Information Technology

Thematic Report

Switch from Infosys to TCS

Key points

- In the uncertain demand environment for the Indian IT services companies, it is advisable to stick to the leader Tata Consultancy Services (TCS) which is our preferred stock among the frontline IT companies. TCS is likely to sustain its much superior track record in terms of revenue growth and margin stability in the coming quarters.
- On the other hand, Infosys is facing transition issues (management change) and the management offers weak commentary on the demand outlook. Industry surveys also indicate that Infosys' top clients are likely to cut back on IT spending, spearheaded by British Telecom (BT), its single largest client. In comparison, the survey indicates a 23% increase in IT spend by TCS' clients. Moreover, according to media reports, Infosys' management has undertaken desperate measures like working on some Saturdays to boost revenues in Q3.
- In terms of valuations, TCS trades at a slight premium to Infosys. The relatively sharper run up in Infosys (as compared to TCS) has narrowed down its discount to TCS which could be utilised as an opportunity to switch from Infosys to TCS due to the latter's superior growth outlook. Currently, we have a Buy rating on TCS and Hold rating on Infosys.
- **Risk:** The key risk to our call is the potential distortion in quarterly results due to cross currency fluctuations (especially Euro/USD and Pound/USD).

Tough macro environment—stick to the leader

In the last three months TCS' stock has underperformed Infosys' with a gain of 19.3% as compared to a gain of 24.3% in Infosys, although both of the stocks have handsomely outperformed the broader market indices (Sensex fell around 3.8%) during the period. The outperformance of IT stocks in the last three months was not owing to any overnight change in the sector's fundamentals; however a majority of the gains were driven by a sharp rupee depreciation of close to 12% during the last three months. In the medium term, where both the macro and micro indicators are getting uncertain for the IT sector with every passing day, it is getting very difficult to take a concrete standpoint on companies' fate on the bourses from a fundamentals perspective without facing volatility headwinds. Nevertheless, in this uncertain time it is wise to shift and stick to the right bet in the sector to earn better investment returns.

Switch from Infosys to TCS: As TCS and Infosys are both the flag bearers of the Indian IT sector, it would be imprudent to completely avoid one over the other. However given the current macro uncertainties it would be better to increase exposure to TCS by cutting some exposure in Infosys till the time the disparity in the latter's fundamentals gets adjusted in its stock valuation.

Why we prefer TCS

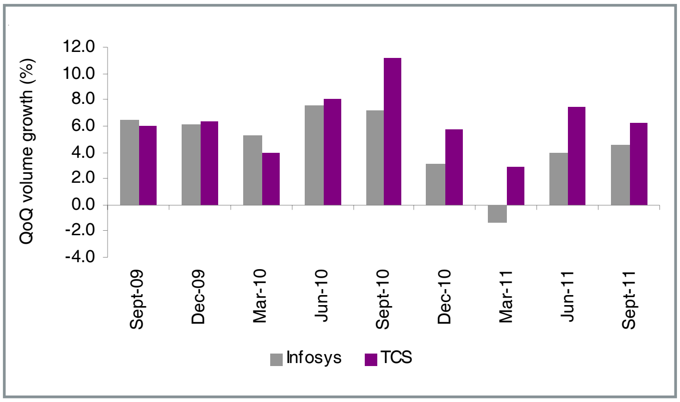
TCS better placed for market share gains: TCS' diversified scale of operations and higher exposure to the high spending banking, financial services and insurance (BFSI; 43% as against Infosys' 35%) and infrastructure management services (IMS; 9.6% as against Infosys' 5.8%) verticals will help it to garner higher market share gains. In the last one year, TCS has gained the highest market share among the Indian IT incumbents. TCS has gained market share quarter over quarter with its market share standing at 37.4% for the September 2011 quarter, up from 35.9% a year back. During the same period, Infosys has seen its market share drop to 25.9% from 26.8% a year back.

