INSTITUTIONAL EQUITY RESEARCH

19 December 2007

Sensex	19,092
Nifty	5,787

Information Technology

Neutral

The news flow from the slowing US economy, concerns over rupee appreciation and end of the tax holidays post FY09 have been the main reasons of fall in the stock prices of Indian IT companies in last two quarters. Currently, the stocks are trading near their FY2003 valuations. This is despite the fact that Indian IT companies are much better placed today as compared to that in the past. Last week we had conference calls with the management of few companies (Infosys, TCS, Wipro and HCL Tech) to discuss some of these concerns. **The common points that the IT companies mentioned are:**

- Demand scenario remains robust and they have a very strong pipeline
- Clients have as yet said nothing about their budgets. Clarity will emerge by the end of January
- They are on target for achieving their FY08 guidance
- Indian IT companies are far better placed today than in 2001 and offshoring is the main trend unlike in the past. Hence even if there is slowdown, higher offshoring will take care of the spending cut.

Our view is:

- Q3FY08 results will be inline with the street's estimates and companies will not reveal much about what clients are saying. Guidance for FY09 numbers will be crucial which will be revealed only at the time of Q4FY08 results.
- Indian IT companies still have a significant portion of their revenue coming from discretionary spending by clients. This will lead to a decline in the volume of work as well as pressure on the pricing in the quarters post FY08.
- Organizational restructuring by the US MNCs could lead to a delay in IT spending.
- Higher offshoring by clients to cut cots may not offset the impact due to spending cut completely in the short term. It takes at least a few quarters to offshore the work. In the medium to long term, IT companies will benefit from higher offshoring.
- Indian IT companies are operating at near peak productivity levels and we see limited room for improvement on that front. Hence margins would continue to remain under pressure.
- Rupee appreciation remains a long term trend but given its ramification for the entire export sector, we expect the pace to be slower.

Valuations and Recommendation: The stocks are trading near their 2003 valuations. The prices are already reflecting the worst and further downside is limited. However, we don't see any short term positive triggers which will lead to significant and sustainable bounce back in the stock prices. Hence, we maintain our **Hold**.

Harshad Deshpande
harshad.deshpande@religare.in
+91 22 6655 0116

Figure: 1 Valuation Matrix

Company	Price (Rs)	Rating	Mkt Cap (Rs bn)	Sales Q2FY08E (Rs mn)	Sales YoY/ QoQ (%)	EBITDA Q2FY08E (Rs mn)	EBITDA YoY/ QoQ (%)	Adj PAT Q2FY08E (Rs mn)	Adj PAT YoY/ QoQ (%)	Adj EPS Q2FY08A (Rs)	Adj EPS YoY/ QoQ (%)	FY08E Adj EPS (Rs)	FY08E P/E (x)	FY09E Adj EPS (Rs)	FY09E P/E (x)
Infosys	1,638	Hold	936	41,060	19.0	12,840	15.8	11,000	18.4	19.1	16.8	79.1	20.7	96.4	17.0
					8.8		18.5		6.5		6.1				
TCS	1,021	Hold	1,000	56,398	25.8	14,821	20.6	12,469	25.8	12.7	25.8	50.0	20.4	62.7	16.3
					8.4		11.7		5.2		5.2				
Wipro	483	Reduce	706	47,995	34.0	9,920	16.5	8,237	17.6	5.68	17.2	23.8	20.3	29.3	16.5
					12.2		14.8		13.5		13.3				
Satyam	404	Accumulate	270	20,317	26.8	4,027	11.1	4,091	27.9	5.97	25.9	25.2	16.0	30.2	13.4
					11.0		-1.8		8.1		8.1				
HCLTech*	301	Hold	200	17,092	23.9	3,639	21.7	2,856	24.2	4.2	22.5	18.4	16.4	21.2	14.2
					6.0		4.7		-38.8		-39.0				

Source: Company, Religare Institutional Equity Research. * HCL Tech has year ending to June. HCL Tech numbers are Q1FY08.

