

Indian IT Services

IT services

Q3FY11: strong quarter; supply still a concern

The Indian IT services sector is witnessing healthy demand traction, led by an improving macroeconomic environment. With most of key leading indicators suggesting recovery is under way in the US and economic expansion is gaining momentum, discretionary IT spend is returning in all major segments. European concerns have not affected business on the ground, though European revenue growth lags that of the Americas in constant currency terms. Management commentaries indicate that CY11 IT budgets are expected to grow 2-3%. Despite Q3FY11 being seasonally weak, all Tier1 companies saw volume growth of ~4% qoq and USD revenue growth of 5.5-7.5% qoq. Even global industry major players (Intel, IBM, Apple, Accenture and Oracle) reported healthy revenue growth, indicating that technology spending is gaining momentum. On the flip side, strong volume growth on the back of slowed hiring in CY09/ 1HCY10 is leading to a lateral hiring spree. This inturn is leading to supply-side pressure combined with high attrition across companies. Some companies are resorting to mid-term wage hikes/ promotions/ RSU awards, etc. While this has affected operating margins, it has also constrained revenue growth for a few companies. In this backdrop, we expect much higher wage hikes in FY12 than in the past few years. Attrition and its impact on margins remain key monitorables.

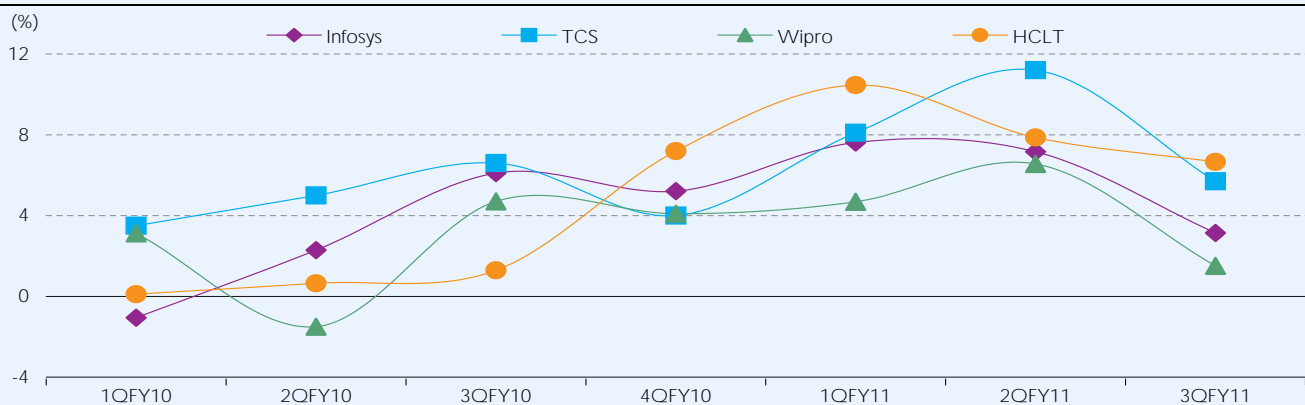
In the dynamic environment, we see Tier1 companies better placed to manage the supply-side challenges with their scale helping them capitalize on strong demand. Within Tier1, Infosys and TCS are better placed with their continued fresher hiring programme over the past 2-3 years. TCS is planning 37,000 and Infosys 26,000 campus offers in the FY12 academic year. With stocks trading at the mean valuations over the business cycle, they are still 15-20% below their peak level. Infosys and TCS remain core IT holdings. HCL Tech is our preferred pick among large caps, while in the small/ mid-cap space we like KPIT and Infinite.

Key highlights

□ Volume growth momentum continues; CY11 IT budgets expected to grow 2-3%

Despite seasonal weakness (Thanksgiving, Diwali and Christmas holidays led to 4-5% lower billing volumes qoq), Q3FY11 witnessed yet another quarter of volume growth for Indian IT services. The top four IT services companies registered an average volume growth of 4.3% qoq in Q3FY11 on the back of ~8% growth in the previous two quarters.

