investors eye

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Index

Provogue India

Ugly Duckling

Stock Idea

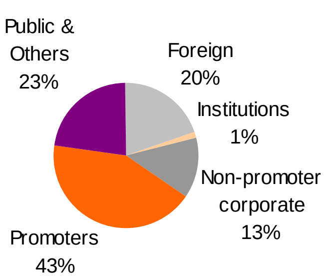
Back in vogue

Buy; CMP: Rs60

Company details

Price target:	Rs95
Market cap:	Rs686 cr
52-week high/low:	Rs73/39
NSE volume: (No of shares)	6.9 lakh
BSE code:	532647
NSE code:	PROVOGUE
Sharekhan code:	PROVIND
Free float: (No of shares)	6.6 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	25.5	20.5	2.0	27.3
Relative to Sensex	22.5	23.0	2.6	7.1

Key points

- **Growth back on track:** Provogue India Ltd (PIL), a leading fashion brand retailing company, is among the key beneficiaries of the revival in urban consumption on the back of the overall improvement in the domestic economy that has led to a significant improvement in the same-store sales for the company. Moreover, the aggressive expansion of PIL's retail stores (the number of its stores to increase by 50-60% in the next two years) and its enhanced product range (introduction of men's inner wear, perfumes and accessories) would further add to the growth momentum.
- **Operating leverage and favourable revenue mix to boost margins:** The higher same-store sales would aid the margins due to economies of scale and operating leverage. The margins would also get support from the favourable shift in PIL's revenue mix towards a higher contribution from the exclusive Provogue stores and a benign cost structure, especially the occupational costs (largely rentals and staff cost). We expect PIL's operating profit to grow at 20.6% over FY2010-12 and its margins to improve by 161 basis points to 12.3% by FY2012.
- **Value in its real estate business:** Its subsidiary Prozone Enterprises Pvt. Ltd (PEPL) is engaged in real estate development in tier-II cities (overall 185 acres of developable land). Currently, it has undertaken the development of 2.4mn sq. ft. of retail real estate in Aurangabad, Nagpur and Coimbatore, and a residential project in Indore. PEPL's balance sheet is well funded with equity infusion of Rs922 crore and it has roped in Liberty International, UK (Liberty) as a strategic partner. We believe that the commencement of operations of PEPL's first mall property in Aurangabad by August 2010 would be a key trigger for the PIL stock to get rerated and to showcase PEPL's execution capabilities. The value of the three malls under development along with the residential project in Indore works out to Rs39 per share (ignoring the other commercial and residential developments, and planned projects in the other cities).
- **Valuations at steep discount:** PIL is poised to report a healthy earnings growth of 22.8% CAGR (over FY2010-12) in its core business of fashion brand retailing, which itself is valued at Rs56 per share even at a discounted multiple of 15x compared to PIL's historical valuation and to the valuation of its peers. Thus, the current market price is completely ignoring the value in PEPL. We assign a value of Rs39 per share to the real estate venture to arrive at an SOTP valuation of Rs95 per share for PIL. We recommend a Buy on the stock.

Key financials	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net sales (Rs cr)	336.6	359.7	480.7	527.1	607.2
Net profit (Rs cr)	25.8	29.5	28.2	32.6	42.5
% yoy change	*13.0*	*14.3*	*-4.5*	*15.7*	*30.4*
No of shares (cr)	11.4	11.4	11.4	11.4	11.4
P/E (x)	26.6	23.3	24.4	21.1	16.2
EV/EBITDA (x)	14.6	12.9	11.6	10.4	8.7
RoE (%)	8.1	4.3	4.0	4.4	5.5
RoCE (%)	10.5	6.6	7.0	7.3	8.2

Company background

PIL is a manufacturer and retailer of apparels for men and women, and operates through three platforms, namely Provogue Studios, national chains and multi-brand stores, and ProMart (off-price lifestyle department stores). It also has presence in the infrastructure space through its 75% subsidiary, PEPL.

Provogue Studios: Positioned as a lifestyle brand for the fashion conscious youth, Provogue targets the premium segment. The brand is sold through PIL's own exclusive stores, "Provogue Studios", as well as through multi-brand outlets. Currently, the brand is distributed through close to 130 stores located throughout the country.

ProMart: ProMart is an off-price lifestyle department store which targets the value-for-money customer that wishes to own fashionable, branded attire at reasonable prices. ProMart sells off-season fashion and lifestyle products, which are sold at a discount of 20-60% to their original prices throughout the year. There are currently two ProMart stores located in Ahmedabad and Indore.

PEPL: PEPL is a 75% subsidiary of PIL and is in the business of developing commercial property including shopping malls. The remaining 25% stake is owned by Liberty, which is a leading retail real estate developer in the UK. PEPL currently has six projects underway situated in Aurangabad, Coimbatore, Nagpur, Indore, Jaipur and Lucknow.

Investment arguments

Consumption demand back on track

With a meagre 4-5% penetration of organised retail in the Indian market and favourable demographics (working age profile, rising disposable income, urbanisation, female working population), the organised retail sector is expected to grow at a compounded annual growth rate (CAGR) of 28% over FY2009-15 to reach a size of $71 billion. Thus, the long-term growth drivers remain intact. In the intermediate period, the global crisis of 2007-08 has had its impact on the consumer discretionary space with the organised retail segment, that has been adversely affected, showing a drop in same-store sales (same-store sales are a lead indicator of the health of the retail industry).

