Prabhudas Lilladher

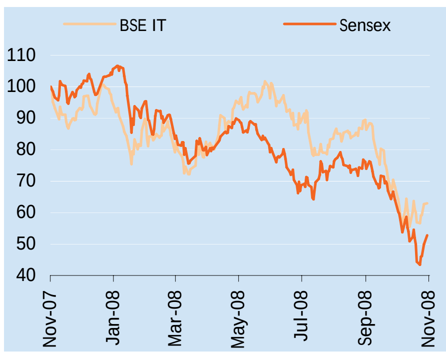
Technology Sector

Going will get tougher

Q2FY09 Result Review

November 3, 2008

IT Index Performance v/s Sensex



Source: Bloomberg

Absolute Stock Performance

(%)	1M	6M	12M
Sensex	**(17.5)**	**(41.3)**	**(48.3)**
Geometric	(28.4)	(50.8)	(63.7)
HCL Tech	(15.5)	(41.1)	(42.0)
Infosys	(0.9)	(23.0)	(27.8)
KPIT	(4.6)	(64.4)	(69.4)
Satyam	(4.3)	(39.3)	(35.0)
TCS	(16.5)	(41.7)	(46.2)
Tech Mahindra	(45.8)	(64.6)	(70.9)
Wipro	(19.0)	(45.0)	(43.9)

- **Currency drives decent Q2FY09 results:** Revenues of the Indian IT sector (as represented by top seven listed companies) increased by 8.4% QoQ, while PAT grew by 12.0% QoQ. The results exceeded our expectations, mainly due to higher impact of currency and marginally better volume growth. Nearly 4.5% of the growth was due to currency factor, with the rest coming from the volume growth.
- **Volume and pricing growth remains under pressure:** The slump in the volume and pricing growth is not a new phenomenon; it has been happening for the past eight quarters. From 32.9% in Q2FY08 to just 20.4% YoY in Q2FY09, the volume is consistently declining. The same is the case with pricing growth. From 5.5% YoY in Q1FY08 to 0.8% YoY in Q2FY09, pricing pressure is clearly evident. This is despite contradictory statements from the players.
- **Client concentration low, but macro factors to affect growth:** Client concentration is at an all time low, with the top ten clients contributing just 30.9% to revenues in Q2FY09, as compared to 33.6% in Q2FY08. So while specific client issues are unlikely to impact numbers significantly, macro factors will play a larger role. We expect retail and manufacturing verticals to present growth challenges along with BFSI, over the next 12-18 months.
- **Valuations cheap, but outlook is not encouraging:** At 10.6x FY09E and 9.1x FY10E earnings, Indian IT is inexpensive, especially given the solid free cash flow generation even in a downturn. However, significant concerns over growth in the next 12-18 months remain. We expect the sector to outperform in the near-term, given the weakness in the Indian Rupee and oversold conditions in stock prices, but remain cautious from a 12-18 month perspective.

Key Financials

	CMP (Rs)	Rating	EPS (Rs)		CAGR	PER (x)		FCF Yield (%)		RoE (%)	
			FY09	FY10	08-10 (%)	FY09	FY10	FY09	FY10	FY09	FY10
Geometric	29	Sell	3.3	4.5	(9.2)	8.8	6.5	(16.6)	7.8	13.5	15.8
HCL Tech	174	Accumulate	22.3	25.5	24.1	7.8	6.8	9.9	9.7	33.8	30.8
Infosys	1,379	Accumulate	99.1	111.6	17.2	13.9	12.3	6.1	6.7	35.9	31.8
KPIT	32	Buy	7.6	9.5	21.4	4.2	3.4	10.6	21.7	20.2	20.0
Rolta	191	Buy	16.3	27.1	38.1	11.7	7.0	5.6	9.1	16.9	20.0
Satyam	300	Accumulate	33.3	36.1	20.8	9.0	8.3	7.8	10.5	27.9	24.5
TCS	549	Accumulate	56.2	65.4	12.9	9.8	8.4	7.7	9.4	38.6	35.0
Tech Mahindra	337	Accumulate	77.9	90.4	23.8	4.3	3.7	19.1	19.4	58.5	43.1
Wipro	276	Reduce	24.4	30.0	15.9	11.3	9.2	7.6	7.9	25.1	26.2

Apurva Shah
ApurvaShah@PLIndia.com
+91-22-6632 2214

Jaspreet Chhabra
JaspreetChhabra@PLIndia.com
+91-22-6632 2256

Highlights

Q2FY09 results have surprised positively

Despite extreme negativity surrounding the technology sector approaching the Q2FY09 quarterly season, technology companies in India reported better-than-expected numbers.

