

Sector View: Cautious

Current Scenario:

- ✘ Sluggish global economy affected demand materially
- ✘ Delays in decision making and budget finalization due to economic uncertainties
- ✘ Lower net employee addition suggests poor current and projected business demand
- ✓ Government pro-active actions globally to revive economy
- ✓ Clean balance-sheets
- ✘ Some companies have large forex losses residing in OCI which would be reflected in income statements in next few quarters, if rupee remains at ~50 levels
- ✘ Unemployment rates remain high in developed economies
- ⇔ CNX IT outperformed broader market by ~10% CYTD

Outlook:

- ✘ Demand environment remain challenging
- ✘ Volume and Pricing remain under pressure
- ✘ Affected sectors contribute ~70% of revenues likely to hinder fast recovery
- ✓ Employee hiring plan fine tune in sync with demand forecasts
- ✓ Developed economies likely to revive by CY09 end
- ✓ Free cash flow likely to remain strong
- ✓ Cross currency rates volatility recedes from December quarter levels, USD depreciation against other major currencies to have positive impact on USD numbers in June quarter
- ✘ Protectionism measures
- ✘ Effective tax rates to move up from FY11 with end of STPI benefits
- ✓ IT sector weightage in Nifty likely to go up by ~2% to ~11% wef June 26, 2009 as Nifty will be calculated using free float market capitalization

Strategy:

Risk-reward ratio seems to be less encouraging for initiating fresh longs at current prices. We would initiate fresh long positions after price correction. **We prefer Infosys and TCS.**

Valuation

Descriptions (INR Mn)	Revenue		Net Profit		EPS (INR)		CMP (INR)	Recom.	Stock Risk
	FY2010	FY2011	FY2010	FY2011	FY2010	FY2011			
HCL Tech *	104,292	109,529	11,980	9,734	17.8	14.4	150	Underperformer	High
Wipro	259,588	294,632	35,949	41,203	24.6	28.1	381	Underperformer	Medium
Infosys	223,904	241,816	58,066	60,957	101.4	106.4	1,553	Marketperformer	Low
TCS	285,825	302,403	53,675	54,661	54.8	55.9	632	Marketperformer	Medium

* Estimates for FY09 and FY10

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Demand Outlook

Growth prospects of global economies deteriorated materially which would impact demand for IT/ITES in near to medium term. Clients from developed countries are facing severe demand pressure in their businesses and thus have substantially reduced their spending on IT/ITES. BFSI, Manufacturing, Hi-tech and Telecom, contributes ~70% of top-4 revenues, shows significant demand and pricing pressure with longer sales cycle. Some players of these industries have received government support/bail-out which could face various restrictions by government (pro-employment in tough times). Possibility of higher off-shoring due to cost pressures gives hope for some growth for Indian IT services, however mounting protectionism measures, such as changes in immigration policy, removing tax incentives, remain major threats.

Demand is likely to remain lower than its long-term trend line, till global economy shows some signs of revival. IT companies have invested in EMEA and APAC regions in last few years to broaden geographic market exposure which would likely to support business momentum.

We believe continued emphasis on cutting operational costs, better acceptance of outsourcing in Euro-region, adoption of technology in emerging markets and transforming into a global service oriented business would augur well for the demand in medium to long term. Financial crisis has increased demand for compliance and regulations considerably which would provide tremendous business opportunities for Indian IT service providers once the dust settle downs.

1QFY10 and FY10 guidance

June quarter guidance given by Infosys and Wipro reflects near-term demand concerns and dispelled any expectations of a demand recovery beginning in June quarter. Feedback from client surveys shared by management during their earning calls continues to show delays in decision-making and budget finalization, cuts in IT spending, and pricing pressure. More than half of the survey participants (result of survey conducted by Infosys) expect demand recovery beyond March 2010. Infosys annual guidance builds in 1.7% - 3% CQGR for remaining three quarters, based from June quarter guidance. However, yoy growth is likely to return from March 2010 quarter only.

We expect business growth momentum to return to normalcy by FY11. We would like to monitor effects of government bail-out packages to various industries closely. If steps taken by governments globally start yielding results as expected, then FY11 might end with growth rate of ~20%.

Pricing

Pricing decline appeared to be more visible in some cases whereas in others remained arrested within reasonable levels. We would like to focus on combined number rather than numbers in isolation as companies might adopt different strategies for growth. Increase in fixed price projects and volume discounts offered are some of factors which could have distorted reported pricing metrics. These factors could also impact reported volume and utilization numbers. Thus, some of the volume pressure being witnessed by the Indian IT players could really be the result of pricing discounts being offered to clients.

