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IT SERVICES

01 September 2020

Deep Dive 3: Swift BFSI recovery ahead – raise TCS to BUY

While BFSI vertical revenues of Indian IT players contracted in Q1FY21, we expect a swift recovery to pre-Covid growth levels through FY21 on the back of (1) receding supply challenges and (2) steady technology budgets at large US banks. In our view, the pandemic will catalyse deepening of technology systems in the BFSI industry as digital channels take centrestage. TCS (31% BFSI revenue mix) is likely to be a key beneficiary – we upgrade the stock to BUY (from ADD) and roll to a new Sep'21 TP of Rs 2,620 (Rs 2,320).

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BFSI to see quick rebound: BFSI forms the largest chunk of revenue for Indian IT companies at ~28%. Revenues from this vertical contracted 2-6% QoQ in Q1FY21, whereas tech spends by large US banks increased both sequentially and annually – this contrast stemmed from supply-side issues, mainly delayed work-from-home approvals due to security, compliance and regulatory concerns. We expect Indian IT players to see a quick rebound in BFSI revenue growth to pre-Covid levels through FY21, as supply challenges have abated and commentary from large US banks indicates intact IT budgets.

Digital channels fortified bank operations amid pandemic, tech budgets intact: Digital channels and technology infrastructure have enabled banks to provide uninterrupted services during the pandemic. In our view, the Covid-19 outbreak will catalyse the entrenchment of technology spending in the banking industry, with large US banks remaining committed to tech investments despite a cost optimisation focus. The proportion of tech spends in operating cost has risen by 200bps for major US banks in the last five years. In Europe, banking majors have fast tracked restructuring plans with a higher resource allocation for IT.

Upgrade TCS to BUY: TCS with its high 31% BFSI exposure is in a favourable position to benefit from the vertical's healthy growth dynamics, on the back of its comprehensive services portfolio, rich product offerings, robust scale and efficient, geographically-diverse delivery model. We upgrade TCS to BUY from ADD. The stock's CYTD underperformance at +5% vs. +15% for the Nifty IT index adequately captures its soft showing in the last two pandemic-hit quarters. We see increased impetus for technology demand catalysed by the Covid crisis and hence raise valuation multiples across our coverage universe, aligning these to the 5Y average P/E +1SD/+2SD.

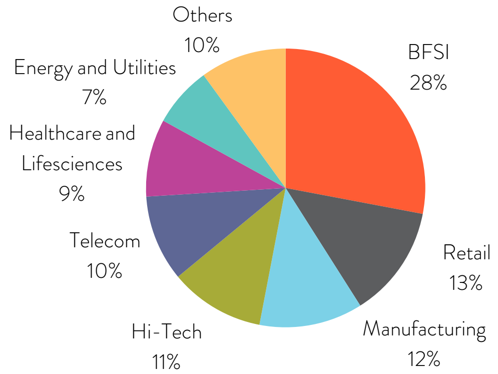
RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
TCS IN	2,257	2,620	BUY
INFO IN	929	1,020	ADD
WPRO IN	271	246	SELL
HCLT IN	694	810	BUY
TECHM IN	741	910	BUY
LTI IN	2,458	3,290	BUY
MPHL IN	1,104	950	SELL
MTCL IN	1,156	1,220	ADD
HEXW IN	396	500	BUY
PSYS IN	958	840	SELL
NITEC IN	1,924	2,110	ADD
ECLX IN	704	580	SELL

Price & Target in Rupees

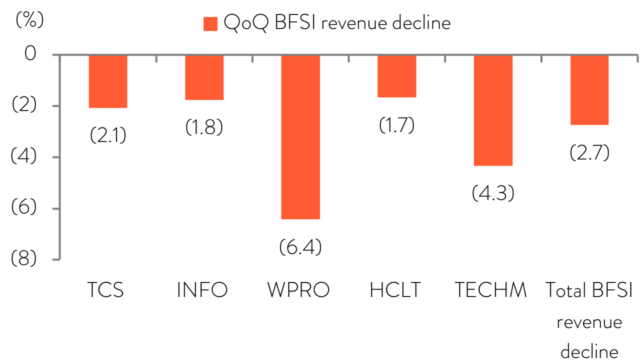
Focus charts

FIG 1 – BFSI VERTICAL FORMS ~30% OF REVENUE FOR TIER-I IT COMPANIES



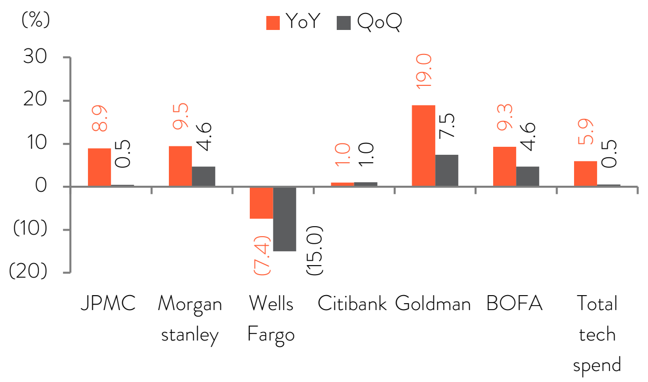
Source: BOBCAPS Research

FIG 2 – BFSI REVENUE DECLINED QOQ FOR TOP-5 COMPANIES DUE TO SUPPLY-SIDE ISSUES IN Q1FY21



Source: BOBCAPS Research

FIG 3 – TECH SPEND INCREASED QOQ FOR MOST TOP US BANKS IN Q1FY21 DESPITE COVID IMPACT



Source: BOBCAPS Research.

FIG 4 – TOP US BANKS UPBEAT ON DIGITISATION: Q1FY21 COMMENTARY

"We also have investments that we will continue to make; investments in technology, investments in enhancing digital capabilities, which have proven to be quite valuable as we manage this crisis."

- Citibank

"We have been rapidly expanding digital access and deploying new tools. Customers are adopting these new tools as demonstrated by 52% increase in dollar volumes of mobile deposits in March 2020 vs. March 2019."

- Wells Fargo

"Our digital banking capabilities have helped with both customer service and sales so our financial centre visits are down and sales are down because of that. We've seen customer digital logins remain steady as people manage their financial lives on a digital basis."

- Bank of America

"Digital channels are at the forefront to provide uninterrupted services especially in consumer banking."

- Goldman Sachs

Source: BOBCAPS Research

FIG 5 – TOP EUROPEAN BANKS ALSO POSITIVE ON DIGITISATION: Q1FY21 COMMENTARY

"The strength of our digital platforms is evidenced in particular by a steady increase in the number of customers active on mobile apps, as well as in the number of daily connections during and after respective lockdowns."

- BNP Paribas

"Consequent to the pandemic lockdown, there has been an increased demand for our digital services. In the long term, the more we can get customers migrating to a digital offering and using the mobile banking app and online to manage their transaction volumes, the better for us."

- Barclays

"Our accelerated digital transition further supports our 2022 financial targets."

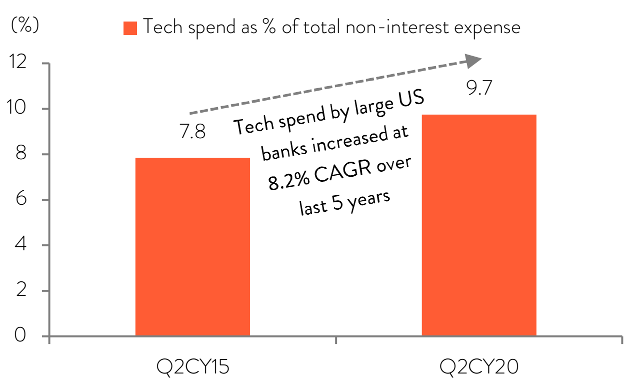
- Deutsche Bank

"The pandemic has accelerated client shift to digital and our smart solution in this area is gaining popularity. We are enhancing our clients' digital experience through new interfaces and functionalities."

