Prabhudas Lilladher

Indian Technology

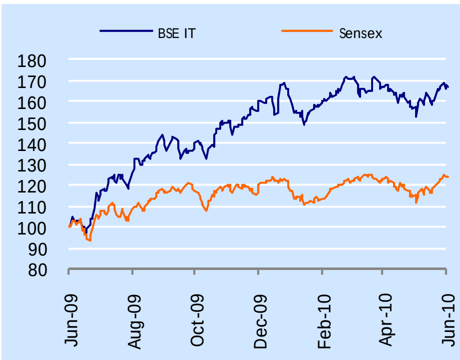
EU-'*phoria*' or EU-'*phobia*'

June 24, 2010

Shashi Bhusan
ShashiBhusan@PLIndia.com
+91-22-6632 2300

Sector Update

BSE Sensex v/s IT Index



Source: Bloomberg

Absolute Stock Performance

(%)	1M	6M	12M
Sensex	**7.7**	**2.1**	**22.9**
CNX IT Index	**6.7**	**3.2**	**73.0**
Geometric	8.3	(2.4)	150.4
HCL Tech.	(3.0)	(4.2)	87.9
Infosys Tech.	8.5	8.8	60.2
KPIT Cummins	55.4	12.3	200.6
Mphasis	(11.5)	(22.6)	44.6
MindTree	4.0	(19.3)	22.8
Patni Computer	(7.6)	7.2	101.1
Rolta India	0.9	(10.5)	31.0
TCS	9.4	4.9	105.5
Tech Mahindra	11.6	(26.3)	(2.8)
Wipro	3.3	(3.6)	75.6

We believe that the announcement made by George Osborne, UK's Chancellor of the Exchequer, in the House of Commons about the budget cut of 25% for most of the department will have little or no impact on the earnings of Tier-1 Indian IT Services companies. We look at the current stock correction as an opportunity to enter the stock.

- **Recent weakness gives great entry point for HCL Tech:** Our analysis shows that TCS, Infosys, Wipro and HCL Tech would not suffer any deceleration in their revenue momentum, even if the UK government spending was to be cut by 50% for discretionary projects and by 10-20% for outsourcing contracts, depending on their expiry dates. Although we can always forecast a more bearish scenario, where recession measures spill over to the private sector, our recent checks suggest that AMJ-10 deal pipeline looks very healthy overall, supporting a return to growth in H2CY10. As a result, we believe that the recent weakness represents a good entry point to buy Tier-1, especially HCL Tech.
- **UK public sector spending would drive no change in earnings estimate:** In our view, the biggest risks from the recent government announcements are from consulting and system integration work, which could be cut by 50%. Outsourcing contract will obviously be under pressure too, but their stronger contractual nature gives them some better protection. Overall, exposure to the government sector is <1% for Infosys, <3% for TCS, <4% for Wipro and <7% for HCL Tech, whereas exposure to the UK government is even lesser, with no exposure for Infosys and Wipro, <1% for TCS and <4% for HCL Tech, implying 0% risk for Infosys and less than a percent risk for TCS, Wipro and HCL Tech for FY11 EPS estimates.
- **Cost-cutting and austerity to give thrust to offshoring; demand strong:** We believe that cost-cutting measures taken by the European government in order to bridge the gap in fiscal deficit would increase acceptability of offshoring (especially in continental Europe). Also, according to our hypothesis, demand recovery in IT is largely driven by public consumption in the first leg of recovery. Our channel checks bode well in terms of H2CY10 demand recovery from Europe.
- **Reiterate Tier-1 as our favourite pick:** We believe that some outsourcing deals could see strong pressure if they are set to expire within the next two years. We believe that concern of deceleration in the earnings momentum due to subdued government spending is overdone. We expect Tier-1 IT Services to continue its earnings momentum. We reiterate our '**BUY**' on Infosys and TCS and '**Accumulate**' on HCL Tech and Wipro, with a target price of Rs3,250, Rs990, Rs430 and Rs480, respectively.

