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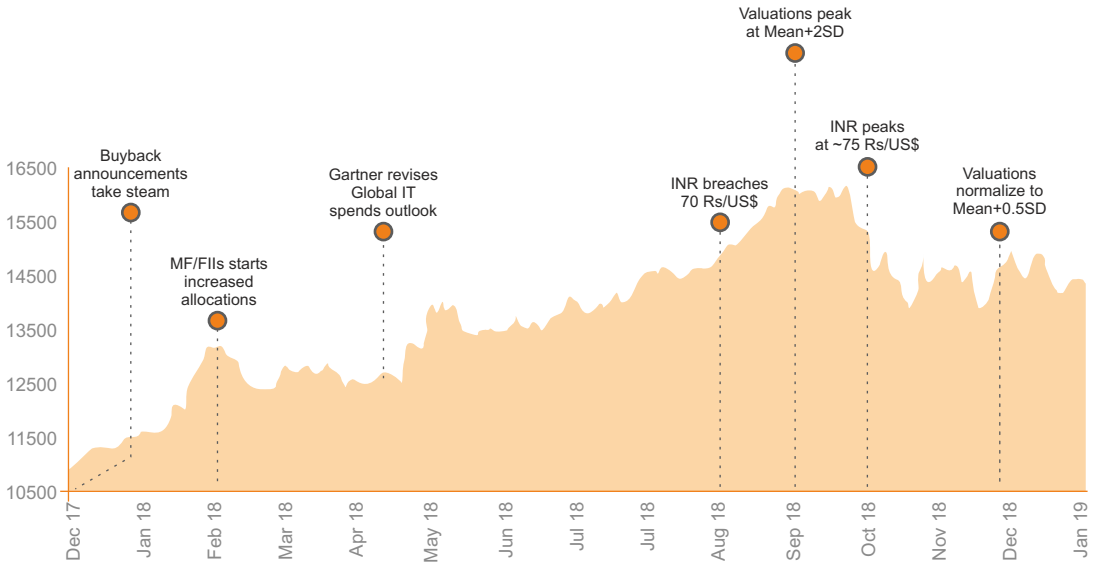
IT Services

January 9, 2019

Valuations Turn Rational



CNXIT Index Absolute Movement

CY19 Strategy – IT Sector (Overweight)

	CY18	CY19E
Gartner IT Spend Outlook	5.5%	4.7%
INR/US$ (Depreciation)	9%	~2%
Fund Ownerships (relative to BSE 200)	Underweight (~300bps)	Underweight (~150bps)
Yield (Buyback+Dividend) - Large-Caps	2.70%	2.40%
Valuation multiples	Mean -1 SD	Mean +0.5 SD
Overweight Ideas	TCS, LTI, Mphasis	HCL Tech, TCS, LTI, OFSS, Mphasis

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Information Technology

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Reasonable valuations compel Overweight stance

In CY18, the CNX IT Index outperformed the broader market by 21%. We believe that in last 12 months, the sector completed a full cycle: from depressed valuations (-1SD of 16x over its 5-year mean in Dec'17) to some irrational exuberance (+2SD by Sep'18), and then to a rerating of stretched valuations, with rationality prevailing in the end (+0.5SD).

The four pillars of IT Index rally: In our view, broadly four factors led to the CY18 rally: 1) Gartner's prediction for a significant growth uptick in IT spending; 2) INR depreciation; 3) sector under-ownership by domestic institutional investors; and 4) attractive payout yields. Among these, two have now neutralized with Gartner cutting IT spends growth estimates by 150bps to 5.9% in Nov'18 (we negated Gartner's optimism in our July'18 report) and the rupee depreciation moderating amid falling crude prices. On the other two, funds are still underweight despite attractive valuations on a PEG basis; and although effective yields are down, large-caps' yields still remain attractive at 2-4%.

We got it right in CY18: In an eventful and tumultuous year for the IT sector, we can say without apprehension that – We got right both on BUY and SELL. First, we were ahead-of-the-curve in highlighting the Buy ideas in Oct'17 underpinned by our differentiated top-down framework-led research methodology on CEO analysis (using the ABCDEF framework). The names we identified (TCS, LTI and Mphasis) using the framework out-delivered peers both on the stock price appreciation and financial performance fronts. Second, when the stock performance turned largely secular due to euphoric sentiments, we remained selective in our approach. The sharp up-moves led to lofty valuations, resulting in our recommendations turning into Reduce/Sell across most of the names. Although many stocks on which we had negative stance saw very sharp upside movements for a brief period, they all achieved our downside target price after the market returned to rationality.

Sector strategy for CY19: With the winning streak in CY18 now a thing of the past and the gains of the IT index receding significantly, for CY19 we are introducing three more analytical tools to our CY19 toolbox: 1) Client-based Global IT demand analysis: We have done an exhaustive sector-based analysis of the large client pools located across the US and UK that collectively account for about 70% of the revenues for Indian IT vendors, wherein the results reveal significant earnings gains accretion for these companies in CY17 and CY18E, giving us confidence on 3%+ growth for global IT spends and thus it would not pose any threat to our near-term growth estimates for Indian vendors. 2) Pricing analysis: Digital will not be margin-accretive as Technology is deflationary by nature. Digital services, like other segments in the past, would get commoditized with scale, and will turn deflationary. 3) Investor survey confluence (non-earnings factors): Our cumulative learnings from our interactions with more than 100 investors are also incorporated into our strategy. CY18 case studies have led to three core inferences: 1) investor preference for valuation-gap plays rather than structural buys; 2) preference for small assured growth and dividend vs. high-but-inorganic growth; and 3) premium for 'known unknown'.

Alpha-generating allocation strategy – CY19: We are Overweight on the Technology sector given growth certainty and favorable valuations on a PEG basis. Our CY19 recommendations for money managers: The biggest skew is coming from going underweight on **Infosys (Underweight)** and **Tech Mahindra (Underweight)** and allocating similar funds into high-growth names such as **HCLT (a deep value buy - Overweight for us)** and **TCS (a structural Buy - slight overweight).** In addition, by avoiding or going underweight on Wipro, we recommend higher weights to high-growth, sustainably-performing mid-caps such as **LTI and Mphasis (both Overweight),** as well as high-potential software plays such as **OFSS (Overweight) (refer to Exhibit 54 for detailed model portfolio).**

TCS	ACCUMULATE
CMP	Target Price
1,898	2,100
Infosys	REDUCE
CMP	Target Price
671	640
HCL Tech	BUY
CMP	Target Price
940	1,265
Wipro	REDUCE
CMP	Target Price
324	300
Tech M	HOLD
CMP	Target Price
690	730
L&T Infotech	ACCUMULATE
CMP	Target Price
1,688	2,020
Mphasis	BUY
CMP	Target Price
925	1,370
Mindtree	HOLD
CMP	Target Price
821	900
NIIT Tech	ACCUMULATE
CMP	Target Price
1,162	1,335

Financial Snapshot (Consolidated)

	EPS			EV/EBITDA			P/E		
(Rs mn)	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
TCS	85.5	94.6	104.8	17.1	15.2	13.3	22.2	20.1	18.1
Infosys	36.6	40.7	42.9	12.9	12.0	11.1	18.3	16.5	15.7
HCL Tech	75.5	82.5	90.4	8.0	7.0	6.0	12.5	11.4	10.4
Wipro	18.8	21.8	23.3	13.3	11.0	9.8	17.3	14.9	13.9
Tech M	48.3	52.2	56.5	8.6	7.6	6.8	14.3	13.2	12.2
L&T Infotech	90.4	100.4	112.4	12.7	11.3	9.8	18.7	16.8	15.0
NIIT Tech	69.3	76.6	83.7	10.3	8.6	7.2	16.8	15.2	13.9
Mphasis	57.1	66.2	76.0	10.6	8.6	7.1	16.2	14.0	12.2
Mindtree	46.5	50.3	56.4	12.0	10.4	9.2	17.7	16.3	14.6

Source: Company, Emkay Research

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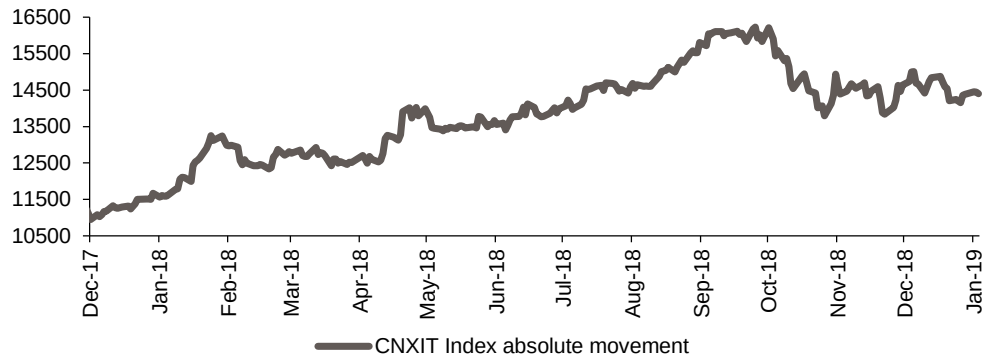
IT Services index – valuations turn rational

Exhibit 1: CNX IT 1-year chart

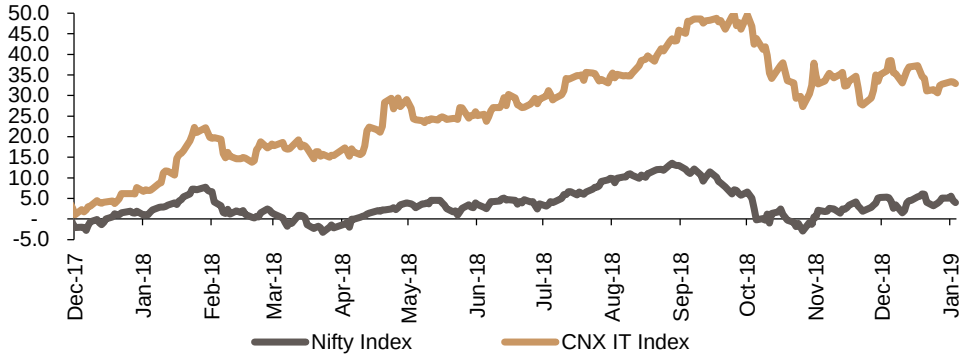


Source: Company, Emkay Research

In 2018, the CNX IT index outperformed the broader market significantly, with a 24% returns vs. the Nifty's modest 3%. Prior to the post-Q2 earnings (Oct'18) correction, the CNX IT in its peak provided about ~47% return (until Sep'18; YTD). In the last 12 months, the sector completed a full cycle: from depressed valuation to some irrational exuberance, and then to a rerating-of stretched valuations, with rationality prevailing in the end. During the year, the sector PE moved from -1 SD of 16x to +2 SD of 21x, and now is back to about 18.5x on TMF earnings, +0.5 SD above its five-year mean.

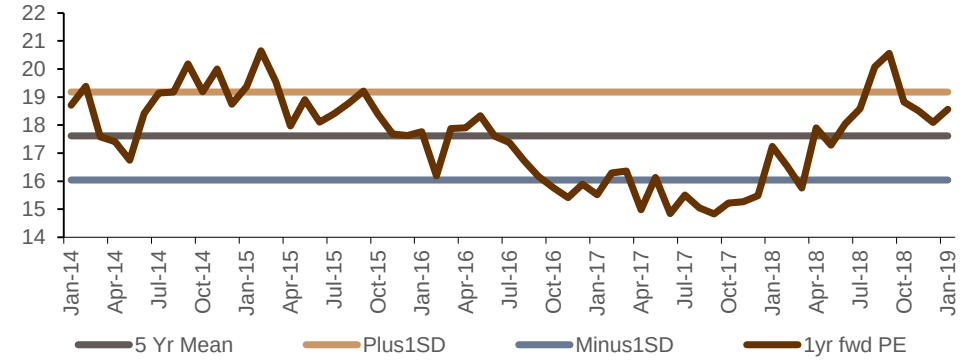
Exhibit 2: CNX IT vs. Nifty

CNX IT outperformed the Nifty by over 21%



Source: Emkay Research

Exhibit 3: CNX IT 5-year PE chart (Mean and 1SD).



Source: Emkay Research, Bloomberg

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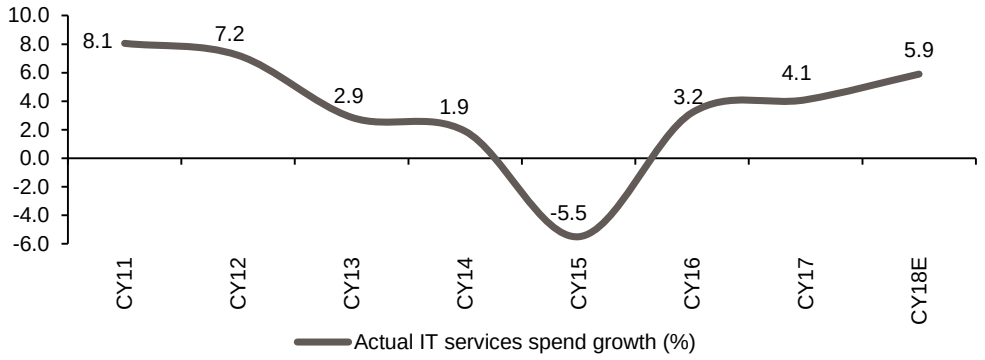
Four factors that led to the rally in IT sector in CY18

In our opinion, the four key factors that drove this large and sharp movement in CY18 were:

1. **Gartner's prediction for a significant growth uptick in IT spending in CY18.** Growth was expected at about 6% for IT Services — ahead of CY17 growth of 4.1% — which drove further optimism in the Street's own growth estimates (refer to Exhibits 4 and 5).

Exhibit 4: Gartner predicted a big jump in CY18 IT spending in its April report (7.4% growth) but lowered its expectations to 5.9% in its October release



Source: Gartner, Emkay Research

Exhibit 5: Comparison of Gartner's expectations and actual growth in Global IT services* spends

	January	April	July	October	Actual
CY14	4.5	4.6	3.8	N.A	1.9
CY15	2.4	-1.3	-5.5	-3.5	-5.5
CY16	3.1	2.1	3.7	3.9	3.2
CY17	4.2	2.3	3.1	N.A	4.1
CY18E	5.5	7.4	N.A	5.9	

Source: Emkay Research, ****Note: Data indicates growth for IT services spend only and not the entire global IT spend***

2. **CY18 seeing about 9% depreciation in the INR against the USD.** This was against a 4% appreciation recorded in CY17, driving reported earnings in INR terms up by about 6-9% for FY19 across players (refer to Exhibit 6).

Exhibit 6: FY19E revenue growth expectations in USD/INR terms for our coverage

Company Name	USD growth (%)	INR growth (%)
TCS	9.4	19.5
Infosys	7.0	16.6
Wipro	1.6	8.9
HCL Tech	8.7	18.5
Tech Mahindra	4.4	14.0
L&T Infotech	17.9	26.1
Mphasis	13.2	18.8
Mindtree	17.0	28.0
Hexaware*	11.5	17.7
Persistent Systems	4.5	13.5
NIIT Tech	13.6	21.4

Source: Company, Emkay Research

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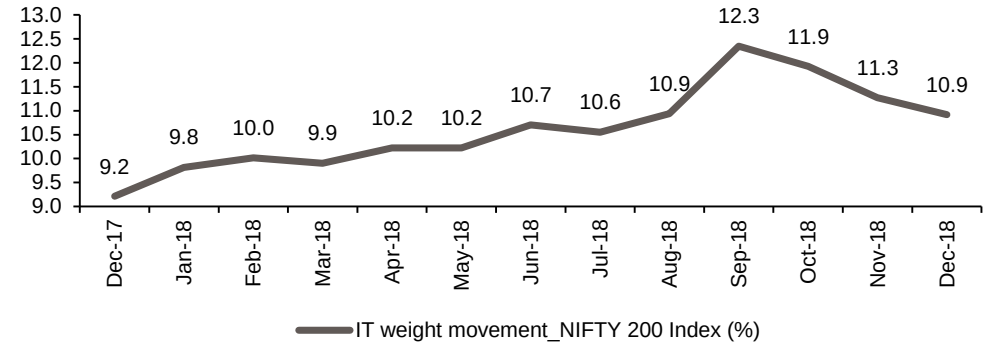
3. **Domestic funds' under-ownership of the IT sector compared with the Nifty weightage for the sector**. The IT sector's weight in the BSE-200 index was around 11%, whereas average allocations for the top-20 Domestic MFs stood at about 6% in Dec'17 (refer to Exhibits 7 and 8). The rally in the IT stocks resulted in an outperformance, with higher MSCI/FTSE-based index weights, leading to higher allocations for passive/active FII funds – the trend has resulted in an improvement in FII average ownership in top-11 IT companies through the year (refer to Exhibits 9 and 10), with Wipro being the only exception.

Exhibit 7: Almost all mutual funds were well-underweight in the sector at beginning of the year and achieved near equal-weight by CY18-end

Fund Name	Sector	Nov-18	Oct-18	Aug-18	Jun-18	Apr-18	Feb-18	Dec-17	Oct-17
		Holding (%)							
Mutual Fund 1	IT - Software	10.1%	10.5%	10.7%	13.9%	14.3%	13.3%	11.7%	11.3%
Mutual Fund 2	IT - Software	9.7%	10.0%	9.1%	9.0%	8.5%	7.9%	7.1%	6.1%
Mutual Fund 3	IT - Software	9.0%	9.2%	9.7%	9.8%	9.2%	9.3%	8.2%	10.1%
Mutual Fund 4	IT - Software	4.3%	4.5%	3.8%	4.0%	3.8%	3.8%	4.4%	4.6%
Mutual Fund 5	IT - Software	8.3%	9.5%	8.5%	8.3%	7.9%	6.1%	5.0%	5.1%
Mutual Fund 6	IT - Software	12.1%	12.6%	12.0%	11.8%	11.9%	11.5%	10.2%	10.2%
Mutual Fund 7	IT - Software	6.9%	7.3%	7.0%	6.7%	6.7%	6.6%	6.5%	6.1%
Mutual Fund 8	IT - Software	8.0%	8.0%	6.1%	6.0%	3.4%	2.9%	2.2%	2.7%
Mutual Fund 9	IT - Software	8.7%	9.4%	9.2%	9.3%	8.4%	6.4%	4.9%	3.6%
Mutual Fund 10	IT - Software	5.5%	6.2%	4.2%	3.8%	3.3%	2.4%	1.1%	1.0%
Mutual Fund 11	IT - Software	8.1%	7.7%	8.0%	7.6%	6.3%	4.8%	3.4%	3.7%
Mutual Fund 12	IT - Software	6.3%	6.4%	5.3%	5.0%	3.5%	3.0%	1.8%	1.8%
Mutual Fund 13	IT - Software	7.2%	7.2%	6.9%	6.0%	6.4%	6.1%	3.8%	3.9%
Mutual Fund 14	IT - Software	13.3%	14.9%	11.7%	8.4%	4.1%	3.2%	1.4%	0.7%
Mutual Fund 15	IT - Software	8.5%	9.3%	8.1%	7.5%	5.9%	5.5%	5.0%	4.6%
Mutual Fund 16	IT - Software	8.3%	8.4%	7.7%	7.2%	6.6%	5.7%	4.6%	4.1%
Mutual Fund 17	IT - Software	9.2%	9.5%	7.8%	4.3%	3.8%	3.5%	2.6%	2.6%
Mutual Fund 18	IT - Software	10.5%	11.7%	10.3%	8.6%	7.1%	6.6%	4.2%	4.7%
Mutual Fund 19	IT - Software	10.9%	9.2%	7.4%	6.1%	9.4%	9.4%	8.6%	8.5%
Mutual Fund 20	IT - Software	9.6%	10.4%	9.4%	8.4%	8.3%	7.5%	5.2%	4.5%

Source: Emkay Research, NAV, Dec-18 data is not yet available

Exhibit 8: IT weight in NIFTY 200



Source: Emkay Research, Industry

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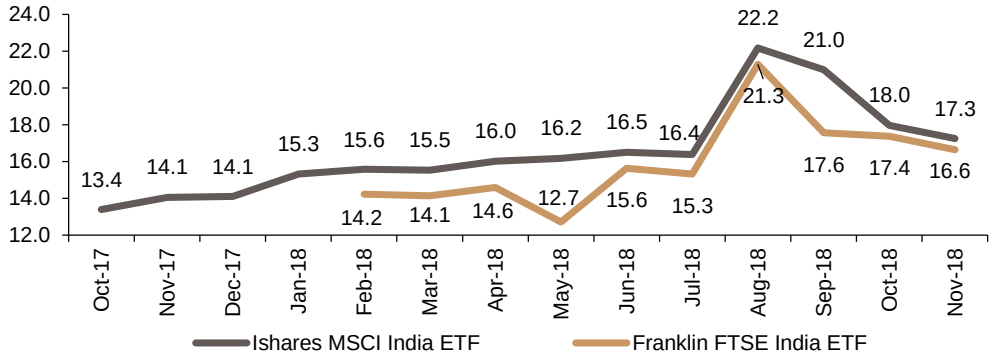
Exhibit 9: IT weightage in global India indices



Source: Emkay Research, Bloomberg

Exhibit 10: FPI ownership has improved across IT services names in CY18

Date	TCS	Infosys	Wipro	HCL Tech	Tech M	LTI	Mphasis	Mindtree	NIIT Tech	Hexaware	Persistent
Sep-17	16.6	34.9	9.8	25.3	36.3	5.9	21.4	40.3	36.1	11.6	22.9
Oct-17	16.6	34.9	9.8	25.3	36.3	5.9	21.4	40.3	36.1	11.6	22.9
Nov-17	16.6	34.9	9.8	25.3	36.3	5.9	21.4	40.3	36.1	11.6	22.9
Dec-17	16.3	35.0	9.8	25.6	36.5	6.1	21.8	40.6	39.5	13.3	24.0
Jan-18	16.3	35.0	9.8	25.6	36.5	6.1	21.8	40.6	39.5	13.3	24.0
Feb-18	16.3	35.0	9.8	25.6	36.5	6.1	21.8	40.6	39.5	13.3	24.0
Mar-18	17.0	35.2	9.3	26.5	37.9	6.9	22.8	41.7	40.7	14.4	26.5
Apr-18	17.0	35.2	9.3	26.5	37.9	6.9	22.8	41.7	40.7	14.4	26.5
May-18	17.0	35.2	9.3	26.5	37.9	6.9	22.8	41.7	40.7	14.4	26.5
Jun-18	16.6	35.1	8.7	26.2	38.1	8.0	29.2	44.4	40.7	14.9	26.2
Jul-18	16.6	35.1	8.7	26.2	38.1	8.0	29.2	44.4	40.7	14.9	26.2
Aug-18	16.6	35.1	8.7	26.2	38.1	8.0	29.2	44.4	40.7	14.9	26.2
Sep-18	16.1	35.1	8.5	28.0	38.5	9.5	29.1	43.2	41.1	14.9	26.5
Oct-18	16.1	35.1	8.5	28.0	38.5	9.5	29.1	43.2	41.1	14.9	26.5
Nov-18	16.1	35.1	8.5	28.0	38.5	9.5	29.1	43.2	41.1	14.9	26.5

Source: Emkay Research, Bloomberg

4. **Attractive payout yields**. Most players are turning generous by increasing the payout ratio and with a unique tax-efficient premium buyback model. Despite modest gains from such arrangements, the buybacks were the talking point for many IT stocks (the model is not beneficial for long-only institutional investors as the premium price leads to no immediate EPS accretion and upside windfalls are taken by Retail shareholders with <Rs0.2mn investment size). In addition, most shareholders attract a capital gain tax on the sale of shares in the buyback. Payouts in FY18 yielded in the range of 1-4% for various IT players and added comfort to investors even though growth rates were not enticing in many cases (refer to Exhibit 11).

Exhibit 11: Yield generated through dividend/buyback in FY18

Company Name	Price as on 01 Jan, 2018	Dividend Yield (%)	Buyback Yield (%)	FY18 Total Yield (%)
Tata Consultancy Services	1,323	1.7	0.4	2.1
Infosys	1,034	2.7	1.1	3.8
Wipro	317	0.9	3.1	4.0
HCL Technologies	879	1.4	0.4	1.8
Tech Mahindra	503	1.6	-	1.6
Larsen & Toubro Infotech	1,145	1.5	-	1.5
Mphasis	738	2.3	0.9	3.2
Mindtree	607	1.8	0.4	2.2
Hexaware Technologies	342	1.2	-	1.2
Persistent Systems	712	1.4	-	1.4
NIIT Technologies	654	1.7	-	1.7

Source: Emkay Research

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These factors were very effective and played crucial role as a few differentiated and consistent performers, such as TCS, LTI, Mphasis and NIIT Tech, kept on surprising investors positively through the last four quarters, augmenting the confidence on the Street's optimism on a possible robust recovery in revenue growth for the Indian IT players.

In sum, this was all about CY18, in which the IT Index outperformed the broader markets by about 21%. However, going into CY19, we need to re-emphasize on the status of these drivers for a possible continuity in outperformance, and if not, how it would affect the investors' strategies going forward.

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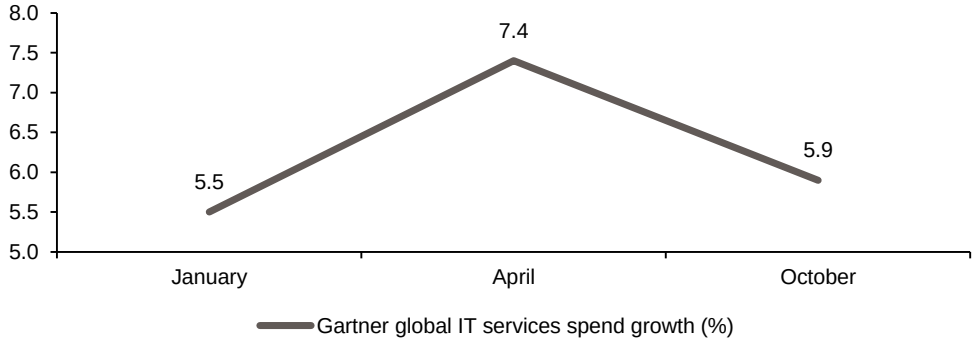
The status of the four factors and their possible impact on CY19 stock performance

1. **In its latest release in Nov'18, Gartner cut its Global IT Services spending growth estimate to 5.9% from 7.4% in April'18 (refer to Exhibit 12). Even the consensus estimates on the Street saw severe cuts in earnings after Q2FY19 results as they were too stretched in some cases, especially in mid-caps, with the sharp rise in stock prices leading to wishful growth estimates.**

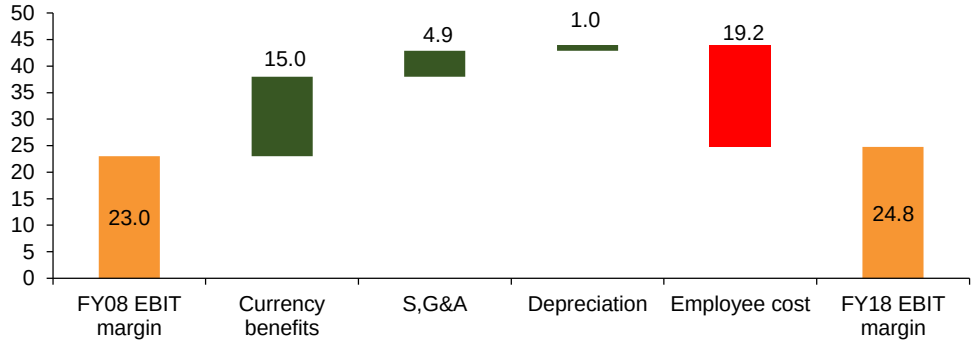
Exhibit 12: Gartner lowered its expectations for IT services spend growth in its October release



Source: Emkay Research, Industry

2. **The INR's fall has finally arrested, at least for now, with the currency recouping the fall by about 7% from a high of Rs74.9/USD in the last two months. We believe that the average depreciation of about 4-6% on an annualized basis should continue, but we know now that these gains would be largely be ploughed back to boosting sales, funding wage hikes, building the much-needed digital competencies, re-skilling, localization, etc., and should not be seen as an OPM-accretive factor for IT vendors, as it was in FY08-18 during which no profitability recorded except by TCS/HCLT despite about 60% depreciation in the INR (refer to Exhibit 13-17). Note: our estimates are factoring in Rs71.5/Rs73 per USD for FY20/21E (computed by Emkay FX estimates and based on the potential cross-currency impact and the respective hedging strategy of the company).**

Exhibit 13: TCS EBIT margin (%) improved on strong 13% USD revenue CAGR over FY08-18



Source: Company, Emkay Research

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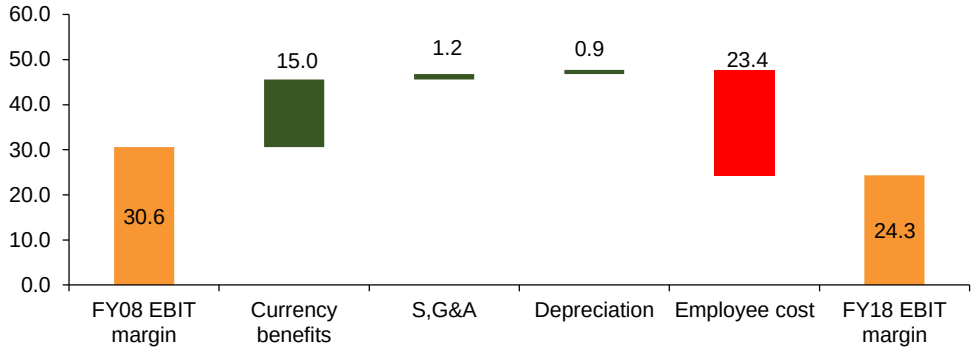
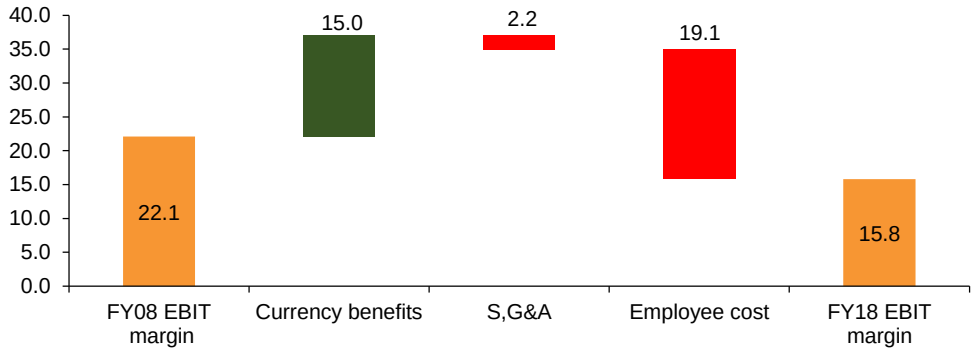
Exhibit 14: Infosys' EBIT margin (%) declined on growth deceleration



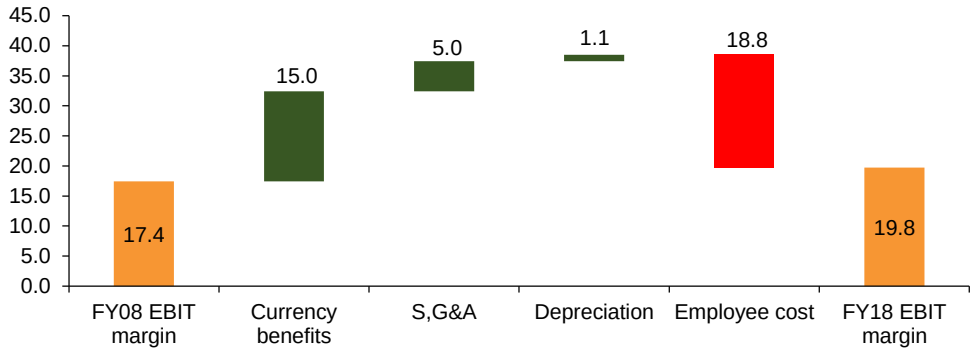
Source: Company, Emkay Research

Exhibit 15: Wipro's EBIT margin (%) declined significantly on muted organic growth rates



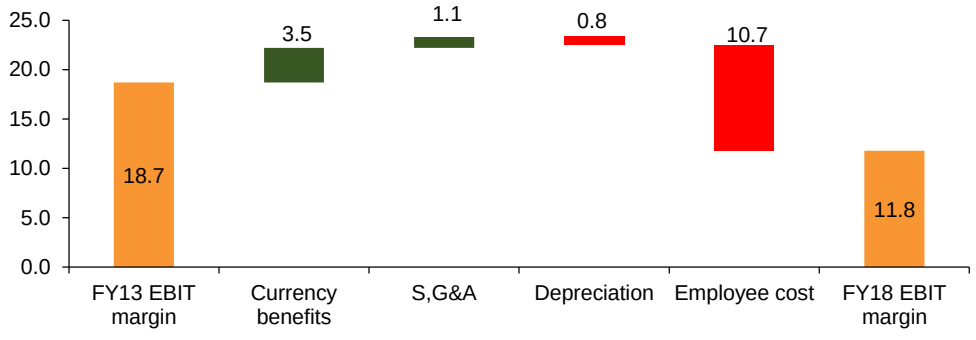
Source: Company, Emkay Research

Exhibit 16: HCL Tech's EBIT margin (%) expanded on sector-leading revenue CAGR of 15%



Source: Company, Emkay Research

Exhibit 17: TechM's OPM (%), post the Satyam integration, declined due to dilutive acquisition



Source: Company, Emkay Research

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3. **Technology stock ownership across funds is still underweight (150-250bps) compared with the BSE-200 Index weightage of about 11%, and thus there will be some more incremental gains from allocations in CY19 though limited in comparison with the previous year (refer to Exhibit 7 and 8). Weightages by the MSCI EM Index as well as for the FTSE World allocation have been quite volatile in CY18 and thus no clear trends can be drawn here for gauging the near-term directions of the flows (refer to Exhibit 9).**

4. **Payout yields are likely to decline for investors amid the increase in stock prices and with potential payouts expected to remain at the same levels. Infosys could be an exception to this as it is paying much more than its annual FCF generation. The yields are down by 30bps but still attractive with an average of about 2.4% on a constant currency basis (refer to Exhibit 18). In many cases (such as Infosys), payout yields were safe strategy in CY18 as valuations were very attractive with good a margin-of-safety. Although valuations have largely turned rational after the recent correction, we believe that the risk in price erosion is also a possibility given the existing market volatility.**

Exhibit 18: FY18 Payout Yield (Dividend + Buyback)

Company Name	Price as on 01 Jan, 2018	Dividend Yield (%)	Buyback Yield (%)	FY18 Total Yield (%)
TCS	1,323	1.7	0.4	2.1
Infosys	1,034	2.7	1.1	3.8
Wipro	317	0.9	3.1	4.0
HCL Tech	879	1.4	0.4	1.8
Tech M	503	1.6	-	1.6
LTI	1,145	1.5	-	1.5
Mphasis	738	2.3	0.9	3.2
Mindtree	607	1.8	0.4	2.2
Hexaware	342	1.2	-	1.2
Persistent	712	1.4	-	1.4
NIIT Tech	654	1.7	-	1.7

Source: Company, Emkay Research

Exhibit 19: Payout yields are down vs. last year but still attractive

Company Name	CY18 End Price	CY18 Start Price	CY18 Stock Return (%)	FY19E Earnings Growth (%)	FY18 Total Yield (%)	Discounting Factor (x)	FY19E Total Yield (%)
TCS	1,893	1,351	40.2	26.4	2.1	0.9	1.9
Infosys	659	521	26.5	-0.6	3.8	0.8	3.0
Wipro	331	314	5.3	5.7	4.0	1.0	4.0
HCL Tech	964	891	8.3	19.5	1.8	1.1	2.0
Tech M	723	504	43.5	13.2	1.6	0.8	1.3
LTI	1,731	1,119	54.7	42.1	1.5	0.9	1.4
Mphasis	1,018	726	40.4	27.7	3.2	0.9	2.9
Mindtree	865	612	41.2	32.9	2.2	0.9	2.1
Hexaware	333	341	-2.3	6.9	1.2	1.1	1.3
	623	718	-13.3	8.7	1.4	1.3	1.8
NIIT Tech	1,149	645	78.2	51.7	1.7	0.9	1.4

Source: Company, Emkay Research; note: we have assumed similar payout ratio for FY19 as was in FY18

In a nutshell, valuations have now turned reasonable and the potential for a further rise now largely rests with continued earnings growth in performing stocks such as TCS, LTI, Mphasis, and NIIT Tech. Otherwise, there should be positive surprises on growth rate recovery in some cases, if any. Example: eClerx - valuations are attractive and can see a re-rating if growth rates come closer or surpass the Indian IT industry average growth rate of about 7% for CY19. However, we believe that the real big money-making stock for CY19 will be HCL Tech, which have a good mix of earnings growth and re-rating scope with the concerns around organic growth and IP investments fading away over the course of the year.

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We got it right - both on 'Buy' and 'Sell'

In an eventful and tumultuous year for the IT sector, we had our share of hits and misses. Nevertheless if we see from the beginning till the end, we can say without apprehension that – 'We got it right'.

Thematic note 1: CEO: Changed Executive Officer

First, we were ahead-of-the-curve in highlighting the Buy ideas in the month of October'17 underpinned by our differentiated top-down framework-led research methodology on CEO analysis (using ABCDEF framework). This unique framework helped us identify consistent growth performers that out-delivered peers both on the stock price appreciation and financial performance fronts. Our top ideas in the report — TCS, LTI and Mphasis — all delivered significant stock upside, beating most of their peers in CY18 (Refer to Exhibits 21-32).

