EPAM Systems, Inc (EPAM)

Information Technology | Result Update

Not Rated

CMP: US$301.2 | Target Price (TP): NA | Upside: NA

February 16, 2024

A slow start but hopes for a strong 2HCY24

Key Points

- EPAM guided for YoY organic CC revenue growth of 1-4% for CY24. With revenue in 1QCY24 to decline by 4% and a weak seasonal 2Q, expectation is for 2HCY24 recovery along the lines of guidance provided by almost all larger peers who reported in recent times - Accenture, Cognizant, and Capgemini. The 2H recovery according to EPAM is based on its conversations with clients.
- In 4QCY23, EPAM's revenues declined by 6% YoY. CC basis and excluding impact of exit from Russia, revenues were down by 7.1%. For CY23, EPAM's revenue of $4.691bn saw a YoY decline of 2.8%. In organic CC terms excluding impact of exit from Russia it saw a decline of 2.6% YoY. It stated that the demand environment in 1H2024 is a continuation of trends seen in 2H2023
- The read through for the Indian IT services industry from the weak start to CY24 indicated by players who have reported recently with a back ended pick up, in our view, could lead to soft revenue growth guidance by Infosys and HCLT for FY25 – possibly in the mid-single digit territory at best – despite strong order inflow in FY24. Much of the mid-single digit growth imputed in the sell side models, we believe, assumes a strong QoQ pickup in growth in 2HFY25 which could be at risk if US does not achieve a soft landing with Fed funds rate being cut significantly. We think both a recession or a no landing scenario (with sticky high inflation and Fed Funds rate remaining higher for longer) in 2HCY24 are the likely macro risks.

Reorganizing delivery with India and LatAm in focus: In 2022 and 2023, EPAM underwent a significant global delivery rebalancing, with a focus on scaling operations in India and Latin America. By the end of 2024, it anticipates India will likely be the largest location or match current scale in Ukraine.

Customers who shifted away due to the war risk are coming back: EPAM indicated that part of the reason for the weak performance in 2023 (it delivered 36% and 27.4% organic CC growth in 2021 and 2022 respectively) was customers shifting away from EPAM due to the perceived war risk due to its erstwhile strong delivery footprint in Ukraine, Belarus, and Russia with low exposure in India and no exposure in Latin America. The diversified geographic footprint with enhanced presence in India and Latin America that EPAM has worked on building since early 2022 and dissatisfaction with new vendors is bringing some of the business back. The company has also been very aggressive in new client addition in the last 12 months and that will continue going forward. It also talked about compressed revenue per capita from India as being one of the reasons for the weak revenue growth guidance.

Working on pyramid and infusion of Gen AI related productivity into operations: Considering the nature of the market which has become much more cost conscious and with pressured pricing, EPAM is focused on bringing its cost structure down. This includes improving employee pyramid and use of AI Co-pilots with delivery staff (with specific adoption targets)

Not hesitating to invest in people as it seems growth coming back: EPAM talked about giving out normal variable compensation and salary hikes as it wants to hold on to people for the expected pick up in 2HCY24 growth.

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Highlights from the 4QFY23 analyst call

Revenue and Margin decline

- Revenue for 4QCY23 came in at US$1.157bn. It was down by 7.3 on a YoY basis in CC terms.
- Full year revenue for CY23 stood at US$4.69bn and was down 3.4% on a YoY basis in CC terms. On a reported basis, revenues declined by 2.8% YoY. Excluding Russia revenues, the YoY growth rate would have been -1.8% reported and -2.4% in CC terms.
- In 4QCY23, EPAM's revenues declined by 6% YoY. CC basis and excluding impact of exit from Russia, EPAM's revenues were down by 7.1%. 4QCY23 results shows a sequential revenue growth, first time after three previous quarters of sequential declines.
- EPAM witnessed a 5% YoY decline in revenues from its top 20 clients, while revenues from clients beyond the top 20 experienced a 7% contraction.

