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India
Technology

Software & IT Services

Recommendation Change

Stable Macro; upgrade sector to NEUTRAL

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Sector View:

New: Neutral

Old: Bearish

Investment Conclusion

- We upgrade India's Software & IT Services sector to NEUTRAL from Bearish.

Summary

- Our economics team is calling for an end to the US recession and does not expect the global economy to enter into a downturn again in the near future.
- In our view, this will lead to a slow and steady recovery in volume growth, evidenced by an increased number of deals and deal closures.
- All companies reported an exceptional quarter (1Q FY10), during which the decline in volume growth was less than expected and margin performance was much better than expected.
- This has led us to upgrade our EPS estimates by 5-60% for all companies for FY10E and FY11E.
- All the stocks under our coverage have outperformed the Sensex, trading at one-year forward P/E multiples between 11x and 21x.
- Our current price targets imply 1-year forward P/E valuations of 18-20x for tier-1 companies and 12-14x for mid caps.
- We upgrade Tata Consultancy Services (TCS), Tech Mahindra and HCL Technologies to BUY, Wipro and Infosys Technologies to NEUTRAL and maintain our BUY rating on Patni Computer System.

We upgrade the IT services sector to NEUTRAL from Bearish, due to the following reasons:

1. Better growth visibility in the US and Europe — Our economics team is calling for an end to the US recession, seeing very low probability of the global economy going into a downturn again.
2. Improvement in the IT spending environment — Over the past six months, the numbers of deals in the market and deal closures by vendors have risen. We believe vendor consolidation and business efficiency-related IT spending by customers are likely to result in sustained volume growth recovery for vendors.
3. Operating margin expansion — A drastic cut in hiring and higher offshoring, along with reductions in sales and marketing and other expenses, have resulted in q-q increases in margins. While many of these cost reductions may be one-off, the operating model has proven to be robust in resisting pricing pressure and other shocks, in our view.

However, companies under our coverage have seen their share prices posting significant gains YTD, with tier-1 companies trading at one-year forward P/E multiples of 18-21x and the rest at 11-15x. We have upgraded TCS, Tech Mahindra and HCLT to BUY, Wipro and Infosys to NEUTRAL and maintained our BUY rating on Patni. Our top pick in the sector is HCL Technologies. An appreciating rupee against the US dollar remains the key risk to our ratings and price targets.

Exhibit 1: Summary of changes

	Ticker	Change of Recc.	New PT (INR)	Current Price (INR)	Potential Upside/Downside%
Infosys	INFO IN	From Reduce to NEUTRAL	2,271	2,200	3.2%
TCS	TCS IN	From Reduce to BUY	640	554	15.6%
Wipro	WPRO IN	From Reduce to NEUTRAL	625	552	13.2%
HCL Tech.	HCLT IN	From Neutral to BUY	389	308	26.2%
Patni	PATNI IN	Maintain BUY	518	415	24.9%
Tech M	TECHM IN	From Reduce to BUY	1,139	957	19.1%

Source: Nomura research

Improvement in global economy

Our global economics team is seeing an improvement in the macro environment. According to the *Global Weekly Economic Monitor* (7 August 2009) – "The US economy has entered its 20th month of recession, the longest slide in economic activity since 1933. But an encouraging July employment report featuring a 0.1% drop in the unemployment rate suggests the end may be near. Other encouraging signs have come from the housing sector, where all the key metrics of activity showed impressive gains in June that for the most part extended gains from earlier months. Meanwhile, the manufacturing sector seems to be stabilising and the second-quarter upturn in orders for manufactured goods may be starting to spur industrial production. Armed with these more encouraging data, we now expect real GDP growth to move solidly into positive territory in the second half of 2009, but still expect growth to remain below potential throughout 2010. We foresee growth remaining below potential throughout 2010 and not reaching that threshold pace until 2011. We see global growth rising to 4.1% in 2011 from 3.3% in 2010 and -1.2% in 2009".

As per our economist team, "While we do not expect a strong or quick global recovery – rather, a prolonged period of weak growth seems much more likely, particularly in Europe and Japan – we view it as very unlikely that the US and global economy will fall back into recession, let alone a serious one".

Positive impact on IT services demand …

The impact of stabilisation on the global economy is manifesting itself in the Indian IT services sector in the following ways:

1. **Improvement in deal pipeline and closures**
   The following is leading to improved deal pipelines and deal closures.

   - Clients are becoming more open to discretionary IT spending, especially in areas such as enterprise resource planning (ERP), in which deep spending cuts have already happened. Customers are also talking about some transformation of deals apart from off-shoring support and maintenance work. Thus, the propensity to spend out of the 2009 budget is much more now compared with that a quarter ago.
   - New order bookings and pipelines have improved substantially, with decision-making more streamlined now.
   - Pricing pressure has reduced, at least at the procurement level (although at the ground level business, IT continues to place offer for deals and get the same work done at lower costs.
   - We expect 2010 IT budgets to be flat or slightly down versus cuts of 10-20% seen in 2009 IT budgets.
   - Many deals in the market are due to customers looking for serious off-shoring work for the first time.
   - Markets in India, the Middle East and Asia have seen good demand for IT services outsourcing, mainly from governments and the telecom and banking sectors.
   - We have seen vendor consolidation and large customers, such as Telstra, British Petroleum (BP) and Aviva, extending bidding offers again for existing businesses at reduced prices to a smaller number of select vendors. This has led to volume growth for selected vendors, which are typically tier-1 companies.

