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Indian IT Services

Tier-1 Players Still Our Preferred Choice

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- **Citi's global economic forecasts revised downward** — Our US economics team has downgraded US GDP growth forecasts to 1.5% for CY08 (from 2.3%) with negative growth in 1Q. We believe that offshoring is defensive as clients focus on cutting costs; however, overall IT budgets could be under more pressure and there could be short-term negatives as clients reprioritize their IT spending plans.
- **Recession testing; Growth in all scenarios** — We have provided stress scenarios, assuming a sharp slowdown in US revenues. We believe that even in the worst case, 10-20% yoy growth in revenues ($ terms) should be achievable. Tier 1 companies should be able to hold margins in the near term.
- **Trends still positive; CTSH guidance a plus** — TPI data suggests that 4QCY07 was the best quarter of CY07. Similarly, order bookings for Accenture and IBM and results and outlook for SAP and Oracle don't appear to have negative indications. Cognizant's CY08 guidance of "at least" ~38% revenue growth is a positive.
- **Adjusting estimates and targets —** In line with Citi's reduced global growth forecasts, we have not assumed any pricing increases in FY09, moderated wage hikes and brought down our hiring assumptions for all companies under coverage. This results in a 2-5% FY09E EPS cut in our Tier 1 coverage. We are also trimming our target multiples given the difficult environment.
- **Underownership + relative historic low valuation to drive the sector —** We continue to believe that Tier 1 is the place to be. Satyam, TCS and Infosys are our top picks in the sector. We also like Mphasis and Patni (among mid caps).

	Rating		Target Price (Rs)		Current Yr Est. (Rs)		Next Yr Est. (Rs)	
Ticker	Old	New	Old	New	Old	New	Old	New
TCS.BO	1L	1M	1290	1165	52.7	51.9	61.4	58.3
INFY.BO	1L	1M	2190	2060	80.8	80.8	96.5	94.5
WIPR.BO	1L	1M	565	535	22.8	22.1	28.2	26.6
SATY.BO	1M	1M	565	540	24.7	24.9	29.8	29.2
HCLT.BO	1M	1M	365	340	18.1	18.4	21.3	20.3
IFLX.BO	3M	3H	1570	1110	38.0	42.3	58.2	53.7
TEML.BO	3H	3H	1330	730	59.0	59.3	78.4	71.4
PTNI.BO	1H	1H	475	390	32.9	33.1	33.8	30.3
MBFL.BO	1M	1H	360	355	12.3	12.4	18.0	17.6
MINT.BO	3H	3H	487	380	25.3	26.8	33.1	30.6
HEXT.BO	1M	1H	122	90	7.9	7.9	9.4	8.6
SKCT.BO	3H	3H	333	138	16.8	12.9	22.6	14.6
KPIT.BO	1M	1H	130	111	7.0	7.0	9.3	8.7

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

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Stress Testing – Tier 1s the Place to Be

Our US economics team has downgraded US GDP growth forecasts to 1.5% for CY08 (from 2.3%) with negative growth in 1Q. In this report, we have provided recession testing, and our view remains that Tier 1 companies should be able to achieve 10-20% yoy revenue growth even in a difficult macro environment. (For a detailed analysis of Tier 1 companies see our 13 Feb 2008 report, *Stress Testing — Tier 1 Players Still Our Preferred Choice.*) We have also monitored trends closely – TPI data for 4QCY07 was better than the preceding three quarters; Accenture and IBM results and commentary suggest strength; and Indian players still remain “cautiously optimistic”. However, in line with Citi's view of slower global growth, we are cutting our estimates for most stocks. We assume no price increases in FY09, slightly moderate wage hikes and lower hiring. We are also trimming our target multiples given the difficult macro environment. Our sector view remains unchanged. We still prefer to stick with Tier 1 companies despite strong relative (within the sector) outperformance. Satyam, TCS and Infosys are our top picks. Better growth profile and relatively defensive quality of earnings are our key considerations for choosing top picks in such times. Among mid caps, we still prefer Mphasis (highest growth stock in our IT services coverage universe) and Patni (cheapest in our IT coverage universe).

Change in Citi's US/Global economy view

Citi's US economics team downgraded the forecast for US economy. Please refer to research report titled, "Forecast Update: Call It Recession" (https://www.citigroupgeo.com/pdf/SNA14059.pdf), dated January 18, 2008. Our global economics team also expects economic activity to slow in other industrial nations, hurting overall global economic growth. Please refer to research report titled, "Global Economic Outlook and Strategy" (https://www.citigroupgeo.com/pdf/SEU12406.pdf), dated January 28, 2008.

According to Citi's economics team, the U.S. economy seems likely to contract as 2008 begins, weighed down by tightening financial conditions, energy cost burdens and fundamental weakness spreading beyond housing. The economist team now expects 2008 US GDP to grow 1.5% from 2.3% at the beginning of the year. Given sharp slowing of the US economy along with slowdown in other industrial nations, Citi's economics team expects 2008 to be the weakest year for global economic growth since 2003.

Recession testing; close look at scenarios

Given Citi's revised forecasts for the US and global economy, we closely look at our forecasts and provide various scenarios for Tier 1 players. The yoy growth across geographies in revenues for the top 5 Indian IT Services players in 3QFY08 (Oct-Dec) is shown in the table below.

Figure 1. Growth in Oct-Dec'07 Quarter by Geography

	Americas	Europe	RoW	Company
TCS	31.3%	39.7%	52.5%	36.8%
Infosys	30.2%	40.9%	20.2%	32.0%
Wipro	29.2%	32.3%	74.2%	42.1%
Satyam	39.8%	61.6%	74.1%	49.7%
HCL Tech	33.7%	41.7%	57.8%	39.3%

Source: Company reports

Assuming there is a sharp slowing down of growth (US growth slows to 10% yoy while other regions also moderate significantly), our scenario analysis still suggests 10-20% yoy growth in revenues. One should also keep in mind that a 10% yoy growth in FY09 would essentially assume that there is no qoq growth in revenues in the four quarters of FY09.

Figure 2. Scenario Analysis for Recession Testing: Worst Case Growth in FY09 by Geography

	Americas	Europe	RoW	Company
TCS	11.3%	19.7%	22.5%	15.5%
Infosys	10.2%	20.9%	10.0%	13.1%
Wipro	10.0%	12.3%	30.0%	11.8%
Satyam	19.8%	30.0%	30.0%	23.9%
HCL Tech	13.7%	21.7%	27.8%	18.3%

Source: Citi Investment Research

Investors have also been concerned about pricing in a slowing US/global economy. However, pricing trends continue to be robust across the sector. In Q3, all the large companies reported an increase in pricing on a qoq basis. Revenue per employee for Infosys, Satyam, etc. has been moving up consistently over the last few quarters.

We have provided a rough sensitivity of EPS to changes in revenue per employee. We assume that the revenue per employee increase does not result in any change in costs and that the companies do nothing in anticipation of this (which clearly is an oversimplification for the sake of providing sensitivity analysis). We have done the analysis for Infosys; the sensitivity increases for lower margin companies. In other words, the sensitivity is much higher for Tier 2 companies.

The revenue per employee changes in the analysis are on a qoq basis. A 1% revenue/employee increase qoq for all four quarters of FY09 means a revenue per employee increase of ~4.1% in pricing.

Figure 3. EPS Sensitivity to QoQ Change in Revenue Per Employee

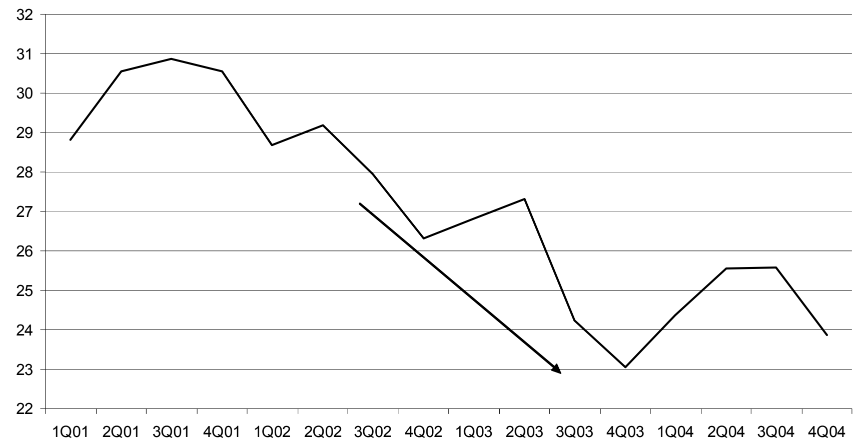
INFOSYS	FY 08E EPS	FY 09E EPS		Rev/Emp change
INR / USD		INR/$ = 38	INR/$ = 39	qoq in FY09E
	80.8	94.5	99.3	0.0%
	80.8	98.1	102.9	0.5%
	80.8	101.0	106.0	1.0%
	80.8	91.7	96.1	-0.5%
	80.8	88.5	92.8	-1.0%

Source: Citi Investment Research

What happened last time?

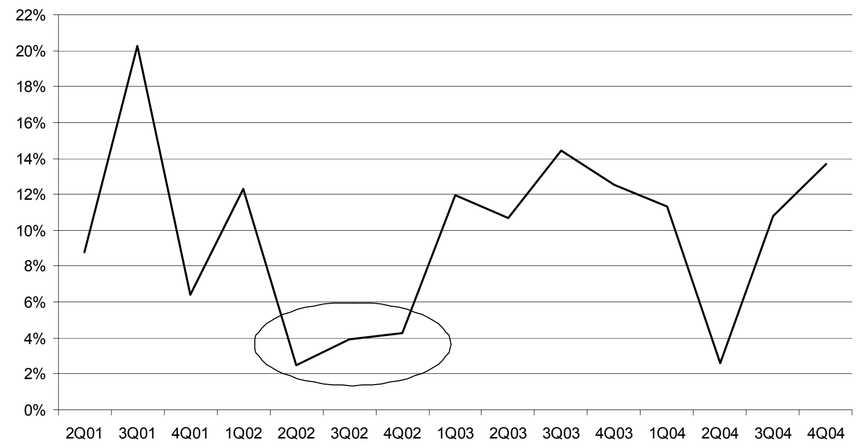
The following qoq volume/pricing charts highlight the last slowdown period for Infosys. Pricing fell sharply in FY02-03, due firstly to dot com/high-tech companies ramping down sharply and secondly to other clients also negotiating lower price points. Volumes suffered for a couple of quarters in FY02 as clients took time reprioritizing their budgets and after that volume growth recovered to high single digit/low double digit levels.

