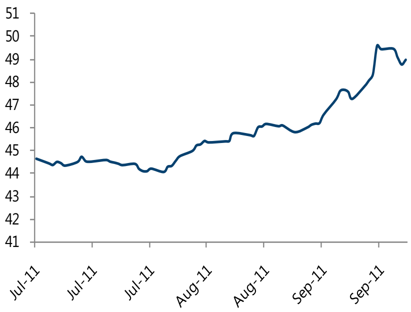
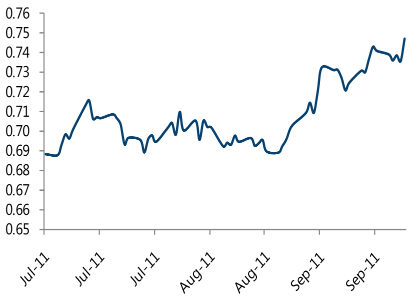
IT Q2FY12 Review

Sector well priced…. CY12 budget crucial

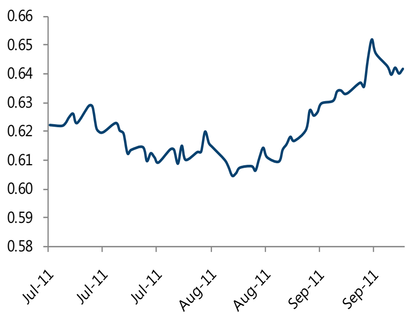
USD-INR



USD-Euro



USD-GBP



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***MSFL* IT Universe performed well in Q2FY12 with 7.3% sequential growth in revenues and net profit increase at 3.7% led by favorable rupee-dollar movement. Among large caps Infosys performed best followed by TCS and HCL Tech. Operational performance was better than expected at 9.1% increase in EBITDA q-o-q across the coverage space on account of better realized rate. However forex losses below EBITDA nullified partial gains resulting in 3.7% q-o-q increase in PAT. Management commentary on demand remains cautiously optimistic as they continue to see projects coming with no signs of budget pull back for remaining part of the calendar year. However the mooted point remains CY12 IT budgets which is still under the clouds of uncertainty with no clear cut views of how it will be shaping out. And good thing amid this feeble macro-environment has been increasing share of Indian vendors in the outsourcing space primarily within the deals coming in from the renewal market. We remain Hold on the sector as positives from currency; and negatives from macro with moderate revenue growth and lower multiples has already been priced in. TCS and HCL remain our preferred picks; Infosys and Wipro remains at watching point for growth trajectory ahead after delivering steady performance in the quarter first time post restructuring.**

Steady revenue growth but CY12 budget to be watchful for

H1FY12 has preferably been an in line first half for the coverage space with volume growth of around 4-6.5%. Similar strength could not be seen in next quarter because of seasonality from lower working days creeping in and non-linear revenues still forming a smaller part of revenue. Pricing was mixed as Infosys and HCL saw increases while TCS and Wipro witnessed price decline. Pricing outlook remains stable.

Business operations taking the demand forward

The key revenue driver in current quarter has been the demand for run the business need. Business operations services like ADM, IMS, Testing and Business process management recorded good growth in the quarter. The demand for them is expected to continue as it comprises almost 70-80% of the current IT spend.

Margin gain from better realized rate

With rupee reaching @ 50 levels, this would surely be a margin driver in near term. Companies hence need to manage their operations so as not to get larger impact in case of rupee reversal. We expect margins to remain range bound for companies under our coverage as we do not see any significant margin levers from here. Utilization could act as a lever for Infosys and HCL only.

Outlook

Concerns over IT spending have already moderated growth assumptions. Key factor to watch out for in coming months would be IT budget allocation for 2012 which would be a decisive factor for growth moderation or sluggishness. At current point in time spends is favorable as no budget cuts have taken place and clients continue to spend in order to streamline their operations taking a longer term view on return from technology investment. As far as margin is concerned rupee is a crucial tailwind but one never knows when the tide will turn. Hence cost management will play crucial role for IT vendors.

Valuation

Moderate revenue growth, feeble macro environment, currency tailwinds has already been factored in the current valuations of the stocks and hence we maintain Hold on the sector. TCS and HCL continue to remain our sector top pick.

