

Equities

2 November 2011 | 10 pages

Indian IT Services

Alert: Cognizant Q3: Implication for Indian IT Services

■ Industry Overview

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- **Market share gains continue** – Cognizant (CTSH), covered by our US IT Services analyst Ashwin Shirvaikar, reported a good Q3 with revenue growth of 7.8% qoq (~7.3% organic), highest among Tier I offshore firms. CTSH continues to gain market share at a rapid pace – please find our US team’s note at: [Cognizant \(CTSH\)](#).
- **Q4 guidance looks a little light** – Q3 guidance (implying “at least” ~3% organic growth) looks a little light (vs. expectations) – can be partly explained by seasonality, lack of budget flush this year, slightly slower growth expectations from Europe and some conservatism. *It is interesting to note that Infosys Oct-Dec quarter guidance (mid point) is higher than CTSH – has not happened for a while.*
- **Comments on pricing** – CTSH management indicated that last year’s pricing discussions had been successful and that resulted in ~4-5% price increase yoy in CY11. However, given that not all customers are “eligible” this year (given that they had given hikes last year), magnitude of pricing increase will be lower next year. However, pricing is stable with an upward bias. *This is in line with Tier I Indian companies where optimism on pricing outlook has moderated in the past few months.*
- **Thoughts on CY12 IT budget** – While it is early in the budgeting process, CTSH management expects 2012 IT budgets to remain flat with a slight upward bias. However, the share of global delivery model is likely to keep increasing. On Europe, the company does not see any disruption but they are building in modest growth in Q4.
- **Business highlights** – (a) All round growth – BFSI grew 7% qoq, healthcare revenues were up 11%, manufacturing/retail was up 5% while the rest (communications/technology/media) was up ~7% qoq; (b) North America was up ~8% qoq while Europe was up ~5.3% qoq (constant currency); (c) Hiring was strong – CTSH added ~12k employees in the quarter; (d) Pricing was stable qoq.
- **Indian IT Services view** – We reiterate our Neutral view on the sector given (a) Moderation in growth rates likely in CY12 given some pressure on budgets (and discretionary spends); (b) Pricing increases unlikely (and there could be some pressure if macro worsens); (c) Base effect impacting growth rates and (d) Valuations (for Infosys/TCS) at close to 5-year averages. We continue to prefer Wipro (more so, after this quarter, where volumes did well and attrition came down) and HCLT (attractive valuations (12x FY13E) for relatively strong earnings growth outlook.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Wipro

(WIPR.BO; Rs373.75; 1)

Valuation

Our target price of Rs420 is based on 17x Sep'12E EPS. Our target multiple is derived from a PE-band analysis of Wipro's historical trading pattern and peer group valuations. Wipro has traded at 8-22x over the past three years. Wipro's management restructuring should result in recovery in growth but at the same time, the overall macro is challenging. Given this background, we believe Wipro should trade slightly higher than the midpoint of its 3-year trading band. We think Wipro will continue to trade at a discount to Infosys. PE is the most appropriate valuation measure, in our view, given Wipro's profitability and earnings visibility.

Risks

The key risks to our investment thesis on Wipro are: (1) an extended slowdown in the US/Global economy; (2) any significant appreciation of the rupee against the USD/EUR/GBP and (3) any margin dilutive acquisition.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

HCL Technologies

(HCLT.BO; Rs438.20; 1)

Valuation

Our target price is Rs515 based on 16x Sep'12E EPS. This is higher than the mid-point of the 5-20x band that the stock has traded in over the past three years. We believe a higher multiple is justified given HCLT's improved positioning in the sector (in terms of sale and capabilities), better service portfolio (post Axon acquisition). We believe PE remains the most appropriate valuation measure given HCLT's profitable track record.

Risks

The key risks to our investment thesis on HCL Tech are: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) a sharp slowdown in the US/Global economy; (3) acquisition-related risks; and (4) the strategy of pursuing large deals could have negative margin implications.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Infosys Ltd

(INFY.BO; Rs2,828.65; 2)

Valuation

Our Rs2,890 target price for Infosys is based on 19x Sep'12E EPS. This is close to the mid-point of the last 3-year trading band of 10-25x 12-month forward earnings and factors in deceleration in growth and macro overhang. Our estimates continue to assume a certain PE premium to the market; this is justified, in our view, given the

strong FCF and ROIC for Infosys vs. the overall market. We believe PE remains the most appropriate valuation measure given Infosys' profitability record and higher earnings visibility.

Risks

The key downside risks to our investment thesis on Infosys are: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) pressure on billing rates; and (3) a prolonged slowdown in the US economy. Key upside risks that could cause shares to exceed our target price include: (1) a sharp recovery in the US/Global economy; and (2) any significant depreciation of the rupee against the USD/EUR/GBP.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price. Conversely, if the impact of any of these upside risks is greater than we anticipate, the stock could exceed our target price.

Tata Consultancy Services

(TCS.BO; Rs1,106.30; 2)

Valuation

Our target price of Rs1,160 is based on ~20x Sep'12E EPS. We estimate TCS' earnings will grow at a ~17% CAGR over FY11-13E, and believe the stock should trade closer to the higher end of its historical three-year trading range of 7-24x 12-month forward earnings. We believe PE remains the most appropriate valuation measure, given TCS' past profitability and future earnings visibility.

Risks

The key downside risks to our investment thesis on TCS are: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) a prolonged recession in the US; and (3) any margin-dilutive acquisition. Key upside risks that could cause the shares to be higher than our target price are: (1) any significant depreciation of the rupee against the USD/EUR/GBP; (2) aggressive pent-up demand from corporates in the US; and (3) any margin-accretive acquisition.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price. Conversely, if the impact of any of these upside risks is greater than we anticipate, the stock could exceed our target price.

Appendix A-1

Analyst Certification

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IMPORTANT DISCLOSURES

HCL Technologies (HCLT.BO)

Ratings and Target Price History Fundamental Research

Analyst: Surendra Goyal, CFA

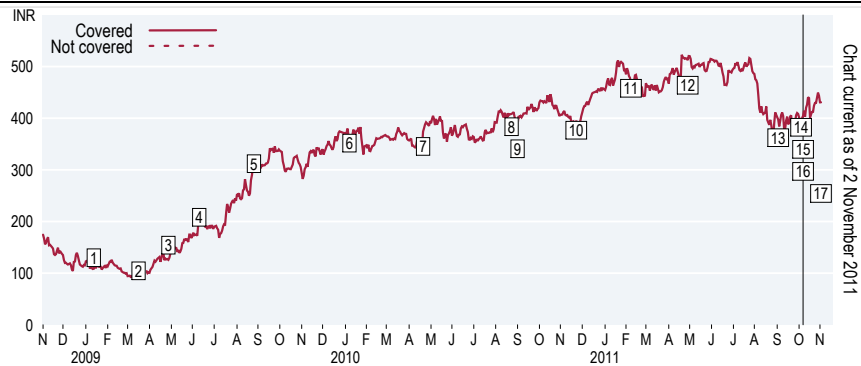


Chart current as of 2 November 2011

Date	Rating	Target Price	Closing Price
1 13-Jan-09	*2H	*120.00	108.60
2 17-Mar-09	2H	*111.00	101.15
3 28-Apr-09	*2M	*140.00	125.85
4 10-Jun-09	2M	*215.00	204.40
5 26-Aug-09	2M	*345.00	301.55
6 7-Jan-10	2M	*435.00	360.50

Date	Rating	Target Price	Closing Price
7 21-Apr-10	*1M	435.00	374.10
8 24-Aug-10	*1L	*495.00	408.50
9 1-Sep-10	1L	*480.00	386.55
10 23-Nov-10	1L	*510.00	394.95
11 8-Feb-11	1L	*560.00	465.50
12 28-Apr-11	1L	*595.00	512.45

Date	Rating	Target Price	Closing Price
13 2-Sep-11	1L	*505.00	397.35
14 5-Oct-11	1L	*510.00	395.10
15 7-Oct-11	Stock rating system changed		
16 7-Oct-11	*1	510.00	404.65
17 2-Nov-11	1	*515.00	430.75

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

HCL Technologies (HCLT.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Surendra Goyal, CFA

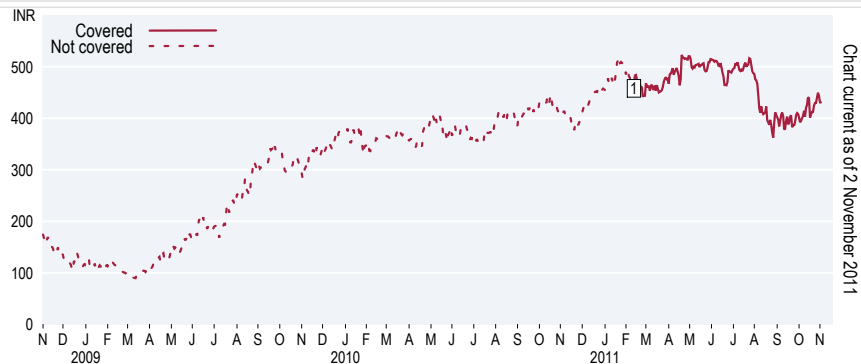


Chart current as of 2 November 2011

Date	Rating	Target Price	Closing Price
1 11-Feb-11	*ADD MP	-	469.95

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Infosys Ltd (INFY.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA

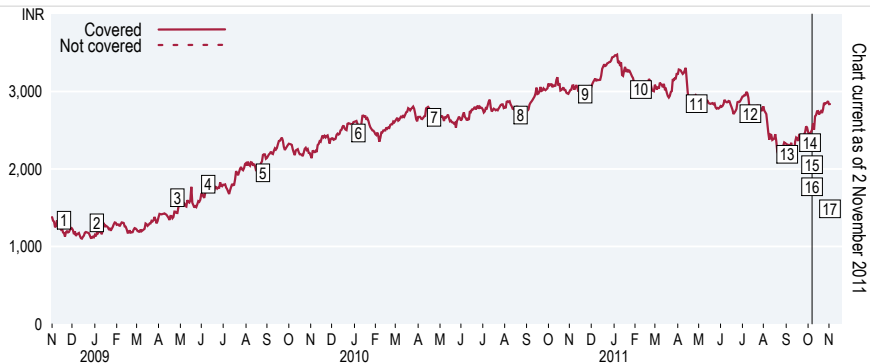


Chart current as of 2 November 2011

	Date	Rating	Target Price	Closing Price
1	19-Nov-08	1M	*1,420.00	1,172.00
2	4-Jan-09	1M	*1,350.00	1,130.95
3	28-Apr-09	*1L	*1,650.00	1,431.55
4	10-Jun-09	1L	*2,060.00	1,803.25
5	26-Aug-09	*2L	*2,290.00	2,181.35
6	7-Jan-10	2L	*2,785.00	2,525.25

	Date	Rating	Target Price	Closing Price
7	23-Apr-10	2L	*2,935.00	2,728.10
8	24-Aug-10	2L	*3,065.00	2,765.50
9	23-Nov-10	2L	*3,220.00	3,013.30
10	9-Feb-11	2L	*3,430.00	3,127.00
11	28-Apr-11	2L	*3,230.00	2,931.55
12	13-Jul-11	2L	*3,125.00	2,784.20

	Date	Rating	Target Price	Closing Price
13	2-Sep-11	2L	*2,570.00	2,315.55
14	5-Oct-11	2L	*2,650.00	2,454.30
15	7-Oct-11	Stock rating system changed		
16	7-Oct-11	*2	2,650.00	2,507.05
17	2-Nov-11	2	*2,890.00	2,837.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Infosys Ltd (INFY.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Surendra Goyal, CFA

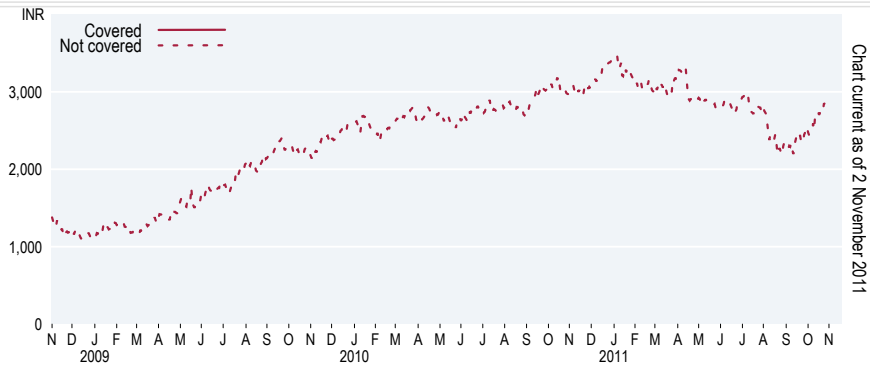


Chart current as of 2 November 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tata Consultancy Services (TCS.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA



Chart current as of 2 November 2011

	Date	Rating	Target Price	Closing Price
1	19-Nov-08	*2H	*280.00	240.43
2	28-Apr-09	*3M	*307.50	299.30
3	10-Jun-09	*1L	*465.00	390.88
4	17-Jul-09	1L	*525.00	433.60
5	26-Aug-09	1L	*630.00	548.30
6	19-Oct-09	1L	*695.00	599.00

	Date	Rating	Target Price	Closing Price
7	7-Jan-10	1L	*855.00	714.65
8	22-Apr-10	*2L	855.00	785.30
9	24-Aug-10	2L	*930.00	868.90
10	23-Nov-10	2L	*1,080.00	1,032.20
11	8-Feb-11	2L	*1,185.00	1,128.45
12	28-Apr-11	2L	*1,260.00	1,160.05

	Date	Rating	Target Price	Closing Price
13	2-Sep-11	2L	*1,110.00	1,021.65
14	5-Oct-11	2L	*1,140.00	1,043.50
15	7-Oct-11	Stock rating system changed		
16	7-Oct-11	*2	1,140.00	1,048.70
17	2-Nov-11	2	*1,160.00	1,107.50

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tata Consultancy Services (TCS.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Surendra Goyal, CFA

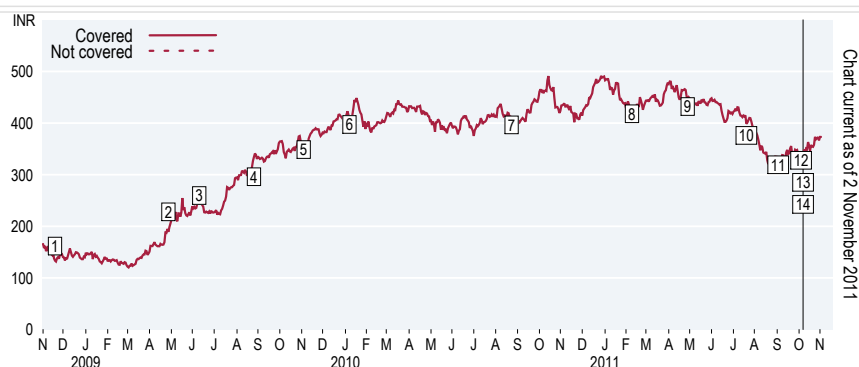


* Indicates change

Wipro (WIPR.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Surendra Goyal, CFA



	Date	Rating	Target Price	Closing Price
1	19-Nov-08	*2H	*159.00	133.53
2	28-Apr-09	*2M	*216.00	189.24
3	10-Jun-09	*2L	*270.00	259.62
4	26-Aug-09	*1L	*372.00	334.35
5	4-Nov-09	1L	*408.00	357.48

	Date	Rating	Target Price	Closing Price
6	7-Jan-10	1L	*486.00	406.53
7	24-Aug-10	1L	*490.00	408.75
8	9-Feb-11	1L	*515.00	423.35
9	28-Apr-11	1L	*525.00	446.70
10	20-Jul-11	1L	*510.00	398.60

	Date	Rating	Target Price	Closing Price
11	2-Sep-11	1L	*410.00	334.10
12	5-Oct-11	1L	*420.00	327.90
13	7-Oct-11	Stock rating system changed		
14	7-Oct-11	*1	420.00	333.80

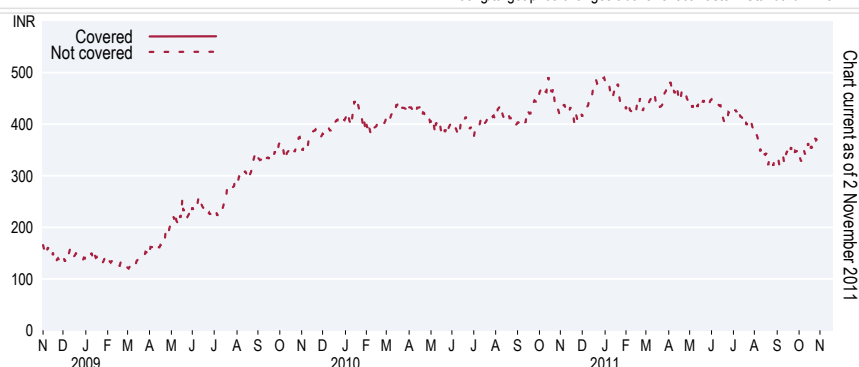
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Wipro (WIPR.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Surendra Goyal, CFA



* Indicates change

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