

India IT Services

Are we entering an era of lower technology spending intensity? ... Not quite so for IT services

IT intensity or IT spending as a % of GDP/corporate profits is a key indicator of the technology spending intensity of an economy. Plotting IT intensity for the US since 1995, we see several outcomes at play that have implications for IT services (IT services is one sub-segment besides hardware, software and telecom services).

- **IT spending as a % of corporate profits for the US has been moderating since CY08 and has reached a 6-year low. This raises questions as to whether the US economy is entering an era of lower technology spending intensity. We think that there are both cyclical (temporary) & structural factors at play here.** Corporate profits/balance sheets are robust in the US; thus capacity to spend on IT is not in question. It is a matter of confidence & timing (hence, **cyclical**). Today, we think corporations are getting over this cyclical hump.
- In addition to cyclical effects, some segments of IT spending are seeing some adverse **structural** impact, particularly on the pure hardware side thanks to technologies such as cloud and supporting virtualization which compresses hardware/data-centre growth. Gartner points out infra-as-a-service business models are forcing disruption on the infrastructure/hardware players (e.g. Dell/HP). Revenue cannibalization resulting from industrialized, cloud-based services risks muting growth for the IT outsourcing providers that are heavily focused on asset-heavy traditional infrastructure outsourcing (e.g. CSC).
- Also, the ongoing tide towards smartphones/tablets is structurally impacting the PC industry (hardware). Though this results in smart secular growth for spending on devices (as per Gartner, devices are among the fastest-growing sub-segments within IT spending – it is the entrenched PC-dependent players who do not seem to be able to cope adequately with this trend). Likewise, on the software side, what we see happening is different players emerging that commercialize newer business models (e.g. Salesforce) – a phenomenon needing established, players (e.g. Oracle) to keep up. This does not necessarily dim the outlook on top-down software spending; it's the incremental shift that needs watching. In fact, Gartner sees software as the fastest growing sub-segment.
- **On the other hand, the picture on asset-light IT services is better, in our view, despite oft-expressed reservations about the lowered intensity of IT services spending in the US.** One common view of pessimists is that investments that had to be made in spreading diffusion of technology in the economy have substantially been done and IT services is already ingrained in business activities within the US. What tends to get missed is the capacity and room for business innovation, change and productivity brought about by technologies which demands increasing IT services consumption.
- **The consumption of technology is still rapidly rising thanks to new waves such as SMAC (social mobility, mobility, analytics and cloud) – much faster than corporate IT budgets can accommodate them.** Therefore, as the units of consumption go up pushing the technology mainstream, price per unit may show a downward trend. Alternatively, keeping the unit pricing competitive for newer business models promotes usage and helps cast the net wider attracting newer & different client segments. It's the pricing trend that needs watching in the price-volume equation – will newer business models impact pricing is the key issue.
- **The SMAC wave buffeting IT services has the potential to change the assimilation & growth landscape for IT services.** We estimate that SMAC-led opportunities alone should raise the 3-5 year revenue CAGR profile of offshore IT services industry by at least 1% (net of cannibalization). Thus, we think a reversion to mean of IT services to profits ratio in the US is possible.

See page 5 for analyst certification and important disclosures, including non-US analyst disclosures.

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Technology, Software & IT services

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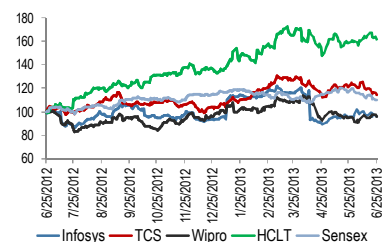
J.P. Morgan India Private Limited

YTD stock performance at a glance

	Rec.	PT (INR)	YTD Ret.
TCS	N	1,575	11%
Infosys	OW	2,700	2%
Wipro	N	400	-2%
HCLT	OW	820	21%