Indian IT companies are far better off now as compared to that in 2000

In the span of last 7-8 years, the US economy is facing a slowdown for 2nd time. Indian IT companies, however, are much stronger now than in the past:

- **Revenue from US has declined**

Figure: 2 US revenue: Infosys' and Satyam's US revenue has declined the most

US revenue (%)	FY2000	Q1FY03	Q2FY03	Q1FY08	Q2FY08
Infosys	78.0	72.3	73.8	62.6	62.6
TCS	NA	NA	NA	51.3	52.2
Wipro Tech	71.5	64.0	65.0	65.0	62.5
Satyam	76.0	76.9	75.4	61.7	58.4
HCL Tech	NA	NA	70.0	54.2	54.2

Source: Company, Religare Institutional Equity Research

- **Client concentration risk is much lower now**

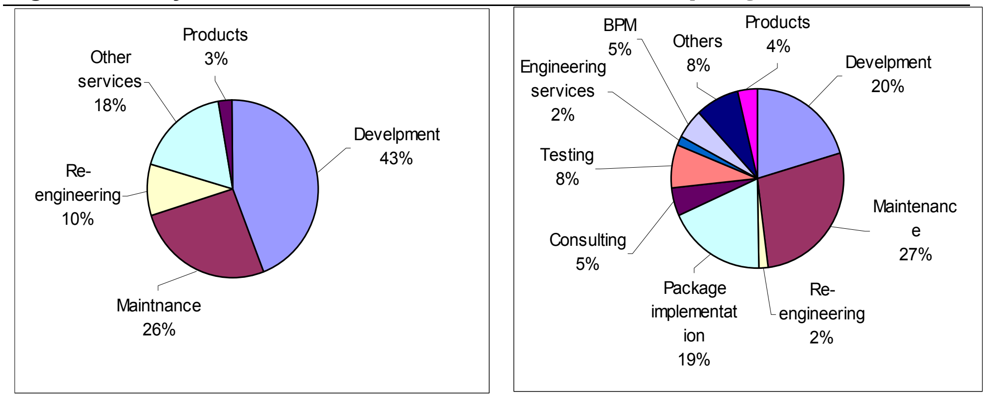
Figure: 3 Client concentration (%)

		FY00	Q1FY03	Q2FY03	Q1FY08	Q2FY08
Infosys	Top customer		5.8	5.9	8.6	7.9
	Top 5	32.8	23.6	24.0	21.4	19.5
	Top 10	48.0	39.1	37.9	32.3	29.9
Wipro Tech	Top customer	16.5	7.0	8.0	3.1	2.9
	Top 5	39.5	23.0	25.0	13.6	13.6
	Top 10	53.8	37.0	39.0	24.1	23.3
Satyam	Top customer	-	19.2	17.9	5.7	5.8
	Top 5	-	43.2	40.7	21.1	20.8
	Top 10	-	55.8	53.9	34.4	33.9

Source: Company, Religare Institutional Equity Research

- **Offerings mix has changed**

Figure: 4 Infosys: Q4FY00 **Infosys: Q2FY08**



Source: Company, Religare Institutional Equity Research

Revenue contribution of development work has declined from 43% in Q4FY00 to 20% in Q2FY08 for Infosys. The same is seen in most of the other companies as well. The Maintenance pie remained at the same levels. The companies have moved up the IT value chain by including services like package implementation, consulting and engineering services.

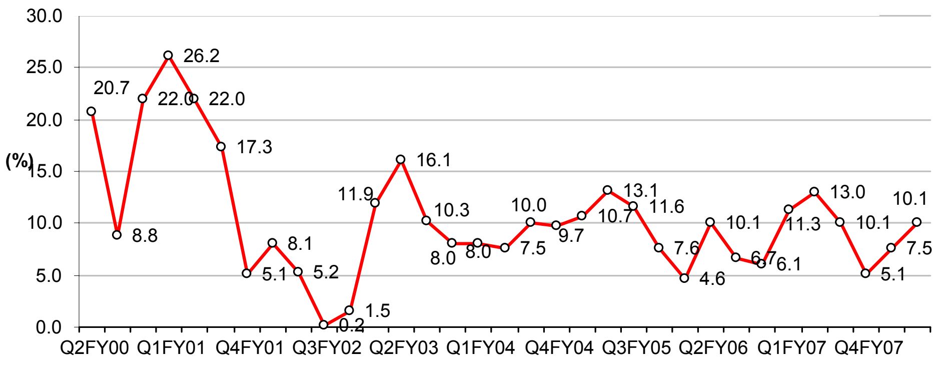
- **Offshoring is a well accepted trend today; unlike in the past**

