

Telecoms, Media & Technology
 IT Services
 Equity – India

Indian IT Services

Indian IT company reverse road-trip wrapup

- ▶ **Companies remain optimistic of continued industry growth**
- ▶ **In our view, growth from key demand markets is likely to be more cyclical going forward as offshore penetration in traditional IT services is high now**
- ▶ **Companies who are continuously diversifying, thereby expanding their addressable market should outperform; OW-rated TCS is our preferred play**

Demand commentaries are positive for 2012

We met with the management of 11 top Indian IT companies* last week to analyse the demand environment and expectations for 2012 and beyond. Most of the companies remain reasonably positive on the 2012 growth prospects. Demand for 1Q2012 looks weak as clients are involved in the budgeting process and cautious of the macro environment, but the "hopium" levels for 2H revival are high.

However, the contours of growth are likely to change, in our view

Long-term growth, we believe, will be a mix of both secular offshoring and fresh IT spending by clients. Revenue growth from mature geographies/vertical markets, such as BFSI (banking, financial services and insurance) in US would increasingly be dependent on the absolute spend (growth or decline) by banks, thereby making it more cyclical. We found similar sentiments for markets such as Retail in US/Europe. Revenues for Indian companies from Retail clients is currently driven by both new growth initiatives by retailers and cost cutting initiatives. Near 50% of growth (from retail industry) is already driven by initiatives such as digital marketing, customer data analytics etc, which are revenue enhancing for clients and not just targeting cost cutting.

Consequently, we believe growth would be highly contingent on IT budget growth, making it more cyclical and market share led growth would continue to moderate. We highlighted our expectation of similar trends in our 8 February 2012 report, "Diversity in Adversity". However, it is worth highlighting again that in this moderating growth scenario, companies that are able to increase their addressable market (as TCS did with pension procession and core banking BPO) should be able to outperform competition.

** We met TCS CFO- Mr. S Mahalingam and Head IR- Mr. Kedar Shirali; Infosys Member of Executive Council and Head of Retail and CPG- Mr. Pravin Rao; Wipro IT services CFO- Mr. Jatin Dalal and Co-head IR- Mr. Aravind V; HCLT CFO- Mr. Anil Chanana; Mindtree CEO Mr. Krishnakumar Natarajan; Hexaware CSO- Mr. Sreenivas V; MahindraSatyam CMO & CPO- Mr. Hari Thalapalli; Mphasis CFO- Mr. Ganesh Murthy; Persistent Systems CFO- Mr. Rajesh Ghonasgi; eClerx CFO- Mr. Rohitash Gupta; Infinite Computers CEO- Mr. Upinder Zutshi)*

22 February 2012

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Indian IT company reverse road-trip - Key highlights:

Big or mid all are moving up the "Vertical" ladder

The IT services industry in India is can largely be categorised into two groups of companies (Large cap and Mid cap). Large companies such as TCS and Infosys are significantly larger than the mid-cap companies such as Mindtree, Hexaware etc. However, across these groups of companies the clear focus on vertical markets was noteworthy. Larger companies have totally aligned their organisations to the vertical structure and smaller companies have shortlisted on the specialised verticals that they focus on for their go-to-market strategy.

While the vertical focus undoubtedly seems to be the right strategy at this stage (as companies are able to offer more domain-centric solution to clients and also improve account management), with all the companies diverting to this common path, it is hard to envisage any compelling competitive advantage for any company, of course other than scale advantage. We still believe that companies with most diversified client base, revenue profile, and growth strategy will continue to lead the market in the long term.

Client mining – the key focus area for all

Another clear focus area for all the companies was client mining and the stress on client relationship/account management to increase the wallet size. Here again, while Wipro has shown a significant improvement in terms of client wallet share metrics (in the past few years), any prediction of this trend to continue would be tough to make as every company outlined a similar strategy/desire to growth (refer chart sheet on page 3).

Non-linear growth:

Focus on non-linear growth (use of reusable tools, platforming, solutioning) was ubiquitous across all companies. There are specific solutions and platforms every company has across various demand markets, but there is no convincing clear winner in any category.

