IT Services

Second law of thermodynamics – in play!

18 August 2016

INDIA | IT SERVICES | Sector Update

The second law of thermodynamics states that the 'entropy of the universe is always increasing'. Entropy, in non-engineering parlance, is a measure of the disorder of a system. We see this law playing out in the global political landscape – the rise of unabashed xenophobic nationalism has led to events like Brexit, which will lead to higher business uncertainty across the world, directly impacting the demand environment for Indian IT companies over the next few years.

In the first report of our 'thermodynamics series' (December 2015), we had downgraded the IT sector based on the inefficient capital allocation policy that it had followed over the last decade. This would cause Indian IT companies to be laggards in the digital transformation wave, which, we had postulated, was a manifestation of the 'first law of thermodynamics'. We were one of the first brokers to downgrade the sector and our call has played out as we expected – almost all IT companies and the CNX-IT are underperforming the broader index since then. In this second report of the same series, we reiterate our Underweight call on the sector and advise investors to further reduce this sector's weight in their portfolios.

Entropy of the universe is increasing

Over the last few years, we have seen an unprecedented rise in the popularity of right-wing extremists across the globe (India, UK, US, Europe) leading to calls for more 'nationalistic' policies and an abandonment of globalisation practices. Events like rise of Donald Trump in the US and the Brexit are testimonies of these voices gaining strength, and are likely to get support from policy makers. We view this is as highly negative for the Indian IT sector, whose fate is intricately linked to the benefits of globalisation.

We believe that the rise of these extremist opinions (entropy, as we prefer to call it in the thermodynamics context) will lead to lower business visibility for enterprises across the world (corroborated by a recent Deloitte Survey) – this would directly impact the demand scenario for IT services companies. We fear a two-pronged effect – (1) near-term currency volatility leading to a negative impact on earnings; (2) lower revenue visibility in the long-term, leading to a de-rating of valuations. This 'rise in entropy of the universe' will potentially lead to the underperformance of the IT services sector.

IT companies unable to mitigate cannibalisation of their traditional businesses

Traditional business streams of Indian IT companies are fast eroding, and we find them ill-prepared to mitigate this from growth in the digital space. Based on the latest ISG report (on traditional vs. 'as-a-service' deals), and our second derivative analysis of ADM/IMS revenues of top-4 IT companies, we saw that the traditional revenue streams of these companies are *already* declining. Meanwhile, high competitive intensity from over 7,000 start-ups in the digital-enterprise space is likely to keep the growth of their digital segments muted.

More headwinds than tailwinds; consensus estimates and valuations are under threat

Overall, we find that the IT sector seems to be facing more headwinds than tailwinds, with a high probability of those headwinds materialising, with higher potential impact. However, consensus is still optimistic, baking in double digit-growth for most large-caps in FY18 and beyond. We see an imminent cut to the consensus estimates over the next few months, with a commensurate valuation de-rating.

Maintain our Underweight call on the sector

We recommend investors reduce the IT sector's weight in their portfolios further. We are below consensus in our earnings estimates for most companies. We downgrade our target multiples for TCS and Infosys, on the uncertainty in the global business environment. We maintain our SELL calls on Wipro, TechM, KPIT and Persistent and retain BUY on Infosys and NIIT Tech.

Sector weight: UW

Companies

Company	CMP	Rating	TP
TCS	2628	NEUTRAL	2550
Infosys	1034	BUY	1330
HCL Tech	785	NEUTRAL	870
Wipro	528	SELL	480
Tech Mahindra	474	SELL	450
MindTree	570	NEUTRAL	600
NIIT Technologies	408	BUY	510
KPIT Technologies	126	SELL	120
Persistent Systems	679	SELL	610

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Entropy of the universe is increasing

On 24th June 2016, as the world watched stunned, 52% of UK's population voted to leave the EU, sparking global turmoil. Brexit's impact was immediately felt on currency (GBP/USD fell 10%, EU/USD fell 5% on June 24) and equities (S&P -3.6%, FTSE -3.1%, Nifty -2.2%). However, this immediate reaction could be just the tip of an iceberg – the fact is that Brexit will transform the European and global trading and business landscapes.

However, Brexit does not appear to be an isolated event if we look at political developments over the last decade. Brexiters' two primary arguments (in favour of 'leave') were immigration and jobs; both allude to one common principle – nationalism. Over the last decade, the world has seen a rise in such arguments from right-wing extremists and their gradual increase in popularity has led to the rise of unabashed, xenophobic nationalism.

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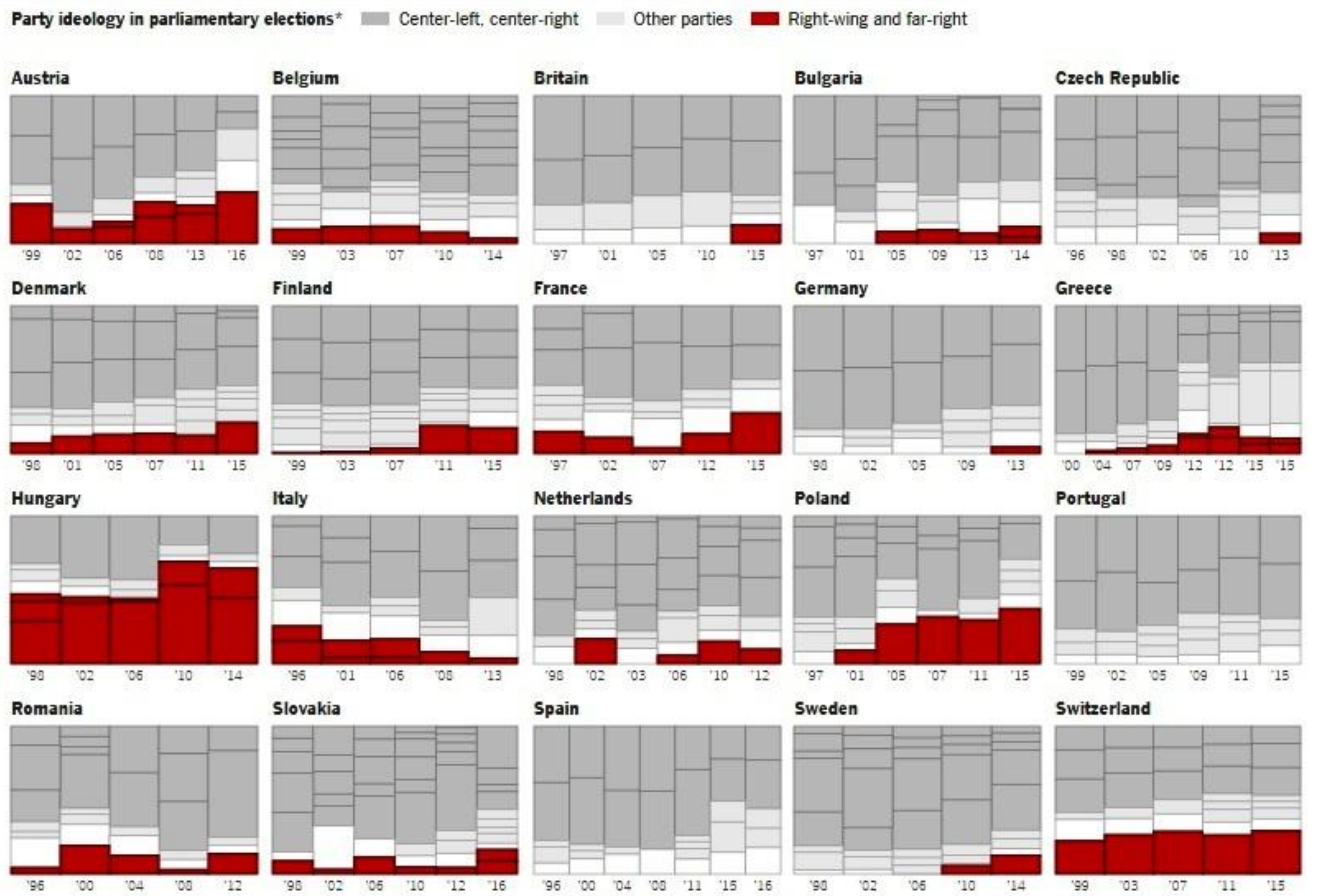
Consider the following events, in reverse chronological order:

1) Brexit – where the primary arguments in favour of leaving were immigration and jobs for locals
2) Rise in popularity of Donald Trump – the mainstay of his election campaign is 'America First'
3) Rise in vote share of right-wing and far-right parties in various elections across Europe over the last fifteen years *(see exhibit below)*
4) Right-wing extremist party, BJP, accedes power in India – it became the first party in the last 30 years to win a majority on its own
5) Continued popularity of the Russian president Vladimir Putin and the Chinese President Xi Jinping – both have followed highly nationalistic agendas

Rise of the right-wing vote share in elections across Europe over the last fifteen years



*The 2016 Austrian presidential election and the 2015 French regional elections are included to add a more recent result for those countries.

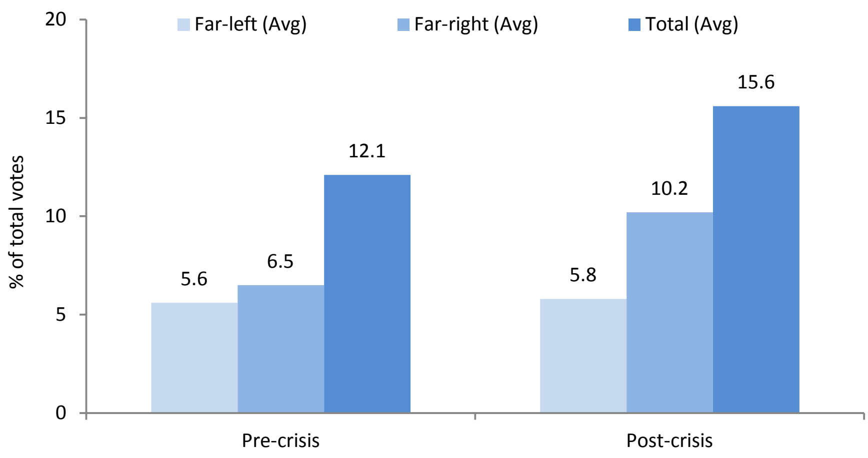
Source: NYTimes, PhillipCapital India Research

It would be incorrect to dismiss these events occurring in various geographies at almost the same time as pure coincidence. The binding factor here seems to be the global recession (set into motion, by the 2008 Lehman collapse), which has dramatically accelerated loss of wealth among the lower-income population and has widened the income gap. This has led to an increase in the perception that globalisation as an ideology has failed. In an attempt to replace this 'flawed' ideology, it was natural that the age-old standby, nationalism would return.

There is an increase in the perception that globalisation as an ideology has failed

Three German economists have studied the political fallout from systemic financial crises over the past 140 years. In a research working paper covering 20 advanced economies and more than 800 general elections, they noted that after a financial crisis *"voters seem to be particularly attracted to the political rhetoric of the extreme right, which often attributes blame to minorities or foreigners. On average, far-right parties increase their vote share by 30% after a financial crisis"*.

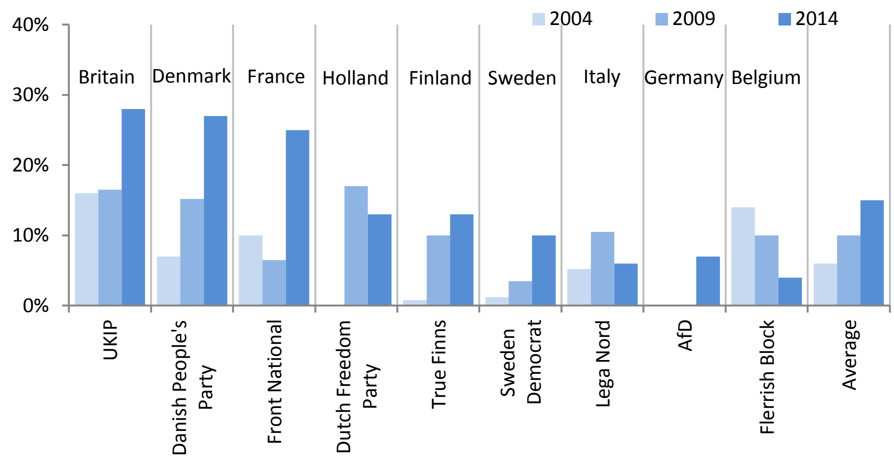
Change in vote share – before and after a financial crisis



Source: Center for Economic Studies - CESifo Group Munich

Read the working paper on ***"Going to Extremes: Politics after Financial Crisis, 1870-2014"*** ***here***

Rise of right-wing populist votes in Europe over the last three elections



Source: Center for Economic Studies - CESifo Group Munich

We see this rise in right-wing extremism as a manifestation of the 'second law of thermodynamics' playing out across the world. The second law states that the 'entropy of the universe is always increasing' – we see this right-wing extremism as a proxy to the entropy (a measure of the disorder of a system) of the universe. This rise in entropy will lead to implementation of nationalistic policies and a shunning of globalisation practices, which in turn will lead to higher business uncertainty across the world.

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What does that mean for global enterprises?

While pages can be, and have been, written on the causes and effects of the rise of right-wing populism – that would not be strictly within the purview of this report. Nevertheless, we believe a 'rebellion' seems to be at work – one that is likely to force those in power to implement policy changes that are closer to 'nationalism' rather than 'internationalism'. The ever-so-melodious song of globalization seems to be fast approaching its end (though it might be temporary), and the next one on the playlist, will not be, in literal sense, music to anyone's ears.

The ever-so-melodious song of globalization seems to be fast approaching its end

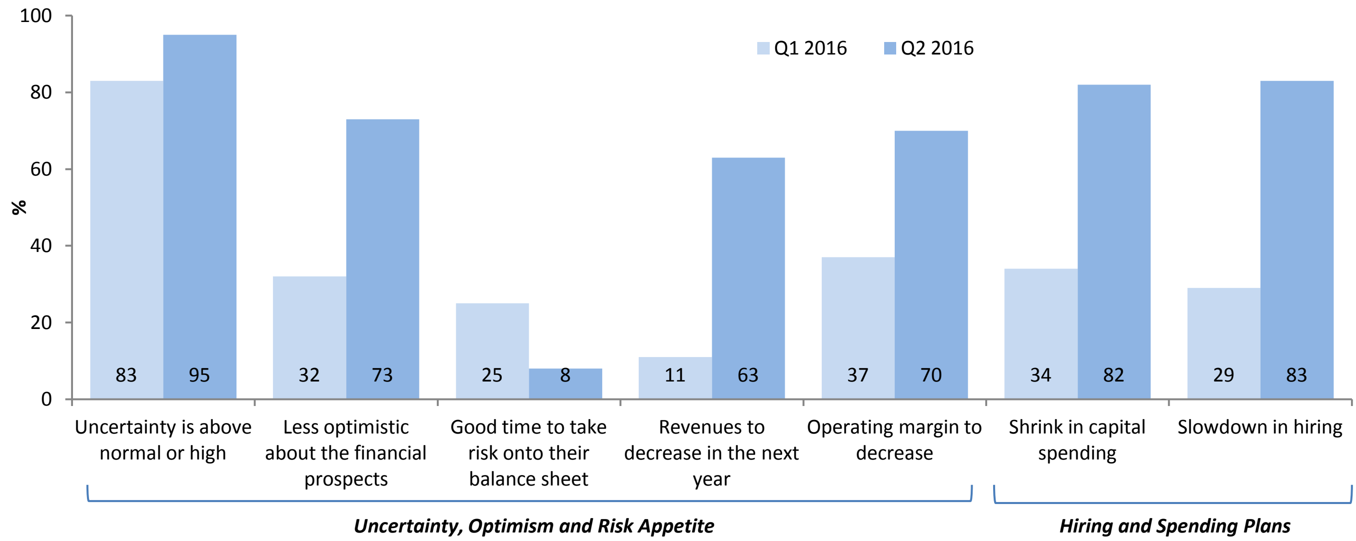
What does this mean for global businesses and consequently for the Indian IT services companies, who have thrived and benefitted the most from globalisation?
The rise of right-wing populism is likely to lead to the implementation of 'nationalistic' policies such as:
1) Forcing businesses to grow more locally than globally
2) Compelling companies to hire more locals than immigrants
3) Protecting jobs and industries from moving out of the country *(even though this would violate the economic principle of global competitive advantage)*

We see the support for these nationalistic policies leading to a rise in business uncertainty and a volatile environment. Support for these policies will also reduce visibility for enterprises and they would hold on to, push back, or postpone their investment decisions indefinitely. Case in point – the Deloitte Group surveyed 132 CFOs from the UK about business visibility after Brexit and their key finding were:
1) 82% of CFOs said they expected their employers to reduce capital spending over the next year (vs. 34% in an earlier survey)
2) 83% predicted a slowdown in hiring (vs. 29% in earlier survey)
3) 95% said the level of uncertainty that their businesses are facing was above normal, high, or very high (vs. 83% in a previous survey)
4) 68% said they thought leaving the EU would cause a long-term deterioration in UK's business environment

Enterprises would hold on to, push back, or postpone their investment decisions indefinitely.

Read the Deloitte survey here

Deloitte Q2-2016 survey points to higher business uncertainty, amongst UK CFOs, especially after Brexit



Source: Deloitte

What does this mean for the IT services industry?

A highly volatile political environment and lack of visibility in the business environment will, in our opinion, hit IT services industry from two sides:

1. Implementation of 'nationalistic' policies will lead to stricter immigration laws across the world; hence, IT services companies will have to remodel their businesses to hire more locals and reduce offshore share.
2. Enterprises will shift to neutral gear focusing on 'keeping the light on' and push back any discretionary spend planned until business clarity emerges. They may even try to renegotiate existing deals with vendors for reduction of scope/price/both.

Stricter immigration laws across the world

Push back in discretionary spend until business clarity emerges

Both these changes will be significantly incrementally negative for the sector. These developments will impact the sector both near and long term.

Near term impact:

Political uncertainty and events like Brexit will have an immediate impact on global currencies. Since Brexit, GBP/EUR have depreciated by 12.8%/ 2.1% against the USD – further volatility in the currencies will lead to significant cross-currency impact for the IT services companies' reported revenues, trickling down all the way down to earnings.

We expect consensus to incorporate the effects of this by lowering their revenue and earnings growth estimates for the next two years.

Medium/long-term impact:

Over the medium/long term, political turmoil and support for stricter immigration laws will lead to higher business uncertainties for the IT services companies.

1) Likely postponement of discretionary spend will directly impact the long-term growth prospects of these companies
2) Stricter immigration laws will impact long-term margins of these companies.

Postponement of discretionary spend will directly impact the long-term growth prospects

We expect the markets to incorporate these impacts, by ascribing a lower multiple to earnings based on lower revenue, margins, and earnings visibility.

Double impact on stock prices of IT services companies

Hence we expect a double impact on the stock prices of the IT Services companies – the near-term currency volatility will lead to a cut in earnings, while medium/long-term lack of visibility in growth prospects will lead to a valuation de-rating. Faced with this double impact, the entire IT services sector (barring few names) will underperform the broader index over the next two years.

The entire IT services sector (barring few names) will underperform the broader index over the next two years

IT services companies – significant impact on near and long term

Source: PhillipCapital India Research

Traditional business streams are fast eroding

Much has been written and predicted about new-age digital technology domains cannibalising traditional revenue streams of IT services companies. While it was just a looming threat few quarters ago, it is now a reality. Latest deal data from ISG shows that traditional outsourcing deals declined 17% yoy in 2QCY16, while new-domains 'as a service' deals grew by 45% yoy.

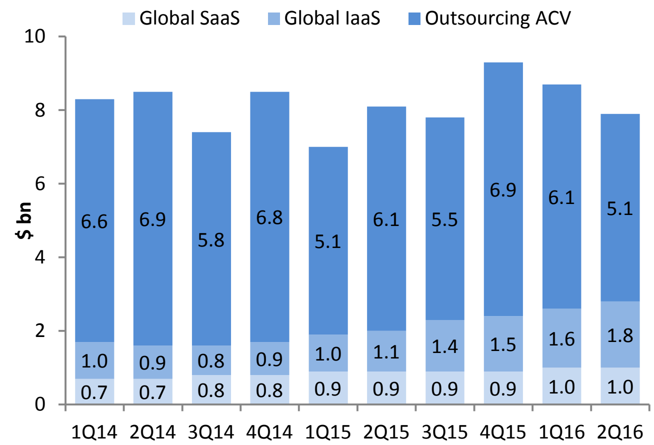
Read the ISG report here

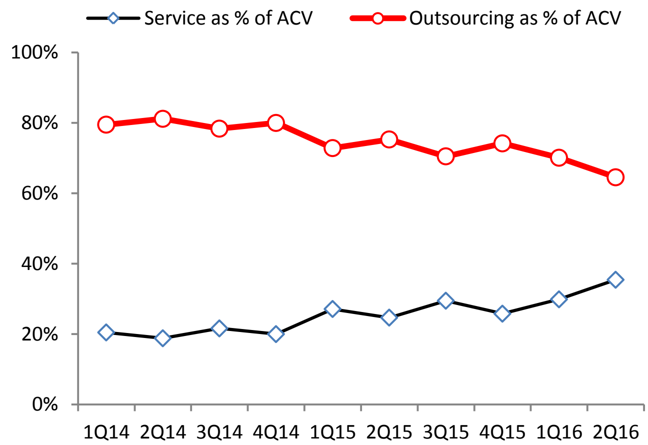
ISG deal data points to a decline in traditional outsourcing deal values

		2QCY16 ACV ($ bn)	yoy Change %	qoq Change %	1HCY16 ACV ($ bn)	yoy Change %
Global Combined Market		7.9	-2.0	-9.0	16.6	10.0
By Type	Outsourcing	5.1	**-17.0**	-16.0	11.1	**-1.0**
	As-a-Service	2.8	**45.0**	7.0	5.5	**44.0**
By Service	ITO	3.6	-24.0	-14.0	7.9	-4.0
	BPO	1.5	4.0	-21.0	3.3	6.0
	IaaS	1.8	70.0	9.0	3.4	69.0
	SaaS	1.0	16.0	4.0	2.0	14.0
By Region	Americas	4.2	7.0	-4.0	8.7	19.0
	EMEA	2.7	-18.0	-22.0	6.1	0.0
	Asia Pacific	1.0	13.0	18.0	1.8	7.0

Source: ISG Research

Rise in share of 'as-a-service' deals and decline in traditional outsourcing deals





Source: ISG Research

Evidence visible in the IT services companies' numbers too

Cannibalisation of revenues has started surfacing in reported numbers. While qoq growth numbers for most companies/segments do not reveal a downtrend, a deeper look into yoy numbers and trends reveals a much worse picture than what even we anticipated.

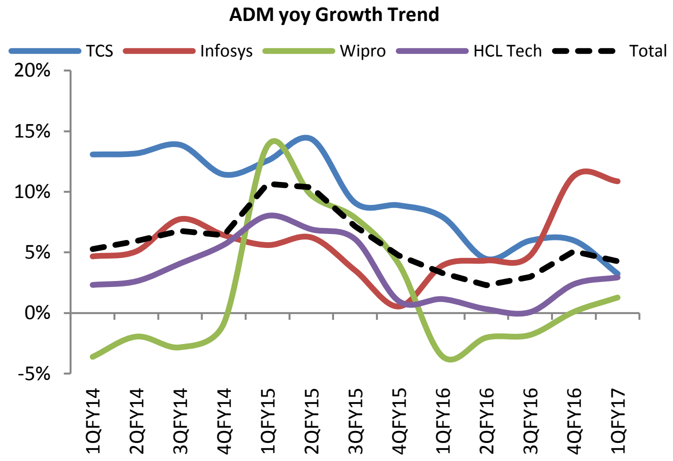
We looked at the last 17 quarters of Application Development and Maintenance (ADM) and Infrastructure Management Services (IMS) revenues of top-4 IT services companies, and their yoy growth trend. Our key findings:

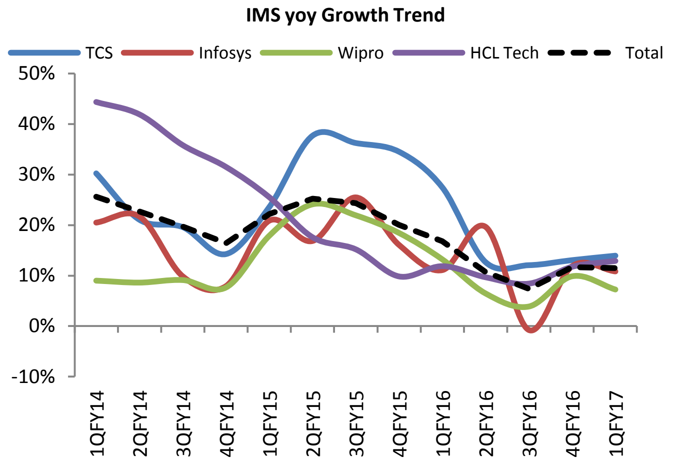
Year-on-year growth analysis

- **ADM**: The growth trend has significantly fallen for all companies except Infosys; particularly sharp for TCS and HCL Tech.
- **Total ADM revenues for top-4**: Clear decelerating trend.

- **IMS**: The growth trend has significantly fallen for all companies with NO EXCEPTION – the trend is particularly sharp for HCL Tech and Wipro.
- **Total IMS revenues for top-4**: Clear decelerating trend.

ADM and IMS: Declining trend in yoy growth for most companies





Source: Companies, PhillipCapital India Research

Second derivative analysis

Although it is on a declining trend, the yoy growth (or dy/dx) stills appear healthy for most companies – hence, it does not convey the true picture. We dug further to find out what the second derivative (d^2y/dx^2) was showing.

A second derivative is nothing but the trend of the trend – comparison of two growth numbers. By definition, a NEGATIVE second derivative (d^2y/dx^2) should indicate a decelerating trend. The second derivative (or d^2y/dx^2):

- **ADM:** Negative 89% of the time for TCS, and 44% for other companies – implying decelerating growth in 90% of quarters for TCS and 44% for the other three. Amongst other three, Wipro is artificially boosted in FY15, because it reported a decline through FY14.
- **Total ADM revenues for top-4**: Negative for 44% of the time – primarily boosted by Infosys's revival in the business (d^2y/dx^2 negative for 67% of the time excluding Infosys).

- **IMS:** Negative 78% of the time for HCL, and 56% for other companies – implying decelerating growth in 80% of the quarters for HCL and 56% for the other three. The decline for HCL Tech is a very significant trend as it is one of the leaders of this segment.
- **Total IMS revenues for top-4**: Negative for 67% of the time.

Second derivative analysis also points at deceleration in ADM/IMS

ADM	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	No of quarters with -ve d^2Y/dX^2	% of quarters with -ve d^2Y/dX^2
TCS	-3.8%	9.0%	-34.5%	-22.2%	-37.0%	-68.8%	-34.3%	-32.6%	-59.0%	**8**	**89%**
Infosys	20.0%	22.4%	-54.6%	-91.6%	-29.9%	-30.5%	34.8%	1986.5%	176.5%	**4**	**44%**
Wipro	481.5%	597.8%	376.9%	573.2%	-126.0%	-120.9%	-123.1%	-97.7%	135.4%	**4**	**44%**
HCL Tech	244.9%	162.9%	49.1%	-82.5%	-85.6%	-95.2%	-98.6%	142.5%	154.2%	**4**	**44%**
Total	**101.9%**	**74.6%**	**5.8%**	**-26.1%**	**-69.0%**	**-77.8%**	**-58.5%**	**7.5%**	**29.4%**	**4**	**44%**
IMS	**1QFY15**	**2QFY15**	**3QFY15**	**4QFY15**	**1QFY16**	**2QFY16**	**3QFY16**	**4QFY16**	**1QFY17**	**No of quarters with -ve d^2Y/dX^2**	**% of quarters with -ve d^2Y/dX^2**
TCS	-22.0%	78.9%	84.9%	141.8%	16.5%	-66.4%	-66.7%	-62.1%	-49.2%	**5**	**56%**
Infosys	1.8%	-22.3%	158.0%	102.6%	-46.8%	16.5%	-102.9%	-26.1%	-2.4%	**5**	**56%**
Wipro	98.9%	180.3%	140.8%	141.4%	-26.2%	-73.3%	-82.4%	-46.5%	-45.2%	**5**	**56%**
HCL Tech	-42.5%	-58.1%	-57.6%	-68.8%	-53.6%	-45.1%	-44.7%	19.5%	8.8%	**7**	**78%**
Total	**-13.5%**	**11.2%**	**23.6%**	**22.3%**	**-24.3%**	**-57.5%**	**-69.8%**	**-41.9%**	**-31.7%**	**6**	**67%**

Source: Companies, PhillipCapital India Research

CQGR analysis

Another way of representing or hair-splitting yoy growth numbers is CQGR analysis. If we compare CQGRs of various periods, reducing the tenure of the period in every iteration, the trend in CQGR should reveal the direction of growth. Accordingly, we compared CQGRs for various companies for the last 16/12/8/4 quarters to decipher an overall trend, if any. The CQGR trend:

The CQGR trend also depicts a decelerating trend

- **ADM:** Depicts a decelerating trend – the CQGR for TCS' ADM business, comes down, from 2.2% over the last 16 quarters – to 1.9% in last 12 – and 1.4% in last 8 quarters. A similar downward trend is visible for Wipro and HCL Tech – Infosys being the only exception.
- **Total ADM for Top-4**: Declines from 1.3% over last 16/12 quarters– to 0.7% in last 8. Resurgence in Infosys's ADM revenues boosted the last 4 quarters CQGR to 1.1%

- **IMS:** For HCL's IMS business comes down, from 4.9% over the last 16 quarters – to 3.4% in last 12 – and 2.1% in last 8 quarters. A similar trend is visible for Infosys, Wipro, and HCL Tech – no exceptions.
- **Total IMS for Top-4**: Declines from 4.2% over last 16 quarters – to 3.6% in last 12 – to 2.8% in last 8 quarters.

