Information Technology

4QFY24 Result Preview

March 26, 2024

Weak FY24 exit and a weak FY25 start could pressure consensus estimates

Key Points

- After a 410bps outperformance by Nifty IT against Nifty in 2023, it has underperformed by 260bps QTD. Elevated PE multiples of Tier-1 and Tier-2 players (Exhibit 2) is either a sign that there is an earnings upgrade cycle in the offing for FY25/FY26 and/or that flows into equities are expected to remain strong going forward. We think that the earnings do not have a material upside (Continued uncertainty to keep a lid on spending).
- We believe that 4QFY24 will be a better quarter QoQ largely because of a higher number of working days. The post quarter commentary on demand conditions for 2024/FY25 will be the highlight. Consensus (including us) is building in a modestly better FY25 vs. FY24 on the back of strong order inflow in FY24 and expectation of a spending pick-up in 2HCY24. Guidance by some global IT companies paints a different picture as a few of them (Capgemini, Cognizant, Tietoevery and Globant) are guiding towards modestly weaker growth in 2024 vs 2023 even after assuming a pick-up in 2HCY24. Recently Accenture lowered its FY24 (YE August) guidance but pointed to likely stronger exit, primarily driven by higher contribution of acquisitions and large deal wins (Update).
- We expect 4-7% CC revenue growth guidance by both Infosys as well as HCL Tech for FY25 with modestly positive demand commentary vs FY24, especially on discretionary spending. The 2H2024 rebound hope is at risk due to: (1) US interest rates remaining higher for longer (2) Expectations of dramatic changes in policies post US elections in Nov. 2024 if Donald Trump wins. The announcement on large deal wins by Indian IT players have been relatively muted since September 2023.
- We persist with our 'Underweight' stance on the IT sector as we believe that we are in a 'slower for longer' demand environment and the risk is for current consensus estimates to be cut rather than raised.

Points to focus on – Industry: (1) Is spending worsening in 2024 compared to 2023 as Accenture has suggested in its 2QFY24 results? (2) when exactly will the growth kick in and what will be the driver of that (3) State of discretionary spending (4) State of demand for key verticals – BFSI, Hi Tech, Manufacturing & Telecom (5) How much of the recent demand slowdown is macro driven vs normalisation of the high 'compressed transformation' demand seen in the pandemic timeframe? (6) How much are global capability centers (GCCs) eating into the business of outsourcing players? (7) Will there be a pent-up demand spike in FY26 that everybody is building into their estimates for FY26? (8) To what extent Gen AI has been used in improving internal productivity? (9) The extent and timing of salary hikes in FY25 (10) Whether hiring has resume

Key points to watch - Tier-1: (1) Whether Infosys and HCLT deliver a 4-7% CC revenue growth guidance and how much of this is back loaded? (2) Whether the TCV to revenue conversion problem continues? (3) Status of mega/large deal ramp-ups.

Key points to watch - Tier-2: (1) Mphasis – Is the mortgage BFS area healing? (2) Persistent Systems – Can it continue to deliver high TCV numbers? (3) Coforge - Will it repeat the revenue growth guidance of FY24 for FY25 with similar EBITDA margin?

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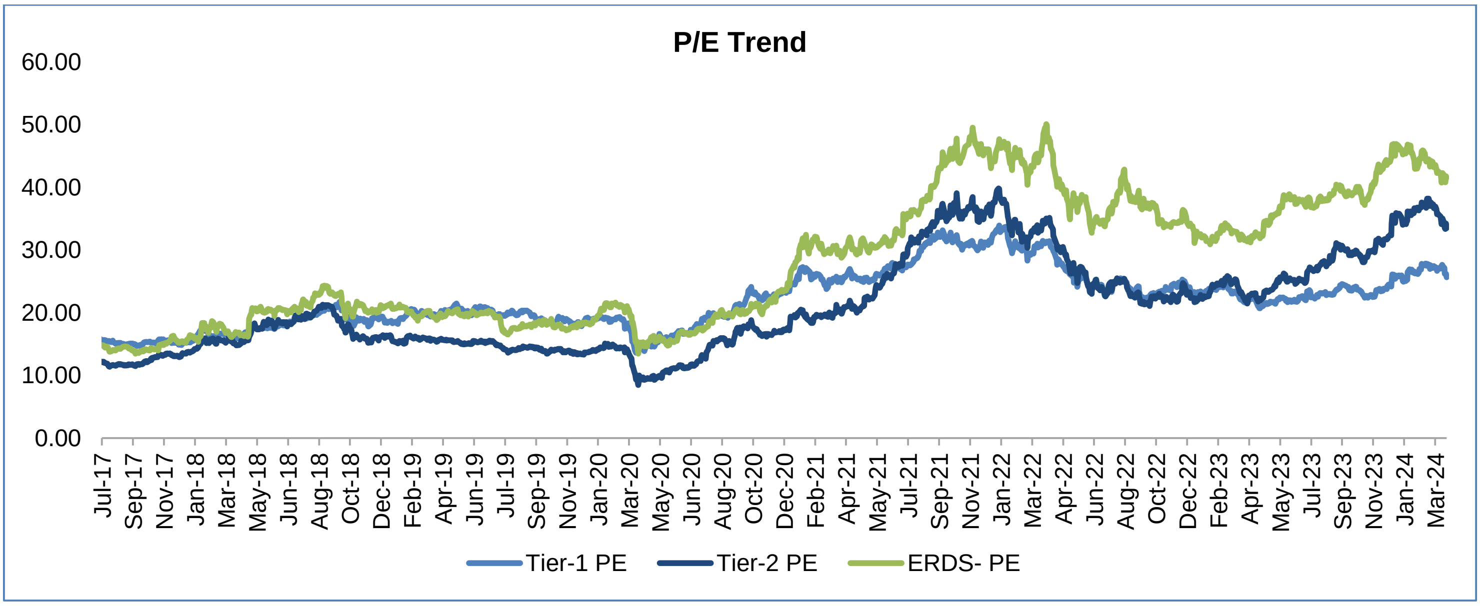
Exhibit 1: Indian IT Services sector - Our assumptions