  In 2001, the offshoring model was not very well accepted. But, in the current scenario, the offshoring model is well known and demand for offshoring is very high. Moreover, Indian IT companies have established their brand in the global offshoring markets.

No signs of slowdown yet in the numbers

- **Revenue growth numbers have shown no signs of slowdown in US$ terms**

Figure: 5 Infosys QoQ revenue (US$) growth (%)

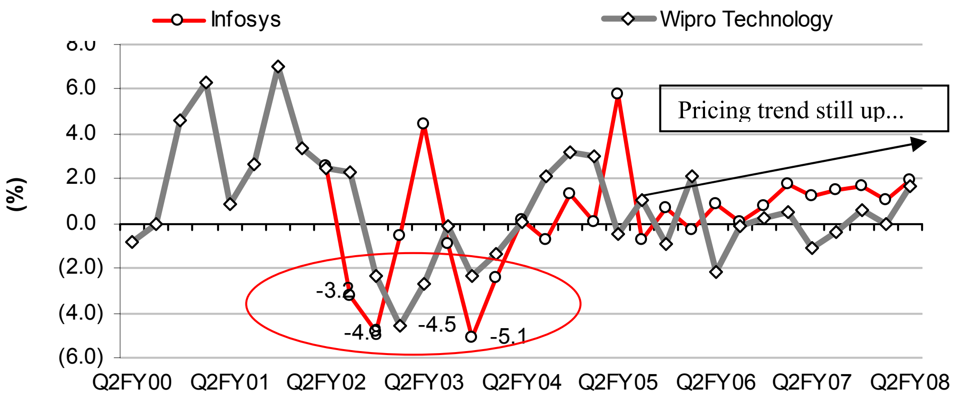


Source: Company, Religare Institutional Equity Research

Infosys, like other IT companies, has reported robust sequential revenue (US$) growth in the last one and a half year and is still quite a distance away from the lowest growth of 0.2% and 1.5% it witnessed in Q3FY02 and Q4FY02 respectively. The companies have reiterated a robust demand scenario and strong pipeline- at least so far.

- **Pricing pressures not seen yet**

Figure: 6 QoQ growth in the billing rates



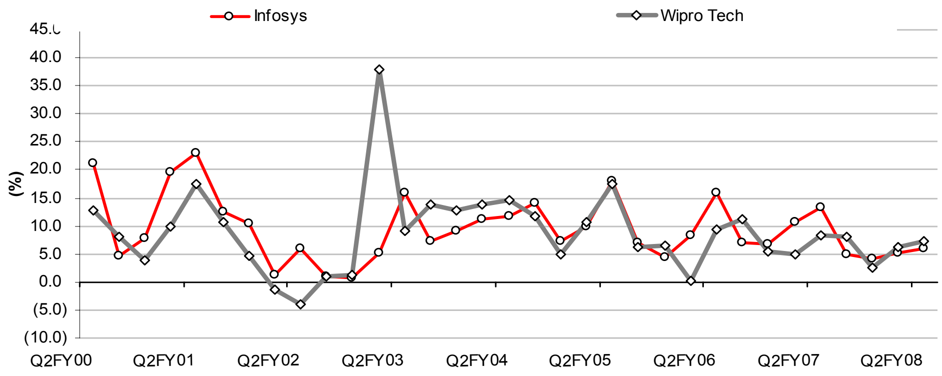
Source: Company, Religare Institutional Equity Research

Over the last several quarters, the growth in billing rates has been positive and moving upward. In the past, the company had witnessed declines of as high as 5% sequentially.