Demand Environment and Outlook

- Revenue growth is projected to be in the range of 1% to 4% in constant currency and reported terms. Inorganic element is minimal in this.
- Overall, EPAM anticipates the 2024 environment to reflect trends from the latter part of 2023, with potential demand picking up towards the second half of the year.
- The management highlighted that client spending had reduced in 2023, with expectations for this trend to continue into 2024 due to client exercises in vendor consolidation for cost management.
- EPAM indicated despite spending adjustments, positive signals indicate a rebound in demand for build-based solutions and EPAM's strong capabilities in advanced tech, data, experience, consulting, and AI.
- EPAM mentioned that it is strategically expanding its new business initiatives by refining sales strategies, forming go-to-market partnerships, creating accelerators, and innovating customer interaction methods.
- The company experienced a notable increase in acquiring new clients in 2023, surpassing previous years' rates.
- Higher compensation levels and limited ability to improve client pricing in the near term will continue to exert pressure on margins throughout 2024.

Verticals and Geographies

- Life sciences and healthcare grew 11.6% YoY. It saw sequential growth after 3 previously declining quarters was driven primarily by clients in life sciences.
- Travel and consumer decreased 4.4% YoY with solid growth in travel and hospitality, offset by declines in revenues derived from consumer goods and retail customers.
- Financial services contracted 7.1%. Business information media declined 14.8% while software and hi-tech declined 16.8% in the quarter. Emerging verticals delivered growth of 4.2%, driven by clients in energy, manufacturing, and education.
- Revenues in the quarter continue to be impacted primarily by a reduction in spend across several large clients due to uncertainty in their end markets, particularly in the mortgage space.
- For the full year, travel & consumer declined 1.8%, business information & media by 6.9%, software and hi-tech by 10.8%, life sciences and healthcare by 3.4%, BFSI by 0.8%, however emerging verticals grew 8.8%.

- In terms of geographies, for 4QCY23 on YoY basis, Americas declined 7.6%, EMEA fell by 0.3%, APAC by 10.9% and CEE which will no longer be separately commented on CY24 onwards on account of its negligible contribution to revenue, declined 91.6%. For the year, Americas decelerated by 5%, APAC registering a larger decline at 15.1%, EMEA growing at 4.9% and CEE fell by 71%.
- For CY23, 22.9% of total revenues came from Travel & Consumer, followed by BFSI at 21.7%, then came Business Information & Media at 16.1%, followed by Software and Hi-Tech at 15.1%, while Emerging Verticals contributed 13.8% and Life Sciences & Healthcare stood at 10.4%.
- In terms of geographies, Americas contributed the most at 58.4%, followed by EMEA at 38.9%. APAC stood at 2.2% of revenues while CEE at 0.5%. For CY23.

Generative AI

- EPAM is currently engaged in over 400 Gen-AI projects, with a majority initiated since the middle 2023.
- The projects cover a broad spectrum of use cases, ranging from knowledge management to supply chain optimization, showcasing the versatility of Gen-AI applications.
- EPAM launched Dial, an enterprise-level orchestration platform, to accelerate the development of Gen-AI empowered business solutions, and it has been made available as open-source.
- The company has witnessed significant interest from clients, with over 60 pursuits and 15 active projects across various industries, including tech, insurance, retail, automotive, life sciences, and business information.

Employee Metrics

- At the close of 4Q, the company's workforce comprised over 47,350 professionals, including consultants, designers, engineers, trainers, and architects. This figure reflects a 10.4% decline compared to Q4 2022, attributed to reduced hiring levels and a combination of voluntary and involuntary attrition.
- The company's total headcount for the quarter exceeded 53,150 employees, with a utilization rate of 74.4%, showing an increase from 73.6% in Q4 of the previous year and 72.7% in Q3 2023.

Miscellaneous

- The Russian invasion of Ukraine necessitated EPAM to relocate over 13,000 individuals and their families. While the majority of these relocations were finalized in 2022, various adjustments occurred for EPAM in 2023.
- At the end of 4Q, DSO was 71 days, a reduction from 73 days in 3Q 2023 and a marginal increase from 70 days in the same quarter last year.

View on the Indian IT services sector: We had downgraded our view on the Indian IT Services sector to UW in a report on 10th April, 2022 (Positive surprises likely low in FY23; Tier-2 risky) and continued to remain underweight through our notes on 19th May, 2022 (Customer stress shows up), 8th July, 2022 (Negatives not in price), 10th October, 2022 (Growth expectations too high), 20th March, 2023 (Sell into delayed landing outperformance), 14th June 2023 (Too early to be positive), 26th September, 2023(Cut FY25 estimates; Slower for longer; Sell into the FOMO rally) and 15th December, 2023(A No/Soft landing).

We advocate that investors use the 'delayed/no landing' rally seen since October 2022 to pare positions if 'overweight', especially in the Tier-2 set. Nifty IT index has advanced by ~117% from 31st Dec, 2019 till 14th Dec, 2023 while Nifty is up by ~73%. This massive outperformance of Nifty IT has been on the back of pandemic-driven Digital Transformation (DT) services-based earnings acceleration and significant multiple expansion on unprecedented monetary stimulus in the US/Europe. The DT high tide over 2HFY20-1HFY23 lifted all boats (including weak ones). However, accelerated normalization of monetary policy in the US raises probabilities of a shallow recession there and consequently high probability of negative surprises on the fundamental side over the next 12 months. We believe consensus is underestimating growth and margin risks in FY25 as it did in FY24. While DT services will continue to remain a key theme over the medium term, we believe IT spends will be curtailed by an 'ability-to-spend' problem as enterprise customers battle earnings pressure from wage inflation, reduced end customer spending power, higher interest rates and likely below-trend growth in western developed economies. This, in our view, will mean that the corporate profits of S&P 500 for CY24 will likely be weaker than currently estimated (although they have been better than expected in CY2023). We also believe that the broader enterprise customer profit picture might look worse. Beyond FY23, we see customers shifting from the current democratic 'skills/capability' focused vendor model to a more discriminating one based on an 'ability-to-deliver' (1) cost take outs and (2) business model changes - in that order. It is here that one will see divergence in growth and valuation. Incrementally, risks are to the downside from both valuation as well as fundamental perspective. We favor Tier-1 IT companies vs Tier-2.

We persist with our 20-month-old 'UW' stance. This is because: (1) We believe that a conclusive Fed pivot is likely only when US core inflation falls to ~2%, which we think is unlikely in the next six months. Financial stress/accident related stopping/easing of current hawkish monetary policy could induce a short-term rally that may not be sustainable (2) Consensus earnings estimates for FY25 continue to be too high and seem to implicitly assume a soft/no landing for the US economy. We are explicitly pricing in a shallow recession sometime in 2024. (3) Even if one were to ignore the next 12–18 months' risks around recession and take a 5-year view, we believe that starting valuations are expensive and can at best deliver mid to high single-digit total stock returns (including capital return to shareholders) for TCS/Infosys, as we believe that structural revenue/earnings growth is being overestimated by the street. We believe that USD revenue growth over a 5-year period (FY23-FY28) for Tier-1 set in aggregate will at best be at par with the FY15-FY20 period (~7%) whereas consensus believes it will be 300-500bps higher. We also expect margins for most companies to remain in a narrow band at around FY24 levels and not see a material expansion (except for Tech Mahindra where it starts from a very low base). *Ceteris Paribus,* this has valuation/return implications.

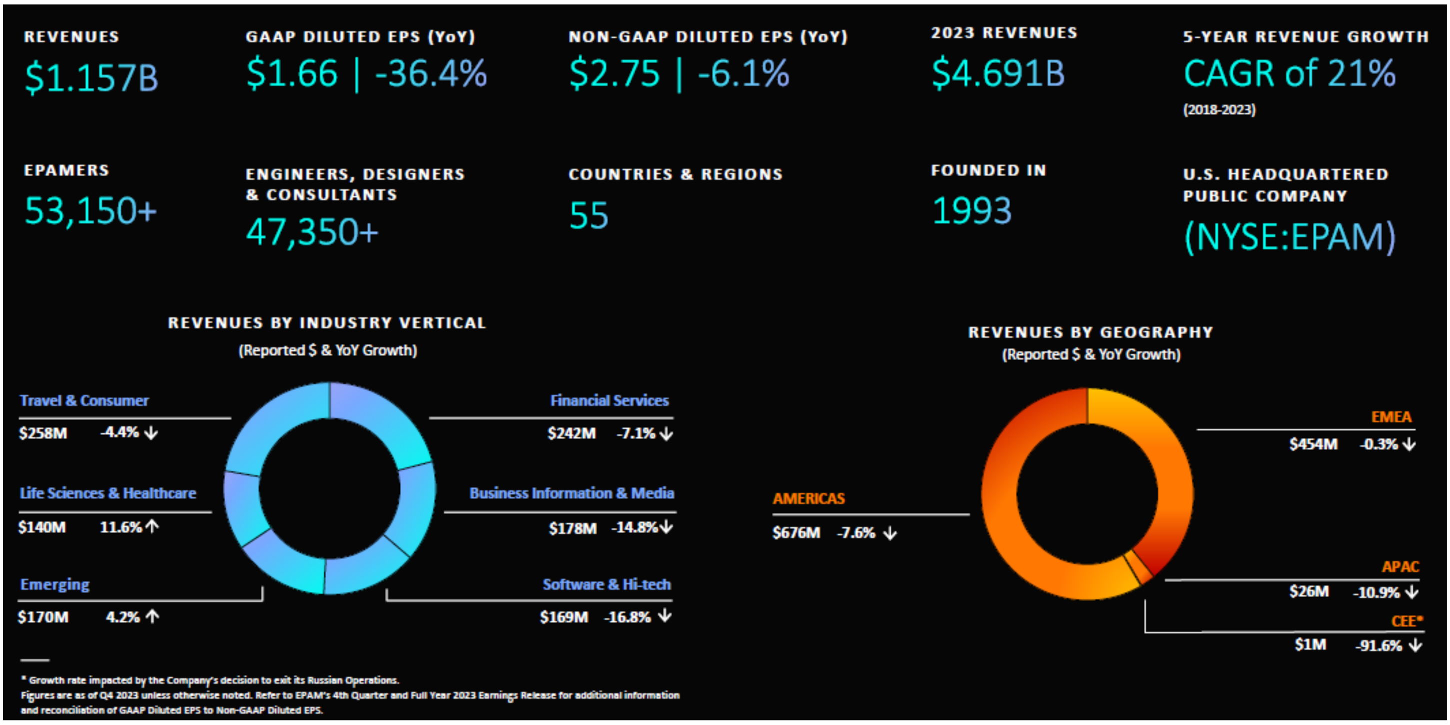
In our base case of a shallow recession in the US in CY24, we are expecting mid single-digit USD revenue growth for Tier-1 IT companies in FY25. In our estimates for FY25, we are assuming modest pricing compression while we believe the street is not considering the same. We continue to have a 'SELL' rating on all IT stocks under our coverage, except Tech Mahindra. Despite having EPS estimates lower than the street in FY25, we suspect it could still see downsides if there is a deep recession in the US.

We continue to maintain TCS as our industry valuation benchmark: We are valuing TCS at target 12-month forward PE of 20x on Dec. 25E EPS, which represents 0.5SD below the last 10-year mean. Target multiples for others are at a discount to TCS. If one were to look back in history, our Target PE multiples are not overly pessimistic as PE multiples of many Tier-1 IT stocks, including that of TCS and Infosys, had reached single-digit levels during GFC. Our target multiples are in fact at the higher end of the pre-pandemic PE range.

Tier-2 could face significant risks in the new environment: We fear that the Indian Tier-2 set would suffer more because of vendor consolidation under the pressured profit picture for customers, a less diversified revenue mix (client, service line, vertical), which could throw up negative growth surprises (as it has been doing for Mphasis in the last 12 months) and a larger exposure to non-Global 1000 clientele, whose profits are more vulnerable in the current macro environment. Indian Tier-2 IT is now at a PE premium of ~40% to Tier-1 (peak of ~60% in November 2021 and the recent low of 10% in January 2023). It used to trade at a discount of 14% on 1st January 2020.

This premium reflects expectations of big positive earnings growth gap between Tier-2 and Tier-1 IT companies over FY21-FY23 and improving return ratios sustaining beyond FY23. We do not agree with that view. We think that the earnings growth gap will compress due to slower revenue growth and next-to-no margin expansion from current levels for most Tier-2 companies. The high PE multiples are also a reflection of the market's view that some Tier-2 IT companies will become US$5-10bn enterprises in the next 10-20 years. Once the 'Digital' high tide recedes, it remains to be seen which of the current Tier-2 set will continue to show promise. In the initial phase of any new tech cycle, customers tend to be open to new vendors, but as the cycle matures (post FY23 in our view), vendors that have scale – Tier-1 - tend to do better. We think customers are looking for revolutionary transformation, which Tier-1 companies with multi-vertical exposure and deeper domain/technology skills are best placed to deliver.