Exhibit 1: IT services qoq volume growth for top four IT services firms



Source: Companies; TCS volume growth is for consolidated business (inc. BPO services)

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In FY12, we expect our thesis of “Accelerated Offshore Adoption” to continue and Indian IT services to witness strong demand traction led by an improving macroeconomic environment in key global markets. We expect the return of discretionary spending across major business segments (however, Telecom vertical IT spend has lagged others) and growth to be largely US-led. Currently, eight of the ten key leading indicators suggest that US economic expansion is gaining momentum and spreading. Also, the recent QE2 (Quantitative easing 2) from the Federal Reserve has enhanced the pace of recovery. While Europe continues to face macroeconomic challenges, Indian IT companies so far have not felt the impact of the same on the IT spending of their clients. In fact, in Q3FY11, revenue growth from Europe was better than that of the previous quarter, though it still lagged the US.

□ Global technology major players indicate recovery in tech spending

The recent quarterly results of global technology majors and their management commentary indicate that economic growth is percolating to tech spending buoyancy. Most of the companies reported record revenue growth and raised their annual guidance on the back of growing demand. Following are the few data points/ comments from the global tech industry:

Intel’s fourth quarter saw a third consecutive record quarter and helped the company achieve highest ever annual revenues of >US\$40bn (~24% growth yoy). The company also recorded the highest ever quarterly gross margin, operating income, and EPS.

IBM reported record fourth quarter revenue of US\$29bn (~4% yoy growth) – ahead of Street expectations. The management expects to see strong revenue growth in FY12.

Apple, a major tech consumer company saw revenues rising by more than 70% yoy to ~US\$27bn. iPhone and iPads sales increased by 75-85%, suggesting an increased demand by consumers.

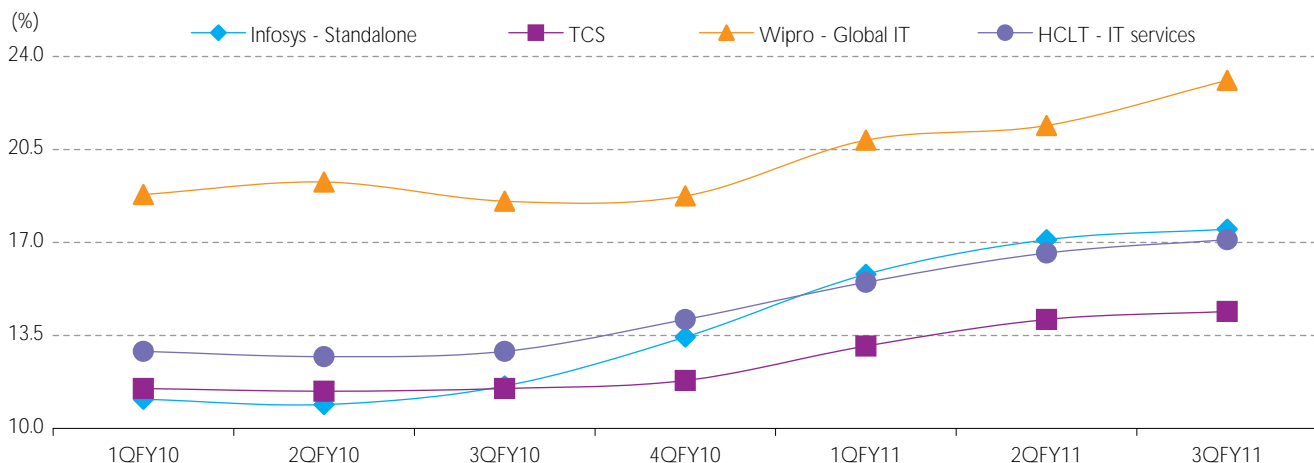
Accenture reported outsourcing revenue growth of 10% in USD terms and 11% in local currency. Overall, it reported the second-highest quarterly revenues in its history and exceeded the upper end of its guided range. The company also raised its FY11 guidance to 8-10% yoy growth from 7-10% earlier.

