



Grant Thornton

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IT services industry

Is cash still the king?



Introduction

IT companies in India have always been cash-rich. However, over the last few years, as the sector has matured and in the absence of any significant investment opportunities, IT companies have increased the cash return to investors by way of dividends and share buybacks.

In this publication, we have evaluated the capital allocation strategy adopted by large and mid-cap Indian IT companies in the last three years to assess how the cash position of these companies has changed.

These publicly listed IT services companies analysed constitute more than 90% market cap of the overall Indian IT services industry.

Large-cap IT services companies analysed

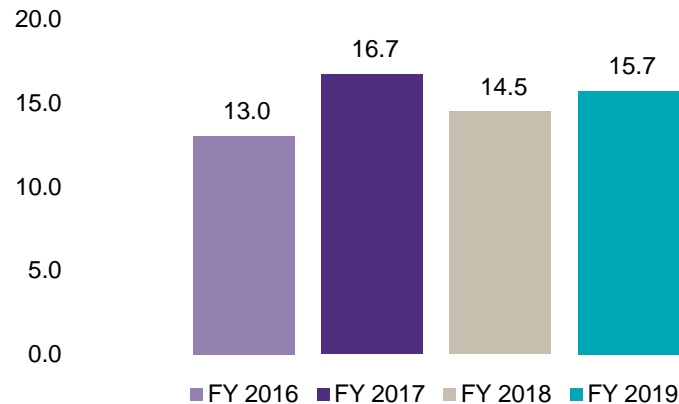
- Tata Consultancy Services
- Infosys
- Wipro
- HCL Technologies
- Tech Mahindra

Mid-cap IT services companies analysed

- Mphasis
- Mindtree
- Hexaware Technologies
- Persistent Systems
- Zensar Technologies
- Larsen & Turbo Infotech

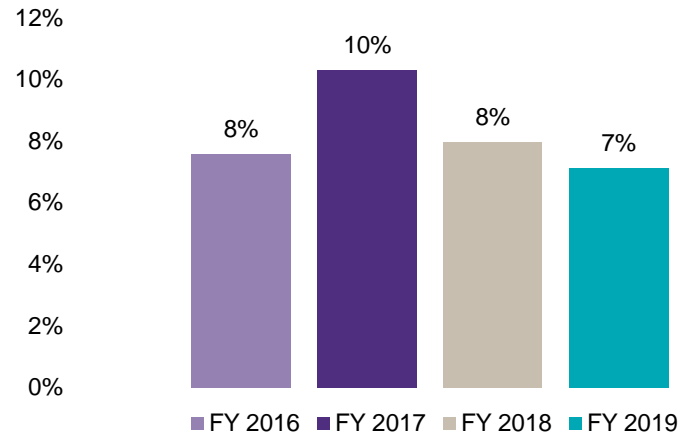
How has the net cash position changed over the last four years?