Figure 4. Infosys Offshore Pricing – Last Slowdown



Source: Company Reports

Figure 5. Infosys Volume Growth – Last Slowdown



Source: Company Reports

What is different this time?

One often-repeated investor query is "What is different this time (compared to the slowdown of 2001-2002) and will things play out differently this time?" In our view, the key differences are:

- In 2001, ~10% of business came from dot com companies. These companies were paying very high billing rates (20-50% higher than average bill rates). As these clients went out of business, revenues were impacted and, more importantly, pricing was severely impacted. This time, the impact seems to be more on financial services customers, which are mostly mature and usually at lowest price points.

- Offshoring is clearly more mainstream, and visibility is higher today compared to 2000-01. The flip-side is that the industry is much larger today, and hence correlation with broader market could be higher.
- In the last slowdown, US share of revenues was ~90%; now it is ~50-65%.
- At the beginning of the last slowdown, valuations were ~50-100x 1-year forward; now they are at ~12-16x 1-year forward. Of course, growth expectations today are lower than when the last slowdown started.
- Companies are much more prepared this time as talks of a slowdown have existed for the past year or so. Also, today, hiring is much more staggered. Last time, utilization took a sharp hit as companies hired in advance.
- Wage structures have a higher component of variable; now ~30% of wages are variable.

Top tier margins should hold in the near term

We believe top tier margins should be more resilient in the near term, although lack of sustained growth could have a negative impact on margins in the longer term. The reasons for our belief are:

- Companies being relatively cautious on hiring; steps like staggered hiring of campus recruits are now followed. This should ensure no sharp dip in utilization in any particular quarter.
- Wage hikes will moderate if demand tapers off. The industry has gone through very strong wage hikes over the last 4-5 years, and there could be moderation if hiring slows down.
- Around 25-30% of wages for larger players are variable in nature and part of that depends on the company's performance as against the budgeted performance. This should provide some operating leverage in case of a drastic slowdown in demand.

Trends over last few months

In this section, we look closely at the sector data coming out in the last couple of months. Surprisingly and in major contrast to the overall macro environment, the sector data and trends do not indicate any major change in the demand environment. While TPI data indicated that 4QCY07 was the best quarter in CY07 in terms of deal flows, results and outlook for SAP, Oracle, Accenture and IBM remained pretty robust. Indian IT majors had a slightly below expectation quarter (Satyam stood out with a strong quarter), but maintained that they don't see any major change in the business environment.

4QCY07 TPI Index – Key takeaways

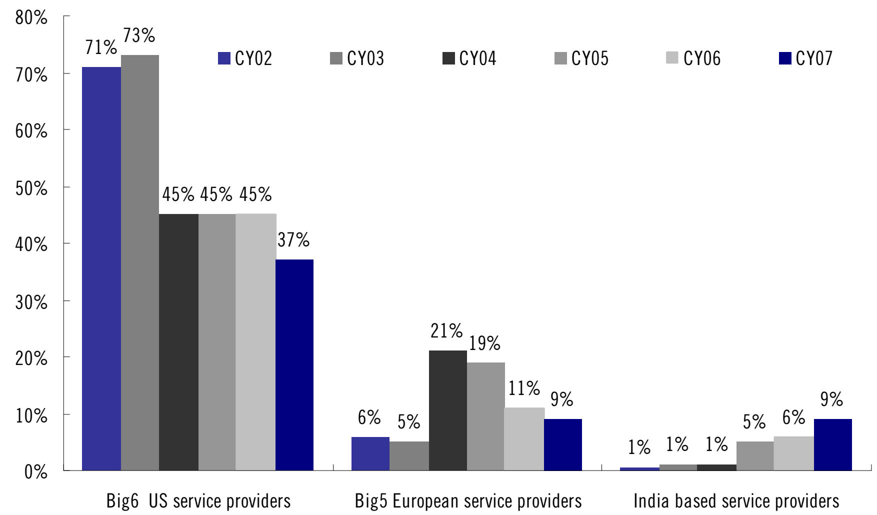
The TPI Index presentation had positive comments for the overall outsourcing industry. Based on contract award data and pipeline, TPI expects overall IT/BPO outsourcing to grow 7% in 2008. Some of the key takeaways from the latest TPI index presentation are:

- Outsourcing contract momentum was one of the highest in the recent past. TCV (total contract value) was up ~16% yoy for 4Q07.

- EMEA (+25% yoy) and AsiaPac (+33% yoy) showed strong demand for 2007, while Americas was sluggish (-17% yoy). EMEA now accounts for more than half of the global market.

- Indian service providers continue to gain market share within the broader outsourcing market (TCV>US$25m). Market share of India-based service providers was up to 9% in 2007 (against 5% and 6% in 2005 and 2006).

Figure 6. Market Share Data, Broader Outsourcing Market



Source: TPI

- Most of the Indian service providers did not figure in mega deals previously (TCV>US$1bn). This quarter, of the 15 mega relationship signed, five involved India-based service providers.

Figure 7. Mega Deals Involving India-based Service Provider

Outsourcer	Vendor	Scope
Commonwealth Bank of Australia	TCS, HCL Tech, IBM	ADM
Cisco	Wipro	BPO, R&D engineering
Deutsche Bank	HCL Tech	ADM
Citigroup	Genpact	BPO - F&A
The Nielsen Company	TCS	Multi-service

Source: TPI

IBM and Accenture results and commentary

Both IBM and Accenture had good results with commentary on demand remaining largely positive. However, we would also like to highlight that US companies have been big gainers due to the depreciating dollar in the past year or so.

IBM had a good quarter for its IT Services, both in terms of revenues and short-term signings. Global technology services revenue was up 16%, while global business services revenue was up 17%. Overall services business was up 17% (10% in constant currency). The company signed $15.4bn of new business; within this, short-term signings were up 8%. IBM's long-term signings have been on a secular downtrend as the market moves towards smaller deals (supported by TPI data over the last many quarters).

Accenture had a good quarter with revenues increasing 12% in local currency yoy. In terms of bookings, consulting bookings were up 12% yoy, while outsourcing bookings were flattish yoy. Even US revenues increased 9% in local currency, which was in line with last few quarters. EMEA and AsiaPac continue to do well with 14% and 21% yoy growth respectively in Q1. Financial services growth was 9% in local currency.

Some comments made by Accenture management in its earnings call which are relevant for Indian IT Services are:

- On IT Budgets - "We have not seen any impact of an IT budget thing on our business at this point."
- On lead indicators to a slowdown - "We have not seen deals terminated, and we have had nothing pushed out because of the economic situation."
- On outlook in the US - "70% of US companies in the business round table expect pretty significant increases in sales and almost 80% of those companies think and expect their employment to rise."
- On ERP - "We are still seeing strong demand for ERP."
- On pricing - "We did implement good salary increases this year and got that covered in our pricing in the first quarter, despite our utilization levels being slightly lower than last year."

SAP and Oracle results and outlook

SAP and Oracle results and comments on the outlook over the last couple of months do not indicate any major deterioration in growth outlook, which is positive for the Indian IT Services industry (and particularly for Satyam, which has a very high proportion of revenues from enterprise software).

SAP's release in January indicated that 4Q2007 software (license) revenues are expected to be approximately €1.41 billion (2006: €1.24 billion), representing an increase of ~14% (~18% at constant currencies) yoy. Even for FY07, the license revenues are expected to increase around 18% yoy at constant currency. More importantly, SAP's guidance for CY08 (excluding Business Objects) implies 12-14% organic growth in software and software related revenues (on a constant currency basis), which is the same as the guidance at the start of CY07.

Oracle had announced its quarterly results in December. Software revenue license growth accelerated from 35% yoy in 1Q to 38% yoy in 2Q. It indicated that it doesn't see any enterprise slowdown in its current pipeline. 3Q guidance remained strong at 15-25% yoy license growth and 20-23% yoy non-GAAP revenue growth.

Comments by Indian IT majors in Q3 earnings call

Comments by Indian IT majors in their post-Q3 earnings call do not indicate any major change in terms of client spending plans/demand for CY08. The table below summarizes the comments made by leading Indian IT Services companies in their post Q3 earnings call.

Figure 8. Comments by Leading Indian IT Companies in Their 3Q Earnings Calls

	Demand	Pricing	IT Budgets
TCS	"...the customers are sticking to the growth plans at this point in time…we do not see any budget cuts as we speak or budget reductions."	"...we continue to expect an upward revision in pricing both in the renewals as well as the new contract..."	"We have not received any special warning from any customer from the budget point of view...We would believe that there can be an offshore uptake if the situation warrants it from the budget freeze or budget reduction point of view."
Infosys	"We have not seen project cancellations, we have not seen panic...we are not seeing any difference in the environment or change"	"The pricing environment continues to be stable with an upward bias. We have got price increases in couple of BFSI segment clients."	"Those clients that have reverted…indicated an increase of about 6% odds in their overall IT budgets…also have indicated that the percentage of offshoring in that IT budget is also going to go up…Normally, visibility into clients' IT budgets would be available to us in early January, but this year it would be available by end of January or early February."
Wipro	"We continue to see good demand for our services and believe the value that global delivery model brings is enduring."	"...have seen price increases from our customers…it is much more stable to a positive bias with respect to the pricing environment that we are seeing at this point in time."	"...most of the clients have flattish IT budgets. There are a couple of clients where their IT budgets have been curtailed. However, that does not automatically mean that it will affect offshoring or outsourcing, it may accelerate that."
Satyam	"...we haven't seen any significant pull back or cancellation of the new work going into this quarter. Generally speaking, the outlook so far, as we could gauge, has been good."	"...been fairly successful in reasoning it out with the customers that, what they need to pay is right price reflective of the value that we are able to create. We have been able to successfully renegotiate for higher prices."	"...what we're seeing is that on an average about 5 to 6% increase in IT budgets, generally that is the outcome, so that we have been able to relate to from the customers."
HCL Tech	"...a large population of people believe that their IT spending to drive efficiency is the answer to drive lower cost."	"...we focus on enhancing the realization...the rate both onsite and offshore, YoY, have gone up..."	"...there is nothing I had discovered in my conversations which indicate any change in the environment of IT budgets going down or up."

