



BUY

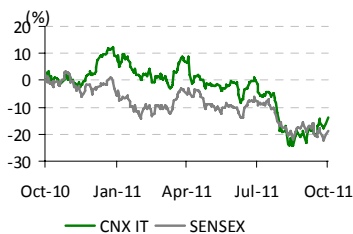
Sector update

Analyst

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CNX IT 5,339
 BSE Index 16,867

Historical Chart



Performance	1m	3m	6m
Absolute (%)	9	-12	-19
Relative (%)	10	-1	-5

India Software Sector

Rise dollar rise...

Present financials of software companies are more leveraged to the US dollar than 2 years ago because of less currency hedged positions. Our analysis shows recent 9% rupee depreciation to Rs49 adds 250bp to GM (transaction gain) and provides translation gain benefits of 4%-7% (net foreign currency receivables) to earnings. Cumulatively it boosts sector earnings by 6%-12% in FY12. FY13 earnings increase 3-10% (only transaction gain). Top beneficiaries in FY13 would be HCL Technologies (HCLT) and Infosys (INFO). We will upgrade our FY12/13 forecast if dollar sustains for next 2 quarters.

Transaction benefits muted in FY12, Upgrades possible for FY13

We are almost at the start of H2 – six months benefit is about 5% because many hedges are at Rs46/US\$. However, FY13 would see benefit of up to 10% in earnings.

Gains now larger than 25% rupee depreciation in FY09 to Rs50/US\$

In '08-'09, rupee depreciation didn't benefit much because currency hedging was excessive. Total hedged positions now are far less (<0.5x) than in '09. This time the exotic derivatives are absent, which caused KPIT lose Rs330m and HEXW Rs1bn in FY09/10.

INFO and HCLT to benefit the most

Of dollar revenue, INFO has hedged 10%, HCLT 9%, and Tata Consultancy (TCS) and Wipro (WPRO) around 22%. Hexaware (HEXW) and Tech Mahindra (TECHM) will gain the least since they have 50% and 73% of revenue locked at Rs47/US\$.

New contracts, likely acquisitions make stocks attractive

Share price correction of up to 30% from recent highs lends comfort to valuation. INFO, TCS at PER of 18x and HCLT at PER of 13x are 20% below historical average. They remain our top IT picks.

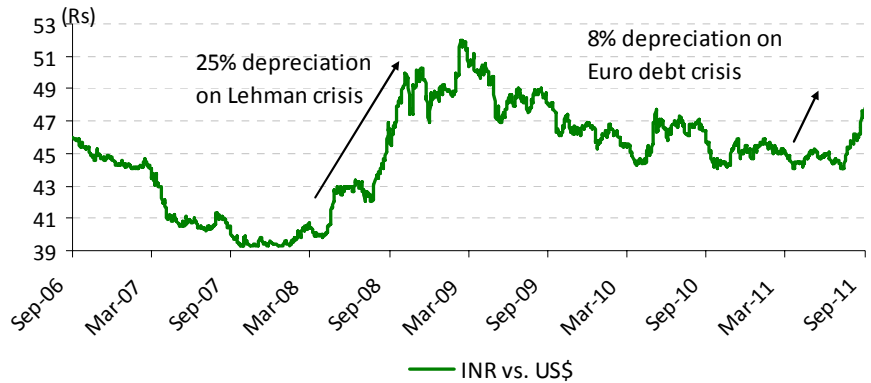
Software Sector: EPS sensitivity to FX rate

	FY12F		Chg (%)	FY13F		Chg (%)
	Rs45/US\$	Rs48/US\$		Rs45/US\$	Rs48/US\$	
INFO	132	144	9	160	172	7
TCS	56	61	10	70	73	4
WPRO	22	24	10	24	26	9
HCLT	31	34	10	40	44	10
TECHM	70	75	7	75	79	4
MPHL	42	46	8	44	48	9
PSYS	32	35	10	39	41	6
KPIT	13	15	12	15	17	10
HEXW	7	8	6	9	9	3

SEE APPENDIX I FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

Recent depreciation is sudden trend reversal

Source: INR vs. US\$ price chart



Source: Bloomberg

In 2008, rupee had depreciated 25% to Rs50 within 2 quarters on sudden risk aversion after the collapse of ‘Lehman Brothers’. The IT vendors did not benefit because:

- Most IT vendors had hedged large positions up to 200% of revenue at Rs41/US\$
- Exotic cross currency derivative positions resulted in P&L cash loss and mark-to-market losses on B/S.

