

Industry Focus

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Indian IT Services

3QFY09 Preview: Sluggish Demand; Cross Currency Headwinds

- **Expect a muted 3Q** — We expect sluggish volumes, stable pricing and ~4% impact from cross currency headwinds – Tier-I companies should report 2-4% QoQ revenue decline (US\$ terms). Cross currency headwinds will partly offset margin benefit due to INR depreciation (against USD).
- **Sharp currency moves** — The sharp currency moves witnessed in 3Q will result in: 1) Negative impact on US\$ term revenue growth due to the adverse movement of US\$ against GBP/EUR; 2) Positive impact of depreciating INR (against US\$) on the margins of companies; and 3) Forex losses on account of hedge positions.
- **Focus on 2009 IT budgets** — Comments by Tier-I companies on IT budgets/pricing trends for 2009 will be the key focus for investors. We expect IT budgets to decline YoY – clarity should come only by March-April as IT budgets are likely to get delayed like last year. We expect companies to be very cautious on their near-term outlook and guide to flattish revenues for the next quarter.
- **IT budgets likely under pressure; pricing pressure likely** — Our channel checks suggest that IT budgets are likely to be under pressure as discretionary spend dries up – for details, refer to our report <https://www.citigroupgeo.com/pdf/SNA28021.pdf>. Pricing pressure is likely to emerge; we factor in ~4-5% price decline YoY for FY10.
- **Sector view remains cautious; Infosys only Tier-I buy** — We maintain a cautious view on the sector – uncertainty is likely to weigh on stock performance in the near term. Infosys remains our only Buy in the Tier-I space due to: 1) Ability to manage costs better; 2) Flight to safety likely to continue; and, (3) Historic low valuations.

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Figure 1. 3QFY09 Results Preview – Part I

Infosys	Dec'07	Sep'08	Dec'08E	QoQ	YoY	Key things to watch for
Revenue (US\$ m)	1,084	1,216	1,167	-4.0%	7.7%	<ul style="list-style-type: none"> ■ Sequentially, we expect -4.0% revenue growth (US\$ terms) with a ~100 bps decline in margins due to cross currency headwinds/continued investments in various initiatives ■ Expect ~Rs300m of forex losses on lower forex cover leading to a net profit growth of ~6% QoQ ■ Key things to watch - comments on 2009 IT budgets and outlook for pricing/volumes
Revenue (Rs m)	42,710	54,180	56,601	4.5%	32.5%	
EBITDA (Rs m)	13,920	17,940	18,192	1.4%	30.7%	
EBITDA margin (%)	32.6%	33.1%	32.1%	-97bp	-45bp	
Net Profit (Rs m)	12,310	14,320	15,242	6.4%	23.8%	
TCS						
Revenue (US\$ m)	1,503	1,574	1,538	-2.3%	2.4%	<ul style="list-style-type: none"> ■ Expect revenue growth of -2.3% in US\$ terms and EBIT margins to decrease ~30bps QoQ due to cross currency headwinds ■ Net profit expected to be up ~11% QoQ due to INR depreciation, lower forex losses QoQ ■ Forex losses pegged at Rs1.5b as against Rs2.6b in Q2 ■ Key things to watch - comments on 2009 IT budgets and outlook for pricing/volumes
Revenue (Rs m)	59,241	69,534	74,613	7.3%	25.9%	
EBIT (Rs m)	15,788	18,197	19,305	6.1%	22.3%	
EBIT margin (%)	26.7%	26.2%	25.9%	-30bp	-78bp	
Net Profit (Rs m)	13,308	12,615	13,969	10.7%	5.0%	
Wipro - IT						
Revenue (US\$ m)	910	1,324	1,289	-2.7%	41.6%	<ul style="list-style-type: none"> ■ For Wipro IT, we expect -2.7% revenue growth in US\$ terms with ~20bps decline in EBIT margins ■ At the company level, we expect ~7% QoQ net profit increase due to lower forex losses on ECB ■ Key thing to watch - outlook of technology business in addition to comments on pricing/volumes
Revenue (Rs m)	36,137	56,479	59,922	6.1%	65.8%	
EBIT (Rs m)	7,443	9,792	10,294	5.1%	38.3%	
EBIT margin (%)	18.1%	17.3%	17.2%	-16bp	-90bp	
Wipro - Consolidated						
Revenue (Rs m)	52,361	64,095	68,320	6.6%	30.5%	
EBIT (Rs m)	8,899	10,167	10,455	2.8%	17.5%	
EBIT margin (%)	17.0%	15.9%	15.3%	-56bp	-169bp	
Net Profit (Rs m)	8,261	8,222	8,810	7.1%	6.6%	
Satyam						
Revenue (US\$ m)	563	652	633	-2.9%	12.5%	<ul style="list-style-type: none"> ■ Expect a decline of 2.9% in revenues QoQ mainly due to cross currency headwinds ■ Expect margins to be down ~10bps due to lower utilization with net profits up only ~1% QoQ ■ Key things to watch - outlook for pricing/volumes; business impact of the aborted Maytas deal/World Bank issue and comments on Unpaid litigation
Revenue (Rs m)	21,956	28,193	30,160	7.0%	37.4%	
EBITDA (Rs m)	4,712	6,509	6,923	6.4%	46.9%	
EBITDA margin (%)	21.5%	23.1%	23.0%	-13bp	149bp	
Net Profit (Rs m)	4,336	5,809	5,836	0.5%	34.6%	