Source: Company Earnings Calls

TCS, Infosys and Wipro indicated that they had made ~22,000, 18,000, and 14,000 campus offers, respectively, for FY09 which is up ~25-30% yoy. Campus offers don't show any kind of negative outlook on demand for FY09 as of now. However, the counter argument remains that these offers can be revoked/delayed if things worsen. The point here is that companies don't see any major hiccups in demand at this point of time.

Having said that, we continue to look out for any worrying signs as historically company comments have not always been a lead indicator of changing market environment.

Cognizant 4Q results and CY08 guidance – Positive read

Cognizant reported 7.4% qoq increase in revenues and, more importantly, the CY08 guidance of "at least" 38% yoy revenue growth topped street estimates.

Comments on IT budgets and outlook by CTSH:

- IT budgets are expected to stay the same or increase modestly in 2008.
- 80% of top 50 clients have finalized the 2008 IT budget, a statistic which is consistent with feedback received in prior years at the same point of time.
- Sees offshoring increase within the client base.
- Guidance assumes that some client-specific unexpected issues will arise due to the economy.
- Net add of ~16,600 to 19,600 expected in CY08; focus on higher utilization to stay.
- No difference in pricing behaviour of customers now vis-à-vis recent past.

- Wage inflation to moderate from 2007 levels.

Valuations at historic lows

Stock valuations over the last 5-6 years

Valuations are clearly close to historic lows. Infosys trades close to historic lows, as it had done post disappointing guidance in April 2003. Satyam has undergone a relative re-rating post the strong performance delivered over the last 10-12 quarters.

Figure 9. Infosys P/E Chart

Source: DataStream, Company Reports and Citi Investment Research Estimates

Figure 10. Satyam P/E Chart

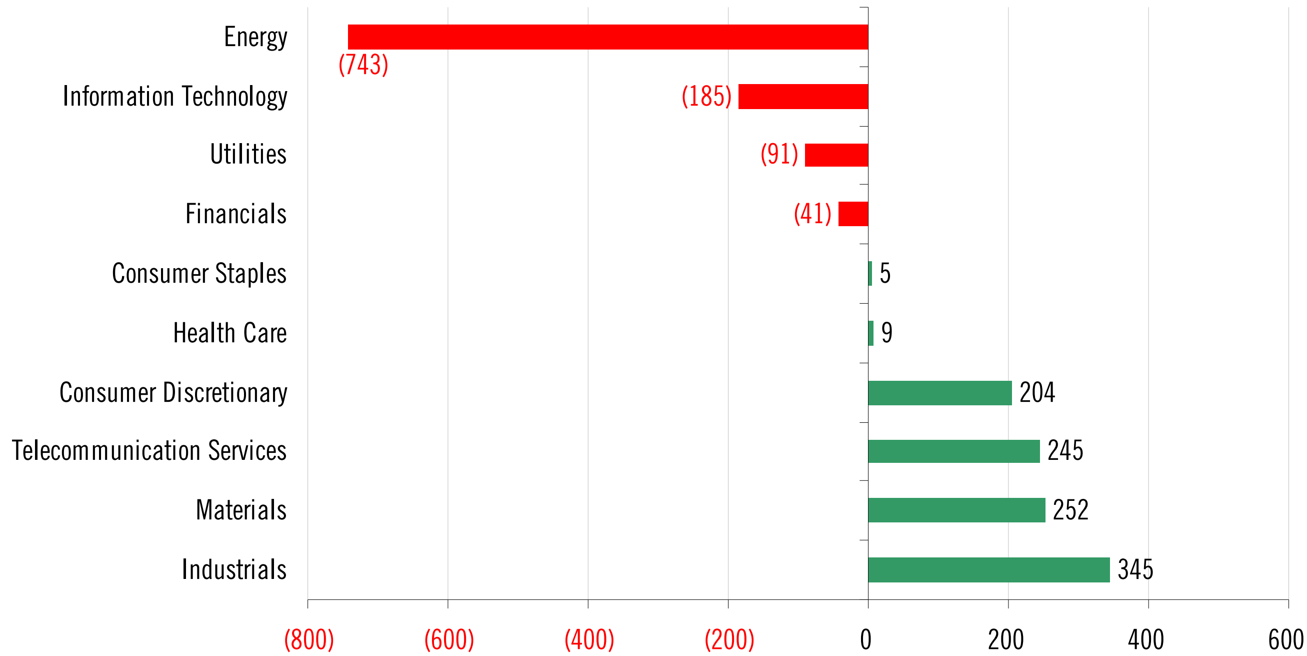
Source: DataStream, Company Reports and Citi Investment Research Estimates

Sector positioning in various portfolios

The following charts clearly highlight the underownership in the sector across all market participants such as FIIs, domestic mutual funds and insurance companies. The extent of underweight has gone up over the past few quarters.

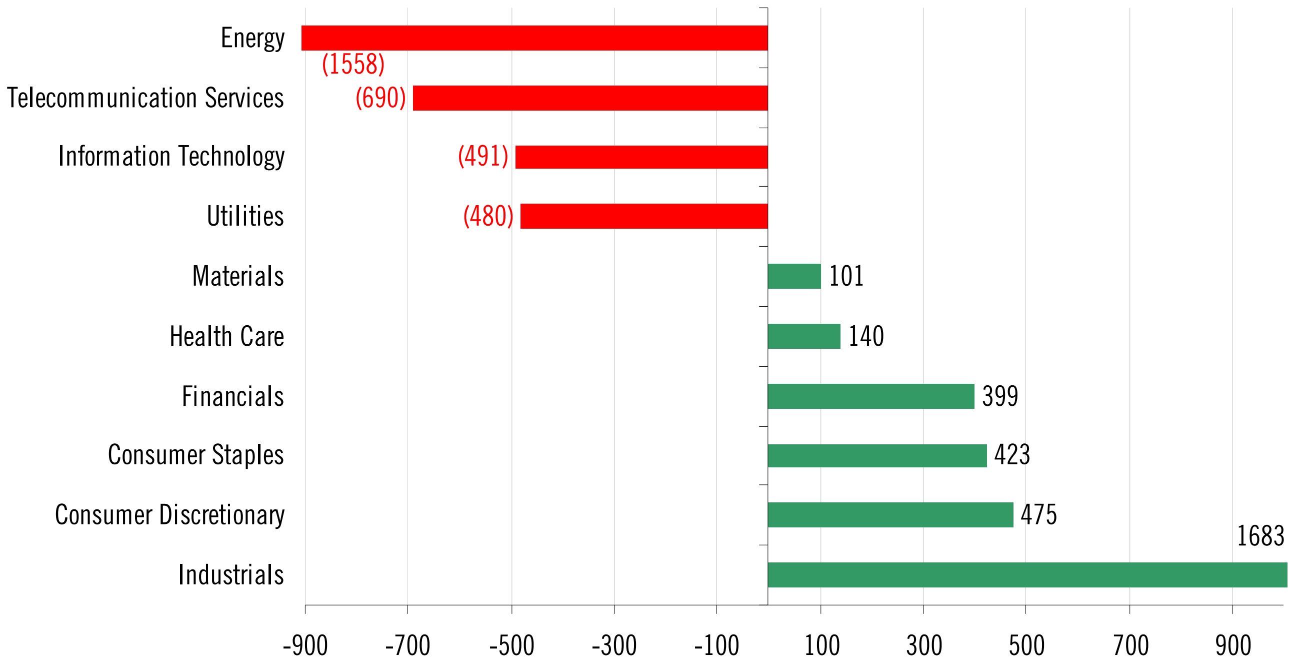
We expect underownership and relative historic valuation lows (vs. market) to drive sector performance going forward.

Figure 11. FII Ownership, Dec'07 (basis points)



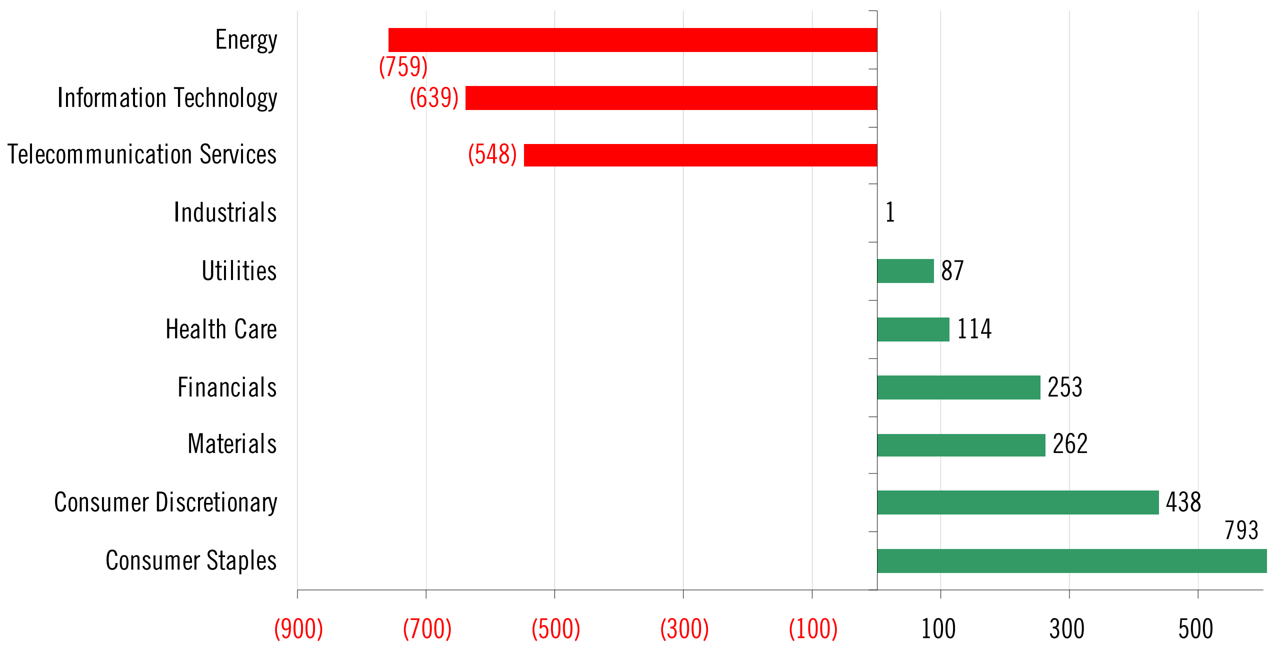
Source: BSE, MSCI

Figure 12. Domestic Mutual Fund Ownership, Dec'07 (basis points)



Source: BSE, MSCI

Figure 13. Insurance Ownership, Dec'07 (basis points)



Source: BSE, MSCI

What does DCF analysis suggest?

