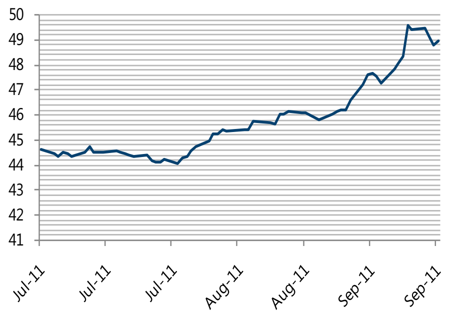
MSFL Research

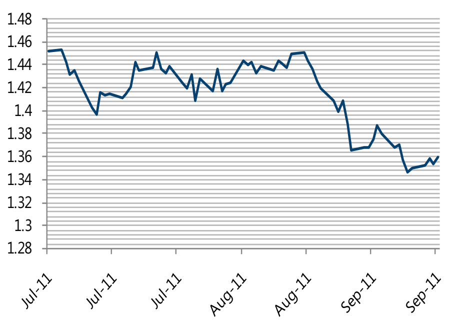
IT Q2FY12 Preview

So far So good...

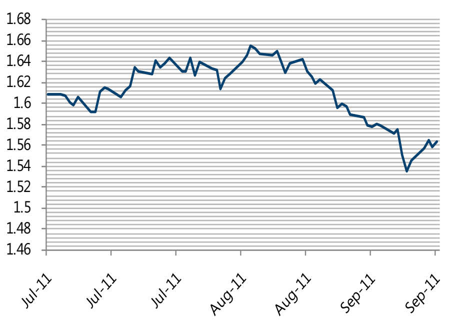
USD-INR



Euro-USD



GBP-USD



After US sovereign debt rating downgrade by S&P to AA+ and concerns over Greece default during the month of July, Stock prices of Indian IT stocks slipped by 8-10% on account of demand concerns. While we do not see any revenue impact in the Q2FY12, CQGR could moderate in coming quarters as highlighted in our Q1 review and incorporated into our estimates. However key thing that has changed this quarter is USD-INR rate which has alleviated stock's valuation. Rupee has depreciated by 10% YTD from last quarter closing while average rate change remains low at 2.5% q-o-q. This will add 80-125bps to EBITDA margins of our coverage universe. However on profitability front, the impact would be mixed depending on hedging exposure and hedged rate. Rupee depreciation will thus act as a short time gainer for IT stocks as larger concern remains on demand outlook. Managements of top players are only suggesting cautiousness with no demand pull back at present. We believe demand for outsourcing should not tone down sharply as clients across are making conscious effort to trim down their operational costs. Accenture and Oracle had come out with strong results along with favorable guidance for coming quarter. Impact could be higher in FY13.

Revenue impact to be negligible from global concern, rupee to benefit: We expect sequential USD revenue growth in 3-6% range for the top 4 with 250bps additional gain in INR growth led by strong rupee depreciation. Cross currency appreciation will take away 25-120bps from USD revenue growth. Mid caps KPIT and Geometric are expected to register sequential USD revenue growth of 4% and 6% respectively. Infosys management is expected to give a cautious outlook while EPS guidance could be upped to ₹ 130-132. Wipro is expected to give a conservative guidance.

Rupee to cheer up margins but mixed impact on profitability: EBITDA margin declined by 200-300bps sequentially in last quarter led by wage hikes, the impact of which is expected to get partially offset in the current quarter as rupee depreciation will add 80-125bps to EBITDA margins. Profitability on the other hand will not see same growth on account of partial hedging loss. Infosys, HCL Tech are expected to benefit most from rupee while TCS is expected to book losses due to high hedging position.

Outlook Neutral for short term: Stock prices after falling off substantially post S&P downgrade and Greece concerns have gained back after rupee depreciation. However things still remains vague in terms of global environment and hence the demand outlook remains uncertain. Companies are winning orders currently but cautiousness still persist which will limit any near term upside in the stocks as rupee depreciation will only be a short term price trigger. We do not see very sharp revenue erosion as clients have identified need for disciplined outsourcing for saving cost and transforming their operational functions. 'TCS' and 'HCL Tech' continue to remain our preferred picks.

