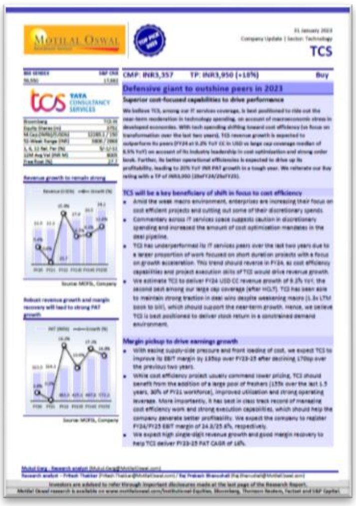
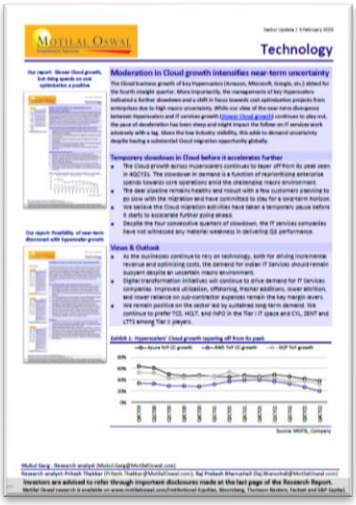
Sector Update | 28 March 2023

Technology

Company	Rating	Old Target Price (INR)	Target PE FY25	New Target Price (INR)
TCS	Buy	3,810	24	3,710
Infosys	Buy	1,760	23	1,750
Wipro	Neutral	380	14	370
HCL Tech	Buy	1,270	19	1,360
TechM	Neutral	1,020	15	1,130
LTIM	Neutral	4,590	22	4,750





BFSI to drag FY24 growth, but structural demand intact

Easing of supply pressure to aid FY24 earnings

- **Near-term demand to remain soft…:** Technology-related spends are likely to remain muted over the near term led by challenging macro environment and concerns on stability of the overall Banking industry (trouble in Credit Suisse and a few of the US regional banks).
- **…but long-term demand intact:** With an already high base (strong spends in FY22 and FY23), this would result in a muted industry topline growth for FY24E. However, we expect the peak of weak macro impact to play out by 1HFY24 before recovering gradually in 2HFY24. With structural demand remaining intact, we continue to expect a strong demand recovery in FY25.
- **TCS – the prime beneficiary:** The adverse impact of IT-related spending cuts should primarily be on discretionary spends, which have been the key spending area post Covid-induced disruptions. On the other hand, cost optimization and vendor consolidation-related spends should remain the prime focus over the next 3-4 quarters, which we see as positive for TCS – our top pick in CY23.

Weakness in global banking environment to hamper near-term spends

- Though IT spends have remained resilient, rising interest rates and current trouble in the US banking system imply adverse near-term impact for IT spends.
- We expect the banks to maintain caution and curtail discretionary technology spending until the situation stabilizes. This would hit IT spends in the early part of FY24 and exert further pressure on near-term growth outlook for IT services.
- We remain watchful of the situation and any further weakness in banking eco-system would be viewed negatively. We have cut our FY24E/FY25E EPS for tier-1 players by 0.4-3.9%/0.8-3.7% due to their near-term weaknesses.

Margin recovery would continue to play out

- With industry hiring ahead of the curve in anticipation of strong demand and high attrition, most of the companies took hit on profitability during the current year.
- However, moderation in hiring, lower backfilling costs due to easing attrition rates, lower sub-contractor expenses and normalization in salary cost for employees should support margin expansion in the medium term.
- Our estimates indicate that the recovery in growth from 2HFY23 and 100bp margin improvement over FY23-25 should drive the industry's earnings growth.

Continue to prefer tier-1 over tier-2 players

- The macro headwinds in the US and Europe could have an adverse impact on near-term growth for the IT services companies. However, considering the scale of offerings, top-notch client profile and execution prowess, we believe that tier-1 companies are better placed in a weakening demand environment.
- This trend has already started to play out in the recent quarter, with tier-1 players outpacing (Exhibit 21) their tier-2 counterparts in terms of revenue growth.

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- Given the resilient revenue profile due to their presence in the global Fortune 500 accounts and service offerings, tier-1 companies are better off amid macro challenges. Further, tier-1 players are likely to benefit from the shift towards cost optimization and vendor consolidation deals.

Valuations and view – Remain constructive on longer term demand

- Though the current macro environment remains weak, the structural demand outlook for the sector remains intact. We continue to believe that the macro challenges will ebb by 1HFY24 and the situation will start improving in the later part of the year. This should be followed by healthy recovery in FY25E with improved visibility for clients and catch up in tech spends.
- Normalization in hiring, higher fresher additions, lower attrition, improvement in utilization and lesser reliance on sub-contractor expenses should drive margin expansion over the medium term.
- Valuations have significantly corrected from their peaks as we believe that the concerns on macro environment have already been factored into the valuations.
- We remain selective in the space and view any correction in the preferred names as an opportunity to accumulate further. We continue to like TCS (our top pick), HCLT, and INFO within our tier-1 IT space.

