Ambit
Asset Management

INVESTOR COMPASS

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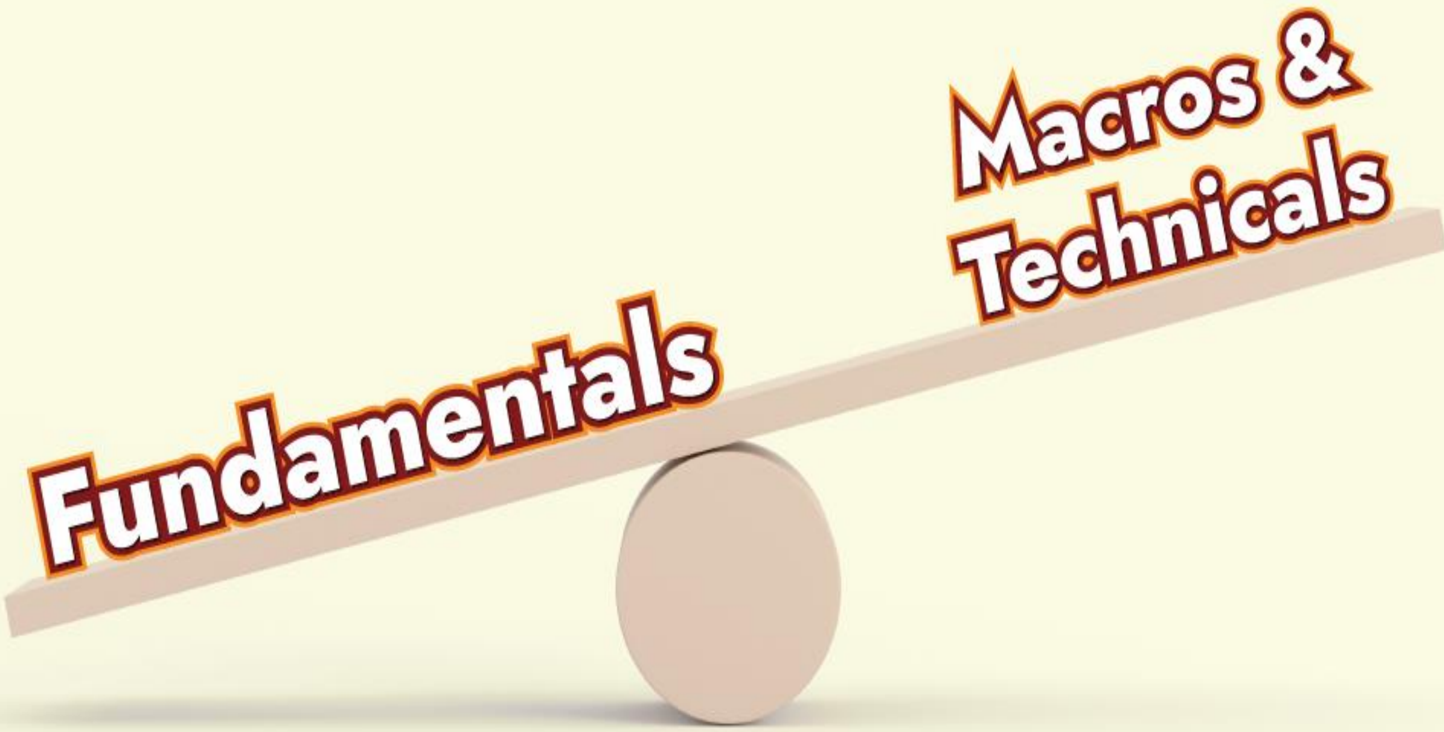
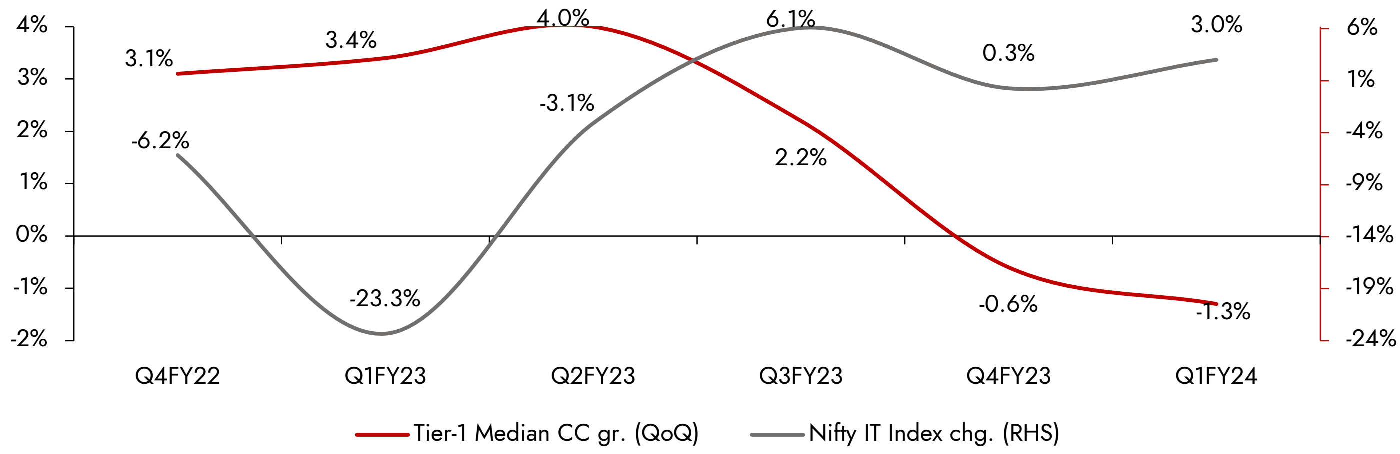
STRIKING A BALANCE: EXPLORING RECENT IT SECTOR PERFORMANCE AND INFLUENTIAL FACTORS