The top seven companies beat our revenue estimate by 2.1% and the consensus by 1.1%. Our PAT estimates were beaten by 4.3%, while the consensus was beaten by 2.4%. The companies reported slightly better volume growth as compared to our expectation. Also, the positive impact of rupee depreciation was also a bit ahead of forecast.

Going forward, our annual FY09 forecast implies a revenue and PAT growth CQGR of just 4.3% and 4.4%, respectively. We believe these numbers are comfortably achievable.

Q2FY09 Results **(Rs m)**

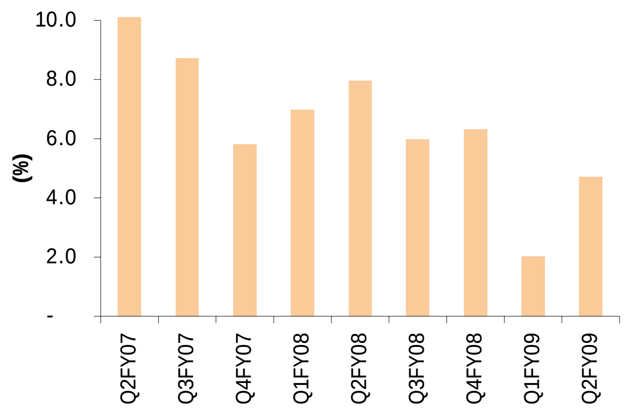
	Revenue			Profit		
	Actual	**PL Est.**	*Variation (%)*	**Actual**	**PL Est.**	*Variation (%)*
HCL Tech*	23,693	23,423	*1.2*	3,562	3,506	*1.6*
Infosys Technologies	54,180	51,938	*4.3*	14,320	13,571	*5.5*
Satyam Computers	28,193	27,519	*2.4*	5,809	5,051	*15.0*
Patni Computers	7,996	8,494	*(5.9)*	1,802	844	*113.5*
TCS	69,534	68,244	*1.9*	12,615	13,760	*(8.3)*
Tech Mahindra	11,648	11,610	*0.3*	3,027	2,701	*12.1*
Wipro	47,523	47,057	*1.0*	8,224	8,338	*(1.4)*
Total	**242,767**	**238,285**	*1.9*	**49,359**	**47,771**	*3.3*
Total (Ex Wipro)	**195,244**	**191,228**	*2.1*	**41,135**	**39,433**	*4.3*

** Y/e June*

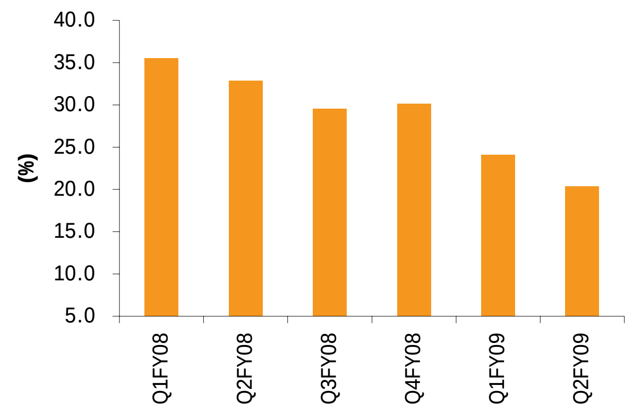
Volume and realization growth both coming off rapidly

The trend of a decline in volume and realization growth, which has been witnessed for the past 6-7 quarters, continued in Q2FY09 as well. Volume growth has declined from 32.9% YoY in Q2FY08 to just 20.4% in Q2FY09. Similarly, pricing growth has declined from 5.5% YoY in Q1FY08 to just 0.8% in Q2FY09.

