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Cognizant Technology Solutions Corp.

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Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, welcome to Cognizant Technology Solutions Q1 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, Senior Director of Investor Relations. Please go ahead, sir. Thank you. You may begin.

Tyler Scott
Senior Director-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 the investor supplement for the company's first 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 now 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. I would like to start today's call by addressing the humanitarian crisis in India. As many of you know, India is the heart of Cognizant, and home to more than 200,000 of our associates. I would like to express my support and solidarity for our Indian associates, wherever they are in the world and my sympathy for any who have suffered a loss during the pandemic.

In addition to the ongoing support of our associates, which includes home care and hospitalization assistance, vaccination cost reimbursement for our associates and their families, and making vaccine availability easier for those with disabilities, Cognizant is making a multimillion dollar investment to assist India through the crisis.

This is focused on covering operational expenses at hospitals throughout India that are caring for COVID-19 patients; funding the efforts of UNICEF in India to deploy oxygen-generation plants, COVID diagnostic testing and medical supplies; and partnering with one of India's leading hospital chains to set up vaccination centers in locations across the country, including some of Cognizant's owned facilities.

The impact of the pandemic on industry attrition rates, absenteeism and client delivery remains somewhat uncertain. We monitor our situation daily, and we'll continue to prioritize the health and safety of our associates, while serving our clients who have been particularly supportive in recent weeks.

As the COVID situation differs throughout the world, our return-to-office strategy remains country-driven. Currently, almost all of our associates are working from home and business travel remains on an exception-only basis.

Let's turn now to the first quarter. First quarter revenue was $4.4 billion, representing growth of 2.4% year-over-year in constant currency. Although, we executed well in the quarter and delivered against our expectations, revenue upside was limited by elevated attrition, reflecting the intensely competitive market for digital talent that we spoke about in our last earnings call. This put some pressure on salaries as rows were filled by lateral hires or contingent workforce. And in some cases, commercial opportunities were forgone due to an inability to source talent.

To address retention challenges, we've been executing a multipart plan that includes stepping up our internal engagement efforts, an increasing investments in our people through training and job rotations to provide opportunities for career growth; shifting to a quarterly promotion cycle for billable associates; and implementing further salary increases and promotions for high-demand skills and critical positions; and ramping our hiring capacity by adding hundreds of recruiters, and making 28,000 plus offers to new graduates in India, a new record.

Daily resignations increased through the first quarter, peaking in March. On a positive note, resignations slowed in April and continued to slow in May. However, given two months' notice periods in India, we anticipate further sequential increases in attrition in Q2 before a gradual recovery in the second half.

Notwithstanding industry attrition challenges, we remain confident in Cognizant's standing as a magnet for skilled talent and a great place to build a career. In recent quarters, we've seen a meaningful increase in our brand perception in the talent market in India. For example, our compass acceptance rates amongst India's top engineering colleges has risen to more than 80% this year, up almost 10 percentage points since 2019.

In addition, LinkedIn just ranked Cognizant a top company in both the US and India based on traits like the ability to advance, skills growth and gender diversity, all of which are consistent with enabling professionals to grow their careers. In India, LinkedIn ranked us Number 2 among 25 leading companies. This honor follows Forbes magazine recently naming Cognizant to its list for World's Best Employers and Best Employers for Diversity.

Moving on, I'm pleased with the health of key leading performance indicators. For example, digital revenue growth accelerated to 15% year-over-year. Digital now represents 44% of our revenue mix. Bookings growth of 5%, which was strong, considering outstanding December bookings and a tough prior year compare.

Year-to-date bookings growth has since been boosted by excellent bookings in April. I'm confident that our sustained book-to-bill ratio of greater than 1.1 times revenue provides us with the opportunity to further accelerate revenue growth. Finally, our qualified pipeline and win rates are strong and give us reason to be bullish.

Turning now to our industry sectors. Financial Services declines moderated. Leading performance indicators, including digital mix and qualified pipeline, have both improved in both insurance and banking. Our turnaround efforts are ongoing, and we expect Financial Services to continue to recover over the course of the year.

I'm pleased with the growing momentum in our Healthcare business. We had a strong quarter with growth across our payer and life sciences businesses and improving trends within our provider business. Over the past 18 months, we've refreshed our product strategy and better aligned our investments with market priorities. We recalibrated our product roadmaps to focus our core platforms and cloud enablement, customer experiences, digital workflows and automation. This intensified pivot to digital has resonated well with both existing clients and prospects, enabling us to achieve double-digit growth in our software product business.

Products and Resources continues to be affected by the pandemic. Declines in retail and consumer goods and in travel and hospitality were offset by continued double-digit growth in manufacturing, logistics, energy and utilities.

Communications, Media and Technology posted solid growth when normalized for the exit of elements of content moderation. Jan will provide more details on the quarter in his prepared remarks.

Let's turn now to the macro environment. Our client conversations suggest a robust and resilient IT services demand picture for 2021 and beyond. This is fueled by business model innovation, customer experience investments, technology modernization, risk mitigation and efficiency initiatives, all driven by hyperscale roadmap and commercial investments.

Creating better experiences is at the center of the digital economy. And that's what clients are most interested in, how to orchestrate technology, data and design to make their employee and customer experiences more productive, intuitive, relevant and valuable.

