

IT SECTOR

Compelling value selectively emerging in midcaps

The table below tracks stock market returns for large-cap versus mid-cap players over the last one month (July 24 – August 24). As against the sensex return of -8.6% (negative 8.6%), the IT-sector has significantly underperformed the sensex returning -11.3% (negative 11.3%). Further, the correction in mid-tier Indian IT has been sharp and in some cases overdone.

<u>Tier 1 returns</u>		<u>Mid-cap returns</u>	
Tata Consultancy Services	(14.2)	Infotech Enterprises	(19.6)
Infosys Technologies	(7.1)	Mastek	(17.2)
Wipro	(11.7)	Mphasis BFL	4.8
Satyam Computer Services	(13.5)	Patni Computer Systems	(17.5)
HCL Technologies	(12.1)	Sasken Communications	(20.8)
<i>Average</i>	<i>(11.7)</i>	KPIT	(12.6)
		Rolta	(12.2)
		Zensar	(5.5)
		Hexaware Technologies	(15.3)
		I-Flex Solutions	(22.1)
		iGate Global Solutions	(13.0)
		<i>Average</i>	<i>(13.7)</i>
		<i>Average (excluding Mphasis)</i>	<i>(15.6)</i>
		<i>Sensex index</i>	<i>(8.6)</i>

We believe that the uncertainty in the US bearing down on stock prices has served to make the risk-reward profile of select mid-cap Indian IT companies significantly more favorable for investors.

How do we identify such stocks? Our **six** fundamental screening criteria are as follows:

- ◆ Choose companies where business is largely intact. Recovery, in case there are business issues, must be seen near-term.
- ◆ Prefer companies where key client traction is steady/uninterrupted
- ◆ Risk to growth remains low
- ◆ Relative absence of exposure to the BFSI vertical as a buffer against the ongoing mortgage crisis in the US
- ◆ Stock returns attractive (at least 30%) and timely (within 12 months)
- ◆ Stock corrections have been disproportionate to fundamentals; valuations are reasonable

On the basis of all the **six** criteria, two mid-caps that make the cut and thus provide a persuasive investment thesis are Rolta and Infotech Enterprises. Hexaware is a dark horse capable of performing but business issues will take at least 4-6 months to fix. Hence, this pick is not as prominent and as preferred as Rolta and Infotech though the stock has been beaten down fairly substantially. We believe that if management moves fast enough to address weakness in certain key accounts and plug gaps in FocusFrame and get the integration process back on track, the stock can offer returns in excess of 30%. We think it prudent for the investor to wait one quarter.

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Rolta - Investment thesis

- All-time high order book and pipeline bids. Order book stands at INR 8.4 bn (more than 12 months of trailing revenues) while deal pipeline that the company is bidding for is an additional INR 16 bn. The company's success rate in converting the pipeline into wins has been high at nearly 60%-70%.
- All business segments witnessing strong traction: engineering, GIS and e-Solutions. Engineering and e-solutions are both growing at over 40% annually, while GIS a respectable 20%-25%.
- Billing rates on a sustained uptrend given the progressive success in moving from projects to larger solutions.
- A pleasing guidance issued for the first time in the company's corporate history guiding towards a 33-35% growth in revenues and 33-36% growth in net profits for
- FY08 over FY07 (both in INR terms). Robust hiring indication of 1,000 professionals (net) and the healthy order book seem to bear out the reasonableness of the magnitude of the guidance. We sense that the management is keen to get it right at the first time and hence we believe that there is some degree of conservatism inherent in the guidance.
- On the engineering side demand the environment continues to be buoyant and seems to be on the threshold of a demand upsurge, similar to what was seen in IT services three-four years back. Rolta, being a strong player in this segment, should benefit from the favorable macro-environment.

