IT

Edelweiss
Ideas create, values protect

Robust demand environment continues

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Outsourcing back to the fore; front-end investments underway

Demand recovery for large Indian vendors has further strengthened, as pent-up demand is now supported by revival of spend focused on revenue strategies (discretionary). Troubled verticals have also turned the corner and will start aiding revenue growth. There has been a surge in the order book and visibility for all large Indian vendors, as clients now not only look to cut their costs, but also invest in developing and implementing solutions/ applications. These trends are clearly evinced from the recent Accenture results that saw solid demand for technology outsourcing and consulting services. Further, new license revenue, a key measure of software growth, posted strong growth for Oracle. Strong demand, however, has resulted in supply-side pressures that have led to higher wage hikes and also high attrition rates across the Indian IT industry. Thus, we remain positive on the near-term business momentum of TCS, Infosys, and Wipro, but believe that valuations largely capture the same.

Result expectations for the sector

We expect the Big-3 to report strong 5.1-6.5% surge in volumes Q-o-Q. However, due to cross-currency impact, revenue growth in INR terms may be restricted to 3.0-4.4%. EBITDA margins are expected to decline by 100-150bps Q-o-Q due to salary increases effective from April 01 (TCS and Infosys). Wipro will have only one month additional impact of salary increases. HCLT, with its highest exposure to Europe, will have the most impact in terms of revenue growth. Further, the INR's 3.4% depreciation against the USD on a quarter-end closing basis will lead to MTM loss accumulating in OCI, particularly Wipro. Strong demand uptick has also led to supply-side pressure once again reinstating. Attrition rates are inching up across industry players, leading to premium salary costs for select skill sets.

Infosys guidance: We see Infosys surpassing its revenue guidance of 2.6-3.4% growth, Q-o-Q, with ease. However, the full year FY11 guidance of 16-18% in USD terms is unlikely to be raised, in our view. Nevertheless, as the company rebases its INR/USD assumption from 44.5 to ~46.0, we see a 5% upgrade in INR EPS, to 116 from INR 111. **Expect tier-2 companies to post revenue traction** as client-specific impact recedes. Infotech and Hexaware are expected to post strong 6-8% constant currency growth Q-o-Q. However, margin decline and loss on hedge maturing during the quarter will negatively impact net profits.

Outlook and valuations: Play the valuation re-rating in tier-2 companies

There seems to be limited room for upside for tier-1 companies, while value emerges in tier-2 companies as business traction improves. We see valuations at P/E of 19-22x for tier-1 companies, offering limited upside hereon. On the other hand, tier-2 companies, with healthy cash position and improving business traction, could offer significant upsides. We see companies such as Hexaware **('BUY')** and Sasken **('Not Rated')** offering opportunity to play the valuation re-rating thesis, while returns in Infotech Enterprises **('BUY')** will be driven by earnings growth.

Top picks: TCS, Hexaware and Infotech Enterprises

Global imbalance and weakness in US economy: Is FY12E at risk?

Recent global imbalance caused by the European sovereign crisis is being used by companies to push faster offshore adoption and build front-end capabilities. Until now, companies have not seen any business volumes being affected due to this crisis (as exposure itself remains low). However, we note that Indian IT companies respond to global cues much later in the global tech value chain. Sharp depreciation of the EUR and the GBP will nevertheless impact the reported financial numbers.

Also, the economic data from the US economy have been mixed-to-negative of late. In recent quarters, private consumption, inventories restocking and net exports have contributed to the GDP growth, while private investments have been anemic. However, going forward, contribution from inventories re-stocking will fade and export scenario weaken by the adverse movements in EUR/USD exchange rate and weakness in European domestic demand. The US consumer is de-leveraging after decades of huge debt build-up and, therefore, cannot be the main driver of the US economic growth. Overall, the risk of double-dip recession has increased, which, in our view, could risk the FY12 growth assumption of 20% plus.

Charting out the impact of currency fluctuation

In the table below, we highlight company-wise impact of cross-currency movements on their reported revenues in USD and INR. For the Big-3, the impact ranges from 1.0-1.2% (in USD), while it will be much higher for Tech M, Sasken, Infotech, and Mastek.