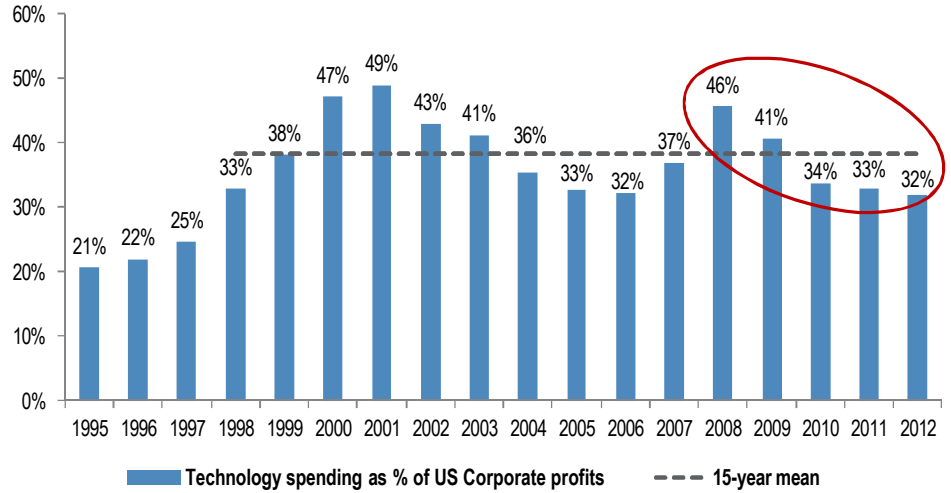
Source: Bloomberg, J.P. Morgan.
Note: Price as of Jun. 25, 2013.

12-month returns from Infosys, TCS, Wipro and HCLT (indexed to 100 on Jun 25, 2012)



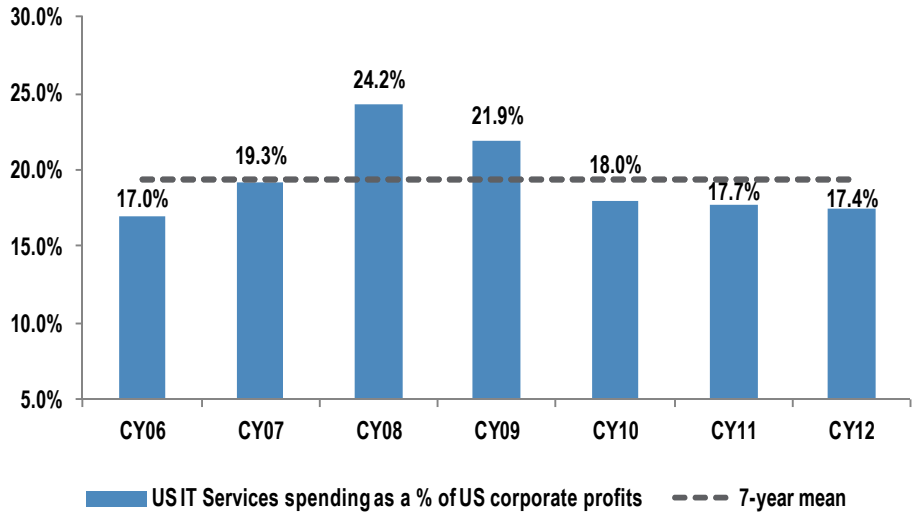
Source: Bloomberg, J.P. Morgan

Figure 1: US technology spending as a % of US corporate profits has consistently moderated over the last 4 years due to healthy growth in US corporates' bottom-line and a decrease in IT intensity; secular trends adversely impacting hardware (e.g. cloud) partly responsible for this



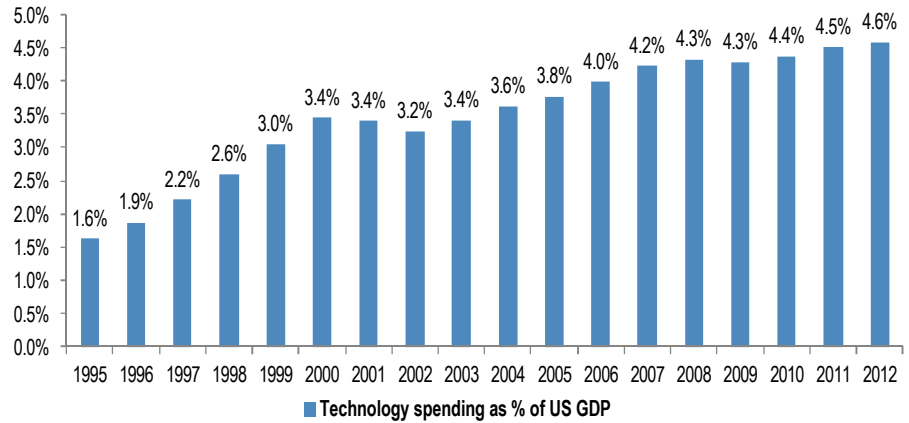
Source: BEA, J.P. Morgan; Note: Technology spending includes IT services, hardware and software spending