QoQ Volume growth

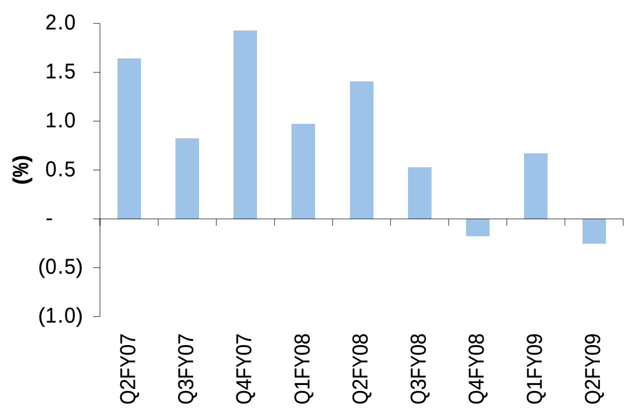


YoY Volume growth

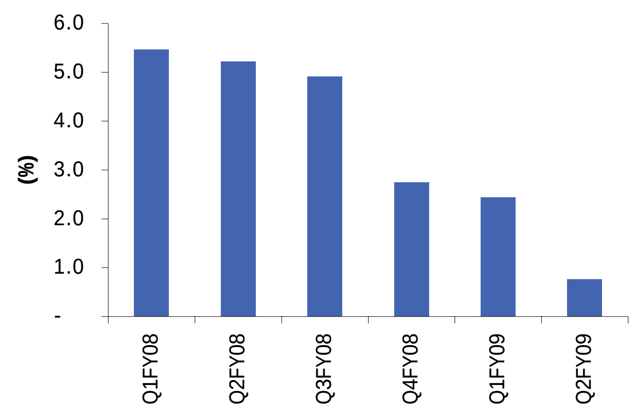


Source: Company Data, PL Research

QoQ Pricing growth



YoY Pricing growth



Source: Company Data, PL Research

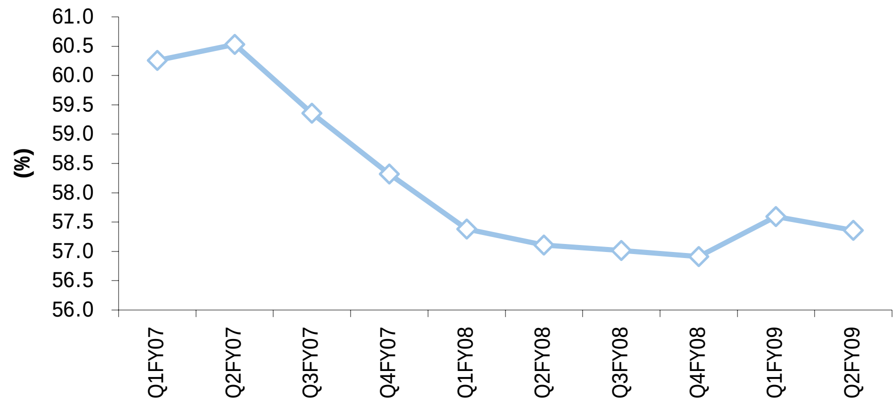
Clearly the Indian IT industry's struggle for growth is not a fall out of just the recent financial crisis and economic slowdown. The industry has been fighting to maintain, and perhaps enhance, its relevance in the face of strong offshore performance of its global peers such as IBM, Accenture, HP and EDS.

As the global economic slowdown bites deeper, we expect technology spending to remain under stress in H2FY09 and early FY10. Thus in the coming few quarters the volume growth for the Indian IT industry is likely to slide to 13-15% YoY and pricing growth will fall to (-)1-2% YoY.

BFSI and US contribution reducing but still high

One of the focus points in analyzing the industry's results off late has been the exposure to the US region and the BFSI vertical. The US remains (and will always remain) the largest client-region for the industry. However, its contribution has been steadily declining. From 60.5% in Q2FY07 to 57.4% in Q2FY09, the decline is discernible but not significant.