Source: Citi Investment Research estimates

Figure 2. 3QFY09 Results Preview – Part II

Tech Mahindra	Dec'07	Sep'08	Dec'08E	QoQ	YoY	Key things to watch for
Revenue (US\$ m)	245	270	245	-9.2%	-0.2%	<ul style="list-style-type: none"> ■ Expect revenue decline of ~10% QoQ in US\$ terms on severe cross currency headwinds (~70% of revenues GBP denominated) ■ We expect margin decline of ~250bps leading to profit decline of ~22% QoQ ■ Key things to watch - Outlook on BT and AT&T (the biggest clients)
Revenue (Rs m)	9,704	11,648	11,873	1.9%	22.4%	
EBITDA (Rs m)	2,129	3,261	3,010	-7.7%	41.4%	
EBITDA margin (%)	21.9%	28.0%	25.4%	-264bp	341bp	
Net Profit (Rs m)	1,994	3,026	2,346	-22.5%	17.7%	
Patni						
Revenue (US\$ m)	174	183	172	-6.4%	-1.4%	<ul style="list-style-type: none"> ■ Expect another muted quarter - revenue decline of ~6% QoQ in US\$ terms with margin decline of ~80bps ■ Net profits expected to decline significantly due to lower other income assumption (given the one-offs in the previous quarter) and forex losses (as guided by the company in Q3 call) ■ Key things to watch - outlook on growth going forward
Revenue (Rs m)	6,862	8,523	8,325	-2.3%	21.3%	
EBITDA (Rs m)	1,128	1,515	1,412	-6.8%	25.1%	
EBITDA margin (%)	16.4%	17.8%	17.0%	-82bp	52bp	
Net Profit (Rs m)	1,006	2,002	727	-63.7%	-27.7%	
MindTree						
Revenue (US\$ m)	47	72	76	5.6%	61.0%	<ul style="list-style-type: none"> ■ We expect ~6% QoQ growth driven by the full quarter impact of Aztec integration ■ We model ~2% QoQ decline on Mindtree's standalone revenues ■ Expect margins to decline by ~400bp QoQ on account of cross currency headwinds and wage hikes affected in the quarter ■ Key things to watch - revision to FY09 guidance
Revenue (Rs m)	1,865	3,120	3,648	16.9%	95.6%	
EBITDA (Rs m)	323	867	867	0.0%	168.7%	
EBITDA margin (%)	17.3%	27.8%	23.8%	-401bp	646bp	
Net Profit (Rs m)	210	373	360	NA	71.0%	
NIIT Ltd						
Revenue (US\$ m)	60.3	70.3	61.2	-12.9%	1.6%	<ul style="list-style-type: none"> ■ Expect revenue growth of ~24% YoY ■ We expect 20% revenue and 27% operating profit growth in individual business while new businesses should remain at Rs100-110m levels QoQ ■ Key thing to watch - ElementK profitability; outlook for individual training business given the sluggishness in IT demand
Revenue (Rs m)	2,388	3,095	2,970	-4.0%	24.4%	
EBITDA (Rs m)	228	406	287	-29.2%	26.0%	
EBITDA margin (%)	9.5%	13.1%	9.7%	-344bp	13bp	
Net Profit (Rs m)	139	297	175	-41.1%	25.8%	
Educomp Solutions						
Revenue (Rs m)	715	981	1,563	59.3%	118.5%	<ul style="list-style-type: none"> ■ Growth momentum to continue - we expect ~120% YoY growth in revenues ■ EBITDA margins expected to increase by ~500bp YoY ■ Key thing to watch - outlook/ramp up on the new school business
EBITDA (Rs m)	334	628	805	28.1%	141.0%	
EBITDA margin (%)	46.7%	64.0%	51.5%	-1252bp	481bp	
Net Profit (Rs m)	190	254	390	53.4%	104.9%	