	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E	FY26E	FY27E
INR/USD	70.1	71.0	74.1	74.6	80.7	83.0	84.6	85.7	86.8
USD revenue growth (%)									
TCS	9.6	5.4	0.6	15.9	8.6	4.2	5.2	9.3	6.4
Infosys	7.9	8.3	6.1	20.3	11.7	2.8	6.4	9.8	6.6
Wipro	1.6	0.8	-1.4	27.3	8.5	-3.7	2.9	8.5	5.8
HCL Technologies	10.1	15.1	2.4	12.8	9.6	5.6	7.5	11.2	9.0
Tech Mahindra	4.2	4.3	-1.4	17.3	10.1	-4.6	3.1	10.1	9.3
Persistent Systems	2.2	4.3	12.9	35.2	35.3	14.4	12.9	16.4	13.9
LTIMindtree*	19.1	13.0	9.5	109.7	17.2	5.1	7.4	12.6	10.9
Coforge	12.8	13.4	5.8	38.0	15.6	12.0	10.9	14.4	11.3
Mphasis	13.1	10.8	5.6	21.7	7.8	-6.0	8.2	11.8	10.9
Birlasoft	-	-	3.4	15.7	7.2	7.4	9.6	11.7	9.8
Zensar	17.6	4.0	-16.2	15.3	6.1	-2.0	6.3	11.9	9.4
EBIT margin (INR) (%)									
TCS	25.6	24.6	25.9	25.3	24.1	24.5	24.7	24.9	25.1
Infosys	22.8	21.3	24.5	23.0	21.1	20.8	21.3	21.4	21.4
Wipro	17.1	17.3	19.9	17.7	15.4	15.2	15.8	16.0	16.4
HCL Technologies	19.6	19.6	21.4	18.9	18.2	18.5	18.6	18.9	18.7
Tech Mahindra	15.0	11.6	14.2	14.6	11.4	6.3	10.8	15.0	16.0
Persistent Systems	12.6	9.2	12.1	13.9	14.9	14.5	15.2	15.7	16.5
LTI Mindtree*	18.4	16.1	19.3	17.8	16.2	16.0	16.7	17.1	17.6
Coforge	14.2	13.1	12.9	13.8	14.3	13.2	14.1	14.3	14.4
Mphasis	16.1	16.0	16.1	15.3	15.3	15.3	15.4	15.5	15.6
Birlasoft	10.1	9.2	12.6	13.6	9.1	14.1	14.6	14.5	14.5
Zensar	10.2	8.5	13.9	11.1	7.6	14.7	13.3	13.6	14.1
EPS (Rs)									
TCS	83.1	86.2	89.3	103.6	115.2	127.3	137.2	152.3	165.5
Infosys	36.0	38.9	45.5	52.4	57.6	58.9	66.4	75.5	83.0
Wipro	18.6	16.6	19.1	22.3	20.7	20.9	23.5	26.6	29.0
HCL Technologies	36.8	40.8	47.7	49.8	54.9	58.8	66.0	75.2	81.7
Tech Mahindra	48.7	45.2	49.9	62.7	54.7	29.3	53.2	81.2	96.6
Persistent Systems	44.1	44.4	58.8	90.2	120.5	139.2	168.9	208.3	253.0
LTI Mindtree*	86.5	87.1	111.2	133.3	149.0	160.2	185.3	218.1	254.0
Coforge	65.6	71.5	74.7	109.0	113.8	139.6	175.3	213.9	251.6
Mphasis	56.1	63.6	64.7	76.4	87.1	83.4	91.3	105.9	121.1
Birlasoft	13.9	8.1	11.6	16.6	12.0	21.8	25.4	28.5	32.3
Zensar	13.7	11.5	15.3	18.3	14.4	27.8	27.4	32.4	37.6
EPS growth (%)									
TCS	24.0	3.8	3.6	16.0	11.2	10.5	7.8	11.0	8.7
Infosys	10.8	8.1	17.0	15.2	9.8	2.4	12.7	13.7	9.9
Wipro	10.5	-10.4	14.9	16.6	-7.2	1.2	12.4	13.0	9.2
HCL Technologies	16.9	10.9	17.0	4.5	10.1	7.2	12.3	13.8	8.7
Tech Mahindra	13.7	-7.0	10.2	25.7	-12.8	-46.5	81.9	52.6	18.8
Persistent Systems	9.2	0.7	32.4	53.5	33.6	15.5	21.4	23.3	21.5
LTI Mindtree*	36.0	0.7	27.7	19.9	11.7	7.5	15.7	17.7	16.5
Coforge	47.7	9.0	4.5	45.9	4.4	22.7	25.6	22.0	17.6
Mphasis	31.2	13.3	1.8	18.0	14.0	-4.2	9.5	16.0	14.4
Birlasoft	6.1	-41.8	42.6	44.1	-27.8	81.4	16.4	12.5	13.1
Zensar	29.0	-16.1	32.8	19.8	-21.5	93.4	-1.3	18.2	15.9

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: 12-month forward PE multiple charts of Tier-1, Tier-2 and ERDS players. Much above pre-pandemic levels



Source: Companies, Bloomberg, Nirmal Bang Institutional Equities.