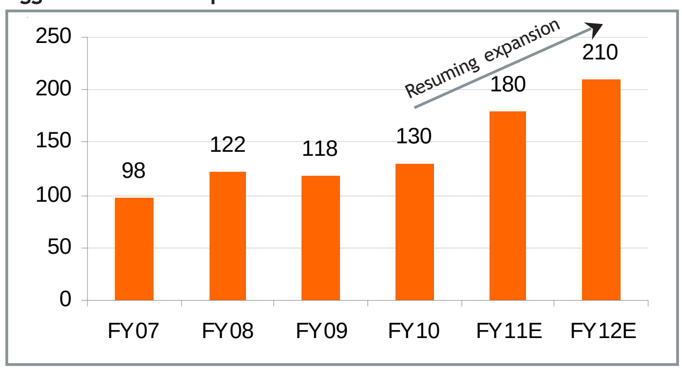
From H2FY2010, with the stabilising economy and the return of economic growth, the organised retail industry has again started witnessing a strong upliftment with players reporting same-store sales growth in double digits. Going forward, we expect this momentum to continue and the growth is likely to be more pronounced in the coming quarters. Further, with a rationalised structure and strong growth we expect the operational leverage to play out with players reporting healthy margin as well as earnings growth (for details on the industry, kindly refer Annexure).

Provogue's growth back on track

Revival in expansion plans...

The *Provogue* brand is positioned as a lifestyle brand targeting the premium segment. Like all lifestyle brands, PIL too was significantly affected by the global economic slowdown, which led to a lower disposable income in the hands of the consumer. As a result of a lower demand for its products coupled with uneconomical store rentals, the company had slowed down its store expansion in the last year as compared to that seen in the past. However, with the strong return of consumption spend in H2FY2010 and with the momentum likely to be maintained, PIL has resumed its retail expansion plans, and aims to add around 50-60 stores in FY2011 and maintain the expansion momentum in FY2012 as well.

Aggressive store expansion ahead



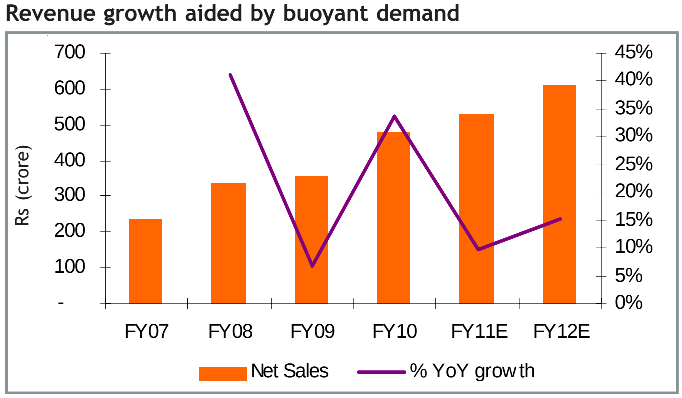
...and extension of product range...

PIL started out as a men's wear brand and later extended its product basket to include women's wear as well as fashion accessories. Going ahead, PIL intends to extend its range of offerings to include all lifestyle products such as perfumes and shaving creams. This move is likely to help the company increase its same-store sales as well as operating profit margin (OPM).

...to drive revenues and earnings going forward

The expansion of its retail outlets coupled with the extension of its product range is expected to help its revenues to grow at a CAGR of 12.4% over FY2010-12.

Revenue growth aided by buoyant demand



In view of the revival in the revenue growth and a benign cost environment in terms of rentals and occupation cost, we expect PIL's stand-alone margin to improve from the current levels to 11.3% and 12.3% in FY2011 and FY2012 respectively. Consequently, the profit after tax (PAT) during the aforesaid period (FY2010-12) would grow at a CAGR of 22.8%.

ProMart: De-risking through diversification

In a bid to expand its target segment PIL has launched ProMart, an off-price store targeting the aspirational middle class segment. ProMart sells off-season fashion and lifestyle products at a discount of 20-60% to their original prices throughout the year. ProMart's unique selling proposition lies in the fact that it offers the same shopping experience as does a mall but at an affordable price. There are currently two ProMart stores located in Ahmedabad and Indore. ProMart will not only help the company gain additional revenues through client diversification but also help it de-risk its revenues to a certain extent. As PIL is primarily a lifestyle company, its revenues are significantly affected during times of an economic slowdown. Value perception is one of the key requirements for consumers during such times and discount formats face a lesser brunt. Though the segment may witness a reduction in the volume of sales, but it is unlikely to witness a total turn-off from consumers. Thus, the presence of ProMart will act as a buffer to the company sales during recessionary times.

Prozone: Retail infrastructure play, value driver

Infrastructure player in tier-II cities

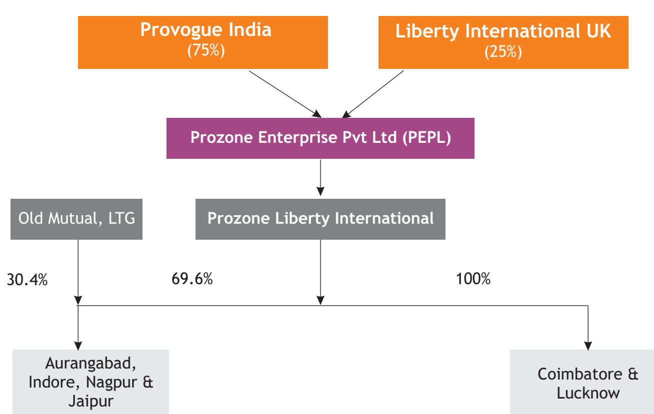
PEPL, a 75% subsidiary of PIL, is in the business of developing commercial property including shopping malls. The remaining 25% stake in the venture is owned by Liberty, which is a leading retail real estate developer in the UK. PEPL plans to build massive projects in tier-II cities. These projects will contain retail, residential, commercial and hotel properties. PEPL has identified a total of six projects, one each in Aurangabad, Coimbatore, Nagpur, Indore, Jaipur and Lucknow, spanning a total area of 16.6mn sq. ft.

Partnership with Liberty

During the recent boom in the real estate sector, the industry as a whole witnessed significant construction activity. The retail real estate space was no exception and the country saw an influx of malls, especially during the years 2006 and 2007. This has today led to a situation of over supply accompanied by high vacancy rates and several mall closures. The failure of several Indian malls can be attributed to factors such as a demand-supply mismatch owing to improper research prior to setting up a retail space and a lack of professional mall management experience. Though PIL had several years of experience in managing a retail business, the company lacked knowledge of retail real estate development. As a result, PIL partnered with Liberty in 2006.

