Batlivala & Karani
B&K SECURITIES
WE UNDERSTAND MONEY
SECTOR UPDATE
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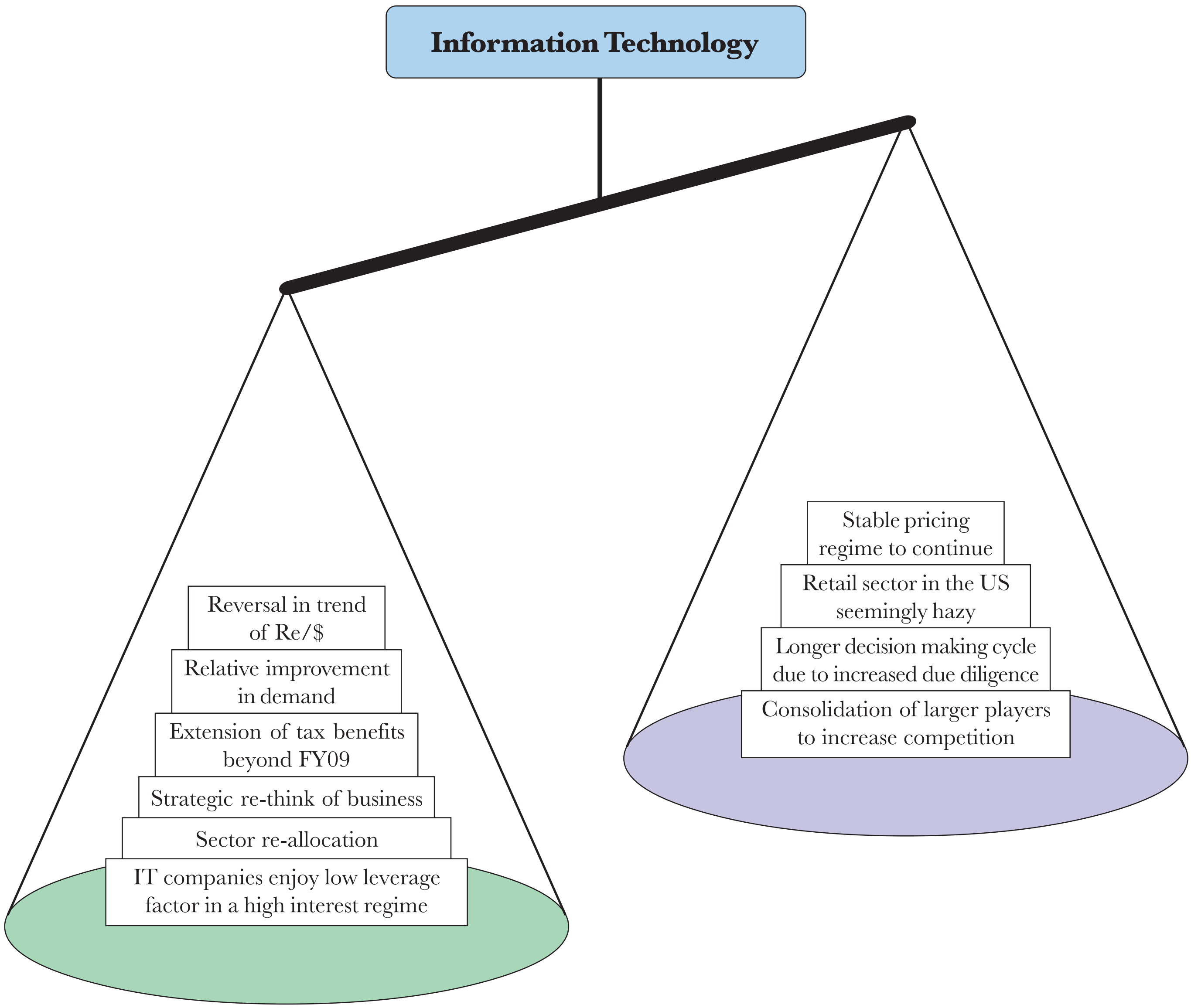

"Positives outweigh Negatives"

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With the dust settling, and demand visibility becoming clearer, we have greater confidence that IT companies will achieve their earnings guidance. IT companies have, so far, reaped the benefits of the low hanging fruits of outsourcing. However, with cost pressures weighing down on all corporates in the US, we believe outsourcing is at the next inflection point. As the outsourcing model has matured over the years, companies will be able to segregate the core and non-core processes to increase outsourcing. This will result in strategic partnerships and large deals in the IT sector that will benefit large Indian IT companies.

