

IT Sector Impact Analysis:

FBT on ESOP, Housing meltdown in US and Rupee Appreciation

Highlight

- **ESOP significant in IT co.s**
 - FBT in Budget FY08 likely to impact IT companies PAT growth
 - To avoid FBT lot of ESOPs have been exercised in March 07
 - According to our calculation Tech Mahindra would be worst affected
 - TCS and Polaris are the clear winners
- **Housing problem in US to impact BFSI growth**
 - Bank stocks in US are underperforming and getting downgraded
 - This might negatively impact BFSI growth of Indian IT companies
- **Recent appreciation of rupee to impact negatively**
 - Impact on companies with higher offshore revenues
 - Forex cash/working capital and lower hedge to also impact negatively
 - Highest impact on Satyam followed by Infosys, Wipro and TCS

High Outstanding ESOP for some IT co.s

- **ESOP part of compensation in IT**
 - In many IT companies ESOP is a significant part of employee compensation
 - A large part of outstanding ESOPs have been exercised in recent months – especially after budget FY08 announcement
- **FBT on ESOP remain gray area**
 - There is lack of clarity on which part of ESOP would be treated as fringe benefit
 - What would be the rate of taxation on this ‘benefit’
 - Whether co.s can pass on the tax to employees

Company	Equity (#mn)	ESOP % of equity	Equity (#mn)	ESOP % of equity
	31-Dec-06	31-Dec-06	31-Mar-07	31-Mar-07
Tech Mahindra	116.1	13.6%	120.0	9.9%
Iflex	81.4	2.6%	82.5	1.2%
Infosys	557.8	3.0%	564.7	1.7%
Wipro	1,439.8	2.6%	1,458.7	1.3%
Polaris	98.3	2.6%	98.6	2.3%
Mphais	162.4	3.4%	162.6	3.3%
Satyam	657.1	5.1%	665.0	3.9%
HCL tech	649.5	10.1%	662.5	7.9%
Infotech Ent	45.9	4.4%	45.9	4.4%

Impact of FBT outflow in FY08: Our estimate

Company	ESOP % of equity	Mkt Price (NR)	Market Cap (NR Mn)	Net profit@ (NR Mn)	Strike price as % of CMP	% of the FY07 Net Profits					
						FBTRate	10%	25%	40%	55%	70%
							31-Mar-07	2-Apr-07	2-Apr-07	FY07E	
Tech Mahindra	9.9%	1,342	161,037	5,627	11.33%	7.2%	6.0%	4.8%	3.6%	2.4%	
					22.66%	14.5%	12.1%	9.7%	7.2%	4.8%	
					33.99%	21.7%	18.1%	14.5%	10.9%	7.2%	
Iflex	1.2%	2,058	169,722	3,171	11.33%	1.7%	1.4%	1.1%	0.8%	0.6%	
					22.66%	3.3%	2.8%	2.2%	1.7%	1.1%	
					33.99%	5.0%	4.1%	3.3%	2.5%	1.7%	
Infosys	1.7%	1,921	1,084,850	37,127	11.33%	1.3%	1.1%	0.9%	0.7%	0.4%	
					22.66%	2.6%	2.2%	1.7%	1.3%	0.9%	
					33.99%	3.9%	3.3%	2.6%	2.0%	1.3%	
Wipro	1.3%	518	755,622	27,181	11.33%	0.9%	0.8%	0.6%	0.5%	0.3%	
					22.66%	1.8%	1.5%	1.2%	0.9%	0.6%	
					33.99%	2.7%	2.3%	1.8%	1.4%	0.9%	
Polaris	2.3%	171	16,808	917	11.33%	1.1%	0.9%	0.7%	0.5%	0.4%	
					22.66%	2.1%	1.8%	1.4%	1.1%	0.7%	
					33.99%	3.2%	2.7%	2.1%	1.6%	1.1%	
Mphais	3.3%	275	44,719	1,420	11.33%	2.7%	2.2%	1.8%	1.3%	0.9%	
					22.66%	5.3%	4.4%	3.6%	2.7%	1.8%	
					33.99%	8.0%	6.7%	5.3%	4.0%	2.7%	
Satyam	3.9%	446	296,780	15,116	11.33%	2.0%	1.6%	1.3%	1.0%	0.7%	
					22.66%	3.9%	3.3%	2.6%	2.0%	1.3%	
					33.99%	5.9%	4.9%	3.9%	2.9%	2.0%	
HCL tech	7.9%	272	180,388	10,837	11.33%	3.4%	2.8%	2.2%	1.7%	1.1%	
					22.66%	6.7%	5.6%	4.5%	3.4%	2.2%	
					33.99%	10.1%	8.4%	6.7%	5.1%	3.4%	
Infotech Ent	4.4%	348	15,976	691	11.33%	2.6%	2.1%	1.7%	1.3%	0.9%	
					22.66%	5.1%	4.3%	3.4%	2.6%	1.7%	
					33.99%	7.7%	6.4%	5.1%	3.9%	2.6%	

