

Triple whammy...

A lot has changed over the past three months. All the concerns haunting the IT sector are now translating into reality. The tone of IT companies related to the business outlook has turned from cautious, at the beginning of Q3FY09, to pessimistic by the end of the same. The IT sector is facing a scenario of a triple whammy under current global financial meltdown with project delays and price cuts due to lack of liquidity for client, high cross-currency volatility and dipping utilisation.

Highlight of the quarter

In the middle of the global financial meltdown when asset prices have fallen sharply, IT companies have turned buyer of these assets to aid growth via the inorganic medium in a scenario of demand erosion in organic business. We saw companies like HCL acquiring Axon Group PLC, TCS acquiring Citigroup Global Services Ltd (CGSL), Wipro acquiring Citigroup technology Services Ltd (CTSL), Rolta India acquiring Piocon Technologies and the most controversial attempt of Satyam to acquire Maytas Infra and Maytas Properties. Q3FY09 saw very high cross-currency volatility with the rupee depreciating by almost 9.6% against the US dollar and the US dollar appreciating against the British pound by almost 19%. In this quarter, we saw the global demand slowdown spread from the BFSI to sectors like auto, manufacturing, aviation, networking, retail, etc, as well as from geographies like US to Europe, Australia, Japan, Singapore, etc.

Broad outlook for the sector for Q3FY09E

We expect the earnings season of Q3FY09E to be disappointing with top tier companies missing on their US\$ guidances on the back of high cross-currency volatility, lower volumes and pricing pressure and poor utilisation. Also, we expect companies to come out with further downward revisions in their revenues and EPS guidance for FY09E. At the onset of Q3FY09E we were concerned about the IT companies with maximum exposure to BFSI and US. However, now the concerns have broken vertical and geographic boundaries. All sectors and geographies are facing demand erosion. This is resulting in lack of liquidity as sales have dropped across the board. So, though the theory of more IT offshoring for prudent cost management sounds logical but liquidity freeze is not favouring it. Therefore this and above factors have caused the short-term outlook for IT sector to be very bleak. Our favourite picks remain Infosys, TCS and Rolta.

Result Summary

Exhibit 1: Coverage Universe

Company	Sales (%) change			EBIDTA (%) change			PAT (%) change		
	OND09	Y-o-Y	Q-o-Q	OND09	Y-o-Y	Q-o-Q	OND09	Y-o-Y	Q-o-Q
Infosys	5,928.8	38.8%	9.4%	1,956.5	40.5%	9.1%	1,582.4	28.5%	10.5%
TCS	7539.6	27.3%	8.4%	1900.7	20.4%	4.5%	1280.5	-3.8%	1.5%
Wipro	6675	27.5%	2.6%	1268.2	27.1%	14.7%	970	17.4%	-0.8%
Tech Mahindra	1276	31.5%	9.5%	316	48.4%	-3.1%	269.5	35.1%	-10.9%
HCL Tech	2426	33.6%	2.4%	534	37.7%	0.6%	362	8.8%	1.5%
3i Infotech	626.5	97.5%	4.1%	123.3	84.4%	7.9%	71.5	47.4%	4.5%
Rolta	379.4	57.0%	9.6%	133.2	43.5%	12.4%	62.0	4.7%	159.7%
Klg	119.0	29.2%	97.3%	26.16	21.7%	35.5%	14	-18.3%	62.0%
NIIT	263.90	10.5%	-14.7%	24.93	9.4%	-38.6%	15.83	13.9%	-46.7%

Source: ICICIdirect.com Research, Company

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Price Performance....

