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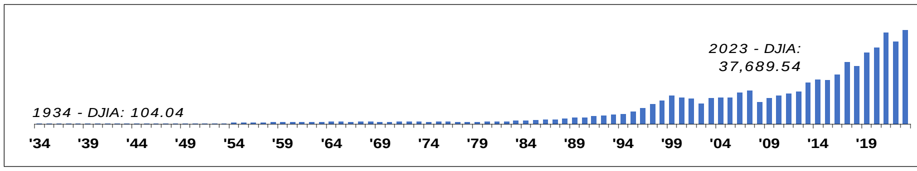
MARKET DIGEST



FRIDAY, JUNE 21, 2024
JUNE 20, DJIA: 39,134.76
UP 299.90

Good Morning. This is the Market Digest for Friday, June 21, 2024, with analysis of the financial markets and comments on **Accenture plc.**

IN THIS ISSUE:

* Growth Stock: Accenture plc: Shares rally on AI optimism (Jim Kelleher)

MARKET REVIEW:

Yogi Berra famously said "When you come to a fork in the road, take it." Stock investors did just that on Thursday, pushing the Dow Jones Industrial Average higher by 0.77% but the Nasdaq Composite and S&P 500 lower by 0.79% and 0.25%, respectively. In a rare event, shares of Nvidia not only lost ground, but lost a relatively meaningful amount (3.5%), proving nothing can go up forever. Still, the major indices are comfortably ahead for the year to date — and the big non-AI mover for stocks is the future direction of interest rates, which remains a concern for Wall Street and (for one day at least) offset AI mania.

ACCENTURE PLC (NYSE: ACN, $306.16) BUY

ACN: Shares rally on AI optimism

* Accenture posted fiscal 3Q24 non-GAAP EPS that missed consensus forecasts. Both revenue and adjusted EPS edged lower year over year.
* Despite cautious fiscal 4Q24 guidance and reduced sales and non-GAAP EPS forecasts for FY24, the shares rallied on growing AI momentum for the business.
* Total bookings were strong in 3Q24, rising 22% annually on acceleration in managed services and resulting in a 1.3 book-to-bill. Accenture still appears to be taking share from competitors.
* We believe that Accenture has the financial resources, customer presence, and market strength to thrive as companies accelerate the process of digital transformation and begin their AI journeys.

ANALYSIS

INVESTMENT THESIS

Shares of BUY-rated Accenture plc (NYSE: ACN) rose solidly on June 20, despite the company reporting fiscal 3Q24 revenue and non-GAAP EPS that missed consensus forecasts. Both GAAP revenue and adjusted EPS edged lower year over year. On a constant currency basis, the consulting and IT outsourcing leader posted 1% growth in revenue year over year, while adjusted earnings declined 2% for fiscal 3Q24.

While the demand environment remains soft in the small-project consulting space, the overall consulting business also returned to growth in 3Q24. Accenture had strong bookings in 3Q24 particularly in managed services, leading to a total 1.3 book to bill.

Despite cautious fiscal 4Q24 guidance and reduced sales and non-GAAP EPS forecasts for FY24, the shares rallied on growing AI business opportunities. Accenture had $900 million in generative AI-related bookings in fiscal 3Q24, and now has over $2 billion in year-to-date FY24. Additionally, the company has achieved $500 million in AI revenue in FY24 to date. Generative AI is the fastest-growing technology opportunity in company history.

CEO Julie Sweet noted that most customers are just getting started on their AI journeys, creating a strong runway for future growth. Clients need to be "far along the path" to digital transformation before implementing Gen AI. While that is acting as a gating factor on full realization of this opportunity, momentum is plainly building with clients. Accenture is investing inorganically to expand its AI and other capabilities; the company's 35 niche acquisitions in FY24 to date are more than in all of FY23.

In our view, Accenture has the size, scale, global reach, and broad industry expertise to continue growing faster than the industry and taking share from competitors. Accenture's share price, which rose in 2023 on competitive share gains and AI interest, has struggled in 2024 with the consulting market. From a valuation perspective, Accenture appears attractive based on our discounted free cash flow model and blended valuation analysis. We are reiterating our BUY rating and our 12-month target price of $380.

RECENT DEVELOPMENTS

Accenture is down 11% year-to-date in 2024, versus a 21% gain for peers. Accenture rose 32% in 2023, versus a 40% gain for the peer group of information processing and computing & storage companies in Argus coverage. Accenture declined 36% in 2022, versus a 30% decline for peers; advanced 59% in 2021, versus 35% for peers; and rose 24% in 2020, while peers were up 9%.