Figure 2: US IT services spending as a % of US corporate profits has moderated over the last 4 years due to healthy growth in US corporates' bottom-line; this should start reverting to mean as IT services as new technologies raise intensity of usage



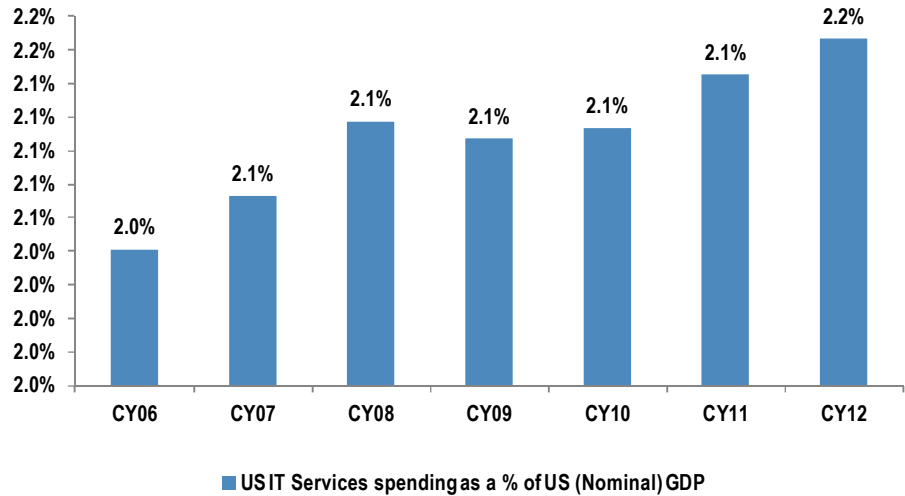
Source: Gartner, BEA, J.P. Morgan

Figure 3: US technology spending as a % of GDP has increased modestly over the last 2-3 years primarily because US government spending (which is about 40% of US GDP) is not increasing in line with private sector spending



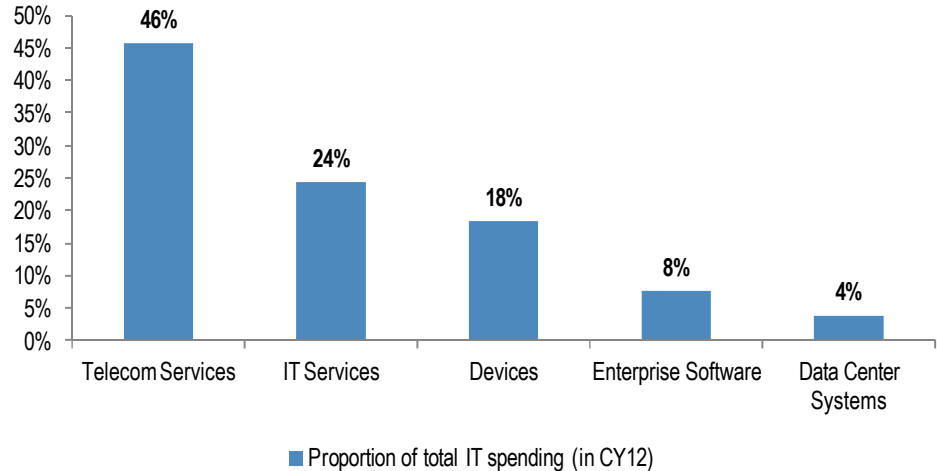
Source: BEA, J.P. Morgan; Note: Technology spending includes IT services, hardware and software spending

Figure 4: US IT services spending as a % of GDP has been broadly stable over the last 2-3 years primarily because government spending (which is about 40% of GDP) is not increasing in line with private sector growth, which is the primary driver for IT services spending



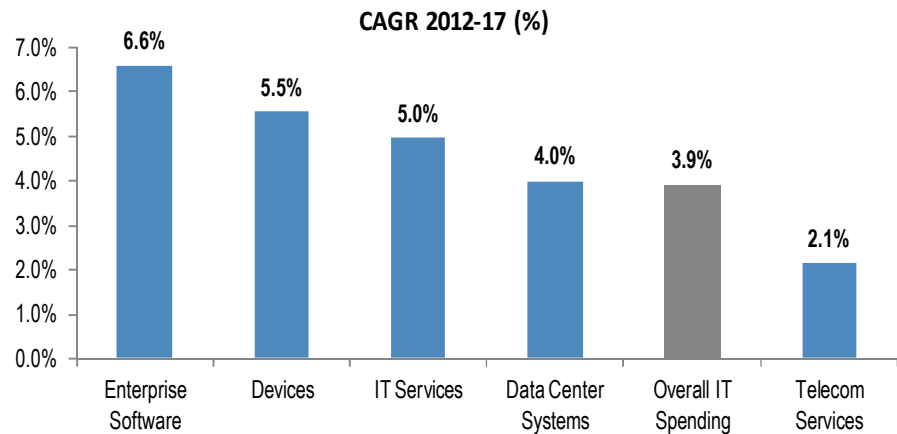
Source: Gartner, BEA, J.P. Morgan

Figure 5: IT services accounts for about one-fourth of overall IT spending (as per Gartner); total worldwide IT spending clocked USD 3.6 trillion in CY12



