Sector Update
Information Technology

March 15, 2024

PE expansion explains entire 12-month upside

Key Points

- PE multiple expansion explains the entire return of both Tier-1 and Tier-2 IT stocks over the last 12 months as consensus FY25E earnings have seen downgrades (Exhibit 1).
- While some in the market believe that PE multiple expansion is a precursor to the start of a consensus earnings upgrade cycle for FY25/FY26, we remain sceptics. We believe it has more to do with strong domestic inflows into equities. The Tier-2 PE premium of 32% currently vs Tier-1 (Exhibit 4) we believe is due to the skewed inflow into Mid Cap mutual funds as much as because of better future growth prospects.
- The market is already assuming FY25 to be a slightly better year than FY24 and that there would be a pent-up demand driven revenue spike in FY26 (which is expected to add on incremental basis revenue a little short of that in blockbuster FY22).
- And if PE multiples are already expensive on existing earnings, it would require a material upgrade to FY25/FY26 estimates for meaningful returns to be made from here on - unless one is betting on a further PE multiple expansion.
- Going by the 2H2024 recovery talk by most IT players, a high probability of 'higher for longer' Fed Funds rate in the US due to recent hotter inflation prints there and uncertainty around economic & immigration policies of the next US administration, we do not think there is a material upside to the earnings estimate in FY25/FY26.
- The other way to interpret the high PE multiples would be that market is assuming that earnings growth of the unprecedented 'compressed transformation' phase of FY20-FY23 could repeat/sustain in the future post the current slowdown. While earnings prospects for some companies could be better than their pre-pandemic phase (albeit not as much as bulls expect), most others will revert to pre-pandemic levels or worse.
- A 10-year study (Exhibit 2) indicates that while Nifty IT has delivered significant outperformance over Nifty, this has been entirely driven by the Digital transformation related pandemic phase – CY2020 and CY2021. Outside of this phase, Nifty IT has underperformed.
- Also, a 10 year study (Exhibit 3) of valuations and earnings growth indicates that Indian IT stocks are currently trading at +1.9SD to +10.6SD higher valuations compared to the mean multiples during the FY15-FY20 period. Yes, we would admit that certain companies have undergone a structural change for the better in their earnings prospects compared to that period, but not to the extent that the bulls assume and not all of them.
- PE of Tier-2 pack vs Tier-1 pack has expanded dramatically in recent years. While we acknowledge that some of them have undergone metamorphosis over the last 5-8 years, we do not believe that the expanded earnings growth gap with Tier-1 of FY21-FY23 will sustain going ahead. We believe the market is being too optimistic about growth prospects of the Tier-2 set over the next five years.
- We expect 4-7% CC revenue growth guidance by both Infosys and HCLT. Even this may be at risk if the Fed Funds rate is not cut materially due to a 'no landing' scenario or if there is a recession of some kind or if enterprise customers freeze up due to US election uncertainty. We see 'slower for longer' demand conditions through 2024 that could pare consensus earnings expectations.

Girish Pai
Research Analyst
girish.pai@nirmalbang.com
+91-22-6273 8017

Exhibit 1: Change in earnings and PE multiples of stocks and the extent to which PE multiple explains the returns.

Company	12-month EPS change (%)		12-month Stock price change (%)	% of stock movement explained by PE multiple expansion (on FY25 EPS)
	FY25	FY26		
TCS	-4	-2	28	113%
Infosys	-13	-16	14	195%
Wipro	-13	-17	33	138%
HCL Tech	-9	-4	51	117%
Tech Mahindra	-28	-17	14	301%
Persistent	-1	12	80	102%
Coforge	-4	7	54	108%
LTIM	-10	-11	13	180%
Mphasis	-17	-12	26	168%
Birlasoft	15	-2	170	91%
Zensar	29		99	71%

Source: Bloomberg, Nirmal Bang Institutional Equities Research Note: Priced on 14 March 2024

Exhibit 2: Performance of Nifty IT versus Nifty over the last 10 years

		Total Shareholder Returns (%)		
From Date	To Date	Nifty IT	Nifty	Outperformance
13-03-14	14-03-24	392.9	292.3	100.6
13-03-14	31-12-19	87.2	103.3	-16.1
31-12-19	31-12-21	157.0	46.6	110.4
31-12-21	14-03-24	2.5	31.7	-29.2
30-12-22	14-03-24	35.6	24.4	11.2