Exhibit 3: Summary of financial performance by IT companies in our coverage universe for 4QFY24E

(Rsmn) Companies	Revenue						EBIT			EBIT Margin (%)			PAT		
	USD (mn)	4QFY24E	YoY (%)	QoQ (%)	QoQ Growth CC (%)	QoQ Growth USD (%)	4QFY24E	YoY (%)	QoQ (%)	4QFY23	3QFY24	4QFY24E	4QFY24E	YoY (%)	QoQ (%)
TCS	7,391	613,714	3.7	1.3	1.0	1.5	157,162	8.5	3.7	24.5	25.0	25.6	121,011	6.2	3.1
Infosys	4,730	392,756	4.9	1.2	1.2	1.45	81,403	3.3	2.3	21.0	20.5	20.7	61,471	0.3	0.7
HCL Tech	3,448	286,282	7.6	0.6	0.5	0.95	53,327	10.3	-5.0	18.2	19.7	18.6	42,287	6.2	-2.8
Wipro	2,676	222,860	-3.9	0.4	0.5	0.75	36,208	-3.6	10.2	16.2	14.8	16.2	29,421	-4.3	9.2
Tech Mahindra	1,577	130,948	-4.5	0.0	0.0	0.25	11,062	-27.7	57.3	11.2	5.4	8.4	9,028	-19.2	76.8
LTIMindtree	1,098	91,163	4.9	1.1	1.0	1.3	14,744	3.7	6.4	16.4	15.4	16.2	12,679	13.8	8.4
Mphasis	416	34,512	1.8	3.0	3.0	3.3	5,363	4.1	7.9	15.2	14.8	15.5	4,082	0.7	9.3
Persistent	310	25,707	14.0	2.9	3.0	3.0	3,796	9.5	4.5	15.4	14.5	14.8	2,925	16.3	2.2
Coforge	290	24,062	10.9	3.6	2.1	2.75	3,715	10.6	16.1	15.5	13.8	15.4	2,736	138.4	15.0
Birlasoft	166	13,744	12.1	2.3	2.0	2.6	1,968	34.8	1.9	11.9	14.4	14.3	1,568	39.8	-2.6
Zensar	148	12,293	1.4	2.1	-4.3	-3.95	1,644	16.8	-6.8	11.6	14.6	13.4	1,419	18.9	-12.2

Source: Company, Nirmal Bang Institutional Equities.

Note 1: Wipro's USD revenue is only for IT services whereas other numbers are for the entire company.

Note 2: Coforge 4QFY23 had one off expenses connected with its US$1bn revenue milestone and ADR expense write off (ADR has not been executed thus far). Excluding these one offs, EBIT margin in 4QFY23 was 15.5%.

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Exhibit 4: Key things to focus on in the numbers and in the management commentary.

TCS	• Expect TCS to report 1.0% revenue growth QoQ in CC terms, backed by strong order inflow of the last 12 months. The headwind will likely be continued compression in existing book of business (albeit much less than in earlier quarters). It is likely to face cross-currency tailwind of ~50bps on QoQ basis. • For 4QFY24, we think that EBIT margin will expand by 60bps QoQ to 25.6%. With sub-con cost already at multi-quarter lows and in line with pre-pandemic times (6.8-7.0%), margins will improve on the back of furlough impact reversal from 3QFY24, pyramid restructuring, higher offshoring, higher utilization and driving efficiencies in discretionary expenses. • TCV for 3QFY24 was US$8.1bn after strong TCV of US$10bn+ in the 3 quarters before 3QFY24 and this had remained in the guided range of US$7-9bn. We believe TCV for 4QFY24 should come in the guided range. • Commentary around BFSI, Retail, Telecom and Technology will be keenly watched as TCS has the highest exposure in the Tier-1 set with deep relationships in both US as well as Europe and it has been indicating weakness in these verticals. But it has been calling out for green shoots in BFSI in the 3Q analyst interaction. • Except for the Aviva relationship extension, there have not been any mega-deal deal announcements during the quarter that are >US$1bn TCV. We believe the Ramboll deal is a net new TCV but it is likely sub-US$1bn TCV. • Things to watch out for: (1) Demand commentary for FY25. While it has stated that FY25 is going to be better than FY24, it has not indicated by how much. (2) Commentary around discretionary spending (3) Update on Gen AI projects (4) By when it can reach the aspirational margin range of 26-28%?
Infosys	• We expect Infosys to hold out revenue growth guidance for FY25 in the 4-7% CC range. We expect margin guidance to be similar to FY24 (20-22% EBIT margin). We think that risk on revenue is to the downside post the recent commentary of global IT Services players like Accenture, Capgemini and Cognizant. • We expect Infosys to report a revenue growth of ~1.2% QoQ in CC terms. It will face cross currency tailwinds of ~25bps. We expect EBIT margin to expand by 20bps QoQ to 20.7% as the impact of salary hikes which were announced from 1st November 2023 will be lower in 4QFY24 and the one-off impact due to McCamish Systems in 3QFY24 will be reversed in 4QFY24. • Large deal TCV stood at US$3.2bn in 3QFY24 compared to US$7.7bn in 2QFY24. We believe that 4QFY24 TCV number will be in the US$2bn- US$3bn range. • Things to watch out for: (1) Guidance for FY25 (2) The timing and extent of salary hikes in FY25 (3) Extent of boost from the margin improvement program in FY25.
HCL Technologies	• We expect HCLT to hold out revenue growth guidance for FY25 of 4-7% in CC terms. We expect margin guidance to be similar to FY24 (18-19% EBIT). • We are expecting 0.5% CC growth QoQ in 4QFY24 after 6.0% CC growth QoQ in 3QFY24 on the back of Products & Platforms seasonality and ASAP acquisition. • After a weak 1HFY24, HCLT had revised its CC growth guidance downward from 6-8% to 4-6% (5-6% including the ASAP acquisition) for FY24 and it further lowered the upper end of the guidance to 5-5.5% in 3QFY24 including inorganic growth. • We expect the EBIT margin to decline by 110bps QoQ to 18.6% as the higher margin P&P business will moderate as 3Q is seasonally the best quarter for this business. • After recording the highest ever TCV number of US$3.97bn in 2QFY24, TCV for 3QFY24 moderated to US$1.93bn and came in at the lower end of the earlier guidance range of US$2-2.5bn. For 4QFY24, we expect TCV to come in the guided range on the back of a healthy pipeline.
Wipro	• We estimate 0.5% CC QoQ revenue growth in 4QFY24 as against (-)1.5% to 0.5% CC growth guidance. There will be a cross-currency tailwind of ~25bps. Our growth number comes on the back of the cautiously optimistic guidance by Wipro and it being one of the only players to indicate green shoots in discretionary spending (in consulting). • In terms of TCV, Wipro has been delivering US$3bn+ for the last five consecutive quarters with 3QFY24 TCV at a healthy US$3.8bn and we expect TCV to not fall below US$3bn. This also comes on the back of Wipro's efforts to let go of some small and loss-making accounts and chase larger deals. The larger issue for Wipro is conversion of TCV to revenue, which seems to be more acute than its peers. • Things to watch out for: (1) When will conversion of TCV to revenue pick up? (2) Impact of high-profile senior management exits on the business (3) is the recovery in the Consulting piece continuing?

