Information Technology Sector

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Sector Update

Large deals: Growth positive but a bolder and riskier phase?

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Over the last few days and months, we have had a number of large deals announced by Tier-1 Indian IT services players. Interestingly many of these deals are with Europe centric organisations. These include but not limited to (1) Daimler deal (made official on 22 December) and the Vanguard deal (announced in July 2020) in the case of Infosys (2) Postbank Systems and the Pramerica deals announced by TCS (both announced in November) (3) Metro deal of Wipro (announced on 22 December). As indicated in our recent note (How much stronger and for how much longer?), we could be at the cusp of many such deals over the next 12-18 months as customers accelerate and compress their digital transformations due to the impact the pandemic has had on their businesses. Many such transformations involve transfer of customers' internal IT teams as well as infrastructure (both of which may be legacy in our view). In the process, customer is able to move to the Cloud (multi and hybrid) and accrue benefits of being more agile, resilient, scalable and cost efficient. As can be expected, these are happening in industries (many currently) that are undergoing significant transformations due to dramatic changes in customer/employee/supplier needs, competition and cost pressures and which have accelerated due to the pandemic. Typically, deals are won by existing long standing vendors. There is an element of trust that is at the core of such large deals. From the customer's side, the hope is that the vendor would do a good job of delivering on SLAs besides taking care of employees transferred. From the vendor's side, it is about having a deeper relationship and a larger share of the customer's wallet. An existing relationship helps vendors get into larger deals as they have a deeper understanding of the IT landscape, which ensures that there are no nasty surprises that could upset the financials of the deal. Vendors are taking on talent in the hope of gaining new vertical skill sets that can be deployed for other customers. While each large deal does add to growth in the medium term, it also adds a layer of risk, which thus far has been well managed in the Indian IT services context. While the size of total contract value (TCV) and annual contract value (ACV) will be key monitorables, the impact on margins is not entirely clear. While IT services players in the past have indicated that large deal margins (through their life) may be a tad lower than corporate margins (if executed well), they could put pressure in the first few years due to initial investments. The IT services companies have opted for a portfolio approach rather than looking at deals on an individual basis. Thus, while a new deal may be putting pressure in the initial phase, there could be older large deals that would have likely moved to a phase of improved profitability on higher offshoring, reduction of staffing levels, usage of automation, additional and likely more profitable tag-along contracts, etc. While details are seldom revealed, some points on large deals to keep in mind include (1) the extent of annuity portion of the contract as that buttresses revenue growth in the latter years of the deal and also predictability of margins (2) fungibility and reskilling quotient of rebadged employees (3) extent of offshoring built into the contract (4) flexibility built into contracts for the vendor, should unforeseen events pop up. While as mentioned earlier each such large deal involves a higher level of risk – companies likely have processes, capabilities and software tools to manage them. But, a look at the global IT services industry over the last many decades indicates that there have been some large incumbents (in the US and in Europe) who have become casualties on the back of risks associated with some large contracts and poor execution. Therefore, we believe that large deals in the medium term could separate the boys from men. Poor execution could lead to customer dissatisfaction, unexpected volatility in margins & profits and therefore stock performance. It is very difficult at this stage to spot the likely players among the current Indian Tier-1 set that would be casualties. As regards our investment view on the sector, we continue to remain 'neutral'. While there could be some upside revisions to revenue in FY22 and FY23, we suspect margins may have to be lowered a tad, leaving EPS broadly constant. We have an Accumulate call on most stocks, except HCL Technologies on which we have a 'Buy' and which we believe could be a significant beneficiary of the shift in infrastructure to the cloud. We believe the market is mispricing both its IT & ITES business as well as its products business.

