INSTITUTIONAL EQUITY RESEARCH

IT Services

Heisenberg's Uncertainty Principle – says – BUY NOW!

28 February 2018

INDIA | IT SERVICES | Sector Update

One might argue that we are perhaps 2 months too late in publishing this sector upgrade report. Others might opine that with the growth still in single-digits, it is NOT YET the time to turn bullish on the sector. This ambiguity in timing is a wonderful manifestation of the very principle that forms the core thesis of this report – the Heisenberg's Uncertainty Principle.

The Heisenberg's Uncertainty Principle states that the momentum and position of an atomic particle cannot be simultaneously calculated with precision. *If we know the momentum, we won't be able to estimate the location, and vice versa. Applying it, we deduce that if we can predict the change in momentum (or turnaround) for the IT sector, it would be impossible to forecast the exact timing of that turnaround. In this report, we highlight the evidence (fundamental parameters) that makes us believe we are already seeing that change in momentum. Hence, we recommend that investors BUY the sector NOW – as it will be impossible to time it to perfection.*

Are we seeing a change in momentum for the sector?
Yes, indeed. Notwithstanding the recent rally in IT stocks, primarily driven by portfolio rebalancing and relatively inexpensive valuations, we see multiple fundamental parameters pointing to change in the momentum for the Indian IT services companies, with a significant build-up of: (1) large traditional deals returning, (2) unprecedented dealflow in last few quarters, (3) ISG data pointing to revival in traditional deals (along with continued growth in digital services solutions), (4) digital services, now forming a formidable chunk of the Indian IT portfolio, continuing to grow strongly, and (5) Accenture's results pointing to a sustained pick-up in outsourcing business.

Over the last two quarters, multiple Indian IT companies have reported multi-year multi-billion-dollar deals – reversing the trend of smaller, shorter duration deals over the preceding three years. While TCS announced a record US$ 2.5bn of large deals in the last few months (Nielsen, Transamerica, M&G Prudential & M&S); HCL and Wipro have also seen the same trend.

Q3FY18 witnessed the strongest ever dealflow for the Indian IT sector. TTM dealflow for Infosys was $3bn. TCS and HCL's managements categorically called-out Q3 as their best quarter in the last three years in terms of dealflow. Midcaps (NIIT, LTTS and MindTree) also reported unprecedented dealflow in Q3. The trend is further corroborated by ISG, whose data shows a sharp rise in the digital (As-a-Service) deals, but simultaneously, a gradual pick-up in traditional deals.

Concurrently, Indian IT companies have grown their digital portfolios to formidable sizes. At 22% of revenues, TCS' digital business stands at a mammoth US$ 4bn and Wipro's is US$ 1.9bn (25% of revenues). While Infosys reports 'new services' rather than digital business, this too stands at a handsome US$ 1bn (10% of revenues). That they continue to report strong mid-to-high-teen growth, on this large base, is commendable.

But perhaps, the most important data to bank on is the growth in the outsourcing business of the market leader, Accenture. Its outsourcing division has seen double-digit growth for two consecutive quarters, and order bookings have grown in double-digits for three consecutive quarters. The global IT market is too large to be serviced by just one Accenture – so we believe it to be a matter of time before the Indian IT companies capture share of this growing pie.

So what do we do about the timing?
As per Heisenberg's principle, since we have estimated the change in momentum, we cannot accurately predict the exact point of change. But we can take into account the fact that historically, NO technology disruption has lasted for more than 3-4 years – after which, multiple players thrive in the market. The digital technology (SMAC) is already into its fourth year, and the 'Innovator' and 'Early Adaptor' phases appear to be reaching an end – leading to the advent of the 'Early Majority' phase. Theoretically, the number of players in the market, expands in this phase, and historically, too, we have seen Indian IT companies do exceedingly well in this phase, capturing market share. Accenture's results and the strong dealflow also indicate that Indian IT players will start reporting strong growth, with a maximum lag of two-three quarters.

Hence, we recommend investors BUY the sector NOW. That way, they should be able to ride the growth curve, given that the current market valuations are not factoring the complete extent of the recovery in the sector. In the worst case scenario, investors could be 1-2 quarters early – even then, inexpensive valuations will limit any near-term downside. We upgrade TCS (to Neutral) and Wipro (to BUY), while retaining our Buy on Infosys and HCL Tech. We remain negative on TechM. In midcaps, we prefer PSYS, Cyient, and NIIT Tech. We also initiate coverage on L&T Infotech, with a NEUTRAL rating.

Upgrade Sector to OW

Companies

TCS	**Neutral (↑)**
CMP	3042
TP	2950
Infosys	**Buy (↔)**
CMP	1148
TP	1350
Wipro	**Buy (↑)**
CMP	293
TP	330
HCL Tech	**Buy (↔)**
CMP	952
TP	1190
Tech Mahindra	**Sell (↔)**
CMP	612
TP	570
L&T Infotech	**Neutral**
CMP	1424
TP	1420
L&T Technology Services	**Neutral (↓)**
CMP	1381
TP	1240
MindTree	**Neutral (↔)**
CMP	805
TP	750
Cyient	**Buy (↔)**
CMP	628
TP	740
Persistent Systems	**Buy (↑)**
CMP	840
TP	980
NIIT Technologies	**Buy (↔)**
CMP	832
TP	930
Intellect Design Arena	**Buy (↔)**
CMP	193
TP	280
Majesco	**Buy (↔)**
CMP	475
TP	650

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Companies

We called it out early, and kept reiterating

In December 2015, we downgraded the IT sector on the back of its inefficient capital allocation policies (that it had followed over the last decade), which we believed would cause these companies to be laggards in the digital transformation cycle – a manifestation of the ***'first law of thermodynamics'*** *(No work without input of energy == no growth without investment)*. We were one of the first brokers to downgrade the sector, and our calls played out to perfection over last three years.

Read our 'First law of thermodynamics' report [here]

Inefficient capital allocation policy of the last decade

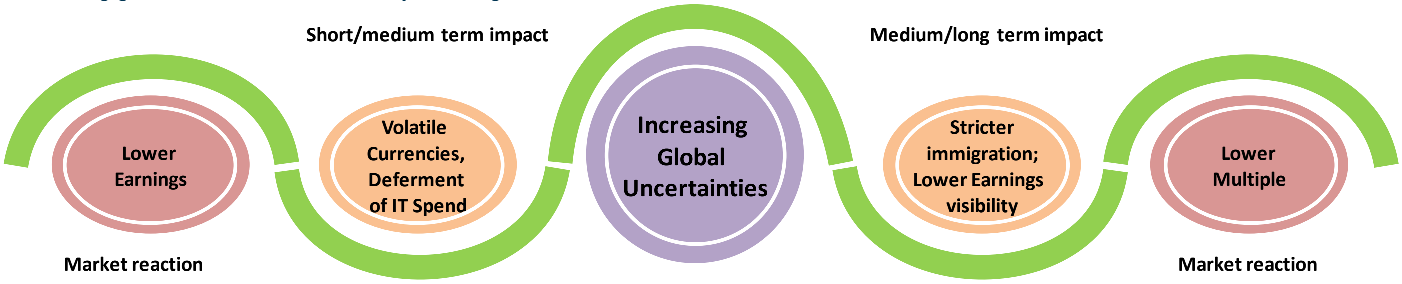
Rs mn	TCS	Infosys	Wipro	HCL Tech	Total
OCF	8,66,621	5,81,590	4,34,505	2,68,958	21,51,674
FCF	6,91,968	4,21,710	3,24,332	2,00,147	16,38,157
Dividend	4,34,687	2,40,310	1,42,558	90,833	9,08,387
Capex	1,74,652	1,59,880	1,04,468	67,693	5,06,694
Cash added	1,95,216	2,85,140	1,55,643	97,991	7,33,990
Acquisitions	41,955	37,030	74,114	37,846	1,90,944
	TCS	**Infosys**	**Wipro**	**HCL Tech**	**Total**
Dividend Pay-out Ratio	36.9%	34.1%	28.7%	33.8%	34.3%
Dividend as a % of OCF	50.2%	41.3%	32.8%	33.8%	42.2%
Capex as % of OCF	20.2%	27.5%	24.0%	25.2%	23.5%
Cash added as % of OCF	22.5%	49.0%	35.8%	36.4%	34.1%
Acquisition as % of OCF	6.1%	8.8%	22.9%	18.9%	11.7%

Source: Companies, PhillipCapital India Research

In our second report of the 'thermodynamic series' (August 2016) we reiterated our Underweight call on the sector, based on the rise of right-wing extremism in the political landscape across the globe (which we represented as increasing entropy of the universe – a manifestation of the ***second law of thermodynamics***). Our argument was that the rise of right-wing populism in the form of unabashed xenophobic nationalism would lead to higher business uncertainty across the world, directly impacting the demand environment of Indian IT companies over the next few years. The report, which we published just after Brexit, was followed by Donald Trump being elected the 45th president of US. Thereafter, a spate of protectionist measures have been implemented (or are being considered) across the world.

Read our 'Second law of thermodynamics' report [here]

Increasing global uncertainties to impact on growth and valuation



Source: PhillipCapital India Research

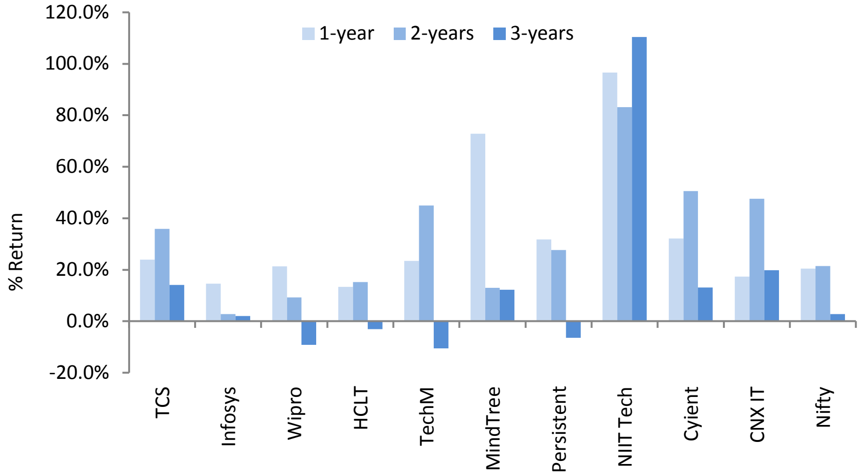
Almost as if taking a cue from our report, many IT services companies embarked on an acquisition spree over the last few quarters, making amends to their inefficient capital allocation policy. HCL Tech and Wipro have been particularly aggressive and have acquired companies with cutting-edge delivery capabilities in the digital space. At the same time, measures such as near-shoring and hiring higher number of local employees, are reducing the sector's dependency on H1B visas and other favours from various governments.

While the impacts of these two laws of thermodynamics are still not over, and would continue to affect Indian IT companies to some extent, we believe the companies have done enough over the last three years to mitigate a large part of the negative effect, and are now ready to traverse a new growth path.

Significant underperformance over last three years

Over the last three years (since we downgraded the sector), *all* IT companies (excl NITEC) along with the CNX-IT Index massively underperformed the broader index. The sector has seen particularly sharp corrections following events such as Brexit (CNX-IT fell 2.5% the following day) and the election of Trump as the US president (CNX-IT fell by 2.9% in the following three days). That, coupled with lacklustre results by IT companies and guidance cuts, led to almost all stocks reporting significant price/time/both correction, over the last three years.

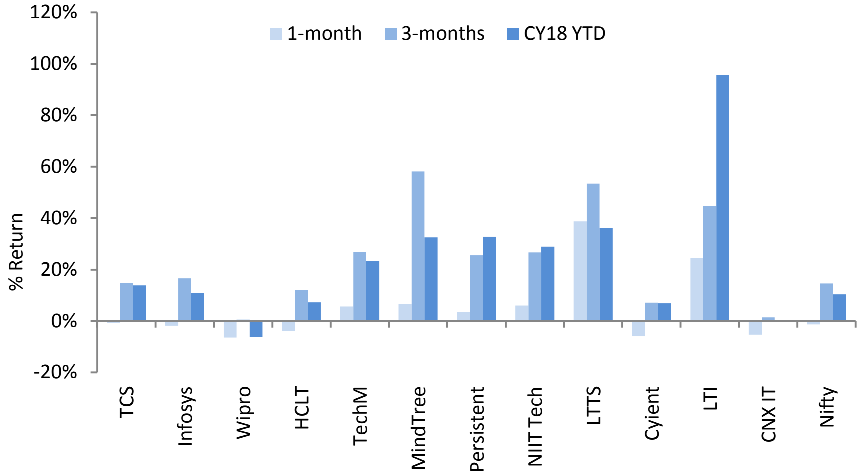
The IT sector has significantly underperformed the broader index over last 3 years



Source: Bloomberg, PhillipCapital India Research

However, a sharp rally YTD in CY18, has seen significant outperformance of IT stocks and the CNX-IT Index, which is up 10% since January 1, 2018; in comparison, the broader markets are down -0.5%. During this period, large-cap stocks (TCS) and midcap stocks (NIIT, LTI, LTTS) have delivered phenomenal returns.

Sharp rally in the last two months in the IT sector socks



Source: Bloomberg, PhillipCapital India Research

We view the recent rally as more of an outcome of portfolio rebalancing by investors and relatively inexpensive valuations of the IT sector (vs. Broader markets and other sectors) than any actual 'growth revival' in the sector

We view the recent rally as more of an outcome of portfolio rebalancing by investors and relatively inexpensive valuations of the IT sector (vs. broader markets and other sectors) than any actual 'growth revival' in the sector. However, as we go on to highlight in this report, there are fundamental parameters (such as deal-wins, competitors' performance, and size of digital portfolios) which point to a 'likely' revival in growth – few quarters ahead. Thus, we argue that this would be, perhaps, a good time to BUY the sector.

Clear signs of change in momentum for the sector

We see significant improvement in key fundamental parameters, which all point to a change in momentum for Indian IT services companies. The evidence of the same are:

1) Large traditional deals returning
2) Unprecedented deal-flow in the last few quarters
3) ISG data pointing to continued growth in digital services solutions
4) Digital services now forming a formidable chunk of the Indian IT portfolio
5) Accenture's results pointing to a sustained pick-up in outsourcing.

1. Large traditional deals are back

One of the biggest troubles that Indian IT companies faced over the last three years was the contraction of deal sizes and tenures. Multi-year multi-billion-dollar deals of the last two decades had given way to shorter duration (and size) deals over the last few years. With the advent of new technology (digital) clients preferred to diversify their vendor base – awarding smaller multiple contracts to several vendors. This had led to shrinkage in the very order backlogs that companies needed in order to sustain growth momentum.

However, over the last two quarters, multiple Indian IT companies have reported multi-year multi-billion-dollar deals – reversing the trend of the last three years. TCS announced a record US$ 2.5bn of large deals in last few months (Nielsen, Transamerica, M&G Prudential & M&S); HCL and Wipro have also reported their share of large deals.

Large deal announcements in last few months

	Time	Geo	Client	$mn	Years	Details of the deal
TCS	Jan '18	EU	M&G Prudential	690	10	To support 4mn policies of Prudential; 1100 incumbent supplier's employees to move to TCS, with further 700 new roles in India
	Jan '18	US	Transamerica	2500	10	TCS will simplify the service of more than 10mn policies into a single integrated modern platform, and drive greater sustainable growth opportunities through superior customer experiences; 2200 Transamerica employees will join TCS
	Dec '17	US	Nielsen Holdings	2250	10	ADM, BPO, KPO and Analytics. Assured of $320mn of business every year from 2017-2020, $186mn every year from 2021-2024 and $139.5mn in 2025. The deal will incrementally add $70-80mn annually
	Jan '18	UK	Marks & Spencer	NA	5	Digital Transformation; 250 employees to be transferred to TCS
HCLT	Jan '18	UK	Cadent	NA	5	Integrated public cloud hosting and SAP and Application Maintenance Services, including the migration of a significant applications portfolio to AWS public cloud
	Nov '17	UK	Jardine Lloyd Thompson	NA	5	Implement a fully orchestrated and automated cloud management platform with advanced automation capabilities, supported through DRYiCE
Wipro	Dec '17	NA	Fortune 500Medical devices	NA	MYMM	Global front-office transformation project
	Dec '17	NA	Global BFSI service provider	NA	MYMM	Upgrade its use experience and simplify their sales and service process
	Nov '17	US	Luxury departmental store	NA	MYMM	Reimagine its employee experience and modernize their HR processes.
	Dec '17	NA	International payment provider	NA	MYMM	Leverage Designit's expertise in technology, product and service design.

Source: Companies, PhillipCapital India Research *(*MYMM – Multi Year Multi Million)*

We see this as a healthy trend for the sector, as it will enable companies to mitigate the fast-eroding base of their traditional IT services business.

2. Unprecedented deal-flow in last few quarters (esp Q3FY18)

Q3FY18 witnessed the strongest ever dealflow for the Indian IT sector. In fact, over the last few quarters, we have seen the deal momentum picking up for most companies. While this was initially confined to mid-cap companies – now large-cap companies are also reporting string dealflow momentum. The TTM deal-flow for Infosys stands at US$ 1.9bn. TCS and HCL's managements categorically called-out Q3 as their best quarter in the last three years, in terms of deal-flow. Midcaps (NIIT, LTTS, and MindTree) also reported unprecedented deal-flow in Q3.

Strong dealflow momentum reported by IT companies over last few quarters

TCV ($mn)	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Infosys	809	1,207	664	806	657	731	779
Yoy growth	17.6%	22.8%	-31.0%	-34.3%	-18.8%	-39.4%	17.3%
MindTree	220	183	314	209	262	207	244
Yoy growth	5.8%	-5.2%	53.9%	-25.6%	19.1%	13.1%	-22.3%
NIIT Tech	101	143	101	112	110	122	130
Yoy growth	4.1%	78.8%	-17.9%	-6.7%	8.9%	-14.7%	28.7%
Cyient	148	145	203	256	160	119	245
Yoy growth	32.9%	41.2%	10.2%	49.4%	8.6%	-17.8%	20.9%

Source: Companies, PhillipCapital India Research

Strong dealflow commentary by IT companies over last few quarters

TCS	Signed first-ever US$50mn+ Digital deal during Q3FY18
HCLT	It signed 20 large transformational deals in Q3FY18, with highest TCV win in the last 12 quarters.
INFOSYS	Won 8 large transformational deals
WIPRO	A lot of the pilots, proof of concepts in Digital are now beginning to turn into projects at scale
LTTS	Won several multimillion dollar deals across multiple verticals
CYIENT	Orderbook has been quite robust across all the verticals
MTCL	Seeing larger, longer, multi-year and multi-million dollar kind of programs in digital
NIITT	Confident of signing ATLEAST two larges deals in Q4FY18

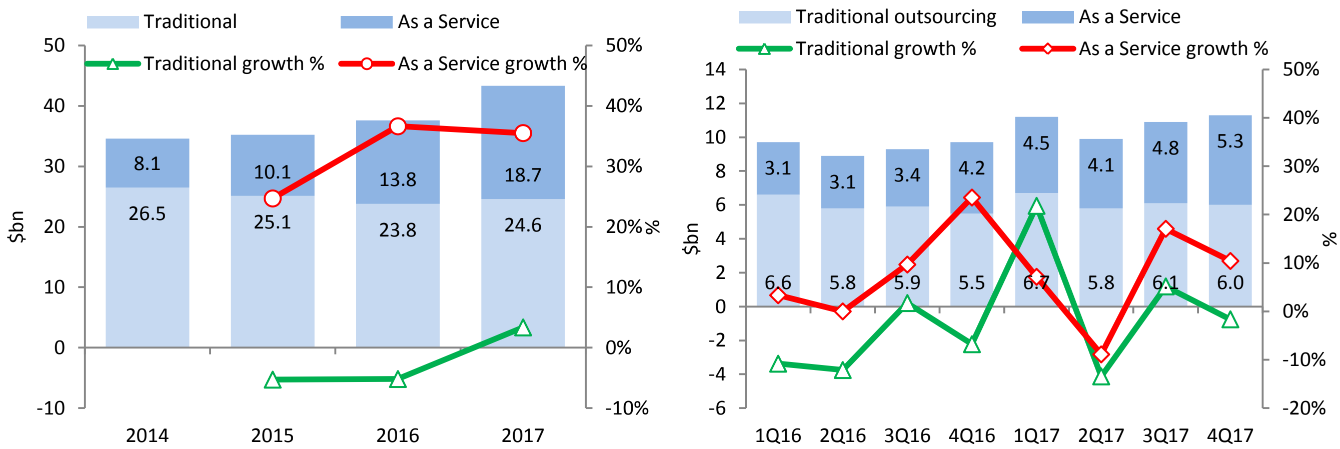
Source: Companies, PhillipCapital India Research

We see this as a very important development, as swelling order backlogs provide the visibility for revenue growth. If this momentum in deal-flow sustains, early-teen to mid-teen growth in dollar revenue will not be far behind.

3. ISG data points to revival in traditional deals

Deal data from Information Services Group (ISG – a leading global IT consultant) indicates a continued rise in digital (As-a-Service) deals. However, over the last few quarters, it has also started showing a reversal in trend for traditional deals – these now appear to be staging a comeback after multiple quarters of decline/muted growth.

ISG dealflow data shows revival in traditional deals, as digital continues to grow



Source: ISG, PhillipCapital India Research

If this trend sustains for the overall sector, Indian IT companies cannot be left far behind. In fact, the biggest beneficiaries from a revival of growth in the traditional segment would be Indian IT companies – also benefitting from a continued growth in the digital domain.

4. Digital services for Indian IT, now significant in size

Over the last three years, as Indian IT companies struggled to mitigate cannibalization of their traditional business streams by new-age digital technologies, companies reskilled themselves significantly (both on delivery and sales), and have grown their digital portfolios into formidable sizes.

Currently, digital business forms 22% of TCS' revenue – standing at a mammoth US$ 4bn – a digital portfolio larger than the full-scale operations of all but four other Indian IT companies. Wipro too, has a sizeable digital portfolio of US$ 1.9bn (25% of revenues). While Infosys reports 'new services' rather than digital business, that too stands at a handsome US$ 1bn (10% of revenue).

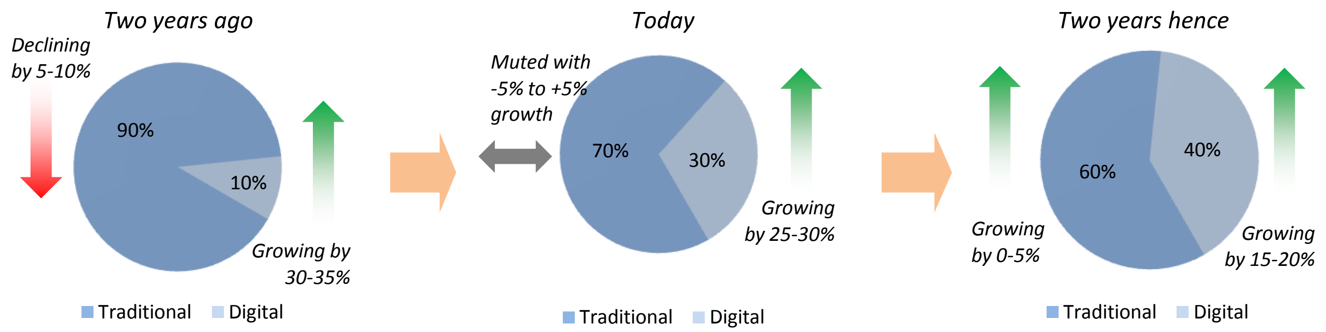
Digital has achieved significant size for Indian IT

	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
TCS					
Digital Rev ($mn)	737	797	868	934	1,058
Digital Share %	16.8%	17.9%	18.9%	19.7%	22.1%
YoY %	*29.8%*	*22.2%*	*25.1%*	*32.6%*	*43.5%*
Infosys*					
Digital Rev ($mn)	*NA*	*NA*	220	256	273
Digital Share %	*NA*	*NA*	8.3%	9.4%	9.9%
YoY %	*NA*	*NA*	*NA*	*NA*	*NA*
Wipro					
Digital Rev ($mn)	413	432	444	485	503
Digital Share %	21.7%	22.1%	22.5%	24.1%	25.0%
YoY %	*NA*	*NA*	*28.4%*	*29.2%*	*21.9%*
MindTree					
Digital Rev ($mn)	76	77	85	88	94
Digital Share %	39.4%	39.6%	42.3%	42.6%	43.9%
YoY %	*13.8%*	*2.9%*	*6.6%*	*13.8%*	*24.2%*
Persistent					
Digital Rev ($mn)	19	21	20	25	27
Digital Share %	16.9%	18.9%	18.0%	20.9%	22.0%
YoY %	*NA*	*NA*	*36.7%*	*54.4%*	*45.0%*
NIIT Tech					
Digital Rev ($mn)	20	22	23	26	29
Digital Share %	19.0%	21.0%	21.0%	23.0%	25.0%
YoY %	*26.0%*	*37.4%*	*26.9%*	*34.4%*	*49.2%*

Source: Companies, PhillipCapital India Research *(*Infosys reports New services, instead of Digital business)*

Interestingly, the companies continue to report strong mid-to-high-teen growth on this high base. While the yoy growth data is not available for all companies for all quarters, the trend for them all depicts consistent robust growth. We believe that this strong growth in digital business will soon reach a point where it will be able to MORE THAN mitigate the impact of a decline (or muted growth) in the traditional businesses. Thereafter, one can expect secular strong growth at an overall company level – paving the way for strong earnings growth.

Traditional and digital revenue pie transformation over last two, and next two years



Source: PhillipCapital India Research

5. Accenture's results pointing to a sustained pick-up in outsourcing

THE most important parameter that we bank on, to gauge the change in momentum for Indian IT companies is – the growth in the outsourcing business of the market leader Accenture.

Over the last three years, Accenture has captured a large part of the digital market – driven by its consulting business and a beakneck acquisitions pace. It made 18 acquisition in CY17, spending US$ 1.8bn. Its total spend on acquisition over the last three years has been a whopping US$ 3.6bn, which provided the company with a significant competitive advantage, as it acquired niche companies in the digital space and provided them with a platform to grow, more than they would have independently.

Accenture's growth has been driven by its breakneck acquisition pace

Traditional domain	EnergyQuote JHA, Total Logistics, S3 TV Technology, Sagacious Consultants, Beacon Consulting Group, Formicary, Realworld OO Systems, Karmarama, Altitude, InvestTech Systems, Endgame
New Domain (ERD, Digital etc)	Axia, Tquila UK, Javelin Group, Brightstep, Pacifilink HK, Chaotic Moon. Solium, Schlumberger BC, AD. Daileto, FusionX, Cloud Sherpas, Cimation, Boomerang Pharma, CRMWaypoint, IMJ Corp, OPS Rules, Maglan Info, dgroup, MOBGEN, Tecnilogica, Redcore, New Energy Group, Kurt Salmon, DayNine, Defense Point, Allen, 2nd Road, Nashco, solid-serVision.com, SinnerSchrader, OCTO Tech, Phase One, Arismore, SolutionsIQ

Source: Accenture, PhillipCapital India Research

However, all along, its overall business growth was driven by the consulting business. Even with the foot-in-the-door provided by its consulting business and a spate of acquisitions, its outsourcing business and order backlog continued to see a decline or muted growth. It too, was NOT able to completely mitigate the cannibalization of its traditional outsourcing business streams.

While outsourcing remained muted for Accenture over FY15-16 ….

Outsourcing ($mn)	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16
Orderbook	3,800	5,100	4,000	4,700	3,300	4,500	4,200	4,200
YoY %	*-13.6%*	*-7.3%*	*-11.1%*	*6.8%*	*-13.2%*	*-11.8%*	*5.0%*	*-10.6%*
Revenue	3,803	3,654	3,658	3,729	3,667	3,653	3,813	3,880
YoY %	*11.2%*	*6.4%*	*0.3%*	*-0.9%*	*-3.6%*	*0.0%*	*4.2%*	*4.1%*

Source: Accenture, PhillipCapital India Research

Over the last few quarters, Accenture's outsourcing business appears to seeing significant revival

Over the last few quarters, Accenture's outsourcing business appears to seeing significant revival. This business reported double-digit growth for two consecutive quarters and its order-bookings have grown in double-digits for three consecutive quarters.

… it has picked up pace over last five quarters

Outsourcing ($mn)	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18
Orderbook	3,400	4,600	4,600	5,000	4,000
YoY %	*3.0%*	*2.2%*	*9.5%*	*19.0%*	*17.6%*
Revenue	3,922	3,912	4,047	4,216	4,339
YoY %	*7.0%*	*7.1%*	*6.1%*	*8.6%*	*10.6%*

Source: Accenture, PhillipCapital India Research

The global IT market is too large to be serviced by just one player – Accenture

We believe that the global IT market is too large to be serviced by just one player – Accenture. At some point, other players WOULD be required to offer outsourcing services (traditional and digital) that enterprises across the world require. Hence, we expect it to be a matter of time before we see a rub-off effect of the growth in Accenture's outsourcing business on Indian IT companies.

But… is it time to buy the sector?

This perhaps, as always, is the million dollar question. While one might agree with the change in momentum, as seen in key fundamental parameters (that we highlighted in the earlier section), the revenue and earnings growth for companies remains muted. Hence, the real turnaround in numbers could still be few quarters away. So, how does one time the recovery then?

To answer that, we take the help of the Heisenberg Uncertainty principle of quantum mechanics. Heisenberg's Uncertainty Principle states that the momentum and position of an atomic particle cannot be simultaneously calculated with precision. If we know the momentum, we won't be able to estimate the location, and vice versa. Applying that principle to the Indian IT services sector, since we have estimated the change in momentum we cannot accurately predict the exact point of change.

Heisenberg Uncertainty Principle

$$\underbrace{\Delta x}_{\text{uncertainty in position}} \overbrace{\Delta p}^{\text{uncertainty in momentum}} \geq \frac{h}{4\pi} = \frac{\hbar}{2}$$

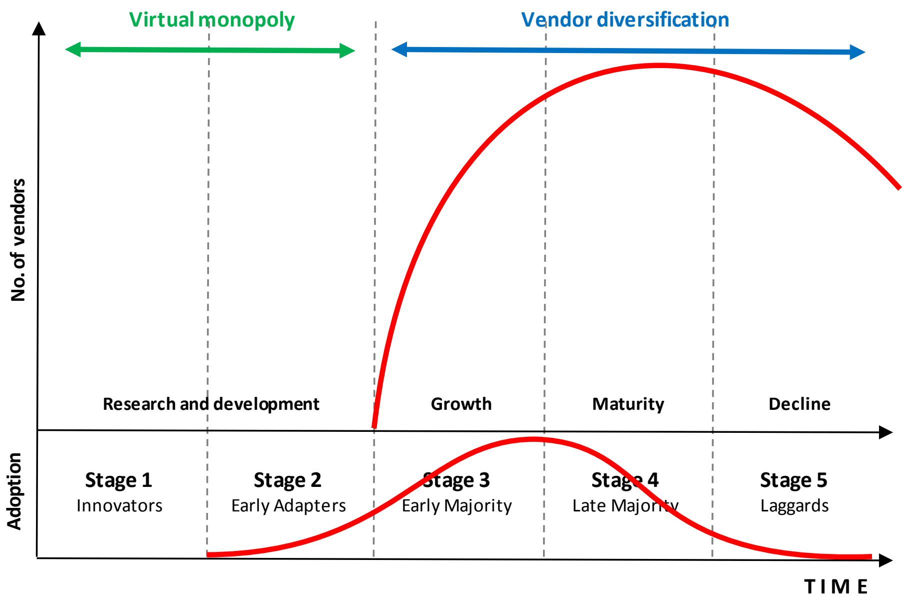
The more accurately you know the position (i.e., the smaller Δx is), the less accurately you know the momentum (i.e., the larger Δp is); and vice versa

Source: PhillipCapital India Research

Historically, NO technology disruption has lasted for more than 3-4 years

We take help from the fact that historically, NO technology disruption has lasted for more than 3-4 years – after this period, multiple players thrive in the market. The digital technology (SMAC) is already into its fourth year, and the 'Innovator' and 'Early Adaptor' phases appear to be reaching an end – leading to the advent of the 'Early Majority' phase. Theoretically, the number of players in the market expands in this phase.

Vendor diversification typically clicks at a later stage of technology adoption cycle

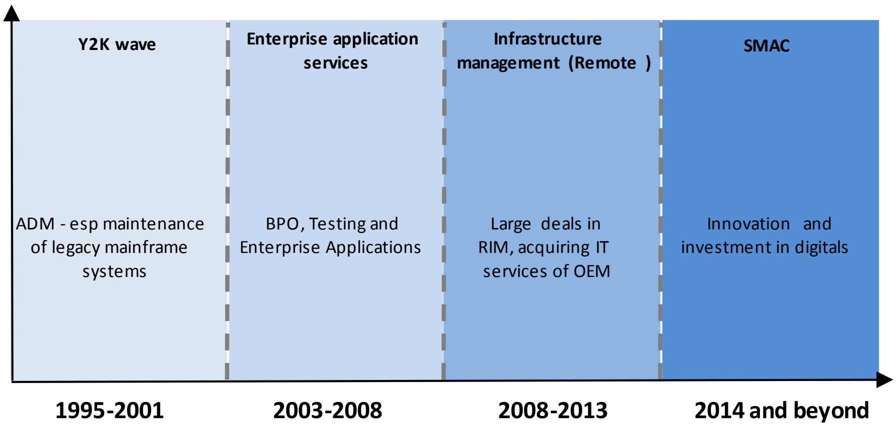


Source: PhillipCapital India Research

Indian IT companies have historically come towards the later stage of any technological wave. Whether it was the maintenance of the legacy, COBOL-based banking platforms, or the Y2K boom, or the current replacement of the legacy systems with the latest architecture, global MNCs (such as IBM, Accenture) have captured the early adapters phase (the most lucrative one) and the Indian IT companies have gradually developed capabilities in those domains, capturing a large share in the mature phase.

Indian IT companies have historically come towards the later stage of any technological wave

Waves of the global IT industry



Source: PhillipCapital India Research

Apart from this market analysis, Accenture’s results, too, show that the other players in the market will start reporting similar numbers, with a lag of a few quarters. And lastly, the unprecedented deal-flow in this quarter (hopefully carried forward into coming quarters), will translate into revenue growth with a maximum lag of 2-3 quarters.

We believe that the current market valuations are not factoring the complete extent of the recovery in the sector – given that the growth expectations still remain in single digits. Hence, we hence recommend investors BUY the sector NOW, which would enable them to ride the growth curve. In the worst-case scenario, investors might be 1-2 quarters early – where, too, inexpensive valuations would limit the near-term downside, if any.

Making amends to the inefficient capital allocation policy

In our December 2015 report, we downgraded the IT sector (on inefficient capital allocation policy) followed by the companies (sitting on excessive cash over the last decade instead of investing it to acquire capabilities). This, we believed would cause these companies to be laggards in the digital transformation cycle, leading to subdued topline and earnings growth over the next three years.

Read our detailed report on the inefficient capital allocation policy of the Indian IT companies here

While the companies have reported muted topline/earnings growth over the last three years, we see many of the companies making amends to their capital allocation policy. Almost all large companies (excl TechM) have announced share buybacks – while maintaining dividend payouts (excl HCL), boosting investor returns.

IT companies have conducted buyback of mammoth Rs 460bn in last two years

	Buyback Price (Rs)	Buyback Size (Rs bn)	% of M-cap	When
TCS	2,850	160	2.8%	Q1FY18
Infosys	1,150	130	5.0%	Q3FY18
Wipro	320	110	7.8%	Q3FY18
	625^	25	1.8%	Q1FY17
HCLT	1,000	35	2.7%	Q1FY18
MindTree	625	2.7	2.3%	Q2FY18

Source: Company, PhillipCapital India Research; ^ Pre-Bonus price

The mammoth buybacks haven't impacted the dividend payout

Dividend payout (%)	FY16	FY17	9mFY18	FY18E	Div yield (%)
TCS	41.4%	41.2%	24.8%	46.8%	1.8%
Infosys	48.1%	48.0%	28.2%	49.7%	2.8%
Wipro	19.4%	13.4%	8.5%	17.5%	1.0%
HCLT	52.4%	46.9%	15.0%	15.0%	0.8%
MindTree	37.4%	46.6%	29.4%	32.4%	1.1%

Source: Company, PhillipCapital India Research

More importantly, many of them (esp HCL and Wipro) have embarked on an acquisition/partnership spree – looking to mitigate lack of organic growth opportunities with inorganic ones. This, we believe, is an important shift in the mindset of Indian IT companies, who have hitherto been reluctant to make acquisitions. This will enable them to ride-out not just the present disruption wave, but also provide them the confidence to tackle the ones in future – which are sure to occur in a highly disruptive domain like technology.

Spate of acquisitions over the last three years by IT companies

	Traditional domains	New domain (ERD, Digital etc)
HCLT	Powerteam LLC, Point to Point, Volvo IT	C2SiS, Geometric, IP Partnerships (6), Butler America
Infosys	Lodestone	Panaya, Skava, Noah Consulting
TCS	None	None
Wipro	Cellent, Healthplan, InfoSERVER, Drivestream	Designit, Appirio, Cooper Software
Cognizant	CNO Financial, Storebrand Baltic, Heliocentric, Frontica Business, Klockner Information, Nova IT, TMG Health	KBACE Tech, ReD Associates, Quick Left, Idea Couture, Mirabeau BV, Adaptra, Brilliant Service, T2C, Netcentric, Zone
TechM	HCI, Target, Sofgen, LCC	Pininfarina
MindTree	-	Magnet 360, Discoverture, Bluefin, Relational
Accenture	EnergyQuote JHA, Total Logistics, S3 TV Technology, Sagacious Consultants, Beacon Consulting Group, Formicary, Realworld OO Systems, Karmarama, Altitude, InvestTech Systems, Endgame	Axia, Tquila UK, Javelin Group, Brightstep, Pacifilink HK, Chaotic Moon. Solium, Schlumberger BC, AD. Daileto, FusionX, Cloud Sherpas, Cimation, Boomerang Pharma, CRMWaypoint, IMJ Corp, OPS Rules, Maglan Info, dgroup, MOBGEN, Tecnilogica, Redcore, New Energy Group, Kurt Salmon, DayNine, Defense Point, Allen, 2nd Road, Nashco, solid-serVision.com, SinnerSchrader, OCTO Tech, Phase One, Arismore, SolutionsIQ

Source: Companies, PhillipCapital India Research

HCLT has been on an acquisition spree over the last two years

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Oct-17	IP Partnership	US	IP License: Notes, Domino, Smart Cloud Notes, Verse and Sametime products	60	NA
Jul-17	IP Partnership	US	IBM Marketing Automation software and products under the IBM CICS z/OStools portfolio, IBM's Tivoli and Rational portfolios.	140	NA
Apr-17	IP Partnership	US	Information management and Database management systems	80	NA
Dec-16	IP Partnership	US	Application security, B2B data transformation, Testing automation and Mainframe management tools	155	50
Dec-16	Butler America Aerospace	US	Engineering & Design services to Aerospace and Defense customers	85	85
Sep-16	IP Partnership	US	API/web service enablement for mainframes	85	15
Jun-16	IP Partnership	US	To invest in and grow workload Automation and DevOps software of a global tech major	350	40
Apr-16	Geometric	India	PLM and engineering services	195	135
Feb-16	Volvo IT	Sweden	External IT services arm of Volvo	135	190
Jan-16	Point to Point	UK	Workplace engineering services	10	12
Nov-15	CSC	US	To operate and expand the existing Core Banking business of CSC	54	NA
Oct-15	PowerObjects	US	Professional services for Microsoft Dynamics CRM	42	37
Oct-15	C2SiS	India	Engineering services firm	2	NA
Aug-15	Trygstad Technical Services	US	Turnkey solutions for a large ISV	10	NA
				1,402	**564**

Infosys has gone silent after three acquisitions in 2015

Date	Target	Country	Business Description	Consideration ($ mn)
2015	Noah Consulting	US	Management consulting for Oil & Gas industry	70
2015	Skava	US	Cloud hosted platform for mobile websites, apps, and other digital shopping experiences to retail industry	120
2015	Panaya	Israel	Automation and AI through CloudQuality	200
				370

Wipro appears to be reinventing its 'string of pearls' strategy of the 1990s

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Oct-17	Cooper Software	US	Design thinking techniques to create innovative products, services, and organizations	8.5	8.3
Jan-17	InfoSERVER	Brazil	ADM Services Provider	8.7	8.7
Oct-16	Appirio	US	Cloud Services Provider	500.0	198.0
Feb-16	Healthplan	US	BPaaS Provider	460.0	223.0
Dec-15	Cellent	Germany	IT Services	78.0	92.3
Jul-15	Designit	Denmark	Strategic Design Firm	94.2	NA
Mar-15	Driverstream	US	Consulting in Oracle Cloud Services	5.0	NA
				1,154.4	**530.3**

MindTree acquired four cutting edge technology firms in 2015-16

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Jan '16	Magnet 360	US	Salesforce platform	50	25
Jul '15	Relational Solutions Inc	US	IT solutions - CPG	10	3
Jul '15	Bluefin Solutions	UK	IT solutions, SAP HANA solutions	63.5	48
Jan '15	Discoverture Solutions	US	P&C Insurance	15	14
				138.5	**90.0**

Tech Mahindra, despite its LCC acquisition debacle, is always on the hunt

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Mar '17	HCI	US	Healthcare services provider, primarily in the US and UK	110.0	114.0
Jun '16	The Bio Agency	UK	UK-based firm specializing in user interface (UI) and customer experience (CX)	56.0	17.5
May '16	Target Group	UK	BPO and software solutions provider to BFSI	156.0	71.0
Dec '15	Pininfarina	Europe	ERD for Automotive	100.0	100.0
Jan '15	Sofgen	Europe	Geneva-based consulting company, specialized in BFSI	30.0	45.0
Nov '14	LCC	US	Network engineering services provider to Telecom	240.0	430.0
				692.0	**777.5**

Source: Companies, PhillipCapital India Research

Corporate tax rate cut in US to boost spending

It is still in its early days, but the TCJA (Tax Cuts and Jobs Act) proposed by the US Senate is expected to provide a significant boost to spending power of US corporates. The key recommendations of the TCJA (among many others) are:

- Reduction in corporate tax rates to 21% from 35%
- Migration to territorial taxation regime from a worldwide regime
- Introduction of BEAT (Base Erosion and Anti-Abuse Tax)

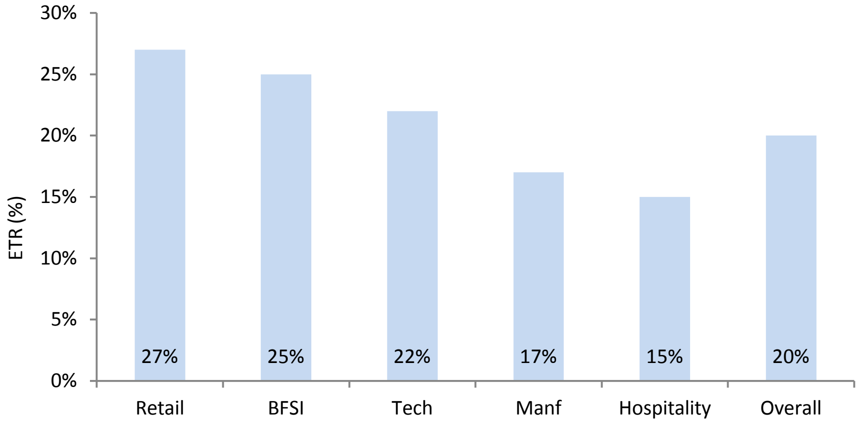
Growth of Indian IT companies has always seen a high correlation with the spending ability of US corporates

The first two steps are expected to lead to significant savings for US corporates. The first step is expected to lower their ETR (effective tax rate) to 21%, from the current 35%; the second step will further lower the tax burden. This should augur well for Indian IT companies, as the growth of Indian IT companies has always seen a high correlation with the spending ability of US corporates – and rightly so, as US corporates have been the initial and large-scale adopters of any new technology.

The biggest impact of TCJA is expected to be on BFSI and retail sectors

The biggest impact of TCJA is expected to be on BFSI and retail sectors – which currently report the highest ETR in the US – followed by technology, manufacturing and hospitality sectors. While it would appear logical to conclude that TCS will benefit the most from this (with highest BFSI exposure), we would like to caution against any such deduction. The positive impact of TCJA will trickle down, after multiple steps, to IT vendors – and the impact in some sectors might be diluted more than in others. At this point, we believe it would be sufficient, and pragmatic to say that ALL IT vendors will benefit to some extent.

Retail and BFSI currently have the highest Effective Tax rate in US



Source: PhillipCapital India Research

The third key recommendation – the introduction of BEAT – is a slight negative for Indian IT companies. BEAT is proposed to be levied on companies that try to 'outsource' or sub-contract' their operations to offshore subsidiaries – to take advantage of a lower tax rate in those regions. Since TCJA proposes a shift from worldwide to a territorial tax regime, it was important to put a mechanism in place, to prevent enterprises from using it to evade taxes.

The various 'heads' that are proposed to come under the BEAT scanner are:

- Payment for sub-contracting and G&A services
- Interest on loan from foreign affiliates
- Rent and D&A on facilities/properties owned by foreign affiliates
- Royalty payments

The exact impact of BEAT on Indian IT companies – which use multiple offshore locations (primarily India) for cost benefits – is expected to be negative; thought its magnitude is still being assessed. However, it will be safe to say that the impact is not expected to be significant, and that Indian IT companies will be able to recalibrate their business models to minimize impact. Overall, the net impact of TCJA (higher IT spends of clients – BEAT impact) is expected to be positive for Indian IT companies.

Interesting trend in hiring across the sector

An interesting trend has emerged amongst the Indian IT companies over the last few quarters – in their hiring patterns. Barring TCS and Infosys, most companies have significantly reduced their employee hiring – esp in the software division. Automation is leading to significant reduction in FTE for the companies – helping them sustain margin, despite pricing pressure on traditional deals. The trend is much more severe with companies like TechM and Persistent reporting a net reduction in their employee headcount, over last few quarters.

Net hiring trends depict a sharp fall over last three quarters

	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
TCS	8,236	9,440	6,978	8,726	-1,414	3,404	1,667
Infosys	3,006	2,779	-66	601	-1,811	-113	3,251
Wipro	-316	1,738	4,227	1,532	1,466	-2,920	-1,205
HCLT	3,072	1,827	1,297	4,881	1,808	1,259	251
TechM	1,784	5,670	4,209	598	-1,713	1,245	-1,984
	15,782	**21,454**	**16,645**	**16,338**	**-1,664**	**2,875**	**1,980**

Source: Companies, PhillipCapital India Research

What about H1B, and other geo-political risks ?

No we haven't forgotten those. The overhang of H1B Visa in US, and other similar 'protectionist' measures in other countries (esp European) continue to cast an overhang on the earnings growth potential of the India IT companies. However, we note that the companies have already taken measures to mitigate the same.

Modifications to the current lottery system of the H1B Visa allocation in US have been proposed for a long time – by both Republicans and Democrats. However, given the partisan nature of the US Senate, no formal law has yet been enacted. This has given the IT companies enough time, to plan for the same. They have hired more locals, moved work to 'nearshore' locations – to reduce their dependence on H1B Visas. They are also trying to apply for higher number of 'Green cards', to further mitigate the impact of any protectionist measure.

Latest visa proposal to have significant impact

Various proposals related to visa restrictions have been introduced in the US Congress – the most agreed-upon one proposes to increase the minimum wage bill for H1B visa holders to US$ 130,000 from the current US$ 60,000. If implemented – *in the current scenario* – this move will affect all IT companies significantly.

US visa regulations to have a significant impact

	Particular	TCS	Infosys	HCLT	TechM
	H1B Employees*	25,000	14,700	3,800	3,300
	Avg Annual Salary of H1B ($)*	69,700	79,000	80,000	75,000
	Per Year Impact (Rs mn)	24,987	11,858	3,232	2,949
FY20	Revenue (Rs mn)	1,457,075	841,842	607,154	352,253
	EBITDA (Rs mn)	397,709	227,599	142,627	55,672
	EBITDA Margin (%)	27.3%	27.0%	23.5%	15.8%
	PAT (Rs mn)	312,571	172,885	103,390	35,769
	EPS (Rs)	163.6	79.5	74.2	40.7
FY20 - Adj	EBITDA (Rs mn)	372,722	215,741	139,395	52,722
	EBITDA Margin (%)	25.6%	25.6%	23.0%	15.0%
	PAT (Rs mn)	287,585	161,027	100,158	32,819
	EPS (Rs)	150.6	74.0	71.9	37.3
Deviation	EBITDA (%)	-6.3%	-5.2%	-2.3%	-5.3%
	Margin (bps)	(171)	(141)	(53)	(84)
	PAT (%)	**-8.0%**	**-6.9%**	**-3.1%**	**-8.2%**

Source: PhillipCapital India Research *(*As per latest data available from various sources)*

Double digit revenue growth in FY19? Unlikely. FY20? Maybe... Quite likely...

Notwithstanding the change in fundamental parameters, we do not expect any large-cap Indian IT company to report double-digit 'organic' revenue growth in USD terms in FY19. The deal-flow momentum has surely been strong – however, it does not (YET) appear enough to be able to boost revenue growth into the double-digit terrain.

On the other hand, most mid-caps are expected to report double-digit 'organic' revenue growth in USD terms in FY19. Some, like LTI, NIIT, and Cyient, have 'formally' guided for this – the current profile of LTTS and Persistent makes that look a near certainty for them. Mindtree is the only midcap IT Services company, under our coverage, where double-digit 'organic' revenue growth appears uncertain.

Most mid-caps are expected to report double-digit 'organic' revenue growth in USD terms in FY19

USD revenue growth to reach double digit for most players, by FY20

Company	FY18 Guidance	FY18E (%)	FY19E (%)	FY20E (%)
TCS	NA	**7.8**	8.0	9.5
Infosys	6.5-7.5%	**7.4**	8.0	9.5
Wipro (IT)	4-4.5%*	**4.5**	5.6	8.0
HCL Tech	12.1-14.1%	**12.3**	8.5	10.0
Tech Mahindra	NA	**8.8**	6.5	7.5
LTI	Mid-teens	**16.0**	16.0	13.5
LTTS	At least 18%	**18.5**	16.0	16.0
MindTree	Higher single digit	**8.0**	10.0	12.0
Cyient	Double-digit	**12.7**	10.7	12.0
Persistent	Double-digit	**11.2**	11.0	12.0
NIIT Tech	Double-digit (FY19)	**10.0**	10.3	11.0
Intellect	NA	**19.5**	15.0	15.0
Majesco	FY18 better than FY17	**1.5**	22.2	21.0

Source: PhillipCapital India Research *(*implied growth by Q4 guidance)*

The sharp contrast in the revenue profile of large-caps versus mid-caps stems from the low base of the mid-cap companies – further helped by the concentrated revenue profile of a few companies (like LTI, LTTS, and Cyient).

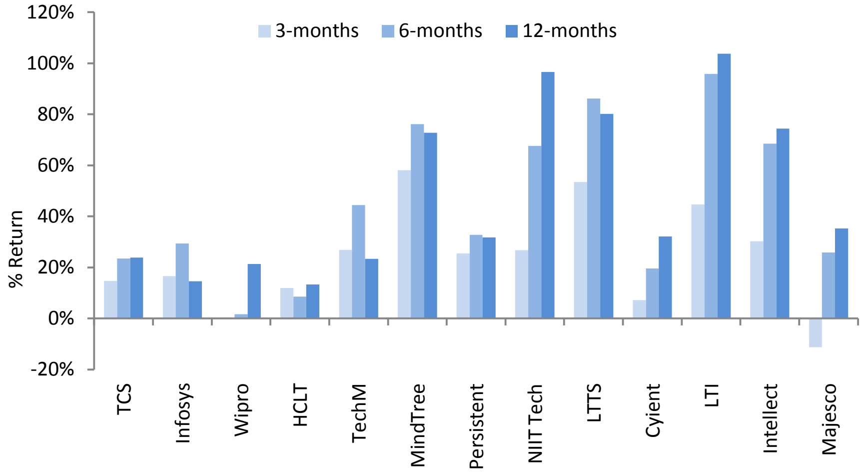
At the same time, we are confident that if the current deal momentum sustains for the next few quarters, even large-cap IT companies will report double digit growth in FY20. As highlighted in the earlier section, the unprecedented deal-flow, along with sustained growth in the already large digital portfolio, should be able to 'more than' mitigate muted growth in the traditional revenue streams – leading to a net impact of low-to-mid teen growth in USD revenues in FY20.

It is on the basis of this expectation (double-digit USD revenue growth for large-caps in FY20, which has been preceded by double-digit USD revenue growth for midcaps in FY19) that we expect rerating for the sector very soon. The strong deal-flow has already led to a 'mini' rerating of the sector since January 2018 and any incremental data that points to a further revival will lead to a larger and a more prolonged rerating, in our opinion.

Mid-caps outperforming large-caps

Over the past year, mid-cap IT services companies have significantly outperformed large-caps and the IT Index. Few mid-caps (like LTI, LTTS, NIIT) have delivered huge returns (>50%) and have outperformed Nifty and other indices too.

Midcaps have significantly outperformed largecaps over the last 3/6/12 months

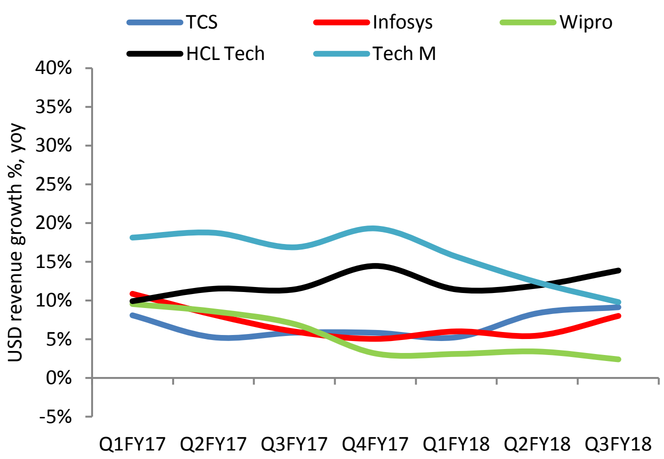


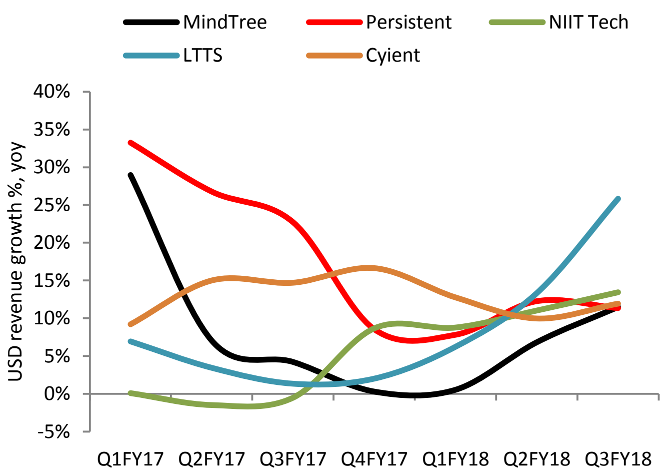
Source: Bloomberg, PhillipCapital India Research

We see two primary reasons behind this:

- Firstly, in the wake of weak revenue growth due to adoption of new-age digital technologies, mid-caps, with their smaller revenue base, have managed to grow at a higher rate than large-caps. The low revenue base of these mid-caps is seen as an asset here, and provides them the agility and ability to turn their businesses around faster than large-caps, with their large revenue base and excess baggage of traditional businesses.
- Secondly, many of these IT companies have a significant presence in a niche domain, or have a concentrated revenue profile – which is helping them withstand the cannibalization of revenues by the digital wave. Key examples are L&T Infotech, which is benefitting from the high concentration in its BFSI segment, L&T Technology and Cyient, which are growing in the ERD segment, which remains decoupled from the digital wave, and NIIT Tech, which is benefitting from the reorganization of its business over the last three years.

While being volatile, midcaps have registered superior yoy growth in revenues





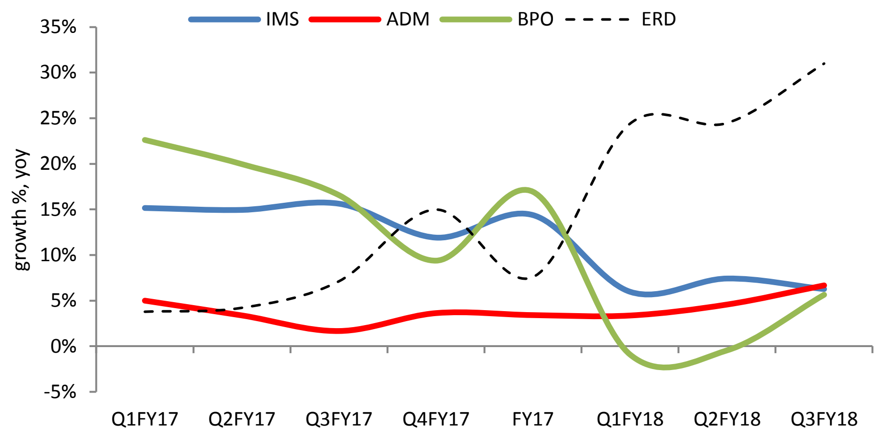
Source: Companies, PhillipCapital India Research

We continue to like ERD, as the theme to play

In the wake of the traditional IT services domains facing significant headwinds due to the adoption of digital technologies by enterprises across the world, 'engineering research and development' (ERD) has emerged as the saviour for the industry. In this domain, Indian IT companies have seen robust growth over the last five years (15% CAGR) – much ahead of the single-digit (down to mid-single digit now) growth in the traditional IT services domains.

It is on this strong growth and a much more sanguine outlook than traditional domains that ED companies like LTTS and Cyient have outperformed traditional large-cap and mid-cap IT services companies.

Segmental growth yoy

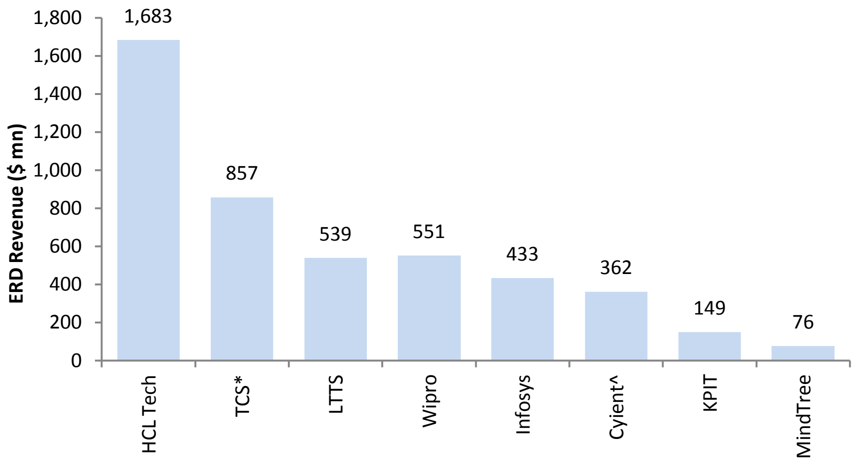


Source: Companies, PhillipCapital India Research

We were one of the first brokers to highlight the potential of ERD space, in our June-2015 Ground-View report

Read our detailed GV report on ERD space

Indian IT – ERD revenue comparison (USD mn)



Source: Companies, PhillipCapital India Research

HCLT closing in on the top ERD outsourcing companies in the world

	Country	Market Cap (US$ bn)	ERD Revenue (US$ bn)
Altran Technologies	France	2.5	2.2
Alten SA	France	2.1	1.8
HCLT	India	18.7	1.7

Source: Companies, PhillipCapital India Research

Breaking down global ERD

Engineering Research & Development – as the name suggests – involves research and development in various engineering domains. The segment is primarily related to sectors that involve high-end engineering capabilities such as automotive, aerospace, telecom, electronics, and medical devices. Companies in these sectors spend huge amounts of resources to continuously develop new products or product enhancements.

In CY15, global ERD spend grew by ~3% to US$ 1.5tn. Automotive and consumer electronics sectors accounted for over 25% of this spend — automotive driven by safety and emission-efficiency requirements and consumer electronics by increasing demand for new products/interfaces. US and Europe continued to account for over 2/3rd of this spend, with Asia (excluding Japan) constituting 14% and growing fast.

Top ERD spenders in different segments

Automotive	Aerospace	SW & Electronics	Medical Services	Core manufacturing
Volkswagen	Boeing	Amazon	J&J	Caterpillar
Toyota	EADS	Alphabet	GE	Cummins
GM	Lockheed Martin	Intel	Medtronic	Komatsu
Ford	General Dynamics	Microsoft	Siemens	Mitsubishi
Daimler	Dassault Aviation	Apple	Baxter	ABB

Top ERD spenders across the globe

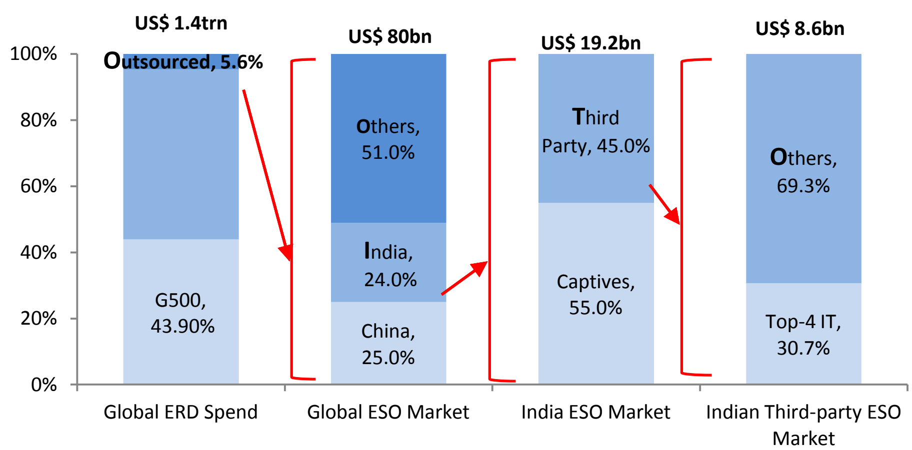
Company	ERD spend (US$ bn)	ERD spend as % of sales	Country	Sector
Volkswagen	13.2	2.5%	Germany	Automotive
Samsung	12.7	6.4%	South Korea	Computing and Electronics
Amazon	12.5	10.2%	US	SW & Internet
Alphabet	12.3	14.9%	US	SW & Internet
Intel	12.1	20.1%	US	Computing and Electronics
Microsoft	12.0	13.4%	US	SW & Internet
Roche	10.0	19.0%	Swiss	Healthcare
Novartis	9.5	16.8%	Swiss	Healthcare
J&J	9.0	11.0%	US	Healthcare
Toyota	8.8	3.5%	Japan	Automotive

Source: PhillipCapital India Research

ERD outsourcing: Huge growth potential

Currently, the engineering services outsourcing (ESO) market stands at US$ 80bn – only 6% of the total global ERD spend. Of this, China has the largest share (25%), driven by its manufacturing industry. India comes a close second at 24%, driven primarily by its captives (55%) and third-party outsourcers (45%). Of the third-party outsourcers, India's top-4 IT companies have almost 30% market share.

The global ERD-ESO market



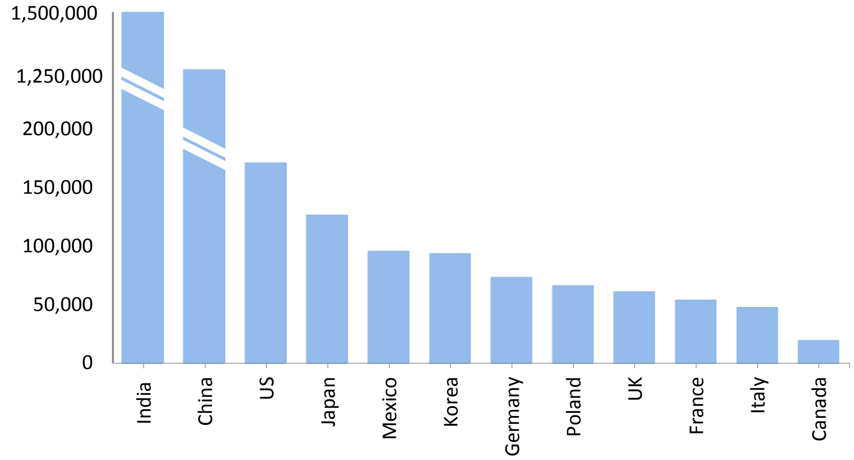
Source: NASSCOM, Zinnov, PhillipCapital India Research

Indian IT companies: The supply advantage

India churns out about 1.5mn engineers every year, from around 6,000 engineering colleges spread across the country. China comes second at 1.25mn and the US is a distant third at 170,000.

Indian IT companies are in an excellent position to leverage this huge pool of engineers to establish their presence in the ERD domain

India accounts for the largest pool of engineers graduating every year



Source: OECD, AICTE, PhillipCapital India Research

Potential for Indian IT companies

Indian IT companies have an unprecedented opportunity to make ERD their forte over the next decade. They can enhance their presence on three fronts:

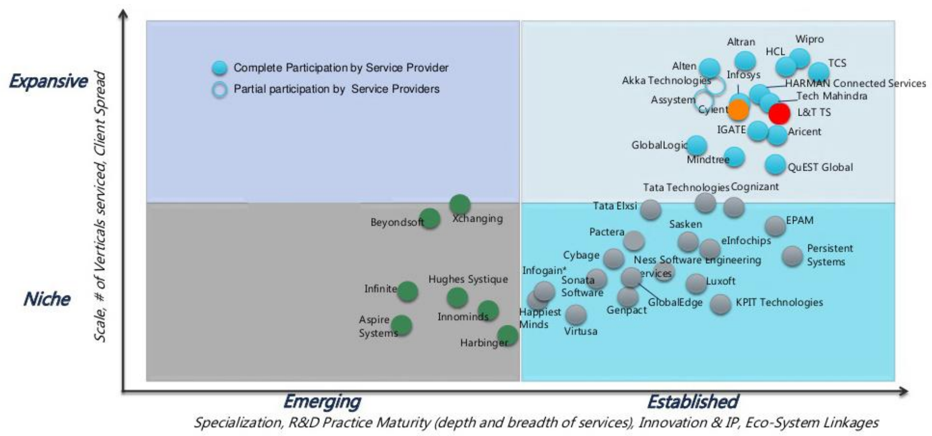
- **New clients:** Leveraging their performance with the existing clients, Indian IT companies can tap new clients — companies that have not outsourced till date.
- **Cross-selling to existing clients:** Indian IT companies currently service companies that spend significantly on ERD, but have outsourced other IT operations (ADM, IMS). Cross-selling to these companies should be relatively easy.
- **Moving up the value chain for existing ERD clients:** In addition, companies can move up the value chain by engaging with their existing ERD customers on a more strategic level and capturing a larger share of their wallet.

Amongst smaller companies, LTTS, Cyient, and Geometric Software's businesses are inclined towards this domain and could be potential beneficiaries

Key strengths of the key companies

TCS	Infosys	HCLT	Wipro	Tech Mahindra
All sectors - Auto/Aero/Consumer Electronics	Overall weak presence - mainly Aerospace	Avionics	Medical devices	Product design
LTTS	**Quest**	**Cap Gemini**	**IBM**	**Accenture**
Industrial products	After sales - esp for aerospace	Technical Publication / Documentation	Process Consultation / PLM implementation	Process Consultation / PLM implementation

Competitive analysis of ERD companies - Zinnov

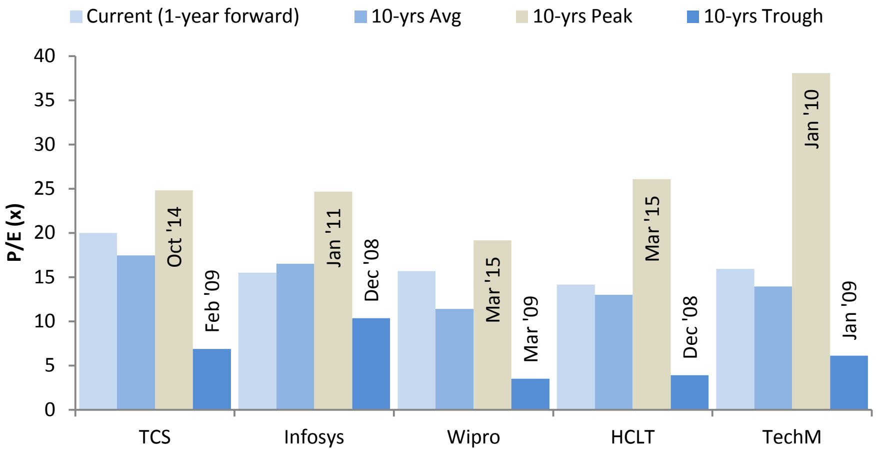


Source: LTTS, Zinnov, PhillipCapital India Research

Valuations – 'relatively' inexpensive

After three years of underperforming the broader index, during which, the index has delivered robust returns, IT stocks are currently trading at valuations inline with their 10 year average – at sharp discount to their historical peak, to the broader index, and also relative to other sectors.

Current valuations are quite distant from 10 year peak and trough multiples



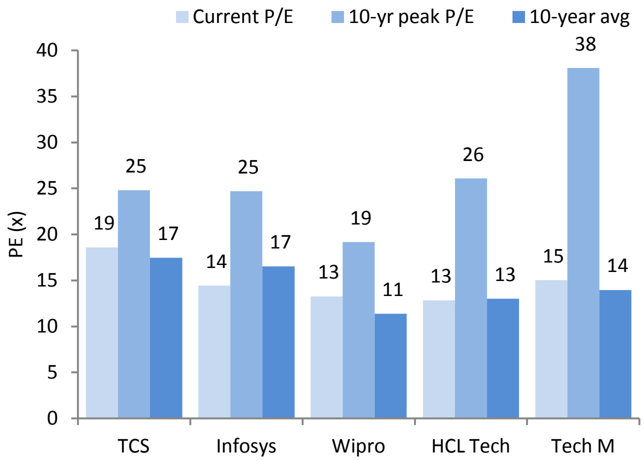
Source: Bloomberg, PhillipCapital India Research

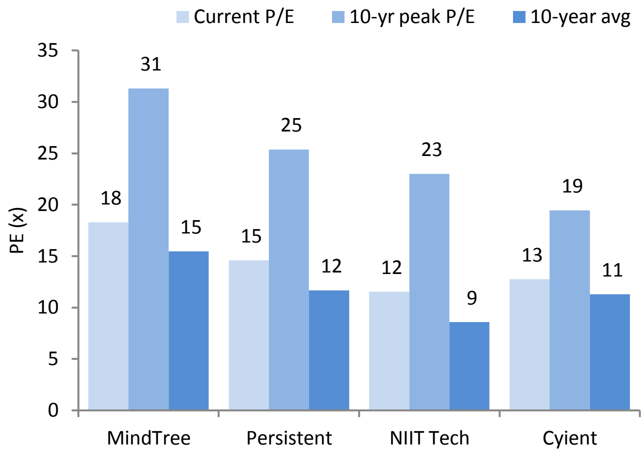
As long as there was low growth visibility for the sector, the relatively low valuations were justified. However, now that we see signs of turnaround in the sector – we believe the valuations could rerate very soon. While FY19 growth prospects still appear to be muted for most companies – the outlook for FY20 and beyond appears more sanguine. The inexpensive valuations thus offer twin benefits – significant upside potential in case of a rerating, and downside protection if the rerating takes longer than expected.

Mid-caps valuations are ahead of large-caps

Historically, large-caps have commanded higher valuations than mid-caps due to their large diversified base – but currently many mid-cap stocks are trading at higher valuations. As explained in the earlier section, we see this as a result of their favourable low base and concentrated revenue profile, helping them to report higher growth than large-caps. We expect this benefit to continue in the near to medium term, as large-caps are able to turn their large businesses around, in a much quicker and more efficient manner.

Few midcaps are currently trading at higher multiple than largecaps – but still below their 10 year peak multiple





Source: Bloomberg, PhillipCapital India Research

Our Recommendations

We have upgraded our assumptions across the sector for FY20. We continue to build in a muted single-digit USD growth in revenues for FY19, gradually growing to low double-digit growth in FY20. For select midcaps (like LTTS, LTI and Cyient) we expect the current momentum to continue in FY19 and beyond.

We also upgrade our target multiples for almost all companies under coverage – expecting the momentum to lead to rerating in near-to-medium term.

Revision of estimates (FY20) – Largecaps

		TCS	Infosys	Wipro
USD Revenue	New	22,417	12,951	9,182
$ mn	Old	22,123	12,840	9,008
	Change	*1%*	*1%*	*2%*
EBIT	New	376	208	109
(Rs bn)	Old	371	206	105
	Change	*1%*	*1%*	*4%*
EBIT Margins	New	25.8%	24.7%	17.8%
	Old	25.8%	24.7%	17.5%
bps	*Change*	*2*	*4*	*29*
PAT	New	313	173	100
(Rs bn)	Old	310	171	96
	Change	*1%*	*1%*	*5%*
EPS	New	164	79	22
(Rs)	Old	162	79	21
	Change	*1%*	*1%*	*5%*

Revision of estimates (FY20) – Midcaps

		LTTS	MindTree	Cyient	NIIT Tech
USD Revenue	New	772	1,057	751	562
$ mn	Old	765	1,008	747	560
	Change	*1%*	*5%*	*1%*	*0%*
EBIT	New	8,040	8,911	6,015	4,767
(Rs mn)	Old	7,978	7,319	5,935	4,699
	Change	*1%*	*22%*	*1%*	*1%*
EBIT Margins	New	16.0%	13.0%	12.3%	13.0%
	Old	16.0%	11.2%	12.2%	12.9%
bps	*Change*	*-1*	*180*	*10*	*15*
PAT	New	6,981	7,215	5,533	3,785
(Rs mn)	Old	6,941	5,990	5,474	3,734
	Change	*1%*	*20%*	*1%*	*1%*
EPS	New	68.7	44.0	49.2	61.8
(Rs)	Old	68.3	36.5	48.7	61.0
	Change	*1%*	*20%*	*1%*	*1%*

Revision of Target PE multiple on FY20 earnings

Company	New Target PE (x)	Earlier Target PE (x)
TCS	18	14
Infosys	17	15
Wipro (IT)	16	12
HCL Tech	15	15
Tech Mahindra	14	13
LTI	17	--
LTTS	18	16
MindTree	17	15
Cyient	15	13
Persistent	17	14
NIIT Tech	15	13
Intellect^	2.5	2.0
Majesco^	3.0	3.0

Source: PhillipCapital India Research *(^ EV/Sales multiple)*

Recommendations summary

	CMP	Mkt Cap	Target	PT	Upside	Rating	USD Rev Growth		EBITDA Margins		EPS (Rs)	
	Rs	Rs bn	Multiple	Rs	%		FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
TCS	3,042	5,993	18	2,950	-3%	NEUTRAL	8.0	9.5	26.9	27.3	149	164
Infosys	1,148	2,625	17	1,350	18%	BUY	8.0	9.5	27.1	27.0	72	79
Wipro	293	1,417	16	330	13%	BUY	5.2	7.6	20.9	21.2	20	22
HCL Tech	952	1,345	15	1,190	25%	BUY	8.5	10.0	23.3	23.5	67	74
Tech Mahindra	612	537	14	570	-7%	SELL	6.5	7.5	15.5	15.8	36	41
LTI	1,424	243	17	1,420	0%	NEUTRAL	16.0	13.5	17.5	17.9	72	84
LTTS	1,381	140	18	1,240	-10%	NEUTRAL	16.0	16.0	16.9	17.3	57	69
MindTree	805	135	17	750	-7%	NEUTRAL	12.0	12.0	14.4	15.9	35	44
Cyient	628	71	15	740	18%	BUY	10.7	12.0	14.6	14.9	43	49
Persistent	840	67	17	980	17%	BUY	11.0	12.0	16.7	17.6	49	57
NIIT Tech	832	51	15	930	12%	BUY	10.3	11.0	16.5	16.8	54	62
Intellect^	193	24	2.5	280	45%	BUY	15.0	15.0	8.0	8.9	4	5
Majesco^	475	13	3	650	37%	BUY	22.2	21.0	5.3	8.6	9	21

Source: Companies, Bloomberg, PhillipCapital India Research; ^ EV/Sales multiple

Financials and valuation snapshot

	$ Revenue Growth (%)			EBITDA Margins (%)			EPS (Rs)			EPS Growth (%)		
Companies	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
TCS	7.8	8.0	9.5	26.5	26.9	27.3	134	149	164	0.6	10.7	10.1
Infosys	7.4	8.0	9.5	27.0	27.1	27.0	75	72	79	18.6	-3.2	10.0
Wipro	4.5	5.6	8.0	20.2	20.9	21.2	19	20	22	6.5	6.3	12.1
HCL Tech	12.3	8.5	10.0	22.7	23.3	23.5	63	67	74	4.6	7.0	10.8
Tech Mahindra	8.8	6.5	7.5	15.0	15.5	15.8	39	36	41	19.8	-6.2	12.0
LTI	16.0	16.0	13.5	17.0	17.5	17.9	65	72	84	14.9	9.5	16.6
LTTS	18.5	16.0	16.0	15.6	16.9	17.3	47	57	69	13.0	20.9	20.3
MindTree	8.0	12.0	12.0	13.3	14.4	15.9	32	35	44	29.4	8.8	25.5
Cyient	12.7	10.7	12.0	14.1	14.6	14.9	36	43	49	16.7	20.3	14.6
Persistent	11.2	11.0	12.0	16.0	16.7	17.6	42	49	57	7.2	18.0	16.2
NIIT Tech	10.0	10.3	11.0	16.7	16.5	16.8	45	54	62	1.7	19.2	14.6
Intellect	19.5	15.0	15.0	6.9	8.0	8.9	2	4	5	NA	63.6	36.4
Majesco	1.5	22.2	21.0	1.4	5.3	8.6	0	9	21	NA	NA	139.9

Financials and valuation snapshot

	ROE (%)			PE (x)			PB (x)			Div Yield (%)		
Companies	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
TCS	31.4	29.4	27.6	22.7	20.5	18.6	7.1	6.0	5.1	1.8	2.0	2.2
Infosys	27.0	23.5	22.9	15.4	15.9	14.4	4.1	3.7	3.3	2.8	3.0	3.0
Wipro	17.4	16.2	16.0	15.7	14.7	13.1	2.7	2.4	2.1	1.0	1.4	1.5
HCL Tech	23.9	20.9	19.3	15.2	14.2	12.8	3.6	3.0	2.5	0.8	0.8	0.8
Tech Mahindra	19.5	16.3	16.1	15.8	16.8	15.0	3.1	2.7	2.4	1.6	1.6	1.6
LTI	29.4	26.0	24.5	21.8	19.9	17.1	6.4	5.2	4.2	1.1	1.1	1.1
LTTS	24.7	23.9	23.0	29.3	24.2	20.1	7.2	5.8	4.6	0.6	0.6	0.6
MindTree	19.8	18.8	20.1	25.0	22.9	18.3	4.9	4.3	3.7	1.1	1.1	1.1
Cyient	17.4	18.3	18.3	17.6	14.6	12.8	3.1	2.7	2.3	2.2	1.9	1.9
Persistent	15.7	16.4	16.7	20.0	17.0	14.6	3.1	2.8	2.4	1.5	1.5	1.5
NIIT Tech	16.0	16.9	17.0	18.4	15.4	13.5	2.9	2.6	2.3	1.7	1.8	1.8
Intellect	3.6	5.5	7.0	81.6	49.8	36.5	2.9	2.8	2.6	-	-	-
Majesco	0.1	4.3	9.3	NA	54.8	22.9	2.5	2.4	2.1	-	-	-

Source: Companies, PhillipCapital India Research

Key Upgrades

TCS (NEUTRAL) – We were wrong

TCS has done remarkably well in the digital space, despite not pursuing the inorganic route. Its digital portfolio at US$ 4bn, constitutes 22% of its revenues. The business has also grown by 33% yoy over the last three quarters, despite the size. The size and sustained growth on that size, is a testimony of the company having won the delivery, as well as the perception, battle in the digital space.

TCS has also reported unprecedented deal-flow in the last two quarters – deal wins of US$ 2.5bn (including renewals), some of them multi-year billion dollar deals like from Nielsen, Transamerica, M&G Prudential & M&S. The strong deal-flow and return of large deals augur well for the company – capturing large deals has been its USP. We expect the momentum provided by the recent deal-flow, to lead to TCS delivering sustainable double-digit USD revenue growth over FY20 and beyond.

In Dec-16, we had downgraded TCS to SELL, expecting growth rate below peers, due to its large base, high exposure to the BFSI segment and expensive valuations. However, TCS (+25%) has outperformed all its peers (Infosys +15%, HCL +16%), CNX-IT (+20%), and the broader index (Nifty, +19%), over the last one year. We admit to our call having gone wrong, and see the robust delaflow and management stability to help TCS command significant premium over Infosys and other peers. We upgrade the stock to NEUTRAL. Expensive valuations prevent us from turning buyers.

Wipro (BUY) – Joker in the pack – Could be THE turnaround story

We see Wipro as a potential joker in the pack – which might just turn out to be the turnaround story of this digital cycle. The company has been taking all the right steps to revamp its business model. Over the last three years, it has maintained its dividend payout, despite conducting two share buyback programs in three years. It has also pursued an inorganic route at a fast pace (relatively) – it made six acquisitions, adding ~US$ 500mn to its revenues. We see Wipro retracing its 'string of pearls' strategy that helped it grow to US$ 1.3bn over FY00-05 from US$ 230mn.

Also, its exposure to E&U and healthcare has over-shadowed its 'decent' growth in other verticals. Sharp fall in crude prices and uncertainty related to Obamacare has led to weak performance from the two verticals. Over the last two quarters, while its overall IT services revenues have grown by 5.1% and 5.8% yoy; excluding the E&U and healthcare, the revenues have grown by 7.6% and 9.7% respectively. The growth has been driven by the BFSI, manufacturing, and consumer verticals. With crude prices now recovering and the ambiguity over Obamacare to clear soon, a revival in these segments will benefit Wipro as disproportionately positively as it had negatively. We upgrade to BUY.

Persistent Systems (BUY) – Pain period over – all set to Gain

We have always been impressed with Persistent's digital prowess, and its early-mover advantage in this domain. However, as the company was looking to expand its business from OPD to Services (which was the logical thing to do), we had forecasted it will lead to back-ended growth, and front ended margin decline – which is how it played out. However, the stock price remained strong all through this period, with investors proably happy to wait out the 'pain period', certain of better times ahead.

Nonetheless, we believe we are close to the end of the pain period for PSYS. It has started showing traction in its enterprise business (CQGR of 8% over Q1FY16-Q3FY18), also reflected in the gradual margin expansion (expansion of 220bps over seven quarters). With digital capabilities ahead of peers, low base and a growing IP portfolio, we expect PSYS to report strong earnings growth over the medium-to-long term. Upgrade to BUY.

Stocks which still look unattractive

Even with our renewed optimism for the entire IT sector, we still remain sceptical about the growth potential of a one stock, whose business model, we believe, is not geared-up to exploit the growth momentum we expect. We remain negative on:

Tech Mahindra (SELL): Precariously poised business model

TechM business has deteriorated significantly over the last two years, and we now find it in an operationally precarious stage — where it might face substantial delivery issues in the near to medium term. Over the last three quarters, TechM has fired 8,900+ employees in its software division – taking the overall company headcount to 115,241 (from 117,693 in Q4FY17). It has also not awarded any salary hikes to employees with more than six years of experience; to employees with less than six, it awarded a basic 3-5% hike in FY18 (after zero hike in FY17). At the same time, its trainee count in the system is ZERO – taking utilization to 85%; not sustainable, by management's own admission. These statistics point to a perfect recipe for an operational disaster – we suspect a high level of demotivation amongst employees, leading to possible serious delivery issues in the near-to-medium term.

All along, TechM's business model of half telecom and half non-telecom appears unattractive, especially in the wake of the ongoing weakness in the global telecom domain. The telecom vertical, at US$ 2bn, has now become too big for TechM to be able achieve double-digit growth. Over the last few quarters, even after adjusting for the LCC decline, TECHM's core telecom business has reported muted growth. On the other hand, while the enterprise business has been growing strongly (+16.5% yoy in FY17, 19% yoy in 9MFY18), it has come on a low base, with no competitive advantage or USP in BFSI, retail, or manufacturing. The enterprise business, thus, will, at best, grow at industry average rates over the medium-to-long term. This combination – of half of its business (enterprise) growing AT and the other half (telecom) growing BELOW industry average – will always keep TechM's growth lower than its peers.

Lastly, we find our faith in the management's judgement dwindling after its repeated failures in the last few quarters. We wouldn't be buyers unless it was trading at extremely inexpensive valuations (<12x PE). Maintain SELL.

Companies Section

Tata Consultancy Services (TCS IN)

We admit we were wrong – Upgrade to NEUTRAL

INDIA | IT SERVICES | Company Update

28 February 2018

In Dec-16, we had downgraded TCS to SELL. Our thesis was that its large base and high exposure to the BFSI segment (which, by the management's own admission, was facing significant challenges) would impede its growth and keep its growth rate below, or at best at par, with peers Infosys and HCL. Its reluctance to pursue the inorganic route, also concerned us, as we believed this to be a superior way of acquiring delivery capabilities in the digital space than developing them in-house. All along, its valuations were expensive (versus peers), and hence we predicted that the stock could only go one way – down!

However, nothing like that happened. The stock did go one way from the time of our call – but that was up! Over the last one year, TCS (+25%) has outperformed all its peers (Infosys +15%, HCL +16%), CNX-IT (+20%), and the broader index (Nifty, +19%) too. All along we maintained (and hoped) that its lacklustre growth (at-par with peers) would eventually translate into a derating of its expensive valuations. But perhaps, the market was ascribing a higher multiple on the back of its management stability, and a robust deal pipeline, which we weren't able to foresee. We admit to our call having gone wrong, and that we grossly underestimated the stock potential.

Putting that behind, we start with a clean slate. We believe that if TCS' stock did not underperform over the last two years, there is NO reason for it to underperform hereafter. IN FACT, now with its digital portfolio demonstrating size AND growth, and the unprecedented deal-flow in the last two quarters, we believe it will continue to outperform its peers. We upgrade the stock to NEUTRAL. Expensive valuations prevent us from turning buyers.

Significant growth and size in the digital space

TCS has done remarkably well in the digital space, despite not pursuing the inorganic route. Its digital portfolio today constitutes 22% of its revenues – a mammoth US$ 4bn – larger than the overall revenue base of all but four Indian IT companies. The business has also shown remarkable growth – average growth of 31% yoy over the last three quarters, despite the size. TCS' size, and sustained growth on that size, is a testimony of the company having won the delivery, as well as the perception, battle in the digital space.

Unprecedented deal-flow in the last two quarters

TCS has reported unprecedented deal-flow in the last two quarters – deal wins of US$ 5.5bn (including renewals), some of them multi-year billion dollar deals like from Nielsen, Transamerica, and M&G Prudential. The strong deal-flow and return of large deals augur well for the company – capturing large deals has been its USP. We expect the momentum provided by the recent deal-flow, to lead to TCS delivering sustainable double-digit USD revenue growth over FY20 and beyond. While we expect FY19 to be muted (single-digit growth), with TCS one can only be certain of one thing – a positive surprise!

Valuations premium over Infosys to stay, with its stable management

TCS has consistently traded at a 10-20% premium to Infosys over the last seven years (but for a brief period in FY16). Over the last seven quarters, the premium has only expanded to more than 20%. All this while, TCS remains the only company with no concerns related to management and succession planning. Going ahead too, we believe TCS' management stability and superior growth expectations will keep its premium over Infosys intact.

Outlook and valuation

TCS is currently trading at 19x FY20 PE – the highest in the IT services space and at a sharp premium to Infosys and HCL (14x FY20 PE) and other large/midcaps. With current low visibility in revenues (not just TCS, but the entire sector), we find it difficult to ascribe a multiple higher than that. We upgrade our target multiple to 18x (14x earlier). Our price target is Rs 2,950 (Rs 2,370 earlier). Upgrade to NEUTRAL.

Upgrade to Neutral

CMP RS 3042

TARGET RS 2950 (-3%)

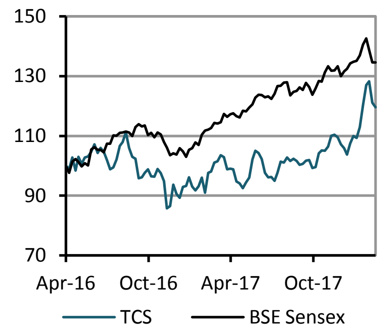
COMPANY DATA

O/S SHARES (MN) :	1914
MARKET CAP (RSBN) :	5840
MARKET CAP (USDBN) :	90.1
52 - WK HI/LO (RS) :	3255 / 2255
LIQUIDITY 3M (USDMN) :	56.5
PAR VALUE (RS) :	1

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	73.6	73.6	73.6
FII / NRI :	16.3	16.6	16.8
FI / MF :	6.1	5.6	5.5
NON PRO :	0.9	0.9	0.9
PUBLIC & OTHERS :	3.2	3.3	3.4

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY18E	FY19E	FY20E
Net Sales	1,224.6	1,330.9	1,457.1
EBIT	303.9	336.4	375.8
Net Profit	256.4	283.8	312.6
EPS, Rs	134.2	148.6	163.6
PER, x	22.5	20.4	18.5
EV/EBIT, x	18.9	17.0	15.1
ROE, %	31.4	29.4	27.6

Source: PhillipCapital India Research Est.

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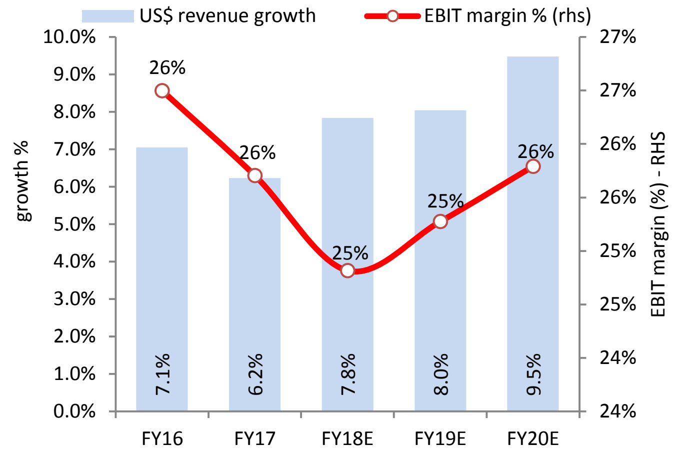
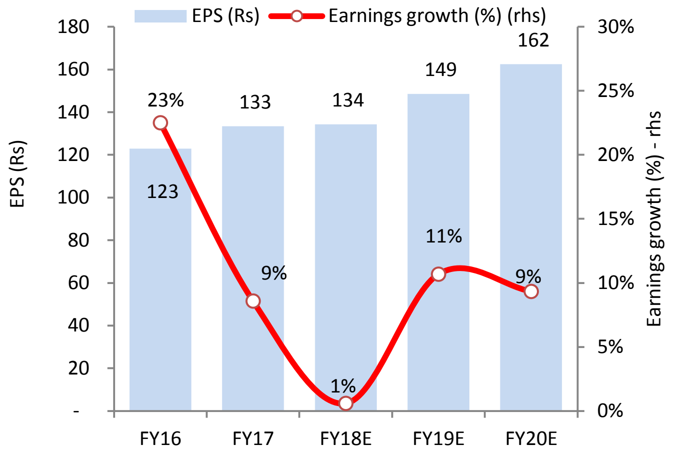
Revenue growth and Margins profile

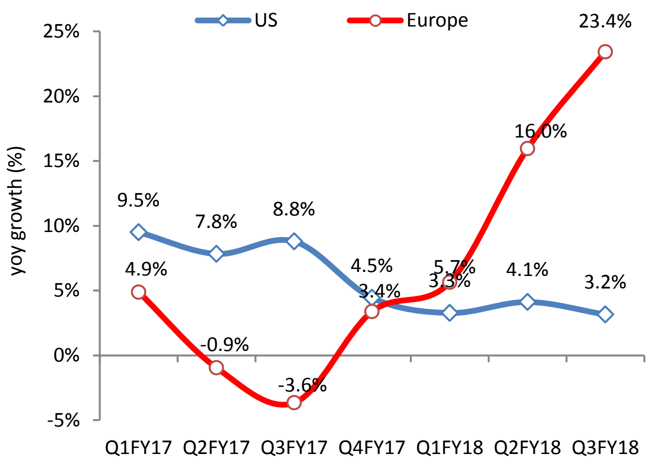


Earnings growth profile

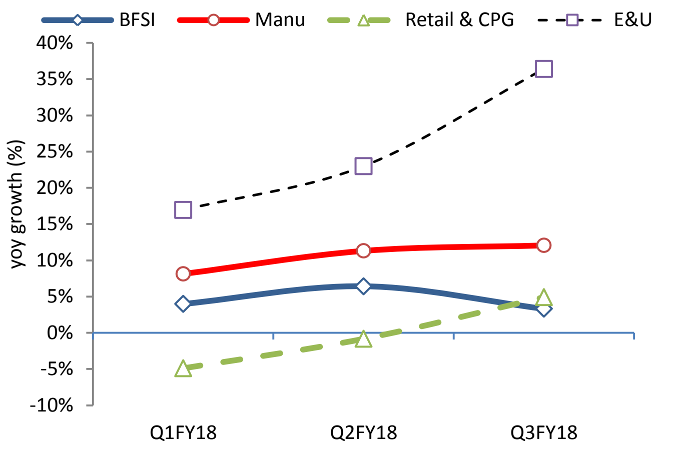


Source: Company, Phillip Capital India Research

Geography growth rate (yoy) over last few quarters

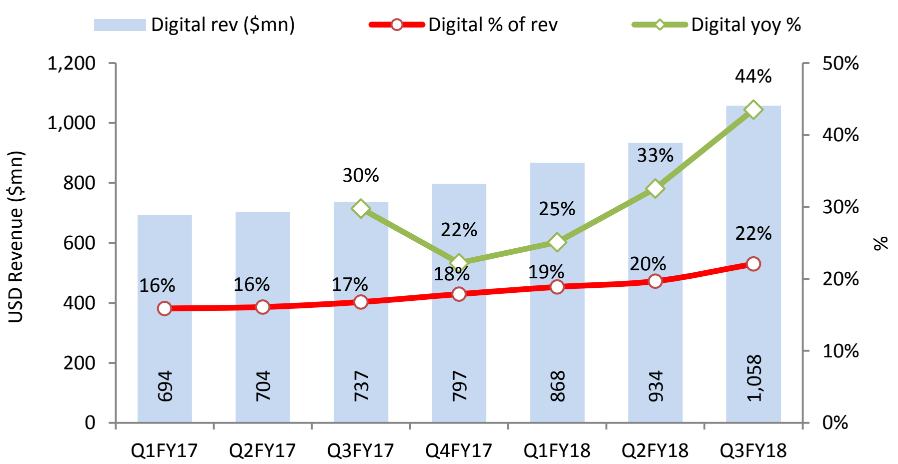


Vertical growth rate (yoy) over last few quarters



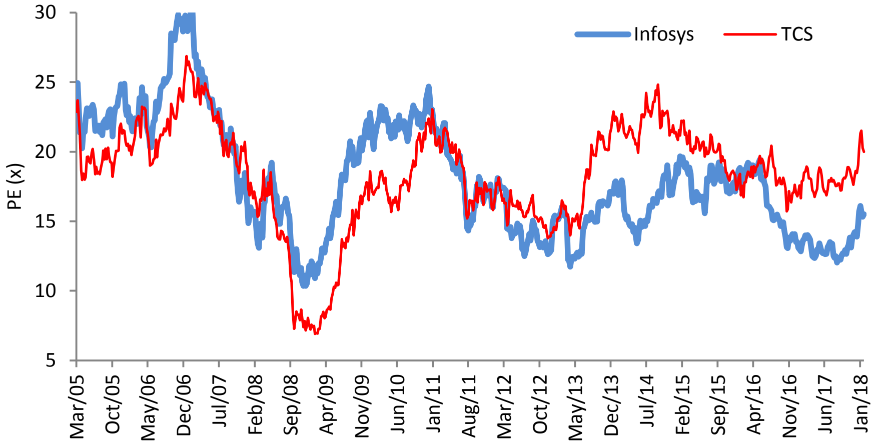
Source: Company, Phillip Capital India Research

Digital revenue growth (yoy) over last few quarters



Source: Bloomberg, PhillipCapital India Research

TCS has mostly commanded a valuation premium vs. Infosys



TCS focussing on creating IP through products & platforms, across verticals

Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**1,179,660**	**1,224,576**	**1,330,948**	**1,457,075**
Growth, %	8.6	3.8	8.7	9.5
Employee expenses	-654,300	-691,492	-756,955	-830,940
Other Operating expenses	-202,250	-208,973	-216,614	-228,426
EBITDA (Core)	**323,110**	**324,110**	**357,379**	**397,709**
Growth, %	5.3	0.3	10.3	11.3
Margin, %	27.4	26.5	26.9	27.3
Depreciation	-19,870	-20,206	-20,966	-21,901
EBIT	**303,240**	**303,903**	**336,414**	**375,808**
Growth, %	5.3	0.2	10.7	11.7
Margin, %	25.7	24.8	25.3	25.8
Interest paid	0	0	0	0
Other Non-Operating Income	41,890	33,553	34,573	32,782
Pre-tax profit	**345,130**	**337,457**	**370,986**	**408,590**
Tax provided	-81,560	-80,719	-87,182	-96,019
Profit after tax	**263,570**	**256,737**	**283,805**	**312,571**
Others (Minorities, Associates)	-680	-330	0	0
Net Profit	**262,890**	**256,407**	**283,805**	**312,571**
Growth, %	8.6	(2.5)	10.7	10.1
Net Profit (adjusted)	**262,890**	**256,407**	**283,805**	**312,571**
Wtd avg shares (m)	1,970	1,910	1,910	1,910

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**17,575**	**18,952**	**20,476**	**22,417**
Growth, %	6.2	7.8	8.0	9.5
Re / US$ (rate)	67.1	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	35,970	43,692	67,169	102,635
Marketable securities at cost	0	0	0	0
Debtors	226,840	258,317	285,022	312,616
Inventory	0	0	0	0
Other current assets	126,090	137,769	150,012	164,535
Total current assets	388,900	439,777	502,203	579,785
Investments	419,800	305,050	385,050	465,050
Net fixed assets	244,830	262,385	288,248	314,756
Non-current assets	0	0	0	0
Total assets	**1,053,530**	**1,007,212**	**1,175,502**	**1,359,592**
Total current liabilities	145,120	165,514	180,859	196,335
Non-current liabilities	21,600	22,570	24,525	26,844
Total liabilities	166,720	188,084	205,384	223,179
Paid-up capital	1,970	1,910	1,910	1,910
Reserves & surplus	881,180	813,498	964,488	1,130,782
Minorities	3,660	3,720	3,720	3,720
Shareholders' equity	886,810	819,128	970,118	1,136,412
Total equity & liabilities	**1,053,530**	**1,007,212**	**1,175,502**	**1,359,592**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	345,130	337,457	370,986	408,590
Depreciation	19,870	20,206	20,966	21,901
Chg in working capital	-18,390	-21,652	-21,649	-24,320
Total tax paid	-81,560	-80,719	-87,182	-96,019
Other operating activities	0	0	0	0
Cash flow from operating activities	**265,050**	**255,292**	**283,121**	**310,152**
Capital expenditure	11,860	-37,761	-46,829	-48,409
Chg in investments	-191,580	114,750	-80,000	-80,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-179,720**	**76,989**	**-126,829**	**-128,409**
Free cash flow	85,330	332,281	156,293	181,743
Equity raised/(repaid)	0	-160,000	0	0
Debt raised/(repaid)	-120	-140	0	0
Dividend (incl. tax)	-108,335	-119,994	-132,815	-146,277
Other financing activities	-3,295	-44,156	0	0
Cash flow from financing activities	**-112,310**	**-324,559**	**-132,815**	**-146,277**
Net chg in cash	-26,980	7,722	23,478	35,466

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	133.4	134.2	148.6	163.6
Growth, %	8.6	0.6	10.7	10.1
Book NAV/share (INR)	448.3	426.9	506.0	593.0
CFPS (INR)	113.3	116.1	130.1	145.2
DPS (INR)	47.0	53.7	59.4	65.5
Return ratios				
Return on assets (%)	26.8	24.9	26.0	24.7
Return on equity (%)	29.8	31.4	29.4	27.6
Return on capital employed (%)	31.7	29.3	30.9	29.0
Turnover ratios				
Asset turnover (x)	2.7	2.7	2.7	2.7
Sales/Total assets (x)	1.2	1.2	1.2	1.1
Sales/Net FA (x)	4.5	4.8	4.8	4.8
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	70.2	77.0	78.2	78.3
Liquidity ratios				
Current ratio (x)	2.7	2.7	2.8	3.0
Quick ratio (x)	2.7	2.7	2.8	3.0
Dividend cover (x)	2.8	2.5	2.5	2.5
Total debt/Equity (%)	0.1	0.1	0.1	0.1
Net debt/Equity (%)	(4.0)	(5.3)	(6.9)	(9.0)
Valuation				
PER (x)	22.7	22.5	20.4	18.5
PEG (x) - y-o-y growth	2.6	37.7	1.9	1.8
Price/Book (x)	6.7	7.1	6.0	5.1
Yield (%)	1.6	1.8	2.0	2.2
EV/Net sales (x)	5.0	4.7	4.3	3.9
EV/EBITDA (x)	18.3	17.7	16.0	14.3
EV/EBIT (x)	19.5	18.9	17.0	15.1

PhillipCapital

Infosys (INFO IN)

Back to the Future

INDIA | IT SERVICES | Company Update

28 February 2018

Infosys has had a torrid time over the last one year. With allegations and counter-allegations between the two exes (ex-promoter and ex-CEO) culminating in a rather unceremonious departure of the CEO, the company roped in a CapGemini stalwart, Mr. Salil Parikh, as CEO. The good thing through the entire fiasco was that Infosys did not lose any clients, maintained its deal-win momentum, and should be able to end FY18 with results along the lines expected at the beginning of the year. We see the company regaining its bellwether tag soon, with deal-flow momentum strengthening and its ability to hold onto its clientele helping it to outperform industry growth in FY20 and beyond.

Back to the Future

Infosys now has a new CEO in Mr. Salil Parikh, who was instrumental in ramping up the India operations of CapGemini – from 300 to the current ~100,000 people. In many ways, he appears to be a 'safe' choice, as opposed to the 'disruptive' one that Dr. Sikka was. He understands the 'Indian IT Services' business intrinsically. Essentially with Mr. Parikh, Infosys has accepted that it is almost impossible to change its 'services' DNA, which Dr. Sikka was attempting to. While we do not see the management backtracking on any of the landmark initiatives that Dr. Sikka had implemented, we expect the 'new' Infosys to be much similar to the 'old' Infosys, which had IT 'services' at its core.

Seeds of change sown by Dr. Sikka might help the company after all

Infosys' strategy (under Dr. Sikka) of focusing on a more strategic role with clients through design thinking and artificial intelligence was a long term transformation strategy – expected to yield back-ended results. While we do not expect the strategy to be abandoned completely, we do not expect it to be pursued aggressively too. As long as the company does not abandon the initiatives completely, we expect these to deliver incremental benefits over the medium to long term.

Significant improvement in client metrics and deal-wins – 'digital' business strong

Over the last six quarters, Infosys has reported deal-wins of US$ 1.67bn in 1HFY18 – already 85% of the total deal-wins in FY17 (US$ 1.95bn). Unlike peers, Infosys follows a much stricter definition of digital business and reports 'new age services' (now 10% of the total revenues), which continues to report strong growth (average 11% qoq in the last two quarters). Also, the number of +US$ 200/100/50/30mn clients for the company has increased to 6/14/50/85 from 3/13/42/70 – with total clients count increasing to 1011 from 890, which shows remarkable success in adding new clients and capturing higher share of their wallets. We see this improvement in deal-wins, growth in 'new age' business, and higher share of large clients leading to a momentum that could propel Infosys to industry-leading growth in FY20.

Strategic acquisitions: We doubt the company will go down that path again

In FY17, Infosys made three acquisitions – Panaya, Kalidus, and Noah Consulting – all small, but with breakthrough technology in the digital space. The synergies from Panaya have already resulted in winning 15 large engagements. However, post the fiasco related to Panaya acquisition, which eventually led to the resignation of the CEO, we do not expect the company to pursue inorganic opportunities aggressively. Noah consulting might well end-up being the last company Infosys acquires for a long time to come. We are not happy with this hypothesis – but we expect it to be the most likely one nonetheless.

Valuations gap versus TCS to contract; TCS to still trade at a premium

Currently Infosys is trading at 14x FY20 P/E – a 25% discount to TCS. We expect this gap to contract over the next two years, as Infosys catches up to report industry-leading growth by FY20. However, with TCS's management stability and larger digital portfolio, we expect it to continue commanding a premium over Infosys. We upgrade our target multiple to 17x (15x earlier) – discount to TCS (@18x). Our price target is Rs 1,350 (*Rs 1,180 earlier*). Maintain BUY.

BUY (Maintain)

CMP RS 1148

TARGET RS 1350 (+18%)

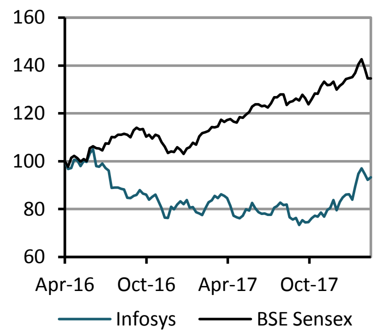
COMPANY DATA

O/S SHARES (MN) :	2184
MARKET CAP (RSBN) :	2530
MARKET CAP (USDBN) :	39
52 - WK HI/LO (RS) :	1220 / 862
LIQUIDITY 3M (USDMN) :	88.5
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	12.9	12.8	12.8
FII / NRI :	35.1	34.1	37.5
FI / MF :	21.6	22.1	20.2
NON PRO :	5.0	5.1	5.1
PUBLIC & OTHERS :	25.4	25.9	24.5

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY18E	FY19E	FY20E
Net Sales	708.1	769.2	841.8
EBIT	172.1	188.5	207.8
Net Profit	162.3	157.2	172.9
EPS, Rs	74.6	72.3	79.5
PER, x	15.4	15.9	14.4
EV/EBIT, x	13.5	12.2	10.9
ROE, %	27.0	23.5	22.9

Source: PhillipCapital India Research Est.

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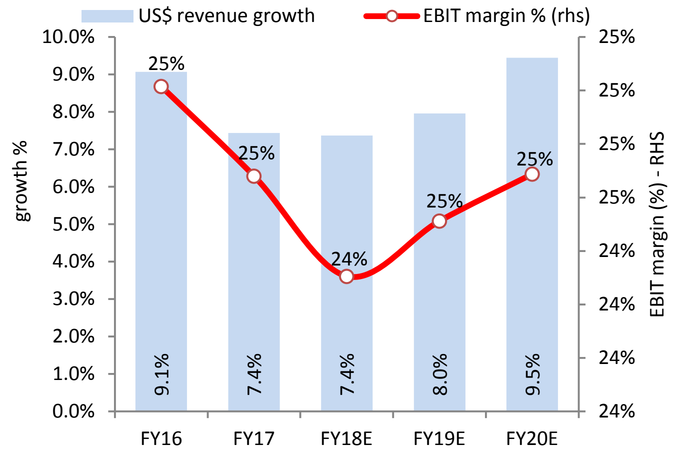
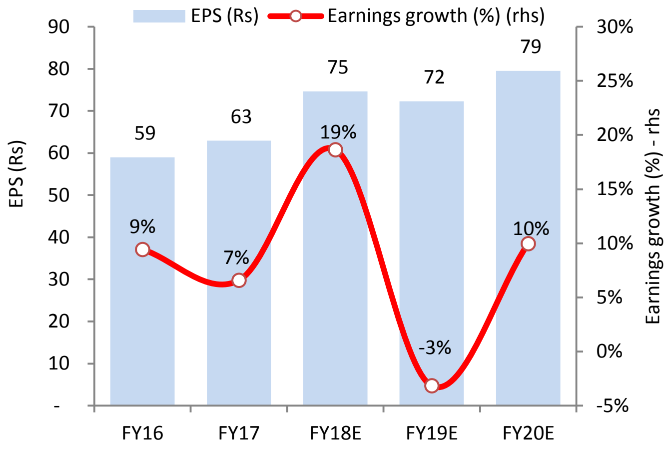
Revenue growth and Margins profile

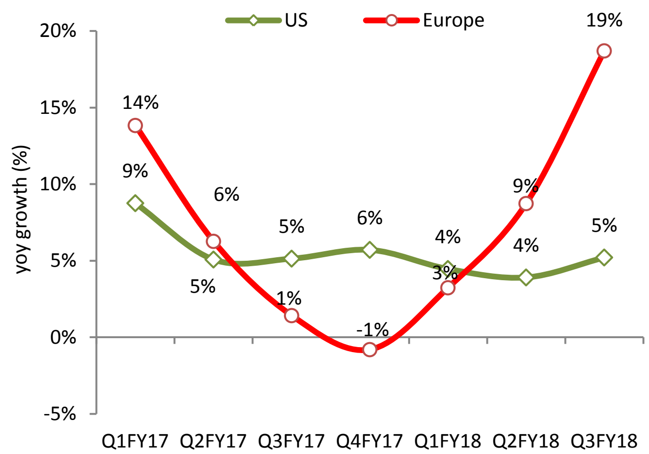


Earnings growth profile

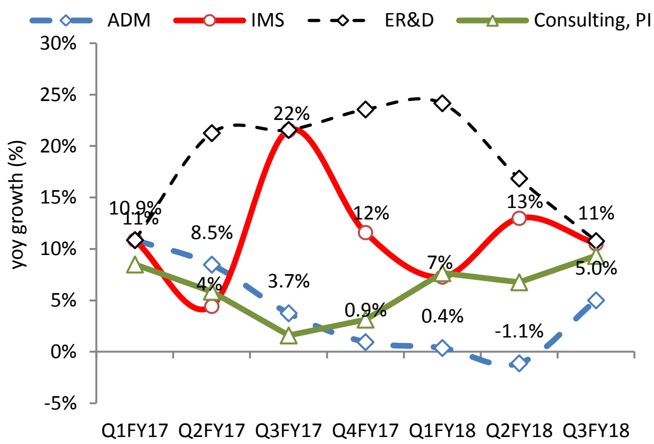


Source: Company, Phillip Capital India Research

Geography growth rate (yoy) over last few quarters

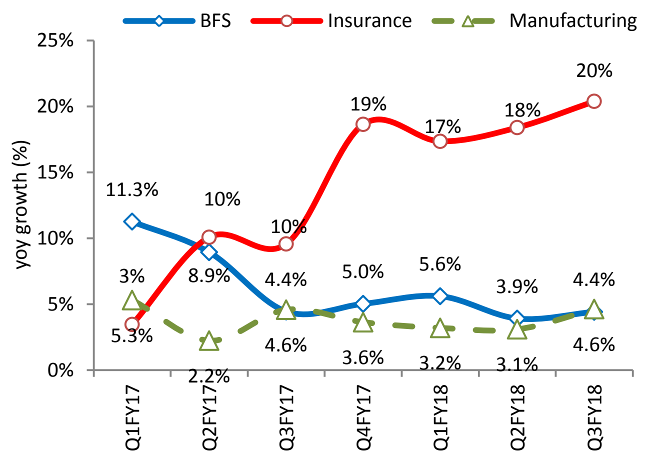


Service line growth rate (yoy) over last few quarters

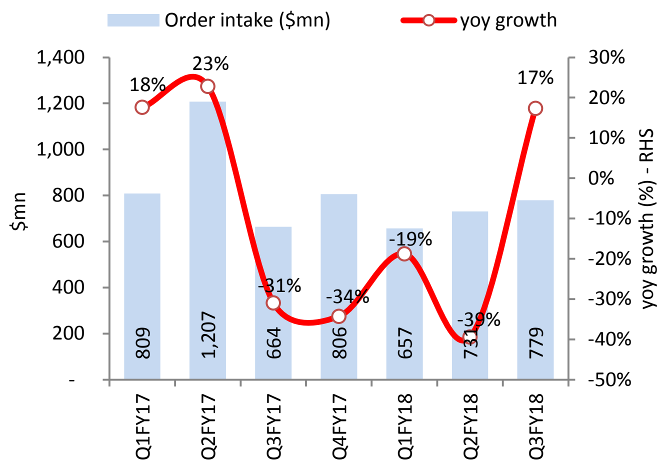


Source: Company, Phillip Capital India Research

Vertical growth rate (yoy) over last few quarters



Order intake improved over last few quarters



Source: Company, Phillip Capital India Research

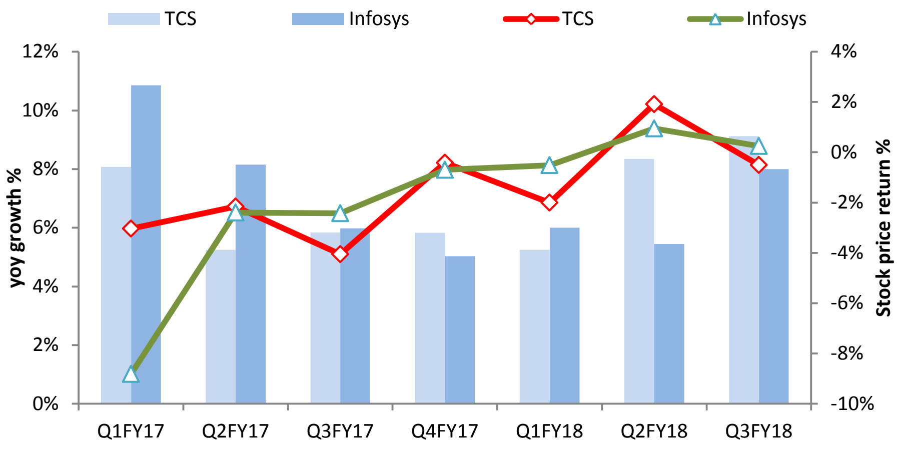
Improving client metrics over the last seven quarters

	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
$100mn+	17	18	18	19	18	19	20
$75mn+	31	30	32	31	31	31	34
$50mn+	52	54	54	56	56	55	56
$25mn+	87	89	90	91	97	100	101
$10mn+	180	186	195	189	190	186	198
$5mn+	268	277	275	282	279	286	290
$1mn+	574	577	591	598	606	620	630

Infosys has gone silent after three acquisitions in 2015

Date	Target	Country	Business Description	Consideration ($ mn)
2015	Noah Consulting	US	Management consulting for Oil & Gas industry	70
2015	Skava	US	Cloud hosted platform for mobile websites, apps, and other digital shopping experiences to retail industry	120
2015	Panaya	Israel	Automation and AI through CloudQuality	200
				390

Infosys vs TCS – neck-and-neck – in quarterly performance and stock price movement



Source: Companies, Phillip Capital India Research

Infosys's stock price has been severely impacted by management 'issues'

Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**684,850**	**708,113**	**769,155**	**841,842**
Growth, %	9.7	3.4	8.6	9.5
Employee expenses	-415,500	-434,049	-472,430	-514,906
Other Operating expenses	-83,300	-82,988	-88,453	-99,337
EBITDA (Core)	**186,050**	**191,075**	**208,272**	**227,599**
Growth, %	8.9	2.7	9.0	9.3
Margin, %	27.2	27.0	27.1	27.0
Depreciation	-17,030	-18,969	-19,737	-19,768
EBIT	**169,020**	**172,106**	**188,534**	**207,831**
Growth, %	8.2	1.8	9.5	10.2
Margin, %	24.7	24.3	24.5	24.7
Forex gains/losses	2,320	1,420	0	0
Other Non-Operating Income	28,470	32,190	26,828	28,998
Pre-tax profit	**199,810**	**205,717**	**215,363**	**236,829**
Tax provided	-55,980	-43,377	-58,148	-63,944
Profit after tax	**143,830**	**162,339**	**157,215**	**172,885**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**143,830**	**162,339**	**157,215**	**172,885**
Growth, %	6.6	12.9	(3.2)	10.0
Net Profit (adjusted)	**143,830**	**162,339**	**157,215**	**172,885**
Wtd avg shares (m)	2,286	2,175	2,175	2,175

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**10,208**	**10,961**	**11,833**	**12,951**
Growth, %	7.4	7.4	8.0	9.5
Re / US$ (rate)	67.1	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	226,250	177,517	201,376	232,478
Marketable securities at cost	0	0	0	0
Debtors	123,220	135,802	143,295	156,836
Inventory	0	0	0	0
Loans & advances	150,170	169,025	178,779	193,809
Total current assets	499,640	482,345	523,450	583,124
Investments	167,070	102,130	142,130	182,130
Net fixed assets	161,440	161,681	161,944	162,176
Non-current assets	0	0	0	0
Total assets	**833,550**	**757,926**	**839,294**	**939,199**
Total current liabilities	143,730	155,820	169,033	185,114
Non-current liabilities	0	0	0	0
Total liabilities	143,730	155,820	169,033	185,114
Paid-up capital	11,440	10,880	10,880	10,880
Reserves & surplus	678,380	591,226	659,381	743,205
Minorities	0	0	0	0
Shareholders' equity	689,820	602,106	670,261	754,085
Total equity & liabilities	**833,550**	**757,926**	**839,294**	**939,199**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	199,810	205,717	215,363	236,829
Depreciation	17,030	18,969	19,737	19,768
Chg in working capital	-18,040	-19,348	-4,033	-12,491
Total tax paid	-56,020	-49,747	-58,148	-63,944
Other operating activities	0	0	0	0
Cash flow from operating activities	**142,780**	**155,590**	**172,920**	**180,162**
Capital expenditure	-25,680	-19,210	-20,000	-20,000
Chg in investments	-146,020	64,940	-40,000	-40,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-171,700**	**45,730**	**-60,000**	**-60,000**
Free cash flow	-28,920	201,320	112,920	120,162
Equity raised/(repaid)	0	-129,995	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-68,858	-80,569	-89,061	-89,061
Other financing activities	-2,942	-39,489	0	0
Cash flow from financing activities	**-71,800**	**-250,053**	**-89,061**	**-89,061**
Net chg in cash	-100,720	-48,733	23,859	31,102

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	62.9	74.6	72.3	79.5
Growth, %	6.6	18.6	(3.2)	10.0
Book NAV/share (INR)	301.7	276.8	308.2	346.7
CFPS (INR)	50.0	56.7	67.2	69.5
DPS (INR)	25.7	31.7	35.0	35.0
Return ratios				
Return on assets (%)	18.1	20.4	19.7	19.4
Return on equity (%)	20.9	27.0	23.5	22.9
Return on capital employed (%)	21.8	25.1	24.7	24.3
Turnover ratios				
Asset turnover (x)	2.4	2.3	2.5	2.6
Sales/Total assets (x)	0.9	0.9	1.0	0.9
Sales/Net FA (x)	4.4	4.4	4.8	5.2
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	65.7	70.0	68.0	68.0
Liquidity ratios				
Current ratio (x)	3.6	3.1	3.1	3.2
Quick ratio (x)	3.6	3.1	3.1	3.2
Dividend cover (x)	2.4	2.4	2.1	2.3
Net debt/Equity (%)	(57.0)	(46.4)	(51.2)	(55.0)
Valuation				
PER (x)	18.1	15.3	15.8	14.3
PEG (x) - y-o-y growth	2.8	0.8	(5.0)	1.4
Price/Book (x)	3.8	4.1	3.7	3.3
Yield (%)	2.3	2.8	3.1	3.1
EV/Net sales (x)	3.5	3.3	3.0	2.7
EV/EBITDA (x)	12.8	12.0	10.9	9.9
EV/EBIT (x)	14.1	13.4	12.1	10.8

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

Wipro (WPRO IN)

Joker in the pack – could be THE turnaround story

INDIA | IT SERVICES | Company Update

28 February 2018

Before its mega-buyback in July-2017, Wipro's stock had delivered 6%/6%/90% in the preceding 1/3/5 years. Its revenue growth rate in FY15/16/17 had been 7%/3.7%/4.9% – all below industry average. In FY18, it will, at best, achieve (by its own guidance) 4.5% USD revenue growth (only 4% organic). And yet, the stock has been the second best-performing IT stock of FY18 (after TCS). While it is difficult to explain the stock price movement fundamentally (we have a logical explanation though), we believe Wipro is taking all the right steps to revamp its business model. Its exposure to E&U and healthcare has over-shadowed its 'decent' growth in other verticals. Its acquisitions over the last two years have been impressive. Under the leadership of Abid Neemuchwala and Rishad Premji, we see Wipro as a potential joker in the pack – which might just turn out to be the turnaround story of this digital cycle. Upgrade to BUY.

Sub-par growth, but deal-wins have been robust

Over the last innumerable quarters, Wipro has consistently disappointed in terms of its growth rate. However, at the same time, its deal-wins have been robust. Over the last two years, the company 'formally' reported two large deals. Even in the last three quarters, its deal-flow momentum has been highly impressive, with large deals from marquee clients like F-500 medical devices company, US luxury departmental store and major international payment provider.

E&U and healthcare: Troubles overshadowing the decent performance in other verticals

Over the last two years, Wipro has been hit hard due to its unique business mix. A sharp fall in crude prices in FY16 meant most of the E&U clients postponed their IT spending. In FY17, in the Donald Trump era, the uncertainty related to the future of Obamacare has led to healthcare clients reduce their spending. Wipro has the highest exposure to these segment (12% E&U, 14% healthcare), which has had a significant impact on its growth.

Over the last two quarters, Wipro's overall IT services revenues have grown by 5.1% and 5.8% yoy. However, excluding the E&U and healthcare verticals, the revenues have grown by 7.6% and 9.7% respectively. The growth has been driven by the BFSI, manufacturing, and consumer verticals. We believe that with crude prices now recovering and the ambiguity over Obamacare to clear soon, a revival in these segments will benefit Wipro as disproportionately positively as it had negatively. If 25% of its revenues start contributing to the already growing 75%, it can potentially deliver superior growth to peers. We expect this to play out over the next few quarters.

Retracing its 'string of pearls' strategy; making amends to the capital allocation policy

Over the last three years, Wipro has made significant progress in amending its inefficient capital-allocation policy of the last decade. IT has maintained its dividend payout, despite conducting two share buyback programs in three years. It has also pursued an inorganic route at a fast pace (relatively) – it made *six* acquisitions, adding ~US$ 500mn to its revenues. While two of these acquisitions have been in the traditional IT space, most others have been in the new age digital technology domain. We see Wipro retracing its 'string of pearls' strategy that helped it grow to US$ 1.3bn over FY00-05 from US$ 230mn.

Valuations at a premium to all large-caps (excl TCS)

Currently, Wipro trades at 13x FY20 P/E, a small discount to TCS, but at a premium to all other large-caps. We believe that with only few things falling into place, Wipro could be the biggest turnaround story of this digital cycle in the IT sector. We upgrade our target multiple to 15x (earlier 12x), still the lowest in our top-4 coverage universe (premium to TechM). Our price target is Rs 330 (*Rs 260 earlier*). Upgrade to BUY.

Upgrade to BUY

CMP RS 293
TARGET RS 330 (13%)

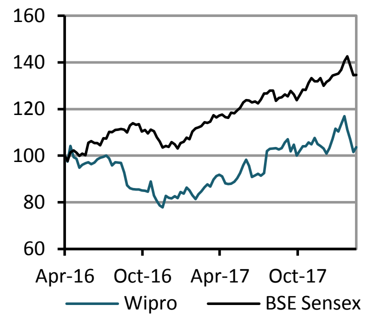
COMPANY DATA

O/S SHARES (MN) :	4524
MARKET CAP (RSBN) :	1325
MARKET CAP (USDBN) :	20.4
52 - WK HI/LO (RS) :	335 / 236
LIQUIDITY 3M (USDMN) :	14.4
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	74.3	73.2	73.2
FII / NRI :	11.4	11.4	11.0
FI / MF :	5.4	5.6	5.8
NON PRO :	5.5	5.7	4.6
PUBLIC & OTHERS :	4.2	5.0	5.4

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY18E	FY19E	FY20E
Net Sales	546.0	570.5	613.7
EBIT	89.4	98.2	109.1
Net Profit	84.2	89.5	99.4
EPS, Rs	18.7	19.9	22.1
PER, x	15.7	14.7	13.3
EV/EBIT, x	13.0	11.2	9.5
P/BV, x	2.7	2.4	2.1
ROE, %	17.4	16.2	15.8

Source: PhillipCapital India Research Est.

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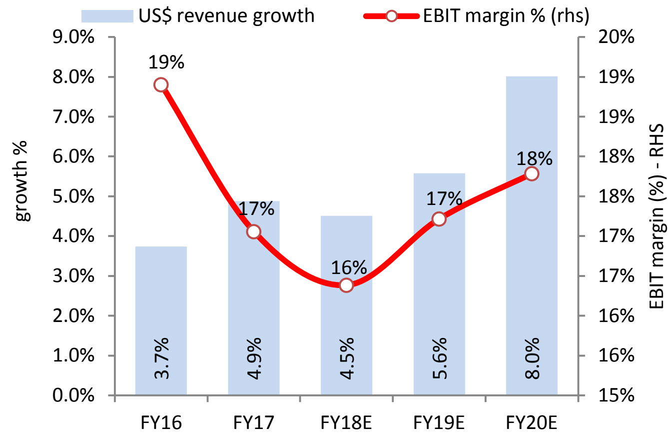
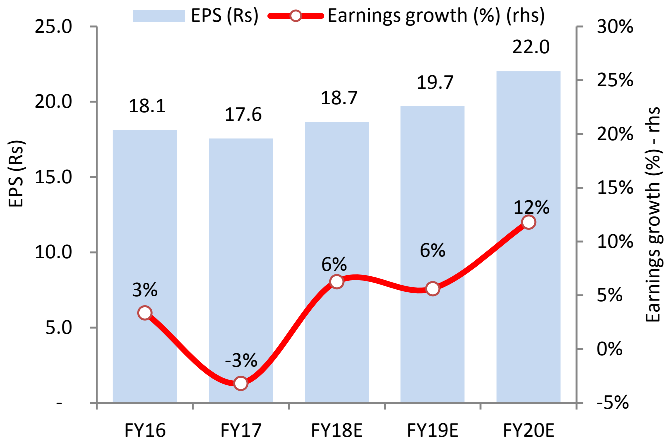
Revenue growth and Margins profile

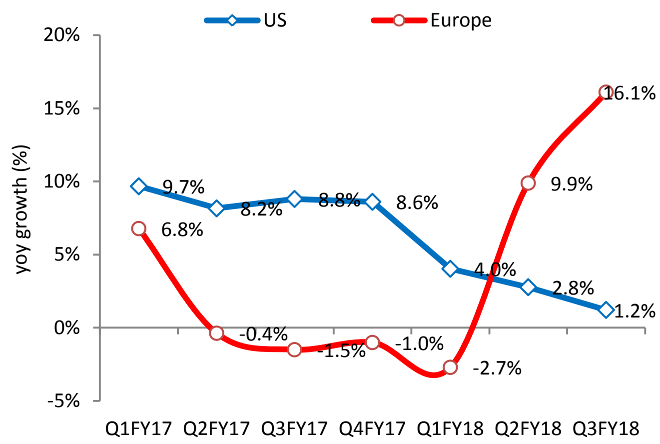


Earnings growth profile

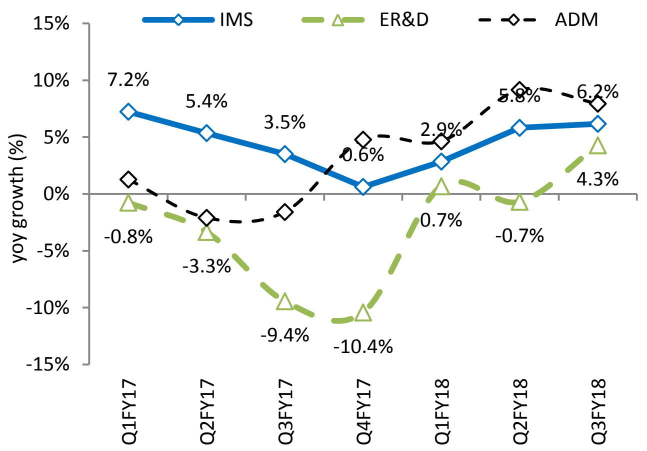


Source: Company, Phillip Capital India Research

Geography growth rate (yoy) over last few quarters

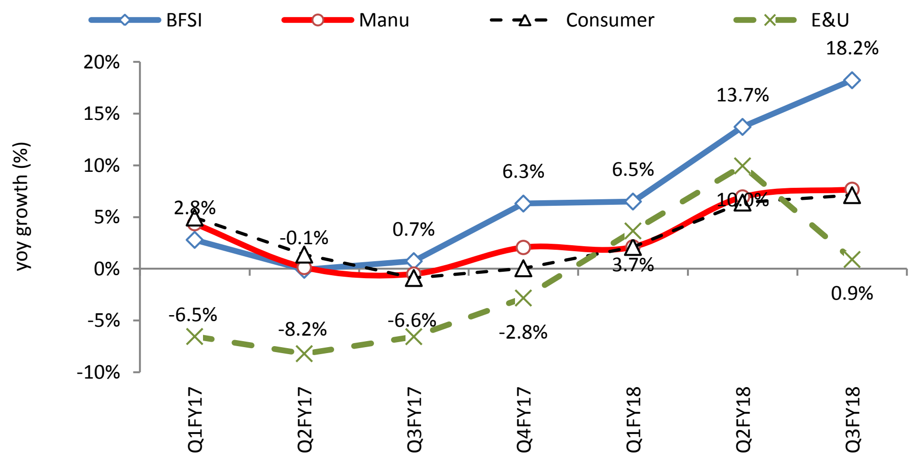


Service line growth rate (yoy) over last few quarters



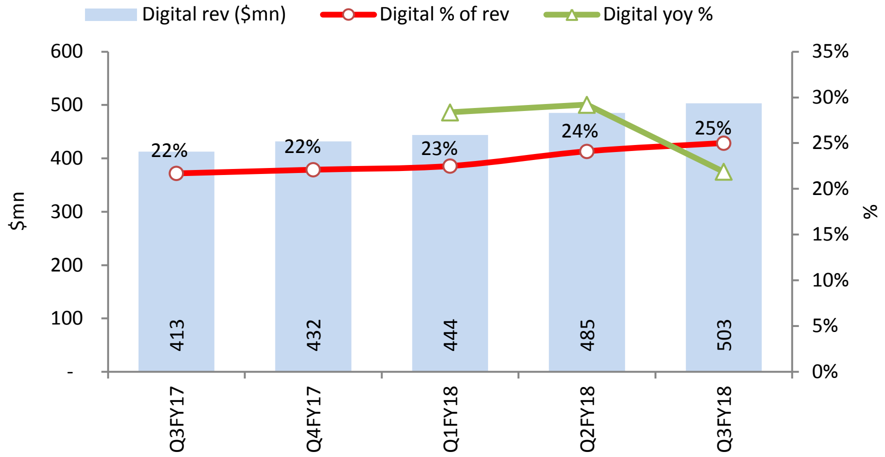
Source: Company, Phillip Capital India Research

Non E&U verticals have been performing exceedingly well



Source: Company, Phillip Capital India Research

Digital revenue growth rate (yoy) over last few quarters



Wipro appears to be reinventing its 'string of pearls' strategy of the 1990s

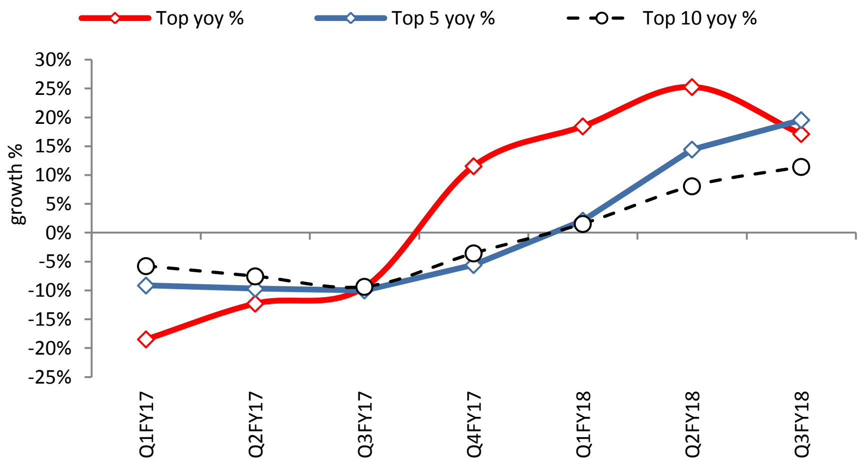
Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Oct-17	Cooper Software	US	Design thinking techniques to create innovative products, services, and organizations	8.5	8.3
Jan-17	InfoSERVER	Brazil	ADM Services Provider	8.7	8.7
Oct-16	Appirio	US	Cloud Services Provider	500.0	198.0
Feb-16	Healthplan	US	BPaaS Provider	460.0	223.0
Dec-15	Cellent	Germany	IT Services	78.0	92.3
Jul-15	Designit	Denmark	Strategic Design Firm	94.2	NA
Mar-15	Driverstream	US	Consulting in Oracle Cloud Services	5.0	NA
				1,154.4	**530.3**

Source: Company, PhillipCapital India Research

Large deal wins in last quarter

Appirio platform	• A Fortune 500 medical devices organization has selected Wipro for a multi-year global front-office transformation project. • A global provider of banking and financial services has awarded Wipro a contract to upgrade its use experience and simplify their sales and service process. • An American chain of luxury departmental stores has selected Wipro to reimagine its employee experience and modernize their HR processes. • Won a customer experience transformation contract from an international charitable organization.
HOLMES	• A leading global manufacturer of cleaning and hygiene products has awarded an end-to-end IT infrastructure contract, which will be implemented using Wipro HOLMES.
Designit	• A major international payments provider has awarded a pilot project focused on payments and wearables. The project will leverage Designit's expertise in technology, product and service design.