TCS and Infosys – best bet, but HCL Tech gaining momentum

	Rating	Current Price (Rs)	Target Price (Rs)	Upside	Revenue (Rs m)			EPS (Rs)			EPS
					FY10	FY11	FY12	FY10	FY11	FY12	CAGR
Infosys	BUY	2,818	3,250	15.3%	227,420	257,916	293,858	109.8	125.0	135.7	11.2%
TCS	BUY	775	990	27.7%	300,289	337,530	397,643	35.1	36.2	41.5	8.7%
Wipro	Acc.	401	480	19.7%	271,277	299,304	365,971	19.0	20.4	21.6	6.6%
HCL Tech	Acc.	359	430	19.8%	122,383	132,148	150,087	19.4	22.8	25.0	13.4%

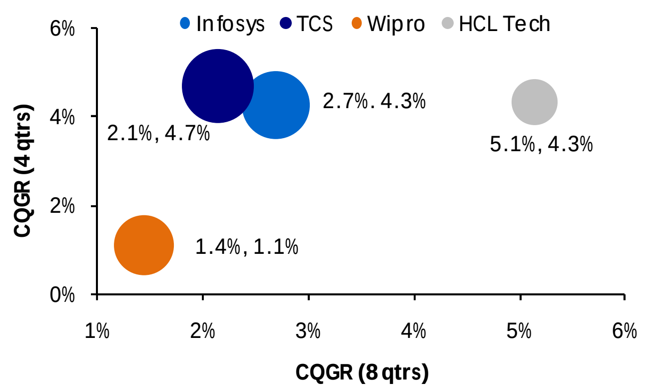
Source: Company Data, PL Research *(All Prices as on June 24, 2010)*

Putting things in perspective

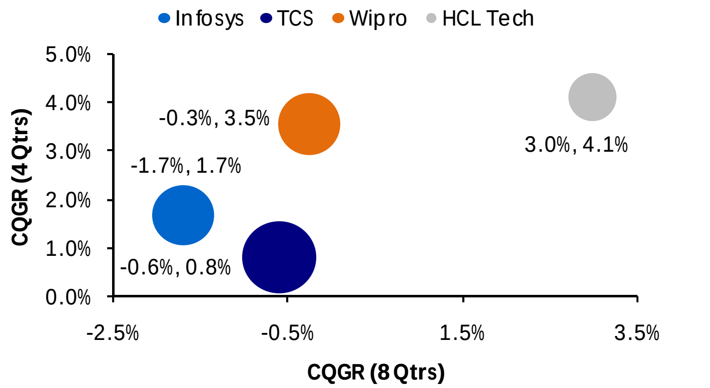
Recent European government austerity measures have raised concerns about its impact on the Indian IT services player. We have estimated that Tier-1 Indian IT services companies have less than a percent earning at risk. HCL Tech has the highest exposure to the government sector and has less than 4% revenue exposed to the European government spending. Due to a relative performance over the last one month, we prefer HCL Tech. We also continue to prefer Infosys and TCS over other Indian IT Services companies.

HCL Tech - strongest performer in Europe despite a challenging environment: HCL Tech reported strongest growth among peers over the last eight and four quarters in terms of revenue CQGR, both in Europe and the US. Despite a challenging environment in Europe, HCL Tech managed to win large business transformational deals.

US Rev - HCL Tech outgrowing peers



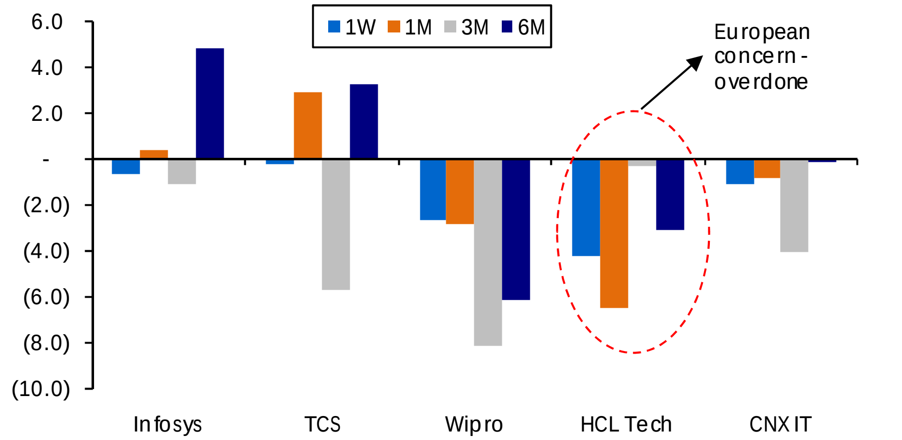
Europe Rev - HCL Tech's strong outperformance



Source: Company Data, PL Research, (x,y)::(8 qtrs, 4 qtrs)CQGR

However, HCL Tech's stock price (7% underperformance in one month relative to NIFTY50) has been under pressure due to its high exposure to Europe; we believe that this concern is overdone. No contract of HCL Tech is exposed to termination or cancellation. However, we do expect that some of the existing contracts may come for renegotiation as government tries to push for rate negotiation.