A good example is the work we've been doing with Papa John's International, one of the largest pizza delivery chains in the United States. We helped Papa John's transform its order operations into a centralized model that enables hyper-personalized offers for customers. We did so through an end-to-end intelligent cloud-based omni-channel solution powered by advanced analytics in 750 of its stores initially, before being expanded to 1,500 stores given early success.

This solution resulted in a revenue uplift of more than 15% per order, significant productivity improvements and halving the time between order placement and delivery. It's also improved the experience of Papa John's employees by lowering their stress from multitasking, while freeing up staff to focus on serving guests.

The shift from traditional to a software-centric business requires clients to transform their business processes and their IT architectures in parallel. This starts with engineering a new digital stack, enabled by software and consumer-grade apps that sit on intelligence, drawn from sophisticated data sets, all of which need to be instrumented and run on cloud platforms.

Within this new stack, we see particularly strong opportunities to help clients in modernizing their applications, data and infrastructure. And as you can imagine, this is driving increasing demand for our digital engineering and cloud solutions portfolio. Our overriding aim is to help clients become modern businesses. That way, they can innovate faster, become more agile and, above all, stay relevant to their customers.

In that vein, we're collaborating with Inchcape, a UK-based automotive distribution and retail leader to digitally transform and simplify their global finance and accounting infrastructure and services. We're applying machine learning, data analytics, RPA and advanced business process services to drive efficiencies and enable Inchcape to make faster and smarter business decisions.

Moving now on to strategy. We remain focused on executing the strategy with four related priorities, building a stronger global brand, further globalizing Cognizant, accelerating digital, and increasing our client relevance. I've covered these priorities in prior calls, so I'll just offer a few broad observations about our execution. We strengthened our portfolio and sharpened its focus on faster-growing markets and geographic segments.

All of our offerings are aligned to the market and aimed at providing the capabilities clients want most, like accelerating cloud migration, enabling omni-channel commerce, unlocking value from data using AI and ML, creating modern mobility experiences and more. As cloud computing has changed the way IT is delivered across infrastructure applications and platforms, we've continued to strengthen our relationships with the world's leading hyperscale and SaaS companies.

With our dedicated business groups from Microsoft, AWS and Google Cloud platform, we can help clients run their core applications and create more agile workflows in the cloud. We're also maintaining our M&A pace to further expand our capabilities in our key digital focus areas of software engineering, data and AI, cloud and IoT.

In Q1, we acquired Servian, an Australian enterprise transformation consultancy specializing in data analytics, AI, digital services, experience design and cloud. We also acquired Linium, a cloud transformation consultancy group specializing in the ServiceNow platform and solutions. And Magenic Technologies, a custom software development services company that expands our global software product engineering network.

During the quarter, we signed an agreement to acquire ESG Mobility, a digital automotive engineering, R&D provider for connected autonomous and electric vehicles. ESG Mobility complements our existing connected mobility offerings and our automotive industry presence.

Before closing, I want to spend a moment on ESG, environmental, social and governance. The public health, economic and societal damage wrought by COVID-19 have caused most businesses to reflect deeply on what they owe their stakeholders.

In keeping with our purpose, we try to be a modern corporation that is responsive to the many larger contexts in which we operate, among them societal, environmental, economic and technological. And that's why the principle of sustainability is so important to us. It speaks to our interdependence with local communities and global ecosystems.

During Q1, we announced a five-year $250 million global philanthropic investment to advance economic mobility, educational opportunity, diversity and inclusion, and health and wellbeing in communities as they emerge from the pandemic. We also recognize how much we must evolve to become a sustainable business.

To do so, we will embed ESG into our thinking, decisions and actions. This is a multiyear endeavor and one of increasing importance to our clients, associates and indeed you, our investors. To mark our progress along this journey, we're planning a series of announcements that will include the publication of Cognizant's 2020 ESG report later in the second quarter.

In closing, we continue to successfully execute our strategy. We are bullish in the industry and our prospects within it. We're working diligently through a multiyear plan to reposition Cognizant to achieve its full growth potential and reestablish our company as an industry leader. As we do so, we are committed to making necessary investments that will set us up for sustained momentum.

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

Jan Siegmund

Chief Financial Officer, Cognizant Technology Solutions Corp.

Thank you, Brian, and good afternoon, everyone. Our Q1 revenue was $4.4 billion, representing growth of 4.2% year-over-year, or 2.4% in constant currency. Compared with the prior-year period, this includes approximately 300 basis points of growth from our acquisitions and a 90 basis points of negative impact from the exit of certain content services.

Digital revenue in Q1 grew approximately 15% and represented 44% of total revenue versus 39% in the prior-year period. We were pleased with this growth acceleration compared to Q4, particularly in light of a competitive hiring environment for digital talent.

Now moving on to segment results, where all growth rates provided will be year-over-year in constant currency.

Financial Services declined 1.7%, reflecting more moderate declines in both banking and insurance, in line with our expectations. We are seeing early signs that the investments and repositioning of both businesses are resonating with our clients. This includes Financial Services bookings growth outpacing total company bookings growth in Q1 and a solid pipeline growth. We continue to expect a paced recovery for this segment over the next several quarters and anticipate that we will see positive momentum throughout the year.