2. **Demand stability across verticals**
   There is stability in areas such as banking and financial services (BFS), manufacturing and ERP, which have seen a sharp contraction in demand over the past few quarters, due to:

   - Demand for IT services in BFS, ERP, retail and manufacturing is coming back, as the numbers of deal closures and deals in pipelines are increasing. Customers are much more comfortable making spending decisions for CY09 IT budgets now than they were a couple of months ago (when budgets were approved but actual spending was being postponed).
   - In BFS, tier-3 banks (mainly regional banks) are actively looking to move work offshore. These banks have hired CIOs or heads of IT — typically people who have implemented and seen the benefits of offshoring at large banks and are keen to get the same benefits in their new organisations.
   - Similarly, manufacturing and retail have seen a lot of new requests for proposals (RFPs) from customers that are planning to move work offshore for the first time.

3. **Vendor consolidation and efficiency spending to drive growth**
   We have seen vendor consolidation and onsite contractor replacement exercises adopted by several large customers, which we believe is likely to result in incremental volume growth for Indian vendors. For example, BP has consolidated its vendors by awarding extra work to IBM, Infosys and Wipro. A similar exercise is being taken by companies such as Chevron, Exxon and a few others. In our view, this wave of offshoring by companies that have offshore spending of less than 10% of total IT application spending is likely to continue. This is likely to happen in verticals such as energy and utilities, media, retail and manufacturing, as most of these companies have yet to reach an optimal level of offshoring, in our view.

   Apart from vendor consolidation, offshore spending is also picking up in areas where global delivery is required for better business efficiency. This includes spending directed towards retaining and growing customers, improving customer service or geographic penetration. According to a report entitled *"State of the Outsourcing Industry in mid-2009: Activity to Resume With a More Cautious and Global Focus,"* released last week by AMR Research Inc., application development, hosting and IT infrastructure outsourcing are likely to resume growth later this year. It also shows that enterprises are turning to outsourcing not only to cut costs, but also to operate more effectively at a more expansive, worldwide level. Some 63% of respondents said the desire for more effective operations at a global level was a driving factor of their contracts. While this type of spending will take a few quarters to pick up, this area could be the next driver of growth for offshore companies, in our view.

… should result in slow and steady recovery volume growth

In our view, while positive signals for demand are visible, volume growth recovery will be gradual and over several quarters, since:

- The average deal size has come down over a period of time, as most of the new deals are coming from clients who are doing serious offshoring for the first time and are still testing the waters.
- Deals given by large offshore mature Fortune-1000 customers are more due to a re-bidding of existing business rather than large incremental outsourcing and off-shoring. In our view, this trend is likely to continue as clients are consolidating similar business or IT functions to a few selected vendors after negotiating for a cut in overall spending. For example, the recent A$450mn over-five-year deal awarded to Infosys by Telstra consists of 30-40% IT outsourced work, which the vendor is already doing for the company. Similarly, BP has awarded additional work to Infosys, Wipro and IBM as part of its vendor consolidation programme.
- Many recently announced large deals in the telecom vertical, such as Unitech Wireless and Etisalat, among others, are more in the nature of system integration with third-party revenues accounting for almost 50% of the deal size. This pass-through revenue typically comes at a very low margin for the system integrator.
- Customers are still reluctant to award any deals that have upfront investments, such as transition costs. The trend has shifted more towards asking for upfront savings from customers and shifting any large investments to the next calendar year.

We have slightly improved our volume growth estimates for the next few quarters. We assume flat pricing, as we believe that most price negotiations and negative surprises are behind us. This also comes on the back of management commentary confirming the same. Exhibit 2 shows our forecasts for US dollar revenue growth for the next few quarters for companies under our coverage.

Exhibit 2: Q-Q volume growth

(%)	2Q FY10E	3Q FY10E	4Q FY10E	1Q FY11E
Infosys	1.3	3.9	3.8	3.0
TCS	1.6	4.3	4.1	2.7
Wipro	2.4	2.7	3.0	2.2
HCL Tech.	2.0	2.8	1.5	2.3
Patni	3.1	1.5	1.4	2.3

Note: Wipro volume growth is for Global IT services business while HCL Tech volume growth is for the core software division

Source: Nomura estimates

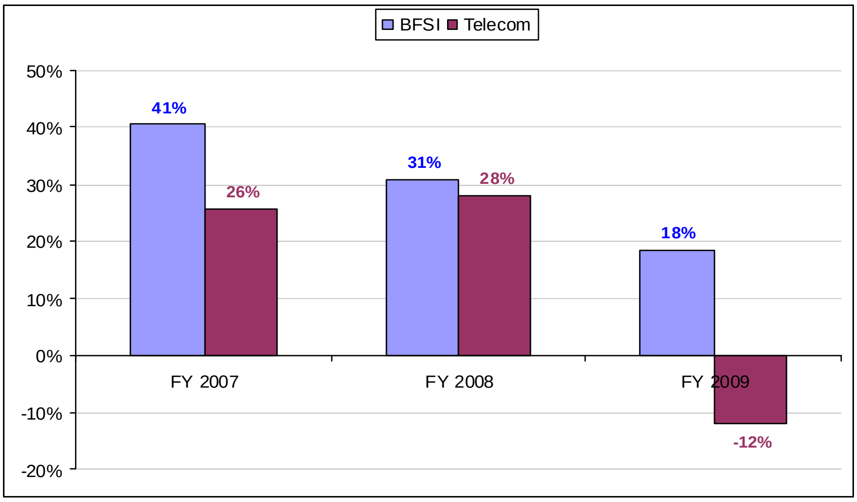
In addition, we believe that with the macro environment improving, revenue growth is likely to improve in FY11E to 10-16% for tier-1 companies such as Infosys, TCS and Wipro.