Visa risks:

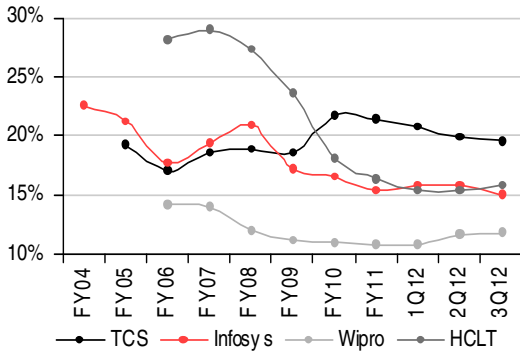
Across the board, the companies agreed on the increase in visa rejections, particularly the L1 visas. However, most of them believed it is still not impacting their business as they already have reasonable number of employees with visas to take care of the onsite deliverables. Wherever required, the companies are hiring onsite (permanent employees or sub-contractors) as well. While this is not margin-dilutive in the near term, a continued trend would impact the organizational flexibility in terms of managing onsite utilization and offshore rotation of employees. TCS has consciously increased its proportion of H1 visas. Historically, the company has relied more on L1 visas for travel requirements.

Growth vs profitability

At this stage, most of the companies were only concerned/involved in capturing growth opportunities. None of the companies/management were worried about margin pressure or wage inflation. It is near certain that wage inflation in 2012 is likely to be in single-digits and companies across the board have planned increase in campus hiring, thereby flattening the employee pyramid. It will be interesting to see if the expected acceleration in growth in 2H2012 would increase supply pressure. As of now, the industry sure seems to be weighted in favour of the employers.

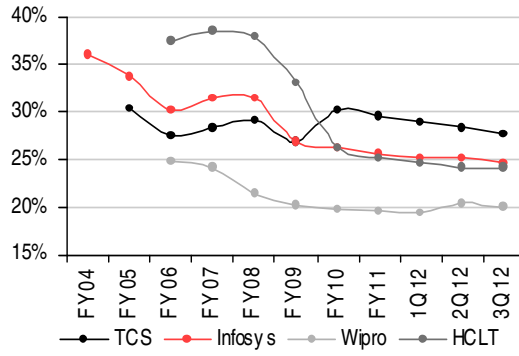
Client mining progress

Contribution of top five clients to revenues (%)



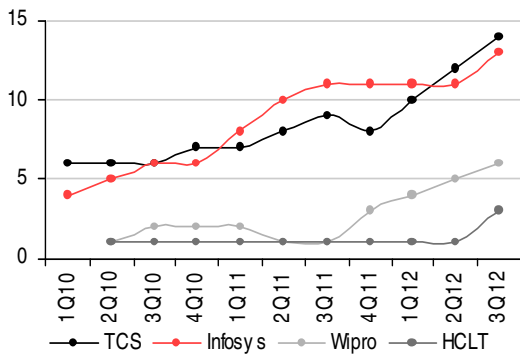
Source:Company data

Contribution of top ten clients to revenues (%)



