

Joining the dots: Pick-up to take time

Stability, not recovery; Recovery to take time, in our view

We remain bearish on Indian IT stocks. We believe 'stability' is not recovery & that incrementally the Rupee poses downside risk to ests. Based on channel checks, including discussions with the senior partner/CEOs of two leading global IT outsourcing consultants, TPI & Alsbridge, we believe decisions are still not being taken & any recovery could be slow. We see no pricing power. We maintain our Underperform ratings on TCS, Infosys, Wipro & HCL Tech at 14-17x FY11 PE & 0-4% 2yr EPSg. Of these, we have a relative preference for TCS on valuation & lower Re sensitivity. Greatest risk of disappointment from Wipro/HCL Tech. Niche buys: Mphasis (8x FY11) on offshoring by EDS & WNS (7x FY11) on BPO.

CY09: "Summer pause now" & ramp ups likely next year

Good news: Market is not worsening & Requests for Information (RFIs) have picked up, but of course, pick up in discussions is from a much lower base than last year & budgets are unlikely to change this year. Bad news: Decisions still not being taken, given client business confidence is yet fragile. Secondly, the impact of the sluggish summer months, starting now, could be more pronounced this year. Finally, given start up costs of a new deal can be high, savings from offshoring may be difficult to achieve this year, & hence the bulk of the deals could ramp next year.

CY10: Flattish budgets? Optimisation, buzz word

In line with our view that global macro recovery will likely be slow, consultants & customers confirm that "optimization" is the theme in IT spending. Hence, the pace of recovery in IT spending is debatable in 2010. Our best estimate is that budgets remain flattish next year & recovery in IT services could be late cycle.

Pricing risk: Too early to call victory

Pricing steadiness post the 5-15% pressure seen earlier in the year likely reflects improved sentiment, but could re-surface, in our view, when deals close. Near term pricing pressure stems from currently low levels of utilization. In BPO, competition from locations like Philippines could cap prices.

Offshore vendors could fare better, but competition stiff

Growth trends for offshore vendors are flat to positive, in our view, given the value offered & likely greater 'passion' of Indian vendors vs incumbents. That said, we have heard of a couple of global vendors being very competitive on pricing. Accenture has ~40,000 people in India now & IBM close to 55,000 in exports. Also alternate "near shore" locations including Mexico, domestic US, Costa Rica etc. could nibble at demand, at the margin.

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RESEARCH

Mitali Ghosh >> Research Analyst DSP Merrill Lynch (India) mitali_b_ghosh@ml.com	+91 22 6632 8661
Pratish Krishnan >> Research Analyst DSP Merrill Lynch (India) pratish_krishnan@ml.com	+91 22 6632 8679
Kunal Tayal >> Research Analyst DSP Merrill Lynch (India) kunal_tayal@ml.com	+91 22 6632 8663

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Table 1: IT Valuation Summary