Source: Gartner, J.P. Morgan

Figure 6: Enterprise software spending expected to grow the fastest followed by Devices (devices powered by shift towards smartphones & tablets) and IT services; Telecom services, the largest component of IT spending (about 46%) to grow the slowest



Source: Gartner, J.P. Morgan

Investment view

We stay constructive on India IT with OW ratings on Infosys and HCLT. We still think that 2013 will be a better year for the India IT services industry than 2012. In our view, the immigration bill overhang is impacting stocks which seem to be substantially factoring in the likely scenario of elevated costs. We continue to assume that the onerous “outplacement” clause will not make its way into the immigration bill and it will more likely be higher costs (visa costs, US onsite wage costs) that the offshore IT services sector will have to bear from the immigration bill.

Companies Recommended in This Report (all prices in this report as of market close on 25 June 2013)

HCL-Technologies (HCLT.BO/Rs751.05/Overweight), Infosys (INFY.BO/Rs2373.90/Overweight), Tata Consultancy Services (TCS.BO/Rs1392.30/Neutral), Wipro Ltd. (WIPR.BO/Rs343.75/Neutral)

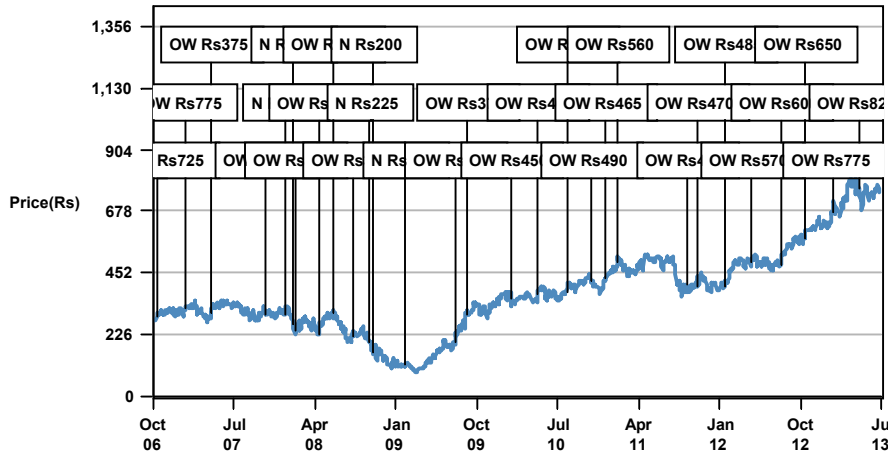
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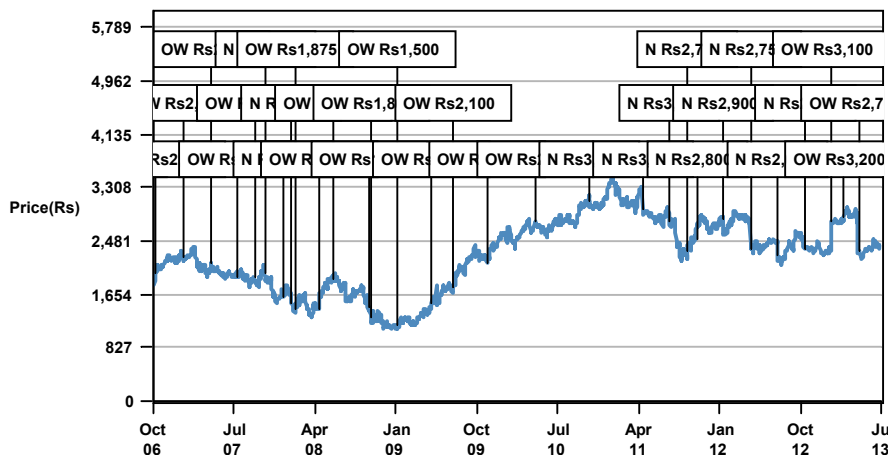
HCL-Technologies (HCLT.BO, HCLT IN) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Initiated coverage Oct 16, 2006.