	% 1m	% 3m	% 6m	% 1y
Infosys	2.8	-11.4	-33.5	-31.1
TCS	-2.7	-18.0	-39.8	-49.5
Wipro	6.9	-24.0	-43.4	-51.1
Tech				
Mahindra	17.2	-48.7	-58.1	-73.6
HCL Tech	10.0	-32.9	-45.0	-58.7
3i Infotech	16.3	-28.2	-59.5	-71.6
Rolta	-8.0	-34.9	-50.0	-63.7
KLG	51.9	-45.5	-69.5	-88.9
NIIT	26.3	-25.4	-69.9	-79.6

Source: ICICIdirect.com Research, Company

Infosys (INFTEC)

- Considering the current scenario the volume growth for the company is expected to be around 0.5%. Also, with blended pricing drop of 0.7% we expect the sequential revenue growth to be flat in dollar terms and around 9.4% in rupee terms on the back of steep rupee depreciation of 9.6% on an average (QoQ). The benefit of rupee depreciation will translate into marginal expansion of 24 bps at the net profit level with margins at 26.3%. The company has hedges worth US\$932 million covering receivables over the next two quarters at US\$/INR of 46.97. Therefore, we estimate losses to the tune of US\$11 million.
- Concerns: Demand erosion has become very prominent with liquidity squeeze causing clients to hold back projects. This will impact volume growth. Utilisation will take a hit on account of less number of working days in this quarter as well as lower attrition, continued hiring and project delays that will increase bench strength. We expect de-growth in pricing with probability of more and more clients asking for contract re-negotiation. High cross-currency volatility i.e. the US dollar's steep appreciation of 19% against the British pound will, to an extent, hamper the benefit of steep rupee depreciation of 9.6% against the US dollar. Due to such high volatility in currencies and the deteriorating demand environment the company may further revise downwards its annual revenue guidance.

Exhibit 2: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y	Q-o-Q	H1Y09	FY09E
Sales	5,928.8	4,271.3	5,417.8	38.8%	9.4%	10,272.3	21,922.9
EBIDTA	1,956.5	1,392.3	1,793.8	40.5%	9.1%	3,273.3	7,118.0
EBIDTA margin	33.0%	32.6%	33.1%	40 bps up	11 bps dip	31.9%	32.5%
Profit	1,582.4	1,231.3	1,431.8	28.5%	10.5%	2,734.2	5,868.9
Profit margin	26.3%	27.8%	26.1%	145 bps dip	24 bps up	26.2%	26.3%
EPS	27.7	21.5	25.0	28.5%	10.5%	47.8	102.6

Source: ICICIdirect.com Research, Company

Tata Consultancy Services (TCS)

- We expect TCS to report sequential de-growth of 0.6% in dollar terms on the back of muted volume, dip in utilisation and pricing pressure. Also, TCS will not benefit from steep rupee depreciation against the dollar on the back of hedging covers worth of US\$480 million having average realisation rate of US\$/INR of 44.75 for this quarter. This will impact the profitability in addition to the above factors. The company acquired Citigroup Global Services Ltd (CGSL) in Q3FY09. This acquisition is expected to drive growth from Q4FY09.
- Concerns: The company is aggressively hedged with realisation rates at US\$/INR level of less than 43 for both FY09 and FY10. The losses because of the hedging covers have eaten up the company's profitability in the last quarter and will prove a spoil sport for the entire FY09. The company has good exposure to BFSI and manufacturing, which are the worst affected sectors in the current slowdown.

Exhibit 3: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y	Q-o-Q	H1FY09	FY09E
Sales	7539.6	5924.1	6953.4	27.3%	8.4%	13364.1	28719.1
EBIDTA	1900.7	1578.8	1819.7	20.4%	4.5%	3351.1	7299.1
EBIDTA margin	25.2%	26.7%	26.2%	144bps dip	96 bps dip	25.1%	25.4%
Profit	1280.5	1330.8	1261.5	-3.8%	1.5%	2505.1	5283.1
Profit margin	17.3%	22.1%	18.6%	475bps dip	127 bps dip	19.0%	18.6%
EPS	13.1	13.6	12.9	-3.8%	1.5%	25.6	54.0

Source: ICICIdirect.com Research, Company

Wipro (WIPRO)

- The management had indicated a flat sequential growth in the last quarter. We believe the cross-currency movement will result in the company missing its dollar guidance. However, due to excessive hedging we believe the company will be unable to take the full impact of the depreciation of the rupee. Margins are expected to dip on the back of wage hikes given by the company and also lower utilisation due to higher number of holidays in the quarter.
- The company has lagged peers in terms of organic growth. Hence, the volume growth of the company would be keenly watched. Management view on the integration of Infocrossing and its growth prospects would also be noted.

Exhibit 4: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y (%)	Q-o-Q (%)	H1FY09	FY09E
Consol Sales	6675	5236	6507.5	27.5%	2.6%	12500.6	25259
EBIDTA	1268.2	998	1105.6	27.1%	14.7%	2451.8	4799.2
EBIDTA margin	19.0%	19.1%	17.0%	6 bps dip	200 bps up	19.6%	19%
Profit	970	826.3	978.2	17.4%	-0.8%	1867.9	3662.6
Profit margin	14.5%	15.8%	15.0%	125 bps dip	50 bps dip	14.9%	14.50%
EPS	6.6	5.6	6.7	17.4%	-0.8%	12.8	25.0

Source: ICICIdirect.com Research, Company

Satyam Computer Services (SATCOM)

On account of the chairman's resignation and admission to manipulation in reporting financial accounts, we suspend our coverage on Satyam.

Tech Mahindra (TECHM)

- Given the current global scenario, we believe the large deals signed by the company over the past few quarters (over \$2 billion worth of deals with BT) would help it to report a healthy topline growth. However, given that the company derives majority of its revenues in British pound, cross currency fluctuations could have a severe impact on the company. Currency along with transitioning costs of these large deals is expected to impact margins (fall by 322 bps).
- Going ahead, the company's commentary on the slow growth in BT's traditional business would be noteworthy given the high dependence of the company on BT. We would also closely watch the growth in business from non-BT clients as an important measure of lowering dependence on BT.

Exhibit 5: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y (%)	Q-o-Q (%)	H1FY09	FY09E
Sales	1276	970	1164.8	31.5%	9.5%	2281.2	4859
EBIDTA	316	213	326	48.4%	-3.1%	613	1246
EBIDTA margin	24.8%	22.0%	28.0%	281bps up	322 bps dip	26.9%	25.6%
Profit	269.5	199.5	302.3	35.1%	-10.9%	560.8	1055.49
Profit margin	20.6%	20.0%	25.2%	69 bps up	455 bps dip	23.9%	21.4%
EPS	20.6	15.2	23.1	35.1%	-10.9%	42.8	80.6

Source: ICICIdirect.com Research, Company

HCL Technologies (HCLTEC)

- We expect HCL Technologies to show sequential de-growth in the dollar revenues and with growth of merely 2.4%. The company will not benefit from steep rupee depreciation on account of being aggressively hedged with hedging covers worth US\$1.9 billion for receivables over the next seven quarters with maximum participation at US\$/INR level of 41.7. The profitability of the company will be impacted on account of high interest cost for loan of £400 million that the company borrowed for the Axon acquisition.
- Concerns: The margins will be under pressure for FY09 because of integration with Axon that will hamper margins. SAP is going through a slowdown post acquisition of Axon. It may not act as a growth driver in the current scenario.

Exhibit 6: Valuation summary

(Rs Crore)	Q2FY09E	Q2FY08	Q1FY09	Y-o-Y (%)	Q-o-Q (%)	FY09E
Sales	2426	1816	2370	33.6%	2.4%	11065
EBIDTA	534	388	531	37.7%	0.6%	2247
EBIDTA margin	22.0%	21.4%	22.4%	66 bps up	39 bps dip	20.3%
Profit	362	332	356	8.8%	1.5%	1597
Profit margin	14.6%	17.8%	14.7%	326 bps dip	13 bps dip	14.2%
EPS	5.4	5.0	5.3	8.8%	1.5%	24.0

Source: ICICIdirect.com Research, Company

3i Infotech (3IINFO)

- The company has a high exposure to the BFSI sector. Given the meltdown in this space we believe the business for mid-tier companies would get affected. We believe this quarter growth would primarily be driven by growth in Regulus. Margins are expected to improve marginally by 70 bps. Net margins are however expected to remain flat due to higher interest costs.
- Management commentary on the demand environment specially the impact of the global melt down on mid-tier banks and financial institutions would be important. The interest payment towards outstanding FCCBs would also be watched as we believe this could be a major drag on the performance of the company.

Exhibit 7: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y	Q-o-Q	H1FY09	FY09E
Sales	626.5	317.3	601.6	97.5%	4.1%	1070.1	2314.4
EBIDTA	123.3	66.9	114.2	84.4%	7.9%	205.4	439.7
EBIDTA margin	19.7%	21.1%	19.0%	140 bps dip	69 bps up	19.2%	19.0%
Profit	71.5	48.5	68.4	47.4%	4.5%	127.0	257.6
Profit margin	11.4%	15.0%	11.3%	364 bps dip	10 bps up	11.8%	11.1%
EPS	5.2	3.7	5.0	39.3%	4.5%	9.2	14.9

Source: ICICIdirect.com Research, Company

Rolta India (ROLIND)

- Rolta India has almost 50% of its revenue from India while the rest from US and Europe is in the proportion of 28% and 12%. Therefore, the impact of cross-currency volatility is limited for Rolta. The revenue growth for this quarter is expected to be 9.6% sequentially, which is robust. At the operational level, there will be sequential margin expansion of 88 bps on the back of cost management. Consolidated EBIDTA margins will show drop of 328 bps (YoY) on the back of consolidation of Whitman heart, which has dragged margins of the EICT business to levels of 15% from 29%. At the net profit level, due to FCCB of US\$150 million the forex losses on account of rupee depreciation over the past quarters is hampering gains. Acquisition of Piocon Technologies by Rolta will aid its engineering design business because this will help Rolta sell its solution to marquee client like Chevron of Piocon and other oil & gas refineries.
- Concerns: Rolta has over a quarter of its revenue coming in from the EICT business, which is largely discretionary spend based. Volume growth for this vertical may be muted in this quarter and utilisation could be lower as most of the work is onshore related for EICT and working days in this quarter are less. This vertical is showing demand slowdown, which may drag growth down.

Exhibit 8: Valuation summary

(Rs Crore)	Q2FY09E	Q2FY08	Q1FY09	Y-o-Y	Q-o-Q	FY09E
Sales	379.4	241.7	346.1	57.0%	9.6%	1530.5
EBIDTA	133.2	92.8	118.4	43.5%	12.4%	534.7
EBIDTA margin	35.1%	38.4%	34.2%	328 bps dip	88bps up	34.9%
Profit	62.0	59.2	23.9	4.7%	159.7%	302.4
Profit margin	15.9%	23.5%	6.6%	759 bps dip	931 bps up	19.2%
EPS	3.9	3.8	1.5	2.5%	159.7%	18.8

Source: ICICIdirect.com Research, Company

KLG Systel (KLGSYS)

- Revenue growth for the company on an annual basis for Q3FY09 will be muted as compared to the previous December ending quarter but better than Q2FY09. Overall operating margins will show a dip because the company is unable to scale up the sales for its power system solution, which are with good operating margins. The life cycle solution vertical is also facing the heat of a slowdown. Thus, both verticals are facing demand erosion.
- Concerns: The company has high dependence on funds allocated for technological reform of power sector under ADPRP II scheme under the Eleventh Plan. These funds are on hold and are expected to be released by the end of March. Thus, revival of sales of power system solutions is expected in the next fiscal year impacting growth and profitability of the company excessively in FY09.

