ABN·AMRO

Friday 28 September 2007

IT Services

Blue blood, going cheap

Even as concerns on the demand outlook and currency impact continue to weigh on valuations, we expect strong 2Q08 results and managements' re-affirmation of outlook to bring investors' interest back. We reiterate our overweight and bias to large-caps.

Key recommendations and forecasts

	Reuters	Year end	Recom	Price	Target price	EPS 1fcst	PE 1fcst
HCL Tech[1]	HCLT.BO	Jun 2008	Buy	Rs301	Rs375.00	17.94	16.8
Infosys Tech[1]	INFY.BO	Mar 2008	Buy	Rs1,893	Rs2440.00	81.61	23.2
KPIT Cummins[1]	KPIT.BO	Mar 2008	Hold	Rs120	Rs140.00	7.68	15.6
NIIT Tech[1]	NITT.BO	Mar 2008	Buy	Rs354	Rs423.00	23.10	15.3
Patni Computer[1]	PTNI.BO	Dec 2007	Hold	Rs470	Rs447.00	30.57	15.4
Satyam Computer[1]	SATY.BO	Mar 2008	Buy	Rs446	Rs585.00	24.56	18.2
Tata Consultcy[1]	TCS.BO	Mar 2008	Buy	Rs1,060	Rs1460.00	51.85	20.4
Tech Mahindra[1]	TEML.BO	Mar 2008	Hold	Rs1,334	Rs1520.00	59.14	22.6
Wipro[1]	WIPR.BO	Mar 2008	Buy	Rs460	Rs632.00	22.33	20.6

1. Normalised EPS - Post-goodwill amortisation and pre-exceptional items
Source: Company data, ABN AMRO forecasts

Deconstructing the myths on pricing and demand outlook

We estimate limited medium-term impact on IT services players - up to 1.5% on FY09F EPS - in the event of lower CY08 IT budgets in the BFSI space (see our report *Opportunities in scepticism*, dated August 2007). We believe the perception that a potential slowdown will affect pricing is misplaced and comparisons with 2001-02 are not on a like-for-like basis. The correction then was mainly in offshore rates – 14% decline between 2Q01 and 4Q02 for Infosys – and more due to change in mix of technology platforms than rate renegotiations. Note the 13% loss in the share of business for Infosys on Internet and proprietary telecom technologies in this period. Also, reduced client visits post 9-11 and the SARS outbreak affected the recovery, in our view.

Operating environment continues to be strong

Billed effort for the top five IT companies grew 8.1% on average in 1Q08; vs 7.8% in 1Q07. All players in our recent interaction denied any change in new projects flow or rate renegotiations from three months ago. This is positive, as we expected uncertainty on the CY08 outlook to have affected new project closures as well as client flexibility on recent MSA renegotiations. Large deal flow remains robust. The top five companies have announced eight US$50+ deals in 1Q08, after 25 such deal wins in FY07. TPI indicates India-based providers are currently bidding for 14 such deals with a total value of US$820m, the highest in the last 12 months. We believe large players will be better placed to manage currency impact on the margins.

Current valuations are building in the worst-base scenario, in our view

The IT services stocks have, overall, underperformed the market; YTD, the BSE IT index is down 12% vs a 25% rise in the Sensex. The top three players have fallen 13-24% YTD and their valuations (on 12-month forward basis) have corrected 25-33%. The stocks have also seen stake unholding, especially by FIIs. For instance, FII holding in Infosys was down to 50.9% in June 2007 from 53.2% two quarters earlier, while DMF holding was stagnant. The number of FIIs with 1%+ holding was down to six from 11 in 4Q06. We believe the underperformance is unjustified given the strength of the fundamental business drivers. Note, Infosys currently trades at just 20% premium to its base-case valuation, on our estimates. We retain our positive sector outlook, with Infosys, TCS and Satyam our key Buys.

India

Sector performance

	(1M)	(3M)	(12M)
Absolute	170.0	-200.0	252.8
Absolute %	3.8	-4.1	5.8
Rel market %	-10.2	-19.3	-23.7

Source: Bloomberg

Sensex: 17150.56
BSE IT: 4643.43

Researched by
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Blue blood, going cheap

We outline the key arguments for our overweight on the sector and bias to large caps.