Oracle reported an outstanding quarter with all – new license revenue, total revenue, and EPS beating guidance. The company also guided for higher-than-Street expected license revenue growth of 10-20% (9-19% CC) and total revenue growth of 31-35% (30-34% CC).

□ Supply-side issues remain a key concern

Companies across the sector reported high attrition rates on a TTM basis, though they commented about a slight easing in the absolute quarterly attrition. While the way to measure attrition varies from company to company, the trend has shown an across-the-board increase.

Exhibit 2: TTM attrition for top four Indian IT services firms



Source: Companies

We note that strong volume growth on the back of slower hiring in CY09/ 1H10 has led to a lateral hiring spree. This has led to supply-side pressure, with attrition remaining high across companies – Tech Mahindra and KPIT witnessed ~30% quarterly annualized attrition rates. Most companies reported that attrition in the experience band of 3-8 years was the highest. This experience band is seeing a stark demand-supply mismatch. To keep costs in check, several clients have been seeking a higher share of mid-level employees, and they neither want a higher proportion of junior inexperienced resources nor highly experienced delivery employees. This has resulted in higher demand for mid-level employees.

To arrest the high attrition, some companies have been resorting to mid-term wage hikes/ promotions/ RSU awards, etc. In the recent past, Tech Mahindra (~3% for onsite and senior employees) and Persistent (about ~10% for all offshore employees, effective Jan'11) announced wage hikes for their employees. In August 2010, Infosys awarded free shares to its employees, while Mphasis awarded RSUs in November 2010. Wipro also announced promotions and grant of RSUs in Q2FY11. While these measures have affected operating margins in general, high attrition rates have also constrained revenue growth for a few companies. Expect much higher wage hikes in FY12 than in the past few years. Though companies expect attrition rates to decline, we believe attrition rates and their impact on margins remain key monitorables.

In a supply constrained environment, Infosys and TCS are relatively better placed with their continued fresher hiring programme over last 2-3 years. For FY12, TCS plans to make 37,000 and Infosys plans 26,000 campus offers.

❑ Diversification beyond ADM and traditional US markets still sluggish

Revenue growth in terms of geography and service line was a mixed bag in Q3FY11. While TCS and Wipro saw strong growth from Europe; Infosys and HCL Tech saw growth emerging from non-US/ non-European markets. Notably, Europe and emerging-market growth was aided by cross-currency movements. During the quarter, on a daily average basis, GBP appreciated by ~2%, Euro by ~5%, Yen by ~4% and AUD by ~9%. In constant currency terms, however, growth from Europe was a tad below that from the US (except for Wipro). Revenue growth was higher from traditional application development and maintenance services for Wipro and HCL Tech. However, TCS and Infosys benefited more from growth in other service lines.

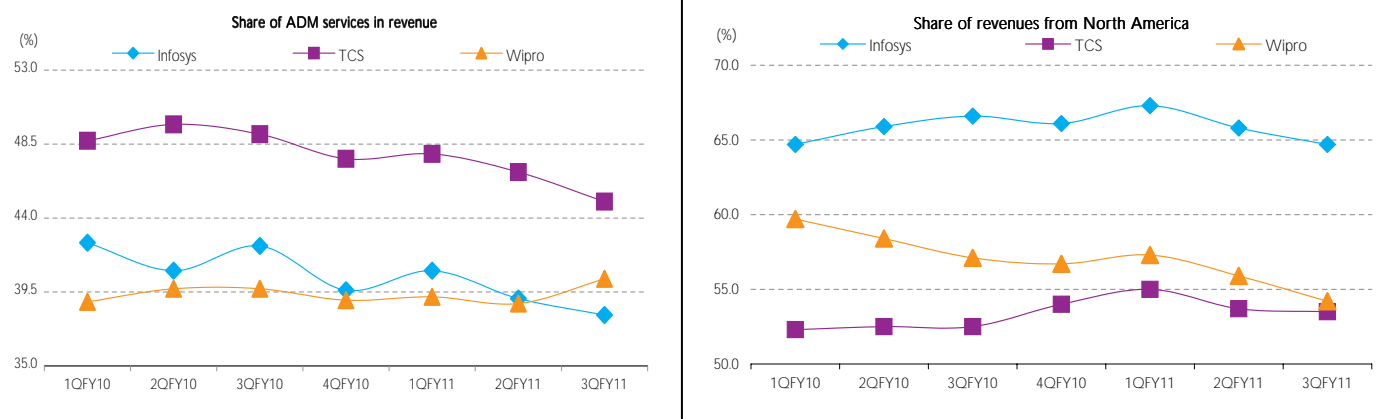
Exhibit 3: Q3FY11 revenue growth by key segments for top four IT services firms

