IT

Edelweiss
Ideas create, values protect

Selectively knocking on value's door

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The recent period has been eventful for IT stocks, albeit largely for the wrong reasons. Our expectation that tier 1 IT stocks will revive following decent Q2FY08 results has been belied given the continuing uncertainty in the US. As we have pointed out before, growing troubles in the US are impacting Indian IT stocks in two ways: (a) a weakening US economy is likely to result in a weakening dollar; and (b) concerns that outsourcing may be affected, at least temporarily.

We believe that current stock prices are pricing in a slowdown, the recent brief rally notwithstanding.

Each day seems to bring new valuation milestones that premier tech companies will not be proud of, for example, we commented over a month ago that Infosys's valuations are below that of the Sensex (from a rolling 12-month P/E basis; its average premium to the Sensex over the past three years has been about 70%). Another data point—Infosys's valuations are pushing seven-year lows since the 2001 slowdown. Also, the company's **trailing** P/E (latest quarter Q2FY08 annualized) is virtually the same as Sensex's rolling 12-month forward P/E (~20.5x).

In the backdrop of plunging valuations, we believe that it is opportune to weigh in on whether the reasonableness of valuations of these companies itself could be the trigger for buying? In other words, is the conservative investor—the value investor—likely to be interested at these levels?

If we capitalize Infosys's FY09E EPS at the cost of equity (13%), we see that this accounts for close to 46-47% of the current market capitalization. Add cash and we have the "no growth beyond FY09" scenario accounting for well over 50% of market capitalization; ditto for Tata Consultancy Services (TCS).

In other words, our conclusion is that, currently, select IT stocks are not far from the ***"value"*** zone that would attract strong value investing. Our value analysis shows that frontline Indian IT stocks, Infosys and TCS, are about 10-15% from their current levels for them to breach the ***"value"*** zone and appear truly compelling as value picks. In other words, this logically should represent the maximum downside whereupon valuations themselves act as powerful catalysts or trigger points.

In this report, we explore this ***"value"*** theme further by asking ten valuation- and earnings-related questions and answering them.

Conclusion of our analysis. Though there could be some tactical buying stemming the downside, we caution that worthwhile appreciation from these levels may not come in the near term. EPS CAGR over FY07-10E of about 16-18% for mainline IT stocks is unlikely to satisfy growth investors for them to accord these companies "growth" multiples, the type of investing that seems to dominate the sentiment of the Indian market today. Cognizant's outlook in January 2008 (the first such event in our list of relevant company schedules) may well set the tone. Having said that, we believe that among the top tiers, Infosys and TCS should give the investors returns of 25% from a 9-12 month perspective from current levels, a long enough period for principal ramifications of the US to manifest themselves. We remain more positive on TCS and Infosys among top tier players for they possess the resilience and flexibility in their business models to manage a slowdown and margins better than the others (Wipro, Satyam, and HCLT). We continue to be cautious on Wipro, given its telecom exposure (a third of revenues), risky margin profile; and on Satyam, on account of its slackening margin management.

Questions

1. *As we head into CY08, how have stocks historically performed in the first half of the calendar year?*
2. *What are the perpetual (no abnormal) growth scenarios and corresponding valuations?*
3. *What are the current embedded growth expectations as a percentage of market cap?*
4. *How do current expectations of growth or the lack of it compare with steady-state sectors?*
5. *Will cash flows be a metric that investors would start to focus on in technology companies? If so, how do tier 1 companies fare on this front?*
6. *How long could the slowdown impact earnings of top tiers in FY09E from our base-case?*
7. *Does a slowdown impact the intrinsic value of a company?*
8. *How do we rank different companies on ten parameters that measure their ability to manage the risks to earnings in FY09E?*
9. *Can stocks outperform from current levels and what would be the trigger points we should watch out for?*
10. *Finally, what would we play in the sector among tier 1 names, and why?*

* We present below the answers to the above questions:

1. *As we head into CY08, how have stocks historically performed in the first half of the calendar year?*

We examined the returns of five IT companies over 2001-07 (Infosys, TCS, Satyam, Wipro, and TCS) in absolute terms and relative to the Sensex in the first half of the calendar year (January-June) and in the second half (July-December). With very few exceptions, as is evident in charts 1-4, that the first half of the calendar year tends to be weak and the second half much stronger for frontline Indian IT stocks.

For example, the Infosys stock has delivered negative stock returns in all the past six years (2001-06) in the first half (both in absolute terms and relative to the Sensex), but bounced back vigorously in the course of the year, delivering strong positive returns in the second half without exception in all six years. In terms of returns relative to the Sensex, Infosys has under-performed the Sensex four times in the past six years in the first half, while outperforming it five times in the second half. Wipro has delivered negative returns in the first half (Jan-June) for four of the last six years (both in absolute terms and relative to the Sensex) while strongly bouncing back in the second half in all the six years (2001-2006).

