Business Standard

Mon, 18 Apr-22; Business Standard - Mumbai; Size : 457 sq.cm.;
Circulation:30029; Page : 2

IT companies stare back at pre-pandemic margins

TCS & Infosys report average Ebidta margin of 27.6%, down from 30.1% last yr

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Mumbai, 17 April

ILLUSTRATION: AJAY MOHANTY

The FY22 fourth-quarter results of Tata Consultancy Services (TCS) and Infosys suggest the bump-up in IT companies' profit margin after the pandemic set in is coming to an end.

The combined EBITDA (earnings before interest, tax, depreciation, and amortisation) margin of TCS and Infosys in the quarter was the lowest since TCS was listed in 2004 except the lockdown quarter (Q1FY21) and Q4FY15, when TCS had given a special one-time bonus to its employees.

The two companies reported an Ebidta margin of 27.6 per cent, on average, in Q4FY22, down from 30.1 per cent a year ago as operating expenses grew at a faster rate than revenue. (*See chart*)

TCS' operating margin was down nearly 201 basis points (bps) year-on-year (Y-o-Y) to 28.7 per cent in Q4FY22 from 30.8 per cent a year earlier.

In comparison, Infosys' operating margin was down 333 bps Y-o-Y to 25.8 per cent in Q4FY22 from 29.1 per cent in Q4FY21.

One basis point is one-hundredth of a per cent.

The combined operating expenses of TCS and Infosys were up 22.2 per cent Y-o-Y in Q4FY22 against 18.4 per cent Y-o-Y growth in sales during the period. The rise was led by overheads, and sales and marketing expenses, while employee costs grew in line with the rise in revenues. For example, non-employee expenses for these two companies were up 36.1 per cent in Q4FY22 while salaries and wages were up 18.2 per cent during the quarter. There was a sharp decline in industry non-employee expenses in FY21 due to factors such as work from home and a virtual halt on international and domestic business travel.

"There has been a re-emergence of operating costs in the IT industry as employees are back in office and business travel has resumed. This is putting pressure on the IT industry's margins," said Dhananjay Sinha, managing director and chief strategist, JM Finance Institutional Equity.

A decline in margins has translated into slow growth in profits of TCS and Infosys compared to revenue growth.

TCS and Infosys reported combined operating profits, or EBITDA, of ₹23,309 crore in Q4FY22, up 8.2 per cent, growing at the slowest pace in the last six quarters.

Similarly, their combined net profit was up 9 per cent in the fourth quarter to ₹15,612 crore, growing at the slowest rate since the October-December 2020 quarter.

Their combined net sales were up 18.4 per cent to ₹82,867 crore in Q4FY22, down marginally from the 18.9 per cent in Q3FY22 quarter but higher than the 10.8 per cent growth during Q4FY21.

Not surprisingly, many analysts are banking on faster revenue growth to lead earnings growth in the industry in FY23.

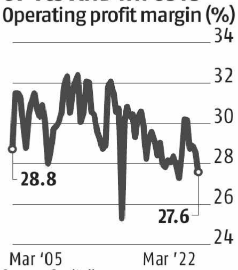
"A strong headcount addition at 22k, a robust demand environment and a robust revenue guidance points towards continued strong revenue growth for FY23," wrote Mukul Garg and Raj Prakash Bhanushali of Motilal Oswal in their Infosys Q4FY22 earnings report.

The brokerage house has, however, lowered its estimate of Infosys' forward earnings per share (EPS) for FY23 and FY24 by 5 per cent each on slower revenue growth and margin pressure.

Analysts at Prabhudas Lilladher say margin pressure is overpowering revenue growth, translating into lower than expected earnings for Infosys.

"We cut Infosys' rating to accumulate from buy and target price to ₹1,899 from ₹2,204 per share earlier. This is because we are lowering forward EPS estimates for FY23 by 10.6 per cent and FY24 EPS by 8.2 per cent led by 100-130 bps cut in EBIT margins," the brokerage wrote.

DWINDLING MARGINS OF TCS AND INFOSYS
Operating profit margin (%)



Source: Capitaline
Compiled by BS Research Bureau

Brokerages are relatively bullish on Tata Consultancy Services due to a lower decline in its margins.

"TCS reported a 4QFY22 EBIT margin at 25 per cent (flat Q-o-Q) due to price hikes amid high attrition. However, we expect FY23E margins to get impacted because of higher SG&A cost (higher attrition & resumption of offices) and accelerated hiring over next two quarters," wrote Mitul Shah of Reliance Securities.

An earnings downgrade and thus a cut in the forward share price of IT companies would have an adverse impact on the overall market. "The top IT companies such as Infosys and TCS have been flag bearers of the rally in the Indian equity market (after the pandemic came). A poor show by them in FY23 would put pressure on the overall market," said Sinha.

Infosys' share was up 39.5 per cent in FY22 while TCS' increased 18 per cent last financial year against an 18.3 per cent rally in the Sensex. Both IT majors saw price declines after their Q4FY22 earnings.