Source: Citi Investment Research estimates

Figure 3. Price performance

	Market Cap US\$ m	Price 5-Jan-09	Performance					
			1W	1M	3M	6M	12M	
Infosys	INFY.BO	13,843	1,164	4.8%	2.4%	-16.4%	-33.7%	-31.3%
TCS	TCS.BO	10,297	506	6.2%	-3.0%	-22.9%	-40.0%	-49.6%
Wipro	WIPR.BO	7,476	246	8.2%	8.2%	-27.9%	-42.7%	-50.5%
Satyam	SATY.BO	2,306	165	11.1%	-26.6%	-47.5%	-64.4%	-61.0%
Tech Mahindra	TEML.BO	721	285	17.3%	13.0%	-54.1%	-59.6%	-74.6%
Patni	PTNI.BO	363	136	7.2%	1.4%	-29.1%	-41.5%	-57.5%
MindTree Ltd	MINT.BO	191	242	0.8%	0.0%	-17.9%	-38.0%	-52.8%
Educomp	EDSO.BO	950	2,645	7.7%	25.7%	-15.6%	-5.0%	-40.8%
NIIT Ltd	NIIT.BO	102	30	22.4%	26.3%	-35.1%	-69.9%	-79.6%
Moser Baer	MOSR.BO	276	79	23.4%	44.0%	-27.2%	-35.5%	-75.8%
Oracle Financial	ORCL.BO	853	490	8.9%	11.0%	-30.2%	-67.6%	-67.0%
Mphasis Ltd	MBFL.BO	725	167	13.6%	3.0%	-5.7%	-17.0%	-42.4%
HCL Infosystems	HCLI.BO	318	89	7.2%	25.0%	-14.4%	-29.0%	-68.3%
Hexaware	HEXT.BO	69	23	17.9%	16.4%	-24.5%	-51.1%	-72.9%
KPIT Cummins	KPIT.BO	44	27	3.0%	10.0%	-18.8%	-51.0%	-78.4%
Rohta	ROLT.BO	421	126	13.4%	-12.8%	-45.5%	-52.6%	-65.6%
Infotech Ent	INFE.BO	128	107	6.7%	5.8%	-46.1%	-54.4%	-63.8%
BSE Sensex	.BSESN	-	10,132	6.3%	13.0%	-19.1%	-24.7%	-51.0%
BSE IT Index	.BSEIT	-	2,316	6.5%	-1.8%	-25.5%	-43.1%	-46.4%

