Earnings Preview

Equity | India | Computer Services
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Entering Seasonally Strong Period

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IT stocks could perk up as seasonally strong period starts

In this note we focus on possible stock triggers/themes in the upcoming results season. Discussions on the outlook for the September quarter will be key. September quarter is seasonally strongest, after project starts in the first half of the calendar and wage hikes for most companies are behind them in the June quarter. This could be a positive trigger for IT stocks.

Annual guidance could be tweaked up

There could be upside to the annual guidance from likely better volumes and 3% Rupee depreciation vs the USD and 9% against the GBP.

Consolidation theme could figure on earnings calls

EDS completed acquisition of MphasiS BFL in the quarter. There continues to be strong speculation that IBM could be scouting around for an acquisition and they could be wooing Satyam. Wipro continues with its 'string of pearls' acquisition strategy. Finally, there have been media reports stating that TCS could be considering an over US$800m acquisition in the BPO space.

Salary pressures will also be a key theme during results

Results season will likely continue to focus on the supply side challenges, with FY08 entry level wages hiked 10% by TCS and 17% by Infosys. We believe margin impact will be mitigated by improving mix of services, investments in newer services like BPO breaking even, and focus on raising productivity.

June 06 results likely ahead of guidance, seasonally weak

We expect the June quarter to be ahead of guidance, though seasonally weak given 1) Annual salary hikes (except for Wipro which gives its salary increase in October) and 2) Visa application costs. Sharp depreciation of the Rupee will help operating performance but not bottom line because of the forex hedges.

Stock picks: Infosys, Satyam and Infotech

Infosys offers the best combination of risk-reward, in our view, with valuations in line with historic levels, strong 30% earnings growth and least risk to margins from large deals or wage pressures. Our contrarian call on Satyam is based on compelling valuation with discount to Infosys PE having widened to 30% from 15% in March, while fundamentals appear to be looking up. We expect Infosys and Satyam to report ahead of guidance (see Table 2). We estimate an 11% qoq PAT decline for Infotech, off a high base, and would regard any correction as a buying opportunity.

Likely disappointments: MphasiS BFL and Patni

MphasiS BFL could disappoint on likely muted revenue growth. Visibility on Patni is poor and concerns on operational issues remain (MLe PAT drop of 17% qoq).

Table 1: Seasonally strong second quarter

Revenue Growth

	Infosys	TCS	Wipro Global IT	Satyam
Q1FY05	12.4%	4.7%	7.1%	7.8%
Q2FY05	15.3%	13.9%	11.8%	10.5%
Q3FY05	7.2%	6.1%	5.8%	5.3%
Q4FY05	6.0%	0.2%	3.3%	7.1%
Q1FY06	4.2%	4.8%	5.5%	9.0%
Q2FY06	10.7%	8.9%	9.4%	9.1%
Q3FY06	10.4%	10.6%	12.0%	9.6%
Q4FY06	3.6%	8.1%	9.2%	3.8%

PAT Growth

	Infosys	TCS	Wipro Total	Satyam
Q1FY05	15.8%	2.3%	11.3%	21.7%
Q2FY05	15.2%	14.8%	15.3%	8.0%
Q3FY05	11.2%	23.4%	3.7%	-6.8%
Q4FY05	3.2%	-20.6%	1.5%	25.0%
Q1FY06	3.6%	14.4%	-1.2%	-7.7%
Q2FY06	13.9%	8.8%	11.7%	24.8%
Q3FY06	10.8%	8.7%	13.7%	13.7%
Q4FY06	3.7%	10.9%	13.7%	5.5%

Source: Company, ML Research

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Refer to important disclosures on page 9 to 10. Analyst Certification on page 7. Price Objective Basis/Risk on pages 6 to7.

June Quarter Results Preview

Potential themes/triggers in upcoming results season

1. IT stocks could perk up as seasonally strong period starts

In this quarter's earnings season, discussions on the outlook for the September quarter will be key. The September quarter is seasonally strongest, after project starts in the first half of the calendar and wage hikes for most companies are behind them in the June quarter. This could be a positive trigger for IT stocks.