YoY change	1QFY09	2QFY09	3QFY09	4QFY09	FY2009	FY2010E
Volume						
Infosys	18.5%	17.3%	14.5%	7.6%	14.3%	2 to 4%
Wipro	23.7%	16.3%	11.7%	-0.9%	12.1%	2 to 4%
Pricing						
Infosys	3.1%	0.8%	-6.0%	-9.1%	-3.0%	-6% to -4%
Wipro	3.5%	4.5%	0.8%	0.1%	2.2%	--5% to -3%



Sector Performance on Bourses

IT Index has outperformed the broader markets by ~10% CYTD in 2009 mainly because of weaker rupee and preference for cash generating assets. However, IT stocks have performed largely in-line with broader markets since April 2008, declined by ~25% as against ~27% decline in broader markets. Lower IT spending by clients in view of sluggish economic growth, currency volatility, protectionism measures and higher effective tax rates (with end of STPI tax benefits) were some of the key concerns in investor's mind, whereas robust cash generations, strong balance-sheets, weaker rupee and lately hope of demand recovery by CY09-end supported valuations.

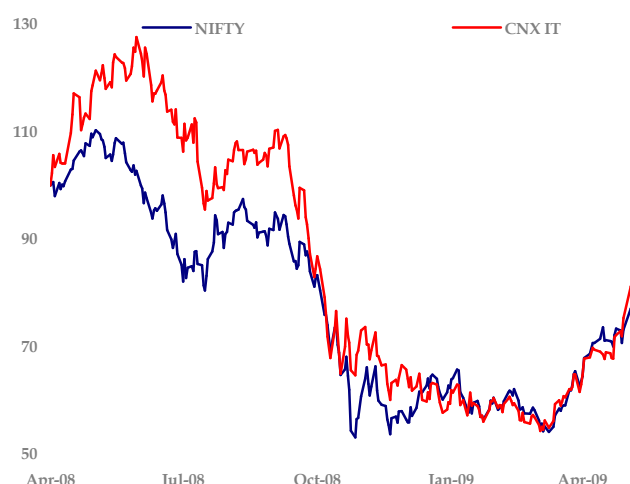
IT sector has ~9% weightage in Nifty which is likely to increase by ~2% w.e.f. June 26, 2009 as Nifty will be calculated using free float market capitalization.

CNX IT Index outperformed broader markets by ~10% CYTD



Source: Bloomberg, Khandwala Research

While it has performed broadly in line with the benchmark index since April 2008



Source: Bloomberg, Khandwala Research

Stock performance on bourses

Return YoY	Nifty	CNX IT	Infosys	TCS*	Wipro	HCL Tech
FY2003	-13.4%	-19.3%	8.2%		-27.8%	-40.3%
FY2004	81.1%	29.4%	22.2%		10.7%	63.5%
FY2005	14.9%	50.9%	82.5%	53.6%	48.1%	49.4%
FY2006	67.1%	48.9%	32.3%	33.6%	66.5%	78.2%
FY2007	12.3%	19.0%	35.0%	25.5%	0.0%	-11.8%
FY2008	23.9%	-28.5%	-28.9%	-32.5%	-23.8%	-13.1%
FY2009	-36.2%	-37.4%	-7.4%	-33.4%	-42.4%	-59.8%
Till date FY2010	21.8%	25.6%	17.2%	17.1%	55.1%	46.8%
CAGR (Apr'02-Till date)	18.1%	6.6%	18.4%	6.7%	4.2%	2.3%

* FY2005 performance calculated from date of listing (i.e.) 25 Aug, 2004

Prices till May 7, 2009

Source: Capitaline, Khandwala Research



Currency Movement

Average rupee rate depreciated by 0.4%, 3.4% and 1.7% against USD, GBP and Euro respectively till date in June quarter over last quarter. Forex market volatility recedes from March 2009 quarter and December 2008 quarter. Cross-currency movements likely to have positive impact during this quarter as till date GBP, Euro, AUD and Yen average rates gained against dollar by 2.9%, 1.3%, 8.4% and 5.6% respectively, which would have positive impact on reported USD revenues. Weaker rupee continues to hurt performance of companies, which have sizable hedging exposure at an average cost around Rs 40-43 per USD.

Infosys USD revenues guidance likely to have positive impact of ~0.5% in June quarter, if cross-currency rates stay at current levels till the end of quarter. However, reported rupee numbers and operating margins might see negative impact of currency because of appreciation of rupee as compared to assumed rate of Rs 50.72 per USD in guidance.

