Indian IT Industry

Sector Report

(January 2020)

Overview of IT Sector

IT & ITeS sector

IT services

- Market Size: US$ 92.49 billion during FY19E.
- Over 81 per cent of revenue comes from the export market.
- BFSI continues to be the major vertical of the IT sector.
- IT services had around 51 per cent share in total Indian IT sector revenues in FY19E.

Business Process Management

- Market size: US$ 36.2 billion during FY19E.
- Around 87 per cent of revenue comes from the export market.
- Market size of BPM industry to reach US$ 54 billion by FY25.
- BPM segment had around 20 per cent share in Indian IT sector revenues in FY19E.

Software products and engineering services

- Market size: US$ 34.39 billion during FY19E.
- Over 83.9 per cent of revenue comes from exports.
- The software products and engineering services segment grew 10.5 per cent in FY17.
- It had around 19 per cent share in Indian IT sector revenues in FY19E.

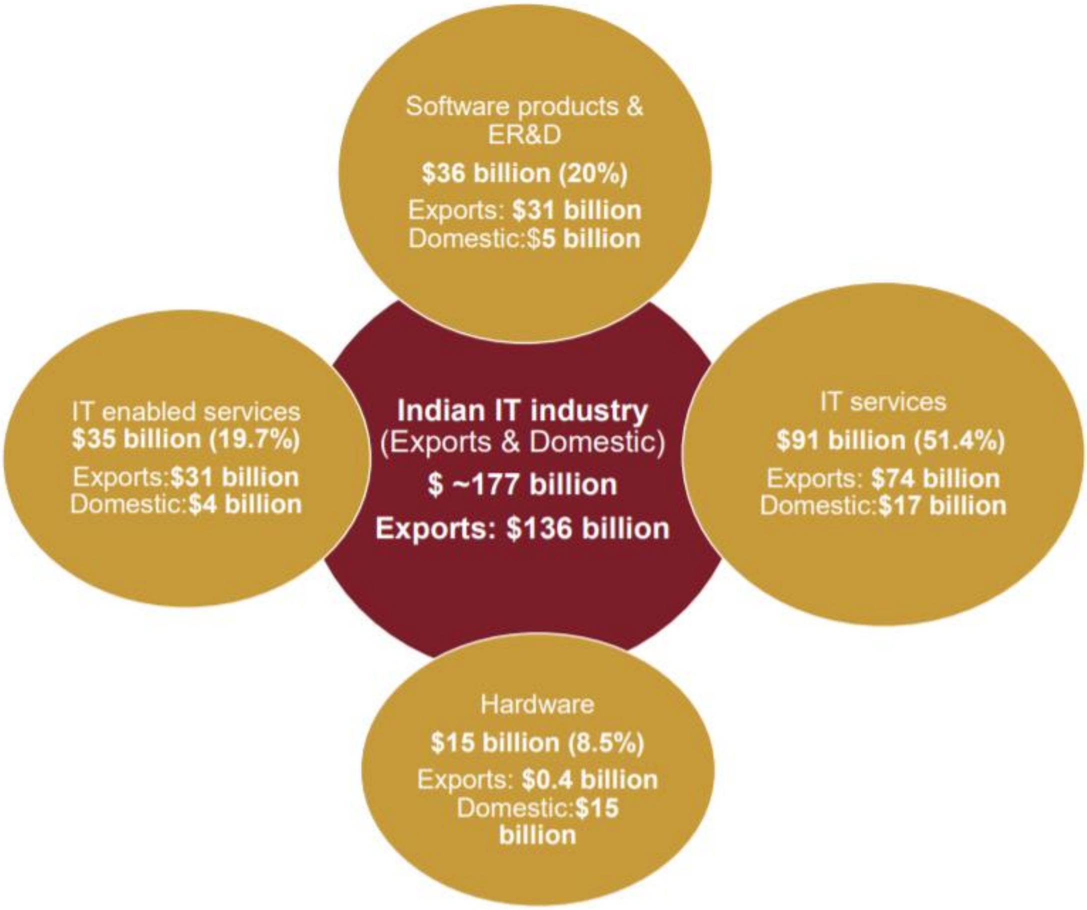
Hardware

- Market size: US$ 14.48 billion in FY19E.
- The domestic market accounts for a significant share.
- The segment had around 8 per cent share in Indian IT sector revenues in FY19E.
- Hardware exports from India are expected to grow at 7-8 per cent in FY19.^

Facts and Figures

Information technology enabled services (ITeS) exports are expected to grow 6-7% (in dollar terms) over the next five years to reach nearly ~$42 billion by fiscal 2024. Growth is expected to slow down from ~9% CAGR between fiscals 2014 to 2019 to a CAGR of 6-7% during fiscal 2019 to 2024, due to lower growth in the customer relationship management (CRM) and transaction segment (accounting for ~78% of the total revenue). These segments logged a CAGR of 7.6% and 8%, respectively, during fiscal 2014 to 2019, which is slow down to to ~5% and ~6%, respectively, over fiscals 2019 to 2024.

