17th August 2016

TMT

Capgemini

Price EUR85.28

Feedback from company contact: risks related to Brexit do not have to be exaggerated

Fair Value EUR94 vs. EUR93 (+10%) **BUY**

Bloomberg	CAP FP
Reuters	CAPP.PA
12-month High / Low (EUR)	89.0 / 69.0
Market Cap (EUR)	14,684
Ev (BG Estimates) (EUR)	16,030
Avg. 6m daily volume (000)	641.8
3y EPS CAGR	10.5%

	1 M	3 M	6 M	31/12/15
Absolute perf.	8.3%	5.7%	19.6%	-0.4%
Softw.& Comp.	8.3%	9.8%	16.1%	4.0%
DJ Stoxx 600	1.6%	2.6%	7.2%	-6.1%

YEnd Dec. (EURm)	2015	2016e	2017e	2018e
Sales	11,915	12,608	12,909	13,410
% change		*5.8%*	*2.4%*	*3.9%*
EBITDA	1,577	1,710	1,837	1,950
EBIT	1,022	1,189	1,375	1,488
% change		*16.3%*	*15.7%*	*8.2%*
Net income	797.4	970.4	1,026	1,105
% change		*21.7%*	*5.7%*	*7.7%*

	2015	2016e	2017e	2018e
Operating margin	10.6	11.4	12.1	12.5
Net margin	9.4	6.2	6.8	7.1
ROE	16.3	11.3	12.0	12.3
ROCE	17.2	13.6	14.5	15.9
Gearing	25.3	19.6	9.5	0.1

(EUR)	2015	2016e	2017e	2018e
EPS	4.66	5.64	5.84	6.29
% change	*-*	*21.1%*	*3.5%*	*7.7%*
P/E	18.3x	15.1x	14.6x	13.6x
FCF yield (%)	5.6%	6.0%	6.7%	7.1%
Dividends (EUR)	1.35	1.50	1.60	1.70
Div yield (%)	1.6%	1.8%	1.9%	2.0%
EV/Sales	1.4x	1.3x	1.2x	1.1x
EV/EBITDA	10.4x	9.4x	8.4x	7.5x
EV/EBIT	13.0x	11.2x	9.8x	8.8x

We reiterate our Buy rating and raise our DCF-derived fair value to EUR94 from EUR93 (+EUR2 on medium-term tax rate - 30% vs. 32% - and -EUR1 on updated fx rates). The takeaways from a company contact we had last week are that: 1) negative comments from Cognizant and Infosys on Brexit are mainly client-specific issues and do not have to be generalised; 2) discretionary IT spending is less important than a few years ago; 3) service automation and new offers will increasingly contribute to op. margin improvement.

ANALYSIS

- **Brexit analysis**. Cognizant's FY16 sales guidance cut to USD13.47-13.6bn (+8.5%/+9.5%) from USD13.65-14bn (+10%/+13%) due to fx (USD40m, -0.5ppt), slower growth in financial services (low interest rates + increased economic uncertainty post-Brexit) and delayed healthcare payer M&A processes (Aetna-Humana, Anthem-Cigna) cannot be extrapolated to Capgemini. We consider the same comment is valid for Infosys with the shelved project from RBS to set up a separate bank for the UK (Williams & Glyn) - with 3,000 Infosys staff to be reallocated to other contracts, and an est. 0.3% headwind to its top line. These negative comments are essentially related to client-specific issues, not a general trend. Capgemini's approach regarding H2 2016 lfl revenue growth (no acceleration vs. +3.3% reported for H1 2016) has to be considered as caution, as a portion of discretionary IT spending - which is definitely lower than it used to be before it was slashed in 2008-09 and 2012-13 - may be put on hold by the end of the year. Capgemini is optimistic regarding IT demand in financial services (26% of sales) as banks cannot avoid digital transformation.
- **Operating leverage: offshoring vs. service automation**. Capgemini's offshore leverage is very likely to increase by only 1-2ppt per year instead of 3-4ppt over 2011-2014, with 55% of headcount now based offshore (medium-term target: 65%), certain geographies reaching a plateau (North America, commercial sectors in the UK), and digital services using more onshore staff. This translates into a halt in the decline of average remuneration per head - it stabilised in H1 2016 to +0.3% lfl -, but also into higher average prices. As such, offshore leverage becomes a less relevant indicator than before for measuring the ability to increase the margin. We understand the medium term operating margin goal (12.5-13%, vs. guidance 11.3-11.5% for 2016) will rely more on further service automation and industrialisation (productivity gains), better managing the "people supply chain" (recruitment, staff mobility, utilisation rates), and new offers (augmented value), than just raising offshore leverage. NB. the benefit from Igate to the op. margin was 0.9ppt in H1 2016 - instead it would have been up 0.6ppt - and management expects 0.4-0.45ppt for the full-year.
- **Use of cash**. Capgemini still continues to intend to give back half of free cash flow (company guidance for 2016: >EUR850m; BG est. EUR895m) to shareholders, in the form of dividends of share buy-back programmes (EUR600m launched in February, o/w one-fourth to be executed in 2016). The EUR500m 5-year bonds issued in 2011 and maturing in November 2016 will not be refinanced. Capgemini will have to redeem senior notes in July 2018 (EUR0.5m), July 2020 (EUR1.25bn) and July 2023 (EUR1bn) - these were issued for the acquisition of Igate - and then EUR400m ORNANE bonds in January 2019. As such, acquisitions are likely to remain small and focused at least in 2016-17 when the integration of Igate will be completed.

VALUATION

- Capgemini's shares are trading at est. 11.2x 2016 and 9.8x 2017 EV/EBIT multiples.
- Net debt on 30th June 2016 was EUR2,270m (net gearing: 36%).

NEXT CATALYSTS

Q3 2016 sales on 26th October before markets open.

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