FY08 was a challenging year for Indian IT companies as they faced multiple headwinds: i) turmoil in their largest target market, the US, leading to project delays and in certain cases, project cancellations; ii) rupee appreciation of 11% and iii) lack of clarity on tax issues. All these factors were well reflected in the stock prices of IT companies with BSE IT underperforming the Sensex by 19% in the last twelve months.

Now, from our recent Bangalore meeting, one common opinion which came up was improving business environment compared to the apprehension during the 4Q earnings conference calls. The management commented about the demand environment being relatively better and companies being confident of growth picking up in the second half of FY09E. Company managements seem to be positive in terms of deal flow as the number of RFPs (Requests for Proposal) and deals in the pipeline has grown significantly. We expect to see increased traction from large clients during the second half of the year and expect a positive trend in FY10.

The strengthening dollar and the extension of STPI (Software Technology Parks of India) tax benefits until FY10 have only made the IT case stronger. Given the current economic outlook, we are revising our average Re/$ assumption for FY09 from Rs 40 to Rs 42.75 and to Rs 44 for FY10, from Rs 40.

Thus, with the backdrop of the improving demand situation, incorporating our new currency assumption and factoring in the tax tailwind for FY10, we upgrade our earnings estimates for IT companies. **This takes earnings growth from the 12-15% range to 17-21%, over FY08-10.**

Change in earnings estimates

	Previous EPS (Rs)		New EPS (Rs)		Change (%)		EPS CAGR FY08-10E (%)	
	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	Previous	New
Infosys	96.2	106.4	101.5	117.9	5	11	14	20
TCS	58.3	64.5	59.9	70.5	3	9	12	17
Wipro	26.1	28.2	27.2	32.5	4	15	13	21
Satyam	30.4	33.4	32.7	36.9	7	11	15	21

Source: B&K Research

Change in target prices

An earnings contraction has pulled down the PE multiples of IT companies in recent quarters. However, given the same PEG of 1x (which we gave when downgrading IT), Tier-I IT companies will command a higher PE multiple in the range of 18-20x. Hence, we revise the target prices upwards for all IT companies.

We believe that, from present levels, IT companies provide a substantial upside, thus warranting us to upgrade the IT sector. **We upgrade Infosys to Buy from Outperformer and upgrade Wipro to Outperformer from Underperformer. We maintain Outperformer on Satyam and TCS.**

Change in target price

(Rs)	Old Target Price	New target Price	Change (%)
Infosys	1,700	2,400	41
TCS	960	1,128	17
Wipro	452	585	30
Satyam	470	591	26

Source: B&K Research

Valuation matrix

	CMP (Rs)	EPS (Rs)			PE (x)			EPS CAGR (%)	Target Price	Upside (%)	
		FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08-10E	(Rs)		Rating
Infosys	1,913	81.3	101.5	117.9	24	19	16	20.4	2,400	25	Upgrade to Buy
TCS	921	51.3	59.9	70.5	18	15	13	17.2	1,128	22	Maintain Outperformer
Wipro	494	22.2	27.2	32.5	22	18	15	21.0	585	18	Upgrade to Outperformer
Satyam	484	25.2	32.7	36.9	19	15	13	21.1	591	22	Maintain Outperformer

Source: B&K Research

Recent performance of the top four companies

QoQ growth 4QFY08 (%)	Infosys	TCS	Satyam	Wipro
Revenue	6.3	2.9	10.0	6.9
EBITDA	6.2	(1.7)	16.9	10.3
PAT	4.1	(5.6)	7.7	6.3
EPS	4.1	(5.6)	7.5	6.3
YoY growth FY08 (%)	**Infosys**	**TCS**	**Satyam**	**Wipro**
Revenue	20.1	22.7	30.7	32.1
EBITDA	19.3	17.3	19.3	12.9
PAT	25.0	21.5	20.2	10.7
EPS	25.0	21.5	19.7	10.0

Source: B&K Research

1. Improving visibility in demand

During our recent visit to Bangalore, we met with the management of Infosys, MphasiS and MindTree.

The management of all companies sounded relatively positive on the demand scenario compared to the apprehension shown during the 4Q results. The managements indicated that their clients' IT budgets have been finalised. They admitted that there was a delay in the decision making on projects to be outsourced in 4Q, leading to the deferment of certain projects and a slowdown in the ramp-up of others.