Our DCF analysis still suggests meaningful upsides in most of the Tier 1 stocks despite our changed assumptions in terms of pricing, hiring and wage hikes for FY09. Please see figure 14 for our DCF values for Tier 1 stocks.

Figure 14. Key DCF Assumptions

	Infosys	TCS	Wipro	Satyam	HCL Tech
Key forecasts					
Revenue CAGR FY07-FY17 (US$)	21.5%	21.2%	23.3%	22.9%	21.1%
Revenue CAGR FY07-FY17 (Rs.)	17.8%	17.6%	19.5%	19.1%	17.9%
EBIT margin decline from FY07	-4.4%	-3.6%	-5.2%	-6.4%	-3.6%
Tax rate in FY2010	21.2%	20.4%	18.0%	20.5%	20.7%
Terminal growth rate	5.0%	4.5%	4.5%	4.5%	4.0%
Discounting Assumptions					
Cost of capital	12.3%	12.1%	13.0%	12.6%	13.0%
Target Debt/Equity	0.0%	0.0%	0.0%	0.0%	0.0%
Cost of Equity	12.3%	12.1%	13.0%	12.6%	13.0%
Risk free rate	7.5%	7.5%	7.5%	7.5%	7.5%
Equity risk premium	6.5%	6.5%	6.5%	6.5%	6.5%
Beta - Bloomberg	0.735	0.712	0.844	0.778	0.845
Discounted Cash Flow Value					
DCF value	1,931	1,153	462	500	341

Source: Bloomberg, Citi Investment Research

Cutting estimates and target prices

We have cut our estimates for our Tier 1 IT services coverage for FY09 and FY10 by 2-5% as we take a more conservative view on the growth outlook in the US (and also Europe). The key changes that we have made are:

- We now assume flat pricing (at 4QFY08) levels for FY09. We had earlier built in 0.5-1% revenue/employee improvement in all quarters of FY09. We believe this is conservative considering that companies like Infosys, Satyam and HCL Tech have had 5-8% yoy increase in revenue/employee despite pricing improving by not more than 2% yoy.

- We have tweaked our headcount addition numbers for FY09. In most cases, our headcount addition in FY09 is flat to lower compared to FY08.

- We have marginally reduced our wage hike expectation to account for the relatively low hiring in the sector. For example, if we expected a 10% blended offshore wage hike earlier, we have now reduced that number to 8%.

We have made the following changes to our target multiples:

- In light of Citi's US/Global economy forecast downgrades, we have trimmed our target multiples for companies in the sector. Our new target multiple for Infosys is 21x (~10% lower than our earlier multiple of 23x). Our target multiples for TCS, Wipro and Satyam are based on ~10%, ~10% and ~15% discount to our target multiple for Infosys.

- For other stocks, we use Satyam as the benchmark. We have increased the discount to Satyam in most cases as we believe that Tier 2 companies will face more challenges in a difficult macro environment.

- We are also rolling forward our target prices to the average of FY09E and FY10E EPS (from FY09E EPS earlier). We have not rolled forward to FY10E given the challenging business environment and resulting lower visibility.

Please find the summary table of our estimate changes below. The impact on Tier 2 companies is higher as the leverage to pricing change is higher for them.

Figure 15. Earnings Revision Table

		Estimates	Net Profit (Rs m)			EPS (Rs.)			EPS Change			Dividend (Rs.)		
			FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E
Infosys	INFY.BO	New	46,339	54,207	58,278	80.82	94.54	101.64	0.0%	-2.0%	-4.1%	15.0	20.0	24.0
		Prev.	46,339	55,310	60,746	80.82	96.47	105.95				15.0	20.0	24.0
TCS	TCS.BO	New	50,817	57,077	63,031	51.93	58.33	64.41	-1.5%	-5.0%	-4.5%	14.0	16.0	18.0
		Prev.	51,602	60,085	66,003	52.73	61.40	67.45				14.0	16.0	18.0
Wipro	WIPR.BO	New	32,201	38,765	42,860	22.12	26.63	29.44	-2.8%	-5.6%	-3.5%	7.0	8.0	10.0
		Prev.	33,171	41,101	44,482	22.76	28.20	30.52				7.0	8.0	10.0
Satyam	SATY.BO	New	17,066	19,991	21,242	24.92	29.20	31.02	1.0%	-2.0%	-3.9%	7.0	10.0	12.0
		Prev.	16,906	20,410	22,101	24.69	29.80	32.27				7.0	10.0	12.0
HCL Tech	HCLT.BO	New	12,518	13,849	15,045	18.35	20.30	22.06	1.5%	-4.7%	-4.6%	8.0	8.0	8.0
		Prev.	12,309	14,509	15,743	18.07	21.30	23.12				8.0	8.0	8.0
Tech Mahindra	TEML.BO	New	7,765	9,345	9,814	59.28	71.43	75.00	0.5%	-8.8%	-17.6%	2.0	3.0	4.0
		Prev.	7,725	10,254	11,918	58.97	78.36	91.08				2.0	3.0	4.0
I-Flex	IFLX.BO	New	3,545	4,499	5,277	42.27	53.66	62.93	11.2%	-7.8%	-21.0%	0.0	0.0	0.0
		Prev.	3,182	4,871	6,674	38.01	58.18	79.70				0.0	0.0	0.0
Patni*	PTNI.BO	New	4,652	4,047	4,015	33.06	30.32	30.07	0.4%	-10.2%	-16.9%	3.0	5.0	5.0
		Prev.	4,609	4,726	5,064	32.93	33.77	36.18				3.5	5.0	5.0
Mphasis	MBFL.BO	New	2,599	3,695	4,577	12.35	17.57	21.76	0.5%	-2.5%	-6.0%	3.0	3.0	3.0
		Prev.	2,588	3,794	4,874	12.30	18.02	23.15				3.0	3.0	3.0
MindTree	MINT.BO	New	1,046	1,191	1,289	26.82	30.60	33.10	6.1%	-7.6%	-9.3%	2.5	3.0	4.0
		Prev.	987	1,293	1,426	25.27	33.12	36.51				2.5	3.0	4.0
Hexaware*	HEXT.BO	New	1,136	1,240	1,359	7.91	8.64	9.46	0.0%	-8.1%	-13.2%	1.8	2.4	2.8
		Prev.	1,136	1,349	1,565	7.91	9.40	10.89				1.8	2.4	2.8
Sasken	SKCT.BO	New	369	417	457	12.93	14.62	16.00	-23.1%	-35.4%	-43.4%	1.0	2.0	2.0
		Prev.	485	653	816	16.82	22.64	28.26				5.0	10.0	10.0
KPIT	KPIT.BO	New	555	687	780	7.02	8.66	9.83	0.1%	-6.7%	-5.5%	0.5	0.8	0.8
		Prev.	557	745	834	7.01	9.28	10.40				0.5	0.8	0.8

Source: Citi Investment Research * December ending companies (FY08E means CY07 and so on)

Figure 16. Citi Estimates vs Consensus

	FY09E			FY10E		
Company	CIR EPS	Cons EPS	Difference	CIR EPS	Cons EPS	Difference
TCS	58.3	61.6	-5.3%	64.4	68.0	-5.3%
Infosys	94.5	96.6	-2.1%	101.6	107.3	-5.2%
Wipro	26.6	27.2	-2.1%	29.4	30.0	-1.9%
Satyam	29.2	30.4	-4.1%	31.0	33.4	-7.2%
HCL Tech	20.3	22.4	-9.4%	22.1	24.3	-9.4%
i-flex Solutions	53.7	53.7	-0.1%	62.9	56.7	10.9%
Tech Mahindra	71.4	76.3	-6.4%	75.0	85.2	-11.9%
Patni	30.3	31.1	-2.6%	30.1	33.9	-11.2%
Mphasis	17.6	17.7	-0.7%	21.8	20.4	6.5%
MindTree	30.6	30.9	-1.1%	33.1	34.9	-5.1%
Hexaware	8.6	10.3	-15.8%	9.5	11.8	-19.6%
Sasken	14.6	20.3	-28.1%	16.0	27.1	-41.0%
KPIT Cummins	8.7	10.0	-12.8%	9.8	10.9	-10.3%

Source: Citi Investment Research, Bloomberg

Prefer Tier 1: Satyam, TCS and Infosys top picks

We continue with our bias towards relatively defensive Tier 1 stocks. Satyam (with strong topline momentum), TCS (decent growth with reasonable valuations) and Infosys (best cost optimization ability) are our top picks in the sector. We also like Mphasis (strong growth momentum with stable margins) and Patni (very cheap valuations with buyback being a positive trigger) in our mid-cap IT Services coverage.

