

# Indian IT Services

 Equity 

## 2QFY10 Preview – Focus on the Pace of Recovery

- **Previewing a better quarter** — We expect some uptick in revenue growth, with tier-I companies reporting ~2-3.5% sequential growth in revenues. Margins are expected to be largely stable (except Infosys, if the guided investments happen). Focus will be on management commentary given the sharp rally in stock prices YTD, which already prices in fair amount of growth, in our view.
- **Expect Infosys to deliver relatively better growth** — We expect Infosys to grow ~3.5% qoq, the highest within the tier-I universe. However, expectations remain high following comments in the press by the head of HR that utilisation has moved up. TCS growth should be relatively subdued (~2% qoq) post a strong 1Q, where it reported ~3% sequential growth.
- **Infosys guidance – focus on 3Q/4Q implied growth** — Infosys will likely raise FY10 guidance, given the expected beat in 2Q. However, the focus will likely be on the implied growth for 3Q/4Q in the guidance – markets are factoring in a return to growth and any disappointment could be a negative for the stock/sector.
- **Other company specific issues** — (1) Tech Mahindra's reported revenues should again be strong due to cross-currency gains; however, we expect pain in the core business to continue. (2) Wipro will likely have a profit decline given that 1Q benefited from ECB-related forex gains. (3) MindTree should deliver a decent quarter with ~4% sequential growth.
- **Will the industry grow 15% in FY11?** — With recovery already priced in, the big question remains what pace will the industry grow at in FY11? At our recent Global Tech Conference, tier-I managements indicated medium-term growth of ~10-20%. If data points do not support a growth of 15% for FY11, it could result in some disappointment, in our view.
- **Valuations vs. earnings upgrade cycle** — The sector has had a big run, with earnings upgrades starting to happen. Quantum of EPS upgrades will likely remain the key driver for stock price performance over the medium term. TCS and Wipro remain our preferred stocks in the sector.

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

Figure 1. 2QFY10 Results Preview – Part I

Infosys	Sep'08	Jun'09	Sep'09E	QoQ	YoY	Key things to watch for
Revenue (US\$ m)	1,216	1,122	1,162	3.5%	-4.5%	<ul style="list-style-type: none"> <li>■ Sequentially, we expect ~3.5% revenue growth (\$-terms), with ~60bps decline in margins due to currency headwinds/investments in various initiatives</li> <li>■ Implies ~2-2.5% growth in revenues in constant currency terms as against flattish guidance</li> <li>■ Key things to watch - Q3/FY10 guidance and outlook on pricing/volumes</li> </ul>
Revenue (Rs m)	54,180	54,720	55,753	1.9%	2.9%	
EBITDA (Rs m)	17,940	18,680	18,671	-0.1%	4.1%	
EBITDA margin (%)	33.1%	34.1%	33.5%	-65bp	38bp	
Net Profit (Rs m)	14,320	15,270	15,244	-0.2%	6.5%	
<b>TCS</b>						
Revenue (US\$ m)	1,574	1,480	1,508	1.9%	-4.2%	<ul style="list-style-type: none"> <li>■ Expect revenue growth of ~1.9% in \$-terms and flattish margins</li> <li>■ Net profit expected to decline ~4% QoQ due to higher tax rate</li> <li>■ Forex losses expected to be ~Rs700m</li> <li>■ Key things to watch - outlook on pricing/volumes</li> </ul>
Revenue (Rs m)	69,534	72,070	72,377	0.4%	4.1%	
EBIT (Rs m)	16,848	17,892	17,942	0.3%	6.5%	
EBIT margin (%)	24.2%	24.8%	24.8%	-4bp	56bp	
Net Profit (Rs m)	12,615	15,203	14,629	-3.8%	16.0%	
<b>Wipro - Global IT</b>						
Revenue (US\$ m)	1,324	1,179	1,246	5.7%	-5.9%	<ul style="list-style-type: none"> <li>■ For Global IT, we expect ~6% revenue growth in \$-terms with ~20bps decline in margins</li> <li>■ In the IT services business, we are building in revenues of \$1,059m (guidance: \$1,035-1,053m)</li> <li>■ At the company level, we expect EBIT margins to be down ~40bps - net profits lower as last quarter benefited from forex gains on ECB</li> <li>■ Key thing to watch - outlook of technology business; comments on pricing/volumes</li> </ul>
Revenue (Rs m)	56,479	55,105	57,927	5.1%	2.6%	
EBIT (Rs m)	9,792	10,629	11,086	4.3%	13.2%	
EBIT margin (%)	17.3%	19.3%	19.1%	-15bp	180bp	
<b>Wipro - Consolidated</b>						
Revenue (Rs m)	64,095	63,188	64,728	2.4%	1.0%	<ul style="list-style-type: none"> <li>■ Key thing to watch - outlook of technology business; comments on pricing/volumes</li> </ul>
EBIT (Rs m)	10,167	10,903	10,895	-0.1%	7.2%	
EBIT margin (%)	15.9%	17.3%	16.8%	-42bp	97bp	
Net Profit (Rs m)	8,222	10,676	9,777	-8.4%	18.9%	
<b>HCL Tech</b>						
Revenue (US\$ m)	505	607	628	3.4%	24.4%	<ul style="list-style-type: none"> <li>■ Expect revenue growth of ~3.4% in \$-term revenues QoQ</li> <li>■ Expect margins to be flattish sequentially</li> <li>■ Key things to watch - outlook for pricing/volumes</li> </ul>
Revenue (Rs m)	23,693	29,085	30,023	3.2%	26.7%	
EBITDA (Rs m)	5,311	6,441	6,631	2.9%	24.8%	
EBITDA margin (%)	22.4%	22.1%	22.1%	-6bp	-33bp	
Net Profit (Rs m)	3,375	3,091	2,954	-4.4%	-12.5%	

