India IT Services

Institutional Equity Research

Results Preview | 07 April 2022

Seasonally weak quarter; Supply Side Issue to Continue Exerting Margin Pressure

In 4QFY22, the Nifty IT Index underperformed the Nifty by ~6%. Though 4Q is a seasonally weak quarter, we expect a strong revenue momentum on the back of deal ramp-ups, IT transformational spends and sustained deal closure activity across our IT coverage universe. We expect rising pressure on EBIT margin due to higher incentives for employees, wage hike to retain talent amid the high attrition, lower utilization due to aggressive fresh hiring, and higher SG&A cost. Moreover, the Ukraine-Russia conflict has further accentuated the issue with a greater impact on ER&D talent supply. Recently, Accenture reported 28% YoY USD revenue growth in its outsourcing services business, which we believe is a key positive for the Indian IT names. Looking ahead, we expect the deal environment to remain robust backed by consistent technology spend on digital services by the global enterprises. We expect strong end-market commentary from the top 8 companies under our IT sector coverage universe. Despite 4QFY22 being a lean quarter in general, we expect healthy deal flows to drive the revenue growth.

Robust Demand Outlook and Digitalization to Accelerate Revenue Growth

We expect the IT companies under our coverage universe to report strong deal momentum (strong book-to-bill ratio and solid deal pipeline) across most verticals due to a strong demand seen for transformation and digitalization. We expect 3.7-2.7% and 4.7-5.6% sequential growth in CC revenue for the large cap and mid-cap companies, respectively. Further, revenue growth is likely to be broad-based across geographies and verticals. We expect the deal bookings to remain strong, given the ongoing digital transformation trend.

Higher Attrition, Lower Utilization & Supply Side Issues to Impact Margins…

We expect the companies under our IT sector coverage universe to report 40bps QoQ decline in EBIT margin due to: (1) accelerated hiring (both freshers and laterals) amid the high attrition; (2) marginal step-up in investment in sales and capabilities, and (3) lower utilization due to hiring freshers. We highlight the margin pressure in 4QFY22 owing to higher employee incentives amid the rising attrition, while operating leverage and cross-currency would nullify the impact to a greater extent. Thus, we expect a more or less stable operating margin. Though attrition would remain elevated, we believe that it has already peaked out now. We expect cost pressure to continue over the next 2 quarters, while margin would recover in 2HFY23. Additionally, we believe the large cap IT names are in a better position to address supply side concerns compared to their mid-cap peers. We believe the accelerated attrition is likely to be a medium-term phenomenon, as we expect the demand environment to remain strong over FY21-FY24. Going ahead, we believe margin expansion would depend on: (1) improved pricing; (2) operating leverage (double-digit revenue growth); and (3) USD appreciation.

IT Names to Guide for Double digit FY23 Revenue Growth & Maintain Margin Outlook

We expect the IT companies to guide for decent double digit revenue growth for FY23 on the back of a solid deal backlog and buoyant deal environment. We also believe a broad-based consensus exists among the large cap and mid-cap IT companies regarding acceleration in technology demand. We expect Infosys to give FY23 revenue growth guidance of 12-14% and FY23 EBIT margin in the range of 22-24%. We expect Indian IT names to record mid-teen double-digit revenue growth in FY23 and maintain margins around the current level in 1HFY23E, while margins would improve by 50-100bps in 2HFY23E. We expect a decline in the utilization rate due to fresher hirings and a rise in discretionary cost.

Key Focus Points

(1) Revenue guidance, 2) large deal pipeline/bookings, 3) IT budget of clients for the next year, 4) hiring intensity, and 5) attrition trend.

Our View

The IT sector (coverage universe) is set to post another quarter of strong growth with decent CC growth and stable margins despite a seasonally weak quarter and cost pressure, based on (1) increasing speed of digital transformation/shift to cloud, 2) improving deal pipeline, and 3) investment in the hyperscalers/SaaS ecosystem. We expect the IT companies to invest the margin gains that they witnessed over the last 1.5 years for capability addition and talent retention, which will aid their market share gain in the medium term. We also expect accelerated disclosures/commentary on the progress of cloud business. Majority of global enterprises are still at an early stage of digital adoption, which is a huge opportunity for the Indian IT companies. Digital services business is likely to clock 15-20% CAGR in the medium term, led by increased cloud adoption by the global enterprises. We expect the IT players to benefit from potential acquisition opportunities of captive units and vendor consolidation efforts. We expect valuation multiple to remain high, though it has peaked out, hence leaving limited scope for further expansion. The stellar performance of Accenture has further strengthened our positive view on the sector.