CQGR analysis corroborates the first and second derivative analysis

ADM	Last 16 quarters	Last 12 quarters	Last 8 quarters	Last 4 quarters
TCS	2.2%	1.9%	1.4%	0.8%
Infosys	1.5%	1.6%	1.8%	2.6%
Wipro	0.4%	0.9%	-0.3%	0.3%
HCL Tech	0.7%	0.8%	0.2%	0.7%
Total	**1.3%**	**1.3%**	**0.7%**	**1.1%**
IMS	**Last 16 quarters**	**Last 12 quarters**	**Last 8 quarters**	**Last 4 quarters**
TCS	5.5%	5.0%	4.8%	3.3%
Infosys	3.7%	3.4%	2.6%	2.6%
Wipro	2.8%	3.0%	2.5%	1.8%
HCL Tech	4.9%	3.4%	2.1%	3.1%
Total	**4.2%**	**3.6%**	**2.8%**	**2.8%**

Source: Companies, PhillipCapital India Research

Accounting for the CC impact

We admit to one flaw in the above analysis – revenues from all streams in FY16 were impacted severely by cross-currency movements. To that extent, negative second derivative and declining CQGR in those quarters could be an impact of cross-currency movement, while the underlying businesses might have actually grown.

To remove that anomaly, we looked at the constant currency growth of these verticals for the top-4 IT companies in all quarters of FY16. Not all companies provide the yoy constant currency growth numbers for every service line; so, we decided to use the ones that do as a proxy. We used TCS's revenues in ADM and HCL's revenues in IMS as proxies for those two service lines – fair proxies in our opinion since they are the leaders and the respective verticals form their mainstays.

Constant-currency growth numbers also convey the same message

Segment	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	No of quarters with -ve d^2Y/dX^2	% of quarters with -ve d^2Y/dX^2
ADM for TCS	-3.8%	9.0%	-34.5%	-22.2%	12.9%	-28.2%	12.2%	-6.6%	-65.5%	**6**	**67%**
IMS for HCL	-42.5%	-58.1%	-57.6%	-68.8%	-24.0%	-7.3%	-11.8%	42.6%	-27.2%	**8**	**89%**

Source: Companies, PhillipCapital India Research

The constant currency picture looks quite similar to the earlier one

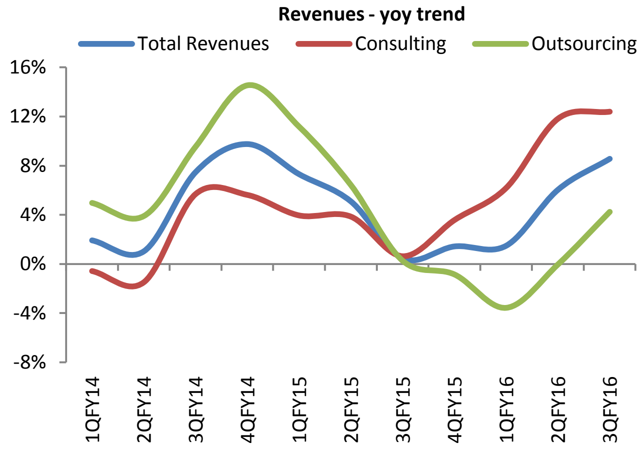
Corroborating our analysis, the constant currency picture looks quite similar to the earlier one. The second derivative for ADM for TCS is negative in six out of nine last quarters, implying deceleration 67% of the time. Similarly, the second derivative for IMS for HCL is negative in eight out of nine last quarters – 89% of the time.

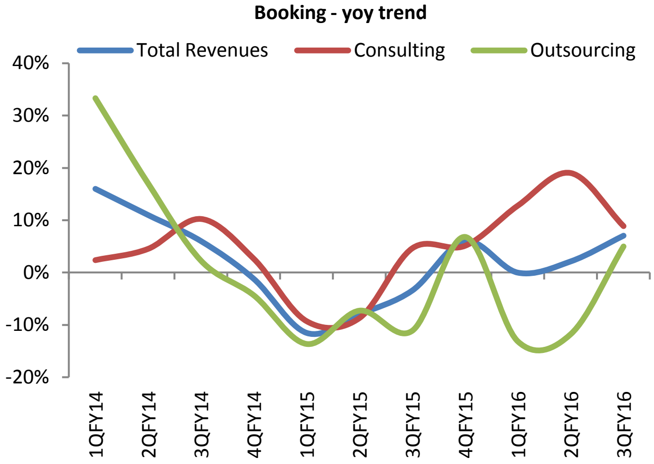
Accenture numbers – even the global giant is feeling the heat

If the cannibalisation of their traditional streams of businesses were limited to Indian companies, it could have been reflective of their relative incompetence; but that is not the case. Indian companies have been, at least for the last decade, ahead of competition in traditional IT services domains and have snatched market share from global companies such as Cap-Gemini, Atos-Origin, and even IBM.

But even the global IT services giant, Accenture, has been reeling under the pressure of declining demand for traditional outsourcing. Over the last eleven quarters, it has reported stupendous growth in its consulting business, but its outsourcing business has lagged behind – both in terms of revenue growth and new order bookings.

Accenture has seen continuous weakness in outsourcing bookings and revenues over the last eleven quarters



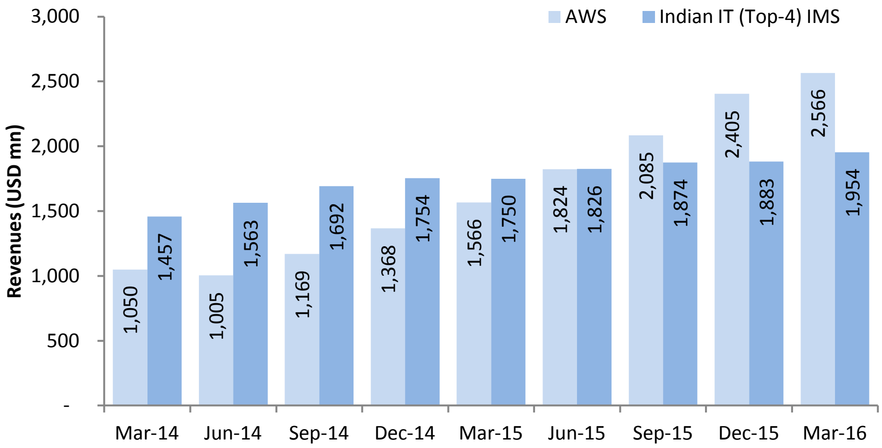


Source: Accenture, PhillipCapital India Research

Amazon Web Server (AWS) – Stepping it up

Cloud platform providers like AWS, Microsoft (Azure), IBM (IBM-Cloud), and Google (Google-Cloud) have raised the competitive intensity in the 'infrastructure-as-a-service' space in the last few quarters, which is fast cannibalising IMS revenues of Indian IT companies. AWS, which equalled the combined IMS revenues of the top-4 Indian IT companies in June last year, is already 25% bigger than them combined.

AWS' revenues are 25% more than the IMS' revenues of top-4 Indian IT companies



Source: Amazon, Companies, PhillipCapital India Research

Higher competition in new disruptive segments

Digital revenues are not able to adequately substitute traditional revenues

While Indian IT services companies are seeing their traditional revenue streams cannibalised, they are unable to make significant inroads into new-age technology domains of digital platforms – social, mobility, analytics and cloud. It is not that these companies are not able to win any contract; it is just that deal sizes are significantly smaller in the digital space, which is why digital revenues are not able to adequately substitute traditional revenues.

Indian IT companies have (or are perceived to have) significantly inferior capabilities in the digital space. We see this as an outcome of their inefficient capital allocation policies

We also believe that Indian IT companies have (or are perceived to have) significantly inferior capabilities in the digital space. We see this as an outcome of their inefficient capital allocation policies of the last decade – top-4 Indian IT companies **distributed 42% of OCF they generated, over the last decade as dividends, invested 24% as capex, and let 34% sit idle as cash/investments. They spent only 12% on acquiring new age technology companies** – which could have given them a competitive edge in the digital deals today. Read the detailed analysis in our last 'thermodynamics report'.

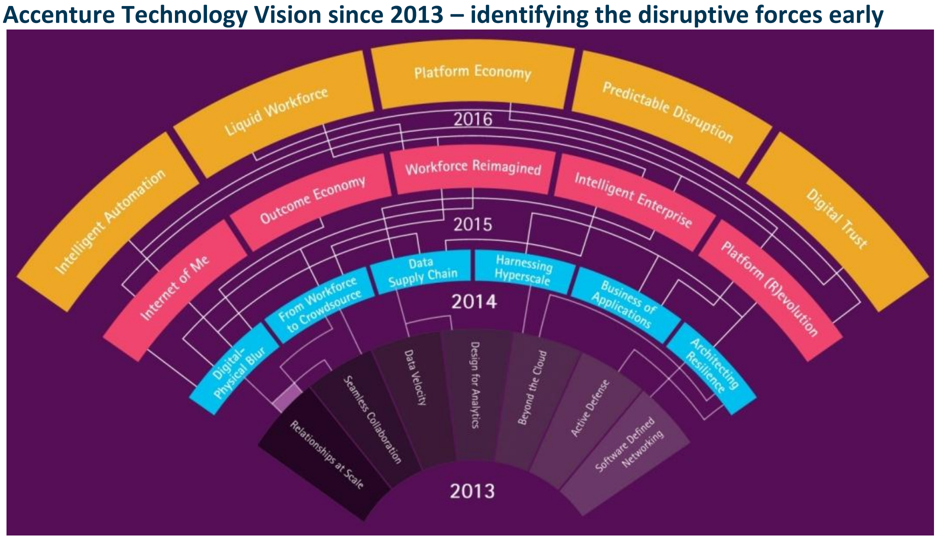
Utilisation of the OCF generated over the last decade

Rs mn	TCS	Infosys	Wipro	HCL Tech	Total
OCF	8,66,621	5,81,590	4,34,505	2,68,958	21,51,674
FCF	6,91,968	4,21,710	3,24,332	2,00,147	16,38,157
Dividend	4,34,687	2,40,310	1,42,558	90,833	9,08,387
Capex	1,74,652	1,59,880	1,04,468	67,693	5,06,694
Cash added	1,95,216	2,85,140	1,55,643	97,991	7,33,990
Acquisitions	41,955	37,030	74,114	37,846	1,90,944
	TCS	**Infosys**	**Wipro**	**HCL Tech**	**Total**
Dividend Payout Ratio	36.9%	34.1%	28.7%	33.8%	34.3%
Dividend as a % of OCF	50.2%	41.3%	32.8%	33.8%	42.2%
Capex as % of OCF	20.2%	27.5%	24.0%	25.2%	23.5%
Cash added as % of OCF	22.5%	49.0%	35.8%	36.4%	34.1%
Acquisition as % of OCF	6.1%	8.8%	22.9%	18.9%	11.7%

Source: Companies, PhillipCapital India Research

Unlike Indian IT companies, Accenture has been at the forefront of digital adoption. Buoyed by its consulting division, the company now derives 40% of its revenues from digital+cloud+security solutions – growing at an annual rate of more than 30%. In its annual 'Technology Vision' document as long back as four years ago, Accenture had noted that digital practices are taking precedence over traditional ones. Small wonder then, that this company and other global behemoths (IBM, Microsoft, Google) are fast capturing the enterprise digital space.

Accenture Technology Vision since 2013 – identifying the disruptive forces early

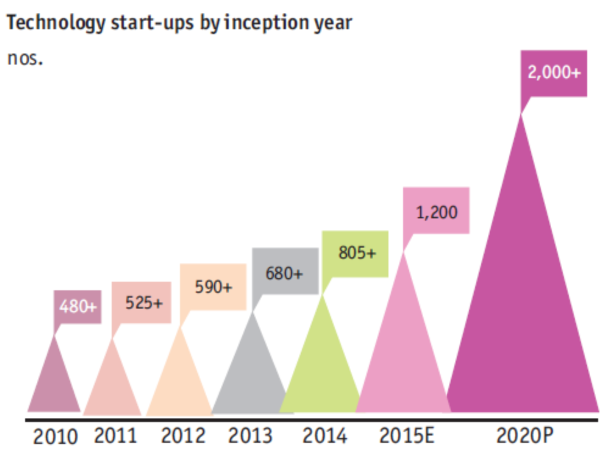


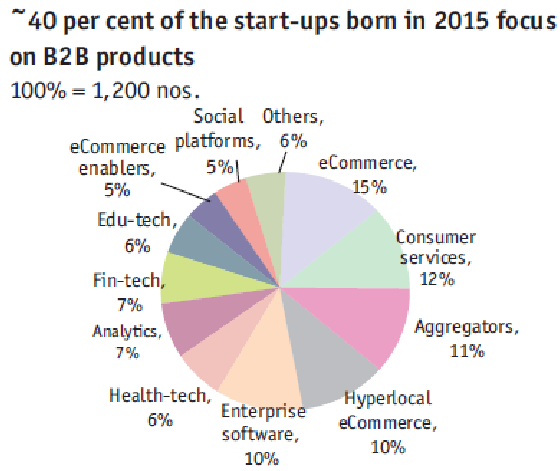
Source: Accenture Technology Vision documents

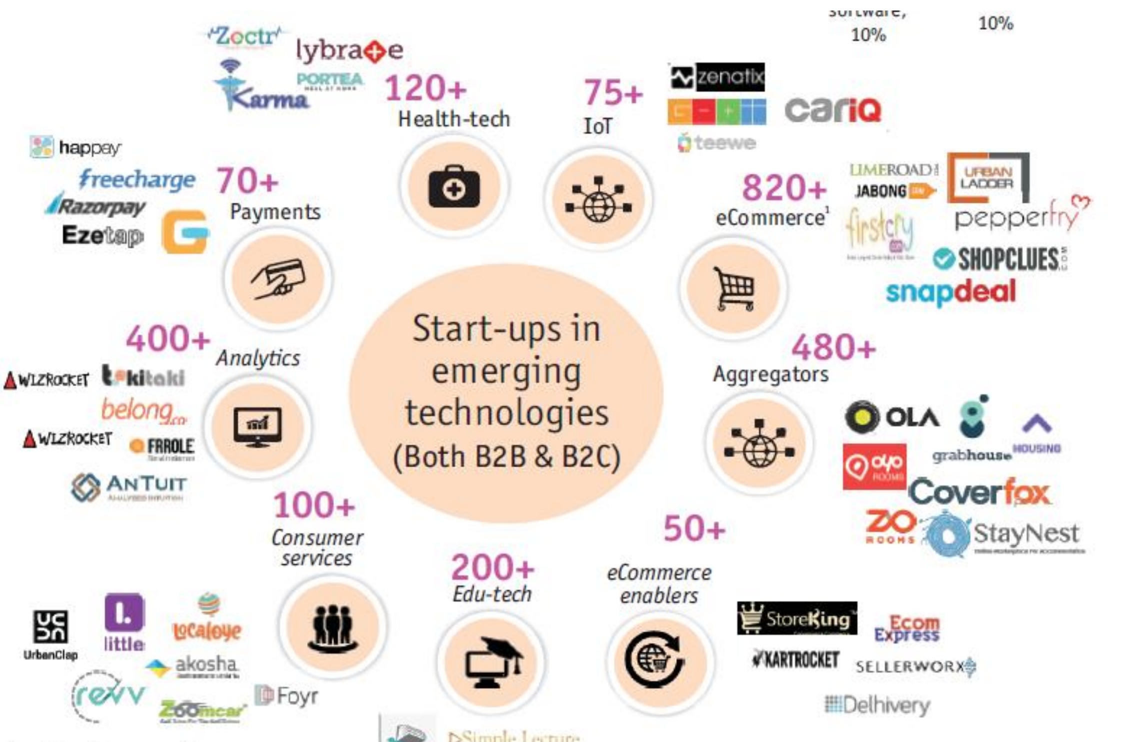
The 'young'uns' are stealing the zing

It is not just the global giants that are giving Indian IT companies a run for their money – they are also facing the heat from small niche companies in the digital space. Nasscom says that there are over 2,000 start-ups in India (7,000 globally) that offer digital solutions to enterprise customers - ranging from mobility platforms to analytic tools. The names of these start-ups often enquired in digital transformation deals, even if they are not (yet!) invited to the final RFP.

Nasscom points to a highly crowded and competitive landscape in the enterprise digital segment



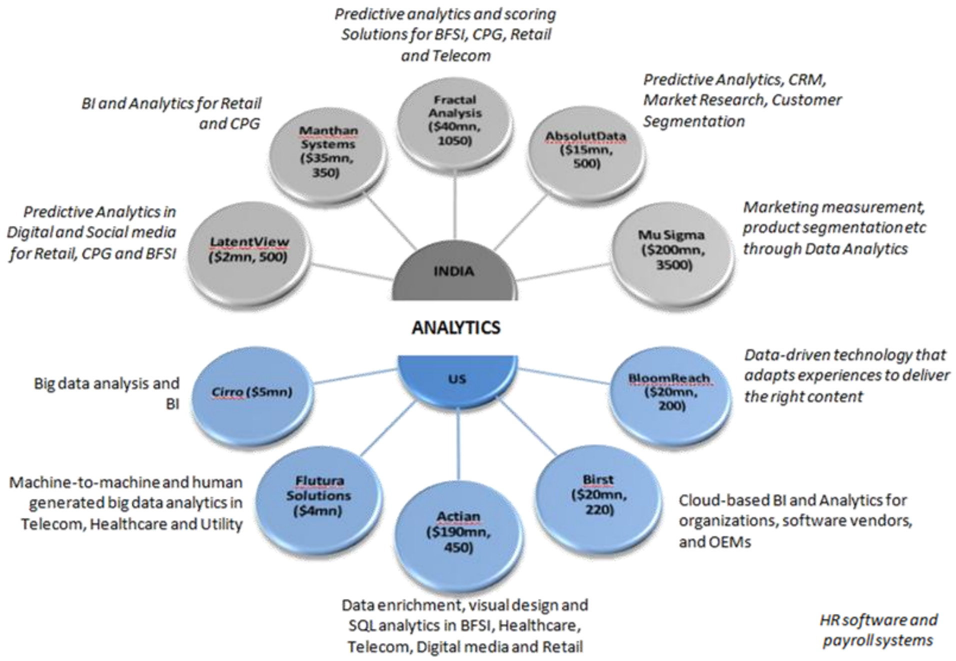




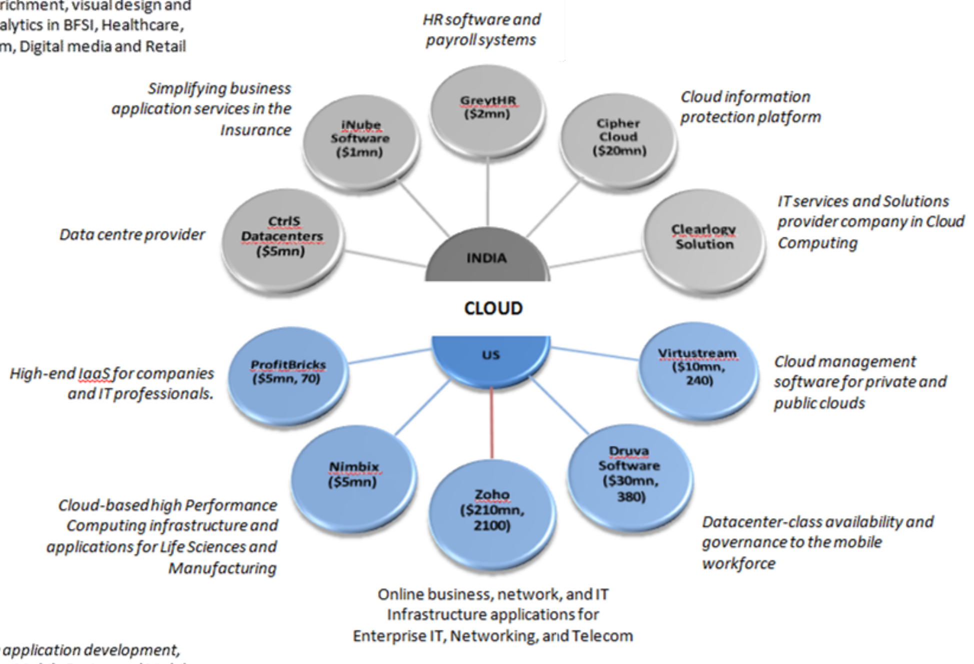
Notes: [1]Include niche eCommerce firms
Source: NASSCOM

We see these companies posing significant challenges to Indian IT companies. Their small size and niche focus provides them a significant advantage over larger and diversified Indian IT companies. Their focus on individual domains (mobility, cloud, analytics) also give them a 'specialists' status, which makes them preferred vendors if the focus of the client is on a specific field.

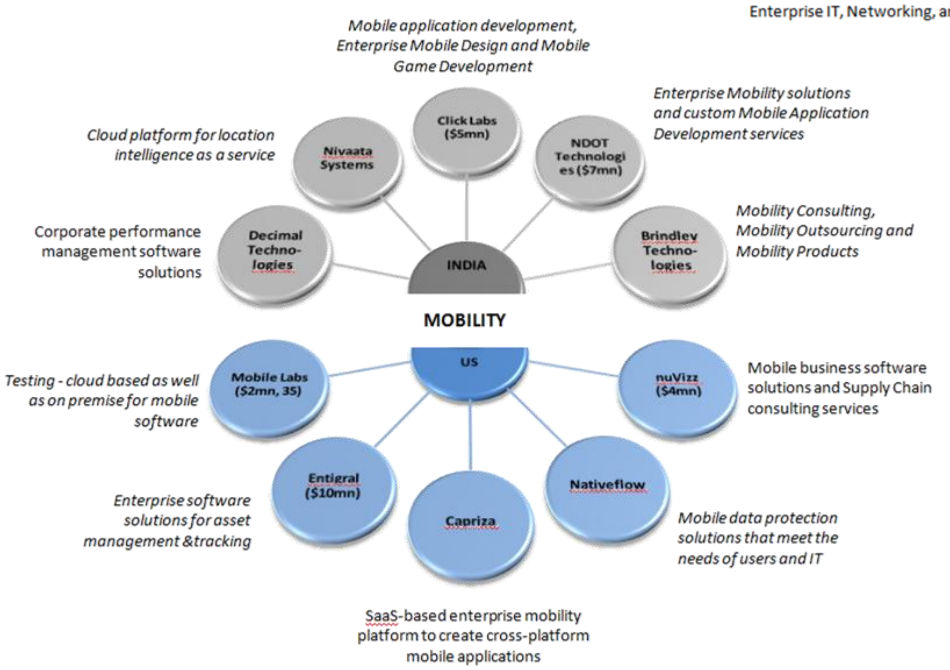
Some exciting start-ups in the digital enterprise space



Start-ups in Analytics



Start-ups in Cloud



Start-ups in Mobility

Source: PhillipCapital India Research
(Company Name, Revenue in USD mn, No of employees)

Incremental pressure from the supply side

The Indian IT industry had everything going for it in the last decade – including supply-side dynamics. A growing young Indian population needed jobs, which the Indian IT industry offered. To capture that opportunity, engineering colleges mushroomed across the country. The number of graduating engineers increased to 1.45mn in 2015 from 0.38mn in 2006. IT companies were hiring about 250,000 (average) freshers every year. Supply far outstripped demand and hence companies did not have to raise salaries in order to attract/retain talent.

India saw a surge in the number of engineers graduating over the last decade

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total talent output	**378,000**	**433,900**	**454,200**	**514,100**	**570,859**	**709,935**	**917,478**	**1,158,000**	**1,307,730**	**1,450,000**
Net hiring (IT professionals)	**136,000**	**190,000**	**259,000**	**131,000**	**72,000**	**185,000**	**182,000**	**199,000**	**182,000**	**209,000**
Talent demand as % of supply	*62.2*	*75.6*	*75.1*	*45.5*	*18.2*	*33.9*	*25.5*	*23.0*	*17.3*	*17.4*
IT Talent demand as % of supply	*36.0*	*43.8*	*57.0*	*25.5*	*12.6*	*26.1*	*19.8*	*17.2*	*13.9*	*14.4*

Source: AICTE, Nasscom, PhillipCapital India Research

However, two things have changed over the last few years and led to companies facing challenges from the supply side.

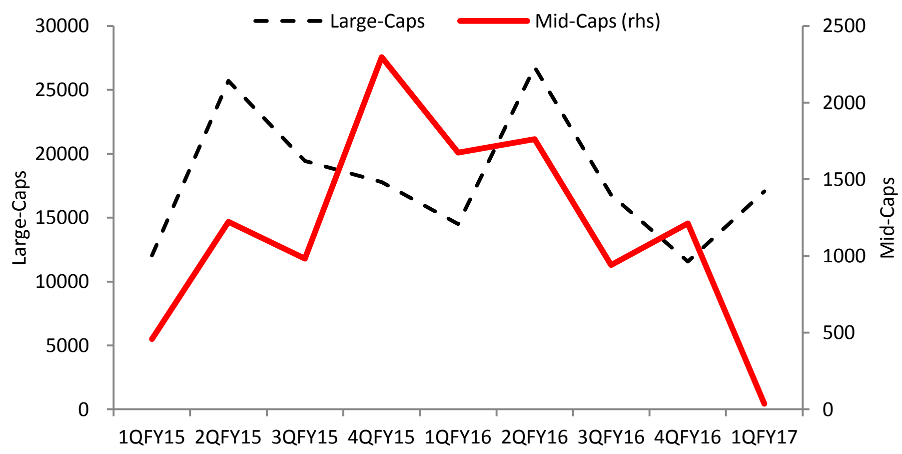
1) Advent of new technology domains like analytics and mobility – these meant that a large part of companies' existing employees need to be trained and reskilled; in some cases, this proves difficult and uneconomical, leading to redundancies.
2) Slew of start-ups financed by leading private equity companies – these are luring away existing talent by offering unprecedented salaries and opportunities to work on new technology platforms.

Start-ups financed by leading private equity companies are luring away existing talent by offering unprecedented salaries and opportunities

Migrating of current employees to a new platform is not easy

Early signs that the Indian IT services companies are facing supply challenges are already visible in their quarterly hiring trends. Net employee additions for most companies have fallen significantly over the last five quarters (1QFY16-1QFY17) vs. the preceding four quarters. The trend has been more pronounced for mid-sized companies, which are expectedly facing more challenges in training and reskilling employees than large companies.

Net employee addition on a downward trend especially for mid-sized companies

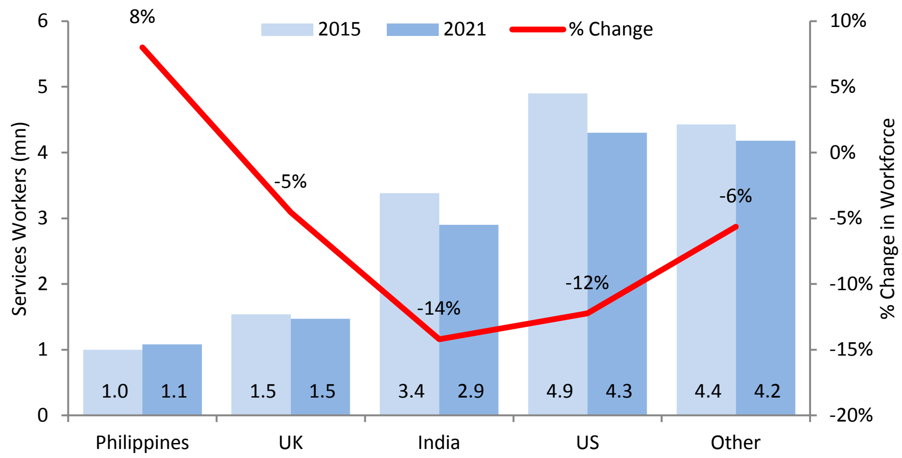


Source: Companies, PhillipCapital India Research

While a part of this lower net hiring might be due to employees becoming redundant, automation is also playing a large role. Many process related to IMS and BPO services are being automated, thereby reducing employee requirements – which also partly explains the declining hiring trend.

A recent report by HfS Research points to 1.4mn IT+BPO jobs being lost over the next six years (2015-21) due to automation. Geographically, India is expected to be impacted the most with close to 0.48mn jobs being lost.

Hfs research expects 15% reduction in the Indian IT+BPM workforce



Source: Hfs research

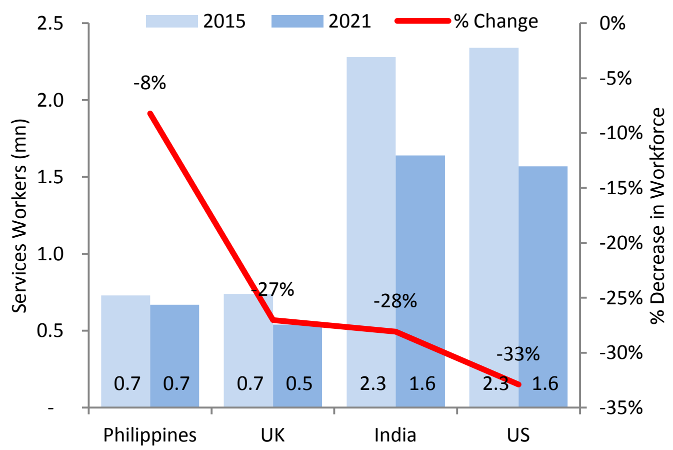
HfS Research predicts 1.4mn IT+BPO job losses over the next six years (2015-21) due to automation

Read the Hfs report here

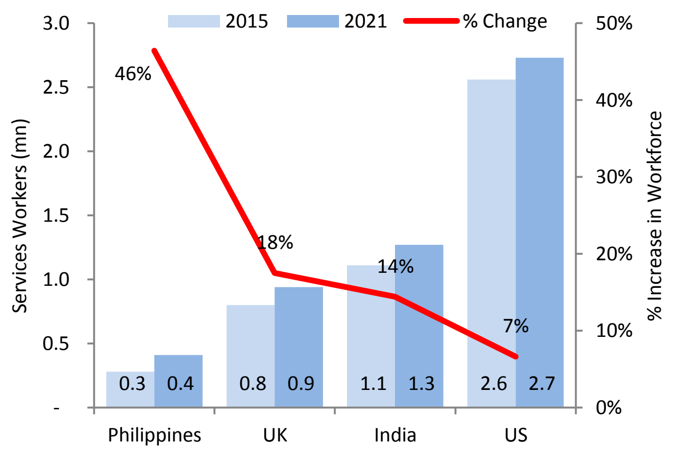
It is important to note that reduction in employees is NOT ALWAYS beneficial for the employer. A lower employee base will only benefit companies if redundancies need not be refilled or can be replaced at a lower cost. The same report calculates the net reduction in India's employees at 0.48mn (because of reduction of 0.64mn low-skilled jobs and addition of 0.16mn high-skilled jobs).