Exhibit 1: Tier-1 valuation table

Company	Rating	Market Cap (USD b)	Target Price (INR)	Upside/ Downside	EPS			P/E (x)			RoE (%)	
					FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E
TCS	Buy	139	3,710	19%	115.9	134.3	154.6	26.9	23.2	20.2	47.6	55.6
Infosys	Buy	70	1,750	27%	58.3	65.8	76.0	23.8	21.1	18.3	33.5	38.7
Wipro	Neutral	24	370	4%	20.7	23.7	26.7	17.4	15.3	13.5	17.2	19.2
HCL Tech	Buy	34	1,360	31%	54.7	63.1	71.6	19.3	16.7	14.7	24.0	28.3
TechM	Neutral	12	1,130	6%	57.0	63.2	75.5	19.3	17.4	14.6	18.8	20.8
LTIM	Neutral	10	4,750	4%	154.1	177.8	215.6	29.6	25.6	21.1	24.0	22.6

Source: Company, MOFSL

Weak near-term outlook; expect growth to recoup in FY25

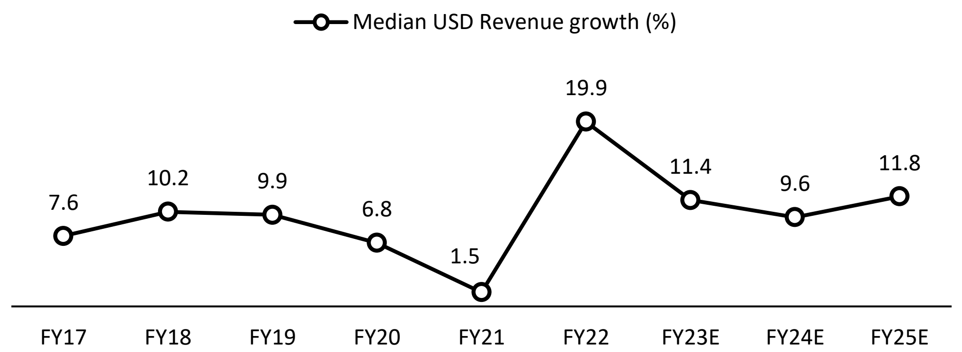
Weakening macro environment and possible recession in the US and Europe have created heightened pressure on the near-term growth prospects of the domestic IT companies. Enterprises have started to prune their discretionary spends and shift the focus to save costs. Management commentaries of various companies that we met recently suggested a near-term pressure on growth and a clear focus to save costs (Exhibit 2). We expect the adverse impact of weak macro to depress IT spends until 1HFY24 before recovering gradually in 2HFY24. Gartner forecasts IT services spends to grow by 5.5% YoY in constant currency (CC) in CY23 v/s 3.0% YoY CC in CY22 despite volatile macro situation. However, with structural demand remaining intact, we expect a healthy recovery in FY25.

Exhibit 2: Demand and revenue commentaries of various IT services companies and industry experts we met recently

INFO	❖ It continues to see weakness in 4QFY23 as this is INFO's weakest quarter along with pressure in its financial services vertical (capital markets and mortgage divisions).
WPRO	❖ There are some incremental concerns on budget for IT from clients. Overall, the visibility is still low and clients are neither releasing budgets quickly not cutting them abruptly.
	❖ Large deals are coming through but deal duration has increased significantly, resulting in longer conversion cycle. ACV is lower than what it used to be a year back.
	❖ Due to cutbacks in discretionary spend, including consulting, WPRO's revenue growth has been hit in the near term.
TECHM	❖ TECHM reiterated the fact of sacrificing growth over margins, while focusing on improving quality revenue, and divesting non-accretive and low-margin businesses.
LTIM	❖ Management indicated that the decision-making cycle is getting elongated and a similar trend has been witnessed across a few accounts. With the emerging macros, the slowdown might get pronounced and 1HFY24 performance might get adversely impacted.
MPHL	❖ Mortgage business might remain under pressure in 4QFY23. Given the past trends, it is hopeful that the vertical should start improving going forward.
	❖ There are limited opportunities on vendor consolidation on the mortgage space as several peers are full-service players, which can only be acquired by banking customers of MPHL.
	❖ On the Direct side, the company continues to struggle with delays in project starts. Further, clients are only starting transformational projects as they free up the money from cost-side mandates, where MPHL has limited exposure
Industry Experts	❖ Clients are not willing to take big bets until they get more clarity on their growth trajectories.
	❖ Discretionary spend is under pressure and it expects some signs to emerge in 4QFY23 and become more pronounced in 1QFY24.
	❖ On BFSI side, IB and mortgage remain under pain and are not expected to come out of the woods for another six months. Retail and commercial banking are relatively better off though.

Source: MOFSL, Company

Exhibit 3: Median revenue growth for our coverage universe



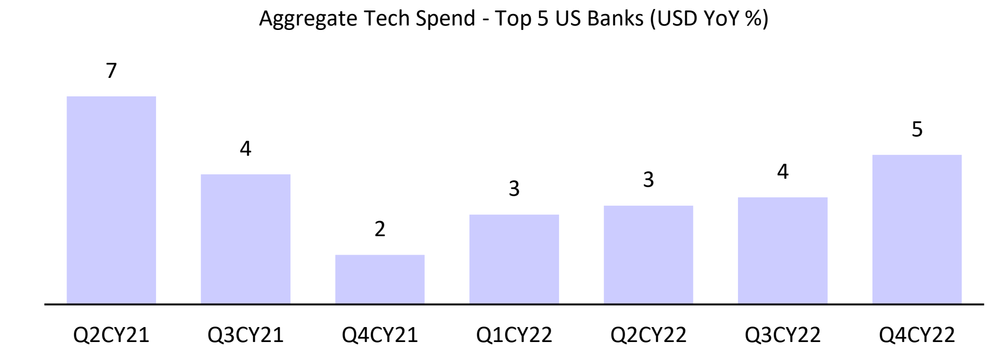
Source: MOFSL, Company

BFSI – Rising risks imminent

IT outsourcing vendors have key dependencies on the BFSI segment (~30% of revenue) and it has been a major growth driver for the industry. Despite weak macro, global banks continue to invest in technology. Ex-JP Morgan, the US banks have increased their spending at 8% YoY in 4QCY22.