When we investigate the returns of the other companies (namely HCLT and Satyam excluding TCS, for which we do not have a long enough listing history), the conclusion remains much the same, with few exceptions. The consistency of this pattern (of a weak first half followed by a strong second-half) is so striking that we study the reasons behind it (see charts 1-4).

Chart 1: (a) Absolute stock returns of Infosys (%)

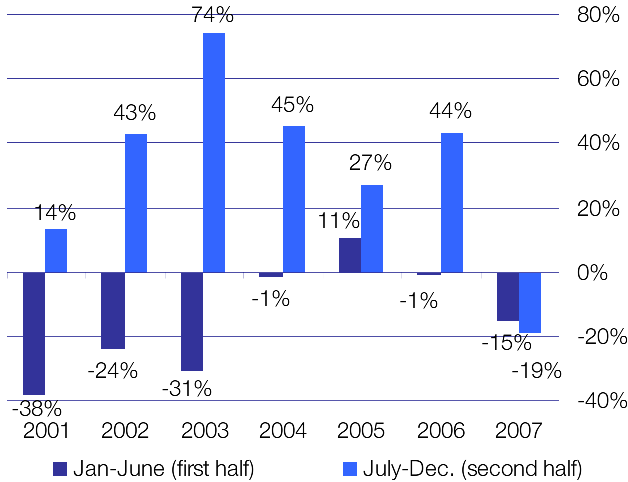


Chart1: (b) Stock returns of Infosys relative to Sensex (%)

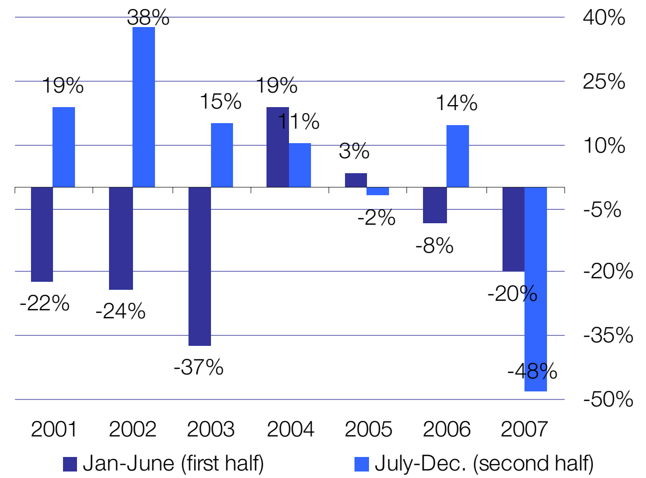


Chart 2: (a) Absolute stock returns of Wipro (%)

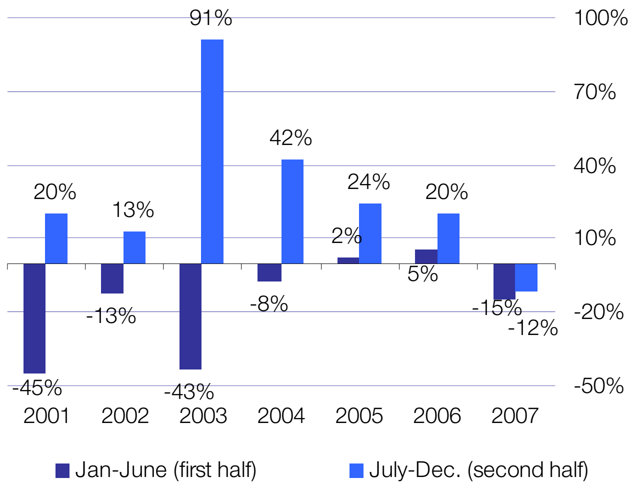


Chart 2: (b) Stock returns of Wipro relative to Sensex (%)

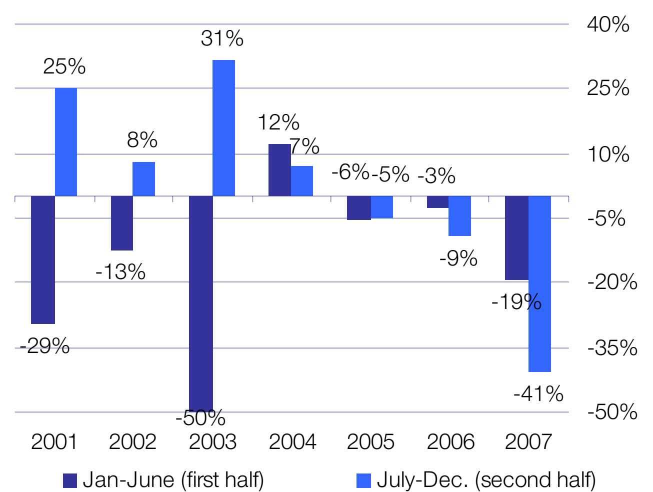


Chart 3: (a) Absolute stock returns of Satyam (%)