Dear Patrons,

It is often said that markets are forward-looking. We got to see a perfect example of that over the last year in the divergent trend between price movement and fundamental performance of Indian IT services companies. The median QoQ Constant Currency (CC) revenue growth in Q2FY23 of Tier-1 / Tier-2 IT companies was 4%/6.2% - with no signs of a slowdown, at least in the reported numbers. However, the IT index was down ~30% from its Jan-22 peak **(Refer Exhibit: 1),** and more downside was anticipated with an impending energy crisis and recession as the winter set in. Fast forward to Aug-2023 and the median Q1FY24 QoQ CC growth was -1.3%/+1.4% for Tier-1/2 companies. Most of the companies have given a cautionary outlook over the near term with uncertainty in corporate spending courtesy of the ensuing macro uncertainty. The IT index, however, is up ~15% from its September-22 bottom, with some companies such as Persistent and Coforge generating 45-50% returns. So what explains this divergent movement? We often get investor queries regarding the same, wondering if IT stocks are overvalued. **In this note, we look at some of the factors, apart from the reported performance, that have been directing the course of IT companies in the near term.**

Exhibit 1: Divergent trend between fundamental performance and price movement

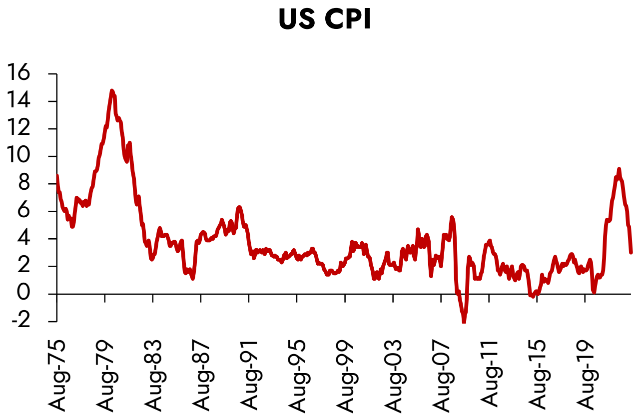


Source: Ambit Asset Management, Company, in.tradingview

Key variables impacting IT stock price:

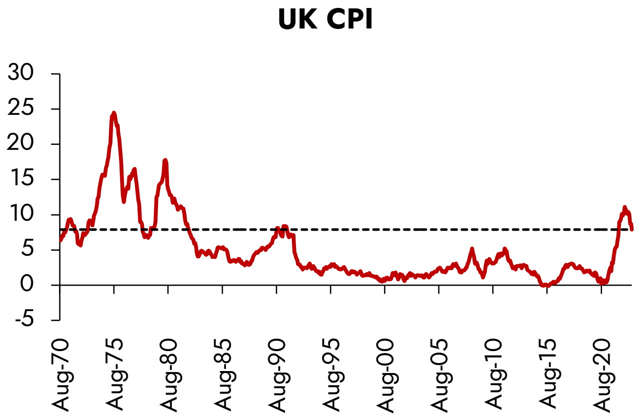
1. **What dragged IT companies in 2022? –** Global headline inflation sparked up sharply in CY2022 owing to post-COVID supply chain challenges exacerbated by the Russia-Ukraine conflict. This compelled central banks globally to raise interest rates at one of the sharpest paces in modern history, which in turn impacted the economy and the growth rates raising fears of a hard landing. This led to an increase in the cost of capital implying higher lending (and refinancing) rates. The days of easy money and Venture funding dried-up compelling companies to become a lot more frugal in their spending – tech included. As a result, while there were no or limited tech project cancellations when compared to earlier such slowdowns, any new project or renewal of discretionary projects where the RoI was limited was put on hold. Most incremental projects started being routed through the board rather than CIO/CTO approval which would have sufficed earlier. This impact was accentuated in CY23 (Q4FY23) as tech budgets were refreshed and revised lower YoY.

