Emkay Research

IT Services

Sector Update

Waiting to hear; Time to tone down optimism???

6th April 2009

Expect sobering commentary cutting across vendors

For Infy: June'09 quarter guidance more critical than annual FY10 guidance. A more back ended annual revenue growth outlook will raise doubts unlike FY09.

Watch for Infy's views on (1)'Volumes V/s margins', (2) business pick up from telecom vertical, (3) more aggressive pricing strategies (some vendors using Balance Sheets to fund client projects and (4) more localized hiring to counter the protectionist measures and increased investments in sales

Retain Infosys as preferred pick in the large cap IT services space apart from Mphasis (BUY, TP Rs 240) and Tech M(BUY, TP Rs 304) . However significant stock appreciation (27% over 3 months) leaves risk reward unfavorable.

Ratings

Company Name	Rating	CMP	Target Price
Infosys	HOLD	1420	1330
TCS	HOLD	579	590
Wipro	REDUCE	270	220
HCL Tech	HOLD	107	139
Tech M	BUY	281	303

Price Performance

(%)	1M	3M	6M	12M
Infosys				
Absolute	19	27	(2)	(3)
Rel. to Sensex	(3)	18	23	47
TCS				
Absolute	30	21	(14)	(32)
Rel. to Sensex	6	13	9	3
Wipro				
Absolute	35	16	(23)	(35)
Rel. to Sensex	10	8	(2)	(1)
HCLT				
Absolute	13	(7)	(48)	(57)
Rel. to Sensex	(8)	(14)	(35)	(34)
Tech Mahindra				
Absolute	15	13	(56)	(61)
Rel. to Sensex	(6)	6	(44)	(41)

Manik Taneja
manik.taneja@emkayshare.com
+91 22 6612 1253

Sweta Sinha
sweta.sinha@emkayshare.com
+91 22 6612 1282

Expect sobering commentary cutting across vendors

Infosys's results and annual guidance on April 15'09 remain keenly awaited by investors given the demand flux for the sector. Given sharp project deferrals/cancellations and slower ramp ups across all offshore vendors becoming the norm, demand recovery still remains a 'wait and watch situation. We expect sobering commentary from the Indian tech vendors as they continue to await better clarity on client spending plans. Though we believe that the sales pipeline for offshore IT vendors has seen an increase, confidence on actual deal closures and subsequent ramp ups would remain the key to volume/revenue pickup for the IT services space. We highlight that during the quarter gone our channel checks have indicated of projects teams being pruned aggressively cutting across vendors at a number of financial services client accounts. Our channel indicate greater pressures for TCS and Wipro in our large cap IT coverage as compared to Infosys (though do not rule out that Infy might have also faced similar pressures)

June'09 guidance more critical than annual FY10 guidance

In our view, Infy's annual commentary could remain subdued (as has been the case over the quarter passed out with Infy acknowledging of pricing pressures between 5-15%). We believe that Infy management would play it conservative and ***expect an annual US$ revenue growth between -5%-+3%***, even if Infy were comfortable with a higher growth target. Also worth noting is that cross currency movements alone would impact US$ revenue growth by ~4%.We are of the view that although annual guidance retains importance, it ***is imperative to watch June'09 quarter guidance rather than the annual revenue guidance*** as a back ended revenue growth would inspire little confidence about growth prospects (unlike April'08 when Infy's June'08 quarter revenue guidance was flat and the 19-21% YoY increase guided for FY09 had to be reduced later). With currency lending a helping hand we **expect an annual EPS guidance of ~Rs 100 for Infosys at the least.** ***(see working below)***

Key things to watch out for

We believe that investors need to watch Indian tech vendors' comments on
(1) budget finalizations at key clients ,
(2) Results of vendor consolidation exercises at financial services clients,
(3) Pricing trends,
(4) More aggressive pricing strategies (some global players and an offshore player using aggressive pricing strategies, some vendors using their Balance Sheets to fund client spends) and
(5) Expectations from the protectionist measures being undertaken in US and Europe

We remain 'HOLD' on the sector post sector downgrade in early May'08 however Infosys remains our preferred pick in the large cap IT services universe apart from BUY rated Mphasis (TP Rs 240) and Tech Mahindra (TP Rs 303).