A lower employee base will only benefit companies if redundancies need not be refilled or can be replaced at a lower cost

Low-skilled jobs are expected to decline by 28% in India …



…. while high-skilled jobs are expected to grow by 14%



Source: Hfs research

High-skilled jobs will come at a higher cost, with steeper training expenses. More importantly, these high-skilled employees will be in short supply compared to low-skilled employees that IT companies have traditionally hired.

High-skilled jobs will come at a higher cost, with steeper training expenses

A recent report by Nasscom and McKinsey expects engineering campus hiring in India to fall in FY17 for the first time since 2009. The IT-BPM industry added 0.2mn jobs in FY16 – lower than 0.22mn in FY15 – and is expected to add, at best, 0.2mn in FY17. According to the report ***"nearly 60-70% of the current workforce will need to be re-skilled in technology, domain, social, and thinking"***.

Overall, the Indian IT services companies will have to change their hiring models significantly over the next few years to mitigate the impact of automation and new technology domains such as analytics and mobility. This would translate into additional margin headwinds in an already weakening demand environment.

Start-ups stealing the thunder

IT services companies are already facing stiff competition from new-age start-up companies. Engineers, fresh out of college, are being encouraged by private equity companies to start ventures of their own. These ventures, with sound financial backing, are offering unprecedented salaries to fresh and experienced developers in the industry.

For the first time in the last seven years, TCS recently increased the freshers' salaries by about 10%. While the hike was long overdue, one cannot help but correlate it to stiff competition that the company and the industry are facing in terms of capturing talent.

For the first time in the last seven years, TCS recently increased the freshers' salaries by about 10%

While it is difficult to get the salary levels of all of these companies, we have taken a sample set of the few larger ones – Flipkart, Snapdeal, Amazon and Mu Sigma. The number of employees in these companies is significantly lesser than in IT services companies, but salary levels are exceptionally higher.

Comparative salaries of software engineers at start-ups

Company	Salary (Rs)
Flipkart	979,104
Snapdeal	594,392
Amazon	550,360
Mu Sigma	589,581
Top-4 Indian IT Services Companies	~397,000

Source: Payscale, Companies, Media sources, PhillipCapital India Research

It's not just the salary that's luring them away

A key point to note here is that the software engineers are not being lured away from traditional IT companies ONLY based on better salaries. What is setting these start-ups apart from IT services companies is differentiation.

Most of these start-ups are working on the latest technology platforms – like Hadoop, iOS, and Android. Analytics platforms ask for developers to write code that separates noise from the data and 'analyses' refined data. Mobility platforms offer a chance to create seamless integration across various devices.

On the other hand, traditional IT services companies still have most of their projects running on legacy platforms like COBOL, Java, C++, and VB – which are fast becoming obsolete. Most 'engineers' work on CRM/ERP applications for BFSI/manufacturing clients – where they are not able to relate with the application or the domain.

Traditional IT services companies still have most of their projects running on legacy platforms like COBOL, Java, C++, and VB – which are fast becoming obsolete

Platforms/verticals that most start-ups work on

New platform	Percentage of people
UI/UX	9%
iOS	10%
Software Developer	13%
Android	14%
Web Developers	37%
Others	17%

Source: Companies, Media sources, PhillipCapital India Research

There is another important aspect – for long, the *biggest* attraction to work in the Indian IT services industry was the onsite opportunity. However, with the US and many other countries looking at implementing strict immigration laws, onsite opportunities are likely to reduce significantly. Infosys has already capped the tenure of an onsite deputation for every employee at 12 months. Similar unofficial practices are followed by other IT companies. With onsite opportunities falling, these companies will be at a significant disadvantage while luring talent as compared to cash-rich and well-funded start-ups.

Onsite opportunities are likely to reduce significantly. Infosys has already capped the tenure of an onsite deputation for every employee at 12 months

Net net – more downsides than upsides

The overall scenario that emerges for Indian IT services sector is one laden with multiple headwinds. We find fewer 'events' that can lead to a positive surprise for IT services companies, than those that can be potentially be negative.

Indian IT service sector faces more headwinds than tailwinds

		Headwinds	Tailwinds
Demand	**Short/Medium term**	Volatile business environment in Europe and UK, following Brexit	-
	Medium/Long term	Rise of the right-wing elements challenging the idea of globalisation - the backbone of the Indian IT services sector	Large number of enterprises yet to outsource/offshore their IT needs - especially in geographies like Europe
Supply	**Short/Medium term**	Need to reskill/train the existing employees on new technology domains	Significantly higher supply of engineers than demand
	Medium/Long term	Competition from expanding space of start-ups in the technology space	Automation leading to higher revenue productivity and hence lower workforce requirement
		Requirement of employees from non-engineering background - from statistics, marketing, and analytics domains	-
Revenue	**Short/Medium term**	Cannibalisation of traditional revenue streams	-
		Cross-currency impact of sharp depreciation in global currencies	
	Medium/Long term	High competitive intensity in the digital space	Migration to digital platforms will lead to higher revenue from digital transformation deals
		Smaller size and tenure of digital deals proving insufficient to mitigate a decline in traditional revenues	-
Margins	**Short/Medium term**	Cross-currency impact	INR depreciation vs. USD
		Possibility of INR appreciation led by volatile environment in Europe and other emerging economies	
	Medium/Long term	More lateral/local hiring, led by stricter immigration laws	Automation initiatives could lead to higher margins
		Employees from non-engineering backgrounds (statistics, marketing and analytics domain) will come at a higher cost	-

Source: PhillipCapital India Research

Few key points from the headwind/tailwind comparison:

1) The number of potential headwinds outnumber potential tailwinds
2) The probability of occurrence of the headwind events is much higher than the probability of tailwinds coming true (except the USD-INR movement, which can move either way)
3) The potential impact of these headwinds is far greater than that of the tailwinds

In such a business environment, where the sector has more headwinds (with a higher probability of occurrence and higher potential impact) we believe the valuation multiples will always be under pressure.

Quarterly volatility not helping the cause

Sharp stock-price movements following quarterly results is 'investor extremism' rather than 'investor activism'

Another investor concern that has come to be associated with the IT services sector is the sharp stock-price movements following quarterly results. In most cases, these sharp reactions have been in response to marginal hits/misses versus expectations. While this could be attributed to the 'priced-to-perfection' state of the IT stocks, we believe this is 'investor extremism' rather than 'investor activism' (our earlier note).

Consider this – in its 1QFY17 results, Infosys **missed revenue expectations by US$ 40mn (on a base of US$ 10bn) – which led to a market-cap erosion of US$ 4bn**. Our analysis of the last nine quarterly results of top-4 IT companies reveals that **on 18 occasions, stocks reacted by more than 5% on the day of the results –** and in only 4 of these cases, results were off expectations by more than 5%.

Stock price reactions and results of top-4 IT services companies – last nine quarters

Company	Quarter	Absolute Stock Returns (%)			Deviation from consensus		Possible explanation
		-1w	1d	+1w	Revenue	EBITDA	
Infosys	Q1FY15	-1.5%	1.0%	-2.2%	-0.7%	2.7%	
	Q2FY15	-4.8%	6.7%	-2.3%	0.1%	3.4%	Low expectations, underperformance leading upto results
	Q3FY15	-0.1%	5.0%	2.0%	0.2%	1.7%	Higher EBITDA margin
	Q4FY15	-3.1%	-6.0%	-0.1%	-3.6%	-3.9%	Lower Revenue growth and EBITDA
	Q1FY16	5.5%	11.1%	-4.4%	2.0%	1.3%	Higher Revenue growth
	Q2FY16	-0.5%	-3.9%	-0.9%	2.8%	4.9%	Lowered FY16 Guidance
	Q3FY16	1.2%	4.3%	0.7%	1.0%	0.8%	Higher Revenue growth, Increased FY16 Guidance
	Q4FY16	-2.4%	5.7%	-0.5%	0.5%	1.4%	Strong FY17 Guidance
	Q1FY17	1.6%	-8.8%	0.0%	-1.5%	-0.7%	Lower Revenue growth, lowered FY17 guidance
TCS	Q1FY15	1.4%	2.6%	6.6%	0.2%	1.3%	
	Q2FY15	-0.1%	-8.7%	0.5%	-0.8%	-2.6%	High expectations
	Q3FY15	4.1%	-0.5%	-1.2%	-0.2%	0.1%	Lower Revenue growth – Diligenta
	Q4FY15	-2.2%	-4.2%	0.8%	-1.1%	1.6%	Lower Revenue growth – Telecom
	Q1FY16	-2.3%	-2.0%	3.5%	0.0%	2.3%	Lower Revenue growth – LaTam and Japan
	Q2FY16	-3.6%	-4.4%	1.7%	-0.2%	-0.1%	Lower Revenue growth – Diligenta and Japan
	Q3FY16	-1.1%	-1.9%	-0.1%	-1.0%	-0.6%	Lower Revenue growth and EBITDA
	Q4FY16	2.1%	-2.8%	2.2%	0.4%	-2.9%	Lower EBITDA margin – UK
	Q1FY17	3.8%	-3.1%	2.8%	0.2%	1.5%	Higher Revenue growth and EBITDA
HCL Tech	Q1FY15	4.5%	-2.7%	-2.2%	-0.5%	1.4%	
	Q2FY15	-1.1%	-9.1%	-0.6%	-1.5%	-3.1%	High expectations
	Q3FY15	-2.4%	9.0%	9.0%	3.6%	5.9%	Higher Revenue growth
	Q4FY15	-4.4%	-3.5%	-2.4%	-1.2%	-9.0%	Lower Revenue growth and EBITDA
	Q1FY16	4.4%	-5.9%	-0.3%	1.1%	-7.2%	Lower EBITDA margin
	Q2FY16	-0.9%	1.9%	1.3%	0.3%	-1.1%	Inline Revenue growth
	Q3FY16	3.5%	-0.6%	-0.4%	0.5%	0.0%	Higher Revenue growth
	Q4FY16	-0.4%	-4.5%	-8.3%	0.3%	2.9%	Lower Revenue growth
	Q1FY17	0.0%	3.2%	-0.9%	1.6%	7.1%	Higher Revenue growth and EBITDA
Wipro	Q1FY15	7.2%	-4.6%	-2.6%	-1.8%	0.4%	Muted guidance for Q2FY15
	Q2FY15	1.7%	-3.6%	-1.1%	-0.5%	0.3%	
	Q3FY15	0.3%	5.3%	2.3%	-0.1%	5.4%	Lower expectations
	Q4FY15	-7.2%	-6.0%	-0.5%	0.8%	3.0%	Lower guidance for Q1FY16
	Q1FY16	2.6%	-3.7%	0.5%	0.8%	2.5%	Higher expectations
	Q2FY16	-0.8%	-1.7%	0.9%	-2.4%	2.7%	
	Q3FY16	-2.3%	0.7%	-0.1%	0.3%	1.5%	
	Q4FY16	10.0%	-7.0%	-1.0%	1.0%	0.0%	Muted guidance for Q1FY17
	Q1FY17	-3.5%	-2.0%	1.9%	-1.4%	-1.4%	Lower EBITDA margin

Source: Bloomberg, PhillipCapital India Research

Excessive focus on quarterly results will inhibit the management of these companies from focusing on long-term growth

We believe that this high volatility is highly detrimental for the sector. Excessive focus on quarterly results will **inhibit the management from focusing on long-term growth**, and force them to 'deliver' results that are in line with expectations, quarter after quarter. Managements would be forced to take decision that will **deliver short-term investor gratification rather than ones that create long-term value**.

High volatility **might also deter managements from providing a correct on-the-ground picture to investors** and encourage the practice of **'expectations management'** – where companies will try to **under-promise and over-deliver**.

Consensus expectations – still baking in optimism

Despite multiple headwinds (near and long term), consensus estimates still predict mid-teen USD revenue growth for FY18 for top-4 Indian IT services companies (except for Wipro). While FY17 estimates have come down after a muted performance in 1QFY17, we believe FY18 estimates are in for a big reset. Almost all the top-5 Indian IT services companies will barely manage to touch double-digit organic growth in the current financial year.

Our estimates vs. consensus

			TCS	Infosys	Wipro	HCL Tech	TechM	MindTree	Persistent	KPIT	NIIT Tech
Revenue	PC	FY17	1,215,036	705,456	557,747	464,214	288,919	55,277	28,830	32,619	28,739
Rs mn		FY18	1,317,421	788,583	595,201	505,706	314,904	63,151	31,180	34,935	31,501
	Consensus	FY17	1,219,241	704,861	556,444	470,763	291,703	55,304	29,555	33,306	28,597
		FY18	1,353,877	790,394	601,582	525,863	322,785	62,945	34,077	35,757	31,428
	Deviation	FY17	-0.3	0.1	0.2	-1.4	-1.0	-0.0	-2.5	-2.1	0.5
		FY18	-2.7	-0.2	-1.1	-3.8	-2.4	0.3	-8.5	-2.3	0.2
EBITDA	PC	FY17	340,099	194,025	110,811	100,956	46,190	8,944	4,601	3,879	4,767
Rs mn		FY18	364,643	217,142	122,119	109,765	51,661	10,601	5,143	4,388	5,344
	Consensus	FY17	338,144	192,173	112,200	101,586	47,440	8,825	4,756	4,186	4,789
		FY18	374,877	216,784	124,273	113,471	54,452	10,569	5,874	4,750	5,380
	Deviation	FY17	0.6	1.0	-1.2	-0.6	-2.6	1.3	-3.2	-7.3	-0.5
		FY18	-2.7	0.2	-1.7	-3.3	-5.1	0.3	-12.4	-7.6	-0.7
PAT	PC	FY17	274,013	150,837	87,246	80,525	30,552	5,959	3,128	2,343	2,811
Rs mn		FY18	295,495	169,501	97,656	87,782	33,072	7,183	3,469	2,692	3,150
	Consensus	FY17	264,887	146,772	88,284	80,927	32,379	5,675	3,184	2,628	2,803
		FY18	293,063	164,446	98,048	90,155	36,974	6,930	3,866	3,008	3,177
	Deviation	FY17	3.4	2.8	-1.2	-0.5	-5.6	5.0	-1.8	-10.8	0.3
		FY18	0.8	3.1	-0.4	-2.6	-10.6	3.7	-10.3	-10.5	-0.8

Source: Bloomberg, PhillipCapital India Research

NASSCOM still seems to be in denial mode

The basic guiding principle for analysts in estimating the growth profile of IT companies (apart from management guidance/commentary) has always been Nasscom's guidance. The industry body has historically been right more often than it was wrong, and top-4 Indian IT companies have consistently beaten industry guidance (apart from a period when Infosys and Wipro had company-specific issues).

However, if we analyse the last three years of Nasscom's guidance and the eventual growth reported by the top-4, we find that they came closer to the lower end of guidance. In FY17, we expect all top-5 Indian IT companies (except Infosys) to miss Nasscom's guidance, thereby taking overall industry growth to below Nasscom estimates of 10-12% constant currency growth.

We expect all top-5 Indian IT companies (except Infosys) to miss Nasscom's guidance, thereby taking overall industry growth to below Nasscom estimates of 10-12% constant currency growth

Nasscom guidance trends

	FY12	FY13	FY14	FY15	FY16	FY17E
NASSCOM guidance	16-18%	11-14%	12-14%	13-15%	12-14%	10-12%
Industry growth	16.5%	10.2%	13.0%	13.0%	12.3%	-

Source: NASSCOM, Companies, PhillipCapital India Research

Reduce position to UW – in line with our strategy report

In line with our first thermodynamics report, where we had downgraded the IT sector, we maintain our Underweight stance on the sector. Recent political developments – a manifestation of the second law of thermodynamics – add to our negative stance on the sector. We recommend investors reduce this sector's weight in their portfolios further – in line with the PhillipCapital model portfolio (7.0% sector weight vs 16.3% in Nifty).

Recent political developments add to our negative stance on the sector

Key recommendations

SELL – Wipro and Tech Mahindra

We maintain our SELL recommendation on Wipro and Tech Mahindra. We expect Wipro to be a laggard in the digital transformation space; it will take much more time to turnaround its operations after the appointment of the new CEO. Tech Mahindra is reeling under the pressure of weakness in its communications business (45% of revenues) and declining margins.

NEUTRAL – TCS and HCL Tech

We maintain our NEUTRAL stance on TCS and HCL Tech. Both stocks, while growing slightly below industry average, have limited downside due to valuations support. However, with TCS' base becoming too big to grow in double digits and HCL missing another growth engine (apart from IMS), we see limited upside potential.

BUY – Infosys

We maintain BUY on Infosys – we expect it to regain its industry leading position as TCS starts decelerating. Infosys is making the right acquisitions and its deal-flow and client metrics have been continuously improving. However, with the poor 1QFY17 results and the cut in guidance, we believe the rerating will be more elongated than we earlier anticipated. Hence, we downgrade its multiple to 18x FY18 P/E (from 20x) – still at 5% premium to TCS. We maintain BUY.

Recommendations summary

	CMP	Mkt Cap	Multiple	PT	Upside	Rating	USD Rev Growth (%)		EBITDA Margins (%)		EPS (Rs)	
	Rs	Rs bn		Rs	%		FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
TCS	2,628	5,178	17	2,550	-3%	NEUTRAL	9.5	8.5	28.0	27.7	139	150
Infosys	1,034	2,363	18	1,330	29%	BUY	10.8	11.8	27.5	27.5	66	74
Wipro	528	1,299	12	480	-9%	SELL	6.6	6.9	19.9	20.5	35	40
HCL Tech	785	1,109	14	870	11%	NEUTRAL	11.1	9.0	21.7	21.7	57	62
Tech Mahindra	474	410	12	450	-5%	SELL	6.8	9.0	16.0	16.4	35	38
MindTree	570	96	14	600	5%	NEUTRAL	15.7	14.1	16.2	16.8	36	43
Persistent	679	54	14	610	-10%	SELL	22.4	8.1	16.0	16.5	39	43
KPIT	126	24	9	120	-5%	SELL	-0.7	7.1	11.9	12.6	12	13
NIIT Tech	408	25	10	510	25%	BUY	4.6	9.4	16.6	17.0	46	51

Financials and valuation snapshot

	$ Revenue Growth			EBITDA Margins			EPS (rs)			EPS Growth (%)		
Companies	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
TCS	7.1	9.5	8.5	28.2	28.0	27.7	123	139	150	22.5	13.2	7.8
Infosys	9.1	10.8	11.8	27.4	27.5	27.5	59	66	74	9.4	11.8	12.4
Wipro	3.7	7.4	7.0	21.8	19.9	20.5	36	35	40	3.1	-2.1	11.9
HCL Tech	7.1	11.1	9.0	21.5	21.7	21.7	39	57	62	-24.9	47.3	9.2
Tech Mahindra	10.2	6.8	9.0	16.2	16.0	16.4	35	35	38	26.1	-0.1	8.2
MindTree	22.3	15.7	14.1	17.6	16.2	16.8	33	36	43	2.7	8.0	20.6
Persistent	14.0	22.4	8.1	18.0	16.0	16.5	37	39	43	2.3	5.2	10.9
KPIT	0.3	-0.7	7.1	13.5	11.9	12.6	14	12	13	20.3	-17.9	14.9
NIIT Tech	5.9	4.6	9.4	17.5	16.6	17.0	45	46	51	139.7	2.3	12.0

	ROE (%)			PE (x)			PB (x)			EV/EBITDA (x)		
Companies	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
TCS	33.1	31.2	28.6	21.4	18.9	17.5	7.1	5.9	5.0	16.8	15.0	13.9
Infosys	21.9	23.2	23.1	17.5	15.7	13.9	3.8	3.6	3.2	11.9	10.4	9.0
Wipro	19.1	16.6	16.6	14.6	14.9	13.3	2.8	2.5	2.2	10.6	10.6	9.4
HCL Tech	19.5	25.1	24.7	20.3	13.8	12.6	4.0	3.5	3.1	15.4	10.0	9.2
Tech Mahindra	19.1	16.9	16.3	13.6	13.6	12.5	2.6	2.3	2.0	8.8	8.5	7.7
MindTree	22.9	21.1	21.6	17.3	16.0	13.3	4.0	3.4	2.9	11.2	10.5	8.7
Persistent	17.9	16.5	16.2	18.3	17.4	15.7	3.3	2.9	2.5	12.7	11.5	10.4
KPIT	19.4	13.9	13.9	8.8	10.8	9.4	1.7	1.5	1.3	5.6	5.6	4.9
NIIT Tech	17.2	16.0	15.9	9.1	8.9	7.9	1.6	1.4	1.3	4.6	4.1	3.6

Source: Companies, PhillipCapital India Research

Companies Section

Infosys (INFO IN)

Still the fastest growing large-cap; rerating imminent

INDIA | IT SERVICES | Company Update

18 August 2016

Ready to lead again

Over the last twelve months, Infosys has shown a remarkable turnaround in headline numbers as well as other supporting metrics. While it reported USD revenue growth of 9.1% in FY16 – highest in the large-cap space, its client metrics and deal flow numbers have been constantly improving. We expect it to report industry-leading growth in FY17, which will lead to the company regaining its bellwether status – the 'honour' that it had lost to TCS for the last five years.

Significant improvement in client metrics and deal-wins

Over the last nine quarters, Infosys' +US$ 200mn clients increased to six from three. Similarly, its +US$ 100/50/30mn clients increased to 17/52/87 from 12/43/78. Total clients increased to 1,126 from 910 – which shows remarkable success in adding new clients and capturing higher share of their wallets. It reported deal-wins of US$ 2.78bn in FY16 – 43% higher than in FY15 – we see this improvement and higher share of large clients leading to a momentum that will propel Infosys to industry-leading growth in FY17.

1QFY17 results – an aberration in an otherwise sound story

After four consecutive quarters of strong performance, Infosys delivered below expected results in 1QFY17. The miss was largely led by lower revenues in life-sciences/CPI. Its guidance cut for FY17 still implies that it would report the highest revenue growth in the large-cap space, second only to MindTree in the midcap space, and in-line with NASSCOM guidance (10-12%). We expect it to leave behind the lacklustre 1QFY17 results and regain momentum from 2Q, based on its robust deal pipeline.

Strategic acquisitions: In the right direction

Over the last eight months, Infosys has made three acquisitions – Panaya, Kalidus, and Noah Consulting – all small, but with breakthrough technology in the digital space. According to the management, synergies from Panaya have already resulted in winning 15 large engagements with 137 deals in the pipeline. It has also laid out its strategy to generate US$ 1.5bn in revenues by 2020 through the inorganic route. We expect it to benefit immensely from this paradigm shift in its capital allocation policy and capture a larger share of digital deals in coming years on these niche acquisitions.

Valuations to come at par with TCS

Our analysis of the last 11 years of Infosys' and TCS' valuation histories reveals that Infosys starts trading at a premium to TCS as soon as its growth rate is about to come at par with TCS. Over the last 11 years, TCS has traded at a premium to Infosys in only two prolonged periods (October 2007 to April 2008 and April 2011 to December 2015) – when it delivered much superior results to Infosys. Also, the maximum premium/discount that either company has enjoyed over the other has remained ~20% – with a peak of 40%. Currently, Infosys is trading at 14x FY17 P/E – a 20% discount to TCS. We see this gap bridging over the next twelve months as TCS suffers from deceleration (large base, lack of inorganic drivers) and Infosys catches up to report industry-leading growth.

More elongated path to rerating; downgrade multiple, but maintain BUY

1QFY17 results have definitely elongated the rerating path for Infosys. With the roles of beating/missing expectations reversed in this quarter, we see Infosys trading at a premium to TCS only after performing consistently for multiple quarters. Until then, unless TCS disappoints yet again, we expect Infosys to reach parity or at best, minor premium to TCS.

Hence, we downgrade our multiple for Infosys to 18x FY18 P/E (from 20x earlier) – still at 5% premium to TCS (which we value at 17x) – incorporating a longer road to rerating. We maintain BUY with revised price target of Rs 1330 (Rs 1480 earlier).

BUY (Maintain)

CMP RS 1034

TARGET RS 1330 (+29%)

COMPANY DATA

O/S SHARES (MN) :	2297
MARKET CAP (RSBN) :	2478
MARKET CAP (USDBN) :	37.1
52 - WK HI/LO (RS) :	1278 / 1012
LIQUIDITY 3M (USDMN) :	65.3
PAR VALUE (RS) :	5

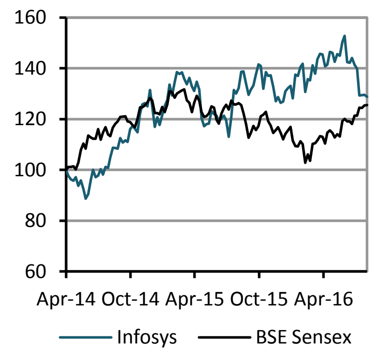
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	12.8	12.8	13.1
FII / NRI :	40.5	40.2	39.6
FI / MF :	17.3	17.5	17.6
NON PRO :	5.9	22.3	6.9
PUBLIC & OTHERS :	23.6	7.3	22.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-6.9	-8.7	-1.5
REL TO BSE	-10.8	-20.4	-1.3

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY16	FY17E	FY18E
Net Sales	624.4	705.5	788.6
EBIDTA	170.8	194.0	217.1
Net Profit	134.9	150.8	169.5
EPS, Rs	59.0	66.0	74.2
PER, x	17.5	15.7	13.9
EV/EBIDTA, x	11.9	10.3	8.9
P/BV, x	4.5	4.0	3.5
ROE, %	21.9	23.2	23.1

Source: PhillipCapital India Research Est.

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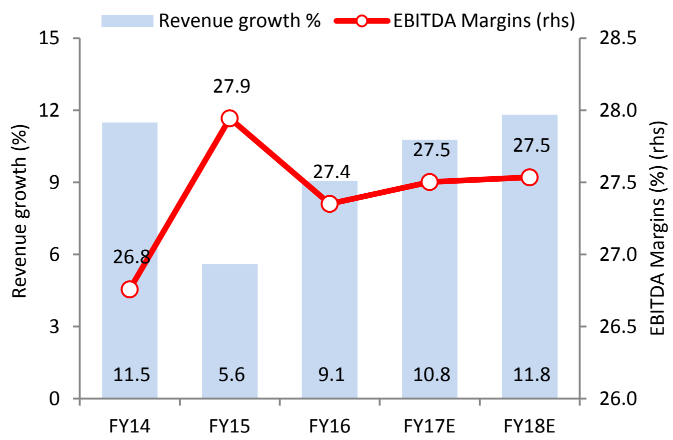
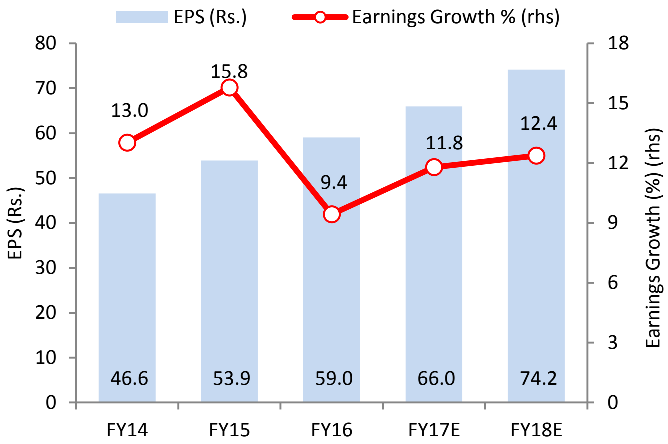
USD revenue growth (%) and EBITDA margins (%)

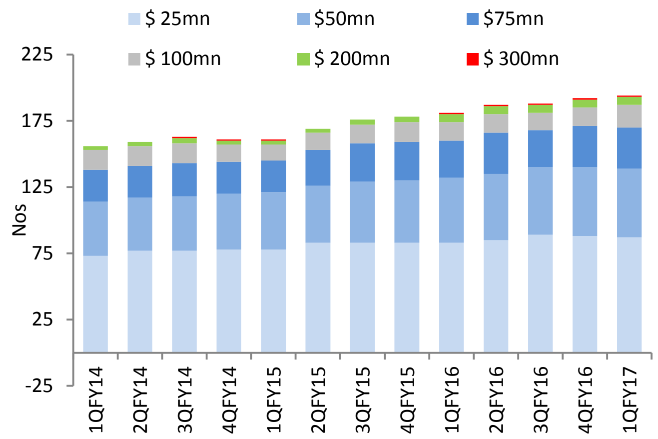


EPS (Rs) and earnings growth (%)