Deconstructing the myths

Myth #1: Likely moderation in the BFSI IT spend to affect offshoring

Our view: We estimate the medium-term impact on IT services players will be limited in the event of the subprime crisis spreading to the larger financial services space and affecting discretionary IT spend in the sector. Of the 38% exposure to the BFSI sector (according to Nasscom), we estimate 10% is to insurance and 12% to commercial banking, where we expect the impact on discretionary IT spend will be limited and well spread. Given the high degree of IT enablement and offshoring in financial services, the discretionary IT spend component of business to Indian players should be about 25%. Thus, even with a 50% cut in spend, we estimate the earnings impact on the large players would be 0.4-0.7% in FY08. Of course, the impact would be higher if the contagion affects US economic growth, but we think that unlikely.

Table 1 : How the US subprime mortgage crisis could affect Indian IT services firms

	Scenario	Likely impact for Indian IT services firms
1st wave	Closure/bankruptcy of sub-prime mortgage firms	No impact, given the less than 1% direct exposure to mortgage clients across all players
2nd wave	Rationalisation of discretionary IT spend by financial services clients following cost control post restructuring in their mortgage business	Possible; note 23 of the Top 30 FS firms across the US and Europe have offshore relationships and 19 of these have exposure to mortgage business EPS impact of 0.2-0.7% in FY08F and 0.7-1.5% in FY09F
3rd wave	Reduced IT spend by the larger BFSI sector as the crisis affects the US financial system	Limited probability; a 1-2.5% impact on FY09F EPS in a worst-case scenario; we estimate this will affect only CY08 IT budgets and thus should affect performance only from 1Q09
4th wave	The financial system crisis affects US economic growth rate and thus IT spend across sectors	Minimal probability; we believe it is too early to take a view; we estimate a 2-6% impact on FY09F EPS in a worst-case scenario

Source: ABN AMRO

Table 2 : IT services coverage universe – potential earnings impact

	TCS	Infosys	Wipro	Satyam	HCL T	Patni	Tech M	NIIT T	KPIT
Scenario 1 - 50% lower discretionary IT spend by Financial Services clients with 1Q lag									
FY08F									
Revenue impact	-0.7%	-0.8%	-0.3%	-0.5%	-0.7%	-0.2%	0.0%	-0.3%	-0.2%
EPS impact	-0.7%	-0.7%	-0.3%	-0.4%	-0.6%	-0.2%	0.0%	-0.3%	-0.2%
FY09F									
Revenue impact	-1.3%	-1.4%	-0.6%	-0.9%	-0.9%	-0.8%	0.0%	-0.5%	-0.3%
EPS impact	-1.2%	-1.3%	-0.6%	-0.8%	-0.8%	-0.7%	0.0%	-0.5%	-0.3%
Scenario 2 - Additional 30% lower discretionary IT spend by Comm. banking clients with 2Q lag									
FY08F									
Revenue impact	-1.0%	-1.1%	-0.5%	-0.6%	-1.1%	-0.2%	0.0%	-0.4%	-0.2%
EPS impact	-1.0%	-1.0%	-0.4%	-0.6%	-0.9%	-0.2%	0.0%	-0.4%	-0.3%
FY09F									
Revenue impact	-2.4%	-2.7%	-1.1%	-1.5%	-1.6%	-1.7%	0.0%	-1.0%	-0.6%
EPS impact	-2.3%	-2.4%	-1.0%	-1.3%	-1.4%	-1.4%	0.0%	-1.0%	-0.6%
Scenario 3 - Additional 30% lower discretionary IT spend by US non-BFS clients with 3Q lag									
FY08F									
Revenue impact	-1.0%	-1.1%	-0.5%	-0.6%	-2.2%	-0.2%	0.0%	-0.4%	-0.2%
EPS impact	-1.0%	-1.0%	-0.4%	-0.6%	-1.9%	-0.2%	0.0%	-0.4%	-0.3%
FY09F									
Revenue impact	-5.7%	-7.0%	-4.9%	-6.7%	-5.9%	-6.8%	-2.0%	-3.4%	-6.1%
EPS impact	-5.5%	-6.2%	-4.4%	-5.9%	-5.2%	-5.4%	-1.8%	-3.4%	-6.1%

