience / continuity (vs domestic sectors), strong beat on subdued estimates, great cost / cash management, lofty expectations around accelerated digital / cloud adoption and rub-off impact of the NASDAQ momentum largely led IT sector's stellar outperformance in CY20 (34% YTD, vs Nifty). Many of these surprises / factors are one time in nature and will cease to be relevant in CY21.
- **Surprisingly, taller expectations for Indian IT vs even global tech.** The strong rally within NASDAQ 100 was largely fueled by stocks like Tesla, Apple, Netflix and Amazon etc – which have different business model and technology constructs (v/s Indian IT). It is interesting to note that global companies which are 'relatively' closer (e.g. Microsoft, Alphabet) have seen their stocks largely underperform Indian IT, as the pandemic unfolded. Multiple re-rating in Indian IT (~up to 41%, v/s pre-Covid) hints at much taller expectations vs global tech (~3-17%).

Adjusted for the COE reset (-150 bps), stocks like Microsoft, Amazon and Alphabet, supposedly the biggest beneficiaries of a potential accelerated digitalisation, sharply de-rated (~3%-17%) over Feb – Dec'20. This indicates that unlike their Indian counterparts, US markets are not sharing a proportionate euphoria about the prospects of a material growth acceleration. More surprisingly, the consensus optimism on Indian IT seems to be relatively pushed out into longer term (v/s global tech) as reflected in FY22/CY21 EPS revisions over the course of the pandemic.

- **CY21 will likely see correction in these 'disproportionate' expectations.** Indisputably, adoption of digital / cloud has been an evolving theme for a few years now benefitting IT firms. Going forward into medium term too, we expect this to be more of an evolution, rather than a revolution. We are skeptical on the street's hyper-optimism around Covid-led acceleration in digital / cloud adoption. (1) Weakness in incremental sales / backlog of hyper-scalars ([link](#)), (2) recent moderation in their commentary, (3) stagnancy in As-A-Service deals reported by advisories like ISG ([link](#)) and (4) Gartner's CY21 IT spending outlook ([link](#)) underpin our assessment.

Sector update

Top picks

Large caps

- Infosys
- HCLT

Midcaps

- Mphasis
- Mindtree

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- **Rather than pent up, IT spends may turn out to be lower than usual.** While Indian IT reported marginal revenue decline / lower-than-usual growth in CY20, same thing cannot be said about the IT spends of some key verticals (e.g. BFSI). IT spends either remained resilient or even increased through the pandemic despite a decline in revenue run-rate across firms. This was understandable given many businesses upped their IT spends to ensure their business continuity / resilience.

For instance, our analysis suggests increase in IT spends of Top-5 US / Top-8 global banks accelerated over 9MCY20 (vs 9MCY19, Refer charts 13-14). Some of these incremental spends may be one-time in nature (e.g. WFH enablement). Even adjusted for this, we understand many firms incurred higher-than-normal spends in strengthening their systems to cater to peak time digital traffic under lockdowns. We reckon this could have translated into partial pull forward of IT spends from future years.

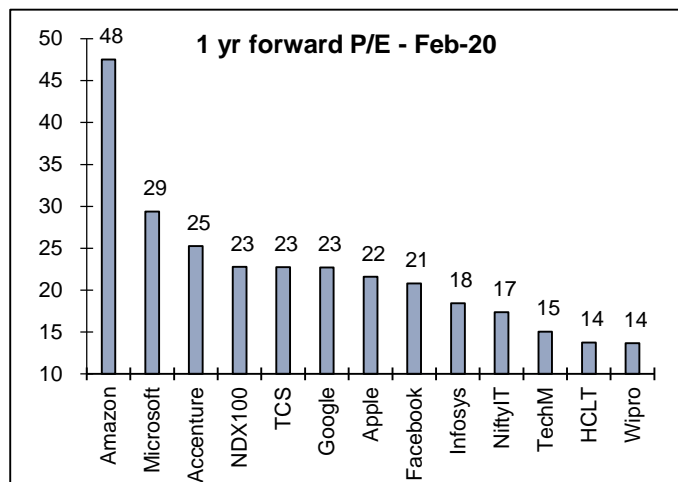
Now we notice that physical activity across most economies and industries is already reverting to pre-Covid baseline levels. Progress on inoculation over 2021 should further accelerate the reversion of traffic from digital to physical channels. As businesses focus on re-establishing human connect after a long gap, we expect re-calibration in IT spends, which appear partly pulled forward into CY20. Contrary to expectations, rather than a pent up, IT spends could turn out to be lower than usual in 2021.