Click here to download thematic report – Changed Executive Officer

Exhibit 20: Status on the IT vendors on our proprietary 'CEO - ABCDEF framework'

Company	Score as of Sep'17	Current Remark based on ABCDEF framework
Internal CEOs		
TCS	●	The continuity benefits magnified
HCL Tech	◕	Most proactive for the future
Mindtree	◖	Recouped the lost ground - need more consistency going forward
Stable CEOs		
Tech M	◖	Need a change to create differentiation on organic basis
Persistent	◕	Desperately need more management bandwidth
External CEOs		
Infosys	◕	Better than past, but nothing spectacular
Wipro	◖	Making relevant changes but large task at hand
LTI	●	Entrepreneurial culture driving the energetic team
Mphasis	●	CEO - made the necessary turn around
Hexaware	◕	Easy pickings are behind - lower near term differentiation to hamper growth
NIIT Tech	◕	Change for growth' has delivered

Source: Emkay Research, ~ Note: you can read the thematic report to understand the ABCDEF methodology in detail

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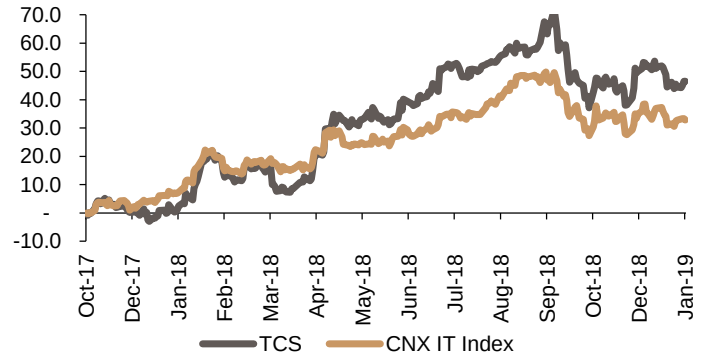
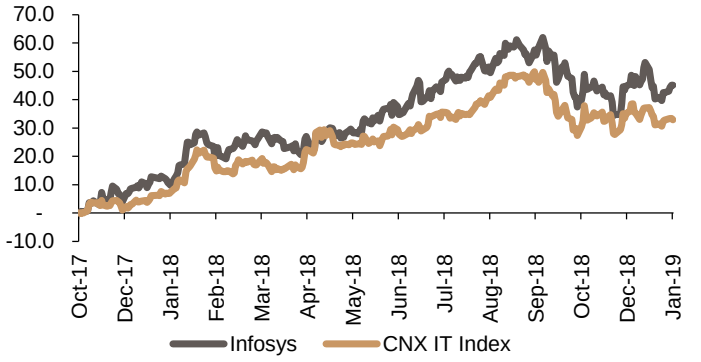
Exhibit 21: TCS – delivered sector-leading returns



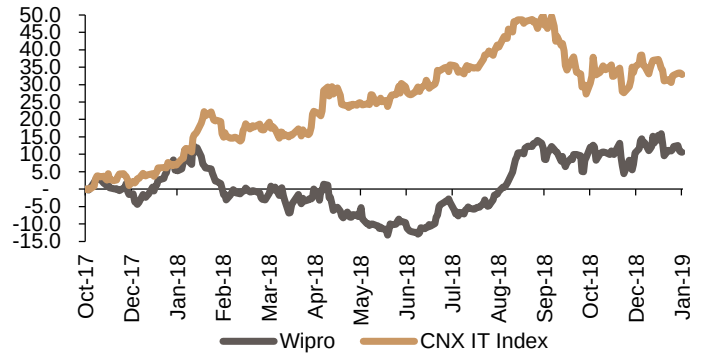
Source: Emkay Research, Bloomberg

Exhibit 22: Infosys – did well on catch-up trade despite modest financials



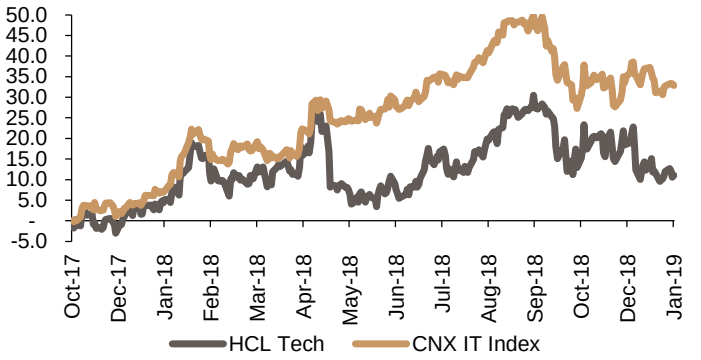
Source: Emkay Research, Bloomberg

Exhibit 23: Wipro – weak earnings led to underperformance



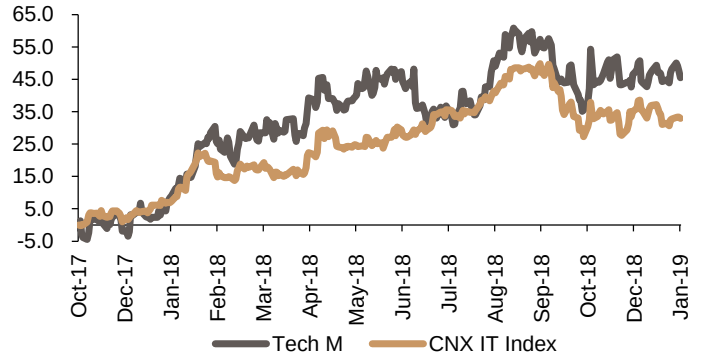
Source: Emkay Research, Bloomberg

Exhibit 24: HCL Tech – poor inorganic growth led to underperformance



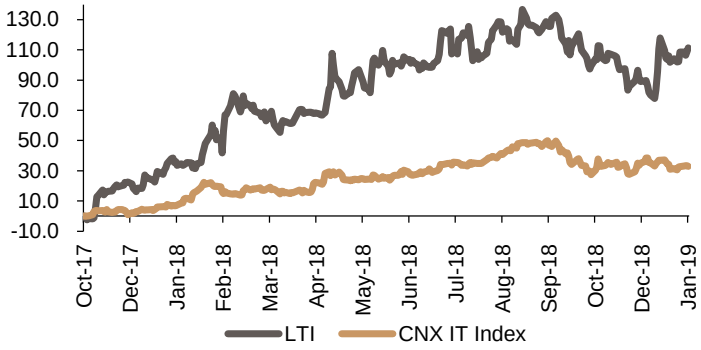
Source: Emkay Research, Bloomberg

Exhibit 25: Tech Mahindra – outperformed and recovered lost ground



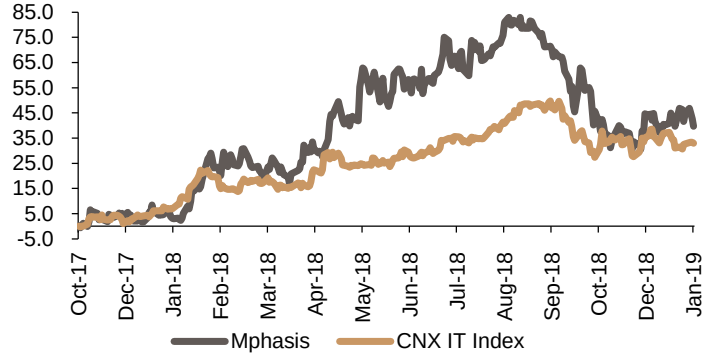
Source: Emkay Research, Bloomberg

Exhibit 26: LTI – best-performing mid-cap stock in CY18



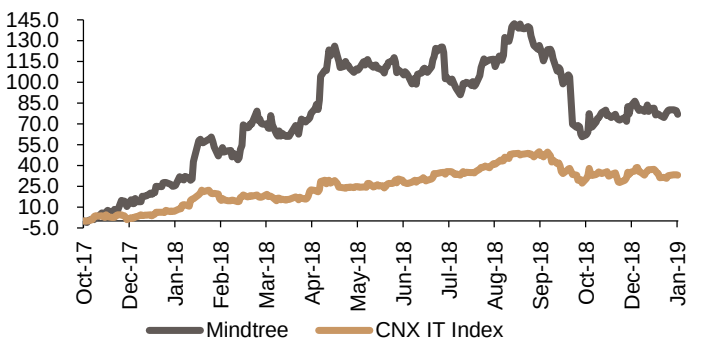
Source: Emkay Research, Bloomberg

Exhibit 27: Mphasis – returns hampered a bit with market correction



Source: Emkay Research, Bloomberg

Exhibit 28: Mindtree – outperformed but with severe volatility



Source: Emkay Research, Bloomberg

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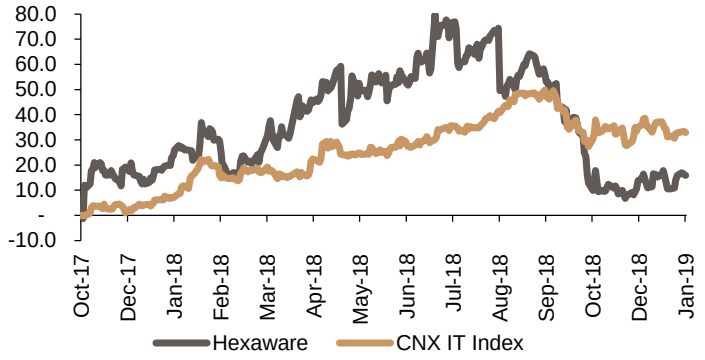
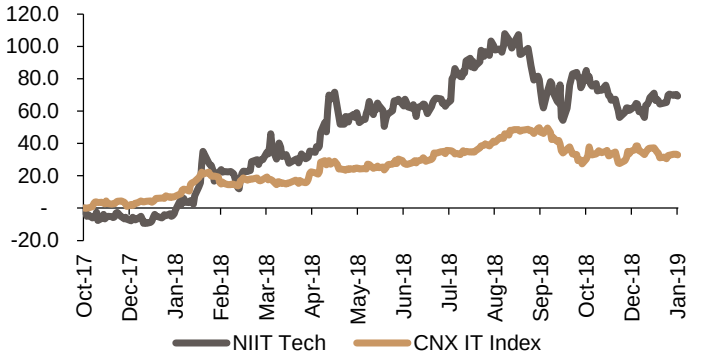
Exhibit 29: Hexaware – underperformed due to stretched valuations and modest financial performance



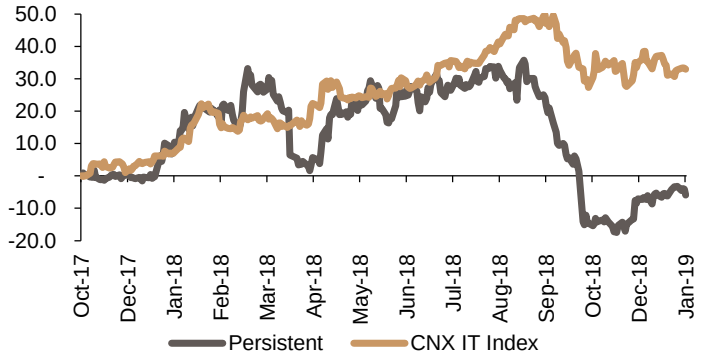
Source: Emkay Research, Bloomberg

Exhibit 30: NIIT Tech – outperformed with constant positive surprises in financial performance



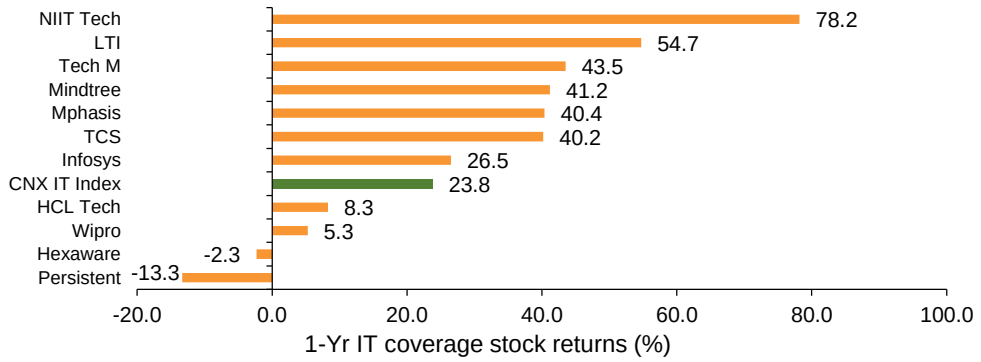
Source: Emkay Research, Bloomberg

Exhibit 31: Persistent – weak financial performance and commentary led to significant underperformance



Source: Emkay Research, Bloomberg

Exhibit 32: Stock price performance in CY2018 for our IT Services coverage universe



Source: Emkay Research

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Thematic note 2: Gartner's thesis of growth uptick misplaced

'Winter is coming': Second, when the stock performance turned largely secular due to euphoric sentiments, we remained selective in our approach, keeping our PEG modality in mind. The sharp up-moves led to stretched valuations in the sector, which in turn resulted in our recommendations turning into Reduce/Sell across most of the names as we did not subscribe to the IT growth recovery hypothesis as we were confident of our learnings from the 'Three-dimensional-analysis' that we did in our thematic report (dated July 10, 2018). For a brief period, many stocks on which we had negative stance, saw very sharp upside movements; however, with rationality prevailing all these names achieved our downside target price in the range of 10-30%.

Click here to download thematic report – Gartner's thesis of growth uptick misplaced.

Vendor-based study to analyze Global IT demand scenario

In this thematic report, we analyzed all global vendors to authenticate the optimism that was observed in the estimates by the Street for Indian IT players. As part of this study, we analyzed revenue projections of about 240 vendors across the globe that cumulatively accounted for about ~45% of all global IT spends and arrived at a conclusion that there are no signs of growth acceleration guided in the management commentary that would have influenced growth rate estimates for these vendors across the market for CY19 (refer to Exhibit 33). This data has been revisited again after the JAS quarter (quarter ending Sep'18) but is indicating similar trend that was witnessed after the AMJ quarter (quarter ending Jun'18).

Exhibit 33: Geography wise classification/sales growth expectations of companies under study

Geography	Number of players	CY17/FY18 Rev (US$bn)	CY17/FY18 growth (%)	CY18E/FY19E growth (%)	CY19E/FY20E growth (%)
USA	41	185	4.3	3.2	4.5
EUROPE	83	85	9.0	7.5	7.1
INDIA	28	61	8.5	7.0	8.6
ROW	88	114	10.7	7.7	8.1
Overall	**240**	**445**	**7.3**	**5.7**	**6.5**

*Source: Emkay Research, Bloomberg, *all estimates based on consensus data*

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Framework for our strategy for CY19

CY18 is now gone and the IT index has pared significant part of its outperformance, so now we need to put in place new tools and framework that could help build our strategic recommendations for CY19. So, in addition to our proprietary framework for 1) CEO analysis and 2) detailed global vendor study based on our three-dimensional growth model, we would like to introduce three more analytical tools as part of our strategic framework for CY19. The three tools forming the strategic framework are:

1) **Client-based study to analyze Global IT demand scenario.**

2) **Pricing analysis: Digital will not be margin-accretive as Technology is deflationary by nature.**

3) **Investor survey confluence (non-earnings factors) - we would like to bring in the latest exhaustive learnings that we got from more than 100 meetings with money managers across four regions based on investor locations.**

Study 1: Client-based study to analyze Global IT demand scenario

Extending our analysis to understand leading indicators of Global IT demand, we have done an exhaustive analysis of the large client pools geographically located across the US and UK that collectively account for about 75% of the revenues of Indian IT vendors. As part of this study, we analyzed long-term historical and projected revenue growth rates and OPMs of the companies selected, which are constituents of the S&P500 and FTSE100 indices. We summed up the numbers for their various verticals to make our data set. We analyzed about 495 companies by selecting the top multi-billion dollar revenue/market-cap players among these constituents.

Exhibit 34: Sector-Wise growth of Top global players (clients of IT services cos) over the years

Sector Growth (%)	CY12	CY13	CY14	CY15	CY16	CY17	CY18E	CY19E	CY20E
Basic Materials		Data not Comparable			-4.3	21.3	11.2	1.6	1.8
Consumer Goods	2.2	3.0	-0.4	-4.7	0.2	2.4	2.5	1.6	3.2
Consumer Services	4.6	4.3	8.5	3.7	5.5	6.3	7.0	6.0	6.1
Financials	-	-2.1	4.0	-8.5	10.2	3.0	-5.7	3.7	3.9
Healthcare	7.5	4.8	5.8	8.4	9.3	5.8	6.8	6.1	5.5
Industrials	-	-	4.0	-2.9	2.5	7.2	8.5	5.1	4.2
Oil & Gas	-2.1	-2.0	-4.8	-35.6	-15.8	25.6	27.3	5.6	0.4
Technology	8.4	3.7	0.7	7.3	0.8	11.6	10.6	7.6	8.5
Telecom	-1.9	2.0	4.8	1.4	2.9	-0.2	4.8	3.1	0.7
Utilities	-0.7	4.9	8.1	-7.4	-3.3	4.2	0.5	2.5	1.8
Total		**Data not Comparable**			**2.2**	**8.0**	**7.2**	**4.9**	**4.3**

Source: Company, Emkay Research

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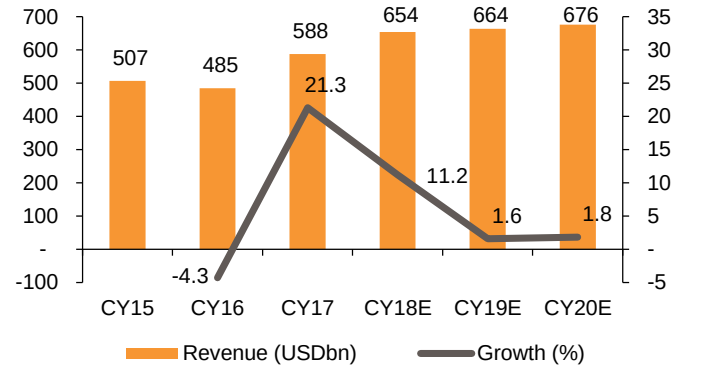
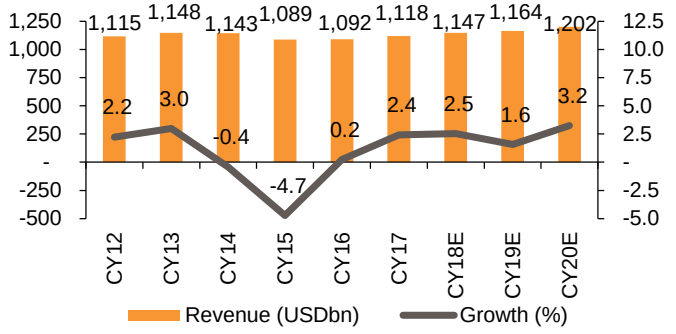
The reading from this study indicates that most of the verticals (except Financials and Telecom) witnessed a growth acceleration or strong revenue growth compared with the long-term average in both CY17 and CY18. However, the study indicates that the growth rates are likely to go down in CY19 for all of these industries, corroborating various assumptions of a slowdown in the GDP growth rates of the US and UK, due to a normalization of the tax reform for the former and the impending Brexit for the latter. Further, we believe that the ongoing trade-war-driven events could lead to tighter immigration norms, higher wage impact for onshore delivery, and the general impact on corporate earnings emanating from trade-war-induced inflation across categories. (Refer to Exhibit 35-44).

Exhibit 35: Basic Materials revenues (USD bn) and growth (%)



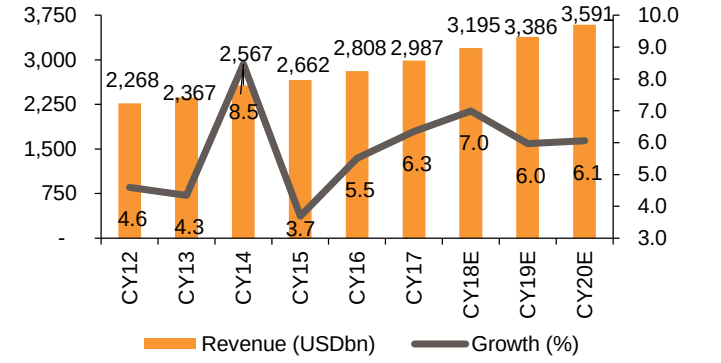
Source: Bloomberg, Company, Emkay Research

Exhibit 36: Consumer Goods revenues (USD bn) and growth (%)



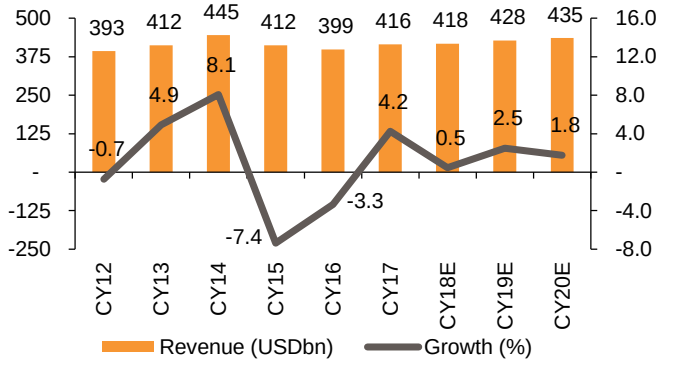
Source: Bloomberg, Company, Emkay Research

Exhibit 37: Consumer Services revenues (USD bn) and growth (%)



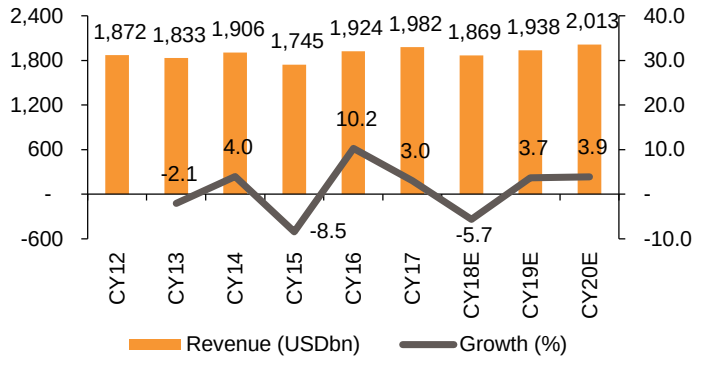
Source: Bloomberg, Company, Emkay Research

Exhibit 38: Utilities revenues (USD bn) and growth (%)



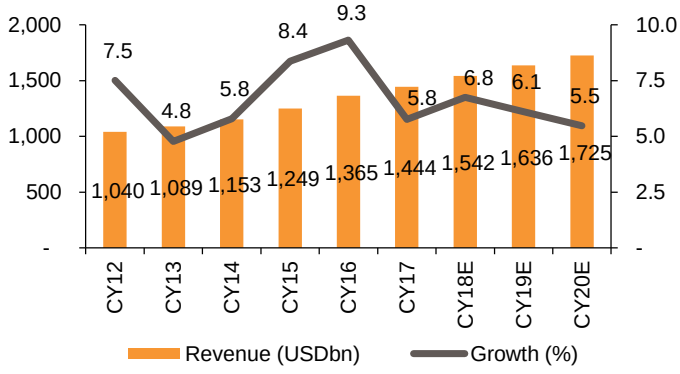
Source: Bloomberg, Company, Emkay Research

Exhibit 39: Financials revenues (USD bn) and growth (%)



Source: Bloomberg, Company, Emkay Research

Exhibit 40: Healthcare revenues (USD bn) and growth (%)



Source: Bloomberg, Company, Emkay Research

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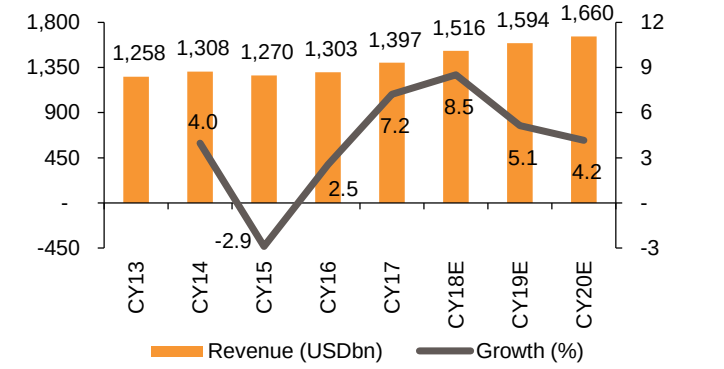
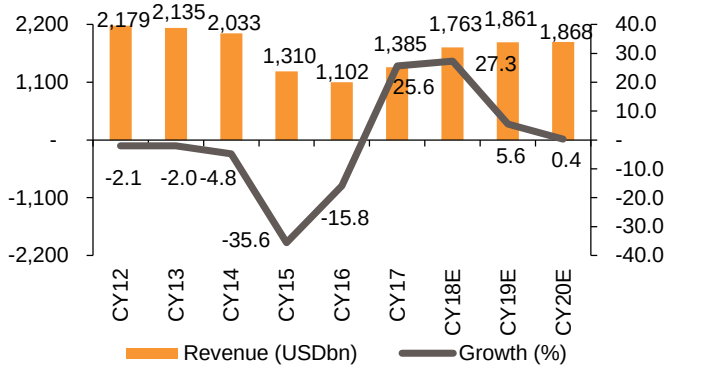
Exhibit 41: Industrials revenues (USD bn) and growth (%)



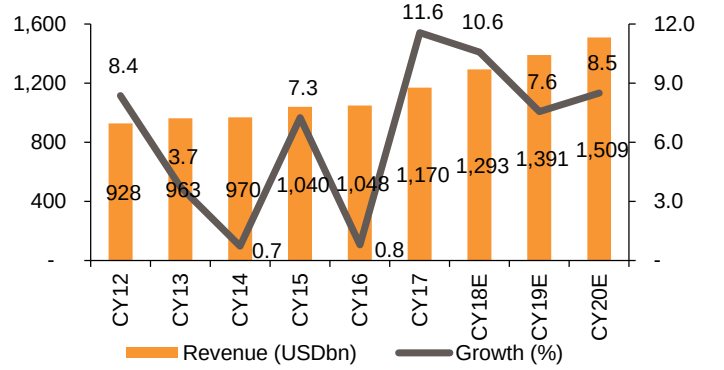
Source: Bloomberg, Company, Emkay Research

Exhibit 42: Oil & Gas revenues (USD bn) and growth (%)



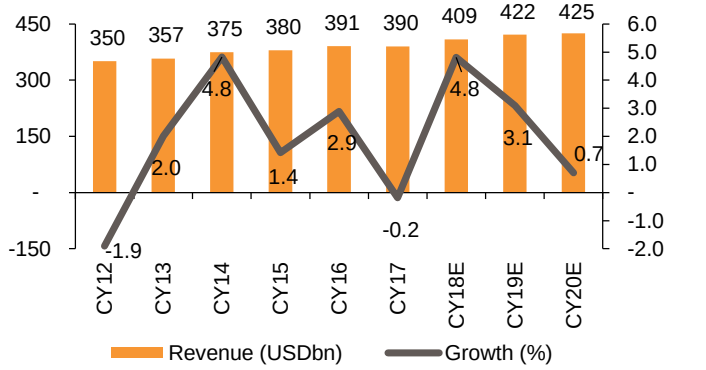
Source: Bloomberg, Company, Emkay Research

Exhibit 43: Technology revenues (USD bn) and growth (%)



Source: Bloomberg, Company, Emkay Research

Exhibit 44: Telecom revenues (USD bn) and growth (%)



Source: Bloomberg, Company, Emkay Research

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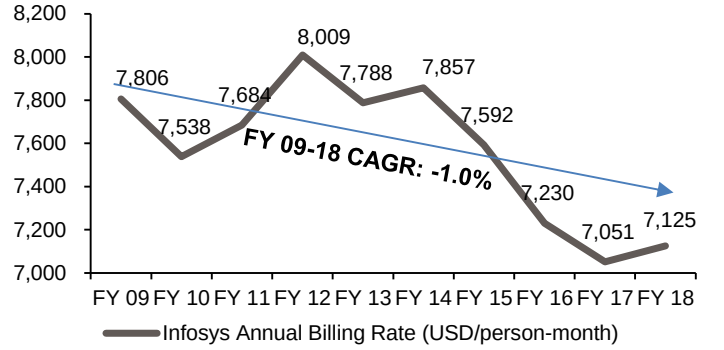
Study 2: Pricing analysis: Digital will not be margin-accretive as Technology is deflationary by nature.

Study: We tested the efficacy of the generally accepted hypothesis that IT vendors' profitability will improve as revenues from Digital gain further scale in the coming years. To understand this, we did an analysis on how the billing rates have improved over the years to compensate for the rising wage inflation which we grasped by analyzing 10-year operating metrics of Infosys — the only company sharing these metrics in such a manner that is suitable for a fair long-term analysis.

Observations: The study of Infosys for its various revenue and cost parameters suggest that over the last ten years, the company has been compensating its wage-led cost inflation of about 7% by improved productivity (higher utilization and non-linear growth – collective gains of 3.1% CAGR) and INR depreciation (average of about 3.7%), while the billing rates, on average, declined at 1% CAGR over FY09-18.

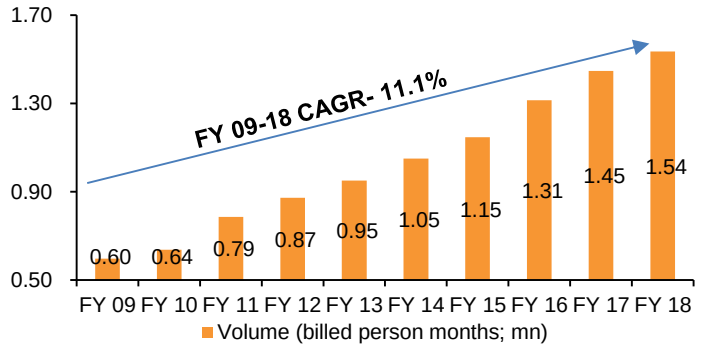
Conclusion: Based on the study, we conclude that for Indian vendors the pricing-led profitability gains stemming from higher share of Digital revenues would not be margin-accretive in the subsequent years. The biggest reason is that Technology, by nature, is a deflationary category, and it becomes all the more apparent as it gains scale. Thus, in the initial phase, the margins are not accretive as investments in newer technology lead to no margin gains, but once scale is achieved, it get commoditized, and will turn deflationary by competitive forces. As a result, for Indian players, we have not factored in — to our estimates — any profitability gains led by higher revenue share from the Digital business over FY18-21E.

Exhibit 45: Portfolio-wide billing rates have declined over the years



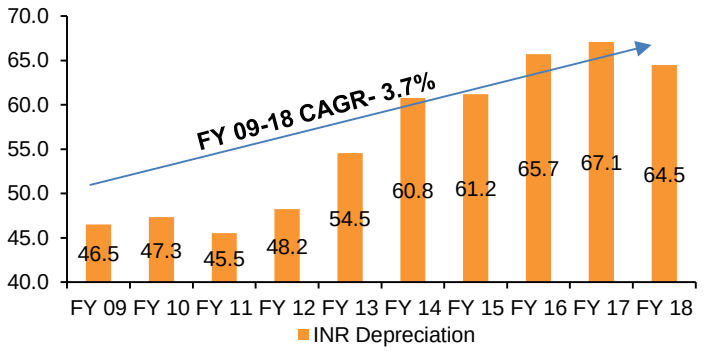
Source: Company, Emkay Research

Exhibit 46: Number of billed person months (volume) has increased



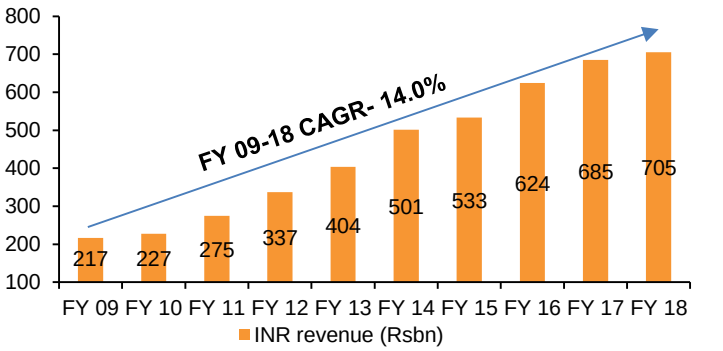
Source: Company, Emkay Research

Exhibit 47: INR depreciation over the years has helped INR rev growth



Source: Company, Emkay Research

Exhibit 48: Overall revenue growth (=Rate*Volume*INR depreciation)



Source: Company, Emkay Research

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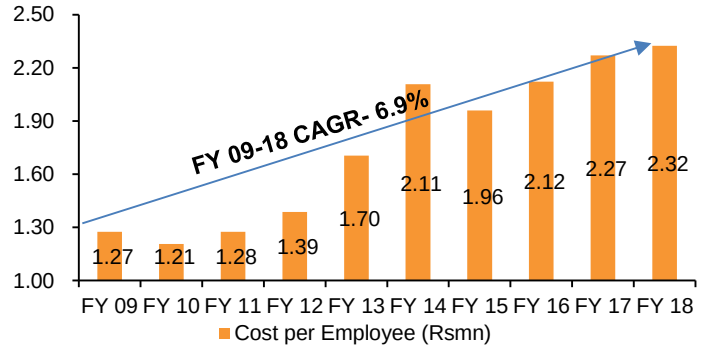
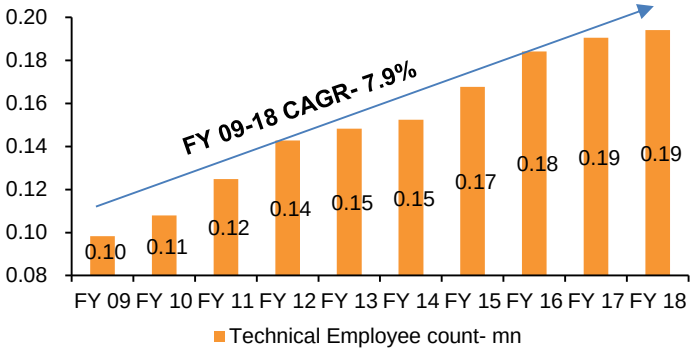
Exhibit 49: Wages have increased at ~7%



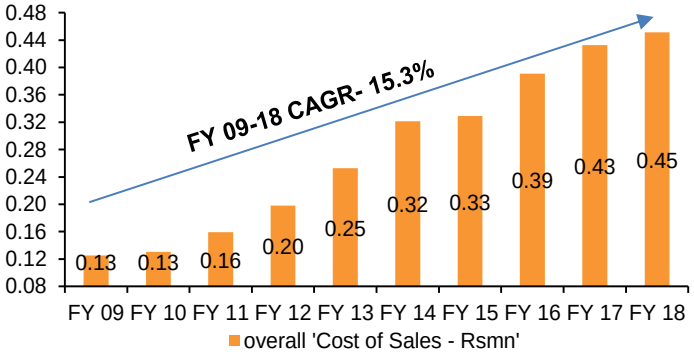
Source: Company, Emkay Research

Exhibit 50: Headcount growth have been slightly non-linear



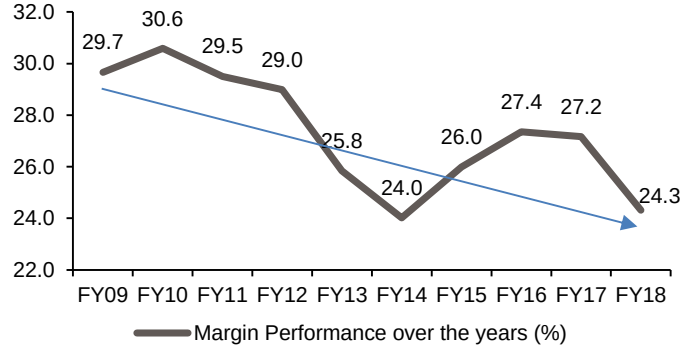
Source: Company, Emkay Research

Exhibit 51: Overall growth in cost of sales



Source: Company, Emkay Research

Exhibit 52: Margins have been on a declining trend



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Study 3: Investor survey confluence framework (a non-earnings factor)

Under this framework, we add a non-earnings factor that influences the stock performance in the short to medium term which is quite contrary to the general fundamental drivers usually taken into consideration. In CY18, we witnessed many such cases wherein investors bought stocks despite not-so-evident factors but nevertheless performed in line with peers, though with some lag. In a way, this exercise would use the 'right-side-of-the-brain' factors as well because we subscribe to Howard Marks' view that 'Investing is more of an art than a science'.

Why we think this is relevant?

- **Case Study 1:** TCS outperformed Infosys just by about 16% despite far superior revenue growth (~250bps, or 30% higher rate) and OPM performance (EBIT margin gains of ~125bps for TCS vs. flat-to-down for Infosys) for FY19E. The primary factors that led to this disparity were the following:
  - DII were underweight on the IT sector until Q1CY18 and then kept on increasing weight in the sector as growth, payouts, and currency turned incrementally favorable.
  - FIIs increased their weight in the IT sector gradually during the year, but remained underweight compared to the MSCI weightage.
  - Most funds missed the rally in TCS (underweight to date) and by choice remained underweight on the name for most part of the year and tried catching up the underperformance by investing in Infosys by going almost equal weight.
  - For near-term performance, this strategy works as valuation gaps widen on differentiated performance but get narrowed as the market starts predicting sector-based tailwinds and thus expect a gradual convergence in growth rates. However, this strategy will lead to underperformance in the long run as investors may end up invested in stocks with lower long-term growth potential.

- **Case Study 2:** Infosys outperformed HCL Tech significantly by 24% in CY18 despite (on a reported basis) under-delivery across parameters such as growth (HCL revenue growth expected to end superior by ~300bps for FY19E) and profitability (HCL Tech's stable margins vs. possible decline in Infosys' OPM for FY19E). The key factors that led to this disparity were:
  - Organic growth of HCL Tech is expected to be lower than that of Infosys, although the overall growth is likely to be superior both for current and future years.
  - Preference for growth investment toward IPs vs. cash payouts through Dividends/Buybacks is seen as an adverse factor as investors have less confidence in HCL's ability to grow these acquired assets despite no apparent evidence of a troubled inorganic growth history.
  - So effectively, investors were willing to pay valuations that are over 2x the growth for Infosys, while valuing HCL Tech at about 1x the growth as for the time being the IP investments are seen as dilutive (contrary to management commentary which indicates that the investments are made with over 15% IRR).
  - This strategy works in the short term as too much consensual pessimism outperforms the smarter wisdom of contra-value-buyer. But such smart calculated contra bets generate large alpha-returns. We believe that this can happen in CY19 and thus have highlighted HCL Tech to be our best pick for the year among Tier-I names.