Tech Mahindra	• We expect Tech Mahindra to lay out its medium-term growth and margin plan through an analyst meet sometime in April or May 2024. We would not be surprised if the broad strokes are revealed in the 4QFY24. • We expect Tech Mahindra (TML) to deliver flat CC QoQ growth, which will be impacted by weakness in the CME vertical (~37% of sales), although slight improvements are being seen. Cross-currency tailwind will be ~25bps. We think there will also be some impact of the business rationalization exercise which will continue into 4QFY24 (120bps margin impact in 3QFY24). • In 4QFY24, we expect TCV to be higher than the 3QFY24 TCV of US$381mn. We think the new organizational set up is just falling in place and we think under Mohit Joshi TML will be much more selective in bidding for large deals. The TCV has been falling outside TML's guided range of US$700-1000mn for the past 4-5 quarters and now with the new management and strategy in place, we believe it will gradually move within the guided range. • We expect adjusted EBIT margin to expand by 140bps QoQ to 8.4% in 4QFY24. TML had recorded its lowest ever EBIT margin of 4.7% in 2QFY24 followed by 5.4% in 3QFY24 due to business restructuring, including termination of unprofitable contracts. • Things to watch out for: (1) When should one expect demand recovery in the CME vertical? (2) Update on business rationalization exercise (3) Plans to increase BFSI contribution (4) Have all members of the new leadership been on-boarded and will there be any more top management changes? (5) Timing and extent of salary hikes.
LTIMindtree	• We are expecting 1.0% CC QoQ growth. We expect cross-currency tailwinds of ~30bps. • We expect EBIT margin to expand by ~80bps to 16.2% in 4QFY24. Tailwinds include improved utilization, operational efficiencies, and improved SG&A spending • The TCV number for 3QFY24 was US$1.5bn after US$1.3bn in 2QFY24 and US$1.4bn in 1QFY24. We expect a similar number for 4QFY24. LTIM did indicate that it is getting some advantage from vendor consolidation and the order book has many of these deals. It also indicated that cross-sell and up-sell strategies are working. Client mining is another area that we will closely watch. We would like to hear about some concrete numbers around its Aramco JV which it recently signed. • Things to watch out for: (1) When should one expect a pick-up in growth? (2) What is the progress on the client mining strategy that it had articulated at its 2023 analyst meet? (3) Is it getting invited for larger contracts now that the size is ~US$5bn? Why is it not winning deals with TCV of US$300-US$500mn, which many of its smaller peers are winning occasionally? (4) Till when is it pushing back the EBIT margin target of 17-18% as it is looking to reinvest more in the business? (5) Views for growth in FY25 as it had started FY24 with a strong double-digit growth view and eventually could not deliver.
Persistent Systems (PSL)	• We are expecting 3% CC QoQ growth. We think it will state that for FY25 it will be in the leaders' quadrant in terms of revenue growth with some YoY improvement in EBIT margin (expecting at least 50bps). • We expect EBIT margin to expand by 30bps QoQ to 14.8% on the back of various tailwinds like higher utilization, lower travel expenses, SG&A rationalization and benefit from headcount optimization. • We expect TCV to come above the US$400mn mark in 4QFY24 after recording highest-ever TCV of US$521.4mn in 3QFY24 as it was indicated that there was some spillover of deal closures from 1HFY24 to 2HFY24. We will keep an eye out for the ACV number, which is expected to come in above the US$300mn mark. PSL has been reporting very strong TCV and ACV numbers for the past 2 quarters. • Hi-tech has been an area of weakness across the industry and we will await commentary on how that will shape up in the coming quarters considering that it is the vertical with the highest weight in the company's revenue mix. However, the BFSI vertical needs watching and especially its largest account there – Wells Fargo – which has undertaken substantial job cuts in the US. • Key points to look at would be: (1) What are its capabilities in the cost takeout type of business, which predominates demand currently? (2) Demand outlook for FY25 as PSL is one of the few IT players who has not cut down headcount and instead has been adding gradually.
Mphasis	• We expect 3.0% CC QoQ growth in 4QFY24 after revenue decline over the past 12 months due to continued pressure from the mortgage business amid high interest rates in the US. The sharp pick-up in growth is largely due to reversal of furloughs. We expect cross-currency tailwinds of ~30bps. • We expect EBIT margin to expand by~70bps QoQ to 15.5% and come within the guided range of 15.25-16.25% given by the company. The margin expansion will come as there will be only a small silverline acquisition impact in 4QFY24 as compared to 3QFY24 and some reversal from the furlough impact mainly in the BFSI segment. • MPHL has been reporting TCV of US$300mn+ for seven of the last eight quarters, with 1QFY24 TCV at US$707mn, which was the highest ever in the company's history and 2QFY24 TCV of US$255mn, which was disappointing. 3QFY24 TCV at US$241mn was a 2nd consecutive quarter of disappointment, but we believe

