

Q2FY23 IT Services Preview



IT Services

MARKET DATA

	Close	1D (%)	1M (%)	YTD (%)
Nifty	17,230	0.6	-2.2	-2.2
Sensex	57,905	0.5	-1.9	-2.2
Nifty IT	27,722	-0.7	-0.4	-29.1
USD / INR	82.4	0.02	3.4	10.6

COVERAGE STOCKS

Company	Current Price (INR)	Target Price (INR)*		Upside (%)	Market Cap. (INR mn)	Fwd PE FY2024E (x)	Reco.*	
		New	Old				New	Old
TCS	3,105	3,739	4,256	20.4%	11,241,703	27.5	ACCUMULATE	ACCUMULATE
Infosys	1,455	1,805	2,094	24%	6,261,814	25	BUY	BUY
HCL Technologies	964	1,119	1,391	16.1%	2,618,144	20	BUY	BUY
Wipro	410	471	602	14.9%	2,237,004	18.5	ACCUMULATE	BUY
Tech Mahindra	1,031	1,181	1,447	14.5%	1,001,089	15.5	BUY	BUY
Mindtree	3,302	3,143	4,509	(5%)	539,338	23	ACCUMULATE	BUY
Persistent Systems	3,559	4,131	4,928	16.1%	268,538	28.5	ACCUMULATE	ACCUMULATE
Tata Elxsi	8,577	8,884	8884	3.5%	532,984	64	ACCUMULATE	ACCUMULATE
Sonata Software*	513	791	931	1.7%	72833	17	BUY	BUY
Happiest Minds Technologies	1,009	1,158	1,300	14.8%	147,524	63	BUY	BUY
Infibeam Avenues	15	28	43	86.7%	39,883	20	BUY	BUY

Note: Sonata* upside calculated post adjustment of TP; We will review targets & ratings post detailed Q3FY22 results analysis and conference call of said companies. UR: Un- Rated ; Source :KRC & Bloomberg, Data as of Oct 06, 2022

SECTOR OVERVIEW

Demand resilience; Continued weak macro environment and adverse forex may dampen the sector spirit

With a weakening macro environment and looming fears of recession, we remain cautious if there is any moderation in the demand commentary across Tier I and Tier II IT Space. We may see some pressure across sectors due to Retail/Manufacturing and will likely to stretch over H2FY23. The growth deficit in Tier I players v/s Tier II peers will further narrow down the band in 2QFY23. The over all Tech space is left with a limited scope with further upside in revenue growth in Q2FY23, given the unchanged demand commentary.

Since last quarter, GBP and EUR dropped by ~10%, aggravated by Yen and AUD, the volatility in currency will adversely impact Q2/Q3 FY23E performance. We expect Tier-1 IT CC growth to remain range bound (11-13%) for FY23E due to negative cross currency impact of ~400bps. And FY24E is likely to imitate the similar growth story like FY23; Tier I/Tier II IT companies are likely to deliver moderated growth due to negative cross currency impact as compared to 18% growth registered in FY22. Infosys is likely to maintain its 14-16% CC growth guidance for FY23E and HCL Tech is expected to maintain its 12-14% growth guidance for FY23E. Wipro's Q3 growth guidance is likely to hover in the range of 1-3% CC QoQ and Persistent is expected to retain its 16-18% CC growth trajectory for FY23E.

We reckon that margins have bottomed out in Q1FY23 after a material correction since post-Covid peak levels Q3FY21. We continue with lower margin for FY23E v/s pre-Covid and expect some recovery in FY24E, supported by medium term tailwinds of normalization in attrition/sub-con cost, higher utilization/pricing. Wage impact and cross currency will impact margin in Q2 which will be partially offset by absence of visa cost, INR depreciation, improved utilization and efficiencies. We see a low downside risk to the margin even in an event of rapid demand moderation.

Key monitorable: (1) CY23 IT budget, (2) steps taken to manage supply-side challenges and available levers to defend margins, (3) demand environment in BFSI, Manufacturing, Retail, and Communications, (4) pricing environment and (5) deals pipeline/closure momentum.

NIFTY IT has underperformed NIFTY by 21% in last 6-months. With valuations correcting meaningfully over last one year (IT services sector P/E at 21.6x, down 35% from the peak and 30% YoY), we maintain our positive stance on the IT Services sector due to a favorable medium to long term demand outlook despite near term pain.

