

January 5, 2011

India IT Services

Dec-10 Quarter: Strong Volume Growth to Continue; Trend in Margins is Key

Quick Comment: We expect Indian IT companies to report strong volume growth due to continued demand momentum. However, with 2.5% rupee appreciation and strong employee addition to lower utilization rates, we believe companies could find it challenging to meet the margin expectation. We do not expect any earnings upgrades for the large IT vendors post the results season. In the event of continued strength in the demand environment, we would expect turnaround stories and valuation catch-up as the key investment themes for the sector in 2011.

Near-term volume growth should remain strong and could match the 7-8% levels seen in 2Q in our view. We forecast 7.5% qoq revenue growth for Infosys and TCS and a 5.5% qoq rev growth for Wipro US\$ revenues in 3Q. Overall, we expect ~27% yoy US\$ revenue growth and 18% yoy net income growth for our coverage universe in Dec-10 quarter.

Historically, Dec-10 quarter has had the lowest number of working days. Infosys does not expect any volume impact due to lower working days for the quarter as it spreads out its holidays through the year to normalize working days in any quarter. Also, most of the festivals in the quarter were on weekends. However, Wipro expects a 1.5% impact due to lower working days in the quarter. The impact of lower working days would be mitigated by 70-80bps help from cross currency (same as Q2), in our view.

Strong hiring trends: Infosys, TCS, Wipro have been hiring in hundreds across campuses. Though so far campus wages have been flat yoy, we would not be surprised by an increase in entry-level salaries. We believe as the placement season progresses, second round companies could push up the entry level salaries in order to hire top quality talent across institutes.

Result dates summary

Company	Result Dates
Infosys	13-Apr
TCS	17-Apr
MindTree	18-Apr
Infotech	19-Apr
Wipro	21-Apr
HCL Tech	3 rd week of January
Tech Mahindra	3 rd week of January
Patni	4 th week of January
Hexaware	4 th week of January
Info Edge	4 th week of January
Educomp	2 nd week of Feb
Mphasis	2 nd week of Feb

Source: Company data, Morgan Stanley Research

Revenue drivers: Strong volume growth momentum (+6 to 7%), Cross currency benefits (+0.7 to 0.8%)

Revenue drag: Lower working days (-1.5%),

Margin drivers: Cross currency gains (~20bps), lower attrition

Factors dragging margins: Rupee appreciation (-100 to 120bps), lower utilization (-50bps)

What could surprise favorably? Strong volume growth, better price realization, lower fx losses could support re-rating

What could surprise negatively? Stable to lower margins vs. expectations of steep increase in 2H, higher tax rates and lack of EPS upgrades could limit upside

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Infosys Guidance: We expect Infosys to raise its US\$ revenue growth guidance for FY11 to 27%-28% yoy from 24%-25% yoy and EPS guidance to Rs120-121 (from Rs115-117). We believe Wipro would give 4Q revenue growth guidance of 4%-5% qoq.

Rupee appreciation of 2.5% would impact margins by 100-120bps for the quarter: Moreover, TCS would be impacted by the normalization of rent and any reversal of writeback in provisions could drag margins further. TCS' management has indicated that it plans to maintain EBIT margins in the 27-28% range. We expect travel and other miscellaneous operating expenses to rise in 2H for TCS.

For Infosys, consensus is expecting a 50bps improvement in EBIT margins vs mgmt guidance of 100-130bps decline for the year. As per consensus, Infosys EBIT margins should increase by 100-300bps qoq in each of the next two quarters. We expect Infosys to maintain margins qoq and believe that consensus expectations of 100-130bps qoq improvement in margins in 2HFY11 are stretched and look difficult to us with companies facing stable pricing and 2.5% rupee appreciation.

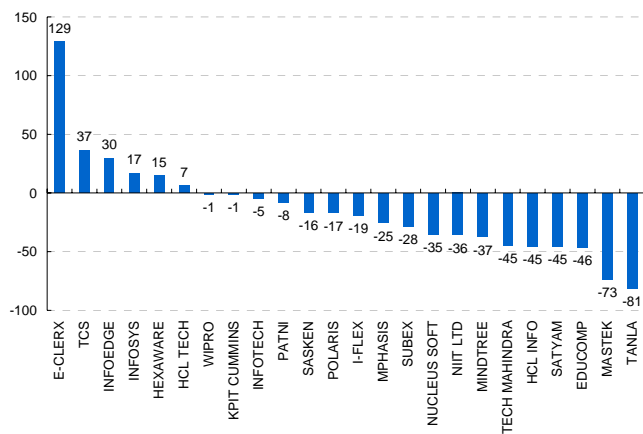
Overall, we forecast Infosys' margins to be down 40-50bps for FY11. Consensus estimates for FY11 and FY12 could rationalize post 3Q results to more realistic levels leading to EPS cuts.