Source: ABN AMRO estimates

We expect any potential impact only from 3Q08

Note that none of the key offshore clients with significant mortgage exposure (such as Wells Fargo, Bank of America and Wachovia) have indicated any problems

A large share of new application development at commercial banks is related to regulatory requirements and thus is not completely discretionary

We do not see a significant probability of this scenario

We believe it is too early to predict a US economic slow-down and thus a correction in overall IT spend

Myth #2: Like last time, pricing will get hit first if there is a slowdown

Realisation correction in 2001-02 was more due to the sharp decline in high priced development works on Internet/ e-business/ proprietary telecom technologies

Our view: Blended realisation for Infosys declined by 11.5% from the high of 2Q01 to the low in 4Q02 even as volume growth remained steady. The common view is to attribute this to pricing confidence disappearing and vendors resorting to downward rates re-negotiations to maintain volume growth. However, we believe the price correction during 2001-02 was more due to the change in technology platforms than pricing pressures. If one looks at the pricing movement more closely:

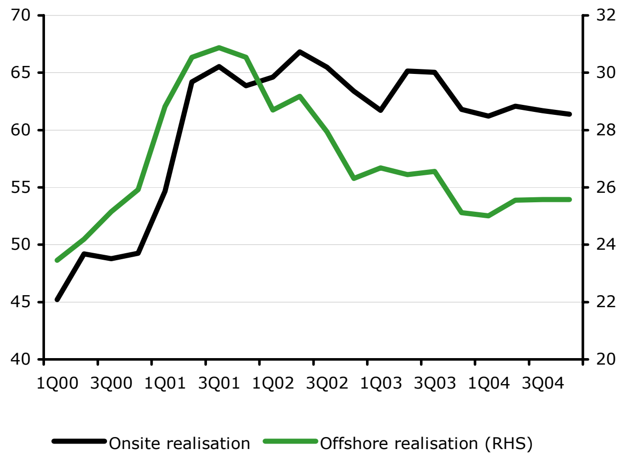
- Correction was primarily in the offshore realisation; onsite realisation declined by only 1.2% between 2Q01 and 4Q02 compared to a 14% drop in offshore realisation during the period; and,
- The rates had run up significantly prior to this. Onsite and offshore realisations increased 42% and 30% respectively between 1Q00 and 2Q01. (Despite this, the differential between onsite and offshore average realisation was 48-52% compared to about 40% at present.)

We attribute the volatility in realisation movements to the rapid shift in the technology platforms mix and the services portfolio.

- The service mix went through a rapid change as business shifted from low-realisation/maintenance-centric Y2K-related services to high-realisation/development-oriented Internet and e-business related services. Note the decline in the maintenance services share to 22% in 2Q01 from 35% in 1Q00 (and high of 42% in 1Q99).
- This was reflective of the change in the development/maintenance technology platform mix. Share of revenues from Internet technologies platforms grew to 31.4% in 2Q01 from 6.4% in 1Q00 (as low as 1.2% in 1Q99). Mainframe/mid-range-centric business fell to 12.9% from 34.2% in the corresponding period.