Liberty is an FTSE-100 company with over 30 years of experience in retail real estate development. It owns 100% of Capital Shopping Centres, a UK regional shopping centre, and Capital and Countries, a retail and commercial property investment and development company. Liberty has shown its commitment towards PEPL by appointing two of its most senior directors to its board. PEPL will benefit significantly from its partnership with Liberty. PIL's knowledge of the Indian market coupled with Liberty's expertise in mall management and development will enable PEPL to create retail formats that will succeed in the Indian context.

PEPL structure



Land details

Particulars		Aurangabad	Nagpur	Indore	Jaipur	Coimbatore	Lucknow	Total
Area	acres	21.0	41.4	43.0	28.0	26.0	26.0	185.4
Area	mn sq ft	1.4	3.6	4.7	2.4	2.3	2.3	16.6
Location		Between MIDC and PWD Colony	Opposite to the airport	Kanadia Bypass Road	Ajmer Road	Sivananda Mill	-	-
Segregration								
Retail	mn sq ft	0.8	0.8	-	-	0.8	-	2.4
Commercial	mn sq ft	0.4	-	-	-	-	-	0.4
Residental	mn sq ft	-	-	4.7	-	-	-	4.7
Hotel	mn sq ft	0.2	-	-	-	-	-	0.2
Balance	mn sq ft	-	2.8	-	2.4	1.5	-	9.0
Prozone's share	%	69.6	69.6	42.0	35.0	100.0	-	

Adequate funding

During the real estate boom, several retail as well as real estate players had leveraged their books to fund their heightened construction activity. PEPL, on the other hand, had access to sufficient funds on account of its partnership with Liberty as well as a stake sale in its special purpose vehicle (SPV). During the formation of the partnership, Liberty and PIL had each infused ~Rs200 crore into PEPL. PEPL then created an SPV called Prozone International consisting of four retail real estate development projects of the company. In 2008, PEPL raised an additional Rs510 crore through the sale of stake (to Old Mutual and LTG) and a fresh issuance in the SPV. After the mobilisation of capital, PEPL holds a 69.6% stake in the SPV. With equity infusion of Rs922 crore, the company is well funded for execution of its projects.

Well funded projects

Particulars	Rs (crore)
PIL's contribution	205
From Liberty for 25% stake in PEPL	202
Stake sold to Old Mutual and LTG	515
Total cash infusion in the subsidiary	922
Spent till date assuming all done by PEPL	558
Balance in escrow account	364

Successful commencement of Aurangabad mall could lead to re-rating of the business

PIL's retail development business is currently in the implementation stage, with the Aurangabad property nearing completion. The Coimbatore and Nagpur properties are expected to commence construction by October 2010 and January 2011 respectively. The successful launch of the Aurangabad mall will provide confidence regarding the future prospects of PEPL's business and could trigger the re-rating of the business.

Provogue's value in PEPL Rs (cr)

Particulars	PEPL	Provogue	Per share
Retail (Aurangabad+ Coimbatore+Nagpur)	367.8	275.8	24.1
Residental (Indore)	176	132	11.5
Commercial (Aurangabad)	50.1	37.6	3.3
Hotel	-	-	-
Overall value	**593.9**	**445.4**	**38.9**

Review of Aurangabad mall

Project details

- Total area: 0.8mn sq. ft.
- Project start date: May 2008
- Mall commencement date: Mid August 2010
- Area signed up: 80%
- Average rental: Rs41/sq. ft./month

Location overview

- The only shopping centre in the Marathawada region
- City population: 1.6 million
- Catchment population: 3.5 million
- 1.5 million tourists per year
- 10 minutes drive from city centre

Location demographics

- 65% of population under 35 years
- Average district per capita income of Rs30,500

Mall details

- Retail mix: Anchor and marquee tenants like Star India Bazaar, Shoppers Stop, Satyam Cinemas, Westside, Globus, Pantaloons, Odyssey
- The only G+1 shopping centre in India that would house over 125 brands across fashion, food, accessories and entertainment.

Valuation of retail projects

Particulars		Aurangabad	Nagpur	Indore	Jaipur	Coimbatore	Lucknow	Total
Average rentals	Rs/sqft/mth	41	60	-	-	55	-	
Cap rate/ Rental yield	%	10.0	10.0	-	-	10.0	-	-
SPV value (on net rentals)	Rs crore	269	297	-	-	278	-	844
SPV equity value	Rs crore	89	191	-	-	173	-	453
Prozone's share	%	70	70	42	35	100	-	-
Prozone's value	Rs crore	62	133	-	-	173	-	368
Provogue's value	Rs crore	46	100	-	-	130	-	276
Provogue's per share value	Rs/Share	4.1	8.7	-	-	11.3	-	24.1

Key risks

Execution risk

PEPL's projects are currently in the implementation stage, with the Aurangabad property nearing completion while the Coimbatore, Nagpur and Indore properties have yet to commence construction. As neither of the prospective properties has commenced operations, there exist uncertainties relating to the successful execution and commercialisation of the same.

Competition

With the global economy showing signs of a revival, several retailers have revived their expansion plans. Competition from Indian retailers as well as new foreign entrants could lead to an erosion of the company's market share going ahead.

Inventory risk

As *Provogue* is a lifestyle brand, targeting fashion conscious youth, there is the risk of carrying inventory that has gone out of fashion. The inventory carrying days of the company are high and stood at 338 days for FY2009. The low inventory churn poses a key investment concern going ahead.

Valuation

PIL is poised to report a healthy earnings CAGR of 22.8% (over FY2010-12) in its core business of fashion brand retailing on the back of strong store expansion, buoyant demand and enhanced product range. PEPL's Aurangabad property is in the last leg of completion while work at the other three sites (Coimbatore, Nagpur and Indore) is likely to commence soon.