* Conclusion

Rolta is a strong growth story in the mid-cap space. It is consolidating itself in the current environment priming itself to expand its opportunity space unlike several others that are now attempting to fix issues in their business. The INR appreciation, which has also contributed in taking the wind out of the sails of the mid-tier pack, has minimal impact on Rolta as it derives almost 60% of its revenues from the domestic market.

* Valuations

We expect Rolta, revenues and net profits to grow at a CAGR of 38.6% and 40.2% over FY07-09E, respectively. At a CMP of INR 433, the stock currently trades at a P/E of 14.1x and 10.4x on our FY08E EPS of INR 30.7 and FY09E EPS of INR 41.9, respectively. The stock has progressively moved to a higher P-E band in the last one year from the 10x-12x range to the 14x-16x range before sliding back to the 13x-14x range in the current environment. We continue to remain positive on the stock and believe that returns will be driven primarily by the robust earnings growth and moderate multiple expansion as well. We look at meaningful returns of ~ 35%-40% over the next one year. We re-iterate our 'BUY' recommendation.

Valuation (x)	FY05	FY06E	FY07E	FY08E	FY09E
EPS (Rs) (Basic)	14.2	18.9	21.6	30.7	41.9
BVPS (Rs)	71.7	117.5	130.8	158.2	192.4
PER	30.6	23.0	20.1	14.1	10.4
Pr/CF	25.0	17.2	12.6	9.7	7.5
P/BV	7.6	3.7	3.3	2.7	2.2
EV/EBITDA	24.6	14.7	11.7	8.0	5.6
EV/Revenues	8.7	6.1	4.7	3.2	2.2
M Cap/ Revenues	8.4	6.5	4.9	3.5	2.5

Infotech Enterprises - Investment thesis

- Both engineering and GIS segments are on track to achieve the growth (engineering which accounts for 60% of revenues will likely grow in excess of 40% in FY08 in USD terms).
- Infotech's top clients are continuing to grow well, with the top two customers showing good traction.
- It is making promising forays into high opportunity sub-verticals such as marine engineering, and witnessing traction in the aerospace vertical having established direct relationships with blue-chip client names such as Boeing.
- The company has also strengthened its hedge position providing it insulation from forex fluctuation. Therefore, we do not expect to see forex losses in Q2FY08 as in Q1FY08. This factor alone is likely to significantly drive up profits q-o-q.
- Employee addition plan also remains strong with planned addition of 1,300 people (25% addition of manpower over FY07).
- Exposure to the US is relatively low at 47% (Europe is as significant as the US unlike in the others where the US is more predominant).

* Conclusion

We see Infotech as a good value play. We believe that the company continues to enjoy competitive advantages in the engineering services space, and business-related issues remain relatively absent. This company is not a mid-cap enterprise IT play and is likely to be relatively insulated from troubles in the US.

* Valuation.

We expect Infotech's revenues and net profits to grow at a CAGR of 29.7% and 29.4%, respectively. Recently, the company has raised money to the tune of INR 3.0 bn (USD 75 mn, 20% of market cap), which it plans to utilise for acquisitions. The current sentiment, particularly towards mid-cap IT, has caused the stock to decline to levels unwarranted by the fundamentals. The stock has corrected more than 25% post the Q1 results, which we believe is overdone. At a CMP of INR 280, the stock trades at a P/E of 15.5x and 11.1x our FY08E and FY09E earnings, respectively. We continue to maintain our 'BUY' rating on it noting the strong potential of the stock to return at least 30% returns to the investor within 12 months.