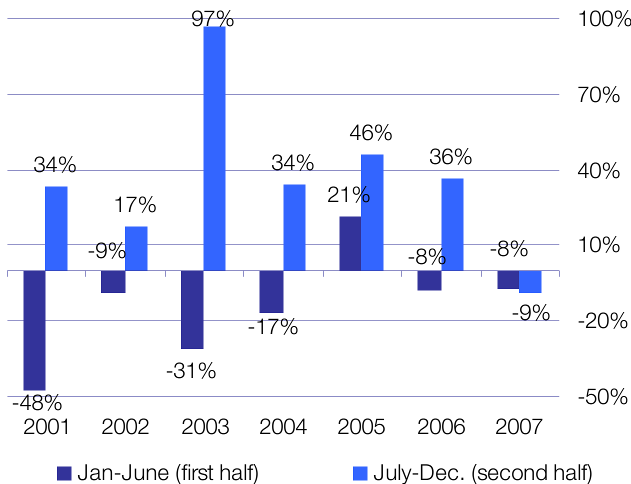


Chart 3: (b) Stock returns of Satyam relative to Sensex (%)

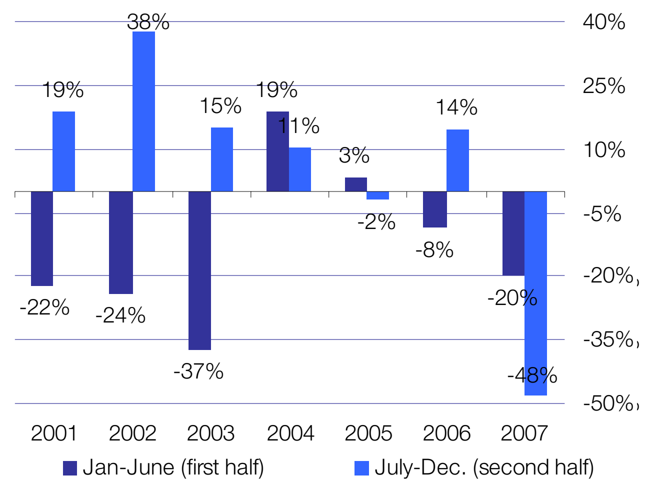


Chart 4: (a) Absolute stock returns of HCLT (%)

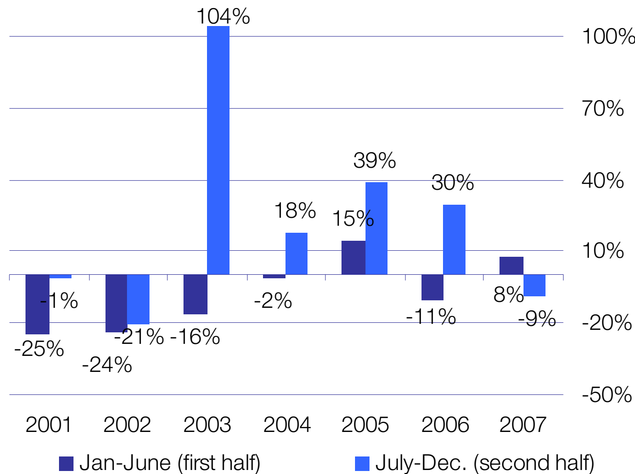
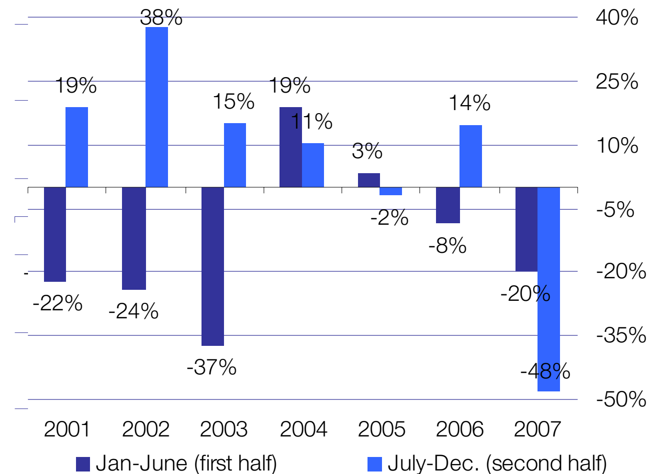


Chart 4: (b) Stock returns of HCLT relative to Sensex (%)



Our finding is that, historically, the magnitude of the financial outperformance of top tier companies relative to expectations (and/or guidance) becomes clear in the course of Q2 and Q3 of the financial year. In addition, in the past there were few other sectors in the Indian economy which grew at historical rates as Indian top tier IT companies, which could capably demonstrate a back-ended earnings trajectory like IT companies and exhibit a comparable strength of the quarterly earnings momentum.

In the backdrop of a historically weak stock performance of IT stocks in the first half of the year and the troubles in the US this time around, it seems that currently we do not have much cause for optimism from a three-six month perspective. There is one difference today though: valuations of frontline stocks are so beaten down that any moderately good news on the US economy and/or INR-USD fronts can only be good news for the stocks.