Structure of the Indian IT Industry:

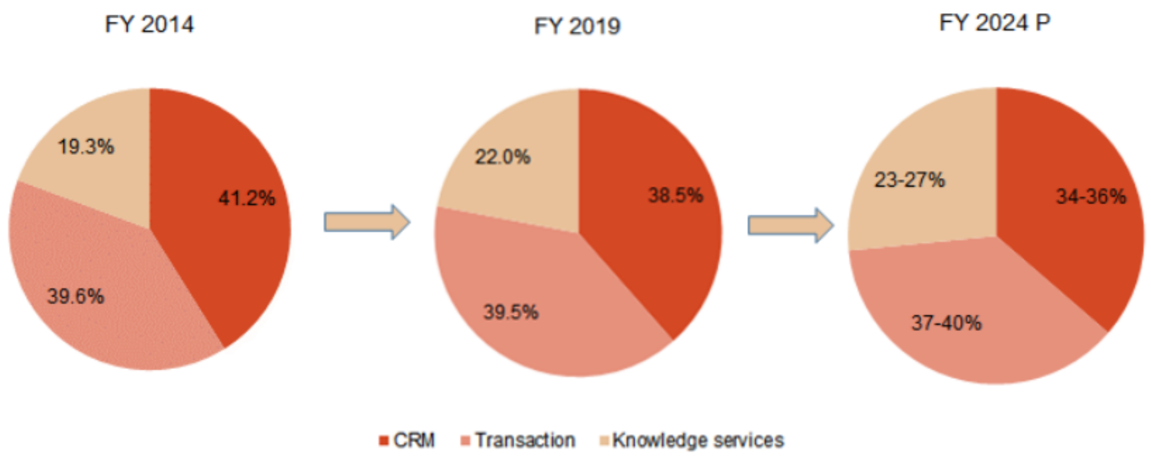


Growth to be driven by knowledge services, cloud and analytics

Revenue, growth in the knowledge services segment is expected to be in the range of 9-11% in fiscal 2020, which would provide some support on both the revenue and margins front for the sector. A shift towards the omni-channel, AI-powered automated CRM services, with customers requiring an integrated and smoother experience, adoption of easy-to-deploy, cloud-based services and rapid growth in analytics are expected to drive growth in the longer term.

Knowledge services are likely to be the fastest growing, driven by high-value services such as big data analytics and artificial intelligence (AI)-based automation. The segment is also expected to increase its share in ITeS export revenue to ~27% by fiscal 2024 from ~22% in fiscal 2019. Meanwhile, the share of CRM is expected to shrink to ~34% in fiscal 2024 from ~40% share in fiscal 2019.

Knowledge services have gained share in export revenue over past few fiscals



ITeS export revenue growth, which clocked ~9% CAGR over the previous five years, is expected to slow down to 6-7% CAGR until fiscal 2024 due to pricing pressure in traditional services such as CRM and transaction services, which accounted for ~78% of the total revenue as of fiscal 2019. Nevertheless, the growth in the knowledge services segment is expected to be in the 9-11% range, which would support both overall revenue and margin.

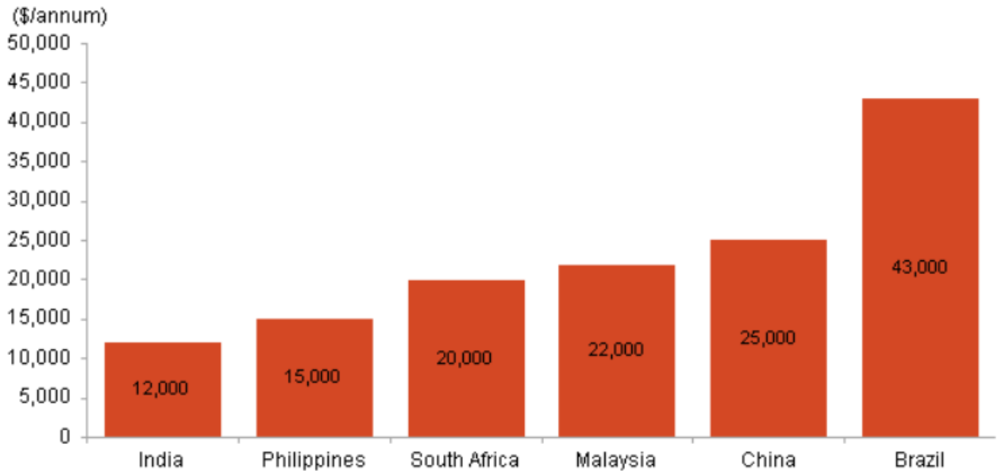
Growth drivers and inhibitors in ITeS exports

