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IT SERVICES | Q3FY25 Preview | 09 January 2025

2HFY25 TCV and Discretionary pickup key monitorables

- **The ~8% US$ consensus rev growth in FY25-FY27 against ~3% (FY23-FY25) requires a strong TCV pick up in 2H after a weak 1HFY25**
- **Discretionary spending must broaden beyond North America BFSI so that small orders offset the TCV under-delivery if any**
- **The expectation of sharply improving IT earnings versus weakness in domestic earnings will require corroboration in 3QFY25 results season**

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Stock performances have been strong in the last 6 months. However, consensus earnings have been broadly flat or turned down a tad. Part of the reason for the stock performances is the view held by the market that growth is going to pick up to high single digits for Tier-1 companies, FY26 on. The PE multiple expansion has also been driven by sectoral rotation to IT and Pharma due to weak earnings performance by many companies which are domestic oriented. We think the latter trend will be subjected to scrutiny as many domestic drivers are turning around.

TCV pick-up in 2H crucial to the sharp upturn narrative of FY26: 1HFY25 saw a steep decline in TCV of Tier-1 players (YoY) – 35%25%/20% for Infosys/HCLT/TCS - which brings into question the consensus expectation of a sharp US$ revenue growth pick up of ~8% for FY26. While management commentary on demand turned incrementally positive in 1H, there was no follow-through in order inflow. It was after all the strong TCV inflow in FY24 that led to better revenue growth in FY25 versus FY24 (albeit modest. From 2% to ~4%). We are not as bullish as the street due to multiple headwinds. See our recent reinitiation report (**Slow is the (new/old) normal**).

'Soft landing' US macro narrative replaced by 'no landing with higher for longer interest rate' has negative implications: Over the last two quarters, managements of Indian IT services firms based their positivity on the 'soft landing' narrative with growth/inflation/Interest rates headed lower in the US. 10 year yields are higher today by 110bps post a 100bps cut of the US Fed Funds rate (a unique situation). That combined with uncertainty on Trump decisions may delay decision making.

Broader discretionary spending should have happened by now. In our conversations with companies, there still is no sign that discretionary spending is making a broader comeback beyond North America BFSI space.

Tier-2 PE premium to Tier-1 at historic high but would require validation. Our concerns largely revolve around margins for the Tier-2 as there is not enough business to go around (reflected in weak 1H TCV) and competition is very high.

What will we watch out for from a sector perspective during the 3QFY25 results season

- Is the Trump policy agenda leading to uncertainty and delayed decision making. Will purses open immediately after the inauguration or will they wait for clarity on policies/fine print?
- Have the deals that were postponed from 1H (as indicated by many companies) closed in 3Q?
- Why were there no announcements of mega deals (>US$500mn). Or is it that many of them have been closed but are kept under wraps? Or has texture of deal making changed and big orders are being split into smaller ones.
- Has discretionary spending picked up in any new pockets of the market besides North America BFS? Will the era of small deals make a comeback? There have been positive hints dropped on the latter by some companies in 2QFY25 which require validation. The question will be how much of this can move the needle in FY26
- How is the recent 'no-landing-higher-for-longer-interest-rate' macro impacting decision making and clients' spending stance?
- Is there continued strength in demand from BFS in North America and can that sustain into 2HFY25 and beyond?
- Extent of seasonality due to furloughs
- Has there been any scale up in Gen AI engagements? Are some of these deals even reaching US$10mn per annum in size?
- When will the large legacy transformation deals driven by Gen AI start to be a tailwind?
- Has the leakage of the book of business (due to rescoping or cancellation of orders) come to an end completely or is it still a problem?
- Are the clients who signed large contracts in the last 24 months coming back to renegotiate them as they may not have Gen AI productivity benefits embedded in them?
- What exactly is the GCC strategy of various players – some players seem to be helping customers to set them up – what is the long-term plan on this front?
- In the savings led transformation that many players are talking about, are the savings being deployed immediately towards new projects or are such savings being redeployed for some other purposes which are not related to IT?
- Margin levers remaining as many of them have been milked to the maximum extent.
- Thoughts on likely changes to the H1-B visa program and how prepared are the companies to face problems if they crop up.