Our Top Results Pick: Infosys

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Exhibit 1: 4QFY22 Preview Table

	CC Revenue Growth (QoQ %)	EBIT Margin (%)
TCS	2.9	24.9
Infosys	3.7	23.2
Wipro	3.0	17.1
HCLT	2.7	18.1
TechM	5.1	14.5
LTI	4.8	17.5
Mindtree	5.6	18.7
Mphasis	4.7	15.0

Source: RSec Research

Exhibit 2: 4QFY22 Average Currency Rates

Currencies	3QFY22- Average rate	4QFY22- Average rate	Delta (%)
AUD USD	0.73	0.73	(0.5)
EUR USD	1.14	1.12	(2.0)
GBP USD	1.35	1.35	(0.2)
USD INR	74.93	75.2	0.4

Source: RSec Research

Exhibit 3: India IT Sector - 4QFY22 Result Preview

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)
TCS					
Revenue (US$mn)	6,684	6,524	2.5	5,989	11.6
Revenue	5,02,670	4,88,850	2.8	4,37,050	15.0
EBIT	**1,25,322**	**1,22,370**	**2.4**	**1,17,340**	**6.8**
Net Income	**1,00,027**	**97,690**	**2.4**	**92,460**	**8.2**
Diluted EPS (Rs)	27.03	26.40	2.4	24.99	8.2
Margin (%)			**Change in bps**		**Change in bps**
EBIT Margin	24.9	25.0	(10)	26.8	(192)
NPM	19.9	20.0	(8)	21.2	(126)

Comments (TCS):

- We expect constant currency revenue growth of 2.9% QoQ. We expect book to bill ratio is likely to be higher than 1.0x.
- We expect EBIT margin to be stable by cross currency headwind due to appreciation of dollar against the pound, the euro and the Australian Dollar (~50bps)
- **Key things to watch:** 1) Deal commentary, 2) Outlook of BFSI, Retail and Healthcare vertical 3) Pricing trends

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)
Infosys					
Revenue (US$mn)	4,395	4,250	3.4	3,613	21.6
Revenue	3,30,515	3,18,670	3.7	2,63,110	25.6
EBIT	**76,642**	**74,840**	**2.4**	**64,400**	**19.0**
Net Income	**59,663**	**58,090**	**2.7**	**50,760**	**17.5**
Diluted EPS (Rs)	14.23	13.85	2.7	11.95	19.1
Margin (%)			**Change in bps**		**Change in bps**
EBIT Margin	23.2	23.5	(30)	24.5	(129)
NPM	18.1	18.2	(18)	19.3	(124)

Comments (Infosys):

- Expect sequential constant currency revenue growth of 3.7%. We expect strong order bookings.
- We expect QoQ decrease in EBIT margin of 30bps due to lesser working days during the quarter and supply side constraints still persisting.
- We expect Infosys to start with its conservative FY23 revenue growth guidance of 12-14% and reiterate FY23 EBIT margin in the range of 22-24%.
- **Key points to watch:** 1) Large deal activity, 2) Outlook of BFSI vertical, 3) Attrition trend and 4) Capital allocation policy

Continued...

India IT Sector - 4QFY22 Results Preview

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)
HCLT					
Revenue (US$mn)	3,048	2,977	2.4	2,696	13.1
Revenue	2,29,280	2,23,310	2.7	1,96,410	16.7
EBIT	**41,528**	**42,570**	**(2.4)**	**32,820**	**26.5**
Net Income	**33,323**	**34,420**	**(3.2)**	**11,020**	**202.4**
Diluted EPS (Rs)	12.27	12.68	(3.2)	4.06	202.4
Margin (%)			**Change in bps**		**Change in bps**
EBIT Margin	18.1	19.1	(95)	16.7	140
NPM	14.5	15.4	(88)	5.6	892

Comments:

- We expect constant currency revenue growth of 2.7% QoQ. We expect acceleration in deal activity.
- We expect EBIT margin to decline by 95bps QoQ due to higher attrition, lower working days and lower utilization.
- We expect HCLT to retain CC double digit revenue growth for FY23 and EBIT margin range of 19-21%
- **Key things to watch:** 1) Update on deal activity, 2) Outlook of financial services and manufacturing vertical and 3) Update on outlook and margin from Mode 2 and Mode 3 business

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)
Wipro					
Revenue (IT Services) (US$mn)	2,721	2,640	3.1	2,152	26.4
Revenue (IT Services)	2,06,237	2,00,936	2.6	1,58,917	29.8
EBIT (IT Services)	**35,342**	**35,535**	**(0.5)**	**34,167**	**3.4**
Net Income	**30,101**	**29,690**	**1.4**	**29,721**	**1.3**
Diluted EPS (Rs)	5.50	5.43	1.4	5.42	1.5
Margin (%)			**Change in bps**		**Change in bps**
EBIT Margin	17.1	17.7	(55)	21.5	(436)
NPM	14.6	14.8	(18)	18.7	(411)

