India

Neutral *(previously Overweight)*

IT Services

Changing dynamics warrant recalibration

- History says tariffs are not good for earnings upgrade/decision-making.
- US government hiring may not be revealing the true picture of unemployment.
- Nifty IT index outperformance + potential lower global growth + consumption focus in the Union budget = trimming of profitable positions. We turn Neutral.

What is priced in?

Since our Overweight call on the IT sector on 21 Aug 2024, Nifty IT Index has outperformed Nifty Index by 6.3% while the peak outperformance, going into 3QFY25 earnings, in Dec 2024 was ~15% and largely attributable to reasons mentioned in our report. However, recent news flow on tariffs is not constructive for earnings upgrade and decision-making. As seen historically, the first-order impact could be trimming of P/E multiples followed by a second-order impact of potential earnings downgrade.

History says tariffs less constructive for earnings/decision-making

While the news flow of Mexico, Canada and China tariffs is well understood, we would like to remind investors of the impact of restrictions on Huawei in 2019 & the retaliatory steps by China to stop buying US agricultural goods. The escalation led to an increase in the 5G network roll-out cost for European telecom providers while lower imports negatively impacted the outlook of US farm equipment players. Potential lower global growth from tariff-led uncertainty could lead to delay in decision-making and change the IT spending pattern due to client-specific challenges. Put together, it outweighs the positives in the near term. Depreciating Indian rupee & CFO yield are key offsets and valuation anchors.

US jobs data may not be revealing the real picture of unemployment

Although we believe that the Department of Government Efficiency (DoGE) may not be an impediment to IT spending but, on the contrary, may accelerate the efficiency/cost take-out theme-driven IT outsourcing, our analysis of jobs data suggests that it may not be revealing the real picture of unemployment & poses near-term headwinds. Further, the impending layoffs faced by government employees and potentially in the private sector too from the return-to-office policy does not bode well for consumer demand and, in turn, for corporate America. Our analysis of US jobs data suggests that government hiring (including federal, state, and local) accounted for ~22% of total non-farm payrolls during 2023-24 vs. an average 6.9% during 2014-22 and an average 2.9% during 2011-20. We believe that government hiring has deflated the unemployment rate by ~70-80bp vs. the reported 4.2%.

Consumption focus in the Union budget could drive a recalibration

InCred's Union Budget 2025-26 analysis suggests an all-out-effort to address the consumption slowdown challenges and reviving the same through personal income-tax rate reduction. Further, InCred also believes that retailing, consumer durable, FMCG, two-wheeler, car and hospitality sectors could be key beneficiaries. This, coupled with 1) the Nifty IT index's outperformance, and 2) potential uncertainties globally may drive the trimming of profitable positions, in the interim, to invest elsewhere.

Lower asset prices could drive M&A activity globally

Potential lower asset prices could drive merger & acquisitions (M&A) globally as well by Indian IT vendors, especially by Tier-II companies to augment capabilities. Generally, M&A leads to integration-related downstream revenue for service providers and aids growth but, again, this could be a second-order impact.

Downgrade IT services sector rating to Neutral from Overweight

Although, we had highlighted in our 12 Dec 2024 report that changing business dynamics (including recovery in demand led by FSI and retail verticals, improvement in decision-making and potential uptick in CY25F IT budgets) coupled with capability investments could improve absolute growth assumptions of Tier-II companies and hence, warrants a relook, we believe the dynamics are changing rapidly and needs a quick recalibration too. We may again hide in Tier-I companies and use better entry valuations to turn BUYers in Tier-IIs. We would revisit the rating/TP of our coverage universe separately.

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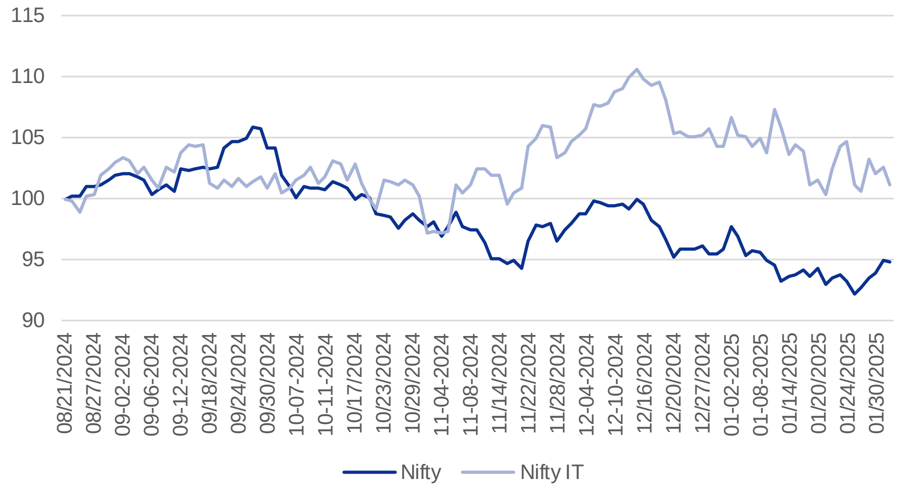
Figure 1: Nifty IT index outperformed Nifty index since our Overweight stance in Aug 2024



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 2: Top 20 export partners of the US