2. *What are the perpetual (no abnormal) growth scenarios and corresponding valuations?*

Our perpetually sustaining long-term growth rate (ex-growth) (g) is derived as follows:

Long-term growth (g) = (1) + (2) - (3) + (4) where:

(1) = sustainable real growth of the global services market in accordance with trend and forecasts of Gartner (assumed 4% in USD terms).

(2) = sustainable market share gain of the Indian vendor in the global IT services market (assumed 1.5% for Infosys and TCS; 1% for Satyam, Wipro, and HCLT).

(3) = steady-state annual INR appreciation against the USD (taken as 2.5%).

(4) = steady-state inflation in India (taken as 3.5%).

On this basis, we arrive at steady-state, perpetual (g) for Infosys and TCS of 6.5% and 6% for Wipro, Satyam and HCLT.

Using the fundamental equation that links perpetuity growth for a company (without debt) to P/E multiples (P/E = 1- growth/return on capital)/(cost of capital – growth), we arrive at the ex-growth, nominal multiples (see table 1). We see that in our set of companies, TCS is closest to its perpetual growth P/E, though the current multiple is still at a meaningful premium (34%) to it.

Table 1: Steady-state perpetual growth (no extraordinary growth) multiples of front-line Indian IT companies

	Cost of capital	Steady-state growth (g)	Steady state ROCE (%)	Steady-state, perpetual growth forward P-E	Current P-E (09E)	Premium to steady-state P-E
TCS	13.0%	6.5%	35%	12.5	16.8	34%
Infosys	13.0%	6.5%	30%	12.1	16.6	38%
Wipro	13.0%	6.0%	25%	10.9	16.3	50%
Satyam	13.5%	6.0%	23%	9.8	13.7	40%
HCLT	13.5%	6.0%	20%	9.3	12.9	39%

Source: Edelweiss research

3. *What are the current embedded growth expectations as a percentage of market cap?*

To answer this, we disaggregate the current market cap of our companies into three easily understood parts:

Current performance or zero-growth value: Capitalizing expected FY09 earnings at the cost of equity gives us the no growth value (in other words, value derived by extrapolating next year's earnings to perpetuity assuming zero growth). Intuitively, this is the value of simply maintaining the investments that the company has already made. Apart from a zero-growth value, it could also be interpreted as zero-value growth (in other words, growth for which ROCE equals the cost of capital and hence, useless growth).

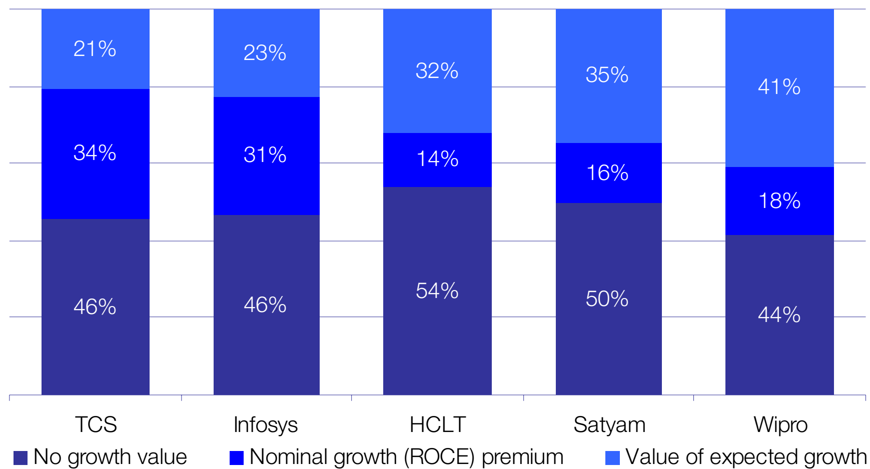
Nominal growth (return) premium: Nominal growth premium is the portion of the value that accrues to the firm by growing its cash flows at perpetual ex-growth rate only (about 6%). We may also interpret this as value the company delivers by earning superior returns on its growth capital in a nominal growth scenario. Hence, this could also be termed as the return premium. This does not assume any phase of abnormal or above long-term growth.

Value from growth: This value represents how much a company delivers by growing over and above the perpetual/steady-state growth. It can be calculated as that portion of growth of the company's current market value that is not captured in current performance or the nominal growth phase.

Chart 5 shows what portion of current market cap accrues from growth for our set of companies. In our set of companies, above nominal growth is least for TCS—at a modest 20%—while that for Infosys is slightly higher at 23%, though it is still over a third for Wipro, HCLT, and Satyam. For Wipro, it is interesting that the future growth value of 41% (as proportion of current market cap) is almost double that of TCS.

In other words, we see that stock prices at about a further 20% decline/downside (for TCS and Infosys), completely imply that future growth is perpetual and steady-state only. Add to this, the FY07-10E earnings CAGR of 15% and returns on capital in excess of 30%, it seems that TCS and Infosys are emerging as compelling value plays.