We maintain a positive stance with Tier I players over their Tier II counterparts, based on the relative valuation (attractiveness/diversified client portfolio), and our stock preferences remain Infosys (top quartile growth, backed by strong deal wins/price revision) , HCLT (significant improvement in core business & cloud adoption in IMS), TCS (long-term structural tailwinds in Tech Services and a relative pickup in growth, aided by the base effect and increased aggression) and TATA Elxsi (led by robust demand in ER&D services) at the top of pecking order in Tier I & Tier II respectively. At present, we agree that the impacts of negative variables weigh more on the sector but we maintain our constructive stance on the sector and the short-term volatility provides strong opportunity for absolute return. We will review our targets & ratings post detailed Q2FY23 results analysis and conference calls.

IT Services

Quarterly result expectation for companies under coverage

INR Mn	Q2Y23E	Q1FY23A	QoQ %	Q2FY22A	YoY%	Remarks
Tata Consultancy Services (TCS)						
Sales (USD Mn)	6,920	6,780	2.1%	6,333	9.3%	<p>We build in 2.1% QoQ USD revenue growth, led by seasonal strength, vender consolidation and tailwinds in digital transformation. We expect reasonable TCV YoY growth to the similar fashion like Q1 USD 9-10bn</p> <p>Key focus areas: 1) CY23 IT budget Spend commentary, 2) demand trends in key verticals such as BFSI, Retail, Manufacturing and Communications, 3) large deal momentum especially in consolidation deals 4) pricing environment, 5) margin outlook in the light of continued wage inflation/little average from pricing, 6) supply-side challenges and attrition</p>
Net Sales	552,285	527,280	4.7%	468,670	17.8%	
EBIT	130,720	121,860	7.3%	119,990	8.9%	
Net Profit	105,016	94,780	10.8%	96,230	9.1%	
OPM (%)	23.7%	23.1%	56 bps	25.6%	-193 bps	

Infosys						
Sales (USD Mn)	4,578	4,444	3.0%	3,998	14.5%	<p>We expect USD revenue growth of +3.0% on the back of discretionary spending by clients. Infosys to retain 13-15% revenue guidance along with 21-23% EBIT margin. We expect manufacturing/retail margins to improve in this quarter.</p> <p>Key focus areas: (1) CY23 IT budget Spend commentary, (2) Quantum of wage increase for onshore employees (3) Supply side pressure and its influence (4) realization of price increase, (5) raise in travel expenses & supply side pressure</p>
Net Sales	3,65,370	3,44,700	6.0%	2,96,020	23.4%	
EBIT	73,680	69,140	6.6%	69,720	5.7%	
Net Profit	59,280	53,600	10.6%	54,280	9.2%	
OPM (%)	20.2%	20.1%	11 bps	23.6%	-339 bps	

HCL Technologies						
Sales (USD Mn)	3,070	3,025	1.5%	2,791	10.0%	<p>We forecast USD revenue growth of 1.5% QoQ driven by continued strength in IT services and P&P. We expect margin to improve by 45-50bps driven by changes in business mix</p> <p>Key focus areas: 1) CY23 IT budget Spend commentary, 2) deal wins and deal pipeline, 3) FY23 outlook across the three segments, 4) FY23 Margin outlook, deal wins and commentary on supply side challenges and any impact of macro concerns on demand</p>
Net Sales	245,017	234,640	4.4%	206,550	18.6%	
EBIT	42,853	39,920	7.3%	39,160	9.4%	
Net Profit	34,098	32,830	3.9%	32,650	4.4%	
OPM (%)	17.5%	17.0%	48 bps	19.0%	-147 bps	

Wipro						
ITS Sales (USD Mn)	2,800	2,736	2.3%	2,580	8.5%	<p>We expect them to report USD revenue growth of 2.3% QoQ. We expect IT services margins likely to improve QoQ basis.</p> <p>Key focus areas: 1) CY23 IT budget commentary, 2) Positive impact from the recent acquisition, Rizing 3) Potential increase in cost structure and wage pressure 4) price negotiations and 5) pipeline of mega deal wins</p>
Cons. Sales (INR Mn)	2,25,680	2,15,286	4.8%	1,96,674	14.7%	
Cons. EBIT	33,684	30,856	9.2%	34,905	-3.5%	
Net Profit	28,987	25,636	13.1%	29,306	-1.1%	
OPM (%)	14.9%	14.3%	59 bps	17.7%	-282 bps	

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Quarterly result expectation for companies under coverage

INR Mn	Q2Y23E	Q1FY23A	QoQ %	Q2FY22A	YoY%	Remarks
Tech Mahindra						
Sales (USD Mn)	1,647	1,632	0.9%	1,473	11.8%	We expect 0.9% QoQ growth in USD revenue, as the strength across verticals. We expect margin to remain flattish in spite of wage hikes, travel expenses, visa expenses and seasonality impact. Key focus areas: 1) CY23 IT budget outlook commentary, 2) FY23 margin outlook and on-going macro concerns on demand environment especially in Europe (as the verticals are directly impacted by recent chain of events) 3) Commentary on deal wins/ pipeline 4) attrition rate, ability to backfill attrition and its impact on the profitability 5) telecom deal momentum specially related to 5G networks
Net Sales	1,31,447	1,27,079	3.4%	1,08,813	20.8%	
EBIT	14,618	14,034	4.2%	16,522	-11.5%	
Net Profit	12,465	11,316	10.2%	13,387	-6.9%	
OPM (%)	11.1%	11.0%	8 bps	15.2%	-406 bps	
Mindtree						
Sales (USD Mn)	413	399	3.5%	350	18.0%	We expect 3.5% QoQ growth is expected to be a strong quarter, mainly driven by strong spending in experience program. Increase in talent retention cost & merger related cost will be partially offset by rupee depreciation and all operating levers. Key focus areas: 1) CY23 IT budget outlook commentary, 2) timeline for integration with LTI 3) timing & quantum of price increase in deals especially in Apps heavy services 4) position on vendor consolidation 5) recovery in retail vertical which has underperformed in H2FY22 6) continuity of the discretionary spend due to weak macro environment
Net Sales	32,962	31,211	5.6%	25,862	27.5%	
EBIT	6,080	5,982	1.6%	4,697	29.4%	
Net Profit	4,985	4,712	5.8%	3,989	25.0%	
OPM (%)	18.4%	19.2%	-72 bps	18.2%	28 bps	
Persistent Systems						
Sales (USD Mn)	254	242	5.2%	182	39.6%	We expect a ~5.2% QoQ USD revenue growth, led by growth across verticals driven by the strong order books. EBIT margins to decline 54 bps sequentially owing to the full impact of amortization and continued supply side challenges Key focus areas: 1) CY23 IT budget outlook commentary, 2) FY23 outlook on growth & margins 3) deal intake and pipeline, 4) demand trends across BFSI, Healthcare and Technology verticals, 5) outlook on Top client/attrition.
Net Sales	20,272	18,781	7.9%	13,512	50.0%	
EBIT	2,792	2,688	3.9%	1,873	49.1%	
Net Profit	2,186	2,116	3.3%	1,618	35.1%	
OPM (%)	13.8%	14.3%	-54 bps	13.9%	-9 bps	
Tata Elxsi						
Sales (USD Mn)	96	94	2.5%	81	19.5%	Revenue is likely to rise by 2.5% QoQ in USD terms, aided by healthy traction in automotive industry as there are lots of investments are coming from major companies/OEMs/Suppliers, leads to growth multi-year tailwind (Automotive business of Tata Elxsi is majorly Europe centric). Increasing travel expenses, rising visa cost & supply side challenge would likely to partially offset the growth in Automotive business, Broadcast & Communications and Healthcare & Medical Devices which may drag down margins in Q2FY23. Key focus areas: (1) Growth outlook for CY23, (2) Wage hike and hiring (3) Commentary on key verticals and (4) Demands and Deal wins
Net Sales	7,695	7,259	6.0%	5,953	29.3%	
EBIT	2,324	2,211	5.1%	1,701	36.6%	
Net Profit	1,931	1,847	4.6%	1,253	54.1%	
OPM (%)	30.2%	30.5%	-26 bps	28.6%	163 bps	