We have valued the company using the sum-of-the-parts (SOTP) methodology. To the retail business we have assigned a multiple of 15x FY2012E earnings (which is a significant discount to the valuation of its peers) to arrive at a value of Rs56 per share. We have also valued the 75% stake in PEPL using the net asset value (NAV) method and arrived at a value of Rs39 per share. Thus, our SOTP price target for the company is Rs95. We recommend a Buy on PIL.

Financials

Profit & Loss a/c Rs (cr)

Particulars	FY08	FY09	FY10	FY11E	FY12E
Operating income	336.6	359.7	480.7	527.1	607.2
Gross profit	154.6	155.3	180.1	228.1	267.6
Gross margin (%)	45.9	43.2	37.5	43.3	44.1
EBITDA	57.3	64.8	72.0	80.9	95.9
EBITDA margin (%)	17.0	18.0	15.0	15.3	15.8
PBT	32.6	40.4	40.0	46.6	60.7
PBT margin (%)	9.7	11.2	8.3	8.8	10.0
Reported PAT	25.8	29.5	28.2	32.6	42.5
PAT margin (%)	7.7	8.2	5.9	6.2	7.0

Balance sheet Rs (cr)

Particulars	FY08	FY09	FY10	FY11E	FY12E
Shareholders fund	320.2	689.3	700.8	733.3	775.8
Loan fund	147.9	153.7	157.0	167.6	192.0
Funds employed	**468.1**	**843.0**	**857.8**	**900.9**	**967.8**
Fixed assets	43.9	74.4	53.3	47.6	37.1
Investment	142.2	346.4	290.4	290.4	290.4
Net current asset	281.9	422.2	514.0	562.9	640.3
Funds deployed	**468.1**	**843.0**	**857.8**	**900.9**	**967.8**

Valuation

Particulars	FY08	FY09	FY10	FY11E	FY12E
EPS (Rs)	2.3	2.6	2.5	2.8	3.7
Cash EPS (Rs)	3.0	3.4	3.5	4.2	5.1
PER (x)	26.6	23.3	24.4	21.1	16.2
P/B (x)	2.1	1.0	1.0	0.9	0.9
EV/EBITDA (x)	14.6	12.9	11.6	10.4	8.7
Mcap/Sales (x)	2.0	1.9	1.4	1.3	1.1

Key ratio

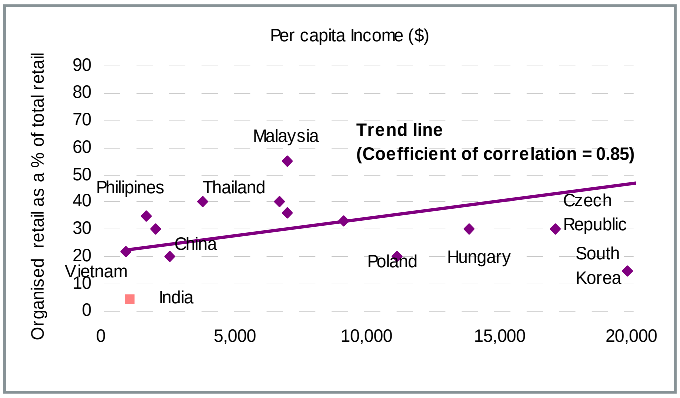
Particulars	FY08	FY09	FY10	FY11E	FY12E
Operating margin (%)	14.3	10.7	10.7	11.3	12.3
EBITDA margin (%)	17.0	18.0	15.0	15.3	15.8
PAT margin (%)	7.7	8.2	5.9	6.2	7.0
Asset turns (x)	0.7	0.4	0.6	0.6	0.6
Inventory turns (x)	1.2	1.1	1.3	1.2	1.1
Debt/Equity (x)	0.3	0.2	0.2	0.2	0.2
RoCE (%)	10.5	6.6	7.0	7.3	8.2
RoE(%)	8.1	4.3	4.0	4.4	5.5

SOTP valuation Rs (cr)

Particulars	Base year	Base method	Net profit	Multiple (x)	Equity value	Per share (Rs)
Provogue	FY2012	PE based	42.5	15	637.4	56
Prozone	Life time	NAV based			445.4	39
Total value					**1,082.8**	
No of shares (cr)						11.4
Value per share (Rs)						**95**

Annexure: Indian organised retail—Poised for growth

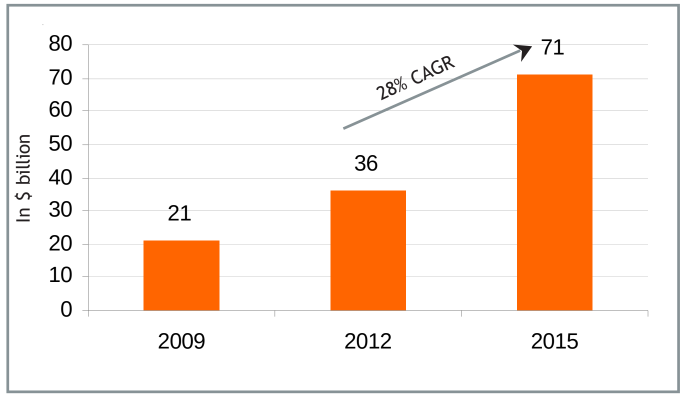
Global ORP vs PP: immense opportunity in India



* ORP: Organised retail penetration ** PP: Purchasing power

Source: Industry, Sharekhan Research

By 2015, organised retail to be a $71-billion market



Source: Industry

Fundamentals back on track

Domestic demand revives

- Fear of holding back of spend recedes
- Buying resumes in urban as well as rural India
- Improvement in same-store sales growth seen

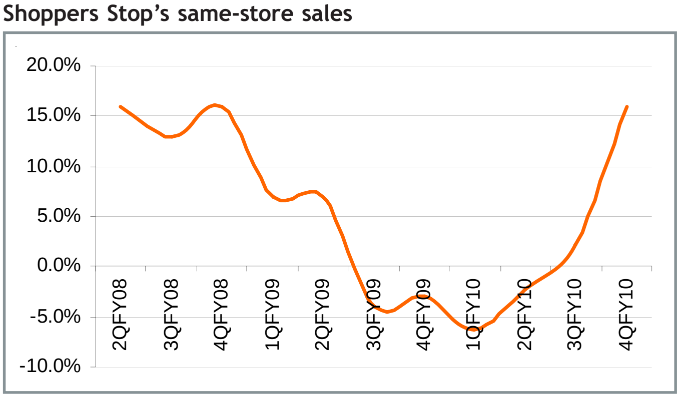
Cost rationalisation—leading towards efficiency