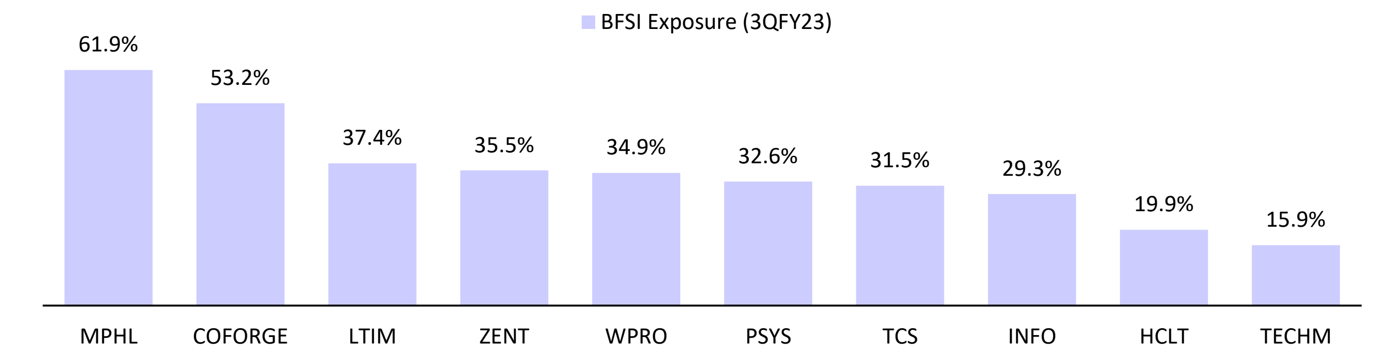
Tech spends of Top 5 US Banks grew 8% YoY, ex- JP Morgan IT spends in 4QCY22.

Exhibit 4: The US banks' tech spends YoY



Source: MOFSL, Company

Exhibit 5: BFSI exposure across players



Source: MOFSL, Company

Though IT spends have remained resilient, rising interest rates and current trouble in the US banking system imply adverse near-term impact for IT spends. Following this chapter, the banks are likely to maintain caution and curtail discretionary tech spending until the situation stabilizes. This would hit IT spends in the early part of FY24 and exert further pressure on near-term growth outlook for IT services. We remain watchful of the situation and any further weakness in banking eco-system would be viewed negatively.

While we are still assessing the impact of weakness in the BFSI space for tier-2 names, we are cutting our estimates for tier-1 companies due to the weakness in BFSI space and based on our discussion with the managements. Our revised estimates are as under:

Exhibit 6: Our BFSI CC revenue growth estimates for Tier-1 companies

Company	FY24
TCS	4.86%
INFO	2.48%
WPRO	4.06%
HCLT	5.55%
TECHM	2.15%
LTIM	11.79%

Source: MOFSL, Company

Exhibit 7: Tier-1 valuation table

Company	Rating	Market Cap (USD b)	Target Price (INR)	Upside/ Downside	EPS			P/E (x)			RoE (%)	
					FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E
TCS	Buy	139	3,710	19%	115.9	134.3	154.6	26.9	23.2	20.2	47.6	55.6
Infosys	Buy	70	1,750	27%	58.3	65.8	76.0	23.8	21.1	18.3	33.5	38.7
Wipro	Neutral	24	370	4%	20.7	23.7	26.7	17.4	15.3	13.5	17.2	19.2
HCL Tech	Buy	34	1,360	31%	54.7	63.1	71.6	19.3	16.7	14.7	24.0	28.3
TechM	Neutral	12	1,130	6%	57.0	63.2	75.5	19.3	17.4	14.6	18.8	20.8
LTIM	Neutral	10	4,750	4%	154.1	177.8	215.6	29.6	25.6	21.1	24.0	22.6

Source: Company, MOFSL

Exhibit 8: Revisions to our estimates for TCS

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.7	82.2	82.5	80.8	82.5	82.5	-0.1%	-0.3%	0.0%
USD revenue (m)	27,934	30,357	33,835	27,945	30,548	34,159	0.0%	-0.6%	-0.9%
Growth (%)	8.7	8.7	11.5	8.7	9.3	11.8	0bps	-60bps	-40bps
EBIT margin (%)	24.1	24.8	25.5	24.2	24.8	25.6	-10bps	-10bps	0bps
PAT (INR b)	424	491	566	425	498	572.2	-0.4%	-1.3%	-1.1%
EPS (INR)	115.9	134.3	154.6	116.3	136.1	156.4	-0.4%	-1.3%	-1.1%

Source: MOFSL

Exhibit 9: Revisions to our estimates for INFO

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.5	82.5	82.5	80.6	82.5	82.5	-0.1%	0.0%	0.0%
USD revenue (m)	18,396	19,819	22,027	18,453	20,147	22,310	-0.3%	-1.6%	-1.3%
Growth (%)	12.8	7.7	11.1	13.1	9.2	10.7	-30bps	-140bps	40bps
EBIT margin (%)	21.1	21.1	21.8	21.2	21.5	22.0	-10bps	-30bps	-10bps
PAT (INR b)	245	276	319	248	284.8	323.0	-1.1%	-3.1%	-1.3%
EPS(INR)	58.3	65.8	76.0	58.9	67.9	76.9	-1.1%	-3.1%	-1.3%