Select large deal details

Infosys

Daimler (announced yesterday):

In the automotive vertical, this seems a significant departure from the type of work that Infosys has done in the past based on what we glean from the customer cases indicated on its website. This is a significant infrastructure transformation program in the automotive space. This involves taking over of people and also hardware (which we believe will not come on to the books of Infosys and will be dealt with using possibly a third party). Media articles seem to indicate that this deal has a size of US$1.3bn to US$3.2bn over its life. Should the deal size be the bigger number, we believe that it could add significant revenue in FY22 (possibly as much as 3%-4%) and possibly make Daimler the largest customer of Infosys in FY22. Infosys' largest deal thus far has been the Vanguard deal whose size is likely US$1.5bn.

From the looks of it, this deal takes Infosys into a new territory and possibly is the first large deal involving the Cobalt suite of cloud solutions. According to the press release put out, "Daimler AG will transform its IT operating model and infrastructure landscape across workplace services, service desk, data center, networks and SAP Basis together with Infosys. The partnership will enable the company to deepen its focus on software engineering and to establish a fully scalable on-demand digital IT infrastructure and anytime-anywhere workplace. The collaboration will empower Daimler to strengthen its IT capabilities, and Infosys, its automotive expertise."

As a part of this partnership, automotive IT infrastructure experts based out of Germany, wider Europe, the US and the APAC region will transition from Daimler AG to Infosys. The number of employees who would get rebadged have not been indicated but based on news media we believe these could be 700-1000. Infosys says that it is well placed to handle the rebadging as it has already integrated more than 16,000 employees through earlier deals.

Vanguard (announced in July 2020)

Vanguard will partner with Infosys as part of its ongoing strategy to enhance and evolve its full-service defined contribution (DC) business. Vanguard is the largest DC asset manager in the US with more than US$1.3 trillion in DC assets. Vanguard currently serves as a strategic partner to nearly 1,500 plan sponsors.

Infosys will assume day-to-day operations, supporting Vanguard's DC record-keeping business, including software platforms, administration and associated processes. Infosys will provide a cloud-based record-keeping platform, enabling greater insights and unprecedented personalization to help deliver better outcomes for nearly five million participants and 1,500 sponsors. Based on media reports, we believe this deal will about US$1.5bn in size over 10 years.

Approximately 1,300 Vanguard roles will transition to Infosys. Transitioning employees will receive same salary, comparable benefits for a transition period of 12 months, plus meaningful incentive opportunities. Infosys serves half of the top 20 retirement service firms in the US. The firm offers end-to-end, enterprise-wide insurance and retirement business-process solutions across five core businesses: life insurance & annuity services, producer services, retirement services, employer sponsored services and functional BPO services.

Wipro

Metro deal (announced yesterday)

As a part of this transaction, Wipro will take over the IT units of METRO AG (the leading German global wholesale company that is in food service distribution industry)— METRO-NOM GMBH in Germany and METRO Systems Romania S.R.L. More than 1,300 employees across Germany, Romania and India will transfer to Wipro. The estimated deal value for the duration of the first 5 years is approximately US$700mn. With a likely extension for 4 additional years, the deal size could rise to US$1bn. Wipro's transformation program will encompass cloud, data center services, workplace and network services, along with application development and operations to provide an integrated, flexible and robust digital infrastructure to help drive METRO's transformation agenda.

According to Metro, 'We are at a stage where we want to focus on the activities that are going to give us the strongest possible competitive advantage and to do that, we need to be confident in the digital infrastructure that underpins our growth. Partnering with Wipro allows us to simplify and streamline our IT landscape, and critically gives us access to innovation and the best digital practices'.

Wipro is launching a Digital Innovation Hub in Düsseldorf, Germany to support METRO and other clients in the region. The proposed Digital Innovation Hub will serve as Wipro's flagship centre in Europe and enable organisations to cross skill and upskill, besides supporting talent development in local communities.