The companies indicated that their interactions with clients now involve a higher level of due diligence, leading to conversations with a higher band of executives in the board room, and these being restricted not only to the CIO level but even reaching the CFO level or above.

The companies in the US have realised the benefits of outsourcing to achieve operational efficiencies. The BFSI (Banking, Financial Services and Insurance) vertical has benefitted in the past from outsourcing and this sector is expected to increase the outsourcing component in the second half of the year, though the retail sector is still facing the heat and is expected to be lacklustre for another two to three quarters. The telecom vertical has seen some consolidation in the last year and it is expected to grow better in FY09. British Telecom (BT) has given an outlook of £ 700 mn worth cost efficiencies for FY09. In the last year, it achieved cost savings worth £ 625 mn.

IT companies like Infosys, Satyam and Cognizant have given a back-ended growth projection. These companies believe the offshore IT spend momentum will build up by the end of FY09, and that this will continue or improve into FY10 on the back of increased allocation for off shoring.

The moderation in wage costs from the previous 14%-18% to10%-14% now, (as indicated by many companies in last quarter's conference calls) offers a second big respite, on the cost front.

According to the management, the momentum of the deal flow has increased, with decisions on project ramp-ups picking up. It affirms a better second half of FY09.

- Infosys says that the deal pipeline has now attained a healthy level and Infosys is pursuing six to seven large deals.
- MindTree's management has indicated that the deal pipeline is the strongest in the last five to six years. It has the least exposure to the BFSI sector and newer verticals are exhibiting good growth.
- MphasiS' management indicated that though there was a delay in projects being kick started in 4Q, leading to lower utilisation, things look better now and projects are witnessing ramp-ups.

2. Stable pricing scenario (with an upward bias)

As indicated by the management of most of the companies we interacted with, pricing is mostly stable across sectors and geographies for existing clients. However, during these difficult times, it is a pleasant surprise to note that new businesses are acquired at higher than blended rates. MindTree's management has indicated a 5% increment in the blended rate for FY09.

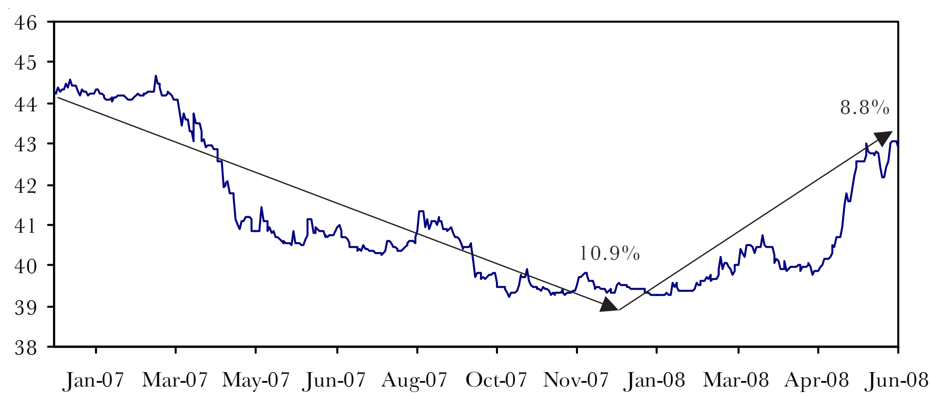
3. Jokers in the pack

a) "Re/$ rate"

The rupee appreciation has been a major headwind for the performance of IT companies, particularly in FY08 when the Re/$ rate appreciated by ~11% in CY08, but now the trend has reversed with the rupee depreciating by ~9% YTD which is now in the IT industry's favour.

Moreover, B&K Research shows further possibility of a depreciation in the Re/$ rate. Our house call on the Re/US$ rate is 44 for FY09 and 46 for FY10. However, we have been a little conservative and have based our projections on a Re/$ rate of 42.75 for FY09 and 44 for FY10. (Please note that, on average, a 1% depreciation of the rupee against the dollar changes the EPS in the range of 1%-1.5%).

Re/$ movement



Source: B&K Research

Substantiation of further expected depreciation in the rupee:

1) The high crude oil prices will result in a high trade deficit and this will further broaden the current account deficit of the country and hence, act as a force against the Re/$ appreciation.
2) The second primary reason is the likelihood of a slowdown in the capital inflows in the country compared to last year. This will strengthen the dollar from current FY09 levels, and a similar situation is expected in FY10.
3) The dollar is expected to be stronger than other global currencies which will control the rising inflation rate in the US.