2. Annual guidance could be tweaked up

There could be upside to the annual guidance from likely better volumes and 3% Rupee depreciation vs the USD and 9% against the GBP.

3. Consolidation theme could figure on earnings calls

EDS completed acquisition of MphasiS BFL in the quarter. There continues to be strong speculation that IBM could be scouting around for an acquisition and they could be wooing Satyam. Wipro continues with its 'string of pearls' acquisition strategy. Finally, there have been media reports stating that TCS could be considering an over US$800m acquisition in the BPO space.

4. Salary pressures will also be a key theme during results

Results season will likely continue to focus on the supply side challenges, with FY08 entry level wages hiked 10% by TCS and 17% by Infosys. We believe margin impact will be mitigated by improving mix of services, investments in newer services like BPO breaking even, and focus on raising productivity.

5. Jun 06 results likely ahead of guidance, seasonally weak

We expect the June quarter to be ahead of guidance, though seasonally weak given 1) Annual salary hikes (except for Wipro, which gives its salary increase in October) and 2) Visa application costs. Sharp depreciation of the Rupee will help operating performance but not bottom line because of the forex hedges.

Company wise highlights of June quarter results

Table 2: Jun 06 Results Preview

	Sales	% change		EBITDA	% change		EBITDA Margin	QoQ Change	EBIT	% change		EBIT Margin	QoQ Change	PAT	% change	
(Rs mn)	Jun 06 E	YoY	QoQ	Jun 06 E	YoY	QoQ			Jun 06 E	YoY	QoQ			Jun 06 E	YoY	QoQ
Infosys	28,529	37.7%	8.7%	8,862	33.5%	6.4%	31.1%	-68bps	7,512	28.7%	9.0%	26.3%	7bps	7,040	32.4%	4.6%
Infosys Guidance	28,045													6,883		
Variance	1.7%													2.3%		
TCS	40,688	50.2%	9.0%	10,636	33.6%	4.9%	26.1%	-102bps	9,738	31.3%	5.0%	23.9%	-92bps	8,466	36.8%	1.7%
Wipro	30,607	34.7%	-0.4%	7,669	40.3%	7.5%	25.1%	182bps	6,820	44.0%	8.4%	22.3%	180bps	6,146	43.6%	-0.5%
Guidance - Global IT	24,518															
ML Estimates	24,097	39.1%	4.0%	6,743	40.0%	2.6%	28.0%	-37bps	5,979	43.8%	2.9%	24.8%	-26bps			
Variance	-1.7%															
Satyam Computers	14,120	33.4%	7.5%	3,496	45.2%	4.5%	24.8%	-70bps	3,080	47.1%	3.6%	21.8%	-82bps	2,961	55.7%	4.0%
Satyam Guidance	13,625													2,803		
Variance	3.6%													5.6%		
HCL Technologies	12,263	32.2%	9.3%	2,771	31.3%	10.9%	22.6%	34bps	2,173	27.8%	10.4%	17.7%	18bps	2,277	40.6%	18.0%
i-Flex Solutions	4052	50.0%	-11.5%	633	368.2%	-51.8%	15.6%	-1307bps	480	2055.8%	-58.7%	11.8%	-1354bps	468	698.7%	-59.9%
MphasiS BFL	2,598	18.2%	3.7%	508	33.1%	-3.1%	19.6%	-138bps	348	27.3%	-6.6%	13.4%	-149bps	301	-10.6%	-14.5%
Mastek	1,850	21.1%	4.3%	320.1	35.2%	-0.7%	17.3%	-87bps	258	37.3%	2.7%	13.9%	-22bps	202	37.0%	16.7%
Patni	6,264	32.1%	9.0%	781.1	-5.4%	-19.7%	12.5%	-447bps	578	-13.1%	-26.0%	9.2%	-437bps	534	-14.4%	-16.5%
Hexaware	1,898	15.0%	7.8%	299.9	21.0%	2.1%	15.8%	-87bps	253	30.0%	2.2%	13.3%	-72bps	258	32.6%	-0.9%
Infotech Ent	1,132	44.7%	5.0%	201.5	47.9%	1.4%	17.8%	-62bps	166	82.6%	10.6%	14.7%	75bps	147	51.4%	-11.3%

Source: ML Estimates, Companies

Anticipate better than expected results for Infosys and Satyam

We expect **Infosys and Satyam** to report ahead of expectations, with Satyam likely to outperform by almost 6%.

Mastek's reported PAT could be 17% up qoq, though on an adjusted basis (excluding Rs36m tax provision last quarter) it is about flat qoq, at the higher end of its PAT guidance. We believe the stock looks attractive at 11x FY07E.

Strong results from HCL Technologies, helped by lumpy other income

HCL Tech is likely to report strong 14.5% qoq growth in US$ profits, helped by lumpy other income. At the EBIT level we forecast 7% qoq growth (US$ terms). PAT Rupee growth number at 18% qoq helped by the company's policy of convenience translation at period rate.

Expect weak results from MphasiS BFL, Patni, Infotech and i-flex. Would Buy into Infotech

MphasiS BFL could disappoint qoq on likely muted revenue growth. We see a downside risk to our estimates. The stock will likely remain sluggish over the next few months, till the synergies with EDS start materializing.

Visibility on **Patni** is poor as yet and concerns on operational issues remain. We estimate Patni's profits to be in line with guidance – a qoq drop of 17%.

We estimate a qoq decline of about 11% in profits from **Infotech** off a high base and continuing weakness in one of its US subsidiaries. We would regard any weakness as a buying opportunity.

i-flex typically sees seasonal weakness in Q1. We expect a qoq decline of 11.5% in revenue and 61% decline in EPS. Last quarter it reported strong numbers with 109% QoQ growth in PAT and healthy License Fees recognition

Steady results for TCS and Wipro

Results could be flattish qoq for **TCS** and **Wipro**, which get impacted by seasonal weakness in their domestic revenues, and also could see some margin impact related to acquisitions/large deals and client specific issues.