Table 1: Impact of cross currency movement across companies on revenues for INR and USD

Impact analysis on reported numbers	Infosys	TCS	Wipro	HCLT	Infotech	Mastek	Hexaware	TechM	Sasken	Patni	MindTree
Due to USD appreciation											
GBP	(0.4)	(0.6)	(0.5)	(0.7)	(0.6)	(2.3)	(0.4)	(2.1)	-	-	(0.1)
Euro	(0.5)	(0.6)	(0.6)	(1.2)	(2.0)	-	(1.6)	(0.6)	(2.8)	(0.8)	(0.2)
INR	0.0	0.1	0.1	-	-	-	-	-	-	-	0.0
AUD	(0.1)	-	(0.1)	-	-	-	-	-	-	-	-
For USD nos.	**(1.0)**	**(1.1)**	**(1.2)**	**(1.8)**	**(2.6)**	**(2.3)**	**(1.9)**	**(2.7)**	**(2.8)**	**(0.8)**	**(0.3)**

Impact analysis on reported numbers	Infosys	TCS	Wipro	HCLT	Infotech	Mastek	Hexaware	TechM	Sasken	Patni	MindTree
Due to INR appreciation											
USD	(0.5)	(0.4)	(0.4)	(0.4)	(0.4)	(0.3)	(0.4)	(0.2)	(0.2)	(0.6)	(0.6)
GBP	(0.4)	(0.7)	(0.6)	(0.8)	(0.7)	(2.7)	(0.4)	(2.4)	-	-	(0.2)
Euro	(0.5)	(0.7)	(0.7)	(1.3)	(2.2)	-	(1.7)	(0.7)	(3.0)	(0.9)	(0.3)
For INR nos.	**(1.5)**	**(1.8)**	**(1.7)**	**(2.5)**	**(3.3)**	**(3.0)**	**(2.6)**	**(3.4)**	**(3.3)**	**(1.4)**	**(1.0)**

Further, companies will also have to bear the mark-to-market losses on the hedge position being carried at the end of the quarter due to depreciation of the INR against USD by 3.4%. Amongst large companies, Wipro will have the highest MTM loss addition in OCI, followed by TCS. For HCLT and Hexaware, we see forex loss to be booked in P/L to impact the net profits significantly, Q-o-Q.

Table 2: Hedge position as at the end of fiscal 10

Companies	Forwards	Options	Total hedged position
TCS	51	1,420	1,471
Infosys	317	200	517
Wipro	1,601	-	1,601
HCLT	468	-	468
Patni	320	-	320
Geometric	54	-	54
Infotech	32	-	32
Mphasis	713	-	713
Hexaware	130	-	130
Sasken	48	-	48

Source: Companies, Edelweiss research

Table 3: Quarterly average and closing rates across different currencies

Quarter average	Q1 FY10	Q2 FY10	Q3 FY10	Q4 FY10	Q1 FY11
USD	48.8	48.4	46.7	45.9	45.6
Q-o-Q change	*(2.0)*	*(0.9)*	*(3.6)*	*(1.5)*	*(0.7)*
Y-o-Y change	*17.2*	*10.5*	*(4.4)*	*(7.8)*	*(6.5)*
GBP	75.7	79.4	76.2	71.6	68.0
Q-o-Q change	*5.7*	*4.9*	*(4.1)*	*(6.0)*	*(5.1)*
Y-o-Y change	*(7.9)*	*(4.2)*	*(0.5)*	*0.0*	*(10.2)*
EURO	66.5	69.2	68.9	63.5	58.0
Q-o-Q change	*2.2*	*4.0*	*(0.5)*	*(7.7)*	*(8.7)*
Y-o-Y change	*2.2*	*5.2*	*7.2*	*(2.4)*	*(12.8)*

Closing rate	Q1 FY10	Q2 FY10	Q3 FY10	Q4 FY10	Q1 FY11
USD	47.9	48.1	46.5	44.9	46.5
Q-o-Q change	*(5.6)*	*0.4*	*(3.3)*	*(3.5)*	*3.4*
Y-o-Y change	*11.3*	*2.5*	*(4.7)*	*(11.5)*	*(3.0)*
GBP	78.9	76.9	75.2	68.1	69.4
Q-o-Q change	*8.5*	*(2.5)*	*(2.1)*	*(9.5)*	*2.0*
Y-o-Y change	*(8.1)*	*(8.1)*	*5.8*	*(6.3)*	*(12.0)*
EURO	67.2	70.4	66.6	60.6	56.8
Q-o-Q change	*(0.0)*	*4.7*	*(5.4)*	*(9.1)*	*(6.2)*
Y-o-Y change	*(0.9)*	*6.4*	*(2.1)*	*(9.9)*	*(15.5)*

