IT SECTOR - RESULT PREVIEW

Edelweiss
Ideas create, values protect

Waiting for disconnect between the macro and micro to narrow

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"We are not seeing any impact yet from our clients."

"We are yet to finalize budgets with our clients."

"We are not yet seeing renegotiation of prices downward on existing contracts."

This is likely to be the broad tenor of commentary from tier I players at they discuss their results for the October-December 2007 quarter. The market will seek greater confidence, particularly on commentary pertaining to the direction of offshore IT budgets and pricing on new contracts/contracts up for renegotiation for CY08.

Looking beyond the quarter, one theme that we identify and take forward in this report is the persisting disconnect or apparent lack of reconciliation between the 'macro and micro', as we call it. Our value-chain analysis discussed threadbare in our Oct 26 report, ***From Intel to Infosys: Anchoring Indian IT in the global technology chain*** (presented again for convenience in Chart 1) details the linkages and the data points that we should monitor at the micro level to analyze if news on the macro front percolates down to the micro front.

News on the macro front is accelerating (increasing and more frequent write-downs, continuing housing weakness, weak job/employment report—the weakest in two years, weak industrial manufacturing data, incipient views on the direction of CY08 IT budgets) relative to that on the micro front. Our value chain analysis predicts that weakness will be first experienced by players such as Intel, Advanced Micro Devices (AMD), and Texas Instruments (TI), who typically are the first sensors of IT spending at the corporate/retail end. The outlook for such players, in turn, is shaped by the fortunes of OEMS such as Dell and Hewlett Packard (HP).

So far, the only negative on the micro front has been the news that there is a build-up of inventories at various channels which does affect the fortunes of companies such as Intel (see table 1). This may be indicative of the beginning of a slowdown in PC off-take, which may affect spending on software/services on an incremental basis. However, we believe that the software and services sectors are likely to exhibit greater resiliency than hardware-related sectors, given their de-bundling with hardware and the lag effect of software/services spend over hardware investments.

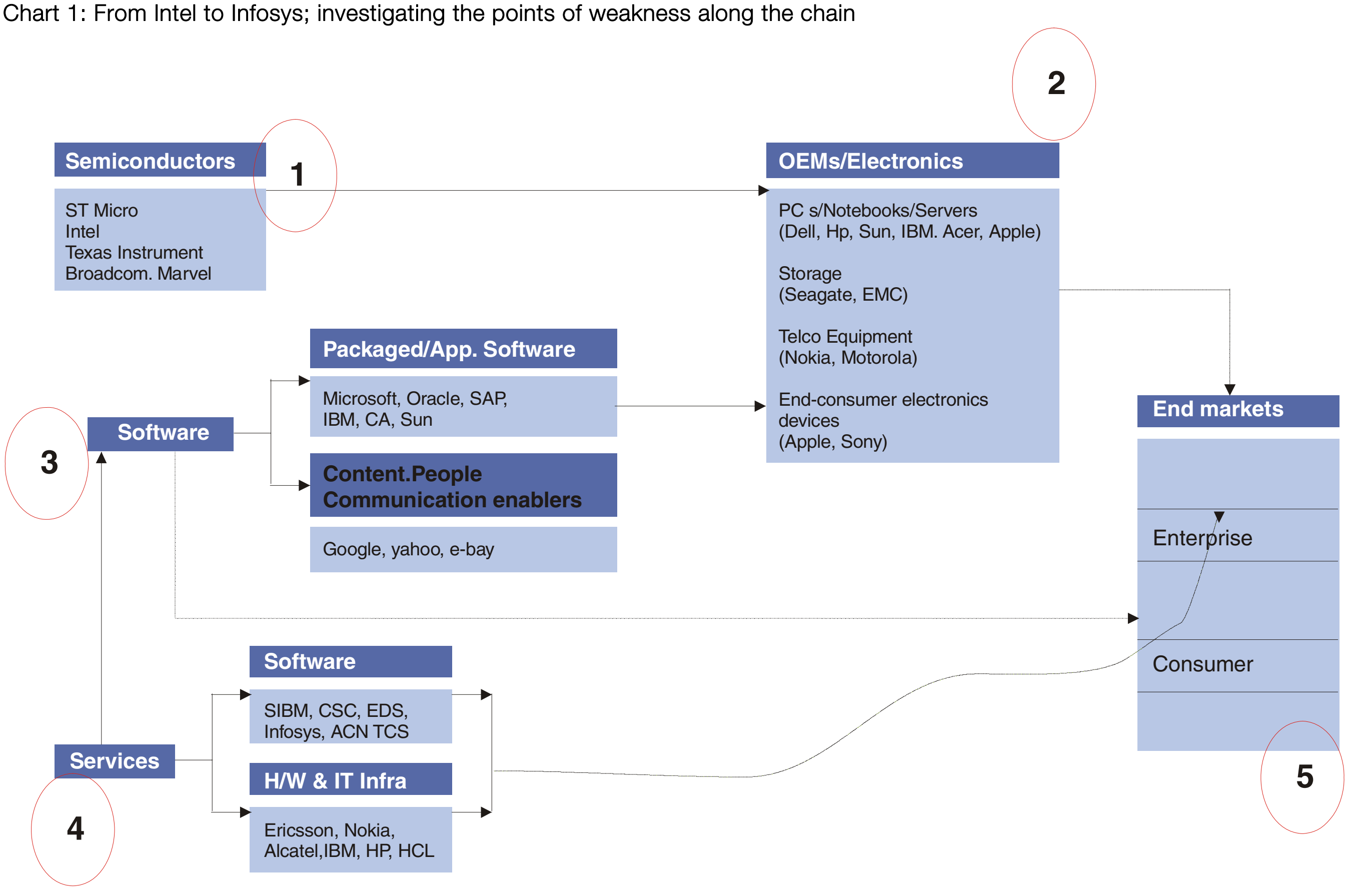
The macro versus micro disconnect must narrow further: Stock prices are acting in response to macro concerns, but we believe have not completely corrected unless we see a clearer micro picture emerging. So far, the micro points to a healthy state and the confidence of players such as Accenture and Oracle on the occasion of their most recent quarterly earnings conference. Witness for instance some of Accenture's statements viz.