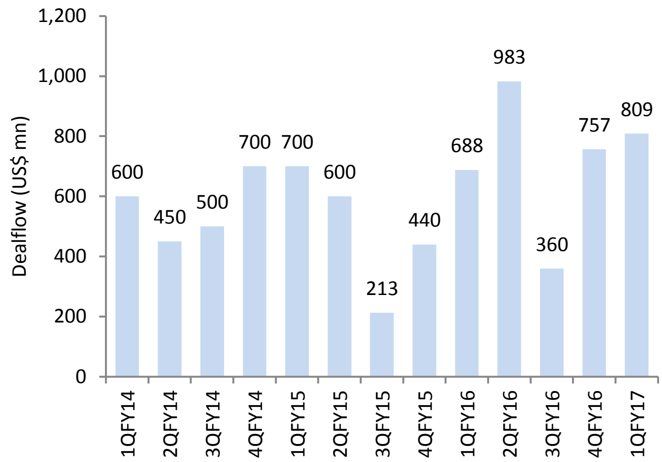


Source: Company, PhillipCapital India Research

Significant improvement in client metrics

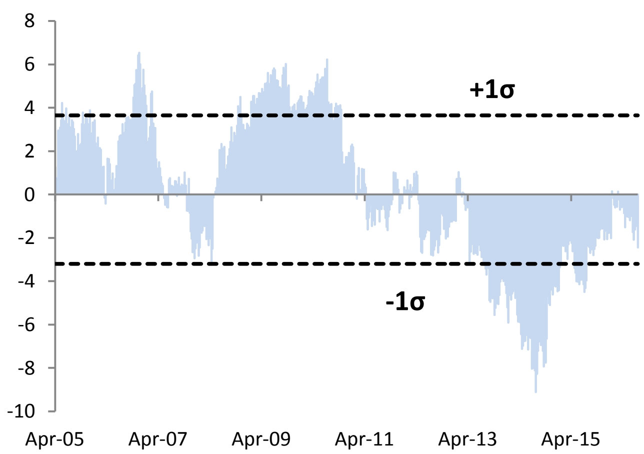


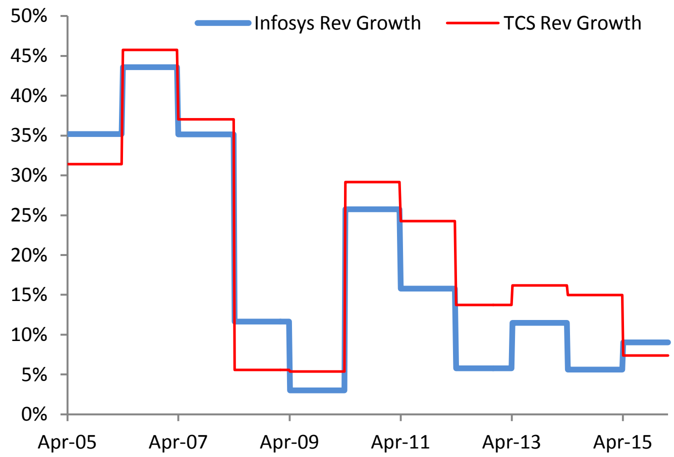
Deal flow has remained strong



Source: Company, PhillipCapital India Research

Infosys' premium over TCS has had a strong correlation with revenue growth rates





Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**533,190**	**624,420**	**705,456**	**788,583**
Growth, %	6.4	17.1	13.0	11.8
Employee expenses	-318,150	-376,400	-425,837	-476,022
Other Operating expenses	-66,040	-77,230	-85,594	-95,419
EBITDA (Core)	**149,000**	**170,790**	**194,025**	**217,142**
Growth, %	11.1	14.6	13.6	11.9
Margin, %	27.9	27.4	27.5	27.5
Depreciation	-10,680	-14,590	-16,406	-17,323
EBIT	**138,320**	**156,200**	**177,619**	**199,819**
Growth, %	14.9	12.9	13.7	12.5
Margin, %	25.9	25.0	25.2	25.3
Forex gains/losses	4,750	1,670	-11	-11
Other Non-Operating Income	29,510	29,570	33,269	37,257
Pre-tax profit	**172,580**	**187,440**	**210,877**	**237,064**
Tax provided	-49,290	-52,520	-60,040	-67,563
Profit after tax	**123,290**	**134,920**	**150,837**	**169,501**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**123,290**	**134,920**	**150,837**	**169,501**
Growth, %	15.8	9.4	11.8	12.4
Net Profit (adjusted)	**123,290**	**134,920**	**150,837**	**169,501**
Wtd avg shares (m)	2,286	2,286	2,286	2,286

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**8,711**	**9,501**	**10,525**	**11,770**
Growth, %	5.6	9.1	10.8	11.8
Re / US$ (rate)	61.2	65.7	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	303,670	326,970	367,929	425,268
Marketable securities at cost	0	0	0	0
Debtors	97,130	113,300	135,293	151,235
Inventory	0	0	0	0
Loans & advances	104,680	135,000	89,942	99,014
Total current assets	505,480	575,270	593,164	675,517
Investments	24,130	20,080	32,160	42,160
Net fixed assets	128,540	152,790	163,244	171,921
Non-current assets	0	0	0	0
Total assets	**663,520**	**753,500**	**794,828**	**895,858**
Total current liabilities	115,890	136,060	145,723	162,821
Non-current liabilities	0	0	0	0
Total liabilities	115,890	136,060	145,723	162,821
Paid-up capital	5,720	11,440	11,440	11,440
Reserves & surplus	541,910	606,000	637,665	721,597
Minorities	0	0	0	0
Shareholders' equity	547,630	617,440	649,105	733,037
Total equity & liabilities	**663,520**	**753,500**	**794,828**	**895,858**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	172,580	187,440	210,877	237,064
Depreciation	10,680	14,590	16,406	17,323
Chg in working capital	-37,170	-26,320	32,728	-7,916
Total tax paid	-51,970	-52,510	-60,940	-67,563
Other operating activities	0	0	0	0
Cash flow from operating activities	**94,120**	**123,200**	**199,070**	**178,909**
Capital expenditure	-35,360	-38,840	-26,860	-26,000
Chg in investments	5,810	4,050	-12,080	-10,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-29,550**	**-34,790**	**-38,940**	**-36,000**
Free cash flow	64,570	88,410	160,130	142,909
Equity raised/(repaid)	2,860	5,720	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-160,313	-64,846	-80,221	-85,570
Other financing activities	106,493	-5,984	-38,950	0
Cash flow from financing activities	**-50,960**	**-65,110**	**-119,171**	**-85,570**
Net chg in cash	13,610	23,300	40,959	57,339

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	53.9	59.0	66.0	74.2
Growth, %	15.8	9.4	11.8	12.4
Book NAV/share (INR)	239.6	270.1	284.0	320.7
CFPS (INR)	28.3	41.0	72.5	62.0
DPS (INR)	59.9	24.2	30.0	32.0
Return ratios				
Return on assets (%)	20.0	19.0	19.5	20.1
Return on equity (%)	22.5	21.9	23.2	23.1
Return on capital employed (%)	24.0	23.0	23.7	24.5
Turnover ratios				
Asset turnover (x)	2.9	2.6	2.8	3.1
Sales/Total assets (x)	0.9	0.9	0.9	0.9
Sales/Net FA (x)	4.6	4.4	4.5	4.7
Working capital/Sales (x)	0.2	0.2	0.1	0.1
Receivable days	66.5	66.2	70.0	70.0
Liquidity ratios				
Current ratio (x)	4.5	4.4	4.1	4.1
Quick ratio (x)	4.5	4.4	4.1	4.1
Dividend cover (x)	0.9	2.4	2.2	2.3
Net debt/Equity (%)	(59.9)	(56.2)	(61.6)	(58.0)
Valuation				
PER (x)	19.2	17.5	15.7	13.9
PEG (x) - y-o-y growth	1.2	1.9	1.3	1.1
Price/Book (x)	4.3	3.8	3.6	3.2
Yield (%)	5.8	2.3	2.9	3.1
EV/Net sales (x)	3.9	3.3	2.8	2.5
EV/EBITDA (x)	13.8	11.9	10.3	8.9
EV/EBIT (x)	14.9	13.0	11.2	9.7

PhillipCapital

Tata Consultancy Service (TCS IN)

Losing momentum; valuations to be capped

INDIA | IT SERVICES | Company Update

18 August 2016

NEUTRAL (Maintain)

CMP RS 2628

TARGET RS 2550 (-3%)

Large base and high expectations – finally catching up

TCS has had a tremendous run over the last three years. It beat Nasscom's guidance every year, delivering robust broad-based growth. Over the last three years, the company has reported topline and earnings CAGR of 15%/17% (adjusting for a one-time bonus of Rs 26bn in FY15). However, the large base (FY16 topline of US$ 16bn) and growth expectations finally seem to be catching up. In FY16, it missed consensus topline growth estimates for four consecutive quarters, leading to muted stock performance.

Difficult to grow on the large base, especially with high BFSI and UK exposure

TCS is now a giant, in terms of its size. Its FY16 topline of US$ 16bn is in catching distance of the Fortune 500 companies of the world. For the company to grow in double digits on this base implies adding US$ 2bn revenues annually (incremental revenues of only US$ 1.1bn in the last four quarters) – a herculean task for any company! We believe the last six quarters (except 1QFY17) of below-expectations growth are a clear indication that its growth engine is slowing down. Given multiple headwinds in the BFSI space (40% of revenues) and UK (15% of revenues), we expect it to fail to achieve double-digit growth rate in FY17 and beyond.

Decent show in 1Q17 – sustainability needs to be ascertained

After more than six quarters of muted performance, TCS delivered an all-round performance in 1QFY17. The surprise on the margins added to the positivity, even though they were below management's guidance. However, 1H has always been a strong period for TCS, and the company would still require CQGR of 2.8% to achieve a growth rate of 10% in FY17 – difficult, in our opinion. The 120bps of operational-efficiency gains in margins do not appear to be sustainable, as it has used up most of its available levers (utilisation at peak level, attrition lowest in last eight quarters).

Inefficient cash utilisation over the last decade to bear sore fruits now

Over the last decade, TCS did not acquire any company of significant size/capability (apart from Alti in 2013). Even now, when companies like Infosys and MindTree are looking to make amends by acquiring small niche companies in the digital space, TCS seems reluctant to follow suit. The management maintains that they have strong in-house delivery capabilities in the digital space, having started much ahead of peers. While we have no reason to doubt the management's claims, we believe its not just the delivery capabilities, but the perception of the Indian IT companies, that TCS will have to mitigate, in order to gain significant traction in the digital space.

Valuations to de-rate and come at par with Infosys

TCS has traded at 10-20% premium to Infosys, over the last three years. The premium had narrowed considerably over the last few quarters, as TCS missed and Infosys beat expectations for four consecutive quarters – before the opposite happened in 1QFY17. The sharp polar movement in their stock prices after the results have led to TCS trading at a 20% premium again to Infosys now. We see this gap bridging over the next few quarters, as TCS suffers from deceleration (large base, lack of inorganic drivers) and Infosys catches up to report industry leading growth. We see the growth and consistency premium (which TCS has commanded over the last three years over Infosys) vanishing over the next few quarters.

Currently trading at 18x FY18 P/E, we find valuations expensive for the company and virtually no upside from current levels. We downgrade our target multiple to 17x (earlier 18x) FY18 P/E – at 5% discount to Infosys – on the impending global uncertainty and its high BFSI exposure. Our price target of Rs 2550 (Rs 2700 earlier) offers 3% downside from current levels. We maintain NEUTRAL.

COMPANY DATA

O/S SHARES (MN) :	1970
MARKET CAP (RSBN) :	5225
MARKET CAP (USDBN) :	78.2
52 - WK HI/LO (RS) :	2769 / 2119
LIQUIDITY 3M (USDMN) :	42.1
PAR VALUE (RS) :	1

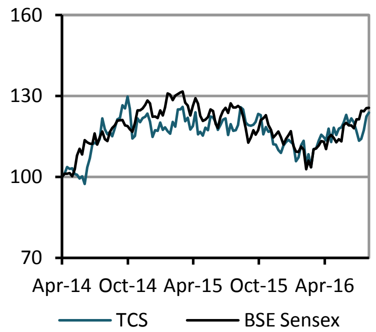
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	73.3	73.4	73.4
FII / NRI :	17.0	16.9	16.9
FI / MF :	5.1	5.1	5.1
NON PRO :	0.9	0.9	0.8
PUBLIC & OTHERS :	3.6	3.7	3.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	9.3	7.3	3.9
REL TO BSE	5.4	-4.4	4.1

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY16	FY17E	FY18E
Net Sales	1,086.5	1,215.0	1,317.4
EBIDTA	306.8	340.1	364.6
Net Profit	242.1	274.0	295.5
EPS, Rs	122.9	139.1	150.0
PER, x	21.4	18.9	17.5
EV/EBIDTA, x	16.7	15.0	13.8
P/BV, x	7.1	5.9	5.0
ROE, %	33.1	31.2	28.6

Source: PhillipCapital India Research Est.

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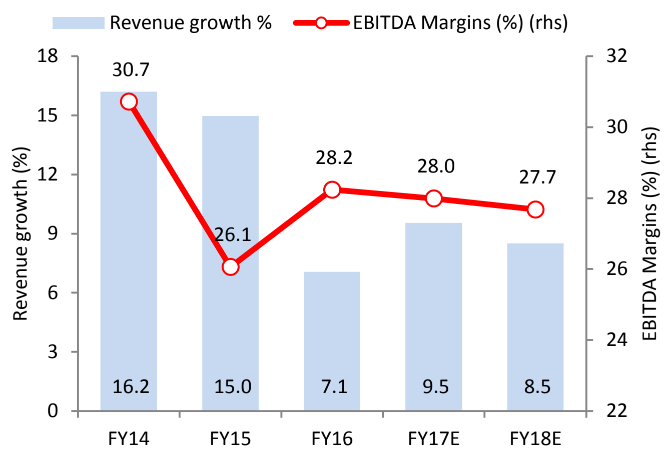
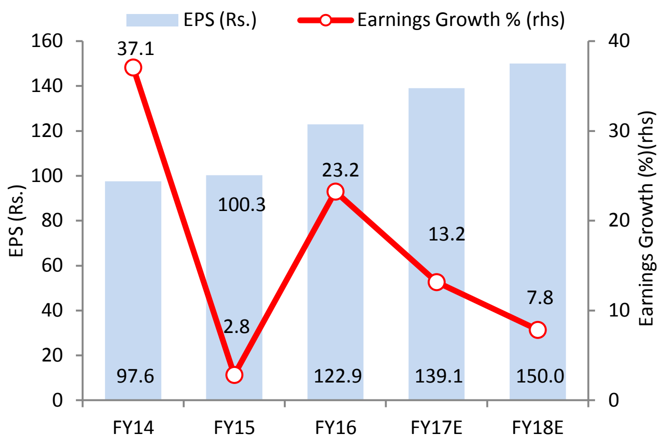
USD revenue growth (%) and EBITDA margins (%)

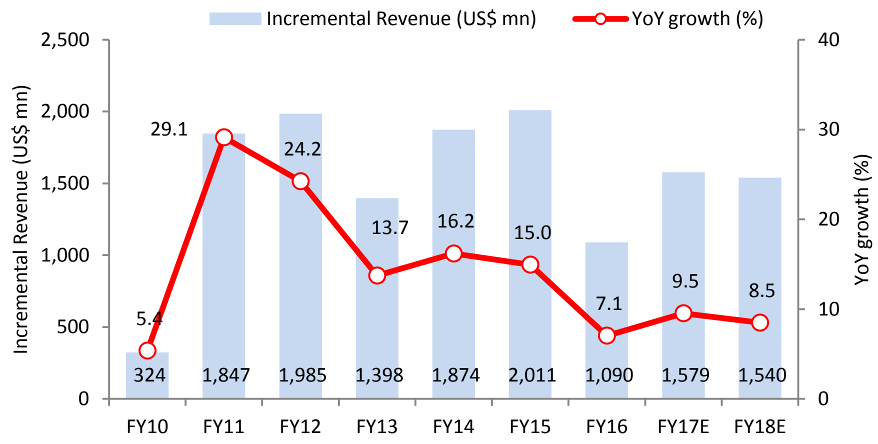


EPS (Rs) and earnings growth (%)



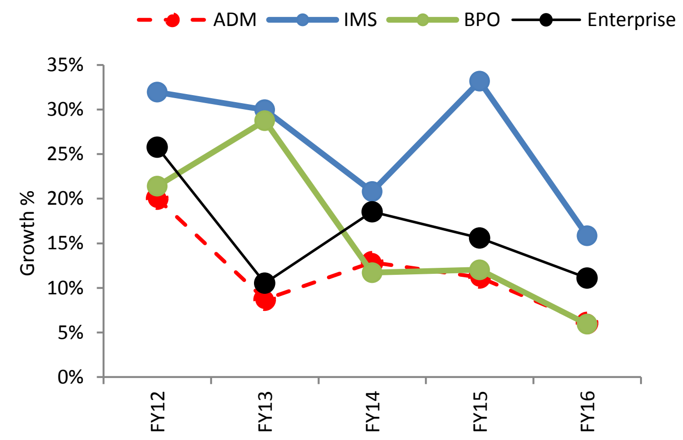
Source: Company, PhillipCapital India Research

Incremental revenue for TCS – peaked out in FY15

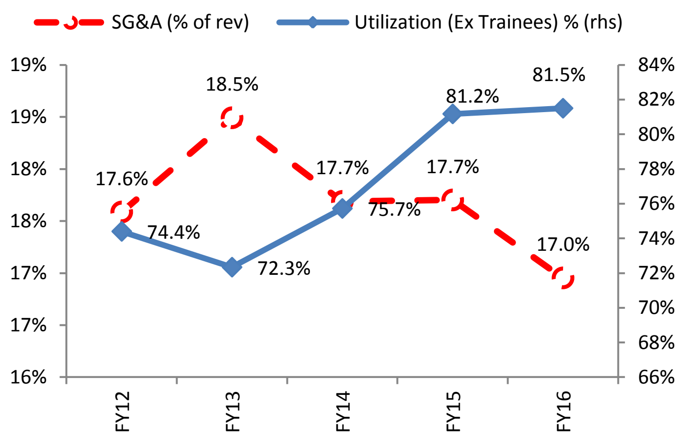


Source: Company, PhillipCapital India Research

Most service lines have been decelerating



Margin levers already used up



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**946,484**	**1,086,462**	**1,215,036**	**1,317,421**
Growth, %	15.7	14.8	11.8	8.4
Employee expenses	-532,274	-595,489	-670,215	-736,161
Other Operating expenses	-167,548	-184,193	-204,722	-216,616
EBITDA (Core)	**246,662**	**306,780**	**340,099**	**364,643**
Growth, %	(1.9)	24.4	10.9	7.2
Margin, %	26.1	28.2	28.0	27.7
Depreciation	-18,698	-18,879	-20,343	-22,772
EBIT	**227,964**	**287,901**	**319,756**	**341,871**
Growth, %	(4.2)	26.3	11.1	6.9
Margin, %	24.1	26.5	26.3	26.0
Interest paid	0	0	0	0
Other Non-Operating Income	31,396	30,503	37,139	44,402
Pre-tax profit	**259,360**	**318,404**	**356,923**	**386,268**
Tax provided	-60,828	-75,027	-82,899	-90,773
Profit after tax	**198,532**	**243,377**	**274,023**	**295,495**
Others (Minorities, Associates)	-2,048	-1,229	-10	0
Net Profit	**196,484**	**242,148**	**274,013**	**295,495**
Growth, %	2.8	23.2	13.2	7.8
Net Profit (adjusted)	**196,484**	**242,148**	**274,013**	**295,495**
Wtd avg shares (m)	1,959	1,970	1,970	1,970

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**15,454**	**16,544**	**18,123**	**19,663**
Growth, %	15.0	7.1	9.5	8.5
Re / US$ (rate)	61.2	65.7	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	18,622	62,950	92,575	132,284
Marketable securities at cost	0	0	0	0
Debtors	204,399	240,730	270,210	291,974
Inventory	0	0	0	0
Other current assets	250,981	103,660	126,554	136,747
Total current assets	474,002	407,340	489,340	561,005
Investments	17,543	228,220	288,220	348,220
Net fixed assets	259,324	276,560	301,058	344,718
Non-current assets	0	0	0	0
Total assets	**750,868**	**912,120**	**1,078,617**	**1,253,943**
Total current liabilities	146,716	155,690	172,422	188,578
Non-current liabilities	20,250	21,000	24,975	26,935
Total liabilities	166,966	176,690	197,397	215,513
Paid-up capital	1,959	1,970	1,970	1,970
Reserves & surplus	572,808	729,920	875,701	1,032,910
Minorities	9,136	3,540	3,550	3,550
Shareholders' equity	583,903	735,430	881,221	1,038,430
Total equity & liabilities	**750,868**	**912,120**	**1,078,617**	**1,253,943**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	259,360	318,404	356,923	386,268
Depreciation	18,698	18,879	20,343	22,772
Chg in working capital	-13,859	121,027	-31,468	-13,840
Total tax paid	-60,828	-75,027	-82,899	-90,773
Other operating activities	0	0	0	0
Cash flow from operating activities	**203,371**	**383,283**	**262,899**	**304,427**
Capital expenditure	-41,495	-36,115	-44,841	-66,432
Chg in investments	17,074	-210,677	-60,000	-60,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-24,421**	**-246,792**	**-104,841**	**-126,432**
Free cash flow	178,950	136,491	158,058	177,995
Equity raised/(repaid)	0	11	0	0
Debt raised/(repaid)	-130	-313	-200	0
Dividend (incl. tax)	-181,042	-100,168	-128,233	-138,286
Other financing activities	5,971	15,131	0	0
Cash flow from financing activities	**-175,016**	**-92,162**	**-128,433**	**-138,286**
Net chg in cash	3,934	44,328	29,625	39,709

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	100.3	122.9	139.1	150.0
Growth, %	2.8	22.5	13.2	7.8
Book NAV/share (INR)	293.4	371.4	445.4	525.2
CFPS (INR)	87.8	179.0	114.6	132.0
DPS (INR)	79.0	43.5	55.6	60.0
Return ratios				
Return on assets (%)	27.6	29.3	27.5	25.3
Return on equity (%)	34.2	33.1	31.2	28.6
Return on capital employed (%)	33.6	35.8	33.0	30.0
Turnover ratios				
Asset turnover (x)	1.8	2.2	2.6	2.5
Sales/Total assets (x)	1.3	1.3	1.2	1.1
Sales/Net FA (x)	3.8	4.1	4.2	4.1
Working capital/Sales (x)	0.3	0.2	0.2	0.2
Receivable days	78.8	80.9	81.2	80.9
Liquidity ratios				
Current ratio (x)	3.2	2.6	2.8	3.0
Quick ratio (x)	3.2	2.6	2.8	3.0
Dividend cover (x)	1.3	2.8	2.5	2.5
Total debt/Equity (%)	0.2	0.1	0.1	0.1
Net debt/Equity (%)	(3.0)	(8.5)	(10.5)	(12.7)
Valuation				
PER (x)	26.2	21.4	18.9	17.5
PEG (x) - y-o-y growth	9.3	1.0	1.4	2.2
Price/Book (x)	9.0	7.1	5.9	5.0
Yield (%)	3.0	1.7	2.1	2.3
EV/Net sales (x)	5.4	4.7	4.2	3.8
EV/EBITDA (x)	20.8	16.7	15.0	13.8
EV/EBIT (x)	22.5	17.8	15.9	14.8

INSTITUTIONAL EQUITY RESEARCH

HCL Technologies (HCLT IN)

Growth engine missing; valuations to be capped

INDIA | IT SERVICES | Company Update

18 August 2016

Cannibalisation of IMS revenues by cloud platform poses a big threat

The biggest concern for HCL Tech has been the expected cannibalisation of IMS revenues by clients moving to cloud platforms. With cloud server providers like AWS and MS-Azure already offering basic infrastructure services with the cloud platform and expanding to include application development platforms, HCL's growth engine appears to be under threat. IMS forms 35% of HCL Tech's revenues, and has contributed 46% of its US$ 3.3bn incremental revenues over FY10-16.

Traditional IMS business slowing down due to nature of deals

Over the last four quarters, we have seen HCL reporting decelerating growth in IMS. The management attributes this to the long-term nature of the IMS deals – higher revenue booking in initial years, which plateaus over their remaining life. While the company was adding new deals every year to its portfolio, the growth impact wasn't significant as the lower revenues of old deals were compensated by higher revenues from new deals. However, with cloud platforms cannibalising IMS revenues and players like IBM and Wipro fighting hard to regain their lost market share in the domain, new large IMS deals have been drying up. As a result, HCL's IMS CQGR has slowed to 2.8% over the last four quarters vs. 4.2% over the last sixteen. Even our second derivative analysis indicates deceleration in IMS business in eight of the last nine quarters.

Decent 1QFY17 results, but sustainability is still a concern

HCL's 1QFY17 performance was robust, but the future does not look too promising. Though FY17 CC USD revenue growth guidance of 12.0-14.0% (at FY16 average FX rate) looks ahead of NASSCOM and Infosys' growth guidance, its organic growth would be 8-10% (adjusting for the Volvo and IP partnership deal). While margins sprang a positive surprise in Q1, we remain skeptical about their sustainability.

Growth in enterprise business still eludes HCL, despite its bundling strategy

Over FY12-14, HCL reported a decent pick-up in its Enterprise Application (EA) business – it reported a CQGR of 1.6% over twelve quarters in FY12-14. It seemed that HCL's strategy to bundle its services with IMS was finally working. However, CQGR of only 0.4% in this division over the last five quarters has once again spawned doubts over sustainability of this strategy and the accompanied growth in EA.

Going fast on acquisitions, but most are in traditional domains

Over the last 10 years, HCL generated Rs 269bn of OCF and paid out 34% of this cash as dividends and 36% is sitting as cash/investments. It did not acquire any company of significant size/capability apart from Axon in 2008. However, over the last six months it made six acquisitions, adding ~US$ 400mn to its revenues. However, we remain concerned since most of these acquisitions are in traditional IT domains (like ADM, IMS), to buy out revenues, and not to enhance delivery capabilities, by investing in the new-age digital space.

Little scope for rerating; not much downside either

After the sharp correction post last quarter's results, and recent run-up, HCL is trading at 13x our FY18 EPS – at a discount to TCS and Infosys, but at par with Wipro. We do not see any significant rerating potential given its inferior revenue and margin profile expected over the next two years due to cannibalisation of revenues by cloud platforms. However, with an ROE of 25%, we do not see significant downside either.

We continue to value the stock at 14x FY18 earnings – at a premium to Wipro and TechM. We maintain NEUTRAL with price target of Rs 870 (unchanged).

NEUTRAL (Maintain)

CMP RS 785

TARGET RS 870 (+11%)

COMPANY DATA

O/S SHARES (MN) :	1411
MARKET CAP (RSBN) :	1155
MARKET CAP (USDBN) :	17.3
52 - WK HI/LO (RS) :	997 / 707
LIQUIDITY 3M (USDMN) :	32.2
PAR VALUE (RS) :	2

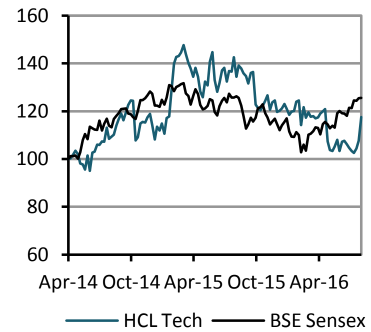
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	60.4	60.4	60.4
FII / NRI :	25.7	26.9	27.6
FI / MF :	6.6	5.7	5.5
NON PRO :	1.2	4.3	1.1
PUBLIC & OTHERS :	6.2	2.7	5.5

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	13.5	13.0	-12.8
REL TO BSE	9.6	1.3	-12.6

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	311.4	464.2	505.7
EBIDTA	67.0	101.0	109.8
Net Profit	54.5	80.4	87.8
EPS, Rs	38.6	56.9	62.1
PER, x	20.3	13.8	12.6
EV/EBIDTA, x	15.1	9.8	9.0
P/BV, x	4.0	3.5	3.1
ROE, %	19.5	25.1	24.7

Source: PhillipCapital India Research Est.

