AXIS SECURITIES

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Top Sector Ideas: IT Services

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IT Services: Q1FY24 Review – Hits & Misses

Q2FY24 Review: Near-term Challenges Persist

✓ *Key POSITIVES*

- Despite the delay in automation spending, deal wins remained strong during the quarter. Many Indian IT service companies reported the highest-ever order book despite the lack of near-term visibility.
- The attrition rate has dropped as we see some easing on the supply side. This would help IT service companies improve their operating margins.
- Subcontractor costs are likely to weaken as demand weakens, which should have a positive impact on operating margins.
- Europe stood relatively strong as compared to North America. ER&D services remained resilient as compared to traditional IT services.

× *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 two to three 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 the second half of the year as deal wins remain resilient and supply-side challenges ease. Many companies are becoming increasingly system-oriented and are unable to escape the costs of automation, thereby creating strong long-term demand

Key monitorables

- Any positive news from North America will lead to a sharp recovery in the Indian IT 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.

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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 second half of the year and FY24 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 Coforge Ltd.	BUY	Rs 5,655 (CMP Rs 5,362)	✓ 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 Q2FY24, with robust quarter-high deal wins at $331 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 4%/2%/2% 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. ✓ Given the company's strong growth potential, supported by solid deal-making and excellent execution capabilities, 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.**

** CMP as of 16th Aug'23*

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Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
Persistent Persistent Systems	BUY	Rs 7,200 (CMP Rs 6401)	✓ **Persistent Systems continues to report strong growth** even during the challenging times with increasing client engagement . TCV in Q2 FY24 stood strong in Q2FY24 with deal wins at $479 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 30x P/E multiple to its FY26E earnings of Rs 239.1/share to arrive at a **TP of Rs 7,200/share, implying an upside of 12% from the CMP. Hence, we recommend a BUY on the stock.**

** CMP as of 16th Aug'23*

Top sector Ideas: IT services

Stock	Reco.	TP/CMP	Recommendation Rationale
Indiamart Intermesh Ltd. (Indiamart)	BUY	Rs 1700 (CMP Rs 1,478)	✓ **Robust investments in commercial vehicle segments:** While the aggregate global market in value terms for medium & heavy commercial vehicles is smaller than passenger vehicles, the commercial vehicle category is especially relevant from an autonomous driving and electrification standpoint. The key variable costs for fleet operators in the CV arena are driver cost and fuel. Autonomous driving technologies and electrified powertrains are cutting costs and making trucking and logistical service operations more cost-effective and profitable. ✓ **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. ✓ In light of these compelling factors, we wholeheartedly recommend a "BUY" rating for KPIT Technologies Ltd. **We have assigned a Target Price of Rs 1,700/share**, derived by applying a multiple of 49x to its FY26E earnings of Rs 34.9/share. This calculation underscores the strong growth potential of KPIT, **promising an attractive upside of 15% from the CMP.**

** CMP as of 16th Aug'23*

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