ArihantCapital
Generating Wealth

09th Oct 2023

IT Services_ Q2FY24 Preview

Mixed Quarter for IT Companies

Tata Consultancy Services	
CMP (INR)	3,589
Rating	Accumulate
TP	3,679
PE FY26E	22x
Infosys Ltd*	
CMP (INR)	1,464
Rating	Reduce
TP	1,222
PE FY26E	20x
Coforge Limited	
CMP (INR)	5206
Rating	Accumulate
TP	5,284
PE FY26E	26x
Persistent Systems*	
CMP (INR)	5,739
Rating	Neutral
TP	4,770
PE FY26E	30x
L&T Technology Services*	
CMP (INR)	4,640
Rating	Neutral
TP	3,915
PE FY25E	30x
Route Mobile	
CMP (INR)	1,562
Rating	Accumulate
TP	1,763
PE FY25E	20x
Firstsource Solutions	
CMP (INR)	163
Rating	Accumulate
TP	167
PE FY26E	16x
Birlasoft*	
CMP (INR)	513
Rating	Buy
TP	460
PE FY25E	22x

CMP as of 6th Oct 2023)
**We will revise our target post results*

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Our recent discussions with IT company management, discussed prior to their silent period, have revealed a consistent subdued demand outlook spanning the past three months. These expectations align with the steady performance expected for Q2FY24 due to the prevailing weakness in discretionary spending. However, it's essential to recognize that macroeconomic challenges are exerting pressure on key industry sectors like banking, telecom, and retail. These challenges stem from factors such as elevated interest rates and inflationary pressures, which have caused delays in discretionary technology spending decisions. Furthermore, deals are now subject to increased scrutiny, leading to extended timelines from pipeline to contract conversion. In some instances, the conversion from the order book to revenue is also occurring at a slower pace.

Accenture's latest quarterly financial report echoes the ongoing trend of lower bookings compared to the typical seasonal strength seen in Q4. The company attributes this trend to the heightened scrutiny surrounding larger deals and the persisting softness in smaller discretionary deals witnessed in previous quarters. Nevertheless, Accenture maintains optimism regarding YoY growth in the Q2FY24.

Revenue: Anticipated factors, such as weakened discretionary spending and a slower pace in deal ramp-ups, suggest that revenue growth for tier I companies will likely remain within a narrow range. It is expected that many of IT companies will adjust their FY24 revenue growth guidance towards the lower end of their previous projections. Nevertheless, there is potential for CY24 growth to improve, particularly as transformation deals that were signed but stalled begin to gain traction, along with an increasing number of cost takeout deals. More clarity regarding CY24 budgets is expected to emerge in the Q3FY24.

Margin: In the upcoming quarter, we anticipate that the margin performance of most companies will be somewhat subdued, owing to several contributing factors. These include a reduction in discretionary program spending, coupled with increased visa costs and expenses associated with returning to the office. Additionally, cost-saving initiatives have yet to fully take effect. Attrition rates are expected to remain stable, and net hiring is projected to remain unchanged.

To provide a more specific breakdown, tier I companies are likely to experience a slight dampening of their margins on a quarter-on-quarter (QoQ) basis. In contrast, tier II companies like Coforge and Persistent are expected to witness margin expansion ranging from 150 basis points to 58 basis points. This expansion can be primarily attributed to the ramping up of large deals. Moving on to tier III companies such as Route Mobile, FSL, and Birlasoft, their margin performance is anticipated to vary. Route Mobile and Birlasoft are projected to report margin expansions ranging from 41 basis points to 23 basis points on a QoQ basis, while FSL is expected to maintain a margin that is relatively flat, with a change of only 23 basis points. In summary, these factors point to a mixed landscape for margins in the industry. Tier I companies are likely to experience slightly muted performance, while tier II and tier III companies are expected to demonstrate varying degrees of margin expansion on QoQ basis.