Table 3: Summary Valuation Table

	TCS	Wipro	Infosys	Satyam	HCL Tech	Patni	Mastek	Infotech	Mphasis-BFL	Hexaware	i-flex	Wipro ADR	Infy ADR	Saty ADR	Patni ADR
ML Code	TACSF	WIPRF	INFYF	SAYPF	HCLTF	PATIF	MSKDF	IFKEF	MPSSF	XFTCF	IFXXF	WIT	INFY	SAY	PTI
ML Rating	C-1-7	C-2-7	C-1-7	C-1-7	C-2-7	C-3-7	C-1-7	C-1-7	C-1-7	C-1-7	C-2-7	C-2-7	C-1-7	C-1-7	C-3-7
Currency	Rs	Rs	Rs	Rs	Rs	Rs	Rs	Rs	Rs	Rs	Rs	USD	USD	USD	USD
Nprice	1,685	441	2,801	667	437	330	318	446	154	127	937	12	70	32	14
Target Price Rs	2,265		3,700	960			435	725	235	195			95	47	
Market Cap in $mn	17,520	13,669	16,779	4,705	3,040	986	191	147	539	329	1,524	16,995	19,396	5,258	1,961
Sales Growth FY05/CY04	36.6%	39.9%	46.9%	37.5%	27.2%	24.5%	28.1%	37.2%	31.9%	61.0%	41.6%	45.7%	53.1%	43.3%	29.7%
Sales growth FY06/CY05	36.3%	29.9%	33.5%	36.1%	30.6%	36.1%	20.4%	41.0%	22.8%	24.3%	30.1%	29.0%	32.6%	35.2%	35.1%
Sales Growth FY07/CY06	33.6%	29.4%	33.4%	28.7%	27.0%	25.4%	17.7%	31.3%	22.0%	12.9%	28.1%	30.2%	34.3%	29.5%	26.2%
Sales Growth FY08/CY07	31.7%	31.8%	32.4%	28.4%	25.1%	23.1%	16.4%	22.5%	24.1%	31.9%	22.5%	31.8%	32.4%	28.4%	23.1%
EBITDA % FY06	27.9%	23.9%	32.5%	24.3%	22.4%	19.0%	17.5%	18.5%	20.9%	16.1%	19.9%	23.9%	32.5%	24.3%	19.0%
EBITDA % FY07	27.1%	24.9%	31.9%	23.4%	21.3%	15.4%	17.7%	18.6%	23.5%	17.5%	21.0%	24.9%	31.9%	23.4%	15.4%
EBITDA % FY08	26.4%	24.1%	31.2%	22.9%	21.0%	17.1%	17.7%	18.0%	23.5%	18.5%	20.8%	24.4%	31.5%	23.1%	17.2%
EBIT % FY06/CY05	25.8%	21.0%	27.9%	21.5%	17.6%	15.6%	13.0%	13.4%	15.3%	12.9%	16.5%	21.0%	27.9%	21.5%	15.6%
EBIT % FY07/CY06	24.8%	22.2%	27.4%	20.4%	16.4%	11.6%	12.4%	13.1%	17.3%	14.2%	17.5%	22.2%	27.4%	20.4%	11.6%
EBIT % FY08/CY07	23.9%	21.4%	26.6%	19.9%	16.0%	13.0%	12.2%	13.2%	16.9%	15.5%	17.6%	21.4%	26.6%	19.9%	13.0%
ROE % (FY05/CY04)	93.0%	36.0%	43.6%	23.9%	17.9%	22.9%	27.7%	19.1%	25.2%	26.4%	19.6%	36.0%	43.6%	23.9%	22.9%
ROE % (FY06/CY05)	69.8%	34.8%	40.4%	25.8%	19.5%	15.5%	28.4%	27.3%	23.1%	29.4%	17.6%	34.8%	40.4%	25.8%	15.5%
ROE % (FY07/CY06)	55.1%	35.9%	39.4%	25.3%	22.4%	11.9%	28.5%	25.2%	25.6%	26.4%	20.3%	35.9%	39.4%	25.3%	11.9%
ROE % (FY08/CY07)	46.9%	35.0%	37.0%	25.6%	24.6%	14.5%	25.7%	24.9%	25.7%	29.0%	20.9%	35.0%	37.0%	25.6%	14.5%
EPS Rs FY05/CY04	47.1	11.6	68.2	22.3	18.8	19.6	19.3	18.6	7.9	5.4	27.1	0.3	1.6	1.0	0.9
EPS Rs FY06E/CY05	59.7	14.5	89.3	30.3	23.6	19.5	24.2	33.2	9.3	7.7	29.3	0.3	2.0	1.4	0.9
EPS Rs FY07E/CY06E	78.1	18.9	117.0	37.2	29.2	19.2	31.1	39.9	11.6	8.8	40.1	0.4	2.7	1.7	0.9
EPS Rs FY08E/CY07E	98.2	23.6	147.8	45.9	35.3	25.5	35.7	49.9	13.9	12.3	48.9	0.5	3.4	2.1	1.2
EPS gr % FY05/CY04	33.1%	56.6%	45.7%	36.8%	9.1%	7.6%	84.2%	201.3%	14.0%	86.6%	18.6%	63.2%	51.9%	42.6%	12.2%
EPS gr % FY06E/CY05	26.7%	25.3%	30.9%	35.8%	25.3%	-0.2%	25.4%	78.3%	17.5%	41.3%	7.8%	24.4%	30.0%	34.8%	-0.9%
EPS gr % FY07E	30.9%	30.6%	31.0%	23.0%	23.7%	-1.6%	28.7%	20.2%	24.2%	15.4%	36.9%	31.4%	31.9%	23.8%	-1.0%
EPS gr % FY08E	25.7%	24.7%	26.4%	23.4%	20.8%	32.7%	14.8%	25.1%	20.5%	38.6%	22.2%	26.0%	27.7%	24.6%	34.0%
EPSgr % FY08-06 2 yr	28.3%	27.6%	29%	23.2%	22.3%	14.3%	21.5%	22.6%	22.3%	26.5%	29.4%	29%	30%	24%	15%
5yr EPS g (FY05-10)	24.0%	22.0%	25.0%	23.0%	20.0%	15.0%	15.0%	24.0%	22.0%	22.0%	24.0%	22.0%	25.0%	23.0%	15.0%
PE FY05 EPSe(x)	35.7	42.9	43.9	30.5	26.2	17.0	17.6	24.1	18.5	24.3	40.4	45.2	46.5	31.5	15.9
PE FY06e EPS(x)	28.1	34.2	33.5	22.4	20.9	17.0	14.1	13.5	15.8	17.2	37.5	36.4	35.8	23.4	16.0
PE FY07e EPS(x)	21.5	26.2	25.6	18.2	16.9	17.3	10.9	11.3	12.7	14.9	27.4	27.7	27.1	18.9	16.2
PE FY08e EPS(x)	17.1	21.0	20.3	14.8	14.0	13.0	9.5	9.0	10.6	10.8	22.4	22.0	21.3	15.1	12.1
PEG (x) FY07E PE to FY06-08 EPS g	0.76	0.95	0.89	0.79	0.76	1.21	0.51	0.50	0.57	0.56	0.93	0.96	0.91	0.78	1.06
PEG (x) FY07E PE to 5-yr EPS g	0.90	1.19	1.02	0.79	0.84	1.15	0.94	0.47	0.72	0.68	1.14	1.26	1.09	0.82	1.08
EV/ EBITDA (FY05) (x)	29.2	33.1	34.0	22.7	18.4	12.0	10.2	13.6	16.1	19.4	27.2	35.0	36.2	10.4	11.1
EV/EBITDA (FY06) x	21.5	26.4	25.1	16.3	14.6	8.7	7.5	9.5	11.6	13.3	25.5	28.1	26.9	7.3	8.0
EV/EBITDA (FY07)x	16.3	19.5	19.1	12.8	12.1	9.0	5.8	7.5	8.3	10.5	18.5	20.6	20.3	5.4	8.2
EV/EBITDA (FY08)x	12.5	15.0	14.4	9.9	9.9	6.8	4.5	5.9	6.6	7.7	14.9	15.7	15.2	3.9	6.2