Industry closing net cash balance (USD billion)*



*Net cash = Cash + Short-term investments - Debt

Cash as a percentage of market cap (%)*^

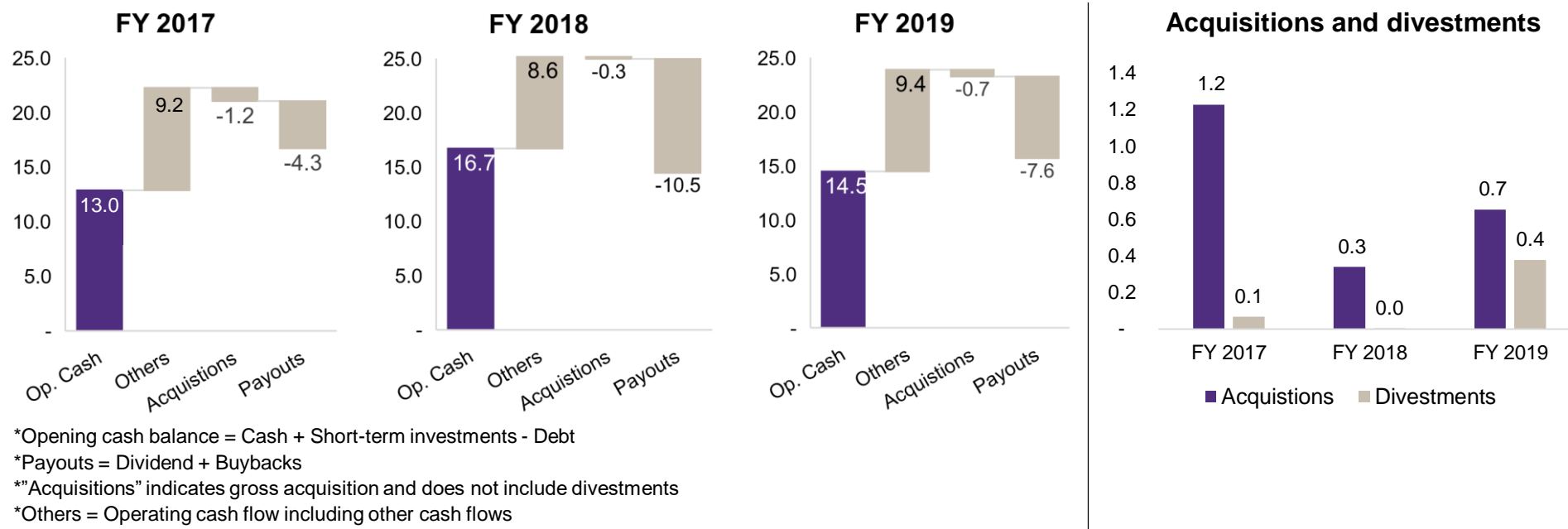


*Net Cash = Cash + Short-term investments - Debt

^Represents weighted average percentages based on market cap weights

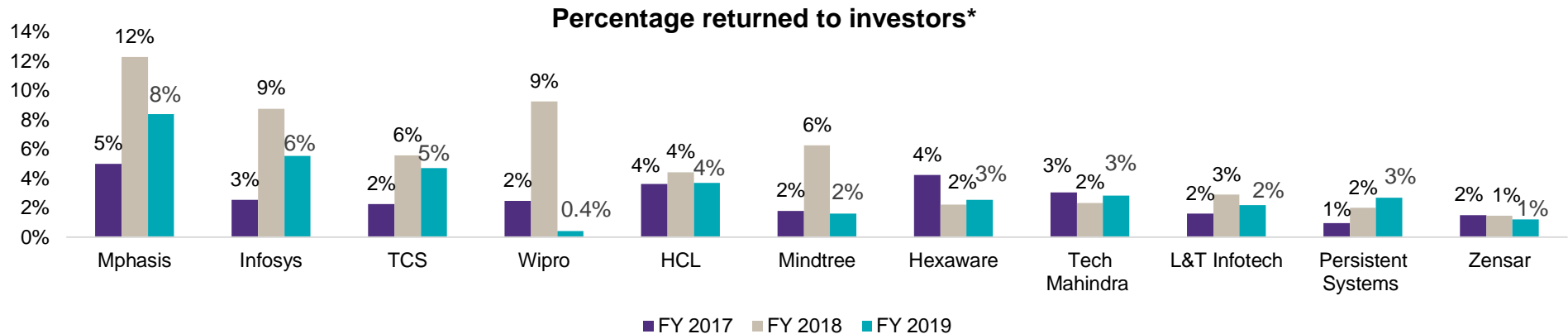
- Despite significant buybacks and dividends, the absolute net cash position has remained fairly stable and has increased in FY2019.
- This implies that companies are not eating into the cash existing on the balance sheet and are primarily using the cash generated in a particular year for the payouts.
- However, net cash as a percentage of market cap has shown a downward trend in the last three years with cash balance now constituting only 7% of the total market cap.

How has net cash been utilised over the last three years?



