HSBC Global Research

# IT Services

Are companies in the US overspending on IT?

- **Our Technology Spend Index indicates total US IT spend in 2006 was only 11% higher compared to levels in 2000**
- **US Technology spend estimated at 8.3% of GDP is lower than 2000 levels – with higher share from the less volatile software services sector**
- **In case of a US slowdown, we believe IT spend in 2007 may not contract as sharply as it did in 2001**

## Tracking US technology spend

### Introducing HSBC Technology Spend Index

We looked at revenues of 480+ technology companies as a proxy for technology spending in the US. We observe, technology/IT spending in 2006 was only 11% higher than in 2000, with contribution from computer and software services increasing to 40% in 2006 from 36% in 2000. The share of hardware and communications declined, reducing contribution from volatile sectors.

### How much could a US slowdown contract IT spend?

Our analysis indicates that unlike 2001, any slowdown in the US is now unlikely to trigger as sharp a contraction in IT spend. Total IT spend accounts for c8.3% of 2006 US GDP compared to a high of 8.8% in 2000-01. Moreover, contribution from more stable software and services has also increased, implying lower volatility, going forward.

### Large offshore vendors at least risk

Offshore vendors are growing at a considerably faster pace than global peers and are gaining market share from incumbents. So far, clients have not indicated any plans of cuts in technology spend. Client profiles for large vendors have improved and clients are now stickier than in 2001. Even in case of a US slowdown, large vendors are better placed to weather the storm in our view due to a superior positioning of services portfolio and client breadth. Infosys and TCS are our top picks in the sector.

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# Summary


- Any overspending on technology may lead to a contraction of total technology spend in the event of a US slowdown
- We analyse the level of technology spending in the US to see if it is significantly higher than levels seen in 2000
- Rationalisation of IT spend and changing mix towards software indicate that a US slowdown in 2007 is unlikely to contract technology spending as severely as it did in the past


## Introduction

The possible recurrence of a US slowdown in 2007 and its impact on technology spend has been the single biggest concern for technology investors. We believe that, the higher the levels of overspending in technology (including hardware, software, services and communication), the greater the chances of a cut in spending during an adverse business environment. In this report, we try to answer three questions:

- How does US spend on technology – as we enter 2007 – compare with spending levels seen six years ago in 2000?
- Currently, is there any excessive overspending on IT (including software, services, hardware) in the US?
- How much will a US slowdown affect offshore IT – will the impact be as severe as was seen six years ago, in 2001?

## How much is spent on technology in the US?

We estimate total US technology spend to be around USD1 trillion. We believe that technology spend across sectors in the US should be captured in revenues of technology vendors in the market. Consequently, we looked at total revenues of over 480 technology companies in the US over the last decade to develop a surrogate index for IT spending. The total revenues of our universe account for c60% of the technology spend in the US. Key conclusions **as per our index were**:

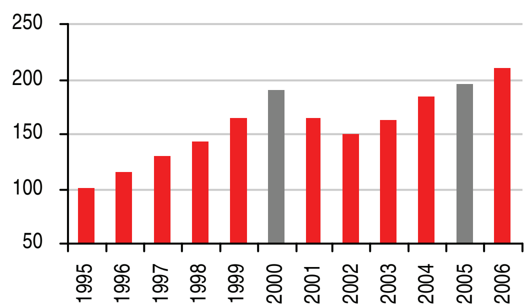
- Growth in technology spend during last four years has been lower at +9% y-o-y compared to +13%y-o-y growth seen prior to 2000
- Absolute levels of the Technology Spend Index in 2005 were close to those in 2000. For the US in 2006, this index was only 11% higher than in 2000 and +7% y-o-y in 2006
- Contribution of software and services to technology GDP has steadily increased with hardware and communication losing share

- Total IT spend in 2006 estimated at c8.3% of the US GDP (only software and services at 3%) may be lower than in 2000, when it touched a peak of 8.8%

## Is the US overspending on IT?

We did not see any significant indicators that point towards an overspending. A lower CAGR of our Technology Spend Index of 9% during 2002-06 compared to a 13% CAGR during 1996-00 implies that companies in the US have significantly rationalised their technology spend in the slowdown period, during 2001-03. The technology spend indicator had grown at an even faster rate of 15%y-o-y, during 1998-00.

**HSBC Technology Spend Index for the US**




Note: Technology includes hardware, telecom, semiconductor and software /services spend; LHS indexed at 100; Base year 1995
Source: HSBC

Software spending has grown faster than spending in other segments and has been relatively less volatile. Consequently, the rationalisation of overall technology budgets has removed excesses from hardware, communication and telecom segments and has resulted in a higher share of software and services in the overall spend.

Specifically for IT services, competition from the emerging global delivery model of offshore vendors is now widely accepted. Incumbent IT service providers have also started ramping up their offshore delivery centres, thereby imparting further momentum to shift towards low-cost locations. India's IT workforce is now c70% of the strength in US software compared to less than 20% a few years ago.

Average compensation increase in the US for software engineers and analysts in 2002-05 has also been low. An average increase of c3%y-o-y is lower than the 4%y-o-y increase see from 1999-02 and is significantly lower than the peak levels of over 8% y-o-y increase seen in 1999-00.

## How much will a US slowdown affect India?

In case of a US slowdown, we do not expect IT spending to contract as sharply as it did in 2001. We estimate the worst case impact will be less than 10% cut in total spending compared to 25% in 2001 (even lower for only software and services).

The specific impact of a US slowdown will depend on the offshore vendor and its positioning. However in the short term, uncertainty due to slowdown is likely to translate into a freeze in pricing, lower sales productivity for vendors and consequently, margin challenges. Companies with strategic client relationships, strong domain understanding with the ability to propose optimal, low-cost solutions will be the winners in such a scenario.

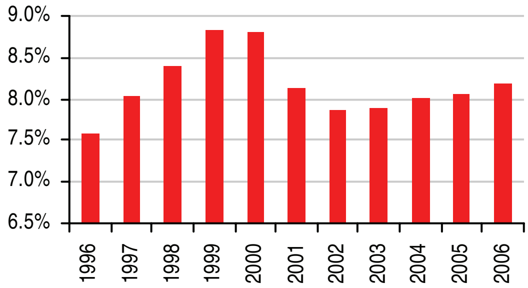
We also expect larger acquisitions by offshore vendors in 2007. So far, smaller Indian vendors have resorted to acquisitions to gain scale and expand service offerings rapidly. However we expect large offshore vendors to focus more on acquisitions in 2007, especially in European geographies.

## Conclusion

Larger and niche vendors may be better placed in the event of a US slowdown than smaller ones. Vendors with large strategic client relationships will be better able to weather the storm. We believe that strategic client relationships will be a focus area for companies going forward. Infosys and TCS remain our preferred picks in large caps. We also rate Satyam and Wipro as Overweight. We retain the ratings on all companies in our India IT Services universe.

In terms of Valuations, large vendors like Infosys and TCS trade in the range of 23-24x FY08e which looks attractive. We expect earnings to grow by 27-29% for these stocks in FY08e with potential for upside surprises.

**US IT spend as percentage of GDP**




Note: IT spend includes comm. services and equipment, software and hardware
Source: Bureau of Economic Analysis (BEA), HSBC

**VALUATIONS SUMMARY**

| Company | RIC Code | Rating | Revenue (INRm) FY07e | Revenue Growth (%) FY07e | Revenue Growth (%) FY08e | Profit (INRm) FY07e | EPS (INR) FY07e | EPS (INR) FY08e | EPS Growth (%) FY07e | EPS Growth (%) FY08e | PE (x) FY07e | PE (x) FY08e |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HCL Tech | HCLT.BO | N | 59,850 | 36 | 24.8 | 10,310 | 15.89 | 19.11 | 32.7 | 20.3 | 19.1 | 15.9 |
| Hexaware | HEXW.BO | N | 8,482 | 36.2 | 23.6 | 1,243 | 9.2 | 11.46 | 16.9 | 24.9 | 16.7 | 13.4 |
| i-flex | IFLX.BO | UW | 19,938 | 34.4 | 28.2 | 3,114 | 39.9 | 51.3 | 40.3 | 28.6 | 49.7 | 38.6 |
| Infosys | INFY.BO | OW | 140,292 | 47.3 | 33.6 | 37,184 | 67.0 | 86.6 | 48.8 | 29.2 | 31.1 | 24.1 |
| Patni | PTNI.BO | N | 26,551 | 31.2 | 25.7 | 3,381 | 24.4 | 30.2 | 23.1 | 23.5 | 15.7 | 12.7 |
| Satyam | SATY.BO | OW | 65,320 | 36.3 | 31.6 | 13,702 | 20.97 | 26.09 | 38.3 | 24.4 | 28.6 | 20.7 |
| TCS | TCS.BO | OW | 186,165 | 40.6 | 31.3 | 41,454 | 42.36 | 53.77 | 42.6 | 26.9 | 29.8 | 23.5 |
| Wipro | WPRO.BO | OW | 149,113 | 41.1 | 30.7 | 28,665 | 19.81 | 25.1 | 35.9 | 26.7 | 29.2 | 23.0 |

*Hexaware and Patni are Dec yer end where Dec06 corresponds to FY07
Source: HSBC

# How much does the US spend on technology?

- We estimate the total technology spending at 8.3% of US GDP for 2006, which is below peak levels in of 8.8% in 2000
- Our Technology Spend Index in 2005 was at similar levels compared to 2000, indicating that any excess spend may have been rationalised by 2005
- HSBC Technology Spend Index indicates that the proportion of spending for software has increased by gaining share from non-software spending, which tends to be more volatile

## Overview

The recurrence of a US slowdown in 2007 and its impact on technology has been the single biggest concern for technology investors. We believe that, the higher the levels of overspending in technology, greater the chances of a cut in spending during adverse business environment. In this report, we try to answer three questions:

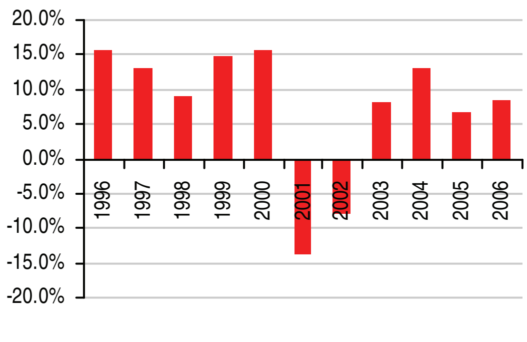
- How does technology spend in US – as we enter 2007 – compare with spending levels seen six years ago in 2000?
- Currently, is there any excessive overspending on IT (including software, services, hardware) in the US? and
- How will a US slowdown affect offshore IT – will the impact be as severe as was seen six years ago, in 2000-01?

## Introducing our Technology Spend Index for the US

We believe that technology spend across sectors in the US should be captured in revenues of technology vendors in the market. Consequently, we compiled total revenues of over 480 technology companies in the US over the last decade. Using it as a surrogate for technology spending in the US, we developed a Technology Spend Index for the total revenues of companies in our sample set for the US and based it at 100 (base year 1995). Our model includes companies in Software, Telecom, Hardware, Semiconductor and Electronics segments. Including companies across a wider sector wise distribution also helped better comparison. We believe the index is comprehensive as it maps up to 60% of the total IT spend of the US, of cUSD1trillion. While it is widely known that technology spend grew rapidly in the US until 2000 and corrected sharply over the next two years, our interest lies in the nature of spend post 2002-till date. Our model indicates:

- Growth in technology spend during last four years has been muted at +9% y-o-y compared to average +13%y-o-y growth seen prior to 2000.

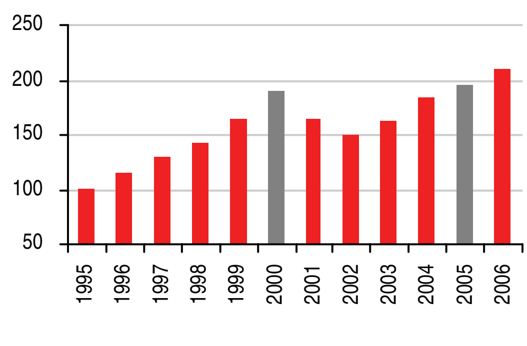
**Trends in growth rates of Technology Spend Index (%y-o-y)**




Note: Trend includes, hardware, software, services, telecom and semiconductor companies
Source: HSBC

- Absolute level of the Technology Index in 2005 was only 4% higher than seen in 2000. Our Technology Spend Index for the US in 2006 is only 11% higher than in 2000, as per our estimates. This implies that there was very little overspending on technology in the US, at least until 2005.

**HSBC Technology Spend Index for the US**



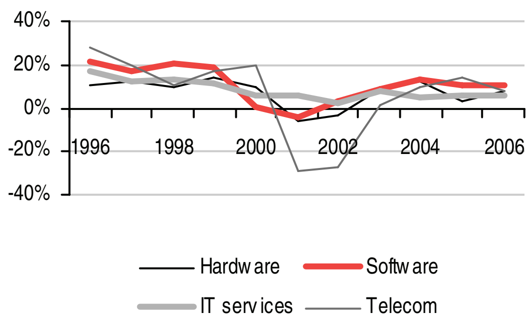

Note: Technology includes hardware, telecom, semiconductor and software /services spend; LHS indexed at 100; base year 1995
Source: HSBC

This also implies that all excess had been taken out and IT spending was rationalised during the five-year period – 2000-05. Consequently even after six years, total technology spend in 2006 is marginally higher than the spend in 2000.

- Finally, the contribution of software and services to technology spend has steadily increased, with hardware and communication equipment losing share. This shift in technology spend mix towards software implies that volatility for total technology spend is likely to be lower, going forward. The contribution of software and services was at 34% of US IT spending in 1999 and we estimate it to have increased to over 40% by 2006.

Our model also indicates that a large proportion of decline in total technology spend in 2000 was contributed by semiconductor and telecom vendors. Decline in software was relatively less severe. Consequently, US technology output is increasingly concentrated in software and IT services, suggesting that future growth in the IT sector may be less volatile than it was in the past.

**Trends in growth rates by sectors (%)**



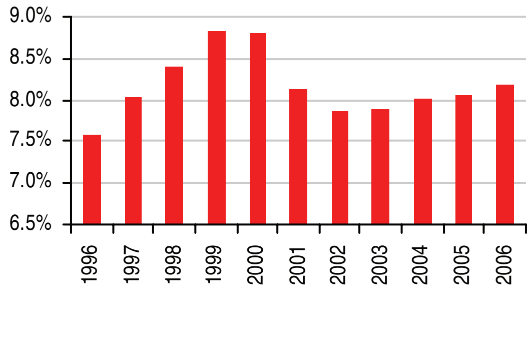

Source: HSBC

We also note that growth rates in software and IT services spend during 2002-06 have been significantly lower than growth rates seen during 1996-00.

## Total IT spend as percent of US GDP is reasonable

We estimate the US to have spent cUSD1 trillion on IT in 2006, which was 8.3% of the total GDP. This was lower than 2000, when technology spend touched a peak of 8.8% of GDP. Although the absolute amount spent in 2006 on IT was higher than the absolute dollar spend in 2000, it remains at reasonable levels when compared with the percent of GDP, and has not reached proportions that are significantly higher than its historical range.

**US IT spend as a percentage of GDP**

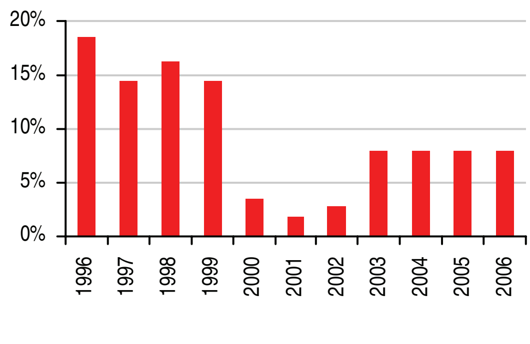



Note: IT spend includes comm. services and equipment, software and hardware
Source: BEA, HSBC

Even in the severe contraction seen in 2002, the IT contribution to GDP did not fall below 7.8%, with software and services showing positive growth. Consequently we do not see any excessive spending on technology in the US and even in the worst case of a US economy slowdown in 2007, we do not expect technology spend in the US to contract as sharply as it did in 2001. The cut is 2001 was also driven by a rationalisation of spend in semiconductor / communication equipments which now contribute an even lower proportion of the total technology spend in the US.

The technology spend as a percentage of GDP expanded by over 130bps in four years until 1999-00. In the last four years, it has expanded by only 50bps and is still less than the historical spending range. As per our index, in 2001 hardware and communication equipment industries saw the sharpest decline in production. Software and communication services were relatively less affected. This also led to a rise in the total contribution of software in the GDP of IT producing industries. We estimate the total contribution of software to have further increased to c40% in 2006 from 36% in 2000 and 29% in 1997.

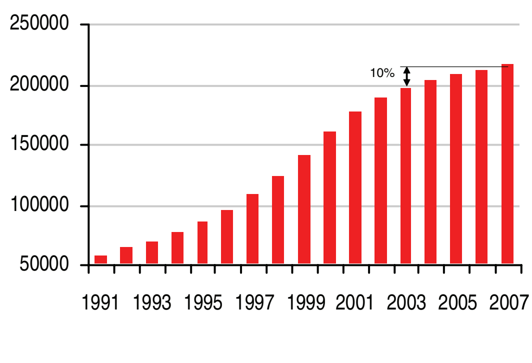
**Trends in growth rates of software spend (%y-o-y)**




Note: Combining only revenues of software and IT services companies in our sample
Source: HSBC model

The growth of spending in software and services has been relatively less volatile. Average growth rates of 8% over the last five years are also lower than the average 12% growth seen prior to 2000.

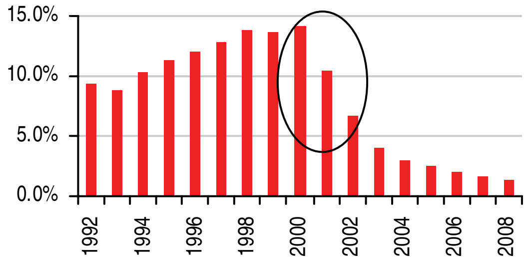
**Total number of PC in US('000)**




Source: Global Market Information Database (GMID)

Another measure of technology spending in US, the total number of PCs by 2007 is estimated to be only 10% higher than 2003 levels, as per market estimates. Clearly, the growth in PCs has also fallen off sharply post 2000-01.

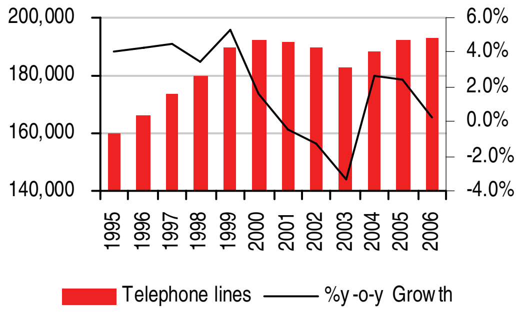
**PC %y-o-y growth in the US has significantly decelerated since 2000**




Source: GMID

software and services should imply a lower volatility in technology spend, going forward.

**Trends in US telephone lines ('000)**




Source: GMID, HSBC

Similarly, the total number of telephone lines in US has not grown significantly since 2000-06.

## Conclusion

The total technology spend in the US would be comparable to levels seen in 2000. Our Technology Spend Index implies only 11% higher levels in 2006 compared to 2000.

**Segment wise IT spending in the US (USDbn)**

| | 2005 | 2006 | 2010 | CAGR(%) 2005-10 |
|---|---|---|---|---|
| BFSI | 75.7 | 81.0 | 96.4 | 5.0% |
| Manufacturing | 75.2 | 78.6 | 94.8 | 4.7% |
| Retail | 36.5 | 38.5 | 45.0 | 4.3% |
| Transportation | 14.3 | 14.9 | 17.8 | 4.5% |
| Communication | 40.0 | 43.0 | 54.5 | 6.4% |
| Utilities | 18.3 | 19.1 | 22.7 | 4.4% |
| Healthcare | 20.9 | 22.2 | 28.7 | 6.5% |
| Others | 166.3 | 175.4 | 205.9 | 4.4% |
| **Total** | **447.2** | **472.7** | **565.8** | **4.8%** |

Note: IDC definition of IT may vary from BEA classification which includes all IT producing industries
BFSI is Banking, Financial Services and Insurance
Source: IDC, HSBC

The last six years have seen declining growth and recovery in segments like telecom, hardware and semiconductors. Consequently, the contribution of software and services to IT producing industries in the US has increased. Growth rates in software have been more stable compared with other IT segments and increasing contribution from

## What does the index exclude?

Our index is just a proxy for tracking the technology spend in the US over a period of time. Consequently, it may not include the impact of deflation in the market due to off-shoring and internal spend moving to third-party vendors. It may overestimate the US technology revenues, as it includes non-US revenues also. And as we have taken leading companies accounting for only 60% of the market, growth in the Technology Spend Index may be higher than the actual market average.

We believe all the above factors would have inflated the index and hence actual spend may be lower than our estimates, further strengthening our argument.

# Is the US overspending on IT?

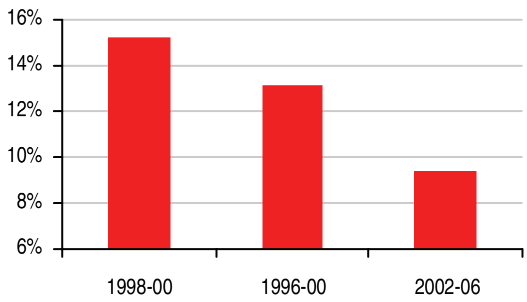
- We believe, the nature of technology spend has changed and companies are now spending on technology not to get ahead, but to avoid falling behind
- Growth in technology spend from 2001-06 (c9%y-o-y) is significantly lower than peak (c15%y-o-y) and average rates seen in 1996-2000
- Software spending has been relatively more stable than other segments. Rebalancing of employees is now following the rationalisation of dollar spending

## Rationalising technology spend

### Changing nature of spend

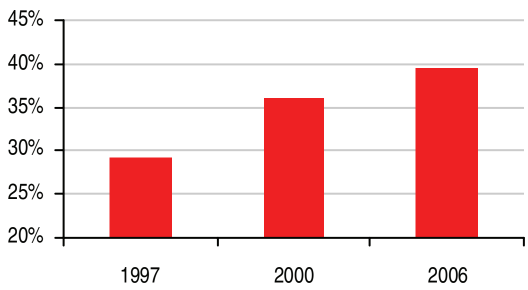
A lower CAGR of our Technology Spend Index of 9% from 2002-06 compared to a 13% CAGR from 1996-00 implies that US companies have significantly rationalised their technology spending since 2001. The technology spend indicator had grown at an even faster rate of 15% during 1998-00.

Technology Spend Index: trends in CAGR (%)




Source: HSBC

Contribution of software to total GDP of IT producing industries in US (%)




Source: BEA, HSBC

We believe the nature of spending has also changed. Now companies are spending on technology not because it will essentially put them ahead of others, but because it will save them from falling behind.

The lower growth in budgets in recent years also implies that CIOs have been more cautious on spending on IT. Consequently, they are now looking for better returns and rationalisation of their technology spend more than ever.

### Change in mix of technology spend

As per IDC estimates, growth in software and services spending is likely to be higher than hardware again in 2007. In recent years, software spending has grown faster than spending in other segments and has been relatively less volatile. Consequently rationalisations of overall technology budgets has removed the excesses from hardware, communication and telecom and resulted in a higher share of software in the overall spending.

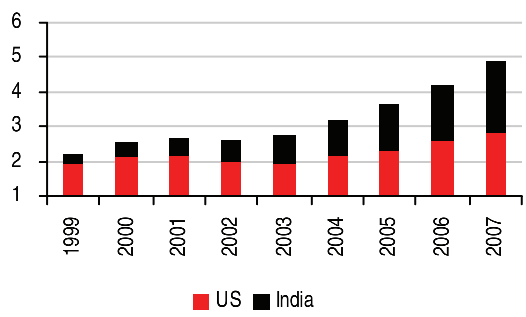
## Rebalancing services workforce

### Increasing presence of MNC vendors in offshore locations

We believe focus on offshore by incumbents is just another manifestation of conscious return expectations of CIOs in the US and Europe. So, in order to stay competitive and align themselves to the emerging global delivery model of offshore vendors, incumbent IT service providers have now started ramping up their offshore delivery centres after their initial mode of denial.