- **Hiring plans intact and higher attrition rates indicate enough opportunities in the market place**

The discussions with the companies reveal that their hiring plans are intact as of now. The demand scenario is still strong. Attrition rates are still on rise (which we believe, for the first time is a positive sign, indicating there are still enough opportunities in the market place; countering the view of a slowdown).

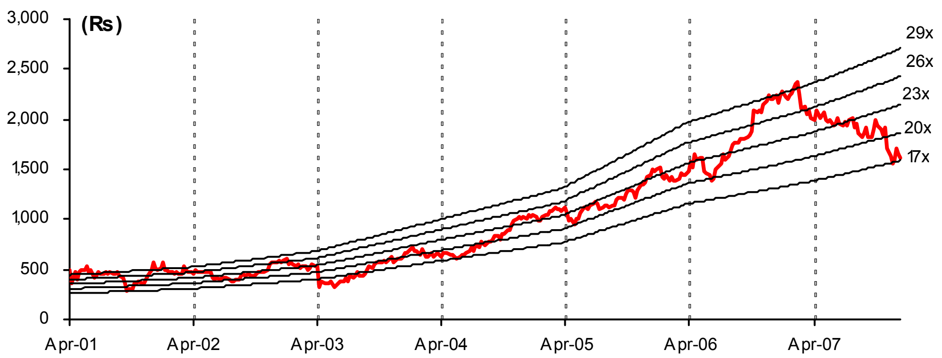
Figure: 7 QoQ Employee growth rate



Source: Company, Religare Institutional Equity Research

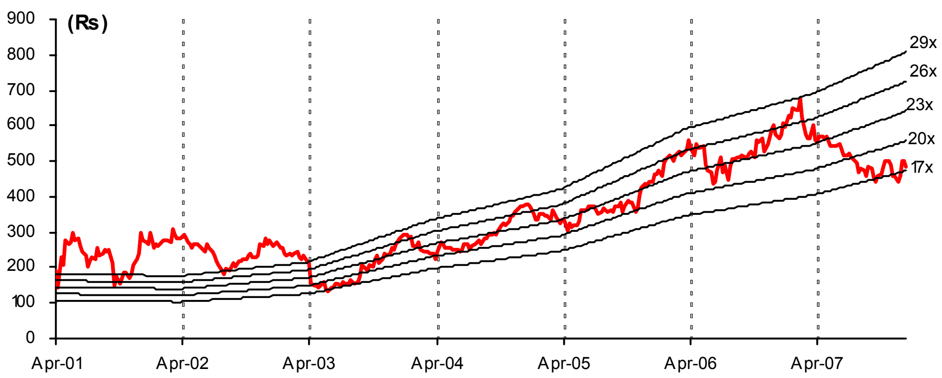
But IT stocks are trading near their 2003 valuations ...

Figure 8: Infosys P/E Band



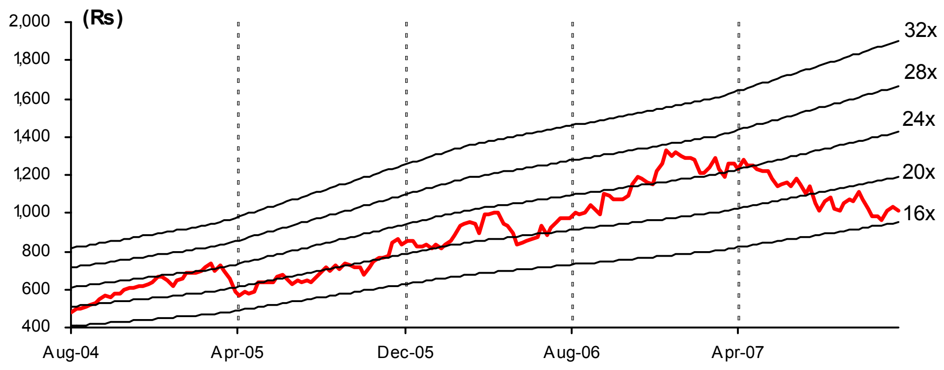
Source: Company, Religare Institutional Equity Research