- **Travel, marketing events and weaker US\$ – Potential cost headwinds.** Besides deferrals of wage hikes, absence of travel costs and marketing events were the biggest margin tailwinds for IT companies over 9MCY20. In our base case, we do not expect travel, marketing events to meaningfully resume before Sep-21. However, our recent conversations with industry stakeholders hint at potentially faster-than-expected resumption in travel. In addition, restarting of marketing events and potentially weaker US\$ are key margin headwinds to look out for.
- **We see high likelihood of NIFTY IT UNDER PERFORMANCE over 2021.** We have been maintaining Over Weight (OW) stance on the sector for the previous three years post Tax Cuts and Jobs Act (TCJA) came into effect in US in Dec-17. As disproportionate and asymmetric expectations of the street around Covid led (1) acceleration in cloud / digital adoption and (2) cost savings come more in-line with reality, we see a high likelihood of NIFTY IT under performance over 2021. Recent Infosys' commentary around reaching 'just' pre-Covid growth in FY22 (~8-10% YoY, vs expectations of strong acceleration) is a good starting point for the expectation reset.

Some of the one-time (elaborated in Section I) and technical (erstwhile DII under-ownership) factors which partly aided the sector's massive re-rating / outperformance (vs both global tech and Nifty) over 2020 will cease to be relevant in 2021. Potentially, the last leg of surprise related to Covid 'comeback' should come in Dec-20 earnings. Current relative valuations of Indian IT (vs global tech) will present a more compelling investment case in the latter, especially for FII's.

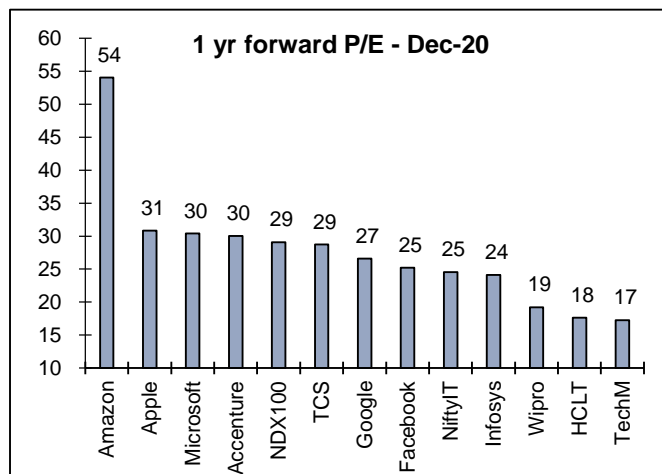
In that context, we stay cautious and selective on IT sector preferring stocks with scope for idiosyncratic surprises & valuation comfort (INFO, HCLT, MPHL & MTCL). Over the previous few years (even pre-Covid), IT emerged as a relative trade to investors looking to hedge the weakness in the Indian economy / INR. Continued weakness in domestic macro can pose key risk to our thesis.

Chart 1: Multiples of Indian IT stocks related..



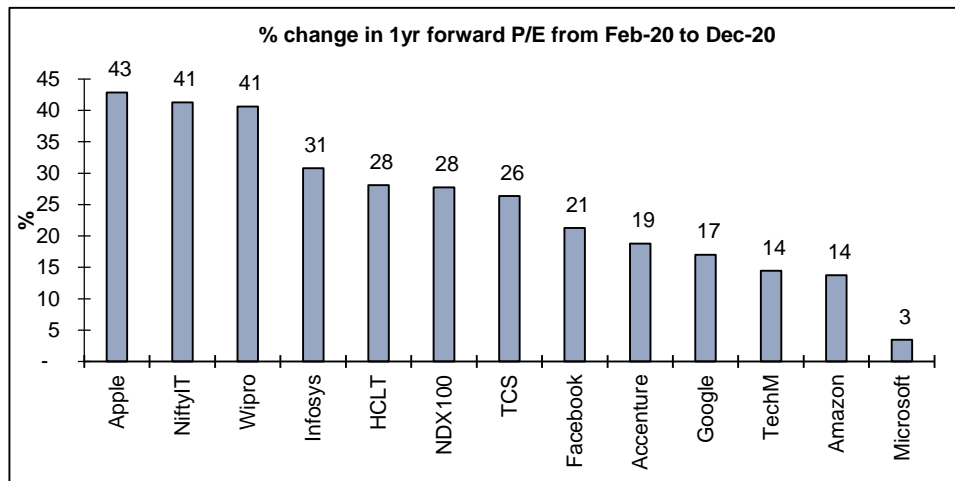
Source: Bloomberg, I-Sec research. Note: NIFTY IT includes Info Edge