Source: Bloomberg, Edelweiss research

Table 4: Quarterly estimates and comments

Stock		Q1FY11E (INR mn)	Q4FY10 (INR mn)	*Q-o-Q growth (%)*	Q1FY10 (INR mn)	*Y-o-Y growth (%)*	Key things to watch out for
Infosys	Revenues	61,858	59,440	*4.1*	54,720	*13.0*	Strong volume momentum due to ramp up of large deals won in earlier quarters, impact of salary hikes on margins to be modest due to improvement in utilisation and tighter cost control. FY11 EPS revision to Rs116 likely from Rs 111 at the higher-end due to INR depreciation but US$ revenue growth of 16-18% for FY11 likely to be maintained due to cross-currency impact and cautious global economic data.
	Revenues (USD mn)	1,355	1,296	*4.6*	1,122	*20.8*	
	EBITDA	20,300	20,220	*0.4*	18,680	*8.7*	
	EBITDA margin (%)	32.8	34.0		34.1		
	PAT	14,833	16,170	*(8.3)*	15,270	*(2.9)*	
TCS	Revenues	79,701	77,365	*3.0*	72,070	*10.6*	Trends in discretionary services, large deal wins, margin levers going forward, hiring trends. Expect 6.1% volume growth and 180bps margin delcine due to salary hike and cross currency headwinds. Forex loss of INR 980mn factored in for the quarter.
	Revenues (USD mn)	1,746	1,686	*3.6*	1,481	*18.0*	
	EBITDA	22,634	23,121	*(2.1)*	19,620	*15.4*	
	EBITDA margin (%)	28.4	29.9		27.2		
	PAT	17,104	19,320	*(11.5)*	15,203	*12.5*	
Wipro	Revenues	72,821	69,772	*4.4*	63,868	*14.0*	Expect USD 1,215mn revenues post USD 14mn cross currency impact. Better than expected volumes to negate the salarly impact as well. Huge hedge position to result in MTM losses in OCI. Outlook for Q2 - expect 3-5% guidance. Hiring expected to be strong.
	Global IT rev (USD mn)	1,215	1,166	*4.2*	1,033	*17.7*	
	EBITDA	15,956	15,194	*5.0*	14,703	*8.5*	
	EBITDA margin (%)	21.9	21.8		23.0		
	PAT	12,012	12,091	*(0.7)*	10,104	*18.9*	
HCL Tech	Revenues	32,305	30,757	*5.0*	29,085	*11.1*	Cross currency impact of 1.5% on US$ revenues, EAS deals won in previous quarter have been ramping up, BPO business to hit bottom due to ramp down in voice business. EBITDA margin to be impacted by cross currency movement, hiring of sub-contractors for EAS and spend on global customer meet.
	EBITDA	5,960	6,073	*(1.9)*	6,441	*(7.5)*	
	EBITDA margin (%)	18.4	19.7		22.1		
	PAT	2,512	3,215	*(21.9)*	3,088	*(18.7)*	
Mphasis	Revenues	12,298	12,205	*0.8*	11,056	*11.2*	Pricing - revision in Application segment and any further renegotiation. Volume outlook whether to be compensated for pricing decline. BPO reaching bottom, Recovery in BFSI segment and US.
	Revenues (USD)						
	EBITDA	3,124	3,150	*(0.8)*	2,919	*7.0*	
	EBITDA margin (%)	25.4	25.8		26.4		
	PAT	2,704	2,673	*1.2*	2,292	*18.0*	
Patni	Revenues	7,803	7,745	*0.7*	7,729	*1.0*	Supply constraint to continue to preclude growth uptick. Margins to be impacted due to salary hikes. Net hiring is key for improvement in growth.
	EBITDA	1,515	1,594	*(5.0)*	1,549	*(2.2)*	
	EBITDA margin (%)	19.4	20.6		20.0		
	PAT	1,352	1,497	*(9.7)*	1,368	*(1.2)*	
InfoEdge	Revenues	684	653	*4.9*	529	*29.4*	Strong hiring trend to continue to drive revenues, reinvestment in non-recruitment verticals. Strategies to overcome increased competition in recruitment. Progress in offline centres for matrimony vertical.
	EBITDA	222	216	*3.1*	129	*72.7*	
	EBITDA margin (%)	32.5	33.1		24.3		
	PAT	176	132	*32.7*	133	*32.1*	
Infotech	Revenues	2,562	2,441	*5.0*	2,326	*10.1*	Ramp up of Hamilton deal, traction in Daxcon's revenue run-rate, UTG segment's performance, margin to decline due performance with headwinds from wage hike and cross-currency. Demand trend in top-10 clients.
	EBITDA	526	526	*(0.1)*	524	*0.4*	
	EBITDA margin (%)	20.5	21.6		22.5		
	PAT	433	514	*(15.7)*	462	*(6.3)*	
Hexaware	Revenues	2,370	2,220	*6.8*	2,591	*(8.5)*	Volumes to return as new projects ramp-up, margins likely to remain under pressure, any attrition challenges. Key would be the revenue outlook for Q3 and order book built-up.
	EBITDA	201	183	*9.9*	558	*(63.9)*	
	EBITDA margin (%)	8.5	8.2		21.5		
	PAT	79	117	*(32.3)*	396	*(80.0)*	