Date	Rating	Share Price (Rs)	Price Target (Rs)
16-Oct-06	OW	292.82	725.00
16-Jan-07	OW	319.45	775.00
17-Apr-07	OW	308.75	375.00
16-Oct-07	OW	302.50	360.00
19-Dec-07	N	301.20	325.00
18-Jan-08	N	266.00	310.00
23-Jan-08	OW	240.90	310.00
15-Apr-08	OW	230.20	300.00
29-May-08	OW	310.05	380.00
05-Aug-08	OW	220.10	325.00
29-Sep-08	N	195.80	225.00
16-Oct-08	N	158.20	200.00
28-Jan-09	N	113.85	130.00
16-Jul-09	OW	194.80	250.00
26-Aug-09	OW	301.55	375.00
27-Jan-10	OW	361.20	450.00
22-Apr-10	OW	373.90	460.00
30-Jul-10	OW	378.05	440.00
21-Oct-10	OW	426.10	490.00
10-Dec-10	OW	433.05	465.00
20-Jan-11	OW	488.75	560.00
09-Sep-11	OW	411.35	480.00
19-Oct-11	OW	401.60	470.00
18-Jan-12	OW	405.95	485.00
19-Apr-12	OW	494.30	570.00
26-Jul-12	OW	480.80	600.00
18-Oct-12	OW	580.55	650.00
18-Jan-13	OW	673.80	775.00
18-Apr-13	OW	762.80	820.00

Infosys (INFY.BO, INFO IN) Price Chart



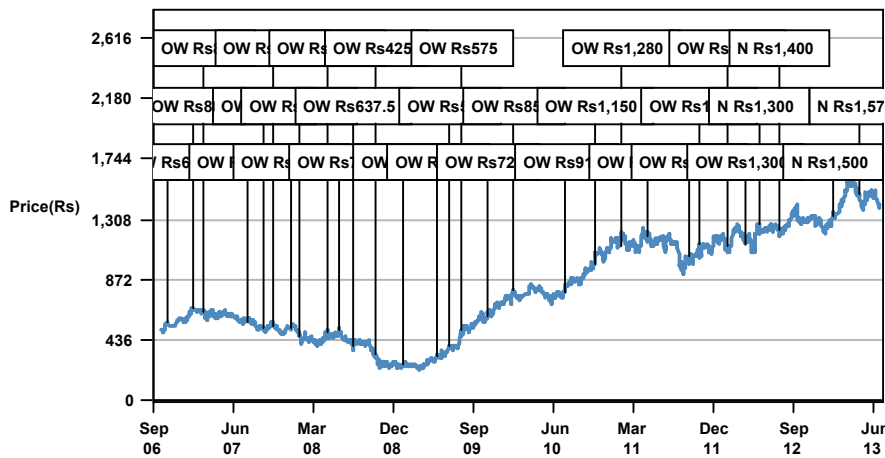
Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Initiated coverage Oct 11, 2006.

Date	Rating	Share Price (Rs)	Price Target (Rs)
11-Oct-06	OW	1981.35	2375.00
12-Jan-07	OW	2222.35	2650.00
16-Apr-07	OW	2128.30	2600.00
12-Jul-07	OW	1921.75	2400.00
10-Sep-07	OW	1908.85	2275.00
12-Oct-07	N	1976.00	2150.00
18-Dec-07	N	1621.95	1900.00
14-Jan-08	N	1530.20	1875.00
23-Jan-08	OW	1422.95	1875.00
15-Apr-08	OW	1422.45	1850.00
29-May-08	OW	1888.75	2350.00
02-Oct-08	OW	1453.90	1825.00
11-Oct-08	OW	1318.55	1800.00
06-Jan-09	OW	1168.55	1500.00
01-May-09	OW	1507.30	1850.00
12-Jul-09	OW	1770.10	2100.00
04-Nov-09	OW	2143.05	2550.00
14-Apr-10	OW	2801.60	2940.00
18-Oct-10	N	3107.05	3400.00
17-Apr-11	N	2989.50	3300.00
13-Jul-11	N	2791.55	3200.00
09-Sep-11	N	2338.45	2700.00
13-Oct-11	N	2504.55	2800.00