	Tata	Infosys				Tech	Rolta		Infotech		Hexaware	Educomp
ML Code	Consultancy	Wipro	Tech	Patni	HCL	Mahindra	India	Mastek	India	Mphasis	Tech	Solu
Bloomberg Code	TACSF	WIPRF	INFYF	PATIF	XHCLF	TMHAF	RLTAF	MSKDF	IFKFF	MPSSF	XFTCF	EUSOF
	TCS IN	WPRO	INFO IN	PATNI	HCLT	TECHM IN	RLTA IN	MAST	INFCT IN	MPHL IN	HEXW IN	EDSL IN
ML Rating	C-3-7	C-3-7	C-3-7	C-1-7	C-3-7	C-2-7	C-3-8	C-3-7	C-3-7	C-1-7	C-3-7	C-1-7
Currency	INR	INR	INR	INR	INR	INR	INR	INR	INR	INR	INR	INR
Year End	Mar	Mar	Mar	Dec	Jun	Mar	Jun	Jun	Mar	Oct	Dec	Mar
Nprice	380	380	1,770	242	192	761	128	219	150	391	49	3,063
Market Cap in mn \$	15,487	11,612	21,128	645	2,680	1,931	430	123	173	1,703	147	1,104
EPS												
EPS Rs FY08	25.6	22.5	79.2	33.5	15.4	50.7	14.5	44.2	15.4	14.1	7.7	38.0
EPS Rs FY09	26.4	26.7	102.5	27.0	15.6	59.4	14.7	48.0	16.7	41.7	4.1	71.4
EPS Rs FY10E	26.2	24.9	95.6	23.5	12.5	43.8	10.8	31.1	18.8	43.3	4.1	115.3
EPS Rs FY11E	28.6	26.0	102.6	27.1	14.6	50.1	12.2	28.9	18.5	51.5	4.9	169.4
EPS gr % FY08	22.6%	10.3%	21.0%	29.7%	-18.3%	7.7%	37.6%	16.6%	2.0%	nm	-11.4%	146.3%
EPS gr % FY09	3.0%	18.7%	29.5%	-19.4%	1.6%	17.0%	1.4%	8.4%	8.3%	nm	-46.4%	87.8%
EPS gr % FY10E	-1.0%	-6.9%	-6.8%	-12.7%	-20.2%	-26.2%	-26.4%	-35.1%	12.2%	4.0%	1.0%	61.6%
EPS gr % FY11E	9.3%	4.4%	7.3%	15.0%	16.8%	14.4%	12.6%	-7.2%	-1.3%	18.8%	17.9%	46.9%
PE (FY08 EPS)(x)	14.8	16.9	22.4	7.2	12.5	15.0	8.8	5.0	9.7	nm	6.4	80.6
PE (FY09 EPS)(x)	14.4	14.2	17.3	9.0	12.3	12.8	8.7	4.6	9.0	9.4	12.0	42.9
PE (FY10E EPS)(x)	14.5	15.3	18.5	10.3	15.4	17.4	11.8	7.0	8.0	9.0	11.8	26.6
PE (FY11E EPS)(x)	13.3	14.7	17.3	8.9	13.2	15.2	10.5	7.6	8.1	7.6	10.0	18.1
EV/EBITDA (FY08)x	12.5	13.7	17.7	3.1	7.4	11.0	4.98	3.0	6.5	17.4	4.9	40.5
EV/EBITDA (FY09)x	10.0	10.5	12.5	3.6	6.4	7.4	4.28	2.7	6.4	6.1	4.6	20.4
EV/EBITDA (FY10E)x	9.9	10.0	13.1	3.5	5.8	7.7	4.47	3.9	4.7	5.2	4.5	11.3
EV/EBITDA (FY11E)x	8.4	9.0	11.3	2.1	5.9	6.8	3.86	3.8	4.8	4.3	4.9	7.8
EBIT % FY08	22.6%	17.3%	27.8%	17.9%	18.2%	16.9%	23.5%	14.2%	12.6%	15.1%	9.3%	32.7%
EBIT % FY09	23.7%	17.5%	29.7%	10.3%	16.8%	20.8%	20.1%	15.5%	14.8%	21.3%	8.8%	26.9%
EBIT % FY10E	21.7%	16.5%	26.2%	9.0%	15.7%	19.1%	16.4%	11.4%	12.8%	21.2%	10.3%	38.5%
EBIT % FY11E	21.6%	15.8%	26.3%	12.4%	14.6%	19.4%	16.4%	11.2%	11.6%	22.1%	8.7%	41.0%
ROE (FY08) (x)	47	31	36	19	22	61	23	32	18	24	17	35
ROE (FY09) (x)	37	31	37	13	20	48	20	29	13	47	9	26
ROE (FY10E) (x)	28	24	27	10	14	24	13	16	13	34	9	26
ROE (FY11E) (x)	24	22	24	11	14	21	13	13	11	31	10	29
Dividend Yield FY08	1.7%	1.6%	0.6%	1.2%	4.5%	0.3%	1.6%	1.9%	0.8%	nm	3.1%	0.1%
Dividend Yield FY09	2.0%	1.6%	1.9%	1.2%	4.9%	0.7%	2.4%	2.0%	0.8%	0.0%	1.5%	0.1%
Dividend Yield FY10	2.1%	1.6%	1.3%	1.2%	3.9%	0.5%	2.3%	2.2%	1.0%	1.0%	1.7%	0.1%
Dividend Yield FY11	2.1%	2.0%	1.4%	1.2%	2.4%	0.6%	1.7%	2.4%	1.3%	1.3%	1.7%	0.1%
PE ex cash FY08	14.6	16.9	22.4	4.4	11.2	14.0	8.9	5.1	9.2	27.7	5.8	72.1
PE ex cash FY09	14.2	14.2	16.8	5.4	11.0	11.7	9.5	4.0	8.7	9.1	9.4	39.0
PE ex cash FY10	14.1	15.0	18.1	6.4	13.0	16.8	12.3	5.7	7.5	8.3	11.2	24.5
PE ex cash FY11	12.5	14.2	16.4	4.3	11.7	14.7	11.0	5.8	7.5	6.4	9.1	17.2

Source: Banc of America Securities-Merrill Lynch Research

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Table 2: BPO Valuation Summary

	Bloomberg Ticker	Share FYE	Share Price	Mkt Cap USD mn	EV/Sales			Dil EPS (Non GAAP)			EV/EBIT			P/E			2-year gr FY09-11CAGR	ROE		
					FY09	FY10E	FY11E	FY09	FY10E	FY11E	FY09	FY10E	FY11E	FY09	FY10E	FY11E		FY09	FY10E	FY11E
Pure Play BPO players (non GAAP)																				
Genpact	G US	Dec *	\$11.5	2,463	2.3	1.8	1.5	0.76	0.68	0.81	13.0	11.7	9.1	15.1	16.9	14.2	3.1%	22.1%	20.8%	17.0%
WNS	WNS US	Mar	\$8.5	360	1.2	1.1	0.8	1.08	1.16	1.28	8.1	6.4	4.9	7.8	7.3	6.6	9.0%	22.4%	26.2%	27.8%
EXL	EXLS US	Dec *	\$9.8	283	0.9	1.0	0.9	0.58	0.43	0.65	14.0	16.7	8.9	16.9	23.1	15.2	5.6%	9.8%	7.4%	10.9%
FSSOF	FSOL IN	Mar	Rs24.0	213	1.3	1.2	1.0	1.43	1.66	2.03	16.9	15.6	12.1	16.7	14.4	11.8	19.0%	7.3%	6.0%	6.9%
Average				830	1.44	1.29	1.07	0.96	0.98	1.19	13.00	12.60	8.74	14.15	15.42	11.95	9.0%			
Median				322	1.28	1.14	0.96	0.92	0.92	1.05	13.52	13.63	8.99	15.91	15.66	13.01	7.0%			
Pure Play BPO players (GAAP)																				
Genpact	G US	Dec *	\$11.5	2,463	2.3	1.8	1.5	0.70	0.59	0.71	14.0	12.6	10.0	16.4	19.5	16.2	0.6%	12.0%	10.7%	10.9%
WNS	WNS US	Mar	\$8.5	360	1.2	1.1	0.8	0.19	0.18	0.38	16.7	16.2	10.0	45.1	46.1	22.5	41.6%	3.9%	4.1%	8.1%
EXL	EXLS US	Dec *	\$9.8	283	0.9	1.0	0.9	0.49	0.19	0.37	10.9	15.3	12.9	19.9	52.6	26.4	-13.2%	8.3%	3.2%	6.3%
Average				1,035	1.5	1.3	1.1	0.46	0.32	0.49	13.9	14.7	11.0	27.2	39.4	21.7	9.7%			
Median				360	1.2	1.1	0.9	0.49	0.19	0.38	14.0	15.3	10.0	19.9	46.1	22.5	0.6%			

Source: Banc of America Securities-Merrill Lynch Research

Table 3: IT Sector Performance

Name	Price as of 19-Jun-09	Absolute Change					Relative Change (%)				
		1 month	3 month	6 month	12 month	YTD	1 month	3 month	6 month	12 month	YTD
Educomp	3063	14%	58%	12%	-8%	27%	13%	-2%	-22%	-7%	-15%
Firstsource	24	40%	66%	84%	-32%	85%	38%	3%	28%	-32%	23%
HCL Technologies	192	21%	84%	37%	-28%	67%	19%	14%	-5%	-28%	11%
Hexaware	49	39%	71%	136%	-11%	132%	37%	6%	64%	-11%	54%
Infosys	1770	14%	36%	49%	-3%	59%	12%	-15%	3%	-3%	5%
Infotech	151	-10%	75%	34%	-34%	46%	-12%	8%	-7%	-34%	-3%
Mastek	219	20%	89%	30%	-45%	35%	18%	17%	-9%	-44%	-10%
Mphasis	391	51%	102%	150%	63%	151%	49%	25%	74%	64%	67%
Patni	242	33%	100%	81%	2%	87%	31%	24%	26%	3%	24%
Rolta	128	45%	138%	1%	-56%	10%	42%	47%	-30%	-56%	-27%
TCS*	380	13%	48%	48%	-12%	59%	12%	-9%	3%	-12%	6%
Tech Mahindra	761	109%	178%	188%	1%	208%	106%	73%	100%	1%	104%
Wipro	380	-1%	64%	53%	-20%	63%	-3%	1%	6%	-19%	8%
BSE IT Index	3277	15%	48%	40%	-22%	47%	13%	-8%	-3%	-22%	-2%
BSE Sensex	14522	2%	61%	44%	0%	51%	0%	0%	0%	0%	0%

*1:1 bonus share issue declared on 16 Jun 2009

Source: Bloomberg

Price objective basis & risk

HCL (XHCLF, C-3-7, Rs191.90)

Our PO of Rs116 is at 8x FY11E PE, at 20% discount to TCS. The discount reflects greater cyclical exposure in its R&D svcs, enterprise application & development svcs, the lower margins and weaker Balance Sheet. Upside risks include faster than expected ramp of deals won and tax holiday extension, which could boost FY11E earnings by 15% to 20%. Key downside risks are integration of the over US\$700m worth of acquisitions made in late CY2008 in SAP consulting and BPO and exposure to engineering & R&D services and now enterprise solutions, both exposed to cuts in discretionary IT spending.

Infosys Tech (INFYF / INFY, C-3-7, Rs1771.10/\$36.14)

Our PO of Rs1,350 (US\$29 for ADR, at parity) is at approx 13x FY11E PE, in line with trough valuations seen in 2001. Risks are steeper and longer than anticipated global slowdown, greater competition from global and Indian vendors, and Rupee appreciation. Upside risks to estimates stem from any large deal wins, weaker-than-expected Rupee or extension of tax holiday beyond Mar 2010.

Mphasis Ltd (MPSSF, C-1-7, Rs391.80)

Our PO of Rs390 is at 9x FY10 P/E, a 20% discount to tier 1 vendors. We believe the narrower discount is fair given increased revenue visibility, improved margins, strong cash flows and stronger 10% two year earnings growth.

Risks: change in transfer pricing mechanism between HP and Mphasis and slower-than-expected volume growth from HP/EDS clients. Industry risks: a worse-than-expected slowdown in the United States, sharper-than-expected INR appreciation and increasing competition.

Tata Consultancy (TACSF, C-3-7, Rs380.85)

Our PO of Rs300 is set at an FY11E PE of 10.5x, based on a 20% discount to Infosys' target PE. This is higher than the historical PE discount range of 5 to 10%, to factor in higher exposure to the banking vertical and the auto sector. Downside risks are steeper and longer than anticipated global slowdown, greater competition from global and Indian vendors, integration and ramp up challenges in e-Serve and Rupee appreciation. Upside risks include faster than expected macro recovery and tax holiday extension.

Wipro (WIPRF / WIT, C-3-7, Rs380.70/11.59)

Our PO of Rs260 (\$8 for ADR, at 25% premium to local) is at about 10x FY11E at 20% discount to Infosys, reflecting relatively higher exposure to vulnerable sectors such as technology, retail & manufacturing and lower predictability of revenues and earnings and a more leveraged Balance Sheet. Risks are faster than expected deal closure and ramp up.

WNS (Holdings) L (WNS, C-1-9, \$8.45)

Our price objective of USD12.8 is at approximately 10x 1-yr forward (FY11) PE, at nearly 20% discount to leader Genpact given the WNS CEO search is still on and given Genpact's superior management depth, global delivery and industry low attrition. Key risks include impending CEO change, high vertical and client concentration with insurance forming nearly 50% of revenues and top client at 25% of revenues. Expiry of income tax holiday in Mar 2010, growing competition, currency volatility are the other key risks.

Analyst Certification

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India - Software & IT Services Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
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	Mphasis Ltd	MPSSF	MPHL IN	Pratish Krishnan
	Patni	PATIF	PATNI IN	Mitali Ghosh
	Patni Computer	PTI	PTI US	Mitali Ghosh
	WNS (Holdings) L	WNS	WNS US	Mitali Ghosh
NEUTRAL				
	Genpact Ltd	G	G US	Mitali Ghosh
	Tech Mahindra	TMHAF	TECHM IN	Pratish Krishnan
UNDERPERFORM				
	ExService Holdi	EXLS	EXLS US	Mitali Ghosh
	Firstsource	FSSOF	FSOL IN	Mitali Ghosh
	HCL	XHCLF	HCLT IN	Mitali Ghosh
	Hexaware Tech	XFTCF	HEXW IN	Pratish Krishnan
	Infosys Tech	INFYF	INFO IN	Mitali Ghosh
	Infosys Tech - A	INFY	INFY US	Mitali Ghosh
	Infotech Enterprises Ltd	IFKFF	INFTC IN	Pratish Krishnan
	Mastek	MSKDF	MAST IN	Pratish Krishnan
	Rollta India	RLTAF	RLTA IN	Pratish Krishnan
	Rollta India-GDR	XLROF	RTI LI	Pratish Krishnan
	Tata Consultancy	TACSF	TCS IN	Mitali Ghosh
	Wipro	WIPRF	WPRO IN	Mitali Ghosh
	Wipro	WIT	WIT US	Mitali Ghosh

Important Disclosures

Investment Rating Distribution: Industrials/Multi-Industry Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	36	40.91%	Buy	16	51.61%
Neutral	20	22.73%	Neutral	6	35.29%
Sell	32	36.36%	Sell	8	29.63%

Investment Rating Distribution: Technology Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	83	40.10%	Buy	32	43.24%
Neutral	46	22.22%	Neutral	23	58.97%
Sell	78	37.68%	Sell	27	36.99%

Investment Rating Distribution: Global Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1243	38.21%	Buy	520	46.39%
Neutral	841	25.85%	Neutral	349	47.04%
Sell	1169	35.94%	Sell	388	36.30%

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