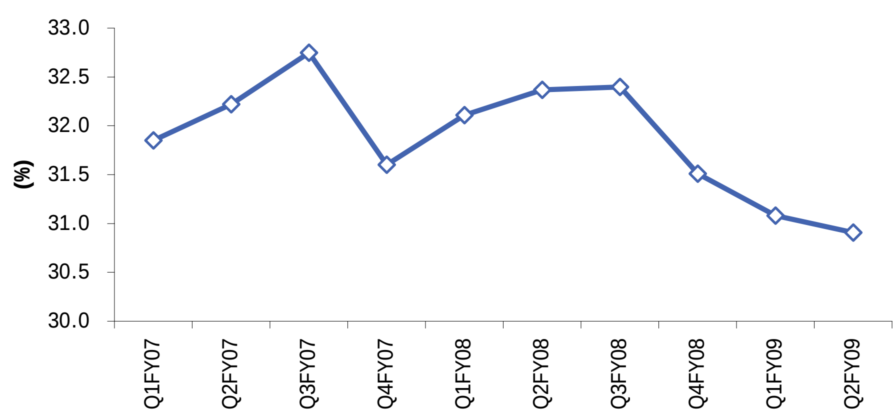
Revenue Contribution from North America



Source: Company Data, PL Research

It's a somewhat similar case with exposure to the BFSI vertical. From 32.2% in Q2FY07 to 30.7% in Q2FY09, BFSI exposure has reduced but still remains very high. Interestingly, the contribution has not come down essentially because most IT companies have experienced significant slowdown from this segment. There have been a few specific clients such as Merrill Lynch, AIG, Lehman, etc., where spending has either completely stopped or at least slowed down considerably, but nothing beyond that for the sector as whole. We suspect the worst is yet to come in terms of IT spending slowdown from this vertical.

BFSI revenue contribution

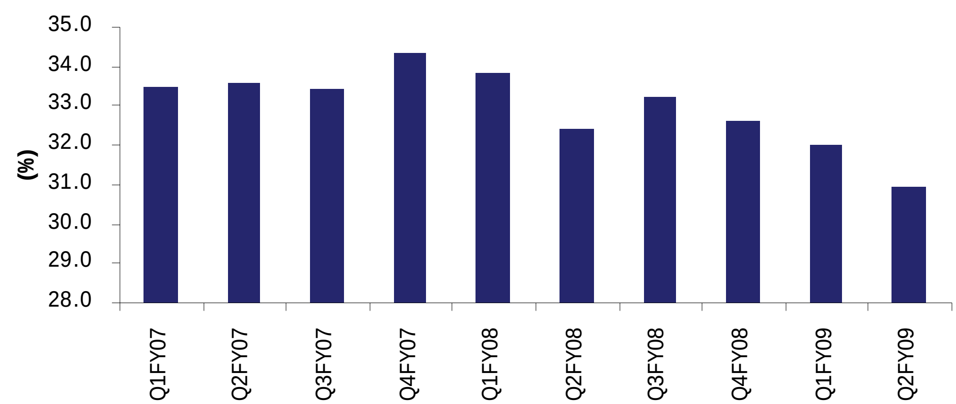


Source: Company Data, PL Research

With client concentration lowest ever, macro factors are more important

One of the biggest positives for the Indian IT sector is the extremely diversified nature of its client profile. The contribution of the top ten clients to revenue (one of the indicators of client risk diversification) in Q2FY09 is now at the lowest ever level of 30.9%. It was 33.6% in Q2FY07.

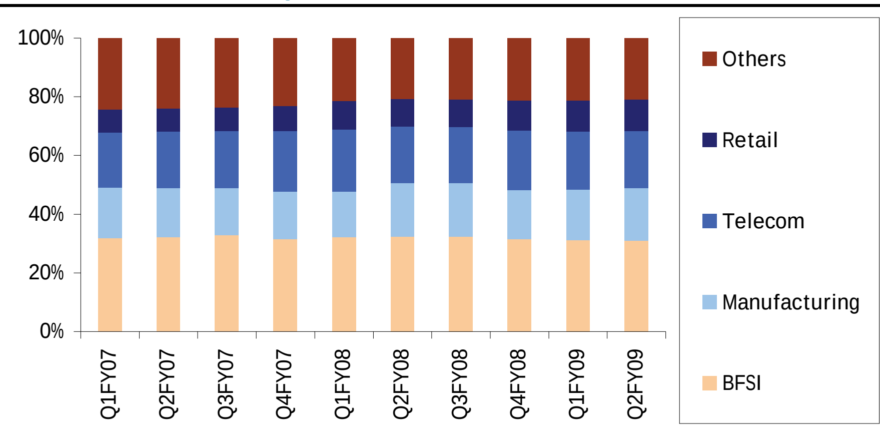
Revenue contribution from top-10 clients



