

IT Services

India

Sector View: **Neutral**

NIFTY-50: **23,259**

June 11, 2024

CTSH—big bet in core engineering services

CTSH announced the acquisition of Belcan for a consideration of US\$1.29 bn, through a mix of cash and stock. Belcan is a North American ERD services provider, with significant presence in asset-heavy industries such as aerospace, defense and industrial products. Acquisition consideration implies a transaction multiple of 1.6X EV/sales. The acquisition follows moves by large Indian IT peers, adopting the inorganic route to acquire ERD services companies. While the acquisition addresses a white space in CTSH's service offerings, ability to address different purchase centers for ERD and IT services would determine the extent of synergy realization. CTSH expects annual revenue synergies of over US\$100 mn within three years.

Contours of the acquisition

CTSH has entered a definitive agreement to acquire Belcan for US\$1.29bn, with a US\$1.19 bn cash payout and US\$97 mn in stock (1.47 mn shares). Belcan has a revenue run-rate of US\$800 mn and grew at 8% over the past two years (lower organically). The acquisition's strategic rationale is to (1) increase exposure to the ERD services market and play on the shift toward outsourcing of spends, (2) access to top clients in the aerospace, defense and industrial products industries and (3) scale ERD delivery leveraging CTSH's global delivery model. Post-acquisition, Belcan would operate as a unit of Cognizant, with its current CEO Lance Kwasniewski continuing to lead the acquired entity. Cognizant expects annual revenue synergies of US\$100 mn within the next three years.

The acquisition would be EPS dilutive in CY2024 due to the impact of (1) amortization of acquired intangibles and (2) integration and related expenses. CTSH expects 40 bps impact on EBITM in CY2024. We believe Belcan's EBITDA margin might be in the high single-digit/low double-digit range, given its onsite-centric delivery model. The acquisition would be broadly neutral on CY2025 EPS and accretive CY2026 onward, driven by revenue and cost synergies.

Choice of verticals interesting; competition intensifying in ERD services

CTSH has relatively modest presences in ERD services and the acquisition addresses this white space. We concur that ERD services is a fast-growing market, with a shift by enterprises to outsource spends, but growth in the addressable market has few nuances—(1) spends are cyclical and aligned with the innovation cycle in an industry, (2) embedded and software engineering services would grow faster than mechanical (core) engineering services and (3) shift in delivery from onsite and nearshore models toward offshore centers.

We believe sourcing patterns in verticals such as aerospace and automotive are mature in comparison to relatively underpenetrated verticals such as industrial products. Furthermore, services oriented toward embedded and software engineering services, though in mature verticals such as automotive, would grow at a faster rate, given the technology transition underway in the industry. For instance, KPIT and TELX have been among primary beneficiaries, given higher exposure to auto ERD services. Large Indian IT peers such as Infosys and HCLT have also made strategic moves to tap into elevated ERD spends by OEMs in the vertical. Nonetheless, we believe competition is intensifying with the entry of larger peers, but would closely watch the ability to extract synergies from cross-sell, given disparate purchase centers for IT and ERD services and differences in the nature of work.

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While Belcan’s offerings are diversified, weightage is higher toward traditional engineering processes, lowering the relative attractiveness from a growth standpoint.

Onsite-centric core engineering services provider to asset-heavy industries

Belcan was founded in 1958 and was acquired by AE Industrial Partners in July 2015. The company had revenues of US\$700 mn and 7K employees in CY2016. It has a significant presence in onshore and nearshore, with 85% of delivery professionals based out of North America. The company has 6.5K engineers and tech consultants, and average revenue productivity of over US\$120K. It has higher client concentration than Indian ERD peers, with its top-15 clients contributing 70% of Belcan’s revenues (Exhibit 2). Some of its marquee clients include Raytheon, Pratt & Whitney, Rolls-Royce, Boeing, Airbus, Lockheed Martin and GM. Belcan has reported a CAGR of 8% over the past two years and is likely to grow in CY2024E.

CTSH expects revenue synergies from–(1) cross-sell of IT services to Belcan’s clients, leveraging CTSH’s digital engineering, data, supply-chain and manufacturing operations capabilities, (2) scaling global ERD delivery to address demand from existing clients in sectors such as commercial aerospace and industrial manufacturing and (3) cross-sell Belcan’s engineering services to CTSH’s automotive and industrial clients. Engineering services require certain level of knowledge of clients’ products and success of cross-sell would depend on companies’ ability to address the varied requirements of CIO and CTO organizations.