Expect sobering commentary

We expect sobering commentary from the Indian tech vendors as they still grapple with limited visibility into client's IT spends (we note that even in cases where client spending budgets have been finalized, spending decisions are being reworked at the end of every month) and significant project cuts during March'08 quarter. Our channel/industry checks have already indicated of sudden ongoing project cancellations/ non renewals of existing projects at almost all offshore services vendors. (Though note our channel checks indicate of far greater hit for TCS and Wipro as compared with Infy, though do not rule out that Infy might have also suffered from the near stall). During the quarter, Infy and Wipro management's sounded cautious about the demand outlook with Infy indicating of pricing pressures

In our view, although offshore tech vendors indicate that deal discussions have progressed much better in the March month as compared with the months of January and February the near term visibility on volumes for them remains low as clients tend to hold on to their spending amidst the weak macro environment. We note that even where annual spending budgets have got finalized, clients are looking at spend on a month to month basis which limits the volume pickup visibility for Indian offshore vendors. We however take comfort in the fact that in a couple of vendor consolidation exercises at large clients, offshore vendors seem to have gained. ***(e.g More recently at Telstra, Infosys and HP-EDS-Mphasis emerged winners from the vendor consolidation phase as they booted out IBM and Satyam, media reports talk of incremental business worth ~US$ 80-100 mn p.a flowing to Infosys from the exercise).***

We believe that the key to volume/demand recovery is not the macro recovery (with some investors calling Indian IT cyclical and linked to US GDP growth, as we are of the view that maintain that outsourcing remains counter cyclical and the macro reality will only drive more demand for outsourcing) but more alignment to the new macro realities whereby clients will look for more cost savings (in order to remain competitive) and thus should drive growth for offshore IT (though difficult to point out the exact time frame for demand/volume pick up as of now)

What to expect from Infy?

We expect cautious comments on pricing from Infosys (we note that in the middle of March'09 quarter, Infy management indicated pricing pressures of ~5-15% from different clients V/s only ~5% earlier), however do not share the same amount of pessisimism as the street on pricing front as we expect co wide portfolio pricing pressures to be limited to ~5% as tech vendors settle for price cuts against increased volumes (which will lead to lower SG& A expenses). Further we would watch out for Infy management's views on the following issues

(1) 'Volume growth V/s margins' : Debate around the subject would gather more importance as pressure on volumes increases ***(as clients bargain hard for price cuts against volumes as well as aggressive vendor competitive activity with some MNC vendors using Balance Sheet Strength to fund client projects)***,

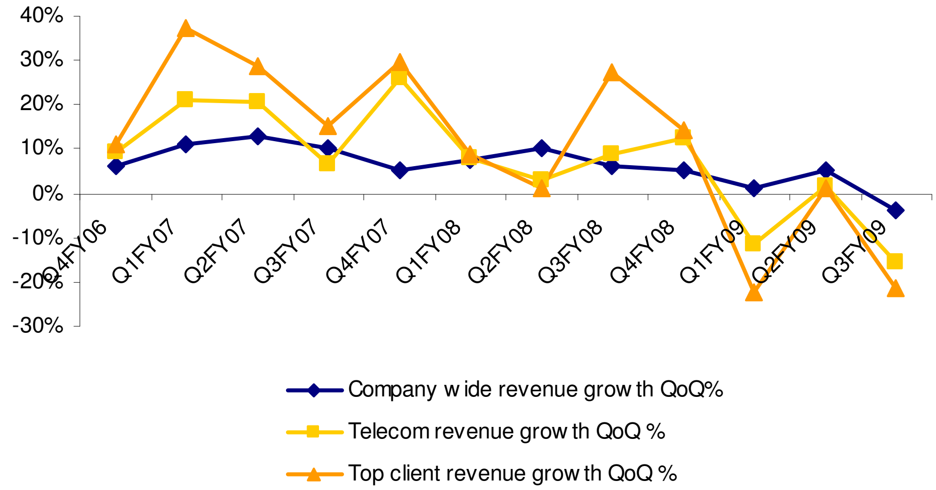
(2) spending trends in the telecom vertical ***(business from the vertical has been under stress after a splendid run pre FY08, though the unconfirmed vendor consolidation win at Telstra would help reduce pressure from ramp down pressures at the top client)*** and