Chart 2:..to a larger extent over Feb – Dec ‘ 20...



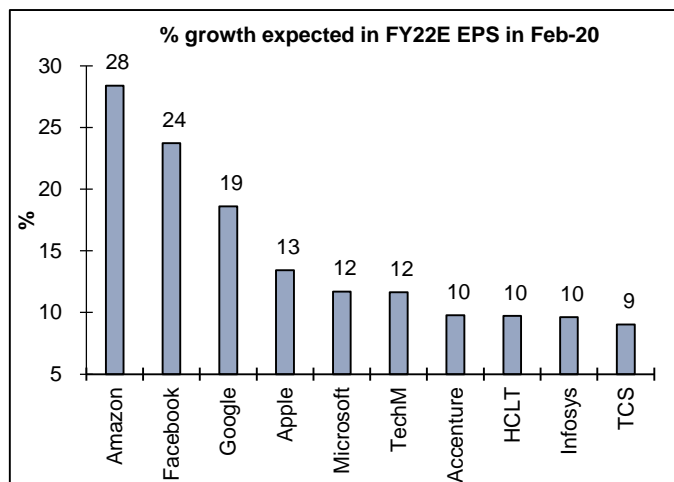
Source: Bloomberg, I-Sec research. Note: NIFTY IT includes Info Edge

Chart 3: ...indicating taller expectation build up v/s even global tech



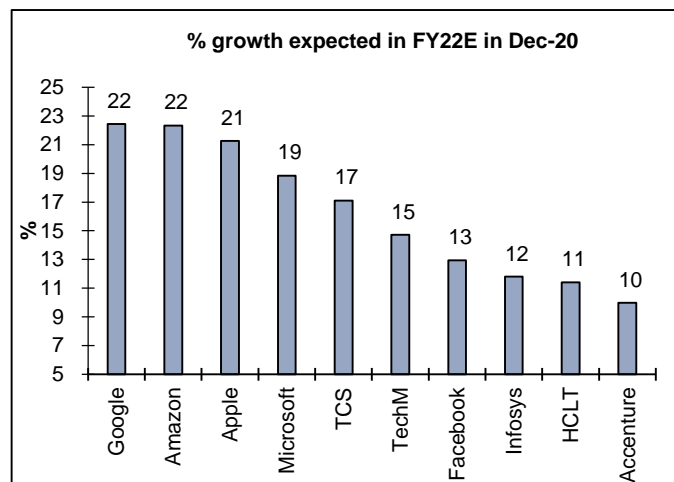
Source: Bloomberg, I-Sec research. Note: NIFTY IT includes Info Edge

Chart 4: Consensus EPS growth estimates for..