TCS, Wipro and HCL Technology are also likely to gain around ~0.5% from cross-currency movements in June quarter. Rupee appreciated from March quarter closing rate which would decrease forex loss residing in OCI and so lower potential losses on outstanding hedging positions.

Till date in June qtr	INR/USD	INR/GBP	INR/EUR	USD/GBP	USD/EUR	JPY/USD	USD/AUD
High	50.5	75.1	67.9	1.5	1.3	101.0	0.8
Low	49.3	72.9	64.9	1.4	1.3	96.5	0.7
Avg	50.0	74.0	66.2	1.5	1.3	98.9	0.7
QoQ	0.4%	3.4%	1.7%	2.9%	1.3%	5.6%	8.4%
YoY	20.0%	-9.9%	1.7%	-25.0%	-15.4%	-5.4%	-23.6%
Close	49.3	74.8	65.7	1.5	1.3	99.3	0.8
QoQ	-2.7%	2.9%	-2.3%	5.8%	0.5%	0.4%	9.4%
YoY	14.6%	-12.9%	-3.1%	-23.9%	-15.5%	-6.5%	-21.1%
Volatility Q1FY10	2.5%	2.9%	4.6%	4.6%	4.3%	4.6%	8.3%
Volatility Q4FY09	7.5%	9.2%	10.4%	10.2%	11.6%	11.1%	14.0%
Volatility Q1FY09	7.9%	9.2%	8.7%	2.7%	3.9%	7.0%	5.9%

Q1FY10 numbers till May 7, 2009

Note: Volatility is calculated as difference between high and low rate divided by average rate for the period.

Source: Bloomberg, Khandwala Research



Valuation

The sector has outperformed markets in CYTD in 2009, by ~10% in anticipation of demand revival earlier than CY09-end. At current prices almost all positives appears to be priced-in and stock prices are expected to react to any negative news. IT sector has shown tremendous resilience, despite poor business performance for last few quarters, because of two key reasons: 1. Rupee depreciation and 2. Other sectors of economy faced severe demand destruction and credit crunch, which resulted into relative preference for cash generating assets (robust free cash flow).

We remain positive on long term earning potential of the sector considering value propositions and cash generations. However, in view of near term challenges and with recent run up in stock prices, risk reward ratio seems to be less encouraging. Protectionism, Clients' postponement/cancellation of IT projects, indecisiveness over IT spending due to uncertainty over global economic growth remains key concerns.

We believe anticipated demand revival (albeit modestly) in other sectors of economy (domestic driven) and limited scope of further currency depreciation suggests absence of catalysts for building a case of relative out-performance from IT stocks till visible signs of recovery from developed economies.

We prefer selective stocks, either expected to have limited downside-risk or relatively cheaper, considering valuations and free cash flow. We downgrade Wipro stock to Underperformer considering recent sharp run up in stock price. **We prefer Infosys and TCS.**

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Developments so far

Positives

- ✓ Weak rupee would help IT companies post relatively decent numbers in otherwise poor demand environment
- ✓ Cross-currency movement likely to have positive impact on USD numbers this time
- ✓ Employee attrition rate - No longer a concern in near future, Wage inflation likely to be under control at least till the demand recovers
- ✓ Government pro-active actions globally to revive economy
- ✓ Developed economies likely to revive by CY09 end, emerging markets like India, China shows stability at lower levels and expected to report moderate growth by 3QCY09.
- ✓ Free cash flow likely to remain strong

Concerns / Negative

- ✓ Protectionism measures against out-sourcing - Government bail-out packages with stiff conditions, Rising unemployment in developed countries
- ✓ Demand environment remain very challenging - IT majors are likely to post third consecutive sequential decline in organic USD revenues
- ✓ Pricing power and volume growth under pressure - We would like to focus on combined number rather than numbers in isolation as companies might adopt different strategies for growth
- ✓ Currency volatility: Forex market appears to return to normalcy after period of heightened volatility in recent past. Cross-currency rates expected to have positive impact as other major currencies gained against USD.
 - Hedging - Companies which had increased their hedging exposure significantly during FY08 would likely miss substantial gain (opportunity loss) from rupee depreciation. Companies had increased hedging exposures in anticipation of business in future, which gets impacted due to global slowdown. Thus, they are facing risk of loss (real loss) on open positions without any underlying. We prefer companies following consistent hedging policy irrespective of levels and trend of rupee.

Gainer: Infosys

Loser: HCL Tech, TCS, Wipro



Aggregate Performance (top 4)

Major IT companies' results and guidance for next year were broadly in-line with expectations. Management remained cautious on demand outlook, however commented stability signs at lower levels. They expect positive growth rates by CY10 end. Markets get some relief and reacted positively after no bad news in the results and possibility of demand revival 2-3 quarter down the line.