Growth drivers	Inhibitors
1. Moving up the value chain by providing analytics services and augmenting transaction business with automation and AI	1. Competition from Philippines and near shore destinations in the voice space
2. Integration of IT and BPO services to create higher value	2. Political uncertainties like anti-outsourcing sentiments in USA and Brexit uncertainty can result in lower spending by clients
3. Long standing relationship with clients and understanding of their business needs	3. Talent issues in the growing knowledge services space

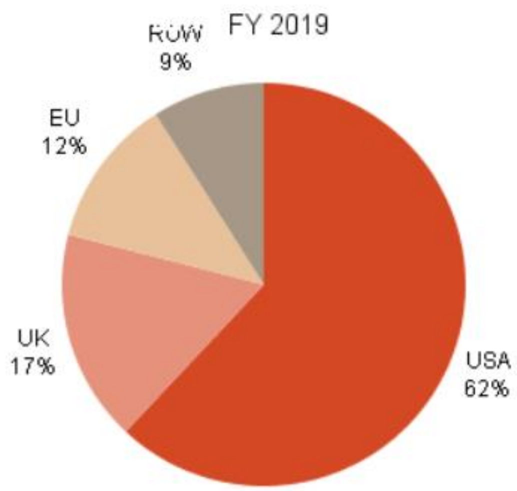
At the end of fiscal 2019, the total employee base stood at ~1.4 million and is expected to reach ~1.6 million by fiscal 2024 at a CAGR of 2-3% compared with ~5% CAGR clocked between fiscals 2014 to fiscal 2019.

India, the Philippines and Latin America (mainly Brazil and Mexico) account for ~80% of the world's ITeS outsourcing market, with India holding around 37% share in global sourcing in 2018 (this is expected to remain steady in 2019 too). India competes with other destinations on cost arbitrage and quality of service.

India still a cost-effective destination with the Philippines closely following



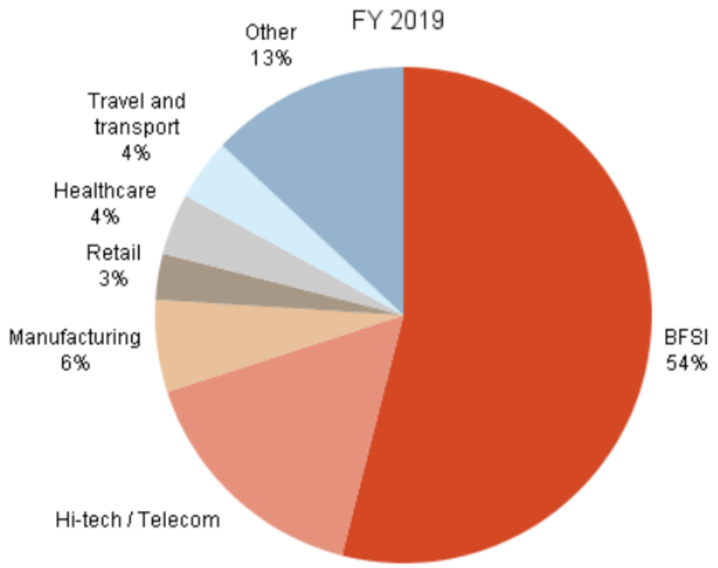
USA to maintain dominant share in revenues



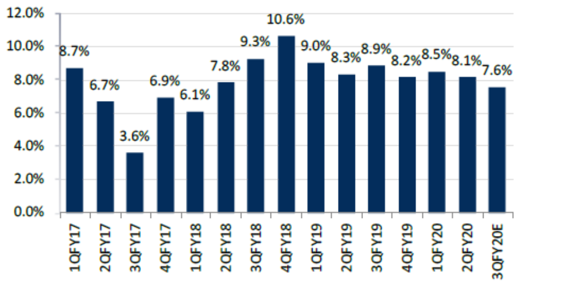
Domestic revenues grew at 8% on-year in rupee terms to touch Rs. 286 billion in fiscal 2019 . The industry's domestic revenue is expected to touch Rs ~309 billion by fiscal 2020 and Rs ~404 billion by fiscal 2024, clocking a 7-8% CAGR over the next five years. While revenue from the BFSI and the government are expected to drive growth due to the increasing share of digital transactions and the financial inclusion drive of the government, growth from the telecom sector is expected to decline, due to price-based competition in the sector.

With their share close to 70%, the BFSI and telecom sectors are dominant revenue contributors for the Indian companies. We expect this trend to continue in the near future. Smaller verticals such as retail, healthcare, travel, and transport are, however, growing faster than BFSI and telecom.