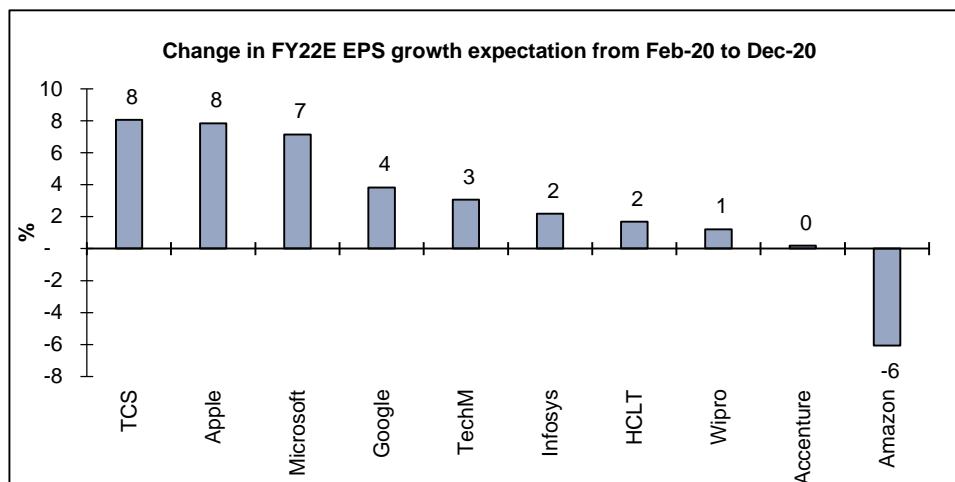


Source: Bloomberg, I-Sec research

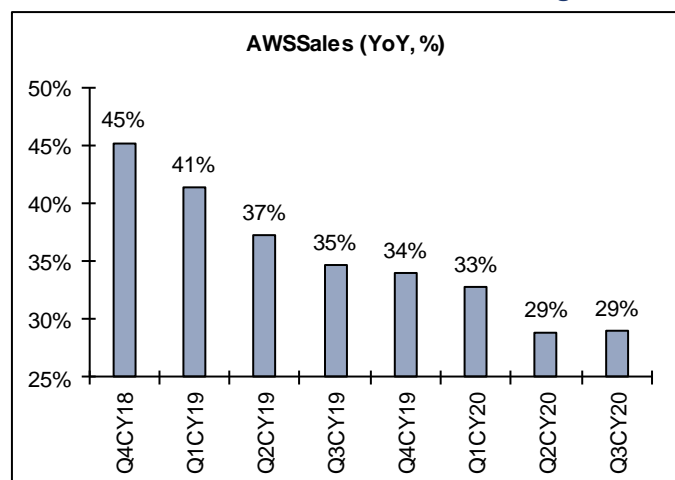
Chart 5: ..FY22 did not change much for Indian IT



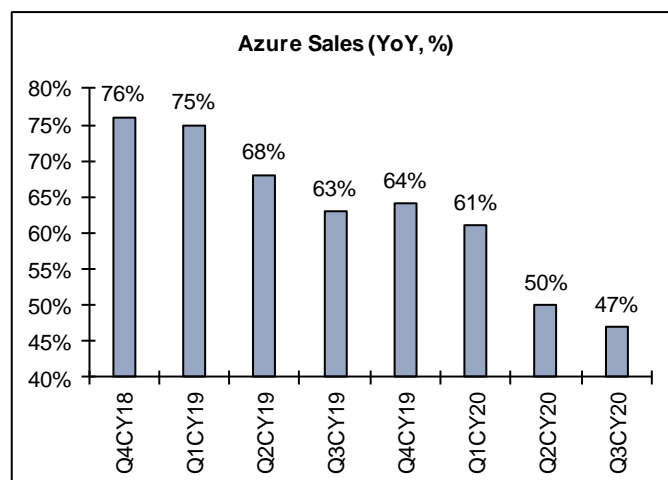
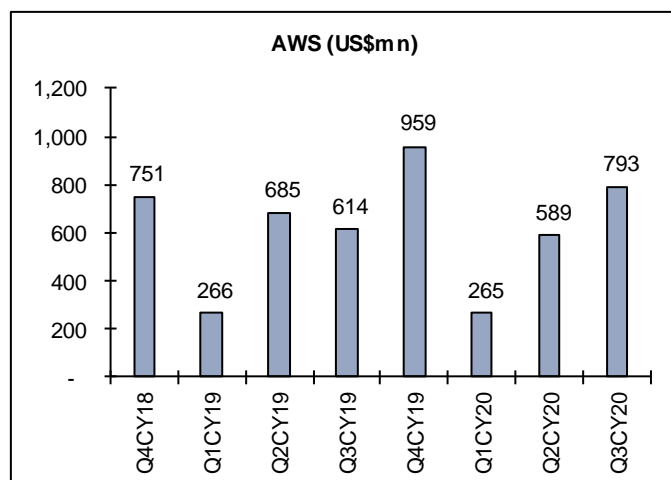
Source: Bloomberg, I-Sec research

Chart 6: ..indicating the expectation build up relatively farther into future

Source: Bloomberg, I-Sec research.

