

Q2FY2024 Results Preview

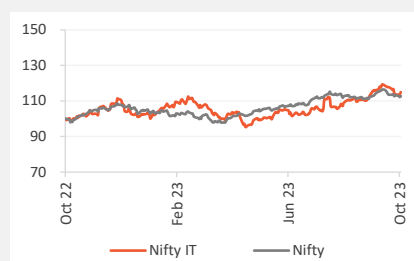
Sector: IT

Sector View: Neutral

Our coverage universe

Companies	CMP (Rs)	Reco.	PT (Rs)
Birlasoft Limited	513	Buy	535
Coforge	5,201	Buy	6,200
Expleo Solutions*	1,382	Positive	1,600
HCL Tech	1,236	Buy	1,265
Infosys	1,462	Buy	1,690
Intellect Design	707	Hold	735
L&T Tech	4,636	Hold	4,225
LTIM	5,227	Buy	5,880
Mastek Limited	2,394	Buy	2,400
NIITMITS	416	Buy	550
Persistent Systems	5,734	Buy	6,000
Tata Elxsi	7,239	Hold	7,500
TCS	3,589	Buy	4,200
Tech Mahindra	1,206	Reduce	1,050
Wipro	407	Hold	420

Price chart



Summary

- ◆ We expect continuity of uncertainty to result in another muted quarter in a seasonally strong quarter for tier 1 companies, which are expected to report constant currency (CC) revenue growth of -0.4% to 1.1% q-o-q; while few of the select outperforming tier 2 companies may witness some moderation, with CC revenue growth of 1.5% to 4.4% q-o-q.
- ◆ EBIT margins are likely to be impacted by slower revenue growth, increased travel, and back-to-office expenses, which may be offset by continuing moderation in sub-contracting costs.
- ◆ Robust deal bookings with several mega and large deals involving cost optimisation and consolidation to support H2 normalisation for tier 1 companies and set the tone for improved FY2025.
- ◆ We believe with the peaking of macro headwinds in the next couple of quarters, long-term digital transformation programmes are expected to resume gradually, but near-term apprehensions may delay any material outperformance following the recent rally. We maintain a Neutral stance on the sector and advise selective investment in the preferred picks.

We expect muted growth for tier 1 IT companies and some moderation in growth for tier 2 companies in a seasonally strong quarter due to weak macros, cuts in discretionary spends, and decision-making delays. We expect q-o-q constant currency (cc) revenue growth of -0.4 to 1.1% for tier-1 Indian IT service companies and 1.5% to 4.4% CC revenue growth for tier-2 IT companies. We expect a modest cross-currency headwind (10-20bps) on the revenue front, as USD has depreciated/appreciated by ~1.1%/0.1% q-o-q vs. GBP and Euro, respectively. EBIT margins are likely to be impacted by slower revenue growth and an increase in travel and back-to-office expenses, which may be offset by continuing moderation in sub-contracting costs. However, EBIT margin is likely to move in a modest range for most tier 1 companies due to the completion of wage hike cycle by some, while few have deferred FY2024 wage hike cycle, thus supporting margins. During the quarter, tier-1 companies led by TCS, Infosys and HCL Technologies have announced multiple large-cost take-out deals, which should result in robust TCV bookings. The deal velocity has picked up, but largely comprises cost take-out deals with discretionary spends continuing to stay muted. While the macro-overhang continues to persist and may weigh on the sector in the near term with increasing cost take-out deals favouring tier 1 companies, select well-diversified tier 2 companies could continue to benefit and display resilience. We believe long-term digital transformation programs will return gradually as macro headwinds start waning after peaking out in the next couple of quarters. However, near-term apprehensions may delay any material outperformance following the recent rally. We continue to maintain a Neutral stance on the sector and prefer TCS, Infosys, and HCL Tech among tier 1 companies and Persistent and Coforge among tier 2 companies, as they are better placed to weather the continuing uncertain environment.