Revised currency assumptions

(Re/$)	FY09E	FY10E
Earlier	40.0	40.0
New	42.8	43.0
Change (%)	7	8

Source: B&K Research

Change in tax rate

(%)	Previous		Revised	
	FY09E	FY10E	FY09E	FY10E
Infosys	14	20	14	18
TCS	13	18	13	14
Wipro	12	12	12	12
Satyam	12	20	12	12

Source: B&K Research

b) Blessing in disguise "Extension of STPI benefits until FY10"

The extension of tax benefits to FY10 has brought relief to most IT companies. The Finance Minister has announced that the income tax exemption for IT companies under the STPI and EOU schemes will be extended by one year, to March 2010, from the previous deadline of March 2009. The extension of the STPI scheme benefits has now given more time to companies to move their work to SEZs.

We have revised our tax rates for all the IT companies for FY10, taking into account the extension of 10A/B tax benefits.

How do the incorporation of a higher Re/$ rate and the extension of tax benefits until FY10 change our numbers?

Change in earnings esimates

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Satyam	30.4	33.4	32.7	36.9	7	11	15	21

Source: B&K Research

4. Strategic re-think

IT companies had a very tough FY08 and they faced the heat on multiple fronts. However, companies have now given a serious re-think to their business models and are adopting various strategies to evolve out of the traditional models. Though companies are moving very aggressively on these new fronts, we believe it is too early to draw any conclusions from these new initiatives and we would rather wait for these initiatives to show results.

a) Wipro, in its analyst meet, announced that it has re-organised its business verticals to capture a larger share of the market. It sounded positive about newer service lines like infrastructure services and emerging markets like India and APAC.

b) Infosys has shown greater focus on its consulting business. Currently, Infosys has 263 consultants and it wants to ramp up the number of consultants to 400 within two years. Consulting will help drive the down-stream revenue and will also provide a non-linear revenue model. During 4Q, it also realigned the service offerings and launched two new services: Software as a Service and Learning Services.

c) TCS, too, has split its operations into five verticals: industry solutions, major market, new growth markets, strategic initiatives and organisation infrastructure. This move will not only bring more responsibility to the middle level management, but also bring more agility to the organisation.

Driving more operational efficiencies

Infosys' guidance hints at a muted hiring for FY09 as the company's focus this year is more on improving utilisation levels.

Though companies like Satyam and TCS have already leveraged the parameters of operational efficiencies to a good extent, we believe there is scope for improvement in the utilisation rate of Infosys and Wipro.

Utilisation levels

(%)	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08
Infosys	74.1	72.9	70	69.7	71.1	67.5	67.5	67.9	**70.5**
TCS	74.8	75.0	75.5	75.8	77.3	75.2	75.0	74.7	76.0
Wipro	67.0	65.0	63.0	65.0	67.0	64.0	62.0	63.0	**67.1**
Satyam	74.2	74.7	74.3	72.2	71.2	71.1	68.5	71.3	76.5

Source: B&K Research

Infosys has indicated that it will maintain its EBITDA margins in the same range as last year, despite operational benefits from the rupee depreciation kicking in. The additional benefits of the rupee depreciation will be invested back into the business, in the form of more investment in sales and marketing and in its subsidiaries like Infosys Consulting and Infosys China. We have seen companies cutting back on their SG&A (selling, general and administrative) expenses front in last two to three quarters to maintain margins, but with the rupee reversal, there could be increased SG&A spend by companies.

5. Forex gain/loss: Boon or Bane?

Benefits from the hedge have been reflected in increased other income for FY08 with maximum benefits accruing to TCS and HCL Tech. High other income helped companies to maintain their net profit margins despite the fall in EBITDA margins.

Going forward into FY09E, with the rupee reversing its trend, we believe that companies which had benefitted in FY08 due to an active hedge policy will be hit by the same bug and report forex losses. Tier-II IT companies are more susceptible to reporting higher forex losses as they are more involved in exotic hedge covers. We have seen instances of Hexaware and KPIT reporting huge forex losses to the tune of Rs 1,030 mn and Rs 892 mn, respectively.

Hedging gains of Tier-I companies in FY08

(Rs mn)	Forex gain in FY08	Other income	Forex gain as a % of Other income	Other income as a % of PBT
Infosys	120	7,040	2	13
TCS	2,755	4,503	61	8
Satyam	(207)	2,572	(8)	13

Source: B&K Research

We see Infosys as the company least affected by forex loss, among the large caps, due to its pro-active stand of cutting down its hedge cover to ~ US$ 760 mn from US$ 1.1 bn, previously. Companies follow different hedging policies; so, on a quarterly basis, it would be difficult to make a like-to-like comparison of their hedging gains/losses.