- FY 2019 witnessed an increase in divestment activities, especially by Wipro, in an effort to streamline the core business of IT services companies. This has also resulted in an increase in the cash balance.
- While the last three years did not have any mega deals, the focus was mainly on acquiring smaller companies to strengthen some specific capabilities of the IT services companies. Cash balance is likely to come down in FY 2020 due to HCL's acquisition of IBM's software products, which is the largest acquisition by an Indian IT company till date.
- Buyback is lower in FY 19 than in FY 18, implying toning down of return of capital by IT services companies. However, as per recent management commentary, these companies are expected to continue returning cash to their investors. For example, TCS has a capital return policy of 80%-100% of free cash flows, for Infosys it is 80% of free cash flows and for HCL it is 50%-60% of net income.

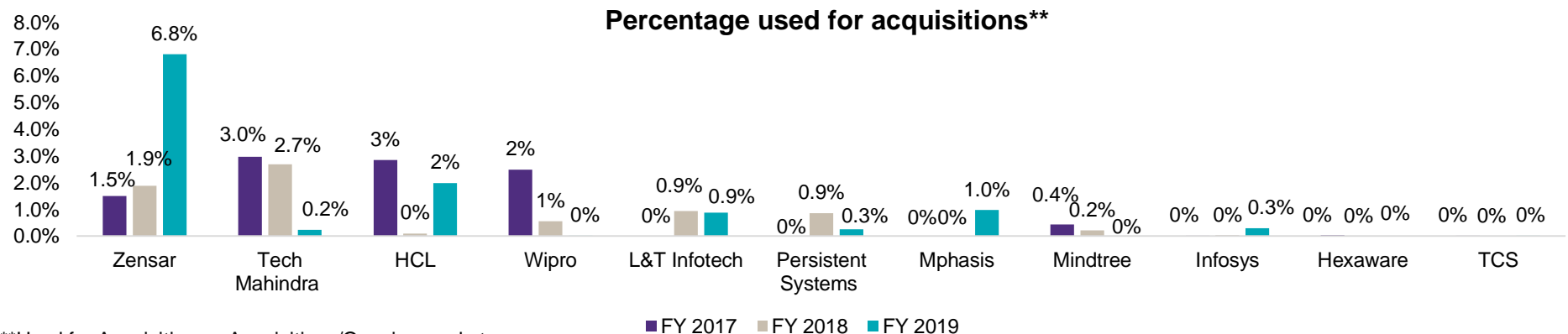
Which company is returning the most to its investors?



*Returned to investors = (Dividend + Buyback)/Opening market cap

*The graph has been presented in descending order based on the average of three years' percentage returned to investors

Which company has spent the most proportion of its cash on acquisitions?

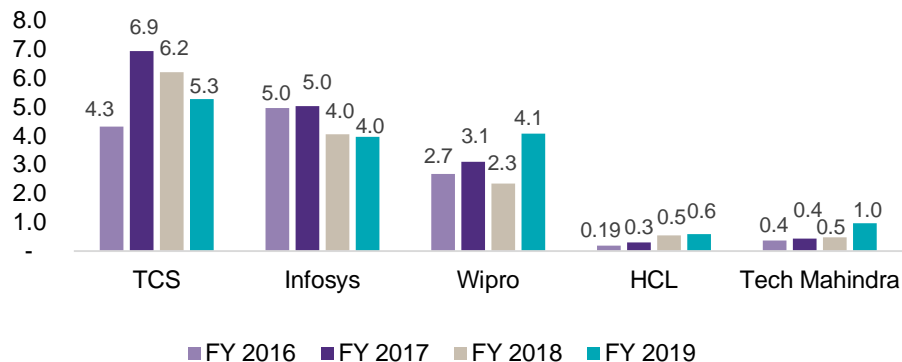


**Used for Acquisitions = Acquisitions/Opening market cap

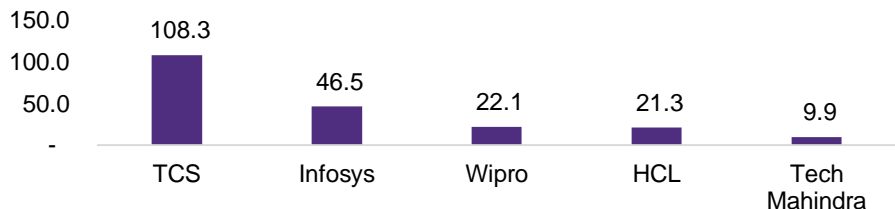
**The graph has been presented in descending order based on the average of three years' percentage used for acquisitions