@ Source Bloomberg Consensus

Most likely situation assuming ESOPs will be exercised over 4 years period

April – 2007

Private & Confidential

ANAND RATHI

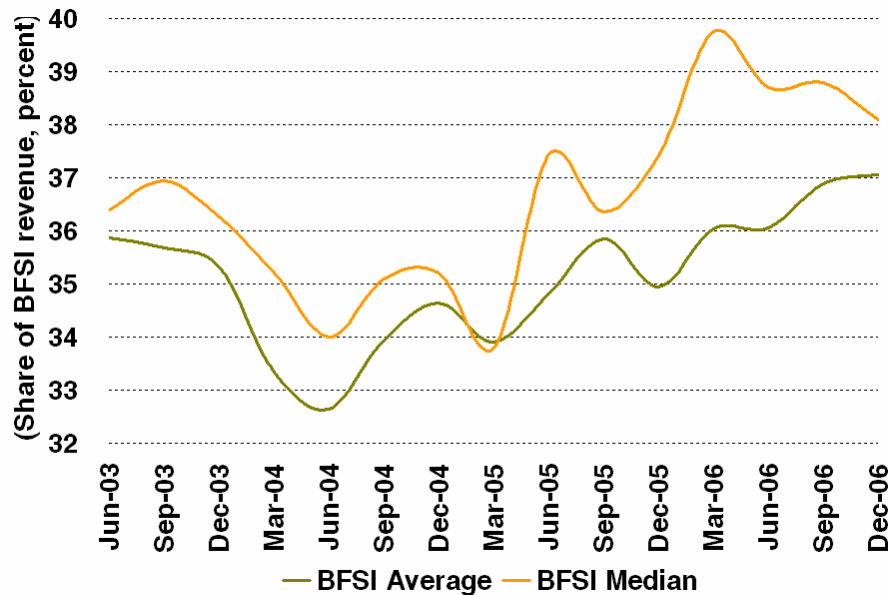
Company-wise impact of ESOP

- **Tech Mahindra would be impacted the most**
 - With strike price at 10% of CMP it forms 21.7% of the FY07 Profits at tax rate of 33.99% and 7.2% at 11.33% tax rate
- **Mphasis, HCL Tech and Infotech Enterprise are impacted**
 - In range of 5-7% at 33.99% FBT rate and ~2% at 11.33% FBT rate
- **The Winner are Polaris and TCS**
 - For Polaris, exercise price is higher than CMP
 - For TCS stock options are not offered to employees