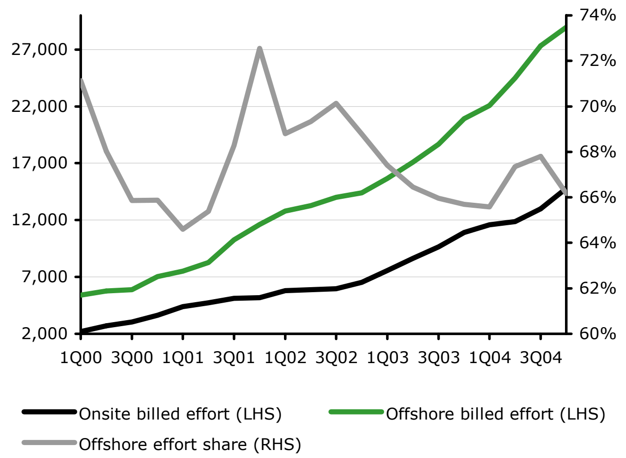
Thus, with moderation in corporate IT spend on e-business technologies post the dot.com bust, the share of high-rate development business on such platforms came down, reducing overall average realisation. The share of business from Internet-related technologies declined to 22.4% by 4Q02 pushing average offshore realisation down by 13.8%. We believe the recovery was also affected by reduced client visits post 9-11 and the SARS scare. Note that 2001-03 was a period when offshore as a concept had yet to gain credibility and physical client visits were critical, especially for application development works.

Chart 1 : Movement in onsite and offshore realisation – Infosys (FY00-03)



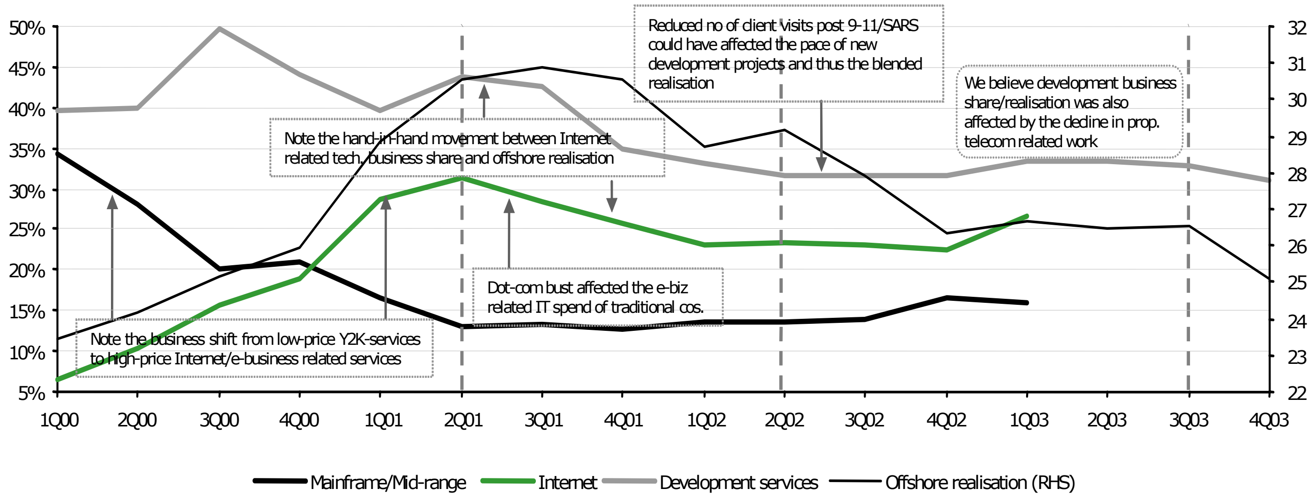
Source: Company data

Chart 2 : Movement in billed effort and share – Infosys (FY00-03)



Source: Company data

Chart 3 : Business mix change and impact on realisation - Infosys (FY00-03)