Source: Company Data, PL Research

Clearly, rather than bottom-up (i.e concentrating on business from specific clients), one needs to analyze the sector and companies top-down (i.e. monitoring macro developments in the western economies and specific verticals). And the macro picture is not too encouraging. The Indian IT industry gets over 80% of its business from the verticals BFSI, manufacturing, telecom and retail. We are of the opinion that over the next 18-months three of these verticals BFSI, retail and manufacturing could be at risk of slowdown in IT spending.

Revenue contribution mix by verticals/domains

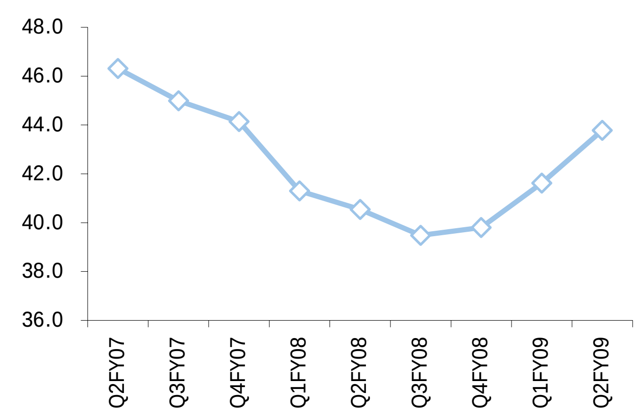


Source: Company Data, PL Research

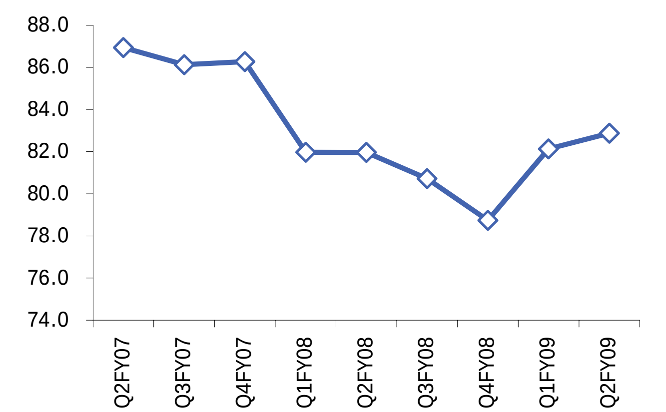
Currency has played major role in sector performance

Compared to September 2007 quarter, the Indian Rupee in the September 2008 quarter, has depreciated versus the currency basket for the Indian IT sector, by 6.0%. Thus the constant currency revenue growth is more like 24.7% YoY in Q2FY09 than the reported growth of 30.7% YoY. If one goes by the rule-of-thumb assumption of 30 bps expansion in EBITDA margin for every one percent depreciation of the rupee, the EBITDA margins for the sector should have risen by 180bps YoY. However the actual EBITDA margin expansion is just 90 bps, the rest being taken out by increased operating costs. It is clear that without support from a favorable currency, the industry would struggle to maintain its margins.

USD-INR



GBP-INR



Source: Bloomberg, PL Research

Valuations reflect much of the negatives

Although on a YTD basis, the IT sector has outperformed BSE Sensex by 10.2%, the sector has been a significant underperformer over the last 3-4 years. Much, if not most, of the out performance this year can be attributed to the weak Indian currency. We believe the Indian IT industry will face a major challenge of growth over the next six quarters as the slowdown in retail and manufacturing begins to bite in addition to BFSI.

Using historic book value and basic assumptions about RoEs and Cost of Equity, we have calculated the long-term growth implied by the current market price of various IT companies. On an average the stock prices seem to imply a long-term growth of 12.5% for the sector. This while appearing reasonably modest needs to be seen in light of the long-term growth of tech spending globally. Since the long-term trend growth in tech spending globally is between 5-7% per annum, the implied growth rate of the Indian IT sector is nearly 2x that. Market share gains for the sector will continue for the foreseeable future though how long and to what extent are debatable. We believe the current prices adequately reflect the long-term sectoral challenge of maintaining growth.

