Wipro Limited

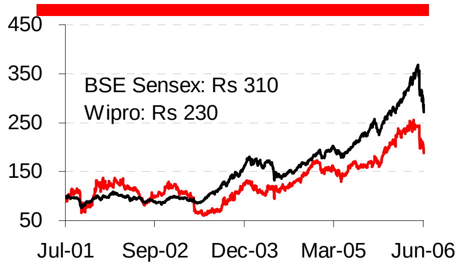
Hold* **Target Price: Rs 620**

Market data

Current price	Rs 514 (BSE)
Market cap	Rs 732,481 m
Face value	Rs 2.0
CY05 Div/share	Rs 5.0
NSE symbol	WIPRO
No of shares	1,425.8 m
Free float	18.6%
52 week H/L	Rs 599 / 345

Share price chart

Rs 100 invested is worth



Shareholding

Category	(%)
Promoters	81.4
Banks, FIs, MFs	1.5
FIIs	4.7
Public	6.9
Others	5.5
Total	100.0%

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Investment Rationale

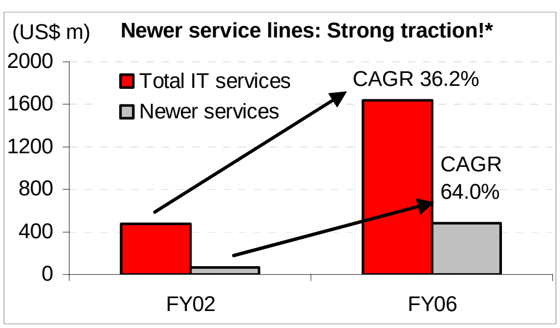
- **Stringing pearls:** Wipro has been one of the most prominent Indian IT companies on 'Deal Street' and, in recent times, has embarked upon a clear acquisition strategy to fill up gaps in its service offerings. The strategy entails adding a complete set of services, technology and domain expertise that the company is endeavoring to build to offer to potential clients. It has acquired as many as 6 companies over the past 6 months. Each of these companies operates in niche areas where Wipro did not earlier have a presence. To give an example, in December 2005, Wipro acquired an Austrian firm called NewLogic. This company operates in the area of chip design, and will give Wipro enhanced capabilities in the semiconductor space and complement its portfolio of patents in wireless and wireline technologies.

  Similarly, Wipro has acquired companies in areas like payments solutions, infrastructure consulting, mechanical design, retail solutions and wireless design. The company has structured payments in such a manner so that it pays part of the consideration initially and the balance on the achievement of financial targets. Therefore, it is largely a performance-based payment structure, apart from the initial payment for the inherent value of the business. This is undoubtedly a positive, and ensures that Wipro ends up paying a fair price for these acquisitions.

  Apart from the 'filling in the gap' strategy, another rationale for the acquisitions is to get non-linear growth (increase in revenues without having to add much to the manpower). The acquired firms are established leaders in their specific domains of expertise, and do not have a large amount of manpower to integrate. Thus, integration issues are less likely to crop up. Wipro can also expand its geographical footprint. While margins of these entities are certainly much lower than those of Wipro, the company expects to scale them up to higher levels, through increased offshoring and some amount of cost leverage. But as we said, the main rationale for these acquisitions is not to gain scale or margins, but to fill up gaps in its offerings. Of course, this is not a substitute for organic growth. But overall, it is the direction that we believe is encouraging.

- Carrying on the offshoring momentum: In line with global technology majors like IBM and Accenture announcing big plans for growing their India operations, there seem to have emerged certain challenges for the Indian players with respect to competing with these global majors, who have deep pockets and wider technology expertise. However, in our talks with the larger Indian software companies, including Wipro, while there seems to be no belittling the MNC IT majors' Indian plans, the former are well on their way to securing faster offshoring momentum in the years to come. While talent retention continues to be a foremost issue for Indian players, what with the MNCs offering fatter pay packets to poach Indian talent, the fact that these companies use Indians as an 'India-specific resource' gives an upper hand to the Indian players, who are providing their employees with a better global experience. And this is the reason as to why companies like Wipro are seeing ex-employees coming back to them after an MNC stint for a year or two. Further, since cost arbitrage (apart from abundant talent) is one of the major reasons for the MNCs to ramp up operations in India, sustenance by consistently paying higher relatively 'attractive' salaries to employees will not be possible. This, overall, makes us positive on top-tier companies like Wipro, which are expected to be less impacted by the surge of MNCs setting up bases in the country.

- **Increasing presence in high-end services:** Wipro, in its gradual move up the value chain, is increasing revenue contribution from providing high-end services like IT consulting, systems integration, technology infrastructure services, testing, package implementation and R&D services. The potential for growth in these areas is immense. In order to get a sense of the company's strong performance on this front, in FY02, revenues from such services totalled 14% of IT service revenues, while in FY06, this figure was nearly 30%. These services have grown at a CAGR of 64% from FY02 to FY06, and in FY06, have nearly touched US$ 500 m in revenues, from just US$ 67 m in FY02.



*New service lines include technology infrastructure services, testing services, package implementation and consulting.

To give just one example, Wipro has been amongst the first movers in services like infrastructure management, which have significant growth potential. Infrastructure management, which is the remote management of a company's IT infrastructure, such as servers, desktops, network management and security systems, used to be an activity that was performed nearly 95% onsite only a few years ago. However, with the increasing acceptance of the offshoring concept, the activity is now performed 65% offshore, with significant cost savings and value addition for the clients. This service line has grown at a CAGR of over 40% from FY02, and given Wipro's strong positioning in this service, appears poised for even stronger growth in future.

- **More technology-intensive than peers:** While Wipro's peers like Infosys and Satyam derive a large part of revenues from the enterprise services business, Wipro has an edge in terms of it being relatively more technology-intensive. The company, as part of its R&D group, provides services in the areas of emerging technologies related to embedded systems, product engineering, home networking, Internet infrastructure, consumer and automotive electronics, to telecom equipment manufacturers like Nortel, Cisco and Lucent. The telecom and Internet accesses space is a lucrative one due to the fact that the R&D spends by the US industry and government has been one of the strongest in this area, according to National Science Foundation (US). As a mater of fact, the technology R&D business accounts for around 37% of the company's total revenues.

The company has learnt from its mistakes of the past as far as telecom R&D is concerned, and has derisked its revenues from equipment makers to now include telecom service providers as well. This gives us confidence with respect to the company's ability to tide over challenges in case there were to be any kind of slowdown in the global telecom and technology industry.

Investment Concerns

- **Integration issues:** In line with the spate of acquisitions that Wipro has done in past and plans to do so in the future, the integration of the acquired entities shall be a risk, as with most acquisitions across the world, across industries. Retaining local talent, providing them with global opportunities and integrating the respective company cultures will be the issues that could take up a lot of management time. While the company has been successful in the past in integrating the acquired companies, this is just a risk to our assumptions and investors need to take this into consideration.

- **Low floating stock:** Wipro's floating stock in the markets is very low. Promoters hold about 81% of the stock. The low liquidity leads to wide fluctuations in the stock price. This is also the reason as to why the company's valuations are on the higher side.

Background

Wipro is India's third-largest software services exporter and has diversified business interests, which include software development, hardware and consumer care and lighting. The company began its swift transformation from a predominantly hardware company to a software services company in FY99. Since then, the contribution of Wipro Technologies, Wipro's global IT services business has consistently been on the rise and has been the major driver of revenue and profit growth. In FY06, the share of Global IT services (Wipro Technologies) increased to 76% from 57% in FY01. Consequently, the contribution of Indian & Asia Pacific IT services and products (Wipro Infotech) declined from 40% in FY99 to 16% in FY06. Wipro Technologies also accounted for as much as 88% of the group's operating profits in FY06. Wipro's IT services' portfolio includes a wide range of services like package implementation, systems integration, testing services, application development, R&D services and BPO.

Industry Prospects

Global technology spending has been on an up-trend over the past two years with the offshore component seeing impressive traction, driven by increasing acceptance of the 'global delivery model'. However, the demand has shifted from low-end services to high-end ones, like IT consulting, package implementation and systems integration. While Indian software companies are increasingly facing competition from global MNCs, the need of the hour for the former is to rapidly move up the software value chain. Increasingly, the demand for technology is likely to be more guided by the 'Return on Investment' factor, i.e., how much of cost saving or return on investment can be obtained by clients from their IT spending. As such, Indian IT companies that provide a broad range of services and have proven capabilities in executing large and complex projects are likely to emerge winners over the long term.

Risk Analysis

Sector: The Indian software industry is in the 'growth phase', with the top-tier players growing at a rate of over 25% annually. Offshoring as a concept is witnessing increased acceptance, leading to a strong accretion to the order books of software majors, resulting in impressive growth for these companies. Going forward, this is expected to continue over the medium-to-long term as well. However, increasing competition from MNC software companies, who are themselves setting up their offshore delivery networks, and most importantly, higher attrition rates and employee costs, leading to reducing the cost arbitrage for Indian companies, are the major headwinds facing the top-tier Indian software incumbents. Based on these factors, we have assigned the stock a medium-risk rating of 5.