"There a lot of things people are doing to improve their business performance. So frankly, we haven't seen any impact of an IT budget thing on our business at this point in time."

"I would tell you this. As it relates to, there are some of the industries that are challenged; there are some clients that are coming to us for services that address short-term cost improvement. So it has caused some acceleration in some of our offerings that may have been more modestly pursued in the last few years, but that is the only thing that we have seen different given the current economic situation as it stands today."

This clear macro-micro disconnect could narrow over the next one-two quarters as budgets are finalized and consumer-led spending weakness also begins to affect enterprise spending. Till then, stocks are unlikely to display any strength on the upside. The global tech bellwethers Intel (on the hardware side) and IBM (on integrated solutions and services) will announce shortly after Infosys does on January 11 and we would watch out for emerging global cues (see table 2). Global cues are likely to be much more influential than local cues in setting stock direction.

Chart 1: From Intel to Infosys; investigating the points of weakness along the chain



Source: Edelweiss research

Table 1: Checkpoints that capture the state of demand

Link ref. no.	Segment	Company	Key lead indicators	State of lead indicator(s) as of now
1	Semiconductors	Intel, AMD	Inventory levels, book-to-build ratio	Uncertain
2	OEMs/electronic systems	Dell, HP	Inventory at distribution channels (e.g. Best Buy)	Nothing adverse yet
3	Packaged application software	SAP, Oracle	New license sales, build-up of license tank	Good
4	Services	IBM, Accenture	Backlog/order book, deal pipeline	Good, news from IBM awaited shortly
5	End markets-consumer	Best Buy, Circuit City	Retail disctribution channels - Best Buy, Circuit City	News on December 07 sales and inventory movement awaited shortly

