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IT

Calm before the storm

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Executive Summary

The phrase, **'Calm before the storm',** best sums up performance of the big-5 league in the July-September 2008 quarter, which was largely on expected lines; the big-5 include Infosys Technologies (Infosys), Wipro, TCS, Satyam Computer Services (Satyam), and HCL Technologies (HCLT). Infosys and TCS are the only companies that retained their target hiring numbers (of employees) articulated at the beginning of FY09. We believe that October-December 2008 or Q3FY09, for the larger Indian companies, is largely protected to the extent of 60-70% of visibility; but, the real uncertainties should start kicking in from Q4FY09 (the first quarter of the next calendar year). Also, there is at least good 3-4 months time before clients' IT budgets get determined. If happenings in the US/Europe (especially in their broader economy) are anything to go by, then budget discussions are not only likely to be delayed, but could also revolve around curtailment of budgets.

In such times, vendor consolidation and/or market share gains will become even more important. Solidity and resilience (as Infosys and TCS are beginning to show) will become lot more apparent in the difficult quarters to come, especially Q4FY09 onwards. We project nominal EPS growth (3-6%) in FY10 for the big-5, but we also add that we are likely to get a much better sense of FY10 only towards the close of FY09. Till then, the global macro scenario could continue to weigh on stock prices.

Reviewing July-September 2008 on ten dimensions: We rate the big-5 on ten distinct dimensions and arrive at an aggregate score for each. This rating exercise also tells us how companies manage their overall portfolio. Infosys and TCS lead others.

A consumer-spending recession is likely to have a rapidly escalating chain impact in the US and Europe, with attendant consequences for Indian IT: Indian IT has not started feeling this impact yet. This adds to the ongoing constriction in the financial services segment. We lay out the chain impact as a flowchart that graphically demonstrates how IT is likely to be hit over and above the direct impact from the financial services segment.

Cost structure of Indian IT companies places them at a disadvantage in difficult environments: Our simple case study shows that due to the cost structure of Indian IT-companies, a business downturn is significantly more harmful than benefits of an upturn.

The silver lining is that cash flows can ironically improve in this environment: Infosys's cash flow performance during FY02-03, the time of the previous tech bust, suggests that this could be a possibility. We believe that cash flow generating capacity may not be impaired as severely as profits as firms scale down in preparation of the slowdown.

Outlook and valuations: Be more discriminating than before

We continue to prefer TCS and Infosys. Though Satyam's valuations are reasonable, we remain concerned about the company's conduct on specific contracts/issues (World Bank, Upaid), and believe the same could be a potential drag on its P/E. Further, we believe, HCLT could be challenged for organic growth in tougher times. Axon is an added concern. Accordingly, we downgrade both Satyam and HCLT, to **'ACCUMULATE'** from **'BUY'**. TCS remains the only **'BUY'** rated stock in our universe of IT companies. On the basis of free cash flows, Infosys remains an attractive stock to own.

In our preview of the Indian IT sector in the lead-up to the results season, we had identified the following as constituting the tone and flavour of management commentary. Companies have largely stayed true to our suppositions.

"We are seeing more larger-scale transformation opportunities in this environment than before" - All the big-five companies talked of this. Some like Infosys and TCS also gave hint of the number and quality of transformation-led engagements won during the quarter. Transformation projects are, however, characterised by long sales cycle (or time to closure) and the associated implementation time-lines are often stretched. It will scarcely have an impact on FY10 and FY11 financials.

"Our clients have not given us indications of their spending with us as they are still coming to terms with their situation" – This is an aspect of demand commentary, universal to the five companies.

"The budget cycle normally begins towards the end of the calendar year, but we are yet to tentatively hear from our clients. We are likely to see this being postponed to the next calendar as we have seen in CY08" - No company has refuted this, though they are reluctant to guess when clients will come back to discuss budgets.

"Pricing is stable for now, though we are not seeing increases as before" – Companies still uphold indications of stable pricing. We believe that this commentary will reverse by Q4FY09/Q1FY10.

