

Pessimism Overdone

Perspective on IT Sector: Valuation correction of 17-49% largely factors in known concerns; Near-term company guidance/commentary is likely to stay unchanged. We expect recovery with Infosys/techm and LTI/LTTS as top picks

"We suffer more often in our imagination than reality" - Seneca.

Global macro-concerns may be as likely and as severe as street expects or may be more/less, we don't know. But valuation correction is likely factoring it in already in near-term at-least, because

- a) IT stocks valuations have corrected 17%-49% and stock prices has corrected 9%-42% in last 6 months (since mid-Dec 2021). Nifty IT index valuation has corrected by 27% and price by 21%. About 2 quarters back we made a case that valuation drivers have peaked, now looking at same drivers we believe that valuations are in a reasonable band now (though at the upper end of the band, rather than lower). For example: Infosys is now trading at 23x 1yr Fwd EPS and 21x 2y Fwd EPS (which given the pre/post-pandemic change in RoCE to 38% in FY22 from 32% in FY20 looks reasonable).
- b) We believe, bulk of margin pressure is pending. However, margin pressure related concerns is already reflecting in guidance/commentary and has led to street estimates cut post-4QFY22 results. Therefore revenue est. cut was 2-4% in most cases but EPS est. cut was up to 7-9%.

Therefore, we believe 2 of 3 legs – 1st leg, margin related and 2nd leg, cost-of-capital related - price corrections are mostly done. Yield gap (between 10Yr G-Sec yield and IT index earnings yield) is now at last 12 years (post-Lehman crises) average level. It may undershoot (we don't know), but atleast it's now at reasonable level (v/s 5-8 months back).

3rd leg (revenue growth cut related leg) is likely to play out over elongated period (2QFY23 onwards).

- c) We believe, revenue cut related earnings impact is still pending which may play out elongated period. Consensus estimate is building 12-17% revenue growth for large caps and 16-22% growth for mid-caps. in near-term, we do not expect revenue guidance cut in post-1QFY23 results and we believe management commentaries may become cautious but more likely to re-iterate strong demand outlook (after all business momentum do not reverse as quickly as stock market). So, in near-term there is trading opportunity, though too early to say all is well.

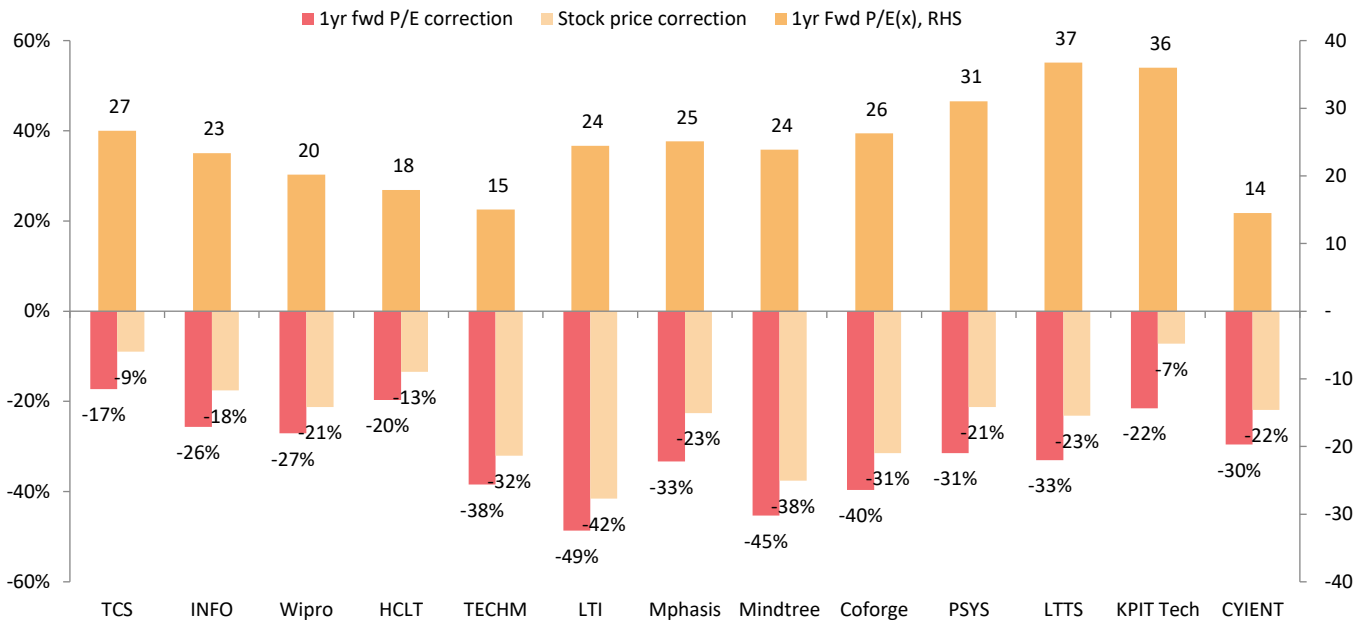
~2 qtrs back, we made case that when we disaggregate growth factor then FY22 growth has large component of deferred demand which is not recurring. Excluding deferred demand part, sustainable growth (from base trend rate + accelerated digitalization) is around 11-14% only (for large cap) with mid-caps 2-5% higher than large caps. So, there is room to cut revenue estimates further by 3-4% (without factoring latest macro-concerns).