Infosys forex management

	FY06	FY07	FY08
Forex loss/gain (Rs mn)	(682.2)	380	120
Forex loss /gain as % of PBT	(2)	1	0

Source: B&K Research

Hedge positions

(US$ mn)	March 2008	Accounting Policy
Infosys	760	Mark-to-market
TCS	2,900	Cash flow hedging
Wipro	2,950	Cash flow hedging
Satyam	1,100	Mark-to-market

Source: B&K Research

TCS and Wipro use cash flow hedging and report forex losses/gains into the operating margin line as well as in the revenue line, while for Infosys and Satyam, forex losses/gains will be reported in the other income line.

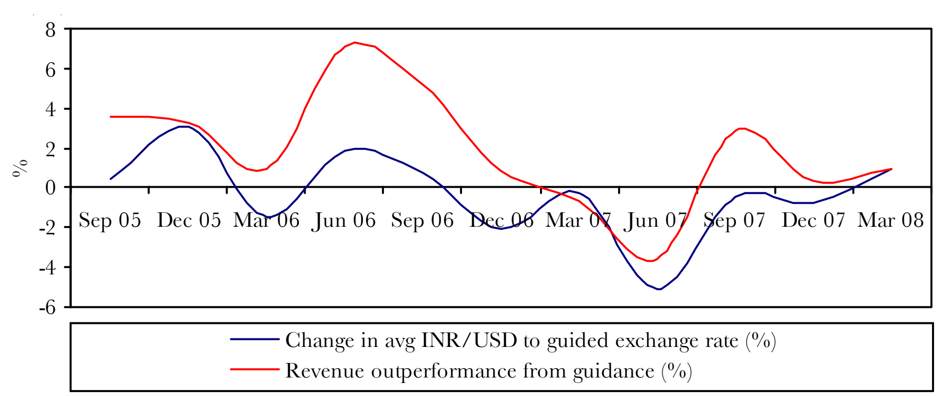
6. Upward revision in guidance expected?

From the guidance provided by companies, **we infer that most of the companies are quite positive about the second half of the year**. TCS, after facing some specific client issues (two of its top 10 clients have cut their IT budgets), is quite confident of an acceleration in momentum in the second half, with the expectation that delayed projects will start employee ramp-up.

Infosys has guided for 21% revenue growth guidance for FY09E and flat growth for 1QFY09E, which reflects ~7% CQGR from 2QFY09E-4QFY09E, to achieve the higher end of revenue guidance of US$ 5,050 mn for FY09E. For Satyam, this translates into a ~4% sequential growth from 2QFY09E onwards, to achieve the revenue growth guidance. **The rupee-based guidance for Infosys and Satyam is based on the currency rate assumption of Rs 40.02 and Rs 40.0, respectively.**

Infosys gives its quarterly guidance based on the period-end rates. Over the last twelve quarters, we have seen that the outperformance of Infosys' revenue over its guidance is distinctly correlated to the average exchange rate for the quarter. **For 1QFY09E, Infosys has guided for Rs 45,820 mn, a ~1% QoQ growth in rupee terms and we expect Infosys to show revenue growth of 9% in the same quarter, driven mainly by the depreciation in the rupee.**

Infosys' Outperformance v/s Dollar Movement



Source: B&K Research

We do not see any material revision in Infosys' US$ guidance. Infosys' US$ revenue guidance assumes a 7% CQGR from 2Q onwards, which we believe is decent given the present US demand environment and we do not expect any improvement in the guidance, in dollar terms. However, for the rupee-based guidance for 2QFY09, Infosys will have to base its guidance on the quarter end exchange rate (assuming an exchange rate of Rs 42.5). **The 2QFY09 rupee based guidance at higher Re/$ rate and outperformance in 1Q due to the rupee depreciation means that Infosys will have to revise its full-year rupee based revenue guidance for FY09 upwards, by ~3%.**