Source: MOFSL

Exhibit 10: Revisions to our estimates for WPRO

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.6	82.5	82.5	80.6	82.5	82.5	-0.1%	0.0%	0.0%
Revenue from IT Services (USD m)	11,183	11,886	12,992	11,174	11,893.7	13,012.7	0.1%	-0.1%	-0.2%
Overall USD Revenue growth (%)	5.5	7.1	9.2	5.4	7.3	9.3	10bps	-20bps	-10bps
EBIT margin – overall (%)	15.4	16.2	16.8	15.5	16.4	17.0	-10bps	-10bps	-20bps
EBIT margin – IT Services (%)	15.7	16.3	16.9	15.8	16.5	17.1	-10bps	-10bps	-20bps
PAT (INR b)	113.7	129.8	146.3	114.5	131.0	148.2	-0.7%	-0.9%	-1.3%
EPS (INR)	20.74	23.66	26.67	20.9	23.9	27.0	-0.7%	-0.9%	-1.3%

Source: Company, MOFSL

Exhibit 11: Revisions to our estimates for HCLT

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.5	82.5	82.5	80.6	82.5	82.5	-0.1%	0.0%	0.0%
USD revenue (m)	12,657	14,018	15,654	12,646	14,034	15,685	0.1%	-0.1%	-0.2%
Growth (%)	10.2	10.8	11.7	10.1	11.0	11.8	10bps	-20bps	-10bps
EBIT margin (%)	18.2	18.7	19.0	18.2	18.7	19.1	0bps	-10bps	-10bps
PAT (INR b)	148	171	194	148	172	196	0.1%	-0.5%	-0.8%
EPS(INR)	54.7	63.1	71.6	54.6	63.4	72.2	0.1%	-0.5%	-0.8%

Source: MOFSL, Company

Exhibit 12: Revisions to our estimates for TECHM

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.6	82.5	82.5	80.6	82.5	82.5	-0.1%	0.0%	0.0%
USD revenue (m)	6,612	6,995	7,649	6,627	7,096	7,766	-0.2%	-1.4%	-1.5%
Growth (%)	10.2	5.8	9.3	10.5	7.1	9.5	-30bps	-130bps	-10bps
EBIT margin (%)	11.6	12.1	13.3	11.8	12.5	13.6	-20bps	-30bps	-30bps
PAT (INR b)	50	56	67	51	58	69	-1.7%	-3.9%	-3.7%
EPS(INR)	57.0	63.2	75.5	58.0	65.8	78.4	-1.7%	-3.9%	-3.7%

Source: MOFSL, Company

Exhibit 13: Revisions to our estimates for LTIM

	Revised estimate			Earlier estimate			Change		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
USD:INR	80.8	82.5	82.5	80.8	82.5	82.5	-0.1%	0.0%	0.0%
USD revenue (m)	4,116	4,550	5,155	4,132	4,639	5,258	-0.4%	-1.9%	-2.0%
Growth (%)	17.6	10.5	13.3	18.0	12.3	13.3	-40bps	-180bps	0bps
EBIT margin (%)	16.5	16.9	18.0	16.6	17.1	18.0	-10bps	-20bps	0bps
PAT (INR b)	45,612	52,652	63,820	46,051	54,361	65,223	-1.0%	-3.1%	-2.2%
EPS(INR)	154.1	177.8	215.6	155.6	183.6	220.3	-1.0%	-3.1%	-2.2%

Source: MOFSL, Company

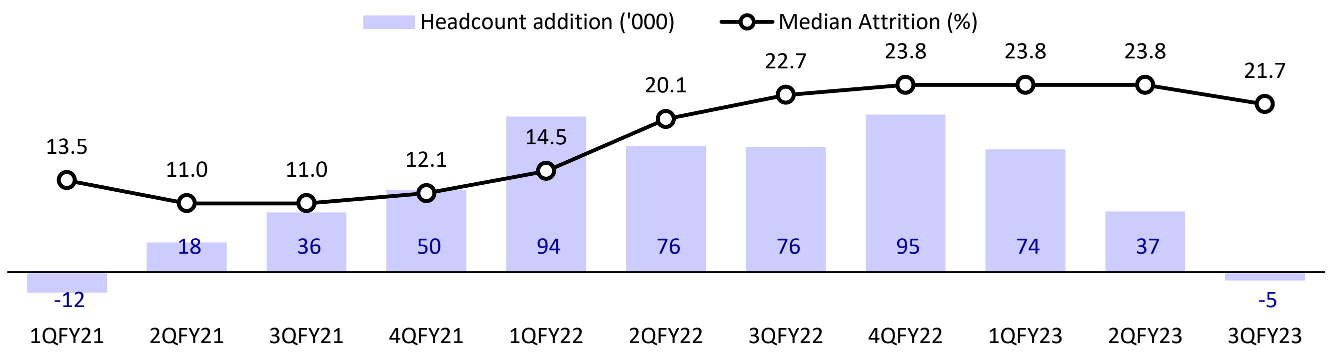
Expect margin recovery during FY23-25

Expect normalization in headcount additions; attrition easing

The industry hired ahead of the curve in FY22 in anticipation of a strong demand and high attrition. With attrition cooling off, the bench requirements have moderated leading to a gradual moderation in hiring activity. We believe there is enough bandwidth with the companies to cater to the incremental demand due to front-loaded hiring, which will keep the hiring activity muted in the near term.