Muted revenue growth: Despite Q2 being a seasonally strong quarter for Indian IT companies, the covered tier 1 Indian IT service companies are expected to continue to report muted sequential revenue growth in CC from -0.4% to 1.1% q-o-q, while select outperforming tier 2 IT companies are expected to report some moderation in CC revenue growth between 1.5% to 4.4% q-o-q. Weak macros, continued uncertainty, rationalisation of discretionary programs and decision-making delays have resulted in a slowdown in discretionary spending and have impacted revenue growth. We expect modest cross-currency headwind (10-20bps) on the revenue front as USD has depreciated/appreciated by ~1.1%/0.1% q-o-q vs. GBP and Euro, respectively. Rupee depreciated by ~1% during the quarter versus USD. TCS, Infosys, and HCL Tech are expected to report 0.8%, 0.7% and 1.1% q-o-q CC revenue growth, while Wipro and Tech Mahindra are expected to report a 0.4% and 0.3% sequential decline, respectively. HCL Tech's growth is expected to be aided by ASAP's acquisition. Under tier 2 companies, Coforge/Persistent/LTTS/Mastek are expected to report decent CC revenue growth of 2.8%/3.1%/3.5%/4.4% q-o-q, respectively. BizAnalytica LLC's acquisition is likely to aid Mastek CC revenue growth.

Margins subdued: For Q2, EBIT margins are likely to be impacted by slower revenue growth, increased travel, and back-to-office expenses, which may be offset by continuing moderation in sub-contracting costs. EBIT margins are likely to report a modest range of -15 bps to 80bps for most tier-1 companies(ex Tech Mahindra) due to the completion of wage hike cycle by some, while a few have deferred FY2024 wage hike cycle, thus supporting margins. Tech Mahindra to see sequential EBIT margin improvement of ~210 bps following sharp drop in Q1FY24. However, the range can be larger for tier 2 IT companies, from around -90 bps to 190 bps. EBIT margins for LTIM/Persistent/Mastek/Tata Elxsi are expected to show a sequential decline of ~40/90/60/40 bps. Coforge is expected to report ~190 bps q-o-q margin improvement after a sharp decline in Q1FY24.

Deal wins: Deal bookings have been robust during the quarter, with several mega and large deals involving cost optimisation and consolidation. Tier-I companies led by TCS, Infosys, and HCL Tech have announced multiple large cost take-out deals, which should result in robust TCV bookings. During Q2FY2024, TCS announced large multi-year deals with NEST (UK), an automotive major, and BSNL, while Infosys announced deals wins (\$1.5-2.0bn) with MNC Telecom company, an undisclosed client and with an existing client. HCL Tech announced significant wins with Verizon and ANZ Banking Group etc. The strong deal velocity is likely to support H2 normalisation and set the tone for an improved FY2025. While demand environment in the U.S. has not shown any meaningful signs of improvement, large cost take-out deals especially from Europe are positive and alleviate some of the growth concerns.

Valuations

Macro apprehensions to restrict material outperformance: After being largely overshadowed by the broader market index due to the plaguing macro environment, IT service companies have started to show a slight outperformance on one-year basis, with Nifty IT Index (up ~ 15%) outperforming benchmark indices (Nifty up ~13%). While the macro-overhang continues to persist and may weigh on the sector in the near term with increasing cost take-out deals favouring tier-1 companies, select well-diversified tier-2 companies could continue to benefit and display resilience. We believe long-term digital transformation programs will return gradually as macro headwinds start waning after peaking out in the next couple of quarters. However, with apprehensions about macros persisting in the near term, material outperformance is likely to be delayed, following the recent rally. We continue to advocate a Neutral rating on the sector and advise selective investment in the preferred picks.

Leaders: TCS, Infosys, HCL Tech, Persistent, and Coforge

Laggards: Wipro and Tech Mahindra

Preferred picks:

- ◆ **Large caps:** TCS, Infosys, and HCL Tech
- ◆ **Mid-cap:** Persistent Systems, Coforge, Mastek, and Birlasoft