Source: Company reports, Citi Investment Research and Analysis

Figure 2. 2QFY10 Results Preview – Part II

Tech Mahindra	Sep'08	Jun'09	Sep'09E	QoQ	YoY	Key things to watch for
Revenue (US\$ m)	270	228	241	5.8%	-10.6%	<ul style="list-style-type: none"> <li>■ Expect revenue increase of ~6% in \$-terms on cross currency tailwinds (~65-70% of revenues GBP denominated)</li> <li>■ We expect flattish margins sequentially</li> <li>■ Key things to watch - outlook on BT/AT&amp;T (the biggest clients); progress on the BTGS deal; update on Mahindra Satyam</li> </ul>
Revenue (Rs m)	11,648	11,130	11,568	3.9%	-0.7%	
EBITDA (Rs m)	3,261	2,805	2,909	3.7%	-10.8%	
EBITDA margin (%)	28.0%	25.2%	25.1%	-5bp	-285bp	
Net Profit (Rs m)	3,026	1,316	1,737	32.0%	-42.6%	
<b>Patni</b>						
Revenue (US\$ m)	183	162	164	1.4%	-10.5%	<ul style="list-style-type: none"> <li>■ Expect ~1.4% revenue growth QoQ in \$-terms with margin decline of ~50bps</li> <li>■ Net profits expected to decline ~13% qoq due to higher other income in the previous quarter</li> <li>■ Key things to watch - Q3 guidance and outlook on growth</li> </ul>
Revenue (Rs m)	8,523	7,729	7,882	2.0%	-7.5%	
EBITDA (Rs m)	1,515	1,647	1,640	-0.4%	8.2%	
EBITDA margin (%)	17.8%	21.3%	20.8%	-50bp	303bp	
Net Profit (Rs m)	2,002	1,365	1,185	-13.2%	-40.8%	
<b>MindTree</b>						
Revenue (US\$ m)	72.0	62.1	64.6	4.0%	-10.3%	<ul style="list-style-type: none"> <li>■ Expect revenue growth of ~4% sequentially; margins expected to expand by ~200bp qoq</li> <li>■ Key things to watch - updates to FY10 guidance; comments on volumes/pricing</li> </ul>
Revenue (Rs m)	3,120	3,048	3,099	1.7%	-0.7%	
EBITDA (Rs m)	867	507	576	13.6%	-33.6%	
EBITDA margin (%)	27.8%	16.6%	18.6%	195bp	-919bp	
Net Profit (Rs m)	373	567	332	-41.6%	-11.0%	
<b>NIIT Ltd</b>						
Revenue (US\$ m)	69.5	53.5	70.3	31.3%	1.2%	<ul style="list-style-type: none"> <li>■ Expect revenue growth of ~7% YoY (rupee terms)</li> <li>■ We expect ~13% revenue and ~12% operating profit growth in individual business</li> <li>■ Key thing to watch - outlook for individual/corporate/schools/new businesses</li> </ul>
Revenue (Rs m)	3,095	2,610	3,304	26.6%	6.7%	
EBITDA (Rs m)	406	285	517	81.6%	27.5%	
EBITDA margin (%)	13.1%	10.9%	15.7%	474bp	255bp	
Net Profit (Rs m)	297	98	271	176.3%	-8.8%	
<b>Educomp Solutions</b>						
Revenue (Rs m)	981	1,480	1,788	20.8%	82.2%	<ul style="list-style-type: none"> <li>■ Growth momentum to continue - expect 80%+ YoY growth in revenues</li> <li>■ EBITDA margins expected to decline by ~950bps YoY but improve by ~400bps QoQ</li> <li>■ Key thing to watch - outlook on K-12 business; school wins in Smart Class/ICT segments, capex plans for FY10/11E</li> </ul>
EBITDA (Rs m)	628	746	975	30.7%	55.2%	
EBITDA margin (%)	64.0%	50.4%	54.5%	413bp	-948bp	
Net Profit (Rs m)	254	363	576	58.9%	126.9%	

