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Cognizant Technology Solutions Corp.

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Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, welcome to the Cognizant Technology Solutions Second Quarter 2021 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

I would now like to turn this conference over to Mr. Tyler Scott, Vice President of Investor Relations. Please go ahead, sir. You may begin.

Tyler Scott

Vice President, Head-Investor Relations, Cognizant Technology Solutions Corp.

Thank you, operator, and good afternoon, everyone. By now, you should have received a copy of the earnings release and investor supplement for the company's second quarter 2021 results. If you have not, copies are available on our website, cognizant.com. The speakers we have on today's call are Brian Humphries, Chief Executive Officer; and Jan Siegmund, Chief Financial Officer.

Before we begin, I would like to remind you that some of the comments made on today's call and some of the responses to your questions may contain forward-looking statements. These statements are subject to the risks and uncertainties, as described in the company's earnings release and other filings with the SEC.

Additionally, during our call today, we will reference certain non-GAAP financial measures that we believe provide useful information for our investors. Reconciliations of non-GAAP financial measures, where appropriate, to the corresponding GAAP measures can be found in the company's earnings release and other filings with the SEC.

With that, I'd like to turn the call over to Brian Humphries. Please go ahead, Brian.

Brian J. Humphries

Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

Thank you, Tyler. Good afternoon, everybody. Against a challenging labor market backdrop and the recent humanitarian crisis in India, we executed well in the second quarter, allowing us to deliver significant upside to our revenue guidance. Second quarter revenue of $4.6 billion represented growth of 15% year-over-year or 12% in constant currency. I'm grateful to our teams across the world for their unflagging dedication to consistently meeting our promises to clients.

Thanks to the professionalism of all our associates, we have no major disruption to client service delivery from the second wave of the pandemic in India. We continue to execute against our previously announced Operation C3, which includes our vaccination drive across the 11 cities where Cognizant has operations in India. To-date, we've administered or reimbursed over 160,000 vaccines to associates or their families and dependents.

I'm pleased with the strength of key commercial metrics. Bookings growth accelerated to 12% year-over-year in the second quarter, and our book-to-bill ratio is now 1.2 on a trailing 12-month basis. Qualified pipeline is significantly up and our win rates are also up year-to-date, positioning us well for continued bookings momentum. Digital revenue growth accelerated to 20% year-over-year in the quarter.

Moving to industry segments, we posted strong double-digit year-over-year constant currency growth in Communications, Media and Technology, Products and Resources, and Healthcare. We've achieved a double-digit CAGR over the past four years in Communications, Media and Technology and remain optimistic on our growth prospects. This industry is now home to some of our largest clients.

Within Products and Resources, we continue to post excellent growth in manufacturing, logistics, energy and utilities. Meanwhile, both retail and consumer goods and travel and hospitality posted their fourth successive quarter of sequential revenue increases and are now close to pre-pandemic revenue levels.

Our Healthcare business had a strong quarter with double-digit year-over-year growth in both the life sciences and US payer and provider businesses.

I'm delighted with our sustained momentum in life sciences, which will allow us to cross the $2 billion annualized revenue threshold later this year. As we strengthen our relationship with existing biopharma and medical device companies, our strong client references and delivery excellence are positioning us well to expand into new logos.

For example, we partnered with Viatris, the newly formed company resulting from the merger of Mylan and Upjohn, a legacy division of Pfizer, to support their integration readiness for day one. We are now continuing our collaboration on post-merger integration services.

We will continue to invest to support our clients' digital needs in the life sciences business. Last week, we agreed to acquire TQS Integration, a privately owned Ireland-based global industrial data and intelligence company that will enhance our smart manufacturing offerings and build upon our successful acquisition of Zenith Technologies from 2019.

And earlier this month, we announced a strategic alliance with global health technology leader Philips to develop end-to-end health solutions that will enable health care organizations to improve patient care and accelerate clinical trials.

Over the past two years, we focused significant effort on reinvigorating the US payer and provider businesses. These efforts have started to bear fruit. During the second quarter, we expanded our existing partnerships with large payer clients and added new logos in the provider market.

The TriZetto product business is highly strategic to our Healthcare business. Following some weakness post the 2014 acquisition, we spent considerable energy soliciting client feedback and refreshing the product road map over the last two years. We are now seeing growing momentum in the business. Annual growth rates in the TriZetto product business doubled in 2020 over 2019 and are on track to double again in 2021, following double-digit revenue growth in the first half of the year.

Turning now to Financial Services, which grew 5% year-over-year in constant currency, both the banking and insurance businesses grew year-over-year and sequentially.

In banking, which is most of the Financial Services business, we have sharpened our focus on the highest potential client relationships over the past 18 months. We've refreshed now about half of our client-facing teams, bringing in seasoned industry talent with an emphasis on executive engagement, and selling and delivering business outcomes in collaboration with the financial services partner ecosystem.