Comments:

- We expect Wipro to report QoQ constant currency growth of 3%
- We expect QoQ decline of 55bp in EBIT margin due to lower utilisation amid new hiring
- **Key points to watch:** 1) Large deal win momentum 2) Pricing trends and 3) Outlook of BFSI and retail vertical

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)
Tech Mahindra					
Revenue (US$mn)	1,606	1,533	4.7	1,330	20.8
Revenue	1,20,783	1,14,508	5.5	97,299	24.1
EBIT	**17,492**	**16,979**	**3.0**	**16,037**	**9.1**
Net Income	**14,050**	**13,685**	**2.7**	**10,814**	**29.9**
Diluted EPS (Rs)	16.00	15.59	2.7	12.38	29.3
Margin (%)			**Change in bps**		**Change in bps**
EBIT Margin	14.5	14.8	(35)	16.5	(200)
NPM	11.6	12.0	(32)	11.1	52

Comments:

- We expect constant currency revenue growth of 5.1% QoQ. We expect deal wins to likely improve sequentially.
- We expect 35bps decline in EBIT margin on account of supply side constraints and lower working days
- **Key things to watch:** 1) Updated on 5G deal activity, 2) Update on margin optimization program

Continued...

India IT Sector - 4QFY22 Results Preview

Company (Rs mn)	4QFY22E	3QFY22	QoQ (%)	4QFY21	YoY (%)	Comments
Larsen & Toubro Infotech						
Revenue (US$mn)	579	553	4.6	447	29.3	▸ Revenue is expected to grow by 4.8% QoQ in constant currency ▸ We expect EBIT margin to decrease by 49bps on account of higher attrition, lesser working days and lower utilization. ▸ **Key Things to Watch:** (1) Outlook on BFSI spend and health of manufacturing and energy verticals; (2) key investment areas for growth; (3) update on M&A strategy 4) Hiring Trends
Revenue	43,507	41,376	5.1	32,694	33.1	
EBIT	**7,594**	**7,426**	**2.3**	**6,329**	**20.0**	
Net Income	**6,284**	**6,120**	**2.7**	**5,452**	**15.3**	
Diluted EPS (Rs)	35.91	34.97	2.7	31.15	15.3	
Margin (%)			**Change in bps**		**Change in bps**	
EBIT Margin	17.5	17.9	(49)	19.4	(190)	
NPM	14.4	14.8	(35)	16.7	(223)	
Mindtree						
Revenue (US$mn)	387	366	5.5	288	34.1	▸ We expect constant currency growth of 5.6%(QoQ) ▸ We expect 51bps decline in EBIT margin due to higher attrition. ▸ **Key things to watch:** 1) Top Client growth outlook, 2) Pace of recovery in travel and hospitality vertical and 3) Update on client diversification efforts
Revenue	29,073	27,500	5.7	21,093	37.8	
EBIT	**5,443**	**5,289**	**2.9**	**3,913**	**39.1**	
Net Income	**4,467**	**4,375**	**2.1**	**3,173**	**40.8**	
Diluted EPS (Rs)	27.11	26.55	2.1	19.27	40.7	
Margin (%)			**Change in bps**		**Change in bps**	
EBIT Margin	18.7	19.2	(51)	18.6	17	
NPM	15.4	15.9	(54)	15.0	32	
Mphasis						
Revenue (US$mn)	434	414	4.7	342	26.7	▸ We expect constant currency growth rate of 4.7% QoQ. ▸ We expect EBIT margin likely to decline by 11bps due to lower operating efficiencies. ▸ **Key things to watch:** 1) Outlook on BFSI spend 2) Update on DXC business and 3) Capital allocation policy
Revenue	32,611	31,237	4.4	25,243	29.2	
EBIT	**4,876**	**4,706**	**3.6**	**4,054**	**20.3**	
Net Income	**3,785**	**3,577**	**5.8**	**3,169**	**19.4**	
Diluted EPS (Rs)	20.19	19.08	5.8	16.94	19.1	
Margin (%)			**Change in bps**		**Change in bps**	
EBIT Margin	15.0	15.1	(11)	16.1	(111)	
NPM	11.6	11.5	15	12.6	(95)	

Source: Company, RSec Research

Change in Ratings

We have changed our rating system and included **HOLD** recommendation. We have **BUY, HOLD and SELL** recommendation now.

We have also shifted to **1-Year Target Price** from **2-Year Target Price**.

Mitul Dilipkumar Shah

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