

13th October 2008

Infy lowers the bar, CTSH hangs on

Event Details:

Co. Name	Rating	CMP	TP
Infosys	Hold	1227	1443
TCS*	Hold	523	1034
Satyam*	Accumulate	250	483
HCL Tech*	Accumulate	171	297
Mphasis*	BUY	132	315
Tech M*	BUY	396	990

*Ratings, TP could be under review with quarterly results

(%)	1M	3M	6M	12M
Infosys				
Absolute	(30)	(32)	(14)	(38)
Rel. to Sensex	(3)	(10)	29	11
TCS				
Absolute	(39)	(40)	(42)	(51)
Rel. to Sensex	(14)	(20)	(14)	(13)
Satyam				
Absolute	(41)	(48)	(42)	(44)
Rel. to Sensex	(18)	(31)	(13)	(0)
HCLT				
Absolute	(31)	(31)	(26)	(45)
Rel. to Sensex	(4)	(9)	12	(2)
Mphasis				
Absolute	(46)	(37)	(38)	(55)
Rel. to Sensex	(25)	(17)	(6)	(20)
Tech Mahindra				
Absolute	(50)	(47)	(52)	(74)
Rel. to Sensex	(31)	(30)	(28)	(53)

After Infosys lowered its annual revenue growth guidance by ~600 bps from 19-21% to ~13-15% V/s ours as well street expectations of a more modest cut of only 200-250 bps, CTSH issued a press release reaffirming its September'08 quarter guidance as well as annual FY08 guidance. We note that CTSH had already lowered its annual revenue growth guidance earlier in the year from 'atleast 38%' to ~31.5% YoY growth. Further we wish to highlight that CTSH follows a Calendar Financial year and thus could see lower risk to FY08 numbers given any out performance on September'08 results could lower the expected run rate for sequential growth in December'08 quarter. **(albeit we believe that consensus FY09 revenue growth for CTSH, currently at ~23% might be lowered given the events that have unfolded over the last 1 month or so)**

What do we make of Infy results???

We note that Infosys September'08 performance was rock solid (for a detailed perspective on the results please refer to our note: Infosys Q2FY09 Result Update: Cautiousness reflects in guidance reset dated October 10'08) with notable margin expansion (**margins expanded by ~260 bps QoQ V/s our expectations of only ~170 bps**), up tick in pricing (**onsite pricing up by 0.6% QoQ while offshore pricing up by 0.1%**), headcount addition during the quarter remaining largely on track with expectations with co also maintaining its annual hiring target of 25,000 and expecting to hire ~ 4,500 freshers during the December'08 quarter alone and good performance on DSO (**down to 60 days from 64 days at the end of Q1FY09**). We also highlight the negatives in the results in the form of edgy performance at top clients (**revenues from the top client grew by a modest 1.3% sequentially during the quarter and top 10 clients remained under pressure for the 2nd consecutive quarter**) as well as the **no of US\$ 1 mn+ clients remaining unchanged at 325**, similar to Q1FY09 level.

Further to complement the surprising larger than expected cut in annual guidance, Infosys management during the investor call remained positive on business prospects saying that it has not seen 'any significant impact in terms of any major project delays/deferrals', 'September month being very good in terms of both new project wins / project ramp ups despite the worsening news flow' and indicating that a large part of the increase in no of active clients came in from the troubled financial services.

Our view: Demand visibility beyond December'08 remains low

The recent news flow /events in the Banking and Financial services sector in our view could lead to structural changes in the financial services world such as lesser number of financial firms to service (**driven by either consolidation or fall of some big fat names**), a rigorous ROI focused approach on IT spending (**could be potentially negative near term as decision making might continue to take long**), several regulatory changes which might be a booster in terms of business (**however for such business opportunity to unfold, dust needs to settle down first of all**).

We maintain that the **main issue for Indian IT Service companies remains the low visibility beyond December'08** as deal discussions continue to linger on with client indecisiveness also stemming from continuous news on worsening prospects (something similar to CY08 budgeting cycle when budgets took longer to close/finalize). We believe that **Indian IT vendors enter CY09 budgeting cycle more precariously placed than ever**. In our view it is this haziness on demand outlook that could keep stock price performance for the Indian IT companies under pressure over at least the next 6 months.

No Buy rated stocks in our large cap universe now, though depressed valuations could make the case compelling soon

Although we have not had any BUY ratings in our large cap IT services universe since our downgrade on the sector in May'08, we believe that valuations have depressed enough which could make the case compelling on accumulating these stocks soon. We do not rule out that Infosys might retest its lows once again (On October 20'08, Infy stock hit 52 week low at Rs 1040 before recovering to close at Rs 1227), but believe that **investors might need to focus on free cash flow generation for these stocks (Infy generated US\$ 551 mn free cash post investment at ~22% of H1FY09 revenues, Infy's FCF has grown at 44% V/s revenue growth of only ~22% in H1FY09)** for these companies soon.

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