All is not well

17 February 2010

A robust pick-up in revenue growth at mid-cap IT vendors is likely to be delayed further. For one, vendor consolidation deals during 2009 have affected most mid-cap vendors adversely. Secondly, large-cap vendors are better placed to benefit from the recent deal flow, given the skew towards multi-service deals, M&A IT integration and infrastructure services deals. In addition, cost pressures from salary hikes and a pick-up in hiring would be relatively intense at mid-tier vendors, as their revenue growth lags that at larger vendors. As such, we continue to prefer larger vendors over mid–tier ones. There is scope for valuation convergence trades among select mid-cap vendors; Patni and Infotech Enterprises remain our preferred picks among mid-cap vendors.

Mid-cap vendors to lag behind larger vendors: While revenue growth at larger vendors has witnessed a strong pick-up, a robust pick-up in demand continues to elude most mid-cap IT vendors. In the quarter ended December 2009, QoQ US$ revenue growth of mid-cap IT vendors had lagged that of the larger vendors by ~4pps and EBITDA margins contracted by ~250bps relative to the larger vendors.

Fewer levers to manage cost escalations: Infosys, HCL Tech and Tech Mahindra have already given salary hikes, and Wipro and TCS are likely to do so over the next two quarters. While likely strong revenue growth at top-tier vendors would mitigate some of the margin pressures, mid-cap IT vendors have their task cut out. In addition, the lower margins at mid-cap vendors imply that the fall in EBITDA would be severe for even an equal contraction in margins.

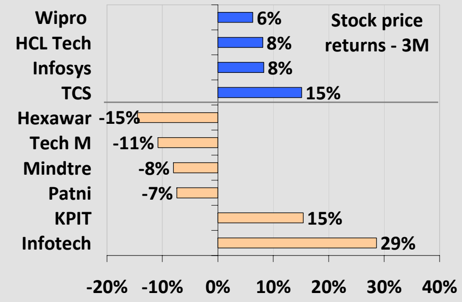
Scope for select valuation convergence trades: Valuation discounts for most of the mid-tier IT vendors (vs larger peers) are in line with their historical average discounts. As such, with likely underperformance in revenue growth and margins, we see the scope for a re-rating only at select vendors. Among the mid-tier vendors, we prefer Patni, owing to its ability to bag multi-service deals and a considerable improvement in its operational efficiency by the new management; and Infotech Enterprises, given its niche positioning and recent large deal wins. We downgrade Hexaware to REDUCE on account of relatively higher margin headwinds and poor revenue visibility at its key client accounts.

Figure 1: Valuation summary

Company	Price (Rs)	Mkt cap (US$ m)	P/E FY10ii	P/E FY11ii	FY10 EV/EBITDA	FY10ii Mkt cap/Rev	ROE	10-12 EPS CAGR	Rec.
TCS	758	32,133	22.2	19.0	17.6	4.9	37.5%	17.2%	ADD
Infosys	2,541	31,554	23.6	20.4	17.1	6.4	30.5%	16.2%	REDUCE
Wipro	670	21,240	21.8	17.9	17.0	3.6	28.9%	16.4%	BUY
HCLT	361	5,205	21.2	13.8	9.8	2.0	17.5%	33.7%	ADD
Patni	465	1,366	10.6	11.2	6.5	2.0	16.7%	-1.6%	ADD
Hexaware	76	236	8.1	8.5	3.6	1.1	18.8%	1.6%	REDUCE
Tech Mah.	950	2,505	12.6	11.7	12.5	2.6	41.4%	2.0%	REDUCE
3i Infotech	77	219	4.9	5.8	7.0	0.4	20.7%	-0.3%	BUY
KPIT	114	193	10.2	10.0	5.9	1.2	43.5%	17.9%	NR
MindTree	551	455	11.0	11.8	8.5	1.6	31.4%	5.5%	REDUCE
Infotech	336	402	12.0	12.0	5.6	1.9	18.4%	8.8%	BUY