Figure 17. Indian IT Services – Valuation Comparison Table

Company	RIC Code	Rating	Mkt cap (US$m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		EV/Sales(x)		P/BV (x)	
						FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
TCS	TCS.BO	1M	21,336	865	1,165	16.7	14.8	13.7	12.1	3.6	3.1	6.7	5.1
Infosys	INFY.BO	1M	22,255	1,545	2,060	19.1	16.3	15.9	13.0	5.0	4.1	5.9	4.6
Wipro	WIPR.BO	1M	15,528	422	535	19.1	15.8	14.4	11.3	2.9	2.3	5.1	4.2
Satyam	SATY.BO	1M	7,109	421	540	16.9	14.4	13.4	11.5	2.9	2.3	4.0	3.4
HCL Tech	HCLT.BO	1M	4,177	249	340	13.6	12.3	9.6	8.3	1.9	1.6	2.8	2.5
I-Flex	IFLX.BO	3M	2,118	1,003	1,110	23.7	18.7	17.0	12.8	3.2	2.6	3.1	2.6
Tech Mahindra	TEML.BO	3H	2,051	671	730	11.3	9.4	10.4	8.3	2.1	1.8	4.9	3.2
Mphasis	MBFL.BO	1M	1,293	246	355	19.9	14.0	11.3	8.3	2.0	1.4	4.3	3.4
Patni*	PTNI.BO	1H	855	244	390	7.4	7.2	3.6	3.6	0.7	0.7	1.3	1.1
MindTree	MINT.BO	3H	319	334	380	12.4	10.9	9.1	7.3	1.6	1.3	2.4	2.0
Hexaware*	HEXT.BO	1M	228	63	90	8.0	7.3	4.3	3.9	0.5	0.5	1.1	1.0
KPIT	KPIT.BO	1M	146	74	111	10.6	8.6	6.8	5.7	1.1	0.9	2.1	1.7
Sasken	SKCT.BO	3H	87	121	138	9.4	8.3	2.5	2.2	0.3	0.2	0.8	0.7

Source: Company Reports and Citi Investment Research Estimates; * December ending companies (hence FY08E means CY07 and so on)

Company Focus

Mphasis (MBFL.BO)

Buy: Decent 3Q; Remains Our Top Mid-cap Pick

Rating change ☑
Target price change ☑
Estimate change ☑

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (12 Feb 08)	Rs245.80
Target price	Rs355.00
from Rs360.00	
Expected share price return	44.4%
Expected dividend yield	1.2%
Expected total return	**45.6%**
Market Cap	Rs51,274M
	US$1,293M

Price Performance (RIC: MBFL.BO, BB: MPHL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,499	9.25	16.9	26.6	6.0	23.0	1.2
2007A	1,801	8.63	-6.7	28.5	5.1	21.6	1.2
2008E	2,599	12.35	43.1	19.9	4.3	23.6	1.2
2009E	3,695	17.57	42.2	14.0	3.4	27.5	1.2
2010E	4,577	21.76	23.9	11.3	2.7	27.2	1.2

Source: Powered by dataCentral

- **Decent 3Q FY08** — Mphasis reported revenues of US$160m (+7.6% qoq, +56% yoy) and flat QoQ net profits of Rs663m. The results fell short of our estimate, but management described it as an investment quarter in which it built the bench for a ramp-up following recent order wins.

- **Order book of over US$1bn; expect strong revenue and earnings growth** — We expect strong revenue and earnings growth (39% and 36% CAGRs respectively in FY07-10E) for Mphasis, driven by strong offshoring from the EDS relationship. Pending order book at end-Dec 07 was well over US$1bn.

- **INR billing should take away large part of currency risk** — Mphasis has been in talks with EDS (52% of revenue) and other key clients for INR billing. This should mitigate the currency risk for Mphasis, as both revenue and costs would be in the same currency.

- **Hiring remains strong** — The company hired ~2,150 employees during the quarter (9% of quarter-ago base). Over CY07 the company hired more than 9,200 employees (+54% yoy), indicating a strong business pipeline. The company has guided for net hiring of 8,000 to 10,000 employees in CY08, with 3,000 fresh engineers likely to join IT services.

- **Trimming estimates and target price on US recession view** — We have cut our FY09E-FY10E earnings estimates for Mphasis by 3-6% to reflect our economics team's expectation of a US recession. We accordingly raise our risk rating to High from Medium and trim our target multiple to 18x average FY09E-10E EPS from 20x FY09E EPS. Our new target price for Mphasis is Rs355.

- **Our top mid-cap pick** — With the demand-side of the equation strong and Mphasis an important part of EDS's revival strategy, we expect strong top-line driven earnings growth for Mphasis. The stock remains our top pick in the mid-cap IT services space.

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	26.6	28.5	19.9	14.0	11.3
EV/EBITDA adjusted (x)	25.5	16.2	11.2	8.2	6.3
P/BV (x)	6.0	5.1	4.3	3.4	2.7
Dividend yield (%)	1.2	1.2	1.2	1.2	1.2
Per Share Data (Rs)					
EPS adjusted	9.25	8.63	12.35	17.57	21.76
EPS reported	9.25	8.63	12.35	17.57	21.76
BVPS	41.03	48.44	57.26	71.54	90.04
DPS	3.00	3.00	3.00	3.00	3.00
Profit & Loss (RsM)					
Net sales	9,401	17,606	24,562	34,493	46,884
Operating expenses	-7,952	-15,563	-21,592	-30,461	-41,522
EBIT	**1,449**	**2,043**	**2,970**	**4,033**	**5,362**
Net interest expense	17	75	101	150	232
Non-operating/exceptionals	77	-135	-257	100	120
Pre-tax profit	**1,543**	**1,983**	**2,814**	**4,283**	**5,714**
Tax	-44	-182	-216	-588	-1,137
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**1,499**	**1,801**	**2,599**	**3,695**	**4,577**
Adjusted earnings	1,499	1,801	2,599	3,695	4,577
Adjusted EBITDA	1,967	3,060	4,379	5,926	7,494
Growth Rates (%)					
Sales	22.8	87.3	39.5	40.4	35.9
EBIT adjusted	42.5	41.1	45.4	35.8	33.0
EBITDA adjusted	39.3	55.6	43.1	35.3	26.5
EPS adjusted	16.9	-6.7	43.1	42.2	23.9
Cash Flow (RsM)					
Operating cash flow	**1,217**	**1,419**	**3,915**	**4,141**	**5,228**
Depreciation/amortization	518	1,017	1,409	1,893	2,132
Net working capital	-706	-1,459	-248	-1,197	-1,129
Investing cash flow	**-698**	**-2,151**	**-3,032**	**-2,497**	**-2,899**
Capital expenditure	-775	-2,080	-2,832	-2,748	-3,251
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-485**	**1,636**	**-712**	**-717**	**-717**
Borrowings	-9	-8	18	0	0
Dividends paid	-555	-579	-716	-717	-717
Change in cash	**34**	**904**	**172**	**927**	**1,612**
Balance Sheet (RsM)					
Total assets	**8,117**	**13,029**	**15,809**	**19,482**	**24,666**
Cash & cash equivalent	989	1,893	2,069	2,995	4,607
Accounts receivable	2,117	4,210	4,924	6,347	8,023
Net fixed assets	1,455	2,518	3,942	4,796	5,916
Total liabilities	**1,511**	**2,944**	**3,860**	**4,555**	**5,879**
Accounts payable	0	0	0	0	0
Total Debt	37	28	46	46	46
Shareholders' funds	**6,606**	**10,085**	**11,949**	**14,927**	**18,787**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.9	17.4	17.8	17.2	16.0
ROE adjusted	23.0	21.6	23.6	27.5	27.2
ROIC adjusted	25.9	27.5	31.0	32.1	32.8
Net debt to equity	-14.4	-18.5	-16.9	-19.8	-24.3
Total debt to capital	0.6	0.3	0.4	0.3	0.2

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Company Focus

MindTree Consulting (MINT.BO)

Sell: Decent 3Q; Valuation Still at Premium to Mid-cap Peers

Target price change ☑
Estimate change ☑

Sell/High Risk	3H
Price (12 Feb 08)	Rs333.80
Target price	Rs380.00
from Rs487.00	
Expected share price return	13.8%
Expected dividend yield	0.7%
Expected total return	**14.6%**
Market Cap	Rs12,656M
	US$319M

Price Performance (RIC: MINT.BO, BB: MTCL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	538	17.20	190.6	19.4	7.6	69.1	0.0
2007A	878	27.00	57.0	12.4	2.9	31.1	0.6
2008E	1,046	26.82	-0.7	12.4	2.4	21.6	0.7
2009E	1,191	30.60	14.1	10.9	2.0	20.4	0.9
2010E	1,289	33.10	8.2	10.1	1.7	18.6	1.2

Source: Powered by dataCentral

- **Decent quarter** — MindTree reported revenues of Rs1.86bn (up 3% qoq) while EBIT margin improved ~50bp qoq to 12.5%. However, lower other income (forex losses on derivative contracts) and higher taxes led to lower profits of Rs208m (down 23% qoq).

- **Better pricing leads to margin expansion** — The company had a decent pricing increase of 5% qoq for on-site and 1% qoq for offshore during the quarter. This led to better-than-expected margins.

- **High offshore and strong INR remain a key risk** — MindTree has a large offshore share (85%+) and hence it is highly leveraged to INR appreciation – this remains a key risk in an appreciating INR environment.

- **Revenue growth not to flow fully into earnings growth** — We continue to forecast strong US$ revenue growth (~35% over FY07-10E) for MindTree; however, this is not likely to flow into EPS growth (~7% over FY07-10E). For 9MFY08, MindTree revenue grew 38% yoy, while net profit growth was just 5% yoy and EPS declined by 15% yoy.

- **Cutting estimates and target price; maintain Sell/High Risk** — In line with our sector thesis, we take a slightly more conservative view and cut our FY09 and FY10 EPS estimates by ~8-9%. Our implied target multiple falls to 12x average FY09E-10E EPS from 15x FY09E EPS, giving us a target price of Rs380. The reduced multiple accounts for the sector de-rating and our view of a slowing US economy.

- **Decent outlook; still at premium to other mid-caps** — After our EPS changes, MindTree trades at ~11x FY09E EPS.