Volume growth in FY11E to be under 15%

We expect volume growth to be between 10% and 15% for the top three companies (Infosys, TCS and Wipro) and do not see the possibility of volume growth higher than 18-20% for FY11E, due mainly to the following reasons:

- **Contribution from large verticals such as BFS and telecom is going down**
  While verticals such as BFS and retail have now stabilised, we do not expect companies in these verticals to start spending on IT significantly. Also, verticals such as manufacturing and Hi-tech are still seeing cuts in discretionary spending. We believe that management commentary and the next quarter's growth outlook could reflect more of the ground reality, where discretionary IT spending is difficult to come by and the ramp-up of new deals is still slow.

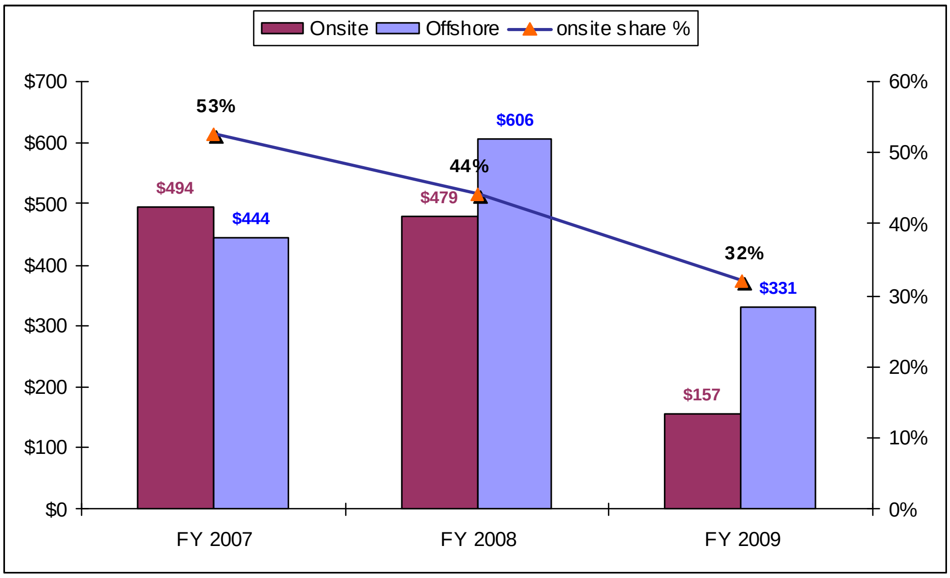
Exhibit 3: Infosys: incremental revenue (in US$mn terms) contribution from BFS, Telecom



Source: Company data, Nomura research

- **Contribution from onsite is going down**
  The proportion of onsite revenue to total revenue has declined for all the three companies due to increased offshore leverage. While this is good for margins, the flipside is that for the same amount of incremental US dollar revenues, offshore volumes will have to be 3-4x higher than corresponding onsite volumes, due to the lower realisations offshore.

Exhibit 4: Infosys: incremental revenue (US$mn) contribution from onsite, offshore



Source: Company data, Nomura research

- **Realisations are expected to be flat to negative**
  As per company management commentary, most of the price negotiations with clients have happened and companies are guiding for flat pricing growth for the remaining year. Current levels of pricing are, however, 3-7% lower than FY09 levels and, in our view, are going to remain the same in FY11, which will make it harder for companies to achieve the same kind of revenue growth seen during 2006-08.

Margins to decline once growth picks up

In the last quarter, operating margins across companies improved as hiring was cut dramatically and offshoring increased. Also, SG&A and other expenses, such as travel, were cut aggressively. (Refer to the section on 1Q FY10 results highlights). While we believe that cost savings due to higher offshore leverage are more permanent in nature, the same cannot be said of SG&A cost reductions. In our view, companies will have to make investment in sales and marketing and in lateral hires, because:

- New focus geographies, such as France, Germany and APAC, will need people at the front end to conduct sales, pre-sales and consulting work.
- Companies need to hire experienced staff to carry out knowledge transition and project management activities for new projects. The layoffs and attrition of the past few quarters has brought utilisation to historically high levels for most companies.
- Also, companies need to hire onsite local employees to keep themselves prepared for any regulations such as the proposed amendment in the US, which mandates that 50% of onsite employees for companies would need to be local residents. Companies such as Infosys, TCS and Wipro have already announced plans to hire 500-1,000 people locally and this is likely to increase salary costs in the next few quarters.
- Many re-bid deals of large vendor consolidations, such as Telstra and BP, have been awarded at a 10-15% cut in existing spending, which is likely to have a negative impact on realized rates in these accounts in the short term.

We estimate a 20-50bp decline in margins for FY11E over FY10E.

Summary of estimates

The exhibit below shows our estimates for growth rates, EBITDA margins and EPS.

Exhibit 5: Estimates for FY10E and FY11E

	Infosys		TCS		Wipro	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
US$ revenue growth	0.1%	15.9%	2.8%	13.9%	-0.7%	13.5%
EBITDA margin %	33.0%	32.4%	26.1%	25.8%	20.5%	20.2%
EPS (INR)	103.5	109.1	29.5	32.5	27.8	31.5

Note: US$ revenue growth for Wipro is only for the IT services division

	HCL Tech.		Patni		Tech M	
	FY10E	FY11E	FY09E	FY10E	FY10E	FY11E
US$ revenue growth	16.5%	15.1%	-13.3%	6.7%	-8.7%	11.3%
EBITDA margin %	22.1%	21.5%	18.7%	18.2%	24.7%	23.4%
EPS (INR)	20.9	27.6	33.2	38.5	59.1	78.4