However, moderation in hiring, lower backfilling costs due to easing attrition rates, lower sub-contractor expenses and normalization in salary cost for employees should support margin expansion in the medium term.

Exhibit 14: Net headcount addition and attrition for our coverage universe

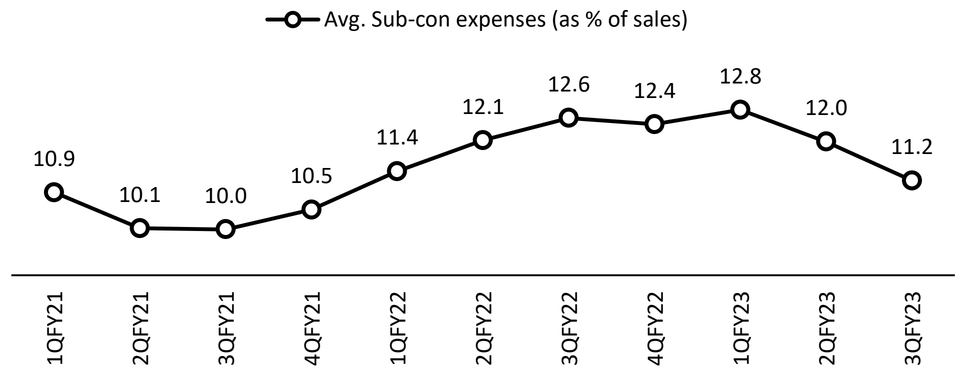


Source: MOFSL, Company

Sub-contractor expenses to ease; utilization levels provide buffer

Supply shortage in FY22 led to increased dependency on sub-contractors. With easing supply situation and normalization in demand, the dependency on sub-contractors has started to ease. We expect this trend to continue and project further normalization in sub-contractor expenses that will aid margins.

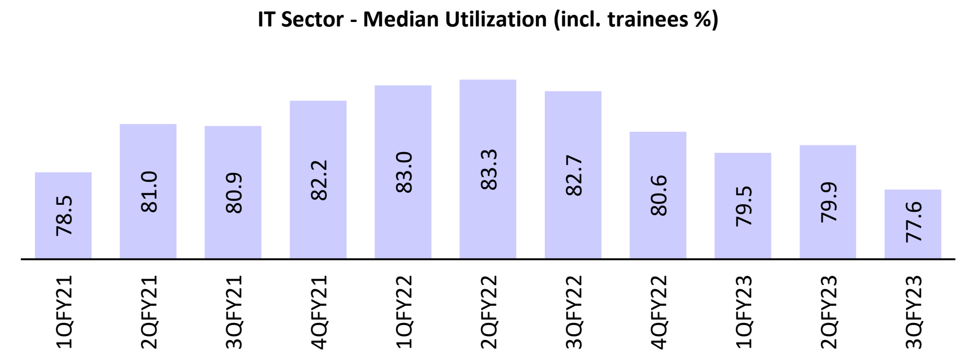
Exhibit 15: Sub-contractor expenses (TCS, INFO, WPRO, and TechM)



Source: MOFSL, Company

Utilization levels have moderated over the last few quarters and leaves good room for improvement. Freshers turning billable should drive improvement in utilization levels in the near term which in-turn should support margins.

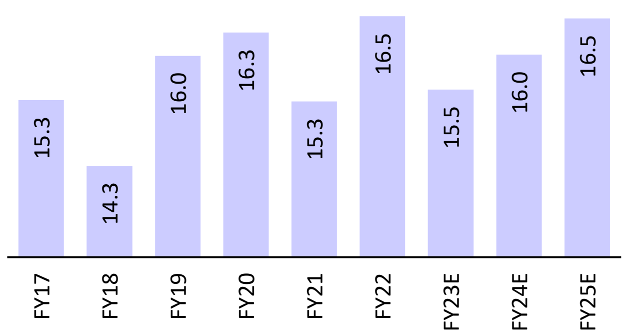
Exhibit 16: Utilization provides room for improvement



Source: MOFSL, Company

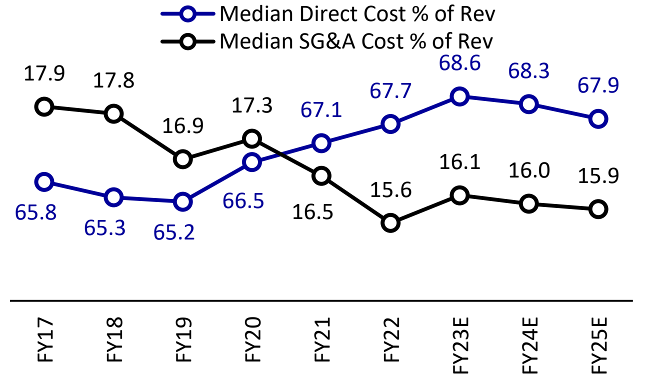
We expect EBIT margin to recover gradually in FY24 and FY25. The consecutive wage hike, retention and backfilling costs (due to heightened attrition) have driven the increase in direct costs to reach the peak in FY23E. We, however, expect normalization of direct costs in FY24 and FY25. SG&A leverage should provide further support to the margins.

