

RESEARCH**[SECTOR REPORT] IT SERVICES**

Slow is the (new/old) normal

SUMMARY**[SECTOR REPORT] IT SERVICES**

- Reinitiate with Underweight stance. Current high PE multiples imply sharp growth pickup in FY25-FY27E. We think it will be slower
- Trump, Covid excess, hyper scaler power, Gen AI compression, GCC expansion, market share shift, etc, will drive 'slow is the normal'
- The earnings dynamic between domestic companies and IT, holding up the latter, we believe, will reverse. Prefer INFO, TECHM, FSOL and ECLX

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IT SERVICES

01 January 2025

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Recommendation snapshot

Ticker	Price	Target	Rating
BSOFT IN	576	508	SELL
COFORGE IN	9,451	6,357	SELL
ECLX IN	3,650	3,695	HOLD
FSOL IN	369	408	HOLD
HCLT IN	1,892	1,728	SELL
INFO IN	1,917	1,970	HOLD
LTIM IN	5,678	5,438	HOLD
MPHL IN	2,884	2,744	HOLD
PSYS IN	6,394	3,721	SELL
TCS IN	4,165	3,923	HOLD
TECHM IN	1,712	1,928	HOLD
WPRO IN	309	251	SELL
ZENT IN	739	654	SELL

Price & Target in Rupees | Price as of 27 Dec 2024

Sector's performance disconnected with earnings: Nifty IT has run up ~34% since 1 June 2024, while consensus earnings for FY25/FY26 have seen modest cuts. Tier-1 and Tier-2 Indian IT services stocks are trading at +1 SD and +2 SD above their five-year means respectively. Expectations of a sharp growth pick up, 'cheaper' relative valuation and relative near-term earnings resilience (vs certain domestic sectors which are experiencing downgrades) are holding up the sector, in our view. Gen AI growth optionality is also built in, on which there is little visibility.

Only a modest near-term acceleration: Even under a US soft landing (with lower interest rates), we think USD revenue growth of Tier-1s will fall short of elevated expectation of ~8% over FY25-FY27E (~3% CAGR FY23-FY25). We believe organic US\$ revenue growth for Tier-1s in FY25-FY27 will be slower than in FY15-FY20 (~7%) with margins likely flat with downside risks.

Multiple speed breakers post FY25: (1) Trump policies raise uncertainty. (2) 'Higher for longer US interest rates' backdrop. (3) Covid-induced pull forward of demand requires a multi-year unwind. (4) Massive hyper scaler AI capex should accentuate re-alignment in IT spend. (5) AI/Gen AI is likely to be deflationary over the next 24-36 months. (6) Internal IT services spend is being shifted offshore leading to upsurge in GCC expansion. (7) Accenture & Tier-2s are gaining share. (8) H1-B issue likely to make a comeback impacting margins. (9) Weak TCV in 1HFY25.

Tier-2 will outgrow Tier-1 but margin expansion will be the casualty: Growth will come from addressing the cost take-out market but margin pressures will be visible. Expect Tier-1s to self-cannibalise to protect their turf against both Tier-1 and Tier-2 challengers in the Gen-AI race. We believe the standalone valuation of certain Tier-2 stocks and collective PE premium to Tier-1s is at a historical high and unsustainable.

Initiate on 13 companies: With valuation a concern and risks to elevated growth expectations, we have no BUYs but 7 HOLDs and 6 SELLs. We are relatively more positive on TECHM and INFO in Tier-1s. In Tier-2, FSOL and ECLX look interesting, though the past six-month run up has been steeper than that of their peers.



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BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

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