- Credit Suisse

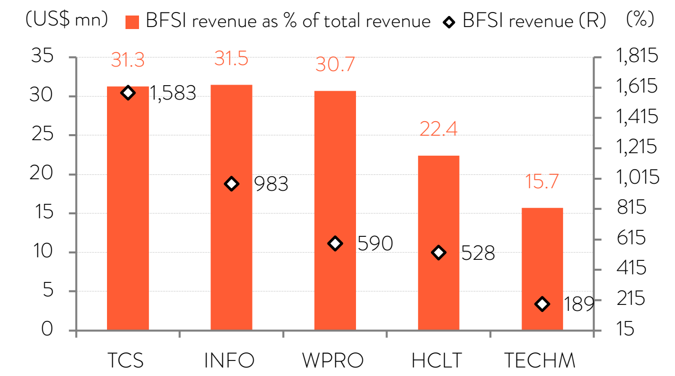
Source: BOBCAPS Research

FIG 6 – 190BPS INCREASE IN PROPORTION OF TECH SPEND IN OPERATING EXPENSES OF LARGE US BANKS



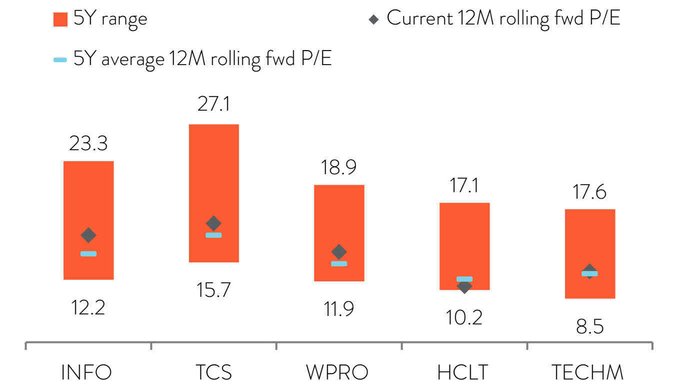
Source: BOBCAPS Research. *Above chart represents aggregate tech spend as reflected in income statement of JPMC, Morgan Stanley, Wells Fargo, Bank of America, Citibank and Goldman Sachs.

FIG 7 – BFSI EXPOSURE FOR TIER-I IT COMPANIES; TCS BEST PLACED IN OUR VIEW



Source: BOBCAPS Research. * TCS' BFSI revenue does not include regional markets and product & platform revenue.

FIG 8 – TCS TRADING AT 8% DISCOUNT TO ITS PEAK VALUATIONS



Source: BOBCAPS Research

FIG 9 – VALUATION SUMMARY

Company	CMP (Rs)	Mkt Cap (US$ bn)	Rating	Target Price (Rs)	US$ revenue CAGR FY20-22E (%)	EBIT CAGR (%) FY20-22E	EPS (Rs)			P/E (x)			ROE (%)		
							FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
TCS	2,257	112.9	BUY	2,620	2.8	10.4	86.2	81.0	102.2	26.2	27.9	22.1	37.0	32.8	34.7
INFO	929	53.8	ADD	1,020	5.7	14.6	39.0	41.1	46.5	23.8	22.6	20.0	26.5	25.2	25.7
WPRO	271	20.7	SELL	246	(2.4)	(0.2)	16.7	14.8	15.5	16.3	18.3	17.4	16.9	14.6	13.5
HCLT	694	25.1	BUY	810	3.4	10.1	40.9	44.0	48.5	17.0	15.8	14.3	23.7	21.8	21.5
TECHM	741	8.6	BUY	910	2.3	17.5	48.3	47.0	55.1	15.3	15.8	13.5	19.8	17.7	18.8
LTI	2,458	5.8	BUY	3,290	9.9	17.7	86.4	93.3	112.4	28.5	26.3	21.9	29.5	27.9	28.5
MPHL	1,104	2.7	SELL	950	5.0	12.9	63.7	62.4	74.9	17.3	17.7	14.7	21.4	19.0	20.9
MTCL	1,156	2.5	ADD	1,220	2.4	29.4	38.3	47.6	59.2	30.2	24.3	19.5	19.5	23.2	25.0
HEXW*	396	1.6	BUY	500	7.3	9.1	22.3	22.4	24.4	17.8	17.7	16.2	26.2	22.5	21.1
PSYS	958	0.8	SELL	840	9.3	33.4	42.7	46.6	56.2	22.5	20.6	17.0	14.1	14.3	15.7
NITEC	1,924	1.6	ADD	2,110	8.5	17.7	73.5	75.8	107.3	26.2	25.4	17.9	18.7	16.8	21.0
ECLX	704	0.4	SELL	580	3.0	8.2	55.5	58.2	69.4	12.7	12.1	10.2	17.5	14.4	16.2

Source: Company, BOBCAPS Research. * HEXW is a calendar year company

Contents

BFSI revenue to rebound rapidly

Following our detailed analysis of **Retail IT spends amid the pandemic** and **shifting trends in the global Telecom industry**, the third report in our 'Deep Dive' series examines the changing technology dynamics in the Banking, Financial Services & Insurance (BFSI) industry. Our analysis includes a closer look at the technology strategies and priorities of large US and European banks as reshaped by the Covid-19 pandemic.

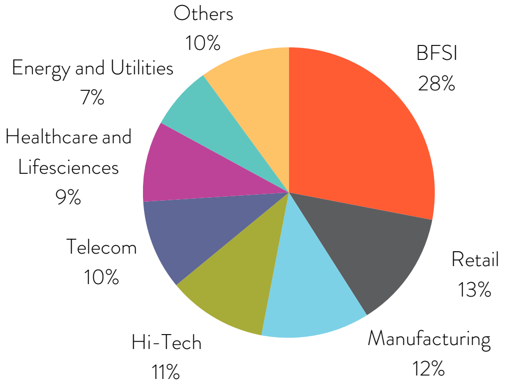
Key report findings are as follows: (1) despite the Covid-19 crisis, technology spends increased at large western banks (especially US banks) in the Jun'20 quarter and their tech budgets are largely intact, and (2) digital channels fortified banking operations during the pandemic and hence technology spending is expected to become more entrenched. These twin factors coupled with ebbing supply challenges will drive a swift rebound in BFSI revenue growth for Indian IT players to pre-Covid levels through FY21, in our view.

BFSI the largest vertical for Indian IT

Indian IT companies derive their largest chunk of revenue from the BFSI vertical, averaging ~28% in Q1FY21. The Big-3 (TCS, Infosys and Wipro) lead the pack, with BFSI forming 31% of their topline, followed by 22% for HCL Tech (HCLT) and 16% for Tech Mahindra (TECHM). Overall, India's US$ 147bn software industry earns a third of its revenue from the BFSI sector. We expect this share to grow further as most other verticals face greater contraction in the wake of Covid-19.

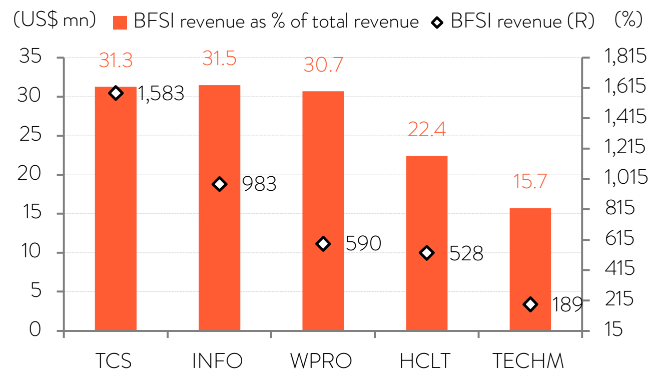
In addition, the BFSI sector typically spends heavily on new technology adoption, customer experience transformation and automation. Technology spending is a matter of competitive advantage in the sector. Following the pandemic outbreak, the use of mobile banking apps, internet banking, blockchain and chatbots has increased while cybersecurity spends have also risen to support the work-from-home model. We expect the continued increase in digital spending to raise BFSI's revenue share.