Company-specific analysis

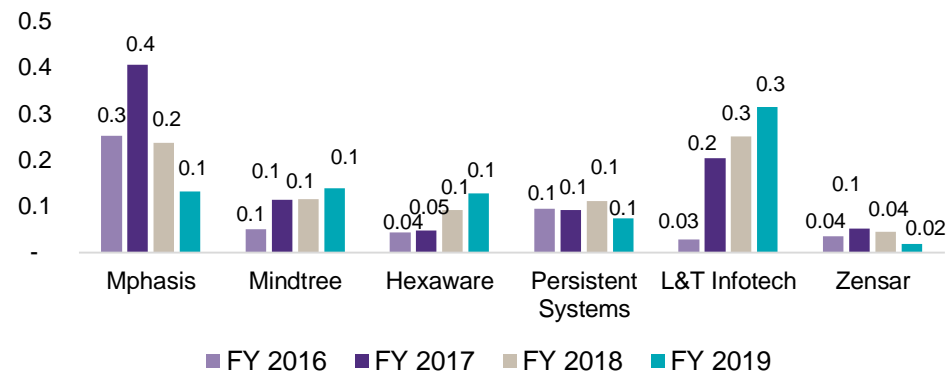
Net cash balances (USD billion) - Large cap*



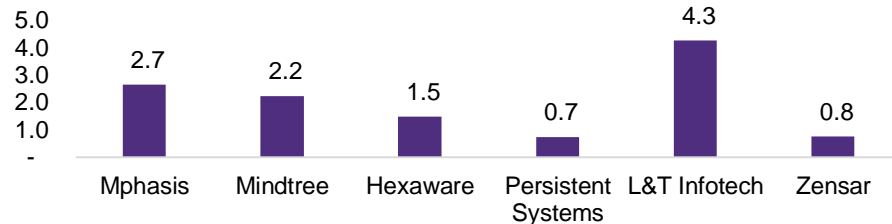
FY19 market cap (USD billion) - Large cap



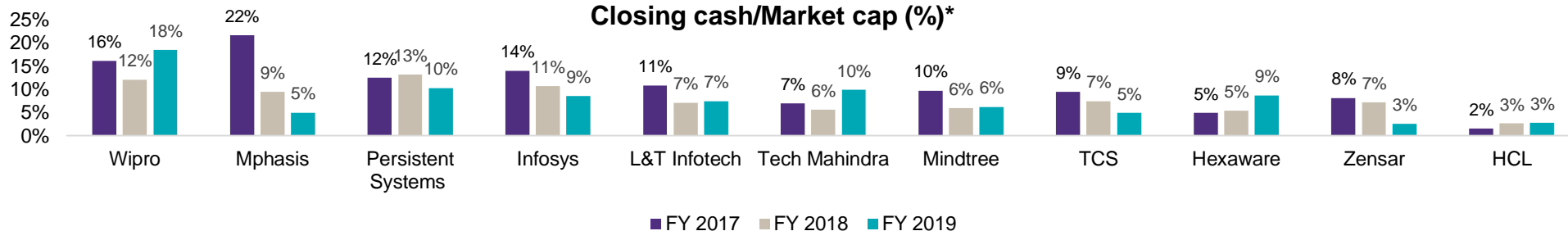
Net cash balances (USD billion) - Mid cap*



FY19 market cap (USD billion) - Mid cap



Closing cash/Market cap (%)*



*Net cash = Cash + Short-term investments - Debt

*The graph has been presented in descending order based on the average of three-year closing cash/market cap percentage

Key takeaways

- Even after returning capital to their investors, IT companies still have sufficient cash reserves to continue acquiring in order to gain digital capabilities and new-age technologies or diversify into engineering and R&D domains, similar to CapGemini's acquisition of Altran.
- However, in the mid to long term, the appetite for larger acquisitions may come down if the companies continue the pace of their cash payout to the shareholders.
- It is interesting to note that out of the companies analysed, Mphasis has returned the most cash to investors as a proportion of total available cash balance.
- Wipro's cash balance has actually increased in 2019 in terms of the percentage of market cap, due to divestments and sharp fall in the payouts in 2019.
- Among all the companies that we have analysed, Zensar has spent the maximum proportion of its available cash balance on acquisition.



References

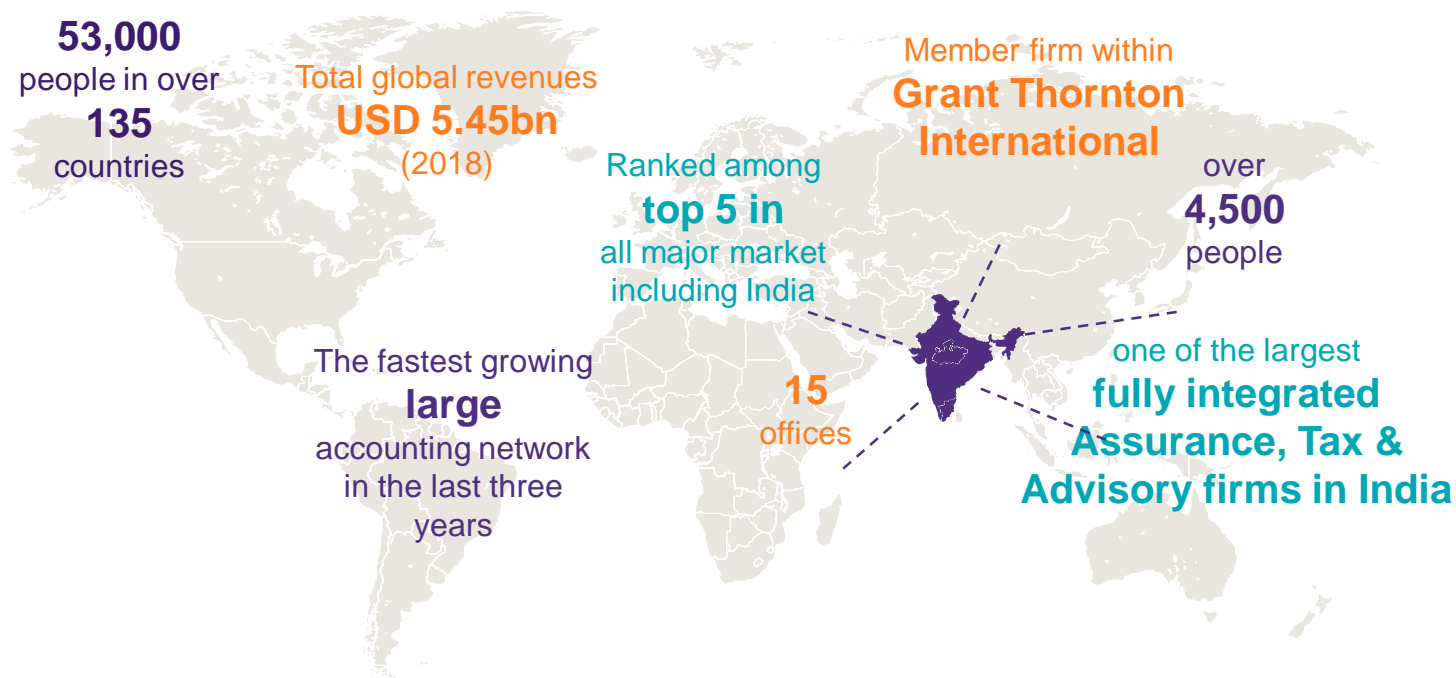
S&P Capital IQ database

Annual filings of IT services companies



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