Source: Edelweiss research

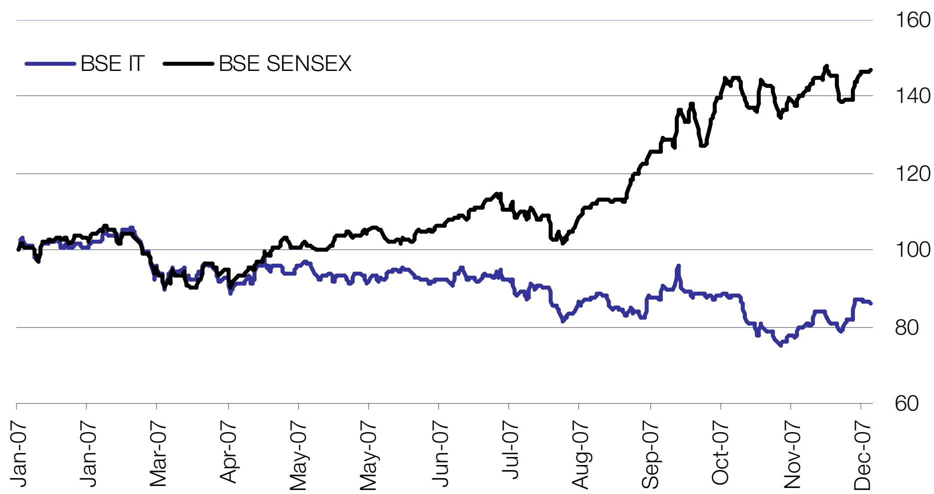
Table 2: Global micro cues emerging on the following dates would be more critical than local cues

Company name	Date	Event
Circuit City	7-Jan-08	Dec 2007 Sales release
Best Buy	11-Jan-08	Dec 2007 Sales release
Intel	15-Jan-08	4Q 2007 Results
AMD	17-Jan-08	4Q 2007 Results
IBM	17-Jan-08	4Q 2007 Results
SUN Microsystems	24-Jan-08	2Q FY2008 Results
Microsoft	24-Jan-08	2Q FY2008 Results
Cognizant	4-Feb-08	4Q 2007 Results
EDS	6-Feb-08	4Q 2007 Results
HP	19-Feb-08	1Q FY 2008 Results
DELL	28-Feb-08	4Q FY 2008 Results

Source: Company

As we look forward to the earnings of the October-December 2007 quarter of Indian technology companies (Q3 for most), we note that the BSE IT Index has underperformed the broader market (Nifty) on a quarterly basis for four successive quarters (see chart 2). Q3 is a relatively weaker quarter for the sector (and also for IT stocks) and we believe this time things will be no different. We see limited downside on beaten down valuations, but see few meaningful triggers to set direction in the near term.

Chart 2: BSE IT has underperformed the BSE Sensex for four quarters in a row



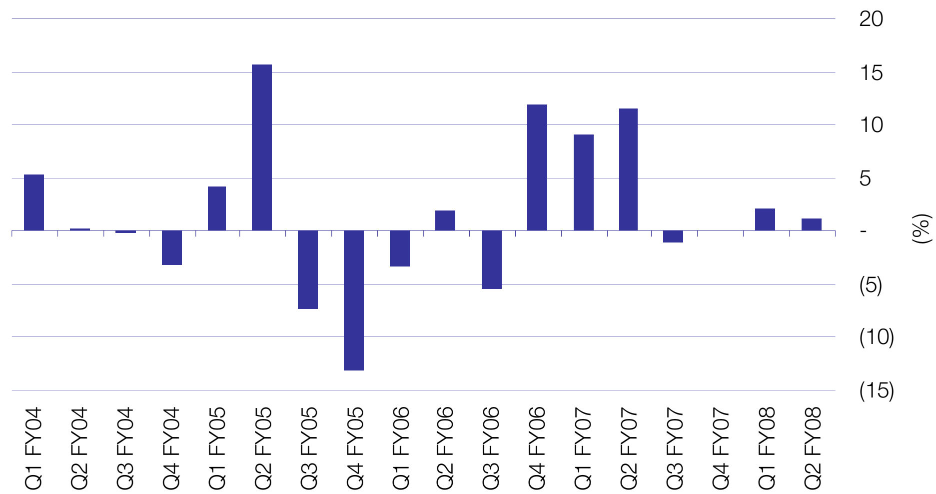
Source: Edelweiss research

* On balance, Infosys's quarterly results is an exaggerated event.

We show this by investigating the stock returns over a 20-day period around the results date (10 days prior to the results and 10 days following the results including the result day, see chart 3 for details). If we take +/-10% as the cut-off for what we would term as abnormal returns, we can see that on only four occasions (of the last eighteen quarters), has Infosys's stock taken direction from the results (or on 14/18 occasions stock movement has been less than abnormal). We can draw two sub-conclusions from this:

- On three of these four occasions, the 20-day returns have exceeded 10% while on one occasion only has the stock declined by more than 10%. Hence, historically the stock has not corrected significantly around the results period (10 days before and 10 days prior) and when it has, the frequency of an abnormal downward movement has been even lower (the last significant fall was in Q4FY05).
- The results have been a virtual non-event for the last four quarters in terms of setting stock price direction (the investor would recall that the run-up to the Q2FY08 results quickly dissipated post results).