Other highlights

- ▶ **Outlook.** CTSH expects 2QCY24 revenues in the upper-half of earlier guided band of US\$4.75-4.82 bn. CY2024 revenue guide remains unchanged and would be revised based on expected closure timelines of the acquisition. The company currently expects closure in 3QCY24.
- ▶ **Share repurchases.** CTSH has increased its share repurchase plan for CY2024 to maintain outstanding shares at its current guidance of 497 mn for CY2024.
- ▶ **Client profile.** Belcan works with each of top-10 R&D spenders in aerospace and defense verticals. There is minimal overlap of clients between both entities

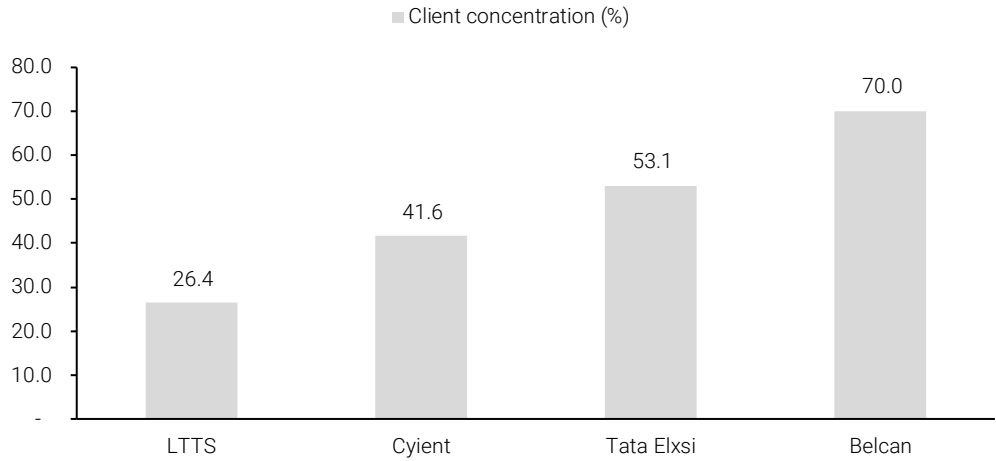
Exhibit 1: Select list of ERD services acquisitions by large IT services providers and transaction multiples (X)

Date	Company	Target	Consideration (US\$ bn)	Revenues (US\$ bn)	EV/sales (X)
Jun-24	Cognizant	Belcan	1.3	0.8	1.6
Apr-24	Infosys	InTech	0.5	0.2	2.6
Jan-24	Infosys	InSemi	0.03	0.02	1.8
Jul-23	HCL Tech	ASAP	0.3	0.2	1.7
Jul-21	Adecco	AKKA	2.4	1.8	1.3
Jun-21	Accenture	Umlaut	1.0	0.5	2.2
Mar-21	Hitachi	GlobalLogic	9.5	1.2	7.9
Jun-19	Capgemini	Altran	5.7	3.6	1.6

Source: Companies, Kotak Institutional Equities

Client concentration of Belcan is higher than Indian pure-play ERD peers such as LTTS and Cyient

Exhibit 2: Client concentration across ERD companies (%)

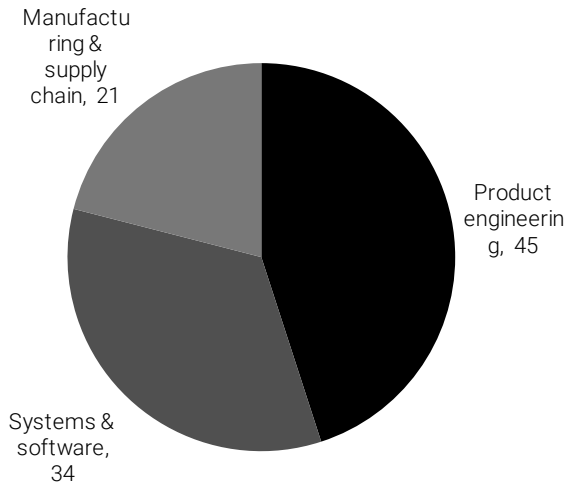


Notes:

(a) Top-10 clients' revenue mix for LTTS, Cyient and TELX; Top 15 clients' revenue contribution for Belcan

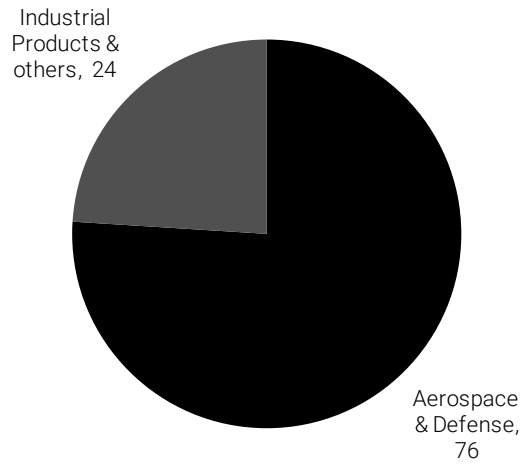
Source: Companies, Kotak Institutional Equities