Exhibit 17: Median EBIT margin (%)



Source: MOFSL, Company

Exhibit 18: Median operating leverage (%)

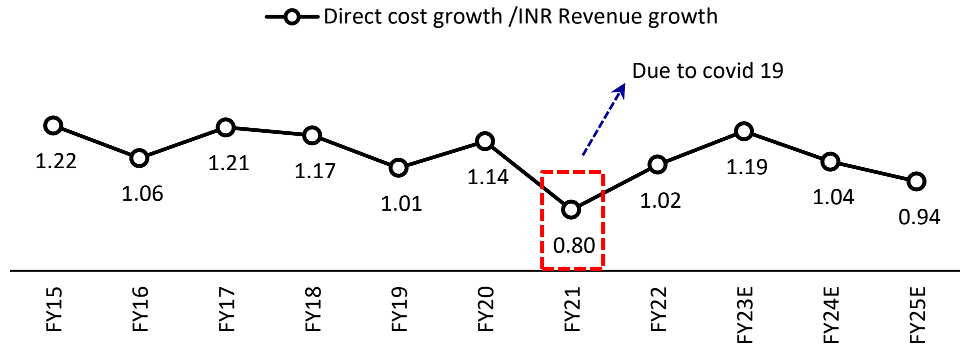


Source: MOFSL, Company

Downside risk to our FY25 margin estimates

Though we remain positive on the margin recovery, there is a downside risk to our margin estimates. The ratio of direct costs to revenue (for any given year) has remained over 1 since FY15 (with exception of FY21 due to Covid). At our current estimates, our FY24 ratio of direct cost growth to INR revenue growth stands at 0.94 suggesting some downside risk to our margin estimates (Exhibit 18). Further, our recent interactions with various companies suggest continued pressure on margins (Exhibit 19).

Exhibit 19: Ratio of 0.94 suggests downside risk to our margin estimates



Source: MOFSL, Company

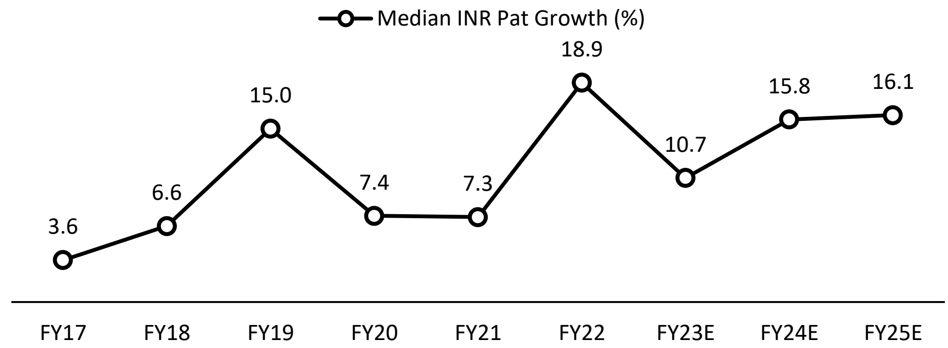
Exhibit 20: Margin commentaries of various IT services companies we met recently

INFO	❖ Absence of growth will weigh on its margins. The company continues to expect an EBITDA margin of 21% over the near term**.**
WPRO	❖ Margins should be within 16.0-16.3% range in 4QFY23. The company should see good margin recovery when the business recovers.
MPHL	❖ The company will also not be able to improve margins due to absence of operating leverage given the muted growth expectation in the near term.

Source: MOFSL, Company

Overall, the recovery on growth from 2HFY23E and 100bp margin improvement over FY23-25E should drive earnings.

Exhibit 21: Median PAT growth of our coverage universe



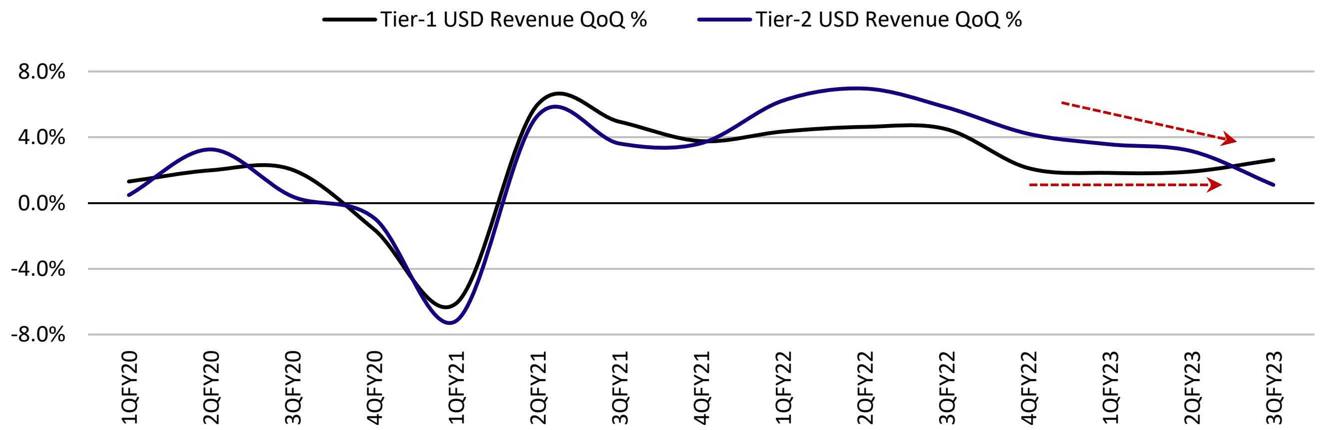
Source: MOFSL, Company

Tier-1 better poised to weather the storm

The macro headwinds in the US and Europe could have an adverse impact on near-term growth for the IT services companies. However, considering the scale of offerings, top-notch client profile and execution prowess, we believe that tier-1 companies are better placed in a weakening demand environment.