Source: Companies, ML Research

Price Objective Basis & Risk

Tata Consultancy Services

Our Rs2,265 PO (set in April 06) is at a target PE of 23.5x 1-year forward (FY08E) earnings. We believe the target PE of 23.5x is reasonable at a little over 5% discount to Infosys' target PE, given TCS' shorter track record as a listed company and likely greater volatility in quarterly profits given a higher proportion of fixed price projects.

Risks are 1) Growing competition from western systems integrators 2) maturity of top 10 clients and a high revenue base 3) ability to scale and manage growth 4) higher than expected wage pressure and 5) industry wide risks, primarily of US slowdown and also risk of Rupee/USD appreciation.

Infosys

Our 1-yr PO of Rs3,700 (set in April 06) is at 25x 1-yr forward (FY08E) earnings, lower than the current 1-yr forward FY07E PE of 26x, and at a target PEG of less than 1. Our ADR PO is at US$95, based on a 10% premium to the local, in line with the current premium and below its 1-yr average of ~20% and current premium of peers at 10-20%.

Risks are 1) Growing competition from western systems integrators like Accenture 2) Ability to scale rapidly and manage growth 3) Industry-wide risks of US economy slowdown and Rupee/USD appreciation.

Satyam Computers

Our PO of Rs960 (set in April 06) is at 21x 1-year rolling forward (FY08E) earnings, at a 15% discount to our multiple for Infosys, which we believe is justified given Infosys' higher growth, margins, RoE and more diversified revenue base. Our ADR PO of US$47 is at a 10% premium to the local, in line with Infosys current premium to local.

Key company-specific risks are high concentration of revenues from enterprise solutions, higher than expected attrition and the risk of large deals having a lower profitability than the company average, especially during the initial transition phase. Prominent industry-wide risks are a slowdown in the US economy and risk of Rupee/USD appreciation.