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	19.4	12.4	12.4	10.9	10.1
EV/EBITDA adjusted (x)	16.6	10.4	8.0	6.7	5.8
P/BV (x)	7.6	2.9	2.4	2.0	1.7
Dividend yield (%)	0.0	0.6	0.7	0.9	1.2
Per Share Data (Rs)					
EPS adjusted	17.20	27.00	26.82	30.60	33.10
EPS reported	17.20	27.00	26.82	30.60	33.10
BVPS	43.86	115.35	140.38	168.39	197.80
DPS	0.00	2.00	2.50	3.00	4.00
Profit & Loss (RsM)					
Net sales	4,488	5,904	7,436	9,612	11,700
Operating expenses	-3,944	-5,063	-6,456	-8,370	-10,290
EBIT	**545**	**841**	**980**	**1,242**	**1,411**
Net interest expense	13	52	191	109	197
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**558**	**893**	**1,171**	**1,352**	**1,608**
Tax	-15	-15	-124	-160	-319
Extraord./Min.Int./Pref.div.	-4	0	0	0	0
Reported net income	**538**	**878**	**1,046**	**1,191**	**1,289**
Adjusted earnings	538	878	1,046	1,191	1,289
Adjusted EBITDA	776	1,085	1,328	1,662	1,873
Growth Rates (%)					
Sales	82.1	31.5	26.0	29.3	21.7
EBIT adjusted	281.0	54.5	16.5	26.8	13.6
EBITDA adjusted	206.6	39.8	22.4	25.2	12.7
EPS adjusted	190.6	57.0	-0.7	14.1	8.2
Cash Flow (RsM)					
Operating cash flow	**378**	**902**	**994**	**1,226**	**1,254**
Depreciation/amortization	232	244	349	420	462
Net working capital	-378	-123	-203	-277	-301
Investing cash flow	**-443**	**-2,107**	**-1,551**	**-765**	**-608**
Capital expenditure	-257	-555	-2,509	-875	-804
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**57**	**1,711**	**499**	**-131**	**-175**
Borrowings	-424	-478	586	0	0
Dividends paid	0	-78	-109	-131	-175
Change in cash	**-7**	**506**	**-59**	**329**	**471**
Balance Sheet (RsM)					
Total assets	**2,844**	**5,656**	**7,468**	**8,921**	**10,417**
Cash & cash equivalent	262	768	709	1,038	1,509
Accounts receivable	1,098	1,172	1,467	1,843	2,244
Net fixed assets	389	699	2,860	3,315	3,656
Total liabilities	**1,556**	**1,301**	**2,154**	**2,548**	**2,929**
Accounts payable	0	0	0	0	0
Total Debt	742	264	850	850	850
Shareholders' funds	**1,288**	**4,355**	**5,314**	**6,374**	**7,487**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.3	18.4	17.9	17.3	16.0
ROE adjusted	69.1	31.1	21.6	20.4	18.6
ROIC adjusted	51.5	57.1	30.1	24.6	21.5
Net debt to equity	37.3	-11.6	2.6	-3.0	-8.8
Total debt to capital	36.6	5.7	13.8	11.8	10.2

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Company Focus

Hexaware Technologies (HEXT.BO)

Buy: Compelling Valuations

Rating change ☑
Target price change ☑
Estimate change ☑

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (12 Feb 08)	Rs63.05
Target price	Rs90.00
from Rs122.00	
Expected share price return	42.7%
Expected dividend yield	2.9%
Expected total return	**45.6%**
Market Cap	Rs9,055M
	US$228M

Price Performance (RIC: HEXT.BO, BB: HEXW IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	913	7.50	49.1	8.4	2.2	29.7	1.0
2006A	1,242	9.02	20.2	7.0	1.4	26.2	2.5
2007E	1,136	7.91	-12.2	8.0	1.1	16.2	2.9
2008E	1,240	8.64	9.2	7.3	1.0	14.6	3.8
2009E	1,359	9.46	9.5	6.7	0.9	14.5	4.4

Source: Powered by dataCentral

- **Awaiting 4Q CY07 results** — Hexaware is set to report 4Q results on 21 February along with full-year audited results. For 4Q CY07, we expect revenue of Rs2.66bn (growth 4.5% qoq) and net profit of Rs253m (decline of 6% qoq). Key points will be how management has provided for forex losses from "potentially fraudulent transactions" and decisions on buybacks.

- **Business momentum recovering** — Hexaware hired 1,000+ employees in 3Q CY07 after two quarters of flattish hiring. New order bookings during 3Q of US$100m+ was also encouraging. This should lead to better business momentum, in our view.

- **Buyback should support stock price** — Buyback decision was deferred due to forex transactions. We expect Hexaware to announce buybacks along with its results. This could provide a possible trigger for the stock price.

- **Cutting estimates and target price; maintain Buy** — In line with our sector thesis, we take a slightly more conservative view and cut our CY08 and CY09 EPS estimates by ~8-13%. Our implied target multiple has declined to 10x average CY08E-09E EPS from 13x CY08E EPS, giving us a target price of Rs90.

- **Cheap valuations and decent outlook** — After lowering our EPS estimates, Hexaware trades at ~7.3x CY08E. In line with our new quant risk rating, we have raised our risk rating for Hexaware to High from Medium. We rate Hexaware Buy/High Risk. Key risks are higher than earlier indicated write-offs on forex transactions, delay in buyback and business deterioration.

Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	8.4	7.0	8.0	7.3	6.7
EV/EBITDA adjusted (x)	7.5	5.7	4.9	3.9	3.3
P/BV (x)	2.2	1.4	1.1	1.0	0.9
Dividend yield (%)	1.0	2.5	2.9	3.8	4.4
Per Share Data (Rs)					
EPS adjusted	7.50	9.02	7.91	8.64	9.46
EPS reported	7.50	9.02	7.91	8.64	9.46
BVPS	29.11	45.46	56.14	62.02	68.27
DPS	0.60	1.60	1.80	2.40	2.80
Profit & Loss (RsM)					
Net sales	6,787	8,482	10,467	12,099	14,186
Operating expenses	-5,913	-7,360	-9,389	-10,931	-12,822
EBIT	**874**	**1,122**	**1,078**	**1,168**	**1,364**
Net interest expense	139	241	258	264	270
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**1,012**	**1,363**	**1,336**	**1,432**	**1,634**
Tax	-100	-120	-201	-192	-275
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**913**	**1,242**	**1,136**	**1,240**	**1,359**
Adjusted earnings	913	1,242	1,136	1,240	1,359
Adjusted EBITDA	1,084	1,322	1,312	1,450	1,686
Growth Rates (%)					
Sales	24.3	25.0	23.4	15.6	17.3
EBIT adjusted	43.1	28.4	-3.9	8.3	16.7
EBITDA adjusted	40.5	22.0	-0.7	10.5	16.3
EPS adjusted	49.1	20.2	-12.2	9.2	9.5
Cash Flow (RsM)					
Operating cash flow	**537**	**1,032**	**980**	**878**	**1,058**
Depreciation/amortization	210	200	234	282	322
Net working capital	-485	-202	-78	-381	-353
Investing cash flow	**-173**	**-1,768**	**-724**	**-652**	**-795**
Capital expenditure	-173	-1,768	-724	-652	-795
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**40**	**2,962**	**-316**	**-132**	**-192**
Borrowings	10	-61	0	0	0
Dividends paid	-164	-247	-293	-396	-462
Change in cash	**403**	**2,227**	**-60**	**94**	**71**
Balance Sheet (RsM)					
Total assets	**4,713**	**9,211**	**10,155**	**11,084**	**12,357**
Cash & cash equivalent	1,187	3,414	3,355	3,449	3,519
Accounts receivable	1,836	2,063	2,294	2,652	3,109
Net fixed assets	933	2,501	2,991	3,361	3,834
Total liabilities	**1,239**	**1,712**	**2,093**	**2,178**	**2,554**
Accounts payable	0	0	0	0	0
Total Debt	62	0	0	0	0
Shareholders' funds	**3,474**	**7,500**	**8,062**	**8,906**	**9,803**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.0	15.6	12.5	12.0	11.9
ROE adjusted	29.7	26.2	16.2	14.6	14.5
ROIC adjusted	36.9	31.3	20.1	19.4	18.7
Net debt to equity	-32.4	-45.5	-41.6	-38.7	-35.9
Total debt to capital	1.7	0.0	0.0	0.0	0.0

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Powered by: dataCentral

Company Focus

KPIT Cummins Infosystems (KPIT.BO)

Buy: Better Pricing Key to Business Performance

Rating change ☑
Target price change ☑
Estimate change ☑

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (12 Feb 08)	Rs74.40
Target price	Rs111.00
from Rs130.00	
Expected share price return	49.2%
Expected dividend yield	0.7%
Expected total return	**49.9%**
Market Cap	Rs5,794M
	US$146M

Price Performance (RIC: KPIT.BO, BB: KPIT IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	326	3.66	7.0	20.3	3.8	26.3	0.5
2007A	505	5.47	49.5	13.6	2.8	29.6	0.5
2008E	555	7.02	28.4	10.6	2.1	23.8	0.7
2009E	687	8.66	23.4	8.6	1.7	23.0	1.0
2010E	780	9.83	13.5	7.6	1.4	21.3	1.0

Source: Powered by dataCentral

- **Weak 3Q results** — Quarterly revenue was Rs1.51bn, up 1.3% qoq and 29% yoy; in US$ terms, revenue was US$37m, up 4.3% qoq and 42% yoy. EBITDA margin at 15.7% and net profit at Rs141m were flat qoq. These results were below expectations and makes the company's FY08 guidance challenging.

- **Pricing increase key to meeting FY08 guidance** — The company has been able to raise its pricing by 10-15% for new clients and a significant number of existing clients. Management remains confident of pricing leverage kicking in from 4Q, helping the company to meet FY08 guidance. Our FY08 net profit estimate is significantly below the company's guidance (Rs630-680m).