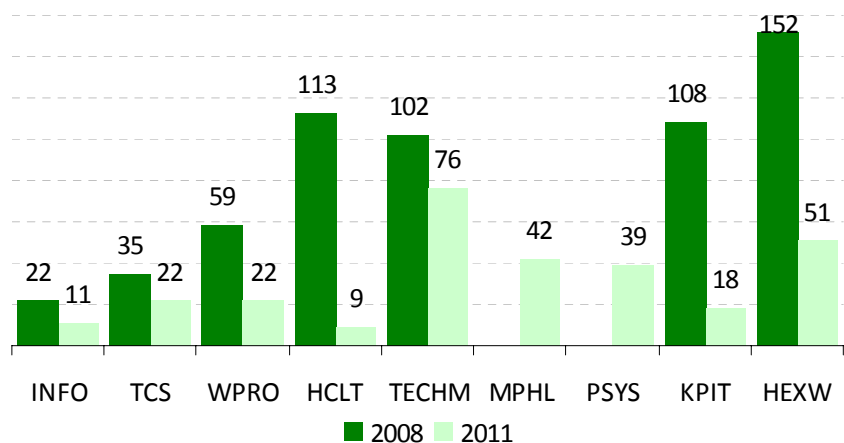
However, since then, most IT vendors have changed their foreign exchange policies and they hedge with simple forward contracts up to two years of revenue. This allows them to participate more significantly in benefits from rupee depreciation. INFO remains the benchmark as it consistently hedges only 50% of net revenue for forward two quarters.

2011 hedges lower than 2008

Software Sector: FX hedges as % of revenue

HCLT and INFO would benefit the most because of their low existing hedges

TECHM and HEXW would benefit the least because of their existing hedges around Rs47/US\$



Source: Company data; KESI estimates

Net foreign currency revenue is 50% of total revenue

Software companies expense out 50% of total expenses in foreign currency. Balance is net foreign currency revenue, which provides transaction gain and boosts rupee earnings following rupee depreciation.

Translation of net monetary assets in the B/S adds to earnings

Translation gain is because of the foreign currency receivables and foreign currency cash for sector companies. We account for the translation gain in the other income component of the P&L. We expect one time gain of 4%-7% in FY12 from translation benefits. These are unrealized gains and would be recognized with settlement of the receivables.

INFO and HCLT key beneficiaries because of low hedges

We believe Infosys and HCLT would benefit the most because of low hedged positions. In 2009, HCLT had booked hedges of US\$1.9bn @ Rs41/US\$, which impacted it by US\$200m when rupee reversed to Rs51/US\$. Since then, it has brought down hedges to US\$390m, which will now allow it to benefit the most from depreciation given its low GM.

Among mid-caps, KPIT would benefit the most as it has hedges covering only 18% of revenue at Rs46/US\$.

Upside is limited for HEXW and TECHM because of their large FX positions, which almost fully cover net foreign currency revenue over the near term.

Software Sector: Hedge positions

	Hedge positions (US\$ m)		Revenue (US\$m)		Hedges as % of Revenue	
	Q1 FY09	Q1 FY12	FY09	FY12F	FY09	FY12
INFO	811	745	4,821	6,995	17%	11%
TCS	1750	2300	6,181	10,614	28%	22%
WPRO	2600	1600	5,711	7,433	46%	22%
HCLT**	1900	390	2,273	4,324	84%	9%
TECHM	850	900	992	1,207	86%	75%
PSYS	NA	86	132	224	NA	38%
KPIT	140	54	176	307	79%	18%
INFTC	50	41	200	345	25%	12%
HEXW***	389	180	389	368	100%	49%

Source: Company data; KESI estimates

Software Sector: Valuations and Recommendations

(Yr to Mar)	Ticker	CMP (Rs)	MCap (US\$m)	PER (x)		P/BV (x)	Reco.
				FY12F	FY13F		
Infosys	INFO	2,590	30,369	17.9	14.6	5.5	BUY
Tata Consultancy	TCS	1,065	42,554	19.1	15.3	9.3	BUY
Wipro	WPRO	349	17,509	16.1	14.5	3.9	HOLD
HCL Tech**	HCLT	414	5,830	13.4	10.3	3.9	BUY
Tech. Mahindra	TECHM	576	1,496	9.0	8.3	2.1	BUY
Mphasis*	MPHL	334	1,432	7.9	7.5	1.6	SELL
Persistent	PSYS	300	245	9.7	8.0	1.6	BUY
KPIT Cummins	KPIT	146	262	10.8	9.6	2.4	BUY
CMC	CMC	795	492	14.7	10.7	1.8	BUY
Hexaware***	HEXW	84	505	11.4	9.8	1.2	HOLD

Source: KESI estimates

Software Sector: Absolute Stock Performance

Company Name	Ticker	Recom.	Absolute Returns (%)		
			1m	6m	Y-T-D
Mphasis*	MPHL	SELL	1	-24	-49
Persistent Systems	PSYS	BUY	-2	-27	-30
Infosys	INFO	BUY	20	-8	-15
HCL Infosystems**	HCLI	SELL	-4	-42	-46
S&P CNX IT Index	CNXIT	NA	14	-18	-21
S&P CNX NIFTY	NIFTY	NA	2	-13	-18
Wipro	WPRO	HOLD	9	-23	-28
Infotech Enterprises	INFTC	BUY	-7	-30	-35
Tata Consultancy	TCS	BUY	9	-9	-8
Hexaware***	HEXW	HOLD	20	23	49
HCL Technologies**	HCLT	BUY	11	-15	-8
Tech Mahindra	TECHM	BUY	-7	-20	-17
KPIT Cummins	KPIT	BUY	-1	-14	2

Source: Company data, KESI estimates

* Yr to October, **Yr to June, ***Yr to Dec

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+15% and above: BUY

-15% to +15%: HOLD

-15% or worse: SELL

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