Source: IIFL Research

Large-cap stocks outperformed mid-caps over the past three months



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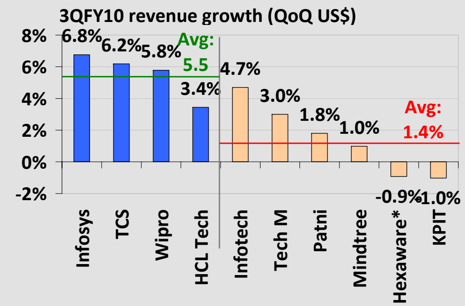
Revenue growth at large vendors is outpacing that at mid-tier vendor



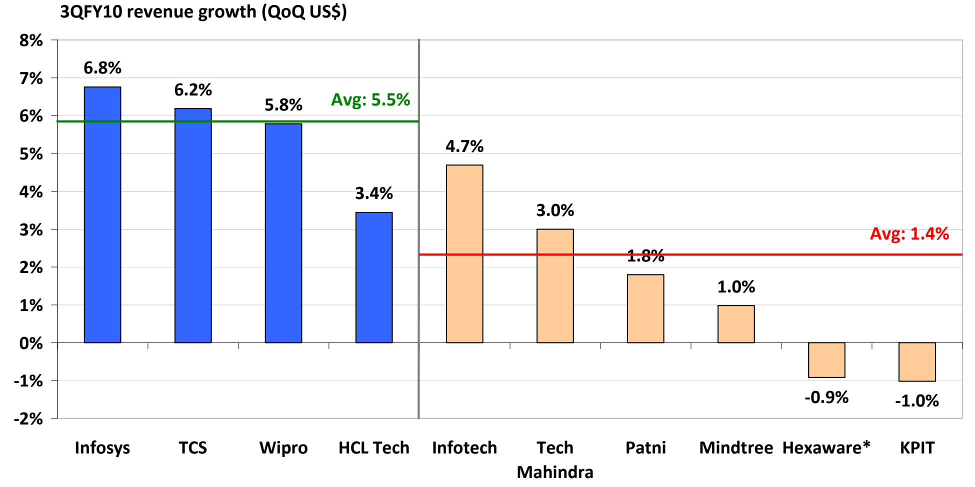
IIFL Research

Sandeep Muthangi
sandeep.muthangi@iiflcap.com
91 22 4646 4686

Better revenue growth and margin sustenance at larger vendors

So far, the larger IT vendors have been the primary beneficiaries of the pick-up in demand. Mid-cap IT vendors, on the other hand, have been adversely affected by the spate of vendor rationalisation deals in 2008/09, including those at BT, Telstra, HP and Cummins. In addition, the increasing share of multi-service deals—in which smaller mid-cap vendors are unable to participate—has been dragging down their relative growth rates. Though there is a pick-up in business momentum, we expect the mid-cap vendors to lag the larger vendors in revenue growth through the rest of FY10 and 1HFY11.

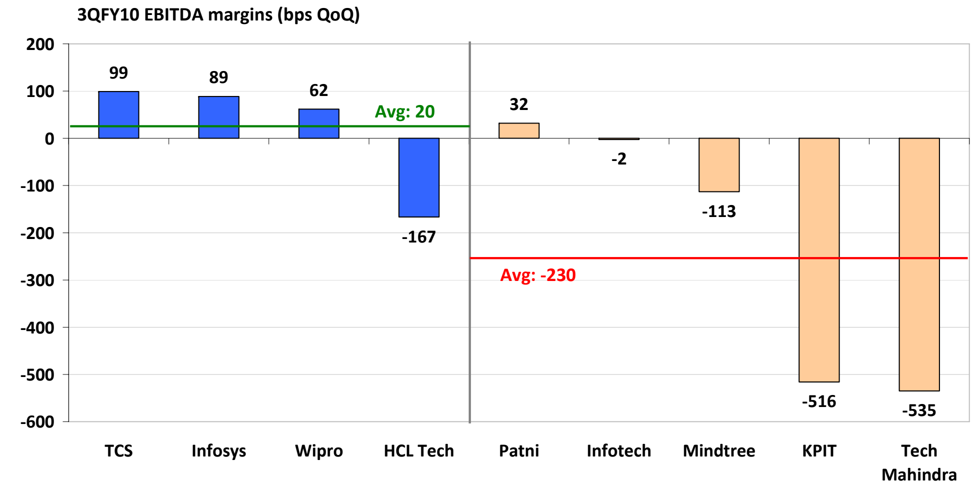
Figure 2: Revenue growth at large vendors is outpacing that at mid-tier vendors



Source: IIFL Research

Larger vendors have also been better able to withstand the margin pressures. During the slowdown, IT companies used up most of the margin levers (save utilisation, at some vendors), and the underperformance in revenue growth has hit the margins of mid-tier vendors. Moreover, the margin gap between large-cap vendors and mid-caps will likely continue to widen in 1HFY11, given the impending salary hikes and a pick-up in hiring.

