India

Neutral *(no change)*

IT Services

Ears to the ground – change in messaging

- Contracting continues, but the mix changing to short-cycle consulting work.
- This could support near-term recovery and alleviate margin pressure.
- E&U, insurance, healthcare, and communication verticals witnessing traction.

Contracting continues, but mix likely shifting to short-cycle projects

Our discussions suggest that the Jun 2024 trends are positive vs. May/Apr 2024 and/or at the beginning of 1QFY24. Client procrastination across industry segments is receding and is being replaced with 1) a sense of urgency, and 2) a change in the speed of decision-making. Talent shortage and layoffs associated with last year's restructuring are impacting reskilling & upskilling and is leading to clients leaning on vendors for competencies including 1) domain skills (role mapping), 2) re-skilling (for GenAI), and 3) growth agenda post organization restructuring. This, in turn, is driving an uptick in consulting projects which could be characterized as a recovery in discretionary demand. As a reminder, Accenture (ACN US: Not Rated) in its 3QFY24 commentary highlighted a return in consulting work, which was weak since 2QFY23 (Aug year-end). Put together, we believe 1QFY25F earnings commentary could be generally constructive.

It could support near-term growth and alleviate margin pressure

A typical consulting playbook for IT services companies comprise 1) advisory to set up own captives, 2) build-operate-transfer (BOT), and 3) carve-out deals while offerings include tax advisory, location strategy, infrastructure & technology including training, hiring, transformation and governance partner, etc. We heard that Tier-I Indian IT services vendors are likely winning a higher share of such consulting projects, given broader offerings and better deal structuring, while Tier-II vendors are partnering mid-sized global consulting firms to participate in such opportunities. The return of short-cycle work could also alleviate margin headwinds, to some extent, given better deal structuring with milestone payments, vs. elongated outcome-based earlier, and moderating employee cost trajectory driven by lower attrition, replacement costs and wage inflation.

Continuation of this trend in 2QFY25F may improve visibility

We have been highlighting an uptick in contracting activity in our previous reports (March 13, 2024) with a caveat that revenue conversion could be slower, given longer deal tenure and transition. However, a recovery in short-duration projects could imply faster ramp-up, with a near-term revenue kicker. This, coupled with the continuing trend of declining quantum of discretionary project roll-offs, could aid an improvement in yoy growth trajectory and drive FY25F earnings upgrade.

Vertical commentary: E&U replacing financial services

Our discussions suggest that large/mega deals are being constructed especially in the energy & utilities (E&U) vertical while communication, healthcare, & insurance verticals are witnessing better traction, and that manufacturing, automotive, consumer packaged goods (CPG), retail, travel & tourism verticals' growth could moderate. Within the financial services vertical, large/mega deal activity has moderated, but is partly compensated by multiple smaller deals while the regional banks' recovery continues.

'Doing more for less' noise could continue

Companies shifting to the captive model could further commoditize the operations to a factory model to safeguard monetization after a few years when the technology trend changes. This implies that commoditization of existing revenue, which is funding consulting assignments, could continue.

It may not be the time to be underweight on the sector

1QFY25F is unlikely to drive upgrades but could limit downgrades and potentially change the messaging, while the continuation of this trend in 2Q could improve visibility & drive FY25F upgrades. Although, the recovery in discretionary projects, if any, is positive for Tier-I companies given their favourable valuations, select Tier-II companies could benefit too.

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