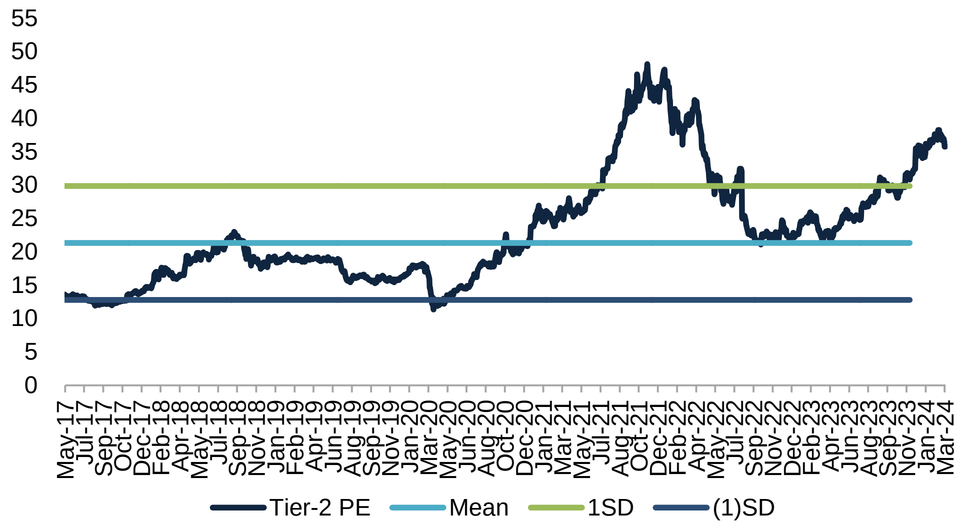
Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 3: 10-year study of PE multiples, earnings and how expensive stocks are compared to FY15-FY20 time frame.

	TCS	Infosys	HCLT	Wipro	Tech M	Persistent	Mphasis	Coforge
Current 12 month forward PE multiple	29.9	24.2	24.8	21.8	23.1	45.0	25.5	33.0
Mean PE multiple during FY15-FY20	23.6	18.8	15.6	16.3	15.9	17.4	18.0	19.6
Highest PE multiple during FY15-FY20	33.6	23.7	19.4	23.0	24.5	23.0	29.7	33.2
1 Std Dev during FY15-FY20	3.3	1.8	1.5	1.7	2.5	2.6	2.2	4.3
Current PE is how many SD over FY15-FY20 mean	1.9	3.0	6.2	3.2	2.9	10.6	3.4	3.1
Earnings growth over FY15-FY20	9.2%	6.5%	9.4%	-1.0%	9.0%	4.1%	14.7%	20.1%
Earnings growth over FY20-FY23	10.2%	13.9%	10.4%	7.5%	6.5%	39.5%	11.1%	16.8%
Earnings growth over FY23-FY26	9.8%	9.5%	11.1%	8.7%	14.1%	18.7%	6.8%	23.4%

Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 4: PE premium of Tier-2 versus Tier-1 has expanded dramatically in recent years



Source: Companies, Nirmal Bang Institutional Equities Research

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Team Details:			
Name		**Email Id**	**Direct Line**
Rahul Arora	CEO	rahul.arora@nirmalbang.com	-
Krishnan Sambamoorthy	Head of Research	krishnan.s@nirmalbang.com	+91 22 6273 8210
Dealing			
Ravi Jagtiani	Dealing Desk	ravi.jagtiani@nirmalbang.com	+91 22 6273 8230, +91 22 6636 8833
Michael Pillai	Dealing Desk	michael.pillai@nirmalbang.com	+91 22 6273 8102/8103, +91 22 6636 8830

Nirmal Bang Equities Pvt. Ltd.

Correspondence Address

B-2, 301/302, Marathon Innova,

Nr. Peninsula Corporate Park,

Lower Parel (W), Mumbai-400013.

Board No. : 91 22 6273 8000/1; Fax. : 022 6273 8010