(%)	TCS	Infosys	Wipro#	HCL Tech
Geography wise growth (% QoQ)				
USA	5.1	4.2	2.4	5.8
Europe	10.9	5.9	12.7	7.1
RoW	7.6	15.3	5.0	14.5
Constant currency geography wise growth (% QoQ)				
USA	~6.4	4.2	2.4	5.8
Europe	~6.4	3.7	9.7	5.8
RoW	~4.2	9.7	1.2	10.8
Key service line wise (% QoQ)				
ADM	2.9	3.2	9.7	9.2
Infra/ BPO services	15.4	4.2	4.6	8.3
Consulting/ Enterprise Solutions	2.7	6.4	2.5	5.5
Other services	5.3	5.9	0.5	6.4
Client segments (% QoQ)				
Top10	7.0	2.0	5.6	6.3
Non-Top10	7.0	7.4	5.6	7.9

Source: Companies; #Wipro – Global IT and BPO services

Interestingly, the trend of diversifying revenues to have a higher share of Europe/ AsiaPac and non-ADM services has still not picked-up. Though Wipro's share from North America, and TCS and Infosys's proportion of ADM services are showing a decreasing trend, all companies still continue to be highly dependent on North America. With the anticipated return in discretionary spending in FY12, we expect IT companies to start witnessing growth in other service lines as well.

Exhibit 4: Share of ADM services and North America for top three companies over last seven quarters