(3) Comments on more investment in sales (more local hiring might be needed to combat the anti -off shoring brigade in both US and Europe). ***(note that SG&A expenses ex Wages have decreased by ~250 bps from Q1FY06 onwards and given the macro weakness at key clients more investments in S& M might be warranted)***

Performance from the telecom vertical has been subdued during FY09 (partly on account of weaker GBP/Euro

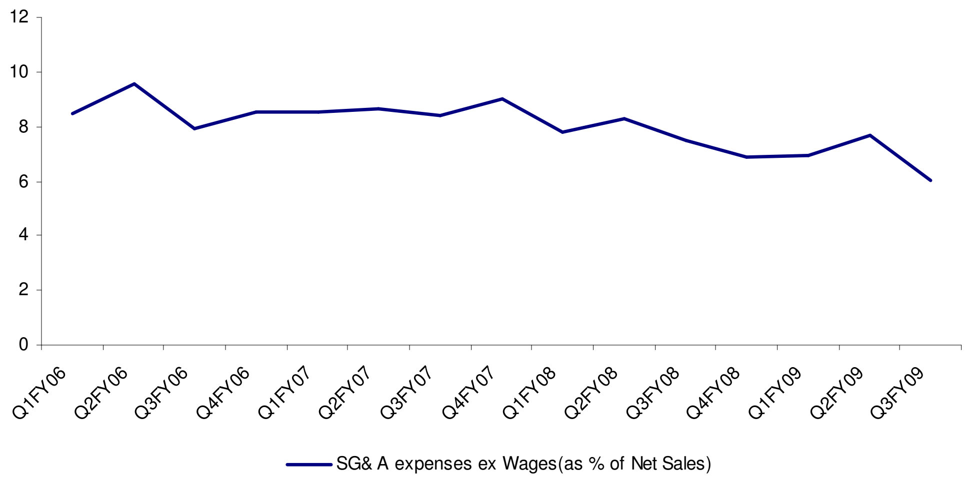
(in US$ mn, except %)	FY06	FY07	FY08	9MFY09
Co wide revenues addition	559	938	1087	508
Telecom revenues addition	59	243	303	11
% of overall revenue addition	***10.6***	***25.9***	***27.9***	***2.1***
BFSI revenues addition	225	381	339	106
% of Co wide revenue addition	***40.2***	***40.6***	***31.2***	***20.9***
Manufacturing revenues addition	69	118	197	260
% of Co wide revenue addition	***12.3***	***12.5***	***18.2***	***51.1***
Retail revenues added	63.3	91.8	183.4	77.6
% of Co wide revenue addition	***11.3***	***9.8***	***16.9***	***15.3***

Source: Company, Emkay Research



Source: Company, Emkay Research

There might be limited room to cut SG&A expenses further. SG&A expenses (ex wages) are down ~250 bps from Q1FY06 levels.



Source: Company, Emkay Research

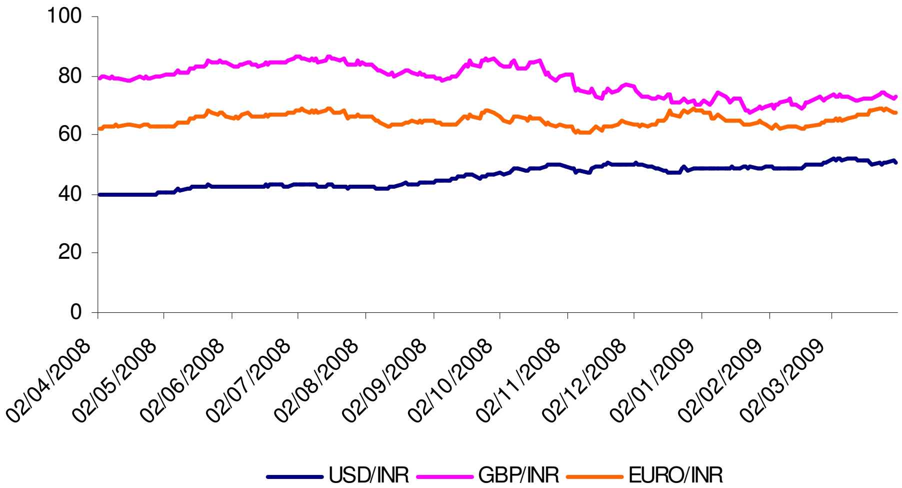
June'09 quarter guidance more critical than annual FY10 guidance