Healthcare growth was 7% and accelerated from last quarter, driven by strong performance in both our healthcare payer and life sciences businesses. Following strong performance in last quarter, in Q1, our Healthcare business had its best year-over-year growth quarter since 2018, benefiting from increased demand for our integrated payer software solutions and improving fundamentals in our provider business. Life sciences revenue continued to benefit from strong demand for our digital services among both pharmaceutical and medical device companies.

Products and Resources increased 2.4%, driven by the fourth consecutive quarter of double-digit growth in manufacturing, logistics, energy and utilities. This growth was partially offset by mid-single-digit declines in retail consumer goods and double-digit declines in travel and hospitality. We have seen some early signs of stabilization within these sectors, most impacted by the pandemic but it remains a fluid demand environment.

Communications, Media and Technology grew 3.1%, including a benefit from recent acquisitions but was partially offset by a negative 600-basis-point impact from our exit of certain portions of our content services business. Outside of this impact, we are very pleased with the growth of our core portfolio of the technology business and expect continued solid growth for the remainder of the year. Segment growth was also partially offset by the demand softness attributable to the pandemic.

Now moving on to margins. In Q1, our GAAP and adjusted operating margin were both 15.2% as there were no adjustments for unusual items to report. On a year-over-year basis, adjusted operating margin improved approximately 10 basis points, reflecting lower travel and entertainment expenses, savings from our cost initiatives in 2020 and lower immigration costs. These benefits were mostly offset by investments impacting our SG&A, including the margin-dilutive impact from our recent acquisitions, investments to accelerate organic growth and corporate investments, including enhancements to our cybersecurity environment.

Our GAAP tax rate in the quarter was 24.1%. And our adjusted tax rate was 23.7%, aided by a discrete benefit of a tax settlement in the quarter. Diluted GAAP EPS was $0.95 and adjusted diluted EPS was $0.97.

Now turning to the balance sheet. We ended the quarter with cash and short-term investments of $2.2 billion or $1.5 billion net of debt. Free cash flow in the first quarter, our seasonally softest quarter, was $93 million and included an approximately $50 million negative impact from unique items in the quarter, including the payment of a portion of our 2020 COVID tax deferrals. Q1 also includes the payment of our annual cash incentive, which was higher this year compared to the 2020 payment. DSO of 70 days was flat sequentially compared to the 74 days in the prior-year period.

As a reminder, in 2021, we expect free cash flow will be lower compared to 2020 as a result of several benefits from 2020 negatively impacting 2021, including government-offered deferrals of certain tax payments, which impacted Q1 and will also impact cash flow later this year. And the higher cash incentive payout this quarter versus Q1 2020 I just mentioned.

Our outlook for 2021 is unchanged and assumes free cash flow conversion will be around 100% of net income as we focus on building upon the DSO improvements achieved last year.

During the quarter, we continued to execute our balanced capital deployment strategy, repurchasing 3.1 million shares for $234 million at a weighted average price of approximately $76 per share. At the end of March, we had approximately $2.6 billion remaining under our share repurchase authorization. We also spent cash of approximately $300 million on acquisitions and $128 million for a regular quarterly dividend.

Turning to guidance. For Q2, we expect revenue in the range of $4.42 billion to $4.46 billion, representing 10.5% to 11.5% growth or 8% to 9% in constant currency based on our expectation that currency will have a favorable approximately 250 basis points impact and inorganic contribution of approximately 400 basis points. This outlook assumes some stabilization in Financial Services and continued pressures across retail and consumer goods, travel and hospitality and communication and media.

Keep in mind that Q2 2020 included a combined impact of COVID and the ransomware attack, which is leading to easier year-over-year compares for all segments in Q2 2021 and growth levels above our full year outlook.

For the full year, we now expect revenue of $17.8 billion to $18.1 billion, representing 7% to 9% growth or 5.5% to 7.5% in constant currency versus our prior guidance of 5.5% to 8.5% growth or 4% to 7% in constant currency, reflecting the improving macro environment and strong demand for our offerings.

Our outlook assumes an unchanged expectation that currency will have a favorable approximately 150 basis points impact and includes approximately 300 basis points of contribution from inorganic revenue.

Moving on to margins. We expect full-year adjusted operating margin in the range of 15.2% to 15.7% versus 15.2% to 16.3% previously, primarily reflecting increased investment in our people and recruiting for digital skills. This includes rapidly accelerating our recruiting capacity, implementing quarterly role-based promotions and leveraging our contractor ecosystem. We're also using it as an opportunity to enhance our employee value proposition and keep Cognizant as a top destination for talent globally. This leads to our full year adjusted EPS guidance, which is unchanged at $3.90 to $4.02.

Our full-year outlook assumes interest income of $20 million to $30 million, which is unchanged from our prior guidance and reflects the $2.1 billion cash repatriation in Q4 2020. Our outlook assumes average shares outstanding of approximately 530 million and a tax rate of 25% to 26%, both unchanged from our prior outlook. Our guidance does not account for any potential impact from events like changes to the immigration and tax policies.

With that, we will open the call for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of James Faucette with Morgan Stanley. You may proceed with your question. James, you may proceed with your question.

Tyler Scott
Senior Director-Investor Relations, Cognizant Technology Solutions Corp.

A

Operator, let's move on to the next question.

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

Bryan C. Bergin
Analyst, Cowen & Co. LLC

Q

Hi. Good afternoon. Thank you. I wanted to ask on the situation in India. Can you just frame how you're thinking about the potential impact this may have on the business in the near term? And I wanted to confirm, is there nothing built into the outlook right now on a potential revenue disruption? And on the margin front, same kind of question, is there anything built in as far as those incremental costs that you may have framed here to support the workforce in the population? Thanks.

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

A

Hey, Bryan, it's Brian here. So let me just touch upon this. First of all, I think it's really important for us to acknowledge it is a humanitarian crisis, and we've been prioritizing the health and safety of our associates and of course, their dependents, and hoping that they stay safe as they work essentially from home at this moment in time. And as I said in my script, we're doing a series of things to help in terms of medical expense support, free vaccinations, covering expenses in hospitals, working with UNICEF, et cetera.

To the question around in terms of how I think about the impact on the business, I think about the humanitarian side as being relevant, but candidly, the business side of the hot market is in some regard more feeling in the sense that most of our attrition and the resignations we talk about were happening in prior months, which are leading indicators of Q2 attrition and the end of Q1 attrition. And all of that was happening in a period when the COVID situation in India was substantially less severe than it is at this moment in time.

So, we are working through, obviously, our business operations, working with our teams who are working remotely. It's a challenging environment, of course, and it's a stressful and emotional time for our associates and their families. The impact, Bryan, on attrition rates and absenteeism and client delivery remains somewhat uncertain. We look at it on a daily basis. We have our crisis management teams involved. We've created a COVID delivery risk management process, which allows us to initiate remediation actions. We're required to review the status of our delivery portfolio, project-by-project where possible to shift work between offshore or near shore and on-site teams.

But I will say clients have been incredibly supportive as we go through this. I've received a series of emails from clients who are wishing us the best of luck and certainly not putting a lot of pressure in the system at this moment in time.

The financial impact of our actions is assumed in our guidance, and that is assumed off of what we know today, which is today's rates of absenteeism and today's resignations that we've seen. It is unclear whether attrition will actually slow because of this or whether attrition will go up or stay stable, but it will potentially go up because of absenteeism. But to-date, our guidance includes what we know today. To-date, we feel as though our guidance is appropriate.

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

Rod Bourgeois
Head-Research, DeepDive Equity Research, LLC

Q

Okay. Great. So, Brian, you're a very full two years into your leadership role at Cognizant. When you started at Cognizant, there were some meaningful management challenges there, waiting for you. You're now navigating a pandemic with multiple ways across regions. So, it's definitely been an eventful two years.

In that context, I'd like to ask if you can grade Cognizant's underlying progress. The progress that you've made over the last couple years. And if there's a way to decipher between internal progress, market progress, financial progress, I'm assuming those dimensions may be progressing at different stages. But overall, it would be helpful to hear how you'd grade Cognizant's last two years in its progress.

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

A

Thank you, Rod. It's a comprehensive question in nature. But yes, I would echo the word an eventful first two years given the transformation agenda, the leadership changes required as part of that, a global pandemic, a ransomware attack, of course, and now a war on talent that is happening in the midst of the humanitarian crisis in India.

I would say, first of all, it's a team sport. This is about 300,000 associates pulling in one direction. I'm truly pleased with the executives I've got around me these days. We're all eager to show what we can do, and hopefully I believe can become an iconic leadership team together in the years ahead. And I've also been supported by a terrific board who've been 100% behind our vision and our strategy of the company.

As I'm answering your question, I will start by saying I inherited a great company and a company of great pedigree and a company with a growth DNA and a company with proud employees. But it is clear that the company had not been hitting its stride in recent years. So, I asked our organization to pull together to help me operationalize a broad transformation agenda, which included strategy, structure, commercial transformation, delivery, optimization, cultural elements. I also asked the company to help me with a restructuring program that we weren't used to, but it would allow us to free up capacity to make investments in growth in our systems and in our people. And this is a growth company, and we needed to restart the engine.

And of course, as part of that, you have to go through the corporate strategy. Who are we? Who do we want to be? That leads to portfolio adjustments, both exits such as content moderation as well as meaningful M&A aligned to the corporate strategy. And of course within that vein, we've also doubled down on partnerships, including hyperscalers. And all of this was just a means to an end to set out to build a pipeline, to accelerate bookings and, ultimately, to get the company back to industry-leading growth because I think growth will ultimately make the P&L work again. So, we're certainly in the middle of a lot of this. I will say I'm more confident now than ever that we can do this, and I believe we're on track and we've made great progress.

Internally, now to go to your framework. Look, we got a clear purpose, vision, a set of values. We got a clear strategy. We got a more competitive portfolio that is aligned to our strategy. We got a better talent philosophy, including D&I, which is critical in a knowledge-based business. We've progressed on important things like sustainability, cybersecurity. I think we're getting our belief back and test them to that is the notion of employee engagement hit multiyear highs in 2020. Although, we are fully aware that we got more work to do on our employee value proposition and indeed, of course, on attrition.

Commercially – and when I'm answering your question on markets, I'm not talking about Wall Street, I'm going to talk about commercial markets as in our clients. We've overhauled our commercial team. We've increased the sophistication of the team. I think we went back to our tuna box model, where we got tight alignment between commercial and delivery.