	4QFY24 TCV should remain above the US$300mn+ mark as the non-BFS segment is seeing some traction for MPHL. • Things to watch out for: (1) How is growth looking in the non-mortgage BFS part of the business? (2) Progress in growth beyond the BFSI vertical and top 10 clients (3) Update on the integration of Silverline.
Coforge	• We expect FY25 CC revenue growth and adjusted EBITDA margin guidance of 13-16% and ~18.5%, respectively. • We expect 2.1% CC QoQ growth in 4QFY24. It is likely to face a cross-currency tailwind of ~65bps. • We expect EBIT margin to expand by 160bps QoQ to 15.4% as all the ESOP costs have likely been accounted for till 3QFY24 and there are no major headwinds in 4QFY24 till a new ESOP scheme starts in the coming quarters. There was also an unusually high furlough impact to margin in 3QFY24. • In terms of TCV, Coforge has been reporting TCV of US$300mn+ for eight consecutive quarters now and we expect it to continue this trend in 4QFY24 as it has indicated that the deal momentum is expected to remain robust and had reported US$354mn TCV in 3QFY24. • Things to watch out for: (1) Is Coforge able to get hold of its reasonable share of cost optimization demand? (2) What is happening to BFSI demand in the UK where bulk of its revenue comes from? (3) What should one expect on the ESOP cost front in the coming quarters and years? (4) What will be the trajectory of SG&A costs which are higher due to investments in sales and marketing?
Birlasoft	• We expect 2.0% CC QoQ growth in 4QFY24 as BFSI segment growth was impacted in 3QFY24 due to furloughs. It is likely to have cross-currency tailwind of ~60bps. • We expect EBIT margin to contract by 10bps QoQ to 14.3% as it looks to invest in capability and S&M. Tailwinds to margin include attrition, higher utilization and pyramiding. • In terms of TCV, Birlasoft has been reporting TCV of US$200mn+ on an average for the past 12 quarters and we expect it to continue this trend in 4QFY24 as it has indicated that the deal momentum is expected to remain robust and had reported US$218mn TCV in 3QFY24. • Things to watch out for: (1) Birlasoft has done a lot of hiring with respect to vertical and geo focused leaders. While it indicated hiring is almost complete, we would want to hear the plans laid down by the company for FY25 and FY26.
Zensar	• We expect 4.3% CC QoQ decline in 4QFY24 mainly due to weakness in the hi-tech vertical (~26% of revenue). It is likely to face cross-currency tailwind of ~35bps. • We expect EBIT margin to contract by 120bps QoQ to 13.4%. This is because there was a write-back on a cost in 3QFY24 which had led to a margin benefit of ~110bps. Margin headwinds mainly include sub-con costs. • Things to watch out for: (1) Demand and margin outlook for FY25 (2) Update on the new healthcare vertical (3) any weaknesses in hi-tech and BFSI segment, which accounts for ~65% of total revenue?

View on the Indian IT Services sector: We downgraded Indian IT Services to UW through a report on 10th April, 2022 (Positive surprises likely low in FY23; Tier-2 risky) and continued to remain underweight through our notes on 19th May, 2022 (Customer stress shows up), 8th July, 2022 (Negatives not in price), 10th October, 2022 (Growth expectations too high), 20th March, 2023 (Sell into delayed landing outperformance), 14th June 2023 (Too early to be positive), 26th September, 2023(Cut FY25 estimates; Slower for longer; Sell into the FOMO rally), 15th December, 2023(A No/Soft landing) and 20th March 2024 (Continued uncertainty to keep a lid on spending)

Nifty IT index's TSR from 31st Dec, 2019 till 14th March, 2024 has been 163% with a 70 percentage point outperformance vs the Nifty. But, the outperformance was front-loaded in the first two years of the period (CY2020 and CY2021). Since 31st December 2021, Nifty IT TSR has underperformed Nifty by 29 percentage points.

The massive outperformance of Nifty IT in 2020 and 2021 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 and in Europe. While DT services will continue to remain a key theme over the long term, we believe that IT spends will be curtailed by an 'ability-to-spend' problem as enterprise customers battle earnings pressure from wage inflation, reduced end customer spending power, higher interest rates and likely below-trend growth in western developed economies. Customers, we believe, had pulled forward spending into the compressed transformation phase of FY20-FY23 from future years. We believe customers are now evaluating ROIs on those projects and on spending normalization.

Macro environment now has one good and two bad scenarios:

The good scenario is obviously the soft-landing scenario where inflation, economy and employment cool, thereby allowing the Fed to lower Fed funds rate to what is considered a neutral rate – which is widely believed to 2.5% (we are currently at 5.25-5.5%). The two bad scenarios are: (1) some sort of a recession in 2024 or (2) a strong economic growth scenario with higher than 2% inflation, which keeps fed funds rate 'high for longer'.