As April 15'09 approaches, investors remain focused on what could Infy guide in the backdrop of a weak macro. In our opinion driven by uncertainty on client's spend it would be prudent to expect Infosys to guide conservatively. We expect Infosys to guide for a wider annual revenue growth guidance of ~-5%-+3% (a wider range as compared to historical precedent) driven my macro uncertainty. We point out that the adverse impact of cross currency movements on US$ revenue growth alone is ~400 bps. We expect Infosys to also build in further pricing pressure into its guidance (usual practice is to assume flat pricing as the last quarter, which might be an aggressive assumptions at this juncture) and thus expect Infosys to guide for margin drop of ~150-200 bps in it's outlook. However we expect Infosys to very easily guide for an EPS of ~Rs 100 or more, aided by weak INR (please refer our working below)

	FY09	FY10(@Rs 50.7/$)		
% change over FY09		*-5*	*0*	*5*
Revenues(in US$ mn)	4690.5	4456	4690	4925
Revenues(in Rs mn)	217989	225917	237807	249698
EBITDA	72574	70034	73720	77406
Op mgns(%)	*33.3*	*31*	*31*	*31*
Net profits(in Rs mn)	60141	57839	60862	63884
EPS(in Rs)	105	100.8	106.0	111.3

Source: Company, Emkay Research

Currency Movements Vis-à-vis US$	GBP	Euro	Aus $
FY10 Guidance V/s FY09 Guidance	**-17**	**-7**	**-14**



Source: Emkay Research

INFOSYS TECHNOLOGIES (HOLD, TP 1330)

Q4FY09 Result expectations

We expect Infosys to report revenues of US$ 1,148 mn, (-2% QoQ, INR term revenues seen down by ~0.8% QoQ, +27.4% YoY) above the lower end of US$ revenue guidance of US$ 1,128-1,170 mn. Operating margins are estimated to be down ~110 bps sequentially to 34% driven by pricing pressures, higher SG&A spend and marginal decline in utilization levels. We expect net profits at Rs 16,371 mn (-0.2% QoQ, 31.4% YoY).

In Rs mn	Q4FY09E	Q3FY09	QoQ (%)	Q4FY08	YoY (%)
Net sales	**57409**	**57860**	**-0.8%**	**45420**	**27.4%**
Operating expenses	37875	37550		30640	
EBITDA	**19,534**	**20,310**	**-3.8%**	**14,780**	**37.4%**
Margins (%)	*34.0*	*35.1*		*32.5*	
Depreciation	1942	1870		1570	
EBIT	**17,592**	**18,440**	**-4.6%**	**13,210**	**39.6%**
Margins (%)	*30.6*	*31.9*		*29.1*	
Interest received	2200	2290		1780	
Other income	-303	-1910		-390	
Pre-tax profit	19,489	18,820		14,600	
Tax provided	3118	2410		2110	
Profit after tax	16,371	16,410		12,490	
Emkay Net profit	**16371**	**16410**	**-0.2%**	**12490**	**31.4%**
EPS, Rs	28.5	28.6		21.8	

Key things to watch out for

(1) Management comments on pricing pressures across different industries.

(2) Guidance for Q1FY10E along with FY10E as in our view a back ended revenue guidance will inspire little confidence unlike early FY09 as macro weakness might weigh down on a back ended prognosis ***(for detailed working on possible revenues and earnings guidance expectations refer section above)***

(3) Comments on 'Volume growth V/s margins' as pressure on volume increases

(4) Spending trends in the telecom vertical

(5) Comments on more investments in sales ((more local hiring might be needed to combat the protectionist measures being adopted in both US and Europe)

TATA CONSULTANCY SERVICES (HOLD, TP 590)

Q4FY09 Result expectations

We expect TCS to report muted performance with revenues at US$ 1,486 mn, +0.2% QoQ (INR term revenues seen up by 2.1% QoQ, 22.8% YoY) aided only by contribution from the CITOS acquisition. (Organic revenues are expected to decline by ~4.5% sequentially) Operating margins are expected to be down by 140 bps sequentially to 25.4%, driven by slippage on utilization, pricing pressure and consolidation of Citi BPO despite the benefit of currency depreciation. We estimate net profits at Rs 13,432 mn (-0.7% QoQ, +7% YoY) as we build in forex losses of Rs 2,000 mn V/s Rs 2,510 in Q3FY09.

In Rs mn	Q4FY09E	Q3FY09	QoQ (%)	Q4FY08	YoY (%)
Net sales	**74285**	**72,770**	**2.1%**	**60,469**	**22.8%**
Operating expenses	55421	53,296		45,343	
EBITDA	**18,864**	**19,474**	**-3.1%**	**15,126**	**24.7%**
Margins (%)	*25.39*	*26.76*		*25.0*	
Depreciation	1689	1,454		1,625	
EBIT	**17,175**	**18,020**	**-4.7%**	**13,501**	**27.2%**
Margins (%)	23.1	24.8		22.3	
Other income	-1200	(1,847)		1,179	
Pre-tax profit	15,975	16,173		14,680	
Tax provided	2396	2481		1988	
Profit after tax	13,578	13,692		12,693	
Emkay Net profit	**13,432**	**13,525**	**-0.7%**	**12,559**	**7.0%**
EPS, Rs	13.7	13.8		12.8	

Key things to watch out for

(1) Co's comments on budget spends / results of vendor consolidation exercises at key troubled financial services clients (TCS's exposure to financial services clients is highest amongst peers) would be under close scrutiny as TCS has sounded more optimistic during the quarter unlike the sobering commentary from peers like Infy and Wipro

(2) Clarity on CY09 IT spending plans and pricing pressures from clients as well as ramp ups

(3) Comments on Citigroup's business

(4) Any reduction in the gross hiring targets for FY10E

WIPRO (REDUCE, TP 220)

Q4FY09 Result expectations

We expect Wipro to report US$ revenues of US$ 1,049 mn (-4.7% QoQ), INR revenues of Rs 66,057 mn (+1% QoQ, +18.1% YoY), slightly above the US$ revenue guidance of US$ 1,045 mn helped by contribution from Citi IT acquisition. EBIT margins are expected to decline by 40 bps sequentially to 15.4%, impacted negatively by higher S,G&A expenses during the quarter. We estimate net profits at Rs 8,758 mn (-2.5% QoQ, -0.3% YoY) impacted by forex losses of Rs 471 mn V/s forex gains of Rs 150 mn during Q3FY09.

In Rs mn	Q4FY09E	Q3FY09	QoQ(%)	Q4FY08	YoY (%)
Net sales	**66,057**	**65,387**	**1.0%**	**55,954**	**18.1%**
Total Income	66,057	65,387		55,954	
Operating expenses	55,418	54,707		46,099	
EBITA	**10,639**	**10,680**	**-0.4%**	**9,855**	**8.0%**
Margins (%)	16.1	16.3		17.6	
Amortization	450	362		192	
EBIT	**10,189**	**10,318**	**-1.2%**	**9,663**	**5.4%**
Margins (%)	15.4	15.8		17.3	
Interest Paid	0	0		0	
Other income	(106)	41		235	
Pre-tax profit	10,083	10,359		9,898	
Tax provided	1311	1364		1095	
Profit after tax	8,773	8,995		8,803	
Minority Interest	15	16		16	
Emkay Net profit	**8,758**	**8,979**	**-2.5%**	**8,787**	**-0.3%**
EPS, Rs	6.0	6.2		6.0	

Key things to watch out for

(1) Client additions during the quarter

(2) Financial services demand environment as more pressure is emerging from this vertical