- **Case study 3:** Street is giving option value to Tech Mahindra's large potential opportunity in the telecom space that would come from 5G roll-outs but not attributing any option value to HCL Tech's IP assets. The key factors that investors differ on this front are:
  - Tech Mahindra's legacy superiority in the Telecom vertical supports its potential to emerge as a potential beneficiary from the 5G-led opportunity – though these are some time away as per the outlook shared by management. However, HCL Tech's significant investments in low-growth but high-margin IP assets are seen as poor allocation given there is no historical precedence of HCL Tech in terms of successfully monetizing opportunities in the IP businesses.
  - Investors are more hopeful on Tech Mahindra, despite its Telecom vertical delivering a mere 1.6% CAGR in the past 3.5 years, while suspecting the growth potential of HCL Tech that has displayed relentless industry-leading revenue growth — though led by inorganic strategies — but without hampering its profitability/RoE/Cashflow profile.

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- Although we are very positive on HCL Tech, we see the risk of the returns being more back-ended given the looming concerns about these investments in the near term.

  We believe that the sustenance of better commentary on organic growth in Q3FY19E earnings and a gradual announcement by HCLT about its sector-leading growth guidance after Q4FY19E earnings may act as triggers in the near term.

How we deal with these?

To deal with the conflicts in structural Buys, tactical allocations with the MSCI/Index-based flows, we would use the relevant learnings from our interactions with more than 100 money managers in the past four months into our recommendations. The key areas that were influenced after factoring this non-earnings factor in to our framework are:

1) **Performance of laggards:** What we learned from the experience of the IT Index in CY18 is that the financial performance matters in the first leg of the rally and later on what matters is the valuation gap as the rally turns more secular with liquidity flowing into any sector allocation.

2) **PE ratio:** The PE ratio for the sector can get stretched for a very small change in growth expectations. This happens as there is only a small universe of stocks that are providing earnings upgrade across sectors. Thus, a small upgrade visibility can drive PE multiple significantly although on a short- to medium-term basis. PEG for large/mid-caps peaked at 2-2.5x in CY18, which is a multi-year high.

3) **TINA factor**: Many investors turned incrementally positive on the sector despite modest growth of 5-10% in large-cap names as although growth was small in constant currency terms, it was still attractive in comparison with the other sectors in INR terms and in terms of absolute valuations. So the 'TINA: There Is No Alternative' factors start playing out favorably, especially for the domestic investors (INR depreciation factors get neutralized for FPIs – thus not very attractive). A classic example is the allocation move away from the Auto sector as the volume/margins performance started to disappoint during the year, stretched valuations for Consumer stocks, and the BFSI sector faced challenges around the 'IL&FS issue', leading to increased comfort in higher valuations as the stock turned attractive on a PEG basis over other sectors (refer to Exhibit 53).

Exhibit 53: Compared to other sectors – IT continues to remain the most attractive on PEG basis

	Auto	FMCG	Pharma	Large Cap IT	Mid Cap IT
FY13-18 INR Sales CAGR	9.8	7.1	13.9	13.7	10.1
FY13-18 INR Earnings CAGR	5.1	9.4	10.1	12.1	6.8
FY18-20E INR Sales CAGR	11.6	14.7	14.7	13.9	17.8
FY18-20E INR Earnings CAGR	7.3	17.5	18.1	13.2	22.2
Last 5 Yr mean 1-Yr fwd P/E multiple	20.3	41.4	27.2	17.4	15.3
Current 1-Yr fwd P/E multiple	20.3	53.9	23.9	18.5	16.5

Source: Company, Emkay Research, Bloomberg

Survey results from 100+ investor meetings

Learnings from our meetings and the investment philosophy they shared with us, we have compiled certain conclusions which we have captured as survey results. We would add a caveat that the results of the survey are derived on the basis of our understanding about their preferences and are not directly collected through any feedback mechanism. So, in reality, it may exhibit some variance which the reader needs to take into consideration.

Observations and learnings

- **US/Singapore investors:** Many investors in these regions have a much diversified ownership in the Indian IT sector and have invested in more than 25 unique ideas in India. As per data from the BSE and Bloomberg, FIIs have invested about USD45bn in large-cap names and another USD4bn in other technology stocks. So, although large amounts of money come to the BSE-100/MSCI constituents — including TCS, Infosys, HCLT, Wipro, and TechM — investors have widened the canvas in terms of their hunt for better growth ideas. In CY18, FII ownership in many mid-tier IT names have increased much more than average gains in the large-cap names (refer to Exhibit 10).

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- **Europe/HK/Taiwan investors:** A large number of investors we met in these regions were mainly invested into the MSCI/BSE-100 constituents — which include TCS, Infosys, HCLT, Wipro, and TechM — and were largely underinvested in the beginning of the year as growth was not attractive and preferred to stay underweight as later on valuations were not comforting. In fact, some funds curtailed/exited their positions in the sector as exit valuations were very attractive.
- **Domestic investors:** Many funds were underinvested in the sector. Although the allocations have improved significantly throughout the year across funds, most still remain underinvested if we benchmark the weights against the Nifty-50 or BSE-200 weights (refer to Exhibits 7 and 8). However, most of them backed the holdings they had and were less keen on venturing into newer names. Only select mid-caps were able to attract new fund entrants in CY18.

Conclusive Confluence from investor surveys

- Survey result no. 1: 70% of the funds would like to back ideas that would register 'sustained-high-growth' even if the valuations are at SD1+, but would not mind to avoid any allocations if growth is poor for the index constituents.
- Survey result no. 2: 40% of the participants are looking for better valuations as an entry point given the ongoing volatility in the market and the inherent need for 'margin-of-safety'. These investors are okay with small-but-sure-of-growth names with reasonable valuations.
- Survey result no. 3: 60% of the participants preferred names with high liquidity (volume and float) as funds at their disposal are global/regional in nature. These investors largely stay with large-caps and select mid-caps with high volume/float even if growth rates are lower on a relative basis.
- Survey result no. 4: 40% of the funds are looking at the IT sector as an 'overweight allocation' for them into CY19 and wants to play the sector with a good mix of large-cap and mid-cap names that can provide alpha returns.
- Survey result no. 5: Domestic investors in particular are okay with the current 7% growth rate for their invested companies as in the long run 7-8% growth + 5-6% INR depreciation + 2-3% payout yields can collectively achieve their desired investment return thresholds. As a result, a smaller growth rate with certainty would command a premium over high-growth with volatility.

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Alpha-generating strategy for money managers in CY19

After taking into account the aforementioned observations, survey conclusions, liquidity positions, current allocation variance, and relative valuations across sectors along with our fundamental views on earnings and valuation multiples, we arrive at the following strategy for money managers in CY19 for their allocations toward the technology sector.

- **Structural Buy ideas:** These are the stocks that we would like investors to have in their portfolio as we expect a very strong and sustainable growth-outperformance from them over their peers. Names that would fit into this investment philosophy are TCS and HCL Tech from the large-cap space and Mphasis and LT Infotech, from the mid-tier arena. Although valuation differentials may lead to differences in our target upsides for these names, irrespective of the potential upside we recommend the addition of these names into investors' portfolios as part of their structural investments in the IT sector from a medium- to long-term perspective.
- **Deep-value Buys:** We would recommend HCL Tech as our only idea under this investment theme as the stock is available at a modest PEG of about 1.1x [compared with ~2x for other Tier 1 vendors]. HCLT is ideal choice for investors looking for alpha returns with a decent margin-of-safety.
- **Tactical allocations:** The recent corrections have made entry points very attractive in many mid-tier names. We would recommend tactical allocations in names such as eClerx and NIIT Tech. We would like to keep this allocations to be tactical and thus would recommend exit if valuations move from current range of 11-14x to 15-18x which we witnessed in these names just three months back.
- **Alternative ideas:** We would also like investors to consider certain ideas beyond the popular IT services segment into the Software segment. We continue to like OFSS, INDA, and a few more names in this segment *(click here to download our thematic report on Software names)*.

Alpha-generating allocation for money managers for CY19 (100bps Overweight)

Based on our strategic framework discussed in detail above, we recommend the following allocations for money managers going into CY19. The biggest skew is coming from going underweight on Infosys (100bps) and allocating similar funds into high-growth names such as HCLT (150bps overweight for us) and TCS (50bps overweight). In addition, by avoiding or going underweight on Wipro (Underweight by 70bps or no weight) and Tech Mahindra (Underweight by 60bps), we recommend investors to allocate higher weights to high-growth, sustainably-performing mid-caps such as LTI (Overweight by 30bps) and Mphasis (Overweight by 40bps), as well as high-potential software plays such as OFSS (Overweight by 40bps – Link for Report). Names in our coverage universe that can feature in small-cap fund allocations could be NIIT Tech (Allocate 20bps – Link for Report) from the IT Services space and Intellect Design Arena (Allocate 20bps – Link for Report) from the Software arena. On a sector basis, overall we recommend 'Overweight' on the Technology space, i.e., higher allocation by 100bps to the BSE-200 weightage.

Exhibit 54: Technology sector: Allocation strategy for CY19

Companies	BSE200	Emkay weights	Recommendations
TCS	3.5	4.0	Overweight by 50bps
Infosys	4.4	3.4	Underweight by 100bps
HCL Tech	0.9	2.4	Overweight by 150bps
Wipro	0.7	0.0	No allocation
Tech Mahindra	0.8	0.2	Underweight by 60bps
Mindtree	0.2	0	No allocation
Mphasis	0.2	0.6	Overweight by 40bps
OFSS	0.1	0.5	Overweight by 40bps
LTI	0.1	0.4	Overweight by 30bps
NIIT Tech	0.0	0.2	Allocate 20bps
Intellect Design	0.0	0.2	Allocate 20bps
Cash	0.0	0.0	No allocation
Weightages (%)	**10.9**	**11.9**	**Overweight by 100bps**

*Source: Company, Emkay Research, Bloomberg; *** Note:** Emkay has an overweight view on the sector at the expense of several domestic facing/government spend dependent sectors.*

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Exhibit 55: IT Services valuation summary

Co Name	CMP	Reco.	Target Price	US$ revenue CAGR (%)		EPS			P/E		
				FY15-18	FY19-21E	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E
TCS	1,898	ACCUMULATE	2,100	7.2	9.1	85.5	94.6	104.8	22.2	20.1	18.1
Infosys	671	REDUCE	640	7.8	6.5	36.6	40.7	42.9	18.3	16.5	15.7
Wipro	324	REDUCE	300	3.2	5.8	18.8	21.8	23.3	17.3	14.9	13.9
HCL Tech	940	BUY	1,265	10.0	10.1	75.5	82.5	90.4	12.5	11.4	10.4
Tech Mahindra	690	HOLD	730	8.9	6.8	48.3	52.2	56.5	14.3	13.2	12.2
L&T Infotech	1,688	ACCUMULATE	2,020	11.6	13.1	90.4	100.4	112.4	18.7	16.8	15.0
Mphasis	925	BUY	1,370	2.3	11.7	57.1	66.2	76.0	16.2	14.0	12.2
Mindtree	821	HOLD	900	13.5	9.7	46.5	50.3	56.4	17.7	16.3	14.6
NIIT Tech	1,162	ACCUMULATE	1,335	6.1	8.9	69.3	76.6	83.7	16.8	15.2	13.9

Source: Company, Emkay Research

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Company Section

- TCS
- Infosys
- HCL Tech
- Wipro
- Tech Mahindra
- L&T Infotech
- Mphasis
- Mindtree

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TCS

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Your success is our success

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Scale and differentiated capabilities to sustain outperformance

CMP	Target Price
Rs 1,898 as of (January 8, 2019)	Rs 2,100 (■) 12 months
Rating	**Upside**
ACCUMULATE (▲)	10.6 %

- TCS's robust deal wins (USD9.8bn in H1FY19); better commentary across verticals; and deal-size scale-up demonstrated by several billion dollar+ deal signings ensure that it will continue its industry-leading financial performance in the coming years as well.
- The company, with its differentiated capabilities (Machine first) and its unique delivery proposition (Distributed agile), is well-positioned to capture market share (see Exhibit 60) from global/Indian peers, which in effect implies lower growth for its peers. TCS sustaining double-digit growth means capturing >5% of incremental global IT spends (about USD2bn of approx. USD40bn incremental spends) vs. its approx. 2% Global market share currently, or around USD20bn of USD1, 000bn overall Global IT spends.
- A higher growth rate for TCS naturally means lower-than-industry growth rates for other Indian peers such as Infosys and Wipro [amid stable 7% Indian industry growth environment]. Thus, although the valuation gap may remain the same between TCS and Infosys – the 250bps+ higher growth outperformance by TCS implies 50%+ stock outperformance over Infosys for investors holding the stock over the next 10 years (see Exhibit 57). In sum, we would recommend investors to back a high-sustainable-growth vendor over an attractively-priced but potential-low-growth peer.
- With TCS highlighting its market share gains and unique margin improvement levers including on-demand hiring with one-of-a-kind hiring platform, we remain confident of its growth and margin protection abilities. We have an Accumulate rating on the stock, with a target price of Rs2,100, valuing it at 20x PE on its FY21 EPS — in line with its 5-year mean — and implying a PEG of 2x.

Growth outperformance to continue, to help protect margins

The continuation of a confident commentary despite signs of adverse macros indicates growth outperformance at the expense of other large IT peers. This is due to TCS' ahead-of-the-curve investments in 1) building differentiated offerings (Machine first- Automation and Platform-led solutions) and 2) robust delivery capabilities (Distributed agile methodology). We believe that these differentiated offerings and delivery capabilities are driving relatively superior growth (>40%+ yoy growth in Digital vs. about 30% yoy growth for the industry). The company's scale and successful client relationships inspire confidence of growth sustainability as digital achieves scale.

Scale differentiation to ensure outperformance; maintain Overweight

With TCS creating digital differentiation in terms of talent (World's largest talent pool on digital), multi-domain-capability, location-independent-agile-delivery model, scale projects learning (winning 1bn$+ traditional and 50mn$+ digital wins), TCS is achieving status of bilateral partner and taking its positioning towards consulting partner status. This will continue to widen the gap of financial performance over peers thus we maintain our Overweight stance on the name with an ACCUMULATE rating on the stock, with a target price of Rs2,100 based on 20x FY21E EPS.

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	1,179,660	1,231,040	1,470,648	1,629,029	1,814,035
EBITDA	323,110	325,160	405,009	446,640	495,539
EBITDA Margin (%)	27.4	26.4	27.5	27.4	27.3
APAT	262,879	258,262	320,043	346,254	383,315
EPS (Rs)	66.7	67.6	85.5	94.6	104.8
EPS (% chg)	8.6	1.3	26.4	10.7	10.7
ROE (%)	33.4	30.1	36.7	38.0	36.2
P/E (x)	28.4	28.1	22.2	20.1	18.1
EV/EBITDA (x)	22.8	21.9	17.1	15.2	13.3
P/BV (x)	8.7	8.5	7.9	7.5	5.8

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	-/-
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	HOLD

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	85.5	94.6
Consensus	84.1	94.4
Mean Consensus TP (12M)	Rs 2,122	

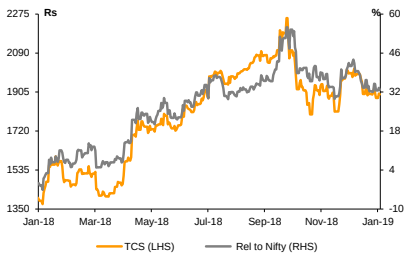
Stock Details	
Bloomberg Code	TCS IN
Face Value (Rs)	1
Shares outstanding (mn)	3,752
52 Week H/L	2,276 / 1,338
M Cap (Rs bn/USD bn)	7,122 / 102.03
Daily Avg Volume (nos.)	2,942,207
Daily Avg Turnover (US$ mn)	81.6

Shareholding Pattern Sep '18	
Promoters	72.1%
FIIs	16.1%
DIIs	7.4%
Public and Others	4.5%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(5)	(10)	(1)	41
Rel. to Nifty	(6)	(14)	(1)	38

Relative price chart



Source: Bloomberg

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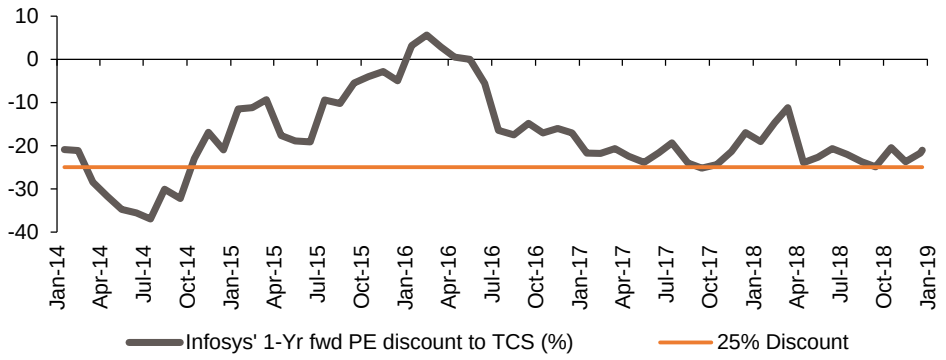
ED: ANISH MATHEW SA: DHANANJAY SINHA

Strategy for TCS versus Infosys play

We believe that TCS' expected growth outperformance of ~250bps in FY19 with 100 bps margin change differential (TCS will expand and Infosys may see fall on CC basis in FY19E), will result in significant earnings outperformance for TCS (about 12-14% on reported EPS basis) in FY19. In addition, irrespective of market dynamics, TCS' 25% multiple differential over Infosys (see Exhibit 56) is expected to sustain, given its capability/delivery-led differentiation, top management stability and historical trends (maintained strong incremental revenue share - see Exhibit 59-60), which, we believe, will help TCS maintain the growth differential. This leads us to believe that, TCS should lead to a considerable outperformance over Infosys due to its better fundamentals and superior earnings growth when seen over a longer duration of time (see Exhibit 57).

Exhibit 56: TCS' Capability/Delivery-led differentiation justifies Infosys' PE discount differential



Source: Company, Emkay Research

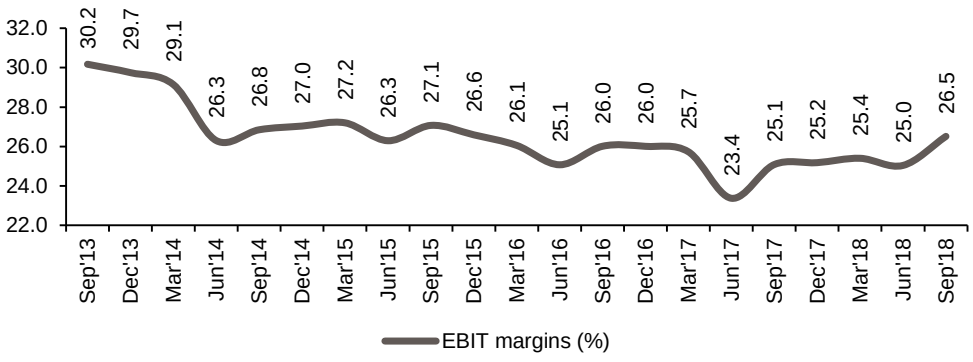
Irrespective of the market behavior, Exhibit 57 suggests that TCS' growth and earnings' outperformance (~250bps over Infosys) will lead to ~50% better stock returns, when seen over a longer period of time. Here, we have assumed that Infosys' ~25% PE multiple discount is here to stay, if not deteriorate, in all market conditions as TCS' capability/delivery-led differentiation, top management stability and historical trends give us the confidence that TCS will continue to win greater percentage of incremental IT spends.

Exhibit 57: Earnings growth differential to help post much stronger stock returns, irrespective of market dynamics

	Y	Y+1	Y+2	Y+3	Y+4	Y+5	Y+6	Y+7	Y+8	Y+9	Y+10	
TCS Earnings	100	109	119	130	141	154	168	183	199	217	237	Long Term Stock Return (%) ↓
Infosys Earnings	100	107	113	121	129	137	146	155	165	176	188	
TCS P/E (x)	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	22.0	
Infosys P/E (x)	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	
TCS TP	2,200	2,398	2,614	2,849	3,105	3,385	3,690	4,022	4,384	4,778	5,208	137%
Infosys TP	1,650	1,757	1,871	1,993	2,123	2,261	2,408	2,564	2,731	2,908	3,097	88%

Source: Company, Emkay Research

Exhibit 58: Margins improved 150bps yoy on an improvement in operational efficiencies



Source: Company, Emkay Research

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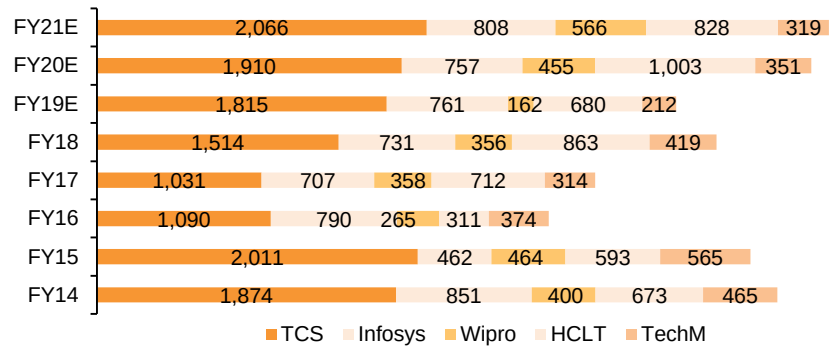
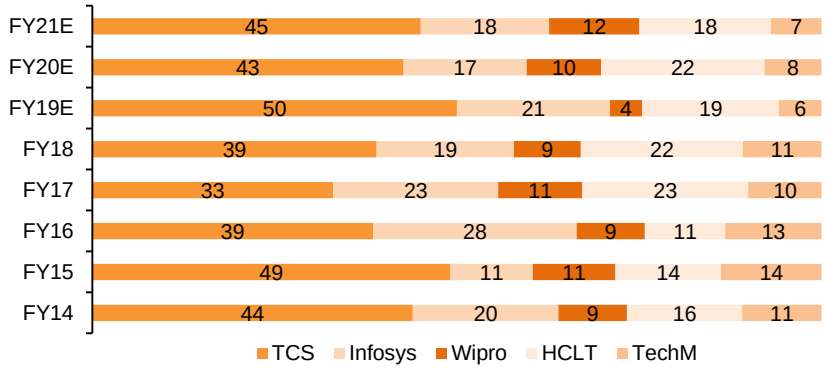
Exhibit 59: Absolute revenue additions in USD terms by Indian large-cap players over the years



Source: Company, Emkay Research

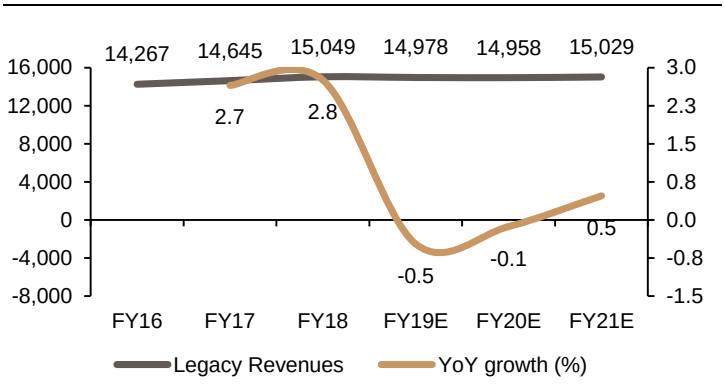
Exhibit 60: Incremental revenues (US$) market share movement among Indian large-cap players over the years; TCS market share expected to improve



Source: Company, Emkay Research

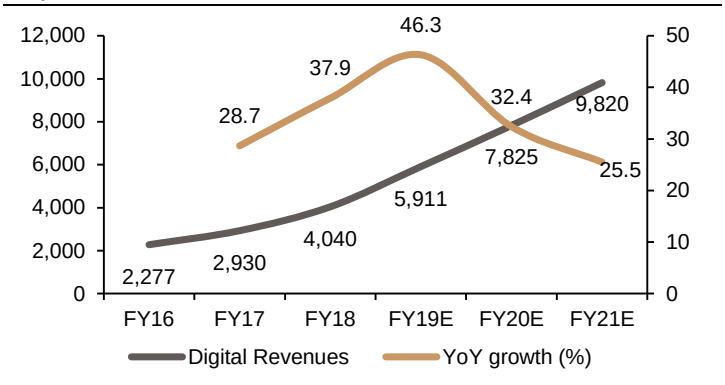
Digital continues to grow: Digital constitutes about 28% of TCS' current revenues and is growing at 40%+ yoy growth (vs. about 30% yoy industry growth). TCS expects this momentum to continue in Digital in the medium term with robust deal signings. Growth in Digital is exceptional on such a large base and this indicates that is emerging as client's preferred choice of vendor for large-scale digital implementations. This is mainly due to its unique location-independent and distributed agile model; ahead of the curve large investment in Digital sales and talent (world's largest talent pool on Digital).

Exhibit 61: Growth in legacy revenues is expected to improve



Source: Company, Emkay Research

Exhibit 62: Relatively superior growth in Digital assures growth outperformance



Source: Company, Emkay Research

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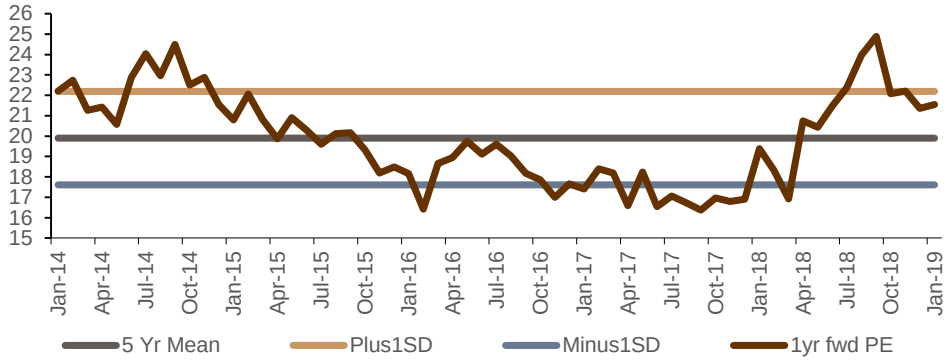
Valuation: With senior management stability (relative to Infosys that struggles with huge leadership and KMPs exits impact) and strong client relationships (winning deals even on bilateral basis), we believe TCS will manage to grow at the expense of its peers. With the company highlighting its market share gains and unique margin improvement levers (on-demand hiring with a unique hiring platform), our view and estimates largely remain unchanged. We have an Accumulate rating on the stock, with a target price of Rs2,100 based on 20x FY21 EPS.

Exhibit 63: TCS' 5-yr historical 1-yr fwd PE chart; valuations are justified on a PEG basis



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**1,179,660**	**1,231,040**	**1,470,648**	**1,629,029**	**1,814,035**
Expenditure	**856,550**	**905,880**	**1,065,638**	**1,182,389**	**1,318,496**
EBITDA	**323,110**	**325,160**	**405,009**	**446,640**	**495,539**
Depreciation	19,870	20,140	20,823	22,806	25,396
EBIT	**303,240**	**305,020**	**384,186**	**423,834**	**470,143**
Other Income	41,890	35,900	38,279	31,764	34,219
Interest expenses	0	0	0	0	0
PBT	**345,130**	**340,920**	**422,465**	**455,598**	**504,361**
Tax	81,571	82,118	101,692	109,343	121,047
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	680	540	730	0	0
Reported Net Income	**262,879**	**258,262**	**320,043**	**346,254**	**383,315**
Adjusted PAT	**262,879**	**258,262**	**320,043**	**346,254**	**383,315**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	1,970	1,910	3,744	3,659	3,659
Reserves & surplus	860,170	849,370	890,753	925,093	1,187,752
Net worth	**862,140**	**851,280**	**894,497**	**928,751**	**1,191,410**
Minority Interest	**3,660**	**4,020**	**4,911**	**5,036**	**5,256**
Loan Funds	**21,600**	**29,380**	**29,120**	**29,301**	**30,277**
Net deferred tax liability	0	0	0	0	0
Total Liabilities	**887,400**	**884,680**	**928,527**	**963,089**	**1,226,944**
Net block	**117,010**	**119,730**	**123,387**	**127,560**	**129,144**
Investment	**511,200**	**475,280**	**451,623**	**485,070**	**522,492**
Current Assets	**388,900**	**455,170**	**551,558**	**562,339**	**790,656**
Cash & bank balance	41,490	71,610	114,499	92,528	288,443
Other Current Assets	0	0	0	0	0
Current liabilities & Provision	**145,120**	**178,280**	**209,321**	**221,661**	**223,627**
Net current assets	**243,780**	**276,890**	**342,237**	**340,679**	**567,028**
Misc. exp	0	0	0	0	0
Total Assets	**887,400**	**884,680**	**928,527**	**963,089**	**1,226,944**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**303,240**	**305,020**	**384,186**	**423,834**	**470,143**
Other Non-Cash items	0	0	0	0	0
Chg in working cap	(18,520)	(2,990)	(22,458)	(20,413)	(30,434)
Operating Cashflow	**223,019**	**240,052**	**280,860**	**317,009**	**344,278**
Capital expenditure	(19,530)	(20,350)	(22,960)	(25,460)	(25,460)
Free Cash Flow	**203,489**	**219,702**	**257,900**	**291,549**	**318,818**
Investments	(162,020)	35,920	23,657	(33,447)	(37,422)
Other Investing Cash Flow	0	0	0	0	0
Investing Cashflow	**(139,660)**	**51,470**	**38,975**	**(27,143)**	**(28,663)**
Equity Capital Raised	0	(160,420)	(160,020)	(191,335)	0
Loans Taken / (Repaid)	600	7,780	(260)	182	976
Dividend paid (incl tax)	(111,015)	(114,600)	(116,807)	(120,740)	(120,740)
Other Financing Cash Flow	666	5,838	141	57	65
Financing Cashflow	**(109,749)**	**(261,402)**	**(276,946)**	**(311,837)**	**(119,699)**
Net chg in cash	**(26,390)**	**30,120**	**42,889**	**(21,971)**	**195,916**
Opening cash position	67,880	41,490	71,610	114,499	92,528
Closing cash position	**41,490**	**71,610**	**114,499**	**92,528**	**288,443**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	27.4	26.4	27.5	27.4	27.3
EBIT Margin	25.7	24.8	26.1	26.0	25.9
Effective Tax Rate	23.6	24.1	24.1	24.0	24.0
Net Margin	22.3	21.0	21.8	21.3	21.1
ROCE	42.5	38.5	46.6	48.2	46.1
ROE	33.4	30.1	36.7	38.0	36.2
RoIC	97.7	94.7	113.6	116.6	120.0

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	66.7	67.6	85.5	94.6	104.8
CEPS	71.8	72.9	91.0	100.9	111.7
BVPS	218.8	222.8	238.9	253.8	325.6
DPS	23.5	25.0	26.0	27.5	27.5

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	28.4	28.1	22.2	20.1	18.1
P/CEPS	26.4	26.0	20.8	18.8	17.0
P/BV	8.7	8.5	7.9	7.5	5.8
EV / Sales	6.3	5.8	4.7	4.2	3.6
EV / EBITDA	22.8	21.9	17.1	15.2	13.3
Dividend Yield (%)	1.2	1.3	1.4	1.4	1.4

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.1)	(0.1)	(0.2)	(0.2)	(0.3)
Net Debt/EBIDTA	(0.3)	(0.4)	(0.4)	(0.3)	(0.7)
Working Cap Cycle (days)	62.6	60.9	56.5	55.6	56.1

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	8.6	4.4	19.5	10.8	11.4
EBITDA	5.3	0.6	24.6	10.3	10.9
EBIT	5.3	0.6	26.0	10.3	10.9
PAT	8.6	(1.8)	23.9	8.2	10.7

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	309,040	320,750	342,610	368,540	379,085
EBITDA	82,880	86,520	90,710	102,780	105,765
EBITDA Margin (%)	**26.8**	**27.0**	**26.5**	**27.9**	**27.9**
PAT	65,310	69,040	73,400	79,010	84,014
EPS (Rs)	**17.4**	**18.4**	**19.6**	**21.1**	**22.4**

Source: Company, Emkay Research

Shareholding Pattern (%)	Dec-17	Mar-18	Jun-18	Jun-18	Sep-18
Promoters	73.6	71.9	71.9	71.9	72.1
FIIs	16.3	16.9	16.6	17.0	16.1
DIIs	6.1	6.9	6.9	6.7	7.4
Public and Others	4.1	4.3	4.6	4.5	4.5

Source: Capitaline

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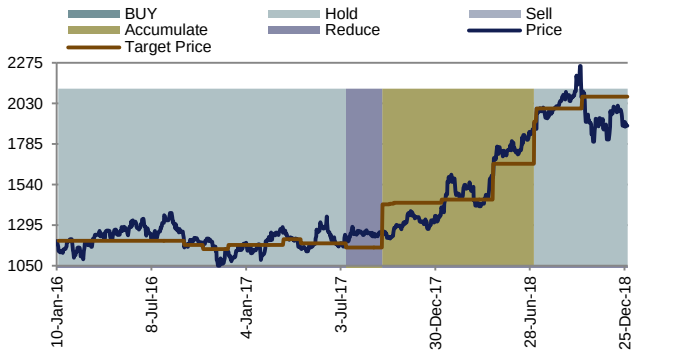
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	1,903	2,100	12m	Hold	Rahul Jain
11-Oct-18	1,980	2,070	12m	Hold	Rahul Jain
5-Oct-18	2,103	2,070	12m	Hold	Rahul Jain
10-Jul-18	1,875	2,000	12m	Hold	Rahul Jain
10-Jul-18	1,875	1,920	12m	Hold	Rahul Jain
6-Jul-18	1,913	1,920	12m	Hold	Rahul Jain
19-Apr-18	1,596	1,665	12m	Accumulate	Rahul Jain
5-Apr-18	1,479	1,450	12m	Accumulate	Rahul Jain
11-Jan-18	1,395	1,450	12m	Accumulate	Rahul Jain
11-Jan-18	1,395	1,450	12m	Accumulate	Rahul Jain
12-Oct-17	1,274	1,430	12m	Accumulate	Rahul Jain
4-Oct-17	1,221	1,425	12m	Accumulate	Rahul Jain
20-Sep-17	1,247	1,420	12m	Accumulate	Rahul Jain
13-Jul-17	1,223	1,160	12m	Reduce	Rahul Jain
10-Jul-17	1,217	1,185	12m	Hold	Rahul Jain
10-Jul-17	1,217	1,185	12m	Hold	Manik Taneja
18-Apr-17	1,154	1,185	12m	Hold	Manik Taneja
16-Mar-17	1,260	1,210	12m	Hold	Manik Taneja
12-Jan-17	1,172	1,175	12m	Hold	Manik Taneja
1-Dec-16	1,132	1,175	12m	Hold	Manik Taneja
14-Oct-16	1,183	1,150	12m	Hold	Manik Taneja
8-Sep-16	1,161	1,175	12m	Hold	Manik Taneja
15-Jul-16	1,223	1,200	12m	Hold	Manik Taneja
21-Jun-16	1,326	1,200	12m	Hold	Manik Taneja
19-Apr-16	1,260	1,200	12m	Hold	Manik Taneja
13-Jan-16	1,140	1,200	12m	Hold	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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Infosys

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Frequent changes in trump cards may not help win the game

CMP	Target Price
Rs 671 as of (January 8, 2019)	Rs 640 (■) 12 months
Rating	**Upside**
REDUCE (■)	(4.6) %

- Infosys has guided for 6-8% CC growth and an EBIT margin band of 22-24% for FY19 (100bps lower to FY18 range). While H1FY19 margins (23.7%) are at the upper end of the guided band, we believe that planned investments in H2FY19 would likely lead to achieving the mid-point of the guided range in FY19 i.e., about 23% vs. 24.3% in FY18.
- Growth underperformance (~250bps) vs. TCS and ~100bps expected margin decline vs. ~100bps improvement for TCS should lead to at least ~1200bps earnings growth underperformance in FY19e. Relatively low growth is expected to continue, given lack of capability/delivery differentiation and elevated attrition at management/high performer levels (see Exhibit 64-66).
- While large-deal TCV has improved in H1FY19 (USD3.0bn in H1FY19 vs. USD1.4bn in H1FY18; 60%+ of which are net new deals), we believe that higher attrition at senior levels will challenge renewals as well as sustainability of Q2FY19 deal TCV number.
- Our 25% expected growth differential vs. TCS (our benchmark) over the medium term coupled with growing margin challenges and planned investments force us to assign a lower multiple to Infosys (15x vs. 20x for TCS; 25% discount). We have a Reduce rating on Infosys, with a target price of Rs640 (based on 15x FY21E EPS).

Competitive landscape would intensify in renewals amid high attrition

Infosys has undergone management shuffle/restructuring in all its verticals (~70% of sales), except in the BFSI segment (~30% of sales), due to a number of senior-level exits over the last 24 months (See Exhibit 64-66). Two out of the three second layer executives, Mr. Nitesh Banga and Mr. Sudip Shah, who were long time Infoscions and who were elevated to lead Manufacturing and ENU verticals, respectively, by the new CEO, Mr. Salil Parekh, after the first layer resigned, have also recently left the organization. The other vertical heads viz. Mr. Mohit Joshi, Mr. Kamesh Vaswani and Mr. Anand Swaminathan have already been assigned additional roles within the organization (see Exhibit 3) due to number of sudden exits. Consolidated attrition is also at all-time high levels (See Exhibit 67). We believe that sudden exits at the first and second layer exposes the third layer of Infosys, which we believe, would pose a challenge when large contracts would be due for renewal.