Chart 5: Just over 20% of the current market cap is attributed to growth for TCS and Infosys



Source: Edelweiss research

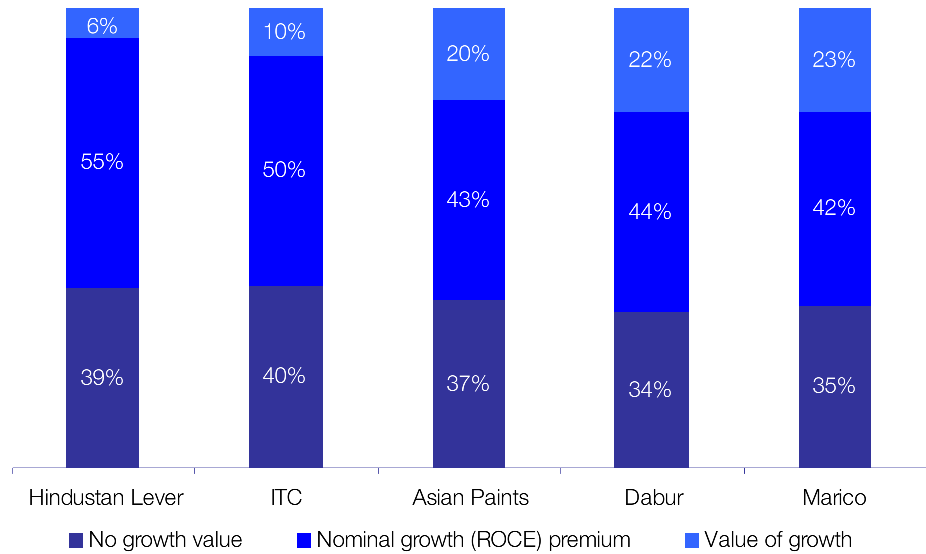
4. *How do current expectations of growth or the lack of it compare with steady-state sectors?*

   Clearly, investors are willing to pay less for growth in the case of Infosys and TCS. How less is less?

   We believe that this question is best answered by seeking out and studying expectations in other perceived defensive and comparable sectors and placing the current no-growth scenarios in Indian IT in this context. Since India is a growth market, scouring the capital market landscape for decisive value stories is relatively hard. Even so, some indicators of value that we could look at include 52-week lows, sustainable PEG below 1, attractive dividend yields, moderate-to-high ROCEs, but moderate price-to-book, earnings growth (FY09 over FY08) in the late teens or low twenties percentage range. In our view, the FMCG sector is appropriate to compare with to appreciate how IT is viewed in growth/ex-growth terms.

   As our chart 6 shows, FMCG stocks, with the exception of HLL and ITC, currently seem to impound the same growth expectations as Infosys and TCS. Notably, our (Edelweiss) earnings growth estimate in FY09E (over FY08E) lies in the 17-23% band for the FMCG sector.

Chart 6: Understanding the growth expectations embedded in current market cap of select FMCG companies



Source: Edelweiss research

5. *Will cash flows be a metric that investors would start to focus on in technology companies? If so, how do tier 1 companies fare on this front?*

Traditionally, investors have preferred not to look at cash flows of technology companies and have focused on earnings and earnings growth in pricing them. If the sector is perceived to have lost its “growth” luster, then cash flows become relevant. It is relatively easy to miss the fact that tier 1 Indian IT companies have a decent cash generating capacity (see chart 7). Historically, Wipro and TCS have had better cash flow generating capacities than Infosys (as % of revenues).

But chart 7 is more significant for another reason: the cash flow generating capacity has deteriorated in recent times with only Infosys as the shining exception, actually improving its performance on this score. Infosys is by far the supreme performer in YTD FY08. Notably, the deterioration has been sharp for Satyam and Wipro.

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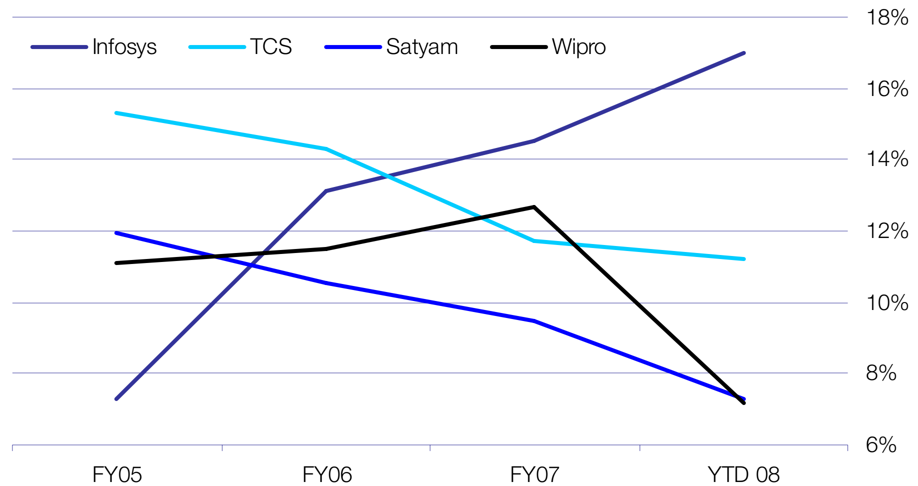
Chart 7: Infosys's cash flow generating capacity is improving over time, while that of others is deteriorating (as % of revenues)*



Source: Edelweiss research
**does not take acquisition capex into account while accounting for free-cash*

How well does Infosys manage its cash flows? At cash flows close to 17% of revenues in YTD FY08, Infosys is clearly ahead of the pack. What is notable is that in YTD FY08, the company's cash flow is greater than that of TCS (by 10%) despite the latter being about 38% larger by revenues.