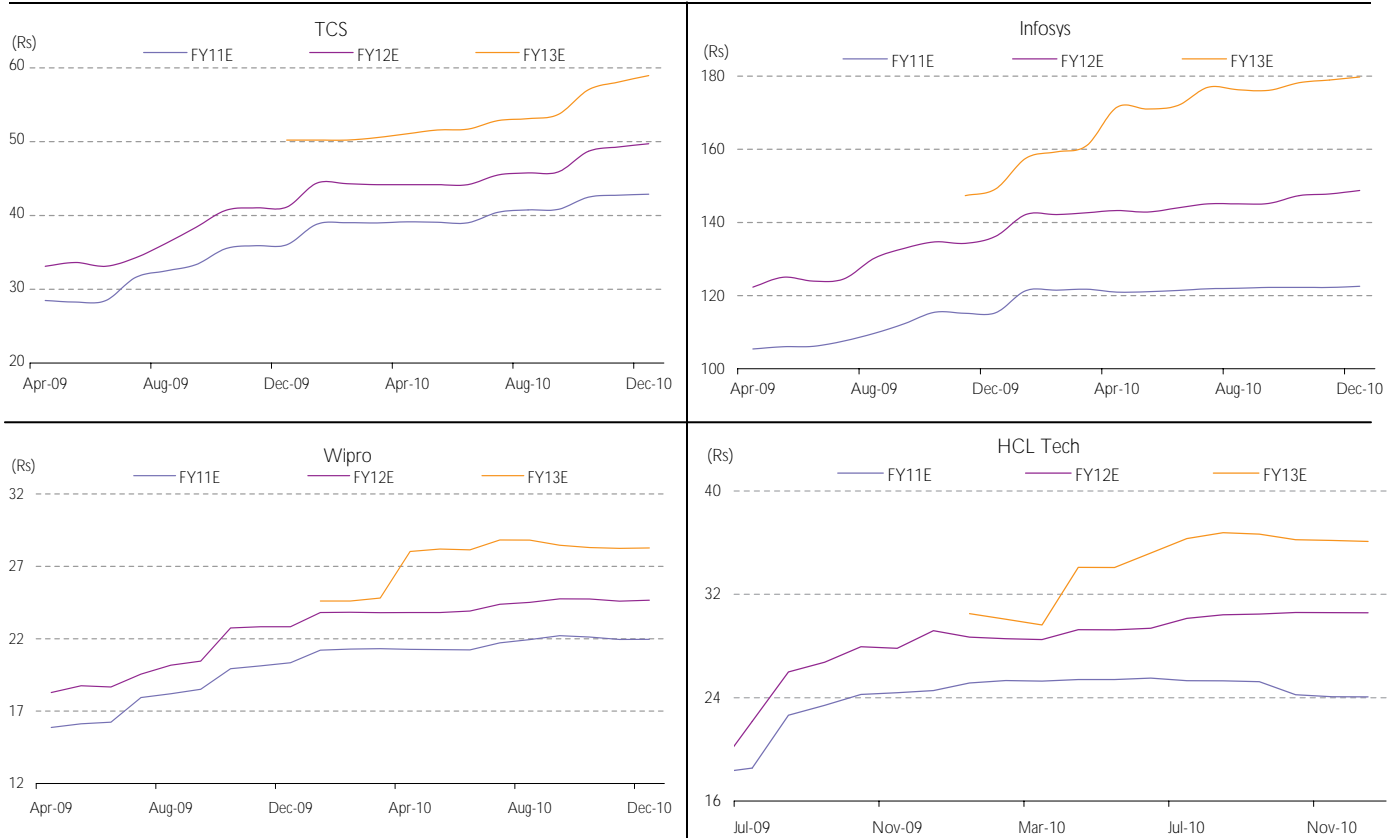


Source: Companies

Earnings upgrade cycle no longer secular

Abating macroeconomic challenges and positive surprises in quarterly results prompted an overall earnings upgrade cycle for Indian IT services companies. However, now the earnings upgrade cycle is no longer secular. While TCS and Infosys continue to see earnings upgrade on the back of their robust quarterly performance and margin expansion, company-specific issues have led to a pause in the upgrade cycle for HCL Tech and Wipro.

Exhibit 5: Bloomberg consensus estimates for top four IT services companies



Source: Bloomberg consensus estimates

Latest quarter (Q3FY11) comparative snapshot for the top four companies

The Q3FY11 results were a mixed bag, with volume growth performances ranging from in-line to better-than-expected. All four companies did well on the margin front – margins have remained healthy despite pressure from a stronger INR and supply-side challenges. Demand has clearly picked up, with broad-based volume growth seen across companies.

Exhibit 6: Key financials – top4 IT services companies

(Q3FY11)	TCS	Infosys	Wipro#	HCL Tech
Revenue growth (%; US\$)				
Change qoq	7.0	5.9	5.6	7.5
Change - 4Q CQGR	7.1	6.5	4.5	7.3
Change yoy	31.1	28.7	19.3	32.6
Revenue growth (%; INR)				
Change qoq	4.1	2.3	3.5	6.9
Change yoy	26.3	23.8	15.2	27.4
EBIT growth (%; INR)				
Change qoq	4.3	2.3	3.6	8.9
Change yoy	29.9	20.3	8.3	1.0
Net profit growth (%; INR)				
Change qoq	10.6	2.5	2.6	23.8
Change yoy	29.6	14.2	9.6	35.8
Margins and changes				
Gross margins - ex Dep (%)				
	47.0	45.8	37.5	34.7
Change qoq (bp)	28bp	(8bp)	39bp	(27bp)
Change yoy (bp)	(89bp)	(134bp)	(29bp)	(542bp)
EBIT margins (%)				
	28.1	30.2	22.2	13.1
Change qoq (bp)	7bp	1bp	3bp	24bp
Change yoy (bp)	77bp	(86bp)	(141bp)	(343bp)