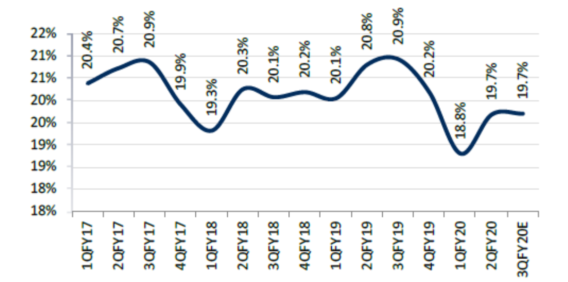
BFSI and telecom will continue to dominate revenue split



IT Sector USD Revenue Growth (% YoY)



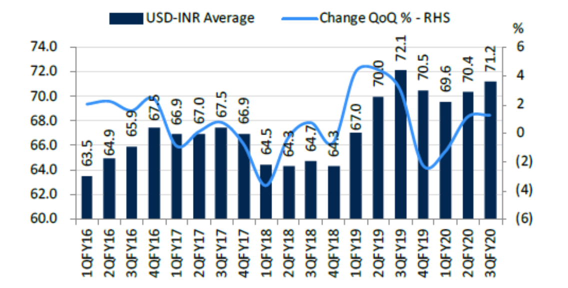
IT Sector EBIT Margin Trend (%)

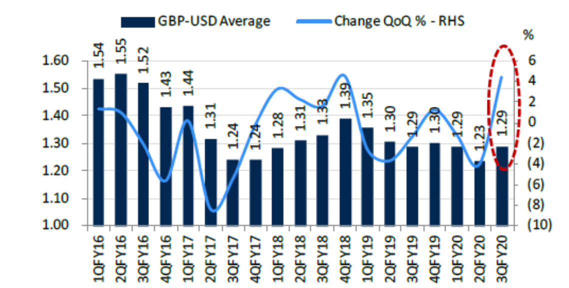


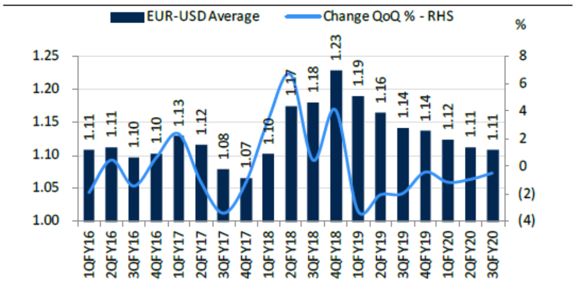
Currency movements

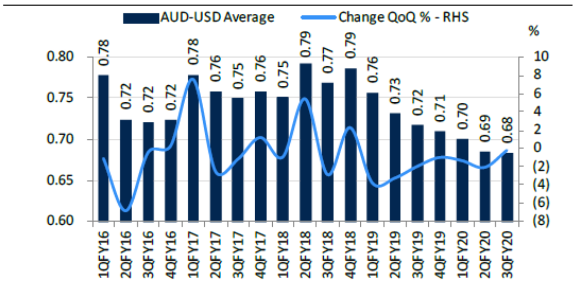
Favourable movement of USD-INR (+1.0% QoQ) to support margins.

Favourable cross currency impact in 3Q due to GBP-USD depreciation of 5% QoQ.

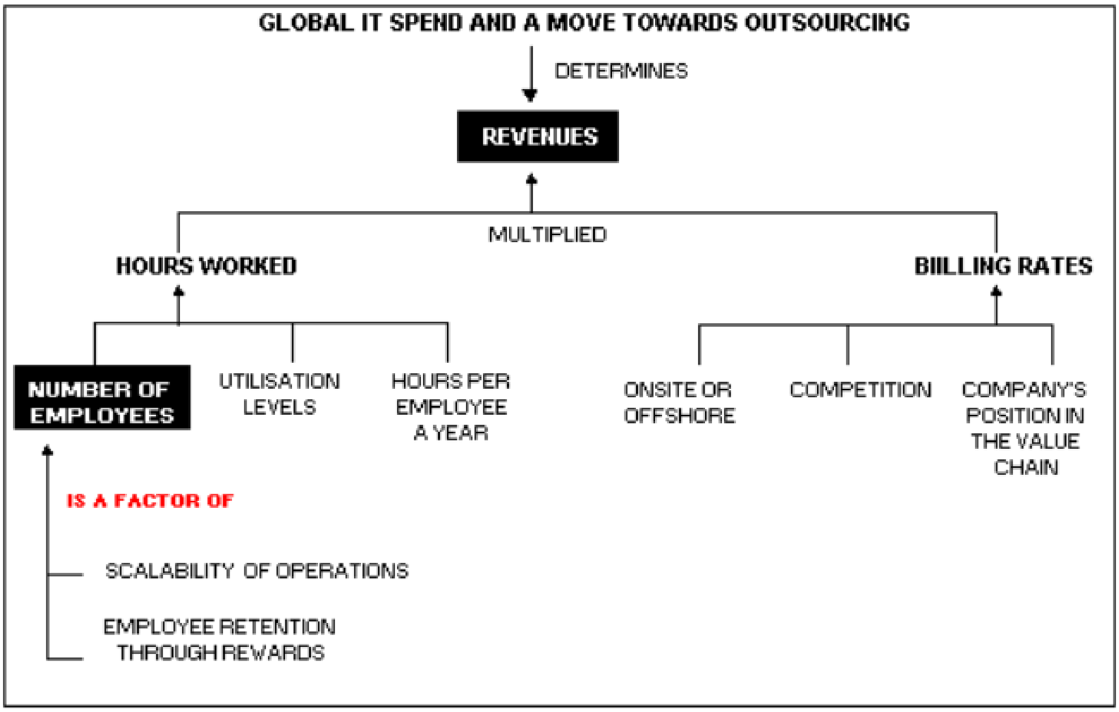








Working of the IT Industry:



Software sector sells man-hours i.e. its earnings are from billing rates (dollars/rupees earned per hour of work) multiplied by number of hours worked by an employee in a year. However, there is one critical factor here. A software company can increase revenues **by adding employees** and/or **by increasing utilization** (number of employees actually working on projects as a percentage of total employee base) and/or **by charging more per hour** (i.e. billing rate).

Comments on individual companies

TCS

It will likely report moderation in yoy revenue growth, sequential margin expansion and strong deal wins in TCV. Revenue growth is expected to be moderate at 6.8% yoy in c/c basis **due to the slowdown in BFS and retail and high base of the previous year**. Continued weakness in European banking and capital market clients in US, combined with account specific challenges in retail vertical, are the key drags. We estimate c/c tailwind of 60 bps to revenue growth on a sequential basis while we expect 30 bps headwind to yoy revenue growth. On profitability, the Rupee depreciation against the USD and GBP and increase in employee utilization rates will contribute to a sequential increase in EBIT margin. We expect a decline in margin yoy due to cost pressures in overseas geos. We expect other income to decline sequentially to Rs9.75 bn, from Rs11.7 bn in 2QFY20 due to a payout of over Rs200 bn in the form of dividend and lower FX gain. We expect a strong TCV print following signing of a mega-deal with the Phoenix group in the quarter. **Expect investor focus on (1) demand from impacted BFS and retail verticals, (2) impact on new outsourcing deals in a US Presidential election year, (3) overall IT budgets and spending outlook, (4) TCV of deals and pipeline of large deals and (5) measures taken to mitigate supply side pressures in the US.**

Infosys

It will likely report 9% c/c yoy revenue growth and sequential margin expansion and tighten revenue growth guidance. We expect c/c revenue growth of 0.7% on a sequential basis and 9% on yoy comparison. Robust yoy growth is partly contributed by acquisitions and other inorganic initiatives. Extended furloughs will impact growth on a sequential basis. On profitability, we expect an EBIT margin increase of 50 bps despite weak growth and furloughs. Improvement will be led by depreciation of the INR against USD and GBP and cost efficiency measures. EBIT margin will start flattening out yoy after a steep decline in the past three quarters. Other income will likely be impacted qoq due to dividend payout and lower FX gains. On a yoy basis, we expect a 38% decline in other income due to a completion of buyback and special dividends paid out, resulting in lower treasury income. We expect Infosys to tighten revenue growth guidance towards the upper end of the guidance band. We note that current revenue growth guidance for FY2020E stands at 9-10%. We expect **investor focus on (1) outcome of investigations into whistleblower complaints against CEO/ CFO, (2) margin outlook in view of a sharp decline in the past five quarters, (3) demand outlook from the banking and retail verticals, and (4) attrition rate trend after a few promising signs in September 2019 quarter.**

Wipro

It will likely report sequential revenue growth at the midpoint of guidance and stable margins. We expect sequential c/c revenue growth of 1.8%, at the midpoint of 0.8-2.8% revenue growth guidance. We expect contribution of 30 bps from the ITI acquisition to revenue growth. On a yoy basis, we expect revenue growth of 2.7 on c/c basis. Revenue growth will be led by the consumer vertical. **We expect stable EBIT margin for the quarter, aided by marginal depreciation of Rupee against the USD and cross-currency tailwind.** Completion of the buyback program has impacted treasury income yoy and qoq. We note that Wipro completed a buyback of 5.5% of equity shares in September 2019. We expect Wipro to guide for 0.5-2.5% sequential revenue growth for March 2020 quarter since March is a seasonally stronger quarter for the company. **We expect investors to focus on (1) outlook of the financial services vertical, especially noting high exposure to accounts facing challenges, (2) growth outlook from the top client, and (3) sustainability of the margin in light of continued growth challenges.**

HCLT

It will likely report ~15% yoy revenue growth and sequential decline in margin while maintaining revenue growth guidance. We expect sequential c/c revenue growth rate of 1% and ~15% yoy. We note that yoy revenue growth includes an inorganic component of 5.5%. **We expect a marginal decline in EBIT margin due to wage revision impact and normalization of profitability in the ER&D segment**. We expect HCLT to retain 15-17% c/c revenue growth guidance for FY2020E. We note that organic revenue growth guidance stands at an industry-leading 10-11%. **We expect investors to focus on (1) revenue growth from digital; Mode 2 services have shown elevated growth in the past few quarters, (2) mega deal pipeline, noting the criticality of the same in ensuring reasonable revenue growth in IMS, (3) method of returning excess cash, (4) target digital acquisitions, (5) EBIT margin sustainability, and (6) outlook of the products business.**