Growth in cash flows can outstrip growth in earnings. Our finding that Infosys's cash flows grew sustainably ahead of earnings growth over FY05-07 and also in H1FY08 (over H1FY07) is a useful pointer to the possibility that select companies can demonstrate stronger cash flow growth than earnings growth going forward (see Table 2).

Table 2: Only Infosys has sustainably grown its cash flows ahead of its earnings over FY05-Q208

	Infosys	TCS	Wipro	Satyam	HCLT
PAT CAGR (FY05-07) (%)	44.6	41.9	35.7	40.5	44.7
Cash-flow CAGR (FY05-07) (%)	97.2	15.8	44.8	20.8	24.0
YTD PAT growth (FY08 over FY07) (%)	25.8	31.2	16.2	16.8	21.1
YTD cash flow growth (FY08 over FY07) (%)	45.5	35.0	(26.1)	(35.1)	17.0

Source: Edelweiss research

Improved balance sheet management (especially by bettering the receivables and unbilled revenues position) can enable TCS to do the same as well. However, we do not see this possibility with Satyam, HCL Technologies, and Wipro.

The other conclusion is that the variability in cash flow performance is far greater and more dispersed than profit growth with clear leaders and laggards (in other words, a clear and significant spread exists in cash flow performance as opposed to profit performance). Given the evidence of YTD FY08, it will likely be so going forward.

Through better balance sheet management, Infosys can continue to maintain ROCE (ex-cash) above 30% through FY08-10E. For example, we believe there is scope to reduce loans/advances to employees/others in the pursuit of a more efficient balance sheet. Companies that pay attention to ROCE (balance sheet) can make up, to some extent, for slower growth and this fundamentally should reflect in the earnings multiple as well. In other words, firms can increase the component of market value attributable to improved

returns/return (ROCE) premium (labeled part 2 in our market value bar chart). The value investor recognizes capital efficiency and free cash flow generation capacity vis-à-vis the growth investor. By demonstrating the ability to convert more of their profits into free cash flows (i.e., by growing cash flows ahead of earnings), select companies like Infosys and TCS will show up on the value investors' screen.

Based on the price-to-cash flow multiple, Infosys actually emerges as the most reasonable IT stock to own among the top tiers (see table 3 for details).

Table 3: Infosys emerges as the cheapest stock on a price-to-cash flow multiple

	P/E (08)	P/E (09)	P/Cash flow (08)	P/Cash flow (09)
TCS	20.6	17.2	38.8	31.0
Infosys	19.8	16.6	29.7	24.0
Wipro*	20.3	16.3	41.8	33.3
HCLT	15.6	12.9	36.0	28.6
Satyam	16.3	13.7	43.2	35.9

Source: Edelweiss research

6. *How long could the slowdown impact earnings of top tiers in FY09E from our base-case?*

We look at how both pricing and volumes will be potentially affected in the event of a slowdown in Indian IT companies. At the time of the last tech slowdown (e-business and telecom meltdown) during 2001-03, Infosys experienced five successive slow quarters from Q4FY01 of just under 5% sequential revenue growth (in USD) before fortunes revived in Q1FY03; Satyam had a four quarter CAGR of about 4.2%, before growth picked up in Q1FY03; Wipro had four successive slow quarters right through FY02 (same period as Satyam) recording a CQGR of a mere 2% (INR) before growth picked up. Clearly, Infosys and Satyam managed the 2001 slowdown better than Wipro, which bore the brunt of a concentrated telecom exposure.

In our view, today if the slowdown is moderate, then the impact on top tier Indian companies will likely be largely felt on pricing alone. There could two-three quarters of moderation in volumes, but the momentum in outsourcing towards the end of FY09 should mean that our current volume growth of 25-27% in FY09E remains largely intact for Infosys and TCS. If we conservatively assume zero increase in pricing of the entire business flow from the BFS vertical, our overall base-case average pricing increase in FY09E (over FY08) of 2.5%-3% is reduced with attendant impact on FY09E earnings (EPS). Table 4 details our impact analysis for top tier Indian companies with attendant impact on FY09E EPS. We believe that Infosys and TCS are best placed to push for volumes, given the superiority of scale and breadth of execution of their business models. The impact on our earnings for FY09E could be a 3-8% downside to our existing estimates.