Source: Company reports, Citi Investment Research and Analysis

Figure 3. Price Performance

		Market Cap \$ m	Price 01-Oct-09	Performance						
				1W	1M	2M	3M	6M	12M	YTD
Infosys	INFY.BO	27,699	2,307	1.0%	7.7%	11.8%	28.4%	67.7%	58.7%	106.4%
TCS	TCS.BO	25,339	618	3.1%	17.4%	17.4%	57.5%	127.1%	84.2%	158.5%
Wipro	WIPR.BO	18,338	597	3.1%	6.8%	21.7%	57.7%	137.3%	71.0%	155.6%
HCL Technologies	HCLT.BO	4,773	339	-1.8%	14.2%	41.2%	78.8%	236.6%	65.0%	194.7%
Tech Mahindra	TEML.BO	2,394	937	4.8%	-3.6%	10.4%	25.4%	243.0%	48.3%	278.2%
Patni	PTNI.BO	1,211	451	7.5%	8.4%	24.6%	73.7%	252.4%	136.1%	249.8%
MindTree Ltd	MINT.BO	505	616	4.8%	21.0%	32.7%	32.2%	185.1%	104.1%	160.0%
Educomp	EDSO.BO	1,841	4,640	3.4%	12.2%	13.0%	9.4%	110.2%	39.2%	93.0%
NIIT Ltd	NIIT.BO	244	71	2.4%	3.7%	16.8%	0.2%	222.4%	40.8%	165.9%
Moser Baer	MOSR.BO	340	96	-0.8%	8.4%	8.2%	8.6%	77.8%	-14.1%	36.4%
Mahindra Satyam	SATY.BO	2,913	118	1.4%	-4.0%	13.2%	60.8%	198.4%	-62.9%	-30.5%
Oracle Financial	ORCL.BO	3,194	1,820	3.0%	3.9%	17.9%	48.2%	131.6%	136.0%	297.1%
Mphasis Ltd	MBFL.BO	2,913	664	3.2%	14.9%	38.6%	79.5%	226.4%	258.7%	324.4%
Hexaware	HEXT.BO	241	80	7.1%	-3.8%	14.4%	68.3%	195.0%	155.5%	281.4%
KPIT Cummins	KPIT.BO	126	77	2.0%	-4.7%	44.9%	55.4%	189.5%	122.2%	183.1%
Rolta	ROLT.BO	597	177	1.0%	2.8%	13.0%	37.4%	189.0%	-27.8%	52.6%
Infotech Enterprises	INFE.BO	310	268	6.4%	7.5%	16.4%	49.0%	207.5%	31.4%	157.2%
HCL Infosystems	HCLI.BO	549	153	-2.2%	2.2%	28.9%	32.1%	99.4%	47.3%	69.0%
BSE Sensex	.BSESN	-	17,094	1.9%	9.9%	9.1%	16.7%	72.6%	30.9%	77.2%
BSE IT Index	.BSEIT	-	4,561	1.6%	8.8%	15.1%	37.5%	93.4%	41.7%	104.7%