FIG 10 – BFSI REVENUE HAS THE LARGEST SHARE IN TOP 5 INDIAN IT PLAYERS (Q1FY21)



Source: Company, BOBCAPS Research

FIG 11 – TCS, INFO AND WPRO LEAD THE WAY IN TERMS OF BFSI EXPOSURE



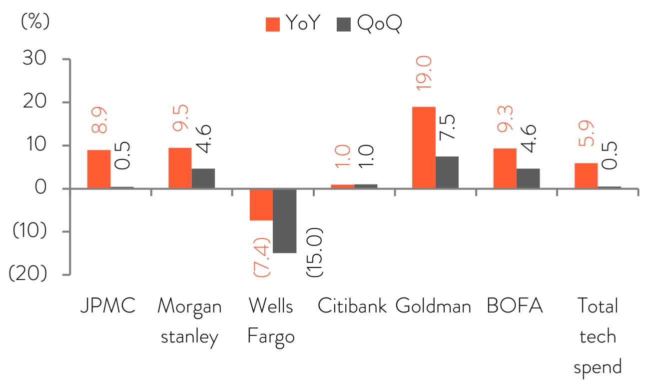
Source: Company, BOBCAPS Research, * TCS' BFSI revenue does not include regional markets and Product & platform revenue.

Tech spending of large US banks increased despite pandemic impact

Technology spending by five of the top six US banks (by revenue) has increased both QoQ and YoY in the pandemic-hit quarter ending Jun'20. These top-5 banks have raised their technological spend by an average of 10% QoQ. The highest yearly as well as sequential growth was seen from Goldman Sachs, followed by JPMC, Bank of America, Morgan Stanley and Citibank.

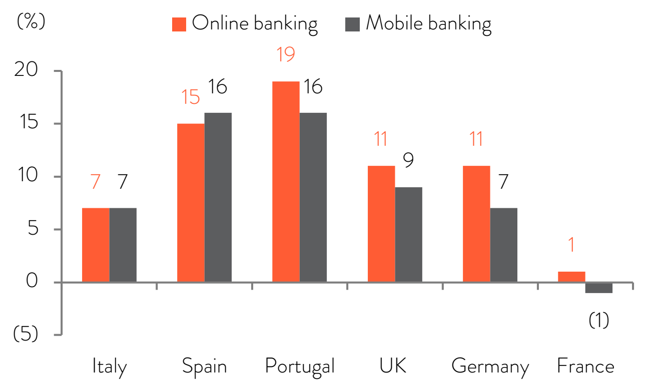
Wells Fargo was the only outlier which retracted its tech spending, as it came into the crisis in a worse shape than peers in the US. Overall, the total technology spend of the top six banks has increased by 0.5% QoQ and 6% YoY in the Jun'20 quarter despite the pandemic. In Europe too, online and mobile banking has gained traction in the last few months – likely keeping tech spending intact.

FIG 12 – YOY AND QOQ GROWTH IN TECH SPENDING OF TOP US BANKS IN JUN'20 QUARTER



Source: Company, BOBCAPS Research | Note: Based on banks' P&L disclosures

FIG 13 – GROWTH IN ONLINE AND MOBILE BANKING COMPARED TO PRE-COVID USAGE



Source: McKinsey survey, BOBCAPS Research

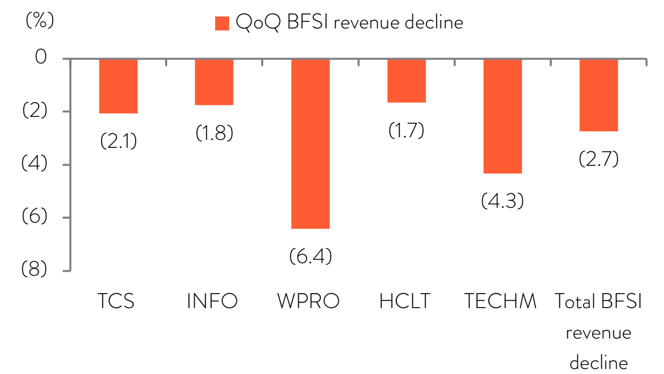
Supply side issues hit Q1 BFSI performance for top Indian IT...

BFSI revenues declined sequentially for all large-cap and most mid-cap Indian IT players in Q1FY21. Cumulatively, large-caps posted a decrease of 2.7% QoQ, with WPRO seeing the biggest fall of 6.4% QoQ, followed by 4.3% for TECHM. INFO, TCS and HCLT showed moderate dips of ~2% each. For mid-caps, total BFSI revenue decreased by 2% QoQ led by declines across the board, barring Hexaware (HEXW) which grew 3%.

The sequential decline in Q1FY21 occurred despite stable tech spending by banking clients – a disconnect that stemmed from various supply-side issues (such as delayed work-from-home approvals) and new projects being shelved amid slower decision-making by clients. TCS reported that its BFSI revenue weakened largely due to residual supply-side issues from early April.

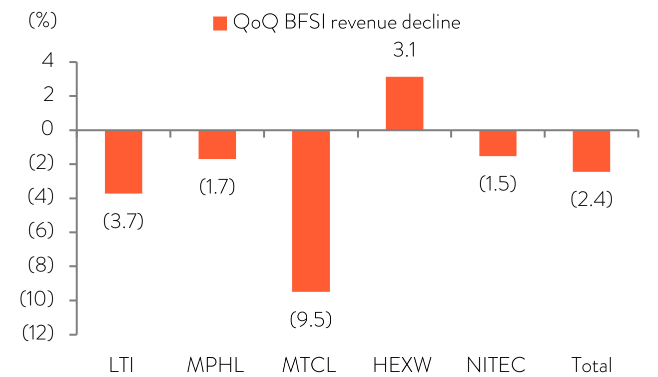
With most of the supply challenges getting sorted out in May, the demand side now appears stronger than anticipated for most IT players. We expect the disconnect between banks' tech spend and IT firms' BFSI revenues to be bridged to some extent in Q2FY21, aiding recovery in segmental revenue growth.

FIG 14 – BFSI REVENUE DECLINED QOQ FOR LARGE-CAPS IN JUN'20 QUARTER...



Source: Company, BOBCAPS Research * TCS' BFSI revenue does not include regional markets and Product & platform revenue.

FIG 15 – ...AND FOR MID-CAPS AS WELL

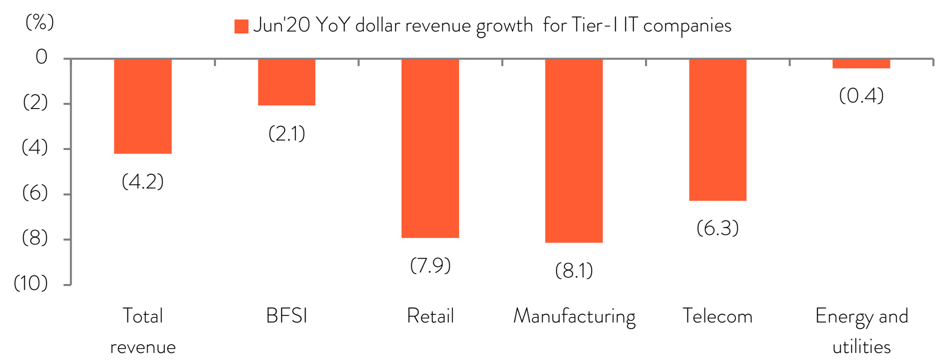


Source: Company, BOBCAPS Research | Note: For LTI, NITEC: BFSI = BFS + Insurance. For HEXW, data is for BFS only. MPHL data is as per latest classification and includes banking, capital market and insurance revenues.