- Manufacturing: While long-term growth prospects remain positive, short-term softness is anticipated due to supply-side disruptions, particularly within the automotive and aerospace sectors. Is that trend continuing and have any subsegments also joined the slow down camp.
- What will be the structure of a Gen AI infused IT services organisation? Will it be flatter on the delivery side, and would it require employees with more experience and therefore increase the average resource cost?
- There has been considerable talk of a new revenue stream from mainframe modernization – hitherto untouched – using Gen AI by various services providers. Have any revenues been clocked or is it that players are talking only about potential
- There have been several guidance reductions, layoffs of employees and closure of stores by various retail players in the US. Are we reaching another point of weakness in the retail vertical which is a sizable exposure for Indian players.
- Expect some revenue guidance upgrade for Infosys (because we felt the old guidance of flattish QoQ growth in 2H - at the midpoint - looked too conservative)
- Global currency volatility will be a major factor affecting profitability. While a stronger dollar (and hence a weaker INR) benefits most IT companies, the weakness of currencies like the EUR, GBP, JPY, and AUD is likely to offset these gains (cross currency impact)
- Companies with higher exposure to these currencies, like Tech Mahindra and Coforge, will face greater cross-currency headwinds than those more exposed to the US, such as Birlasoft, Mphasis, and LTIM
- Besides, the actual cross-currency impact could be larger from the calculated numbers than what we have used in our estimates.
- **Gen AI:** Data around traction here. Enterprises remain cautious regarding Gen AI, carefully considering ROI and taking time to thoroughly assess potential returns before committing to adoption. As Accenture had said in their 1QFY25 results that while many clients are eager to explore AI, the overall spending environment remains cautious, with most prioritizing AI spending within their existing budgets rather than increasing overall budgets

Fig 1 – Summary of financial performance by Indian IT services industry for 3QFY25

Company Name	3QFY25E Revenue	QoQ CC	US$ revenue growth (%)		EBIT Margin (%)		
	US$ mn	Growth (%)	QoQ	YoY	3QFY24	2QFY25	3QFY25E
TCS	7,643	0.5	(0.35)	5.0	25.0	24.1	24.1
Infosys	4,901	1.0	0.14	5.1	20.5	21.1	21.0
HCLT	3,594	5.0	4.32	5.2	19.7	18.6	19.5
Wipro	2,607	(1.0)	(1.99)	(1.8)	14.8	16.8	16.2
Tech Mahindra	1,573	0	(1.00)	(0.0)	5.4	9.6	9.3
LTI Mindtree	1,132	1.0	0.44	4.4	15.4	15.5	13.9
Mphasis	428	2.0	1.64	6.4	14.9	15.4	15.2
Persistent Systems	354	3.0	2.59	17.9	14.5	14.0	14.1
Coforge	375	2.8	1.63	33.1	13.8	11.7	11.3
Birlasoft	164	1.0	0.65	1.9	14.4	10.5	10.8
Zensar	153	(1.0)	(1.74)	6.1	14.6	13.1	13.1
Firstsource	248	8.4	7.97	29.3	10.7	10.8	11.4
Eclerx	100	2.1	1.43	10.8	23.1	22.0	21.0

Source: Company, BOBCAPS Research. Note: Coforge QoQ growth is inclusive of Cigniti

View on the Indian IT services sector: We reinitiated coverage on the Indian IT Services with UW stance through a report on 1 January, 2025 (**Slow is the (new/old) normal**).

Current valuations are disconnected with fundamentals. Since 1 June 2024, Nifty IT has outperformed Nifty significantly. However, consensus earnings for FY25 and FY26 have not moved much during this period. It has been an entirely PE expansion story. Tier-1 and Tier-2 Indian IT services stocks are trading at +1 SD and +2 SD above their five-year means respectively. The PE premium of Tier-2 to Tier-1 is at its historic peak.

