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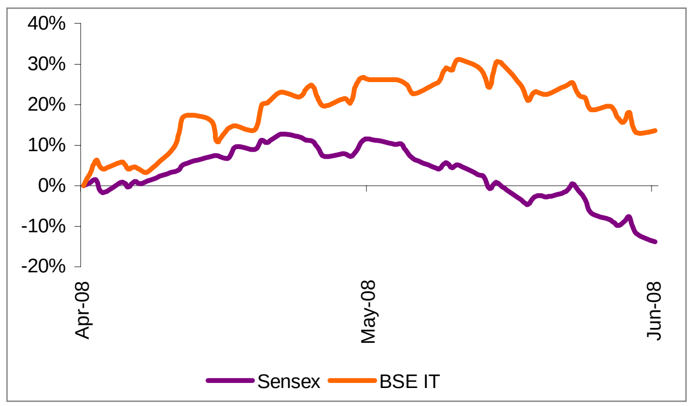
Q1FY2009 IT earnings preview

Guidance in dollar terms, commentary on pricing scenario to influence sentiments

- The top lines of frontline tech stocks are expected to grow in the range of 6.5%-11.1% sequentially in the rupee terms in Q1FY2009. The growth in the top lines is primarily driven by a volume growth of 1%-2%, boosted by ~7% depreciation in the rupee against the US dollar during the quarter. In dollar terms, the sequential growth is expected to remain muted during the quarter.
- On the margin front, the margins of frontline IT companies during the first quarter of the fiscal are generally dented by visa cost. For Infosys and Tata Consultancy Services (TCS), the margins in the first quarter of the fiscal are impacted by wage hikes in addition to visa cost. Consequently, the operating profit margins (OPM) of Infosys and TCS in Q1FY2009 are expected to decline by around 185-205 basis points, in spite of the positive impact of the rupee depreciation.
- On the net income front, we expect HCL Technologies' net income to decline by 29.6% year on year (yoy), as the company had reported foreign exchange (forex) gains of Rs250 crore in Q1FY2008. Beside this, HCL Technologies and Wipro Technologies had increased their hedge positions in Q4FY2008. Hence, the two companies may report higher forex losses, given the recent depreciation of the rupee.

Tech stocks have considerably outperformed the benchmark indices during the period April2008-June 2008 due to the rupee depreciation, the better-than-expected guidance by IT companies and the extension of tax exemptions under section 10A/B for one more year. Going forward, the forthcoming results and the management's commentary on the below mentioned points will be the key to the share price performance of the tech stocks.

Sensex v/s BSE IT



The following are the key points to be watched out.

- **Possible upgrade of guidance in dollar terms:** Infosys is expected to revise up its revenue growth guidance by 5-7%, purely on the back of the steep depreciation in the rupee. However, the sentiments towards tech stocks would be boosted only when there is a meaningful upgrade in the growth guidance in dollar terms. We expect a marginal increase in the guidance for FY2009 in US dollar terms.

Quarterly estimates

(Rs crore)	Net sales			Net profit			EPS	OPM
	Q1FY09	% qoq	% yoy	Q1FY09	% qoq	% yoy	(Rs)	(%)
Infosys Tech	4896	7.8	29.8	1254	2.0	21.9	21.9	30.7
Guidance	*4570-4582*	*0.6-0.9*					20.7	
Satyam	2685	11.1	46.7	519	11.2	37.1	7.7	22.6
Guidance	*2500-2512.5*						*7.64-7.68*	
HCL Tech	2149	10.5	33.3	342.9	0.1	-29.6	5.2	21.7
Wipro (Cons)	6089	8.8	45.6	881	0.6	24.0	6.0	16.3
Wipro (Global IT)	4172							
Guidance (Global IT)	*$988 mn*							
TCS	6492	6.5	24.8	1212	-3.5	2.3	12.4	20.8

- **Pricing scenario:** Given the recent media reports related to weakness in billing rates from some of the banking and financial services clients, the commentary on pricing environment has become an important factor. And rightly so, since the consensus estimates have currently factored in a stable or marginal improvement in the blended billing rates. Any decline in the pricing cuts may affect frontline tech companies' margins significantly, as a 1% decline in the blended rates implies a 50- 70 basis points drop in the OPM.

- **Confidence in implied back-ended growth:** The guidance of tech companies indicates a subdued performance in the first quarter, followed by a strong ramp up in the second half of the fiscal. For instance, the Q1 guidance of Infosys implies a compounded quarterly growth rate of ~6.5% in its revenues in the following three quarters. Consequently, the street would look for any sign that indicates any change in the management's confidence in ramping up the business in the second half of the fiscal.