- **Business performance better than other mid-cap peers** — For 9MFY08, KPIT revenue grew 42% yoy, led by strong volume growth of 35% and better price realization. This is better than most other mid-cap peers in the IT services space. Also, hiring over TTM is 33% of the base – indicating a good business pipeline.

- **Cutting estimates and target price; maintain Buy** — In line with our sector thesis, we take a slightly more conservative view and cut our FY09 and FY10 EPS estimates by 5-7%. We also, on a valuation basis, reduce the discount to Satyam to ~35% from ~25%, which results in an implied target multiple of 12x FY09E and FY10E EPS. Our new target price is Rs111.

- **Cheap valuations and decent outlook** — After our EPS revisions, KPIT trades at ~8.5x FY09E EPS. We have raised our risk rating for KPIT to High from Medium, in line with our quantitative risk rating system which tracks 260-day historical share price volatility.

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	20.3	13.6	10.6	8.6	7.6
EV/EBITDA adjusted (x)	12.9	8.8	6.5	5.2	4.1
P/BV (x)	3.8	2.8	2.1	1.7	1.4
Dividend yield (%)	0.5	0.5	0.7	1.0	1.0
Per Share Data (Rs)					
EPS adjusted	3.66	5.47	7.02	8.66	9.83
EPS reported	3.66	5.47	7.02	8.66	9.83
BVPS	19.67	26.62	34.68	42.73	51.98
DPS	0.35	0.35	0.50	0.75	0.75
Profit & Loss (RsM)					
Net sales	3,182	4,637	6,004	7,424	9,016
Operating expenses	-2,804	-4,043	-5,299	-6,566	-7,960
EBIT	**378**	**594**	**706**	**858**	**1,056**
Net interest expense	0	0	0	0	0
Non-operating/exceptionals	-19	-39	-73	-69	-45
Pre-tax profit	**359**	**555**	**632**	**789**	**1,010**
Tax	-33	-52	-78	-99	-226
Extraord./Min.Int./Pref.div.	0	2	0	-3	-4
Reported net income	**326**	**505**	**555**	**687**	**780**
Adjusted earnings	326	505	555	687	780
Adjusted EBITDA	462	715	943	1,126	1,343
Growth Rates (%)					
Sales	26.0	45.7	29.5	23.6	21.4
EBIT adjusted	24.9	57.3	18.8	21.6	23.0
EBITDA adjusted	38.1	54.9	31.8	19.4	19.2
EPS adjusted	7.0	49.5	28.4	23.4	13.5
Cash Flow (RsM)					
Operating cash flow	**-156**	**824**	**711**	**847**	**877**
Depreciation/amortization	84	121	237	268	287
Net working capital	-587	158	-155	-181	-240
Investing cash flow	**-519**	**-1,028**	**-476**	**-463**	**-525**
Capital expenditure	-500	-940	-402	-393	-479
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**540**	**416**	**-76**	**-363**	**-362**
Borrowings	505	348	-209	-300	-300
Dividends paid	-26	-30	-44	-66	-66
Change in cash	**-135**	**212**	**159**	**21**	**-9**
Balance Sheet (RsM)					
Total assets	**2,675**	**3,893**	**4,308**	**4,774**	**5,351**
Cash & cash equivalent	411	625	785	803	790
Accounts receivable	868	1,102	1,267	1,525	1,853
Net fixed assets	826	1,397	1,562	1,687	1,879
Total liabilities	**1,253**	**1,898**	**1,625**	**1,467**	**1,326**
Accounts payable	0	0	0	0	0
Total Debt	875	1,223	1,014	714	414
Shareholders' funds	**1,422**	**1,995**	**2,683**	**3,307**	**4,025**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.5	15.4	15.7	15.2	14.9
ROE adjusted	26.3	29.6	23.8	23.0	21.3
ROIC adjusted	24.8	24.4	23.1	25.1	24.4
Net debt to equity	32.6	30.0	8.6	-2.7	-9.3
Total debt to capital	38.1	38.0	27.4	17.8	9.3

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Mphasis

Company description

Mphasis Ltd (formerly Mphasis BFL Ltd.) is a mid-tier Indian IT services company headquartered in Bangalore, India. The company has a presence in IT services (primarily application development and maintenance) and BPO services. It serves global clients across financial services, retail, logistics and transportation verticals and had 80 million-dollar clients at end-FY07. Mphasis BFL was originally formed by the integration of BFL Software, Mphasis Corp and Msource. It later acquired Navion Shanghai Software (2003), Kshema Technologies (2004), Princeton Consulting (Feb 2005) and Eldorado Consulting (March 2005) over a few years after the tech slowdown in the US. Post majority stake acquisition in Mphasis and merger with EDS India, Electronic Data Systems Corporation (EDS) holds over 60% in Mphasis.

Investment strategy

We rate Mphasis as Buy/High Risk (1H) based on a fundamental 12-month view. Offshore IT outsourcing has now become a mainstream option. Scale and scalability offshore, in our view, remains the key criterion for success of MNC firms like IBM, Accenture, EDS, etc. Mphasis is in a sweet spot as the offshore arm of a global IT major, EDS, for whom getting its best shore strategy right is a key to success. The demand side of the business is near-guaranteed for Mphasis due to EDS' order backlog and new large deals it has signed. Supply-side scalability and execution record are also key factors. In our view, revenue and earnings growth should accelerate from here as offshore creditability of Mphasis is established. We expect a revenue CAGR of 39% and an EPS CAGR of 36% in FY07-10.

Valuation

Our target price of Rs355 is based on 18x average FY09-10E EPS. We believe P/E remains the most appropriate valuation measure given the company's profitable record and high earnings visibility. The 18x target multiple is closer to the lower end of the last one-year trading band of 16-30x one-year forward earnings post the EDS acquisition of a majority stake. This multiple factors in some premium for the likelihood of de-listing as EDS would like to own a larger share of its offshore base. We forecast a revenue CAGR of 39% and EPS CAGR of 36% over FY07-10E. This is at the higher end of our coverage universe, with some upside potential from further wins in the offshore application space for the EDS-Mphasis combination. Eventual de-listing from Indian exchanges could be a likely endgame for Mphasis, in our view.

Risks

Although our quantitative risk-rating system suggests Medium Risk for Mphasis, we rate it as High Risk given the risk ratings of similar IT peer-group companies in our coverage universe and greater global economic risks. Key risks that could impede the stock from reaching our target price include: (1) high client concentration; (2) a slowdown in the financial, retail, transportation & logistics industries; (3) a slowdown in the US/global economies; (4) supply-side situation becoming more difficult, i.e., wage inflation being higher than that factored in our model, or higher-than-expected attrition; (5) surprises in INR appreciation; (6) risk of transfer pricing; and (7) limited quota for H1B visas.

MindTree Consulting

Company description

MindTree is a mid-tier Indian IT services company providing offshore-based services to global organizations in BFSI, manufacturing, transportation and hi-tech industries. The company offers a range of services including IT and R&D services. In IT services, its offerings include application development, maintenance, package implementation, testing and infrastructure management services. The company has consciously stayed away from BPO services. In R&D services, the company offers product design, re-engineering, optimization and support.

Investment strategy

We rate MindTree Sell/High Risk. Although the stock has underperformed sharply after its listing, its current valuations still look fairly valued against the 7% EPS CAGR we forecast for FY07-10E. Strong offshoring demand and MindTree's process orientation will lead to a revenue CAGR of 35% (in US$ terms) in FY07-10, based on our estimates. But declining margins, higher tax rates, and ESOP- and IPO-related dilution would curtail the EPS CAGR. Large exposure to application development work (~55% of revenues) would expose MindTree to greater risk if demand from the US slowed. MindTree's exposure to newer services is relatively small.

Valuation

Our target price of Rs380 (12x average FY09E-10E EPS) is based on a ~35% discount to our 18x target multiple for Satyam, which is widely used as a benchmark for mid-tier IT stocks in India. Our discount reflects MindTree's smaller size, lesser diversified revenue mix and higher client concentration. We have increased the discount to Satyam to ~35% (from earlier 20%) to reflect our view that Tier II stocks will face more challenging times in a difficult business environment and that investor interest in Tier II stocks will be lower in such an environment. MindTree has a short trading history, hence we have compared it with our India IT coverage. Large-cap Indian IT companies (market cap of more than US$5bn) trade on 13x-20x 12 months forward EPS and mid-tier Indian IT companies on 8x-14x 12 months forward EPS. We believe a P/E-based valuation is appropriate to value MindTree given the company's earnings record and the widespread use of this methodology to value IT services companies.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share-price volatility, rates MindTree a default Speculative Risk because of the stock's short trading history. But we believe a High Risk is more appropriate as the company has strong cash flows and a solid balance sheet. This is also in-line with risk rating of similar size companies. Upside risks that could test our target price include: (1) large order wins; (2) better than expected pricing improvement; (3) inorganic activity at attractive valuations, (4) rupee depreciation leading to improved profitability for the offshore business; (5) acquisition of MindTree by a large MNC player; and (6) easing of the supply-side situation.

Hexaware Technologies

Company description

Hexaware was established in 1992 and began international operations in 1995. In February 2001, it merged with the software division of Aptech. The merged entity was later de-merged from the training arm of Aptech and listed as Hexaware Technologies. It offers BPO service through 100% subsidiary CaliberPoint. Hexaware has built its business by scaling up in niche areas such as ERP, airlines and BFSI. It employs over 5,500 people in its IT and BPO operations, and has more than 150 clients.

Investment strategy

We rate Hexaware as Buy/High Risk (1H). Offshore IT outsourcing has now become the norm, with scale IT services players as well as smaller companies with niche focus benefiting. Hexaware has carved a niche for itself in several small though scalable areas, and has targeted under-penetrated markets. Ties with PeopleSoft/Exult/Hewitt have helped Hexaware develop expertise in HR-IT, and relationships with Air Canada/Lufthansa have led the company to the broader travel and transportation vertical. Recent news flow on the macro environment and the company's forex deals have weighed on stock performance. We see value in the stock at current levels; we forecast a 16% revenue CAGR and a 9% EPS CAGR for Hexaware over 2007-09E.