Figure 9: Wipro P/E Band



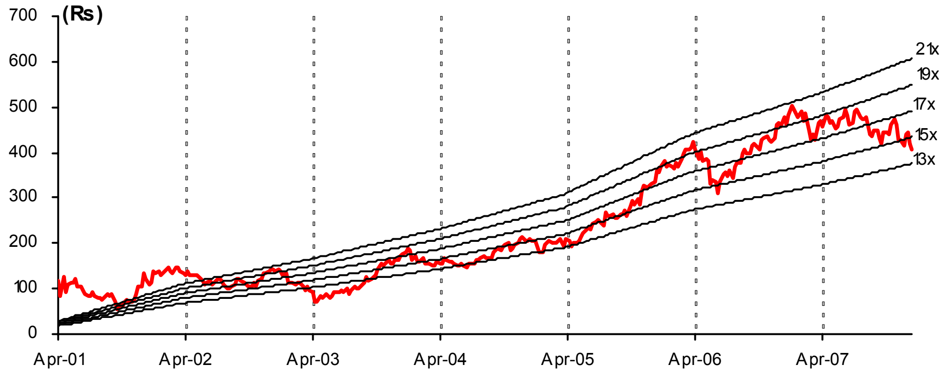
Source: Company, Religare Institutional Equity Research

Figure 10: TCS P/E Band



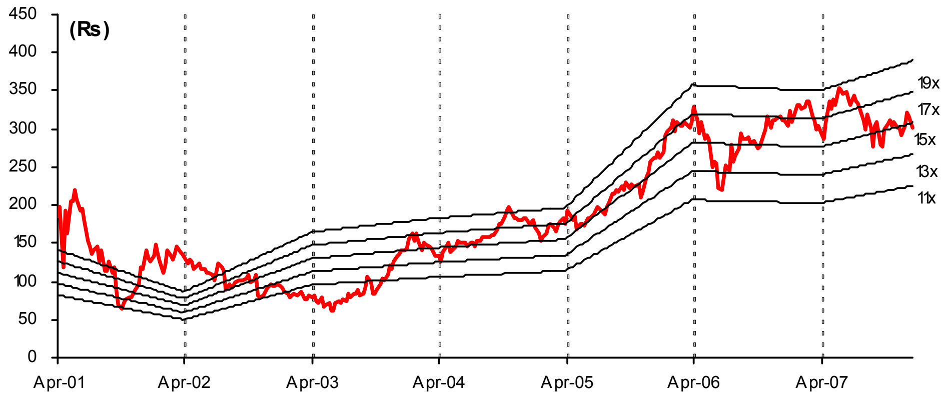
Source: Company, Religare Institutional Equity Research

Figure 11: Satyam Computers P/E Band



Source: Company, Religare Institutional Equity Research

Figure 12: HCL Tech P/E Band



Source: Company, Religare Institutional Equity Research

The debate has shifted from whether or not there will be slowdown in the US to how severe it will be. It is this anticipation of the slowdown in the US that has seen the Indian IT stock prices correct. The stocks are currently trading near their 2003 valuations. This implies that the prices are factoring in the worst.

Figure 13: Absolute Performance (%)

	1 Day	1 week	1 mth	3 mths	6 mths	12 mths	QTD	YTD
HCL Technologies Ltd	0	(5)	2	6	(10)	0	0	(7)
Infosys Technologies Ltd	1	(3)	1	(12)	(16)	(24)	(14)	(27)
Satyam Computer Services Ltd	(0)	(6)	(4)	(6)	(14)	(13)	(9)	(17)
Tata Consultancy Services Ltd	1	(3)	3	(0)	(12)	(11)	(3)	(16)
Wipro Ltd	(0)	(4)	6	8	(7)	(15)	5	(20)

Source: Religare Institutional Equity Research

What lies ahead?

- **Q3FY08 results may not give much of the needed insights**

The management has said that they are well on target of achieving their guidance for Q3FY08 and FY08. Moreover, they have reiterated a robust demand scenario, no pricing cuts and a strong pipeline. Generally, US clients finalize their budgets from January-March every year. And hence, Q3FY08 results may not give any detailed insights into what clients are saying; but just another cautious view. Q4FY08 results will be crucial when the Indian IT companies will give guidance for FY09.