Indian IT and US finance companies

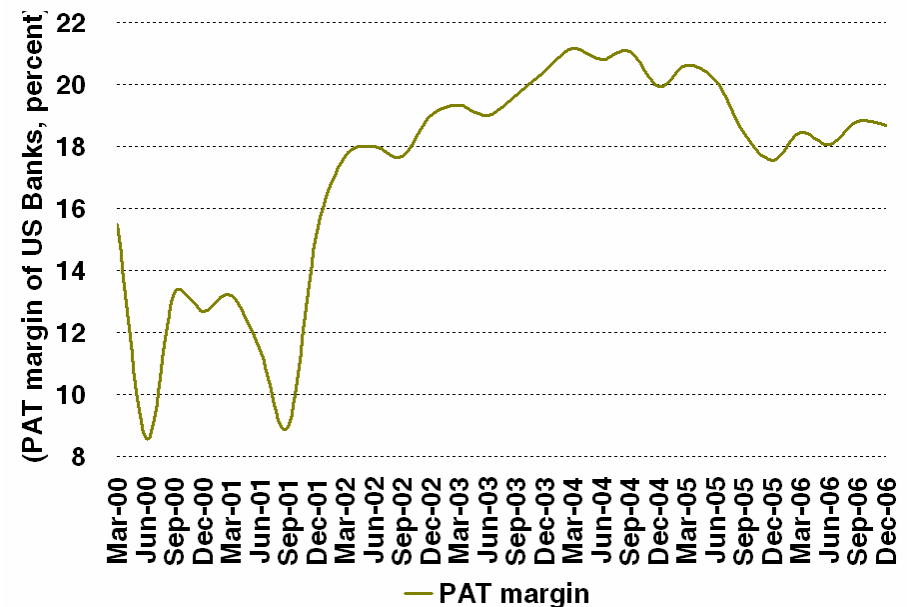
Increasing share of BFSI

- Share of banking, financial services and insurance (BFSI) is on the rise for Indian IT companies*
- Currently it accounts for over 1/3rd of the top line of IT companies
- BFSI companies from US provides the major business



Healthy PAT Margins of US banks

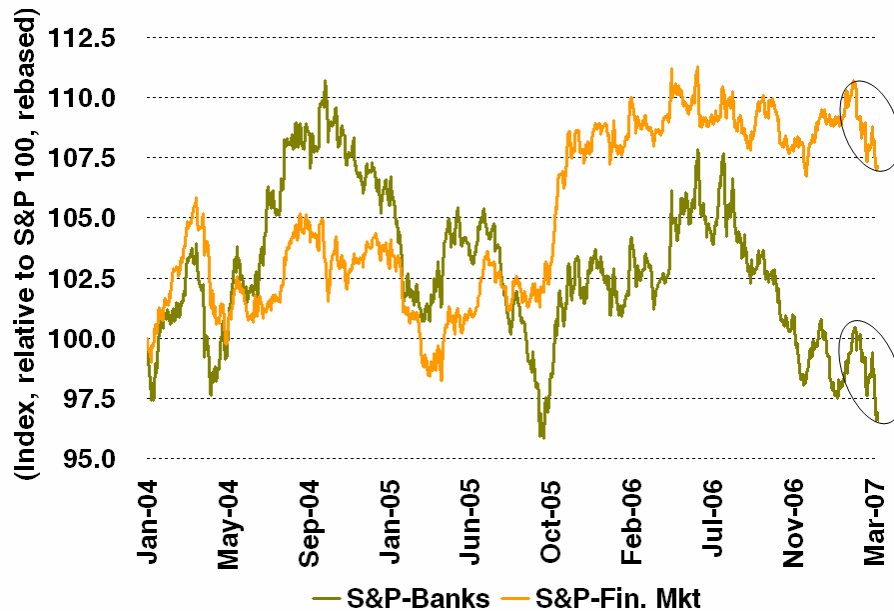
- PAT margins of US banks improved significantly since 2001
- Despite some deterioration in 2005, the margin remains healthy
- Strong growth in US financial sector has been a major revenue driver for Indian IT companies



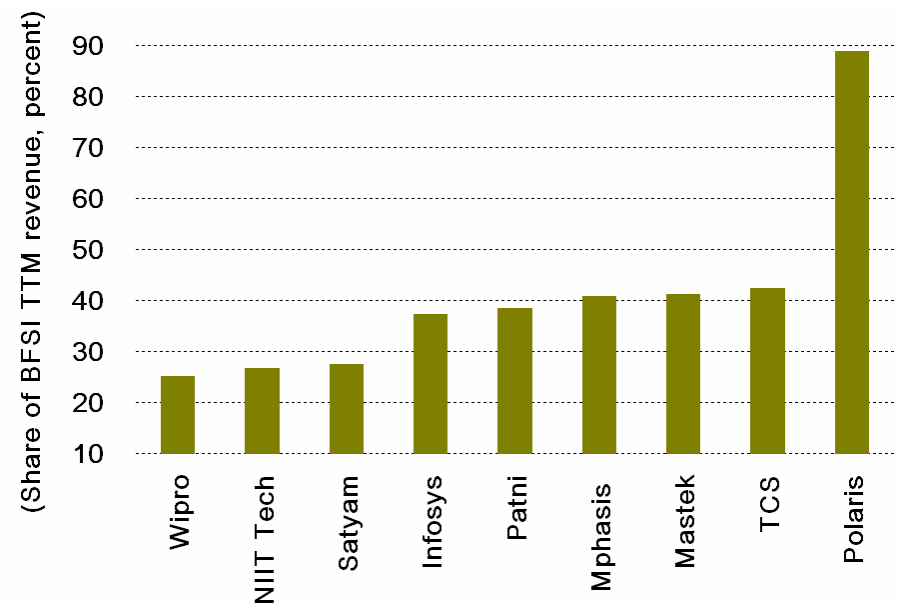
*: Companies included in our sample include TCS, Infosys, Wipro, Satyam, Patni, Polaris, Mphasis, Mastek and NIIT Tech.