Current high PE multiples imply sharp growth pickup in FY25-FY27E. We think it will be slower. We do not believe structurally Indian IT services industry will see the pandemic's 'compressed transformation' type of demand in the foreseeable future. We believe the industry's structural USD organic revenue growth from here on will be lower than the ~7% CAGR – seen during FY15-FY20.

10-year study of valuations and earnings growth indicates that Indian IT stocks are currently trading at +2.1 SD to +18.3 SD higher valuations compared to the mean multiples during the FY15-FY20 period. Yes, we would admit that certain companies have undergone a structural change for the better, but not to the extent that the bulls assume and not all of them.

Multiple speed breakers post FY25 drives our underweight stance

- Trump policies raise uncertainty. The tariffs, the conditional tax breaks, the immigration push back, DOGE, etc all point to uncertainty in the coming days which may delay decision making.
- Higher for longer interest rate environment: One of reasons for optimism around the Indian IT service sector in recent quarters has been the view that US would achieve a soft landing in 2025 (which we define as 0.5- 1.5% real GDP growth) and

that Fed Funds rate would be gradually lowered from the recent peak of 5.25-5.5%, driven by lower inflation. This, the market felt, was the apt environment for a broader pick up in discretionary spending beyond that of North American BFSI sector, especially after two muted years when the constant refrain from vendors for the weak growth was of 'macro uncertainty'. However, recent inflation prints, stronger GDP growth, and a higher fiscal deficit have raised concerns. With US 10-year yields rising to 4.7% from a September 2024 low of 3.6%, there are fears that sustained high interest rates could reduce IT outsourcing demand, particularly in sectors like BFSI and Telecom, and dampen US consumption in areas like housing, autos and retail.

- Covid-induced pull forward of demand requires a multi-year unwind. We think there were excesses during the compressed transformation phase which are yet to be fully unwound.
- Gen AI – value compressive in the near term: Gen AI has significantly boosted revenue in semiconductors, data centers, and hyper scalers, but IT services have seen limited benefits. ROI remains a top concern arise due to heavy investment in surrounding services
- Massive hyper scaler AI capex should accentuate re-alignment in IT spend: Software players, including hyperscalers, are increasing capex on AI-related data centers. This will drive higher pricing, forcing enterprises to allocate more IT spend to cloud/SaaS
- Indian Tier-1 companies now face higher competition from Accenture, Tier-2 players, and Cognizant, likely slowing their growth compared to FY15-FY20. This is besides the fact that by FY25, Tier-1 revenue will reach $85bn, double that in FY15. Due to the higher base now, growth may not be as rapid as it was when the base was lower
- The weak TCV for certain players in 1HFY25 and lack of any mega deal announcements in recent quarters points to a brewing growth problem for FY26

How we are valuing companies: We are using PE methodology and using TCS as our industry benchmark. The target PE multiple used for TCS is 24.6x (which is the average PE multiple of TCS over the last 5 years less 1SD). This is by no means pessimistic. 24.6x is higher than the 23.6x multiple which was the mean multiple of the FY15-FY20 time frame when revenue growth was ~150bps faster. During the Global Financial Crisis (GFC) downturn, the stock traded in the single digit PE multiple territory. We are using a 1SD discount to the five-year PE as we believe that industry and TCS will see a 'slower for longer' growth situation.

Why use a PE multiple that is 1SD lower than 5-year mean of TCS:

Through our choice of the benchmark Target PE multiple, we seek to capture the probability of downside risks to consensus growth expectations for FY26/FY27.

While the strong consensus estimates seem to imply a soft-landing macro scenario in the US, the higher probability event is a 'no landing, higher-for-longer interest rate' scenario which we believe has a 50-60% probability. The probability of a recession is also not insignificant (20% based on Bloomberg estimates).