...albeit better off than other verticals

Retail, travel-transportation and manufacturing appear to be the verticals worst affected by the pandemic. BFSI and telecom have been more resilient – the reason being that banks have been at the forefront of providing uninterrupted services during Covid-19, making digitisation of operations the need of the hour. As illustrated in Fig 16, the YoY decline in BFSI revenues during the Jun'20 quarter has been less sharp than that of other major verticals.

FIG 16 – VERTICAL-WISE PERFORMANCE OF TOP-5 IT PLAYERS IN JUN'20 QUARTER: BFSI FARED RELATIVELY BETTER

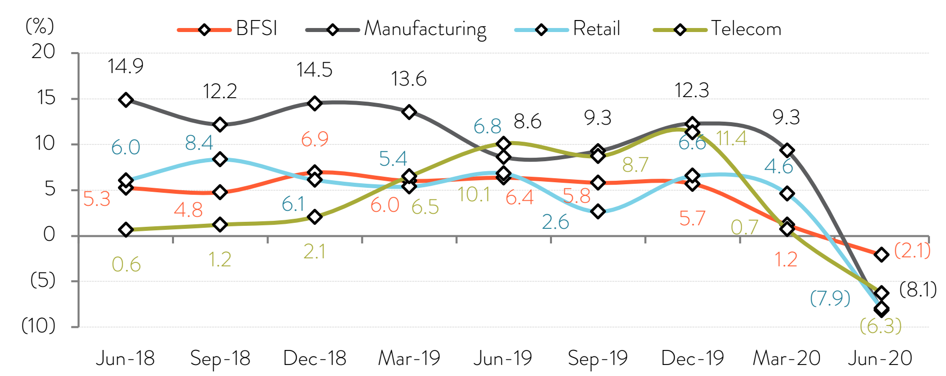


Source: BOBCAPS Research

An analysis of YoY growth trends in major verticals for tier-I IT companies over the last nine quarters shows that BFSI tends to be relatively less volatile (Fig 17). This has held true for the pandemic-hit quarter of Q1FY21 as well. But while growth recovery should be swift, it is unlikely to be sharp given the muted growth trend in BFSI prior to the Covid outbreak coupled with pandemic-related uncertainty.

Banks are staring at potentially large Covid-led delinquencies, rising NPAs cascading into Q3 and Q4FY21, and weaker interest rates. Insurance companies are facing lowest-ever interest rates and higher medical costs for health insurers. In the best-case scenario, we expect BFSI growth for tier-I players to retrace to pre-Covid levels through FY21.

FIG 17 – YOY GROWTH OF MAJOR VERTICALS FOR TIER-I IT COMPANIES: BFSI EXHIBITS LOWEST VOLATILITY



Source: BOBCAPS Research

Technology budgets to remain intact

As per World Bank, the key banking trends post Covid-19 will be (1) softer interest rates for longer, a weaker economic landscape and higher NPAs; (2) lower regulatory burden, and (3) accelerated digitisation.

Management commentary from large US banks in Jun'20 coupled with their steady tech spends during the pandemic indicates that banks and insurers remain committed to technology investments along with a cost optimisation focus. European banks have fast tracked restructuring plans with higher resource allocation for IT. In our view, technology and automation will be used as a tool to cut costs in other business areas.

US banks – upbeat commentary on digitisation

Large US-based banks make no mention of any cutback in technology spending in their annual reports or June quarter earnings commentary. Albeit emphasis on digital channels and technology investments was across-board.

- **JP Morgan's** annual report for 2019 disclosed that it will increase its technology spend by 4% over last year despite the pandemic, of which 50% will be dedicated to new-gen areas.
- **Wells Fargo** indicated that it is focusing on materially reducing its expenses but will continue pushing digital adoption for retail and commercial clients.
- **Citibank,** in its 2019 annual report, stated that digital technology is driving change across the industry, and Citi is adapting by migrating its capabilities to a digital platform.

FIG 18 – JUN'20 COMMENTARY OF TOP US BANKS

"We have also investments that we will continue to make; investments in technology, investments in enhancing digital capabilities, which have proven to be quite valuable as we manage through this crisis"

- Citibank

"We have been rapidly expanding digital access and deploying new tools. Customers are adopting these new tools as demonstrated by 52% increase in dollar volumes of mobile deposits in March 2020 vs. March 2019"

- Wells Fargo

"Our digital banking capabilities have helped with both customer service and sales so our financial center visits are down and sales are down because of that. We 've seen customer digital logins remain steady as people manage through their financial lives on a digital basis"

- Bank of America

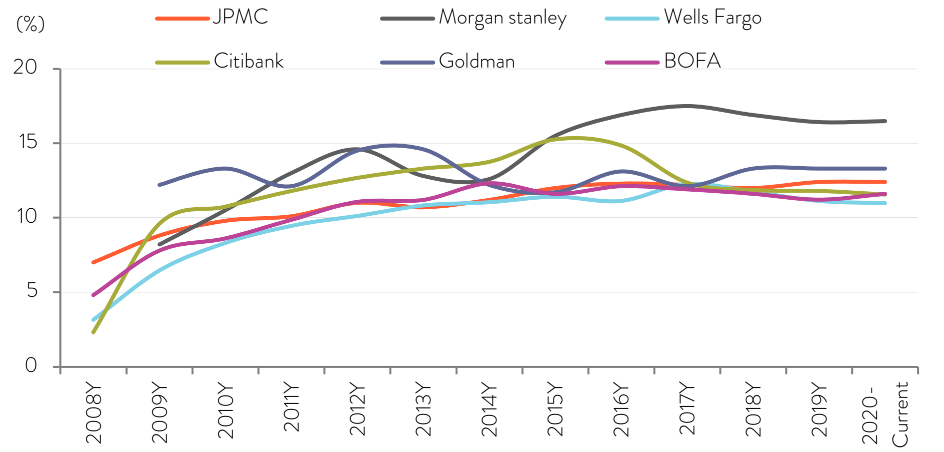
"Digital channels at the forefront to provide uninterrupted services especially in consumer banking"

- Goldman Sachs

Source: Company, BOBCAPS Research

Covid-19 has been compared to the Great Financial Crisis (GFC) and has resulted in similar levels of economic contraction. The GFC had severely impacted banks across the globe. However, top US banks are now much better prepared to face the potential wave of defaults and delinquencies as they have strengthened their balance sheets by steadily improving tier-I common equity ratios since the last financial crisis.

FIG 19 – TIER-I COMMON EQUITY RATIOS HAVE IMPROVED FOR TOP US BANKS

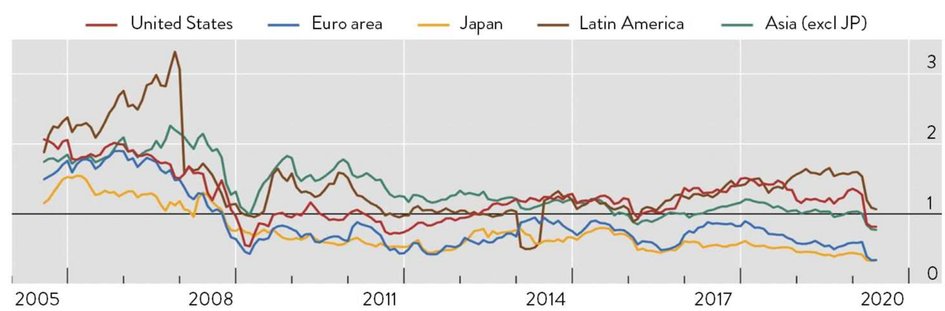


Source: BOBCAPS Research, Bloomberg | Note: Tier-I capital comprises a bank's core capital, common shares, stock surplus resulting from issue of common shares and retained earnings. This plays a major role in absorbing unexpected losses arising during a crisis. In the event of crisis, equity is first used up from Tier 1.