We persist with our 'UW' stance. This is because:

(1) Valuations for most IT stocks in our coverage universe are expensive in relation to their 5-year or 10-year histories and we see no material upside to FY25/FY26 earnings for our coverage in the next 12 months

(2) As things stand today, while our earlier base case of a shallow recession sometime in 2024 seems to have a low probability (though professional forecasters still give a probability of 40% for a recession in the next 12 months based on Bloomberg consensus), chances of a no landing with hotter inflation with 'higher rates for longer' scenario seems to have a better probability and is also not a positive scenario for customers.

A 'higher for longer' rates scenario could mean tepid growth in both FY25 and FY26; a shallow recession could mean a significant deceleration in demand and consequently in revenue & earnings growth for the sector.

Even if one were to ignore the next 12–18 months' risks around a recession/the 'higher for longer' interest rate regime and take a 5-year view, we believe that starting valuations are expensive and can at best deliver mid to high single-digit total stock returns (including capital return to shareholders) for TCS/Infosys, as we believe that structural revenue/earnings growth is being overestimated by the street. We believe that USD revenue growth over a 5-year period (FY23-FY28) for Tier-1 set in aggregate will at best be at par with the FY15-FY20 period (~7%). We also expect margins for most coverage companies to remain in a narrow band at around FY24 levels and not see a material expansion (except for Tech Mahindra where it starts from a very low base). *Ceteris Paribus,* this has valuation/return implications.

We continue to maintain TCS as our industry valuation benchmark: We are valuing TCS at target 12-month forward PE of 23.7x, which represents 1SD below the 5-year historical mean. This has been raised from the 20x that we had assigned earlier (10-year mean less 0.5SD). Target multiples for others are at a premium/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 are in fact at the higher end of the pre-pandemic PE range. We have used a higher target PE multiple not because we think that a material earnings upgrade cycle is on the cards for FY25/FY26, but to acknowledge the higher domestic inflows into equities, which have lifted valuations of the entire Indian market and particularly that of Mid-cap and Small-cap stocks.

The Tier-2 pack has held out better than anticipated: Growth for well-run Tier-2 IT companies has materially decelerated from their FY22/FY23 levels but has not been as bad as we had expected. That we believe is because the US macro held up better than we/consensus had anticipated. Had we seen a shallow recession (our earlier base case scenario), growth in both Tier-1 and Tier-2 set would have come off a lot more than it eventually did in FY24.

Tier-2 still faces significant risks: Tier-2 set has a less diversified revenue mix (client, service line and vertical), which could throw up negative growth surprises (as has been seen in case of Mphasis in the last 12-18 months), and a larger exposure to non-Global 1000 clientele, whose profits are more vulnerable in a weaker macro environment. Indian Tier-2 IT pack is now at a PE premium of ~27% to Tier-1 compared to a discount of 25% on 1st January 2020. The premium is at the highest ever level, driven by strong flows into SMID stocks by the Indian mutual funds.

This premium reflects expectations of a big positive earnings growth gap between Tier-2 and Tier-1 IT companies over FY21-FY23 and improving return ratios sustaining beyond FY23. We do not agree with that view. We think that the earnings growth gap will compress due to slower revenue growth and next-to-no margin expansion from current levels for most Tier-2 IT companies. The high PE multiples are also a reflection of the 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 FY23 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 5: Stock and Index Performance (%)