Some of the speed breakers are industry/technology related, and some are related to the macro and policy environment especially in the US which is the key market for Indian IT services firms. Besides the US, we believe the European market macro looks quite bad (Europe – including UK – forms about 30-40% of revenue for Indian IT services firms) and corporate IT spending would be muted

Tier- 2 valuation reflects growth gap between it and Tier-1:

The Tier-2 set have been taking away market share from the Tier-1 set due to better execution and also due to their smaller size. And unlike in the past cycles, they have performed better than the Tier-1 largely due to better management teams.

However, the current PE premium to the Tier-1s is excessive as we believe that to deliver on the high consensus revenue growth expectations, they may be taking on more cost take out projects which are likely to impact their margins adversely.

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Fig 2 – TCS

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	7,281	7,670	7,643	(0.4)	5.0
Revenue (Rs mn)	6,05,830	6,42,590	6,45,055	0.4	6.5
EBIT (Rs mn)	1,51,550	1,54,650	1,55,651	0.6	2.7
PAT (Rs mn)	1,17,350	1,19,090	1,21,720	2.2	3.7
EBIT Margin (%)	25.0	24.1	24.1	6bps	(89bps)
PAT Margin (%)	19.4	18.5	18.9	34bps	(50bps)

Source: Company, BOBCAPS Research

Fig 3 – Infosys

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	4,663	4,894	4,901	0.1	5.1
Revenue (Rs mn)	3,88,210	4,09,860	4,13,638	0.9	6.6
EBIT (Rs mn)	79,610	86,490	87,047	0.6	9.3
PAT (Rs mn)	61,060	65,060	67,488	3.7	10.5
EBIT Margin (%)	20.5	21.1	21.0	(6bps)	54bps
PAT Margin (%)	15.7	15.9	16.3	44bps	59bps

Source: Company, BOBCAPS Research

Fig 4 – HCL Technologies

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	3,415	3,445	3,594	4.3	5.2
Revenue (Rs mn)	2,84,460	2,88,620	3,03,329	5.1	6.6
EBIT (Rs mn)	56,150	53,620	59,182	10.4	5.4
PAT (Rs mn)	43,500	42,350	46,494	9.8	6.9
EBIT Margin (%)	19.7	18.6	19.5	93bps	(23bps)
PAT Margin (%)	15.3	14.7	15.3	65bps	4bps

Source: Company, BOBCAPS Research

Fig 5 – Wipro

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	2,656	2,660	2,607	(2.0)	(1.8)
Revenue (Rs mn)	2,22,051	2,23,016	2,20,895	(1.0)	(0.5)
EBIT (Rs mn)	32,865	37,555	35,802	(4.7)	8.9
PAT (Rs mn)	26,942	32,494	29,785	(8.3)	10.6
EBIT Margin (%)	14.8	16.8	16.2	(63bps)	141bps
PAT Margin (%)	12.1	14.6	13.5	(109bps)	135bps

Source: Company, BOBCAPS Research

Fig 6 – Tech Mahindra

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	1,573	1,589	1,573	(1.0)	0.0
Revenue (Rs mn)	1,31,013	1,33,132	1,32,747	(0.3)	1.3
EBIT (Rs mn)	7,031	12,804	12,379	(3.3)	76.1
PAT (Rs mn)	5,105	12,501	9,664	(22.7)	89.3
EBIT Margin (%)	5.4	9.6	9.3	(29bps)	396bps
PAT Margin (%)	3.9	9.4	7.3	(211bps)	338bps

Source: Company, BOBCAPS Research

Fig 7 – LTI Mindtree

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	1,084	1,127	1,132	0.4	4.4
Revenue (Rs mn)	90,166	94,329	95,508	1.2	5.9
EBIT (Rs mn)	13,859	14,582	13228	(9.3)	(4.6)
PAT (Rs mn)	11,693	12,516	11,491	(8.2)	(1.7)
EBIT Margin (%)	15.4	15.5	13.9	(161bps)	(152ps)
PAT Margin (%)	13.0	13.3	12.0	(124bps)	(94bps)