We believe incumbents have resorted to a long term approach to their offshore ramp-ups. India IT workforce, which accounted for less than 20% of US software employees, now accounts for 70%.

**Total software professionals in US and India (million)**

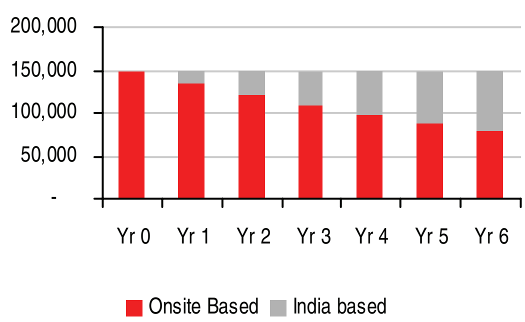



Source: BEA, Nasscom, HSBC

Incumbents are also making the transition as smooth as possible in order to avoid getting affected by the changing trends of offshore. Their approach is to take advantage of inherent attrition in their workforce to scale down their operations in high-cost locations and instead build up their presence in offshore locations like India.

Assuming a conservative attrition rate of 10% for any multinational company (MNC) with c150,000 employees, we see that it can significantly improve its offshore presence without explicitly cutting US-based employees if it simply replaces the attritions with new staff in India.

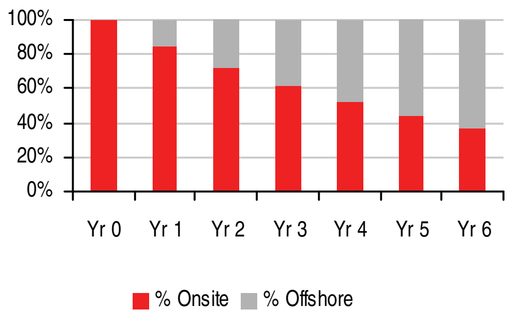
**How does rebalancing of employees work ?**




Source: HSBC

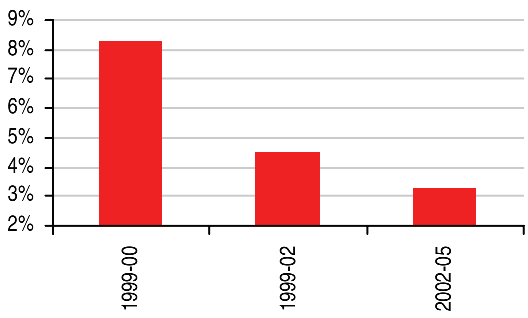
We believe this is the model most large MNCs have adopted, to avoid a direct confrontation with the social systems in their home countries and at the same time scale up operations in offshore locations.

Increase in % of offshore staff by replacing US attrition in India




Source: HSBC

Average annual increase in compensation for US software analysts and engineers (%)




Source: BLS, HSBC

Presence of select MNCs in India

| | Employees in India | Total Employees | % in India |
|---|---|---|---|
| IBM | 50,000 | 200,000 | 25% |
| Accenture | 27,000 | 140,000 | 19% |
| EDS | 20,000 | 131,500 | 15% |
| Convergys | 17,000 | 70,000 | 24% |
| CapGemini | 13,250 | 68,000 | 19% |
| CSC | 7,000 | 80,000 | 9% |
| ACS | 4,600 | 62,000 | 7% |
| Logica CMG | 3,000 | 41,000 | 7% |
| Atos Origin | 1,500 | 47,000 | 3% |
| TietoEnator | 250 | 16,000 | 2% |
| **Total Avg** | **142,350** | **857,500** | **17%** |

IBM global services only; Accenture has plans to scale up to 36k by Aug; CSC will be 13% excluding federal business
Source: Companies, HSBC

## Lower increase in US compensation

Another indicator of lack of any excessive spending in software and services has been the lower rate of increase in the average compensation of software engineers in the US.

As per data released by the Bureau of Labour Statistics, average compensation increase in the US in 2002-05 has been c3%, which is significantly lower than the 4% increase seen during 1999-02 and the peak levels of over 8% y-o-y increase seen in compensation levels in 1999-00 in the US for software engineers and analysts.

## Indicators do not point towards an overspending in technology in US

As economies expand, information requirements across industries and related markets have also grown. At the same time, escalating pressures on cost controls and rationalising technology spend have led to redistribution of budgets towards segments that are critical towards effectively managing business operations and improving productivity. For example, over 60% of US manufacturing establishments that have computer networks also have higher productivity than those without networks.

We believe that US businesses will continue to seek greater benefits from their technology spend and in the process, accelerate transition of work towards low-cost locations like India.

As of now, we see no indicator pointing towards any excessive spending in technology in the US. On the contrary, businesses looking to generate synergies have led to rebalancing and rationalisation of technology spends to more productive segments both in terms of dollar as well as employee distribution. Consequently, IT budget increases for 2007 may be in line with the increase in spending seen in 2005 and 2006.

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# How much will a US slowdown hurt India IT?

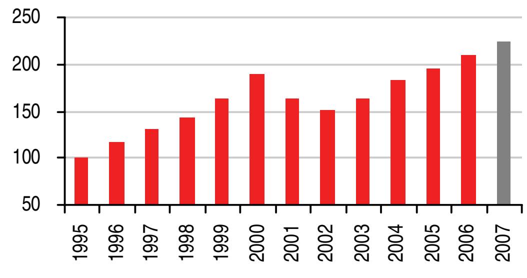
- The extent of contraction in US technology spend during a slowdown will depend on the level of overspending in the sector
- Our Technology Spend Index in 2005 was at similar levels as in 2000. Average increase over last three years has been +9%y-o-y (below peak growth of 15% y-o-y)
- In case of a US slowdown we do not expect IT spending to contract as sharply as it did in 2001. Worst case impact may be less than 10% fall in tech spending compared to c25% earlier

## No signs of US overspending

### How severely will a US slowdown affect technology spend?

Our analysis indicates that current spending in the US is comparable with levels seen in 2000.

Best Case: HSBC IT Spend Index forecast for 2007

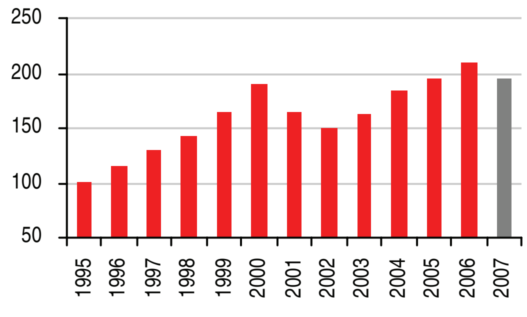



LHS indexed at 100; Base 1995
Source: HSBC

Moreover, technology companies have also expanded their geographic presence and reduced spending concentration on traditional segments.

As per industry estimates, companies are now spending their IT budget in the ratio of 40:20:40 for hardware, software and services with a higher proportion for software and services than earlier.

Worst case: HSBC IT Spend Index forecast for 2007



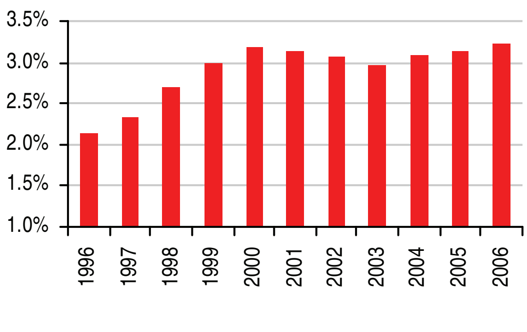

LHS indexed at 100, Base 1995
Source: HSBC

Extrapolating our Technology Spend Index to model best and worst case of spending scenarios in the US indicates that even in the worst case of a US slowdown in 2007, contraction in technology spend is unlikely to be as severe as it was in the past.

We estimate the worst case impact in case of a US slowdown could be less than 10% compared to c25% levels in 2001-02 for total technology budgets.

A downturn may lead to some shrinkage in the overall market. However, software and services is a relatively stable segment and should see an even lower impact. With their track record of on time and within budget performance, Indian vendors should continue to gain acceptability and dominance in the global arena.

**Software and Services spend as % of US GDP**

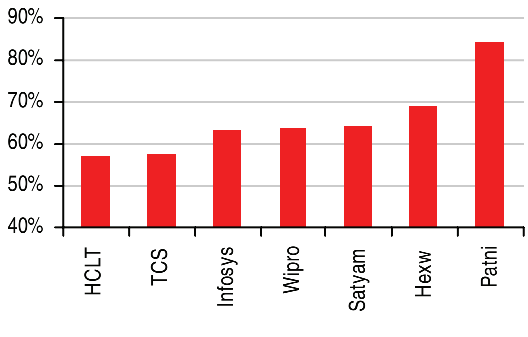



Source: BEA, HSBC

## Impact of US slowdown on offshore vendors

The impact of a US slowdown will depend on the offshore vendor and its positioning. Even so, any US slowdown will bring in uncertainties and revenue growth / margin challenges for clients of offshore vendors. This is likely to translate into a freeze in pricing, lower sales productivity for vendors and consequently margin challenges in the short term. But given that we do not expect as severe a contraction in IT spend, offshore vendors should be relatively better placed than incumbents.

**Revenue contribution from the US**




Source: Companies, HSBC

Large companies with diversified skill sets and broader service offerings will have a better chance of maintaining growth rates and surviving the slowdown without significantly altering their existing business models.

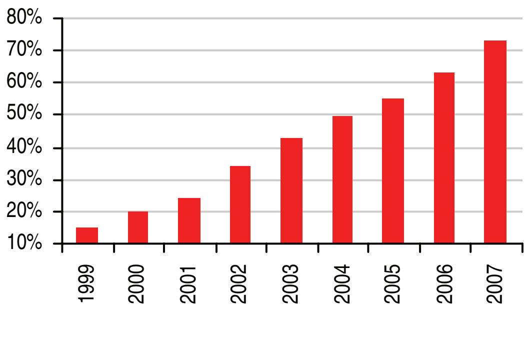
However, smaller vendors with limited annuity revenues and large onsite presence are likely to be affected disproportionately.

## India advantage well understood

India based vendors have been investing significantly in expanding their service offerings, building on domain knowledge, introducing new service offerings and changing mindsets to building solutions rather than selling technology services alone.

Consequently, offshore services have grown significantly faster than the global market and the India IT sector, which employed less than 20% of the workforce in the US, has now grown to over 70% of the software employee base in the US.

IT employees in India as % of only software employees in US




Source: BEA, Nasscom, HSBC

We expect the momentum towards offshore outsourcing to be sustained and further strengthen as global vendors look to aggressively expand their presence in India.

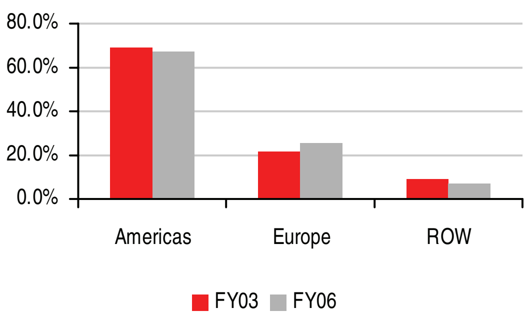
# Changing mix of revenues for offshore

## UK growing faster than the US

Despite improving acceptability of offshore in Europe, the US, at c60% of revenues, remains the largest market for Indian offshore vendors.

However, Europe has been growing significantly faster and continues to increase its revenue contribution.

US and UK remain dominant markets for India IT services




Source: Nasscom

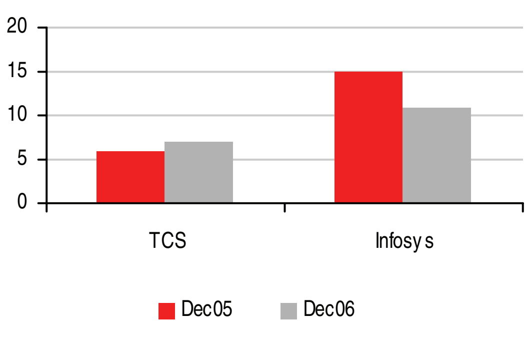
In the event of a US slowdown, we expect Indian vendors to increase selling efforts in lesser penetrated European countries like Germany, France and Italy to further increase their presence in these markets.