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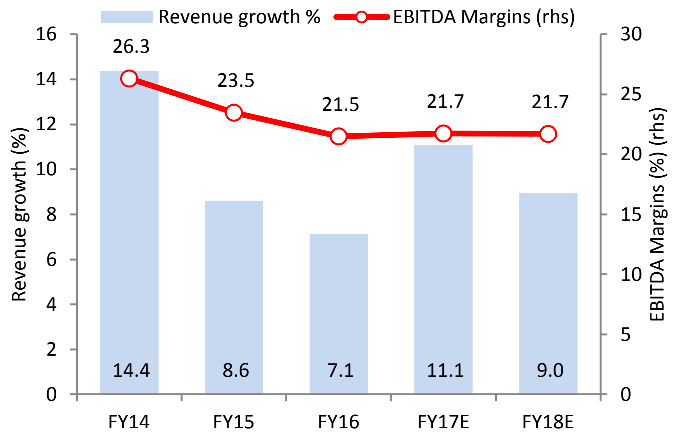
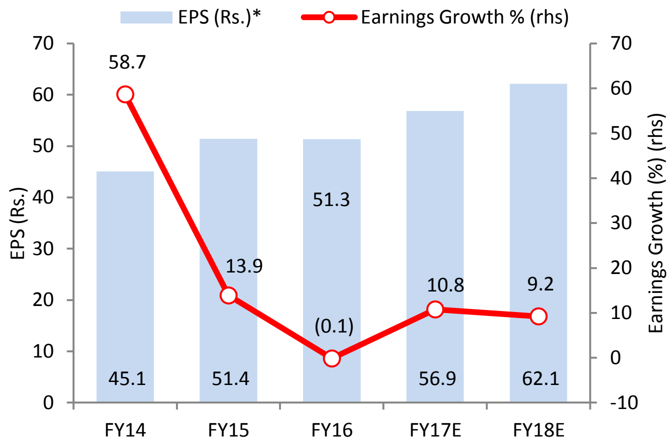
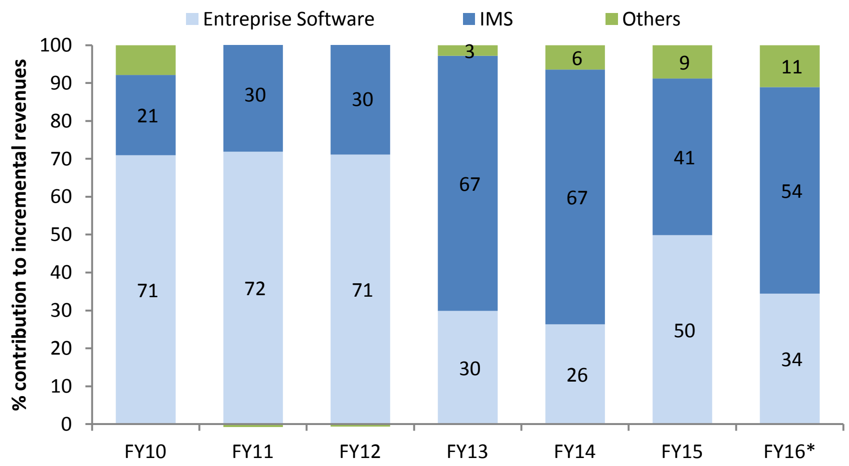
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



Share of enterprise business in incremental revenues has been constantly declining



Source: Company, PhillipCapital India Research; * FY16 9mnths

HCL Tech – IMS revenues over last nine quarters depict a clear decelerating trend

HCL Tech - IMS	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	No of quarters with -ve d^2Y/dX^2	% of quarters with -ve d^2Y/dX^2
dY/dX	25.5%	17.6%	15.2%	9.8%	19.4%	16.3%	13.4%	14.0%	14.1%		
d^2Y/dX^2	-42.5%	-58.1%	-57.6%	-68.8%	-24.0%	-7.3%	-11.8%	42.6%	-27.2%	8	89%

Source: Company, PhillipCapital India Research

Renewal deals missed in FY16

Company	Deal Value ($ mn)
Reader's Digest	350
UBS Group	300
Skandia	200
Microsoft	170
Singapore Stock Exchange	110
Xerox (outsourcing)	100
Nokia	100
UTi Worldwide	50+
GlaxoSmithKline	50+
Vestas Wind Systems	50+

Source: Media sources, Company, PhillipCapital India Research

On an acquisition spree – 8 acquisitions in last 12 months

Date	Target	Business Description	Consideration ($ mn)	Revenue ($ mn)
Jun-16	IP Partnership	Workload Automation and DevOps software of a global tech major	350.0	40.0
Apr-16	Geometric	PLM and engineering services	195.0	135.0
Feb-16	Volvo IT	External IT services arm of Volvo	135.0	190.0
Jan-16	Point to Point	Workplace engineering services	10.0	NA
Nov-15	CSC	Core Banking business of CSC	53.5	NA
Oct-15	Powerteam LLC	Professional services for MS Dynamics CRM	41.5	37.0
Oct-15	C2SiS	Engineering services firm	2.0	NA
Aug-15	Trygstad Technical Services	Turnkey solutions for a large ISV	10.0	NA
	Total		**797.0**	**402.0**

Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16*	FY17E	FY18E
Net sales	**370,620**	**311,360**	**464,214**	**505,706**
Growth, %	13	-16	49	9
Employee expenses	-237,970	-204,710	-304,577	-335,518
Other Operating expenses	-45,630	-39,690	-58,681	-60,422
EBITDA (Core)	**87,020**	**66,960**	**100,956**	**109,765**
Growth, %	0.4	(23.1)	50.8	8.7
Margin, %	23.5	21.5	21.7	21.7
Depreciation	-4,510	-4,450	-7,883	-8,313
EBIT	**82,510**	**62,510**	**93,073**	**101,453**
Growth, %	4.0	(24.2)	48.9	9.0
Margin, %	22.3	20.1	20.0	20.1
Other Non-Operating Income	9,320	6,630	8,434	10,371
Forex Gains\ (Losses)	-200	370	692	0
Pre-tax profit	**91,630**	**69,510**	**102,199**	**111,824**
Tax provided	-19,080	-14,990	-21,843	-24,042
Profit after tax	**72,550**	**54,520**	**80,356**	**87,782**
Non Recurring Item	0	0	0	0
Net Profit	**72,550**	**54,520**	**80,356**	**87,782**
Growth, %	13.9	(24.9)	47.4	9.2
Net Profit (adjusted)	**72,550**	**54,520**	**80,356**	**87,782**
Wtd avg shares (m)	1,411	1,412	1,413	1,413

US$ Revenues

	FY15**	FY16**	FY17E	FY18E
US$ Revenue ($ mn)	**5,821**	**6,236**	**6,927**	**7,548**
Growth, %	8.6	7.1	11.1	9.0
Re / US$ (rate)	62.3	66.3	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16*	FY17E	FY18E
Cash & bank	13,520	7,293	20,642	22,085
Marketable securities at cost	104,370	111,236	121,308	131,308
Debtors	94,860	107,228	119,551	130,236
Inventory	0	0	0	0
Other current assets	23,380	24,102	26,485	28,680
Total current assets	236,130	249,859	287,986	312,309
Investments	80	1,601	1,629	1,629
Net fixed assets	120,900	146,213	178,001	197,871
Non-current assets	0	0	0	0
Total assets	**357,110**	**397,673**	**467,616**	**511,809**
Total current liabilities	92,320	95,085	120,996	128,692
Non-current liabilities	17,280	22,367	25,976	27,472
Total liabilities	109,600	117,452	146,972	156,164
Paid-up capital	1,341	1,341	1,341	1,341
Reserves & surplus	246,170	278,881	319,304	354,304
Minorities	0	0	0	0
Shareholders' equity	247,510	280,221	320,644	355,644
Total equity & liabilities	**357,110**	**397,673**	**467,616**	**511,809**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16*	FY17E	FY18E
Pre-tax profit	91,630	69,510	102,199	111,824
Depreciation	4,510	4,450	7,883	8,313
Chg in working capital	-9,555	-10,325	11,206	-5,185
Total tax paid	-19,080	-14,990	-21,843	-24,042
Other operating activities	0	0	0	0
Cash flow from operating activities	**67,505**	**48,645**	**99,444**	**90,910**
Capital expenditure	-18,991	-29,763	-39,671	-28,182
Chg in investments	76	-1,521	-28	0
Chg in marketable securities	-14,578	-6,866	-10,072	-10,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-33,493**	**-38,150**	**-49,771**	**-38,182**
Free cash flow	34,012	10,495	49,673	52,727
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	-4,844	5,087	3,609	1,497
Dividend (incl. tax)	-37,773	-29,648	-39,586	-52,782
Other financing activities	11,919	7,839	-346	0
Cash flow from financing activities	**-30,698**	**-16,722**	**-36,324**	**-51,285**
Net chg in cash	3,314	-6,227	13,349	1,442

Valuation Ratios

	FY15	FY16*	FY17E	FY18E
Per Share data				
EPS (INR)	51.4	38.6	56.9	62.1
Growth, %	14.1	(24.9)	47.3	9.2
Book NAV/share (INR)	175.4	198.4	226.9	251.7
CFPS (INR)	41.2	29.7	64.4	57.0
DPS (INR)	22.9	17.9	23.9	31.9
Return ratios				
Return on assets (%)	21.9	14.4	18.6	17.9
Return on equity (%)	29.3	19.5	25.1	24.7
Return on capital employed (%)	29.8	19.2	24.8	24.1
Turnover ratios				
Asset turnover (x)	2.7	1.9	2.4	2.3
Sales/Total assets (x)	1.1	0.8	1.1	1.0
Sales/Net FA (x)	3.3	2.3	2.9	2.7
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	93.4	125.7	94.0	94.0
Liquidity ratios				
Current ratio (x)	2.6	2.6	2.4	2.4
Quick ratio (x)	2.6	2.6	2.4	2.4
Dividend cover (x)	2.2	2.2	2.4	1.9
Total debt/Equity (%)	7.0	8.0	8.1	7.7
Net debt/Equity (%)	1.5	5.4	1.7	1.5
Valuation				
PER (x)	15.3	20.3	13.8	12.6
PEG (x) - y-o-y growth	1.1	(0.8)	0.3	1.4
Price/Book (x)	4.5	4.0	3.5	3.1
Yield (%)	2.9	2.3	3.1	4.1
EV/Net sales (x)	2.7	3.3	2.1	1.9
EV/EBITDA (x)	11.6	15.1	9.8	9.0
EV/EBIT (x)	12.2	16.2	10.7	9.7

**9 months from July-15 to Mar-16*

*** Annualised numbers from April to March*

PhillipCapital

Wipro (WPRO IN)

Miles to go before …

INDIA | IT SERVICES | Company Update

18 August 2016

SELL (Maintain)

CMP RS 528

TARGET RS 480 (-9%)

COMPANY DATA

O/S SHARES (MN) :	2471
MARKET CAP (RSBN) :	1357
MARKET CAP (USDBN) :	20.3
52 - WK HI/LO (RS) :	613 / 509
LIQUIDITY 3M (USDMN) :	13.6
PAR VALUE (RS) :	2

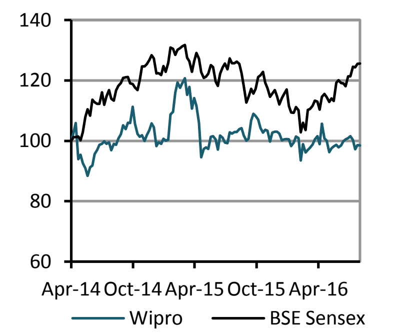
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	55.5	73.3	73.4
FII / NRI :	7.0	11.6	11.2
FI / MF :	4.2	4.6	4.4
NON PRO :	29.1	3.9	4.6
PUBLIC & OTHERS :	4.1	6.6	6.6

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-2.3	3.1	-3.5
REL TO BSE	-6.2	-8.6	-3.3

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY16	FY17E	FY18E
Net Sales	512.4	557.7	595.2
EBIDTA	111.9	110.8	122.1
Net Profit	89.0	87.2	97.7
EPS, Rs	36.2	35.4	39.6
PER, x	14.6	14.9	13.3
EV/EBIDTA, x	10.2	9.9	8.6
P/BV, x	2.8	2.5	2.2
ROE, %	19.1	16.6	16.6

Source: PhillipCapital India Research Est.

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Subpar growth despite robust deal-wins

Over the last nine quarters, Wipro has consistently disappointed in terms of its growth rate. While it reported below-industry average growth over FY12-14 too, a large part of it was due to management reshuffle. Strong deal-wins in FY15 of US$ 3bn vs. US$ 1.55bn in FY14 (*announced large deals*) led to the belief that it was finally turning the corner. However, it reported revenue growth of 7.0%/3.7% in FY15/16 despite robust deal flow, as it continued to lose a large part of its existing business to competitors. In FY17, we expect USD revenue growth of 5.7% – lowest in the top-4 bracket. We do not see the scenario changing much over the next 2-3 years, and see Wipro lagging its peers.

On an acquisition spree – but acquisitions are still in the traditional technology domains

Over the last few months, Wipro made four acquisitions at a total investment of US$ 760mn; these added US$ 370mn to its topline. It clearly seems to be retracing its 'string of pearls' strategy of early 2000, where it had embarked upon a series of acquisitions to drive growth. However, we remain concerned about this strategy as all its recent acquisitions are in the traditional technology spaces of IMS/BPO/ADM (none in the new age digital space). While companies like Infosys and MindTree are acquiring small niche companies to enhance their delivery capabilities in the digital space, Wipro continues to buy out revenues. We also view these acquisitions as an admission by the Wipro management of their inability to match industry growth organically.

1QFY17 results – lacklustre guidance, yet again

In line with Wipro's last six quarters' results, its 2QFY17 guidance also did not allay growth concerns. Its 2.2% qoq revenue growth in 1QFY17 was below peers, and we continue to expect sub-5% USD organic growth for its IT-services business in FY17 – lowest in our large-cap coverage universe. Also, its exposure to its E&U vertical (14% of revenues) is much higher than peers and will continue to keep growth under pressure in the near term.

Captures the early-mover advantage, but squanders it away

Wipro has had a history of identifying pockets of opportunities earlier than its competitors. However, it almost always squandered its first-mover advantage. It was the first company to start an IMS practice amongst Indian IT companies, but TCS and HCL have a much bigger IMS practice than Wipro now. Ditto in ERD, where the company was one of the first to explore the potential of outsourcing engineering design but its ERD division has seen 0% CAGR over the last 10 years against 17% and 16% for TCS and HCL Tech.

Another round of management reshuffle will further delay revival

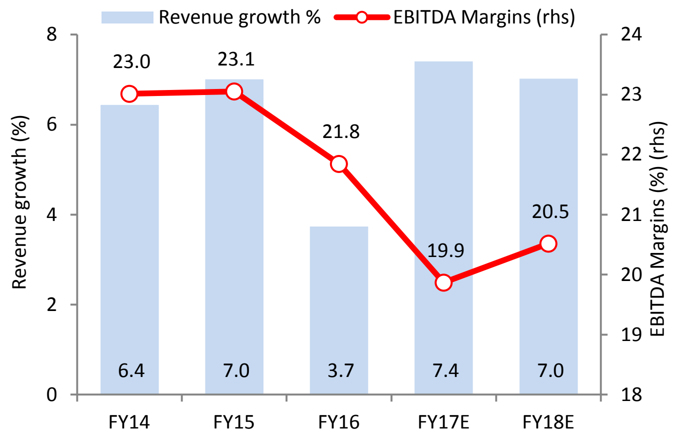
Wipro's new CEO, Abid Neemuchwala (ex-TCS), is an industry stalwart with strong credentials in terms of delivery capabilities – probably what Wipro needs the most right now. However, we fear that this appointment will lead to another round of management reshuffle, with many key personnel already quitting. While this could be positive for the long term (the current team clearly failed to deliver on expectations), it will only delay the company's turnaround process further.

No reason to trade at current levels, especially at par with HCL

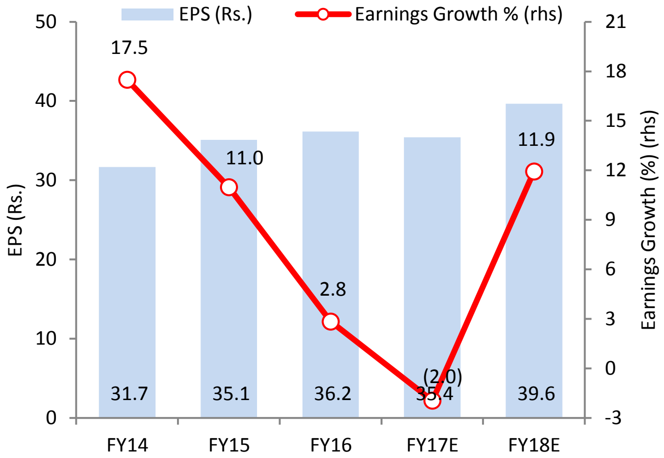
Currently, Wipro trades at 13x FY17 P/E – at a discount to TCS and Infosys, but at par with HCL Tech. Despite headwinds that HCL faces in its IMS business, its growth and returns over the next three years would be better than Wipro's. There is no reason for Wipro to trade at par with HCL Tech; so we expect the stock to de-rate from current levels.

We continue to value the stock at 12x FY18 earnings – at a discount to HCL and at par with TechM. Maintain SELL with a price target of Rs 480 (unchanged).

USD revenue growth (%) and EBITDA margins (%)

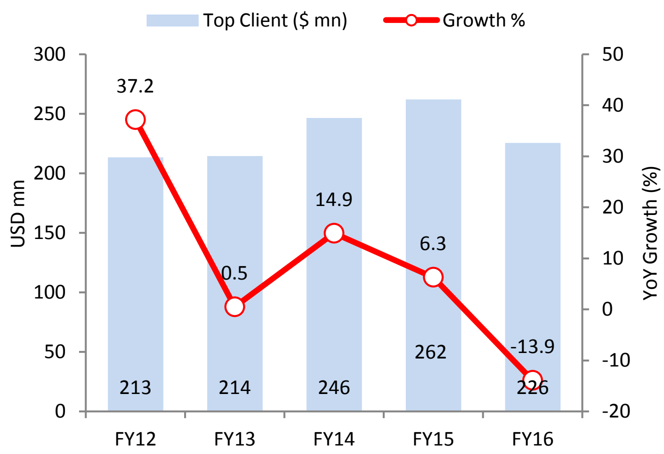


EPS (Rs) and earnings growth (%)

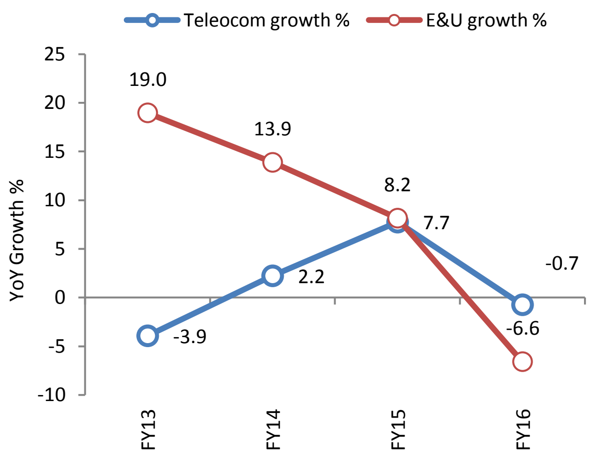


Source: Company, PhillipCapital India Research

Top client has been on a continuous declining trend



Weakness in telecom & E&U has impacted overall growth



Source: Company, PhillipCapital India Research

Wipro's major acquisition over the years

Year	Acquired Company	Business Description	Geography	Acquisition value ($ mn)	Revenue ($ mn)	EV/Sales
2016	HealthPlan Services	BPaaS provider to US healthcare market	US	460.0	223.0	2.1
2015	VITEOS *	BPaaS provider for buy side funds	US	130.0	27.0	4.8
2015	Cellent	Consulting in DACH region	Germany	78.0	92.0	0.8
2015	Designit	Design firm	Denmark	93.0	30.0	3.1
2014	ATCO I-Tek	IT Services - Logistics & Utilities*	Canada	195.0	112.0	1.7
2013	Opus CMC	High end mortgage BPO	US	75.0	43.4	1.7
2012	Promax Application	Trade Promotions Management - Data Analytics	Australia	36.0	16.0	2.3
2011	SAIC's Oil & Gas Tech	Consulting, IMS - Oil & Gas segment	US	150.0	188.0	0.8
2008	Citi Tech Services	IT Services to Citigroup*	US	127.0	83.3	1.5
2007	Infocrossing	IMS, BPO	US	600.0	232.0	2.6
2006	Enabler	Retail - Consulting, package implementation	Portugal	52.0	39.0	1.3
2005	NewLogic	Engineering solutions, IP	Austria	56.0	16.7	3.4
2002	Spectramind	BPO	India	93.0	75.0	1.2

Source: Company, PhillipCapital India Research; * called-off

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**469,545**	**512,440**	**557,747**	**595,201**
Growth, %	8.1	9.1	8.8	6.7
Employee expenses	-308,460	-341,759	-376,548	-398,427
Other Operating expenses	-52,840	-58,735	-70,388	-74,655
EBITDA (Core)	**108,245**	**111,946**	**110,811**	**122,119**
Growth, %	8.3	3.4	(1.0)	10.2
Margin, %	23.1	21.8	19.9	20.5
Depreciation	-12,823	-14,965	-17,528	-18,337
EBIT	**95,422**	**96,981**	**93,283**	**103,782**
Growth, %	6.8	1.6	(3.8)	11.3
Margin, %	20.3	18.9	16.7	17.4
Interest paid	0	0	0	0
Other Non-Operating Income	16,260	17,791	19,273	21,851
Pre-tax profit	**111,682**	**114,772**	**112,556**	**125,633**
Tax provided	-24,624	-25,297	-25,008	-27,639
Profit after tax	**87,058**	**89,475**	**87,548**	**97,994**
Others (Minorities, Associates)	-531	-492	-302	-338
Net Profit	**86,527**	**88,983**	**87,246**	**97,656**
Growth, %	11.0	2.8	(2.0)	11.9
Net Profit (adjusted)	**86,527**	**88,983**	**87,246**	**97,656**
Wtd avg shares (m)	2,466	2,461	2,463	2,463

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**7,082**	**7,346**	**7,890**	**8,444**
Growth, %	7.0	3.7	7.4	7.0
Re / US$ (rate)	62.2	66.3	67.2	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	158,940	99,049	155,429	204,908
Marketable securities at cost	53,908	204,244	197,671	197,671
Debtors	91,531	100,976	108,221	115,488
Inventory	4,849	5,390	6,833	7,291
Other current assets	127,264	94,528	106,127	113,254
Total current assets	436,492	504,187	574,281	638,613
Investments	0	0	0	0
Net fixed assets	130,215	182,784	189,267	193,830
Non-current assets	33,326	37,032	34,395	36,705
Total assets	**600,033**	**724,003**	**797,943**	**869,148**
Total current liabilities	164,029	218,561	231,483	237,746
Non-current liabilities	26,376	38,058	38,499	39,724
Total liabilities	190,405	256,619	269,982	277,470
Paid-up capital	4,937	4,941	4,941	4,941
Reserves & surplus	403,045	460,219	520,472	583,850
Minorities	1,646	2,224	2,549	2,887
Shareholders' equity	409,628	467,384	527,962	591,678
Total equity & liabilities	**600,033**	**724,003**	**797,943**	**869,148**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	111,682	114,772	112,556	125,633
Depreciation	12,823	14,965	17,528	18,337
Chg in working capital	-18,658	73,576	-4,728	-10,900
Total tax paid	-24,624	-25,297	-25,008	-27,639
Other operating activities	0	0	0	0
Cash flow from operating activities	**81,223**	**178,016**	**100,347**	**105,431**
Capital expenditure	-26,231	-67,534	-24,011	-22,900
Chg in investments	0	0	0	0
Chg in marketable securities	6,649	-150,336	6,573	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-19,582**	**-217,870**	**-17,438**	**-22,900**
Free cash flow	61,641	-39,854	82,909	82,531
Equity raised/(repaid)	7,187	4,320	3,522	0
Debt raised/(repaid)	5,414	11,682	441	1,225
Dividend (incl. tax)	-34,565	-17,273	-30,623	-34,277
Other financing activities	5,334	-18,852	108	0
Cash flow from financing activities	**-16,902**	**-20,037**	**-26,529**	**-33,052**
Net chg in cash	44,739	-59,891	56,380	49,479

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	35.1	36.2	35.4	39.6
Growth, %	10.8	3.1	(2.1)	11.9
Book NAV/share (INR)	165.4	189.0	213.3	239.0
CFPS (INR)	17.0	49.7	30.4	34.9
DPS (INR)	12.0	6.0	10.6	11.9
Return ratios				
Return on assets (%)	15.8	13.5	11.5	11.8
Return on equity (%)	21.2	19.1	16.6	16.6
Return on capital employed (%)	21.7	19.0	16.3	16.4
Turnover ratios				
Asset turnover (x)	2.1	1.9	2.0	2.0
Sales/Total assets (x)	0.9	0.8	0.7	0.7
Sales/Net FA (x)	3.8	3.3	3.0	3.1
Receivable days	71.2	71.9	70.8	70.8
Inventory days	3.8	3.8	4.5	4.5
Liquidity ratios				
Current ratio (x)	2.7	2.3	2.5	2.7
Quick ratio (x)	2.6	2.3	2.5	2.7
Dividend cover (x)	2.9	6.0	3.3	3.3
Total debt/Equity (%)	22.7	31.4	28.5	25.7
Net debt/Equity (%)	(16.3)	10.1	(1.0)	(9.1)
Valuation				
PER (x)	15.0	14.6	14.9	13.3
PEG (x) - y-o-y growth	1.4	4.8	(7.2)	1.1
Price/Book (x)	3.2	2.8	2.5	2.2
Yield (%)	2.3	1.1	2.0	2.3
EV/Net sales (x)	2.5	2.2	2.0	1.8
EV/EBITDA (x)	10.9	10.2	9.9	8.6
EV/EBIT (x)	12.4	11.8	11.8	10.1

INSTITUTIONAL EQUITY RESEARCH

Tech Mahindra (TECHM IN)

Expectation reset required

INDIA | IT SERVICES | Company Update

18 August 2016

Market clearly alluding to consensus expectation being reset

TechM's stock hasn't gone anywhere in the last eight months (YTD). At current levels, the stock trades at 11.5x FY18 P/E 'consensus' multiple. However, we believe these multiples are misleading. Despite the company reporting only 4% organic revenue growth in FY16, consensus expects 8%/11% revenue growth and 40bps/90bps margin expansion in FY17/18. We find consensus numbers highly aggressive, leading to the multiples appearing significantly lower than they ought to be. We are 4%/9% below street expectation for FY17/18; on our numbers, TechM trades at 13x FY18 P/E, not necessarily inexpensive given that its profile now resembles a large, better-managed mid-cap company.

Back to where it started

After its acquisition of Satyam, TechM saw a sharp rerating – from 10x (pre-FY13) to a peak multiple of 17x in FY15. The underlying argument was that the Satyam acquisition helped it transform from a telecom player (95% of revenues) to a diversified one, with significant scope for margin expansion. However, after its badly managed acquisition of LCC, telecom forms over 45% of its revenues and margins are down to ~15%. It now resembles a 'typical' midcap company – strong concentration of one vertical and low margins.

1QFY17 results – not much to speak of, margin concerns remain

TechM's 1QFY17 performance did not signal any turnaround in margins or in its organic growth profile. Telecom (50% of revenue) continues to remain under pressure, and with LCC business still being rationalised, growth will remain subdued. Margins continued their free-fall (down 530bps over the last seven quarters) and are likely to remain under pressure due to multiple headwinds in the coming quarters (GBP depreciation, acquisitions, salary hike). Growth in enterprise business remains the only positive aspect of TechM's performance over the last few quarters.

Deceleration in telecom leads to growth concerns gaining credence

While the enterprise business has been growing at a strong rate, telecom continues to remain weak. Even in FY16, the segment reported organic USD revenue growth of only 1.5% – largely due to a decline in top 1/5/10 clients. This casts dark shadows on its growth potential for FY17 and beyond.

We also believe that the telecom vertical has now become too big for TechM to be able to grow in double digits. The business, now at over US$ 2bn in annual revenues, has reported a CAGR of 14% over the last five years and accounts for 34% of the total telecom revenue of the top-5 Indian IT companies. With leading global telecom giants like AT&T, Verizon, and BT already under its belt, a deceleration in TechM's telecom revenues is imminent.

No clarity on margin revival, expect the LCC pain to continue

TechM management has not been able to provide any timeline about the revival of LCC and TechM's margins. After the LCC acquisition, margins fell by 500bps – to 15.2% (from 20.2%). While margins did improve to 16.9% in 3QFY16 – additional headwinds like weak Comviva business and visa costs have kept margin expansion in check thereafter (1QFY17 margins of 14.9%). With low-hanging fruits (utilisation, net employee reduction) already plucked, and multiple headwinds in the coming quarters (GBP depreciation, acquisitions, salary hike), we expect margin expansion hereafter to be a steep climb.

Outlook and valuation

We maintain our negative stance and believe that the stock will remain under pressure due to imminent consensus downgrades (which is currently at highly aggressive assumptions). We continue to value the stock at 12x FY18 P/E. Our price target of Rs 450 *(unchanged)* represents 5% downside from current levels. We maintain SELL.

SELL (Maintain)

CMP RS 474

TARGET RS 450 (-5%)

COMPANY DATA

O/S SHARES (MN) :	971
MARKET CAP (RSBN) :	488
MARKET CAP (USDBN) :	7.3
52 - WK HI/LO (RS) :	575 / 403
LIQUIDITY 3M (USDMN) :	13.3
PAR VALUE (RS) :	5

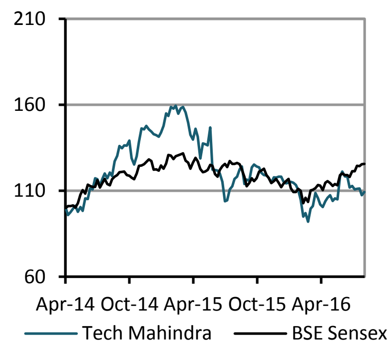
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	36.3	36.4	36.5
FII / NRI :	39.6	38.1	36.9
FI / MF :	10.8	11.1	12.0
NON PRO :	3.5	3.8	3.6
PUBLIC & OTHERS :	9.9	10.6	10.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.3	7.9	-5.0
REL TO BSE	-2.5	-3.8	-4.8

PRICE VS. SENSEX



KEY FINANCIALS

Rs bn	FY16	FY17E	FY18E
Net Sales	264.9	288.9	314.9
EBIDTA	42.9	46.2	51.7
Net Profit	30.2	30.6	33.1
EPS, Rs	35.0	34.9	37.8
PER, x	13.6	13.6	12.5
EV/EBIDTA, x	9.2	8.4	7.1
P/BV, x	2.6	2.3	2.0
ROE, %	19.1	16.9	16.3

Source: PhillipCapital India Research Est.