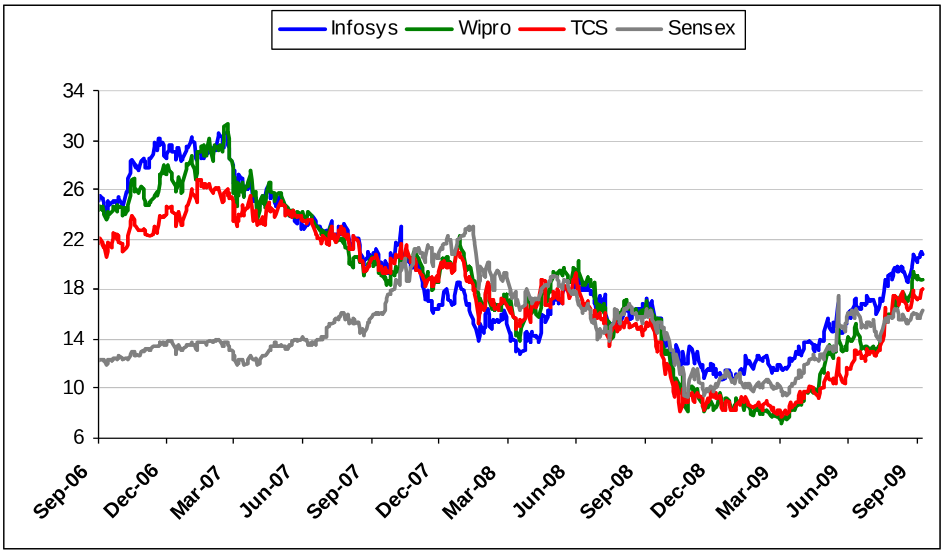
Note: Patni FY estimates are for year ending Dec, HCL Tech for year ending June

Source: Nomura estimates

Run-up in stocks

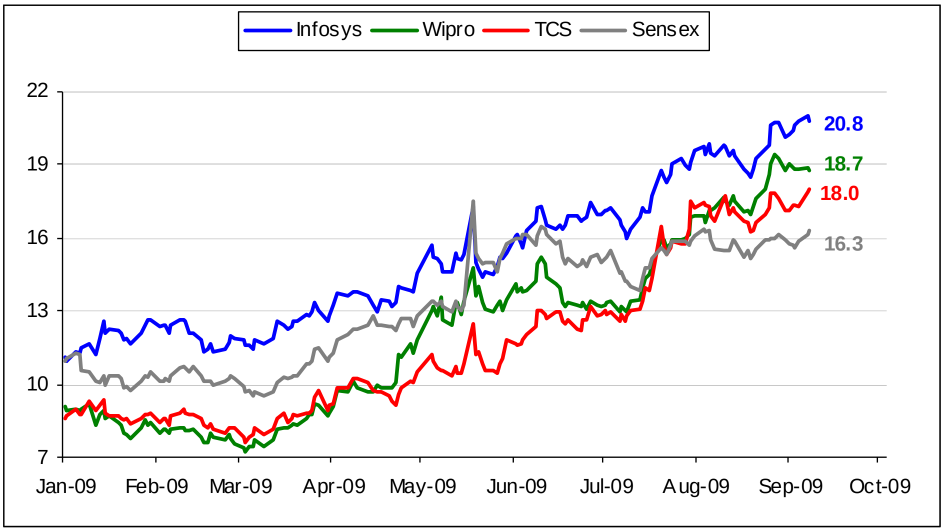
The one-year forward P/E ratio of Infosys, TCS and Wipro are currently in the 18-21x range last seen in November-December 2007. Stocks valuations have run up significantly post 1Q FY10 results, and the current premium to the Sensex for Infosys is about 30%, while for Wipro and TCS, it is in the range of 13-20%.

Exhibit 6: One-year forward P/E trend from 2006-YTD for Infosys, Wipro, TCS and Sensex



Source: Bloomberg, Nomura research

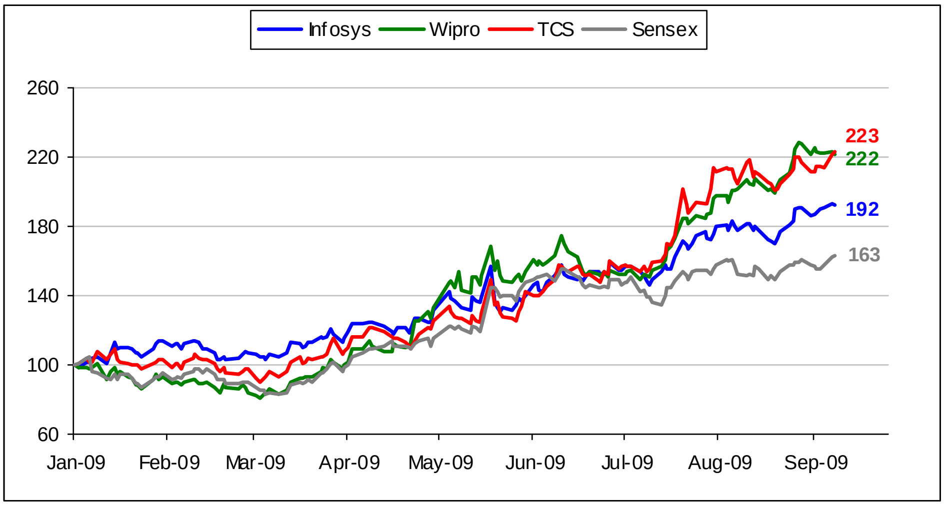
Exhibit 7: One-year forward P/E trend YTD for Infosys, Wipro and TCS vs Sensex



Source: Bloomberg, Nomura research

Tier-1 stocks have outperformed the Sensex by a wide margin YTD. The run-up in TCS share price, which has outperformed both the Sensex and other tier-1 stocks occurred after its 1Q FY10 results, which were better than most street expectations.

