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Top Sector Ideas: IT Services

Omkar Tanksale

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Lack of Near Term Visibility

- ✓ **Disappointing revenue growth:** Most IT companies have reported disappointing revenue growth in Q4FY24, indicating subdued demand from the world's largest economies. The Indian IT Services sector does not foresee a quick recovery in discretionary spending due to uncertainty in macroeconomic factors.
- ✓ **Revenue growth** from North America continues to lag behind Europe for Tier-1 tech companies, similar to recent quarters. On the vertical front, the BFSI sector witnessed tepid growth. Companies continue to report no improvement in the discretionary spending environment, although they expect some improvement in BFSI vertical performance through FY25, following pressure throughout FY24. Verticals such as Telecommunication and Hi-tech are struggling to demonstrate strong growth. Lower discretionary spending is likely to continue, as many IT services companies lack visibility in the near term. However, the outlook for verticals like Retail and Manufacturing continues to show better growth momentum.
- ✓ **Margin performance** for Q4FY24 was mixed despite reduced supply-side constraints. Among Tier-1 Techs, TCS and Wipro demonstrated superior execution with margin expansion for the quarter, while TechM's margins have started to recover from an unsustainably low level and deterioration throughout most of FY24. Tier-1 techs, except for Infosys and TechM (due to significant restructuring in progress), have managed to improve margins slightly in FY25 despite weak revenue growth, aided by tight cost optimization, including lower sub-contracting expenses. Conversely, Tier-2 techs, which previously excelled at defending or improving margins through FY20-23 due to superior growth, have seen margins come under slight pressure in FY24. Even companies like Persistent reported a YoY drop in margins despite benefiting from certain one-time reversals.
- ✓ **Midcap IT Services/Tier-2 IT Services** companies, which showed relative margin resilience through FY21-23, were impacted by moderating growth through FY24 and now guide for stable margins in FY25. We see only a likely modest recovery in FY25E and therefore continue to advocate a tactical approach, with preference for TechM among Tier-1 techs and KPIT, Zensar, and Firstsource among the Tier-2s.
- ✓ **Employee Count:** Employee count continued to decline for the second consecutive quarter for the majority of large-cap IT companies, indicating sluggish demand or no large deal ramp-ups in the near term. Among large caps, only HCL Tech reported positive hiring compared to the previous year. Midcap IT Services companies showed a similar trend of slowing down on hiring as they lack visibility, with most companies highlighting the scope for cost optimization.
- ✓ **Deal Wins:** Deal wins remained resilient despite ongoing uncertainty. The demand for newer technologies such as AI, cloud transformations, data analytics, and IoT remains strong, with the majority of companies closing all-time high deals. This indicates that when macroeconomic factors turn positive, there will likely be a strong V-shaped recovery.

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IT Services: Q4FY24 Review – Hits & Misses

Q4FY24 Review: Uncertainty Continues; H2 FY25 May Witness Quicker Recovery

✓ ***Key POSITIVES***

- Despite the delay in automation spending, particularly from North America**, deal wins remained strong** during the quarter. Many Indian IT service companies see continued demand for new-edge technologies like generative AI, IoT, and machine learning, despite the lack of near-term visibility.
- The **attrition rate has dropped**, indicating some easing on the supply side constraints, which would help IT service companies improve their operating margins.
- **Europe performed relatively better** compared to North America. Engineering, Research, and Development (ER&D) services remained resilient compared to traditional IT services.
- The management of most major IT companies anticipates a pickup in demand from FY25 and expects to ramp up deals as soon as uncertainties settle down.

✕ ***MISSES during the quarter***

- Growth visibility is likely **to remain under pressure** as the slowdown negatively impacts overall business activity.
- Delayed decisions have **weakened revenue growth momentum**, even if the deal wins remain resilient.
- Higher onsite expenses and rising costs and pricing pressure have negatively **impacted operating margins**.
- Lack of visibility caused IT providers to **slow down the hiring process**, impacting future revenue growth momentum.

IT Services: Sector Outlook & Key Monitorables

What does FY24 hold for IT Services?

IT Services Outlook

- ✓ After strong revenue growth momentum in FY22 and FY23, we believe IT services may face challenges on demand and margin fronts on account of the economic slowdown and macroeconomic uncertainties. We have a skeptical near-term outlook due to delayed decision making for automation.
- ✓ Deal wins remained resilient even during the difficult times, which gives us confidence that automation spending will rebound strongly in next couple of quarters. Demand in industries such as retail and manufacturing remains strong and is expected to regain momentum in the near future.
- ✓ Demand for newer technology services such as generative AI, machine learning, IoT, and cloud transformations remains stable and is likely to recover more quickly as certain macroeconomic challenges subside.
- ✓ We continue to believe that most IT services companies will regain momentum in couple of quarters as deal wins remain resilient and supply-side challenges ease. Dovish stand taken by Federal Reserve may encourage macroeconomics in North America which may drive demand for Automation spend.

Key monitorables

- ✓ Primary rate cuts in North America will lead to a sharp recovery in the Indian IT services sector.
- ✓ Easing Banking crisis is expected to lead to higher confidence in automation spend and is likely to lead to a strong recovery in the BFSI vertical.

