



Q4FY2007 IT earnings preview

Rupee adds to the seasonal weakness

The steep appreciation of the rupee has further added to the seasonal weakness in the fourth quarter which would limit the revenue growth of the information technology (IT) companies to 5-6.6% on a sequential basis. The margins would be under pressure, especially in case of Wipro (because of a relatively lower forward cover and the impact of annual salary hikes to its onsite employees in Q4) and Satyam Computer Services (Satyam; due to an incremental cost of \$4.5 million related to stock-based compensation). The earnings growth is expected to vary substantially for the various companies with a wide range of 1.3% to 6% sequentially.

Rupee rage

The average exchange rate of Rs44.2 against the dollar is quite close to the assumption of Rs44.1-44.3 made by the domestic companies (Infosys Technologies [Infosys]: Rs44.1; Satyam: Rs44.3) in their Q4 guidance. The other major currencies such as the euro and pound sterling were more or less flat on an average basis.

However, the steep appreciation of the rupee at the fag end of the quarter has resulted in a weighted average appreciation of around 1.2% in the rupee in terms of the end-of-period rates. This is likely to adversely affect the non-operating income (or the other income component) in

the fourth quarter results of companies like Infosys and Satyam that use the fair value method of accounting for the currencies hedges.

On the other hand, the other income component of Tata Consultancy Services (TCS) and Wipro would not be affected by the appreciation of the rupee as they use the cash flow hedging method of accounting for the bulk of the exchange rate cover. However, in the cash flow hedging method, the impact would be more pronounced on the revenue growth as the end-of-period exchange rates are used for the conversion.

Exchange rate movement

INR vs	End of period rates		Average rates	
	31-Dec-06	31-Mar-07	31-Dec-06	31-Mar-07
US Dollar	44.3	43.5	45.0	44.2
% qoq chg		-1.6		-1.7
Euro	58.3	58.2	58.0	57.9
% qoq chg		-0.2		-0.2
Pound sterling	86.9	85.5	86.2	86.3
% qoq chg		-1.6		0.1

In terms of the forward cover, TCS and HCL Tech are more comfortably placed with hedged positions for the next three to four months of revenues. On the other hand, Wipro had

Quarterly estimates

(Rs crore)	Net sales			Net profit			EPS (Rs)	OPM (%)
	Q4FY07	% qoq	% yoy	Q4FY07	% qoq	% yoy		
Infosys Tech	3877.0	6.1	47.8	1031.3	4.9	53.2	18.5	32.6
Guidance	3789-3798			977-978			17.9	
Satyam Computer	1751.5	5.4	33.3	353.1	4.7	23.9	5.4	24.6
Guidance	1728-1736			355.0			5.4	
HCL Tech#	1552.6	6.0	38.4	290.0	1.3	50.2	4.5	21.7
Wipro (cons)	4181.7	5.5	36.9	775.4	4.1	29.8	5.5	19.4
Wipro (global IT)	3044.8	5.5	33.0					
Guidance (global IT)	\$685 mn							
TCS	5183.7	6.6	39.2	1170.6	6.0	46.3	12.0	26.3

Please note HCL Tech is a June ending company.

considerably reduced its forward cover to around one month revenues as on December 2006 and runs the risk of getting caught on the wrong foot if timely actions have not been initiated during the quarter.

Forex cover

(\$ million)	Sep-06	Dec-06	FY2007E revenues	% forex hedge
Infosys Tech	373	360	3102	11.6
Satyam Computer	158	254	1448	17.5
HCL Tech	451	515	1336	38.5
Wipro (Global IT)	377	188	2461	7.6
TCS	1100	1250	4165	30.0

Ahead of consensus in case of Infosys

Our estimates are slightly ahead of consensus in case of Infosys and behind consensus estimates for Satyam. The consensus estimates already factor in a much sober performance in Q4 and the same is also reflected in the recent underperformance of the BSE IT Index as compared to the benchmark indices.

Consensus vs our estimates

(Sequential growth in %)	Net sales		Net profit	
	Consensus	Our estimates	Consensus	Our estimates
Infosys Tech	5.3	6.1	3.7	4.9
Satyam Computer	5.7	5.4	6.3	4.7
HCL Tech	6.0	6.0	2.4	1.3
Wipro (Cons)	7.2	5.5	3.2	4.1
TCS	5.5	6.6	6.7	6.0

Scope for positive surprise in FY2008 guidance

In terms of the FY2008 guidance also, the street expectations are a lot more conservative now. Most analysts expect Infosys to give an earnings guidance of 23-24% in rupee terms. It is much lower than the 26.5-28.5% earnings growth guidance given at the beginning of FY2007 and implies a less than 5% sequential growth in the earnings over the four quarters.

We believe that the street expectations are over conservative and leave enough room for positive surprises.

Notwithstanding the obvious concerns related to rupee appreciation, a possible slowdown in the USA and wage inflation, the recent surveys don't indicate any slowdown in IT spending of US companies but hint at further momentum in offshore outsourcing by major global corporations and increasing penetration in newer markets (especially in parts of Europe). Moreover, the annual growth guidance given by Cognizant Solutions (a Nasdaq-listed Indian offshore vendor) for CY2007 is quite robust (more or less similar to the one given by the company in February 2006) and doesn't indicate any serious concerns related to growth in the current year.

Cognizant—robust guidance for CY2007

	CY2006G	CY2006A	CY2007G
Revenues	42%	61%	43%
PAT	36%	48%	35%

Valuation

The street expectations have toned down considerably in terms of both Q4 performance and the annual guidance for FY2008, and the recent underperformance of the tech stocks indicates that the same has already been factored in the valuations. This essentially means that the negatives have been priced in, leaving limited scope for downside. But positive surprises, especially in terms of higher than expected annual guidance by Infosys, are not ruled out. However, the continued strengthening of the rupee and seasonal weakness in Q1 (due to wage hikes and additional visa related cost) would continue to influence sentiments on tech counters in the short run. We believe that any further weakness would be an opportunity to accumulate the front-line tech stocks and prefer Infosys and TCS.

Valuation matrix

	EPS (Rs)		P/E	
	FY07	FY08	FY07	FY08
Infosys	67.8	89.8	29.0	21.9
TCS	42.1	53.6	28.5	22.4
Wipro	20.1	24.9	26.6	21.4
Satyam	21.0	25.0	21.9	18.4
HCL Tech	16.8	20.5	17.3	14.1

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

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