Sales: Wipro generated average revenues to the tune of nearly Rs 65 bn (US$ 1.4 bn). Further, in the latest fiscal (FY06), the company generated Rs 106 bn in sales (US$ 2.4 bn). Based on our parameters, we assign a low-risk rating of 10 to the stock.

Current ratio: Wipro's average current ratio during the period FY02 to FY06 has been 1.7 times. This indicates that the company is comfortably placed to pay off its short-term obligations, which gives comfort to its lenders. We assign a medium-risk rating of 6.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering Wipro's average debt to equity ratio of less than 0.02 over the past five fiscals, we have assigned a low-risk rating of 10 to the stock.

Long term EPS growth: We expect the company's net profit to grow at a compounded rate of around 30% over the period FY06-FY09 (CAGR of 25% during FY01-FY06). Based on a normal scenario, we consider a compounded growth of over 20% in net profits over a 5-year period as healthy for a company. As such, the rating assigned to the stock on this factor is 8.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Wipro's average payout ratio has been a healthy 27% over the past 5 fiscals, including a special one-time cash dividend of Rs 25 per share in FY04. Thus, we have assigned a low-risk rating of 7.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the promoter holding in Wipro stood at 81.4%, which is healthy. We have assigned a low-risk rating of 7 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. The FII holding in Wipro at the end of March 2006 stood at just 4.7%, which is comfortably within the limits. Therefore, the rating assigned is 9.

Liquidity: The average daily trading volumes of Wipro's stock over the past 5 years stand at over 800,000 shares. Despite a large promoter holding, such high liquidity levels give us comfort with respect to stability in the company's valuations. The rating assigned is 10.

Margin of safety: This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as EPS divided by market price (reciprocal of P/E). Considering Wipro' P/E of 35.5 times its FY06 earnings, the earning power is 2.8%, which is fairly low. Thus, the rating assigned is 1.

Considering the above parameters, the total ranking assigned to the company is 73. This makes the stock a low-risk investment from a long-term perspective.

Risk Matrix

	High Risk	Medium Risk	Low Risk
Rating	(1 to 3)	(4 to 6)	(7 to 10)
Sector	High	Medium	Low
Sales (US$ m)	< 500	501 - 1,000	> 1,000
Current Ratio (x)	< 1	1 - 2	> 2
Debt to equity ratio (x)	> 1	0.5 - 1	< 1
Long term EPS growth (%)	< 10	10 - 20	> 20
Dividend Payout (%)	< 15	15 - 25	> 25
Promoter holding (%)	< 25	25 - 40	> 40
FII holding (%)	> 25	10 - 25	< 10
Liquidity (Nos. '000)	< 100	100 - 200	> 200
Margin of Safety (%)	< 3	3 - 6	> 6
Final Rating	< 30	30 - 60	> 60

Valuations

We had last recommended Wipro in August 2005 at Rs 359 with a target price of Rs 520. Since then, the stock has crossed our target, reaching a high of Rs 599 before declining in line with the overall market. The stock currently trades at Rs 514, implying a price-to-earnings multiple of 19.9 times our estimated FY08 earnings. Considering the fact that offshoring, as a practice, is gaining increasing acceptance globally, and clients are now looking at outsourcing/offshoring high-end services to third party vendors, the top-tier Indian software services players like Wipro are likely to benefit tremendously in the future. Apart from this, the company is doing well to fill in the service line gaps and penetrate into newer verticals and geographies through acquisition of niche companies globally. Based on these aspects, and the management's ability to chart a strong growth path even in the face of tough competition, we expect Wipro to clock superior topline and bottomline growth over the long-term. We, thus, recommend a HOLD** on the stock with a revised target price of Rs 620 from a long-term perspective.

**By this recommendation of HOLD, what we mean is that existing shareholders would be better off holding on to the stock with a two-year perspective. However, if an investor would like to BUY this stock, then the upside from the current levels is about 21% point-to-point (11.3% CAGR). Investors could take the investment decision based on this premise.*

Valuation table

(Rs m)	FY06	FY07E	FY08E	FY09E
Revenue	106,029	148,230	198,284	256,383
Net profit	20,674	28,292	36,887	46,309
EPS (Rs)	14.5	19.8	25.8	32.4
Price to earnings (x)	35.5	25.9	19.9	15.8
Price to sales (x)	6.9	4.9	3.7	2.9

Recent acquisitions...

