

## Industry

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# Indian IT Services

 Equity 

## Sector Outperformance: Tracking Recovery or Running Ahead?

- **Focus back on valuations** — Post the sharp re-rating in the Indian IT Services stocks, the focus is back on: (1) Quantum of earnings upgrades – Dependent on pace of economic/IT budget recovery, and (2) Valuations – Back to pre-slowdown levels. While the sector could continue to show relative strength near-term, given concerns on Monsoons, absolute upsides will require material earnings upgrades.
- **Infosys PE back to Apr-08 levels** — Infosys 1-year forward PE is ~20x, which is back at Apr-08 levels. The premium to market has expanded from ~5% then to ~30% now. However, one can argue that Apr-08 was the start of the earnings downgrade cycle while present levels are the early stages of an upturn – suggesting scope for some more multiple expansion. *For the above analysis, we have used dynamic PE charts – based on IBES estimates at that point of time.*
- **TCS/Wipro – not too different** — PE charts for TCS/Wipro are not too different from the Infosys PE pattern either. Wipro's PE is back at May-08 levels whereas TCS' is at Oct-07 levels. Both stocks now trade at a ~20-22% premium to the market.
- **10% EBIT growth CAGR for Infosys required to justify valuations** — Reverse DCF analysis implies ~13% revenue (\$-terms) and ~10% EBIT growth CAGR for Infosys over the next 10-years (WACC of 11%, terminal growth of 4%), which is unlikely to be easy. To meet FY19E implied revenue, Infosys will need ~300,000 employees (assuming 3% productivity improvements yoy). For Wipro, the EBIT growth required is highest at ~12% CAGR while for TCS it is lowest at ~8% CAGR.
- **FCF yields decent, but meaningfully lower than Accenture** — FCF yields for Indian IT Services majors are now between ~4-8%, lower following the recent run up. However, FCF yields are meaningfully lower than global peers like Accenture (14% FCF yield). While Indian IT could be defensive in the Indian market context, it is difficult to argue the same from a global tech perspective.
- **Rising tide lifting all stocks, we stay selective** — With hopes of a global recovery, IT Services stocks have moved up meaningfully. Valuations are back to pre-slowdown levels and need to be sustained by earnings upgrades. Tier-I's continue to be better placed and we prefer our selective approach. We continue to like Infosys (strong margin defense, earnings upgrades not happened yet) and TCS (biggest beneficiary of stability in BFSI, strong earnings momentum).

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Infosys trades at ~20x 1-year forward  
IBES EPS – similar to April 2008 levels

## Valuations at Pre-Slowdown Levels

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Figure 1. Infosys dynamic 1-year forward PE chart



Source: IBES, CIRA

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TCS and Wipro are not too different...both  
stocks now trade at a ~20% premium to  
the Indian market

Figure 2. TCS dynamic 1-year forward PE chart



Source: IBES, CIRA

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Figure 3. Wipro dynamic 1-year forward PE chart



Source: IBES, CIRA

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Valuations imply ~8-12% EBIT CAGR over the next ten years...assuming 4% terminal growth and ~11-12% cost of capital

Figure 4. DCF Assumptions

	Infosys	TCS	Wipro
<b>Key Forecasts</b>			
10 year EBIT growth (%)	9.8%	8.0%	11.9%
Terminal growth rate	4.0%	4.0%	4.0%
<b>Discounting Assumptions</b>			
Cost of capital	11.0%	11.0%	12.3%
Target Debt/Equity	0.0%	0.0%	0.0%
Cost of Equity	11.0%	11.0%	12.3%
Risk free rate	7.0%	7.0%	7.0%
Equity risk premium	6.0%	6.0%	6.0%
Beta - Bloomberg	0.667	0.669	0.882
<b>Discounted Cash Flow</b>			
DCF value (Rs)	2,100	543	512

Source: CIRA Estimates

Figure 5. FCF yields

Company Name	Year End	RIC Code	CIRA Rating	CMP (LC)	TP (LC)	Net Debt (\$ m)	Mcap (\$ m)	EV (\$ m)	FCF (\$ m)		FCF/EV	
									CY09E	CY10E	CY09E	CY10E
Infosys	Mar	INFY.BO	1L	2,092	2,060	-1,736	25,104	23,368	996	977	4%	4%
TCS	Mar	TCS.BO	1L	555	525	-192	22,761	22,569	1,002	938	4%	4%
Wipro	Mar	WIPR.BO	2L	520	450	-250	15,950	15,699	708	621	5%	4%
HCL Tech	Jun	HCLT.BO	2M	254	215	-573	3,560	2,987	253	220	8%	7%
Accenture	Aug	ACN.N	2H	36	37	-3,615	22,071	18,456	2,558	2,259	14%	12%
Cognizant	Dec	CTSH.O	1H	34	40	-763	9,972	9,210	321	312	3%	3%
SAP	Dec	SAPG.DE	1H	33	38	921	57,951	58,872	2,367	3,619	4%	6%
IBM	Dec	IBM.N	1M	119	135	21,018	155,602	176,620	17,573	18,828	10%	11%
HP	Oct	HPQ.N	1M	44	54	7,606	104,208	111,814	9,149	9,972	8%	9%

Source: CIRA Estimates

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