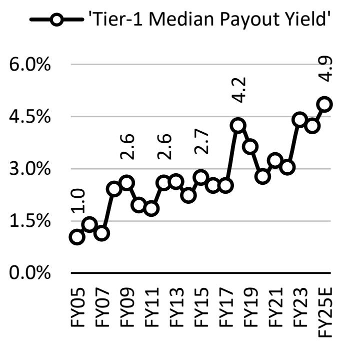
Technology

Valuation summary

Cos	Rating	Target PE (x)	Target Price (INR)	Upside %
TCS	Buy	25	3,860	18
Infosys	Buy	21	1,520	20
Wipro	Neutral	14	360	-6
HCL Tech	Buy	18	1,250	16
TechM	Neutral	15	1,080	3
LTIM	Neutral	22	4,650	1

Tier-1 Median Payout Yield



Attractive payout yield to buffer near-term macro pain

FY25 payout yield expected to be highest in sector's history

IT services stocks have significantly de-rated over the last one year, owing to growth moderation due to a weak macro environment and historically high base valuations. While FY24 industry growth is expected to remain muted due to pressure in key client industries, we are positive on the sector due to 1) good long-term demand outlook, and 2) Tier-1 median P/E at 17x (1-yr forward) factoring in the near-term weakness. Moreover, we see support for share prices of our Tier 1 coverage from historically high payout yields (FY24/FY25 median yield at 4.2%/4.9%), having crossed the 4% mark in FY23 for the first time since FY18.

Weak FY24 growth an overhang on share price

- **Near-term macro overhang on demand:** While we remain positive on the long-term demand outlook for the IT services industry amid growing tech adoption from enterprises, near-term growth is seeing signs of slowdown on account of macroeconomic pressure in key economies. The cautionary environment has reprioritized spends toward cost optimization initiatives and has also led to tighter scrutiny and delayed approval cycle. In our base case, we expect demand to improve for the sector in H2FY24E, although the visibility remains low.
- **Valuations factor in near-term pain:** The median 1-year forward PE of tier-1 pack is currently trading at 17x, at its 10-year average and down substantially from the peak of 33x in 2021. With valuations now trending in line with pre-Covid levels despite better long-term visibility and the focus on technology at enterprises, we believe that the current macro uncertainty and demand slowdown have already been factored into the valuation.

Attractive payout yield to support stock prices

- **Attractive payout (dividend + buyback) yield:** Tier-1 IT services companies have been delivering a good median payout yield of ~3% for the last five years. However, the yield has declined from the FY18 peak (4.2%) on stock price appreciation, as industry growth has recovered after a hit over FY16-FY18 from the initial digital adoption. While the cash return to shareholders has grown consistently during FY18-FY22 (with the exception of FY20 on initial Covid concerns), the yield has moderated (exhibit 3) due to faster valuation growth. With the FY23 median payout yield of 4.4%, the payout yield for the sector is again looking attractive. We expect the yield to stay above the 20-year average rate of 2.8% in FY24/FY25, given the valuation of tier-1 coverage has corrected meaningfully (down 21% YoY) in FY23, while capital allocation continues to be supported by positive earnings growth.
- **Absolute payout likely to remain stable:** The tier-1 pack has maintained a robust capital allocation policy (~96% of net Income) in FY23 and it is expected to follow a similar trend in FY24/FY25. Given their healthy balance sheets and a robust cash-to-market cap ratio of ~7% (slightly below 20-year median) in FY23, we do not expect any change in the payout policy in FY24/FY25.

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Valuation and Outlook - positive on longer-term secular demand

- We are constructive on long-term demand but remain cautious on the near-term slowdown, likely caused by a reduction in discretionary spends and a weakness in selective pockets. We expect the demand recovery to come through 2HFY24, with a broad-based recovery in verticals that are currently going through a rough patch and severe pain. This would lead to better revenue visibility and earnings growth for the sector in FY25E.
- An expected recovery in H2FY24E earnings with attractive payouts should make the tier-1 pack more preferable over tier-2. We remain selective in the space and view any correction in the preferred names as an opportunity to accumulate further. We prefer TCS (top pick), HCLT, and INFO within our tier-1 IT coverage.

Attractive capital allocation policy

- IT services companies have maintained consistent capital allocation policies and continued to return a substantial portion of their cash generation throughout the year.
- Among the tier-1 pack, TCS and Infosys have the best payout and have returned 90%-100% of their net income to shareholders. We expect the companies to follow a similar payout policy over FY24/FY25 as well.

Exhibit 1: Sustainable value creation for shareholders

Company	Payout Policy in FY24E
TCS	Consistently paid out ~100% of Net Income since FY18
Infosys	85% of FCF
HCL Tech	75% of Net Income
Wipro	45-50% of Net Income
TechM	Give out additional cash post investments (if any)

Source: MOFSL, Company

- Looking at the previous trend of payouts and companies' policy to maintain the threshold, we expect the average payout in FY24/FY25 to be slight lower at ~84% v/s ~96% in FY23 for the tier-1 pack.

