PhillipCapital

Hexaware Technologies (HEXW IN)

Growth story moderated; Barings' overhang remains

INDIA | IT SERVICES | Initiating Coverage

13 April 2020

Hexaware (HEXW)'s stock is currently reeling under multiple headwinds – some business related, while others external. On the business side, its largest vertical BFS stays weak, with sub-segments of the industry sluggishness and client-specific issues; deal flow has been muted and margins remain impacted by rising sub-contracting costs. In addition, Covid-19 will add more pain to its Travel vertical (10% of revenue), deal flows and margins in CY20. On the external side, the overhang of Barings' exit continues to impact the stock, as the exit timeline for the fund draws closer. We believe the above concerns will continue to impact the growth and HEXW's valuation multiple, and the stock will continue to underperform its peers in the near-to-medium term. Inexpensive valuations however, should come to its aid. We initiate coverage with a NEUTRAL rating.

The overhang of Barings' exit to continue; merger with NIIT Tech imminent: Barings Private Equity Asia (BPEA) acquired 70% stake in HEXW in Aug-2013. While the stock has delivered robust returns for BPEA since then (2.0x on CMP, 2.5x pre Covid-19 led correction), along with handsome dividend payouts, BPEA now needs to exit this 6-year old investment soon. Unfortunately, it has not been able to find buyers; even as it tried in 2018 and on other occasions. We believe this overhang of BPEA's exit is one of the key reasons for HEXW trading at a discount (11x CY21 PE) to almost all its midcap peers (12-14x FY22).

We believe a merger of HEXW and NIIT Tech is likely in the next 1-2 years, despite BOTH managements denying it. We believe Barings PE's acquisition of NITEC was done to facilitate HEXW's exit. Both BPEA-owned companies (HEXW 62.4%; NIIT Tech 70.1%) offer significant synergies if merged. Integrated, HEXW + NITEC would be US$1.3bn Company, with presence across ALL key verticals and geographies – much more 'saleable' entity than HEXW alone.

BFS remains weak – will continue to drag overall growth: In CY19, BFS (35% of revenue) underperformed significantly compared to HEXW's overall growth at 5.5% yoy vs. 17.1% yoy (10.3% organic). The performance was impacted by: (1) insourcing and budget cuts by a top customer in secondary mortgage resulting in 3% headwind to CY19 revenue, (2) broader weakness in capital markets and secondary mortgage segments, (3) delays in decision making by clients, and (4) onshore staffing shortages for a few of its BFS clients. We believe that the BFS vertical will remain muted for two more quarters, until issues with top clients in the vertical are resolved. With this vertical more skewed towards capital markets than banking, it will take some time for HEXW to return to industry-leading growth here.

Non-BFS verticals were stellar in CY19; Covid-19 to impact significantly: HEXW's growth in the remaining verticals (healthcare/insurance, manufacturing/consumer, high tech/professional services and travel/transport,) has been stellar with 26% in CY19 and 16% CAGR over the last three years. We believe Hexaware's travel vertical (10% of revenue) will be substantially impacted due travel restrictions in most parts of the world.

Deal-flow remains tepid: In CY19, net new deal TCV for HEXW stood at US$ 130mn, down -38% yoy *(+18% yoy, adjusting for cancellation of US$ 100mn deal won in CY18)*. This was not encouraging vs. CY16-17 levels of US$ 150-180mn. While quantitatively the deal-wins were lacklustre, management believes their quality has improved within targeted clients, with scope to increase the potential opportunity. We expect new deal wins to be remain muted as clients defer discretionary spending in the near term.

Outlook and valuations: We expect HEXW to report 7% USD revenue CAGR over CY19-21. EBIT margins should decline to 13.0% in CY20 from 13.9% in CY19 – due to IND AS 116 adoption and Covid-19 impact. HEXW is currently trading at 11.0x CY21 P/E, much lower than the current midcap range of 12-14x. We value the stock at 12x CY21 EPS (25% discount to our target multiples for LTI) because of HEXW's lower growth, margins, issues and overhang of Barings exit. We initiate coverage with a NEUTRAL rating and a target of Rs 290. Upside risk include faster than anticipated pickup in BFS vertical while downside risk include top clients further dragging revenue growth in CY20.

NEUTRAL

CMP RS 270

TARGET RS 290 (+8%)

SEBI CATEGORY: MID CAP

COMPANY DATA

O/S SHARES (MN) :	298
MARKET CAP (RSBN) :	81
MARKET CAP (USDBN) :	1.1
52 - WK HI/LO (RS) :	455 / 202
LIQUIDITY 3M (USDMN) :	0.5
PAR VALUE (RS) :	2

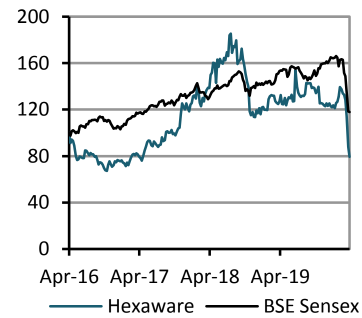
SHARE HOLDING PATTERN, %

	Dec 19	Sep 19	Jun 19
PROMOTERS :	62.4	62.5	62.5
FII / NRI :	17.7	18.6	16.8
FI / MF :	11.6	10.8	11.9
NON PRO :	2.1	2.1	2.1
PUBLIC & OTHERS :	6.1	6.0	6.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-27.9	-24.9	-28.6
REL TO BSE	-8.9	0.5	-7.2

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	CY19	CY20E	CY21E
Net Sales	55,824	58,842	65,273
EBIT	7,745	7,652	8,752
Net Profit	6,579	6,382	7,300
EPS, Rs	22.0	21.4	24.5
PER, x	12.3	12.6	11.0
EV/EBIT, x	10.3	10.1	8.6
P/BV, x	2.9	2.6	2.3
ROE, %	23.8	20.6	21.0

Source: PhillipCapital India Research Est.

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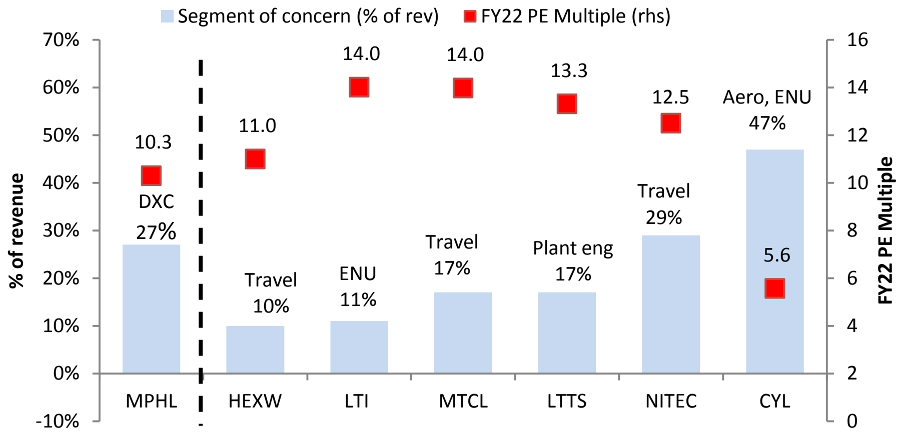
Covid-19 impact to add to uncertainty

We see Covid-19 impacting the sector in two ways: (1) business operations would be impacted significantly, as companies are forced to move a large part of their workforce to 'work-from-home', and (2) clients' businesses being affected, which might lead to lower discretionary (and even non-discretionary in some cases) spending. As per our analysis and interaction with various consultants/corporates, the immediate (or near-term) impact of this is expected to be visible through: (1) weak order inflow in Q4FY20, due to deferment of deals, and (2) weak revenue growth in Q1FY21 (possibly Q2FY21 too), due to weaker order inflow in Q4 and clients' recovery expected only by Q3FY21. While Q4FY20 will report limited impact of the Covid-19 pandemic, the outlook appears to highly uncertain, as highlighted in our recent report **here**.