Chart 3: Influence of quarterly results in providing thrust to the stock price is infrequent and diminishing



Source: Bloomberg, Edelweiss research

In essence, results themselves do not provide stock thrust. Given secular concerns on the ability to sustain margins on a secular basis, the longer-term outlook will likely prevail. Hereon, quarterly results is likely to be less relevant in setting the direction of stock prices expect perhaps on the occasion of the fourth and final quarter when Infosys provides its full year guidance for the coming fiscal.

Infosys' results: Positive surprise that cheers the market seems unlikely

- While we note that Infosys is likely to register ~7-8% sequential growth in USD in Q3FY08, we believe that the stock-catalyst can come only in the form of a significantly raised outlook for the year. We believe that this should be at least 4-5% points above 34.5-35% USD revenue growth guided so far for FY08 to cheer the markets and which would guide to an exceptional Q4, an unlikely event in our opinion. Commentary could focus on client's CY08 budgets and incremental pricing in the wake of the difficulties in the US though it is premature to conclude definitively the direction and quantum of IT budgets for they will get determined only in the first quarter of the calendar year (CY08).
- Infosys's EBITDA margins could see a meaningful uptick of ~60-70 bps in Q3FY08 (32%) translating into a reasonably decent 7% sequential growth.
- Our recent checks indicate that traction still remains robust, pipe-line is solid and large-account scale-ups are materializing in an unhindered fashion. As far as the company is concerned, it is still business as usual although the company, of late, is adopting a cautious outlook.

- Infosys, TCS and Satyam are in the middle of large end-user scale up plans with several clients in their overall portfolio. Notably, many of such clients are from Europe. HCLT will still have a quarter left of top-client ramp-down in its BPO. Hence, on a broad basis, we remain currently comfortable with our USD revenue growth estimates in FY09.

Top-tier players: Likely to be a decent quarter

We expect top tier companies to report Q-o-Q revenue growth of about 7-9% in USD terms (5-7% in INR terms) with Satyam leading the pack. This is likely to have a beneficial impact on EBITDA margins of Satyam, (about 150-200bps; also annual wage hikes have already been effected in the immediately preceding quarter, so the base effect will kick in), TCS and Infosys (showing a 70-100bps sequential uptick).The strong other income (including forex hedging gains) in Q2FY08 may not repeat on the same scale in Q3FY08 and hence, sequential net profit growth is likely to track sequential EBITDA growth.

Mid-tier players: A slow quarter for most, with notable exceptions

MphasiS, Rolta, and Infotech Enterprises (Infotech) are likely to post sequential revenue growth of around 6-8% (in INR terms) in Q3FY08. We believe that business momentum in these companies continues uninterrupted. MphasiS demonstrates the reality that companies that struggle will likely outsource more to reduce costs and/or stay competitive (case in point: EDS has been weakening in the global IT-services arena, losing market share over the past three years, yet it has been making offshoring its central theme). As mid-tier companies such as Patni, Hexaware, iGATE Global Solutions (iGATE), and Sasken Communications try to put their house in order, we expect the October-December 2007 quarter for these companies to be slow. Topline growth is likely to be muted of the order of 2-6%, but cost containment measures are likely to sequentially improve EBITDA margins. Mid-cap stocks have corrected significantly in the past two quarters, but we would not rush to invest in them on valuation grounds till we see business momentum on a more sustainable basis. We advocate selectivity in the mid-cap space.

We prefer TCS and Infosys among large caps (in that order); valuations are reasonable enough to absorb the risks of a moderate slowdown, in our view. In the mid-tier basket, our top picks are Infotech and MphasiS. Given its recent stock price performance, Rolta will likely track FY09 earnings growth to provide further meaningful upside. We do not expect this to happen in the near term.

Our table below (table 3) shows how EPS estimates could be provisionally affected for companies in our universe of coverage in the event of worse-than-expected news from the US. We still believe that TCS has the most defensive portfolio and is capable of containing the EPS downside impact better than others.