We've refined our customer segmentation strategy, so we know who are the clients that we need to partner with deeply. We've implemented a more refined variable compensation program. We've refreshed our talent to ensure we can represent the entire portfolio and address client pain points beyond the CTO or CIO. And I'm excited as to how we're now being seen by clients, Rod, to be honest. We're no longer necessarily just being viewed in the build or operate space. We've got growing reputation and recognition in digital and cloud following our M&A strategy. And that is now showing up in sustained book-to-bill ratios in excess of 1.1, which I feel is critical to drive the revenue growth rate that I'm aspiring to drive, and our qualified pipeline and win rates are as healthy as they have ever been.

Now, all of that leads ultimately to financial outcomes. And I don't think the true benefits of this are yet visible. We have seen the margin dilution of the investments, commercial hiring, IT security modernization, M&A, dilution, some brand investments we're making. Of course, we continue to review the trade-offs between revenue growth and margin expansion. But I will say, we expect to see revenue benefits on the back of the bookings momentum. And margin should improve each year for the foreseeable future, albeit with a balanced approach to trade-offs between revenue growth and further investments to drive a sustained outperformance versus the competition. So, in short, a lot of work, and I look forward to great years ahead.

Rod Bourgeois
Head-Research, DeepDive Equity Research, LLC

Q

Great. And just a quick follow-up that kind of dovetails with some of the things you mentioned. It seems attrition is a top of the list of things to address at this stage. Can you just speak to what you see as the root factors causing the attrition and your confidence in being able to fix that?

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

A

Look, it's a two-edged sword. We've seen a V-shaped recovery as an industry, and Cognizant certainly has after a weak March, April last year, we snapped back immediately. And that leads with a skill shortage. So, it's an industry problem. I think you've seen that in the earnings cycle to-date.

Of course, I caution people to compare attrition rates between various competitors. We include BPO, and our calculation is current quarter annualized, which is the worst of all world at this moment in time versus some peers exclude BPO and look at attrition on a rolling or in the last 12 months, which includes some lower levels of attrition because of COVID.

But, Rod, I think about our attrition, which went up 200 basis points sequentially against two parameters. One is macro considerations. The market is extremely competitive at this moment in time. There are supply/demand imbalances across cloud, across digital engineering, across data. I sense that the work-from-home environment has giving people, let's say, less sense of community. And I also see, obviously, the build-out of captives, which tend to pressurize salaries.

And then on top of that macro backdrop, I think we have some Cognizant considerations as we continue to transform the company. We're driving towards a culture of meritocracy and a performance culture. And we're evolving more towards a global or sometimes local workforce, which is in line with client expectations, but also in line with regulatory policy around the world. And in some regards, we're late to some of those elements. And so, we're dealing with some of the pain that others have dealt with previously.

I will say, I'm 100% confident we're actively managing attrition as best we can. I'm pleased to say that attrition peaked in March, slowed in April and continues to slow in May, albeit early days in May. We got a lot of work streams around employee engagements, training, job rotations. We've taken the decision to invest more in targeted salary increases and promotions and shifting to quarterly promotion cycles for billable associates. And we've added hundreds of recruiters in the last four months. And we're making a record number of 28,000 offers to new graduates in India, which is up from 17,000 hired in 2020. And I think in 2018, we may have actually not even hired any Gen Z graduates into Cognizant.

So we're doing the right thing to address attrition. And of course, in the meantime, we're working to manage the salary inflationary elements of this. As Jan pointed out, T&A expectations in the second half of the year are lower than previously anticipated. So that will temper some of the downsides. But in the same vein, these are investments that I think will help stem attrition, which will give us more productive hours in our employees. And in the same vein, of course, we got other levers at our disposal to manage salary inflation, be that on offshore or near shore mix, pyramid optimization, delivery industrialization, including automation, methodologies, templates and the like.

Procurement leverage for subcontractors. We got a new Chief Procurement Officer coming on board soon. And of course, everything else we're doing as we evolve the company against the line of work that we actually sell and deliver as we shift from staff augmentation towards managed services and project-based delivery transformation that brings different considerations as well.

So, we know what we need to do, and we're on it. And as I said, I think we'll see sequential increases in attrition based on the resignations in the last few months because there is a two-month notice period in India. So, we have a strong understanding as to what attrition will be in Q2. But that's been factored into our model and into our guidance. And in the meantime, we've been hiring at record pace given the extra recruiters we've put to work.

Rod Bourgeois
Head-Research, DeepDive Equity Research, LLC

Q

Good stuff. Thank you.

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

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. Hi, Brian. Hi, Jan. So, a couple of things, I guess. I might have missed this, but can you quantify the revenue growth you were not able to get solely because of the talent shortage? And then, when I think of head count growth, in spite of the hiring, head count growth still at relatively low sequential levels. Is it a question of these folks have not yet joined? Or is that the net number because of the attrition? And could you separate out what is digital head count growth versus overall head count growth?

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

A

Well, head count grew about 5,000 people year-over-year, but Ashwin, that excludes subcontractors and contingent labor, and they have increased sequentially and year-over-year materially. It's not a number we disclose. But we have turned to, obviously, external sources, both lateral hires and subcontractors and contingent labor as we've been working through the attrition situation internally, nor do we break out digital versus non-digital head count.

