Information Technology Sector

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Sector Update

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Commentary points to a weaker-than-expected December quarter

Over the last few days, we have had the opportunity to listen to HCL Tech (at its US investor day), Cognizant (at an investor conference) besides a chance to interact with Infosys Investor Relations (IR) team. HCL Tech has indicated that growth for FY23 will come at the lower end of the range that it had indicated post its 2QFY23 results (update) due to higher-than-expected furloughs (highlighted BFSI and Hi-Tech being problem areas). We do expect this to be an industry-wide problem and not an HCL Tech specific one. While there was no discussion on specific numbers by either Infosys or Cognizant, we get the sense that December 2022 and possibly March 2023 are likely going to be growth challenged quarters for the industry; may be a bit more than earlier anticipated. HCL Tech management commentary also highlighted another problem that we foresee in FY24 – pricing. It hinted that price increases are more selective now than they were 6-9 months back. We also believe that instead of a typical budget flush (because of a spend-it-or-lose-it condition), there is likely under-spending of budgets that could affect Dec'22 quarter revenue. We are also not sure whether the IT industry will have great visibility about spending in 2023 as we expect budgeting to be delayed and/or short-term oriented (quarter by quarter), with the possibility of divergence between spending vs budget if economic conditions and P&L/balance sheet conditions deteriorate. Going into 2023, we have been surprised by the resilience of the US consumer and believe that our explicit recession call is likely to be a mid 2023 or a 2H2023 event instead of a 1H2023 event that we were initially anticipating. We continue to advocate an "UNDERWEIGHT" stance on the IT sector and use the recent rally to cut positions if one is overweight. We continue to prefer Tier-1 to Tier-2.

HCLT US investor day: Post 2QFY23, two months back, HCL Tech had raised the revenue growth guidance for FY23 from 12-14% to 13.5-14.5% in CC terms. However, at the US Investor Day held on 8th December, 2022, it indicated that revenue will likely come in at the lower end of the band since furloughs have been far greater than what it had anticipated. The Dec'22 quarter is also the best quarter for P&P sales and the visibility tends to be poor as deals are booked at the very end of the quarter. With macro conditions deteriorating, positive news on this front is highly unlikely, we believe. HCL Tech also highlighted that there is greater level of vendor consolidation underway right now than in the recent past not only due to challenging macro circumstances, but also due to weeding out of a few global top 10 service providers based on risks associated with them. It also stated that post a phase of usage of many boutique vendors for digital work, customers are now consolidating work with global scale players. It also talked of consolidation due to operating model change where both application development and application maintenance work is done by the same player unlike in the past. Similar is the situation on infrastructure services and application work. It also stated that it will persist with its Services + P&P business model and believes that the latter is a long-term bet and not much unlike the bet it took on Infrastructure Management Services market (two decades back) when there were very few believers in it.

Cognizant's (CTSH) commentary: Three pieces of its current strategy include: (1) Globalizing both revenue and delivery (2) Growing the digital business both organically as well as inorganically (3) Focusing more on non-T&M business. Weakness in the BFSI piece was partly attributed to the predominance of the Time & Material business within that vertical, which it is consciously trying to reduce. According to CTSH, T&M is much more vulnerable to budget cuts. We believe this may be an industry-wide problem and not just a CTSH issue. Moving to a fixed price model CTSH insists is critical to industrialise delivery. CTSH has been underperforming on the revenue front in recent times due to onsite supply challenges (Lowers 2022 revenue growth yet again). Cognizant has had two high profile hires in recent times in Mr Ravi Kumar (ex-Infosys) – who joins as President of Americas (70% of revenue of Cognizant) and Mr Prasad Sankaran (ex-Accenture), who has joined as the Global Head of Software & Platform Engineering.

Infosys commentary: More deals in the pipeline are coming in the cost optimization area. Deals on the cost saving or efficiency improvement side are longer in tenure, so the value is higher compared to normal digital deals which are agile and short-term execution deals. Definition of Discretionary spending is subjective and varies from client to client depending on which stage of the digital transformation journey the client is currently on. Seasonality in revenue growth will be along what one has typically seen in pre-pandemic times. On the subcontractor cost cuts, Infosys was of the view that onsite subcon decreases will be tougher in the near term as there is a visa processing problem currently underway and travel from India to the US to replace the subcontractors may not happen soon. What can be cut are the offshore subcon costs.