Source: Company, BOBCAPS Research

Fig 8 – Mphasis

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	402	421	428	1.6	6.4
Revenue (Rs mn)	33,379	35,362	36,123	2.2	8.2
EBIT (Rs mn)	4,971	5,444	5,506	1.1	10.8
PAT (Rs mn)	3,735	4,234	4,308	1.7	15.3
EBIT Margin (%)	14.9	15.4	15.2	(15bps)	35bps
PAT Margin (%)	11.2	12.0	11.9	(5bps)	74bps

Source: Company, BOBCAPS Research

Fig 9 – Persistent Systems

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	301	345	354	2.6	17.9
Revenue (Rs mn)	24,982	28,972	29,898	3.2	19.7
EBIT (Rs mn)	3,631	4,062	4,201	3.4	15.7
PAT (Rs mn)	2,861	3,250	3,290	1.2	15.0
EBIT Margin (%)	14.5	14.0	14.1	3bps	(48bps)
PAT Margin (%)	11.5	11.2	11.0	(21bps)	(45bps)

Source: Company, BOBCAPS Research

Fig 10 – Coforge

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	282	369	375	1.6	33.1
Revenue (Rs mn)	23,233	30,623	31,685	3.5	36.4
EBIT (Rs mn)	3,201	3,598	3,568	(0.8)	11.5
PAT (Rs mn)	2,380	2,022	2,640	30.6	10.9
EBIT Margin (%)	13.8	11.7	11.3	(49bps)	(252bps)
PAT Margin (%)	10.2	6.6	8.3	173bps	(191bps)

Source: Company, BOBCAPS Research

Fig 11 – Birlasoft

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	161	163	164	0.6	1.9
Revenue (Rs mn)	13,430	13,682	13,872	1.4	3.3
EBIT (Rs mn)	1,932	1,431	1,492	4.3	(22.8)
PAT (Rs mn)	1,611	1,275	1,319	3.4	(18.1)
EBIT Margin (%)	14.4	10.5	10.8	30bps	(363bps)
PAT Margin (%)	12.0	9.3	9.5	19bps	(249bps)

Source: Company, BOBCAPS Research

Fig 12 – Zensar Technologies

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	145	156	153	(1.7)	6.1
Revenue (Rs mn)	12,041	13,080	12,954	(1.0)	7.6
EBIT (Rs mn)	1,764	1,714	1,696	(1.1)	(3.9)
PAT (Rs mn)	1,616	1,558	1,663	6.7	2.9
EBIT Margin (%)	14.6	13.1	13.1	(1bps)	(156bps)
PAT Margin (%)	13.4	11.9	12.8	92bps	(59bps)

Source: Company, BOBCAPS Research

Fig 13 – Firstsource Solutions

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	192	230	248	8.0	29.3
Revenue (Rs mn)	15,966	19,254	20,958	8.9	31.3
EBIT (Rs mn)	1,709	2,081	2,380	14.3	39.3
PAT (Rs mn)	1,287	1,383	1,688	22.1	31.2
EBIT Margin (%)	10.7	10.8	11.4	55bps	65bps
PAT Margin (%)	8.1	7.2	8.1	87bps	0bps

Source: Company, BOBCAPS Research

Fig 14 – Eclerx

	3QFY24	2QFY25	3QFY25E	QoQ growth (%)	YoY growth (%)
Revenue (US$ mn)	91	99	100	1.4	10.8
Revenue (Rs mn)	7,528	8,318	8,461	1.7	12.4
EBIT (Rs mn)	1,737	1,832	1,779	(2.9)	2.4
PAT (Rs mn)	1,386	1,402	1,373	(2.1)	(1.0)
EBIT Margin (%)	23.1	22.0	21.0	(99bps)	(205bps)
PAT Margin (%)	18.4	16.9	16.2	(64bps)	(219bps)

Source: Company, BOBCAPS Research

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