However, at 10.6x FY09E and 9.1x FY10E earnings, Indian IT appears inexpensive. We expect the sector to outperform in the near-term given the weak prognosis for the Indian Rupee, but cautious from a 12-18 month perspective.

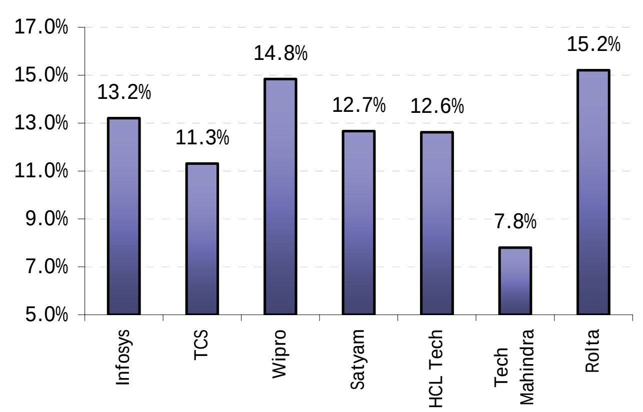
We like Infosys (best placed to weather the storm), HCL Tech (good growth and inexpensive) and KPIT (too cheap). Tech Mahindra stock is also extraordinarily cheap, but risk to growth is high given high client concentration.

Free Cash Flow Yield

	Price (Rs.)	FCF per share (Rs.)			*FCF Yield (FCF/Price %)*		
		FY08	**FY09E**	**FY10E**	*FY08*	*FY09E*	*FY10E*
Geometric	29	9.0	(4.8)	2.3	*30.9*	*(16.6)*	*7.8*
HCL Tech	174	11.1	17.3	17.0	*6.4*	*9.9*	*9.7*
Infosys	1,379	71.2	84.8	92.3	*5.2*	*6.1*	*6.7*
KPIT	32	3.6	3.4	7.0	*11.3*	*10.6*	*21.7*
Rolta	191	4.6	10.6	17.3	*2.4*	*5.6*	*9.1*
Satyam	300	12.8	23.3	31.5	*4.3*	*7.8*	*10.5*
TCS	549	31.3	42.3	51.3	*5.7*	*7.7*	*9.4*
Tech Mahindra	337	6.8	64.2	65.3	*2.0*	*19.1*	*19.4*
Wipro	276	17.2	20.9	21.7	*6.2*	*7.6*	*7.9*

Source: PL Research

Implied Long-term Growth in Earnings



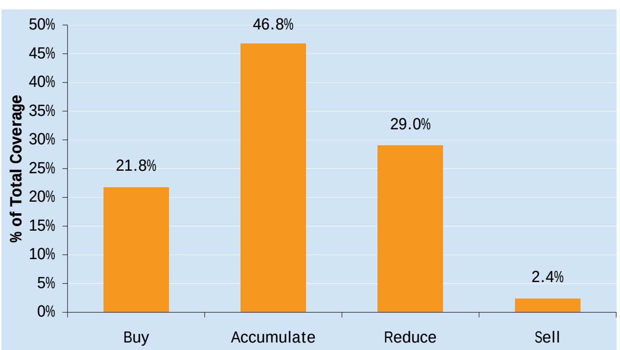
Source: PL Research

Assumptions

	Price	Book Value Per Share	*Exp. rate of return*	*RoE*	*Implied Growth*
Infosys	1,379	240	*17.0%*	*35.0%*	*13.2%*
TCS	549	127	*17.0%*	*36.0%*	*11.3%*
Wipro	276	54	*17.0%*	*26.0%*	*14.8%*
Satyam	300	106	*17.0%*	*25.0%*	*12.7%*
HCL Tech	174	62	*17.0%*	*25.0%*	*12.6%*
Tech Mahindra	337	96	*17.0%*	*40.0%*	*7.8%*
Rolta	191	71	*17.0%*	*20.0%*	*15.2%*

Prabhudas Lilladher Pvt. Ltd.
3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India
Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly