FIDENT FOCUS

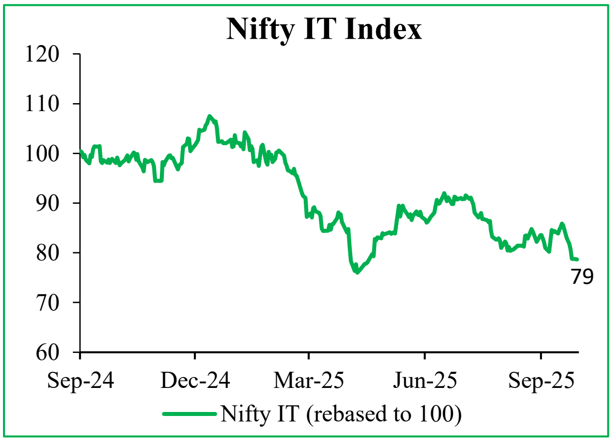
IT Services: A look at the yonder

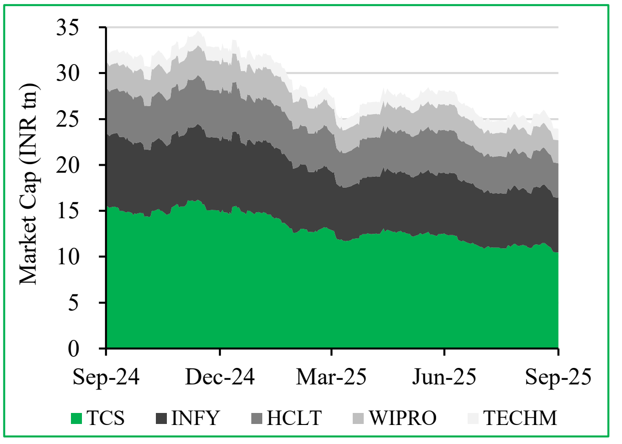
Why are we heavy on IT?

FIDENT ASSET MANAGEMENT

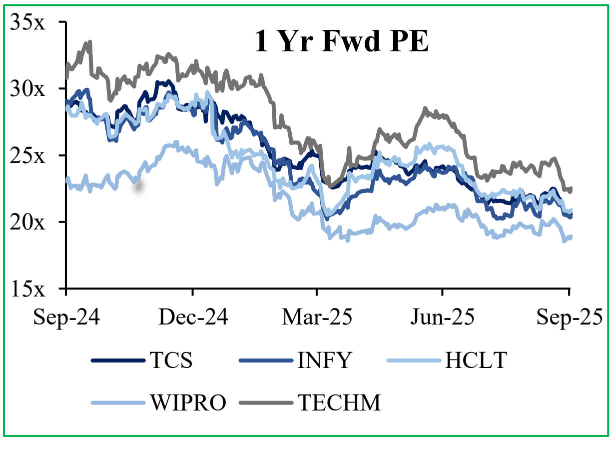
I. The Setup: Market Correction In IT Services

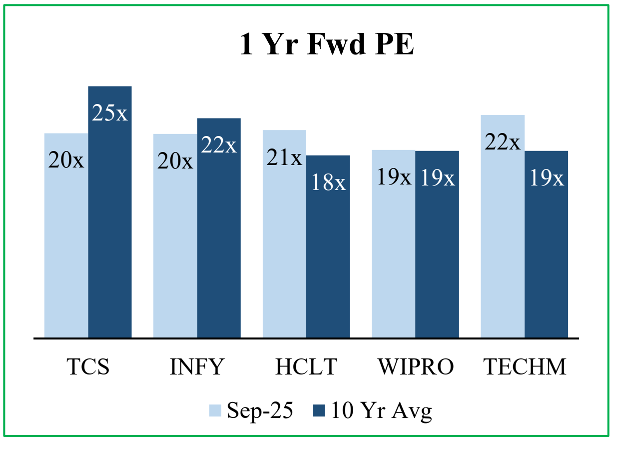
The IT Services sector has been a clear underperformer this year. For context, in the past 1 year, the Nifty IT index is down 21% while the combined market cap of the top 5 IT companies is down by staggering ₹ 8.5 trillion (-26% YoY).





Valuation Plunge: P/E multiples across the sector have fallen sharply—in many cases, from highs of **30x+** during the post-pandemic boom to current levels around **20x–25x**, nearing historical averages.





II. The Prevailing View: Negative Sentiment Triggers

The current market pessimism is primarily driven by uncertainty in two major areas:

A. Macro & Policy Uncertainty (The Near-Term Headwinds)

- **Subdued Global Demand:** A persisting soft global macro-environment has led to significant deferrals and cutbacks in discretionary IT spending by clients.
- **U.S. Economic Slowdown Fear:** Heightened expectation of a U.S. economic downturn, partially driven by the market reaction to recent trade policies and Trump tariffs.
- **Visa Cost Pressure:** Sentiment was further dampened by the prospect of massive fee hikes for H-1B visas, directly impacting the cost structure and margin outlook for IT firms reliant on global talent mobility.