Table 3: A harder-than-expected slowdown can impact our pricing and volume increase assumptions differently for different companies

	Price Impact versus our earlier price increase expectations	Nature of impact
TCS	Average pricing increase lower by ~ 50-75 bps	No pricing increase in BFSI
Infosys	Average pricing increase lower by ~1% (100 bps)	No pricing increase in BFSI
Wipro	Average pricing increase lower by ~1%	Some impact from manufacturing/telecom clients
Satyam	Negative pricing impact unlikely	Operates at the lower end of the price chain
HCLT	Average pricing increase lower by ~ 50 bps	Impact from the mid-market strategy

	Volume impact versus our earlier volume growth estimates	Nature of impact	Downside to our FY09 EPS
TCS	Overall volume increase likely to be largely intact	Will likely make up for possible BFSI impact	Within 3%
Infosys	Overall volume increase likely to be lower by ~ 3%	BFSI volumes impacted to the extent of 6-8%	~ 3-5%
Wipro	Overall volume increase likely to be lower by ~ 3%	Some impact from manufacturing/telecom clients	~ 5-8%
Satyam	Overall volume increase likely to be lower by 3-5%	Package implementation traction could be affected	~ 5-7%
HCLT	Overall volume increase likely to be lower by 3%	BPO volumes lower than expected	~ 5%

Source: Edelweiss research

✻ Recommendation snapshot

Table 4: Recommendation table

Company	CMP (INR)	Recommendation
Geometric Software	85	ACCUMULATE
HCL Technologies	300	BUY
Hexaware	83	BUY
i-flex Solutions	1,451	ACCUMULATE
iGATE Global Solutions	398	BUY
Infosys Technologies	1,638	BUY
Infotech Enterprises	297	BUY
Mastek	346	ACCUMULATE
MphasiS	285	BUY
Patni Computer	310	ACCUMULATE
Rolta India	727	BUY
Sasken Communication	332	ACCUMULATE
Satyam Computers	413	BUY
TCS	976	BUY
TAKE Solutions*	1,254	WITHHELD
Wipro*	483	WITHHELD

Source: Edelweiss research ** withheld as currently on restricted list*

✻ Currency woes likely to continue

Interest rate cuts in the US may lead to a further strengthening of the INR. During the current quarter, the rupee appreciated against the USD by 0.9%, against the GBP by 3.9%, while depreciated by 1.4% against the Euro, based on closing rates for the quarter (see chart 4).