View: The recent surge in IT stock prices can be attributed to the initial anticipation of pick-up in demand. However, after reviewing Accenture's results and engaging in discussions with various IT companies, it has become evident that growth prospects across the IT sector are subdued, indicating that demand is not aligning with earlier expectations. We recommend considering these high-quality companies: 1) Tier I: TCS, 2) Tier II: Coforge and Persistent 3) Tier III: Birlasoft. These firms have strong management, excel in cost optimization, and focus on digital transformation opportunities for clients.

Tata Consultancy Services INR (Mn.)	Q2FY24E	Q1FY24A	Q2FY23A	QoQ	YoY	Remarks
Revenue (CC Terms) (Mn USD)	7330	7226	6877	1.4%	7%	Anticipating flattish QoQ revenue growth due to discretionary spending weakness, with a 1.4% QoQ moderation. EBIT margin expected to rise 100bps QoQ to 24.17%, driven by efficiencies, while TCV of deals, including BSNL, estimated at US$12 bn, a 48% YoY increase.
Net Revenue	604,000	593,810	553,090	1.7%	9.2%	
EBIT	145,960	137,550	132,790	6.1%	9.9%	
EBIT Margin	*24.17%*	*23.2%*	*24.0%*	100bps	16bps	
PAT	115,200	110,740	104,310	4.0%	10.4%	
Infosys (Mn.)	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	4655	4617	4555	0.8%	2.2%	Anticipating subdued 0.8% QoQ and a 2% YoY revenue growth, driven by continued discretionary program rationalization. Expect a -60 bps YoY EBIT margin decline due to rising travel and other costs. Focus on mega deal dynamics, ramp-up timelines, margin levers, senior leadership changes, and wage revision date.
Net Revenue	384,920	379,330	365,380	1.5%	5%	
EBIT	80,650	78,910	78,730	2.2%	2%	
EBIT Margin	*20.95%*	*20.80%*	*21.55%*	15bps	-60bps	
PAT	61,830	59,390	6,021	4.1%	927%	
Coforge Limited	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	275	272	246.9	1.2%	11.4%	Anticipating robust 1.2% QoQ revenue growth driven by large deal ramp-up, with a significant 150bps QoQ EBIT margin expansion. Attrition should come down below 13.3% in Q2FY24.1 large deal in this quarter. Key focus on client demand, deal wins, second-half outlook for revenue and margins, as well as hiring and attrition trends.
Net Revenue	22950	22210	19594	3.3%	17.1%	
EBIT	3003	2572	2830	16.8%	6.1%	
EBIT Margin	13.1%	11.6%	14.4%	150bps	-136bps	
PAT	2214	1658	2011	33.5%	10.1%	
Persistent Systems	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	292	283	256	3.18%	14.24%	We expect consistent 3.2% QoQ revenue growth for PSYS, propelled by broad-based vertical growth. However, we expect a 58bps QoQ EBIT margin contraction due to wage hikes, partially offset by productivity gains. Monitoring FY24 demand outlook, margin strategies, top client growth, deal wins, and hiring/attrition trends.
Net Revenue	24070	23212	20486	3.70%	17.49%	
EBIT	3230	2980	2987.0	8.39%	8.14%	
EBIT Margin(%)	13.4%	12.8%	14.6%	58bps	-116bps	
PAT	2730	2288	2200	19.3%	24.1%	
L&T Technology Services	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	288	280	247	2.9%	16.6%	Anticipating robust 2.9% QoQ revenue growth, led by strong demand in Transportation, Plant Engineering, and Industrial sectors. Margin contraction of 53bps QoQ expected due to wage hikes, partly offset by productivity gains. Key focus on FY24 revenue and margin outlook, momentum in large deal wins, demand commentary, and potential synergies from SWC integration.
Net Revenue	23935	23014	19951	4.0%	20.0%	
EBIT	3985	3954	3628	0.8%	9.8%	
EBIT Margin	16.6%	17.2%	18.2%	-53bps	-154bps	
PAT	3115	3121	2832	-0.2%	10.0%	
Route Mobile	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Net Revenue	10035	9673	8458	1.42%	15.98%	We expect revenue to grow 1.4% QoQ on the back of better deal momentum. EBITDA Margin is likely to flat QoQ led by increase in travel cost. Key thing would watch for 1) Outlook on large deal, 2) outlook on the client budget, 3) outlook for demand
EBIT	1226	1169	864	4.88%	41.90%	
EBIT Margin	12.2%	12.1%	10.2%	13bps	200bps	
PAT	989	917	726.3	7.9%	36.2%	
Firstsource Solutions	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	188	186	187	1.1%	0.5%	We anticipate a relatively flattish quarter, with fluctuations primarily attributed to the interest rate movements in the US. Clients are gradually adapting to the elevated interest rates, and we anticipate that by February, the interest rate will have settled at its current level. Key areas of focus during this period include: 1)Assessing the outlook for the mortgage segment.2) Monitoring updates on guidance and future projections.
Net Revenue	15350	15290	14880	0.4%	3.2%	
EBIT	1760	1789	1250	-1.6%	40.8%	
EBIT Margin	11.5%	11.7%	8.4%	-23bps	307bps	
PAT	1270	1260	1294.0	1%	-2%	
Birlasoft	**Q2FY24E**	**Q1FY24A**	**Q2FY23A**	**QoQ**	**YoY**	
Revenue (CC Terms) (Mn USD)	156.0	153.6	149	1.6%	4.8%	Expecting growth supported by client mining, cross-selling, timely deal ramp-up, and improved execution, even without one-off revenue as in 1QFY24. Growth leverage to mitigate the one-month impact of wage hikes on EBIT margin. Order-booking may remain flat to modestly positive due to slower deal conversion.
Net Revenue	12950	12628	11544	2.5%	12.2%	
EBIT	1790	1717	1502	4.3%	19.2%	
EBIT Margin	*13.82%*	*13.60%*	*13.01%*	23bps	81bps	
PAT	1395	1375	1207.0	1.4%	15.6%	