Wipro's margins could benefit from lower Fx losses during the quarter due to rupee appreciation. We expect Wipro to improve IT services margins by ~40bps qoq in Dec10 quarter.

HCLT BPO is likely to remain in investment mode. Fx could drag margins by 40-50bps with fx loss narrowing to ~US\$5m. We expect strong hiring to continue at HCLT. Overall, HCLT margins should move steadily towards 15% EBIT level by the Jun-11 quarter on our estimates.

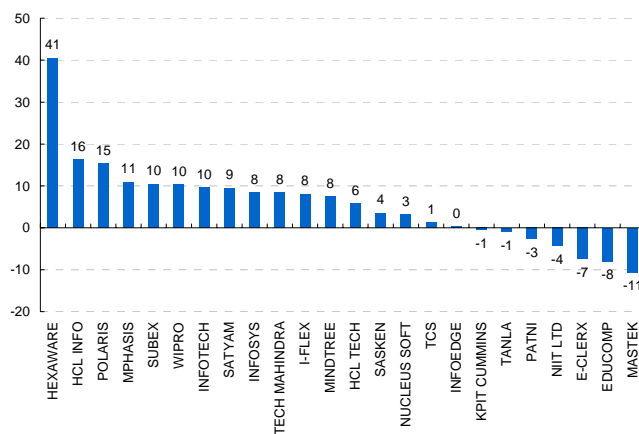
What are the stocks pricing in? Over the last one month, the stocks of large IT vendors have run up by 10-20% (vs market performance of 6%). At 20x-24x FY12e EPS, large cap stocks are already pricing in ~25% yoy US\$ revenue growth in FY12e. We do not believe that the risk reward is favorable for investors for large cap stocks at current levels.

Exhibit 1
In last 1-year large vendors outperformed while smaller vendors underperformed the market (%)



Source: Bloomberg, Morgan Stanley Research; Above chart represents relative performance of the stocks with respect to Sensex; Based on closing prices of 4th Jan 2011

Exhibit 2
Over last 1 month, smaller IT vendors are catching up with larger names (relative performance %)



Source: Bloomberg, Morgan Stanley Research; Above chart represents relative performance of the stocks with respect to Sensex; Based on closing prices of 4th Jan 2011

Exhibit 3

India IT Services: Dec-10 quarter preview (Rs m, %)