Relative Performance (NIFTY); HCL Tech witnessed sharpest correction

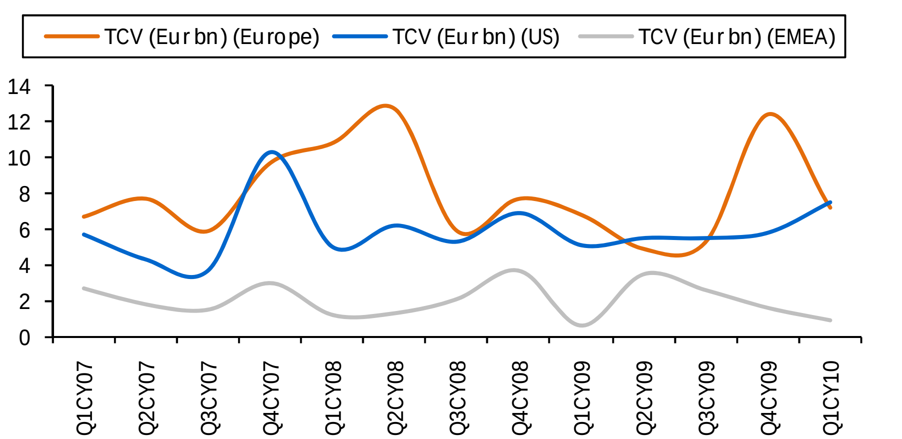


Source: Bloomberg, PL Research

Deal flow from Europe stronger than the US

According to TPI, over the last eight and four quarters, Europe has outsourced TCV (total contract value) of €62.9bn and €29.8bn, respectively, whereas the US has outsourced €47.8bn and €24.3bn, respectively. We believe that in the absence of public sector spending, spending by private sector would be a key. We expect the private sector to continue with their IT spend that will drive the growth in Europe for Tier-1 Indian IT Services companies.

TCV from Europe much stronger than that from the US



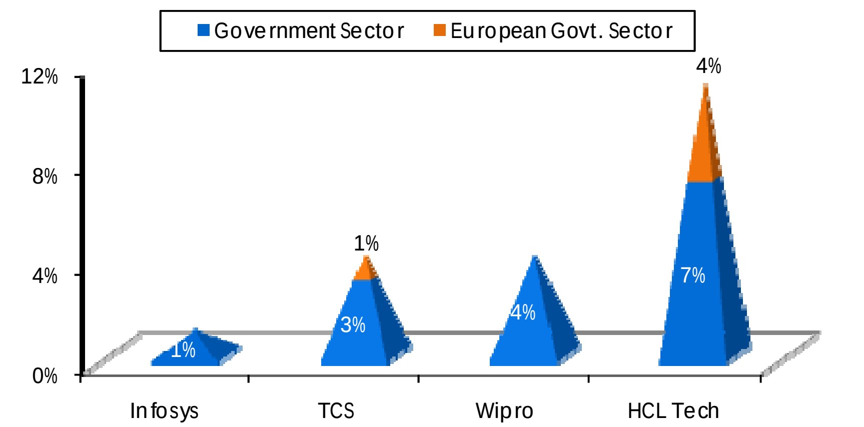
Source: TPI, PL Research

Dig at European public sector

Exposure of the Indian IT Services companies is concentrated around the expenditure of the UK government. We believe that the most likely area to be cut would be the discretionary spend of the government like consulting, package implementation and system integration. However, most of the work that Indian IT services do for the government is '*keeping the lights on*' in nature. We believe that the current austerity measure would benefit IT outsource (offshoring) as it helps containing the cost of a department.