"Europe is showing signs of noticeably slowing down as well"– Infosys had alluded to this at its analysts meet on August 27; others have merely confirmed this at the time of their results. It is now a truism in the face of our prior repeated conclusions and of global phenomena, currently unraveling that the impact on Indian IT is likely to cascade beyond BFSI and the US.

"The months July and August largely tracked expectations, but activity and revenues in September (particularly in the second half of September) have ebbed/slowed down" – No company has reported a pronounced late-September impact, perhaps because the Indian IT is still downstream in the IT budget scheme of enterprises. We could see commentary on a pronounced slowdown in activity emerging in a quarter or two from now.

We rate companies' July-September 2008 performance on ten metrics that we track on an ongoing basis (see tables 1 and 2 on the following page):

Table 1: Company-metrics on select parameters

No.	Parameter	Infosys	TCS	Satyam	Wipro	HCLT
1	Q-o-Q volume growth (%)	6.5	6.0	5.4	1.2	1.8
2	Q-o-Q revenue growth (in USD) (%)	5.3	3.2	2.3	4.0	0.4
3	Q-o-Q revenue growth (constant currency)(%)	7.1	5.1	5.0	5.3	2.4
4	EBITDA margin change Q-o-Q (in bps)*	264	228	156	53	42
	*(adjusted for salary hikes given in July-Sep 08)					
5	Gross employee addition target for FY09 indicated in Q4FY08/Q1FY09	25,000	30,000 - 35,000	14,000 - 15,000	13,000 - 14,000	No guidance
6	Revised gross employee addition after H1FY09	Unrevised	Unrevised	8,000-10,000	Revised down	No guidance
7	Gross employee addition in H1FY09	17,299	18,664	5,353	NA	6,363
8	% of FY09 gross employee addition target met in H1 (at lower end of band)	69.2	62.2	66.9	NA	NA
9	Net employee addition in H1FY09 as % of FY08 employee base (overall)	10.0	9.2	5.5	6.3	5.8
10	Net employee addition in H1FY09 as % of FY08 employee base (IT only)	6.2	NA	3.6	1.2	5.4
11	Client addition to the USD 1 mn (USD 5 mn) plus category	0 (5)	35 (21)	-7 (0)	22 (6)	4 (2)
12	Receivable days (including unbilled revenues) in Q2FY09 (Q1FY09)	73 (76)	101 (107)	92 (97)	86 (81)	81 (80)
13	Forex losses in H1FY09 due to hedging (INR bn)	2.1	3.4	0.3	1.8	0.4
14	Operating cash flows as % of revenues in H1FY09	25.1	12.6	21.0	14.0	NA
15	Free cash flows as % of revenues in H1FY09	18.1	8.6	15.0	7.1	NA

Source: Company, Edelweiss research

Table 2: Company rank on operational, financial, and balance sheet attributes

		Infosys	TCS	Satyam	Wipro	HCLT
1	Q-o-Q revenue growth (constant currency)	1	2	4	3	5
2	Q-o-Q volume growth	1	2	3	5	4
3	Q-o-Q EBITDA margin change	1	2	3	4	5
4 (a)	Operating cash flow performance	1	4	2	3	5
4 (b)	Conversion of profits to free cash flow	1	4	2	3	5
5	Net hiring in H1FY09 as % of FY08 manpower	1	2	3	5	4
6	Client addition to the USD 1mn plus club	4	1	5	2	3
7	Client addition to the USD 5 mn plus club	3	1	5	2	4
8	Improvement in receivables	2	3	1	5	4
9 (a)	Hedged position as % of receivables (proxy for natural hedge cover in balance sheet)	1	3	2	4	5
9 (b)	Risk from other comprehensive income on account of hedging derivatives	1	3	2	4	5
10	Managing the overall portfolio					
	(a) Growth of top-10 clients in H1FY09	4	5	3	1	2
	(b) Growth of new clients bagged in FY09	5	3	4	1	1
	(c) Managing BFSI fall-out (based on performance in Q2FY09)	2	3	5	1	4
	(d) Utilization (ex-trainees) indexed to company's best performance	3	1	2	4	5
	(e) Traction from high-growth services (PI, testing and infrastructure management)	1	3	4	2	5
	Aggregate or overall performance rank	**1**	**2**	**4**	**3**	**5**