Chart 7: Both AWS and Azure witnessed growth...

Source: Company data, I-Sec research. Note: Above data should be read in conjunction with an increasing base.

Chart 8: ...deceleration over 9MCY20**Chart 9: Incremental revenue (QoQ) over 9MCY20**

Source: Company data, I-Sec research

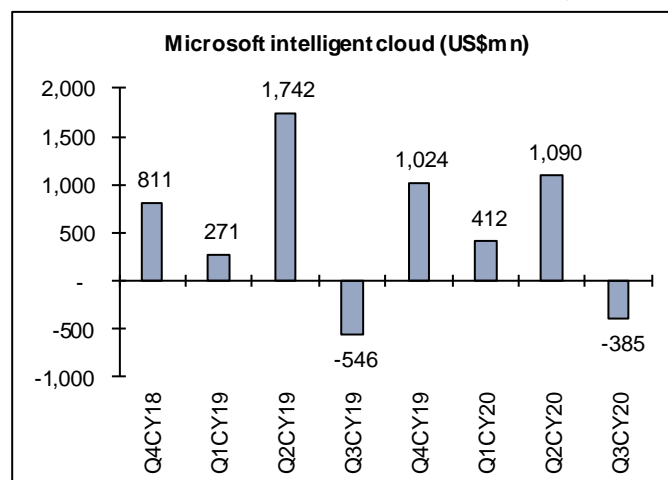
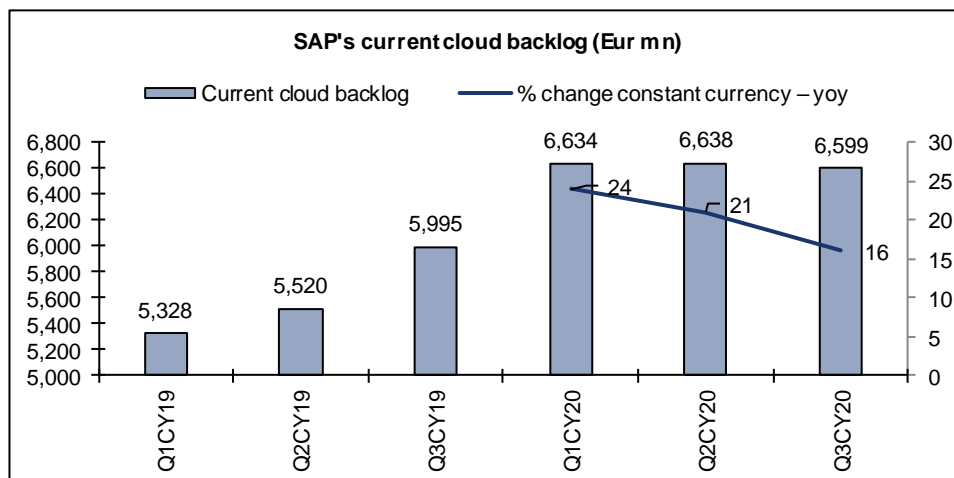
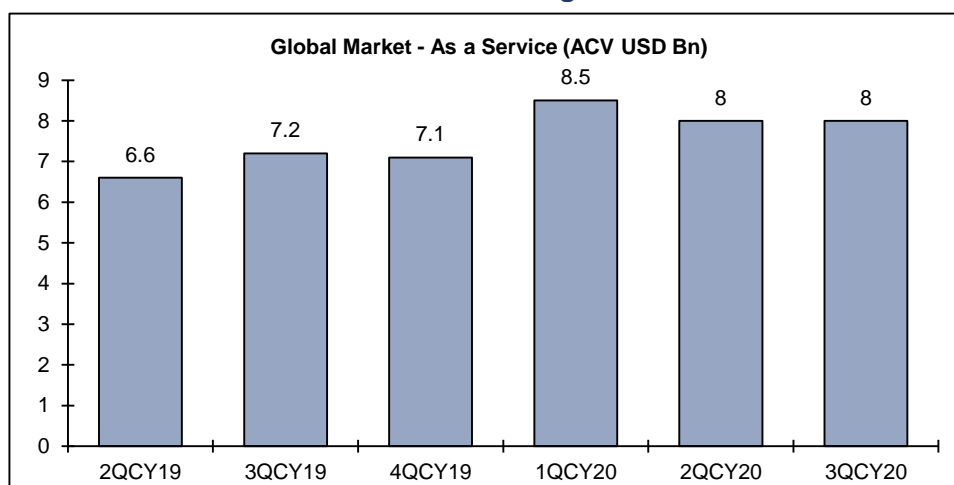
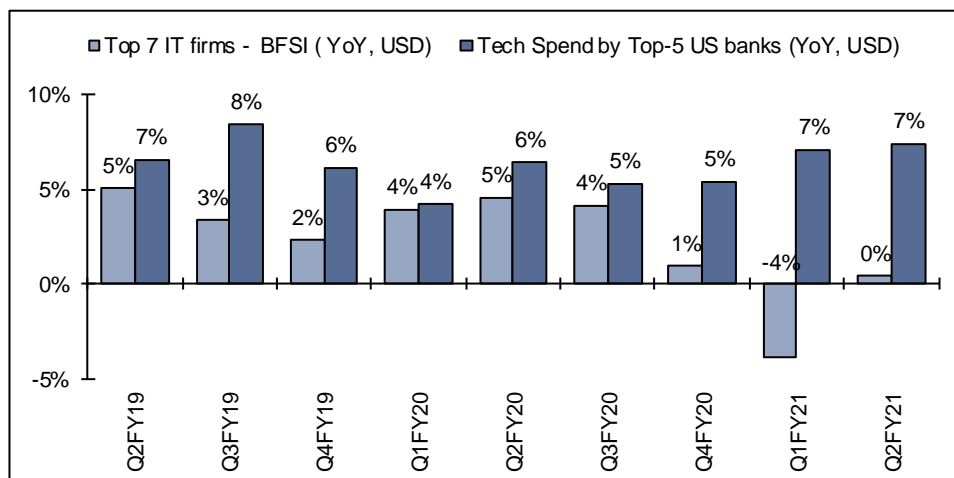
Chart 10: ...was weak despite the Covid hype