Exhibit 3: Belcan—services revenue mix (%)



Source: Company, Kotak Institutional Equities

Exhibit 4: Belcan—vertical revenue mix (%)



Note: Industrial products and others includes space and marine verticals

Source: Company, Kotak Institutional Equities

Exhibit 5: Valuation summary of key Indian technology companies

Company	10-Jun-24		Mkt cap.		EPS (Rs)			P/E (X)			EV/EBITDA (X)			RoE (%)		
	Price (Rs)	Rating	(Rs m)	(US\$ m)	2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E
Cyient	1,887	BUY	209,304	2,506	66.3	79.3	91.0	28.5	23.8	20.7	15.6	13.9	11.9	18.3	18.2	18.8
HCL Technologies	1,419	ADD	3,850,012	46,102	57.9	61.9	68.9	24.5	22.9	20.6	14.8	14.0	12.7	23.8	24.4	26.1
Infosys	1,500	BUY	6,226,805	74,564	58.5	62.6	71.3	25.6	23.9	21.0	16.6	15.5	13.7	29.7	28.4	30.0
KPIT Technologies	1,482	SELL	406,295	4,865	21.3	27.3	36.8	69.6	54.3	40.3	40.2	32.2	24.6	30.4	30.2	32.0
L&T Technology Services	4,799	SELL	507,551	6,078	123.5	129.1	148.6	38.9	37.2	32.3	24.9	24.8	21.4	25.4	23.9	24.1
LTIMindtree	4,903	REDUCE	1,452,222	17,390	155.0	168.0	200.6	31.6	29.2	24.4	21.2	19.9	16.8	25.0	23.3	24.4
Mphasis	2,395	REDUCE	452,664	5,420	82.4	89.6	103.4	29.1	26.7	23.2	18.1	16.8	14.6	18.6	18.8	20.4
Persistent Systems	3,746	REDUCE	576,994	6,909	73.7	83.7	105.9	50.8	44.8	35.4	33.0	28.6	22.8	25.6	24.1	25.9
Rategain	735	ADD	86,631	1,037	12.9	17.9	23.7	57.0	41.1	31.1	42.8	32.0	23.5	13.5	13.6	15.4
Tata Elxsi	7,140	SELL	444,663	5,325	127.2	137.7	165.6	56.1	51.9	43.1	41.0	36.7	30.6	34.5	32.1	33.9
Tata Technologies	1,058	SELL	429,015	5,137	17.0	20.5	24.7	62.0	51.5	42.8	44.4	35.7	29.2	22.3	24.3	25.8
TCS	3,859	ADD	13,961,114	167,179	129.6	142.3	157.3	29.8	27.1	24.5	21.0	19.1	17.1	50.4	52.7	52.4
Tech Mahindra	1,340	REDUCE	1,182,890	14,165	31.6	46.0	61.4	42.4	29.2	21.8	22.6	16.3	12.9	10.3	15.3	19.9
Wipro	475	SELL	2,484,923	29,756	20.9	23.6	25.3	22.7	20.2	18.8	13.1	11.7	10.7	14.3	15.2	14.6

Company	Target Price (Rs)	O/S shares (mn)	EPS CAGR (%) 2024-26E	EPS growth (%)			Net Profit (Rs mn)			EBITDA (Rs mn)			Sales (Rs mn)		
				2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E
Cyient	2,275	111	17.2	28.6	19.5	14.9	7,349	8,785	10,091	13,029	14,360	16,564	71,473	78,844	91,038
HCL Technologies	1,600	2,716	9.1	5.9	6.9	11.3	157,070	168,017	187,206	241,959	254,995	277,551	1,099,155	1,156,154	1,274,316
Infosys	1,750	4,146	10.3	1.7	7.0	13.8	242,640	259,607	295,384	364,250	388,669	436,031	1,536,710	1,603,967	1,772,330
KPIT Technologies	1,050	273	31.5	51.9	28.1	34.9	5,811	7,448	10,048	9,913	12,329	15,864	48,715	59,501	71,331
L&T Technology Services	4,400	106	9.7	11.4	4.5	15.1	13,036	13,627	15,688	19,189	19,736	22,642	96,472	104,416	118,815
LTIMindtree	4,800	296	13.8	4.0	8.4	19.4	45,821	49,674	59,296	63,874	66,856	77,523	355,170	371,708	418,614
Mphasis	2,400	189	12.0	(5.2)	8.7	15.4	15,549	16,926	19,535	24,190	26,069	29,748	132,785	142,820	162,467
Persistent Systems	3,450	155	19.9	22.2	13.6	26.5	11,421	12,973	16,416	17,243	19,656	24,318	98,216	113,794	134,435
Rategain	900	119	35.5	148.8	38.6	32.4	1,454	2,119	2,807	1,897	2,467	3,232	9,570	11,517	13,643
Tata Elxsi	5,400	62	14.1	4.9	8.2	20.3	7,924	8,576	10,316	10,466	11,599	13,841	35,521	38,965	45,977
Tata Technologies	700	406	20.4	10.8	20.5	20.2	6,914	8,332	10,018	9,411	11,642	14,109	51,171	59,453	69,679
TCS	4,300	3,619	10.1	12.6	9.7	10.6	466,132	514,756	569,087	642,950	704,715	780,268	2,408,930	2,589,105	2,790,099
Tech Mahindra	1,220	890	39.3	(44.5)	45.3	33.5	28,160	40,917	54,609	49,645	69,505	86,971	519,955	520,764	563,558
Wipro	440	5,231	10.1	1.1	12.6	7.6	109,720	123,228	132,539	170,081	178,776	188,975	897,942	900,773	955,775

