



Q3FY2007 IT earnings preview

The performance of IT companies to sober down

After a handsome growth in the past two quarters, the performance of the front-line information technology (IT) companies would be affected in Q3 by the dual impact of a lower number of working days and a steep appreciation in the rupee. We estimate an average revenue growth in the range of 5-8% on a sequential basis for the period. The earnings growth is expected to be very substantial among various companies with a wide range of 1% to 6.5%.

Appreciation of the rupee dents the performance

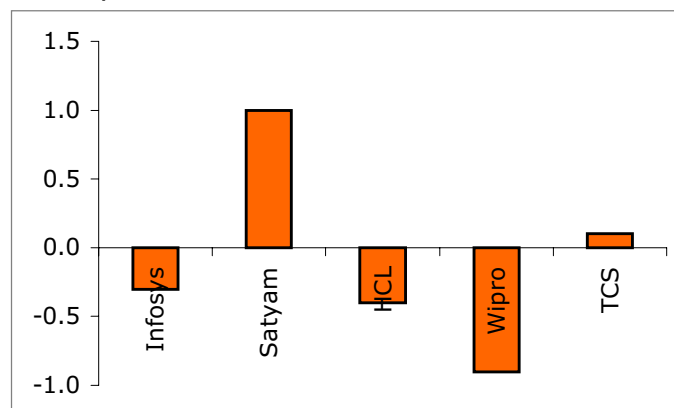
INR vs	End of period rates		Average rates	
	30-Sep-06	31-Dec-06	30-Sep-06	31-Dec-06
US (\$)	45.9	44.3	46.3	45.0
% chg qoq		-3.6		-2.9
Euro	58.4	58.3	59.1	58.0
% chg qoq		-0.2		-1.8
Pound Sterling	86.1	86.9	87.0	86.2
% chg qoq		1.0		-0.8

The appreciation of the rupee was anticipated by the front-line companies and is clearly reflected in the exchange rate assumption taken by Infosys Technologies (Rs45.6 per USD) and Satyam Computer Services (Rs45.3 per USD) in the guidance given for the third quarter. However, the rupee has appreciated much more than expected and is likely to limit the outperformance over the indicated guidance.

Margins, performance to vary considerably

There are expectations of a substantial improvement in the operating profit margin (OPM) of Tata Consultancy Services (TCS) based on the indications given by the management. The OPM of Satyam Computer Services is also expected to improve, as the impact of its salary hikes was already factored in its Q2 results and the performance of its subsidiaries is expected to improve hereon. On the other hand, Wipro is expected to report an equally steep decline in its OPM due to the impact of annual salary increments to its offshore employees (partially with effect from September and November 2006).

Diverse performance



Quarterly estimates

(Rs crore)	Q3FY07	Net sales		Q3FY07	Net profit		EPS (Rs)	OPM (%)
		QoQ(%)	YoY(%)		QoQ(%)	YoY(%)		
Infosys Tech	3,728.5	8.0	47.3	977.2	5.2	50.6	17.6	31.8
Guidance	3,602-3,625	-		935.0			16.8	-
Satyam Computer	1,695.2	5.8	34.0	340.0	6.3	25.9	5.2	23.6
Guidance	1,660-1,674	-		334.5			5.1	-
HCL Tech#	1,471.3	6.7	39.6	258.8	3.4	42.7	8.0	21.3
Wipro (cons)	3,694.3	5.1	33.2	704.5	1.2	32.3	5.1	20.4
Wipro (Global IT)	2,864.6	7.2	33.1	-	-	-	-	-
Guidance (Global IT)	\$633 mn	-	-	-	-	-	-	-
TCS	4,788.0	6.8	51.7	1,055.6	6.5	53.0	10.8	25.4

Steep margin expansion anticipated in TCS

Going by the consensus estimates, TCS is estimated to report a sequential earnings growth of 6.5%, relatively higher than that of its peers. The expectations are built on the indicated improvement in the OPM and higher other income, despite the steep appreciation of the rupee during the quarter. Thus, we believe that TCS runs the highest risk of negatively surprising the markets by not meeting the consensus estimates.

Sequential growth comparison

	Net sales		Net profit	
	Our estimates	Con-sensus	Our estimates	Con-sensus
Infosys Tech	8.0	7.1	4.7	3.9
Satyam Computer	5.8	5.8	6.3	6.5
HCL Tech	6.7	5.4	3.4	0.7
Wipro (Cons)	5.1	4.2	1.2	3.1
TCS	6.8	6.4	6.5	9.6

Possible earnings upgrade in TCS, HCL Tech and Wipro

Based on our Q3 estimates, the implied earnings growth in Q4FY2007 for TCS, HCL Technologies and Wipro are 1.1%, 1.6% and 0.2% respectively. This leaves sufficient room for an earnings upgrade. We would make the required changes in the result updates of the respective companies.

Implied growth for Q4

	Q4FY2007 (I)	
	Net sales	Net profit
Infosys Tech	5.7%	12.8%
Satyam Computer	4.1%	6.5%
HCL Tech	5.8%	1.6%
Wipro (Cons)	1.7%	0.2%
TCS	3.0%	1.1%

Valuation

Overall, the relatively weak performance in the third quarter and the seasonal weakness in Q4 (as the ramp-up in volumes slows down with most clients getting busy finalising their annual budgets) are expected to limit the upside to the valuations over the next few months. Moreover, institutional investors tend to wait for the annual growth guidance (given in February by Cognizant and in April by Infosys Technologies) before making fresh allocations for the IT sector. We continue to prefer Infosys Technologies as our top pick among the front-line stocks in the sector.

Valuation matrix

	EPS (Rs)		P/E	
	FY07	FY08	FY07	FY08
Infosys Tech	68.2	90.0	32.3	24.5
TCS	40.6	51.0	30.6	24.4
Wipro	19.1	24.0	30.3	24.1
Satyam Computers	21.0	25.2	23.1	19.3
HCL Tech	32.0	40.2	18.8	15.0

The author doesn't hold any investment in any of the companies mentioned in the article.

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