

RESEARCH
IT SERVICES | Q1FY24 PREVIEW

No sign of demand improvement yet

BOB ECONOMICS RESEARCH | MONTHLY CHARTBOOK

Hawk-eyes on inflation

SUMMARY
IT SERVICES | Q1FY24 PREVIEW

- Despite seasonality, Q1FY24 growth is likely to remain weak while margins are unlikely to surprise positively
- High interest rate and inflationary pressure in USA / Europe will likely continue to weigh on the discretionary demand recovery
- We downgrade HCLT, PSYS, COFORGE & AFFLE to HOLD on run-up in share prices. Infosys is our top pick in the sector

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INDIA ECONOMICS: MONTHLY CHARTBOOK

Inflation concerns in India reignited with some upswing in vegetable prices especially tomato (0.57% wt in CPI) and onion (0.64% wt in CPI). Though there is some seasonality involved, production has also been impacted due to erratic rains. Apart from this, lower acreage of pulses and rice have added to woes. We expect CPI to settle ~4.6% in Jun'23. The trajectory would pick up further since Q3 onwards, once favourable base dissipates. On growth front, high frequency data painted a mixed picture, even though macros are favourably placed relative to global peers. While Centre's capex picked pace, new project announcements showed some degree of softening in Q1FY24, albeit higher than same period of previous year. The growth inflation puzzle will likely keep RBI in a 'wait and watch mode' throughout CY23.

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Daily macro indicators

Ticker	05-Jul	06-Jul	Chg (%)
US 10Y yield (%)	3.93	4.03	10bps
India 10Y yield (%)	7.11	7.15	4bps
USD/INR	82.22	82.51	(0.3)
Brent Crude (US\$/bbl)	76.7	76.5	(0.2)
Dow	34,289	33,922	(1.1)
Hang Seng	19,110	18,533	(3.0)
Sensex	65,446	65,786	0.5
India FII (US\$ mn)	04-Jul	05-Jul	Chg (\$ mn)
FII-D	6.6	42.6	35.9
FII-E	306.9	278.7	(28.2)

Source: Bank of Baroda Economics Research

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07 July 2023

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No visible growth triggers near term: Due to a soft demand outlook with limited large deals during Q1FY24, we expect QoQ revenue growth for our coverage companies to be in the range of -1.5% (Wipro) to +3.4% (Persistent) in CC terms. We expect weak sequential growth due to slowdown in communication, media, and entertainment verticals. Note, many IT companies faced spending cuts and project cancellations in Q4FY23, especially on the discretionary side. We believe these cancellations will, in part, offset growth from new projects.

Margin pressures to continue: We expect margins to be adversely impacted by seasonal factors too (visa cost / wage hike / travel expenses). Indian IT companies are finding it difficult to exploit traditional levers such as utilisation and pyramid correction in the current low growth environment. The pricing seems stable currently but a shift in client focus from discretionary to efficiency would adversely impact realisations. Companies like HCLT and TCS, with a higher revenue share from maintenance spends, are better placed to manage margins. Note, over the last two years, Infosys faced higher wage inflation versus TCS, however, recent deal wins will likely help Infosys bill more for these resources.

TCV to remain concentrated in a few verticals: Though the demand remains intact for select verticals and service lines, there is a near-term weakness visible due to approval delays/ deal scrutiny. This in turn may result in project deferrals and temporary pauses in project execution. As per guidance from Accenture, (details in our note [ACN report](#) of 23 June 2023) demand environment in Q1FY24 is likely to remain tepid. We do not anticipate a sharp recovery in H2FY24 either. The recovery in our view is likely to be gradual with higher growth likely only from FY25 onwards.

Downgrade to HOLD: We downgrade HCL Tech, Persistent, Coforge and Affle from BUY to HOLD on recent stock runs, which in our opinion capture positives fairly. There is no change in our estimates or target price. Note, rationalisation in clients' discretionary spends could lead to more earnings downgrade post Q1FY24 results in our view. We also expect the Q1FY24 commentary to be weak. Infosys will report the highest CC growth in Q1 among large cap IT names as per our estimates.

Recommendation snapshot

Ticker	Price	Target	Rating
AFFLE IN	1,057	1,110	HOLD
COFORGE IN	4,692	4,830	HOLD
HCLT IN	1,158	1,240	HOLD
INFO IN	1,330	1,760	BUY
MPHL IN	1,878	2,541	BUY
PSYS IN	4,830	5,330	HOLD
TCS IN	3,329	3,580	HOLD
TECHM IN	1,156	1,130	HOLD
WPRO IN	396	420	HOLD

Price & Target in Rupees | Price as of 7 Jul 2023



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Demand continues to strengthen: Domestic demand continued to largely shine with electricity demand, non-oil-non-gold and electronic imports registering improvement. Digital payments including UPI payments continued to remain strong. Some deceleration was seen in PV sales. Electric vehicle sales on MoM basis took a strong beating after the reduction in FAME subsidies by government. Moreover, some moderation in both manufacturing and services PMI was also noticed, though both remained in the expansionary zone. On rural front, led by supply side challenges two wheeler sales recorded contraction in Jun'23. After a delayed start, monsoon has picked up pace (5% below LPA- 6 July) with improvement in kharif sowing. However, acreage of rice and pulses continue to be lower than last year.

Health of centre's finances: Fiscal deficit ratio (% of GDP, 12MMA basis) of the central government inched down to 6.2% as of May'23, from 6.5% as of Apr'23. On FYTD basis (Apr-May), revenue collections improved, as contraction

in gross tax revenue growth softened to (-) 1.3% from (-) 6.1% in Apr'23. Net revenue growth rebounded to 15.7%, from (-) 13.9% in Apr'23. Contraction in direct tax collections eased and indirect tax receipts recovered. On the other hand, spending growth slowed to 6.9% in Apr-May'23 from 10.6% in Apr'23. Revenue expenditure fell sharply (-4.3% versus 15.2%), while capex outgo gained momentum (56.7% versus -0.6%). We expect, expenditure growth to pick up pace in the next few months.

India's 10Y yield inched up: India's 10Y yield rose by 13bps in Jun'23, and by another 3bps in Jul'23 (till 6th). This has been in tune with rising global yields especially in the US and UK. Hawkish rhetoric by major global central banks on the backdrop of puzzling growth inflation dynamics have resulted in the same. RBI's reiteration of maintaining 4% inflation target repeatedly, also signalled a hawkish pause. Further, reversal in prices of onion, tomato and few components of pulses on the back of seasonality and drop in production, have added to further woes. We expect 10Y yield to trade between 7.05-7.15% in the current month, with risks tilted to the upside.

Fed rate hikes to weigh on INR: After registering its best week since Jan'23, INR has once again come under pressure. Minutes of Fed policy highlighted that members are leaning towards further rate hikes. Even macro data from US supports this narrative. Hence, expectations of 2 rate hikes by Fed have increased, which have contributed to a rally in DXY. This is weighing on INR which closed Jun'23, higher by 0.8%. FPI inflows, range-bound oil prices and RBI's forex intervention should help ease some of this pressure. We expect INR to trade in the range of 82-83/\$ in the near-term.

Note: The source for all exhibits is 'CEIC and Bank of Baroda' unless otherwise specified

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Note: Recommendation structure changed with effect from 21 June 2021

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