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ISG Q2CY20 Index: Trends and call highlights

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The Q2CY20 ISG Index reflects stalled deal activity (ACV down 4.7% YoY) and a drop in managed services deal sourcing due to Covid-19. ISG expects recovery in contract activity in H2CY20, but forecasts a 7.5% YoY decline in managed services deals in CY20 vs. 7% earlier. These muted trends come as no surprise – we expect deal TCV moderation in the Jun'20 quarter for IT companies under our coverage. We prefer HCLT (BUY, TP: Rs 680) and TECHM (BUY, TP: Rs 690) among large-caps and LTI (BUY, TP: Rs 2,230) among mid-caps.

About ISG: ISG is one of the largest third-party outsourcing deal advisors globally and publishes the ISG Index every quarter where it assesses contracting activity in the IT sector. ISG classifies the contracts into Managed Services (more relevant for Indian IT) and As-a-Service sourcing. Below are key takeaways from the ISG Q2CY20 Index conference call on deal sourcing trends in the global IT services sector.

Absence of large deals hits managed services: The ISG Index shows a 4.7% YoY decline in global commercial outsourcing contracts with annual contract value (ACV) of US$ 5mn or more in Q2CY20. Managed services deals are estimated to have declined 15.7% YoY vs. 2.2% growth in Q1, owing to delays or cancellation of large deals. About 90% of managed services deals in Q2 were below US$ 50mn ACV (or smaller deals). The decline was especially pronounced in APAC and EMEA while America reported YoY growth on a weak Q2CY19 base.

ISG lowers CY20 outlook after baking in H2 recovery: ISG trimmed its CY20 managed services outlook and now expects a 7.5% YoY decline vs. a 7% decline earlier. The revised outlook bakes in sequential recovery in managed services deals in Q3 and Q4 CY20. As-a-service contracts are expected to grow 11% YoY in CY20.

Puzzling vertical trends: ISG's expectation of a larger impact on BFSI in Q3CY20 (–16% YoY) vs. travel & transportation (–13% YoY) and retail & CPG (–10% YoY) is puzzling. In the current Covid-19 environment, travel & transportation and retail have been more severely affected than BFSI. Telecom/ media and hi-tech (business services) are expected to be resilient (–5% YoY). Similarly, Q1 and H1CY20 vertical trends read together suggest deal activity slackened in BFSI and telecom/media, while surging in retail/CPG. ISG said this contrasting trend was due to the existing pipeline where deals were in the signing stage.

RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
TCS IN	2,219	2,160	ADD
INFO IN	775	760	ADD
WPRO IN	223	170	SELL
HCLT IN	575	680	BUY
TECHM IN	583	690	BUY
LTI IN	2,054	2,230	BUY
MPHL IN	921	780	SELL
MTCL IN	988	880	REDUCE
HEXW IN	338	350	ADD
PSYS IN	721	590	REDUCE
NITEC IN	1,539	1,430	ADD
ECLX IN	463	420	REDUCE