I mean, to be very clear, you can have somebody working with testing capabilities, they can work on what could be viewed as legacy projects, but in the same vein as part of an agile squad, they could be working on something around, something as familiar as a frequent flyer website, which some of the work we do around experience and software product engineering there, it's not viewed as legacy, it's certainly viewed as digital.

So, it's very hard to classify workforce between legacy and digital. With regards to the opportunity costs, look, we're not quantifying that, but certainly, it's material that I've talked about. And when I review countries, there's hundreds of basis points of growth in some cases that we could have had. In other cases, less. But it's been a pain point for us throughout the quarter. We talked about attrition being a worry in our last quarter, because we could see resignation rates, and we can see what's happening in the industry as people are doing their best to putting counter offers to stop resignation. And I'm glad we anticipated it, and we set appropriate guidance, and we're doing the same this time around.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.

Q

Could you comment also on the potential for greater use of technology to decouple revenue and head count growth?

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

A

Well, that's the Holy Grail, of course, in some regards. But a lot depends on the way you're running your business and the businesses you're winning, whether you're in a BPO-type business or a tech services-centric project. We have a huge effort underway around automation, not just in delivery, but also some very exciting IP that we have been developing that hopefully, we'd be able to talk about in the next quarter or so that I think will completely set us apart in the industry.

So, it is a holy grail. Of course, you've also got to think about the pyramid. I talked earlier about adding 28,000 offers for freshers into the bottom of the pyramid this year. The bill rates of those will be very different than bill rates of onshore delivery. So, it's very difficult, in a succinct way, to decouple revenue growth from head count growth because there are so many factors at play. But rest assured that the industrialization of delivery, including automation, is top of mind for us.

Ashwin Vassant Shirvaikar
Analyst, Citigroup Global Markets, Inc.

Q

Got it. Thank you.

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

Keith Bachman
Analyst, BMO Capital Markets Corp.

Q

Hi, guys. Brian, I wanted to direct this to you, if I could. I want to understand how you're thinking about growth. You've obviously given guidance for the year, but I wanted to see if you could put some context and maybe even some philosophical views on longer term. You're guiding to basically 3% to 4% organic constant currency growth, maybe a little bit closer to the 4% if we take out or normalize for the Facebook business. And how should investors be thinking about that growth potential longer term?

And A, if you could talk a little bit about how the pipeline growth looks now? What are some metrics that you could provide us? Also in terms of, B, the capacity that you see for incremental M&A from here, whether it's the ability to – the Financial Services and/or the management resources to keep driving M&A?

And then finally, C, I was hoping you could touch on Financial. It's still candidly serving as an anchor to your growth rate, not in a positive way, but limiting your consolidated growth. And so, if you could just again touch on how you're thinking about growth, pipeline, M&A capacity and then financial? Thank you.

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

A

Okay. So, M&A, first of all, let's go back to the capital framework we've set forth in recent quarters. We plan to deploy approximately 100% of our annual free cash flow through a balanced capital allocation program. I will say these are guiding principles, and we will continue to be opportunistic. Approximately 50% towards M&A, an area that's wholly aligned to our strategic priorities. And of course, about the remaining 50% towards dividends and share repurchases, targeting a consistent dividend payout ratio in the range at about 25% on that and the rest for repurchases.

So, M&A will continue to be a priority for us. And as I said earlier, we announced three acquisitions in the first quarter, and indeed signed an agreement to acquire ESG Mobility. It's not that M&A is something we wake up every morning until we have to do. It's just, it's an enabler for us to achieve our strategy.

Now, our strategy is built around accelerating digital, which are higher growth categories, and our strategy is also built around globalizing the company, both from a global delivery network, but also getting after exponential growth overseas. And digital as well as our overseas opportunity, I think, puts us in a position to have ambitions well in excess of the 3% to 4% organic growth rate, Keith, that you mentioned.

However, I will refrain from getting into long-term financial statements here. But I would be very, very disappointed in the years ahead if we do not significantly exceed those growth rates. And I would say, we have been doing what was needed in the last year to start replenishing our backlog, to consistently drive a book-to-bill ratio in excess of 1.1. That puts us in a position that organically coupled with the accretive nature of the acquisitions we've done, we should have continued upward pressure on revenue on a go-forward basis.

And that being said, I would caution everybody, we're in somewhat of an unpredictable world at this moment in time with the humanitarian crisis in India. So that's how I think about our organic possibilities as well as the fact that we have an M&A lever that is exposing us to higher growth categories. And all of this, of course, is against the context where, from my perspective, we are substantially more operationally inclined and more sophisticated in terms of how we think about delivery and commercial levers going forward.

On Financial Services, look, it is critical. We turned around Financial Services. I'm proud with the progress we made in Healthcare, which is catching up on Financial Services as almost being our single biggest industry sector. Well, Financial Services is one-third of our revenue. And in dollar terms, it modestly grew, but in constant currency terms, it declined 1.7%.

And Keith, within that, we ultimately have two groups. We have a banking and financial services business that is more than half of the business, and we have insurance which is kind of less than the half. And it's the tale of two cities. In insurance, North America was weaker than the international business. But North American insurance is the vast majority of the insurance business, so that weakness hurt us in banking and financial services. Actually, North America was modestly up, but our international business was down.