- **Will the US slowdown hit the Indian IT companies?**

Indian IT companies still earn about 20-30% of their revenue from the discretionary spending of their clients. Each of the service lines of the Indian IT services includes a component of discretionary spending. This predominantly includes revenues from development, package implementation, consulting etc. Barring the discretionary spending from Non-US geographies and some portion of irreversible work, a significantly higher proportion of revenue continues to remain exposed to discretionary spending by US clients. This we believe is the main cause of worry. This may lead to a decline in the volume of new work in the short term and a pressure on pricing.

- **Organizational restructuring may delay the IT spending further**

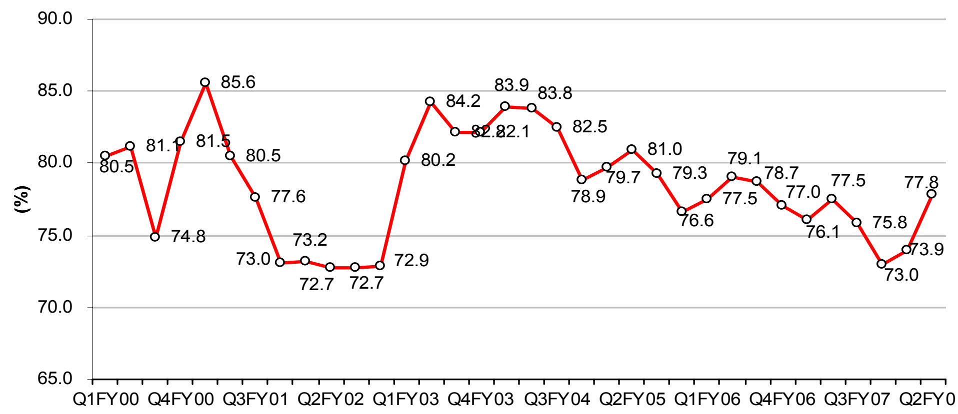
The subprime and mortgage market crisis has led to a change in the management control at some of the well known global US MNCs. And some of them have declared that they will initiate corporate restructuring. Some of these are large accounts of Indian IT companies. The restructuring initiative typically delays the new projects further (the recent example of TechMahindra's BT account).

- **Higher offshoring due to slowdown may not completely offset the impact due to spending cut in the short term…**

Even if we assume that the global companies will take decisions to offshore more of their work (and there are multiple pockets from which the work will flow to Indian companies), it will take another 2-3 quarters to do so. And even if that happens, on an incremental basis, the growth will be muted in the latter part of FY10, if the slowdown lasts longer.

- **Some room left for improving the utilization rates**

Figure14: Infosys Utilization rates (excluding trainee)



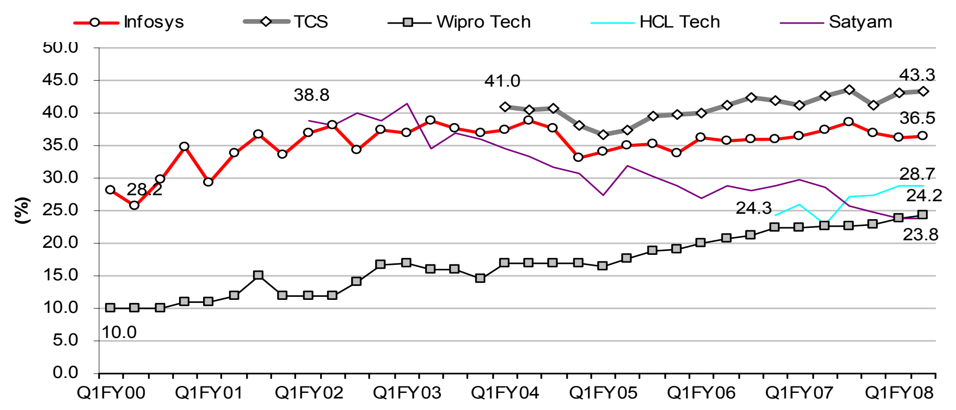
Source: Company, Religare Institutional Equity Research

The Indian IT companies have improved their efficiencies to contain the rupee pressure in the Q1FY08. Currently, most of them are working on their 10-12 quarters highest level of productivity. In the past, the company had worked at as high as 85.6% of utilization levels. So, there is some room to improve utilization levels. But the scale at which it operates now, we believe that maintaining such a higher level of utilizations is difficult. Hence margins may come under pressure.