Infosys	Dec-09	Sep-10	Dec-10e	%qoq	%yoy	Comments
Sales (US\$m)	1,232	1,496	1,608	7.5%	30.5%	3Q11 Revenue guidance of US\$1547-1562m (Rs68.8-69.5bn) ;FY11 guidance of US\$5.95-6bn (Rs269.5-271.7bn)
Net Profit (US\$m)	334	374	397	6.2%	18.9%	3Q Net income guidance of US\$377-US\$383m (Rs16.8-17.1bn); FY11 guidance of US\$1.45-US\$1.47bn (Rs65.7-66.9bn)
Sales	57,410	69,470	72,417	4.2%	26.1%	3Q11 revenues would benefit from currency by ~US\$8-9m
EBIT	18,070	20,980	21,830	4.1%	20.8%	Gross hiring target of 40,000 in FY11e and 11,000 in 3Q11
Margin (%)	31.5%	30.2%	30.1%	-6 bps	-133 bps	Mgmt expects FY11e margins to decline by 100-130bps yoy
Net Profit	15,820	17,370	17,886	3.0%	13.1%	Expect tax rates to be 26-26.5% in FY11e
EPS Diluted (Rs)	27.7	30.4	31.3	2.9%	13.0%	3Q11 EPS guidance of Rs29.4-Rs29.9 (US\$0.66-US\$0.67); FY11 EPS of Rs115.1-117.1 (US\$2.54-US\$2.58)
TCS						
Sales (US\$m)	1,635	2,004	2,155	7.5%	31.8%	
Net Profit (US\$m)	383	455	480	5.5%	25.2%	
Sales	76,503	92,864	97,018	4.5%	26.8%	
EBIT	20,888	26,008	26,665	2.5%	27.7%	
Margin (%)	27.3%	28.0%	27.5%	-52 bps	18 bps	Expect to maintain margins at ~27% level for FY11e
Net Profit	17,975	21,065	21,603	2.6%	20.2%	Total hedge position of US\$500m as of 30 Sep, 2010
Wipro						
IT Services revenues (US\$m)	1,127	1,273	1,342	5.5%	19.1%	3Q guidance of US\$1317-1343m (+3.5% to 5.5%qoq)
IT Services revenues	49,981	57,471	60,006	4.4%	20.1%	
EBIT	12,181	12,746	13,561	6.4%	11.3%	
Margin (%)	24.4%	22.2%	22.6%	42 bps	-177 bps	
Total Revenues	69,380	77,719	78,635	1.2%	13.3%	
EBIT	13,142	14,447	14,801	2.4%	12.6%	
Margin (%)	18.9%	18.6%	18.8%	23 bps	-12 bps	
Net Profit	12,075	12,849	13,448	4.7%	11.4%	Hedge position of US\$1.5bn as on Sep10
HCL Tech						
Sales (US\$m)	652	804	860	7.0%	32.0%	
Net Profit (US\$m)	59	67	79	18.0%	34.8%	Expect RSU cost of US\$20.8m in FY11e
Sales	30,325	37,081	38,702	4.4%	27.6%	
EBIT	4,783	4,560	4,607	1.0%	-3.7%	Management expects full year margins to decline by 250bps
Margin (%)	15.8%	12.3%	11.9%	-39 bps	-387 bps	Management expects to maintain flat margins in 2Q
Net Profit	2,726	3,088	3,552	15.0%	30.3%	Expect FY11e tax rate ~22%
Tech Mahindra						
Sales (US\$m)	254	328	275	-16.3%	8.2%	2Q Revenues included a one time item of US\$63.5m; excluding this we expect 3Q revenue growth of ~4% qoq
Recurring Net profit (US\$m)	37	32	37	14.9%	-0.8%	Management reiterated plans to merge TechMahindra and Mahindra Satyam in another 9-12months
Sales	11,873	15,339	12,493	-18.6%	5.2%	
EBIT	2,476	2,471	2,274	-8.0%	-8.2%	Excluding pass-through EBITDA margins were 21.7% in 2Q vs reported 18.4%
Margin (%)	20.9%	16.1%	18.2%	209 bps	-265 bps	TechM plans to give onsite salary hikes in 3Q, which could impact margins in 3Q
Recurring net profit	1,728	1,873	1,683	-10.1%	-2.6%	

Source: Company data, Morgan Stanley Research; e = Morgan Stanley Research Estimates