- Rationalisation of occupation and other cost
- Strong focus on efficient inventory management and back-end system
- Margin expansion visible

Benign competitive environment

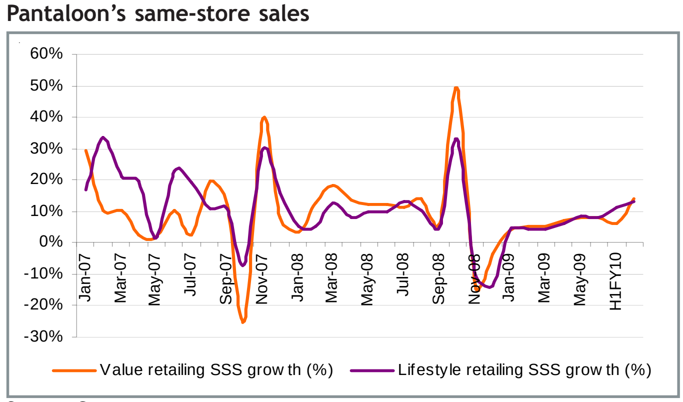
- Marginal and small retailers thrown out of business
- Number of players reduced

Shoppers Stop's same-store sales



Source: Company

Pantaloon's same-store sales



Source: Company

The author doesn't hold any investment in any of the companies mentioned in the article.

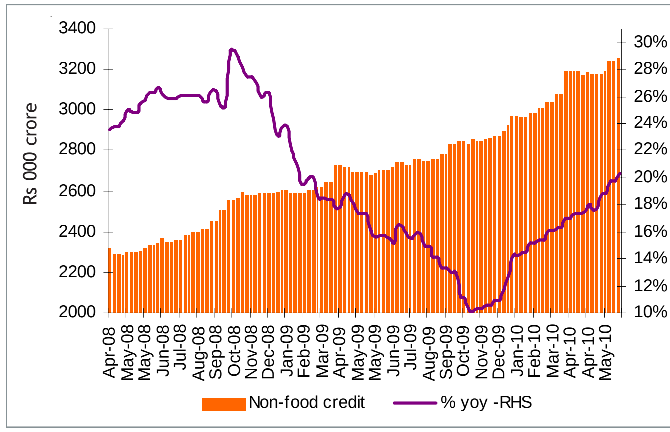
Sharekhan Special

Q1FY2011 Banking earnings preview

Credit growth on the uptrend

Since revival in Q4FY2010, the credit growth rate has continued to pick momentum well into Q1FY2011. The credit off-take remained strong at around 20% year on year (yoy) as on June 18, 2010, higher than that seen in the previous quarter. The credit off-take ordinarily is subdued during the first quarter of a fiscal, however, in Q1FY2011, the growth momentum continued as a result of an increased credit demand from the telecommunication companies to make payment to the government for the recently-concluded third generation (3G)/broadband wireless access (BWA) spectrum auctions.

Trend in credit growth



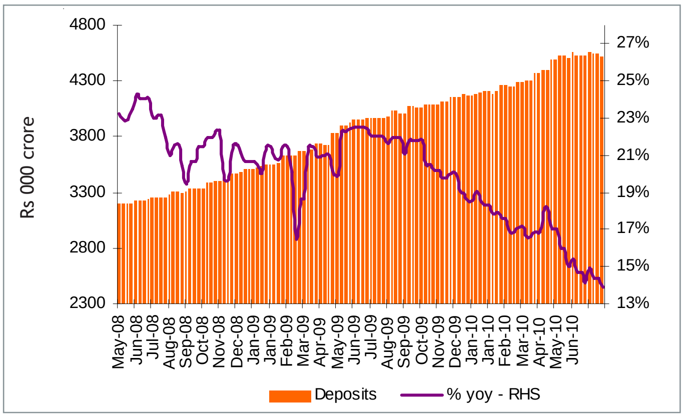
Quarterly estimates (Rs crore)

Banks	NII			PPP			PAT		
	Q1FY11E	Q1FY10	% yoy	Q1FY11E	Q1FY10	% yoy	Q1FY11E	Q1FY10	% yoy
Pvt banks									
HDFC Bank	2,371	1,856	27.8	1,721	1,519	13.3	814	606	34.3
ICICI Bank	1,946	1,985	-2.0	2,246	2,529	-11.2	1,027	878	16.9
Axis Bank	1,483	1,046	41.8	1,378	1,176	17.1	728	562	29.5
Federal Bank	401	290	38.1	330	278	18.4	142	136	3.9
Pvt bank total	6,200	5,177	19.8	5,674	5,502	3.1	2,710	2,183	24.2
PSB banks									
Allahabad Bank	752	629	19.6	702	591	18.9	337	303	11.1
Andhra Bank	653	441	47.9	500	348	43.6	275	256	7.1
Bank of Baroda	1,721	1,205	42.8	1,361	1,010	34.7	794	685	15.9
Bank of India	1,569	1,301	20.7	1,299	1,094	18.8	469	585	-19.8
Corp Bank	647	468	38.4	572	571	0.1	299	261	14.6
IDBI Bank	747	316	136.2	617	756	-18.4	180	172	4.8
PNB	2,436	1,862	30.8	1,936	1,569	23.4	1,080	832	29.8
SBI	6,473	5,025	28.8	4,373	3,674	19.0	2,394	2,330	2.7
UBI	1,380	802	72.2	1,080	787	37.1	546	442	23.5
PSB total	16,378	12,048	35.9	12,440	10,401	19.6	6,373	5,867	8.6
Banks total	22,578	17,225	31.1	18,114	15,903	13.9	9,083	8,050	12.8
NBFCs	**NII**			**Operating profit**			**PAT**		
	Q1FY11E	Q1FY10	% yoy	Q1FY11E	Q1FY10	% yoy	Q1FY11E	Q1FY10	% yoy
HDFC	931	669	39.3	1,021	796	28.3	715	565	26.5
TFCI	11.0	7.4	47.7	9.7	6.8	42.1	7.0	5.8	20.1