Sectoral Exposure of Indian IT companies

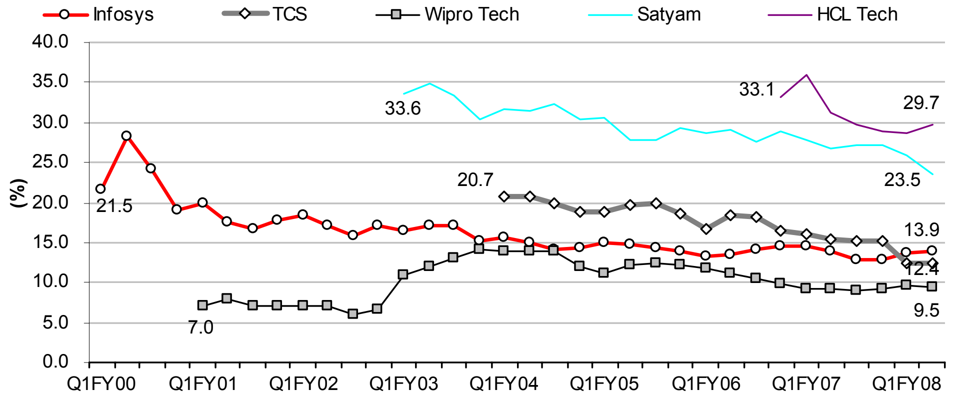
If slowdown in US is severe and wide spread, apart from BFSI, the other industries where we might see IT spending cut could be Manufacturing, Retail and Telecom. Following charts depict the exposure of Indian IT companies to various industries (the immediate impact will be limited to revenue from US):

Figure 15: BFSI revenue: highest for TCS and the least for Satyam



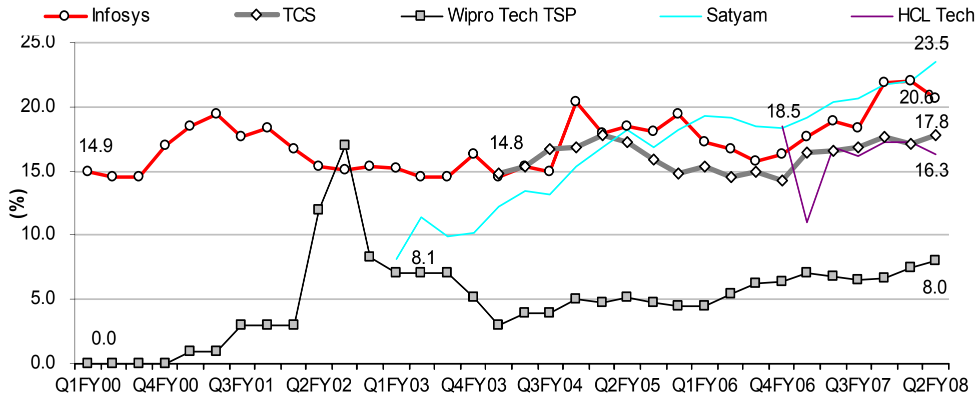
Source: Company, Religare Institutional Equity Research