Source: Powered by dataCentral. dataCentral is the CIRA's proprietary database, which includes Citi estimates, data from company reports, and feeds from Reuters, Datastream, Firstcall, IBES and Toyo Keizai.

Figure 4. Currency Movements

	1QFY10	2QFY10	Change (diff)	Change (%)
<b>USD / INR</b>				
Period end	47.75	47.74	0.02	0.0%
Average	48.66	48.28	0.38	-0.8%
<b>GBP / USD</b>				
Period end	1.65	1.60	0.05	-2.8%
Average	1.55	1.64	-0.09	5.7%
<b>EUR / USD</b>				
Period end	1.40	1.46	-0.06	4.3%
Average	1.36	1.43	-0.07	4.9%

Source: Powered by dataCentral

Figure 5. Hedge Position (at the end of Jun'09)

	Forex Cover (\$ m)			Revenue - Jun'09 (\$ m)	Hedge (% of quarterly revenue)
	Forwards	Options	Total		
Infosys	413	187	600	1,122	53%
TCS	553	1,568	2,121	1,480	143%
Wipro	1,238	413	1,650	1,033	160%
HCL Tech	813	0	813	607	134%

Source: Company Reports and CIRA Estimates

Figure 6. Infosys 2QFY10 Guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	53,180	54,130	-2.8%	-1.1%
Revenue (\$ m)	1,110	1,130	-1.1%	0.7%
EPS - basic (Rs)	23.67	24.09	-11.2%	-9.6%

Source: Company Reports; Guidance at USD/INR of 47.91

Figure 7. Patni 3QCY09 Guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (\$ m)	163	165	0.7%	1.9%
Net profit (\$ m)*	22.5	23.5	-20.1%	-16.5%

Source: Company Reports; \*Excluding forex gain/loss; guidance at USD/INR of 48.50

Figure 8. Valuation Comparison Table

Company Name	RIC Code	CIR Rating	MCap (US\$ m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		Div. Yield (%)	
						FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
<b>IT services</b>											
Infosys	INFY.BO	2L	27,699	2,307	2,290	22.7	21.2	17.3	15.8	1.3%	1.4%
TCS	TCS.BO	1L	25,339	618	630	20.7	18.6	15.6	14.6	1.5%	1.5%
Wipro	WIPR.BO	1L	18,338	597	620	21.6	18.5	16.4	14.3	1.2%	1.3%
HCL Tech	HCLT.BO	2M	4,773	339	345	20.3	14.7	9.4	8.8	1.2%	1.8%
Tech Mahindra	TEML.BO	3M	2,394	937	825	19.4	16.1	10.6	10.2	0.0%	0.4%
Patni*	PTNI.BO	3M	1,211	451	440	13.7	12.3	7.1	7.2	0.6%	0.6%
MindTree	MINT.BO	3M	505	616	485	15.5	15.9	11.2	9.8	0.5%	0.6%
<b>Educational services</b>											
Educomp	EDSO.BO	3M	1,841	4,640	3,750	38.6	25.8	18.3	12.0	0.1%	0.1%
NIIT	NIIT.BO	3H	244	71	50	15.4	13.3	11.0	9.8	1.8%	2.1%

Source: Company Reports and CIRA Estimates; \*Using CY09/10E (Dec year-ending); Priced on 01-Oct-09

## Appendix A-1

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