For fiscal 3Q24 (ended May 31, 2024), Accenture reported revenue of $16.47 billion, which was down 1% year over year on a reported basis and up 1% in local currency. Revenue was below $16.55 billion midpoint of management's $16.25-$16.85 billion guidance range and missed the $16.54 billion consensus forecast. On a non-GAAP basis, Accenture earned $3.13 per diluted share in fiscal 3Q24, down 2% year over year. Non-GAAP EPS missed the consensus forecast of $3.15. The company guides on annual EPS but not typically on quarterly EPS.

CEO Julie Sweet noted that FY24 has not materialized as the company initially anticipated at the beginning to the year, due to inflation and high interest rates have led to caution in discretionary spending. The consulting business, exposed to highly discretionary and shorter-term projects that are mainly small to mid-sized in scope, has been particularly impacted by these trends.

The CEO stated that Accenture has responded to the challenging environment with "resilience and agility" while remaining laser focused on clients. The company has moved quickly to adjust to lower levels of discretionary spending on smaller projects. The business environment is somewhat better in the Managed Services space (formerly Outsourcing). Accenture recorded 23 deals with total value exceeding $100 million in fiscal 3Q24, bring the year-to-date total of such deals to 92 — which was seven more than were recorded as of the same point in FY23. This money will "layer in" in FY25, helping offset the weaker current environment.

Most notably, the company is shifting resources and investing inorganically (via M&A) to prepare for the large-scale reinventions represented by generative AI. Accenture achieved two milestones in this market in 3Q24, according to the CEO. The company had over $900 million in gen AI bookings in 3Q24, nearly matching the first half total, and bringing FY24-to-date gen AI bookings to more than $2 billion. Accenture also has had over $500 million in year to date Gen AI revenue as this opportunity has been fast to monetize.

Customers are in the early phases of their AI journeys, and Accenture currently is mainly seeing smaller and tentative investments from clients. Every client is investing in this area, however, and from smaller projects clients "are headed toward larger projects." One way Accenture is scaling up rapidly for this opportunity is inorganic growth via acquisition, which is adding both niche capabilities and geographic breadth. Accenture has conducted 35 acquisitions for $5.2 billion in FY24 YTD; that compares with $2.5 billion spent on acquisitions for all of FY23.

Clients need to be far along the path to digital transformation before implementing Gen AI, and that is acting as a gating factor on full realization of this opportunity. The need for clients to be digitally ready in order to embrace generative AI fully is both a challenge and an opportunity, according to CEO Sweet.

Cloud migration is the starting point to digitization and enabling AI. Management believes up to 90% of the opportunity to help customers transition to hybrid cloud is in front of the company. Similar high percentage opportunities are in front of the company in network security, automation, and other high-growth digital categories. In our view, Accenture has the global scale, industry expertise, and deep experience to help companies on their path to digitization.

In a positive sign for future business, bookings in 3Q24 extended strength from 1H24 following a soft second-half FY23 trend. For 3Q24, bookings of $21.1 billion increased 22% year over year in GAAP and 26% in local currency. Based on revenue of $16.6 billion, the total book-to-bill for 3Q24 was 1.28.

For 3Q24, consulting bookings of $9.28 billion (44% of total) rose 4% from the prior year, and were down 12% sequentially. Given consulting revenue of $8.46 billion (51% of total), consulting book-to-bill was 1.10. Managed Services (formerly Outsourcing) bookings were $11.78 billion, up 42% annually and 7% sequentially. Outsourcing revenue was $8.01 billion (49% of total), up 2% in GAAP and 4% in local currency. Outsourcing book-to-bill was 1.47, exceeding 1.4 for a second consecutive quarter.

Accenture looks at its business in multiple ways, including what it calls service dimensions: Operations, Technology Services, and Strategy & Consulting Services. On a local-currency basis, Technology and Strategy & Consulting Services posted low-single-digit growth, while Operations was about flat in local currency. Strategy & Consulting has been impacted in recent quarters by weakness in small enterprise contracts, so its recovery in the quarter is a positive sign.

On a regional basis, fiscal 3Q24 North American revenue of $7.83 billion (48% of total) was up 1% in local currency and on a GAAP basis. North American constant-currency results reflected strength in Public Service & Health, partly offset by weaker trends in CMT and Banking & Capital Markets. North American operating profit rose 2% year over year on an adjusted basis (excluding business reorganization costs).

Formerly Europe-only regional sales now include Middle East & Africa, and this region is now called EMEA. On a restated basis for all periods, EMEA sales (35% of revenue) decreased 1% in local currency and grew 3% on a GAAP basis. EMEA saw growth in Public Services, and was offset by weakness in CMT and in Banking & Capital Markets. Strength in Italy offset weak French results.