Hexaware Technologies Ltd

Our PO of Rs195 (set in April 06), at 16x estimated 1-year rolling forward earnings, is in line with our target multiple for peers – MphasiS BFL and Infotech Enterprises. With a strong 4QCY05 and encouraging growth guidance for 1QCY06, we believe that Hexaware will trade at least in line with peers as the previous uncertainty on growth outlook and margins appears to have been resolved.

Risks: Slower than expected margin expansion, risk to PeopleSoft implementation revenues (~25% of revenues), and industry-wide risks of growing competition and rupee appreciation.

Infotech Enterprises Ltd

Our PO of Rs725 (set in April 06) is based on 15x estimated 1-yr forward EPS, in line with current multiple supported by a ~25% 2-yr CAGR in adjusted earnings over FY06-08E. Our target P/E is at a marginal discount to peers, MphasiS BFL and Hexaware, given its relatively smaller size.

Risks to our PO are: High client concentration, non-annuity revenues in GIS and threat of captive in engineering services.

MphasiS-BFL Ltd.

Our PO of Rs235 (set in April 06) is based on ~16x estimated 1-yr forward EPS, which is in line with its current multiple. We believe the current multiple is sustainable given our estimate of 3-year EPS growth of 23% over FY05-FY08E and improving growth visibility post rebound in BPO revenue growth and EBIT margin expansion.

Risks to our PO are 1) Continued margin decline in the BPO business, 2) Delayed client ramp-ups in IT Services and non-voice BPO, and 3) Industry-wide risks of rupee appreciation and wage inflation.

Mastek

Our PO of Rs435 (set in April 06) is at ~13x estimated 1-yr forward earnings. We believe this is justified given that it is in line with the current multiple and at a 20% discount to its mid-tier peers' (MphasiS BFL & Hexaware) target P/E of 16x with 22% EPS CAGR over FY05-08E.

Risks are 1) Refilling risk given that ~70% of total revenues are project driven; any delay or shortfall in order booking could impact quarterly profits significantly, 2) Reliance on alliances, exposing Mastek to the fortunes of its partners as well as their decisions to outsource work, and 3) Industry-wide risks, including wage inflation and rupee appreciation.

Analyst Certification

I, Mitali Ghosh, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

In accordance with the SEBI (Foreign Institutional Investors) Regulations and with guidelines issued by the Securities and Exchange Board of India (SEBI), foreign investors (individuals as well as institutional) that wish to transact the common stock of Indian companies must have applied to, and have been approved by SEBI and the Reserve Bank of India (RBI). Each investor who transacts common stock of Indian companies will be required to certify approval as a foreign institutional investor or as a sub-account of a foreign institutional investor by SEBI and RBI. Certain other entities are also entitled to transact common stock of Indian companies under the Indian laws relating to investment by foreigners. Merrill Lynch reserves the right to refuse copy of research on common stock of Indian companies to a person not resident in India. American Depositary Receipts (ADR) representing such common stock are not subject to these Indian law restrictions and may be transacted by investors in accordance with the applicable laws of the relevant jurisdiction. Global Depository Receipts (GDR) and the Global Depository Shares of Indian companies, Indian limited liability corporations, have not been registered under the U.S. Securities Act of 1933, as amended, and may only be transacted by persons in the United States who are Qualified Institutional Buyers (QIBs) within the meaning of Rule 144A under the Securities Act. Accordingly, no copy of any research report on Indian companies' GDRs will be made available to persons who are not QIBs.

Important Disclosures

Investment Rating Distribution: Industrials/Multi-Industry Group (as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	32	58.18%	Buy	8	25.00%
Neutral	19	34.55%	Neutral	5	26.32%
Sell	4	7.27%	Sell	0	0.00%

Investment Rating Distribution: Technology Group (as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	94	39.33%	Buy	22	23.40%
Neutral	135	56.49%	Neutral	20	14.81%
Sell	10	4.18%	Sell	2	20.00%

Investment Rating Distribution: Global Group (as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1145	40.29%	Buy	393	34.32%
Neutral	1474	51.86%	Neutral	430	29.17%
Sell	223	7.85%	Sell	44	19.73%

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