Mphasis*	Jan-10	Oct-10	Jan-11e	%qoq	%yoy	
Sales	11,916	13,454	14,022	4.2%	17.7%	
EBIT	2,678	2,830	2,906	2.7%	8.5%	
Margin (%)	22.5%	21.0%	20.7%	-31 bps	-175 bps	Hedge position of US\$536m at Rs47.66 for 1-2 years
Net Profit	2,683	2,839	2,795	-1.6%	4.2%	Tax rate to be 18-18.5% in FY11e and 25% in FY12e
MindTree	Dec-09	Sep-10	Dec-10e	%qoq	%yoy	
Sales (US\$m)	70.4	82.4	87.9	6.7%	24.8%	
Net Profit (US\$m)	11.4	5.0	3.6	-28.5%	-68.7%	
Sales	3,319	3,844	3,989	3.8%	20.2%	
EBIT	489	271	364	34.6%	-25.4%	
Margin (%)	14.7%	7.0%	9.1%	209 bps	-559 bps	Mgmt expects to improve margins qoq in 2H
Net income	537	233	339	45.4%	-36.8%	Expect one time costs of US\$3.9m related to restructuring of Smartphone initiative into services business
Patni						
Sales (US\$m)	170	179	185	3.4%	8.6%	4Q revenue guidance of US\$180-181m (+0.7% to +1.2% qoq)
Net Profit (US\$m)**	30	29	28	-3.0%	-5.6%	Management has guided for 4Q net income excluding Fx gains/loss of US\$22.25-23m (-4% to -6% qoq); Management expects Fx gains of US\$1.5m in 4Q at Rs45/US\$
Sales	7,896	7,967	8,273	3.8%	4.8%	Patni plans to add ~1000 people (net) in 4Q
EBIT	1,397	1,220	1,231	0.9%	-11.9%	Management expects to maintain utilization ~75% levels in the current quarter
Margin (%)	17.7%	15.3%	14.9%	-43 bps	-281 bps	
Net Profit	1,366	1,281	1,247	-2.6%	-8.7%	Expect tax rate of 18% for CY10 and ~25-26% for CY11
Infotech						
Sales (US\$m)	51.3	63.5	68.6	8.0%	33.7%	Wellsco acquisition would contribute full three months at US\$3m (vs US\$1.8m in 2Q)
Net Profit (US\$m)	8.1	7.1	8.0	12.7%	-1.6%	
Sales	2,391	2,955	3,099	4.9%	29.6%	
EBIT	407	329	366	11.3%	-9.9%	Targets gross hiring of 2775 for FY11e and net hiring of 1600
Margin (%)	17.0%	11.1%	11.8%	68 bps	-519 bps	Management's outlook for FY11e EBITDA margins is ~18%
Net Profit	379.1	330.7	362.0	9.5%	-4.5%	
Hexaware						
Sales (US\$m)	54.0	61.1	65.0	6.5%	20.4%	4Q revenue guidance of US\$64-65m (+4.8% qoq to +6.4% qoq)
Net Profit (US\$m)	7.7	3.6	5.7	55.2%	-26.7%	
Sales	2,520	2,817	2,928	3.9%	16.2%	
EBIT	385	182	218	20.0%	-43.3%	
Margin (%)	15.3%	6.5%	7.5%	100 bps	-782 bps	
Net Profit	360	168	255	51.5%	-29.3%	
Info Edge						
Sales	589	712	767	7.8%	30.4%	Business environment continues to improve for recruitment and 99 acres. Management indicated that price discounts for Naukri are coming down.
EBIT	165	200	231	15.6%	40.2%	Management expects 99 acres to break even by year-end (F2011)
Margin (%)	28.0%	28.0%	30.1%	204 bps	212 bps	Company expects losses in Jeevansathi to continue for another couple of years as Info Edge will continue to invest on brand building
Net Profit	156	179	201	12.3%	28.4%	Expects capex of Rs950mn over next 24 months
Educomp						
Sales	2,601	2,768	3,693	33.4%	42.0%	Revenue guidance of Rs13-13.5bn in FY11e
EBIT	1,025	830	1,284	54.7%	25.3%	
Margin (%)	39.4%	30.0%	34.8%	478 bps	-463 bps	
Net Profit	612	578	787	36.1%	28.6%	Management has guided for PAT of Rs3.3bn in FY11e

Source: Company data, Morgan Stanley Research; e = Morgan Stanley Research Estimates ; *Mphasis has October ending financial year

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Exhibit 4

Infosys: Revenue and EPS guidance for 3Q and FY11

Upper End	Rs m					USD m				
	F1Q11	F2Q11	F3Q11e	F4Q11e	F2011e	F1Q11	F2Q11	F3Q11e	F4Q11e	F2011e
Revenue	61,980	69,470	69,530	70,670	271,650	1,358	1,496	1,562	1,584	6,000
% qoq	4.3	12.1	0.1	1.6	19.4	4.8	10.2	4.4	1.4	24.9
EPS/EPADS	26.1	30.4	29.9	30.7	117.1	0.57	0.65	0.67	0.69	2.58
% qoq	-5.1	16.7	-1.7	2.7	7.4	-6.6	14.0	3.1	3.0	12.2
Lower End	F1Q11	F2Q11	F3Q11e	F4Q11e	F2011e	F1Q11	F2Q11	F3Q11e	F4Q11e	F2011e
Revenue	61,980	69,470	68,840	69,220	269,510	1,358	1,496	1,547	1,549	5,950
% qoq	4.3	12.1	-0.9	0.6	18.5	4.8	10.2	3.4	0.1	23.9
EPS/EPADS	26.1	30.4	29.4	29.2	115.1	0.57	0.65	0.66	0.66	2.54
% qoq	-5.1	16.7	-3.4	-0.5	5.5	-6.6	14.0	1.5	0.0	10.4

Source: Company data, Morgan Stanley Research; Guidance based on currency rates of Rs44.50/US\$, 1.36US\$/Euro, 1.58US\$/GBP, 0.97AUD/US\$

Exhibit 5

Quarter "Average" rates (% qoq)