Within banking and financial services, there are relatively consistent trends with what we talked about previously. Capital markets declined. Retail banking grew modestly, but it was offset by declines in commercial banks and cards and payments. And if I think about things differently, the global banks, as we call them, have continued to in-source and that business continues to decline for us, offset somewhat by good momentum we have with some of the regional banks.

Now all of this comes back to what are we doing about it. I would say we have a plan of attack. We have had healthy bookings throughout Financial Services, both banking and insurance in 2020. We've added extra commercial coverage. We've actually changed out and refreshed a significant amount of our commercial teams. We've been embracing digital, and we've had strong digital bookings in those areas in 2020. And we've been working more with our partners who are very interested in our strength in Healthcare and indeed Financial Services.

So, as Jan pointed out, it is a business that is under repair, and we expect to see gradual recovery in 2021, we should see stronger growth in Q2, obviously, for easy compare reasons as well as COVID and the ransomware attack. But I'd like to think in the course of the year, we can get this thing shaped up to be in better shape than it is today.

Keith Bachman
Analyst, BMO Capital Markets Corp.

Q

Thanks. And any comments on pipeline, Brian?

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

A

Look, pipeline is very healthy overall. It's as healthy as I have seen it. And pipeline, candidly, for Financial Services, is also healthy. So, from my perspective, Keith, we don't have a demand issue in an industry. I'm actually quite bullish on the industry for 2020 and indeed for 2021. And that's based on client conversations, and I speak with clients every day, as well as, obviously, we keep an eye on what industry analysts are saying. I think talent shortages and attrition are a greater concern for the entire industry. But clients are making investments. They are decisive. And indecision is the enemy of people like myself. So, clients being decisive is good.

They are talking about more strategic partners. We are in the mix more than ever in that vendor consolidation, so I'm quite excited about that. And fundamentally, the things we see driving the pipeline, a lot around business model innovation, customer experience, technology modernization, risk mitigation and efficiency initiatives. And kind of be one of the reasons I was so adamant in doubling down with the hyperscalers two years ago is because these companies – I don't think you should underestimate the sheer power and scale of hyperscale companies. They are investing massively by commercial teams, commercial terms, aligning with companies like Cognizant around industries, massively accelerating cloud migrations.

And if you believe in platform economics, which opens up the possibilities of microservices and APIs, I think this is going to be the future. So, we set up two business groups or business groups in the hyperscalers in the last few years, and I think we're reaping the benefits of that now.

Keith Bachman
Analyst, BMO Capital Markets Corp.

Q

Many thanks, Brian.

Operator: Our next question comes from the line of Jason Kupferberg with Bank of America. You may proceed with your question.

Q

Hey, guys. This is [ph] Cathy (00:51:21) on for Jason. So, I mean, the spring timeframe is when enterprises typically make decisions on ramping up and moving forward with some of the discretionary projects. Can you just talk a little bit about what you're seeing on that front? Is there any hesitancy or are there any challenges in terms of meeting demand in that regard?

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

A

Well, it's very consistent with my last answer, [ph] Cathy (00:51:45), to be honest. I'm expecting a robust environment. Clients are being decisive, discretionary projects are being funded. I think we've all grown used to the new world. And kind of we were getting at bats more often than ever before beyond bill run and more in the innovation and transformation agenda. So, I feel very good and optimistic about the macro demand picture. But as I said earlier, talent shortages and attrition are a much bigger concern for me at this moment in time than macro demand.

Q

Okay. Got it. Thanks.

Operator: Our next question comes from the line of Lisa Ellis with MoffettNathanson. You may proceed with your question.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Sure. Thanks for taking my question. First one, just on M&A, just a follow-up there. Your Cognizant's pace of M&A has increased quite a bit in the last few quarters. Can you just comment a bit on how you're building that muscle so that it becomes more of a strategic differentiator for Cognizant? Like, what changes have you made to how you're doing sourcing or integration of these companies? Thank you.

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

A

Jan, do you want to address that?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Yes. Look, the M&A activity had been healthy in the first quarter. So, we spent approximately $300 million and announced four acquisitions. But I wouldn't read too much to it as an accelerated pace. I think we're executing against the plan and trying to spend in the framework of the capital that we strategically want to allocate towards M&A and we're executing that. The team has done really a fantastic job in aligning our deal sourcing across industries and across the globe.

So, you see this, for example, we talked in the last quarter about a slight shift towards more geographic expansion, and we have two deals this, an Australian deal and, of course, very close to my heart, a German deal also part of the transactions that we could announce and some of them closed.

So, we're executing really in a classic manner. The team is very focused partnering with our markets and with our service lines on identifying the strategic areas of growth that we want to do and it's been very diligent and creative of identifying acquisition opportunities. It has really worked really well. And I think the natural spacing of these things will lead us to kind of execute against our allocated capital against it.

Now it's what we have been lumpy in and out, but a consistent way to do so. The focus in the company is clearly on integration because the synergies that these companies deliver are at the heart of the viability of our M&A

strategy. And we are pleased with the ability to generate synergies. Our business plans are generally pretty close to the reality on the revenue synergies. And as we now have a larger portfolio of companies that we have acquired, we have increased our focus quite naturally on integration and efficiencies so that these companies can fit into the fabric of Cognizant and benefit from the scale that we can bring to the table. You see we have still dilution some acquisitions, putting pressure on our margin. And so you'll see us continuing working on driving integration and reaping also some of the cost efficiencies that might be available to us in the future.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Terrific. Thank you. And then just a quick follow-up, I know, Brian, you mentioned that now you've had a 1.1 or greater book-to-bill for, I think, more than a year now on a very sustained basis. Can you just kind of comment on how you're feeling about the backlog at this point, your confidence level, whether it's improved in kind of your visibility into the sales pipeline and sales forecasting? Thanks.