Source: Bloomberg, Company, Kotak Institutional Equities

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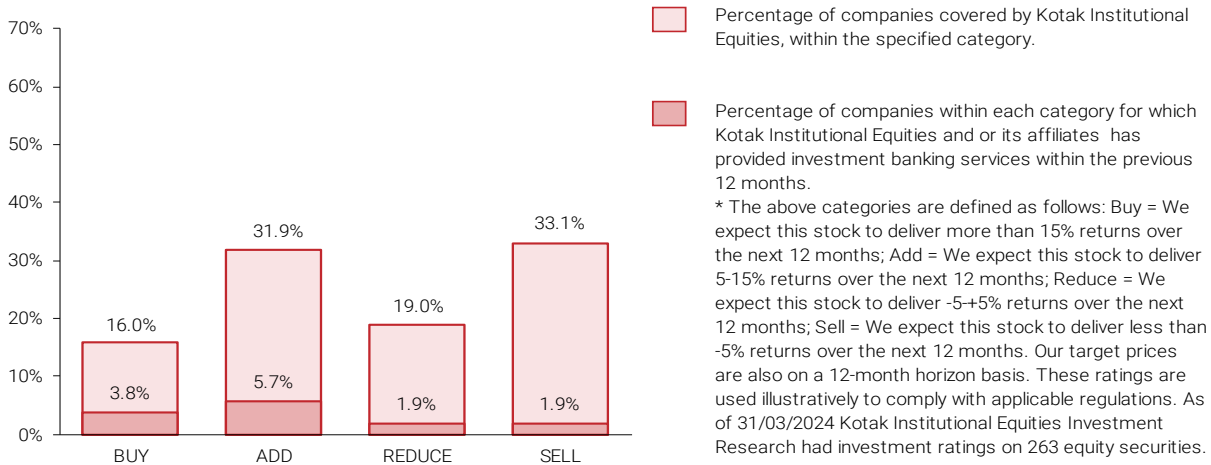
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As of March 31, 2024

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Derivatives are a sophisticated investment device. The investor is requested to take into consideration all the risk factors before actually trading in derivative contracts. Compliance Officer Details: Mr. Hiren Thakkar. Call: 022 - 4285 8484, or Email: ks.compliance@kotak.com.

Kotak Securities Limited. Registered Office: 27 BKC, C 27, G Block, Bandra Kurla Complex, Bandra (E), Mumbai 400051. CIN: U99999MH1994PLC134051, Telephone No.: +22 43360000, Fax No.: +22 67132430. Website: www.kotak.com / www.kotaksecurities.com. Correspondence Address: Infinity IT Park, Bldg. No 21, Opp. Film City Road, A K Vaidya Marg, Malad (East), Mumbai 400097. Telephone No: 42856825. SEBI Registration No: INZ000200137 (Member of NSE, BSE, MSE, MCX & NCDEX), AMFI ARN 0164, PMS INP000000258 and Research Analyst INH000000586. NSDL/CDSL: IN-DP-629-2021. Compliance Officer Details: Mr. Hiren Thakkar. Call: 022 - 4285 8484, or Email: ks.compliance@kotak.com

Details of	Contact Person	Address	Contact No.	Email ID
Customer Care/ Complaints	Mr. Ritesh Shah	Kotak Towers, 8th Floor, Building No.21, Infinity Park, Off Western Express Highway, Malad (East), Mumbai, Maharashtra - 400097	18002099393	ks.escalation@kotak.com
Head of Customer Care	Mr. Tabrez Anwar		022-42858208	ks.servicehead@kotak.com
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In absence of response/complaint not addressed to your satisfaction, you may lodge a complaint with SEBI at SEBI, NSE, BSE, Investor Service Center | NCDEX, MCX. Please quote your Service Ticket/Complaint Ref No. while raising your complaint at SEBI SCORES/Exchange portal. Kindly refer <https://www.kotaksecurities.com/contact-us/> and for online dispute Resolution platform - [Smart ODR](#)