Source: Company, Edelweiss research

Conclusion about the road ahead

Infosys and TCS are beginning to show their resilience and mark their differentiation, which could be starker in coming quarters. Wipro has begun to show semblance of solidity but its volume growth is the most tepid among the five, relying almost wholly on pricing uptick for now, which is unlikely to sustain. Unless we see pick-up in volume growth, we will continue to be less confident of Wipro's performance in the more testing FY10. Loss of senior management at Wipro in recent times, in the wake of the institution of the joint-CEO structure, is a concern. We will play Satyam on valuations per se as and when the stock approaches zero-growth valuation levels (as the Satyam stock did at close to INR 255-260 level (no-growth value is got by capitalising FY09 EPS by cost of equity of 13.5%). We continue to believe that Axon is too risky and expensive for HCLT in this environment of attractive valuations, dividend yield of HCLT notwithstanding. Among big-5, it seems that HCLT is most challenged for organic growth.

Unraveling the chain impact on Indian IT from weakening consumer spend

It is almost certain, if not already so, that consumer spending in the US is sharply decelerating into the fourth quarter of the calendar year. As we have written in our notes before, a weak back-to-September sales seen in 2008 is likely to foreshadow a weak back-to-season (December) spending. It is being generally predicted that consumer spending will decline in the current quarter, (October – December), by far the strongest quarter of spending in the US on account of the holiday season. The last time this happened was during the 1991 recession. Note that consumer spending did not weaken in the 2001-2002 tech recession, which enabled the US economy to be back on rails/track quickly enough. Given the importance of consumer spend in the GDP of the US (nearly three-quarter of the US GDP), we lay out a chain impact of how it flows through the system to impact Indian IT frontliners, in case the worst case materialises.

Fig. 1: Flowchart illustrating the chain impact of weakening consumer spending on Indian IT

Rapidly diminishing home equity (market value of homes) + Inability to obtain loans (leveraged spending) + Rising unemployment (lack of or uncertainty in income).

1 →

Decelerating consumer spending (this is currently happening in the US).

2 ↓

Impact on retailers (Wal-Mart, Best Buy, and others), and on online channels (such as e-bay) who cut back on orders from manufacturers and assemblers (B2C suppliers in particular) – this is already beginning to happen).

Potential impact on Indian IT: Slowdown in spending from retailers (Infosys has exposure to Sainsbury, Tesco, JC Penny, etc).

3 ←

Broader impact on manufacturing (why will manufacturers produce when retailers can't sell)?

In particular, impact on B2C players who directly/indirectly sell part of products and services to the consumer (technology OEMs such as Dell, consumer electronics such as Nokia, Sony, and Motorola etc.) and auto (Ford, GM, and Chrysler). This impact is also being strongly felt as is evident from pronouncements of Dell, Nokia, and Sony.

This also has cascading impact on those who are suppliers to such consumer-oriented plays (Intel/Texas Instruments) and auto-components – second order effect.

Potential impact on Indian IT: Slowdown in spending from technology providers and auto – A large enough segment for players with big-3 auto exposure (Satyam) and tech-OEM exposure such as Wipro and HCLT.

4 →

General B2B impact (though this may not be as direct/strong as the B2C impact)

This impact is triggered by primary/first weakness in the B2C segment. The B2C segment now emerges as centre of weakness for enterprises and application service providers who sell to them. E.g. reduced product sales to consumers by Dell/HP means that Dell/HP could spend less on upgradation/new product launches, in turn, impacting software suppliers such as Oracle, SAP. Capital spending exhibits a general slowdown.

Potential impact on Indian IT: More broad-based.

Source: Edelweiss research

Indian IT is not such a defensive sector as may be commonly imagined

The cost structure of Indian IT has a not-so-pleasant consequence in times of a downturn. This is because people costs account for an overwhelming proportion of overall operating expenses (80-85% of the operating costs to the EBIT level). Even adjusting for the fact that 20% of wage costs tend to be variable in nature, it still implies that over three-fourth of total costs are fixed or semi-fixed, and therefore, provide little flexibility for adjustment in the near-term during a downturn. This has much more serious consequences for profitability than it has for revenues.

We explore this argument on the basis of a simple example. Say, a firm operates at gross margins of 40% and EBITA margins of 20%. If 2% of revenues is at risk because of a client going bust, the revenue loss is almost wholly translated to the operating profit (EBIT) with a 10% downward impact (2%/20%) (this ignores the very low fully variable costs specific to an account; variable costs can be adjusted downward in times of stress while it need not necessarily increase in good times in the near-term).[1]

What does this mean? Our firm will continue to experience a 10% negative impact on its EBIT on account of this 2% revenue loss, during the time it is unable to take any of the following courses of action:

(a) relocate and accommodate people attached to this failed client account to another client and start billing them thereof

(b) let go of people to reduce the fixed costs associated with this account – An option it may deem unpalatable or myopic.

When the going is good, firms can manage (a) the first course of action. However, in times as these, it is particularly difficult for the smaller IT firms to find replacement (new) projects. The impact on EBIT is particularly hard on smaller firms that cannot manage this and also on the firms that have lower EBIT margins.

But the reverse does not happen in better times, the more interesting finding: Instead of a 2% revenue loss, we consider a scenario of 2% revenue gain from an existing or new account. Also, we assume no incremental SG&A expense associated with this account (a benign assumption). Cost of revenues of the account (i.e. 60% of revenues above the gross profit line) have to be incurred, namely costs of manpower additionally hired to service the account, assuming existing utilisation is already optimal. Thus, the beneficial impact on EBIT margins is now significantly lower at 0.8%/20% = 4.0% (versus 10% downward impact in the revenue loss scenario).

This simple case study shows that due to the cost structure of Indian IT-companies, a business downturn is significantly more harmful than benefits of an upturn. It also means that companies with superior ability to manage the overall business portfolio and higher margins can come out of these times relatively better than the others. Advantage: Infosys (see table 3 below for a concise illustration of this argument).

[1] Providing for variable costs, a more precise thumb rule is: impact on EBIT (%) = [(Revenue loss as % / EBIT margins) * (1- Proportion of variable costs in cost structure*operating costs as % of revenues)]. Following this precision, the impact on EBIT, of revenue loss of 2%, is ~8.4% rather than 10% of our model firm, taking into account variable costs as 20% of overall costs.

Table 3: Impact on gross profits and EBITDA is more severe during a revenue downturn than it is beneficial from a revenue upturn of same magnitude

Basic assumptions of our model firm		
Cost of revenues	60%	
Gross margins	**40%**	
SG&A, depreciation & other expenses	20%	
EBITA margins	**20%**	
Firm is at optimal utilization		
	Upturn	**Downturn**
Event: Revenue impact on account of client	+2.0%	-2.0%
Impact on gross profits		
(a) Ignoring variable costs or treating all costs as fixed	+2.0%	-5.0%
(b) Taking variable costs @20% of overall costs	+2.5%	-4.5%
Impact on EBITDA		
(a) Ignoring variable costs or treating all costs as fixed	+4.0%	-10.0%
(b) Taking variable costs @20% of overall costs	+4.5%	-8.4%

Source: Edelweiss research

Cash-flow-generating performance is a silver lining in this environment

Infosys' and Satyam's Q2 FY09 results tentatively confirm what we said could happen prior to the results kick off. The free cash flow-generation of tier-1 Indian IT companies can ironically improve in FY09-10, despite revenue woes. This is because we see two factors playing out in the difficult environment when growth moderates:

(a) **Utilisation could improve in the medium term:** When growth slows down, companies need not keep bench beyond their stated employment commitments (firm offers already handed out), as they can hire as per demand after that. In fact, over the long-term as growth moderates, the need to keep bench is lower. Accenture, growing at 9-12%, operates at utilisation of 86%, proving that as growth is on a lower trajectory, utilisation could be higher consistently.

(b) **Free cash flows as % of revenues can go up as growth capex slows:** Again growth capex is linked to growth. In periods of high growth, Infosys invests up to 10% of its revenues in capex. It can be as low as 5-6% as growth moderates, thus releasing as much as 4-5% of revenues in free cash flows. Accenture invests about 1.5% of its revenues in capex, given its growth trajectory. So, why can't Infosys' capex moderate a lot more?

Thus, it is not inconceivable that growth in free cash flows can outstrip growth in revenues and net profits in FY09 and FY10.

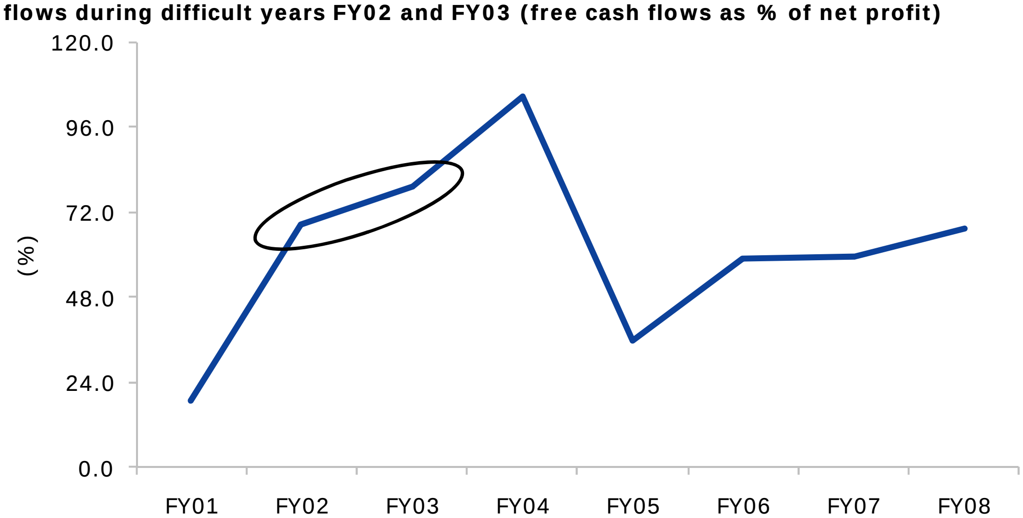
Already, Infosys' free cash flows (after capex) for the six months ended Q2FY09 stand at 18% of revenues. They have grown at 39% (in INR), well ahead of revenue growth of 30% and net profit growth of 25% YTD (H1FY09 over H1FY08). Likewise, Satyam's free cash flows for the six-month period (ending September 2008) stood at 15% of revenues, while operating cash flows stood at 21% of revenues. Operating free cash flows in H1FY09 almost doubled for Satyam over H1FY08 (Y-o-Y), growing well ahead of revenues and profits for the same period.

Do we have a precedent for this hypothesis?

We had examined Infosys' cash flow performance at the time of the last slowdown (2002-03). It is instructive to note that in that period, the company's cash flow performance was decidedly ahead of its performance on revenues and net profits. Infosys' free cash flows (as a percentage of revenues) in FY02 and FY03 stood at 19% of revenues respectively, steeply up from 5% in FY01 (FY01 was the last boom year preceding the tech bust of 02-03). For the two-year period (FY02-03), Infosys' operating and free cash flows notably grew at a CAGR of 30% and 200%, ahead of growth in net profits (24%) for the corresponding period (see charts below).