Chart 11: SAP's backlog growth too has been on a decelerating trend

Source: Company Data, I-Sec research

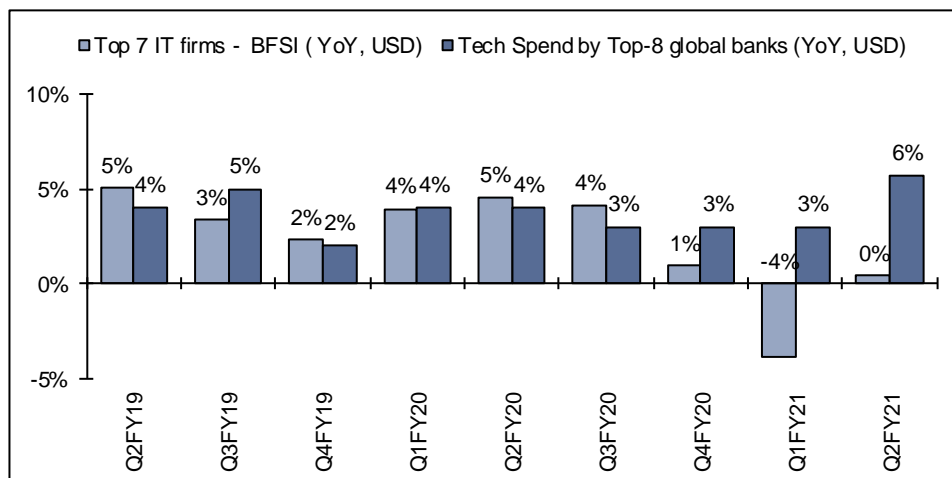
Chart 12: As-A-Service ACV remained stagnant over 9MCY20