Expect underperformance vs. TCS lead to a Reduce rating

Infosys prefers growth over profitability as it has planned investments in digital/training/sales/localization in H2FY19. However, we are of the view that company-specific challenges, such as high attrition, coupled with macro-level challenges, such as trade wars/Brexit, will normalize its deal-win trajectory, hampering growth prospects. We believe that our lower multiple is justified (15x vs. 20x for TCS) due to ~25% growth differential and absolute margin differential vs. TCS (200bps) in FY19. We have a Reduce rating on the stock, with a TP of Rs640 (based on 15x FY21 EPS).

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	684,840	705,220	822,632	890,694	968,330
EBITDA	186,040	189,248	213,019	230,413	250,702
EBITDA Margin (%)	27.2	26.8	25.9	25.9	25.9
APAT	143,530	145,970	159,317	171,431	180,563
EPS (Rs)	31.3	33.5	36.6	40.7	42.9
EPS (% chg)	6.4	7.0	9.1	11.2	5.3
ROE (%)	22.0	21.8	23.5	25.0	25.5
P/E (x)	21.4	20.0	18.3	16.5	15.7
EV/EBITDA (x)	15.3	14.4	12.9	12.0	11.1
P/BV (x)	4.5	4.5	4.1	4.2	3.8

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	-/-
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	REDUCE

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	36.6	40.7
Consensus	37.5	41.7
Mean Consensus TP (12M)	Rs 788	

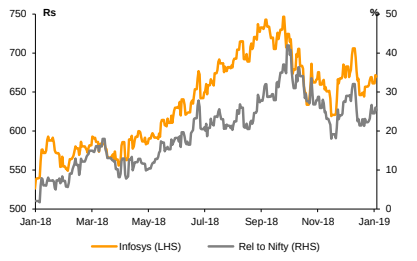
Stock Details	
Bloomberg Code	INFO IN
Face Value (Rs)	5
Shares outstanding (mn)	4,369
52 Week H/L	755 / 503
M Cap (Rs bn/USD bn)	2,932 / 42.01
Daily Avg Volume (nos.)	8,847,911
Daily Avg Turnover (US$ mn)	84.7

Shareholding Pattern Sep '18	
Promoters	12.8%
FIIs	35.1%
DIIs	22.1%
Public and Others	30.0%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(2)	(7)	5	34
Rel. to Nifty	(2)	(11)	5	31

Relative price chart



Source: Bloomberg

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ED: ANISH MATHEW SA: DHANANJAY SINHA

KMP attrition to hamper profitability and growth prospects

Infosys has seen a huge churn in its senior-level management team (see Exhibits 64-67). Given low revenue growth visibility amid management instability, we expect 'Stability' scenario to stay and believe that 'Momentum and Accelerate' phases will take time.

Exhibit 64: FY18 vs. FY17 Board comparison; board has seen considerable amount of change

Name	Post (March'17)	Name	Present
R. Seshasayee	***Chairman - Resigned***	**Nandan M. Nilekani - External**	**Chairman**
Ravi Venkatesan	***Co-Chairman - Resigned***		
Dr. Vishal Sikka	***CEO - Resigned***	**Salil Parekh - External**	**CEO**
U.B. Pravin Rao	COO	U.B. Pravin Rao	COO
Kiran Mazumdar-Shaw	Independent Director	Kiran Mazumdar-Shaw	Independent Director
D.N. Prahlad	Independent Director	D.N. Prahlad	Independent Director
Roopa Kudva	Independent Director	Roopa Kudva	Independent Director
Dr. Punita Kumar-Sinha	Independent Director	Dr. Punita Kumar-Sinha	Independent Director
Prof. Jeffrey S. Lehman	***Independent Director - Resigned***	**D. Sundaram - External**	**Independent Director**
Prof. John W Etchemendy	***Independent Director - Resigned***	**Micheal Gibbs - External**	**Independent Director**

*Source: Company, Emkay Research, Please note that '**Bold Italics' are exits and '**Bold Underlined'** are new entrants*

Exhibit 65: FY18 vs. FY17 leadership (Presidents) comparison; Dearth of executives will impact renewal success

Name	Post (March'17)	Name	Present
Dr. Vishal Sikka - Resigned	***CEO***	**Salil Parekh - External**	**CEO**
U.B. Pravin Rao	COO	U.B. Pravin Rao	COO
M.D. Ranganath - Resigned	***CFO***	**Nilanjan Roy - External**	CFO*
Ravi Kumar S.	Deputy COO	Ravi Kumar S.	Deputy COO (Head- Consulting)
Mohit Joshi	Head- BFSI	Mohit Joshi	President (Head- BFSI and HC&LS)
Sandeep Dadlani - Resigned	***Head- MFG, Retail & CPG***		
Rajesh K. Murthy - Resigned	***Head- Consulting, ENU and Telecom***		

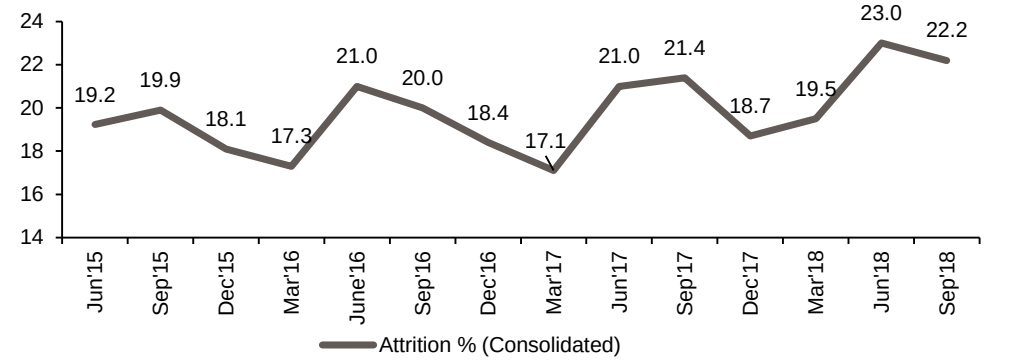
*Source: Company, Emkay Research, Please note that '**Bold Italics' are exits and '**Bold Underlined'** are new entrants,*Effective 01 Mar 2019*

Exhibit 66: FY18 vs. FY17 leadership (presidents) comparison; Infosys has undergone management shuffle in ~70% of its business

Vertical Name	March'17	After New CEO joined	Present	% of sales
BFSI	Mohit Joshi	Mohit Joshi	Mohit Joshi	32.2%
HC&LS	***Sangita Singh - Resigned***	Mohit Joshi	Mohit Joshi	6.4%
Manufacturing	***Sandeep Dadlani - Resigned***	***Nitesh Banga***	**Jasmeet Singh - Internal**	9.6%
Retail, CPG and Logistics	***Sandeep Dadlani - Resigned***	**Karmesh Vaswani - Internal**	**Karmesh Vaswani - Internal**	16.8%
Hi-Tech	***Sandeep Dadlani - Resigned***	**Anand Swaminathan Internal**	**Anand Swaminathan Internal**	7.5%
Telecom And Media	***Rajesh K. Murthy - Resigned***	**Anand Swaminathan - Internal**	**Anand Swaminathan - Internal**	12.3%
ENU	***Rajesh K. Murthy - Resigned***	***Sudip Singh – Internal****		12.3%

*Source: Company, Emkay Research, Please note that '**Bold Italics' are exits and '**Bold Underlined'** are new heads; * Sudip Singh has also left as per news on 8th Jan 19*

Exhibit 67: Infosys' consolidated attrition at alarming levels



Source: Company, Emkay Research

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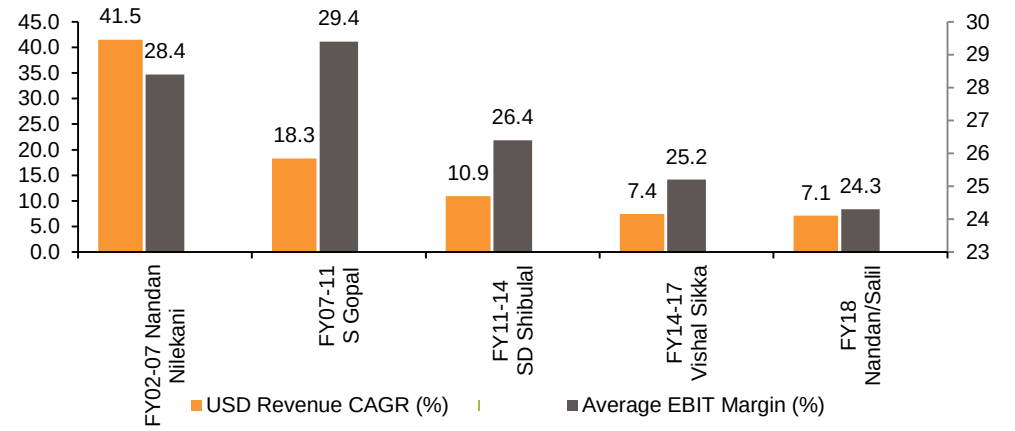
Preferring growth over profitability first time ever

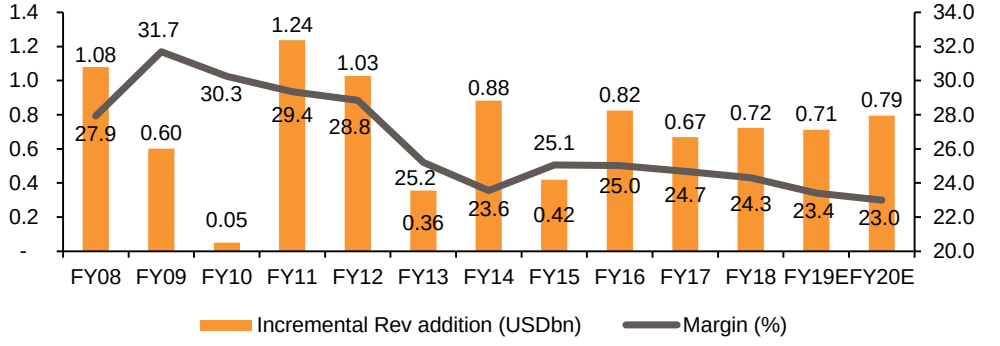
Commentary not encouraging: For the first time in its history, Infosys has put revenue growth ahead of profitability. Traditionally, under the leadership of its past CEOs, it has preferred profitability ahead of revenue growth (see Exhibit 4). However, the new CEO, in its first annual outlook lowered the OPM guidance for FY19E to 22-24% vs. the 23-25% guidance of FY18 due to: 1) it sees the need to re-invigorate its sales team (more feet on ground in Europe, digital specialist salespersons and account expansion program from both service lines and geographic perspective); 2) enhanced Digital capabilities from offering/delivery perspective; 3) re-skilling of existing employees; and 4) local hiring and delivery. Management expects to build four innovation centers in the US to locally hire 10,000 employees by the end of FY19. We believe that management's three-year goal of 'FY19 – Stability, FY20 – Momentum and FY21 – Accelerate' would not fructify given the challenging demand scenario and continuous shift in Strategy/CEO. We believe that at best Infosys would be able to, at best, meet the industry growth rate.

Exhibit 68: Growth/Margin performance under various CEOs; historically, change of face has never helped Infosys



Source: Company, Emkay Research

Exhibit 69: Infosys' absolute revenue addition has been flat while margins have been declining



Source: Company, Emkay Research

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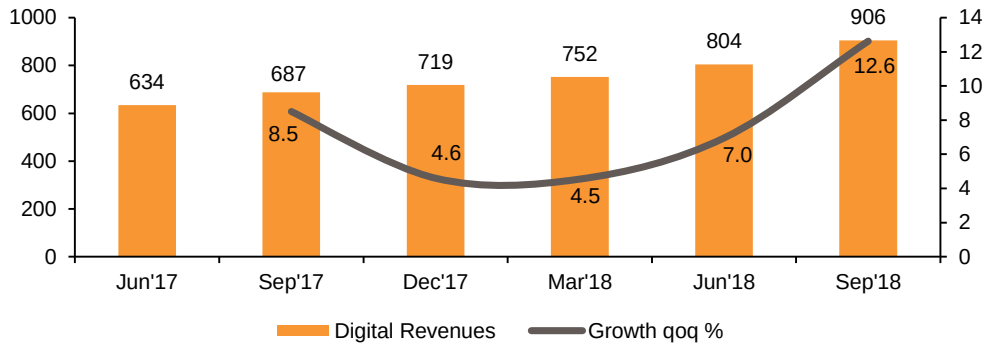
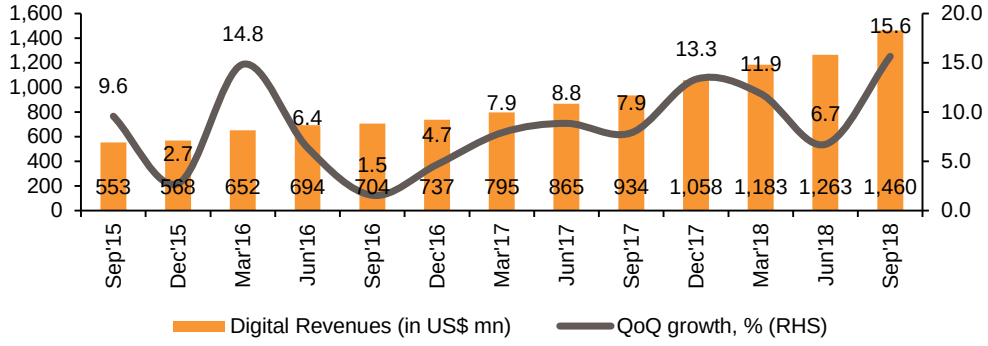
Digital growth healthy but relatively larger peer growing at a significant higher rate: Digital (~30% of sales) grew by ~30% yoy (vs. ~40% yoy growth for TCS on almost double the base) in H1FY19. We believe that growth is strong but relatively slower than TCS' growth (See Exhibit 70 & 71).

Exhibit 70: Infosys' Digital revenues (USD mn) – Quarterly revenue and growth trends



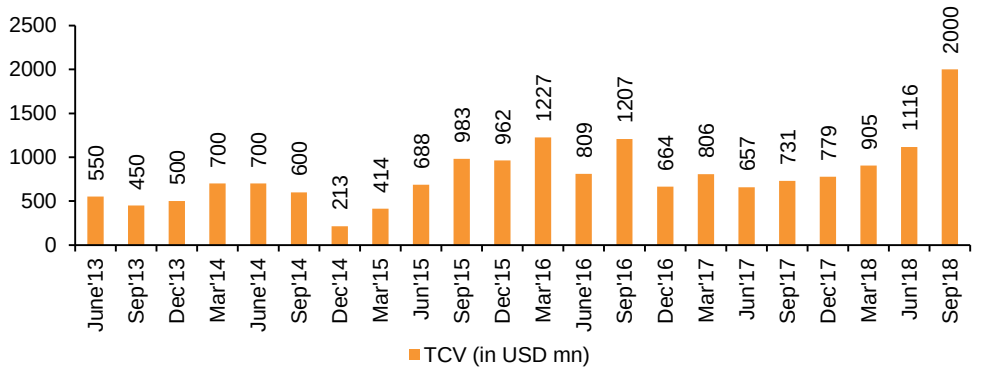
Source: Company, Emkay Research

Exhibit 71: TCS' Digital revenues (USD mn) - Digital continues to post strong growth



Source: Company, Emkay Research

Exhibit 72: Elevated top level attrition to impact large renewals, leading to normalization of gains emanating out of improved large deal TCV



Source: Company, Emkay Research

Profitability outlook: Infosys trimmed its margin band guidance by 100bps to 22-24% for FY19 vs. 23-25% for FY18 and provided 6-8% organic growth in CC terms for FY19. The reduction in margins has been indicative of the increased investments in building sales and digital capabilities, localization, and re-skilling as part of its 'three-stage roadmap', i.e., Stability, Momentum and Accelerate.

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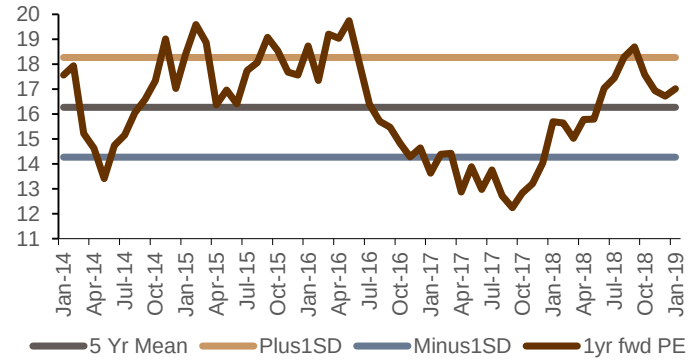
Valuation

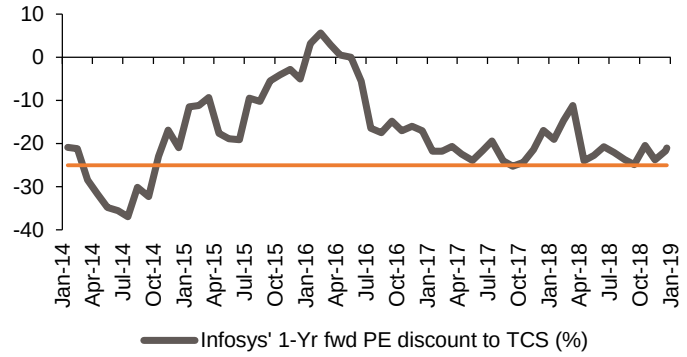
We believe that TCS' expected growth outperformance of ~250bps in FY19 with a 100bps margin improvement against 100bps margin decline for Infosys in FY19 will result in significant earnings outperformance for TCS (12-14%) in FY19e. In addition, irrespective of market dynamics, TCS' 25% multiple differential over Infosys is expected to sustain, given its capability/delivery led differentiation, top management stability and historical trends (See Exhibit 73), which, we believe, would help it maintain the growth differential. We have a Reduce rating on Infosys, with a target price of Rs640 (based on 15x FY21 EPS).

Exhibit 73: Infosys' 5-yr historical 1-yr fwd PE chart



Source: Company, Emkay Research

Exhibit 74: Infosys' 1-yr fwd PE discount to TCS (%)



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**684,840**	**705,220**	**822,632**	**890,694**	**968,330**
Expenditure	**498,800**	**515,972**	**609,614**	**660,280**	**717,627**
EBITDA	**186,040**	**189,248**	**213,019**	**230,413**	**250,702**
Depreciation	17,030	17,768	20,898	22,615	24,597
EBIT	**169,010**	**171,480**	**192,120**	**207,798**	**226,106**
Other Income	30,800	31,220	25,836	25,441	19,559
Interest expenses	0	0	0	0	0
PBT	**199,810**	**202,700**	**217,956**	**233,239**	**245,664**
Tax	55,980	56,730	58,639	61,808	65,101
Extraordinary Items	0	14,320	0	0	0
Minority Int./Income from Assoc.	300	0	0	0	0
Reported Net Income	**143,530**	**160,290**	**159,317**	**171,431**	**180,563**
Adjusted PAT	**143,530**	**145,970**	**159,317**	**171,431**	**180,563**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	11,440	10,880	21,760	21,060	21,060
Reserves & surplus	678,380	638,360	682,347	648,390	727,864
Net worth	**689,820**	**649,240**	**704,107**	**669,450**	**748,924**
Minority Interest	**0**	**0**	**0**	**0**	**0**
Loan Funds	**3,600**	**8,610**	**8,610**	**8,610**	**8,610**
Net deferred tax liability	0	0	0	0	0
Total Liabilities	**693,420**	**657,850**	**712,717**	**678,060**	**757,534**
Net block	**214,940**	**241,170**	**267,670**	**295,670**	**324,670**
Investment	**167,610**	**142,390**	**160,390**	**179,390**	**199,890**
Current Assets	**437,350**	**415,340**	**444,207**	**383,650**	**436,623**
Cash & bank balance	226,250	198,180	178,825	65,092	59,549
Other Current Assets	87,880	43,130	63,852	88,528	115,544
Current liabilities & Provision	**140,130**	**141,050**	**159,550**	**180,650**	**203,649**
Net current assets	**297,220**	**274,290**	**284,657**	**203,000**	**232,974**
Misc. exp	0	0	0	0	0
Total Assets	**693,420**	**657,850**	**712,717**	**678,060**	**757,534**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**169,010**	**202,700**	**217,955**	**233,239**	**245,663**
Other Non-Cash items	0	1,900	0	0	0
Chg in working cap	(16,470)	840	(29,722)	(32,076)	(35,517)
Operating Cashflow	**113,590**	**132,180**	**124,656**	**136,528**	**150,084**
Capital expenditure	(88,230)	(19,980)	(26,500)	(28,000)	(29,000)
Free Cash Flow	**25,360**	**112,200**	**98,156**	**108,528**	**121,084**
Investments	(76,130)	46,820	(18,000)	(19,000)	(20,500)
Other Investing Cash Flow	0	(530)	454	38	42
Investing Cashflow	**(133,560)**	**43,990**	**(44,046)**	**(46,962)**	**(49,458)**
Equity Capital Raised	0	(130,410)	0	(105,000)	0
Loans Taken / (Repaid)	3,600	0	0	0	0
Dividend paid (incl tax)	(70,699)	(74,640)	(104,448)	(101,088)	(101,088)
Other Financing Cash Flow	(13,651)	810	4,483	2,788	(5,080)
Financing Cashflow	**(80,750)**	**(204,240)**	**(99,965)**	**(203,300)**	**(106,168)**
Net chg in cash	**(100,720)**	**(28,070)**	**(19,355)**	**(113,734)**	**(5,542)**
Opening cash position	326,970	226,250	198,180	178,825	65,092
Closing cash position	**226,250**	**198,180**	**178,825**	**65,092**	**59,549**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	27.2	26.8	25.9	25.9	25.9
EBIT Margin	24.7	24.3	23.4	23.3	23.4
Effective Tax Rate	28.0	28.0	26.9	26.5	26.5
Net Margin	21.0	20.7	19.4	19.2	18.6
ROCE	30.6	30.0	31.8	33.5	34.2
ROE	22.0	21.8	23.5	25.0	25.5
RoIC	71.7	56.9	55.6	51.5	48.5

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	31.3	33.5	36.6	40.7	42.9
CEPS	35.1	37.6	41.4	46.1	48.7
BVPS	150.6	149.2	161.8	158.9	177.8
DPS	12.9	21.8	20.0	20.0	20.0

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	21.4	20.0	18.3	16.5	15.7
P/CEPS	18.7	17.5	15.9	14.3	13.5
P/BV	4.5	4.5	4.1	4.2	3.8
EV / Sales	4.2	3.9	3.3	3.1	2.9
EV / EBITDA	15.3	14.4	12.9	12.0	11.1
Dividend Yield (%)	1.9	3.2	3.0	3.0	3.0

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.3)	(0.3)	(0.2)	(0.1)	(0.1)
Net Debt/EBIDTA	(1.2)	(1.0)	(0.8)	(0.2)	(0.2)
Working Cap Cycle (days)	37.8	39.4	47.0	56.5	65.4

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	9.7	3.0	16.6	8.3	8.7
EBITDA	8.9	1.7	12.6	8.2	8.8
EBIT	8.2	1.5	12.0	8.2	8.8
PAT	6.4	11.7	(0.6)	7.6	5.3

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	177,940	180,830	191,280	206,090	212,773
EBITDA	43,190	44,720	45,370	48,940	48,937
EBITDA Margin (%)	**24.3**	**24.7**	**23.7**	**23.7**	**23.0**
PAT	36,970	36,900	36,120	41,100	41,481
EPS (Rs)	**8.5**	**8.5**	**8.3**	**9.5**	**9.5**

Source: Company, Emkay Research

Shareholding Pattern (%)	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	12.9	12.9	12.9	12.8
FIIs	35.0	35.2	34.9	35.1
DIIs	21.8	21.6	22.5	22.1
Public and Others	30.3	30.3	29.7	30.0

Source: Capitaline

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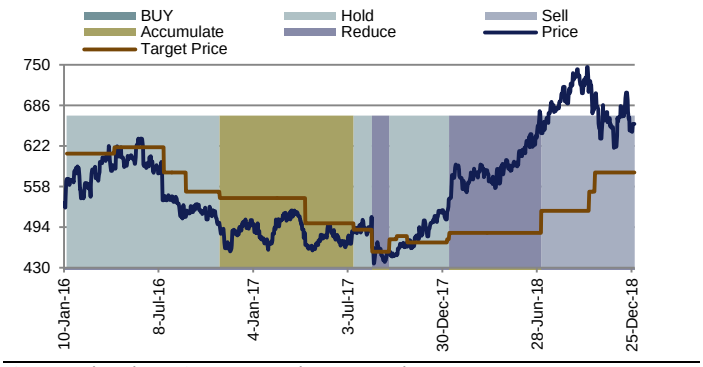
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	665	640	12m	Reduce	Rahul Jain
16-Oct-18	695	580	12m	Sell	Rahul Jain
5-Oct-18	725	550	12m	Sell	Rahul Jain
18-Aug-18	715	520	12m	Sell	Rahul Jain
13-Jul-18	659	520	12m	Sell	Rahul Jain
10-Jul-18	651	520	12m	Sell	Rahul Jain
6-Jul-18	642	520	12m	Sell	Rahul Jain
13-Apr-18	586	485	12m	Reduce	Rahul Jain
5-Apr-18	574	485	12m	Reduce	Rahul Jain
28-Mar-18	566	485	12m	Reduce	Rahul Jain
12-Jan-18	539	485	12m	Reduce	Rahul Jain
8-Jan-18	518	475	12m	Hold	Rahul Jain
4-Dec-17	493	470	12m	Hold	Rahul Jain
24-Oct-17	463	470	12m	Hold	Rahul Jain
4-Oct-17	450	480	12m	Hold	Rahul Jain
20-Sep-17	456	475	12m	Hold	Rahul Jain
18-Aug-17	462	455	12m	Reduce	Rahul Jain
14-Jul-17	486	490	12m	Hold	Rahul Jain
10-Jul-17	479	500	12m	Accumulate	Manik Taneja
13-Apr-17	466	500	12m	Accumulate	Manik Taneja
13-Jan-17	488	540	12m	Accumulate	Manik Taneja
1-Nov-16	495	540	12m	Accumulate	Manik Taneja
14-Oct-16	514	550	12m	Hold	Manik Taneja
29-Aug-16	511	550	12m	Hold	Manik Taneja
16-Aug-16	526	580	12m	Hold	Manik Taneja
18-Jul-16	541	580	12m	Hold	Manik Taneja
21-Jun-16	603	620	12m	Hold	Manik Taneja
15-Apr-16	586	620	12m	Hold	Manik Taneja
15-Jan-16	570	610	12m	Hold	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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HCL Tech

Your success is our success

Refer to important disclosures at the end of this report

Paying the price for thinking long term

CMP	Target Price
Rs 940 as of (January 8, 2019)	Rs 1,265 (■) 12 months
Rating	**Upside**
BUY (■)	34.7 %

- Following the release of its Q2FY19 results, HCL Tech maintained its revenue growth of 10.5% and margin guidance in the range of 19.5% to 20.5%, while providing favorable commentary on organic growth outlook — which fared better at 6%+ in H1FY19 — and the IMS segment which saw a recovery with 3.2% CC qoq growth in Global (ex-India) business.
- While the positive performance and commentary were getting factored in the stock price in Oct-Nov, HCLT announced a major deal with IBM for a total consideration of about USD1.8bn, which the market perceived as a large but low-potential capital allocation.
- Unlike the Street, we are enthused by HCL Tech's strategy to transform its business at the right time by equipping itself with capabilities that would future-proof the business. Our confidence is stemming from: 1) the (post-deal) emergence of HCL Tech as the fastest growing large-cap player over FY19-21E; 2) its impressive performance in past IP investments – two turnarounds, one stabilization, but one higher deceleration; and 3) the expectation that the deal will improve the OPM/RoE profile of the business.
- In our view, amid the expected decline in growth rates for its peers in the future, best-in-class growth performance by HCL Tech should eventually help moderate the unfavorable perception of this inorganic/IP investment. We maintain our Buy rating on the stock, with a TP of Rs1,265, valuing it at 14x FY'21E EPS (on par with its 3-year historical mean, implies ~1.5x on PEG basis).

Earnings should take precedence over unwarranted negativity on IP initiatives

The market seems to perceive HCL Tech's continued inorganic investments as an indication of management's lack of confidence in its organic growth prospects. HCL's large investments in IPs have created considerable negativity around its future earnings and cash generation ability. In fact, the current valuations are in some way factoring in flat earnings growth for the total business taking the impact of these IP investments into account, despite the fact that management sees 15% IRR and 15%+ Cash EPS accretion from these IPs. Further, we are of the view that the market has not discounted HCL Tech's 30% addition to its reported EPS over last 48 months, leading the stock to trade at an almost same enterprise value over this period. We see these factors as temporary, and believe that all stocks – in the long run – get valued either on the basis of underlying sales growth, or earnings and cash-flows. Even when keeping our assumptions conservative, we deem the stock as cheap on all possible valuation metrics, and believe it will see significant upside soon as the prevailing negative perception fades away.

Past track record offers us comfort to our ahead-of-consensus estimates; Buy

HCLT, in the past, has achieved the desired results with its inorganic growth strategy, driving its financial outperformance in the past and thus is an encouraging sign. As a consequence, we believe that HCL Tech will be able to further drive growth/margin improvement with this transaction, putting the company ahead of its peers on the growth front. Our conservative assumptions call for ~10% US$ revenue/EPS CAGR for FY19-21. Maintain Buy, with a target price of Rs1,265 (valued at 14x 21e earnings, implies 1.5x on PEG).

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	467,220	505,700	599,468	669,705	754,037
EBITDA	103,090	114,400	141,372	160,635	183,995
EBITDA Margin (%)	22.1	22.6	23.6	24.0	24.4
APAT	84,570	87,820	102,285	108,960	119,373
EPS (Rs)	59.9	63.1	75.5	82.5	90.4
EPS (% chg)	11.9	5.4	19.6	9.3	9.6
ROE (%)	28.0	25.2	26.0	24.6	23.0
P/E (x)	15.7	14.9	12.5	11.4	10.4
EV/EBITDA (x)	11.6	10.5	8.0	7.0	6.0
P/BV (x)	4.0	3.6	3.1	2.6	2.2

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	0.1/(1.9)
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	BUY

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	75.5	82.5
Consensus	73.6	79.9
Mean Consensus TP (12M)	Rs 1,158	

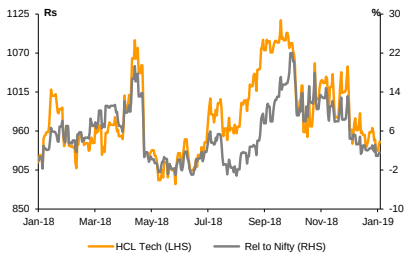
Stock Details	
Bloomberg Code	HCLT IN
Face Value (Rs)	2
Shares outstanding (mn)	1,393
52 Week H/L	1,125 / 880
M Cap (Rs bn/USD bn)	1,309 / 18.75
Daily Avg Volume (nos.)	2,184,330
Daily Avg Turnover (US$ mn)	31.1

Shareholding Pattern Sep '18	
Promoters	60.2%
FIIs	28.0%
DIIs	8.2%
Public and Others	3.7%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(2)	(13)	-	4
Rel. to Nifty	(3)	(17)	-	2

Relative price chart



Source: Bloomberg

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ED: ANISH MATHEW SA: DHANANJAY SINHA

Unwarranted negativity around IP business

HCL Tech, with its large investments in IP, has attracted significant negativity around its future earnings and cash generation ability of the business. In fact, the current valuations are in some way factoring in flat earnings growth for the total business taking the impact of these IP investments into account, despite the fact that management sees 15% IRR and 15%+ Cash EPS accretion from these IPs.

However, these arguments are not backed by historical precedence or any visible dilution in its financial metrics - RoE and OPM have not been impacted and remain strong. The growth rates for the acquired IP cannot be ascertained as we do not have any break-up of organic/inorganic rate. However, the company anticipate ~4% growth for the incremental revenue portfolio in CY20 that is expected to be added in CY19, which is an encouraging sign.

With regard to HCL Tech's IP strategy, we draw comfort from:

- Confident commentary by management on growth, margins, cash flows, as well as the IRR profile of the investments made so far.
- Most of the products acquired are leaders in their respective categories and have very large existing client bases, opening up significant cross-selling and up-selling opportunity and geographical reach (refer to Exhibit 1).
- The acquired IPs have a good mix of matured technologies and futuristic ones. Thus, at the portfolio level, it is unlikely to hurt growth rates or the profitability profile of the business.
- The past performance track record of HCLT on its four IP investments gives us confidence that the company will be able to add value for clients as they tend to hold on to the product for 4-6 quarters (Refer to Exhibit 76).
- Two out of the four products are already clocking double-digit growth and the other two, which are in a declining mode, have seen product releases in the JAS quarter (quarter ending Sep'18) and thus should see better prospects over next four quarters.

Exhibit 75: Product-wise information – segment, opportunity, ranking, client and vertical info

	Market	Market Size (US$ bn)	Market Growth Rate	Market Position - Recognition	Number of clients	Key Verticals
AppScan	App Security	2.8	26.4%	Top 3 - Leader in Gartner Magic Quadrant in Mar'18 (Testing)	2000	FS, Retail and Technology
Big Fix	Endpoint management	14.8	8.4%	Top 3 - Leader in Gartner Magic Quadrant in 2015 (Client management tools)	2200	Government, Distribution, Education, FS
Notes	Enterprise Email	32.6	5.0%	Top 3	13000	Financials, Government, Manufacturing
Domino	Low Code	4.3	45.0%	N/A		
Connections	Enterprise Collaboration	34.7	11.6%	Top 3 - Leader in Gartner Magic Quadrant in 2018 (Digital Commerce)	2000	Financials, Government, Transportation
DX	Digital Experience	9.7	14.0%	Top 3 - Leader in Gartner Magic Quadrant 2018 (Web Content Management)	1400	Consumer Goods, Manufacturing, Airlines, Public Sector
Unica	Marketing Automation	5.0	8.6%	Top 3 - Leader in Gartner Magic Quadrant in Apr'18 (Multichannel Marketing Hubs)	600	Retail, Telco, Transportation
Commerce	Digital Commerce Apps	6.5	10.0%	Top 5 - Leader in Gartner Magic Quadrant in Mar'18	425	Retail, Healthcare

Source: Company, Emkay Research

Exhibit 76: Past performance track record on IP partnerships and roadmap ahead

Proven past track record	Partnership commencement date	Growth at inception (approx)	Current growth rate (approx)	Remark
Product 1	1QFY17	-10%	10%+	Turnaround - as product demand robust on SaaS model
Product 2	2QFY17	-5%	-15%	New product release made in Q2FY19 (no major product release in last five years prior to this), has strong potential going forward as past backlogs of customer requests cleared
Product 3	4QFY17	-12%	-14%	Steady and consistent improvement – released a new version in Q2FY19 but expect a major release due in FY20.
Product 4	4QFY17	15%	15%	Best-performing product - optimistic on outlook as the segment has witnessed strong demand improvements

Source: Company, Emkay Research

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Investor concerns point to amplified pessimism, but our view is different

Based on our conversations with various investors, we have understood a few concerns that have been highlighted and have tried to counter them with some justification, hypothesis and scenario analysis.

Concern 1: The IP seller (IBM) is the beneficiary from the transaction or in a way HCL Tech has acquired end-of-lifecycle products and they are likely to witness a gradual deceleration and thus will create negative impact on profits/cash-flow.

The rationale behind the transaction

For the Seller: We believe that the seller of the IP exited this business as it does not see much larger opportunity in them and thus over a period of time incremental revenues would not support the cost inflation and may subsequently make the business dilutive.

For the Buyer: The buyer of the IP believes that with further investments in both in technology and sales, revenue growth can be reinvigorated or if it does not play out then, the cost should continue to deflate over a period of time to maintain profitability, OCFs and IRR.

Our take: We believe what can happen to these IP revenue-segment is the same that can happen to any traditional business in the IT services space. For the last few years, the traditional businesses for many players have been reporting flat-to-negative growth and management commentary and popular belief suggest the trend would continue in the coming years. So, effectively the transaction is not very different from acquiring any other IT-services business, and looks like a win-win situation to us as the current success rate in the four case studies shared so far are testimony for it.

Concern 2: Current and future margins appear to be inflated as current amortization rates are very conservative and thus if shorter lifespans are assumed for the IPs, adjusted EPS may look much lesser than the current reported number.

Our take: We believe the life of any intangible asset is a debatable aspect, and thus the ideal run rate for amortization is very subjective. Using different life-of-asset in earnings calculations can hurt static valuations (PE based) but not on cash-flow-based valuation metrics (DCF, cash-flow yields). Hypothetically, one can assume full write-off now and subsequently build much larger clean-profits in coming years.

Concern 3: HCL Tech has no history with this kind of business and may not be able to add any value to this business

Our take: Similar perception was there when HCL Tech invested in the IMS business 10 years ago ─ IMS is a margin-dilutive and capital-intensive business. However, HCL Tech was able to deliver industry-leading revenue growth largely led by the IMS segment differentiation and later other larger peers also ventured into that segment. We believe HCL Tech has the ability to foresee technology changes ahead of others as it can be seen from its ahead-of-the-curve investments in IMS and ER&D segment as both these segments gradually emerged as leading growth segments for Indian IT services vendors. In addition, remember that HCL designed and launched India's first 8C microcomputer in 1978, around the same time as Apple.

Concern 4: HCL Tech's capital allocation is poor as it is investing in businesses that are non-accretive on earnings/growth/cash-flow. They would be better off if they pay dividend like its peers.