Our view on the Indian IT services sector: We had downgraded our view on the Indian IT Services sector to UW on a 12-month basis through a report on 10th April, 2022 (Positive surprises likely low in FY23; Tier-2 risky) and cut target prices further through our notes on 19th May, 2022 (Customer stress shows up), 8th July, 2022 (Negatives not in price) and 10 October, 2022 (Growth expectations too high). We advocate that investors use the likely 1HFY23 strength to pare positions if overweight, especially in expensive Tier-2 set. Nifty IT index advanced by ~144% from 1st Jan, 2020 till 31st March, 2022 while Nifty was up 44% (Nifty Bank was up by only 13%!). This massive outperformance of Nifty IT was on the back of pandemic-driven Digital Transformation (DT) services-based earnings acceleration and significant multiple expansion on unprecedented monetary stimulus in the US/Europe. DT high tide over the last 24 months has lifted all boats (including weak ones). However, accelerated normalization of monetary policy in the US raises probabilities of a hard landing there and consequently high probability of negative surprises on the fundamental side over the next 12-18 months. We believe consensus is underestimating growth and margin risks in FY24. While DT services will continue to remain a key theme for the next several years, we believe that 'willingness-to-spend' will be constrained by 'ability-to-spend' as enterprise customers battle earnings pressure from commodity and wage inflation, supply chain challenges, reduced consumer spending power, higher interest rates and likely below-trend growth in western developed economies. This, in our view, will mean that the current peak corporate profits of S&P 500 are unlikely to sustain. We also believe that the broader enterprise customer profit picture might look worse in the west. Beyond FY23, we see customers shifting from the current democratic 'skills/capability' focused vendor model to a more discriminating one based on 'ability-to-deliver' (1) cost take outs and (2) business model changes - in that order. It is here that one will see divergence in growth and valuation from what seems a tight homogeneous bunch currently, with Tier-2 set being given significant benefit of doubt (by us too). Incrementally, risks are to the downside from both valuation as well as fundamental perspective. We favour Tier-1 IT companies vs Tier-2.

While the chances of a near term Fed pivot (due to likely financial/economic stress rather than lower inflation) and the consequent risk-assets run-up are fair, we persist with our 'UW' stance on the Indian IT Services sector. This is because: (1) We believe that a conclusive Fed pivot is likely only when US inflation falls to ~2%, which we think is unlikely in the next six months. Financial stress/accident related stopping/easing of current hawkish monetary policy could induce a short-term rally that may not be sustainable (2) Consensus earnings estimates for FY24/FY25 continue to be too high and seem to implicitly assume a soft-landing of the US economy while probability of a recession (shallow/deep) has risen significantly in the last six months. The latter could lead to pressure on business volume and pricing. We are explicitly pricing in a shallow recession (3) Even if one were to ignore the next 12–18-month earnings/valuation volatility and take a 5-year view, we believe that starting valuations are expensive and can at best deliver mid-high single-digit stock returns for TCS/Infosys, as we believe that structural revenue/earnings growth are being overestimated by the street. We believe that revenue/earnings growth over a 5-year period (FY23-FY28) will be 100-200bps higher than the FY15-FY20 period (~7%) whereas peers believe that it will be 300-500bps higher. *Ceteris Paribus*, this has valuation/return implications. In our base case of a shallow recession in the US in CY23, we are expecting low single-digit USD revenue growth for Tier-1 IT companies in FY24. In our new estimates for FY24, we are assuming some pricing compression as well as some compensation cost increase (neither had been assumed in the previous numbers). We continue to have a 'Sell' rating on all stocks under our coverage. Despite having EPS estimates lower than the street, we suspect they could still see downsides if there is a deep recession in the US. Our "V" shaped recovery estimate in FY25 USD revenue and earnings is predicated on the expectation that US inflation will ease off to 2% by the end of CY23 and the Fed will be able to not only cut interest rates, but possibly also announce some unconventional stimulus measures. We believe there are downside risks to that assumption.

We continue to maintain TCS as our industry valuation benchmark: We are valuing TCS at target 12-month forward PE of 19.9x on FY24E EPS, which represents 1SD below the last 5-year mean. Target multiples for others are at a discount to TCS. If one were to look back in history, our target PE multiples are not overly pessimistic as PE multiples of many Tier-1 IT stocks, including that of TCS and Infosys, had reached single-digit levels during GFC.