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

A

Yeah. Well, actually, I should thank Jan for this when he came in. He did a tremendous job really decomposing down prior bookings and tracing them to follow the breadcrumbs into revenue. And so at this moment in time, we have much better visibility into that than we had this time last year.

I really feel good about our bookings momentum, to your point, really since the last – if you think about it, throughout 2020, we had an exceptionally strong Q1. And then through the course of the year, we had strength with mid-teens for the course of the year. But really in 2019, it starts, you don't get bookings until you start building a pipeline.

So, we really put a lot of efforts in the second half of 2020 into pipeline build. That started showing up in terms of bookings momentum in 2020 and then, of course, into 2021. We don't have the same easy compares now as we had last year which is why I wanted to really contextualize Q1 bookings growth of 5%. I actually am delighted with that because our December was really outstanding. It was an excellent month for us. And April has been an excellent month, so the Q1 period has been sandwiched between that. And it's really important to me that people think about bookings on a rolling four-quarter basis, because something stepping from a Friday to a Monday or vice versa could take a deal from Q1 to Q2 or Q1 to Q4.

So, it's important to contextualize that. So, book-to-bill is the right way to also think about it. I think once you're north of 1.1 times, it creates a backlog of opportunity to go execute against and hopefully accelerate revenue on from here. So, we're confident in our numbers. And we're also confident we'll have a very strong Q2 bookings number on the back, not just of excellent April results, but also, let's face it, the compare wasn't exactly stellar in May this time last year for many other reasons.

Lisa Ellis
Analyst, MoffettNathanson LLC

Q

Thanks. And thanks for everything you're doing in India. Thank you.

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

A

Thank you.

Operator: Our last 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 know you're at the bottom of the hour here. I just want to get a clarification here on the margin side and just ask it at a high level, if just the cost of doing business is going up. I mean, I see your gross margin in the first quarter was pretty good, but I know you move in to the lower end of the margins how you said to lead that some of the M&A integration costs are going up. I understand that. But is the rest of it just people? And again, is the cost of doing business overall, just maybe going higher than you had expected 90 days ago?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Tien-Tsin, thank you for the question. I was wondering if it wouldn't come actually. So I appreciate it because there's a lot of momentum, a movement in our margins that I think is important to put our eyes on. When you compare our margins overall operating margin, we're kind of roughly flat, slightly improved year-over-year. And on the gross margin side, you see the benefits of our Fit for Growth, and you can see also the benefits of the lower T&E that helped us to expand the growth margins. Utilization helped a little bit. And also, we had obviously a little bit help in the rupee. That all helped on the margin side.

But then we had on the SG&A side, you see an accelerated growth, but we are really laser-focused on directing that SG&A growth to our strategic initiatives that we think will yield – we view them as investments, will yield accelerating revenue growth rates. And you pointed out the two biggest items. M&A and its dilutive element in its initial years as well as our investments into sales and account management and growth in essence.

Those are two offsetting factors that we have seen in the past quarters, but also this quarter. When we now outlook, you're pointing out we are basically down ticking our margin guidance a tiny bit. I think that is reflective of a balance that we're trying to strike here reflecting what we anticipate could be some increase in our compensation costs due to the measures in order to lower attrition, attract and retain our talent. And we're planning to offset that partially with some change in assumptions. I think the prices in India illustrates that maybe T&E is not coming back as fast as we have anticipated.

And we're also carefully and surgically monitoring our future SG&A growth to tie it all so that we keep the overall margin equation together for the full year. But the second quarter will be kind of in line or similar to our first quarter margin expectation, in particular since we're anticipating the SG&A moderation to accelerate basically in the third and fourth quarter, but some of the compensation measures will be probably visible already in the second quarter.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Thank you for going through that. That was very clear, Jan. So maybe as a quick follow-up. Just you didn't mention contract execution and performance, so I'm assuming things are going well there. Any update on contract execution and risk management if it has identified any changes since last quarter in the portfolio?

Jan Siegmund
Chief Financial Officer, Cognizant Technology Solutions Corp.

A

Yes. No, I presume you refer to our management of escalations deals, et cetera. I think we have had a very usual quarter. We made progress on our implementation of improvements for deal reviews and deal acceptance and pricing as we rolled out those initiatives are gaining momentum.

And on the delivery side, I think the issues that we're hearing the most, and Brian mentioned it is, obviously, our ability to fulfill and to have talent available is a primary concern of our clients. But overall, I would say it was a very solid quarter relative to execution.

Tien-Tsin Huang
Analyst, JPMorgan Securities LLC

Q

Great. Thank you for the complete answers. Thanks.

Tyler Scott
Senior Director-Investor Relations, Cognizant Technology Solutions Corp.

All right. I think with that, we'll end today's call. Thank you all for the questions, and we look forward to speaking with you next quarter.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation, and enjoy the rest of your evening.