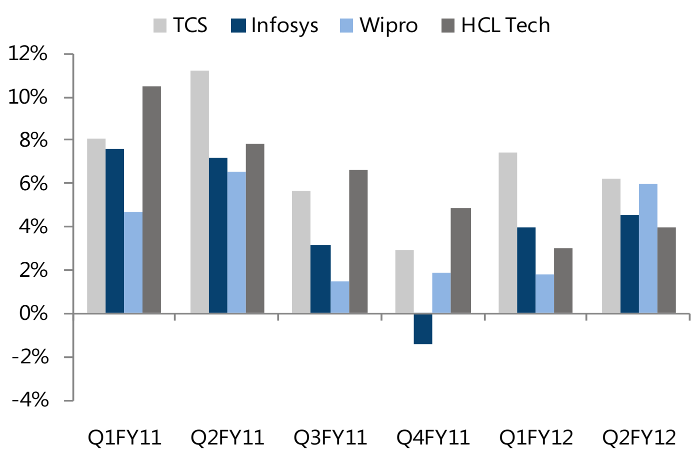
(in ₹ mln)	Sales			EBITDA			Net Profit			Reco	TP
IT	Q2FY12	% y-o-y	% q-o-q	Q2FY12	% y-o-y	% q-o-q	Q2FY12	% y-o-y	% q-o-q		
TCS	116335	25.3%	7.7%	33,800	21.7%	11.5%	24390	14.7%	2.5%	Hold	1125
Infosys	80990	16.6%	8.2%	25160	7.8%	16.9%	19060	9.7%	10.7%	Hold	2784
Wipro	90070	15.9%	6.1%	16523	0.7%	-0.3%	13009	1.2%	-2.5%	Hold	388
HCL Tech	46513	25.4%	8.2%	7949	31.7%	0.1%	4971	50.1%	-2.7%	Accumulate	476
Firstsource	5330	5.9%	1.9%	462	-34.5%	7.8%	215	-35.4%	101.6%	Hold	11.3
KPIT	3250	38.3%	2.8%	444	21.8%	11.7%	365	53.6%	51.4%	Accumulate	180
Geometric	1912	25.9%	10.7%	276	37.3%	67.1%	134	-3.1%	14.0%	Buy	58
Aggregate	**344401**	**20.4%**	**7.3%**	**84613**	**13.1%**	**9.1%**	**62143**	**12.0%**	**3.7%**		

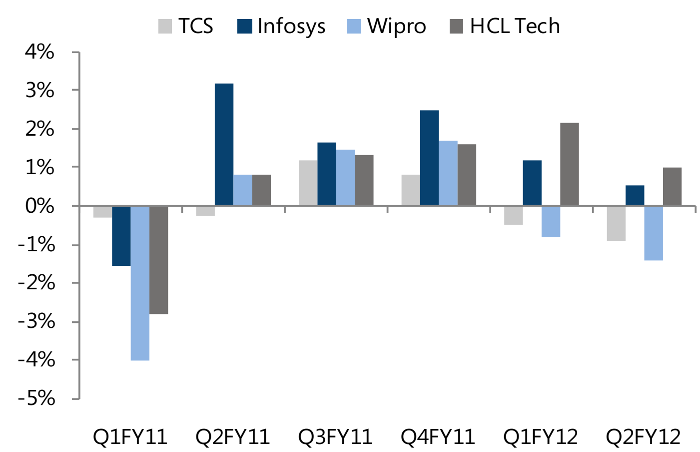
Indian vendors gaining a sweet spot in renewal market…

Volume growth for Q2FY12 was well within the range of 4-6.5% for our coverage universe. Pricing however saw a mixed performance. While Infosys and HCL Tech saw improvement in pricing, TCS and Wipro saw sequential dip. TCS covered the dip by recording highest volume growth within our coverage space. Pricing outlook across the board however remains stable.

TCS has been the leader in the pack in terms of volume growth even on a higher base exuding strong market presence and reach; building confidence on better revenue visibility going ahead. The recent win for TCS of USD 2.2bln contract by UK based Friend's life to its UK based subsidiary Diligenta supports for higher reach and delivery by TCS.

Exhibit 1: Volume and Pricing growth





Source: Company, Bloomberg, MSFL Research

We maintain our estimates after incorporating recent results into our model. We might see slow growth in coming quarters on account of seasonality and as fresh budget cycles get decided during the month of Nov 2011-Jan 2012. Any outperformance in next quarter could be a result of budget flush which we see as a low possibility. Pricing outlook at current point in time is maintained at Q2FY12 levels. However we need to keep a watch on pricing esp. for TCS and Wipro as we have seen two simultaneous quarters of price decline (primarily led by change in FP contracts in Q2FY12) for both.

One good thing has been continuation of deal win by Indian Vendors specifically TCS and HCL Tech as they are gaining higher market share in the renewal market. Moreover TCS and HCL Tech have been placed among top 15 IT service providers in the latest TPI Index.

Exhibit 2: Key quarterly pointers

	TCS	Infosys	Wipro	HCL Tech
• Volume growth	Highest @ 6.3%	4.5%	Organic at 4.6%	Steady growth at 4%
• Pricing growth	90bps decline	50bps increase	140bps decline	120bps increase
• Geographical growth drivers	Asia pacific, Continental Europe, UK, US and MEA	North America, Europe, ROW	Japan, emerging markets, India & ME, Europe, US	US and Europe
• Vertical drivers	E&U, Retail, Mfg Transportation, HC& Life science, Hi-tech	Life science, E&U, BFSI, Mfg	E&U, BFSI, Retail	Retail & Mfg
• Horizontal Service drivers	Asset leverage, consulting, Assurance, Engineering, Enterprise	ADM, Testing, Product Engineering, BPM etc	Analytics, Infrastructure, Product engineering, Consulting, Business application etc	Engineering & R&D, Custom application, Infra
• Guidance	NA	Upped INR EPS guidance to ₹ 143-145 from ₹ 128-130; toned down FY12 USD revenue guidance to 17-19% from 18-20%.	1.9-3.9% growth for Q3FY12	NA
• Gross/Net hiring	20349/ 12580	15352/ 8262	NA/ 5240	9311/ 3474
• Attrition	13.7%	15.6%	18.5%	15.9%
• Growth among				
Top Client	1.8%	6.8%	17.3%	3.4%
Top 5 Clients	1.2%	4.5%	11.3%	2.0%
Top 10 Clients	2.5%	4.5%	7.9%	0.8%

Rupee to aid in margin improvement

With rupee touching 50 levels, the benefit of the same will flow into operating performance of the companies. Apart from favorable rupee; there are not enough margin levers primarily for TCS and Wipro. Infosys and HCL Tech are better placed in terms of utilization at 76-77% and hence acts as a margin leverage for the same. Fixed price (FP) proportion has moved down drastically for TCS (down by 290bps) and Wipro (down by 180bps) in the current quarter (explained as reason behind pricing drop in Q2). Increase in FP share for both should act positively.

Exhibit 3: Average currency movement during Q2FY12 (in %)

Average quarter appreciation of -->	INR	GBP	Euro	AUD
USD	-2.46%	-1.07%	-1.51%	-1.16%

Source: Company, MSFL Research

Exhibit 4: Closing and Average currency movement during Q3FY12 as of now (in %)

Closing quarter appreciation of -->	INR	GBP	Euro	AUD
USD	-2.6%	-2.4%	-2.1%	-6.1%
Average quarter appreciation of -->				
USD	-7.1%	-1.6%	-2.6%	-1.8%

Source: Company, MSFL Research

Mixed impact on Profitability

Profitability is expected to be better with partial gains from better realized rate depending on the hedging exposure. Infosys still is least hedged at current point in time and will hence stand to benefit the most from the change. The full quarter impact of sharp rupee movement will be visible in next quarter.

Exhibit 5: Hedging position as on Sep 2011

Hedge Position	Forex cover as on Sep 2011 (USD mln)			Revenue in Sep 2011 (USD mln)	% of Revenue Hedged
	Forward	Options	Total		
TCS	384	2414	2798	2525	111%
Infosys	729	0	729	1746	42%
Wipro	1609	-	1609	1472	109%
HCL Tech	235	478	713	1002	71%