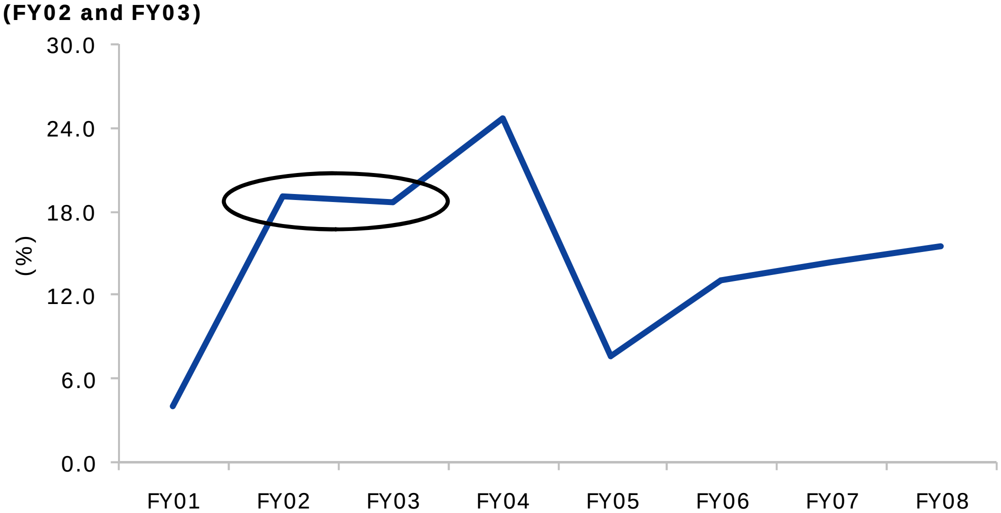
One of the reasons for this strong free cash flow performance was the absolute lower capex of Infosys in both FY02 and FY03 relative to FY01. Interestingly, this relatively better cash flow performance came about during a time operating margins took a dive. This tells us that even as firms batten down preparing for the slowdown, their cash flow generating capacity is not necessarily impaired. We would hesitate to extrapolate this tentative hypothesis more generally to the IT sector except for firms that are focused on the balance sheet even in difficult times. Advantage: Infosys again.

Chart 1: Infosys converted a much greater proportion of its profits to free cash flows during difficult years FY02 and FY03 (free cash flows as % of net profit)



Source: Company, Edelweiss research

Chart 2: Infosys's free cash flows touched 19% of revenues during difficult years (FY02 and FY03)



Source: Company, Edelweiss research

Outlook and valuations: Be more discriminating than before

We continue to prefer TCS and Infosys. Though Satyam's valuations are reasonable, we remain concerned about the company's conduct on specific contracts/issues (World Bank, Upaid), and believe the same could be a potential drag on its P/E. Further, we believe, HCLT could be challenged for organic growth in tougher times. Axon is an added concern. Accordingly, we downgrade both Satyam and HCLT, to **'ACCUMULATE'** from **'BUY'**. TCS remains the only **'BUY'** rated stock in our universe of IT companies. On the basis of free cash flows, Infosys remains an attractive stock to own.

Another way to view how valuations would work on a free-cash flow basis could be: study stocks through the price-to-free cash flow multiple screens. Is this similar to price-to-earnings? Not really, but if our hypothesis - in difficult times, free cash flows could still be assured in the Indian IT sector for well-managed companies holds true, then, investors may start pricing stocks on a free-cash flow basis rather than on earnings alone. In such a scenario, companies like Infosys (converting much higher proportion of their profits to cash flows) could end up looking more attractive on a free-cash flow multiple basis than they would on earnings multiples.

Table 4: Based on the price-to-cash flow multiple, Infosys actually emerges as a reasonable IT stock to own among the top tiers

	P-E	P-Cash flow	% of profit converted to free cash flows		
	(09)	(09)	FY07	FY08	FY09E
Infosys	13.6	19.4	60.0	67.0	70.0
TCS	9.5	20.2	54.0	50.0	47.0
Satyam	9.1	14.5	44.0	56.0	62.0
Wipro	10.5	21.0	64.3	30.8	50.0
HCLT	7.8	20.3	40.0	62.0	60.0

Source: Bloomberg, Edelweiss research

Table 5 provides our recommendation snapshot for stocks in universe of our coverage.

Table 5: Recommendation snapshot

Recommendation	Earlier	Now
Infosys Technologies	Accumulate	Accumulate
Wipro	Accumulate	Accumulate
Satyam Computer Services	Buy	Accumulate
HCL Tech	Buy	Accumulate
Patni Computer Systems	Sell	Sell
Geometric Software Solutions	Sell	Sell
Hexaware Technologies	Sell	Sell
Mastek	Accumulate	Accumulate
Mphasis BFL	Buy	Buy
Infotech Enterprises	Buy	Buy
Sasken Communication Technologies	Accumulate	Accumulate
Tata Consultancy Services	Buy	Buy
Rolta India	Buy	Buy

Source: Edelweiss research

Table 6: Valuation snapshot

	EPS (INR)			P/E (x)			EV/EBITDA (x)			Mcap /Revenue (x)			Pr/ BV (x)		
	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10	FY08	FY09	FY10
Geometric	5.1	5.9	8.0	5.6	4.9	3.6	4.2	2.8	2.1	0.4	0.3	0.3	0.7	0.7	0.6
HCL Tech	15.6	22.3	27.1	11.1	7.8	6.4	6.9	5.4	4.2	1.5	1.2	1.0	2.2	1.9	1.8
Hexaware	7.9	4.5	7.5	2.5	4.5	2.7	(0.4)	1.1	1.5	0.3	0.3	0.2	0.4	0.4	0.4
Infosys	81.3	102.1	108.7	17.1	13.6	12.8	13.8	9.5	8.3	4.8	3.7	3.4	5.8	4.2	3.3
Infotech	17.0	21.2	25.6	8.5	6.8	5.6	3.1	2.6	2.1	1.1	0.8	0.7	1.1	1.0	0.9
Mastek	44.0	53.3	57.4	4.8	4.0	3.7	3.5	1.8	0.9	0.6	0.5	0.5	1.6	1.1	0.9
Mphasis	12.2	19.5	22.9	13.2	8.2	7.0	7.8	4.6	3.0	1.4	1.0	0.8	2.9	2.3	1.7
Patni	34.6	31.2	33.2	4.0	4.5	4.2	0.2	(0.2)	(0.3)	0.7	0.6	0.6	0.7	0.6	0.6
Rolta	12.9	18.9	25.7	14.2	9.8	7.2	8.0	5.5	3.4	2.8	2.0	1.5	2.5	2.1	1.5
Sasken	11.3	17.0	19.0	6.6	4.4	3.9	2.7	1.7	1.6	0.4	0.3	0.3	0.5	0.4	0.4
Satyam	24.7	33.3	35.0	12.3	9.1	8.7	8.7	5.2	4.3	2.4	1.8	1.7	2.8	2.2	1.8
TCS	51.2	56.6	62.7	10.5	9.5	8.6	8.5	6.8	5.9	2.3	1.9	1.7	4.3	3.6	2.9
Wipro	22.2	26.0	28.2	12.3	10.5	9.7	9.8	7.3	6.4	2.0	1.5	1.3	3.1	2.5	2.1

Source: Edelweiss research

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Coverage group(s) of stocks by primary analyst(s): Information Technology

Geometric, HCL Tech, Hexaware, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, Take Solutions and Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
25-Oct-08	**Hexaware Technologies**	Challenges continue to linger; *Result Update*	21	Sell
24-Oct-08	**Geometric**	Mixed bag; *Result Update*	29	Sell
23-Oct-08	**Patni Computer**	Nothing to cheer about; *Result Update*	153	Sell
22-Oct-08	**TCS**	Evinces confidence amidst turbulence; *Result Update*	547	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	94	59	14	8	187

* 10 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	75	65	47

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period