AXIS SECURITIES

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Top Sector Ideas: IT Services

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IT Services: Q3FY24 Review – Hits & Misses

Q3FY24 Review: Near-term Challenges Still Persist; FY25 may witness quicker recovery

✓ *Key POSITIVES*

- Despite the delay in automation spending(specially from North America), deal wins remained strong during the quarter. Many Indian IT service companies sees the demand for new edge technology like generative AI, IoT Machine learning etc despite the lack of near-term visibility.
- The attrition rate has dropped as we see some easing on the supply side constraints. This would help IT service companies improve their operating margins.
- Europe stood relatively strong as compared to North America. ER&D services remained resilient as compared to traditional IT services.
- *Management of majority of IT major sees pickup in demand from FY25 and likely to ramp-up deals as soon as uncertainties will 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 have negatively impacted operating margins.
- Lack of visibility caused IT providers to slow down the hiring process, which impacted 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 for North America (~40% of revenue).
- ✓ 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 researve 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.*

Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
Coforge Ltd.	BUY	Rs 6,905 (CMP Rs 6,545)	✓ We are encouraged by the **improved outlook in the vertical and engagement with clients** gives us confidence in the company's future prospects. ✓ **TCV was strong in Q3FY24, with robust quarter-high deal wins at $354 Mn each in BFSI and Travel verticals.** ✓ **Continuing strength in demand environment in the medium term:** The US is seeing higher cost optimization deals (with faster decision-making) while the Europe market remains impacted. As the macro environment stabilizes, the company expects decision-making to pick up. Coforge has also won deals across verticals indicating strong demand across geographies even during challenging times. It has strong execution capabilities and improved client engagement indicating a strengthened growth prospectus going ahead. ✓ **Broad-based vertical growth:** On the vertical front, the BankingI/Insurance/Transport verticals delivered an encouraging growth of 3.4%/4%/3% QoQ respectively. Other verticals grew by 1% QoQ. 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. ✓ The recently stock has moved up however we remain confident on the company's growth in near future. **We recommend buy on dips on the stock with the targeted price.**

** Note: Target Price is based on our Q3FY24 Result Update Report*

Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
Persistent Persistent Systems	BUY	Rs 9,570 (CMP Rs 8,524)	✓ **Persistent Systems continues to report strong growth** even during the challenging times with increasing client engagement . TCV in Q3 FY24 stood strong in Q3FY24 with deal wins at $521 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 upgrade the stock valuation from 35x FY26E earnings to 40x to its FY26E earnings, given the company's strong growth potential, supported by solid deal-making and excellent execution capabilities. We assign a 40x P/E multiple to its FY26E earnings of Rs 239.1/share to arrive at a **TP of Rs 9,570/share, implying an upside of 12% from the CMP. Hence, we recommend a BUY on the stock.**

** Note: We have upgraded target price from our Q3FY24 result update report*

Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
KPIT Tech Ltd.	BUY	Rs 1,750 (CMP Rs 1,565)	✓ **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 3.9% on a QoQ basis. Client concentration has also increased from 84% in Q2FY24 to 85% in Q3FY24. ✓ **Robust Services mix:** On the Services line front, Feature development and integration services (90% of revenue) showed a strong growth of 3.8% 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 de-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 10% from the CMP. Hence, we recommend a BUY on the stock.**

** Note: Target Price is based on our Q3FY24 Result Update Report*

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