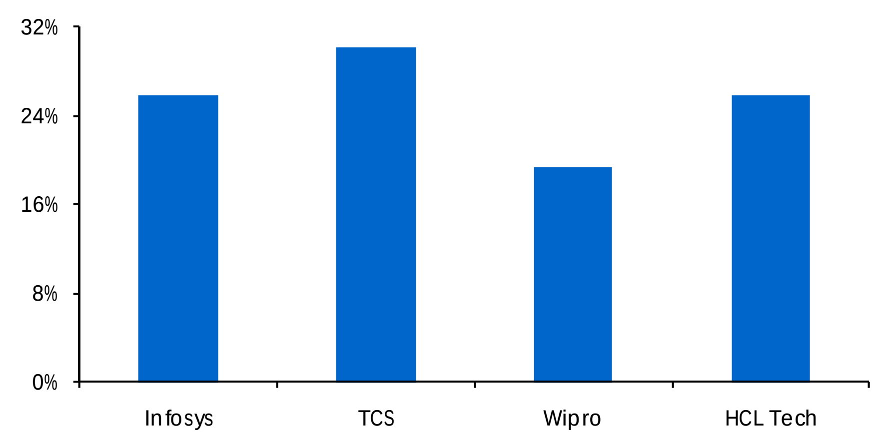
There is a possibility of outsourcing contract being renegotiated (in terms of price), terminated or curtailed (in terms of scope). There is also a possibility of budget cut for the existing IT project (rate card negotiation) which could put pressure on the margin of the existing contract. However, strong offshoring model of Indian IT companies would help them deliver services with little or no impact on margins.

European government sector - not a material exposure for Tier-1 Indian IT



Source: Company Data, approximated using public information

European exposure less than one-third of revenue



Source: Company Data, PL Research

According to media report, UK's Minister for Pensions, Steve Webb, had indicated that his government will review the pension's contract. Also, George Osborne has indicated that treasury is going to have a relook at all the contracts awarded after January 1, 2010. According to our deal summary, barring one contract signed by TCS, no other companies face any risk. According to the TCS management, the company has not received any notification, either from pension authority or from the UK treasury.

Selected deal wins from the UK government – Indian IT least exposed

Vendor	Outsourcer	Announced	Deal Size ($m)	Run Rate ($m)
BT	Department for Work and Pensions	Q1CY10	360	120
Tata	Department for Work and Pensions (Personal Accounts Delivery Authority)	Q1CY10	911	91
Fujitsu	Department for Work and Pensions	Q1CY10	456	76
Atos	Department for International Development	Q1CY10	14	14
HP	Ministry of Defence	Q4CY09	820	156
HP	Ministry of Defence	Q4CY09	420	140
Capgemini	Environment Agency of England and Wales	Q4CY09	759	108
Atos	Department for Work and Pensions	Q4CY09	531	106
IBM	Essex County Council	Q4CY09	774	97
Fujitsu	Home Office	Q4CY09	501	84
IBM	Department for Transport (Driver and Vehicle Licensing	Q4CY09	182	61
Capita	Department of Health (NHS Business Services Authority)	Q4CY09	202	29
Atos	Home Office	Q4CY09	152	25
Capita	Department for Children, Schools and Families	Q4CY09	24	24
Fujitsu	Highland Council	Q4CY09	100	20
Tata	County Council of the City and County of Cardiff	Q4CY09	228	15
HP	Department of Health	Q3CY09	106	106
Logica	Crown Prosecution Service	Q3CY09	172	57
BT	Ministry of Defence	Q3CY09	150	30
Liberata	Department for Culture, Media & Sport	Q3CY09	81	27
Fujitsu	Her Majesty's Treasury	Q3CY09	76	15
Capita	Department for Children, Schools and Families	Q2CY09	96	96
HP	Ministry of Defence	Q2CY09	253	84
CSC	Home Office	Q2CY09	573	57
IBM	Home Office (Border Agency)	Q2CY09	394	39
IBM	Home Office (Identity and Passport Service)	Q2CY09	208	30