Source: Arihant Research

Recent Interaction with the Management

Coforge Ltd: The company foresees a slightly softer quarter ahead, with a potential couple of percentage points growth in topline. A substantial deal is in the pipeline for this quarter, contributing to a margin expansion of 150 basis points. Factors like the absence of wage hikes, limited hiring, and decreased hedge losses will drive this improvement. Margin should drop below 13.3% during Q2FY24. While some clients in the IT industry are delaying, this situation is expected to be temporary, with no signs of deteriorating conditions. All three segments of the company are performing well, with a focus on enhancing performance in the healthcare sector in the US and increasing attention on Austria and the UK.

Firstsource Solutions Ltd (FSL): Q2FY24 is expected to remain largely unchanged, with a flattish performance, as the industry adapts to higher interest rates. The BFS sector may show moderate performance in H1FY24, with improvements anticipated in H2FY24. Positive traction is seen in digital collections, and digital initiatives continue to be a focal point. While clients are not constrained by budgets, spending has been slower. Q2FY24 is slower than expected due to interest rate fluctuations, and headcount trends will remain stable, with some respite in attrition during Q2FY24.

Persistent Systems: Anticipates a revenue growth of approximately 3% in the upcoming Q2FY24, with a slight impact on margins due to a wage hike in the same quarter, projecting a margin of 13.4%. Good deal wins of around 5-10% are expected, along with a ramp-up in the hi-tech segment. The company is hiring strategically, focusing on offshore resources and aiming to increase utilization in the coming quarters. Attrition is expected to be on the lower side. The company recently hired 800 fresher's in Q2FY24, contributing to a positive momentum in the healthcare and BFSI segments. Everything is progressing as expected, but there is a slowdown in discretionary spending.

Route Mobile Limited: The company anticipates a flattish performance on a quarter-on-quarter basis, but remains optimistic when considering annual performance. The business segment shows strength and resilience, although margins may remain stable due to increased travel expenses. A recent deal with Vodafone Idea to manage international A2P SMS traffic will impact cash flow during Q2FY24.

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Stock Rating Scale	Absolute Return
BUY	>20%
ACCUMULATE	12% to 20%
HOLD	5% to 12%
NEUTRAL	-5% to 5%
REDUCE	-5% to -12%
SELL	<-12%

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