## Focus on strategic clients

The IT budgets of smaller companies are more volatile; they grow fast and shrink faster. Hence offshore vendors are rationalising clients and focussing on strategic clients. Being a strategic vendor to a client also helps in: i) addressing their internal IT spend; ii) replacing incumbent vendors as the failure rate in global IT projects is still very high, and iii) leading to sub-optimal use of IT spend and offering business critical solutions to clients and partnering in strategic IT roadmap. Eg. Infosys was selected the best IT vendor for Wachovia after having entered the account only in 2005.

However, in the event of a slowdown, we believe the initial impact is i) a freeze in technology budgets, and ii) rationalisation of existing spend on projects that can further improve efficiencies and reduce costs and cycle times even in an adverse business cycle.

Number of USD50m clients: large vendors increase focus on strategic client relationships




Source: Companies, HSBC

We believe vendors that focus on developing domain knowledge, and large strategic relationships with clients, will be better placed in such a scenario.

## Moving to consulting and higher value added services

The link between investments in IT and increased productivity for companies is often most apparent when IT investment is accompanied by organisational change. This can only be done by service providers if they also understand the changing needs of businesses and are able to come up with new solutions.

Most clients categorise their budget use for: i) operational/maintenance, and ii) strategic/advancement purposes. From a client perspective, operational technology investments simply reduce costs. It cannot alter old service models and change client relationships. It is the strategic investments that are expected to lead to new business or more revenues from clients.

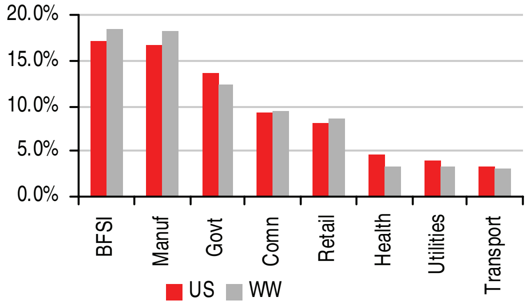
Consulting services helps in demonstrating to the clients a higher value proposition and hence helps in commanding premium pricing. Instead of focussing only on consulting, India based vendors are using this as a platform to generate further downstream work.

## Expanding to non-prime verticals

BFSI, Telecom, Manufacturing and Retail are the primary verticals for India-based IT services vendors. Together they account for c50% proportion of the total IT services spend in the US currently, as per Nasscom estimates.

However, over the last few years, offshore vendors have also expanded their presence in relatively smaller verticals like Healthcare, Utilities and Transport where the phenomenon of offshore has not penetrated as much and where companies are likely to accelerate offshoring if their core markets were to slow down.

**Sector-wise share in IT spend in the US and worldwide (%)**




Source: IDC, HSBC

# Inorganic moves

## Larger players, bigger acquisitions?

We expect larger-sized acquisitions by offshore vendors in 2007. So far, smaller vendors have resorted to acquisitions to gain scale and expand service offerings rapidly. However, we expect large offshore vendors to focus more on acquisitions in 2007, especially in European geographies. Wipro has already stated that it will look at larger USD50m-100m deals going forward. Infosys is looking at acquiring companies in Europe to expand their base in the region. TCS has already shown a propensity to go for large deals and acquisitions. We think Satyam may be inclined to make an acquisition to rapidly scale its geography / services portfolio.

Tier 1 vendors are clear leaders in terms of scale and are widening the gap with other players. However, for other vendors to bridge the gap, organic efforts may not be enough and hence outside the tier 1 vendors, other companies may also increasingly resort to acquisitions in order to maintain their competitive edge and ward off competition from MNCs.

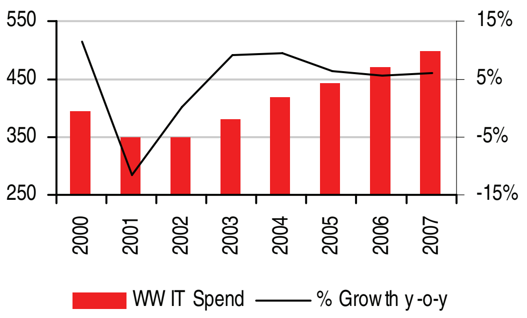
# Risks

## What could affect IT stocks?

Apart from any slowdown in the US, a slowdown in the GDP growth rate of India will lead to a significant PE re-rating of the overall market, which may also have an impact on near term valuations of IT Services stocks. A broad based correction in the market remains the biggest risk to the performance of IT services stocks. Other key risks include policy measure of the Indian government, employee attrition and currency appreciation.

Earnings of IT services vendors will not be affected by the tightening measures of the central bank and rising interest rates in India. In the medium term we expect average 25%+ growth to continue for the offshore IT services sector.

Trends in world wide IT spending (USD bn)




Source: IDC, Nasscom, HSBC

# Large and niche vendors better placed

## Growth vs. margins

In case of an eventual US slowdown, we believe large tier 1 vendors and some niche small vendors may be better placed than peers. Smaller vendors will be faced with the dual dilemma of lower revenue growth, as well as rising employee training and SG&A costs in India. In 2007, we also expect small vendors to use the inorganic route to gain critical mass whereas larger vendors may use acquisitions to rapidly scale up their presence in European locations or capabilities in new service offerings/ domains.

## Strategic client relationships

Revenues distribution of India vendors across services is based on management judgement and may vary across companies. Moreover, each segment within itself could also have multiple revenues streams of development and maintenance. Consequently, it is difficult to estimate the exposure of companies to development work alone.

We believe vendors that have strategic relationships with clients are likely to continue increasing market share even in the event of a slowdown or vendor consolidation by clients. Infosys has been consciously focussing on developing large relationships of over USD50m with clients. TCS has also rationalised its client base to address large clients and weed out the smaller ones post its integration with Tata Infotech.

## India advantage to be sustained

We expect the offshore phenomenon to gain further momentum. Accenture has publicly stated that India will emerge as its largest employee base in 2007 – ahead of the US. We believe over the next couple of years, total IT employees in India will also exceed the total employees engaged in software and services in US.

## Management execution is key

Finally in an adverse business environment, performance will largely depend on management vision and execution. In the event of any slowdown, we expect the gap between leaders and the also-rans to widen further.

# Company Profiles

# HCL Technologies

- Focus on large deals and penetrating uncontested market spaces
- Expansion outside US continues; recent wins in Europe and New Zealand
- We expect HCL's revenue and earnings to grow 36% and 33% in FY07e; maintain Neutral with a target price of INR335

## Valuations

We rate HCL Tech Neutral with a target price of INR335 based on PE of 17.5x FY08e EPS. Our target PE is derived from analysis of the historical trading pattern of the stock and its trading range compared to Infosys. Over the last three years, HCL Tech has traded in a rolling one-year forward PE range of 13-23x, with an average of 17x. Its PE discount to Infosys is 0-40% over the last two years with an average of 25%.

## Risks

The key risks that may prevent HCL Tech from achieving our target price are:

- HCLT has 46% revenues from Hi-tech and telecom segment where budgets are more volatile and can be a risk in case of a US slowdown;
- Any significant rupee appreciation will be detrimental to margins of HCL. It has a forward cover of USD560m which is significantly higher than peers;
- Country risks, terrorist attacks, acquisition and investment portfolio related risks. Geopolitical risks may delay travel plans for clients leading to a disruption in flow of volumes;
- Upside risks for HCL include: Any significant deals, rupee depreciation and improved management execution

HSBC

# Financials & valuation: HCL Technologies

Neutral

**Financial statements**

| Year to | 06/2006a | 06/2007e | 06/2008e | 06/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 44,007 | 59,850 | 74,683 | 90,528 |
| EBITDA | 9,848 | 13,017 | 16,052 | 18,828 |
| Depreciation & amortisation | -2,033 | -2,558 | -3,068 | -3,308 |
| Operating profit/EBIT | 7,815 | 10,459 | 12,984 | 15,520 |
| Net interest | 0 | 0 | 0 | 0 |
| PBT | 8,388 | 11,507 | 14,088 | 16,678 |
| HSBC PBT | 8,388 | 11,507 | 14,088 | 16,678 |
| Taxation | -626 | -1,171 | -1,660 | -1,966 |
| Net profit | 7,746 | 10,310 | 12,399 | 14,680 |
| HSBC net profit | 7,746 | 10,310 | 12,399 | 14,680 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 9,720 | 9,841 | 10,770 | 12,546 |
| Capex | -4,180 | -4,346 | -4,964 | -6,093 |
| Cash flow from investment | -3,418 | -4,350 | -4,964 | -6,093 |
| Dividends | -5,148 | -5,175 | -5,822 | -6,469 |
| Change in net debt | -1,359 | -1,061 | 0 | 0 |
| FCF equity | 4,961 | 4,459 | 4,718 | 5,311 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 8,394 | 8,392 | 8,392 | 8,392 |
| Tangible fixed assets | 8,742 | 10,530 | 12,426 | 15,210 |
| Current assets | 32,192 | 38,446 | 45,924 | 54,243 |
| Cash & others | 2,438 | 3,500 | 3,500 | 3,500 |
| Total assets | 50,445 | 58,530 | 67,904 | 79,007 |
| Operating liabilities | 8,952 | 11,103 | 13,872 | 16,732 |
| Gross debt | 83 | 84 | 84 | 84 |
| Net debt | -2,355 | -3,416 | -3,416 | -3,416 |
| Shareholders funds | 40,558 | 47,210 | 53,787 | 61,998 |
| Invested capital | 37,938 | 42,765 | 49,370 | 57,613 |

**Ratio, growth and per share analysis**

| Year to | 06/2006a | 06/2007e | 06/2008e | 06/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 30.6 | 36.0 | 24.8 | 21.2 |
| EBITDA | 27.6 | 32.2 | 23.3 | 17.3 |
| Operating profit | 26.8 | 33.8 | 24.1 | 19.5 |
| PBT | 16.2 | 37.2 | 22.4 | 18.4 |
| HSBC EPS | 24.9 | 32.7 | 20.3 | 18.4 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 1.2 | 1.5 | 1.6 | 1.7 |
| ROIC | 19.6 | 23.3 | 24.9 | 25.6 |
| ROE | 19.8 | 23.5 | 24.6 | 25.4 |
| ROA | 16.1 | 19.0 | 19.7 | 20.0 |
| EBITDA margin | 22.4 | 21.7 | 21.5 | 20.8 |
| Operating profit margin | 17.8 | 17.5 | 17.4 | 17.1 |
| EBITDA/net interest (x) | | | | |
| Net debt/equity | -5.8 | -7.2 | -6.3 | -5.5 |
| Net debt/EBITDA (x) | -0.2 | -0.3 | -0.2 | -0.2 |
| CF from operations/net debt | | | | |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 11.97 | 15.89 | 19.11 | 22.62 |
| HSBC EPS (fully diluted) | 11.97 | 15.89 | 19.11 | 22.62 |
| DPS | 15.92 | 15.95 | 17.94 | 19.94 |
| NAV | 62.70 | 72.76 | 82.89 | 95.55 |

**Valuation data**

| Year to | 06/2006a | 06/2007e | 06/2008e | 06/2009e |
|---|---|---|---|---|
| EV/sales | 4.4 | 3.2 | 2.6 | 2.1 |
| EV/EBITDA | 19.8 | 14.9 | 12.1 | 10.3 |
| EV/IC | 5.1 | 4.5 | 3.9 | 3.4 |
| PE* | 25.3 | 19.1 | 15.9 | 13.4 |
| P/NAV | 4.8 | 4.2 | 3.7 | 3.2 |
| FCF yield (%) | 2.5 | 2.3 | 2.4 | 2.7 |
| Dividend yield (%) | 2.6 | 2.6 | 3.0 | 3.3 |

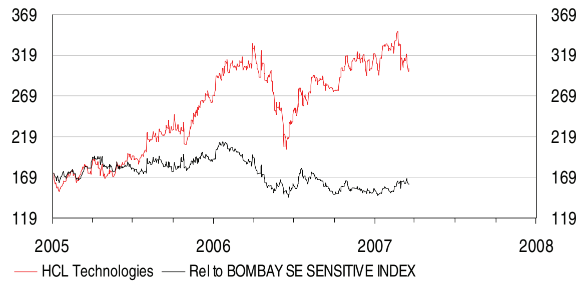
Note: * = Based on HSBC EPS (fully diluted)

**Issuer information**

| Share price (INR) | 303.35 | Target price (INR) | 335.0 | Potent'l tot rtn (%) | 13.4 |
|---|---|---|---|---|---|

| | | | |
|---|---|---|---|
| Reuters (Equity) | HCLT.BO | Bloomberg (Equity) | HCLT IN |
| Market cap (USDm) | 4,510 | Market cap (INRm) | 197,391 |
| Free float (%) | 23.2 | Enterprise value (INRm) | 193859 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

**Price relative**




Source: HSBC

Note: price at close of 19 Mar 2007

**Disclaimer & Disclosures.** This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, that form part of it.

# Hexaware

- Management may spend up to USD40m on acquiring a services company in Europe with presence in Financial services and Transportation
- Demand environment remains favourable and Hexaware is witnessing increased traction in Germany and UK
- Currently trades at 13x 2008e EPS on earnings growth of 20% in FY08; maintain Neutral, target price INR180

## Valuations

We rate Hexaware Neutral with a target price of INR180 based on a rolling one-year forward PE of 12x. Our target PE is based on analysis of the historical trading pattern of the stock. Over the last two years, Hexaware has traded in a range of 11-18x its rolling one-year forward PE. At the current stage of its growth cycle, we believe Hexaware should trade at the lower end of its historical trading range and we apply a 12x multiple to reach our target price.