Exhibit 9: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y	Q-o-Q	H1FY09	FY09E
Sales	119.0	92.1	60.3	29.2%	97.3%	117.8	338.2
EBIDTA	26.16	21.5	19.3	21.7%	35.5%	41.9	93.4
EBIDTA margin	22.0%	23.3%	32.0%	135 bps dip		35.5%	27.6%
Profit	14	17.1	8.6	-18.3%	62.0%	21.6	48.2
Profit margin	11.7%	18.5%	14.3%	679 bps dip		18.2%	14.2%
EPS	9.3	15.8	5.4	-41.1%	72.2%	14.2	31.9

Source: ICICIdirect.com Research, Company

NIIT Ltd (NIIT)

- Traditionally, the December ending quarter has been weak for NIIT Ltd with its Corporate Learning Solution (CLS) and School Learning Solution (SLS) having negative annual growth. This December ending quarter is expected to be the worst for CLS given the scenario of liquidity crunch in the US. Also, enrolment volume for Individual Learning Solution (ILS) may be muted due to credit squeeze, thus even impacting the growth driver vertical for NIIT. We expect net sales to grow 10.5% annually.
- Concerns: Credit squeeze has decreased consumer spending across the board. Thus, this may impact the enrolment and order book for ILS and FMT in addition to CLS.

Exhibit 10: Valuation summary

(Rs Crore)	Q3FY09E	Q3FY08	Q2FY09	Y-o-Y	Q-o-Q	H1FY09	FY09E
Net Sales	263.90	238.8	309.5	10.5%	-14.7%	569.1	1207.5
EBIDTA	24.93	22.8	40.6	9.4%	-38.6%	59.4	126.8
EBIDTA margin	9.4%	9.5%	13.1%	10 bps dip	367 bps dip	10.4%	10.5%
Profit	15.83	13.9	29.7	13.9%	-46.7%	46.7	82.6
Profit margin	6.1%	5.9%	9.5%	20 bps up	347 bps dip	8.2%	6.8%
EPS	1.0	0.8	1.8	20.3%	-46.7%	2.8	5.0

Source: ICICIdirect.com Research, Company

Coverage Universe Valuation table

				M	EPS			P/E (x)			EV/EBIDTA (x)			ROCE			ROE		
	CMP	TP	Ratings	Rs Cr.	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10
Infosys	1187	1415	P	67961	79.1	102.6	111.1	15.0	11.6	10.7	11	8.2	7	41.4%	36.0%	34.5%	37.2%	35.2%	34.5%
TCS	504	610	OP	49293	51.3	54	61	9.8	9.3	8.3	7.7	6.2	5.6	55.1%	39.2%	37.7%	47.2%	45.2%	44.5%
Wipro	243	257	P	35595	22.2	25	28.6	10.9	9.7	8.5	8.9	6.7	5.9	21.0%	27.4%	25.9%	30.8%	28.8%	28.1%
Tech Mahindra	253	446	OP	3072	59.1	80.6	84.1	4.3	3.1	3.0	3.9	2.3	1.8	69.4%	57.2%	55.7%	70.8%	68.8%	68.0%
HCL Tech	110.25	135	OP	7346	15.3	24	22.8	7.2	4.6	4.8	3.9	4.3	4.2	21.5%	26.2%	24.7%	22.9%	20.9%	20.2%
3i Infotech	37	43	P	476	13.5	14.9	18	2.7	2.5	2.1	5.1	4.9	4.7	11.5%	18.1%	16.6%	32.5%	30.5%	29.8%
Rolta	121	189	OP	1951	14.3	18.8	24.4	8.5	6.4	5.0	3.3	2.9	2.9	22.0%	25.3%	23.8%	20.7%	18.7%	17.9%
KLG	94	113	P	119	48.2	32.6	44.9	2.0	2.9	2.1	3.4	3.4	2.9	19.4%	21.3%	19.8%	35.5%	33.5%	32.7%
NIIT	25	31	OP	405	4.6	5	6.2	5.4	5.0	4.0	4.2	3.4	2.8	17.0%	20.0%	22.0%	21.1%	19.0%	21.0%

Source: ICICIdirect.com Research, Company

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