Source: Companies, #Wipro – Global IT and BPO services

Exhibit 7: Key execution metrics – top4 IT services companies

(Q3FY11)	TCS	Infosys	Wipro#	HCL Tech
Volume growth and hiring				
IT services volume growth (QoQ %)	5.7	3.1	1.5	6.7
Hiring (%)				
Change qoq	7.2	4.3	3.1	2.9
Change yoy – TTM	24.9	16.3	16.3	29.8
Revenue per employee (US\$)				
Onsite price realization (%)				
Change qoq	-	1.4	0.6	3.4
Change yoy	-	5.1	(3.7)	(0.9)
Offshore price realization (%)				
Change qoq	-	2.6	3.8	(2.2)
Change yoy	-	(3.9)	2.6	0.3
Blended price realization (%)				
Change qoq	1.2	1.6	3.0	0.6
Change yoy	4.4	1.6	2.3	(1.9)

Source: Companies, #Wipro – Global IT and BPO services

□ Management commentary and Q4FY11 guidance

The managements of all Tier1 companies commented about an increase in CY11 IT budgets (we expect 2-3% growth) and a revival of discretionary spending. They suggested that while macroeconomic concerns may linger, they will not affect the IT services business at large. In its remarks about FY12, the Infosys management commented that it will likely be a normal year for the industry (+18-20% yoy revenue growth) – similar to FY11. Notably, at the beginning of FY11, Infosys guided that the year would witness 18-20% yoy revenue growth. However, after continuous upward revisions, it now expects FY11 revenue growth of ~26%. While the macroeconomic challenges are not completely behind, all IT services companies expect to witness volume-driven revenue growth in FY12. Pricing is expected to be stable, with a positive bias.

In general, the fourth fiscal quarter being the first quarter of client's IT budgets is usually a seasonally weak quarter. Infosys, usually conservative, guided for 1-2% USD revenue growth (also raised its FY11 USD revenue growth outlook by ~2% to ~26% yoy), while Wipro, relatively more realistic, guided for 3-5% qoq revenue growth.

Exhibit 8: Infosys – Q4FY11 guidance

	Q3FY11 Actual	Guidance		Implied growth (%)	
		Lower	Upper	Lower	Upper
Revenue (US\$ m)	1,585	1,601	1,617	1.0	2.0
Revenue (Rs m)	71,060	71,570	72,300	0.7	1.7
EPS - basic (Rs)	31.16	31.06	31.28	(0.3)	0.4

Source: Company

Exhibit 9: Wipro – Q4FY11 guidance

	Q3FY11 Actual	Guidance		Implied growth (%)	
		Lower	Upper	Lower	Upper
Revenues (US\$ m)	1,344	1,384	1,411	3.0	5.0