Source: Company, MSFL Research

Key Things to watch out for going ahead

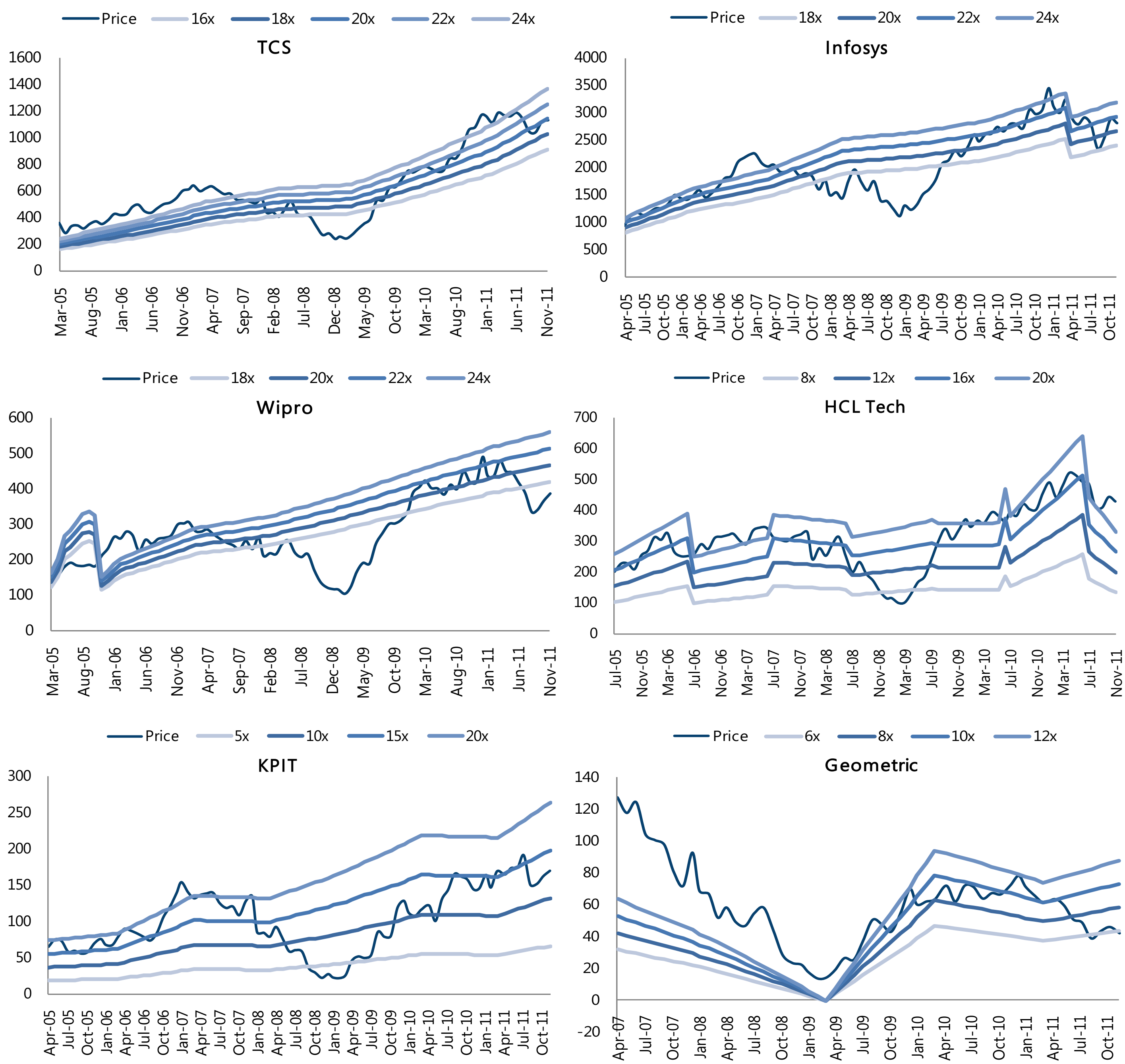
- Discussion on CY12 budgets, take by clients.
- USD-INR movement
- Outlook on pricing

Exhibit 6: Estimates and Valuation

	Sales (in ₹ mln)		EBITDA Margin (%)		EPS		P/E Assigned	TP	Reco
	FY12P	FY13P	FY12P	FY13P	FY12P	FY13P			
TCS	476426	539604	30.1	29.3	54.7	60.8	18.5	1125	Hold
Infosys	331944	377842	31.7	30.3	139.8	154.6	18	2784	Hold
Wipro	367833	407365	20.0	19.3	23.8	25.0	15.5	388	Hold
HCL Tech*	198143	221814	17.7	17.1	31.1	35.5	14	476	Accumulate
FSL**	21707	23244	8.5	8.5	1.6	2.4	4.8	11.3	Hold
KPIT#	13516	15146	14.9	14.1	14.4	14.9	10.8	180	Accumulate
Geometric	7721	8392	14.0	13.4	7.9	8.3	7	58	Buy

*Source: Company, MSFL Research; * - HCL Valued on FY13 march ending EPS of ₹34; ** - FSL valued on average of P/E and FCF; # - KPIT has ₹ 19/share contribution from SYSTIME*

Exhibit 7: Forward P/E band



MSFL View:-

Moderate revenue growth, feeble macro environment, currency tailwinds has already been factored in the current valuations of the stocks and hence we maintain Hold on the sector.

TCS and HCL Tech continues to remain our sector top pick on back of better benefiters from renewal market and thus gaining market share. Infosys and Wipro could perform better provided they come out with consistent delivery in next quarter coupled with broad base growth rather than being client, geographic, service or vertical specific. Any investment should be done at lower levels.

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Key ratings:

Rating	Expected Return
Buy	> 15%
Accumulate	5 to 15%
Hold	-5 to 5%
Sell	< -5%
Not Rated	-

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