Source: ISG, I-Sec research

Chart 13: Growth in tech spends at Top-5 US banks accelerated over 9MCY20

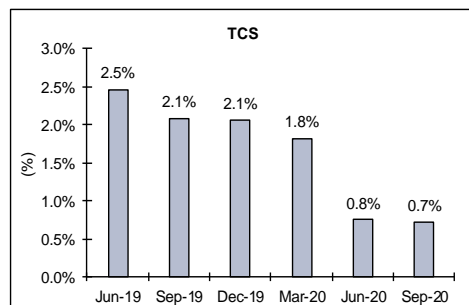
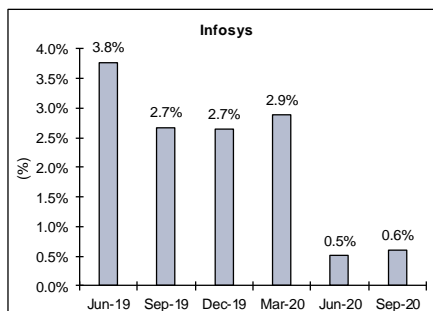
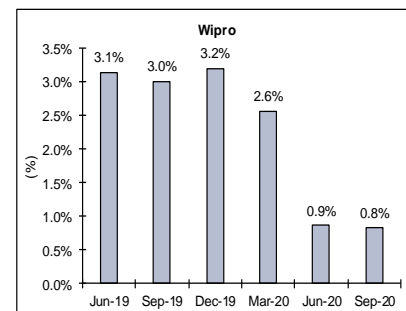
Source: Company Data, I-Sec research

Note: Top-5 US banks' sample = JPM, Citi, BofA, Morgan Stanley and US Bancorp. Top-7 IT companies' sample = Accenture, TCS, Cognizant, Infosys, Wipro, HCL Tech and Tech Mahindra

Chart 14: Growth in tech spend at Top-8 global banks accelerated over 9MCY20

Source: Company Data, I-Sec research

Note: Top-8 global banks' sample = JPM, Citi, BofA, Morgan Stanley, US Bancorp, DB, Credit Suisse and UBS.
 Top-7 IT firms' sample = Accenture, TCS, Cognizant, Infosys, Wipro, HCL Tech and TechM.

Chart 15: Faster than expected...**Chart 16: resumption in travel..****Chart 17: can be a key risk**

Source: Company data, I-Sec research

Table 1: Relative valuation table

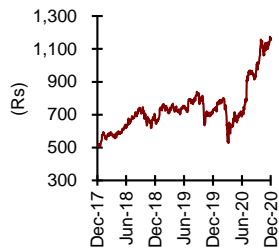
	P/E (x)				Revenue growth (US\$,%)				EBIT (%)			
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
TCS	32.7	34.2	28.0	24.5	5.4	-1.5	10.5	9.8	24.6	24.5	26.0	26.5
Infosys	29.9	26.4	22.3	19.2	8.2	4.8	10.2	11.5	24.5	26.8	27.9	28.5
Wipro	21.5	20.8	18.9	17.4	1.7	-3.4	5.9	7.1	17.1	18.1	18.6	18.6
HCLT	21.7	19.9	16.6	14.2	15.1	1.3	11.7	11.5	19.6	20.2	21.0	21.5
TechM	20.1	18.2	15.6	13.4	4.3	-1.6	6.0	7.5	11.6	13.5	14.5	15.5
Mphasis	21.5	21.4	17.0	14.6	10.8	7.2	11.3	12.4	16.0	15.8	17.3	17.8
Persistent	29.4	23.9	18.4	15.4	4.3	9.2	9.5	9.7	9.2	11.3	13.0	14.0
LTI	37.9	31.3	26.2	20.5	13.0	8.2	17.9	21.3	16.1	18.9	18.6	19.2
Mindtree	38.1	24.2	19.3	16.0	8.7	-2.5	15.7	12.0	10.5	16.1	16.7	17.5
Coforge	35.1	34.9	27.7	23.8	11.1	9.2	11.8	10.0	13.1	12.0	13.1	13.7
LTTS	23.8	31.8	25.3	21.7	8.7	-8.3	7.0	11.0	16.5	13.8	16.5	17.5
Cyient	16.1	17.2	15.2	12.7	-5.3	-12.9	5.0	7.5	9.2	9.3	10.8	11.8