Top 4 IT majors reported 12% yoy growth in USD terms (~28.5% in INR) in FY09. EBIT margin has improved by ~70 bps over last year to 23.9%. Net profit for the period was negatively impacted mainly by forex losses.

(In Mn)	Mar-09	Dec-08	Q-o-Q chg	Mar-08	Y-o-Y chg	FY2009	FY2008	Y-o-Y chg
Revenue (USD)	4,140	4,266	-3.0%	4,178	-0.9%	17,062	15,231	12.0%
In Rupee								
Revenue	204,754	206,337	-0.8%	166,549	22.9%	784,380	610,547	28.5%
EBIT	47,796	51,545	-7.3%	38,834	23.1%	187,382	141,357	32.6%
PBT \$	37,426	39,410	-5.0%	33,070	13.2%	143,062	128,144	11.6%
Net Profit \$	31,454	33,668	-6.6%	28,473	10.5%	122,490	111,484	9.9%

Note: Includes only Global IT numbers for Wipro. For HCL Technology, Cash flow hedge accounting gain/(loss) considered in revenue line. The company has changed its reporting format from March 2009 quarter and now report it below EBIT line.

\$ Excluding Wipro numbers

* TTM basis in case of year-end is other than March

Top 4 IT majors include Infosys, TCS, Wipro and HCL Tech

Employee Addition

Employee hiring started showing sign of slowdown from last few quarters. Poor demand and margin maintenance by operating at higher operating levels resulted into lower net employee additions in FY09.

(INR Mn)	4QFY09	3QFY09	Q-o-Q chg	4QFY08	Y-o-Y chg	FY2009	FY2008	Y-o-Y chg
Net Addition	19,114	16,262	17.5%	15,166	26.0%	52,463	68,942	-23.9%

4QFY09 and FY09 numbers includes employee additions through inorganic initiatives



INDIA

EQUITY RESEARCH		TEL. NO. +91 22 4076 7373	FAX +91 22 4076 7378
Name	Designation	Sectors	E-mail
Ashok Jainani	VP, Head Research	Market Strategy	ashokjainani@kslindia.com
Dipesh Mehta	Sr. Research Analyst	IT, Telecom	dipesh@kslindia.com
Hatim K Broachwala	Research Analyst	BFSI	hatim@kslindia.com
Vinay Nair	Research Analyst	Energy	vinay.nair@kslindia.com
Giriraj Daga	Research Analyst	Metals & Mining	giriraj@kslindia.com
Kruti Shah	Research Associate	Economics	kruti.shah@kslindia.com
Sandeep Shrimali	Research Associate	Cement	sandeep.shrimali@kslindia.com
Dinesh Bhatia	Research Associate	Technical Analysis	dinesh.bhatia@kslindia.com
Sandeep Bhatkhande	Research Associate	Publishing	sandeep@kslindia.com
Lydia Rodrigues	Research Executive	Data Mining	lydia@kslindia.com

INSTITUTIONAL DEALING		TEL NO. +91 22 4076 7342-47/56	FAX NO. +91 22 4076 73 77-78
Biranchi Sahu	Head	Institutional Equity	bsahu@kslindia.com
Gopi Doshi	Senior Dealer	Institutional Equity	gopi.doshi@kslindia.com
Mayank Patwardhan	Dealer	Institutional Equity	mayank.patwardhan@kslindia.com

PRIVATE CLIENT GROUP		TEL No. +91 22 4076 7317-21	FAX NO. +91 22 4076 73 77
Sanjay K Thakur	President	Sales & Marketing	thakursk@kslindia.com
Subroto Duttaroy	General Manager	Equity & Portfolio Mgmt. Service	subroto@kslindia.com
Jagdish R Modi	Manager	Equity & Portfolio Mgmt. Service	jrmodi@kslindia.com

BRANCH OFFICE (PUNE)		TEL NO. +91 20 2567 1404/06	FAX NO. +91 20 2567 1405
Ajay G Laddha	Vice President		ajay@kslindia.com

Corporate Office:

Vikas Building, Ground Floor,
Green Street, Fort,
MUMBAI 400 023.

Tel. No. (91) (22) 4076 7373

Fax No. (91) (22) 4076 7377/78

E-mail: research@kslindia.com

Web site: www.kslindia.com

Branch Office:

C8/9, Dr. Herekar Park,
Off. Bhandarkar Road,
PUNE 411 004

Tel. No. (91) (20) 2567 1404/06

Fax. No. (91) (20) 2567 1405

Email: pune@kslindia.com

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