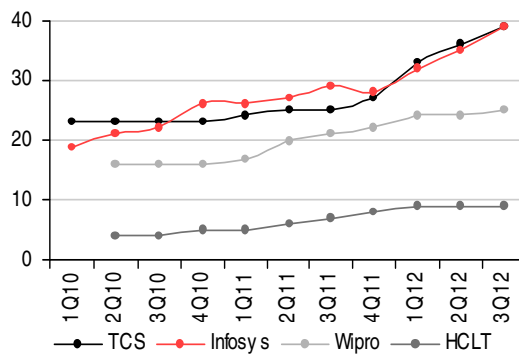
Source:Company data

No of clients contribution to more than USD 100m in revenues



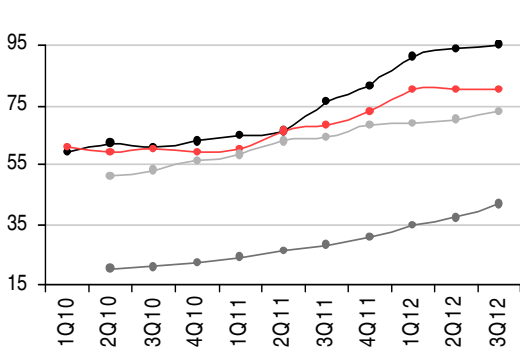
Source:Company data

No of clients contribution to more than USD 50m revenues



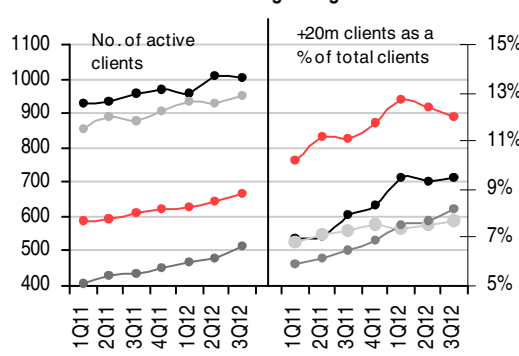
Source:Company data

No of clients contribution to more than USD 20m in revenues



Source:Company data

Clients contributing >USD 20m in revenues as a proportion of total active clients has been growing.



Source:Company data

Valuation sheet

Valuation sheet

Company	Ticker	Rating	Target price (INR)	Current price (INR)	Potential return†	52-week range		Year-end (month)	Shares in issue (m)	Market cap (USDm)*	Net debt (USDm)*	EV (USDm)*
						High	Low					
Tata Consultancy Services Ltd	TCS.BO	Overweight	1,365	1,229	11%	1,253	903	Mar	1,957	48,801	(1,238)	47,564
Infosys Ltd	INFY.BO	Overweight	3,000	2,951	2%	3,317	2,169	Mar	574	34,179	(3,665)	30,514
Wipro Ltd	WIPR.BO	Neutral (V)	430	449	-4%	490	310	Mar	2,458	22,385	(1,045)	21,340
Hcl Technologies Ltd	HCLT.BO	Overweight	490	491	0%	528	360	Jun	692	6,916	80	6,996
Mphasis Ltd	MBFL.BO	Neutral (V)	380	399	-5%	687	277	Oct	210	1,700	5	1,705
Tech Mahindra Ltd	TEML.BO	Underweight	580	660	-12%	798	524	Mar	127	1,710	243	1,953
Patni Computer Systems Ltd	PTNI.BO	Neutral	360	474	-24%	502	250	Dec	148	1,306	0	1,306
Mindtree Ltd	MINT.BO	Neutral	470	469	0%	525	321	Mar	41	387	(14)	373
Polaris Financial Technology Ltd	POLF.NS	Overweight (V)	235	164	43%	214	112	Mar	99	331	(9)	321
Company	Absolute Share Price Performance (%)				Rel. Performance vs Index (%)				Rel. Performance vs BSE-IT (%)			
	1m	3m	12m	YTD	1m	3m	12m	YTD	1m	3m	12m	YTD
Tata Consultancy Services Ltd	11.3	10.4	10.8	5.8	0.2	-0.6	12.1	-10.6	0.1	-0.4	11.0	-3.1
Infosys Ltd	10.9	7.3	-5.2	6.7	-0.1	-3.5	-4.0	-9.8	-0.3	-3.6	-4.9	-2.2
Wipro Ltd**	8.3	22.2	4.2	12.6	-2.5	10.0	5.4	-4.8	-2.9	11.3	4.4	3.7
HCL Technologies Ltd	15.7	20.0	5.1	26.6	4.2	8.0	6.4	7.0	4.5	9.2	5.4	17.6
Tech Mahindra Ltd	10.6	33.4	-41.8	33.0	-0.5	20.0	-41.1	12.4	-0.6	22.5	-41.6	24.0
Patni Computer Systems Ltd	8.3	10.4	-0.6	15.1	-2.5	-0.6	0.6	-2.7	-2.9	-0.4	-0.4	6.2
Mindtree Ltd	0.6	10.6	3.1	6.2	-9.5	-0.5	4.4	-10.3	-10.6	-0.3	3.4	-2.8
Polaris Software Lab Ltd	5.9	18.5	4.1	18.0	-4.6	6.7	5.3	-0.3	-5.3	7.7	4.3	9.0
Persistent Systems Ltd	17.0	26.8	-15.4	32.5	4.4	12.4	-15.7	10.1	5.8	15.9	-15.2	23.5
Average	-1.9	3.0	-19.3	-2.3	-11.6	-7.3	-18.3	-17.5	-13.1	-7.9	-11.3	-11.3
Valuation Multiples	P/E (x)				EV/EBITDA (x)				EV/Sales			
	FY12E	FY13E	FY14E	PEG (x)	FY11	FY12E	FY13E	FY14E	FY11	FY12E	FY13E	FY14E
Tata Consultancy Services Ltd	22.7x	19.8x	17.1x	1.3x	19.1x	14.7x	12.7x	11.1x	5.8x	4.7x	4.2x	3.6x
Infosys Ltd	20.2x	17.9x	15.2x	1.2x	15.3x	12.5x	11.0x	9.6x	5.0x	4.3x	3.8x	3.3x
Wipro Ltd**	19.3x	16.8x	13.6x	0.9x	14.7x	13.2x	11.2x	9.2x	4.1x	3.6x	3.2x	2.9x
HCL Technologies Ltd	15.3x	13.1x	11.2x	0.8x	11.6x	8.3x	7.5x	6.1x	2.0x	1.7x	1.5x	1.2x
Tech Mahindra Ltd	10.2x	10.8x	9.8x	4.8x	6.1x	7.8x	7.3x	6.7x	1.6x	1.5x	1.5x	1.4x
Patni Computer Systems Ltd	8.5x	7.9x	7.4x	1.2x	8.8x	9.4x	7.9x	7.4x	1.7x	1.7x	1.6x	1.5x
Mindtree Ltd	19.6x	15.7x	11.4x	0.5x	10.2x	11.6x	9.9x	7.6x	1.9x	1.7x	1.5x	1.3x
Polaris Software Lab Ltd	9.5x	9.9x	8.3x	1.4x	9.4x	6.0x	6.8x	6.8x	1.1x	0.9x	0.8x	0.7x
Persistent Systems Ltd	7.3x	6.8x	5.4x	0.4x	6.8x	4.4x	4.4x	3.4x	0.9x	0.7x	0.7x	0.6x
Average	8.6x	7.1x	5.9x	0.3x	5.5x	3.7x	3.1x	2.6x	1.1x	0.9x	0.8x	0.7x
Income Statement (INR,m)	Revenue (USDm)				Revenue (INR bn)				EPS			
	FY11	FY12E	FY13E	FY14E	FY11	FY12E	FY13E	FY14E	FY11	FY12E	FY13E	FY14E
Tata Consultancy Services Ltd	8,186	10,173	11,422	13,206	373	489	571	660	44.5	54.2	62.0	71.7
Infosys Technologies Ltd	6,044	7,057	7,945	9,139	275	344	398	457	119.4	146.1	164.6	193.8
Wipro Ltd**	5,221	5,920	6,584	7,423	235	288	330	371	22.0	23.2	26.7	33.1
HCL Technologies Ltd	3,545	4,182	4,823	5,668	159	209	241	283	22.9	32.2	37.6	43.9
Tech Mahindra Ltd	1,100	1,116	1,132	1,223	50	51	58	62	52.0	39.0	37.1	40.8
Patni Computer Systems Ltd	1,127	1,167	1,225	1,345	51	56	61	67	51.6	77.8	83.5	88.6
Mindtree Ltd	701	759	882	1,008	31	34	39	45	42.5	24.2	30.2	41.4
Polaris Software Lab Ltd	331	401	450	514	15	19	22	26	24.8	49.3	47.2	56.5
Persistent Systems Ltd	348	443	490	560	16	21	24	28	20.3	22.6	24.3	30.5
Growth Rates & Margins	Revenue (USD)				EBITDA Margins				EPS Growth			
	FY12E	FY13E	FY14E	2-Yr CAGR	FY11	FY12E	FY13E	FY14E	FY12E	FY13E	FY14E	2-Yr CAGR
Tata Consultancy Services Ltd	24.3%	12.3%	15.6%	13.9%	30.0%	29.8%	29.5%	29.2%	21.8%	14.3%	15.7%	15.0%
Infosys Ltd	16.8%	12.6%	15.0%	13.8%	32.6%	31.9%	31.4%	31.5%	22.3%	12.7%	17.7%	15.2%
Wipro Ltd**	13.4%	11.2%	12.8%	12.0%	27.8%	25.2%	25.9%	28.2%	5.8%	5.8%	23.9%	19.2%
HCL Technologies Ltd	18.0%	15.3%	17.5%	16.4%	17.2%	18.2%	17.4%	18.2%	40.5%	16.6%	17.0%	16.8%
Mphasis Ltd	1.5%	1.4%	8.1%	4.7%	25.1%	19.3%	18.2%	18.5%	-25.0%	-4.8%	9.9%	2.3%
Tech Mahindra Ltd	3.6%	5.0%	9.8%	7.4%	19.5%	16.8%	18.1%	17.6%	50.7%	7.3%	6.2%	6.7%
Patni Computer Systems Ltd	8.3%	16.1%	14.3%	15.2%	18.4%	15.0%	15.0%	17.2%	-43.1%	24.8%	37.1%	30.8%
Mindtree Ltd	21.2%	12.2%	14.2%	13.2%	11.8%	14.6%	10.9%	9.6%	98.7%	-4.4%	19.8%	7.1%
Polaris Software Lab Ltd	27.3%	10.5%	14.3%	12.4%	13.5%	15.5%	13.5%	15.0%	11.4%	7.5%	25.7%	16.2%
Persistent Systems Ltd	22.1%	16.3%	17.2%	16.8%	20.4%	22.9%	23.2%	24.0%	6.4%	21.2%	21.0%	21.1%
Average	15.6%	11.3%	13.9%	12.6%	21.6%	20.9%	20.3%	20.9%	19.0%	11.0%	19.4%	15.0%

†In this table, potential return equals the percentage difference between the current share price and the target price (does not include forecast dividend yield)
Source: Thomson Reuters Datastream, HSBC estimates; priced at close of 20 February 2012

**Wipro estimates are for their IT services division

Valuation and risks

TCS (TCS.BO; INR1,220, Overweight; TP INR1,365)

TCS is currently trading at nearly 20x FY13e EPS. We believe it will continue to trade at this valuation level. We value the company at 20x our December 2013 annualised earnings, with a target price of INR1,365 and remain Overweight.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate for India stocks of 11%. At the time we set our target price, it implied a potential return that was above the Neutral band; therefore, we rate the stock Overweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Risks

1) Deterioration in macroeconomic conditions is a primary risk which may result in a delay in decision making and, therefore, project ramp-ups. 2) The appreciation of the rupee against the US dollar is one of the key risks to our estimates. While management is confident of maintaining an EBIT margin of around 27% even if the rupee appreciates to 46, any appreciation in the rupee will impact sentiment and stock valuation.

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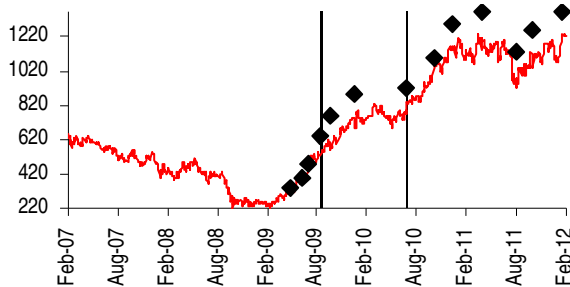
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Overweight (Buy)	52%	(26% of these provided with Investment Banking Services)
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Share price and rating changes for long-term investment opportunities

TCS (TCS.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral (V)	Overweight (V)	01 September 2009
Overweight (V)	Overweight	15 July 2010
Target Price	Value	Date
Price 1	335.00	12 May 2009
Price 2	400.00	25 June 2009
Price 3	480.00	20 July 2009
Price 4	640.00	01 September 2009
Price 5	755.00	07 October 2009
Price 6	890.00	07 January 2010
Price 7	925.00	15 July 2010
Price 8	1100.00	22 October 2010
Price 9	1300.00	02 January 2011
Price 10	1360.00	21 April 2011
Price 11	1130.00	23 August 2011
Price 12	1260.00	18 October 2011
Price 13	1365.00	08 February 2012

Source: HSBC

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