Short and Medium-term Outlook

The Indian IT services industry is facing near-term challenges due to the economic slowdown and weaker macroeconomic outlook. However, its long-term outlook remains robust with the economy showing signs of recovery. We believe that the said recovery will begin in the start of the new year and FY25 will show strong revenue growth.

(a) Near-term demand visibility remains a key monitorable;

(b) Challenging macro environment could potentially slow down growth

(a) Broad-based growth led by Manufacturing/Retail segments

(b) Deal wins still remain resilient

(c) Easing supply-side constraints to help gain margins

Key monitorables – *(1) Development in macroeconomic conditions, (2) Ability to spend on the automation by world's largest economies.*

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Top Sector Ideas: IT Services

Stock	Reco.	TP/CMP	Recommendation Rationale
Persistent Systems	BUY	Rs 4,350 (CMP Rs 3,510)	✓ **Persistent Systems continues to report strong growth** even during the challenging times with increasing client engagement. TCV in Q4FY24 stood strong with deal wins at $447 Mn. The management is confident of gaining medium-term demand momentum on the backdrop of the deals it has won in the previous quarters. It also expects improvement on the margin front. ✓ **Strength in medium-term demand continues:** The UK is seeing higher cost optimization deals (with faster decision-making), while the European market continues to be impacted. As the macroeconomic environment stabilizes, the company expects decision making to pick up. ✓ **Broad-based vertical growth:** On the vertical front, the BFSI, Pharma, Tech, and Other verticals delivered an encouraging QoQ growth of 1%/4%/1% respectively. The majority of the verticals witnessed strong growth and are likely to report further growth backed by a strong deal pipeline in the near term. ✓ We believe Persistent is **well positioned for encouraging growth given its numerous long-term contracts** with the world's leading brands. Improved revenue visibility gives us confidence in the company's continued growth. ✓ We assign **a 35x P/E multiple to its FY26E earnings** of Rs 125.8/share to arrive at **a TP of Rs 4,350/share, implying an upside of 24% from the CMP.** Hence, we recommend a BUY rating on the stock.

** Note: Target Price is based on our Q4FY24 Result Update Report*

Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
KPIT Tech Ltd.	BUY	Rs 1,750 (CMP Rs 1,499)	✓ **Accelerating demand for digital ER&D services:** Digital engineering spends are accelerating across industries, and companies moving from traditional to digital engineering will quickly adopt digital engineering. Major industries such as Manufacturing, BFSI, Media & Technology, Retail, Healthcare Payers & Providers, and Travel & Hospitality are developing new products and services to differentiate themselves in their respective industries, thereby creating remarkable opportunities for the company. ✓ **Broad-based vertical growth:** On the vertical front, the Passenger Car vertical grew by 6.2% QoQ, demonstrating robust execution. The management is also confident in continuing the growth momentum in the near term. The strategic revenue from these clients grew by 8.4% on a QoQ basis. Client concentration has also increased from 85% in Q3FY24 to 86% in Q4FY24. ✓ **Robust Services mix:** On the Services line front, Feature development and integration services (90% of revenue) showed a strong growth of 7.5% QoQ. Cloud-based connected services (26% of revenue) continue with strong growth of 9% QoQ, while Architecture and Middleware consulting (29% of revenue) continue to demonstrate growth of 6.1% QoQ. ✓ Given the company's strong growth potential, supported by solid deal-making and excellent execution capabilities. We **assign a 47x P/E multiple to its FY26E earnings of Rs 37.1/share to arrive at a TP of Rs 1,750/share, implying an upside of 17% from the CMP**. Hence, we recommend a BUY on the stock.

** Note: Target Price is based on our Q4FY24 Result Update Report*

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Sr. Nos	Name	Designation	E-mail
1	Neeraj Chadawar	Head of Research	neeraj.chadawar@axissecurities.in
2	Preeyam Tolia	Research Analyst	preeyam.tolia@axissecurities.in
3	Omkar Tanksale	Research Analyst	omkar.tanksale@axissecurities.in
4	Uttamkumar Srimal	Research Analyst	uttamkumar.srimal@axissecurities.in
5	Ankush Mahajan	Research Analyst	ankush.mahajan@axissecurities.in
6	Dnyanada Vaidya	Research Analyst	dnyanada.vaidya@axissecurities.in
7	Aditya Welekar	Research Analyst	aditya.welekar@axissecurities.in
8	Prathamesh Sawant	Research Analyst	prathamesh.sawant@axissecurities.in
9	Akshay Mokashe	Research Analyst	akshay.mokashe@axissecurities.in
10	Shikha Doshi	Research Associate	shikha.doshi@axissecurities.in
11	Shridhar Kallani	Research Associate	shridhar.kallani@axissecurities.in
12	Suhanee Shome	Research Associate	suhanee.shome@axissecurities.in
13	Shivani More	Research Associate	shivani.more@axissecurities.in

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Compliance Officer: Jatin Sanghani, Email: compliance.officer@axisdirect.in, Tel No: 022-49212706