TCS

Acquisition of Postbank Systems

In November 2020, Deutsche Bank (DB) and TCS announced an agreement regarding the sale of Postbank Systems AG (PBS) to TCS. PBS is the full-range captive IT service provider that provides project management, application management and infrastructure support services to Postbank and other subsidiaries of Deutsche Bank. PBS and its around 1,500 employees will become part of TCS, deepening the relationship between the two organizations. The sale represents an important step for Deutsche Bank's announced strategic transformation. The expected revenue from this deal in 2021 is ~US$315mn. We understand that the entire 1500 rebadged employees will be billed to DB in 2021 and the numbers billed will reduce as years pass by. However, these employees will be redeployed to other clients of TCS. This deal will add to TCS' scale in Germany and strengthen its growth outlook. Present in Germany since 1991, TCS partners with over 100 leading German corporations in their growth and transformation journeys, including 17 of the DAX30.

This deal involves consolidation of IT platform for DB's retail banking brand Postbank into the Deutsche Bank platform. TCS is already a long-standing IT services partner for DB. With this deal, TCS will become a significant digital transformation partner of DB and will acquire market specific capabilities in the banking domain.

Large deal with Prudential Financial - announced in November 2020

TCS and Prudential Financial, Inc. (PFI) entered into an agreement that will see TCS acquire the staff and select assets of Pramerica Systems Ireland Ltd, PFI's subsidiary based in Ireland. It builds on a long relationship between the two and will see over 1,500 of Pramerica's staff in Ireland transfer to TCS. As part of TCS' new Global Delivery Centre in Ireland, they will continue to provide PFI with a range of business, digital and technology services, while also expanding TCS nearshore capabilities to provide the multifunctional, digital services and solutions to other customers in Ireland, the UK, Europe and the US.
This deal expands the relationship with TCS, while advancing PFI's ongoing transformation process.

Our view on the Indian IT services sector: In our sector updates of 6th September 2020 (Rising monetary and digital tides lifting most boats)and of 28th September 2020 (Medium term commentary turning more positive), we upgraded our view to 'neutral' on the sector from a 'cautious' one held for the last many years on the back of both, higher earnings and higher target PE multiples. The earnings uplift is coming from expectation of margin expansion over the next 2-4 years along with a 300-400bps pick-up in organic revenue growth over FY21-FY23. The changed view on margins has been driven by business model changes that the pandemic has induced, which we think are structurally positive. Higher PE multiples are driven by a combination of valuation exuberance (irrational!?) in the enterprise technology space in the US and constrained domestic investment choices. The demand uplift is more widespread and is a 'rising-tide-lifting-all-boats' kind of situation. Reasons for change in customer behavior, in our view are: (1) quick and unprecedented 'whatever-it-takes' monetary and fiscal actions in the US and Europe that likely eliminated tail risks to economic recovery and reduced risk aversion among corporates. While customer P&Ls and cash flows saw pain, credit market conditions significantly eased up with investment grade and junk bond yields more than halving from their pandemic peak as the US Federal Reserve stepped into the credit markets directly. Corporate America binged on cheap debt. These monetary conditions could last, we believe, for at least 24 months if not longer. (2) Strong need for digital transformation, not only to structurally cut costs, but also to deliver contact-less consumer and employee experiences, driven by the nature of the pandemic. Based on the commentary from customers, software companies and IT services vendors, we believe that digital demand has been pulled forward from the future. While there could be a growth spike in FY22 after a modest dip in FY21 (lower than anticipated), we see organic revenue growth over FY20-FY23 largely at par with that seen over FY17-FY20 as Digital upsurge will be met with a legacy drag.

Why not a sell:(1) We see earnings acceleration over FY20-FY23 due to a better margin trajectory on lower talent and SGA expenses. We see a structural reshaping of the employee pyramid, both onsite and offshore, driven by shorter shelf life of digital skills, need to be multiskilled and visa restrictions. Work from home/anywhere (WFH/WFA) and crowdsourcing platforms would open up talent pools hitherto untapped to keep costs in check. We could also see an offshore delivery shift, which may improve margins but could deflate revenues. Also, broader and deeper automation and vertical/horizontal platforms will likely offset compression in legacy services. (2) better relative earnings picture of IT services sector in the Indian equity market over the next 24 months vis-à-vis erstwhile favorite 'financials' sector, which is seeing uncertainty due to likely rise in bad assets. Worst is likely behind for Indian IT services but that can't be said about the Indian lenders and other domestic plays. (3) Current exuberance (irrational!?) in enterprise tech valuations in the US likely rubbing off on Indian IT services.