Figure 3: EBITDA margin expansion has been superior at larger vendors

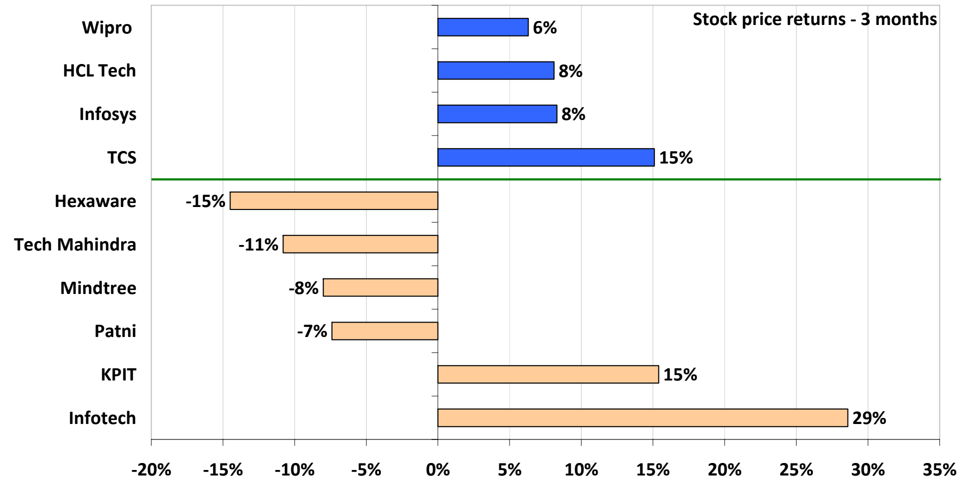


Source: Companies, IIFL Research

Outperformance at larger vendors to continue

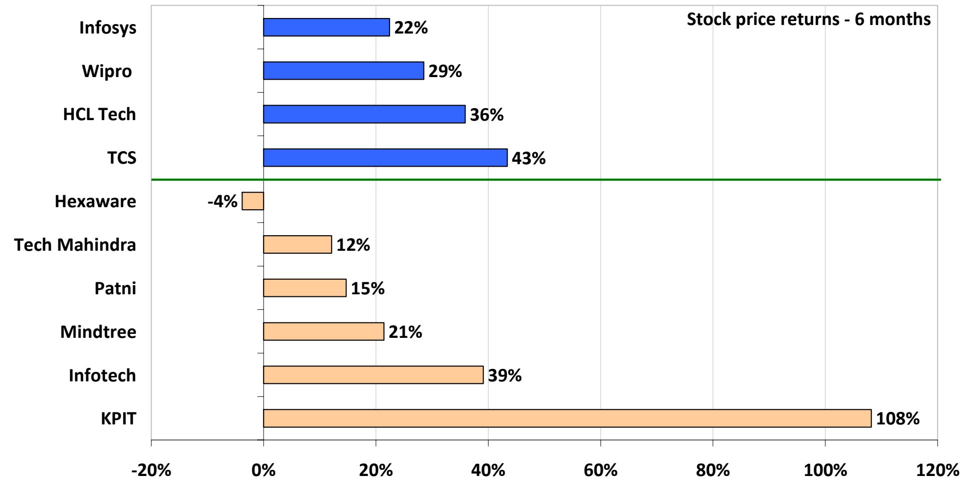
The revenue and margin outperformance at larger vendors has also led to superior stock price performance over the past three and six months. We expect acceleration in the industry's revenue growth towards 1HFY11, as clients' IT budget cycles resume and new project spending picks up. In our view, the larger vendors are better positioned for growth, owing to the increasing proportion of multi-service deals and clients' continuing wariness in discretionary spending. (Our discussions with company management indicate that IT budgets would stay flat YoY for FY11).