Exhibit 1: 4QCY23 snapshot



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Financial picture

	2022					2023				
	Q1	Q2	Q3	Q4	Full Year	Q1	Q2	Q3	Q4	Full Year
Revenues										
Total Revenues	$1,171.6	$1,194.9	$1,226.9	$1,231.3	$4,824.7	$1,210.9	$1,170.2	$1,152.1	$1,157.3	$4,690.5
Year-Over-Year Growth Rate	50.1%	35.6%	24.1%	11.2%	28.4%	3.4%	(2.1%)	(6.1%)	(6.0%)	(2.8%)
Sequential Quarter Growth Rate	5.8%	2.0%	2.7%	0.4%	n/a	(1.7%)	(3.4%)	(1.5%)	0.4%	n/a
Year-Over-Year Growth Rate in Constant Currency (2)	53.0%	40.1%	29.8%	14.4%	32.4%	4.9%	(2.4%)	(8.0%)	(7.3%)	(3.4%)
Sequential Quarter Growth Rate in Constant Currency (2)	6.8%	3.2%	4.4%	(0.5%)	n/a	(2.5%)	(3.6%)	(1.4%)	0.3%	n/a
Verticals										
Travel & Consumer	$265.3	$276.3	$280.4	$270.2	$1,092.2	$278.3	$273.5	$263.0	$258.2	$1,073.0
As % of Total Revenues	22.6%	23.1%	22.9%	21.9%	22.7%	23.0%	23.4%	22.8%	22.3%	22.9%
Year-Over-Year Growth Rate	90.9%	61.1%	41.9%	16.0%	47.4%	4.9%	(1.0%)	(6.2%)	(4.4%)	(1.8%)
Financial Services	$260.1	$251.0	$254.7	$260.9	$1,026.7	$270.7	$259.0	$246.4	$242.3	$1,018.4
As % of Total Revenues	22.2%	21.0%	20.8%	21.2%	21.3%	22.4%	22.1%	21.4%	20.9%	21.7%
Year-Over-Year Growth Rate	54.0%	29.4%	10.4%	2.4%	21.0%	4.1%	3.2%	(3.3%)	(7.1%)	(0.8%)
Business Information & Media	$194.3	$197.9	$208.9	$208.9	$810.0	$202.4	$189.7	$183.9	$178.0	$754.0
As % of Total Revenues	16.6%	16.6%	17.0%	17.0%	16.8%	16.7%	16.2%	16.0%	15.4%	16.1%
Year-Over-Year Growth Rate	31.5%	25.4%	20.8%	10.9%	21.4%	4.2%	(4.1%)	(12.0%)	(14.8%)	(6.9%)
Software & Hi-Tech	$189.5	$195.3	$205.4	$203.0	$793.2	$189.2	$175.2	$174.3	$169.0	$707.7
As % of Total Revenues	16.2%	16.3%	16.7%	16.5%	16.4%	15.6%	15.0%	15.1%	14.6%	15.1%
Year-Over-Year Growth Rate	28.8%	22.7%	17.8%	10.3%	19.4%	(0.2%)	(10.3%)	(15.1%)	(16.8%)	(10.8%)
Life Sciences & Healthcare	$123.8	$128.5	$129.7	$125.4	$507.4	$111.2	$114.4	$124.2	$140.1	$489.9
As % of Total Revenues	10.6%	10.8%	10.6%	10.2%	10.5%	9.2%	9.8%	10.8%	12.1%	10.4%
Year-Over-Year Growth Rate	35.9%	40.1%	35.0%	11.5%	29.7%	(10.1%)	(10.9%)	(4.2%)	11.6%	(3.4%)