Q2FY2024 result estimates

Company	Sales				OPM (%)				Net profit (Rs. cr)			
	Q2FY24E	Q2FY23	YoY (%)	QoQ (%)	Q2FY24E	Q2FY23	YoY (bps)	QoQ (bps)	Q2FY24E	Q2FY23	YoY (%)	QoQ (%)
TCS	60,073	55,309	8.6	1.2	26.1	26.2	-17	82	11,287	10,431	8.2	1.9
Infosys	38,322	36,538	4.9	1.0	23.8	24.4	-60	-13	6,160	6,021	2.3	3.6
HCL Tech	26,669	24,686	8.0	1.4	21.7	22.0	-26	123	3,655	3,489	4.7	3.4
Wipro	22,949	22,645	1.3	0.5	19.2	17.9	134	86	2,963	2,659	11.4	3.2
Tech M	13,172	13,130	0.3	-0.4	12.6	15.1	-251	243	963	1,310	-26.5	39.1
LTIM	8,870	8,228	7.8	1.9	18.4	19.9	-148	-39	1,202	1,189	1.1	4.4
L&T Tech (LTTS)	2,390	1,995	19.8	3.8	20.0	21.0	-99	35	325	282	14.9	4.3
Coforge	2,305	1,959	17.6	3.8	16.6	17.6	-94	171	236	201	17.3	42.7
Persistent Systems	2,406	2,049	17.4	3.6	17.6	18.0	-39	-65	268	220	21.9	-3.3
Birlasoft Limited	1,292	1,192	8.4	2.3	15.0	14.8	22	-28	135	115	17.0	-2.1
Tata Elxsi	877	763	14.8	3.1	29.3	29.7	-39	-27	190	174	8.8	0.6
Mastek Limited	759	625	21.4	4.7	16.9	17.2	-28	-62	78	54	44.6	11.0
Intellect Design	667	528	26.4	4.3	23.6	15.9	768	13	97	46	112.0	3.8
NIITMTS	384	300	28.0	0.5	22.2	17.7	448	-12	59	42	40.9	6.1
Soft coverage												
Explo Solutions	233	131	77.6	3.4	15.3	20.6	-534	67	24	18	36.4	18.7

Source: Company, Sharekhan Research;

Valuations

Company	Reco	Price target (Rs.)	CMP (Rs)	EPS (Rs.)				P/E (x)			
				FY22	FY23	FY24E	FY25E	FY22	FY23	FY24E	FY25E
TCS	Buy	4,200	3,589	103.6	115.2	128.4	142.0	34.6	31.2	28.0	25.3
Infosys	Buy	1,690	1,462	52.6	57.6	59.3	69.4	27.8	25.4	24.6	21.1
HCL Tech	Buy	1,265	1,236	49.7	54.7	57.3	64.3	24.8	22.6	21.6	19.2
Wipro	Hold	420	407	22.3	20.7	22.7	25.0	18.3	19.7	17.9	16.3
Tech Mahindra	Reduce	1,050	1,206	62.8	59.7	48.5	64.7	19.2	20.2	24.8	18.6
LTIM	Buy	5,880	5,227	133.5	149.0	168.3	204.5	39.2	35.1	31.1	25.6
L&T Tech	Hold	4,225	4,636	90.7	114.5	126.3	145.9	51.1	40.5	36.7	31.8
Coforge	Buy	6,200	5,201	109.0	133.6	162.2	195.7	47.7	38.9	32.1	26.6
Persistent Systems	Buy	6,000	5,734	90.3	127.2	148.0	173.9	63.5	45.1	38.8	33.0
Birlasoft Limited	Buy	535	513	16.4	11.9	20.2	24.2	31.2	43.0	25.4	21.2
Tata Elxsi	Hold	7,500	7,239	88.3	121.3	126.2	150.5	82.0	59.7	57.4	48.1
Mastek Limited	Buy	2,400	2,394	103.4	86.6	105.2	132.2	23.2	27.6	22.8	18.1
Intellect Design	Hold	735	707	25.1	19.2	28.8	35.4	28.1	36.8	24.5	20.0
NIITMTS	Buy	550	416	15.0	14.3	15.0	22.0	27.7	29.1	27.7	18.9
Soft coverage											
Explo Solutions	Positive	1,600	1,382	43.6	67.0	70.3	89.6	31.7	20.6	19.7	15.4

Source: Company, Sharekhan Research;

Q2FY2024E: USD revenue and EBIT estimates

Company	Revenue (USD mn)						EBIT Margin (%)				
	Q2FY24E	Q2FY23	YoY (%)	Q1FY24	QoQ (%)	CC QoQ (%)	Q2FY24E	Q2FY23	YoY (bps)	Q1FY24	QoQ (bps)
TCS	7,273	6,877	5.8	7,226	0.6	0.8	24.0	24.0	-3	23.2	81
Infosys	4,639	4,555	1.9	4,617	0.5	0.7	20.7	21.5	-88	20.8	-14
HCL Tech	3,229	3,082	4.8	3,200	0.9	1.1	17.7	17.9	-22	17.0	76
Wipro	2,765	2,798	-1.2	2,779	-0.5	-0.4	16.1	15.1	103	16.0	10
Tech M	1,595	1,638	-2.6	1,601	-0.4	-0.3	8.9	11.4	-246	6.8	213
LTIM	1,074	1,022	5.1	1,059	1.4	1.5	16.3	17.5	-120	16.7	-37
L&T Tech (LTTS)	289	247	17.1	280	3.3	3.5	17.3	18.1	-73	17.2	15
Coforge	279	247	13.0	272	2.7	2.8	13.4	14.4	-107	11.5	185
Persistent Systems	291	256	14.0	283	2.9	3.1	14.1	14.6	-51	14.9	-87
Birlasoft Limited	156	149	5.1	154	1.8	1.9	13.5	13.1	42	13.6	-12
Tata Elxsi	106	95	11.5	103	2.6	2.8	26.7	26.8	-13	27.1	-36
Mastek Limited	92	78	17.7	88	4.3	4.4	14.2	14.4	-25	14.8	-60
Intellect Design	81	66	22.1	78	3.8	-	18.4	10.3	802	18.2	20
NIITMTS	NA	NA	NA	NA	NA	-	18.4	14.1	431	18.3	11
Explo Solutions	28	16	72.9	27	2.9	-	12.1	17.6	-552	11.0	111