## Risks

Key risks that may prevent Hexaware's stock from achieving our target price are:

- Dependence on a few large clients is a risk; top 10 clients account for 47% of revenues;
- Any slowdown/uncertainty in IT spend in the Europe/US, the primary markets for Hexaware;
- Any significant appreciation of the rupee against the dollar will be detrimental to margins of IT services companies;
- Any reduction in the number of H1B visas granted by the US will have an adverse impact on business prospects of India offshore vendors;
- Management execution, acquisition related risks and threat from offshore expansion of MNCs are risks that can hamper expected growth rates.

Upside risks include any large deals and better than expected organic performance in core IT business.

# Financials & valuation: Hexaware

Neutral

### Financial statements

| Year to | 12/2006a | 12/2007e | 12/2008e | 12/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 8,482 | 11,551 | 14,275 | 17,648 |
| EBITDA | 1,323 | 1,837 | 2,371 | 2,942 |
| Depreciation & amortisation | -200 | -283 | -348 | -444 |
| Operating profit/EBIT | 1,122 | 1,554 | 2,024 | 2,497 |
| Net interest | 0 | 0 | 0 | 0 |
| PBT | 1,363 | 1,799 | 2,345 | 2,838 |
| HSBC PBT | 1,363 | 1,799 | 2,345 | 2,838 |
| Taxation | -120 | -162 | -227 | -595 |
| Net profit | 1,243 | 1,637 | 2,118 | 2,243 |
| HSBC net profit | 1,243 | 1,637 | 2,118 | 2,243 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 1,330 | 1,864 | 2,456 | 2,640 |
| Capex | -1,768 | -950 | -1,125 | -1,400 |
| Cash flow from investment | -1,768 | -950 | -1,125 | -1,400 |
| Dividends | -288 | -334 | -421 | -406 |
| Change in net debt | -2,298 | -577 | 589 | -834 |
| FCF equity | -679 | 669 | 1,010 | 899 |
| **Balance sheet summary (INRm)** | | | | |
| Tangible fixed assets | 2,501 | 3,168 | 3,946 | 4,901 |
| Current assets | 6,711 | 7,858 | 7,785 | 9,264 |
| Cash & others | 3,414 | 3,991 | 3,402 | 4,236 |
| Total assets | 9,208 | 11,046 | 11,750 | 14,185 |
| Operating liabilities | 1,708 | 2,223 | 2,729 | 3,327 |
| Gross debt | 0 | 0 | 0 | 0 |
| Net debt | -3,414 | -3,991 | -3,402 | -4,235 |
| Shareholders funds | 6,000 | 7,323 | 9,021 | 10,858 |
| Invested capital | 4,089 | 4,812 | 5,599 | 6,603 |

### Ratio, growth and per share analysis

| Year to | 12/2006a | 12/2007e | 12/2008e | 12/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 25.0 | 36.2 | 23.6 | 23.6 |
| EBITDA | 21.6 | 38.9 | 29.1 | 24.0 |
| Operating profit | 29.5 | 38.5 | 30.2 | 23.4 |
| PBT | 34.7 | 32.0 | 30.4 | 21.0 |
| HSBC EPS | 16.9 | 24.9 | 29.4 | 5.9 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 2.6 | 2.6 | 2.7 | 2.9 |
| ROIC | 31.5 | 31.8 | 35.1 | 32.4 |
| ROE | 26.0 | 24.6 | 25.9 | 22.6 |
| ROA | 17.7 | 16.2 | 18.6 | 17.3 |
| EBITDA margin | 15.6 | 15.9 | 16.6 | 16.7 |
| Operating profit margin | 13.2 | 13.5 | 14.2 | 14.2 |
| EBITDA/net interest (x) | | | | |
| Net debt/equity | -56.9 | -54.5 | -37.7 | -39.0 |
| Net debt/EBITDA (x) | -2.6 | -2.2 | -1.4 | -1.4 |
| CF from operations/net debt | | | | |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 9.12 | 11.16 | 14.44 | 15.29 |
| HSBC EPS (fully diluted) | 9.18 | 11.46 | 14.84 | 15.71 |
| DPS | 1.57 | 1.73 | 2.17 | 2.10 |
| NAV | 44.32 | 51.30 | 63.19 | 76.06 |

### Valuation data

| Year to | 12/2006a | 12/2007e | 12/2008e | 12/2009e |
|---|---|---|---|---|
| EV/sales | 2.0 | 1.4 | 1.2 | 0.9 |
| EV/EBITDA | 12.7 | 8.8 | 7.1 | 5.4 |
| EV/IC | 4.1 | 3.4 | 3.0 | 2.4 |
| PE* | 16.7 | 13.4 | 10.3 | 9.7 |
| P/NAV | 3.5 | 3.0 | 2.4 | 2.0 |
| FCF yield (%) | -3.4 | 3.3 | 5.0 | 4.4 |
| Dividend yield (%) | 1.0 | 1.1 | 1.4 | 1.4 |

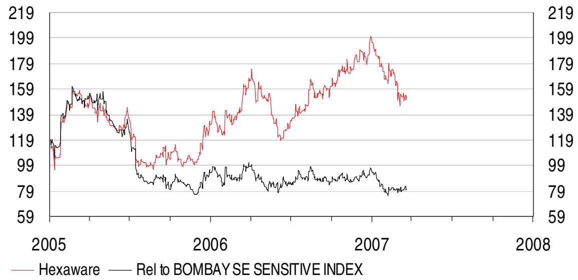
Note: * = Based on HSBC EPS (fully diluted)

### Issuer information

| Share price (INR) | 153.10 | Target price (INR) | 180.00 | Potent'l tot rtn (%) | 17.6 |
|---|---|---|---|---|---|

| | | | |
|---|---|---|---|
| Reuters (Equity) | HEXT.BO | Bloomberg (Equity) | HEXW IN |
| Market cap (USDm) | 465 | Market cap (INRm) | 20,218 |
| Free float (%) | 74 | Enterprise value (INRm) | 16226 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

### Price relative




Source: HSBC

Note: price at close of 20 Mar 2007

# i-flex Solutions

- Oracle has stated that it does not plan to de-list i-flex unless the price is significantly lower than its open offer price of INR2100
- We expect profit to grow by 29% and 26% in FY08e and FY09e
- Expensive at 38x FY08e EPS, a 60% premium to Infosys; reiterate Underweight rating, raise target price to INR1,610

## Valuations

We rate i-flex Underweight with a target price target of INR1,610 based on a rolling one-year forward PE of 25x. We are raising our target price from INR1,380 to INR1,610 due to roll over of earnings. Our target PE is based on analysis of the historical trading pattern of the stock and its trading range compared to Infosys. Over the last three years, i-flex has traded in range of 15-41x its rolling one-year forward PE. At the current stage of its growth phase, we believe i-flex should trade in line with its historical trading range and we apply a multiple of 25x, in line with Infosys, to reach the target price.

## Risks

Key risks that may prevent i-flex from achieving our target price are:

- Uncertainty over future plans of Oracle remains a key risk;
- Weaker IT spend in the US, the largest market for Indian IT services companies;
- Any significant depreciation of the rupee against the dollar will be beneficial to margins of IT services companies;
- Country risks, product obsolescence risks and geopolitical risks may delay travel plans leading to a disruption in flow of volumes; high dependence on a single client, Citigroup;
- Any reduction in the number of H1B visas granted by the US will have adverse impact on business prospects of India offshore vendors;
- Any higher than expected increase in onsite/offshore salaries

HSBC

# Financials & valuation: I-Flex Solutions

Underweight

**Financial statements**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 14,835 | 19,938 | 25,570 | 32,296 |
| EBITDA | 2,950 | 3,996 | 5,073 | 6,352 |
| Depreciation & amortisation | -505 | -532 | -567 | -583 |
| Operating profit/EBIT | 2,445 | 3,464 | 4,506 | 5,769 |
| Net interest | 275 | 345 | 421 | 527 |
| PBT | 2,723 | 3,844 | 4,996 | 6,379 |
| HSBC PBT | 2,726 | 3,844 | 4,996 | 6,379 |
| Taxation | -535 | -730 | -939 | -1,193 |
| Net profit | 2,188 | 3,114 | 4,057 | 5,186 |
| HSBC net profit | 2,190 | 3,114 | 4,057 | 5,186 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 2,113 | 1,554 | 2,877 | 3,739 |
| Capex | -782 | -530 | -530 | -530 |
| Cash flow from investment | -765 | -596 | -530 | -530 |
| Dividends | -270 | -312 | -356 | -400 |
| Change in net debt | -356 | -2,993 | -2,181 | -3,014 |
| FCF equity | 1,331 | 989 | 2,278 | 3,126 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 387 | 387 | 387 | 387 |
| Tangible fixed assets | 1,563 | 1,561 | 1,524 | 1,471 |
| Current assets | 13,129 | 15,959 | 19,987 | 25,031 |
| Cash & others | 6,862 | 9,856 | 12,036 | 15,050 |
| Total assets | 18,024 | 19,555 | 23,571 | 28,562 |
| Operating liabilities | 4,143 | 1,878 | 1,978 | 1,978 |
| Gross debt | 0 | 0 | 0 | 0 |
| Net debt | -6,862 | -9,856 | -12,036 | -15,050 |
| Shareholders funds | 13,495 | 17,290 | 21,206 | 26,197 |
| Invested capital | 4,073 | 6,173 | 7,883 | 9,860 |

**Ratio, growth and per share analysis**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 30.1 | 34.4 | 28.2 | 26.3 |
| EBITDA | 6.5 | 35.5 | 26.9 | 25.2 |
| Operating profit | 0.5 | 41.7 | 30.1 | 28.0 |
| PBT | 0.5 | 41.2 | 29.9 | 27.7 |
| HSBC EPS | 4.7 | 40.3 | 28.6 | 26.3 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 4.0 | 3.9 | 3.6 | 3.6 |
| ROIC | 52.5 | 54.8 | 52.1 | 52.9 |
| ROE | 17.7 | 20.2 | 21.1 | 21.9 |
| ROA | 13.6 | 16.6 | 18.8 | 19.9 |
| EBITDA margin | 19.9 | 20.0 | 19.8 | 19.7 |
| Operating profit margin | 16.5 | 17.4 | 17.6 | 17.9 |
| Net debt/equity | -50.9 | -57.0 | -56.8 | -57.5 |
| Net debt/EBITDA (x) | -2.3 | -2.5 | -2.4 | -2.4 |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 28.39 | 39.89 | 51.30 | 64.77 |
| HSBC EPS (fully diluted) | 28.42 | 39.89 | 51.30 | 64.77 |
| DPS | 3.50 | 4.00 | 4.50 | 5.00 |
| NAV | 175.09 | 221.46 | 268.18 | 327.17 |

**Valuation data**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| EV/sales | 10.4 | 7.6 | 5.8 | 4.5 |
| EV/EBITDA | 52.4 | 37.9 | 29.5 | 23.1 |
| EV/IC | 38.0 | 24.6 | 19.0 | 14.8 |
| PE* | 69.7 | 49.7 | 38.6 | 30.6 |
| P/NAV | 11.3 | 8.9 | 7.4 | 6.1 |
| FCF yield (%) | 0.8 | 0.6 | 1.4 | 1.9 |
| Dividend yield (%) | 0.2 | 0.2 | 0.2 | 0.3 |