Emerging Verticals	$138.6	$145.9	$147.8	$162.9	$595.2	$159.1	$158.4	$160.3	$169.7	$647.5
As % of Total Revenues	*11.8%*	*12.2%*	*12.0%*	*13.2%*	*12.3%*	*13.1%*	*13.5%*	*13.9%*	*14.7%*	*13.8%*
Year-Over-Year Growth Rate	*59.4%*	*36.1%*	*26.6%*	*20.8%*	*33.5%*	*14.7%*	*8.6%*	*8.5%*	*4.2%*	*8.8%*
Geographies										
Americas	$686.8	$721.6	$747.1	$731.7	$2,887.2	$709.8	$679.1	$677.4	$676.4	$2,742.7
As % of Total Revenues	*58.7%*	*60.4%*	*60.9%*	*59.4%*	*59.9%*	*58.6%*	*58.0%*	*58.8%*	*58.4%*	*58.4%*
Year-Over-Year Growth Rate	*46.0%*	*36.8%*	*26.3%*	*14.7%*	*29.7%*	*3.4%*	*(5.9%)*	*(9.3%)*	*(7.6%)*	*(5.0%)*
EMEA	$421.9	$423.0	$438.2	$454.8	$1,737.9	$463.9	$459.1	$446.2	$453.6	$1,822.8
As % of Total Revenues	*36.0%*	*35.4%*	*35.7%*	*36.9%*	*36.0%*	*38.3%*	*39.2%*	*38.7%*	*39.2%*	*38.9%*
Year-Over-Year Growth Rate	*62.7%*	*45.2%*	*35.3%*	*18.0%*	*38.0%*	*10.0%*	*8.5%*	*1.8%*	*(0.3%)*	*4.9%*
APAC	$29.6	$30.2	$31.4	$29.2	$120.4	$26.8	$24.2	$25.1	$26.0	$102.1
As % of Total Revenues	*2.5%*	*2.5%*	*2.6%*	*2.4%*	*2.5%*	*2.2%*	*2.1%*	*2.2%*	*2.3%*	*2.2%*
Year-Over-Year Growth Rate	*41.2%*	*20.8%*	*10.5%*	*0.0%*	*16.2%*	*(9.4%)*	*(19.7%)*	*(20.2%)*	*(10.9%)*	*(15.1%)*
CEE	$33.3	$20.1	$10.2	$15.6	$79.2	$10.4	$7.8	$3.4	$1.3	$22.9
As % of Total Revenues	*2.8%*	*1.7%*	*0.8%*	*1.3%*	*1.6%*	*0.9%*	*0.7%*	*0.3%*	*0.1%*	*0.5%*
Year-Over-Year Growth Rate	*10.5 %*	*(46.7%)*	*(77.2%)*	*(71.8%)*	*(52.9%)*	*(68.8%)*	*(61.1%)*	*(66.4%)*	*(91.6%)*	*(71.0%)*
Customer Concentration, as % of Total Revenues										
Top 5 Customers	17.0%	16.5%	16.4%	16.1%	16.4%	17.4%	16.8%	16.4%	16.0%	16.6%
Top 10 Customers	24.1%	24.2%	24.4%	23.1%	23.8%	24.4%	23.8%	23.5%	23.6%	23.6%
Top 20 Customers	35.7%	35.5%	36.1%	34.4%	35.2%	36.3%	35.4%	35.3%	34.8%	35.4%
Outside of Top 20 Customers	64.3%	64.5%	63.9%	65.6%	64.8%	63.7%	64.6%	64.7%	65.2%	64.6%
Number of Accounts with Revenues:										
Over $20 Million	-	-	-	-	49	-	-	-	-	44
$10 - $20 Million	-	-	-	-	51	-	-	-	-	56
$5 - $10 Million	-	-	-	-	85	-	-	-	-	76
$1 - $5 Million	-	-	-	-	303	-	-	-	-	305
$0.5 - $1 Million	-	-	-	-	185	-	-	-	-	175
Contract Types										
Time-and-Material	$1,023.2	$1,059.6	$1,084.8	$1,072.0	$4,239.6	$1,075.0	$1,028.0	$995.6	$983.9	$4,082.5
As % of Total Revenues	*87.3%*	*88.6%*	*88.4%*	*87.1%*	*87.9%*	*88.7%*	*87.8%*	*86.4%*	*85.0%*	*87.1%*
Fixed-Price	$143.5	$131.2	$136.4	$149.3	$560.4	$130.5	$135.4	$147.0	$166.3	$579.2
As % of Total Revenues	*12.3%*	*11.0%*	*11.1%*	*12.1%*	*11.6%*	*10.8%*	*11.6%*	*12.8%*	*14.4%*	*12.3%*
Licensing and other revenues	$4.9	$4.1	$5.7	$10.0	$24.7	$5.4	$6.8	$9.5	$7.1	$28.8
As % of Total Revenues	*0.4%*	*0.4%*	*0.5%*	*0.8%*	*0.5%*	*0.5%*	*0.6%*	*0.8%*	*0.6%*	*0.6%*

Source: Company, Nirmal Bang Institutional Equities Research

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SELL < -5%

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