Chart 4: Rupee movement against USD, GBP, and Euro during the current quarter

Source: Bloomberg

Expected numbers

Table 5: Quarterly estimates and key points to watch out for

		Q3FY08E	Q2FY08	*Q-o-Q growth %*	Q3FY07	*Y-o-Y growth %*	Remarks and key things to watch out for
TCS	Revenues	59,257	56,398	*5.1*	48,605	*21.9*	- Number of new hires to be indicative of momentum, look out for actual
	EBITDA	16,046	14,820	*8.3*	13,753	*16.7*	- Attention on whether meaningful increase in client-base in USD 50 mn plus and USD 100 mn plus category seen in Q2FY08 will repeat
	Margin (%)	*27.1*	*26.3*		*28.3*		- Exposure to BFS relatively high; watch out for commentary here
	Net profits	13,244	12,469	*6.2*	11,047	*19.9*	- Net profit growth of 6.2% (Q-o-Q) weaker than EBITDA growth on account of weaker expected hedging income
Infosys	Revenues	43,102	41,060	*5.0*	34,510	*24.9*	- Likely to marginally up the revenue and EPS guidance for FY08
	EBITDA	13,728	12,840	*6.9*	11,090	*23.8*	- Hiring numbers in Q3FY08 in focus as Q2FY08 hiring was sluggish
	Margin	*31.9*	*31.3*		*32.1*		- Commentary on tentative client budgets for CY08 awaited
	Net profits	11,749	11,000	*6.8*	9,290	*26.5*	- Interest in assessing pricing improvement in Q3FY08 to figure out if it sustains to the same degree as in the previous quarters
Satyam	Revenues	22,036	20,317	*8.5*	16,611	*32.7*	- Industry-leading sequential revenue growth likely
	EBITDA	4,750	4,027	*18.0*	4,100	*15.9*	- OPM to face pressure with salary hike
	Margin	*21.6*	*19.8*		*24.7*		- 16% offshore and 5% onsite salary hikes expected to take effect in Q2FY08
	Net profits	4,390	4,091	*7.3*	3,372	*30.2*	- Investor focus on other services other than enterprise solutions (package implementation)
HCL Tech	Revenues	18,177	17,092	*6.3*	14,651	*24.1*	- Infrastructure management and software services likely to show 7-9% USD sequential growth; BPO likely to be sluggish
	EBITDA	3,926	3,639	*7.9*	3,241	*21.1*	- Rs150-200m charge towards amended bonus policy laid down by the government – bonus provisions to be made retrospectively for employees falling in the monthly basic salary bracket of Rs3,500-10,000
	Margin	*21.6*	*21.3*		*22.1*		- Commentary on success of the mid-market strategy awaited
	Net profits	3,002	2,856	*5.1*	2,597	*15.6*	
Patni	Revenues	6,804	6,747	*0.8*	6,840	*(0.5)*	- Lower working days, higher depreciation and foreign exchange impact will cause reduction in net profits (~30% Q-o-Q)
	EBITDA	966	927	*4.2*	1,474	*(34.4)*	- 50bps improvement in EBITDA margins expected
	Margin	*14.2*	*13.7*		*21.5*		- Watch out for attrition trend
	Net profits	685	994	*(31.0)*	1,233	*(44.4)*	- Top 10 accounts organic growth - key metric to be seen
i-flex	Revenues	6,196	5,840	*6.1*	5,502	*12.6*	- Services business to perform strong; margins to improve
	EBITDA	1,104	820	*34.7*	1,064	*3.7*	- Tank size to determine incremental traction in products
	Margin	*17.8*	*14.0*		*19.3*		- Increased product revenues to contribute to margin expansion
	Net profits	755	640	*17.9*	773	*(2.4)*	
MphasiS	Revenues	6,228	6,017	*3.5*	4,547	*37.0*	- IT services volumes to continue decent growth, while BPO revenues may decline
	EBITDA	1,177	1,079	*9.1*	601	*96.0*	- EBITDA margins expected at ~19%; to improve going forward as ramp-ups happen in Q1FY09
	Margin	*18.9*	*17.9*		*13.2*		- Comments on people addition for CY09 to indicate traction
	Net profits	683	663	*3.0*	481	*42.2*	- ITO migration work, and success on billing in INR to watch out
Hexaware	Revenues	2,613	2,546	*2.6*	2,402	*8.8*	- Huge forex provision to wipe of almost full year profits
	EBITDA	291	304	*(4.2)*	357	*(18.5)*	- Revenue growth to be impacted due to rupee appreciation
	Margin	*11.1*	*11.9*		*14.9*		- OPM expected to decline marginally
	Net profits	(510)	269	*(289.4)*	325	*(256.9)*	- New order wins to watch out for alongwoth update on new contract ramp ups
Rolta	Revenues	2,372	2,210	*7.3*	1,681	*41.1*	- EDA expected to continue strong growth trajectory of double digit
	EBITDA	911	840	*8.4*	677	*34.6*	- Healthy order book pile-up to continue; previous quarter it stood at INR 9.8 bn
	Margin	*38.4*	*38.0*		*40.2*		- Billing rate increases to help improve operating margins by ~ 50 bps
	Net profits	589	538	*9.4*	409	*43.8*	