	EPS (Rs)				RoE (%)			
	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
TCS	86.2	82.2	100.3	115.0	36.4	33.0	34.8	34.1
Infosys	38.9	44.2	52.3	60.6	25.2	26.0	26.6	26.6
Wipro	16.6	17.2	19.0	20.5	17.3	18.3	19.0	17.7
HCLT	40.7	44.6	53.4	62.5	24.3	21.8	21.2	21.0
TechM	45.9	50.7	59.0	68.7	18.5	18.1	18.7	19.4
Mphasis	63.1	63.4	79.8	92.9	21.4	20.4	24.3	24.8
Persistent	44.4	54.6	71.1	84.7	14.3	15.8	18.2	19.3
LTI	86.7	105.0	125.4	160.4	31.1	30.9	30.2	31.5
Mindtree	38.3	60.2	75.5	91.4	20.0	25.3	26.0	25.5
Coforge	72.1	72.7	91.4	106.7	18.8	19.3	21.4	21.7
LTTS	77.5	57.9	72.9	84.8	31.2	20.9	23.5	24.1
Cyient	33.9	31.6	35.9	43.0	14.6	13.2	14.0	15.4

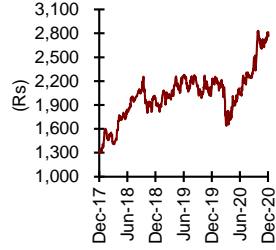
Source: Company data, Bloomberg, I-Sec Research

Price charts

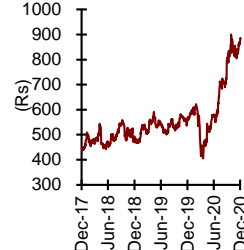
Infosys



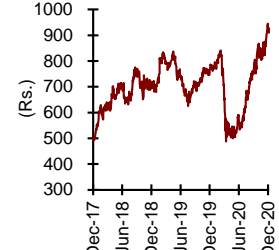
TCS



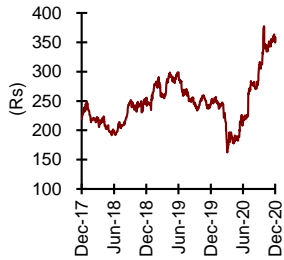
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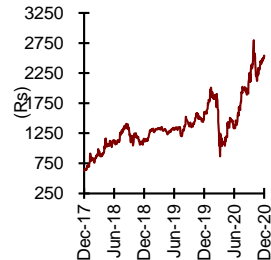
Tech Mahindra



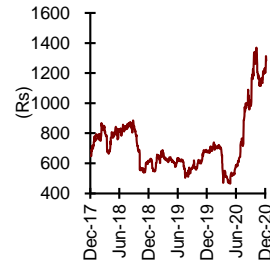
Wipro



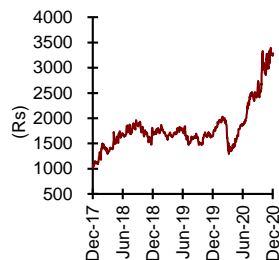
Coforge



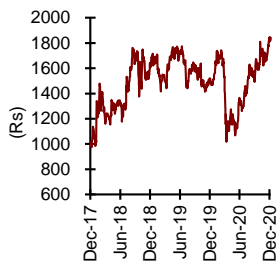
Persistent Systems



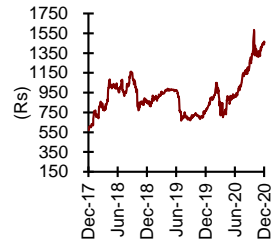
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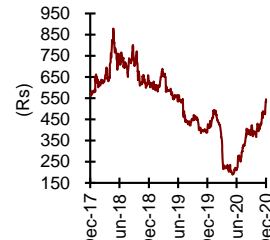
L&T Technology Services



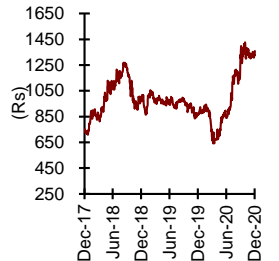
MindTree



Cyient



Mphasis



Source: Bloomberg

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