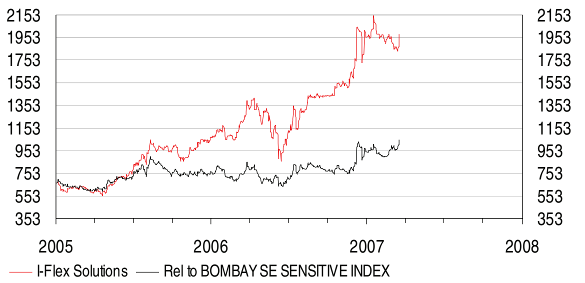
Note: * = Based on HSBC EPS (fully diluted)

**Issuer information**

| Share price (INR) | 1981.6 | Target price (INR) | 1610.0 | Potent'l tot rtn (%) | -18.8 |
|---|---|---|---|---|---|

| | | | |
|---|---|---|---|
| Reuters (Equity) | IFLX.BO | Bloomberg (Equity) | IFLEX IN |
| Market cap (USDm) | 3,692 | Market cap (INRm) | 161,583 |
| Free float (%) | 17 | Enterprise value (INRm) | 151613 |
| Country | India | Sector | Software |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

**Price relative**




Source: HSBC

Note: price at close of 19 Mar 2007

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# Infosys

- Client feedback remains positive with budgets expected to increase 3-4% in FY08e
- We expect Infosys to guide at earnings growth of 24-25% for FY08e with an EPS range of INR84-85
- Currently trades at 24x FY08e and 19x FY09e EPS on earnings growth of 29% and 26% in FY08 and FY09e respectively; reiterate Overweight, target price INR2,560

## Valuations

We rate Infosys an Overweight with a target price of INR2,560 based on a rolling one-year forward PE of 25x. Our target PE is based on analysis of the historical trading pattern of the stock. Over the last two years, Infosys has traded in a range of 18-29x its rolling one-year forward PE. At the current stage of its growth phase, we believe Infosys should trade towards the higher end its two-year range and we apply a multiple towards the higher end of its historical trading range to reach our target price. Our target price implies a multiple of c29x FY08e EPS for Infosys.

## Risks

The risks that may prevent the Infosys stock from achieving our target price are:

- Any slowdown/uncertainty in IT spend in the US, the largest market for Indian IT services companies;
- Any significant appreciation of the rupee against the dollar will be detrimental to margins of IT services companies;
- Country risks, terrorist attacks and geopolitical risks, which may delay travel plans leading to a disruption in flow of volumes;
- Any significant policy change for taxes on profits of IT vendors before FY09, could have an impact on earnings.

# Financials & valuation: Infosys Technologies

Overweight

**Financial statements**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 95,216 | 140,292 | 187,391 | 241,412 |
| EBITDA | 30,917 | 44,943 | 59,287 | 75,236 |
| Depreciation & amortisation | -4,371 | -5,558 | -7,290 | -8,970 |
| Operating profit/EBIT | 26,546 | 39,385 | 51,997 | 66,266 |
| Net interest | 1,794 | 1,968 | 2,798 | 3,566 |
| PBT | 27,931 | 42,253 | 54,674 | 69,687 |
| HSBC PBT | 27,931 | 42,253 | 54,674 | 69,687 |
| Taxation | -3,132 | -4,980 | -6,636 | -9,180 |
| Net profit | 24,598 | 37,184 | 48,038 | 60,507 |
| HSBC net profit | 24,598 | 37,184 | 48,038 | 60,507 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 32,720 | 34,262 | 50,922 | 64,223 |
| Capex | -10,470 | -16,634 | -19,150 | -19,650 |
| Cash flow from investment | -10,470 | -16,614 | -19,150 | -19,650 |
| Dividends | -14,120 | -6,925 | -9,388 | -11,891 |
| Change in net debt | -13,977 | -12,698 | -23,636 | -33,934 |
| FCF equity | 16,304 | 17,187 | 27,640 | 39,649 |
| **Balance sheet summary (INRm)** | | | | |
| Tangible fixed assets | 22,260 | 33,337 | 45,196 | 55,876 |
| Current assets | 70,870 | 97,562 | 134,594 | 184,499 |
| Cash & others | 41,820 | 54,518 | 78,154 | 112,088 |
| Total assets | 93,800 | 131,688 | 180,580 | 241,165 |
| Operating liabilities | 9,340 | 15,223 | 19,961 | 25,609 |
| Gross debt | 0 | 0 | 0 | 0 |
| Net debt | -41,820 | -54,518 | -78,154 | -112,088 |
| Shareholders funds | 69,660 | 102,804 | 142,706 | 192,573 |
| Invested capital | 41,970 | 61,157 | 81,675 | 102,678 |

**Ratio, growth and per share analysis**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 33.5 | 47.3 | 33.6 | 28.8 |
| EBITDA | 32.4 | 45.4 | 31.9 | 26.9 |
| Operating profit | 29.6 | 48.4 | 32.0 | 27.4 |
| PBT | 26.0 | 51.3 | 29.4 | 27.5 |
| HSBC EPS | 31.0 | 48.8 | 29.2 | 26.0 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 2.6 | 2.7 | 2.6 | 2.6 |
| ROIC | 63.2 | 67.4 | 64.0 | 62.4 |
| ROE | 40.4 | 43.1 | 39.1 | 36.1 |
| ROA | 30.7 | 33.1 | 30.8 | 28.7 |
| EBITDA margin | 32.5 | 32.0 | 31.6 | 31.2 |
| Operating profit margin | 27.9 | 28.1 | 27.7 | 27.4 |
| Net debt/equity | -59.5 | -53.0 | -54.8 | -58.2 |
| Net debt/EBITDA (x) | -1.4 | -1.2 | -1.3 | -1.5 |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 43.77 | 65.49 | 84.61 | 106.57 |
| HSBC EPS (fully diluted) | 45.05 | 67.03 | 86.59 | 109.07 |
| DPS | 22.67 | 11.01 | 15.00 | 19.00 |
| NAV | 127.58 | 185.31 | 257.23 | 347.12 |

**Valuation data**

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| EV/sales | 11.8 | 7.9 | 5.8 | 4.4 |
| EV/EBITDA | 36.3 | 24.7 | 18.3 | 14.0 |
| EV/IC | 26.7 | 18.1 | 13.3 | 10.2 |
| PE* | 46.3 | 31.1 | 24.1 | 19.1 |
| P/NAV | 16.4 | 11.3 | 8.1 | 6.0 |
| FCF yield (%) | 1.4 | 1.5 | 2.4 | 3.4 |
| Dividend yield (%) | 1.1 | 0.5 | 0.7 | 0.9 |

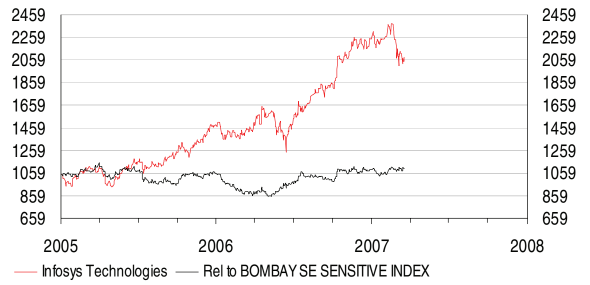
Note: * = Based on HSBC EPS (fully diluted)

**Issuer information**

| Share price (INR) | 2087.25 | Target price (INR) | 2560.00 | Potent'l tot rtn (%) | 22.6 |
|---|---|---|---|---|---|

| | | | |
|---|---|---|---|
| Reuters (Equity) | INFY.BO | Bloomberg (Equity) | INFO IN |
| Market cap (USDm) | 26,605 | Market cap (INRm) | 1,164,369 |
| Free float (%) | 78.3 | Enterprise value (INRm) | 1109851 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

**Price relative**




Source: HSBC

Note: price at close of 19 Mar 2007

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# Patni

- 1H07 likely to be muted due to seasonally weak 1Q and margin impact of salary hikes to be implemented in 2Q
- Sustainability of margins and enhancing internal efficiencies remain the primary concerns
- Currently trades at 12x FY08e and 11x FY09e EPS on earnings growth of 23% and 15% in FY08 and FY09e; maintain Neutral, target price INR465

## Valuations

We rate Patni Neutral with a target price of INR465 based on a rolling one-year forward PE of 12x. Our target PE was based on analysis of the historical trading pattern of the stock and its historical discount range to Satyam. Over the last three years, Patni has traded in a range of 8-16x its rolling one-year forward PE with an average of 12x. At its current stage of growth, we believe Patni should trade towards the lower end of its trading range. Our target price also implies a multiple of c15x based on 2007 EPS.

## Risks

Key concerns for Patni are managing the impact of rising costs on margins and restoring margins in line with peers. Other risk factors that may prevent Patni from achieving our target price are:

- Any slowdown/uncertainty in IT spend in the US as Patni has one of the highest exposures to US amongst peers;
- Any significant rupee appreciation will be detrimental to margins of IT services companies;
- Country risks, terrorist attacks and geopolitical risks;
- Management execution and sustainability of margins;
- Any higher than expected increase in onsite/offshore salaries;
- Upside risks include any large deals, and tighter control on cost management leading to improved margins

# Financials & valuation: Patni Computers

Neutral

**Financial statements**

| Year to | 12/2005a | 12/2006e | 12/2007e | 12/2008e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 20,242 | 26,551 | 33,383 | 41,110 |
| EBITDA | 3,926 | 4,838 | 5,966 | 6,997 |
| Depreciation & amortisation | -684 | -832 | -1,124 | -1,364 |
| Operating profit/EBIT | 3,242 | 4,006 | 4,842 | 5,633 |
| Net interest | 114 | 300 | 350 | 400 |
| PBT | 3,356 | 3,393 | 5,192 | 6,033 |
| HSBC PBT | 3,356 | 3,393 | 5,192 | 6,033 |
| Taxation | -620 | -926 | -1,002 | -1,189 |
| Net profit | 2,736 | 2,467 | 4,190 | 4,844 |
| HSBC net profit | 2,736 | 3,381 | 4,190 | 4,844 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 3,996 | 1,395 | 4,169 | 4,933 |
| Capex | -2,297 | -3,160 | -3,570 | -2,678 |
| Cash flow from investment | -2,297 | -3,160 | -3,570 | -2,678 |
| Dividends | -216 | -344 | -389 | -468 |
| Change in net debt | -6,044 | 1,345 | -364 | -2,050 |
| FCF equity | 1,699 | -852 | 599 | 2,255 |
| **Balance sheet summary (INRm)** | | | | |
| Tangible fixed assets | 3,997 | 6,325 | 8,771 | 10,085 |
| Current assets | 18,565 | 18,978 | 21,217 | 25,490 |
| Cash & others | 13,039 | 11,693 | 12,057 | 14,107 |
| Total assets | 24,842 | 27,584 | 32,269 | 37,856 |
| Operating liabilities | 3,538 | 4,080 | 4,887 | 6,021 |
| Gross debt | 519 | 519 | 519 | 519 |
| Net debt | -12,520 | -11,174 | -11,538 | -13,588 |
| Shareholders funds | 20,440 | 22,596 | 26,394 | 30,767 |
| Invested capital | 5,985 | 9,530 | 13,044 | 15,446 |

**Ratio, growth and per share analysis**

| Year to | 12/2005a | 12/2006e | 12/2007e | 12/2008e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 43.2 | 31.2 | 25.7 | 23.1 |
| EBITDA | 16.0 | 23.2 | 23.3 | 17.3 |
| Operating profit | 12.0 | 23.6 | 20.9 | 16.3 |
| PBT | 16.4 | 1.1 | 53.0 | 16.2 |
| HSBC EPS | -1.6 | 23.1 | 23.5 | 15.2 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 3.7 | 3.4 | 3.0 | 2.9 |
| ROIC | 47.8 | 37.5 | 34.6 | 31.7 |
| ROE | 16.3 | 15.7 | 17.1 | 17.0 |
| ROA | 13.5 | 9.4 | 14.0 | 13.8 |
| EBITDA margin | 19.4 | 18.2 | 17.9 | 17.0 |
| Operating profit margin | 16.0 | 15.1 | 14.5 | 13.7 |
| Net debt/equity | -61.2 | -49.5 | -43.7 | -44.2 |
| Net debt/EBITDA (x) | -3.2 | -2.3 | -1.9 | -1.9 |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 19.85 | 17.84 | 30.19 | 34.77 |
| HSBC EPS (fully diluted) | 19.86 | 24.44 | 30.19 | 34.78 |
| DPS | 2.00 | 2.50 | 3.00 | 3.50 |
| NAV | 148.34 | 163.38 | 190.16 | 220.87 |