Deposit growth lags credit growth

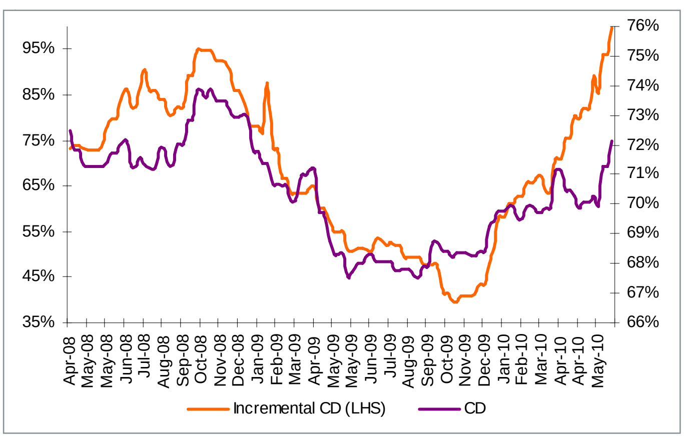
During the quarter, the deposit growth did not maintain pace with the strong credit growth. The deposit growth as on June 18, 2010 stood at 13.9% yoy, down from around 17% year-on-year (y-o-y) growth seen at the end of Q4FY2010. This seems to be a reflection of the relatively lower rates prevailing in term deposits. The lower deposit growth (compared with the credit growth) cannot be sustained for long, so we believe that the term deposit rates are likely to see an uptrend in due course.

Trend in deposit growth



...thus leading to improved deployment

Trend in deployment

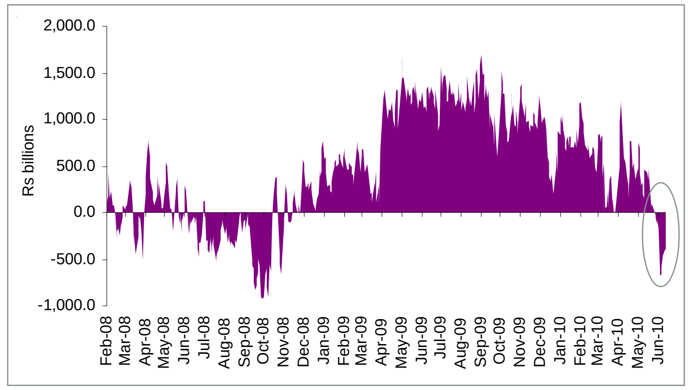


With the deposit growth lagging the credit growth, the deployment rate has improved to 72.1% as on June 18, 2010 from 71.1% on March 26, 2010. Meanwhile the incremental credit-deposit (CD) ratio has expanded to 99.6% as on June 18, 2010 from 70.9% on March 26, 2010.

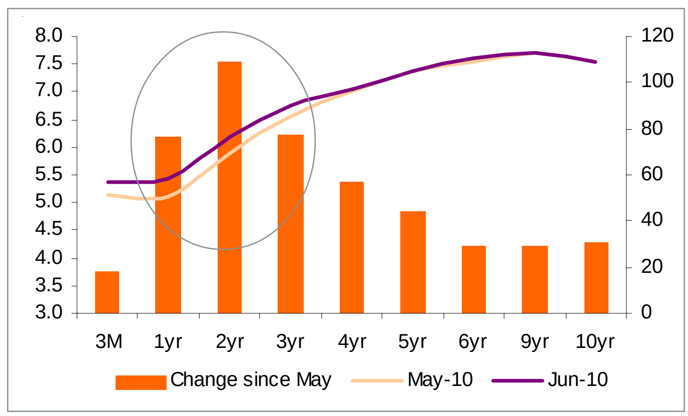
....but tighter liquidity

During the quarter, the liquidity situation remained tight with the total amount of funds parked with the Reserve Bank of India (RBI) turning negative towards the end of the quarter. The declining liquidity scenario was a result of the monetary tightening measures, the advance tax outgoes and the payments by the telecommunication companies to the government for 3G and BWA spectrum auctions. The tightening liquidity situation has led the lower end of the yield curve move upwards as compared to its previous position thereby resulting in the flattening of the yield curve.

Trend in liquidity position



Yield curve movement



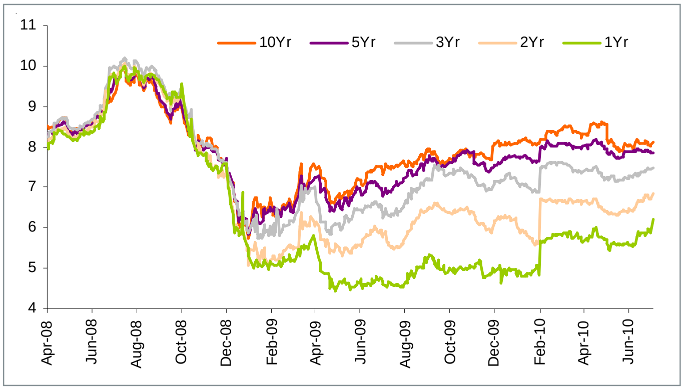
NIM to dip sequentially

We expect the banks under our coverage to witness a sequential dip in their net interest margin (NIM) as they move to a new system of calculation of interest payment on savings accounts on a daily basis from April 01, 2010. The transition is expected to hit the banks in the range of 10-20 basis points. However, this would be offset partially by an improved deployment.