	CY21	CY22	CY23	4QCY20	1QCY21	2QCY21	3QCY21	4QCY21	1QCY22	2QCY22	3QCY22	4QCY22	1QCY23	2QCY23	3QFY23	4QCY23	QTD	YTD
TCS	30.6	(12.9)	16.5	14.9	11.0	5.3	12.8	(1.0)	0.0	(12.6)	(8.0)	8.4	(1.6)	3.0	6.9	7.5	3.1	3.1
Infosys	50.3	(20.1)	2.3	24.6	8.9	15.6	6.0	12.7	1.0	(23.3)	(3.3)	6.7	(5.3)	(6.5)	7.5	7.5	(2.2)	(2.2)
HCL Tech	85.2	(45.1)	41.1	23.2	7.2	31.8	16.2	12.8	(17.3)	(29.7)	(5.2)	(0.4)	(7.0)	9.5	3.9	18.7	6.3	6.3
Wipro	39.4	(21.2)	20.0	16.6	3.9	0.1	30.1	3.1	(11.8)	(16.4)	(4.2)	11.5	4.4	6.5	4.3	16.1	3.4	3.4
LTIM	84.0	(43.2)	44.2	22.9	1.9	10.5	26.0	29.7	(16.3)	(33.3)	0.9	0.8	8.4	9.2	0.2	20.8	(20.5)	(20.5)
Tech Mahindra	223.3	(21.1)	25.2	13.1	26.7	52.9	26.5	32.0	(2.8)	(28.6)	(4.7)	19.4	19.1	2.6	8.1	4.1	(0.8)	(0.8)
Mphasis	117.7	(34.1)	38.9	16.5	8.2	42.0	26.1	12.4	(24.3)	(20.6)	(5.0)	15.5	(1.8)	5.5	25.4	15.3	(12.8)	(12.8)
Persistent	25.0	(17.7)	90.9	44.3	21.4	24.6	-13.7	(4.2)	1.4	(6.4)	(19.2)	8.3	(3.5)	8.7	15.7	27.5	7.9	7.9
Coforge	118.8	(54.4)	61.5	21.5	10.3	33.9	19.8	23.6	(20.8)	(29.9)	(8.7)	(5.1)	(12.2)	23.5	8.3	22.9	(11.7)	(11.7)
LTTS	8.3	(35.5)	42.7	18.0	(4.7)	(11.3)	7.1	19.6	1.1	(23.6)	(14.9)	(0.4)	6.5	16.5	16.3	14.8	2.2	2.2
KPIT Infotech	44.3	(46.5)	39.3	21.4	(4.6)	5.6	28.2	11.8	(16.6)	(30.5)	7.5	(10.1)	(2.5)	27.3	(4.8)	21.1	(12.4)	(12.4)
Tata Elxsi	58.7	(35.6)	115.0	15.6	5.8	6.7	8.5	29.6	(18.7)	(17.0)	(7.3)	3.7	7.1	17.8	5.7	31.4	(8.5)	(8.5)
Cyient	86.5	(51.0)	182.7	10.8	10.7	28.8	11.6	17.2	(55.6)	3.6	22.9	(9.5)	(8.8)	50.8	12.9	35.3	(14.4)	(14.4)
Birlasoft	70.0	(27.6)	141.4	15.5	14.4	11.6	11.2	19.6	(6.0)	(16.5)	1.3	(5.8)	9.5	37.4	34.7	49.2	1.4	1.4
Mastek	99.4	(20.7)	64.9	33.8	26.2	32.8	23.6	(3.7)	(9.3)	(18.4)	4.8	2.3	22.7	26.1	23.5	17.4	(6.5)	(6.5)
Zensar	120.6	(41.9)	186.7	11.3	15.4	20.1	45.5	9.4	(0.6)	(32.1)	(9.0)	(5.5)	(9.0)	41.0	33.7	18.0	(3.3)	(3.3)
Newgen Software	100.4	(40.5)	333.7	43.9	10.8	0.4	41.6	27.2	(16.0)	(35.4)	12.1	(2.1)	9.0	50.6	32.7	73.5	(2.3)	(2.3)
Happiest Minds	139.3	(34.2)	1.7	44.6	13.4	9.4	61.8	19.2	(8.8)	(40.6)	18.5	2.6	(8.3)	27.4	(10.6)	2.4	(13.2)	(13.2)
HGS	219.7	7.1	(25.6)	42.6	46.7	59.8	30.0	4.9	50.7	(7.6)	4.7	(26.5)	(5.2)	4.8	(7.0)	(1.4)	(19.8)	(19.8)
Intellect Design	135.6	(39.9)	87.5	41.1	134.9	(2.2)	-1.9	4.5	27.4	(33.0)	(18.3)	(13.8)	(8.0)	53.1	12.4	18.4	31.2	31.2
OFSS	23.3	(23.7)	39.3	4.6	(0.4)	14.1	24.8	(13.1)	(9.4)	(13.3)	(3.7)	1.4	8.0	18.2	6.5	2.5	98.9	98.9
Ramco Systems	(21.2)	(46.4)	14.8	41.3	(11.7)	14.9	-21.1	(1.5)	(44.1)	6.3	(6.3)	(3.5)	(24.7)	33.6	29.5	(11.9)	(3.7)	(3.7)
DXC	29.1	(26.5)	33.5	66.5	36.3	11.4	2.9	(17.4)	(12.9)	(20.5)	0.7	5.6	(0.9)	4.5	(22.0)	9.8	(8.1)	(8.1)
Endava	17.2	(29.5)	30.7	30.9	(10.0)	14.8	30.8	(13.3)	(19.1)	(16.6)	2.7	1.9	(5.3)	(22.9)	10.7	35.7	(51.4)	(51.4)
Cognizant	(6.2)	(0.5)	70.4	92.3	6.9	(4.8)	-9.5	1.9	(3.2)	(6.0)	19.5	(10.2)	(11.2)	7.1	3.8	11.5	(3.9)	(3.9)
Accenture	120.6	(45.2)	141.4	26.5	2.5	57.9	2.5	33.0	(16.5)	(22.4)	(20.0)	5.8	(12.6)	8.0	(0.5)	14.3	(1.7)	(1.7)
Globant SA	166.7	(43.4)	64.9	31.0	7.7	85.8	37.6	(3.2)	10.0	(35.4)	(18.8)	(1.8)	(9.8)	9.6	10.1	20.3	(15.3)	(15.3)
Epam Systems INC	119.7	(59.2)	186.7	23.4	15.4	13.7	53.5	9.2	(29.6)	(25.8)	(22.2)	0.6	28.8	(24.8)	13.8	16.3	(4.6)	(4.6)
Cap Gemini	119.5	(38.9)	333.7	23.8	5.5	125.3	-8.5	1.0	(21.0)	(23.2)	(0.3)	1.0	25.1	1.6	(4.5)	13.8	14.2	14.2