Figure 4: Large-cap stocks outperformed mid-caps over the past three months…



Source: Bloomberg, IIFL Research

Figure 5: … and over the past six months as well



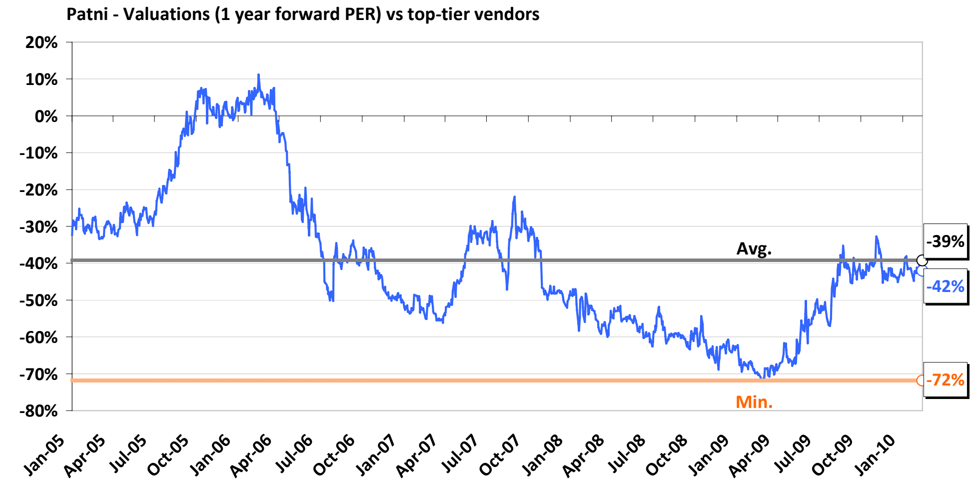
Source: Bloomberg, IIFL Research

Selective scope for valuation convergence trades

Many mid-cap IT vendors are trading at discounts to larger vendors, but these discounts are largely in line with their historical averages. For some like Hexaware and MindTree, where the discounts are sharper vs their historic average, valuations have deteriorated progressively over the past two years, and as such, offer little scope for a sharp re-rating in the near term.

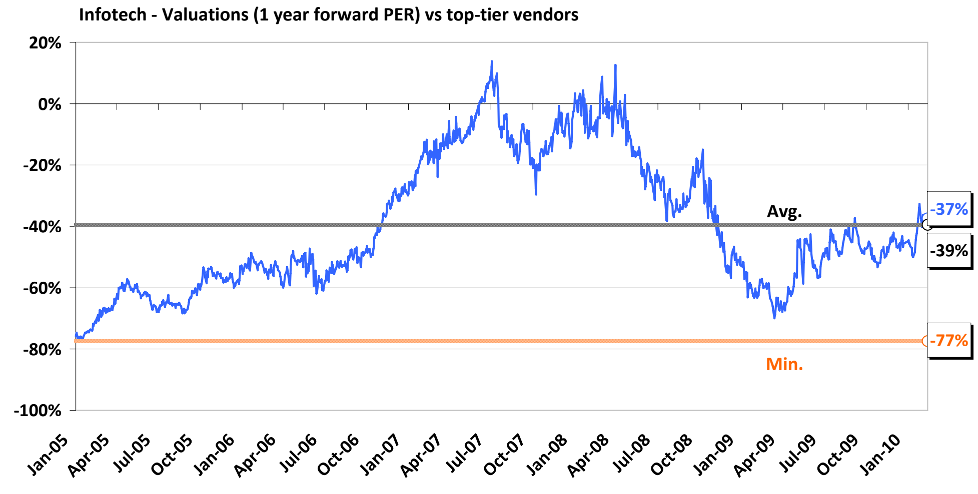
Patni and Infotech continue to be our preferred vendors on better revenue visibility. They have reported the best deal flows in the quarter ended December 2009 among mid-cap vendors. Infotech has won a large deal from its key client, Hamilton Sunstrand. The steady-state ACV of the deal would be ~5% of Infotech's FY10ii revenues. Patni's management too indicated that it is on the verge of winning certain large deals whose TCV would be among the highest witnessed in the company's history.

