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Investors in IT stocks remain on the edge

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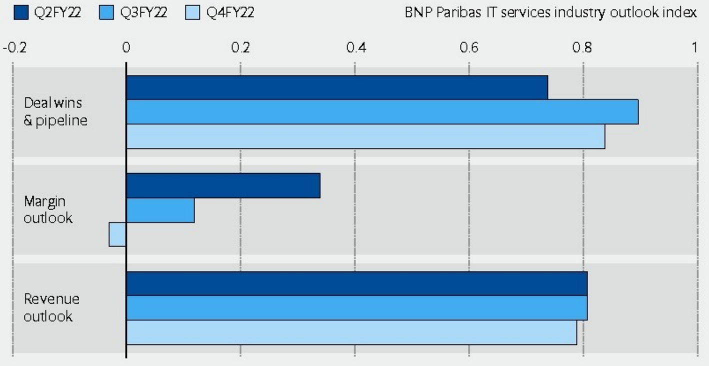
Upbeat mood

Indian IT companies are confident on revenue and deal outlook for the upcoming quarter, but are cautious on margins.



Note: BNP Paribas has assigned ratings that range from -1 to +1 for management commentary, where available, for each parameter and then taken revenue-weighted average for a composite score; +1 represents improvement in outlook q-o-q, -1 represents deteriorating outlook q-o-q.

Source: Companies, Bloomberg, BNP Paribas

SATISH KUMAR/MINT

Indian technology giant Infosys Ltd has dismissed concerns about a slowdown, and is optimistic on the demand outlook. At its recently held analyst day, the management said that in spite of the global macro-economic challenges, its clients continue to spend on cloud-related services. So, Infosys' FY23 constant currency revenue growth guidance of 13-15% and Ebit margin forecast of 21-23% are intact. Ebit is short for earnings before interest and tax.

Global IT companies are also beaming with confidence as far as the sustenance of demand momentum is concerned. In fact, the March quarter earnings for calendar year 2022 (Q1CY22) of companies such as EPAM Systems, Inc., Globant, Endava Plc and Capgemini have surpassed consensus expectations on revenue growth, said analysts at JM Financial Institutional Securities Ltd. "In addition to the strong 1QCY22 revenue performance, the companies continue to guide for strong revenue momentum sustaining into CY22/FY23 and increase their annual outlook," added the JM Financial report dated 1 June.

But the Nifty IT index does not reflect this upbeat mood. The sectoral index has declined by around 24% so far this calendar year. It's not just Indian investors, technology stocks lost favour among global investors as well. In fact, according to the latest global fund manager survey by BofA Securities, allocation to technology stocks plummeted 23 percentage points on a month-on-month basis in May to net 12% underweight. This is the largest net underweight in technology stocks since August 2006, said the survey report. Concerns are that corporates might scale back their IT spends amid the global economic turmoil and interest rate increases by central banks. This will have a bearing on the sector's FY24 deal wins and pipelines, especially from developed economies.

"Given the high correlation between US GDP growth and Indian IT services revenues, concerns of recession or slowdown induced by Fed rate hikes is a key headwind for the IT stocks," said Kumar Rakesh, a senior automobile and technology analyst at BNP Paribas Securities India.

So, despite a strong demand outlook, investors would closely watch for macro-economic headwinds, he said.

Besides, near-term margin compression is almost a given due to a tough supply-side environment, elevated attrition and return of travel costs. Indian IT companies see attrition easing only gradually.

"As far as the near-term margin outlook is concerned, there are more headwinds than tailwinds. We are pencilling-in a margin compression of around 160 basis points for the IT stocks under our coverage in the June quarter. Given the macro-economic uncertainties, we see two quarters of pain for the IT sector," said Omkar Tanksale, analyst, Axis Securities Ltd. One basis point is 0.01%.

He said attrition may remain elevated in short term. Since employee costs account for 60-65% of the expenses, wage hikes and retention bonuses would weigh on Ebit margins for now.

To be sure, with increased fresher hiring the employee pyramid for IT companies will improve, which is seen as one of levers for margin in the medium-to-long term.

Meanwhile, after the recent rout, valuations of Indian stocks have come off. If the global growth narrative falters, or inflation fails to soften, both valuations and earnings estimates will be at a risk.

"Valuations of IT stocks, especially midcaps, have corrected 30-50% from their peaks reflecting inflation concerns on growth stocks. That said, consensus EPS estimates (for FY24) for Indian IT services companies have declined by 1-6% as yet," added Kumar. EPS is short for earnings per share.

LIMITED CHEER

DESPITE macro-economic uncertainties, IT cos are confident of robust demand

THE sector's margin is a near-term risk that arises from wage hikes and higher travel costs

POST the recent correction in IT stocks, the valuations of these have cooled off