Table 4: A slowdown can impact our pricing and volume increase assumptions (in FY09E) differently for different companies

	Price Impact versus our earlier price increase expectations	Nature of impact
TCS	Average pricing increase lower by ~ 50-75 bps	No pricing increase in BFSI
Infosys	Average pricing increase lower by ~1% (100 bps)	No pricing increase in BFSI
Wipro	Average pricing increase lower by ~1%	Some impact from manufacturing/telecom clients
Satyam	Negative pricing impact unlikely	Operates at the lower end of the price chain
HCLT	Average pricing increase lower by ~ 50 bps	Impact from the mid-market strategy

	Volume impact versus our earlier volume growth estimates	Nature of impact	Downside to FY09 EPS
TCS	Overall volume increase likely to be largely intact	Will likely make up for possible BFSI impact	Within 3%
Infosys	Overall volume increase likely to be lower by ~ 3%	BFSI volumes impacted to the extent of 6-8%	~ 3-5%
Wipro	Overall volume increase likely to be lower by ~ 3%	Some impact from manufacturing/telecom clients	~ 5-7%
Satyam	Overall volume increase likely to be lower by 3-5%	Package implementation traction could be affected	~ 6-8%
HCLT	Overall volume increase likely to be lower by 3%	BPO volumes lower than expected	~ 3-5%

Source: Edelweiss research

7. *Does a slowdown impact the intrinsic value of a company?*

   Unlikely, if the slowdown merely affects the pace of growth for one year. If revenue growth rebounds in FY10E on profitable market share gains, the company's intrinsic (or DCF) value is less significantly affected. The fair price for Infosys (as indicated by our DCF model) is impacted by about 3% (fair price of INR 2,200 now becomes about INR 2,140) by moderating our EPS growth estimate in FY09E to 17% from the base case of 20%, assuming growth picks up in 2009. Likewise, that for TCS now becomes about INR 1,226 from the earlier INR 1,280 (including cash).

   In that case, we believe it is only a matter of time before the stock retracks its fundamental (DCF) value. Any downward aberrations from the intrinsic value precipitated by slowdown/recession fears should be seen as an opportunity for value-buying. The market is quick to shun stocks that are temporarily out of favor and easily extrapolates the near-term troubles far out into the future. It may not take into account regression to the mean tendency of earnings. However, if the slowdown affects the company's trajectory over a period of two-three years, then we believe there is likely to be a material downward impact on the DCF.

8. *How do we rank different companies on ten parameters that measure their ability to manage the risks to earnings in FY09E?*

   Our exhaustive table (table 5) rates the top-tier names on ten dimensions. We have assigned relative ratings to each company on each dimension based on a 4-point scale below:

   1 = Least effective
   2 = Somewhat effective
   3 = Effective
   4 = Very effective

Table 5: How do we rank our companies on ten key dimensions?

Risk management parameter	HCL Tech	Infosys	Satyam	TCS	Wipro
Optimal mix of discretionary (high-value) and stable non-discretionary business	3.0	3.0	2.5	3.5	3.0
Ability to hold billing rates in the event of a slowdown	2.5	3.0	3.0	3.5	3.0
Ability to diversify US exposure by aggressive ex-US growth	3.5	3.0	2.5	3.5	2.5
Innovative service delivery models (e.g. non-linear, fixed price)	2.5	3.5	2.0	3.0	2.5
Ability to win large multi-practice deals	2.5	3.5	2.5	4.0	3.0
Ability to manage margins and revenue volatility	3.0	4.0	2.0	3.5	2.5
De-risking the business model by newer services/verticals	3.0	3.5	2.5	3.5	3.5
Ability/Willingness to take big bets (go for the jugular)	2.5	2.0	2.5	3.0	4.0
Ability to make clients count (client-mining)	2.5	4.0	2.5	3.5	3.0
Optimizing (maxmizing) conversion of profits to free cash flow	2.5	4.0	2.5	3.5	2.5
Overall rating (average)	*2.8*	*3.4*	*2.5*	*3.5*	*3.0*

Source: Edelweiss research

9. *Can stocks outperform from current levels and what would be the trigger points we should watch out for?*

Near-term news flow is unlikely to offer a distilled picture of the repercussions of the US economy. However, as clients provisionally firm up budgets for CY08 in December-January, we perceive the following as indictors of how the state of affairs is likely to shape up:

- Commentary from Indian tech companies at the time of their Q3FY08 (October-December 2007) results.
- Cognizant's CY08 outlook in January 2008 may well set the near-term tone. Consensus revenue growth rate (USD) in 2008 over 2007 stands at 35-36%, if the company guides materially below this, Indian IT will likely pick up the negative cues.
- Monitoring for weakness in the tech value chain (see our report, *From Intel to Infosys, Anchoring Indian IT in the global technology chain* dated Oct 26). Thus far, only Cisco has sounded concern on spending from its top US clients, though HP has sounded upbeat. Application software providers (SAP, Oracle), an important constituent of the tech chain, seem buoyant, but their continued vitality and good health are necessary for Indian IT to continue to profit from traction in this space.