European banks – restructuring to unlock opportunities

European banks are among the most vulnerable amidst Covid-19. These banks had not recovered fully from the low interest rates that followed the last financial crisis, and their ROA and P/B continue to be depressed. Many large European banks are thus resorting to business restructuring post the pandemic.

FIG 20 – P/B OF BANKS LOWER IN EUROPE AND JAPAN



Price-to-book ratio [1]

Source: BIS, World Bank | [1] Monthly averages of daily data.

On the restructuring front, **Société Générale** is revamping its equities and credit derivatives business. **ABN AMRO** is shifting its key business focus to Northwest Europe. Other banks such as **HSBC, ABN** and **Credit Suisse** have new CEOs this year who view the pandemic as a catalyst to make alterations to their banks' business models. HSBC's new CEO wants to invest in technology to cut costs and make the bank more digitised. All these restructuring changes in core business model present a good opportunity for Indian IT players that have platform capabilities in BFSI.

This also supports our hypothesis that other operating expenses (excluding tech spending) will bear the brunt of banks' cost-cutting drive. Technology will be used as a tool to cut costs in other areas of business by use of hyper-automation alongside closure of retail branches.

FIG 21 – JUN'20 COMMENTARY OF TOP EUROPEAN BANKS

"During the Covid-19 crisis, our digital model is enabling us to continue to grow primary customers and keep NII stable. We will continue with harmonisation and digitisation to offer a better digital experience."

- ING

"Our digital mobile-first strategy, in my view, is the right strategy and under my leadership, we will continue with this. We slowly transform our clients from assisted channels, such as chat or call centres or even branches to digital banking or to mobile banking."

- ING

"We've also leveraged the crisis to accelerate digital interactions with customers."

- AXA

"Our digital adoption has accelerated a lot. Our digital products and services are becoming more important than ever. Digital sales penetration is now 11ppt higher than in the first half of 2019."

- Banco Santander

Source: Company, BOBCAPS Research

"The strength of our digital platforms is evidenced in particular by a steady increase in the number of customers active on mobile apps, as well as in the number of daily connections during and after respective lockdowns."

- BNP Paribas

"Consequent to the pandemic lockdown, there has been an increased demand for our digital services. In the long term, the more we can get customers migrating to a digital offering and using the mobile banking app and online to manage their transaction volumes, the better for us."

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"Our accelerated digital transition further supports our 2022 financial targets."

- Deutsche Bank

"The pandemic has accelerated client shift to digital and our smart solution in this area is gaining popularity. We are enhancing our clients' digital experience through new interfaces and functionalities."

- Credit Suisse

Source: Company, BOBCAPS Research

Mixed commentary by large-caps; mid-caps more optimistic

Large-cap Indian IT players, namely TCS and INFO, had sounded cautious on BFSI vertical outlook in Q4FY20. Their commentary has turned much more positive in Q1FY21 backed by a strong pipeline. WPRO felt the impact of negative interest rates and higher provisioning for potential delinquencies in Q1. The company continues to have a negative outlook as it's mostly pursuing deals in the cost-cutting legacy segment. HCLT, which has signed an agreement with banking software solutions provider 'Temenos' for complementing its mode-3 strategy, has a neutral outlook, as does TECHM despite a significant growth decline in Q1.

Commentary from mid-cap players appears a lot more positive as their BFSI pipeline looks better compared to other verticals. Some mid-caps with high exposure to the travel vertical are attempting to diversify more into BFSI.

FIG 22 – LARGE-CAP INDIAN IT COMMENTARY ON BFSI

Company	Jun'20 quarter commentary	Deal win commentary	Sentiment meter
TCS	▪ BFSI revenue declined by 2.1% QoQ US$ largely due to pandemic-related softness in UK and Canada, and residual supply-side issues from early April. Other than that, BFSI revenues held up relatively well in other markets. ▪ Banking and financial services proved to be more resilient than originally expected, given the experience in Q4. Especially now, with the supply-side getting sorted out by April and May, the demand side has turned out to be much stronger than originally anticipated. ▪ Another element is the acceleration of various forms of remote and contactless banking. We have seen one of our largest customers in Europe experimenting with video banking.	In BFSI, the contract value was US$ 2.1bn	Positive
INFO	▪ After an initial drop in the early part of Q1, financial services saw a faster recovery in business volumes and deals during the quarter, especially in US and APAC banking. ▪ Strength in the vertical was also driven by high levels of remote enablement for our employees in different geographies. ▪ We see some softness in the capital markets and cards & payment sectors. Likewise, near-zero interest rates are also expected to affect profitability of banks. ▪ Some provisions taken by a couple of the large banks in the US market, for their Q2 numbers, have been expanded.	On the positive side, we had multiple deal signings in Q1. In early Q2, we signed the largest ever deal in INFO's history in this vertical.	Cautiously positive
WPRO	▪ There are two big uncertainties – specifically with unemployment at the rate it is and the US, being our biggest market, people are worried about delinquencies. ▪ With near-zero interest rates or this could even be negative, banks as well as financial institutions are very careful in terms of the uncertainties. ▪ The Gartner report has clearly stated that there will be a 4% decline in terms of technology spending.	We are seeing a lot of discussions around the run- side (legacy part) of the bank where people are spending to cut cost and we are participating very, very heavily in that part.	Negative
HCLT	▪ The partnership with Temenos is very much a win-win. They had acquired a leading-edge technology called Kony which is around low-code, no-code development, digital experience and mobile technologies, and was rated very highly by analysts. ▪ From Temenos' point of view, see a great opportunity to exploit that technology with banking customers, and specifically take that horizontal technology and then build banking specific and core banking functionality on top of it.		Neutral
TECHM	▪ Our BFSI has done reasonably well; our retail online business has done reasonably well. Overall, we continue to see high growth in the HLS provider space.	We announced a big deal in HLS.	Neutral

Source: BOBCAPS Research

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FIG 23 – MID-CAP INDIAN IT COMMENTARY ON BFSI

Company	Jun'20 quarter commentary	Deal win commentary	Sentiment meter
LTI	▪ In BFS, we grew 9.4% YoY and declined 4.2% sequentially. While our top client continues to grow, Q1 performance in this vertical had an impact from delays in securing 'Work from Home' approval from a key customer and also one-time Covid-related commercial discounts – both in Europe. ▪ In Insurance, we registered 3.9% YoY growth and declined 2.7% sequentially. With increased exposure, lowest-ever interest rates and slowdown in economic conditions, insurance companies are facing significant economic challenges.	▪ We added 16 new logos across all our verticals during the quarter and won a large deal with a BFS logo in the UK. ▪ The multi-year deal, with a net new TCV of US$ 20mn is with a wealth management firm.	Mixed Positive on banking; negative on insurance
HEXW	▪ BFS grew sequentially. ▪ In banking, on the mortgage side because of the interest going down, mortgage rates are substantially up, volumes of mortgage – both for refinancing and new homes – is up and, of course, some of it is simply kind of revenge buying. ▪ There was a little lull in activity and it has gone up, but we think it is sustainably up. In any case, it is with one of these clients that we had a headwind for three quarters and that client has bottomed out.		Positive
MTCL	▪ As far as BFSI is concerned, we have been fairly strong in insurance even, so we have to just wait and see; hopefully, we should be able to revive that as we go along.	In banking, there are a few deals we are working on.	Positive
PSYS	▪ Areas such as BFSI are continuing to see an uptick. ▪ We are launching new products with an Indian company over the next three to five years.	▪ Significant deal in financial services with a leading global investment firm based out of the US. This is a multi-million-dollar, multi-year deal. ▪ In India, we won a deal with one of the largest banking, financial services company, a Salesforce implementation deal.	Positive
MPHL	▪ Banking, life insurance, consumer products, etc., faced a lesser impact and are expected to recover much faster. These have been highlighted as green zones in the chart. ▪ We continue to see strong growth momentum and positive outlook in our key focus vertical of banking and capital markets. The segment reported yet another strong quarter and double-digit growth with 12% YoY growth. We believe this is best-in-class growth in that industry segment and was broad-based across segments of BCM as well as in Digital Risk.	▪ In a large deal with America's top bank, MPHL will help clients in managing the home preservation applications process. ▪ Another large Tier-I bank in America chose MPHL as	Positive

Company	Jun'20 quarter commentary	Deal win commentary	Sentiment meter
	▪ The banks we are dealing with are still the large banks that have a large spend in both tech and ops, and we continue to win wallet share by cross leveraging these capabilities. ▪ We do expect both BCM and insurance to have good sequential growth because both of those have been in the pipeline.	their partner to deliver strategic programs such as modernisation and accelerating cloud adoption.	
NITEC/ Coforge	▪ BFS business grew 6.2% sequentially and contributed to 17.2% of revenue. In Q1, our Insurance services business grew 1.9% QoQ, contributing to 33% of the firm's revenue. ▪ We deployed omni-channel customer service for a leading NA-based insurance firm.	▪ The first deal was in the BFS vertical where we signed a US$ 30mn plus multi-year deal. ▪ We launched a co-innovation lab for a leading US bank focused on banking gateways.	Positive

Source: BOBCAPS Research

Covid-19 crisis speeding up digital transformation

Digital channels and technology infrastructure have helped ensure uninterrupted banking services during the pandemic. We note that the proportion of technology spends in operating cost has increased by 200bps for large US banks in the last five years. In our view, the current crisis will further accelerate technology entrenchment in the banking industry, opening up new growth avenues for IT vendors. Cloud, contactless banking and underwriting, and video banking are a few of the emerging demand areas.

Digital channels fortified bank operations during pandemic

Most large banks in the US and Europe have been happy with past digital investments which helped them navigate operations amid lockdowns and social distancing restrictions. The following statements, among many others, indicate an increased thrust on digitisation of the banking sector post Covid-19, which is an opportunity for Indian IT players.

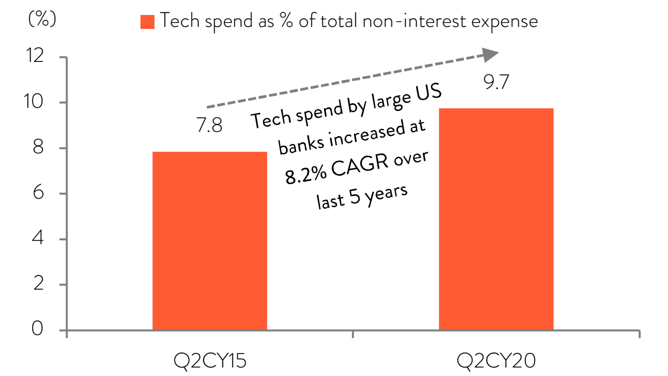
- As per **Bank of America**, there were 2.3bn customer log-ins during Q2CY20 – an increase of 20% in the past 12 months. Average log-ins per user are also up 14%, demonstrating engagement in terms of quantity of users and depth of use. About 9% more customer investment accounts were added this year than last year, with over 30% of those added digitally.
- **Wells Fargo** pointed towards strong trends in digital usage with digital log-ins increasing 21% YoY. The number of cheques deposited using a mobile device reached a record high in Q2, up 32% from Q1CY20.
- **Citibank** reported acceleration in digital deposit sales bolstered by increased digital acquisition and engagement.
- **BNP Paribas** praised the strength of its digital platforms which is evidenced by a steady increase in the number of customers active on its mobile app.
- According to **ING,** digital use by customers went up dramatically in Q2CY20 with 87% of interactions being purely via mobile and 41% of its clients being active only on the mobile. It is also experimenting with blockchain as an end-to-end payment system, especially for trade.
- Spanish bank **Banco Santander** has added 6mn mobile customers since Jun'19, growing 22% and reaching 40mn digital customers. In the first half of 2020, it grew 50% more than in the first half of 2019. Its digital sales penetration increased to 47% in Q2CY20 vs. 36% in 2019. Of note, Santander UK had an exceptional 92% of total sales as digital sales in Q2 and 76% in H1CY20.

Technology to become more entrenched

Technology spending has become imperative for the survival of banks and has rarely fallen significantly in the last five years. Better digital capabilities are seen as a competitive advantage and hence banks have always tried to reduce spending under other heads of operating expense in order to keep margins buoyant. This provides reassurance against a sharp decline in technology spend post pandemic.

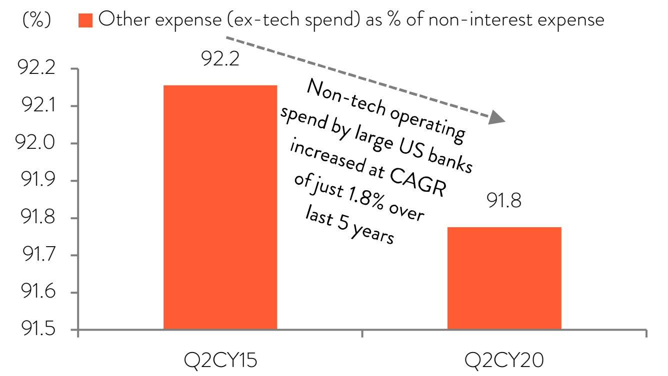
The tech spend of the top-6 banks in the US as a percentage of total non-interest expense has remained entrenched over the last 22 quarters and has increased steadily despite the pandemic. Over the last five years, tech spending at the top-6 US banks has clocked a CAGR of 8.2% while other expense (ex-tech spending) grew at a mere 1.8%. This implies that banks prefer to rein in other operating expenses (but not tech costs) to preserve margins

FIG 24 – 5- YEAR TECH SPEND CAGR OF LARGE US BANKS AT 8.2%



Source: Company, BOBCAPS Research

FIG 25 – 5- YEAR OTHER EXPENSE (EX-TECH SPEND) CAGR OF LARGE US BANKS AT JUST 1.8%



Source: Company, BOBCAPS Research

Emerging technologies post pandemic

We expect Covid-19 to catalyse faster digitisation as the BFSI sector seeks to adapt to the new business environment. Banks are already accelerating the transition to cloud to accommodate a workforce that operates from home, is spread across locations and connects to enterprise servers remotely. Most banks are looking for a single vendor that can provide cloud expertise at scale and has strong platform capabilities (e.g. INFO won the US$ 1.5bn Vanguard deal given its BFSI platform Finacle). This explains the steady BFSI pipeline of most Indian IT players going into Q2FY21. But the overall budget hasn't increased and there is a move towards vendor consolidation.

We discuss some emerging demand areas where investments by BFSI clients have become imperative rather than discretionary.

- **Cloud**: Cloud migration is spearheading faster adoption of digital technologies. Banks have been among the early adopters of cloud-based software and video conferencing services, facilitating work from home. INFO has struck a US$ 1.5bn-2bn cloud migration deal with Vanguard and recently signed another major five-year cloud customer experience deal with Genesys. Amazon Web Services (AWS) signed a big deal with HSBC, and Google also announced partnerships with Goldman Sachs and Deutsche Bank.

  Covid-19 has accelerated the trend towards digital banking. Dutch group ING said that it would close a quarter of its retail branches. Microsoft, in a cloud contract signed with Santander, completed the rollout of its Teams video conferencing service to the Spanish bank's employees across its global banking operations.

- **Contactless banking:** Contactless banking has been present across the world for some time now. But the US has been slow in adopting this technology. In 2018, only 3% of cards in use in the US were contactless vs. ~64% in the UK and up to 96% in South Korea, according to a study by global management consulting firm A.T. Kearney. This presents a gap in the market which IT companies can fill. Overall usage of contactless payments in the US has risen 150% since Mar'19, indicating the large market opportunity.

  Contactless technologies include radio frequency identification (RFID) and near field communication (NFC). NFC technology is used for a variety of other activities besides payments, such as e-ticketing.

- **Video banking:** Video banking provides professional banking services to customers during non-traditional banking hours at convenient times. This gives customers the benefit of personal teller services during hours when bank branches are not typically open. The technology is being used for a range of different services, such as mortgage advice, by the likes of Bank of America. A recent report from research firm Retail Banking Research (RBR) reveals that the use of video teller machines increased significantly last year. It will gain traction due to the pandemic and need for social distancing.

- **Contactless underwriting:** Digital lending has gained momentum in a Covid-hit world. This presents a huge data science and analytics opportunity which will be used to minimise delinquencies. Implementation of automated processes will help in rapid origination and processing. Most IT companies are positive regarding demand from the mortgage underwriting and evaluation space.

- **Distribution of stimulus:** Major economies have announced stimulus and banks are part of the supply chain for distribution of funds. Hence, the required online reconfiguration of banks for distribution of stimulus has opened up new opportunities for IT players.

TCS best placed – upgrade to BUY

Two quarters into the Covid-19 outbreak in March, the commentary from most Indian IT companies has turned more optimistic. Enterprises across globe have accelerated digitization catalysed by pandemic and this will augment tech spends in the areas of cloud migration and automation. We, therefore, upgrade our target P/E multiples across the sector, using the last five-year average forward P/E (adjusted by +1sd or +2sd) for most stocks in our coverage universe.

We believe the BFSI, telecom and hi-tech verticals would fare better than others, i.e. manufacturing, travel, communication and retail, in the coming year. TCS (31.3% BFSI exposure) is best placed in our view – we upgrade the stock to BUY from ADD and increase our target P/E from 22x to 24.2x. Our FY22E EPS for TCS is already 8% above consensus. Management commentary indicates that supply-side issues seen in Q1FY21 have abated and the BFSI deal pipeline for FY21 is stable. Strong platform and digital capabilities, the highest EBIT margin among peers, high exposure to the BFSI vertical, and increased localisation in the US will act as valuation drivers.

We also upgrade HEXW to BUY from ADD due to strong traction in BFSI and healthcare, and a healthy TCV. We raise MTCL to ADD from REDUCE given expected margin resilience in the near term and record high renewal TCV of US$ 315mn in Q1FY21. ECLERX stands downgraded to SELL from REDUCE due to poor business fundamentals, lack of diversified revenue streams and project-based revenues. We retain our previous ratings for other stocks.

FIG 26 – TARGET PRICE AND RATING CHANGES

Company	CMP (Rs)	Old			New			Upside to CMP (%)	New Recomm-endations
		TP (Rs)	Recomm-endation	Target P/E (x)	Sep'22 ending EPS	New target PE (x)	New TP (Rs)		
TCS IN	2,257	2,320	ADD	22.0	108.0	24.2	2,620	16	BUY
INFO IN	929	950	ADD	20.0	49.0	21.0	1,020	10	ADD
WPRO IN	271	180	SELL	11.0	16.2	15.2	246	(9)	SELL
HCLT IN	694	730	BUY	14.5	51.9	15.6	810	17	BUY
TECHM IN	741	780	BUY	13.8	58.0	15.7	910	23	BUY
LTI IN	2,458	2,790	BUY	24.0	122.0	27.0	3,290	34	BUY
MPHL IN	1,101	840	SELL	11.0	79.0	12.0	950	(14)	SELL
MTCL IN	1,156	930	REDUCE	15.3	62.4	19.6	1,220	6	ADD
HEXW IN	396	410	ADD	15.0	27.6	18.0	500	26	BUY
PSYS IN	958	740	SELL	12.5	62.0	13.5	840	(12)	SELL
NITEC IN	1,924	1,880	ADD	17.0	114.1	18.5	2,110	10	ADD
ECLX IN	704	510	REDUCE	7.2	72.2	8.0	580	(18)	SELL

Source: BOBCAPS Research

Stock performance

FIG 27 – TCS

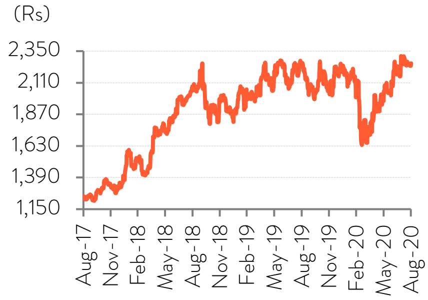


FIG 28 – INFOSYS

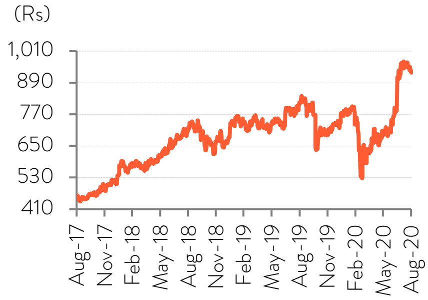


FIG 29 – WIPRO

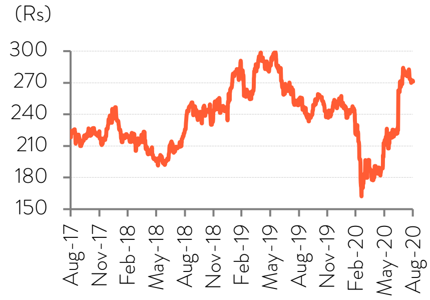


FIG 30 – HCL TECH

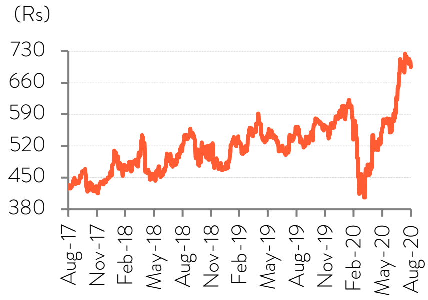


FIG 31 – TECH MAHINDRA

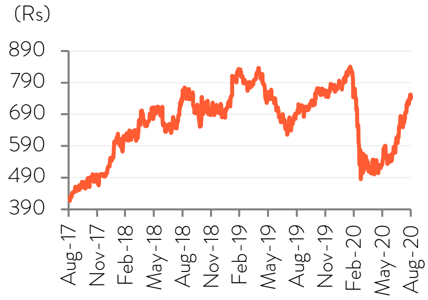


FIG 32 – LTI INFOTECH

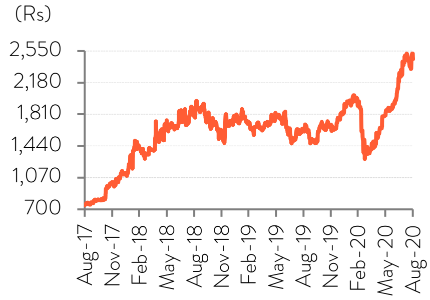


FIG 33 – MPHASIS

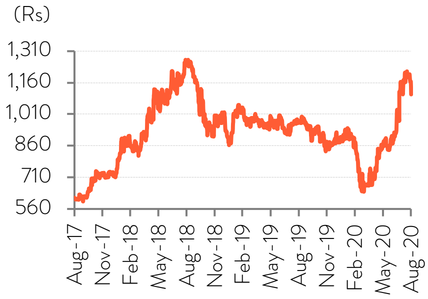


FIG 34 – MINDTREE

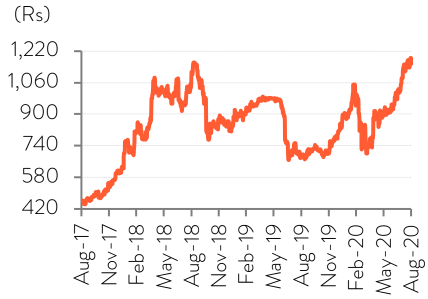


FIG 35 – HEXAWARE

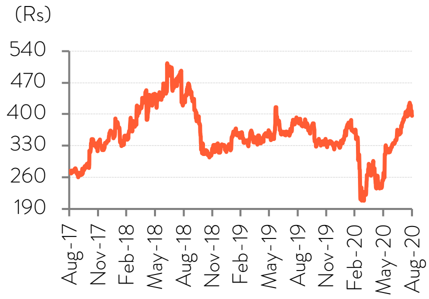


FIG 36 – PERSISTENT SYSTEMS

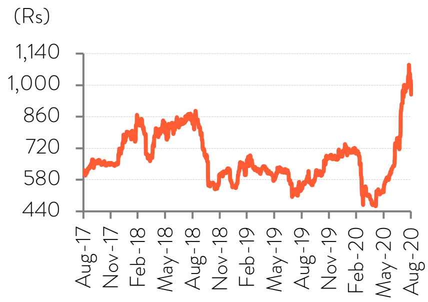


FIG 37 – NIIT TECHNOLOGIES

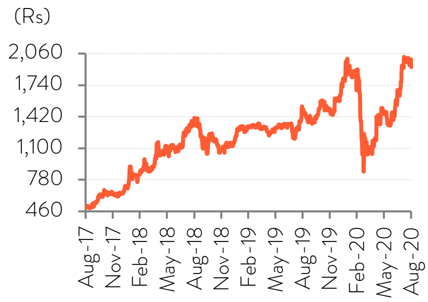
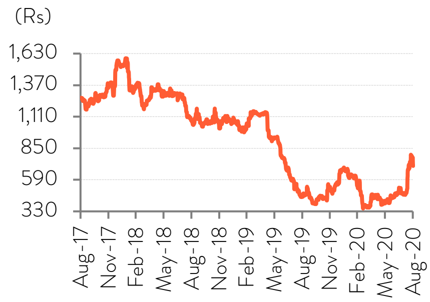


FIG 38 – ECLERX



Source: NSE

Financials – TCS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue	**1,464,630**	**1,569,490**	**1,591,402**	**1,817,106**	**2,032,632**
EBITDA	395,050	421,100	424,612	511,077	571,048
Depreciation	20,550	35,300	38,377	40,473	43,922
EBIT	374,500	385,800	386,236	470,605	527,126
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	41,130	36,680	17,446	34,660	36,160
Exceptional items	0	0	0	0	0
EBT	415,630	422,480	403,682	505,264	563,285
Income taxes	100,010	98,010	98,624	121,263	135,188
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	(380)	(1,070)	(1,010)	(600)	(600)
Reported net profit	**315,240**	**323,400**	**304,048**	**383,401**	**427,497**
Adjustments	0	0	0	0	0
Adjusted net profit	**315,240**	**323,400**	**304,048**	**383,401**	**427,497**

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	0	0	0	0	0
Other current liabilities	250,000	292,440	274,680	313,638	350,838
Provisions	0	0	0	0	0
Debt funds	440	69,060	69,060	69,060	69,060
Other liabilities	0	0	0	0	0
Equity capital	3,750	3,750	3,750	3,750	3,750
Reserves & surplus	0	0	0	0	0
Shareholders' fund	898,990	847,490	1,006,179	1,205,611	1,427,911
Total liabilities and equities	**1,149,430**	**1,208,990**	**1,349,919**	**1,588,308**	**1,847,808**
Cash and cash eq.	72,240	86,460	169,007	366,700	545,031
Accounts receivables	273,460	305,320	348,800	348,486	389,820
Inventories	0	0	0	0	0
Other current assets	243,530	239,510	261,600	298,702	334,131
Investments	349,540	273,760	273,760	273,760	273,760
Net fixed assets	113,740	198,410	191,861	187,731	184,462
CWIP	0	0	0	0	0
Intangible assets	18,790	19,930	19,930	19,930	19,930
Deferred tax assets, net	26,560	28,280	28,280	28,280	28,280
Other assets	51,570	57,320	56,680	64,719	72,395
Total assets	**1,149,430**	**1,208,990**	**1,349,920**	**1,588,309**	**1,847,809**

Source: Company, BOBCAPS Research

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Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	236,600	359,770	343,434	424,473	472,019
Interest expenses	(25,640)	(36,680)	(17,446)	(34,660)	(36,160)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(21,690)	8,850	(82,691)	(5,869)	(47,238)
Other operating cash flows	96,660	(2,965)	0	0	0
Cash flow from operations	**285,930**	**328,975**	**243,298**	**383,945**	**388,621**
Capital expenditures	(21,320)	(119,970)	(31,828)	(36,342)	(40,653)
Change in investments	73,820	(75,780)	0	0	0
Other investing cash flows	(36,050)	36,680	17,446	34,660	36,160
Cash flow from investing	**16,450**	**(159,070)**	**(14,382)**	**(1,683)**	**(4,493)**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(1,940)	0	0	0	0
Interest expenses	(162,310)	0	0	0	0
Dividends paid	(114,720)	(155,685)	(146,369)	(184,569)	(205,797)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	**(278,970)**	**(155,685)**	**(146,369)**	**(184,569)**	**(205,797)**
Changes in cash and cash eq.	**23,410**	**14,220**	**82,547**	**197,693**	**178,331**
Closing cash and cash eq.	**72,240**	**86,460**	**169,007**	**366,700**	**545,031**

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	84.0	86.2	81.0	102.2	113.9
Adjusted EPS	84.0	86.2	81.0	102.2	113.9
Dividend per share	30.0	34.5	32.4	40.9	45.6
Book value per share	239.5	225.8	268.1	321.2	380.5

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	5.8	5.4	5.3	4.6	4.1
EV/EBITDA	21.3	20.0	19.8	16.5	14.5
Adjusted P/E	26.9	26.2	27.9	22.1	19.8
P/BV	9.4	10.0	8.4	7.0	5.9

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	75.8	76.5	75.3	75.9	75.9
Interest burden (PBT/EBIT)	111.0	109.5	104.5	107.4	106.9
EBIT margin (EBIT/Revenue)	25.6	24.6	24.3	25.9	25.9
Asset turnover (Revenue/Avg TA)	131.1	133.1	124.4	123.7	118.3
Leverage (Avg TA/Avg Equity)	1.3	1.4	1.4	1.3	1.3
Adjusted ROAE	35.5	37.0	32.8	34.7	32.5

Source: Company, BOBCAPS Research | Note: TA = Total Assets

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Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	19.0	7.2	1.4	14.2	11.9
EBITDA	21.5	6.6	0.8	20.4	11.7
Adjusted EPS	25.3	2.6	(6.0)	26.1	11.5
Profitability & Return ratios (%)					
EBITDA margin	27.0	26.8	26.7	28.1	28.1
EBIT margin	25.6	24.6	24.3	25.9	25.9
Adjusted profit margin	21.5	20.6	19.1	21.1	21.0
Adjusted ROAE	35.5	37.0	32.8	34.7	32.5
ROCE	34.3	35.8	33.6	39.4	43.1
Working capital days (days)					
Receivables	65	67	75	70	66
Inventory	0	0	0	0	0
Payables	78	86	89	82	83
Ratios (x)					
Gross asset turnover	12.8	10.1	8.2	9.6	10.9
Current ratio	2.6	2.4	3.0	3.4	3.8
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.1)	0.0	(0.1)	(0.2)	(0.3)

Source: Company, BOBCAPS Research

Disclaimer

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)

Rating distribution

As of 31 August 2020, out of 100 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 48 have BUY ratings, 21 have ADD ratings, 11 are rated REDUCE and 20 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

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