While we are making progress in our client engagement strategy and have seen sustained momentum in regional banks, banking results continue to be hindered by ongoing revenue erosion in large global banks. As such, while we expect full-year financial services revenues to grow modestly, the repositioning of the business continues.

Before discussing the macro demand environment, I would like to acknowledge the progress we've made in our BPO business, which we call digital business operations. Two years ago, we made the decision to exit certain non-strategic elements of the content moderation business that had been a meaningful contributor to growth. This decision impacted the growth trajectory of DBO and required us to reposition the business.

Two years on, we've now successfully completed the exit of the content moderation business. And as of the third quarter, revenue compares will be like-for-like. I'm pleased with the revised strategic direction of digital business operations, which focuses on automation, analytics and consulting, as well as platform-based and core business process operations.

Year-to-date, we've seen double-digit revenue growth in digital business operations and we expect to sustain this growth in the coming years, driven by strong results in modern BPO segments, like digital natives and intelligent process automation, and by our leadership position in BPaaS within the Healthcare segment.

A recent example of our client momentum is Johns Hopkins HealthCare, who turned to us to transition their Medicaid and commercial lines of business from legacy platforms and operations to our leading BPaaS solution. We'll be providing a modern, scalable cloud-based platform to enable Johns Hopkins HealthCare to be a more robust, flexible organization that can deliver better, more affordable patient outcomes.

Let's turn now to macro demand, which is particularly robust, as clients modernize their legacy environments, embrace the cloud and invest in innovation. We continue to believe that the next phase of digital is about transforming processes to become agile, intelligent and automated, and always with an eye on customer experience. Hyper-personalization is fueling significant demand in analytics, AI and ML.

Given strong demand and our bullish outlook on the industry, we are committed to meaningfully scaling our head counts over the coming quarters. However, this macro demand backdrop has also created a demand-supply imbalance in key skills and has meaningfully increased industry attrition.

As we noted in last quarter's remarks, we expected attrition to go up sequentially in Q2, and it did. Second quarter voluntary attrition reached 29% on an annualized basis, or 18% on a trailing 12-month basis. As a reminder, our attrition metric captures the entire company, including trainees and corporate, across both IT services and BPO.

Against this backdrop, we continue to take a series of actions to reduce attrition, including compensation adjustments, job rotations, reskilling and promotions, and a host of associate engagement activities.

Fortunately, we meaningfully increased our recruiting capacity over the last six months, as we anticipated a spike in attrition following the V-shaped demand recovery in the second half of 2020.

Our human resources team have done a remarkable job, helping us mitigate the impact of elevated attrition through comprehensive hiring, onboarding and skilling programs. In fact, we now expect to hire approximately 100,000 laterals in 2021 and to train close to 100,000 associates. In addition, we expect to onboard approximately 30,000 new graduates in 2021 and make 45,000 offers to new graduates in India for 2022 onboarding.

Over recent years, we've been methodically shifting our revenue mix to digital, which now accounts for more than 44% of our revenue. Since 2019, we've invested more than $2 billion in mergers and acquisitions to accelerate our digital capabilities.

While the impact of recent acquisitions has reduced Q2 company margins, given diligence and integration costs and acquired company margin dilution, it has nonetheless been the right thing to do. These investments have changed the growth profile of Cognizant by shifting our businesses to higher growth categories and reducing our exposure to non-digital categories that have declined in recent years.

Today, I wanted to spend a moment addressing some of our progress against our targeted digital battlegrounds, including IoT, digital engineering and cloud. Our IoT business has scaled rapidly and revenues are now expected to exceed $600 million in 2021, almost twice the size of what it was in 2019. Cognizant was recently ranked number one in the Managed IoT Services category in ISG's 2021 IoT Services Evaluation for both the US and Europe.

Our digital engineering business is now at a $1.2 billion annual run rate, growing 30%, making it one of the largest digital engineering businesses in the world. In June, Cognizant was named a leader in Everest Group's PEAK Matrix for Software Product Engineering Services 2021 Report.

We've also made tremendous headway in our cloud business. Seven of our acquisitions over the past 18 months have been cloud-related. As you may know, Gartner in its Magic Quadrant for Public Cloud Infrastructure and Managed Services Providers elevated Cognizant from a Niche Provider Player in 2018 to Challenger in 2019 and to Leader in 2020. We now have three cloud-focused business groups; one for Microsoft, another for AWS and a third most recently for Google, each supported by specialized cloud experts and solution architects.

For example, we've been recently engaged with Microsoft industry clouds in areas like financial services, health care and retail. In the past two years, thanks to our ongoing market momentum, the acquisitions of New Signature, Contino and 10th Magnitude and the formation of our Microsoft business group, we have meaningfully changed our ranking to become one of Microsoft's leading global system integrator partners. Our commitment to the partnership and focus on technical intensity is demonstrated by more than 100% year-over-year growth in our Microsoft cloud certifications.

Our success in expanding our portfolio has not only made us more competitive, but has encouraged more clients to engage us to execute their transformation agendas. This positions us to take full advantage of our client base by enabling us to up-sell and cross-sell in our existing accounts and enables us to get new logos by leading with digital.

For example, Gilead Sciences selected us to lead a body of work related to IT business transformation, as well as development of an enhanced security and compliance posture. We will utilize our deep life science industry knowledge augmented by recent acquisitions like Zenith Technologies and collaborative solutions, along with our proprietary legacy modernization framework and robust automation capabilities to support this work. Our aim is to accelerate the company's technology transformation and further enhance its digital capabilities.

In another example, given our advanced capabilities in digital automotive, engineering R&D and smart connected mobility, Qualcomm Technologies, one of the world's foremost semiconductor and connectivity solutions companies, turned to us to build a reliable cloud-agnostic connected vehicle management solution. The aim of this integrated platform is to connect vehicular onboard applications, manage car-to-cloud operations and work across nearly every OEM vehicle platform and its cloud infrastructure.

Lastly, building exceptional digital experiences is of increasing importance to clients who sometimes struggle to connect the dots between the experience itself and the underlying business functions. With our extended portfolio, we're now able to orchestrate software, data, platforms and programs to transform high-value interactions into personalized experiences that drive business results.

A great example of this is how we're now partnering with NBC to reimagine their customer experience, creating direct-to-consumer commerce strategies, driving attendance to their theme parks and supporting their marquee event, the 2021 Summer Olympic Games.

In closing, I've been in the CEO role now for more than two years, and I see a new Cognizant taking shape. Our solution portfolio is stronger than at any time in our history. This has changed the way clients and partners perceive us and helps us deliver differentiated business outcomes. We are bullish on the industry and our prospects within it. We are well-positioned to capitalize on digital transformation market trends, which are accelerating, and we have an enormous opportunity in our international markets.

But we are in one of the hottest job markets in many years, and expect elevated attrition to remain a factor across the industry in the coming quarters. Our recruitment and skilling programs, as well as targeted actions to offset margin headwinds stemming from the industry's talent shortage provide us confidence in our outlook for the year.

With that, I'll turn the call over to Jan, who will cover the details of the quarter and our financial outlook before we take your questions. With that, over to you, Jan.

Jan Siegmund

Chief Financial Officer, Cognizant Technology Solutions Corp.

Thank you, Brian, and good afternoon, everyone. Our Q2 revenue was $4.6 billion, representing growth of approximately 15% or 12% in constant currency. Revenue was $125 million above the high end of our guidance range, driven by continued demand for digital, which grew 20% and represented 44% of total revenues. Year-over-year revenue growth also includes approximately 390 basis points of growth from our recent acquisitions and benefited from an easier compare to Q2 2020, where our revenues were impacted in the early months of the pandemic and by the ransomware attack in April 2020.

Moving on to segment results, where all growth rates provided will be year-over-year in constant currency. Financial Services revenue increased approximately 5%, in line with our expectations. We continue to make progress as we reposition this business and observed a strong improvement in the pipeline. We still expect a paced recovery through the remainder of the year.

Healthcare revenue increased approximately 13%. Again, driven by a strong performance in both our healthcare payer and life sciences businesses. Revenue growth within our Healthcare business was primarily organic and we continue to see strong demand for our integrated payer software solutions and improving fundamentals in our provider business. As Brian mentioned, we remain very pleased with the growth in our life sciences business.

Products and Resources revenue increased approximately 18%, driven by the fifth consecutive quarter of double-digit growth in manufacturing, logistics, energy and utilities. Segment growth included approximately 600 basis points from inorganic revenue.

As Brian mentioned, we also experienced growth in retail consumer goods and travel and hospitality, driven in part by the lapping of the pre-pandemic conveyors. There are early signs of stabilization within these sectors most impacted by the pandemic, but we continue to monitor closely.

Communications, Media and Technology revenue grew 18%, of which approximately half of the growth was attributable to recent acquisitions. This growth was partially offset by a negative 190 basis points impact from our exit of certain portions to our content services business. Overall, we are very pleased with the growth of our core portfolio.

Now moving on to margins. In Q2, our GAAP and adjusted operating margin were both 15.2%. On a year-over-year basis, adjusted operating margin improved approximately 110 basis points, primarily reflecting the savings from our cost initiatives in 2020 and the impact from the pandemic and ransomware attack in Q2 2020.

This year-over-year benefit was offset in part by SG&A investments, including those intended to drive and support organic revenue growth as well as the negative impact on margins by our recently completed acquisitions, and costs related to the modernization of our IT core and security infrastructure.

In addition, we anticipate continued cost pressure from our elevated attrition, which includes higher recruiting costs, lateral higher wages and subcontractor costs. Our GAAP tax rate in the quarter was 26.5% and our adjusted tax rate was 25.4%, in line with our expectations. Diluted GAAP EPS was $0.97 and adjusted diluted EPS was $0.99.

Now turning to the balance sheet. We ended the quarter with cash and short-term investments of $1.9 billion or $1.2 billion net of debt. Free cash flow in Q2 was $466 million. This included a payment from the settlement with two of the three customers that were part of the proposed customer engagement exit we announced in our fourth quarter 2020 earnings.

Excluding this one-time payment, free cash flow would have been approximately 100% of net income. The payments made this quarter were in line with our prior expectations and resulted in no impact to our earnings in Q2.

Overall, we were pleased with the outcome of the settlement, which includes a continued commercial relationship with both customers. Negotiations with the third client are ongoing and constructive. DSO of 71 days increased by 1 day sequentially and has improved from 77 days in the prior-year period.

During the quarter, we repurchased 4 million shares for $296 million at a weighted average price of approximately $74 per share. At the end of June, we had $2.3 billion remaining under our share repurchase authorization. We also spent cash of approximately $350 million on acquisitions and $127 million for our regular quarterly dividend.

Turning to guidance. For Q3, we expect revenue in the range of $4.69 billion to $4.74 billion, representing year-over-year growth of 10.6% to 11.6% or 10% to 11% in constant currency. Our guidance assumes currency will have a favorable 60 basis points impact and inorganic contribution of approximately 320 basis points.

For the full year, we now expect revenue of $18.4 billion to $18.5 billion, representing 10.2% to 11.2% growth or 9% to 10% in constant currency. This compares to our prior guidance of 7% to 9% growth as reported or 5.5% to 7.5% in constant currency.

Our outlook assumes currency will have a favorable 120 basis points impact and includes approximately 320 basis points contribution from inorganic revenue. Our outlook assumes continued momentum across Healthcare, CMT and Products and Resources, while we continue to expect a paced recovery in Financial Services over the next couple of quarters.

Moving on to margins, we expect full-year adjusted operating margin to be approximately 15.4%, the midpoint of our prior guidance of 15.2% to 15.7%. As I mentioned earlier, elevated attrition is leading to increased costs in certain areas. We are also continuing to fund investments in our people, including compensation, quarterly promotions, retention and training. We expect these costs will weigh on our results for the next several quarters as management remains keenly focused on addressing our high attrition levels through a comprehensive set of initiatives.

We continue to expect SG&A growth for the remainder of the year, driven in part by the impact from our M&A activity. However, we are slowing the pace of growth in some areas not directly related to our strategic initiatives to mitigate some of this cost pressure. This leads to our full-year adjusted EPS guidance which is $4 to $4.06, compared to $3.90 to $4.02 previously.

Our full-year outlook assumes interest income of $25 million to $30 million, compared to $20 million to $30 million previously. Our outlook assumes average shares outstanding of approximately $528 million compared to $530 million previously and a tax rate of 25% to 26%, which is unchanged from our prior outlook.

Finally, we continue to expect free cash flow will represent approximately 100% of net income for the full year. We remain committed to our balanced capital deployment strategy and returning at least 50% of free cash flow to shareholders through dividends and share repurchases.

Before opening the call for questions, I wanted to let you know that we are planning to hold an investor briefing in the fall during which Brian and I will provide a review of our strategy and an update on our progress over the last two years. We will also provide our multiyear financial framework. Please keep an eye out and save the date in the coming weeks.

With that, we will open the call for your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Lisa Ellis with MoffettNathanson. You may proceed with your question.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Good afternoon. Thanks for taking my questions. Good stuff here. A follow-up question, as I'm sure you'll get 20 of them, related to the attrition and head count dynamics.

One, maybe, Jan, can you just elaborate on what gives you confidence in your ability to expand margins in the second half of the year while you're still sort of battling through this attrition environment? Like, so for example, are you – given the high demand environment, are you able to take price, etcetera? Just a little bit more color there.

And then I'll just ask my second one kind of related is just around employee health. I'm just wondering like how employee satisfaction is faring at Cognizant? I know that's something that you watch pretty closely. So what's your confidence level in being able to bring attrition down over the next couple of quarters? Thank you.

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Yeah. Thank you, Lisa, and somehow I anticipated questions around our margin guidance being of interest. It's a complex situation, Lisa, in that we have actually quite a few dynamics going on that impact the margin dynamic for the second half. And so you rightly concluded that for the second half we are expecting really, on average, margin development around 15.6% to meet our midpoint of our guidance.

And as you're also aware, we have a little bit of a quarterly dynamic towards the year-end. So, margins in the third quarter, we're thinking, are going to be slightly higher than towards the fourth quarter due to typical end-of-season dynamics, including the merit increase that will fully filter in in the fourth quarter when we administer and implement the merit thing. So, that's kind of all the general margin dynamic.

What we have seen, I want to point out a few other elements of the margin dynamic. We have seen, in this quarter, a fairly healthy margin dynamic on the gross margin side, and we reported a shift in our digital revenue mix, which comes actually with higher gross margin than our traditional business, which is part of the strategic rationale of why we are, of course, engaging in the transformation of the business. And that margin effect was accelerated actually, we shifted share, but we also improved that relative margin in our second quarter. So we anticipate to continue to have some benefit from that mix shift also in the second half.

And then, of course, we see pressure from the compensation measures coming into our P&L. And we're offsetting that by controlling the growth of certain SG&A components that have been growing kind of lightly, I would say, and bring that more to a controlled or flattish outcome towards the end of the year. And so it's a number of factors that we have to keenly execute in order to keep, of course, the overall structure of our P&L in place, but that's the principal dynamic that we are following.

And I hand over the employee engagement question to Brian.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Thanks, Jan. Hi, Lisa. Look, it's very much top of mind. As you can imagine, voluntary attrition in the quarter was 29%. But on a trailing 12-month basis, which is more how the industry tends to look at it, it was 18%. And we've seen primarily the attrition in the more junior levels of the organization or mid-levels in India, but it's also a global phenomenon.

It's really one of the hottest markets we've seen or our team has seen over the last 10-plus years. So we're all dealing with it. As it happens, in the last month, we had the results of our annual engagement survey. We're actually very pleased with our results. They're at or above, in many cases, industry benchmarks.

I'm really pleased to see the delivery organization's engagement scores are actually above the company average, and they're very much as a total company in the same range as where we've been from 2016 and beyond. Last year, we actually had a particularly strong year as many companies did because of the pandemic when people were pleased when they had secure jobs and whatnot.

So, from one perspective, I feel very, very good about it. But in the same vein, of course, I don't feel very good about the attrition. And so, that's top of mind and it's got a lot of management focus. I'm pleased that we executed well in the quarter. We exceeded our revenue guidance despite elevated attrition, but my great hope is, over time, we can reduce attrition and yet continue to hire at the pace we have been hiring at, which is something we're very pleased with. The throughput of our recruitment team has really been terrific.

So, what are we doing to reduce attrition and to continue to drive employee engagement is the next obvious question. Well, look, annual merit-based increases have been announced here in the last few weeks. They're effective October 1. That's on top of a whole host of ad hoc measures we played through in the course of the last year, out-of-cycle increases, promotion, retention dollars.

We've announced a shift in the last few months to quarterly promotion cycles for billable resources. We've really fast-tracked job rotations and reskilling initiatives across the company, done a host of things with Cognizant Academy which is our training capability, as well as higher education programs for select employees as well.

And we've put an enormous effort behind our employee value proposition, celebrating delivery success, big wins, et cetera. So, more work to be done, but I'm confident we're doing the right things.

And as I said, while I'm pleased we executed through it this quarter, the reality is 15% revenue growth this quarter also gives the organization a little bit of energy that, okay, growth is coming back and with growth comes good things in terms of career path opportunities, rotations and promotions and whatnot. So, I'm sure today's top line story will help broader employees feel better and we'll keep doing all the other things we're doing.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Yes, great to see the revenue acceleration. Thank you. Good stuff.

Operator: Our next question comes from the line of Ashwin Shirvaikar with Citibank. You may proceed with your question. Ashwin, you may proceed with your question.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.
Q

Hi. Sorry. Can you hear me now?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.
A

Yes.

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.
A

Yes.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.
Q

Good quarter, guys. I wanted to follow-up also on attrition. Could you talk a little bit more about what you expect for 3Q, 4Q attrition? And what's been the client feedback in the face of the situation?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.
A

So, look, from my perspective, the first thing I would think about are our associates and our clients, and you can't be client-centric unless you're associate-centric. And so, as we start thinking about this, of course, it gets into how we engage our clients and how we think about the demand signal that will help us facilitate the right resources at the right time. Communication is important in a time like this, setting appropriate expectations regarding resource availability time lines.

Entity prioritization, Ashwin, as you can imagine, getting the right resources on our most strategic accounts is very much top of mind and part of our execution rigor we do now on a day-in, day-out basis.

Regrettably, despite growing 15% in the quarter, we're yet unable to meet the full expectations of our own potential and what is out there in the market. So, we're working through that as best we can and doing our best, as I said, to minimize attrition, whilst at the same time to maximize employee engagement and to maximize onboarding. As I said in my remarks, we'll bring on about 100,000 lateral hires this year alone. We'll train about 100,000 people, and we'll onboard about 30,000 freshers and we'll make offers to 45,000 freshers.

Regardless of our attrition rate, we will still go through with those numbers because there is enough market demand for us to get after that opportunity. And that's what we're quite excited about. I think the portfolio is more compelling than ever before, and we've made huge progress in the last year to get after that market opportunity. So we're feeling pretty good about that. But it's a hot market and I think you've heard that through the earnings cycle. So we're all dealing with the same problem.

Operator: Our next question comes from the line of Bryan Bergin with Cowen. You may proceed with your question.

Bryan C. Bergin
Analyst, Cowen and Company, LLC

Q

Hi. Good afternoon. Thank you. I'll just ask two upfront here. So, as it relates to bookings and the growing commercial momentum you called out, can you comment on how well-distributed the bookings contribution has been across the sales force? So how much of your sales force would you say is optimized and converting, versus those that are still building pipeline and will convert over the balance of this year into next? And then just to clarify on attrition, have you continued to see the trend of declining resignations month-to-month?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Well, I'll deal with that first. Look, we look at net resignations. It went through – actually, at the end of last quarter, we thought we'd hit an apex and then it went up modestly, but it's – we're expecting, and it's inherent in our guidance, elevated attrition to remain in the coming quarter and we'll see what happens thereafter. It's a very, as you can imagine, hot market out there and so it's very difficult to call. I think we're doing the right things to mitigate that. But rest assured that these levels of attrition and slightly beyond are in our guidance.

With regards to bookings, look, I feel really good about our bookings, to be very honest. It's important to look at bookings not just on a weekly or a quarterly basis, but really on a trailing 12-month basis. And now we have rounded that one-year period, so we have a good book-to-bill ratio over the last 12 months of 1.2 times, which I think is very, very healthy. We look at it in terms of geographic. We look at it in terms of business mix. We look at it in terms of new and expansion versus renewals. And it's pretty solid across the board and the pipeline is solid across the board as well. So I feel good about the market opportunity. Candidly, I don't think demand is the problem for this industry. I think it's a great time to be in the services. It's more of a supply constraint at this moment in time.

With regard to the sales, our commercial teams we brought on board, look, they're ramping. I don't think we have full productivity. At this stage, we've got a lot of exercises underway to make sure we get true gearing ratios. But in the same vein, I feel as though we've got a client-facing team now that is better able to walk the corridors if and when we get back from COVID virtually for now and to cross-sell the entire portfolio.

And if you think about our installed base, it's a huge asset for us and the opportunity is real. About 4 out of 10, or 40% of our accounts, we only sell one of our practices into those and we have 10-plus practices. So, think about cross-sell as a huge opportunity for us. And of course, the M&A that we have conducted in the last two years, which is 100% aligned to our digital strategy, enables that cross-sell more than ever before and indeed cross-sell is core to the business case of those acquisitions.

So we're pretty excited about what we can do there, both in terms of our installed base, which, of course, is a big priority for us. But we also have opportunity through this extended portfolio to get after new logos. And the Qualcomm example I cited in my script is a good example of that, where we're leading with digital. And accordingly, we'll try and cross-sell the non-digital business as well.

Bryan C. Bergin
Analyst, Cowen and Company, LLC

Q

Great. Thank you.

Operator: Our next question comes from the line of Rod Bourgeois with DeepDive Equity Research. You may proceed with your question.

Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

Okay. Thank you. Hey, Brian. So, when you consider your pipeline and your inorganic growth plan going forward, are you in a position to further substantially increase your digital mix over the next year? I'd love any color to help dimension the remaining mix shift potential over the next year or so, that would be really helpful. Thanks.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Yeah. Hey, Rob. So, as you know very well, one of our biggest priorities when I joined the company was to accelerate our digital mix. It was 28% or less than 30% certainly at the end of 2018 for the year. And it's been very much part and parcel of what we're setting out to achieve. It's 44% of our mix today. Candidly, numerator-denominator comes into play. We actually had very good success this quarter, driving growth as well in our non-digital business, which has declined in 2019 and 2020. So, candidly, that has slowed the digital mix ramping further, the share growth of non-digital this quarter.

But overall, the digital business will continue to grow. I'd like to think as we get to the latter part of this year, we'll be up closer to 50%, and it will start becoming a bigger portion of our overall business over time. That's important for us because: A, it helps us be exposed to higher growth categories; but B, it increases our intimacy with the broader C-suite in our installed base of accounts, and that enables us to sell beyond the CTO organization into the CMO, into the line of service leader, etcetera.

Of the accounts that we have added in the first half of this year versus the first half of last year, the vast majority of the bookings is actually in what we would term digital. So, Rod, that mix shift to digital will continue, and I'm pretty optimistic that we'll continue to see a nice ramp there. That is not just good for revenue or client intimacy, it's actually also very good for our margin rate as a company as well. So we feel as though we're doing the right things. Our M&A strategy is 100% behind this and it puts us in a position to actually get after our installed base to cross-sell and upsell and actually get new logos and really become a challenger in the digital arena.

Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

And...

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Maybe, Rod, if I add one comment on the dynamic of the digital organic revenue growth, we very carefully monitor the organic growth that our M&A is generating within itself, but also, of course, as a cross-sell into our client base. And we have seen a very robust organic growth from that portfolio that is kind of, in most cases, meeting our business case assumptions. So we're very pleased that actually the shift is not only of M&A, it's not only adding the incremental acquired revenues to the portfolio, but that portfolio also is accelerating and growing faster than the average in its growth trajectory.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

And Rod, I meant to – you explicitly asked around the pipeline. Look, the digital pipeline has grown at multiples of the non-digital pipeline. And actually, our win rates in digital are higher than our win rates in non-digital. So there's a lot of good leading indicators.

Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

Great. And Jan, you kind of read my mind. My follow-up was related to the acquisitions. And looking for an update on your progress in being able to cross-sell the newly acquired offerings into your existing accounts, that's a muscle that tends to take time to develop. So, maybe just give us some thinking on where you are in that journey? Are you well into that journey? Or is there still some juice left on the cross-selling into existing accounts with these newly acquired capabilities that you have?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

I would say we're still in the early and mid-parts of our journey. We made really good outcomes happen for acquisitions that – I have examples where we haven't even closed the acquisition, we started to think about cross-selling the product already prior to the close. So there's plenty of excitement in our sales force to bring these solutions to our clients.

And as we now focus to fully integrate this acquired portfolio of digital capabilities into the fold of Cognizant, many other benefits of pipeline management will become easier, the learning for the acquired companies will grow. So I'm optimistic that we will continue to reap really good benefits out of the M&A regarding to the organic growth that they are generating, which is what I'm really keenly focused on.

Rod Bourgeois
Analyst, DeepDive Equity Research, LLC

Q

Great. Thank you, guys.

Operator: Our next question comes from the line of Keith Bachman with BMO Capital Markets. You may proceed with your question.

Bradley Clark
Analyst, BMO Capital Markets Corp.

Q

Hi. This is Brad Clark on for Keith. Thank you for taking my question. I would like to ask if there was any way to quantify either the impact or size of the planned wage increases for employees.

And then, secondly, given ongoing employee and market pressure on margin throughout the remainder of the year, how do you view future M&A strategy compared to the past 12 to 18 months? Is the pace of M&A sustainable? What are your views on that going forward? Thank you.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Jan?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

yeah, thank you for your question. We don't disclose really the elements of our compensation moves externally. So I can't help you with that. It is clearly reflecting the market dynamics. We are orienting our compensation, obviously, on market data and reflect – our compensation moves really reflect an assessment about keeping Cognizant a competitive employer and recruiter in the marketplace. And we are very pleased actually with that.

The ability to attract associates into the Cognizant family is great. We've been ranked in a variety of applications as really employer of choice, and particularly, in the critical market of India for us. So it will feather through country-specific and market-oriented based on wage developments in those countries.

On the M&A program, we just talked about, I think, at the end of last year, about a capital allocation framework for the company, which about dedicates 50% of our cash flow to M&A, for a reminder, about 25% used to offset the dilution of our equity compensation and 25% for dividend. And we use this framework not to position, but as a really good framework for us to execute our strategy.

So, going forward, I'm anticipating to spend within the range of that capital allocation framework to support the execution of our strategy. We remain focused in that M&A program on our strategic objectives and focused on our digital battlegrounds. You have seen in some of the acquisitions in the beginning of this year, that we may have, and it's with few transactions, hard to describe a trend, but there is a keen focus on executing and using the strategy also to help the globalization of Cognizant. And so you have seen with Servian earlier in the year, an acquisition in the Australian marketplace. We acquired ESG Mobility in the fatherland, my home country, which I was very happy about, really a leading provider on the Internet of Things, IoT, with keen leadership positions in the automotive sector.

So there is more geographic diversion still needed for us. And so we'll adapt as we make progress on the positioning of our practices and our industry groups to the needs of the strategy. And so this is a long answer for you. But, yes, we anticipate to continue our acquisition-driven strategy execution.

Operator: Our next question comes from the line of Tien-Tsin Huang with JPMorgan. You may proceed with your question.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Hey. Thanks so much. I'll mix it up and ask about TriZetto. I think I heard that your repositioning is driving better growth, double-digits. I was a little surprised by that. I'm curious, can you elaborate on that? What are you doing differently? And could this kind of change be extended or applied to other areas as well?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

So our product business in Healthcare, Tien-Tsin, is something that we inherited through the TriZetto acquisition at the end of 2014. To be very honest, I think we didn't execute the integration of that optimally. And in the last few years, we've really tried to get after that opportunity, because I think it's a crown jewel that I felt we could do a better job on.

And so, starting with that, we got off to the road map that we had, tried to understand, solicit customer feedback to make sure we had something that in the eyes of clients was in line with their needs, that the user interface and the code was appropriate and fit for purpose. And in the meantime, we had some competitors that had emerged that, frankly, I didn't think had the right to beat us given our heritage in this space.

Fortunately, now, we've had three quarters in a row of double-digit growth in the product business. And as I said, our growth in 2020 versus 2019 doubled, and we're on track to double growth rate year-over-year again and we're getting some fantastic logos.

And this is a great business in itself. It's software-centric, higher margins. But, of course, the stickiness of that enables us to pull through a rich services suite thereafter. So the team has done a fantastic job. I view it as highly strategic for us, and we're 100% committed to that business and you'll see us scale in that over time.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Okay. No, it's encouraging to hear. I'll ask quickly, if you don't mind, just on the supply side, just with more lateral hires. Can we just infer that's indicative of more digital work, so you need to go out there and grab some of the lateral hires? Or is it just purely out of necessity, given what you said about demand and the timing of university hiring, or maybe more work needs to be done on the training side to meet the type of work that needs to be done? I'm just trying to understand what's structural versus cyclical there.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Well, if you think about the lateral hires, it's really with a view to doing two things. One is addressing the attrition that we have and also getting after the market potential that we see.

And so you go back to where is attrition greatest, it's at the mid-junior levels of the pyramid, particularly in India. But it's also in hot skills. And if you think about hot skills, think about hyperscalers, think about leading SaaS players, think about digital engineering, full stack engineers or across data, AI and ML.

And so you find yourself in a situation where you've got a demand-supply imbalance and that's an area as well where we're also going after lateral skills and trying to get them in as quickly as we can, whilst also trying to train and promote our internal employees as well.

So it's a race for talent in a red hot market. And I anticipate, given how bullish I am on the market, and my sense is we'll have a resilient services demand picture for the foreseeable future, I anticipate elevated attrition across the industry.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Yeah. Makes sense. Thank you, Brian.

Operator: Our next question comes from the line of James Friedman with SIG. You may proceed with your question.

Q

Hey, guys. This is [ph] Mike (0:52:01) on for Jamie. Thanks for taking my question. So my first one, can you guys talk a little bit about your updated perspective on 5G? And this quarter with CMT growing so well, has 5G offered any tailwind there?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Look, from my perspective, 5G is still in its very early days, both in terms of handset proliferation and the use cases that probably, given the need for latency security and other considerations, will be more B2B or B2B2B rather than B2C. I don't think B2C is a huge inflection point for the telco industry, albeit many people will talk about it to justify CapEx outlays.

With regards to our CMT industry vertical, it has not been a major driver of the business to-date. We're very intrigued around autonomous driving. As Jan said, we acquired ESG Mobility in Germany. We've got a big emphasis on the automotive vertical and indeed on the CMT vertical, but 5G has not been a massive factor to-date. I think IoT will be unlocked by the benefits of 5G and different cellular technologies, but it's premature at this stage.

Operator: Our next question comes from the line of James Faucette with Morgan Stanley. You may proceed with your question.

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. I wanted to ask on pricing. I mean, you touched a bit on that earlier. But how has pricing trended in the quarter, particularly given some of the peer commentary around pricing stability? And I guess what we're really trying to get at is are you able to pass on some of the wage costs and how are clients responding to that?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Yeah, we have observed pricing trends by segment. And I implied in my comments that we have been expanding our gross margins on the digital business, and we have seen an ability to the tight labor market, allowing us to get good pricing for our services. We see also continued pricing pressure in the more traditional services that we have been talking about in past quarters, where clients are seeking additional cost benefit and that pricing pressure in those more traditional type of services haven't changed at this point in time.

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Thanks for that, Jan. And just on digital quickly, we're big believers in your acquisition strategy, and I appreciate the early color around digital battlegrounds. But are there any digital battlegrounds where you're currently under-indexed relative to the demand that you're seeing that you could take a better advantage of?

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

A

Hey, James. This is Brian. I'll address that. Look, the digital arena more holistically for us, goes well beyond the four digital battlegrounds that I focused on when we joined, which were notably around cloud, around digital engineering, around applications and IoT and data and analytics rather.

If you think about other areas that are not included in those so-called battlegrounds, things like digital experience continue to grow rapidly for us, and I'm very optimistic that that becomes a core part of the sale, the whole user experience as you think about digital workflows. So it's broad-based.

Digital engineering is something we prioritize. It's growing rapidly. As I said, it's one of our biggest growth potential units in the years ahead, something that has scaled meaningfully in the last two years, and we're now one of the largest digital engineering companies in the world. We've complemented our capabilities with the acquisitions of Softvision in 2018, and then, in more recent years, Magenic and Tin Roof.

And I just feel very good about our potential there, but more broadly, there's just a lot of demand in this arena, and I just feel good about our potential because we're scaling, it's still a smaller portion of our mix. The more we scale, the higher company average CAGR. And as Jan has implied, it's good for our margin rate as well. So, we're full speed ahead after the digital opportunity.

James E. Faucette
Analyst, Morgan Stanley & Co. LLC

Q

Thanks for the color, Brian and Jan.

Tyler Scott
Vice President, Head-Investor Relations, Cognizant Technology Solutions Corp.

All right. I think with that, we'll wrap it up. Thank you, everybody, for joining, and look forward to speaking with everyone next quarter.

Brian J. Humphries
Chief Executive Officer & Director, Cognizant Technology Solutions Corp.

Thank you.

Operator: This concludes today's Cognizant Technology Solutions second quarter 2021 earnings conference call. You may disconnect your lines at this time. Thank you for your participation. Enjoy the rest of your day.