Period	USD INR	EUR INR	GBP INR	GBP USD	EUR USD
Mar-09	1.8	0.4	-4.9	-6.5	-1.3
Jun-09	-3.7	2.5	6.1	10.4	6.6
Sep-09	-0.1	4.3	3.1	2.9	4.3
Dec-09	-3.4	-1.6	-3.5	0.0	1.9
Mar-10	-2.0	-8.9	-7.2	-5.3	-7.0
Jun-10	0.0	-7.7	-3.5	-3.5	-7.6
Sep-10	1.0	5.0	5.5	4.5	4.1
Dec-10*	-2.5	-0.1	-1.8	0.6	2.4

Source: Bloomberg, Morgan Stanley Research; Dec-10 rates based on closing rates of 31st Dec10

Exhibit 6

Quarter "End" rates (% qoq)

Month	USD INR	EUR INR	GBP INR	GBP USD	EUR USD
Mar-09	4.2	-0.6	2.3	-1.8	-4.6
Jun-09	-5.5	0.2	10.1	16.5	6.0
Sep-09	0.3	4.0	-3.6	-4.0	3.6
Dec-09	-3.3	-5.1	-2.4	0.9	-2.0
Mar-10	-3.4	-9.3	-9.4	-6.1	-6.1
Jun-10	3.3	-5.7	2.2	-1.2	-8.7
Sep-10	-3.2	7.2	1.6	5.0	10.8
Dec-10*	-0.5	-2.2	-1.7	-1.4	-1.8

Source: Bloomberg, Morgan Stanley Research; Dec-10 rates based on closing rates of 31st Dec10

Exhibit 7

Software Valuations: P/E and P/S Ratio

Company	Ticker	Curr	Price (Local)	M Cap (\$mil)	EPS (Respective Currency)			P/E (x)			EPS Growth (%)			EPS CAGR	P/S(x)
					FY10	FY11e	FY12e	FY10	FY11e	FY12e	FY10	FY11e	FY12e	10-12	FY11e
US Listed															
Accenture	ACN	USD	48	36,696	2.7	3.1	3.6	18.1	15.3	13.4	NM	18.3	14.2	16.3%	1.7
Amdocs*	DOX	USD	28	5,285	2.1	2.3	2.3	13.0	11.9	11.8	28.5	9.0	1.0	4.9%	1.8
Cognizant Solutions*	CTSH	USD	74	22,506	1.8	2.4	2.6	41.7	31.5	28.0	23.3	32.4	12.4	22.0%	4.9
Computer Sciences *	CSC	USD	51	7,856	5.3	5.4	5.7	9.6	9.5	8.9	NM	1.7	6.2	3.9%	0.5
Infosys - ADR*	INFY	USD	77	44,139	2.3	2.7	3.3	33.0	28.4	23.6	8.6	16.2	20.4	18.3%	7.1
Patni - ADR*	PTI	USD	21	1,397	1.8	1.8	1.8	12.0	11.8	12.1	36.8	2.1	-3.1	-0.5%	2.0
Wipro - ADR*	WIT	USD	16	38,325	0.4	0.5	0.5	38.5	32.1	28.5	31.6	20.0	12.4	16.1%	5.6
European Listed															
Cap Gemini	CAP	EUR	36	7,411	1.7	1.9	2.5	21.4	18.8	14.4	-42.8	13.8	30.8	22.0%	0.6
Logica PLC	LOG	GBp	136	3,408	10.6	12.4	13.1	12.9	11.0	10.4	10.1	17.4	5.7	11.4%	0.6
TietoEnator	TIE1V	EUR	14	1,375	0.9	1.1	1.2	15.4	12.5	11.6	22.8	0.0	11.7	15.3%	0.6
India Listed															
HCL Tech	HCLT	INR	461	7,103	17.5	25.0	29.8	26.3	18.5	15.4	-2.3	42.7	19.4	30.6%	2.0
Hexaware	HEXW	INR	127	419	9.0	5.3	8.3	14.0	23.9	15.2	119.7	-41.3	57.1	-3.9%	1.7
Infosys - Local	INFO	INR	3,468	44,131	108.8	121.4	147.0	31.9	28.6	23.6	4.2	11.6	21.1	16.2%	7.1
Infotech	INFTC	INR	174	430	15.4	12.8	14.5	11.3	13.6	12.0	77.6	-16.8	13.3	-2.9%	1.7
MindTree	MTCL	INR	552	504	52.4	36.3	44.8	10.5	15.2	12.3	282.2	-30.6	23.3	-7.5%	1.4
Mphasis @	MPHL	INR	682	3,185	43.2	51.8	52.8	15.8	13.2	12.9	78.8	19.9	2.0	10.6%	2.8
Patni - Local	PATNI	INR	468	1,396	35.2	41.1	40.4	13.3	11.4	11.6	30.0	16.8	-1.7	7.1%	1.9
TCS	TCS	INR	1,144	49,857	35.1	42.7	49.5	32.6	26.8	23.1	32.9	21.5	16.0	18.7%	6.0
Tech Mahindra	TECHM	INR	745	2,163	54.4	72.9	91.1	13.7	10.2	8.2	-26.1	34.1	24.9	29.5%	1.9
Wipro - Local	WPRO	INR	484	26,404	18.8	21.9	24.6	25.8	22.2	19.7	17.5	16.5	12.6	14.5%	3.8
BPO															
Genpact	G	USD	15	3,415	0.73	0.75	0.87	21.2	20.7	17.8	NM	2.5	16.0	9.1%	2.7
WNS	WNS	USD	12	507	1.15	1.03	1.16	10.1	11.2	10.0	6.2	NM	12.0	0.4%	1.3
Convergys*	CVG	USD	14	1,684	1.16	0.99	1.14	11.9	14.0	12.1	-254.7	-14.7	14.9	-1.0%	0.8
Teletech*	TTEC	USD	20	1,194	1.22	1.04	1.19	16.5	19.5	17.0	15.1	-15.1	14.7	-1.3%	1.1
EXL*	EXLS	USD	22	632	0.54	0.77	0.87	39.9	28.1	24.8	0.0	42.1	13.2	26.8%	2.6
ADP*	ADP	USD	47	23,122	2.40	2.47	2.67	19.5	19.0	17.5	NM	3.0	8.1	5.5%	2.4