Valuation

Our 12-month target price of Rs90 is based on 10x average CY08-09E EPS. Our target multiple is derived by using a ~45% discount to our target multiple of 18x for Satyam. We apply this discount as Satyam, which we use as a benchmark to value all mid-tier IT services companies, is a much larger and more diversified company. We have increased the discount to Satyam to ~45% (from 30% earlier) to reflect our view that Tier II stocks will face more challenging times in a difficult business environment and that investor interest in Tier II stocks will be lower in such an environment. We expect -9% EPS CAGR over CY07-09E and revenue CAGR of 22% in US$ terms. Also, a low valuation multiple could attract M&A interest. Moreover, the company is mulling buyback of its equity share - this should serve as support for valuations. We believe a P/E-based valuation is appropriate given Hexaware's earnings track record and the widespread use of this methodology.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, rates Hexaware Technologies as High Risk. Risks that could impede the stock from reaching our target price include: (1) high client concentration; (2) a slowdown in the financial and transportation industry; (3) a slowdown in the US/global economies; (4) losing edge to scale players; (5) supply-side situation becoming more difficult - wage inflation being higher than factored in our model; (6) upside surprises in currency appreciation; and (7) limited H1B visas.

KPIT Cummins Infosystems

Company description

KPIT Cummins Infosystems is a mid-tier IT services provider focused on two verticals: manufacturing services and BFSI (banking, financial services and insurance). Within these two verticals, the company is focused on a few key customers. Among service lines, in addition to regular application development and maintenance services, KPIT Cummins offers VLSI and embedded software services, package implementation, business intelligence, and BPO services. The company has close to 4,000 employees working for over 100 clients.

Investment strategy

We rate KPIT Cummins as Buy/High Risk (1H). With offshoring becoming mainstream, clients are increasingly using offshore for newer service areas like product engineering, embedded software, and engineering design services. KPIT Cummins has a head-start in the fast-growing embedded software and VLSI design services due to its Cummins and Renesas relationships. With client access to 7 of the top 10 auto OEMs, 13 leading tier 1 & 2 auto suppliers and five of top 10 semiconductor manufacturers, KPIT Cummins could become one of the top offshore vendors in auto electronics and semiconductor design - leading to 33% revenue and 34% earnings CAGRs over FY07-10E.

Valuation

Our 12-month target price is Rs111 based on 12x average FY09-10E EPS. Our target multiple is derived by applying a ~35% discount to our target multiple for peer Satyam. We apply this discount as Satyam is a large and diversified company, while KPIT is a niche-focused mid-tier IT player. We have increased the discount to Satyam to ~35% (from earlier 25%) to reflect our view that Tier II stocks will face more challenging times in a difficult business environment and that investor interest in Tier II stocks will be lower in such an environment. Our target multiple is also supported by an historical valuation range of 10-20x forward earnings (average 15x) for the KPIT stock over the past three years. We believe a P/E-based valuation is most appropriate given KPIT's profitable track record and widespread investor use of this metric.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, rates KPIT Cummins as High Risk. Risks that could impede the stock from reaching our target price include: (1) high client concentration; (2) a slowdown in the auto-electronics industry; (3) a slowdown in the US/global economies; (4) technology obsolescence; (5) supply-side situation becoming more difficult - wage inflation being higher than that factored in our model; (6) currency appreciation more than that factored in our model; and (7) limited H1B visas.

Appendix A-1

Analyst Certification

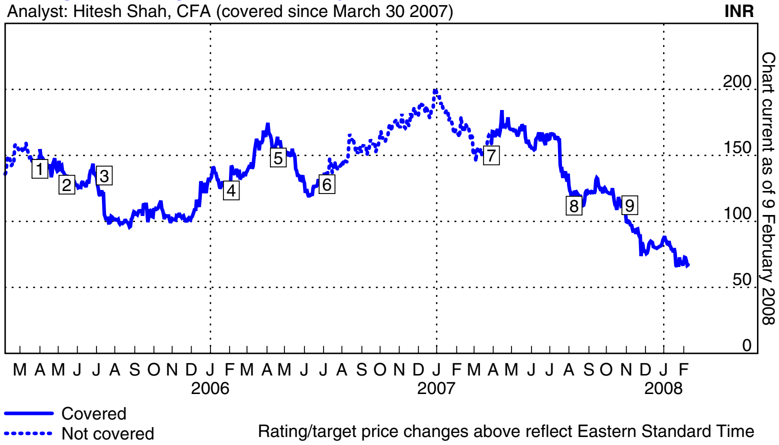
Each research analyst(s), strategist(s) or research associate(s) responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst, strategist or research associate covers in this research report, all of the views expressed by that research analyst, strategist or research associate in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s), strategist(s) or research associate(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst, strategist or research associate in this research report.

IMPORTANT DISCLOSURES

Hexaware Technologies (HEXT.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Hitesh Shah, CFA (covered since March 30 2007)



Rating/target price changes above reflect Eastern Standard Time

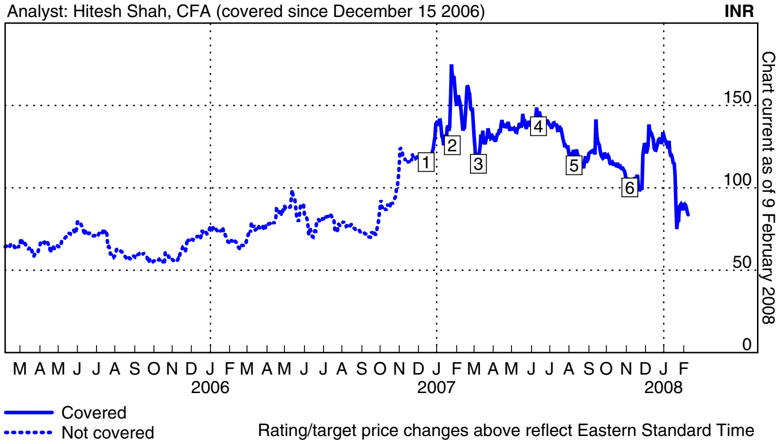
#	Date	Rating	Target Price	Closing Price
1:	1 Apr 05	1M	176.00	154.73
2:	16 May 05	1M	*160.00	135.15
3:	14 Jul 05	*3H	*100.00	105.20
4:	3 Feb 06	*2M	*140.00	142.25
5:	20 Apr 06	*3M	*150.00	159.20
6:	7 Jul 06	Coverage suspended		
7:	29 Mar 07	*1M	*214.00	159.00
8:	9 Aug 07	1M	*155.00	122.25
9:	7 Nov 07	1M	*122.00	98.80

*Indicates change.

KPIT Cummins Infosystems (KPIT.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Hitesh Shah, CFA (covered since December 15 2006)



Rating/target price changes above reflect Eastern Standard Time

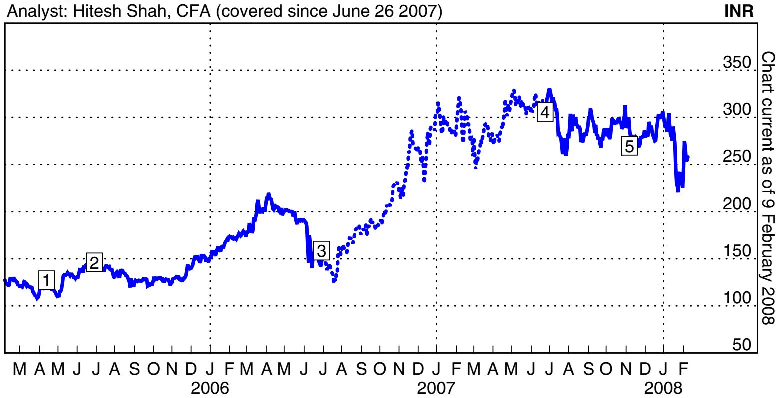
#	Date	Rating	Target Price	Closing Price
1:	14 Dec 06	1M	140.00	117.75
2:	25 Jan 07	*3M	*173.00	167.85
3:	8 Mar 07	*1M	173.00	120.00
4:	13 Jun 07	1M	*180.00	140.60
5:	9 Aug 07	1M	*154.00	120.35
6:	7 Nov 07	1M	*130.00	103.05

*Indicates change.

Mphasis (MBFL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Hitesh Shah, CFA (covered since June 26 2007)



#	Date	Rating	Target Price	Closing Price
1:	13 Apr 05	*2M	*145.00	127.25
2:	29 Jun 05	2M	*155.00	141.85
3:	29 Jun 06	Coverage suspended		
4:	25 Jun 07	*1M	*400.00	305.80
5:	7 Nov 07	1M	*360.00	286.50

*Indicates change.

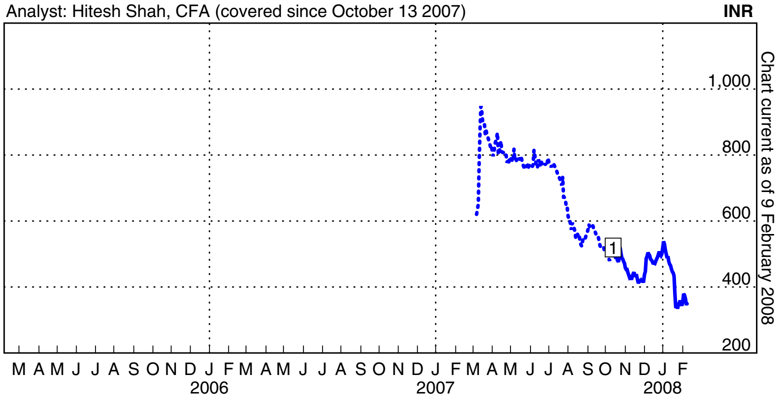
Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

MindTree Consulting (MINT.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Hitesh Shah, CFA (covered since October 13 2007)



#	Date	Rating	Target Price	Closing Price
1:	12 Oct 07	3H	487.00	492.20

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 December 2007	**Buy**	**Hold**	**Sell**
Citi Investment Research Global Fundamental Coverage (3421)	50%	37%	12%
% of companies in each rating category that are investment banking clients	52%	53%	40%

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