Exhibit 2: This extent of jump in inflation was last seen in the 1980s in the US...



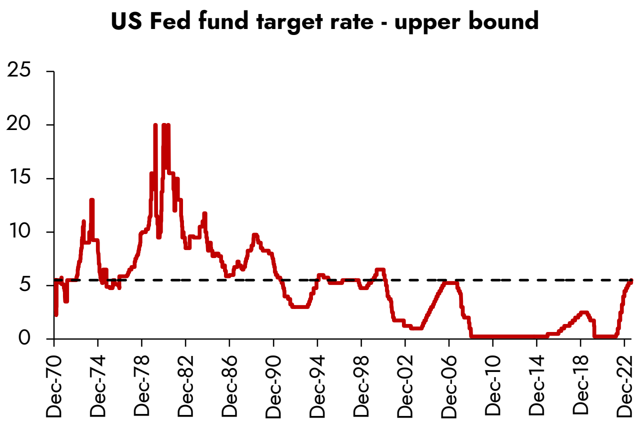
Source: Ambit Asset Management, Bloomberg

Exhibit 3: ...and in the UK, where the inflation has been much more sticky



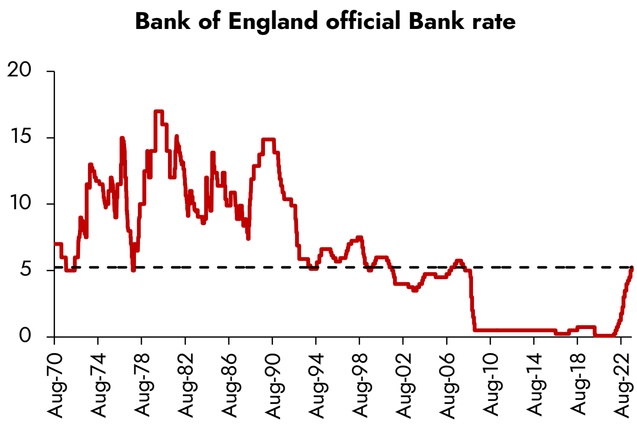
Source: Ambit Asset Management, Bloomberg

Exhibit 4: This led central banks to increase interest rates sharply...



Source: Ambit Asset Management, Bloomberg

Exhibit 5: ... the quantum of which was last seen in the 1980s



Source: Ambit Asset Management, Bloomberg

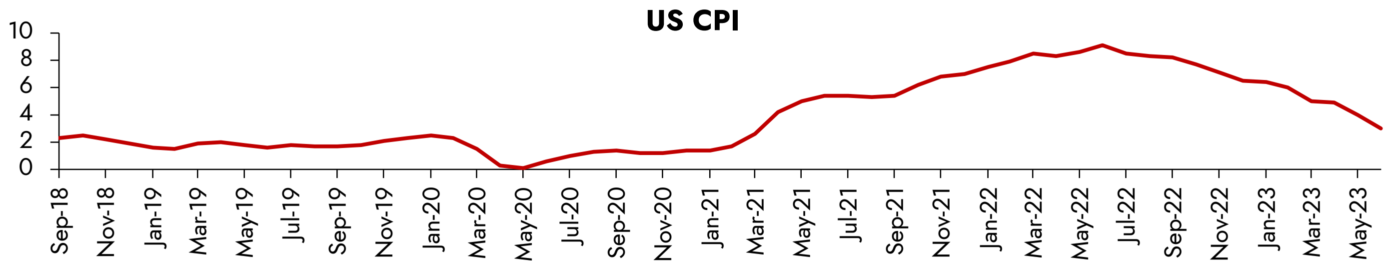
2. **Cooling inflation leading to hopes of peaking fed rate –** Global Inflation (especially in the US) is now showing signs of cooling down **(Refer Exhibit: 7)**, albeit at a slower pace. This would imply that Central Banks (especially the US Fed) may not have to raise rates as aggressively as they did in 2022 and we may be nearing a peak interest rate cycle (**Refer Exhibit: 6**), thus allaying fears of hard lending. This would imply an end to a conservative and cautious spending environment by corporates. There are also hopes of 'Budget Flush' as most of the Tech budgets allocated for the year by clients remained under-utilized. Moreover, any possible cuts in the future would also imply a reduction in the cost of capital thus helping valuations favorably.