Housing meltdown, Banks in US and Indian IT

- **Housing a big risk for US banks**
 - The rising delinquency in US sub-prime mortgage market is a big threat to the US banks and financial sector
 - Recent relative performance of US banks and financial sector on stock market has been negative



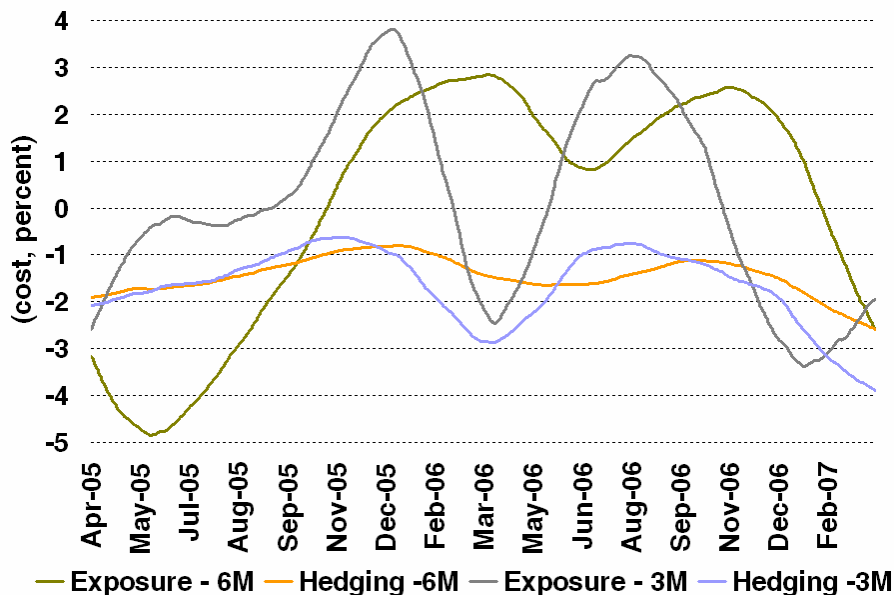
- **Downgrade and margin pressures**
 - Analysts have started downgrading earning outlook and margins of the US banks and financial sector
- **BFSI revenue is likely to be impacted**
 - Growth of BFSI revenue of Indian IT companies is likely to be hit