Travel, transportation and hospitality (TTL) industry is hardest hit due to travel restrictions in most parts of the world and pullback of leisure travel by tourists due to pandemic spreading globally. These industries (airlines, cruise lines, hotels) are expected to aggressively push vendors for costs reductions. As per ISG, TTL ACV is expected to decline 45% yoy in Q2CY20. Companies like NIIT Tech (29% of revenues), Mindtree (17%), and Cyient (32% Aerospace & Defence) to be impacted severely in FY21. Hexaware too, with 10% of revenue exposure to TTL vertical, is expected to be impacted, though in a limited magnitude. It has one client in its Top 10 client bucket (top-10 forms 43% of revenue) from TTL vertical.

Hexaware's Travel vertical to be impacted significantly due to Covid-19 crisis



Source: Company, PhillipCapital India Research

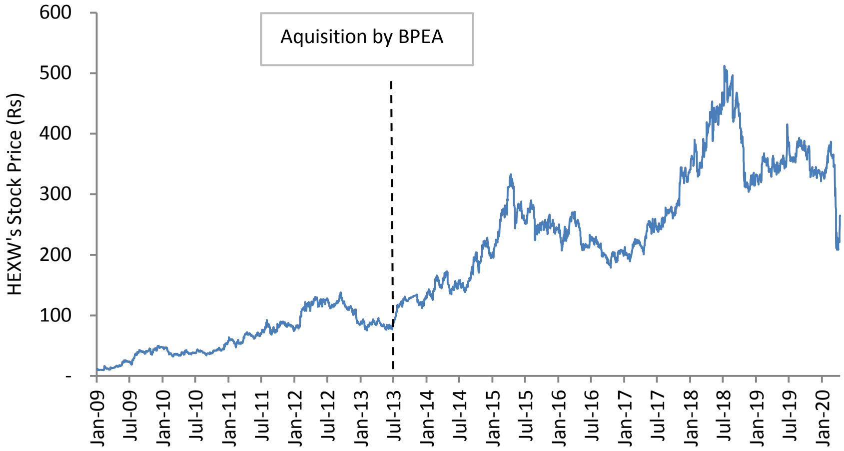
Apart from Travel, the management highlighted Education, High end Retail and Fitness verticals will be impacted due to facilities remaining either partially or fully shut due to lockdowns. However, the exposure of these verticals is marginal. Due to all these business uncertainties and limited visibility, the Hexaware management indicated that it will revisit its earlier CY20 guidance (15-17% revenue growth; EBITDA margins 15-16%) at the time of Q1CY20 results.

We see the Covid-19 pandemic adding more business uncertainty to the already existing overhang of Baring's exit *(we discuss that in next section in detail)* for the stock. The two, cumulatively, will keep its multiple suppressed, and lead to the stock underperforming its peers, in our opinion.

The overhang of the Barings' exit continues

Barings Private Equity Asia (BPEA) acquired 42% stake in HEXW in August 2013, from founders, and upped its stake to almost 70% through open offer and buying minority shareholders. The transaction was at Rs 135 per share for a valuation of 11x CY13 earnings. Over the next few years, with the new management and change in strategy, HEXW became a leading mid-cap IT company, resulting in significant appreciation in the stock price *(2.0x on CMO. 2.5x pre Covid)* since the acquisition. At the same time, it also meaningfully enhanced HEXW's dividend payout profile, which also enhanced shareholders' returns.

HEXW's stock has delivered 100% returns since BPEA acquired the promoter stake



Source: Bloomberg, PhillipCapital India Research

BPEA acquisition boosted the dividend payout for HEXW

	CY12	CY13	CY14	CY15	CY16	CY17	CY18	CY19
Dividend per Share (Rs)	5.4	11.1	9.4	8.6	5.5	4.0	8.5	8.5
Dividend payout (%)	47.2%	81.0%	79.5%	66.4%	39.7%	23.8%	43.3%	39.5%
Total Dividend (incl DDT) (Rs mn)	1,924	4,002	3,419	3,138	1,998	1,428	3,038	2,896
Buyback (Rs mn)	-	-	-	-	-	1,367	-	-
Total return to shareholders (Rs mn)	**1,924**	**4,002**	**3,419**	**3,138**	**1,998**	**2,795**	**3,038**	**2,896**

Source: Company, PhillipCapital India Research

HEXW is now a six-year-old investment for BPEA. As part of its Fund-I, the PE needs to exit the investment, but has been unable to find buyers. In 2018, the PE fund tried scouting for buyers, but was unable to find one and ended up selling 8.4% stake in Aug. 2018 in the markets.

One of the key reasons, for HEXW trading at a discount to almost all its midcap peers (11.0x CY21 PE vs. average 12-14x FY22 PE for midcaps) is the overhang of BPEA's exit. The market's knowledge that BPEA will have to exit HEXW sooner rather than later, has created an overhang of possible supply of shares in the market, or the fund selling the stake at cheaper valuations (having already made 2.0x on its original investment, along with dividend retained). This overhang, in our opinion, might keep the valuations capped in the near to medium term.

Merger with NIIT Tech very likely

In our recent report, we had highlighted how we expect M&A activity to surge in the midcap IT space, with possible mergers of select companies (with same promoters) and with significant amount of synergies that can be accomplished. Apart from a possible merger of LTI and Mindtree, we believe a merger of Hexaware and NIIT Tech is highly likely. Read our detailed report here.

In April 2019, Baring Private Equity Asia (BPEA) entered into an agreement with NIIT Ltd and other promoters to acquire a 30.2% stake in NIIT Tech at Rs 1,394 per share for Rs 26.3bn. It raised its stake through open-market purchases and an open offer taking the stake to 70.1% (as of Dec 2019) of the total equity in NIIT Tech.

BPEA also holds 62.4% stake in Hexaware

An integrated entity (see the table below), formed by a merger of these two companies without taking merger synergies into account, will have a revenue base of US$ 1.3bn, and EBIT margins of 14%. BFSI will constitute 39% of its revenues, followed by Manufacturing & Consumer (32%) and Travel & Transport (17%). The firm will have 64% of revenue from the US and 24% from Europe.

NIIT Tech + Hexaware

	NITEC	HEXW	NITEC + HEXW	Rev share
Topline ($mn)	**528**	**793**	**1,321**	
EBIT margin (%)	**14%**	**14%**	**14%**	
Key verticals				
BFSI	232	282	514	39%
Auto, Manf	153	263	417	32%
E&U	-	-	-	0%
Travel, Transport	143	82	224	17%
Healthcare	-	167	167	13%
Geographies				
US	259	590	849	64%
EU	174	139	313	24%
ROW	95	64	159	12%
Horizontals				
ADM	370	238	608	50%
IMS	90	119	208	17%
EAS	21	64	86	7%
BI & Analytics	-	89	89	7%
BPO	21	49	71	6%
IP + Products	26	-	26	2%
Others	-	119	119	10%

Source: PhillipCapital India Research *(NIIT Tech FY19 numbers; HEXW CY19)*

Why do we believe a merger is imminent, despite the managements' denials?

As part of the NITEC deal, BPEA will not merge the two companies (NITEC and HEXW), at least for the next two years. This has been echoed by both managements. However, we still believe a merger is likely maybe next 2 years down the line because of what we call **Baring's Hexaware Dilemma**:

- We find it highly unlikely that BPEA will be able to find an investor (financial/strategic) to acquire more than 50% stake in HEXW at current valuations and in the current macro-environment.
- We believe the acquisition of NITEC by BPEA was done to facilitate HEXW's exit. Integrated, it would be a +US$ 1.3bn company, with a presence across ALL key verticals and geographies – a much more 'saleable' entity than HEXW.
- We note that other than a strategic investor buying HEXW/NITEC, BPEA does not have too many options to monetize its investment. Cross-selling holdings from one fund to another is virtually impossible because of different charters for different funds.

SWOT analysis

Strength	Weakness	Opportunity	Threat
Strong presence in BFSI and Travel/Transport	Near absence of Telecom and E&U	Larger revenue base would open doors of large clients and deals	High level of competition in BFSI services
Diversified geographic mix	Higher share of ADM; zero presence in ERD		Revenue diversification can lead to loss of focus

Source: PhillipCapital India Research

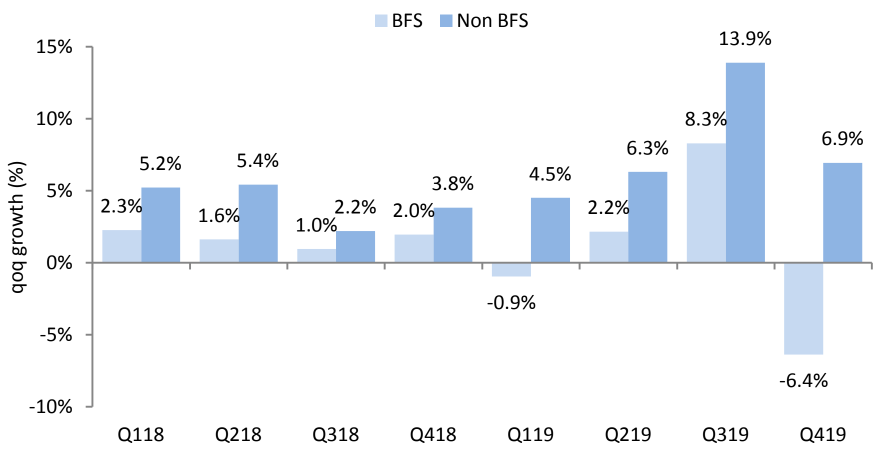
BFS – to remain a drag in near term

In CY19, HEXW's USD revenue grew 17.1% yoy (10.3% organic, adjusting for Mobiquity acquisition). Within that, growth in its banking and financial services vertical (BFS, 36% of revenue) was softer at 5.5% while the rest of its verticals saw strong 26% growth.

HEXW has historically had strong competency in the BFS segment – the segment registered healthy revenue CAGR of 17% over CY15-18, compared with the company's overall revenue CAGR of 12%. It has taken a conscious view of targeting select pockets of the BFS segment, rather than focusing on all segments. It caters to capital markets, investment banking, and mortgage services. In banking, HEXW is more of a challenger in areas where larger players are well entrenched.

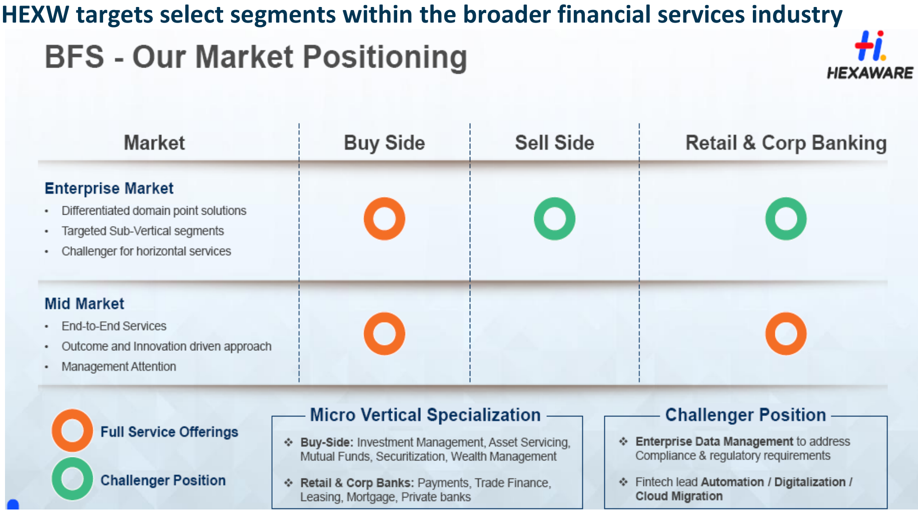
The company has been facing a drop in revenues from one of its top clients (Freddie Mac) in the secondary-mortgage segment due to change in that company's management. This has resulted in reduction in its outsourcing spends, along with budget cuts, resulting in ramp down of engagements in 2HCY19. This has had a 3% headwind on HEXW's CY19 overall revenue – translating to 8% headwind in its BFS vertical. After the ramp down, Freddie Mac is no longer a top client for HEXW in the BFS segment. It is expected to bottom out in Q1CY20; HEXW is already seeing volumes stabilising.

Robust growth in non-BFS verticals offsetting slowdown in BFS



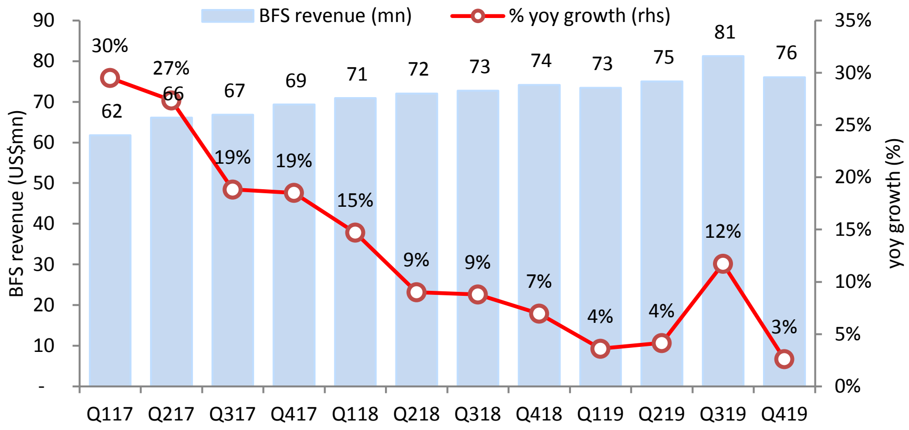
Source: Company, PhillipCapital India Research; *Note: Revenue growth rate includes contribution from Mobiquity*

HEXW targets select segments within the broader financial services industry



Source: Company, PhillipCapital India Research

BFS segment revenue – decelerating growth, dragged by top-3 clients



Source: Company, PhillipCapital India Research *(*Mobiquity acquisition in Q2CY19 and Q3CY19)*

Overall, in CY19, growth in the BFS vertical was impacted by: (1) a broader weakness in the capital markets and secondary-mortgage segments, (2) delays in decision making by clients and delays in budget allocation for projects, and (3) staffing shortages for a couple of BFS clients – where the projects were predominantly onshore in H1CY19.

HEXW had earlier provided a muted growth outlook for the financial services vertical, citing weakness in capital markets and secondary mortgage segments. While incremental growth outlook in other accounts has improved, weakness in the top client caused deterioration in outlook, resulting in a cut in guidance twice in CY19. BFS revenue has been muted, with just 5.5% USD revenue growth in CY19. Q3CY19 was impacted positively because of the contribution from Mobiquity's revenue to the vertical; hence yoy growth rate appears to be strong at 12%.

We believe that the BFS vertical will remain muted for at least two quarters, until issues with its top clients in this vertical are resolved. Also, since HEXW's BFS vertical is more skewed towards capital markets than banking, it will take some time for HEXW to return to industry leading growth here.

Stellar growth in non-BFS verticals

HEXW has reported strong growth in its other verticals, namely healthcare-insurance, manufacturing-consumer, high tech-professional services and travel-transport with 26% USD revenue growth in CY19 and 19% CAGR over the last two years.

Healthcare & insurance – Guidewire Partnership is fuelling growth

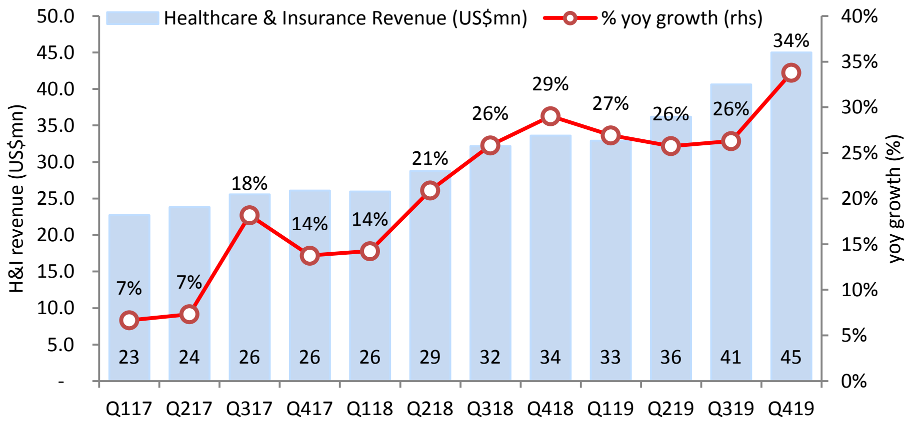
Healthcare & Insurance represents 21% of HEXW's revenues, and has seen 26% revenue CAGR since CY17, while the company has grown at 14%. HEXW's insurance business has a larger concentration in Europe, where it is doing very well.

In Feb 2019, Guidewire Software announced HEXW as its new consulting-alliance partner. Guidewire is the leading platform for property and casualty (P&C) insurance globally. The management said that it had invested in Guidewire for about three years, before becoming its partner. It's a highly qualified ecosystem (see table below) in which companies acquire/build specialist consulting capabilities to get into the ecosystem. But HEXW has built and invested organically to get into that ecosystem.

HEXW's Guidewire competency centres are located strategically across the globe – in Poland (Warsaw), Mexico (Saltillo), and India (Chennai, Pune and Mumbai). In Feb 2020, HEXW partnered with IKOR, a Germany-based technology-consulting company that specialises in Guidewire consulting to jointly develop and support Guidewire offerings for German and other European markets.

HEXW's stronger performance in Healthcare and Insurance vertical is the result of (1) expansion in Europe and (2) Guidewire partnership. It has been able to win new accounts because of this partnership, replacing incumbent service providers in some cases, with core implementation opportunities. The outlook for this vertical remains strong with the company now trying to replicate its success in US geography.

Healthcare & insurance: Guidewire partnership fuelling growth



Source: Company, PhillipCapital India Research

Guidewire consulting partners globally

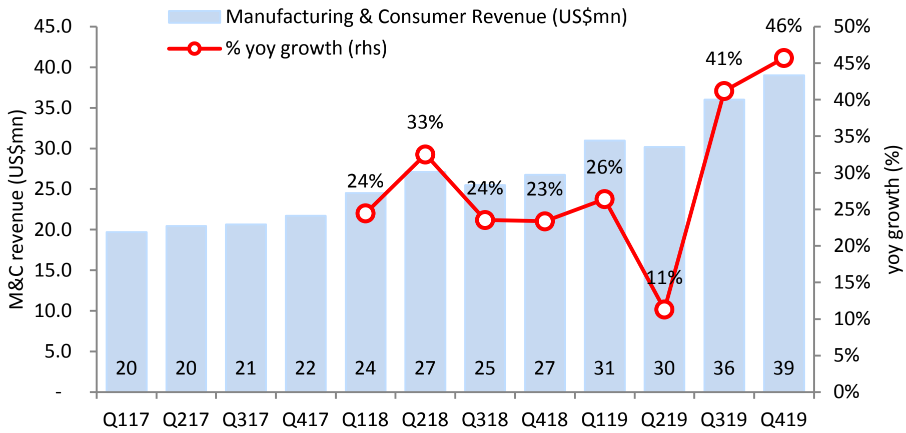
Larger players	Indian mid-cap	Others	Others
Accenture	**Hexaware**	Blackcomb Consultants	Alchemy Technology Services
TCS	LTI	Business Agility	B-Prost
Capgemini	Zensar	CastleBay Consulting	Centric Consulting
Cognizant		GFT	**IKOR – (HEXW Partner)**
EY		Sollers Consulting	ITS
PwC		Tenzing	Jet Infosystems
Deloitte		4impact	JIEC
IBM		SBI Technology	Climb
EPAM			
CGI			

Source: Guidewire, PhillipCapital India Research

Manufacturing & consumer: has been growing at above company average growth
Manufacturing and consumer represent 18% of HEXW's revenue and has seen 29% revenue CAGR since CY17 as compared to company growth rate of 14%. This vertical includes sub segments like process manufacturing, retail, telecom and education. In retail, HEXW is a challenger and does not have large legacy ADM, BPO, or IMS contracts, and current engagements are mainly on the customer-transformation side. Absence of large legacy footprints in the retail vertical are positive, given the sheer pressure from retailers who are cutting legacy budgets where larger peers of HEXW are struggling. In telecom, too, HEXW's presence is small, with few large clients with whom the company is doing well.

The outlook is positive in this vertical because of deal-traction, the pipeline, and lesser drag from the legacy business.

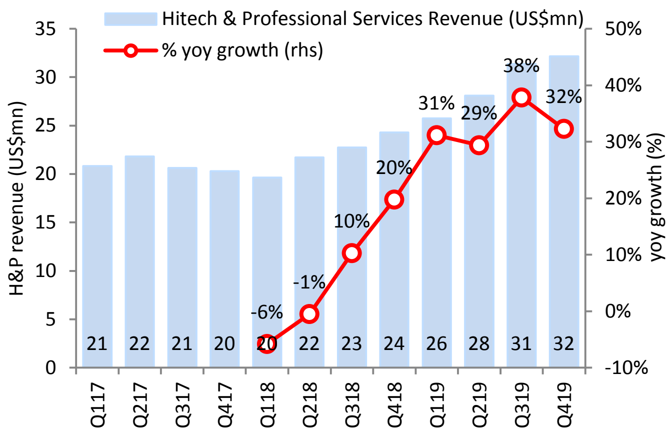
Manufacturing & consumer: has been growing above the company's average



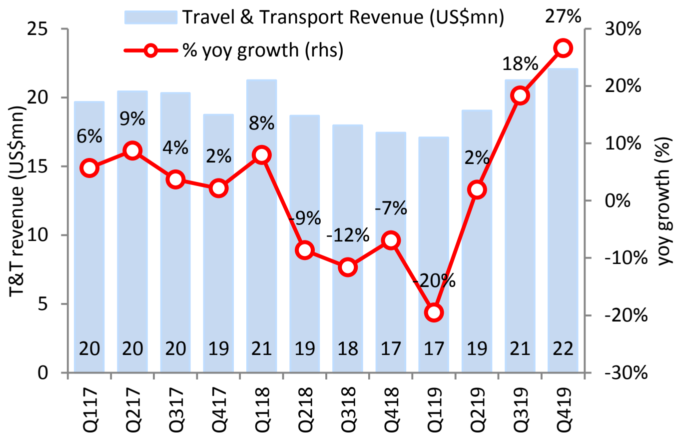
Source: Company, PhillipCapital India Research *(*Numbers were reclassified from Q1FY17)*

Hitech & professional-services is doing well; travel & transport volatile
Hitech and professional-services represent 15% of revenue, and has seen 4% CQGR since 1QCY17. Travel is HEXW's smallest vertical with 10% revenue contribution; its performance has been volatile in recent quarters and no growth since CY17. HEXW's management said in Q4CY19 that due to the then recent outbreak of Coronavirus, clients are reluctant to travel to the east, and as such, were delaying projects. There are reverse travel restrictions in place too – from India to the US and Europe. HEXW's CY20 guidance doesn't factor any impact from Coronavirus.

Hitech & professional services doing well ...



...while travel & transport has been volatile

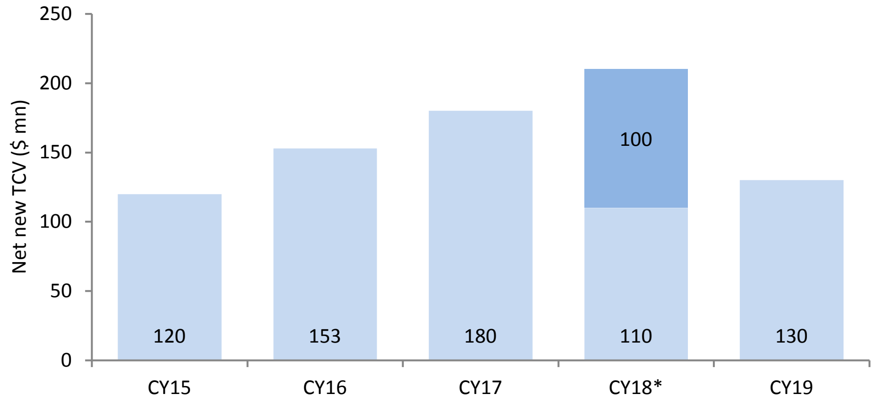


Source: Company, PhillipCapital India Research

Deal wins for CY19 fail to impress

HEXW's net new-deal TCV in CY19 was US$ 130mn down 38% yoy (+18% yoy adjusting for cancellation of US$ 100mn deal won in CY18). This is not encouraging compared to CY16-17 levels of US$ 150-180mn While quantitatively, the deals wins were lacklustre, management believes their quality has improved within the target clients, with scope to increase the potential opportunity. While the deal-win number may look low compared to peers, we note that HEXW only includes new wins from new clients.

Net new TCV, which grew for last few years, was unimpressive in CY19



Source: Company, PhillipCapital India Research *(*US$100mn deal win in CY18 got cancelled later)*

Key deal wins for HEXW over last two years

Quarter	US$mn	Service Lines	Industry	Geo
Q4CY19	**30**	App upgradation	Educational Institute	Asia
		Guidewire Consulting	Insurance	Europe
		IMS	Healthcare	Europe
		IMS	BFSI	US
Q3CY19	**28**	ADM	Online Real Estate Marketplace	
		IMS	In-flight Catering & Logistics	
		ADM & Support	Insurance	UK
		Assurance	Professional Services	
		IMS	Furniture Retail Store	US
Q2CY19	**36**	Private Cloud Implementation	Healthcare company	
		Guidewire Testing	Insurance	Europe
		CX Transformation	Real Estate	US
		RPA & Accounts Payable Automation	Grocery Distributor & Retailer	US
		Testing	Law Firm	US
Q1CY19	**36**	Digital consulting		
		Cloud Native Development	Shipping Services Co	
		Consulting & Data Lake	Commercial Bank	
		App modernization using Mulesoft	Insurance & Financial Services Co	
Q4CY18	**116**	Ops transformation	Financial Services	Nordics
		IT outsourcing (end to end)	Shipping services	Europe
		Devops implementation	Financial Services	US
		ADM	Manufacturing	Global
		App management	Insurance	Europe
Q3CY18	**25**	App and IMS support	Financial Services	Global
		Network Ops	Energy	US
		App support	Manufacturing & Technology	Finland
Q2CY18	**41**	Automation services	Financial Services	UK
		Automation services	Bank	Switzerland
		ADM & Testing	Analytics co	
Q1CY18	**28**	Automation services	Education	
		Remote IMS	Law firm / Professional services	
		Enterprise Monitoring & Devops	Manufacturing	

Source: Company, PhillipCapital India Research

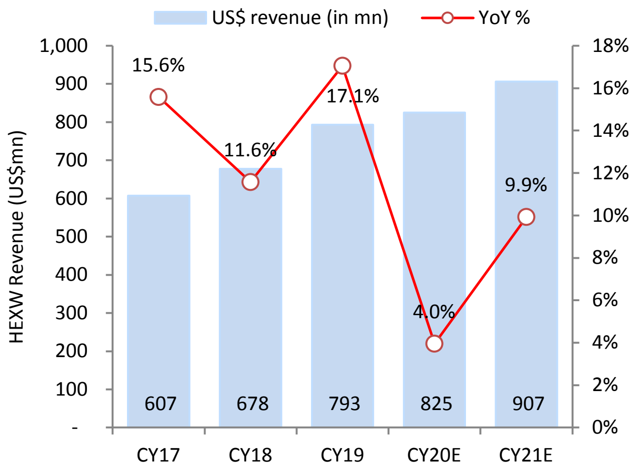
CY20 needs continued support of non-BFS

HEXW earlier guided for a CY20 USD revenue growth of 15-17% (10-12% on an organic basis as per our estimates, excluding the impact of Mobiquity). Due to the severe impact of Covid-19 crisis on verticals such as travel, education, high end retail and fitness, management has decided to revisit the guidance during its Q1CY20 results. Apart from the impact on its other verticals, there will be drag from its large BFS account as it would decline in Q1CY20. Since the BFS vertical is more skewed towards capital markets than banking, it will take some time for it to return to industry leading growth in this vertical.

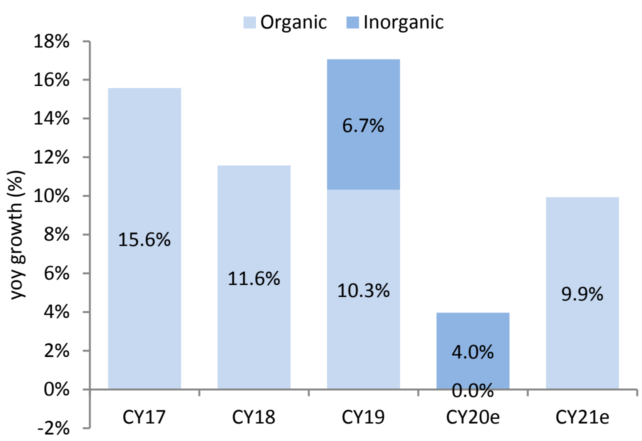
We note that HEXW's guidance track record, especially in CY19, wasn't great. In CY19, the company cut its guidance twice. First in Q2CY19 due to higher-than-anticipated weakness in financial services, and later in Q3CY19, mainly due to weak Q3CY19 results, possibility of extended furloughs in Dec 2019, and a drag from the ongoing ramp-downs in a top US secondary-mortgage client.

The net new-deal TCV for HEXW in CY19 at US$ 130mn – disappointing as compared to CY16-17 levels of US$ 150-180mn. Post Covid-19, deals wins are expected to further deteriorate. We forecast USD revenue growth of 4.0% yoy for CY20 overall (organic business to be flat, 4% incremental impact of Mobiquity) and 10% for CY21.

CY20 to be impacted by Covid-19 led impact...



... and will also have inorganic contribution



Source: Company, PhillipCapital India Research *(*Assumptions include Mobiquity revenue assuming quarterly revenue run rate of US$ 21.1mn)*

M&A strategy / acquisition of Mobiquity

M&A strategy: In Q1CY19, HEXW's management had unveiled a broad acquisition strategy and indicated it expected to spend US$ 250-300mn for acquisitions in the next 2-3 years, which would contribute c.US$ 125mn in revenues. It had also reduced dividend payout 2-3 years ago in anticipation of such investments.

Areas identified for acquisition included cloud and customer experience. In the target company, it was looking for the following attributes - annual revenue-run rate greater than US$ 25mn, EBITDA margin in the vicinity of HEXW's margin, and acquisition not be EPS dilutive.

In June 2019, HEXW acquired US-based customer experience consulting firm Mobiquity Inc for an all-cash consideration of US$ 182mn, at an EV of 2.6x. Incorporated in 2011, Mobiquity is an independent customer-experience consulting firm, specialising in creating a frictionless multi-channel digital experience, leveraging cloud technologies.

The acquisition is expected to help HEXW gain traction in banking and pharma verticals, which are its focus areas.

Key highlights of the transaction:

- Reported revenues of US$ 70mn for CY18; CAGR of 24% over the last 3 years.
- Consideration of US$ 182mn includes US$ 131mn upfront payment and a deferred consideration of US$ 51mn ($30mn paid in January 2020 and rest $21mn to be paid in October 2020).
- Has a workforce of 650 employees spread across 9 locations who have joined HEXW.
- Has a strong AWS partnership in which it is one of the few partners for 'digital customer-experience consulting'. Also, it brings strong capabilities in the omni-channel banking, through its Backbase partnership.
- HEXW has raised a term loan of US$ 20mn to part fund the Mobiquity acquisition
- Top-20 clients contribute 90% of its total revenue. Four Mobiquity accounts are HEXW's top-20.
- **Vertical overlap**: Mobiquity is focused on BFSI and the pharmaceuticals vertical. HEXW has a presence in capital markets and mortgages, while it has limited exposure to Banks. Also, Mobiquity brings strong reference capabilities to expand within pharma clients.