**Valuation data**

| Year to | 12/2005a | 12/2006e | 12/2007e | 12/2008e |
|---|---|---|---|---|
| EV/sales | 2.0 | 1.6 | 1.2 | 1.0 |
| EV/EBITDA | 10.4 | 8.7 | 7.0 | 5.7 |
| EV/IC | 6.8 | 4.4 | 3.2 | 2.6 |
| PE* | 19.4 | 15.7 | 12.7 | 11.1 |
| P/NAV | 2.6 | 2.4 | 2.0 | 1.7 |
| FCF yield (%) | 3.2 | -1.6 | 1.1 | 4.2 |
| Dividend yield (%) | 0.5 | 0.6 | 0.8 | 0.9 |

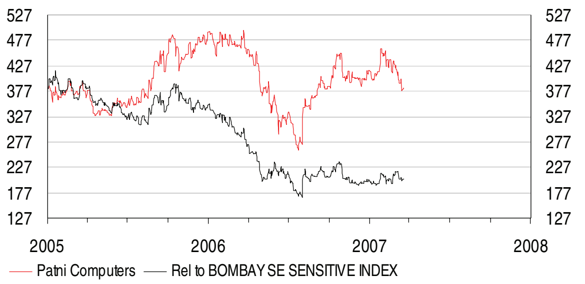
Note: * = Based on HSBC EPS (fully diluted)

**Issuer information**

| | | | | | |
|---|---|---|---|---|---|
| Share price (INR) | 392.0 | Target price (INR) | 465.00 | Potent'l tot rtn (%) | 18.6 |

| | | | |
|---|---|---|---|
| Reuters (Equity) | PTNI.BO | Bloomberg (Equity) | PATNI IN |
| Market cap (USDm) | 1,216 | Market cap (INRm) | 53,222 |
| Free float (%) | 18.4 | Enterprise value (INRm) | 42047 |
| Country | India | Sector | IT Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

**Price relative**




Source: HSBC

Note: price at close of 20 Mar 2007

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# Satyam

- We expect Satyam management to guide for EPS of cINR25 (+18%-20% y-o-y) for FY08e
- Business momentum remains strong; we expect more clarity on status of RSUs once the government policy on taxing ESOPs is outlined.
- Trades at 17x FY08e and 14x FY09e EPS for earnings growth of 24% and 19% in FY08 and FY09e respectively; reiterate Overweight, target price INR530

## Valuations

We rate Satyam Overweight with a target price of INR530 based on a rolling one-year forward PE of 18x. Our target PE is based on analysis of the historical trading pattern of the stock and its historical discount range to Infosys. Over the last three years, Satyam has traded in a range of 13-21x its rolling one-year forward PE.

At the current stage of its growth phase, we believe Satyam should trade towards the higher end of its historical trading range and apply an 18x multiple to derive our target price. This translates to a 25% discount to our target multiple for Infosys. Our target price implies a PE of 20x based on FY08e EPS.

## Risks

These are the risks that may prevent the Satyam stock from achieving our target price.

- Any slowdown/uncertainty in IT spend in the US, the largest market for Indian IT services companies;
- High concentration of revenues (42%) for enterprise business is a risk
- Any significant appreciation of the rupee against the dollar will be detrimental to margins of IT services companies;
- Country risks, terrorist attacks and geopolitical risks may delay travel plans leading to a disruption in flow of volumes

HSBC

# Financials & valuation: Satyam Computer

Overweight

### Financial statements

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 47,926 | 65,320 | 85,946 | 108,655 |
| EBITDA | 11,661 | 15,374 | 19,636 | 24,114 |
| Depreciation & amortisation | -1,373 | -1,641 | -1,847 | -2,309 |
| Operating profit/EBIT | 10,288 | 13,734 | 17,789 | 21,805 |
| Net interest | 1,107 | -108 | -110 | -110 |
| PBT | 11,401 | 15,465 | 19,730 | 23,622 |
| HSBC PBT | 11,401 | 15,465 | 19,730 | 23,622 |
| Taxation | -1,509 | -1,763 | -2,682 | -3,382 |
| Net profit | 9,819 | 13,702 | 17,048 | 20,239 |
| HSBC net profit | 9,819 | 13,702 | 17,048 | 20,239 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 8,580 | 14,818 | 17,383 | 20,660 |
| Capex | -3,167 | -4,152 | -10,421 | -14,214 |
| Cash flow from investment | -2,404 | -4,152 | -10,421 | -14,214 |
| Dividends | -1,968 | -1,967 | -2,248 | -2,529 |
| Change in net debt | -6,578 | -10,205 | -6,889 | -6,361 |
| FCF equity | 4,544 | 8,045 | 3,805 | 3,423 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 0 | 0 | 0 | 0 |
| Tangible fixed assets | 5,573 | 8,084 | 16,658 | 28,563 |
| Current assets | 45,752 | 59,061 | 70,412 | 81,584 |
| Cash & others | 31,117 | 41,587 | 48,476 | 54,836 |
| Total assets | 51,371 | 67,586 | 87,583 | 110,746 |
| Operating liabilities | 4,370 | 5,903 | 7,746 | 9,574 |
| Gross debt | 1,027 | 1,292 | 1,292 | 1,292 |
| Net debt | -30,090 | -40,295 | -47,184 | -53,545 |
| Shareholders funds | 43,173 | 56,849 | 73,897 | 94,137 |
| Invested capital | 15,837 | 19,656 | 30,848 | 45,737 |

### Ratio, growth and per share analysis

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 36.1 | 36.3 | 31.6 | 26.4 |
| EBITDA | 34.6 | 31.8 | 27.7 | 22.8 |
| Operating profit | 36.7 | 33.5 | 29.5 | 22.6 |
| PBT | 35.9 | 35.6 | 27.6 | 19.7 |
| HSBC EPS | 35.3 | 38.3 | 24.4 | 18.7 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 3.6 | 3.7 | 3.4 | 2.8 |
| ROIC | 67.8 | 68.6 | 60.9 | 48.8 |
| ROE | 25.8 | 27.4 | 26.1 | 24.1 |
| ROA | 22.4 | 23.2 | 22.1 | 20.5 |
| EBITDA margin | 24.3 | 23.5 | 22.8 | 22.2 |
| Operating profit margin | 21.5 | 21.0 | 20.7 | 20.1 |
| EBITDA/net interest (x) | | 142.6 | 178.2 | 218.9 |
| Net debt/equity | -69.6 | -70.9 | -63.9 | -56.9 |
| Net debt/EBITDA (x) | -2.6 | -2.6 | -2.4 | -2.2 |
| CF from operations/net debt | | | | |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 14.58 | 20.33 | 25.30 | 30.03 |
| HSBC EPS (fully diluted) | 15.16 | 20.97 | 26.09 | 30.97 |
| DPS | 3.53 | 3.50 | 4.00 | 4.50 |
| NAV | 66.64 | 86.99 | 113.07 | 144.04 |

### Valuation data

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| EV/sales | 5.3 | 3.7 | 2.8 | 2.1 |
| EV/EBITDA | 21.9 | 15.9 | 12.1 | 9.6 |
| EV/IC | 16.1 | 12.5 | 7.7 | 5.1 |
| PE* | 28.6 | 20.7 | 16.6 | 14.0 |
| P/NAV | 6.5 | 5.0 | 3.8 | 3.0 |
| FCF yield (%) | 1.6 | 2.8 | 1.3 | 1.2 |
| Dividend yield (%) | 0.8 | 0.8 | 0.9 | 1.0 |

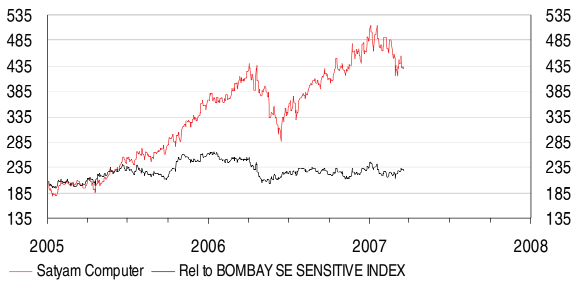
Note: * = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (INR) 433.15 Target price (INR) 530.00 Potent'l tot rtn (%) 22.4

| | | | |
|---|---|---|---|
| Reuters (Equity) | SATY.BO | Bloomberg (Equity) | SCS IN |
| Market cap (USDm) | 6,517 | Market cap (INRm) | 285,196 |
| Free float (%) | 84.3 | Enterprise value (INRm) | 244901 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

### Price relative




Source: HSBC

Note: price at close of 19 Mar 2007

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# Tata Consultancy (TCS)

- Focus on cross-selling services and establishing delivery centres in Latin America
- We expect TCS to grow earnings by 27% in FY08 and 23% in FY09e
- Currently trades at 23x FY08e and 19x FY09e EPS; maintain Overweight, target price INR1,600

## Valuation

We rate TCS Overweight with a target price of INR1,600, based on a higher rolling one-year forward PE of 25x. Our target PE is based on analysis of the historical trading patterns of the stock and its discount range to Infosys. Over the last year TCS has largely traded at a discount to Infosys, with a maximum of 0-15% and an average of 5% over the last two years. At the current stage of TCS's growth phase, we believe the stock should trade at the higher end of its historical trading range and apply an in line multiple with our Infosys valuations for our target price.

## Risks

Key risk factors are:

- Given its focus on inorganic growth, acquisition and execution-related risks are the primary risks for TCS;
- Any slowdown in or uncertainty about IT spend in the US, the largest market for Indian IT services companies;
- Any significant appreciation of the rupee against the dollar could be detrimental to margins of IT services companies;
- Country risks, terrorist attacks, and geopolitical risks may have an impact on projects;
- TCS's limited disclosures, despite one of the strongest industry processes, is a cause for concern, in our view

HSBC

# Financials & valuation: TCS

Overweight

## Financial statements

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 132,455 | 186,165 | 244,511 | 312,305 |
| EBITDA | 36,947 | 51,251 | 66,357 | 82,425 |
| Depreciation & amortisation | -2,810 | -4,029 | -5,257 | -6,090 |
| Operating profit/EBIT | 34,137 | 47,222 | 61,100 | 76,335 |
| Net interest | 350 | 421 | 640 | 640 |
| PBT | 34,327 | 48,331 | 62,230 | 77,577 |
| HSBC PBT | 34,327 | 48,331 | 62,230 | 77,577 |
| Taxation | -4,989 | -6,544 | -9,212 | -12,073 |
| Net profit | 29,074 | 41,454 | 52,618 | 65,044 |
| HSBC net profit | 29,074 | 41,454 | 52,618 | 65,044 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 23,024 | 24,379 | 44,121 | 51,147 |
| Capex | -7,012 | -8,597 | -8,385 | -12,504 |
| Cash flow from investment | -10,089 | -11,079 | -12,837 | -19,014 |
| Dividends | -6,606 | -11,743 | -14,679 | -17,615 |
| Change in net debt | -2,281 | -1,911 | -20,449 | -22,526 |
| FCF equity | 16,172 | 15,094 | 35,247 | 38,040 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 8,692 | 13,568 | 13,568 | 13,568 |
| Tangible fixed assets | 15,072 | 19,639 | 22,767 | 29,182 |
| Current assets | 49,600 | 81,435 | 126,280 | 187,615 |
| Cash & others | 3,965 | 5,698 | 26,147 | 48,673 |
| Total assets | 94,318 | 143,252 | 196,816 | 272,460 |
| Operating liabilities | 24,675 | 34,004 | 44,188 | 62,879 |
| Gross debt | 979 | 802 | 802 | 802 |
| Net debt | -2,986 | -4,896 | -25,345 | -47,871 |
| Shareholders funds | 58,408 | 82,881 | 122,344 | 171,128 |
| Invested capital | 44,723 | 74,940 | 92,279 | 118,812 |