Company	Acquisition price	Revenues	Domain of expertise	Verticals served
NewLogic	47 m Euros (US$ 56 m), 21 m Euros payable upfront	14 m Euros (US$ 16.7 m, 2005)	Chip design, IP cores in W-LAN, Bluetooth	Semiconductor, telecom
mPower	US$ 28 m	US$ 18 m	Payments Solutions	Financial services
cMango	US$ 20 m upfront, earn-outs based on achievement of financial targets	US$ 13 m	Infrastructure consulting	BFS, pharma, hi-tech, retail, public sector
Quantech	US$ 10 m	US$ 12.7 m	CAD/CAE services	Automobile, aerospace, consumer goods
ENABLER	41 m Euros (US$ 53.3 m) earn-outs based on financial targets	US$ 39 m	Integration of Oracle Retail (Retek), retail consulting	Retail
Saraware Oy	25 m Euros (US$ 31.6 m) upfront, including debt takeover, earn-outs on achievement of financial targets	14 m Euros (US$ 17.7 m)	Wireless design and engineering services	Telecom

Performance over the years…

	FY03	FY04	FY05	FY06
Promoter holding (%)	83.9	83.7	83.1	81.4
Net sales (Rs m)	42,865	58,400	81,606	106,029
EBDITA margin (%)	24.6%	21.8%	25.1%	23.9%
Net profit (Rs m)	8,206	10,315	16,285	20,674
Net margin (%)	19.1%	17.7%	20.0%	19.5%
Debt to equity (x)	0.0	0.0	0.0	0.0
Return on Net worth (%)	27.0%	28.5%	36.0%	34.8%
Dividend per share (Rs)	1.0	29.0	5.0	5.0

Financials at a glance

(Rs m)	FY06	FY07E	FY08E	FY09E
Sales	106,029	148,230	198,284	256,383
Sales growth (%)	*29.9%*	*39.8%*	*33.8%*	*29.3%*
Operating profit	25,374	33,991	44,430	57,210
Operating profit margin (%)	*23.9%*	*22.9%*	*22.4%*	*22.3%*
Net profit	20,674	28,292	36,887	46,309
Net profit margin (%)	*19.5%*	*19.1%*	*18.6%*	*18.1%*
Balance Sheet				
Current assets	42,567	73,685	107,989	145,256
Fixed assets	18,154	19,598	21,061	23,306
Investments	30,812	30,812	30,812	30,812
Goodwill	3,528	2,352	1,176	-
Other assets	594	594	594	594
Total Assets	**95,655**	**127,041**	**161,632**	**199,968**
Current liabilities	28,770	39,689	49,621	59,609
Net worth	66,127	86,354	110,623	138,451
Loan funds	757	606	485	363
Minority interest / other liabilities	-	392	903	1,545
Total liabilities	**95,655**	**127,041**	**161,632**	**199,968**

Comparative Valuations

(Rs m)	Wipro	Infosys	TCS	Satyam
Operating ratios				
Sales CAGR (FY02-FY06, %)	32.5	38.3	31.9	24.9
EBDITA margin (FY06, %)	23.9	32.5	27.7	24.3
Profits CAGR (FY02-FY06, %)	23.6	32.1	27.1	88.1
Net profit margin (FY06, %)	19.5	25.8	21.8	20.5
Revenues per employee (FY06, Rs m)	2.2	2.1	2.4	2.0
Return ratios				
Return on equity (FY06, %)	34.8	40.0	63.8	25.8
Return on assets (FY06, %)	24.9	29.8	39.8	26.5
Asset turnover (FY06, x)	1.1	1.0	1.5	0.9
Valuations				
Price (Rs)	514	3,078	1,736	711
Price to earnings (FY08E, x)	19.9	19.9	18.8	15.1
Price to sales (FY08E, x)	3.7	5.0	3.9	2.8
EV/EBDITA (FY08E, x)	14.9	14.3	13.4	10.1

Sector Statistics

Sales (Rs m)		Market cap. (Rs m)		EBDITA margin (%)		Net profit margin (%)		Return on NW (%)	
Accenture*	17,094	Accenture	26,990	Infosys	32.5%	Infosys	25.8%	TCS	63.8%
TCS	2,969	Infosys	19,204	TCS	27.7%	TCS	21.8%	Accenture	59.3%
Wipro* **	**2,356**	TCS	18,873	**Wipro**	**23.9%**	**Wipro**	**19.5%**	Infosys	40.0%
Infosys	2,151	**Wipro**	**16,302**	Accenture	12.3%	Accenture	5.5%	**Wipro**	**34.8%**

* US-based technology major.

** Conversion rate at US$ 1 = Rs 45.

*** Consolidated numbers

**** All figures taken are FY06/CY05 numbers.