Treasury gains to remain lacklustre

During Q1FY2011, the short-term yields hardened on a quarter-on-quarter (q-o-q) basis on the back of tighter liquidity and rate hike concerns. Meanwhile the long-term yields contracted on the back of forecast of a normal monsoon, which helped anchor the inflationary expectations to a certain extent. For Q1FY2011, we expect the treasury gains to remain lacklustre compared to the year-ago levels, though better than that in the previous quarter. The lower treasury gains could be compensated, to some extent, by lower mark-to-market (MTM) provisioning on the investment portfolio arising out of easing up of long-term yields.

Trend in G-sec yields



Asset quality—negative surprises likely

With Q1FY2011 marking the end of the moratorium for some of the loans restructured in the year-ago quarter, the banks would now realise/book non-performing assets (NPAs), if any. Further, the government's agri debt waiver scheme (one-time settlement), which was extended by another six months, has expired on June 30, 2010. With the scheme expiring in the quarter under review, there is a possibility of some of the loans restructured under the scheme being realised as NPAs. As a result, negative surprises on asset quality front specifically from the public sector banks cannot be ruled out, which would increase their provisioning requirement and hence pressurise their bottom lines. However, a few banks such as Punjab National Bank (PNB) and Bank of Baroda (BoB) have on a prudential basis already provided for agri NPAs arising from the agri debt waiver scheme and hence would not be materially impacted by the expiry of the scheme.

Divergence in bottom line growth to continue

We expect the cumulative bottom line of the private sector banks under our coverage to report a healthy growth of ~24% yoy and the public sector banks a slower growth of around 8.6% yoy. For the quarter ended June 30, 2010, among the public sector banks under our coverage, we expect PNB and Union Bank of India to report relatively better numbers and among the private players, we expect HDFC Bank and Axis Bank to report a healthy bottom line growth.

The author doesn't hold any investment in any of the companies mentioned in the article.

Sharekhan Special

Q1FY2011 IT earnings preview

- Q1FY2011 is expected to be another quarter of strong volume growth for the front-line IT companies as the demand environment remains buoyant in the USA and the emerging economies and on account of their limited exposure to Portugal, Italy, Ireland, Greece and Spain (PIIGS) economies. We see the demand to be driven mainly by: 1) The companies' increased focus on off-shoring on account of growing cost consciousness, 2) Higher spending to implement stricter regulatory compliance, and 3) Opportunities arising from merger and acquisition (M&A) integration. However, we highlight that the US dollar-term revenues of these companies will be hit by unfavourable cross currency movements (especially the appreciation of the Euro and other European currencies against the US dollar). We expect the front-line IT companies under our coverage to report a 2.9-4.9% sequential top-line growth in US dollar terms.
- The IT companies are expected to experience a 50-100 basis-point sequential decline in their operating profit margin (OPM) in Q1FY2011 on account of wage hike and volatility in currency movements. The higher income tax rates coupled with margin pressure is expected to negatively impact their bottom line.
- We expect Infosys Technologies (Infosys) to raise its FY2011E dollar-term revenue growth guidance of 16-18% and the rupee earnings per share (EPS) growth guidance of -1.7 to 2.4%, as visibility on volume growth improves with the progress of the fiscal year. The earnings guidance of Rs106.8-111.3 per share for FY2011 seems quite conservative and way below the consensus estimate. Our positive stance on strong demand stems from the strong hiring plan (a gross addition of 30,000 employees; we highlight that historically Infosys has increased its hiring guidance) by the company in FY2011.
- Apart from Infosys' guidance, the street is keenly waiting for management commentaries on overall IT budgets for CY2010 coupled with the impact of the recent European debt crises on the demand environment, going forward. The street would also keep a keen watch on the management comments on pick-up in discretionary spending, improvement in pricing scenario, hiring targets, attrition and utilisation levels.
- We do not see the Europeans debt crisis to have any major impact on the demand scenario for Indian IT companies, as they have limited exposure to the PIIGS economies (just around 0.5% of their revenue) and the major chunk of their revenue comes from the UK, Germany, France and Switzerland. Though we do not rule out IT spending cut by the European countries, as they impose stringent measures to reduce their fiscal deficit, the concern at present is the fluctuation in the exchange rate (as indicated by a strong depreciation of the Euro and the other European currencies against the US dollar).

Quarterly estimates

(Rs crore)		Net sales			Net profit		EPS	OPM
	Q1FY11	% qoq	% yoy	Q1FY11	% qoq	% yoy	(Rs)	(%)
Infosys Tech	6,213	4.5	13.5	1,542	-1.7	1.0	27.0	33.5
Guidance	*5919-5963*						*24.34-24.79*	
HCL Tech	3,245	5.5	11.6	307	-10.7	-7.0	4.5	18.7
Wipro (Cons)	7,337	5.2	14.9	1,181	-2.3	16.9	4.8	18.2
Wipro (Global IT Services)	5,504							
Guidance (Global IT services)	*$1,190-$1,215 million*							
TCS	8,070	4.3	12.0	1,798	-6.9	18.3	9.2	26.5

- The media reports indicate that oil & gas major British Petroleum (BP) has cut its global IT budget for FY2011 drastically, to USD300 million from USD2 billion, mainly due to oil spill losses in the Gulf of Mexico. If the media reports are indeed true, BP would be cutting its IT budget by around 85%. Further, the company is also expected to re-negotiate the pricing for its existing IT contracts with its vendors. IBM is very large vendor of BP. Among Indian vendors, BP has awarded multi-year contracts to Infosys, Tata Consultancy Services (TCS) and Wipro in August 2009. Hence Infosys and TCS have significant exposure to BP.
- In Q1FY2011, BSE IT (the IT index) declined by 0.7%, under-performing the broader indices such as the Sensex (that was flattish during the quarter). The under-performance was mainly on the account of unfavourable cross currency movements (especially the depreciation of the Euro against the US dollar).

Rupee-term revenue growth to be 4.3%-5.5%

The rupee has slightly depreciated, by 0.5%, against the US dollar in Q1FY2011 on a sequential basis. We expect the revenue for front-line IT companies in rupee terms to grow by 4.3-5.5% on a quarter-on-quarter (q-o-q) basis.