Figure 16: Manufacturing revenue: highest for HCLT and the least for Wipro Tech



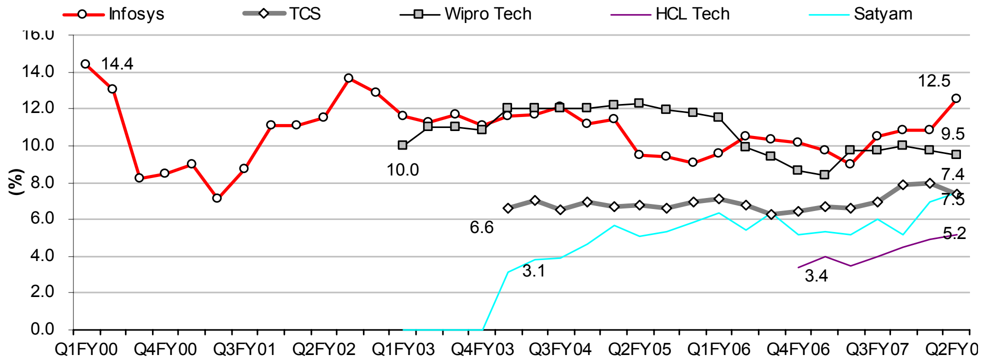
Source: Company, Religare Institutional Equity Research

Figure 17: Telecom: Revenue from Telecom services provider (TSPs) has increased



Source: Company, Religare Institutional Equity Research * Satyam Telecom revenue: TIMES (Telecom, Infrastructure, Media, Entertainment, Semiconductor)

Figure 18: Retail: has been range bound; Satyam has shown significant growth



* Source: Company, Religare Institutional Equity Research

Religare Institutional Equity Team

Name	Sector	E-Mail ID	Telephone
Sangeeta Purushottam *(Head Institutional Business)*		sangeeta.p@religare.in	+91 22 6655 0102
Research - Equity			
Arvind Jain	Auto, Steel Pipes	arvind.jain@religare.in	+91 22 6655 0140
Kunal Sheth	Capital Goods / Power Utilities	kunal.sheth@religare.in	+91 22 6655 0141
Manak Gaushal	Cement, Logistics	manak.gaushal@religare.in	+91 22 6655 0106
Nimit Shah	Construction, Real Estate	nimit.shah@religare.in	+91 22 6655 0128
Harshad Deshpande	Information Technology	harshad.deshpande@religare.in	+91 22 6655 0116
Abneesh Roy	Media, FMCG	abneesh.roy@religare.in	+91 22 6655 0176
Paresh Jain	Metals	paresh.jain@religare.in	+91 22 6655 0117
Dikshit Mittal	Oil & Gas	dikshit.mittal@religare.in	+91 22 6655 0115
Vikas Sonawale	Pharmaceuticals	vikas.sonawale@religare.in	+91 22 6655 0112
Naveen Kulkarni	Telecom	naveen.kulkarni@religare.in	+91 22 6655 0185
Archit Kumar	Auto, Steel Pipes, Textiles	archit.kumar@religare.in	+91 22 6655 0190
Sneha Rungta	Logistics, Construction, Cement	sneha.rungta@religare.in	+91 22 6655 0170
Technical research - Equity			
Vidur Pendharkar		vidur.p@religare.in	+91 22 6655 0109
Sales - Equity			
Paresh Mehta		paresh.mehta@religare.in	+91 22 6655 0108
Aisha Udeshie		aisha.udeshie@religare.in	+91 22 6655 0107
Ankur Varman		ankur.varman@religare.in	+91 22 6655 0103
Dealing - Equity			
Rajeev Gupta *(Head - Dealing and Sales trading)*		rajeev.g@religare.in	+91 22 6655 0104
Jayesh Balsara		jayesh.balsara@religare.in	+91 22 6655 0186
Govind Satam		govind.satam@religare.in	+91 22 6655 0181
Vinita Pandya		vinita.pandya@religare.in	+91 22 6655 0180
Production, Database and administration			
Sanjeev Chaukekar		sanjeev.chaukekar@religare.in	+91 22 6655 0157
Vishal Randive		vishal.randive@religare.in	+91 22 6655 0160
Sachin Jadhav		sachin.jadhav@religare.in	+91 22 6655 0189

Rating definition

Buy	: > 15% returns relative to Sensex	**Accumulate**	: +5 to +15% returns relative to Sensex
Sell	: > (-)15% returns relative to Sensex	**Reduce**	: (-) 5 to (-) 15% returns relative to Sensex
Hold	: Upto + / (-) 5% returns relative to Sensex		

Religare Securities Ltd. Taj Building, 210, D.N. Road, Mumbai - 400001

For inquiries contact:
Email: institutionalsales@religare.in
Phone: 6655 0000