Tech Mahindra

It will likely report modest sequential revenue growth, decline in margins and strong TCV of deal wins. We forecast sequential c/c revenue growth rate of 2% and 5% yoy. **We expect 30 bps inorganic contribution to revenue growth from acquisition of BORN Group. Revenue growth will be led entirely by the communications vertical**. All verticals in the enterprise segment will likely report growth though this will be offset by a decline in revenues from HCI. Revenues from AT&T contract are likely to be spread across December 2019 and March 2020 quarter as compared to our earlier expectation of entire revenue flowing through in the December 2019 quarter**. We forecast EBIT margin decline of 50 bps qoq despite benefit of Rupee depreciation on account of (1) large rebadging and transition costs of AT&T deal, and (2) one-off gain of 60 bps from recovery of bad debt.** We expect FX gain of US$7 mn in the quarter. We expect strong TCV of over US$1 bn+ for the quarter as compared to the quarterly range of US$300-400 mn. **We expect investors to focus on (1) margin profile in light of continued volatility in portfolio companies and execution. Management has guided for 15% EBIT margin in FY2021E, which seems aggressive, (2) profile of large deals and drivers of Tech Mahindra's success, (3) attrition**

rates, (4) progress on 5G roll out and deal wins and (5) demand outlook of the impacted auto sub-vertical.

Key trends across IT Companies:

Moderation in revenue growth due to weak tech spending in key verticals and high furloughs

We expect 0.7-2% sequential constant currency revenue growth and 2.3-15% yoy revenue growth for Tier I companies. We believe moderation in revenue growth is underpinned by sluggish growth in BFS, retail and manufacturing, high furlough activity and client specific challenges for a few companies. Revenue growth for TCS will likely moderate to 6.8% yoy in c/c basis due to a slowdown in BFS and retail and the high base of the previous year. We expect Infosys to deliver 9% revenue growth yoy partly driven by acquisitions and other inorganic initiatives. For mid-tier firms, sequential revenue growth will likely be modest with the exception of LTI. Yoy revenue growth will likely moderate for all mid-tier firms under coverage with Hexaware, LTI and Mphasis affected by client-specific issues and Mindtree impacted by a hostile takeover by L&T.

Cross-currency movement led by GBP in the quarter will likely provide a 20-60 bps tailwind on a qoq basis and a 0-50 bps headwind yoy to revenue growth for companies in our coverage universe.

High onsite cost structure, high pace of investments in digital continue to pressure margins

We expect a 30-380 bps decline in EBIT margins for Tier I firms yoy. Rupee depreciation against the USD and GBP in the quarter will provide some margin tailwind qoq for companies. Reasons for the decline in margins remain the same— (1) high cost structure in the US due to a tightening of the visa regime and tech labor shortage, (2) higher investments in digital capabilities to better address change in the business spends of clients and (3) transition costs involved in the execution of large/mega deals for a few companies. We believe a substantial portion of the impact of increased cost structure in the US and higher pace of investments to build digital capabilities are already in the base leading to less incremental pressure for margins in the coming quarters.

Expect companies to report strong TCV of deal wins

Despite a moderation in revenue growth we expect companies that disclose TCV of deal wins to report strong numbers for the quarter. TCS will likely report strong growth in TCV on its mega deal win with Phoenix Group. We expect deal win momentum in Infosys to continue although TCV of wins will be significantly less compared to the previous two quarters which saw one-off elements. Conversion of the strong deal pipeline will likely drive strong deal win momentum in Tech Mahindra and LTI. On the other hand, we expect Mindtree to continue its trend of poor TCV growth due to delays in deal closures.

Mixed outlook for demand in CY2020

- **Technology spending outlook of BFS firms.** Weak tech spends in US and Europe BFS firms, especially in capital markets and banking, have impacted BFS revenue growth of IT companies in CY2019 with several companies calling out client specific issues in the vertical. Tech spending outlook remains weak in Europe, particularly in the UK though we believe there is improvement in the spending outlook in the US, a positive for IT firms. Whether the slowdown in spends continues or not, there are several interesting opportunities available in the market in the form of captive carve-outs, BPO deals, consolidation deals, etc. Companies that can address these opportunities through the right mix of services and ability to shape and win large deals can deliver healthy growth in CY2020 despite a muted outlook for the vertical.

- **Disruption in the retail industry.** Demand outlook in the retail vertical has been impacted due to higher volatility in technology spends of disrupted retailers. The outlook for the retail vertical in Europe remains weak due to low economic growth and Brexit. However, consumer spending continues to be strong in the US and is unaffected by trade war tensions. Retailers have accelerated the pace of investment in business to keep pace with disruption in the industry, creating opportunities for IT firms with strong capabilities in digital. However, the threat to demand comes from retailers that could potentially go out of business if they fail to cope with the disruption. Companies with significant exposure to run-the-business spends of retailers are also at risk of a squeeze in run spends to fund digital initiatives. Nearly all companies are vulnerable though CTSH is better positioned, while Infosys is more vulnerable than peers.

- **Impact of US elections.** Demand outlook for CY2020 can feel some heat from US elections. During the run-up to elections, clients could be wary of signing large outsourcing deals with offshore providers that entail significant rebadging of onsite workforce, leading to delays in deal closures.

On the whole, demand indicators are mixed and suggest similar or lower demand outlook in CY2020 compared to CY2019. Companies with strong drivers of revenue growth with a safety cushion on valuations such as Infosys and Tech Mahindra should emerge as the top picks in the sector while LTI should be a preferred pick among mid-tier firms.

Peer set comparison

Company	MCap	CMP	TP	RECO	EPS (Rs)				P/E (x)				RoE (%)				$ Rev CAGR% FY19-22	EPS CAGR% FY19-22
	(Rs bn)	(Rs)	(Rs)		FY19	FY20E	FY21E	FY22E	FY19	FY20E	FY21E	FY22E	FY19	FY20E	FY21E	FY22E		
TCS	8,257	2,200	2,030	NEU	83.9	85.7	92.9	104.7	26.2	25.7	23.7	21.0	36.1	35.4	37.1	39.9	8.2	7.7
Infosys	3,144	739	850	BUY	37.2	37.9	43.6	48.2	19.9	19.5	16.9	15.3	24.4	25.4	28.4	28.5	9.7	9.0
Wipro	1,418	252	235	NEU	16.0	17.7	18.4	19.9	15.8	14.3	13.7	12.7	17.3	17.7	17.1	15.9	4.6	7.5
HCL Tech	1,579	582	640	BUY	37.3	37.4	41.1	47.4	15.6	15.6	14.2	12.3	26.0	22.4	20.9	20.6	11.5	8.3
TechM	743	770	870	BUY	48.9	47.5	52.5	59.9	15.8	16.2	14.7	12.9	22.0	20.2	20.5	20.5	7.4	7.0
Tier-1 IT Median									**15.8**	**16.2**	**14.7**	**12.9**	**24.4**	**22.4**	**20.9**	**20.6**	**8.2**	**7.7**
LTI	316	1,819	1,945	BUY	87.3	85.1	96.1	112.2	20.8	21.4	18.9	16.2	34.6	27.9	27.1	27.3	11.7	8.7
Mphasis	163	875	1,165	BUY	57.6	58.3	65.5	75.0	15.2	15.0	13.4	11.7	20.0	19.7	19.9	20.2	10.2	9.2
LTTS	156	1,502	1,760	BUY	68.0	76.0	88.5	102.7	22.1	19.8	17.0	14.6	32.0	29.0	28.4	27.6	11.4	14.7
Mindtree	136	824	805	NEU	44.1	35.6	48.0	60.7	18.7	23.1	17.2	13.6	24.9	16.9	23.1	25.3	10.4	11.3
Hexaware #	100	335	450	BUY	19.6	21.6	24.5	28.3	17.1	15.5	13.6	11.8	26.5	24.7	24.1	24.0	14.7	13.1
Cyient	48	426	485	NEU	43.6	36.9	40.5	45.6	9.8	11.5	10.5	9.3	19.5	15.6	15.7	16.1	3.8	1.5
Zensar	41	182	245	BUY	14.3	14.9	17.9	21.4	12.7	12.2	10.2	8.5	17.6	16.0	16.9	17.6	11.2	14.4
Persistent	52	683	725	BUY	47.8	45.2	48.5	57.7	14.3	15.1	14.1	11.8	15.7	14.3	14.8	15.8	8.6	6.5
Tata Elxsi	51	823	720^	NR	46.6	38.3	46.6	53.2	17.7	21.5	17.7	15.5	34.5	23.6	24.8	24.1	6.4	4.5
Sonata	32	311	400	BUY	23.7	27.5	30.5	34.6	13.1	11.3	10.2	9.0	35.1	34.9	34.2	34.4	11.9	13.4
Intellect	19	146	255	BUY	7.7	2.6	7.3	11.2	19.0	56.8	19.9	12.9	11.1	3.3	8.7	12.1	10.8	13.7
eClerx	24	652	560^	NR	61.7	52.0	53.7	57.0	10.6	12.6	12.1	11.4	17.6	14.0	14.7	14.6	2.3	(2.6)
Majesco	11	384	655	BUY	18.3	19.9	30.0	36.7	20.9	19.3	12.8	10.5	8.4	7.9	11.0	12.2	9.9	26.1
HGS	13	600	745^	NR	84.6	100.3	110.9	129.5	7.1	6.0	5.4	4.6	8.5	13.1	13.3	13.7	5.7	15.2
Mastek	10	409	515	BUY	40.4	40.9	45.1	52.9	10.1	10.0	9.1	7.7	16.1	13.7	13.6	14.4	6.5	9.4
Tier-2 IT AVG									**15.3**	**18.1**	**13.5**	**11.3**	**21.5**	**18.3**	**19.4**	**20.0**	**9.0**	**10.6**
Tier-2 IT Median									**15.2**	**15.1**	**13.4**	**11.7**	**19.5**	**16.0**	**16.9**	**17.6**	**10.2**	**11.3**
TeamLease	42	2,475	3,600	BUY	57.3	55.9	74.3	95.5	43.2	44.3	33.3	25.9	20.0	16.2	18.1	19.2	18.9*	18.6
MCX	61	1,208	1,300	BUY	29.5	43.4	46.1	57.1	40.9	27.8	26.2	21.2	11.4	17.3	17.7	20.9	19.7 *	24.5
BSE	22	496	590	NEU	46.1	38.7	43.7	50.7	10.8	12.8	11.4	9.8	7.1	7.1	8.1	9.5	8.4 *	3.2
CDSL	25	240	315	BUY	10.9	11.0	12.1	14.0	22.1	21.7	19.9	17.1	17.0	15.8	15.8	16.6	12.4*	8.9
Median									**31.5**	**24.8**	**23.0**	**19.1**	**14.2**	**16.0**	**16.7**	**17.9**	**15.6**	**13.7**