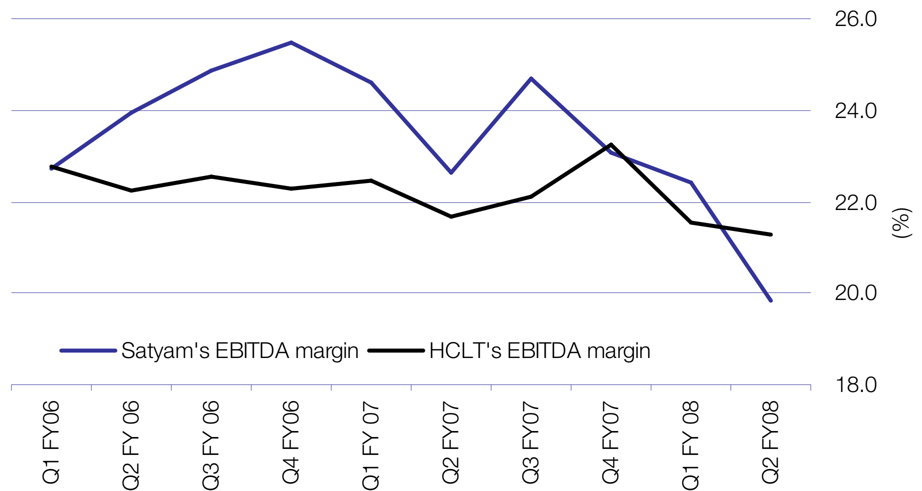
We stress that outperformance will be selective, it will favor stocks that are closer to breaching the "value" zone and will likely play out only on a 9-12 month horizon, a long enough period for principal ramifications of the US to manifest themselves. This horizon also factors in our assumption that leading names can weather a moderate slowdown within two-three quarters.

10. Finally, what would we play in the sector among tier 1 names, and why?

Our preferred top picks, also our conviction buys, continue to be TCS and Infosys. We believe these companies are best placed to minimize negative surprises, as they have the ability to minimize revenue volatility and walk the balance between growth and margins better than others in an uncertain environment. Current valuations are reasonable and undemanding as proved through our value analysis. In addition, their commonly glossed over ability to grow cash flows ahead of the pack and convert a greater proportion of profits in to cash flows make us prefer these companies to HCLT and Satyam, which remain our "risk" picks. We believe that among the top tiers, Infosys and TCS should give the investors returns of 25% from a 9-12 month perspective from current levels, a long enough period for principal ramifications of the US to manifest themselves.

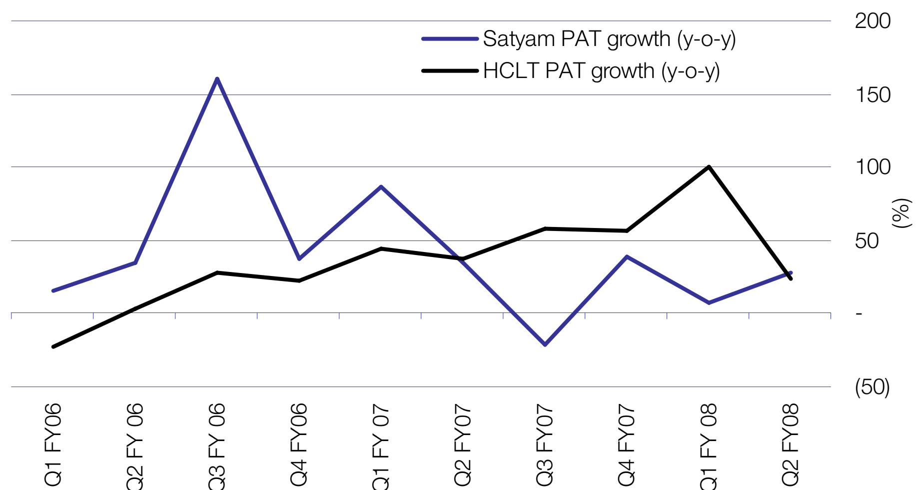
We continue to prefer HCLT to Satyam, the latter's recent rally notwithstanding, given HCLT's better track record of managing margins (see charts 8 and 9).

Chart 8: Satyam's EBITDA margin has been more volatile than that of HCLT



Source: Edelweiss research

Chart 9: Satyam's Y-o-Y PAT growth has been more volatile and in decline than that of HCLT



Source: Edelweiss research

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

Geometric, HCL Tech, Hexaware, i-flex, i-Gate, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, and Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
29-Nov-07	Moser Baer	PV is the long term bet; *Visit Note*	252	Buy.
21-Nov-07	IT Fact sheet	*Routine Update*		
19-Nov-07	Nucleus Software Exports	Attractive valuations; *Result Update*	275	Buy
2-Nov-07	IT	Five themes gaining currency and one notable miss; *Sector Update*		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	103	47	22	3	190

* 13 stocks under review / 2 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	96	65	29

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

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