

ISG Index - Growth in deal wins continues

Acceleration takes a breather amid decision slowdown in the US

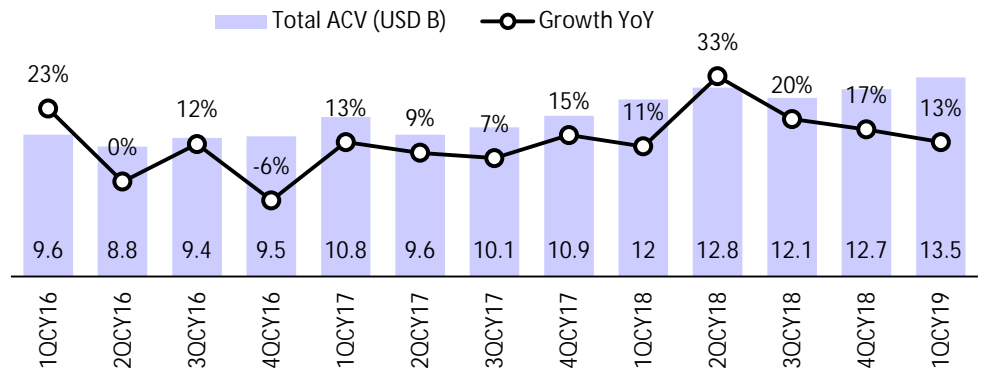
We attended a quarterly call by ISG, where it cited the progress on deal wins and key developments in the IT industry. With traditional sourcing a major component of the deals data tracked by ISG, the trends hold relevance from Indian IT Services' perspective. Key highlights:

- n Total deals ACV (annualized contract value) continued to rise, but traditional deals ACV came off in the US (growth supported by APAC and EMEA on a low base).
- n There was some slowdown in decision making in the US through the course of 1QCY19. There has been tendency to drive cost savings and operational excellence. This could be just settling of activity levels on a high CY18 base too, according to the ISG. ISG tapered the outlook for 2019 traditional sourcing ACV growth to 3.2% from 4%.
- n Infrastructure as a Service (IaaS) and Software as a Service (SaaS) continue to surge in deal sizes. IaaS is helping service providers and showing no signs of slowing, while SaaS is hurting. Digital Systems Integration remains a massive opportunity just having scratched the surface.
- n Talent crunch is severe and driving some M&A activity in the sector, such as Luxoft. Despite the constrained supply, pricing is not inching higher – macro in part has a role to play.
- n Indian mid-tier providers are in a sweet spot, given their agility to navigate to newer areas and service demand.
- n Captives will continue gaining prominence as Digital spending is driven by units outside IT Office.

TCV trend – taking a breather in the US

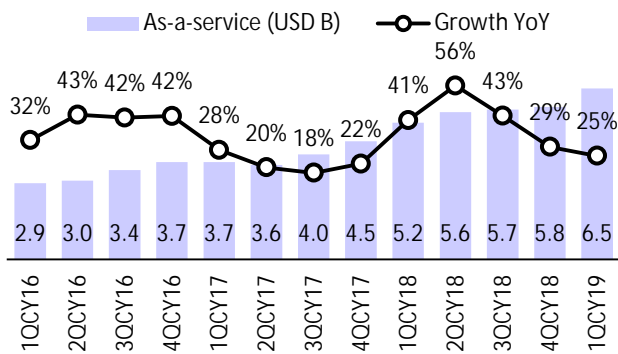
- n ISG cited that (based on the database it maintains of large deal activity) total annualized contract value (ACV) increased 12.5% YoY to USD13.5b in 1QCY19, with the pace of growth slowing from 16.5% in the previous quarter.
- n While growth in both 'as-a-service' and 'traditional sourcing' contributed to the deceleration, the major impact was seen in sourcing. As-a-service grew at 25% YoY (vs. 29% in 4QCY18) and traditional sourcing inched up merely by 2.9% YoY (v/s 8% in 4QCY18).
- n ACV remained stagnant in the US, with growth in as-a-service (+26% YoY) completely offset by a decline in traditional sourcing (-16% YoY).
- n Overall growth was supported by EMEA (+23% YoY) and APAC region (+34% YoY).