Valuation (x)	FY05	FY06E	FY07E	FY08E	FY09E
EPS (Rs)	6.2	11.1	18.1	18.0	25.3
BVPS (Rs)	35.4	46.5	65.5	137.6	157.1
PER	45.2	25.3	15.4	15.5	11.1
Pr/CF	32.8	21.0	13.3	11.3	8.0
P/BV	9.3	6.8	4.8	2.0	1.7
EV/EBITDA	46.0	28.7	15.6	9.7	6.3
EV/Net Sales	5.5	3.9	2.6	1.5	1.0
Market Cap/ Sales	5.6	4.0	2.7	2.1	1.6

Comparative snapshot matrix: Valuations of select stocks in the mid-cap universe are compelling, time is ripe for selectively investing to get attractive and timely returns

	EPS (INR)		P/E (x)		Cash P/E (x)		EV/EBITDA (x)		Mcap/Revenue (x)		EPS CAGR
	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	
TCS	53.0	65.8	19.2	15.4	17.2	14.0	15.0	11.3	4.3	3.3	24.9%
Infosys	81.6	102.4	22.4	17.8	19.7	15.6	17.5	12.4	6.0	4.6	21.6%
Wipro	22.9	30.3	19.9	15.0	17.0	13.0	14.4	10.4	3.6	2.8	22.1%
Satyam	24.1	31.1	18.1	14.0	16.7	12.5	11.1	9.0	3.5	2.8	21.5%
HCL Tech	19.2	24.4	14.4	11.3	11.5	9.2	10.0	8.1	2.3	1.9	12.4%
Patni	34.5	34.7	13.0	12.9	11.8	10.7	9.3	6.6	2.2	1.7	8.3%
i-flex	42.7	58.7	44.6	32.5	34.9	25.9	27.6	21.8	6.3	4.7	29.2%
Mphasis	13.2	17.2	21.1	16.1	10.5	8.1	11.3	8.4	2.3	1.7	25.2%
Mastek	36.7	42.3	7.0	6.1	5.4	4.6	3.4	2.5	0.9	0.8	15.3%
Hexaware	9.4	12.3	11.9	9.1	9.7	7.8	8.0	5.9	1.3	1.0	14.1%
Geometric	8.2	11.1	11.8	8.6	7.8	5.7	7.9	4.9	1.1	0.8	34.6%
iGATE	21.4	32.7	10.0	6.5	5.9	4.3	4.3	2.5	0.8	0.6	43.2%
Infotech	18.0	25.3	15.5	11.1	11.7	8.6	9.7	6.3	2.1	1.6	18.1%
Sasken	15.5	27.7	20.7	11.6	10.6	6.9	10.3	6.0	1.6	1.2	32.8%
Rolta	30.7	41.9	14.1	10.4	9.8	7.6	8.0	5.6	3.5	2.5	39.2%

Source: Edelweiss research

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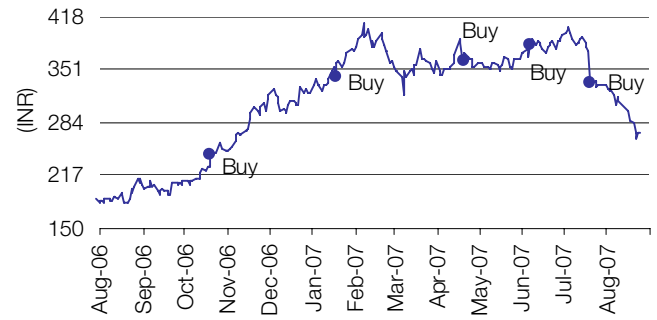
Coverage group(s) of stocks by primary analyst(s): Information Technology:

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

Rolta



Infotech Enterprises



Recent Research

Date	Company	Title	Price (INR)	Recos
24-Aug-07	Infotech Enterprises	Fundamentals intact, risk-reward more favorable; <i>Visit Note</i>	280	Buy
24-Aug-07	Infosys Tech.	Ten questions asked, all reassuring answers; <i>Event Update</i>	1,808	Buy
13-Aug-07	HCL Tech.	Consistently improving performance; <i>Result Update</i>	317	Buy
09-Aug-07	Mphasis	Synergies panning out; <i>Result Update</i>	291	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	92	43	24	6	176
* 8 stocks under review / 3 rating withheld					
	> 50bn	Between 10bn and 50 bn	< 10bn		
Market Cap (INR)	75	66	35		

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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