B. AI Disruption Threat (The Structural Fear)

- **Job Cannibalization:** Fear that genAI will rapidly displace entry-level coding and testing jobs, directly cannibalizing the sector's traditional, lower-margin work.
- **Revenue Deflation:** Expectation that customers will demand more for less and AI-driven efficiency gains will be passed on to customers in an intensely competitive environment, leading to deflationary revenue growth rather than margin expansion.

III. The Contrarian Thesis: Looking At The Yonder

Our overweight position is based on the long-term structural tailwinds, a favourable view of how the sector is adapting to headwinds and an attractive risk-reward from valuation standpoint.

A. Core Structural Tailwinds (The Inevitable Future)

- **Enduring Digital Imperative**: The structural tailwind of digital transformation and legacy modernization remains intact, serving as a massive, recurring, multi-year demand driver for IT services, irrespective of near-term macro cycles.
- **Re-rating Catalyst:** While the near-term timeline is uncertain, a re-rating of the sector is simply contingent on the emergence of a new technology cycle (which AI is poised to be) and the subsequent return to meaningful earnings upgrades.

B. Policy Headwinds Mitigation (The H-1B Story)

- **Reduced H1B Reliance:** Indian IT vendors have significantly de-risked their on-site operations over the last decade through localization and local hiring drives. H-1B holders now represent ~5% of the active workforce.[1]
- **Offshore Amplification:** The new visa fees will compel IT vendors to hire locally instead of paying the exorbitant fee. Such policy hurdles will only accelerate the shift to offshore delivery, potentially improving the cost efficiency of the companies.

C. The AI Opportunity (Beyond Disruption)

- **Widened Revenue Pool (Integration Demand):** Generative AI creates a new wave of enterprise demand for advisory, integration, and implementation services. IT service firms are perfectly positioned as system integrators to help clients adopt these complex technologies, expanding the total addressable market (TAM).
- **Productivity Gains are Real:** AI yields tangible productivity efficiencies in software delivery, enabling IT firms to handle greater volume/employee vs pre-genAI era.
- **Competitive Margin Pressure:** The gains will likely lead to margin risk (as efficiency is passed to clients) and an intensification of competition, meaning AI is likely a revenue volume driver (larger TAM) rather than a pure medium-term margin expansion driver.

D. Favourable Risk/Reward Conducive to the Contrarian Call

- **Asymmetric upside:** The valuations for the top 5 companies now imply ~6% growth over 10 years based on a reverse DCF analysis.[2] This means that the bad news is already priced in. If the US economy avoids a recession, or if AI integration proves faster than expected, the **surprise factor (upside)** could potentially be high. The downside is largely protected by current low valuations.

Conclusion: Embracing the "Yonder"

The classic setup of a contrarian investment lies in recognizing a disconnect between a sector's **strong long-term fundamentals** and its **poor current market perception**. Our conviction in the IT services sector is precisely this - we believe the current negative narrative has created a cyclically compelling entry point.

Our long-term thesis remains grounded:

- **Structural Tailwinds Endure:** The massive and recurring demand for **digital transformation and legacy modernization** remains intact, now being accelerated by the **AI cycle**. Recent management interactions reiterate the scale of this opportunity for system integrators.
- **The Worst is Likely Priced In:** While an immediate acceleration in order books may be slow, we believe the worst of the macro-driven demand uncertainty is behind us.
- **Favourable Entry Point:** At current valuations, the sector offers a **defensible risk/reward profile**. Even if sentiment remains flat in the near term, we view IT services sector as a **neutral investment at a minimum** (neither underpriced nor overpriced) based on stable earnings.

For investors focused "at the yonder," the combination of a **positive, long-term narrative** with **favourable risk/reward profile**, we find a high-quality, free cash flow-generating sector trading at a discount, creating compelling entry point for long-term investors. However, in that process we also acknowledge that a contrarian bet demands **patience and a long-time horizon**, requiring the stomach to bear potential near-term volatility.

Company Name	MCap (₹ bn)	TTM P/E	P/E FY26E	P/E FY27E	FY25A EPS	FY26E EPS	FY27E EPS	2 Yr CAGR
TCS	10,544	21.4x	21x	19x	₹ 65	₹ 69	₹ 75	7%
INFY	5,993	22x	21x	19x	₹ 64	₹ 64	₹ 72	6%
HCLT	3,765	22x	22x	19x	₹ 13	₹ 13	₹ 13	3%
WIPRO	2,524	19x	19x	18x	₹ 155	₹ 174	₹ 199	13%
TECHM	1,519	32x	30x	26x	₹ 48	₹ 59	₹ 74	24%
PERSISTENT	1,254	28x	24x	19x	₹ 90	₹ 113	₹ 137	23%
COFORGE	740	51x	44x	36x	₹ 25	₹ 42	₹ 53	45%
MPHASIS	536	58x	38x	30x	₹ 89	₹ 99	₹ 113	12%

Source: S&P Capital IQ

1. MOSFL report
2. Investec Report

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