Our take: We believe that all heavy capital allocation decisions are seen as poor in the short term as the investments are front-loaded and rewards are back-dated. However, as the investments phases out the rewards on FCF are huge. The case in point is its HCL investment phase wherein it invested heavily during FY09-12 resulting in poor FCF but later on witnessed huge jump in FCF over FY12-15, resulting in ~300% stock returns over a three-year period.

We also firmly believe that the current market share of Indian vendors (about 10%) is still insignificant given our differentiated cost/talent advantage and thus the company needs to invest in building capabilities instead of higher dividend payouts. The probability of benefits that can accrue from investing in IP/acquisition can range anywhere between 0 and 1. However, the future benefits from dividend payouts is exactly 0.

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Concern 5: HCL Tech's continued investments in acquisitions suggest lower confidence of the management on its organic growth prospects.

Our take: In our view, HCLT's long list of acquisitions and IP investments (20+ transactions in the last four years) indicates its growth hungry attitude and unsaid commitment toward maintaining double-digit revenue growth for the business irrespective of underlying company specific (IMS segment under stress) or macro challenges. In our view, this should be seen as positive as 1) the acquisition-led strategy has not diluted its financial or operational metrics so far; 2) the company has no history of failed acquisitions or write-offs; and 3) HCLT understands the need of inorganic strategy as an important tool to sustaining high-growth performance for current and future years.

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In the end, stock gets valued on 'Sales Growth', 'Earnings' or 'Cash flows'

HCL Tech has added 30% to its reported EPS over last 48 months but has been trading on the same enterprise value. In other words, the stock has got de-rated 30% over CY14-CY18 despite clocking faster-than-industry growth rate over the same period. Note that Wipro has also given no returns in the same period but its earnings have actually been flat during the same period. Even Infosys delivered stock returns of about 20% though earnings grew in line with that of HCL Tech in the same period. So, effectively, HCL Tech's valuations are a clear victim of perception and uncertainty given its organic/inorganic mix overhang. We see these factors as temporary, and believe that all stocks – in the long run – get valued either on the basis of underlying sales growth, or earnings and cash-flows. Even when keeping our assumptions conservative, we deem the stock as cheap on all possible valuation metrics, and believe it will see significant upside soon as the prevailing negative perception fades away.

Implied valuation of HCL Tech across different methodologies

Price-to-earnings multiple: Based on this most popularly used methodology for IT Services businesses, the current valuations of 11x on its FY21E earnings suggest that the stock is already below its SD1 valuations multiple and is currently factoring in much lesser earnings growth for the business despite the current guidance of 10.5%+ growth in FY19 and inorganic additions of USD600mn+ revenues from the recently acquired IPs on an incremental basis ensures about another 7% growth on FY19 exit rate. Thus, the implied earnings-multiplier right now is very unfair and is factoring on only the current organic growth rate of about 5-6% and thus implying 2x on PEG basis similar to other large-cap peers. Both TCS and Infosys are too trading on 2x of their CC growth rate of 10% and 7.5% CAGR over FY18-21E - assuming no margin impact over this period. We believe that as the organic/inorganic discussion becomes a thing of past, the stock may see a significant multiple upgrade, and the near-term trigger for the same could be HCL Tech's annual guidance after its Q4FY19 earnings release.

Sales growth multiplier: In an era of declining revenue growth rates, superior growth attracts premium valuations over peers. HCL Tech, with its committed growth through its recent inorganic announcement, has secured significant growth already for FY20/21 (about ~7%+ on the run rate that it expect to close in FY19). Technically, in our calculations, HCL would be definitely delivering better-than-industry growth rate of 7% over FY19-21E, even if we assume a modest 4%+ organic growth rate over the same period. Based on our estimates, the stock should trade at 2x of its sustained long-term sales growth rate of 7% as we believe that after the consummation of these IP assets, it should deliver 7%+ growth rate organically. So, the valuations should be around 14x on its earnings. That will value the business same as our valuations on a PE basis.

Cash-flow discounting (DCF): The best valuation metrics in our opinion for HCL Tech in the current scenario is DCF, as it would neutralize the concerns related to the amortization policy of the company. In addition, the concerns around balance-sheet sponsored growth of HCL Tech gets partially addressed as one would look the trends on long chart. HCL had made significant investments of OCF into business during FY09-FY12, however as it curtailed some of these investments the FCF profile improved materially over FY12-15, leading to four-fold jump in the stock price. The current valuations are implying about 6% growth rates for EBIDTA over FY19-23E, which is much conservative compared with its past performance and the current business visibility (10.5% growth guidance for FY19 and acquisition that would imply another ~2% CAGR over FY19-23E). Based on our TP, the company needs to grow its cash-flow just by 5% on a long term basis, which is quite conservative. If the company continues to grow its OCF by 8% over FY19-23E, the FCF would grow by more than 13% as capex would normalize to Rs20-25bn, if it does not invest furthermore in new IP purchases. So effectively, the stock is trading at about 10% cash-flow yields on in its FY22E FCF.

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Re-rating in the offing

HCL Tech's valuations are getting impacted by the overhang around the likely outcome of its large investments in IP portfolio. The current stock prices are indicative the Street's view that the IP investments are bad capital allocations and may not improve profit/cashflow ability of the business. Thus, any positive inputs toward these investments may act as a strong trigger for the stock. Tech Mahindra was in a similar situation when it acquired Satyam, resulting in suppressed valuations amid concerns about growth, margins, and contingent liabilities (class-actions, tax disputes, infringements, etc.). However, as things settled over FY12 and FY13, the stock witnessed 300%+ returns over the next 40 months. In our view, with regard to HCLT the concerns and uncertainties are relatively less grave compared with the Tech Mahindra-Satyam. Thus, the positives should kick in as some of the following events materialize and may act as re-rating triggers going forward:

- IMS growth improves further in H2FY19 - either in Q3 or Q4 earnings
- Organic growth rate improves in its annual guidance for FY20 in Apr'19.
- Growth rate improves for IP assets across products (currently 2 out of 4 IP assets are growing).
- HCL Tech may come forward and commits that there would not be any meaningful investments toward IP/acquisitions in CY19/20.

Case study: Tech Mahindra's acquisition of Satyam (April 2009, at Rs58 per share for a 51% stake for Rs29bn – estimated revenues were about USD1.3bn with an OPM of 3% (reported USD1.8bn before the fraud was detected). On the day of the announcement, Tech Mahindra's stock rose to Rs400 from Rs312 as it gave bid for Satyam (CMP was Rs45).

Exhibit 77: Tech Mahindra price movement study post Satyam acquisition and eventual re-rating

Date	Event	Price for Tech Mahindra
July'06-07	TechM IPO launched Rs315-365. Listing gains extended and stock rallied with markets.	High of Rs2000 achieved in six months of listing
April'09	TechM emerged as highest bidder for Satyam at Rs58 per share.	Rs349
October'10	Announced reinstated results for FY09, FY10 and audited H1FY11 results (with a 1 quarter lag). The run was market-led post the election results in mid-2009.	Rs760
April'11	Satyam settles class-action suits filed in the US for US$125mn	Rs680
March'12	Announced swap ratio of 1 TechM share for 8.5 share of Satyam	Rs666
April'13	Tech Mahindra to announce merged financials with Satyam and shared aspirational vision of $5bn revenues by 2015.	Rs950
Jun'14	Tech Mahindra made new life-high after 7 years as it made strong growth both organic as well as through acquisition.	Rs2100
Jan'15	Tech Mahindra continued as it added growth organically as well as inorganic (Complex IT, MES, LCC, and Sofgen)	Rs2850

Source: Company, Emkay Research

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Differentiated strategy working out as planned

Improved commentary, confident on better H2 performance

With about 65% of incremental revenues coming from organic growth, HCL Tech improved its organic growth outlook by indicating larger organic contribution in FY19 vs. its earlier expectation for about 50-50% contribution from organic and inorganic means. With regard to IMS, which accounts for about 30% of sales, HCL Tech expects less pricing erosion in FY20 as it expects 1) relatively lower number of renewals in FY20 vs. FY19; and 2) improvement in market share with ongoing vendor consolidation. Order bookings and pipeline continue to remain strong. Q2 bookings were above the average for the last four quarters and qualified pipeline is up ~10% qoq. While HCL Tech maintained its margin guidance in the range of 19.5-20.5%, we believe that in the absence of wage hikes, visa costs, and significant INR depreciation, margins will have a positive bias to drift toward the higher end of the band. In Q3FY19, strong growth in IP revenues should more than offset furloughs and lower number of working days. We have built in 3% sequential growth in CC terms for HCLT on a favorable seasonal environment for the IP business in the quarter.

Business update: Mode 2 and Mode 3 Commentary

Mode2: HCL Tech indicated that enterprises are now moving from Proof-of-Concept (POC) to large digital transformations. HCL Tech indicated that clients are rationalizing existing vendors (vendor consolidations) based on their capabilities and its early investments and proof cases are helping it emerge as a clear winner. This is resulting in continued large-deal win momentum in large-scale projects — both with existing clients and new clients — across different industries and geographies. On lower margins in Mode-2 services (10.8% in Q2FY19 vs. 14.8% in Q1FY19), HCL Tech stated that while gross margins are better in Mode-2 services, the ongoing investment in SG&A expenses, in an attempt to spur growth, will continue the volatility in Mode-2 margins.

Mode3 – recent acquisition announcement: HCLT announced a landmark deal with IBM for a total consideration of about USD1.8bn, which is expected to add incremental revenues of approx. USD625mn after completion, with estimated EBIDTA margins of about 50%. The deal could also lead to an EPS accretion of about 5-10% when consummated entirely by Jun'19.

Under the deal, HCLT will acquire 100% ownership in eight product IPs in fast-growing areas such as Security, Marketing and Commerce. The total consideration of about USD1.8bn (including earn-outs) will be made in two equal tranches in Jun'19 and Jun'20. The deal should add significant traction to HCLT's Mode 3 (IP-led) business and should increase its contribution to the overall revenues to 17% from the current level of about 11%. All acquired products are highly rated ─ Top-3 in respective categories ─ with large customer bases and come with well-spread geographical reach. The transaction will add more than 5000 enterprise customers to HCL Tech's roster and will create significant cross-selling opportunities for the company.

As part of the deal, HCLT will take over the sales/development teams, and over a period of time, it will try to 1) enhance the salability of the products through R&D; 2) lower cost of operations; 3) control client attrition; and 4) drive growth by increased software sales, SaaS-based opportunity and services potential around it.

Commentary post Q2 earnings on Mode 3: Mode-3 revenues grew ~10% qoq in CC terms and reached a critical milestone of USD1bn+ annualized revenue run-rate. HCL Tech stated that Mode-3 IPs are aligning well with its Mode 1&2 services, helping it win large transformational deals. It recently won one such deal with one of the largest US banks. In addition, its third wave of IP releases — continuous re-engineering of acquired IPs — is helping it improve retention and client stickiness, resulting in improved product ratings. On organic IPs, HCL Tech stated that it has formed a 100+ member product sales team which is helping it improve the traction for its products in new and undiscovered geographies. Some of these products are also being taken to the market independently — through independent sales teams — and some have found places in product catalogues of enterprise platform vendors such as SAP, indicating strong potential growth opportunities in the future.

Margins: Mode2/3 contributed about 28% of total revenues in Q2FY19. Mode1 margins improved 130bps qoq compared with company-level margins of about 20.0%. Mode-2 (Digital) margins were low due to significant investments in talent and capability building. Over-investments in the initial stages of new projects to develop referenceable proof cases also led to low margins in Mode-2 services.

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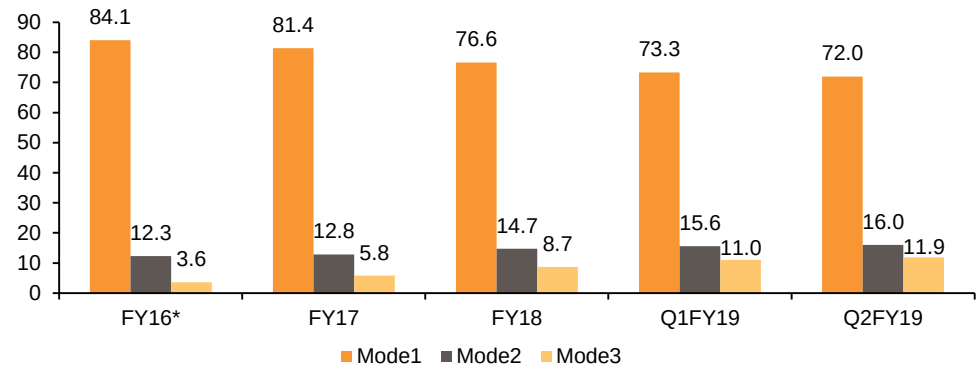
Exhibit 78: Mode 1-2-3 quarterly revenue and margin comparison

Revenue contribution (%)	Q1FY19	Q2FY19
Absolute Revenues (USD mn)		
Mode 1	1,506	1,511
Mode 2	321	336
Mode 3	226	250
Overall	**2,052**	**2,097**
CC qoq growth (%)		
Mode 1	0.5	1.4
Mode 2	8.2	5.3
Mode 3	11.7	10.4
Overall CC growth	**2.7**	**3.0**
EBIT Margin (%)		
Mode 1	19.9	21.2
Mode 2	14.8	10.8
Mode 3	25.2	24.4
Overall	**19.7**	**20.0**

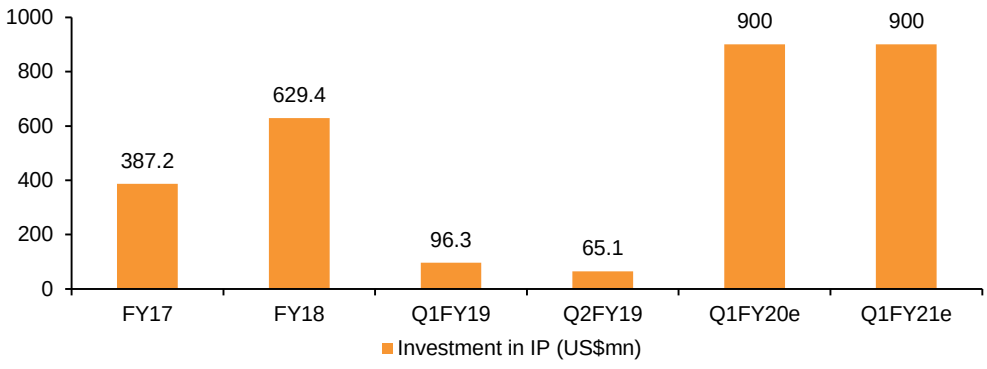
Source: Company, Emkay Research

Exhibit 79: Mode 2/3 services revenue contribution has been increasing continuously



Source: Company, Emkay Research

Exhibit 80: HCL Tech has further committed about US$1.8bn towards IP purchase from IBM scheduled to be paid in Jun'19 and Jun'20 (two equal tranche)



Source: Company, Emkay Research, Emkay Research

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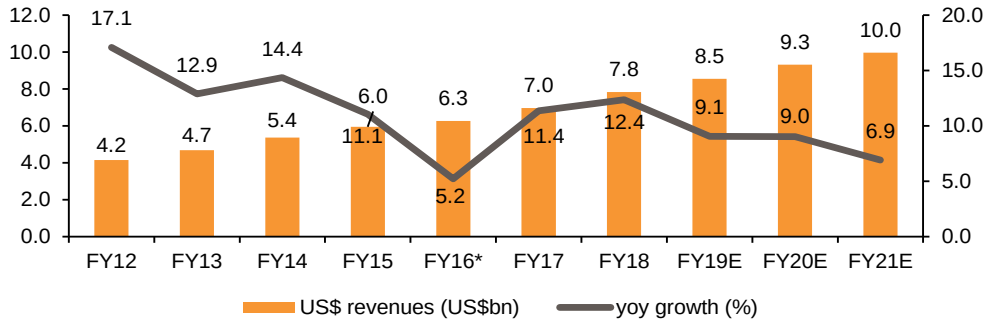
Business performance on track in H1FY19

Revenue guidance: With 17 new transformational deals — broad based and not including renewals — HCL highlighted that deal bookings in Q2FY19 were above the average of last four quarters and will help it deliver strong growth in the long term. For FY19, HCL Tech maintained its CC revenue growth guidance of 9.5-11.5% and margin guidance of 19.5-20.5% as it expects benefits from new deal ramp-up into revenues to start flowing toward H2FY19/FY20 start, i.e., at an average lag of four months.

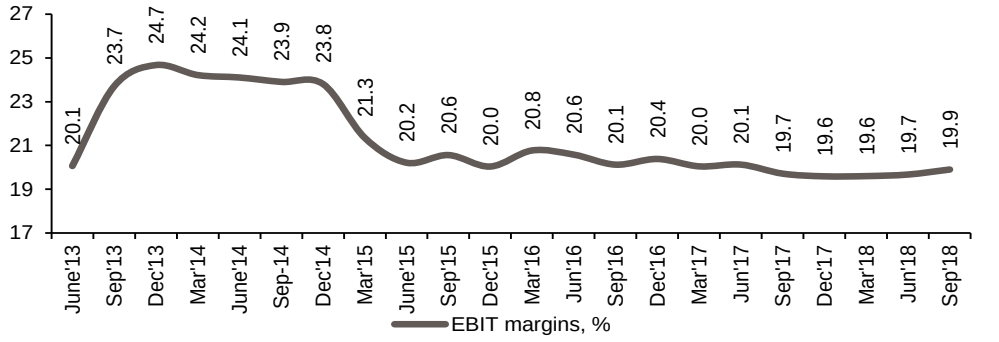
Exhibit 81: HCL has delivered on growth irrespective of Industry fluctuations over the years



Source: Company, Emkay Research

Margins: HCL Tech reiterated its margin guidance of 19.5-20.5% as it intends to direct some of the INR depreciation benefits toward digital investments such as Innovation centers and expects an increase in costs as new deals ramp up**.**

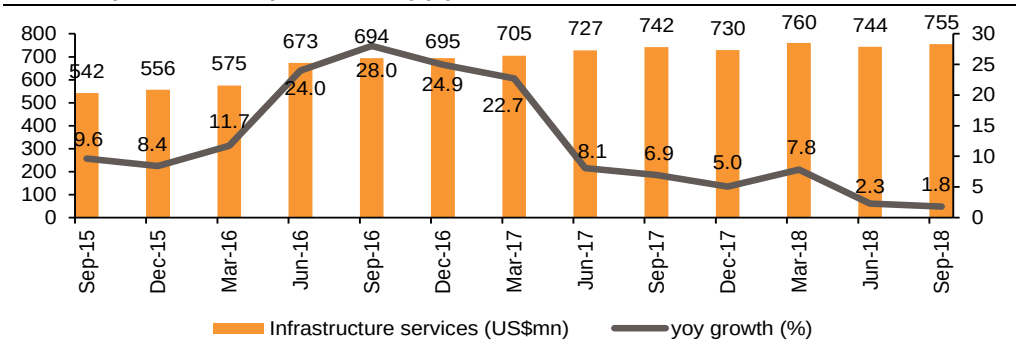
Exhibit 82: EBIT margins have remained stable despite many acquisitions



Source: Company, Emkay Research

IMS Service line (~36% of sales): HCL Tech stated that while pricing pressures in contract renewals continue to plague the growth of this service line, it feels more confident to see revival in this service line on the back of its recent large transformational deal wins in the space. HCL Tech indicated that customer spends are shifting, and not diminishing, toward clouds, digital-workplace, platform-based infrastructures (from core Infra), and software-defined data centers. The company also indicated that it is now rightly positioned to capture increased spends and gain market share.

Exhibit 83: After an exceptional FY17 show, IMS has been slow but is expected to pick up with recent deal wins (Nokia and P&G) and a healthy pipeline



Source: Emkay Research, Company

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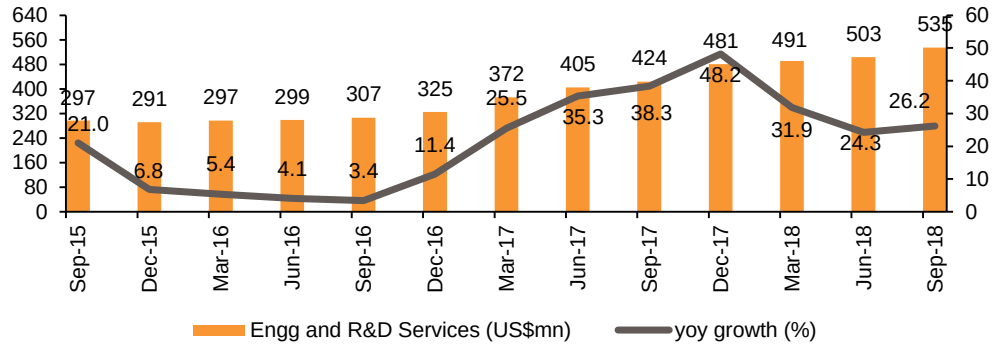
E,R&D service line (about 25% of sales): Organic growth in E,R&D space is expected to pick up with strong deal wins and healthy pipeline. It expects its recent acquisition H&D (Germany) to help it post good growth in the Automobile engineering and IMS space as well, with the entry into German clients starting in Q3FY19.

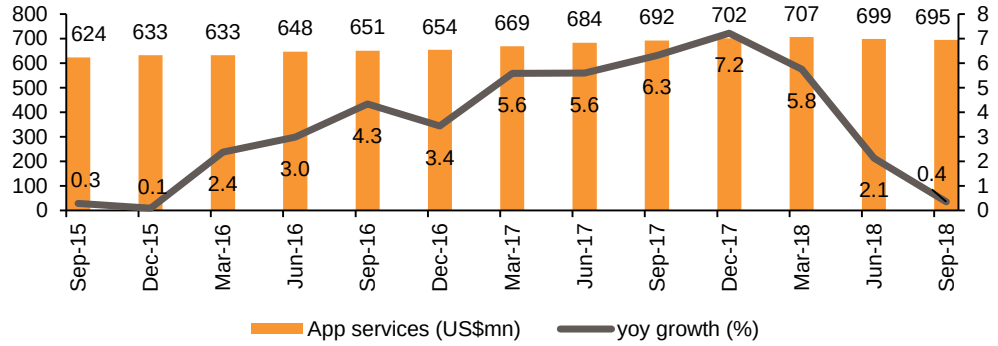
Exhibit 84: E,R&D has posted strong growth for quite some time now



Source: Company, Emkay Research

Applications Service line (34% of sales): HCL Tech reiterated that while it is seeing good deal momentum in the new areas, its overall growth in IMS and ADM areas has been affected due to pricing pressures in contract renewals. HCL Tech is seeing pressure on some of the traditional areas but its digital practice is displaying hope. Q2FY19 performance was poor due to disappointment in couple of financial services clients.

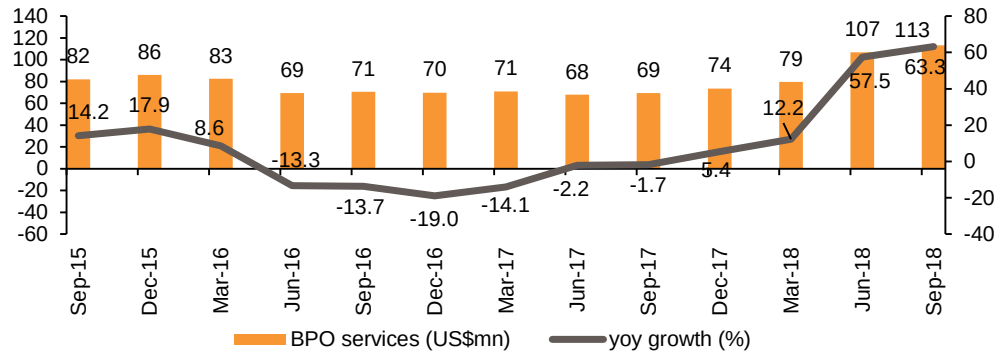
Exhibit 85: Growth in ADM has been weak due to pricing pressures in contract renewals



Source: Company, Emkay Research

BPO service line (~5% of sales) grew about 63% yoy, thanks to additional revenues from its recent acquisition of C3i in the Lifesciences vertical.

Exhibit 86: BPO service line has picked up well*



*Source: Company, Emkay Research., *June'18 nos include contributions from its C3i acquisition*

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Exhibit 87: Change in estimates

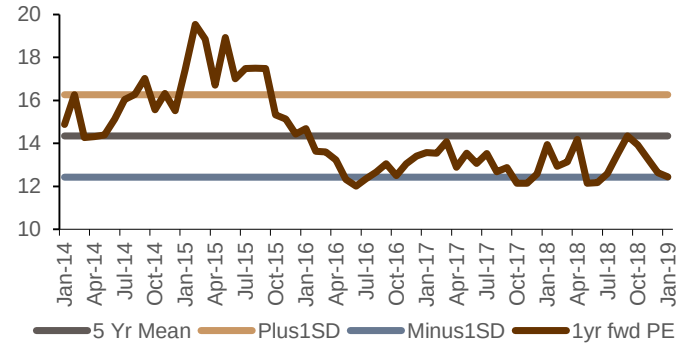
(All fig in Rs mn except EPS)	FY19E			FY20E			FY21E		
	Old	New	% change	Old	New	% change	Old	New	% change
Revenues(US$ mn)	8,518	8,518	0.0	9,522	9,367	-1.6	10,349	10,329	-0.2
YoY growth, %	*8.7%*	*8.7%*		*11.8%*	*10.0%*		*8.7%*	*10.3%*	
Revenues	599,468	599,468	0.0	685,553	669,705	-2.3	745,159	754,037	1.2
EBIT	120,527	120,385	-0.1	138,255	133,860	-3.2	150,491	150,347	-0.1
EBIT mgns, %	*20.1*	*20.1*		*20.2*	*20.0*		*20.2*	*19.9*	
Net profits	102,194	102,285	0.1	111,017	108,960	-1.9	119,288	119,373	0.1
EPS	75.4	75.5	0.1	84.1	82.5	-1.9	90.3	90.4	0.1

Source: Company, Emkay Research

Valuation

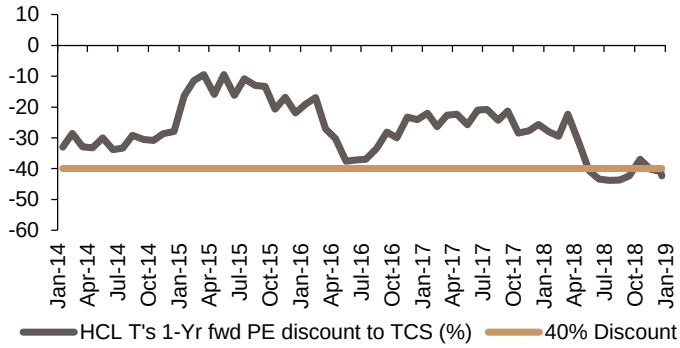
HCL Tech commentary turned significantly optimistic as it expects the organic growth momentum to accelerate going forward given sustained strong deal bookings recorded in Q2FY19. With improved organic growth outlook, reassurance on IMS recovery, sustained order intake, growth acceleration in the Mode 3 business, and reasonable valuations (~12x on a TMF basis), we continue to maintain HCL Tech as our top pick among Tier-I names, with a target price of Rs1,265, valued the stock at 14x on FY21'E EPS.

Exhibit 88: HCL Tech's 5-Yr historical 1-Yr fwd PE chart



Source: Company, Emkay Research

Exhibit 89: HCL Tech's 1-Yr fwd PE discount to TCS



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**467,220**	**505,700**	**599,468**	**669,705**	**754,037**
Expenditure	**364,130**	**391,300**	**458,095**	**509,070**	**570,042**
EBITDA	**103,090**	**114,400**	**141,372**	**160,635**	**183,995**
Depreciation	8,340	14,520	20,987	26,776	33,649
EBIT	**94,750**	**99,880**	**120,385**	**133,860**	**150,347**
Other Income	9,340	11,110	9,561	5,833	4,684
Interest expenses	0	0	0	0	0
PBT	**104,090**	**110,990**	**129,946**	**139,692**	**155,030**
Tax	19,520	23,170	27,662	30,732	35,657
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	0	0	0	0	0
Reported Net Income	**84,570**	**87,820**	**102,285**	**108,960**	**119,373**
Adjusted PAT	**84,570**	**87,820**	**102,285**	**108,960**	**119,373**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	2,854	2,784	2,712	2,642	2,642
Reserves & surplus	326,644	365,384	414,716	465,898	566,254
Net worth	**329,498**	**368,168**	**417,427**	**468,540**	**568,896**
Minority Interest	**0**	**0**	**0**	**0**	**0**
Loan Funds	**14,779**	**4,371**	**4,371**	**4,371**	**4,371**
Net deferred tax liability	0	0	0	0	0
Total Liabilities	**344,277**	**372,539**	**421,798**	**472,911**	**573,267**
Net block	**44,462**	**51,847**	**65,360**	**124,064**	**180,935**
Investment	**137,408**	**99,895**	**102,245**	**106,645**	**111,445**
Current Assets	**275,824**	**332,609**	**375,005**	**371,613**	**417,899**
Cash & bank balance	13,211	16,939	40,835	16,143	37,429
Other Current Assets	176,844	219,276	219,276	219,276	219,276
Current liabilities & Provision	**113,417**	**111,812**	**120,812**	**129,412**	**137,012**
Net current assets	**162,407**	**220,797**	**254,193**	**242,201**	**280,887**
Misc. exp	0	0	0	0	0
Total Assets	**344,277**	**372,539**	**421,798**	**472,911**	**573,267**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**105,420**	**110,240**	**129,946**	**139,692**	**155,030**
Other Non-Cash items	2	(50)	(50)	(50)	(50)
Chg in working cap	3,190	(12,340)	(11,850)	(17,100)	(22,200)
Operating Cashflow	**89,952**	**83,230**	**111,372**	**118,586**	**130,772**
Capital expenditure	(43,190)	(55,740)	(34,500)	(85,480)	(90,520)
Free Cash Flow	**46,762**	**27,490**	**76,872**	**33,106**	**40,252**
Investments	(1,030)	29,440	0	0	0
Other Investing Cash Flow	5,890	3,470	0	0	0
Investing Cashflow	**(38,330)**	**(22,830)**	**(34,500)**	**(85,480)**	**(90,520)**
Equity Capital Raised	0	(35,140)	(40,012)	(42,000)	0
Loans Taken / (Repaid)	(4,280)	(1,640)	0	0	0
Dividend paid (incl tax)	(40,690)	(20,310)	(13,014)	(15,848)	(19,017)
Other Financing Cash Flow	(570)	470	0	0	0
Financing Cashflow	**(45,740)**	**(56,670)**	**(53,026)**	**(57,848)**	**(19,017)**
Net chg in cash	**5,882**	**3,730**	**23,846**	**(24,742)**	**21,235**
Opening cash position	7,330	13,210	16,989	40,885	16,193
Closing cash position	**13,211**	**16,939**	**40,835**	**16,143**	**37,429**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	22.1	22.6	23.6	24.0	24.4
EBIT Margin	20.3	19.8	20.1	20.0	19.9
Effective Tax Rate	18.8	20.9	21.3	22.0	23.0
Net Margin	18.1	17.4	17.1	16.3	15.8
ROCE	32.6	31.0	32.7	31.2	29.6
ROE	28.0	25.2	26.0	24.6	23.0
RoIC	56.4	44.5	45.1	42.6	38.8

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	59.9	63.1	75.5	82.5	90.4
CEPS	65.8	73.5	90.9	102.8	115.9
BVPS	233.2	264.5	307.9	354.8	430.8
DPS	28.8	14.6	9.6	12.0	14.4

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	15.7	14.9	12.5	11.4	10.4
P/CEPS	14.5	13.0	10.5	9.3	8.2
P/BV	4.0	3.6	3.1	2.6	2.2
EV / Sales	2.6	2.4	1.9	1.7	1.5
EV / EBITDA	11.6	10.5	8.0	7.0	6.0
Dividend Yield (%)	3.1	1.6	1.0	1.3	1.5

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.4)	(0.3)	(0.3)	(0.3)	(0.3)
Net Debt/EBIDTA	(1.3)	(1.0)	(1.0)	(0.7)	(0.8)
Working Cap Cycle (days)	72.0	72.1	62.3	58.1	53.2

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	12.5	8.2	18.5	11.7	12.6
EBITDA	13.5	11.0	23.6	13.6	14.5
EBIT	11.6	5.4	20.5	11.2	12.3
PAT	11.9	3.8	16.5	6.5	9.6

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	128,080	131,790	138,780	148,610	154,723
EBITDA	29,640	30,360	32,260	34,990	36,515
EBITDA Margin (%)	**23.1**	**23.0**	**23.2**	**23.5**	**23.6**
PAT	21,940	22,290	24,040	25,400	26,275
EPS (Rs)	**15.7**	**16.0**	**17.3**	**18.2**	**19.4**

Source: Company, Emkay Research

Shareholding Pattern (%)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	60.1	60.2	60.2	60.2	60.2
FIIs	25.3	25.6	26.5	26.2	28.0
DIIs	9.9	10.5	9.8	9.7	8.2
Public and Others	4.7	3.7	3.5	3.9	3.7

Source: Capitaline

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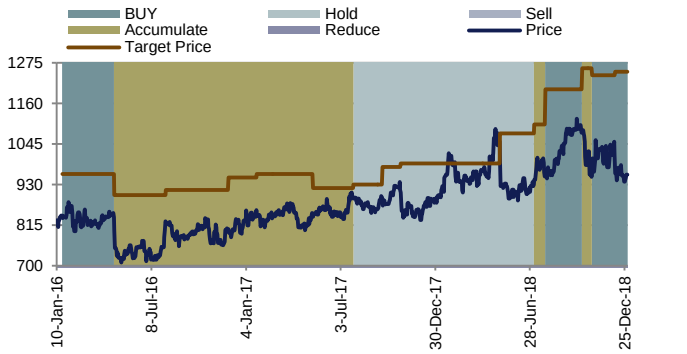
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	962	1,265	12m	Buy	Rahul Jain
7-Dec-18	962	1,250	12m	Buy	Rahul Jain
24-Oct-18	981	1,240	12m	Buy	Rahul Jain
5-Oct-18	1,084	1,260	12m	Accumulate	Rahul Jain
27-Jul-18	963	1,200	12m	Buy	Rahul Jain
10-Jul-18	980	1,100	12m	Accumulate	Rahul Jain
6-Jul-18	944	1,100	12m	Accumulate	Rahul Jain
2-May-18	1,001	1,075	12m	Hold	Rahul Jain
5-Apr-18	962	990	12m	Hold	Rahul Jain
19-Jan-18	958	990	12m	Hold	Rahul Jain
25-Oct-17	907	990	12m	Hold	Rahul Jain
4-Oct-17	887	980	12m	Hold	Rahul Jain
20-Sep-17	889	980	12m	Hold	Rahul Jain
27-Jul-17	890	930	12m	Hold	Rahul Jain
10-Jul-17	850	920	12m	Accumulate	Rahul Jain
11-May-17	839	920	12m	Accumulate	Manik Taneja
24-Jan-17	849	960	12m	Accumulate	Manik Taneja
1-Dec-16	803	950	12m	Accumulate	Manik Taneja
21-Oct-16	832	915	12m	Accumulate	Manik Taneja
24-Aug-16	790	915	12m	Accumulate	Manik Taneja
4-Aug-16	824	915	12m	Accumulate	Manik Taneja
21-Jun-16	770	900	12m	Accumulate	Manik Taneja
28-Apr-16	800	900	12m	Accumulate	Manik Taneja
20-Jan-16	842	960	12m	Buy	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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Wipro

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Margins improve, yet growth overhang remains

CMP	Target Price
Rs 324 as of (January 8, 2019)	Rs 300 (■) 12 months
Rating	**Upside**
REDUCE (■)	(7.5) %

- Wipro has endured continued growth underperformance (~250-300bps lower than the industry) due to continuous low-margin business hive-offs (Eco-Energy and Data Center - USD150mn annualized revenues); ongoing restructuring in India and the Middle East (although the impact is not quantified); client insolvencies (USD50mn); and macro uncertainties around the Affordable Care Act (ACA) in the US (HPS annualized run-rate down by USD130mn).
- Adjusted for all its recent acquisitions and hive-offs, Wipro delivered organic CAGR of about ~3% in the last five years while overall EBIT growth was negligible in CC terms. It has been progressing well on its 6-themed strategy and gaining good traction for its Digital services (~30% of sales). However, growth in rest of the business (70% of sales) has been a challenge (See Exhibit 92) and is witnessing flat to negative growth.
- Going ahead, Wipro has guided its quarterly EBIT margin to be around Q2FY19 margin levels (i.e., 18.0% vs. adj. EBIT margin of 16.8% in FY18) as it sees further scope of improvement in utilization, automation and profitability from its subsidiaries.
- With no incremental improvement in growth commentary amid signs of mixed macros outlook and a continuation of right-sizing moves, our estimates remain largely unchanged. We assign a 35% discount to our benchmark PE multiple (20x) due to below-par growth performance and have a Reduce rating, with a TP of Rs300 (13x FY21 EPS).

Right-sizing driving margins up, but no new concerns are in estimates

We believe that the overhang on overall revenue growth is expected to continue for some more time with ongoing restructuring and healthcare vertical business (HPS) uncertainty. In addition, tumbling oil prices over the last two months and rising uncertainty over ACA in the US are likely to impact Wipro more than its peers due to its greater exposure. Even as Wipro's growth challenges remain, a good likely improvement of ~250bps qoq in its H2FY19 adjusted margins is a strong positive sign. Wipro has attributed margin growth to improvements in utilization, automation and profitability of its subsidiaries and has indicated margins to remain within the narrow band of 18%. The growth rates are expected to improve and OPM are also expected to stay at the improved levels of FY19. However, we have a relative lower confidence on these estimates as Wipro has quite often announced several negative surprises in past hampering the actual performance that is much lower than estimates.