Exhibit 2: Healthy balance sheet with strong liquidity

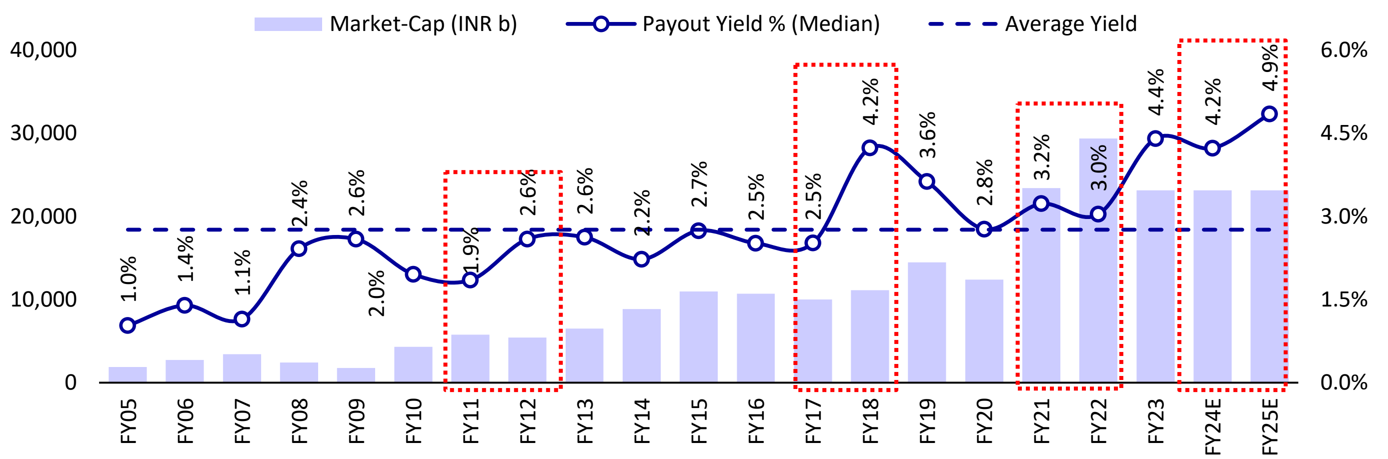
Company	FY23 Net Cash (INR b)	FY23 Net Cash % of Market Cap	FY24E Payout %	FY25E Payout %
TCS	472.4	4.0	90	90
Infosys	190.8	3.6	85	85
HCL Tech	227.0	7.8	90	90
Wipro	401.1	18.8	70	70
TechM	70.4	6.8	85	85

Source: MOFSL, Company

FY24E payout yield likely to stay above the 20-year average

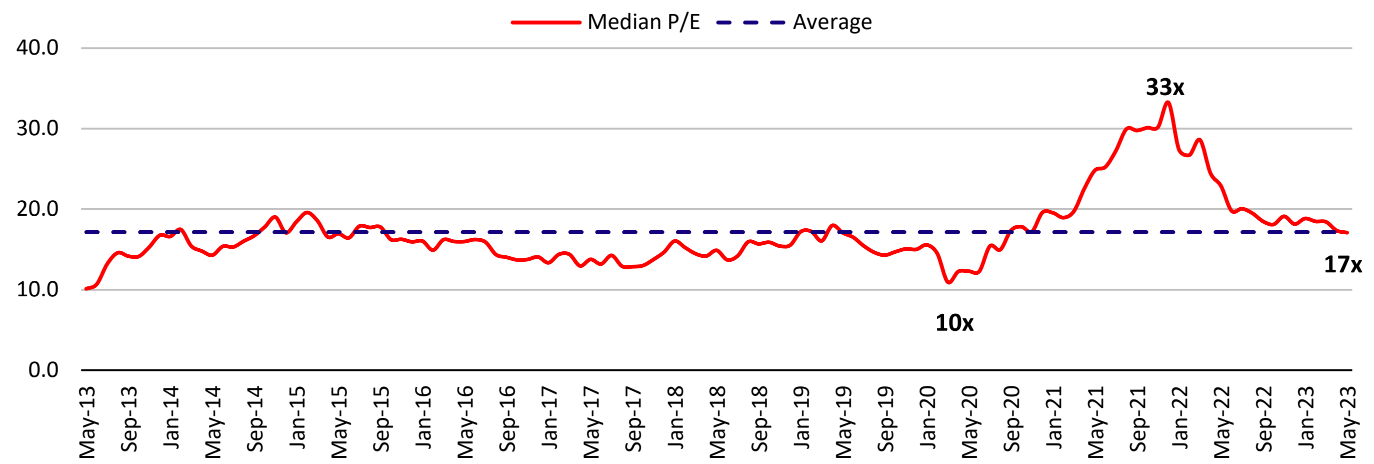
- The payout (dividend + buyback) yield trend of the top 5 IT companies indicates that a slump in the market cap (resulting in a spike in yield) is generally followed by a substantial increase in the payout yield in the following year (for example in FY18).
- In FY17, FY20 and FY23, the market cap (collectively for tier-1) had fallen by 6%/14%/21%, which was followed by a sharp uptick in the payout yield in the following years (FY21 was an exception due to Covid).
- The magnitude of the fall (market cap) in FY23 was even higher compared to the trend, which implies an attractive payout yield in FY24E/FY25E as the market sentiment improves with a recovery in earnings through H2FY24E.