Why not a buy:(1) rising Covid-19 cases in the US and Europe that could lead to slower than V shaped FY22 recovery, which is currently priced in. Delay in a medical solution will call into question this recovery. (2) Adverse impact on US corporate profits in 2021 and beyond (leading to cut back in spending) due to higher taxation if new US President Joe Biden is able to push them through. (3) BFSI becoming a problem area in the medium term due to lower for longer (and possibly negative) interest rates (4) Likely slower organic growth in the medium term as spends are pulled forward. Growth could settle into mid-single digit territory in USD terms. (5) A likely deflation in enterprise tech valuations in the US.

Valuation and stock calls: TCS continues to be our sector benchmark as it has the strongest position in the industry. With enterprise tech sector in the US going through a bout of exuberance currently, an overshoot on the upside is not entirely ruled out. We back our higher PE multiples with (1) expectation of earnings acceleration over FY21-FY23 against FY17-FY20 on margin expansion (2) lower for longer interest rates globally and likely in India too that could keep PE multiples elevated (3) stress in earnings in many domestic sectors in the next 12-24 months, especially for lenders (4) potential for good return of capital to investors due to strong cash flows. We have benchmarked all other companies with respect to TCS. While historically we have not liked mid-tier companies due to their significant client, geographic and vertical concentration risks and weaker capabilities, we believe they could be beneficiaries in the next 24 months of robust demand. We believe vendor consolidation risks are lower due to this. We also think that some of them are undergoing a structural change for the better under new managements, which could set them up for better growth, margins and PE multiples.

Exhibit 1: Assumptions on macro and companies

	2018	2019	2020	2021	2022
Real US GDP growth (%)	3.0	2.2	–3.5	3.9	3.1
	FY19	**FY20**	**FY21E**	**FY22E**	**FY23E**
INR/USD	70.1	71.0	74.3	75.2	76.8
	FY19	**FY20**	**FY21E**	**FY22E**	**FY23E**
USD revenue growth (%)					
TCS	9.6	5.4	(1.9)	12.4	9.1
Infosys	7.9	8.3	3.3	11.4	8.2
Wipro (IT services)	1.6	0.8	(2.6)	8.9	7.2
HCL Technologies	10.1	15.1	0.9	11.8	10.1
Tech Mahindra	4.2	4.3	(2.5)	8.7	9.0
Mindtree	18.3	8.7	(2.4)	11.3	8.5
Persistent Systems	2.2	4.3	9.1	12.0	11.2
EBIT margin (INR) (%)					
TCS	25.6	24.6	25.3	26.2	26.7
Infosys	22.8	21.3	23.9	23.3	23.3
Wipro	17.1	17.3	18.4	18.7	18.9
HCL Tech	19.6	19.6	20.8	20.7	20.6
Tech Mahindra	15.0	11.6	12.9	13.6	14.8
Mindtree	12.8	10.1	16.1	17.2	17.1
Persistent Systems	12.6	9.2	11.6	13.0	13.6
EPS (Rs)					
TCS	83.1	86.2	87.3	105.3	119.5
Infosys	36.0	38.9	45.5	51.4	56.9
Wipro	18.6	16.6	17.9	20.4	23.2
HCL Tech	36.8	40.8	46.4	52.7	59.6
Tech Mahindra	48.7	45.2	49.6	56.9	68.3
Mindtree	45.8	38.3	61.2	73.1	81.4
Persistent Systems	44.1	44.4	55.2	71.8	85.6
EPS growth (%)					
TCS	24.0	3.8	1.3	20.6	13.5
Infosys	11.0	8.1	16.9	13.0	10.6
Wipro	10.5	(10.4)	7.6	14.2	13.5
HCL Tech	17.5	10.9	13.7	13.6	13.3
Tech Mahindra	12.5	(7.0)	9.7	14.6	20.0
Mindtree	32.3	(16.3)	59.8	19.3	11.4
Persistent Systems	9.2	0.7	24.3	30.1	19.2