Source: IDC, Company Data, PL Research

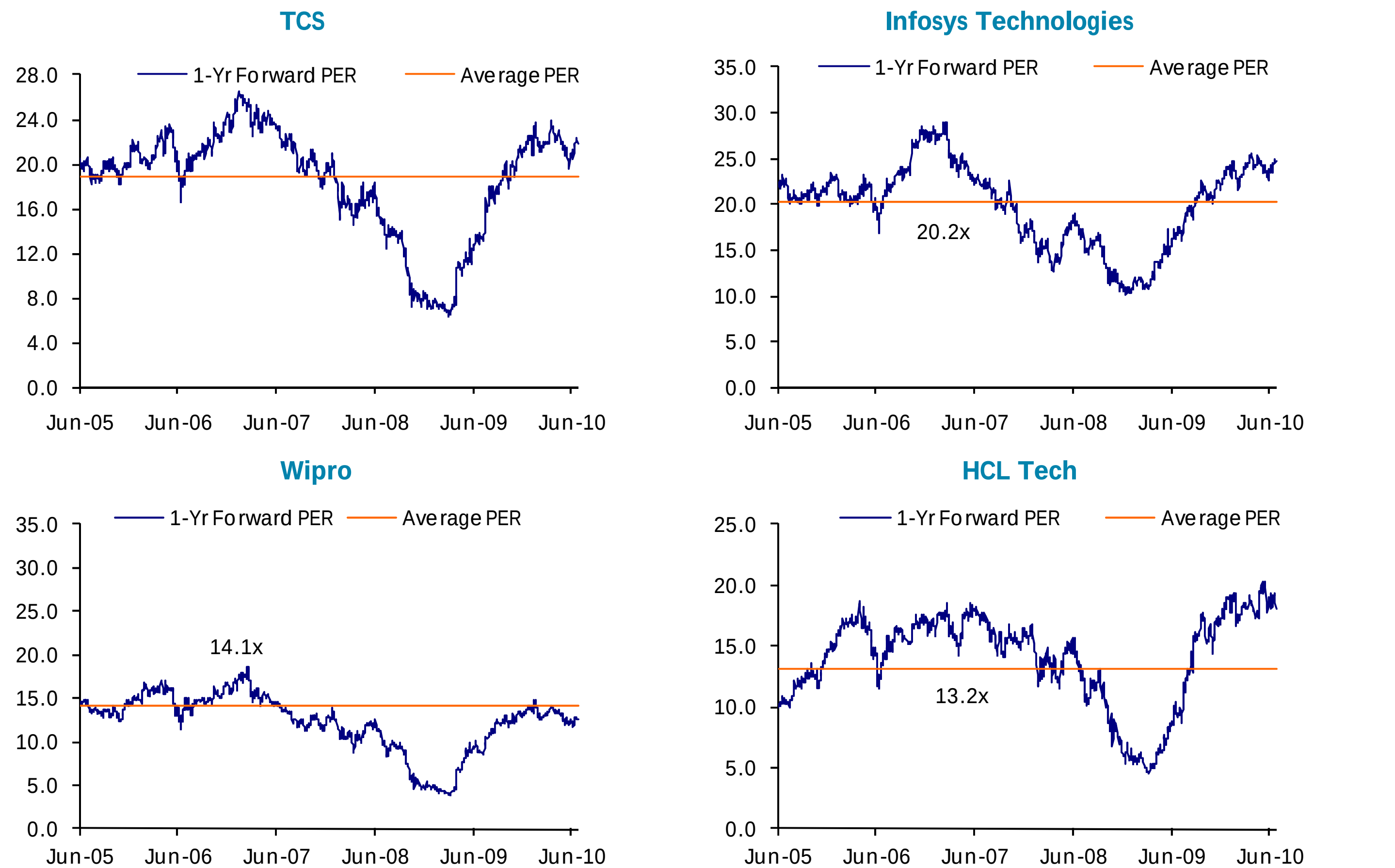
Reiterate 'BUY' on INFO & TCS and entry opportunity in HCLT

Over the last week, the Top-4 IT companies corrected by 2-8% due to the concerns of the European government austerity measure. We believe that the concern is slightly overdone. The cost-leadership commanded by Tier-1 Indian IT companies would act as an advantage for cost conscious European companies, which would act as a trigger for outsourcing.

We recognize that every contract is different and cuts will have an impact on some of the existing contracts. Also, the cost cognizance by the European government could have some spill on the private sector spending as well. But we believe that Tier-1 Indian IT Services companies manage to deliver strong growth in cost-conscious corporate environment.

The current correction provides good opportunity to enter HCL Tech. We reiterate our '**BUY**' on Infosys and TCS and '**Accumulate**' on Wipro and HCL Tech, with a target price of Rs3,250, Rs990, Rs800 and Rs430, respectively.

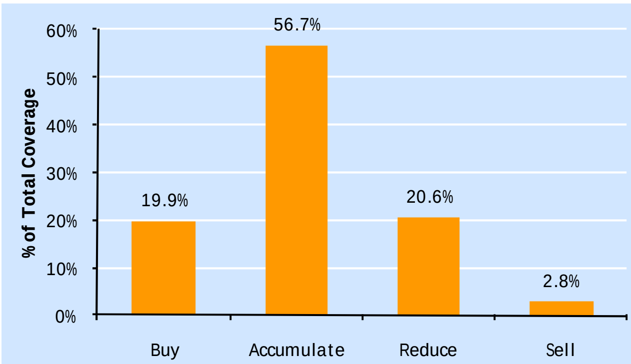
Our top picks, TCS and Infosys, HCLT correction provides entry opportunity



Source: Bloomberg, PL Research

Prabhudas Lilladher Pvt. Ltd.
3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India
Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly