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Continental Europe – opportunity in adversity

TCS and Wipro poised to gain as Europe strives to stretch its IT spends

Our conversations with 55 key IT decision makers in European companies suggest that Indian vendors are on track to become strategic partners for their key clients. TCS and Wipro were cited as the best positioned to deliver value as European CTOs face budget constraints on 'run-the-business' spends. A key challenge for Indian vendors is domain expertise – 60% of European IT spend is on project-based services with a skew toward manufacturing, which is different from the US where BFSI dominates in IT spends.

Key takeaways from our conversations with CTO for CY12E IT budgets

(a) Overall budgets will be flat to marginally lower, but share of offshoring would increase to manage cost pressures. (b) 'More-for-less' is the mantra for IT spends on run-the-business so that companies do not compromise their 'change-the-business' spends. (c) Vendor consolidation is accelerating and companies are partnering with their larger vendors in a more strategic manner.

Gaining domain expertise is key challenge for Indian vendors

Sixty percent of European IT spend is on higher-margin project-based services such as system integration and package implementation, skewed toward manufacturing companies. This compares to 45% spend on ADM, skewed toward BFSI space – Indian vendors' current stronghold. Nearshoring should alleviate the issue in the medium term but in the long run, Indian vendors should cultivate domain knowledge through their ranks. Skill shortages in Europe are a structural positive factor, which should aid this transition.

TCS – Emerging as the most preferred offshore vendor in Europe

TCS featured most frequently among the top three IT vendors according to most European customers we spoke with. It is likely to gain wallet share as its clients consolidate spending. We believe this is the primary reason for TCS' above-average revenue growth, which we believe will be sustained due to the structural shift in client spending patterns.

Wipro – Clients recognize improvement in quality of its service delivery

Based on our conversations, we note (a) rising customer satisfaction with the quality of Wipro's service after the organization restructuring, (b) appreciable decline in attrition at the individual project level – a key performance metric for clients and (c) recognition of its inorganic initiatives to gain wallet share with marquee clients.

TCS and Wipro are our preferred sector picks

TCS trades at 17x FY13E earnings (10% discount to its average trading multiple for the last two years). Given its forecast earnings growth of 20% over FY12-14, we believe the stock is attractively priced. We value the company at 20x FY13E P/E and increase our target price marginally from INR1,280 to INR1,320. We expect Wipro to deliver earnings CAGR of 21% over FY12-14. At 14x FY13E P/E, the stock trades at an inexpensive valuation. We value Wipro at 19x FY13E P/E and raise its target price from INR400 to INR510. We also marginally increase our FY13E EPS for Infosys and raise its target price marginally from INR2,950 to INR3,000. We retain our Hold rating on HCL Tech with no changes to estimates or target price. Key risks: US and Europe recession impacting technology spend and a higher-than-expected rupee appreciation. (See pages 40-49 for more details.)

Top Picks	
Tata Consultancy (TCS.BO),INR1,175.50	Buy
Wipro (WIPR.BO),INR394.35	Buy

Companies Featured			
Infosys Technologies (INFY.BO),INR2,696.80			Buy
	2011A	2012E	2013E
P/E (x)	24.7	19.5	16.6
EV/EBITDA (x)	16.9	12.8	10.6
Price/book (x)	6.8	5.1	4.5
Tata Consultancy (TCS.BO),INR1,175.50			Buy
	2011A	2012E	2013E
P/E (x)	21.3	21.7	18.3
EV/EBITDA (x)	15.9	15.6	13.0
Price/book (x)	9.1	8.0	7.0
Wipro (WIPR.BO),INR394.35			Buy
	2011A	2012E	2013E
P/E (x)	22.2	17.2	14.7
EV/EBITDA (x)	17.3	11.7	9.9
Price/book (x)	4.9	3.6	3.2
HCL Tech (HCLT.BO),INR417.35			Hold
	2011A	2012E	2013E
P/E (x)	18.9	14.2	12.5
EV/EBITDA (x)	11.2	7.6	6.2
Price/book (x)	4.0	2.9	2.4
Mahindra Satyam (SATY.BO),INR69.90			Hold
	2011A	2012E	2013E
P/E (x)	–	10.3	8.0
EV/EBITDA (x)	15.7	5.9	3.8
Price/book (x)	4.5	2.8	2.1

This report changes target prices and estimates for several companies under coverage. For a detailed list of these changes see page 9.

Deutsche Bank AG/Hong Kong

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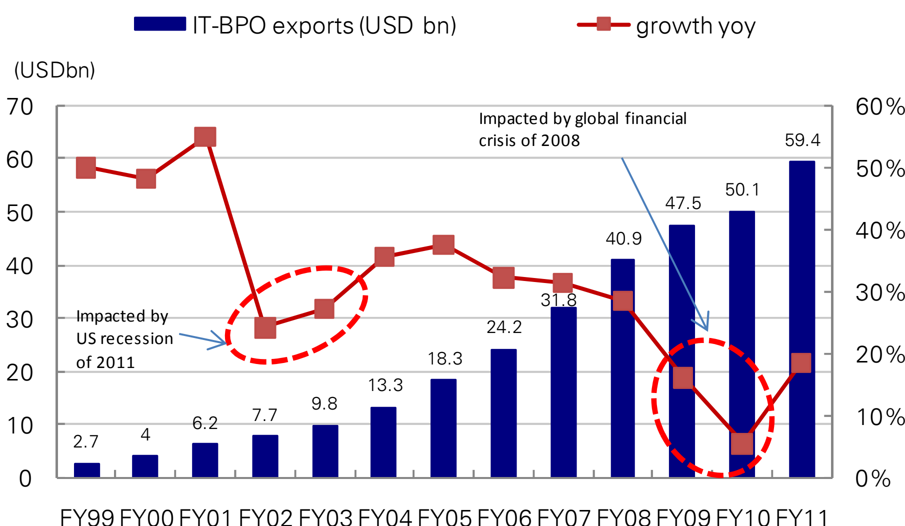
Recession in Europe – a boon for Indian IT vendors

Indian IT industry has leveraged recessions to increase market share

After each recession, the industry has emerged stronger and better placed on fundamentals

The performance of the Indian IT service industry is closely tied to the economic environment in Western markets. Historically, recessions in the US, UK and other key markets have had a severe impact on the near-term growth of the industry. However, after each economic downturn, the industry has emerged stronger and better placed on fundaments than before the recession.

Figure 1: IT exports have rebounded strongly after each recession



Source: Nasscom Strategic Review , Deutsche Bank

We found that Indian vendors used the US recession of 2001 to broad base their geographical exposure and service mix. After the recession of 2008-09, IT service spending improved moderately and top tier Indian vendors were key beneficiaries of vendor consolidation. Thus in FY11, while the industry grew 18.6% yoy, the top four Indian vendors (Infosys, TCS, Wipro, and HCL Tech) reported revenue growth of 26% yoy. The likely CY12 recession in Europe presents an ideal opportunity for Indian vendors to gain market share in this region.

Figure 2: Indian vendors better placed for market share gains

	Infosys			TCS			Wipro		
	FY01	FY05	FY11	FY01	FY05	FY11	FY01	FY05	FY11
Revenue (USD m)	410	1,593	6,042	678	2,378	8,187	382	1,206	5,221
Revenue from US (USD m)	302	1,038	3,945	451	1,376	4,707	244	787	2,887
US geo revenues	73.50%	65.20%	65.30%	66.50%	57.90%	57.50%	64.00%	65.30%	55.30%
Revenue from Europe (USD m)	77	355	1,302	137	513	2,029	112	359	1,415
Europe geo revenues	18.80%	22.30%	21.60%	20.20%	21.60%	24.80%	29.40%	29.80%	27.10%
Client concentration									
Active customers	273	438	620	NA	621	1034	217	421	904
% revenue from top five customers	26.00%	21.20%	15.40%	NA	19.30%	21.40%	30.00%	18.00%	10.90%
% revenue from top 10 customers	39.20%	33.80%	25.70%	NA	30.50%	29.60%	45.00%	30.30%	19.50%
Non-ADM Revenue	25.30%	46.90%	61.00%	NA	27.10%	53.50%	8.00%	37.60%	60.50%
Total Employees	9,831	36,750	130,820	NA	45,714	198,614	9,934	41,857	122,385
Net worth (INRm)	13,896	52,420	259,760	NA	34,775	245,048	18,762	48,936	224,877

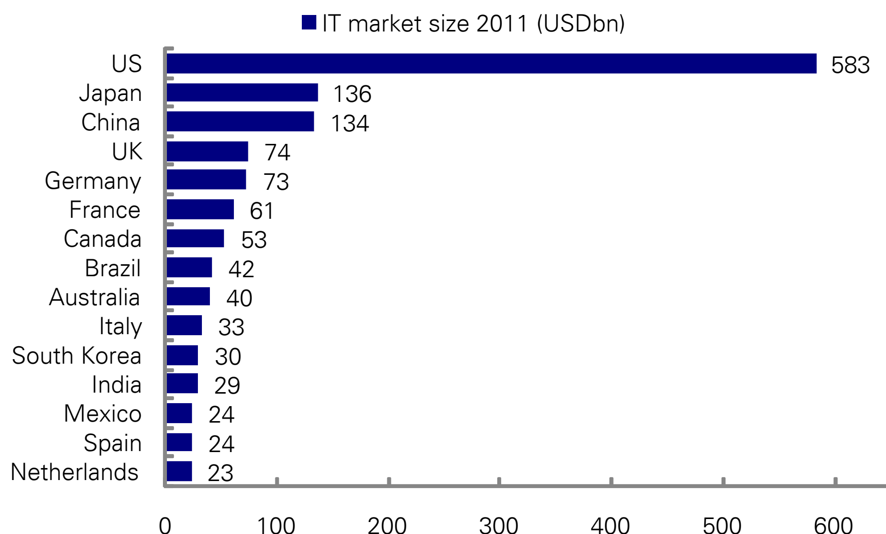
Source: Company data, Deutsche Bank, NA = Not available

Indian vendors investing in Europe for the long term

Indian vendors have used the last downturn as an opportunity to set their house right in continental Europe. Most vendors now aspire to expand their presence in the French and German markets by making subtle changes to their strategies and delivery mechanisms. This is important since in terms of the size of opportunity, the French and German markets are 1.8 times larger than that of the UK.

Most Indian vendors aspire to expand their presence in France and Germany

Figure 3: 15 largest IT markets in 2011 ranked by size in USDbn



Source: Forrester

German market – Structural impediments but improving prospects

Europe's largest economy, Germany, ranks second behind the UK among the European nations for most IT spending. Industry specialists believe that besides the language barrier and other cultural issues, solid labour laws and powerful labour unions make it difficult to outsource. Despite all the issues identified above, more German companies are slowly starting to use offshore services, recognizing the strategic significance of offshore services. In fact, several large German corporations (Deutsche Bank, Bosch, Siemens, SAP, etc.) are long-time global leaders in the use of offshore services. In time, it can be expected, that more companies will pursue larger-scale offshore strategies.

Unlike the US, where financial services companies dominate IT spending, in Germany, manufacturing is the leader in terms of IT usage, with manufacturing companies spending more than one-fourth of total IT spend in Germany. In addition, roughly 60% of the IT service spend from this region is mostly on project-based services like package implementation, custom application development, system integration, technology consulting, etc,. The proportion of worldwide IT services spend on these services is 34%. The skew in favour of higher value-add services makes investment in the German market value accretive.

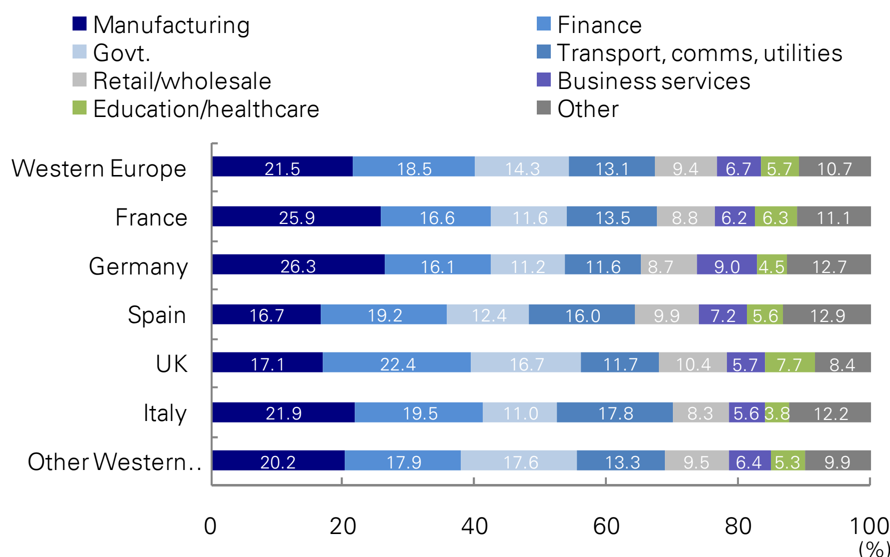
60% of the IT service spend from this region is mostly on project-based services vs 34% worldwide..

French market – About 80% of the IT service work is outsourced onshore

France is the third-largest IT services market in the EU behind the UK and Germany. Industry specialists note that the French IT services market is dominated by global service providers, which account for nearly 60% of the market. However, France is the only European country where domestic companies have maintained a significant market share. About 80% of IT service work is outsourced onshore, 15% nearshore and just 5% offshore.

French IT services market is dominated by global service providers, accounting for~60% of the market

Figure 4: IT spending breakdown by verticals



Source: IDC

Low penetration rates

The penetration rates of the Indian vendors in each of these markets are low.

Figure 5: Revenue exposure of Indian vendors to key European economies

	Revenue %				
	Europe	UK	Germany	France	Rest of Europe
Infy	21.5%	11.4%	1.5%	1.0%	7.6%
TCS	24.8%	15.5%	2.5%	0.7%	6.1%
Wipro	27.1%	15.6%	2.7%	0.8%	8.0%
HCL Tech	26.9%	13.3%	2.7%	0.5%	10.4%

Source: Company data, Deutsche Bank

Figure 6: Market size and penetration rates

USD m	Germany	France
FY11		
Overall IT market size 2011	**73,000**	**61,000**
Total IT service spend	44,125	37,049
Application outsourcing	4,906	4,059
Infrastructure-related outsourcing	8,664	7,287
Project-based services	26,426	22,229
BPO	4,128	3,474
Revenues of tier I Indian vendors	531	179
Total IT service + BPO exports from India	1,365	460
Value market share (top tier)	1.2%	0.5%
Value market share - India	3.1%	1.2%

Source: Forrester, Deutsche Bank

Value market share of Indian IT services Industry in Germany and France is the low single digits

To address the issues of low penetration, Indian vendors have recently made some structural changes in their operating model. Some noteworthy changes in approach are below.

Key changes in business mode to address Europe :
1. *Country focus*
2. *Hybrid delivery with nearshore capabilities*
3. *Strategic acquisitions*

1. Although most companies are vertically aligned to ensure increased attention is paid to the focus geographies within Europe, they have appointed local heads. TCS is an exception to this norm.
2. Germany and France are the target markets within continental Europe, with special delivery strategies and client engagement models.
3. For France and Germany in particular, many companies are attempting to move away from the 30:70 onsite offshore ratio. While some like Infosys seek to add more local headcount with a 20:20:60 local, onsite and offshore model, others like Cognizant look to alter the delivery model by adding nearshore to the 'plain vanilla' onsite/offshore delivery. Wipro, on the other hand, is positioning itself as a hybrid of the Infosys and Cognizant delivery models.
4. Since Indian vendors have a sizable presence in all key service lines and have achieved scale, they are looking to make integrated offerings with consulting and package implementation, infrastructure management and BPO to win large deals.
5. Indian vendors are increasingly adopting the inorganic growth route with a clear focus on acquiring capabilities in continental Europe. Wipro, HCL Tech and Cognizant are notable examples of this.

TCS, followed by Wipro, are the most favoured Indian vendors

TCS, followed by Wipro, is viewed as the best positioned on our 8 parameter screen, which compares relative attractiveness of the top four Indian vendors at making share gains in Europe. Of the customers we had conversations with, TCS was considered a strategic vendor by many. Also, its greater revenue exposure (absolute USD revenues) to Germany and France gives it an advantage at making share gains in this market. Wipro on the other hand, offers the best nearshore delivery alternatives and has recently made some key strategic acquisitions. HCL Tech, despite deriving the highest proportion of revenues from Europe, fares poorly on our screen on account of lack of strategic vendor status with most large customers in Europe.

1. *TCS considered as a strategic vendor by many customers*
2. *Wipro has the best nearshore delivery options*

Figure 7: Europe market share gains – relative attractiveness of Indian vendors analysed

Scorecard parameters	Description	Ranking of stocks from 1-5 with 5= least attractive			
		HCL Tech	Infosys	TCS	Wipro
Nearshore development centres	Number and quality of delivery options nearshore	4	3	2	1
Offshore delivery	Quality of offshore delivery	3	1	1.5	2.5
Recruitment challenges	Local headcount recruitment challenges	4.5	3.5	3.5	4
Strategic vendor status	Top three vendor status with the customer	4	2.5	1	3
Domain expertise	Ability to provide higher value-add services	3	1	2	3
Inorganic initiatives	Ability to make strategic acquisitions	1	5	2.5	3
Senior management attention	CEO level engagement	3	3	1	2
Geographic exposure	exposure to Germany + France	3	4	1	2
Average on 8 parameters		**3.2**	**2.9**	**1.8**	**2.6**

Source: Deutsche Bank

Top picks – TCS and Wipro

We forecast Wipro to deliver sector-leading earnings CAGR of 22% over FY12-14E,

We continue to believe that the current global macroeconomic worries will boost offshoring and benefit large Indian vendors that are strategic partners with their key customers. Since customers are inclined to do 'more with less', we estimate the proportion of the offshore effort will rise by 200-300bps yoy in FY13 (78%-79% vs 75%-76% in FY11). Also, given offshore billing rates are one third of those onsite, companies' reported USD revenue growth will moderate in FY13E. However, we believe the impending recession in Europe would be a long-term positive event for Indian vendors as customers on this continent increase offshore leverage. Thus, Indian companies with a stronger presence in this market are likely to report market share gains in the near future. Thus, we expect USD revenue growth for the top-tier companies to bounce back to about 25% yoy in FY14E vs 16% in FY13E.

TCS, followed by Wipro, are best positioned to gain from the rise in offshoring from Europe. Thus, we forecast Wipro to deliver sector-leading earnings CAGR of 22% over FY12-14E, followed by TCS at 19.6%.

Figure 8: Key forecasts and assumptions

	Infosys			TCS			Wipro			HCL Tech		
	FY13E	FY14E	CAGR (FY12-14E)	FY13E	FY14E	CAGR (FY12-14E)	FY13E	FY14E	CAGR (FY12-14E)	FY13E	FY14E	CAGR (FY12-14E)
Revenue (USD m)	8,245	10,266	*19.5%*	12,143	15,437	*22.7%*	6,881	8,316	*17.9%*	4,888	6,136	*20.8%*
INR m												
Revenue	**382,605**	**466,865**	***18.3%***	**563,404**	**702,074**	***21.5%***	**434,090**	**531,842**	***19.3%***	**225,679**	**277,658**	***18.6%***
Gross Profit	170,921	204,521	*17.7%*	267,036	325,637	*20.7%*	138,940	170,297	*18.8%*	74,156	88,724	*17.6%*
EBITDA	**123,452**	**146,597**	***18.0%***	**168,362**	**201,967**	***19.4%***	**87,148**	**106,841**	***18.7%***	**38,463**	**44,821**	***15.7%***
EBIT	112,856	134,952	*18.8%*	156,664	188,579	*19.5%*	75,942	94,438	*19.8%*	30,824	35,354	*14.0%*
Net Income	**93,327**	**110,217**	***17.6%***	**125,546**	**151,865**	***19.6%***	**65,709**	**82,609**	***21.9%***	**23,226**	**26,582**	***14.2%***
EPS	**162.28**	**191.65**	***17.6%***	**64.14**	**77.59**	***19.6%***	**26.75**	**33.63**	***21.9%***	**33.44**	**38.27**	***14.2%***
Margins			*bps*			*bps*			*bps*			*bps*
Gross Margin	44.7%	43.8%	*-40*	47.4%	46.4%	*-56*	32.0%	32.0%	*-26*	32.9%	32.0%	*-53*
EBITDA Margin	32.3%	31.4%	*-12*	29.9%	28.8%	*-101*	20.1%	20.1%	*-23*	17.0%	16.1%	*-82*
EBIT Margin	29.5%	28.9%	*29*	27.8%	26.9%	*-91*	17.5%	17.8%	*14*	13.7%	12.7%	*-106*
Net Income Margin	24.4%	23.6%	*-27*	22.3%	21.6%	*-70*	15.1%	15.3%	*62*	10.3%	9.6%	*-75*
Re/US$	46.4	45.5	*-2.0%*	46.4	45.5	*-2.0%*	46.40	45.48	*-2.0%*	46.2	45.2	*-2.0%*
Billing rates/ man month (USD)												
Onsite	12,202	12,385	*-0.2%*	8717	8,846	*-0.4%*	11,948	11,949	*-0.1%*	13,240	13,565	*1.0%*
Offshore	4,060	4,101	*-0.7%*	3193	3,224	*-1.1%*	4,321	4,321	*-0.5%*	3,628	3,701	*0.5%*
Manpower cost/man month (USD)												
Onsite	7,708	8,017	*2.4%*	4,415	4,504	*0.9%*	6,463	6,592	*2.0%*	7,055	7,193	*1.1%*
Offshore	1,100	1,232	*7.8%*	1,311	1,443	*5.1%*	722	795	*10.0%*	1,318	1,449	*5.3%*
Net employees added	22,325	28,200	*17.6%*	72,302	67,575	*23.3%*	8,680	20716	*54.3%*	7,805	19,639	*87.7%*
Revenue/employee (USD)	47,508	50,884	*3.5%*	38,512	40,179	*-2.7%*	55,796	55,674	*2.8%*	50,736	48,743	*-2.2%*
Cost per employee (USD)	24,611	26,560	*3.4%*	20,043	21,905	*0.3%*	22,786	23,352	*5.0%*	30,161	29,682	*-0.9%*

Source: Deutsche Bank estimates

Our new target prices imply 15%-35% upside

Our three Buy-rated stocks have a potential return of 15% (Infosys) to 35% (Wipro). The only major stock on which we are raising conviction is Wipro. We raise the company's FY13 earnings growth expectation by 4% and now estimate it to deliver 21% earnings CAGR over FY12-14. The two key positive factors driving the upward revision are (a) rising customer satisfaction with Wipro's quality of service post the organisation restructuring and (b) significant decline in attrition not only at the overall company level but also at individual project levels. In addition, some of its recent inorganic initiatives are helping Wipro consolidate its position with large customers. Wipro is now one of our top picks along with TCS.

The two key factors driving our positive stance on Wipro are

1. *Rising customer satisfaction with Wipro's quality of service post the organization restructuring and*
2. *Significant decline in project level attrition*

Figure 9: Revised target price and upside potential

Company	Reco	EPS (FY13E)	Target P/E		Target Price		Price	Potential Return
			New	Old	New	Old	30/11/2011	
Wipro	Buy	26.8	19	15	510	400	377	35.3%
TCS	Buy	64.1	20	20	1,320	1,280	1,116	18.3%
Infosys	Buy	162.3	18	18	3,000	2,950	2,607	15.1%
HCL Tech	Hold	33.6	13	13	440	440	384	14.6%

Source: Deutsche Bank estimates

Key target markets – Germany and France

Europe – A critical cog in the growth wheel

Recently, Indian vendors have intensified their investments in Europe with a particular interest in Germany and France. Infosys, the second-largest Indian IT service company, has set a long-term target revenue contribution of 40:40:20 from North America, Europe and Rest of the World (ROW) vs the current 62:25:12, respectively. The company is investing in Europe with a particular focus on Germany and France. They, like most other Indian IT service companies, have now appointed dedicated country heads for these countries.

Infosys has set a long-term target revenue contribution of 40:40:20 from North America, Europe and Rest of the World (ROW) vs the current 62:25:12

In our view, the relative state of the economy in the US and Europe and inorganic growth initiatives pursued by the Indian vendors will be the key determinant of how soon the diversification in geographical revenue contribution is achieved. Our analysis suggests that Indian vendors would have to make rapid market share gains in Germany and France in particular to achieve that objective by FY20E.

India's market share will have to quadruple in eight years to achieve 40% revenue contribution from Europe

Figure 10: Key market share data

USD m	Germany	France	UK	Rest of Europe	Europe
FY11					
Total IT service spend	**44,125**	**37,049**	**49,176**	**66,485**	**196,835**
Value market share (top tier)	530.8	179.0	3243	2,493.4	6,447
Total IT service + BPO exports from India	1,364.5	460.1	8,337.4	6,409.5	16,572
Value market share (top tier)	**1.2%**	**0.5%**	**6.6%**	**3.8%**	**3.3%**
Value market share - India	**3.1%**	**1.2%**	**17.0%**	**9.6%**	**8.4%**
FY20E (Deutsche Bank Estimate)					
Overall IT service spend	**65,192**	**54,739**	**72,655**	**98,229**	**290,816**
IT+BPO exports from top tier Indian vendors	10,653	4,096	17,428	15,812	47,989
Total IT-BPO exports from India	21,306	8,192	34,857	31,624	95,979
Value market share (top tier)	**16.3%**	**7.5%**	**24.0%**	**16.1%**	**16.5%**
Value market share - India	**32.7%**	**15.0%**	**48.0%**	**32.2%**	**33.0%**
Key Assumptions					
USD/EUR	1.35	1.35	1.35	1.35	
Europe IT+BPO revenue of top four Indian IT service vendors/ India's total IT exports to Europe (FY11)	38.9%	38.9%	38.9%	38.9%	
Europe IT+BPO revenue of top four Indian IT service vendors/India's total IT exports to Europe (FY20)	50.0%	50.0%	50.0%	50.0%	
Overall IT service spend CAGR (FY11-20E)	5.0%	5.0%	5.0%	5.0%	

Source: Forrester research, Nasscom Strategic review 2011, Deutsche Bank

Moreover, we believe success at achieving greater penetration in markets like Germany and France will ensure long-term revenue growth rates of about 20%-plus in USD terms for the large Indian IT services companies.

Indian vendors have had moderate success at penetrating Europe, and are gaining on account of the rapidly rising adoption of the offshore model by global customers. However, they will be faced with stiff challenges in Europe in their quest of replicating their success in the US.

Europe is not a homogeneous market

Peculiarities of the European IT service market

1. *Every country has its own buying behaviour*
2. *Re-badging of employees is common*
3. *Longer decision making cycle*
4. *Aversion towards large outsourcing deals*

The attempt at approaching other continental European countries with a similar strategy to that used in English-speaking markets has not been hugely successful. In our view, some of the reasons for this are as follows.

1. In terms of market characteristics, Europe is not a homogenous market. Every country has its own buying behaviour. We think one cannot expect a British person to sell in France or a French person to sell in Germany very successfully. Vendors need a separate strategy for each market.

2. Labour laws are also relatively inflexible. For instance, re-badging of employees is almost a necessity in large outsourcing deals from this region.

3. From a decision-making cycle perspective, continental European customers tend to be more conservative and take longer than their US counterparts. Even small project decisions take six to nine months, while larger deals take anywhere between nine and fifteen months and in some cases even two years.

4. Customers are normally averse to doing large outsourcing deals upfront and will typically begin with low levels of offshoring and then increase as they become comfortable with the vendors' delivery.

Most of these issues persist, which would need to be addressed over time by the Indian vendors. However, we believe that (a) prolonged period of sluggish economic growth and need to cut costs to drive efficiency, (b) IT skill shortages and (c) investments made by Indian vendors over the last two years at increasing local presence both in terms of physical capacity and resources, will help Indian vendors gain market share in this region.

Prolonged period of sluggish economic growth

IT service spending from UK and continental Europe has not bounced back at the same pace as US

After sharp spending cuts in 2009 following the global recession, technology spending has bounced back over the last two years primarily due to a marked improvement in the economic activity in the largest market – the US. However, spending from the UK and continental Europe has not bounced back at the same pace. This is also reflected in the declining share of revenue contribution from the UK and continental Europe, while that of the US has risen over the past two years (Figure 14).

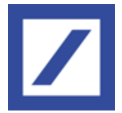
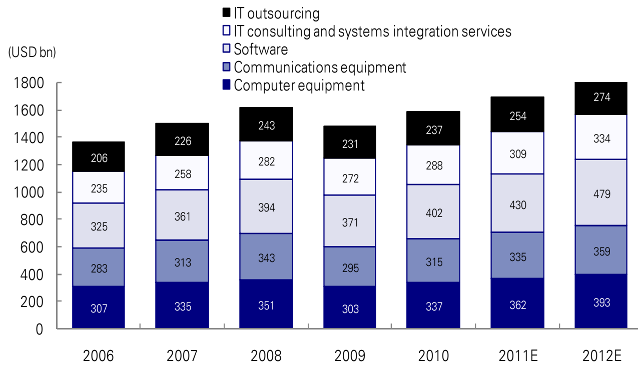
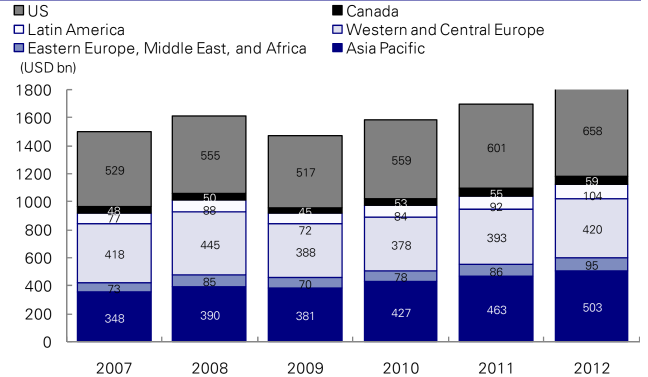


Figure 11: Global business and government purchases of IT goods and services



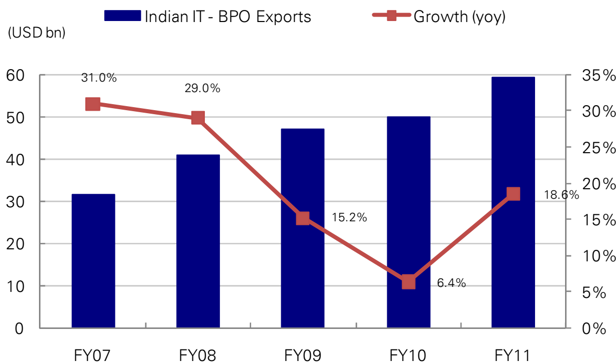
Source: Forrester

Figure 12: Global IT purchases by region



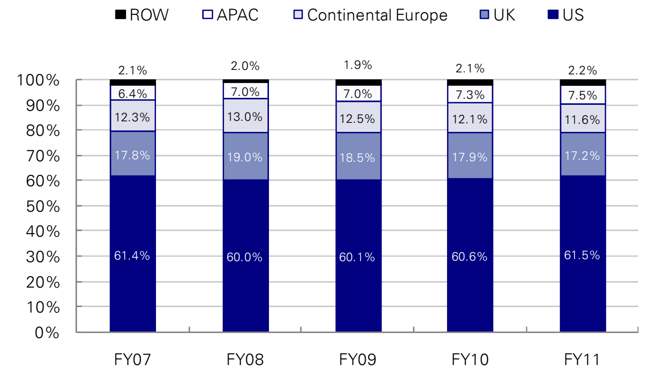
Source: Forrester

Figure 13: India IT-BPO export trend



Source: NASSCOM Strategic Review k

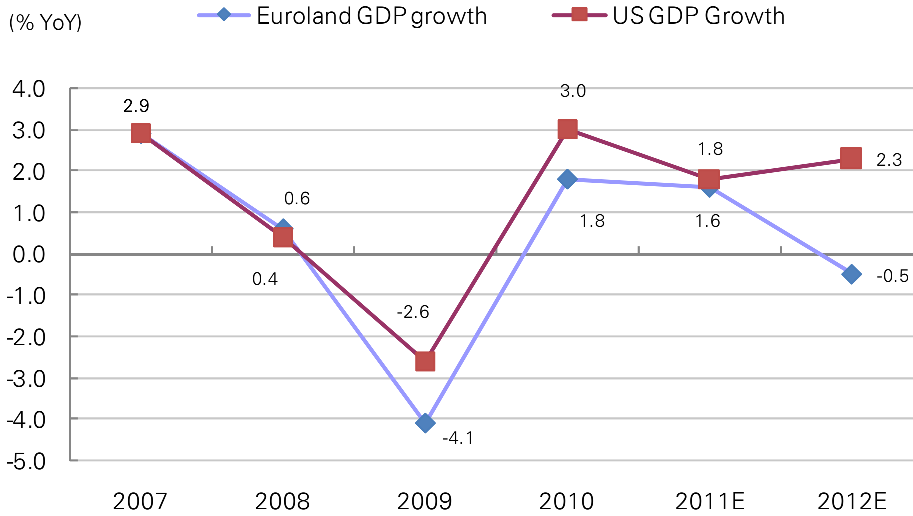
Figure 14: Geographical contribution to India's IT-BPO exports



Source: NASSCOM Strategic Review

In our view, a sluggish economic recovery following the financial crisis of 2008-09 is the key reason for the slow spending recovery in Europe. Moreover, Deutsche Bank economists now expect the European region to dip into recession in CY12E.

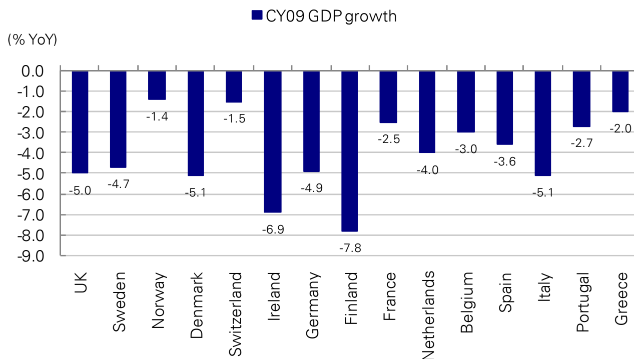
Figure 15: Trend in real GDP growth rates



Source: Deutsche Bank, government sources

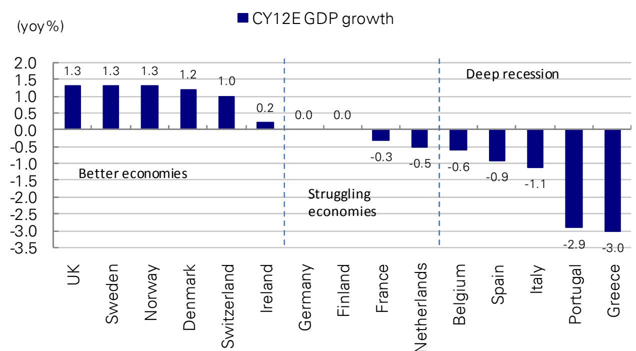
However, we note that unlike the recession of 2009 where all European countries registered steep declines in economic activity, the CY12 forecast is for deep recession only in those countries roiled by the level of their country's debt crisis and consequent implementation of austerity measures. Thus, based on the forecast economic growth for CY12, we classify the European countries into three categories, i.e., better economies, struggling economies and economies in deep recession.

Figure 16: CY09 real GDP growth of major European countries



Source: Deutsche Bank, government sources

Figure 17: CY12E real GDP growth forecast for major European countries



Source: Deutsche Bank

Although a recession should have negative implications on technology spending (as has been witnessed in the past), we believe that there will be a minimal impact (if at all) on the existing revenues that the Indian vendors derive from Europe. We note that the best-performing European economy, the UK, contributes about two-thirds of the revenues from Europe for most Indian vendors. Revenue exposure to the rest of the troubled economies is less than 1% for most tier 1 Indian IT services companies.

The best-performing European economy, the UK contributes about two-thirds of the revenues from Europe for most Indian vendors

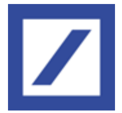
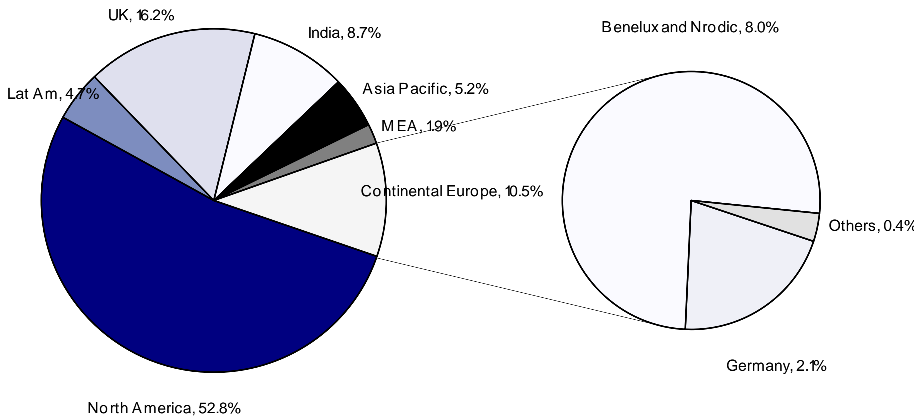


Figure 18: TCS –Revenue contribution by region



Source Company data, Based on FY10 numbers

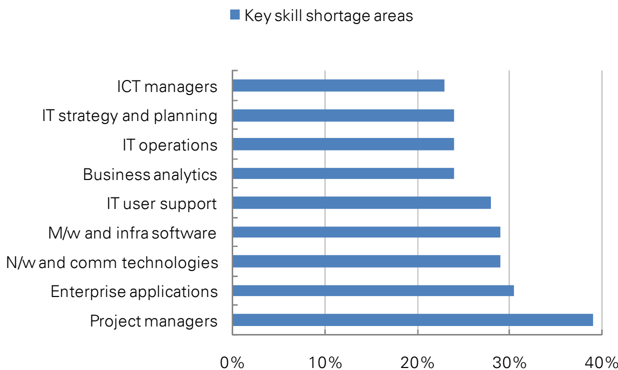
With the US economy expected to show reasonable growth, the prolonged sluggish economic growth will put pressure on European corporations with global operations to cut costs and drive efficiency. This, in our view, will accelerate the need for outsourcing/offshoring.

Skill shortage in Europe

Industry specialists, IDC, note that around 20% of Western European organizations find it difficult to recruit skilled IT professionals

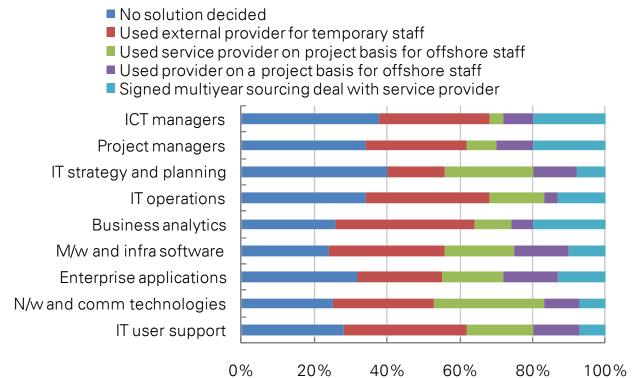
While language and labour issues have been the chief stumbling blocks to the attempts made by the Indian vendors to expand their client portfolio in Europe, the existing skill shortage, in our view, is one of the most important reasons toward favouring offshore faster than expected. Industry specialists, IDC, note that around 20% of Western European organizations find it difficult to recruit skilled IT professionals. The problem is most acute in the Nordic region. Companies in Western Europe are finding it most difficult to find project managers followed by enterprise application consultants.

Figure 19: Key IT skill shortage areas in Europe



Source: IDC European Services Survey 2011

Figure 20: Solutions adopted by customers to address IT skill shortages



Source: IDC European Services Survey 2011

On average, about 23% of all skill shortages were addressed with staff augmentation by a third-party offshore service provider or by signing a long-term IT service contract with a vendor. However, customers have not been able to find a solution to almost 30% of their resource requirements.

While India ranks second in terms of total annual graduates, it has the largest ready-to-hire graduate pool

This, in our view, is significant opportunity for the offshore service providers. While India ranks second in terms of total annual graduates, it has the largest ready-to-hire graduate pool (Figure 27 and Figure 28). Industry specialists (Nasscom) believe that although China churns out a higher number of graduates and provides similar cost savings, it does not have an English-speaking population to match India's credentials. This is reflected in the lower share of ready-to-hire graduates compared with 37% of total global annual graduates. China is perceived to be only best suited for regional work and Chinese vendors lack the capabilities to support high-end engagements. Similarly, the Philippines may have a larger proportion of those fluent in English but is perceived to be much lower in the services value chain when compared with India.

TCS best positioned to make market share gains

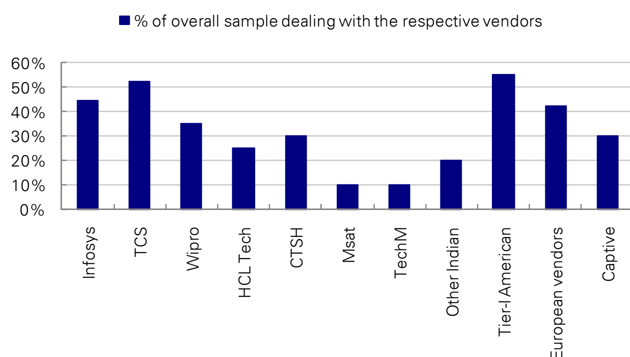
Conversation with customers suggest rising adoption of offshore delivery

As part of a joint study with the Value Leadership Group, we spoke to the CTOs/vendor relationship heads of 55 European companies that leverage offshore/nearshore IT service delivery. This was done in order to benchmark the relative positioning of the Indian vendors amongst themselves and versus tier 1 American (includes Accenture, IBM, CSC, HP, etc,) and tier 1 European (Cap Gemini, Atos, Tieto, Logica, Steria, etc.). The study also provides insights about the key opportunities and challenges faced by the Indian vendors in this geography. The following sections attempt to discuss each issue in detail.

Tata Consultancy – Biggest beneficiary of the increasing offshore focus of continental European customers

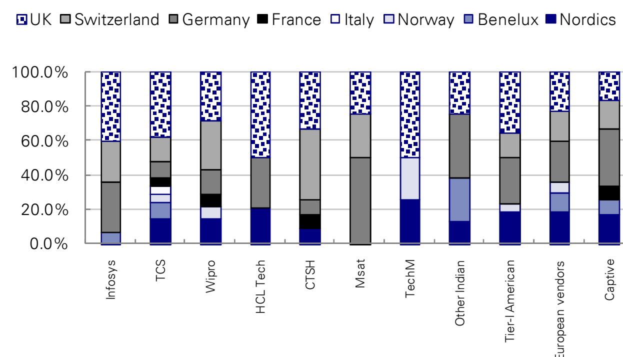
Our checks reveal that, of the tier 1 Indian vendors, TCS has the most broad-based exposure to continental Europe and also has very strong client relationships in each of these regions with exceptionally high client satisfaction.

Figure 21: Distribution of sample by vendor relationship



Source: Deutsche Bank

Figure 22: Distribution of sample of client relationship of each vendor



Source: Deutsche Bank

Majority of the customers we spoke to rated TCS as their first choice amongst the Indian vendors with respect to leveraging offshore delivery

Moreover, the majority of the customers we spoke to rated TCS as their first choice amongst the Indian vendors with respect to leveraging offshore delivery. This, in our view, is extremely important during difficult macroeconomic conditions, when customers are looking to 'do more with less' and there is pressure on client budgets. Like many other Indian vendors, TCS's biggest challenge is to improve local headcount and domain expertise. Many customers believe that if the Indian vendors get this right over time, they can make significant share gains on large deals. Some of the key positives and negatives points of TCS's operations in continental Europe are outlined below:

Key Positives

- TCS has the most experience amongst the Indian vendors of operating in Europe and enjoys strong client references in each of the constituent markets. Most continental European customers also consider TCS easier to work with compared with some peers.
- Customers also consider TCS to be extremely flexible with its delivery and hence is in most cases the first choice for customers wanting to leverage a higher proportion of offshore delivery in order to cut costs and 'do more with less'.
- We noticed that with most customers where TCS is amongst the top vendors, it invariably is the lowest cost vendor for the customer. This helps it to win more volume share with low risk to its existing billing rates. It also can extract operating efficiencies by having large exposure to customers.
- Customers are satisfied with CEO-level management that they have witnessed on their account and are thus inclined to award more work to TCS. This is especially true of smaller TCS customers within continental Europe.
- In the majority of cases of vendor consolidation exercises conducted by the client over the last two years, TCS has made gains significantly higher than Indian peers. Customers attribute this to not only the CEO-level of engagement but also to a very strong sales focus with good business propositions.
- Given that continental Europe customers have global operations; TCS has successfully leveraged its exposure to these customers in geographies outside of Europe to win business in Europe.

1. TCS - best beneficiary of vendor consolidation
2. Leveraging global relationships to expand in Europe

Key negatives

- Although customers rate TCS as one of the easiest offshore companies to negotiate with, it often escalates issues of operations to the vendor's management team, resulting in redrafting the SLA's (service level agreements) and thus increasing operating costs.
- In our view, TCS's biggest challenge is to improve local headcount and domain expertise. Many customers believe if the Indian vendors get this right over time, they can make significant share gains on large deals.
- Based on our checks, we believe TCS still depends on its traditional services like ADMS (Application development and maintenance), core banking products, etc., to win business in continental Europe. While this can be an advantage during difficult times when customers are focused on cost cutting, from a longer-term perspective it limits growth opportunities for the company. In our view, the company needs to accelerate its investment in higher value-added services like consulting and package implementation to have better visibility on long-term growth in this market and a strategic positioning amongst the client vendors.
- Although overall company-wide attrition at TCS is the lowest amongst tier 1 Indian vendors, customers complain of significantly higher attrition at the project level. This is primarily due to the shifting of resources across customers. A stable delivery team can result in increased business opportunity.
- While the Tata brand name does resonate well with potential customers, TCS also tends to lose out on business from competitors of Tata group companies.

1. Increase revenue contribution from project based services
2. Increase in local headcount and nearshore capabilities

Wipro – Renewed business priorities helping gain wallet share

Taking steps to consolidate business with existing customers and win relationships

Despite having the most aggressive nearshore strategy and significant investments in hiring local talent, Wipro has lost ground over the last two years in continental Europe. The two key reasons for this were (a) an alarming increase in attrition and (b) the impact of the organization restructuring following the dismantling of the Jt. CEO structure. However, under the leadership of Mr. T K Kurien, the vertical-focused organization is now taking positive steps to consolidate the business with existing customers and win relationships. In our assessment, while Wipro does not stand to gain by targeting continental European customers, our checks reveal that in the majority of cases, customers are keen to engage Wipro for servicing their Middle East and Asia-Pacific business. Some of Wipro's key positive and negative points on operation/strategy in continental Europe are as follows;

Key positives

1. New Wipro with a 'can do' attitude
2. Recently concluded strategic acquisitions will help gain share

- After the organization restructuring, Wipro's customers have witnessed increased involvement of senior management in managing business with existing tier 1 customers. This new 'can do' attitude of Wipro is also leading them to view Wipro favourably for future contracts.
- The cooling off of attrition, after a massive rise over the last one and one-half years, has improved the quality of project delivery for most vendors.
- Recently, new management has also orchestrated some strategic acquisitions, which have the potential of having an impressive increase in the business from Wipro's large strategic customers.
- Among Indian vendors, Wipro is one of the most eager to invest in nearshore centres and hiring local talent.

Key negatives

1. Customers still perceive it to be a commodity IT service company
2. Reactive and does not provide innovative solutions

- Given Wipro's historical focus on commoditised services like ADMS (application development and maintenance) and BPO (Business Process Outsourcing), customers still perceive the company as a commodity IT services player. This, in our view, can have negative effect on the company's long-term growth potential in the region.
- As a corollary to the perception of Wipro being a commoditised IT service player, customers also believe that Wipro is reactive and account management and delivery teams do not provide sufficient innovation solutions.

Infosys - best delivery but complacency and extreme risk aversion limit business opportunities

Infosys' delivery quality is at par with its tier 1 American and European counterparts

Infosys has arguably the best delivery quality among offshore vendors. Moreover, most customers we interviewed consider Infosys' delivery quality to be at par with its tier 1 American and European counterparts. TCS it is also considered as very transparent with its dealings. Based on our checks, we believe among the Indian vendors, it is the best positioned to move up the value chain in Europe in terms of the services delivered. However, many customers complain that Infosys is extremely difficult when negotiating the commercial terms of a contract. In addition, almost 22% of the customers we interviewed noted that they have not sought Infosys' service or have not been approached by the vendor in the past. Importantly, all these customers count TCS, Wipro or HCL Tech as their strategic vendor or are likely to engage with them in the near future. In our view, Infosys is faced with some significant challenges/drawbacks that it needs to overcome in order to gain market share in continental Europe. Some of Infosys' key positive and negative factors are highlighted below:

Key positives

- Delivery quality is at par with tier 1 American and European vendors. The company is highly transparent in their dealings.
- Eager to move up the value chain. It has demonstrated capability to manage large ERP rollouts, which includes all four phases, i.e., initiation, blueprinting, configuration and preparation. Customers are impressed with Infosys' SAP factory model and highlight that it is the sole company that offers this. Its factory approach and work packages are significantly different and better organized when compared with that of other Indian and global competitors.
- Although most offshore service providers are considered reactive, our checks reveal that Infosys screened the best at making suggestions for improvement to the client and has the most streamlined processes.
- Is making an effort to connect with C-level executives within the client organization.

1. Eager to provide higher value-add services
2. Best at making suggestions for improvement

Key negatives

- Twenty-two percent of the customers we interviewed noted that they have not sought Infosys' service or have not been approached by the vendor in the past. Importantly, all these customers count TCS, Wipro or HCL Tech as their strategic vendor or are likely to engage with them in the near future. Smaller customers also think Infosys is too large for them.
- Complacency at managing small but long-lasting customers has meant losing some of the incremental business from these customers to tier 2 Indian vendors.
- Extreme risk aversion and premium pricing can be impediments for winning new business when customers are focusing on cutting costs and gaining efficiency.
- Has not gained significantly from the vendor consolidation exercise undertaken by most large European accounts of Infosys.

1. Complacent at managing small but longstanding customers
2. Extreme risk aversion

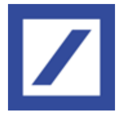
HCL Tech – Strong IMS capability but not tier-I as of yet for the rest of the services

Among Indian vendors, HCL Tech stands out for its IMS offering. However, despite the acquisition of Axon, which significantly enhanced HCL Tech's SAP capability in Europe, it trails peers such as Infosys in this market. Also, with respect to commoditised service like ADMS, TCS and Wipro are preferred by customers. With only IMS finding favour with customers although HCL Tech's opportunities of increasing exposure to Europe seem limited, that IMS figures among one of the priorities of customers to reduce operating costs only improves HCL's chances of winning incremental business in this region. Some of HCL's key positive and negative points are as follows.

Key positives

- Extremely strong IMS capability
- Easy to deal with and is willing to take risks
- Most client relationships are very closely monitored by senior management. In our view, HCL Tech makes best use of client references for attracting new customers.

1. Extremely strong RIM capability
2. Easy to deal with



Key negatives

- Most customers we interviewed did not consider HCL Tech for ADMS of package implementation deals.
- In a few of its large accounts, it has been ceding business to late entrants. With customers consolidating their volumes with preferred vendors, this could mean loss of share for HCL Tech.
- In contracts with the government or government-funded corporations, the company has been facing the impact of protectionism.

1. HCL Tech still a commodity service player
2. Could face the effect of protectionism

Mahindra Satyam – Flexible and entrepreneurial but lacks the advantages of tier 1 vendor

Most of Mahindra Satyam's (MSat) longstanding customers we interviewed highlighted that the biggest positive factor in favour of the company was that the quality of delivery after the announcement of fraud by the erstwhile promoter actually improved and was better than the rest of the vendors for a sustained period of time. While this helped retain these customers, the ensuing uncertainty meant that incremental business to Mahindra Satyam was limited. However, the new management team has been working very closely with the customers. In fact, our checks showed that none of MSat's clients complained about the commitment of the company to provide good service. However, due to lack of relevant resources onshore, there is a roughly 10% rise in the client's operating cost in managing offshore delivery. Some of MSat's operations' key positive and negative factors in Europe are as follows:

Quality of delivery after the announcement of fraud by the erstwhile promoter actually improved and was better than the rest of the vendors

Key positives

- After announcement of fraud by erstwhile management, the quality of the service did not decline. Low attrition also helped the interim management team retain large client relationships in Europe.
- The company is extremely flexible and entrepreneurial. The CEO is actively engaged with the client and takes a keen interest in strengthening the relationship with the customers.
- The company has successfully leveraged client references to win new business.

1. CEO is actively engaged with the client
2. Successfully leveraged client references to win new business

Key negatives

- Lacks the necessary talent onshore and is also not proactively investing in building a strong base for the future.
- Customers complain that managing the relationship with Mahindra Satyam requires an additional 10% in costs. Also, Mahindra Satyam had accepted high price discounts in 2009 to retain customers. These discounts have not been revised.
- The impending merger with Tech Mahindra is creating uncertainty in the minds of the customers. Customers are of the view that the merger would upset the flexibility and entrepreneurial spirit at MSat.

1. Lacks necessary talent onshore.
2. Managing the relationship with MSat requires an additional 10% in costs

Advantages of a centre-based delivery model

Homogeneous solutions in heterogeneous markets

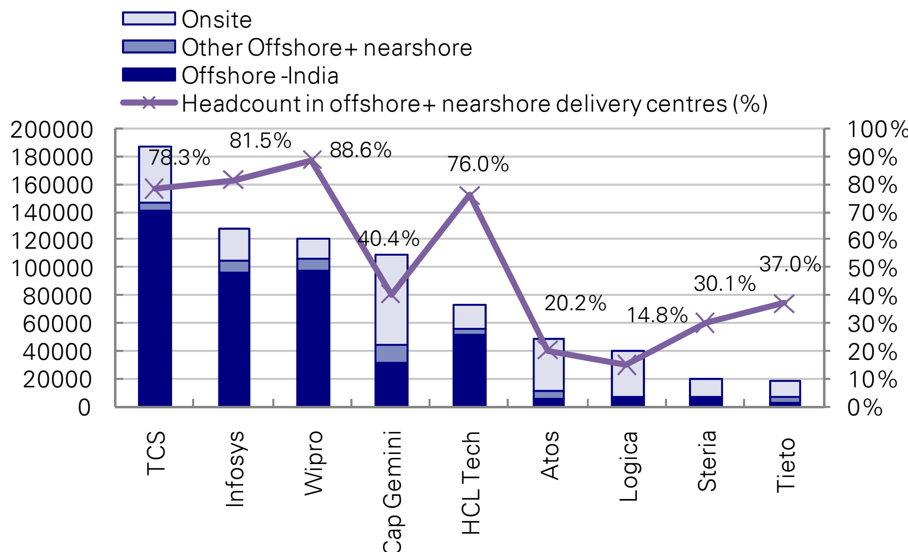
Why clients prefer Indian vendors?

1. *Large- scale operations in a single location*
2. *Superior knowledge repository*
3. *Cost reduction to fund growth*

The delivery models of the Indian vendors and their multi-national counterparts are a study in contrasts. While the consulting-focused multi-nationals have largely relied on high-cost onsite staff to attract business, the offshore centre-based delivery model of the Indian vendors provided definite advantages to global companies especially with an intention to cut fixed costs and operating expenses. Labour arbitrage was the primary attraction for most first generation outsourcers. However, as a function of both an uncertain global macroeconomic environment and a dynamic business environment, the second generation outsourcing demands speed, flexibility and a more responsive IT capability. In our view, especially for midsize companies with global operations, the following benefits make the operating model of the Indian vendors attractive:

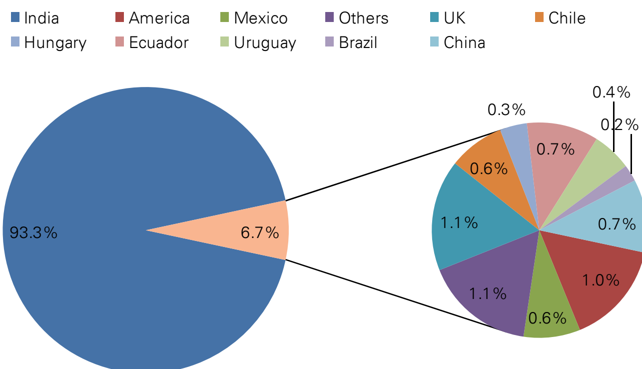
- Large-scale operations at a single location (Figure 23) ensures speed of response, particularly for global rollouts.
- The largely India-dependant operating structure (Figure 24 and Figure 25) also ensures a superior knowledge repository. This, in our view, is the cornerstone for the dissemination of best practices and maintenance of consistent delivery standards across markets.
- The high offshore delivery content helps customers to 'free-up' costs from 'run-the-business' to then allocate more to 're-invent'.

Figure 23: Onsite and offshore distribution of headcount



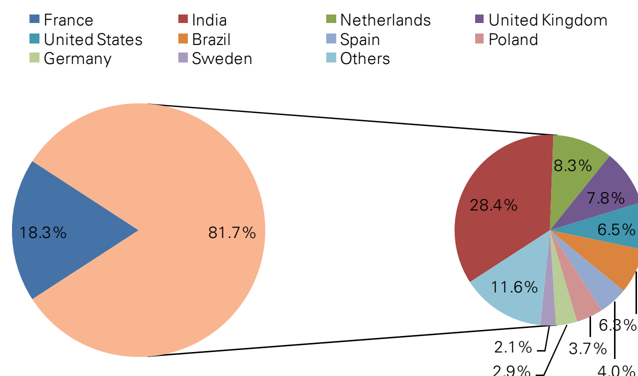
Source: Company data, Deutsche Bank, Data as of 31 Dec 2010

Figure 24: TCS – geographical distribution of headcount



Source: Company data, Data based on headcount as of 30 Sept 2011

Figure 25: Cap Gemini – geographical distribution of headcount



Source: Company data, Data based on headcount as of 31 Dec 2010

To support our views, below mentioned are some observations made by the head of global IT of one of Europe's largest sports retailer, which counts Infosys and a tier 1 European IT service company amongst its key vendors.

- Business is very dynamic, meaning IT projects often need to ramp-up very quickly. For example, often a client demands 50 consultants almost immediately. This cannot be accomplished with traditional IT vendors.
- GDM (global delivery model) is critical for the client because they have integrated global projects that are resourced in various geographies. Servicing these projects is only possible with offshore service providers like Infosys. Tier 1 European IT service providers, in contrast, portend to have a GDM.
- The tier 1 European IT service company with which the customer was working with, left a great impression on them in India, but they do not behave / have the mindset of a true global company. In contrast to Infosys, the European vendor still has a fragmented country-based model. Infosys offers one uniform service across the globe. The client is still doing business with the European vendor, but with their traditional onshore organization, not using their global delivery organization.

Vertically aligned organization structures ensure homogeneity of solutions

Drawback in organization structure of MNC vendors:

1. *Delivery teams are geographically aligned*
2. *Onsite and offshore teams are loosely connected*

A recurring complaint we heard from some large customers having global operations/contracts was that, delivery teams of the American and European vendors were aligned by geography and each country operated in a silo which prevented the sharing of best practices especially between offshore and onsite teams, eventually increasing the cost to the customer. For example, the head of sourcing for a large telecom company in Europe with global operations noted that:

- The tier 1 American vendors that they worked with provided less transparency when compared with Infosys/TCS. There was no sharing of IP across countries, e.g., between Portugal and Spain.
- The offshore ratio for ADMS (application development and maintenance) in the UK was 40%-50 %(higher in Ireland). In Australia it is at 65%-70%. The lower ratio in the UK was presumably related to contention between the local management of the vendor in the UK and its India operations.
- The American vendor's onsite team had a loose relationship with its Indian counterparts, and there was no transparency. The client received different messages from local and the offshore operations of the same vendor.

- The offshore operations had to sell their services to the client independently because their UK counterparts were not always willing to engage them.
- During the process of signing, as compared to Infosys, the tier 1 American vendor was easier to negotiate with, but attempted to re-negotiate and often pressed for rates outside the agreements.

This stems from the fact that primary business segments for most large multinational vendors operating in Europe was geography-based (See Figure 26) and so were the delivery teams.

Figure 26: Organization structures of most multinational vendors are geographically aligned

Company	Key business segment	Comments
Accenture	Vertical	Our operating groups are our reportable operating segments. These are communications & high tech, financial services, health & public service, products and resources.
IBM	Conglomerate/Geography	IBM, unlike the rest of the IT service vendors mentioned herein is a conglomerate and has interests in hardware, software, IT services and leasing. It thus has five primary reportable segments, namely Global Technology services (GTS), Global Business Services, Software, Systems and technology, Global Financing and others. In addition to the revenue presentation by reportable segment, the company also measures revenue performance on a geographic basis.
Cap Gemini	Geography/Service Lines	The groups' basic business units are geographically aligned. These are (1) North America, (2) UK and Ireland, (3) France, (4) Benelux, (5) Nordic, (6) Germany and central European countries, (7) Southern Europe, including LatAm and (8) Asia-Pacific. This is also accompanied by a breakdown of the group by seven strategic business units.
Atos	Geography	The internal management reporting is designed on two axes: Global Business Units and Service Lines. Global Business Units have been determined by the group as key indicators by the chief operating decision maker. A GBU is defined as a geographical area or the aggregation of several geographical areas. Each GBU is managed by dedicated members of the Executive Committee.
Logica	Geography	Logica is organized into six geographical segments based on the location of assets. The Executive Committee reviews the performance of the group based on geographic segmentation.
Steria	Geography	Groupe Steria SCA is managed on the basis of eight geographical operating segments. Three are major individual countries: France, the UK and Germany. The other segments comprise Spain, Scandinavia (Norway, Sweden and Denmark), Benelux (Belgium and Luxembourg), Switzerland and Poland.
Tieto	Geography	The reportable operating segments based on country dimension are Finland, Sweden and International. International consists of 22 countries outside Finland and Sweden. The Leadership Team assesses the performance of the operating segments based on operating profit (EBIT) which corresponds to the operating profit in the income statement according to IFRS.

Source: Company data

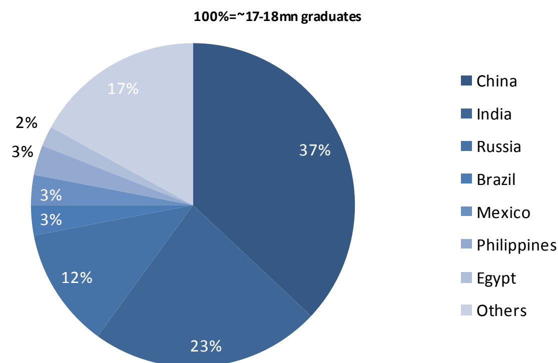
Conversely, while most Indian companies had a matrix organization structure recently with profit responsibilities for both geographic and vertical segments, over the last three years we have seen TCS, Infosys and Wipro switch over to aligning their business by key go-to-market verticals such as financial services, manufacturing, telecom, consumer products and energy and utilities. This, in our view, will help the top tier Indian firms further strengthen their relationships with European customers by delivering homogeneous solutions, especially during global rollouts.

Larger and expanding talent pool

India ranks second in terms of total annual graduates, but has the largest ready-to-hire graduate pool

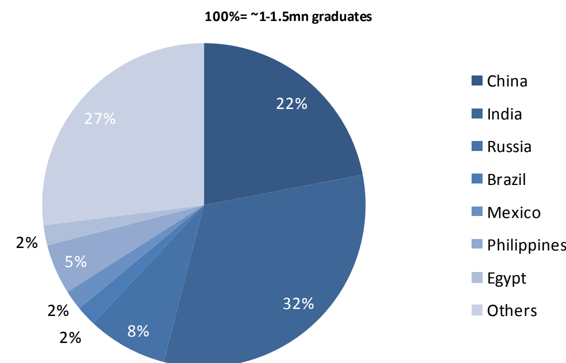
While India ranks second in terms of total annual graduates, it has the largest ready-to-hire graduate pool (Figure 27 and Figure 28). Industry specialists (Nasscom) believe that although China churns out higher numbers of graduates and provides similar cost savings, it does not have an English-speaking population to match India's credentials. This is reflected in the lower share of ready-to-hire graduates compared with 37% of total global annual graduates. China is perceived to be only best suited for regional work and Chinese vendors lack the capabilities to support high-end engagements. Similarly, the Philippines may have a larger proportion of those fluent in English but is perceived to be much lower in the services value chain when compared with India.

Figure 27: Global annual output of graduates (FY10E)



Source: NASSCOM Strategic Review 2011

Figure 28: Global annual pool of Ready-to-hire graduates (FY10E)

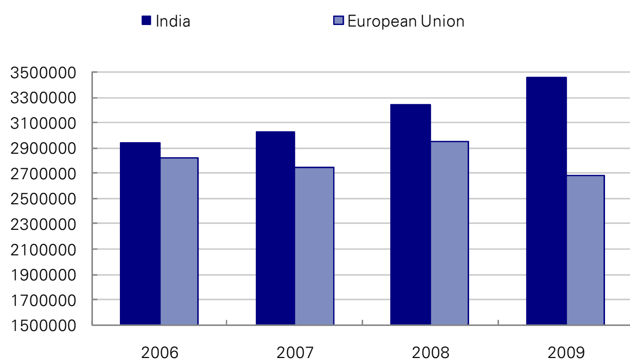


Source: NASSCOM Strategic Review 2011k

Figure 29 also shows that while India's addition to the graduate talent pool began to increase just over the last few years, annual addition to graduate talent pool in the European Union is on the decline. Moreover, at 26, the median age of the population in India is significantly lower than that of most developed European countries, creating a natural need for offshore delivery of services, we believe.

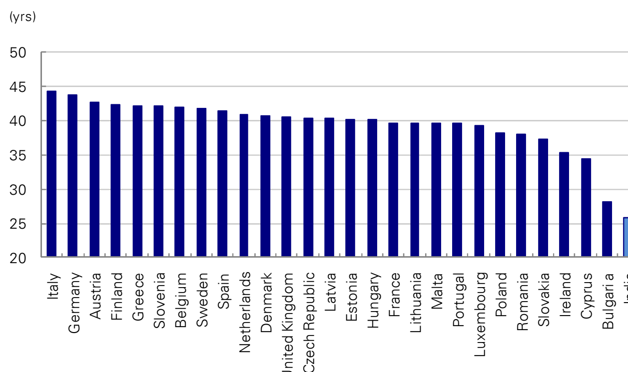
Annual addition to graduate talent pool in the European Union is on the decline

Figure 29: Annual additions to graduate talent pool



Source: Nasscom, Eurostat, Note – Numbers for India include technical and non-technical graduates and post graduates. The numbers for European Union Graduates in ISCED 3 to 6

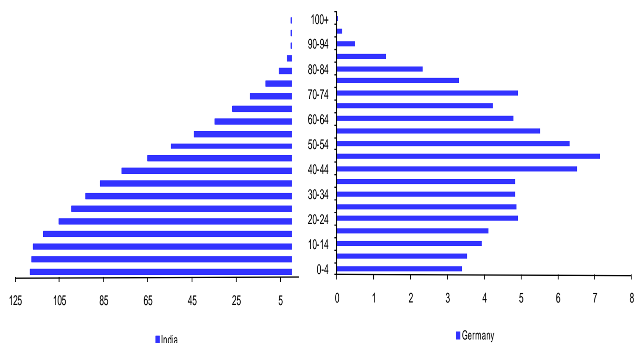
Figure 30: Median age of population 2011



Source: Central Intelligence Agency

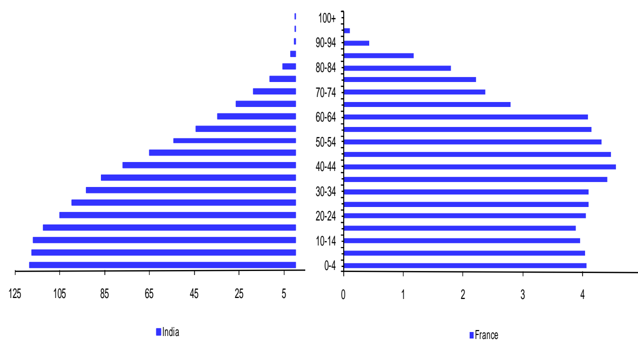
Figure 31 and Figure 32 show that with a bulge in the group of those ages 40-55, business in countries like Germany and France, which have not been leveraging offshore delivery in a meaningful manner, would be compelled to make greater use of offshore services going forward.

Figure 31: Population pyramids of India and Germany



Source: US Census Bureau, Populations are in millions. Data if for 2011E

Figure 32: Population pyramids of India and France



Source: US Census Bureau, Populations are in millions. Data if for 2011E

Customers beginning to view Indian vendors as strategic partners

Indian vendors tend to exploit longevity of relationship better to deepen client exposure.

Our checks show that Indian vendors tend to exploit longevity of relationship better to deepen client exposure. Most customers, where Indian vendors are amongst the top two vendors, tend to view them as partners in innovation rather than mere vendors.

For instance, one of Infosys' midsize manufacturing clients mentioned that they set a quarterly target for Infosys employees to provide three ideas for process improvement. This could be in the form of a reduction in the number of tickets for a particular process by changing platforms or process, or re-training users, etc. Although it may not be practicable to implement all strategies, due to quality or cost issues, many of them are kept for future use, which generates additional business for the incumbents.

Customers also tend to invest proactively to integrate top vendors into their organization. A top automobile company from Italy serves Indian food in its cafeteria, imparts Italian-language training to the vendor's delivery staff (TCS – in this case), and its CEO personally meets with the TCS delivery team once every quarter.

Weak local footprint and domain expertise pegs down advantage

Weak local footprint

The importance of having local leadership in key continental European markets cannot be overemphasized. One cannot expect British person to sell in France or a French- to sell in Germany successfully. Vendors thus need a separate strategy for each market. The following two anecdotes distinctly demonstrate the importance of having a local country head in key continental European markets:

Cannot expect a British person to sell in France or a French person to sell in Germany

#1: Scaling back presence in Germany hurts a tier 2 Indian vendor

- After the financial crisis of 2008-09, management teams from the tier 2 Indian vendors decided to focus on reducing costs.
- It was decided to that management levels would be reduced in Europe and thus senior management of continental Europe was moved to the UK.
- The existing senior management in Germany warned of a potential impact on business from German customers due to the shift in management to the UK
- The Indian management did not pay heed these warnings and hence the senior management in Germany resigned.
- The 100% German subsidiary, which was the vehicle for managing German accounts, was dissolved and the entire management team was moved to the UK.
- As expected, the existing customers viewed this move negatively and within six months the overall turnover from Europe was reduced to EUR1m versus EUR6-7m earlier. One of its largest customers in Europe switched to another vendor.

#2: Mahindra Satyam wins multimillion-dollar contract from a leading chemical company in Germany

- MSat's Germany head had a close relationship with the client's management team and could convince the India-based senior management to make a large investment.
- The company then set up a team of 25 India-based experts in various fields of IT consulting, infrastructure, support and maintenance, etc., and for over three weeks these teams showcased their skills to the customers' representatives.
- Despite competition for large players like TCS, the investment was large and ambitious on MSat's part.
- This aggression helped MSat win the multimillion-dollar contract with the client

To address this issue, most Indian companies (with the exception of TCS) have appointed local heads for each of the key markets within this geography.

Figure 33: Heads of business at key continental European countries

Country heads	Infosys	TCS	Wipro	HCL Tech	Cognizant
Germany	Mr. Franz- Josef Schurmann	Europe headed by Mr. A.S. Lakshminarayan	Mr. Ralf Reich	Mr. Horst Plieske	Mr. Dieter Berz
France	Mr. Eric Laffarque	Mr. Christope Martinoli	Mr. Chris Connors	Mr. Olivier Cavrel	
Nordics				Mr. Liselotte Hdgertz Engstam	Mr. Stefan Metzger

Source: Company data

Moreover, for France and Germany in particular, many companies are attempting to move away from the 30:70 onsite offshore ratio. While some like Infosys seek to add more local headcount with a 20:20:60 local, onsite and offshore model, others like Cognizant look to alter the delivery model by adding nearshore to the plain vanilla onsite/offshore delivery. Wipro, on the other hand, is positioning itself with as a hybrid of the Infosys and Cognizant delivery models.

1. Infosys – adding more local headcount
2. Cognizant – adding nearshore capabilities
3. Wipro – hybrid of the above models

Figure 34: Offshore and nearshore delivery centres of Indian vendors serving continental European customers

Company	Nearshore delivery centres
Infosys	Brazil, China, Czech Republic, India, Mauritius, Mexico, Philippines, Poland
TCS	China, Hungary, India, Morocco, Netherlands, Uruguay
Wipro	India, 20 delivery centres in Europe including centres in Hungary, Poland, Portugal and Romania,
HCL Tech	India, Poland and Northern Ireland
Cognizant	India, Hungary, UK

Source: Company data, Forrester, Deutsche Bank

Challenges Indian companies face while recruiting in Europe

We spoke to senior executives of two large executive search firms in Europe. These firms are regularly contracted by the Indian vendors to hire senior management and consulting talent in Europe. Our conversations reveal that Indian companies have a strong preference for those who work at firms with well-known names, e.g., tier 1 American IT service companies. Indian firms generally tend to prefer candidates who are more entrepreneurial, have more experience and strong sales focus and are not afraid to pay premiums. However, given the lesser brand positioning and the conservative nature of these candidates, in many cases, Indian firms end up hiring mediocre talent at a premium. Some of the other observations are as follows:

Indian companies have a strong preference to hire those from tier 1 American IT service companies

- Challenges are greatest when recruiting candidates for position outside the core business of the Indian firms, e.g., in management consulting.
- Recruiting candidates from tier1 American firms is challenging as these candidates are very comfortable in their setting. Enticing someone to move from these firms to a company that does not have a comparable well-known name is incredibly difficult.
- It is easier to recruit for the senior management positions, e.g., managing director.
- Management consultants tend to be highly conservative and it is difficult to persuade them to even consider opportunities at companies which are not recognized for this business.
- In contrast, the management consulting capabilities of tier 1 American IT service companies are not commonly questioned.

- Hiring candidates with 10 years of experience is highly difficult because of the scarcity of talent in this category.
- Recruiting from Indian firms is easier for tier 1 American and European IT service companies, than the reverse. These firms are recruiting from Indian firms to gain staff with expertise in offshoring and shaping large deals.
- Need to triple the long list of candidates when compared with a tier 1 American or European IT service company Three percent of the candidates pursued were introduced to the Indian client, this number for a tier 1 American company stands at 7%.

3% of the candidates pursued were introduced to the Indian client, this number for a tier 1 American company stands at 7%.

Move up the value chain by enhancing domain expertise

Although there is a rising awareness about the rapidly improving quality of the performance of the offshore vendors, many customers still continue to consider the domain skills of most Indian vendors to be inferior to the likes of global vendors. These issues could be with regard to both vertical and service line skills. We use the following two examples to support our views:

Many customers still continue to consider the domain skills of most Indian vendors to be inferior to the likes of global vendors

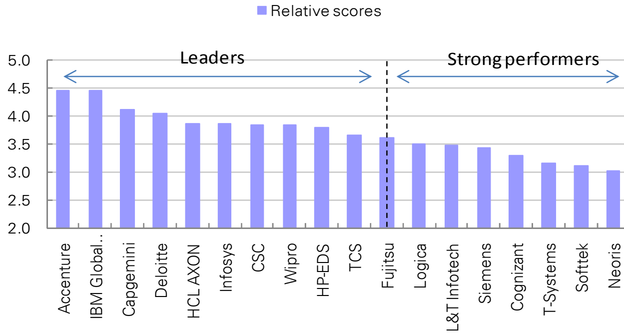
#1: Lack of sufficient knowledge of German insurance intricacies

- Indian companies are comfortable supporting familiar IT processes. However, there are differences even in the insurance processes of a UK and German insurance company. This is an item with which the Indian companies tend to struggle.
- To some extent they underestimate the challenges arising from those differences and so very often the projects, during the early engagement phase run into serious trouble. This definitely dents the goodwill created by these companies from their other operations.
- As a consequence, it is difficult for the customer management teams to completely rely on the Indian vendors. While they do seek the best price, the view quality and reliability of service are more important factors.
- Thus, in the case of this German insurance company, despite the higher price, management resulted in awarding the contract to a tier 1 American vendor versus TCS or HCL Tech.
- To overcome such issues and still leverage the benefits of offshore, firms tend to rely on captives. The advantages of these are as follows:
  - Employees are made to feel as be part of the group and thus more committed to reaching targets, objectives and overall strategy of the organization.
  - Since the attrition rate is lower, people stay with the firms longer. This helps in having a mature employee base with respect to company-specific processes, IT applications support and maintenance.
  - Moreover, the company can keep the knowledge base intact in the captive in India

#2: IBM and Accenture lead the overall breadth and depth of service offerings

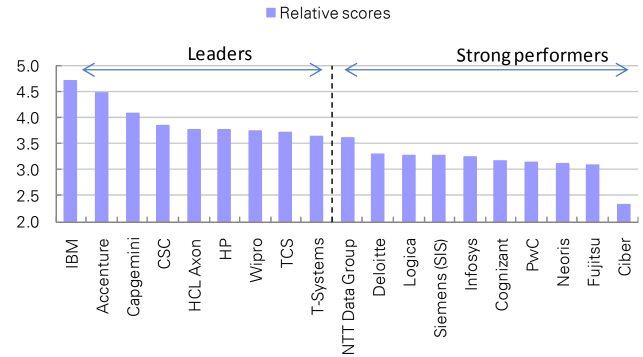
Customers acknowledge that Indian vendors have significantly better application development and maintenance capabilities. However, with respect to new service lines like package implementation services, IBM and Accenture are considered to have better offerings than their Indian counterparts. SAP and Oracle are the two most important software, from the implementation of which Indian vendors derive a large part of their package implementation revenues.

Figure 35: Relative standings of SAP implementation providers in 2009



Source: Forrester

Figure 36: Relative standings of SAP implementation providers in 2011



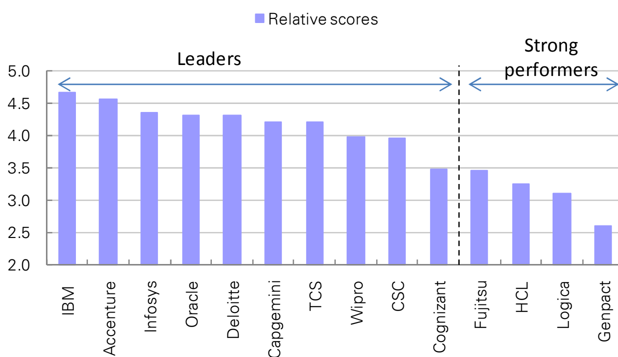
Source: Forrester

SAP implementation - Accenture, IBM and Cap Gemini have maintained their lead over the Indian vendors

Figure 35 and Figure 36 show that, over the two years, Accenture, IBM and Cap Gemini have maintained their lead over the Indian vendors. Moreover, with the exception of TCS, the relative market presence of almost all the Indian vendors has deteriorated.

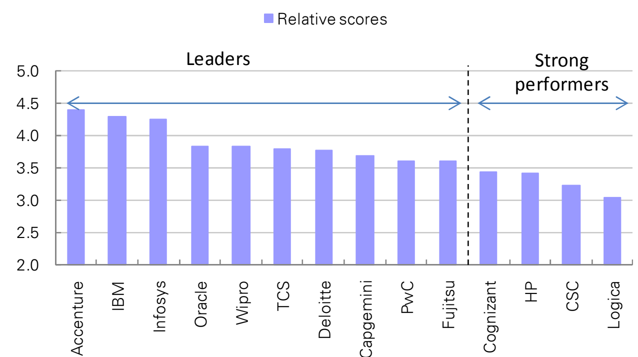
Most customers believe that Accenture and IBM are full-service providers with strong presence across strategy consulting, support and hosting services. Also, their decades of experience with larger, complex, multinational rollouts, reduces the perceived risk the client faces with these relationships. While Indian vendors are winning business over their multinational counterparts, SAP support still remains the key service area of their success. They still must make reasonable progress with their SAP consulting and implementation capabilities, which would require some immediate investments, both organic and inorganic. This is extremely important, since about 14% of the IT service spending in Western Europe is toward package implementation.

Figure 37: Relative standings of Oracle implementation providers 2009



Source: Forrester

Figure 38: Relative standings of Oracle implementation providers 2011



Source: Forrester

Oracle - Indian vendors are better placed

Unlike SAP, amongst the Oracle implementation partners, Indian vendors tend to fare slightly better. Infosys is now considered as a leader alongside Accenture and IBM. More importantly, apart from Accenture, Infosys is the sole vendor with a Diamond Partner status. Industry specialists believe that TCS, Wipro and Cognizant have also made good progress with their Oracle implementation capabilities. These firms have all moved beyond application maintenance and support work to strategic advisory and process consulting.

‘When Indian firms say global, they mean “India”’

While a centre-based approach can be a distinct advantage as outlined in the previous section, it can sometimes prove to be a drawback. The delivery model of the Indian vendors is basically India-driven and thus even when it comes to delivering services onsite, most employees onsite are also Indians holding valid visas. While most global customers were not too bothered about the delivery staff being Indian or local, they highlighted that not having the right skills at the right time can certainly constrain the deal win rates of the Indian vendors.

1. *Almost all of the bench strength of the Indian vendors resides offshore*
2. *‘Importing’ an employee onsite could take >3 months*

Most Indian vendors tend to have bench strength of about 20% of their overall headcount. But almost all of this resides in the offshore development centres. Onsite locations tend to operate at about a 95%-plus capacity utilisation. As a consequence they tend to ‘import’ employees onsite only after being awarded the project. This creates a significant bottleneck since it can take about three months to get the relevant skills onsite, thereby impacting project timelines adversely.

Indian vendors are attempting to address this issue by increasing the local hire content. However, most customers mentioned that they have yet to see the necessary change in the delivery teams of their current projects.

Cost consciousness accelerates offshore shift

Complacent incumbents

Incumbents, who were high up on the customers preferred list, did not fare well during the RFP stage

Post the financial crisis of 2008-09, many global customers of the Indian vendors embarked upon a process of vendor's consolidation in order to cut operating costs. We noticed that because of complacency, some of the multinational companies (traditional vendors/incumbents), which were very high up on the customers preferred list of vendors, did not fare well during the RFP stage. Below mentioned are some of the comments made by the vendor manager of a large European energy and utilities company:

Vendors are evaluated on the basis of RFP and not reputation

- The initial RFI was for 18 vendors. Of these, 8-10 were short listed for the RFP stage. Five of these were finally selected as strategic vendors which included three offshore vendors from India.
- Although the customer had a very small agreement with TCS before the process of vendor consolidation, the customer managed to gain from the process the vendor's consolidation. It had a good proposal overall, both in terms of what it bid and what it was able to demonstrate. Their engagement was optimal from the CEO level with a very strong team forming the proposal.
- With the proliferation of the offshore delivery model, while the quality of resources of most vendors is the same, what matters to the customer is the perceived ability to leverage them.
- Despite the large bid, many incumbents did not invest enough time and money, with the belief that they would win contracts due to familiarity with the client organisation.
- But ironically, TCS, which was one of the least knowledgeable about the customer's organisation, was the most impressive. It was mainly about those bidding and the amount of time they dedicated to bidding.
- Vendors believe that a combination of expertise and determination is key. Some of the vendors which were very highly favoured did not do very well during the RFP because they were viewed as complacent. Customers evaluate vendors on the basis of RFP, not on the basis of reputation in the market.

Indian vendors provide a better opportunity to cut costs

Moreover, most customers we polled stated that despite the service agreements, during the last financial crisis tier-I American and European vendors saw resource issues offshore and used a greater proportion of their onsite headcount while executing application development projects. This increased the overall cost of execution. In contrast, the service agreements with the Indian vendors stipulated that over 60% of the work be delivered offshore. This meant that the customers could transfer a greater proportion of their existing projects offshore. The Indian vendors seemed willing to make this change due to a higher margin potential from this move. However, the tier-I American and European vendors were less able or keen to incorporate these changes into their delivery model, according to some of our discussions.

Instances like these and a focus on more offshore work have helped large-size Indian vendors gain market share versus their multinational counterparts. Importantly, customers rate the quality of delivery of the Indian vendors at par with that of their multinational counterparts. This could lead to a further market share gains by the Indian vendors in uncertain times.

Strategic acquisitions – important tool to accelerate penetration

We believe Wipro's acquisition of SAIC's energy and utilities segment is excellent

Our checks suggest offshore vendors can use strategic acquisitions as an important tool to increase presence across key customers in Europe. Wipro's acquisition of SAIC's global oil and gas IT practice is a pertinent example.

Wipro announced on April 2011 the acquisition of SAIC's (Science Application International Corporation) global oil and gas IT segment for an all-cash consideration of aboutUSD150m. Some of the important aspects of the deal were:

- The practice provides consulting, system integration and outsourcing services to global oil majors and has capabilities in areas of digital oil field, petro-technical data management and petroleum application services for the upstream segment.
- 1,450 (1.2% of Wipro's employee base) employees would transition to Wipro across North America, Europe, India and Middle East.
- We estimate that, post this acquisition, Wipro's energy and utilities vertical would contribute 11%-12% of the overall IT services revenues.
- With a greater investment in offshore, we believe the margins of the acquired company can be brought in line with the Wipro's average in the next two to three years.

Our checks suggest that:

- A large energy and utilities company from Europe represents roughly 80% of SAIC's commercial business. However, SAIC was one the biggest losers of the vendor consolidation.
- Although SAIC employed many of former employees of the customer, it lacked a compelling offshore delivery capability.
- We think this was an excellent acquisition by Wipro. SAIC had a significant exposure to the customer's upstream business, which contributes about 70%-80% to the profits to the company. No other offshore vendor has any exposure to the IT spending from this segment of the company's operations.
- Wipro's acquisition has hurt a tier 1 American company the most. It has since then tried to lure Wipro's employees from the acquired entity but has failed to garner any additional business from the customer despite these moves.
- Wipro is now a preferred vendor post the SAIC acquisition. It gave Wipro a platform for growth with the addition of the global energy and utilities major.
- Since the acquisition, Wipro is now placed at the top of the vendor rankings, both by capabilities and incremental business.

Need to do more with less

A higher value is derived by having more work done offshore than proposing to customers a price cut

Our checks suggest that since the last recession, pricing has been under pressure. However, customers underscore that the value derived by having more work done offshore is much higher than proposing to customers a price cut on the existing business. The former option helps banks operate more efficiently by sending work offshore, while it also aids offshore vendors in maintaining their margins.

For example, the vendor relationship head of a large bank states that since vendors are considered strategic partners, they are expected to share the burden if business conditions deteriorate. However, customers underscore that the value derived by getting 5% of extra work offshore is much higher than proposing to customers a 5% price cut. The former option helps banks to get more for less, and sending more work offshore also aids the offshore vendors in maintaining their margins. This has led vendors to adopt a fixed-price model.

Easier for Indian vendors to move up the value chain

In our view, with regard to the issue of moving up the value chain, the Indian vendors face two challenges:

Two key challenges before vendors

- Quality local talent and domain expertise
- Weak branding
- Availability of necessary bench strength onsite with strong domain expertise.
- Not having a strong brand name in the Western markets limits access to high quality talent.

Since there is no wage differential between an Indian employee sent onsite and a local hire, the increase in proportion of local hires onsite will not impact profitability of Indian vendors adversely.

However, when it comes to increasing the proportion of employees offshore to improve profitability, the multinational companies are faced with tough choices regarding:

- Lower revenue growth and profits,
- Restructuring costs and other labour issues due to downsizing of local staff onsite and
- Finding appropriate talent offshore to replace the onsite employees displaced due to the restructuring.

Figure 39 shows that, ceteris paribus, with a 5% increase in proportion of efforts offshore, overall revenues decline 4.9%, while EBIT (after restructuring expenses) drops 0.5%. However, EBIT margins improve by 24bps.

Figure 39: Impact of a 5ppt improvement in offshore effort on revenue and profits of MNC IT service companies

Particulars	Prior estimate	Shift offshore	New Estimate	Change
Assumptions				
Billed employees (nos)				
Onsite	70,000	-5,040	64,960	-7.2%
Offshore	30,000	5,040	35,040	16.8%
Proportion of billed employees				
Onsite	70%		65.0%	
Offshore	30%		35.0%	
Shift offshore	**7%**			
Billing rate/ man day (EUR)				
Onsite	400		400	
Offshore	100		100	
Employee cost/man day (EUR)				
Onsite	247		247	
Offshore	41		41	
Offshore employee cost/onsite employee cost	**16.7%**			
Performa Income statement (EUR m)				
Revenue (EUR m)				
Onsite	7,000		6,496	-7.2%
Offshore	750		876	16.8%
Total	**7,750**		**7,372**	**-4.9%**
Employee costs (EUR)	**4,627**		**4,367**	**-5.6%**
Onsite	4,318		4,007	-7.2%
Offshore	308		360	16.8%
Other expenses	2,395		2,278	-4.9%
EBITDA	**729**		**727**	**-0.3%**
Depreciation	202		202	0.0%
EBIT	**527**		**525**	**-0.4%**
Restructuring expenses	116		116	
EBIT (after restructuring expenses)	**411**		**409**	**-0.5%**
Margins				
EBITDA	9.4%		9.9%	45
EBIT	6.8%		7.1%	32
EBIT (after restructuring expenses)	5.3%		5.5%	24

Source: Deutsche Bank

Key challenges

Resistance at the operating level

While the case for offshore services is slowly developing in the minds of managers, only few truly believe it is a strategic imperative. Industry experts, Value Leadership Group, note that tacit attitudes and perceptions toward offshore continue to be rather negative amongst many decision makers, IT managers, and staff. These fears, uncertainties, and doubts represent invisible and intransigent barriers.

Most managers focus on low-risk incremental improvement strategies that maintain operational continuity and stability.

For example, German IT managers tend to be risk-averse and control-oriented. Most managers focus on low-risk incremental improvement strategies that maintain operational continuity and stability, their key objectives. Offshoring is perceived as risky. Moreover, while companies are not reporting their offshore successes, negative experiences are being widely reported.

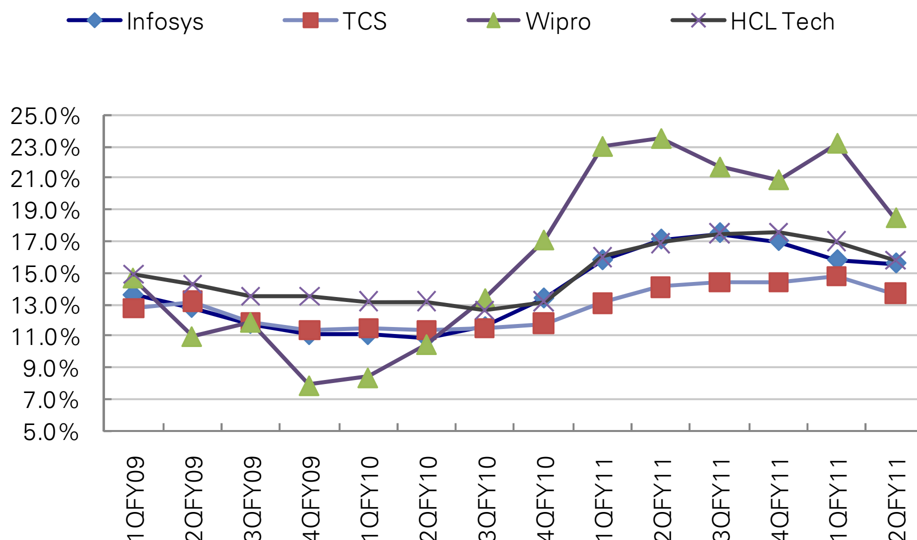
At most companies, senior management is driving the decision to try offshore services. Not surprisingly, many middle managers have not yet bought into the idea and do not actively support it. In an act of conservatism, middle managers perceive offshore services as inferior and believe that their organizations are not prepared, lack both management and process compatibilities necessary to ensure success. To minimize their risk exposure, middle managers will often define a very narrow offshore project scope, which leads to a staffing or extended workbench agreement.

Project level attrition more important than overall attrition

Project level attrition can be 2-4x of overall companywide attrition

A spike in overall attrition for the vendors has an impact on client service levels, knowledge repository and domain expertise. To address these issues most vendors focus on bringing the companies' overall attrition levels within manageable levels of 10%-14%, by attractive wage hikes, providing better work conditions, etc.

Figure 40: Trend of Indian vendor attrition rates



Source: Company data

However, we believe that for a better client experience, and incremental business from existing customers, vendors should first focus on maintaining attrition project levels. More importantly, particularly under tough market conditions, should company-wide attrition be low, better project attrition level would distinguish vendors. The following example helps support our view:

50% attrition in a unit of a large energy and utilities company serviced by an offshore vendor

- In this unit, no FTE of any of the three offshore service providers stayed for more than two years. The company-wide attrition reported by each of the vendors was in the mid-to low teens.
- The client tracks vendor staff movement on a project, unit, segment and company-wide basis. Over a three- to four-year period, many vendor FTEs even move out of the customer, leading to knowledge erosion.
- When the staff turnover is high, it is difficult for employees to understand the processes and knowledge well enough to be able to carry out quality work.

Captives can limit business potential of Indian vendors

Many continental European companies tend to rely on captives to leverage offshore. Based on our numerous conversations while performing our checks, with respect to use of captives, we noticed an underlying strategy/pattern emerge involving a three-tier strategy. The stages are as follows:

Stages in captive leverage:

1. *Understand offshore delivery*
2. *Move non critical work to third party*
3. *Divest to strategic vendor*

- Adoption – Most customers with very low offshore delivery experience tend to invest in an offshore captive. This also serves the purpose of maintaining data confidentiality.
- Consolidation - With process maturity and scale, customers tend to move repetitive processes to third-party offshore service providers. In this stage, customers tend to divide projects between the captive and offshore vendors with a gradual increase in the proportion of their reliance on offshore service providers over time.

- Divestiture – With customers achieving maturity in using offshore service providers, they monetise their interest in captives by selling them to strategic vendors. We have witnessed this post the financial crisis of 2008-09.

The following three examples display the pattern discussed above.

1: Large financial services firm from Benelux prefers India

- Offshoring began five to six years ago but was not well planned. The customer did not have a centralised vendor strategy and hence had a scattered portfolio of suppliers.
- Is now considering a major increase in offshoring as part of the strategic workforce planning.
- At present, offshoring application development and management from the home country is lower than 5% of spend. It is largely serviced internally, but should change in the near future.
- As part of the strategic workforce planning, the company is planning to outsource 3 000 FTE's to offshore and nearshore captives.
- Setting up captive in India and nearshore delivery centres in Poland and Romania.

#2: Western European financial services firm shifting non-confidential work from captive to third-party vendors

- One of the large banks in Europe spends about20%-25% of its total IT budgets offshore. This includes spending on both captives and offshore Indian vendors.
- The ratio of spending between captives and Indian vendors is 70:30. This ratio is likely to move to 50:50 over the next three to four years.
- Also, the banks plan to increase the proportion of offshore spending from the current approximate20%-25% to 30%-plus.
- While this means meaningful volume gains for the incumbents, it also means that in times of crisis, volume gains could partly mitigate any potential pricing decline.

3: Another large financial services firm divests non-strategic captives

- Setting up the captive was the first step to gain from labour arbitrage. The company was testing the waters then so did not have the risk appetite to work with vendors.
- The portfolio of services included investment banking support, application development and maintenance, network monitoring and IT operations.
- Saving per FTE was 60%-70%.
- However, over time the company has gained significant experience in using third-party vendors. As a consequence, the new management team questioned the need to do the processes in-house.
- Management recently divested the captive to one of its Indian vendors.
  - Company cultural fit was the key criteria while selecting the acquirer
  - The acquiring vendor has leveraged off the centre and moved up the value chain. It is now the largest outsourcing vendor for this customer.

Customers introduce new vendors to keep larger vendors on their toes

Tier 2 Indian vendors are introduced to ward off complacency on the part of larger vendor

Recently, customers with disproportionately high exposure to a single vendor have added tier 2 Indian vendors to their vendor list of options. The primary motive of doing so is to ward off complacency on the part of the larger vendor. In all such cases, the strategy seemed to achieve the desired results with a marked improvement in service levels from the larger vendors. Below are some examples:

#1: Large sports retailer in Europe leverages tier-2 Indian vendor to get Infosys to become more responsive

- Currently, offshore constitutes 80% of the IT spending. Infosys is the largest vendor; however, its lead over tier 2 vendors had slowed recently.
- When the customer first used Infosys as a vendor more than one decade ago, Infosys was highly hungry.
- Infosys has always been mature in terms of delivery but has eventually become complacent since it believes that its preferred vendor status with the customer would not change. Consequently, the customer received less senior executive attention.
- While the customer still continues to outsource with Infosys on managed services and intends to continue to use them the preferred vendor, the customer had added three tier 2 vendors to their vendor list. Awards to the tier 2 vendors are predominantly staff augmentation projects.
- This has served as a wake-up call for Infosys. It is now willing to actively negotiate to retain business.
- Customer's satisfaction with Infosys has improved. Infosys is now staffing projects with better resources.

#2: TCS's gains share with a large financial services customer from Europe

- A large bank in Europe has the policy of allocating 60% of spends in a particular region to a preferred vendor (TCS in this case) and split the balance in amongst the rest.
- This was largely done to force the preferred vendor to maintain solid management.
- Spending data for the last two years shows that most preferred vendors have gained share and ended up with about 80%-plus of the spends for that region.

#3: Cognizant keeps Infosys on its toes

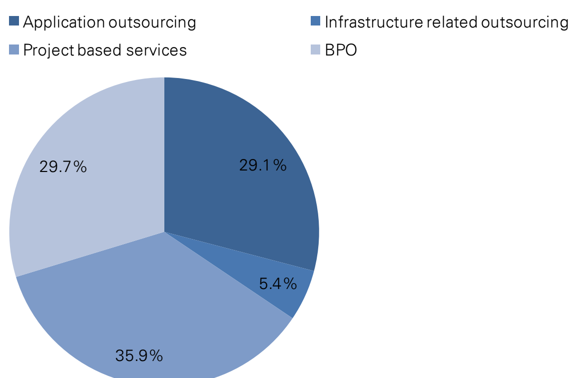
- One of the earliest customers of Infosys in Europe, recently added Cognizant as an offshore service provider. The customer felt that they were no longer getting the best service from Infosys.
- Once Cognizant was on board, Infosys significantly increased performance.
- The vendor has managed to maintain competition between the two vendors despite similar billing rates; Infosys has been winning more business.

Richer service mix positive for margins

More than 50% spending on project-based services

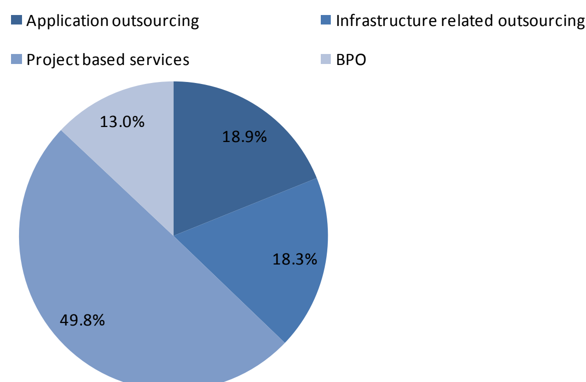
On a Pan-European level, system integration projects and consulting engagements gain the most attention, followed by application outsourcing. On average, almost 50% of the spending is on project-based services. In contrast, just 36% of India's exports are on project-based services.

Figure 41: India IT-BPO exports by service line



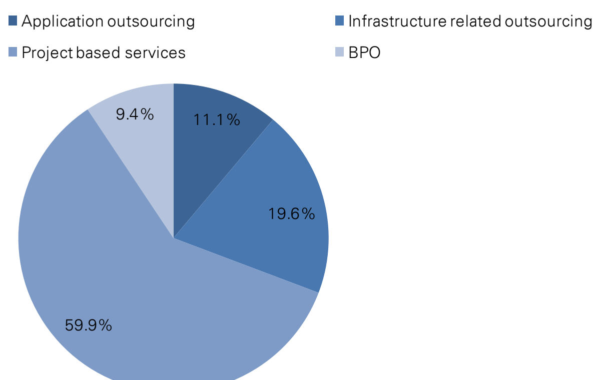
Source: Nasscom Strategic Review (data from 2010)

Figure 42: Europe IT-BPO spend by service line



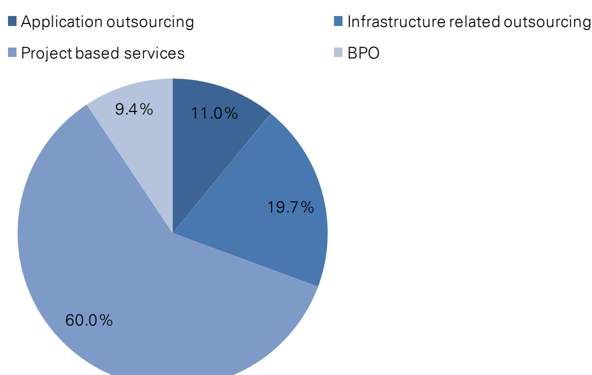
Source: : Forrester (data from 2010)

Figure 43: Germany – IT-BPO spend by service line



Source: Forrester (data from 2010)

Figure 44: France – IT-BPO spend by service line



Source: Forrester (data from 2010)

Capturing a greater proportion of spend on project-based services will help Indian vendors move up the value chain and improve net realisations. While commensurate costs of executing these services could also be higher, we note that historically operating margins of the European business have been higher than those in the US (primary market).

Higher spend on project-based services will help

1. *Indian vendors move up the value chain and*
2. *Improve net realizations*

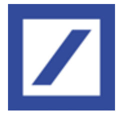
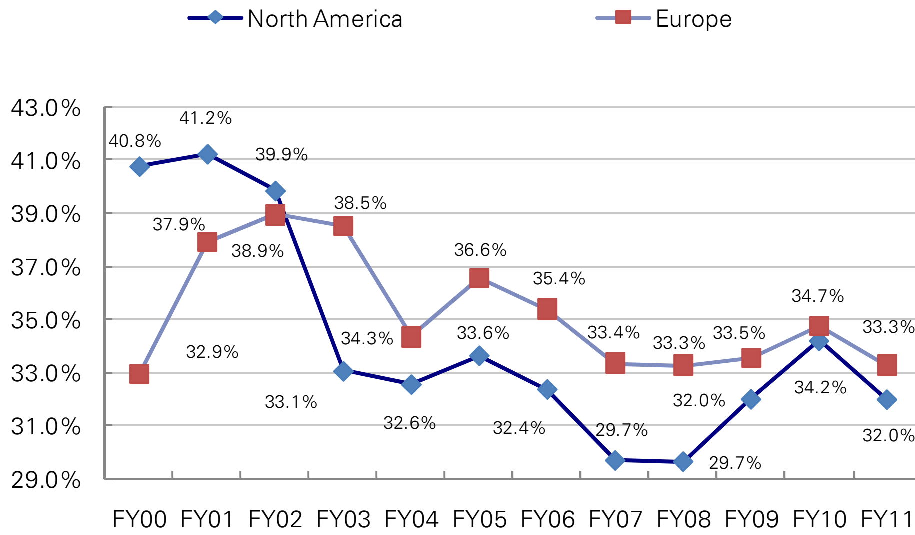


Figure 45: Infosys – North America and Europe operating margin trend



Source: Company data

Valuation and risks

Infosys

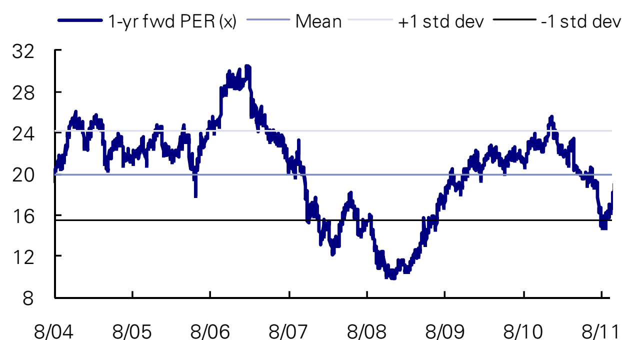
Outlook

While near-term demand for the top-tier vendors is intact, uncertain global macroeconomic outlook could weigh on clients' CY12E IT budgets. This, in our view, will only accelerate the need to cut costs and hence Indian IT services companies should benefit from the increase in offshoring by clients. For the long term, we expect Indian IT services companies to benefit structurally from increased outsourcing. We believe that incremental demand should largely flow from 1) European geography, 2) an increase in adoption of cloud computing and 3) improvement in discretionary spending (revenue productivity is also set to improve further). Infosys, India's No.2 offshore services provider, is now a strategic partner to most of its large clients. With a high ROE (+30%) and a strong balance sheet (+USD3.8bn cash balance), the company could gain market share and/or in theory make EPS- and/or ROE-accretive acquisitions. We value Infosys at 18x FY13E, given its earnings CAGR of 16% over FY12-14E. This translates to a PEG of 1.1. We maintain our Buy rating.

Valuation

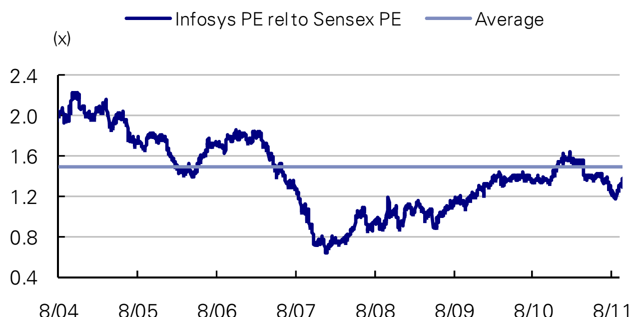
We value Indian IT services firms on a P/E basis relative to their historical trading range, compared with both peers and growth rates. We value Infosys at 18x FY13E. The lowered multiple factors in the increased macroeconomic uncertainty. We believe the multiple is justified since the company should report an earnings CAGR of 16% over FY12-14E and is better positioned than in 2003 on such key factors as revenue size, net worth, dependence on the US and client concentration. We believe our use of the stock's recent average PEG of 1.1 captures the potential upside.

Figure 46: Infosys – one-year forward P/E



Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Figure 47: Infosys P/E relative to Sensex P/E



Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Risks

Key downside risks include a severe and protracted global recession, significant rupee appreciation in the near term, global vendor competition, Infosys' execution on its consulting agenda and ability to maintain its premium position in terms of billing rates (and consequently in margins) and managing rapid growth. We believe the rhetoric over outsourcing will likely remain strong and may even become a sector overhang as political pressure on outsourcing increases.

Model updated:02 December 2011

Running the numbers

Asia

India

Software & Services

Infosys Technologies

Reuters: INFY.BO	Bloomberg: INFO IN

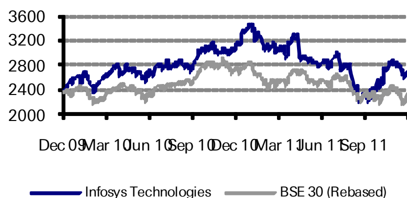
Buy

Price (2 Dec 11)	INR 2,696.80
Target Price	INR 3,000.00
52 Week range	INR 2,189.65 - 3,475.85
Market Cap (m)	INRm 1,540,439
	USDm 30,086

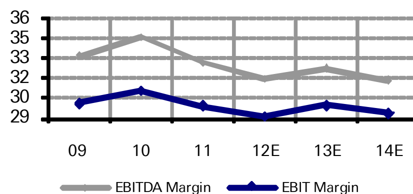
Company Profile

Infosys, one of the best managed and most profitable firms in the space, in our view, has one of the most risk-averse business models in the sector. We continue to believe Indian vendors are in a strong competitive position to weather this macro environment and capitalize on continued shift to low-cost sourcing overseas. Infosys is also well positioned, we believe, to capitalize on increasing demand for back-end integration services.

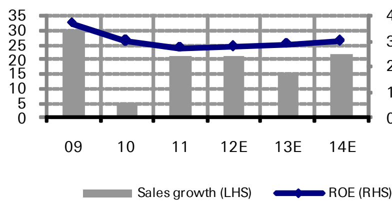
Price Performance



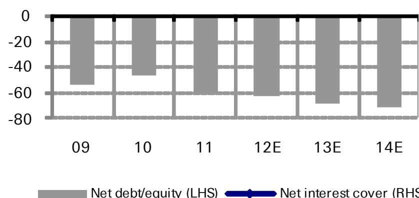
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 31-Mar	2009	2010	2011	2012E	2013E	2014E
Financial Summary						
DB EPS (INR)	102.28	108.30	119.46	138.59	162.28	191.65
Reported EPS (INR)	102.28	108.30	119.46	138.59	162.28	191.65
DPS (INR)	23.50	23.06	60.03	69.40	81.14	95.82
BVPS (INR)	317.6	403.5	478.1	532.7	600.4	680.4
Weighted average shares (m)	575	571	571	575	575	575
Average market cap (INRm)	848,802	1,227,003	1,684,612	1,540,439	1,540,439	1,540,439
Enterprise value (INRm)	749,931	1,084,323	1,516,282	1,346,494	1,303,402	1,260,285
Valuation Metrics						
P/E (DB) (x)	14.4	19.9	24.7	19.5	16.6	14.1
P/E (Reported) (x)	14.4	19.9	24.7	19.5	16.6	14.1
P/BV (x)	4.17	6.48	6.77	5.06	4.49	3.96
FCF Yield (%)	5.0	5.4	3.0	4.6	6.3	6.9
Dividend Yield (%)	1.6	1.1	2.0	2.6	3.0	3.6
EV/Sales (x)	3.5	4.8	5.5	4.0	3.4	2.7
EV/EBITDA (x)	10.4	13.8	16.9	12.8	10.6	8.6
EV/EBIT (x)	11.7	15.6	18.7	14.1	11.5	9.3
Income Statement (INRm)						
Sales revenue	216,930	227,420	275,010	333,847	382,605	466,865
Gross profit	99,280	106,710	124,470	147,602	170,921	204,521
EBITDA	71,950	78,610	89,640	105,216	123,452	146,597
Depreciation	7,610	9,050	8,620	9,670	10,596	11,646
Amortisation	0	0	0	0	0	0
EBIT	64,340	69,560	81,020	95,547	112,856	134,952
Net interest income(expense)	9,090	7,750	11,330	15,865	16,765	12,005
Associates/affiliates	0	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	-4,340	1,360	780	0	0	0
Profit before tax	69,090	78,670	93,130	111,412	129,621	146,956
Income tax expense	10,270	16,810	24,900	31,710	36,294	36,739
Minorities	0	0	0	0	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	58,820	61,860	68,230	79,702	93,327	110,217
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	58,820	61,860	68,230	79,702	93,327	110,217
Cash Flow (INRm)						
Cash flow from operations	56,140	75,797	53,923	81,600	107,476	117,342
Net Capex	-13,380	-9,060	-3,430	-10,000	-10,000	-10,000
Free cash flow	42,760	66,737	50,493	71,600	97,476	107,342
Equity raised/(bought back)	-1,722	-1,836	-4,395	-5,109	-5,973	-7,054
Dividends paid	-13,450	-14,340	-34,335	-39,913	-46,664	-55,109
Net inc/(dec) in borrowings	0	0	0	0	0	0
Other investing/financing cash flows	0	0	0	0	0	0
Net cash flow	27,589	50,562	11,762	26,578	44,839	45,179
Change in working capital	*-11,350*	*4,087*	*-22,968*	*-7,771*	*3,553*	*-4,521*
Balance Sheet (INRm)						
Cash and other liquid assets	96,950	105,560	166,660	192,274	235,367	278,483
Tangible fixed assets	53,540	53,550	48,440	48,894	48,299	46,653
Goodwill/intangible assets	0	0	8,730	8,730	8,730	8,730
Associates/investments	0	37,120	1,670	1,670	1,670	1,670
Other assets	71,140	81,130	87,130	101,275	113,445	134,440
Total assets	221,630	277,360	312,630	352,844	407,511	469,977
Interest bearing debt	0	0	0	0	0	0
Other liabilities	38,720	46,870	39,600	46,504	62,227	78,700
Total liabilities	38,720	46,870	39,600	46,504	62,227	78,700
Shareholders' equity	182,540	230,490	273,030	306,340	345,285	391,277
Minorities	0	0	0	0	0	0
Total shareholders' equity	182,540	230,490	273,030	306,340	345,285	391,277
Net debt	*-96,950*	*-105,560*	*-166,660*	*-192,274*	*-235,367*	*-278,483*
Key Company Metrics						
Sales growth (%)	30.0	4.8	20.9	21.4	14.6	22.0
DB EPS growth (%)	29.6	5.9	10.3	16.0	17.1	18.1
EBITDA Margin (%)	33.2	34.6	32.6	31.5	32.3	31.4
EBIT Margin (%)	29.7	30.6	29.5	28.6	29.5	28.9
Payout ratio (%)	23.0	21.3	50.2	50.1	50.0	50.0
ROE (%)	36.7	30.0	27.1	27.5	28.6	29.9
Capex/sales (%)	6.2	4.0	1.2	3.0	2.6	2.1
Capex/depreciation (x)	1.8	1.0	0.4	1.0	0.9	0.9
Net debt/equity (%)	-53.1	-45.8	-61.0	-62.8	-68.2	-71.2
Net interest cover (x)	nm	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

Tata Consultancy

Outlook

While near-term demand for the top-tier vendors is intact, uncertain global macroeconomic outlook could weigh on the CY12E IT budgets of clients. This, in our view, will only accelerate the need to cut costs and hence Indian IT services companies should benefit from the increase in offshoring by clients. We expect TCS, India's largest offshore services provider, to be the key beneficiary of clients' increased focus on using offshore delivery. For FY13, we forecast earnings to grow 18% in rupee EPS. We believe our target P/E of 20x FY13E is fair given an earnings CAGR of 20% over FY12-14E. The company has an estimated long-term earnings growth potential of at least 15%-20% given a likely increase in focus on cost control and outsourcing in developed economies. As such, we rate TCS Buy and name it our top pick.

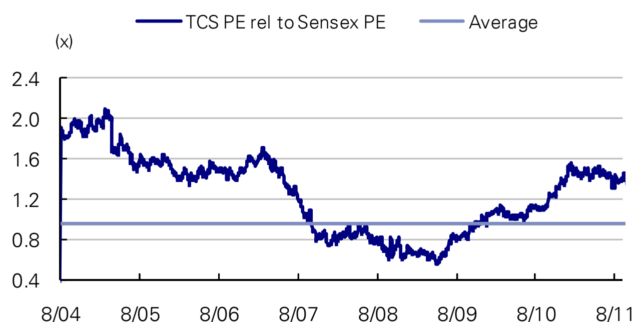
Valuation

We value Indian IT services firms on a P/E basis relative to their historical trading range, compared with peers as well as growth rates. We value TCS at a target P/E of 20x FY13E to factor in its consistent outperformance over Infosys on revenues and profits. Although our target P/E multiple is at a PEG of 1, we believe this adequately factors in the downside potential from growing global macroeconomic concerns. On a one-year forward basis, TCS currently trades at a 10% premium to Infosys and we believe this will likely continue in the short term.

Figure 48: TCS – one-year forward P/E

Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Figure 49: TCS P/E relative to Sensex P/E



Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Risks

We identify three industry-level risks: a) a more-severe-than-anticipated global slowdown, b) global vendor competition, c) aggressive steps taken by global vendors to adopt the offshore model and d) increasing wage inflation with supply-side issues. For TCS, the key company-specific downside risks remain relatively higher exposure to the BFSI (Banking, Financial Services and Insurance) vertical and consequent compression of its earnings multiple due to a greater impact of the financial market turmoil.

Model updated:02 December 2011

Running the numbers

Asia

India

Software & Services

Tata Consultancy

Reuters: TCS.BO | Bloomberg: TCS IN

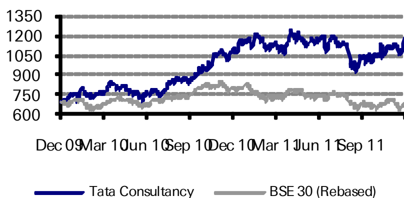
Buy

Price (2 Dec 11)	INR 1,175.50
Target Price	INR 1,320.00
52 Week range	INR 918.30 - 1,239.40
Market Cap (m)	INRm 2,300,713
	USDm 44,935

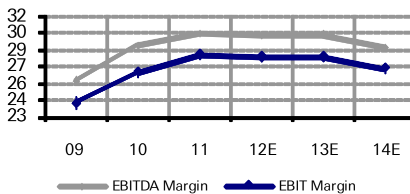
Company Profile

Tata Consultancy Services, a division of Tata Sons Limited, is a global IT services organization that provides a comprehensive range of IT services to its clients in diverse industries. The company, through its offices in 32 countries and development centers in 10 countries, serves over 800 global clients including some of the top companies in the US.

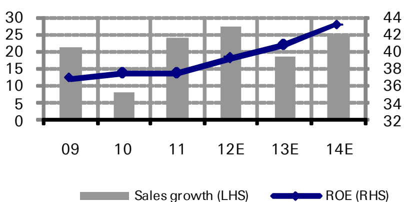
Price Performance



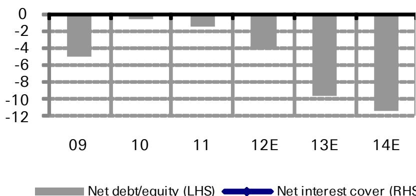
Margin Trends



Growth & Profitability



Solvency



Fiscal year end 31-Mar	2009	2010	2011	2012E	2013E	2014E
Financial Summary						
DB EPS (INR)	26.43	35.12	44.53	54.29	64.14	77.59
Reported EPS (INR)	26.43	35.12	44.53	54.29	64.14	77.59
DPS (INR)	14.00	19.00	25.00	31.00	38.00	0.00
BVPS (INR)	80.0	107.7	129.8	146.6	167.3	192.4
Weighted average shares (m)	1,957	1,957	1,957	1,957	1,957	1,957
Average market cap (INRm)	679,584	1,113,289	1,860,525	2,300,713	2,300,713	2,300,713
Enterprise value (INRm)	657,526	1,039,907	1,782,668	2,211,396	2,193,438	2,177,069
Valuation Metrics						
P/E (DB) (x)	13.1	16.2	21.3	21.7	18.3	15.1
P/E (Reported) (x)	13.1	16.2	21.3	21.7	18.3	15.1
P/BV (x)	3.38	7.25	9.11	8.02	7.03	6.11
FCF Yield (%)	1.9	6.0	2.6	3.7	4.5	5.0
Dividend Yield (%)	4.0	3.3	2.6	2.6	3.2	0.0
EV/Sales (x)	2.4	3.5	4.8	4.6	3.9	3.1
EV/EBITDA (x)	9.2	12.0	15.9	15.6	13.0	10.8
EV/EBIT (x)	10.0	13.1	17.0	16.7	14.0	11.5
Income Statement (INRm)						
Sales revenue	278,129	300,289	373,245	475,854	563,404	702,074
Gross profit	127,354	143,045	173,872	223,373	267,036	325,637
EBITDA	71,781	86,799	111,984	141,706	168,362	201,967
Depreciation	5,766	7,208	7,214	9,550	11,698	13,388
Amortisation	0	0	0	0	0	0
EBIT	66,015	79,591	104,770	132,156	156,664	188,579
Net interest income(expense)	1,197	1,561	5,007	7,865	7,608	8,918
Associates/affiliates	-7	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	-5,869	684	317	845	1,927	2,402
Profit before tax	61,343	81,836	110,093	140,866	166,199	199,899
Income tax expense	9,011	12,088	21,738	33,743	39,888	47,976
Minorities	604	1,019	1,191	870	765	59
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	51,720	68,729	87,164	106,253	125,546	151,865
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	51,720	68,729	87,164	106,253	125,546	151,865
Cash Flow (INRm)						
Cash flow from operations	56,190	76,526	67,201	96,478	118,304	129,752
Net Capex	-43,594	-9,760	-18,774	-11,723	-14,275	-14,871
Free cash flow	12,597	66,766	48,427	84,755	104,029	114,881
Equity raised/(bought back)	-919	7,523	7,527	-1,743	0	0
Dividends paid	-18,077	-21,954	-51,488	-71,667	-84,969	-102,782
Net inc/(dec) in borrowings	-179	2,134	2,686	-1,877	1,623	2,571
Other investing/financing cash flows	10,065	-58,048	-1,872	-3,522	1,962	-4,883
Net cash flow	3,488	-3,579	5,279	5,946	22,645	9,787
Change in working capital	*7,638*	*-13,348*	*21,899*	*28,130*	*16,100*	*0*
Balance Sheet (INRm)						
Cash and other liquid assets	14,839	10,250	15,539	21,600	43,144	57,201
Tangible fixed assets	37,490	41,377	51,996	54,168	56,746	58,229
Goodwill/intangible assets	34,185	32,850	33,791	33,791	33,791	33,791
Associates/investments	17,271	74,390	77,205	81,597	80,400	85,342
Other assets	123,906	114,023	149,353	212,540	251,644	313,581
Total assets	227,691	272,890	327,883	403,696	465,724	548,143
Interest bearing debt	6,920	9,053	11,739	9,863	11,486	14,058
Other liabilities	60,094	50,800	58,953	102,815	122,979	149,416
Total liabilities	67,013	59,854	70,692	112,678	134,465	163,473
Shareholders' equity	156,545	210,842	254,044	286,887	327,464	376,546
Minorities	3,133	2,204	3,147	4,017	4,782	4,841
Total shareholders' equity	159,678	213,046	257,191	290,904	332,246	381,387
Net debt	*-7,920*	*-1,197*	*-3,800*	*-11,737*	*-31,658*	*-43,143*
Key Company Metrics						
Sales growth (%)	21.7	8.0	24.3	27.5	18.4	24.6
DB EPS growth (%)	3.0	32.9	26.8	21.9	18.2	21.0
EBITDA Margin (%)	25.8	28.9	30.0	29.8	29.9	28.8
EBIT Margin (%)	23.7	26.5	28.1	27.8	27.8	26.9
Payout ratio (%)	53.0	54.1	56.1	57.1	59.2	0.0
ROE (%)	36.9	37.4	37.5	39.3	40.9	43.1
Capex/sales (%)	15.7	3.3	5.0	2.5	2.5	2.1
Capex/depreciation (x)	7.6	1.4	2.6	1.2	1.2	1.1
Net debt/equity (%)	-5.0	-0.6	-1.5	-4.0	-9.5	-11.3
Net interest cover (x)	nm	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

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Wipro

Outlook

The three key reasons behind our conviction are a) rising customer satisfaction with Wipro's service quality after the organization restructuring, (b) the appreciable fall in attrition not only at the overall company level but also at individual projects and (c) bold inorganic initiatives to consolidate position with large clients. Moreover, with best-in-pack forecast earnings of 21% over FY12-14E, Wipro trades at relatively inexpensive valuation of 14x FY13E (18% discount to TCS. Based on improving business traction and attractive valuations, we rate the shares Buy.

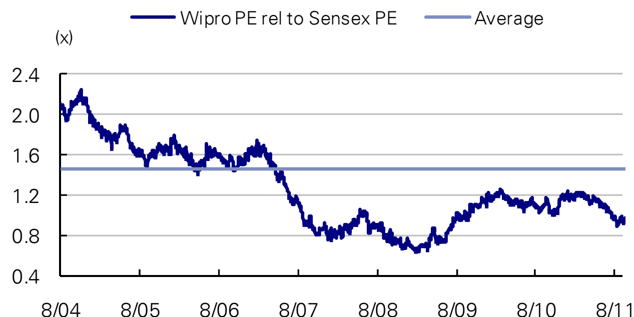
Valuation

We value Indian IT services firms on a P/E basis relative to their historical trading range, compared with peers as well as growth rates. Our 12-month target price is based on 19x FY13E P/E (vs 15x earlier) and is now valued at a slight premium to Infosys' target P/E multiple. Wipro is likely to report earnings CAGR of 21% over FY12-14E. We value Wipro at a premium to Infosys given its better near-term growth. We believe our target P/E is well supported by its earnings CAGR of 21% over FY12-14E.

Figure 50: Wipro – one-year forward P/E

Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1st Nov 2011

Figure 51: Wipro P/E relative to Sensex P/E



Source Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1st Nov 2011

Risks

We identify four industry-level risks: (1) rupee appreciation, (2) a protracted global economic slowdown, (3) aggressive steps by global vendors to adopt the offshore model leading to competition for clients as well as for employees and (4) increasing wage inflation with supply side (employees) issues. For Wipro, the key risks remain that of beefing up its enterprise IT (especially BFSI) portfolio, executing well on the turnaround of the BPO business and integrating its various acquisitions.

Model updated:02 December 2011

Running the numbers

Asia

India

Software & Services

Wipro

Reuters: WIPR.BO Bloomberg: WPRO IN

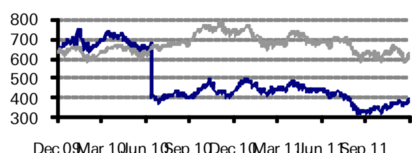
Buy

Price (2 Dec 11)	INR 394.35
Target Price	INR 510.00
52 Week range	INR 319.25 - 491.40
Market Cap (m)	INRm 968,787
	USDm 18,921

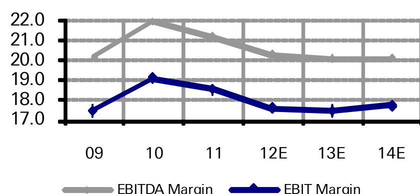
Company Profile

Wipro Limited specializes in IT and computer related technologies. The Group's services encompass a number of areas, including software architecture, business intelligence systems, e-commerce, data warehousing, Internet access devices, network management, system administration, messaging systems, IT consulting and design. Wipro also has subsidiary businesses that sell soaps and vegetable oils.

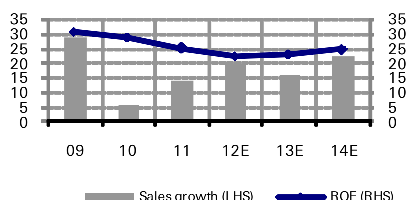
Price Performance



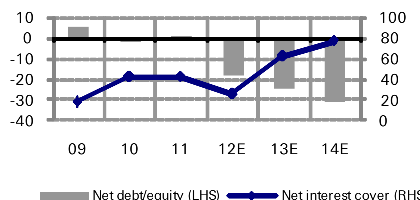
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 31-Mar	2009	2010	2011	2012E	2013E	2014E
Financial Summary						
DB EPS (INR)	26.46	18.74	21.70	22.96	26.75	33.63
Reported EPS (INR)	26.46	18.74	21.70	22.96	26.75	33.63
DPS (INR)	4.03	5.00	6.00	10.00	10.00	10.00
BVPS (INR)	93.6	74.3	97.6	109.3	124.8	147.1
Weighted average shares (m)	1,463	2,457	2,457	2,457	2,457	2,457
Average market cap (INRm)	504,305	1,333,187	1,185,818	968,787	968,787	968,787
Enterprise value (INRm)	494,220	1,297,199	1,136,509	887,663	861,046	821,846
Valuation Metrics						
P/E (DB) (x)	13.0	29.0	22.2	17.2	14.7	11.7
P/E (Reported) (x)	13.0	29.0	22.2	17.2	14.7	11.7
P/BV (x)	2.62	9.52	4.90	3.61	3.16	2.68
FCF Yield (%)	3.8	1.9	0.8	6.1	5.6	6.9
Dividend Yield (%)	1.2	0.9	1.2	2.5	2.5	2.5
EV/Sales (x)	1.9	4.8	3.7	2.4	2.0	1.5
EV/EBITDA (x)	9.5	21.7	17.3	11.7	9.9	7.7
EV/EBIT (x)	11.0	24.9	19.7	13.5	11.3	8.7
Income Statement (INRm)						
Sales revenue	256,996	272,175	310,986	373,450	434,090	531,842
Gross profit	84,410	93,175	105,405	120,565	138,940	170,297
EBITDA	51,838	59,651	65,880	75,868	87,148	106,841
Depreciation	6,864	7,624	8,211	10,073	11,205	12,402
Amortisation	0	0	0	0	0	0
EBIT	44,974	52,027	57,669	65,796	75,942	94,438
Net interest income(expense)	-2,539	-1,232	-1,360	-2,617	-1,226	-1,226
Associates/affiliates	362	504	349	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	2,759	4,128	6,238	6,988	7,420	9,091
Profit before tax	45,194	54,923	62,547	70,167	82,136	102,303
Income tax expense	6,457	9,255	9,714	13,552	16,427	19,693
Minorities	100	135	-135	209	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	38,999	46,037	53,317	56,406	65,709	82,609
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	38,999	46,037	53,317	56,406	65,709	82,609
Cash Flow (INRm)						
Cash flow from operations	51,569	33,976	42,641	73,517	67,828	80,411
Net Capex	-32,156	-8,180	-33,240	-14,200	-13,500	-13,500
Free cash flow	19,413	25,796	9,401	59,317	54,328	66,911
Equity raised/(bought back)	-12,798	16,668	21,018	0	0	0
Dividends paid	-6,856	-16,561	-17,098	-27,711	-27,711	-27,711
Net inc/(dec) in borrowings	12,042	5,621	0	0	0	0
Other investing/financing cash flows	-16,271	201	0	0	0	0
Net cash flow	-4,470	31,725	13,321	31,606	26,617	39,200
Change in working capital	*0*	*0*	*0*	*0*	*0*	*0*
Balance Sheet (INRm)						
Cash and other liquid assets	49,117	64,878	61,141	111,171	137,788	176,988
Tangible fixed assets	52,563	56,294	67,628	71,755	74,050	75,148
Goodwill/intangible assets	56,521	53,346	67,041	67,041	67,041	67,041
Associates/investments	18,096	34,060	52,275	34,060	34,060	34,060
Other assets	102,214	117,505	123,358	140,212	160,267	192,551
Total assets	278,511	326,083	371,443	424,239	473,206	545,787
Interest bearing debt	56,892	62,513	63,416	63,416	63,416	63,416
Other liabilities	85,084	80,690	67,656	91,548	102,518	120,200
Total liabilities	141,976	143,203	131,072	154,964	165,934	183,616
Shareholders' equity	136,299	182,443	239,680	268,584	306,581	361,480
Minorities	236	437	691	691	691	691
Total shareholders' equity	136,535	182,880	240,371	269,275	307,272	362,171
Net debt	*7,775*	*-2,365*	*2,275*	*-47,755*	*-74,372*	*-113,572*
Key Company Metrics						
Sales growth (%)	28.6	5.9	14.3	20.1	16.2	22.5
DB EPS growth (%)	18.8	-29.2	15.8	5.8	16.5	25.7
EBITDA Margin (%)	20.2	21.9	21.2	20.3	20.1	20.1
EBIT Margin (%)	17.5	19.1	18.5	17.6	17.5	17.8
Payout ratio (%)	15.1	26.7	27.6	43.6	37.4	29.7
ROE (%)	30.8	28.9	25.3	22.2	22.8	24.7
Capex/sales (%)	12.5	3.0	10.7	3.8	3.1	2.5
Capex/depreciation (x)	4.7	1.1	4.0	1.4	1.2	1.1
Net debt/equity (%)	5.7	-1.3	0.9	-17.7	-24.2	-31.4
Net interest cover (x)	17.7	42.2	42.4	25.1	61.9	77.0

Source: Company data, Deutsche Bank estimates

HCL Technologies

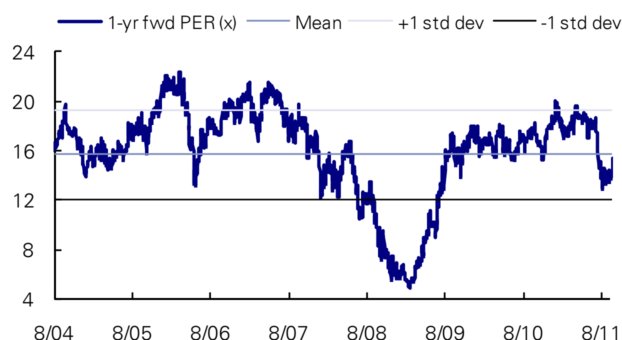
Outlook

HCL Tech's improving growth expectations have been led by impressive deal wins. This strategy will be tested again in a deteriorating macroeconomic environment. However, given HCL Tech’s strong revenue growth performance during the last downturn, we estimate the company to report 15% yoy (versus an estimated12% yoy for Infosys) USD revenue growth in FY13. Our key concerns in the medium term continue to be a decline in margins on account of wage hikes, higher reliance on lateral recruits and BPO business losses. HCL Tech has the most comprehensive SAP practice, in our view, and could thus be hardest hit if demand for software and services declines in CY12E. The stock has outperformed the Sensex by 7% ytd. At 13x FY13E P/E, we believe it is fairly valued. We reiterate our Hold rating on HCL Tech.

Valuation

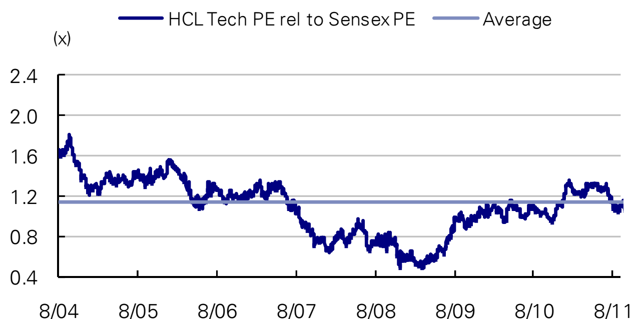
We value Indian IT service firms on a P/E basis relative to their historical trading range in relation to peers as well as growth rates. We value HCL Tech at 13x FY13E P/E. Our target P/E multiple for HCL Tech is at about a 25% discount to Infosys' target P/E multiple based on FY13E. The reduced discount to Infosys (vs. 35% in the past) is to account for sector-leading growth in revenues reported by the company over the last two years, its relatively higher exposure to key revenue drivers for the next two years, namely Europe and exposure to spending in package implementation.

Figure 52: HCL Tech – one-year forward P/E



Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Figure 53: HCL Tech P/E relative to Sensex P/E



Source: Company data, Deutsche Bank estimates, Bloomberg Finance L.P, Prices as of 1 Nov 2011

Risks

We identify four industry-level risks: (1) rupee appreciation, (2) a potential economic slowdown in the US to which HCL Tech is more vulnerable than peers, (3) global vendor competition and (4) increasing wage inflation with supply-side (employees) issues. For HCLT, the key downside risk remains maintaining margins while executing its large deals. The key upside risk is higher-than-expected volume growth due to the strong deal pipeline from the deals won in FY09, creating a significant growth driver.

Model updated:18 October 2011

Running the numbers

Asia

India

Software & Services

HCL Tech

Reuters: HCLT.BO Bloomberg: HCLT IN

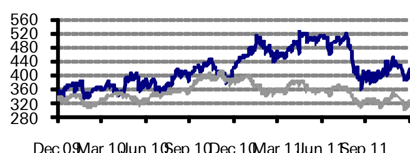
Hold

Price (2 Dec 11)	INR 417.35
Target Price	INR 440.00
52 Week range	INR 362.30 - 522.85
Market Cap (m)	INRm 288,389
	USDm 5,632

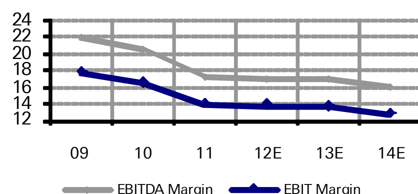
Company Profile

HCL Technologies Limited provides software development and related engineering services. The Group's technologies utilize a variety of technologies, including Internet and e-commerce, networking, internet telephony, embedded software, ASIC/VLSI design and testing, satellite and wireless communications, and component based object technologies, including COM, DCOM and COBRA.

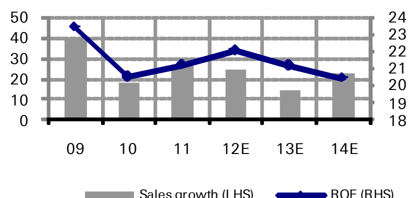
Price Performance



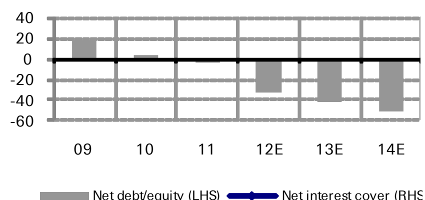
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 30-Jun	2009	2010	2011	2012E	2013E	2014E
Financial Summary						
DB EPS (INR)	18.76	19.06	23.63	29.33	33.44	38.27
Reported EPS (INR)	18.76	19.06	23.63	29.33	33.44	38.27
DPS (INR)	7.00	8.00	8.00	8.00	0.00	0.00
BVPS (INR)	85.6	103.0	122.1	145.2	172.4	204.5
Weighted average shares (m)	664	683	691	691	691	691
Average market cap (INRm)	107,033	226,825	308,056	288,389	288,389	288,389
Enterprise value (INRm)	117,455	228,331	304,107	255,224	237,795	215,398
Valuation Metrics						
P/E (DB) (x)	8.6	17.4	18.9	14.2	12.5	10.9
P/E (Reported) (x)	8.6	17.4	18.9	14.2	12.5	10.9
P/BV (x)	2.17	3.54	4.04	2.87	2.42	2.04
FCF Yield (%)	nm	3.7	2.6	11.7	7.6	9.3
Dividend Yield (%)	4.3	2.4	1.8	1.9	0.0	0.0
EV/Sales (x)	1.1	1.8	1.9	1.3	1.1	0.8
EV/EBITDA (x)	5.0	8.9	11.2	7.6	6.2	4.8
EV/EBIT (x)	6.2	11.0	13.7	9.4	7.7	6.1
Income Statement (INRm)						
Sales revenue	106,301	125,650	158,539	197,442	225,679	277,658
Gross profit	40,817	43,691	50,668	64,134	74,156	88,724
EBITDA	23,455	25,729	27,176	33,494	38,463	44,821
Depreciation	4,494	5,010	4,990	6,271	7,639	9,466
Amortisation	0	0	0	0	0	0
EBIT	18,961	20,719	22,186	27,224	30,824	35,354
Net interest income(expense)	0	0	0	0	0	0
Associates/affiliates	27	12	-2	-17	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	-3,671	-5,302	-1,125	243	462	453
Profit before tax	15,290	15,417	21,061	27,466	31,286	35,807
Income tax expense	2,543	2,404	4,648	7,078	8,060	9,225
Minorities	0	0	0	0	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	12,774	13,025	16,411	20,371	23,226	26,582
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	12,774	13,025	16,411	20,371	23,226	26,582
Cash Flow (INRm)						
Cash flow from operations	15,799	13,850	15,314	39,390	29,410	36,581
Net Capex	-42,779	-5,431	-7,425	-5,758	-7,546	-9,750
Free cash flow	-26,980	8,419	7,889	33,632	21,864	26,831
Equity raised/(bought back)	-2,861	3,493	0	0	0	0
Dividends paid	-5,244	-2,996	-2,996	-2,996	-2,996	-2,996
Net inc/(dec) in borrowings	29,771	-3,139	-5,392	-2,967	-2,967	-2,967
Other investing/financing cash flows	-310	-353	0	0	0	0
Net cash flow	-5,624	5,424	-499	27,669	15,901	20,868
Change in working capital	*401*	*-2,905*	*-4,836*	*13,243*	*-1,155*	*1,432*
Balance Sheet (INRm)						
Cash and other liquid assets	18,995	24,419	24,009	50,275	64,756	84,205
Tangible fixed assets	15,862	18,486	22,165	25,840	29,516	33,192
Goodwill/intangible assets	45,325	43,122	41,878	37,690	33,921	30,529
Associates/investments	370	707	1,180	1,180	1,180	1,180
Other assets	46,390	48,981	57,003	76,184	87,147	104,464
Total assets	126,942	135,715	146,235	191,170	216,520	253,570
Interest bearing debt	29,771	26,632	21,240	18,273	15,307	12,340
Other liabilities	40,309	38,715	40,650	72,579	82,086	99,935
Total liabilities	70,080	65,347	61,890	90,853	97,393	112,275
Shareholders' equity	56,846	70,368	84,345	100,300	119,092	141,240
Minorities	16	0	0	17	36	54
Total shareholders' equity	56,862	70,368	84,345	100,317	119,128	141,294
Net debt	*10,776*	*2,213*	*-2,769*	*-32,001*	*-49,450*	*-71,865*
Key Company Metrics						
Sales growth (%)	39.1	18.2	26.2	24.5	14.3	23.0
DB EPS growth (%)	13.8	1.6	24.0	24.1	14.0	14.4
EBITDA Margin (%)	22.1	20.5	17.1	17.0	17.0	16.1
EBIT Margin (%)	17.8	16.5	14.0	13.8	13.7	12.7
Payout ratio (%)	36.4	42.0	33.7	27.1	0.0	0.0
ROE (%)	23.4	20.5	21.2	22.1	21.2	20.4
Capex/sales (%)	40.2	4.3	4.7	2.9	3.3	3.5
Capex/depreciation (x)	9.5	1.1	1.5	0.9	1.0	1.0
Net debt/equity (%)	19.0	3.1	-3.3	-31.9	-41.5	-50.9
Net interest cover (x)	nm	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

Mahindra Satyam

Outlook

We rate Mahindra Satyam (MSat) Hold with a target price of INR90. We believe the announcement of the revised financials has gone a long way to rebuild client confidence in the company. With the prospect of strong improvement in new client wins and broad-based exposure to existing clients, we expect the company to report a 15.5% revenue CAGR over FY12-14E. This should improve employee utilisation and help Satyam substantially raise its very low margin. We thus expect the company to report an earnings CAGR of 27% over the same period. In spite of the near resolution of the most cases pending against the company and no perceived incremental adverse impact on its financial health, we retain our Hold rating since the stock has outperformed the Sensex by 25% ytd and we believe our target price adequately reflects the lowered risk profile of the company.