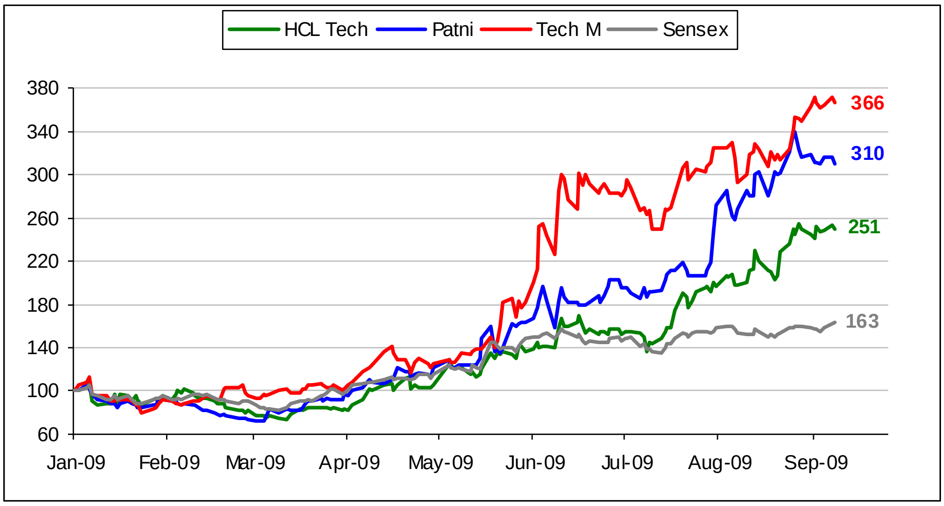
Exhibit 8: YTD stock performance for Infosys, Wipro and TCS vs. Sensex



Source: Bloomberg, Nomura research

Tier-2 stocks have also outperformed the Sensex by a wide margin. Both Tech Mahindra and Patni have gained around 200%-plus YTD, compared with Sensex's gains of 63% during the same period.

Exhibit 9: YTD stock performance HCL Tech, Tech M and Patni vs. Sensex



Source: Bloomberg, Nomura research

Valuation

We value Infosys, TCS, Wipro and HCL Technologies using the discounted cash flow (DCF) methodology. For Tech Mahindra and Patni, we base their valuations on a discount to Infosys' implied one-year forward P/E valuation.

Our current one-year forward P/E valuations are between 18x and 20x for the top tier companies and 12-14x for the rest of the company, which broadly lie between their three-year and five-year historical P/E valuations. (Refer to the exhibit below)

Exhibit 10: P/E valuations

	Target Price	Current 1-yr	Historical average 1-yr forward P/E			
	Implied P/E	forward P/E	1yr	2yr	3yr	5yr
Infy	19.2	20.8	14.2	15.6	19.1	20.7
TCS	18.5	18	11.2	14.5	17.5	18.9
Wipro	18.5	18.7	11.6	15.0	18.4	20.5
HCL Tech.	14	13.8	8.0	11.6	13.5	14.4
Patni	12	11.2	5.4	7.2	9.1	11.8
Tech M	13	14.1	7.3	10.0	14.5	n/a

Source: Nomura research

Exhibit 11: Valuation chart

		P/E		EV/EBITDA	
	M. Cap (INR bn)	FY10E	FY11E	FY10E	FY11E
Infosys	1,262	21.2	20.2	15.9	14.6
TCS	1,084	18.8	17.0	13.8	12.8
Wipro	807	19.9	17.5	14.5	13.1
HCL Tech.	207	14.8	11.2	8.5	7.6
Tech M	116	16.2	12.2	13.2	13.2
Patni	53	12.5	10.8	6.5	6.6

Note: Patni FY estimates are for year ending Dec, HCL Tech for year ending June; Tech M EV/EBITDA exclude Satyam EBITDA

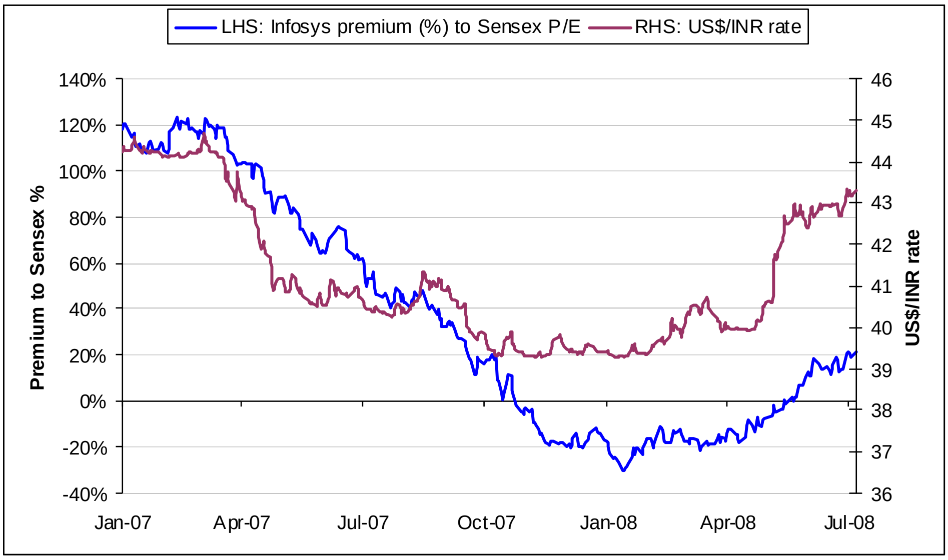
Source: Bloomberg, Nomura estimates

Our top pick in the sector is HCL Technologies on account of its higher FY09-11E EPS growth of 20.3% and upside potential of 26.2% from current levels.

Valuation sensitivity to currency

Our US$/INR assumptions are currently INR47.2 for FY10E and INR45 for FY11E. P/E valuations of IT services are highly sensitive to US$/INR rates. When the rupee appreciated against the US dollar from April 2007 to January 2008 (the rupee moved from 42 to 39.4 per US dollar), the P/E premium of Infosys over the Sensex narrowed and entered negative territory. Currently, tier-1 IT companies trade at a premium to the Sensex, which we believe the premium will narrow if the rupee appreciates further from current levels.

Exhibit 12: P/E valuation sensitivity to US dollar/rupee rate



Source: Bloomberg, Nomura research

1Q FY10 results highlights

Demand stability and positive guidance

The demand environment has stabilised from 4Q FY09 when companies missed or barely achieved their guidance targets. In 1Q FY09, companies such as Infosys, Wipro and Patni outperformed their quarterly revenue guidance by 0.5-4%. Also, the upper-end guidance given by Infosys, Wipro and Patni suggests positive sequential growth in the range of 0.7% to 2%. However, companies were cautious about the demand outlook and seemed to suggest that discretionary IT spending would continue to be cut while decision-making among clients continued to be slow, leading to lengthened sales cycles.

Exhibit 13: Companies' guidance (US$ mn)

Infosys	Q4FY09	Q1FY10
Guidance upper end	$1,170	$1,080
Actual	$1,121	$1,122
Outperformance	-4.2%	3.9%
Wipro	**Q4FY09**	**Q1FY10**
Guidance upper end	$1,045	$1,025
Actual	$1,046	$1,033
Outperformance	0.1%	0.7%
Patni	**Q4FY09**	**Q1FY10**
Guidance upper end	$155	$159
Actual	$156	$162
Outperformance	0.9%	1.9%

Guidance for Q2FY10E	Upper	Lower
Infosys	0.7%	-1.1%
Wipro	2.0%	0.2%
Patni	0.7%	1.9%

Source: Company data

Volume decline was less than expected

Sequential volume growth in 1Q FY10 for TCS and Infosys was above expectations. From negative 2.7% in 4Q FY09, TCS delivered positive 3.5% sequential volume growth in 1Q. Similarly, while we were expecting a 3% decline for Infosys, volume growth came in at -1.1%. The improvement in volume growth in companies under our coverage can be attributed to stability in the BFS sector, which is the largest in terms of contribution to revenue, and growth in some others, such as retail, healthcare and utilities. Meanwhile, verticals such as manufacturing and telecom continue to remain weak and management commentary suggests that the weakness will persist for at least a quarter more.

Exhibit 14: Companies' q-q volume growth

q-q Volume growth %	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	6.5%	2.0%	-1.4%	-1.1%
TCS	6.0%	2.4%	-2.7%	3.5%
Wipro	1.2%	2.2%	-6.3%	-1.5%
HCL Tech.	1.0%	1.1%	5.4%	0.1%

Note: Wipro volume growth for Q1FY10 excludes CITOS, HCL Tech volume growth is for the Core software division

Source: Company data

Vertical and service line performance

For Infosys, BFS was flat during 1Q FY10 in constant currency terms, while all other verticals declined sequentially. Management commented that it was seeing traction in client engagements in the pharmaceutical and energy utility verticals, while in manufacturing and retail verticals, it would continue to see weakness. Among service lines, application maintenance picked up during 1Q, while consulting services and package implementation continued to decline.

TCS management is optimistic about growth in energy, utilities, pharmaceutical and healthcare verticals, while on BFS, it added that signs of stability and growth were seen in 1Q FY10. Manufacturing, telecom and hi-tech were the verticals still witnessing weakness in the quarter. Among service lines, infrastructure services and assurance services improved while business intelligence and enterprise solutions remained weak.

Wipro sees challenges in technology and telecom although growth has started to pick up in communication media and service providers, energy and utilities, and healthcare and services verticals. Management commented that BFS saw signs of stability in 1Q FY10.

HCL Technologies registered good growth in enterprise application services due to the Axon acquisition (in 4Q FY09], while in verticals, life sciences and media publishing & entertainment registered positive sequential growth. Weakness continues in the retail vertical and the engineering and R&D service line.

For Patni, growth was seen in insurance and application, development and maintenance (ADM) while (BPO) in services and manufacturing in verticals registered sequential declines.

Exhibit 15: Company-wide performance across verticals and service lines

	Verticals		Service Lines	
	Weak	Strong/Stable	Weak	Strong/Stable
Infosys	Manufacturing Retail	Pharma Energy & Utility BFS	Consulting service Package Implementation Product Engineering	Application Maintenance BPO
TCS	Manufacturing Telecom Hi-tech	Energy & Utility Pharma Healthcare BFS	Business Intelligence Enterprise Solutions Engineering & Industrial Services	Infrastructure Services Assurance Services AD&M BPO
Wipro	Technology Telecom	Communication, Media and Service Providers Energy & Utility Healthcare BFS	Product Engineering Technology Infrastructure	Testing Services BPO Package Implementation
HCL Tech.	Retail	Life Sciences Media Publishing & Entertainment BFS	Engg. & R&D Services Industry Solutions	Enterprise Application Services Infrastrucuture Services
Patni	Communications, Media & Utilities Manufacturing, Retail & Distribution	Insurance Financial Services	BPO Product Engineering Services	ADM

Source: Company data, Nomura research

IT companies did well in BPO in 1Q FY10, which has been a service line that has been relatively unaffected by the recession. TCS acquired Citigroup Global Services (CGSL) in 4Q FY09, and in the process, almost doubled its revenues from BPO. In addition, according to report in *Business Standard* (19 July 2009), TCS plans to make BPO a US$3bn business in the next five years from the current size of US$600mn.

According to Gartner, the BPO market share of India-centric vendors is expected to double by 2010. In 2008, as per Gartner's estimate, the top-20 India-centric BPO providers accounted for US$4bn in revenue, representing 5% of the US$80bn revenue of the top-150 BPO vendors.