Source: Company data, ABN AMRO

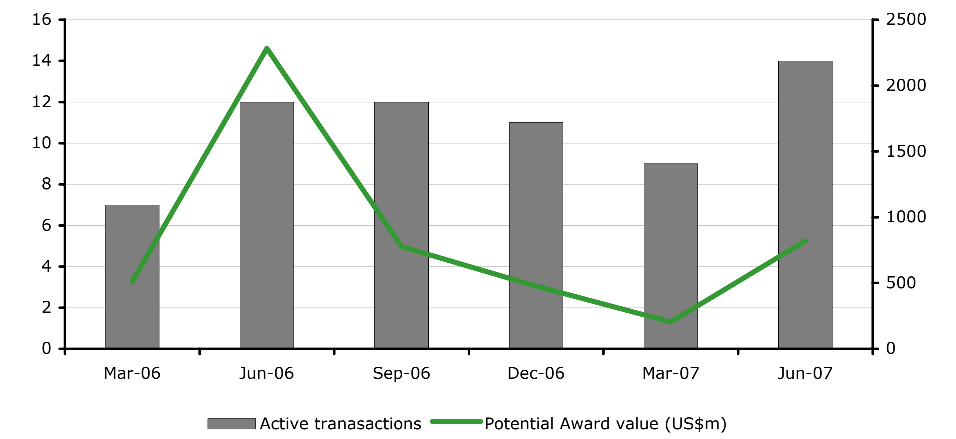
Operating environment remains strong…

Volume growth tracks well; traction continues in large deal flow/pipeline…

Billed effort for the top five IT companies grew 8.1% on average in 1Q08; higher the than 7.8% reported in 1Q07. All players in our recent interaction denied any change in business environment in terms of new projects flow or rate renegotiations from months ago. We had thought recent uncertainty on the CY08 outlook could have affected new project closures as well as clients' flexibility on recent MSA renegotiations.

Large deal flow remains robust. The top five companies have announced eight and 25 US$50+ deals in 1Q08 and FY07 respectively vs eight deals in the whole of FY06. TPI, an outsourcing advisory major, sees a growing preference for offshoring US$50m+ deals among its clients. Its pipeline indicates India-based providers are currently bidding for 14 such deals with a combined worth of US$820m, the highest in the last 12 months. This corroborates the data points from the top five players; each of whom are bidding for at least 10 US$50m+ deals. Infosys's Philips BPO deal suggests the risk-aversion to asset/people-takeover style deals is also coming down, which should increase the pie of deals for which Indian companies can bid.

Chart 4 : TPI transaction pipeline for India-based service providers



Source: TPI

Indian players are currently bidding for 14 transactions advised by TPI, the highest ever

Given this strong deal pipeline, we expect market share to rise in 2HCY07

Table 3 : Large US$50m+ wins by top five Indian IT firms – last five quarters

	1Q07	2Q07	3Q07	4Q07	1Q08	Total
Infosys	0	1	5	0	3	**9**
TCS	1	0	5	2	1	**9**
Wipro	0	5	0	0	1	**6**
Satyam	0	0	1	1	2	**4**
HCL Technologies	1	1	1	1	1	**5**
TOTAL	**2**	**7**	**12**	**4**	**8**	**33**

Source: Company data

Of these 33 large deals during the past five quarters, at least 14 are of over US$100m each

Significant increase in the quantum of large deals – just eight were announced in the whole of FY06