Wipro's underperformance relative to peers to continue; Reduce

Even though a positive move, we believe that divestments of its slow-growing businesses will continue to hamper Wipro's near-term growth rates. Thus, will take some more time to match the industry-level growth rates (which is most likely by the end of FY20). We assign a Reduce rating, with a target price of Rs300 (based on 13x FY21 EPS).

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	554,179	546,359	594,779	643,666	683,495
EBITDA	89,797	84,294	93,912	109,482	117,166
EBITDA Margin (%)	16.2	15.4	15.8	17.0	17.1
APAT	82,723	80,046	84,677	98,252	105,363
EPS (Rs)	17.1	17.7	18.8	21.8	23.3
EPS (% chg)	(5.8)	4.0	5.7	16.0	7.2
ROE (%)	16.8	16.0	16.8	17.8	17.4
P/E (x)	19.0	18.3	17.3	14.9	13.9
EV/EBITDA (x)	15.2	15.4	13.3	11.0	9.8
P/BV (x)	3.0	3.0	2.8	2.5	2.3

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	(0.1)/(0.6)
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	REDUCE

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	18.8	21.8
Consensus	19.5	21.9
Mean Consensus TP (12M)	Rs 322	

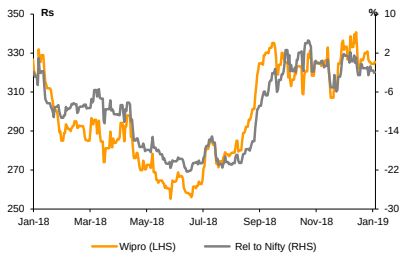
Stock Details	
Bloomberg Code	WPRO IN
Face Value (Rs)	2
Shares outstanding (mn)	4,525
52 Week H/L	344 / 254
M Cap (Rs bn/USD bn)	1,467 / 21.02
Daily Avg Volume (nos.)	4,012,040
Daily Avg Turnover (US$ mn)	18.6

Shareholding Pattern Sep '18	
Promoters	74.3%
FIIs	8.5%
DIIs	7.3%
Public and Others	9.9%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(3)	-	23	5
Rel. to Nifty	(3)	(5)	23	3

Relative price chart



Source: Bloomberg

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ED: ANISH MATHEW SA: DHANANJAY SINHA

No new negatives may bring it back on track

Wipro's recent past performance has been constantly hampered by several macro-specific (Oil prices, client insolvencies) and company specific impact (poor renewal rates on traditional business). Even its inorganic effort have not delivered desired result as most of these entities – Cellent, Designit, Promax, Opus, Atco – eventually struggled to grow beyond a point. However, its recent investment in the Alight Solutions resulted into a large deal win from the client to the tune of US$1.5bn over a 10 year period. The current right-sizing strategy, improved deal wins and its renewed 6-theme strategy would collectively help it come back to 5-6% growth rate in FY20-21E. However, all these estimates assumes no further company specific negatives such as business division hive-offs, client exits, etc.

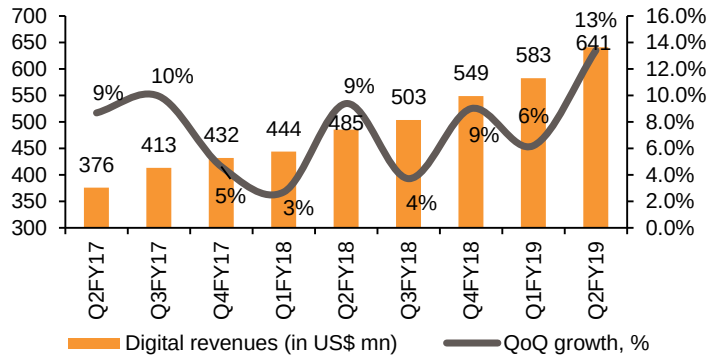
6-Themed strategy: Wipro saved 3.0% efforts (vs. 1.1% efforts in Q1FY19) across its Fixed-Price projects, thanks to automation. Wipro funded two new companies in the eco-system and now has a headcount of 63,000 (vs. 57,000 employees in Q1FY19) on its cloud sourcing platform 'Topcoder'. Wipro has so far re-skilled 102,000 employees in Digital (vs. 97,000 employees at the end of Q1FY19). So far, it has filed 2,071 patents (vs. 2,042 patents at the end of Q1FY19), off which, 40% are in new-age technologies such as AI/NLP and wireless.

Exhibit 90: CEO 6-themed strategy

Period	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19	Q2FY19
Efforts savings- No. of FTE#	1100-L1	3200-L1	2700-L1	5000-L1	2100-L2	2500-L2	1500-L2	1900-L2	-	
Wipro Holmes engagements (No.)	35	70	120	140	175	250	275	320	-	
Digital (% of sales)	17.9	19.6	21.7	22.1	22.5	24.1	-	26.7	28.0	31.4
US Localisation (% of employees)	-	-	-	-	50	52	>55	>55	58.0	>60.0
Eco-system Wins	-	-	-	10	25	18	7	18	-	
Adroit training (sales)- Client Mining	200	488	700	1000	-	-	-	-	-	
Non-Linearity (No of patents)	900	1000	1353	1662	1709	1789	1862	-	2042	2071

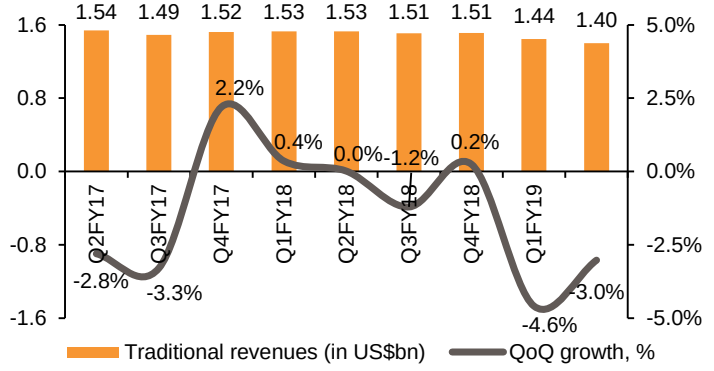
Source: Company, Emkay Research

Exhibit 91: Digital growth has been healthy…..



Source: Emkay Research, Company

Exhibit 92: Disappointing growth in rest of the business



Source: Emkay Research, Company

Exhibit 93: Change in estimates

(All fig in Rs mn except EPS)	FY19E			FY20E			FY21E		
	Old	New	% change	Old	New	% change	Old	New	% change
IT Services Revenues(US$ mn)	8,222	8,193	-0.4	8,677	8,617	-0.7	9,243	9,179	-0.7
US$ revenues growth YoY, %	*2.0%*	*1.6%*		*5.5%*	*5.2%*		*6.5%*	*6.5%*	
Company Wide Revenues	595,178	594,779	-0.1	648,309	643,666	-0.7	688,400	683,495	-0.7
EBIT	94,028	93,912	-0.1	110,223	109,482	-0.7	117,962	117,166	-0.7
EBIT mgns, %	*15.8*	*15.8*		*17.0*	*17.0*		*17.1*	*17.1*	
Net profits	84,768	84,677	-0.1	98,829	98,252	-0.6	105,982	105,363	-0.6
EPS	18.8	18.8	-0.1	21.9	21.8	-0.6	23.5	23.3	-0.6

Source: Company, Emkay Research

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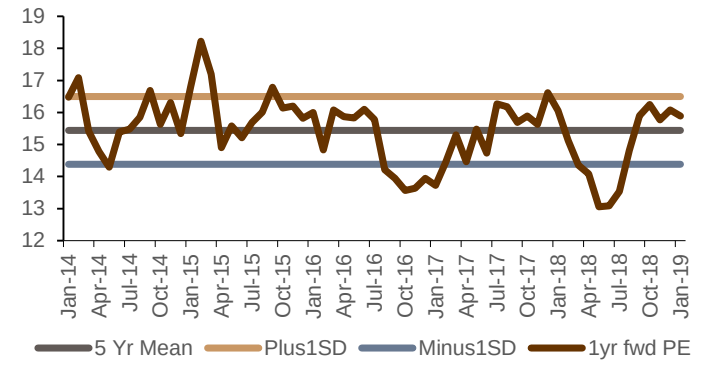
Valuation

Although margin performance and commentary have improved significantly, macro uncertainties and ongoing internal reshuffle continue to plague near-term growth overhang. We believe that divestments of its slow-growing businesses will continue to impact near-term growth rates.

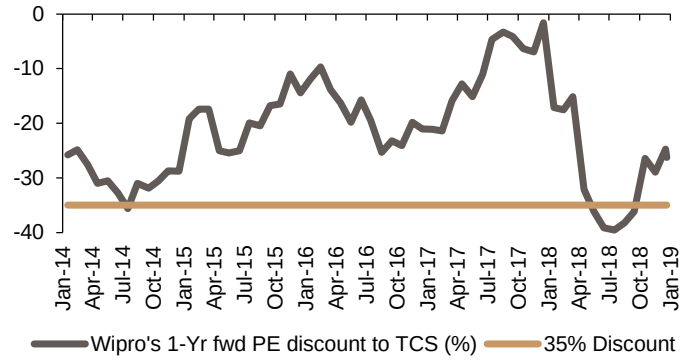
Wipro will take some more time to match the industry-level growth rates (which is most likely by the end of FY20). We now assign a Reduce rating, with a target price of Rs300 (based on 13x FY21 EPS) as we expect the company to continue its underperformance for some more time.

Exhibit 94: 5-yr Historical 1-yr fwd PE chart



Source: Company, Emkay Research

Exhibit 95: Wipro's 1-yr fwd PE discount to TCS



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**554,179**	**546,359**	**594,779**	**643,666**	**683,495**
Expenditure	**464,382**	**462,065**	**500,867**	**534,183**	**566,328**
EBITDA	**89,797**	**84,294**	**93,912**	**109,482**	**117,166**
Depreciation	0	0	0	0	0
EBIT	**89,797**	**84,294**	**93,912**	**109,482**	**117,166**
Other Income	18,388	18,169	15,126	16,806	18,293
Interest expenses	0	0	0	0	0
PBT	**108,185**	**102,463**	**109,038**	**126,288**	**135,460**
Tax	25,214	22,390	24,718	28,036	30,072
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	248	27	(358)	0	25
Reported Net Income	**82,723**	**80,046**	**84,677**	**98,252**	**105,363**
Adjusted PAT	**82,723**	**80,046**	**84,677**	**98,252**	**105,363**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	4,861	9,048	9,048	9,048	9,048
Reserves & surplus	515,443	473,888	517,802	568,755	623,396
Net worth	**520,304**	**482,936**	**526,850**	**577,803**	**632,444**
Minority Interest	**2,391**	**2,410**	**2,052**	**2,052**	**2,077**
Loan Funds	**142,412**	**138,259**	**138,259**	**138,259**	**138,259**
Net deferred tax liability	(8,492)	(22,198)	(22,198)	(22,198)	(22,198)
Total Liabilities	**656,615**	**601,407**	**644,963**	**695,916**	**750,582**
Net block	**202,561**	**184,460**	**176,285**	**168,187**	**163,016**
Investment	**299,133**	**257,968**	**257,968**	**257,968**	**257,968**
Current Assets	**267,765**	**277,275**	**343,154**	**412,617**	**480,391**
Cash & bank balance	52,710	44,925	90,577	141,043	193,885
Other Current Assets	67,201	81,058	84,736	89,937	93,629
Current liabilities & Provision	**121,795**	**133,976**	**148,124**	**158,536**	**166,473**
Net current assets	**145,970**	**143,299**	**195,029**	**254,081**	**313,918**
Misc. exp	0	0	0	0	0
Total Assets	**656,615**	**601,407**	**644,963**	**695,916**	**750,582**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**89,797**	**84,294**	**93,912**	**109,482**	**117,166**
Other Non-Cash items	0	0	0	0	0
Chg in working cap	66,152	(18,820)	(6,079)	(8,585)	(6,995)
Operating Cashflow	**92,773**	**43,084**	**63,115**	**72,861**	**80,100**
Capital expenditure	(54,461)	22,919	(16,000)	(16,000)	(16,000)
Free Cash Flow	**38,312**	**66,003**	**47,115**	**56,861**	**64,100**
Investments	(155,347)	41,165	0	0	0
Other Investing Cash Flow	0	0	0	0	0
Investing Cashflow	**(191,420)**	**82,253**	**(874)**	**806**	**2,293**
Equity Capital Raised	(80)	4,187	0	0	0
Loans Taken / (Repaid)	17,191	(4,153)	0	0	0
Dividend paid (incl tax)	(11,673)	(9,634)	(40,764)	(47,299)	(50,722)
Other Financing Cash Flow	46,870	(123,522)	24,175	24,098	61,546
Financing Cashflow	**52,308**	**(133,122)**	**(16,589)**	**(23,201)**	**(29,551)**
Net chg in cash	**(46,339)**	**(7,785)**	**45,652**	**50,466**	**52,843**
Opening cash position	99,049	52,710	44,925	90,577	141,043
Closing cash position	**52,710**	**44,925**	**90,577**	**141,043**	**193,885**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	16.2	15.4	15.8	17.0	17.1
EBIT Margin	16.2	15.4	15.8	17.0	17.1
Effective Tax Rate	23.3	21.9	22.7	22.2	22.2
Net Margin	15.0	14.7	14.2	15.3	15.4
ROCE	17.5	16.3	17.5	18.8	18.7
ROE	16.8	16.0	16.8	17.8	17.4
RoIC	28.5	29.1	33.3	39.0	41.5

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	17.1	17.7	18.8	21.8	23.3
CEPS	17.1	17.7	18.8	21.8	23.3
BVPS	107.3	107.0	116.7	128.0	140.1
DPS	2.0	1.8	7.5	8.7	9.3

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	19.0	18.3	17.3	14.9	13.9
P/CEPS	18.1	17.4	16.5	14.2	13.2
P/BV	3.0	3.0	2.8	2.5	2.3
EV / Sales	2.5	2.4	2.1	1.9	1.7
EV / EBITDA	15.2	15.4	13.3	11.0	9.8
Dividend Yield (%)	0.6	0.5	2.3	2.7	2.9

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.4)	(0.3)	(0.4)	(0.5)	(0.5)
Net Debt/EBIDTA	(2.3)	(2.0)	(2.2)	(2.4)	(2.7)
Working Cap Cycle (days)	61.4	65.7	64.1	64.1	64.1

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	7.3	(1.4)	8.9	8.2	6.2
EBITDA	(7.2)	(6.1)	11.4	16.6	7.0
EBIT	(7.2)	(6.1)	11.4	16.6	7.0
PAT	(7.2)	(3.2)	5.8	16.0	7.2

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	136,815	138,243	140,548	146,627	152,944
EBITDA	19,775	19,385	20,777	20,347	26,109
EBITDA Margin (%)	**14.5**	**14.0**	**14.8**	**13.9**	**17.1**
PAT	19,342	18,041	21,256	18,889	23,358
EPS (Rs)	**4.3**	**4.0**	**4.7**	**4.2**	**5.2**

Source: Company, Emkay Research

Shareholding Pattern (%)	Dec-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	74.3	74.3	74.3	74.3	74.3
FIIs	9.8	9.8	9.3	8.7	8.5
DIIs	5.4	5.4	5.8	6.3	7.3
Public and Others	10.5	10.5	10.6	10.7	9.9

Source: Capitaline

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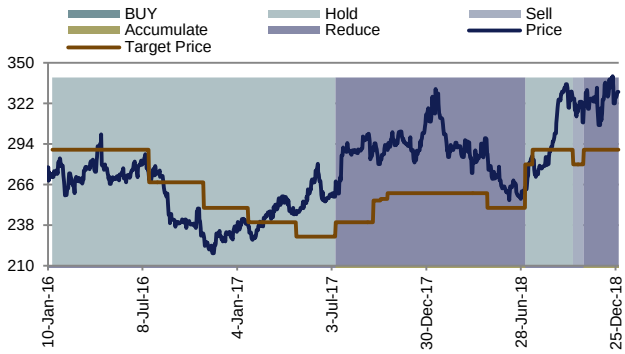
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	327	300	12m	Reduce	Rahul Jain
25-Oct-18	319	290	12m	Reduce	Rahul Jain
5-Oct-18	325	280	12m	Sell	Rahul Jain
20-Jul-18	283	290	12m	Hold	Rahul Jain
10-Jul-18	271	280	12m	Hold	Rahul Jain
6-Jul-18	263	280	12m	Hold	Rahul Jain
25-Apr-18	287	250	12m	Reduce	Rahul Jain
5-Apr-18	286	260	12m	Reduce	Rahul Jain
19-Jan-18	329	260	12m	Reduce	Rahul Jain
17-Oct-17	290	260	12m	Reduce	Rahul Jain
4-Oct-17	283	256	12m	Reduce	Rahul Jain
20-Sep-17	292	255	12m	Reduce	Rahul Jain
21-Jul-17	286	240	12m	Reduce	Rahul Jain
10-Jul-17	268	240	12m	Reduce	Rahul Jain
26-Apr-17	245	230	12m	Hold	Manik Taneja
25-Jan-17	237	240	12m	Hold	Manik Taneja
1-Nov-16	230	250	12m	Hold	Manik Taneja
21-Oct-16	250	268	12m	Hold	Manik Taneja
20-Jul-16	269	268	12m	Hold	Manik Taneja
21-Jun-16	281	290	12m	Hold	Manik Taneja
21-Apr-16	279	290	12m	Hold	Manik Taneja
18-Jan-16	274	290	12m	Hold	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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Tech Mahindra

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IT spends not happening in Tech M's stronghold; 5G story lacks substance

CMP	Target Price
Rs 690 as of (January 8, 2019)	Rs 730 (■) 12 months
Rating	**Upside**
HOLD (■)	5.8 %

- Tech M has maintained its FY19 organic growth outlook at about 5% and 8-10% growth in CC terms for its Telecom segment (42% of sales) and Enterprise segment (58% of sales), respectively, leading to an overall ~7% growth in FY19 (although we have factored in 6% growth) in CC terms. While Tech M's growth outlook has improved qualitatively, unchanged guidance still makes us stick to our cautious stance.
- Expectations of a revival in Telecom growth as a result of the increase in 5G spends is too far-fetched as we believe that Tech M's Telecom superiority is overrated and getting deteriorated (see Exhibit 2 & 3). Our reading of global peers suggests that incremental spends in Communication, Media and Telecom space are happening on the Media and Hi-Tech side, where we see players like Accenture, Cognizant, TCS and Infosys capturing the market.
- With indications of a continuation in its inorganic growth strategy in its Nov'18 Analyst Meet amid increasing supply-side constraints, delay in Telecom pick-up, and steps to curb high attrition, we do not see any significant headroom for future margin improvement.
- While growth outlook improved qualitatively, unchanged guidance and limited scope for further margin improvement, we assign a Hold rating with a TP of Rs730 (based on 13x FY21E EPS; a 35% discount to our benchmark (TCS) PE multiple of 20x).

5G gains are too far-fetched

We believe gains from 5G opportunity are too far-fetched at the moment to be factored in to our estimates for Tech Mahindra. The major reasons for our anti-consensus view on 5G opportunity are 1) 5G is not a Telecom play but across the business vertical play (Industrial); 2) infrastructure and eco-system situation suggests nothing material on cards for next couple of years (the leader in space Huawei is banned in many advanced markets such as the US, UK and Australia due to security concerns); and 3) it lacks big trigger for consumer moment to make it a mass movement that may help adoption. Example: iPhone launch drove the 3G network success. Also, given the ongoing troubles of Apple and Qualcomm, it is highly unlikely that it would be able to launch a handset before H2CY20. While Tech M has indicated increase in its Telecom pipeline (up 20-25% yoy) due to the convergence of Telcos, OTT and Media players, it has maintained its near-term outlook of mid-single digit growth, and has said 5G led opportunity would be big but gradual.

Acquisition-led growth strategy will challenge margin improvement

With unchanged growth outlook and continuation of acquisition-led growth strategy, we largely retain our revenue growth and margin estimates. We believe that structural reasons behind lower-than-peer margins and slightly lower or in-line with industry growth in the near term will force Tech M to trade at a discount (about 35%) to the industry leader TCS. We maintain our Hold rating, with a TP of Rs730 (based on 13x FY21E EPS).

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	291,408	307,729	350,694	381,733	415,113
EBITDA	41,843	47,169	64,265	70,543	76,972
EBITDA Margin (%)	14.4	15.3	18.3	18.5	18.5
APAT	28,410	38,001	43,083	46,529	50,388
EPS (Rs)	31.9	42.7	48.3	52.2	56.5
EPS (% chg)	(7.5)	33.6	13.2	8.0	8.3
ROE (%)	18.4	21.5	21.4	20.5	19.8
P/E (x)	21.6	16.2	14.3	13.2	12.2
EV/EBITDA (x)	13.6	11.8	8.6	7.6	6.8
P/BV (x)	3.7	3.3	2.9	2.6	2.3

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	0.7/(2.2)
Target Price change (%)	-
Target Period (Months)	12
Previous Reco	HOLD

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	48.3	52.2
Consensus	47.5	53.6
Mean Consensus TP (12M)	Rs 834	

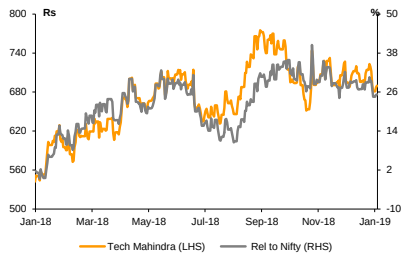
Stock Details	
Bloomberg Code	TECHM IN
Face Value (Rs)	5
Shares outstanding (mn)	981
52 Week H/L	781 / 519
M Cap (Rs bn/USD bn)	677 / 9.66
Daily Avg Volume (nos.)	3,033,311
Daily Avg Turnover (US$ mn)	30.4

Shareholding Pattern Sep '18	
Promoters	36.0%
FIIs	39.2%
DIIs	12.4%
Public and Others	12.4%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(1)	(1)	9	29
Rel. to Nifty	(2)	(5)	8	27

Relative price chart



Source: Bloomberg

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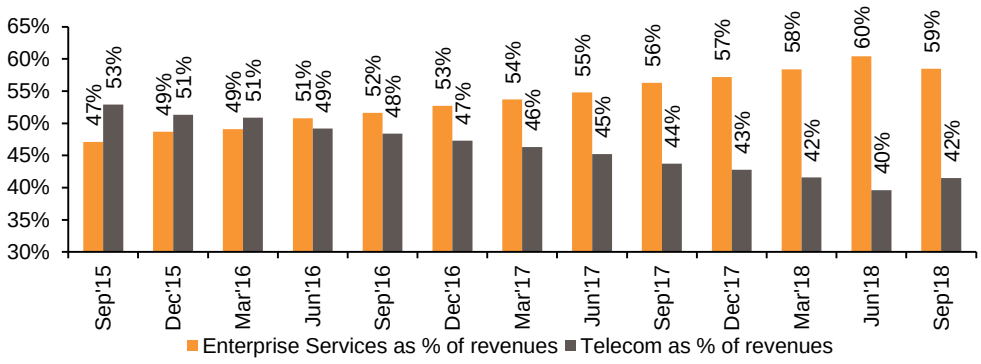
ED: ANISH MATHEW SA: DHANANJAY SINHA

Traditional Telecom still weak; 5G is too far fetched

Telecom (42% of sales): Tech M stated that the pipeline continues to look better (up 20-25% yoy) due to vertical integration and adjacent M&As happening in the telecom industry. While Tech M indicated improvement in pipeline, its growth outlook for this segment remained same at mid-single digit growth in the near term due to the voluntary retirement [divestment] of unprofitable businesses and later-than-expected flow of revenues related to 5G roll-outs. We believe gains from 5G opportunity are too far-fetched at the moment to be factored in for Tech Mahindra. The top few reasons for our anti-consensus view on 5G opportunity are: 1) 5G is not a Telecom play but across the business vertical play; 2) infrastructure and eco-system situation suggests nothing material on cards for next couple of years (the leader in space Huawei is banned in many advanced markets such as the US, UK and Australia due to security concerns); and 3) it lacks big trigger for consumer moment to make it a mass movement that may help adoption. Example: iPhone launch drove the 3G network success. However, given the ongoing troubles of Apple and Qualcomm, it is highly unlikely that it would be able to launch a handset before H2CY20. Tech M has also stated that 5G spends are some time away and are going to be distributed over a long spend cycle.

Exhibit 96: While Telecom saw growth reversal in Q2FY19 but sustenance of growth momentum in coming quarters is key to bringing change in long-term growth outlook



Source: Company, Emkay Research

Telecom superiority is overrated: Exhibit 97 suggests incremental revenue additions by all major global IT service providers in the CMT space. Clearly, Tech M does not seem to have an edge over other peers in Telecom verticals as other peers such as Accenture, Cognizant, TCS and Infosys are doing quite well in terms of growth in this vertical. In addition, its size in this vertical has become comparable (more in case of TCS) to peers. We believe that while spends in the traditional areas have been declining due to automation and consolidation, spends are increasing in new and emerging areas such Media and Hi-Tech where Tech Mahindra is seemingly losing the game to other peers.

Exhibit 97: Peer comparison for Communication, Media and Technology (CMT) revenues

Co. Name	FY17 CMT revenues (US$bn)	FY18 CMT revenues (US$bn)	Absolute revenue addition	Incremental revenue Share (%)	YoY CMT growth (%)	YoY company growth (%)
Accenture	6.6	6.9	269	27.3	4.5	6.0
Cognizant	1.6	1.9	281	28.6	18.8	9.8
TCS	2.6	3.0	360	36.6	13.8	8.6
Infosys*	1.0	1.2	150	15.2	14.9	7.2
Wipro*	0.6	0.5	-53	-5.4	-9.4	4.6
HCL tech*	0.6	0.6	-21	-2.1	-3.4	12.4
Tech M	2.0	2.0	-2	-0.2	-0.1	9.6
Total	**15.0**	**16.1**	**984**	**100.0**	**6.9**	

Source: Company, Emkay Research, Pls note Infosys, Wipro and HCL Tech nos do not include Hi-Tech revenues and only include media and Telecom revenue

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Exhibit 98: Most recent Telecom commentary by major players

Company	Most recent management commentary	Emkay Remarks
Accenture	**Q1FY19 commentary:** "Communications, Media & Technology grew 14% yoy. Continued strong momentum was driven by double-digit growth in software and platforms, which was the primary contributor to overall double-digit growth in North America and the Growth Markets." **Q4FY18 commentary: "**These companies (Telecom clients) are facing significant challenges and you now know they embark in some massive M&A consolidation, and so a lot is happening, including they're all launching new networks. We're moving from – we have been moving from the three to the four to the fifth G. You put the fiber on top of it, so they need to continue investing and, again, they need people like us to support their transformation as well as being an enabler of their network implementation.	**Reading of the top Telecom service providers indicates 1) increasing client spend toward new and emerging verticals such as Media and Hi-Tech vertical and not so much toward traditional services in the communications vertical (which is Tech M's expertise domain). While Tech M in its Nov'18 analyst meet indicated an increase in focus toward the Media vertical, we believe that other peers like Accenture and Cognizant are already ahead of the game and Tech M is lagging behind and may have to do a lot of catch-up; 2) divergence in commentaries related to the ongoing consolidation in the communication service providers' (CSPs) space where some players are indicating an improvement in client spends (Infosys Wipro and HCL Tech) and some are still indicating volatility due to the ongoing consolidation (Accenture, Cognizant and TCS) do not announce summer either. FY18 performance (Exhibit 97) suggests that players with lower burden of traditional services (which is being impacted by vendor consolidation, insourcing and ongoing M&As) have grown at a relatively much faster pace in emerging verticals like Media and Hi-Tech vs. players with large exposure to traditional service lines. While we acknowledge the increase in spending on the network transformation, IOT, and associated digital services, we believe that it will be offset by the compression in traditional services and players with higher baggage of traditional services (Tech Mahindra) will find it challenging to grow faster than industry in this vertical going ahead.**
Cognizant	**Q3CY18 commentary:** Communications, Media and Technology, which had strong year-over-year growth of 17.1%. Within Communications, we are helping clients co-innovate the networks of the future to enable rich complex information to move at speeds more than 30 times faster than what's possible today, leading to a significant improvement in virtual reality, robotics, healthcare, and more. Within Media, analytics has become essential to our clients' long-term success, and in our Technology vertical, content moderation continues to drive client revenue. It's worth noting that in the third quarter, two of our technology clients were part of Cognizant's ten largest clients and both are continuing to grow. "That compares with just three years ago when our entire top ten were either banking or healthcare clients." **Q2CY18 commentary:** "Let's take a closer look at how our verticals performed, starting with our Communications, Media and Technology, which had strong year-over-year growth of 15.8%. This performance came mostly from our Technology and Media clients and offset slower growth with our clients in the Communications industry, where consolidation and M&A activity are under way"	
TCS	**Q1FY19 commentary:** Communications vertical continues to generate lot of fresh investment post its consolidation phase. As we saw in most of these markets, the CSP universe which was a significant segment of our customer base has gone through a series of consolidation exercises and now have switched into market making and investment mode, and we are participating in their investment cycle - both from an engineering perspective, where they are trying to essentially up their infrastructure to provide smart infrastructure play as well as on the digital market place and digital ecosystem driver kind of path where we are working a lot with them in enabling a much more holistic product suite to their customer set. So, the Communications vertical we are quite positive on, and we think that it should continue across most of the developed markets. **Q2FY19 commentary:** Tech and Coms is an area which is quite volatile, if you look at Technology that has been the case for some time now and is likely to continue. Communications is a space which is going through massive changes which gives both opportunity as well as risk. We're participating very strongly in the front-end transformation and shift to a product-based organization that most of these guys are going through. We're also participating heavily in their new investment areas. The average data consumption there has now shot up to 20 GB per customer per month. And so, we're seeing very, very aggressive, much differentiated strategies being tried out. We're participating strongly in these areas. We're participating strongly in network redevelopment on the actual fiber network. Our network planning group is very strongly involved. We were deeply involved in what happened in Australia. And we're participating strongly now in opportunities in Europe. Network virtualization is another area that we're participating. And so communication is a space, which is very active, but big bets – big strategies of where it will play out and how it will pan out we'll have to wait and see.	
Infosys	**Q1FY19 commentary:** IT budget in the telecom sector continues to face headwinds due to competition in the industry and change in the industry dynamics leading to severe topline and bottom-line squeeze. M&A activities, vendor consolidation, cost cutting measures insourcing and competition for legacy services are impacting growth. Spending trends are opening up in 'innovation' areas like digital transformation, software design networks, IoT, customer experience and cyber security. Digital deal sizes are seeing an upward movement. **Q2FY19 commentary:** Communication segment has strong deal pipeline with its broad-based across geographies. We expect near-term growth to remain strong due to recent deal wins, though quarter three will be impacted due to transition, lower working days and furloughs. We're seeing investments around adoption and deployment of 5G leading to advances in consumer IoT. We are working with clients and the industry forums to develop 5G use cases like network slicing that will reinforce the monetization of 5G network.	
Wipro	**Q1FY19 commentary:** Communications is showing signs of recovery. The current quarter performance is impacted by the bankruptcy that we had seen in that segment in India but overall, we feel positive about the future prospects of Communications as we move forward in the year. **Q1FY19 commentary:** We have also seen an uptick in our communication business driven by core enterprise spend as well as the new-age areas like 5G.	
HCL Tech	Telecom is something where we have had some excellent bookings in a couple of deals (including Nokia deal) and we see a good pipeline in Telecom, so I see that also picking up moving forward.	

Source: Company, Emkay Research

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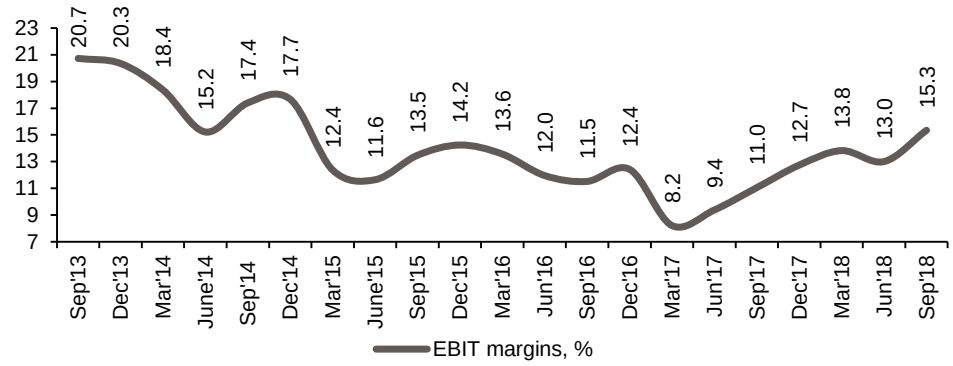
Margin improvement has been healthy over the last six quarters but headroom for further improvement is limited: EBIT margins have been improving over the last six quarters (i.e., ~14% in H1FY19 vs. ~10% in H1FY18). Margin improvement is largely on the back of increased offshoring in its onsite heavy acquisitions (about 200bps change in delivery mix from 33.4% in Q4FY18 to 35.5% in Q2FY19) and improvement in utilization (77% at the end of Q4FY17 vs. 81% at the end of Q2FY19) over the last few quarters. However, going ahead, Tech M expects only a modest qoq improvement in its margins from current levels in FY19. We believe that the modest expectations in improvement in margins are due to structural reasons, such as the acquisition-led growth focus and cyclicality in communication business, increasing supply-side constraints, delay in Telecom pick-up, and steps being taken to curb high attrition.

Exhibit 99: EBIT margin improvement is healthy but headroom for further improvement is limited



Source: Company, Emkay Research

Exhibit 100: Change in estimates

(All fig in Rs mn except EPS)	FY19E			FY20E			FY21E		
	Old	New	Change	Old	New	Change	Old	New	Change
US$ Revenues (US$ mn)	4,983	4,983	0.0%	5,334	5,339	0.1%	5,653	5,686	0.6%
YoY growth, %	4.4%	4.4%		7.0%	7.1%		6.0%	6.5%	
Revenues	349,445	350,694	0.4%	384,053	381,733	-0.6%	407,033	415,113	2.0%
EBITDA(in Rs mn)	63,848	64,265	0.7%	70,796	70,543	-0.4%	75,027	76,972	2.6%
EBITDA mgns, %	18.3	18.3		18.4	18.5		18.4	18.5	
Net Profits	42,802	43,083	0.7%	47,591	46,529	-2.2%	50,195	50,388	0.4%
EPS	48.0	48.3	0.7%	53.4	52.2	-2.2%	56.3	56.5	0.4%

Source: Company, Emkay Research

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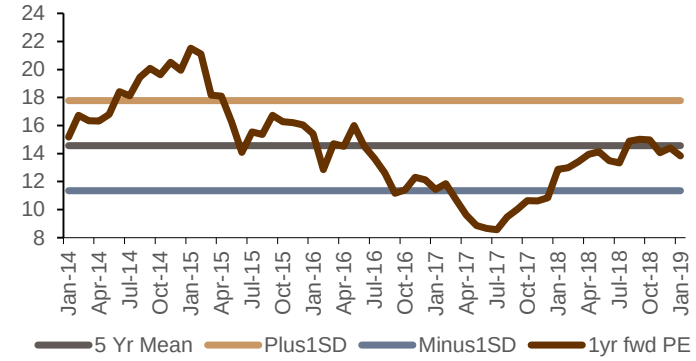
Valuation

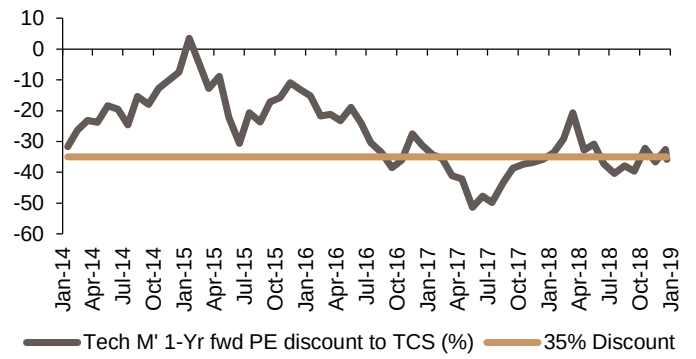
While Tech M's growth outlook has improved qualitatively, unchanged guidance and upholding of acquisition-led growth strategy still make us stick to our cautious stance. Structural reasons, such as acquisition-led growth focus and the cyclicality in the communication business, behind lower-than-peer margins (about 18% EBITDA margins vs. approx. 28% for TCS) do not provide significant headroom for future margin improvement. In addition, indications of increasing supply-side constraints, delay in Telecom pick-up, and steps to curb high attrition should keep margins around current levels in the near term. We have a Hold rating on Tech M with a TP of Rs730 (based on 13x FY21E EPS; 35% discount to the PE multiple we have assigned to our benchmark player TCS). We believe a 35% discount to our benchmark PE multiple is justified, given 25% lower organic growth and structural reasons behind lower-than-benchmark margin.

