Man Financial

IT sector earnings preview: Offshore uninterrupted

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Volumes: No slowdown in the offing

Interest in offshore continues unabated

We believe that volume growth for the industry majors is a non-issue. The industry continues to see steady addition of new large customers. The activity is also spreading across more industry verticals with new prospects coming from manufacturing and entertainment. However, even now, BFSI remains the key industrial vertical.

Deals closures picking up; most contracts could ramp up in FY07

Deals closures picked up at the end of 2005 and have persisted in this year too. Large Indian IT companies have been bidding and winning few mega-contracts (size in excess of US$ 1bn). We believe that most of these contracts will start ramping up in FY07 and could be potential revenue growth drivers over the coming couple of years.

Global IT companies looking at India for their back-end functions

The other highlight in recent months has been that global IT service companies are getting aggressive about building their Indian back ends.

We expect volume growth to be:

TCS	:	6.1%
Infosys	:	9.0%
Wipro	:	4.5%
Satyam	:	5.3%
Mastek	:	4.0%

Polarisation seen in the long term

We believe business volumes will continue to grow strongly in the medium term. However, with global IT service companies getting increasingly active, competition will increase. Over the last 18 months, the industry has become more polarised with the top-tier Indian IT services companies grabbing a significant portion of the business — a trend that will escalate going forward. Eventually, the top 3-4 Indian IT companies will compete with global IT services majors and other smaller ones will fall behind and look at alternate strategies.

	Sales			EBITDA			Net Profit			EPS (Rs)	P/E (x)
Rs mn	Q1FY07E	Q4FY06	%chg	Q1FY07E	Q4FY06	%chg	Q1FY07E	Q4FY06	%chg	FY07E	FY07E
TCS	39,917	37,092	7.6	10,418	9,921	5.0	8,422	8,419	0.04	80.2	21.8
Infosys	29,231	26,240	11.4	9,091	8,330	9.1	7,301	6,800	7.4	116.6	26.6
Wipro	31,092	30,719	1.2	7,089	7,137	-0.7	5,779	6,124	-5.6	17.2	27.2
Satyam	13,955	13,140	6.2	3,443	3,349	2.8	2,898	2,852	1.6	36.0	19.2
Mastek*	1,860	1,774	4.8	342	322	6.2	209	173	20.8	34	10.2

* Q4 estimates Source: Company, Man Financial Research

Topline growth to be robust

Revenues are expected to grow by 5-11% backed by strong volume growth and higher realisation in rupee terms due to 2.2% rupee depreciation. Infosys will lead the pack with a sequential growth of 11.4% while Wipro's global IT revenues are expected to grow by 5.8%. TCS and Satyam are expected to grow sequentially by 6% and 7%, respectively. Mastek will be reporting its Q4FY06 numbers (June ending) and we expect a sequential topline growth of 4.9%.

Topline drivers for Q1FY07

	Volumes	Price	Offshore Utilization	Overall revenues
TCS	6.1%	0%	68%	7.6%
Infosys	9.0%	0%	77%	11.4%
Wipro*	4.5%	0%	64%	6.2%
Satyam	5.3%	0%	74%	6.2%
Mastek	4.0%	0%	80%	4.9%

* Global IT services

Source: Company, Man Financial Research

Pricing remains stable

All the companies have indicated a 3-5% higher pricing from new customers led by non-ADM offerings. However, we have assumed flat pricing in our estimates for all companies.

Margins

EBITDA margins to decline almost across the board

Rupee depreciation will partially absorb the pressure on EBITDA margins due to salary hikes. A 2.2% rupee depreciation is expected to restrict pressure over operating margins to 65-90bps. We expect:

- A 65bps qoq decline for Infosys.
- A higher margin decline of 65% for TCS, due to realignment of onsite salaries in Europe to industry levels.
- Wipro's EBITDA margins to be under pressure (43bps) due to single-digit margins in few of its acquired companies.
- Satyam's EBITDA margins to decline by 81bps (against the management's guidance of a 100bps decline).
- Mastek's EBITDA margins to improve by 40bps (no salary hikes in this quarter and rupee depreciation).

	Salary	SG&A	EBITDA margins
TCS	⇧	⇧	⇩ (65bps)
Infosys	⇧	⇔	⇩ (65bps)
Wipro	⇔	⇧	⇩ (45bps)
Satyam	⇧	⇔	⇩ (81bps)
Mastek	⇔	⇔	⇧ (40bps)

Source: Company, Man Financial Research

Net profit growth to be impacted due to forex losses

Net profit growth is not expected to be in sync with the topline growth, as most of the companies will book forex losses on their hedging contracts. TCS' and Wipro's forex losses are expected to be higher. We expect:

- Infosys to have the highest sequential net profit growth at 7.4%
- Wipro's net profit to see a decline of 5.6% led by seasonality in its India & APAC business.
- TCS' profit growth to be flat
- Satyam's profit growth at 2%
- Mastek's net profit growth at 21% mainly due to lower tax provision.

Valuations

We remain positive on the fundamentals of the sector and expect strong business traction to result in continued strong financial performance over the next 9-12 months. While the sector has underperformed the Sensex by 6%, we believe that sustained strength in financial performance make way for share price appreciation from a one-year perspective.

On a relative basis, our top picks are Infosys and TCS among large caps and Mastek among mid caps.

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