Market share of Top 4 (%)

Particulars	Quarter ended							Mkt Share
	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Gain/Loss (bps)
Infosys	26.8	26.7	26.8	26.7	26.0	25.9	25.9	(93.4)
Wipro	24.1	23.6	22.8	22.6	22.7	21.8	21.8	(229.8)
TCS	34.9	35.2	35.9	36.1	36.4	37.4	37.4	254.9
HCL Tech	14.2	14.5	14.4	14.6	14.8	14.9	14.9	68.3

Source: Company and Sharekhan Research

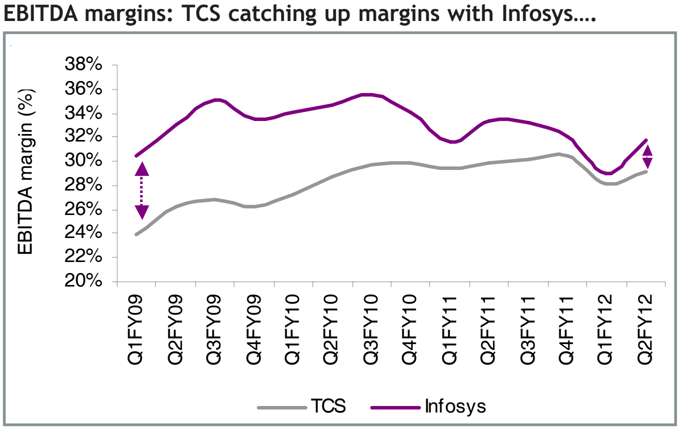
Volume growth: Infosys vs TCS



Source: Company and Sharekhan Research

TCS displaying superior margin performance: Infosys has lagged TCS in terms of margin performance. Despite Infosys taking pride in reporting the highest margins in the sector, the margins have come under pressure due to the lower volume growth and cost pressures. TCS has on the other hand shown an impressive margin improvement. Over the last two years, where Infosys has seen its EBITDA margin slip by 220 basis points to 31.1%, TCS has been able to improve margins by 60 basis points (bps) to 29.1% during the same period. Over the next two years, we expect TCS' EBITDA margins to fall by 130bps, whereas Infosys is likely to see a fall in its margins by 320bps.

EBITDA margins: TCS catching up margins with Infosys....



Source: Company and Sharekhan Research

More stable and aggressive management in place: Infosys has seen the adverse impact of the management change that took place in August 2011 where S D Shibulal took over as the CEO and the company saw the exit of atleast three key management personnel namely Mohandas Pai, Subhash Dhar and K Dinesh. Infosys has taken time to re-coup from the change which has cost it volume growth as it has had to focus on two aspects, one to get stability back in the management structure and second the uncertain macro environment. In contrast, TCS with N Chandrasekaran at its helm has seen a strong performance on the back of a more stable management team which reflects more preparedness to face the uncertain macro environment.

Reason to cut exposure in Infosys

- **Weak management commentary does not inspire confidence:** The recent warning on a revenue growth guidance (3.2% - 5.4%) miss by Infosys' management for Q3FY2012 citing concerns related to the uncertain macro-economic environment does not inspire confidence going into the next fiscal. Further taking an unusual step of making two Saturdays working in a month in the current quarter also does not inspire confidence. Conversely, TCS' management remains upbeat on the demand environment despite the uncertain global environment which inspires confidence.

- **Industry indicators not on Infosys' side:** A recent survey of 1,000 chief information officers (CIOs) done by Forrester Research, found that in the next 12 months, Infosys, which had 105 respondents, would see a 4% fall in client spends. One of the reasons for the drop in client spending could be the re-bid of BT deals as indicated by BT which is one of the top clients for Infosys. The second reason could be the increasing pricing war among the incumbent vendors to increase their market share. This could result in a revenue loss for Infosys in the medium term. In contrast, as per the study, TCS (with 111 respondents) will see a 23% rise in client spends, Cognizant (with 78 respondents) will see a 13% rise, Wipro (with 94 respondents) will see a 13% rise, and HCL Technologies (with 44 respondents) will see an 11% rise.