This trend has already started to play out in the recent quarter, with the tier-1 companies outpacing (exhibit-21) their tier-2 peers in terms of revenue growth. Given the resilient revenue profile due to their presence in the global Fortune 500 accounts and service offerings, tier-1 companies are better off amid macro challenges. Further, tier-1 players are likely to benefit from the shift towards cost optimization and vendor consolidation deals.

Exhibit 22: Tier-1 and tier-2 USD revenue growth QoQ (%)



Source: MOFSL, Company

Vendor consolidation

The commentaries across large companies are suggesting increasing vendor consolidation opportunities in the space. In vendor consolidation deals, the large players have edge to win the share from smaller players given their scale and end-to-end capabilities. In the current scenario, the companies are consolidating the mandates to a few large vendors. Further, vendor consolidation deals offer larger scope for the remaining companies, which increases the control and efficiency for the vendor.

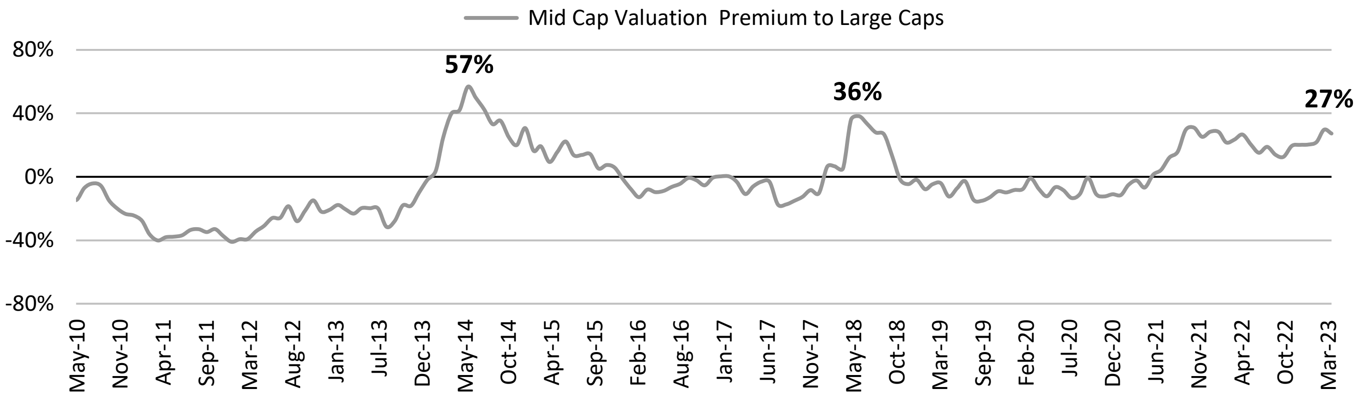
Large, cost take-out deals

With weakening macro environment, clients have started cutting on discretionary spends with increased focus on cost optimization. Automation and efficiency-driven deals are seen as deflationary forces in an environment where inflation continues to remain elevated. Clients continue to focus on projects with high ROIs and low payback period with immediate return. Commentaries across IT services space suggest caution in discretionary spending and the companies increased the amount of cost optimization mandates in the deal pipeline.

Resilient diversified portfolio and end-to-end capabilities

Tier 1 companies have more resilient portfolio of large companies and offer a more diversified play. End-to-end proficiencies and superior execution capabilities make tier-1 companies more resilient than tier-2 names in a weakening macro environment.

Exhibit 23: Mid-cap IT valuation premium to Large-cap IT should reverse going forward



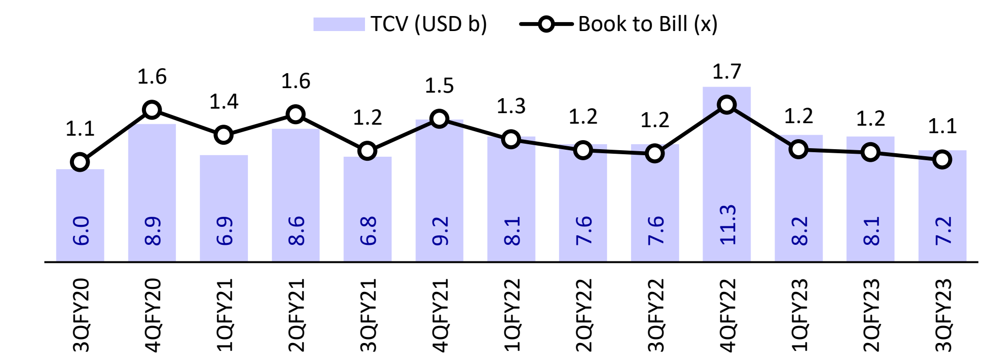
Source: MOFSL, Company

The valuation premium of mid-cap companies over large-cap has stayed elevated (at ~39%) for a longer time-frame than it has been in the earlier two cycles (at ~36% and ~57%, respectively). We believe the valuation premium of mid-cap over large-cap has peaked and should trend downwards. Therefore, we believe that tier-1 companies are better positioned in a weakening macro environment.