Key Conclusions:

Indian IT's increased investments in (1) Re-skilling, (2) Localisation/near-shore (HCLT - Canada, Lithuania; Wipro - Virginia, Melbourne), (3) Platforms and partnerships (HCLT-GCP; Wipro-Mulesoft) continue to augment its digital prowess with increasing penetration across the portfolio. Headwinds such as (1) Tighter cost controls by enterprises/clients (particularly in large BFS), and (2) Elevated onsite metrics (localisation, sub-contracting) persist. However, we expect a steady 2020 as reflected in strong deal pipelines and continuity in large deal wins (TCS-Phoenix, INFY-Telenet, Siemens, Arlanxeo, Wipro-Olympus) and stable outlook/guidance increase by Accenture.

Key monitorables include: (1) Commentary on client budgets and spends in CY20 (esp. key verticals of BFSI, Retail & CPG), (2) Deal wins & order book (TCS, INFY, TechM, Mphasis, Mindtree, Hexaware, Zensar, Cyient), (3) Digital performance and large accounts metrics, (4) Update to rev/margin guidance (INFY, Wipro, HCLT, LTTS, Hexaware).

Revenues

- IT services exports grew by 7.2% in fiscal 2019 aided by strong demand for digital services and is expected to grow at 7-8% on-year constant currency dollar terms to reach $79 bn in fiscal 2020 with Q1 of current fiscal showing ~9% on-year dollar growth for Tier 1 players driven by:
    - Strong digital services growth of ~20%+ and moderate growth in key BFSI vertical and US market
    - Strong uptick in total contract value signed in fiscal 2019 which are up by ~70% on-year and 2x on-year in Q1FY20 by value

- Domestic IT services revenues expected to grow at 8-10% in rupee terms to reach Rs. 1.2 trillion in fiscal 2020 mainly supported by government and BFSI spends

Margins

- EBITDA margins improved by 30 bps in fiscal 2019 mainly due to rupee depreciation tailwind

- EBITDA margins expected to fall by 50-100 bps in fiscal 2020 due to higher employee costs with first half margins expected to see margins contraction at higher pace due to wage hikes and visa related expenses.

Trends

- Robotics process automation (RPA) based market to grow at robust pace of 25-30% CAGR in next three years and is expected to cross $1 billion in 2020, collaboration with technology vendor key for success for ITeS service providers.
- Employee additions for players increasing at faster pace in Philippines compared to India as voice based services continue movement from India on account of better cultural fit and similar cost structures.
- Net employee additions in export and domestic markets to grow at 2-3% & 1-2% CAGR, respectively, in next five years, because of increased automation
- Shift to digital based technologies along with increased automation is expected to augment in non-linear revenue generation
- Negative sentiments towards H-1b visa resulted in ~80% drop in new H-1B visas issuance to Indian IT players on-year in fiscal 2019; policy advocate spends increased by ~50% CAGR post Trump; local hires to cost ~27% more compared to H-1B based employees; sub-contracting costs increasing for the players to meet short term demand.
- Consolidation in the sector inevitable as digital at scale would require complex capabilities to execute
- GICs making a comeback with focus on digital technologies; both an opportunity and threat for IT players, collaboration key to success

Key monitorables:

- Brexit is set to be completed by October 2019 whose outcome remains a key monitorable; growth prospects in advanced economies
- Policies of President-elect Donald Trump and their execution with regards to the immigration and outsourcing