Growth markets (17% of total) were down 1% in GAAP and up 6% in local currency, reflecting solid demand led by Resources and Banking & Capital Markets. Demand from Japan and Argentina were strong in the quarter, while Australia was weak.

After a FY23 period in which Accenture focused on restructuring Americas operations, a significant portion of restructuring in FY24 is in overseas markets. Excluding restructuring costs, operating income rose 3% in EMEA and fell 9% in growth markets during fiscal 3Q24.

For the company's operating groups, Communications, Media, & Technology (17% of revenue) was down 4% in GAAP and down 1% in constant currency. CMT continues to be hurt by the softness in deals with smaller customers, particularly in software & platforms, and by corporate downsizing at North American communications and media customers.

Products, the largest operating group at 30% of revenue, posted revenue of $4.98 billion; that represented sales of at least $4.5 billion for a ninth straight quarter. Product sales were up 2% in local currency. Financial services (18% of revenue) was down 5% in local currency, as insurance, banking and capital markets are all impacted by weakened activity due to high interest rates.

The Health & Public Services category (21% of sales) grew revenue 9% in local currency, for a nineteenth straight quarter of double-digit growth. The Resources businesses (14% of revenue) was up 3% annually in local currency. Energy and chemical companies are using Accenture's tools for digital transformation as they cost-optimize in a weak commodities pricing environment.

Altogether, and despite multiple challenges in the operating environment, Accenture in fiscal 3Q24 experienced growth in seven of the 13 broad industry verticals that it serves. Accenture trimmed its already conservative FY24 profit outlook, but continues to model single-digit sales and EPS growth for FY24. The outlook reflects ongoing macroeconomic pressures, but also suggests growth in targeted areas, disciplined cost management, share gains at the expense of smaller rivals, and momentum in the very early days of the generative AI opportunity.

EARNINGS & GROWTH ANALYSIS

For fiscal 3Q24 (ended May 31, 2024), Accenture reported revenue of $16.47 billion, which was down 1% year over year on a reported basis and up 1% in local currency. Revenue was below $16.55 billion midpoint of management's $16.25-$16.85 billion guidance range and missed the $16.54 billion consensus forecast.

The GAAP gross margin was 33.4% in 3Q24, compared to 30.9% in 2Q24 and 33.4% a year earlier. The GAAP operating margin was 16.0% in 3Q24, compared to 13.0% in 2Q24 and 14.2% a year earlier. Accenture took a $77 million charge for business reorganization in 3Q24 and a total $333 million charge for FY24 to date. Adjusted to exclude one-time charges, the non-GAAP operating margin was 16.4% in 3Q24, compared to 13.7% in 2Q24 and 16.4% a year earlier.

On a non-GAAP basis, Accenture earned $3.13 per diluted share in fiscal 3Q24, down 2% year over year. Non-GAAP EPS missed the consensus forecast of $3.15. The company guides on annual EPS but not typically on quarterly EPS.

For all of FY23, Accenture generated record revenue of $64.1 billion, up 4% on a GAAP basis. Non-GAAP earnings rose 9% to $11.67 per diluted share.

For fiscal 4Q24, Accenture guided for revenue of $16.05-$16.65 billion, which would be up 2% to 6% annually in local currency. Accenture assumes that currency translation will have a negative 2% impact in the current quarter, implying that revenue will be flat to up 4% on a GAAP basis for 4Q24.

Management guided for FY24 revenue growth of 1.5%-2.5% in local currency, tightened from earlier guidance of 1%-3%. The company is now assuming a 0.7% current headwind for FY24, after earlier guiding for a neutral currency impact for the full year. On that basis, Accenture is also guiding for 0.8%-1.8% GAAP revenue growth for FY24.

Management is modeling 10 basis points of non-GAAP operating margin expansion, to 15.5%, compared with 15.4% for FY23. As a result of these changes and other line-item inputs, management now forecasts full-year non-GAAP EPS of $11.85-$12.00, reduced from $11.97-$12.20; the new guidance implies growth of 2%-3% from FY23. That is down from 3%-5% growth guidance offered in March 2024.

We are reducing our FY24 non-GAAP earnings estimate to $11.88 per diluted share from $12.11. However, we are raising our FY25 forecast to $12.70 per diluted share from $12.68. Our long-term annualized EPS growth rate forecast is 10%.

FINANCIAL STRENGTH & DIVIDEND

Accenture's financial strength ranking is High. The company, which formerly had fractional debt, had $1.68 billion in debt as of the end of 3Q24. Moody's long-term credit rating on Accenture is Aa3, and Standard & Poor's long-term rating is A+.