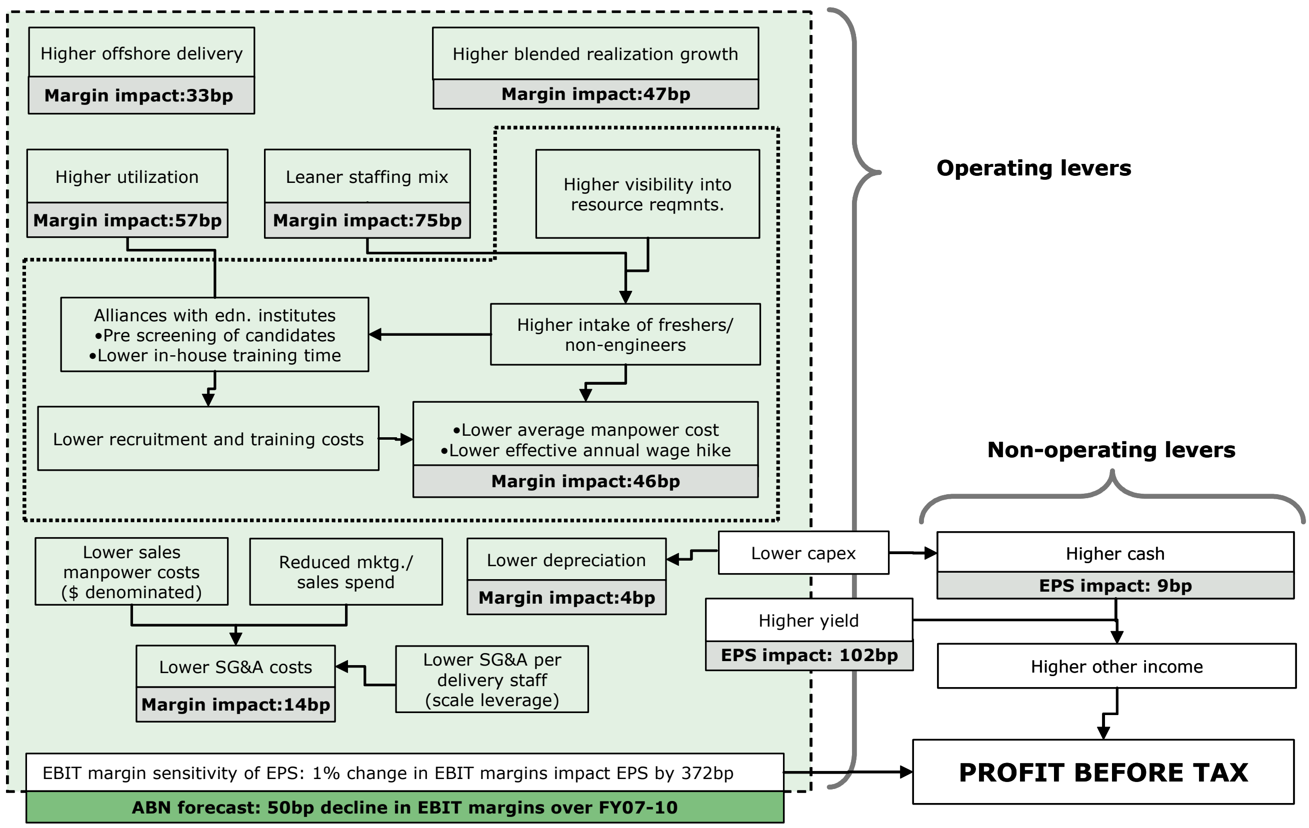
...and its not just about large deals

In addition to large deals, we are seeing increased client mining. Revenues per active client for the top four players showed a 7% CQGR over the last four quarters, on average. Revenues from top 10 clients, showed a similar trend, with a 9.7% CQGR during that period. We believe this is being driven by increasing penetration in non-traditional services – share of ADM revenues has declined from 60.2% in 1Q06 to 50.5% in 1Q08.

... and currency impact on margins can be managed

As argued earlier, we believe the FY08 EBITDA margins for the large players will be in the 56-207bp range, around the levels of FY07, despite the significant rupee appreciation during the year (we have built in 10% appreciation in INR/USD rate in FY08 vs 10.2% appreciation YTD.) Several levers exist to mitigate the margin impact. Utilisation levels are currently low due to higher fresher hiring levels – we expect an increase given increasing focus on time to billing and closer monitoring of bench. The Top five players have announced plans to increase the intake of non-engineers, particularly for services such as infrastructure management and application testing. These resources are typically paid 30-35% less than engineers. In addition, leaner staffing mix in non-T&M projects can drive significant margin productivity.

Chart 5 : Where can Infosys focus: key margin/non-operating levers and sensitivities



Note: Margin impact refers to impact of 1% change each variable on the EBIT margin

Source: ABN AMRO

Current valuations are close to base-case scenario

Stocks significantly off 52-week highs; valuation corrections even more significant

Overall, IT services stocks have underperformed the market; YTD, the BSE IT index is down 12% vs a 25% rise in the Sensex. The top three players have fallen 13-24% YTD and their valuations (on a 12-month forward basis) have corrected 25-33%.

Table 4 : IT services coverage universe – price performance and valuation

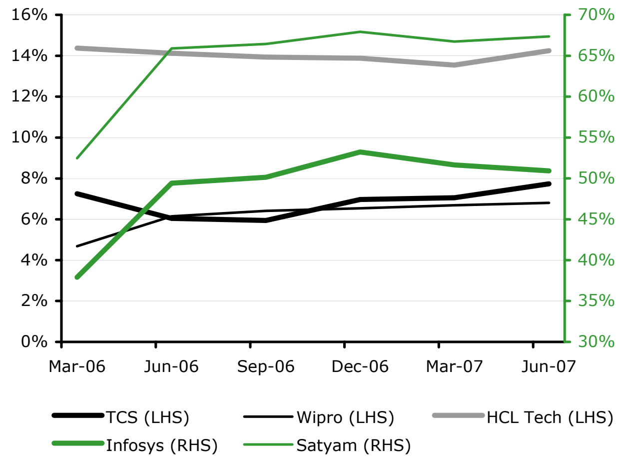
	BB code	Rating	Price (Rs)	12m F PE	24/12m EPS grwth	Change from: 52-wk high	52-wk low	Stock price change over: 1mth	3mths	12mths
Infosys	INFO IN	Buy	1,893	20.5x	20.7%	-21.6%	10.4%	0.7%	-1.7%	1.9%
Tata Consultancy	TCS IN	Buy	1,060	18.7x	20.3%	-23.7%	8.4%	3.1%	-6.7%	3.9%
Wipro	WPRO IN	Buy	460	18.5x	19.7%	-33.4%	8.3%	-1.4%	-10.6%	-11.8%
Satyam	SCS IN	Buy	446	15.7x	14.9%	-18.9%	17.4%	-0.7%	-4.8%	9.3%
HCL Tech	HCLT IN	Buy	301	14.7x	16.2%	-17.8%	18.0%	3.2%	-10.3%	9.5%
Tech Mahindra	TECHM IN	Hold	1,334	17.0x	37.7%	-34.9%	119.4%	10.2%	-4.8%	117.6%
Patni Computer	PATNI IN	Hold	470	13.2x	-	-21.5%	33.1%	-0.9%	-7.9%	21.8%
KPIT Cummins	KPIT IN	Hold	120	10.8x	31.5%	-34.1%	54.5%	1.2%	-14.4%	52.0%
NIIT Tech	NITEC IN	Buy	354	13.3x	20.1%	-16.6%	202.6%	21.7%	1.8%	182.2%

Prices at the close of 28 September on the NSE
Source: Bloomberg, ABN AMRO estimates

Shareholding pattern shows declining institutional ownership

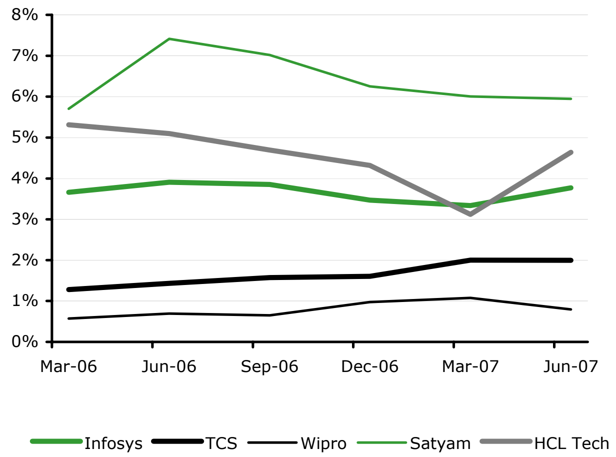
An analysis of the shareholding pattern for the top five companies shows a lack of institutional interest; FII share of ownership came down 29bp on average over Jan-June 2007 as investors took a cautious stance on concerns around rupee appreciation and, later, potential demand slowdown. DMF ownership remained stable during this period.

Chart 6 : Share of FII holding over last six quarters



Source: Company data

Chart 7 : Share of DMF holding over last six quarters



Source: Company data

We believe the large-cap stocks are currently trading at only an 18-22% premium to their base case valuations that build in a pessimistic 3% annual currency appreciation for the next eight years, a terminal 15% EBITDA margin by FY30F and effective tax rate at 34% post 2020. These assume no proactive/reactive management initiatives on pricing and operating efficiencies to mitigate the margin impact. Infosys, for instance, is currently trading at just 20% above our base case DCF valuation, indicating most of the concerns on exchange rates/margins are already priced in.

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