Figure 6: Patni is trading at close to its five-year average PER (1-yr-fwd) valuation discounts (vs larger vendors). The strong deal flow, we believe, will sustain its re-rating



Source: IIFL Research

Figure 7: Infotech and Patni remain our preferred picks among mid-cap IT vendors



Source: IIFL Research

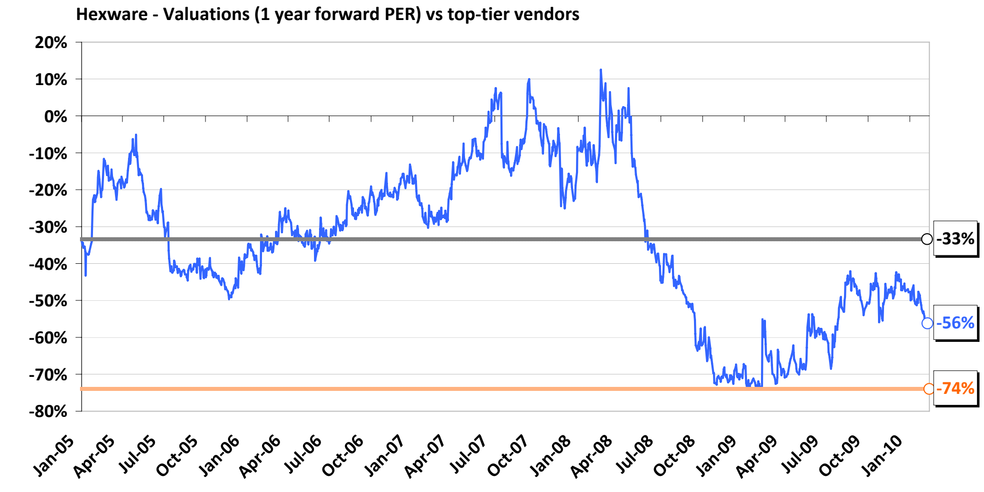
We downgrade Hexaware to REDUCE

Poor visibility at key clients will likely continue to be an overhang on Hexaware's revenue growth for the medium term. Margin headwinds are also likely to be relatively intense as the company resets wages after temporary wage cuts.

Management's initial intentions of introducing such wage resets through variable salaries and thereby offset some of the margin headwinds might not work due to likely poor revenue growth. Also, we believe the company has to accommodate another round of salary hikes along with peers. In effect, these are likely to result in a ~400 to 450bps contraction in EBITDA margins over the next two to three quarters.

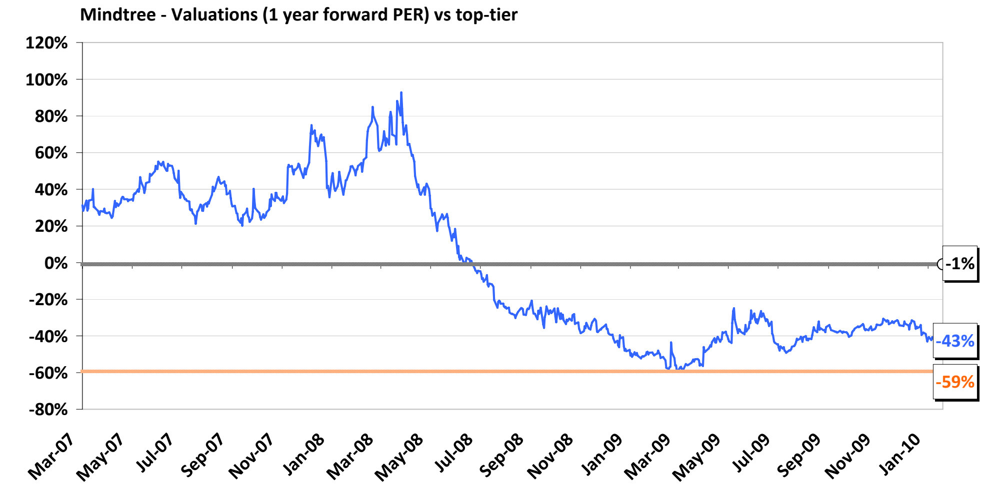
On poor visibility from key clients and a likely sharp contraction in margins, we are downgrading Hexaware to Reduce.