Summary Financials

(in ₹ Mln)	Net Sales			EBITDA			PAT		
	Q2FY12P	y-o-y	q-o-q	Q2FY12P	y-o-y	q-o-q	Q2FY12P	y-o-y	q-o-q
TCS	116882	26%	8%	33687	21%	11%	23811	28%	0%
Infosys	80766	16%	8%	24527	5%	13%	18526	4%	6%
Wipro*	89224	15%	5%	16093	-2%	-3%	12379	-4%	-7%
HCL Tech#	49040	36%	14%	8061	37%	1%	4669	55%	-5%
FSL	5273	5%	1%	476	-33%	11%	139	-58%	30%
KPIT	3406	45%	8%	484	33%	22%	256	8%	6%
Geometric	1836	21%	6%	206	3%	25%	67	-52%	-43%

**consolidated; # - HCL INR numbers on closing USD-INR rate; ADSL dropped from coverage*

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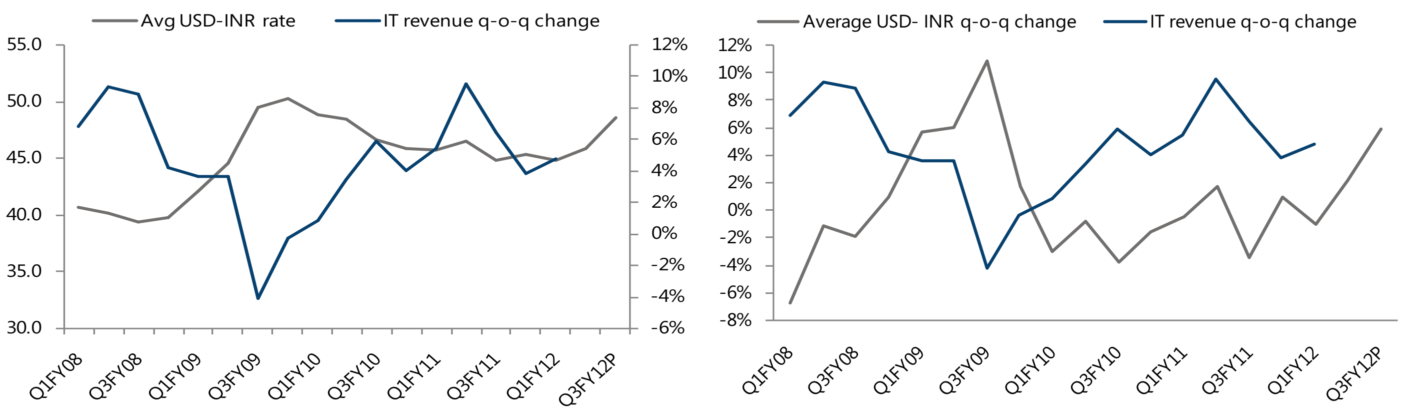
Witness a good quarter but demand certainty still in woods

While global environment is yet to come back in a state of certainty, the same is not expected to impact the September quarter results of Indian IT services. Q2 is expected to deliver favorable sequential performance with 4.8% USD revenue growth and 8% INR revenue growth for our coverage universe. Rupee depreciation will add ~240 bps to INR growth in the quarter.

HCL Tech is expected to record highest sequential INR growth at 14% (INR reporting on closing rate rather than average rate as followed by others) followed by TCS and Infosys each at 8.3% and 7.9% respectively. Wipro is expected to continue to lag peer growth at 5.1% q-o-q growth. In the mid-cap space KPIT and Geometric are expected to register sequential revenue growth in the range of 6-8% in INR terms. FSL growth is expected to remain muted at 1% q-o-q growth because of its telecom client ramp down and new deal wins to start operating from H2 onwards.

As far as clues from rupee depreciation are concerned, in 2008 as well it was very sharp followed by falling revenue growth q-o-q. Only a big event like Lehman collapse (in today's scenario country default rather than sector pressure) might put revenue pressure as things stand different to what it has been earlier and hence we do not see any sharp revenue erosion at current point in time.

Exhibit 1: Sequential revenue growth vis-a-vis USD-INR movement



Source: Company, Bloomberg, MSFL Research

Rupee depreciation to add 80-125bps to margins

Rupee depreciation is a short term trigger for IT stocks. INR has depreciated by close to 10% YTD from last quarter closing which will work in favor of EBITDA margins. The gain would be lower in the current quarter as average q-o-q rate change stand at 2.5% only, which will add 80-125bps to EBITDA margin of companies under our coverage partially compensating for wage hike impact of last quarter. The gain in coming quarter will however be significant provided rupee stays at ₹ 48-49 levels.

Exhibit 2: Average currency movement (in %)

Average quarter appreciation of -->	INR	GBP	Euro	AUD
USD	-2.46%	-1.07%	-1.51%	-1.16%

Source: Company, MSFL Research

Infosys will gain highest in large cap with EBITDA margin expansion of 131bps q-o-q because of higher proportion of USD revenue followed by TCS at 75bps. Wipro's gain from currency will get offset by wage hike provided in the month of June, the full impact of which will be visible in the current quarter. HCL Tech also gives wage hike in September quarter and has guided 250bps margin impact from same and 50bps from fresher hiring. The impact will however be lower because of rupee depreciation which will partially compensate for the wage hikes. KPIT and Geometric both are expected to witness sequential margin expansion of 160-170 bps.

Mixed impact on Profitability

Higher volatility in USD-INR rate after 2007 has resulted in companies reducing their hedging exposure of their net inflows. However this also varies from company to company. All companies under our coverage follow cash flow hedge accounting with different duration. As per the accounting, changes in fair value (MTM) of effective hedges are recognized in reserves in balance sheet and ineffective hedges are recognized directly in Profit & Loss account. Thus in the current quarter companies will book hedging losses in P&L depending on the maturity time of the contracts. Hedging policy and exposure taken by companies under our coverage are –

TCS: Covers the net USD exposure for 2 quarters
Infosys: Hedge up to two quarters of net cash inflow.
Wipro: Covering the net USD exposure for two quarters.
HCL Tech: Layer hedging policy taking position on a monthly basis; hedges 20-40% of its inflows.
KPIT: Hedge on rolling two quarter basis at almost 75% of net USD exposure being hedged.
Geometric: Hedges nearly 70% of its cash flow for a period of 24 months.
Firstsource: Follows cash flow hedge accounting covering portion of full year exposure.

Exhibit 3: Hedging position as on June 2011

Hedge Position	Forex cover as on June 2011 (USD mln)			Revenue in June 2011 (USD mln)	% of Revenue Hedged
	Forward	Options	Total		
TCS	342	1672	2014	2412	83%
Infosys	722	0	722	1671	43%
Wipro	1585	-	1585	1408	113%
HCL Tech	390	-	390	963	41%
KPIT	54	-	54	70	77%
Geometric	150	-	150	39	384%
FSL	19.5	-	19.5	117	17%

Source: Company, MSFL Research

Variability in hedging policy will thus result in mixed impact on profitability. Infosys and HCL Tech can participate in rupee depreciation to a higher extent because of lower hedging exposure and will hence witness higher profitability though forex losses will be booked based on contract maturity. TCS had USD 1.1bln in terms of revenue hedges for September quarter and had increased its position in options during Q1. This is expected to weigh on profits due to heavy hedging loss. Wipro's hedging position is also more than 100% of its quarterly revenue.

KPIT will not stand to gain from rupee depreciation on profitability front as company had USD 54mln position at an average rate of ₹ 45. Of this USD 28mln is beyond FY12. Geometric though has a higher hedge position but its average rate stands at a favorable rate of ₹ 48.55 and hence will see limited impact from rupee depreciation. FSL is also hedged at an average rate of ₹ 47.5 for FY12 and ₹ 48 for FY13 and hence will not see any significant impact.

What lays ahead – the real question to be answered?

The muted question still remains on continuation of demand going forward. Our recent conversations with the companies has not indicated any signs of projects pull back from client side, but any major event like Greece default might put pressure on demand resulting in a cascading effect.

Exhibit 4: Demand debate

Facts favoring demand	Facts against Demand
• Management commentary indicates no project pull back by clients till now. • TPI forecast indicating H2CY12 to be one of the strongest for deal flow. • Better balance sheet positioning of clients with good cash levels. • Renewal deals coming up with higher share for Indian vendors than incumbents. Share of incumbents down from 95% to 70%. • Strong y-o-y growth reported by oracle and Accenture.	• Weak global data for GDP, unemployment, consumer and manufacturing index. • Layoffs across a spectrum of banks in US, UK and Europe. • Government protectionist policy regarding IT offshoring. • Concern on bankruptcy by any major bank in US or Europe or a sovereign debt default by any European economy may result in catastrophic effect.