TCS remains our Top Pick

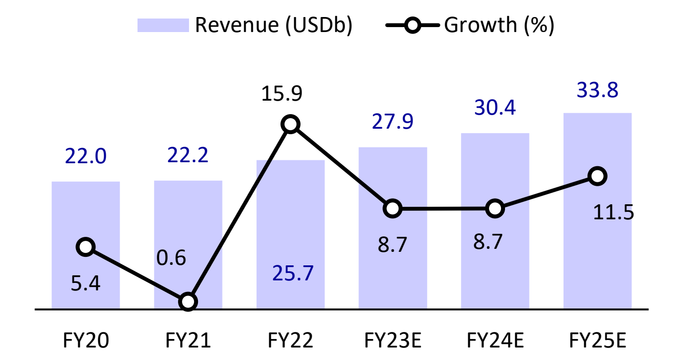
We believe TCS, within our IT services coverage universe, is best positioned to benefit from the near-term moderation in technology spending because of macroeconomic stress in developed economies. With tech spending shifting towards cost efficiency (v/s focus on transformation over the last two years), TCS' revenue growth is expected to outperform its peers due to its industry leadership in cost optimization and strong order book. Further, its better operational efficiencies are likely to drive up its profitability, leading to a strong INR PAT growth in a tough year.

Exhibit 24: TCS' deal wins continue to remain strong despite macro concerns



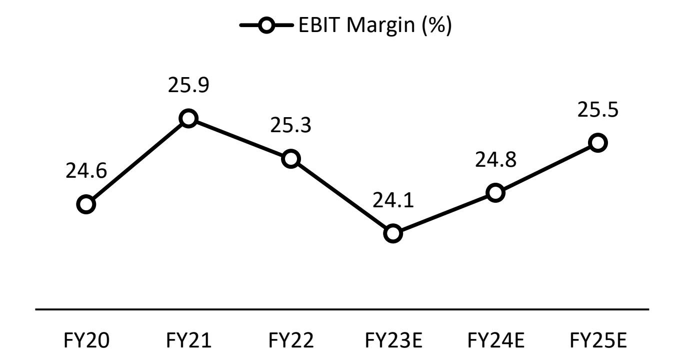
Source: Company, MOFSL

Exhibit 25: Revenue growth to remain strong



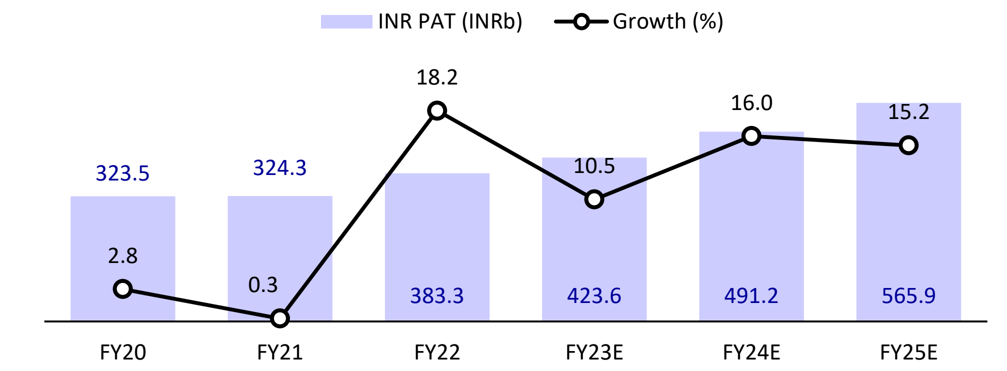
Source: MOFSL, Company

Exhibit 26: Supply easing; expect strong recovery in margins



Source: MOFSL, Company

Exhibit 27: Robust revenue growth and margin recovery will lead to strong PAT growth

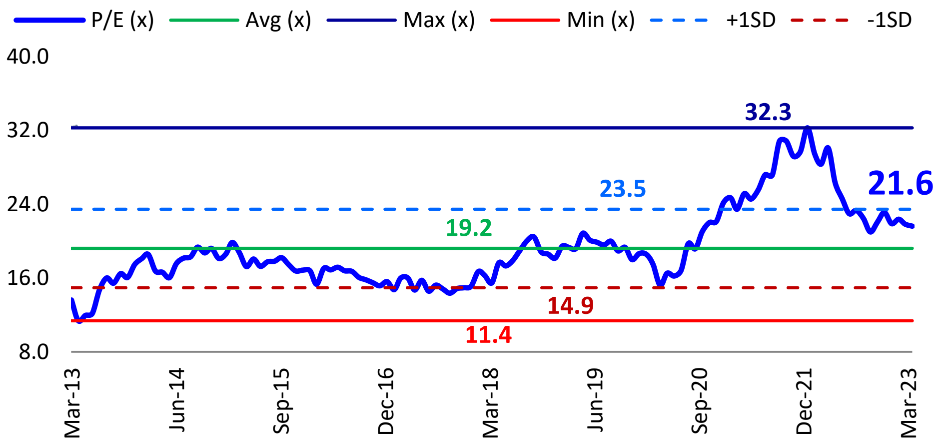


Source: MOFSL, Company

Valuations and view – Remain constructive on longer term demand

- Though the current macro environment remains weak, the structural demand outlook for the sector remains intact. We continue to believe that the macro challenges will ebb by 1HFY24 and the situation will start improving in the later part of the year. This should be followed by healthy recovery in FY25E with improved visibility for clients and catch up in tech spends.
- Cloud migration and digital transformation initiatives will continue to drive significant demand for Indian IT companies over the medium term. Normalization in hiring, increased fresher additions, lower attrition, improvement in utilization and decreased reliance on sub-contractor expenses should drive margin expansion.
- Valuations have significantly corrected from their peaks as we believe that the concerns on macro environment have already been factored into the valuations.
- We remain selective in the space and view any correction in the preferred names as an opportunity to accumulate further. We continue to like TCS, HCLT, and INFO within tier-1 space and CYL and ZENT among the tier-2 players.

Exhibit 28: IT services' P/E



Source: MOFSL, Company

NOTES

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Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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