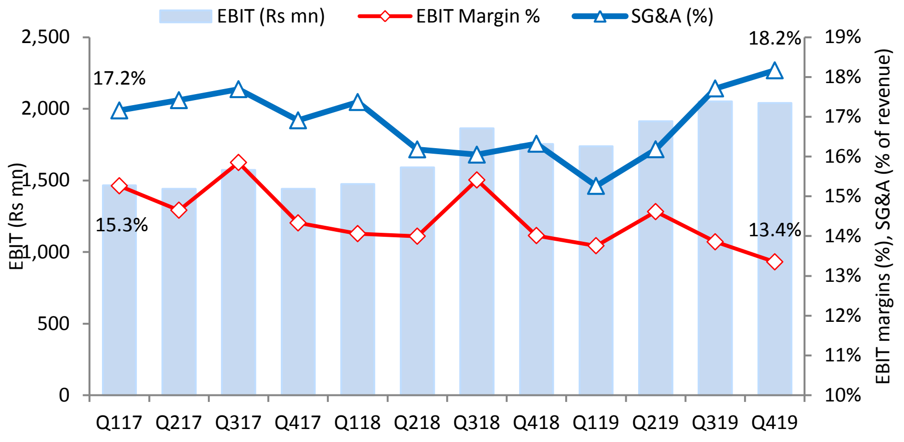
Since HEXW has done a sizable transaction in CY19 acquiring Mobiquity, we expect it would make 'tuck in' acquisitions in the digital space in the near future, not as big as Mobiquity.

Margins to remain range bound

While HEXW saw strong revenue CAGR of 13% over CY15-19, its EBIT margins have remained in a narrow band of 14-16% due to an inferior revenue mix. CY20 will see negative impact of Ind AS 116 adoption and Covid 19 led impact on EBIT margins.

Utilization currently are at 78% as compared to recent peak of 81%. Management wants to cap it at around 80%, so we don't think utilization would be a big lever for margins. Shifting work offshore can be a margin lever, as HEXW's offshore revenue, at 40%, is significantly lower than LTI, at 51%. It has one of the highest subcontractor expenses as a percentage of revenue at around 17% vs. 7.5-12.0% for other mid-cap peers; this is likely due to high share of US geography (75% of revenue) where the talent situation is tight, and high onsite revenue (63%).

EBIT margins have been stable for HEXW



Source: Company, PhillipCapital India Research

Subcontractor expenses (as % of revenue) are one of the highest amongst peers

	FY2015	FY2016	FY2017	FY2018	FY2019
Mindtree	6.2%	6.7%	5.9%	6.4%	7.5%
LTI	6.9%	6.9%	6.7%	7.3%	7.7%
NIIT Tech	5.7%	5.3%	5.5%	7.1%	8.2%
Persistent	5.8%	6.9%	7.6%	10.5%	10.4%
Mphasis	6.0%	5.9%	6.1%	9.4%	11.9%
Hexaware	9.5%	11.9%	12.9%	14.1%	16.9%

Source: Company, PhillipCapital India Research *(*For HEXW, FY2019=CY2018 and so on)*

While the company has margin levers – offshore mix, reducing subcontracting expenses, and SG&A leverage – we believe margins will remain in the narrow range of ~13.0-13.5%, largely due to a high onsite presence (which would keep costs high), and the management's strategy of sharing benefits of automation with its clients (which should help future growth).

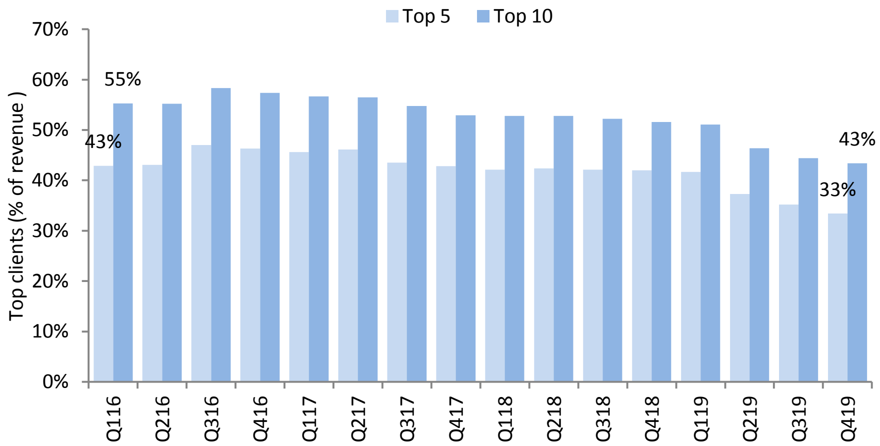
In addition, in CY20, there will be a negative impact due to Ind AS-116 adoption on EBIT margins (we build in 60bps dilution). The recent acquisition of Mobiquity would have acted as margin headwinds in the near future, given the integration cost and higher SG&A proportion for Mobiquity.

In the near term margins will be impacted due to Covid-19 impact with revenue declines, work from transition costs acting as headwinds.

Client concentration reducing

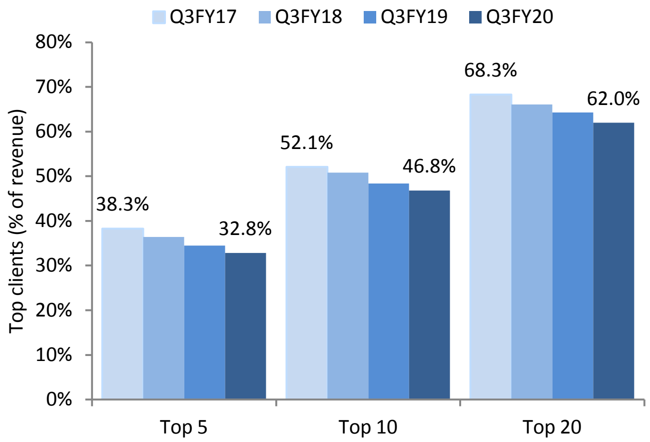
Client concentration has been gradually reducing at HEXW since the last 3-4 years. This is partly due to revenue reduction from the top-three BFS clients. Revenue from its top-five/top-ten clients now contributes 33%/43% of revenues in Q4CY19 vs. 43%/55% as of Q1CY16.

Client concentration is reducing for HEXW

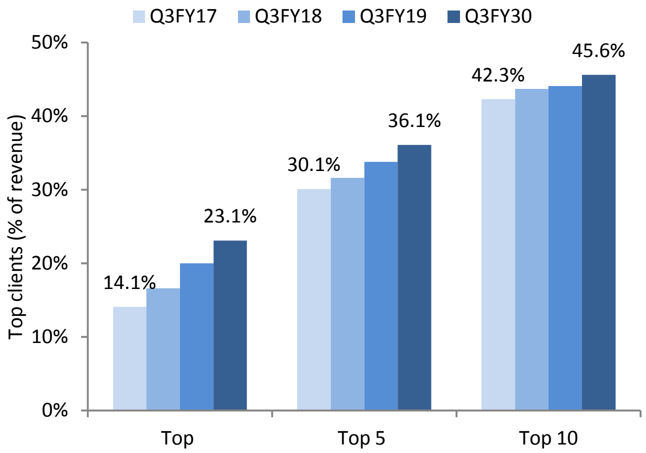


Source: Company, PhillipCapital India Research

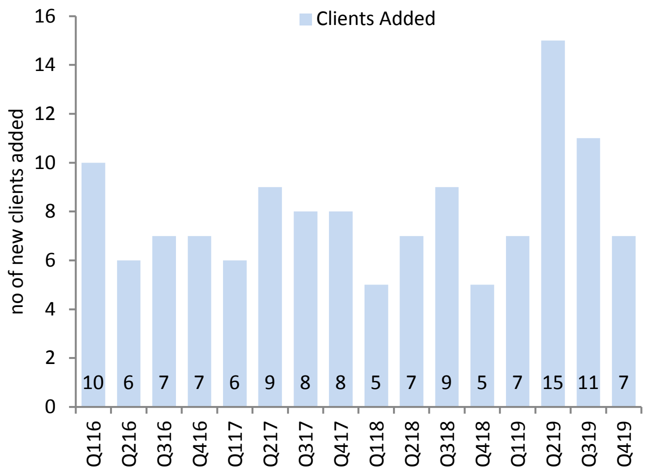
As compared to HEXW, LTI's client concentration is reducing...