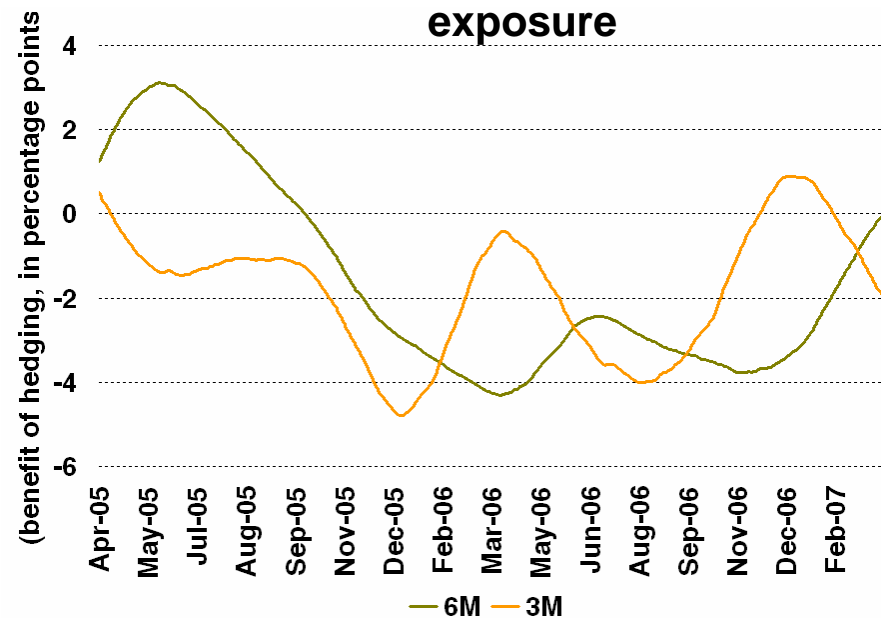
Rupee appreciation: General impact

- **Rupee appreciation impacts IT co.s**
 - Because they earn mainly in forex but spend and account in rupee
- **The impact is higher**
 - If spending in rupee is high (e.g. co.s with higher % of offshore revenues)
 - Co.s with large forex cash/ working capital (leading to translation losses)
- **Forex exposure can be reduced**
 - In the short-run through hedging
 - But not in the long-run as long-term (>12 M) contracts not available
- **Hedging also involve cost**
 - Hedging reduces earning volatility
 - But effective cost of hedging can be more than cost of exposure

Hedging reduces cash-flow volatility



Cost of hedging can be > cost of forex exposure



Rupee appreciation: Dollar income worst affected

- **Rupee appreciated between 3Q FY07 & 4QFY07**
 - Rupee appreciated against all major currencies
 - Appreciation has been the highest against dollar
 - Appreciation has been more at the closing of 4QFY07

	Average Rates		Change	Closing Rates		Change
	3Q07	4Q07		3Q07	4Q07	
USD	44.97	44.16	-1.8%	44.26	43.47	-1.8%
Pound	86.15	86.28	0.2%	86.70	85.55	-1.3%
Euro	57.98	57.86	-0.2%	58.42	58.06	-0.6%

Source: Bloomberg

Rupee appreciation: Satyam worst hit

- **Negative impact highest for Satyam**
 - Followed by Infosys, Wipro and TCS

	Infosys	TCS	Wipro	Satyam	
Exposure					
USD	74%	63%	81%	80%	
Pound	12%	16%	15%	7%	
Euro	5%	8%	3%	4%	
% Offshore Revenues - 3Q07	50.8%	41.6%	53.1%	48.9%	Higher the offshore revenue higher is forex risk
Debtor Days (including unbilled revenues)	62	91	65	82	Higher the debtor days higher is forex risk
Approximate Cash in Foreign Currency - USD Mn	75	222	40.0	25	Higher the cash in forex higher is forex risk
Hedged Positions - USD Mn	360	1,250	600	253	
Revenue - 4Q07 Guidance/Expectation - USD Mn	861	1,150	685	395	
Hedged Position as % of Qtrly revenue	42%	109%	88%	64%	Lower the hedge higher is forex risk
Impact on EBITDA Margins	-100 bps	-80 bps	-111 bps	-107 bps	
Impact due to Translation Losses	-116 bps	-165 bps	-128 bps	-148 bps	
Recoupment due to Hedging	45 bps	133 bps	104 bps	82 bps	
Net impact of Foreign currency	-170 bps	-112 bps	-134 bps	-174 bps	

Sujan Hajra
Chief Economist

sujanhajra@rathi.com
+91-22 6626 6720

Sumit Poddar
Analyst

sumitpoddar@rathi.com
+91-22 6626 6707

Prashant Sawant
Economist

prashantsawant@rathi.com
+91-22 6626 6743

Naushil Shah
Analyst

naushilshah@rathi.com
+91-22 6626 6708

Disclaimer

This report has been issued by Anand Rathi Securities Limited (ARSL), which is regulated by SEBI. The information herein was obtained from various sources; we do not guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities or any options, futures or other derivatives related to such securities ("related investments"). ARSL and its affiliates may trade for their own accounts as market maker / jobber and/or arbitrageur in any securities of this issuer(s) or in related investments, and may be on the opposite side of public orders. ARSL, its affiliates, directors, officers, and employees may have a long or short position in any securities of this issuer(s) or in related investments. RSL or its affiliates may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any entity mentioned in this report. This research report is prepared for private circulation. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities, if any, may fluctuate and that each security's price or value may rise or fall. Past performance is not necessarily a guide to future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report.

April – 2007

Private & Confidential

ANAND RATHI