13-Jan-12	N	2826.60	2900.00
15-Apr-12	N	2364.55	2750.00
13-Jul-12	N	2264.40	2600.00
14-Oct-12	N	2365.60	2400.00
14-Jan-13	OW	2806.50	3100.00
22-Feb-13	OW	2840.55	3200.00
14-Apr-13	OW	2339.05	2700.00

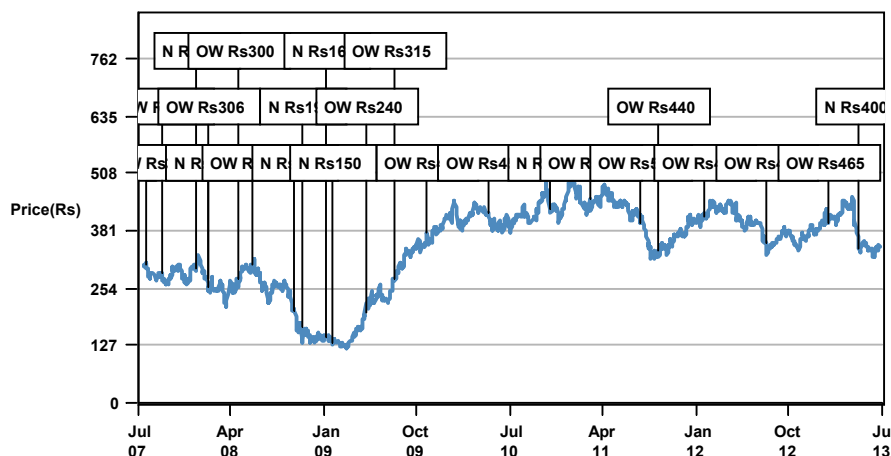
Date	Rating	Share Price (Rs)	Price Target (Rs)
16-Oct-06	OW	565.22	662.50
15-Jan-07	OW	663.95	800.00
21-Feb-07	OW	642.98	825.00
16-Jul-07	OW	568.42	737.50
10-Sep-07	OW	523.48	725.00
15-Oct-07	OW	536.82	662.50
20-Dec-07	OW	522.62	612.50
16-Jan-08	OW	469.12	587.50
21-Apr-08	OW	496.28	562.50
29-May-08	OW	504.85	700.00
17-Jul-08	OW	389.60	637.50
02-Oct-08	OW	335.50	425.00
06-Jan-09	OW	257.50	350.00
01-May-09	OW	311.60	425.00
11-Jun-09	OW	387.72	550.00
19-Jul-09	OW	500.10	575.00
20-Oct-09	OW	608.80	725.00
17-Jan-10	OW	802.20	850.00
16-Jul-10	OW	774.65	915.00
22-Oct-10	OW	986.20	1150.00
18-Jan-11	OW	1120.15	1280.00
22-Apr-11	OW	1192.10	1425.00
09-Sep-11	OW	1036.05	1175.00
18-Oct-11	OW	1134.25	1210.00
18-Jan-12	OW	1109.40	1250.00
20-Mar-12	OW	1134.85	1300.00
08-May-12	N	1273.25	1300.00
13-Jul-12	N	1236.00	1400.00
15-Jan-13	N	1334.50	1500.00
18-Apr-13	N	1483.15	1575.00

Tata Consultancy Services (TCS.BO, TCS IN) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 Initiated coverage Oct 16, 2006.

Wipro Ltd. (WIPR.BO, WPRO IN) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Jul 22, 2007.

Date	Rating	Share Price (Rs)	Price Target (Rs)
22-Jul-07	OW	305.40	360.00
10-Sep-07	OW	286.95	345.00
17-Dec-07	N	298.32	315.00
21-Jan-08	N	272.61	306.00
23-Jan-08	OW	258.84	306.00
18-Apr-08	OW	275.55	300.00
29-May-08	OW	304.56	375.00
02-Oct-08	N	205.02	240.00
23-Oct-08	N	167.64	195.00
06-Jan-09	N	145.62	165.00
22-Jan-09	N	130.80	150.00
01-May-09	OW	198.51	240.00
24-Jul-09	OW	276.36	315.00
28-Oct-09	OW	375.42	405.00
24-Apr-10	OW	419.46	456.00
25-Oct-10	N	430.35	470.00
21-Feb-11	OW	451.05	540.00
21-Jul-11	OW	398.95	500.00
09-Sep-11	OW	338.15	440.00
21-Jan-12	OW	413.75	480.00
25-Jul-12	OW	356.45	405.00
20-Jan-13	OW	397.35	465.00
22-Apr-13	N	339.40	400.00

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