Exhibit 101: Tech M's 5-Yr Historical 1-Yr fwd PE chart



Source: Company, Emkay Research

Exhibit 102: Tech M's 1-Yr forward PE discount to TCS (%)chart



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**291,408**	**307,729**	**350,694**	**381,733**	**415,113**
Expenditure	**249,565**	**260,560**	**286,429**	**311,190**	**338,141**
EBITDA	**41,843**	**47,169**	**64,265**	**70,543**	**76,972**
Depreciation	9,781	10,849	11,928	12,979	14,114
EBIT	**32,062**	**36,320**	**52,338**	**57,564**	**62,858**
Other Income	6,490	12,469	4,722	4,373	4,673
Interest expenses	0	0	0	0	0
PBT	**38,552**	**48,789**	**57,060**	**61,937**	**67,531**
Tax	9,785	10,925	14,045	15,408	17,143
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	357	(137)	(68)	0	0
Reported Net Income	**28,410**	**38,001**	**43,083**	**46,529**	**50,388**
Adjusted PAT	**28,410**	**38,001**	**43,083**	**46,529**	**50,388**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	4,388	4,417	4,417	4,417	4,417
Reserves & surplus	159,984	184,011	208,939	235,861	265,016
Net worth	**164,372**	**188,428**	**213,356**	**240,278**	**269,433**
Minority Interest	**4,641**	**5,091**	**5,091**	**5,091**	**5,091**
Loan Funds	**12,195**	**23,380**	**23,380**	**23,380**	**23,380**
Net deferred tax liability	9,630	(11,237)	(11,237)	(11,237)	(11,237)
Total Liabilities	**190,838**	**205,662**	**230,590**	**257,512**	**286,667**
Net block	**63,590**	**76,224**	**89,296**	**101,318**	**112,205**
Investment	**37,139**	**49,565**	**49,565**	**49,565**	**49,565**
Current Assets	**153,533**	**152,643**	**172,920**	**195,219**	**221,444**
Cash & bank balance	20,013	30,443	38,670	50,348	68,251
Other Current Assets	33,608	7,522	9,608	11,504	12,510
Current liabilities & Provision	**67,153**	**75,169**	**83,590**	**90,989**	**98,945**
Net current assets	**86,380**	**77,474**	**89,330**	**104,230**	**122,499**
Misc. exp	0	0	0	0	0
Total Assets	**190,838**	**205,662**	**230,590**	**257,512**	**286,667**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**32,062**	**36,320**	**52,338**	**57,564**	**62,858**
Other Non-Cash items	0	0	0	0	0
Chg in working cap	(15,830)	(1,531)	(3,629)	(3,223)	(366)
Operating Cashflow	**15,218**	**30,374**	**46,592**	**51,913**	**59,463**
Capital expenditure	(7,682)	(22,153)	(25,000)	(25,000)	(25,001)
Free Cash Flow	**7,536**	**8,221**	**21,592**	**26,913**	**34,462**
Investments	(12,205)	(12,426)	0	0	0
Other Investing Cash Flow	0	0	0	0	0
Investing Cashflow	**(13,397)**	**(22,110)**	**(20,278)**	**(20,627)**	**(20,328)**
Equity Capital Raised	(451)	29	0	0	0
Loans Taken / (Repaid)	2,173	11,185	0	0	0
Dividend paid (incl tax)	(9,639)	(15,014)	(18,155)	(19,607)	(21,234)
Other Financing Cash Flow	(14,029)	5,966	68	0	1
Financing Cashflow	**(21,946)**	**2,166**	**(18,087)**	**(19,607)**	**(21,233)**
Net chg in cash	**(20,125)**	**10,430**	**8,227**	**11,678**	**17,903**
Opening cash position	40,138	20,013	30,443	38,670	50,348
Closing cash position	**20,013**	**30,443**	**38,670**	**50,348**	**68,251**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	14.4	15.3	18.3	18.5	18.5
EBIT Margin	11.0	11.8	14.9	15.1	15.1
Effective Tax Rate	25.4	22.4	24.6	24.9	25.4
Net Margin	9.9	12.3	12.3	12.2	12.1
ROCE	21.8	24.6	26.2	25.4	24.8
ROE	18.4	21.5	21.4	20.5	19.8
RoIC	29.0	28.7	39.8	39.0	39.1

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	31.9	42.7	48.3	52.2	56.5
CEPS	42.9	54.8	61.7	66.7	72.3
BVPS	184.8	211.5	239.2	269.4	302.0
DPS	9.0	14.0	16.9	18.3	19.8

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	21.6	16.2	14.3	13.2	12.2
P/CEPS	16.0	12.5	11.1	10.3	9.5
P/BV	3.7	3.3	2.9	2.6	2.3
EV / Sales	2.0	1.8	1.6	1.4	1.3
EV / EBITDA	13.6	11.8	8.6	7.6	6.8
Dividend Yield (%)	1.3	2.0	2.5	2.6	2.9

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.3)	(0.3)	(0.3)	(0.3)	(0.4)
Net Debt/EBIDTA	(1.1)	(1.2)	(1.0)	(1.1)	(1.2)
Working Cap Cycle (days)	83.1	55.8	52.7	51.5	47.7

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	10.0	5.6	14.0	8.9	8.7
EBITDA	(2.0)	12.7	36.2	9.8	9.1
EBIT	(8.7)	13.3	44.1	10.0	9.2
PAT	(7.3)	33.8	13.4	8.0	8.3

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	77,760	80,545	82,763	86,298	89,936
EBITDA	12,647	14,119	13,569	16,186	17,088
EBITDA Margin (%)	**16.3**	**17.5**	**16.4**	**18.8**	**19.0**
PAT	9,432	12,221	8,979	10,642	11,385
EPS (Rs)	**10.6**	**13.7**	**10.1**	**11.9**	**12.8**

Source: Company, Emkay Research

Shareholding Pattern (%)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	36.1	36.0	36.0	36.0	36.0
FIIs	37.4	37.6	39.0	38.7	39.2
DIIs	12.8	13.2	12.4	12.8	12.4
Public and Others	13.6	13.1	12.6	12.5	12.4

Source: Capitaline

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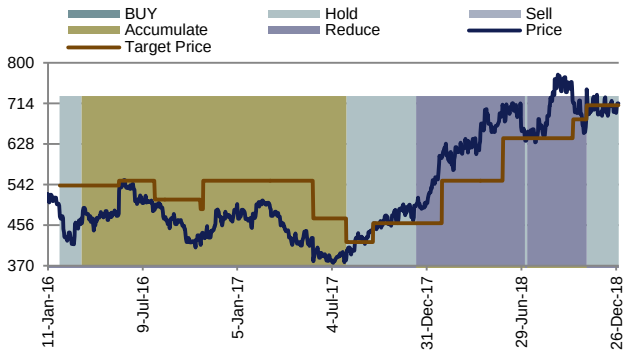
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	719	730	12m	Hold	Rahul Jain
31-Oct-18	744	710	12m	Hold	Rahul Jain
5-Oct-18	715	680	12m	Reduce	Rahul Jain
31-Jul-18	681	640	12m	Reduce	Rahul Jain
10-Jul-18	651	640	12m	Reduce	Rahul Jain
6-Jul-18	635	640	12m	Hold	Rahul Jain
25-May-18	703	640	12m	Reduce	Rahul Jain
5-Apr-18	617	550	12m	Reduce	Rahul Jain
29-Jan-18	605	550	12m	Reduce	Rahul Jain
11-Dec-17	501	460	12m	Reduce	Rahul Jain
2-Nov-17	468	460	12m	Hold	Rahul Jain
4-Oct-17	465	460	12m	Hold	Rahul Jain
20-Sep-17	449	460	12m	Hold	Rahul Jain
31-Jul-17	386	420	12m	Hold	Rahul Jain
10-Jul-17	384	470	12m	Accumulate	Rahul Jain
29-May-17	379	470	12m	Accumulate	Manik Taneja
30-Jan-17	472	550	12m	Accumulate	Manik Taneja
1-Nov-16	434	550	12m	Accumulate	Manik Taneja
27-Oct-16	414	490	12m	Accumulate	Manik Taneja
1-Aug-16	490	510	12m	Accumulate	Manik Taneja
21-Jun-16	535	550	12m	Accumulate	Manik Taneja
25-May-16	529	550	12m	Accumulate	Manik Taneja
15-Mar-16	460	540	12m	Accumulate	Manik Taneja
2-Feb-16	474	540	12m	Hold	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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L&T Infotech

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Your success is our success

Refer to important disclosures at the end of this report

Raising the bar every quarter

CMP	Target Price
Rs 1,688 as of (January 8, 2019)	Rs 2,020 (■) 12 months
Rating	**Upside**
ACCUMULATE (■)	19.7 %

- In the last four quarters, LTI has consistently outperformed industry growth rates: 20%+ yoy growth in USD terms vs. the industry rate of about 8%. The growth drivers were 1) effective client mining — both Top 20 and non-Top 20 clients grew at 20%+ yoy in H1FY19; 2) large deal wins — at least one large deal/quarter in the past 10 quarters; and 3) new logo acquisitions — added 12 Fortune-500 clients in last 10 quarters.
- EBIT margin too has been improved on a qoq basis (see Exhibit 104) over the last six quarters, driven by cost optimizations such as higher utilization (81.8% in H1FY19 vs. 75.7% in FY16). Digital services has witnessed 10% CQGR in the past 10 quarters, leading to a significant improvement in its revenue per employee, which rose to USD50.5K in H1FY19 from USD42.9K in FY16.
- Differentiated capabilities (e.g., Mosaic platform) and marketing efforts, such as awards and analyst recognitions, help win new logos and increase large-deal participation, while alliances with all large platform providers, such as SAP, AWS, and Microsoft, are helping to mine & hunt clients — 73 new logos added on TTM basis — leading to large deal wins.
- We continue to like LTI's differentiated growth (double digit for Traditional services) and margin protection focus despite increased investments in areas such as next-gen services, platforms, and talent. In addition, LTI's continued efforts to raise offshore delivery (agile) protects it from increasing onsite supply-side constraints. We assign Accumulate rating with a TP of Rs2,020, valuing it at 18x FY21E EPS.

Entry into marquee logos provides long-term growth opportunity

We believe that LTI's entry into 61 out of Fortune-500 companies provides it a differentiated revenue expansion scope. Currently, 36 of these Fortune-500 accounts are at a small revenue run rate (<US$10mn), but we believe that these engagements can be scaled to multi-fold of their current average sizes, providing us near- to medium-term growth visibility. LTI's growth in the non-Top 20 accounts — >20%+ yoy growth over the past five quarters — and healthy new client additions (73 new logos added in last 12 months) is a testament to its increased focus on client mining (Minecraft and ADEA) and hunting (Marketing and Alliances). On the margins front too, we believe that increased focus on growing offshore agile delivery (77.4% in Q2FY19 vs. 76.7% in Q2FY18 – delivery mix) protects it from rising supply-side constraints on the onsite front.

Large deal wins every quarter provide medium-term growth visibility

We believe that consistent large deal wins, addition of marquee logos, comprehensive digital offerings with its own product IPs, such as the MOSAIC offerings, as well as continued investments in traditional/digital offerings will ensure sustained financial outperformance for LTI over other mid/large peers. Strong and improving metrics give comfort to our estimated 13%/12% CAGR for USD Revenue/EPS over FY19-21E. We maintain LTI as our preferred pick among the mid-tier names and assign it an Accumulate rating with a TP of Rs2,020, valuing it at 18x FY21E EPS.

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	66,654	76,421	96,330	108,947	124,693
EBITDA	13,940	15,232	21,737	23,862	26,807
EBITDA Margin (%)	20.9	19.9	22.6	21.9	21.5
APAT	9,711	11,124	15,811	17,560	19,671
EPS (Rs)	55.7	63.6	90.4	100.4	112.4
EPS (% chg)	12.8	14.2	42.1	11.1	12.0
ROE (%)	37.6	31.8	36.9	33.6	31.2
P/E (x)	30.3	26.5	18.7	16.8	15.0
EV/EBITDA (x)	20.2	18.3	12.7	11.3	9.8
P/BV (x)	9.4	7.7	6.3	5.2	4.3

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	-/-
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	ACCUMULATE

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	90.4	100.4
Consensus	85.7	96.6
Mean Consensus TP (12M)	Rs 1,987	

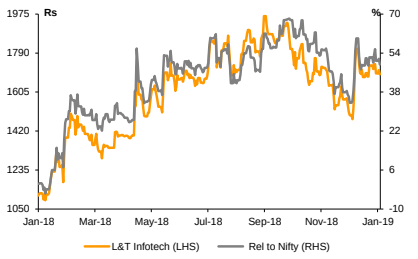
Stock Details	
Bloomberg Code	LTI IN
Face Value (Rs)	1
Shares outstanding (mn)	173
52 Week H/L	1,990 / 1,075
M Cap (Rs bn/USD bn)	293 / 4.18
Daily Avg Volume (nos.)	236,783
Daily Avg Turnover (US$ mn)	5.6

Shareholding Pattern Sep '18	
Promoters	75.0%
FIIs	9.5%
DIIs	5.9%
Public and Others	9.6%

Price Performance

(%)	1M	3M	6M	12M
Absolute	13	(5)	1	51
Rel. to Nifty	12	(9)	1	48

Relative price chart



Source: Bloomberg

This report is solely produced by Emkay Global. The following person(s) are responsible for the production of the recommendation:

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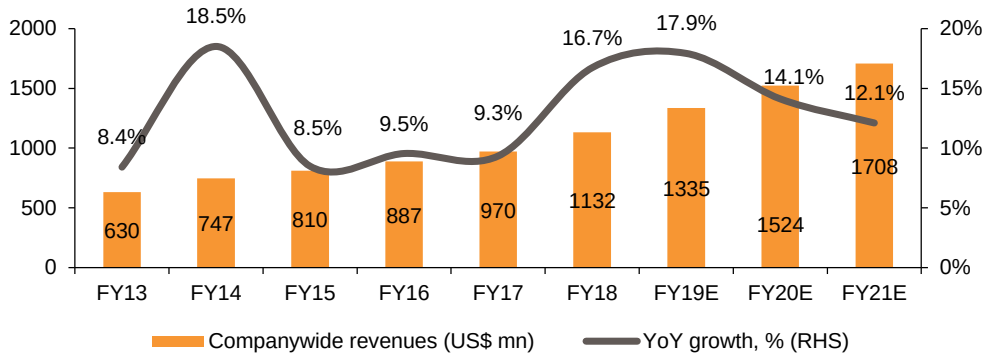
ED: ANISH MATHEW SA: DHANANJAY SINHA

Firing on all cylinders – TCV, client mining, large logos

Industry-leading growth: After securing at least one large deal win (USD50mn+) per quarter in the past 10 quarters, with cumulative deal TCV standing at USD575mn, LTI provides us the confidence of continuation of industry-leading growth in the near term. The focus on hunting new clients and its parent (L&T) credentials have helped LTI gain differentiated entry into 61 Fortune-500 clients, which we believe provides LTI a long-term growth opportunity. The fruitfulness of LTI's efforts have reflected in the numerous awards and recognitions it received in the past, and it helps the company in building brand visibility in the targeted verticals and domains. Its alliances with major platform players such as SAP, Salesforce, AWS, Microsoft, IBM, and Microfocus are doing well with many successful product implementations. Improving brand visibility and strengthening relationships with all major platform vendors help LTI improve deal participations and win large deals.

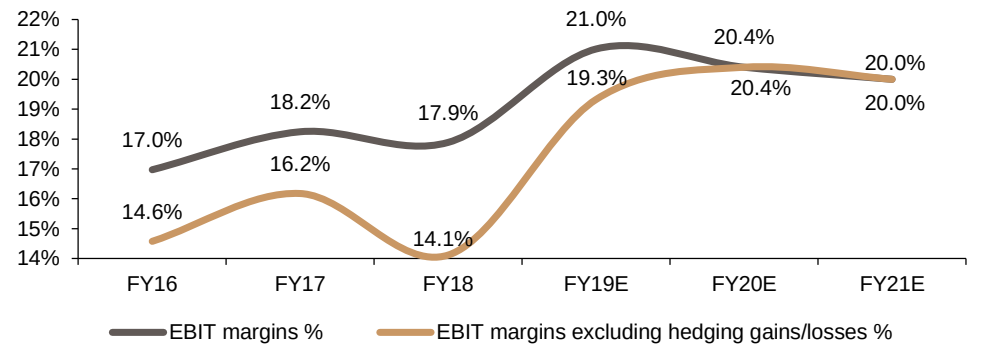
Exhibit 103: USD revenues (mn) and growth (%)



Source: Company, Emkay Research

EBIT margin, ex. hedging gains, improved to 20.0% in H1FY19 from about 18% in H1FY18 despite continued investments in capability building and talent acquisition. The improvement was mainly driven by a weak INR and higher operational efficiencies stemming from strong revenue growth. LTI, however, expects margins to remain at current levels going ahead, factoring in future investment requirements amid the changing industry dynamics.

Exhibit 104: EBIT margin (ex-hedge gains) historical trajectory and expectations



Source: Company, Emkay Research

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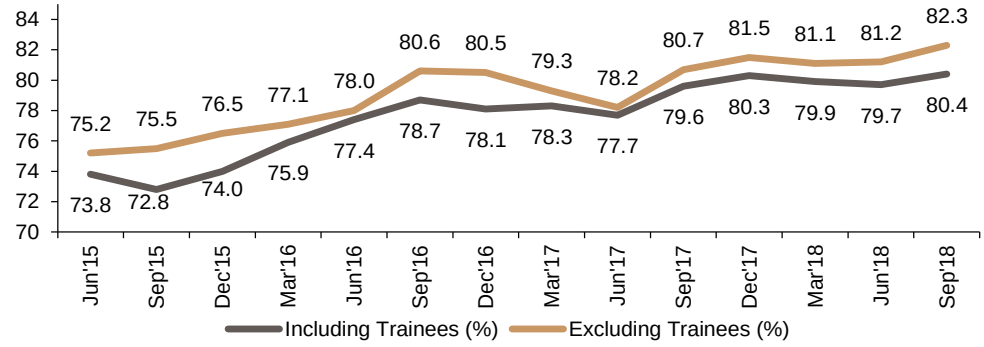
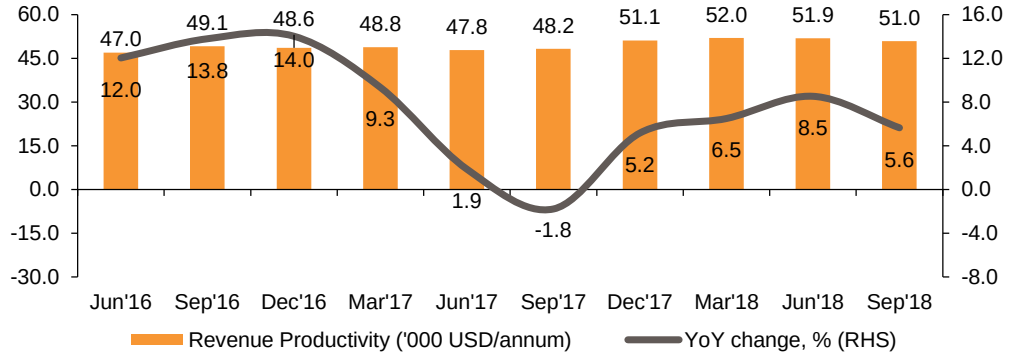
Exhibit 105: Margins improved despite flat utilization, indicating scale leverage and better automation capabilities



Source: Company, Emkay Research

Exhibit 106: Revenue productivity has been increasing continuously on a yoy basis

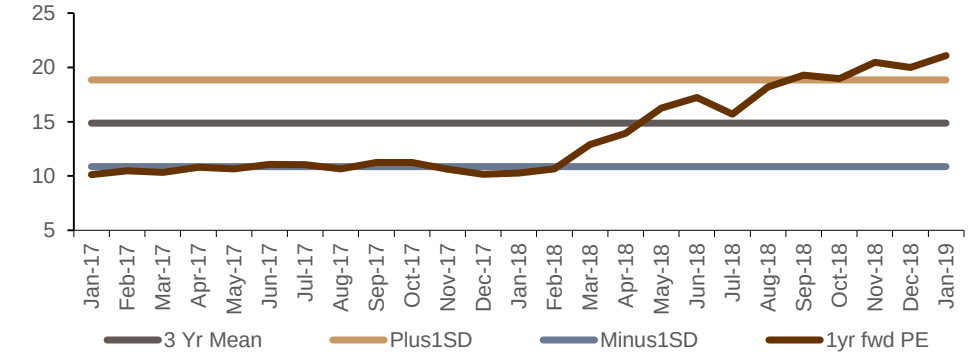


Source: Company, Emkay Research

Valuation

While valuations seem to be stretched on an absolute basis, comfort comes when valuations are seen relative to growth (PEG of 1.2x). In addition, consistent large deal wins, large logo additions, comprehensive digital offerings with its own product IPs (e.g., MOSAIC offerings), and continued investments in traditional/digital offerings should ensure sustained financial outperformance for LTI over other mid- and large-cap peers. Strong and improving metrics give comfort to our estimated 13%/12% CAGR for USD Revenue/EPS over FY19-21E. We maintain LTI as our preferred pick among the mid-tier names and assign it an Accumulate rating with a TP of Rs2,020, valuing it at 18x FY21E EPS (implied PEG of 1.5x).

Exhibit 107: LTI's 2-Yr Historical 1-Yr fwd PE chart



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**66,654**	**76,421**	**96,330**	**108,947**	**124,693**
Expenditure	**52,714**	**61,189**	**74,594**	**85,085**	**97,886**
EBITDA	**13,940**	**15,232**	**21,737**	**23,862**	**26,807**
Depreciation	1,780	1,563	1,494	1,634	1,870
EBIT	**12,160**	**13,669**	**20,243**	**22,228**	**24,937**
Other Income	200	745	973	1,502	1,645
Interest expenses	0	0	0	0	0
PBT	**12,359**	**14,414**	**21,216**	**23,730**	**26,582**
Tax	2,648	3,290	5,405	6,170	6,911
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	0	0	0	0	0
Reported Net Income	**9,711**	**11,124**	**15,811**	**17,560**	**19,671**
Adjusted PAT	**9,711**	**11,124**	**15,811**	**17,560**	**19,671**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	171	172	172	172	172
Reserves & surplus	31,272	38,426	46,974	57,155	68,407
Net worth	**31,443**	**38,598**	**47,146**	**57,327**	**68,579**
Minority Interest	**8**	**13**	**13**	**13**	**13**
Loan Funds	**0**	**0**	**0**	**0**	**0**
Net deferred tax liability	(1,434)	(1,921)	(1,921)	(1,921)	(1,921)
Total Liabilities	**30,017**	**36,690**	**45,238**	**55,419**	**66,671**
Net block	**5,419**	**6,807**	**8,813**	**10,679**	**12,309**
Investment	**9,406**	**12,643**	**12,643**	**12,643**	**12,643**
Current Assets	**28,072**	**32,387**	**42,347**	**53,103**	**65,771**
Cash & bank balance	3,761	3,633	6,982	13,106	19,993
Other Current Assets	7,890	6,427	11,349	12,835	14,690
Current liabilities & Provision	**12,893**	**15,215**	**18,633**	**21,074**	**24,120**
Net current assets	**15,179**	**17,172**	**23,714**	**32,029**	**41,651**
Misc. exp	0	0	0	0	0
Total Assets	**30,017**	**36,690**	**45,238**	**55,419**	**66,671**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**12,160**	**13,669**	**20,243**	**22,228**	**24,937**
Other Non-Cash items	0	0	0	0	0
Chg in working cap	(1,109)	(2,608)	(3,193)	(2,191)	(2,735)
Operating Cashflow	**13,718**	**9,334**	**13,140**	**15,501**	**17,161**
Capital expenditure	(754)	(3,010)	(3,500)	(3,500)	(3,500)
Free Cash Flow	**12,964**	**6,324**	**9,640**	**12,001**	**13,661**
Investments	(8,977)	(3,237)	0	0	0
Other Investing Cash Flow	0	0	0	0	0
Investing Cashflow	**(9,531)**	**(5,502)**	**(2,527)**	**(1,998)**	**(1,855)**
Equity Capital Raised	114	1	0	0	0
Loans Taken / (Repaid)	0	0	0	0	0
Dividend paid (incl tax)	(1,978)	(4,524)	(6,320)	(7,379)	(8,419)
Other Financing Cash Flow	(595)	563	(943)	0	0
Financing Cashflow	**(2,459)**	**(3,960)**	**(7,263)**	**(7,379)**	**(8,419)**
Net chg in cash	**1,728**	**(128)**	**3,349**	**6,124**	**6,887**
Opening cash position	2,034	3,761	3,633	6,982	13,106
Closing cash position	**3,761**	**3,633**	**6,982**	**13,106**	**19,993**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	20.9	19.9	22.6	21.9	21.5
EBIT Margin	18.2	17.9	21.0	20.4	20.0
Effective Tax Rate	21.4	22.8	25.5	26.0	26.0
Net Margin	14.6	14.6	16.4	16.1	15.8
ROCE	47.5	43.2	51.8	47.2	43.5
ROE	37.6	31.8	36.9	33.6	31.2
RoIC	67.3	73.5	88.2	80.6	78.5

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	55.7	63.6	90.4	100.4	112.4
CEPS	65.9	72.5	98.9	109.7	123.1
BVPS	180.2	220.6	269.5	327.7	392.0
DPS	11.3	21.5	30.0	35.0	40.0

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	30.3	26.5	18.7	16.8	15.0
P/CEPS	25.6	23.3	17.1	15.4	13.7
P/BV	9.4	7.7	6.3	5.2	4.3
EV / Sales	4.2	3.7	2.9	2.5	2.1
EV / EBITDA	20.2	18.3	12.7	11.3	9.8
Dividend Yield (%)	0.7	1.3	1.8	2.1	2.4

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.4)	(0.4)	(0.4)	(0.4)	(0.5)
Net Debt/EBIDTA	(0.9)	(1.1)	(0.9)	(1.1)	(1.2)
Working Cap Cycle (days)	62.5	64.7	63.4	63.4	63.4

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	10.8	14.7	26.1	13.1	14.5
EBITDA	16.7	9.3	42.7	9.8	12.3
EBIT	19.1	12.4	48.1	9.8	12.2
PAT	16.1	14.5	42.1	11.1	12.0

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	19,609	20,922	22,398	24,023	24,752
EBITDA	3,987	3,829	5,031	5,501	5,544
EBITDA Margin (%)	**20.3**	**18.3**	**22.5**	**22.9**	**22.4**
PAT	2,829	2,893	3,612	4,003	4,057
EPS (Rs)	**16.2**	**16.5**	**20.6**	**22.9**	**23.2**

Source: Company, Emkay Research

Shareholding Pattern (%)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	84.0	83.7	83.0	81.5	75.0
FIIs	5.9	6.1	6.9	8.0	9.5
DIIs	2.0	2.2	2.2	2.8	5.9
Public and Others	8.0	8.0	7.9	7.7	9.6

Source: Capitaline

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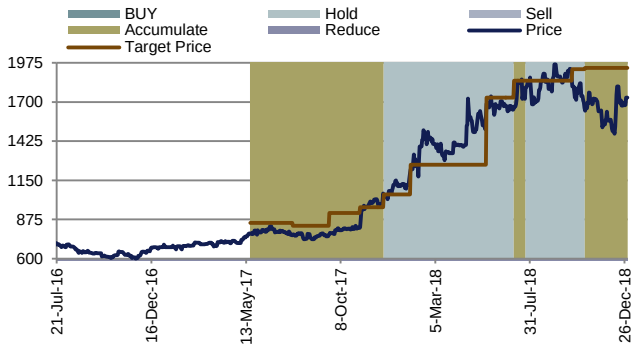
25-Oct-18	1,639	1,940	12m	Accumulate	Rahul Jain
5-Oct-18	1,809	1,930	12m	Hold	Rahul Jain
24-Jul-18	1,803	1,850	12m	Hold	Rahul Jain
10-Jul-18	1,720	1,850	12m	Accumulate	Rahul Jain
6-Jul-18	1,668	1,850	12m	Accumulate	Rahul Jain
24-May-18	1,686	1,730	12m	Hold	Rahul Jain
5-Apr-18	1,394	1,260	12m	Hold	Rahul Jain
25-Jan-18	1,228	1,260	12m	Hold	Rahul Jain
14-Dec-17	1,044	1,050	12m	Hold	Rahul Jain
7-Nov-17	820	960	12m	Accumulate	Rahul Jain
4-Oct-17	813	920	12m	Accumulate	Rahul Jain
20-Sep-17	770	920	12m	Accumulate	Rahul Jain
25-Jul-17	770	830	12m	Accumulate	Rahul Jain
10-Jul-17	788	850	12m	Accumulate	Manik Taneja
19-May-17	774	850	12m	Accumulate	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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Mphasis

Your success is our success

Refer to important disclosures at the end of this report

Strong TCV offers better visibility

CMP	Target Price
Rs 925 as of (January 8, 2019)	Rs 1,370 (■) 12 months
Rating	**Upside**
BUY (■)	48.1 %

- Strong leading growth indicators (TTM deal TCV up approx. 24% yoy in direct channel), differentiated growth channels in the form of Blackstone portfolio companies and longtime client relationships (HP and 16 strategic accounts; see Exhibits113), as well as confident management commentary reinforce our ahead-of-consensus growth sustainability.
- Mphasis was the only player that guided for a 100bps improvement in its margin guidance band (15-17% vs. 14-16% in FY18) at the start of the year. With strong growth, sales team centralization and INR depreciation in FY19, Mphasis will most likely end the year close to the upper band of its margin guidance, in our view.
- The sector-wide fall in IT stocks (NIFTY IT index was down ~9% in Q3FY19) has led to a contagion correction in Mphasis. We believe current valuations (1.2x PEG) are attractive and provide an opportunity to enter this fundamentally sound name.
- Although Mphasis shares similar growth and margin improvement profile with LTI, it is currently trading at a 20% discount to LTI (see Exhibit 117), which we believe is unwarranted. We have a Buy rating on the stock, with a TP of Rs1370, valuing it at 18x FY21E EPS.

Commentary confident across businesses; OPM to improve gradually

Mphasis' commentary remains strong for its Direct International (ex-Digital risk business; ~60% of sales) and HP segment (~25% of sales). Mphasis has guided for industry-leading growth for its Direct International segment. After posting ~20%/~23% yoy in FY18/H1FY19 in HP channel, Mphasis expects growth momentum to continue in this segment as it gets deeper into segments (other than DXC Tech) of HP (i.e., HPE, HP Inc. and Micro Focus). Growth revival in HP has been a result of strategic changes (such as One Mphasis and Team centralizations), incorporated by the new CEO Nitin Rakesh. Digital Risk (about 10% of revenues) has been underperforming over the last few quarters but Mphasis expects growth stability (USD27mn-30mn run-rate) and margin improvement in this segment going ahead as it sees significant potential in terms of its elite client roster that features several Tier-I mortgage players that can be cross-sold on various other service offerings.

TCV supports visibility for FY19 and beyond; remains as our top pick

With differentiated growth channels in the form of Blackstone portfolio companies and longtime client relationships, improving margin profile, confident management commentary and strong leading indicators (New deal TCV up ~24% yoy on LTM basis), we believe that the recent correction in Mphasis is most likely a contagion effect of the sector-wide correction in Q3FY19 (NIFTY IT Index was down ~9% in Q3FY19) and provides a good opportunity to enter this fundamentally sound name. We have a Buy rating on the stock, with a TP of Rs1370, valuing it at 18x FY21E EPS.

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	60,763	65,459	77,739	89,354	101,836
EBITDA	9,096	9,917	12,631	14,802	17,083
EBITDA Margin (%)	15.0	15.1	16.2	16.6	16.8
APAT	8,187	8,507	10,614	12,315	14,127
EPS (Rs)	38.9	44.0	57.1	66.2	76.0
EPS (% chg)	12.9	13.1	29.7	16.0	14.7
ROE (%)	13.6	14.6	20.0	22.4	22.2
P/E (x)	23.8	21.0	16.2	14.0	12.2
EV/EBITDA (x)	16.5	14.1	10.9	8.8	7.2
P/BV (x)	3.2	3.3	3.4	2.9	2.5

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	(1.5)/(2.7)
Target Price change (%)	NA
Target Period (Months)	12
Previous Reco	BUY

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	57.1	66.2
Consensus	55.6	63.8
Mean Consensus TP (12M)	Rs 1,171	

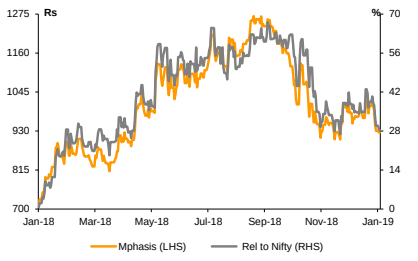
Stock Details	
Bloomberg Code	MPHL IN
Face Value (Rs)	10
Shares outstanding (mn)	193
52 Week H/L	1,279 / 700
M Cap (Rs bn/USD bn)	179 / 2.55
Daily Avg Volume (nos.)	484,775
Daily Avg Turnover (US$ mn)	6.9

Shareholding Pattern Sep '18	
Promoters	52.3%
FIIs	29.1%
DIIs	8.7%
Public and Others	9.9%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(6)	(16)	(17)	29
Rel. to Nifty	(7)	(19)	(17)	27

Relative price chart



Source: Bloomberg

This report is solely produced by Emkay Global. The following person(s) are responsible for the production of the recommendation:

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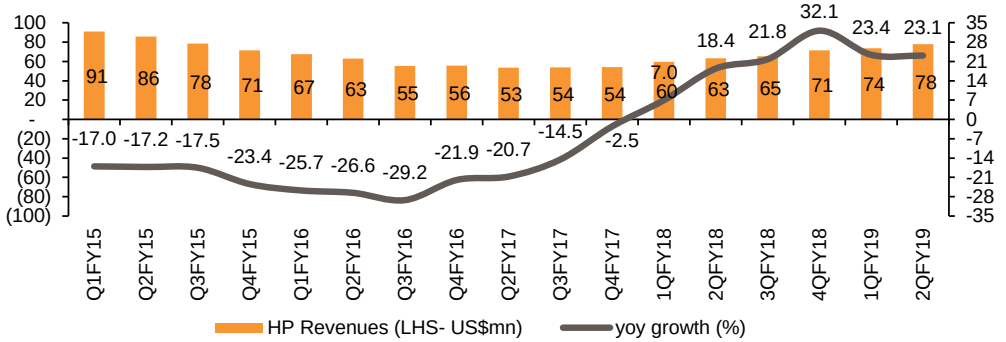
ED: ANISH MATHEW SA: DHANANJAY SINHA

Differentiated client intimacy acting as an edge

HP Channel (~25% of sales): After declining ~20% yoy for 5 straight years, HP has shown a strong recovery in FY18/H1FY19, where it is up ~20%/~23% yoy. Growth in HP has been a result of strategic changes (such as One Mphasis and Team centralizations), incorporated by the new CEO Nitin Rakesh, which has resulted in segment growth. Mphasis expects growth momentum to continue in this segment as it gets deeper into segments (other than DXC Tech, which contributes ~80% of current HP segment revenues) of HP (i.e., HPE, HP Inc. and Micro Focus).

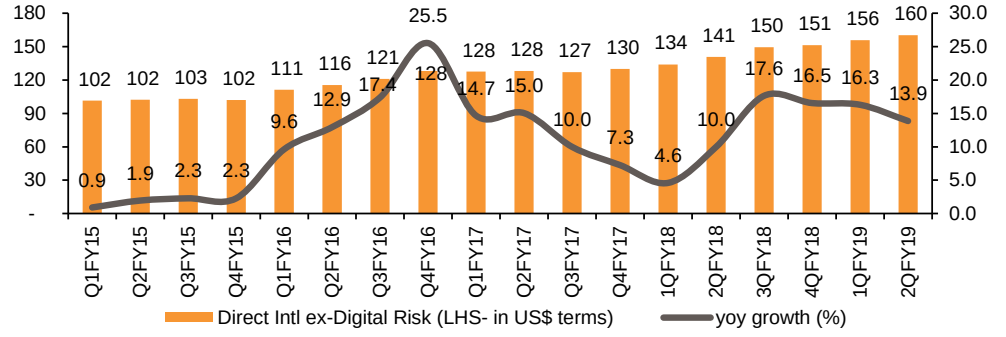
Exhibit 108: HP/DXC strategic relationship to help accelerate growth in FY20



Source: Company, Emkay Research

Direct International (ex-Digital Risk) (~60% of sales): Direct International has been Mphasis' best-performing business segment with industry leading yoy growth over the last three years (see Exhibit 2). Digital Risk (~10% of revenues) has been underperforming over the last few quarters but Mphasis expects growth stability and margin improvement in this segment going ahead.

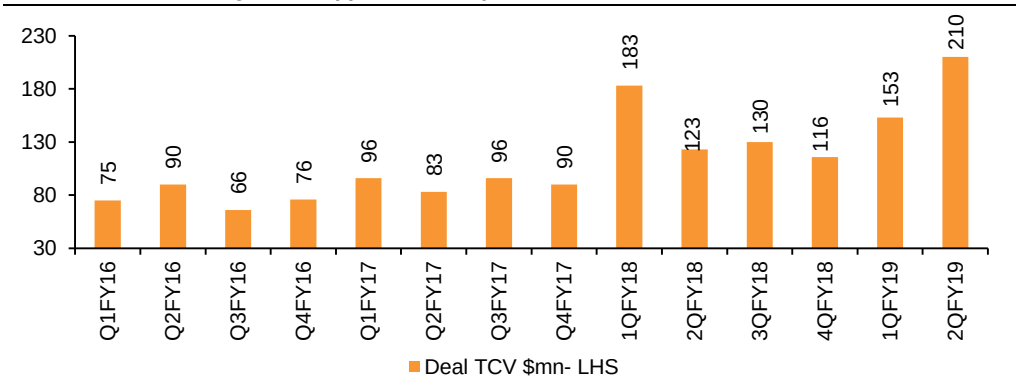
Exhibit 109: Direct Intl (ex-DR) growth continues to remain market leading



Source: Company, Emkay Research

Deal TCV: Direct International deal TCV has seen a strong growth over the last six quarters (up ~24% yoy on a TTM basis). HP segment too, has recovered and grew 20%+ in FY18 and ~23% yoy in H1FY19. With both engines fired up, we remain confident of Mphasis' growth and margin improvement trajectory over FY19-21E.