(3) Any cuts in dividend payout (as had been indicated by co earlier during Q3FY09

HCL TECHNOLOGIES (HOLD, TP 139)

Q3FY09 Result expectations

We expect HCL Tech to report US$ revenues of US$ 601 mn (+17.5% QoQ, INR revenues of Rs 28,962 mn, up 16.3% QoQ, 23.9% YoY) helped by consolidation of Axon during the quarter. Operating margins are expected to decline by ~490 bps QoQ to 16.8%, impacted negatively by consolidation of Axon acquisition. We expect net profits at Rs 2,054 mn (-42.1% QoQ, -36% YoY) impacted negatively by interest paid on account of debt raised for Axon acquisition and higher forex losses of Rs 1,275 mn.

In Rs mn	Q3FY09E	Q2FY09	QoQ(%)	Q3FY08	YoY (%)
Net sales	**28,962**	**24,909**	**16.3%**	**19,449**	**48.9%**
Total Income	28,962	24,909		19,449	
Operating expenses	24,086	19,510		15,353	
EBITDA	**4,875**	**5,399**	**-9.7%**	**4,096**	**19.0%**
Margins (%)	16.8	21.7		21.1	
Depreciation	1,365	971		773	
EBIT	**3,511**	**4,428**	**-20.7%**	**3,323**	**5.6%**
Margins (%)	12.1	17.8		17.1	
Interest Paid	-371	0		0	
Other income	(747)	(213)		228	
Pre-tax profit	2,393	4,215		3,551	
Tax provided	311	667		351	
Profit after tax	2,082	3,548		3,200	
Emkay Net profit	**2,054**	**3,548**	**-42.1%**	**3,207**	**-36.0%**
EPS, Rs	3.0	5.2		4.7	

Key things to watch out for

(1) Clarity on spending trends / vendor consolidation exercises at key clients as well as ramp up of large deals

(2) Business environment for Axon's offerings over the next few quarters.

(3) Hedging losses on large forex hedge position.

(4) Cuts in dividend payout driven by investments in the recently concluded large deals announced by the co and macro weakness

TECH MAHINDRA (BUY, TP 303)

Q4FY09 Result expectations

We expect Tech Mahindra to report 3.8% sequential revenue decline to US$ 223 mn (INR term revenues seen down by ~4.5% QoQ, +5.9% YoY) driven by full impact of US$ appreciation V/s GBP/Euro during the quarter. We estimate operating margins to decline by ~470 bps QoQ to 23.4%, impacted negatively by currency fluctuations. We estimate net profits at Rs 2,069 mn (-7.2% QoQ, -5.5% YoY).

In Rs mn	Q4FY09E	Q3FY09	QoQ(%)	Q4FY08	YoY (%)
Net sales	**10817**	**11322**	**-4.5%**	**10218**	**5.9%**
Total Income	10,817	11,322		10,218	
Operating expenses	8283	8142		7994	
EBITDA	**2,534**	**3,180**	**-20.3%**	**2,224**	**13.9%**
Margins (%)	23.4	28.1		21.8	
Depreciation	283	286		229	
EBIT	**2,251**	**2,894**	**-22.2%**	**1,995**	**12.8%**
Margins (%)	20.8	25.6		19.5	
Interest Paid	0	0		5	
Other income	100	-397		364	
Pre-tax profit	2,351	2,497		2,354	
Tax provided	282	269		165	
Profit after tax	2,069	2,228		2,189	
Emkay Net profit	**2,069**	**2,228**	**-7.2%**	**2,188**	**-5.5%**
EPS, Rs	15.8	17.0		16.7	

Key things to watch out for

(1) Spending trends in the top client BT (as our channel checks indicate of delays in finalization of spend at the client)

(2) Ramp up on the BTGS deal as well as progress on transition of work on the ANDES deal (co's initial indication of revenues flowing from the deal in June'09 quarter)

Emkay Global Financial Services Ltd.
Paragon Center, H -13 -16, 1st Floor,
Pandurang Budhkar Marg, Worli, Mumbai – 400 013.
Tel no. 6612 1212. Fax: 6624 2410