Country	Share, %	Export CAGR, 2019-2023
Canada	17.5%	4.8%
Mexico	16.0%	6.0%
China	7.3%	8.6%
Netherlands	4.1%	12.7%
Germany	3.8%	6.3%
Japan	3.8%	0.6%
United Kingdom	3.7%	1.8%
Republic of Korea	3.2%	3.5%
France	2.2%	4.2%
Brazil	2.2%	1.1%
Singapore	2.1%	8.0%
India	2.0%	4.1%
Taipei, China	2.0%	6.3%
Belgium	1.9%	2.8%
Australia	1.7%	6.8%
Italy	1.4%	5.1%
Switzerland	1.4%	11.7%
Hong Kong, China	1.4%	-2.5%
Spain	1.2%	13.0%

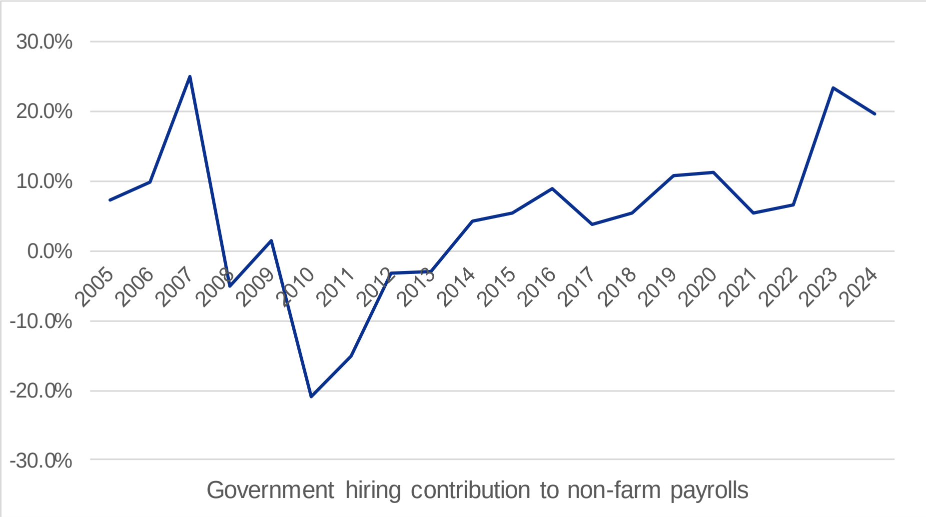
SOURCE: INCRED RESEARCH

Figure 3: Top 20 import partners of the US

Country	Share, %	Import CAGR, 2019-2023
Mexico	15.1%	7.5%
China	14.1%	-1.2%
Canada	13.6%	7.2%
Germany	5.1%	5.8%
Japan	4.8%	0.8%
Republic of Korea	3.8%	10.6%
Vietnam	3.7%	14.5%
Taipei, China	2.8%	12.6%
India	2.8%	9.8%
Ireland	2.6%	7.4%
Italy	2.4%	6.3%
United Kingdom	2.1%	0.4%
France	1.9%	0.1%
Thailand	1.8%	14.0%
Switzerland	1.7%	3.9%
Malaysia	1.5%	3.4%
Brazil	1.3%	6.3%
Singapore	1.3%	11.1%
Netherlands	1.2%	6.4%
Indonesia	0.9%	7.4%

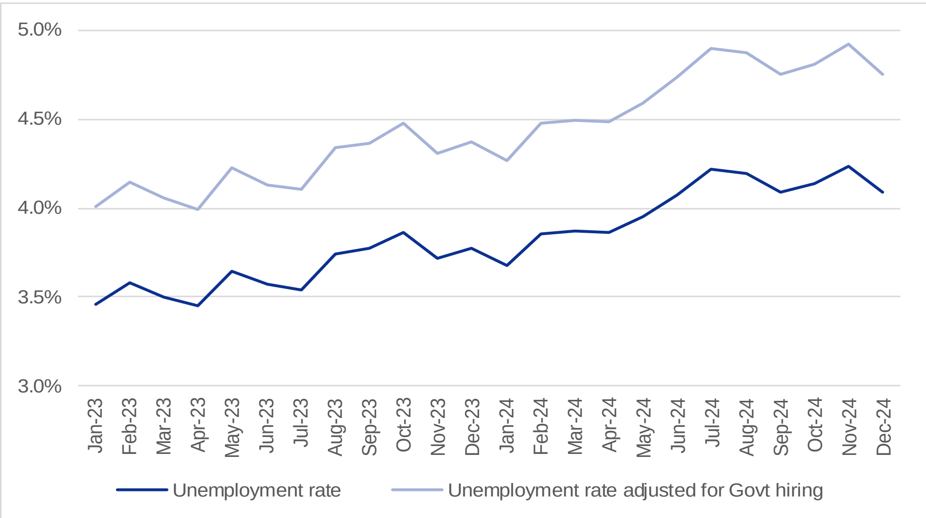
SOURCE: INCRED RESEARCH

Figure 4: Government hiring accounted for 22% of the total US non-farm payrolls vs. 2.9% during 2011-20



SOURCE: INCRED RESEARCH

Figure 5: Substantial government hiring may not reflect the true picture of the US unemployment rate



SOURCE: INCRED RESEARCH

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Stock Ratings	Definition:
Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.