Source: Edelweiss research

Table 5: Valuation snapshot

	Diluted EPS			P/E			EV/EBITDA			Mcap/Revenue			Price/BV(x)		
	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY12
TCS	35.1	38.6	43.2	21.2	19.3	17.2	16.4	14.3	12.3	4.8	4.2	3.7	7.0	5.5	4.5
Wipro	18.8	20.7	23.8	20.5	18.6	16.2	15.1	13.0	10.8	3.5	3.0	2.6	4.8	4.0	3.4
Infosys	108.9	122.3	142.4	25.0	22.3	19.2	18.0	15.5	12.7	6.9	6.0	5.1	6.8	5.5	4.6
HCLT	18.1	24.9	30.5	19.5	14.2	11.6	10.1	8.9	7.1	1.9	1.7	1.5	3.6	2.9	2.4
Mphasis	43.0	51.9	51.0	13.9	11.5	11.7	10.2	8.7	7.7	2.9	2.5	2.3	5.4	3.8	2.9
Patni	43.9	41.4	42.2	11.6	12.3	12.0	7.5	6.7	5.5	2.1	2.1	1.9	1.9	1.7	1.5
Rolta	16.2	20.1	22.7	10.3	8.3	7.3	6.4	5.2	4.3	1.7	1.5	1.3	1.6	1.4	1.2
Infotech	15.4	16.0	17.5	12.1	11.7	10.7	7.5	6.2	4.8	2.2	1.8	1.6	2.2	1.9	1.6
Hexaware	9.0	6.2	10.3	8.3	12.1	7.3	3.3	4.9	3.3	1.0	1.1	1.0	1.3	1.1	1.0
Info Edge	19.4	27.4	35.7	45.6	32.3	24.8	33.1	21.4	15.9	10.2	8.4	6.9	6.3	5.3	4.4

Source: Edelweiss research

Table 6: Stock performance of coverage companies

Company	3MO	1MO	6MO	1YR	YTD
TCS	(6.2)	0.8	1.2	91.6	(0.4)
Wipro	(10.1)	(4.2)	(4.7)	66.3	(7.2)
Infosys	2.7	5.4	5.5	55.7	7.0
HCLT	(0.9)	(0.4)	(4.4)	93.5	(1.6)
Mphasis	(6.9)	4.9	(17.2)	57.3	(19.7)
Patni	(7.2)	(4.7)	5.5	98.9	6.6
Rolta	(8.6)	3.9	(15.0)	31.6	(14.7)
Infotech	0.3	1.3	22.2	109.7	22.7
Hexaware	9.9	3.1	(19.9)	60.1	(19.3)
Info Edge	0.2	0.6	(0.1)	45.5	0.5

Source: Bloomberg

Table 7: Result dates

Company	Date	Company	Date
Infosys	13-Jul-10	e-clerx	30-Jul-10
Infotech	14-Jul-10	Mphasis	25-Aug-10
TCS	15-Jul-10	Rolta	1st week of Aug
Mindtree	19-Jul-10	Info Edge	3rd week of July
Persistent	21-Jul-10	Allied Digital	Last week of July
Geometric	23-Jul-10	Infinite	Last week of July
Wipro	23-Jul-10	KPIT	Last week of July
TechM	26-Jul-10	Patni	Last week of July
Firstsource	28-Jul-10	HCLT	Last week of July
Hexaware	29-Jul-10	Sasken	Last week of July

Source: Edelweiss research

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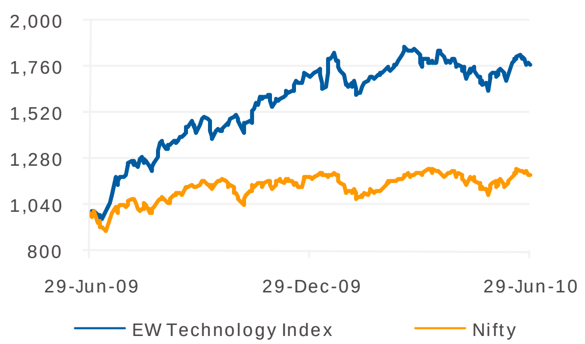
Coverage group(s) of stocks by primary analyst(s): *Information Technology*

HCL Technologies, Hexaware Technologies, Infosys Technologies, Info Edge, Infotech Enterprises, Mphasis, Patni Computer Systems, Tata Consultancy Services, Wipro

EW Indices



Recent Research

Date	Company	Title	Price (INR)	Recos
16-Jun-10	**Wipro**	On an improvement drive; *Visit Note*	409	Buy
16-Jun-10	**Infosys Technologies**	Cautious on guidance due to cross-currency impact; *Visit Note*	2,769	Hold
08-Jun-10	**Sasken**	Execution key to re-rating; *Visit Note*	187	Not Rated
03-Jun-10	**TCS**	In the pink of health;; *Visit Note*	760	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	101	56	9	169

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	103	53	13

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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