Exhibit 1: 1QCY19 ACV growth declined amid slow decision making in the US



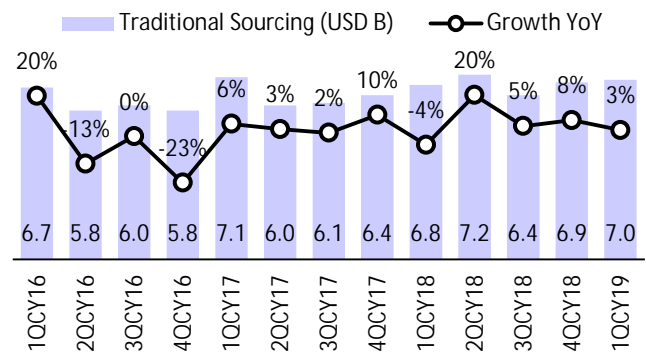
Source: MOFSL, Company

Exhibit 2: As-a-Service growing at 25% YoY



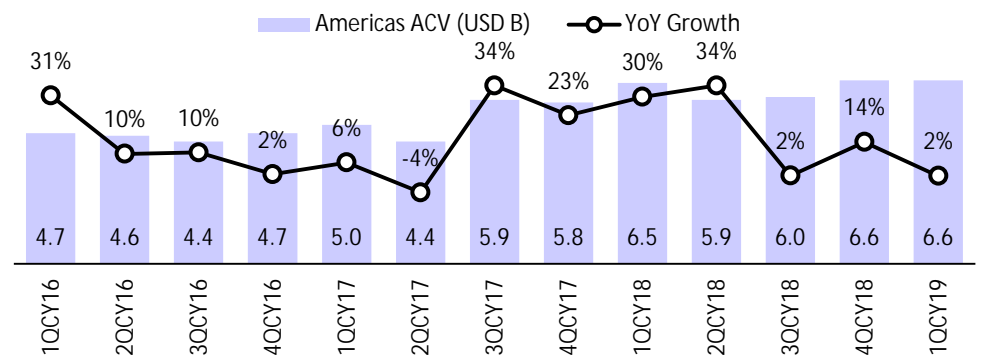
Source: Company, MOFSL

Exhibit 3: ...with traditional sourcing growth touching low single digit



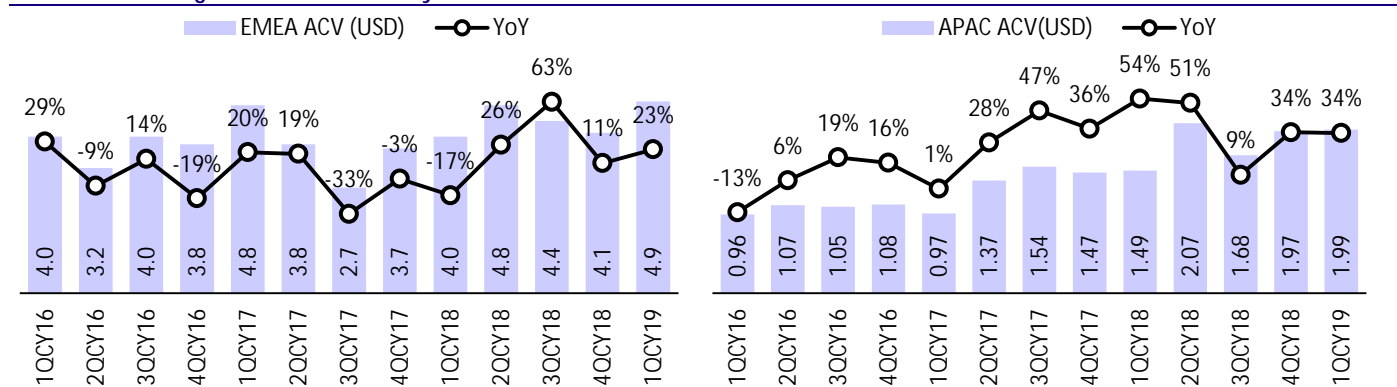
Source: Company, MOFSL

Exhibit 4: Stagnant ACV in the US amid slow decision making, and on a high CY18 base



Source: MOFSL, Company

Exhibit 5: ...with growth dominated by EMEA and APAC



Source: MOFSL, Company

Overall activity strong, but signals remain mixed amid macro caveat

- n Healthy ACV numbers came with a caveat, as large enterprises are cautious amid possibilities of a slowdown.
- n Downturn in the US has resulted in some pullback in demand, especially in the last couple of quarters. Deals are now clustered around cost savings and operational excellence.
- n ISG remains confident about 'As-a-service', keeping its guidance unchanged at 25% YoY growth. Given the headwinds from the cautious macro environment, it has revised its outsourcing deals growth guidance to 3.2% v/s 4% earlier.

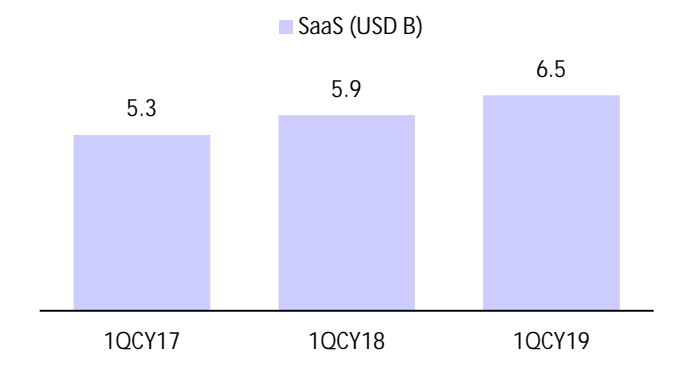
Supply-pricing dichotomy

- n There is a significant crunch of talent around newer skills like AI, analytics, dev-ops and cognitive automation.
- n The situation for service providers is not that worse, as enterprises are finding it even harder to find talent. This only helps create more demand to service providers.
- n While the scenario makes a case for improved billing rates, macro is not allowing that. Pricing for agile dev-ops projects is not per-person, but is being worked at the project level.