Source: Company, MSFL Research

We do not expect a similar situation as happened during 2008-09 when volumes dipped suddenly and pricing declined because of better cash position of clients, increasing need for managing cost, driving operational efficiency & expansion plans as also the increasing market space for Indian vendors. However we might see softening CQGR in coming quarters as we mentioned in our Review report. Hence at current point in time, we believe it is better to take position in stocks with steady business momentum, hold on restructuring and better operational management.

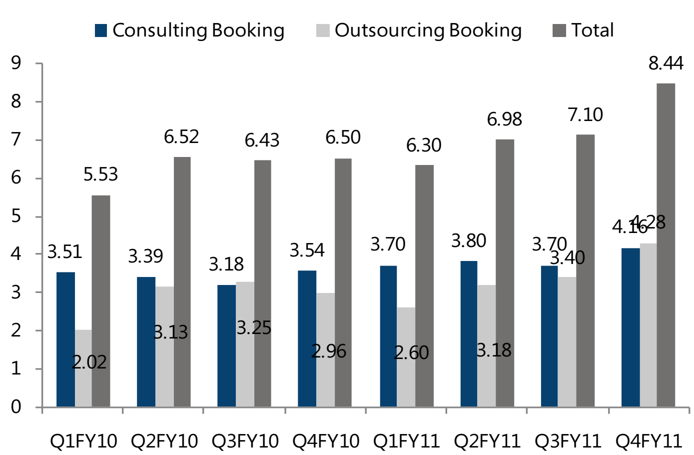
Takes from recent result releases –

Accenture and Oracle results indicate good outsourcing demand

Accenture reported strong Q4 revenue numbers at USD 6.7bln beating the upper range of guidance of USD 6.5bln. New contract bookings came is at all time high at USD 8.4bln compared to USD 7.1bln in last quarter with book to bill ratio at 1.3x. Company added 12570 net employees in the quarter with utilization at 85%.

As per Accenture management call – Clients continues to invest in replacing their core systems and initiating more cost reduction projects and improving operational effectiveness. Growth was also driven by global operating model programs and post merger integration projects.

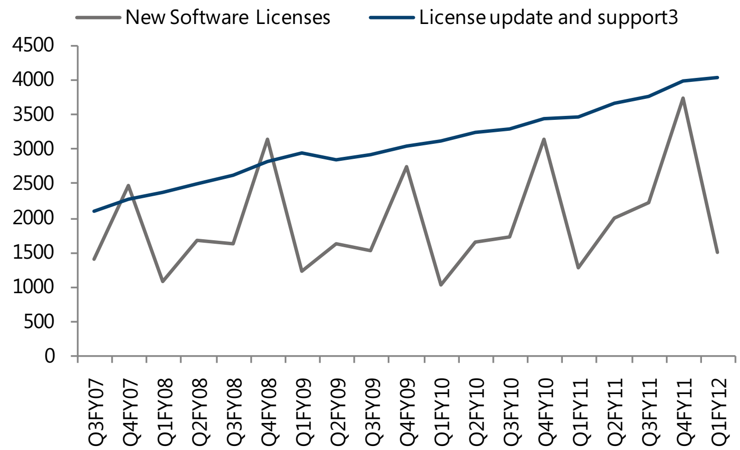
Exhibit 5: Contract Bookings (in USD bln)



Source: Company, MSFL Research

Oracle's new software license sales grew by 16% Y-o-Y and update and support revenue increased by 16.6% Y-o-Y. This also indicates incremental demand coming in from discretionary spend. Management has guided for 6-16% y-o-y growth in new software license for next quarter.

Exhibit 6: Oracle revenue trend (in USD mln)



Source: Company, MSFL Research

MSFL View:-

Valuations for IT stocks have regained after rupee's rally towards 49-50 levels. However we do not see this as a long term upside for the stocks as this only lends support to margin profiling largely.

We recommend investing in stocks with strong business momentum and a flexible business model after a significant correction. 'TCS' and 'HCL Tech' continue to remain our sector top pick as they continue to fit the bill in the said parameters. Infosys is also done with its restructuring; however a little rigid business model in terms of margin and a still evolving growth strategy after restructuring makes it a second in our preferred list. Wipro is yet to deliver a good performance post it restructuring. In mid cap space KPIT remains our preferred pick.

Exhibit 7: Q2FY12 Projections

(in ₹ Mln)	Q2FY12P	Q1FY12	Q2FY11	Q-o-Q (%)	Y-o-Y (%)	Comments
TCS						
Sales	116882	107970	92864	8.3%	25.9%	USD revenue growth at 5.8% q-o-q, cross currency impact of ~35bps on USD revenue growth. Margin expansion of 75bps q-o-q to get offset by forex loss. Look for demand commentary.
EBITDA	33687	30310	27775	11.1%	21.3%	
EBITDA margin (%)	28.82	28.07	29.91	75bps	(109)bps	
PAT	23811	23803	18632	0.0%	27.8%	
EPS	12.17	12.16	9.52	0.0%	27.8%	
Infosys						
Sales	80766	74850	69470	7.9%	16.3%	USD revenue growth at 5.5% q-o-q, cross currency impact of ~30bps on USD revenue growth. EBITDA margin to increase by 131bps q-o-q. Lower hedging exposure to limit loss. Guidance to remain the watch point.
EBITDA	24527	21750	23330	12.8%	5.1%	
EBITDA margin (%)	30.37	29.06	33.58	131bps	(321)bps	
PAT	18526	17490	17750	5.9%	4.4%	
EPS	32.4	30.1	30.37	7.6%	6.7%	
Wipro						
Sales	89224	84929	77719	5.1%	14.8%	Expect 3.1% q-o-q USD revenue growth in IT services. Full quarter wage hike impact to result in 148bps margin erosion. Cross currency impact at ~45bps on USD revenue growth.
EBITDA	16093	16579	16415	-2.9%	-2.0%	
EBITDA margin (%)	18.04	19.52	21.12	(148)bps	(308)bps	
PAT	12379	13349	12849	-7.3%	-3.7%	
EPS Adj	5.04	5.44	5.24	-7.3%	-3.8%	
HCL Tech*						
Sales	49040	43035	36116	14.0%	35.8%	USD revenue growth at 4.2% q-o-q, cross currency impact of ~125bps on revenue growth, margin erosion of 203bps q-o-q from wage hike and fresher hiring, gain from rupee depreciation to get offset by hedging loss.
EBITDA	8061	7949	5876	1.4%	37.2%	
EBITDA margin (%)	16.44	18.47	16.27	(203)bps	17bps	
PAT	4669	4914	3004	-5.0%	55.4%	
EPS Adj	6.78	7.15	4.42	-5.2%	53.4%	
Firstsource						
Sales	5273	5231	5036	0.8%	4.7%	Slow revenue growth in the quarter as revenue from new ramp ups to get offset by telecom client ramp down, margin expansion at 83bps q-o-q.
EBITDA	476	429	705	11.0%	-32.5%	
EBITDA margin (%)	9.03	8.20	14.01	83bps	(498)bps	
PAT	139	106	332	30.4%	-58.2%	
EPS	0.32	0.25	0.77	30.4%	-58.3%	
KPIT						
Sales	3406	3161	2349	7.7%	45.0%	USD revenue growth at 6.1% q-o-q, cross currency impact of 25bps on revenue growth. 164bps q-o-q margin expansion, gain from rupee depreciation to get offset by hedging exposure.
EBITDA	484	397	364	21.8%	32.8%	
EBITDA margin (%)	14.20	12.56	15.50	164bps	(130)bps	
PAT	256	241	237	6.5%	8.0%	
EPS	2.91	2.77	3.01	5.1%	-3.2%	
Geometric						
Sales	1836	1727	1519	6.3%	20.8%	USD revenue growth at 3.8% q-o-q, cross currency impact of 26bps on USD revenue growth, 170bps margin expansion, hedging loss to offset the gain from rupee depreciation.
EBITDA	206	164	201	25.4%	2.6%	
EBITDA margin (%)	11.22	9.52	13.22	170bps	(200)bps	
PAT	67	117	138	-43.0%	-51.6%	
EPS	1.07	1.88	2.22	-42.9%	-51.7%	

*Source: MSFL Research; * HCL tech INR numbers reported at closing rate while others are reported at average rate*

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Buy	> 15%
Accumulate	5 to 15%
Hold	-5 to 5%
Sell	< -5%
Not Rated	-

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