Source: Company, Sharekhan Research

Q2FY2024 IT earnings preview

Company wise key expectations

Company	Comment
TCS	TCS is expected to report revenue growth at 0.8% in CC terms due to weak discretionary spends, with ~20 bps cross-currency headwinds to result in reported USD revenue growth of 0.6% q-o-q. EBIT margins are likely to improve by ~80 bps q-o-q, aided by operating efficiencies.
Infosys	Infosys is expected to report revenue growth at 0.7% in CC terms due to discretionary spend rationalisation, with ~20 bps cross-currency headwinds to result in reported USD revenue growth of 0.5% q-o-q. EBIT margins are likely to decline by ~20 bps q-o-q, impacted by higher travel and back-to-office costs.
HCL Technologies	HCLTech is expected to report sequential revenue growth at 1.1% in CC terms, better than peers, aided by ASAP's acquisition. EBIT margin to improve by ~80 bps q-o-q, aided by operational efficiencies.
Wipro	Wipro is expected to report a sequential decline of -0.4% in revenue in CC terms, in line with Q2 guidance of -2% to 1%. EBIT margin is expected to stay flat, aided by operational efficiencies.
Tech Mahindra	TechM is expected to report a revenue decline of 0.3% sequentially due to continued weakness in the communication vertical. EBIT margin is expected to recover sequentially by ~210 bps, following the sharp decline in Q1FY2024.
LTIM	LTIM is expected to report sequential revenue growth of 1.5% in CC terms, aided by manufacturing, healthcare, and travel verticals, partly offset by weakness in the BFSI and retail verticals. EBIT margins are likely to decline by ~40 bps q-o-q, impacted by wage hikes.
L&T Tech	LTTS is expected to report sequential revenue growth of 3.5% in CC terms, aided by ramp-up of deals. EBIT margin is expected to stay flat, aided by operational efficiencies.
Coforge	Coforge is expected to report sequential revenue growth of 2.8% in CC terms, aided by ramp-up of deals. EBIT margin is likely to improve by ~190 bps q-o-q, aided by operating efficiencies, following the sharp decline in Q1FY2024.
Persistent Systems	Persistent is expected to report sequential revenue growth at 3.1% in CC terms, aided by ramp-up of deals, offset by weakness in the financial service vertical. EBIT margin is expected to decline by ~90 bps q-o-q, impacted by wage hikes, offset by operational efficiencies.
Birlasoft	Birlasoft is expected to report sequential revenue growth of 1.9% in CC terms, aided by ramp-up of deals. EBIT margin is expected to stay flat, aided by operational efficiencies.
Tata Elxsi	Tata Elxsi is expected to report sequential revenue growth of 2.8% in CC terms, aided by the transportation vertical. EBIT margin is expected to decline by ~40 bps q-o-q, impacted by wage hike.
Mastek Limited	Mastek is expected to report sequential revenue growth of 4.4% in CC terms, aided by BizAnalytica's acquisition. EBIT margin is expected to decline by ~60 bps q-o-q.
Intellect Design	Intellect Design is expected to report sequential revenue growth of 3.8%, aided by platform revenues, offset partially by weakness in license revenue. EBIT margin is expected to stay flat, aided by operational efficiencies.
NIITMTS	NIITMTS is expected to report sequential revenue growth of 0.7%, aided by the recent acquisition. EBIT margin is expected to stay flat, aided by operational efficiencies.
Expleo Solutions	Expleo Solutions is expected to report sequential revenue growth of 2.9%. EBIT margin is expected to recover by ~110 bps after a sharp deterioration in Q1FY2024, following the integration of group companies.

Source: Sharekhan Research

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Sharekhan

by BNP PARIBAS

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