Figure 8: Despite the steeper valuation discounts, we expect Hexaware to languish, given relatively higher margin pressures and poor revenue visibility at key clients



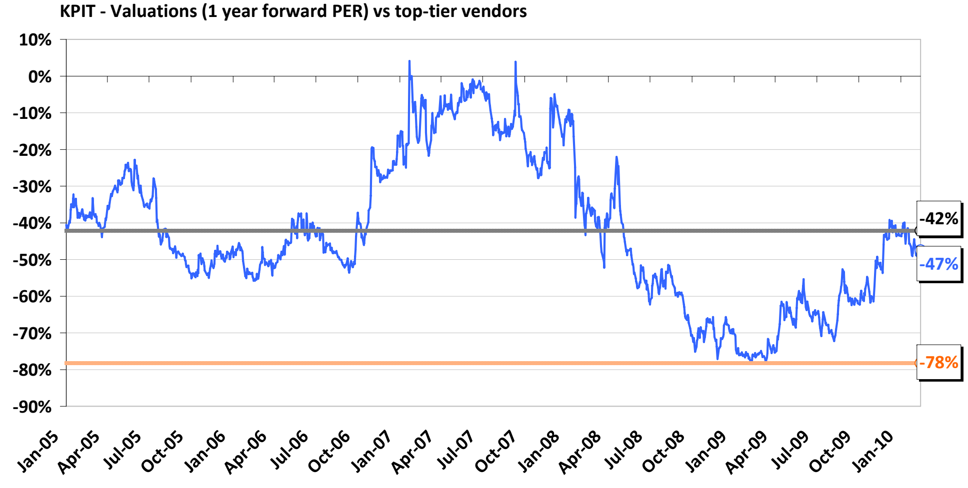
Source: IIFL Research

Figure 9: MindTree's valuations, once at a premium to even larger vendors, have deteriorated, partly because of financial volatility from aggressive forex hedging, lacklustre revenue growth from key clients and even acquisitions in non-core areas



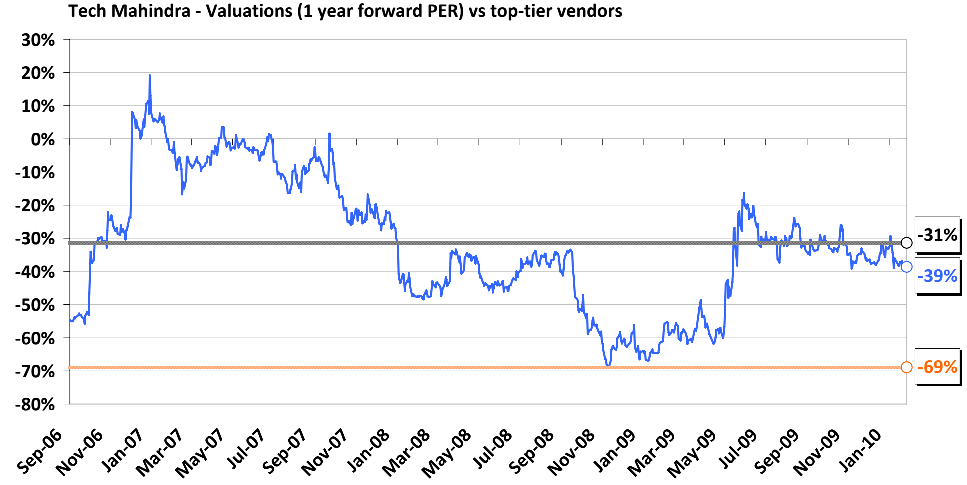
Source: IIFL Research

Figure 10: KPIT is trading near its average five-year valuation discounts. Poor revenue growth at its top client would continue to be an overhang on the stock price.



Source: IIFL Research

Figure 11: Tech Mahindra, we believe, is adversely affected by price cuts and volume rampdowns at BT. Though the recent cash payment from BT is a positive surprise, we believe BT has extracted equal or greater discounts from Tech Mahindra in return.



Source: IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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