Exhibit 16: BPO revenues (INRmn)

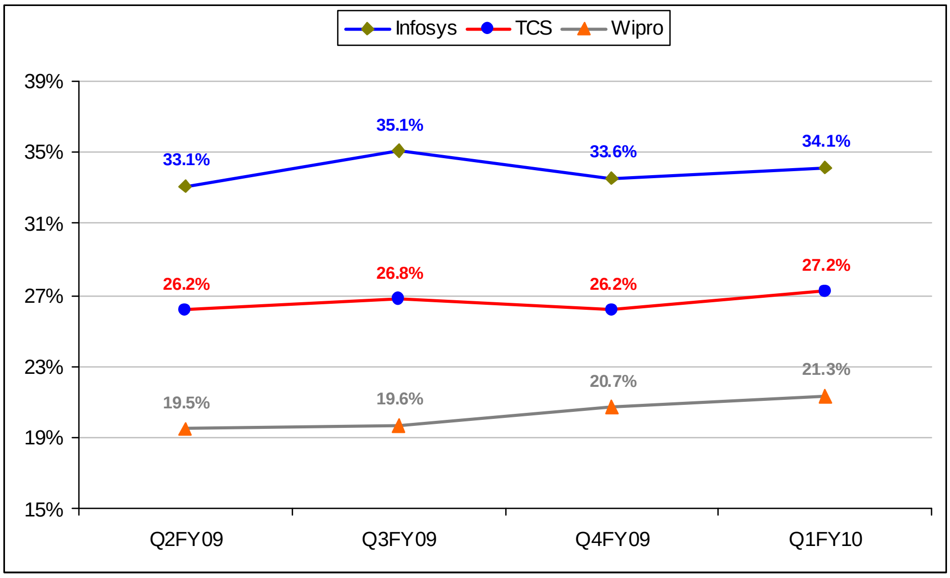
	2Q FY09	3Q FY09	4Q FY09	1Q FY10
Infosys	3,251	3,298	3,381	3,338
TCS	4,033	4,221	7,961	8,216
Wipro	4,037	4,318	4,735	4,873
HCL Tech.	2,678	3,089	2,862	2,821
Patni	443	480	501	410
Tech Mahindra	636	676	537	677

Source: Company data, Nomura research

Cost rationalisation has been exceptional

Operating margin performance was impressive for IT companies during 1Q FY10. For companies under our coverage, EBITDA margins improved broadly by 50-100bp in the quarter vs. our expectation of a 100bp decline. These companies were quick in controlling hiring and moving work from onsite to offshore, which has caused employee compensation to decline by close to 4% over the past two quarters from 3Q FY09 levels. Net adds were negative for Infosys and TCS this quarter, while for Wipro the workforce rationalisation happened two quarters ago (in 3Q FY09). Cost reductions were also brought about in SG&A – where items such as overseas business expenditure have been cut down significantly.

Exhibit 17: EBITDA margin comparison — Infosys, TCS and Wipro



Source: Company data, Nomura research

Exhibit 18: Employee compensation & SG&A expense cuts across companies

Employee Compensation as a % of Revenues

	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	50.0%	50.8%	52.3%	51.6%
TCS	56.6%	57.7%	56.9%	56.2%
Wipro	40.1%	42.4%	42.4%	42.0%

Note: Wipro total entity

Employee Compensation (INR mn)

	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	27,070	29,400	29,470	28,240
TCS	39,323	42,016	40,808	40,537
Wipro	26,176	28,012	27,704	26,966

Note: Wipro total entity

SG&A as a % of revenues

	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	13.5%	11.8%	12.4%	12.6%
TCS	20.8%	19.2%	20.6%	19.8%
Wipro	12.0%	12.8%	11.4%	10.6%
HCL Tech.	17.0%	17.4%	15.7%	15.5%
Patni	7.2%	7.5%	8.3%	7.4%
Tech M	13.0%	13.9%	14.8%	13.4%

Note: Wipro numbers are for IT services division

SG&A (INR mn)	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	7330	6800	6990	6890
TCS	14,458	13,948	14,802	14,243
Wipro	5,716	6,436	5,718	5,218
HCL Tech.	4,019	4,329	4,502	4,512
Patni	612	642	662	573
Tech M	1,520	1,570	1,557	1,487

Note: Wipro numbers are for IT services division

Source: Company data, Nomura research

Due to the offshore leverage, the offshore revenue share has moved up by 2-5% for these companies over the past two quarters, as seen below. In addition, utilisation improved for TCS and Wipro, owing to hiring control, thus bringing current levels of utilisation very close or above peak levels seen in the past two years. Infosys has still more leverage left as current levels are at least 5% lower than the peak level.

Exhibit 19: Offshore leverage and Utilisation across companies

Offshore Revenue Share %	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	48.0%	49.4%	48.9%	48.6%
TCS	42.8%	43.6%	47.7%	50.4%
Wipro	45.9%	46.8%	48.8%	50.4%
HCL Tech.	52.0%	53.5%	41.1%	41.2%
Patni	42.0%	41.4%	42.2%	44.5%
Tech M	60.0%	60.0%	61.0%	62.0%

Utilization%	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Peak Utilization rate achieved during last 2 years
Infosys	69.2%	66.9%	65.2%	64.3%	70.0%
TCS	74.7%	71.8%	69.4%	71.3%	76.0%
Wipro	77.0%	76.6%	75.4%	77.1%	77.1%
HCL Tech.	74.4%	74.5%	74.1%	76.2%	76.2%
Patni	75.0%	73.1%	70.3%	74.4%	75.0%
Tech M	69.0%	67.0%	70.0%	71.0%	73.0%

Source: Company data, Nomura research

Control in hiring

IT services companies have kept hiring under strict check and have brought them in line with the demand outlook. As a result, net adds have, for the first time, entered negative territory. Most companies have stayed away from campuses this year, as they have yet to absorb graduates given with offer letters last year. While companies have maintained that they would honour the offers given earlier, the induction of fresh graduates would happen in a staggered manner with the majority set to join towards the latter half of CY10 as indicated by management.

Exhibit 20: Employee Net adds and Total Head Count across companies

Net adds	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	5,927	2,772	1,772	-945
TCS	5,302	8,733	959	-2,119
Wipro	1,877	-587	845	711
HCL Tech.	1,973	304	-992	190
Patni	1,388	-328	245	-367
Tech M	766	294	-457	510

Note: Wipro numbers are for IT services division; TCS for Q4FY09 excludes CGSL acquisition; HCL numbers for Q3FY09 excludes Axon acquisition

Total HC	Q2FY09	Q3FY09	Q4FY09	Q1FY10
Infosys	100,306	103,078	104,850	103,905
TCS	121,610	130,343	143,761	141,642
Wipro	97,552	96,965	97,810	98,521
HCL Tech.	52,714	55,018	54,026	54,216
Patni	16,540	16,212	16,457	16,090
Tech M	25,135	25,429	24,972	25,482

Note: Wipro numbers are for IT services division

Source: Company data, Nomura research

VALUATION METHODOLOGIES AND RISKS

WIPRO:

Valuation Methodology: Our 12-month price target of INR625 is derived using a sum-of-the-parts valuation for its various businesses. This includes INR593 for the global IT services segment, and the rest from its other businesses (INR6 for IT product, INR26 for consumer products and INR0 for others). We assume a cost of equity of 11% and a terminal growth rate of 5% after FY20F.
Risks Which May Impede the Achievement of the Price Target: There are two risks to our target price 1) greater-than-expected appreciation of the rupee against the US dollar and 2) a double dip recession in the global economy.

INFOSYS:

Valuation Methodology: Our 12-month price target of INR2,271 is based on a DCF calculation, assuming a terminal growth rate of 5% and a 11% cost of equity in rupee terms for Indian software companies.
Risks Which May Impede the Achievement of the Price Target: There are two risks to our target price 1) greater-than-expected appreciation of the rupee against the US dollar and 2) a double dip recession in the global economy.

HCL:

Valuation Methodology: Our DCF based price target is INR 389 and is calculated using 11% discount rate and terminal growth rate assumption of 5%. The target price of INR 389 also translates into a 14X one-year forward P/E which is a 30% discount to the target price P/E multiple for Infosys.
Risks Which May Impede the Achievement of the Price Target: There are two risks to our target price 1) Lower revenue ramp up from the order book 2) greater-than-expected appreciation of the rupee against the US dollar.

PATNI:

Valuation Methodology: Our price target of INR 518 is based on a 12X one-year forward P/E, which is also at a 40% discount to our one-year forward P/E multiple for Infosys' price target.
Risks Which May Impede the Achievement of the Price Target: High geographical and client concentration, and possibility of a large-scale value destructive acquisition.

TCS :

Valuation Methodology: Our 12-month price target of INR 640 is based on a DCF calculation assuming a terminal growth rate of 5%, and 11% cost of capital in rupee terms for Indian software companies.
Risks Which May Impede the Achievement of the Price Target: There are two risks to our target price 1) greater-than-expected appreciation of the rupee against the US dollar and 2) a double dip recession in the global economy.

TECH MAHINDRA

Valuation Methodology: Our 12-month price target is INR1,139 is based on 13x one-year forward P/E, a 33% discount to our target one-year forward P/E for Infosys and in line with the historical average discount between the multiples of two companies.
Risks Which May Impede the Achievement of the Price Target: The three key investment risks to our price target are: 1) greater-than-expected appreciation of the rupee against the US dollar, 2) lower ramp-up in BTGS and other large deals and 3) restated financials of Satyam leading to lower revenue and margin figures than we have assumed.

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We, Harmendra Gandhi and Pinku Pappan, hereby certify (1) that the views expressed in this Industry Note accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Industry Note and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Industry Note.

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Mentioned Company	Ticker	Price	Price Date	Stock / Sector Rating
HCL Technologies	HCLT.NS	INR 308.30	08 Sep 2009	Buy / Neutral
Infosys Technologies	INFY.NS	INR 2200.05	08 Sep 2009	Neutral / Neutral
Patni Computer Systems Ltd.	PTNIb.BO	INR 414.60	08 Sep 2009	Buy / Neutral
Tata Consultancy Services	TCS.NS	INR 553.80	08 Sep 2009	Buy / Neutral
Tech Mahindra	TEML.NS	INR 956.60	08 Sep 2009	Buy / Neutral
Wipro	WIPR.NS	INR 551.90	08 Sep 2009	Neutral / Neutral

All share prices mentioned are closing prices unless otherwise stated.

Rating and target price changes

	Rating		Target Price	
	Old	**New**	**Old**	**New**
HCLT.NS	Neutral	Buy	INR 187.00	INR 389.00
INFY.NS	Reduce	Neutral	INR 1598.00	INR 2271.00
PTNIb.BO	Buy	Buy	INR 163.00	INR 518.00
TCS.NS	Reduce	Buy	INR 383.00	INR 640.00
TEML.NS	Reduce	Buy	INR 723.00	INR 1139.00
WIPR.NS	Reduce	Neutral	INR 357.00	INR 625.00

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• A rating of "3", or **"Neutral"**, indicates that the analyst expects the stock to either outperform or underperform the Benchmark by less than 5% over the next six months.
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