Tier-2 could face significant risks in the newer environment: We fear that the Indian Tier-2 set would suffer more because of vendor consolidation under the pressured profit picture for customers, a less diversified revenue mix (client, service line, vertical), which could throw up negative growth surprises, and a larger exposure to non-Global 1000 clientele, whose profits are more vulnerable in the current macro environment. Indian Tier-2 IT is now at a PE premium of ~25% to Tier-1 (from peak of ~60% in November 2021) from a discount of 14% on 1st Jan, 2020, that too on elevated earnings. This premium reflects expectations of big positive earnings growth gap between Tier-2 and Tier-1 IT companies over FY21-FY24 and improving return ratios. We don't think this level of growth gap will sustain much beyond FY24. The high PE multiples are also reflection of market's view that some Tier-2 IT companies will become US$5-10bn enterprises in the next 10-20 years. Once the 'Digital' high tide recedes, it remains to be seen which of the current Tier-2 set will continue to show promise. In the initial phase of any new tech cycle, customers tend to be open to new vendors, but as the cycle matures (post FY24 in our view), vendors that have scale – Tier-1 - tend to do better. We think customers are looking for revolutionary transformation, which Tier-1 companies with multi-vertical exposure and deeper domain/technology skills are best placed to deliver.

Exhibit 1: Indian IT services sector valuations

	TCS	Infosys	Wipro	HCL Tech	Tech Mahindra	Persistent
Year ending	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 08-Dec-22	**3,351**	**1,620**	**404**	**1,101**	**1,074**	**4,102**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rs Bn)	11,471.0	6,379.1	2,072.3	2,796.4	978.4	293.3
(US$mn)	**1,48,974**	**82,845**	**26,913**	**36,317**	**12,707**	**3,810**
Sep 2023 Target Price	2,608	1153	340	842	889	2705
Upside/(downside)	-22.2%	-28.8%	-15.8%	-23.5%	-17.2%	-34.1%
Recommendation	Sell	Sell	Sell	Sell	Sell	Sell
FDEPS (Rs)						
FY20	86.2	38.9	16.6	40.8	45.2	44.4
FY21	89.3	45.5	19.1	47.7	49.9	58.8
FY22	103.6	52.4	22.3	49.8	62.7	90.2
FY23E	116.5	57.6	20.4	53.1	59.4	121.1
FY24E	123.0	59.8	22.7	56.5	63.1	136.1
FY25E	139.0	68.9	26.0	64.3	74.4	166.0
FY26E	144.6	77.4	28.9	71.8	83.8	195.2
PE (x)						
FY20	38.9	41.6	24.3	27.0	23.7	92.5
FY21	37.5	35.6	21.1	23.1	21.5	69.8
FY22	32.3	30.9	18.1	22.1	17.1	45.5
FY23E	28.8	28.1	19.8	20.8	18.1	33.9
FY24E	27.2	27.1	17.8	19.5	17.0	30.1
FY25E	24.1	23.5	15.5	17.1	14.4	24.7
FY26E	23.2	20.9	14.0	15.3	12.8	21.0
EV/EBITDA (x)						
FY20	28.9	30.8	15.6	17.4	15.1	62.7
FY21	26.2	24.4	12.4	13.7	12.0	44.5
FY22	22.9	21.8	11.2	13.8	10.9	32.1
FY23E	20.7	20.0	12.4	12.9	10.6	21.0
FY24E	19.7	18.8	10.7	12.0	9.8	18.6
FY25E	17.5	16.3	9.3	10.7	8.5	15.4
FY26E	15.8	14.5	8.2	9.6	7.5	13.0
EV/Sales (x)						
FY20	7.8	7.5	3.2	4.1	2.3	8.7
FY21	7.4	6.8	3.2	3.8	2.2	7.3
FY22	6.3	5.6	2.5	3.3	2.0	5.4
FY23E	5.5	4.8	2.3	2.8	1.7	3.8
FY24E	5.2	4.5	2.1	2.7	1.6	3.4
FY25E	4.6	3.9	1.8	2.3	1.4	2.7
FY26E	4.1	3.4	1.6	2.1	1.3	2.3
Pre-Tax ROIC (%)						
FY20	55.5	43.0	32.2	33.3	28.6	35.1
FY21	54.9	45.7	35.9	33.7	32.8	57.2
FY22	59.7	47.0	32.3	33.0	33.3	58.0
FY23E	65.0	49.3	24.2	35.6	27.7	51.4
FY24E	65.3	50.0	25.7	36.4	29.4	48.5
FY25E	68.6	53.7	30.3	39.2	34.2	58.6
FY26E	69.8	56.2	34.7	41.5	37.7	68.5

Source: Company, Nirmal Bang Institutional Equities Research

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