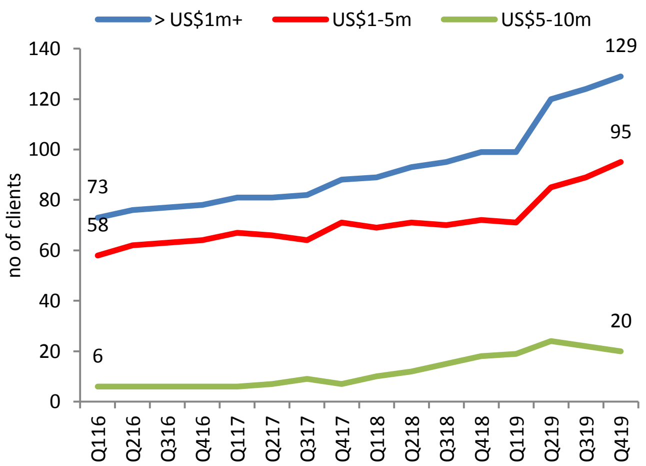
...while Mindtree's is increasing



New client addition remains strong for HEXW



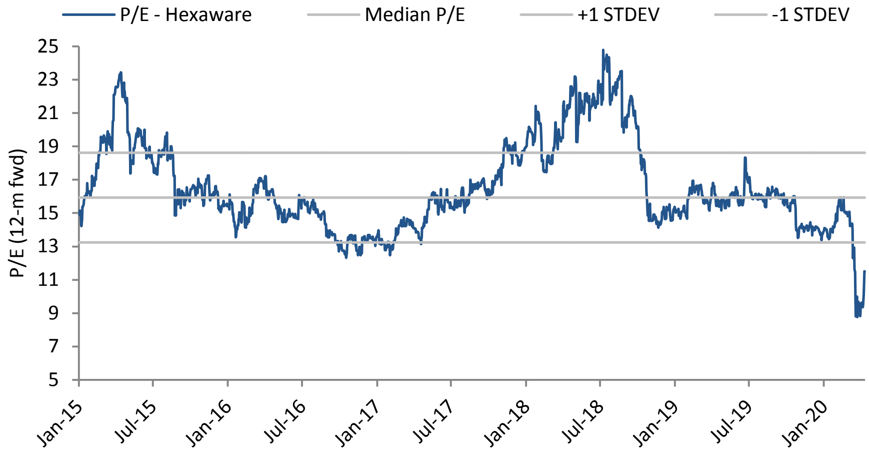
New client addition in smaller buckets remains robust



Source: Companies, PhillipCapital India Research

Valuations

HEXW's one-year forward PE ratio is now much below -1 standard deviation



Source: Bloomberg, PhillipCapital India Research

Comparative Valuation

IT Midcaps – Recommendations summary

	CMP	Mkt Cap	Target	PT	Upside	Rating	USD Rev Growth (%)		EBIT Margins (%)		EPS (Rs)	
	Rs	Rs bn	Multiple	Rs	%		FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
LTI	1,389	242	16.0	1,580	14%	**BUY**	0.1	11.6	15.2	16.5	81	99
LTTS	1,168	121	15.0	1,330	14%	**BUY**	-0.6	12.4	16.0	17.1	75	88
MindTree	737	121	17.0	890	21%	**BUY**	-0.4	10.7	11.1	12.5	41	53
Cyient	220	24	8.0	320	45%	**BUY**	-3.1	6.5	10.4	10.8	35	40
NIIT Tech	1,110	69	11.0	1,090	-2%	NEU	-0.4	12.1	13.9	14.8	74	89
Mphasis	675	131	13.0	850	26%	**BUY**	-1.0	8.8	15.4	16.0	56	66
Hexaware	269	80	12.0	290	8%	NEU	4.0	9.9	13.0	13.4	21	24

IT Midcaps – Financials and valuation snapshot

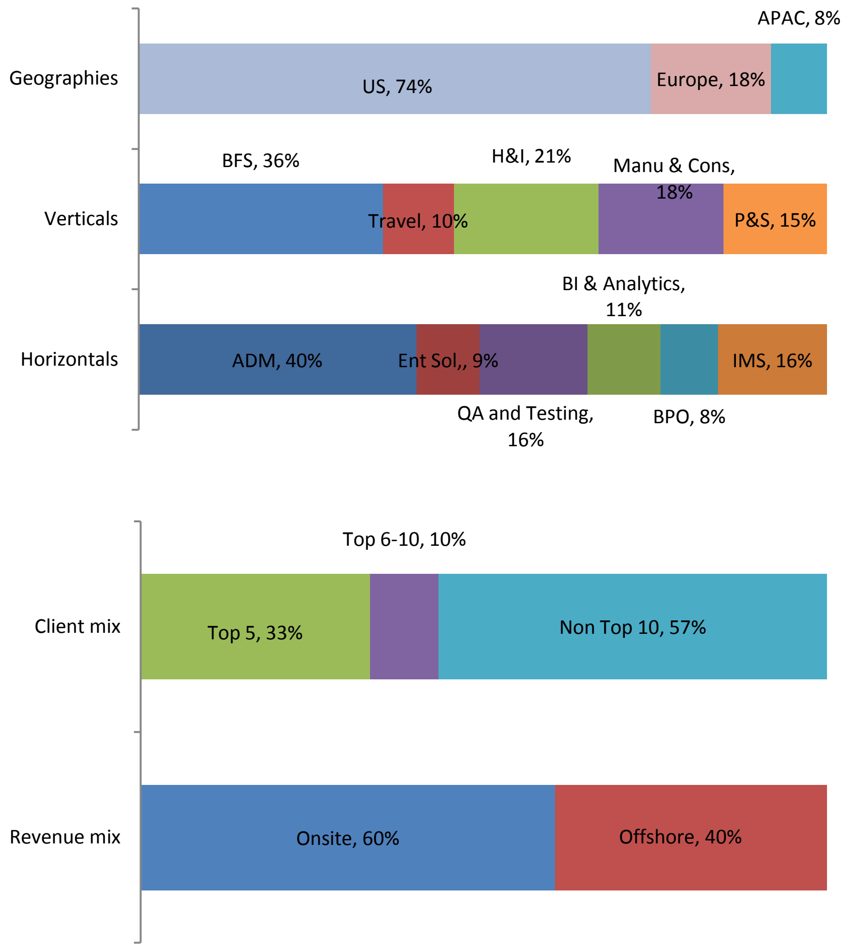
	USD Revenues ($mn)			INR Revenues (Rs mn)			EBIT (Rs mn)			PAT (Rs mn)		
Companies	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
LTI	1,519	1,520	1,696	107,937	107,902	122,082	17,374	16,425	20,099	14,971	14,158	17,248
LTTS	796	791	889	56,232	56,159	64,035	9,479	8,974	10,918	8,185	7,758	9,124
MindTree	1,096	1,091	1,209	77,396	77,492	87,013	7,790	8,567	10,839	6,266	6,800	8,641
Cyient	634	614	654	44,734	43,598	47,075	4,306	4,516	5,098	4,085	3,833	4,346
NIIT Tech	594	591	663	41,769	41,986	47,714	5,558	5,819	7,073	4,472	4,606	5,540
Mphasis	1,241	1,229	1,336	87,957	87,230	96,211	14,109	13,402	15,412	11,219	10,586	12,315
Hexaware	793	825	907	55,824	58,842	65,273	7,745	7,652	8,752	6,409	6,382	7,300

	$ Revenue Growth (%)			EBIT Margins (%)			EPS (Rs)			EPS Growth (%)		
Companies	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
LTI	12.6	0.1	11.6	16.1	15.2	16.5	86	81	99	-1.2	-5.4	21.8
LTTS	10.0	-0.6	12.4	16.9	16.0	17.1	79	75	88	6.5	-5.2	17.6
MindTree	9.4	-0.4	10.7	10.1	11.1	12.5	38	41	53	-16.9	8.5	27.1
Cyient	-4.0	-3.1	6.5	9.6	10.4	10.8	37	35	40	-16.1	-6.1	13.4
NIIT Tech	12.4	-0.4	12.1	13.3	13.9	14.8	72	74	89	8.5	2.7	20.3
Mphasis	10.9	-1.0	8.8	16.0	15.3	16.0	60	56	66	7.6	-5.6	16.3
Hexaware	17.1	4.0	9.9	13.9	13.0	13.4	21	21	24	9.4	-0.5	14.4

	ROE (%)			PE (x)			PB (x)			Div Yield (%)		
Companies	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
LTI	28.0	23.1	24.0	16.1	17.1	14.0	4.5	4.0	3.4	2.1%	2.3%	2.3%
LTTS	29.5	23.9	24.0	14.8	15.7	13.3	4.4	3.7	3.2	1.9%	2.1%	2.5%
MindTree	19.2	18.4	20.1	19.3	17.8	14.0	3.7	3.3	2.8	1.1%	1.8%	1.8%
Cyient	15.5	13.3	13.8	5.9	6.3	5.6	0.9	0.8	0.8	5.5%	5.5%	5.5%
NIIT Tech	18.2	16.8	17.8	15.4	15.0	12.5	2.8	2.5	2.2	2.3%	2.3%	2.3%
Mphasis	21.6	18.5	19.4	11.3	12.0	10.3	2.4	2.2	2.0	4.4%	4.2%	4.9%
Hexaware	23.2	20.6	21.0	12.5	12.6	11.0	2.9	2.6	2.3	2.4%	2.4%	2.4%

Source: Companies, PhillipCapital India Research

Hexaware – Business profile



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Dec, Rs mn	CY18	CY19	CY20E	CY21E
Net sales	**46,477**	**55,824**	**58,842**	**65,273**
Growth, %	17.9	20.1	5.4	10.9
Employee expenses	-31,122	-37,572	-39,707	-43,956
Other Operating expenses	-8,020	-9,474	-10,050	-11,010
EBITDA (Core)	**7,335**	**8,777**	**9,085**	**10,307**
Growth, %	11.9	19.7	3.5	13.5
Margin, %	15.8	15.7	15.4	15.8
Depreciation	-650	-1,033	-1,507	-1,555
EBIT	**6,685**	**7,745**	**7,578**	**8,752**
Growth, %	12.9	15.9	-2.2	15.5
Margin, %	14.4	13.9	12.9	13.4
Other Non-Operating Income	108	21	76	115
Pre-tax profit	**7,265**	**7,958**	**7,853**	**9,067**
Tax provided	-1,432	-1,379	-1,531	-1,768
Profit after tax	**5,833**	**6,579**	**6,322**	**7,299**
Growth, %	16.8	12.8	-3.9	15.5
Net Profit (adjusted)	**5,833**	**6,579**	**6,322**	**7,299**
Wtd avg shares (m)	297.4	298.5	298.5	298.5

	CY18	CY19	CY20E	CY21E
US$ Revenue ($ mn)	**677.7**	**793.3**	**824.7**	**906.6**
Growth, %	11.6	17.1	4.0	9.9
Re / US$ (rate)	68.6	70.4	71.4	72.0

Balance Sheet

As at 31st Dec, Rs mn	CY18	CY19	CY20E	CY21E
Cash & bank	8,205	2,466	5,027	6,818
Debtors	10,761	13,331	13,015	14,944
Loans & advances	553	743	964	1,107
Total current assets	**20,154**	**17,665**	**19,810**	**23,792**
Investments	127	30	30	30
Net fixed assets	**7,986**	**21,239**	**21,819**	**22,619**
Non-current assets	1,283	1,317	1,285	1,476
Total assets	**31,335**	**41,688**	**44,381**	**49,354**
Current liabilities	6,425	11,939	10,465	12,012
Provisions	916	620	1,223	1,092
Total current liabilities	7,340	12,558	11,688	13,104
Non-current liabilities	76	1,474	1,701	1,541
Total liabilities	**7,416**	**14,033**	**13,389**	**14,645**
Paid-up capital	595	597	597	597
Reserves & surplus	23,324	27,058	30,395	34,112
Shareholders' equity	**23,919**	**27,655**	**30,992**	**34,709**
Total equity & liabilities	**31,335**	**41,688**	**44,381**	**49,354**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Dec, Rs mn	CY18	CY19	CY20E	CY21E
Pre-tax profit	7,265	7,958	7,853	9,067
Depreciation	650	1,033	1,507	1,555
Chg in working capital	-567	1,903	-195	-925
Total tax paid	-1,881	-1,032	-1,531	-1,768
Cash flow from operating activities	**5,467**	**9,861**	**7,634**	**7,929**
Capital expenditure	-659	-14,285	-2,087	-2,355
Chg in investments	86	97	0	0
Cash flow from investing activities	**-573**	**-14,188**	**-2,087**	**-2,355**
Free cash flow	4,894	-4,327	5,547	5,574
Equity raised/(repaid)	1	2	0	0
Debt raised/(repaid)	0	1,429	0	-200
Dividend (incl. tax)	-3,038	-2,896	-2,985	-3,582
Other financing activities	1,050	52	0	0
Cash flow from financing activities	**-1,987**	**-1,413**	**-2,985**	**-3,782**
Net chg in cash	2,907	-5,740	2,562	1,792

Valuation Ratios

	CY18	CY19	CY20E	CY21E
Per Share data				
EPS (INR)	19.6	22.0	21.4	24.5
Growth, %	16.6	12.4	(3.0)	14.4
Book NAV/share (INR)	80.4	92.6	104.0	116.5
CFPS (INR)	18.4	33.1	25.4	26.8
DPS (INR)	8.5	8.5	10.0	12.0
Return ratios				
Return on assets (%)	20.5	18.0	14.8	15.6
Return on equity (%)	24.4	23.8	20.6	21.0
Return on capital employed (%)	25.4	24.1	20.0	20.5
Turnover ratios				
Asset turnover (x)	3.5	2.9	2.3	2.5
Sales/Total assets (x)	1.6	1.5	1.4	1.4
Sales/Net FA (x)	5.8	3.8	2.7	2.9
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	84.5	87.2	80.7	83.6
Liquidity ratios				
Current ratio (x)	3.1	1.5	1.9	2.0
Quick ratio (x)	3.1	1.5	1.9	2.0
Dividend cover (x)	2.3	2.6	2.1	2.0
Net debt/Equity (%)	(34.3)	(3.7)	(11.8)	(16.2)
Valuation				
PER (x)	13.8	12.3	12.6	11.0
PEG (x) - y-o-y growth	0.8	1.0	(4.2)	0.8
Price/Book (x)	3.4	2.9	2.6	2.3
Yield (%)	3.1	3.1	3.7	4.4
EV/Net sales (x)	1.6	1.4	1.3	1.1
EV/EBITDA (x)	9.8	9.1	8.4	7.3
EV/EBIT (x)	10.8	10.3	10.1	8.6

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year. We have different threshold for large market capitalisation stock and Mid/small market capitalisation stock. The categorisation of stock based on market capitalisation is as per the SEBI requirement.

Large cap stocks

Rating	Criteria	Definition
BUY	>= +10%	Target price is equal to or more than 10% of current market price
NEUTRAL	-10% > to < +10%	Target price is less than +10% but more than -10%
SELL	<= -10%	Target price is less than or equal to -10%.

Mid cap and Small cap stocks

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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