Cash was $5.54 billion at the end of 3Q24. Cash was $9.05 billion at the end of FY23, $8.1 billion at the end of FY22, $8.42 billion at the end of FY21, and $8.5 billion at the end of FY20.

Cash flow from operations was $9.52 billion in FY23, $9.54 billion in FY22, $8.98 billion in FY21, $8.36 billion in FY20, and $6.63 billion in FY19.

Accenture forecast free cash flow of $8.7-$9.3 billion for FY24. For FY23, free cash flow was $9.0 billion. Free cash flow was $8.2 billion in FY22, $8.4 billion in FY21, and $7.6 billion in FY20.

Accenture expects to return at least $7.7 billion to shareholders in FY24. Accenture returned $7.2 billion to shareholders in FY23; $6.1 billion to shareholders in FY22; $5.9 billion in FY21; $5.0 billion in FY20; and $4.6 billion in FY19.

Beginning in FY20, Accenture switched from paying semiannual dividends to quarterly dividends. In September 2023, it announced a 15% hike its quarterly dividend to $1.29 per share. It previously raised its quarterly payout by 15% to $1.12 in September 2022, by 10% to $0.97 in November 2021, and by 10% to $0.88 in November 2020.

Our dividend estimates are $5.16 per share for FY24 and $5.40 for FY25.

MANAGEMENT & RISKS

Julie Sweet became CEO in September 2019, and at that time joined the board of directors; she has since become chairman. KC McClure has been CFO since 2019, and is now slated to retire in September 2024.

We expect to see other leadership changes in fall 2024. Currently, John Walsh is COO; he previously served as chief strategic accounts & global sales officer. Former COO Manish Sharma is group CEO of North America. Leo Framil is group CEO of Growth Markets, and Jean-Marc Ollagnier remains group CEO of Europe. The company has a deep bench of talent and tends to promote from within, so we expect any leadership changes to be uneventful for Accenture.

Under CEO Sweet, Accenture has stepped up its already brisk pace of niche acquisitions and has even made two much larger deals. The company's demonstrated success in integrating new assets and deriving value from new holdings mitigates the risk associated with acquisitions.

Longer-term risks to investing in Accenture include cyclicality in the consulting business. The company also has substantial exposure to Europe, which is facing pressure from high inflation and the war in Ukraine, and to the public sector, which downsized in response to reduced tax receipts during the pandemic. However, Accenture expects government purchases of consulting services to be stable to higher in the coming quarters, as agencies invest in technology to keep costs low.

The company's strength in outsourcing, which generates more-consistent revenue, helps to temper this volatility. Accenture's five operating groups also provide diversification during periods of weakness for any particular industry.

With low barriers to entry, the consulting business can be quite competitive. Cognizant and IBM are leading competitors. McKinsey remains an industry force in consulting, while India-based firms such as Infosys compete in IT outsourcing. We believe that Accenture's push into services such as digital, cloud and security give it a growth advantage over companies tied to legacy IT outsourcing, which has been hurt by the rapid switch to the cloud.

COMPANY DESCRIPTION

Based in Dublin, Ireland, Accenture is a global management consulting, technology services and outsourcing company. The two main lines of business are consulting and outsourcing. The company is also organized along five key industry verticals served, including Communications, Media & Technology; Financial Services; Products; Health & Public Service; and Resources. In FY23, approximately 47% of revenue was generated in the Americas, 33% in EMEA, and 20% in growth markets.

VALUATION

The ACN shares trade at 25.8-times our FY24 non-GAAP EPS estimate and at 23.65-times our FY25 projection. The two-year average forward P/E of 24.7 is now below the historical five-year (FY19-FY23) average of 27.3. The two-year average forward relative P/E of 1.07 is below the historical relative P/E of 1.42. We believe that Accenture warrants a premium relative P/E in the 1.5- to 1.7-times range based on strong revenue and rising new orders, strong cash-growth trends, market-share gains, and increasing profitability. On all measures of historical comparable valuation, we calculate a value in the $340s, in a stable trend.

Peer comparable analysis values Accenture in the $250s, in a slightly declining trend. Accenture trades at shrinking premiums to peers on P/E and price/book, and at a discount on price/sales; we believe that Accenture warrants meaningful premiums to peers.

Our more forward-looking discounted free cash flow analysis points to a value in the $550s, in a stable trend. Our calculated blended value for Accenture is in the mid- to upper-$400s, in a stable trend and above current prices.

Appreciation to our 12-month target price of $380 implies a risk-adjusted total return, including the 1.7% dividend yield, in excess of our forecast for S&P 500 capital appreciation. On that basis, we are reiterating our BUY rating.

On June 20, BUY-rated ACN closed at $306.16, up $20.81. (Jim Kelleher, CFA, 6/20/24)

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