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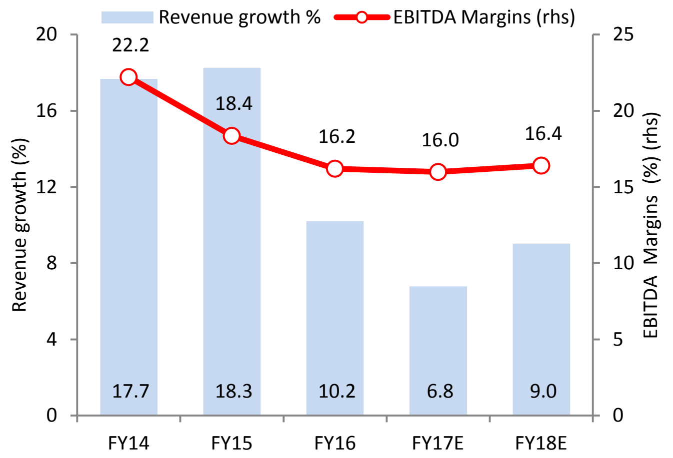
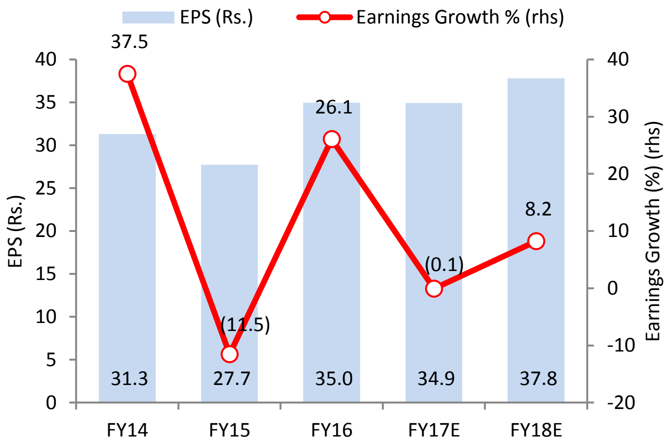
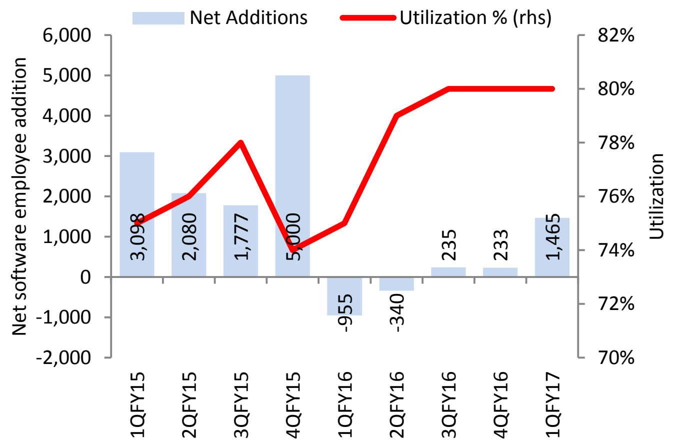
USD revenue growth (%) and EBITDA margins (%)



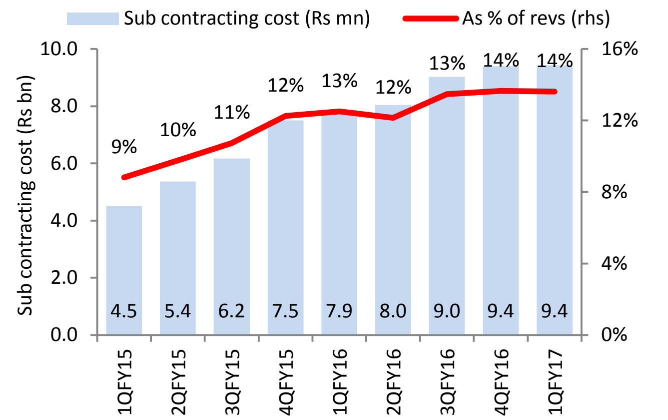
EPS (Rs) and earnings growth (%)



Utilisations have improved, on net employee reduction



Sub-contracting costs have risen sharply



TechM's major acquisition over the years

Year	Acquired Company	Business Description	Geography	Revenue ($ mn)	Acquisition value ($ mn)
2016	The Bio Agency	Digital transformation	UK	£ 12.5mn	£ 40mn
2016	Target Group	BPaaS	UK	£ 51mn	£ 112mn
2015	Pininfarina	Engineering Services	Europe	€ 80mn	€ 81.0mn
2015	Sofgen	Core Banking Solutions	Europe	45.0	30.0
2014	LCC	Engineering Services	US	430.0	240
2013	Mahindra Engineering Services	Engineering Services	India	45.0	115.1
2013	Complex IT	SAP	Brazil	60.0	25.0
2012	Comviva	VAS	MNC	70.0	48.0
2012	Hutchison Global Services	BPO	Australia	175.0	87.1
2012	vCustomer International	BPO	India	NA	27.0

TechM margins – headwinds in almost every quarter

	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17E	Q3FY17E	Q4FY17E
EBITDA Margins	20.2%	15.2%	14.4%	16.6%	16.9%	16.7%	14.9%			
Negative impact		**340**	**230**	**30**		**150**	**280**	**~50**		**~100-150**
Reasons for decline		Salary hike, LCC	Visa cost, LCC	LCC		Salary hike	Comviva, Visa cost	GBP (Brexit)		Salary hike

TechM has over 1/3rd market share in the telecom space (top-5 Indian IT)

Top-5 Telecom	FY11	FY12	FY13	FY14	FY15	FY16	CAGR
Infosys	779	715	719	687	754	781	0.1%
TCS	986	1,076	1,138	1,270	1,363	1,394	7.2%
HCL Tech	364	343	374	473	530	611	10.9%
Wipro*	892	928	892	912	984	975	1.8%
TechM	**1,120**	**1,155**	**1,206**	**1,527**	**1,919**	**2,097**	**13.4%**
Share	**27%**	**27%**	**28%**	**31%**	**35%**	**36%**	

Source: Company, PhillipCapital India Research; ** Telecom & Media*

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**226,213**	**264,942**	**288,919**	**314,904**
Growth, %	20.1	17.1	9.1	9.0
Employee expenses	-151,578	-183,257	-201,750	-221,330
Other Operating expenses	-33,107	-38,757	-40,979	-41,913
EBITDA (Core)	**41,528**	**42,928**	**46,190**	**51,661**
Growth, %	(0.7)	3.4	7.6	11.8
Margin, %	18.4	16.2	16.0	16.4
Depreciation	-6,114	-7,608	-8,133	-8,899
EBIT	**35,414**	**35,320**	**38,057**	**42,762**
Growth, %	(3.3)	(0.3)	7.7	12.4
Margin, %	15.7	13.3	13.2	13.6
Interest paid	-299	-972	-1,101	-1,102
Other Non-Operating Income	1,065	5,144	5,647	4,673
Pre-tax profit	**36,181**	**39,492**	**42,603**	**46,332**
Tax provided	-9,596	-8,880	-10,167	-11,220
Profit after tax	**26,585**	**30,613**	**32,436**	**35,112**
Others (Minorities, Associates)	-310	-386	-1,884	-2,040
Net Profit	**26,275**	**30,226**	**30,552**	**33,072**
Growth, %	(9.7)	15.0	1.1	8.2
Net Profit (adjusted)	**26,274**	**30,226**	**30,552**	**33,072**
Wtd avg shares (m)	948	865	875	875

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**3,664**	**4,037**	**4,311**	**4,700**
Growth, %	*18.3*	*10.2*	*6.8*	*9.0*
Re / US$ (rate)	61.7	65.6	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	24,049	23,897	34,607	58,623
Debtors	52,059	57,705	63,325	64,706
Inventory	245	403	396	431
Other current assets	19,404	40,180	43,536	43,138
Total current assets	127,240	141,070	161,653	188,467
Investments	21,334	28,579	31,079	33,579
Gross fixed assets	65,363	81,725	91,725	101,725
Less: Depreciation	-25,034	-32,642	-40,775	-49,674
Add: Capital WIP	5,677	0	0	0
Net fixed assets	46,006	49,083	50,950	52,051
Total assets	**198,481**	**224,054**	**249,003**	**279,419**
Current liabilities	32,813	44,762	44,219	48,511
Provisions	22,088	8,510	9,752	10,996
Total current liabilities	54,901	53,272	53,971	59,506
Non-current liabilities	7,186	10,597	10,597	10,597
Total liabilities	62,087	63,869	64,568	70,103
Paid-up capital	4,804	4,355	4,355	4,355
Reserves & surplus	129,989	153,894	176,260	199,100
Minorities	1,601	1,936	3,820	5,861
Shareholders' equity	136,394	160,185	184,436	209,316
Total equity & liabilities	**198,481**	**224,054**	**249,003**	**279,419**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	36,181	39,492	42,603	46,332
Depreciation	6,114	7,608	8,133	8,899
Chg in working capital	-27,559	-1,897	-10,415	1,493
Total tax paid	-4,386	-23,879	-8,925	-9,976
Other operating activities	-1	0	0	0
Cash flow from operating activities	**10,349**	**21,325**	**31,396**	**46,748**
Capital expenditure	-23,514	-10,685	-10,000	-10,000
Chg in investments	-6,405	-7,245	-2,500	-2,500
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-29,919**	**-17,930**	**-12,500**	**-12,500**
Free cash flow	-19,570	3,395	18,896	34,248
Equity raised/(repaid)	2,457	-452	0	0
Debt raised/(repaid)	6,222	3,275	0	0
Dividend (incl. tax)	-6,654	-12,141	-8,186	-10,232
Other financing activities	8,591	5,823	0	0
Cash flow from financing activities	**10,470**	**-3,547**	**-8,186**	**-10,232**
Net chg in cash	-9,100	-152	10,710	24,016

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	27.7	35.0	34.9	37.8
Growth, %	(11.5)	26.1	(0.1)	8.2
Book NAV/share (INR)	142.2	183.0	206.5	232.6
CFPS (INR)	9.8	18.7	29.4	48.1
DPS (INR)	6.0	12.0	8.0	10.0
Return ratios				
Return on assets (%)	15.0	14.8	14.0	13.6
Return on equity (%)	19.5	19.1	16.9	16.3
Return on capital employed (%)	21.1	19.9	18.1	17.3
Turnover ratios				
Asset turnover (x)	2.4	2.2	2.3	2.4
Sales/Total assets (x)	1.3	1.3	1.2	1.2
Sales/Net FA (x)	6.1	5.6	5.8	6.1
Working capital/Sales (x)	0.2	0.2	0.3	0.2
Receivable days	84.0	79.5	80.0	75.0
Liquidity ratios				
Current ratio (x)	2.3	2.6	3.0	3.2
Quick ratio (x)	2.3	2.6	3.0	3.2
Dividend cover (x)	4.6	2.9	4.4	3.8
Total debt/Equity (x)	0.1	0.1	0.1	0.0
Net debt/Equity (x)	(0.1)	(0.1)	(0.1)	(0.2)
Valuation				
PER (x)	17.1	13.6	13.6	12.5
PEG (x) - y-o-y growth	(1.5)	0.5	(250.4)	1.5
Price/Book (x)	3.3	2.6	2.3	2.0
Yield (%)	1.3	2.5	1.7	2.1
EV/Net sales (x)	1.9	1.5	1.3	1.2
EV/EBITDA (x)	10.4	9.2	8.4	7.1
EV/EBIT (x)	12.2	11.2	10.2	8.6

PhillipCapital

MindTree (MTCL IN)

Strong growth profile, but expensive valuations

INDIA | IT SERVICES | Company Update

18 August 2016

One of the fastest growing IT services companies; growth-oriented business mix

MTCL delivered a strong 13% CAGR over FY12-16 as its 'back-to-basics' strategy yielded results. In FY16, it reported USD revenue growth of 22.5% (15.4% in organic terms, 18.6% organic CC) – highest in the listed IT services space. The company has the right mix of emerging businesses – digital (38%) and ER&D (20%). Specialisation in chosen verticals and deep account mining led the growth. We expect continued improvement in its wallet-share in top accounts and revenue CAGR of 15% over FY16-18 — highest in our coverage universe.

Focused acquisition strategy

MTCL management maintains 'focused-acquisition' as one of the pillars of its growth strategy. It has set up an M&A team under Mr Rahul Malhotra, who joined MindTree in February 2015 from Tech Mahindra (where he looked after M&A). MTCL's goal is for inorganic revenues to constitute 10% of its revenue by 2020. Acquisitions will be largely to strengthen its digital business and to gain access to large clients. Its recent acquisition of Discoverture, Bluefin, and Relational Solutions are in all in the digital space to enhance delivery capabilities.

1QFY17 results allude to multiple headwinds on both growth and margins front

MTCL missed revenue and margin expectations in 1QFY17 – its grew 2.1% (vs. 2.8% estimate) and its margins fell by 200bps (vs. a foreseen 25bps fall). The management attributed these misses to a revenue decline in Bluefin Solutions (acquired last year). While it expects the entity to be back on the growth path from Q2FY17, it sees margins to be impacted (~200bps) due to salary hikes. For FY17, the management commentary lacked visibility on both revenue and margins. It 'indirectly' lowered its FY17 revenue guidance to 'beating NASSCOM's guidance' from its earlier guidance of 'beating NASSCOM's guidance organically' – leading to the reported USD growth expectations falling to 15% from 18%. On the margins front, it expects to maintain FY16 margins (17.6%) in FY17 – which would translate into 20.5% margins in H2FY17 – an almost impossible feat in our opinion.

Management churn: Big concern

In the last few quarters, MTCL has seen multiple top-level exits that have resulted in organisational restructuring. These can have an impact on near-term performance due to transition impact on client mining and loss of management bandwidth. Historically, MTCL has had a very unstable management with multiple restructuring exercises over the last five years.

Outlook and valuations – good franchise, expensive valuations

MindTree's 1QFY17 result, and more importantly the management commentary, alludes to significant headwinds – both for growth and margins. While the company might still end up reporting the highest revenue growth in the listed IT services space in FY17, the margin contraction will ensure muted earnings growth. With FY18 earnings growth highly dependent on margin expansion (unlikely for the entire sector), we expect valuations, which have remained rich as compared to peers, to come under pressure.

While we still expect MTCL to report revenue CAGR of 17% over FY15-18 (highest in our coverage universe), earnings CAGR will remain muted due to pressure on margins. With single-digit earnings growth over next two years, we expect current (expensive) valuations (13x FY18 P/E vs. 14x for Infosys and 13x for HCL/Wipro) to be tested. We value MTCL at 14x FY18 EPS (at par with HCL, highest in our mid-cap universe) – signifying limited upside potential. But with the strongest growth profile in the industry, we don't expect much downside either. We maintain NEUTRAL.

NEUTRAL (Maintain)

CMP RS 570

TARGET RS 600 (+5%)

COMPANY DATA

O/S SHARES (MN) :	168
MARKET CAP (RSBN) :	103
MARKET CAP (USDBN) :	1.5
52 - WK HI/LO (RS) :	804 / 549
LIQUIDITY 3M (USDMN) :	5.1
PAR VALUE (RS) :	10

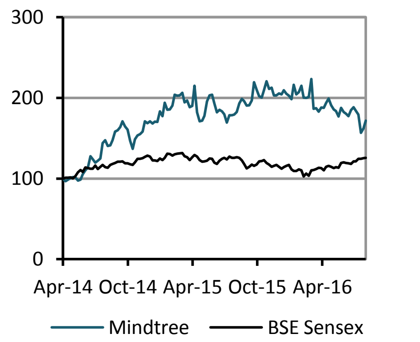
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	13.7	13.8	13.8
FII / NRI :	40.9	41.8	44.3
FI / MF :	7.2	6.3	6.8
NON PRO :	10.5	11.0	28.6
PUBLIC & OTHERS :	27.7	27.2	6.5

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-5.9	-6.8	-5.1
REL TO BSE	-9.8	-18.5	-4.9

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	46,730	55,277	63,151
EBIDTA	8,210	8,944	10,601
Net Profit	5,525	5,959	7,183
EPS, Rs	32.9	35.5	42.9
PER, x	17.3	16.0	13.3
EV/EBIDTA, x	11.4	10.3	8.4
P/BV, x	4.0	3.4	2.9
ROE, %	22.9	21.1	21.6

Source: PhillipCapital India Research Est.

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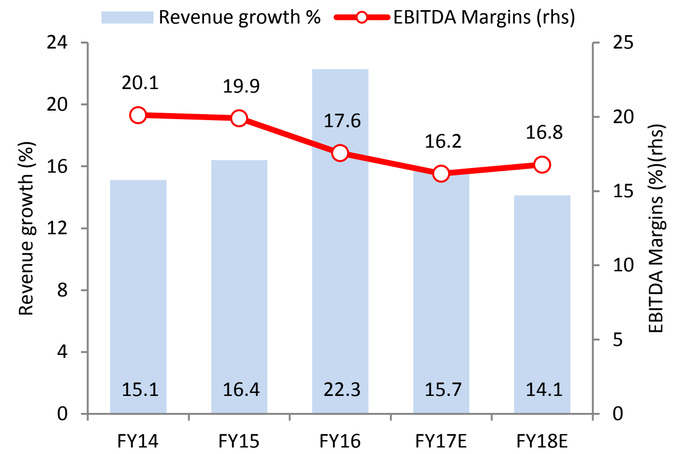
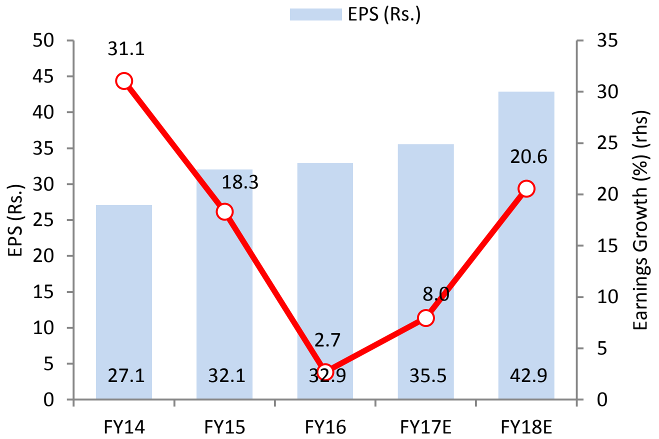
USD revenue growth (%) and EBITDA margins (%)



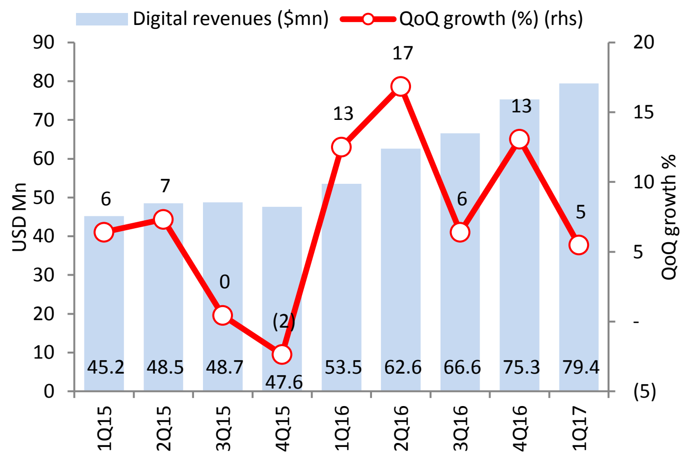
EPS (Rs) and earnings growth (%)



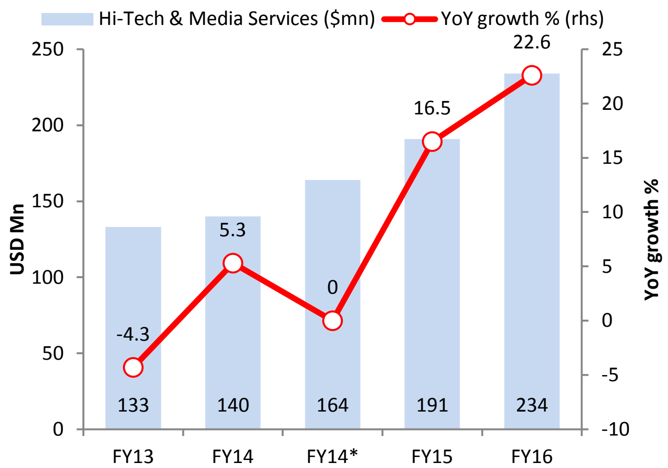
MTCL's acquisition history

Company	Space	Year	Revenue (US$)	Price(US$ mn)	Employees	Multiple
Magnet 360	Salesforce platform partner	2016	25	50	NA	2.0
Relational Solutions Inc	IT solutions — CPG	2015	3	10	NA	3.3
Bluefin Solutions Limited	IT solutions, SAP HANA solutions	2015	48	64	NA	1.3
Discoverture Solutions LLC	Property and Casualty Insurance	2015	NA	15	300	NA
7Strata	Remote infrastructure management services	2010	NA	7.2	90	NA
Kyocera Wireless India Pvt Ltd	Wireless services.	2009	NA	6.2	600	NA
Aztecsoft	Product engineering and Testing services company	2008	6.3	40	2200	NA
TES-Purple Vision	Electronics(IC Design).	2007	4.5-5	6.5	150	1.4

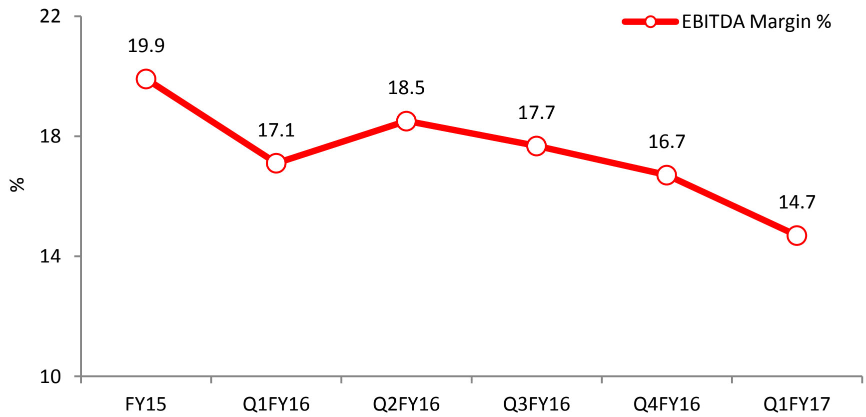
Digital revenues picking up momentum



Hi Tech revenues



Continuously declining margins have been a major concern



Source: Company, PhillipCapital India Research *(*FY14 is post-merger of hi-tech and media services)*

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**35,619**	**46,730**	**55,277**	**63,151**
Growth, %	17.5	31.2	18.3	14.2
Other Operating income	0	0	0	0
Total income	35,619	46,730	55,277	63,151
Employee expenses	-20,744	-27,991	-34,344	-38,972
SG&A	-7,783	-10,529	-11,989	-13,577
EBITDA (Core)	**7,092**	**8,210**	**8,944**	**10,601**
Growth, %	16.3	15.8	8.9	18.5
Margin, %	19.9	17.6	16.2	16.8
Depreciation	-1,018	-1,658	-1,923	-2,135
EBIT	**6,074**	**6,552**	**7,021**	**8,466**
Growth, %	14.8	7.9	7.2	20.6
Margin, %	17.1	14.0	12.7	13.4
Other Non-Operating Income	834	839	870	947
Pre-tax profit	**6,908**	**7,231**	**7,687**	**9,209**
Tax provided	-1,545	-1,706	-1,728	-2,026
Profit after tax	**5,363**	**5,525**	**5,959**	**7,183**
Net Profit	**5,363**	**5,525**	**5,959**	**7,183**
Growth, %	19.0	3.0	7.9	20.5
Net Profit (adjusted)	**5,363**	**5,525**	**5,959**	**7,183**
Unadj. shares (m)	168	168	168	168
Wtd avg shares (m)	167	168	168	168

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**584**	**714**	**826**	**943**
Growth, %	16.4	22.3	15.7	14.1
Re / US$ (rate)	61.0	65.4	66.9	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	3,763	2,332	3,490	6,621
Debtors	6,963	9,728	11,220	13,076
Loans & advances	3,091	3,643	3,633	3,633
Other current assets	1,006	1,149	1,202	1,362
Total current assets	14,823	16,852	19,546	24,692
Investments	5,351	2,328	3,166	3,166
Gross fixed assets	5,555	11,620	11,684	12,484
Add: Capital WIP	354	232	345	345
Net fixed assets	5,909	11,852	12,029	12,829
Non-current assets	17	1,331	1,432	1,432
Total assets	**26,549**	**32,769**	**36,647**	**42,593**
Current liabilities	4,019	6,475	5,266	5,966
Provisions	2,045	1,289	2,484	2,692
Total current liabilities	6,064	7,764	7,749	8,658
Non-current liabilities	357	856	626	626
Total liabilities	6,421	8,620	8,375	9,284
Paid-up capital	837	1,678	1,678	1,678
Reserves & surplus	19,291	22,471	26,594	31,631
Shareholders' equity	20,128	24,149	28,272	33,309
Total equity & liabilities	**26,549**	**32,769**	**36,647**	**42,593**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	6,908	7,231	7,687	9,209
Depreciation	1,018	1,658	1,923	2,135
Chg in working capital	428	-1,814	-3,072	-1,315
Total tax paid	-1,121	-2,419	-601	-1,817
Cash flow from operating activities	**7,233**	**4,656**	**5,937**	**8,212**
Capital expenditure	-2,995	-7,601	-2,100	-2,935
Chg in investments	-2	3,023	-838	0
Cash flow from investing activities	**-2,997**	**-4,578**	**-2,938**	**-2,935**
Free cash flow	4,236	78	2,999	5,276
Equity raised/(repaid)	13	541	-81	0
Debt raised/(repaid)	-4	-5	-4	0
Dividend (incl. tax)	-1,657	-2,045	-1,756	-2,146
Cash flow from financing activities	**-1,648**	**-1,509**	**-1,841**	**-2,146**
Net chg in cash	2,588	-1,431	1,158	3,131

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	32.1	32.9	35.5	42.9
Growth, %	18.3	2.7	8.0	20.6
Book NAV/share (INR)	120.3	143.9	168.6	198.7
FDEPS (INR)	31.9	32.9	35.5	42.7
CEPS (INR)	38.2	42.8	47.0	55.6
CFPS (INR)	32.1	28.1	33.3	43.3
DPS (INR)	8.5	10.5	9.0	11.0
Return ratios				
Return on assets (%)	22.6	19.0	17.5	18.4
Return on equity (%)	26.6	22.9	21.1	21.6
Return on capital employed (%)	28.9	24.7	22.6	23.3
Turnover ratios				
Asset turnover (x)	3.1	2.9	2.7	2.7
Sales/Total assets (x)	1.5	1.6	1.6	1.6
Sales/Net FA (x)	7.2	5.3	4.6	5.1
Working capital/Sales (x)	0.1	0.1	0.2	0.1
Receivable days	71.4	76.0	74.1	75.6
Payable days	15.7	17.9	15.0	15.0
Working capital days	51.2	52.8	54.8	54.4
Liquidity ratios				
Current ratio (x)	2.4	2.2	2.5	2.9
Quick ratio (x)	2.4	2.2	2.5	2.9
Dividend cover (x)	3.8	3.1	3.9	3.9
Total debt/Equity (%)	0.1	1.8	0.0	0.0
Net debt/Equity (%)	(18.6)	(7.9)	(12.3)	(19.8)
Valuation				
PER (x)	17.8	17.3	16.0	13.3
PEG (x) - y-o-y growth	1.0	6.4	2.0	0.6
Price/Book (x)	4.7	4.0	3.4	2.9
Yield (%)	1.5	1.8	1.6	1.9
EV/Net sales (x)	2.6	2.0	1.7	1.4
EV/EBITDA (x)	13.0	11.4	10.3	8.4

NIIT Tech (NITEC IN)

COO exit elongates the turnaround process

INDIA | IT SERVICES | Company Update

18 August 2016

BUY (Maintain)
CMP RS 408
TARGET RS 510 (+25%)

COMPANY DATA

O/S SHARES (MN) :	61
MARKET CAP (RSBN) :	26
MARKET CAP (USDBN) :	0.4
52 - WK HI/LO (RS) :	631 / 405
LIQUIDITY 3M (USDMN) :	3.3
PAR VALUE (RS) :	10

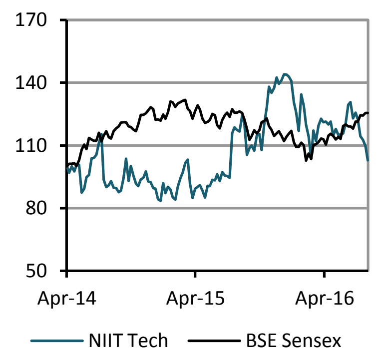
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	30.8	30.8	30.8
FII / NRI :	32.7	31.8	35.6
FI / MF :	20.2	21.5	21.7
NON PRO :	6.3	4.3	4.0
PUBLIC & OTHERS :	10.0	11.6	7.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-16.1	-13.5	-11.9
REL TO BSE	-20.0	-25.2	-11.7

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	26,850	28,739	31,501
EBIDTA	4,705	4,767	5,344
Net Profit	2,743	2,811	3,150
EPS, Rs	44.9	46.0	51.5
PER, x	9.1	8.9	7.9
EV/EBIDTA, x	4.1	4.1	3.3
P/BV, x	0.7	0.7	0.6
ROE, %	17.2	16.0	15.9

Source: PhillipCapital India Research Est.

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The exit of COO Sudhir Chaturvedi – a significant negative

In a recent development, NITEC's COO Mr Sudhir Chaturvedi resigned to pursue other interests. Mr Chaturvedi had joined NITEC in August 2013 from Infosys and was chiefly responsible for the company's turnaround over the last three years. After joining, he had laid out a strategy of: (1) cross-selling IMS, (2) expanding the BFSI business in the US, (3) securing a leadership position in the transport vertical, and (4) reducing the low-margin government business. The strategy was executed to perfection; over FY13-16, IMS grew 55%, US' contribution increased to 45% from 37%, and government business contribution reduced to 2% from 11%.

We see Mr Chaturvedi leaving as a big setback. The post of COO was created specifically for Mr. Chaturvedi, to groom him as the next CEO. With him leaving, the company will probably look to hire someone directly for the CEO post, or perhaps, create an interim post – elongating the turnaround process. Scepticism is also likely to surround the terms of engagement of his successor, and whether he/she is given enough rope.

Basic framework in place; strong growth likely from FY18

While Mr Chaturvedi's exit is a big blow, the fruits of his strategy are there to stay. The company has significantly rationalised its portfolio over the last two years, exiting the low-margin government business and focussing on the high-margin onsite business, which resulted in hardware revenue reducing to an annual rate of Rs 380mn in FY16 from Rs 730mn in FY13. Rationalisation is now complete and the current order book of US$ 300mn consists of largely high-margin onsite revenue. While FY17 revenue might still be tepid because of a weak 1QFY17 and lower government business, strong revenue growth in FY18 and beyond is possible based on the current order book – this would provide levers for margin expansion.

1QFY17 results: Tepid performance following soft H2FY16

NITEC reported a rather disappointing 1QFY17. While topline fell 0.6% qoq (in line with expectations), margins declined by 300bps (much more than anticipated) primarily due to salary hike and reduction in GIS/NITL businesses. Fresh order bookings fell to US$ 101mn (from US$ 120mn in Q4FY16) leading to a flat executable order book. Lower bookings and declining government business will translate into muted topline growth in FY17. On the margins front, the decline in 1QFY17 coupled with the impact of GBP depreciation in next quarter is likely to lead to a yoy fall in margins in FY17, which would translate into flat earnings – thereby shifting the entire onus of earnings growth on to FY18.

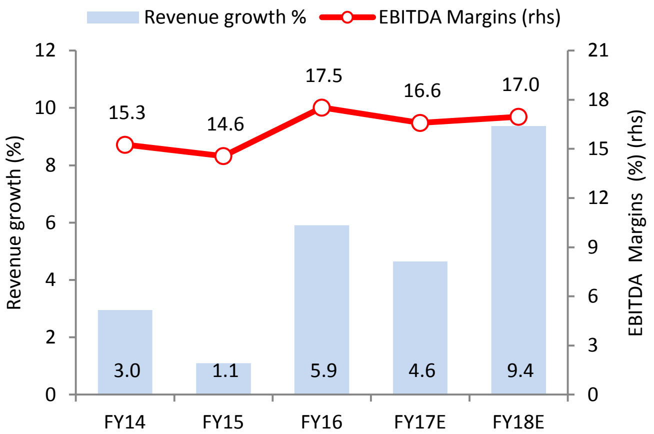
Outlook and valuations – lower visibility, attractive valuations

NITEC's strategy for FY16 (to increase its digital presence with clients and up its BFSI presence in the US) has played out along expected lines. However, a weak 1QFY17 (after a soft H2FY16) adds to concerns of lower order bookings impacting revenue growth. With margins likely to remain under pressure, near-term earnings visibility remains extremely low. The COO's exit also reduces the medium/long-term visibility.