Exhibit 110: Deal TCV growth supports visibility



Source: Company, Emkay Research

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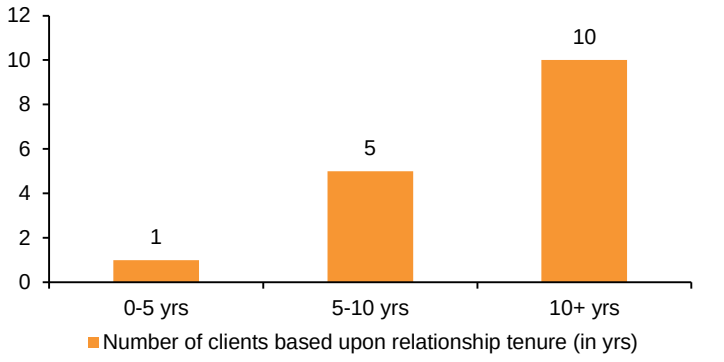
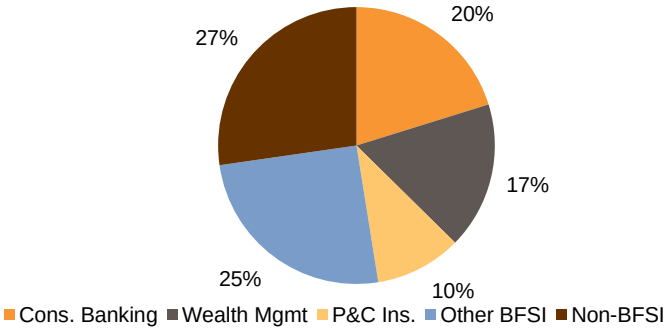
Client relationships: Mphasis has 16 strategic accounts where it is having long-term and growing relationships. 10 out of these 16 strategic accounts are 10+ year old accounts (see Exhibit 5). Client list includes major global firms and 11 out of these 16 strategic accounts are in the BFSI vertical. Mphasis has a differentiated growth strategy to grow by mining strategic accounts, to hunt Blackstone portfolio companies and new logos.

Exhibit 111: Mphasis has a number of long-term and growing client relationships



Source: Company, Emkay Research

Exhibit 112: Mphasis has a micro-focus approach and has developed differentiated solutions to service BFSI sub-verticals



Source: Company, Emkay Research

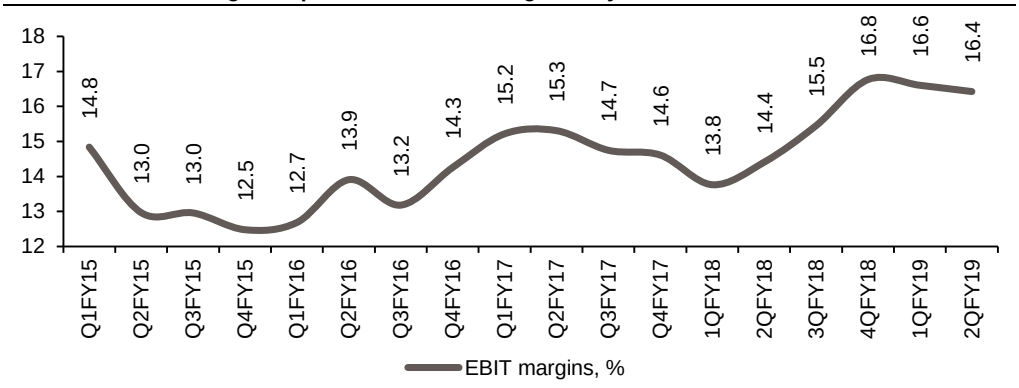
Exhibit 113: Client list includes some of the most enviable names

S.No.	Client Description
1	Largest Bank in North America
2	Largest Insurance Company in North America
3	Largest publicly traded Invest. Services Firm
4	Largest Logistics Provider
5	Largest Commercial RE player

Source: Company, Emkay Research

Margins: The improvement in margins has been secular across all business verticals on the back of strong revenue growth and various cost optimizations (like centralization of sales efforts and improvement in subsidiary profitability).

Exhibit 114: EBIT margins expansion will continue gradually



Source: Company, Emkay Research

Exhibit 115: Change in estimates

(All fig in Rs mn	FY19E			FY20E			FY21E		
except EPS and %)	Old	New	% change	Old	New	% change	Old	New	% change
Overall Revenues(in US$ mn)	1127	1117	-0.9%	1271	1250	-1.7%	1408	1395	-0.9%
YoY growth, %	*14.2%*	*13.2%*		*12.8%*	*11.9%*		*10.8%*	*11.6%*	
Revenues	78,144	77,739	-0.5%	91,537	89,354	-2.4%	101,379	101,836	0.4%
EBIT	12,944	12,631	-2.4%	15,410	14,802	-3.9%	17,132	17,083	-0.3%
EBIT mgns, %	*16.6*	*16.2*		*16.8*	*16.6*		*16.9*	*16.8*	
Net profits	10,774	10,614	-1.5%	12,662	12,315	-2.7%	14,152	14,127	-0.2%
EPS	57.9	57.1	-1.5%	68.1	66.2	-2.7%	76.1	76.0	-0.2%

Source: Company, Emkay Research

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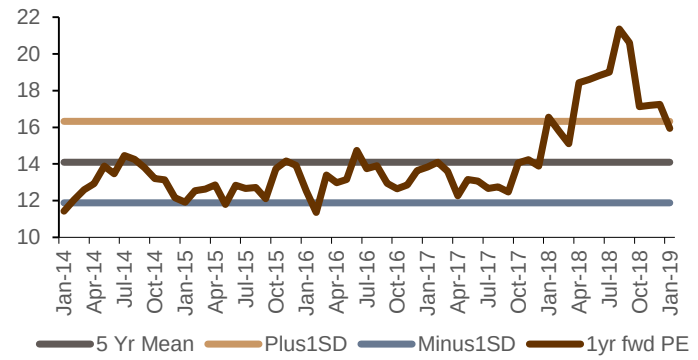
Valuation

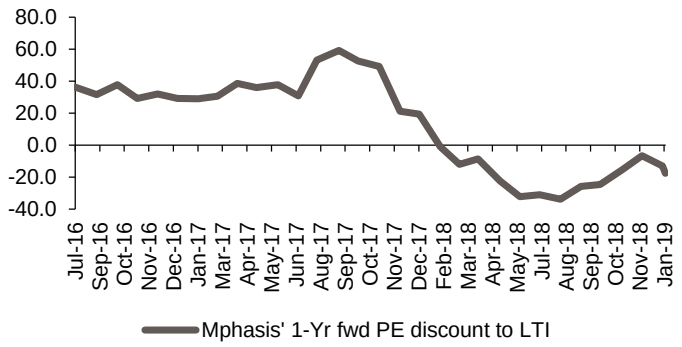
With strong historical revenue growth and expectations, differentiated growth channels in the form of Blackstone portfolio companies and longtime client relationships (HP group companies such as DXC Tech, HPE, HP Inc. and Micro Focus and 16 strategic accounts), improving margin profile (guided for 15-17% EBIT margins vs. 14-16% in FY18), confident management commentary and strong leading indicators (New deal TCV up ~24% yoy on LTM basis), we believe that recent correction in Mphasis is most likely a contagion effect of the sector-wide correction in Q3FY19 (NIFTY IT Index was down ~9% in Q3FY19) and provides a good opportunity to enter this fundamentally sound name. In addition, Mphasis shares a similar growth and margin improvement profile with LTI which makes us believe that the present P/E discount (~20%; see Exhibit 117) between the two names is unwarranted and should narrow down. We have a Buy rating on the stock with a target price of Rs1,370 (based on 18x FY21E EPS).

Exhibit 116: Mphasis' 5-Yr historical 1-Yr fwd P/E multiple chart



Source: Company, Emkay Research

Exhibit 117: Mphasis' 1-Yr fwd P/E discount to LTI



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**60,763**	**65,459**	**77,739**	**89,354**	**101,836**
Expenditure	**51,667**	**55,542**	**65,107**	**74,552**	**84,753**
EBITDA	**9,096**	**9,917**	**12,631**	**14,802**	**17,083**
Depreciation	0	0	0	0	0
EBIT	**9,096**	**9,917**	**12,631**	**14,802**	**17,083**
Other Income	2,385	1,620	1,596	1,795	2,065
Interest expenses	139	130	117	94	73
PBT	**11,342**	**11,407**	**14,111**	**16,503**	**19,075**
Tax	3,155	2,900	3,497	4,188	4,948
Extraordinary Items	(152)	131	0	0	0
Minority Int./Income from Assoc.	0	0	0	0	0
Reported Net Income	**8,035**	**8,638**	**10,614**	**12,315**	**14,127**
Adjusted PAT	**8,187**	**8,507**	**10,614**	**12,315**	**14,127**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	2,104	1,933	1,859	1,859	1,859
Reserves & surplus	59,420	52,885	49,229	57,081	66,745
Net worth	**61,524**	**54,818**	**51,088**	**58,940**	**68,605**
Minority Interest	**0**	**0**	**0**	**0**	**0**
Loan Funds	**761**	**1,016**	**1,062**	**1,111**	**1,162**
Net deferred tax liability	651	872	959	1,055	1,161
Total Liabilities	**62,936**	**56,706**	**53,110**	**61,106**	**70,927**
Net block	**19,215**	**18,844**	**19,353**	**19,791**	**20,208**
Investment	**38,843**	**33,007**	**32,865**	**35,029**	**39,741**
Current Assets	**15,106**	**17,984**	**14,230**	**19,553**	**24,764**
Cash & bank balance	6,144	7,067	2,792	8,010	10,535
Other Current Assets	2,683	2,800	2,800	2,856	2,914
Current liabilities & Provision	**10,235**	**13,148**	**13,356**	**13,286**	**13,804**
Net current assets	**4,870**	**4,836**	**874**	**6,268**	**10,960**
Misc. exp	0	0	0	0	0
Total Assets	**62,936**	**56,706**	**53,110**	**61,106**	**70,927**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**11,144**	**11,407**	**14,111**	**16,503**	**19,075**
Other Non-Cash items	125	0	0	0	0
Chg in working cap	(1,045)	0	683	(391)	(2,523)
Operating Cashflow	**6,641**	**7,726**	**10,559**	**11,035**	**10,445**
Capital expenditure	(1,150)	0	(1,250)	(1,250)	(1,250)
Free Cash Flow	**5,491**	**7,726**	**9,309**	**9,785**	**9,195**
Investments	3,373	0	446	(1,853)	(4,251)
Other Investing Cash Flow	0	0	(1,213)	0	0
Investing Cashflow	**2,679**	**1,490**	**(538)**	**(1,403)**	**(3,508)**
Equity Capital Raised	3	0	(9,880)	0	0
Loans Taken / (Repaid)	(1,976)	0	46	49	51
Dividend paid (incl tax)	(5,055)	(4,638)	(4,463)	(4,463)	(4,463)
Other Financing Cash Flow	(13)	0	0	0	0
Financing Cashflow	**(7,114)**	**(4,638)**	**(14,296)**	**(4,414)**	**(4,412)**
Net chg in cash	**2,207**	**4,578**	**(4,276)**	**5,218**	**2,525**
Opening cash position	3,749	6,144	7,067	2,792	8,010
Closing cash position	**6,144**	**7,067**	**2,792**	**8,010**	**10,535**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	15.0	15.1	16.2	16.6	16.8
EBIT Margin	15.0	15.1	16.2	16.6	16.8
Effective Tax Rate	27.8	25.4	24.8	25.4	25.9
Net Margin	13.5	13.0	13.7	13.8	13.9
ROCE	18.4	19.3	25.9	29.1	29.0
ROE	13.6	14.6	20.0	22.4	22.2
RoIC	58.7	57.4	74.2	83.4	88.3

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	38.9	44.0	57.1	66.2	76.0
CEPS	38.9	44.0	57.1	66.2	76.0
BVPS	292.4	283.6	274.7	317.0	368.9
DPS	20.0	20.0	20.0	20.0	20.0

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	23.8	21.0	16.2	14.0	12.2
P/CEPS	23.8	21.0	16.2	14.0	12.2
P/BV	3.2	3.3	3.4	2.9	2.5
EV / Sales	2.5	2.1	1.8	1.5	1.2
EV / EBITDA	16.5	14.1	10.9	8.8	7.2
Dividend Yield (%)	2.2	2.2	2.2	2.2	2.2

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)
Net Debt/EBIDTA	(4.9)	(3.9)	(2.7)	(2.8)	(2.9)
Working Cap Cycle (days)	(7.7)	(12.4)	(9.0)	(7.1)	1.5

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	(0.2)	7.7	18.8	14.9	14.0
EBITDA	10.6	9.0	27.4	17.2	15.4
EBIT	10.6	9.0	27.4	17.2	15.4
PAT	20.0	7.5	22.9	16.0	14.7

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	16,607	17,445	18,202	19,149	19,895
EBITDA	2,566	2,925	3,022	3,145	3,104
EBITDA Margin (%)	**15.5**	**16.8**	**16.6**	**16.4**	**15.6**
PAT	2,150	2,639	2,583	2,709	2,548
EPS (Rs)	**11.6**	**14.2**	**13.9**	**14.6**	**13.7**

Source: Company, Emkay Research

Shareholding Pattern (%)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	60.4	60.4	60.4	52.4	52.3
FIIs	21.4	21.8	22.8	29.2	29.1
DIIs	9.8	9.1	7.6	9.1	8.7
Public and Others	8.4	8.7	9.3	9.4	9.9

Source: Capitaline

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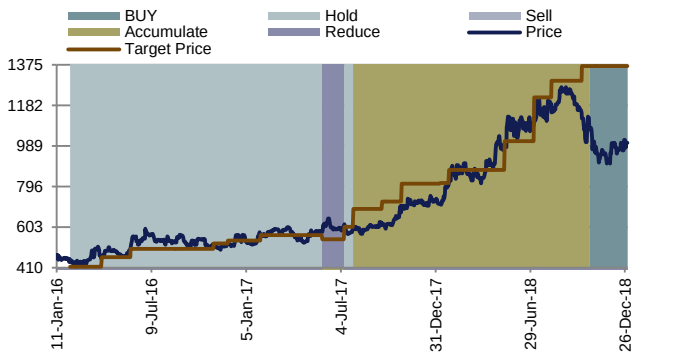
RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	1,004	1,370	12m	Buy	Rahul Jain
19-Oct-18	1,068	1,370	12m	Buy	Rahul Jain
5-Oct-18	1,121	1,370	12m	Accumulate	Rahul Jain
8-Aug-18	1,150	1,300	12m	Accumulate	Rahul Jain
10-Jul-18	1,132	1,220	12m	Accumulate	Rahul Jain
6-Jul-18	1,109	1,220	12m	Accumulate	Rahul Jain
14-May-18	984	1,012	12m	Accumulate	Rahul Jain
11-May-18	988	1,012	12m	Accumulate	Rahul Jain
5-Apr-18	870	875	12m	Accumulate	Rahul Jain
25-Jan-18	824	875	12m	Accumulate	Rahul Jain
8-Jan-18	716	813	12m	Accumulate	Rahul Jain
27-Oct-17	704	810	12m	Accumulate	Rahul Jain
4-Oct-17	617	725	12m	Accumulate	Rahul Jain
20-Sep-17	614	725	12m	Accumulate	Rahul Jain
27-Jul-17	603	690	12m	Accumulate	Rahul Jain
10-Jul-17	616	605	12m	Hold	Rahul Jain
29-May-17	581	545	12m	Reduce	Manik Taneja
6-Mar-17	592	565	12m	Hold	Manik Taneja
1-Feb-17	564	565	12m	Hold	Manik Taneja
1-Dec-16	529	540	12m	Hold	Manik Taneja
4-Nov-16	509	525	12m	Hold	Manik Taneja
26-Jul-16	536	500	12m	Hold	Manik Taneja
21-Jun-16	546	500	12m	Hold	Manik Taneja
30-May-16	506	500	12m	Hold	Manik Taneja
5-Apr-16	458	460	12m	Hold	Manik Taneja
5-Feb-16	440	415	12m	Hold	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



Source: Bloomberg, Company, Emkay Research

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Mindtree

Your success is our success

Refer to important disclosures at the end of this report

Lacking differentiated growth levers

CMP	Target Price
Rs 821 as of (January 8, 2019)	Rs 900 (▼) 12 months
Rating	**Upside**
HOLD (■)	9.6 %

- Increasing top-client concentration (20.2% of sales in Q2FY19 vs. 16.1% in Q2FY18), continuous churn in other Top2-10 accounts, and indications of macro concerns in Q2FY19 commentary do not provide us medium-term growth visibility. We believe that Mindtree lacks differentiated growth levers like 1) LTI's presence in 61 Fortune-500 clients; and 2) opportunity to tap Blackstone portfolio cos. and HP channel for Mphasis.
- While margins have improved by ~300bps from current bottomed-out levels (~12.6% on TTM basis now vs. ~9.1% 12 month prior to that), we do not see much headroom for improvement on this front due to planned investments in Endowments amid increasing supply-side constraints.
- With relatively low growth in its TTM deal TCV (~13% yoy vs. Revenue CAGR of ~16%), we expect Mindtree to, at best, deliver ~10% CAGR revenue growth over FY19-21E vs. ~12%+ CAGR for other peers such as LTI/Mphasis over the same period.
- While we acknowledge Mindtree's good performance in FY19, Mindtree's cautious commentary, high top-client dependency, relatively low deal TCV growth and limited margin expansion scope do not excite us. After Mindtree's steep correction in Q3FY19 (down ~16%), we have a Hold rating on the stock with a target price of Rs900 (based on 16x FY21E EPS).

Increasing top-client concentration makes Mindtree vulnerable

We believe that Mindtree lacks differentiated growth levers like 1) LTI's presence in 61 Fortune-500 clients and parental (L&T) heritage; and 2) opportunity to tap Blackstone portfolio companies and HP channels for Mphasis. In our view, the over-dependence on one client for growth (the top client constitute ~20% of sales and contributes ~50% of incremental revenues and relationship is now at about US$200mn on run rate – small change here can change the prospects materially) makes Mindtree's growth vulnerable and prone to adverse impacts from bad events. In addition, softer commentary, relatively modest order book growth, and declining gross margins (gross margin was down 20bps despite strong currency tailwinds in Q2FY19) should lead to a cut in earnings estimates on the Street.

Low growth and margin improvement visibility result in Hold rating

With low medium-term revenue growth visibility, cautious management commentary and limited headroom for further margin improvement, we expect Mindtree, at best, deliver 11% earnings CAGR over FY19-21E vs. ~15% CAGR for other mid-tier peers such as Mphasis over the same period. We have a Hold rating on Mindtree with a target price of Rs900 (based on 16x FY21E EPS).

Financial Snapshot (Consolidated)

(Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	52,364	54,628	69,926	77,823	87,120
EBITDA	7,181	7,405	10,603	12,047	13,552
EBITDA Margin (%)	13.7	13.6	15.2	15.5	15.6
APAT	4,410	5,701	7,615	8,242	9,242
EPS (Rs)	26.3	34.8	46.5	50.3	56.4
EPS (% chg)	(27.0)	32.5	33.6	8.2	12.1
ROE (%)	17.7	21.4	25.2	22.9	22.4
P/E (x)	31.3	23.6	17.7	16.3	14.6
EV/EBITDA (x)	18.9	17.7	12.0	10.4	9.2
P/BV (x)	5.4	4.9	4.1	3.5	3.1

Source: Company, Emkay Research

Change in Estimates	
EPS Chg FY19E/FY20E (%)	4.4/1.9
Target Price change (%)	(2.2)
Target Period (Months)	12
Previous Reco	HOLD

Emkay vs Consensus

EPS Estimates	FY19E	FY20E
Emkay	46.5	50.3
Consensus	46.1	53.7
Mean Consensus TP (12M)	Rs 1,021	

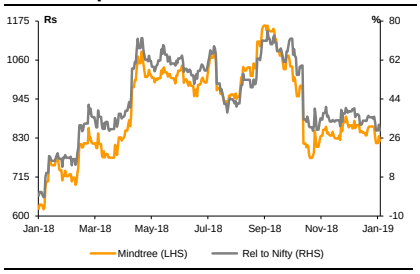
Stock Details	
Bloomberg Code	MTCL IN
Face Value (Rs)	10
Shares outstanding (mn)	164
52 Week H/L	1,184 / 599
M Cap (Rs bn/USD bn)	135 / 1.92
Daily Avg Volume (nos.)	1,562,336
Daily Avg Turnover (US$ mn)	18.9

Shareholding Pattern Sep '18	
Promoters	13.3%
FIIs	43.2%
DIIs	7.8%
Public and Others	35.7%

Price Performance

(%)	1M	3M	6M	12M
Absolute	(5)	(18)	(17)	30
Rel. to Nifty	(6)	(21)	(18)	28

Relative price chart



Source: Bloomberg

This report is solely produced by Emkay Global. The following person(s) are responsible for the production of the recommendation:

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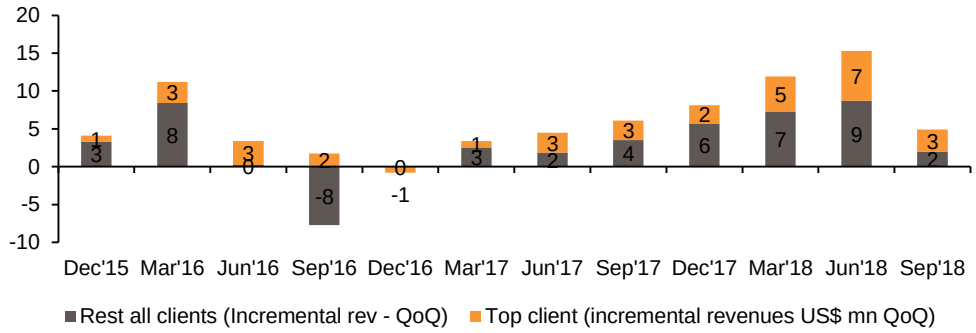
ED: ANISH MATHEW SA: DHANANJAY SINHA

Performance is strong, leading indicators are not

Top client dependence: Based on our checks we believe that major revenues from its Top client to be coming from 1) new cloud roll-outs in new geographies; 2) management of cloud subscriptions across 44 client locations (data centers) across the globe; and 3) providing associated services such as data analytics. With approx. USD200mn annual revenue run-rate (based on Q1 contribution) and about 40-50% of incremental revenues over the past many quarters, we believe that Mindtree relies heavily on this account for growth. Although we acknowledge Mindtree's strong growth in this top account, we remain apprehensive of future growth in this account, owing to its increased size and dependency.

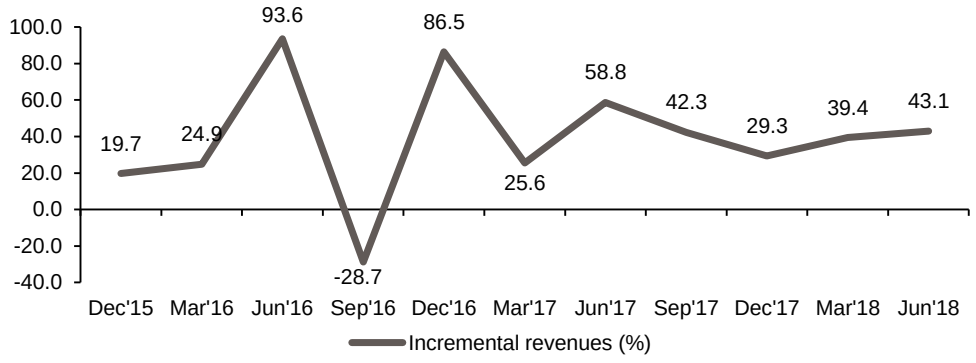
Exhibit 118: Incremental revenue from Top client still alarmingly high



Source: Company, Emkay Research

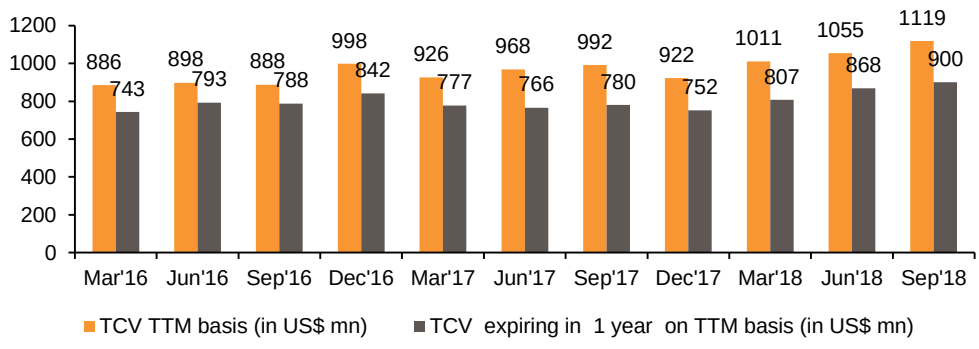
Other Top clients: Mindtree's other Top2-10 clients have seen significant churn in the recent past. While Mindtree indicated return of stability in other Top2-10 clients (except for a BFSI client), we would still remain cautious on growth in these accounts and wait for growth to start reflecting in numbers.

Exhibit 119: Top client's incremental revenue contribution to overall revenue (%)



Source: Company, Emkay Research

Exhibit 120: Deal TCV improving but large revenue growth momentum



Source: Company, Emkay Research

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Exhibit 121: Change in estimates

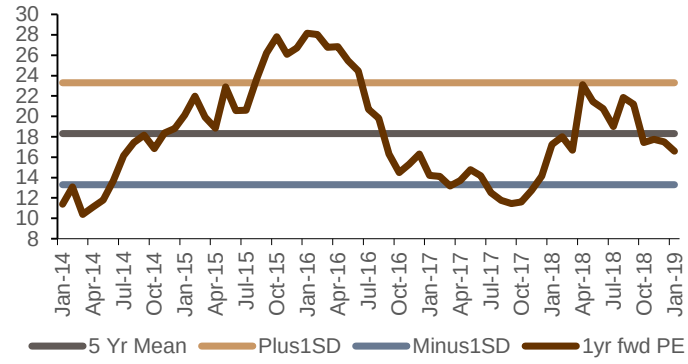
(All fig in Rs mn except EPS and %)	FY19E			FY20E			FY21E		
	Old	New	% change	Old	New	% change	Old	New	% change
Overall Revenues(in US$ mn)	993	991	-0.2%	1,086	1,088	0.3%	1,172	1,193	1.8%
YoY growth, %	*17.3%*	*17.0%*		*9.3%*	*9.8%*		*8.0%*	*9.6%*	
Revenues	69,816	69,926	0.2%	78,165	77,823	-0.4%	84,384	87,120	3.2%
EBIT	10,497	10,603	1.0%	11,926	12,047	1.0%	12,966	13,552	4.5%
EBIT mgns, %	*15.0*	*15.2*		*15.3*	*15.5*		*15.4*	*15.6*	
Net profits	7,292	7,615	4.4%	8,091	8,242	1.9%	8,888	9,242	4.0%
EPS	44.4	46.3	4.4%	49.2	50.1	1.9%	54.1	56.2	4.0%

Source: Company, Emkay Research

Valuation

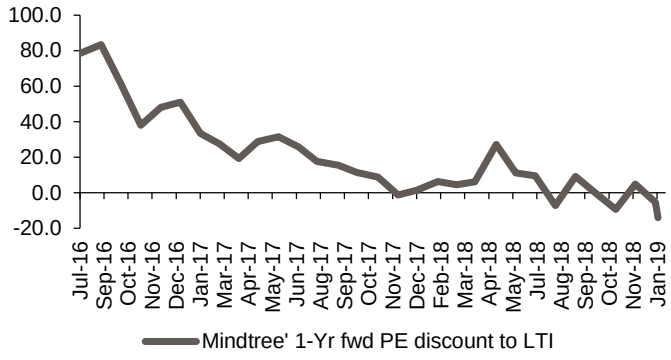
Increasing Top client concentration (20.2% of sales in Q2FY19 vs. 16.1% of sales in Q2FY18), cautious Q2FY19 commentary (highlighted macro concerns), planned investments in Endowment to achieve the longer-term vision of becoming an IP-led organization and increasing supply-side constraints do not provide us medium-term revenue growth visibility. We expect Mindtree, at best, to deliver ~11% earnings CAGR over FY19-21E vs. ~15% CAGR for Mphasis over the same period. We have a Hold rating on Mindtree with a target price of Rs900 (based on 16x FY21E EPS).

Exhibit 122: Mindtree's 5-Yr historical 1-Yr fwd P/E multiple chart



Source: Company, Emkay Research

Exhibit 123: Mindtree's 1-Yr fwd P/E discount to LTI



Source: Company, Emkay Research

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Key Financials (Consolidated)

Income Statement

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**52,364**	**54,628**	**69,926**	**77,823**	**87,120**
Expenditure	**45,183**	**47,223**	**59,322**	**65,776**	**73,568**
EBITDA	**7,181**	**7,405**	**10,603**	**12,047**	**13,552**
Depreciation	1,858	1,715	1,630	1,790	2,026
EBIT	**5,323**	**5,690**	**8,973**	**10,257**	**11,526**
Other Income	641	1,902	1,470	1,015	1,215
Interest expenses	191	169	39	20	80
PBT	**5,773**	**7,423**	**10,404**	**11,252**	**12,661**
Tax	1,363	1,722	2,789	3,010	3,418
Extraordinary Items	0	0	0	0	0
Minority Int./Income from Assoc.	0	0	0	0	0
Reported Net Income	**4,410**	**5,701**	**7,615**	**8,242**	**9,242**
Adjusted PAT	**4,410**	**5,701**	**7,615**	**8,242**	**9,242**

Balance Sheet

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Equity share capital	1,680	1,639	1,639	1,639	1,639
Reserves & surplus	24,091	25,775	31,423	37,305	42,040
Net worth	**25,771**	**27,414**	**33,062**	**38,944**	**43,679**
Minority Interest	**0**	**0**	**0**	**0**	**0**
Loan Funds	**314**	**94**	**94**	**94**	**94**
Net deferred tax liability	0	0	0	0	0
Total Liabilities	**26,085**	**27,508**	**33,156**	**39,038**	**43,773**
Net block	**10,220**	**9,568**	**11,688**	**14,398**	**17,871**
Investment	**2,884**	**2,674**	**2,824**	**3,724**	**4,624**
Current Assets	**20,610**	**25,031**	**30,285**	**34,432**	**36,668**
Cash & bank balance	2,508	3,289	7,193	9,590	10,076
Other Current Assets	0	0	0	0	0
Current liabilities & Provision	**7,821**	**9,857**	**11,732**	**13,607**	**15,482**
Net current assets	**12,789**	**15,174**	**18,553**	**20,825**	**21,186**
Misc. exp	0	0	0	0	0
Total Assets	**26,085**	**27,508**	**33,156**	**39,038**	**43,773**

Cash Flow

Y/E Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
PBT (Ex-Other income) (NI+Dep)	**5,549**	**7,423**	**10,404**	**11,252**	**12,661**
Other Non-Cash items	(451)	(1,282)	0	0	0
Chg in working cap	1,217	(833)	525	125	125
Operating Cashflow	**6,535**	**5,644**	**9,810**	**10,177**	**11,473**
Capital expenditure	(846)	(1,011)	(3,750)	(4,500)	(5,500)
Free Cash Flow	**5,689**	**4,633**	**6,060**	**5,677**	**5,973**
Investments	(3,746)	(1,041)	(150)	(900)	(900)
Other Investing Cash Flow	0	0	0	0	0
Investing Cashflow	**(4,533)**	**(2,000)**	**(3,900)**	**(5,400)**	**(6,400)**
Equity Capital Raised	8	(2,639)	0	0	0
Loans Taken / (Repaid)	550	1,906	0	0	0
Dividend paid (incl tax)	(1,934)	(2,142)	(1,967)	(2,360)	(4,507)
Other Financing Cash Flow	0	0	0	0	0
Financing Cashflow	**(1,431)**	**(2,863)**	**(2,006)**	**(2,380)**	**(4,587)**
Net chg in cash	**571**	**781**	**3,904**	**2,397**	**486**
Opening cash position	1,937	2,508	3,289	7,193	9,590
Closing cash position	**2,508**	**3,289**	**7,193**	**9,590**	**10,076**

Source: Company, Emkay Research

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Key Ratios

Profitability (%)	FY17	FY18	FY19E	FY20E	FY21E
EBITDA Margin	13.7	13.6	15.2	15.5	15.6
EBIT Margin	10.2	10.4	12.8	13.2	13.2
Effective Tax Rate	23.6	23.2	26.8	26.8	27.0
Net Margin	8.4	10.4	10.9	10.6	10.6
ROCE	23.3	28.3	34.4	31.2	30.8
ROE	17.7	21.4	25.2	22.9	22.4
RoIC	26.5	27.1	40.3	42.1	42.2

Per Share Data (Rs)	FY17	FY18	FY19E	FY20E	FY21E
EPS	26.3	34.8	46.5	50.3	56.4
CEPS	37.3	45.2	56.4	61.2	68.8
BVPS	153.4	167.3	201.7	237.6	266.5
DPS	11.5	7.0	10.0	12.0	12.5

Valuations (x)	FY17	FY18	FY19E	FY20E	FY21E
PER	31.3	23.6	17.7	16.3	14.6
P/CEPS	22.0	18.1	14.6	13.4	11.9
P/BV	5.4	4.9	4.1	3.5	3.1
EV / Sales	2.6	2.4	1.8	1.6	1.4
EV / EBITDA	18.9	17.7	12.0	10.4	9.2
Dividend Yield (%)	1.4	0.9	1.2	1.5	1.5

Gearing Ratio (x)	FY17	FY18	FY19E	FY20E	FY21E
Net Debt/ Equity	(0.1)	(0.1)	(0.2)	(0.2)	(0.2)
Net Debt/EBIDTA	(0.3)	(0.4)	(0.7)	(0.8)	(0.7)
Working Cap Cycle (days)	71.7	79.4	59.3	52.7	46.5

Growth (%)	FY17	FY18	FY19E	FY20E	FY21E
Revenue	11.7	4.3	28.0	11.3	11.9
EBITDA	(13.5)	3.1	43.2	13.6	12.5
EBIT	(23.6)	6.9	57.7	14.3	12.4
PAT	(26.9)	29.3	33.6	8.2	12.1

Quarterly (Rs mn)	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19E
Revenue	13,777	14,640	16,395	17,554	18,025
EBITDA	2,074	2,355	2,310	2,699	2,794
EBITDA Margin (%)	**15.1**	**16.1**	**14.1**	**15.4**	**15.5**
PAT	1,415	1,822	1,582	2,063	2,098
EPS (Rs)	**8.6**	**11.1**	**9.7**	**12.6**	**12.8**

Source: Company, Emkay Research

Shareholding Pattern (%)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoters	13.6	13.6	13.4	13.4	13.3
FIIs	40.3	40.6	41.7	44.4	43.2
DIIs	5.6	8.3	8.7	6.9	7.8
Public and Others	40.5	37.5	36.2	35.4	35.7

Source: Capitaline

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RECOMMENDATION HISTORY TABLE

Date	Closing Price	TP	Period (months)	Rating	Analyst
02-Jan-18	863	920	12m	Hold	Rahul Jain
17-Oct-18	978	880	12m	Sell	Rahul Jain
5-Oct-18	1,041	850	12m	Sell	Rahul Jain
4-Sep-18	1,118	760	12m	Sell	Rahul Jain
19-Jul-18	971	760	12m	Sell	Rahul Jain
10-Jul-18	1,036	690	12m	Sell	Rahul Jain
6-Jul-18	993	690	12m	Sell	Rahul Jain
18-Apr-18	865	630	12m	Reduce	Rahul Jain
5-Apr-18	806	580	12m	Reduce	Rahul Jain
17-Jan-18	625	550	12m	Reduce	Rahul Jain
8-Jan-18	633	510	12m	Reduce	Rahul Jain
25-Oct-17	507	510	12m	Hold	Rahul Jain
4-Oct-17	480	500	12m	Hold	Rahul Jain
20-Sep-17	464	500	12m	Hold	Rahul Jain
19-Jul-17	507	490	12m	Reduce	Rahul Jain
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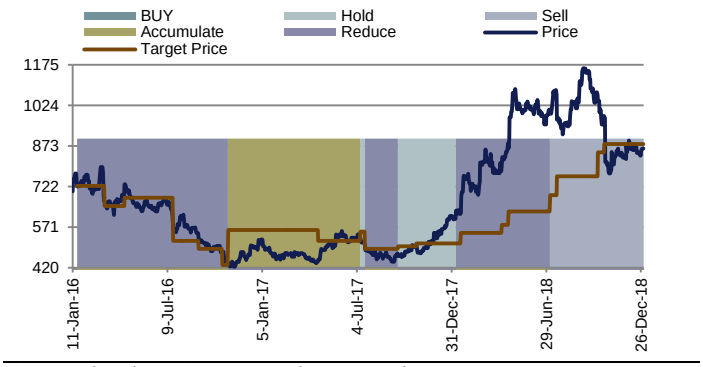
22-Feb-17	468	560	12m	Accumulate	Manik Taneja
19-Jan-17	485	560	12m	Accumulate	Manik Taneja
1-Nov-16	440	560	12m	Accumulate	Manik Taneja
21-Oct-16	479	430	12m	Reduce	Manik Taneja
19-Sep-16	505	490	12m	Reduce	Manik Taneja
6-Sep-16	525	490	12m	Reduce	Manik Taneja
9-Aug-16	597	520	12m	Reduce	Manik Taneja
19-Jul-16	562	520	12m	Reduce	Manik Taneja
21-Jun-16	658	680	12m	Reduce	Manik Taneja
18-Apr-16	731	680	12m	Reduce	Manik Taneja
11-Mar-16	663	650	12m	Reduce	Manik Taneja
19-Jan-16	722	725	12m	Reduce	Manik Taneja

Source: Company, Emkay Research

RECOMMENDATION HISTORY CHART



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Emkay Rating Distribution

BUY	Expected total return (%) (Stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (Stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
HOLD	Expected total return (%) (Stock price appreciation and dividend yield) of upto 10% within the next 12-18 months.
REDUCE	Expected total return (%) (Stock price depreciation) of upto (-) 10% within the next 12-18 months.
SELL	The stock is believed to underperform the broad market indices or its related universe within the next 12-18 months.

Completed Date: 09 Jan 2019 21:34:09 (SGT)
Dissemination Date: 09 Jan 2019 21:35:09 (SGT)

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