Source: Companies, Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 2: Indian IT services sector valuations

	TCS	Infosys	Wipro	HCL Tech	Tech Mahindra	Mindtree	Persistent
Year ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 22-Dec-20	**2,873**	**1,221**	**364**	**914**	**945**	**1,525**	**1,377**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rs Bn)	10,625	5,035	2,031	2,372	881	236	101
(US$mn)	143,091	67,808	27,354	31,940	11,861	3,179	1,354
Sept 2022 Target Price	2,809	1218	382	1053	1017	1544	1377
Upside/(downside)	-2.2%	-0.2%	4.9%	15.2%	7.7%	1.2%	0.0%
Recommendation	Accumulate	Accumulate	Accumulate	Buy	Accumulate	Accumulate	Accumulate
FDEPS (Rs)							
FY18	67.0	32.5	16.8	31.5	42.8	34.6	40.4
FY19	83.1	36.0	18.6	36.8	48.7	45.8	44.1
FY20	86.2	38.9	16.6	40.8	45.2	38.3	44.4
FY21E	87.3	45.5	17.9	46.4	49.6	61.2	55.2
FY22E	105.3	51.4	20.4	52.7	56.9	73.1	71.8
FY23E	119.5	56.9	23.2	59.6	68.3	81.4	85.6
PE (x)							
FY18	42.9	37.6	21.7	29.1	22.1	44.1	34.1
FY19	34.6	33.9	19.6	24.9	19.4	33.3	31.2
FY20	33.3	31.3	21.9	22.4	20.9	39.8	31.0
FY21E	32.9	26.8	20.3	19.7	19.0	24.9	25.0
FY22E	27.3	23.7	17.8	17.4	16.6	20.9	19.2
FY23E	24.0	21.5	15.7	15.3	13.8	18.7	16.1
EV/EBITDA (x)							
FY18	31.4	24.1	18.2	18.7	15.2	30.1	19.9
FY19	25.5	21.9	15.0	15.4	10.8	21.1	15.1
FY20	24.2	20.6	13.8	12.9	12.1	20.9	17.6
FY21E	22.9	17.2	12.7	10.9	10.4	14.1	13.2
FY22E	19.7	15.7	10.3	9.4	9.0	11.8	10.9
FY23E	17.1	14.1	8.6	8.0	7.3	10.5	9.3
EV/Sales (x)							
FY18	8.3	6.5	3.4	4.2	2.3	4.1	3.1
FY19	7.0	5.5	2.9	3.6	2.0	3.2	2.6
FY20	6.5	5.1	2.9	3.0	1.9	2.9	2.4
FY21E	6.4	4.6	2.8	2.8	1.8	2.7	2.1
FY22E	5.6	4.1	2.4	2.4	1.6	2.3	1.9
FY23E	4.9	3.6	2.0	2.0	1.4	2.0	1.6
Pre Tax ROIC (%)							
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19	61.8	47.5	30.4	36.3	37.9	45.5	44.2
FY20	55.5	43.0	32.2	33.3	28.6	33.2	35.1
FY21E	53.4	46.4	33.5	31.6	28.2	54.6	48.5
FY22E	58.5	48.1	39.5	33.3	31.9	65.7	58.8
FY23E	62.2	50.0	45.2	35.4	37.3	66.6	67.4

Source: Company, Nirmal Bang Institutional Equities Research

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