## Ratio, growth and per share analysis

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 36.2 | 40.6 | 31.3 | 27.7 |
| EBITDA | 29.6 | 38.7 | 29.5 | 24.2 |
| Operating profit | 26.8 | 38.3 | 29.4 | 24.9 |
| PBT | 24.0 | 40.8 | 28.8 | 24.7 |
| HSBC EPS | 21.1 | 42.6 | 26.9 | 23.6 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 3.8 | 3.1 | 2.9 | 3.0 |
| ROIC | 82.8 | 68.2 | 62.3 | 61.1 |
| ROE | 64.3 | 58.7 | 51.3 | 44.3 |
| ROA | 40.8 | 35.2 | 31.2 | 27.9 |
| EBITDA margin | 27.9 | 27.5 | 27.1 | 26.4 |
| Operating profit margin | 25.8 | 25.4 | 25.0 | 24.4 |
| Net debt/equity | -5.0 | -5.7 | -20.2 | -27.4 |
| Net debt/EBITDA (x) | -0.1 | -0.1 | -0.4 | -0.6 |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 29.71 | 42.36 | 53.77 | 66.47 |
| HSBC EPS (fully diluted) | 29.71 | 42.36 | 53.77 | 66.47 |
| DPS | 6.75 | 12.00 | 15.00 | 18.00 |
| NAV | 59.69 | 84.69 | 125.02 | 174.87 |

## Valuation data

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| EV/sales | 9.2 | 6.5 | 4.9 | 3.7 |
| EV/EBITDA | 33.1 | 23.8 | 18.0 | 14.1 |
| EV/IC | 27.4 | 16.3 | 12.9 | 9.8 |
| PE* | 42.4 | 29.8 | 23.5 | 19.0 |
| P/NAV | 21.1 | 14.9 | 10.1 | 7.2 |
| FCF yield (%) | 1.3 | 1.2 | 2.9 | 3.1 |
| Dividend yield (%) | 0.5 | 1.0 | 1.2 | 1.4 |

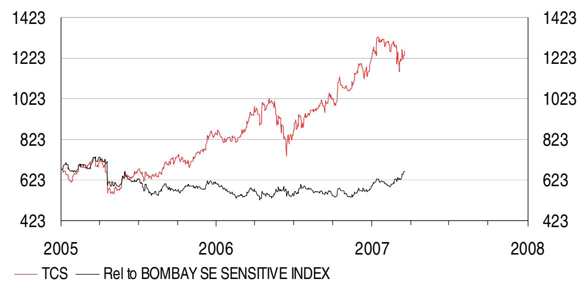
Note: * = Based on HSBC EPS (fully diluted)

## Issuer information

| Share price (INR) | 1260.9 | Target price (INR) | 1600.0 | Potent'l tot rtn (%) | 26.9 |
|---|---|---|---|---|---|

| | | | |
|---|---|---|---|
| Reuters (Equity) | TCS.BO | Bloomberg (Equity) | TCS IN |
| Market cap (USDm) | 28,194 | Market cap (INRm) | 1,233,930 |
| Free float (%) | 15.2 | Enterprise value (INRm) | 1219277 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

## Price relative




Source: HSBC

Note: price at close of 19 Mar 2007

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# Wipro

- Focus on improving sales efficiencies by addressing potential USD100m clients over the next three years
- Acquisitions likely to be margin dilutive but overall margins will be maintained in a narrow band; management plans to make acquisitions non-disruptive to the organic business
- We expect Wipro to grow revenue and profit at 31% and 27% in FY08e; currently trades at 23x FY08e and 19x FY09e EPS; maintain Overweight, target price INR750

## Valuations

We rate Wipro Overweight with a target price of INR750 based on a rolling one-year forward PE of 25x. Our target PE is derived from analysis of the historical trading pattern of the stock and its trading range compared to Infosys. Over the last three years, Wipro has traded in a range of 17-30x its forward one-year rolling PE. Its PE premium to Infosys has been 0-30% over the last two years. More recently, Wipro has traded at a 1-10% discount to Infosys (breached on occasions). At the current stage of its growth phase we use 25x rolling one-year forward PE which is in line with its historical trading range and the multiple used for Infosys.

## Risks

These are the key risks that may prevent Wipro from achieving our target price:

- High exposure to technology verticals; diversifying its presence to other verticals will help Wipro address this risk;
- Any slowdown/uncertainty in IT spend in the US, the largest market for Indian IT services companies;
- Any significant appreciation of the rupee against the dollar would be detrimental to margins of IT services companies;
- Country risks, terrorist attacks and geopolitical risks may delay travel plans, leading to a disruption in flow of volumes;
- Any reduction in the number of H1B visas granted by the US would have an adverse impact on business prospects of India offshore vendors;
- Liabilities that Wipro carries for clients while signing projects

# Financials & valuation: Wipro

Overweight

## Financial statements

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Profit & loss summary (INRm)** | | | | |
| Revenue | 105,694 | 149,113 | 194,879 | 239,889 |
| EBITDA | 25,606 | 34,585 | 44,617 | 54,460 |
| Depreciation & amortisation | -3,099 | -4,175 | -5,457 | -6,717 |
| Operating profit/EBIT | 22,506 | 30,410 | 39,160 | 47,743 |
| Net interest | 1,034 | 2,272 | 2,527 | 3,376 |
| PBT | 23,908 | 32,682 | 41,687 | 51,118 |
| HSBC PBT | 23,908 | 32,682 | 41,687 | 51,118 |
| Taxation | -3,391 | -4,297 | -5,490 | -7,271 |
| Net profit | 20,804 | 28,665 | 36,534 | 44,253 |
| HSBC net profit | 20,804 | 28,665 | 36,534 | 44,253 |
| **Cash flow summary (INRm)** | | | | |
| Cash flow from operations | 19,023 | 28,061 | 35,728 | 45,138 |
| Capex | -7,702 | -9,772 | -12,324 | -14,300 |
| Cash flow from investment | -7,976 | -9,772 | -12,324 | -14,300 |
| Dividends | -3,972 | -8,642 | -9,674 | -11,372 |
| Change in net debt | -10,029 | -5,586 | -14,069 | -19,875 |
| FCF equity | 10,954 | 18,289 | 23,404 | 30,838 |
| **Balance sheet summary (INRm)** | | | | |
| Intangible fixed assets | 3,528 | 7,899 | 7,899 | 7,899 |
| Tangible fixed assets | 18,154 | 23,751 | 30,618 | 38,201 |
| Current assets | 72,384 | 87,565 | 115,459 | 148,529 |
| Cash & others | 38,675 | 44,261 | 58,331 | 78,205 |
| Total assets | 99,170 | 132,986 | 173,238 | 221,162 |
| Operating liabilities | 20,642 | 30,034 | 43,424 | 58,464 |
| Gross debt | 757 | 757 | 757 | 757 |
| Net debt | -37,918 | -43,504 | -57,573 | -77,448 |
| Shareholders funds | 66,114 | 85,226 | 110,479 | 141,807 |
| Invested capital | 34,750 | 44,920 | 52,222 | 57,961 |

## Ratio, growth and per share analysis

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| **Y-o-y % change** | | | | |
| Revenue | 30.2 | 41.1 | 30.7 | 23.1 |
| EBITDA | 25.8 | 35.1 | 29.0 | 22.1 |
| Operating profit | 25.7 | 35.1 | 28.8 | 21.9 |
| PBT | 27.3 | 36.7 | 27.6 | 22.6 |
| HSBC EPS | 26.9 | 35.9 | 26.7 | 20.1 |
| **Ratios (%)** | | | | |
| Revenue/IC (x) | 3.4 | 3.7 | 4.0 | 4.4 |
| ROIC | 61.8 | 66.3 | 70.0 | 74.3 |
| ROE | 35.0 | 37.9 | 37.3 | 35.1 |
| ROA | 23.2 | 24.5 | 23.7 | 22.3 |
| EBITDA margin | 24.2 | 23.2 | 22.9 | 22.7 |
| Operating profit margin | 21.3 | 20.4 | 20.1 | 19.9 |
| Net debt/equity | -57.4 | -51.0 | -52.1 | -54.6 |
| Net debt/EBITDA (x) | -1.5 | -1.3 | -1.3 | -1.4 |
| **Per share data (INR)** | | | | |
| EPS Rep (fully diluted) | 14.57 | 19.81 | 25.10 | 30.15 |
| HSBC EPS (fully diluted) | 14.57 | 19.81 | 25.10 | 30.15 |
| DPS | 4.99 | 5.91 | 6.92 | 7.86 |
| NAV | 46.30 | 58.89 | 75.89 | 96.61 |

## Valuation data

| Year to | 03/2006a | 03/2007e | 03/2008e | 03/2009e |
|---|---|---|---|---|
| EV/sales | 7.5 | 5.3 | 4.0 | 3.2 |
| EV/EBITDA | 31.1 | 22.8 | 17.4 | 13.9 |
| EV/IC | 22.9 | 17.6 | 14.9 | 13.0 |
| PE* | 39.7 | 29.2 | 23.0 | 19.2 |
| P/NAV | 12.5 | 9.8 | 7.6 | 6.0 |
| FCF yield (%) | 1.3 | 2.2 | 2.8 | 3.7 |
| Dividend yield (%) | 0.9 | 1.0 | 1.2 | 1.4 |

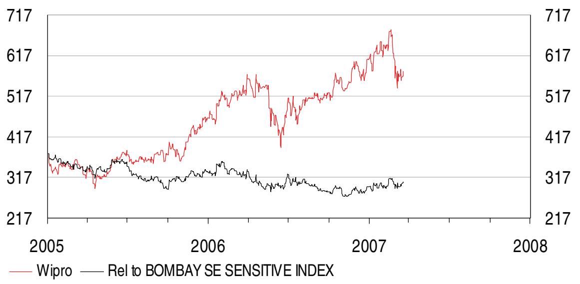
Note: * = Based on HSBC EPS (fully diluted)

## Issuer information

| | | | | | |
|---|---|---|---|---|---|
| Share price (INR) | 578.25 | Target price (INR) | 750.00 | Potent'l tot rtn (%) | 29.7 |

| | | | |
|---|---|---|---|
| Reuters (Equity) | WIPR.BO | Bloomberg (Equity) | WPRO IN |
| Market cap (USDm) | 19,061 | Market cap (INRm) | 834,219 |
| Free float (%) | 16.9 | Enterprise value (INRm) | 789733 |
| Country | India | Sector | It Services |
| Analyst | Vipin Khare | Contact | +9122 22681238 |

## Price relative




Source: HSBC

Note: price at close of 19 Mar 2007

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# Disclosure appendix

## Analyst certification

The following analyst(s), who is(are) primarily responsible for this report, certifies(y) that the views expressed herein accurately reflect their personal view(s) about the subject security(ies) and issuer(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Vipin Khare

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This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at www.hsbcnet.com/research. Details of these short-term investment opportunities can be found under the Reports section of this website.

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

## Rating distribution for long-term investment opportunities

**As of 22 March 2007, the distribution of all ratings published is as follows:**

| | | |
|---|---|---|
| **Overweight (Buy)** | 44% | (16% of these provided with Investment Banking Services) |
| **Neutral (Hold)** | 37% | (16% of these provided with Investment Banking Services) |
| **Underweight (Sell)** | 19% | (11% of these provided with Investment Banking Services) |

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| Company | Ticker | Recent price | Price Date | Disclosure |
|---|---|---|---|---|
| HCL TECHNOLOGIES | HCLT.NS | 297.05 | 21-Mar-2007 | 4 |
| HEXAWARE | HEXT.BO | 151.70 | 21-Mar-2007 | 4 |
| PATNI COMPUTERS | PTNI.NS | 391.65 | 21-Mar-2007 | 4 |
| SATYAM COMPUTER | SATY.NS | 451.35 | 21-Mar-2007 | 4 |
| WIPRO | WIPR.BO | 581.75 | 21-Mar-2007 | 6, 7 |

Source: HSBC

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2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
3 At the time of publication of this report, HSBC is a market maker in securities issued by this company.
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6 As of 31 January 2007, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking-securities related services.
7 As of 31 January 2007, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
8 A covering analyst/s has received compensation from this company in the past 12 months.
9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
10 A covering analyst/s or a member of his/her household is an officer, director or supervisory board member of this company, as detailed below.

Analysts are paid in part by reference to the profitability of HSBC which includes investment banking revenues.

For disclosures in respect of any company, please see the most recently published report on that company available at www.hsbcnet.com/research.

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2 All market data included in this report are dated as at close 19 March 2007, unless otherwise indicated in the report.
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