Rupee depreciation continues

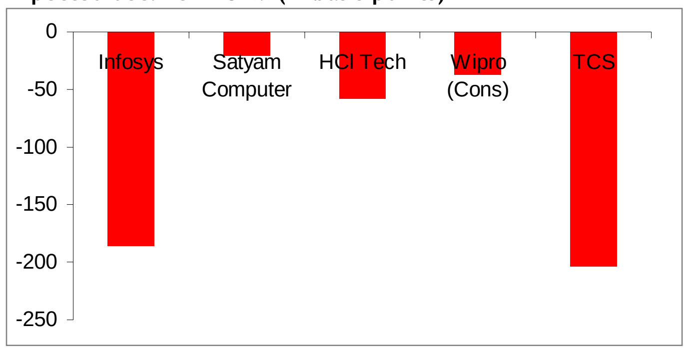
The rupee continued to depreciate during the quarter, which is expected to have a positive impact on the top line of frontline tech companies. The average exchange rate of Rs42.8 against the dollar is also above the assumption of Rs40 made by the domestic companies (Infosys assumed Rs40.02 per dollar and Satyam Computer Services [Satyam]—Rs40 a dollar). This will help boost the growth in Q1FY2009. On a quarterly basis, the rupee on an average has depreciated by 4.5% against the dollar. Even against the Euro and the Pound, the rupee has depreciated by 9% and 4.3% respectively. Such a high depreciation in the quarter is likely to have a positive impact on the margins of the companies.

INR vs	End of period rates		Average rates	
	31-Mar-08	30-Jun-08	31-Mar-08	30-Jun-08
US$	39.9	42.84	39.8	41.6
% qoq		*7.4*		*4.5*
Euro	63.1	67.7	59.6	65.03
% qoq		*7.3*		*9.1*
Pound sterling	79.7	85.5	78.7	82.05
% qoq		*7.28*		*4.3*

OPM to decline significantly for TCS and Infosys in spite of rupee depreciation

IT companies, in general, see a dented margin in the first quarter of a fiscal due to visa cost. In addition to visa cost, companies such as Infosys and TCS are expected to hike wages for their offshore employees (11-13% for Infosys, 8-10% for TCS) and onsite employees (4-5% for Infosys, 3-4% for TCS) in Q1FY2009 (from April). These factors are expected to shrink the margins of both the companies by 250 to 350 basis points. However, the rupee depreciation in this quarter is likely to restrict the entire OPM decline. Hence, we expect ~185-basis point decline for Infosys and a 205-basis point drop for TCS during the quarter.

Expected decline in OPM (in basis points)



Better global and domestic cues during this quarter

During this quarter, we witnessed relatively positive news flow from both global and domestic markets.

Global cues

- Accenture came out with better-than-expected street results for Q3FY2008. The company highlighted that it has not witnessed any cancellation or big delay in its business as a result of a weaker US economy and the financial sector in specific. New bookings, a key indicator of future revenues, totaled $6.77 billion in the third quarter compared with $6.44 billion in the second quarter. Improved bookings gives near-term visibility about the company.

- Oracle's result for May quarter ending were also above the street expectations. Oracle's new software licenses, a key indicator for the future revenues, were up by 27% year on year in the quarter. The management expects the new software sales to rise only by 10-20% during the quarter compared to 35% in the last year quarter.

- Recent CIO survey indicates that IT spending is expected to remain stronger than expected in 2008. The survey mentions that IT spending is expected to grow at 8% in the second half of the year compared to 3% in the second half of last year. This is also in line with the guidance of frontline tech IT companies, which implied back-ended growth.

- The survey also suggested that the demand for offshore IT services would remain strong in 2008. The IT spending budget is expected to grow by 4.4% on a year-on-year basis in FY2008. The survey also brought to notice that the onshore bill rates are expected to be 4.0%, while the offshore bill rates are expected to be 4.5% in CY2008. Beside this, CIO has regarded infrastructure outsourcing and business process outsourcing (BPO) as a high priority area.

Domestic cues

- Infosys management is of the view that the outsourcing trend for the quarter is relatively better than that of the previous quarter, as the current quarter did not have much bad news percolating from the global economy.
- TCS expects order picking to take off from the second quarter onwards on the back of a strong deal pipeline. The company expects some impact due to the US slowdown, however the management is of the view that a diversified set of clients could mitigate the problem to some extent.

Valuation

We continue to prefer Satyam and TCS as our top picks. Satyam continues to be our top pick because of its improving operating matrix. At the current market price, the stock trades attractively at 15.3x FY2009 earning estimates and 13.3x FY2010 earning estimates. We also like TCS purely on a valuation basis (the stock is trading at 23.7% discount to Infosys. At the current market price, the stock trades attractively at 14.0x FY2009 earning estimates and 12.3x FY2010 earning estimates).

Valuation table

	EPS* (Rs)			P/E		
	FY08	FY09	FY10	FY08	FY09	FY10
Infosys	79.3	95.2	106.1	22.1	18.4	16.5
TCS	51.3	59.7	68.4	16.3	14.0	12.3
Wipro	22.5	27.8	31.6	18.9	15.4	13.5
Satyam	25.2	30.4	34.8	18.4	15.3	13.3
HCL Tech	18.2	21.4	24.9	12.8	10.9	9.4

*Given the steep depreciation of the rupee, we will revise our exchange rate assumption post Q1FY2009 results, which would lead to 4%-7% upward revision in earning estimates.

The author doesn't hold any investment in any of the companies mentioned in the article.