Infosys' guidance history

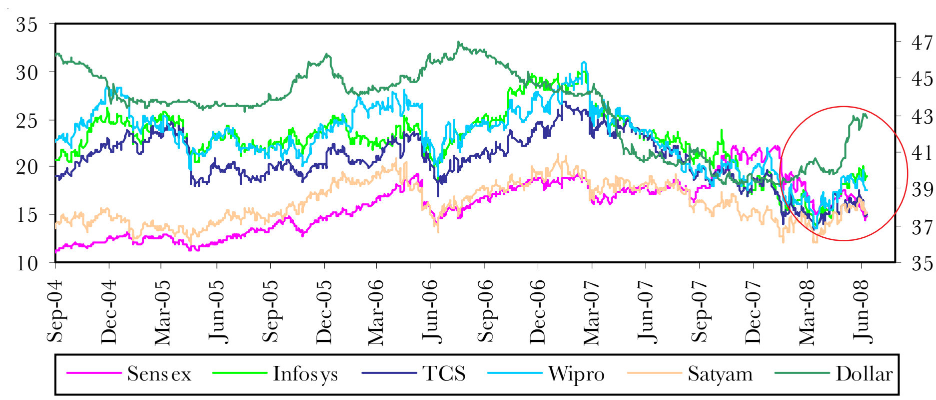
	FY06	FY07	FY08
Average Re/$ rate	44.26	45.23	40.27
Currency movement (+/- %)	0.4	2	(11)
Guidance based on Re/$ rate	43.62	44.48	43.10
Revenue outperformance from the guidance (%)	5.5	11.6	(3.6)
EPS outperformance from the guidance (%)	4.8	19.6	(0.1)

Source: B&K Research

7. Valuation

The rupee appreciation against the dollar and the fogginess in demand outlook in the US have dampened the sentiment for investment in the IT sector. Although historically the IT sector PE multiples have enjoyed a premium over the Sensex, because of the above mentioned concerns, the PE multiples have come down to 16-20x one year forward. However, the forward PEG of the IT sector has remained in the range of 0.8-1.2 over the past fiscal. **We have valued Infosys on a PEG of 1x and arrived at a PER of 20x. We choose Infosys as a proxy for the sector as it is the bellwether stock in the industry and has a long listing and disclosure history. We have valued other IT companies keeping Infosys as the benchmark.**

Correlation of PERs of the top four companies with Sensex



Source: B&K Research

The valuation gap between Infosys and TCS has now broadened and TCS is trading at a discount of 20% to Infosys. We believe this discount is justified in light of certain client-specific issues with TCS, posing a threat to its volume and client transition discount given also dampening the sentiments. We give a 20% discount to TCS over Infosys's multiple and arrive at a target price of Rs 1,128.

Satyam had an excellent run in FY08, with an average blended volume growth of ~7% sequentially, and it outperformed its peers by delivering industry-leading growth. The robust guidance for FY09 indicates yet another strong year for Satyam. Thus, we maintain the same discount of 20% over Infosys for Satyam and arrive at a target price of Rs 591.

We give a discount of 10% to Wipro over Infosys' target multiple and arrive at a target price of Rs 585.

Valuation Matrix

PER	Old	New
Infosys	16	20
TCS	15	16
Wipro	16	18
Satyam	14	16

Source: B&K Research

PER discount to Infosys

(%)	Average of the last year	Average of the last two years	Average of the last three years	Latest
TCS	(6)	(7)	(9)	(21)
Wipro	0	(1)	1	(7)
Satyam	18	(23)	(25)	(19)

Source: B&K Research

8. Conclusion

Favourable rupee-dollar movement and extension of the tax holiday up to FY10, are an advantage for the IT sector. Improved demand visibility makes us confident of companies achieving their guidance. With higher earnings growth, IT companies will command better valuations, which we have captured in our new estimates. Infosys is our top pick, with strong upsides and the capability to deliver. We maintain Outperformer on Satyam and TCS and upgrade Wipro to Outperformer from Underperformer.

Valuation matrix

	CMP (Rs)	EPS (Rs)			PE (x)			EPS CAGR (%)	Target Price	Upside (%)	
		FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08-10E	(Rs)		Rating
Infosys	1,913	81.3	101.5	117.9	24	19	16	20.4	2,400	25	Upgrade to Buy
TCS	921	51.3	59.9	70.5	18	15	13	17.2	1,128	22	Maintain Outperformer
Wipro	494	22.2	27.2	32.5	22	18	15	21.0	585	18	Upgrade to Outperformer
Satyam	484	25.2	32.7	36.9	19	15	13	21.1	591	22	Maintain Outperformer

Source: B&K Research

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2. **OUTPERFORMER:** 0 to +25%
3. **UNDERPERFORMER:** 0 to -25%
4. **SELL:** Potential downside of < -25% (absolute returns)

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