

## Covid-19 to dent Q1; demand recovery cues key to watch

We expect a broad-based demand-led decline in revenue and margins for IT services players in Q1FY21 due to the Covid-19 impact. We estimate 5-7% QoQ revenue shrinkage for large-caps and a 3-8% QoQ decline for mid-caps. TCVs too are likely to moderate. Operating margins are forecast to contract 180bps QoQ on average across most of our coverage despite aggressive use of traditional operating levers. We await key commentary on: (1) demand outlook for FY21, (2) pockets of growth, (3) repricing, and (4) discretionary spending patterns.

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**Expect sharp QoQ revenue decline:** Based on the sector's Q4FY20 results, we expect TCS/Infosys (INFO) to report dollar revenue declines of 5.4%/5.7% QoQ in Q1FY21. Wipro is estimated to see a sharper fall of 6.1% on account of CEO transition and higher exposure to the retail vertical. Tech Mahindra (TECHM) could be a laggard among large-caps due to sustained weakness in its communications business and headwinds in the BPO and enterprise segments.

Mindtree (MTCL) looks headed for an 8% QoQ decline due to a lumpy revenue mix, while travel and hospitality exposure could drive a 5.7% drop for NIIT Tech. We expect Persistent Systems, eClerx, Hexaware and L&T Infotech (LTI) to decline in the range of 5-7%. Among mid-caps, Mphasis could fall the least (~3%).

**Severe margin impact:** Operating margins face several headwinds from (1) a lower revenue base, (2) higher bench costs due to reduced utilisation, (3) work-from-home costs, (4) increased subcontractor and localisation costs due to H1B visa challenges and travel restrictions, and (5) competitive pricing to retain clients. In our view, these challenges will outweigh the tailwinds of currency depreciation, low travel costs, and deferred hiring, promotions and bonuses. Barring LTI and MTCL, we expect ~180bps QoQ margin declines on average for our coverage.

**Key areas of concern:** While healthcare, hi-tech, telecom and CPG will see better demand, verticals such as manufacturing, auto, energy, utilities, retail, travel and hospitality will see a stronger and immediate fallout from the pandemic. Large players such as TCS and INFO have also expressed concerns over BFSI due to low/negative interest rates. IMS and run-business will see demand for higher productivity. New deal wins are expected to moderate post a strong Q4, and small- and mid-cap players will face the risk of vendor consolidation. In a silver lining for the sector, cloud, collaborative tools, cybersecurity and virtualisation feature among the emerging areas of demand.

### RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
TCS IN	2,263	2,160	ADD
INFO IN	764	760	ADD
WPRO IN	223	170	SELL
HCLT IN	579	680	BUY
TECHM IN	581	690	BUY
LTI IN	2,000	2,230	BUY
MPHL IN	911	780	SELL
MTCL IN	961	880	REDUCE
HEXW IN	335	350	ADD
PSYS IN	651	590	REDUCE
NITEC IN	1,436	1,430	ADD
ECLX IN	480	420	REDUCE

Price &amp; Target in Rupees



## Prefer HCLT and TECHM

We prefer HCL Tech (HCLT, BUY, TP: Rs 680) and TECHM (BUY, TP: Rs 690) among large-caps and LTI (BUY, TP: Rs 2,230) among mid-caps.

- We like TECHM for attractive valuations, likely resilient telecom tech spends and an on-course 5G roadmap in the US despite Covid-19.
- In our view, HCLT offers relatively higher near-to-mid-term growth visibility than peers on the back of (1) its growing software (Mode-3) business which forms 15.7% of revenue and is relatively immune to Covid-led volatility, (2) healthy large deal wins (the 14 contracts won in Q4FY20 will transition to revenue-bearing mode in Q2FY21), and (3) its IMS heritage which offers unique positioning to leverage the cloud migration opportunity catalysed by the pandemic.
- LTI with its robust sales focus, strong offshore presence and operational efficiency is our favourite among mid-caps.

**FIG 1 – JUN'20 QUARTER ESTIMATES**

Company	Revenues (US\$ mn)	US\$ Revenue growth (%)		CC growth QoQ (%)	EBIT margins (%)	EBIT (Rs mn)	EBIT growth (%)		EBIT margins (bps)		PAT (Rs mn)	PAT growth (%)	
		QoQ	YoY				QoQ	YoY	QoQ	YoY		QoQ	YoY
TCS	5,151	(5.4)	(6.1)	(5.0)	24.2	94,166	(6.1)	2.1	(90)	(80)	74,631	(7.3)	(8.2)
INFO	3,015	(5.7)	(3.7)	(5.5)	20.2	45,812	(7.0)	2.5	(102)	(36)	37,198	(15.1)	(3.2)
WPRO*	1,947	(6.1)	(4.5)	(6.0)	14.5	22,026	(15.3)	(10.7)	(200)	(370)	20,122	(13.5)	(15.7)
HCLT	2,366	(7.0)	0.1	(6.8)	17.3	30,933	(20.3)	10.3	(350)	30	25,101	(20.4)	13.1
TECHM	1,185	(8.5)	(5.0)	(8.3)	8.8	7,864	(17.2)	(20.8)	(120)	(270)	7,877	(2.0)	(17.9)
LTI	389	(5.2)	9.0	(4.8)	17.2	5,041	0.1	27.0	50	120	3,892	(8.9)	9.5
MPHL	310	(3.0)	1.2	(3.1)	14.1	3,295	(14.0)	(5.0)	(220)	(200)	2,553	(27.7)	(6.6)
MTCL	256	(8.0)	(3.0)	(7.8)	11.9	2,308	(9.8)	104.8	(50)	(100)	1,685	(18.3)	91.1
HEXW	197	(6.7)	4.5	(6.5)	10.5	1,569	(13.7)	(17.9)	(130)	(410)	1,206	(31.1)	(20.3)
PSYS	121	(4.8)	1.1	(4.8)	8.3	757	(11.6)	(7.2)	(90)	(150)	594	(29.2)	(28.0)
NITEC	146	(5.7)	5.4	(4.0)	12.7	1,404	(8.7)	42.1	(116)	244	1,105	(20.6)	26.0
ECLX	45	(6.1)	(12.0)	(6.1)	13.0	437	(26.2)	(10.8)	(380)	(80)	355	(35.7)	(10.6)

Source: BOBCAPS Research. | \*EBIT margins refers to IT Services business | CC – Constant Currency

**FIG 2 – JUN'20 QUARTER CURRENCY MOVEMENT**

Exchange rate	Jun'20	Mar'20	Jun'19	QoQ (%)	YoY (%)
<b>USD/INR</b>					
Average	75.41	73.03	69.52	3.3	8.5
Close	75.48	75.39	68.92	0.1	9.5
<b>Euro/USD</b>					
Average	1.11	1.10	1.12	0.4	(1.5)
Close	1.12	1.23	1.14	(9.2)	(1.4)
<b>GBP/USD</b>					
Average	1.24	1.28	1.27	(2.9)	(2.6)
Close	1.24	1.23	1.27	0.6	(2.0)

Source: BOBCAPS Research

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### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

**ADD** – Expected return from >+5% to +15%

**REDUCE** – Expected return from -5% to +5%

**SELL** – Expected return <-5%

**Note:** Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

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