Exhibit 6: Based on easing inflation, the Fed is expected to maintain rates at these levels with possible cuts starting in 2024

Rate (in %)	Market Yields	Q3CY23	Q4CY23	Q1CY24	Q2CY24	Q3CY24	Q4CY24
US 10-Year	4.10	3.75	3.64	3.54	3.48	3.45	3.42
US 2-Year	4.83	4.65	4.41	4.07	3.80	3.58	3.41
Fed Funds Rate (Upper)	5.50	5.50	5.50	5.25	4.80	4.35	4.00
Germany 10-Year	2.61	2.46	2.32	2.23	2.18	2.11	2.08
ECB Deposit Rate	3.75	3.86	3.88	3.85	3.69	3.48	3.17
UK 10-Year	4.45	4.33	4.06	3.98	3.77	3.69	3.46
BOE Bank Rate	5.25	5.55	5.65	5.60	5.30	5.00	4.70

Source: Ambit Asset Management, Bloomberg, Note: Data as of 8th Aug 2023

Exhibit 7: US CPI is now showing signs of cooling down

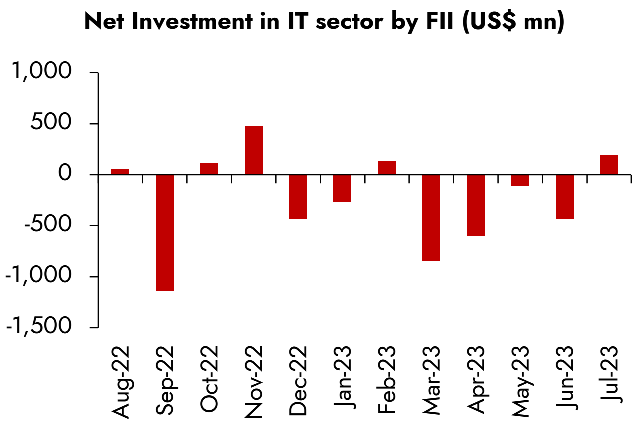


Source: Ambit Asset Management, Bloomberg

3. **Signs of a turn-around in the sharpest impacted sectors/companies –** While traditional wisdom would imply that BFSI clients would be most impacted by interest rate movement, the performance (of these clients for Indian IT) has varied sharply owing to exposure to various sub-segments within BFSI. Companies with high exposure to interest rate-sensitive verticals such as Mortgage, Investment Banking, and Capital Markets were relatively more impacted as compared to those having exposure to Consumer Banking and Risk / Compliance. Mphasis, for eg, was most impacted courtesy of its exposure to mortgage BPO – which is dependent on loan origination – which slowed down severely. Mphasis was one of the first companies to see an impact on fundamentals with a revenue decline of ~10% over the last 3 quarters. However, it is also one of the first companies to indicate some signs of bottoming out and pick-up in mortgage volumes – which is the most interest rate, sensitive thus leading to hopes of bottoming interest rate cycle.

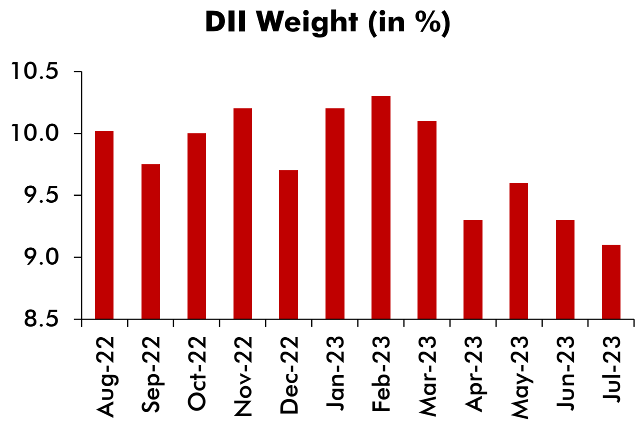
4. **The flow show –** Foreign investors are turning net positive on India after a spate of huge selling last year **(Refer Exhibit: 8)**. Additionally, these investors are also reducing their under-weight position in the tech sector which is acting as an incremental support to prices

Exhibit 8: FII Underweight in IT is reducing…



Source: Ambit Asset Management, Bloomberg

Exhibit 9: … while DIIs continue to be underweight



Source: Ambit Asset Management, Bloomberg

Conclusion

The sharp correction in IT stocks in 2022 was in anticipation of macro pressures which have played out (perhaps, more than anticipated) over the last few quarters. The subsequent bounce-back is preceding a similar assumption of macro headwinds receding. It'll be difficult to anticipate future movements but it would be fair to expect sharp volatility until global (especially, US) macros stabilize. We remain positive on the 3-5 years prospects of the sector given better growth prospects owing to increased Digital spending post-COVID, superior return rations, cash conversion, and payout.

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