As-a-Service: IaaS benefiting, SaaS hurting service providers

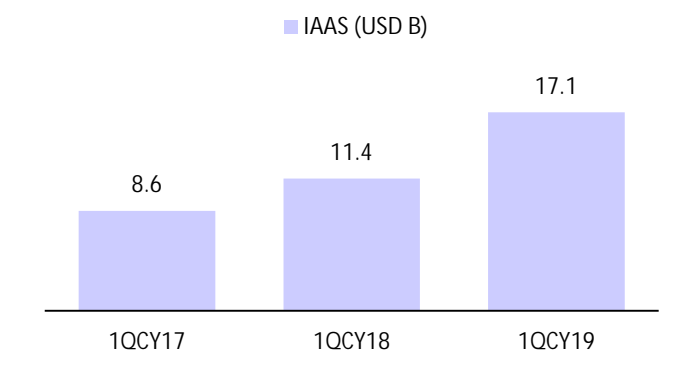
- n Within as-a-service, growth was majorly dominated by IaaS (+46% YoY), while growth in SaaS stood at 10% YoY. This was majorly led by high adoption of cloud.
- n For Indian vendors, growth has been a function of IaaS over the past few quarters, which feeds into IaaS growth – by enabling a new operating environment. On the other hand, development of SaaS is hurting the implementation and maintenance revenue, which is a fraction of that in the case of on-premise instances.
- n Indian vendors have always heavily relied on enterprise implementation. According to ISG, earlier for every dollar spent on enterprise, software companies had to spend 3-5 dollars on implementing and maintaining it. However, with newer SaaS-based products like Workday implementation, the cost has gone down to half a dollar for every dollar spent on the product.

Exhibit 6: SaaS growing at 10% YoY



Source: Company, MOFSL

Exhibit 7: IaaS growing at 46% YoY



Source: Company, MOFSL

Immense opportunity in Digital Systems Integration

- n Advantage of SaaS compared to enterprise software is mainly due to [1] predictability in forecasting expense, [2] lower cost and lower commitment products for adjacent business functions, [3] higher innovation and [4] lower implementation cost.
- n ISG estimates SaaS' current market at USD127b, and given high demand, it is expected to be double in five years. For the providers with capabilities, the opportunity in applications and Digital SI has just scratched the surface.

Competitive intensity is the highest; Captives too remain relevant

- n With shorter deals in SaaS-based implementation, the competition has become huge with smaller players getting a shot at them. The number of vendors competing over a deal has grown five-fold.
- n **Captives** will continue gaining prominence as Digital spending is driven by units outside IT Office. The dependence on data and its relevance as an asset will make Enterprises want to control the same.

Exhibit 8: Valuation Comparison

	CMP	Rating	EPS (INR)			PE (INR)			CAGR (FY18-20)		
			FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	Revenue	Margin (bp)	Earnings
Tier-I Technology											
TCS	2,040	Neutral	82.3	88.2	98.6	24.8	23.1	20.7	9.5	60	15.6
Infosys	753	Buy	36.2	38.7	45.3	20.8	19.5	16.6	9.2	(230)	9.3
Wipro	281	Neutral	14.8	16.6	18.3	19.0	17.0	15.3	5.1	100	11.1
HCL Tech	1,098	Neutral	73.7	81.1	91.7	14.9	13.5	12.0	12.8	130	13.9
TechM	790	Buy	49.9	55.1	61.8	15.8	14.3	12.8	6.0	290	13.2
Tier-II Technology											
Mphasis	995	Neutral	56.9	60.8	70.4	17.5	16.4	14.1	13.2	80	17.5
LTI	1,648	Neutral	88.7	93.0	102.7	18.6	17.7	16.0	15.6	110	18.4
Mindtree	970	Neutral	45.4	50.7	61.2	21.4	19.1	15.9	15.5	110	21.4
Cyient	592	Neutral	38.4	46.8	50.4	15.4	12.6	11.7	8.9	(20)	10.6
Hexaware	347	Neutral	19.3	21.0	23.6	17.9	16.5	14.7	12.1	(100)	12.4
NIIT Tech	1,298	Neutral	66.2	74.5	89.9	19.6	17.4	14.4	13.5	100	27.9
Persistent	625	Buy	42.7	58.1	51.9	14.7	10.7	12.0	6.0	280	20.0
Zensar	230	Buy	14.0	15.5	18.5	16.4	14.8	12.5	14.1	80	21.2

Source: Company, MOSL

Explanation of Investment Rating	
Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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