EWM Top Picks: Based on valuation correction and expected likelihood broadly unchanged guidance/commentary in 1QFY23. Our preferred pick to play IT stocks in near terms is Infosys (valuations corrected 26%, price by 18%) and TECHM (valuation down 38%, price - 32%) among large caps. Among mid-caps preferred picks are: LTI (valuation -49%, price - 42%) and LTTS (valuation -33%, price -23%). Under volatile/uncertain scenario, we prefer large caps or large mid-caps over small caps.

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Source: Edelweiss Wealth Research

	CMP	Mcap (INR mn)	Revenue (US\$ mn)			EBIT Margins			EPS (INR)			P/E (x)			ROE (%)		
			FY22A	FY23E	FY24E	FY22A	FY23E	FY24E	FY22A	FY23E	FY24E	FY22A	FY23E	FY24E	FY22A	FY23E	FY24E
TCS	3,261	1,19,37,000	25,707	30,132	33,985	25%	25%	25%	106	122	136	31	27	24	45	46	44
Infosys	1,461	61,46,000	16,310	19,088	21,985	23%	23%	23%	53	63	73	28	23	20	29	32	32
HCL Tech	1,004	27,42,000	11,481	13,256	14,900	19%	20%	21%	50	56	68	20	18	15	22	24	27
Wipro	467	25,53,000	10,356	12,062	13,880	17%	17%	19%	23	25	32	20	19	15	21	20	23
Tech M	1,123	16,72,000	5,998	7,271	8,184	15%	13%	14%	64	70	81	18	16	14	22	21	21
LTI	3,998	7,01,252	2,103	2,716	3,350	17%	18%	19%	131	175	217	31	23	18	30	35	37
Mindtree	2,866	4,72,741	1,411	1,762	2,120	19%	17%	19%	100	112	145	29	26	20	34	32	33
Coforge	3,671	2,23,664	867	1,099	1,336	15%	16%	16%	113	161	199	33	23	18	27	30	30
LTTS	3,449	3,64,262	880	1,129	1,386	18%	20%	21%	91	126	164	38	27	21	26	30	32
Persistent Systems	3,546	2,70,797	766	1,000	1,241	14%	14%	15%	119	151	184	30	23	19	23	26	28
Birlasoft	363	1,01,359	555	658	786	14%	14%	15%	16	21	26	22	18	14	20	21	22
Cyient	781	86,174	608	705	806	14%	14%	14%	48	54	60	16	15	13	17	18	17
eClerx	2,055	69,476	285	328	368	26%	23%	21%	122	122	130	17	17	16	26	22	20

Source: Edelweiss Wealth Research

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Coverage Universe

Sr. No	Coverage
1	Aditya Birla Fashion & Retail Ltd
2	Aegis Logistics Ltd
3	Amber Enterprises India Ltd
4	Astral Ltd
5	Balaji Amines Ltd
6	Bata India Ltd
7	Birla Corporation Limited
8	Can Fin Homes Ltd
9	Century Plyboards India Ltd
10	Cholamandalam Inv and Finance Ltd
11	City Union Bank Ltd
12	CreditAccess Grameen Ltd
13	Crompton Greaves Consumer Electricals Ltd
14	CSB Bank Ltd
15	Deepak Nitrite Ltd
16	Easy Trip Planner Ltd
17	Escorts Ltd
18	Finolex Industries Ltd
19	Home First Finance Company India Ltd
20	Indo Count Industries Ltd
21	K P R Mill Ltd
22	KNR Constructions Ltd
23	Krishna Institute of Medical Sciences Ltd
24	Lumax Industries .Ltd
25	Metropolis Healthcare Ltd
26	Minda Industries Ltd
27	Motherson Sumi Ltd
28	Navin Fluorine International Ltd
29	Neogen Chemicals Ltd
30	Newgen Software Technologies Ltd
31	Orient Electric Ltd
32	PSP Projects Ltd
33	Rossari Biotech Ltd
34	Shriram Transport Finance Company Ltd
35	SRF Ltd
36	Vinati Organics Ltd
37	Voltas Ltd
38	Westlife Development Ltd
39	Zydu Wellness Ltd

Sr. No	Tactical Buy
1	ACC Ltd
2	Ajanta Pharma Ltd
3	Ambuja Cements Ltd
4	Ashok Leyland Ltd
5	Axis Bank Ltd
6	Bharat Electronics Ltd
7	Brigade Enterprises Ltd
8	DLF Ltd
9	eClerx Services Ltd
10	Globus Spittits Ltd
11	GNA Axles Ltd
12	HDFC Life Insurance Co.Ltd
13	ICICI Bank Ltd
14	Indusind Bank Ltd
15	Jamna Auto Industries Ltd
16	JK Cement Ltd
17	Larsen & Toubro Ltd
18	Mahindra and Mahindra Ltd
19	Max Financial Services Ltd
20	Max Healthcare Institute Ltd
21	PNC Infratech Ltd
22	RBL Bank Ltd
23	Sun Pharma Ltd
24	TechMahindra Ltd
25	Ultratech Cement Ltd

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