Industry

30 August 2010 | 10 pages

Indian IT Services

Equity

Earnings Expectations and Ownership – A Closer Look

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- **Earnings beat/upgrades to drive stock prices** — Given current valuations, EPS beat/upgrades remain the key catalyst for the sector, in our view. For example, post 1Q results, TCS was the only stock that witnessed meaningful operational upgrades – after which, TCS outperformed its peers. In that context, we take a closer look at expectations as they can limit or result in surprises/upgrades.
- **Expectations for Infosys are the highest; Wipro the lowest** — Our analysis (Fig. 1) highlights that consensus (IBES) expectations for Infosys are the highest – implied EBITDA CQGR over next three quarters is ~10%. The same number for TCS and HCLT is 4.1% and 4.5%. Wipro stands out – expectations are lowest at ~1.2% CQGR over next three quarters (we are slightly ahead).
- **What does history suggest?** — Our analysis (Fig. 2) suggests that Infosys has on an average delivered ~8% CQGR (2Q to 4Q) over the last 5 years. While that does not rule out the possibility of positive surprise, it is a limiting factor. Also, 2Q is strong but 3Q/4Q are seasonally weak quarters. Wipro, on the other hand, has delivered an ~8% CQGR (2Q to 4Q) over the last 5 years – good likelihood of EPS upgrades, we would argue.
- **Is Indian IT under-owned?** — Yes, it is – FIIs (300bps), DMFs (~600bps) and Insurance (~700bps) are all underweight. However, the key question is: whether it is a technical under-ownership? The surprising part is that over the last 5 quarters, the sector has outperformed but its relative weight (vs index) has gone down. In MSCI India, Infosys is ~11% while in Nifty it is ~8.3% (and ~10% in Sensex). With most funds unlikely to have such a big exposure to a single stock, under-ownership may remain and may not be a big supporting factor.
- **Remain Neutral on the sector; Buy HCLT/Wipro** — Given recent macro concerns and high expectations/valuations, it is difficult to see meaningful upside. In the expectation context, Wipro looks a likely candidate for EPS surprises, has underperformed (~7% vs. BSEIT YTD) and trades at ~15-20% discount to TCS and Infosys. HCLT/Wipro are our top picks in Indian the IT services space.

Figure 1. Indian IT Tier-I – valuation comparison table

Company Name	RIC Code	CIR Rating	MCap ($m)	CMP (Rs)	TP (Rs)	P/E (x) FY11E	P/E (x) FY12E	EV/EBITDA (x) FY11E	EV/EBITDA (x) FY12E
Infosys	INFY.BO	2L	33,022	2,709	3,065	22.1	18.7	15.9	13.4
TCS	TCS.BO	2L	35,754	856	930	20.9	18.8	16.2	14.4
Wipro	WIPR.BO	1L	20,742	397	490	17.8	15.8	13.5	11.3
HCL Tech	HCLT.BO	1L	5,837	403	495	16.7	13.2	10.1	8.2

Source: Citi Investment Research and Analysis estimates Priced as on 27-Aug-2010

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

The Expectations Angle…

We have analyzed the consensus operating profit (EBITDA) assumptions and have looked at the CQGR needed over the next three quarters (four quarters in the case of HCLT as it is a June ending company).

A glance at the table below suggests that with an expected CQGR of 9.8% (over the coming three quarters) Infosys has the highest expectations, while at 1.2% CQGR Wipro is the lowest. TCS/HCLT are somewhere between 4-4.5% CQGR.

Figure 2. Quarterly EBITDA Trends — Actuals and Estimates Required for Consensus

	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	FY11	Consensus
TCS	19,619	21,342	22,718	23,121	24,088	25,075	26,103	27,172	102,438	102,438
	4.4%	8.8%	6.4%	1.8%	4.2%	4.1%	4.1%	4.1%		
Infosys	18,680	19,330	20,380	20,220	19,600	21,522	23,633	25,950	90,705	90,705
	-1.2%	3.5%	5.4%	-0.8%	-3.1%	9.8%	9.8%	9.8%		
Wipro	13,581	15,482	15,755	15,464	16,610	16,813	17,019	17,227	67,669	67,669
	-0.6%	14.0%	1.8%	-1.8%	7.4%	1.2%	1.2%	1.2%		
HCLT	6,888	6,386	6,073	6,381	6,668	6,968	7,281	7,608	28,524	28,524
	6.9%	-7.3%	-4.9%	5.1%	4.5%	4.5%	4.5%	4.5%		

Source: Company Reports, IBES, HCLT is June year end (rest March end)

We have also taken a look at the last five years of actual data and analyzed the CQGR achieved by the companies over 2Q to 4Q (1Q to 4Q in the case of HCLT). Since there are variations from one year to another, it might make sense, in our view, to look at the average numbers. *In that context, we find that the range has been ~6-8% for the tier-I companies.*

The average for Infosys is the highest at 8.1% but is a little short of the required expectation of 9.8%. *Though the company has even achieved an ~11% CQGR during the heyday of FY08, what it does highlight, in our view, is that further upgrade, if any, would be limited.*

Figure 3. EBITDA CQGR — Past and Estimates Required for Consensus

EBITDA	FY06	FY07	FY08	FY09	FY10	Average	CQGR needed
TCS	5.7%	13.3%	5.4%	7.1%	5.6%	7.4%	4.1%
Infosys	7.9%	10.4%	10.9%	8.5%	2.7%	8.1%	9.8%
Wipro	10.9%	7.6%	12.3%	4.0%	4.4%	7.8%	1.2%
HCLT	7.5%	5.4%	10.0%	6.1%	-0.2%	5.7%	4.5%

Source: Company Reports, IBES

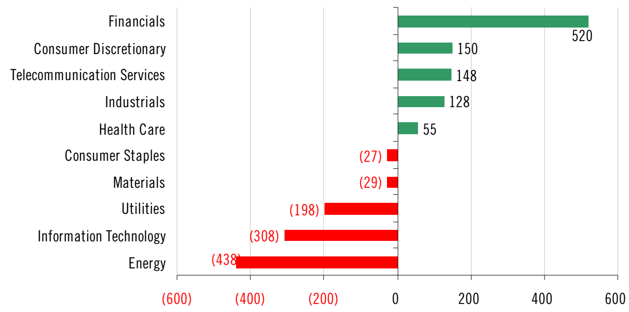
The Ownership Conundrum…

Foreign institutional investors (FIIs), domestic mutual funds (DMFs) and even domestic insurance players are underweight the IT sector (refer to charts below). *What is surprising is that in the last 5 quarters, the sector has outperformed meaningfully but the sector has always been meaningfully under-owned.*

For FIIs, the underweight has increased over the last three quarters – was 252bps in Dec'09 vs. 308bps in Jun'10. DMFs and insurance companies have also followed the same trend – were underweight 419/624bps in Dec'09 vs. 595/737bps in Jun'10.

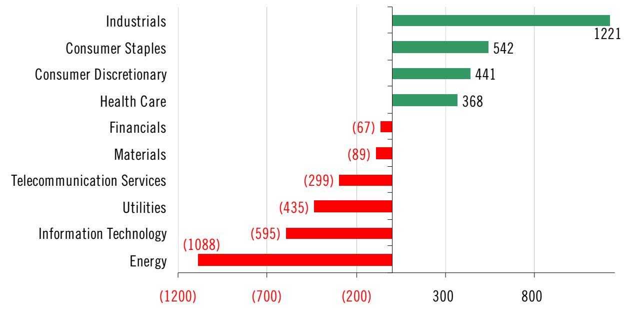
Interestingly, the sector's weight in FII portfolios has gone up from 11.4% to 13.6% over the last five quarters; however, the underweight has gone up from ~170 bps to ~310bps as the weight of the sector in MSCI has gone up faster.

Figure 4. FII Relative Weight with MSCI (bps)



Source: BSE; MSCI India; Citi Investment Research and Analysis

Figure 5. DMF Relative Weight with NIFTY (bps)



Source: BSE; NSE; Citi Investment Research and Analysis

The big question is whether the under-ownership is technical given the high weight of a single stock. Infosys is ~11% in MSCI India (largest along with Reliance), ~8.4% in Nifty and ~10% in Sensex. *Given that most funds are unlikely to have such a high single stock exposure, the ownership issue might be more technical and may not act as a downside support.*

Figure 6. Weight of IT Stocks in Benchmarks

	MSCI India	Nifty	BSE-30
Infosys	10.97%	8.32%	9.92%
TCS	3.38%	2.55%	3.05%
Wipro	1.73%	1.29%	1.53%
HCLT	0.54%	0.56%	0.00%
Sector	**17.06%**	**12.72%**	**14.50%**

Source: MSCI, NSE and BSE

HCL Technologies

(HCLT.BO; Rs392.80; 1L)

Valuation: Our target price is Rs495 based on 18x Dec'11E EPS. This is higher than the mid-point of the 6-23x band that the stock has traded in over the past three years. We believe a higher multiple is justified given improving macro and potential benefits arising out of the Axon acquisition. We believe PE remains the most appropriate valuation measure given HCLT's profitable track record.

Risks: We rate HCLT shares Low Risk which is inline with our quantitative risk-rating system as the company has significant scale, enjoys a good brand name and continues to generate significant FCF. Key downside risks to our target price include: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) a sharp slowdown in the US/Global economy; (3) acquisition-related risks; and (4) the strategy of pursuing large deals could have negative margin implications.

Infosys Technologies

(INFY.BO; Rs2,696.00; 2L)

Valuation: Our Rs3,065 target price for Infosys is based on 22x Dec'11E EPS. This is around the mid-point of the last 3-year trading band of 11x-30x 12-month forward earnings and factors in some deceleration in growth. Our estimates continue to assume a certain PE premium to the market; this is justified, in our view, given the strong FCF and ROIC for Infosys vs. the overall market. We believe PE remains the most appropriate valuation measure given Infosys' profitability record and higher earnings visibility.

Risks: We rate Infosys Low Risk which is inline with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to our target price include: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) pressure on billing rates (as Infosys still continues to enjoy a 10-15% premium in its billing rates); and (3) a prolonged slowdown in the US economy. Key upside risks include: (1) any significant depreciation of the rupee against the USD/EUR/GBP; and (2) a pickup in the US/global economy leading to better than expected spends.

Tata Consultancy Services

(TCS.BO; Rs846.65; 2L)

Valuation: Our target price of Rs930 is based on 21x Dec'11E EPS. Given that businesses are bottoming and we estimate TCS' earnings will grow at an ~13% CAGR over FY10-13E, we believe the stock should trade closer to the higher end of its historical three-year trading range of 7-27x 12-month forward earnings. We believe PE remains the most appropriate valuation measure given TCS' past profitability and future earnings visibility.

Risks: We rate TCS Low Risk which is inline with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks that could cause the shares to be lower than our target price are: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) a prolonged recession in the US; and (3) any margin-dilutive acquisition. Key upside risks that could cause the shares to be higher than our target price are: (1) any significant depreciation of the rupee against the USD/EUR/GBP; (2) aggressive pent up demand from corporates in the US; and (3) any margin accretive acquisition.

Wipro

(WIPR.BO; Rs398.45; 1L)

Valuation: Our target price of Rs490 is based on 20x Dec'11E EPS. Our target multiple is derived from a PE-band analysis of Wipro's historical trading pattern and peer group valuations. Wipro has traded at 8-31x over the past three years. Given that revenue visibility is improving with business environment stabilizing, we believe Wipro should trade higher than the mid-point of the band. We think Wipro will continue to trade at a marginal discount to Infosys. PE is the most appropriate valuation measure, in our view, given Wipro's profitability and earnings visibility.

Risks: We rate Wipro Low Risk which is inline with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks that could cause shares to fall below our target price include: (1) an extended slowdown in the US economy; and (2) any significant appreciation of the rupee against the USD/EUR/GBP.

Appendix A-1

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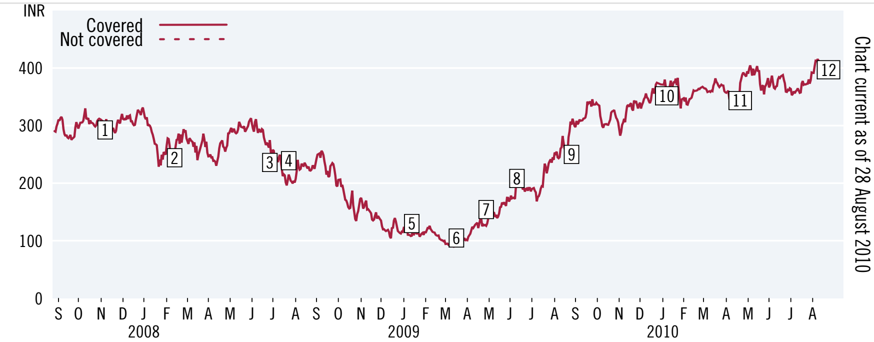
Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA



	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1M	*365.00	295.35
2	13-Feb-08	1M	*340.00	251.45
3	26-Jun-08	1M	*350.00	274.80
4	23-Jul-08	1M	*245.00	214.95
5	13-Jan-09	*2H	*120.00	108.60
6	17-Mar-09	2H	*111.00	101.15
7	28-Apr-09	*2M	*140.00	125.85
8	10-Jun-09	2M	*215.00	204.40
9	26-Aug-09	2M	*345.00	301.55
10	7-Jan-10	2M	*435.00	360.50
11	21-Apr-10	*1M	435.00	374.10
12	24-Aug-10	*1L	*495.00	408.50

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Infosys Technologies (INFY.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA

	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1L	*2,190.00	1,743.85
2	13-Feb-08	*1M	*2,060.00	1,549.15
3	26-Jun-08	1M	*2,175.00	1,781.85
4	23-Jul-08	1M	*1,910.00	1,603.70
5	20-Nov-08	1M	*1,420.00	1,127.25
6	4-Jan-09	1M	*1,350.00	1,130.95
7	28-Apr-09	*1L	*1,650.00	1,431.55
8	10-Jun-09	1L	*2,060.00	1,803.25
9	26-Aug-09	*2L	*2,290.00	2,181.35
10	7-Jan-10	2L	*2,785.00	2,525.25
11	23-Apr-10	2L	*2,935.00	2,728.10
12	24-Aug-10	2L	*3,065.00	2,765.50

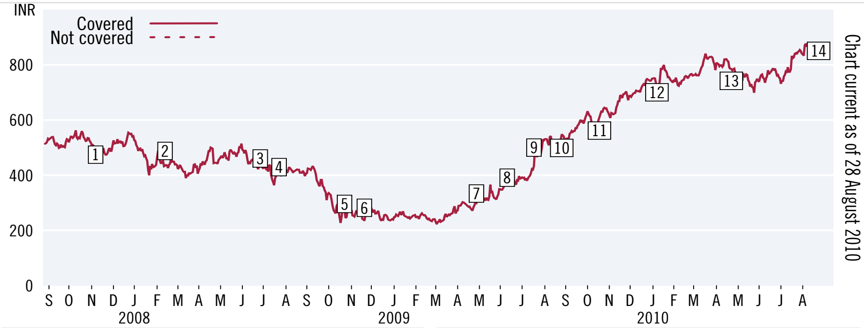
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tata Consultancy Services (TCS.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA



#	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1L	*645.00	499.13
2	13-Feb-08	*1M	*582.50	434.48
3	26-Jun-08	1M	*587.50	438.43
4	23-Jul-08	*2M	*462.50	429.25
5	23-Oct-08	2M	*312.50	273.73
6	20-Nov-08	*2H	*280.00	234.75
7	28-Apr-09	*3M	*307.50	299.30
8	10-Jun-09	*1L	*465.00	390.88
9	17-Jul-09	1L	*525.00	433.60
10	26-Aug-09	1L	*630.00	548.30
11	19-Oct-09	1L	*695.00	599.00
12	7-Jan-10	1L	*855.00	714.65
13	22-Apr-10	*2L	855.00	785.30
14	24-Aug-10	2L	*930.00	868.90

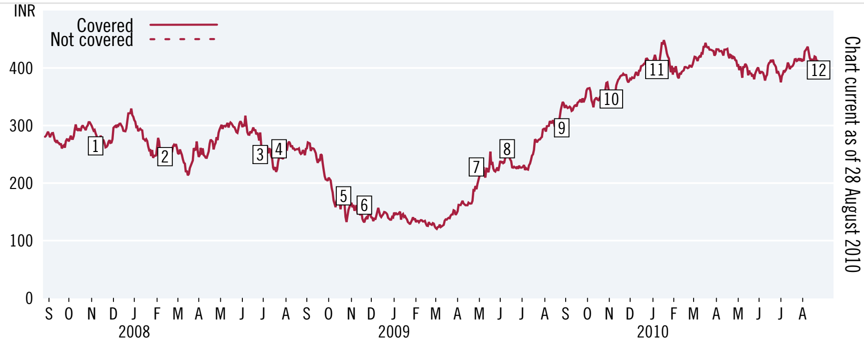
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Wipro (WIPR.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA



#	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1L	*339.00	286.41
2	13-Feb-08	*1M	*321.00	245.97
3	26-Jun-08	1M	*330.00	287.97
4	23-Jul-08	*2M	*264.00	244.65
5	22-Oct-08	2M	*195.00	167.55
6	20-Nov-08	*2H	*159.00	131.76
7	28-Apr-09	*2M	*216.00	189.24
8	10-Jun-09	*2L	*270.00	259.62
9	26-Aug-09	*1L	*372.00	334.35
10	4-Nov-09	1L	*408.00	357.48
11	7-Jan-10	1L	*486.00	406.53
12	24-Aug-10	1L	*490.00	408.75

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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