Source: DataStream

Figure 4. Currency movement

	2QFY09	3QFY09	Change (diff)	Change (%)
USD / INR				
Period end	46.82	48.62	-1.81	3.9%
Average	43.71	48.59	-4.87	11.2%
GBP / USD				
Period end	1.78	1.46	0.32	-18.0%
Average	1.89	1.57	0.32	-17.1%
EUR / USD				
Period end	1.41	1.40	0.01	-0.9%
Average	1.50	1.32	0.19	-12.3%

Source: DataStream

Figure 5. Hedge position (at the end of Sep'08)

	Forex Cover (US\$ m) - Sep'08			Revenue (Sep'08) US\$ m	Hedge as a % of quarterly revenues
	Forwards	Options	Total		
Infosys	306	630	936	1,216	77%
TCS	916	3,093	4,008	1,574	255%
Wipro	1,519	651	2,170	1,324	164%
Satyam	308	308	616	652	94%

Source: Company Reports

Figure 6. Infosys 3QFY09 guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	55,190	57,300	1.9%	5.8%
Revenue (US\$ m)	1,175	1,220	-3.4%	0.3%
EPS - basic (Rs)	26.63	26.63	6.5%	6.5%

Source: Company Reports; Company guidance at USD/INR of 46.97.

Figure 7. Satyam 3QFY09 guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	29,450	30,340	4.5%	7.6%
Revenue (US\$ m)	634	652	-2.8%	0.0%
EPS (Rs)	8.39	8.65	-2.8%	0.2%

Source: Company Reports; Company guidance at USD/INR of 47.00.

Figure 8. Patni 4QCY08 guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (\$ m)	176	177	-4.1%	-3.5%
Net profit (US\$ m)*	22.0	22.5	-48.3%	-47.2%

Source: Company Reports; *Excluding forex gain/loss; Company guidance at USD/INR of 47.00.

Figure 9. Indian IT – Valuation Comparison Table

Company Name	RIC Code	CIR Rating	Mkt cap (US\$m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		EV/Sales(x)		P/BV (x)		Div. Yield (%)	
						FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
IT software and services															
Infosys	INFY.BO	1M	13,843	1,164	1,350	11.5	11.2	8.6	8.2	2.8	2.6	3.7	3.0	2.6%	2.6%
TCS	TCS.BO	2H	10,297	506	560	9.1	9.0	6.7	6.6	1.7	1.6	3.0	2.4	2.8%	3.0%
Wipro	WIPR.BO	2H	7,476	246	265	9.9	9.2	6.8	6.3	1.3	1.2	2.5	2.1	2.4%	3.3%
Satyam	SATY.BO	3H	2,306	165	170	5.0	4.9	2.6	2.4	0.6	0.5	1.2	1.0	2.4%	3.0%
Tech Mahindra	TEML.BO	2H	721	285	310	3.4	3.7	2.9	2.8	0.7	0.6	1.6	1.1	2.5%	2.8%
Patni*	PTNI.BO	3H	363	136	125	3.9	5.0	0.9	0.9	0.1	0.1	0.6	0.6	2.2%	1.8%
MindTree	MINT.BO	1H	191	242	367	7.7	5.6	3.0	3.0	0.7	0.6	1.4	1.1	1.2%	1.2%
Educational services															
Educomp	EDSO.BO	3H	950	2,645	2,410	35.9	22.0	14.3	8.6	6.6	3.6	10.8	7.1	0.1%	0.1%
NIIT	NIIT.BO	3H	102	30	27	5.7	5.4	5.6	4.5	0.5	0.5	1.0	0.9	3.4%	3.4%
Hardware															
Moser Baer	MOSR.BO	3H	276	79	62	-4.2	14.4	7.0	3.2	1.2	0.7	0.6	0.6	0.0%	1.3%

Source: Company data and Citi Investment Research estimates; *Using CY08E and CY09E (31-Dec year-ending); Priced on 5-Jan-09.

Appendix A-1

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