		Q3FY08E	Q2FY08	*Q-o-Q growth %*	Q3FY07	*Y-o-Y growth %*	Remarks and key things to watch out for
iGATE	Revenues	2,088	2,008	*4.0*	2,107	*(0.9)*	- Revenue growth to revive; 4.0-4.5% growth expected
	EBITDA	359	317	*13.4*	267	*34.7*	- Margins expected to be improve further. However, Q4 to be much stronger
	Margin	*17.2*	*15.8*		*12.7*		- New client addition to remain at 3-4
	Net profits	243	229	*5.9*	160	*52.2*	- De-listing approval awaited; last quarter before delisting
Mastek	Revenues	2,115	2,042	*3.6*	2,064	*2.5*	- Expect to meet lower end of the guided revenues
	EBITDA	332	296	*12.3*	371	*(10.5)*	- EBITDA margins to improve by ~ 100bps. Order book expected to increase to INR 3.5 bn
	Margin	*15.7*	*14.5*		*18.0*		- Buy-back programme expected to start only from mid-January
	Net profits	258	251	*2.6*	218	*18.0*	- Client addition to track historic trend
Infotech	Revenues	1,748	1,611	*8.5*	1,430	*22.2*	- Revenue momentum to continue
	EBITDA	329	293	*12.1*	323	*1.9*	- Higher other income due to large cash position
	Margin	*18.8*	*18.2*		*22.6*		- Price increase to cushion EBITDA margins, expected 18.5% plus
	Net profits	274	253	*8.5*	187	*46.2*	- Bidding for a few large contracts; win to provide increased visibility
Sasken	Revenues	1,473	1,432	*2.8*	1,310	*12.4*	- Services expected to post 2-3% INR growth; utilisation to improve to by 100-150bps
	EBITDA	180	235	*(23.4)*	194	*(7.4)*	- Product revenues to remain mainly flat Q-o-Q
	Margin	*12.2*	*16.4*		*14.8*		- Services EBITDA margin expected to be around 13.5-14%
	Net profits	76	143	*(46.7)*	106	*(27.7)*	- Increase in attrition, another pressure point
Geometric	Revenues	1,323	1,225	*8.0*	1,067	*23.9*	- High margin direct win project execution to drive operating margin
	EBITDA	192	144	*33.3*	243	*(21.2)*	- Back-ended growth
	Margin	*14.5*	*11.7*		*22.8*		- New direct order wins to watch out for
	Net profits	106	91	*17.4*	177	*(39.8)*	- Modern progress critical - offshoring and contribution to profits

Source: Edelweiss research

Valuations at a glance

Table 6: Valuation matrix of our universe of coverage

	EPS (INR)		P/E (x)		EV/EBITDA (x)		EV/Revenue (x)		Mcap/Revenue (x)		FY07-09
	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	EPS CAGR (%)
TCS	52.4	62.0	18.6	15.7	15.1	12.2	4.0	3.2	4.1	3.3	21.2
Infosys	80.7	96.5	20.3	17.0	16.2	11.9	5.1	3.8	5.6	4.4	18.1
Wipro	22.1	27.6	21.9	17.5	16.2	12.4	3.2	2.6	3.6	3.0	16.4
Satyam	25.5	31.0	16.2	13.4	9.3	9.1	2.7	2.0	3.3	2.6	21.3
HCL Tech	18.7	22.9	16.0	13.1	11.3	9.0	2.5	2.0	2.7	2.2	10.0
Patni	32.4	35.8	9.6	8.7	6.4	3.8	1.2	0.9	1.6	1.4	10.0
i-flex	36.4	55.8	39.8	26.0	22.1	17.8	4.7	3.5	4.8	3.6	26.0
MphasiS	12.9	16.2	22.0	17.5	11.9	9.1	2.3	1.7	2.4	1.8	21.6
Mastek	36.9	40.3	9.4	8.6	6.1	4.6	1.0	0.8	1.2	1.1	12.6
Hexaware	8.4	10.8	9.9	7.7	6.4	4.9	0.8	0.7	1.1	0.9	6.8
Geometric	7.2	10.0	11.8	8.6	9.1	5.2	1.2	0.9	1.0	0.8	27.3
iGATE	25.8	30.5	15.4	13.1	8.5	6.4	1.3	1.0	1.5	1.3	38.2
Infotech	18.0	24.9	16.5	11.9	12.7	7.6	1.8	1.2	2.3	1.7	17.1
Sasken	12.9	23.8	25.8	13.9	13.4	7.3	1.7	1.3	1.6	1.3	23.2
Rolta	31.7	43.1	23.0	16.9	14.2	9.8	5.6	3.9	5.9	4.3	41.3
Mid-tier Average			14.8	10.6	9.4	6.0	1.3	1.0	1.5	1.2	
Large Cap Average			18.6	15.3	13.6	10.9	3.5	2.7	3.9	3.1	

Source: Edelweiss research

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

Geometric, HCL Tech, Hexaware, i-flex, i-Gate, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam and TCS

Recent Research

Date	Company	Title	Price (INR)	Recos
31-12-07	TAKE Solutions	Uniqueness + Scalability = Powerhouse in the making; *Initiating Coverage*	1,267	Buy
27-12-07	IT	Waging a raging battle at the campus… who's winning; *Sector Update*		
26-12-07	Sasken Communication Technologies	Near term pressure to continue; *Visit Note*	337	Accum.
13-12-07	IT	Is Hexaware the tip of the iceberg? *Sector Update*		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	107	45	18	3	193

* 13 stocks under review / 7 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	104	69	20

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period