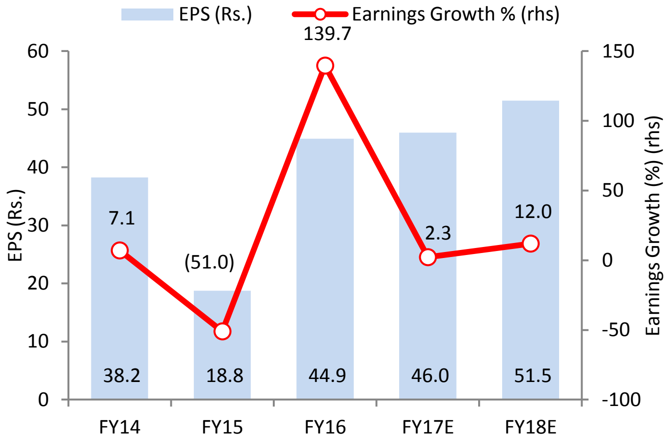
However, the ramp-up in the US business and winding-down of the government business implies strong growth prospects for FY18. Currently, the stock trades at a highly attractive valuation of 8x FY18 P/E – much lower than other midcaps (Hexaware, eClerx, MindTree, Persistent) and even KPIT. We reiterate our positive stance on the company and maintain it as our top pick in the IT midcap space.

We continue to value the company at 10x FY18 P/E (lower multiple to factor in prevailing macro and company-specific headwinds). We maintain BUY on attractive valuations.

USD revenue growth (%) and EBITDA margins (%)

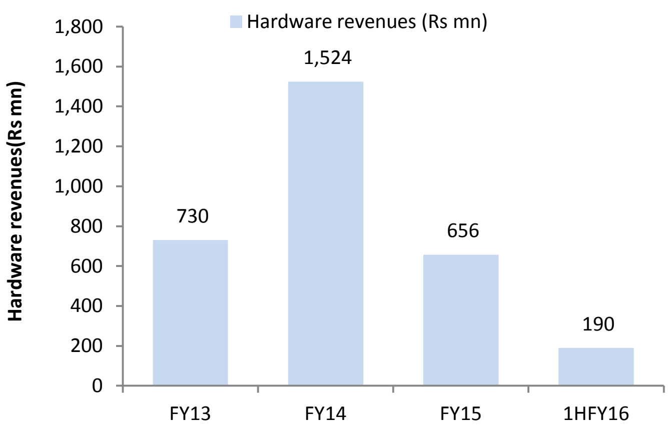


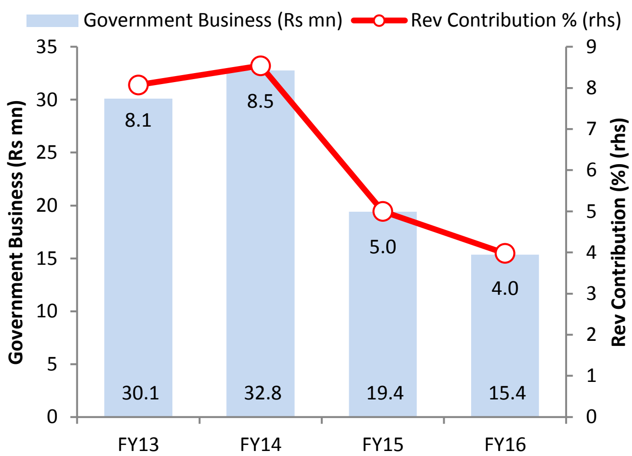
EPS (Rs) and earnings growth (%)



Source: Company, PhillipCapital India Research

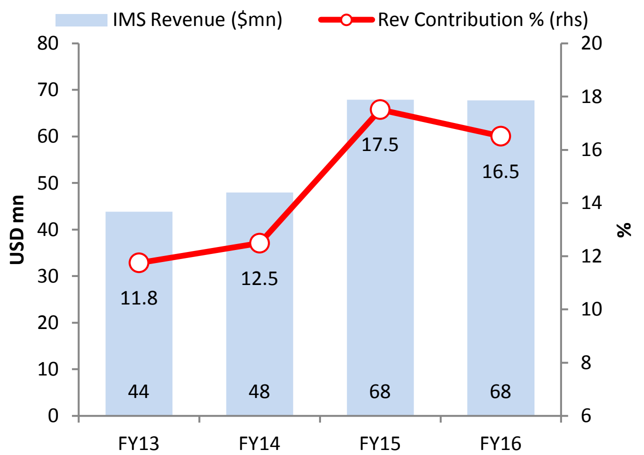
Declining revenues from hardware and government business – as per NITEC's strategy

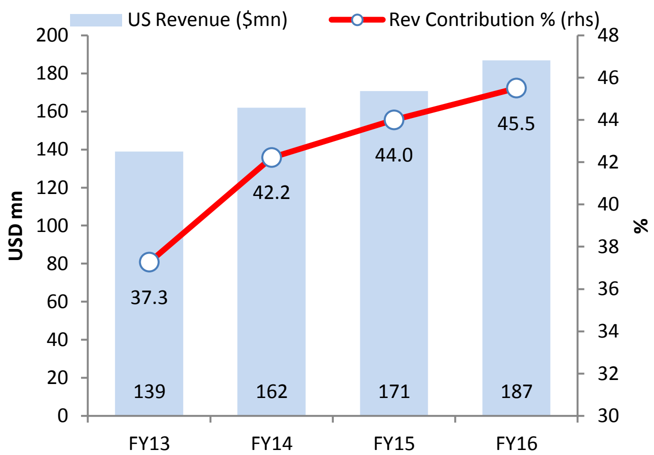




Source: Company, PhillipCapital India Research

Growing contribution from US and IMS – as per NITEC's strategy





Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**23,724**	**26,850**	**28,739**	**31,501**
Growth, %	2.9	13.2	7.0	9.6
Employee expenses	-15,656	-16,950	-18,205	-19,918
Other Operating expenses	-4,612	-5,195	-5,766	-6,239
EBITDA (Core)	**3,456**	**4,705**	**4,767**	**5,344**
Growth, %	-1.7	36.1	1.3	12.1
Margin, %	14.6	17.5	16.6	17.0
Depreciation	-916	-1,158	-1,286	-1,320
EBIT	**2,540**	**3,547**	**3,482**	**4,024**
Growth, %	(12.3)	39.6	(1.8)	15.6
Margin, %	10.7	13.2	12.1	12.8
Interest paid	0	0	0	0
Other Non-Operating Income	-781	198	244	273
Exceptional Item	0	0	-361	0
Pre-tax profit	**1,759**	**3,745**	**3,364**	**4,297**
Tax provided	-541	-833	-730	-945
Profit after tax	**1,218**	**2,912**	**2,635**	**3,351**
Others (Minorities, Associates)	-79	-169	-184	-201
Net Profit	**1,139**	**2,743**	**2,450**	**3,150**
Growth, %	(50.6)	140.8	2.5	12.1
Net Profit (adjusted)	**1,139**	**2,743**	**2,811**	**3,150**
Wtd avg shares (m)	61	61	61	61

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**388**	**411**	**430**	**470**
Growth, %	1.1	5.9	4.6	9.4
Re / US$ (rate)	61.2	65.4	66.9	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	3,185	5,660	5,553	7,232
Marketable securities at cost	0	0	0	0
Debtors	6,060	5,901	7,086	7,767
Inventory	52	52	52	52
Other current assets	1,717	1,988	2,026	2,152
Total current assets	12,410	15,280	16,576	19,315
Investments	551	2,301	2,301	2,301
Net fixed assets	6,421	4,652	4,837	5,117
Non-current assets	0	0	0	0
Total assets	**19,768**	**22,492**	**24,088**	**27,107**
Total current liabilities	5,921	5,837	5,648	6,163
Non-current liabilities	84	102	88	99
Total liabilities	6,005	5,939	5,736	6,262
Paid-up capital	610	612	612	612
Reserves & surplus	12,964	15,296	16,911	19,202
Minorities	189	645	829	1,030
Shareholders' equity	13,763	16,553	18,352	20,844
Total equity & liabilities	**19,768**	**22,492**	**24,088**	**27,107**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	1,759	3,745	3,364	4,297
Depreciation	916	1,158	1,286	1,320
Chg in working capital	1,407	-479	-1,592	-544
Total tax paid	-704	-706	-845	-945
Other operating activities	0	0	361	0
Cash flow from operating activities	**3,378**	**3,718**	**2,574**	**4,127**
Capital expenditure	-1,517	611	-1,471	-1,600
Chg in investments	0	-1,750	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,517**	**-1,139**	**-1,471**	**-1,600**
Free cash flow	1,861	2,579	1,103	2,527
Equity raised/(repaid)	3	2	0	0
Debt raised/(repaid)	-5	18	-14	11
Dividend (incl. tax)	-678	-716	-788	-788
Other financing activities	-129	305	-409	-72
Cash flow from financing activities	**-888**	**-104**	**-1,211**	**-848**
Net chg in cash	973	2,475	-108	1,679

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	18.8	44.9	46.0	51.5
Growth, %	(51.0)	139.7	2.3	12.0
Book NAV/share (INR)	223.5	260.6	286.5	323.8
CFPS (INR)	68.5	57.7	32.2	63.0
DPS (INR)	9.5	10.0	11.0	11.0
Return ratios				
Return on assets (%)	6.4	13.8	11.3	13.1
Return on equity (%)	8.4	17.2	16.0	15.9
Return on capital employed (%)	8.1	17.4	13.9	15.8
Turnover ratios				
Asset turnover (x)	2.1	2.5	2.7	2.6
Sales/Total assets (x)	1.3	1.3	1.2	1.2
Sales/Net FA (x)	3.9	4.8	6.1	6.3
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	93.2	80.2	90.0	90.0
Liquidity ratios				
Current ratio (x)	2.8	3.5	3.9	4.2
Quick ratio (x)	2.8	3.5	3.9	4.2
Dividend cover (x)	2.0	4.5	4.2	4.7
Total debt/Equity (%)	0.6	0.6	0.5	0.5
Net debt/Equity (%)	(22.8)	(34.9)	(31.2)	(36.0)
Valuation				
PER (x)	21.8	9.1	8.9	7.9
PEG (x) - y-o-y growth	(0.4)	0.1	3.9	0.7
Price/Book (x)	1.8	1.6	1.4	1.3
Yield (%)	2.3	2.5	2.7	2.7
EV/Net sales (x)	0.9	0.7	0.7	0.6
EV/EBITDA (x)	6.3	4.1	4.1	3.3
EV/EBIT (x)	8.6	5.5	5.6	4.4

PhillipCapital

KPIT (KPIT IN)

Wrong place, wrong time!

INDIA | IT SERVICES | Company Update

18 August 2016

Doesn't seem to be able to grow organically; inorganic route leads to cash flow issues

KPIT reported strong growth of 31% over FY10-14, because of acquisitions. The company spent US$ 107mn over the period to acquire five companies. While the inorganic strategy helped meet guidance and achieve scale, it also led to negative FCF of Rs 848mn over the last five years.

Over FY14-16, as the acquisitions dried up, the growth too fled; it reported muted topline/earnings CAGR of 5%/7% over FY14-16 – missing its guidance for two consecutive years. Growth tepidness was primarily due to (1) leakages in its top-10 clients, (2) delay in its ERP business revival, and (3) cost overruns. We expect growth to remain tepid as revival in ERP, wallet share gains in its largest client (Cummins) and growth in its automotive business are long drawn out processes.

ERP business – lack of management foresight

KPIT's ERP business is a perfect example of being at the wrong place at the wrong time. While the world was moving to SAP HANA platform, KPIT acquired Sparta Consulting – a company with capabilities in the older SAP version, which was slowly becoming obsolete. This led to significant revenue loss and 11% margin decline in the vertical in FY14. At the same time, training employees on the new version meant margin erosion (down to 10.9% from 16.9%), leading to a double whammy for earnings.

Few quarters later, just when the SAP division was showing signs of a turnaround, its Oracle (JD Edwards) business suffered from migration to cloud platforms – precisely what had impacted the SAP business four quarters back. That KPIT's management failed to prevent this, even after the SAP debacle, points to a lack of foresight and management inability in anticipating the industry's trends. We fear that a revival in its ERP business hereafter will be slow. We see KPIT as the first causality of a shift in technology to cloud from on-premise.

1QFY17 results – volatile performance continues

KPIT reported muted performance for Q1FY17, after the profit warning issued before the results. USD revenue declined 3.5% qoq and margins contracted 507bps to 10.7%. Its top client (Cummins) continued to decline (-11.4% qoq), while its mainstay, the automotive division also reported a significant decline (-4.8% qoq). With continued weakness in its key service offerings (Oracle, SAP), the management indicated flat Q2FY17 revenue growth (and margins) and sees a return to higher growth only in H2FY17.

Business requires significant rebuilding

We expect the road to revival for KPIT to be long-drawn from here – especially when the only growth engine that appears to be working is the automotive division (ignoring the high quarterly volatility) – which has been KPIT's mainstay. The impact of a poor 1QFY17 will mean that the company will need to deliver CQGR of 3.8% in 2HFY17 – if it were to match its FY16 topline of US$ 490mn – a big ask in our opinion. This would also mean that KPIT will end up reporting zero revenue growth over the last three years. Margins are also likely to remain under pressure – leaving little scope for rerating.

Outlook and Valuation

At current levels, the stock is trading at 9x FY17 P/E – expensive in our opinion, considering the inferior returns (ROE of 15%) and continuous problems in ERP. Also, we are 12% below consensus on FY17/18 PAT estimates – with the street STILL baking in high level of optimism in numbers. We expect significant downgrade to consensus estimates through the year. We continue to value the stock at 9x FY18 P/E – lowest in our midcap coverage universe based on a weak cash-conversion cycle and profitability. We maintain SELL.

SELL (Maintain)

CMP RS 126

TARGET RS 120 (-5%)

COMPANY DATA

O/S SHARES (MN) :	197
MARKET CAP (RSBN) :	26
MARKET CAP (USDBN) :	0.4
52 - WK HI/LO (RS) :	197 / 98
LIQUIDITY 3M (USDMN) :	3.3
PAR VALUE (RS) :	2

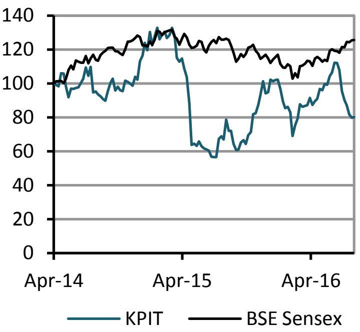
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	16.7	16.8	17.3
FII / NRI :	52.7	49.9	48.1
FI / MF :	1.5	1.7	1.9
NON PRO :	13.0	16.1	11.4
PUBLIC & OTHERS :	16.1	15.5	16.3

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-11.4	-16.6	1.6
REL TO BSE	-15.3	-28.3	1.8

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	32,256	32,619	34,935
EBIDTA	4,346	3,879	4,388
Net Profit	2,846	2,343	2,692
EPS, Rs	14.2	11.7	13.4
PER, x	8.3	10.3	9.0
EV/EBIDTA, x	5.4	6.0	5.0
P/BV, x	1.7	1.5	1.3
ROE, %	20.6	14.6	14.5

Source: PhillipCapital India Research Est.

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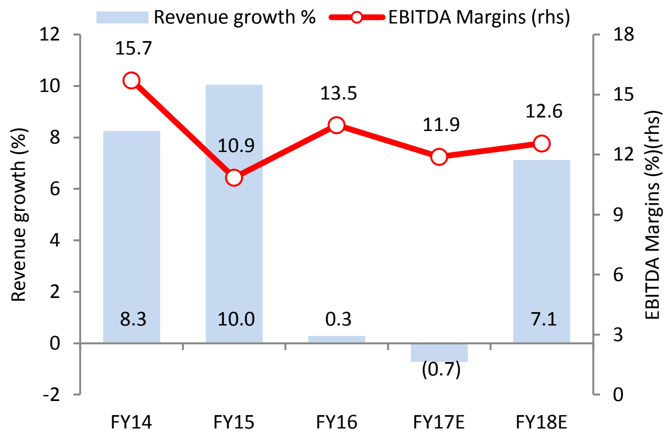
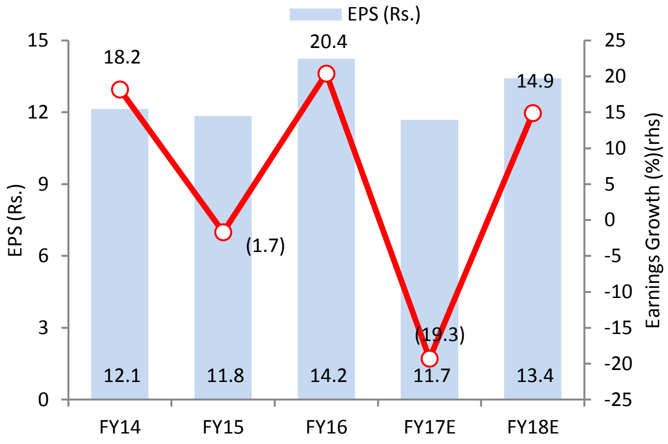
USD revenue growth (%) and EBITDA margins (%)

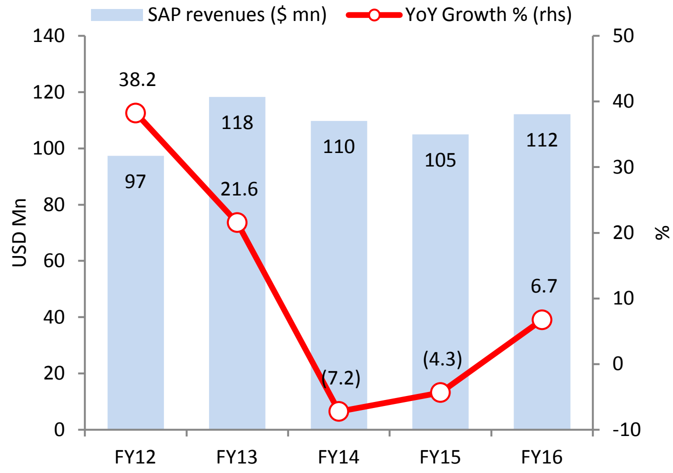


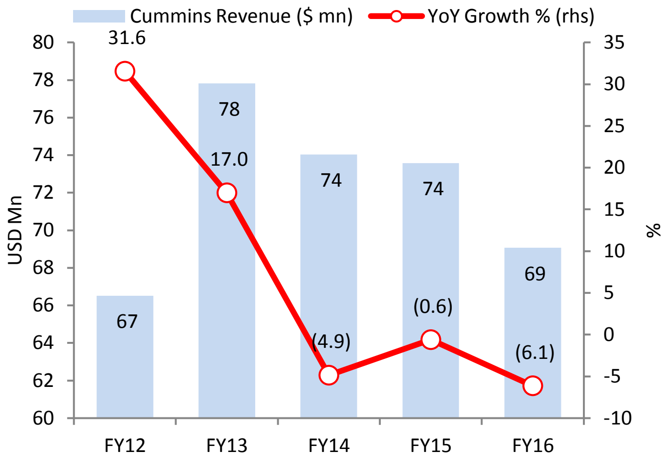
EPS (Rs) and earnings growth (%)



Source: Company, PhillipCapital India Research

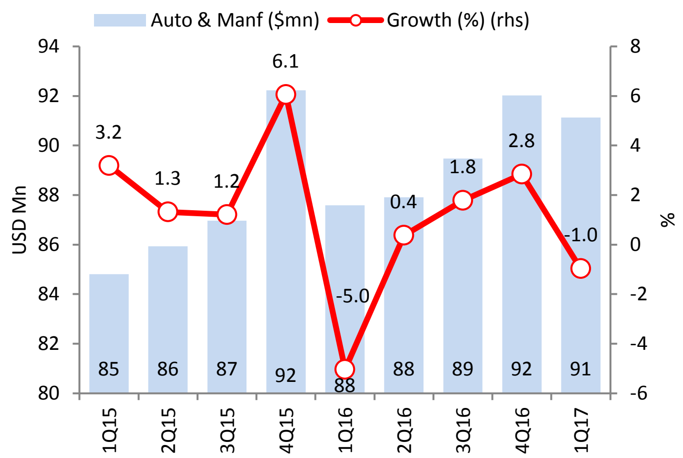
Declining revenue trends from SAP business and top client (Cummins)



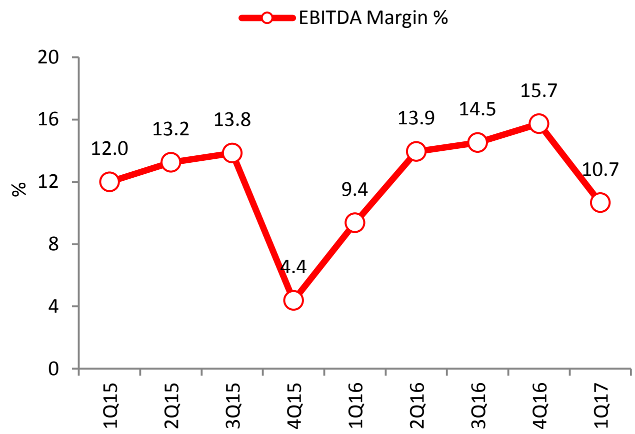


Source: Company, PhillipCapital India Research

Growth in Auto and Manufacturing has also been volatile



Margins have been extremely volatile



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**29,899**	**32,256**	**32,619**	**34,935**
Growth, %	11.0	7.9	1.1	7.1
Employee expenses	-22,442	-23,317	-24,505	-26,033
Other Operating expenses	-4,213	-4,593	-4,235	-4,514
EBITDA (Core)	**3,244**	**4,346**	**3,879**	**4,388**
Growth, %	(23.4)	34.0	(10.7)	13.1
Margin, %	10.9	13.5	11.9	12.6
Depreciation	-851	-691	-757	-799
EBIT	**2,393**	**3,655**	**3,122**	**3,588**
Growth, %	(35.2)	52.8	(14.6)	14.9
Margin, %	8.0	11.3	9.6	10.3
Interest paid	-276	-156	-222	-221
Other Non-Operating Income	352	172	266	320
Pre-tax profit	**2,469**	**3,671**	**3,166**	**3,688**
Tax provided	-115	-826	-823	-996
Profit after tax	**2,354**	**2,846**	**2,343**	**2,692**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,354**	**2,846**	**2,343**	**2,692**
Growth, %	(1.6)	20.9	(17.7)	14.9
Net Profit (adjusted)	**2,354**	**2,846**	**2,343**	**2,692**
Wtd avg shares (m)	187	188	192	192

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**489**	**490**	**487**	**521**
Growth, %	10.0	0.3	(0.7)	7.1
Re / US$ (rate)	61.1	65.8	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	3,638	3,953	5,529	6,650
Marketable securities at cost	0	0	0	0
Debtors	6,979	6,861	7,608	8,194
Inventory	0	0	0	0
Other current assets	1,942	1,963	1,925	2,072
Total current assets	12,559	12,777	15,062	16,917
Investments	590	0	500	1,000
Net fixed assets	7,416	6,875	7,245	7,646
Non-current assets	2,173	2,300	2,379	2,379
Total assets	**22,738**	**21,952**	**25,186**	**27,941**
Total current liabilities	5,319	5,974	5,685	5,984
Non-current liabilities	4,457	2,171	3,422	3,422
Total liabilities	9,776	8,145	9,107	9,406
Paid-up capital	386	386	386	386
Reserves & surplus	12,576	13,422	15,693	18,149
Minorities	0	0	0	0
Shareholders' equity	12,962	13,808	16,079	18,535
Total equity & liabilities	**22,738**	**21,952**	**25,186**	**27,941**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	2,469	3,671	3,166	3,688
Depreciation	851	691	757	799
Chg in working capital	-628	532	-1,152	-435
Total tax paid	75	-733	-730	-996
Other operating activities	0	0	0	0
Cash flow from operating activities	**2,768**	**4,162**	**2,041**	**3,056**
Capital expenditure	-113	-150	-1,127	-1,200
Chg in investments	1,151	590	-500	-500
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**1,038**	**440**	**-1,627**	**-1,700**
Free cash flow	3,806	4,602	414	1,356
Equity raised/(repaid)	-7	-7	-1	0
Debt raised/(repaid)	67	-2,286	1,234	0
Dividend (incl. tax)	-206	-480	-480	-480
Other financing activities	-1,930	-1,513	409	244
Cash flow from financing activities	**-2,076**	**-4,286**	**1,162**	**-236**
Net chg in cash	1,730	316	1,576	1,120

Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	11.8	14.2	11.7	13.4
Growth, %	(1.7)	20.4	(19.3)	14.9
Book NAV/share (INR)	69.3	73.5	83.9	96.8
CFPS (INR)	18.2	21.9	9.7	14.3
DPS (INR)	0.9	2.2	2.2	2.2
Return ratios				
Return on assets (%)	11.5	13.2	10.5	10.7
Return on equity (%)	18.2	20.6	14.6	14.5
Return on capital employed (%)	14.6	17.6	14.0	13.6
Turnover ratios				
Asset turnover (x)	2.5	3.0	3.0	2.9
Sales/Total assets (x)	1.4	1.4	1.4	1.3
Sales/Net FA (x)	3.8	4.5	4.6	4.7
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	85.2	77.6	85.1	85.6
Liquidity ratios				
Current ratio (x)	2.4	2.1	2.6	2.8
Quick ratio (x)	2.4	2.1	2.6	2.8
Interest cover (x)	8.7	23.4	14.0	16.2
Dividend cover (x)	13.3	6.9	5.7	6.5
Total debt/Equity (%)	34.4	15.7	21.2	18.4
Net debt/Equity (%)	6.3	(12.9)	(13.2)	(17.5)
Valuation				
PER (x)	10.0	8.3	10.3	9.0
PEG (x) - y-o-y growth	(5.9)	0.4	(0.5)	0.6
Price/Book (x)	1.8	1.7	1.5	1.3
Yield (%)	0.8	1.7	1.7	1.7
EV/Net sales (x)	0.9	0.7	0.7	0.6
EV/EBITDA (x)	8.0	5.4	6.0	5.0
EV/EBIT (x)	10.8	6.4	7.4	6.1

INSTITUTIONAL EQUITY RESEARCH

Persistent (PSYS IN)

Buying growth with margins; expensive valuations

INDIA | IT SERVICES | Company Update

18 August 2016

SELL (Maintain)

CMP RS 679

TARGET RS 610 (-10%)

COMPANY DATA

O/S SHARES (MN) :	80
MARKET CAP (RSBN) :	54
MARKET CAP (USDBN) :	0.8
52 - WK HI/LO (RS) :	797 / 563
LIQUIDITY 3M (USDMN) :	0.7
PAR VALUE (RS) :	10

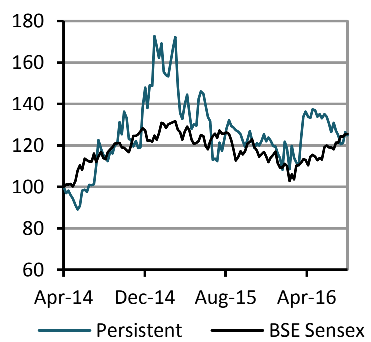
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	38.1	38.5	38.5
FII / NRI :	22.6	22.1	23.0
FI / MF :	12.1	12.0	11.3
NON PRO :	14.4	9.9	9.6
PUBLIC & OTHERS :	12.9	12.9	12.6

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-1.0	-7.7	-3.6
REL TO BSE	-4.9	-19.4	-3.4

PRICE VS. SENSEX



KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	23,123	28,830	31,180
EBIDTA	4,171	4,601	5,143
Net Profit	2,974	3,128	3,469
EPS, Rs	37.2	39.1	43.4
PER, x	18.3	17.4	15.7
EV/EBIDTA, x	12.7	11.6	10.3
P/BV, x	3.3	2.9	2.5
ROE, %	17.9	16.5	16.2

Source: PhillipCapital India Research Est.

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Buying out growth with margins

PSYS has been chasing growth at the expense of margins – its EBITDA margins have declined by a whopping 1,200bps over the last nine quarters, to support revenue CQGR of 4.7% (2.2% organic, excluding Aepona and IBM deal). Even the recent growth from the IBM IoT deal has come at the expense of over 250bps. We do not like the quality of the growth (which is not significantly ahead of industry anyway) and believe that it will not be easy for the company to recover margins, which have plummeted to 15% in 1QFY17 (from 27% in 4QFY14).

Long road to enter the enterprise segment

PSYS has been an offshore product development (OSPD) company. But having reached a plateau in terms of the growth potential of the OSPD segment, the company is now trying to enter the enterprise segment through digital transformational (EDT) deals where it will provide customised digital solutions to enterprise customers.

While this might be the correct strategy for the future, we believe it will be an arduous task that would require significant investment. For their EDT needs, most enterprises today either choose an existing vendor or a large global consultant (largely because the enterprises remain unaware of the potential and the risks of implementing a digital transformation). We believe it will be extremely difficult for PSYS to penetrate this domain. The benefits of this strategy will also be highly back-ended, while it will require upfront investments.

Slowdown in organic IP business, over the last six quarters, expected to continue

PSYS's IP-led revenues saw negative CQGR of 2% over six quarters (Q1FY15 – Q2FY16), before the numbers were boosted by acquisitions (Aepona and IBM deal). The fact is, the company hasn't been able to breach the US$ 15mn quarterly run-rate, organically, that it achieved in Q1FY15. While the IP revenues now constitute 28% of its revenues – meeting the management guidance – organic growth in the business still eludes it. We believe the company would need to invest more, to achieve significant organic growth in this business.

Strong 1QFY17 performance – driven by top client (IBM)

Persistent reported strong revenue growth of 4.3% qoq – driven by strong growth in IBM (+19.1% qoq). EBITDA margins fell to 15.1% (-80bps qoq) – a decline of 1200bps over last nine quarters. While its top client (IBM) led growth (+19.1% qoq), this has increased revenue concentration (29% comes from IBM). With additional headwinds of salary hike in the next quarter, margins are likely to remain under pressure.