Foreign exchange rates

INR vs	End of period rates		Average rates	
	31-Mar-10	30-Jun-10	31-Mar-10	30-Jun-10
US$	44.92	46.45	45.92	45.68
% qoq		*3.41*		*-0.54*
Euro	60.56	56.82	63.48	57.98
% qoq		*-6.19*		*-8.66*
Pound Sterling	68.07	69.41	71.57	68.03
% qoq		*1.98*		*-4.95*
AUD	41.12	39.06	41.50	40.27
% qoq		*-5.02*		*-2.97*

Source: Bloomberg

Unfavourable cross-currency movements to hit dollar-term revenue

The unfavourable cross-currency movements during the quarter are likely to have a negative impact of 1.1% on the dollar-term revenue of the front-line IT companies in Q1FY2011.

Cross-currency rates

USD vs	End of period rates		Average rates	
	31-Mar-10	30-Jun-10	31-Mar-10	30-Jun-10
GBP	1.52	1.49	1.56	1.49
% qoq		*-1.57*		*-4.33*
EUR	1.35	1.22	1.38	1.27
% qoq		*-9.42*		*-8.01*
AUD	0.92	0.84	0.90	0.88
% qoq		*-8.33*		*-2.37*

Source: Bloomberg

OPM to shrink by 50-100 basis points on sequential basis

The front-line IT companies are expected to see their OPM contract by 50-100 basis points in the quarter to reflect the impact of wage hike and unfavourable cross-currency movements.

No major impact from European debt crisis; currency fluctuations major worry in the near term

We do not see the European debt crisis to hit the demand scenario for the Indian IT companies in any major way, as the domestic vendors have limited exposure to the PIIGS economies (just around 0.5% of their revenue) and the major chunk of their revenue comes from the UK, Germany, France and Switzerland. Though we do not rule out IT spending cut by the European countries, as they tighten their belts to contain their fiscal deficit, the concern at present is the fluctuation in the exchange rate (as indicated by a strong depreciation of the Euro and the other European currencies against the US dollar).

BP cuts global IT budgets for FY2011—IBM major vendor; Infosys and Wipro significantly exposed

The media reports indicate that the oil & gas behemoth, BP, has drastically cut its global IT budget for FY2011— to USD300 million from USD2 billion, mainly due to the oil spill losses in the Gulf of Mexico. If media reports are indeed true, BP would be slashing its IT budget by around 85%. Further, the company is also expected to re-negotiate the pricing for its existing IT contracts with its vendors. IBM is a very large vendor of BP. Among Indian vendors, BP has awarded multi-year contracts to Infosys, TCS and Wipro in August 2009. Hence Infosys and TCS have significant exposure to BP.

Exposure of Indian IT companies to BP

Company	Annual revenues from BP (USD million)	Comment
TCS	5	In August 2009, BP selects TCS as a strategic IT vendor to reduce complexity, standardise processes and reduce cost.
Infosys	100	In August 2009, Infosys wins a multi-million five-year application outsourcing and support services contract from BP.
Wipro	Exact amount not known but exposure likely to be significant	In August 2009, Wipro enters into a five-year contract to provide IT application development and maintenance services to BP.
HCL	No exposure	

Valuation and view

In the near term, we expect HCL Technologies to offer better alpha among the IT majors mainly due to the widening of the valuation gap and positive surprise on large deal flow. Hence, HCL Technologies is our top pick in the IT sector and we maintain our Buy recommendation on the stock. For Infosys, Wipro and TCS, we maintain our Hold recommendation.

Valuation table

Particulars	CMP (Rs)	EPS (Rs) FY2010	FY2011E	FY2012E	CAGR (%) FY2010-FY2012E	P/E (x) FY2010	FY2011E	FY2012E
Infosys	2,787	108.7	119.2	138.3	12.8	25.6	23.4	20.1
TCS	758	35.1	38.7	43.9	11.8	21.6	19.6	17.3
Wipro	396	19.0	21.6	23.3	10.8	20.9	18.3	17.0
HCL Tech	360	18.6	24.5	27.2	20.9	19.3	14.7	13.2

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Evergreen

Housing Development Finance Corporation
HDFC Bank
Infosys Technologies
Larsen & Toubro
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
Apollo Tyres
Bajaj Auto
Bajaj Finserv
Bajaj Holdings & Investment
Bank of Baroda
Bank of India
Bharat Electronics
Bharat Heavy Electricals
Bharti Airtel
Corporation Bank
Crompton Greaves
Glenmark Pharmaceuticals
Godrej Consumer Products
Grasim Industries
HCL Technologies
Hindustan Unilever
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico
Maruti Suzuki India
Lupin
Piramal Healthcare (Nicholas Piramal India)
Punj Lloyd
Sintex Industries
State Bank of India
Tata Tea
Wipro

Cannonball

Allahabad Bank
Andhra Bank
IDBI Bank
Madras Cements
Phillips Carbon Black
Shree Cement
Tourism Finance Corporation of India

Emerging Star

3i Infotech
Alphageo India
Allied Digital Services
Axis Bank (UTI Bank)
Cadila Healthcare
Emco
Greaves Cotton
Max India
Opto Circuits India
Patels Airtemp India
Thermax
Zydus Wellness

Ugly Duckling

BASF India
Deepak Fertilisers & Petrochemicals Corporation
Federal Bank
Gayatri Projects
Genus Power Infrastructures
India Cements
Ipca Laboratories
ISMT
Jaiprakash Associates
Orbit Corporation
Pratibha Industries
Provogue India
Punjab National Bank
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Selan Exploration Technology
Shiv-Vani Oil & Gas Exploration Services
Subros
Sun Pharmaceutical Industries
Sunil Hitech Engineers
Torrent Pharmaceuticals
UltraTech Cement
Union Bank of India
United Phosphorus
Zensar Technologies

Vulture's Pick

Esab India
Mahindra Lifespace Developers
Orient Paper and Industries
Tata Chemicals
Unity Infraprojects