Price & Target in Rupees

Other highlights

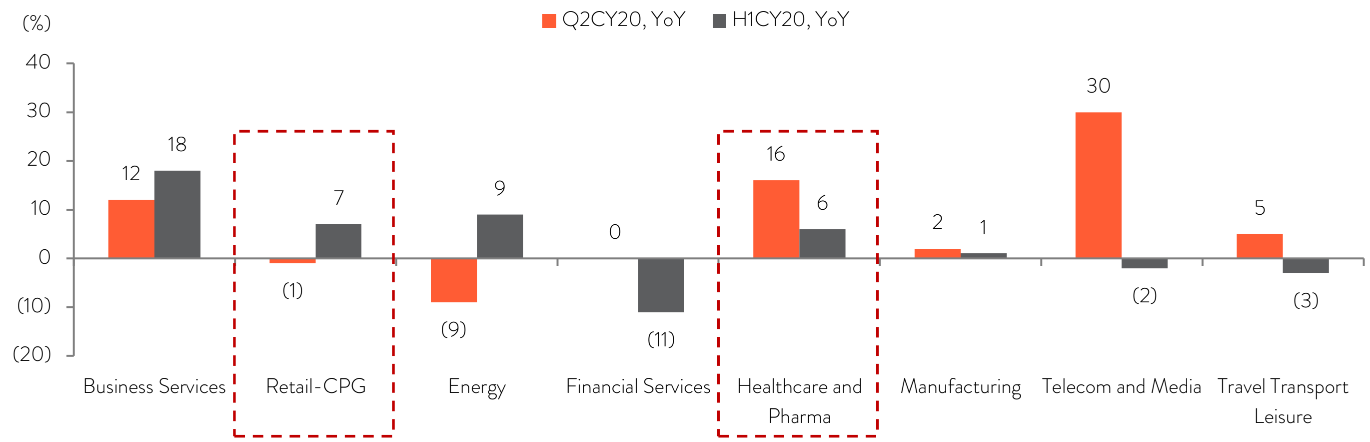
- **Everything-as-a-service gains momentum:** IaaS (infrastructure-as-a-service) ACV, led by hyper-scalers, grew 10.5% YoY in Q2CY20 with significant moves to public cloud. ACV rallied 11% YoY in H1CY20 globally despite the downturn, catalysed by the shift to work-from-home (WFH). ISG expects as-a-service contracts to grow 11% in CY20. The cloud market will continue to grow significantly, especially benefiting Google Cloud, AWS and Microsoft. Network and security will also change radically. Consulting and implementation services, application managed services and traditional data centres will likely see revenues drying up.
- **Covid-19 impact sharply differs from GFC:** The pandemic has hit all industries simultaneously vis-à-vis the GFC which affected financial services the most. ISG expects the recovery to be sharp and V-shaped as there is no underlying economic cause for this downturn.
- **Clients' IT discretionary spend slumps:** March saw a big collapse in spends followed by improvement in June as the pandemic slowed managed services deals. America was the only region to grow.
- **BPOs hit hard:** As per ISG, BPO ACV declined 22% YoY in H1CY20 in the US and 52% in APAC. Contact centres and facilities management have been particularly affected. While WFH has raised productivity, virtual chatbots and automation are increasingly coming handy. On a strategic level, fewer customers are looking for cost takeout and are instead looking for improved customer experience. Captive operations have been hit due to lack of agility and scalability. Captives have not been as resilient as service providers and their monetisation is gaining momentum as enterprises face a liquidity crunch.
- **Retail, BFSI, travel and healthcare have declined:** Healthcare and hi-tech are expected to bounce back faster. Flexible workspaces will be in demand. Retailers are seeing recovery from ecommerce and automation. Two-thirds of retail activity is drive by as-a-service contracts.
- **Vendor consolidation to benefit larger players:** The industry is likely to go through a consolidation phase. Larger players have been more agile in handling the WFH transition during the pandemic. A move towards cloud and SaaS will accelerate vendor consolidation.

FIG 1 – COVID-19 FORESTALLED DEAL ACTIVITY IN Q2CY20

Segment	Q2CY20 ACV (US$ bn)	YoY change (%)	H1CY20 ACV (US$ bn)	YoY change (%)
Managed Services	6.0	(15.7)	12.8	(7.1)
As-a-Service	7.2	6.9	15.4	10.7
Total	**13.2**	**(4.7)**	**28.2**	**1.9**

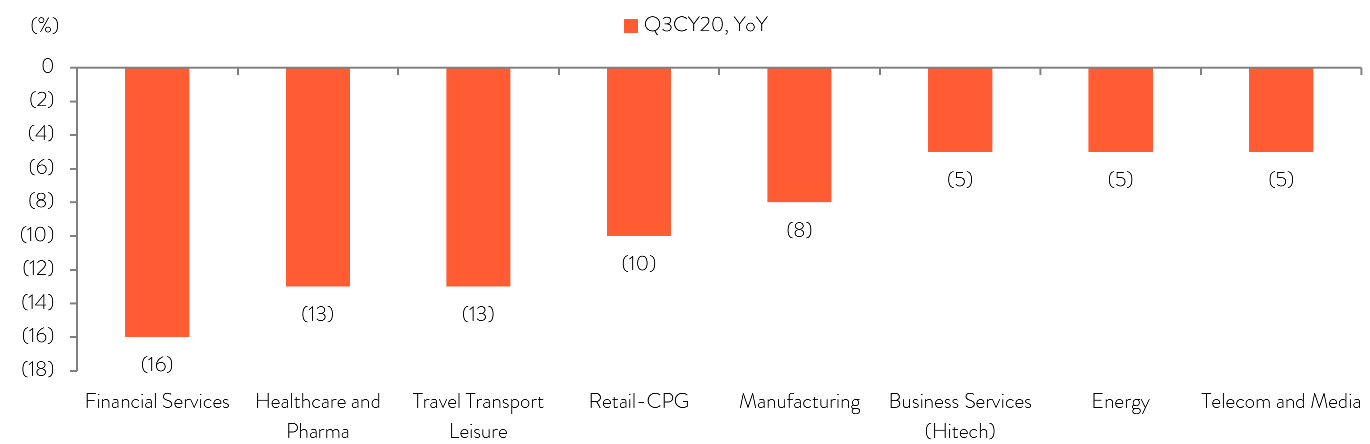
Source: ISG Q2CY20 Index, BOBCAPS Research

FIG 2 – PUZZLING VERTICAL TRENDS – BFSI DEAL ACTIVITY PLUMMETED IN Q2CY20, RETAIL ACTIVITY SURGED



Source: ISG Q2CY20 Index, BOBCAPS Research

FIG 3 – ISG PREDICTS SIMILAR TRENDS IN Q3CY20 – HIGHER DECLINE IN BFSI VS. TRAVEL/TRANSPORTATION AND RETAIL



Source: ISG Q2CY20 Index, 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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