Exhibit 3: Tier 1 payouts are currently at record high



Note: Evaluated for Top-5 IT companies, TechM is included from FY11, FY20 trend was impacted due to Covid Source: MOFSL, Company

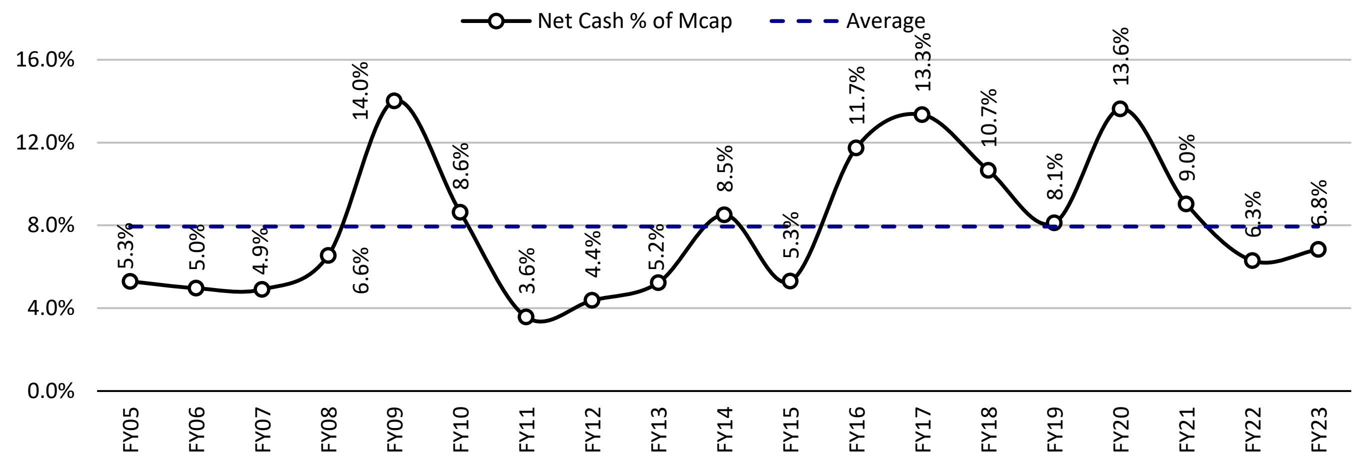
Exhibit 4: Median 1-Year forward PE (Top-5 IT companies)



Source: MOFSL, Bloomberg

- The top 5 IT companies have maintained healthy balance sheets with robust cash & equivalents-to-market cap in the range of 4%-19% (near 20-year median) in FY23.
- With strong operating cash conversion (75%+) and no meaningful capex, we expect the tier-1 pack to maintain a robust cash payout policy with a combination of both dividends and buybacks.

Exhibit 5: Enough liquidity to arrest further downside



Note: Evaluated for Top-5 IT companies, TechM is included from FY11

Source: MOFSL, Company

Valuations and view – positive on longer-term secular demand

- We are constructive on long-term demand but remain cautious on the near-term slowdown, likely caused by a reduction in discretionary spends and a weakness in selective pockets. We expect the demand recovery to come through 2HFY24, with a broad-based recovery in verticals that are currently going through a rough patch and severe pain. This would lead to better revenue visibility and earnings growth for the sector in FY25E.
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Exhibit 6: Valuation table

Company	Rating	Price (INR)	MCap (USD b)	Target Price (INR)	Upside/ Downside (%)	EPS		P/E (x)		Rev growth (%) (CC)		EBIT Margin (%)		PEG
						FY24E	FY25E	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E	FY23-25E
TCS	Buy	3,284	147	3,860	18	132.4	154.3	24.8	21.3	7.7	12.1	24.5	25.5	1.4
Infosys	Buy	1,271	65	1,520	20	63.2	72.3	20.1	17.6	5.2	11.3	21.1	21.7	1.4
Wipro	Neutral	382	25	360	-6	22.0	25.5	17.4	15.0	2.2	10.9	16.2	16.9	1.4
HCL Tech	Buy	1,079	35	1,250	16	60.6	69.3	17.8	15.6	6.8	12.5	18.4	18.8	1.2
TechM	Neutral	1,048	11	1,080	3	59.8	72.1	17.5	14.5	4.7	10.1	11.7	12.9	1.2
LTIM	Neutral	4,620	10	4,650	1	174.0	211.2	26.6	21.9	9.5	14.5	16.6	17.6	1.2

Source: MOFSL, Company

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
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