Source: Company

Exhibit 10: Indian IT services – comparative valuations

Company	Price (Rs)	Mkt Cap		Reco	TP (Rs)	PE (x)			EPS CAGR (%)		EV/ EBITDA FY11E (x)	EV/Sales (x)
		(Rs bn)	(US\$ m)			FY11E	FY12E	FY13E	FY10-12E	FY11-13E		
Large Cap (>US\$ 1bn)												
TCS	1,212	2,371	51,983	OP	1,400	27.4	23.0	19.1	22.6	20.0	20.6	8.1
Infosys	3,244	1,862	40,824	OP	3,900	26.9	21.7	17.5	17.2	23.9	18.8	8.0
Wipro	456	1,119	24,522	OP	560	21.0	18.5	15.7	14.6	15.6	16.4	4.1
HCL Tech	500	342	7,491	OP	625	22.0	16.2	12.9	32.4	30.9	12.7	2.9
Mphasis*	686	144	3,156	OP	850	13.3	12.9	10.7	11.1	11.4	10.6	3.5
Tech M	690	87	1,905	OP	840	18.4	14.9	11.6	8.7	25.6	7.1	1.6
Patni*	467	61	1,345	UP	430	12.2	13.0	11.3	0.2	3.9	6.7	1.4
Small and mid cap (<US\$1bn)												
MindTree	544	22	478	OP	650	18.8	11.7	9.9	(6.1)	37.8	10.6	1.8
Persistent Systems	411	16	360	OP	540	11.7	12.1	8.9	3.0	14.7	8.0	2.3
Hexaware*	120	17	382	OP	110	19.2	14.2	10.8	(3.6)	33.1	15.7	1.4
KPIT Cummins	159	13	275	OP	220	13.6	10.8	9.1	16.7	22.2	8.4	1.8
Infinite Computers	198	9	191	OP	260	8.3	7.0	-	18.0	-	5.3	1.3

Source: Company; IDFC Research

*For companies with fiscal year ending in last 3 months of calendar, FY10A, FY11E and FY12E refers to FY09A, FY10E and FY11E respectively

Exhibit 11: Stock performance

	21-Jan-11 Mcap (US\$ m)	CMP (Rs)	Absolute (%)					YTD
			1M	2M	3M	6M	12M	
Technology indices								
SENSEX	-	19,008	(5)	(3)	(6)	6	11	(7)
BSE IT Index	-	6,630	(1)	13	9	21	26	(3)
CNX IT Index	-	7,250	(1)	11	8	19	22	(3)
IT services and software								
TCS	51,983	1,212	4	19	23	44	57	4
Infosys	40,824	3,244	(3)	9	7	17	24	(6)
Wipro	24,522	456	(6)	14	(3)	10	7	(7)
HCL Tech	7,491	500	10	33	18	34	35	9
Oracle Financial	4,193	2,280	-	6	(2)	5	(1)	(2)
Mphasis	3,156	686	2	22	9	11	(1)	2
Satyam	1,712	66	(4)	(5)	(18)	(26)	(38)	-
Tech Mahindra	1,905	690	(1)	2	(9)	(8)	(38)	(2)
Patni	1,345	467	(5)	-	-	(10)	(7)	(2)
Rolta	532	151	(2)	(10)	(9)	(15)	(22)	(3)
MindTree	478	544	5	5	4	(1)	(16)	(3)
Hexaware	382	120	11	43	42	48	33	3
Infotech Enterprises	397	163	12	5	(2)	(6)	-	(6)
Polaris	387	178	2	18	4	(4)	(1)	2
NIIT Tech	269	208	3	1	(7)	6	8	5
KPIT Cummins	275	159	16	10	(4)	12	27	9
Persistent Systems	360	411	(1)	5	(3)	(15)	-	(4)
Infinite Computers	191	198	13	23	21	15	-	6
Sasken	98	161	(4)	(9)	(30)	(24)	(16)	(11)
Mastek	99	168	(5)	(14)	(23)	(43)	(57)	(9)
Technology (Others)								
Opto Circuits	1,038	258	(3)	(7)	(12)	(3)	14	(4)
Redington India	625	72	(9)	(14)	(15)	(4)	10	(13)
HCL Info	511	107	1	10	(10)	(3)	(28)	(9)
eClerx	382	604	(14)	(11)	(2)	31	90	(16)
OnMobile services	329	256	(11)	(8)	(29)	(12)	(41)	(11)
Tulip telecom	548	172	(1)	(1)	(7)	(7)	(12)	(2)
FirstSource	206	22	(7)	(6)	(21)	(20)	(36)	(12)
Moser Baer	206	56	(2)	(9)	(20)	(17)	(34)	(10)
Allied Digital	173	169	(8)	(13)	(28)	(31)	(30)	(10)

Source: Bloomberg

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