Valuation

At the current market price of Rs1,180 and Rs2,731 of TCS and Infosys respectively, they trade at 19.0x and 17.3x FY2013 earnings estimates. In the last six months TCS' average premium over Infosys was around 8.2%, which is likely to expand further in the coming quarters with Infosys likely to lag behind TCS in financial performance parameters. Infosys' stock is likely to remain weak in the run-up to third quarter results, with recent earnings warning and a potential miss and revision of FY2012E guidance. Further, we believe Infosys' earnings will remain vulnerable to downgrades in FY2013E as compared to TCS owing to TCS' relatively higher exposure to BFS and IMS verticals. On the overall sector perspective, we continue to remain cautiously optimistic and would keenly wait for the finalisation of IT budgets for CY2012. Our interaction with the company's management suggests at budget closure by end January 2012. We continue to maintain our earnings estimates and price targets for both the stocks. We maintain Hold on Infosys with a price target of Rs2,772 and Buy on TCS with a price target of Rs1,250.

Valuation

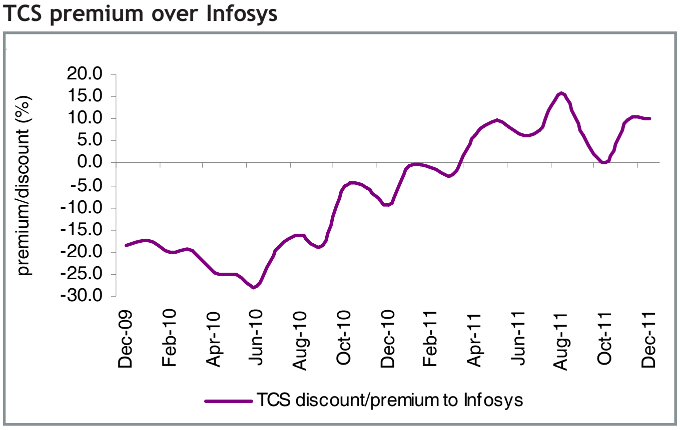
TCS' Rs (cr)

Particulars	FY2010	FY2011	FY2012E	FY2013E
Total revenue	30,028.9	37,324.5	47,855.9	56,035.6
EBITDA margin (%)	28.9	30.0	29.6	28.7
Net profit	6,889.5	8,682.9	10,537.6	12,229.6
EPS (Rs)	35.2	44.4	53.8	62.5
PE (x)	33.5	26.6	21.9	18.9
CEPS (Rs)	76.5	94.9	113.8	124.9
EV/EBITDA (x)	25.7	19.8	15.3	13.2
RoE (%)	40.8	42.0	39.8	36.4
RoCE (%)	46.4	51.5	51.6	46.2
Dividend yield (%)	1.7	1.2	1.5	1.7

Infosys Rs (cr)

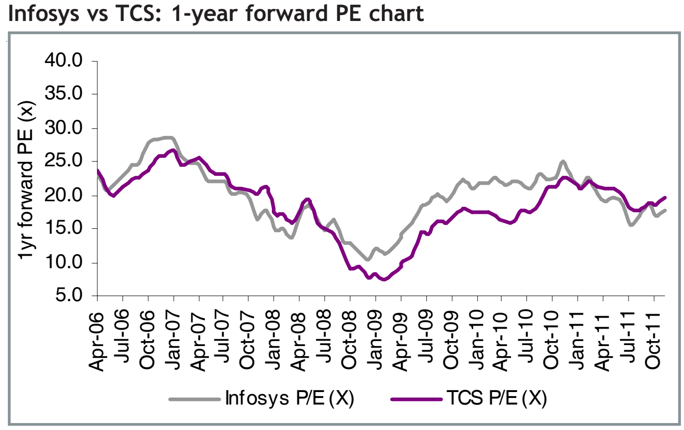
Particulars	FY2010	FY2011	FY2012E	FY2013E
Total revenue	22,742.0	27,501.0	33,968.5	37,869.2
EBITDA margin (%)	34.6	32.6	32.0	29.4
Net profit	6,266.0	6,835.0	8,212.2	9,038.3
EPS (Rs)	109.5	119.5	143.6	158.0
PE (x)	24.9	22.9	19.0	17.3
CEPS (Rs)	125.4	134.4	160.9	179.2
EV/EBITDA (x)	18.1	16.6	12.2	11.5
RoE (%)	30.1	27.9	28.4	25.8
RoCE (%)	38.0	37.7	39.3	34.6
Dividend yield (%)	0.4	0.9	0.5	0.6

TCS premium over Infosys



Source: Company and Sharekhan Research

Infosys vs TCS: 1-year forward PE chart



Source: Company and Sharekhan Research

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