Genpact	276.6	(32.0)	1.7	(1.3)	56.9	85.9	37.4	(6.0)	(18.5)	(21.5)	19.9	(11.3)	(12.9)	(18.7)	(3.6)	(4.1)	(5.9)	(5.9)
Perficient Inc	193.0	(19.5)	(25.6)	62.7	53.0	39.2	19.1	15.5	(38.1)	4.2	18.5	5.2	(22.6)	15.4	(30.6)	13.8	(11.0)	(11.0)
Thought Works Inc	171.3	(46.0)	(5.7)	11.5	23.2	37.0	43.9	11.7	(14.9)	(17.4)	(29.1)	7.4	3.4	2.6	(46.0)	17.9	(49.9)	(49.9)
Just Dial	-	-	115.0	66.5	36.3	11.4	2.9	(17.4)	(12.9)	(20.5)	0.7	5.6	(0.9)	24.1	(1.3)	10.0	(0.6)	(0.6)
Infoedge	-	-	(25.1)	30.9	(10.0)	14.8	30.8	(13.3)	(19.1)	(16.6)	2.7	1.9	(5.3)	20.4	(7.1)	23.4	2.0	2.0
Makemytrip	-	-	(52.8)	92.3	6.9	(4.8)	-9.5	1.9	(3.2)	(4.3)	19.5	(10.2)	(11.2)	10.3	50.2	15.9	45.5	45.5
Zomato	-	-	108.6	NA	NA	NA	NA	0.6	(40.1)	(34.6)	15.8	(4.9)	(14.0)	47.2	35.2	21.9	40.8	40.8
Nykaa	-	-	12.3	NA	NA	NA	NA	NA	(19.6)	(16.7)	(9.6)	(27.0)	(19.8)	19.6	3.1	13.5	(6.0)	(6.0)
Paytm	-	-	19.7	NA	NA	NA	NA	NA	(60.4)	27.9	(5.6)	(16.8)	19.9	36.3	(1.2)	(25.9)	(36.7)	(36.7)
PB Infotech	-	-	77.3	NA	NA	NA	NA	NA	(26.9)	(17.5)	(17.5)	(5.1)	42.5	9.1	9.8	3.8	45.0	45.0
Index Performance (%)																		
Nasdaq	26.6	(33.0)	53.8	12.9	1.6	11.2	0.9	11.1	(9.1)	(21.4)	(4.6)	(0.3)	20.5	15.2	(3.1)	14.3	8.9	8.9
S&P 500	26.9	(19.4)	24.2	11.7	5.8	8.2	0.2	10.6	(4.9)	(15.7)	(5.3)	7.1	7.0	8.3	(3.6)	11.2	9.9	9.9
Stox 600	22.2	(12.9)	12.7	10.5	7.7	5.4	0.4	7.3	(6.5)	(9.3)	(4.8)	9.6	7.8	0.9	(2.5)	6.4	6.4	6.4
DAX	15.8	(12.3)	20.3	7.5	9.4	3.5	-1.7	4.1	(9.3)	(9.8)	(5.2)	14.9	12.2	3.3	(4.7)	8.9	8.5	8.5
Nikkei	4.9	(9.4)	28.2	18.4	6.3	(1.3)	2.3	(2.2)	(3.4)	(3.7)	(1.7)	0.6	7.5	18.4	(4.0)	5.0	22.2	22.0
MSCI EM	(4.6)	(22.4)	7.0	19.3	1.9	4.4	-8.8	(1.7)	(7.3)	(11.3)	(12.5)	9.2	3.5	(0.1)	(3.7)	7.4	2.4	2.4
Bovespa	(11.9)	NA	NA	25.8	(2.0)	8.7	-12.5	(5.5)	14.5	(17.0)	11.7	NA	NA	15.9	(1.3)	NA	NA	NA
HSCEI	(23.3)	(18.6)	(14.0)	14.3	2.2	(2.8)	-18.2	(5.6)	(8.6)	2.2	(22.9)	13.4	3.9	(7.8)	(4.3)	(6.2)	2.4	2.4
NIFTY IT	59.6	(26.0)	24.1	21.6	6.6	12.8	20.1	10.5	(6.2)	(23.3)	(3.1)	6.1	0.3	3.0	7.5	11.7	(0.9)	(0.9)
NIFTY BANK	13.5	21.2	12.3	45.7	6.5	4.4	7.6	(5.2)	2.5	(8.1)	15.6	11.3	(5.5)	10.2	(0.4)	8.3	(3.0)	(3.0)
NIFTY FMCG	10.0	17.5	29.0	14.5	2.2	3.3	12.0	(7.0)	(3.4)	3.8	17.9	(0.5)	3.9	13.7	(1.1)	10.4	(5.6)	(5.6)
NIFTY AUTO	19.0	15.3	47.6	16.3	7.3	7.5	0.0	3.2	(3.5)	10.9	8.5	(0.7)	(2.9)	23.7	6.8	15.0	13.0	13.0
NIFTY ENERGY	33.7	14.3	29.4	12.6	7.5	9.0	15.3	(1.0)	14.1	(2.8)	1.9	1.1	(11.8)	8.2	10.6	22.5	14.8	14.8
NIFTY PHARMA	10.1	(11.4)	33.6	9.7	(5.0)	16.6	1.1	(1.7)	(4.5)	(10.5)	6.7	(2.9)	(4.6)	14.6	12.0	9.1	11.8	11.8
NIFTY METAL	69.7	21.8	18.7	45.1	22.2	31.1	7.6	(1.6)	16.3	(27.4)	23.8	16.6	(18.2)	12.9	10.1	16.6	1.9	1.9
NIFTY INFRA	35.6	6.1	39.1	18.5	12.0	6.2	15.8	(1.5)	1.4	(7.9)	7.3	5.9	(3.1)	12.7	8.8	17.0	11.5	11.5
NIFTYMIDCAP	46.1	3.5	46.6	22.7	13.7	13.8	12.7	0.2	(2.5)	(10.9)	15.9	2.7	(4.7)	19.0	13.4	13.9	2.4	2.4
NIFTY SMALLCAP	59.3	(13.8)	55.6	21.7	14.5	20.0	11.9	3.7	(7.6)	(19.1)	11.8	3.1	(7.6)	20.5	17.6	18.8	(0.6)	(0.6)
NIFTY	24.1	4.3	20.0	24.3	5.1	7.0	12.1	(1.5)	0.6	(9.6)	8.3	5.9	(4.1)	10.5	2.3	10.7	1.7	1.7
USD/INR	73.9	78.6	82.6	73.8	72.9	73.8	74.1	75.0	75.2	77.3	79.8	82.2	82.3	82.2	82.7	83.3	83.0	83.0

Source: Bloomberg, Nirmal Bang Institutional Equities Research, Prices as of 22March, 2024

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