IT Services

Quarterly result expectation for companies under coverage

INR Mn	Q2Y23E	Q1FY23A	QoQ %	Q2FY22A	YoY%	Remarks
Sonata Software						
Sales (USD Mn)	58	57	2.3%	49	18.6%	We expect SSOF to grow by 2.3% QoQ, supported by Microsoft portfolio aided by traction in key verticals including Hi-tech, Retail, Manufacturing and Commodities. Deal flow and pipeline continues to robust on the back of Retail Essential, Retail Non-Essential and Domestic Product Business. Consolidated EBIT margin is likely to expand materially in Q2.
Net Sales	12,122	17,789	-31.9%	9,632	25.9%	
EBIT	1,311	1,287	1.9%	1,114	17.7%	
Net profit	1,021	1,078	-5.3%	912	12.0%	
OPM(%)	10.8%	7.2%	358 bps	11.6%	-75 bps	
Key focus areas: (1) Growth outlook for IITS business, (2) Travel vertical recovery, (3) Microsoft account growth, and (4) Demands and Deal wins						
Happiest Minds Technologies						
Sales (USD Mn)	45	42	5.7%	36	23.9%	USD revenue growth is likely at 5.7% led by robust digital investments by clients across verticals. EBIT margin is likely to witness a meagre expansion by 17 bps QoQ, with PAT likely to grow 9.1% QoQ.
Net Sales	3,560	3,289	8.2%	2,645	34.6%	
EBIT	813	746	9.0%	522	55.8%	
Net Profit	614	563	9.1%	444	38.3%	
OPM (%)	22.9%	22.7%	17 bps	19.7%	311 bps	
Key focus areas: (1) Growth outlook for CY23, (2) Demands and Deal wins (3) Further scope for M&A, given large cash balance on the books and healthy cash generation each quarter.						
Infibeam Avenues						
Sales (USD Mn)	65.7	42.0	56.6%	56.5	16.4%	We expect the top-line to increase at 68.6% YoY in Q2FY23E (vs. 93.3% YoY growth in Q1FY23, 83.6% YoY growth in Q4FY22, and 74.3% YoY growth in Q3FY22) led by likely strong growth in daily TPVs, driven by strong merchant sign-ups, GeM procurement, and recovery in high-value sectors, which were affected by the pandemic. We expect the Transaction Processing Value (TPV) to rise at 70.0% YoY (vs. 72.2% YoY growth in Q1FY23 and 69.7% YoY growth in Q4FY22) in Q2FY23E. We expect the EBITDA margin to decline by 132 bps YoY (-39.0 bps QoQ) and adjusted Net Profits Margins (NPMs) to decline by 127 basis points YoY (-93 bps QoQ) though, in Q2FY23E. We expect the low fees-oriented verticals and higher operating costs towards new businesses such as CPGS to affect margins; partially offset by a recovery in high-value sectors.
Net Sales	5,242.5	3,109.9	68.6%	4,183.1	25.3%	
EBITDA	512.2	344.8	48.5%	425.0	20.5%	
Net Profit	234.3	178.6	31.2%	225.9	3.7%	
OPM (%)	9.8%	11.1%	-132 bps	10.2%	-39 bps	
Key Parameters: Any improvement in product mix and steady improvement in gross realization/Net Take Rate (NTR) per transaction processed due to increased share of value-added new businesses such CPGS, express settlement, credit services, and international remittance businesses.						

IT Services

Rating Legend (Expected over a 12-month period)	
Our Rating	Upside
Buy	More than 15%
Accumulate	5% – 15%
Hold	0 – 5%
Reduce	-5% – 0
Sell	Less than – 5%

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KRChoksey Shares and Securities Pvt. Ltd.

Registered Office:

1102, Stock Exchange Tower, Dalal Street, Fort, Mumbai – 400 001.

Phone: +91-22-6633 5000; Fax: +91-22-6633 8060.

Corporate Office:

ABHISHEK, 5th Floor, Link Road, Andheri (W), Mumbai – 400 053.

Phone: +91-22-6696 5555; Fax: +91-22-6691 9576.

ANALYST

Saptarshi Mukherjee, research4@krchoksey.com, +91-22-6696 5555

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is also available on Bloomberg KRCS<GO>
Thomson Reuters, Factset and Capital IQ

Phone: +91-22-6696 5555, Fax: +91-22-6691 9576

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