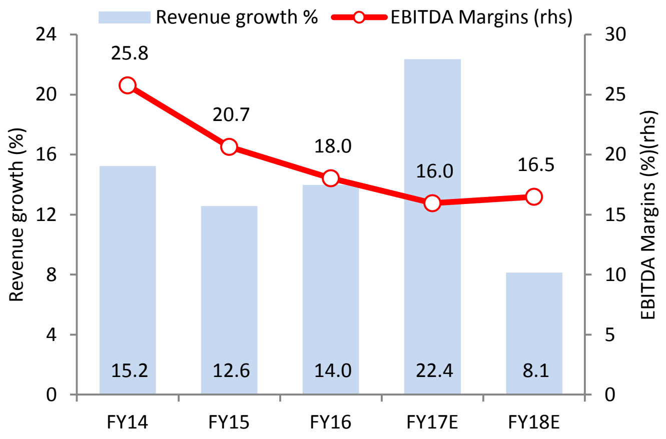
Expensive valuations; maintain SELL

At current levels, the stock is trading at 16x our FY18 earnings estimates (we are 2%/10% below consensus estimates for FY17/18) – a significant premium to its historical average, to the IT-midcap average, and to all the large cap companies (excluding Infosys and TCS) – which have a much more diversified profile, higher margins, and superior return ratios.

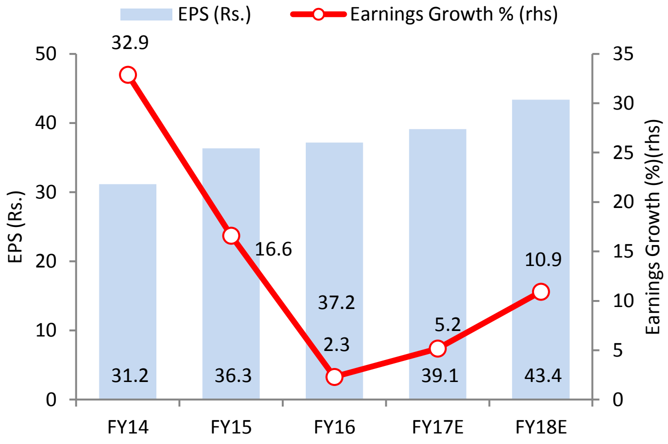
We see no reason for the stock to trade at those levels, especially with the profound margin concerns. While the IBM deal has addressed the medium-term growth concerns, margin contraction will keep earnings growth and ROE on a declining trend. Also with IBM now forming 29% of the total revenues, we find additional risk of high client concentration (especially when IBM itself is struggling with growth). We expect significant cut in consensus estimates over the next few quarters – leading to further pressure on the stock.

We continue to value the company at 14x FY18 P/E (unchanged). Our price target of Rs 610 (unchanged) offers 10% downside from current levels. Maintain Sell.

USD revenue growth (%) and EBITDA margins (%)

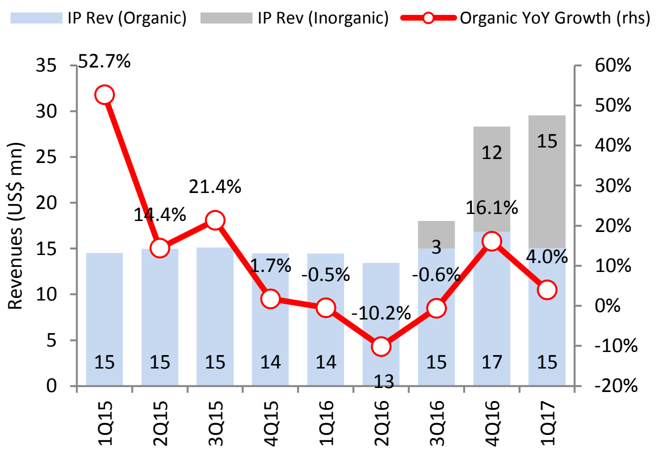


EPS (Rs) and earnings growth (%)

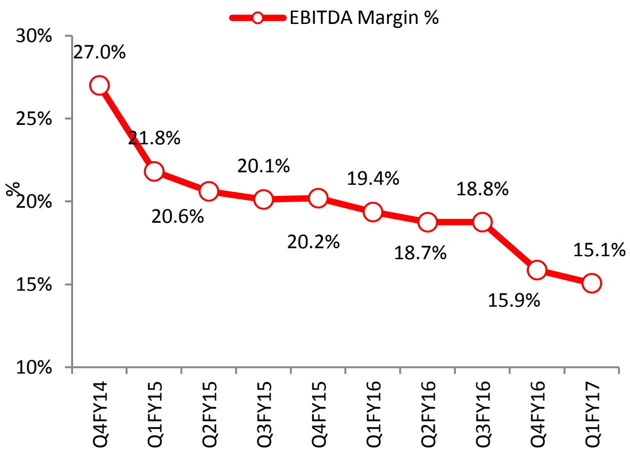


Source: Company, PhillipCapital India Research

Organic IP led revenues have remained largely flat

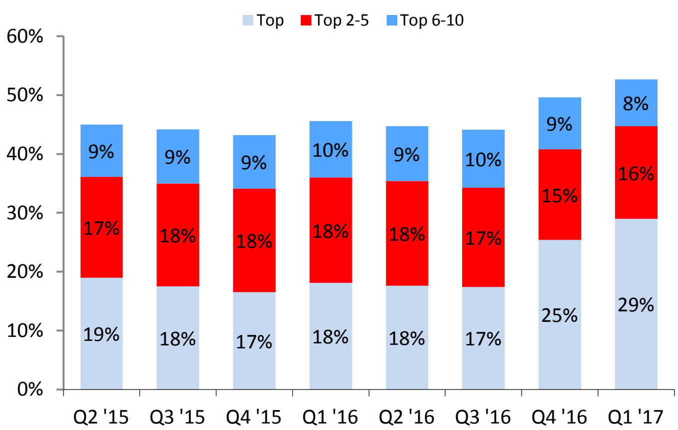


Margins have followed a free fall profile

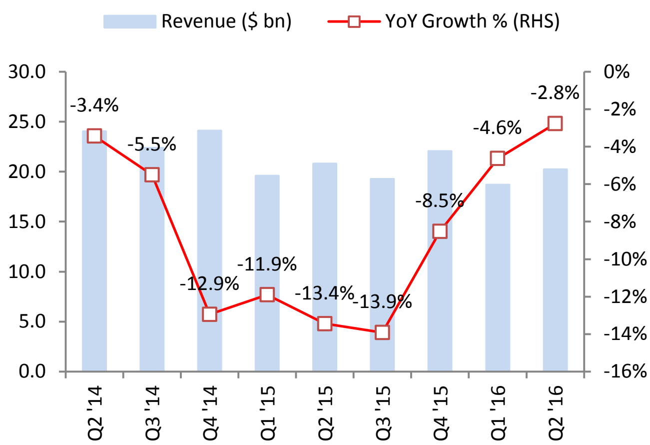


Source: Company, PhillipCapital India Research

Increasing Top client revenue concentration



Top client itself facing growth concerns – IBM Revenue trend



Source: Company, PhillipCapital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Net sales	**18,913**	**23,123**	**28,830**	**31,180**
Growth, %	13.3	22.3	24.7	8.2
Employee expenses	-11,316	-14,305	-18,876	-20,516
Other Operating expenses	-3,690	-4,648	-5,352	-5,520
EBITDA (Core)	**3,906**	**4,171**	**4,601**	**5,143**
Growth, %	(9.2)	6.8	10.3	11.8
Margin, %	20.7	18.0	16.0	16.5
Depreciation	-939	-965	-1,447	-1,556
EBIT	**2,967**	**3,206**	**3,154**	**3,587**
Growth, %	(9.4)	8.0	(1.6)	13.7
Margin, %	15.7	13.9	10.9	11.5
Interest paid	0	0	0	0
Other Non-Operating Income	463	604	665	688
Pre-tax profit	**3,900**	**3,956**	**4,140**	**4,595**
Tax provided	-993	-983	-1,012	-1,126
Profit after tax	**2,907**	**2,974**	**3,128**	**3,469**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,907**	**2,974**	**3,128**	**3,469**
Growth, %	16.6	2.3	5.2	10.9
Net Profit (adjusted)	**2,907**	**2,974**	**3,128**	**3,469**
Wtd avg shares (m)	80	80	80	80

US$ Revenues

	FY15	FY16	FY17E	FY18E
US$ Revenue ($ mn)	**309**	**352**	**430**	**465**
Growth, %	12.6	14.0	22.4	8.1
Re / US$ (rate)	61.3	65.8	67.0	67.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Cash & bank	1,416	1,439	1,016	1,427
Marketable securities at cost	0	0	0	0
Debtors	3,586	4,275	4,533	5,097
Inventory	0	0	0	0
Other current assets	1,049	3,205	3,072	3,072
Total current assets	6,581	10,049	9,857	11,090
Investments	6,735	6,384	6,876	7,876
Net fixed assets	4,093	4,637	6,001	6,444
Non-current assets	24	0	0	0
Total assets	**17,749**	**21,247**	**22,986**	**25,663**
Total current liabilities	3,669	4,594	4,041	4,184
Non-current liabilities	25	27	0	0
Total liabilities	3,693	4,621	4,041	4,184
Paid-up capital	800	800	800	800
Reserves & surplus	13,255	15,826	18,145	20,679
Minorities	0	0	0	0
Shareholders' equity	14,055	16,626	18,945	21,479
Total equity & liabilities	**17,749**	**21,247**	**22,986**	**25,663**

Source: Company, PhillipCapital India Research Estimates

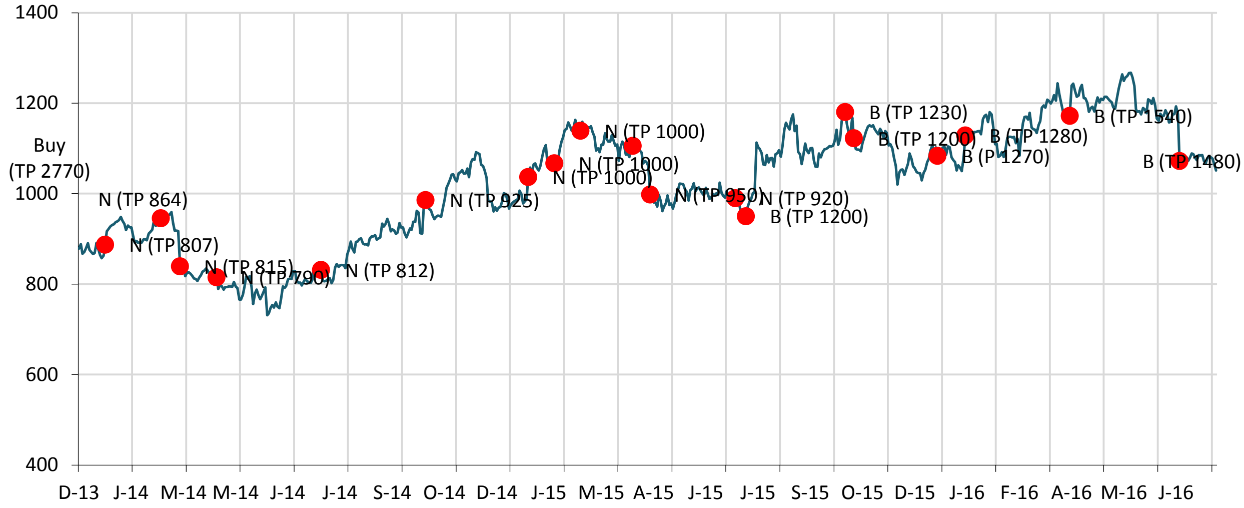
Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17E	FY18E
Pre-tax profit	3,900	3,956	4,140	4,595
Depreciation	939	965	1,447	1,556
Chg in working capital	-205	-2,494	-810	-678
Total tax paid	-1,049	-845	-1,088	-1,126
Other operating activities	0	0	0	0
Cash flow from operating activities	**3,585**	**1,583**	**3,689**	**4,347**
Capital expenditure	-669	-1,509	-2,811	-2,000
Chg in investments	-1,381	352	-492	-1,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-2,051**	**-1,157**	**-3,303**	**-3,000**
Free cash flow	1,534	425	386	1,347
Equity raised/(repaid)	400	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-1,404	-749	-843	-936
Other financing activities	-71	346	34	0
Cash flow from financing activities	**-1,075**	**-403**	**-808**	**-936**
Net chg in cash	460	23	-423	411

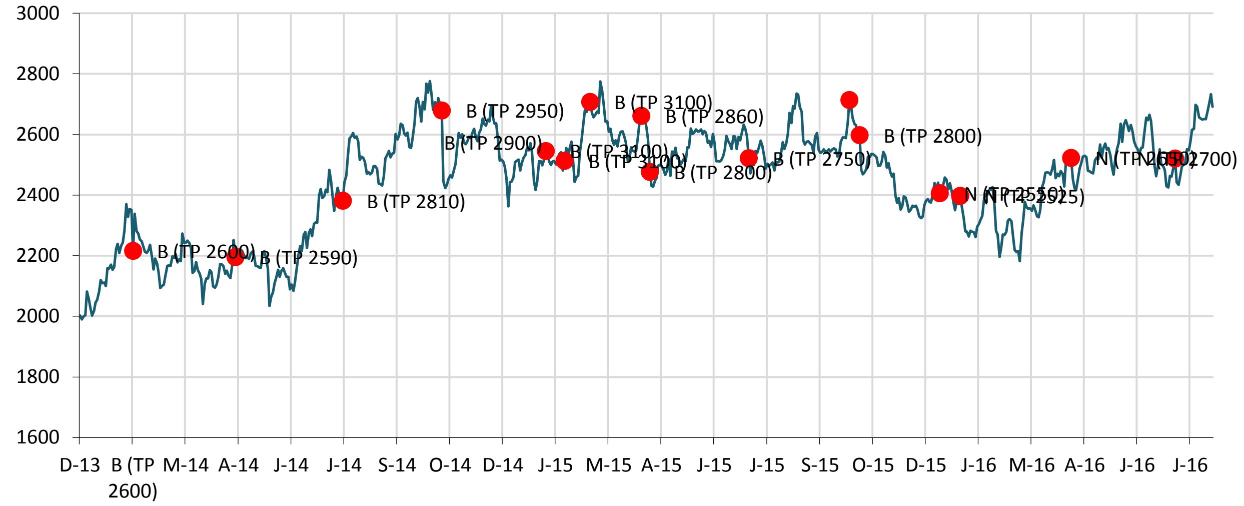
Valuation Ratios

	FY15	FY16	FY17E	FY18E
Per Share data				
EPS (INR)	36.3	37.2	39.1	43.4
Growth, %	16.6	2.3	5.2	10.9
Book NAV/share (INR)	175.7	207.8	236.8	268.5
CFPS (INR)	39.0	11.9	37.8	45.7
DPS (INR)	15.0	8.0	9.0	10.0
Return ratios				
Return on assets (%)	17.5	15.3	14.1	14.3
Return on equity (%)	20.7	17.9	16.5	16.2
Return on capital employed (%)	19.5	17.5	16.4	16.3
Turnover ratios				
Asset turnover (x)	2.6	2.7	2.6	2.5
Sales/Total assets (x)	1.1	1.2	1.3	1.3
Sales/Net FA (x)	4.5	5.3	5.4	5.0
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	69.2	67.5	57.4	59.7
Liquidity ratios				
Current ratio (x)	3.7	3.1	3.4	3.6
Quick ratio (x)	3.7	3.1	3.4	3.6
Dividend cover (x)	2.4	4.6	4.3	4.3
Net debt/Equity (%)	(10.1)	(8.7)	(5.4)	(6.6)
Valuation				
PER (x)	18.7	18.3	17.4	15.7
PEG (x) - y-o-y growth	1.1	7.9	3.4	1.4
Price/Book (x)	3.9	3.3	2.9	2.5
Yield (%)	2.2	1.2	1.3	1.5
EV/Net sales (x)	2.8	2.3	1.8	1.7
EV/EBITDA (x)	13.5	12.7	11.6	10.3
EV/EBIT (x)	17.8	16.5	16.9	14.7

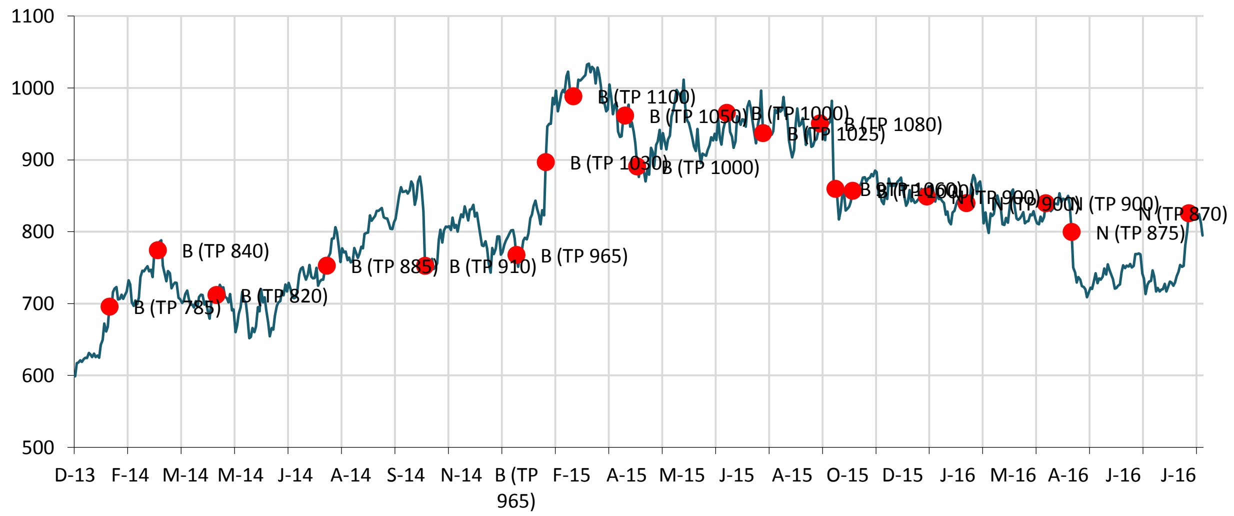
Stock Price, Price Target and Rating History (Infosys)



Stock Price, Price Target and Rating History (TCS)



Stock Price, Price Target and Rating History (HCL Technologies)



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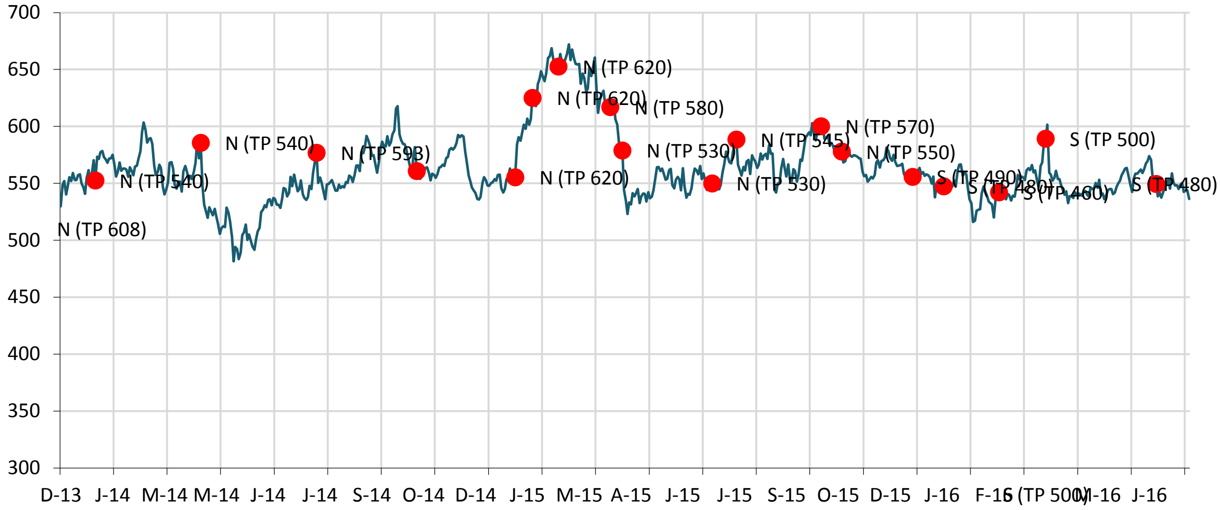
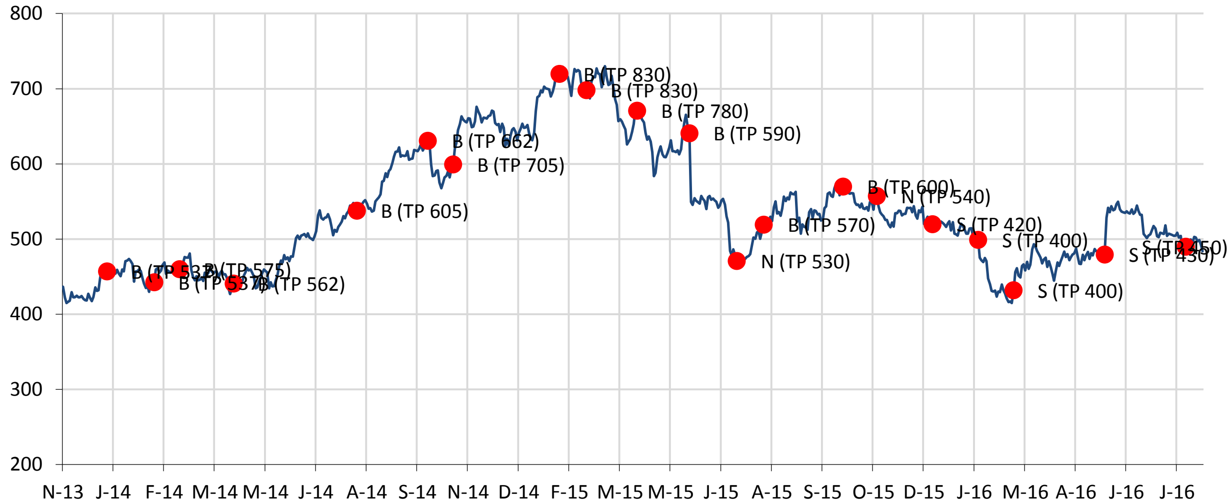
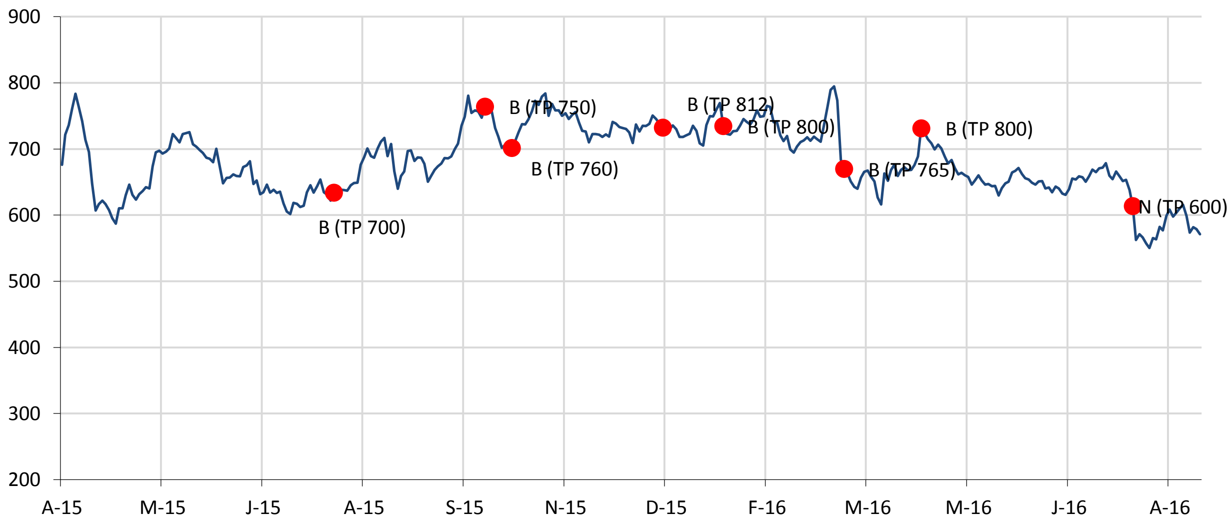


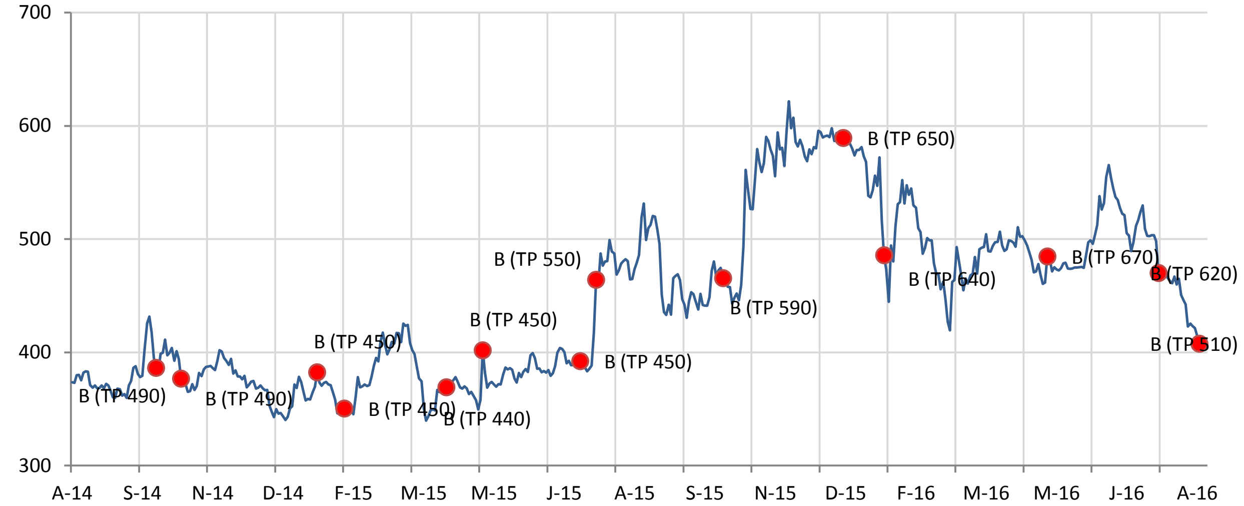
Stock Price, Price Target and Rating History (Tech Mahindra)



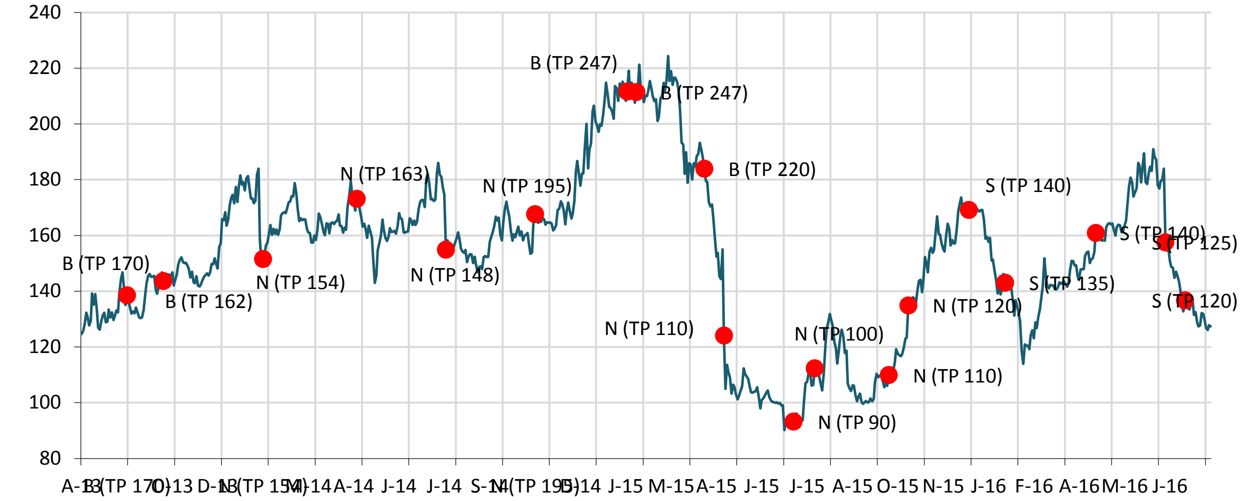
Stock Price, Price Target and Rating History (MindTree)



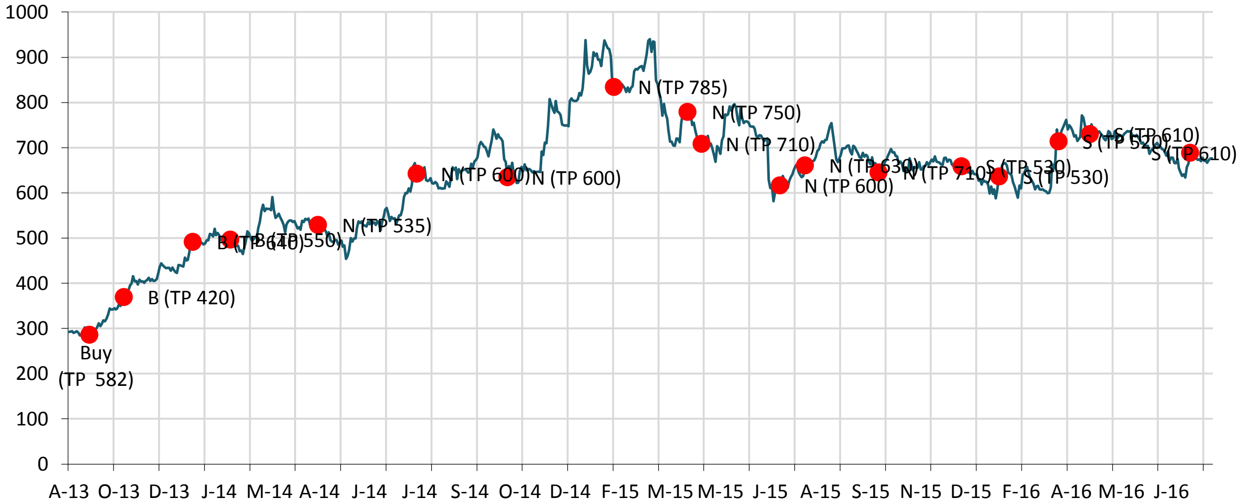
Stock Price, Price Target and Rating History (NIIT Tech)



Stock Price, Price Target and Rating History (KPIT)



Stock Price, Price Target and Rating History (Persistent)



Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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