Valuation

With MSat's announcement of its audited and re-stated financials, thereby making it current with respect to financial reporting, we believe it is appropriate to value the company. In line with peers, we value MSat on a one-year forward P/E basis. Although it has better capability, Satyam's current revenue profile puts it in line with the valuation of other mid-cap companies, in our opinion. Thus, disregarding the company's high earnings potential and taking cognizance of the overhang from contingent liabilities, we value the company at 10x FY13E. Our target P/E multiple is based on the average of FY13E P/E multiples at which comparable mid-cap IT services companies are trading in the Indian market.

Risks

Key upside risks to our Hold rating include: (1) A better-than-expected turnaround in revenue growth and margin trajectory, (2) amicable resolution of the outstanding disputes with minimum damage to the financial health of the company and (3) a sharp pickup in discretionary spending in the package implementation segment, in which the company has a dominant presence. Key downside risks to our Hold rating include: (1) pressure on billing due to lower rates negotiated during the re-building period, (2) continuation of client attrition and poaching of the highly skilled package implementation resources, (3) significantly higher liability from lawsuits and (4) extreme volatility in currency-denting margins and a longer-than-expected global downturn prolonging the recovery for the industry in general and the company in particular.

Model updated:11 November 2011

Running the numbers

Asia

India

Software & Services

Mahindra Satyam

Reuters: SATY.BO	Bloomberg: SCS IN

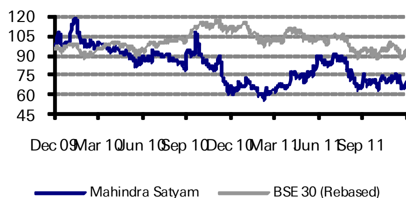
Hold

Price (2 Dec 11)	INR 69.90
Target Price	INR 90.00
52 Week range	INR 55.80 - 91.15
Market Cap (m)	INRm 82,202
	USDm 1,605

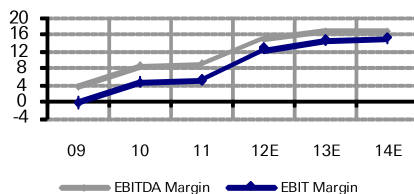
Company Profile

Satyam Computer Services Limited is a software services company specializing in IBM, Windows, and Unix platforms. The Company undertakes turnkey execution of projects in India and abroad, and has pioneered offshore software development in India using its high-speed satellite data communication. Satyam also provides Internet access through Satyam Infoway.

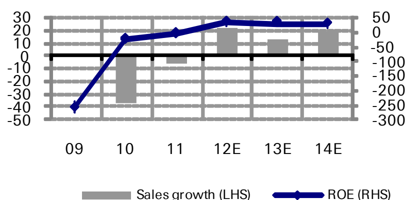
Price Performance



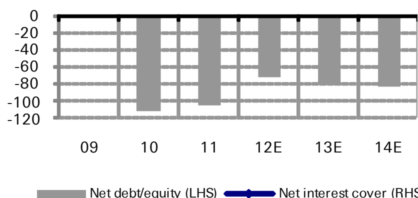
Margin Trends



Growth & Profitability



Solvency



Fiscal year end 31-Mar	2009	2010	2011	2012E	2013E	2014E
Financial Summary						
DB EPS (INR)	-121.33	-1.06	-1.22	6.78	8.73	10.92
Reported EPS (INR)	-121.33	-1.06	-1.22	6.78	8.73	10.92
DPS (INR)	0.00	0.00	0.00	0.00	0.00	0.00
BVPS (INR)	-13.1	16.0	14.7	24.9	33.6	44.5
Weighted average shares (m)	674	1,176	1,176	1,176	1,176	1,176
Average market cap (INRm)	198,447	108,052	93,790	82,202	82,202	82,202
Enterprise value (INRm)	201,775	80,639	71,398	55,533	45,296	33,035
Valuation Metrics						
P/E (DB) (x)	nm	nm	nm	10.3	8.0	6.4
P/E (Reported) (x)	nm	nm	nm	10.3	8.0	6.4
P/BV (x)	-2.94	5.79	4.48	2.81	2.08	1.57
FCF Yield (%)	nm	12.0	nm	nm	14.3	16.6
Dividend Yield (%)	0.0	0.0	0.0	0.0	0.0	0.0
EV/Sales (x)	2.3	1.5	1.4	0.9	0.6	0.4
EV/EBITDA (x)	66.9	17.6	15.7	5.9	3.8	2.3
EV/EBIT (x)	nm	33.3	26.4	7.1	4.4	2.6
Income Statement (INRm)						
Sales revenue	88,126	54,810	51,450	62,968	70,859	84,007
Gross profit	27,389	14,999	15,507	22,036	23,215	27,526
EBITDA	3,017	4,569	4,551	9,372	11,877	14,085
Depreciation	3,263	2,144	1,847	1,555	1,537	1,423
Amortisation	0	0	0	0	0	0
EBIT	-246	2,425	2,704	7,817	10,340	12,662
Net interest income(expense)	10	727	2,845	1,978	2,499	3,391
Associates/affiliates	0	0	0	0	0	0
Exceptionals/extraordinaries	-79,920	-4,169	-6,411	0	0	0
Other pre-tax income/(expense)	0	0	0	0	0	0
Profit before tax	-236	3,152	5,549	9,795	12,840	16,053
Income tax expense	1,590	222	578	1,811	2,568	3,211
Minorities	22	7	0	13	0	0
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	-81,768	-1,246	-1,440	7,971	10,272	12,842
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	-81,768	-1,246	-1,440	7,971	10,272	12,842
Cash Flow (INRm)						
Cash flow from operations	-72,949	10,429	-17,077	-2,316	11,047	13,071
Net Capex	-15,651	2,523	366	-6	727	613
Free cash flow	-88,600	12,952	-16,711	-2,322	11,774	13,684
Equity raised/(bought back)	72,968	0	0	0	0	0
Dividends paid	0	0	0	0	0	0
Net inc/(dec) in borrowings	8,142	-7,723	-45	-29	0	0
Other investing/financing cash flows	195	-6,268	1,904	-1,146	0	0
Net cash flow	-7,295	-1,039	-14,852	-3,497	11,774	13,684
Change in working capital	*-5,621*	*9,524*	*-17,484*	*-7,802*	*-762*	*-1,195*
Balance Sheet (INRm)						
Cash and other liquid assets	5,009	21,768	18,593	21,632	31,869	44,130
Tangible fixed assets	12,388	9,865	9,499	9,505	8,778	8,164
Goodwill/intangible assets	0	0	0	0	0	0
Associates/investments	0	6,268	4,348	5,540	5,540	5,540
Other assets	23,167	18,096	28,774	29,536	33,663	40,137
Total assets	40,564	55,997	61,214	66,212	79,850	97,972
Interest bearing debt	8,142	422	315	286	286	286
Other liabilities	41,027	36,565	43,416	36,438	39,804	45,083
Total liabilities	49,169	36,987	43,731	36,724	40,090	45,369
Shareholders' equity	-8,800	18,809	17,249	29,271	39,543	52,385
Minorities	195	201	234	217	217	217
Total shareholders' equity	-8,605	19,010	17,483	29,488	39,760	52,602
Net debt	*3,133*	*-21,346*	*-18,278*	*-21,346*	*-31,583*	*-43,844*
Key Company Metrics						
Sales growth (%)	nm	-37.8	-6.1	22.4	12.5	18.6
DB EPS growth (%)	na	99.1	-15.6	na	28.9	25.0
EBITDA Margin (%)	3.4	8.3	8.8	14.9	16.8	16.8
EBIT Margin (%)	-0.3	4.4	5.3	12.4	14.6	15.1
Payout ratio (%)	nm	nm	nm	0.0	0.0	0.0
ROE (%)	-257.2	-24.9	-8.0	34.3	29.9	27.9
Capex/sales (%)	17.8	0.0	0.0	0.0	0.0	0.0
Capex/depreciation (x)	4.8	0.0	0.0	0.0	0.0	0.0
Net debt/equity (%)	nm	-112.3	-104.5	-72.4	-79.4	-83.3
Net interest cover (x)	nm	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

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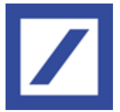

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Appendix 1

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Company	Ticker	Recent price*	Disclosure
Infosys Technologies	INFY.BO	2,696.80 (INR) 2 Dec 11	2,14
Tata Consultancy	TCS.BO	1,175.50 (INR) 2 Dec 11	1,7
Wipro	WIPR.BO	394.35 (INR) 2 Dec 11	
HCL Tech	HCLT.BO	417.35 (INR) 2 Dec 11	14,15
Mahindra Satyam	SATY.BO	69.90 (INR) 2 Dec 11	

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies

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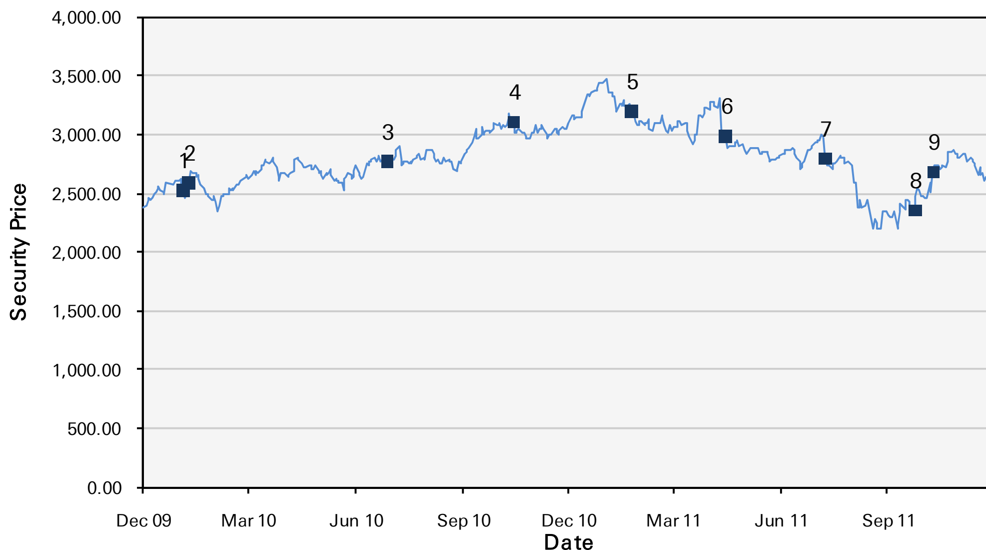
Historical recommendations and target price: Infosys Technologies (INFY.BO)

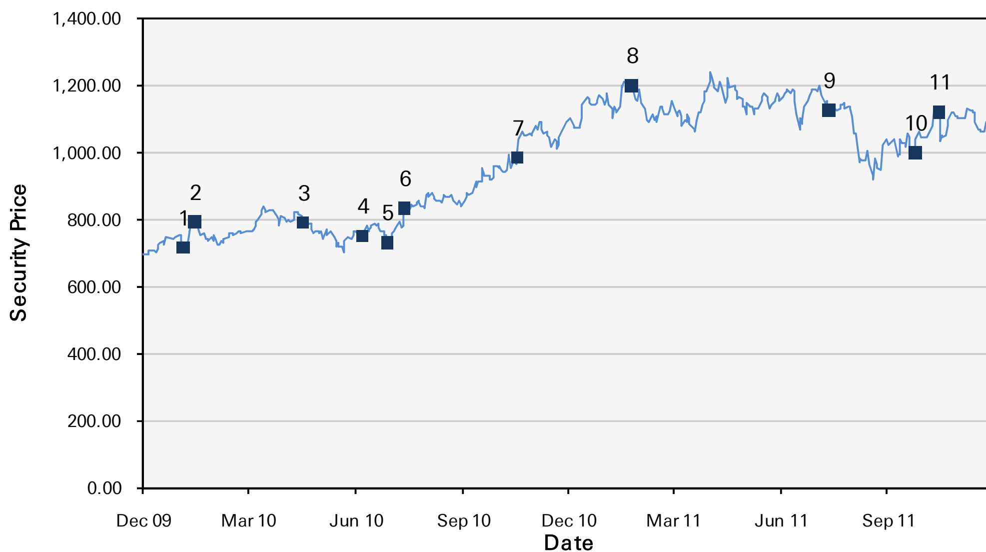
(as of 12/2/2011)



1. 07/01/2010: Buy, Target Price Change INR3,100.00
2. 12/01/2010: Buy, Target Price Change INR3,200.00
3. 01/07/2010: Buy, Target Price Change INR3,500.00
4. 18/10/2010: Buy, Target Price Change INR3,800.00
5. 27/01/2011: Buy, Target Price Change INR4,000.00
6. 18/04/2011: Buy, Target Price Change INR3,600.00
7. 12/07/2011: Buy, Target Price Change INR3,200.00
8. 27/09/2011: Buy, Target Price Change INR2,820.00
9. 13/10/2011: Buy, Target Price Change INR2,950.00

Historical recommendations and target price: Tata Consultancy (TCS.BO)

(as of 12/2/2011)



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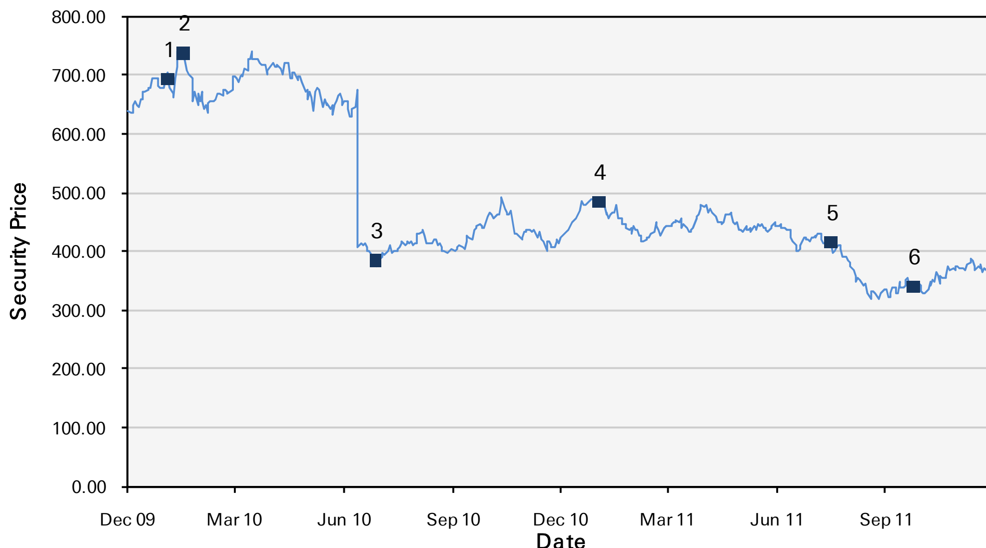
4. 10/06/2010: Buy, Target Price Change INR880.00
5. 01/07/2010: Buy, Target Price Change INR940.00
6. 16/07/2010: Buy, Target Price Change INR990.00
7. 21/10/2010: Buy, Target Price Change INR1,200.00
8. 27/01/2011: Buy, Target Price Change INR1,400.00
9. 15/07/2011: Buy, Target Price Change INR1,460.00
10. 27/09/2011: Buy, Target Price Change INR1,250.00
11. 18/10/2011: Buy, Target Price Change INR1,280.00

Historical recommendations and target price: Wipro (WIPR.BO)

(as of 12/2/2011)



Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

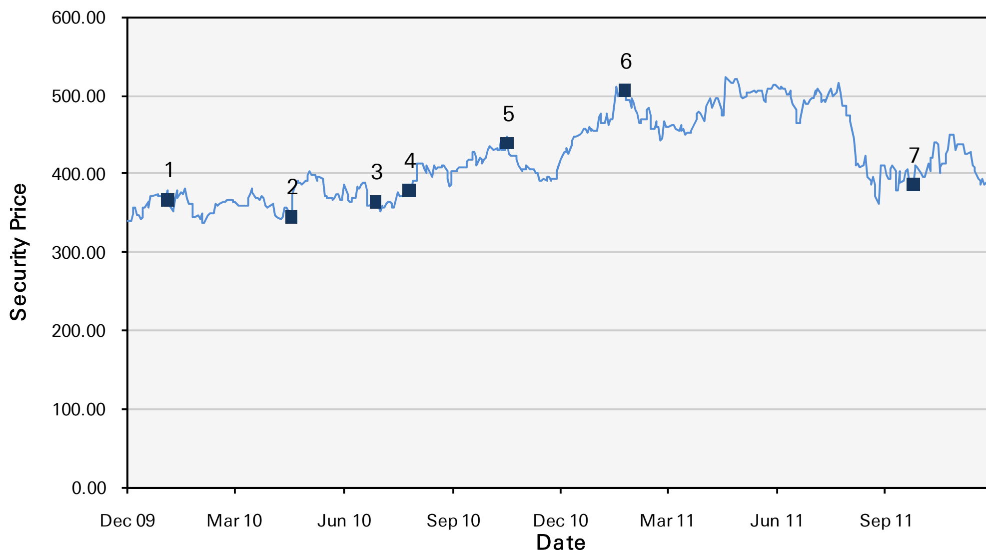
Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9,2002

1. 07/01/2010: Buy, Target Price Change INR780.00
2. 20/01/2010: Buy, Target Price Change INR800.00
3. 01/07/2010: Buy, Target Price Change INR480.00
4. 05/01/2011: Buy, Target Price Change INR510.00
5. 20/07/2011: Buy, Target Price Change INR460.00
6. 27/09/2011: Buy, Target Price Change INR400.00

Historical recommendations and target price: HCL Tech (HCLT.BO)

(as of 12/2/2011)



Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure as of September 9,2002

1. 07/01/2010: Hold, Target Price Change INR330.00
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3. 01/07/2010: Hold, Target Price Change INR370.00
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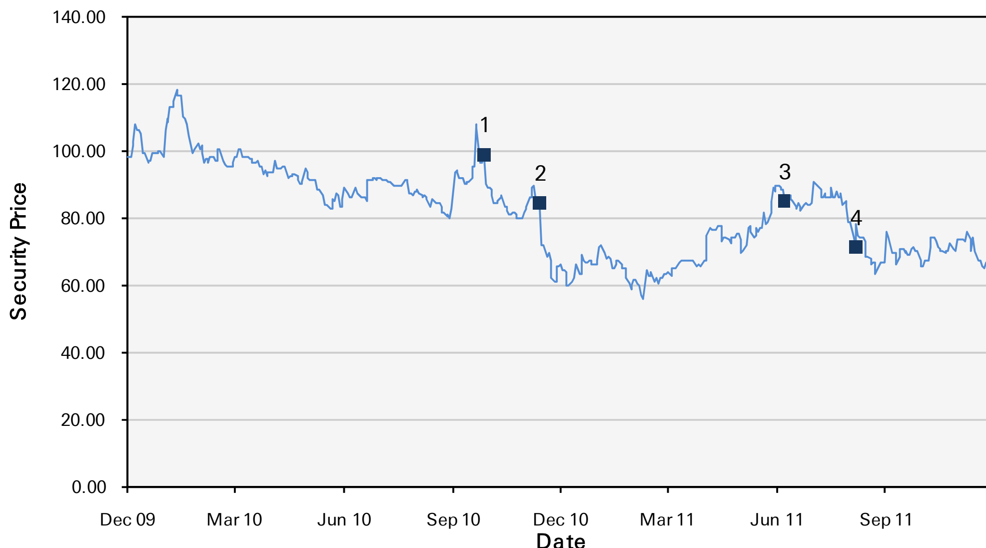

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Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
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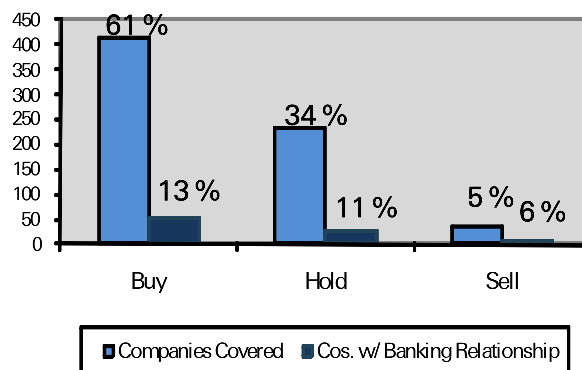
   Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



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