Prices as on 4th Jan 2011; Sources: Company data, FactSet, Morgan Stanley Research

E = Morgan Stanley Research estimates, except for those marked with an asterisk (*), which are consensus estimates as provided by FactSet

NM = Not Meaningful

@ Mphasis EPS include EDS India from F2007; Mphasis FY09e represent actual EPS for the period of 7 months from April08-October08; FY10e represent our estimates for the period of Nov08-Oct09

* Companies with * mark represent estimates by Factset

WNS EPS represent company-adjusted numbers; Genpact EPS represent MS adjusted numbers (GAAP EPS adjusted for formation-related expense and FBT costs).

Estimates for Indian ADRs are taken from FactSet.

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Cognizant, Cap Gemini, Logica, Hexaware and Patni have a December-ending fiscal year, Accenture has an August-ending FY, Amdocs has a September-ending FY, HCL Tech has a June-ending FY, and the rest have a March-ending FY. For companies with a December-ending fiscal year, FY10 represents their actual CY09 numbers.

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(as of December 31, 2010)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1145	40%	437	44%	38%
Equal-weight/Hold	1192	42%	422	42%	35%
Not-Rated/Hold	119	4%	25	3%	21%
Underweight/Sell	382	13%	109	11%	29%
Total	2,838		993		

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Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index on a risk-adjusted basis, over the next 12-18 months.

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Industry Coverage:India Software

Company (Ticker)	Rating (as of)	Price* (01/04/2011)
Vipin Khare		
Genpact Limited (G.N)	E (08/26/2008)	US\$15.48
HCL Technologies (HCLT.BO)	O (08/26/2009)	Rs460.8
Hexaware Technologies Limited (HEXT.BO)	O (07/30/2009)	Rs126.6
Infosys Technologies (INFY.BO)	E (01/14/2010)	Rs3,468
Infotech Enterprises (INFE.BO)	O- (09/16/2010)	Rs173.95
MindTree Ltd. (MINT.BO)	E (04/29/2010)	Rs551.55
Mphasis Limited (MBFL.BO)	U (08/20/2009)	Rs682.4
Patni Computer Systems (PTNI.BO)	U (11/16/2009)	Rs468.3
Tata Consultancy Services (TCS.BO)	E (07/20/2009)	Rs1,143.75
Tech Mahindra Limited (TEML.BO)	U (03/11/2009)	Rs744.95
WNS Global Services (WNS.N)	E (03/11/2009)	US\$11.6
Wipro Ltd. (WIPR.BO)	E (07/23/2009)	Rs484.35

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