Large clients growth (yoy) over last few quarters



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**550,402**	**545,951**	**570,529**	**613,718**
Growth, %	7.4	-0.8	4.5	7.6
Employee expenses	-368,437	-364,662	-382,819	-410,093
Other Operating expenses	-64,979	-71,118	-68,316	-73,715
EBITDA (Core)	**116,986**	**110,171**	**119,394**	**129,910**
Growth, %	4.6	(5.8)	8.4	8.8
Margin, %	21.3	20.2	20.9	21.2
Depreciation	-23,107	-20,725	-21,175	-20,761
EBIT	**93,879**	**89,446**	**98,219**	**109,149**
Growth, %	(3.1)	(4.7)	9.8	11.1
Margin, %	17.1	16.4	17.2	17.8
Interest paid	0	0	0	0
Other Non-Operating Income	16,477	18,928	17,202	18,989
Pre-tax profit	**110,356**	**108,373**	**115,421**	**128,138**
Tax provided	-25,213	-24,195	-25,970	-28,831
Profit after tax	**85,143**	**84,178**	**89,451**	**99,307**
Others (Minorities, Associates)	-248	-11	55	62
Net Profit	**84,895**	**84,167**	**89,507**	**99,368**
Growth, %	(4.7)	(0.9)	6.3	11.0
Net Profit (adjusted)	**84,895**	**84,167**	**89,507**	**99,368**
Wtd avg shares (m)	4,836	4,502	4,502	4,502

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**7,705**	**8,052**	**8,501**	**9,182**
Growth, %	4.9	4.5	5.6	8.0
Re / US$ (rate)	68.6	65.5	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	52,710	74,554	102,077	131,723
Marketable securities at cost	292,030	237,283	273,283	309,283
Debtors	94,846	100,216	104,727	112,655
Inventory	3,915	2,992	3,126	3,363
Other current assets	95,397	88,287	92,262	99,246
Total current assets	538,898	503,331	575,475	656,269
Net fixed assets	211,512	218,437	219,262	220,501
Non-current assets	43,106	32,757	34,232	36,823
Total assets	**793,516**	**754,524**	**828,968**	**913,593**
Total current liabilities	229,543	218,095	223,009	230,102
Non-current liabilities	41,278	50,963	51,987	53,464
Total liabilities	270,821	269,059	274,996	283,566
Paid-up capital	4,861	9,047	9,047	9,047
Reserves & surplus	515,443	474,051	542,614	618,730
Minorities	2,391	2,367	2,312	2,250
Shareholders' equity	522,695	485,466	553,972	630,027
Total equity & liabilities	**793,516**	**754,524**	**828,968**	**913,593**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	110,356	108,373	115,421	128,138
Depreciation	23,107	20,725	21,175	20,761
Chg in working capital	11,644	1,565	-5,182	-10,647
Total tax paid	-25,213	-24,195	-25,970	-28,831
Other operating activities	0	0	0	0
Cash flow from operating activities	**119,894**	**106,469**	**105,444**	**109,421**
Capital expenditure	-51,835	-27,650	-22,000	-22,000
Chg in investments	0	0	0	0
Chg in marketable securities	-87,786	54,747	-36,000	-36,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-139,621**	**27,097**	**-58,000**	**-58,000**
Free cash flow	-19,727	133,566	47,444	51,421
Equity raised/(repaid)	-10,680	-110,000	0	0
Debt raised/(repaid)	3,220	9,685	1,023	1,477
Dividend (incl. tax)	-11,343	-14,760	-20,945	-23,252
Other financing activities	-7,728	3,388	0	0
Cash flow from financing activities	**-26,612**	**-111,722**	**-19,921**	**-21,775**
Net chg in cash	-46,339	21,844	27,523	29,646

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	17.6	18.7	19.9	22.1
Growth, %	(3.2)	6.5	6.3	11.0
Book NAV/share (INR)	107.6	107.3	122.5	139.5
CFPS (INR)	19.3	21.7	19.9	20.7
DPS (INR)	2.0	2.8	4.0	4.4
Return ratios				
Return on assets (%)	11.2	10.9	11.3	11.4
Return on equity (%)	16.3	17.4	16.2	15.8
Return on capital employed (%)	15.9	15.3	15.7	15.4
Turnover ratios				
Asset turnover (x)	1.9	1.8	1.9	2.0
Sales/Total assets (x)	0.7	0.7	0.7	0.7
Sales/Net FA (x)	2.8	2.5	2.6	2.8
Receivable days	62.9	67.0	67.0	67.0
Inventory days	2.6	2.0	2.0	2.0
Liquidity ratios				
Current ratio (x)	2.3	2.3	2.6	2.9
Quick ratio (x)	2.3	2.3	2.6	2.8
Dividend cover (x)	8.8	6.7	5.0	5.0
Total debt/Equity (%)	31.5	31.7	27.9	24.8
Net debt/Equity (%)	21.4	16.3	9.4	3.8
Valuation				
PER (x)	16.7	15.7	14.7	13.3
PEG (x) - y-o-y growth	(5.2)	2.4	2.3	1.2
Price/Book (x)	2.7	2.7	2.4	2.1
Yield (%)	0.7	1.0	1.4	1.5
EV/Net sales (x)	2.2	2.1	1.9	1.7
EV/EBITDA (x)	10.6	10.5	9.2	8.0
EV/EBIT (x)	13.2	13.0	11.2	9.5

HCL Technologies (HCLT IN)

Doing the right things – will eventually get the right valuation

INDIA | IT SERVICES | Company Update

28 February 2018

HCLT is our top pick in the IT large-cap space. It is taking the right steps (acquisitions, IP partnerships) to amend its capital allocation policy over the last decade (read our Dec-15 downgrade report ***here****). Over the last three years, it has invested US$ 870mn in six IP partnerships with IBM, and US$ 530mn to acquire eight companies – mostly in new-age digital technology (or ERD). We expect these investments to pay-off in the medium to long term, and HCLT to come out as the winner from this disruption cycle. Its valuation has always been at a discount to large-cap peers – we expect this to correct over the next two years.*

On the right track – making amends to an inefficient capital-allocation policy

Over the last three years, HCLT has made much better progress in amending the inefficient capital allocation policy (followed by IT companies over the last decade) than its peers. While maintaining the dividend payout and conducting a share buyback program, the company has pursued the inorganic route at a breakneck speed (relatively). It has made *six* acquisitions, adding ~US$ 500mn to its revenues. Most of its acquisitions are in the new-age digital-technology domain or the fast-growing ERD segment. It has also invested US$ 870mn into six IP partnerships with IBM, which will enable it to grow along with the global giant, and provide it an entry with prospective new clients.

ERD: The segment with huge growth potential – going strong

HCLT is the largest Indian IT services player in the ERD domain, with revenues of US$ 1.6bn in LTM. It is also the third-largest ESO company in the world, second to Altran Technologies and Alten SA – both French companies. We are highly optimistic about the potential of the ERD domain, where Indian IT companies are looking at increasing their presence based on domain expertise developed over the last decade and an abundant supply of engineers. HCLT strengthened its presence in this domain by acquiring Geometric Ltd (US$ 135mn revenues) in April 2016 and Butler America Aerospace Ltd (US$ 85mn revenues) in October 2016. We expect ERD to significantly mitigate the impact of a slowdown in other service lines for the company (especially IMS) over the next few years.

IMS stabilising; still a long way before large-scale migration to cloud happens

The biggest concern for HCLT has been cannibalisation of IMS revenues by clients moving to cloud platforms. However, the acquisition of Volvo's IT business has expanded its footprint in the European IMS market. IMS now forms 37% of HCLT's revenues, and 71% of the IMS revenues come from G2000 clients – who we believe will take at least 3-5 years to migrate a significant part of their business to cloud platforms, because of (1) their present investments in existing infrastructure, and (2) security concerns. We believe that this client profile provides HCLT enough time to reinvent itself and develop capabilities that will help it to grow, even after a large-scale migration to cloud platforms takes place.

Innovation in DNA; lean structure to help it turnaround sooner

HCLT has always had this uncanny ability to reinvent itself. Its entry (and leadership position) in the IMS and ERD domain are testimony to its innovative DNA. Even in Europe, it was one of the first Indian IT company to open a delivery centre and look beyond the UK – to Scandinavia and South European countries. Currently, the company is choosing its battles smartly – like not investing in developing its own automation solution (already crowded space with four large competitors) but partnering with the leader IBM. We expect its innovation-laden DNA and lean structure (only 111k employees vs. TCS/Infosys/Wipro's 378k/200k/179k) to help it reinvent itself once again – and come out of the current technology disruption as a transformed company.

Outlook and Valuation

HCLT is trading at 13x FY20 P/E – at a discount to TCS and Wipro (in line with Infosys). The market has always been unkind to HCL – giving it a lower multiple than TCS/Infosys – despite it reporting stronger growth many times. We expect this to correct over the next two years, as its investments start delivering superior results. We upgrade our target multiple to 16x (earlier 15x). Our target is Rs 1,190 (*Rs 1,080 earlier*).

BUY (Maintain)

CMP RS 952
TARGET RS 1190 (+25%)

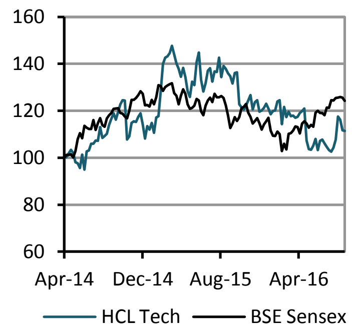
COMPANY DATA

O/S SHARES (MN) :	1392
MARKET CAP (RSBN) :	1345
MARKET CAP (USDBN) :	20.8
52 - WK HI/LO (RS) :	1042/ 797
LIQUIDITY 3M (USDMN) :	25.8
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	60.2	60.1	59.7
FII / NRI :	25.6	25.3	25.3
FI / MF :	10.5	9.9	10.5
NON PRO :	1.0	2.0	1.5
PUBLIC & OTHERS :	2.6	2.7	3.1

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	506.1	552.2	607.2
EBIT	100.3	110.5	123.9
Net Profit	87.2	93.3	103.4
EPS, Rs	62.6	67.0	74.2
PER, x	15.2	14.2	12.8
EV/EBIT, x	12.3	10.5	8.8
P/BV, x	3.6	3.0	2.5
ROE, %	23.9	20.9	19.3

Source: PhillipCapital India Research Est.

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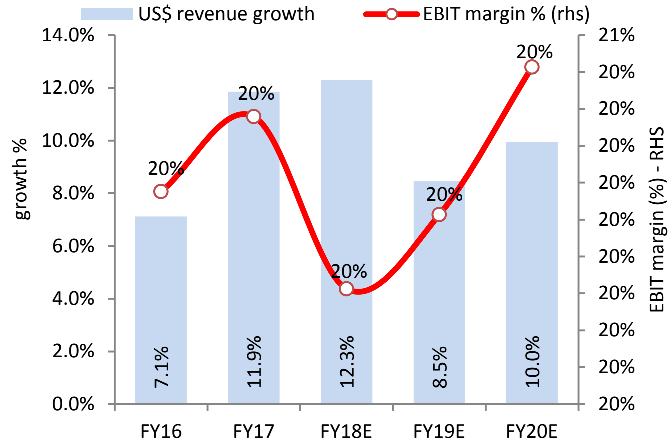
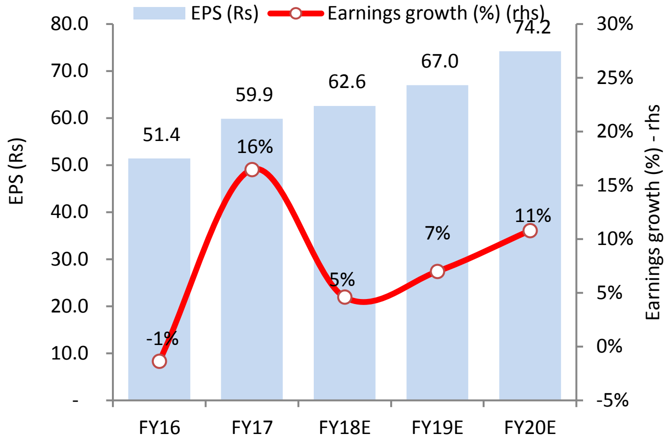
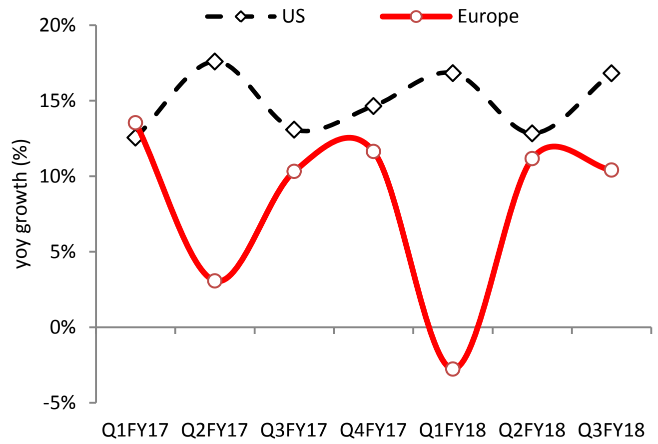
Revenue growth and Margins profile



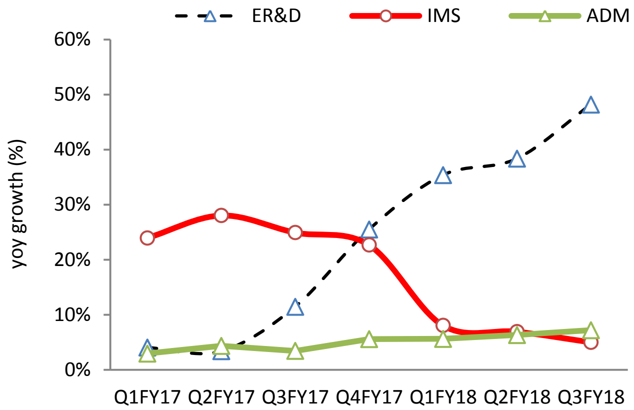
Earnings growth profile



Geography growth rate (yoy) over last few quarters



Service line growth rate (yoy) over last few quarters



HCLT IP partnerships over the last three years

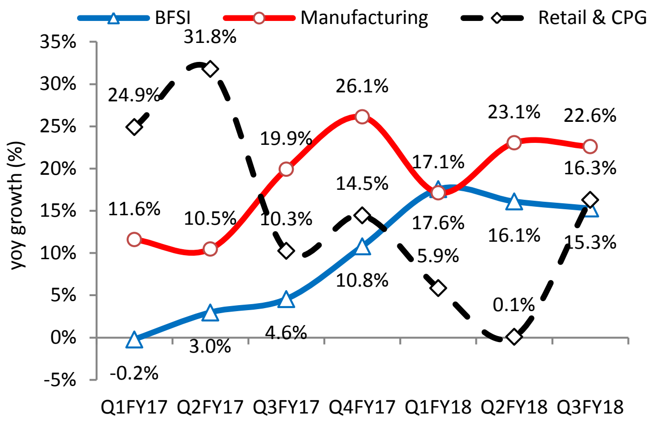
Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Oct-17	IP Partnership	US	IP License: Notes, Domino, Smart Cloud Notes, Verse and Sametime products	60	NA
Jul-17	IP Partnership	US	IBM Marketing Automation software and products under the IBM CICS z/OStools portfolio, IBM's Tivoli and Rational portfolios.	140	NA
Apr-17	IP Partnership	US	Information management and Database management systems	80	NA
Dec-16	IP Partnership	US	Application security, B2B data transformation, Testing automation and Mainframe management tools	155	50
Sep-16	IP Partnership	US	API/web service enablement for mainframes	85	15
Jun-16	IP Partnership	US	To invest in and grow workload Automation and DevOps software of a global tech major	350	40
				870	**105**

HCLT acquisitions over the last three years

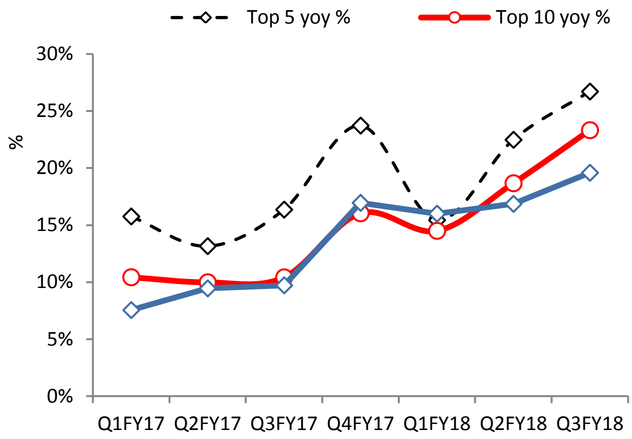
Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Dec-16	Butler America Aerospace	US	Engineering & Design services to Aerospace and Defense customers	85	85
Apr-16	Geometric	India	PLM and engineering services	195	135
Feb-16	Volvo IT	Sweden	External IT services arm of Volvo	135	190
Jan-16	Point to Point	UK	Workplace engineering services	10	12
Nov-15	CSC	US	To operate and expand the existing Core Banking business of CSC	54	NA
Oct-15	PowerObjects	US	Professional services for Microsoft Dynamics CRM	42	37
Oct-15	C2SiS	India	Engineering services firm	2	NA
Aug-15	Trygstad Technical Services	US	Turnkey solutions for a large ISV	10	NA
				533	**459**

Source: Company, PhillipCapital India Research

Vertical growth rate (yoy) over last few quarters

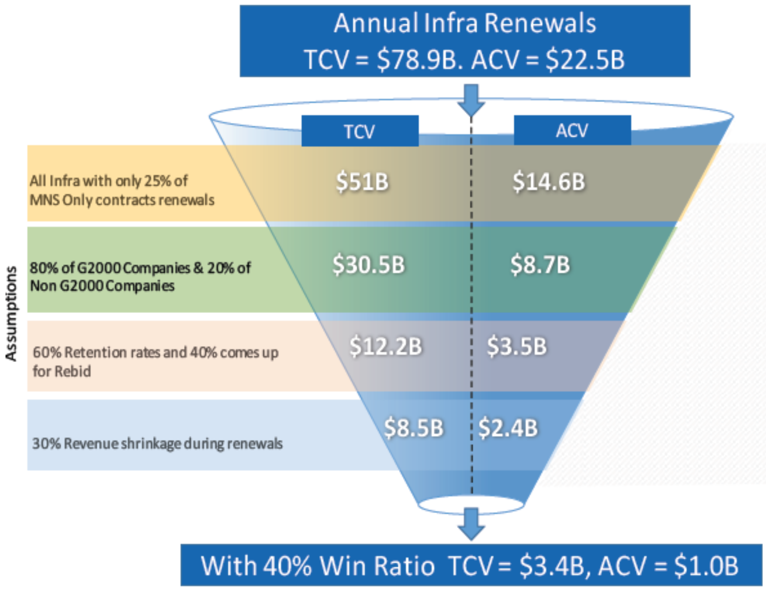


large clients growth (yoy) over last few quarters

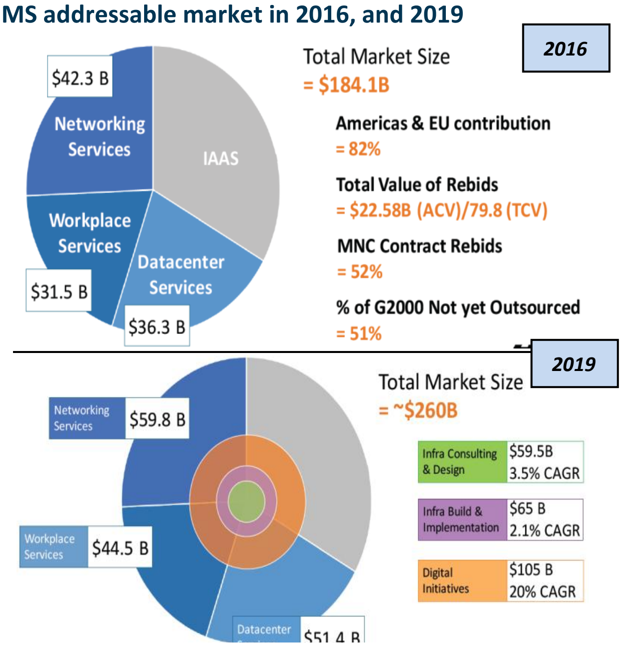


Source: Company, Phillip Capital India Research

HCLT sees tremendous opportunity from IMS deal renewals

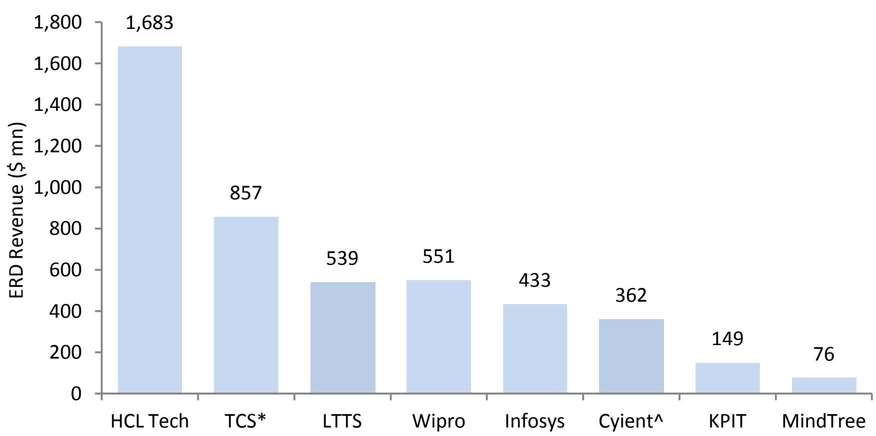


IMS addressable market in 2016, and 2019



Source: Company

HCLT is, by far, the largest Indian ERD player (ERD TTM revenues, USD mn)



Source: Companies, PhillipCapital India Research; * FY17 revenues; ^ Assumed

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**467,220**	**506,084**	**552,208**	**607,154**
Growth, %	50	8	9	10
Employee expenses	-308,890	-332,799	-359,064	-390,455
Other Operating expenses	-55,240	-58,432	-64,608	-74,073
EBITDA (Core)	**103,090**	**114,853**	**128,536**	**142,627**
Growth, %	54.0	11.4	11.9	11.0
Margin, %	22.1	22.7	23.3	23.5
Depreciation	-8,340	-14,583	-18,017	-18,683
EBIT	**94,750**	**100,270**	**110,518**	**123,944**
Growth, %	51.6	5.8	10.2	12.1
Margin, %	20.3	19.8	20.0	20.4
Other Non-Operating Income	7,460	5,681	6,365	6,763
Forex Gains\ (Losses)	1,880	4,050	2,000	1,000
Pre-tax profit	**104,090**	**110,000**	**118,883**	**131,707**
Tax provided	-19,520	-22,773	-25,560	-28,317
Profit after tax	**84,570**	**87,228**	**93,323**	**103,390**
Non Recurring Item	0	0	0	0
Net Profit	**84,570**	**87,228**	**93,323**	**103,390**
Growth, %	55.1	3.1	7.0	10.8
Net Profit (adjusted)	**84,570**	**87,228**	**93,323**	**103,390**
Wtd avg shares (m)	1,413	1,393	1,393	1,393

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**6,975**	**7,833**	**8,496**	**9,341**
Growth, %	11.9	12.3	8.5	10.0
Re / US$ (rate)	67.0	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	13,160	28,970	47,730	74,072
Marketable securities at cost	113,660	79,760	127,760	175,760
Debtors	108,020	119,242	130,109	143,055
Inventory	0	0	0	0
Other current assets	29,830	30,400	32,439	36,044
Total current assets	264,670	258,371	338,038	428,931
Investments	1,470	2,260	2,260	2,260
Net fixed assets	198,190	236,708	247,173	258,879
Non-current assets	0	0	0	0
Total assets	**464,330**	**497,339**	**587,470**	**690,071**
Total current liabilities	111,480	113,972	122,967	133,717
Non-current liabilities	17,950	17,656	18,499	19,988
Total liabilities	129,430	131,629	141,466	153,705
Paid-up capital	1,414	1,393	1,393	1,393
Reserves & surplus	333,486	364,317	444,612	534,972
Minorities	0	0	0	0
Shareholders' equity	334,900	365,710	446,005	536,365
Total equity & liabilities	**464,330**	**497,339**	**587,470**	**690,071**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	104,090	110,000	118,883	131,707
Depreciation	8,340	14,583	18,017	18,683
Chg in working capital	9,875	-9,299	-3,911	-5,802
Total tax paid	-19,520	-22,773	-25,560	-28,317
Other operating activities	0	0	0	0
Cash flow from operating activities	**102,785**	**92,512**	**107,429**	**116,271**
Capital expenditure	-60,317	-53,101	-28,482	-30,389
Chg in investments	131	-790	0	0
Chg in marketable securities	-2,424	33,900	-48,000	-48,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-62,610**	**-19,991**	**-76,482**	**-78,389**
Free cash flow	40,175	72,520	30,947	37,882
Equity raised/(repaid)	2	-35,002	0	0
Debt raised/(repaid)	-4,417	-294	842	1,489
Dividend (incl. tax)	-39,626	-13,116	-13,029	-13,029
Other financing activities	9,734	-8,299	0	0
Cash flow from financing activities	**-34,308**	**-56,711**	**-12,187**	**-11,540**
Net chg in cash	5,867	15,810	18,760	26,342

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	59.9	62.6	67.0	74.2
Growth, %	16.5	4.6	7.0	10.8
Book NAV/share (INR)	237.1	262.5	320.2	385.0
CFPS (INR)	67.5	62.3	72.5	78.6
DPS (INR)	24.0	8.0	8.0	8.0
Return ratios				
Return on assets (%)	19.6	18.1	17.2	16.2
Return on equity (%)	25.3	23.9	20.9	19.3
Return on capital employed (%)	25.8	23.7	22.0	20.3
Turnover ratios				
Asset turnover (x)	2.3	2.0	2.0	2.1
Sales/Total assets (x)	1.1	1.1	1.0	1.0
Sales/Net FA (x)	2.7	2.3	2.3	2.4
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	84.4	86.0	86.0	86.0
Liquidity ratios				
Current ratio (x)	2.4	2.3	2.7	3.2
Quick ratio (x)	2.4	2.3	2.7	3.2
Dividend cover (x)	2.5	7.8	8.4	9.3
Total debt/Equity (%)	5.4	4.8	4.1	3.7
Net debt/Equity (%)	1.4	(3.1)	(6.6)	(10.1)
Valuation				
PER (x)	15.9	15.2	14.2	12.8
PEG (x) - y-o-y growth	0.3	3.3	2.0	1.2
Price/Book (x)	4.0	3.6	3.0	2.5
Yield (%)	2.5	0.8	0.8	0.8
EV/Net sales (x)	2.6	2.4	2.1	1.8
EV/EBITDA (x)	11.9	10.7	9.1	7.7
EV/EBIT (x)	13.0	12.3	10.5	8.8

PhillipCapital

Tech Mahindra (TECHM IN)

Precariously poised business model

INDIA | IT SERVICES | Company Update

28 February 2018

TechM business has deteriorated significantly over the last two years, and we now find it in an operationally precarious stage — where it might face substantial delivery issues in the near to medium term. Its business model of half telecom and half non-telecom appears unattractive, especially in the wake of the ongoing weakness in the global telecom domain. Lastly, we find our faith in the management's judgement dwindling after its repeated failures in the last few quarters. We wouldn't be buyers unless it was trading at extremely inexpensive valuations (<12x PE). Maintain SELL.

Operations precariously poised

Over the last three quarters, TechM has fired 8,900+ employees in its software division – taking the overall company headcount to 115,241 (from 117,693 in Q4FY17). It has also not awarded any salary hikes to employees with more than six years of experience; to employees with less than six, it awarded a basic 3-5% hike in FY18 (after zero hike in FY17). At the same time, its trainee count in the system is ZERO – taking utilization to 83%; not sustainable, by management's own admission. These statistics point to a perfect recipe for an operational disaster – we suspect a high level of demotivation amongst employees, leading to possible serious delivery issues in the near-to-medium term.

Telecom business – Too big to grow

The telecom vertical has now become too big for TechM to be able achieve double-digit growth. The business, now at over US$ 2bn in annual revenues, accounts for 45% of the total telecom revenue of top-5 Indian IT companies, and is even bigger than Accenture's telecom business. Over the last few quarters, even after adjusting for the LCC decline, TECHM's core telecom business has reported muted growth. With leading global telecom giants such as AT&T, Verizon, and BT already under its belt, there is little that the company can do in terms of adding new clients or incremental mining of existing clients in this domain. We believe its telecom business will only revive if a new technology (like 5G) is rolled out – which, by the management's own admission, is not happening before FY20.

Skewed business mix to keep growth in check

While telecom continues to remain weak for TechM, its enterprise business has been growing strongly. The business grew by 16.6% yoy in FY17, and has already grown by 19% yoy in 9MFY18. However, we note that this growth has come on a low base, with no competitive advantage or USP that the company can claim in segments such as BFSI, retail, and manufacturing. We thus believe its enterprise business will, at best, grow at industry average rates over the medium-to-long term. This combination – of half of its business (enterprise) growing AT and the other half (telecom) growing BELOW industry average – will always keep TechM's growth lower than its peers.

Margin expansion an uphill task hereafter

Over the last three quarters, TechM has expanded its EBIT margins by 450bps – which had contracted by over 620bps over the preceding six quarters – primarily driven by LCC operations. Expansion in margins was possible due to utilisation reaching a peak level of 83%, zero trainees in the system, net firing of 2400+ employees, minimal hike given to less than half the employees, and rationalization of LCC operations. All these 'low-hanging' fruits have been plucked and any margins expansion from here will require simultaneous revenue growth and operational efficiencies – a herculean task in our opinion.

Outlook and valuation

TechM is currently trading at 15x FY20 PE – a discount to TCS, but at a premium to Infosys, Wipro and HCL – all of whom have a much superior business models. We upgrade our target multiple (as for the entire sector) to 14x (13x earlier) – still the lowest in our large-cap coverage universe. Our target is Rs 570 (*Rs 530 earlier*). We maintain SELL.

SELL (Maintain)

CMP RS 612

TARGET RS 570 (-7%)

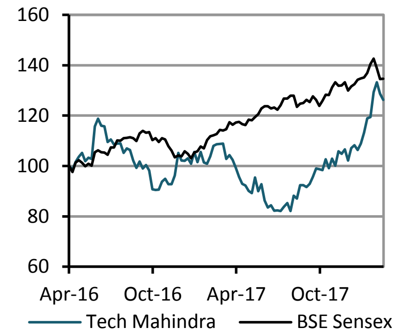
COMPANY DATA

O/S SHARES (MN) :	980
MARKET CAP (RSBN) :	603
MARKET CAP (USDBN) :	9.3
52 - WK HI/LO (RS) :	631 / 358
LIQUIDITY 3M (USDMN) :	27.1
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	36.0	36.1	36.2
FII / NRI :	37.9	37.6	35.4
FI / MF :	13.2	12.8	14.4
NON PRO :	3.5	3.5	3.3
PUBLIC & OTHERS :	9.4	9.9	10.8

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY18E	FY19E	FY20E
Net Sales	305.7	327.8	352.3
EBIT	35.1	38.2	42.1
Net Profit	34.1	31.9	35.8
EPS, Rs	38.7	36.3	40.7
PER, x	15.8	16.8	15.0
EV/EBIT, x	14.9	13.3	11.6
P/BV, x	3.1	2.7	2.4
ROE, %	19.5	16.3	16.1

Source: PhillipCapital India Research Est.

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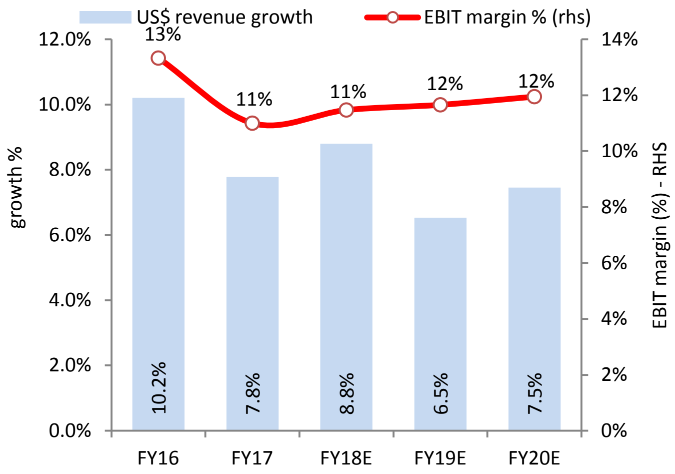
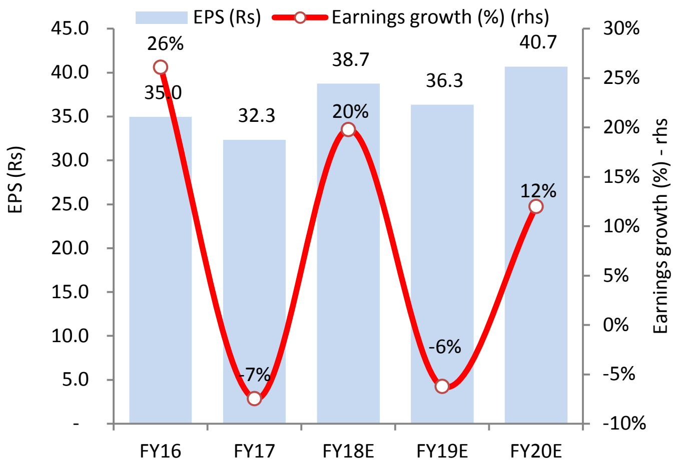
Revenue growth and Margins profile

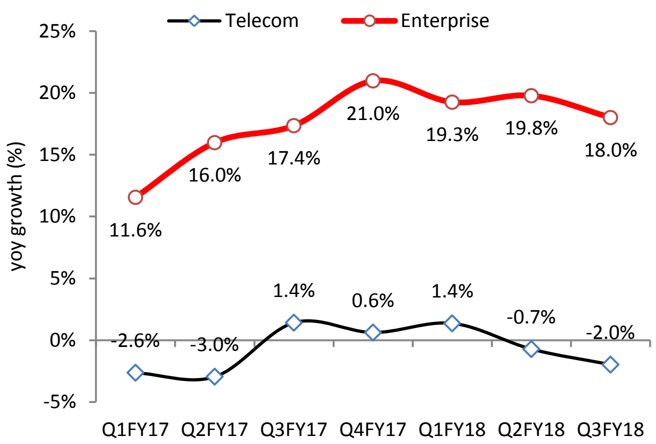


Earnings growth profile

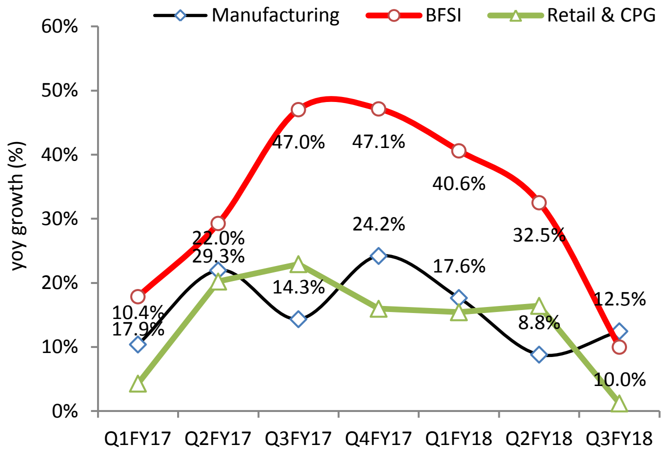


Source: Company, Phillip Capital India Research

Telecom and Enterprise growth rate (yoy) over last few quarters

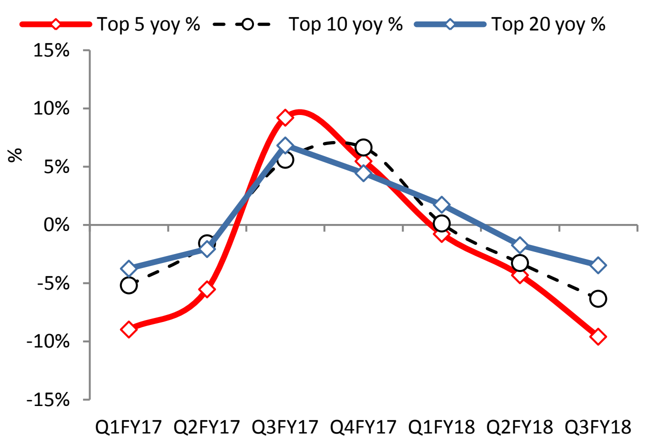


Revenue growth across enterprise side

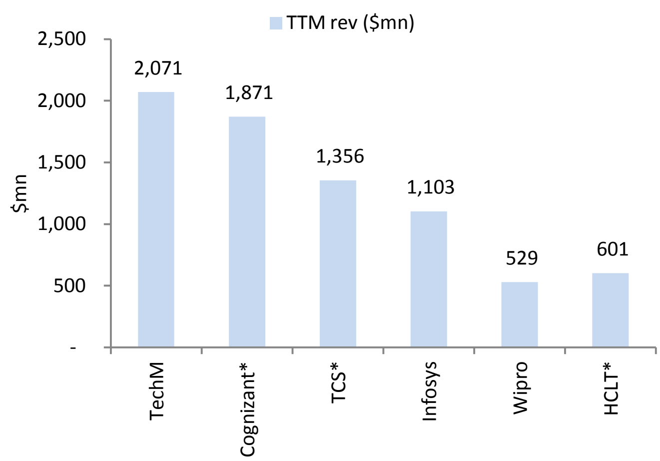


Source: Company, Phillip Capital India Research

Top clients have consistently declined over last few quarters

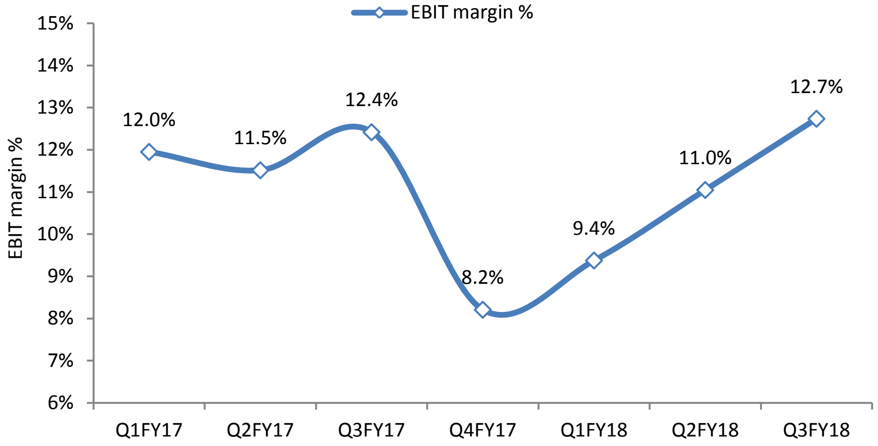


Techm's telecom has become too big too grow

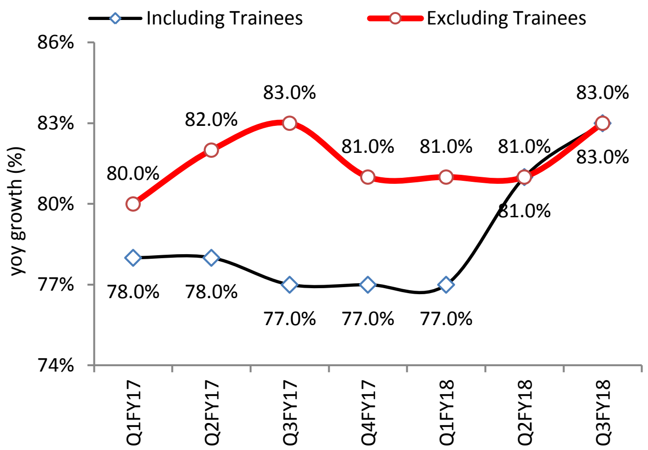


Source: Company, PhillipCapital India Research; * includes Media

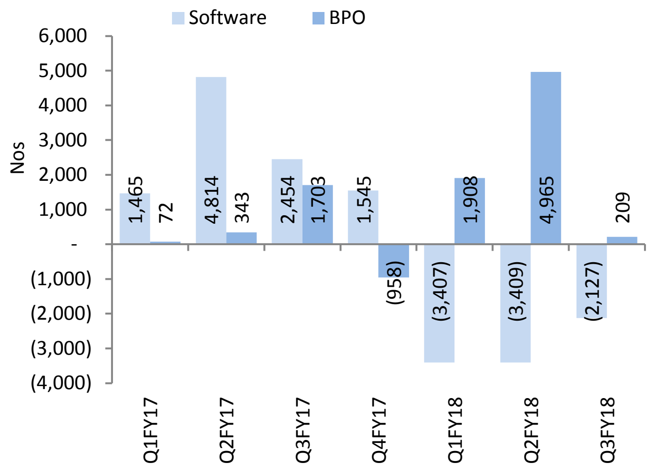
EBIT margin have recovered over last three quarters ... driven by ...



...virtually no trainees in the system ...



.. and significant employee reduction over last few quarters



Source: Company, Phillip Capital India Research

TechM, despite its LCC acquisition debacle, is always on the hunt

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Mar '17	HCI	US	Healthcare services provider, primarily in the US and UK	110.0	114.0
Jun '16	The Bio Agency	UK	UK-based firm specializing in user interface (UI) and customer experience (CX)	56.0	17.5
May '16	Target Group	UK	BPO and software solutions provider to BFSI	156.0	71.0
Dec '15	Pininfarina	Europe	ERD for Automotive	100.0	100.0
Jan '15	Sofgen	Europe	Geneva-based consulting company, specialized in BFSI	30.0	45.0
Nov '14	LCC	US	Network engineering services provider to Telecom	240.0	430.0
				692.0	**777.5**

Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**291,408**	**305,681**	**327,821**	**352,253**
Growth, %	10.0	4.9	7.2	7.5
Employee expenses	-194,465	-205,422	-221,923	-239,433
Other Operating expenses	-55,100	-54,380	-55,017	-57,148
EBITDA (Core)	**41,843**	**45,880**	**50,882**	**55,672**
Growth, %	(2.5)	9.6	10.9	9.4
Margin, %	14.4	15.0	15.5	15.8
Depreciation	-9,781	-10,806	-12,660	-13,572
EBIT	**32,062**	**35,073**	**38,222**	**42,100**
Growth, %	(9.2)	9.4	9.0	10.1
Margin, %	11.0	11.5	11.7	12.0
Interest paid	-1,309	-1,452	-1,421	-1,421
Other Non-Operating Income	7,776	11,368	5,753	6,634
Pre-tax profit	**38,529**	**44,990**	**42,553**	**47,313**
Tax provided	-9,785	-10,946	-10,213	-11,355
Profit after tax	**28,744**	**34,044**	**32,340**	**35,958**
Others (Minorities, Associates)	-357	13	-402	-189
Net Profit	**28,387**	**34,058**	**31,938**	**35,769**
Growth, %	(6.0)	20.0	(6.2)	12.0
Net Profit (adjusted)	**28,387**	**34,058**	**31,938**	**35,769**
Wtd avg shares (m)	878	879	879	879

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**4,351**	**4,734**	**5,043**	**5,419**
Growth, %	7.8	8.8	6.5	7.5
Re / US$ (rate)	67.0	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	32,186	30,264	45,606	64,856
Debtors	53,533	64,518	69,901	74,560
Inventory	611	472	472	472
Other current assets	21,836	17,205	18,640	19,883
Total current assets	146,112	144,885	167,045	192,198
Investments	23,955	40,154	40,154	40,154
Net fixed assets	68,330	80,291	86,291	92,291
Total assets	**260,665**	**292,433**	**320,593**	**351,746**
Current liabilities	23,117	23,549	25,514	27,214
Provisions	10,071	14,740	16,006	17,139
Total current liabilities	33,188	38,289	41,520	44,353
Non-current liabilities	58,464	74,525	77,800	80,634
Total liabilities	91,652	112,814	119,320	124,987
Paid-up capital	4,388	4,415	4,415	4,415
Reserves & surplus	159,984	170,368	192,023	217,508
Minorities	4,641	4,836	4,836	4,836
Shareholders' equity	169,013	179,619	201,274	226,759
Total equity & liabilities	**260,665**	**292,433**	**320,593**	**351,746**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	38,529	44,990	42,553	47,313
Depreciation	9,781	10,806	12,660	13,572
Chg in working capital	-5,279	9,512	-1,579	-1,367
Total tax paid	-5,924	-8,098	-8,947	-10,222
Other operating activities	0	0	0	0
Cash flow from operating activities	**37,107**	**57,210**	**44,688**	**49,296**
Capital expenditure	-28,178	-22,767	-18,660	-19,572
Chg in investments	-11,530	-16,199	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-39,708**	**-38,966**	**-18,660**	**-19,572**
Free cash flow	-2,601	18,244	26,027	29,723
Equity raised/(repaid)	33	27	0	0
Debt raised/(repaid)	2,174	3,272	0	0
Dividend (incl. tax)	-9,241	-10,284	-10,284	-10,284
Other financing activities	-716	-13,389	0	0
Cash flow from financing activities	**-5,393**	**-20,166**	**-10,686**	**-10,473**
Net chg in cash	-7,994	-1,922	15,342	19,251

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	32.3	38.7	36.3	40.7
Growth, %	(7.5)	19.8	(6.2)	12.0
Book NAV/share (INR)	187.3	198.8	223.5	252.5
CFPS (INR)	37.5	55.6	44.3	48.5
DPS (INR)	9.0	10.0	10.0	10.0
Return ratios				
Return on assets (%)	12.2	12.6	10.8	11.0
Return on equity (%)	17.3	19.5	16.3	16.1
Return on capital employed (%)	14.0	14.5	12.5	12.6
Turnover ratios				
Asset turnover (x)	2.8	2.7	2.8	2.9
Sales/Total assets (x)	1.2	1.1	1.1	1.0
Sales/Net FA (x)	4.9	4.1	3.9	3.9
Working capital/Sales (x)	0.3	0.2	0.2	0.2
Receivable days	67.1	77.0	77.8	77.3
Liquidity ratios				
Current ratio (x)	4.4	3.8	4.0	4.3
Quick ratio (x)	4.4	3.8	4.0	4.3
Dividend cover (x)	3.6	3.9	3.6	4.1
Total debt/Equity (x)	0.1	0.1	0.1	0.1
Net debt/Equity (x)	(0.1)	(0.1)	(0.2)	(0.2)
Valuation				
PER (x)	18.9	15.8	16.8	15.0
PEG (x) - y-o-y growth	(2.5)	0.8	(2.7)	1.3
Price/Book (x)	3.3	3.1	2.7	2.4
Yield (%)	1.5	1.6	1.6	1.6
EV/Net sales (x)	1.8	1.7	1.5	1.4
EV/EBITDA (x)	12.3	11.4	10.0	8.8
EV/EBIT (x)	16.1	14.9	13.3	11.6

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

L&T Infotech (LTI IN)

A unique business model – geared for growth

INDIA | IT SERVICES | Initiating Coverage

28 February 2018

L&T Infotech (LTI) is the sixth largest Indian IT company, with FY17 revenues of US$970mn. It has a strong presence in the BFSI space with a marquee clientele including Citi Bank, Chevron, Times Warner, Barclays, and Nordea. The company has roped-in industry stalwarts like Sanjay Jalona (from Infosys) and Sudhir Chaturvedi (ex-NIIT, ex-Infosys), who have transformed its business model from 'one of the L&T subsidiaries' to an independent formidable force in the IT Services space. We like the business model, but the current valuations (@ 17x FY20 P/E) appear highly expensive to be entering at. We see limited upside potential in near-to-medium term and initiate coverage with NEUTRAL.

A unique concentrated portfolio in the BFSI space: LTI has one of the strongest solutions portfolios in the BFS segment, which is quite unique in nature. The segment, which forms 47% of the company's revenues derives that revenue from four stable sources – Property & Casualty insurance (P&C, 20%), Citibank (14%), Platforms (4%) business and Global Risk & Compliance & Others (GRC, 10%). While P&C business continues to well, GRC remains unaffected by the slowdown in the segment. All along, LTI's revenues from Citibank have seen a CQGR of 3.3% over Q1FY16-Q4FY17, despite no meaningful increase in its IT spend, due to increase in wallet share. It is due to this concentrated BFSI portfolio that despite recent slowdown in client spending by large banks in the US, LTI has reported strong USD revenue CQGR of 3.7% in BFSI over the last ten quarters.

Client stickiness remains a core strength: LTI has 289 active clients as of Q3FY18, which includes 54 F-500 clients. It has focused on aggressive client mining and not just adding clients to expand its client base. Better client mining has resulted in LTI having one of the highest top client revenue concentrations, with its top 1/5/10/20 clients contributing 15%/36%/51%/66% of total revenues. Its large client, Citibank, generated US$ 141mn (14.5% of revenue) for FY17, +9.6% vs. FY16. Large clients are spread across verticals – with Citibank (BFS), Chevron (O&G), Honda (Automotive) and Time Warner (Media).

Digital business gaining traction: LTI derives 33% of its revenues from Digital, which has seen 9% CQGR over the last four quarters. It has a dedicated team of digital managers and has started a new initiative ADEA (Analytics and Digital in Every Account), aimed at increasing the presence of newer-age technologies in every account. This is evident in digital penetration in 37 of its top 50 clients. Due to its strong capabilities in analytics, it won a US$ 100mn CBDT project from GoI to identify tax non-compliance by plugging loopholes in the taxation system using advanced technologies.

Stable management team: Over FY12-15, LTI had a series of exits (four CEO/COO changes) at the top level. However, in Aug-2015, Mr Sanjay Jalona – who was earlier heading Infosys' manufacturing division, with a great record – was appointed MD and CEO. Under his leadership, LTI strengthened its management team through a series of recruitments at the sales and delivery levels. The management team has been stable ever since.

Outlook and valuations: We expect LTI to report 15% USD revenue CAGR over FY17-20. We expect it to report USD revenue growth of 16% in FY18 – easily achievable in our opinion, on the back of acceleration in top clients, strong growth across its target verticals (BFSI, Manufacturing), and traction in Digital. With higher and stable crude prices, it is seeing demand from its E&U clients too, which is reflected in the last few quarters' performance.
LTI is currently trading at 17x FY20 P/E – a premium to most mid-cap and large-cap IT companies. While we believe it will continue to command premium valuations due to its strong revenue visibility and better business mix (vs mid-cap peers), current valuations appear too expensive to be entering at. We see limited upside potential in near-to-medium term and initiate coverage with price target of Rs 1,420 (17x FY20) and NEUTRAL rating.

NEUTRAL

CMP RS 1424

TARGET RS 1420 (+0%)

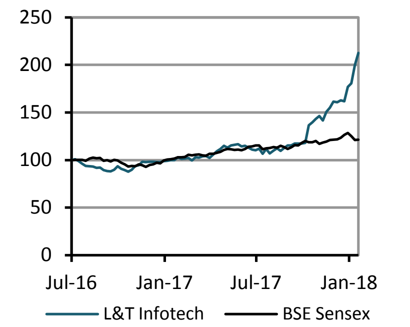
COMPANY DATA

O/S SHARES (MN) :	172
MARKET CAP (RSBN) :	247
MARKET CAP (USDBN) :	3.8
52 - WK HI/LO (RS) :	1543 / 682
LIQUIDITY 3M (USDMN) :	3.3
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	83.7	84.0	84.3
FII / NRI :	6.1	5.9	5.7
FI / MF :	2.2	2.0	2.0
NON PRO :	2.7	2.5	2.5
PUBLIC & OTHERS :	5.3	5.5	5.7

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	72,648	84,824	96,243
EBIT	10,762	13,142	15,430
Net Profit	11,157	12,213	14,244
EPS, Rs	65.4	71.6	83.5
PER, x	22.0	20.1	17.2
EV/EBIT, x	23.0	18.5	15.4
P/BV, x	6.5	5.2	4.2
ROE, %	29.4	26.0	24.5

Source: PhillipCapital India Research Est.

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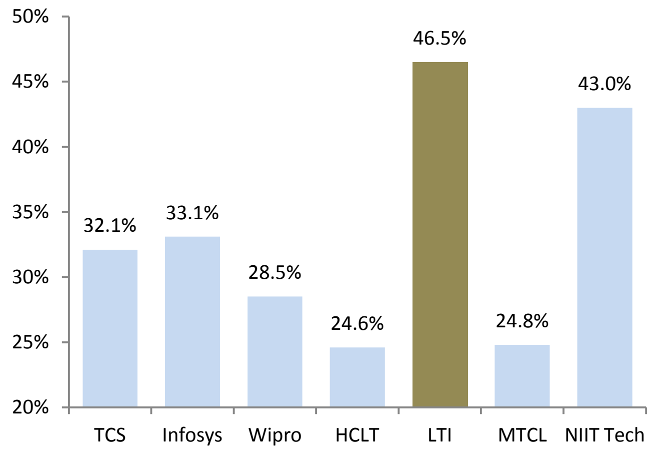
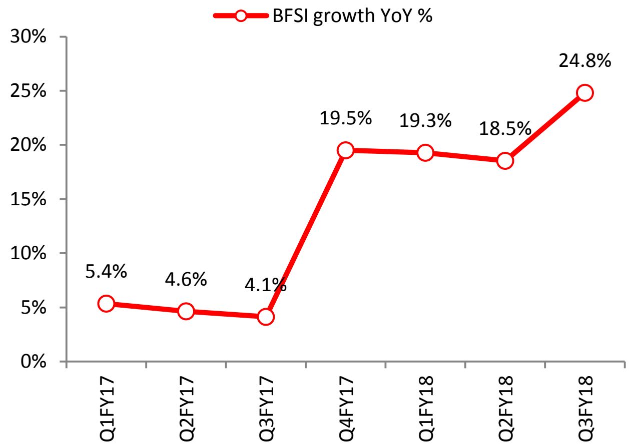
Strong presence in BFSI

LTI has one of the strongest solutions portfolios in the BFSI segment, which is quite unique in nature. The segment, which forms 47% of the company's revenues derives that revenue from four stable sources – Property & Casualty insurance (P&C), Global Risk and Compliance (GRC), Citibank and Platforms business.

LTI has largest share of revenue from BFSI segment ...



... and has reported strong growth over last few quarters



In the BFSI segment (47% of revenue), LTI focuses on:

1. **Property and casualty insurance (20% of revenue):** LTI has higher exposure to few of the largest P&C insurance service providers
2. **Citibank (14% of revenue)**: Despite no meaningful IT spend increase Citibank, LTI's revenue from Citibank have witnessed a CQGR of 3.3%, over Q1FY16-Q4FY17, largely due to the wallet share increase.
3. **Platforms (4% of revenue)**.
4. **Global risk & compliance and Others (10% of revenue):** A segment that has not been affected by the recent slowdown in IT spending. LTI provides data consolidation and risk management services for internal regulatory reporting like AML, FATCA, Basel norms, etc.

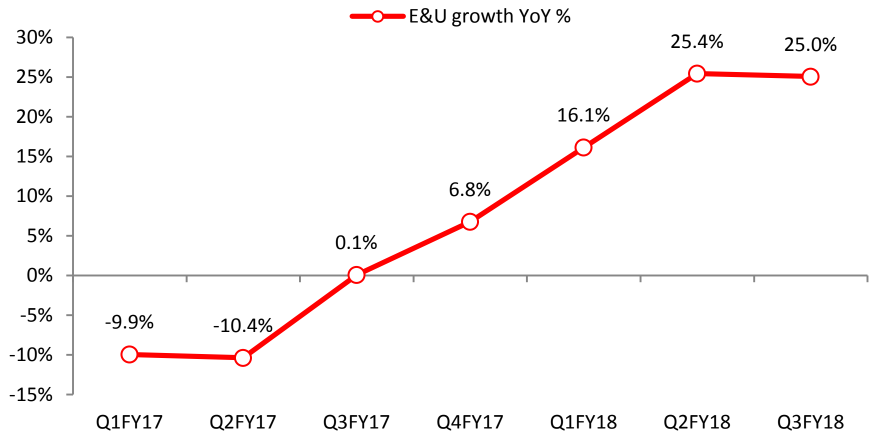
Though it may look like over-dependence on the BFSI segment, we believe LTI's focus on select segments of BFS and significant presence in P&C provides it a cushion. It is due to this concentrated BFSI portfolio that despite recent slowdown in client spending by large banks in the US, LTI has reported strong USD revenue CQGR of 3.7% in BFSI over the last ten quarters.

E&U stabilizing, with stable crude oil prices

LTI has a decent exposure to E&U, which contributes 12% of its revenue. Under this segment, LTI offers software solutions and consultancy, mainly in three sub-verticals: Oil & Gas, Mining, and Process Manufacturing. In Oil & Gas, LTI works with the entire lifecycle of crude processing: upstream, midstream and downstream.

LTI's performance in E&U segment was dented over FY14-17 due to lower crude oil prices – it reported revenue CAGR of -13% over this period – significantly below its average revenue growth rate of 9%. However, with higher and stable crude prices now, LTI is seeing an uptick in demand from upstream and downstream oil companies. This is also reflected in the last few quarters' performance – 6% CQGR over the last five quarters for the vertial, ahead of the company revenue CQGR of 4%. We believe the worst is over for LTI in the vertical, and it should see strong revenue growth in the segment hereafter.

E&U segments appears to be picking up, after crude prices stabilizing



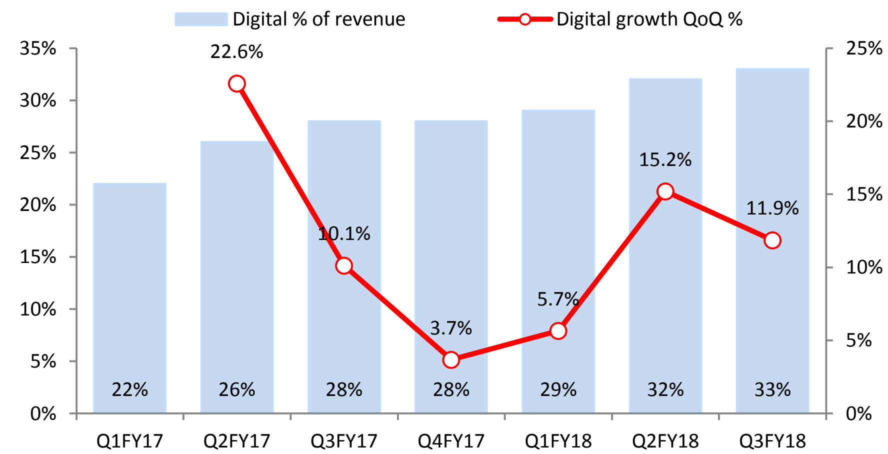
Source: Company, PhillipCapital India Research

Digital business to drive growth

LTI derives 33% of its revenues from Digital, which has grown at a CQGR of 9% over the last four quarters. In newer technologies, LTI focuses on: (1) digital, (2) automation, (3) analytics, (4) cloud, and (5) IoT. It has a dedicated team of digital managers. Its newer initiatives — such as IP-based platform MOSAIC (Mobile, Online, Social, Analytics, IoT, Cloud) and ADEA – Analytics and Digital in Every Account — are major differentiators for LTI. AEDA is aimed at increasing the presence of newer-age technologies in every account.

This is evident in LTI's digital penetration in 37 of its top-50 clients. Due to its strong capabilities in the Analytics, the company won a US$ 100mn CBDT project from GoI (to identify tax non-compliance through plugging the loopholes in the taxation system using advanced technologies).

LTI has 1/3rd of its revenue from digital stream, which is growing strongly



Source: Company, PhillipCapital India Research

Marquee client profile

It has 289 active clients as of Q3FY18, which includes 54 F-500 companies. It has focused on aggressive client mining, rather than just adding clients to expand the client base. Better client mining has resulted in LTI having one of the highest top client revenue concentrations, with its top 1/5/10/20 clients contributing 15%/36%/51%/66% of total revenues.

Some of its large clients across the verticals are:

- Insurance: Two of the top-5 global brokers
  Three of the top-10 insurers in North America
  Leading five workers'-compensation insurers
  One of the top-3 global reinsurers
- BFS: Three of the top-10 global banks
  Three of the top-10 AMCs in the US
  Two of the top-5 banks in the UK
  Two of the top-5 banks in Europe
  Two of the top-5 banks in South Africa

Its large client, Citibank, generated US$ 141mn (14.5% of revenue) for FY17, registering a growth of 9.6% over FY16. The large clients are spread across verticals, with Citibank (BFS), Chevron (O&G), Honda (Automotive), and Time Warner (Media).

LTIS has a marquee clientele, contributing large part to its revenue

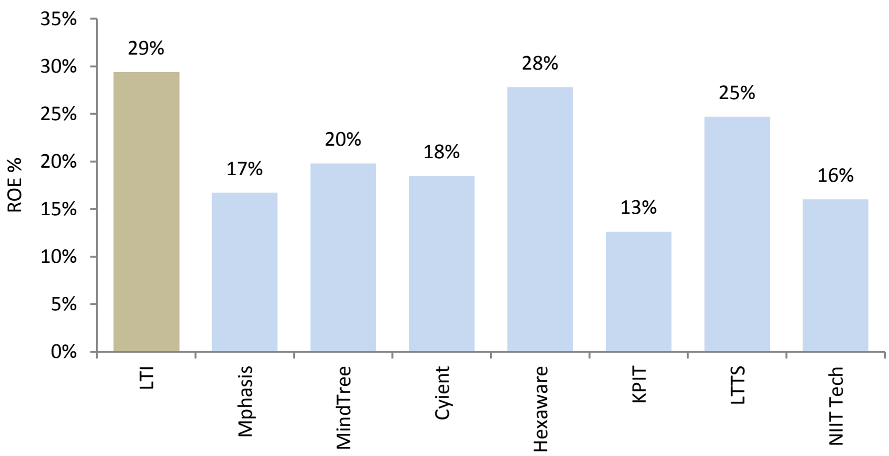
Segment	Client	% of Rev (FY16)	Since
BFSI	Citibank	14.6%	2001
	Barclays	3.1%	2007
	Nordea	NA	NA
O&G	Chevron	5.9%	2004
Media	Time Warner	1.5%	2013
Automotive	Honda	NA	NA

Source: Company, PhillipCapital India Research

Sound capital allocation policy

LTI has followed a high dividend payout policy, with a payout of over 75% over the last three years. This has resulted in ROEs of 45.6%, much superior to mid-cap and even some large-cap IT Services companies. We note that only Hexaware comes close to the payout ratio of LTI – the high ratio at the former driven by its parent PE company.

LTI has one of the best ROEs in the industry



Source: Company, PhillipCapital India Research

On the inorganic front, it has followed a focused acquisition strategy for growth. Rather than just buying out revenues, it has made few but meaningful acquisitions in the last few years. It acquired four companies over the last six years. These acquisitions were either to expand its capabilities or to enter into a new region or both. In November 2017, it acquired Luxembourg-based Syncordis S.A., a provider of pure-play core banking Temenos implementation specialist.

Focussed acquisitions continue to be the growth driver for LTI

Time	Acquired entity	Country	Description	US$mn
Dec 2006	GDA Technologies	US	Electronic Design Services and Silicon Intellectual Provider	NA
Jan 2011	Citigroup Fund Services	Canada	Captive center of Citigroup Canada	47
Oct 2014	ISRC	US	IT unit of Otis Elevator	13
Oct 2016	Augment IQ	India	Big Data Platform	NA
Nov 2017	Syncordis	Europe	To enhance core banking implementation capabilities	23

Source: Company, PhillipCapital India Research

Stable management team

LTI had a series of exits at the top level with four CEO/COO changes over FY12-15. However, in Aug-2015, Mr Sanjay Jalona – who was heading Infosys' manufacturing division earlier – was appointed as the MD and CEO of the company. Mr Jalona has a great track record with Infosys. Under his leadership, LTI strengthened its management team through a series of recruitments at the sales and delivery level.

Stable management team, with excellent past track record

Personnel	Current Role	Previous Role and Organization
Aftab Ullah	COO	BofA captive unit
Sudhir Chaturvedi	President – Sales	COO - NIIT Tech
Rohit Kedia	Head - Manu & ERP, Analytics	Head - Manufacturing, Infosys
Siddharth Bohra	Head - Tech, Media, CRP & Digital, Americas	Head - HiTech, Infosys
Soumendra Mohanty	Chief Digital and Anlytics Officer	Digital Architecture Lead at MindTree

Source: Company, PhillipCapital India Research

Valuations are at a premium, initiate with NEUTRAL

We expect LTI to report 15% USD revenue CAGR over FY17-20. We expect it to report USD revenue growth of 16% in FY18 – we believe it will be able to achieve this because of acceleration in top clients, strong growth across its target verticals (BFSI, Manufacturing) and traction in Digital.

LTI is currently trading at 17x FY20 P/E – a premium to most mid-cap and large-cap IT companies. While we believe it will continue to command premium valuations due to its strong revenue visibility and better business mix (vs mid-cap peers), current valuations appear too expensive to be entering at. We see limited upside potential in near-to-medium term and initiate coverage with price target of Rs 1,420 (17x FY20 earnings) and NEUTRAL rating.

Valuation table: IT services

	CMP	M-Cap	ROE (%)		P/E (x)		P/BV (x)		Div Yield (%)	
Companies	Rs	Rs bn	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
TCS	3,042	5,993	29.4	27.6	20.5	18.6	6.0	5.1	2.0	2.2
Infosys	1,148	2,625	23.5	22.9	15.9	14.4	3.7	3.3	3.0	3.0
Wipro	293	1,417	16.2	16.0	14.7	13.1	2.4	2.1	1.4	1.5
HCL Tech	952	1,345	20.9	19.3	14.2	12.8	3.0	2.5	0.8	0.8
Tech Mahindra	612	537	16.3	16.1	16.8	15.0	2.7	2.4	1.6	1.6
LTI	**1,424**	**243**	**26.0**	**24.5**	**19.9**	**17.1**	**5.2**	**4.2**	**1.1**	**1.1**
LTTS	1,381	140	23.9	23.0	24.2	20.1	5.8	4.6	0.6	0.6
MindTree	805	135	18.8	20.1	22.9	18.3	4.3	3.7	1.1	1.1
Cyient	628	71	18.3	18.3	14.6	12.8	2.7	2.3	1.9	1.9
Persistent	840	67	16.4	16.7	17.0	14.6	2.8	2.4	1.5	1.5
NIIT Tech	832	51	16.9	17.0	15.4	13.5	2.6	2.3	1.8	1.8
Intellect	193	24	5.5	7.0	49.8	36.5	2.8	2.6	-	-
Majesco	475	13	4.3	9.3	54.8	22.9	2.4	2.1	-	-

Source: Company, PhillipCapital India Research

3QFY18 results: Better than expectations

LTI's 3QFY18 results were way ahead of expectations.

- USD revenue at US$ 294mn, grew +19.7% yoy (+8.5% qoq) – significantly above estimates of +2.5% qoq growth.
- EBIT margins expanded +40bps qoq to 14.9% (-40bps yoy), driven by improvement in utilization and lower SG&A expenses – ahead of expectations.
- PAT at Rs 2.8bn, +14% yoy (+3.6% qoq) – above estimates, was driven by higher than expected topline and better margin performance.

Quarterly performance

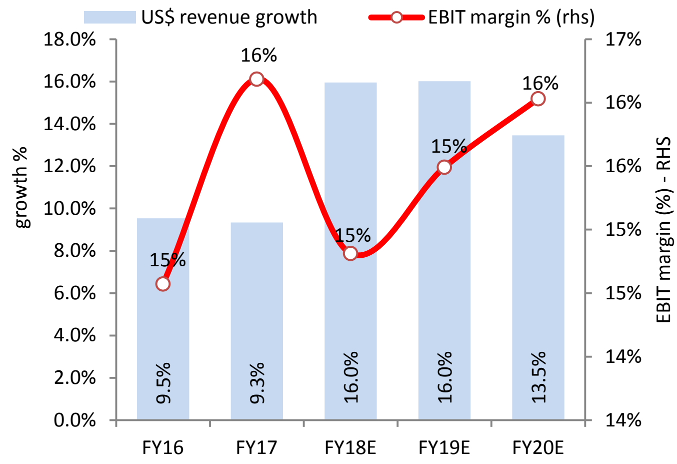
Rs mn	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
US$ revenues	**245**	**254**	**259**	**271**	**294**
QoQ growth %	*2.3%*	*3.7%*	*2.0%*	*4.4%*	*8.5%*
Net sales	**16,667**	**16,772**	**16,707**	**17,508**	**18,838**
QoQ growth %	*4.0%*	*0.6%*	*-0.4%*	*4.8%*	*7.6%*
YoY growth %	*12%*	*8%*	*7%*	*9%*	*13%*
Cost of revenues	9,647	9,384	9,844	10,731	11,020
SGA & other exp	4,002	4,198	4,065	3,835	4,602
EBITDA	**3,018**	**3,190**	**2,798**	**2,942**	**3,216**
QoQ growth %	*-0.9%*	*5.7%*	*-12.3%*	*5.1%*	*9.3%*
YoY growth %	*4%*	*12%*	*-8%*	*-3%*	*7%*
Margins (%)	18.1%	19.0%	16.7%	16.8%	17.1%
Depreciation	469	417	393	406	403
EBIT	**2,549**	**2,773**	**2,405**	**2,536**	**2,813**
Margins (%)	15.3%	16.5%	14.4%	14.5%	14.9%
Interest expenses	11	0	35	36	35
Other income incl FX	609	502	1,119	1,053	917
Pre-tax profit	**3,147**	**3,275**	**3,489**	**3,553**	**3,695**
Tax provided	667	730	817	823	867
Profit after tax	**2,480**	**2,545**	**2,672**	**2,730**	**2,828**
QoQ growth %	*6.6%*	*2.6%*	*5.0%*	*2.2%*	*3.6%*
YoY growth %	*10%*	*11%*	*13%*	*17%*	*14%*
Margins (%)	14.9%	15.2%	16.0%	15.6%	15.0%
Minority interest	0	0	0	0	0
PAT (after MI)	**2,480**	**2,545**	**2,672**	**2,730**	**2,828**
EPS, Rs	14.6	14.9	15.7	16.0	16.5

Source: Company, PhillipCapital India Research

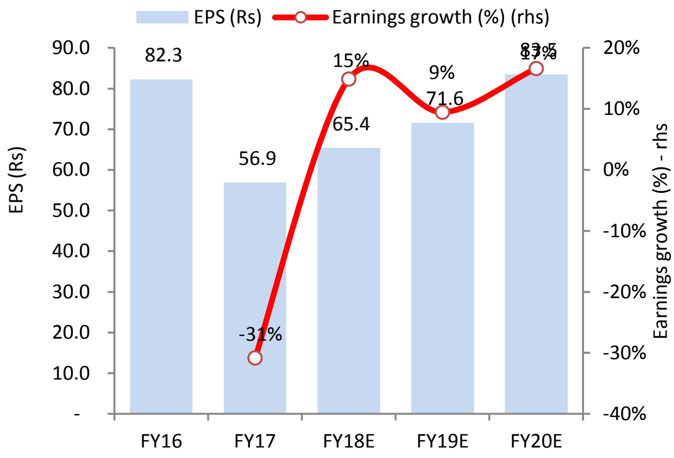
Key takeaways from the conference call:

- The higher revenue performance was driven by: (1) 2.2% qoq incremental revenue from India pass-through, (2) 0.7% qoq (US$ 1.9mn) from Syncordis acquisition. Organic USD revenue growth at +5.4% qoq.
- Volume growth of 4.3% qoq.
- Verticals: BFSI grew +19% yoy (+5.3% qoq) and Manufacturing grew +15.7% yoy (+16.6% qoq).
- Geographies: Growth driven by US and Europe, which grew +17.8% yoy each (+3.7%/+11.6% qoq respectively).
- It won 17 new clients, of which 3 were F-500 companies
- Digital is now 33% of its revenue; grew +41% yoy, +12% qoq

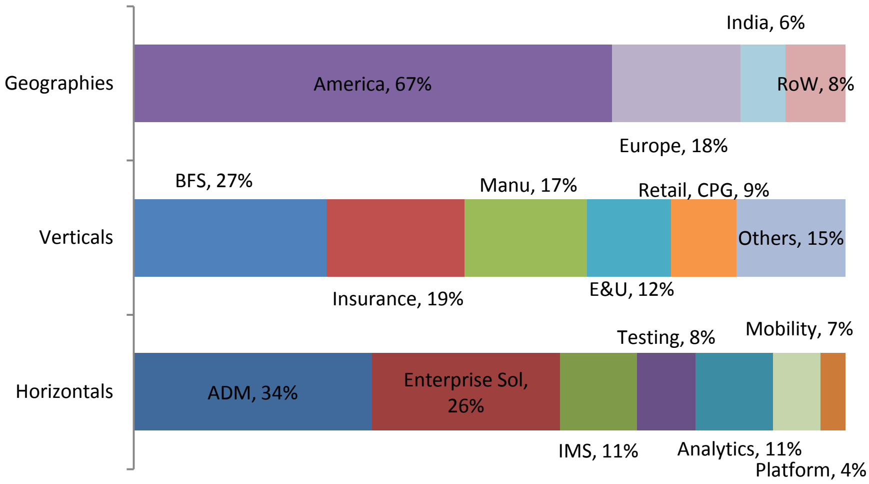
Revenue growth and Margins profile

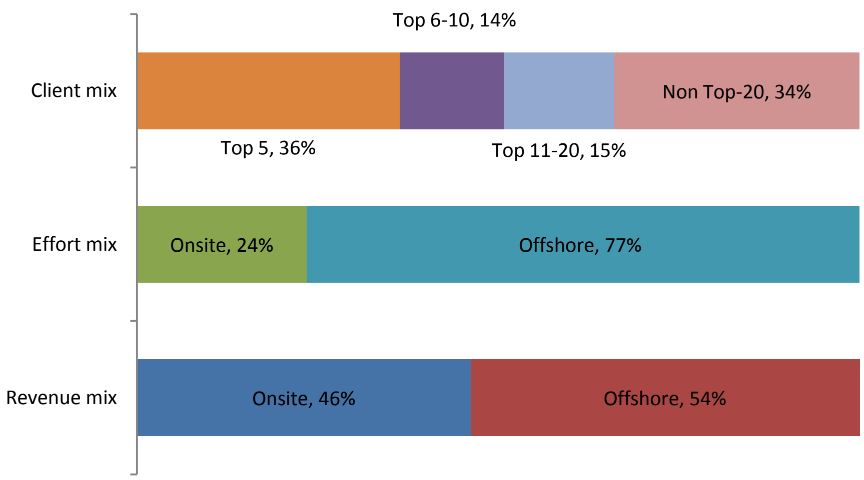


Earnings growth profile



LTI – Business profile





Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**65,009**	**72,648**	**84,824**	**96,243**
Growth, %	11	12	17	13
Total income	65,009	72,648	84,824	96,243
Employee expenses	-37,529	-43,071	-49,206	-55,926
Other Operating expenses	-15,177	-17,205	-20,782	-23,098
EBITDA (Core)	**12,303**	**12,373**	**14,836**	**17,219**
Growth, %	19.9	0.6	19.9	16.1
Margin, %	18.9	17.0	17.5	17.9
Depreciation	-1,780	-1,611	-1,694	-1,789
EBIT	**10,523**	**10,762**	**13,142**	**15,430**
Growth, %	23.5	2.3	22.1	17.4
Margin, %	16.2	14.8	15.5	16.0
Interest paid	-17	-141	-140	-140
Other Income	1,852	3,967	3,067	3,453
Pre-tax profit	**12,358**	**14,588**	**16,069**	**18,743**
Tax provided	-2,649	-3,431	-3,857	-4,498
Profit after tax	**9,709**	**11,157**	**12,213**	**14,244**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**9,709**	**11,157**	**12,213**	**14,244**
Growth, %	16.1	14.9	9.5	16.6
Net Profit (adjusted)	**9,709**	**11,157**	**12,213**	**14,244**
Wtd avg shares (m)	171	171	171	171

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**970**	**1,125**	**1,305**	**1,481**
Growth, %	9.3	16.0	16.0	13.5
Re / US$ (rate)	67.0	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	3,795	3,592	8,429	14,915
Debtors	16,421	20,400	23,003	26,227
Loans & advances	4,854	5,274	5,885	6,594
Other current assets	0	0	0	0
Total current assets	25,070	29,267	37,316	47,736
Investments	9,406	11,044	13,044	15,044
Net fixed assets	5,432	6,979	7,379	7,779
Non-current assets	2,280	2,362	2,663	3,037
Total assets	**44,344**	**51,898**	**62,649**	**75,842**
Current liabilities	10,365	10,461	11,805	13,467
Provisions	2,056	3,014	3,401	3,880
Total current liabilities	12,421	13,475	15,207	17,348
Non-current liabilities	472	464	464	464
Total liabilities	12,893	13,939	15,671	17,812
Paid-up capital	171	172	172	172
Reserves & surplus	31,280	37,787	46,806	57,858
Shareholders' equity	31,451	37,959	46,978	58,030
Total equity & liabilities	**44,344**	**51,898**	**62,649**	**75,842**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	12,358	14,588	16,069	18,743
Depreciation	1,780	1,611	1,694	1,789
Chg in working capital	-1,763	-3,428	-1,783	-2,165
Total tax paid	-1,490	-3,529	-3,857	-4,498
Cash flow from operating activities	**10,885**	**9,242**	**12,124**	**13,868**
Capital expenditure	-641	-3,158	-2,094	-2,189
Chg in investments	-8,977	-1,638	-2,000	-2,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-9,618**	**-4,796**	**-4,094**	**-4,189**
Free cash flow	1,267	4,446	8,030	9,680
Equity raised/(repaid)	1	1	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-3,298	-3,193	-3,193	-3,193
Other financing activities	3,789	-1,456	0	0
Cash flow from financing activities	**492**	**-4,649**	**-3,193**	**-3,193**
Net chg in cash	1,759	-203	4,836	6,486

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	56.9	65.4	71.6	83.5
Growth, %	(30.8)	14.9	9.5	16.6
Book NAV/share (INR)	184.4	222.5	275.4	340.2
CEPS (INR)	67.4	74.8	81.5	94.0
CFPS (INR)	42.0	34.5	50.9	58.3
DPS (INR)	16.5	16.0	16.0	16.0
Return ratios				
Return on assets (%)	25.6	23.4	21.5	20.7
Return on equity (%)	30.9	29.4	26.0	24.5
Return on capital employed (%)	34.0	29.8	26.7	25.3
Turnover ratios				
Asset turnover (x)	3.1	2.9	2.9	3.0
Sales/Total assets (x)	1.7	1.5	1.5	1.4
Sales/Net FA (x)	10.8	11.7	11.8	12.7
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	92.2	102.5	99.0	99.5
Payable days	23.3	21.5	20.9	21.1
Working capital days	61.3	76.4	73.5	73.4
Liquidity ratios				
Current ratio (x)	2.4	2.8	3.2	3.5
Quick ratio (x)	2.4	2.8	3.2	3.5
Interest cover (x)	619.0	76.3	93.9	110.2
Dividend cover (x)	3.4	4.1	4.5	5.2
Total debt/Equity (%)	18.6	14.0	12.8	11.8
Net debt/Equity (%)	6.5	4.5	(5.2)	(13.9)
Valuation				
PER (x)	25.3	22.0	20.1	17.2
PEG (x) - y-o-y growth	(0.8)	1.5	2.1	1.0
Price/Book (x)	7.8	6.5	5.2	4.2
Yield (%)	1.1	1.1	1.1	1.1
EV/Net sales (x)	3.8	3.4	2.9	2.5
EV/EBITDA (x)	20.1	20.0	16.4	13.8
EV/EBIT (x)	23.5	23.0	18.5	15.4

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

L&T Technology Services (LTTS IN)

Engineering in the DNA; valuations expensive

INDIA | IT SERVICES | Company Update

28 February 2018

LTTS' stock price has increased 51% over the last six months due to better-than-expected performance in the last two quarters, and anticipation of highest revenue growth (18%) among the Indian IT companies for FY18. It now trades at a valuation of 20x FY19 and 17x FY20 earnings – a significant premium to its peers. While we really like the business model, and it expertise in the ERD domain, we believe current valuations leave little upside in the near to medium term. Downgrade to Neutral, purely on valuation concerns.

Fastest growing company in the sector: LTTS has reported 15% yoy growth in 9MFY18 (12% organic) – and is all set to report more than 18% growth for the full year (15.5% organic) – by far, the highest in the sector. The growth is driven by strong deal-flow momentum in last two quarters (won US$ 250mn of deals). We expect the strong deal momentum to continue and drive growth in FY19 and beyond.

Telecom on a recovery path driven by Esencia: Telecom (24% of revenue) has remained volatile for LTTS due to macro (highly competitive domain) and micro (ramp-down by one of its biggest clients in FY16) reasons. However, in the last four quarters, the segment has seen strong recovery with CQGR of 20% (18% organic), driven by large deal wins and acquisition of Esencia – a US-based service provider in Digital Signal Processing for Communications, Video Security, and Networking. While the growth might not sustain at these levels, we see strong growth potential for the domain going forward.

Transport: LTTS continues to see strong traction in this domain (32% of revenue). Over the last seven quarters, the segment has reported a CQGR of 3%. It is associated with some marquee clients such as BMW, Calsonic Kansei, Scania, Harley Davidson, Honda, Boeing, Airbus, Thales, and Daimler. The management remains highly optimistic about the domain, with fuel-efficient energy cars changing the dynamics of the automotive industry and core business of auto electronics gradually becoming non-core.

Process design to bottom-out in FY18: Process design is a segment with very little presence of Indian/global ESO companies. This domain involves part/complete design of plants for various chemical, FMCG, and petroleum companies. LTTS has a competitive advantage in this domain and has been able to make inroads into many clients (Shell, Unilever, P&G) because of its parent company L&T. The segment had declined 15% in FY17, due to lower incremental capex by clients in E&U and retail segments. With crude prices now inching up, and retail companies looking to expand capacity, the management expects a revival in the segment. It reported 8% qoq (3% yoy) growth in Q3, after two years of muted performance.

IP monetization to aide margin: LTTS is betting big on monetization of its IPs. It is looking to develop plug-and-play solutions for various industries through them, and monetize them to implement the 'develop once deploy multiple' strategy. It has developed various IP platforms like UBIQWeise, WAGES, and I-BEMS. It intends to increase the higher-margin IP revenue (US$ 4.5mn in FY17). Any traction in IP business can lead to significant margin expansion (US$ 1mn of increase in IP revenue results in 80bps margin expansion).

Outlook and valuations: We expect revenue CAGR of 16% over FY17-20 — highest in our coverage universe. The management is confident of USD revenue growth of ATLEAST 18% in FY18 and double-digit USD revenue growth for FY19 – both achievable in our opinion. We continue to like companies in the ERD space (read our detailed report here). We upgrade our target multiple to 18x PE (16x earlier, premium to Cyient @ 15x), on LTTS' much superior revenue and earnings growth visibility. However, we downgrade to Neutral on expensive valuations. Our target is Rs 1,240 (*Rs 1,090 earlier)*.

Downgrade to NEUTRAL

CMP RS 1381

TARGET RS 1240 (-10%)

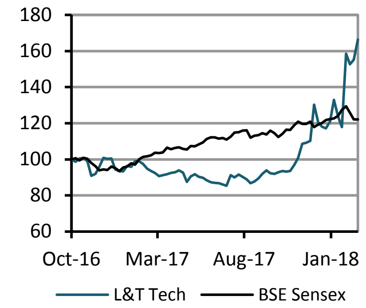
COMPANY DATA

O/S SHARES (MN) :	102
MARKET CAP (RSBN) :	141
MARKET CAP (USDBN) :	2.2
52 - WK HI/LO (RS) :	1547 / 671
LIQUIDITY 3M (USDMN) :	2.2
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	89.3	89.5	89.8
FII / NRI :	3.2	3.1	3.2
FI / MF :	1.1	1.1	1.1
NON PRO :	0.8	0.5	0.2
PUBLIC & OTHERS :	5.7	5.8	5.7

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	37,033	43,242	50,157
EBIT	5,203	6,708	8,040
Net Profit	4,800	5,803	6,981
EPS, Rs	47.2	57.1	68.7
PER, x	29.7	24.5	20.4
EV/EBIT, x	27.5	21.1	17.3
P/BV, x	7.3	5.9	4.7
ROE, %	24.7	23.9	23.0

Source: PhillipCapital India Research Est.

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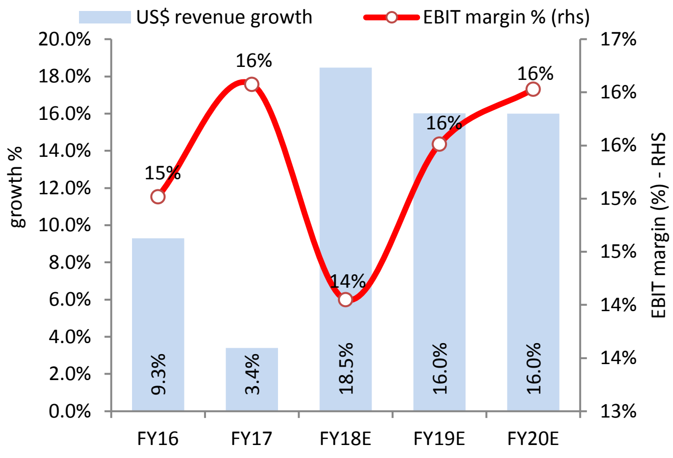
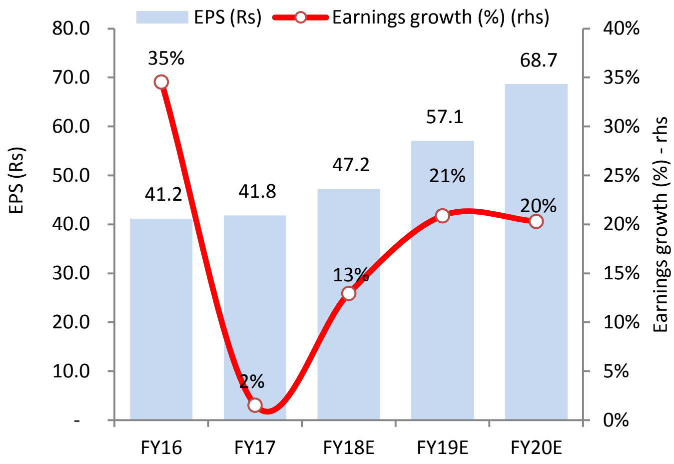
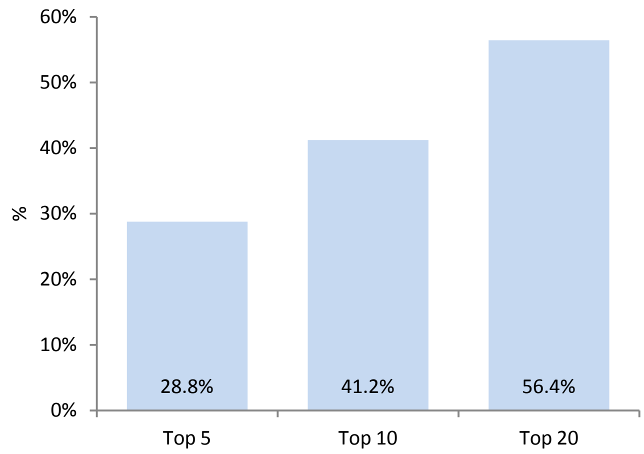
Revenue growth and Margins profile



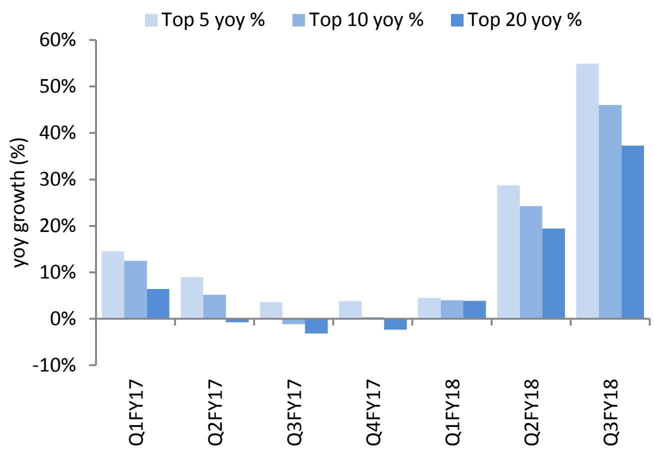
Earnings growth profile



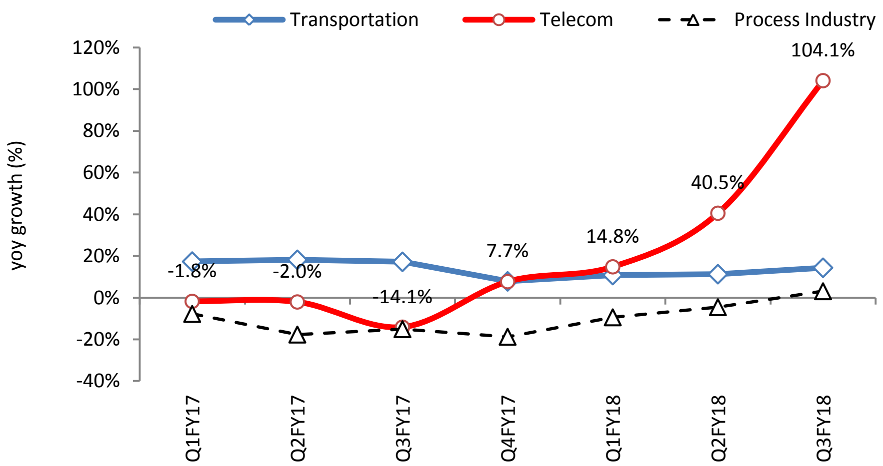
Client concentration remains high for LTTS ....



..... and is helping it report strong growth



Vertical growth rate (yoy) over last few quarters



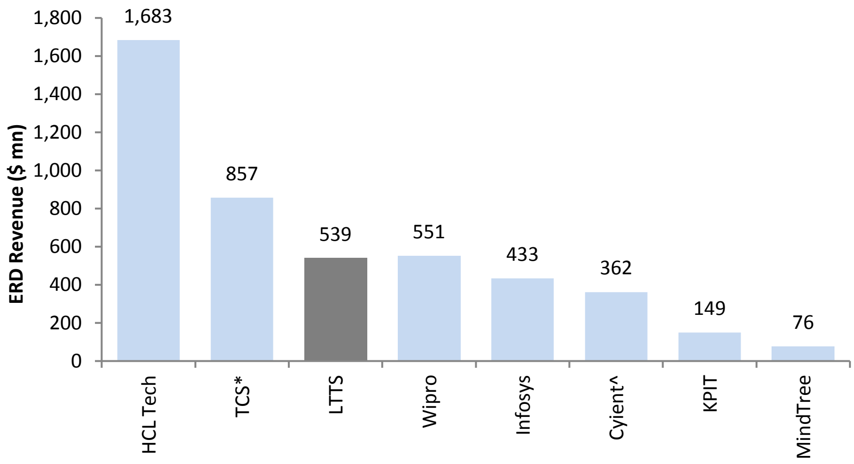
Source: Company, PhillipCapital India Research

LTTS has deployed a focussed acquisition strategy

Time	Company	Remarks	Consideration
May '17	Esencia Technologies (US)	Embedded Systems and Perceptual Computing	$27 mn
Nov '14	Dell USA	Engineering Services Division	$12.2mn
July '14	Dell India	Engineering Services Division	Rs 13.6mn
Jun '14	Thales Software India Pvt Ltd	74% of stake	Rs 60.4mn

Source: Company, PhillipCapital India Research

Indian IT – ERD revenue comparison (TTM, USD mn)



Source: Companies, PhillipCapital India Research; * FY17 revenues

WAGES – A unique IP with immense potential

With constant fluctuations in prices of commodities like coal, gas, and crude, companies are finding it difficult to maintain operational expenditure of their plants. To insulate themselves from changes in commodity prices, they explore different ways to minimise plant operating costs. With legacy systems as part of most companies' core infrastructure, a natural starting point for them is to transition to smarter digital outfits, with advanced capabilities. WAGES solution (Water, Air, Gas, Electricity, Steam) developed by LTTS helps companies identify, audit, monitor, engineer, deploy, and meter wages. It includes measuring data on-site, conducting analysis, site auditing, producing assessment and reports, and consulting on potential energy-saving schema.

WAGES solution (Water, Air, Gas, Electricity, Steam) developed by LTTS helps companies identify, audit, monitor, engineer, deploy, and meter wages

Wages' value proposition

Source: Company, PhillipCapital India Research

Use Cases of WAGES

LTTS completed the audit for 28 sites of a global manufacturing consumer packaged goods in four months. It identified potential opportunities for energy conversation worth US$ 18mn for this client and aligned and cloud-hosted audit data at the enterprise level.

- For one of its industrial clients, LTTS evaluated and consulted on the energy consumption of a waste-heat recovery system, which resulted in reduced natural gas usage by 200 lb/hour and hot-water boiler requirements by half.
- For a beverage company, it designed and installed a zero liquid discharge facility across countries, reduced cost by 10%, and savings from design optimisation by 20%.

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**32,483**	**37,033**	**43,242**	**50,157**
Growth, %	6	14	17	16
Total income	32,483	37,033	43,242	50,157
Employee expenses	-20,958	-24,422	-28,662	-32,850
Other Operating expenses	-5,678	-6,825	-7,265	-8,627
EBITDA (Core)	**5,847**	**5,786**	**7,316**	**8,680**
Growth, %	12.6	(1.0)	26.4	18.6
Margin, %	18.0	15.6	16.9	17.3
Depreciation	-625	-583	-607	-639
EBIT	**5,222**	**5,203**	**6,708**	**8,040**
Growth, %	13.4	(0.4)	28.9	19.9
Margin, %	16.1	14.1	15.5	16.0
Interest paid	-21	-19	-10	-10
Other Income	591	1,449	1,144	1,404
Pre-tax profit	**5,792**	**6,634**	**7,842**	**9,434**
Tax provided	-1,542	-1,834	-2,039	-2,453
Profit after tax	**4,250**	**4,800**	**5,803**	**6,981**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**4,250**	**4,800**	**5,803**	**6,981**
Growth, %	1.5	13.0	20.9	20.3
Net Profit (adjusted)	**4,250**	**4,800**	**5,803**	**6,981**
Wtd avg shares (m)	102	102	102	102

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**484**	**573**	**665**	**772**
Growth, %	3.4	18.5	16.0	16.0
Re / US$ (rate)	67.1	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	674	2,555	4,858	7,390
Debtors	7,106	8,863	9,886	11,622
Loans & advances	2,328	2,589	2,410	2,670
Other current assets	0	0	0	0
Total current assets	10,108	14,007	17,153	21,683
Investments	1,946	1,969	3,569	5,169
Net fixed assets	6,161	7,392	7,792	8,192
Non-current assets	3,779	4,321	4,819	5,666
Total assets	**22,317**	**28,010**	**33,654**	**41,030**
Current liabilities	6,194	6,931	7,549	8,599
Provisions	1,271	1,516	1,691	1,988
Total current liabilities	7,465	8,448	9,240	10,587
Non-current liabilities	0	118	118	118
Total liabilities	7,465	8,566	9,358	10,705
Paid-up capital	203	204	204	204
Reserves & surplus	14,649	19,241	24,092	30,121
Shareholders' equity	14,852	19,445	24,296	30,325
Total equity & liabilities	**22,317**	**28,010**	**33,654**	**41,030**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	5,792	6,634	7,842	9,434
Depreciation	625	583	607	639
Chg in working capital	-3,832	-1,578	-549	-1,497
Total tax paid	-835	-1,714	-2,039	-2,453
Cash flow from operating activities	**1,750**	**3,926**	**5,862**	**6,124**
Capital expenditure	-465	-1,814	-1,007	-1,039
Chg in investments	-1,391	-23	-1,600	-1,600
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,856**	**-1,837**	**-2,607**	**-2,639**
Free cash flow	-106	2,089	3,254	3,485
Equity raised/(repaid)	-2,797	1	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-834	-952	-952	-952
Other financing activities	3,577	743	0	0
Cash flow from financing activities	**-54**	**-208**	**-952**	**-952**
Net chg in cash	-160	1,881	2,303	2,533

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	41.8	47.2	57.1	68.7
Growth, %	1.5	13.0	20.9	20.3
Book NAV/share (INR)	146.1	191.2	238.9	298.2
CEPS (INR)	47.9	52.9	63.0	74.9
CFPS (INR)	30.0	30.9	48.8	50.5
DPS (INR)	7.0	8.0	8.0	8.0
Return ratios				
Return on assets (%)	20.4	19.1	18.8	18.7
Return on equity (%)	28.6	24.7	23.9	23.0
Return on capital employed (%)	30.4	25.9	24.6	23.9
Turnover ratios				
Asset turnover (x)	2.7	2.6	2.7	2.9
Sales/Total assets (x)	1.6	1.5	1.4	1.3
Sales/Net FA (x)	5.2	5.5	5.7	6.3
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	79.8	87.4	83.4	84.6
Payable days	25.3	26.6	25.8	26.2
Working capital days	36.4	44.6	40.1	41.4
Liquidity ratios				
Current ratio (x)	1.6	2.0	2.3	2.5
Quick ratio (x)	1.6	2.0	2.3	2.5
Interest cover (x)	248.7	280.0	648.5	777.3
Dividend cover (x)	6.0	5.9	7.1	8.6
Total debt/Equity (%)	24.5	18.1	15.5	13.9
Net debt/Equity (%)	20.0	4.9	(4.5)	(10.5)
Valuation				
PER (x)	33.5	29.7	24.5	20.4
PEG (x) - y-o-y growth	21.9	2.3	1.2	1.0
Price/Book (x)	9.6	7.3	5.9	4.7
Yield (%)	0.5	0.6	0.6	0.6
EV/Net sales (x)	4.5	3.9	3.3	2.8
EV/EBITDA (x)	24.9	24.8	19.3	16.0
EV/EBIT (x)	27.8	27.5	21.1	17.3

MindTree (MTCL IN)

Good franchise; Turning around; Valuations expensive

INDIA | IT Services | Company Update

28 February 2018

MTCL, not so long ago, was the poster boy of mid-cap companies. Born digital, it had a superior digital portfolio (42% of its revenues) and marquee clients (Microsoft, Unilever etc). For three consecutive years through FY14-16, it reported the highest growth in the sector, and its valuation multiple remained the highest in the mid-cap space. However, with a change in management, its fortunes started to dwindle. It lost key personnel to competition, the acquisition didn't play out as expected, and margins nosedived as growth receded to single digits. While MTCL has shown signs of a turnaround recently, we believe it needs to do more to deserve the multiple it currently trades at. Maintain Neutral.

3QFY18 performance – manifestation of an imminent turnaround in business

MTCL reported a strong performance in Q3, with 11.5% yoy growth in USD revenues, driven by increase in price realisation and stable performance from its subsidiaries (Bluefin and Magnet 360). All its verticals (except seasonally weak retail) and geographies (except RoW) reported double-digit yoy growth. Margin performance was also extremely strong (EBIT margins of 12% – a 380bps qoq expansion and highest in the last seven quarters). Even on the TCV front, it reported strong 18% qoq growth (US$ 244mn) with 57% qoq growth (+28% yoy) in digital deals. The overall strong performance, on all fronts, was accompanied with a highly sanguine outlook by the management – clear signs of a significant turnaround.

Europe stabilising with recovery in Bluefin business

MTCL acquired UK-based Bluefin solutions, a SAP HANA solutions provider, in June 2015. This helped it to expand its consulting-led onsite implementation across UK, US, and Singapore. However, the unexpected Brexit in June-2016 resulted in a delay in new deal signing across the European region. With majority of its clients in this region, MTCL's Europe revenue declined at a CQGR of 2.1% over Q1FY17-Q1FY18. However, with the stabilized business and improved dealflow in Bluefin, Europe has rebounded with strong 12% average yoy revenue growth over the last two quarters.

Digital portfolio gaining traction, after few hiccups in FY17

MTCL had superior delivery capabilities in the digital space vs. its Indian peers – probably because the company was 'born digital'. Its acquisitions of Discoverture, Bluefin, Relational, and Magnet 360 – were all in the digital space (to enhance delivery capabilities), and acquired at inexpensive valuations. In Sep-2016, Ms Radha R, Head - Digital, who was instrumental in building the digital portfolio, left the organization. This, coupled with global events like Brexit and US elections, led to muted digital revenue performance over FY17. However, with a new leadership team in Digital, it reported stellar 15% revenue growth for 9MFY18. Digital now consists of 42% of revenue, highest among the Indian IT companies.

Strong orderbook provides visibility for growth

Over the last twelve months, MTCL has won deals worth US$ 922mn – a book-to-bill of 1.1x, of which US$ 374mn (40% of total) is in Digital. The company is witnessing a strong deal pipeline in its focused verticals of Technology & Media and Travel & Hospitality, while BFSI and Retail, impacted by structural challenges, are seeing moderate demand.

Outlook and valuations – good franchise, but expensive valuations

MindTree has reported strong performance in the last two quarters – in both revenue and margins. Though the TCV won during this quarter still reflect a declining trend yoy, we believe it was largely due to the one large deal win in Q3FY17. We upgrade our target multiple to 17x PE (15x earlier) on the back of strong deal pipeline, stable subsidiaries performance and improved margin profile. However, current valuations still appear expensive, after the sharp 33% surge in stock price in recent weeks, leaving limited upside. Maintain NEUTRAL with price target of Rs 750 (*Rs 550 earlier*).

NEUTRAL (Maintain)

CMP RS 805

TARGET RS 750 (-7%)

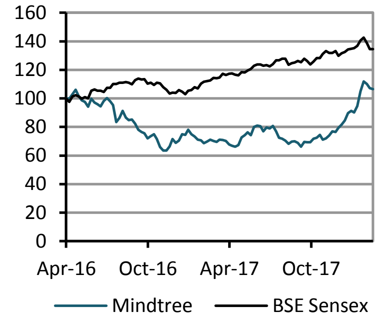
COMPANY DATA

O/S SHARES (MN) :	164
MARKET CAP (RSBN) :	128
MARKET CAP (USDBN) :	2.0
52 - WK HI/LO (RS) :	787 / 433
LIQUIDITY 3M (USDMN) :	13.3
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	13.6	13.6	13.6
FII / NRI :	41.4	40.7	40.4
FI / MF :	7.6	5.2	6.3
NON PRO :	11.4	12.4	12.5
PUBLIC & OTHERS :	25.9	28.0	27.1

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	54,411	61,308	68,678
EBIT	5,497	7,055	8,911
Net Profit	5,287	5,751	7,215
EPS, Rs	32.3	35.1	44.0
PER, x	25.0	22.9	18.3
EV/EBIT, x	24.1	18.3	14.1
P/BV, x	4.9	4.3	3.7
ROE, %	19.8	18.8	20.1

Source: PhillipCapital India Research Est.

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Vibhor Singhal (+ 9122 6246 4109)
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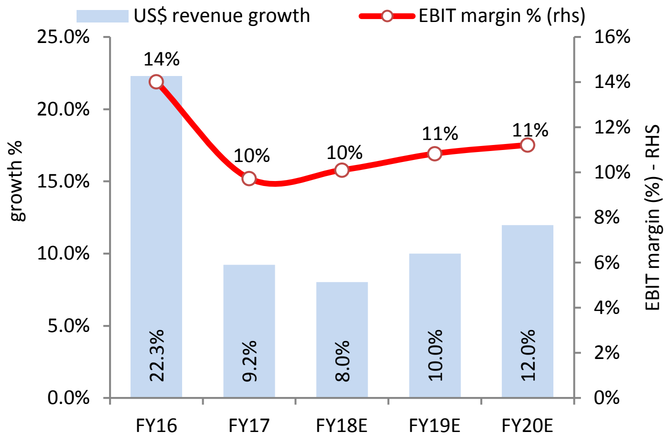
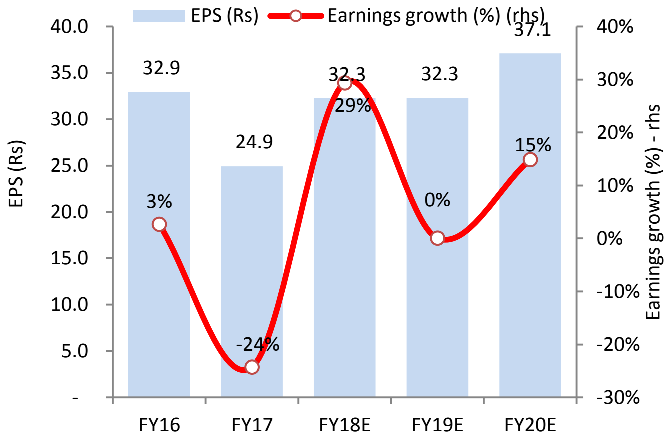
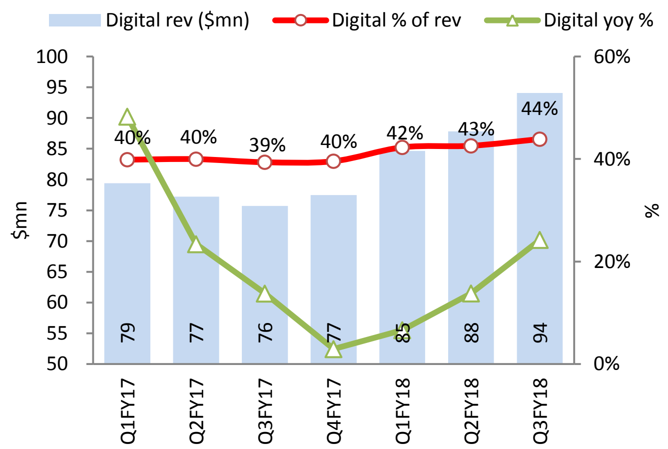
Revenue growth and Margins profile



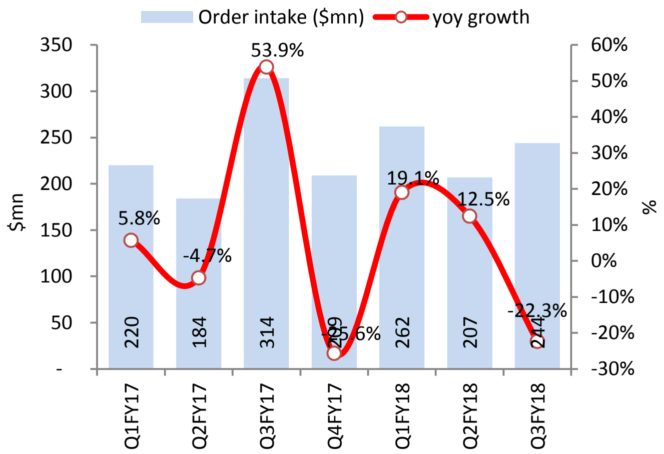
Earnings growth profile



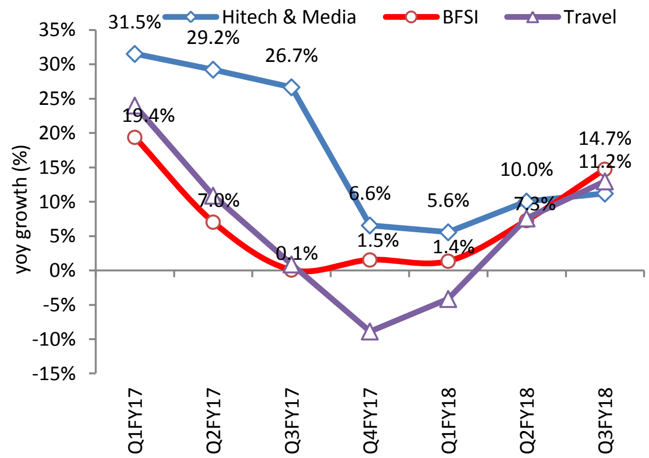
Digital revenues picking up momentum



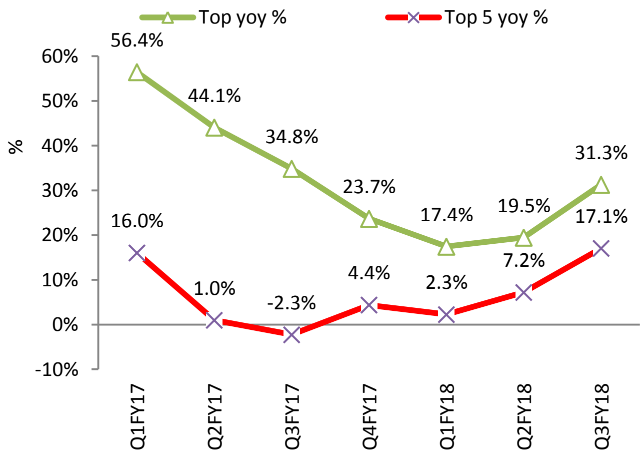
Order intake has remained in upward trajectory



Vertical growth rate (yoy) over last few quarters



Top clients performance improving



MindTree acquired four cutting edge technology firms in 2015-16

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Jan '16	Magnet 360	US	Salesforce platform	50	25
Jul '15	Relational Solutions Inc	US	IT solutions - CPG	10	3
Jul '15	Bluefin Solutions	UK	IT solutions, SAP HANA solutions	63.5	48
Jan '15	Discoverture Solutions	US	P&C Insurance	15	14
				138.5	**90.0**

Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**52,364**	**54,411**	**61,308**	**68,678**
Growth, %	12.1	3.9	12.7	12.0
Total income	52,364	54,411	61,308	68,678
Employee expenses	-34,125	-35,604	-40,193	-44,601
SG&A	-11,286	-11,555	-12,262	-13,186
EBITDA (Core)	**6,953**	**7,252**	**8,854**	**10,890**
Growth, %	(15.3)	4.3	22.1	23.0
Margin, %	13.3	13.3	14.4	15.9
Depreciation	-1,858	-1,755	-1,799	-1,980
EBIT	**5,095**	**5,497**	**7,055**	**8,911**
Growth, %	(22.2)	7.9	28.3	26.3
Margin, %	9.7	10.1	11.5	13.0
Other Operating expenses	645	1,455	797	893
Pre-tax profit	**5,549**	**6,796**	**7,668**	**9,619**
Tax provided	-1,363	-1,508	-1,917	-2,405
Profit after tax	**4,186**	**5,287**	**5,751**	**7,215**
Net Profit	**4,186**	**5,287**	**5,751**	**7,215**
Growth, %	(24.2)	26.3	8.8	25.5
Net Profit (adjusted)	**4,186**	**5,287**	**5,751**	**7,215**
Wtd avg shares (m)	168	164	164	164

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**780**	**842**	**943**	**1,057**
Growth, %	9.2	8.0	12.0	12.0
Re / US$ (rate)	67.2	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	2,508	2,159	5,056	9,044
Debtors	8,962	9,800	10,623	12,314
Loans & advances	3,113	3,536	3,536	3,536
Other current assets	1,034	1,027	1,114	1,291
Total current assets	15,617	16,522	20,328	26,185
Investments	5,927	7,542	7,542	7,542
Gross fixed assets	10,220	9,497	10,097	10,697
Add: Capital WIP	192	326	326	326
Net fixed assets	10,412	9,823	10,423	11,023
Non-current assets	1,326	1,595	1,595	1,595
Total assets	**33,906**	**35,938**	**40,344**	**46,801**
Current liabilities	6,716	7,827	8,276	9,197
Provisions	1,105	1,298	1,407	1,631
Total current liabilities	7,821	9,125	9,683	10,828
Non-current liabilities	314	95	95	95
Total liabilities	8,135	9,220	9,778	10,923
Paid-up capital	1,680	1,639	1,639	1,639
Reserves & surplus	24,091	25,079	28,927	34,240
Shareholders' equity	25,771	26,718	30,566	35,879
Total equity & liabilities	**33,906**	**35,938**	**40,344**	**46,801**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	5,549	6,796	7,668	9,619
Depreciation	1,858	1,755	1,799	1,980
Chg in working capital	1,117	-626	-461	-948
Total tax paid	-1,762	-1,147	-1,808	-2,181
Cash flow from operating activities	**6,762**	**6,777**	**7,198**	**8,471**
Capital expenditure	-418	-1,166	-2,399	-2,580
Chg in investments	-3,599	-1,615	0	0
Cash flow from investing activities	**-4,017**	**-2,781**	**-2,399**	**-2,580**
Free cash flow	2,745	3,996	4,798	5,891
Equity raised/(repaid)	2	-2,700	0	0
Debt raised/(repaid)	-5	-4	0	0
Dividend (incl. tax)	-1,950	-1,712	-1,712	-1,712
Other financing activities	-616	-2,629	-190	-190
Cash flow from financing activities	**-2,569**	**-4,345**	**-1,902**	**-1,902**
Net chg in cash	176	-349	2,896	3,989

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	24.9	32.3	35.1	44.0
Growth, %	(24.3)	29.4	8.8	25.5
Book NAV/share (INR)	153.5	163.0	186.5	218.9
FDEPS (INR)	24.9	32.3	35.1	44.0
CEPS (INR)	36.0	43.0	46.1	56.1
CFPS (INR)	33.1	24.9	39.1	46.2
DPS (INR)	10.0	9.0	9.0	9.0
Return ratios				
Return on assets (%)	12.9	15.4	15.4	16.8
Return on equity (%)	16.2	19.8	18.8	20.1
Return on capital employed (%)	16.9	20.4	20.4	22.0
Turnover ratios				
Asset turnover (x)	2.8	3.0	3.2	3.3
Sales/Total assets (x)	1.6	1.6	1.6	1.6
Sales/Net FA (x)	4.7	5.4	6.1	6.4
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	62.5	65.7	63.2	65.4
Payable days	13.3	13.4	13.1	13.7
Working capital days	36.9	35.1	33.3	33.6
Liquidity ratios				
Current ratio (x)	2.0	1.8	2.1	2.4
Quick ratio (x)	2.0	1.8	2.1	2.4
Dividend cover (x)	2.5	3.6	3.9	4.9
Total debt/Equity (%)	3.8	9.4	8.2	7.0
Net debt/Equity (%)	(5.9)	1.3	(8.4)	(18.2)
Valuation				
PER (x)	32.3	25.0	22.9	18.3
PEG (x) - y-o-y growth	(1.3)	0.8	2.6	0.7
Price/Book (x)	5.2	4.9	4.3	3.7
Yield (%)	1.2	1.1	1.1	1.1
EV/Net sales (x)	2.6	2.4	2.1	1.8
EV/EBITDA (x)	19.2	18.2	14.6	11.5

PhillipCapital

Cyient Limited (CYL IN)

All set for take-off; valuations attractive

INDIA | IT SERVICES | Company Update

28 February 2018

Cyient's stock price has jumped 10% over the last one month on its superior performance in 3QFY18. Despite weak DLM performance (revenue pushed to the next quarter), Cyient reported 12% yoy growth on strong deal wins in the last few quarters. For FY18, it has maintained its double-digit USD revenue growth guidance – easily achievable in our opinion. It now trades at a valuation of 15x FY19 and 13x FY20 earnings – at a significant discount to LTTS. We maintain BUY.

Domain expertise in aerospace to drive growth

Cyient generates 35% of its revenues from aerospace, working with companies like P&W, Boeing, Airbus, and Bombardier. It has a leadership position in the new engine designs and Zinnov has ranked it a leader in the aerospace vertical. After acquiring Rangsons in 2015, it was able to extend its offerings to design *and* manufacturing (from only design earlier). The division has seen a CQGR of 3% over the last four quarters – we expect strong performance to continue, driven by its domain expertise.

Transport back on track after subdued FY17 (which was largely due to cross currency)

Cyient reported modest revenue growth of 7.3% in transport in FY17. As a majority of its clients in the transport segment are in the European region, the sharp depreciation in GBP/EUR resulted in a significant CC impact, which led to moderate USD revenue growth. The segment has reported 25% yoy average growth in last four quarters, driven by momentum in key accounts. With increased traction from its focus segments of rolling stock and signalling, we expect the strong performance to continue.

Acquisitions to fill in the white spaces

Over the last few years, Cyient has acquired six companies across verticals and geographies. These acquisitions have helped it in enhance its capabilities and deepening its partnership with a few of its strategic clients (such as Pratt & Whitney). It has also invested for a minority stake in one start-up venture and made an IP investment through a partnership.

S3 strategy – paying rich dividends

With the acquisition of Rangsons, Cyient forayed into manufacturing and testing, expanding its capabilities in the product lifecycle. In FY16, it announced its 'S3' strategy, where it targets 50% revenues from systems, 30% from solutions, and 20% from services by 2020 vs. 80:20 share of services and systems at present.

Outlook and valuations

We expect revenue/earnings CAGR of 12%/17% over FY17-20. It will achieve FY18 growth of 12% driven by (1) acceleration in top clients and (2) superior business mix. Recent acquisitions of Blom Aerofilms and Certon Software will lead to industry-leading growth in FY18, and beyond. We continue to believe that companies like Cyient, which have significant presence in the ERD space, will be less impacted by the current digital transformation cycle, and hence, will report superior growth over their traditional IT peers (read our detailed report **here**).

Currently, Cyient is trading at 13x FY20 PE – a sharp discount to its fraternal twin LTTS. While part of this discount is attributable to LTTS being a 100% ERD business (Cyient - 63%) and growing at a higher rate, we find the magnitude of the discount unwarranted. We value Cyient at 15x FY20 earnings – at discount to our target multiple for LTTS (18x). Maintain Buy with a target of Rs 740 (*Rs 630 earlier*). While we like the business model of LTTS more, at current valuations, the risk-reward for Cyient appears more favourable in the near- to medium-term investment horizon.

BUY (Maintain)

CMP RS 628

TARGET RS 740 (+18%)

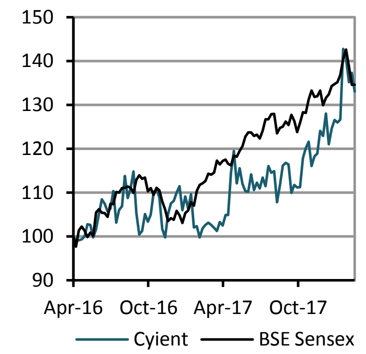
COMPANY DATA

O/S SHARES (MN) :	113
MARKET CAP (RSBN) :	70
MARKET CAP (USDBN) :	1.1
52 - WK HI/LO (RS) :	685 / 435
LIQUIDITY 3M (USDMN) :	4.3
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	22.2	22.2	22.2
FII / NRI :	44.1	51.4	58.2
FI / MF :	18.9	12.1	6.2
NON PRO :	4.4	4.2	4.0
PUBLIC & OTHERS :	11.7	10.1	9.5

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	39,189	43,617	48,839
EBIT	4,464	5,212	6,015
Net Profit	4,015	4,830	5,533
EPS, Rs	35.7	42.9	49.2
PER, x	16.8	14.9	13.0
EV/EBIT, x	14.4	12.0	9.9
P/BV, x	3.1	2.7	2.4
ROE, %	18.5	18.3	18.3

Source: PhillipCapital India Research Est.

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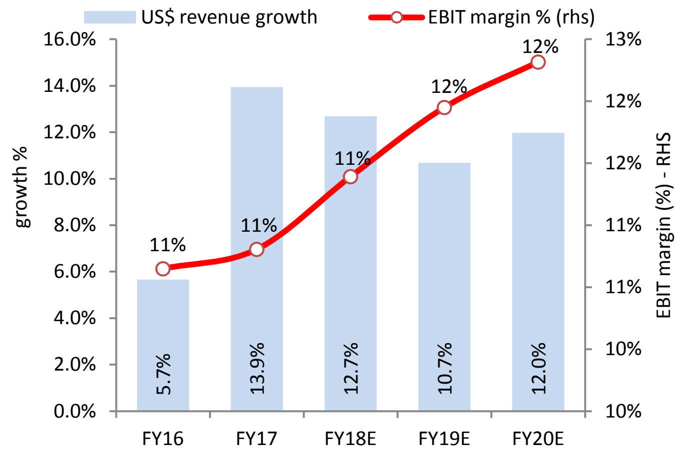
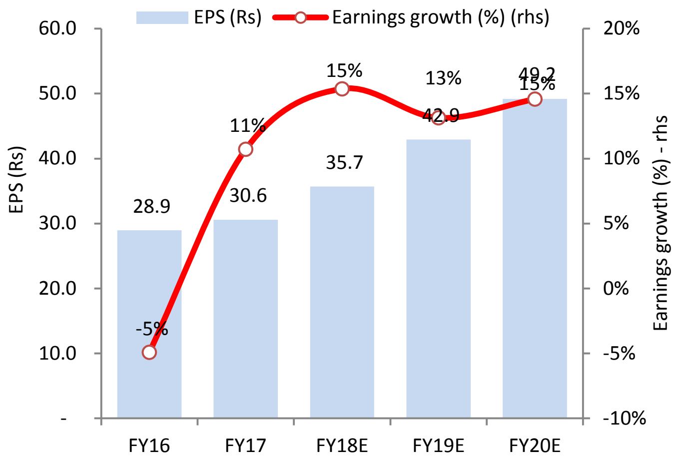
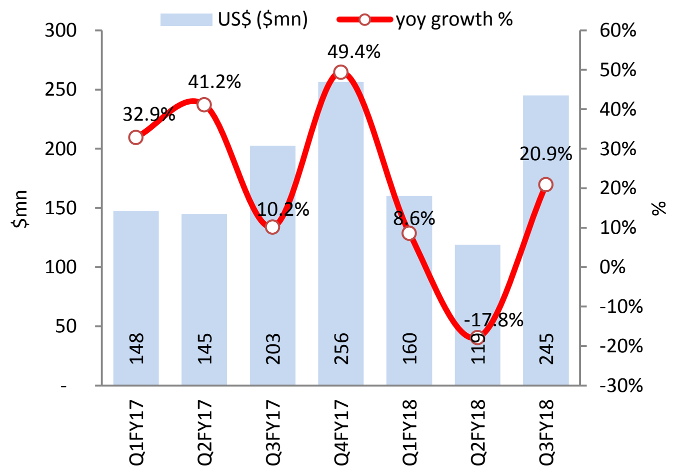
Revenue growth and Margins profile



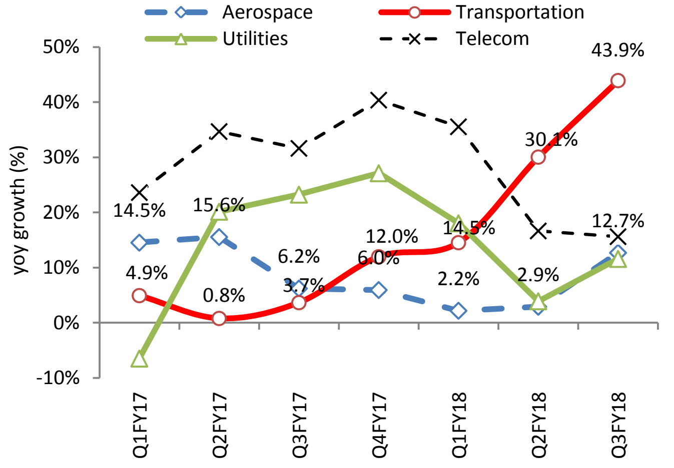
Earnings growth profile



Order intake has remained in upward trajectory



Verticals performance over last few quarters



Source: Company, PhillipCapital India Research Estimates

DLM's financial performance has revived, esp on the margins front

DLM	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	FY16	FY17
Revenue ($mn)	**10.9**	**12.6**	**10.1**	**13.5**	**14.8**	**16.0**	**11.8**	**15.8**	**12.1**	**40.0**	**54.4**
% Growth qoq	3.9%	16.3%	-20.2%	33.4%	10.2%	8.0%	-26.2%	33.7%	-23.3%	NA	36.0%
Revenue	719	857	676	902	1,002	1,069	763	1,017	785	2,641	3,648
Gross Profit	86	108	32	105	111	105	42	97	95	326	353
Gross Profit Margin (%)	12.0%	12.6%	4.7%	11.7%	11.1%	9.8%	5.5%	9.5%	12.1%	12.4%	9.7%
EBITDA	26	43	-49	18	19	-3	-53	8	9	107	-15
EBITDA Margin (%)	3.7%	5.0%	-7.2%	2.0%	1.9%	-0.3%	-6.9%	0.8%	1.1%	**4.1%**	**-0.4%**
PBT	-13	-15	-92	-27	-19	-37	-92	-37	-23	-64	-175
PBT Margin (%)	-1.8%	-1.8%	-13.6%	-3.0%	-1.9%	-3.5%	-12.1%	-3.6%	-2.9%	-2.4%	-4.8%

Source: Company, PhillipCapital India Research

Acquisition be the next growth driver for Cyient

Year	Acquired company	Country	Acquisition Price	Revenue	Valuation	Margin
2015	Invati Insights.	India (Hyderabad)	NA	$1mn	NA	NA
2015	Softential	USA	$19mn	$ 17 mn	0.9	25-30%
2015	Rangsons Electronics	India (Mysore)	$50mn	$66mn	0.8	2-4%
2016	Global Services Engineering Asia	Singapore	$6mn	$12mn	0.5	12-14%
2016	Blom Aerofilms	UK	NA	$10mn	NA	10%
2017	Certon Software	US	$8mn	$7mn	1.1	Low double digit

Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**36,066**	**39,189**	**43,617**	**48,839**
Growth, %	16	9	11	12
Employee expenses	-23,647	-25,412	-28,090	-31,381
Other Operating expenses	-7,569	-8,253	-9,166	-10,158
EBITDA (Core)	**4,850**	**5,523**	**6,361**	**7,301**
Growth, %	15.8	13.9	15.2	14.8
Margin, %	13.4	14.1	14.6	14.9
Depreciation	-953	-1,059	-1,149	-1,286
EBIT	**3,897**	**4,464**	**5,212**	**6,015**
Growth, %	18.0	14.6	16.8	15.4
Margin, %	10.8	11.4	11.9	12.3
Interest paid	-189	-208	-175	-90
Other Income	874	1,361	1,452	1,513
Pre-tax profit	**4,321**	**5,363**	**6,489**	**7,438**
Tax provided	-1,047	-1,431	-1,622	-1,860
Exceptional item	0	0	0	0
Profit after tax	**3,274**	**3,932**	**4,867**	**5,579**
Others (Minorities, Associates)	166	83	-37	-45
Net Profit	**3,440**	**4,015**	**4,830**	**5,533**
Growth, %	10.7	15.4	13.1	14.6
Net Profit (adjusted)	**3,440**	**4,015**	**4,830**	**5,533**
Wtd avg shares (m)	112	112	112	112

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**538**	**606**	**671**	**751**
Growth, %	13.9	12.7	10.7	12.0
Re / US$ (rate)	67.0	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	8,781	9,340	11,507	14,019
Debtors	6,496	6,990	7,517	8,451
Inventory	935	1,165	1,253	1,408
Other current assets	3,553	4,077	4,385	4,930
Total current assets	19,765	21,572	24,661	28,808
Investments	1,957	1,499	1,499	1,499
Net fixed assets	7,775	7,922	8,522	9,122
Non-current assets	1,766	1,864	2,004	2,253
Total assets	**31,364**	**33,124**	**36,954**	**41,949**
Current liabilities	7,632	7,316	7,780	8,604
Provisions	1,472	1,643	1,757	1,975
Total current liabilities	9,104	8,958	9,537	10,579
Non-current liabilities	1,061	1,053	1,053	1,053
Total liabilities	10,165	10,011	10,590	11,632
Paid-up capital	563	563	563	563
Reserves & surplus	20,636	22,550	25,800	29,754
Shareholders' equity	21,199	23,113	26,363	30,317
Total equity & liabilities	**31,364**	**33,124**	**36,954**	**41,949**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	4,321	5,363	6,489	7,438
Depreciation	953	1,059	1,149	1,286
Chg in working capital	882	-1,492	-483	-842
Total tax paid	-849	-1,659	-1,622	-1,860
Cash flow from operating activities	**5,568**	**3,524**	**5,533**	**6,022**
Capital expenditure	-2,056	-1,206	-1,749	-1,886
Chg in investments	-359	458	0	0
Cash flow from investing activities	**-2,415**	**-748**	**-1,749**	**-1,886**
Free cash flow	3,153	2,776	3,784	4,136
Equity raised/(repaid)	1	0	0	0
Debt raised/(repaid)	-613	54	0	0
Dividend (incl. tax)	-1,382	-1,842	-1,579	-1,579
Other financing activities	507	-513	0	0
Cash flow from financing activities	**-1,321**	**-2,218**	**-1,616**	**-1,624**
Net chg in cash	1,832	559	2,167	2,512

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	30.6	35.7	42.9	49.2
Growth, %	10.7	15.4	13.1	14.6
Book NAV/share (INR)	188.5	205.5	234.4	269.5
CFPS (INR)	39.6	17.9	37.5	42.3
DPS (INR)	10.5	14.0	12.0	12.0
Return ratios				
Return on assets (%)	11.6	12.6	14.2	14.3
Return on equity (%)	17.5	18.5	18.3	18.3
Return on capital employed (%)	15.1	16.4	18.1	18.0
Turnover ratios				
Asset turnover (x)	3.0	3.0	3.0	3.1
Sales/Total assets (x)	1.2	1.2	1.2	1.2
Sales/Net FA (x)	5.0	5.0	5.3	5.5
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	65.7	65.1	62.9	63.2
Inventory days	9.5	10.9	10.5	10.5
Payable days	45.8	36.9	35.8	36.1
Working capital days	33.9	45.8	45.0	46.2
Liquidity ratios				
Current ratio (x)	2.6	2.9	3.2	3.3
Quick ratio (x)	2.5	2.8	3.0	3.2
Interest cover (x)	20.6	21.4	29.8	66.6
Dividend cover (x)	3.1	2.7	3.6	4.1
Total debt/Equity (%)	9.0	8.5	7.4	6.5
Net debt/Equity (%)	(41.6)	(38.4)	(41.9)	(44.7)
Valuation				
PER (x)	19.1	16.5	14.6	12.8
PEG (x) - y-o-y growth	1.8	1.1	1.1	0.9
Price/Book (x)	3.3	3.1	2.7	2.3
Yield (%)	1.7	2.2	1.9	1.9
EV/Net sales (x)	1.8	1.6	1.4	1.2
EV/EBITDA (x)	13.1	11.5	9.6	8.0
EV/EBIT (x)	16.4	14.2	11.7	9.7

INSTITUTIONAL EQUITY RESEARCH

Persistent Systems (PSYS IN)

Pain period over – Gain period to start

28 February 2018

INDIA | IT Services | Company Update

Consider this – a company reports revenue growth below industry average (and below expectations), margins decline of over 1400bps, and zero earnings growth over a period of three years – and the stock goes up by 15%. This is the story of PSYS over FY15-17.

We were always impressed with its digital prowess, and the fact that it possessed an early-mover advantage in this domain. However, as it was looking to expand its business from OPD to Services (which was the logical thing to do), we had forecasted it will lead to back-ended growth, and front ended margin decline – which is how it played out. The only difference being that the stock price movement did not reflect this. Perhaps the investors were happy to wait out the 'pain period', certain of better times ahead.

Nonetheless, we believe we are close to the end of the pain period for PSYS. It has started showing traction in its services business, also reflected in the gradual margin expansion. With digital capabilities ahead of peers, low base and a growing IP portfolio, we expect PSYS to report strong earnings growth over the medium-to-long term. Upgrade to BUY.

Investments in the enterprise segment have started reflecting

PSYS had started as an offshore product development (OSPD) company; but having reached a plateau in terms of OSPD's growth potential, it started trying to enhance the enterprise segment through digital transformational (EDT) deals, where it provides customised digital solutions to enterprise customers. The enterprise segment has grown at a CQGR of 8% over Q1FY16-Q3FY18, and now contributes 35% of its total revenue (vs. 25% in Q1FY16). The strong performance in enterprise has more than offset the decline in the ISV segment, which is facing structural headwinds over the last few years.

Top client (IBM) gaining traction

IBM has remained mainstay for PSYS since its inception, and PSYS now derives 28% of its revenue from IBM. PSYS works with IBM in two different businesses – product engineering services and Watson IoT partnership (started from Q4FY16).The Watson IoT partnership provided significant revenue traction (US$ 50mn/year) for PSYS, resulting in strong 22% USD revenue growth for FY17.

Strong 3QFY18 performance

PSYS reported stellar revenue growth of 11.4% yoy due to strong performance in services segment (+13.8% yoy). EBIT margin has also expanded by a sharp 220bps to 12.4%. The management appeared confident of achieving double-digit USD revenue growth in FY19, while margins appear to move in structurally positive direction.

All set to traverse the growth path; Upgrade to Buy

Persistent reported strong performance in Q3 on all fronts – revenue growth, margins as well as profitability. IBM IP deal, too, has reported decent 5% growth for CY17 (US$ 49mn revenue), with narrowing losses expected to lead to profitability in CY18. The management also remained confident of 'double-digit' growth for FY19.

All these place PSYS on a strong pedestal. At current levels, the stock is trading at 15x FY20 earnings estimates, a premium to its historical average – justified in our opinion given the strong performance and bright outlook. We have not made any changes to our estimates. We increase our target multiple to 17x P/E (*14x earlier*). Upgrade to BUY with price target of Rs 980 (*Rs 800 earlier)*.

Upgrade to BUY

CMP RS 840

TARGET RS 980 (+17%)

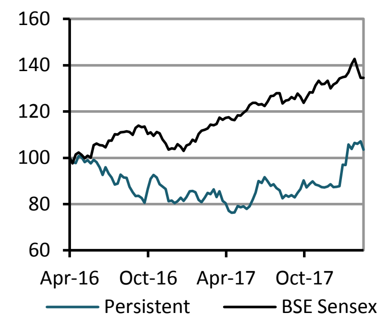
COMPANY DATA

O/S SHARES (MN) :	80
MARKET CAP (RSBN) :	65
MARKET CAP (USDBN) :	1.0
52 - WK HI/LO (RS) :	877 / 558
LIQUIDITY 3M (USDMN) :	2.4
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	30.6	30.7	30.7
FII / NRI :	24.2	23.1	22.5
FI / MF :	14.3	14.4	14.0
NON PRO :	13.6	13.5	14.1
PUBLIC & OTHERS :	17.3	18.4	18.9

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	30,840	34,422	38,544
EBIT	3,394	4,138	5,002
Net Profit	3,354	3,958	4,600
EPS, Rs	41.9	49.5	57.5
PER, x	20.0	17.0	14.6
EV/EBIT, x	19.5	15.9	12.9
P/BV, x	3.1	2.8	2.4
ROE, %	15.7	16.4	16.7

Source: PhillipCapital India Research Est.

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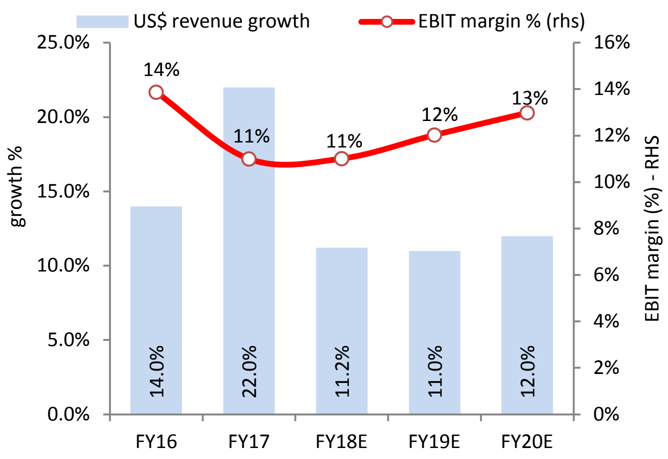
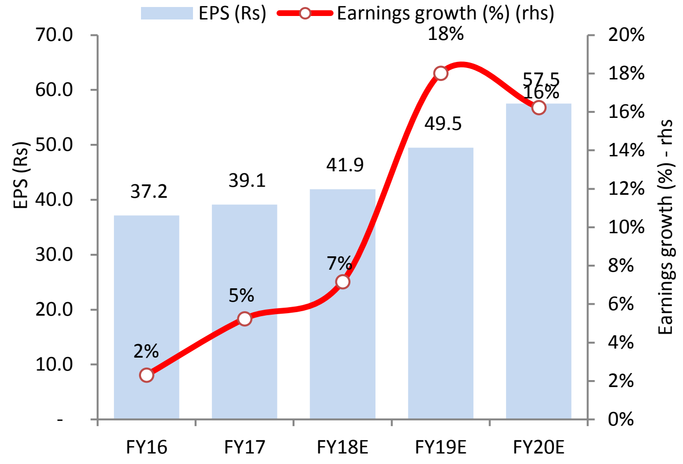
Revenue growth and Margins profile

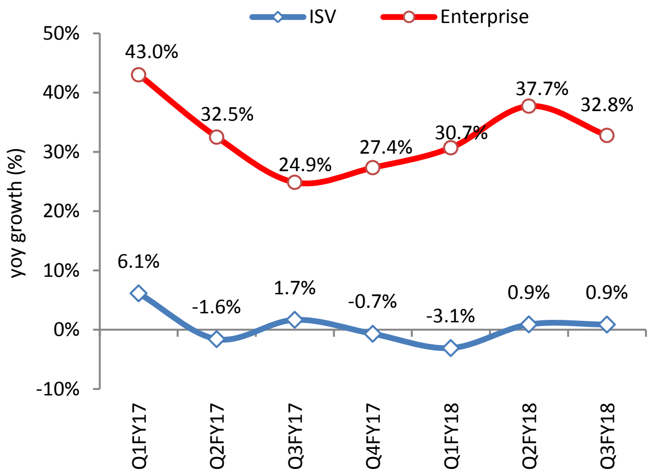


Earnings growth profile

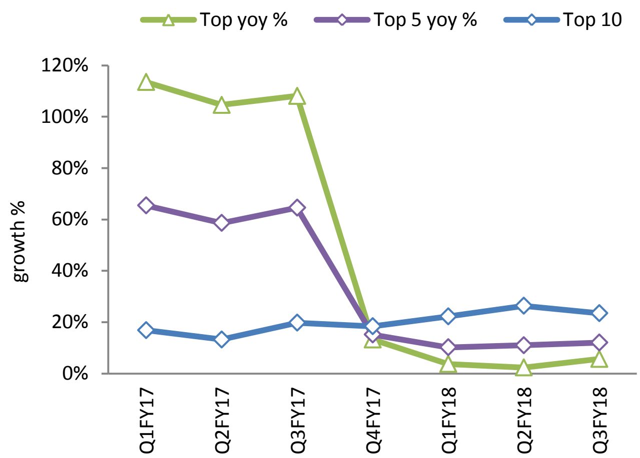


Source: Company, Phillip Capital India Research

Enterprise has reported strong growth over last few quarters

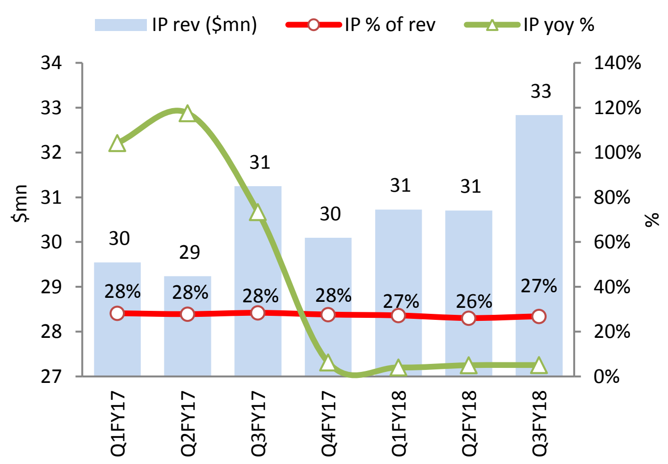


Top clients performance over last few quarters

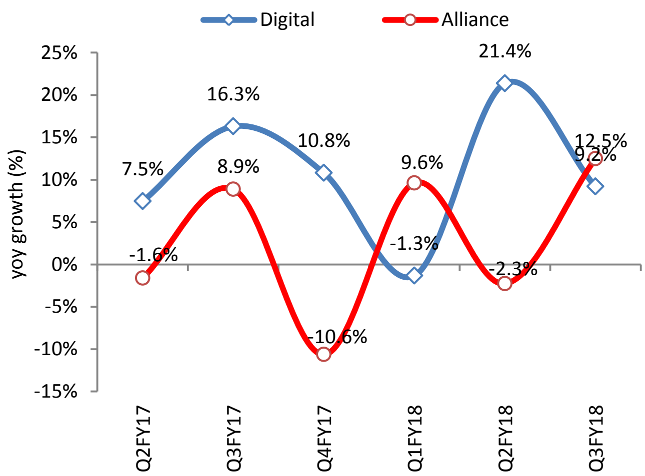


Source: Company, Phillip Capital India Research

IP revenue performance



Segmental growth rate



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**28,784**	**30,840**	**34,422**	**38,544**
Growth, %	24.5	7.1	11.6	12.0
Employee expenses	-18,518	-19,891	-22,052	-24,520
Other Operating expenses	-5,612	-6,006	-6,614	-7,226
EBITDA (Core)	**4,654**	**4,943**	**5,756**	**6,797**
Growth, %	11.6	6.2	16.4	18.1
Margin, %	16.2	16.0	16.7	17.6
Depreciation	-1,490	-1,549	-1,618	-1,795
EBIT	**3,164**	**3,394**	**4,138**	**5,002**
Growth, %	(1.3)	7.3	21.9	20.9
Margin, %	11.0	11.0	12.0	13.0
Interest paid	0	0	0	0
Other Non-Operating Income	689	565	659	771
Pre-tax profit	**4,007**	**4,455**	**5,277**	**6,133**
Tax provided	-992	-1,102	-1,319	-1,533
Profit after tax	**3,015**	**3,354**	**3,958**	**4,600**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**3,015**	**3,354**	**3,958**	**4,600**
Growth, %	5.2	7.2	18.0	16.2
Net Profit (adjusted)	**3,129**	**3,354**	**3,958**	**4,600**
Wtd avg shares (m)	80	80	80	80

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**429**	**477**	**530**	**593**
Growth, %	22.0	11.2	11.0	12.0
Re / US$ (rate)	67.1	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	1,510	1,007	1,510	2,741
Marketable securities at cost	0	0	0	0
Debtors	4,754	5,103	5,634	6,354
Inventory	0	0	0	0
Other current assets	3,243	4,165	4,165	4,165
Total current assets	10,669	11,596	12,766	14,904
Investments	6,839	8,532	9,532	10,532
Net fixed assets	5,573	5,582	6,364	6,969
Non-current assets	76	75	75	75
Total assets	**23,464**	**26,114**	**29,067**	**32,809**
Total current liabilities	4,449	4,687	4,899	5,258
Non-current liabilities	22	18	18	18
Total liabilities	4,471	4,705	4,917	5,276
Paid-up capital	800	800	800	800
Reserves & surplus	18,193	20,609	23,350	26,733
Minorities	0	0	0	0
Shareholders' equity	18,993	21,409	24,150	27,533
Total equity & liabilities	**23,464**	**26,114**	**29,067**	**32,809**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	4,007	4,455	5,277	6,133
Depreciation	1,490	1,549	1,618	1,795
Chg in working capital	-697	-1,194	-456	-547
Total tax paid	-1,121	-1,125	-1,319	-1,533
Other operating activities	0	0	0	0
Cash flow from operating activities	**3,679**	**3,685**	**5,119**	**5,848**
Capital expenditure	-2,505	-1,558	-2,400	-2,400
Chg in investments	-455	-1,693	-1,000	-1,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-2,960**	**-3,250**	**-3,400**	**-3,400**
Free cash flow	719	435	1,719	2,448
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-843	-1,217	-1,217	-1,217
Other financing activities	194	280	0	0
Cash flow from financing activities	**-649**	**-937**	**-1,217**	**-1,217**
Net chg in cash	71	-502	502	1,231

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	39.1	41.9	49.5	57.5
Growth, %	5.2	7.2	18.0	16.2
Book NAV/share (INR)	237.4	267.6	301.9	344.2
CFPS (INR)	37.4	39.0	55.8	63.5
DPS (INR)	9.0	13.0	13.0	13.0
Return ratios				
Return on assets (%)	13.5	13.5	14.3	14.9
Return on equity (%)	16.5	15.7	16.4	16.7
Return on capital employed (%)	15.6	15.4	16.2	16.7
Turnover ratios				
Asset turnover (x)	2.7	2.5	2.5	2.6
Sales/Total assets (x)	1.3	1.2	1.2	1.2
Sales/Net FA (x)	5.7	5.5	5.8	5.8
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	60.3	60.4	59.7	60.2
Liquidity ratios				
Current ratio (x)	3.7	3.8	3.9	4.1
Quick ratio (x)	3.7	3.8	3.9	4.1
Dividend cover (x)	4.3	3.2	3.8	4.4
Net debt/Equity (%)	(7.9)	(4.7)	(6.3)	(10.0)
Valuation				
PER (x)	21.5	20.0	17.0	14.6
PEG (x) - y-o-y growth	4.1	2.8	0.9	0.9
Price/Book (x)	3.5	3.1	2.8	2.4
Yield (%)	1.1	1.5	1.5	1.5
EV/Net sales (x)	2.3	2.1	1.9	1.7
EV/EBITDA (x)	14.1	13.4	11.4	9.5
EV/EBIT (x)	20.8	19.5	15.9	12.9

PhillipCapital

NIII Technologies (NITEC IN)

Finally appears to be realizing its true potential

INDIA | IT Services | Company Update

28 February 2018

NITEC reported strong 3QFY18 results in both revenue and order bookings. Actually, its last five quarters' performance has been highly impressive. After reporting muted USD revenue growth in FY17, we see growth rebounding strongly in FY18 on robust orderbook, completion of ramp-down of government business, and bottoming out of NITL/GIS business. For the first time in many years, the management guided to likelihood of double-digit revenue growth in FY19. The stock has jumped sharply in the last 6 months (70%) and appears to be breaking its traditional valuation barrier of 12x (currently 13x FY20 P/E). We maintain BUY.

Basic framework in place; efforts have started yielding results

NITEC has significantly rationalised its portfolio over the last two years, exiting the low-margin government business and focussing on the high-margin onsite business. It has executed its four-pronged strategy to perfection: cross-selling IMS, expanding the BFSI business in US, securing a leadership position in the transport vertical, and reducing the low-margin government business. Over FY13-17, IMS has grown by 63%, US' contribution has increased to 50% from 37%, and government business contribution reduced to 2% from 11%. Rationalisation is now complete and the current order book of US$ 329mn largely consists of high-margin business. We believe the current order book will lead to strong revenue growth in FY18 and beyond, concurrently providing levers for margin expansion.

The orderbook has grown considerably in the last two quarters

Over the last couple of years, the company has improved its sales effort considerably. It signed five large deals in 9MFY18, with management confident of signing AT LEAST two large deals in Q4. Fresh order bookings in 3QFY18 alone stood at US$ 130mn (US$ 122mn in 2QFY18).The improved deal flow has resulted in a total orderbook of US$ 329mn – the highest in its history. We expect this foundation of strong deal-flow to help NITEC report its highest revenue growth in the last six years in FY19.

Digital business gaining traction

NITEC's strategy of increasing digital presence has played out along expected lines. The digital revenue now is 25% of revenue (vs. 18% in Q1FY17), registering a CQGR of 8% over the last seven quarters. To report yoy growth of 50% (3QFY18), on a relatively large base of digital revenues of US$ 20mn is commendable, and places NITEC in a strong position.

Subsidiaries' performance stabilizing

Over the last two years, NITEC's subsidiaries' revenue and margin performance has either been impacted by client specific issues or macro uncertainties (Brexit, US elections). This has now stabilized in the last few quarters, largely due to the steps taken by the management in improving financial stability. Barring Morris (which was acquired by GateHouse Media in Oct 2017), all other subsidiaries have reported decent performance in 9MFY18. Margins for Morris and NITL have expanded over the last three quarters, and almost all subsidiaries have reported growth that is in line or better than the company's average. As the subsidiaries' drag fades, NITEC should report strong growth, at consolidated level.

Outlook and valuations – turnaround story playing out as expected

NIIT Tech stock has risen almost ~30% in the last 3m, breaking out from its regular band of 9-10x one-year forward PE. Currently the stock trades at 13x FY20 P/E – still at a discount to the mid-cap average. However, with the company set to report double digit growth in FY18/19 and beyond, we expect a significant rerating. We have not made any changes to our estimates. We upgrade our target multiple at 15x PE (*earlier* 13x), on much stronger revenue and earnings growth visibility. Our target is Rs 930 (*Rs 790 earlier*). Maintain BUY.

BUY (Maintain)

CMP RS 832

TARGET RS 930 (+12%)

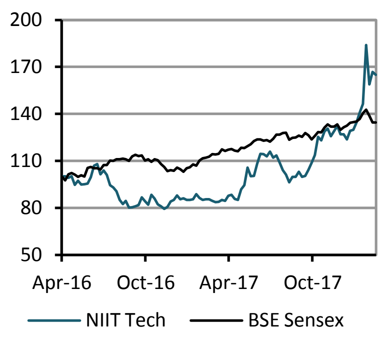
COMPANY DATA

O/S SHARES (MN) :	61
MARKET CAP (RSBN) :	50
MARKET CAP (USDBN) :	0.8
52 - WK HI/LO (RS) :	929 / 404
LIQUIDITY 3M (USDMN) :	20.6
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	30.7	30.7	30.7
FII / NRI :	39.7	36.1	33.2
FI / MF :	16.8	19.4	21.5
NON PRO :	6.1	6.3	6.9
PUBLIC & OTHERS :	6.7	7.5	7.6

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	29,709	32,935	36,543
EBIT	3,680	4,143	4,767
Net Profit	2,772	3,304	3,785
EPS, Rs	45.3	54.0	61.8
PER, x	18.3	15.4	13.4
EV/EBIT, x	12.1	10.1	8.0
P/BV, x	2.9	2.6	2.3
ROE, %	16.0	16.9	17.0

Source: PhillipCapital India Research Est.

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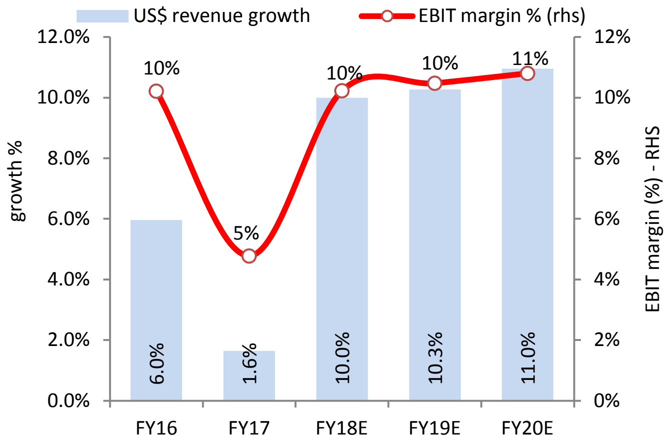
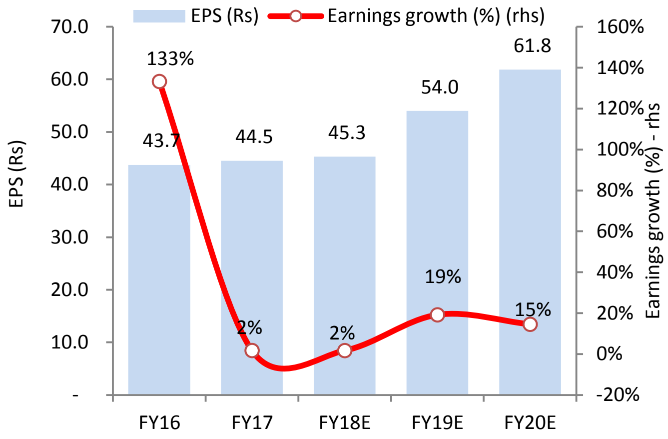
Revenue growth and Margins profile

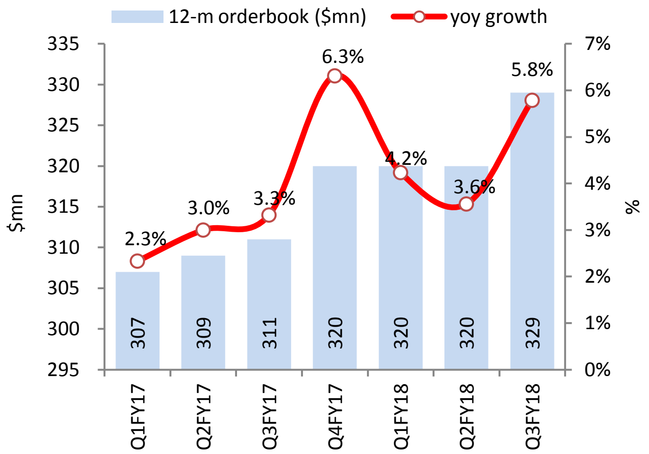


Earnings growth profile

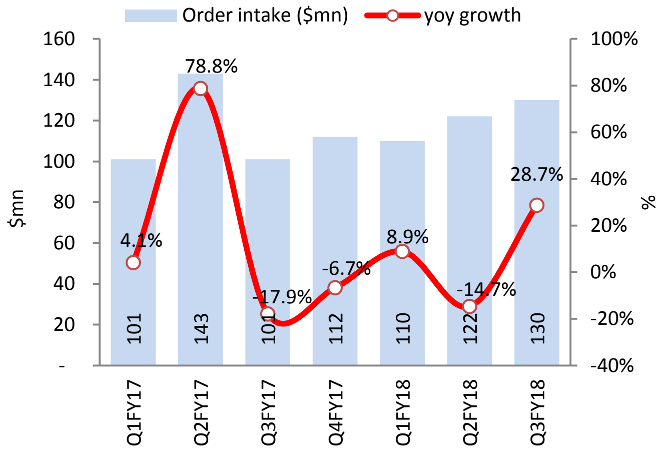


Source: Company, Phillip Capital India Research

Continuous growth in the 12-months orderbook ...

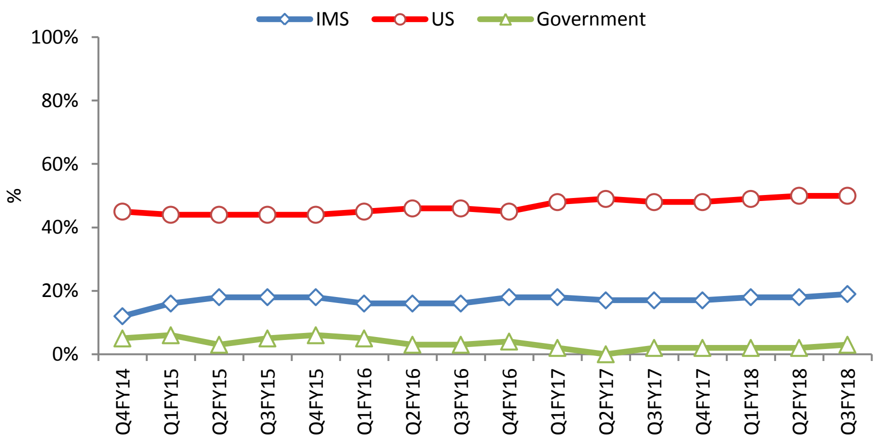


... with a continuous increase in order intake



Source: Company, Phillip Capital India Research

Share of IMS and US has grown, while that of Government business has declined – as envisaged

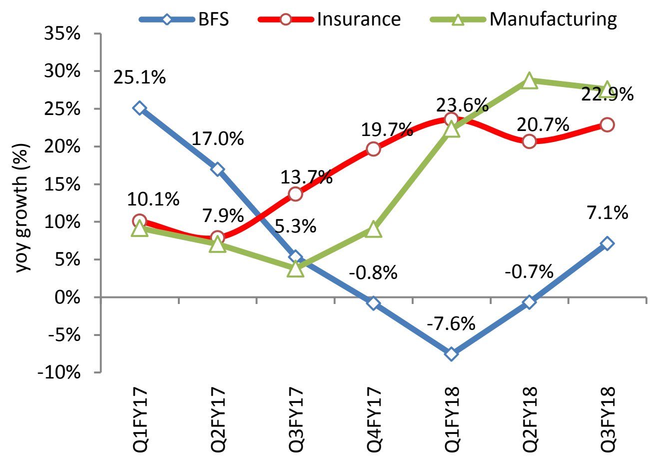


Source: Company, Phillip Capital India Research

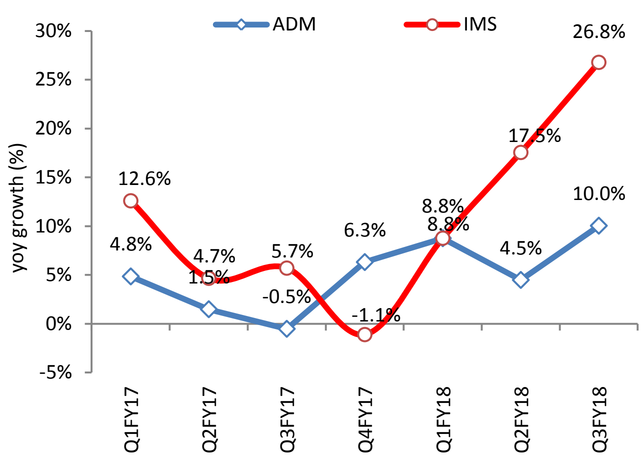
Performance of subsidiaries, which had been a drag, has been constantly improving

Segmental Revenue (Rs mn)	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Morris	401	348	353	341	401	391	342
Incessant	486	552	530	545	543	730	832
GIS	267	286	352	526	300	263	347
NITL (Insurance)	374	356	348	334	357	371	415
Proyecta	189	134	137	138	160	NA	NA
Yoy Growth (%)							
Morris	-13.0%	-14.1%	-15.6%	-15.0%	0.0%	12.4%	-3.1%
Incessant	119.9%	60.0%	51.0%	31.6%	11.7%	32.2%	57.0%
GIS	14.1%	-8.0%	30.9%	36.3%	12.4%	-8.0%	-1.4%
NITL (Insurance)	-19.9%	-32.6%	-19.4%	-18.1%	-4.5%	4.2%	19.3%
Proyecta	33.1%	-8.8%	6.2%	0.0%	-15.3%	NA	NA
Segmental margin (%)							
Morris	11%	4%	7%	7%	8%	12%	15%
Incessant	24%	26%	26%	29%	23%	23%	20%
GIS	24%	20%	22%	33%	21%	14%	23%
NITL (Insurance)	13%	18%	20%	18%	18%	19%	23%
Proyecta	-20%	-12%	-4%	-20%	-4%	NA	NA

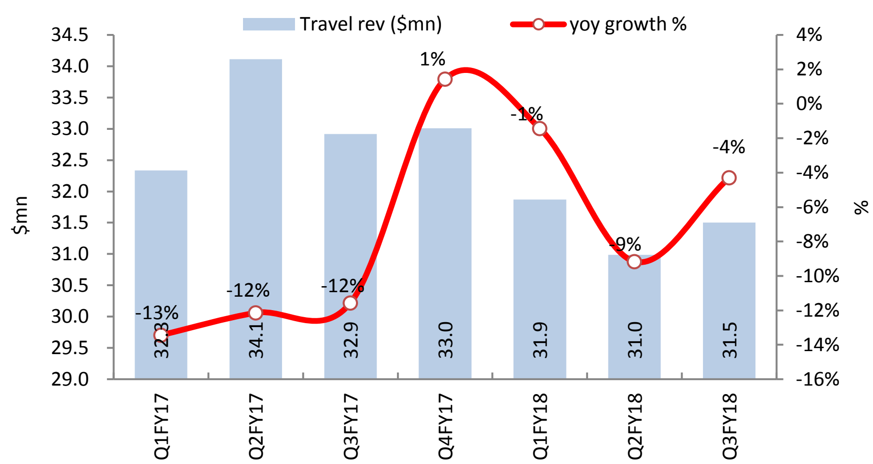
Vertical growth rate (yoy) over last few quarters



Horizontal growth rate (yoy) over last few quarters



Travel has remained muted over the last few quarters, due to client specific issues



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**28,021**	**29,709**	**32,935**	**36,543**
Growth, %	4.2	6.0	10.9	11.0
Employee expenses	-17,903	-19,023	-21,258	-23,879
Other Operating expenses	-5,272	-5,711	-6,235	-6,509
EBITDA (Core)	**4,846**	**4,975**	**5,442**	**6,154**
Growth, %	2.6	2.7	9.4	13.1
Margin, %	17.3	16.7	16.5	16.8
Depreciation	-1,276	-1,295	-1,299	-1,387
EBIT	**3,570**	**3,680**	**4,143**	**4,767**
Growth, %	2.1	3.1	12.6	15.1
Margin, %	12.7	12.4	12.6	13.0
Interest paid	0	0	0	0
Other Non-Operating Income	159	217	297	320
Exceptional Item	-221	0	0	0
Pre-tax profit	**3,508**	**3,897**	**4,441**	**5,088**
Tax provided	-786	-909	-999	-1,145
Profit after tax	**2,722**	**2,988**	**3,441**	**3,943**
Others (Minorities, Associates)	-220	-217	-138	-158
Net Profit	**2,502**	**2,772**	**3,304**	**3,785**
Growth, %	2.0	1.8	19.2	14.6
Net Profit (adjusted)	**2,723**	**2,772**	**3,304**	**3,785**
Wtd avg shares (m)	61	61	61	61

US$ Revenues

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**418**	**460**	**507**	**562**
Growth, %	1.6	10.0	10.3	11.0
Re / US$ (rate)	67.1	64.7	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	7,689	6,674	8,979	12,792
Marketable securities at cost	0	0	0	0
Debtors	4,903	5,291	5,865	6,508
Inventory	52	52	52	52
Other current assets	1,202	1,424	1,541	1,649
Total current assets	15,568	15,220	18,453	23,304
Investments	2,301	2,301	2,301	2,301
Net fixed assets	3,139	4,203	3,904	2,517
Non-current assets	0	0	0	0
Total assets	**21,979**	**22,879**	**25,814**	**29,277**
Total current liabilities	4,764	5,082	5,649	6,244
Non-current liabilities	113	233	233	233
Total liabilities	4,877	5,315	5,882	6,477
Paid-up capital	614	614	614	614
Reserves & surplus	16,251	16,709	18,939	21,650
Minorities	237	241	378	536
Shareholders' equity	17,102	17,564	19,931	22,800
Total equity & liabilities	**21,979**	**22,879**	**25,814**	**29,277**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	3,508	3,897	4,441	5,088
Depreciation	1,276	1,295	1,299	1,387
Chg in working capital	780	-349	-361	-443
Total tax paid	-886	-1,094	-999	-1,145
Other operating activities	221	0	0	0
Cash flow from operating activities	**4,899**	**3,750**	**4,379**	**4,887**
Capital expenditure	167	-2,359	-1,000	0
Chg in investments	0	0	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**167**	**-2,359**	**-1,000**	**0**
Free cash flow	5,066	1,391	3,379	4,887
Equity raised/(repaid)	2	0	0	0
Debt raised/(repaid)	11	120	0	0
Dividend (incl. tax)	-869	-1,002	-1,074	-1,074
Other financing activities	-717	-1,311	0	0
Cash flow from financing activities	**-1,749**	**-2,406**	**-1,074**	**-1,074**
Net chg in cash	3,317	-1,016	2,305	3,813

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	44.5	45.3	54.0	61.8
Growth, %	1.8	1.7	19.2	14.6
Book NAV/share (INR)	275.7	283.1	319.5	363.8
CFPS (INR)	73.9	57.7	66.7	74.6
DPS (INR)	12.5	14.0	15.0	15.0
Return ratios				
Return on assets (%)	12.6	13.3	14.1	14.3
Return on equity (%)	16.1	16.0	16.9	17.0
Return on capital employed (%)	15.3	15.9	16.9	17.1
Turnover ratios				
Asset turnover (x)	3.3	3.6	3.6	4.2
Sales/Total assets (x)	1.3	1.3	1.4	1.3
Sales/Net FA (x)	7.3	8.1	8.1	11.4
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	63.9	65.0	65.0	65.0
Liquidity ratios				
Current ratio (x)	4.4	4.0	4.4	5.0
Quick ratio (x)	4.3	4.0	4.3	5.0
Dividend cover (x)	3.6	3.2	3.6	4.1
Total debt/Equity (%)	0.7	1.3	1.2	1.0
Net debt/Equity (%)	(44.9)	(37.2)	(44.7)	(56.4)
Valuation				
PER (x)	18.6	18.3	15.4	13.4
PEG (x) - y-o-y growth	10.6	10.5	0.8	0.9
Price/Book (x)	3.0	2.9	2.6	2.3
Yield (%)	1.5	1.7	1.8	1.8
EV/Net sales (x)	1.5	1.5	1.3	1.0
EV/EBITDA (x)	8.9	8.9	7.7	6.2
EV/EBIT (x)	12.1	12.1	10.1	8.0

Intellect Design Arena (INDA IN)

Strong orderbook; GeM the potential game changer

INDIA | IT Services | Company Update

28 February 2018

INDA is well-poised to ride the digital wave: INDA is well-poised to ride the digital spending wave from banks due to proactive investments in digital banking and into its design centre. This can be gauged from its deal wins – the company generated 60% of revenue from Digital with 60%+ deal pipeline in this segment. Its capabilities in Digital have led to a 70% conversion rate for digital transformational deals with average deal size more than doubling in the last few years.

Diversified product portfolio across touch points, geographies, and clients: Since INDA's product portfolio is well diversified, the risk attached to single-product companies does not exist. It has carefully invested into four lines (to de-risk its portfolio), which touches all points – banking, financial services, and insurance. In the proliferation phase of its product cycle, INDA should easily increase wallet share from these clients. Deal wins with central banks (RBI and the Central Bank of Sweden) increases confidence and trust in the company. It has the right geographical mix – 47% of its revenues come from high-income countries (where banks are looking at software upgradation) and 53% from low-income ones (where banks are exploring first-time investments for core banking).

Government eMarketplace (GeM) – a potential game changer: In September 2017, INDA, in consortium with Infibeam and Tata Communication bagged the deal to manage the GeM portal. GeM is an online marketplace website which supports a number of functions for all the government departments, public sector units, universities etc. The upgraded portal has already gone live on 26th January, 2018. INDA will procure goods while Infibeam and Tata Communications will manage eCommerce services and cloud services respectively.

Based on historical data, DGS&D (Directorate General of Supplies and Disposal) estimates value of orders on GeM, to reach Rs 1tn in the next five years. We assume 0.2% of the transaction value as the commission for the consortium with a share of 60:35:5 between Intellect:Infibeam:Tata Communication. Based on these assumptions, we estimate Rs 488/910mn revenue (4%/7% of total revenue) for Intellect from this project for FY19/20 – going upto Rs 1500mn in FY22 (12% of revenue).

Strong order-backlog: Intellect has witnessed strong new deal wins in the last two quarters, which includes deal wins from clients such as Bank of Bangkok, GeM, HDFC etc. This has resulted in a strong order-backlog of ~US$ 147mn (ex-GeM, 90% of LTM revenue) – of which management expects 80% to be executed over the next 12-months. This, along with US$ 115mn orderbook from GeM (spread over five years), provides good visibility for FY19 and beyond.

Sharp improvement in DSO: One of the concerns with INDA was higher DSO days, potentially due to the nature of the product companies. This was elevated with the delay in collection in FY16-17 that resulted in DSO days increasing to 188 in Q3FY17 (vs. 157 days in Q1FY16). However, with the aggressive efforts on collections in the last three quarters, DSO days reduced to 148 in Q3FY18. The sharp improvement in collections has helped the working-capital cycle to improve.

Outlook and valuations

INDA should see 16% USD revenue CAGR over FY17-20, led by multiple growth engines. With increasing acceptance in the US and in Europe, the share of its license fees should improve, thus improving profitability.

Globally IT product companies are trading at an average CY19 EV/sales of 4x. In recent M&A transactions, too, average acquisition price has been 4x EV/sales. INDA trades at 1.7x FY20 EV/sales — a significant discount to global IT product companies and M&A transaction valuations. We have not made any changes to our FY19/20 estimates. However, we upgrade our multiple to 2.5x FY20 EV/sales (40% discount to global players, and 15% discount to Majesco, which we value at 3x EV/sales). Maintain Buy with a target of Rs 280 *(Rs 220 earlier).*

BUY (Maintain)

CMP RS 193

TARGET RS 280 (+45%)

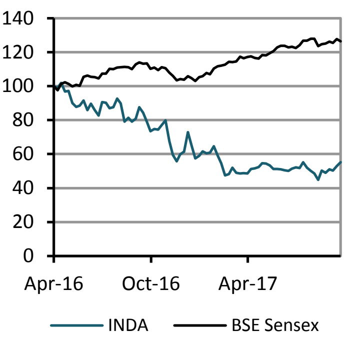
COMPANY DATA

O/S SHARES (MN) :	125
MARKET CAP (RSBN) :	23
MARKET CAP (USDBN) :	0.4
52 - WK HI/LO (RS) :	205 / 97
LIQUIDITY 3M (USDMN) :	2.4
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	31.1	31.2	29.4
FII / NRI :	13.3	12.4	11.9
FI / MF :	7.3	7.1	7.9
NON PRO :	18.8	16.9	22.7
PUBLIC & OTHERS :	29.5	32.4	28.2

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	10,521	12,171	13,993
EBIT	477	668	916
Net Profit	296	484	661
EPS, Rs	2.4	3.9	5.3
PER, x	81.6	49.8	36.5
EV/Sales, x	2.3	2.0	1.7
P/BV, x	2.9	2.8	2.6
ROE, %	3.6	5.5	7.0

Source: PhillipCapital India Research Est.

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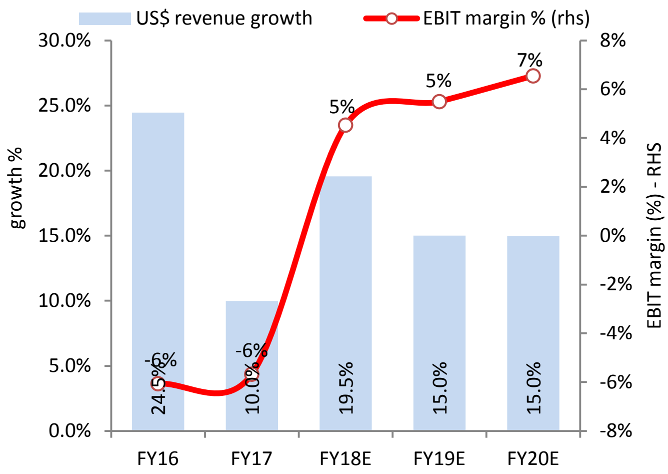
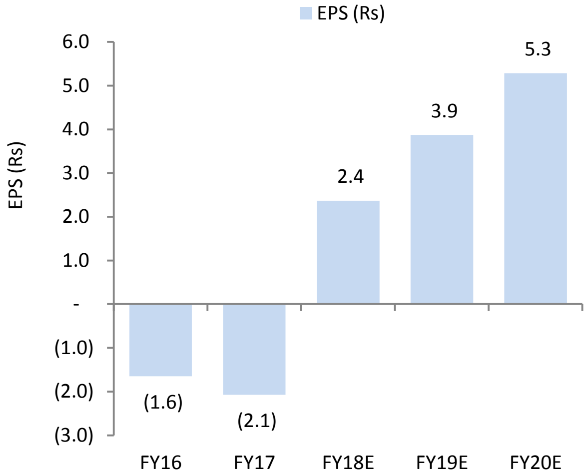
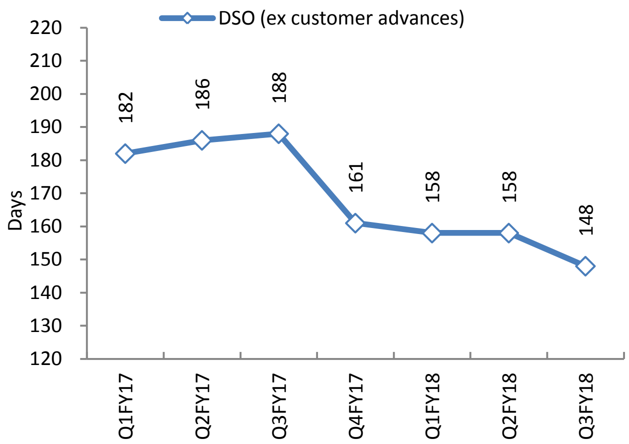
Revenue growth and Margins profile



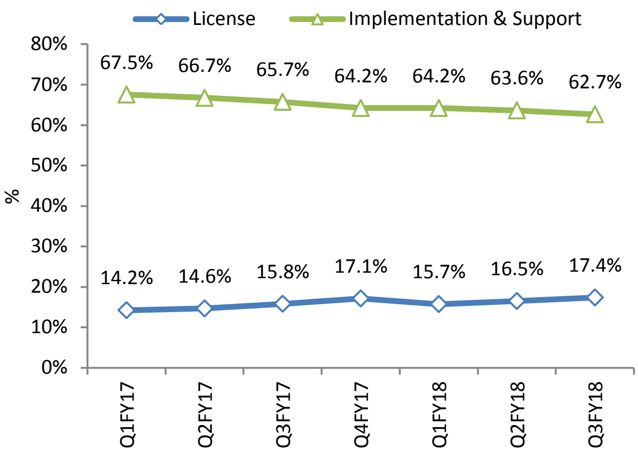
Earnings profile



Improvement in collections

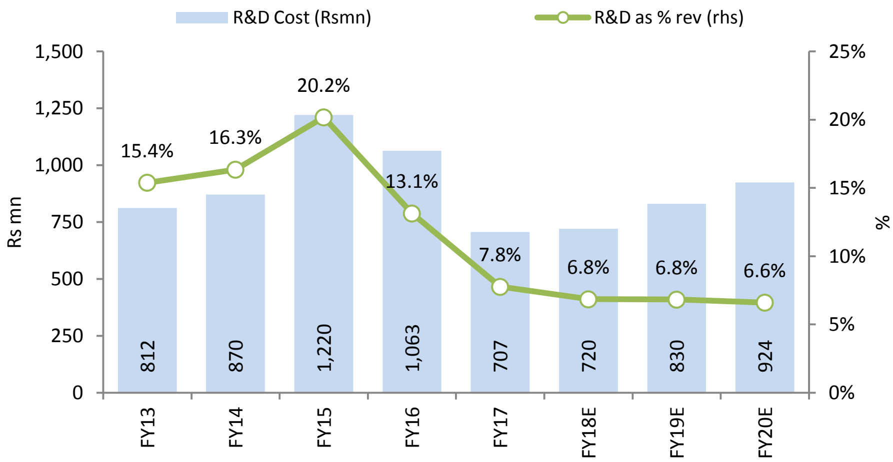


License revenue share increasing



Source: Company, PhillipCapital India Research

R&D expenses declined in FY17 mainly due to change in accounting treatment



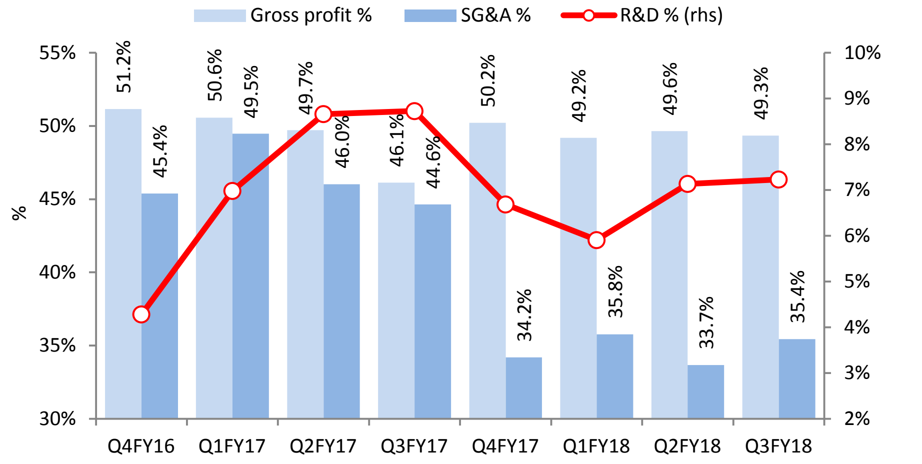
Source: Company, PhillipCapital India Research

R&D cost (expense vs. capitalized)

R&D cost (Rs mn)	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
Expensed	93	156	199	198	167	142	192	196
Capitalized	343	248	226	235	284	291	277	272
Total	**436**	**404**	**424**	**432**	**451**	**433**	**469**	**468**

Source: Company, PhillipCapital India Research

Lower SG&A and R&D has resulted in positive EBITDA margin in last 4 quarters



Source: Company, PhillipCapital India Research

Strong dealflow in last few quarters has resulted in strong license revenue

TTM Rev ($mn)	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
License	19.3	17.7	18.6	20.7	23.3	22.5	24.8	27.5
AMC	22.0	22.6	23.6	24.2	25.4	28.6	29.9	31.6
Implementation & Support	82.5	83.9	84.6	86.0	87.4	91.7	95.5	99.2
Total	**123.8**	**124.2**	**126.7**	**130.9**	**136.2**	**142.9**	**150.1**	**158.4**

Source: Company, PhillipCapital India Research

GeM is expected to generate Rs 488/910mn revenue for FY19/20

	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	FY19	FY20
GeM rev ($ mn)	1.0	1.5	2.0	3.0	3.0	3.0	3.5	4.5	7.5	14.0
qoq growth %		50.0%	33.3%	50.0%	0.0%	0.0%	16.7%	28.6%	NA	86.7%
GeM rev (Rs mn)	65.0	97.5	130.0	195.0	195.0	195.0	227.5	292.5	488	910
qoq growth %		50.0%	33.3%	50.0%	0.0%	0.0%	16.7%	28.6%	NA	86.7%
GeM expenses (Rs mn)	39.0	58.5	65.0	97.5	101.4	101.4	118.3	152.1	260.0	473.2
GeM gross profit (%)	40%	40%	50%	50%	48%	48%	48%	48%	47%	48%

Source: Company, PhillipCapital India Research

Valuation: Global product companies

			Mcap	Revenue (mn)			EBITDA margin (%)			EV/Sales (x)		EV/EBITDA (x)		Rev CAGR (%)
Company	Currency	CMP	(bn)	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	
Temenos	CHF	113	8	735	981	1,090	36	34	35	9.0	8.1	23.1	20.5	21.7%
Fiserv	USD	144	30	5,696	6,133	6,575	34	35	34	5.6	5.2	15.4	14.1	7.4%
Jack Henry	USD	120	9	1,431	1,616	1,719	35	33	32	5.7	5.4	16.7	15.7	9.6%
Oracle Financial Services	INR	3,871	331	44,265	49,128	52,991	39	38	38	6.3	5.8	15.1	14.0	9.4%
FIS	USD	98	33	9,123	8,845	9,204	32	35	36	4.6	4.4	12.3	11.8	0.4%
ACI Worldwide	USD	24	3	1,024	1,085	1,190	18	24	25	3.2	2.9	11.5	12.0	7.8%
Guidewire	USD	82	6	514	754	857	9	16	17	7.4	6.5	38.0	27.2	29.1%
Intellect Design*	INR	193	24	10,521	12,171	13,993	7	8	9	2.0	1.7	24.7	19.1	15.3%
Majesco India*	INR	491	12	8,071	9,812	11,870	1	5	9	1.0	0.8	18.9	9.2	21.3%

Source: Bloomberg Estimates, PhillipCapital India Research; * PhillipCapital Estimates

Financials

Consolidated Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**9,110**	**10,521**	**12,171**	**13,993**
Growth, %	12.5	15.5	15.7	15.0
Employee expenses	-4,633	-5,332	-6,106	-6,924
Other Operating expenses	-4,753	-4,461	-5,090	-5,821
EBITDA (Core)	**-276**	**728**	**975**	**1,248**
Growth, %	-2.7	-364.2	33.9	28.1
Margin, %	-3.0	6.9	8.0	8.9
Depreciation	-241	-251	-306	-332
EBIT	**-517**	**477**	**668**	**916**
Growth, %	5.3	-192.2	40.3	37.1
Margin, %	-5.7	4.5	5.5	6.5
Interest paid	-113	-144	-127	-127
Other Non-Operating Income	361	153	126	130
Pre-tax profit	**-243**	**485**	**667**	**919**
Tax provided	-28	-88	-106	-186
Profit after tax	**-272**	**398**	**561**	**732**
Others (Minorities, Associates)	62	-102	-76	-71
Net Profit	**-209**	**296**	**484**	**661**
Growth, %	26.0	-241.5	63.6	36.4
Net Profit (adjusted)	**-209**	**296**	**484**	**661**
Wtd avg shares (m)	101	125	125	125

	FY16	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**124**	**136**	**163**	**187**	**215**
Growth, %	24.5	10.0	19.5	15.0	15.0
Re / US$ (rate)	65.4	66.9	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	1,258	1,776	1,590	1,860
Marketable securities	216	292	292	292
Debtors	2,048	2,085	2,432	2,640
Inventory	0	0	0	0
Other current assets	2,827	3,039	3,397	3,736
Total current assets	6,494	7,371	7,926	8,772
Investments	439	404	404	404
Net fixed assets	4,161	4,828	5,228	5,548
Non-current assets	636	953	1,073	1,137
Total assets	**11,842**	**13,669**	**14,744**	**15,973**
Total current liabilities	5,295	4,039	4,630	5,199
Non-current liabilities	564	1,302	1,302	1,302
Total liabilities	5,859	5,341	5,932	6,501
Paid-up capital	509	625	625	625
Reserves & surplus	5,475	7,632	8,116	8,777
Minorities	0	70	70	70
Shareholders' equity	5,983	8,328	8,812	9,473
Total equity & liabilities	**11,842**	**13,669**	**14,744**	**15,973**

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	-243	485	667	919
Depreciation	241	251	306	332
Chg in working capital	1,128	-1,856	-270	-71
Total tax paid	-17	-87	-106	-186
Other operating activities	0	0	0	0
Cash flow from operating activities	**1,108**	**-1,207**	**597**	**993**
Capital expenditure	-1,162	-919	-706	-652
Chg in investments	-17	35	0	0
Chg in marketable securities	84	-76	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,095**	**-960**	**-706**	**-652**
Free cash flow	14	-2,167	-110	341
Equity raised/(repaid)	5	117	0	0
Debt raised/(repaid)	563	738	0	0
Dividend (incl. tax)	0	0	0	0
Other financing activities	75	1,861	0	0
Cash flow from financing activities	**705**	**2,684**	**-76**	**-71**
Net chg in cash	719	518	-186	270

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	(2.1)	2.4	3.9	5.3
Growth, %	26.0	(214.0)	63.6	36.4
Book NAV/share (INR)	59.4	66.0	69.9	75.2
CFPS (INR)	(8.6)	1.6	4.7	7.4
DPS (INR)	-	-	-	-
Return ratios				
Return on assets (%)	(1.8)	3.8	4.5	5.3
Return on equity (%)	(3.5)	3.6	5.5	7.0
Return on capital employed (%)	(3.0)	5.8	6.2	7.5
Turnover ratios				
Asset turnover (x)	1.8	1.6	1.7	1.8
Sales/Total assets (x)	0.8	0.8	0.9	0.9
Sales/Net FA (x)	2.5	2.3	2.4	2.6
Working capital/Sales (x)	0.0	0.2	0.1	0.1
Receivable days	82.1	72.3	72.9	68.9
Liquidity ratios				
Current ratio (x)	1.3	2.0	1.9	1.8
Quick ratio (x)	1.3	2.0	1.9	1.8
Total debt/Equity (%)	38.8	22.0	20.8	19.3
Net debt/Equity (%)	10.5	(4.4)	(2.0)	(4.7)
Valuation				
PER (x)	(93.0)	81.6	49.8	36.5
PEG (x) - y-o-y growth	(3.6)	(0.4)	0.8	1.0
Price/Book (x)	3.3	2.9	2.8	2.6
EV/Net sales (x)	2.2	2.3	2.0	1.7
EV/EBITDA (x)	(73.7)	32.8	24.7	19.1
EV/EBIT (x)	(39.3)	50.1	36.0	26.0

Source: Company, PhillipCapital India Research Estimates

PhillipCapital

Majesco (MJCO IN)

E(i)nsuring growth in a disruptive environment

INDIA | IT Services | Company Update

28 February 2018

Large addressable opportunity: US is the largest insurance market in the world. As per the National Association of Insurance Commissioners, the Gross Written Premium (GWP) for P&C and L&A insurance in 2016 in the US was US$ 1.4tn. As per market estimates, insurance companies spend about 3.5% of their GWP on IT expenses, taking the total IT expenses to US$ 49bn; of this, 42% is spent on hardware/software and maintenance, which pegs the IT outsourcing market size at US$ 20bn. As per Majesco's management, it caters to 50% of that market – making the addressable target opportunity US$ 10bn. Majesco, which caters to all the segments of insurance (P&C and L&A), is present across the entire value-chain of the insurance process – policy, billing, and claims. It is among the top-3 service providers for the insurance industry (others being Guidewire and Accenture).

Cloud migration – the next big wave: Cloud is the fastest growing segment for the insurance industry (80% of Majesco's deal pipelines). The benefit of the shift to cloud can be seen in cloud revenue CQGR of 9% over the last seven quarters vs. overall revenue CQGR of -0.3%. As per management, cloud subscription revenue from existing customers should see a CAGR of 25% over the next three years. With cloud deals signed in the last year likely to ramp-up from FY19, we expect revenue growth to improve significantly ahead.

IBM partnership – a multi-million-dollar opportunity: In October 2016, Majesco announced a five-year partnership with IBM to jointly offer a new cognitive, cloud-based platform to help insurance carriers worldwide. The partnership enables insurance companies, with multiple options, to bring new business models, products, and services to the market rapidly. Majesco has already announced a 10-year cloud subscription deal (US$ 35mn) from IBM's partnership with MetLife. In addition to the subscription revenue, Majesco will also get implementation and support revenue – which we expect to be significant, given that cloud deals typically have significant proportion of implementation and support revenue.

The company has already started implementing the MetLife deal from Q2FY18, which resulted in strong qoq revenue growth of 8.8%/4.7% in Q2/Q3. We estimate US$ 200-300mn revenue from the IBM deal over the next five years, with revenue share of 50:50. IBM will provide system integration while Majesco will work on software configuration. Considering the size of the opportunity and additional revenue growth over the five years, we estimate the deal to provide incremental revenue growth of 8%/12%/13% in FY18/19/20.

Improving orderbook: With the increase in deal flow in cloud, coupled with strong addition in new clients, Majesco has witnessed strong traction in its new order wins. The current 12-month executable order backlog stands at US$ 92mn (~80% of its TTM revenue), providing better visibility for FY18 and beyond.

Building cash chest through QIP: The company recently raised Rs 2.3bn through a QIP (issued 4.4mn equity shares to QIBs at a price of Rs 520/share, resulting in ~19% equity dilution). It intends to use this cash for future acquisitions.

Outlook and valuations: We expect Majesco's FY17-20 revenue CAGR at 15% led by: (1) implementation revenue from the cloud deals signed in the last few quarters, (2) more client wins through IBM partnership, and (3) traction in existing clients (read our recent detailed report here). We have not made any changes to our FY19/20 revenue estimates. We continue to value Majesco at 3x FY20 EV/sales (a discount of 50% to its global competitor Guidewire, and 20% premium to INDA). We further provide a 50% holding-company discount to arrive at Majesco India's valuation. We ascribe Rs 640/share value to the core business, while valuing the QIP cash (to be deployed for inorganic growth later) at book value (Rs 10/share). Maintain Buy with price target of Rs 650 *(unchanged)*.

BUY (Maintain)

CMP RS 475

TARGET RS 650 (+37%)

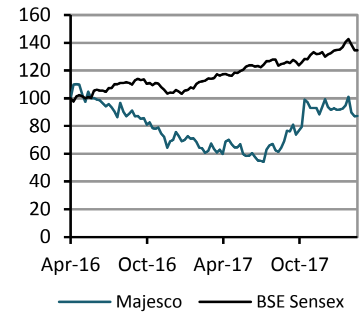
COMPANY DATA

O/S SHARES (MN) :	28
MARKET CAP (RSBN) :	13
MARKET CAP (USDBN) :	0.2
52 - WK HI/LO (RS) :	604 / 299
LIQUIDITY 3M (USDMN) :	1.7
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	47.9	48.1	48.0
FII / NRI :	0.8	1.0	2.6
FI / MF :	9.6	8.0	10.3
NON PRO :	16.5	9.7	7.7
PUBLIC & OTHERS :	25.1	33.3	31.4

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	8,071	9,812	11,870
EBIT	-73	301	775
Net Profit	6	243	583
EPS, Rs	0.2	8.7	20.8
PER, x	NA	54.5	22.7
EV/Sales, x	1.2	1.0	0.8
P/BV, x	2.4	2.3	2.1
ROE, %	(1.9)	4.3	9.3

Source: PhillipCapital India Research Est.

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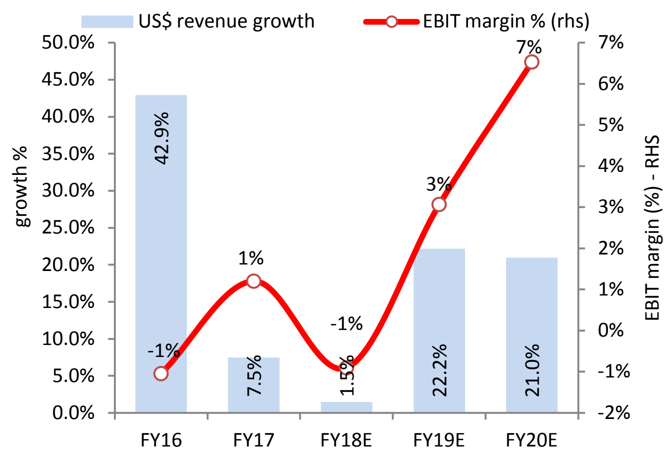
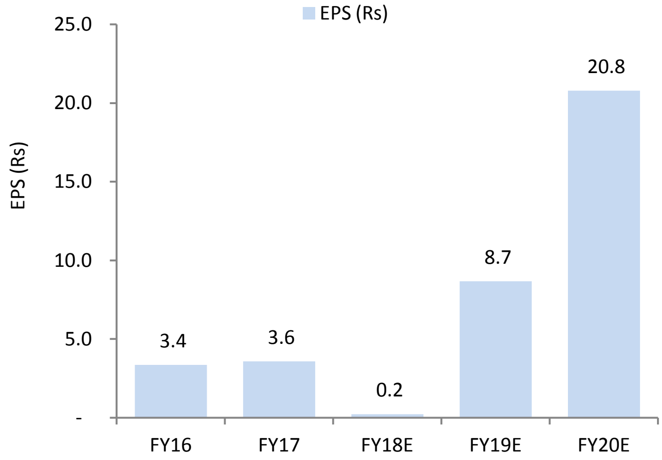
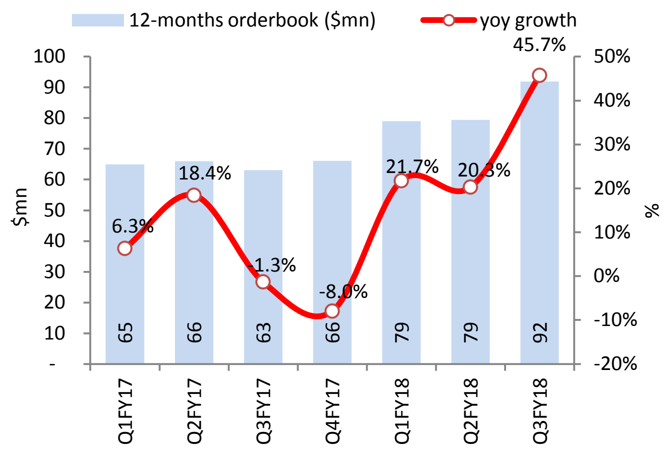
Revenue growth and Margins profile



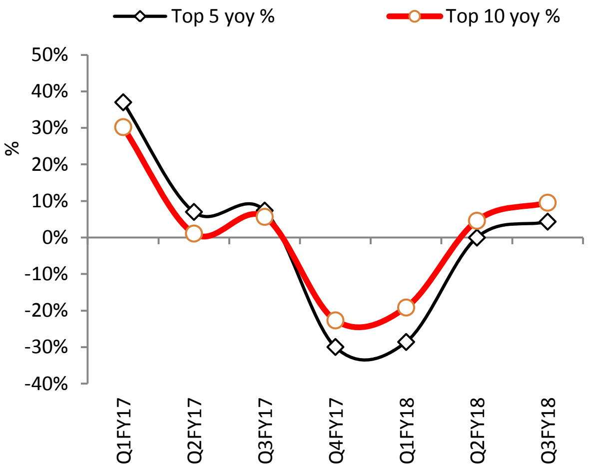
Earnings profile



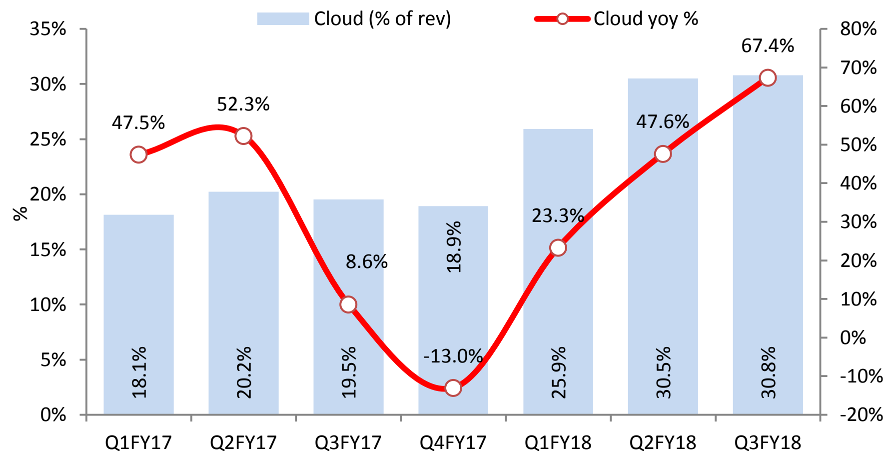
Order backlog has improved considerably



Top clients performance has started improving



Strong growth in Cloud revenue has mitigated decline in on-premise

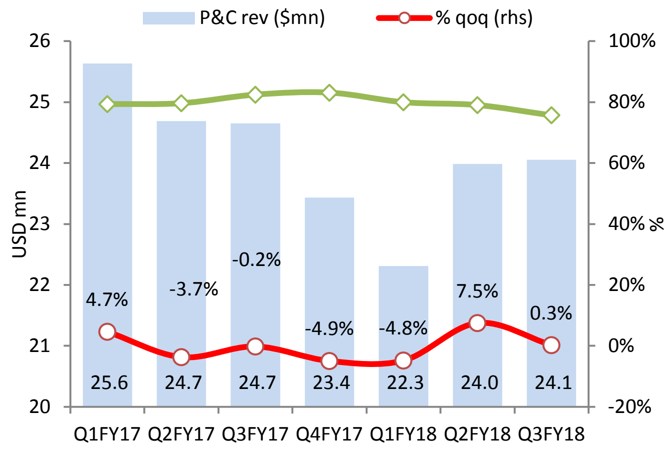


Majesco IBM partnership revenues – PC estimates

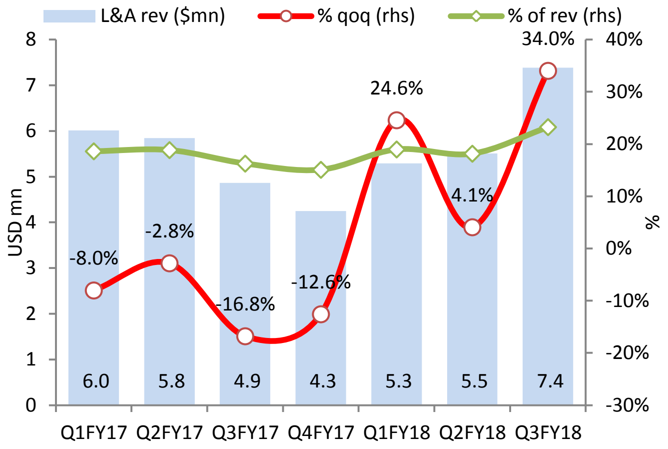
	FY18E	FY19E	FY20E	FY21E	FY22E
Majesco Organic Rev ($mn)	116	135	159	178	199
Growth	-4.7%	16.3%	17.5%	12.0%	12.0%
Majesco Rev share ($mn)	8	16	24	25	30
Incremental growth %	6.5%	11.9%	15.1%	14.1%	15.1%
Total Revenue ($mn)	124	151	183	203	229
Total revenue growth %	1.5%	22.2%	21.0%	11.0%	13.0%

Source: PhillipCapital India Research

P&C revenue profile



L&A revenue profile



Source: Company, PhillipCapital India Research

Majesco has acquired only 5 companies in last 10 years

Date	Acquired entity	Country	Deal Value (USD mn)	Particulars
Dec '14	Cover-All Technologies	USA	33	Solutions provider to the P&C insurance industry
Dec '14	Agile Technologies	USA	9	IT consulting services to the insurance industry
Dec '10	SEG Software, LLC	USA	NA	Policy administration software for individual and group life, health, and annuity-insurance products
Mar '08	Systems Task Group	USA	29	Enterprise-wide solutions to the P&C insurance industry
Jul '07	Vector Technologies	USA	9	Technology solutions provider and third-party administrator that focuses on the L&A insurance industry

Source: Company, PhillipCapital India Research

Annual recurring revenue growth potential from current engagements

Customer	Revenue Drivers	Customer Since	Annual Recurring Revenue (US$ mn) Minimum	Current	In 3 Years	CAGR
Customer 1	Premium Growth	2013	0.75	2.50	3.00	6.3%
Customer 2	Additional Lines of Business Premium Growth	2016	0.85	1.00	2.25	31.0%
Customer 3	Additional Lines of Business Premium Growth	2012	0.50	1.25	2.25	21.6%
Customer 4	Global Rollout Premium / TRX Volume Growth	2016	0.75	0.75	1.00	10.1%
Customer 5	System Modules and LOB Rollout Conversion & Premium Growth	2015	0.25	0.25	1.50	81.7%
Customer 6	Expansion across Segments Conversion & Premium Growth	2017	1.00	0.00	4.00	NA
Remaining Private Cloud Customers	Current book including Puerto Rico Customers		3.25	3.25	3.50	2.5%
Total			**7.35**	**9.00**	**17.50**	**24.8%**

Source: Company, PhillipCapital India Research

Valuation: Global product companies

Company	Currency	CMP	Mcap (bn)	Revenue (mn) FY18E	FY19E	FY20E	EBITDA margin (%) FY18E	FY19E	FY20E	EV/Sales (x) FY19E	FY20E	EV/EBITDA (x) FY19E	FY20E	Rev CAGR (%)
Guidewire	USD	82	6	514	754	857	9	16	17	7.4	6.5	38.0	27.2	29.1%
Accenture	USD	163	89	36,765	40,952	43,688	15	16	16	2.5	2.3	14.4	13.2	9.0%
Ebix	USD	87	2	298	470	NA	38	31	NA	6.4	NA	18.2	NA	NA
Sapiens	USD	10	1	216	355	NA	16	11	NA	1.1	NA	NA	NA	NA
Oracle Financial Services	INR	3,830	301	44,265	49,128	52,991	39	38	38	6.3	5.8	15.1	14.0	9.4%
Intellect Design*	INR	193	24	10,521	12,171	13,993	7	8	9	2.0	1.7	24.7	19.1	15.3%
Majesco India*	INR	491	12	8,071	9,812	11,870	1	5	9	1.0	0.8	18.9	9.2	21.3%

Source: Bloomberg Estimates, PhillipCapital India Research; * PhillipCapital Estimates

Financials

Consolidated Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**8,275**	**8,071**	**9,812**	**11,870**
Growth, %	9	-2	22	21
Employee expenses	-5,578	-5,714	-6,731	-7,756
Other Operating expenses	-2,382	-2,246	-2,559	-3,096
EBITDA (Core)	**316**	**112**	**522**	**1,018**
Growth, %	218.9	(64.7)	367.6	95.1
Margin, %	3.8	1.4	5.3	8.6
Depreciation	-217	-185	-221	-243
EBIT	**99**	**-73**	**301**	**775**
Growth, %	(225.3)	(173.7)	(510.7)	157.7
Margin, %	1.2	(0.9)	3.1	6.5
Interest paid	-67	-42	-39	-33
Other Income	95	79	63	70
Non-recurring Items	-27	107	0	0
Pre-tax profit	**101**	**70**	**325**	**812**
Tax provided	13	-136	-97	-243
Profit after tax	**114**	**-65**	**227**	**568**
Others (Minorities)	-31	72	16	15
Net Profit	**84**	**6**	**243**	**583**
Growth, %	(4.1)	(191.2)	(341.9)	139.9
Net Profit (adjusted)	**84**	**6**	**243**	**583**
Wtd avg shares (m)	23	28	28	28

	FY17	FY18E	FY19E	FY20E
US$ Revenue ($ mn)	**122**	**124**	**151**	**183**
Growth, %	7.5	1.5	22.2	21.0
Re / US$ (rate)	68.0	65.3	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	1,581	3,157	2,976	3,367
Marketable securities at cost	176	1,068	1,068	1,068
Debtors	830	1,002	1,204	1,423
Loans and advances	580	644	774	915
Other current assets	241	191	287	339
Total current assets	3,409	6,063	6,309	7,112
Investments	0	0	0	0
Net fixed assets	2,634	2,571	2,643	2,715
Non-current assets	104	119	143	169
Total assets	**6,551**	**9,224**	**9,565**	**10,468**
Total current liabilities	1,728	1,878	1,920	2,151
Provisions	295	327	372	432
Total current liabilities	2,023	2,204	2,292	2,583
Non-current liabilities	841	905	916	945
Total liabilities	2,863	3,109	3,208	3,527
Paid-up capital	117	140	140	140
Reserves & surplus	2,815	5,268	5,511	6,094
Shareholders' equity	3,688	6,114	6,357	6,940
Total equity & liabilities	**6,551**	**9,224**	**9,565**	**10,468**

Cash Flow

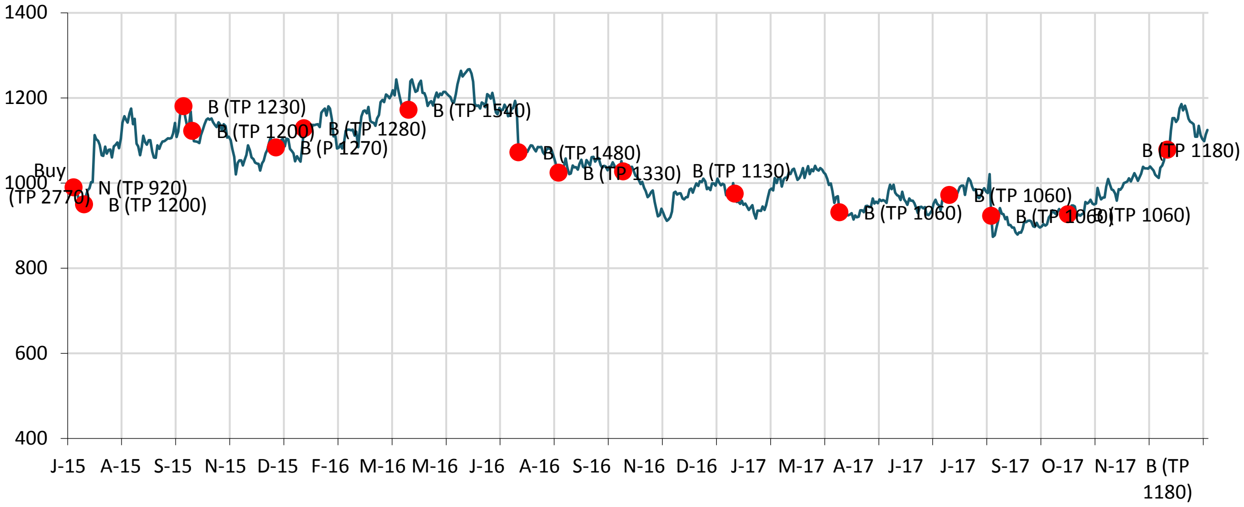
Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	101	70	325	812
Depreciation	217	185	221	243
Chg in working capital	229	64	-311	-80
Total tax paid	-10	-203	-97	-243
Cash flow from operating activities	**535**	**116**	**137**	**731**
Capital expenditure	-257	-121	-293	-315
Chg in investments	24	0	0	0
Chg in marketable securities	-56	-892	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-290**	**-1,014**	**-293**	**-315**
Free cash flow	246	-898	-156	416
Equity raised/(repaid)	2	23	0	0
Debt raised/(repaid)	91	-18	-40	-40
Dividend (incl. tax)	0	0	0	0
Other financing activities	87	2,447	0	0
Cash flow from financing activities	**183**	**2,473**	**-24**	**-25**
Net chg in cash	429	1,575	-180	391

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	3.6	0.2	8.7	20.8
Growth, %	(11.8)	(176.0)	(341.9)	139.9
Book NAV/share (INR)	125.5	192.9	201.5	222.3
CFPS (INR)	35.8	1.6	5.6	26.7
DPS (INR)	-	-	-	-
Return ratios				
Return on assets (%)	2.7	(0.3)	2.8	6.0
Return on equity (%)	3.8	(1.9)	4.3	9.3
Return on capital employed (%)	3.9	(0.4)	3.6	7.5
Turnover ratios				
Asset turnover (x)	3.0	3.4	3.9	4.3
Sales/Total assets (x)	1.2	1.0	1.0	1.2
Sales/Net FA (x)	3.2	3.1	3.8	4.4
Working capital/Sales (x)	(0.0)	(0.0)	0.0	0.0
Receivable days	36.6	45.3	44.8	43.8
Liquidity ratios				
Current ratio (x)	2.0	3.2	3.3	3.3
Quick ratio (x)	2.0	3.2	3.3	3.3
Total debt/Equity (%)	24.4	13.0	10.7	8.1
Net debt/Equity (%)	(29.5)	(45.3)	(42.0)	(45.9)
Valuation				
PER (x)	100.2	NA	54.5	22.7
PEG (x) - y-o-y growth	(8.5)	0.7	(0.2)	0.2
Price/Book (x)	3.8	2.4	2.3	2.1
EV/Net sales (x)	1.2	1.2	1.0	0.8
EV/EBITDA (x)	31.6	87.0	18.8	9.1
EV/EBIT (x)	100.5	(132.7)	32.6	12.0

Source: Company, PhillipCapital India Research Estimates

Stock Price, Price Target and Rating History (Infosys)



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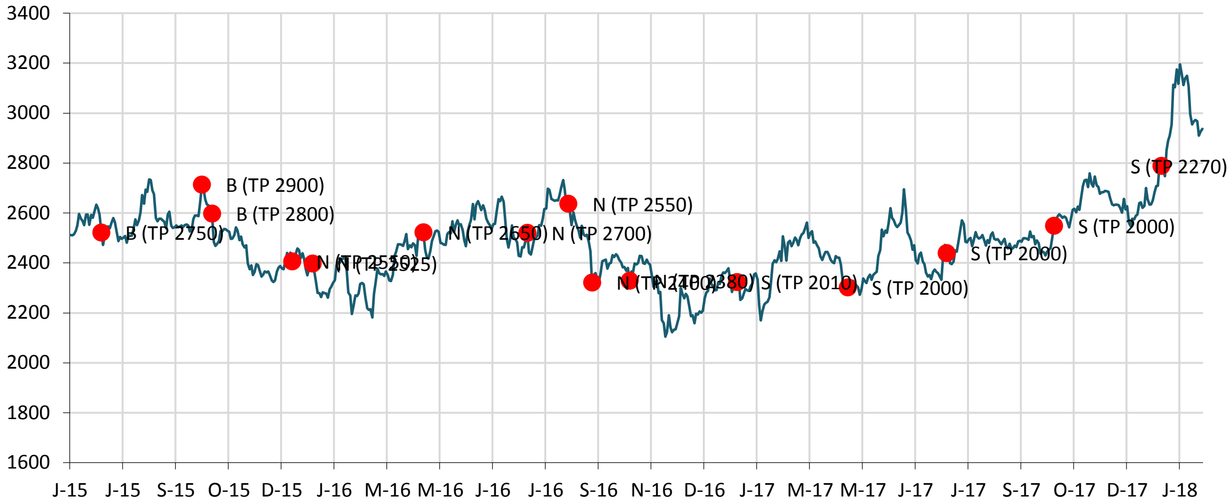
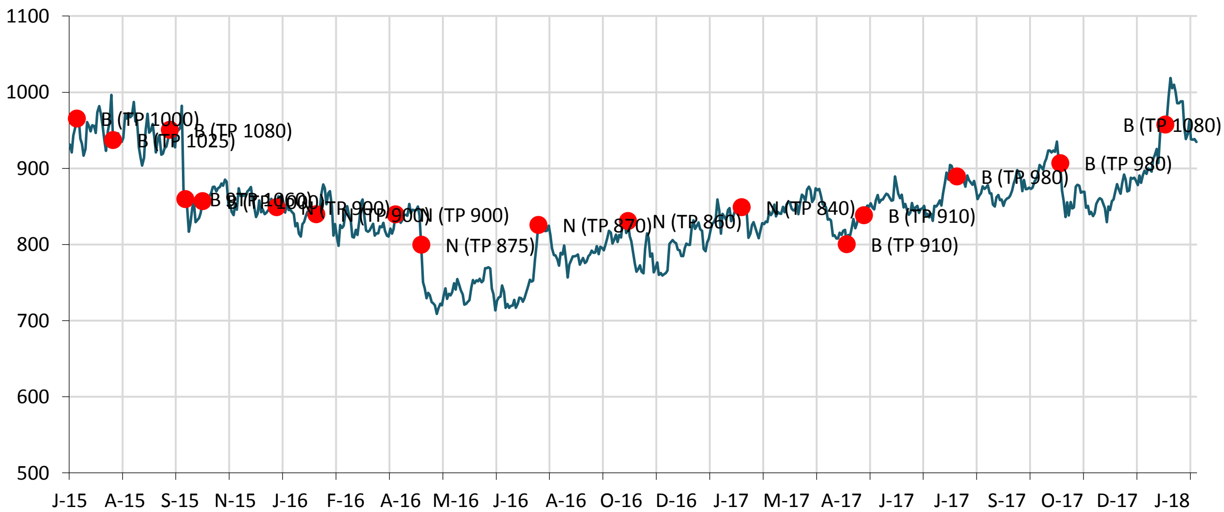
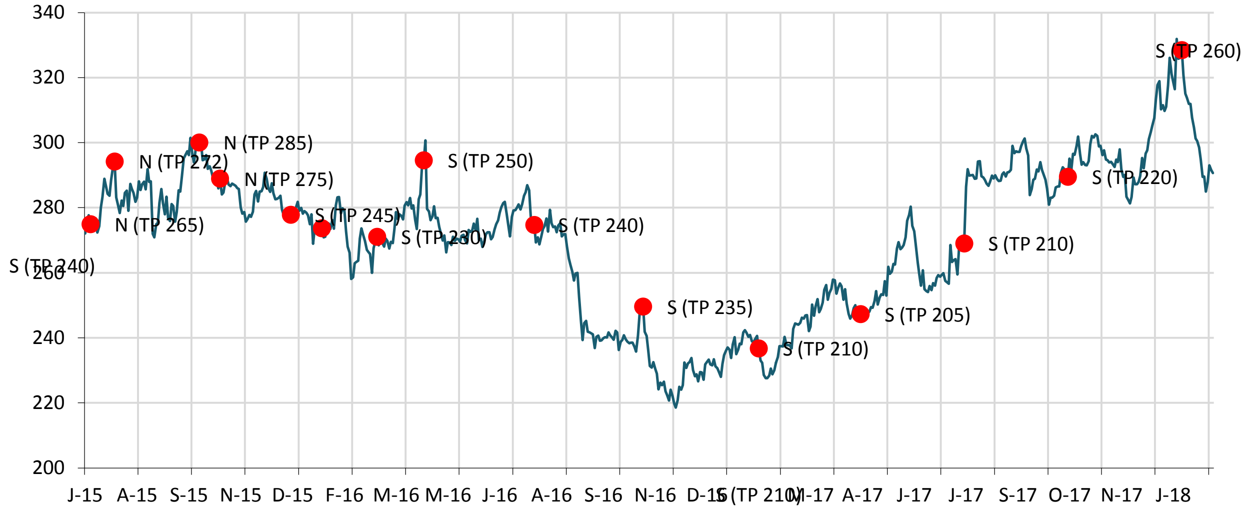


Stock Price, Price Target and Rating History (HCL Technologies)

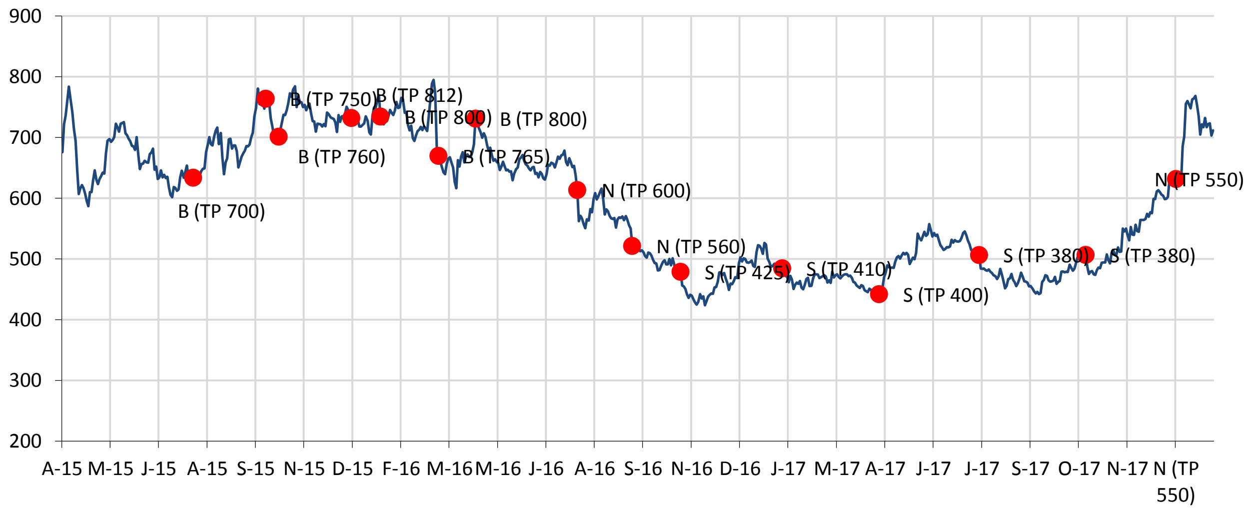


Stock Price, Price Target and Rating History (Wipro)

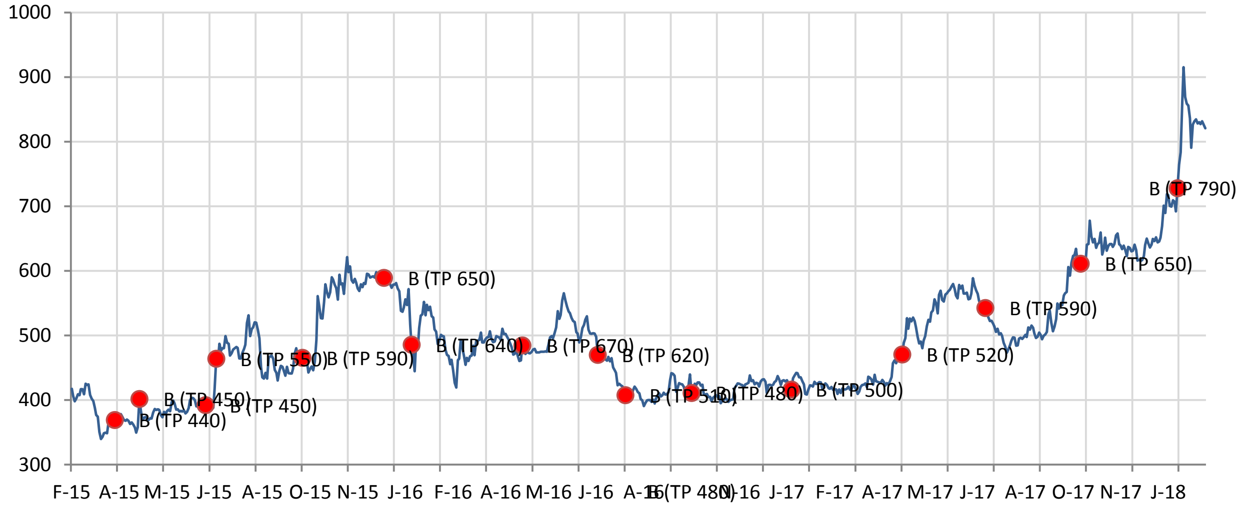


Stock Price, Price Target and Rating History (Tech Mahindra)

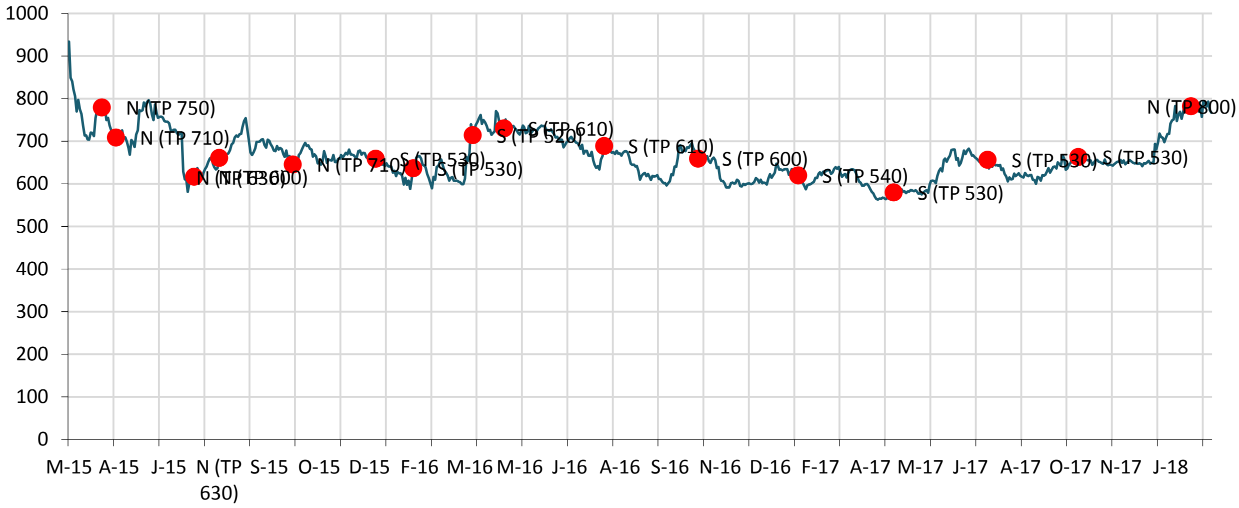
Stock Price, Price Target and Rating History (Mindtree)



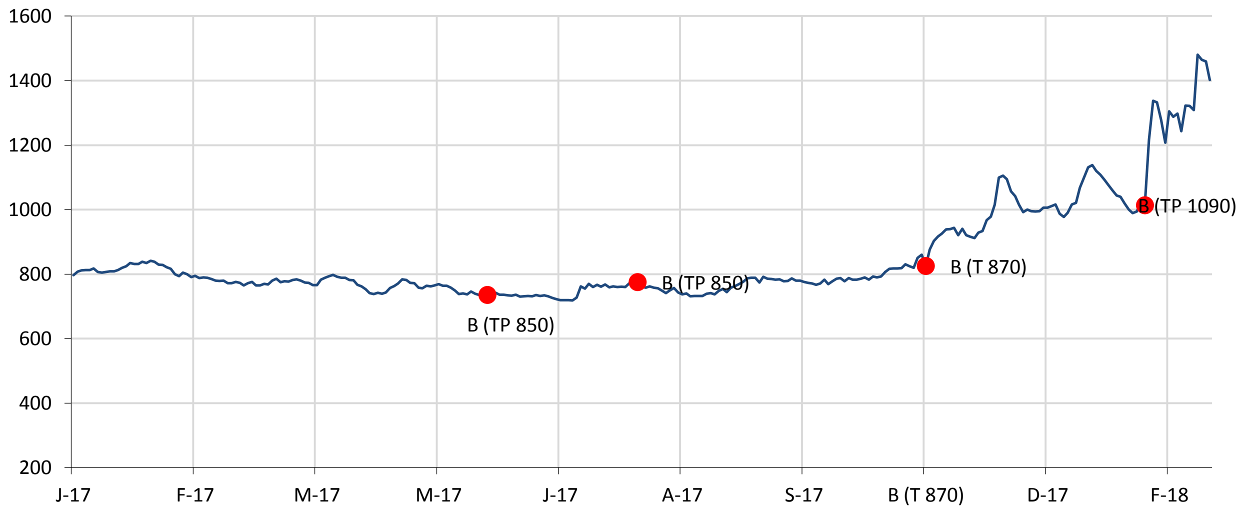
Stock Price, Price Target and Rating History (NIIT Tech)



Stock Price, Price Target and Rating History (Persistent)

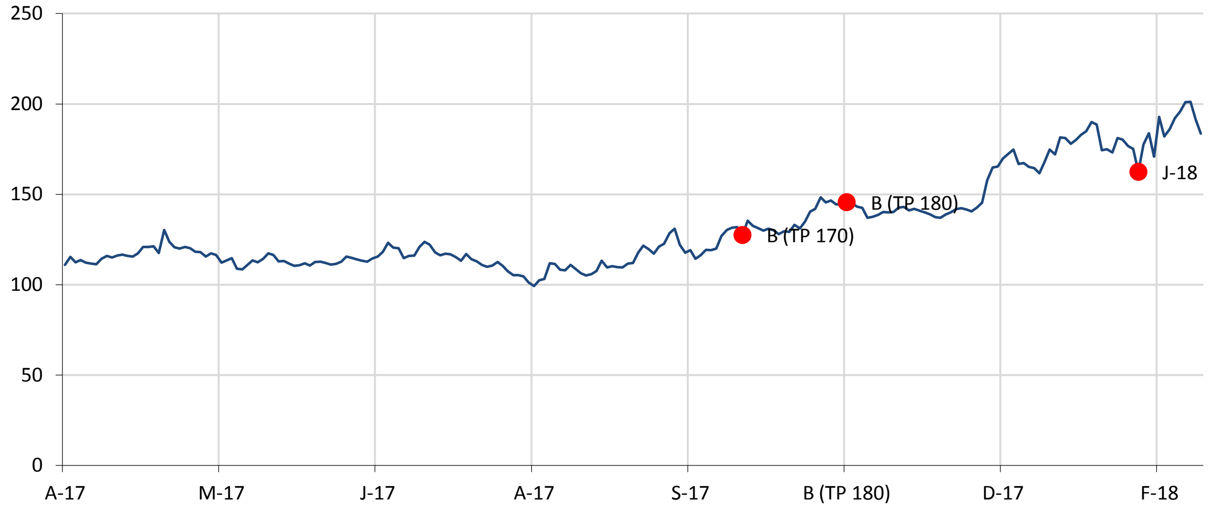


Stock Price, Price Target and Rating History (L&T Technology)



Stock Price, Price Target and Rating History (Cyient)

Stock Price, Price Target and Rating History (Intellect Design Arena)



Stock Price, Price Target and Rating History (Majesco)

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We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

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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